Information on economic trends

October 2016

1 Summary

In the second quarter of 2016, economic activity grew at a rate similar to that at the beginning of the year, with the real GDP rising by 2.8% on an annual level, a much better result than previously expected. The data available for the third quarter point to further GDP growth, largely associated with good results in tourism, which could, on an entire year level, accelerate real GDP growth to levels higher than projected in July. Domestic inflation remained in negative territory in the conditions of low prices for energy and other raw materials and subdued inflation in the euro area. The surplus in the current and capital account rose in the second quarter, driven by increased use of EU funds and growth in exports of tourist services. In the public finance area, the fiscal deficit was reduced considerably owing to the favourable dynamics of revenues and restriction in expenditure growth. The expansionary orientation of the monetary policy was further boosted by structural repo operations which encourage increased kuna lending and the maintenance of favourable conditions of domestic financing. By pursuing such a 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.

The second quarter witnessed a small slowdown in global growth, with a diminished volume of world trade and rising insecurity.

Global economic growth in the second quarter of 2016 was mostly driven by developing countries and emerging market countries, while the slowdown in the Chinese economy was compensated for by crisis alleviation in Russia and Brazil. By contrast, the economies of developed countries grew slower than expected. This is particularly true of the USA, and, to a lesser extent, the euro area. The UK vote towards end-June to leave the European Union led to temporary volatility in the financial markets, but according to the first indicators, it did not have a significant impact on economic activity. Inflation on the global level remained subdued, despite rising prices of oil and other raw materials. The monetary policy in the USA and in the euro area remained unchanged, and the exchange rate of the euro appreciated slightly against the American dollar and most other major global currencies.

In 2016, real domestic GDP growth might be faster than previously expected primarily due to fast economic growth in the second quarter and favourable developments at the beginning of the third quarter.

Real GDP growth in 2016 will likely be faster than the 2.3% projected in July. The upward revision of the projection is the result of better outturns in the second quarter of this year than expected, with growth in gross fixed capital formation and government consumption exceeding earlier expectations the most. By contrast, goods and services exports slowed down considerably on an annual level, while personal consumption and goods and services imports rose in accordance with the previous expectations. Real GDP thus grew by 2.8% on an annual level in the second quarter and on a quarterly level, economic activity continued to accelerate at a rate similar to that in the first three months of this year (0.5% on a quarterly level). Positive developments are expected to continue until the end of the year, and the CNB's nowcasting model, assessed by using incomplete data, suggests that economic activity in the third quarter might see a fast quarterly acceleration as a result of an extremely good tourist season. However, the annual growth rate of the real GDP might be somewhat slower than in the second quarter owing to a very strong acceleration in economic activity in the third quarter of the previous year.

Favourable developments in the labour market continued in the second quarter of 2016.

In the second quarter of 2016, employment continued to rise, primarily due to the increased number of persons employed in other service activities of the private sector and in trade. Unemployment continued to trend downwards, but for the first time since end-2014, outflows due to other reasons (primarily removal from the register) were dominant if compared to employment. At the same time, the growth in nominal and real wages slowed down, with the growth in real wages being faster due to a simultaneous fall in consumer prices.

The annual fall in consumer prices accelerated in the first eight months from –0.6% in December 2015 to –1.5% in August 2016.

The biggest contribution to acceleration in the annual fall in consumer prices was made by a reduction in the rate of change in the CPI, excluding food and energy, mostly influenced by the prices of clothing, footwear, telephone services and tobacco. By contrast, energy, as the component which makes the biggest negative contribution to annual inflation, rose from –0.9 percentage points in December 2015 to –1.2 percentage points in August, fully attributable to a reduction in natural gas prices. The negative contribution of food to inflation also rose, mostly driven by acceleration in the annual fall in the prices of fruit and vegetables, milk and non-alcoholic beverages. This was largely the result of the spillover of globally lower food raw material prices onto domestic prices and a fall in prices due to surpluses in the EU market.

Increased use of EU funds and growth of services exports in tourism are the main contributors to the surplus in the current and capital account of the balance of payments.

The annual growth in the current and capital account surplus in the second quarter of 2016 was mostly spurred by increased use of EU funds (of both a current and a capital nature) and increased net exports of services provided in tourism. In contrast, developments in foreign trade had an unfavourable effect on the current account balance due to higher growth in imports than in exports. If cumulative values over the past year are observed, the surplus in the current and capital account in mid-2016 stood at 5.4%

of GDP, which is, if the effect of banks' costs associated with the conversion of loans in Swiss francs (estimated at approximately 2% of GDP) is excluded, only slightly below its level in the same period of the previous year.

Financing conditions of the domestic sectors continued to improve which contributed to a slowdown in the speed of deleveraging of non-financial corporations and households.

The financing conditions of the domestic sectors continued to improve in July and August, again helped by the high level of liquidity in the domestic and international financial markets. Household lending rose in the second quarter of 2016 and so did the total debt of non-financial corporations, which contributed to a slowdown in deleveraging, still seen in both sectors on an annual level. Increased borrowing of private enterprises from domestic credit institutions as well as other domestic financing, contributed to this. By contrast, corporations have been deleveraging abroad.

Net capital outflow was again largely the result of improvement in the net external position of banks.

In the second quarter of 2016, the net capital outflows held steady at a level similar to that in the same period of 2015. This is the result of further deleveraging of the domestic sectors, particularly credit institutions. Net inflows from equity investment which took place during the same period were largely determined by the increase in the retained earnings of the banks. The stock of net and gross external debt at the end of June 2016 accounted for 49.0% and 97.3%, respectively, of GDP, a decrease of 3.5 and 6.3, respectively, percentage points from the end of the previous year.

The CNB continues to pursue an expansionary monetary policy and to maintain the stability of the exchange rate.

In the first nine months of 2016, the CNB held three structural repo auctions, placing a total of HRK 945.9m for a four year term, thus ensuring the banks access to long-term sources of kuna liquidity. This helps keep low domestic interest rates and supports the trend of increased kuna lending by banks which accelerated in 2016. In addition to keeping high liquidity, towards the end of the third quarter, the CNB used a foreign exchange intervention and regular weekly reverse repo operations to alleviate appreciation pressures on the exchange rate of the kuna against the euro.

Available data indicate a strong fiscal consolidation in the first half of 2016.

The available fiscal data point to a sharp fall in the deficit in the first half of 2016, from the same period of the previous year. Such developments were the result of more favourable developments in revenues, which in turn mainly reflect recovery in economic activity and restrictions of the growth on the expenditure side of the budget. It appears that the beginning of the second half of the year was marked by a rising central government deficit at an annual level, but this is partly the result of value added tax payments into the government budget being later. The debt of the consolidated general government stood at HRK 285.7bn at the end of June which is, as a result of exchange rate differences and use of government deposits with the CNB, a fall of HRK 3.9bn from the debt stock at the end of 2015.

2 Global developments

Global developments in the second quarter of 2016 were marked by continued global growth, a decline in the volume of world trade and heightened uncertainty and volatility in the financial markets. The economies of developed countries grew below expectations, in particular the US economy, which in the second quarter recorded the lowest growth in the past two years, i.e. mostly due to a considerable weakening in private sector investment and a decline in exports. Economic growth in the euro area also slowed down moderately, and the UK vote at the end of June to leave the EU increased the uncertainty among investors and exporters. However, the indicators of economic activity in the UK in the first months following the referendum were relatively positive, which mitigated the originally very negative expectations. In developing and emerging market countries, the expected dynamics of growth was maintained during the first half of 2016; a continued slowdown in the Chinese economy was offset by easing of the crisis in Russia and Brazil. Inflation remained subdued at a global level, despite the increase in the prices of oil and other raw materials.

The intensity of economic growth in the euro area slowed down slightly in the second quarter of 2016 (after 0.5% in the first quarter, a growth of 0.3% was achieved), despite the still low prices of energy and stimulative monetary policy. This reflects the stagnation in individual large markets, such as Italy, France and Austria, in which personal consumption and investment weakened. Existing structural problems make economic recovery in Italy very difficult, as do rising political uncertainty and high levels of domestic sectors' debts. In the case of Austria, judging by the latest indicators, stagnation was brief and its economy should soon rebound to growth at a stable pace.

On the other hand, Germany continued to record solid growth, while Spain stood out with positive developments, primarily in tourism and in the labour market. The German economy continued to grow above the euro area average (in the second quarter, growth stood at 0.4% relative to the previous three months). In addition to stable personal consumption, exports made the largest contribution to economic recovery, i.e. mostly exports to other euro area members, which partially offset the weak demand from the global market. The indicators of business environment in Germany remained positive in recent months, despite uncertainty concerning the effects of Brexit and other external factors. The Slovenian economy also continued to recover. Overall, it seems that stable domestic demand in euro area member countries still manages to offset weak foreign demand, and the available indicators for the third quarter suggest that such a trend could be maintained in the forthcoming period.

Interest rate trends

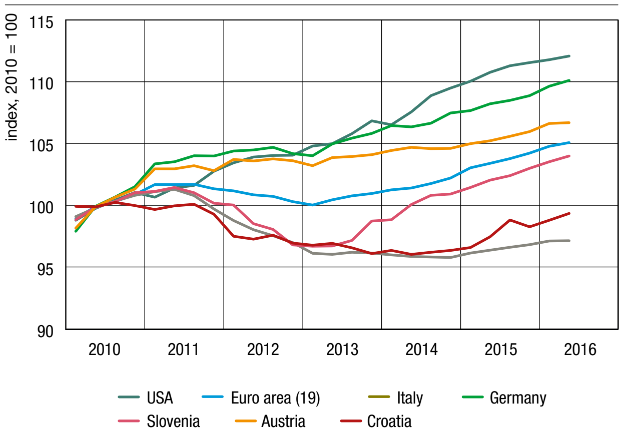
Monetary policies in the US and the euro area remained unchanged. Thus the planned tightening of monetary policy in the US was not realised during the first nine months of the current year because of weaker economic indicators and high global risks as well as uncertainty in the financial markets. There were no additional changes in the ECB policy after the benchmark interest rate was cut to zero in March (in addition to reductions of the marginal interest rate and the interest rate on bank deposits by 5 and 10 basis points respectively). The implementation of the ECB's March decision to increase the monthly amount of the bond purchase programme in the secondary market from EUR 60bn to EUR 80bn and to expand the list of securities to include corporate bonds started in April and according to announcements it will remain in force at least until the end of the first quarter of 2017.

Financing conditions for European emerging market countries improved constantly over the past months. In the first half of the year, the yield spread based on the EMBI index for European emerging market countries was at the level of about 190 basis points, dropping to approximately140 basis points by the end of September. In addition, the continued fall in the EURIBOR indicates an improvement in financing conditions in the interbank market.

Exchange rates and price movements

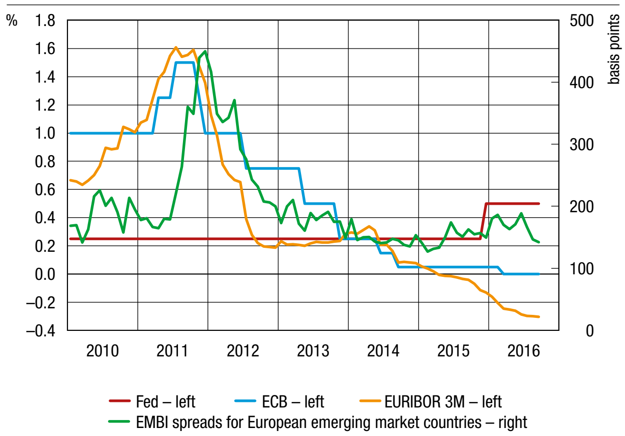
Divergent movements of the euro with respect to important world currencies were recorded in the third quarter of 2016. The euro strengthened slightly against the US dollar, after it had weakened in the first half of the year. This was, among other things, the result of expectations of market participants that the Fed could

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



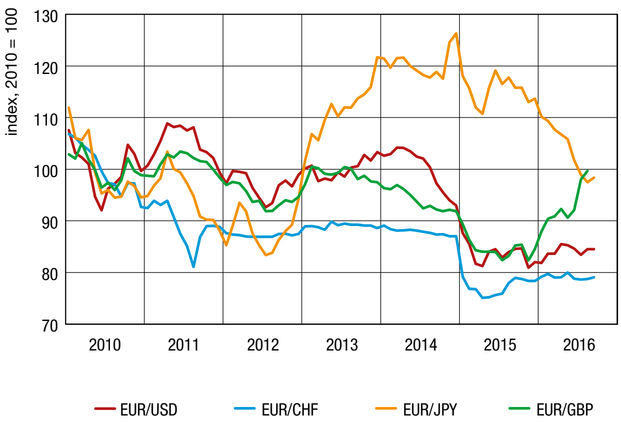
Sources: Eurostat, BEA and CNB.

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



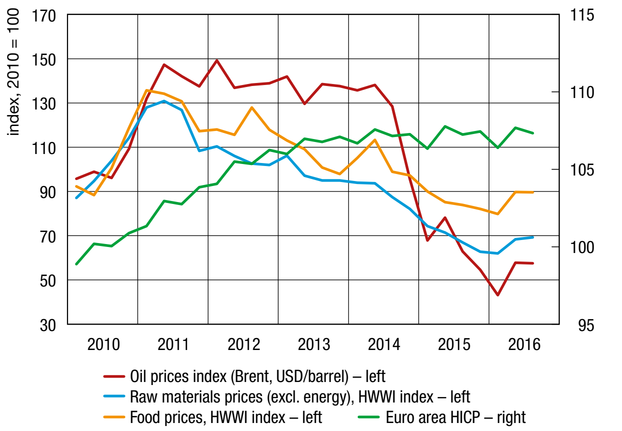
Note: Data up to 26 September 2016.
Source: Bloomberg, 26 September 2016.

Figure 2.3 Exchange rates of individual currencies against the euro



Note: A growth in the index denotes a depreciation of a currency against the euro.
Source: Eurostat.

Figure 2.4 Prices



Note: Data on the euro area HICP inflation rate in the third quarter of 2016 refer to July and August.
Sources: Eurostat, Bloomberg and HWWI.

again postpone the increase in the key interest rate due to weaker than expected US economic indicators. At the same time, increased uncertainty following the UK referendum on EU membership resulted in a sharp fall in the value of the pound sterling against the euro. On the other hand, the rise in risk aversion had an effect on the further strengthening of the Japanese currency against the euro in the global foreign exchange market.

The price of crude oil stabilised in the third quarter of 2016, following its growth in the first half of the year. This was attributed to lower than expected demand for petrol in the US, high inventories of processed petroleum products and the increase in supply from OPEC Member Countries and Russia. The price of Brent crude oil on average stood at USD 45.8 per barrel in the third quarter of 2016, which was about 9% lower than in the same period of the previous year.

