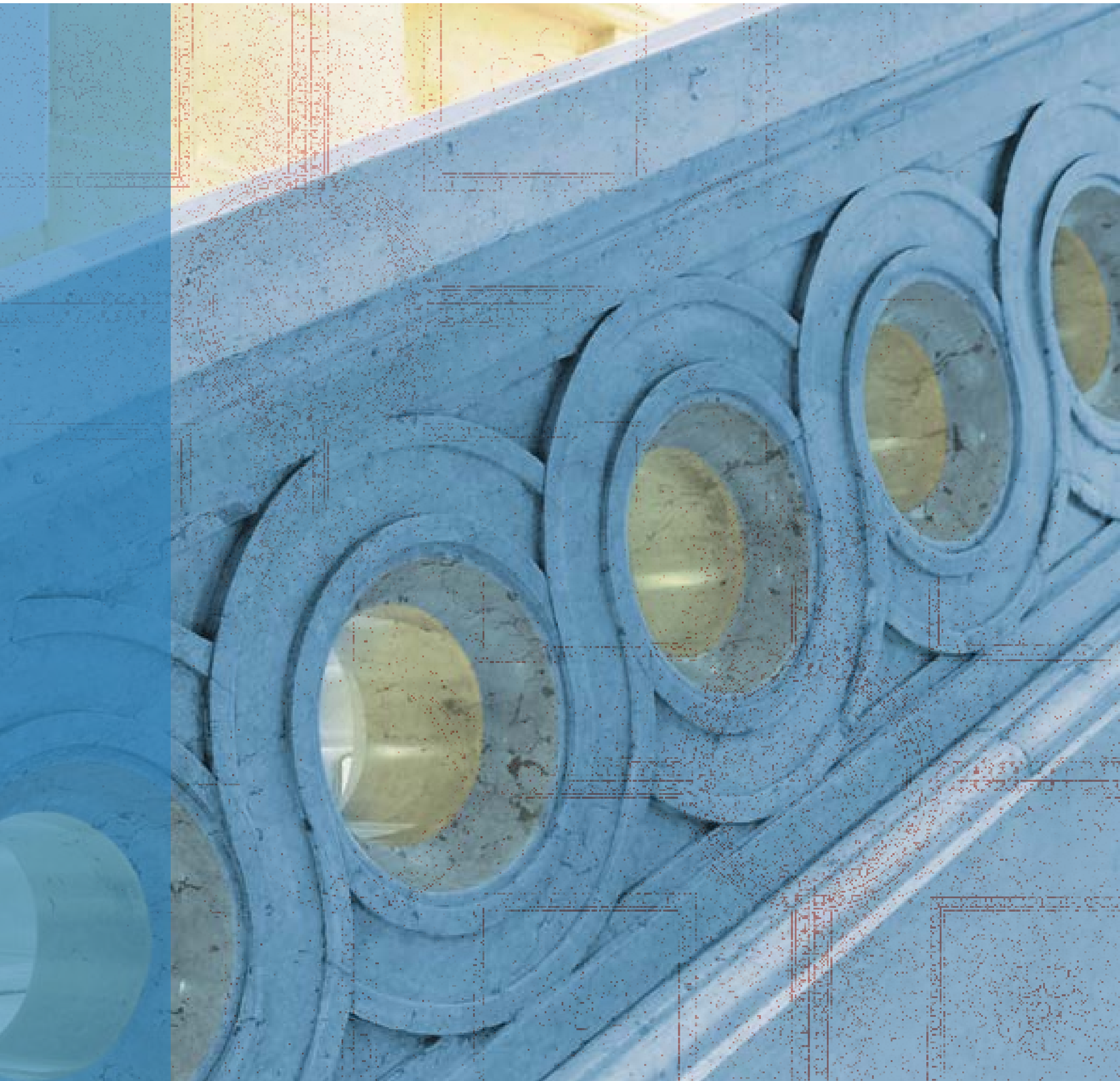
HNB

Macroeconomic Developments and Outlook

Year IV · Number 6 · July 2019



PUBLISHER

Croatian National Bank
Publishing Department
Trg hrvatskih velikana 3, 10000 Zagreb
Phone: +385 1 45 64 555
Contact phone: +385 1 45 65 006
Fax: +385 1 45 64 687

www.hnb.hr

Any additional corrections that might be required will be made in the website version.

ISSN 2459-8607

Contents

General information on Croatia

Economic indicators

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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]	4.310	4.303	4.290	4.280	4.268	4.256	4.238	4.204	4.174	4.125	4.089
GDP (million HRK, current prices)[b]	347,750	331,367	329,143	333,457	330,825	331,785	331,570	339,616	351,349	365,643	381,799
GDP (million EUR, current prices)	48,144	45,148	45,173	44,854	44,008	43,808	43,456	44,630	46,664	49,013	51,496
GDP per capita (in EUR)	11,171	10,493	10,530	10,480	10,311	10,293	10,254	10,616	11,180	11,882	12,594
GDP – real year-on-year rate of growth (in %)	2.0	–7.3	–1.5	–0.3	–2.3	–0.5	–0.1	2.4	3.5	2.9	2.6
Average year-on-year CPI inflation rate	6.1	2.4	1.1	2.3	3.4	2.2	–0.2	–0.5	–1.1	1.1	1.5
Current account balance (million EUR)[c]	–4,227	–2,299	–482	–313	–50	414	858	2,066	1,173	1,700	1,267
Current account balance (as % of GDP)	–8.8	–5.1	–1.1	–0.7	–0.1	0.9	2.0	4.6	2.5	3.5	2.5
Exports of goods and services (as % of GDP)	38.5	34.5	37.6	40.4	41.6	42.8	45.3	48.1	48.8	51.3	51.9
Imports of goods and services (as % of GDP)	46.5	38.2	38.0	40.8	41.2	42.5	43.4	45.8	46.0	49.1	50.9
External debt (million EUR, end of year)[c]	40,590	45,600	46,908	46,397	45,297	45,803	46,416	45,384	41,668	40,247	38,836
External debt (as % of GDP)	84.3	101.0	103.8	103.4	102.9	104.6	106.8	101.7	89.3	82.1	75.4
External debt (as % of exports of goods and services)	219.1	292.7	275.8	255.9	247.3	244.1	235.9	211.4	182.9	160.0	145.4
External debt service (as % of exports of goods and services)[d]	33.8	52.9	49.5	40.9	43.3	41.0	44.1	42.5	34.9	32.0	26.3
Gross international reserves (million EUR, end of year)	9,121	10,376	10,660	11,195	11,236	12,908	12,688	13,707	13,514	15,706	17,438
Gross international reserves (in terms of months of imports of goods and services, end of year)	4.9	7.2	7.5	7.3	7.4	8.3	8.1	8.0	7.6	7.8	8.0
National currency: kuna (HRK)											
Exchange rate on 31 December (HRK : 1 EUR)	7.3244	7.3062	7.3852	7.5304	7.5456	7.6376	7.6615	7.6350	7.5578	7.5136	7.4176
Exchange rate on 31 December (HRK : 1 USD)	5.1555	5.0893	5.5683	5.8199	5.7268	5.5490	6.3021	6.9918	7.1685	6.2697	6.4692
Average exchange rate (HRK : 1 EUR)	7.2232	7.3396	7.2862	7.4342	7.5173	7.5735	7.6300	7.6096	7.5294	7.4601	7.4141
Average exchange rate (HRK : 1 USD)	4.9344	5.2804	5.5000	5.3435	5.8509	5.7059	5.7493	6.8623	6.8037	6.6224	6.2784
Consolidated general government net lending (+)/borrowing (–) (million HRK)[e]	–9,605	–19,844	–20,655	–26,220	–17,420	–17,517	–17,033	–10,829	–3,440	2,889	758
Consolidated general government net lending (+)/borrowing (–) (as % of GDP)[e]	–2.8	–6.0	–6.3	–7.9	–5.3	–5.3	–5.1	–3.2	–1.0	0.8	0.2
General government debt (as % of GDP)[e]	39.0	48.3	57.3	63.9	69.5	80.4	84.0	83.7	80.5	77.8	74.6
Unemployment rate (ILO, persons above 15 years of age)	8.5	9.2	11.6	13.7	15.9	17.3	17.3	16.2	13.1	11.2	8.4
Employment rate (ILO, persons above 15 years of age)	48.6	48.2	46.5	44.8	43.2	42.1	43.3	44.2	44.6	45.8	46.9

[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 2018 are preliminary.
[b] The GDP data are presented according to the ESA 2010 methodology. Data for 2017 and 2018 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 first quarter of 2019 and data on the gross external debt position as at the end of March 2019.
[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

In the first quarter of 2019, the growth in economic activity accelerated compared to the last three months of 2018, which recorded only a small increase in current activity. In accordance with the favourable expectations regarding the growth in investment activity of the public and the private sectors and in household consumption, in 2019 GDP growth rate might reach 3.1%. The labour market expects to see a further growth in the number of employed persons and a fall in the unemployment rate; however, the dynamics of favourable developments will gradually decrease. Inflation in 2019 is expected to slow down to 0.7%, mainly due to a fall in the contribution of energy prices and the effect of the reduction in the value added tax on food products and pharmaceutical products. The expected decline in the current and capital account surplus is the result of a further widening of the foreign trade deficit the effects of which are mitigated by a further growth in net exports of services and an increase in the use of EU funds. At the same time, the trend of improvement in the relative indicators of external debt might continue. The CNB has continued to pursue an expansionary monetary policy and support economic recovery while maintaining the stability of the exchange rate of the kuna against the euro. As regards fiscal developments, according to the Convergence Programme of the Government of the Republic of Croatia, the general government budget balance might be around –0.3% of GDP in 2019, while the projection of the European Commission suggests a more favourable balance.

