Information on economic, financial and monetary developments

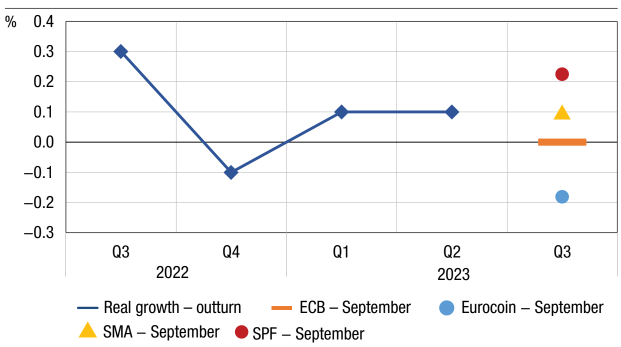
October 2023

Summary

The real growth rate of the euro area economy was revised down in the second quarter from the first three months of 2023 (to only 0.1%), with available high-frequency indicators signalling that economic activity remained subdued in the summer months. The purchasing manager index for the services sector, whose growth in the past several quarters cushioned the extremely negative trends in the manufacturing industry, suggests that this sector also entered contractionary territory in August and September. According to available estimates, euro area economic growth probably weakened in the third quarter (Figure 1)[1], whereas real GDP might also show a slight decrease relative to the preceding quarter average. Against a backdrop of faltering economic activity and restrictive monetary policy, consumer price inflation in the euro area dropped noticeably, to 4.3% in September, from 5.2% in the previous month (Figure 2). The slowdown in inflation was due to all the main components, with the smaller contribution of food and energy prices reflecting the statistical effect of the base period. Core inflation, excluding food and energy prices, slowed down from 5.3% in August to 4.5% in September, largely owing to a smaller contribution of services prices. In turn, this was mainly due to the base effect associated with subsidies for transport services in Germany, which expired in September of 2022.

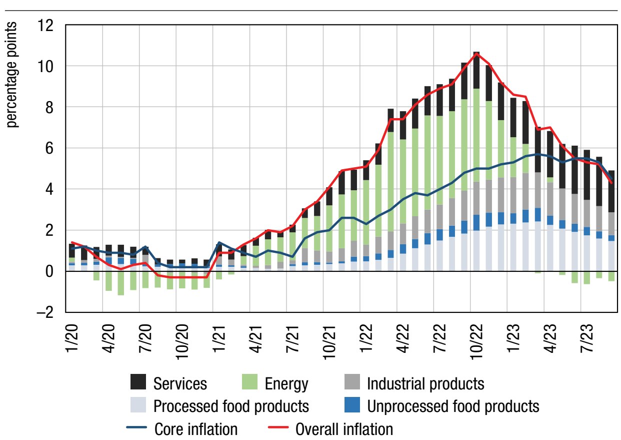
Monthly indicators for part of the third quarter suggest that real activity in Croatia is likely to slacken. According to the CNB's nowcasting model of economic activity, which mostly draws on data for July and August, real Croatian GDP might decrease by 0.6% from July to September relative to the quarter before; this fall is slightly more pronounced than previously anticipated as August data were somewhat less favourable than those of July. As a result, the annual growth rate of real GDP might drop to 1.8%, although it was 2.7% in the second quarter of 2023 (Figure 3). After a decline in July, industrial production contracted further in August and was thus perceptibly lower in the first two months of the third quarter than the previous quarter average. Broken down by main industrial groupings, the production of energy, capital goods and non-durable consumer goods decreased, while the production of intermediate goods, capital goods and durable consumer goods increased. While recent data suggest that the number of tourist nights was marginally higher in the first twenty days of September than in the same period last year, the third quarter as a whole saw a decrease on an annual level (Figure 4). This probably explains, in part, the relatively subdued performance of retail trade, which continued to hold steady in August, at the average level recorded in the previous quarter. On the other hand, the July growth in construction suggests that investments picked up from the April-to-June period, with growth seen in the volume of construction works and a decrease recorded in the volume of civil engineering works. Amid persistently elevated inflation and growing prices

