CROATIAN NATIONAL BANK

Information on economic trends

March 2016

1 Summary

Although the end of the year showed a slight weakening in current economic activity, which was related to the higher level of GDP from the base period, i. e. the third quarter, due to the successful tourist season, at the level of the whole of 2015 economic developments were generally favourable, so GDP growth reached 1.6%. In addition to the continued high rates of growth of exports of goods and services, domestic demand also started recovering, which was followed by a slight rise in the number of employed persons and wages. The current account surplus registered at the end of 2015 also continued widening. In the public finance area, the fiscal deficit was considerably reduced owing to the favourable dynamics of revenues and stagnation in expenditures. The annual rate of consumer price inflation was negative in 2015, which continued throughout January 2016, mainly as a result of the fall in the prices of crude oil. In addition to maintaining the stability of the kuna exchange rate against the euro, the orientation to an expansive monetary policy was underlined at the beginning of this year through the introduction of long-term structural repo operations that should set the conditions for more favourable lending in domestic currency.

The end of 2015 was marked by modest economic growth worldwide, by a decline in crude oil prices and gradual tightening of American monetary policy.

Economic activity in the US continued growing in the fourth quarter of 2015, if at a slower pace than in the previous quarter, while GDP growth in developing and emerging market countries continued slowing down. The euro area and Croatia's main trading partners grew at a modest pace. Crude oil prices, as well as the prices of raw materials excluding energy, went down noticeably in the last quarter of 2015 while the exchange rate of the euro lost ground against the majority of the world's most important currencies.

After six years of decline in the Croatian economy in 2015 real growth of 1.6% was achieved.

Real GDP growth in 2015 totalled 1.6%, which was much better than initially expected at the beginning of the year. The steepest growth was seen in the third quarter, primarily under the influence of a successful tourist season. Although economic activity weakened slightly at the end of the year, favourable trends continued in most activities so the weakening of the current activity may be linked with the exceptionally good results of the tourist season in the previous quarter. Industrial production and retail trade grew further, while construction contracted again. On the expenditure side, personal consumption increased again at the end of the year under the influence of recovery in the labour market and rising consumer optimism, while investments were most probably under the greatest influence of continued stronger private investments. Foreign demand for domestic goods and services continued to rise at a strong pace.

Favourable developments in the labour market intensified again at the turn of the year.

At the end of 2015 and at the beginning of 2016 favourable developments in the labour market continued. The growth of employment intensified vis-à-vis the third quarter, while unemployment went down. The growth of real gross wages continued due to further decline of consumer prices.

The negative annual consumer price inflation rate in January 2016 was primarily a result of the decline in the prices of energy.

In January 2016 the annual consumer price inflation rate stood at –0.8%, equal to the average inflation rate in the last quarter of 2015. Energy prices contributed –0.6 percentage points to this rate. In addition, the price of unprocessed food products went down on an annual basis. The annual growth rates of other main inflation components were lower (up to 0.5%), amid the spillover of the decline in the prices of crude oil and other raw materials on consumer prices, low inflation in other countries of the European Union and stagnation of domestic unit labour cost.

The current account balance improved significantly.

The current account deficit narrowed in the last quarter of 2015 from the same period last year, owing to the continued improvements in the primary and secondary income account balances. In contrast, developments in foreign trade had an unfavourable effect on the current account balance due to the higher growth in imports than in exports in absolute terms. In accordance with favourable developments throughout the year, the annual current account surplus perceptibly improved in 2015, to an estimated 5.2% of GDP from 0.9% of GDP in 2014.

Despite relatively favourable financing conditions households continued to deleverage, while the overall debt of enterprises increased.

At the beginning of 2016, market interest rates on corporate loans in the domestic market held at last year's average, while interest on household loans was substantially influenced by the conversion of loans indexed to the Swiss franc into loans in euros, because statistically converted loans are registered as new business. In 2015, banks' domestic household and corporate placements continued decreasing, with corporates making up for this fall by obtaining finance from foreign sources. Domestic government borrowing costs decreased additionally at the beginning of 2016, while the price of foreign borrowing remained at relatively high levels.

Foreign net capital outflow continued at the end of 2015.

The fourth quarter of 2015 saw a net capital outflow in the financial account of the balance of payments (excluding the transactions of the central bank), primarily due to the decline in external indebtedness of credit institutions and net liabilities of other domestic sectors to affiliated enterprises, which was followed by somewhat stronger growth of corporate debt to other creditors. The same factors marked 2015, resulting in a year-on-year net capital outflow. The net and gross external debt stock went down at the end of 2015 to 52.0% or 103.7% of GDP.

By introducing structural repo operations at the beginning of 2016 the CNB additionally strengthened the expansive orientation of its monetary policy.

In addition to continuing with its regular reverse repo operations, the CNB set the conditions for more vigorous and more favourable lending of the banking system in domestic currency through its structural repo operations by means of providing access to long-term sources of kuna liquidity. This additionally strengthened the expansive orientation of the monetary policy, reflected in the record surplus of kuna liquidity observed in the first two months of 2016. At the same time, interest rates in the money market were held at favourable levels and domestic borrowing costs of the government went down. By pursuing an expansive monetary policy, the CNB strives to stimulate banks' lending activity and the recovery of the Croatian economy, ensuring the stability of the exchange rate of the kuna against the euro at the same time.

Available data indicate a strong fiscal consolidation in 2015.

The consolidated general government deficit, according to the ESA 2010 methodology, went down by HRK 9bn in the first three quarters of 2015, from the HRK 13.5bn registered in the same period 2014. The sharp fall of the deficit reflected favourable developments on the revenue side of the budget paired with the parallel stagnation of the general government expenditures. At the level of the whole 2015 the deficit could be much narrower than planned by the MoF (in accordance with ESA 2010 methodology) and assessed by the CNB in December last year (–5.0% of GDP). General government debt totalled HRK 285.3bn at the end of November 2015, which was HRK 5.7bn more than at the end of 2014, while debt to GDP ratio (85.4% of GDP) remained almost unchanged.

Macroeconomic indicators

The table below shows the major macroeconomic measures for Croatia.

Table 1.1 Summary table of macroeconomic measures

	2008	2009	2010	2011	2012	2013	2014	2015[a]
National accounts (real rate of change, in %)								
GDP	2.1	–7.4	–1.7	–0.3	–2.2	–1.1	–0.4	1.6
Personal consumption	1.2	–7.5	–1.5	0.3	–3.0	–1.9	–0.7	1.2
Government consumption	–0.7	2.1	–1.6	–0.3	–1.0	0.3	–1.9	0.6
Gross fixed capital formation	9.2	–14.4	–15.2	–2.7	–3.3	1.4	–3.6	1.6
Exports of goods and services	0.8	–14.1	6.2	2.2	–0.1	3.1	7.3	9.2
Imports of goods and services	4.0	–20.4	–2.5	2.5	–3.0	3.1	4.3	8.6
Labour market								
Number of employed persons (average rate of change, in %)	2.3	–2.1	–4.2	–1.1	–1.2	–1.5	–2.0	0.7
Prices								
Consumer price index (average rate of change, in %)	6.1	2.4	1.1	2.3	3.4	2.2	–0.2	–0.5
Consumer price index (rate of change, end of period, in %)	2.9	1.9	1.8	2.1	4.7	0.3	–0.5	–0.6
External sector								
Current account balance (as % of GDP)	–8.8	–5.1	–1.1	–0.7	0.0	1.0	0.9	5.2
Goods	–22.4	–16.5	–13.2	–14.3	–14.3	–15.1	–14.8	–15.0
Services	14.3	12.8	12.8	13.8	14.8	15.6	16.8	17.9
Primary income	–3.0	–3.6	–3.1	–2.9	–3.3	–2.0	–3.3	–0.7
Secondary income	2.2	2.2	2.4	2.7	2.8	2.6	2.1	3.0
Current and capital account balance (as % of GDP)	–8.7	–5.0	–1.0	–0.6	0.1	1.2	1.1	5.6
Gross external debt (as % of GDP)	84.3	101.1	104.2	103.7	103.0	105.6	108.4	103.7
Monetary developments (rate of change, in %)								
Total liquid assets – M4	4.1	–1.0	1.9	5.6	3.6	4.0	3.2	5.1
Total liquid assets – M4[b]	3.8	–0.8	0.7	4.6	3.9	3.6	2.4	5.0
Credit institution placements to the private sector	10.7	–0.6	4.7	4.8	–5.9	–0.5	–1.6	–2.9
Credit institution placements to the private sector[b,c]	8.7	–0.3	2.3	3.5	–1.2	1.0	–1.5	–2.2

[a] Exchange rate effects excluded.
[b] Rates of change are calculated on the basis of data on transactions (see Annex 1 Introduction of data on transactions in monetary developments analysis in Bulletin 221.)
Sources: CBS, CPIA, CNB and CNB projections.

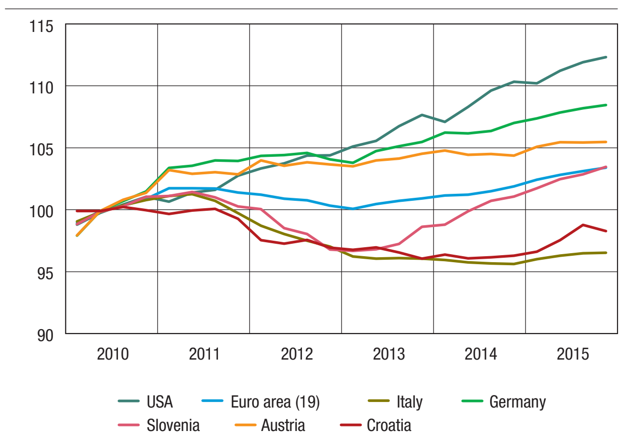
2 Global developments

Global developments in the last quarter of 2015 were marked by continued global economic growth, a decline in the prices of crude oil and the beginning of the tightening of the US monetary policy. The economic growth of developed economies continued at much the same pace as over the previous quarter, while in emerging market countries it continued slowing down. Economic activity in the US slowed down due to the slackening of the growth of personal consumption and of the decline in investments and exports. The restructuring of the Chinese economy continued, marked by a visible trend of a slowdown in the growth of investments and an acceleration in the growth of personal consumption, as reflected by the strengthening of the service sector. Net exporters of oil and other raw materials, such as Russia and Latin American countries, continued to be affected by recession, predominantly because of the fall in the prices of their main export products. Foreign trade in goods and services, after the poor performance in the first half of 2015, recovered in the second half of the year.

The slight GDP growth in the euro area continued in the last quarter of 2015 (0.3% from the previous quarter). The major contributors to growth were investments, while recent indicators in construction and in capital goods production point towards an increase in investments in construction projects, machinery and equipment, although the level of investments remained much below the pre-crisis level. Personal consumption growth slowed down, while a slight increase in the growth of exports supported the growth of developed economies and a weaker euro. Estonia and Slovakia boasted the fastest growth of the fourth quarter, while Germany and France registered modest growth rates. Latvia was the only country whose economy recorded recessionary trends. In the future we expect recovery in the euro area to continue supported by the decline in the prices of oil, which increases disposable income of households and enhances corporate performance, as well as by the expansive policy of the ECB. On the other hand, growth will be limited by slower growth of developing and emerging market countries and the risks associated with financial market volatility.

The economic activity of Croatia's main trading partners in the fourth quarter of the past year was mostly modest. Germany thus boasted 0.3% growth from the previous quarter, primarily due to the growth of investments, while in Italy economic activity levelled off. In Austria, economic growth picked up (0.2%) due to growth in government and personal consumption. However, in the observed period its exports saw a sharp fall. In Slovenia, on the other hand, favourable economic developments continued primarily due to the strengthening of exports. As for Croatia's trading partners outside the EU, Serbia's economic activity in the last quarter remained no higher than the level reached in the previous three months, while Bosnia and Herzegovina recorded growth.

Figure 2.1 Gross domestic product of selected economies
seasonally adjusted data, constant prices, 2010 = 100



Sources: Eurostat, BEA and CNB.

Interest rate trends

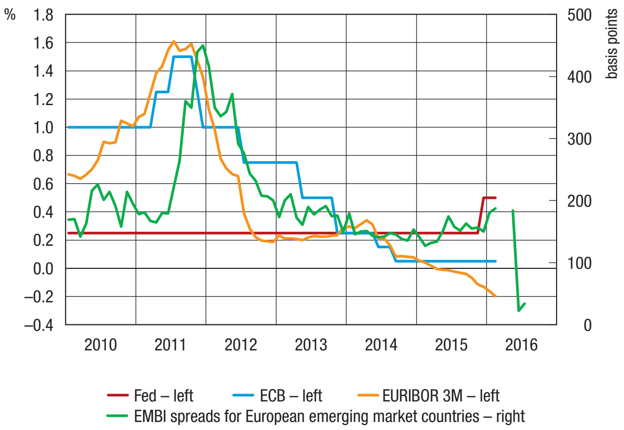
Key interest rates in the US and the euro started to diverge when the Fed increased the target range for its benchmark interest rate to the level of 0.25 to 0.5 percentage points. This first increase of the Fed's key interest rate in the past nine years signalled the beginning of the Fed's gradual tightening of its monetary policy as a consequence of the belief that the US economy had largely recovered from the financial crisis. In contrast, the ECB maintained its zero key interest rate (decreasing the interest rate on bank deposits to –0.3% in December 2015) and continued with its bond purchase programme in the secondary market in the monthly amount of a minimum of EUR 60bn. The recent statements by the US monetary policy makers indicate that the continuation of unfavourable developments in the developing and emerging market countries could slow down the planned further raising of the benchmark rate, while the ECB considers the possibility of introducing additional expansive measures. Financing conditions for European emerging market economies deteriorated slightly early in 2016 from the end of the previous year, probably due to the increase in financial market instability and capital outflows from emerging market countries to developed countries.

Exchange rates and price movements

The euro lost strength against the majority of the world's most important currencies in the last quarter of 2015. The strengthening of the US dollar against the euro in the fourth quarter 2015 was to the greatest extent a result of the Fed's announcement of the decision to raise its key overnight interest rate that was published in December. The ECB's decision worked in the opposite direction, given that the widening of the programme of stimulus measures was weaker than expected. The US dollar thus appreciated against the euro from EUR/USD 1.12 at the end of September to EUR/USD 1.09 at the end of November 2015. The sharp fall in crude oil prices on the global market in the middle of January and signs of possible slowdown in the US economic growth contributed to a slight weakening of the exchange rate of the US dollar against the euro, which in the second half of February 2016 totalled EUR/USD 1.10. The exchange rate of the Swiss franc against the euro appreciated in the last quarter of 2015 by 1.1% as against the end of September, totalling EUR/CHF 1.08 at the end of December. However, by mid-February 2016 the exchange rate of the Swiss franc against the euro depreciated to the level of EUR/CHF 1.10.

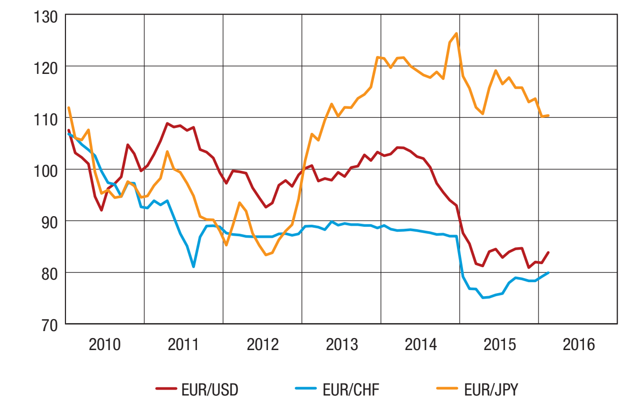
The price of crude oil continued to decline in the last quarter of 2015 after its temporary mild recovery in the first half of the year. The price of Brent crude oil went down by over 13% in the fourth quarter of the year relative to the average of the previous quarter. The strong growth in the prices of crude oil continued

Figure 2.2 Benchmark interest rates and the average yield spread on bonds of European emerging market countries
end of period



Note: Data up to 22 February 2016.
Source: Bloomberg, 22 February 2016.