Economic growth accelerated in the first quarter of 2019, with the real GDP rising by 1.8% from the last three quarters of 2018 when it rose by 0.2%. A high growth of 3.9% was recorded on an annual level in the first quarter of 2019, mostly fuelled by very favourable developments in household consumption and capital investments and a positive contribution to economic activity from government consumption. As regards foreign demand, goods exports grew at a higher rate than at the end of the previous year, while the annual growth rate of goods exports slowed down. Since total goods imports accelerated, the contribution of net foreign demand to total economic growth remained negative at the beginning of 2019. High-frequency data for April point to further economic growth in the second quarter of this year with the real GDP growth estimation for 2019 standing at 3.1%. Household consumption is expected to accelerate and be the main driver of economic growth this year. Capital investments are expected to accelerate as a result of increased investment activity of the private and public sector, and government consumption might also make a positive contribution to GDP growth. As regards foreign demand, goods and services

Table 1.1 Summary table of projected macroeconomic measures

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
National accounts (real rate of change, in %)											
GDP	–1.5	–0.3	–2.3	–0.5	–0.1	2.4	3.5	2.9	2.6	3.1	2.7
Personal consumption	–1.5	0.3	–3.0	–1.9	–1.6	1.0	3.4	3.6	3.5	4.2	3.7
Government consumption	–0.6	–0.4	–0.8	0.6	1.8	–1.0	0.7	2.7	2.9	2.7	2.4
Gross fixed capital formation	–15.2	–2.7	–3.3	1.4	–2.8	3.8	6.5	3.8	4.1	8.0	6.5
Exports of goods and services	6.2	2.2	–0.1	3.1	6.0	9.4	5.6	6.4	2.8	2.7	2.8
Imports of goods and services	–2.5	2.5	–3.0	3.1	3.1	9.2	6.2	8.1	5.5	5.8	5.3
Labour market											
Number of employed persons (average rate of change, in %)	–4.2	–1.1	–1.2	–1.5	–2.0	0.7	1.9	1.9	2.3	1.9	1.2
Registered unemployment rate	17.4	17.8	18.9	20.2	19.6	17.0	14.8	12.1	9.7	8.6	7.8
ILO unemployment rate	11.6	13.7	15.9	17.3	17.3	16.2	13.1	11.2	8.4	7.2	6.5
Prices											
Consumer price index (average rate of change, in %)	1.1	2.3	3.4	2.2	–0.2	–0.5	–1.1	1.1	1.5	0.7	1.1
Consumer price index (rate of change, end of period, in %)	1.8	2.1	4.7	0.3	–0.5	–0.6	0.2	1.2	0.8	1.3	1.1
External sector											
Current account balance (as % of GDP)	–1.1	–0.7	–0.1	0.9	2.0	4.6	2.5	3.5	2.5	1.3	0.4
Current and capital account balance (as % of GDP)	–0.9	–0.6	0.0	1.1	2.4	5.3	3.9	4.5	3.8	3.1	2.2
Gross external debt (as % of GDP)	103.8	103.4	102.9	104.6	106.8	101.7	89.3	82.1	75.4	69.5	65.3
Monetary developments (rate of change, in %)											
Total liquid assets – M4	1.9	5.6	3.6	4.0	3.2	5.2	4.7	2.1	5.5	2.9	4.2
Total liquid assets – M4[a]	0.7	4.6	3.9	3.6	2.4	5.0	5.3	3.1	6.1	3.4	4.3
Credit institution placements to the private sector	4.7	4.8	–5.9	–0.5	–1.6	–3.0	–3.7	–1.2	2.0	3.9	3.9
Credit institution placements to the private sector[b]	2.3	3.5	–1.2	1.0	–1.5	–2.2	1.1	2.9	4.4	4.3	4.3
Credit institution placements to corporates[b]	5.9	7.6	–1.5	2.2	–3.7	–2.9	3.2	2.5	1.9	2.2	3.1
Credit institution placements to households[b]	–1.4	–0.7	–1.1	–1.2	–0.7	–1.7	0.5	4.0	6.2	6.1	5.4

[a] Exchange rate effects excluded.
[b] 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.

exports are expected to grow. However, an acceleration of domestic demand and the expected rise in total goods exports will probably result in faster imports of goods and services. As a result, the negative contribution of net foreign demand to economic growth is expected to be bigger than in 2018. Economic activity in 2020 might rise by 2.7%, with the annual slowdown in the real growth being primarily attributable to the smaller increase in capital investments expected as well as in household consumption. According to the central estimates and projections of real GDP growth in 2019 and 2020, the risks are balanced.

In 2018, the number of employed persons rose by 2.3% on an annual level, while the ILO unemployment rate fell on average to 8.4%. In view of relatively favourable developments in the preceding part of the year, employment could rise by 1.9% and the ILO unemployment rate could fall to 7.2% in 2019. Both the private and the public sector expect to see a further growth in gross and net wages. The labour market will also see further, albeit slightly slower, positive developments next year.

The average annual consumer price inflation could slow down to 0.7% from 1.5% in 2018, as a result of the fall in the growth rate of energy and food prices expected. The projected slowdown in the annual growth rate of energy prices can largely be attributed to a smaller contribution of refined petroleum products to inflation, which reflects developments in the global market. The slowdown in the annual growth of food prices in 2019 was largely due to a fall in the rate of VAT on some food products. Imported inflationary pressures in 2019 might be mainly subdued, taking into account, for instance, the expected small fall in crude oil prices on the global market and the ECB's downward revision of core inflation in the euro area under the June 2019 projection. Domestic inflationary pressures might increase slightly due to the acceleration of growth in domestic demand and a small increase in positive output gap in 2019, as well as to cost pressures stemming from growing unit labour costs, i.e. the faster wage than labour productivity growth, but subdued foreign inflation and the effects of tax changes might overpower them. The projected acceleration in consumer price inflation to 1.1% in 2020 might mostly be attributed to the increase in the average annual rate of change in food prices, mostly as a result of the waning effect of the reduced VAT rate in early 2019 on the annual rate of change of this CPI component. The risks of lower or higher than projected inflation this and next year are estimated to be balanced.

The surplus in the capital and current account might fall in 2019 and 2020 from 2018 as a result of a further widening of the foreign trade deficit. However, further growth in net services exports might alleviate the unfavourable developments, particularly owing to a rise in revenues from tourism, though slower than in the previous years. In addition, the surplus in the secondary income account and capital transactions account is expected to rise as a result of increased use of EU funds. With regard to foreign capital flows, the net outflow of capital might decline gradually in this and the following year. The expected net outflow reflects a further decline in net foreign debt liabilities of the domestic sector and a further improvement of the relative indicators of gross and net external debt. International reserves are also expected to grow sharply.

By pursuing an expansionary monetary policy, the CNB has continued to support the exceptionally high levels of monetary system liquidity while maintaining at the same time a stable exchange rate of the kuna against the euro. In such conditions, banks had no interest in the short-term kuna funds offered at regular weekly reverse repo auctions. High liquidity also continued to support the trend of falling interest rates on loans of domestic credit institutions present for many years, which has, along with employment and economic activity growth, led to increased lending to domestic sectors. In the first five months of 2019, the annual growth of placements to non-financial corporations slowed down, while household placements accelerated, mostly fuelled by growth in general-purpose cash loans. To lessen the risks associated with the granting of general-purpose cash loans, in February the CNB issued a Recommendation on actions in granting non-housing consumer loans, recommending credit institutions to exercise caution when granting new general-purpose cash loans, particularly loans with longer maturities and encouraging consumers to exercise prudence when borrowing.

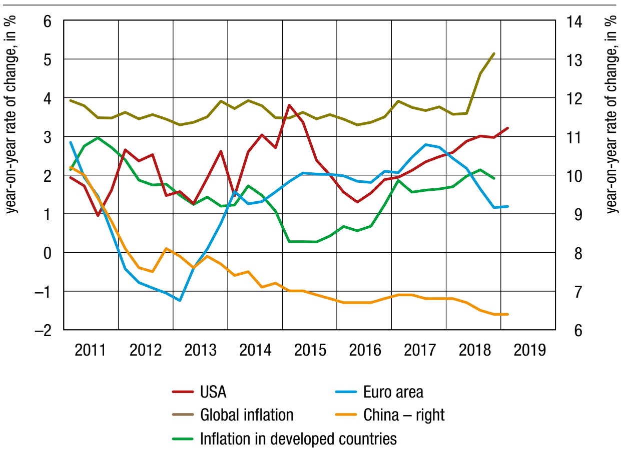
Despite growth on the expenditure side of the budget, partly as a result of activation of guarantees issued to shipyards, the general government ran a surplus of HRK 0.8bn (0.2% of GDP) in 2018. At the same time, the relative indicator of public debt, which stood at 74.6% of GDP at the end of 2018 continued to decline. The Convergence Programme of the Republic of Croatia suggests that the general government might run a deficit of –0.3% of GDP in 2019 and a surplus of 0.2% of GDP in 2020. In June this year, the European Commission issued an assessment of the mid-term fiscal projections of the Government of the Republic of Croatia establishing that the general government balance might be more favourable in both 2019 and 2020. The Commission is also of the opinion that the general government debt will continue to decline in accordance with the prescribed fiscal rules.

2 Global developments

Developments in the global economy were relatively unfavourable towards the end of 2018 but improved somewhat in the first quarter of 2019. The slowdown in economic growth towards the end of 2018 was widespread, particularly in the developed countries, and was accompanied by global trade weakening in the conditions of rising trade tensions. As the uncertainty temporarily eased in the first quarter of 2019 and the one-off negative effects in large countries waned, global economic activity has stabilised. Nevertheless, global inflation remained relatively low, with the exception of some emerging markets hit by crisis. Due to the accommodative monetary policies still prevailing in the majority of large economies financing conditions remained relatively favourable, except in several unstable emerging markets countries.

Unlike most other developed countries, the USA achieved very good economic results, with the annual growth reaching 3.2% in the first quarter of 2019, the fastest growth since 2015. The main driver of the US economic growth was again personal consumption even though it was slower than in the previous several quarters. The growth was also fuelled by considerable private sector investment activity and even more by the slowdown in imports which had grown sharply in the previous quarters in expectation of the announced duties. US core inflation remains subdued, although overall inflation in April 2019 stood at 2.0%,

Figure 2.1 Economic growth in selected markets and global inflation



Sources: Eurostat, BEA, NBS and IMF.

exceeding the average of other developed countries.

After a considerable slowdown in the previous two quarters, the annual growth in the euro area stabilised at 1.2% in the first quarter of 2019. All the biggest member states, including Germany, Italy and France, made a positive contribution to growth. After two quarters of negative growth, Italy thus exited the recession and the slowdown of German economic growth came to a halt, although at a relatively low level of 0.7% annually. In addition, it appears that strikes in France did not have a big impact on economic activity. Overall, in the first quarter of 2019, private sector investments and personal consumption made the biggest contribution to economic growth in the euro area, followed by the contribution of goods and services exports, partly transferred from the previous quarter, in which some goods exports from Germany were postponed due to problems in the car industry and low water levels on the River Rhine.