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



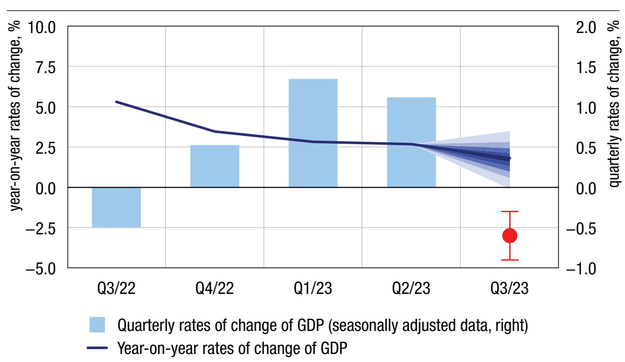
Notes: Abbreviation ECB – September refers to ECB September projections of real growth in the euro area (Macroeconomic Projection Exercise, MPE). Abbreviations SMA (Survey of Monetary Analysts) and SPF (Survey of Professional Forecasters) refer to the results of the ECB survey of market participants in September. The Eurocoin indicator developed by Banca d'Italia refers to the model for nowcasting the quarterly rate of change in the real GDP of the euro area derived from the available high-frequency data (September estimate).
Sources: Eurostat, ECB and Banca d'Italia.

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.

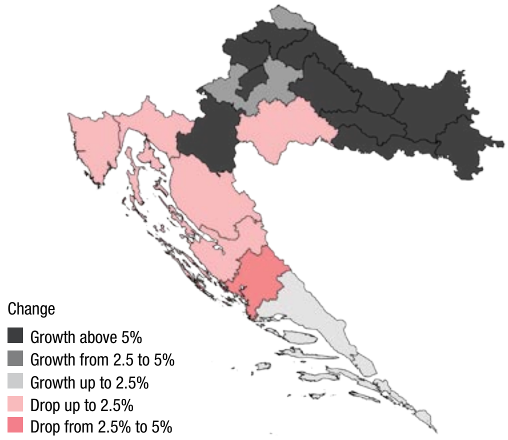
Figure 3 Quarterly gross domestic product



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 29 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.

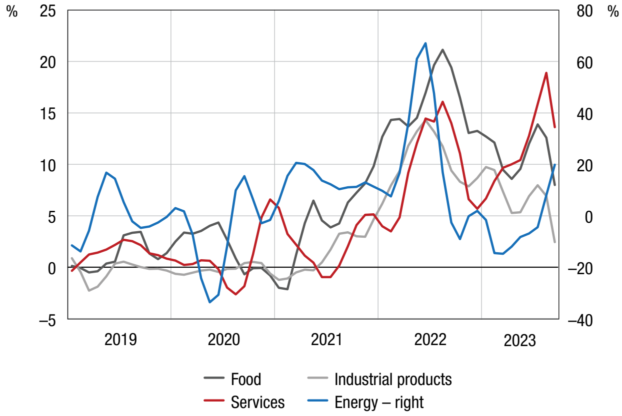
1 In addition to figures shown in the Information on economic, financial and monetary developments, there is an additional group of figures and relevant data from which they were derived. These figures and time series are shown in an Excel datafile Annex: Figures and tables

Figure 4 Change in the number of overnight stays in the third quarter of 2023 from the same period in 2022



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

Figure 6 Momentums of main inflation components

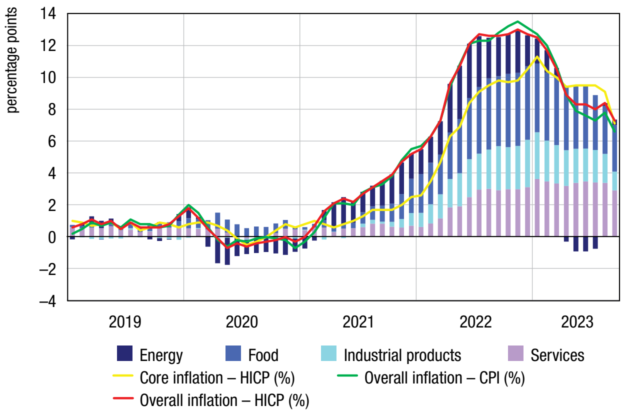


Note: The quarter-on-quarter rate of change on an annual level is calculated from the quarterly moving average of seasonally adjusted harmonised consumer price indices.
Sources: Eurostat and CNB calculations.

of refined petroleum products, consumer confidence dropped slightly in the third quarter, while employment and real wages continued to rise, albeit at a pace slower than in the previous three months. For the most part, the current increase in wages is attributable to wage growth in the public sector following the agreement between the Government of the Republic of Croatia and government employees' unions in effect as of 1 June this year. Business expectations in construction remained high from July to September and were slightly more optimistic than the previous quarter average. By contrast, expectations in industry and services deteriorated sharply and came close to their long-term average.

