Information on economic, financial and monetary developments

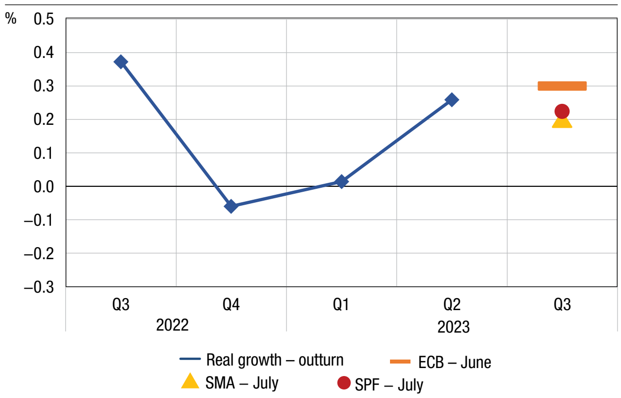
September 2023

Summary

Having edged up in the second quarter, the euro area economy started showing signs of slowing down over the summer. Economic activity in the euro area grew by 0.3% in the second quarter of 2023 from the quarter before, in line with expectations. The intensity of growth was in part related to the operations of foreign enterprises registered in Ireland and a temporary increase in the exports of ships from France. In most other countries, economic activity either stagnated or recorded very low positive growth rates, while in some countries, such as Italy and the Netherlands, it decelerated noticeably. Most of the growth in real activity still comes from the services sector, with manufacturing industry lagging behind considerably. According to available estimates, economic activity might moderate further in the third quarter (Figure 1)[1]. High-frequency indicators, such as the purchasing manager index, signal further slowdown in the services sector and its contraction in August. Despite a slight recovery in the purchasing manager index in August, manufacturing has been in contractionary territory for a while now. Amid subdued real activity, consumer price inflation in the euro area continued its downward trend in July, while in August the decline halted at 5.3% due to a rebound in energy prices (Figure 2). The annual growth of the prices of industrial products (excluding energy) and food products continued to slow down. However, the rise in the prices of services, particularly of transport and tourist services, has shown no visible signs of weakening. Consequently, core inflation (excluding food and energy), went down only marginally to 5.3% in August, which indicates the persistence of inflationary pressures. Although there are still marked differences among inflation rates across euro area member states, these differences have continued to shrink.

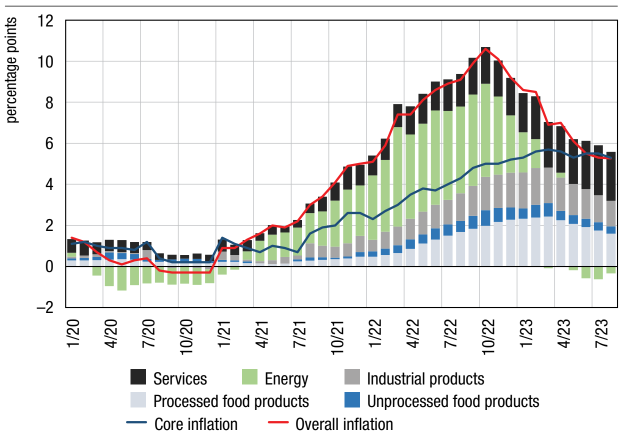
According to the first CBS estimates, real GDP in Croatia continued its relatively steady upward trend in the second quarter of 2023, at the pace seen at the beginning of the year. Economic activity went up by 1.1% in the second quarter from the quarter before, growing by 2.7% from the same period of the previous year. On the demand side, this growth was mostly fuelled by personal consumption and exports of services, which may be associated with continued favourable developments in the labour market, the recovery in real income and a strong inflow of foreign tourists. Developments in other components were relatively subdued. Goods exports decreased. However, given that the goods imports also declined considerably, the influence of trade in goods was relatively neutral. In addition, government consumption and investments edged down from the previous quarter. The drop in investments can partly be associated with weaker public investment relative to the levels recorded at the beginning of the year, as evident from the trends in civil engineering works. Economic activity continued its upward pace on a quarterly level in most activities (excluding construction and agriculture), following unfavourable trends