As regards the group of countries with emerging market economies, early 2019 saw a slowdown in the growth recorded in the preceding quarters. This is particularly true of China whose growth stabilised at the annual level of 6.4%, which indicates that infrastructural incentives do produce the desired effect. Oil-exporting countries benefitted from the price growth seen at the beginning of the year. However, the long-lasting crisis in some regions, notably in Latin America and the Middle East, was further exacerbated.

Croatia's main trading partners

Most of Croatia's main trading partners witnessed a small improvement in economic activity at the beginning of 2019 from the previous few quarters, although their growth is still relatively slow. This is particularly true of the trading partners from the euro area, such as Italy and Germany. Italy's economic growth in the first quarter of 2019, although barely positive, was supported by a certain progress achieved in the agreement with the European Commission on the 2019 budget, which temporarily eased the uncertainty. It appears that the trend of slowdown in economic activity in Germany was also brought to a halt, owing to a gradual normalisation of car industry deliveries and improvement in weather conditions. The growth rate of economic activity also stabilised in Austria and Slovenia and stood at higher rates than the averages in the euro area. Trading partners in the SE region, particularly Serbia and Bosnia and Herzegovina also witnessed higher growth rates in early 2019 than partners from the euro area, although they were lower than in the previous years.

Prices, exchange rates and financing conditions

As regards the prices of raw materials, early 2019 was marked by a trend of growth in crude oil prices on the global market. The price of a barrel of Brent crude oil reached USD 72 at the end of April, an increase of over one third from the end of 2018. This can be mostly attributed to factors on the supply side which include cuts in oil output agreed by OPEC countries and other major producers and the fall in oil output in Iran, Libya and Venezuela caused by geopolitical uncertainties. The increase in the price of crude oil was also driven by the expected decline in the supply of this energy product following the US decision to end sanction exemptions for major importers of Iranian oil such as China and India. The price increase was also driven by some factors on the demand side associated, among other things, with more favourable than expected developments in global activity at the beginning of the year.

The trend of crude oil prices to increase was halted in May and the price of a barrel fell to USD 66 by the end of the month. This was mostly due to the heightening of trade tensions between the USA and China and the possible unfavourable effects including an economic growth slowdown and a reduced demand for oil. The price fall was also due to increased oil production in the USA and a rise in crude oil reserves.

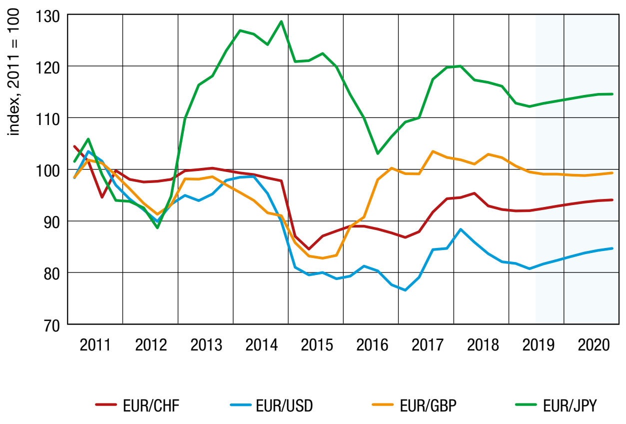
The price of raw materials excluding energy rose slightly in the first five months of 2019. This was mostly due to the increased price of iron ore that may be associated with disturbances in supply. At the same time, prices of various groups of food products, including cereals, oil seeds, beverages and sugar fell.

With regard to monetary policy, early 2019 witnessed a significant turn in Fed policy. In 2018, the Fed raised interest rates four times, pursuing a normalisation of monetary policy. But, at the beginning of this year, the Fed changed direction and left the interest rates unchanged, explaining that the interest rates reached were in line with the objectives of full employment and low inflation. As regards the ECB, from the end of 2018 when it ended the bond purchase programme, the central bank did not change the benchmark interest rates. This year it further postponed the raising of interest rates and announced a fresh stimulus in the form of cheap long-term financing of banks from the euro area that will start in September 2019 and end in March 2021.

On the global foreign exchange market, the American dollar continued to strengthen against the euro in the first five months of 2019, contrary to expectations. At the end of May 2019, the exchange rate of the US dollar against the euro stood at EUR/USD 1.11, which is an increase of 2.8% from the end of 2018. Its strengthening was due, on the one hand, to good economic indicators in the USA and decreased trade tensions with China, which heightened the confidence in the American economy. By contrast, the economy of the euro area during that period was under the pressure of rising uncertainty and political risks associated with Brexit. The turn in the Fed's monetary policy alleviated the strengthening of the dollar to some extent. At the same time, although it was expected to weaken, the exchange rate of the Swiss franc against the euro remained relatively stable. Thus the exchange rate of the Swiss franc against the euro was only 0.1% lower than at the end of December 2018 and stood at EUR/CHF 1.12.

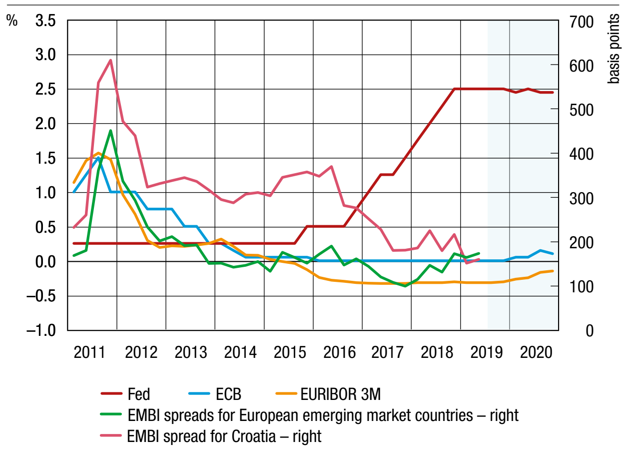
Financing conditions for European emerging markets, Croatia included, remained relatively favourable in the past several months. The EMBI index, after a 2018 growth fuelled by high trade tensions and the culmination of the political and economic

Figure 2.2 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 (June 2019).

Figure 2.3 Benchmark interest rates and the average yield spread on bonds of European emerging market countries
end of period



Source: Bloomberg (forecast), 7 June 2019.

crisis in Turkey, stabilised at the level reached in the first half of 2019.

Projected developments

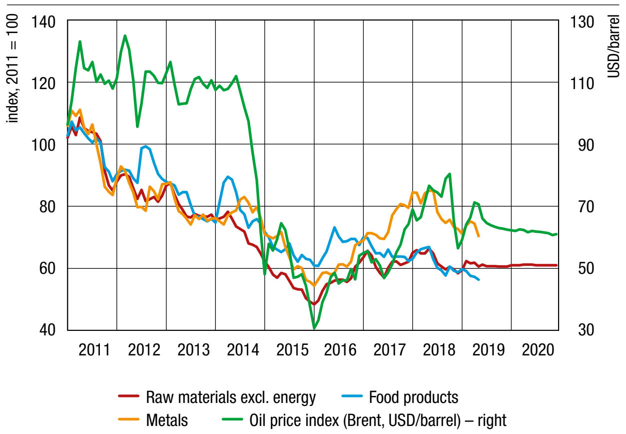
The projection is based on the assumptions of a moderate slowdown of global trade which will decelerate the growth of developed countries, of a moderate strengthening of the euro against major global currencies, and the reduced divergence between the monetary policies of the USA and the euro area. Furthermore, crude oil prices are expected to fall, while the prices of other raw materials excluding energy might fall slightly in 2019 and rise slightly in the following year.

According to the expectations published in the June 2019 Foreign Exchange Consensus Forecast, the projection period might see a small recovery of the euro on the global foreign exchange market. The average exchange rate of the US dollar against the euro might stand at EUR/USD 1.13 in 2019, a decrease of 4.4% from EUR/USD 1.18 in 2018. As regards the Swiss franc, the average exchange rate in 2019 might stand at EUR/CHF 1.13, a decrease of 2.2% from 2018.

In contrast with end-2018, when the three-year trend of monetary policy tightening in the US was expected to continue, the Fed announced in January that in 2019 it would probably not raise its benchmark interest rates due to the signs of slowdown of the domestic economy and of worsening of the global environment. This was confirmed at the Fed's meetings in March and June and at the latter meeting a possible interest rate cut was announced. The markets expect that the interest rate cuts might take place before the end of the current year. As a result of relatively slow economic developments and low inflation, the ECB further relaxed its, postponing the expected first increase of the ECB's benchmark interest rate by two quarters, or until mid-2020.

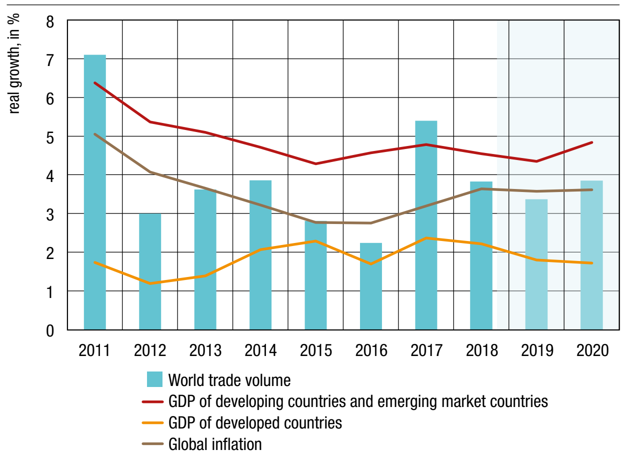
As regards the prices of raw materials on the global market, market expectations suggest that crude oil prices might fall additionally in the rest of the year and in the following year. The factors contributing to this include, among others, a slowdown in the growth of global demand, caused by trade tensions and other negative risks to global economic growth and a further production growth in the US and uncertainty regarding further compliance with the agreement to cut oil production by some of the world's largest oil producing countries. The prices of other

Figure 2.4 Prices of raw materials on the international market



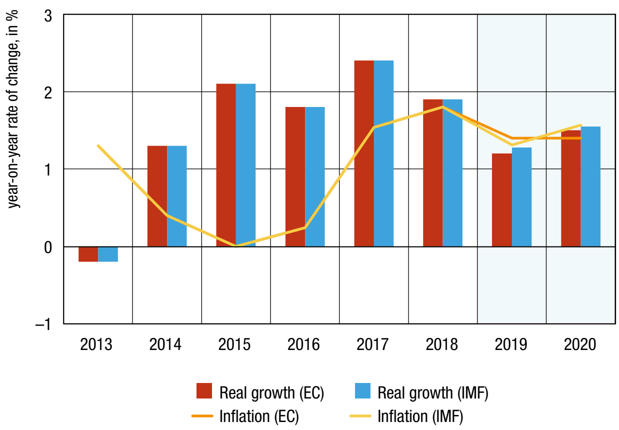
Sources: HWWI, IMF (May 2019), oil prices: Bloomberg (Brent crude oil futures, 30 May 2019) and CNB estimates.

