HNB

# Macroeconomic Developments and Outlook

# Contents

# General information on Croatia

## Economic indicators

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Area (square km) | 56,594 | 56,594 | 56,594 | 56,594 | 56,594 | 56,594 | 56,594 | 56,594 | 56,594 | 56,594 | 56,594 |
| Population (million)[a] | 4.303 | 4.290 | 4.280 | 4.268 | 4.256 | 4.238 | 4.204 | 4.174 | 4.125 | 4.089 | 4.067 |
| GDP (million HRK, current prices)[b] | 330,771 | 328,824 | 333,215 | 330,509 | 331,209 | 331,343 | 339,696 | 351,169 | 366,426 | 382,965 | 400,102 |
| GDP (million EUR, current prices) | 45,067 | 45,130 | 44,822 | 43,966 | 43,732 | 43,426 | 44,640 | 46,640 | 49,118 | 51,654 | 53,969 |
| GDP per capita (in EUR) | 10,474 | 10,520 | 10,472 | 10,301 | 10,275 | 10,247 | 10,619 | 11,174 | 11,907 | 12,632 | 13,270 |
| GDP – real year-on-year rate of growth (in %) | –7.4 | –1.5 | –0.3 | –2.2 | –0.5 | –0.1 | 2.4 | 3.5 | 3.1 | 2.7 | 2.9 |
| Average year-on-year CPI inflation rate | 2.4 | 1.1 | 2.3 | 3.4 | 2.2 | –0.2 | –0.5 | –1.1 | 1.1 | 1.5 | 0.8 |
| Current account balance (million EUR)[c] | –2,959 | –974 | –799 | –789 | –461 | 111 | 1,452 | 994 | 1,702 | 951 | 1,499 |
| Current account balance (as % of GDP) | –6.6 | –2.2 | –1.8 | –1.8 | –1.1 | 0.3 | 3.3 | 2.1 | 3.5 | 1.8 | 2.8 |
| Exports of goods and services (as % of GDP) | 32.7 | 36.2 | 38.9 | 39.6 | 40.5 | 43.3 | 46.4 | 47.7 | 50.1 | 50.5 | 52.3 |
| Imports of goods and services (as % of GDP) | 38.3 | 37.9 | 40.6 | 41.2 | 42.5 | 43.7 | 46.1 | 46.5 | 49.4 | 51.3 | 52.5 |
| External debt (million EUR, end of year)[c] | 48,173 | 49,423 | 49,117 | 47,575 | 48,471 | 49,095 | 48,230 | 44,714 | 43,683 | 42,710 | 40,877 |
| External debt (as % of GDP) | 106.9 | 109.5 | 109.6 | 108.2 | 110.8 | 113.1 | 108.0 | 95.9 | 88.9 | 82.7 | 75.7 |
| External debt (as % of exports of goods and services) | 327.0 | 302.3 | 282.0 | 273.4 | 273.6 | 260.9 | 232.7 | 201.0 | 177.5 | 163.6 | 144.8 |
| External debt service (as % of exports of goods and services)[d] | 56.0 | 51.2 | 42.5 | 46.1 | 43.5 | 46.3 | 44.0 | 35.7 | 33.1 | 27.1 | 29.6 |
| Gross international reserves (million EUR, end of year) | 10,376 | 10,660 | 11,195 | 11,236 | 12,908 | 12,688 | 13,707 | 13,514 | 15,706 | 17,438 | 18,560 |
| Gross international reserves (in terms of months of imports of goods and services, end of year) | 7.2 | 7.5 | 7.4 | 7.5 | 8.3 | 8.0 | 8.0 | 7.5 | 7.8 | 7.9 | 7.9 |
| National currency: kuna (HRK) | | | | | | | | | | | |
| Exchange rate on 31 December (HRK : 1 EUR) | 7.3062 | 7.3852 | 7.5304 | 7.5456 | 7.6376 | 7.6615 | 7.6350 | 7.5578 | 7.5136 | 7.4176 | 7.4426 |
| Exchange rate on 31 December (HRK : 1 USD) | 5.0893 | 5.5683 | 5.8199 | 5.7268 | 5.5490 | 6.3021 | 6.9918 | 7.1685 | 6.2697 | 6.4692 | 6.6499 |
| Average exchange rate (HRK : 1 EUR) | 7.3396 | 7.2862 | 7.4342 | 7.5173 | 7.5735 | 7.6300 | 7.6096 | 7.5294 | 7.4601 | 7.4141 | 7.4136 |
| Average exchange rate (HRK : 1 USD) | 5.2804 | 5.5000 | 5.3435 | 5.8509 | 5.7059 | 5.7493 | 6.8623 | 6.8037 | 6.6224 | 6.2784 | 6.6223 |
| Consolidated general government net lending (+)/borrowing (–) (million HRK)[e] | –20,005 | –21,261 | –26,369 | –17,695 | –17,677 | –17,725 | –11,262 | –3,338 | 2,920 | 850 | 1,553 |
| Consolidated general government net lending (+)/borrowing (–) (as % of GDP)[e] | –6.0 | –6.5 | –7.9 | –5.4 | –5.3 | –5.3 | –3.3 | –1.0 | 0.8 | 0.2 | 0.4 |
| General government debt (as % of GDP)[e] | 48.7 | 57.8 | 64.4 | 70.1 | 81.2 | 84.7 | 84.3 | 80.8 | 77.8 | 74.7 | 73.2 |
| Unemployment rate (ILO, persons above 15 years of age) | 9.2 | 11.6 | 13.7 | 15.9 | 17.3 | 17.3 | 16.2 | 13.1 | 11.2 | 8.4 | 6.6 |
| Employment rate (ILO, persons above 15 years of age) | 48.2 | 46.5 | 44.8 | 43.2 | 42.1 | 43.3 | 44.2 | 44.6 | 45.8 | 46.9 | 47.7 |

[a] The population estimate of the Republic of Croatia for 2000 is based on the 2001 Census and that for the 2001-2017 period on the 2011 Census. Data for 2019 are preliminary.
[b] The GDP data are presented according to the ESA 2010 methodology. Data for 2018 and 2019 are preliminary.
[c] Balance of payments and external debt data are compiled in accordance with the methodology prescribed by the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) and the new sector classification of institutional units in line with ESA 2010. Balance of payments and external debt data are based on the most recent available balance of payments data up to the third quarter of 2020 and data on the gross external debt position as at the end of September 2020.
[d] Includes principal payments on bonds, long-term trade credits and long-term loans (excluding liabilities to affiliated enterprises), as well as total interest payments (including FISIM), without interest payments on direct investment.
[e] Fiscal data is shown according to the ESA 2010 methodology.
Sources: CBS, MoF and CNB.
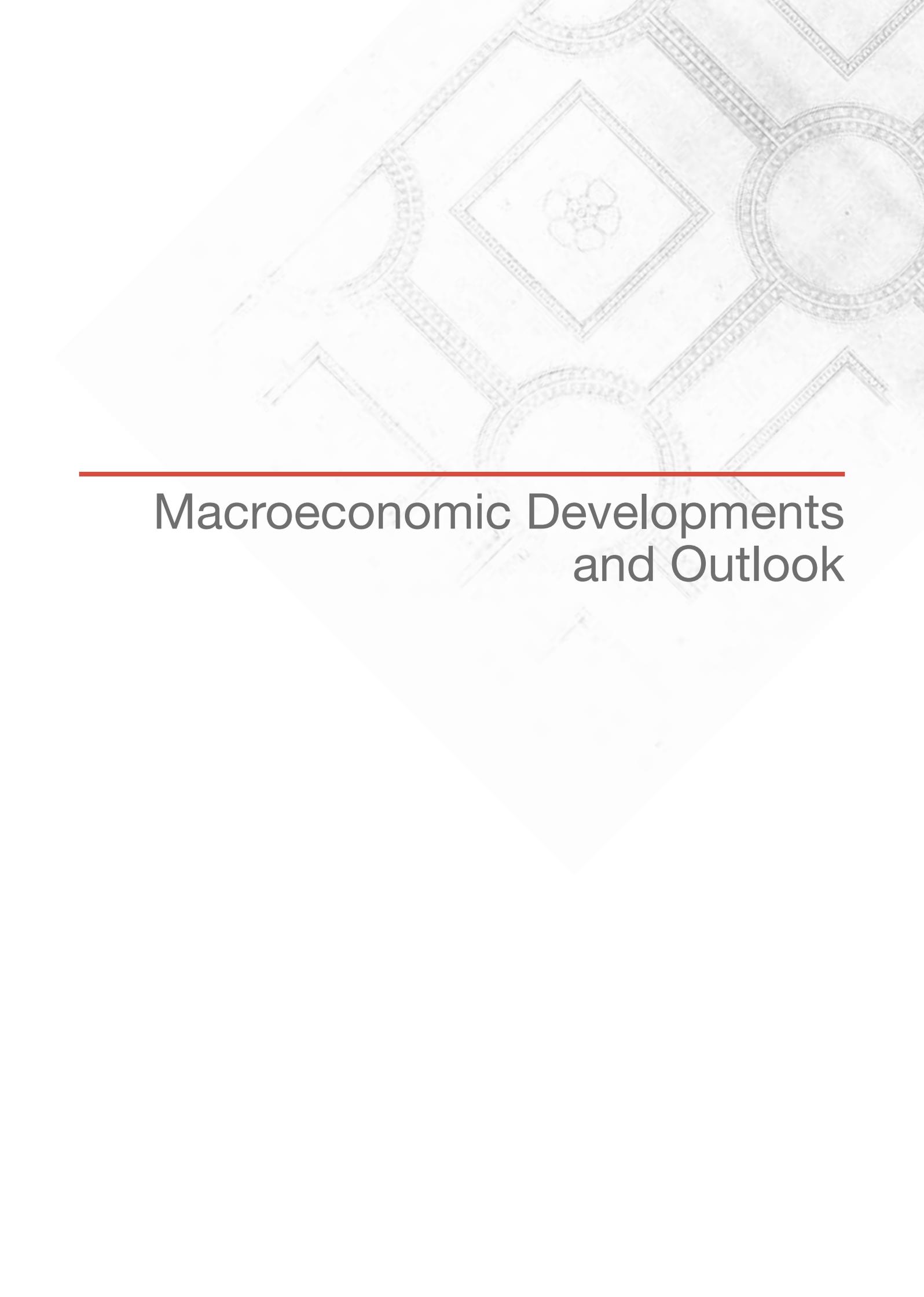
# Macroeconomic Developments and Outlook

# 1 Introduction

The improvement in the epidemiological situation in the third quarter of 2020 was reflected in economic developments, so that real GDP increased on a quarterly basis after a sharp decline in the second quarter. However, the available data for October, as well as the unfavourable development of the epidemiological situation, point to a strong slowdown of the recovery in the last quarter that might also continue in the beginning of 2021. Therefore, real GDP at the level of the whole year might decrease by 8.9%. It is expected that in the course of 2021 the pandemic will be relatively successfully controlled and, if an effective vaccine is deployed, a gradual recovery of economic activity might begin in the second quarter and the annual growth of economic activity might stand at 4.9%. Although employment might fall by 1.5% and the unemployment rate might increase to 7.5%, the labour market reaction to the decline in economic activity in 2020 was mitigated by the strong measures of the Government of the Republic of Croatia to preserve employment. For this reason, the recovery of the labour market in 2021 might also be relatively moderate. The inflation rate is expected to slow down to 0.2% in 2020, mostly due to the significant decrease in the prices of energy (primarily of refined petroleum products) from the previous year, and inflationary pressures might also be subdued in 2021, in which an inflation rate of 1.0% is anticipated; the acceleration of inflation would mostly be the result of the annual rate of change in energy prices entering positive territory. In foreign economic relations, following a noticeable decrease in the current and capital account surplus in 2020, primarily due to the sharp fall in tourism revenues, the surplus is expected to grow, mostly spurred by the expected recovery of tourist activity. In the second half of 2020, the CNB maintained a highly expansionary monetary policy ensuring favourable domestic financing conditions and maintaining the stability of the exchange rate of the kuna against the euro. Banks' free reserves thus reached a record high in November, which contributed to keeping most interest rates at historical lows, similar to those before the pandemic outbreak. In the first ten months, household lending slowed down, mostly because of the decline in general-purpose cash loans. Following a strong growth in the first quarter, from April to October, credit activity directed at corporations was subdued. The CNB will continue to maintain the stability of the exchange rate of the kuna against the euro and support favourable domestic financing in 2021 as well. Due to the impact of the pandemic on the decrease in budget revenues and the growth of budget expenditures, the latest amendments to the 2020 budget suggest that the general government deficit might come to 8.0% of GDP in the current year, with a much lower deficit being expected in 2021. Following a steep increase in 2020, the general government debt-to-GDP ratio might resume its downward trend in 2021.

In the third quarter of 2020, real economic activity recovered partially, following a sharp fall in real GDP in the previous three months caused by the global coronavirus pandemic and the measures introduced to suppress it. Real GDP thus grew by 6.9% on a quarterly basis, after a fall of 15.0% three months earlier. On an annual basis, real GDP decreased by 10.0% in the third quarter from the same period of the previous year. If observed by components, the decrease in total exports, particularly of services, was reflected the most in the decline in economic activity on an annual level. A negative contribution to growth was also made by all domestic demand components, except government consumption. Goods and services imports fell sharply from the previous year, but less than total exports, so that the contribution of net foreign demand to the change in real GDP was extremely negative.

Real GDP might fall by 8.9% in 2020, and then rise by 4.9% in 2021. The monthly data, available mostly for October, as well as the data on the development of the epidemiological situation in the Republic of Croatia, point to a slowdown of the recovery in the last quarter of 2020 that might also continue in the beginning of 2021. In 2020, the largest negative contribution to growth might come from the fall of total exports, due in particular to the strong decline in the exports of services, compounding the fall in the exports of goods. It is also expected that a negative contribution might come from all domestic demand components, except government consumption. However, the developments in exports can be estimated as being relatively favourable in the given circumstances, since volume indicators suggest that the annual decline in the exports of tourist services might be smaller than in the main competitors, while the performances of goods exports show a smaller decline than the average decline in Central and Eastern European countries. The expected economic growth in 2021 will not enable economic activity to return to the level of before the pandemic outbreak, as the pandemic might also leave some long-term consequences. The strongest boost to the growth of real economic activity in 2021 might be provided by a rise in total exports, with growth also expected in all components of domestic demand. A contribution to the growth of investments might come from the larger availability of EU funds aimed at financing significant new investments for the purpose of the reconstruction of Zagreb after the earthquake. The reduction of income taxation should contribute to the growth of personal consumption. Total imports might also rise on the back of the recovery of the domestic and foreign demand. It is estimated that the risks in the GDP growth projection are balanced around the mentioned central value. The main upside and downside risks are associated with the development of the epidemiological situation and the measures to curb it and with the absorption of EU funds. The main downside risks for economic growth are associated with the possibility of the intensified spreading of the virus and the introduction of more restrictive measures than currently expected, with the possible logistic challenges concerning the organisation of the vaccination of the population and the rollout of the vaccine, as well as with the smaller than expected absorption of EU funds. Upside risks are associated with the possibility that a large number of people receive the vaccine before the next tourist season, not only in Croatia but also in its main trading partners, and with a better absorption of EU funds from the available financial envelope when compared with the relatively conservative assumptions integrated in the projection.

The measures of the Government of the Republic of Croatia to preserve jobs mitigated the market reaction in 2020 relative to the estimated decline in economic activity. Thus, after

a several-year trend of favourable developments in the labour market, employment is expected to fall by 1.5% in 2020, while the ILO unemployment rate might go up from 6.6% in 2019 to 7.5% of the labour force. The number of employed persons is expected to grow moderately in 2021, while the ILO unemployment rate might fall to 7% of the labour force. As regards wages, the average nominal gross wage is expected to grow in 2020 by 2%, and in 2021, its growth might accelerate to 2.3%, primarily because of the increase in wages in the public sector, while wages in the private sector might increase only slightly.

The average annual consumer price inflation might slow down to 0.2% in 2020 (from 0.8% in 2019), and then rise to 1.0% in 2021. The slowdown in inflation in 2020 was primarily the result of the considerable decrease in the prices of energy (mostly refined petroleum products) from the previous year, while the annual rate of change in the prices of energy is expected to rise in 2021. The average annual rate of consumer price inflation excluding food and energy might accelerate moderately in 2020 to 1.0% and remain around the level of its long-term average. The decline in demand due to the coronavirus pandemic is a factor impacting the easing of inflationary pressures, particularly in the segment of tourism-related services and durable consumer goods. On the other hand, among the factors that impact the growth in inflation in 2020 are, in particular, administrative decisions (increase in excise duties) and the rise in unit labour costs and the costs associated with the implementation of epidemiological measures. Furthermore, it has been forecast that in 2021, in conditions of the recovery of demand, consumer price inflation (excluding food and energy)

might increase slightly to about 1.1%. It is expected that in conditions of a gradual recovery of tourist demand the annual rate of change in the prices of tourism-related services will increase. Low inflation in 2021 should also be attributed to subdued inflationary pressures from the external environment, having in mind the low projected inflation in Croatia's major trade partners. The average annual rate of growth of food prices is expected to slow down in 2021.

Tourist activity suffered a severe blow from the coronavirus pandemic, the accompanying epidemiological measures of restricted travel and physical distancing, the worsened economic situation and the fear of the spreading of the contagion and the avoidance of exposure to the risk of infection. Revenues from foreign tourist consumption in Croatia might be cut by more than a half in 2020 from the previous year; this is the main factor of a noticeable decrease in the current and capital account surplus. By contrast, unfavourable trends might be mitigated by the decrease in the deficit in foreign trade in goods due to the sharper decline in the imports than in the exports, as well as, to a smaller extent, the decline in profitability of domestic enterprises and banks in foreign ownership and a more intensified absorption of EU funds. In addition to a strong deterioration in the developments in the current and capital account, the intensity of the deleveraging of domestic sectors is also expected to decrease. Nevertheless, due to the sharp fall in nominal GDP, the relative indicator of gross external debt might worsen temporarily. In accordance with the expected recovery of tourist activity, the current and capital account surplus might increase in 2021. In addition to the growth in revenues from tourism, a further

## Table 1.1 Summary table of projected macroeconomic measures

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **National accounts** (real rate of change, in %) | | | | | | | | | | | |
| GDP | −0.2 | −2.4 | −0.4 | −0.3 | 2.4 | 3.5 | 3.4 | 2.8 | 2.9 | −8.9 | 4.9 |
| Personal consumption | 1.0 | −2.4 | −1.6 | −2.5 | 0.2 | 3.1 | 3.2 | 3.3 | 3.6 | −6.6 | 4.5 |
| Government consumption | 0.5 | −1.2 | −0.1 | 1.6 | −1.6 | 0.5 | 2.2 | 2.3 | 3.4 | 2.0 | 2.2 |
| Gross fixed capital formation | −2.7 | −3.3 | 1.4 | −2.8 | 3.8 | 6.5 | 5.1 | 6.5 | 7.1 | −5.2 | 7.2 |
| Exports of goods and services | 2.3 | −1.5 | 2.5 | 7.4 | 10.3 | 7.0 | 6.8 | 3.7 | 6.8 | −26.4 | 19.3 |
| Imports of goods and services | 2.5 | −2.4 | 3.2 | 3.5 | 9.4 | 6.5 | 8.4 | 7.5 | 6.3 | −16.3 | 15.0 |
| **Labour market** | | | | | | | | | | | |
| Number of employed persons (average rate of change, in %) | −1.1 | −1.2 | −1.5 | −2.0 | 0.7 | 1.9 | 1.9 | 2.3 | 2.3 | −1.5 | 0.7 |
| Registered unemployment rate | 17.8 | 18.9 | 20.2 | 19.6 | 17.0 | 14.4 | 11.6 | 9.2 | 7.6 | 9.1 | 8.5 |
| ILO unemployment rate | 13.7 | 15.9 | 17.3 | 17.3 | 16.2 | 13.1 | 11.2 | 8.4 | 6.6 | 7.5 | 7.0 |
| **Prices** | | | | | | | | | | | |
| Consumer price index (average rate of change, in %) | 2.3 | 3.4 | 2.2 | −0.2 | −0.5 | −1.1 | 1.1 | 1.5 | 0.8 | 0.2 | 1.0 |
| Consumer price index (rate of change, end of period, in %) | 2.1 | 4.7 | 0.3 | −0.5 | −0.6 | 0.2 | 1.2 | 0.8 | 1.4 | −0.3 | 1.4 |
| **External sector** | | | | | | | | | | | |
| Current account balance (as % of GDP) | −1.7 | −1.8 | −1.1 | 0.3 | 3.3 | 2.1 | 3.4 | 1.8 | 2.8 | −1.0 | 0.1 |
| Current and capital account balance (as % of GDP) | −1.6 | −1.5 | −0.9 | 0.7 | 4.0 | 3.7 | 4.5 | 3.2 | 4.8 | 1.4 | 3.0 |
| Gross external debt (as % of GDP) | 109.3 | 108.0 | 110.6 | 113.1 | 108.1 | 95.9 | 88.7 | 82.2 | 75.3 | 82.2 | 76.2 |
| **Monetary developments** (rate of change, in %) | | | | | | | | | | | |
| Total liquid assets – M4 | 5.6 | 3.6 | 4.0 | 3.2 | 5.2 | 4.7 | 2.1 | 5.5 | 2.9 | 8.9 | 3.2 |
| Total liquid assets – M4[a] | 4.4 | 3.5 | 3.8 | 2.4 | 4.6 | 5.3 | 3.2 | 6.1 | 3.5 | 8.4 | 3.4 |
| Credit institution placements to the private sector | 4.8 | −5.9 | −0.5 | −1.6 | −3.0 | −3.7 | −1.2 | 2.0 | 2.8 | 3.2 | 3.0 |
| Credit institution placements to the private sector[a] | 3.5 | −1.2 | 0.8 | −1.5 | −2.3 | 1.1 | 2.9 | 4.4 | 4.2 | 2.8 | 3.3 |
| Credit institution placements to corporates[a] | 7.6 | −1.5 | 1.8 | −3.7 | −3.0 | 3.2 | 2.5 | 1.9 | 0.4 | 2.6 | 3.7 |
| Credit institution placements to households[a] | −0.7 | −1.1 | −1.2 | −0.7 | −1.8 | 0.5 | 4.0 | 6.2 | 7.4 | 3.4 | 3.5 |

[a] 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 the CNB Bulletin No. 221).
Sources: CBS, MoF and CNB.

increase in the absorption of EU funds might also make a con-tribution, to a smaller extent. By contrast, in parallel with the recovery of demand in the major trading partners, goods exports are expected to increase noticeably. At the same time, however, the growth of goods imports might be faster than the recovery of personal consumption and investments, as well as the exports of goods and services, which together with the much larger imports base might result in a strong worsening of the foreign trade defi-cit. As regards capital flows, net capital outflows are expected to intensify again in 2021 in addition to the continuation of the pre-crisis trend of improvements of relative foreign liabilities indicators.

In the second half of 2020, the CNB maintained its high-ly expansionary monetary policy ensuring favourable domestic financing conditions and maintaining the stability of the ex-change rate of the kuna against the euro. Banks' free reserves thus reached a record high in November, which contributed to keeping most of the interest rates at historical lows, similar to those before the pandemic outbreak. In the course of the third quarter, banks relaxed credit standards for household loans after the strong tightening in the first half of the year, while continu-ing to tighten credit standards for corporate loans. The annual growth of household placements continued to decelerate moder-ately, mostly due to the decrease in general-purpose cash loans. The annual growth of placements to corporations accelerated,

mostly due to the strong increase in the first quarter. However, from April to October, credit activity directed at corporations was subdued, mostly driven by the decrease in loans for working capital, which had recorded a sharp increase in March as a re-sult of the demand of corporations for liquid assets. In 2020 as a whole, household placements are expected to slow down when compared with the previous year due to the decline in general-purpose cash loans, while growth in corporate loans is expected to accelerate, mostly as a result of the strong credit activity in the first quarter. Although Croatia has been in the ERM II regime since 10 July 2020, the CNB's monetary and foreign exchange policy has not changed.

As regards fiscal policy, according to the latest amendments to the 2020 budget of November, the budget proposal for 2021 and the projections of the Ministry of Finance for 2022 and 2023, after the general government budget surplus in 2019 of 0.4% of GDP, in 2020, under the effect of the recession, a gen-eral government deficit might amount to 8.0% of GDP, while a general government deficit of 2.9% of GDP is expected for 2021. The autumn projections of the European Commission from November 2020 show a somewhat narrower deficit in 2020 (6.5% of GDP), and a similar deficit in 2021 (2.8% of GDP). At the same time, the general government debt-to-GDP ratio, following a steep increase in 2020, should resume its downward path in 2021.

# 2 Global developments

Significant changes in consumer and corporate behaviour caused by the coronavirus pandemic and the accompanying re-strictive epidemiological measures resulted in a strong deteriora-tion in global economic developments. In the first nine months of 2020, the world economy recorded the deepest contraction since the Second World War. The deterioration in developments was not of the same intensity across the world (Figure 2.1) due to the differences in epidemiological situations and the differ-ent timing of the introduction of epidemiological measures. Af-ter the sharp decline in the first quarter, the Chinese economy again recorded a positive annual rate of change in real GDP as

early as in the subsequent three months, and during the summer months, the recovery accelerated additionally. By contrast, the pandemic spread slightly later in the rest of the world, in particu-lar in the USA and the euro area and the strongest contraction was recorded in the second quarter. Due to the improved epide-miological situation and the lifting of many restrictive measures, economic recovery was strong on a quarterly basis in the third quarter, both in the USA and in the euro area, although eco-nomic activity remained noticeably below the pre-crisis levels.

The unprecedented deterioration in economic conditions led to a strong tightening of financing conditions in money markets and a plunge in the value of major stock exchange indices. How-ever, thanks to the strong response by central banks worldwide and an extremely expansionary monetary policy, financial mar-kets stabilised very quickly and financing conditions remained relatively favourable, particularly in terms of government bond yields. The stabilisation of yields facilitated the strong fiscal re-sponse, which noticeably mitigated the social and economic consequences of the pandemic. On the back of the information on a strong recovery in economic activity following the lifting of restrictive measures in May and June 2020, stock exchange indices offset most of the losses incurred in the beginning of the year.

After a sharp fall in the second quarter (9.0% on an annual level), the US economy started to recover perceptibly in the third quarter. Despite the continued relatively unfavourable epidemio-logical situation and the large number of new cases even dur-ing the summer, in the third quarter the US economy recovered strongly from the previous quarter, thanks to an extremely ex-pansionary monetary policy and the federal budget's large fiscal stimulus. Nevertheless, viewed on an annual level, a 2.9% con-traction was also recorded in the third quarter. The early eco-nomic activity indicators available so far for the last months of
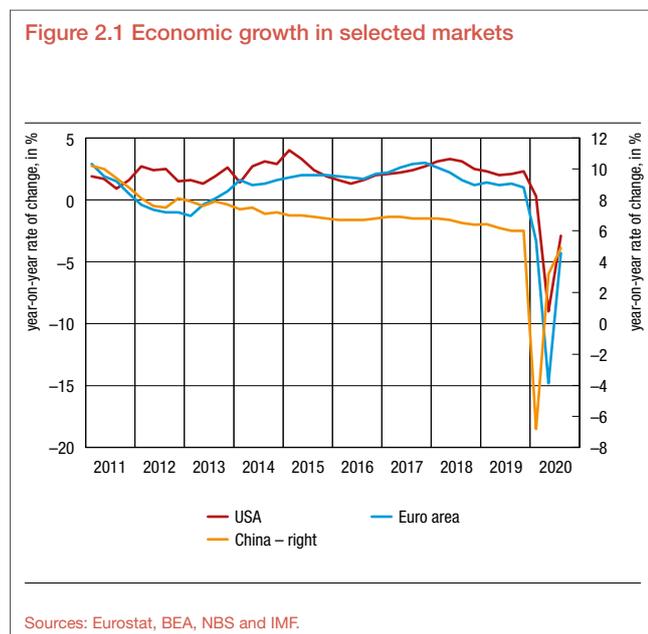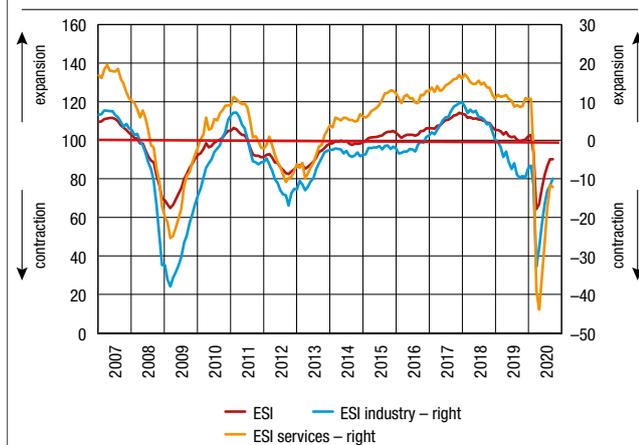


Figure 2.1 Economic growth in selected markets

Sources: Eurostat, BEA, NBS and IMF.

Figure 2.2 Euro area confidence indicators

Note: Data are up to October 2020.
Source: Eurostat.



Figure 2.3 Stringency index of epidemiological measures in Croatia's main trading partners relative to the world average

Notes: Data from the beginning of the year up to 31 October 2020. The stringency index of epidemiological measures for trading partners is calculated as the weighted average in terms of the countries' share in Croatian exports. The global average was calculated as an unweighted average of all countries in the world. Zero indicates a minimum and a hundred indicates a maximum level of stringency of the epidemiological measures imposed.
Source: Oxford COVID-19 Government Response Tracker.

the year show that the recovery is slowing down due to the worsening epidemiological situation, the growing uncertainty concerning the US elections and the failure to reach an agreement on the new fiscal package of assistance to the economy funded from the federal budget.
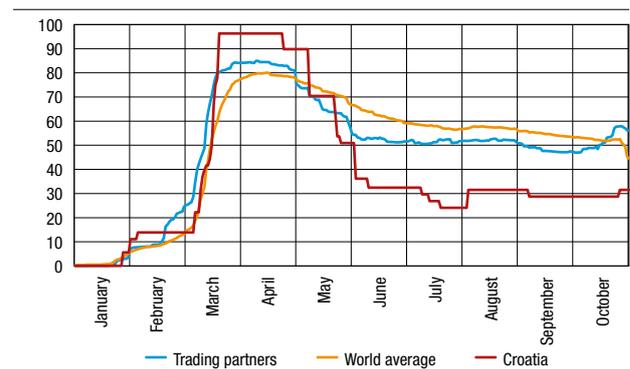
A similar quarterly dynamics was also recorded in the euro area. After a strong deterioration of the epidemiological situation in most of the member states in spring this year, in particular in Italy, Spain and France, economic activity in the euro area decreased by 14.8% on an annual basis in the second quarter. The contraction was the most pronounced precisely in countries with the most unfavourable epidemiological situation and a high share of service activities in national income generation. However, after the relaxation of the measures, economic activity rebounded strongly in the summer months, compared with the previous quarter, so that the GDP level was 4.3% lower in the third quarter than in the same period of the previous year. Early economic activity development indicators available for October (Figure 2.2) suggest that economic activity might contract again on a quarterly basis in the last three months of the current year as a result of the imposition of stringent measures after the worsening of the epidemiological situation in autumn.

After growing steadily for several decades, the Chinese economy saw an annual fall in economic activity of 6.8% due to the outbreak of the epidemic in the first quarter of 2020. However, after the restrictive epidemiological measures had been lifted, the Chinese economy returned to the positive annual growth rates as early as in the second quarter, when growth stood at 3.2% and then accelerated additionally in the third quarter to 4.9%. The recovery of the Chinese economy was strongly driven by a growth in industrial production and the normalisation of activities in the real estate market, in particular the sale as well as the construction of residential buildings.

## Croatia's main trading partners

All Croatia's major trading partners recorded extremely unfavourable economic developments in the first nine months of 2020. This particularly refers to trading partners in the euro area, in particular Italy, one of the countries that was the most severely affected by the pandemic in global terms. The economic downturn in other major trading partners in the euro area, such as Slovenia, Austria or Germany, was slightly smaller. On the other hand, unfavourable trends were less pronounced in trading

partners outside the euro area and in the immediate vicinity, in particular Serbia, despite the relatively unfavourable epidemiological situation. After the relaxation of the measures on a global level in the late spring of this year, the stringency of the restrictive measures that remained in force in Croatia's major trading partners was slightly lower than the world average until October 2020 (Figure 2.3). The renewed tightening of the measures noticeable from the end of October might have an unfavourable impact on foreign demand for Croatian export products.

## Prices, exchange rates and monetary and fiscal policy

The price of Brent crude oil, having fallen sharply in the first four months, recovered partially in the rest of the year, although it remained below the level of before the pandemic outbreak. In late April, the price of oil was about USD 20 per barrel, and then increased to about USD 40 at the end of June. In July and August, the price continued to grow up to USD 45, after which it fell to the level of USD 37 by the end of October. On one hand, the recovery in oil prices was due to the agreement among OPEC countries and other oil producers to reduce production in response to the decline in demand, a fall in crude oil reserves in the USA and the relaxation of the measures after the first wave of the economic lockdown. On the other hand, the drop in the price was, among other things, the result of the autumn growth in the number of new coronavirus infection cases and the introduction of new measures to prevent its spread. The recent growth of the crude oil price from USD 37 in late October to USD 47 at the end of November was driven by the information on the discovery and the expected early deployment of the coronavirus vaccine, the increase in the quotas for the imports of oil into China in 2021 and a fall in crude oil reserves in the USA. Despite this, the price of crude oil was almost a third lower than at the end of 2019.

As regards raw materials excluding energy, after the fall in the first four months of 2020, the prices increased in the remainder of the year. The increase in the prices of raw materials was the result of the easing of the initially introduced measures to prevent the spread of the coronavirus pandemic. The growth in the prices of metals spurred by the reactivation of industry worldwide was the most pronounced, while the prices of food products increased in all segments except the prices of rice and meat. The decline in the prices of rice can be attributed to its

cropping season in Asia, while the prices of meat, mainly pork, fell as a consequence of the smaller demand due to restrictions on meat imports from Europe into China.

After the strong response by central banks to the deterioration of the economic situation in the beginning of the year, there were no significant changes in the monetary policy. In response to the first signs of deterioration, the Fed reduced the range for its benchmark interest rate to the minimum at several extraordinary meetings and introduced several funding programmes that strongly increased the Fed's balance sheet. The ECB also responded very decisively by a series of monetary policy measures aimed at maintaining financial stability and favourable financing conditions for all sectors of the economy, such as the additional programme to purchase government and corporate bonds and additional long-term financing operations of banks. At the same time, both the Fed and the ECB concluded currency swaps with a large number of central banks in order to secure sufficient dollar and euro liquidity for the global economy. All instruments introduced in spring are still in force. As the epidemiological situation worsened again in autumn, in particular in the euro area, in which some member states reintroduced the most stringent restrictive measures, markets expect that by the end of the year the ECB might react and strengthen the expansionary character of the monetary policy further by increasing the volume of securities purchases.

After the one-off strong deterioration in the beginning of 2020 due to the increased uncertainty caused by the pandemic outbreak, financing conditions nevertheless improved significantly and remained very favourable towards the end of the year. This was primarily attributed to the described strong response by central banks, in particular with regard to the stabilisation of government bond yields. Favourable financing conditions enable the continuation of many governments' major fiscal measures to mitigate the consequences of the pandemic. However, it is expected that in the coming quarters the fiscal stimulus will be slightly smaller and targeted primarily to the hardest hit economic sectors.

Global foreign exchange market developments continued to be strongly affected by the unfavourable events in the international environment in the third quarter. During the summer months, the exchange rate of the US dollar against the euro depreciated strongly and stood at EUR/USD 1.17 in late September 2020, which is an increase of 6.1% from the end of June 2020. The weakening of the dollar is a reflection of several factors, primarily the lower risk aversion of investors after the indications of the economic recovery following the relaxation of measures in late spring and the resulting smaller demand for safe havens, as well as the growing uncertainty as regards the results of the US elections. The euro strengthened on the back of the summer agreement among member states concerning the multiannual budget and the funding of a common EU recovery instrument. Trends similar to that in the case of the USD were also seen in the exchange rate of the Swiss franc. Thus, the exchange rate of the Swiss franc against the euro was 1.3% higher at end-September than at the end of June 2020 and stood at EUR/CHF 1.08.

## Projected developments

After the initial dramatic worsening due to the outbreak of the pandemic, the economic growth estimate for 2020 stabilised and even improved slightly for some parts of the world, compared with the previous forecasts (Figure 2.4). However, these estimates still do not fully reflect the epidemiological situation, which has worsened again and is accompanied by new epidemiological measures introduced in the fourth quarter.



Figure 2.4 Expected real GDP growth for 2020 in selected countries
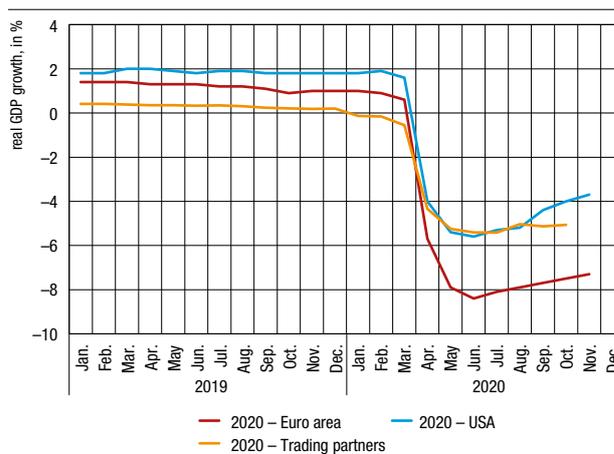
Source: Consensus Forecasts.