Figure 1 Quarterly growth rates of real GDP in the euro area



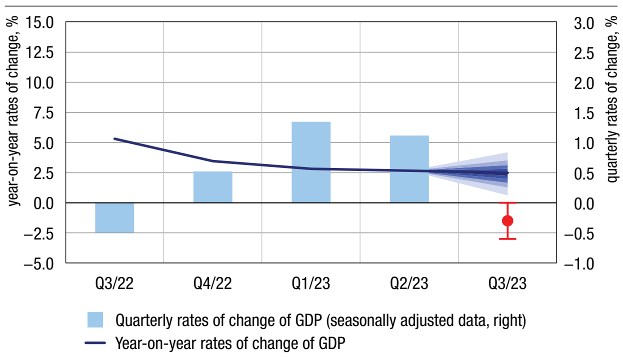
Notes: Abbreviation ECB – June refers to ECB June projections of real growth in the euro area (Broad Macroeconomic Projection Exercise, BMPE). Abbreviations SMA (Survey of Monetary Analysts) and SPF (Survey of Professional Forecasters) refer to the results of the ECB survey of market participants in July.
Sources: Eurostat and ECB.

Figure 2 Annual rates of inflation in the euro area



Note: Core inflation is measured by the harmonised index of consumer prices that excludes energy, food, alcoholic beverages and tobacco prices.
Source: Eurostat.

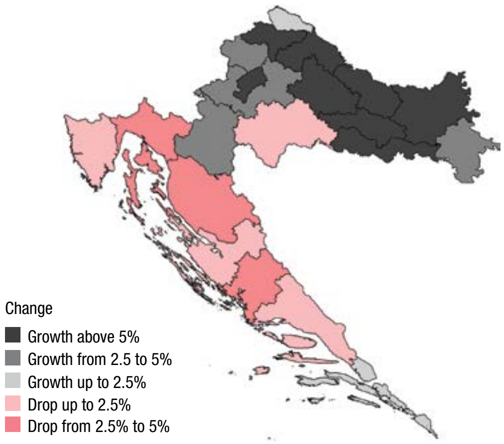
Figure 3 Quarterly gross domestic product



Notes: The estimate for the third quarter of 2023 refers to the Monthly Indicator of Real Economic Activity of the CNB (for more details on the calculation of the MRGA indicator, see Kunovac, D., and B. Špalat: "Nowcasting GDP Using Available Monthly Indicators", CNB Working Paper, W-39). The models are estimated on the basis of data published until 1 September 2023. The red dot denotes an estimate of the quarterly change in real GDP, with historical errors of estimates within ±1 standard deviation.
Sources: CBS (seasonally adjusted by the CNB) and CNB calculations.

1 In addition to figures shown in the Information on economic, financial and monetary developments, there is an additional group of figures and relevant data from which they were derived. These figures and time series are shown in an Excel datafile Annex: Figures and tables

Figure 4 Change in the number of overnight stays in July and August 2023 from the same period in 2022



Note: Data refer to July and the first twenty days of August.
Source: eVisitor.

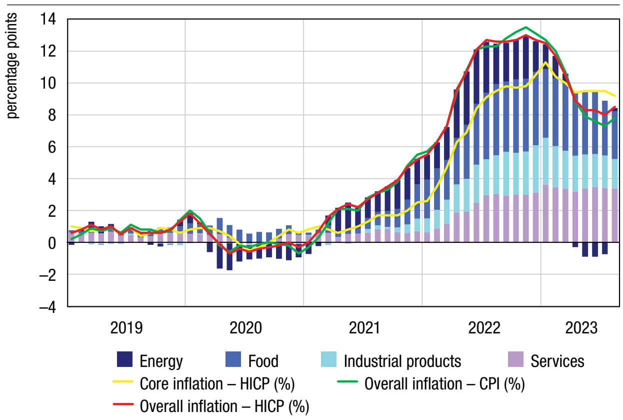
in many activities in the second half of 2022. Financial activities recorded a sharp growth, probably due to the rise in the net interest margins of banks, which also include income of banks from overnight deposits with the CNB.