Figure 2.5 Global economic developments



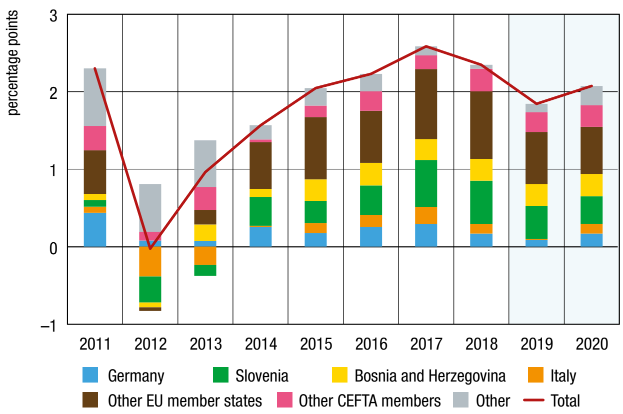
Source: IMF (WEO, April 2019).

Figure 2.6 Economic growth and inflation in the euro area



Sources: IMF (WEO, April 2019) and EC (May 2019).

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, April 2019).

raw materials might also fall slightly during 2019 as a whole. A fall in the prices of food products, agricultural raw materials and beverages could be accompanied by a rise in metal prices. The expected rise in metal prices is lower than that last year and is mostly associated with a further increase in demand from China, the world's biggest producer. By contrast, the prices of other raw materials might rise slightly in 2020, with the prices of food products and beverages expected to rise and those of metal to fall.

As regards global economic activity, under the last IMF projections (WEO, April 2019), global economic growth is first expected to slow down in 2019 to 3.3% and then accelerate to 3.6% in 2020. The growth might remain unbalanced and exposed to large uncertainties and negative risks. On the one hand, economic growth of emerging market economies might accelerate slightly in the projection period and provide a growing impetus to global growth. On the other, developed countries' growth might continue to decelerate. Amid weakening demand from developed countries and the absence of growth in the prices of raw materials, no significant acceleration of inflation is expected in the forthcoming period. The financing conditions might deteriorate further for some countries exposed to specific risks, but on the global level they should remain relatively favourable, owing to the accommodative monetary conditions prevailing in most large economies.

With regard to the euro area, the IMF estimates that economic growth in this area could slow down from 1.8% in 2018 to 1.3% in 2019 and accelerate slightly to 1.5% in 2020. More recent projections of the European Commission from May and the ECB from June 2019 support these expectations (the projected growth stands at 1.2% in 2019 and 1.4-1.5% in 2020). The growth of the euro area in 2019 will be constrained most by the uncertainty that has for some time already had a negative impact on investment activity and investment, with weakening of global demand also possibly having a significant effect. However, a small fiscal expansion, wage growth and favourable financing conditions are expected to boost growth. The unfavourable global factors are expected to be reflected the most in the most open member states, such as Germany, whose growth might slow down to only 0.8%. With stabilisation of the global economy in 2020 and easing of uncertainties, euro area growth is expected to recover slowly. Inflation in the euro area might remain below the ECB target over the projection period, mainly due to the expected fall in the price of energy products and the weak small spillover of wage growth onto inflation (according to the latest projections of the ECB, after standing at 1.8% in 2018, inflation is expected to reach 1.3% and 1.4% in 2019 and 2020, respectively).

The IMF expects that economic growth in the USA, after reaching 2.9% in 2018, the highest rate in the last few years, will slow down to 2.3% and 1.9%, respectively in the following two years. Growth slowdown is expected primarily because of gradual waning of the positive effect of the tax reform in 2017 and the negative effect of protectionist measures that could spill over to corporate sector earnings and limit their room for investments. Another factor that could impede USA growth, in addition to the negative effect of global demand weakening, is the structural limitations on the labour market.

In accordance with the described trends in the global economy and trade, the rise in demand for Croatian exports is also expected to diminish over the projection period (Figure 2.7). Of Croatia's major trading partners, the demand from euro area member states is expected to fall the most, particularly the demand from Italy and Germany, whose growth might be below the average of the countries in this group. A slowdown in economic activity is also likely in Slovenia and Austria. By contrast, the growth of foreign trade partners in the SE region (most notably Serbia and Bosnia and Herzegovina) is expected to remain relatively dynamic, although slightly slower than the very good rates of growth recorded in 2018.

The outlook on global economic growth is exposed to increasing negative risks, which have begun to materialise in part. The greatest risk that has not been factored in the main projections of the IMF and the European Commission lies in a hard Brexit, the probability of which has increased additionally. The trade relations between China and the USA continue to be tense and their significant worsening might have bigger consequences on global growth and trade. Another significant risk lies in faster than envisaged slowdown of the Chinese economy if economic policy incentives fail to prove sufficiently efficient. By contrast, the risks of a possible faster normalisation of monetary policy in the USA have lessened after the Fed halted the three-year cycle of monetary policy tightening in January.

3 Aggregate supply and demand

Real GDP rose by 1.8% in early 2019 compared with the previous quarter, in which stagnation was recorded. Such developments mostly reflect acceleration of investment activity, but if compared with the previous quarter, other components of GDP also grew. The available monthly indicators for April suggest that economic growth was slightly lower in the second quarter of this year than in the beginning of the year.

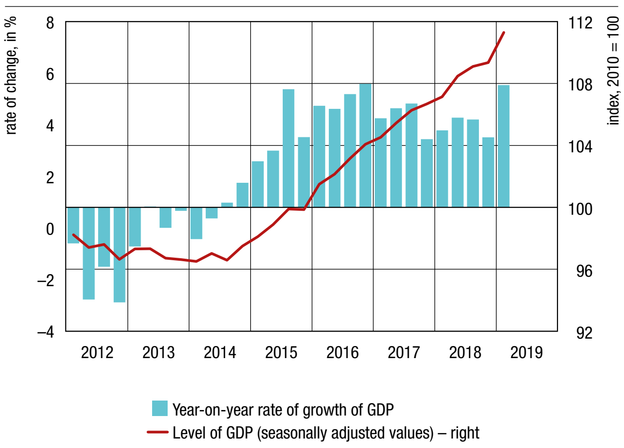
The strengthening of economic activity in early 2019 from the end of the previous year resulted in an increase in economic growth rate on an annual level: real GDP was 3.9% higher in the first quarter of 2019 than in the same period of 2018. Personal consumption again made the biggest contribution to economic activity growth from the same period of the previous year, followed by gross fixed capital formation, whose positive contribution was almost equal to the contribution of household consumption. Goods and services exports were also up from the same period of the previous year but strong domestic demand resulted in high imports, leaving the contribution of net foreign demand to increased economic activity negative.

The production side of the calculation of GDP shows that gross value added rose substantially less: 3.2% from the first quarter of 2018. All activities recorded an increase on an annual level, and the real growth in gross value added was fuelled the most by service activities such as retail trade, transportation and storage, accommodation and food service activities and construction.

Aggregate demand

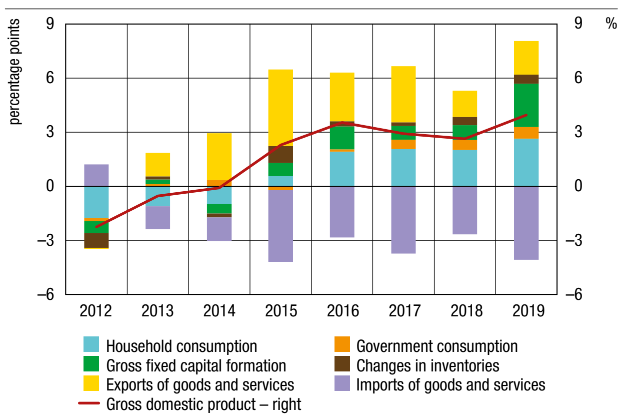
In the first quarter of 2019, the real exports of goods and services rose by 3.1% from the previous quarter, after their fall in the second half of 2018. The growth on a quarterly level in the first quarter was the result of a rise in goods exports, while services exports held steady at end-2018 levels. Nominal data on the trade in goods show that of the main industrial groupings, exports of intermediate goods, durable and non-durable consumer goods were greater in the first three months of this year

Figure 3.1 Gross domestic product
real values



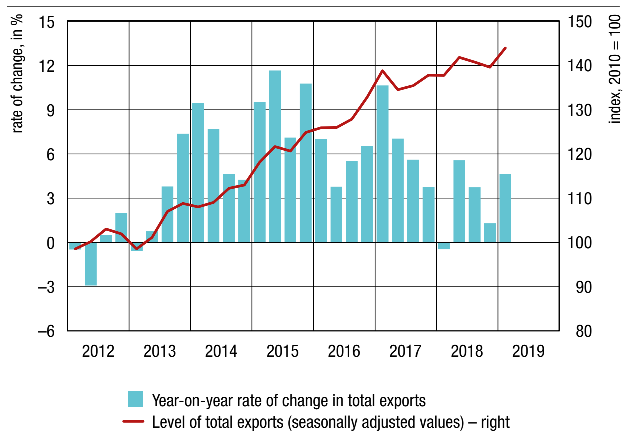
Source: CBS (seasonally adjusted by the CNB).

Figure 3.2 GDP rate of change
contributions by components



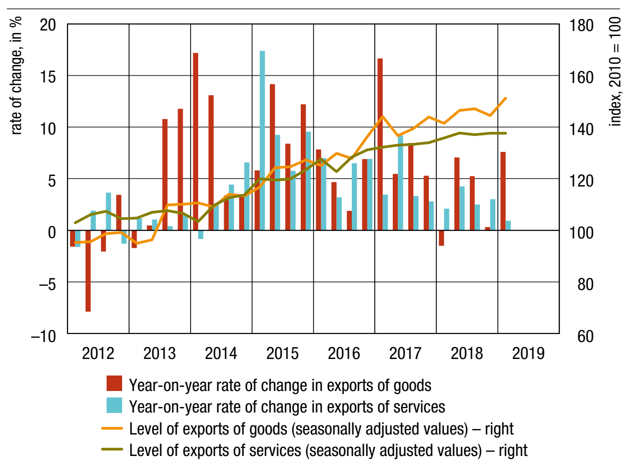
Notes: Data for 2019 refer to the first quarter of 2019. In that quarter, real GDP growth shown as the sum of contributions of individual components significantly deviates from the real GDP growth rate.
Source: CBS.