Most of the published projections for 2021 are based on the assumption of normalisation of the epidemiological situation in the course of 2021, primarily thanks to the expected fast deployment of the vaccine, which should lead to a perceptible recovery of economic activity and the volume of global trade. At the same time, the Fed and the ECB are expected to maintain their exceptionally expansionary monetary policy. Furthermore, crude oil prices are expected to recover gradually, while the prices of other raw materials excluding energy might decrease only slightly.

According to IMF projections (WEO, October 2020), under the baseline scenario the global economy is expected to shrink by 4.4% in 2020 (Figure 2.5). The decline in economic activity might be broad-based, however, the deepest contraction is expected in developed countries, primarily in the euro area, while the assumed decline in economic activity of emerging market countries is slightly less pronounced thanks to the quick recovery of the Chinese economy. Under the assumption of stabilisation of the epidemiological situation, the baseline scenario expects a strong recovery of the global economy by 5.2% in 2021. It should be noted that the projection is still mostly exposed to downside risks, particularly in terms of possible new waves of



Figure 2.5 Global economic developments
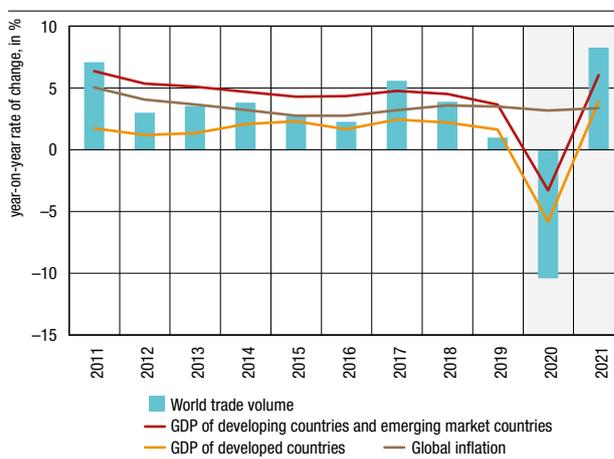
Source: IMF (WEO, October 2020).

the infection that would slow down economic recovery further.

According to IMF October estimates, the contraction of the euro area economy might stand at 8.3% in 2020 under the baseline scenario, which, notwithstanding the strong and rapid response of monetary and fiscal policy, with the exception of the UK, would be the sharpest economic downturn in developed countries (Figure 2.6). At the same time, the IMF expects that economic activity might rebound by 5.2% in 2021. However, the recent European Commission forecasts from November are slightly more favourable and expect that economic activity in the euro area would fall by 7.8% in 2020. On the other hand, in contrast to the IMF, the European Commission estimates a slower recovery in 2021, of 4.2%.

In accordance with the described trends in the global economy, demand for Croatian export products is expected to plunge in 2020 (Figure 2.7). This might be mostly due to the sluggish imports of key partners from the euro area, such as Slovenia, Italy and Germany. On the other hand, a leap in foreign demand is expected in 2021, which, in addition to euro area members, might also be attributable to other non-euro area EU member states.

As regards the prices of raw materials on the global market, market expectations suggest that crude oil prices might continue to grow moderately until the end of the current year and in 2021 (Figure 2.8). Price recovery might be supported by a possible delay of the output hike by OPEC+ countries, the expected implementation of a medical solution for the coronavirus and a faster than expected recovery of the global demand for oil.

The prices of raw materials excluding energy might increase at the level of the whole of 2020 and the rise in the prices of metals, beverages and food products might be partially offset by the fall in the prices of agricultural raw materials. In the remainder of the projected period, the prices of raw materials excluding energy might fall only slightly as a consequence of the decline in the prices of all subcomponents, although at the level of the whole of 2021 on average they might be higher than the average prices in 2020.

Markets expect that the exceptionally expansionary monetary policy will be maintained for the time being. Benchmark interest rates might stay at their current very low levels during most of the projected period and they are not expected to be raised before the second half of 2022 (Figure 2.9). As regards monetary



Figure 2.6 Economic growth and inflation in the euro area
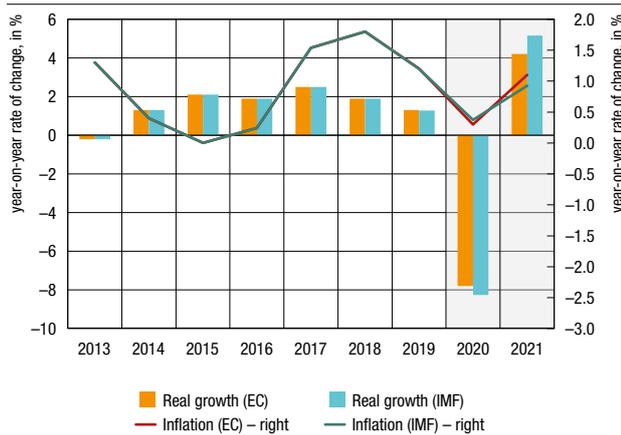
Sources: IMF (WEO, October 2020) and European Commission (November 2020).



Figure 2.8 Prices of raw materials on the international market
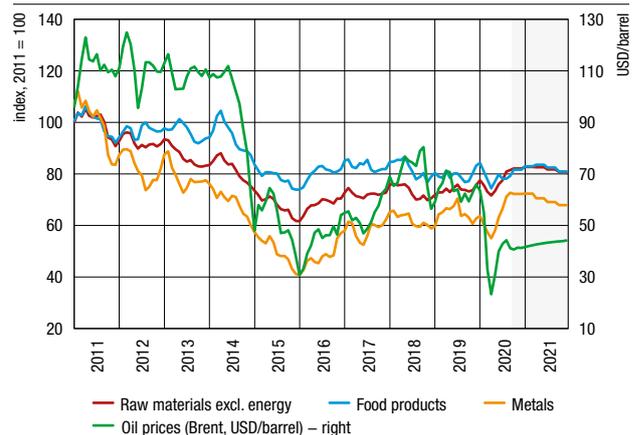
Sources: IMF (September 2020), prices of oil: Bloomberg (Brent crude oil futures, 5 November 2020) and CNB estimates.



Figure 2.7 Foreign demand
contributions of Croatia's trading partners
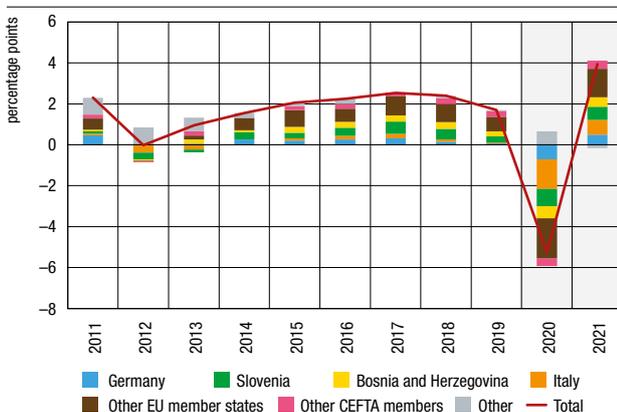
Note: Foreign demand is calculated as the weighted average of real GDP growth of Croatia's trading partners, with their shares in Croatia's exports of goods used as weights.
Source: IMF (WEO, November 2020).



Figure 2.9 Benchmark interest rates and the average yield spread on bonds of European emerging market countries
end of period
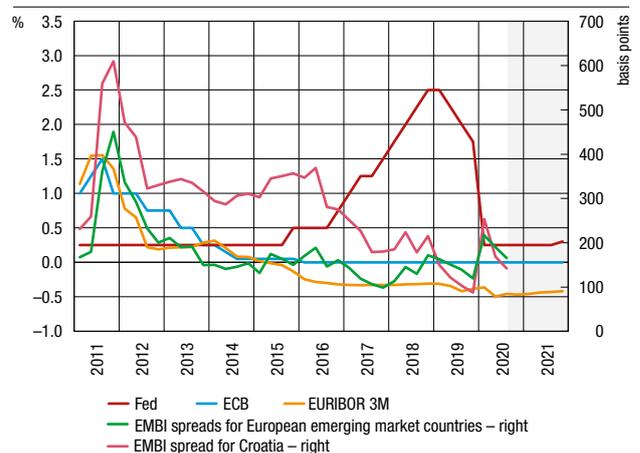
Source: Bloomberg.

policy normalisation, the first step might again be made by the Fed, with the reduction of the volume or the termination of un-conventional measures, such as various programmes to finance all sectors of the economy, but there are yet no clear signs when this might happen.

According to the expectations published in the Novem-ber Foreign Exchange Consensus Forecast, the trend of the strengthening of the euro against the US dollar on the global foreign exchange market is expected to continue until the end of 2020 and throughout 2021 (Figure 2.10). The average ex-change rate of the US dollar against the euro might stand at EUR/USD 1.14 in 2020, an increase of 1.6% from EUR/USD 1.12 in 2019. By contrast, as regards the Swiss franc, the aver-age exchange rate in 2020 might stand at EUR/CHF 1.07, a decrease of 4.0% from 2019.

Although reports of the high vaccine efficacy in the final phase of trials have contributed greatly to the reduction of un-certainty as regards the assumed recovery of the world econo-my, the pandemic still represents the largest risk for the global economy with still more pronounced downside risks. The safe distribution and a rapid deployment of the vaccine pose a large organisational and logistical challenge, so that a successful med-ical solution to the pandemic in the first half of 2021cannot be assumed with certainty. On the other hand, in addition to the risks directly associated with the pandemic development, the deterioration in the global economic situation is exacerbated by the possibility of the materialisation of other risks and idiosyn-cratic economic shocks due to accumulated macroeconomic

**Figure 2.10 Exchange rates of individual currencies against the euro**
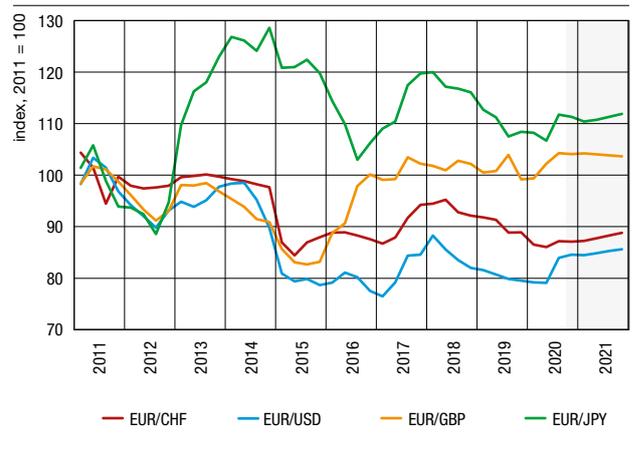


Note: A growth in the index indicates a depreciation of a currency against the euro.
Sources: Eurostat and Foreign Exchange Consensus Forecasts (November 2020).

imbalances in all major global economies. The sustainability of the high levels of debt that governments and other sectors across the world have accumulated and additionally raised to finance the fiscal response and mitigate the consequences of the pan-demic merits particular attention.

# 3 Aggregate supply and demand

After a sharp quarterly fall in real GDP in the second quar-ter of 2020 (15.0%), caused by the global coronavirus pandem-ic, economic activity in Croatia recovered partially in the third quarter and grew by 6.9%. Despite the growth on a quarterly ba-sis, real GDP decreased by 10.0% in the third quarter from the same period of the previous year. The monthly data, available mostly for October, suggest that the economy also continued to recover in the last quarter of 2020, although at a much slower

pace, which was also associated with the worsening epidemio-logical situation.

The fall in total exports, particularly the exports of services, made the largest contribution to the decrease in economic ac-tivity on an annual level in the third quarter. A negative contri-bution to growth was also made by all domestic demand com-ponents except government consumption. In accordance with such developments, the imports of goods and services decreased

**Figure 3.1 Gross domestic product (GDP)**
real values
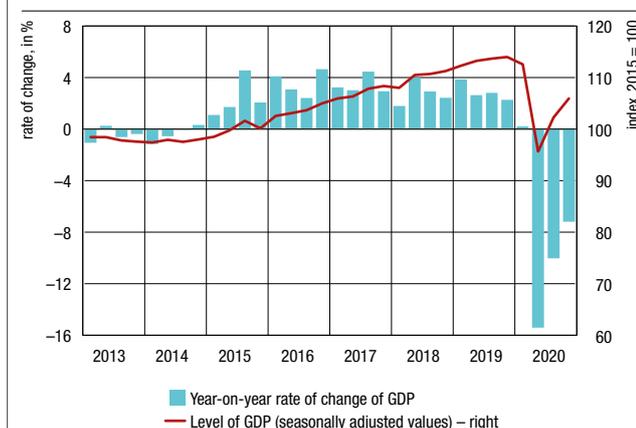


Note: The data for the fourth quarter of 2020 refers to the CNB's indicator of real activity, estimated from the data published until 30 November 2020.
Source: CBS (seasonally adjusted by the CNB).

**Figure 3.2 GDP rate of change**
contributions by components
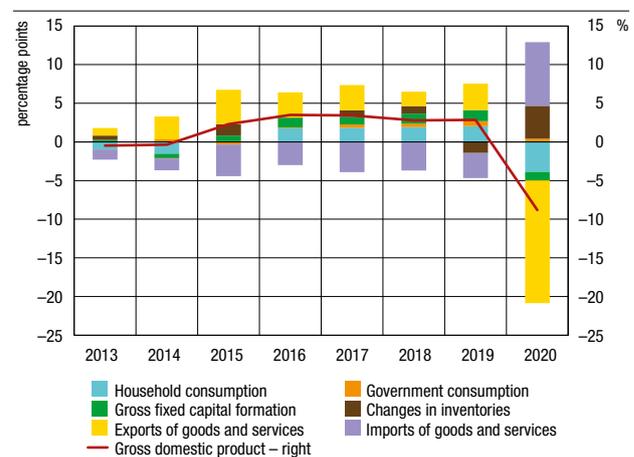


Note: Data for 2020 refer to the first three quarters of 2020.
Source: CBS.

sharply, but less than total exports, so that the contribution of net foreign demand to total economic growth was extremely negative in the third quarter.

The production side of the calculation of GDP shows that gross value added (GVA) fell by 7.6% in the third quarter from the same period of the previous year, while in the second quarter the rate of decline was 12.0%. As in the previous quarter, GVA fell much less than GDP. The largest decrease in GVA was recorded in wholesale and retail trade, transportation and storage, accommodation and food service activities, that is, in the activities connected with tourism and those very susceptible to the physical distancing measures.
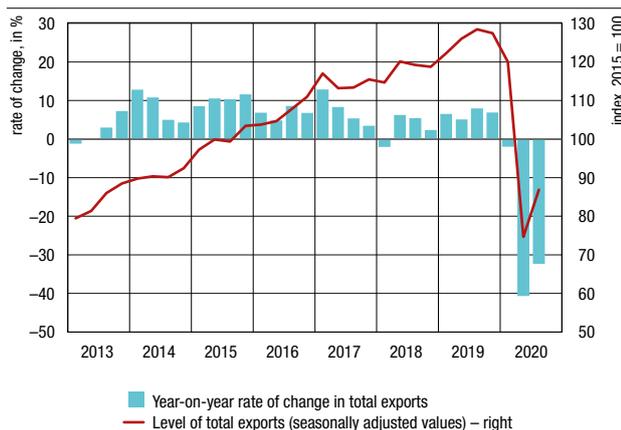
## Aggregate demand

As regards movements in foreign demand, total exports in the period from July to September were 32.3% smaller than in the same period of 2019 (the annual decline in the second quarter was 40.7%). The mentioned decline in the third quarter was primarily the consequence of the annual decrease in the exports of services (45.3%), while the annual fall in the exports of goods was much less pronounced (3.0%). Such developments reflect

the high sensitivity of the tourist sector to the physical distancing measures introduced to curb the coronavirus pandemic, and the concomitant global fall in demand for tourist services. Observed on a quarterly basis, total real exports increased by 16.3% in the third quarter. After an almost complete suspension of tourist travel in April and May, a gradual recovery of tourist activity began in June, as evidenced by the data on the number of tourist nights stayed. The exports of goods also increased on a quarterly basis, with nominal data on goods trade showing that the recovery of exports in the third quarter was achieved thanks to the growth of exports in all MIG components.
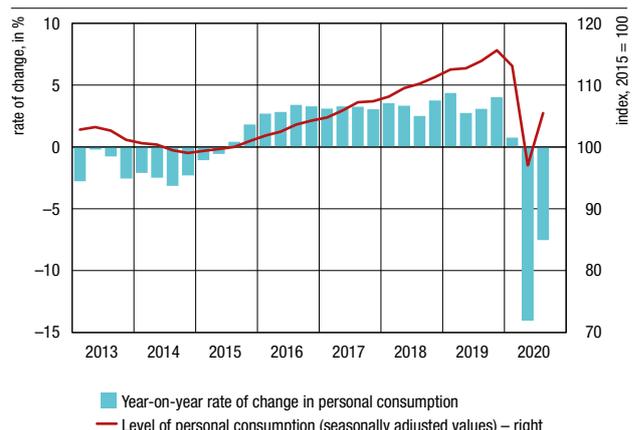
Personal consumption also partially recovered in the third quarter and increased by 8.7% from the previous three months. Favourable developments reflect the lifting of a large number of physical distancing measures, as well as the partial recovery of consumer optimism. As regards consumer expectations, the rise in optimism on a quarterly basis is the consequence of improved expectations regarding the financial situation of households in 12 months from now and the expectations regarding the overall economic situation in Croatia in 12 months compared with the present situation. Nevertheless, like the developments in



Figure 3.3 Exports of goods and services
real values

Year-on-year rate of change in total exports
Level of total exports (seasonally adjusted values) – right

Source: CBS (seasonally adjusted by the CNB).



Figure 3.5 Personal consumption
real values

Year-on-year rate of change in personal consumption
Level of personal consumption (seasonally adjusted values) – right

Source: CBS (seasonally adjusted by the CNB).



Figure 3.4 Exports of goods and services

Year-on-year rate of change in exports of goods
Year-on-year rate of change in exports of services
Level of exports of goods (seasonally adjusted values) – right
Level of exports of services (seasonally adjusted values) – right
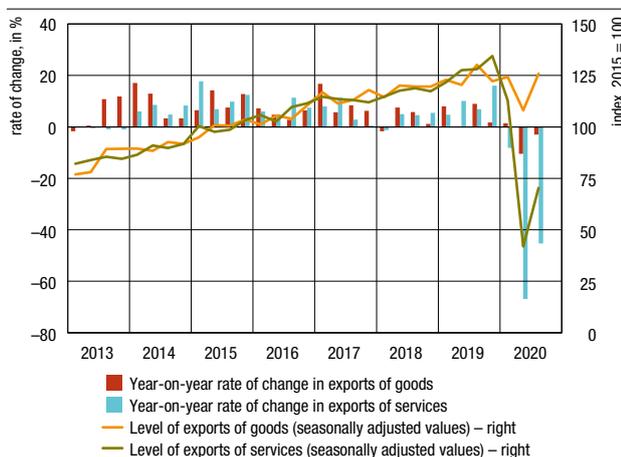
Source: CBS (seasonally adjusted by the CNB).



Figure 3.6 Determinants of personal consumption
real values and index

Compensation of employees and social benefits in cash        Personal consumption
Consumer confidence indicator (standardised values) – right
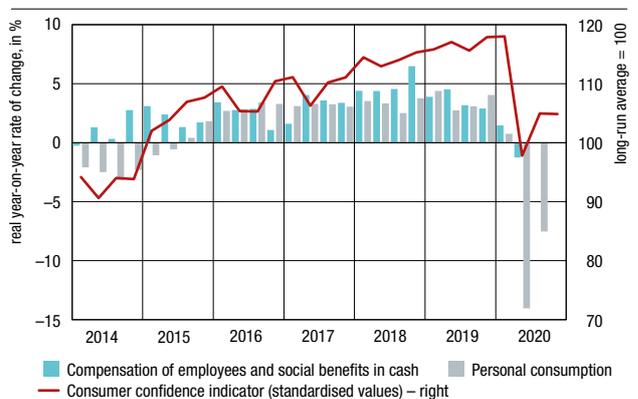
Notes: Real values of compensation of employees and social benefits in cash were calculated by deflating nominal values using the personal consumption deflator. Consumer confidence indicator values were calculated as three-member averages of monthly data, where the most recent data refers to November 2020.
Sources: CBS, Ipsos and CNB.

expectations, the recovery of household consumption was also incomplete, so that household consumption in the third quarter of the current year was 7.5% lower than in the same period of the previous year.

Investment activity also showed signs of recovery in the third quarter of 2020 and was 15.1% higher than in the previous three months. The monthly data on construction works point to such developments and show that the real volume of construction works in the third quarter was 5.6% larger than in the same period of the previous year. The growth of the volume of works was achieved in both buildings and civil engineering works; this, when added to the available data on the movement of individual public investment projects, indicates that the recovery of investments was supported by the activity of both the private sector and the general government. If viewed on an annual level, gross fixed capital formation was 3.0% lower than in the same period of the previous year.

Government consumption in the third quarter of 2020 increased by 1.5% from the previous three months, and it also grew by the same percentage on an annual level as a result of which this component stands out as the only component with a positive contribution to the annual change of real GDP. Nominal data show that, on an annual level, consumption for employee compensations increased, most likely not only as a result of the previously agreed increase in the base for the calculation of wages in the public sector of 2%, but also as a result of the increase in the number of overtime hours in the health sector. In addition, consumption for goods and services probably increased as well because of the larger consumption in the health sector for the purchase of medical equipment.

The imports of goods and services also rebounded on a quarterly basis in the period from July to September and increased by 17.6% relative to the previous three months. The nominal data on goods trade show that imports increased in all MIG components, as they did in services. Despite this, total imports remained 14.1% smaller than in the same period last year, while both the imports of goods and the imports of services declined on an annual level. Although the annual decline in total imports in the third quarter of 2020 was strong, it was smaller than the decline in total exports, which resulted in a negative contribution of net foreign demand to the total change in GDP (of 17.4 percentage points).



**Figure 3.7 Gross fixed capital formation**
real values

■ Year-on-year rate of change in capital investment
— Level of capital investment (seasonally adjusted values) – right

Source: CBS (seasonally adjusted by the CNB).



**Figure 3.9 Imports of goods and services**
real values

■ Year-on-year rate of change in total imports
— Level of total imports (seasonally adjusted values) – right
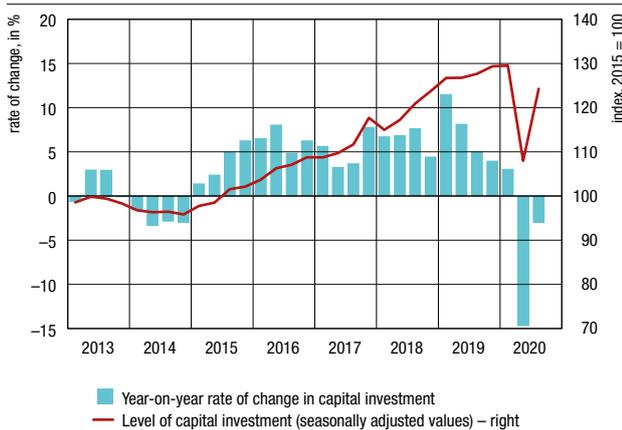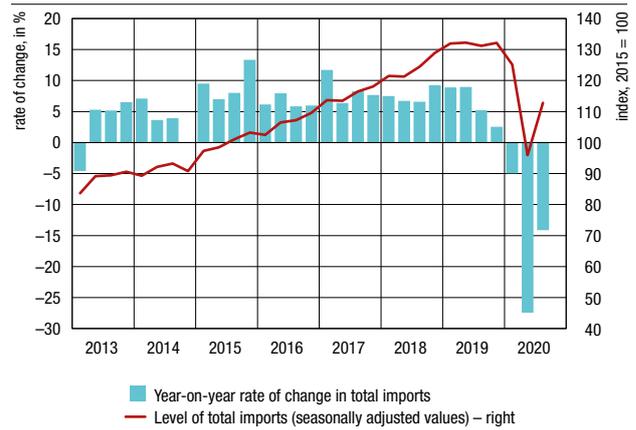
Source: CBS (seasonally adjusted by the CNB).



**Figure 3.8 Government consumption**
real values

■ Year-on-year rate of change in government consumption
— Level of government consumption (seasonally adjusted values) – right
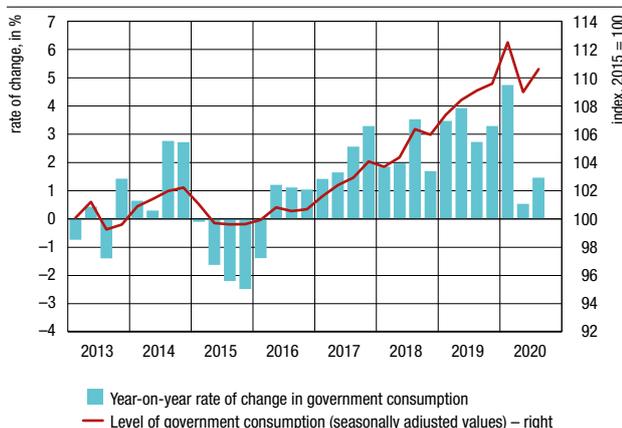
Source: CBS (seasonally adjusted by the CNB).



**Figure 3.10 Real imports of goods and services**

■ Year-on-year rate of change in imports of goods
■ Year-on-year rate of change in imports of services
— Level of imports of goods (seasonally adjusted values) – right
— Level of imports of services (seasonally adjusted values) – right
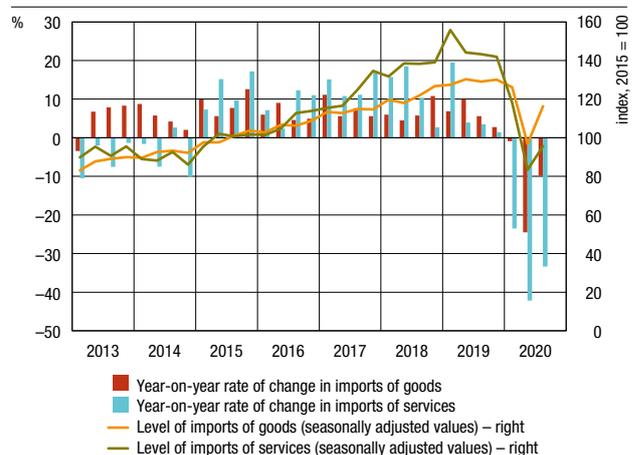
Source: CBS (seasonally adjusted by the CNB).

## Aggregate supply

Gross value added showed significant recovery in the third quarter and was 5.6% higher than in the previous three months. A quarterly increase in GVA was seen in all activities, except in public administration and defence, education, human health and social work activities. If viewed on an annual level, GVA decreased by 7.6% in the third quarter from the same period previous year (in the second quarter, the fall was 12%), with the largest contribution to the fall coming from service activities from the group consisting of wholesale and retail trade, transportation and storage, accommodation and food service activities. The mentioned activities are closely associated with tourism, which was the hardest hit by the impact of the pandemic. In addition, it is likely that the pandemic has also triggered changes in the behavioural patterns of economic agents or their consumer habits. By contrast, some activities proved to be much more resilient to the negative impact of the pandemic on the economy, so that gross value added grew on an annual basis in agriculture, forestry and fishing, construction, information and communication and real estate activities.
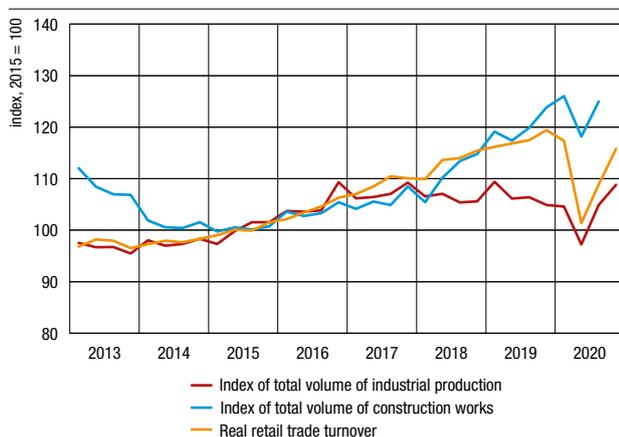
It should be noted that in the third and in the second quarter
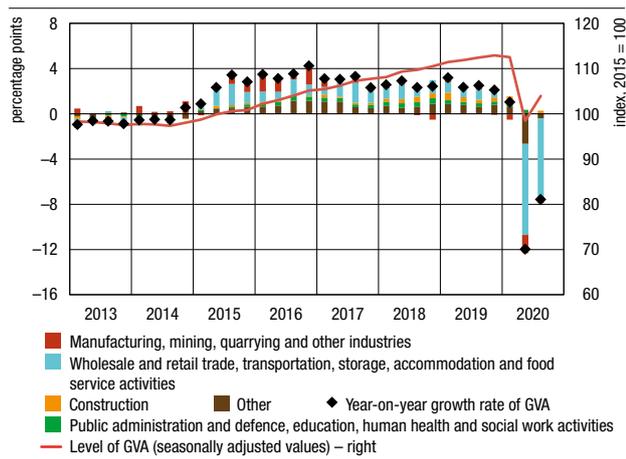
**Figure 3.13 Business confidence indicators**
standardised seasonally adjusted values



- Construction business confidence indicator
- Industry business confidence indicator
- Trade business confidence indicator
- Services business confidence indicator
- Long-run average = 100
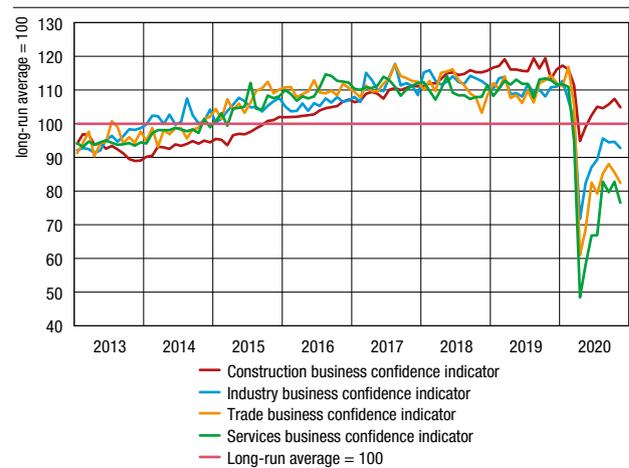
Sources: Ipsos and CNB (seasonally adjusted by the CNB).

the annual fall in GDP was much more pronounced than the fall in GVA due to the significant annual decline in the category of taxes and subsidies, so that the share of taxes and subsidies in GDP decreased after a several-year growth period.

The GDP nowcasting model, based on monthly data that are mainly available for October only, shows that economic growth on a quarterly level continued to slow down in the fourth quarter of 2020. Such developments are also linked to the epidemiological situation, which is significantly less favourable than in the third quarter. However, industrial production in October 2020 was 3.7% higher than the average performance in the previous three months. On a quarterly level, the production of intermediate goods and non-durable consumer goods increased, while the production of energy, capital goods and durable consumer goods decreased. At the same time, real retail trade turnover increased by 6.4% relative to the performance from the third quarter.

Consumer Confidence Survey data show that the consumer confidence index in October and November remained at the level from the third quarter, the recovery of optimism initiated in May having been thus halted. The waning growth of the household confidence index most likely reflects the deterioration of the epidemiological situation. At the same time, business confidence recorded from May to October also waned in all activities.

**Figure 3.11 GVA rate of change**
contributions to the annual change by components



- Manufacturing, mining, quarrying and other industries
- Wholesale and retail trade, transportation, storage, accommodation and food service activities
- Construction
- Other
- Year-on-year growth rate of GVA
- Public administration and defence, education, human health and social work activities
- Level of GVA (seasonally adjusted values) – right

Source: CBS (seasonally adjusted by the CNB).

## Projected developments

The coronavirus pandemic triggered a strong negative economic shock, so that real GDP in 2020 is expected to be 8.9% lower than in 2019. The expected decline, which might be the largest in recent Croatian history (the decline recorded in 2009, immediately after the escalation of the global financial crisis, was −7.4%), reflects a simultaneous decrease in both domestic and foreign demand. Total exports in 2020 might decrease by 26.4%, following the 6.8% growth achieved in 2019. The expected decrease relates more to the fall in the exports of services than to the fall in the exports of goods, thus reflecting the extremely strong negative impact of the coronavirus pandemic, as well as the restrictive measures implemented to curb it, on the demand for tourist services.

Among the domestic demand components, personal consumption might decrease by 6.6% (relative to the growth of 3.6% recorded in 2019) and thus make the strongest negative contribution to the decline in real economic activity of all domestic demand components. The expected development of

**Figure 3.12 Short-term economic indicators**
seasonally adjusted values



- Index of total volume of industrial production
- Index of total volume of construction works
- Real retail trade turnover

Notes: Quarterly data are calculated as an average of monthly data. Data on industry and trade in the fourth quarter of 2020 refer to October.
Source: CBS (seasonally adjusted by the CNB).

personal consumption reflects the relatively unfavourable trends in the labour market, the decline in consumer confidence and the hindered provision of certain services that require close physical contact. Gross fixed capital formation might also see a sharp decrease on an annual level (5.2%). The expected dynamics reflects the decrease in investment activity in both the private and the public sector relative to the previous year, when investments grew by 7.1% on an annual level. Government consumption might increase by 2.0% on an annual level, mostly as a result of the increase in expenditures for intermediary consumption. Government consumption might thus be the only domestic demand component with a positive contribution to the change in total real economic activity, albeit with a smaller intensity of growth from the previous year, when it increased by 3.4%. Although the imports of goods and services might fall sharply on an annual level (16.3% from the growth of 6.3% in 2019) on the back of the slump in domestic demand, the drastic projected fall in tourism activities and smaller than expected exports of goods, the decline will be less than the parallel drop in exports. Thus, the contribution of net foreign demand to the change in real economic activity in the current year might be a high −5.2 percentage points (from 0.2 percentage points in 2019).

A partial recovery of economic activity is anticipated in 2021, but it will not reach the level of before the outbreak of the epidemic. A 4.9% economic growth is expected in 2021, under the assumption that the pandemic will be relatively successfully controlled until the deployment of an effective vaccine even without the implementation of the most stringent restrictive epidemiological measures. The strongest contribution to the recovery might come from the growth of the exports of goods and services. All domestic demand components are also expected to increase, thus, personal consumption might increase, prompted by the recovery in the labour market, as well as by the favourable effect of the fifth round of the tax reform, that is, the additional disburdening primarily in the income tax system. Gross fixed capital formation is also expected to grow significantly, and the reconstruction of the city of Zagreb after the earthquake might make an additional contribution to the growth of investment activity of the public sector. Private sector investments might also increase noticeably as a reaction to the postponement of investment consumption in the course of 2020 and a further growth of the inflow of EU funds. The recovery of domestic and



Figure 3.14 Projection of real GDP dynamics
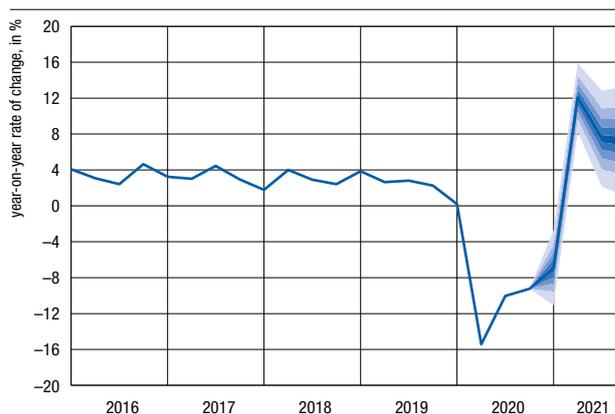
Sources: CBS and CNB.

foreign demand might spur a strong growth of the imports of goods and services. With regard to the above, the contribution of net foreign demand to total economic growth in 2021 might be positive.

It is estimated that the risks associated with the central values in the GDP projection during the projection period are balanced. The main upside and downside risks are associated with the development of the epidemiological situation in the projected period and the measures to curb the epidemic, as well as with the absorption of EU funds. The main downside risks to economic growth refer to the possibility of an intensified spreading of the virus, which would result in the introduction of more restrictive measures, then to the potential problems with the approval, distribution and efficacy of new vaccines and a smaller than expected absorption of EU funds. By contrast, upside risks refer to the possibility that a large number of people in Croatia and its main trading partners are vaccinated before the next tourist season. In addition, upside risks are also associated with a conservative projection of the use of EU funds relative to the available financial envelope.

# 4 Labour market
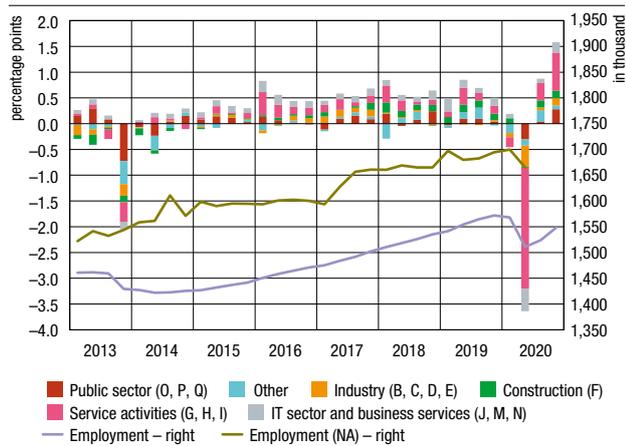
## Employment and unemployment

The renewed acceleration of economic activity, as a result of the improvement of the epidemiological situation and the subsequent relaxation of restrictive epidemiological measures, was reflected favourably in the developments in the labour market in the third quarter of 2020. The number of employed persons in the beginning of the third quarter of 2020 continued to grow at a similar rate as in June, after their number decreased cumulatively by almost 5% from March to May. The growth dynamics was maintained in the remainder of the quarter, so that total employment at the end of September was 1.6% higher (according to the seasonally adjusted data) than at the end of the second quarter. The strongest increase in the number of employed persons was recorded in the accommodation and food service activities, which had previously been the hardest hit (Figure 4.1). In October 2020, although the intensity of the growth in the

number of employed persons accelerated, total employment remained 1.4% lower than in the same month of the previous year.