Figure 2.3 Exchange rates of individual currencies against the euro
2010 = 100

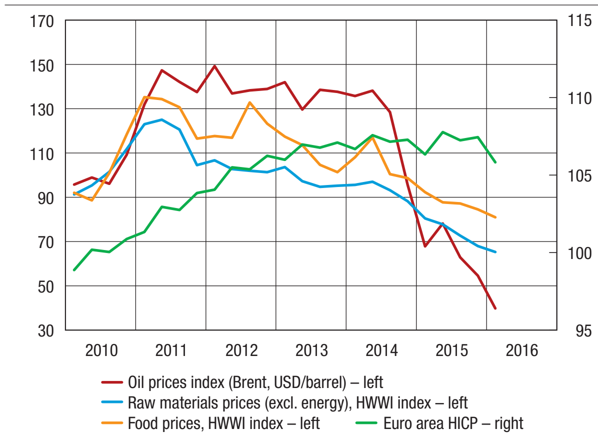


Note: Data for the first quarter of 2016 are incomplete and cover only the period up to 22 February 2016. A growth in the index denotes a depreciation of a currency against the euro.
Source: Eurostat.

throughout January 2016, the price of Brent crude oil dropping to 26 USD per barrel, an amount last seen in September 2003. Several factors contributed to such developments: the decision of OPEC leaders at their last meeting in December 2015 to continue with the strategy of maintaining their market share, the noticeable surplus of global supply over demand and the growth of exports from Iran after international sanctions were lifted, which happened sooner than expected. In addition, the slowdown in US production from the use of new technology was weaker than expected and additional downward pressure on crude oil prices came from a mild winter and growing concern over the economic growth in emerging market countries, primarily China, Brazil and Russia. The worsening of the political situation in the Middle East and speculations of possible cuts in the production quotas of OPEC member countries contributed to a slight recovery of crude oil prices in mid-February to 34 USD.

The decline in the raw material prices measured by the HWWI index (excluding energy, in US dollars) continued in the last quarter of 2015. This was predominantly a result of the decline in prices of iron ore due to the growth in global supply, although concern over the economic slowdown in China, one of the largest global consumers of the commodity, grew. The prices of food raw materials (excluding beverages and sugar) also went down, largely due to good weather conditions in most producing regions (despite the effects of El Niño) and a record crop yield for some crops, primarily wheat. The decline in the price of raw materials continued in January 2016, primarily due to further

Figure 2.4 Prices
2010 = 100



Note: Data for the first quarter of 2016 refer to January and the index of oil prices refers to January and February (up to 22 February 2016).
Sources: Eurostat, Bloomberg and HWWI.

reductions in the price of food and non-ferrous metals, while the price of iron ore went slightly up. The prices of raw materials, excluding energy products, were down 21% in January from the same period of the previous year.

3 Aggregate demand and supply

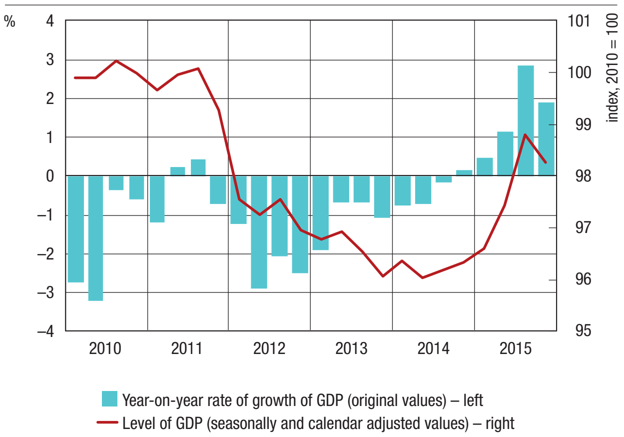
The level of domestic economic activity went down in the fourth quarter of 2015. Recovery in personal and government consumption continued together with the strong growth of the exports of goods and services from the previous quarter but this resulted in the strong growth of imports. Real GDP was thus reduced by 0.5% from the third quarter, while on an annual basis growth reached 1.9%. On the supply side, gross value added went up by 1.6% annually, the contribution of industry being only slightly lower than the contribution of service activities. At the level of 2015 as a whole, GDP growth reached 1.6%, its first positive growth rate since 2008.

Aggregate demand

The real exports of goods and services increased sharply again in the third quarter of 2015, contributing the most to the overall economic growth on an annual basis as they had in the third quarter. The real exports of goods went up 14.4% annually, while on quarterly level they increased substantially after a mild decline in the third quarter. The nominal data on trade in goods in October and November showed that the growth in the exports of goods on a quarterly basis is a reflection of favourable developments in intermediate goods and consumer goods. As for the exports of services, their annual growth rate was 8.5%, while data from the balance sheet indicate that this is the greatest result of the exports in other services.

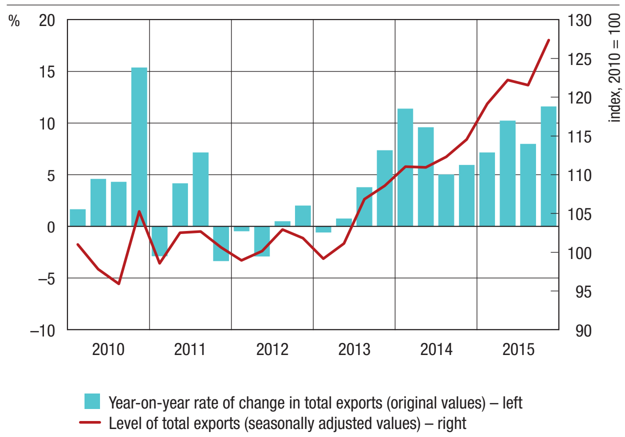
Personal consumption went up by 2.4% in the last quarter of the year on an annual basis so after exports it contributed the most to the growth of total economic activity. Broken down by quarters, the recovery of personal consumption that had started at the beginning of 2015 picked up momentum at the end of the year (0.9% from the previous quarter). Such developments reflect the growth in the real disposable income due to the continued recovery in the labour market but are also due to the decline in the general level of prices. Namely, in the period from

Figure 3.1 Gross domestic product
real values



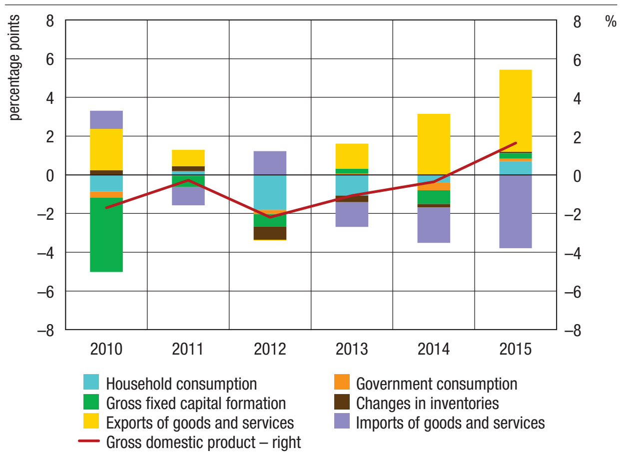
Source: CBS data seasonally adjusted by the CNB.

Figure 3.3 Exports of goods and services
real values



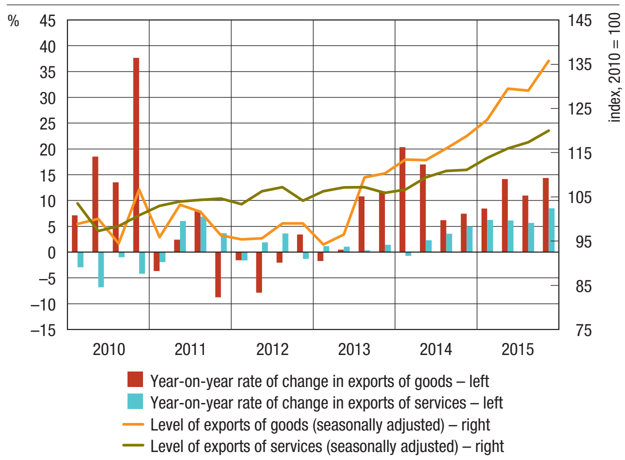
Source: CBS data seasonally adjusted by the CNB.

Figure 3.2 Change in GDP
contribution to the year-on-year rate of change by components



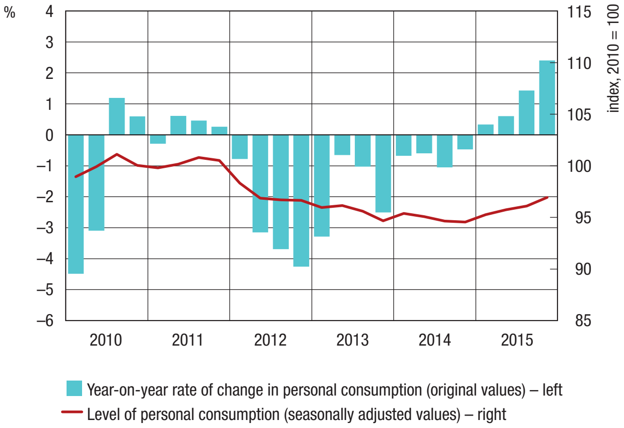
Source: CBS.

Figure 3.4 Real exports of goods and services



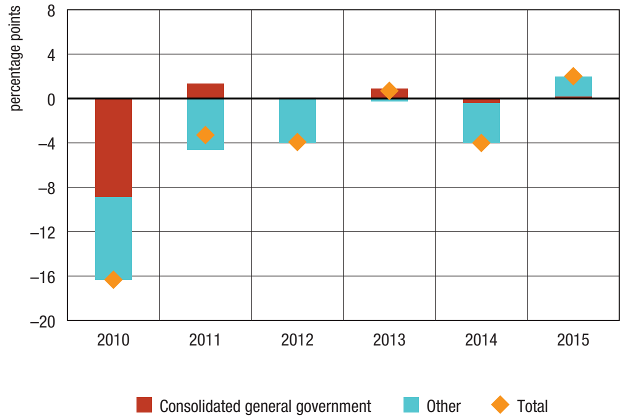
Source: CNB.

Figure 3.5 Personal consumption
real values



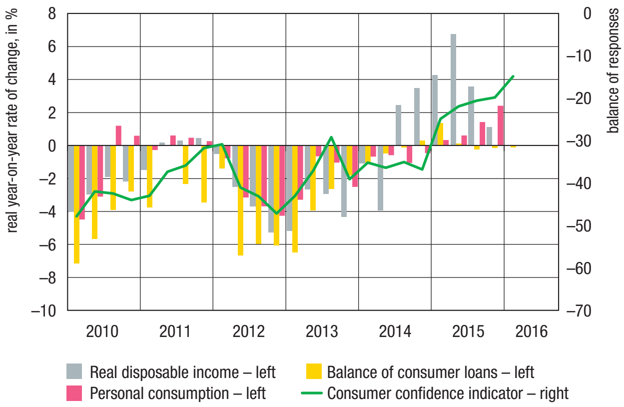
Source: CBS data seasonally adjusted by the CNB.

Figure 3.8 Gross fixed capital formation, contribution to the year-on-year growth by sectors
nominal values



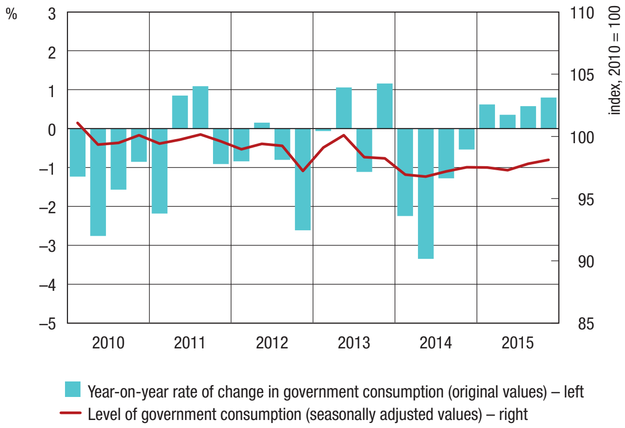
Note: Sector contributions are CNB's estimate.
Sources: CBS and CNB calculations.

Figure 3.6 Determinants of personal consumption



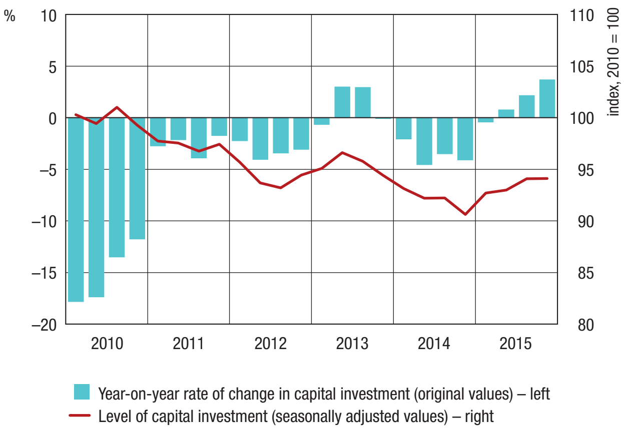
Note: The values of the consumer confidence indicator in a month are calculated as averages of monthly data. The balance of consumer loans in the first quarter of 2016 refers to January and the consumer confidence indicator to January and February.
Sources: CBS, Ipsos and CNB.

Figure 3.9 Government consumption
real values



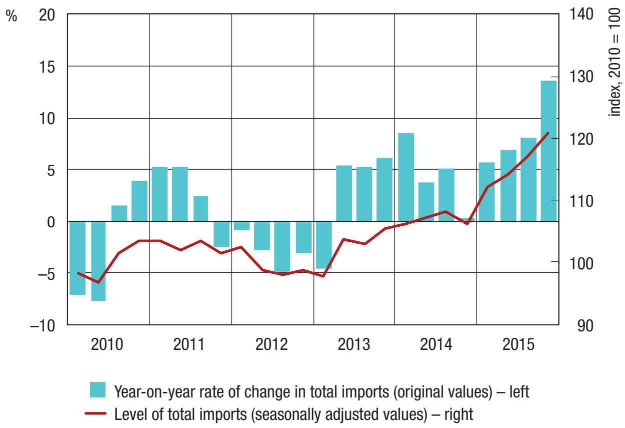
Source: CBS data seasonally adjusted by the CNB.

Figure 3.7 Gross fixed capital formation
real values



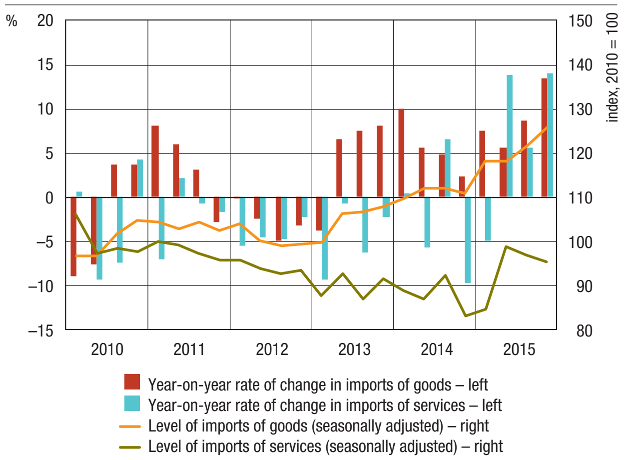
Source: CBS data seasonally adjusted by the CNB.

Figure 3.10 Imports of goods and services
real values



Source: CBS data seasonally adjusted by the CNB.

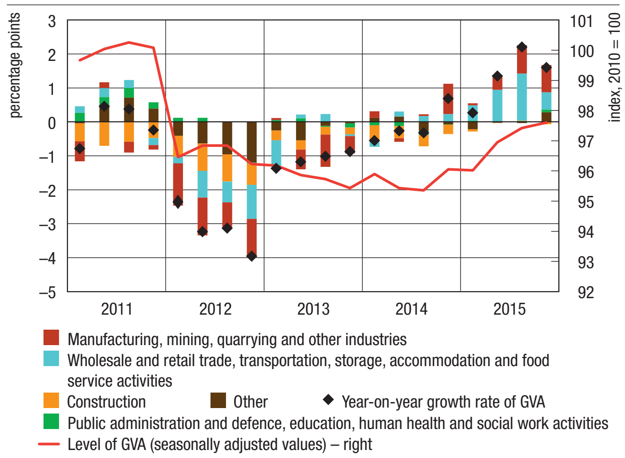
Figure 3.11 Real imports of goods and services



Source: CBS data seasonally adjusted by the CNB.