According to the first Eurostat estimate, inflation in Croatia measured by the harmonised index of consumer prices decelerated perceptibly in September (to 7.3%, from 8.4% in August), due mostly to the smaller contribution of the prices of industrial products and services and, to a slightly smaller extent, the prices of food (Figure 5). Core inflation (the calculation of which excludes the prices of energy and food) fell by 2.0 percentage points, to 7.1%, after being 9.1% in August. As regards the two most important sub-components of core inflation,

Figure 5 Inflation indicators in Croatia



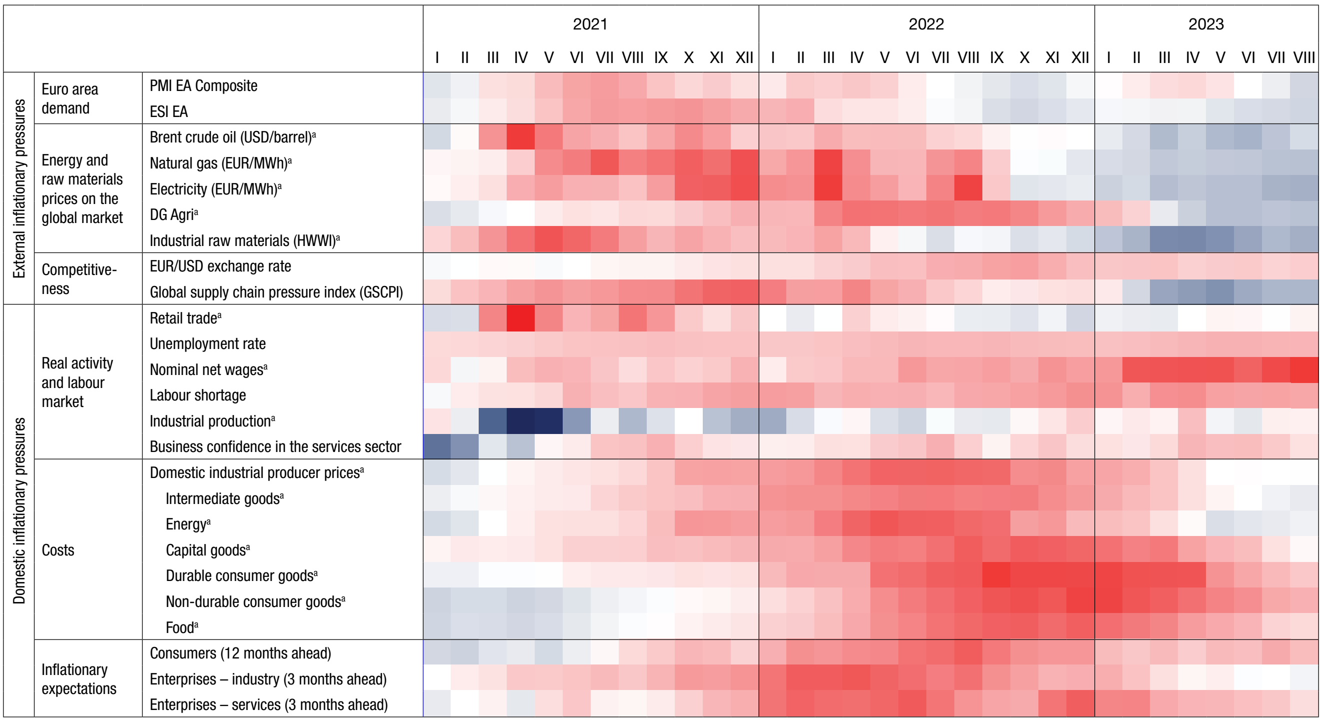
Notes: Core inflation is measured by the harmonised index of consumer prices that excludes energy, food, alcoholic beverages and tobacco prices. The last available data refer to the first estimate for August 2023.
Sources: Eurostat and CNB calculations.