Unemployment continued to decline in the beginning of the third quarter of 2020 at the same rate as in June, following a growth in unemployment from March to May. The decline in unemployment slowed down in August and then accelerated again in September 2020 as a result of an increased outflow from the CES register due to employment, so that at the end of September the number of unemployed persons was 5% lower than at the end of the second quarter (Figures 4.2 and 4.3). The beginning of the fourth quarter of 2020 was marked by a further acceleration of the fall in the number of unemployed persons; however, their number was still higher than in the period before the crisis outbreak.
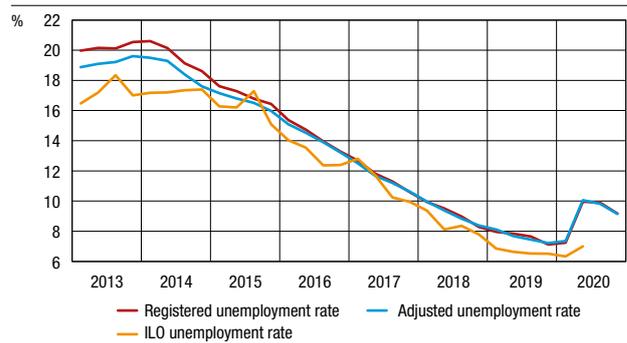
The registered unemployment rate (seasonally adjusted data) stood at 9.9% of the labour force in the third quarter from 10%

## Figure 4.1 Employment by NCA activities
seasonally adjusted data, contributions to the quarterly rate of change
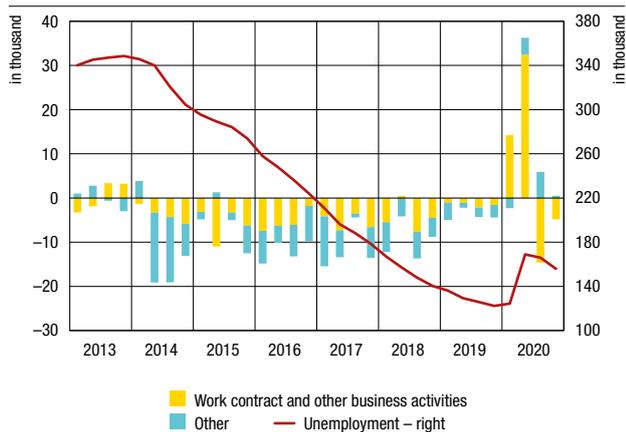


Note: Data for the fourth quarter of 2020 refer to October.
Source: CPII (seasonally adjusted by the CNB).

## Figure 4.2 Total unemployment and net unemployment inflows
seasonally adjusted data



Note: Data for the fourth quarter of 2020 refer to October.
Source: CES (seasonally adjusted by the CNB).

## Figure 4.3 Unemployment and the number of newly unemployed persons
seasonally adjusted monthly data
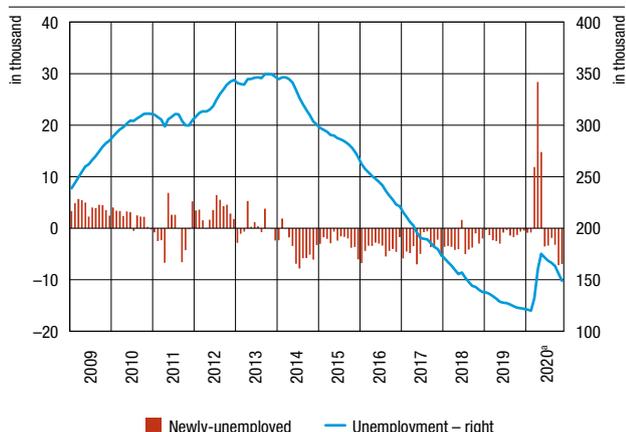


ª Data for November refers to the situation as at 1 December 2020.
Source: CES (seasonally adjusted by the CNB).

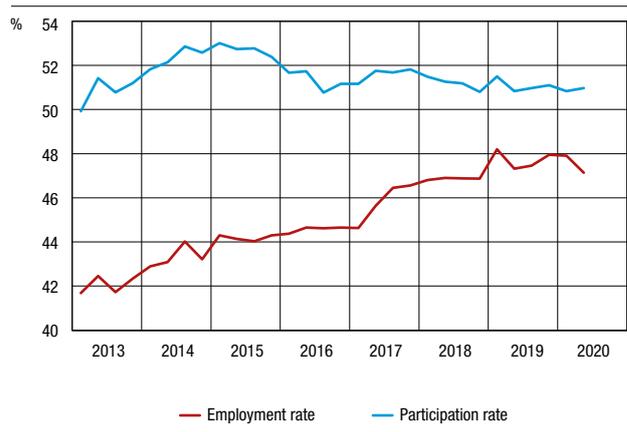## Figure 4.4 Unemployment rates
seasonally adjusted data



Notes: The adjusted unemployment rate is the CNB estimate and is calculated as the share of the number of registered unemployed persons in the working age population, estimated as the sum of unemployed persons and persons insured with the CPII. Since January 2015, the calculation of the registered unemployment rate published by the CBS has used the data on employed persons from the JOPPD form. Data for the fourth quarter of 2020 for the registered and the adjusted unemployment rate refer to October.
Sources: CBS, CES and CNB calculations (seasonally adjusted by the CNB).

## Figure 4.5 Labour Force Survey
seasonally adjusted series



Source: CBS (seasonally adjusted by the CNB).

in the second quarter of 2020. According to the most recent data available for October, the registered unemployment rate dropped to 9.2% of the labour force (Figure 4.4), or up by 2 percentage points from October 2019.

According to the latest available data from the Labour Force Survey, the unemployment rate increased to 7% of the labour force in the second quarter of 2020 (from 6.3% in the first quarter). The performances for the second quarter of 2020 point to a strong widening of the gap between the registered and ILO unemployment rates that might reflect the decline in the quality of such data taking into consideration the specific conditions in which the Labour Force Survey was conducted.

The employment rate decreased in the second quarter of 2020, while the participation rate increased very slightly (47.1% and 51% respectively) from the levels in the first quarter (Figure 4.5).

## Wages and unit labour costs

Wage growth, which started in June, continued in the third quarter of 2020, after the decrease in wages in April and May, primarily because of the decrease in wages in the private sector,

**Figure 4.6 Average nominal gross wage by NCA activities**
seasonally adjusted data, quarterly rate of change
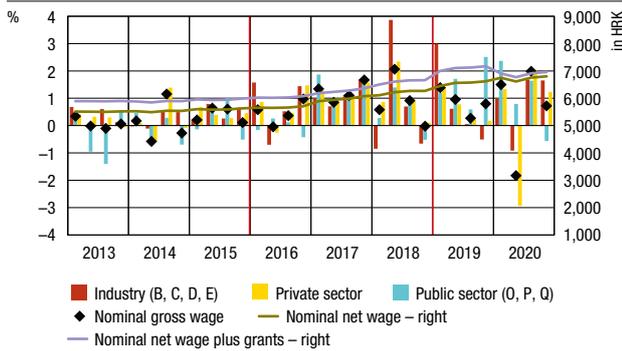


Notes: Data on the average nominal gross wage by activity refer to data from the RAD-1 form, and from January 2016 to data from the JOPPD form. Data on average wages paid in February 2020 were reported in full-time equivalent. Data on wages in 2019 reported in full-time equivalent were released for analytical purposes. Data on disbursements paid before 2016 are CNB estimates. Data for the fourth quarter of 2020 refer to October.
Sources: CBS and CNB calculations (seasonally adjusted by the CNB).

**Figure 4.7 Average nominal gross wage by NCA activities**
seasonally adjusted data, monthly rate of change



Sources: CBS and CNB calculations (seasonally adjusted by the CNB).

**Figure 4.8 Compensation per employee, productivity and unit labour costs**
seasonally adjusted data, quarterly rate of change and levels (2015 = 100)



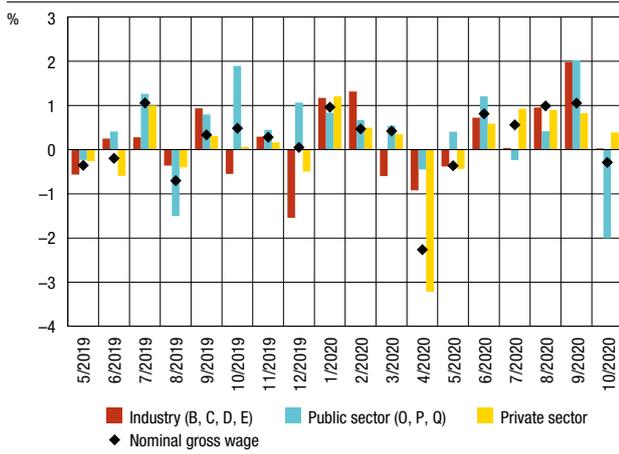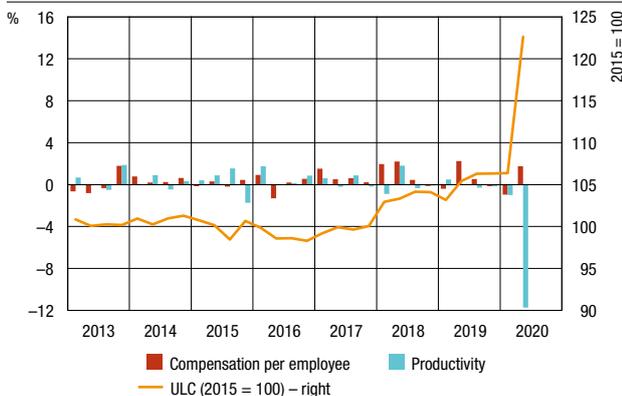Note: In the calculation of unit labour costs, paid compensation of employees and real GDP were taken from the national accounts, while data on the number of employees (persons employed in legal persons and natural persons who received compensation) and total employment were taken from the CPII.
Sources: CPII and Eurostat (seasonally adjusted by the CNB).

which reacted more strongly to the decline in economic activity. The average nominal gross wage at the end of September 2020 was 2.6% higher than in June, with a slightly more pronounced increase in wages being recorded in the private than in the public sector (Figures 4.6 and 4.7). According to the latest available data, in October 2020, the average nominal gross wage was slightly lower than in the previous month, or 2.6% higher than in the same month of 2019. Furthermore, in October, as in the previous months, smaller payments of non-taxable income were recorded, as a result of which net wages increased by the non-taxable compensations per employed person were almost equal to the net average wage paid.

In the third quarter of 2020, real wages also grew, which slowed down in the beginning of the fourth quarter.

Unit labour costs increased by 15.3% in the second from the first quarter of 2020, primarily reflecting a strong decline in labour productivity, and only in a smaller part an increase in labour costs (Figure 4.8). An equally sharp decline in labour productivity is also recorded when productivity is calculated as the ratio between production and the number of working hours (instead of production and the number of employed persons). According to the official CBS data, no significant decline in the number of working hours was recorded in Croatia in the second quarter of 2020, although such a fall was recorded in most of the other EU member states.

## Projected developments

The reaction of the labour market to the decline in economic activity at the onset of the coronavirus pandemic was swift. However, as a result of the measures taken by the Government of the Republic of Croatia aimed at preserving jobs, the adjustment was reflected in the dismissal of workers to a small extent only. Also, in the largest number of cases no decrease in wages was recorded, by which the purchasing power was preserved.

Taking into account the performance in the first ten months, the number of employed persons is expected to decrease by 1.5% in 2020. The expected employment index, although still in negative territory in the services sector, points to a recovery as regards the movements in the number of employed persons in the following three months (Figure 4.9). It is also estimated that in the whole of 2020 the registered and the ILO unemployment rate might stand at 9.1% and 7.5% of the labour force respectively.

**Figure 4.9 Employment expectations by sectors (in the following three months)**
seasonally adjusted data, three-member moving average of monthly data
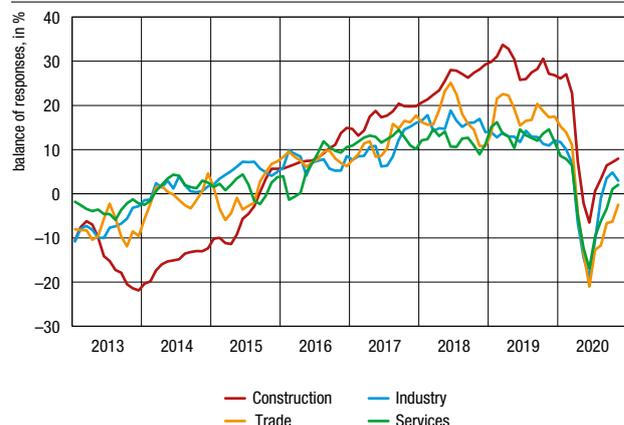


Source: Ipsos (seasonally adjusted by the CNB).

Figure 4.10 Employment expectations by sectors (in the following three months)
seasonally adjusted data



Source: Ipsos (seasonally adjusted by the CNB).

Table 4.1 Projection of labour market indicators for 2020 and 2021
year-on-year rates of change, in %

|  | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|
| Number of employed persons – CPII | 1.9 | 2.3 | 2.3 | −1.5 | 0.7 |
| Number of employed persons – national accounts | 2.2 | 1.8 | 1.4 | −1.5 | 0.7 |
| Participation rate (ILO) | 51.6 | 51.2 | 51.2 | 51.1 | 51.4 |
| Unemployment rate (ILO) | 11.2 | 8.4 | 6.6 | 7.5 | 7.0 |
| Average nominal gross wage | 3.9 | 4.9 | 3.8 | 2.0 | 2.3 |
| ULC | −0.7 | 1.4 | 1.9 | 9.7 | −1.8 |
| Productivity | 0.9 | 0.8 | 1.5 | −7.5 | 4.2 |

Notes: The year-on-year rates of change in employment refer to data on persons insured with the CPII, year-on-year rates of change in the average gross wage until 2015 refer to data from the RAD-1 monthly survey, and from 2016 to data from the JOPPD form, whereas year-on-year rates of change in unit labour costs and productivity refer to national accounts data. Projections of unit labour costs (and productivity) assume that the rise in employment and total employment in the national accounts will be equal to the expected increase in the number of persons insured with the CPII.
Sources: CBS, Eurostat, CPII and the CNB projection.

In 2020, the average gross wage is expected to increase by 2%, primarily as a result of the growth of wages in the public sector, mirroring the impact of the increase in wages in the health sector in 2019, as well as the achieved 2% increase in the wage calculation base in the public sector. At the same time, wages in the private sector might increase only slightly.

The expected growth in economic activity in 2021 might be reflected positively in the employment and unemployment indicators only to a smaller extent as a result of the measures taken by the Government of the Republic of Croatia to mitigate the consequences of the pandemic, offsetting the labour market response to the decline in economic activity. Therefore, the growth in the number of employed persons is expected to slow down in 2021 (0.7%), while the ILO unemployment rate might fall to 7% of the labour force.

As regards wages, the average nominal gross wage is expected to increase by 2.3% in 2021, primarily on the back of the expected increase in public sector wages, as a result of the decision of the Government of the Republic of Croatia to raise the wage calculation base for public and civil servants by the remaining 4% in the beginning of 2021. Wages in the private sector are expected to maintain the growth dynamics from the previous year. In 2021, a more pronounced increase in net wages is also expected as a result of the announced tax disburdening from January 2021 (cutting the income tax rates from 24% and 36% to 20% and 30%). Thus, in 2021, the nominal net wage might increase by 3.4%.

# 5 Inflation

The annual consumer price inflation slowed down considerably in the first ten months of 2020, driven largely by the fall in energy prices, most notably refined petroleum products. It mirrored the sharp drop in crude oil prices on the global market that was mostly the result of the decrease in global demand in the period of the coronavirus pandemic. An impact on the easing of inflationary pressures was also made by the indirect effects of cheaper refined petroleum products on the prices of goods/services in the production of which such refined petroleum products are largely used. In addition to the prices of energy, the spreading of the pandemic was also reflected negatively in the prices of tourism-related services and durable consumer goods. On the other hand, inflationary pressures in 2020 resulted from the rise in excise duties, the disruptions in supply chains, the increase in unit labour costs and the costs associated with the implementation of epidemiological measures.

The annual consumer price inflation mostly remained in negative territory in the period from June to October (Figure 5.2). The annual fall in inflation decelerated slightly to −0.1% in October (from −0.2% in June). The deceleration was mostly the result of the slowdown in the fall of the annual rate of change of prices of industrial products (excluding energy) to −0.1%

in October (from −0.7% in June), to a large extent as a consequence of the increase in the annual rate of change of the prices of clothing and the administered prices of textbooks. The annual fall in the prices of energy slowed down to −6.4% in October (from −7.1% in June) as a result of the increase in the prices of refined petroleum products during the summer months.

By contrast, in the previous four months, the annual growth rate of the prices of processed food products (in most subcomponents, particularly meat preparations and bread and cereals) decreased to 2.0% (from 2.7% in June). In addition, the annual growth of the prices of unprocessed food products also slowed down. Several important factors had an impact on the decrease in the contribution of the prices of food products to annual inflation, such as the decrease in the prices of individual food raw materials on the global market, surpluses on the EU market due to the smaller imports of meat into China and the normalisation of the supply chain. Furthermore, the annual growth of the prices of services slowed down moderately from 1.6% in June to 1.5% in October.

Core consumer price inflation (excluding agricultural products prices, energy prices and administered prices) was 0.8% in October or 0.3 percentage points lower than in June 2020.

## Table 5.1 Price indicators

year-on-year rate of change

| | 12/2019 | 3/2020 | 6/2020 | 9/2020 | 10/2020 |
|---|---|---|---|---|---|
| **Consumer price index and its components** | | | | | |
| Total index | 1,4 | 0,6 | –0,2 | 0,0 | –0,1 |
|    Energy | 3,4 | –3,8 | –7,1 | –5,8 | –6,4 |
|    Unprocessed food | 0,7 | 5,6 | 1,9 | 0,7 | 1,3 |
|    Processed food | 2,3 | 1,7 | 2,7 | 2,1 | 2,0 |
|    Non-food industrial goods without energy | –0,6 | –0,1 | –0,7 | 0,0 | –0,1 |
|    Services | 1,5 | 1,6 | 1,6 | 1,4 | 1,5 |
| **Other price indicators** | | | | | |
| Core inflation | 1,2 | 1,3 | 1,1 | 0,7 | 0,8 |
| Index of industrial producer prices on the domestic market | 1,4 | –1,2 | –3,1 | –3,2 | –2,4 |
| Index of industrial producer prices on the domestic market (excl. energy) | 0,5 | 0,5 | 0,4 | –0,4 | –0,3 |
| Harmonised index of consumer prices | 1,3 | 0,5 | –0,4 | –0,3 | –0,2 |
| Harmonised index of consumer prices at constant tax rates | 2,1 | 1,0 | –0,3 | –0,2 | 0,0 |

Note: Processed food includes alcoholic beverages and tobacco.
Source: CBS.

### Figure 5.1 Indicators of current inflation trends



Notes: The month-on-month rate of change is calculated from the quarterly moving average of seasonally adjusted consumer price indices. The inflation diffusion index is measured by a 6-month moving average. The inflation diffusion index shows the share of the number of products that increased in price in a given month in the total number of products and is based on the monthly rates of change derived from the seasonally adjusted components of the HICP.
Sources: CBS and CNB calculations.

### Figure 5.3 Indicators of price developments in Croatia and the euro area



Sources: CBS and Eurostat.
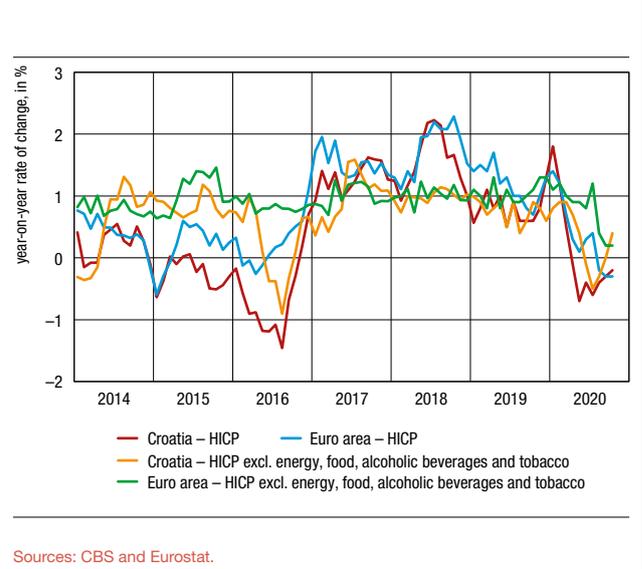
### Figure 5.2 Year-on-year inflation rate and contributions of components to consumer price inflation



Note: Core inflation excludes agricultural product prices, energy prices and administered prices.
Sources: CBS and CNB calculations.
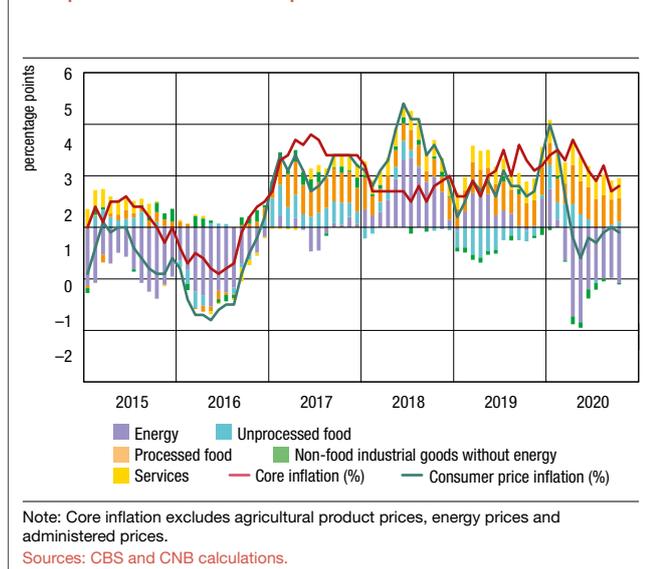
The main contributors to the slowdown of core inflation were the prices of meat, furniture and non-durable household goods, used motor vehicles, hotel and restaurant services and health insurance. By contrast, the annual rate of change in the prices of clothing increased.

Consumer price inflation in the euro area was in negative territory since August (Figure 5.3). Overall inflation of –0.3% in October was thus 0.6 percentage points lower when compared with inflation in June 2020. In addition to the decrease in the annual growth of food prices, the slowdown in inflation was also under the effect of the decrease in indirect taxes in some countries (particularly the temporary decrease in the VAT rate in Germany in the second half of 2020) and the appreciation of the euro against the basket of currencies. In October, energy was the component that continued to make the largest negative contribution to inflation in the euro area of –0.8 percentage points.

In the conditions of weak demand in the last three months, core inflation (excluding the prices of energy, food, beverages and tobacco) also slowed down in the euro area, standing at 0.2% in October, or 1 percentage point lower than in July. This

was mostly the result of the deceleration in the annual growth of the prices of tourism-related services (international air transport, package holidays and accommodation services) and communication services. The annual growth of the prices of industrial products (excluding energy) also slowed down.

Croatia's annual inflation rate measured by the HICP increased from –0.4% in June to –0.2% in October, while core inflation measured by the HICP increased from –0.1% in June to 0.4% in October. The relatively low core inflation in October 2020, compared with October 2019, is the result of a significant decrease in the contribution of the prices of restaurants and hotels in the observed period. Thus, the overall inflation rate was higher in October by 0.1 percentage point, compared with the euro area, while core inflation was higher by 0.2 percentage points.
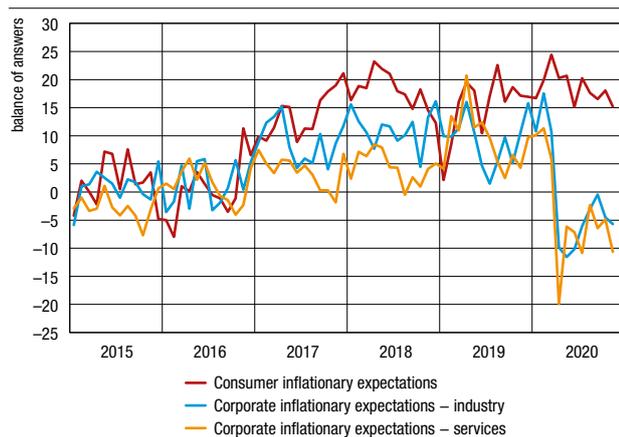
## Inflationary expectations

Consumer inflationary expectations in Croatia rose briefly at the onset of the pandemic, which was probably associated with the acceleration of the growth of food prices and the larger share of food in the consumer basket during the pandemic. The annual



**Figure 5.4 Short-term consumer and corporate inflationary expectations**

Note: The consumer expectations refer to a twelve-month period ahead and the corporate expectations refer to a three-month period ahead.
Source: Ipsos.



**Figure 5.5 Short-term inflationary expectations by economic analysts**

Source: Eastern Europe Consensus Forecasts.

growth rate of food prices slowed down considerably in the remainder of the year and was only 1% in October (from 4% in April) 2020. The trend of reduced consumer inflationary expectations was also noticeable from April to November (Figure 5.4). However, consumer inflationary expectations (unlike, for example, in 2016) remained in positive territory, which suggests that consumers who expect prices in the following twelve months to rise prevail over those who believe that prices will fall or remain unchanged. By contrast, corporate inflationary expectations decreased considerably in 2020, with a temporary increase during the summer months only when the pandemic faded, tourist activity strengthened and oil prices on the global market increased.

In March and April, economic analysts revised and reduced significantly their short-term expectations regarding consumer price movements in Croatia in 2020 (by a total of 0.7 percentage points), and the trend of the gradual decrease in their inflationary expectations continued until August, when inflationary expectations stabilised at the level of 0.2% (Figure 5.5). At the same time, inflationary expectations for 2021 were also reduced, with a stabilisation within a narrow range from 1% to 1.1% after May.
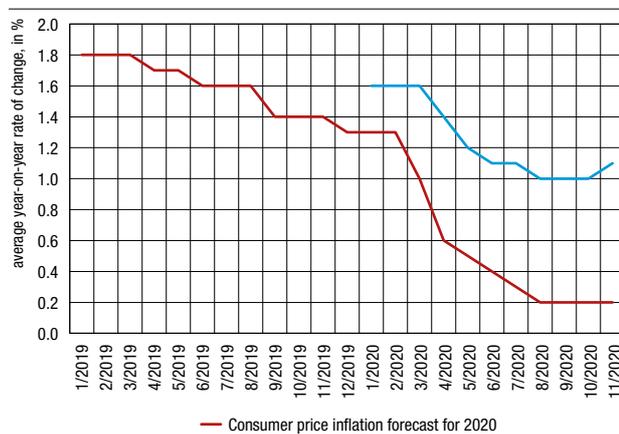
## Projected developments

It is estimated that the average annual consumer price inflation might slow down in 2020 to 0.2% (from 0.8% in 2019), mostly due to the considerable fall in the annual rate of change in the prices of energy from 1.8% in 2019 to –5.4% in 2020. The largest impact on the decrease in the contribution of energy to overall inflation in 2020 came from the decline in the refined petroleum product prices mirroring a sharp fall in the prices of crude oil on the global market and, to a smaller extent, the appreciation of the kuna against the US dollar.

The average annual growth rate of the consumer price index excluding food and energy might accelerate moderately in 2020 to 1.0% (from 0.9% in 2019) and remain around the level of its long-term average.[1] The weakening of demand due to the coronavirus pandemic is a factor that has had an effect on the easing of inflationary pressures, particularly in the segment of tourism-related services (for instance, the accommodation and transportation services) and individual non-durable consumer goods (used motor vehicles and furniture). An impact on the easing of inflationary pressures was also made by the indirect effects of cheaper refined petroleum products on the prices of goods in the production of which such refined petroleum products are largely used. By contrast, the most significant factors contributing to the increase in inflation in 2020 include administrative decisions (the increase in the excise duties on cigarettes, and sugary and alcoholic beverages) and the rise in unit labour costs and the costs associated with the implementation of epidemiological measures that spill over to the increase in the prices of individual services (hairdressing services, recreational and sporting services, etc.).[2]

As regards food prices, their average annual growth rate in 2020 might accelerate to 2.0% (from –0.2% in 2019). The annual growth of food prices accelerated in early 2020 due to the base effect (that is, the fading of the effect of the VAT rate cut in early 2019 on the annual rate of change in prices) and in March and April as a result of increased demand (stocking up) and interruptions in supply chains caused by the pandemic. By contrast, the trend of a slowdown in the annual growth of food prices was present in the rest of 2020. This was due to several

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1    In the period from 2009 to 2019.
2    Physical distancing measures are applied in the mentioned activities, as a result of which the number of consumers that may use certain services at the same time is reduced.

Figure 5.6 Domestic and foreign inflation indicators
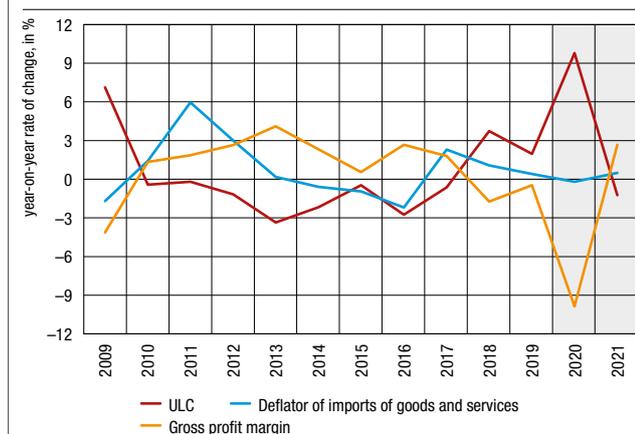


Note: Gross profit margin is calculated as the difference between the annual rate of change of the GDP deflator and the annual rate of change of unit labour costs.
Sources: Eurostat, CBS and CNB calculations.

Figure 5.7 Projection of consumer price inflation
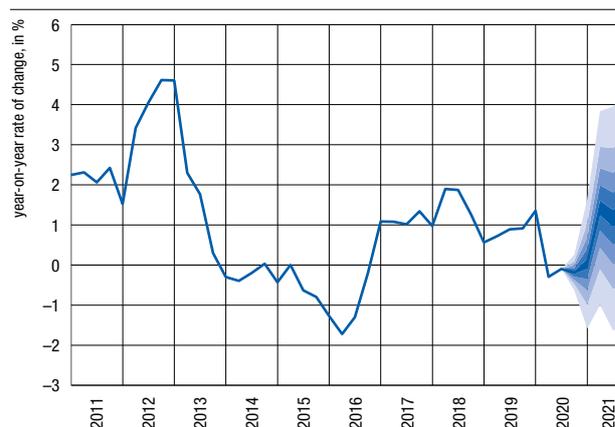


Sources: CBS and CNB calculations.

factors, such as the normalisation of the cross-border circulation of goods and the decrease in the prices of pork and fruit on the EU market.

The projections for 2021 point to an acceleration of the average annual consumer price inflation rate to 1.0%, which should mostly be the result of the expected increase in the annual rate of change in the prices of energy from –5.4% in 2020 to about 0.5% in 2021. After the positive news on the development/efficacy of the coronavirus vaccine and the easing of political uncertainty in the USA, the movement of the price of Brent crude oil in the spot market indicates a moderate growth of these prices in the course of 2021 because of the expected increase in demand. The contribution of the prices of energy to overall inflation should also enter positive territory again in the beginning of the second quarter of 2021 because of the positive base effect and the fading of the effect of the significant drop in the prices of refined petroleum products following the sharp decline in global demand for oil at the onset of the pandemic.

Furthermore, it has been forecast that in 2021, in conditions of the recovery of demand, the annual growth rate of the consumer price index (excluding food and energy) might increase moderately to about 1.1% but still remain low and stable. It can be expected that in conditions of a gradual recovery of tourist demand the annual growth rate of the prices of tourism-related services will return to positive territory. Low and stable inflation is also attributed to subdued inflationary pressures from the external environment, having in mind the low projected inflation in Croatia's major trade partners. Thus, it has been projected that core consumer price inflation in the euro area in 2021 might stand at about 0.7%[3] (the same as in 2020), while producer prices in Germany and Italy in 2021 are expected to grow by 0.7 and 1.6%, respectively.[4]

By contrast, the average annual growth rate of the prices of

food is expected to slow down in 2021 to about 1.0% (from 2.0% in 2020), the consequence, to the greatest extent, of the negative base effect due to the fading of the effect of the significant increase in the prices of food at the onset of the pandemic (in the first half of 2020) on the movement of the annual rate of change in the prices of food.

The risks and the uncertainty associated with the inflation projection in 2021 are very pronounced. Inflation trends in 2021 to a large extent are related to any possible worsening/improvement of the epidemiological situation relative to the projection's baseline scenario. Any worsening of the epidemiological situation in the country and the introduction of more restrictive epidemiological measures (relative to the projection's baseline scenario) would have a negative effect on economic activity so that inflationary pressures in 2021 might be less pronounced due to the weaker and delayed recovery of demand. In addition, in the case of a less pronounced recovery of global economic activity in 2021 because of the need to implement more restrictive epidemiological measures and/or a possible delay in the deployment of an effective and safe vaccine, inflationary pressures from the external environment might also decrease relative to the projection's baseline scenario, primarily because of the lower prices of crude oil and other raw materials on the global market and lower inflation in Croatia's major trading partners. In the case of improvement in the epidemiological situation relative to the projection's baseline scenario, inflationary pressures in 2021 might be somewhat more strongly pronounced. Furthermore, the more stringent epidemiological measures of the end of November 2020 that, among other things, include the closing down of bars and restaurants, will again make the statistical measurement of the movements of consumer prices more difficult because of the change in the structure of consumption and the potential price imputation.
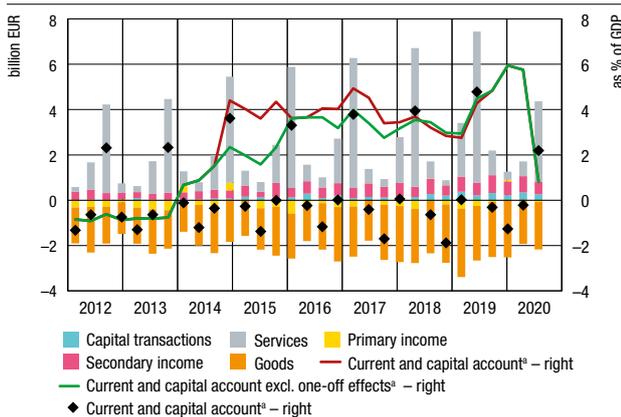
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3   Measured by the HICP excluding the prices of food, energy, alcoholic beverages and tobacco.
4   Consensus Forecasts, November 2020.

# 6 Current and capital account

The current and capital account surplus was much lower in the third quarter of 2020 than in the same period of the previous year. The pandemic of the coronavirus and fear of its spreading as well as deteriorating economic conditions severely hit the tourism activity. Despite the relatively favourable epidemiological situation throughout most of the main tourist season and a gradual recovery in tourism, revenues from tourism consumption of foreign guests almost halved in the third quarter of 2020 from the same period in 2019, contributing to a marked deterioration of the balance in the current and capital account. In contrast, unfavourable developments were at the same time mitigated by the decrease in the foreign trade deficit due to stronger contraction in the imports than in the exports of goods, brought about by the decline in personal and investment consumption and the import dependence of exports. Moreover, noticeably lower profits of banks and enterprises in foreign ownership contributed to the decrease in the negative investment income

36.5% year-on-year in the second quarter, declined by 13.1% in the third quarter. The cumulative values in the last four quarters show that the goods account deficit stood at 17.9% of GDP in the period up to the end of September, an improvement of 1.4 percentage points from 2019.

Detailed CBS data reveal that the annual decrease in total goods exports in the third quarter of 2020 was mainly the result of the fall in exports of other transport equipment (i.e. ships) to Malta and the Marshall Islands (Figure 6.2). Other manufacturing categories recorded much smaller falls in exports, with a noteworthy decrease seen in exports of energy products due to the decline in exports of oil and refined petroleum products (primarily to Bosnia and Herzegovina and Italy) and electricity to Slovenia and Hungary. Exports of medical and pharmaceutical products to Germany and Israel also dropped. In contrast, the fall in total exports was mitigated by an increase in exports of food products, particularly cereals and cereal preparations to Italy.



**Figure 6.1 Current and capital account balance and its structure**

ᵃ Sum of the last four quarters.
Note: One-off effects include the conversion of CHF-linked loans in 2015 and bank provisions for loans to the Agrokor Group in 2017 and 2018.
Source: CNB.