Figure 3.12 Change in GVA

contribution to the year-on-year rate of change by components



Source: CBS data seasonally adjusted by the CNB.

October to December the prices of oil and refined petroleum products went down considerably, favourably affecting household consumption capacity. It seems that the growth in personal consumption was slightly more prominent than the recovery in the disposable income of households, which reflects a continuation in the strong growth of consumer confidence. At the entire 2015 level, personal consumption was 1.2% higher than in 2014.

Gross fixed capital formation boasted the strongest annual growth rate in the last quarter of 2015 since the end of 2008. However, on a quarterly basis it stagnated. This was probably the greatest result of the weakening in investment activity from the government, as indicated by the data on the decline in civil engineering works, predominantly comprising infrastructure facilities. On the other hand, there is a visible recovery in private investments. Namely, in the period from October to November, production and imports of capital goods went up, while the corresponding exports went down. In comparison, investments went up by 1.6% in 2015 from the previous year and it seems that the main reason for this is the favourable impact of private investments, which made a positive contribution for the first time in six years.

Real government consumption continued growing in the last quarter of 2015 from the previous quarter, going up 0.8% on an annual basis. The data on the number of employed persons and the nominal data on government expenditures indicate that this rise in government consumption is linked to the real growth in compensations to employees and intermediary consumption.

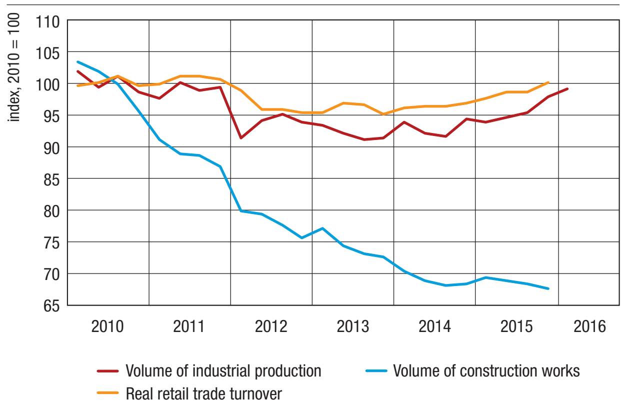
Goods and services imports rose sharply in the fourth quarter 2015, by 13.6% from the same period in the previous year. Goods imports intensified, while the imports of services declined on a quarterly basis as well. Nominal data on trade in goods show strong growth in all main industrial groupings, excluding energy. The strong growth in the imports of energy is most likely to be linked to the price of oil and refined petroleum products that continued falling in the global markets in the last quarter of 2015.

Aggregate supply

Gross value added increased by 1.6% in the last quarter of 2015 compared with the same period in the previous year. The greatest contribution to this growth came from industry, especially manufacturing, which can be linked to the continued

Figure 3.13 Short-term economic indicators

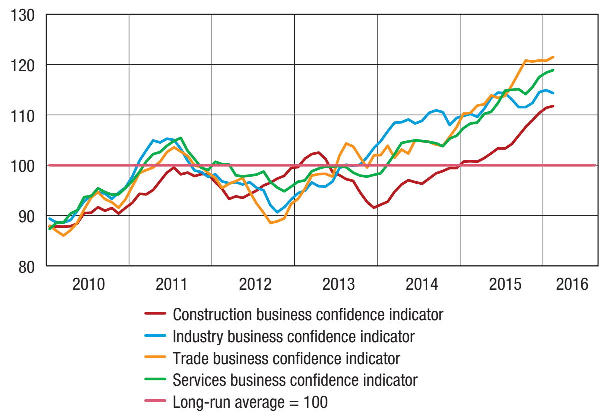
seasonally adjusted values



Note: Quarterly data are calculated an average of monthly data. Data on construction in the fourth quarter of 2015 refer to October and November. Data on industry in the first quarter of 2016 refer to January.
Source: CBS data seasonally adjusted by the CNB.

Figure 3.14 Business confidence indicators

standardised and seasonally adjusted values, three-member moving averages



Note: New weights have been applied to the series of business confidence indicators; as of July 2014, the weights are based on total income instead of the number of employees.
Sources: Ipsos, CNB and EC data seasonally adjusted.

strong growth of foreign demand for domestic goods. Moreover, a noticeable contribution to the growth of the total GVA came also from trade, transport and tourism, and the intensification of recovery in personal consumption at the end of the year. On the other hand, after more favourable results recorded at the beginning of the year, the GVA in construction went down again. This can, according to the data on construction work volume, be explained by poorer investment activity of the government at the very end of the year, for there was a sharp fall in civil engineering works in October and November, primarily related to infrastructure facilities. At the entire 2015 level, total GVA growth was 1.4%.

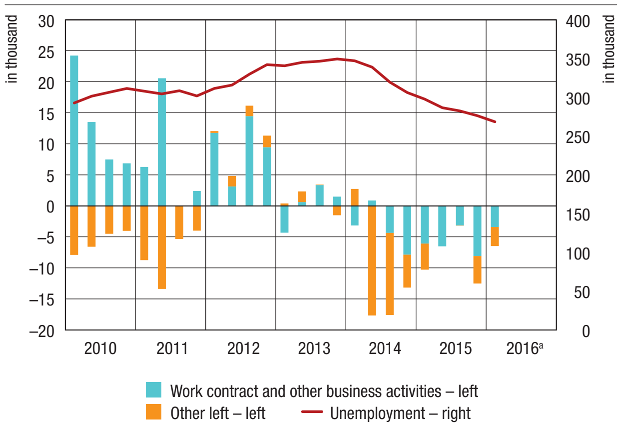
The available data on developments at the beginning of this year indicate continued economic growth. The industrial production volume index increased strongly in January 2016 compared with the averages in the last three months (1.3%). Broken down by main industrial groupings, these developments were largely a result of the growth in the production of intermediate goods and non-durable consumer goods. Further, the results of the survey on business expectations for January and February also reflect the continuation of favourable trends. Companies operating in the segment of trade and services expect demand to increase in the following three months, while construction companies expect to increase the number of their employees. On the other hand, although the expected production in the next three months is higher than at the end of the previous year, business optimism in industry stagnated primarily due to the fact that an increasing number of companies consider the numbers of orders insufficient and their inventories of finished goods too great.

4 Labour market

Favourable developments in the labour market continued in the fourth quarter 2015. Employment (persons insured with the CPIA) went up by 0.3% on a quarterly basis predominantly due to the increase in the number of the employed in private and public sector service activities. At the level of the whole of 2015 there were on average 10 thousand or 0.7% more employed persons than the year before. Active labour market policies considerably affected employment in 2015 given that it is estimated according to the detailed CPIA data that one third of the annual increase is accounted for by on-the-job training without work contract. Positive trends in employment continued early in 2016, when trade and industry boasted growth, although contributions to favourable developments were made by other activities as well.

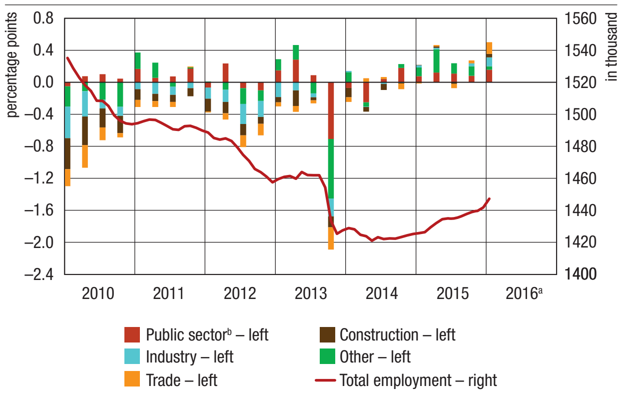
The declining trend in the number of unemployed persons registered with the CES continued in the last quarter of the previous year due to the prevailing influence of the net outflows from the CES register for employment and other business activities. In accordance with these developments, registered unemployment declined slightly in the period under review (17.2% according to seasonally adjusted data). In January 2016, the number of unemployed persons continued to decrease due to

Figure 4.2 Total unemployment and net inflows from unemployment



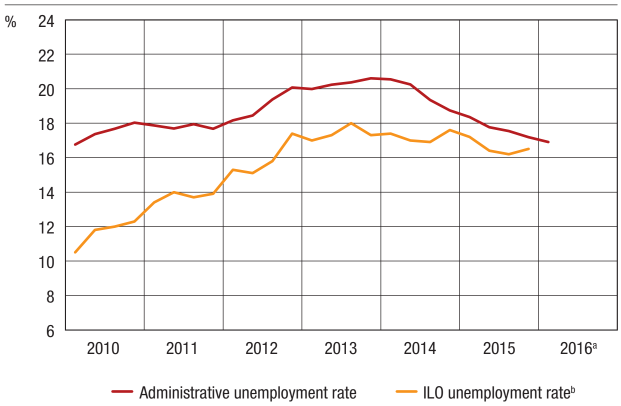
ª Data for the first quarter of 2016 refer to January.
Note: Series in the figure are seasonally adjusted.
Source: CES data seasonally adjusted by the CNB.

Figure 4.1 Total employment and contribution to the quarterly change in employment by sector
seasonally adjusted data



ª Data for the first quarter of 2016 refer to January.
ᵇ Public administration and defence, education and human health and social work activities
Note: Around 20,000 insured persons were removed from the CPIA register due to administrative reasons in October 2013.
Source: CPIA data seasonally adjusted by the CNB.

Figure 4.3 Unemployment rate

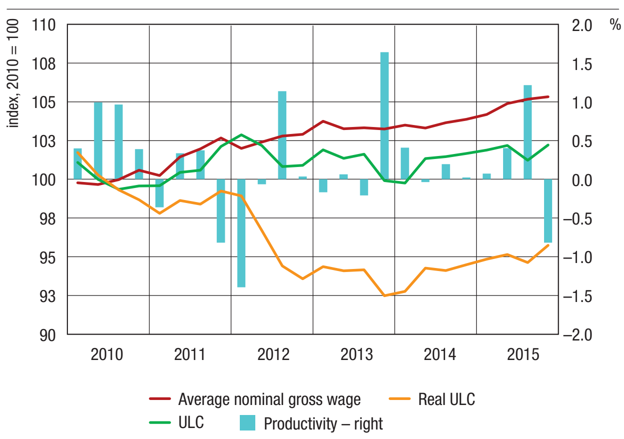


ª Data for the first quarter of 2016 refers to January.
ᵇ Monthly ILO unemployment rate is Eurostat's estimate.
Note: Series in the figure are seasonally adjusted.
Sources: Eurostat and CES data seasonally adjusted by the CNB.

the net outflow for employment and other reasons. The administrative unemployment rate thus went down to 16.9% in January (according to seasonally adjusted data). The internationally comparable ILO unemployment rate for the last quarter of 2015 is estimated by Eurostat and will be revised when data from the Labour Force Survey are available at the end of 2016. According to the latest available data for the fourth quarter 2015, the ILO unemployment rate went up slightly from the previous quarter (16.5% vis-à-vis 16.2%). At an annual level, the ILO unemployment rate totalled 16.6% in 2015, compared with 17.3% in 2014.

Nominal gross and net wages stagnated in the fourth quarter 2015 compared to the average in the preceding three months. However, the purchasing power of the average wage continued to increase given that consumer prices decreased during the period. At the level of the whole of 2015, nominal gross wages grew at the rate of 1.2% on average, which is their largest annual growth in the last four years, while net wages increased by as much as 3.4% due to changes in the income tax regime. This wage growth was generated primarily by the private sector, where wage growth was accompanied by growth in productivity. The unit cost of labour increased in the last quarter of 2015 after having fallen in the previous quarter.

Figure 4.4 Gross wages, productivity and unit labour costs



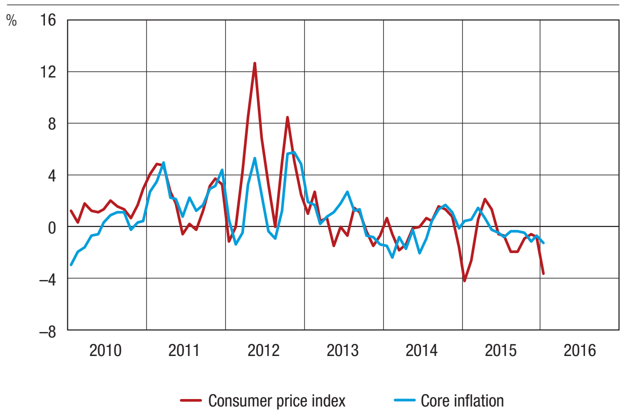
Sources: CBS and CPIA data seasonally adjusted by the CNB.

5 Inflation

In January 2016, consumer prices declined by 0.7% from the previous month, leading to a further fall in price levels. The biggest contribution to this was provided by a seasonal fall in the prices of clothing and footwear and a fall in the prices of refined petroleum products and natural gas. The negative values of the current indicators of total and core inflation were due to a sharp fall in the prices of crude oil in world markets, of over 30% in the last three months. The increase in the prices of individual food products, primarily vegetables, only partly offset the total fall in consumer prices in January from the previous month. The contribution of the increase in vegetables prices was smaller than in the same period of the previous year. Price increases in other food products in January were mainly associated with price increases following the usual pre-Christmas price reductions (milk, eggs, butter, sugar, etc.).

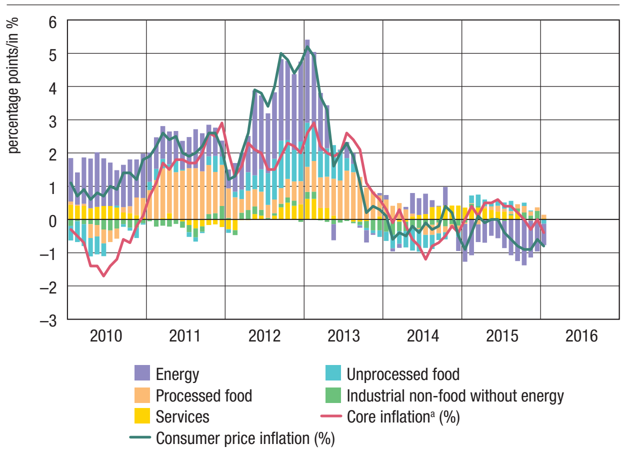
In the conditions of a significant fall in the prices of crude oil, low inflation in the countries of the European Union, stagnation in domestic labour unit costs and the stable exchange rate of the kuna against the euro, the annual consumer price inflation stood at –0.8% in January 2016, equalling the average rate of inflation recorded in the last quarter of 2015. The annual rate of price changes in January fell by 0.2 percentage points from December 2015. The biggest contribution to the fall in the annual rate of inflation in January, compared with December, was provided by industrial products, as a result of a more pronounced seasonal fall in the prices of footwear and clothing compared

Figure 5.1 Indicators of current developments in overall and core inflation
annualised month-on-month rate of change



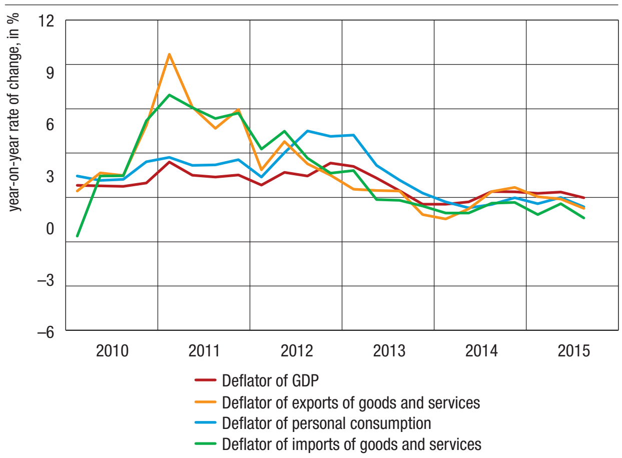
Note: The month-on-month rate of change is calculated from the quarterly moving average of seasonally adjusted price indices.
Sources: CBS and CNB calculations.