industrial goods inflation dropped sharply (to 4.5%, from 6.9% in August) against the backdrop of lower prices of raw materials in the global market, normalisation of supply chains and slower annual growth in producer prices on the domestic market. Inflation of services prices decelerated to 9.2% in September (from 10.7% in August). Food prices (including alcohol and tobacco) were 0.5% lower in September than in the month before, reflecting the measures the Croatian government implemented to limit the prices of some products.[2] The annual rate of food price inflation slowed down slightly (to 10.0%, from 10.3% in August) as the annual inflation rate in this September was no longer affected by the price decrease of last September. More specifically, the first round of price caps took place in September 2022, with food prices decreasing by 0.2% on a monthly level amid relatively strong current inflationary pressures. The dynamics of slowdown in overall inflation in September softened the rise in energy inflation to 2.7% (from 1.4% in August), largely as a result of the growth in the prices of refined petroleum products on the back of the increase in global crude oil prices. 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 Saudi Arabia and Russia. The average price was USD 94 in September, an increase of 17.3% from July. The short-term indicators of overall and core inflation, which reflect current developments, went down noticeably in September, after increasing sharply just ahead of and during the peak tourist season. The momentum of the prices of services, food and industrial products eased perceptibly (Figure 6). Despite the inflation slowdown, price developments remained under significant pressure, which is, except for the recent increase in global energy prices, mostly associated with wage dynamics (Figure 7).

The ECB's Governing Council raised key ECB interest rates by a further 25 basis points at a meeting on 14 September (Figure 8). In response to expectations that inflation will remain too high for too long, the lifting of key interest rates is a part of the continued efforts to bring inflation down to the target level. Accordingly, the interest rate on monetary deposits

2 Trends in the prices of food and industrial products in September 2023 were also affected by Croatian government measures to impose limits on the retail prices of some food and non-food products as of 18 September and keep them at a level lower than before. Several retail chains joined government efforts to ease inflationary pressures by reducing the prices of some 1000 products in the second half of September.

Figure 7 Indicators of external and domestic price pressures



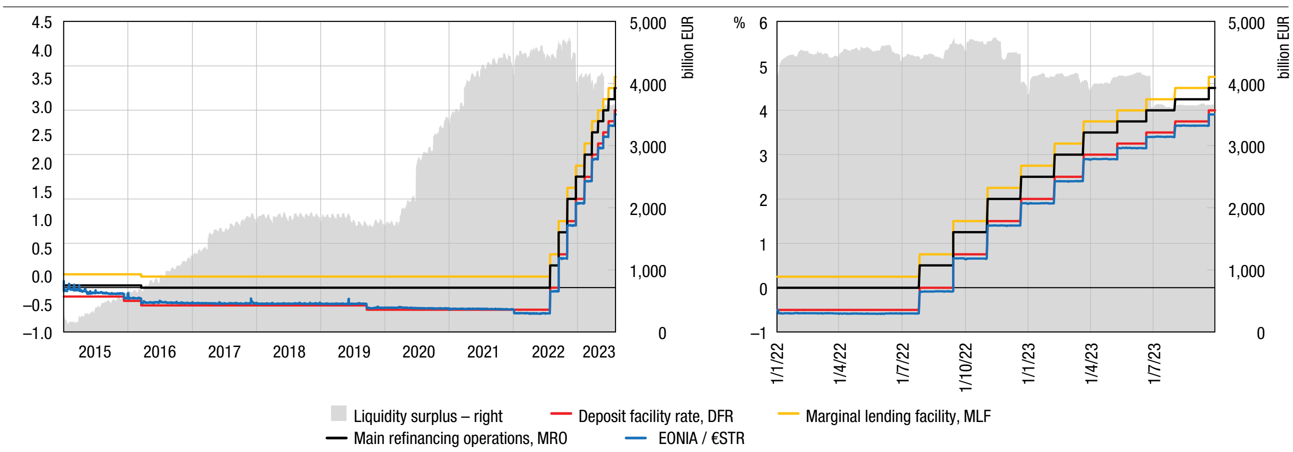
[a] Annual rate of change.
Notes: Labour shortage shows the ratio between the vacancy rate and the registered unemployment rate. The PMI EA Composite and ESI EA series have been corrected after standardisation so as to show the neutral value in white. The red (blue) colour indicates a positive (negative) deviation in the value in a given month relative to the 2010–2022 average (expressed by the number of standard deviations), where the intensity of the colour shade indicates the size of an upward (downward) deviation from the average.
Sources: ECB, SDW, Eurostat, Bloomberg, NY Fed, HWWI, CBS and Ipsos.