The increase in raw material prices (excluding energy) recorded in the second quarter of 2016 continued in the following three months, albeit at a slower pace. This was mostly due to the increase in agricultural raw material prices, primarily textile because of the weaker than expected cotton harvest in India. Metal prices also grew on the back of better prospects in manufacturing in China and partly because of favourable trends in the Chinese real estate market. Raw material prices (excluding energy, in USD) were 3.4% higher in the third quarter of 2016 than in the same period of 2015.

3 Aggregate demand and supply

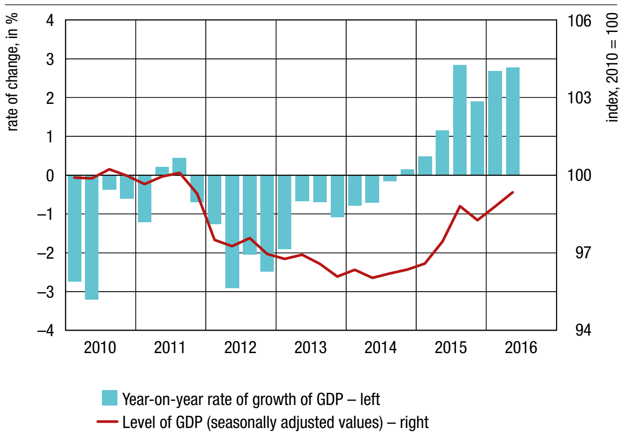
In the second quarter of 2016, real GDP continued to grow at a rate similar to that of the first quarter (on a quarterly basis it grew by 0.5% and on an annual basis by 2.8%). Economic trends in the second quarter of 2016 were marked by a continuation of recovery in domestic demand, with a significant growth of gross fixed capital formation (6.3%). On the supply side, gross value added grew by 2.5% on an annual basis, primarily because of a continuation of favourable developments in manufacturing, wholesale and retail trade, transportation and storage. Positive developments are expected to continue until the end of the year. Available monthly data suggest that economic activity might have a high quarterly increase in the third quarter as a result of a very good tourist season. Thus, at the level of the whole year real GDP might grow more than expected in the July projection (2.3%).

Aggregate demand

Real exports of goods and services declined at the beginning of the year, but increased slightly in the second quarter, reflecting favourable trends in goods exports. However, although total exports, primarily of goods, again contributed significantly to the increase in economic activity, a slowdown in its growth at an annual level is evident (4.1% after the annual growth of 7.1% in the first quarter). Nominal data on trade in goods broken down by the main industrial groupings show that, on a quarterly basis, exports of energy increased the most, and exports of capital goods also grew, with a slight increase in exports of durable goods.

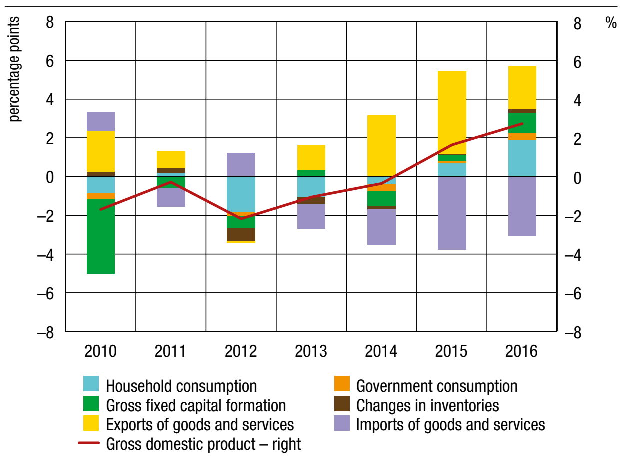
In the second quarter of 2016, personal consumption continued to grow for the sixth consecutive quarter, and the growth was a relatively high 3.0% at an annual level. Such developments

Figure 3.1 Gross domestic product
real values



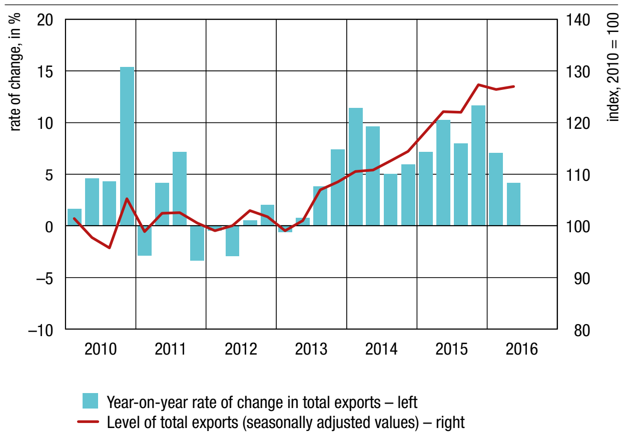
Source: CBS data seasonally adjusted by the CNB.

Figure 3.2 Change in GDP
contribution by components



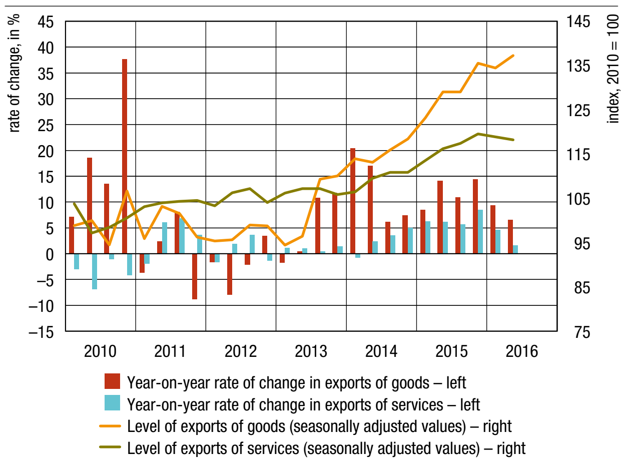
Note: Data for 2016 refer to the first half of 2016.
Source: CBS.

Figure 3.3 Exports of goods and services
real values



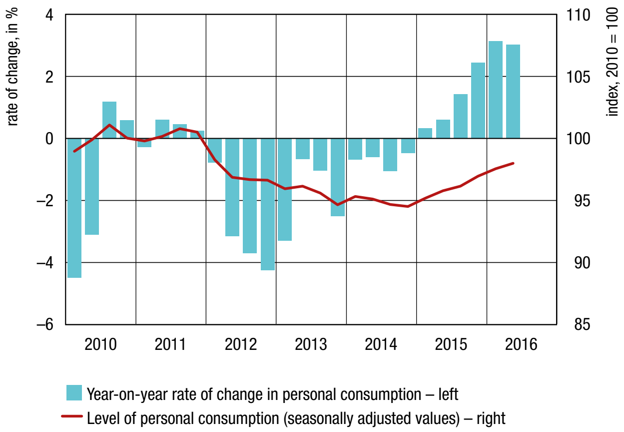
Source: CBS data seasonally adjusted by the CNB.

Figure 3.4 Real exports of goods and services



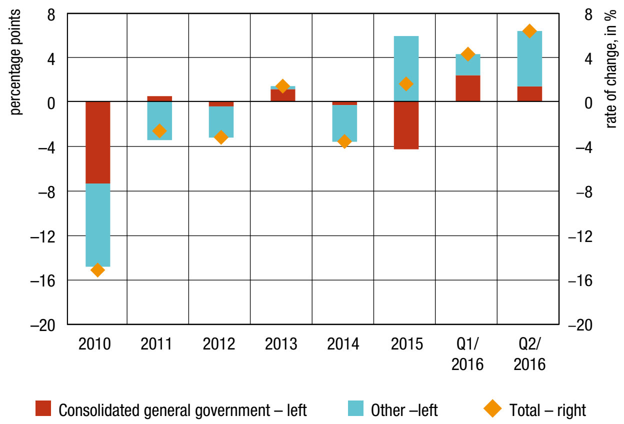
Source: CBS data seasonally adjusted by the CNB.

Figure 3.5 Personal consumption
real values



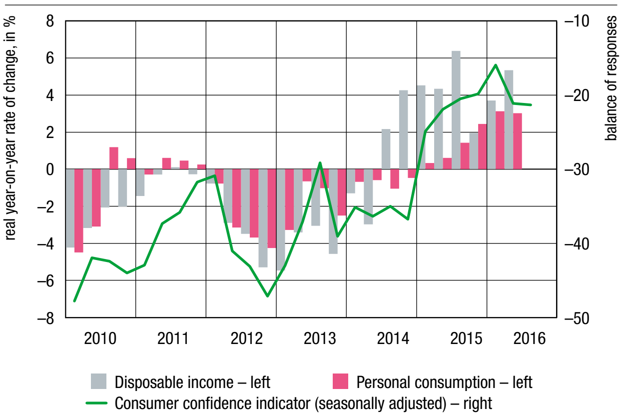
Source: CBS data seasonally adjusted by the CNB.

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



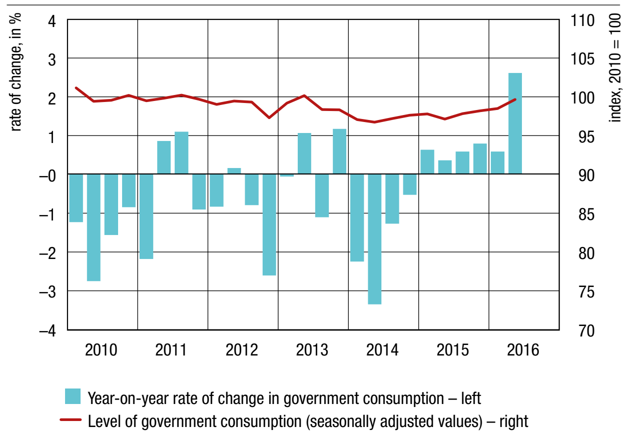
Note: Sector contributions are the CNB's estimate. Real values are obtained by deflating nominal values with the deflator of gross fixed capital formation.
Sources: CBS and CNB calculations.

Figure 3.6 Determinants of personal consumption
real values and index



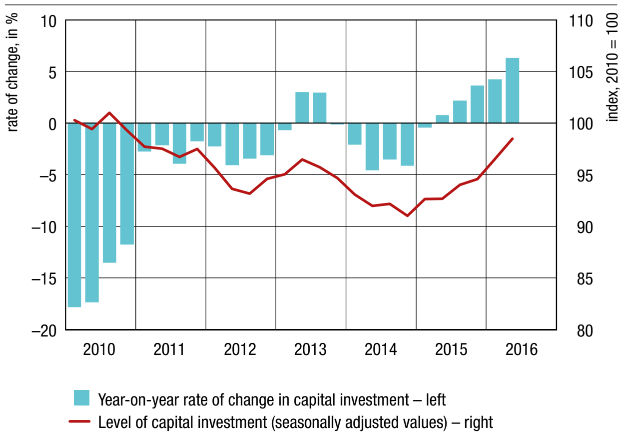
Note: The values of the consumer confidence indicator in a month are calculated as three-member averages of monthly data. The most recent data available for the calculation of consumer confidence refers to September 2016.
Sources: CBS, Ipsos data seasonally adjusted by the CNB and CNB.

Figure 3.9 Government consumption
real values



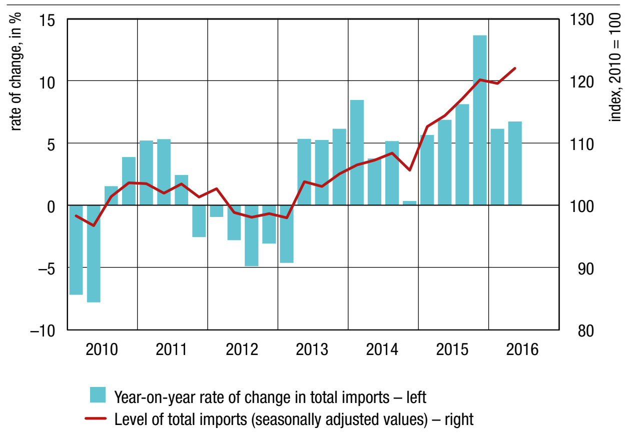
Source: CBS data seasonally adjusted by the CNB.

Figure 3.7 Gross fixed capital formation
real values



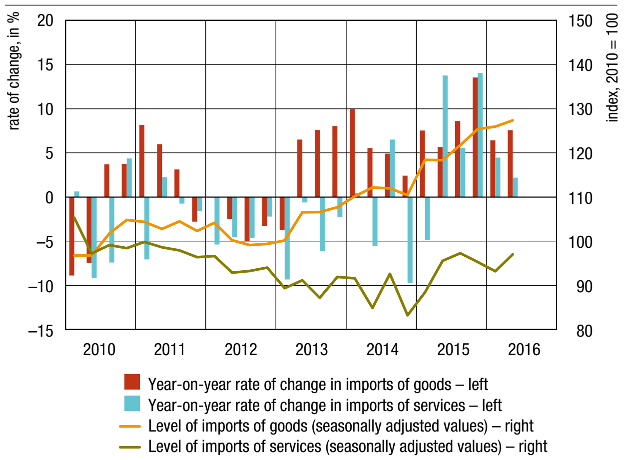
Source: CBS data seasonally adjusted by the CNB.

Figure 3.10 Imports of goods and services
real values



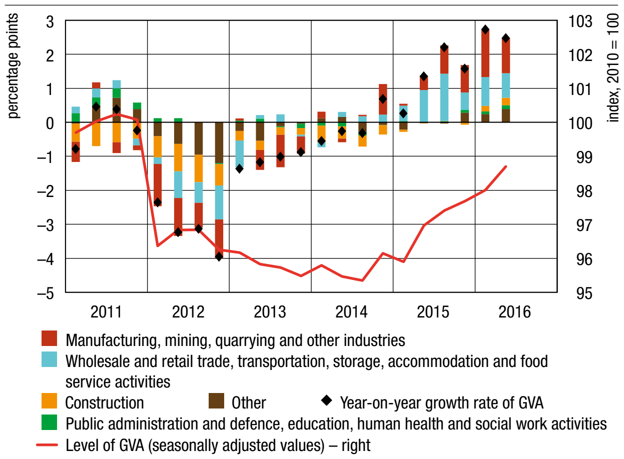
Source: CBS data seasonally adjusted by the CNB.

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.

reflect the continuation of recovery in the labour market, the decrease in the prices of energy and food as well as the levels of confidence, which remained relatively high despite a slight fall.

Gross fixed capital formation increased by 2.0% from the previous three months, while growth of as much as 6.3% was recorded at an annual level (the highest annual growth rate since 2008). Such developments were mostly the result of favourable movements in the private sector, as suggested by monthly indicators on construction works on buildings, as well as production and imports of capital goods. In addition, the government's investment activity probably increased.