Figure 5.2 Year-on-year inflation rates and contribution of components to consumer price inflation



[a] Core inflation does not include agricultural product prices and administrative prices.
Sources: CBS and CNB calculations.

Figure 5.3 Deflator of GDP and its individual components



Source: CBS.

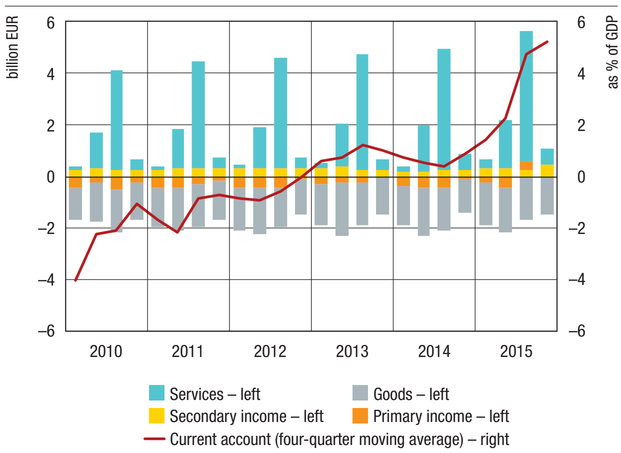
to the same period of the previous year, and unprocessed food products (vegetables). By contrast, the negative contribution of energy prices to the annual rate of inflation fell from –0.9 percentage points in December 2015 to –0.6 percentage points in January, as a result of the effect of the base period, i. e. a more pronounced fall in the prices of refined petroleum products in January 2015. In addition, the share of energy in the CPI basket declined by two percentage points and now stands at 17%. The fall in the annual rate of core inflation from 0.0% in December 2015 to –0.4% in January was the result of the mentioned development in the prices of industrial products.

The annual rate of fall in the deflator of goods and services imports rose in the third quarter of 2015, indicating growing pressures on the fall in domestic prices arising from the fall in the prices of imported raw materials and final goods during that period. By contrast, the annual rate of fall in the deflator of goods and services exports rose slightly in the third quarter of 2015, indicating better improvement in the conditions of trade than in the previous quarter.

6 Foreign trade and competitiveness

Positive developments in the current account[1] continued into the last quarter of 2015, resulting in a considerable increase in the current account surplus on an annual level, which rose from 0.9% of GDP in 2014 to 5.2% of GDP in 2015. The main factor behind this improvement is a considerable narrowing in the primary income account deficit due to losses of banks in foreign ownership in the third quarter, resulting from recording the effects of conversion of loans in Swiss francs in euro as well as, although to a much lesser extent, from an increase in compensations to residents working abroad. The growth in the current account surplus can also be attributed to the positive results in foreign trade in goods and services, primarily to the exceptional success of the tourist season, and to a lesser extent, improvement in the balance of trade in other services (particularly goods-related services, IT services and personal, cultural and recreational services) By contrast, the foreign trade deficit widened despite a faster growth in exports than in imports as the increase in imports in an absolute amount exceeded the increase in exports. A significant increase in the use of EU funds, which resulted in an increase in net income based on secondary income and, to a lesser extent, net inflows in the capital account, also had a favourable impact on the current account balance. Combined, the current and capital account surplus rose from 1.1% of GDP in 2014 to 5.6% of GDP in 2015.

Figure 6.1 Current account balance and its structure



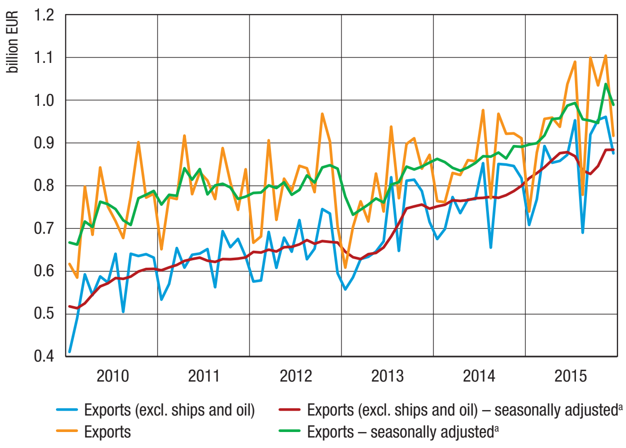
Source: CNB.

A decrease in the current account deficit in the last quarter of 2015 of 0.5% of GDP from the same period in the previous year is due to an improvement in the secondary and primary account balance, while the developments in foreign trade in goods had an unfavourable impact. The increase in net inflows based on secondary income was mostly due to net transactions with the EU budget. The last quarter of the year saw a considerable increase in the use of EU funds, mostly involving allocations to end beneficiaries of the previously received funds. At the same time, the reduction in the primary account deficit was mostly due to income from direct equity investments. However, the losses of foreign enterprises in domestic ownership increased and the performance of domestic enterprises in foreign ownership deteriorated still further. The biggest losses were recorded in financial corporations in foreign ownership and in activities such as the production of refined petroleum products[2], hotels and restaurants and real estate activities, while foreign enterprises in domestic ownership reported the biggest losses in the manufacture of refined petroleum products, and extraction of crude oil and natural gas. The business results of both domestic enterprises in

1 The balance of payments developments are described based on preliminary and incomplete version of the balance of payments for the fourth quarter of 2015.

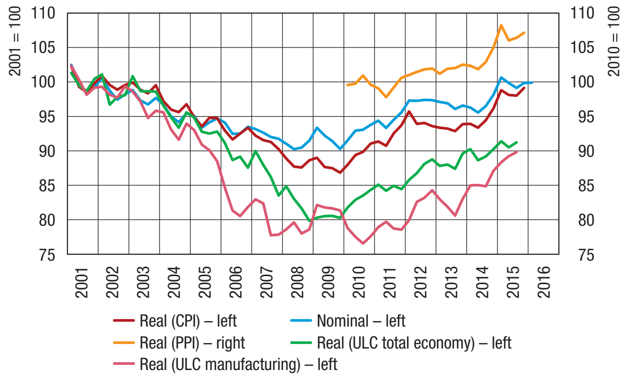
2 Losses were also recorded in 2013 and 2014, and they reflect not only on the profit of domestic enterprises in foreign ownership but also on the profit of their enterprises abroad and, consequently, on reinvested earnings in the context of foreign direct investments in the financial account of the balance of payments.

Figure 6.2 Goods exports (f.o.b.)



[a] Three-member centred moving averages of monthly data.
Source: CBS data seasonally adjusted by the CNB.

Figure 6.4 Nominal and real effective exchange rates of the kuna



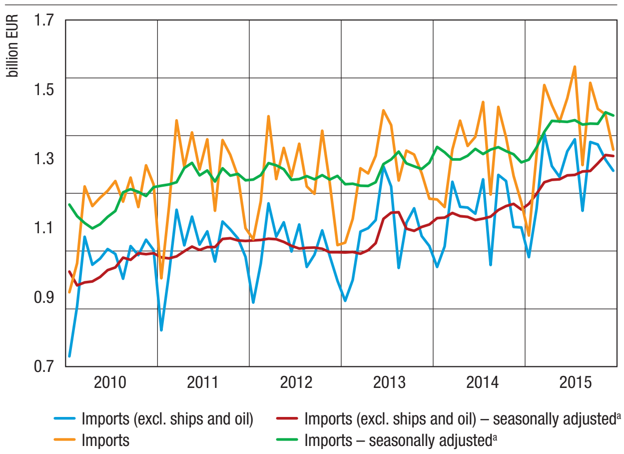
Note: The Croatian index of industrial producer prices on the non-domestic market, which is available from January 2010, is included in the calculation of the real effective exchange rate of the kuna deflated by producer prices. A fall in the index denotes an effective appreciation of the kuna. Data for the first quarter of 2016 refer to January.
Source: CNB.

foreign ownership and foreign enterprises in domestic ownership were negatively influenced by the effects of value adjustments of their assets. Another factor influencing a reduction in the primary income account deficit is further growth in income from compensations to residents working abroad. By contrast, interest expenses of foreign financing (excluding FISIM) rose slightly.

The deficit in the foreign trade in goods and services rose in the last quarter of 2015 as a result of unfavourable developments in foreign trade. Even though the annual growth in goods exports was only slightly faster than imports growth, the foreign trade deficit widened because, in absolute terms, imports grew faster than exports. The balance in the trade of other services improved slightly, mostly owing to positive results in the trade of other business services (particularly advertising and market research services) and personal, cultural and recreational services. Income from travel services also rose but was accompanied by an almost equal increase in expenditures. By contrast, net exports based on processing and transport services declined on an annual level.

If CBS data on foreign trade are considered, then after a brief halt in the third quarter, the growth in total goods exports continued in the fourth quarter of 2015 when exports, according to seasonally adjusted data, rose 3.9% from the preceding three months' average. The main factor behind this growth is the export of the narrow aggregate (excluding ships and oil) which rose by 6.8%, mostly boosted by stronger exports of capital goods (particularly power generating machinery and equipment and electrical machinery, apparatus and appliances), medical and pharmaceutical products to Russia, the Netherlands and the USA, oil seeds and fruits to Serbia, manufactures of metals to Italy and clothing to Italy and Spain. At the same time, exports of road vehicles to Belgium declined.

Figure 6.3 Goods imports (c.i.f.)



[a] Three-member centred moving averages of monthly data.
Source: CBS data seasonally adjusted by the CNB.

The total goods imports, after having fallen slightly in the third quarter, according to seasonally adjusted data, rose in the last quarter of 2015 by 1.8% from the previous quarter average. This was largely influenced by the fall in the import of oil and refined petroleum products from Russia, Hungary and Slovenia. Imports of ships previously exported for finishing purposes also declined, so, if these two categories are excluded, the growth in imports of the narrow aggregate was even sharper (3.8%). The growth in imports of road vehicles (particularly from Germany) stands out and so does the growth in imports of furniture and parts thereof, scientific and control instruments and capital goods (particularly telecommunications, sound recording and reproduction apparatus). By contrast, imports of electricity from neighbouring countries (Hungary, Slovenia, Bosnia and Herzegovina and Serbia) fell considerably.

The indicators of the price competitiveness of Croatian goods exports improved over the last quarter of 2015, mainly due to exchange rate developments. The indicators of cost competitiveness, available for the third quarter of 2015, also point to an improvement. If data are observed at an entire 2015 level, the price and cost competitiveness of Croatian goods exports also improved perceptibly from the previous year. Also contributing to the depreciation of the real effective exchange rate of the kuna deflated by consumer prices were more favourable developments in consumer prices in Croatia than in the main trading partners, present in quarterly terms ever since early 2013. The contribution of domestic producer prices to the depreciation of the real effective exchange rates in the last three years was also mainly positive.

7 Financing conditions and capital flows

Domestic government financing costs in kuna fell further in early 2016 in the conditions of historically the highest monetary system liquidity, supported by the extremely expansionary CNB policy. The interest rate on one-year kuna T-bills, after holding steady at 1.50% for over a year, gradually fell to 1.13% from December 2015 to end-February 2016. At the same time, the interest rate on one-year T-bills with a currency clause fell to 0.3% during February. The cost of government borrowing abroad, estimated by the sum of yields on the German government bond and the EMBI index for Croatia, fell slightly in early 2016. However, this was entirely the result of a fall in yields on the German government bond, as the value of the EMBI index for Croatia rose slightly during that period (Figure 7.1). The costs of government financing abroad remained at relatively high levels. The credit default swap or CDS for Croatia also remained at a high level of approximately 300 basis points (Figure 7.2).

Credit default swaps of parent banks of the largest banks in Croatia, after relative stability in 2015, rose considerably in the first two months of 2016 (Figure 7.2). In addition to CDS increase, there was a big drop in their share prices, reflecting financial markets' concern over bank profitability in the future and the increased risk of bank bonds in the light of new European regulation on the bail-in instrument.

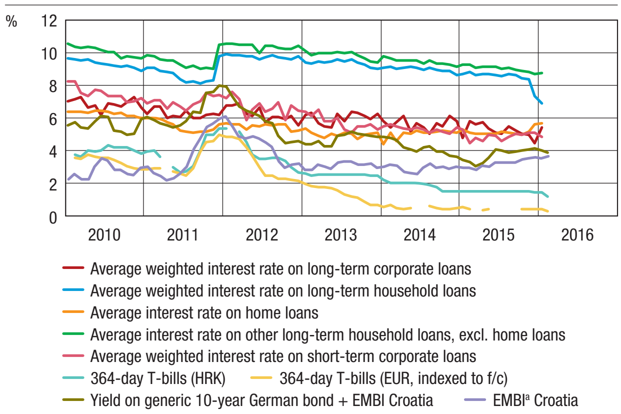
The domestic interest rates of banks on long-term and short-term corporate loans held steady in early 2016 at their previous year's average level (Figure 7.1); however, the standards for granting loans to this sector relaxed visibly. Namely, according to banks' responses under the Bank lending survey, the standards for granting corporate loans in the fourth quarter of 2015 were the most favourable since this Survey[3] was first conducted (Figure 7.3). This was mostly due to more favourable expectations regarding general economic developments, market competition and favourable liquidity.

Corporate credit demand also recorded the most favourable developments since the Survey was first conducted, with a particular jump being observed in demand from small and medium sized enterprises. Over one third of the banking sector stated gross fixed capital formation as the main contributing factor to demand growth, a reversal from previous years when this factor was one of the main causes for the fall in corporate demand.

The total debt of non-financial corporations declined slightly in the fourth quarter of 2015, while on the entire 2015 level, debt grew by 0.2% (Figure 7.4). In the fourth quarter, the enterprises partly compensated for the reduction in their debt to domestic credit institutions by borrowing from other sources, primarily those abroad. This related mainly to public enterprises borrowing, in particular to the foreign bond issue of Hrvatska elektroprivreda in October in the amount of USD 550m, 80% of which was used for the refinancing of the existing foreign bond. By contrast, private enterprises deleveraged in the fourth quarter, both in relation to domestic and foreign creditors. On an annual level, the total growth in corporate sector debt was also generated by foreign borrowing, while domestic corporate financing declined. In terms of ownership, the growth in corporate debt in 2015 was mainly due to private enterprises as public enterprises reduced their debt from end-2014. The trend of growth in indebtedness of private enterprises and deleveraging of public enterprises continued for the fifth consecutive year.

The nominal interest rates on long-term household loans (excluding housing loans) and on short-term loans held steady in early 2016 at their average level in the last quarter of the previous year (Figure 7.1). However, the interest rates on home loans jumped considerably in December 2015 and in January 2016, mostly as a result of the conversion of loans in Swiss francs. The level of the renegotiated interest rates on converted loans was determined by a special law and, for a significant portion of those loans, it was higher than the market interest rate currently applicable to newly approved housing loans indexed to the euro, which significantly raises the interest rate average for total newly agreed housing loans. By contrast, the average interest rates on the total of newly approved long-term household loans (including housing loans) fell considerably as a result of the conversion, as the share of newly approved housing loans in all long-term household loans rose sharply in the process of conversion and the interest rates on those converted loans were as a rule much

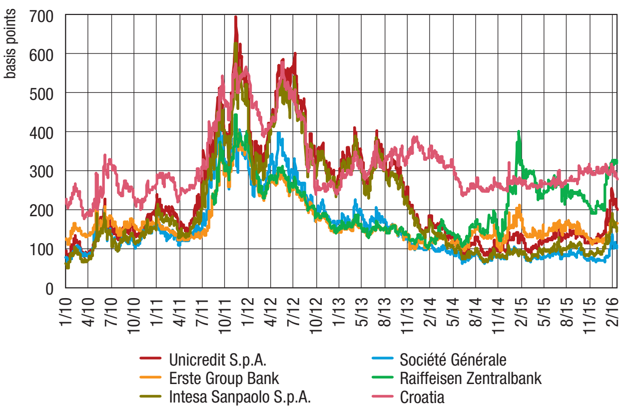
Figure 7.1 Costs of domestic and foreign financing



[a] EMBI (Emerging Market Bond Index) is the spread between yields on government securities of emerging markets, including Croatia, and risk-free securities of developed countries.

Sources: MoF, Bloomberg and CNB.