of credit institutions with the central bank (currently a relevant indicator of the ECB's monetary policy) has been set at 4.00% starting from 20 September. For the first time, the Governing Council pointed out that it considers that the key ECB interest rates have reached levels that, maintained for a sufficient duration, will make a substantial contribution to the timely return of inflation to the target. The Governing Council's future decisions will ensure that the key ECB interest rates are set at sufficiently restrictive levels for as long as necessary and will continue to follow a data-dependent approach.

The size of the Eurosystem's balance sheet is decreasing gradually, further strengthening the ECB's restrictive monetary policy stance (Figure 9). Banks are still repaying amounts borrowed under the targeted longer-term refinancing operations, whereas the portfolio of securities purchased within the asset purchase programme (APP) is declining steadily at a measured and predictable pace, given that from July 2023 the Eurosystem no longer reinvests the principal payments from maturing securities. By contrast, the principal payments from maturing securities purchased under the pandemic emergency purchase programme (PEPP) will be reinvested until at least the end of 2024. Also, flexibility will be applied in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

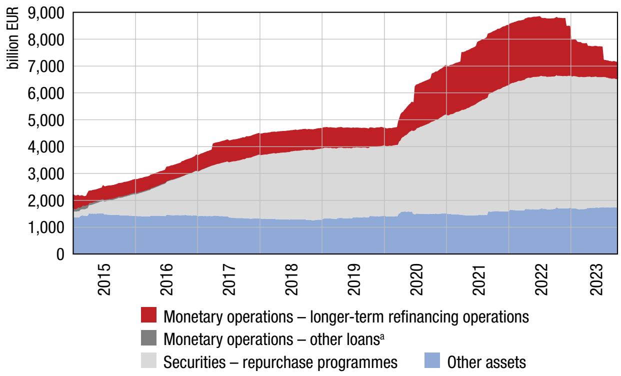
The rise in key ECB interest rates by a further 25 basis

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.

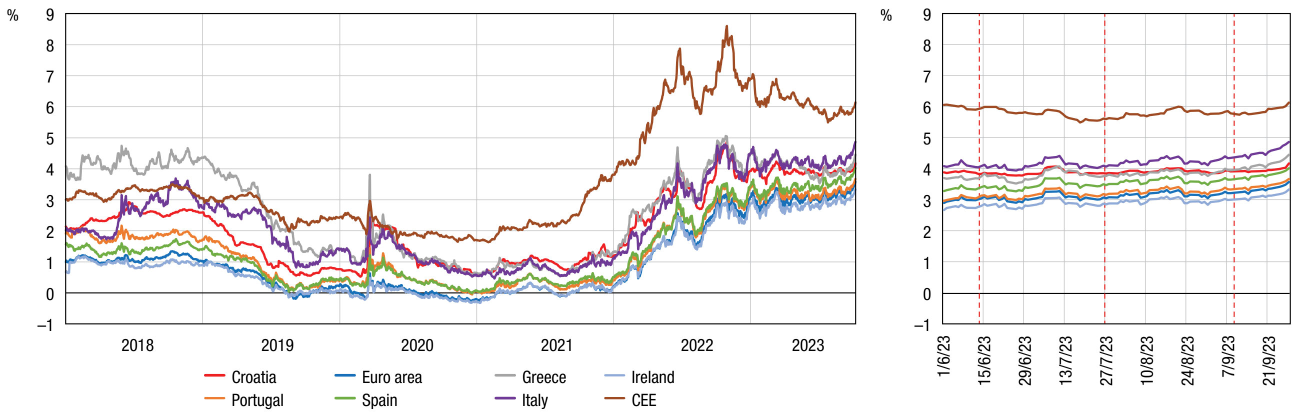
Figure 9 Eurosystem balance sheet



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.

