

Introduction

Having grown steadily in the first half of 2016, Croatia's economic activity accelerated further in the summer months of the year. The positive trends were primarily supported by strong tourism performance and the acceleration of recovery in personal consumption. Positive labour market trends notwithstanding, concerns have been raised over a gradual decline in the labour force, partly caused by the outflow of working age population, which has a diminishing effect on long-term growth potentials. The annual consumer price decline decelerated substantially in September and October from August, to a large extent due to energy price trends. Favourable fiscal developments continued, with the result that the general government deficit contracted significantly compared with the first ten months in 2015 and public debt remained almost unaltered from the end of 2015.

Pursuing an expansionary monetary policy, the CNB continued to support the recovery of the domestic economy, started already in late 2014, and maintain the stability of the kuna to euro exchange rate. In the Croatian monetary system, a stable exchange rate is a prerequisite for the preservation of financial stability and an anchor for expectations of future price trends. Structural repo operations, introduced by the CNB in early 2016, provide banks with long-term kuna liquidity, thus facilitating a long-term decrease in interest rates and stimulating lending in kuna. At the four reverse repo auctions held so far, the central bank placed a total of close to HRK 1bn for a period of four years, reducing the interest rate at the last two auctions

from 1.8% to 1.4%. The interest rate for regular weekly reverse repo operations was cut from 0.5% to 0.3% in mid-September and the amount of funds placed increased from the previous part of the year. Due to high liquidity in the financial market banks' lending and deposit rates decreased further. This, together with positive business and household expectations of future economic trends and improved credit standards, boosted loan demand and placement growth. Household placements recorded a positive growth rate for the first time since the several-year deleveraging in this sector.

As favourable developments continued early in the fourth quarter of 2016 (industrial production and retail trade increased and most confidence indicators improved) real activity is expected to grow at an annual rate of 2.6% in the last three months of the year. GDP could increase annually by 2.8% in 2016 and accelerate growth to 3.0% in 2017. Foreign demand could again be the biggest contributor to domestic activity growth. Gross fixed capital formation is also expected to rise, partly due to a better use of EU funds and persistent investments in the tourism sector. Due to the positive effects of the tax reform on net disposable household income, personal consumption will continue to grow and remain a significant contributor to overall GDP growth. The risks to the realisation of projected GDP growth rates are balanced. Specifically, the assumed growth rate of tourist services exports in 2017 could prove to be underestimated if trends recorded in the last two years continue and the tax

Table 1.1 Summary table of projected macroeconomic measures

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
National accounts (real rate of change, in %)										
GDP	2.1	-7.4	-1.7	-0.3	-2.2	-1.1	-0.5	1.6	2.8	3.0
Personal consumption	1.2	-7.5	-1.5	0.3	-3.0	-1.9	-1.6	1.2	3.1	3.3
Government consumption	-0.7	2.1	-1.6	-0.3	-1.0	0.3	-0.8	-0.3	1.4	1.0
Gross fixed capital formation	9.2	-14.4	-15.2	-2.7	-3.3	1.4	-2.8	1.6	4.1	6.8
Exports of goods and services	0.8	-14.1	6.2	2.2	-0.1	3.1	7.6	10.0	6.1	5.5
Imports of goods and services	4.0	-20.4	-2.5	2.5	-3.0	3.1	4.5	9.4	6.5	7.4
Labour market										
Number of employed persons (average rate of change, in %)	2.3	-2.1	-4.2	-1.1	-1.2	-1.5	-2.0	0.7	1.8	1.5
Registered unemployment rate	13.2	14.9	17.4	17.8	18.9	20.2	19.6	17.0	15.0	14.4
ILO unemployment rate	8.5	9.2	11.6	13.7	15.9	17.3	17.3	16.3	14.3	13.9
Prices										
Consumer price index (average rate of change, in %)	6.1	2.4	1.1	2.3	3.4	2.2	-0.2	-0.5	-1.2	1.6
Consumer price index (rate of change, end of period, in %)	2.9	1.9	1.8	2.1	4.7	0.3	-0.5	-0.6	0.1	1.6
External sector										
Current account balance (as % of GDP)	-8.8	-5.1	-1.1	-0.7	-0.1	1.0	2.1	5.1	2.8	2.0
Current and capital account balance (as % of GDP)	-8.7	-5.0	-1.0	-0.6	0.1	1.1	2.3	5.8	3.8	3.1
Gross external debt (as % of GDP)	84.3	101.1	104.2	103.7	103.0	105.3	107.9	103.4	93.8	87.5
Monetary developments (rate of change, in %)										
Total liquid assets – M4	4.1	-1.0	1.9	5.6	3.6	4.0	3.2	5.1	4.8	4.1
Total liquid assets – M4 ^a	3.8	-0.8	0.7	4.6	3.9	3.6	2.4	5.0	5.2	4.0
Credit institution placements to the private sector	10.7	-0.6	4.7	4.8	-5.9	-0.5	-1.6	-2.9	-4.0	-1.3
Credit institution placements to the private sector ^b	8.7	-0.3	2.3	3.5	-1.2	1.0	-1.5	-2.2	1.4	2.6

^a Exchange rate effects excluded.

^b Rates of change are calculated on the basis of transaction data (see Annex 1 Introduction of data on transactions in monetary developments analysis in Bulletin 221).

Note: The estimates for 2016 and projections for 2017 are derived from data available until 8 December 2016.

Sources: CBS, MoF and CNB.

reform could make a stronger impact on household consumption if a smaller part of the increased income is channelled to savings deposits. The main negative risks are related to external effects, such as a stronger than expected effect of the Brexit vote on economic trends in Croatia's foreign trade partners and a possible re-escalation of the refugee crisis.

The average annual consumer price inflation rate for 2016 is estimated at -1.2% , with the greatest negative contribution to inflation coming from energy. Crude oil prices are expected to increase slightly towards the end of the year and, aided by the base period effect, lead to a gradual increase in overall inflation. The average annual consumer price inflation rate could rise to 1.6% in 2017, primarily as a result of rising imported inflation pressures, including an expected increase in the prices of crude oil and other raw materials, the acceleration of the euro area inflation rate and the strengthening of the US dollar against the euro (and, in turn, against the kuna), as well as because of changes in the indirect tax system.

In 2016, fiscal policy was marked by the continued narrowing of the deficit, caused to a large extent by the cyclical upturn. The deficit could thus fall well below 2.7% of GDP on an annual basis in 2016, the figure required under the excessive deficit procedure (EDP). The projected general government debt dynamics suggest that the debt criterion could also be met and that Croatia could exit the corrective arm of the Stability and Growth Pact in 2017. However, the structural deficit will probably deepen in 2017.

Given a relatively low expected inflation rate and the still relatively slow recovery in lending to the private sector, monetary policy will remain expansionary. The stability of the kuna to euro exchange rate will also continue to be maintained. Domestic interest rates will remain low on the back of surplus kuna liquidity of the monetary system, supported by CNB's structural and regular repo operations, which is expected to spur placement growth and favourably influence overall economic developments.