Figure 7.2 CDS spreads for Croatia and selected parent banks of domestic banks

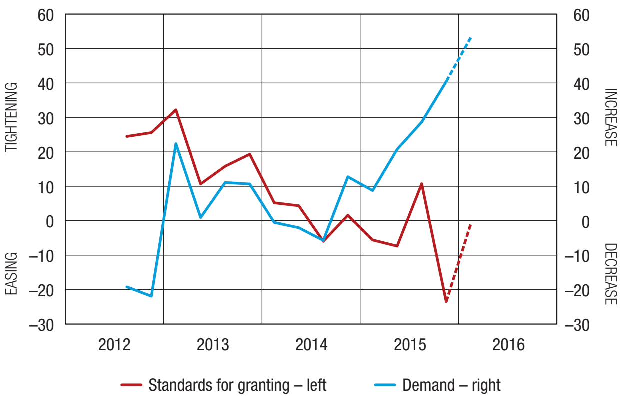


Note: Credit default swaps (CDS) spread is an annual premium that a CDS buyer pays for protection against credit risk associated with an issuer of an instrument.

Source: S&P Capital IQ.

3 The CNB has been conducting the Bank lending survey on a quarterly basis since the third quarter of 2012.

Figure 7.3 Standards for granting loans and corporate demand for loans



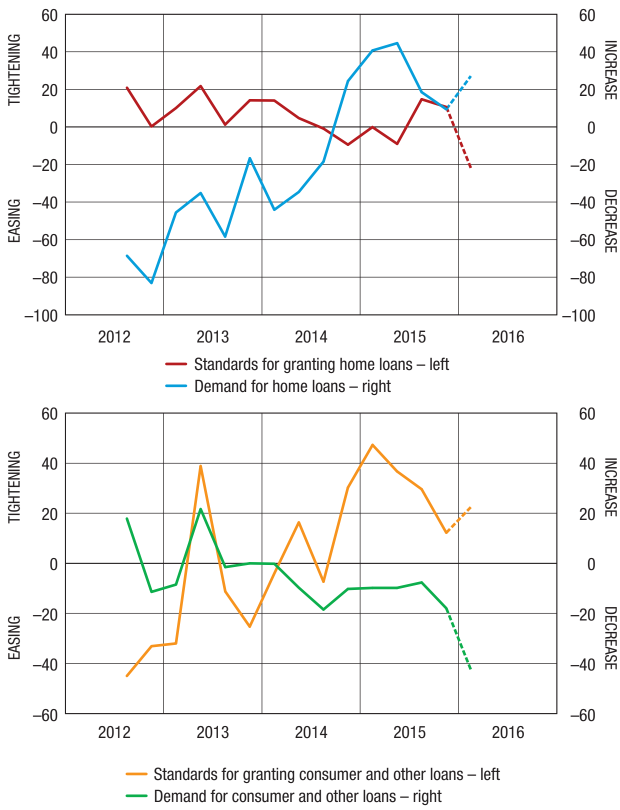
Note: Data represent the net percentage of banks weighted by the share in total loans to corporations. Broken lines represent expectations for the first quarter of 2016.
Source: CNB.

lower than those on non-housing long-term loans. The interest rate on the balance of all housing loans with a currency clause rose from December 2015 due to the fact that the balance of housing loans indexed to the Swiss franc, whose interest rate had been set by a special law at a level much below the market level, started to decline. However, the interest rates on the balance of housing loans with a currency clause in euro, converted loans included, continued to trend downwards in January 2016.

The results of the Bank lending survey show improvements in the household loans granting standards in the fourth quarter of 2015 for consumer and other loans, while the standards for granting housing loans continued to tighten, in line with the developments in the previous quarter, mostly influenced by large banks. The demand for both groups of household loans continued to rise, driven by rising consumer confidence, despite obvious evidence of a slowdown in labour intensity.

The developments in household loans at the end of the previous year and in early 2016 was greatly influenced by the process of conversion and a partial write off-of loans in Swiss francs initiated in substantial amounts in December. At the end of November 2015, placements to households in the Swiss franc and

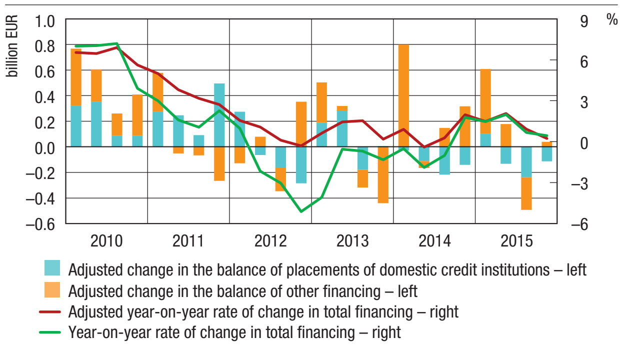
Figure 7.5 Standards for granting loans and household demand for loans



Note: Data represent the net percentage of banks weighted by the share in total loans to households. Broken lines represent expectations for the first quarter of 2016.
Source: CNB.

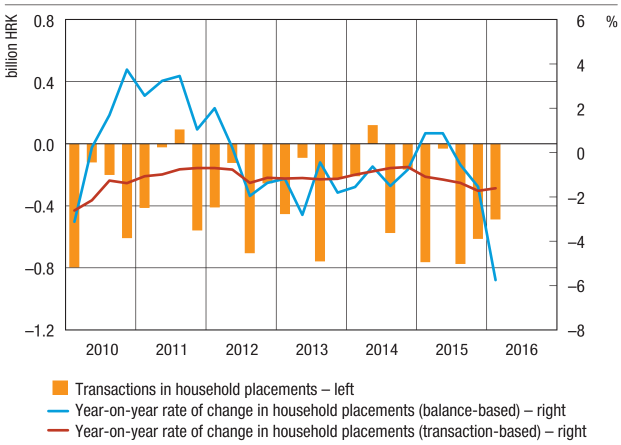
indexed to the Swiss franc stood at HRK 21.7bn and at the end of January 2016 they stood at HRK 12.3bn. Of that decline, HRK 2.8bn can be ascribed to the write-off of a part of the principal of loans in the Swiss franc and the rest can be ascribed to conversion. Despite relatively favourable developments in market interest rates and gradual recovery in the economic activity, the trend of household deleveraging present for many years continued, and the annual fall in placements to households stood at

Figure 7.4 Corporate financing by sources



Note: Other financing includes corporate borrowing from domestic leasing companies and direct borrowing from the CBRD, as well as borrowing from foreign banks and affiliated enterprises abroad. The adjusted changes are calculated on the basis of data on transactions in placements of domestic credit institutions and data on the developments in external debt which do not include the effect of the assumption of loans to the shipyards by the Ministry of Finance in 2012 and the effect of the transformation of debt into equity.
Sources: HANFA, CNB and CNB calculations.

Figure 7.6 Household placements



Note: Data for the first quarter of 2016 refer to January.
Source: CNB.

–1.6% at the end of January (exchange rate and write-off effects excluded).

Capital flows between Croatia and foreign countries

In contrast with net inflows of capital common for the end of the year, the fourth quarter of 2015 saw a net capital outflow of EUR 0.5bn in the financial account of the balance of payment (excluding central bank transactions). This was mostly due to deleveraging, i. e. a pronounced reduction in foreign liabilities of credit institutions, also spurred by adjustments of currency positions of banks with the effects of write-offs of parts of loans in the Swiss franc. Banks' deleveraging was also a major factor behind the net outflow of capital abroad throughout 2015.

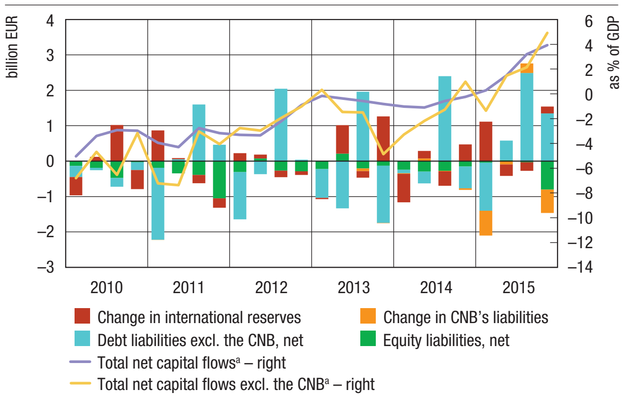
Equity investment in the fourth quarter of 2015 was largely influenced by transactions associated with debt repayment to affiliated creditors. The majority of equity investments involved recapitalisation and simultaneous repayments of debt to affiliated companies, which in fact looks like a transaction that transforms debt into equity. In addition, actual transactions of the transformation of debts of non-financial corporations into equity were recorded, although to a much smaller extent. If the mentioned transactions are excluded, the transactions associated with equity investments (reinvested earnings included) generated a net capital outflow. New equity investment was very modest and mostly took place in trade and real estate activities. Furthermore, the negative reinvested earnings on the liabilities side were more than two times bigger than those in the same period of the previous year, mainly as a result of a revaluation of long-term tangible assets of enterprises with their market value. Although to a lesser extent than in the case of liabilities, negative values in reinvested earnings were also observed on the asset side, mainly in crude oil and natural gas extraction and production of refined petroleum products.

The net capital outflow based on debt investments in the fourth quarter of 2015 was largely due to the mentioned considerable decline in liabilities to foreign affiliated creditors through transactions which were in effect transactions of the transformation of debt into equity. If these transactions are excluded, the biggest contribution to deleveraging was provided by credit institutions, which continued to reduce their foreign liabilities in a scope which exceeded the reduction in foreign assets. The net external debt of the government sector remained unchanged, although the stock of external debt rose as a result of unfavourable exchange rate differentials. By contrast, net liabilities of other domestic sectors to non-affiliated creditors rose, primarily as a result of a reduction in foreign claims.

The net external position of the central bank deteriorated in the last quarter of 2015. Although the investment of a part of international reserves in repo agreements resulted in increases in CNB liabilities and assets in equal amounts, the withdrawal of funds from the government's foreign currency deposit with the CNB and a foreign exchange intervention by the central bank[4] had an unfavourable effect on reserves.

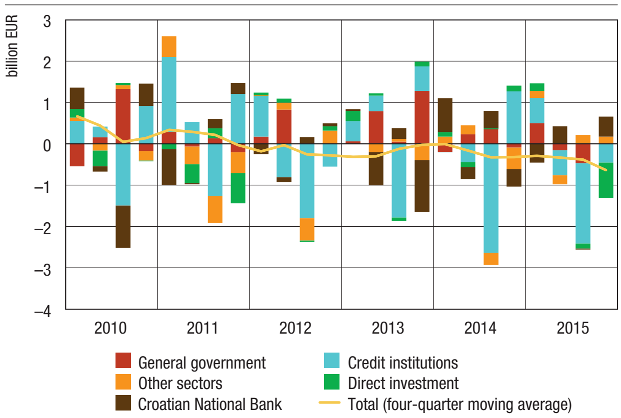
At the end of 2015, net international reserves stood at EUR 12.0bn, having fallen by EUR 0.2bn or 1.9% from the end of the previous year as the central bank's gross external debt growth was faster than the growth in gross international reserves. In 2015, gross international reserves rose by EUR 1.0bn from the end of the previous year, mostly attributable to their investment

Figure 7.7 Foreign capital flows



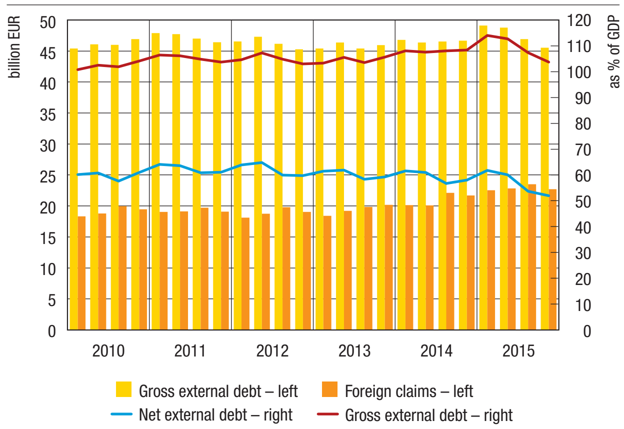
[a] Four-quarter moving average.
Note: A positive value denotes net outflow of equity abroad (including on the basis of the growth in international reserves). Net liabilities represent the difference between the change in assets and the change in liabilities.
Source: CNB.

Figure 7.8 Net external debt transactions by sectors



Note: Transactions refer to the change in debt excl. cross-currency changes and other adjustments. Net external debt is calculated as gross external debt stock net of foreign debt claims.
Source: CNB.

Figure 7.9 Gross and net external debt



Note: Net external debt is calculated as gross external debt stock net of foreign debt claims.
Source: CNB.

4 In a foreign exchange intervention held on 30 September, the banks were sold EUR 268.3m, but since foreign exchange interventions are settled two working days after the date of interventions, the transaction was reflected in reserves balance in early October.

in repo agreements, the purchase of foreign exchange from the government and cross-currency changes due to the strengthening of the American dollar against the euro. At the end of 2015, reserves thus reached EUR 13.7bn, an amount sufficient to cover 8.0 months of goods and services imports, compared with 7.9 months of imports at the end of the previous year. The coverage by reserves of short-term debt by remaining maturity improved, rising from 92.2% at the end of 2014 to 96.5% at the end of 2015.

The gross external debt of the Republic of Croatia stood at EUR 45.5bn at the end of 2015, a decrease of EUR 1.1bn from the end of the previous year. The biggest contribution to its fall was provided by the deleveraging of credit institutions (especially in the second half of the year) and other domestic sectors vis-à-vis affiliated foreign creditors. By contrast, the central bank increased its foreign liabilities due to the already mentioned investments of reserves in repo agreements. Unfavourable cross-currency changes and other adjustments amounting to as much as EUR 1.0bn, most of which were attributable to the government sector, had a similar effect, increasing the value of the total foreign liabilities. The gross external debt thus fell to 103.7% of GDP at the end of 2015 (from 108.4% at the end of 2014) and with the simultaneous increase in foreign assets of the domestic sectors, the net external debt fell even further (to 52.0% of GDP, from 58.0% at the end of 2014).

8 Monetary policy

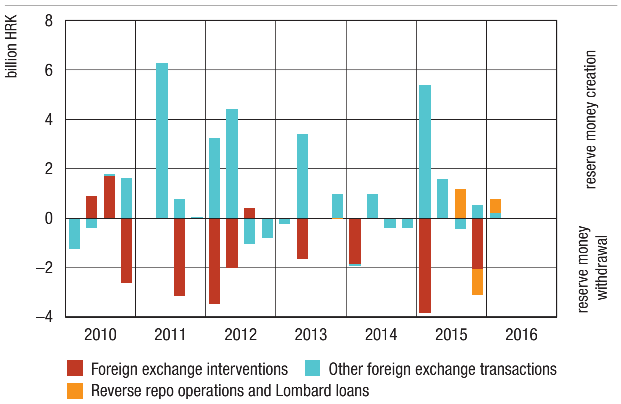
At the beginning of 2016, the CNB introduced long-term structural reverse repo operations, thus further supporting the expansionary orientation of its monetary policy. These operations provide the banks access to longer-term sources of kuna liquidity at a competitive interest rate, and enable increased lending and better lending conditions for the economy and households in the domestic currency. At the first structural repo auction in mid-February, one of the four planned for 2016, the central bank placed HRK 0.6bn with a four-year maturity at the fixed rate of 1.8%. The CNB also continued to conduct regular weekly reverse repo operations, the average daily balance of which during the first two months of 2016 stood at HRK 0.2bn, at a fixed repo rate of 0.5%.

In addition to increased liquidity based on structural repo operations, in the first two months of 2016, the CNB purchased, in foreign exchange transactions with the MoF, EUR 103.1m and sold EUR 72.9m to the European Commission thus creating HRK 0.2bn by means of its foreign exchange transactions. A record kuna liquidity surplus was recorded in the monetary system in January and February, averaging HRK 9.5bn and on some days even exceeding HRK 11.5bn. Under such conditions, the interest rates on the money market remained low (Figure 8.2) and the yield on kuna Treasury bills of the MoF also fell. The kuna curve of the yield on government bonds was falling from the beginning of 2016 and the structural reverse repo operation conducted in mid-February helped keep it at a lower level.