**Figure 6.2 Exports of goods**
year-on-year rate of change and contributions

ᵃ Labour-intensive goods (according to the SITC) include: textile, wearing apparel, footwear, leather, paper, cork and wood, furniture, manufactures of metals and non-metallic mineral manufactures, prefabricated buildings and manufactured articles n.e.c.
Sources: CBS and CNB.

balance and the use of EU funds became more intensive. The cumulative values in the last four quarters show that the current and capital account surplus stood at 0.8% of GDP in the period up to the end of September 2020, which is a considerable decrease from 2019 (4.8% of GDP) and can mainly be attributed to extremely adverse developments in the third quarter of 2020 (Figure 6.1).
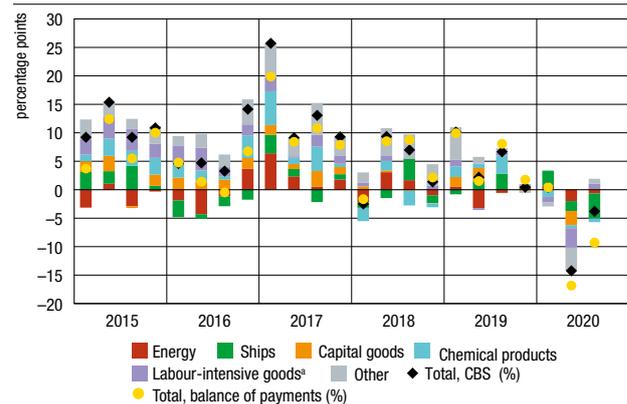
## Foreign trade and competitiveness

According to the balance of payments data,[5] goods exports and imports decreased by 16.7% and 26.4% respectively in the second quarter of 2020 from the same period in 2019, this fall amounting to 8.7% and 10.6% respectively in the next three months. As a result, the goods trade deficit, after falling by



**Figure 6.3 Imports of goods**
year-on-year rate of change and contributions
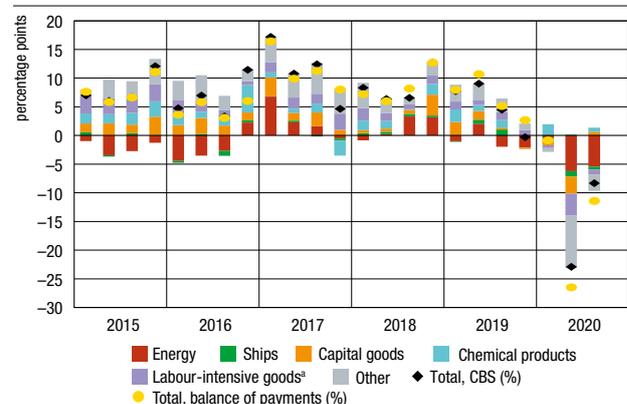
ᵃ Labour-intensive goods (according to the SITC) include: textile, wearing apparel, footwear, leather, paper, cork and wood, furniture, manufactures of metals and non-metallic mineral manufactures, prefabricated buildings and manufactured articles n.e.c.
Sources: CBS and CNB.

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5   According to CBS data, exports and imports of goods shrank by 4.5% and 9.3% respectively in the third quarter of 2020 and the goods trade deficit dropped by 17.7% from the same period in 2019. For more information on the differences in the scope of the trade in goods according to the balance of payments and CBS data see Box 3 Foreign trade developments according to the balance of payments data, Macroprudential Developments and Outlook No. 2, July 2017.

As regards imports of goods, the annual fall in the third quarter of 2020 was mostly the result of smaller imports of energy products (Figure 6.3), in particular oil and refined petroleum products (from Italy, Iraq and Azerbaijan) and electricity (from Hungary). A decrease was also observed in imports of road vehicles (from Germany, Slovenia and the Czech Republic) and food products, mostly meat and meat preparations, from Poland, Spain and Slovenia. In contrast, an increase was recorded in imports of medical and pharmaceutical products from Belgium and particular categories of capital goods (notably electrical machinery, apparatus and appliances and power generating machinery and equipment from China).

Due to the favourable epidemiological situation at the end of the second quarter, Croatia opened its borders to foreign visitors, which resulted in a partial recovery of tourism revenues and a slowdown in the fall of total net exports of services. Hence, the annual decrease in net exports of services in the third quarter of 2020 stood at 46.8%, as compared to the decrease of 72.6% in the second quarter. The deterioration of the balance in the international trade in services mainly reflected a significant fall in revenues from tourism consumption of non-residents (49.0% from

to the same period in 2019, Figure 6.4). Recent tourism results are analysed in more detail in Box 1 Tourism in the time of pandemic. Concurrently, tourism consumption of residents abroad also trended downwards, by as much as 57.0%. The cumulative values recorded over the past year suggest that the surplus in the international trade in services went down from 19.0% of GDP in 2019 to 11.2% in the period up to the end of September 2020.

After the improvement in the first half of 2020, the price competitiveness of Croatia's goods exports slightly deteriorated in the rest of the year (Figure 6.5)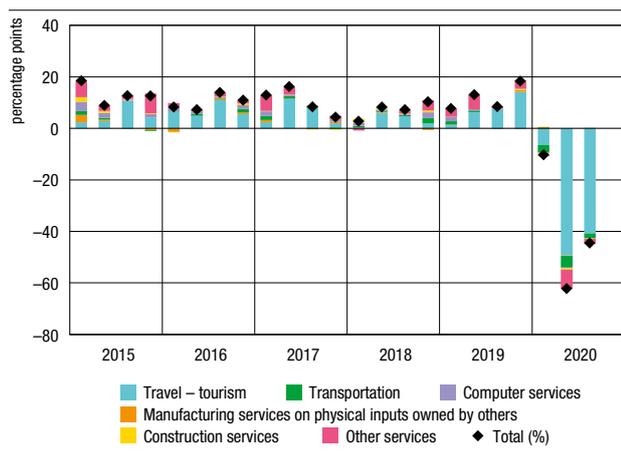. The real effective exchange rates of the kuna deflated by consumer and producer prices appreciated in the second half of the year, due partly to an appreciation of the nominal effective exchange rate and partly to faster growth in domestic prices than in the prices of the major trading partners. Developments in the real effective exchange rates of the kuna in the tourism in the period from Croatia's accession to the EU to September 2020 are portrayed in Box 2 Price competitiveness of Croatia's tourism.

## Income and transactions with the EU

The negative balance in the primary income account narrowed considerably in the third quarter of 2020 from the same period in 2019 due to a smaller investment income deficit (Figure 6.6). This mainly reflects lower expenditures on direct equity investment brought about by lower profits of domestic banks and enterprises in non-resident ownership (especially those engaged in accommodation, real estate and oil industry activities). Moreover, net interest expenditures on foreign debt liabilities of domestic sectors declined to a much smaller extent.

Total net income from transactions with the EU budget rose in the third quarter of 2020 from the same period in 2019, mainly as a result of the more intensive use of EU funds and, to a small extent, of lower payments to the EU budget. However, withdrawals of EU funds grew at a somewhat slower pace than in the first half of 2020. As regards the structure of the use of funds, a larger share related to current than to capital revenues, with the government receiving more funds than other domestic sectors. The surplus of EU funds utilised over the payments to the EU budget, reported as the sum of the last four quarters, thus increased from 2.6% of GDP at the end of 2019 to 3.6% of GDP at the end of September 2020 (Figure 6.7). In addition, the net inflow from other income (which excludes income from equity and debt investments and transactions with the EU



**Figure 6.4 Services exports**
year-on-year rate of change and contributions

Source: CNB.



**Figure 6.5 Nominal and real effective exchange rates of the kuna**
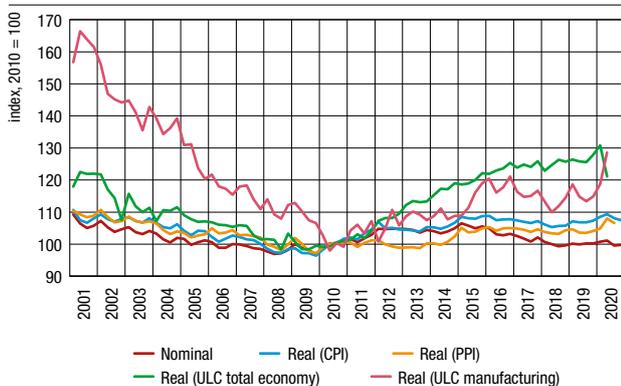
Notes: A fall in the index indicates an effective appreciation of the kuna. Data for the fourth quarter of 2020, relating to the nominal exchange rate refer to October and November and those relating to real exchange rates deflated by consumer and producer prices refer to October.
Source: CNB.



**Figure 6.6 Investment income**
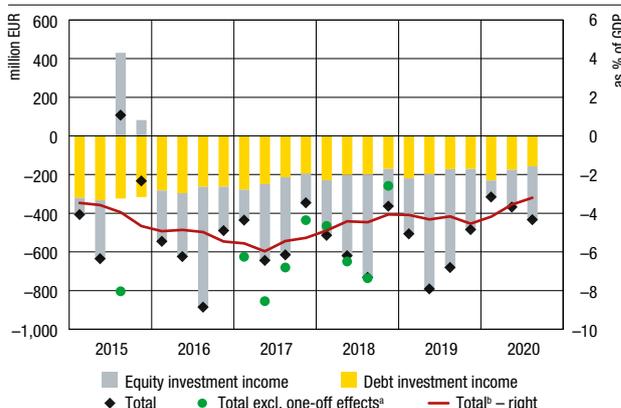
a One-off effects include conversion of CHF-linked loans in 2015 and bank provisions for loans to the Agrokor Group in 2017 and 2018.
b Sum of the last four quarters, excluding one-off effects.
Source: CNB.

Figure 6.7 Transactions with the EU budget



a Sum of the last four available quarters.
Notes: 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 6.8 Other income, excluding investment income and transactions with the EU



a Sum of the last four quarters.
Note: Compensation of employees is recorded in the primary income account, while other series (personal transfers, other private sector income and government transfers) are recorded in the secondary income account.
Source: CNB.

budget) decreased, owing to a fall in net revenues from compensation of persons temporarily employed abroad and from personal transfers (Figure 6.8).

## Projected developments

The deficit in the current and capital account is expected to be considerably lower in the fourth quarter of 2020 than in the same period in 2019, mostly as a result of the decline in the goods trade deficit that might outweigh further deterioration in the international trade in services. However, the excepted decrease in the current and capital account deficit in the fourth quarter might only mitigate the strong deterioration of the balance in the earlier part of the year, bringing the surplus in the current and capital account down to 1.4% of GDP in 2020, as against the 4.8% of GDP in 2019. If only the current account balance were analysed, the deterioration might be stronger and, for the first time after 2013, the current account could show the deficit of 1.0% of GDP, in contrast with the surplus of 2.8% of GDP in 2019.

The fall in net exports of services is the main factor behind the expected declined in the current and capital account surplus in 2020. This mainly refers to the decrease in net revenues from travel services, the record contraction of which due to the pandemic might continue in the last three months of 2020. At the entire 2020 level, tourism revenues could decline by more than one half. In addition, net exports of other services are expected to continue declining, albeit at a 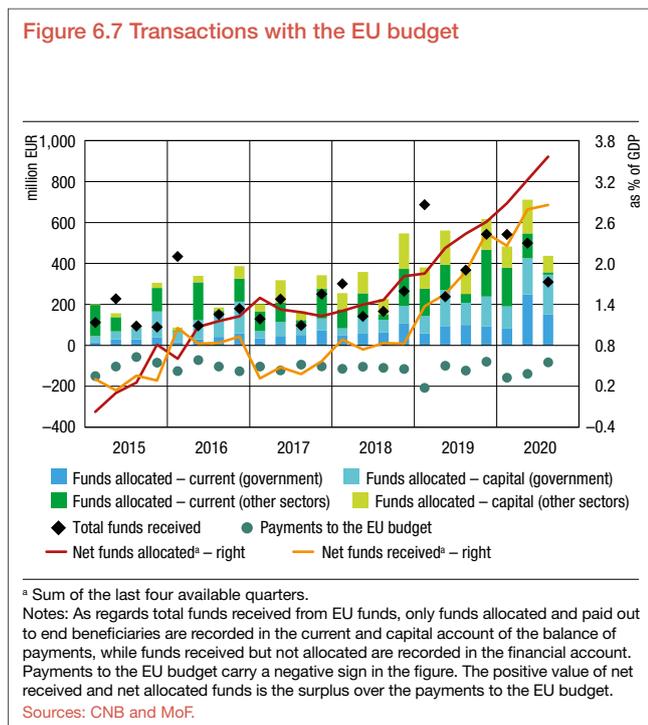much lower intensity than in tourism. In contrast to the international trade in services, the foreign trade deficit could shrink considerably and thus alleviate unfavourable developments in the current and capital account. Moreover, the decline in foreign demand is expected to result in lower goods exports, reflecting the performance in the earlier part of the year when Croatia's goods exports showed relative robustness and recorded a much smaller fall than most of the peer countries. At the same time, the decrease in goods imports could be more pronounced due to the fall in domestic personal and investment demand.

In addition to the foreign trade in goods, unfavourable developments in the current and capital account in 2020 could be mitigated by the fall in net expenditures on investment income
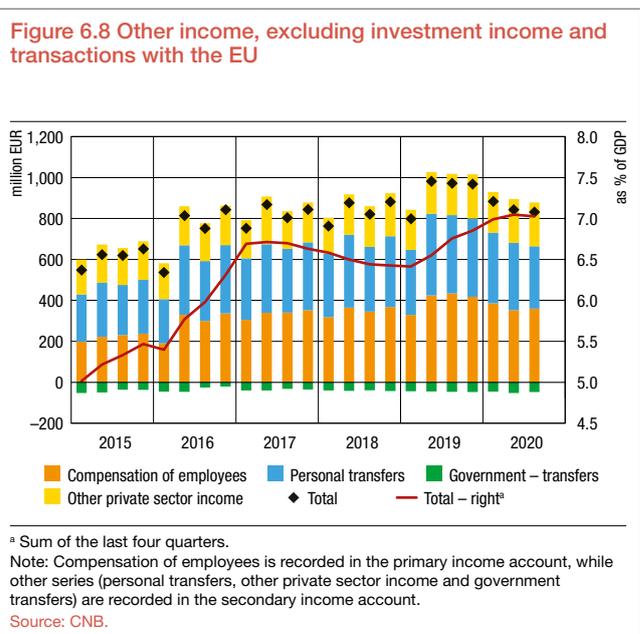
and markedly greater use of EU funds. The results for the first nine months forecast a strong annual decrease in profits of banks and enterprises in foreign ownership in 2020 as a whole and consequently a more vigorous improvement in the primary account balance. Moreover, the dynamics of payments of EU funds to end beneficiaries is expected to continue strengthening, bringing the positive balance with the EU budget up to 3.9% of GDP in 2020. In contrast, following uninterrupted five-year growth, net income from personal remittances could experience a decrease in the current year.

In line with the assumed recovery of foreign demand and tourism, it is expected that 2021 will be marked by an increase in the current and capital account surplus, which might reach 3.0% of GDP. The rise in the surplus is, to a large extent, associated with the forecast growth in net exports of services and, to a small extent, with a further increase in the use of EU funds. However, a noticeable deterioration is expected in the balance in goods trade and the balance in the primary income account due to the growth in the profitability of domestic enterprises in foreign ownership.

The assumption that the epidemiological situation will stabilise as summer months approach might be strongly reflected in tourism trends in 2021; as a result, revenues from tourism consumption of foreign guests are expected to see a strong recovery, which could be a major contributor to the rise in the current and capital account surplus. This notwithstanding, the overall financial result for tourism might still remain much lower than in the pre-crisis and record-setting year of 2019. By contrast, the foreign trade deficit might widen significantly. Goods exports might rise substantially in 2021, due to a recovery of demand in key trading partners, notably in the euro area. However, the concurrent growth in goods imports could be stronger due to the recovery of personal consumption and investments and exports of goods and services, which, in combination with a much wider import base, might lead to sharp deterioration of the foreign trade balance.

The assumed worsening of the primary account balance is the results of gradual recovery in profits of banks and enterprises in foreign ownership. Furthermore, the surpluses in the secondary income and capital accounts might improve significantly owing to the continuation of a stronger uptake of EU funds. In addition, it is expected that 2021 might see the beginning of the utilisation of funds from the current financial perspective as well

as from the new financial perspective 2021-2027 (Next Generation EU) and the Solidarity Fund for the Reconstruction of Zagreb after the earthquake.

The projection of developments in the current and capital account is exposed to significant risks. A significant downside risk relates to a possible deterioration and prolongation of the unfavourable epidemiological situation in Croatia and the key trading partners, which, if accompanied by stronger epidemiological measures, could result in a slower than expected recovery in 2021 and thus in a slower growth in exports of goods and services in 2021. It also remains to be seen whether the pandemic will bring in a lasting change in the behavioural patterns of economic entities and consequently affect personal consumption, investments and imports. It is highly uncertain to what extent the pandemic might permanently change the habits of

consumers as regards international travel, which in turn could impact the structural characteristics of domestic tourism and have a noticeable effect on the financial result. In addition to the restrictions in the production, supply and placing of the novel vaccine in wide use, there is still a risk that it will be ineffective due to a possible mutation of the coronavirus. However, the fact that a large number of people in Croatia and its main outbound markets might get immunised before the next tourist season is recognised as an upside risk to the projection of tourism revenues. Finally, both positive and negative risks exist as regards the expected use of EU funds, which, on the one hand, are forecast conservatively in relation to the overall financial envelope, and, on the other, could be absorbed in a lower proportion than expected.

## Box 1 Tourism in the time of pandemic

*Tourism belongs to those global economic activities that are disproportionately strongly affected by changes in consumer behaviour due to the outbreak of the coronavirus pandemic and restrictive epidemiological measures. Therefore, in this Box, a series of available high-frequency indicators is used to analyse in detail the tourist year of 2020 so far and to show how the pandemic influenced not only the level of the tourism activity but also the structural characteristics of tourism in Croatia. In addition, the performance of tourism in Croatia is compared to that in other Mediterranean countries, indicating that in the observed period of 2020 Croatia had noticeably better results than any other country in the Mediterranean.*

After the outbreak of the coronavirus pandemic, almost all countries of the world introduced restrictive epidemiological measures in spring 2020 to contain the spread of infection which at first generally included the restriction of international travel and the closure of borders. According to UNWTO data, from mid-April of 2020 almost 96% of the word destinations introduced some form of restrictions on foreign passengers' arrivals[6]. In such circumstances, it seemed that Croatian tourism

Figure 2 Year-on-year rate of change in the number of nights stayed by foreign guests in the third quarter and the first nine months of 2020
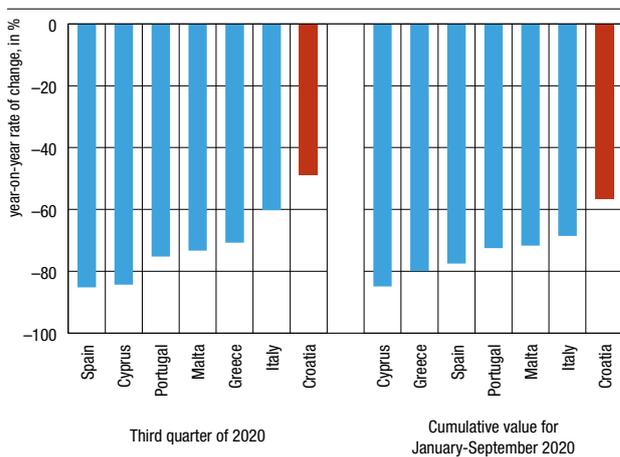


Sources: Eurostat, CBS and national statistical offices.

would be severely hit by the pandemic, in particular having in mind that foreign tourists account for the bulk of nights stayed and arrivals to Croatia (more than 90%). Excluding only Malta and Cyprus, this share is the highest one among the direct Mediterranean competitors[7], while in other countries the component of domestic tourism accounts for a much larger share (Figure 1). Because as early as spring it could be assumed that arrivals by foreign tourists would be greatly hindered and uncertain due to the announcement of lasting restrictions and since due to the worsening of economic circumstances in the country and the low level of the available income domestic tourists would not be able to significantly compensate for the absence of foreign guests, Croatia's tourism was expected to be among those most affected in the Mediterranean.

However, although the tourism sector in Croatia suffered disproportionate damage relative to most other economic activities during the pandemic, the available volume indicators suggest that the tourism performance was still noticeably better in Croatia than in any of the competitors in the Mediterranean, and

Figure 1 Share of foreign and domestic guests in total nights stayed in the Mediterranean countries in 2019



Source: Eurostat.

6   UNWTO, 2020. Available at: https://www.unwto.org/news/covid-19-response-travel-restrictions.

7   For the purposes of this analysis, the Mediterranean countries are considered the following countries: Malta, Cyprus, Greece, Spain, Portugal, Italy and France.

therefore far above the spring expectations, both in the third quarter and in the first nine months of 2020 (Figure 2).

Several factors contributed to this trend, including individual structural characteristics of domestic tourism, which in normal circumstances could be qualified as relatively unfavourable. For instance, the trends in tourism in Croatia are characterised by high seasonality, noticeably stronger than in any other competitor country. According to data for 2019, almost three fourths of all the nights stayed by foreign guests were in the June to August period (Figure 3), which is the reason why the Ministry of Tourism and the Croatian National Tourist Board have implemented numerous activities in past years in order to boost tourism in the rest of the year, notably in the continental part of Croatia. However, high seasonality amid the pandemic conditions was a mitigating circumstance and the opening of borders and favourable epidemiological situation in the summer months contributed to the tourism performance much more in Croatia than in its Mediterranean competitors.

In addition, unlike the competitors, the structure of foreign guests' arrivals to Croatia is dominated by road transport, while air transport is considerably less represented, which would

Figure 3 Share of the number of foreign guest nights by months in total year-on-year number of nights in 2019
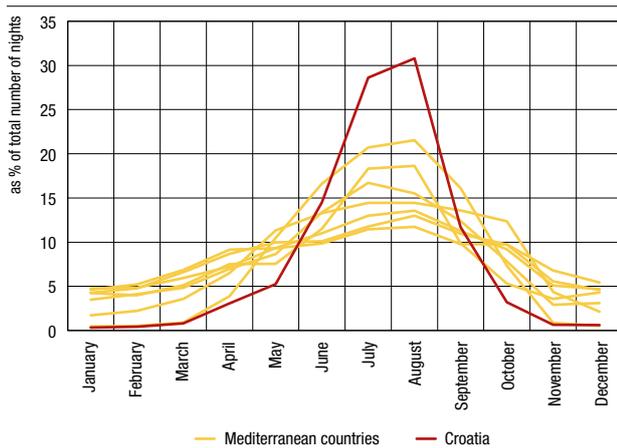


Source: Eurostat.

Figure 4 Cumulative foreign passenger arrivals by road transport to Croatia
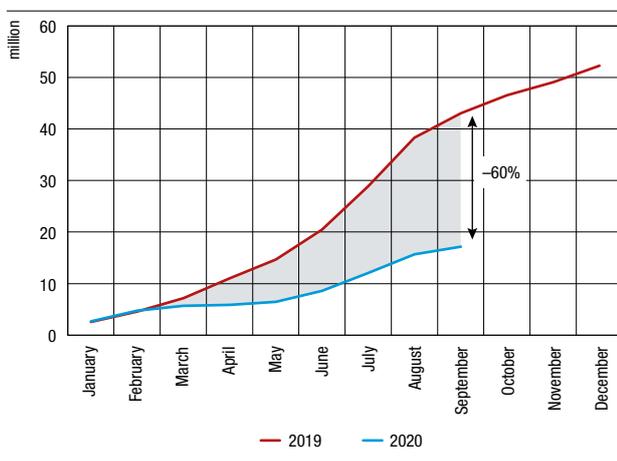


Source: Ministry of the Interior.

Figure 5 Cumulative foreign passenger arrivals by air transport to Croatia (above) and the number of international air arrivals by countries (below)
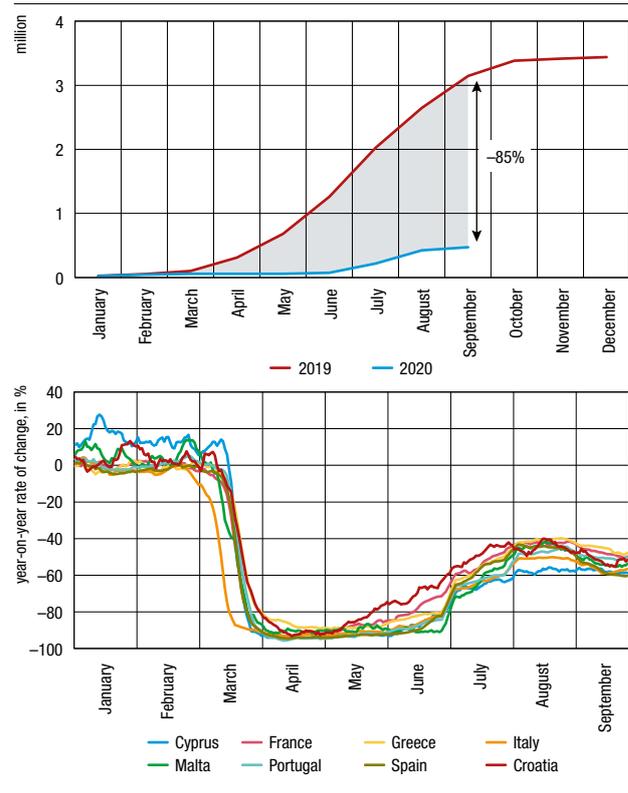


Note: The figure below shows seven-day moving averages.
Sources: Ministry of the Interior and aviationstack.com.

otherwise be considered another structural disadvantage of domestic tourism as guests arriving by air spend on average more. However, in view of the pronounced reluctance of consumers to travel by plane during the pandemic due to the increased possibility of infection, air transport recorded significantly larger losses than road transport. The Ministry of the Interior data show a 60% decrease in foreign passenger arrivals by road transport to Croatia in the first nine months of 2020 from the same period in 2019 (Figure 4), this being largely due to weaker transit through Croatia, which is also included in the statistics, and smaller number of one-day arrivals, mainly from neighbouring Bosnia and Herzegovina and Slovenia.

In contrast, the foreign passengers' arrivals by air transport declined by as much as 85% in the first nine months of 2020. However, despite much stronger fall in air transport than in road transport, the high-frequency indicators suggest that at the peak of the tourist season Croatia also recorded a smaller decline in international air arrivals than any other Mediterranean country (Figure 5).

Given that the outbreak of the pandemic led to significant changes in the patterns of consumer behaviour, not all parts of the tourism sector were equally affected by the crisis and this year's structure of the tourism activity was marked by noticeable changes to the usual trends.

In terms of the main outbound markets, the smallest decrease in volume indicators was observed in the countries whose citizens mainly use road transport to arrive to Croatia and which, at the same time, were marked by relatively favourable epidemiological situations; they primarily included Germany, Slovenia, Austria, Poland, the Czech Republic, Hungary and Switzerland (Figure 6, above). In the observed countries the recovery of volume indicators began in mid-June and picked up

Figure 6 Year-on-year rate of change in the number of nights by outbound markets (above), destinations (middle) and types of accommodation (below)

| Outbound markets | Market share (%) | January | February | March | April | May | June | July | August | September |
|---|---|---|---|---|---|---|---|---|---|---|
| Germany | 21,5 | | | | | | | | | |
| Slovenia | 8,0 | | | | | | | | | |
| Domestic tourists | 8,0 | | | | | | | | | |
| Austria | 7,8 | | | | | | | | | |
| Poland | 6,4 | | | | | | | | | |
| Italy | 5,5 | | | | | | | | | |
| Czech R. | 5,5 | | | | | | | | | |
| UK | 4,8 | | | | | | | | | |
| Hungary | 3,3 | | | | | | | | | |
| Netherlands | 3,1 | | | | | | | | | |
| Slovak R. | 3,1 | | | | | | | | | |
| France | 2,4 | | | | | | | | | |
| BIH | 2,1 | | | | | | | | | |
| USA | 1,8 | | | | | | | | | |
| Sweden | 1,6 | | | | | | | | | |
| Switzerland | 1,2 | | | | | | | | | |
| Norway | 1,1 | | | | | | | | | |
| Belgium | 1,0 | | | | | | | | | |
| Russia | 1,0 | | | | | | | | | |
| Denmark | 0,9 | | | | | | | | | |

| Destinations | Market share (%) | January | February | March | April | May | June | July | August | September |
|---|---|---|---|---|---|---|---|---|---|---|
| County: | | | | | | | | | | |
| County of Istria | 27,6 | | | | | | | | | |
| County of Split-Dalmatia | 19,4 | | | | | | | | | |
| County of Primorje-Gorski Kotar | 16,0 | | | | | | | | | |
| County of Zadar | 11,3 | | | | | | | | | |
| County of Šibenik-Knin | 5,5 | | | | | | | | | |
| County of Dubrovnik-Neretva | 4,7 | | | | | | | | | |
| City: | | | | | | | | | | |
| Dubrovnik | 4,7 | | | | | | | | | |
| Rovinj | 4,2 | | | | | | | | | |
| Split | 2,9 | | | | | | | | | |
| Zagreb | 2,5 | | | | | | | | | |
| Pula | 2,2 | | | | | | | | | |
| Zadar | 2,1 | | | | | | | | | |
| Makarska | 1,7 | | | | | | | | | |
| Šibenik | 1,6 | | | | | | | | | |
| Opatija | 1,4 | | | | | | | | | |
| Rijeka | 0,4 | | | | | | | | | |

| Types of accommodation | Market share (%) | January | February | March | April | May | June | July | August | September |
|---|---|---|---|---|---|---|---|---|---|---|
| Households facilities | 41,4 | | | | | | | | | |
| Hotels | 20,9 | | | | | | | | | |
| Camping sites | 20,9 | | | | | | | | | |
| Tourist resorts | 3,4 | | | | | | | | | |
| Apartments | 3,4 | | | | | | | | | |
| Rooms | 1,5 | | | | | | | | | |
| Tourist apartments | 1,2 | | | | | | | | | |
| Hostels | 0,9 | | | | | | | | | |
| Studio-type suits | 0,8 | | | | | | | | | |
| Summer houses | 0,7 | | | | | | | | | |
| Boarding houses | 0,5 | | | | | | | | | |
| All-suite hotels | 0,2 | | | | | | | | | |
| Facilities on the family farm | 0,1 | | | | | | | | | |

Notes: Ten-day data up to 30 September 2020. Data on market share refer to 2019. The figure shows the year-on-year rates of change in the number of nights in the ten-day period relative to the same period in 2019, with the range moving from the maximum rate of 20% (shaded dark green) to the negative rate of change of 100% (shaded dark red).
Source: eVisitor, Croatian National Tourist Board.

in the period up to the end of August when due to the worsening of the epidemiological situation in Croatia a large number of countries, including Austria, Slovenia and Germany, decided to introduce tighter travel conditions for their citizens travelling to Croatia. In contrast, the recovery throughout the entire season was much slower in countries with unfavourable epidemiological situations, despite the fact that many of them are located in the immediate proximity of Croatia, such as Bosnia and Herzegovina or Italy. Concurrently, the largest rates of decrease were recorded in visitors from outbound markets, such as the USA, the

United Kingdom, Norway, Sweden and Russia, for which Croatia is an air destination. This dynamics contributed to the significant increase in the concentration of Croatia's tourism in the first nine months of 2020 as the five main outbound markets (Germany, Slovenia, Poland, the Czech Republic and Austria) accounted for almost three fourths of the total number of nights stayed, which is an increase of over 20 percentage points from the same period in 2019.

Furthermore, the dynamics of the tourism activity showed rather diverging trends on the regional level (Figure 6, middle). In particular, the tourism activity of foreign guests fell at the smallest rate in the counties in which the structure of guests is dominated by the guests arriving from road destinations. This refers in particular to the County of Primorje-Gorski Kotar, the County of Istria and the County of Zadar in which the recovery to a substantial degree began as early as in mid-June. They were followed by the County of Split-Dalmatia and the County of Šibenik-Knin in which stronger recovery began in mid-July. The poorest performance among all Adriatic counties during the entire season was recorded in the County of Dubrovnik-Neretva, i.e. the city of Dubrovnik, which usually records a substantial number of arrivals by air transport. The situation in this county slightly improved only in the first ten days of August in which the recovery in arrivals of UK guests intensified to a certain degree; however, this trend reversed as soon as the end of August following the worsening of the epidemiological situation and the UK's decision to put Croatia on the list of risky travel destinations.

Diverse trends in the tourism activity were also pronounced in terms of the type of accommodation (Figure 6, below). As regards the months of the peak tourist season, the smallest decrease was recorded in tourist resorts and camping sites as well as in almost all forms of private accommodation, which started to recover much earlier than other types of accommodation. In contrast, the biggest losses were recorded in hotels and hostels where no loss lower than 50% was recorded in any ten-day period of the summer months. Such developments may be attributed to the fall in the number of guests arriving from air destinations who on average more often stay in hotel accommodation[8]. In addition, they also partly reflect changes in the behavioural pattern of guests due to the outbreak of the pandemic, i.e. their stronger preferences for accommodation offering safer epidemiological conditions. One of the main characteristics of Croatia's tourism, even before the outbreak of the pandemic, was a high preference for private accommodation and camping sites, while hotel accommodation accounted for only about one fourth of all nights stayed in 2019. This differs noticeably from the average for other Mediterranean countries where hotel accommodation accounted for almost 80% in the structure of nights stayed and was well above 90% in Malta and Cyprus in 2019. The difference in relation to the Mediterranean countries could thus further increase in view of the trend dynamics in 2020 which reduced the share of the hotel accommodation to only about 15%.

With respect to the changes in the structure, i.e. noticeably



Figure 7 Year-on-year rate of change in the number of nights of foreign guests, spending per cards of foreign issuers and fiscalised receipts in accommodation and food service activities in 2020

Cards of foreign issuers — Nights stayed (eVisitor) — Fiscalisation of accommodation and food service activities
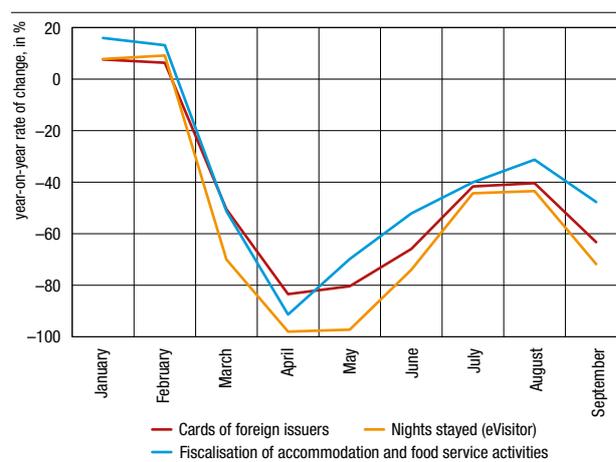
Sources: Croatian National Tourist Board, CNB and the Tax Administration.

stronger fall in tourists arriving from air destinations and staying in the hotel accommodation or in the Adriatic counties marked by significantly higher average consumption of foreign guests, it is surprising that according to the available data the financial result in 2020 did not depart significantly from the volume indicators. Hence, Figure 7 shows that financial results based on the data of the Tax Administration on the value of fiscalised receipts in accommodation and food service activities and on the data of the CNB on spending per cards of foreign issuers were somewhat better even than the results based on the volume indicators provided by eVisitor.

Finally, it can be concluded that despite a sharp drop in the tourism activity in Croatia the reported decrease was considerably smaller than in any other Mediterranean country. This is mainly attributed to the main structural characteristics of Croatia's tourism, i.e. high seasonality in the summer months, which coincided with the improvement in the epidemiological situation, and to the widespread use of roads as means of transportation to Croatia due to the proximity of the main outbound markets. However, the pandemic conditions resulted in significant changes in the structure of Croatia's tourism. The concentration of the five main outbound markets, which are at the same time predominantly road destinations, grew considerably while the share of tourists arriving from air destinations fell additionally. This contributed to the fall in the share of hotel accommodation and accommodation in the counties located in the far south of Croatia which due to larger dependency on air destinations were more strongly affected by the consequences of the pandemic during the summer months. These changes notwithstanding, the available financial data do not point to more pronounced deviations from the dynamics of volume indicators.

## Box 2 Price competitiveness of Croatia's tourism

*This Box analyses developments in the price competitiveness of Croatia's tourism in the period from its accession to the EU, using the calculation of the specific indicators of the real effective exchange rates of the kuna in tourism. Unlike the real effective exchange rates deflated by total consumer prices that depreciated in the period from 2013 to 2019, the real effective exchange rates deflated by catering and accommodation services*

*suggest a deterioration in the price competitiveness of Croatia's tourism in the past seven years, a trend that was halted during the pandemic. The deterioration in price competitiveness notwithstanding, the annual growth rates of tourism revenues in the 2013-2019 period were higher than their long-term averages, indicating the relevance of non-price (qualitative) indicators for the growth in these revenues in the past seven years.*

The external competitiveness of tourism demonstrates the market position of a country in comparison with competitor countries, and it may be measured by different qualitative and quantitative indicators. As one of the features of the external competitiveness, the index of the real effective exchange rate of the kuna in tourism was designed[9] for the purpose of monitoring the competitiveness of Croatia's tourism. It is used to estimate the price competitiveness of Croatia's tourism as regards two reference groups of countries: the countries that represent the main outbound markets for Croatia's tourism (the RC generates the largest amount of revenues from tourism based on the consumption of guests from those countries) and the countries that represent the main tourism competitors. The index of the nominal exchange rate of the kuna against the currencies of the selected reference market countries was deflated by the relative ratio of total consumer price indices (CPI), i.e. the prices of catering and accommodation services, in the RC and those countries. The prices of catering and accommodation services comprise the prices that are specific for the tourism activity: restaurants and hotels. The relative importance assigned to the prices and the exchange rate depends on the representativeness of an individual outbound market, i.e. on the importance of a competitor country for the tourism of the RC. The index has been designed in the manner that slower (faster) growth of total prices, i.e. prices of catering and accommodation services, in the RC than in the countries from the reference groups, with the unchanged nominal effective exchange rate, results in the growth or depreciation (the fall or appreciation) of the index of the real effective exchange rate of the kuna, indicating the strengthening (weakening) of the price competitiveness of Croatia's tourism with respect to the observed countries.