With regard to trends in the third quarter of 2023, the CNB's nowcasting model of economic activity, which currently draws on a relatively small number of available data, mostly for July, indicates that real GDP edged down from the quarter before, which might lead to a slowdown in the annual growth rate to 2.5% (Figure 3). Industrial production decreased noticeably in July from the levels recorded in the previous quarter. The production of energy and non-durable consumer goods decreased, while the production of intermediate goods, capital goods and durable consumer goods increased. In addition, available data for July and August suggest a small decrease in the number of tourist nights from the year before (Figure 4), while retail trade held steady in July, at the average level recorded in the previous quarter. Consumer and business confidence indicators for July and August mostly point to unfavourable trends, with the exception of the construction sector, while a particularly strong deterioration in optimism was recorded in industry and services, in which the levels came close to their long-term average.

According to the first Eurostat estimate, inflation measured by the harmonised index of consumer prices accelerated in August to 8.5% (from 8.0% in July) due to the rise in energy prices, while core inflation, including only the prices of industrial products and services, decreased from 9.5% to 9.2%. The prices of Brent crude oil (in USD) on the global market started trending up in mid-July under the influence of supply cuts from OPEC+ countries and grew by around 8% in August. This triggered a rise in retail prices of petroleum products in the domestic market, and so the annual rate of change in energy prices was higher in August than in July (1.6% compared with –5.8%). Unlike energy prices, the annual growth in the prices of all other main inflation components decelerated from July to August, even though it still remained high (Figure 5). Against the backdrop of lower prices of raw materials in the global market (Figure 7), normalisation of supply chains and appreciation of the euro in nominal effective terms, food price inflation (including alcohol and tobacco) dropped to 10.3% (from 11.8% in July), while inflation in industrial products fell to 7.0% (from 7.7% in July). In addition, the decline in inflation in food and industrial products is largely also due to the positive effect of the base period, associated with the surge in the prices of these goods in 2022. Services inflation edged down from 10.8% in July to 10.7% in August. The factors influencing the persistently elevated prices of services, particularly catering and accommodation services, include a sizeable wage growth and the spillover of the past increase in input costs caused by the rise in the prices of energy and food amid strong demand of foreign visitors for tourist services. Furthermore, the short-term indicators of energy and services inflation (Figure 6) increased markedly in August, which resulted in a rise in the momentum of overall and core inflation for the fourth consecutive month. According to the CNB's macroeconomic projections, the acceleration of total annual inflation in August should be temporary, and the slowdown in inflation, begun in end-2022, should continue.

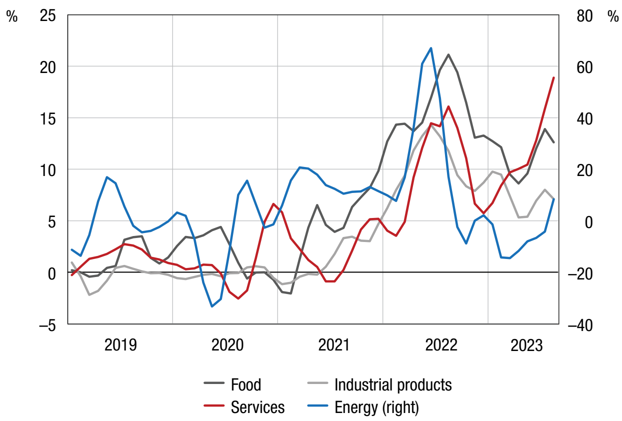
Key ECB interest rates were raised by a further 25 basis points at the meeting of the Governing Council on 27 July. The interest rate on monetary deposits of credit institutions with the central bank (currently a relevant indicator of the ECB's monetary policy) has been set at 3.75% starting from 2 August. The Governing Council also decided to set the remuneration