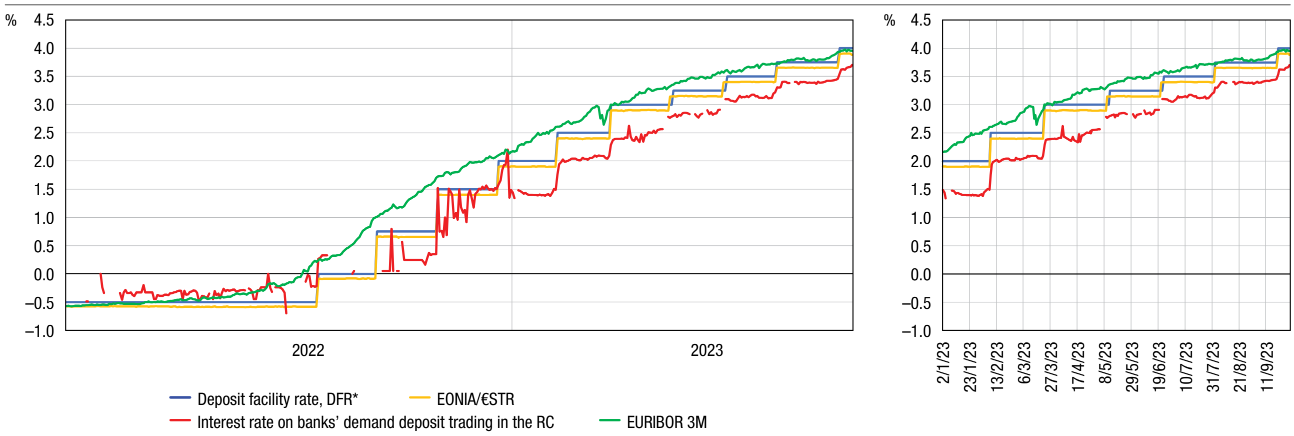
points immediately spilled over to money market interest rates and was accompanied by an increase in government bond yields. After the last decision of the Governing Council came into force on 20 September, the overnight interest rate on the European money market, €STR, closely followed the increase in key interest rates (a rise by 25 basis points) and reached 3.9%, remaining at that level until the end of the month (Figure 11). The three-month EURIBOR also continued to rise gradually, reflecting expectations of a prolonged period of high interest rates, and reached 4.0% at the end of September. 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 31 basis points in September, standing at 3.7% at the end of that month. Long-term euro area sovereign yields rose in September, driven in part by global factors, also evident in higher yields on US and UK bonds in the second half of the month, as well as factors related to the euro area, such as investor concerns regarding public finances in some Member States and the Governing Council's announcements of its intention to keep the key ECB interest rates high for a prolonged period (Figure 10). Even though the yields edged down in response

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



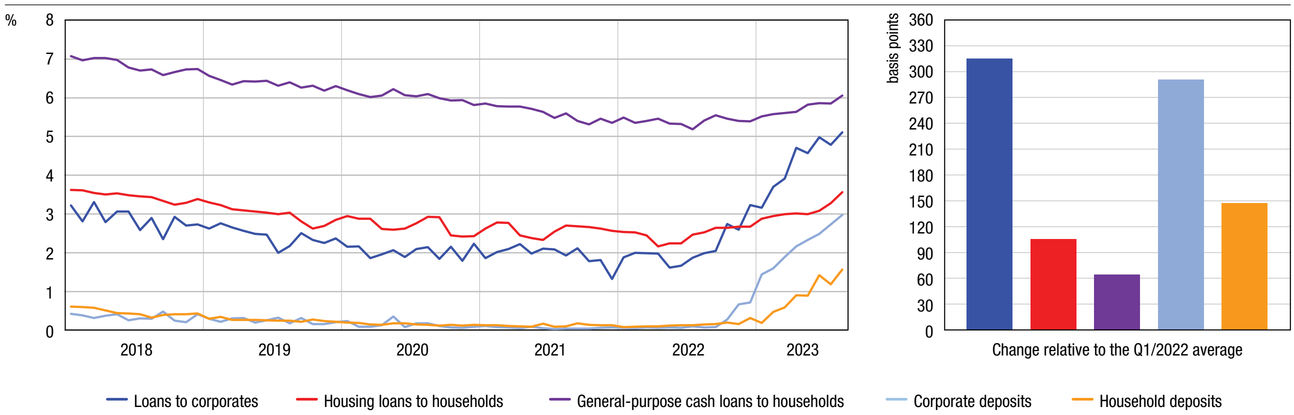
Notes: CEE – countries of Central and Eastern Europe (the Czech Republic, Hungary, Poland and Romania); yields for the euro area and CEE have been weighted by the share of GDP of the countries included. Data from the euro area do not include those from Estonia, Latvia, Luxembourg and Malta. The red dotted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