### Real effective exchange rate of the kuna against the currencies of the main outbound market countries

In the calculation of the index of the real effective exchange rate of the kuna against the currencies of the main outbound markets, the weights reflecting the relative importance of individual countries are based on the structure of total tourism revenues in the RC. A total of 16 countries[10] have been selected, which generated on average almost 85% of total tourism revenues in the 2013-2019 period. The weights assigned to those countries are shown in Table 1a.

The real effective exchange rate of the kuna against the main outbound markets, with total CPI as the deflator (REER_CPI_Tourism), weakened by 4% (Figure 1) in the past seven years (from Croatia's accession to the EU to September 2020), indicating an improvement in the price competitiveness of Croatia's tourism. This development reflects slower growth in consumer prices in Croatia than in the main outbound markets that was only in part mitigated by the appreciation of the nominal effective exchange rate in the reference period. The developments in the real effective exchange rate of the kuna against the currencies of the main outbound markets did not diverge substantially in the reference period from the developments in the standard real effective exchange rate (which is based on the structure of trade in manufactured goods); this may be explained by the similarities in the structure of the weights used to calculate the real effective exchange rates of the kuna against the currencies of the main

**Table 1 Weights for the calculation of the real effective exchange rate of the kuna**

| a) Outbound markets (%) | | | |
|---|---|---|---|
| Germany | 27.4 | France | 3.2 |
| Italy | 13.6 | Slovak R. | 3.0 |
| Austria | 12.2 | Czech R. | 3.0 |
| Slovenia | 9.0 | Hungary | 2.7 |
| United Kingdom | 5.8 | Sweden | 2.2 |
| Switzerland | 4.4 | Russia | 2.2 |
| Netherlands | 4.3 | USA | 1.9 |
| Poland | 3.7 | Belgium | 1.4 |
| **b) Competitor countries (%)** | | | |
| Italy | 30.3 | Portugal | 4.9 |
| Spain | 26.0 | Bulgaria | 2.5 |
| France | 24.9 | Cyprus | 1.1 |
| Greece | 9.4 | Malta | 0.9 |
| **c) Countries – standard REER_CPI** | | | |
| Germany | 19.5 | Belgium | 2.8 |
| Italy | 13.1 | Bosnia and Herzegovina | 2.7 |
| Slovenia | 8.1 | Spain | 2.5 |
| Austria | 7.7 | Serbia | 2.2 |
| China | 7.4 | United Kingdom | 2.1 |
| Hungary | 4.8 | Turkey | 2.0 |
| Netherlands | 4.3 | Slovak R. | 1.9 |
| France | 4.1 | Switzerland | 1.6 |
| USA | 4.0 | Japan | 1.1 |
| Poland | 3.5 | Sweden | 1.0 |
| Czech R. | 2.9 | Russia | 0.8 |

Sources: CNB and Eurostat.

outbound markets and the standard real effective exchange rate.

The structure of tourism consumption of non-residents shows that on average almost 70% of total consumption was accounted for by catering and accommodation services[11], while the remaining 30% was accounted for by the purchase of consumer goods, fuel, car and vessel rentals and other. This is also explains why the real effective exchange rate deflated by the prices of restaurants and hotels is used for monitoring the price competitiveness of tourism (REER_RC_Tourism). In contrast to the index of the real effective exchange rate deflated by total consumer prices that depreciated in the past seven years, the index deflated by the prices of restaurants and hotels appreciated by about 4% in the same period. This was mostly due to the appreciation of the nominal effective exchange rate of the kuna (largely brought about by the strengthening of the kuna against the euro) and only to a small extent due to faster growth in the prices of restaurants and hotels in Croatia than in the main outbound markets. The faster growth in the prices in Croatia than in the observed countries was registered in 2016 and 2017[12], whereas the growth in the prices in 2017 can be attributed to the increase in the VAT rate on catering services in the RC from 13% to 25%.

Despite the deterioration in the price competitiveness, the

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9   The index of the real effective exchange rate in tourism was also used in Box 2 Competitiveness of Croatia's tourism, CNB Bulletin No. 194, July 2013.

10  Only 16 countries meet the criteria for a share that exceeds 1% in the structure of nights stayed in the RC and for the availability and completeness of the data on exchange rates and prices of catering services. Although they generate more than 1% of Croatia's total tourism revenues, Bosnia and Herzegovina and Serbia are not included in the calculation due to the unavailability of data.

11  Residents' consumption of catering and accommodation services is substantially smaller and amounts to about 5%.

12  The growth in the prices of catering services in Croatia in 2016 and 2017 was 8%, while the weighted growth in prices in the observed countries in the same period was 4%.
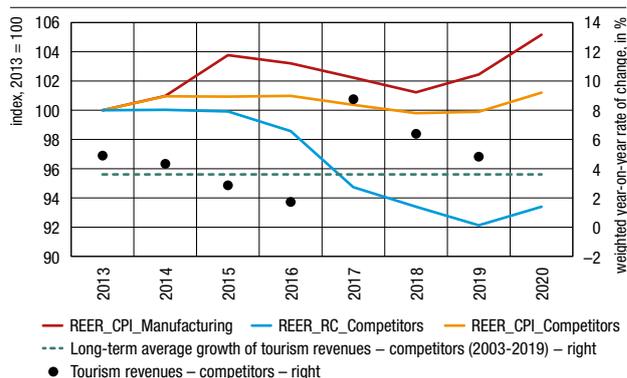
Figure 1 Comparison of the real effective exchange rates of the kuna in tourism (by outbound markets) and manufacturing
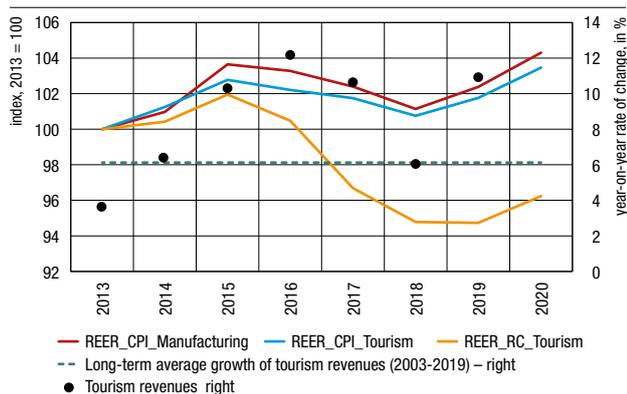


Notes: The series REER_CPI_Manufacturing refers to the index of the real effective exchange rate of the kuna deflated by the total consumer price index, with the weights that reflect the structure of trade in manufactured goods, the series REER_CPI_Tourism refers to the index of the real effective exchange rate of the kuna deflated by the total consumer price index, with the weights that reflect the structure of tourism revenues and the series REER_RC_Tourism refers to the index of the real effective exchange rate of the kuna deflated by the restaurants and hotels price index, with the weights that reflect the structure of tourism revenues. Data for 2020 refer to January to September period.
Sources: Eurostat, OECD and CNB calculations.

Figure 2 Comparison of the real effective exchange rates of the kuna in tourism (by competitors) and manufacturing



Notes: The series REER_CPI_Manufacturing refers to the index of the real effective exchange rate of the kuna deflated by the total consumer price index, with the weights that reflect the structure of trade in manufactured goods, the series REER_CPI_Competitors refers to the index of the real effective exchange rate of the kuna deflated by the total consumer price index, with the weights for competitors that take into account the main outbound markets for Croatia's tourism and the series REER_RC_Competitors refers to the index of the real effective exchange rate of the kuna deflated by the restaurants and hotels price index, with the weights for competitors that take into account the main outbound markets for Croatia's tourism. Data for 2020 refer to January to September period.
Sources: Eurostat, OECD and CNB calculations.

annual growth rate of tourism revenues in the past seven years (with the exception of 2013) hovered around or was higher than its long-term average (which covers the period from 2003 to 2019). Higher growth rates in tourism revenues may in part be attributed to the positive effects of Croatia's accession to the EU in 2013 and to the non-price factors influencing the competitiveness of Croatia's tourism. In comparison with the competitor countries, Croatia stands out in particular in terms of tourism infrastructure, safety and natural resources.[13]

As regards recent developments in 2020, when tourism was strongly affected by the coronavirus pandemic, the price competitiveness of Croatia's tourism slightly improved in the first nine months. The real effective exchange rates of the kuna deflated by the total CPI and the prices of catering and accommodation services depreciated by 1% in the January to September period of 2020 relative to 2019, due partly to the depreciation of the nominal effective exchange rate of the kuna and partly to more favourable price developments in Croatia than in the main outbound markets. However, one should take into account that the spring closing of the economy considerably hampered the collection of statistical data[14] and that the prices of catering services were entirely imputed for April and in part for May and June. The imputed prices of catering services in Croatia were an extrapolation of the last recorded prices for restaurants, cafés and canteens or an imputation that included the monthly change in accommodation services relative to the previous year.

## Real effective exchange rates of the kuna against the competitor countries

The real effective exchange rate of the kuna was also constructed against the currencies of Italy, Spain, France, Greece, Portugal, Bulgaria, Cyprus and Malta – the countries that represent the key competitors to tourism in the RC.[15] The weights assigned to individual countries are shown in Table 1b and they are based on the consumption of guests from outbound markets

that are most important for Croatia's tourism in the competitor countries. The index of the real effective exchange rate, designed in this way, shows the changes in the price competitiveness of Croatia s tourism relative to its direct competitors, taking into account the key outbound markets for Croatia's tourism. For instance, slower growth in the prices of restaurants and hotels in the RC in comparison to the same prices in the competitor countries contributes to the strengthening of the relative price attractiveness of the tourism in the RC relative to its tourism competitors.

The competitiveness of Croatia's tourism against the competitor countries measured by the real effective exchange rate of the kuna deflated by the total CPI did not change substantially in the last seven years (Figure 2). However, the price competitiveness of Croatia's tourism measured by the real effective exchange rate of the kuna deflated by the prices of catering and accommodation services with the weights for competitors shows a considerable deterioration in the price competitiveness in the 2013-2019 period, mainly attributed to faster growth in domestic prices than in the competitors' prices and also to a smaller extent to the strengthening of the kuna.

In contrast to Croatia which in the past seven years predominantly registered a growth rate of tourism revenues considerably higher than its long-term average, the weighted growth rate of tourism revenues in the competitor countries in the past seven years did not on average diverge substantially from the long-term average growth. Moreover, despite the deterioration in the price competitiveness of tourism in Croatia with respect to competitor countries, the average growth rate of tourism revenues in Croatia was in the past seven years 3.8 percentage points higher than the average growth rate of tourism revenues in the competitor countries, which also indicates the relevance of non-price factors for Croatia's tourism results.

Recent developments in 2020 suggest a slight improvement in the competitiveness of Croatia's tourism. As a result, the real

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13  For more details see Box 2 Exports of tourist services – recent developments and expectations, Macroeconomic Developments and Outlook, July 2019.
14  For more details see Box 3 Methodological approach to the calculation of the consumer price index during the Covid-19 pandemic, Macroeconomic Developments and Outlook, July 2020.

15  The currency of all competitor countries is the euro, except for Bulgaria, whose currency, the lev, is pegged to the euro. The competitor countries also comprise Turkey which, due to the unavailability of data, has not been taken into account in the calculation of the real effective exchange rates against the currencies of the competitor countries.

effective exchange rates against the currencies of the competi-tor countries (deflated by both the total CPI and the prices of restaurants and hotels) depreciated by about 3% in January to September period of 2020. The depreciation was in part a con-sequence of the weakening of the kuna against the euro and in part a consequence of more favourable price developments in Croatia than in those countries.

The following conclusions can be drawn: although in the peri-od from Croatia's accession to the EU to 2020 the kuna strength-ened against the euro and thus against other currencies of the main outbound market countries and the competitor countries, faster growth in total consumer prices in those countries than in Croatia prevented the appreciation of the real effective exchange

rates of the kuna. However, the price competitiveness of Croa-tia's tourism measured by the real effective exchange rates de-flated by the prices of catering and accommodation services de-clined in the past seven years on the account of the stronger kuna and faster growth in the prices of domestic services com-pared with the reference markets. Nevertheless, the trends ob-served during the pandemic suggest that more favourable price developments, accompanied by the weakening of the kuna against the euro and other currencies, have contributed to the improvement in the price competitiveness of Croatia's tourism as regards both the main outbound market countries and the competitor countries.

# 7 Private sector financing

The growth of private sector borrowing slowed down in the second half of 2020. Costs of domestic sectors' financing did not change significantly in the same period or were higher than in the period before the outbreak of the pandemic due to a still relatively high share of renegotiated corporate loans granted at interest rates higher than those on pure new loans. Banks con-tinued to tighten credit standards for corporate loans in the third quarter but eased credit standards for household loans.

Having increased slightly in the second half of 2020, gov-ernment borrowing costs, one of the determinants of borrow-ing costs of other domestic sectors, went down to or were even somewhat below the level seen at the end of 2019. The interest rate on one-year kuna T-bills in the domestic market remained at 0.06% in October 2020, holding steady from October 2019 (Figure 7.2), while the interest rate on euro T-bills of the same maturity issued in the domestic market went down to –0.05%. Costs of long-term government financing were also more fa-vourable in October than in the first half of the year (Figure 7.1), with the yield on two-year kuna government bond with a currency clause in euro decreasing markedly, to –1.2%. The government issued several long-term bonds in the first half of the year in order to refinance liabilities and finance measures aimed at assisting the economy following the outbreak of the

pandemic. Financing costs remained favourable, with a yield at issue ranging between 0.37% for the five-year kuna bond and 1.28% for the kuna bond with a currency clause in euro and 20 year maturity, the longest maturity for a bond issue so far. The government did not issue any new bonds in the second half of 2020 as the needs for long-term financing were met in the ear-lier part of the year.

The decrease in financing costs following the initial shock triggered by the pandemic reflected, among others, the cost of government borrowing on the foreign market, estimated by the sum of the EMBI index for Croatia and the yield on the German government bond. After reaching 2.1% at the end of March, financing costs declined steadily due mainly to the downward trend in the EMBI index for Croatia, ending November at 0.7% (Figure 7.3). Croatia's credit default swap (CDS) went up to 91 basis points in March, stabilised at 71 basis points in the period up to the end of September and then grew slightly to 76 basis points at the end of November. Credit rating agencies, Standard & Poor's and Fitch, maintained Croatia's BBB–investment rat-ing with a stable outlook, while the Moody's upgraded its rating from Ba2 with a positive outlook to Ba1 with a stable outlook in mid-November, one notch below investment grade.
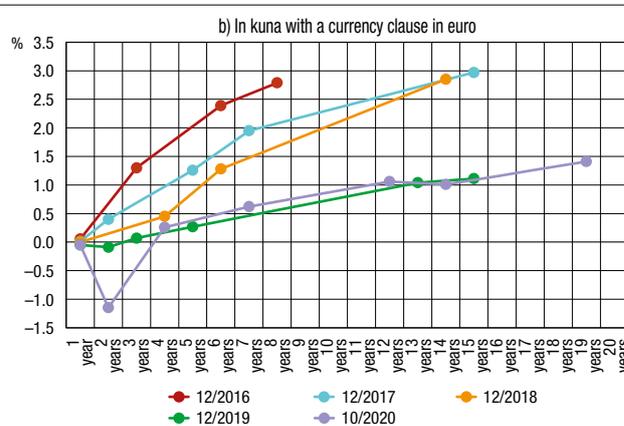
As regards the corporate sector, the average interest rate on



Figure 7.1 Yield-to-maturity on RC bonds
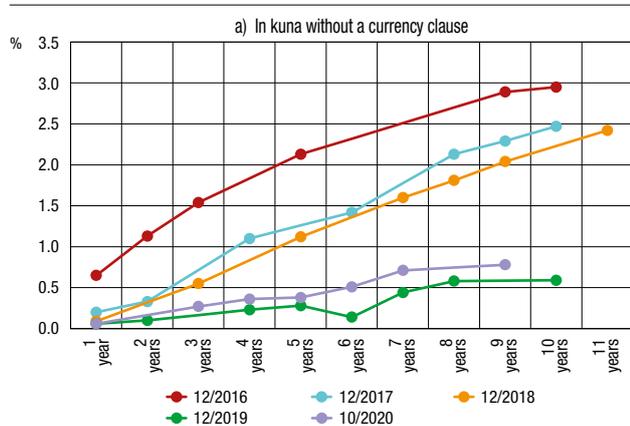
Notes: The dots show the achieved yields, while other values have been interpolated. Data for a one-year yield refer to the achieved interest rate on one-year kuna T-bills without a currency clause.
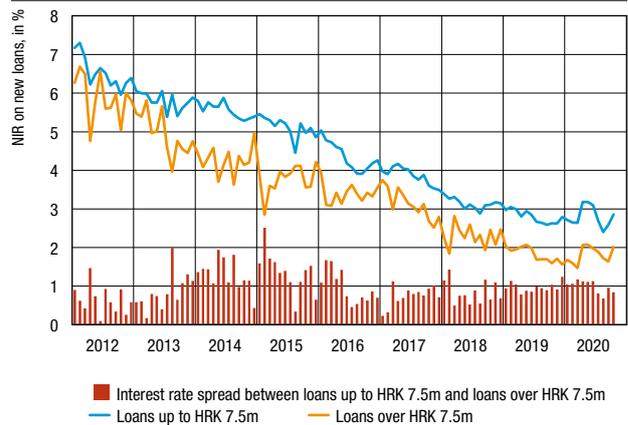Source: CNB.

Notes: The dots show the achieved yields, while other values have been interpolated. Data for a one-year yield refer to the achieved interest rate on one-year kuna T-bills with a currency clause in euro, while data for the end of 2016 refer to November and for the end of 2017 and 2019 to October respectively.
Source: CNB.

short-term corporate borrowing from banks in kuna without a currency clause did not change substantially in the July-October period relative to the last quarter of 2019 (Figure 7.2). However, the average interest rate on long-term loans with a currency clause was 0.4 percentage points higher in the reference period than in the fourth quarter of 2019 (Figure 7.3). Such developments were mainly the result of the larger amount of renegotiated loans granted at interest rates higher than those on pure new loans. This effect was the strongest in the second quarter of 2020 when the moratoria were mainly granted; however, the share of renegotiated loans in total loans remained relatively high in the following months as well. Analysis of the average costs of financing and the amount of loans shows that the average interest rate on loans above HRK 7.5m grew by 0.2 percentage points in the July-October period relative to the fourth quarter of 2019, while the interest rate on loans of up to HRK 7.5m edged down (Figure 7.4).
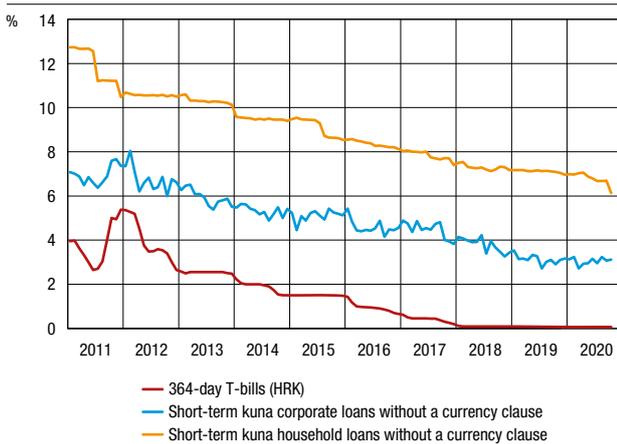
The average interest rate on short-term kuna household loans without a currency clause continued to trend downward in the July to October period of 2020 and was 0.5 percentage points lower than in the last quarter of 2019 (Figure 7.2). The

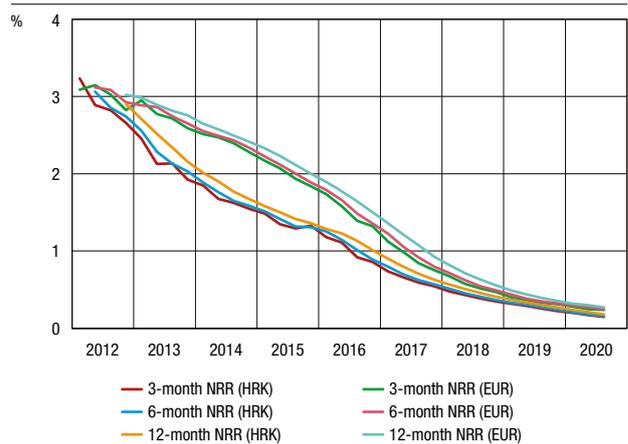**Figure 7.4 Bank interest rates on loans to non-financial corporations by volume**



Interest rate spread between loans up to HRK 7.5m and loans over HRK 7.5m
Loans up to HRK 7.5m
Loans over HRK 7.5m

Source: CNB.

**Figure 7.2 Short-term financing costs**
in kuna without a currency clause



364-day T-bills (HRK)
Short-term kuna corporate loans without a currency clause
Short-term kuna household loans without a currency clause

Sources: MoF and CNB.

**Figure 7.5 National reference rate (NRR)**



3-month NRR (HRK)          3-month NRR (EUR)
6-month NRR (HRK)          6-month NRR (EUR)
12-month NRR (HRK)         12-month NRR (EUR)

Note: The rates shown are the rates for all natural and legal persons.
Sources: HUB and CNB.

**Figure 7.3 Long-term financing costs**
in kuna with a currency clause and in foreign currency



Long-term corporate loans with a currency clause
546/547-day T-bills (EUR, indexed to f/c)
455-day T-bills (EUR, indexed to f/c)
Long-term housing loans to households with a currency clause
Yield on generic 10-year German bond + EMBI Croatia
Long-term household loans with a currency clause, excl. housing loans
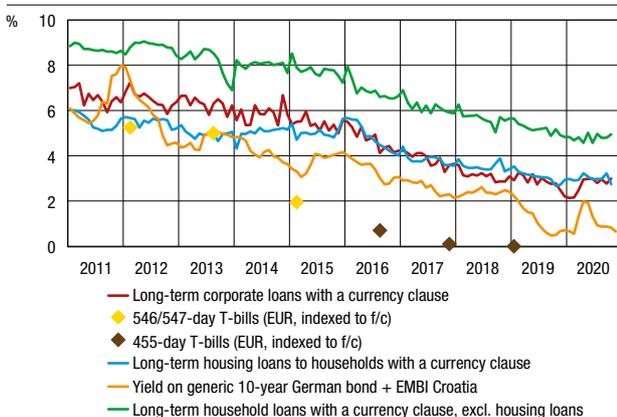
Note: EMBI, or the Emerging Market Bond Index, shows the spread between yields on government securities of emerging market economies, Croatia included, and risk-free securities issued by developed countries.
Sources: MoF, Bloomberg and CNB.

**Figure 7.6 Credit standards and corporate demand for loans**



Credit standards – left          Demand – right
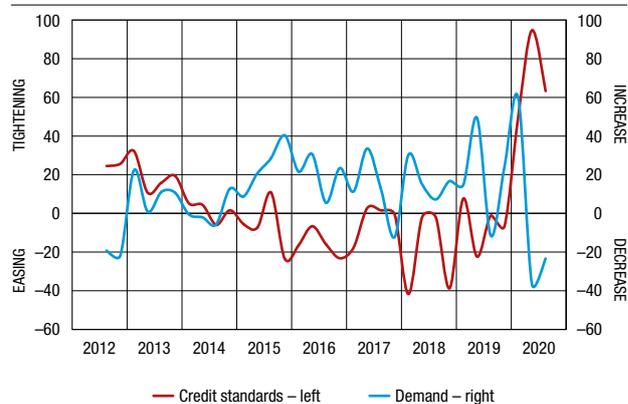
Note: Data show the net percentage of banks weighted by the share in total corporate loans.
Source: CNB.

**Figure 7.7 Credit standards and household demand for loans**



a) Housing loans

b) Consumer and other loans

Credit standards for housing loans – left
Demand for housing loans – right

Credit standards for consumer and other loans – left
Demand for consumer and other loans – right
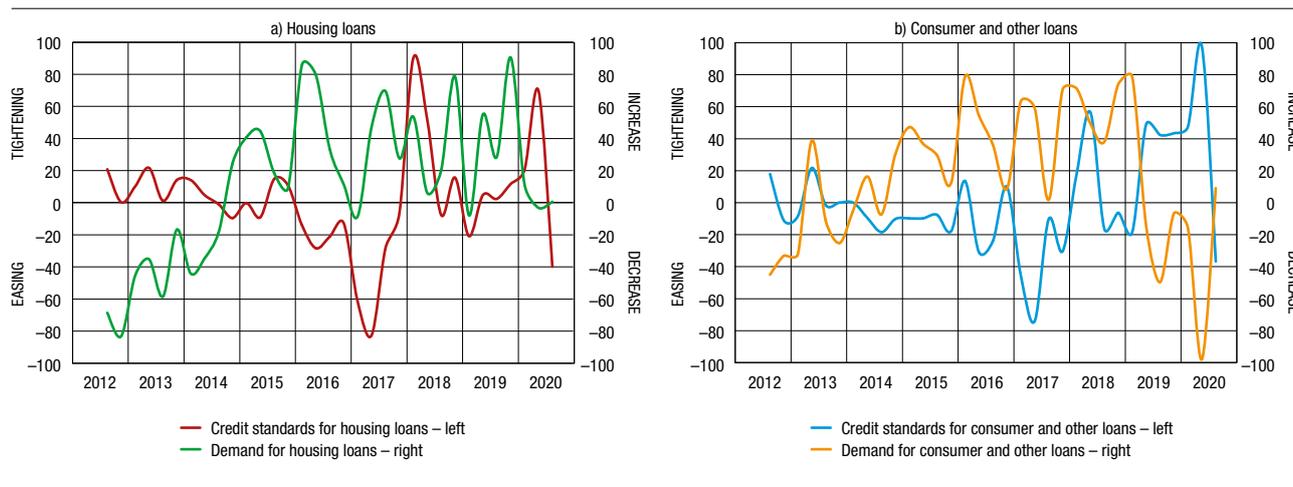
Note: Data show the net percentage of banks weighted by the share in total household loans.
Source: CNB.

average interest rate on long-term housing loans with a currency clause was 0.2 percentage points higher in the reference period, partly as a result of the decline in the level of interest rates in the last quarter of 2019 due to implementation of the housing loans subsidy programme. Concurrently, the interest rate on long-term household loans with a currency clause, excluding housing loans, went down by 0.1 percentage point (Figure 7.3).
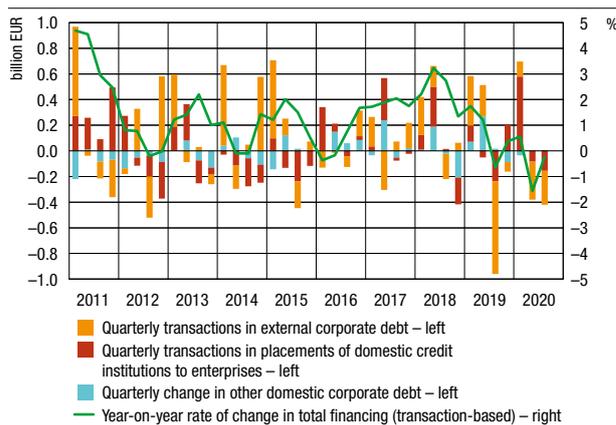
Further decrease in the funding costs of the Croatian banking system in conditions of the exceptionally expansionary monetary policy and historically high surplus liquidity contributed to the maintenance of the favourable financing conditions of the private sector. Despite the increase in the first half of 2020, EU-RIBOR fell and reached its historical low in November (Figure 2.6), while the national reference rate (NRR)[16] continued to decline moderately also in the third quarter (Figure 7.5).

According to the bank lending survey, credit standards for corporate loans continued to tighten in the third quarter (Figure 7.6) due to the worsened outlook of industry or the individual corporation, negative expectations related to overall economic trends and collateral risk. The decline in demand for loans also continued, mostly as a result of the fall in investments, but it was mitigated by the need of corporations for debt restructuring and financing of working capital. Against this background, an increase was registered only in demand for short-term loans.

Following a substantial tightening in the first half of 2020, banks eased credit standards for household loans in the third quarter, to the same extent for both housing loans and consumer and other loans (Figure 7.7). Such developments were due to improved expectations related to overall economic trends, with housing loans being characterised by much better real estate market prospects and consumer and other loans by competition among banks. After hitting a record low in the second quarter since the introduction of the survey, the demand for consumer and other loans slightly increased in the third quarter on the back of the growth in consumer confidence and consumption of durable goods. The demand for housing loans stagnated following a mild decrease in the second quarter.

In these circumstances, after growing strongly in the first

**Figure 7.8 Corporate financing**



Quarterly transactions in external corporate debt – left
Quarterly transactions in placements of domestic credit institutions to enterprises – left
Quarterly change in other domestic corporate debt – left
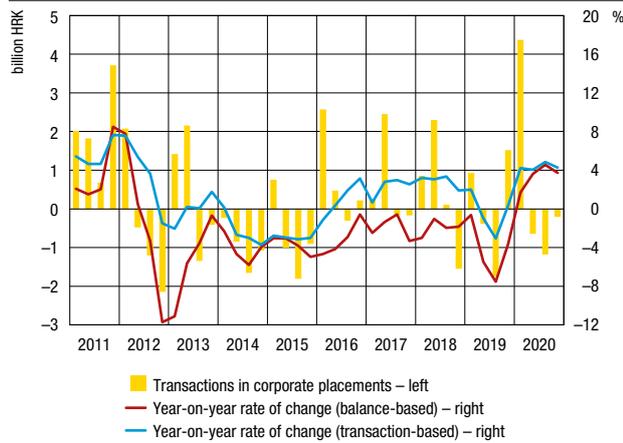Year-on-year rate of change in total financing (transaction-based) – right

Notes: Other domestic financing includes borrowing from domestic leasing companies and the CBRD. Foreign debt excludes the effect of debt-equity swaps. All changes were calculated according to transactions (except for other domestic debt).
Sources: HANFA, CNB and CNB calculations.

quarter of the year, total corporate debt declined during the second and third quarters (Figure 7.8), largely on account of external deleveraging, while domestic debt also showed the decline. Total corporate debt was 0.2% lower at the end of September observed on an annual basis (transaction-based).

As regards bank financing of non-financial corporations, corporate domestic placements of credit institutions fell on a monthly basis in April to October period of 2020, not counting their mild increase in June (see Box 3 Corporate financing during the pandemic). However, owing to the increase in placements at the end of 2019, and notably in the first quarter of 2020, their annual growth rate stood at 4.3% at the end of October (transaction-based, Figure 7.9). The disappearance of the negative effect of the decrease in claims on the Agrokor Group and the activation of government guarantees to shipyards also contributed to the increase in the annual growth rate of corporate placements. The annual growth of placements was entirely the result of developments in investment loans, which were 11.6% higher in October than in the same month of the previous year (Figure 7.10), while loans for working capital and notably other loans dropped on an annual basis. Observing the growth

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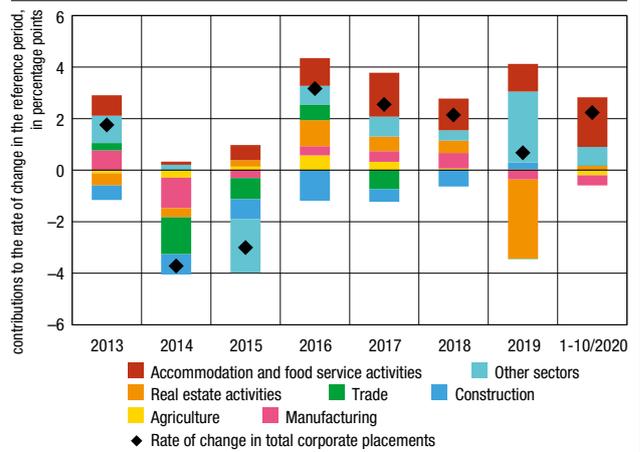16  The national reference rate (NRR) is the average interest rate paid on deposits by the banking sector. It is used as one of the benchmark interest rates for determining the level of the variable component of variable interest rate on loans, in accordance with Article 11a of the Consumer Credit Act (pursuant to the Act on Amendments to the Consumer Credit Act, OG 143/2013).

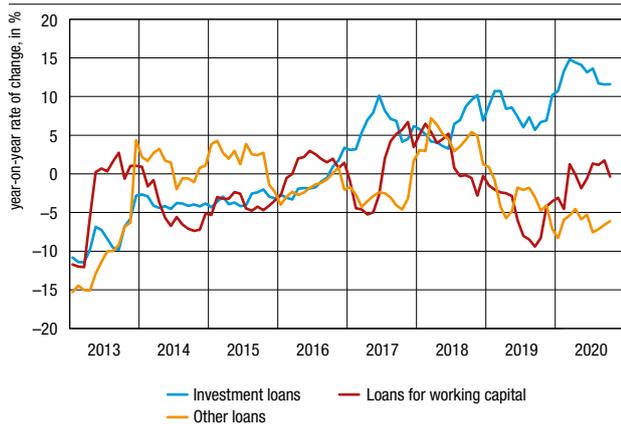## Figure 7.9 Corporate domestic placements of credit institutions



Transactions in corporate placements – left
Year-on-year rate of change (balance-based) – right
Year-on-year rate of change (transaction-based) – right

Note: Data for the fourth quarter of 2020 refer to October.
Source: CNB.

## Figure 7.12 Growth of corporate placements by activity
transaction-based



Accommodation and food service activities          Other sectors
Real estate activities          Trade          Construction
Agriculture          Manufacturing
Rate of change in total corporate placements

Source: CNB.

## Figure 7.10 Growth of corporate loans by purpose
transaction-based



Investment loans          Loans for working capital
Other loans

Source: CNB.

## Figure 7.13 Household placements



Transactions in household placements
Year-on-year rate of change in household placements (balance-based) – right
Year-on-year rate of change in household placements (transaction-based) – right

Note: Data for the fourth quarter of 2020 refer to October.
Source: CNB.

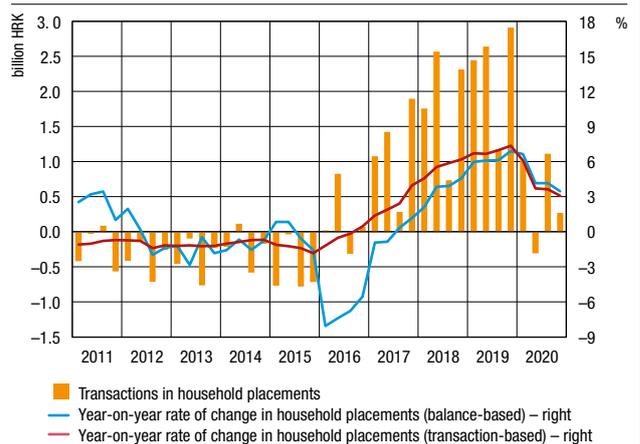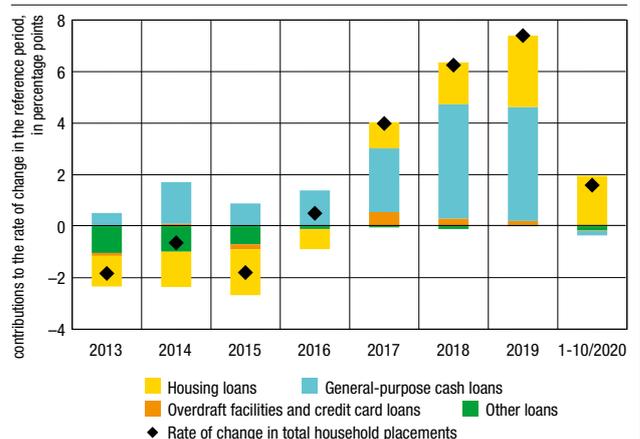## Figure 7.11 Growth of corporate placements by size
transaction-based



Micro, small, medium-sized          Large          Total
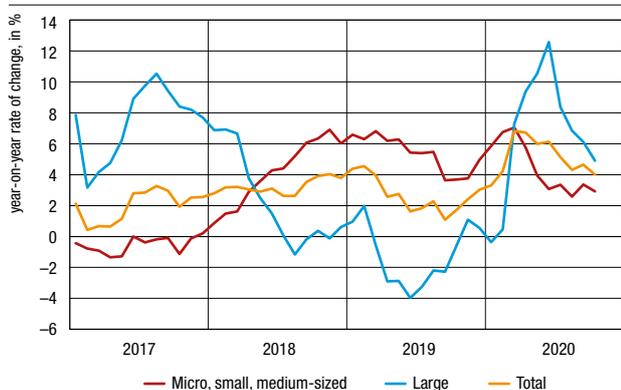
Note: The data were adjusted for the assessment of the effect of activated government guarantees for loans to particular shipyards and the decrease in the claims on the Agrokor Group linked to the operational implementation of the settlement.
Source: CNB.

## Figure 7.14 Growth of household placements by loan type
transaction-based



Housing loans          General-purpose cash loans
Overdraft facilities and credit card loans          Other loans
Rate of change in total household placements

Source: CNB.