The growth of real government consumption intensified additionally in the second quarter of 2016, increasing by 1.2% from the previous three months. At an annual level, growth stood at 2.6%. Nominal data on government expenditures suggest that the increase in government consumption was primarily related to an increase in social benefits in kind, but also to the more extensive use of goods and services and the rise in compensations to employees.

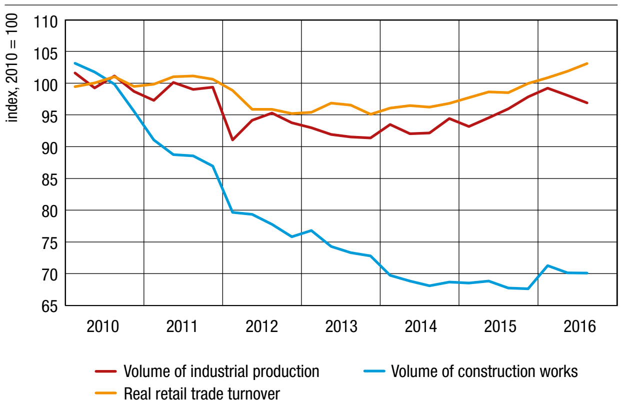
Imports of goods and services increased in the second quarter after a slight decrease in the first three months of the year. Total imports increased by 6.7% annually, primarily because of the growth of goods imports. Nominal data on trade in goods show that imports grew in all main industrial groupings, excluding energy, in the second quarter of 2016, relative to the same period in 2015. Imports of services also increased in the second quarter of 2016, with imports of other services and tourist services increasing the most.

Aggregate supply

Gross value added increased by 2.5% in the second quarter from the same period in 2015. Such developments were mostly the result of favourable movements in industry, in particular manufacturing, which grew the most. In addition to industry, a noticeable contribution to GVA growth came from trade, transportation and tourism, which can be associated with continued increase in household purchasing power as well as favourable developments in tourism. All other activities grew within the observed period, thus making a positive contribution to the development of gross value added at the level of the entire economy.

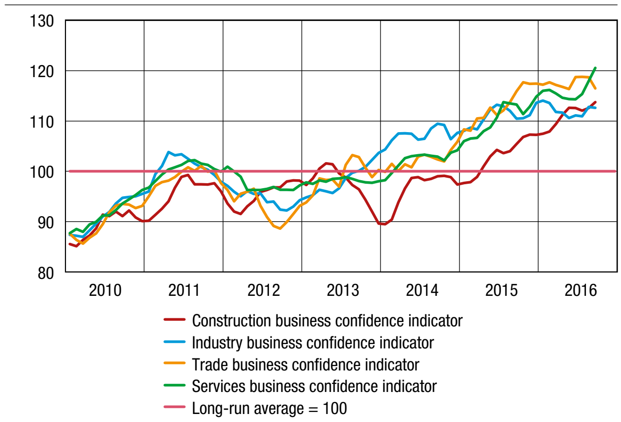
Short-term indicators of economic activity point to the continuation of relatively favourable economic movements in the third quarter of the year. In July and August 2016, real retail trade

Figure 3.13 Short-term economic indicators
seasonally adjusted values



Note: Quarterly data are calculated as an average of monthly data. Data on construction in the third quarter of 2016 refer to July, while data on industrial production and retail trade refer to July and August.
Source: CBS data seasonally adjusted by the CNB.

Figure 3.14 Business confidence indicators
standardised and seasonally adjusted values, three-member moving averages



Sources: Ipsos and CNB data seasonally adjusted.

turnover was 1.2% higher than the average in the previous three months. In addition, data on tourist arrivals and nights suggest a very good peak tourist season. On the other hand, in July 2016 construction stagnated at the level of the previous quarter, while industrial production declined in July and August, mostly because of the fall in the production of intermediate and capital goods. Nevertheless, the annual real GDP growth rate might be somewhat lower than in the second quarter because of the very strong acceleration of economic activity in the third quarter of 2015.

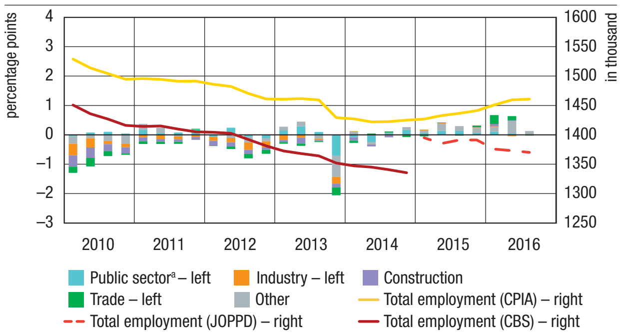
Data on business expectations reveal a continuation of the upward trend, with the business confidence indicator at the pre-crisis level in all activities. Thus, in the third quarter of 2016 construction business confidence continued to grow, while in industry it improved after a fall recorded in the first half of the year. Services business confidence also grew, primarily because of the business climate in the past three months, which companies believe to have improved, but also because of the increased demand in the same period. With regard to expectations in trade, business confidence worsened in September, but the average of the third quarter was slightly higher than in the previous three months.

4 Labour market

Favourable trends in the labour market marked the second quarter of 2016. According to the CPIA data, there was a 0.6% increase in the number of employed persons in the second quarter from the previous quarter, mostly contributed to by other service activities of the private sector and trade, the contribution of other activities being negligible. The beginning of the third quarter was marked by stagnation in employment, but there was accelerated growth again in August under the impact of favourable movements in industry and the continuation of the increase in the number of employed persons in the public sector (Figure 4.1).[1]

In addition to a continued increase in the number of employed persons, the second quarter of 2016 was marked by a further decrease in unemployment, which was 6% lower than in the previous quarter. This decrease was to quite a large extent determined by what are called other reasons, primarily removal from the register because of non-compliance with the legal provisions, cancellations and failure to report regularly, and to a lesser extent for employment on work contract basis and other business activities. The declining trend in the number of unemployed persons slowed down in July and August (–3.1% from the previous quarter), with outflows from the register for other reasons still prevailing (Figure 4.2).

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

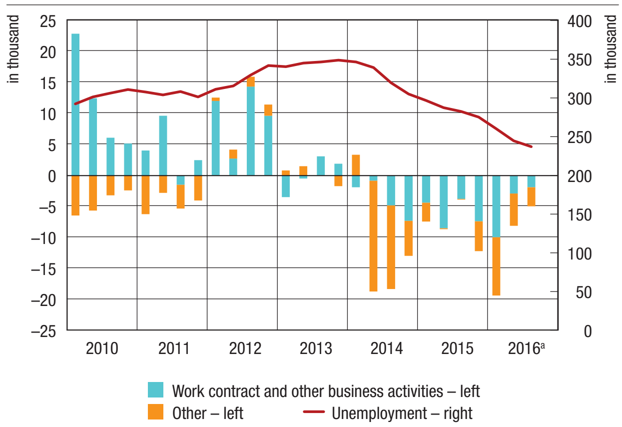


[a] Public administration and defence, compulsory social security, education and human health and social work activities.
Note: Around 20,000 insured persons were removed from the CPIA register due to administrative reasons in October 2013. The JOPPD form is now the source of data on employed persons and wages due to changes in the CBS methodology for collection and processing of data on employed persons and wages in effect as of January 2015. Structural columns show contributions by sector in accordance with CPIA data. Data for the third quarter of 2016 refer to July and August.
Sources: CBS and CPIA data seasonally adjusted by the CNB.

1 The CNB uses CPIA data to assess employment trends. Administrative CBS data on the number of employed persons collected on the basis of the JOPPD form point to negative employment trends in the first eight months of 2016.

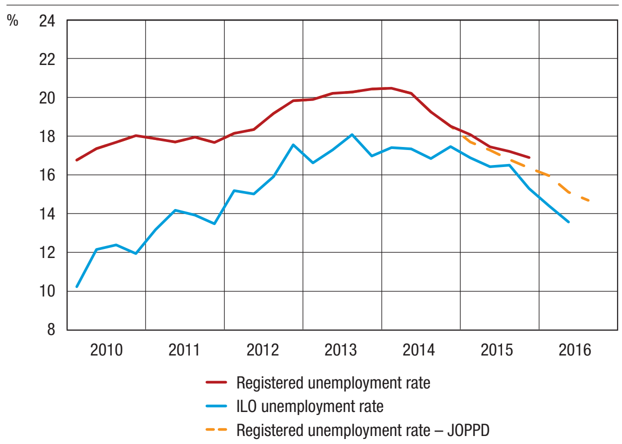
In view of the above decrease in the number of unemployed persons, the administrative unemployment rate continued to decline, and in the second quarter stood at 15.1% (down from 16%

Figure 4.2 Total unemployment and net inflows from unemployment
seasonally adjusted series



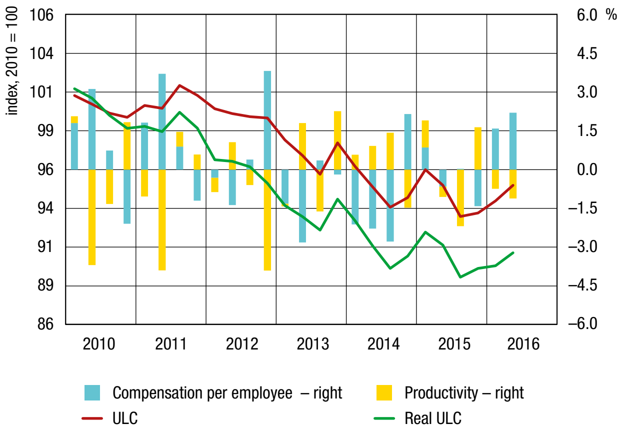
Note: Data for the third quarter of 2016 refer to July and August.
Source: CES data seasonally adjusted by the CNB.

Figure 4.3 Unemployment rates
seasonally adjusted series



Note: Data on the registered unemployment rate in the third quarter of 2016 refer to July and August.
Source: CBS data seasonally adjusted by the CNB.

Figure 4.4 Compensation per employee, productivity and unit labour costs
seasonally adjusted series, levels and quarterly rates of change



Note: Productivity growth carries a negative sign.
Sources: CBS and Eurostat data seasonally adjusted by the CNB.

in the previous quarter) and dropped to 14.6% in August, according to seasonally adjusted data (Figure 4.3). According to the latest available data from the Labour Force Survey, the internationally comparable ILO unemployment rate (seasonally adjusted data) fell to 13.6% in the second quarter of 2016 (from 14.4% in the first quarter).

With regard to labour costs, the quarterly increase in nominal and real wages slowed down in the second quarter of 2016. In the observed period, the average nominal gross wage grew by 0.4% based on the increase in average wages in service activities of the public and private sector. In the above period, real wages grew (0.6%) more than their nominal values because of the simultaneous decrease in consumer prices. In addition, the latest available data for July and August suggest a stagnation of the average nominal and real gross wage relative to the average of the previous three months.

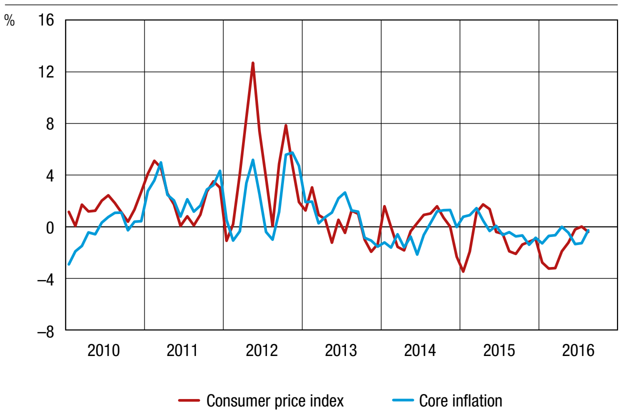
In the second quarter of 2016, the quarterly growth of the unit labour cost accelerated, starting early in 2016 (1.1% from 0.7%) because of a rise in employee compensation significantly sharper than the increase in labour productivity in the observed period (Figure 4.4).

5 Inflation

In August, consumer prices declined by 0.2% from the previous month, the largest contribution to the fall coming from a decline in the prices of refined petroleum products, footwear and fruit and vegetables. In contrast, the core consumer price index, which excludes, among other things, prices of energy and agricultural products, increased by 0.1%, mostly because of the increase in the prices of meat and milk. The annual overall inflation rate remained at the level of –1.5% in August, the same as that recorded in July, while the annual decline in core inflation slowed down by 0.1 percentage points, to –0.7%. In August, the indicators of current developments in inflation diverged: the core inflation indicator increased and moved closer to positive territory, and the indicator of current developments in overall inflation fell slightly.

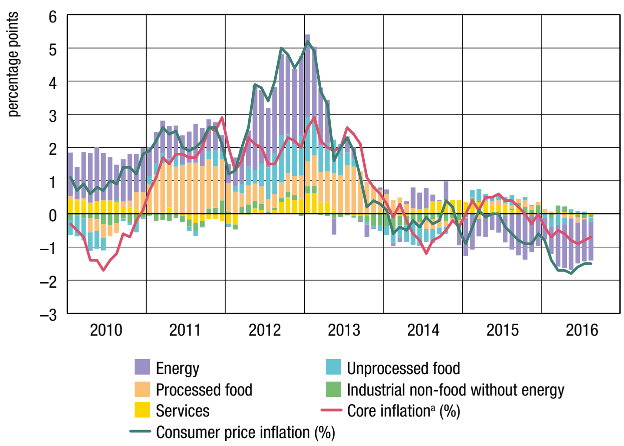
In conditions of relatively low prices of crude oil and other raw materials in the global market and low inflation in EU countries, the annual decline in consumer prices during the first eight months of 2016 accelerated from –0.6% in December 2015 to –1.5% in August 2016. On the other hand, developments in the domestic economic environment point to mild inflationary pressures if the moderate growth of personal consumption and a slight increase in unit labour costs are taken into consideration. The largest contribution to the acceleration of the annual decline in consumer prices was made by the decrease in the annual rate of change in the CPI, excluding food and energy, from 0.7% in December 2015 to –0.1% in August 2016, which was mostly affected by the prices of clothing and footwear, telephone services and tobacco. Energy is the component that made the largest negative contribution to annual inflation, which increased from –0.9 percentage points in December 2015 to –1.2 percentage points in August 2016, which was entirely the result of the decline in the

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



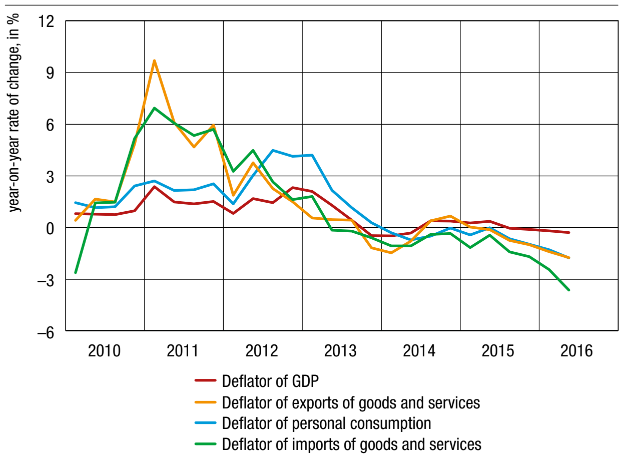
Note: The month-on-month rate of change is calculated from the quarterly moving average of seasonally adjusted consumer price indices.
Sources: CBS and CNB calculations.