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



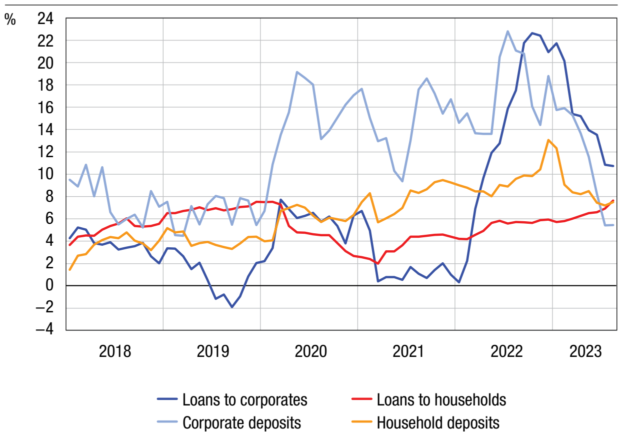
Notes: DFR (deposit facility rate). The EONIA was replaced by €STR in early 2022. The overnight interest rate on the money market in Croatia in 2022 is based on euro transactions.
Sources: ECB and CNB.

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.

to more favourable preliminary data on inflation in the euro area and in Croatia published in late September, they remained higher than at the beginning of the month. The euro area GDP-weighted average of long-term government bond yields rose by 45 basis points in September, reaching 3.5%, with the yield on long-term Croatian bonds growing by 19 basis points, to 4.1%.

The growth in key ECB interest rates is increasingly passing through to domestic financing conditions, with rising interest rates on domestic sectors' borrowing from banks being coupled with growing interest rates on deposits. The average interest rate on pure new loans to non-financial corporations reached 5.1% in August, up by 32 basis points from the month before, or up by 315 basis points from the period preceding monetary policy normalisation (Figure 12). The growth in the interest rate on pure new loans to corporates in August was largely driven by the increase in the share of syndicated loans (granted at relatively high interest rates) in total financing, with a simultaneous decrease in the share of loans granted at relatively low interest rates (working capital loans). Households also borrowed at higher interest rates in August than in July, for both housing and general-purpose cash loans. The interest rate on pure new housing loans increased by 28 basis points in August and stood at 3.5%, partly reflecting 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. At the same time, the interest rate on pure new general-purpose cash loans stood at 6.0%, up by 20 basis points from the month before. Viewed in relation to the period preceding the ECB's monetary tightening cycle, the interest rate on pure new housing loans rose by 105 basis points, while that on pure new general-purpose cash loans grew by 64 basis points. Parallel to the rise in lending rates, the interest rates on deposits also grew perceptibly in August. This was more evident in the household sector, with the interest rate on pure new time deposits of households standing at 1.6%, up by 38 basis points from July and up by 147 basis points from the period preceding the lifting of key ECB interest rates. In August, the interest rate on total pure new corporate time deposits reached 3.0%, up by 24 basis points on the month before, and up by 291 basis points from the period preceding the increase in key ECB's interest rates.

Despite the steady rise in interest rates, the lending activity of banks remained relatively strong. Total loan growth was mostly driven by household loans, which accelerated their growth on an annual level from 6.9% in July to 7.6% in August (transaction-based). The growth in housing loans picked up from 9.5% to 10.1%, while the increase in general-purpose cash loans went up from 6.8% to 7.4%. Despite the slight improvement in July, corporate lending remained subdued. The growth in corporate loans slowed down slightly on an annual basis (from 10.8% in July to 10.7% in August) as even the marginal growth in August outpaced the rise seen in the same month last year. As regards domestic deposits, their growth picked up from 5.2% in July to 5.4% in August (transaction-based) on an annual basis, with growth in household deposits accelerating from 7.2% to 7.5% and growth in the deposits of non-financial corporations edging up from 5.4% to 5.5%, mostly owing to the good financial performance during the peak tourist season (Figure 13).