**Figure 7.15 Loans under payment deferral or restructuring measures**



Source: CNB.
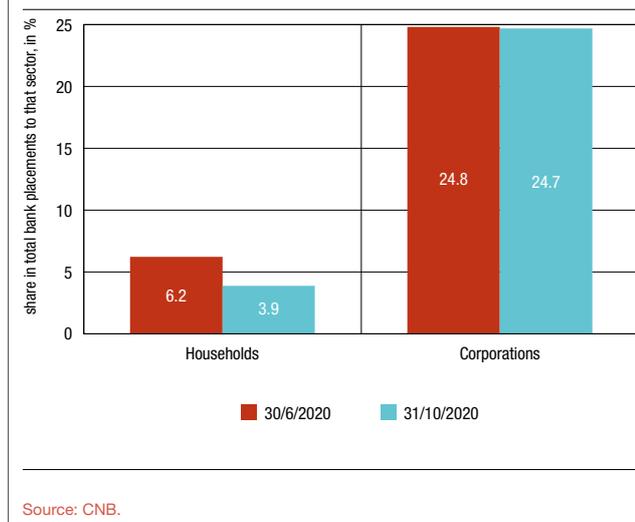
of placements by the size of enterprises, after strong growth in the first half of 2020, large enterprises, mostly deleveraging since July, contributed to a substantial slowdown in the annual growth rate of their placements that stood at 4.9% in October (Figure 7.11). The annual growth of placements to micro, small and medium-sized enterprises also slowed down, hovering around 3% in June to October period of 2020.

The analysis of corporate loans by activities shows that the activities of accommodation and food service accounted for the bulk of the growth in placements in the first ten months of 2020, the trend observed in most previous years[17] (Figure 7.12). In contrast, a mild decrease was recorded in manufacturing and agriculture.

In contrast to the fall reported in the second quarter, during the July to October period there was a rise of HRK 1.4bn in placements to households, mostly consisting of housing loans. The annual growth of placements continued to slow down mildly and ended October at 3.1% (transaction-based), falling by almost one half from the end of 2019 (Figure 7.13). The smaller growth resulted from a continued slowdown in the annual

growth of general-purpose cash loans, which amounted to only 0.3% in October relative to 11.5% at the end of the previous year. In contrast, the annual growth of housing loans accelerated from 6.4% in 2019 to 7.7% in October, spurred also by the implementation of the housing loans subsidy programme. In line with this, housing loans were the main source of growth in household placements in the first ten months of 2020 (Figure 7.14), while general-purpose cash loans, after a substantial positive contribution in the previous years, went down in the reference period of 2020.

With respect to the measures for the deferral of payments and the restructuring of existing credit liabilities directed at households and corporations affected by the crisis, the amount of placements covered by measures was substantially higher in the corporate sector than in the sector of households. At the end of October, out of total bank placements to corporations, 24.7% was encompassed by the measures, almost the same amount as in June (Figure 7.15). However, in the household sector this share decreased by one third in the same period, amounting to 3.9% at the end of October

### Projected developments

Total placements (government excluded) in 2020 might grow by 2.8% (transaction-based), following the increase of 4.2% in 2019. The slowdown in 2020 largely reflects slower growth in loans to households that could amount to 3.4% in 2020, due mainly to the decline in general-purpose cash loans. In contrast, corporate placements could see a rise of 2.6% following the previous year's modest growth. Stronger growth in placements to the corporate sector was due to an upsurge in corporate lending at the end of 2019 and in the first quarter of 2020, after which they started to decline.

In 2021, total year-on-year growth in placements (government excluded) might reach 3.3% (transaction-based), an increase of 0.5 percentage points relative to the growth forecast for 2020. Reinforced lending to the corporate sector and, to a smaller extent, lending to the household sector could contribute to faster growth in placements. The extent to which the placements will grow largely depends on the degree in which adverse economic developments caused by the pandemic will affect the financial vulnerability of these sectors.

<div style="background-color:#8a9a2b; color:white; padding:4px;">Box 3 Corporate financing during the pandemic</div>

*At the beginning of 2020 and before the upswing in the coronavirus pandemic, corporate lending activity was strong and loans for investments grew noticeably due to favourable macroeconomic trends in previous years. The intensification of the pandemic and the increasing uncertainty about future economic activity led to a considerable growth in corporate demand for liquid funds, pushing working capital loans upwards in March. In the continuation of the year, from April to October, corporate placements showed a monthly decline while deposits grew at a substantial rate.*

The coronavirus pandemic came upon the sector of non-financial corporations at a time when liquidity was favourable and investment had momentum, as suggested by credit activity

during 2019 and at the beginning of 2020. In 2019, investment loans[18] grew by HRK 3.7bn while working capital loans fell by HRK 1.1bn and other corporate domestic placements of credit institutions by almost HRK 2bn (Figure 1). The external debt also declined, by HRK 1.2bn. These developments reflect the years-long upward trend in macroeconomic indicators, which reached its peak in 2019, for the first time outstripping the real GDP level of 2008, with the largest share of goods and services exports in GDP so far and historically low costs of financing.

The corporate lending activity at the beginning of 2020 pointed to intensifying positive trends as, during the first quarter, investment loans rose by HRK 2.9bn. However, the intensification of the pandemic in March significantly changed the lending patterns. Due to the increased uncertainty about future economic

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17  In October 2019, a large corporation switched from Section L Real estate activities to Section E Water supply, sewerage, waste management and remediation activities. This is why a sharp decrease in placements was recorded in Real estate activities, and a substantial rise was seen in Other sectors, which include water supply in 2019.

18  Investment loans include the following lending facilities: investment loans, construction loans, loans for agriculture and tourism and the shares in syndicated loans.

## Figure 1 Transactions in corporate placements
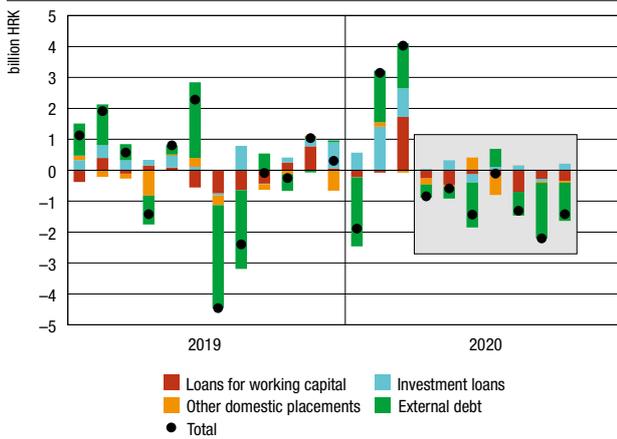


Note: Data on external debt in October 2020 is estimated.
Source: CNB.

## Figure 2 Change in total corporate deposits in 2020 by activity
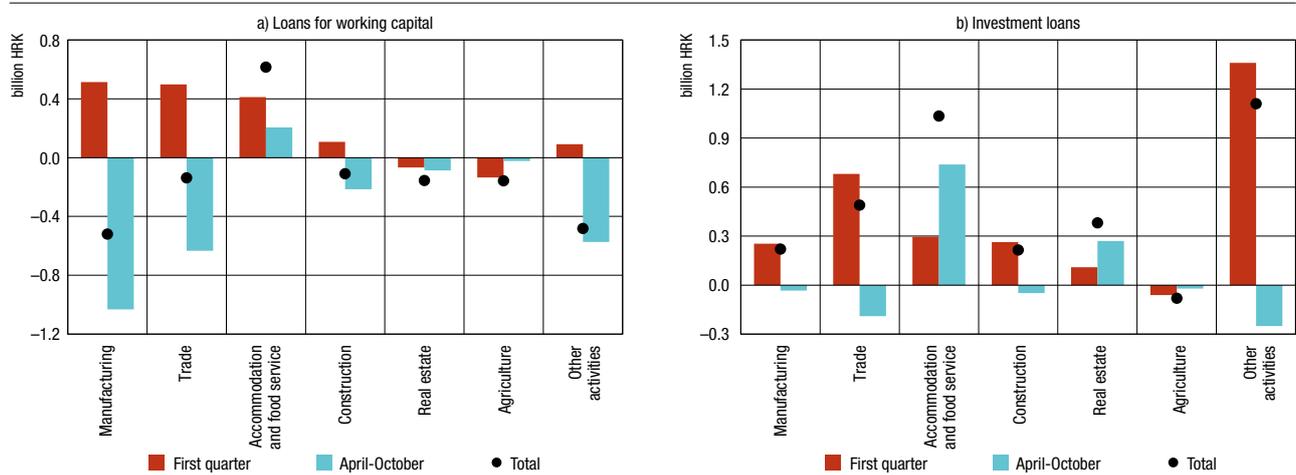transaction-based
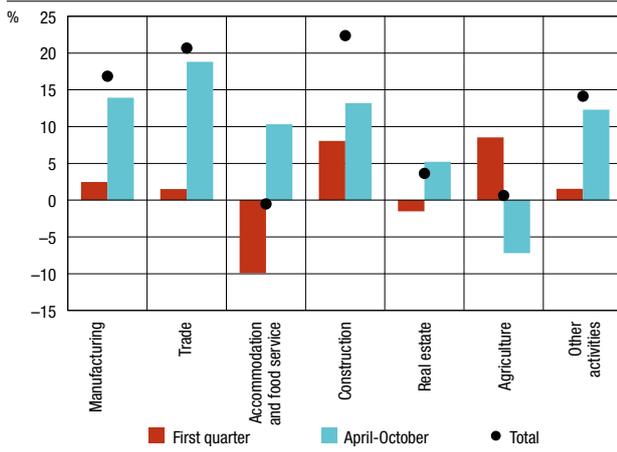


Source: CNB.

trends and sources of finance for current costs, the corporate demand for liquid funds grew noticeably. Against this background, working capital loans grew by HRK 1.7bn in March.

Following vigorous lending activity in the first quarter of 2020, corporate placements declined on the account of several factors. First, the introduction of a series of fiscal, monetary and supervisory measures began in Croatia as early as in March in order to counter the consequences of the pandemic, which, in addition to the equivalent measures in the world's largest economies, acted to reduce uncertainty and mitigate the corporate demand for liquid funds. Second, in order to preserve liquidity, corporations reduced the amounts of planned investments, contributing to lower demand for loans for investments. Third, the corporate sector sought to cut costs as much as possible by implementing crisis-management measures, which also resulted in lower borrowing requirements. Fourth, in the conditions of the crisis, banks tightened lending terms and standards, which could have led to reduced availability of funds for more vulnerable enterprises. Fifth, the easing of anti-epidemic measures that began in May led to gradually recovery in corporate revenues of the affected activities. Finally, corporations usually borrow less in the second half of the year as compared to the first half due to increased economic activity and revenue inflows from tourism; however, it is likely that this effect will be noticeably smaller this year.

The impact of these factors and the corporations' efforts to preserve liquid resources were also reflected in the increase of total domestic corporate deposits in 2020 that outweighed their growth during the reference period of the previous year. From April to October deposits rose by HRK 9.7bn, despite the decrease in indebtedness and a large decline in the economic activity during this period. The largest growth in deposits from April to October was in trade, manufacturing and the construction industry (Figure 2).

As for developments in domestic placements of credit institutions by activity, in almost all activities the decrease in loans for working capital from April to October 2020 exceeded their growth during the first quarter (Figure 3a), which was particularly pronounced in manufacturing. The exception were the activities of accommodation and food service that were among the activities suffering the most from the consequences of the pandemic. In these activities, loans for working capital grew until July and then slightly decreased, probably under the influence of the inflow of receipts from tourism consumption.

## Figure 3 Transactions in domestic placements in 2020 by activity



Source: CNB.

**Figure 4 Change in loans in 2020 by size of enterprises**
transaction-based

a) Loans for working capital

b) Investment loans

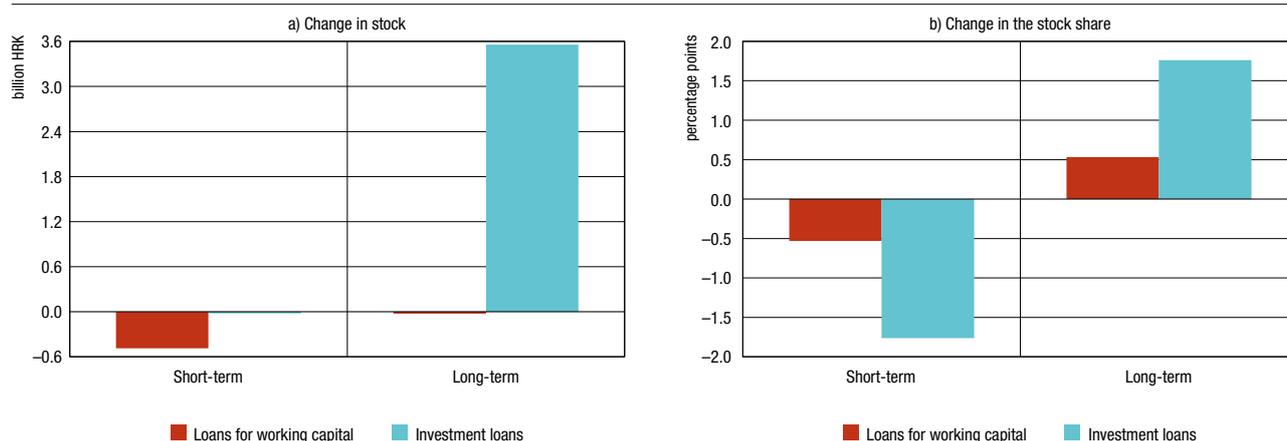Legend: First quarter | April-October | Total
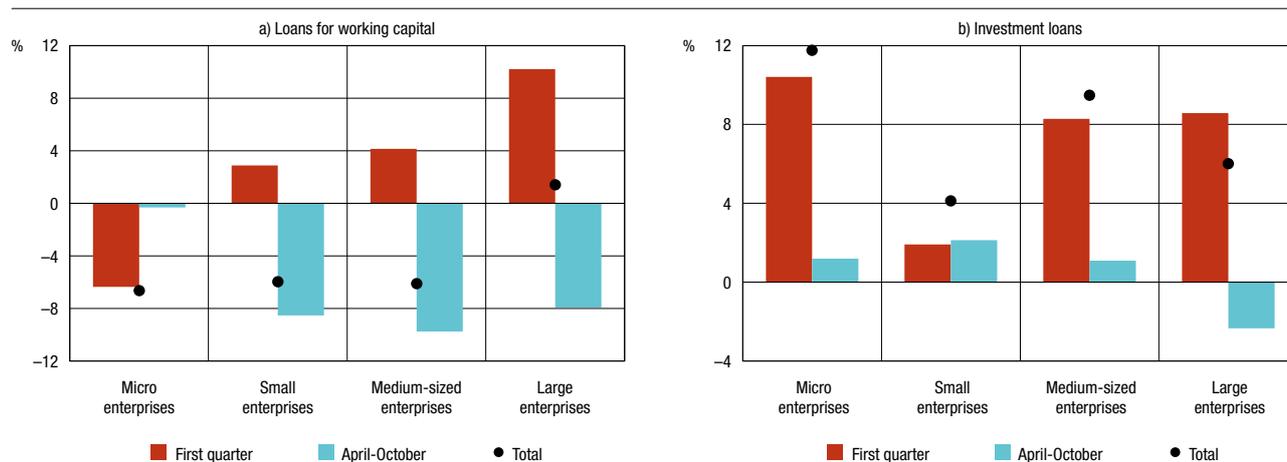
Source: CNB.

**Figure 5 Change in loans by remaining maturity**

a) Change in stock

b) Change in the stock share

Legend: Loans for working capital | Investment loans

Notes: Changes refer to the period from 31 December 2019 to 30 September 2020. Short-term debt includes loans with remaining maturity up to (and including) 12 months.
Source: CNB.

On the other hand, investment loans increased in the first ten months of 2020. However, most of this growth was achieved in the first quarter (Figure 3b), particularly in professional, scientific and technical activities and trade. In the period from April to October, most activities saw a slight decline in investment loans. Exceptions include the real estate activity and the activities of accommodation and food service, showing larger growth in loans for investments in this period than in the first quarter. In accordance with the described trends, the activities of accommodation and food service were responsible for the bulk of growth in total domestic corporate placements in the first ten months of 2020.

In terms of enterprise size, the growth in the first quarter was mainly seen in loans for working capital and was most pronounced in large enterprises, while only micro enterprises reduced this type of financing (Figure 4a). However, in the coming period, loans for working capital decreased in all groups, the decline in micro enterprises being modest. Overall, in the first ten months of 2020 only large enterprises reported a slight increase in working capital loans while other groups reported a moderate decrease.

On the other hand, loans for investments recorded a growth in almost all observed periods and groups (Figure 4b). The strong growth in the first quarter was almost evenly distributed among the groups, except for in the group of small enterprises that reported modest growth. Investment loans grew at a much smaller rate in April to October period than in the first quarter and even fell in the group of large enterprises.

As far as the structure of loans by remaining maturity is concerned, working capital loans expectedly showed considerably shorter maturity than investment loans. For instance, at the end of September two thirds of the stock of working capital loans had a remaining maturity of up to one year, that share for investment loans amounting to 19%. In the first nine months of 2020, the stock of short-term working capital loans, i.e. those maturing within the next 12 months, went down by HRK 0.5bn, while the stock of short-term investment loans remained almost unchanged (Figure 5a). In contrast, the stock of long-term investment loans grew by HRK 3.6bn. The change in the share shows the increase in the significance of long-term debt for both types of loans (Figure 5b), which was particularly pronounced in investment loans.
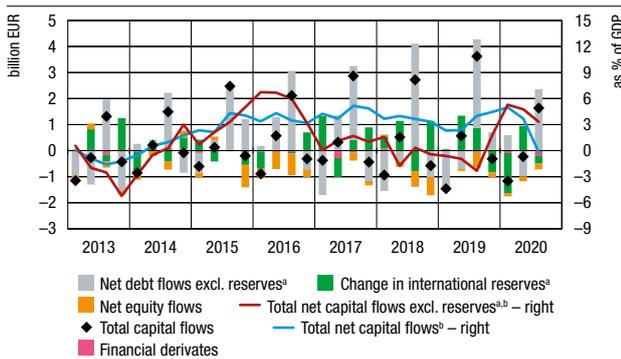
# 8 Foreign capital flows

The notable deterioration in current and capital account developments triggered by the crisis brought on by the coronavirus pandemic had a strong impact on foreign capital flows. A fall in the net foreign liabilities of domestic sectors in the third quarter of 2020 of EUR 1.9bn, excluding the change in international reserves and liabilities of the CNB, was as much as EUR 0.8bn less than in the same period of the previous year (Figure 8.1). Observing cumulative values, a small net inflow of capital was seen over the past four quarters, for the first time since the beginning of 2014, due to the decrease in gross international reserves.

The third quarter of 2020 saw a modest net inflow from equity investments of EUR 0.2bn, considerably less than that in the same period of the previous year, resulting from reinvested earnings on the liabilities side being more than twice as small, which was largely due to developments seen in the accommodation activity and the oil industry. New foreign direct equity investments in Croatia were only slightly lower than in the same period of

2019 and mostly took place in the real estate sector and computer programming activities (Figure 8.2).

A decline in net debt liabilities in the third quarter of 2020 of EUR 2.4bn, excluding the change in international reserves and liabilities of the CNB, was the result of a decrease in foreign liabilities and a simultaneous, but less pronounced, increase in foreign assets. All domestic sectors reduced their net debt liabilities, particularly the government, which in July repaid USD 1.25bn worth of bonds issued in 2010, after having issued new bonds worth EUR 2.0bn on the international market in June, which were intended to cover the July repayment of due bonds and in part to finance the counter-crisis measures aimed at mitigating the negative impacts of the pandemic. A decrease in banks' net liabilities was smaller than in the same period in the last few years due to significantly weaker foreign currency inflows during the peak tourist season. In addition, the decrease in total net debt liabilities was also spurred by the rise in debt claims of



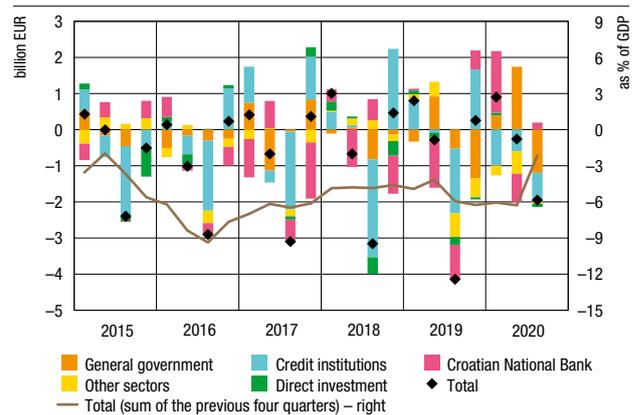**Figure 8.1 Flows in the financial account of the balance of payments**

Legend:
- Net debt flows excl. reserves[a]
- Net equity flows
- Total capital flows
- Financial derivates
- Change in international reserves[a]
- Total net capital flows excl. reserves[a,b] – right
- Total net capital flows[b] – right

[a] Changes in gross international reserves net of CNB liabilities.
[b] Sum of the previous four quarters.
Notes: Net flows mean the difference between changes in assets and liabilities. Equity flows comprise changes in foreign direct equity investments, reinvested earnings and portfolio equity investment, while net borrowing from affiliated enterprises is composed of debt equity flows. Positive value means net capital outflow abroad.
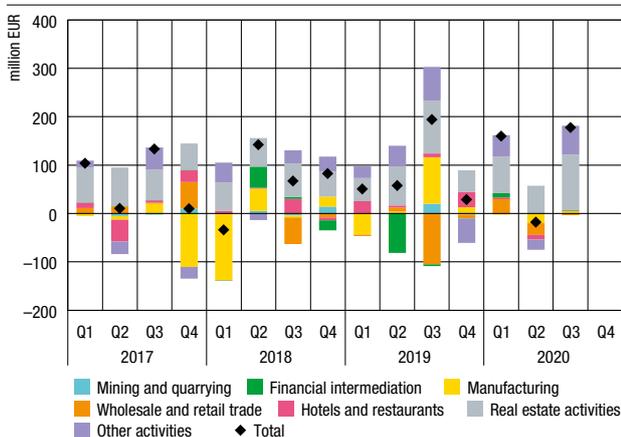Source: CNB.



**Figure 8.2 Foreign direct equity investment in Croatia by activities**

Legend:
- Mining and quarrying
- Wholesale and retail trade
- Other activities
- Financial intermediation
- Hotels and restaurants
- Total
- Manufacturing
- Real estate activities

Note: Equity investment net of debt-to-equity transactions and round-tripping investments.
Source: CNB.



**Figure 8.3 Net external debt transactions by sectors**

Legend:
- General government
- Other sectors
- Total (sum of the previous four quarters) – right
- Credit institutions
- Direct investment
- Croatian National Bank
- Total

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



**Figure 8.4 Stock of gross and net external debt**
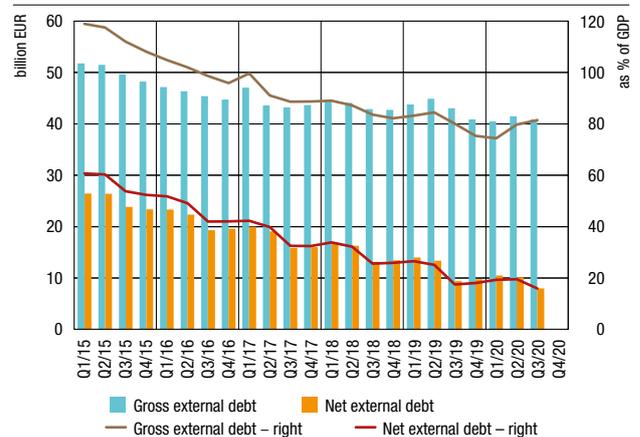
Legend:
- Gross external debt
- Gross external debt – right
- Net external debt
- Net external debt – right

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

**Figure 8.5 International investment position (net) by sectors**



a Stock of international debt investments (net) equals the negative value of the net external debt.

Source: CNB.
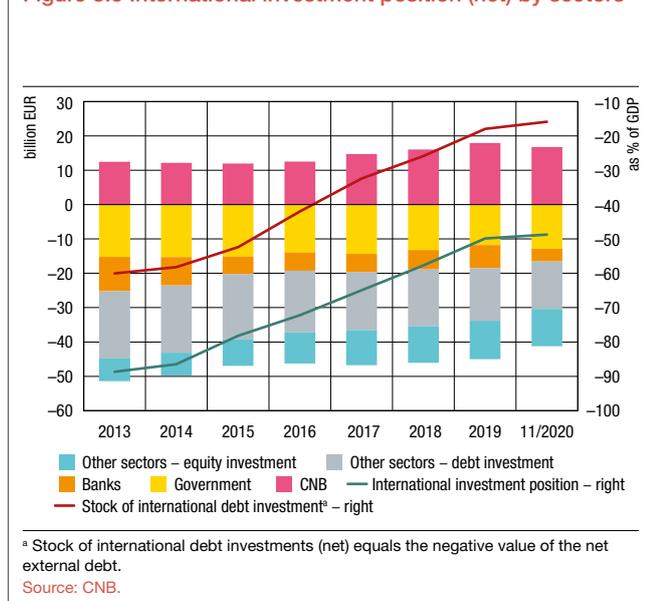
other domestic sectors.

Gross international reserves grew perceptibly in the third quarter of 2020, largely due to the greater value of repo transactions, which led to an equivalent increase in gross international reserves and an increase in CNB liabilities. If the effect of repo transactions is excluded, international reserves decreased in the period under review.

As regards the indicators of external debt, gross external debt stood at EUR 40.9bn at the end of September 2020, close to its level at the end of 2019. However, as a result of the sharp economic contraction in the second and third quarters and the consequent smaller nominal GDP, the relative indicator of gross external debt deteriorated notably, standing at 81.4% of GDP at end-September 2020, an increase of 6.1 percentage points from the end of 2019. By contrast, as foreign assets grew strongly in the same period, the relative indicator of net external debt improved notwithstanding the unfavourable impact of the fall in nominal GDP. By the end of September 2020, net external debt came to EUR 7.9bn or 15.8% of GDP, a decrease of EUR 1.8bn or 2.1 percentage points from the end of 2019.

The relative indicator of the net international investment position improved from –49.9% of GDP at the end of 2019 to –48.7% of GDP at the end of September 2020 (Figure 8.5). This was largely due to the favourable effect of price, exchange rate and other adjustments and the sharp decrease in net debt liabilities of domestic sectors, particularly credit institutions.

## Projected developments

Extremely negative trends in the current and capital accounts triggered by the pandemic-induced crisis have also affected the assessment of foreign capital flows for the whole of the current year. The several-year-long trend of large net capital outflows is expected to be temporarily halted in 2020. The noticeably lower estimated net capital outflow is the result of a further decrease in domestic sectors' net foreign debt liabilities, which might be much smaller than in the previous years. On the other hand, the expected net capital inflow from equity investments might also be smaller.

The much lower estimate for total net equity capital inflows in 2020 is in part due to the fall in profitability and the related decrease in reinvested earnings of non-financial corporations in foreign ownership resulting from the deep contraction of the domestic economy. In addition, due to the global economic downturn and the growing uncertainty and caution on the part of investors, the already relatively modest inflow of direct equity investments in Croatia might see a further fall.

As regards debt investments, the continuation of the decrease in net foreign debt liabilities of domestic sectors in 2020 is the outcome of the further increase in net foreign assets of credit institutions and a decrease in net debt liabilities of other domestic sectors, mostly due to the deleveraging of private non-financial corporations. By contrast, the net debt position of the government should significantly worsen due to the larger need to finance the budget deficit, which was partly satisfied by the issue of new foreign bonds in June 2020. As regards the central bank, the slight deterioration of its foreign position on the whole year level is mostly a result of a noticeable fall in international reserves following record large interventions in the foreign exchange market after the outbreak of the coronavirus pandemic. The growth in reserves in the remainder of the year might largely offset the decrease seen early in the year.

Despite the expected fall in the gross external debt in an absolute amount, the relative indicator might deteriorate perceptibly and go from 75.3% of GDP at the end of 2019 to 82.2% of GDP at the end of 2020, as a result of the sharp fall in nominal GDP. This would temporarily bring to a halt the several-year-long trend of decline in the gross external debt-to-GDP ratio and the international investment position-to-GDP ratio. By contrast, the relative indicator of the net external debt might further improve and fall to below 17.0% of GDP, after being 17.9% at the end of 2019.

In line with the projected economic recovery and a larger surplus in the current and capital account, the net capital outflow might grow in 2021, mainly owing to the resumed increase in international reserves. The expected continued decline in net debt liabilities is related to banks and other domestic sectors, while the government alone might worsen its position by borrowing in the foreign market to finance the projected budget deficit. On the other hand, the net inflow from equity investments might be slightly larger than in the previous year. The pre-crisis trend of improvement in the relative indicators of foreign liabilities temporarily interrupted in 2020 is expected to continue.

# 9 Monetary policy

In the second half of 2020 the CNB continued to pursue its highly expansionary monetary policy. In response to the unfavourable economic and financial circumstances caused by the outbreak of the coronavirus pandemic, in the first half of the year the CNB adopted a series of monetary policy measures to maintain the stability of the kuna/euro exchange rate, ensure sufficient kuna and foreign exchange liquidity and support the stability of the government securities market. Once the financial conditions on domestic financial markets had stabilised, no further changes in monetary policy measures were needed in the second half of the year. The liquidity surplus went up additionally, due also to autonomous factors.

To preserve exchange rate stability amid growing uncertainty regarding the effects of the pandemic, the CNB intervened strongly on the foreign exchange market, selling to banks a total of EUR 2.7bn. The bulk of the foreign exchange was sold in the second half of March and at the beginning of April, after which the exchange rate stabilised and there were no foreign currency sales or purchases from the middle of April to end-November. Exchange rate movements were also smoothed by the agreement between the CNB and the ECB on establishing a currency swap line. As regards other foreign exchange transactions, from the beginning of the year to the end of November, the CNB purchased EUR 1.7bn from the Ministry of Finance, creating HRK 12.7bn. Most of this amount was recorded in June, when the CNB purchased EUR 1.5bn. When foreign exchange transactions in the first eleven months of 2020 are observed, the CNB sold a total of EUR 1.0bn net, withdrawing HRK 0.8bn in reserve money (Figure 9.1).

On the other hand, reserve money creation in 2020 was supported by the CNB's securities purchases, the first of which took place in March and was aimed at creating additional liquidity needed to normalise the functioning of that segment of the financial market and maintaining favourable financing conditions for all sectors. At five auctions held from March to June, the CNB purchased bonds with a total market value of HRK 20.3bn (Figure 9.3). There was no need for further purchases of government bonds in the second half of the year.

As for other monetary policy measures, in 2020 the CNB placed long-term kuna funds to banks via structural operations. The first auction, worth HRK 3.8bn, was conducted in March and the second auction, worth HRK 0.5bn, was held in November, both for a five-year term at an interest rate of 0.25%. A portion of the funds was used by banks for the partial early repayment of existing structural loans, so that their balances were HRK 2.6bn larger at the end of November than at the beginning of the year. In addition to long-term funds, the CNB placed to banks short-term kuna funds via regular weekly operations at a fixed interest rate that was cut from 0.3% to 0.05%. The banks' demand peaked in April, when the average amount of funds placed reached HRK 1.1bn. However, amid very high levels of kuna liquidity surplus, banks have shown no interest in funds available through this monetary policy instrument since mid-May 2020. Finally, the reserve requirement rate was kept at 9% throughout the second half of 2020, after the CNB reduced it from 12% to 9% in March, releasing to banks HRK 6.34bn of the funds previously allocated to a special statutory reserve account held with the CNB.

By purchasing government bonds, holding structural and regular open-market operations and cutting the reserve requirement rate, the CNB supplied banks with a total of HRK 29.3bn in kuna liquidity from March to end-November 2020, almost all of which was released in the period from March to early July. As a result, the banks' free reserves started to reach historical highs. The average daily surplus kuna liquidity of the domestic banking market grew from HRK 32.2bn in 2019 to HRK 41.2bn in July 2020 and further to HRK 45.7bn in November (Figure 9.2). The larger liquidity surplus in the second half of the year was also due to a fall in government kuna deposits with the CNB, which at end-November fell to their lowest level since the end of June.

The central bank's balance sheet structure changed significantly over the first half of 2020 as a result of the increase in claims on domestic banks and government bond purchase. The share of foreign assets, i.e. international reserves, decreased temporarily due to the sale of foreign currency to banks at the onset of the pandemic, but it has grown steadily since June (Figure 9.3).



Figure 9.1 Flows of reserve money (M0) creation

Notes: The possibility of using Lombard loans was abolished, while the possibility of using overnight credits was introduced on 28 September 2017. 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 fourth quarter of 2020 are up to November.
Source: CNB.



Figure 9.2 Bank liquidity and reserve money

Note: Data are up to November 2020.
Source: CNB.
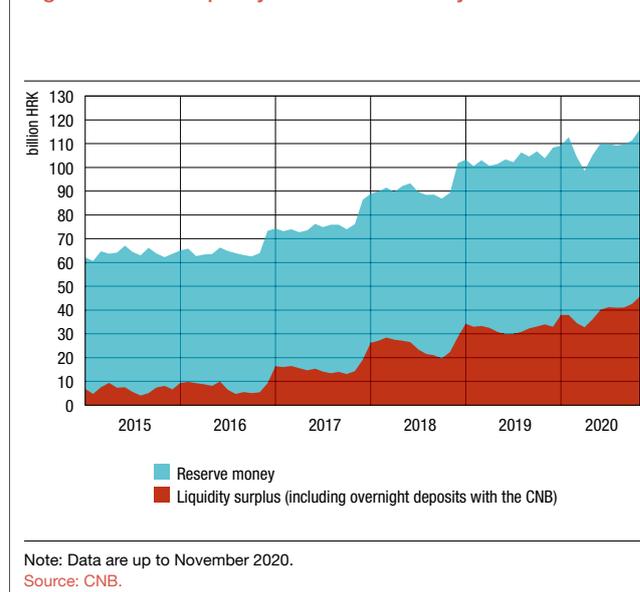
**Figure 9.3 CNB balance sheet structure**



Net foreign assets   Claims on central government
Loans to credit institutions
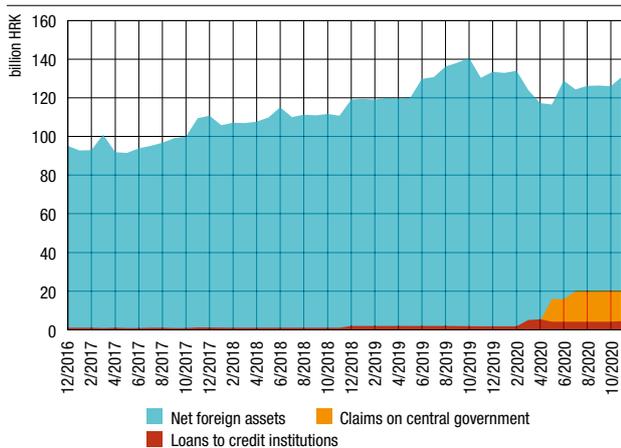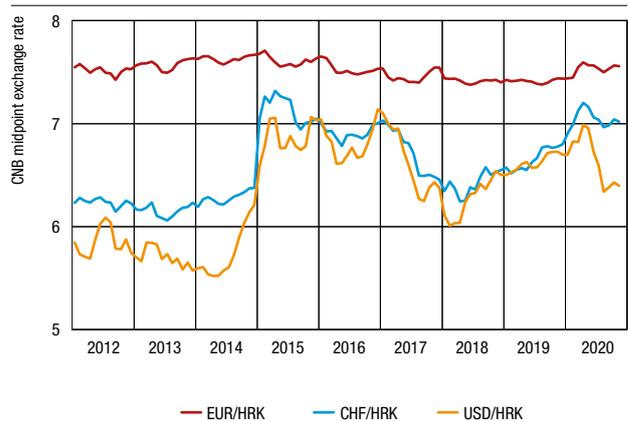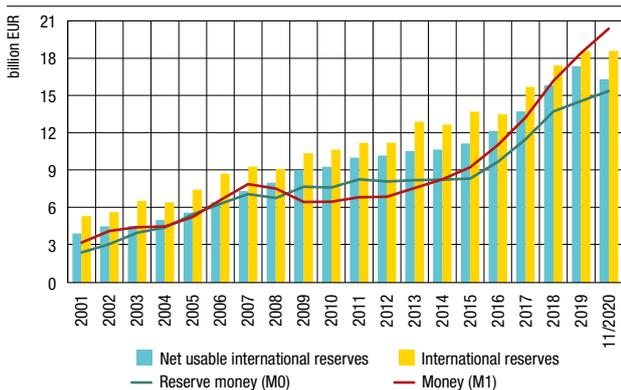
Note: Data are up to November 2020.
Source: CNB.

**Figure 9.5 Nominal exchange rates of the kuna against selected currencies**



EUR/HRK   CHF/HRK   USD/HRK
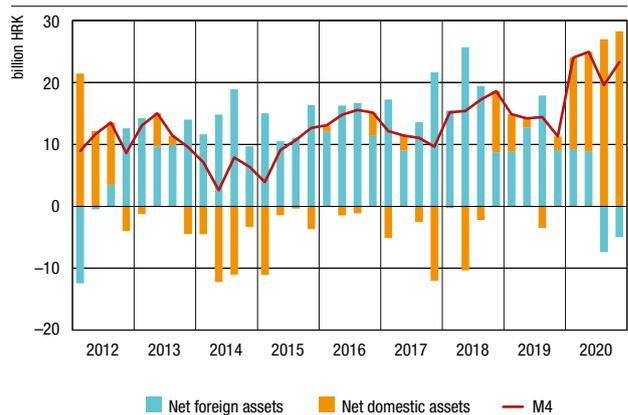
Source: CNB.

**Figure 9.4 International reserves of the CNB and monetary aggregates**



Net usable international reserves   International reserves
Reserve money (M0)   Money (M1)

Notes: Net usable international reserves are defined as international reserves net of CNB foreign liabilities, reserve requirements in f/c, government foreign currency deposits and off-balance sheet liabilities (swaps). The most recent data available for M1 in 2020 refer to October.
Source: CNB.