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.

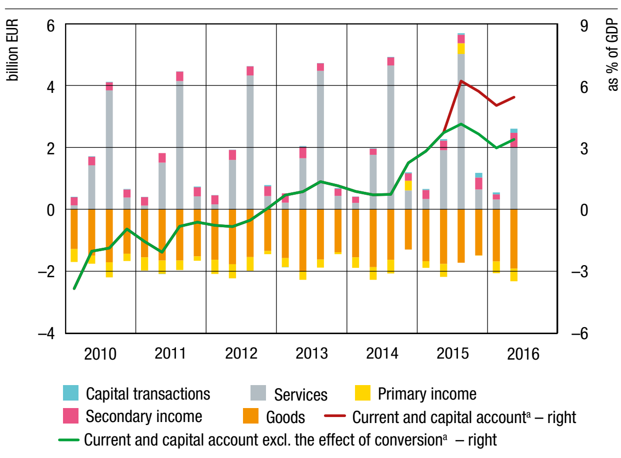
price of natural gas. The negative contribution of refined petroleum products to annual inflation was slightly less expressed in August, relative to the end of 2015, standing at 0.6 percentage points. In addition, the negative contribution of food to inflation increased moderately, mostly under the effect of an acceleration of the annual fall in the prices of fruit and vegetables, milk and non-alcoholic beverages. The decrease in the price of food products was to a considerable extent the consequence of the spillover of lower prices of food raw materials in the world market onto domestic prices and the decline in prices because of surpluses in the EU market.

The annual rate of fall in the deflator of goods and services imports rose in the second quarter of 2016, indicating growing pressures for domestic prices to fall arising from the decline in the prices of imported raw materials and finished products. By contrast, the annual rate of fall in the deflator of goods and services exports accelerated to a lesser extent in the second quarter of 2016, resulting in an improvement in the terms of trade.

6 Foreign trade and competitiveness

The second quarter of 2016 saw an increase in the current and capital account surplus from the same period of the previous year, largely as a result of increased use of EU funds which had a positive effect on secondary income and capital account balance. The growth in net exports of services in tourism also had a favourable effect on the total balance. By contrast, the foreign trade deficit widened due to a faster growth in imports than in exports in absolute terms, while the deficit in the primary account balance remained unchanged. If cumulative values over the past year are observed, the surplus in the current and capital account in the second quarter stood at 5.4% of GDP. By the end of the year, the surplus in the current and capital account might fall considerably, mostly due to the fact that the effects of the costs of banks associated with the conversion of loans in Swiss francs (estimated at approximately 2% of GDP) will have waned by then, but also due to

Figure 6.1 Current and capital account balance and its structure



[a] Sum of the last four quarters.
Source: CNB.

better business results of foreign enterprises in Croatia, especially banks, and the deterioration in the foreign trade balance.

The net exports of services rose in the second quarter of 2016 from the same period of the previous year the most in travel services. Revenues from tourist services provided to non-residents rose by 5.3% on an annual level. This was due to an increase in the number of nights in commercial accommodation of 3.6%, in particular an increase in the number of arrivals from the United Kingdom and Poland and better financial results, evident, among other things, in a pronounced increase in average consumption by traveller. The net exports of transport services also rose during the same period, while the balance in the trade of other services deteriorated as a result of unfavourable results in the trade in financial services, construction services and advertising and market research services. The available indicators show that, in the third quarter, the favourable developments in tourism accelerated, with a large increase in arrivals and nights of foreign tourists, higher income from road tolls and increased passenger traffic at airports.

The net revenue in the secondary income account rose considerably in the second quarter of 2016, largely as a result of the distribution of previously received EU funds to end beneficiaries, particularly other sectors. The value of the funds allocated to capital projects, in particular to the government also increased, pushing up the surplus in the capital transactions account.

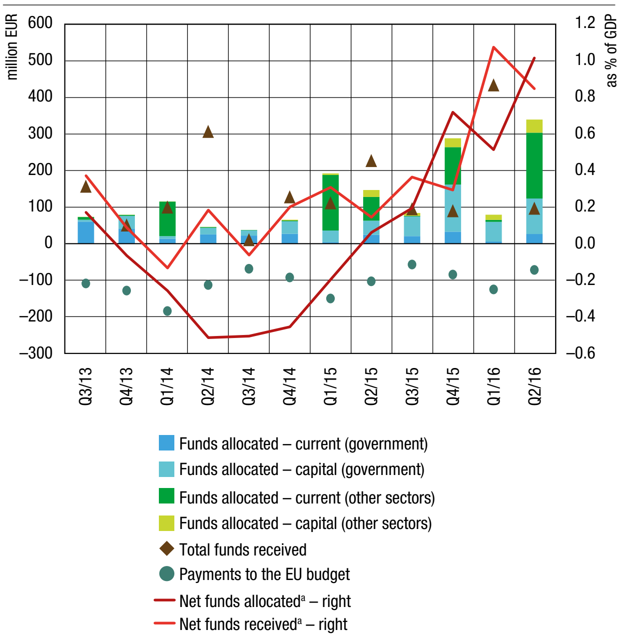
The balance in the primary income account held steady at the same level as in the corresponding period of the previous year. On the one hand, revenues from compensations to residents working abroad rose, and interest expenses of foreign financing (excluding FISIM) fell, while on the other hand, the growth in expenditures based on revenues from direct investment had an unfavourable impact on the primary income account balance. The profit of foreign-owned enterprises, most notably banks, rose and its structure shows that reinvested earnings rose considerably while dividend payments were reduced, following poor business results of banks in the previous year associated with the effect of conversion of loans in Swiss francs.

The foreign trade deficit rose in the second quarter of 2016 from the same period of the previous year, as imports growth exceeded exports growth in an absolute amount. Goods exports rose by 4.2% on an annual level, growing at the same speed as in the first quarter, which is still considerably slower than the fast annual growth rates seen in the first half of the previous year. This was due to a fall in exports of oil and refined petroleum products, particularly to Bosnia and Herzegovina, Slovenia and Hungary, as well as to a fall in exports of other transport equipment seen for the second consecutive month. By contrast, favourable export developments were largely due to the growth in exports of the narrow aggregate (of 9.7%), excluding ships and oil. Particularly noticeable were exports of medical and pharmaceutical products to the USA and the Netherlands, exports of miscellaneous manufactured goods (mostly other ammunition and its parts) to Saudi Arabia and the USA, prefabricated buildings to Sweden and Germany, road vehicles to Germany and Turkey and electrical machinery, apparatus and appliances to Egypt and Germany.

The growth in total goods imports accelerated additionally to 5.8% in the second quarter of 2016 from the same period of the previous year. The growth in the imports of the narrow aggregate of 9.8% made the biggest contribution to total imports growth, analogously to the situation with exports. This is the result of a faster imports of road vehicles from Germany, Slovenia and France, general industrial machinery from Germany and the Netherlands, medical and pharmaceutical products from Korea, machinery specialised for particular industries from Italy and miscellaneous manufactured goods (particularly other ammunition and its parts) from Bulgaria. By contrast, the imports of oil and refined petroleum products continued to trend downwards, particularly imports from Azerbaijan and Russia, while the imports of other transport equipment did not change much.

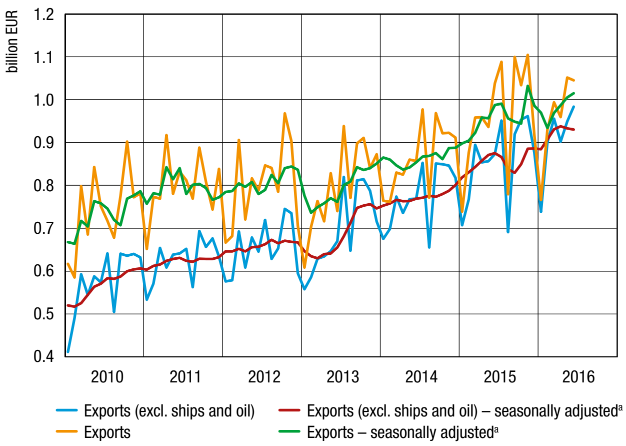
The indicators of price competitiveness improved slightly early

Figure 6.2 Transactions with the EU budget



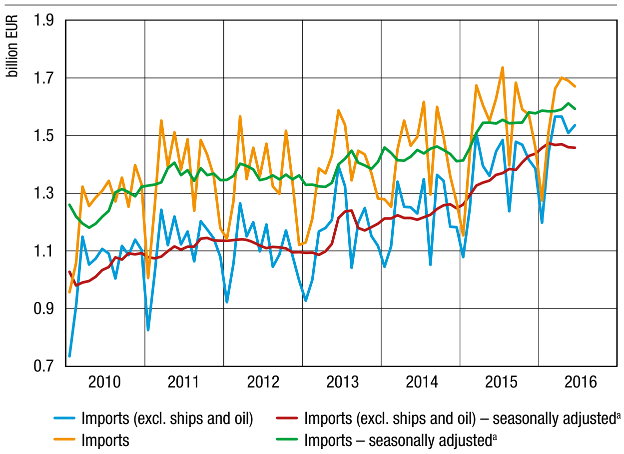
[a] Average of the last four available quarters.
Note: As regards total funds received from EU funds, only funds allocated and paid out to end beneficiaries are recorded in the current and capital account of the balance of payments, while funds received but not allocated are recorded in the financial account. Payments to the EU budget carry a negative sign in the figure.
The positive value of net received and net allocated funds is the surplus over the payments to the EU budget.
Sources: CNB and MoF.

Figure 6.3 Goods exports (f.o.b.)



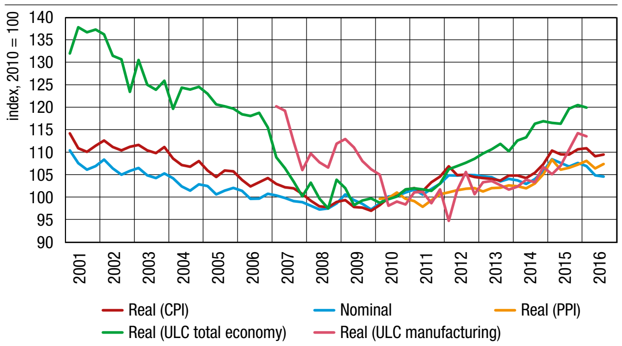
[a] Three-member moving averages of monthly data.
Source: CBS data seasonally adjusted by the CNB.

Figure 6.4 Goods imports (c.i.f.)



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

Figure 6.5 Nominal and real effective exchange rates of the kuna



Note: Real effective exchange rate of the kuna deflated by producer prices includes the Croatian index of industrial producer prices on the non-domestic market, which is available from January 2010. The unit labour cost is calculated as the ratio between compensation per employee and labour productivity (expressed as GDP per person employed). A fall in the index denotes an effective appreciation of the kuna. Data on the real exchange rate deflated by consumer and producer prices in the third quarter of 2016 refer to July and August.
Source: CNB.

in the third quarter of 2016. The real effective exchange rates of the kuna deflated by consumer and producer prices depreciated slightly, partly offsetting the appreciation in the second quarter. This was due to relatively favourable developments in domestic prices in comparison with the main trading partners, while at the same time, the nominal effective exchange rate of the kuna continued to appreciate, though at a slower pace. Data on the real effective exchange rates of the kuna deflated by unit labour costs are available only for the first quarter of 2016 and they point to a small deterioration in cost competitiveness from the previous quarter.

7 Financing conditions and capital flows

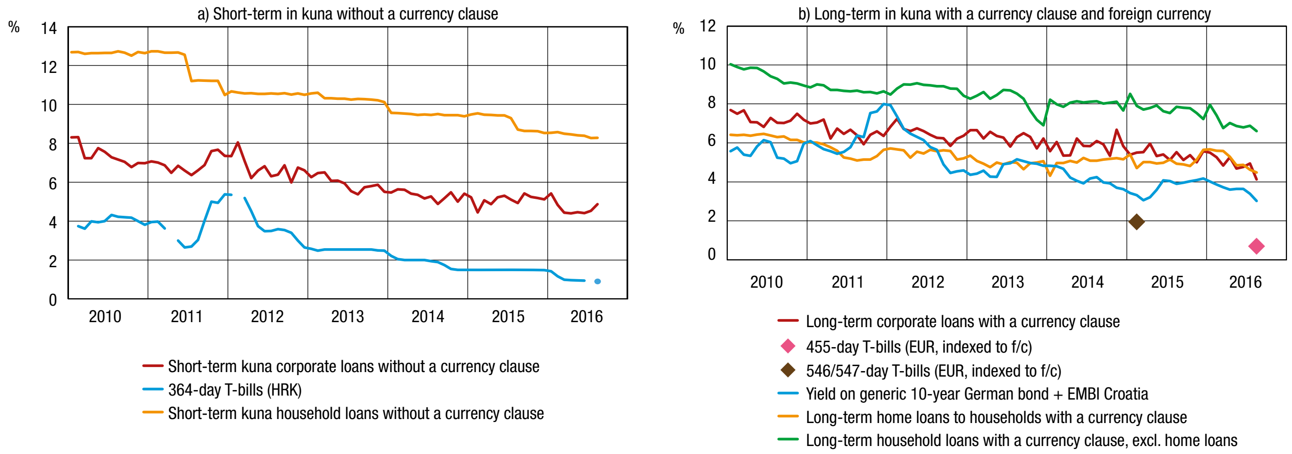
The financing conditions of domestic sectors continued to improve slowly in July and August, supported by high liquidity in the domestic and international financial markets. The costs of bank lending, both in kuna and with a currency clause, have become more favourable for all the sectors with the exception of corporate short-term kuna financing, which rose slightly in July and August. By contrast, the long-term price of corporate financing with a currency clause declined and so did the interest rate on household home loans. Home loans with a currency clause saw the biggest decline from the first half of the year as at that time the procedure of conversion of loans indexed to the Swiss franc into euro-indexed loans temporarily pushed upwards the interest rates on such transactions (Figure 7.1). In addition to high liquidity, the fall in domestic interest rates was also driven by the low costs of sources of funds for the Croatian banking system, with EURIBOR and the national reference rate (NRR[2]) continuing to trend downwards and hitting the lowest levels ever.