Figure 5 Inflation indicators in Croatia



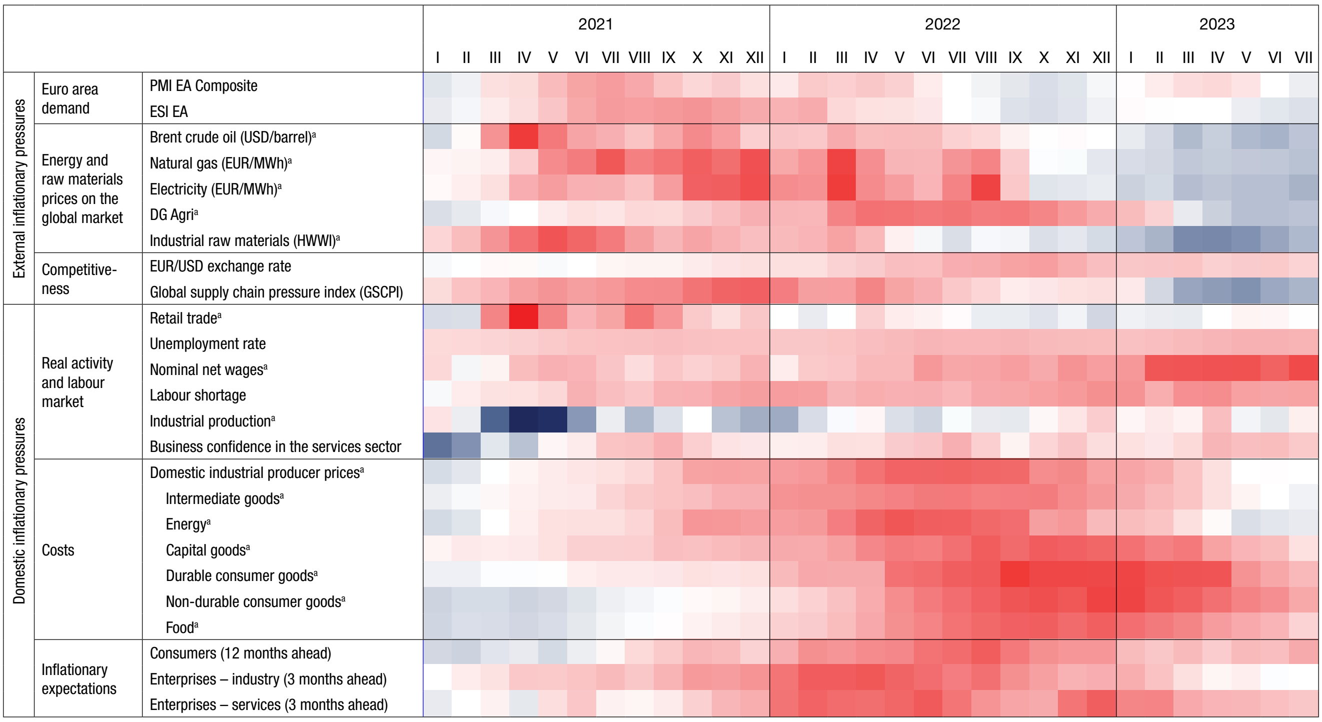
Notes: Core inflation is measured by the harmonised index of consumer prices that excludes energy, food, alcoholic beverages and tobacco prices. The last available data refer to the first estimate for August 2023.
Sources: Eurostat and CNB calculations.

Figure 6 Momentums of main inflation components



Note: The quarter-on-quarter rate of change on an annual level is calculated from the quarterly moving average of seasonally adjusted harmonised consumer price indices.
Sources: Eurostat and CNB calculations.