In addition to increased kuna liquidity creation, the CNB continued to pursue the policy of a stable exchange rate of the kuna against the euro. Following a mild strengthening of the kuna against the euro in 2015, when the average nominal exchange rate of the kuna against the euro stood at EUR/HRK 7.61, a decrease of 0.3% from the previous year's average, in the first two months of 2016, the exchange rate of the kuna against the euro also appreciated slightly and was on average 0.7% lower than in the same period of the previous year. The American dollar weakened against the kuna in early February 2016, owing to the strengthening of the euro against the dollar in the global foreign exchange markets due to the current expectations of a slowdown in the growth of benchmark interest rates in the US. The kuna also strengthened slightly against the Swiss franc in early 2016.

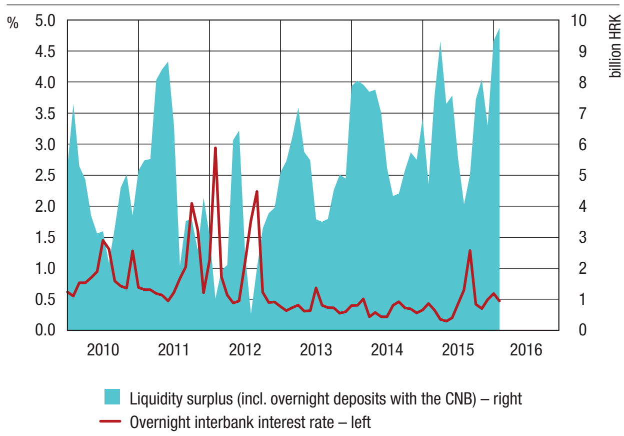
Gross international reserves declined in the first two months of 2016 by EUR 0.8bn or 5.5% and stood at EUR 12.9bn at the end of February. The decline in gross reserves was mostly due to the lower level of negotiated repo transactions and CNB decision on the repeal of the requirement to allocate the foreign exchange component of reserve requirements with the central

Figure 8.1 Flows of reserve money (M0) creation



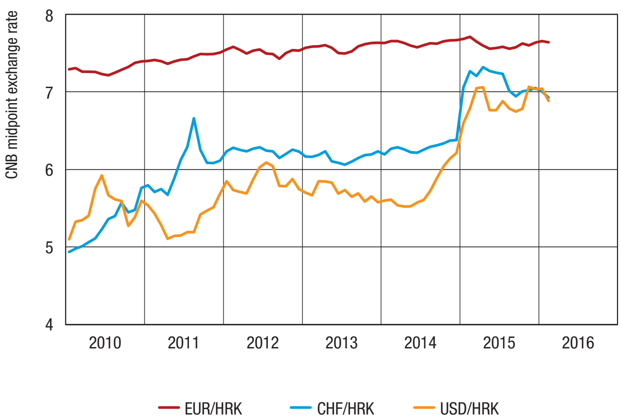
Note: Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and the EC and foreign currency swaps with banks, where the positive values refer to the purchase of foreign exchange by the CNB. Data for the first quarter of 2016 refer to January and February.
Source: CNB.

Figure 8.2 Bank liquidity and overnight interbank interest rate



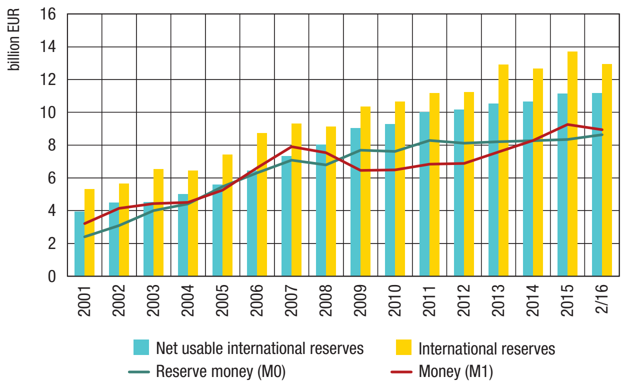
Source: CNB.

Figure 8.3 Nominal exchange rates of the kuna against selected currencies



Source: CNB.

Figure 8.4 International reserves of the CNB and monetary aggregates

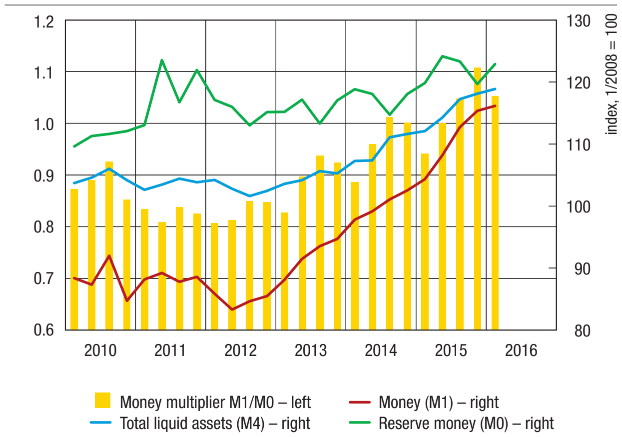


Note: Net usable international reserves are defined as international reserves net of foreign liabilities of the CNB, reserve requirements in f/c, government foreign currency deposits and off-balance sheet liabilities (swaps). The most recent data available for M1 refers to end-January 2016.
Source: CNB.

bank of EUR 0.5bn from mid-January. This decision makes it possible for the banks to take a more flexible approach to foreign exchange liquidity management, allowing them to meet the total foreign exchange component of reserve requirements by average daily balances of foreign currency assets. Net usable international reserves remained almost unchanged from the end of the previous year and stood at EUR 11.2bn at the end of February. Gross and net international reserves continued considerably to exceed the balance of the narrowest monetary aggregates M0 and M1.

The real values of money (M1) and total liquid assets (M4) continued to grow steadily. In the conditions of subdued domestic credit activity, the growth in monetary aggregates on an annual level was clearly boosted by inflows from the tourist season and foreign borrowing of enterprises, as well as by a small growth in the purchasing power of households due to employment growth and growth in nominal net wages and subdued inflation. The growth in money (M1) was particularly pronounced, being influenced by the increased propensity of the domestic sectors to keep more liquid forms of assets. So, for instance, household and corporate demand deposits had risen nominally by 18.0% and 11.3%, respectively, at the end of January 2016 from the end of January of the previous year. However, the nominal annual growth in savings and time deposits of the domestic sectors was much slower and stood at 3.4% at the end of January (the exchange rate effects excluded), and was almost entirely due to corporate deposits as household deposits rose by only 0.5% during that period. The real value of reserve money (M0) in January 2016 also rose, although the growth in this aggregate was slower over a longer period compared to broader monetary aggregates M1 and M4.

Figure 8.5 Monetary aggregates and money multiplier
index of developments in seasonally adjusted values, deflated by the consumer price index



Note: Data for the first quarter of 2016 refer to January.
Source: CNB.

9 Public finance

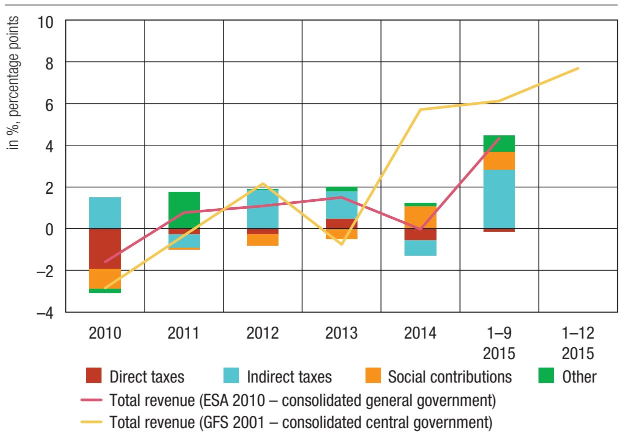
General government revenues, in accordance with the ESA 2010 methodology, rose by 4.3% in the first three quarters of 2015 from the same period of the previous year. Indirect taxes and social contributions made the biggest contribution to the growth in revenues. A sharp increase in indirect taxes is mostly due to an increase in revenues from VAT, partly attributable to a recovery in personal consumption and the good tourist season and partly to a low base in 2014. Income from excise duties also rose considerably, mainly due to higher excise duties on tobacco and petroleum products. As regards revenues from social contributions, their more favourable developments reflect the base effect of the increase in the health care contributions in April 2014. By contrast, direct taxes declined slightly, with revenues from profit taxes rising sharply, while revenues from income taxes declined as a result of changes in the system of income taxation introduced in early 2015.

The available data of the Ministry of Finance, according to the GFS 2001 methodology, indicate that favourable revenue dynamics continued into the fourth quarter of 2015. Revenues from VAT and excise duties rose and revenue from social contributions (adjusted for the amount of the transfer from the second to the first pension pillar of EUR 1.2bn in November 2015, since according to the ESA 2010 methodology, the funds from the transfer were not to be recorded as budget revenue but were to be recorded in the financial accounts). Due to lack of data, the developments in direct taxes in the last quarter of 2015 are not clear, and their final amount for 2015 will not be known before the second quarter of 2016 since under the ESA 2010 methodology, cash receipts from profit tax are recorded with a four month lag. Therefore, profit tax revenues under the ESA 2010 methodology could be influenced by the cost of conversion of a part of loans from Swiss francs to the euro as soon as 2015.

As regards the expenditure side of the budget, the first three quarters of 2015 were marked by stagnation (methodology ESA 2010) at the consolidated general government level. However, interest expenditures and the expenditures for intermediary consumption rose quite considerably. Employee compensation also rose slightly, particularly in the third quarter, which can probably be attributed to the growth in the number of civil servants and government employees. At the same time, other items, most notably social benefits and other current expenditures fell. The available data of the Ministry of Finance point to an annual increase in expenditures in the last quarter of 2015; however, methodological changes (exclusion of the CIHI from the government budget and changes in the scope of the central government) prevent a more detailed insight into the components on the expenditure side of the budget. We can expect a further growth in employee compensation as a result of an annex to the Collective Agreement in the health care sector which entered into force on 1 October 2015 and provides for wage increases for those working in the health sector in the form of supplements for special working conditions and responsibility for human life and health.

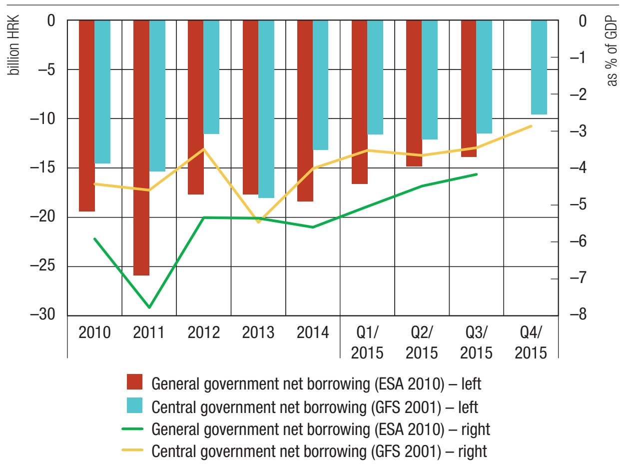
As a result of favourable developments on the revenue side and a simultaneous stagnation on the expenditure side of the budget, the consolidated general government deficit, under the ESA 2010 methodology fell to HRK 9bn in the first three quarters of 2015, from HRK 13.5bn in the same period of 2014. According to available MoF data (methodology GFS 2001), the general government deficit widened slightly in the last quarter of

Figure 9.1 Consolidated general (ESA 2010) and central government revenue (GFS 2001)
year-on-year rate of change and contributions



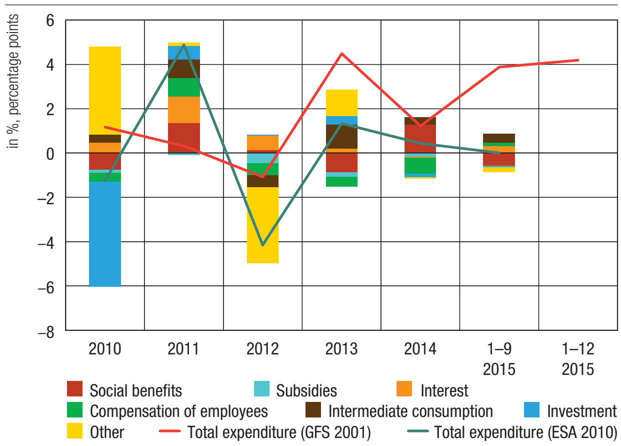
Note: Structural columns show the contributions of individual revenue categories to the change in total revenue presented according to the ESA 2010 methodology.
Sources: MoF (CNB calculations).

Figure 9.3 Consolidated general (ESA 2010) and central government balance (GFS 2001)



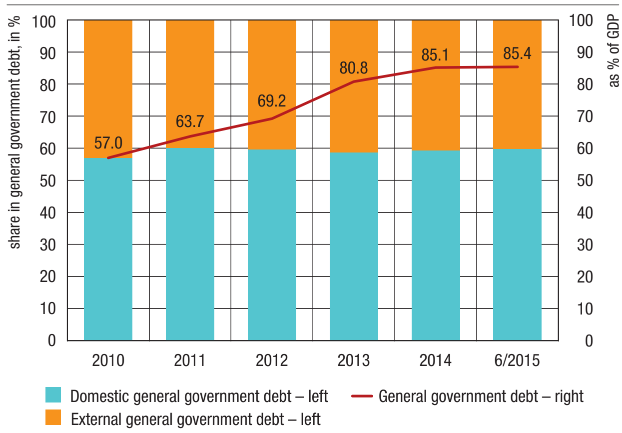
Note: Data for 2015 show four-quarter moving sums.
Sources: MoF (CNB calculations) and Eurostat.

Figure 9.2 Consolidated general (ESA 2010) and central government expenditure (GFS 2001)
year-on-year rate of change and contributions



Note: Structural columns show the contributions of individual expenditure categories to the change in total expenditure presented according to the ESA 2010 methodology.
Sources: MoF (CNB calculations).

Figure 9.4 General government debt
end-period stock

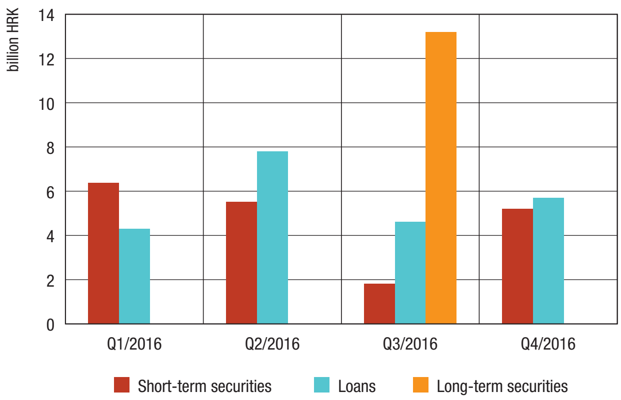


Note: GDP for 2015 was used for the calculation of the relative indicator at the end of November 2015.
Source: CNB.

2015 from the same period of the previous year. However, at the entire year level, the deficit could be much smaller than planned by the MoF (in accordance with the ESA 2010 methodology) and projected by the CNB in December last year.

The general government debt stood at HRK 285.3bn or 85.4% of GDP at the end of November 2015, which is an increase of HRK 5.7bn from the end of the previous year. A much slower growth in debt than in the deficit was due to the use of deposited funds obtained by borrowing in 2014, and the almost unchanged share of debt in GDP from the end of 2014 (85.1%) was due to the growth in the estimated nominal GDP. The growth in the level of general government debt was mostly driven by an increase in the level of the domestic central government debt, which rose by HRK 5.1bn in the first 11 months of 2015. The data point to positive changes in the maturity structure of general government debt, reflecting an increase in the share of long-term securities and a decrease in short-term securities and loans. As at the end of last year, the central government had approximately HRK 36.0bn falling due in 2016 based on loans and long-term securities, and if the debt based on short-term securities is included, the total amount of liabilities falling due is approximately HRK 55.0bn, with the largest amount falling due in the third quarter of this year.

Figure 9.5 Projection of general government debt maturity



Note: Projection of the repayment of short-term and long-term securities is based on the balances as at 24 February 2015 and projection of the repayment of loans on the balance as at 31 December 2015.
Sources: MoF and CNB.