The cost of government short-term borrowing on the domestic market, expressed through the interest rate on one year kuna T-bills, has been falling since early 2012 and in August 2016 it reached its historical low of 0.90%. Also, in early August, the government borrowed using foreign exchange 455-day T-bills of EUR 1.5bn at an interest rate of 0.7%. The price of government financing abroad also fell, as estimated by the sum of the EMBI index for Croatia and the yield on the German government bond. That government financing conditions are more favourable is also suggested by the July issue of a five-year kuna bond of HRK 6bn, at thus far the lowest interest rate of 2.75%. Furthermore, if the yield curve on Croatian government bonds is observed, yield to maturity on a four-year kuna bond without a currency clause was 100 basis points lower towards the end of August 2016 than at the end of 2015, and the yield on a four-year kuna bond with a currency clause in euro also fell equally during the same period (Figure 7.2).

Following stagnation in the first quarter, the total debt of non-financial corporations rose in the second quarter of 2016. However, on an annual level, it continued to fall, though at a slower pace (–1.0% in the second quarter from –1.4% in the first quarter) (Figure 7.3). The increase in domestic credit institutions' lending to private enterprises contributed to that; after falling for two years it rose for the first time. Other domestic financing also increased. By contrast, deleveraging abroad of the public and the private corporate sectors continued on an annual level into the second quarter, with a more pronounced fall in public enterprises. As regards developments in domestic corporate lending in the third quarter, July and August saw an increase in placements, so the total increase in corporate placements in the first eight months stood at HRK 2.7bn or 2.8% (transaction-based).

More favourable financing terms and a further recovery in economic activity, coupled with positive developments in the labour market, contributed to an increase in household lending. In the first eight months of 2016, household placements rose by HRK 0.4bn or 0.3% (transaction-based) (Figure 7.4), with a sharp increase taking place in lending in the domestic currency. Observed on an annual level, the trend of household deleveraging continued at a considerably slower pace. Thus, at the end of August, total

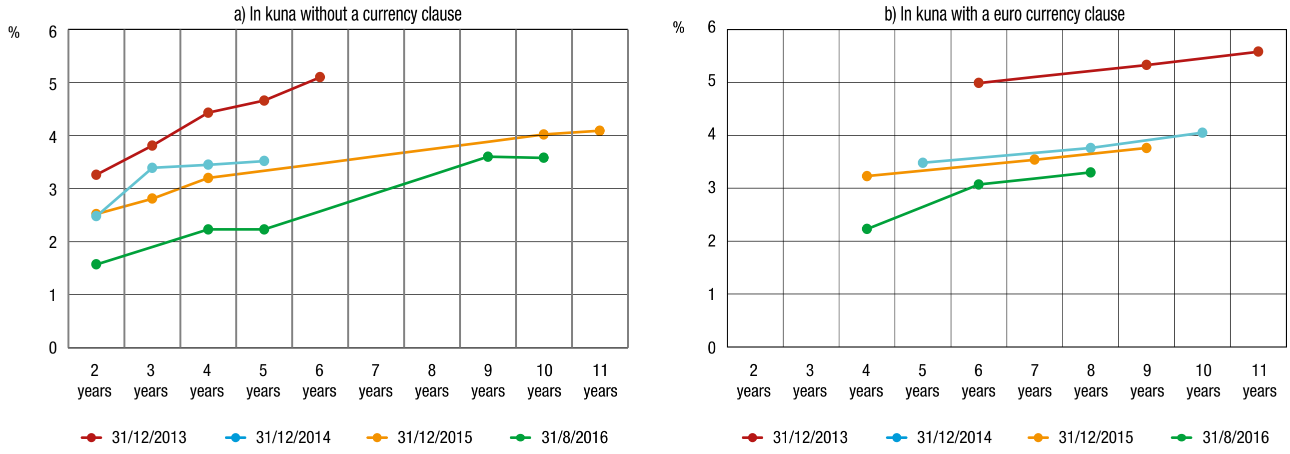
Figure 7.1 Costs of financing of domestic sectors



Note: 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.

2 The national reference rate (NRR) represents the average interest rate paid on deposits by the banking sector. It is used as one of the benchmark interest rates for determining the level of the variable part of the variable interest rate on loans, in accordance with Article 11a of the Consumer Credit Act.

Figure 7.2 Yield-to-maturity on RC bonds



Note: Dots show achieved yields; other values are interpolated.
Source: CNB.

placements to this sector fell by 0.2% on an annual level. By contrast, the 6.7% decrease in the nominal value of placements in that period was mostly the result of the process of the conversion and partial write-off of household loans indexed to the Swiss franc, in which banks wrote off a total of HRK 5.9bn in the period from end-November 2015 to end-August 2016.

Capital flows between Croatia and foreign countries

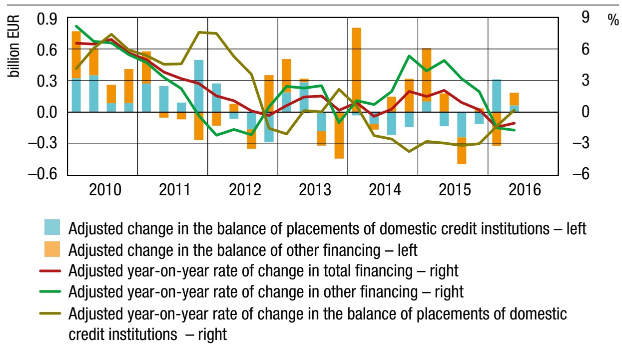
In the second quarter of 2016, the net capital outflows held steady at levels similar to those in the same period of the previous year. Net external liabilities in the financial account of the balance of payments, excluding change in gross international reserves reduced by CNB liabilities[3], fell by EUR 0.6bn as a result of domestic sector deleveraging, particularly that of credit institutions, and a simultaneous, though less pronounced, growth in foreign assets.

In the second quarter of 2016, the net inflow based on equity investments was largely influenced by a sharp increase in reinvested earnings on the liabilities side, which related mainly to the activities of financial intermediation following a growth in bank profit. In addition, direct equity investment rose in Croatia, mainly due to debt-to-equity swaps, while new investments remained very modest and mostly took place in other business activities, retail trade and real estate activities. The decline in equity investments on the assets side in both direct and portfolio investments contributed to the net inflow from equity investment.

Net capital outflow based on debt investment (EUR 1.2bn) in the second quarter of 2016 was the result of a sharp decline in foreign liabilities, accompanied, to a lesser extent, by an increase in foreign assets. Credit institutions improved their net debt position the most. Having witnessed an increase in funds of EUR 0.1bn they reduced their liabilities even more (EUR 0.3bn). Net external debt of the government sector also fell. As regards other domestic sectors, approximately one half of deleveraging vis-à-vis affiliated foreign creditors was related to debt-to-equity swap transactions and the other half to a reduction in liabilities of one enterprise financed by the sale of its foreign assets. By contrast, net liabilities of other domestic sectors to non-affiliated creditors rose.

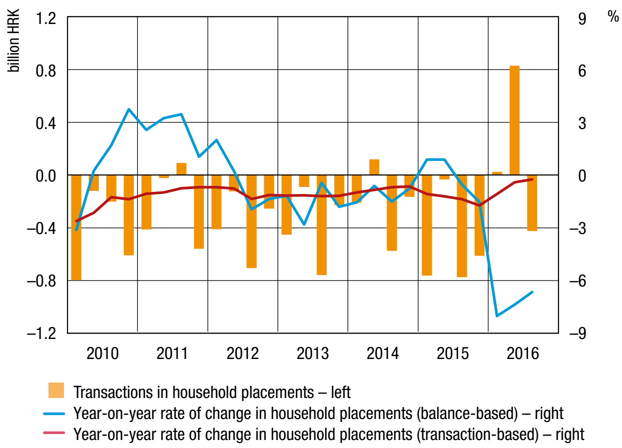
3 Foreign liabilities of the CNB include the investment of a part of international reserves in repo agreements which lead to a change in the same amount in the international reserves.

Figure 7.3 Corporate financing by sources



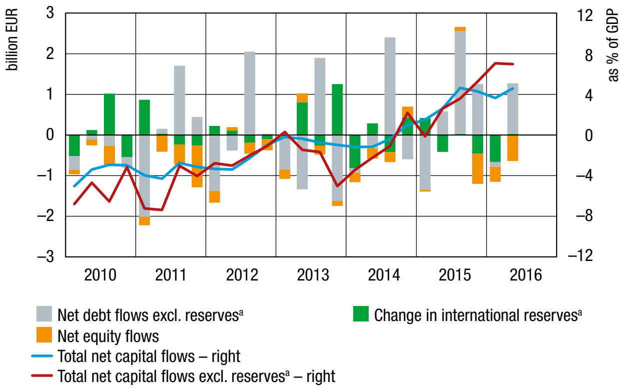
Note: Other financing includes corporate borrowing from domestic leasing companies and direct borrowing from the CBRD, as well as borrowing from foreign banks and affiliated enterprises abroad. The adjusted changes are calculated on the basis of data on transactions in placements of domestic credit institutions 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 7.4 Household placements



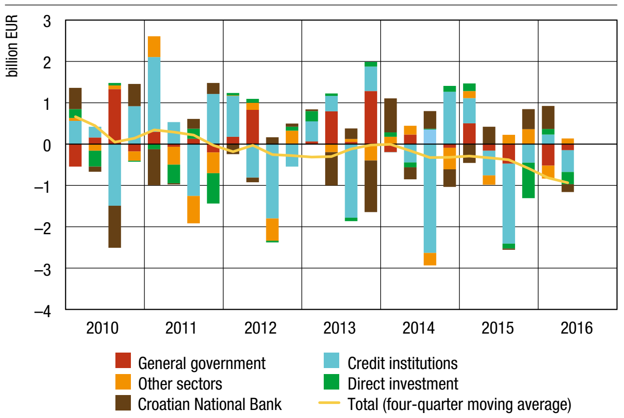
Note: Data for the third quarter of 2016 refer to July and August.
Source: CNB.

Figure 7.5 Financial account flows



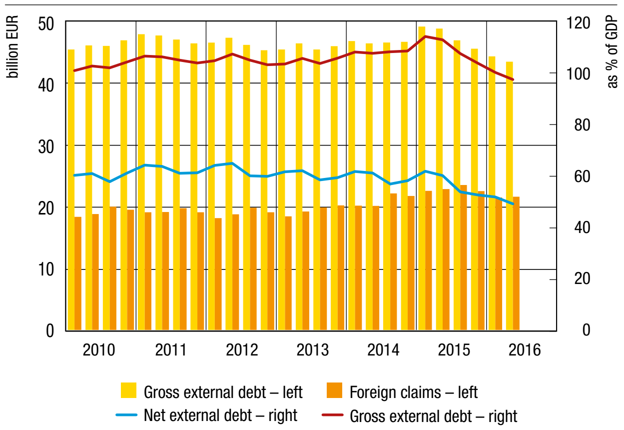
[a] The change in gross international reserves is reported net of the liabilities of the CNB.
Note: A positive value denotes net outflow of equity abroad. Net flows represent the difference between the change in assets and the change in liabilities. Total net capital flow series are shown as the sum of the last four quarters.
Source: CNB.

Figure 7.6 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 7.7 Gross and net external debt



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

After falling considerably in the first quarter of 2016, gross external debt of the Republic of Croatia fell additionally in the second quarter (EUR 0.9bn), mostly as a result of deleveraging of monetary institutions and the government. Unfavourable cross-currency changes and other adjustments amounting to EUR 0.2bn had an opposite effect on the stock of foreign liabilities. Gross external debt thus stood at EUR 43.4bn, or 97.3% of GDP at the end of June. Given a small increase in the foreign assets of domestic sectors, net external debt declined further in the second quarter (EUR 1.0bn) and at the end of June stood at EUR 21.9bn, accounting for 49.0% of GDP.

Gross international reserves fell by EUR 0.8bn in the first half of the year, mostly driven by a CNB decision to repeal the requirement for the banks to allocate the foreign exchange component of reserve requirements with the central bank. At the end of June, gross international reserves thus stood at EUR 12.9bn, an amount sufficient to cover 7.3 months of goods and services imports, compared with 7.9 months of imports at the end of the previous year. However, at the same time, the indicator of the short-term debt coverage by international reserves deteriorated from 96.5% at the end of 2015 to 82.9% at the end of June 2016, mostly driven by a pronounced growth in short-term debt on a remaining maturity basis[4].

4 The growth in short-term debt on a remaining maturity basis from end-2015 is largely the result of the maturity of a long-term debt falling due in the second quarter of 2017 consisting of USD 1.5bn worth government bond issued in 2012 on the American market, with a currency risk hedge, and of EUR 250m worth bond issued by the CBRD in 2007.

8 Monetary policy

The CNB continued pursuing an expansionary monetary policy during the third quarter while maintaining the stability of the kuna exchange rate against the euro. At the third structural repo operation in July HRK 234.4m was placed at a lowered fixed repo rate of 1.4%. In all, at the three structural repo operations, the central bank created HRK 945.9m for a period of four years, which provided the banks access to additional long-term sources of kuna liquidity. This should support the trends of declining domestic interest rates and intensified bank lending in kuna, which accelerated in 2016. The CNB also continued to conduct regular weekly reverse repo operations, reducing the fixed repo rate from 0.5% to 0.3% from mid-September. The average amount of funds placed through these operations in the third quarter stood at HRK 117.0m.

Due to the strong seasonal increase in currency in circulation outside credit institutions and a higher level of kuna deposited by the government with the CNB, the surplus of liquidity in bank accounts with the central bank was significantly lower in the third quarter than in the first half of the year (HRK 5.5bn as compared to HRK 9.2bn). Despite the seasonal outflow of liquidity, interest rates in the money market were low during July and August, while in September, in addition to a noticeable growth in transactions, overnight interbank interest rates increased to 0.84%. Higher demand for kuna liquidity led to an increase in transactions in regular weekly reverse repo operations, which grew to HRK 630m in early September. Also at the beginning of September, the CNB intervened in the foreign exchange market by purchasing EUR 69.0m from banks, thus creating HRK 0.5bn of reserve money (M0). In the rest of September, the amounts placed through weekly reverse repo operations fell noticeably, while appreciation pressures were interrupted.

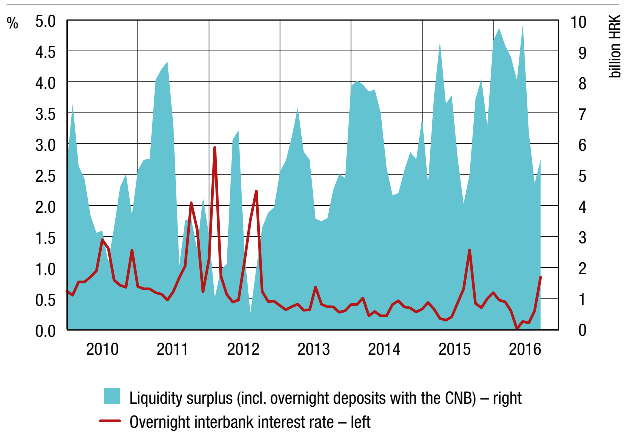
When foreign exchange transactions of the CNB in the first nine months of 2016 are considered, the CNB purchased in all EUR 270.4m from banks and the MoF. At the same time, purchases were exceeded by sales to the European Commission, standing at EUR 277.8m, so that the central bank withdrew HRK 68.3m from the market in all foreign exchange transactions.