**Figure 9.6 Net foreign assets, net domestic assets and total liquid assets (M4)**
absolute changes in the last 12 months



Net foreign assets   Net domestic assets   M4

Notes: Absolute changes exclude the exchange rate effect. Data for the fourth quarter of 2020 refer to end-October.
Source: CNB.

International reserves, which dropped sharply in March and April as a result of large foreign exchange sales, have begun to recover in June, due also to purchases of foreign exchange from the government. International reserves again grew at a modest but steady pace in the second half of the year, reaching EUR 18.6bn at the end of November 2020, which was the same as at the end of 2019 (Figure 9.4). Net usable reserves dropped by EUR 1.0bn (6.0%) from the end of 2019, ending November at EUR 16.3bn. Both gross and net reserves are still higher than reserve money (M0).

The exchange rate of the kuna against the euro stabilised, after having depreciated in March and the first half of April. However, over the summer months, the expectations regarding the strengthening of the kuna as a result of better than expected tourist indicators led to an appreciation of the kuna/euro exchange rate. As early as the second half of August the exchange rate started depreciating slightly due to epidemiological measures tightening in outbound markets. The trend of mild depreciation continued over the following two months due to growing uncertainty regarding the coronavirus pandemic. Nevertheless, the kuna/euro exchange rate started to appreciate mildly in

early November and by the end of that month returned to the level seen in early October. This was due among other things to weaker demand of legal persons for foreign exchange on the domestic foreign exchange market. The exchange rate of the kuna against the euro stood at EUR/HRK 7.55 at the end of November 2020, up by 1.6% relative to the end of the same month in 2019, while the average exchange rate in the first eleven months of 2020 stood at EUR/HRK 7.53, an increase of 1.6% on the same period in 2019 (Figure 9.5).[19] The exchange rate of the kuna against the US dollar was lower at the end of November 2020 than at the end of the same month 2019, as a result of the weakening of the US dollar versus the euro, prompted by uncertainty regarding the elections and epidemiological situation in the USA. By contrast, the kuna/Swiss franc exchange rate went higher in the period under review, reflecting the combined effect of the weakening of the kuna against the euro and the weakening of the euro against the Swiss franc.

19  In July 2020, Croatia entered the Exchange Rate Mechanism II, with the central rate of the kuna being set at 1 euro = 7.5345 and the standard fluctuation band at ±15% around this rate (Box 4 Croatia's entry into the Exchange Rate Mechanism II (ERM II)).

The upward trend in monetary aggregates continued in the second half of 2020 albeit at a weaker intensity than in the first half of the year. The annual rate of growth in total liquid assets (M4) was 7.0% (transaction-based) in October 2020, which is slightly less than in June (7.7%), but still twice as high as at end-2019 (Figure 9.6). The growth in M4 was again largely driven by the strong increase in net domestic assets (NDA), mostly due to increased borrowing of the government from banks and the CNB's purchase of government bonds on the secondary market. The increase in M4 slowed down slightly in the second half of the year as a result of a fall in net foreign assets (NFA). Among M4 components, the sharpest increase was seen in foreign exchange deposits and money (M1), that is, kuna funds in transaction accounts.

Against the backdrop of the currently unfavourable economic situation and increased uncertainty regarding the dynamics of economic recovery, the CNB will continue to pursue an expansionary monetary policy and support the high liquidity of the monetary system using available monetary policy instruments. This will be conducive to the maintenance of favourable financing conditions for the domestic sectors and provide support to domestic credit activity.

## Box 4 Croatia's entry into the Exchange Rate Mechanism II (ERM II)

*On 10 July 2020, Croatia entered the Exchange Rate Mechanism II (ERM II), thus taking a crucial formal step on the path to euro adoption. An important determinant of ERM II participation is the central rate of the kuna against the euro, set at 1 euro = 7.53450 kuna, with a standard fluctuation band of ±15% around this rate. After joining the ERM II, the exchange rate policy of the CNB will be the same as before, while the established central rate of the kuna for the euro will most probably be the official rate at which the kuna will be exchanged for the euro. In the run-up to euro adoption, Croatia must participate in ERM II for a minimum of two years, fulfil convergence criteria and implement the additional pre-entry commitments it undertook in its application for entry into ERM II.*

Croatia's entry into the Exchange Rate Mechanism II (ERM II) is a result of a several-years-long process and a number of activities taken. Although domestic economic policymakers long ago believed that Croatia would benefit from euro adoption, the crisis and unfavourable macroeconomic indicators presented an obstacle on that path. However, economic recovery, public finance consolidation confirmed by the exit from the Excessive Deficit Procedure in 2017 and the removal of excessive imbalances, which the European Commission confirmed in early 2019, were preconditions for a steady path towards euro adoption. In late 2017, the CNB and the Croatian government presented the Strategy for the Adoption of the Euro in Croatia, and in July 2019 Croatia's letter of intent to join the ERM II was addressed to the EU member states and institutions. In its letter, the Republic of Croatia undertook to fulfil several pre-entry commitments in the following six policy areas: (i) strengthening banking system supervision; (ii) improving the macroprudential framework; (iii) strengthening the anti-money laundering framework; (iv) improving the collection, production and dissemination of statistics; (v) enhancing public sector governance; and (vi) reducing the administrative and financial burden on the economy.

Having successfully implemented the pre-entry commitments specified in the letter of intent, Croatia satisfied the requirements for ERM II entry, which became formal on 10 July 2020.

An important determinant of ERM II participation is the central exchange rate. In agreement with EU institutions, member states and Denmark, the central exchange rate of the kuna was set at 7.53450 to the euro, with a standard fluctuation band of ±15% around the central exchange rate to be maintained during the participation in ERM II. Viewed in historical terms, the exchange rate has never come close to the levels set as fluctuation limits. After joining the ERM II, the exchange rate policy of the CNB will be the same as before. The CNB will continue to pursue the policy of a stable exchange rate as it has successfully done over the past 27 years, so that the established central rate will probably be the official rate at which the kuna will be exchanged for the euro. While the final decision on this matter will be made by the EU Council some six months before euro adoption, the experience of other countries suggests that the central exchange rate is usually used as the conversion rate.
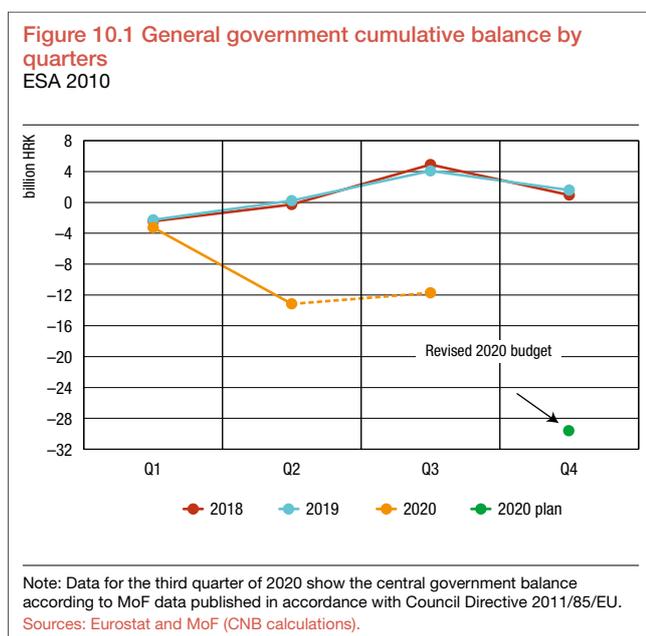
Entry to ERM II is a crucial step on the path to euro adoption and the process of euro adoption is very firmly structured. Future dynamics of the process of joining the euro area primarily depends on the successful fulfilment of post-entry commitments the Republic of Croatia has undertaken in its application for ERM II entry. They relate to the following four areas: (i) strengthening the anti-money laundering framework following the transposition of the 5th Anti-Money Laundering Directive; (ii) further reducing the administrative and financial burdens on the economy; (iii) improving corporate governance of state-owned enterprises through revising and aligning regulation and practices in accordance with the OECD guidelines; and (iv) strengthening the national insolvency framework. The post-entry commitments build on the measures taken before ERM II entry.

In addition to making commitments, a country has to participate in ERM II for at least two years and meet convergence criteria before it can qualify for euro adoption. As regards the nominal convergence criteria, Croatia has satisfied them all ever since 2016 and, despite the 2020 pandemic, no difficulties are foreseen with regard to the fulfilment of the exchange rate, inflation and interest rate criteria. However, the pandemic has led to a severe deterioration in public finance indicators, so that the relevant criterion is not currently satisfied and Croatia might face the greatest challenges in the meeting of fiscal criteria.

The agreement on the participation of the Croatian kuna in ERM II includes, among other things, the obligation to establish close cooperation between the Croatian National Bank and the European Central Bank (ECB), which has marked the beginning of Croatia's participation in the banking union. The CNB thus joined the Single Supervisory Mechanism (SSM) even before joining the euro area, which means that the ECB has taken over the supervision of significant Croatian banks, while the CNB will, on behalf of the ECB, exercise supervision of institutions identified as less significant. In addition to CNB representatives becoming members of the ECB's joint supervisory teams, a CNB representative has become member of the ECB's highest supervisory decision-making body, with the same rights and obligations as other members, including voting rights. The CNB continues to formulate and implement macroprudential policy, but in cooperation with the ECB. In addition, Croatia also participates in the Single Resolution Mechanism (SRM).

# 10 Public finance

According to the quarterly data on the execution of the consolidated general government budget (ESA 2010), the budget recorded a deficit of HRK 13.2bn in the first half of 2020. This reflects the unfavourable impact of the crisis caused by the coronavirus pandemic on economic activity and tax revenues (see Box 5 Assessment and role of fiscal elasticities in Croatia), as well as of provisional measures aimed at alleviating the negative consequences of the crisis, evident both in the decline in revenues (due to tax write-offs) and the rise in expenditures (driven by job preservation grants). As a result, budgetary trends worsened significantly when compared with the same period of 2019 (a surplus of HRK 0.2bn). Viewed by quarters, the deficit of HRK 3.2bn generated in the first quarter of 2020 was comparable to that recorded in the first quarter of the previous year, but it widened considerably in the second quarter, to HRK 9.9bn.

Figure 10.1 General government cumulative balance by quarters
ESA 2010



Note: Data for the third quarter of 2020 show the central government balance according to MoF data published in accordance with Council Directive 2011/85/EU.
Sources: Eurostat and MoF (CNB calculations).

In early November 2020, the Croatian government adopted the second amendments to the state budget and financial plans of budgetary users to raise the expected deficit of the general government budget to 8.0% of GDP in 2020, from 6.7% GDP in the first budget revision of May. The budget revision reflects a sizeable increase in revenues and an even larger increase in expenditures, most notably larger expenditures for health care associated with the rehabilitation of health system debt and the accumulation of new outstanding liabilities[20], more vigorous use of job preservation measures, and other expenditures, including larger outlays for pensions and unemployment benefits and measures to secure additional liquidity in state-owned enterprises.

Total revenues of the consolidated general government dropped sharply in the first half of 2020, by 8.2% relative to the comparable period of the previous year. The drop was mostly related to indirect taxes due to unfavourable effects of the pandemic-induced economic contraction, which were also reflected in a slump in personal consumption and weaker dynamics of demand in tourism-related activities. The fall in revenues from

indirect taxes was also influenced by the reduced burden of the VAT system, that is, the widened coverage of the 13% VAT rate to include food and drink service activities as of January 2020. Furthermore, a strong negative contribution to revenues also came from government income from the sales of goods and services (such as administrative fees or university revenues from the private sector), primarily due to restrictive epidemiological measures that limited the provision of most government services. Direct taxes made a smaller contribution to the fall in revenues, which may be largely attributed to the successful alleviation of the negative consequences of epidemiological measures on employment figures. Revenues from direct taxes fell much less, which reflects the fact that deferred tax payments are recorded as revenues when the tax liability arises (under the ESA methodology). Direct tax revenues were also smaller due to the reduction in the tax burden implemented in the fourth round of the comprehensive tax reform, that is, the increase in the number of profit taxpayers subject to a lower tax rate, as well as the increase in personal tax exemption for income taxpayers. The relatively limited negative impact of the crisis on the labour market is evident in the much smaller decrease in revenues from social contributions, while other revenues were largely supported by the continued successful absorption of EU funds, including one-off exceptional aid from the EU under the European Commission decision to allow member states to use the remaining funds from the current multiannual financial framework (2014 – 2020) to finance measures aimed at addressing the repercussions of the pandemic (such as job preservation grants, provision of additional liquidity and the procurement of medical equipment).

As regards the expenditure side of the consolidated general government budget, total expenditures were much larger in the first half of 2020 (6.6%) than in the same period of the previous year, mainly as a result of the sharp increase in expenditures on subsidies, largely reflecting the job preservation grants paid out to employers.

The growth in expenditures was also driven by employee compensation, which reflected the 2% increase in the wage calculation base for civil servants and government employees

Figure 10.2 Consolidated general government revenues
ESA 2010, year-on-year rate of change and contributions
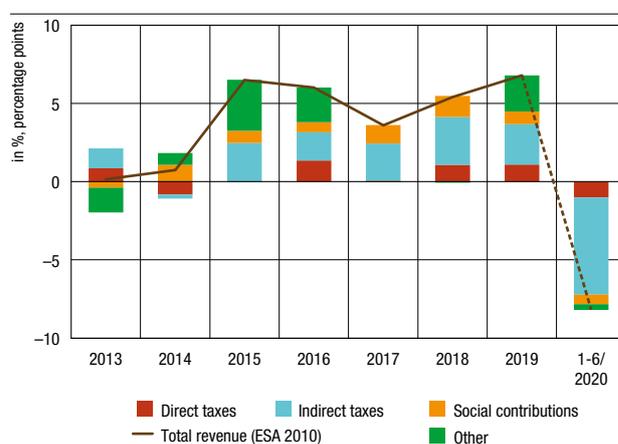


Source: Eurostat (CNB calculations).

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20 According to the ESA methodology accumulation of new outstanding liabilities is accounted for as a liability and recorded as expenditure.
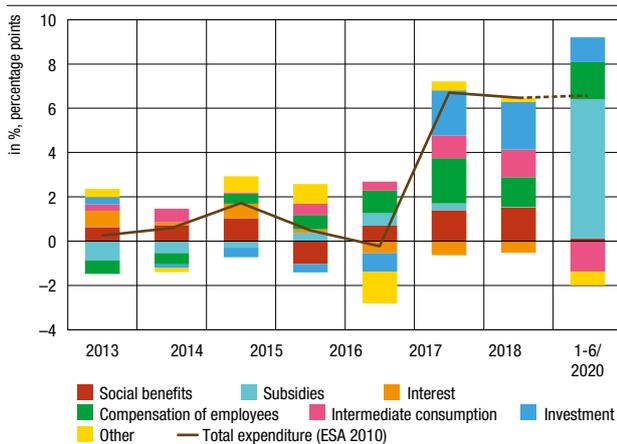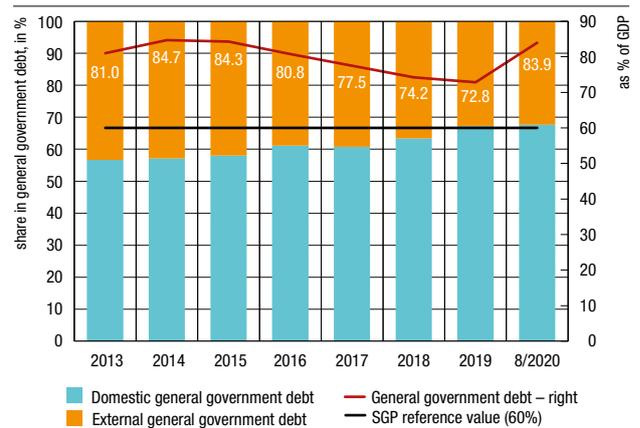
**Figure 10.3 Consolidated general government expenditure**
ESA 2010, year-on-year rate of change and contributions
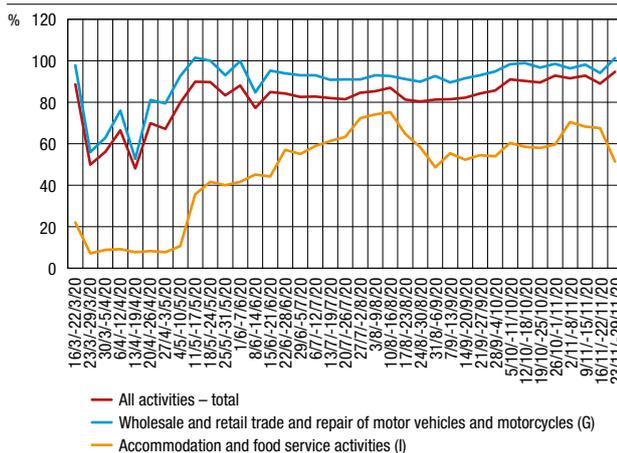


Source: Eurostat (CNB calculations).

**Figure 10.5 General government debt**
stock, end of period



Note: Nominal GDP for the last four available quarters was used to calculate the relative indicator as at the end of August 2020.
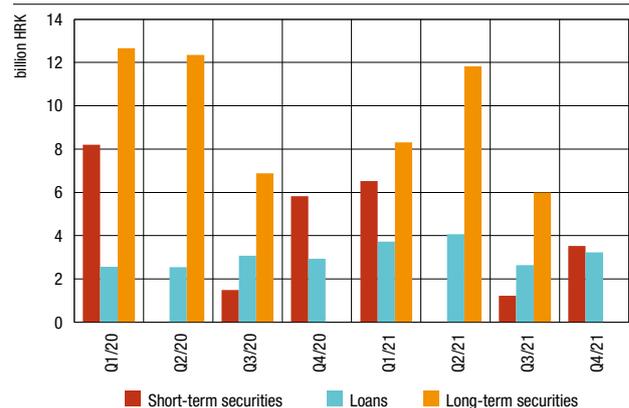Source: CNB.

**Figure 10.4 Index of the amount of fiscalised receipts relative to the comparable period in the preceding year**



Sources: MoF and Tax Administration (CNB calculations).

**Figure 10.6 General government debt maturity**



Note: Projection of the repayment of short-term and long-term securities is based on the balances as at 30 November 2020 and projection of the repayment of loans on the balance as at 30 September 2020.
Sources: MoF and CNB.

starting from 1 January 2020 and the impact of the previously agreed increase in wages to employees in the health and education system. Furthermore, general government investments also went up, which, in addition to the continued infrastructure projects financed by EU funds, reflects the purchase of medical equipment necessary to alleviate and contain the consequences of the pandemic.

The increase in total expenditures was cushioned by the negative contributions of intermediary consumption, and interest and other expenditures. The reduction in expenditures for intermediary consumption was due to the reallocation of some such expenditures under the budget revision to other expenditure items (mostly job preservation grants). Interest expenditures were smaller due to a stable credit rating and continued favourable financing conditions in the financial markets, which were made use of to refinance the previously maturing debt.

According to preliminary MoF data under Council Directive 2011/85/EU, the central government generated a surplus of HRK 1.4bn in the third quarter of 2020. This surplus is an improvement from the quarter before but is also HRK 6bn smaller on an annual basis. MoF government budget data under

the accounting plan suggest that indirect tax revenues (VAT and excise duties) recorded much more unfavourable trends than social contributions and profit tax. As regards the expenditure side of the budget, expenditures on subsidies recorded perceptible annual growth in the third quarter, though much slower than in the quarter before, which reflected the markedly smaller amounts paid out in job preservation grants. In addition, the growth was seen in most categories of benefits paid to individuals and households, in particular unemployment benefits. The funds earmarked for the acquisition of non-financial assets also increased.

As regards the developments in budget revenues and expenditures, according to MoF data[21], a negative central government budget balance of HRK 2.5bn was recorded in October 2020, which is a deterioration of HRK 3.8bn from the same period in

21 Monthly data for the central government, state government and social security sub-sectors, which are required, under Council Directive 2011/85/EU, to be published before the end of the following month. The published data refer to general government units according to the scope of ESA 2010 statistical methodology, except for data pertaining to local government, which are published on a quarterly basis.

2019, caused by a decrease in revenues (possibly influenced by delayed VAT payments) and a concurrent increase in revenues. However, available recent data from the fiscalisation system point to a slight improvement in the performance of some economic activities from October to November.

Consolidated general government debt stood at HRK 325.9bn at the end of August 2020, an increase of about HRK 32.9bn from the end of 2019. The substantial growth in debt predominantly reflects the increased need of the government for budget deficit financing in the first eight months as well as the remainder of 2020 and the impact of unfavourable exchange rate differentials on the part of debt that is indexed to foreign currency, which raised the public debt by HRK 2.1bn in the first eight months of the year. Larger financing needs are a result of the negative effects of the pandemic on economic activity, as well as of the implementation of the measures to mitigate the negative effects of the crisis. The government met the financing needs mainly in the domestic market. Data revision, that is, the inclusion of a series of units from the sector of non-financial corporations into central and local government, raised the level of overall debt from January 2001 onwards. A more considerable spike in the debt level (of around HRK 0.5bn) in the period from 2007 to 2014 is a consequence of the reclassification of the company HŽ Putnički prijevoz.

As regards bond issues in financial markets, in late February the government issued three bond tranches in the domestic market worth a total of HRK 15bn (two kuna issues worth HRK 5bn and HRK 4bn, the latter of which was added to the November 2019 issue, and a EUR 800m worth bond indexed to foreign currency), used to refinance maturing bonds worth HRK 12.7bn. To refinance a large amount of T-bills (HRK 7.8bn), the government issued new domestic bonds worth EUR 1.445bn in early May. The government also issued a bond worth EUR 2.0bn on the international market in June to repay foreign bonds maturing in July and to finance much larger current needs. In June the government also issued two bond tranches in the domestic market worth a total of HRK 5.05bn (two kuna issues worth HRK 2.46bn and HRK 2.59bn). Notwithstanding the unfavourable economic situation, all these bonds were issued on favourable terms.

## Box 5 Assessment and role of fiscal elasticities in Croatia[22]

*Amid the coronavirus pandemic, Croatia's budget deficit grew sharply as a result of the counter-crisis economic measures as well as the strong impact of the economic slump on the budget. Fiscal elasticities, which measure the budget's sensitivity to economic developments, have a key role in public finance projections and calculations of structural budget balances, which puts them in a central position within the EU fiscal framework defined under the Stability and Growth Pact. Analysis results show that assessments of fiscal elasticities under different methodological approaches may enhance the quality of the forecast of fiscal variables and that methodological differences affect the estimate of the fiscal stance of Croatia.*

Fiscal elasticities measure the sensitivity of budget revenues and budget expenditures to macroeconomic developments. In other words, they provide information on automatic changes in budget revenues and expenditures under the influence of business cycles. By definition, fiscal elasticities measure the percentage change of a fiscal variable due to the percentage change of GDP (or domestic output gap). Fiscal elasticities have three major roles in fiscal analysis.

First, fiscal elasticities have a key role in forecasting developments in budget revenues and, to a lesser extent, expenditures.[23] Second, fiscal elasticities are used to assess the cyclical component of the budget balance, that is, to separate cyclical and discretionary fiscal policy measures and thereby identify the fiscal stance. This role puts them in a central position within the EU fiscal framework, defined under the Stability and Growth Pact.[24] More specifically, within the Pact's preventive arm, an assessment is made of whether Croatia's structural deficit is in line with the medium-term objective (MTO), where the structural deficit threshold for members of the Exchange Rate Mechanism II (ERM II) is set at 1% of GDP. Furthermore, under the Pact's corrective arm, that is, the Excessive Deficit Procedure, fiscal elasticities are employed to: 1) make forecasts used as basis for decisions to open or close the EDP; 2) assess the structural balance, where a change is an indicator of a country's effective fiscal effort; and 3) revise the achieved structural assessment.

Third, fiscal elasticities have a significant impact on both the assessment and the size of fiscal multipliers.[25] As cyclical adjustments to fiscal time series attempt to exclude exogenous changes (those independent of the business cycle), which are necessary for an unbiased assessment of the size of fiscal multipliers, their adequate assessment is of crucial importance.

Of the three most frequently used approaches to assess fiscal elasticities that have served as a basis to assess elasticities for Croatia, the first two are econometric approaches based on (vector) error-correction models (VEC) and (dynamic) ordinary least squares methods (OLS, DOLS). The third approach, which represents the official OECD methodology applied also by the European Commission, is a combination of econometric assessments, arithmetic calculations based on micro-data on tax payments and adjustment (calibration) based on theoretical assumptions.

Results of the elasticities assessed by use of all three approaches with regard to GDP and the relevant macroeconomic base are presented in Table 1. With the assumption of future movements in individual macroeconomic bases, fiscal elasticities may be used to forecast movements in relevant budgetary categories to quantify the macroeconomic effects on the budget, so as to project the budget balance, government's financing needs and public debt.[26] Obtained ex-post projections were

22  This Box provides a summary overview of the working draft of a paper entitled "Assessment and role of fiscal elasticities in fiscal analysis: the case of Croatia" by Milan Deskar-Škrbić, Ana Grdović Gnip and Darjan Milutinović within the CNB's research project on the macroeconomic effects of fiscal policy in Croatia.

23  Mourre, G., C. Astarita and A. Maftei (2016): *Measuring the uncertainty in predicting public revenue* (No. 039), Directorate General Economic and Financial Affairs (DG ECFIN), European Commission, No. 039; Boschi, M. and S. d'Addona (2019): *The Stability of Tax Elasticities over the Business Cycle in European Countries*, The Journal of Applied Public Economics.

24  Mourre, G. and A. Poissonnier (2019): *What Drives the Responsiveness of the Budget Balance to the Business Cycle in EU Countries?*, Intereconomics.

25  Caldara, D. and C. Kamps (2017): *The analytics of SVARs: a unified framework to measure fiscal multipliers*, The Review of Economic Studies.

26  Each budgetary revenue category is forecast by means of the following equation: $F_t^i = F_{t-1}^i \cdot \left(1 + \frac{g_t^{MB^i}}{100} \cdot \varepsilon_{F_i}\right) + D_t^i$, where the revenue level of the $i$-th revenue category in year $t(F_t^i)$ is equal to the level of the same revenue category in the year before $(F_{t-1}^i)$ adjusted by the rate of growth of the relevant macroeconomic base $(g_t^{MB^i})$, with corresponding elasticity of the $i$-th revenue category to the corresponding macroeconomic base $(\varepsilon_{F_i})$. Finally, added to this is the effect of tax changes (discretionary measures) of the $i$-th category in a given year $(D_t^i)$.

**Table 1 Fiscal elasticities and projection results for revenue categories**

| Revenue category | Approach | MB | $\varepsilon_Y$ | $\varepsilon_{MO}$ | $MAPE_{t+1}$ | $MAPE_{t+2}$ |
|---|---|---|---|---|---|---|
| Indirect taxes | VDN | Personal consumption | 0.79 | 0.84 | 2.6 | 4.2 |
| | GA | | 1.0 | 1.00 | 2.5 | 3.8 |
| | BD | | 0.75/0.88 | 1.16 | 2.5 | 3.8 |
| | B | | – | 1.19 | 2.6 | 3.8 |
| | EC | | 1.0 | 1.00 | 2.5 | 3.8 |
| | CNB | | – | 1.00 | 2.5 | 3.8 |
| Income tax | VDN | Wage bill | 1.1 | 0.98 | 4.3 | 6.5 |
| | GA | | 0.9 | 1.51 | 4.1 | 4.2 |
| | BD | | 1.68/1.03 | 1.26 | 3.9 | 4.9 |
| | B | | – | 1.80 | 4.7 | 5.6 |
| | EC | | 1.71 | 1.75 | 4.6 | 5.3 |
| | CNB | | – | 1.40 | 4.0 | 4.2 |
| Profit tax | VDN | Gross operating surplus | 1.07 | 1.00 | 11.8 | 14.9 |
| | GA | | 1.94 | 1.00 | 11.8 | 14.9 |
| | BD | | 1.82/0.60 | 1.15 | 11.5 | 14.4 |
| | B | | – | 0.50 | 12.9 | 17.4 |
| | EC | | 2.29 | 1.81 | 10.4 | 13.1 |
| | CNB | | – | 1.50 | 10.7 | 13.6 |
| Social contributions | VDN | Wage bill | 0.88 | 0.84 | 1.6 | 2.6 |
| | GA | | 0.65 | 0.84 | 1.6 | 2.6 |
| | BD | | 2.05/1.23 | 1.02 | 1.6 | 2.3 |
| | B | | – | 0.48 | 2.7 | 4.8 |
| | EC | | 0.7 | 1.00 | 1.5 | 2.2 |
| | CNB | | – | 1.00 | 1.5 | 2.2 |
| Unemployment benefits | VDN | Unemployment | –5.0 | 1.00 | | |
| | GA | | –0.74 | 1.00 | | |
| | BD | | –5.0/–4.05 | 1.09 | – | – |
| | B | | – | 1.05 | – | – |
| | EC | | –2.39 | 1.00 | – | – |

Notes: MB – macroeconomic base, $\varepsilon_Y$ – elasticity of the budgetary category with respect to domestic output, $\varepsilon_{MB}$ – elasticity of the budgetary category with respect to the macroeconomic base, $MAPE_{t+1}$ – mean absolute percentage error in first projection year, $MAPE_{t+2}$ – mean absolute percentage error in the second projection year, VDN – Van den Noord (2000), GA – Girouard & Andre (2005), BD – Boschi and d'Addona (2019), B – Bouthevillain et al. (2001), EC – European Commission (OECD), Price, Dang and Guillemette (2014), CNB – ECB's internal estimate (2019). The results shown are averages for the period from 2004 to 2019. All methodological approaches use long-run elasticities, with the exception of Bouthevillain (2001), which estimates only short-run elasticities with regard to the macroeconomic base, and the approach by Boschi and d'Addona (2019) in elasticities with regard to GDP, which first shows long-run and then short-run elasticities.
Source: CNB.

**Table 2 Comparative overview of semi-elasticities and elasticities under various approaches**

| Approach | $\varepsilon_R$ | $\varepsilon_E$ | $\dfrac{R}{Y}$ | $\dfrac{E}{Y}$ | $s\varepsilon_R$ | $s\varepsilon_E$ | $\varepsilon_{balance}$ | $s\varepsilon_{balance}$ |
|---|---|---|---|---|---|---|---|---|
| Van den Noord | 0.85 | –0.06 | | | –0.066 | –0.504 | 0.79 | 0.438 |
| Girouard and Andre | 0.92 | –0.01 | 44 | 47.5 | –0.035 | –0.48 | 0.91 | 0.445 |
| Boschi and d'Addona | 1.31 | –0.06 | | | 0.133 | –0.502 | 1.25 | 0.635 |
| OECD (EC) | 0.9 | –0.03 | | | –0.044 | –0.489 | 0.87 | 0.443 |

Note: The shares of budgetary revenues and expenditures in GDP reflect their average value in the period from 2004 to 2019. The averages in Mourre, Poissonnier and Lausegger (2019) are not the same, so the final parameter of the budget balance semi-elasticity in the table does not correspond to that reported for Croatia in Mourre, Poissonnier and Lausegger (2019).
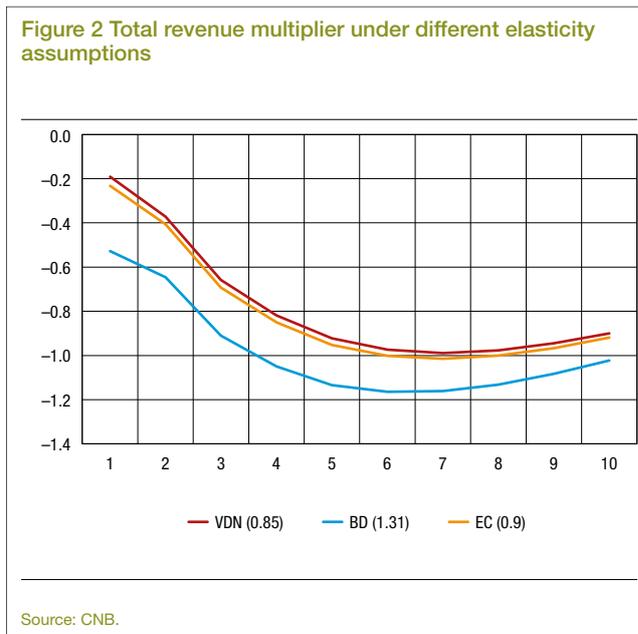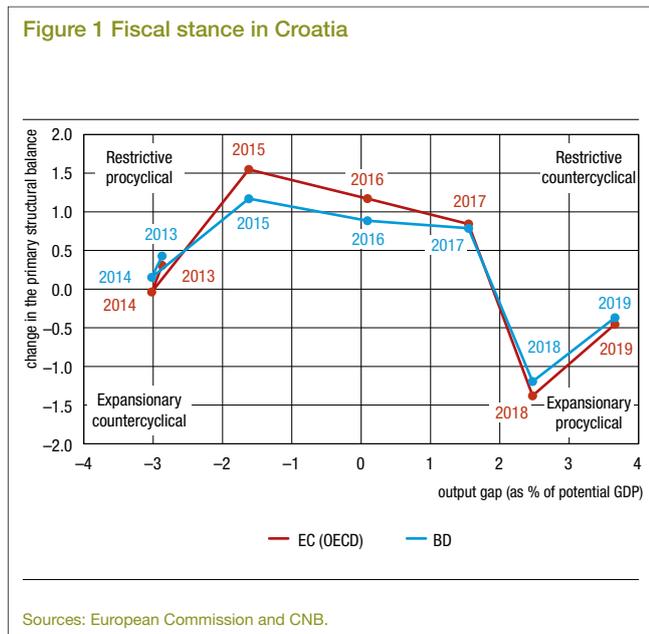Source: CNB.

compared to actual revenue outturns over the projection horizon so as to calculate deviations (projection errors) using the mean absolute percentage error (MAPE). These results enable the choice of elasticities for revenue projections with the smallest estimation error, which enhances the precision of fiscal projections.

Taking into account elasticity parameters from Table 1, Table 2 shows fiscal semi-elasticities calculated on the basis of various methodologies for Croatia. Fiscal semi-elasticities are an alternative measure of the sensitivity of fiscal variables to macroeconomic developments, which show a change in the ratio of fiscal variables to GDP due to a percentage change in GDP.

The results indicate that a 1% change in GDP in Croatia leads to a change in the budget balance of around 0.44 percentage points of GDP according to various methodologies or 0.63 percentage points according to the econometric approach used

Figure 1 Fiscal stance in Croatia



Sources: European Commission and CNB.

Figure 2 Total revenue multiplier under different elasticity assumptions



Source: CNB.

by Boschi and d'Adonna (2019). Estimates of different long-run elasticities of fiscal variables to GDP provide for a cyclical adjustment of the budget deficit and analysis of the fiscal stance.

The fiscal stance is established by comparing a change in the structural primary balance, which mostly reflects discretionary measures of fiscal policy, with a change in the domestic output gap, which shows changes in an economy's cyclical position. A change in the structural primary balance shows whether fiscal policy is expansionary (deterioration in the structural balance) or restrictive (improvement in the structural balance), while, depending on a change in the cyclical position, it can be either procyclical or contercyclical. The relationship between a change in the structural primary balance and domestic output gap from Croatia's accession to the EU is shown in Figure 1, which gives an estimate of the fiscal stance based on the semi-elasticity of the budgetary balance to the domestic output gap used by the European Commission and the semi-elasticity calculated under the approach of Boschi and d'Adonna (2019), which in this analysis results in extreme long-run semi-elasticity, while the semi-elasticity calculated under other approaches is very similar to that obtained by the European Commission (Table 2).

Figure 1 shows that different semi-elasticities not only result in a different intensity of changes in the primary structural balance, but may also yield different conclusions about the fiscal stance in different periods of time. For example, according to the European Commission's methodology, in 2014, fiscal policy was expansionary and procyclical, while it was restrictive and procyclical according to Boschi and d'Adonna (2019).[27]

It should also be noted that fiscal elasticities have an important role in estimating fiscal multipliers, in line with the dominant Blanchard and Perotti methodology (2002).[28] Under that approach, fiscal elasticities serve to identify structural fiscal shocks. A cyclical adjustment of the VAR model errors is made

using the estimated fiscal elasticities to finally obtain structural shocks that should reflect discretionary fiscal policy measures, which are exogenous to the business cycle, where elasticities have the largest effect on estimates of revenue multipliers. Total revenue elasticities are used to analyse the sensitivity of the calculations of fiscal multipliers (Table 2).

Assumptions of revenue elasticities to GDP may have a significant impact on the size of the revenue multiplier (Figure 2). For example, assuming tax revenue elasticity of 1.31, a structural revenue shock of one unit leads to a fall in GDP of 0.53 units at the time the shock hits, while assuming elasticity of 0.9, a one unit shock leads to a GDP decline of only 0.23 units.[29] Also, assuming elasticity of 1.31, the total revenue multiplier in the long-run is greater than 1, while under the assumption of lower elasticities, the highest multiplier is below or equal to 1. Furthermore, as the OECD methodology applied by the European Commission yields the most precisely projected revenue forecasts (Table 1), it follows that total revenue elasticity relative to GDP of 0.9 implies the most precise multiplier under the Blanchard and Perotti approach (2002). The size of the multiplier has significant consequences for the conclusions about the effectiveness and stabilisation potential of fiscal (tax) policy as well as about the expected effects of discretionary fiscal policy measures on macroeconomic projections.