Figure 3.3 Exports of goods and services
real values



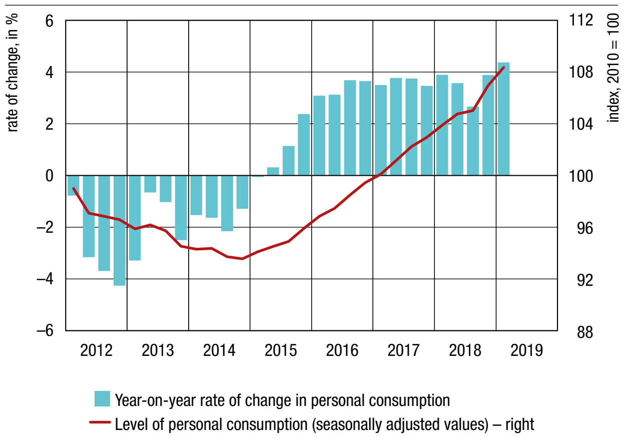
Source: CBS (seasonally adjusted by the CNB).

Figure 3.4 Real exports of goods and services



Source: CBS (seasonally adjusted by the CNB).

Figure 3.5 Personal consumption
real values



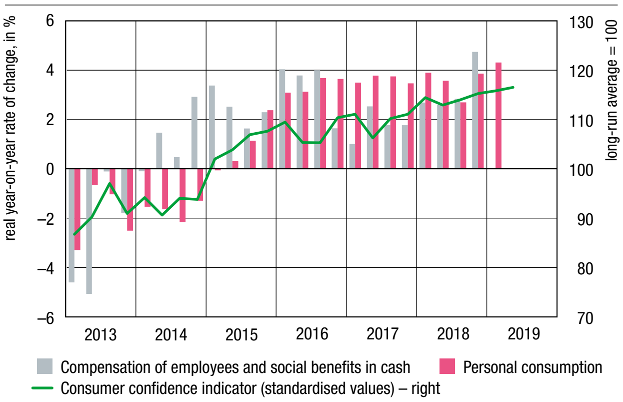
Source: CBS (seasonally adjusted by the CNB).

than in the previous quarter while the exports of capital goods held steady during that period. On an annual level, in the first quarter of the year total exports rose by 7.6% from the same period of the previous year, supported by a fall in exports in the first quarter of the previous year.

In the first quarter of 2019, personal consumption rose by 1.3% from the previous three months, thus having grown continuously for over four years. The favourable developments reflect the effects of tax disburdening and continued employment and net wages growth as well further growth of household lending. Amid such conditions, the consumer confidence index also rose additionally, reaching its highest level ever. On an annual level, the growth in personal consumption continued to accelerate with its growth rate standing at 4.4% (3.9% at the end of 2018), thus continuing to contribute the most to total economic activity growth.

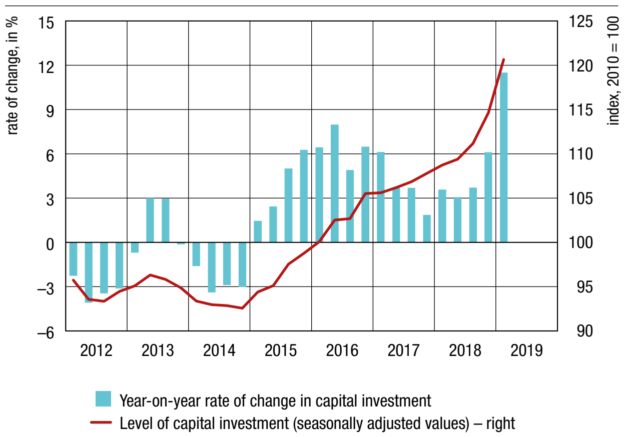
Investment activity rose sharply in the first quarter of 2019 (5.2% from the previous quarter). Such developments resulted in a high annual growth of gross fixed capital formation of 11.5%. Acceleration of capital investments probably reflects the acceleration of investment activity of the general government

Figure 3.6 Determinants of personal consumption
real values and index



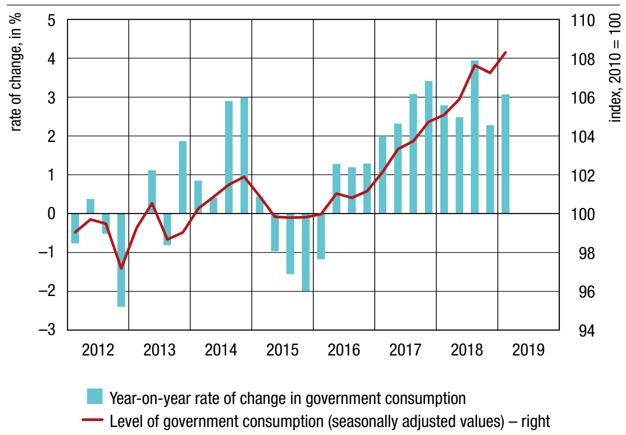
Notes: Real values of compensation of employees and social benefits in cash were calculated by deflating nominal values using the personal consumption deflator. Consumer confidence indicator values were calculated as three-member averages of monthly data, where the most recent data refers to May 2019.
Sources: CBS, Ipsos and CNB.

Figure 3.7 Gross fixed capital formation
real values



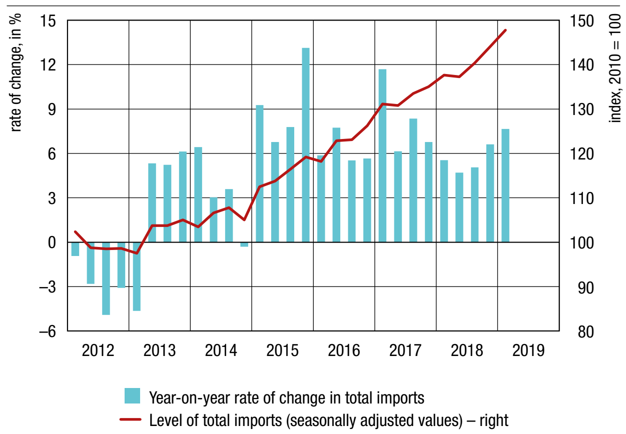
Source: CBS (seasonally adjusted by the CNB).

Figure 3.8 Government consumption
real values



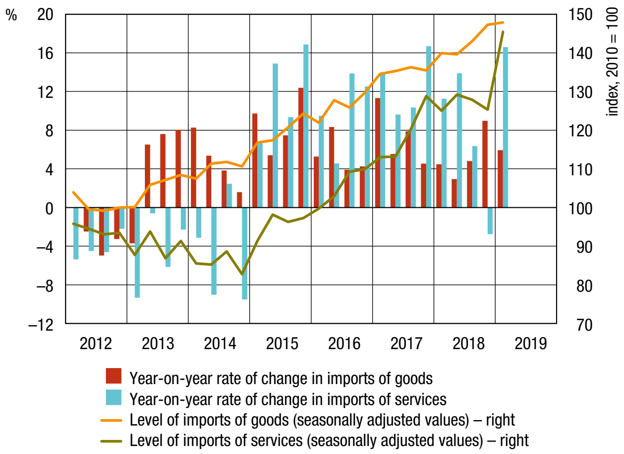
Source: CBS (seasonally adjusted by the CNB).

Figure 3.9 Imports of goods and services
real values



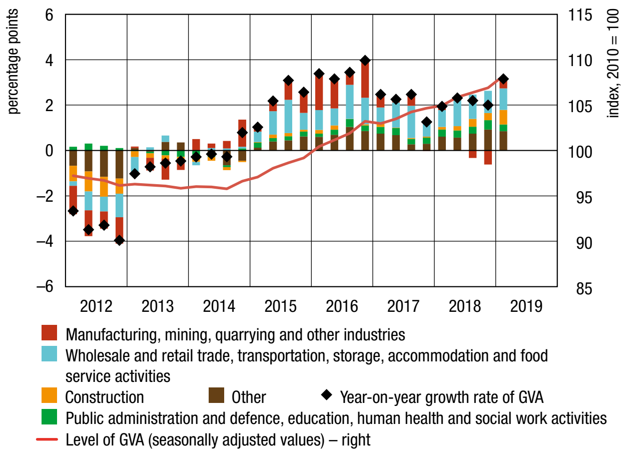
Source: CBS (seasonally adjusted by the CNB).

Figure 3.10 Real imports of goods and services



Source: CBS (seasonally adjusted by the CNB).

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



Source: CBS (seasonally adjusted by the CNB).

and the private sector, as suggested by the data on other civil engineering works and construction works on buildings while the favourable developments in the private sector point to continued imports of capital goods.

In early 2019, government consumption rose by 1.0% from the previous three months, with its growth accelerating to 3.1% on an annual level.

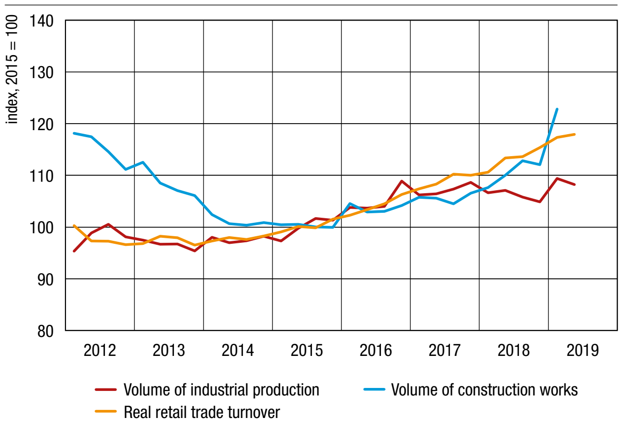
The pace of imports of goods and services in early 2019 was similar to that at the end of the previous year, with goods imports growth slowing down on a quarterly level, in contrast with services imports, which grew at an extremely fast rate. The nominal data on goods trade show that the slowdown in goods imports is primarily the result of a significant fall in energy imports, which may be associated with favourable weather conditions at the beginning of this year. In addition, a decline on a quarterly level was also seen in the imports of durable consumer goods. Such developments resulted in a slowdown in the growth of goods imports on an annual level, but due to acceleration in the growth of services imports, the annual growth rate of total imports stood at 7.7%, an increase from the previous year. As a result, the negative contribution of net foreign demand to total economic growth in the first quarter was bigger than in 2018 (–2.2 percentage points).