Influenced by seasonal developments, during most of the third quarter, the exchange rate of the kuna against the euro remained at lower levels than in the previous part of the year. Accordingly, the average exchange rate of the kuna against the euro during the first nine months of 2016 stood at EUR/HRK 7.53, or down by 1.0 from the same period in 2015. The exchange rates of the kuna against the Swiss franc and the US dollar were also lower in the third quarter than in the same period of 2015.

Gross international reserves rose by EUR 0.1bn in the third quarter, while net usable reserves remained almost unchanged. At the end of September, gross reserves stood at EUR 13.0bn, or down by EUR 0.7bn (–4.9%) from the end of the previous year, which was mostly the result of the suspension of the foreign currency reserve requirement allocation at the beginning of the year. On the other hand, net usable reserves stood at EUR 11.3bn, or up by EUR 0.1bn (1.1%). Gross and net international reserves remained at higher levels than money (M1) and reserve money (M0).

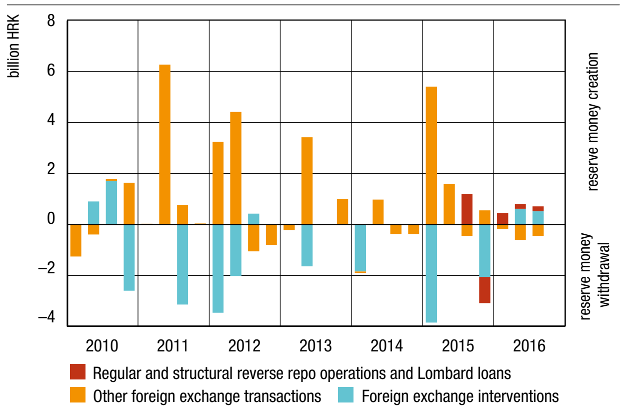
The several-year trend of growth in the real seasonally adjusted

Figure 8.2 Bank liquidity and overnight interbank interest rate



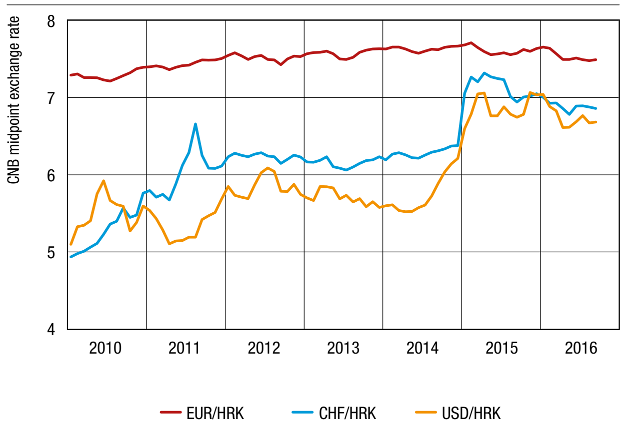
Source: CNB.

Figure 8.1 Flows of reserve money (M0) creation



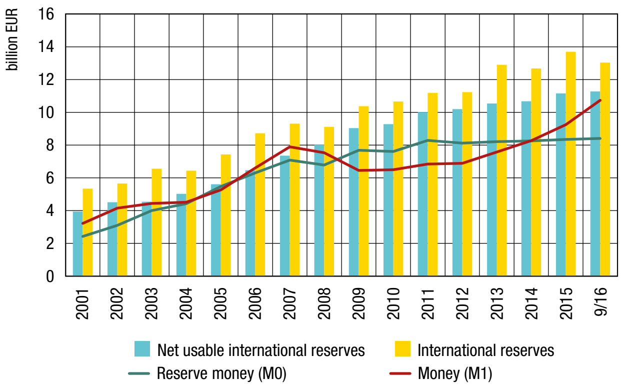
Note: Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and the EC and foreign currency swaps with banks, where the positive values refer to the purchase of foreign exchange by the CNB.
Source: CNB.

Figure 8.3 Nominal exchange rates of the kuna against selected currencies



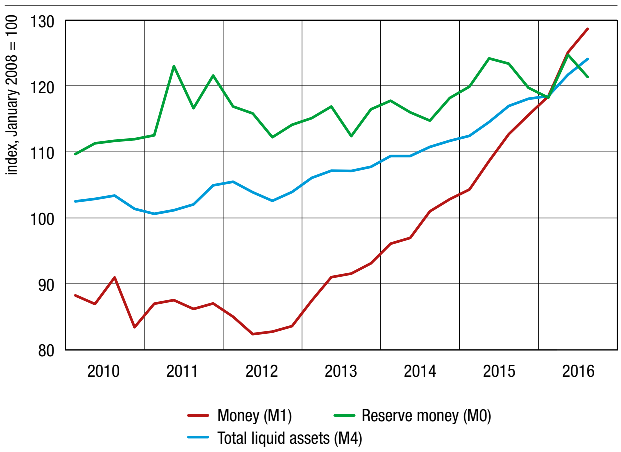
Source: CNB.

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-August 2016.
Source: CNB.

Figure 8.5 Real monetary aggregates
index of developments in seasonally adjusted values, deflated by the consumer price index



Note: Data for the third quarter of 2016 refer to August.
Source: CNB.

value of M1 and total liquid funds (M4) continued in the third quarter. Contributing to these developments, in conjunction with continued subdued inflation, were inflows from the record tourist season and better absorption of EU funds, as well as a mild recovery in domestic lending. The growth in money (M1) was particularly pronounced because of the continued decrease in interest rates on savings and time deposits and the recovery of economic activity. On the other hand, the real value of reserve money (M0) decreased in the third quarter, recording a slightly lower level relative to the same period of the previous year.

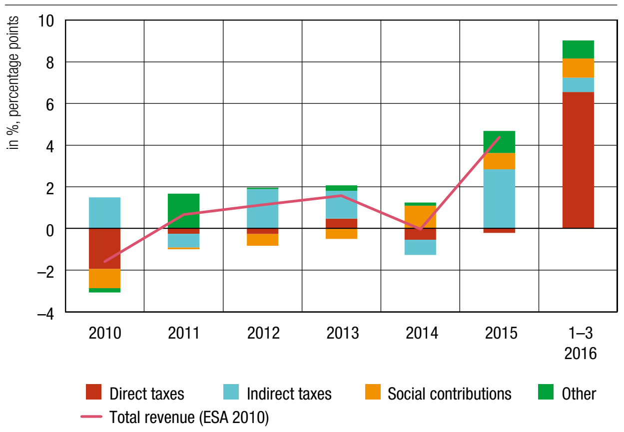
9 Public finance

The available fiscal data point to a sharp fall in the deficit in the first half of 2016 from the same period of the previous year. Such developments were the result of favourable developments in revenues and mainly reflect a recovery in economic activity and restrictions on growth on the expenditure side of the budget. It appears that the beginning of the second half of the year was marked by a rising central government deficit on an annual level, but this is partly the result of value added tax being paid later into the government budget.

The first quarter of 2016 was marked by favourable developments in all major items on the revenue side of the general government budget (measured by ESA 2010 methodology). Total revenues thus rose by 9.0% from the same period of 2015, mostly driven by tax revenues, particularly those from direct taxes. It seems that the fast growth in direct taxes may largely be associated with rising revenues from profit tax, which in turn is the result of a considerable growth in entrepreneurs' profit in 2015 and the introduction of additional conditions for the use of tax reliefs based on reinvested profit. The contribution of indirect taxes in the first quarter of 2016 was slightly positive. It can be attributed to an increase in revenues from excises, which partly reflects the lower level of excises on refined petroleum and tobacco products that obtained in the first half of 2015. By contrast, revenues from VAT, despite favourable economic developments fell slightly, apparently due to a different dynamics in VAT return refunds. Revenues from social contributions also rose, again reflecting favourable developments in the labour market, and positive developments were also seen in other capital revenues, which can probably be attributed partly to increased use of EU funds.

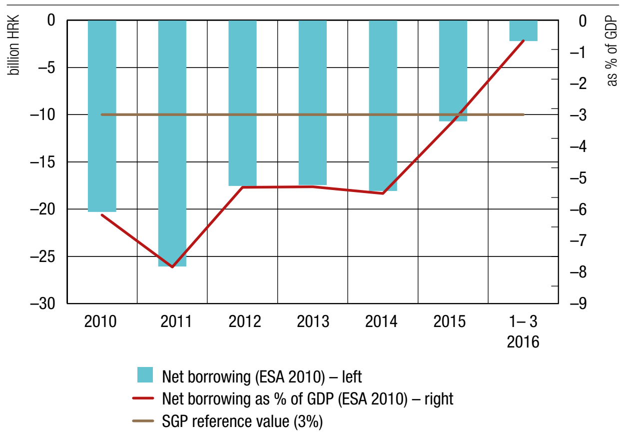
The Ministry of Finance consolidated general government data, on a cash basis, suggest that the developments in revenues in the second quarter of this year will continue to be positive. The increase in revenues was mostly driven by indirect taxes, with a particularly noticeable increase in revenues from excises, followed

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



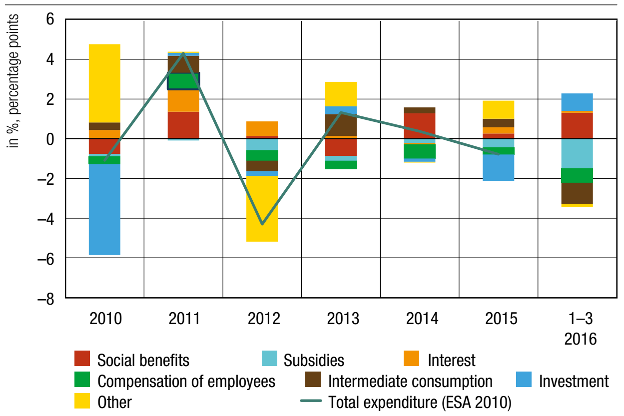
Source: Eurostat (CNB calculations).

Figure 9.3 Consolidated general government balance (ESA 2010)



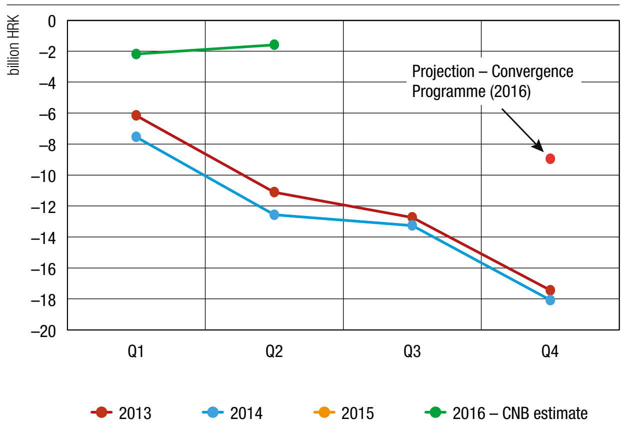
Note: SGP – Stability and Growth Pact. GDP in the first quarter of 2016 is calculated as the sum of the last four quarters.
Source: Eurostat (CNB calculations).

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



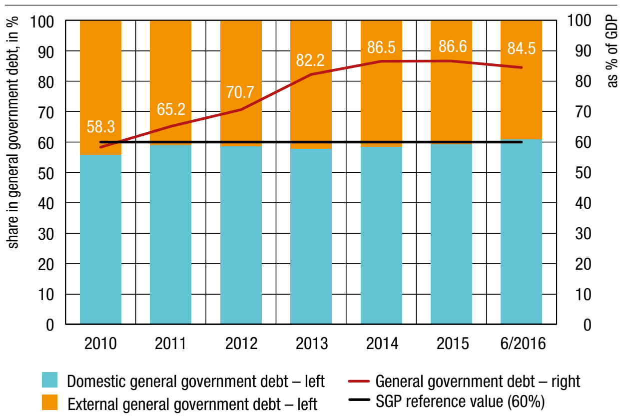
Source: Eurostat (CNB calculations).

Figure 9.4 General government cumulative balance by quarters (ESA 2010)



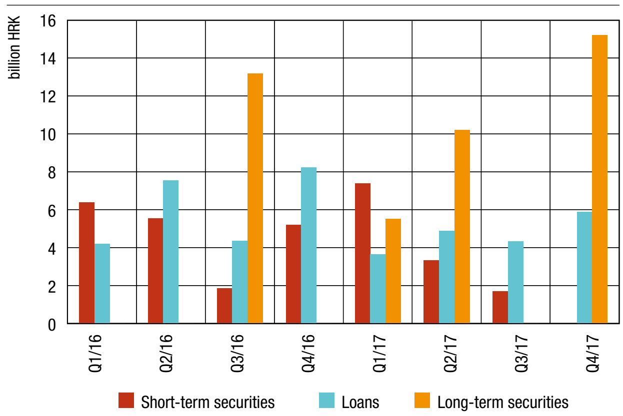
Sources: Eurostat and MoF (CNB calculations).

Figure 9.5 General government debt
end-period stock



Note: Nominal GDP calculated as the sum of GDP for the second quarter of 2016 and the last three available quarterly data was used for the calculation of the relative indicator at the end of June 2016.
Source: CNB.

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 30 September 2016 and projection of the repayment of loans on the balance as at 30 June 2016.
Source: CNB.

by an increase in revenues from VAT. As regards direct taxes, revenues from income taxes and revenues from profit taxes rose sharply, with the rise in revenues from income tax appearing to be partly attributable to shifts in refunds on the income tax returns. Receipts from the EU budget also made a positive contribution, but with the exception of the replacement of domestic funds by EU funds for direct payments in agriculture, these flows do not have a direct impact on the budget balance. Data for July point to a fall in revenues on an annual level, mostly as a result of a fall in what are called other revenues. However, the fall is partly also the result of shifts in VAT payments, given the fact that this year the last day of July fell on a Sunday so VAT payments were moved to early August.

The expenditure side of the consolidated general government budget (ESA 2010 methodology) saw a decrease of 1% in the first quarter of 2016 from the same period of the previous year. This decrease may partly be attributed to the fact that expenditures of the government budget and extrabudgetary funds were executed during the period of interim financing. The fall in expenditures was mostly due to expenditures for subsidies and intermediate consumption, and expenditures for employees also moved in the same direction. However, expenditures for investments rose, in contrast with their considerable fall in the previous year and the expenditures for social benefits also rose. Expenditures for interest were almost similar to those in the first quarter of 2015, with expenditure dynamics being positively influenced by a fall in borrowing costs.