Figure 7 Indicators of external and domestic price pressures

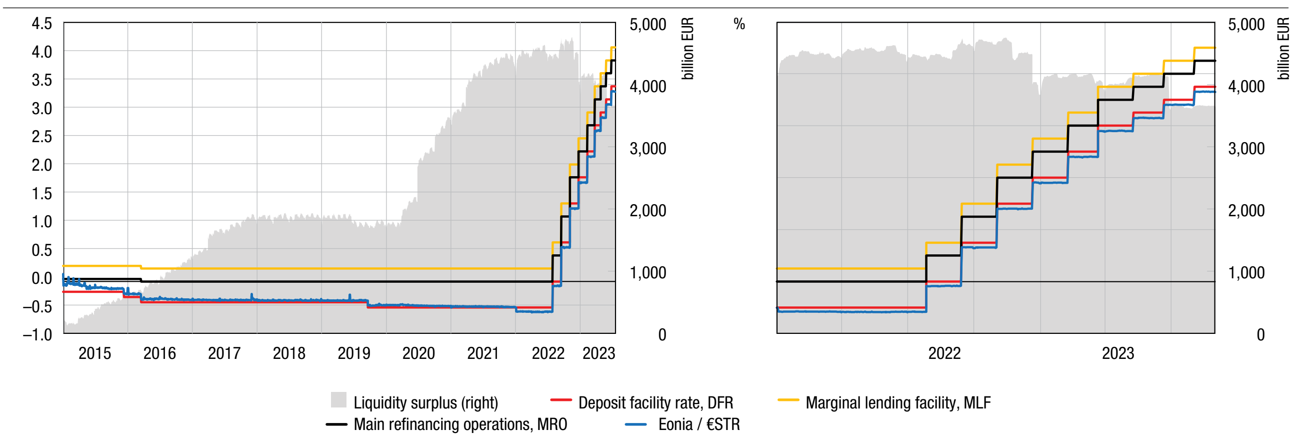


[a] Annual rate of change.
Notes: Labour shortage shows the ratio between the vacancy rate and the registered unemployment rate. The PMI EA Composite and ESI EA series have been corrected after standardisation so as to show the neutral value in white. Grey indicates that no data are available in the current month.
Sources: ECB, SDW, Eurostat, Bloomberg, NY Fed, HWWI, CBS and Ipsos.

of minimum reserves at 0% instead of deposit facility rate. The change will become effective as of the beginning of the reserve maintenance period starting on 20 September 2023. The decision to reduce the remuneration on minimum reserves will preserve the effectiveness of monetary policy by maintaining the current degree of control over the monetary policy stance and ensuring the full pass-through of the Governing Council's interest rate decisions to money markets. At the same time, it will improve the efficiency of monetary policy by reducing the overall amount of interest that needs to be paid to banks in order to implement the appropriate monetary policy stance. In addition, after a large repayment in June (of around EUR 500bn), banks have continued repaying the smaller amounts under the targeted longer-term refinancing operations (TLTRO), which considerably reduced the Eurosystem balance sheet (Figure 9) as well as surplus liquidity in the banking system. The asset purchase programme (APP) is declining at a measured and predictable pace, given that from July 2023 the Eurosystem no longer reinvests the principal payments from maturing securities. As concerns the pandemic emergency purchase programme (PEPP), the Governing Council intends to reinvest the principal payments from maturing securities purchased under the programme until at least the end of 2024.

The rise in key ECB interest rates by additional 25 basis points immediately spilled over to money market interest rates, while government bond yields have been stable for quite some time now. After the last decision of the Governing Council came into force in early August, the overnight interest rate on the

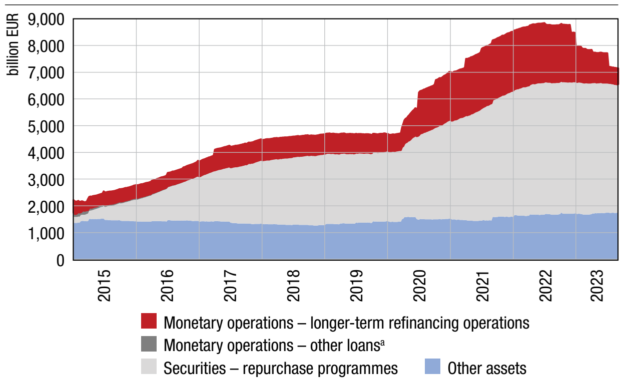
Figure 8 ECB key interest rates and reference market interest rates in the euro area



Notes: DFR (deposit facility rate); MLF (marginal lending facility); MRO (main refinancing operations). The EONIA was replaced by €STR in early 2022.
Source: ECB.