Aggregate supply

Gross value added rose by 1.2% from the previous three months, continuing the trend of growth. The fast growth compared to the end of the previous year, when GVA went up by 0.5%, was primarily the result of favourable developments in manufacturing and construction. In addition, GVA rose in all activities except agriculture, forestry and fishing and in public sector activities. However, if annual rates of change are observed, GVA rose by 3.2% from the same period of 2018, mostly driven by retail trade, transportation and storage, which may be associated with growth in household consumption and construction.

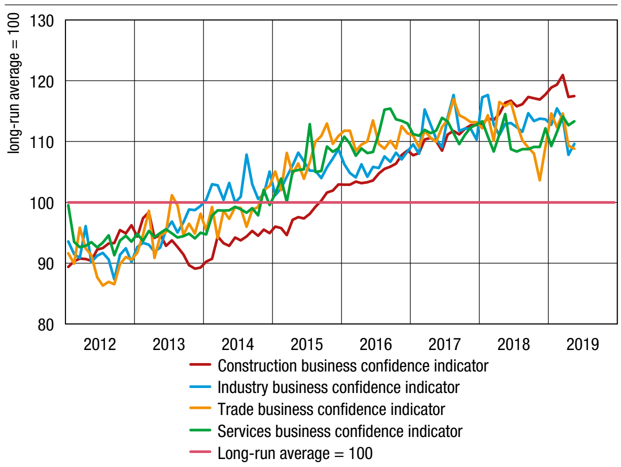
The GDP nowcasting model based on high-frequency data that are mainly available for April only shows that economic growth on a quarterly level slowed down slightly. In April, real retail trade turnover increased by 0.5% from the beginning of the year. Industrial production in April held steady at February and March levels and, taking into account a very favourable result in January, it was down 1.1% from the average recorded in the first three months of this year. The growth in the production

Figure 3.12 Short-term economic indicators
seasonally adjusted values



Notes: Quarterly data are calculated as an average of monthly data. Data on industry and trade in the second quarter of 2019 refer to April.
Source: CBS (seasonally adjusted by the CNB).

Figure 3.13 Business confidence indicators
standardised seasonally adjusted values



Sources: Ipsos and CNB (seasonally adjusted by the CNB).

of capital goods and non-durable consumer goods on a quarterly level was not sufficient to make up for the decline in other main industrial groupings.

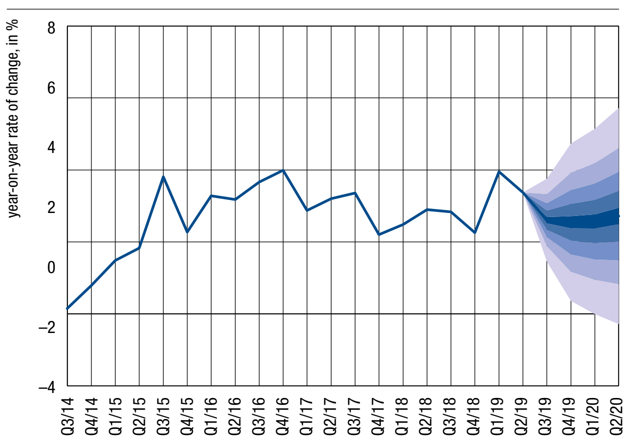
Consumer optimism continued to improve in May 2019, reaching a historical high. The increase in optimism in April and May 2019 from the average recorded in the first quarter of the same year reflects more favourable developments in all subcomponents of the index. By contrast, the expectations of business entities on a quarterly level were gloomier in all activities except service activities, with trade recording the biggest fall in the confidence index.

Projected developments

The acceleration of economic activity at the beginning of this year might spur acceleration in the annual growth rate of GDP with the expectations for real GDP growth in 2019 standing at 3.1% (2.6% in 2018). However, in 2020, the GDP growth might be slower than this year. Economic growth is expected to be driven primarily by strong domestic demand while the negative contribution of net foreign demand might rise further.

In 2019, goods and services exports might continue to grow at a similar rate as in the year before and reach a growth rate of 2.7%. Real growth of goods exports is expected to be slightly faster, in contrast with growth in the exports of services that could be a little slower than in the previous year, reflecting an improvement in the economic and political situation in competitive tourist destination countries. Of the components of domestic demand, capital investments are expected to accelerate and rise by 8.0% in 2019, almost twice the rate of 4.1% recorded in 2018. Possibly in the lead in total investment activity due to a better use of EU funds and the further development of transport and public utility infrastructure will be general government. However, private sector capital investments are also expected to rise. In 2019, personal consumption might rise by 4.2% from the year before and thus remain the main driver of total economic growth. Faster household consumption compared with the previous year (3.5%) mirrors further favourable conditions on the labour market, primarily acceleration in the growth of real net wages, supported also by a cut in VAT, and as shown by available data, a further rapid growth in household lending. Consumer optimism is also at its highest since household expectations have been measured, which indicates increased propensity for spending. Government consumption might rise by 2.7% this year, primarily due to a further growth in intermediate consumption. Thus, its contribution to economic growth might remain slightly positive. The acceleration of domestic demand and further growth in total exports are expected to result in a slightly more pronounced growth in goods and services imports than in the previous year (5.8% compared to 5.5% in 2018).

Figure 3.14 Projection of real GDP dynamics



Sources: CBS and CNB.

Economic activity may continue to accelerate in 2020, albeit at a slower pace than the year before, with the real GDP growth rate expected to stand at 2.7%. The slowdown in economic activity primarily mirrors the expected smaller increase in capital investments and household consumption. Nevertheless, of all GDP components, household consumption might continue to give the biggest positive contribution to economic growth.

It is estimated that the risks associated with the central projected measure in the GDP projection are balanced. The positive risk arises from the possibility of a greater than projected investment growth, as a result of faster investment growth in the private or public sector, also associated with accelerated withdrawal of EU funds. Also, personal consumption might grow faster than projected, in view of the record high level of consumer optimism shown by Consumer Confidence Survey data. In addition, the growth in exports of tourist services whose forecasts continue to be conservative, might be greater than currently expected, provided that much better results in the main season are achieved than those already registered. By contrast, the downside risks arise from the external environment and are related to potential further strengthening of protectionism on a global level and a slowdown in the growth of Croatian trading partners. Uncertainty with regard to Italy's public debt sustainability might result in a slower growth of the Italian economy, which could have an unfavourable impact on Croatian exports and total economic growth, given that Italy is one of Croatia's main trading partners.

4 Labour market

Employment and unemployment

Favourable developments in the labour market continued in early 2019. The total number of employed persons was up by 0.5% from the last quarter of 2018 and in April and May, it grew by an additional 0.6% from the first quarter. The most significant contribution to the increase came from employment in the construction sector and tourism-related service activities. On the other hand, April and May saw a drop in the number of persons employed in industry (Figure 4.1).

In addition to the increase in employment, the first quarter also witnessed a continued decline in the number of unemployed persons. According to administrative data, the average number of unemployed persons dropped to 131 thousand in the first quarter of 2019, which was, for the greater part, due to clearings from the records for other reasons (non-compliance with legal provisions, registration cancellation and failure to report regularly) and, to a somewhat smaller extent, due to new employment from the CES register. The fall in the unemployment figures slowed down in the second quarter, with the number of unemployed persons in April and May holding steady at the level recorded in the preceding quarter (Figure 4.2).

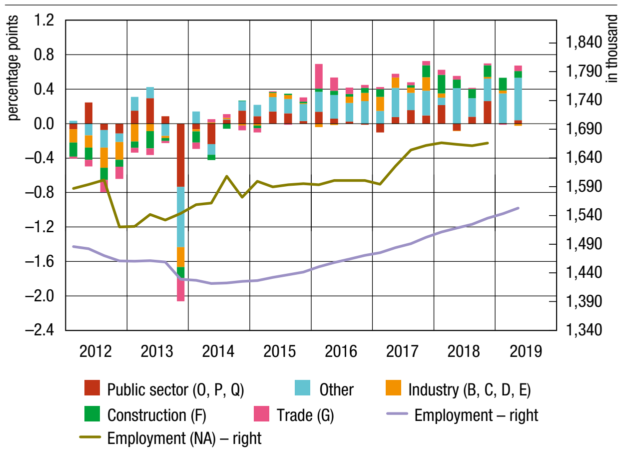
In line with the developments described above, the registered unemployment rate continued to decline, standing at 8.4% of labour force in April, down from the end of 2018, when it was 8.6% (Figure 4.4). The Labour Force Survey data available for 2018 suggest that the ILO unemployment rate dropped from 8.3% in the third quarter of 2018 to 7.9% of the labour force at the end of the same year (Figure 4.3).

The Labour Force Survey data from the same period suggest that the number of employed persons stagnated, with the employment rate at 47% in the last quarter of 2018. In the same period, the participation rate declined by 0.4 percentage points from the preceding quarter, reaching 50.8% (Figure 4.4).

Wages and unit labour costs

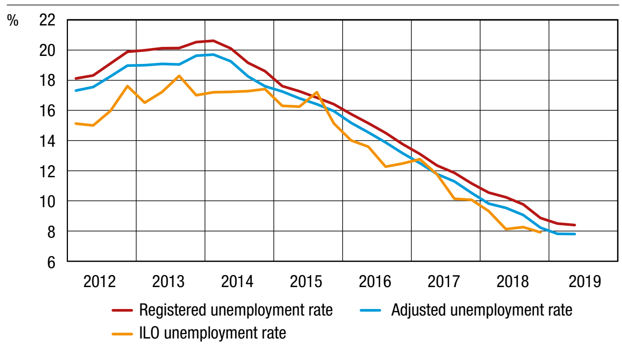
Following the stagnation recorded at end-2018, in 2019,

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



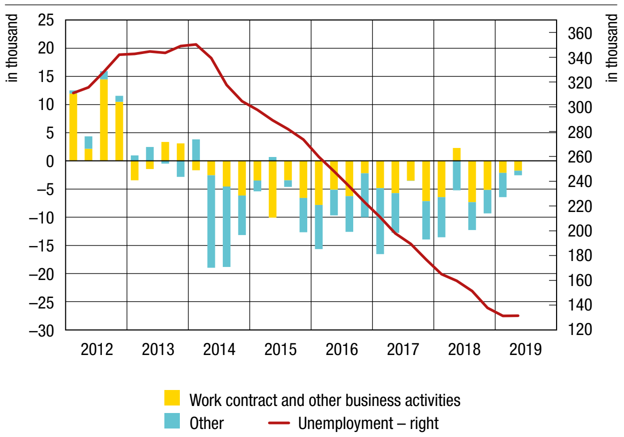
Note: Data for the second quarter of 2019 refer to April and May.
Sources: Eurostat and CPII (seasonally adjusted by the CNB).