Conclusions of the empirical analysis suggest that the use of different methodologies to estimate fiscal elasticities may enhance the quality of public finance projections and of the estimate of the impact of fiscal policy on macroeconomic projections. Also, the presentation of the sensitivity of key fiscal indicators, such as the structural balance, to the choice of fiscal elasticities is important for analysis of Croatian public finances in the context of the EU fiscal framework defined under the Stability and Growth Pact.

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27  This presentation is for illustrative purposes as it is highly unlikely that Croatia has the highest degree of budget sensitivity to the output gap, but it aims at recalling that fiscal elasticities may also have significant repercussions on conclusions regarding the fiscal stance.

28  Blanchard, O. and R. Perotti (2002): *An empirical characterization of the dynamic effects of changes in government spending and taxes on output*, Quarterly Journal of Economics. It should be noted that this is just one of many methodologies, which also include model and other empirical estimates.

29  The presented multiplier is based on the non-accumulated impulse response function, while fiscal shocks are performed on quarterly data.

# 11 Deviations from the previous projection

As regards the international environment, the estimates of real developments for 2020 for most countries are significantly less favourable than anticipated in the July 2020 projection. This is primarily due to unfavourable developments in the second quarter, which suggested that the impact of the pandemic on economic activity might be more marked than anticipated, even despite the relatively strong recovery seen in the third quarter. The most recent IMF projections of October suggest that the global economy might contract by as much as 1.4 percentage points more than anticipated in spring, while the projected economic downturn in the euro area (where most Croatia's main trading partners come from) was raised by another 0.8 percentage points. As for monetary policy, there are no major changes in expectations regarding key interest rates and major central banks are expected to continue with their extremely expansionary monetary policy.

The projected fall in total economic activity in 2020, while slightly smaller than expected in the July projection (–9.7%), is larger than that projected in October (–8.0%), and might come to –8.9%. The revision from the July projection largely reflects better than expected performance in the exports of goods and services, with total exports likely to be 26.4% less than in 2019, instead of the previously projected fall of 38.1%. Of the components of domestic demand, personal consumption might decrease by 6.6% in 2020, slightly more than previously projected (–5.3%). This downward revision reflects worse than expected results in the second and third quarters as well as poorer expectations for the last quarter of 2020 due to the deterioration in the epidemiological situation. Capital investments are likely to go down by 5.2%, which is much less than expected in the July projection (–12.1%). The upward revision of the projection is the result of much better outturns than projected in July, due

in particular to heightened investment activity from the general government. In line with the previous expectations, government consumption might continue to increase at a rate similar to that in the year before, growing by 2.0% on an annual basis (previously projected 1.9%). Imports of goods and services might fall at a lower rate than projected in July (–16.3% vs –30.8%), as suggested by performance so far and revised expectations regarding total exports and investment activity. While this projection anticipates a smaller than expected fall in both imports and exports, the correction is larger for imports than for exports, so that the negative contribution of net foreign demand to total economic growth might be much larger than projected in July 2020 (–5.2 percentage points vs the previously expected –3.6 percentage points).

The projected average annual consumer price inflation of 0.2% in 2020 is 0.3 percentage points higher than that projected in July 2020. This is mainly a result of the increase in the estimated average annual rate of change in the CPI excluding food and energy (from 0.3% in the previous projection to 1% in the current one), which is mostly attributable to the slightly smaller than expected decrease in the prices of some tourism-related services (e.g. services in restaurants and cafés, package holidays, etc.) and clothing and footwear. Also, the projected annual fall in energy prices has been lowered to –5.4% (vs the previously projected –6.7%), largely due to a smaller annual decrease in the prices of refined petroleum products owing in turn to their sharper increase in June and July 2020. In contrast, the estimated average annual growth in the prices of food products in 2020 has been reduced from 3.6% in the previous to 2% in the current projection as a result of the slower than anticipated annual increase in food prices.

The estimate of the current and capital account surplus in

## Table 11.1 Basic assumptions, deviations from the previous projection

| | 2020 | | |
|---|---|---|---|
| | Previous projection (7/2020) | Current projection | Deviation |
| **GDP** (real rate of change, in %) | | | |
| Rest of the world | –3.0 | –4.4 | –1.4 |
| Euro area | –7.5 | –8.3 | –0.8 |
| USA | –5.9 | –4.3 | 1.6 |
| Developing countries and emerging market countries | –1.0 | –3.3 | –2.3 |
| Central and Eastern European countries | –5.2 | –4.6 | 0.6 |
| Main trading partners of the Republic of Croatia | –4.9 | –5.3 | –0.4 |
| **Prices** | | | |
| Euro area HICP[a] | 0.3 | 0.3 | 0.0 |
| Oil prices (USD/barrel)[b] | 36.4 | 41.4 | 5.1 |
| **Key interest rates** | | | |
| EURIBOR 3M (end of year)[c] | –0.41 | –0.49 | –0.1 |
| ECB main refinancing rate[c] | 0.00 | 0.00 | 0.0 |
| US federal funds target rate[c] | 0.25 | 0.25 | 0.0 |

[a] ECB, September 2020. [b] Bloomberg, Brent crude oil futures. [c] Bloomberg.
Source: IMF (WEO), October 2020.

**Table 11.2 Domestic indicators, deviations from the previous projection**

| | 2020 | | | 2021 | | |
|---|---|---|---|---|---|---|
| | Previous projection (7/2020) | Outturn | Deviation | Previous projection (7/2020) | Current projection | Deviation |
| **National accounts** (real rate of change, in %) | | | | | | |
| GDP | −9.7 | −8.9 | 0.8 | 6.2 | 4.9 | −1.3 |
|    Personal consumption | −5.3 | −6.6 | −1.3 | 4.6 | 4.5 | −0.1 |
|    Government consumption | 1.9 | 2.0 | 0.1 | 3.4 | 2.2 | −1.2 |
|    Gross fixed capital formation | −12.1 | −5.2 | 7.0 | 6.8 | 7.2 | 0.4 |
|    Exports of goods and services | −38.1 | −26.4 | 11.7 | 44.5 | 19.3 | −25.3 |
|    Imports of goods and services | −30.8 | −16.3 | 14.5 | 36.5 | 15.0 | −21.5 |
| **Labour market** | | | | | | |
| Number of employed persons (average rate of change, in %) | −3.2 | −1.5 | 1.7 | 2.0 | 0.7 | −1.3 |
| Registered unemployment rate | 10.6 | 9.1 | −1.5 | 9.2 | 8.5 | −0.7 |
| ILO unemployment rate | 9.1 | 7.5 | −1.6 | 7.8 | 7.0 | −0.7 |
| **Prices** | | | | | | |
| Consumer price index (rate of change, in %) | −0.1 | 0.2 | 0.3 | 0.7 | 1.0 | 0.3 |
| **External sector** | | | | | | |
| Current account balance (as % of GDP) | −0.4 | −1.0 | −0.6 | 0.5 | 0.1 | −0.4 |
| Current and capital account balance (as % of GDP) | 2.0 | 1.4 | −0.6 | 2.7 | 3.0 | 0.4 |
| Gross external debt (as % of GDP) | 81.7 | 82.2 | 0.5 | 76.5 | 76.2 | −0.3 |
| **Monetary developments** (rate of change, in %) | | | | | | |
| Total liquid assets – M4 | 8.1 | 8.9 | 0.8 | 2.7 | 3.2 | 0.5 |
| Total liquid assets – M4[a] | 6.5 | 8.4 | 1.9 | 2.8 | 3.4 | 0.5 |
| Credit institution placements | 4.8 | 3.2 | −1.6 | 2.9 | 3.0 | 0.2 |
| Credit institution placements[b] | 3.7 | 2.8 | −0.8 | 3.1 | 3.3 | 0.2 |

[a] 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 the CNB Bulletin No. 221).
Source: CNB.

2020 was reduced from the previous projection by 0.6 percentage points. The correction is a result of a larger foreign trade deficit due to a noticeably smaller than expected decrease in goods imports, which was mitigated by more favourable estimates of export dynamics. In contrast, net exports of services are expected to be noticeably higher, mostly thanks to larger revenues from tourism consumption of foreign tourists during the peak tourist season. In addition, the primary income account might record a neutral balance, which is a substantial improvement from the previously projected deficit. This might be mostly due to a sharper decrease in the profit of domestic enterprises and banks in foreign ownership, and the related expenditures on direct investments. At the same time, the estimate of the surplus in the accounts of secondary income and capital transactions remained almost unchanged. In view of the less favourable balance in the current and capital accounts and the smaller net capital outflow in the financial account, the projection of the relative indicators of gross external debt at end-2020 has been revised upwards from the July projection.

The projection for 2020 growth in credit institutions' placements (excluding to the government) has been revised downwards from previous expectations. Placements might grow by 2.8% in 2020, compared with the previously projected 3.7% (on the basis of transactions). The smaller increase in placements is due to slower-than-expected lending to non-financial corporations, while lending to households outstripped expectations due mostly to the faster increase in housing loans, which was spurred by the programme of subsidised housing loans, as well as by borrowing for the purpose of reconstructing housing units damaged in the earthquake that struck the city of Zagreb and its surroundings.

The growth in total liquid assets (M4) in 2020 is projected at 8.4% and has been revised upward from the earlier projection, which expected the growth to be 6.5% (transaction-based). This is mainly attributable to the stronger increase in demand deposits, reflecting an increased propensity for domestic sectors to accumulate funds in transaction accounts in conditions of growing uncertainty. The growth in foreign exchange deposits is projected to be slower than previously expected. More specifically, the upsurge in deposits under the previous projection was based on the continuance of their strong growth seen at the onset of the pandemic, which was associated with concerns over the weakening of the domestic currency amid growing uncertainty regarding the effects of the pandemic.

# 12 Annex A: Macroeconomic projections of other institutions

### Table A.1 Macroeconomic projections of other institutions
change in %

| | GDP | | Household consumption | | Gross fixed capital formation | | Exports of goods and services | | Imports of goods and services | | Industrial production | | Consumer prices | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 |
| **Croatian National Bank (December 2020)** | **–8.9** | **4.9** | **–6.6** | **4.5** | **–5.2** | **7.2** | **–26.4** | **19.3** | **–16.3** | **15.0** | **–** | **–** | **0.2** | **1.0** |
| Eastern Europe Consensus Forecasts (November 2020) | –8.8 | 4.8 | –6.9 | 3.8 | –9.0 | 5.8 | – | – | – | – | –4.4 | 4.2 | 0.2 | 1.1 |
| European Bank for Reconstruction and Development (November 2020) | –8.5 | 3.5 | – | – | – | – | – | – | – | – | – | – | – | – |
| European Commission (November 2020) | –9.6 | 5.7 | –6.7 | 4.3 | –8.2 | 5.5 | –29.5 | 29.2 | –22 | 22.4 | – | – | 0.1 | 1.2 |
| International Monetary Fund (October 2020) | –9.0 | 6.0 | – | – | – | – | – | – | – | – | – | – | 0.3 | 0.8 |
| Raiffeisen Research[a] (October 2020) | –9.4 | 5.1 | – | – | – | – | –27.7 | 15.1 | –21.3 | 10.9 | –5.8 | 3.5 | 0.1 | 1.0 |
| Ministry of Finance (October 2020) | –8.0 | 5.0 | –6.3 | 4.5 | –6.1 | 3.9 | –24.7 | 24.0 | –17.6 | 19.3 | – | – | 0.2 | 0.8 |
| World Bank (June 2020) | –9.3 | 5.4 | – | – | – | – | – | – | – | – | – | – | – | – |

[a] Rates of change in exports and imports of goods and services refer to the change in the nominal value.
Note: Projection of the Ministry of Finance was taken from the Explanation of the state budget and the financial plans of the extrabudgetary users for 2021 and the projections for 2022 and 2023.
Sources: Publications of the respective institutions.

# 13 Annex B: Comparison of Croatia and selected countries

### Table 13.1 Gross domestic product

| | Year-on-year rate of change, original data | | | Quarter-on-quarter rate of change, seasonally adjusted data | | | |
|---|---|---|---|---|---|---|---|
| | 2017 | 2018 | 2019 | Q4/19 | Q1/20 | Q2/20 | Q3/20 |
| Bulgaria | 3.5 | 3.1 | 3.7 | 0.6 | 0.4 | –10.1 | – |
| Czech R. | 5.2 | 3.2 | 2.3 | 0.4 | –3.3 | –8.5 | 6.9 |
| Estonia | 5.5 | 4.4 | 5.0 | 0.5 | –0.8 | –5.5 | 3.3 |
| Croatia | 3.4 | 2.8 | 2.9 | 0.3 | –1.3 | –15.0 | 6.9 |
| Latvia | 3.3 | 4.0 | 2.1 | 0.1 | –2.3 | –7.1 | 7.1 |
| Lithuania | 4.3 | 3.9 | 4.3 | 0.8 | 0.0 | –5.9 | 3.8 |
| Hungary | 4.3 | 5.4 | 4.6 | 0.6 | –0.4 | –14.6 | 11.4 |
| Poland | 4.8 | 5.4 | 4.5 | 0.2 | –0.3 | –9.0 | 7.9 |
| Romania | 7.3 | 4.5 | 4.2 | 1.4 | 0.0 | –12.2 | 5.6 |
| Slovak R.[a] | 3.0 | 3.8 | 2.3 | 0.6 | –5.1 | –8.3 | 11.7 |
| Slovenia | 4.8 | 4.4 | 3.2 | 0.4 | –4.7 | –9.8 | 12.4 |
| **Average**[b] | **4.5** | **4.1** | **3.6** | **0.5** | **–1.6** | **–9.6** | **7.7** |

[a] Slovak R.: seasonally adjusted data. [b] Simple average.
Sources: Eurostat, EC, CBS and CNB.

### Figure 13.1 Industrial production and goods exports
year-on-year rate of change



Industrial production, 1st half 2020
Industrial production, 7-10/2020
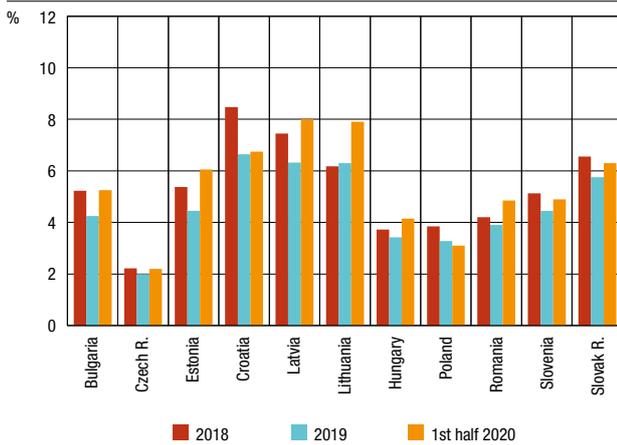Goods exports, 1st half 2020
Goods exports, Q3/2020
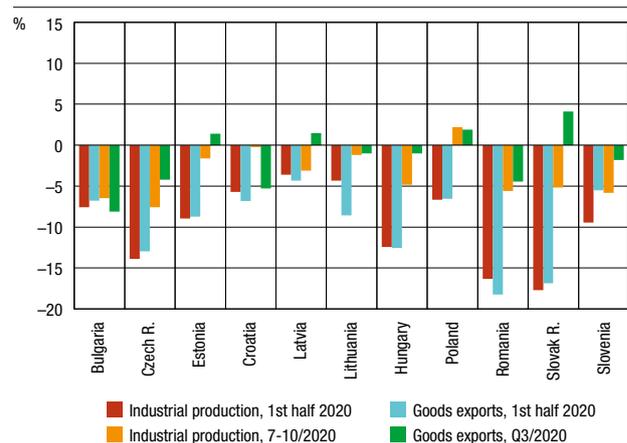
Sources: Eurostat and CBS.

**Figure 13.2 Labour Force Survey employment rate**
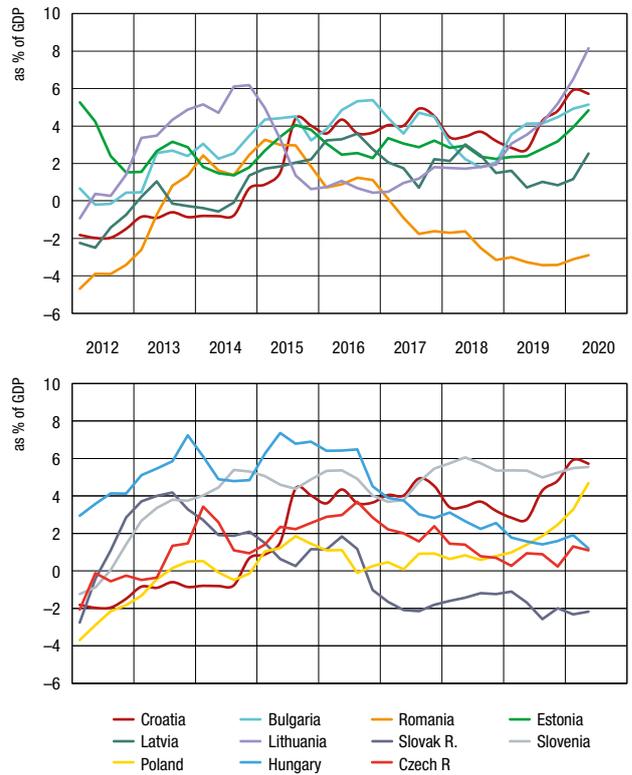year-on-year rate of change
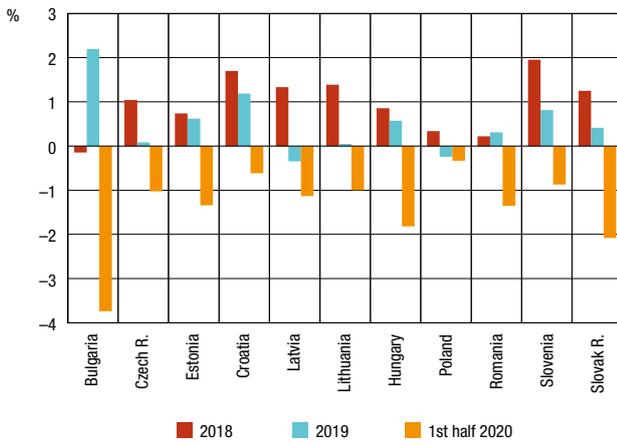


Source: Eurostat.
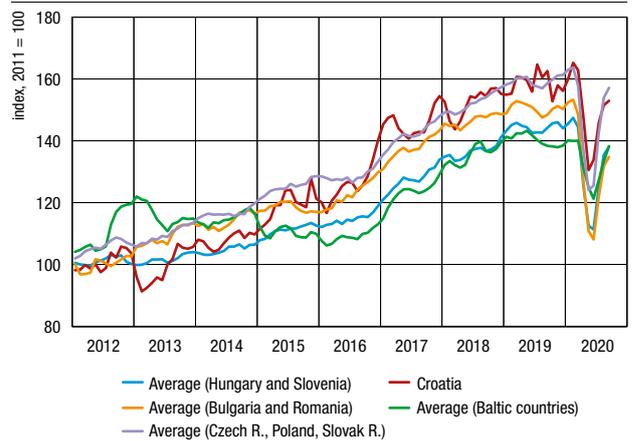
**Figure 13.3 Labour Force Survey unemployment rate**



Source: Eurostat.

**Figure 13.4 Current and capital account balance**
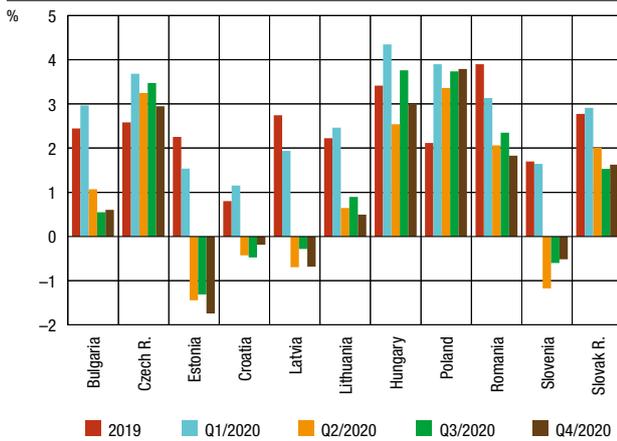sum of the last four quarters



Sources: Eurostat and CNB.

**Figure 13.5 Goods exports**
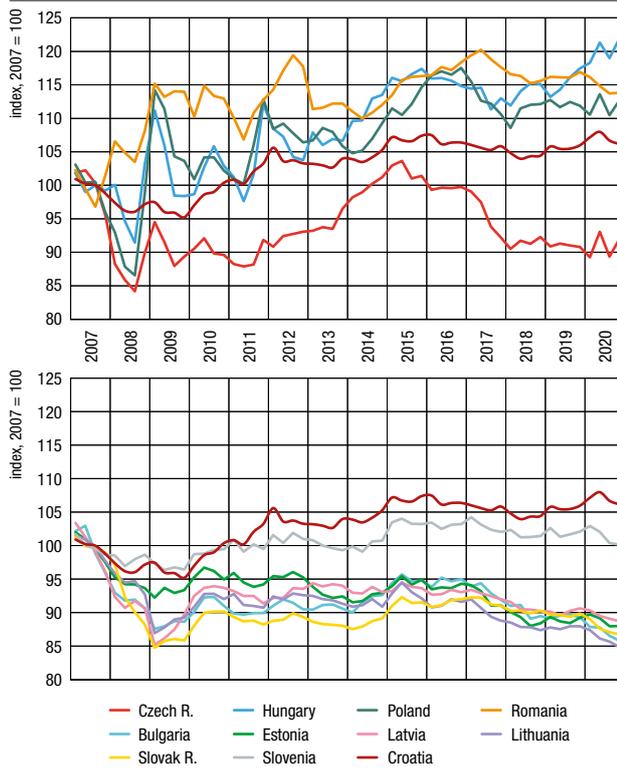quarterly moving average, seasonally adjusted data



Sources: Eurostat and CNB.

**Figure 13.6 Consumer price inflation**
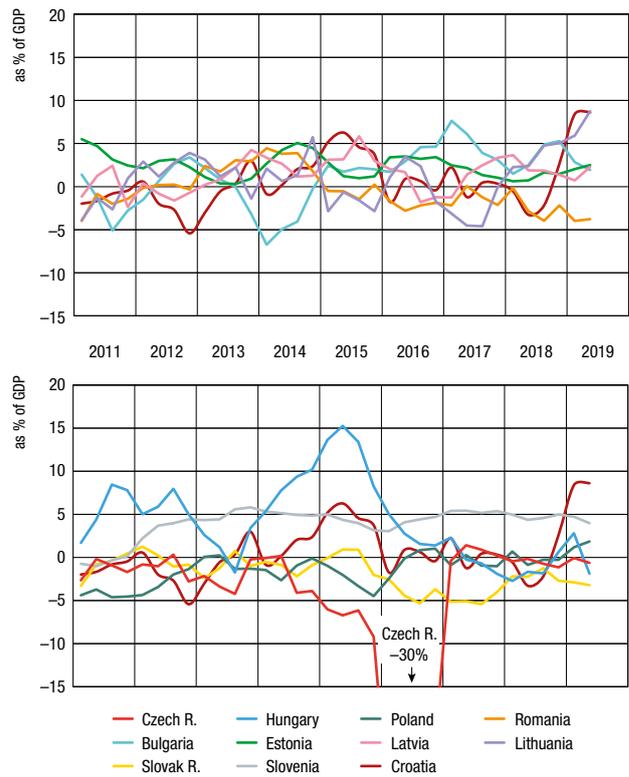average year-on-year rate of change



Note: Data for the second quarter of 2020 refer to April and May.
Source: Eurostat.

**Figure 13.7 Real effective exchange rate (deflated by consumer prices) in selected countries**



Notes: Data for 2020 refer to the January-May period. A fall in the index indicates a real effective appreciation.
Sources: BIS and CNB.

**Figure 13.8 Balance of payments financial account balance, excluding the change in international reserves**
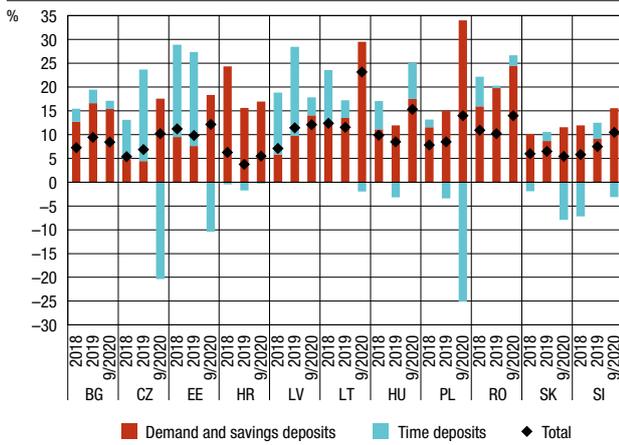sum of the last four quarters



Sources: Eurostat and CNB.

**Figure 13.9 Bank loans to the private sector**
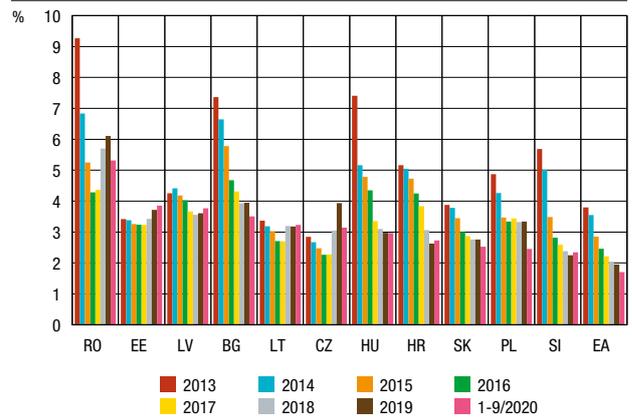contributions to the year-on-year rate of change, transaction-based
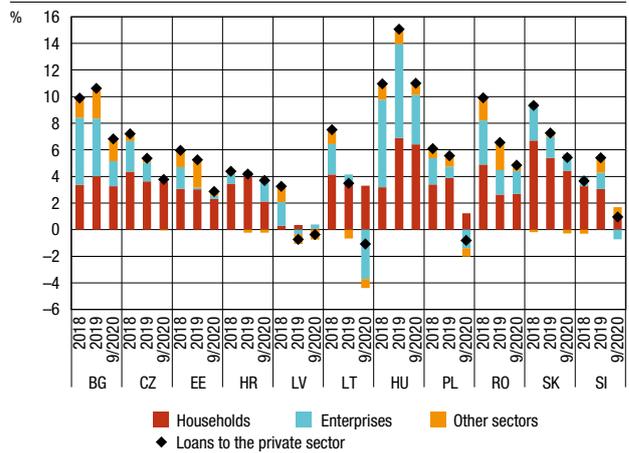


Sources: ECB and CNB.

## Figure 13.10 Private sector deposits
year-on-year rate of change, excluding the exchange rate effect



Demand and savings deposits ◆ Total
Time deposits

Sources: ECB and CNB.

## Figure 13.13 Short-term interest rates on corporate loans



2013 2014 2015 2016
2017 2018 2019 1-9/2020

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

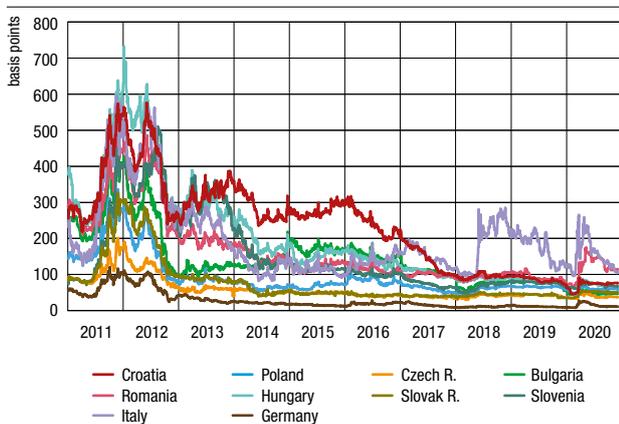## Figure 13.11 Placement to deposit ratio of the private sector



2012 2013 2014 2015 2016
2017 2018 2019 9/2020
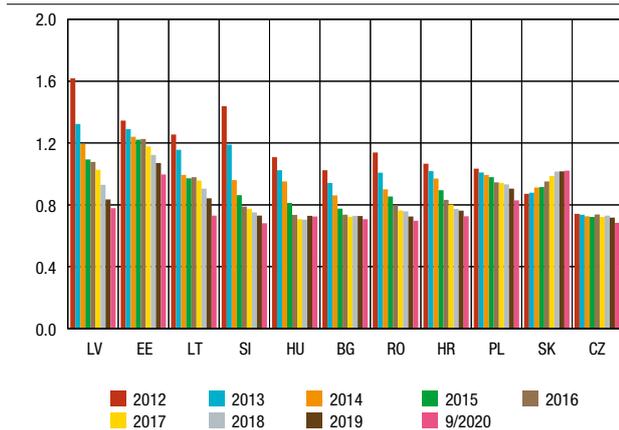
Sources: ECB and CNB.

## Figure 13.14 Interest rates on housing loans



2013 2014 2015 2016
2017 2018 2019 1-9/2020
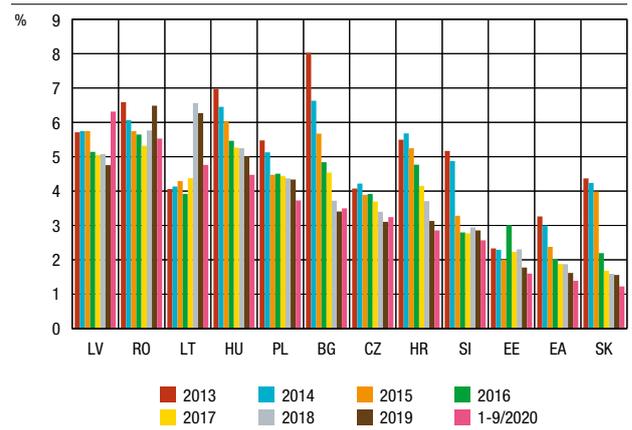
Sources: ECB and NCBs.

## Figure 13.12 CDS spreads for 5-year government bonds of selected countries



— Croatia — Poland — Czech R. — Bulgaria
— Romania — Hungary — Slovak R. — Slovenia
— Italy — Germany

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.

## Figure 13.15 Expected real interest rate on corporate loans
up to EUR 1m and with maturity up to 1 year
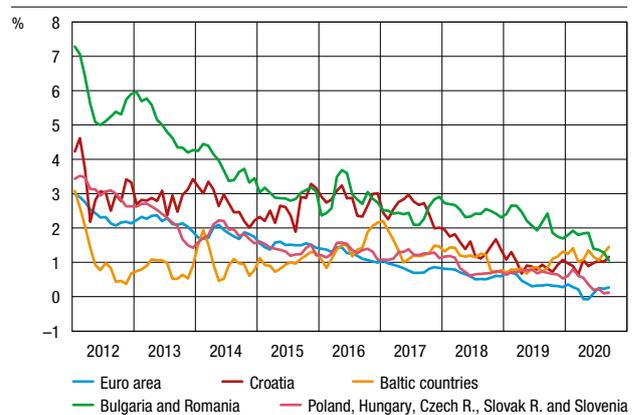


— Euro area — Croatia — Baltic countries
— Bulgaria and Romania — Poland, Hungary, Czech R., Slovak R. and Slovenia

Notes: The expected real interest rate equals the nominal interest rate deflated by inflation projected for the next year from the Consensus Forecasts. Country group averages are not weighted.
Sources: ECB and Consensus Forecasts.

## Figure 13.16 Spread between expected and achieved real interest rate on corporate loans
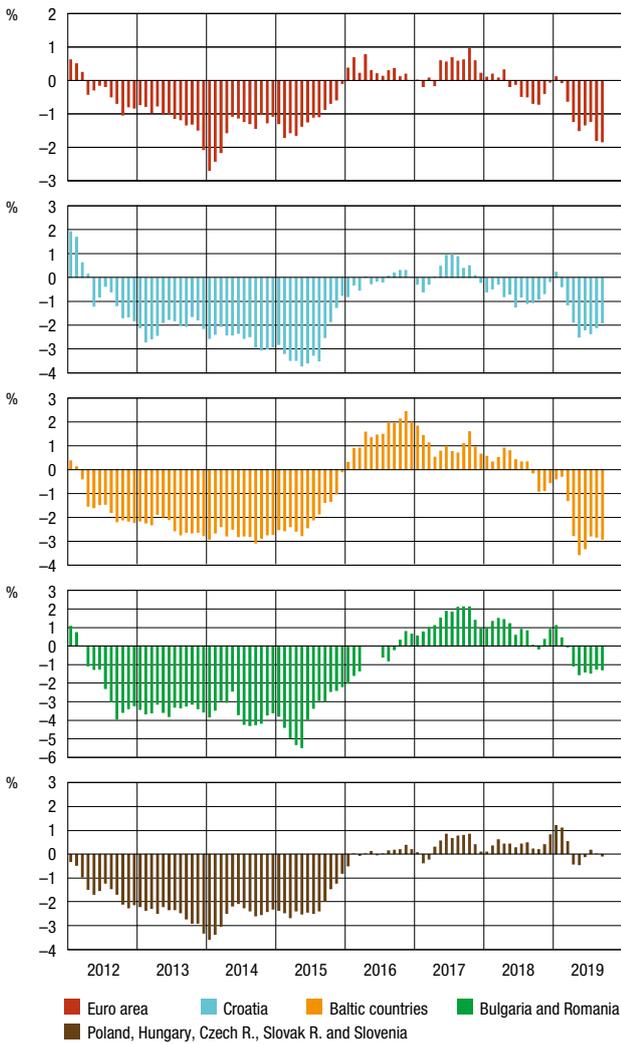up to EUR 1 and with maturity up to 1 year



Notes: The expected real interest rate equals the nominal interest rate deflated by inflation projected for the next year from the Consensus Forecasts and the achieved real interest rate equals the nominal interest rate deflated by inflation achieved. Country group averages are not weighted.
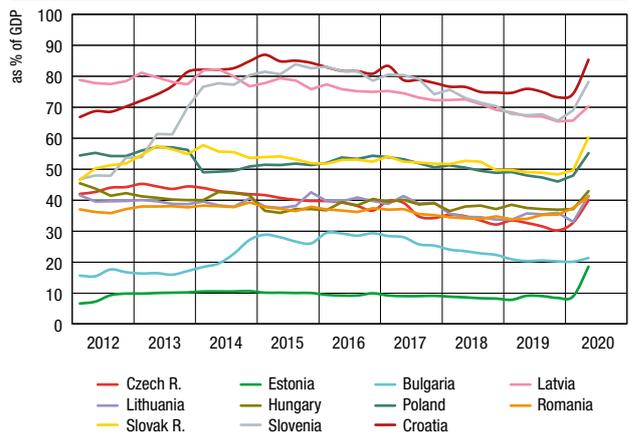Sources: ECB and Consensus Forecasts.

## Figure 13.17 Consolidated general government balance
four-quarter moving sums
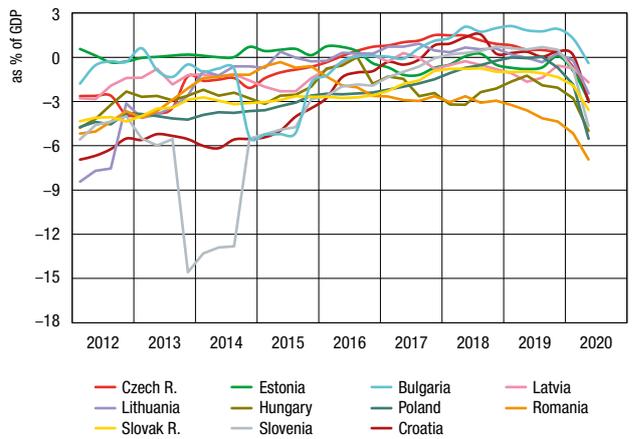


Sources: Eurostat and CNB.

## Figure 13.18 General government debt
end-quarter stock



Sources: Eurostat and CNB.

# Abbreviations and symbols

## Abbreviations

| | |
|---|---|
| ARZ | – Rijeka-Zagreb Motorway |
| BIS | – Bank for International Settlements |
| bn | – billion |
| b.p. | – basis points |
| BEA | – U. S. Bureau of Economic Analysis |
| 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 |
| CHIF | – Croatian Health Insurance Fund |
| CM | – Croatian Motorways |
| CLVPS | – Croatian Large Value Payment System |
| CNB | – Croatian National Bank |
| CPF | – Croatian Privatisation Fund |
| CPI | – consumer price index |
| CPII | – Croatian Pension Insurance Institute |
| 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 |
| FISIM | – financial intermediation services indirectly measured |
| 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 |
| HUB | – Croatian Banking Association |
| 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 |
| NA | – national accounts |
| NBS | – National Bureau of Statistics of China |
| 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 |
| SE | – South-East |
| SITC | – Standard International Trade Classification |
| SGP | – Stability and Growth Pact |
| ULC | – unit labour cost |
| 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 |
| XDR | – special drawing rights |

## Two-letter country codes

| | |
|---|---|
| AT | – Austria |
| BE | – Belgium |
| BG | – Bulgaria |
| CY | – Cyprus |
| CZ | – Czech Republic |
| DE | – Germany |
| DK | – Denmark |
| EE | – Estonia |
| ES | – Spain |
| FI | – Finland |
| FR | – France |
| GB | – Great Britain |
| GR | – Greece |
| HR | – Croatia |
| HU | – Hungary |
| IE | – Ireland |
| IT | – Italy |
| LT | – Lithuania |
| LV | – Latvia |
| MT | – Malta |
| NL | – Netherlands |
| PL | – Poland |
| PT | – Portugal |
| RO | – Romania |
| SI | – Slovenia |
| SK | – Slovak Republic |
| UK | – United Kingdom |

## 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 |