The cash data for the second quarter point to a pronounced increase in expenditures, however it seems that this is largely influenced by a different payment dynamics of individual expenditures across the year. Thus subsidies grew sharply, following a considerable decline at the beginning of the year, and expenditures for the use of goods and services also rose considerably, after falling in the first quarter. Expenditures for employees continued to grow and expenditures for social benefits also rose slightly, partly as a result of pension adjustments because of rises in consumer prices and the average gross wage in the economy. By contrast, expenditures for interest on a cash basis decreased and so did the expenditures for grants. When the first six months of 2016 are observed, the consolidated general government expenditures under the GFS 2001 methodology rose only slightly, while data for July suggest that they continued to grow slowly at the beginning of the second half of the year.

As follows from the above, the first quarter of 2016 saw a strong fiscal consolidation, reducing the general government deficit under the ESA 2010 methodology to HRK 2.2bn, a decrease of HRK 3.4bn from the same period of the previous year. The available data on a cash basis point to a general government budget surplus in the second quarter, in contrast to a deficit of almost HRK 3.0bn in the same period of the previous year, so the half-year result might be even more favourable.

Towards the end of June, the consolidated general government debt reached HRK 285.7bn, a decrease of HRK 3.9bn from its stock at the end of 2015. The same period also saw an increase in GDP, with the share of debt in GDP falling to 84.5%. The reduction in debt was brought about by the appreciation of the kuna against the euro and the financing of a part of the deficit by the funds deposited in previous periods. In July, the Ministry of Finance issued on the domestic market HRK 6bn worth of 5-year bonds followed by EUR 1.5bn worth of 455-day T-bills in August, thus refinancing due liabilities and raising part of the funds required to finance the deficit. In the last quarter of 2016, the general government will have approximately 3% of GDP worth of liabilities falling due, most of which relate in particular to liabilities based on T-bills and loans.

10 Comparison of Croatia and selected countries

Favourable developments in economic activity in the majority of CEE countries continued in the first half of 2016. In the second quarter of 2016 growth was recorded in all countries under review, with Latvia, Hungary and Poland more than compensating for the reduction observed in the beginning of the year. Real GDP growth picked up speed in the Czech Republic in the second quarter, while at the same time economic activity in Lithuania slowed down. In other countries, including Croatia, gross domestic product continued growing at a pace similar to that in the first quarter of 2016.

Industrial production increased in the first half of 2016 from the same period a year ago in all countries under review but Estonia. In the Czech Republic, Croatia, Latvia and Slovenia growth rates were higher than in the second half of 2015. At the same time, industrial activity intensified the most in Croatia, where in the first six months of this year industrial production increased the most among all CEE countries. In the first half of 2016, the exports of goods rose in most of the countries under review, speeding up additionally in Romania. While in Bulgaria and Latvia the exports of goods continued declining at a faster rate, in Estonia and Lithuania the decrease in the exports of goods slowed down. The positive trend that started in Croatia in 2013 continued in 2016, the export of goods increasing by 4.4% in the first six months on an annual basis.

The data for the first quarter of 2016 indicate a rise in ILO employment in all CEE countries, except Slovenia which registered a slight fall. In early 2016, Hungary (3.5%) and Slovakia (2.9%) registered the strongest and Romania (0.2%) and Latvia (0.6%) the weakest annual growth in employment. In the first quarter of 2016, the rise from the same period of the previous year in the number of employed persons under the ILO methodology in Croatia totalled 0.8%, which was below the CEE average (1.4%).

The ILO unemployment rate reduced in the first quarter of 2016 in all CEE countries except in Latvia and Estonia where it remained almost unchanged from the same period of the previous year. The average unemployment rate in the above group of countries was 8.4%, the actual rate varying greatly among countries. The Czech Republic thus registered the lowest ILO unemployment rate of 4.4%, while Croatia registered the highest, totalling 15.4%.

The current and capital account balances in most CEE countries improved in 2015, but developments in the first quarter of 2016 differed. On one side, the surplus in the current and capital accounts increased in Bulgaria and Slovenia, predominantly thanks to positive results in foreign trade in goods. On the other, the widening of the deficit in the trade of goods contributed to the deterioration in the current and capital account balance in Romania, which was exacerbated by the growth of the deficit in the primary income account, and in Estonia, where it was followed by unfavourable developments in the capital account. At the same time, the surplus decrease in Croatia was primarily a consequence of the deterioration in the primary and secondary account balances and in the trade of services. Despite this, all countries continued to register current and capital account surpluses, especially Hungary and Slovenia, which boasted high figures, while Romania found itself in equilibrium.

The growth in the exports of goods in most CEE countries continued throughout the first half of 2016 at the same intensity as in the previous half of the year, but lower than in the first half of 2015. Romania, Hungary, Estonia and Slovenia stood out for the growth of their exports of goods. The growth of Croatia's exports of goods accelerated from the previous half of the year, which again placed Croatia among the countries with the greatest increase. In contrast, exports in Latvia and Lithuania continued decreasing due to weakened trade flow with Russia, one of their most important trading partners.

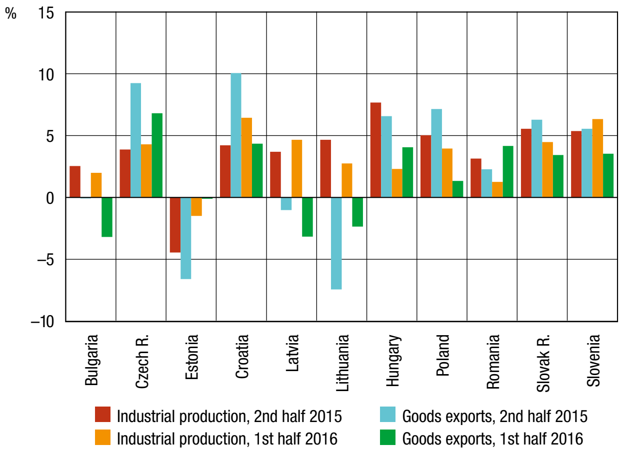
Positive developments in the exports of goods were not followed by an improvement in price competitiveness (measured in terms of the real effective exchange rate deflated by consumer prices) in most countries under review; in most of them, price competitiveness of exports deteriorated negligibly in the first eight months of 2016 from the fourth quarter of 2015, except in Poland and Romania. This was predominantly a result of the nominal effective appreciation of their currencies. In contrast, the improvement of the price competitiveness of exports in Poland was

Table 10.1 Gross domestic product

	Year-on-year rate of change, original data			Quarter-on-quarter rate of change, seasonally adjusted data			
	2013	2014	2015	Q3/2015	Q4/2015	Q1/2016	Q2/2016
Bulgaria	1.3	1.5	3.0	0.7	0.7	0.7	0.7
Czech R.	–0.5	2.7	4.5	1.0	0.3	0.4	0.9
Estonia	1.4	2.8	1.4	–0.5	1.1	–0.5	0.5
Croatia	–1.1	–0.4	1.6	1.4	–0.5	0.5	0.5
Latvia	3.0	2.4	2.7	0.6	–0.3	–0.1	0.6
Lithuania	3.5	3.0	1.6	0.5	0.5	0.9	0.2
Hungary	1.9	3.7	2.9	0.4	0.9	–0.5	1.0
Poland	1.3	3.3	3.6	0.8	1.3	–0.1	0.9
Romania	3.5	3.0	3.8	1.6	1.2	1.5	1.5
Slovak R.	1.4	2.5	3.6	–	–	–	–
Slovenia	–1.1	3.1	2.3	0.3	0.6	0.5	0.5
Average[a]	1.3	2.5	2.8	0.7	0.6	0.4	0.7

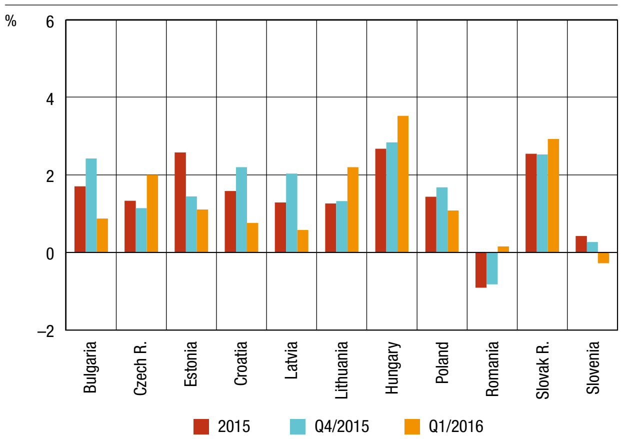
[a] Simple average.
Sources: Eurostat, EC, CBS and CNB.

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



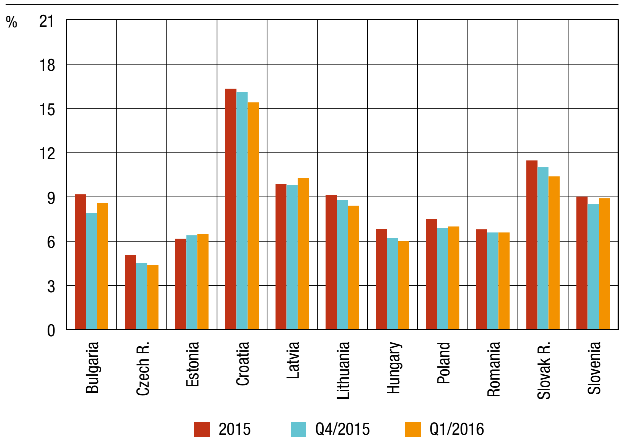
Sources: Eurostat and CBS.

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



Source: Eurostat.

Figure 10.3 Labour Force Survey unemployment rate



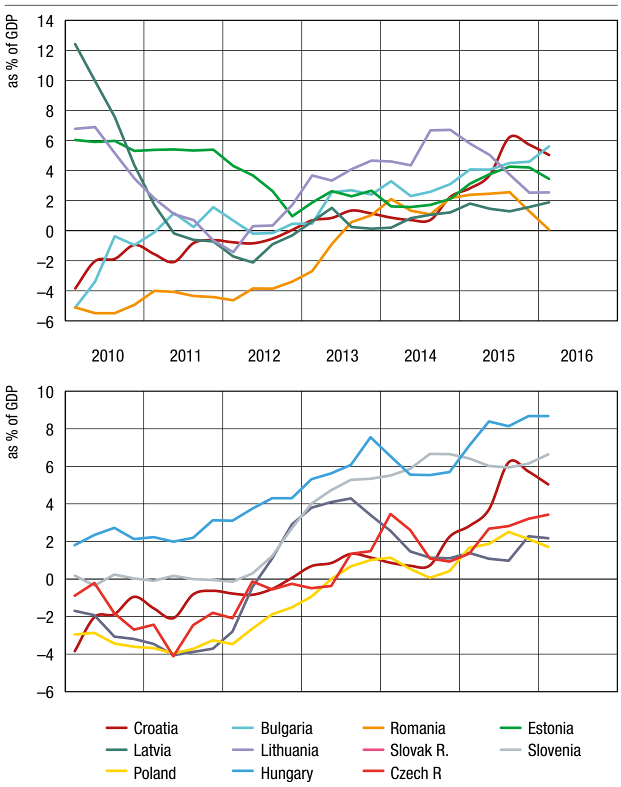
Source: Eurostat.

predominantly aided by the nominal effective depreciation of the zloty, while in Romania the improvement was a result of the relatively more favourable change in domestic prices vis-a-vis its main trading partners.

In the majority of CEE countries the third quarter of 2016 registered an increase in the annual consumer price inflation rate, the most in Romania and Bulgaria. The average annual inflation rate in July and August ranged between –1.3% in Croatia and 1.0% in Estonia. The rise in the annual rate of change in the prices of energy and food largely contributed to the increase in the annual inflation rate in the majority of countries under review, mostly as a result of the base effect, that is, the decline in these prices over the third quarter of 2015. This effect was most pronounced in respect of food prices in Romania amid a strong decline of these prices due to the lowering of taxes on food products in the third quarter of 2015.

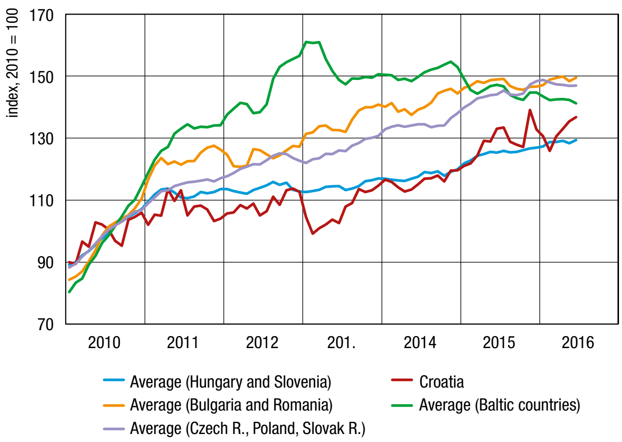
Net capital outflow from CEE countries continued in the first quarter 2016, taking into account the common cumulative values in the balance in the financial account of the balance of payments in the last four quarters (excluding the change in international reserves). Hungary registered the largest capital outflow, exceeding 16% of GDP, which resulted from deleveraging under the item of other and portfolio investments. Slovenia and Estonia also saw stronger capital outflows. Croatia was also among the countries with prominent capital outflows, spurred by deleveraging in the account of other investments. On the other hand, the Czech Republic and Lithuania registered the strongest net capital inflows. The changes in international reserves were in line with these developments so the Czech Republic boasted their highest growth and Hungary their largest fall. At the same time, the already modest net inflow of foreign direct investments into countries under review continued shrinking.

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



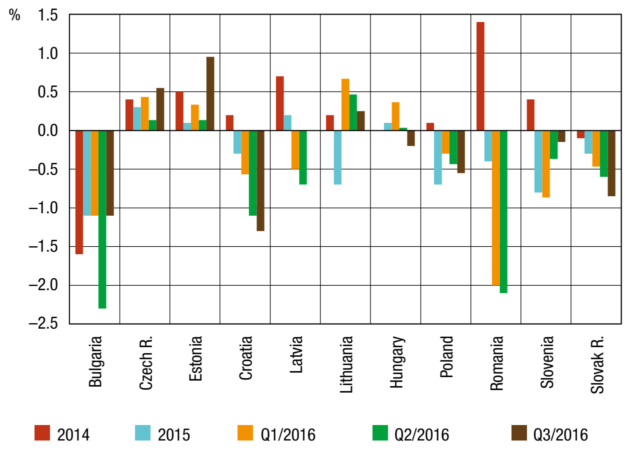
Sources: Eurostat and CNB.

Figure 10.5 Goods exports
quarterly moving average, seasonally adjusted data



Sources: Eurostat and CNB.