Figure 4.3 Unemployment rates
seasonally adjusted data



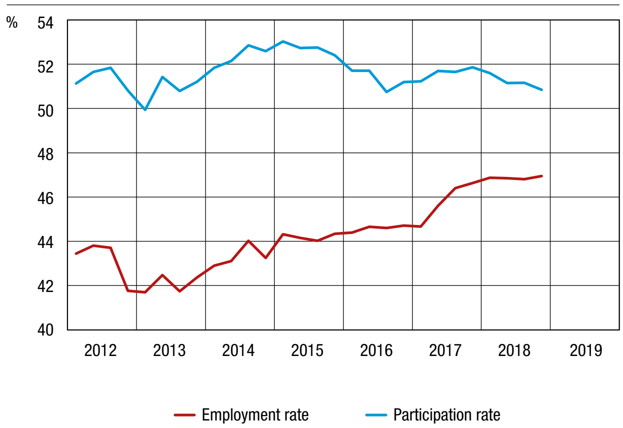
Notes: The adjusted unemployment rate is the CNB estimate and is calculated as the share of the number of registered unemployed persons in the working age population estimated as the sum of unemployed persons and persons insured with the CPII. Since January 2015, the calculation of the registered unemployment rate published by the CBS has used the data on employed persons from the JOPPD form. The registered unemployment rate data for the second quarter of 2019 refer to April, while data for the adjusted rate refer to April and May.
Sources: CBS, CES and CNB calculations (seasonally adjusted by the CNB).

Figure 4.2 Total unemployment and net unemployment inflows
seasonally adjusted data



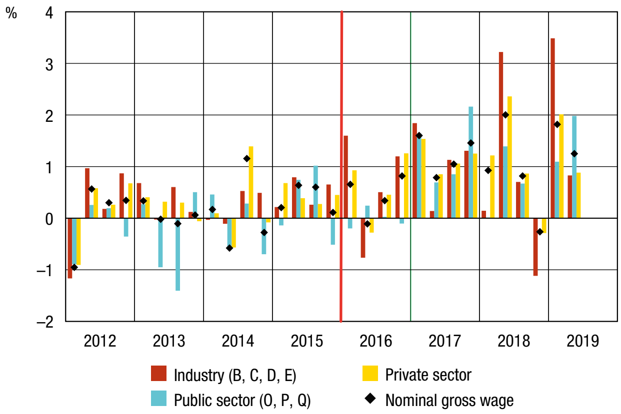
Note: Data for the second quarter of 2019 refer to April and May.
Source: CES (seasonally adjusted by the CNB).

Figure 4.4 Labour Force Survey
seasonally adjusted series



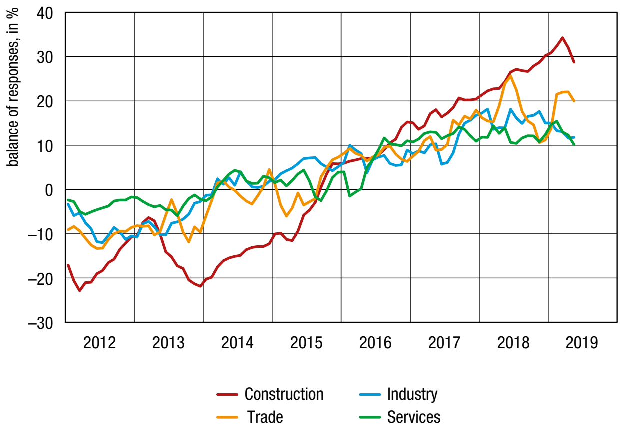
Source: CBS (seasonally adjusted by the CNB).

Figure 4.5 Average nominal gross wage by NCA activities
seasonally adjusted data, quarterly rate of change



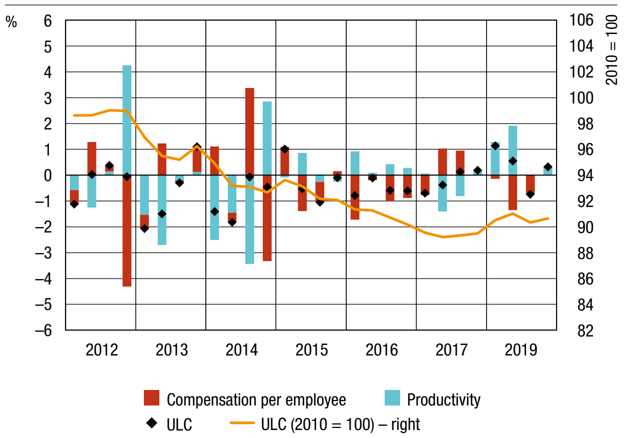
Notes: Data on the average nominal gross wage by activity refer to data from the RAD-1 form, and from January 2016 to data from the JOPPD form. Data for the second quarter of 2019 refer to April.
Sources: CBS and CNB calculations (seasonally adjusted by the CNB).

Figure 4.7 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 4.6 Compensation per employee, productivity and unit labour costs
seasonally adjusted data, quarterly rate of change and levels (2010 = 100)



Note: Productivity growth carries a negative sign.
Sources: CBS, CPII and Eurostat (seasonally adjusted by the CNB).

Table 4.1 Projection of labour market indicators for 2019 and 2020
year-on-year rates of change

	2016	2017	2018	2019	2020
Number of employed persons – CPII	1.9	1.9	2.3	1.9	1.2
Number of employed persons – national accounts	0.3	2.2	1.8	1.9	1.2
Participation rate (ILO)	51.3	51.6	51.2	51.7	52.2
Unemployment rate (ILO)	13.1	11.2	8.4	7.2	6.5
Average nominal gross wage	1.9	3.9	4.9	4.5	4.4
ULC	–1.8	–1.8	1.3	2.8	2.8
Productivity	3.2	0.7	0.8	1.1	1.5

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 CNB projection.

wages continued their previous growth. The average nominal gross wage was up by 1.8% at the quarterly level in the first three months of the year, with the increase being more pronounced in the private than in the public sector (2.0% versus 1.1%). Nominal gross wages were 1.3% higher in April than in the first three months of 2019 (Figure 4.5). Real wage growth was somewhat more moderate when the rise in consumer prices in the same period is factored in.

Although the national accounts data on the number of employed persons for the first quarter of 2019 were not available at the time of writing, data from other sources suggest that in early 2019, wage growth was faster than the growth in labour productivity, which is why the growth of unit labour costs could be stronger in the first quarter of 2019 than in the preceding year.

Projected developments

Considering the developments in the number of employed persons in the first five months of the current year and the anticipated strengthening of economic activity at an annual level, employment could see an increase of 1.9% during the year as a whole, with favourable trends suggested by the results of the Business Confidence Survey s as well (Figure 4.7). Increase in employment is expected in all activities over the following three months, particularly in construction and trade. The number of unemployed persons could continue to decline thanks to steady employment growth, but also as a result of the possible continued emigration of the working-age population. The ILO unemployment rate could thus drop to 7.2%, which would be the lowest unemployment rate recorded since the survey was initiated in Croatia.

As regards labour costs, the growth in gross wages might slow down in 2019 (4.5%) despite the increasingly pronounced limits on the labour force supply side and the amendments to collective agreements in the public sector. Wage growth could continue both in the private and the public sector. Real wage growth could be slightly slower in 2019 (3.7%).

Similar labour market developments are expected to continue in 2020, although at a slightly slower pace than in the 2019. The number of employed persons could rise by 1.2%, while the ILO unemployment rate could drop to 6.5%. The annual average nominal gross wage growth rate could reach 4.4% in 2020.

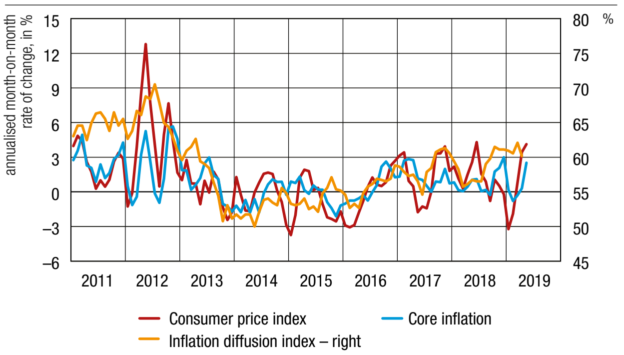
5 Inflation

The annual consumer price inflation slowed down visibly in January 2019, influenced by a cut in the VAT rate on certain products and a fall in crude oil prices on the global market towards the end of 2018. After that, inflation accelerated, with certain fluctuations, mostly driven by the increase in the annual rate of growth of energy prices. Accordingly, the indicator of current developments in overall inflation rose in the first five months of 2019; however, the indicator of current developments in core inflation, which excludes the prices of energy, agricultural products and administered prices (Figure 5.1) fell slightly. Such developments suggest that faster growth of unit labour costs and other factors putting pressure on inflation have for now only a small effect on price increase. In addition, the inflation diffusion index that shows the share of the number of products that have gone up in price in the total number of products fell slightly from the end of the previous year but still stands at a slightly higher level than the average in 2018.

The annual rate of consumer price inflation fell from 0.8% in December to 0.2% in January and then rose to 0.9% in May (Table 5.1). The developments in consumer price inflation were largely influenced by tax changes at the beginning of the year, which is analysed in detail in Box 1 Estimation of the impact of the VAT rate cut for certain products on short-term consumer price movements. Core inflation slowed down from 1.0% in December to the average of 0.7% in the following four months, mainly due to the fall in the annual rate of change in the prices of some agricultural products (particularly meat and milk), prices of clothing and footwear and pharmaceutical products. However, the annual rate of core inflation returned to 1.0% in May, mostly driven by an increase in the annual rate of growth of processed food products.