10 Comparison of Croatia and selected countries

Favourable developments in economic activity in all CEE countries continued in the second half of 2015. In the third quarter, the growth of real GDP accelerated in all of them except in the Czech Republic, Latvia and Slovenia, while in Estonia it fell. In Bulgaria, Hungary and Poland economic activity intensified, in Latvia it stagnated, in Estonia it recovered, while in Croatia it went down slightly. On an annual level, economic growth was registered in all countries under review, but the growth of real activity in Croatia was below the CEE average.

Industrial production increased in the second half of 2015 from the same period in the previous year in all CEE countries except in Estonia, while the exports of goods increased in most. Croatia's exports of goods went up by 10.6% on an annual basis, continuing the positive trend started back in 2013. As in the first six months of 2015, Croatia was the country with the greatest registered growth rate of the exports of goods. Latvia, Lithuania and Estonia registered a substantial fall in the exports of goods primarily due to unfavourable economic developments in Russia, an important foreign trade partner of these countries.

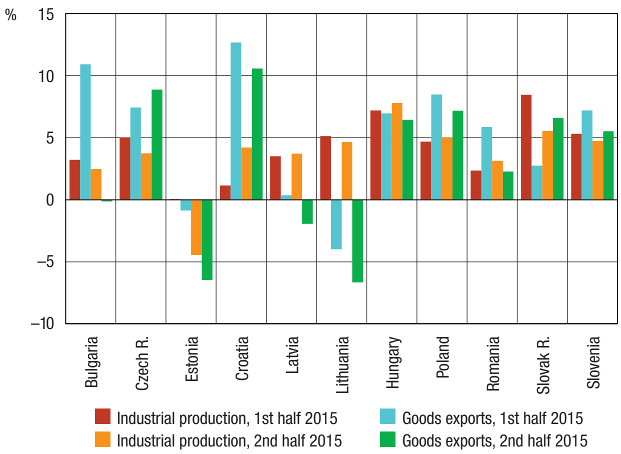
In the third quarter of 2015, the annual rate of employment growth was positive in all CEE countries, except Lithuania, while in the first nine months of 2015 the number of employed

Table 10.1 Gross domestic product

	Year-on-year rate of change, original data		Quarter-on-quarter rate of change, seasonally adjusted data				2015
	2013	2014	Q1/2015	Q2/2015	Q3/2015	Q4/2015	
Bulgaria	1.3	1.5	0.9	0.6	0.7	0.8	2.2
Czech R.	–0.5	2.0	2.5	1.0	0.5	–	4.5
Estonia	1.6	2.9	–0.8	0.6	–0.4	1.2	0.9
Croatia	–1.1	–0.4	0.3	1.0	1.3	–0.5	1.6
Latvia	3.0	2.4	0.5	1.2	0.9	0.0	2.7
Lithuania	3.5	3.0	0.7	0.4	0.5	0.5	1.6
Hungary	1.9	3.7	0.8	0.6	0.7	1.0	2.7
Poland	1.3	3.3	1.0	0.6	0.9	1.1	3.5
Romania	3.0	2.9	1.3	–0.2	1.5	1.1	3.6
Slovak R.	1.4	2.5	0.9	1.0	1.0	1.0	3.5
Slovenia	–1.1	3.0	0.7	0.7	0.4	–	2.5
Average[a]	1.3	2.5	0.8	0.7	0.7	0.7	2.7

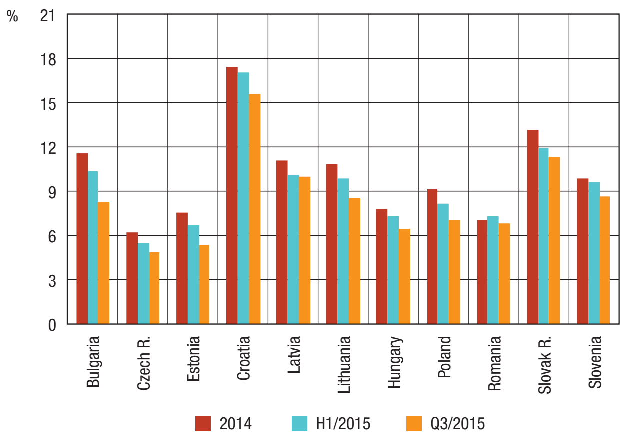
[a] Simple average.
Sources: Eurostat, EC, CBS and CNB.

Figure 10.1 Industrial production and goods exports
year-on-year rate of change, original data



Sources: Eurostat and CBS.

Figure 10.3 Labour Force Survey unemployment rate



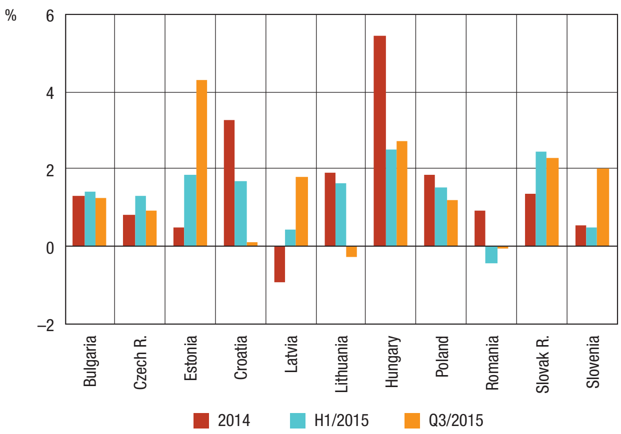
Source: Eurostat.

persons increased in all countries under review apart from Romania. The unemployment rate went down in all countries under review in the third quarter of 2015 from the same period a year before, except in Romania where it remained unchanged. In the countries under review, Croatia stood out again with the largest unemployment rate (15.6%), while most other countries boasted unemployment rates below 10% (except Slovakia).

The surplus in the current and capital accounts of CEE countries in the third quarter 2015 ranged between 1% and 9% of GDP (taking into account the cumulative value in the last four quarters), the greatest surplus being registered in Hungary and Slovenia (exceeding 7% of GDP). The greatest increase in surplus in the first three quarters of 2015 was recorded in Croatia, primarily due to the conversion of loans in Swiss franc and a very successful tourist season. In 2015, current and capital account balances considerably improved also in Hungary, Estonia and the Czech Republic, deteriorating only in Lithuania.

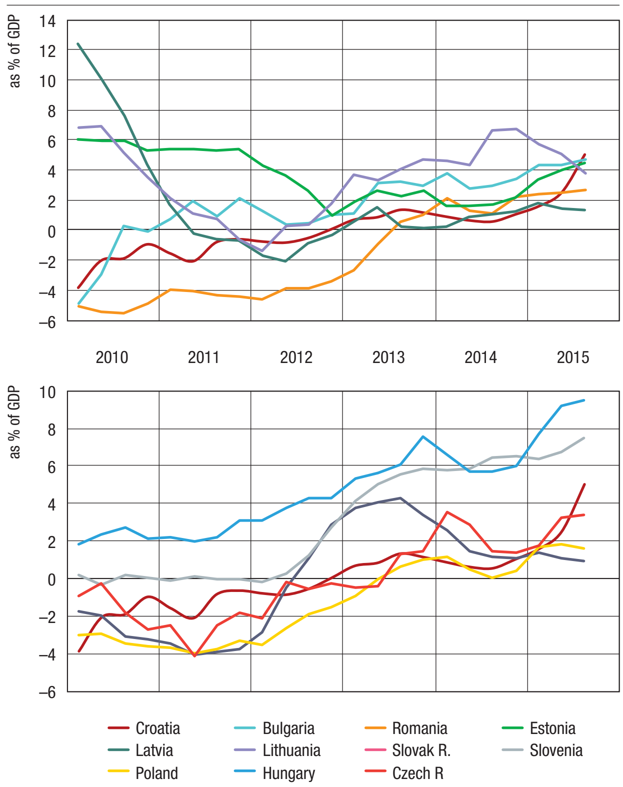
The growth of the exports of goods continued in the second half of the year in almost all CEE countries, although at a slightly slower pace than in the previous half of the year. The most sizeable growth in the second half of 2015 was observed in the Czech Republic and Lithuania, while the greatest slowdown was seen in Bulgaria and Estonia. At the level of the whole of 2015, Croatia boasted the greatest growth (exceeding 10%) for the second year in a row because EU membership facilitated trade in goods with other EU member states. Quite strong annual growth of exports was also seen in the Czech Republic, Poland and Hungary. By contrast, a fall in the exports of goods on an annual basis was registered only in the three Baltic countries, primarily as a consequence of the unfavourable economic situation in Russia, one of their most important trading partners and of the quotas that

Figure 10.2 Labour Force Survey employment rate
year-on-year rate of change



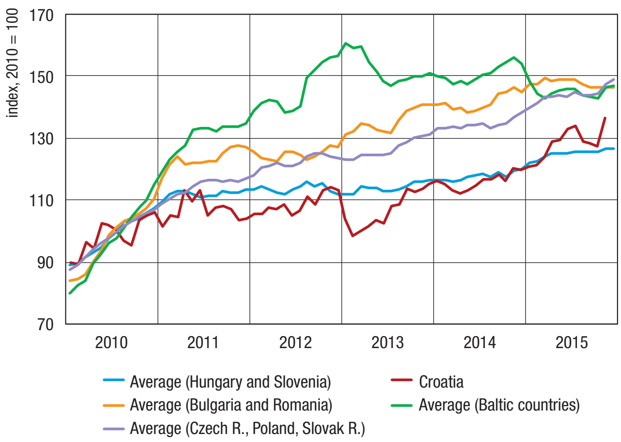
Source: Eurostat.

Figure 10.4 Current and capital account balance
sum of the last four quarters



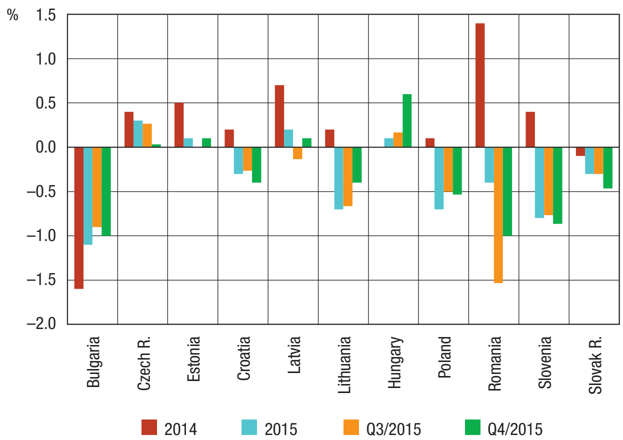
Sources: Eurostat and CNB.

Figure 10.5 Goods exports
quarterly moving average, seasonally adjusted data



Note: Data for Croatia in 2015 refer to the period from January to November.
Sources: Eurostat and CNB.

Figure 10.7 Consumer price inflation
average year-on-year rate of change



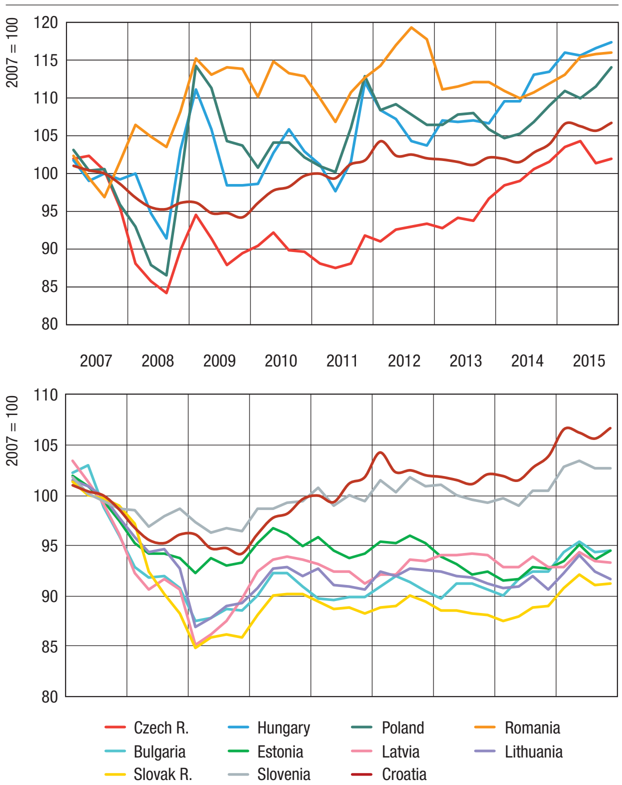
Source: Eurostat.

Russia imposed on the imports of certain agricultural products from the EU.

Export price competitiveness (measured in terms of the real effective exchange rate deflated by consumer prices) in the CEE countries deteriorated in the second half of the year from the second quarter of 2015 in the euro area countries and Bulgaria and improved in Poland, Hungary, Romania and Croatia. The depreciation of real effective exchange rates in Poland was predominantly caused by the nominal effective depreciation of the zloty, while the improvement in the price competitiveness in Hungary, Croatia and especially Romania was primarily determined by favourable developments in domestic prices in comparison to their main trading partners.

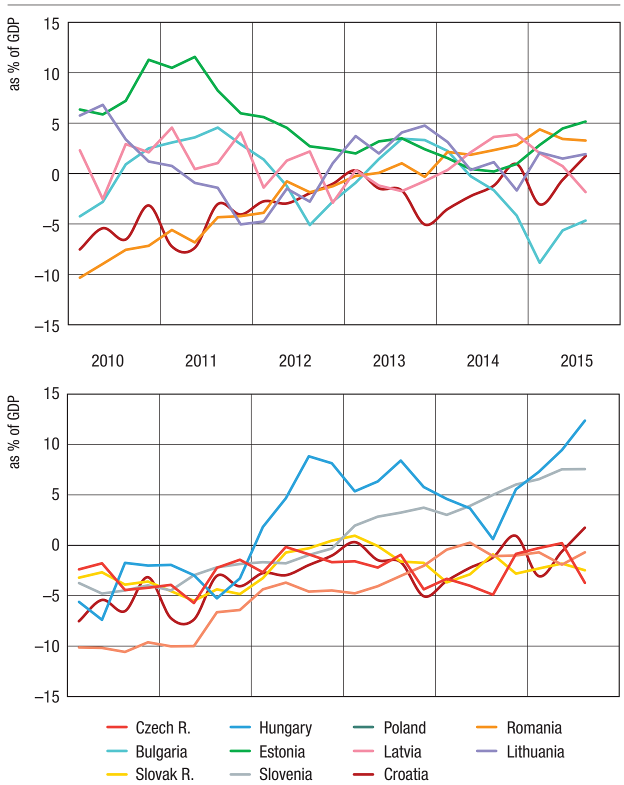
Consumer price inflation in the last quarter of 2015 remained negative in the majority of CEE countries, and only slightly positive in the others. This was to the greatest extent a consequence of the decline in the negative contribution of energy to overall inflation due to the base effect (greater decline in the fall of prices of petroleum products in the fourth quarter of the previous year). On the other hand, the annual inflation rate went

Figure 10.6 Real effective exchange rate (deflated by consumer prices) in selected countries



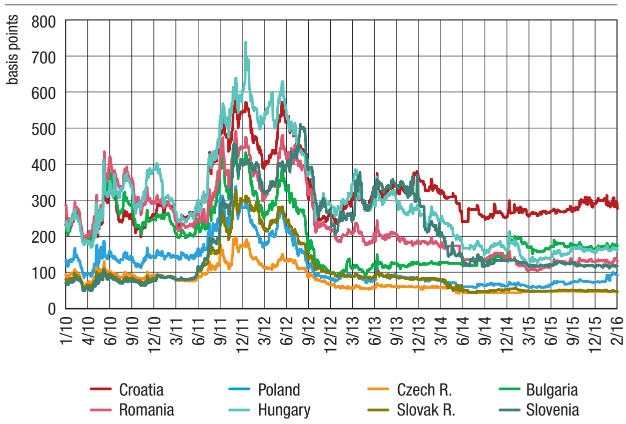
Note: A fall in the index denotes a real effective appreciation.
Sources: BIS and CNB calculations.