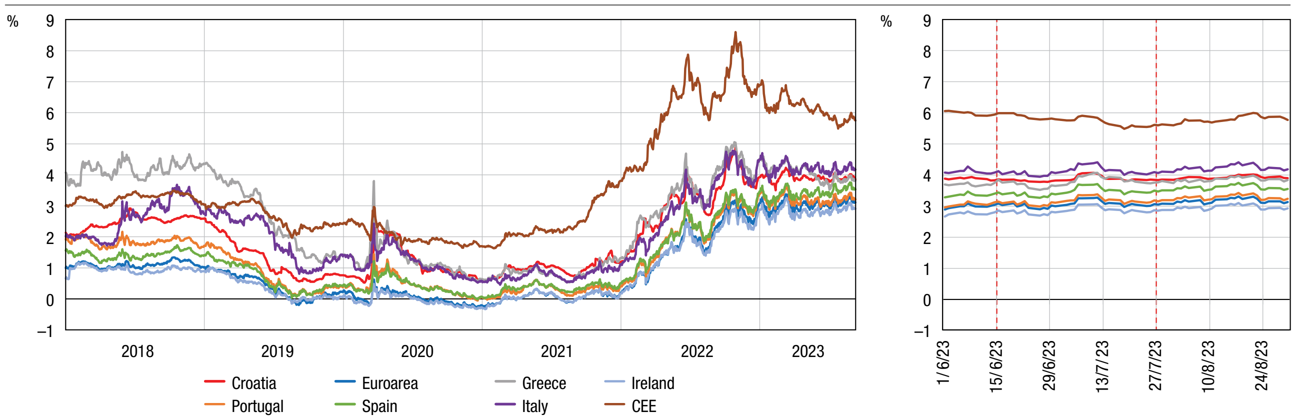
European money market, €STR, closely followed the increase in key interest rates (a rise by 25 basis points) and reached 3.7%, remaining at that level until the end of the month (Figure 11). The three-month EURIBOR continued to rise gradually, reflecting the risk of an additional increase in key interest rates, and reached 3.8% at the end of August. The increase in key ECB interest rates spilled over quickly to the Croatian money market. Thus the overnight interest rate on banks' demand deposits trading rose by 20 basis points in August, standing at 3.4% at the end of that month. As regards short-term government financing costs, only 182-day T-bills were placed at the auction of T-bills of the Ministry of Finance in August, while bids for the subscription of 346-day T-bills were fully rejected. Yield at issue of 182-day T-bills stood at 3.20% and remained unchanged from the last auction held in May. As in the previous few months, yields on long-term government bonds were stable in August and remained almost unchanged in late August from the levels recorded at end-July (Figure 10). The euro area GDP-weighted average of long-term government bond yields stood at 3.1% at the end of August, with the yield on long-term Croatian bonds standing at 3.8%.

Figure 9 Eurosystem balance sheet



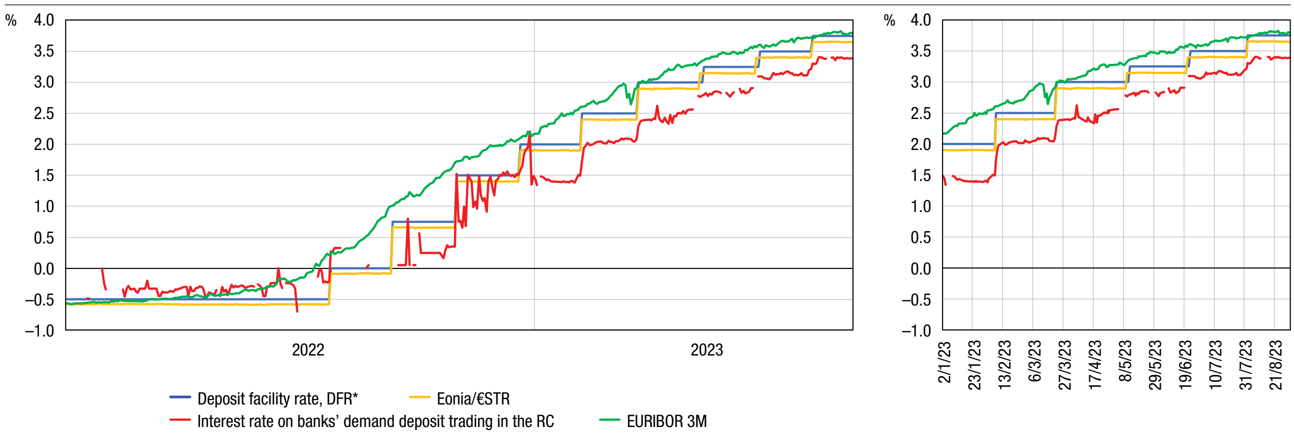
Notes: The Eurosystem monetary balance sheet asset items are shown in grey and red and non-monetary in blue.
[a] Other loans include main refinancing operations, fine-tuning reverse operations, structural reverse operations, marginal lending facility and credits related to margin calls.
Source: ECB.