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

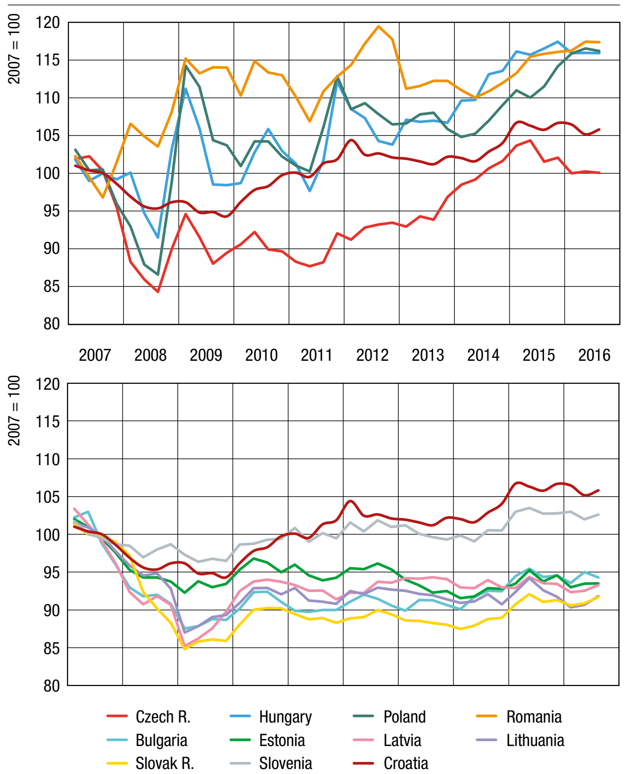


Note: Data for the third quarter of 2016 refer to July and August.
Source: Eurostat.

Among relatively different developments in the external debt of CEE countries it is visible that in the first quarter of 2016 Croatia boasted the greatest decrease in external debt, with its gross debt falling to 100.1% of GDP at the end of March (from 103.7% of GDP at the end of 2015). This was a result of the decrease in the foreign liabilities of the general government, credit institutions and other domestic sectors. In addition to Croatia, Hungary boasted a more prominent decline in external debt, primarily due to the deleveraging of the general government and corporates towards their affiliated creditors, as well as Slovakia, due, among other things, to the fall in liabilities of other domestic sectors. On the other hand, the growth of external debt was the strongest in Latvia and Lithuania, as a consequence of the growth in the central bank's liabilities and additional borrowing by Lithuanian credit institutions.

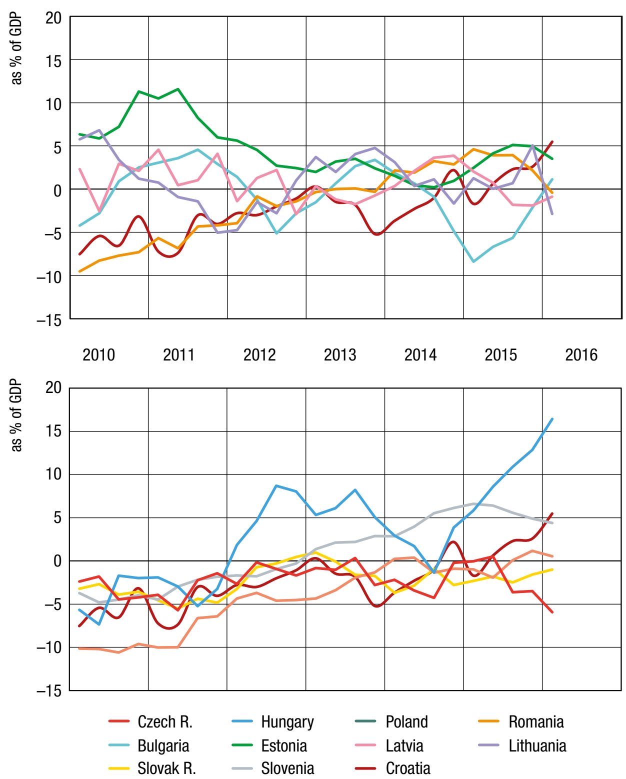
Credit default swaps of all countries under review were lower at the end of September 2016 than at the end of the previous year. Croatia's credit default swaps saw the greatest fall, but remained at a level higher than in any of the comparable countries. The United Kingdom's EU referendum decision led to a momentary

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



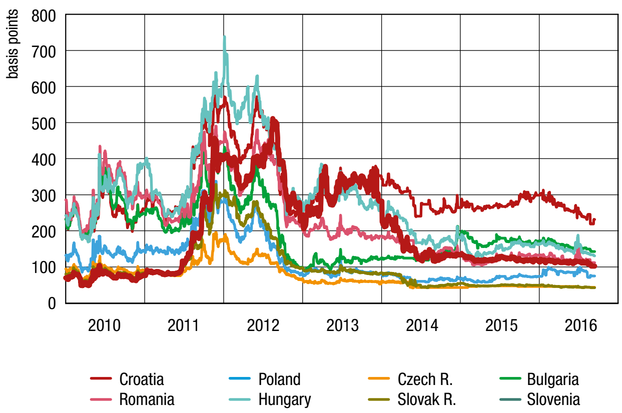
Note: Data for the third quarter of 2016 refer to July and August. A fall in the index denotes a real effective appreciation.
Sources: BIS and CNB calculations.

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



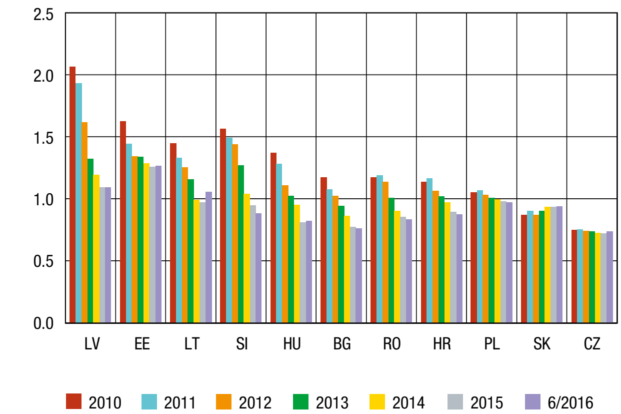
Sources: Eurostat and CNB.

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



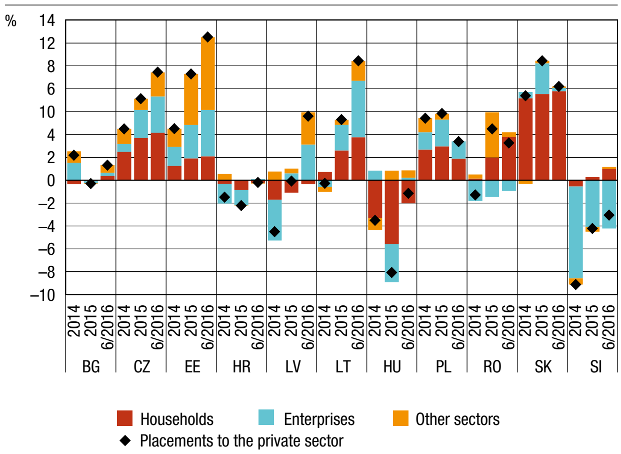
Note: Credit default swaps (CDS) spread is an annual premium that a CDS buyer pays for protection against credit risk associated with an issuer of an instrument.
Source: Bloomberg.

Figure 10.12 Placement to deposit ratio of the private sector



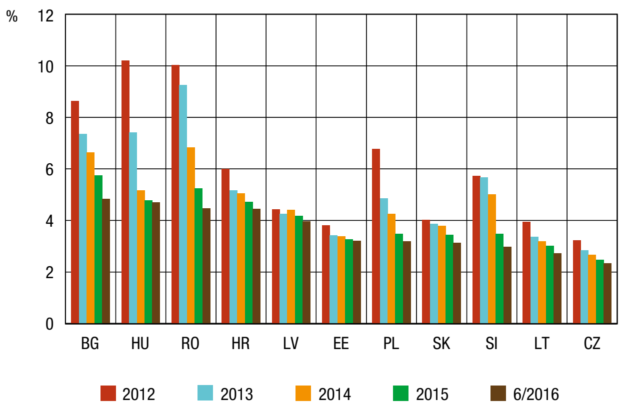
Sources: ECB and CNB.

Figure 10.10 Bank placements to the private sector
contribution to the year-on-year rate of change, transaction-based



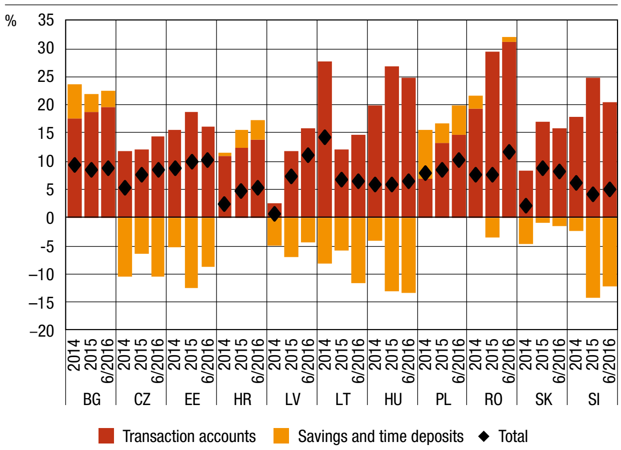
Sources: ECB and CNB.

Figure 10.13 Short-term interest rates on corporate loans



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

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



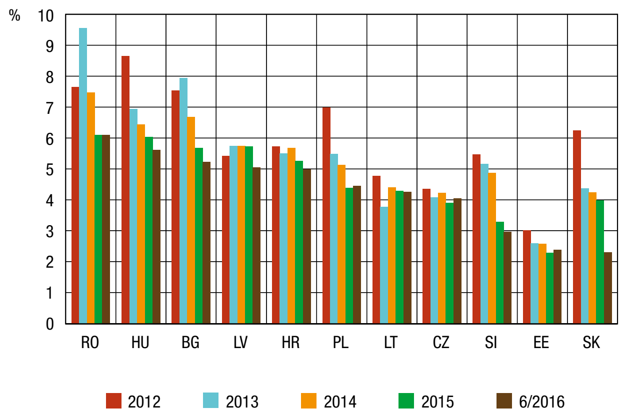
Sources: ECB and CNB.

jump in the CDS market, which was especially noticeable in the context of Romania, Hungary and Poland at the end of June. However, this effect was short term so risk premiums decreased to levels more favourable than before the referendum in the coming months.

Credit activity in most countries under review boasted growth on an annual level in mid 2016, Baltic countries, the Czech Republic and Slovakia leading the way. Estonia, which observed a noticeable jump in loans granted by other financial institutions, registered the strongest growth in placements. Credit activity intensified in Latvia and Lithuania as well, largely as a result of increased lending to corporates. The Czech Republic and especially Slovakia observed the highest growth among household placements. In Slovenia and Hungary, the decrease in lending slowed down compared to previous years, while in Croatia it stopped.

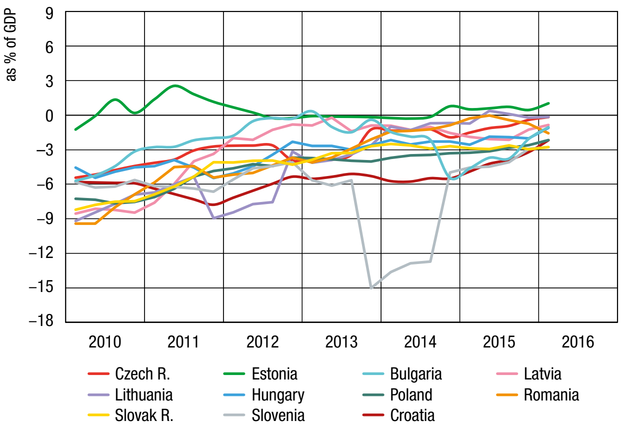
Private sector deposits continued increasing in all countries under review, Romania, Latvia, Poland and Estonia having the highest rates. These developments were aided by the continuation of the strong growth of assets in transaction accounts amid continued decline in deposit interest rates and the recovery in economic activity. In line with the stronger growth of more liquid

Figure 10.14 Interest rates on home loans



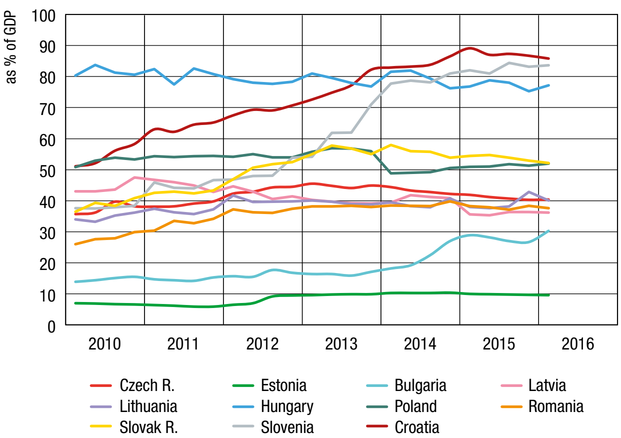
Sources: ECB and NCBs.

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.

Figure 10.16 General government debt
end-quarter stock



Sources: Eurostat and CNB.

forms of assets, savings and time deposits decreased in most countries. Developments in Croatia stayed in line with those in other countries.

In the middle of 2016, the placement to deposit ratio stagnated in most countries relative to the end of the previous year, stabilising at much lower rates than in the pre-crisis period. A noticeable growth of this indicator was observed in Lithuania, so placements exceeded deposits in the middle of the year only in the Baltic countries.

In the first half of 2016, short-term interest rates on corporate loans continued trending downwards in the majority of countries as they did over the last few years, stagnating only in Estonia and Hungary. Bulgaria, Romania and Slovenia saw the greatest fall in interest expenses, while these interest rates remained the lowest in the Czech Republic. Short-term interest rates for corporate financing in Croatia continued to follow the movements of the CEE average, at a slightly higher level.

Interest rates on home loans also went down in the majority of the observed countries in the first half of 2016, with the exception of Slovakia and Latvia. On the other hand, a mild increase in interest rates was observed in the Czech Republic, Estonia and Poland. In Croatia these interest rates went down but slower than the average.

All countries under review continued the process of fiscal consolidation in the first quarter of 2016. Thus, the share of GDP deficit measured by the moving sum of the past four quarters went down in all countries, except Romania. The greatest improvement was seen in Croatia which no longer stood out as the country with the highest deficit among all CEE countries. As for the indicator of the share of debt in GDP, Estonia boasts the most favourable figure of 9.6% of GDP. As well as in Croatia, where the share of debt reached 85.6% of GDP in the first quarter of 2016, the benchmark level of 60% of GDP was exceeded by Slovenia and Hungary. It is noteworthy that general government debt in all countries apart from Hungary and Bulgaria either stagnated or was reduced in the period under review.