Figure 10.8 Balance of payments financial account balance, excluding the change in international reserves
sum of the last four quarters



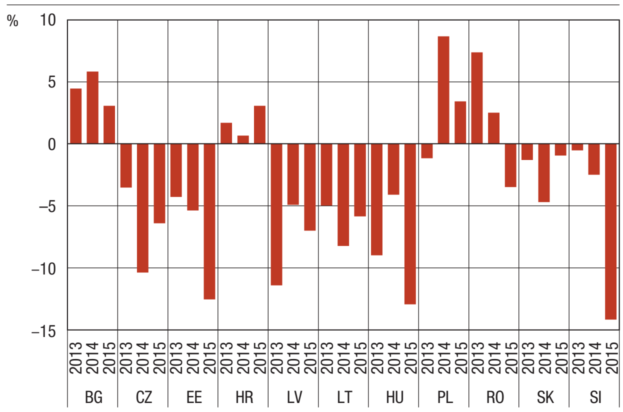
Sources: Eurostat and CNB.

Figure 10.9 CDS spreads for 5-year government bonds of selected countries



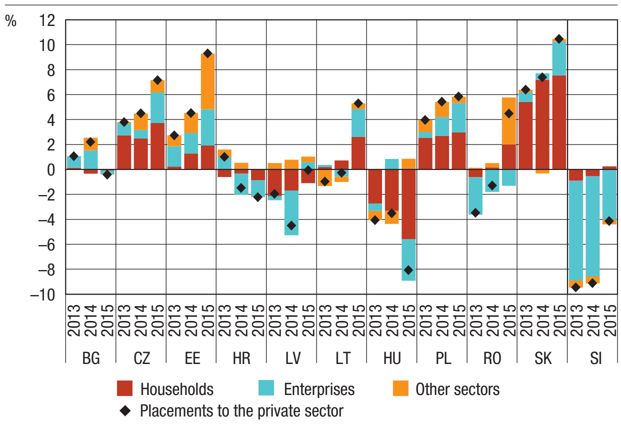
Note: Credit default swaps (CDS) spread is an annual premium that a CDS buyer pays for protection against credit risk associated with an issuer of an instrument.
Source: Bloomberg.

Figure 10.11 Private sector deposits
year-on-year rate of change, excluding the exchange rate effect



Sources: ECB and CNB.

Figure 10.10 Bank placements to the private sector
contribution to the year-on-year rate of change, excluding the exchange rate effect



Sources: ECB and CNB.

down the most in Slovakia and the Czech Republic (0.2 percentage points) in the last quarter of 2015, almost entirely due to the decline in the prices of food, while lower prices of services contributed the most to further slowdown of inflation in Croatia. At the level of the whole of 2015, the annual inflation rate continued declining in most countries except in Bulgaria and Hungary, where, in addition to the growth of food prices, the growth in the prices of services and industrial products, excluding energy, contributed to a slight acceleration of inflation.

Net capital outflow from CEE countries continued in the first three quarters of 2015, intensifying mildly compared with the previous year, predominantly due to deleveraging. Hungary boasted the largest capital outflows (if cumulative values in the balance in the financial account of the balance of payments are taken into account, excluding the change in international reserves) and sizeable capital outflows were recorded in Slovenia and Estonia. On the other hand, the greatest net capital inflow was recorded in Bulgaria and the Czech Republic. The total net FDI inflow in CEE countries decreased in the first ten months of 2015 from its already modest level to some 1% of GDP on average. Among the countries under review, the greatest net inflow of FDI was seen in Bulgaria, exceeding 4% of GDP. At the same time, changes in international reserves were uneven, Bulgaria and the Czech Republic boasting growth and Hungary registering a reduction.

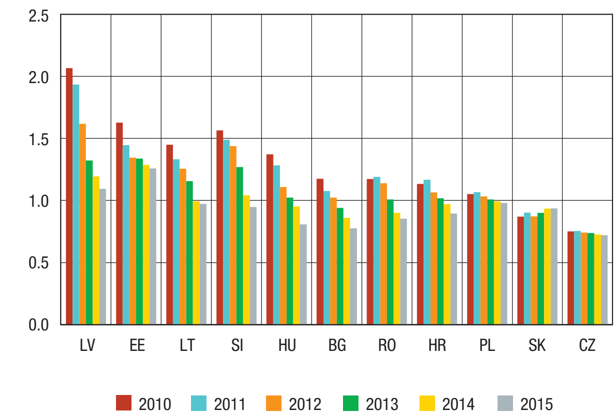
Relative gross external debt indicators improved in most CEE countries in the first three quarters of 2015. The ratio of gross external debt to GDP went down the most in Bulgaria (from 92.1% at the end of 2014 to 78.1%), primarily thanks to the deleveraging of other domestic sectors to affiliated creditors; additional deleveraging was also seen from credit institutions. External debt fell noticeably also in Romania and Hungary, for the most part owning to the deleveraging of the central government, followed by slightly weaker deleveraging of monetary institutions and other domestic sectors. At the same time, the reduction in Croatia's external debt was a consequence of the fall in the liabilities of its credit institutions. On the other hand, of all the countries under review external debt rose the most in Lithuania and the Czech Republic. A sharp growth in the central bank's short-term liabilities was seen in Lithuania, reaching almost one fifth of the overall gross external debt[5]. In contrast to most other countries, in which the foreign liabilities of credit institutions are declining or stagnating, in the Czech Republic foreign borrowing of banks contributed the most to the increase in the overall debt.

Credit default swaps for most CEE countries stabilised in the first two months of 2016. Only Poland registered a gradual rise in its credit default swaps since mid January (paired with its credit rating being downgraded by one agency). The credit default swap for Croatia remained the highest among the peer countries.

Credit activity in the observed countries continued to vary substantially in 2015, in terms of both dynamics and structure. As many countries recorded growth in total placements to the private sector in annual terms as decline. Slovakia, Estonia, the Czech Republic and Poland continued to lead the way in extending multi-year credit lines, predominantly as a result of a rise in household lending, with the exception of Estonia, where a noticeable rise was observed in placements to other financial

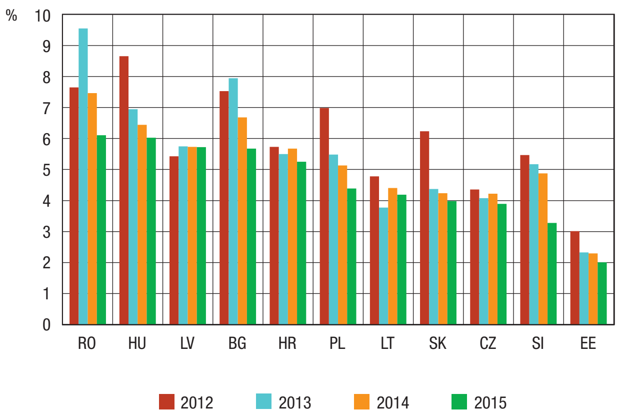
5 By introducing the euro in January 2015, Bank of Lithuania, became a member of the European System of Central Banks, with its balance sheet reconstructed to correspond to the methodologies of other euro area central banks. Therefore, the balance sheet data for 2015 are not comparable to the data from the previous years.

Figure 10.12 Placement to deposit ratio of the private sector



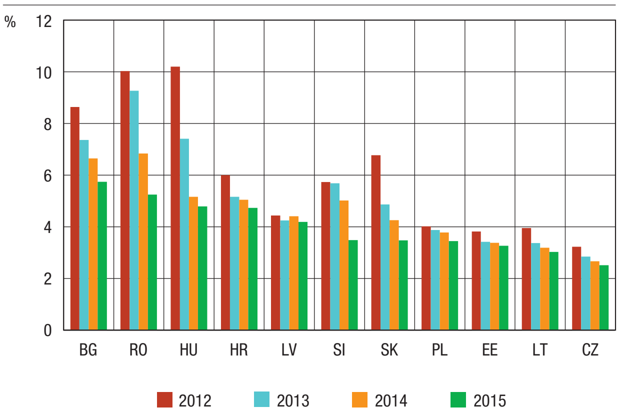
Sources: ECB and CNB.

Figure 10.14 Interest rates on home loans



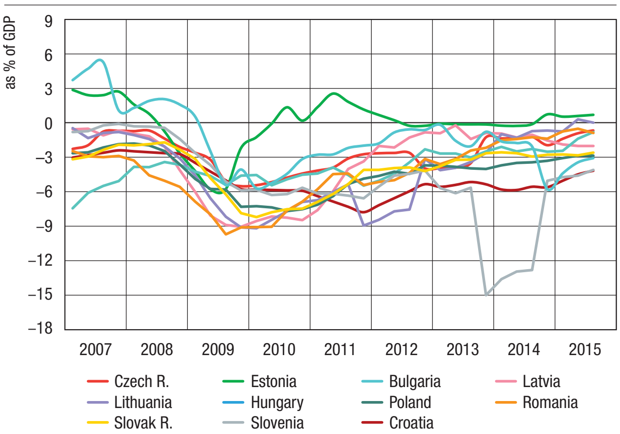
Sources: ECB and NCBs.

Figure 10.13 Short-term interest rates on corporate loans



Notes: Includes average interest rates on corporate loans up to EUR 1m and with a maturity of up to 1 year.
Source: ECB.

Figure 10.15 Consolidated general government balance
four-quarter moving sums



Note: Quarterly data for Croatia in the 2007–2012 period were obtained by linear interpolation of the annual data.
Sources: Eurostat and CNB.

institutions. The strongest decline in placements was observed in Hungary, largely as a consequence of the fall in household demand stemming from the conversion of a share of loans in foreign currency into the domestic currency at the exchange rate lower than that of the market. A noticeable decrease in placements in 2015 was also seen in Slovenia; however, corporate deleveraging slowed down substantially in comparison to the previous two years. After Hungary and Slovenia, Croatia saw the third greatest decline in domestic placements due to the fall in loans both to households and corporates alike.

In the majority of observed countries, savings and time deposits of the private sector dwindled, the most in Slovenia, Hungary and Estonia. On the other hand, moderate growth of savings and time deposits was seen only in Bulgaria and Poland. However, in all economies under review, including Croatia, there was a concurrent strong growth of funds in transaction accounts, which at the end of 2015 in some countries, like Romania, Hungary and Slovenia, amounted to over 20% at an annual level. The strong growth of more liquid financial assets may be linked to the decline in deposit interest rates, but also to the recovery in economic activity.

The placements to deposits ratios continued decreasing in 2015 in the majority of the observed countries, stagnating only in Slovakia and the Czech Republic. Such developments in this indicator reflect the growth of total deposits amid poor bank lending activity, especially in comparison to the pre-crisis period when completely opposite trends were observed. At the time, domestic placements in most countries were fully covered by domestic deposits, except in Latvia and Estonia, which had already before the crisis registered a much wider disproportion between lending and domestic sources of funds.

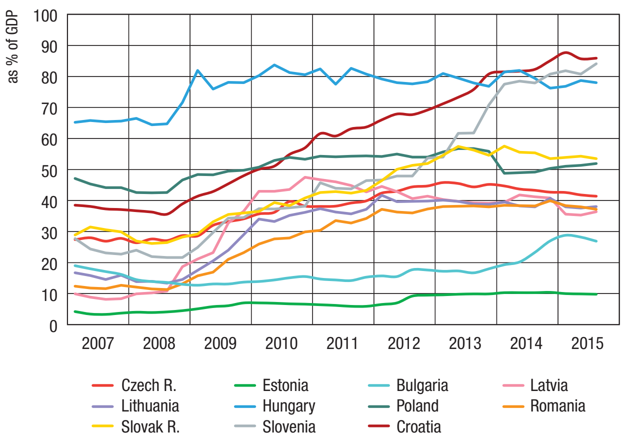
Short-term interest rates on corporate loans continued trending downwards in 2015 in all of the countries under review. The sharpest fall in interest rates was noticed in Romania, Slovenia, Bulgaria and Poland. Short-term interest rates for corporate financing in Croatia in 2015 remained slightly higher than the average of all countries.

Interest rates on home loans also went down in 2015 in almost all countries under review. Most favourable developments were seen in Slovenia, Romania and Poland, while Croatia remained positioned approximately in the middle of the interest rate band.

The majority of observed countries saw an improvement in the consolidated general government balance in the first nine months of 2015 in comparison with the same period in 2014. Favourable fiscal developments thus reflected adjustments both on the revenue and the expenditure side of the budget. Despite considerable fiscal consolidation, Croatia, next to Slovenia, stands out by the size of its fiscal deficit. In June this year the Excessive Deficit Procedure was suspended in Poland, and is now applied only in Croatia and Slovenia, out of the observed countries. However, the latest forecasts by the European Commission (the Winter 2016 European Economic Forecast) indicate that in 2015 Slovenia might have managed to decrease its deficit to slightly below the threshold of 3% of GDP.

General government debt went up the most over the period in Slovenia, while on the other hand it declined substantially in Latvia and followed a downward path in other Baltic countries and Romania and the Czech Republic as well. In Croatia, general government debt increased slightly in the first nine months of 2015. At the end of the third quarter 2015, Croatia continued to register the highest debt level among the peer countries, followed by Slovenia and Hungary. The levels reached in those countries are much above the average in other peer countries whose general government debt is at the same time below the benchmark level of 60% of GDP.

Figure 10.16 General government debt
end-quarter stock



Sources: Eurostat and CNB.

Abbreviations and symbols

Abbreviations

BIS – Bank for International Settlements
bn – billion
b.p. – basis points
BOP – balance of payments
c.i.f. – cost, insurance and freight
CBRD – Croatian Bank for Reconstruction and Development
CBS – Central Bureau of Statistics
CCI – consumer confidence index
CDCC – Central Depository and Clearing Company Inc.
CDS – credit default swap
CEE – Central and Eastern European
CEFTA – Central European Free Trade Agreement
CEI – consumer expectations index
CES – Croatian Employment Service
CM – Croatian Motorways
CIHI – Croatian Institute for Health Insurance
CLVPS – Croatian Large Value Payment System
CNB – Croatian National Bank
CPF – Croatian Privatisation Fund
CPI – consumer price index
CPIA – Croatian Pension Insurance Administration
CR – Croatian Roads
CSI – consumer sentiment index
DAB – State Agency for Deposit Insurance and Bank Resolution
dep. – deposit
DVP – delivery versus payment
EC – European Commission
ECB – European Central Bank
EFTA – European Free Trade Association
EMU – Economic and Monetary Union
ESI – economic sentiment index
EU – European Union
excl. – excluding
f/c – foreign currency
FDI – foreign direct investment
Fed – Federal Reserve System
FINA – Financial Agency
f.o.b. – free on board
GDP – gross domestic product
GVA – gross value added
HANFA – Croatian Financial Services Supervisory Agency
HICP – harmonised index of consumer prices
ILO – International Labour Organization
IMF – International Monetary Fund
incl. – including
IPO – initial public offering
m – million
MIGs – main industrial groupings
MM – monthly maturity
MoF – Ministry of Finance
NCA – National Classification of Activities
NCB – national central bank
NCS – National Clearing System
n.e.c. – not elsewhere classified
OECD – Organisation for Economic Co-Operation and Development
OG – Official Gazette
R – Republic
o/w – of which
PPI – producer price index
RTGS – Real-Time Gross Settlement
Q – quarterly
RR – reserve requirement
SDR – special drawing rights
SITC – Standard International Trade Classification
VAT – value added tax
WTO – World Trade Organization
ZMM – Zagreb Money Market
ZSE – Zagreb Stock Exchange

Three-letter currency codes

ATS – Austrian schilling
CHF – Swiss franc
CNY – Yuan Renminbi
DEM – German mark
EUR – euro
FRF – French franc
GBP – pound sterling
HRK – Croatian kuna
ITL – Italian lira
JPY – Japanese yen
USD – US dollar

Two-letter country codes

BG – Bulgaria
CZ – Czech R.
EE – Estonia
HR – Croatia
HU – Hungary
LV – Latvia
LT – Lithuania
PL – Poland
RO – Romania
SK – Slovak R.
SI – Slovenia

Symbols

– – no entry
.... – data not available
0 – value is less than 0.5 of the unit of measure being used
∅ – average
a, b, c,... – indicates a note beneath the table and figure
* – corrected data
( ) – incomplete or insufficiently verified data