Figure 10 Yields on long-term government bonds with the remaining maturity of approximately 10 years



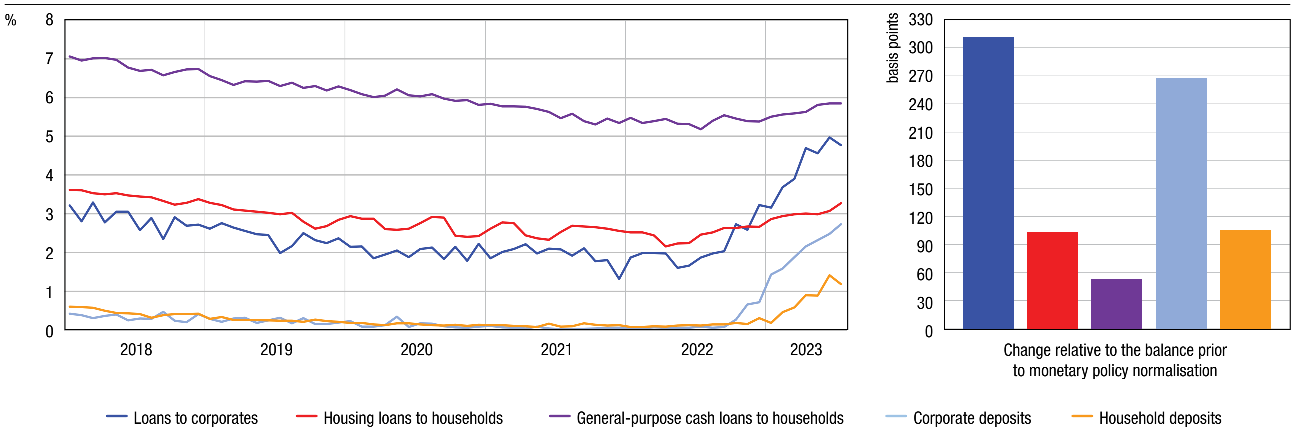
Notes: CEE – countries of Central and Eastern Europe (the Czech Republic, Hungary, Poland and Romania); yields for the euro area and CEE have been weighted by the share of GDP of the countries included. Data from the euro area do not include those from Estonia, Latvia, Luxembourg and Malta. The red dotted lines denote ECB Governing Council meetings in June and July.
Sources: Bloomberg and CNB calculations.

Figure 11 ECB key interest rate and overnight market interest rates in the euro area and Croatia



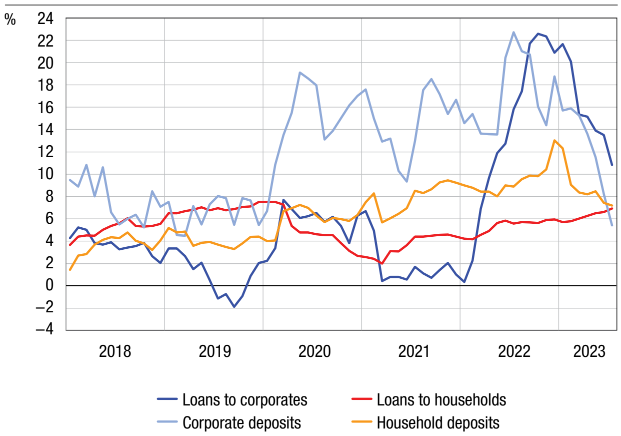
Notes: DFR (deposit facility rate). The EONIA was replaced by €STR in early 2022. The overnight interest rate on the money market in Croatia in 2022 is based on euro transactions.
Sources: ECB and CNB.

Figure 12 Interest rates on pure new loans and time deposits of corporates and households



Notes: Data up to December 2022 refer to loans and deposits in kuna and currencies indexed to kuna and in euro and currencies indexed to euro, and from January 2023 to loans and deposits in euro and currencies indexed to euro. Data refer to pure new loans and deposits. Deposits with a maturity of up to 1 month have been excluded.
Source: CNB.

Figure 13 Corporate and household loans and deposits



Note: Annual rates of change, transaction-based.
Source: CNB.

Interest rates of Croatian banks continued their gradual upward trend due to further tightening of the ECB's monetary policy, even though some differences across sectors and instruments persist.[2] Households borrowed at somewhat higher interest rates in July than in June, especially for house purchases. The interest rate on pure new housing loans increased by 20 basis points from June to July and stood at 3.27%, with the noticeable influence of smaller amounts of pure new housing loans granted under the government subsidy programme (usually made at lower interest rates than the market average) relative to the levels recorded in recent months. The interest rate on pure new general-purpose cash loans remained almost unchanged and stood at 5.84% in July. In the non-financial corporations sector, the average interest rate on pure new loans amounted to 4.77% in July, down by 20 basis points from 4.97% in June (Figure 12). The fall in the interest rate on pure new loans to corporates in July was largely due to the decrease in the share of syndicated loans (granted at relatively high interest rates) in total financing, with a simultaneous increase in the share of loans granted at relatively low interest rates (working capital loans). If the impact of these instruments is excluded, July also saw a rise in the borrowing costs of corporates. When sources of bank financing are observed, the rise in key ECB interest rates also affected the interest rates on deposits, especially in the corporate sector – the interest rate on pure new time deposits of corporates stood at 2.73% in July, up by 25 basis points from June. Over the same period, the interest rate on total pure new household time deposits reached 1.18%, down by 24 basis points from June. The higher interest rate in June was due to the one-off effect of a large short-term time deposit in one bank, carrying a much higher interest rate than the average interest rate. If this effect is excluded, the interest rate on pure new time deposits of households in July remained almost the same as in June.

Despite the steady increase in banks' interest rates on loans, lending activity remained robust in the household sector, while corporate lending was subdued. As regards household loans, general-purpose cash loans and housing loans grew from 6.3% and 9.2% in June to 6.8% and 9.5% in July (transaction-based) respectively, year-on-year. This was due to the new round of the government housing loan subsidy programme. Lending activity in the non-financial corporations sector was subdued in July, while the growth in loans to this sector continued to slow down on an annual level, from 13.5% in June to 10.8% in July, which reflects the effect of the base period, that is, the very strong increase in loans granted to corporates in July last year. The effect of the base period is also mirrored in the deceleration of the annual growth in domestic deposits (from 5.8% to 5.2%) as a result of considerable corporate borrowing following the growth in the prices of raw materials and energy products in mid-2022, as well as stronger inflow of cash to banks on the eve of the euro introduction. Broken down by sector, deposits of non-financial corporations and households slowed down their growth on an annual basis, from 8.2% and 7.4% in June to 5.4% and 7.2% in July, respectively (Figure 13).

2 For more information on the differences in the pass-through of key ECB interest rates to interest rates on loans and deposits in Croatian banks, see Deskar-Škrbić, Jukić, Lesničar and Zrnc (2023), *Koliko je porasta ključnih kamatnih stopa ESB-a preneseno na kamatne stope banaka u Hrvatskoj?*, HNBlog, available at https://www.hnb.hr/-/koliko-je-porasta-kljucnih-kamatnih-stopa-esb-a-preneseno-na-kamatne-stope-banaka-u-hrvatskoj