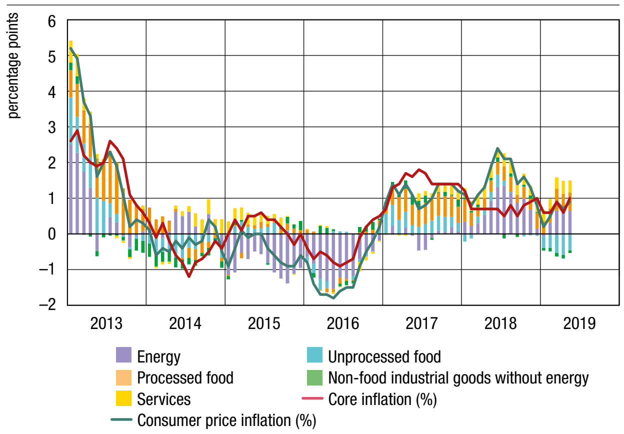
Unlike consumer prices, the annual rate of change of industrial producer prices (excluding energy) rose from –0.3% in December to 0.8% in May, mostly driven by price growth in the production of non-durable consumer goods such as food products and beverages. In addition, the annual rate of change of

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 5.2 Year-on-year inflation rate and contributions of components to consumer price inflation



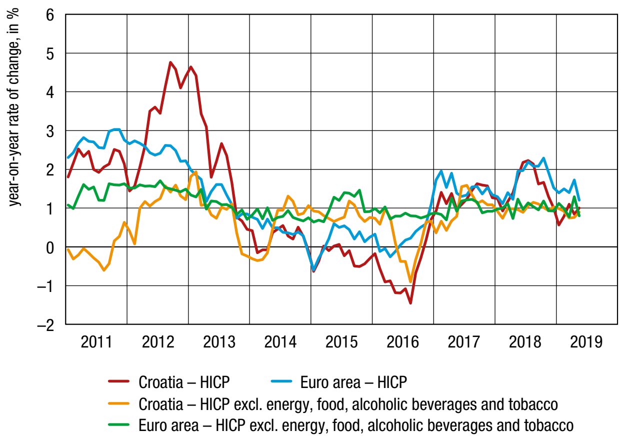
Note: Core inflation does not include agricultural product prices, energy prices and administered prices.
Sources: CBS and CNB calculations.

Table 5.1 Price indicators
year-on-year rate of change

	12/2017	3/2018	6/2018	9/2018	12/2018	3/2019	5/2019
Consumer price index and its components							
Total index	1.2	1.1	2.4	1.4	0.8	0.9	0.9
Energy	0.4	1.8	7.9	5.3	0.9	4.0	3.9
Unprocessed food	2.6	2.1	3.8	–0.1	–0.6	–5.7	–4.9
Processed food	2.0	1.1	1.5	0.9	1.9	2.6	2.2
Non-food industrial goods without energy	0.8	0.3	0.5	–0.3	0.1	–0.4	–0.3
Services	1.0	1.0	1.0	1.4	1.2	1.2	1.3
Other price indicators							
Core inflation	1.4	0.7	0.7	0.5	1.0	0.9	1.0
Index of industrial producer prices on the domestic market	2.1	1.2	3.4	3.4	0.5	2.3	1.4
Index of industrial producer prices on the domestic market (excl. energy)	1.0	0.5	–0.1	–0.2	–0.3	0.1	0.8
Harmonised index of consumer prices	1.3	1.2	2.2	1.6	1.0	1.1	1.0
Harmonised index of consumer prices at constant tax rates	1.2	1.1	2.1	1.5	0.8	1.7	1.6

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

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



Sources: CBS and Eurostat.

the prices of durable consumer goods, such as production of furniture, rose visibly. Such developments point to a small acceleration of inflationary pressures coming from the production process.

Broken down by individual components, overall consumer price inflation accelerated slightly in the first five months of 2019 mainly as a result of the increase in the annual rate of growth in energy prices (Figure 5.2). The contribution of energy prices to overall inflation thus rose from 0.1 percentage point in December 2018 to 0.6 percentage points in May 2019. This was mostly due to the increase in the prices of refined petroleum products, driven by the increase in the price of crude oil on the global market in the first four months of this year (for more details on trends and factors influencing crude oil prices, see Chapter 2 Global developments) and the increase in the administered price of natural gas. In addition, the contribution of services prices and prices of processed food products (mostly bread and cereals and oil and fats) to overall inflation rose slightly in the first five months of the year.

By contrast, the contribution of unprocessed food products, particularly fruit and vegetables, declined. Fruit prices in May fell by 13% from the same month of the previous year. As a result, the contribution of unprocessed food products to overall inflation fell from –0.1 percentage point in December to –0.5 percentage points in May. The prices of industrial products (excluding energy) made a much smaller contribution to the slowdown in the annual rate of inflation in the first five months. The contribution of the prices of pharmaceutical products fell the most.

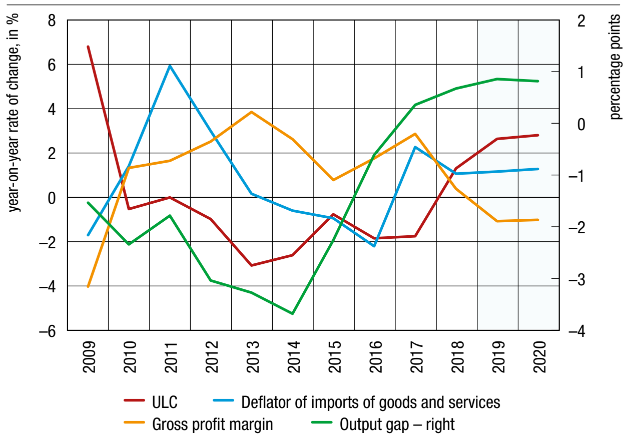
The annual rate of inflation in the euro area measured by the harmonised index of consumer prices (HICP) slowed down from 1.5% in December to 1.2% in May (Figure 5.3). This was mostly due to energy prices whose annual growth rate fell from 5.5% in December to 3.8%. The euro area also recorded a fall in the contribution of the prices of services and unprocessed food products to annual inflation. By contrast, the contribution of industrial products and processed food products rose slightly during that period. Core inflation (which excludes the prices of energy, food, alcoholic beverages and tobacco) fell slightly in the euro area; from 0.9% in December to 0.8% in May, spurred mostly by the mentioned decline in the annual growth of services prices.

The annual rate of inflation in Croatia measured by the harmonised index of consumer prices (HICP) stood at 1.0% in May, which was the same as at the end of the previous year. The effect of the cut in the VAT rate on the fall in the price of unprocessed food products and over-the-counter medicines has thus been cancelled out by the increase in the prices of natural gas for households and refined petroleum products. In May 2019, inflation in Croatia was 0.2 percentage points lower than in the euro area, which is mostly the result of a much slower annual rate of change in the prices of unprocessed food products. Core inflation, measured by the HICP, which excludes the prices of energy, food, alcoholic beverages and tobacco, slowed down slightly from 1.0% in December 2018 to 0.9% in May and was only slightly higher (0.1 percentage point) than that in the euro area.

Projected developments

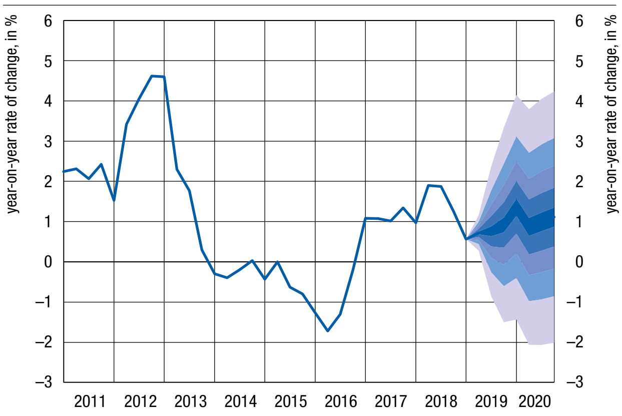
It has been estimated that in 2019 the average annual consumer price inflation might fall to 0.7%, from 1.5% in 2018 (Figure 5.5) due to the expected decline in the rate of growth of energy and food prices. The projected slowdown in the annual growth of energy prices from 4.4% in 2018 to 1.5% is very much the result of a smaller contribution of refined petroleum products to inflation, which reflects developments in the global market. The average Brent crude oil prices rose by 24% annually in 2018, but these prices are expected to fall by 5% this year (expressed in kuna). The prices of crude oil on the global market fell considerably in May and June and the developments in these prices on the spot market point to their further gradual fall in the second half of 2019. Accordingly, it is estimated that the contribution of retail prices of refined petroleum products to annual inflation in the rest of the year might be mostly negative. In addition, the annual rate of change in food prices is expected to slow down from 1.0% in 2018 to –0.2% in 2019, mostly as a result of a cut in VAT on some food products. It has also been estimated that the average annual growth rate of the consumer price index excluding food and energy might remain at the level of approximately 0.9% in 2019, which is the same as in the previous year. Imported inflationary pressures are expected to remain mainly subdued, taking into account, for instance, the expected small fall in the prices of crude oil on the global market and the ECB's downward revision of core inflation in the euro area under the June 2019 projection. However, in the first five months of 2019, the prices of some agricultural products (e.g. milk and pork) rose on the European Union market due to increased

Figure 5.4 Domestic and foreign determinants of inflation



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 5.5 Projection of consumer price inflation



Sources: CBS and CNB calculations.

demand on the global market and these developments started gradually to spill over to the domestic producer and consumer prices of these products. The domestic inflationary pressures involve in particular an acceleration in domestic demand growth, i.e. a small increase in the positive domestic output gap in 2019 and cost pressures arising from unit labour costs, i.e. faster wage than labour productivity growth (Figure 5.4).

The projected consumer price inflation acceleration to 1.1% in 2020 should mainly be the result of an increase in the average annual rate of change in food prices to 2.3%, mostly due to the fading of the effect of the VAT cut in early 2019 on the annual rate of change in some food products. It has also been estimated that the average annual rate of growth of the consumer price index excluding food and energy might accelerate slightly (from 0.9% in 2019 to 1.0% in 2020) amid the expected growth of core inflation in the euro area, positive domestic output gap and a possible spillover of the increase in unit labour costs to product prices. By contrast, the average annual growth rate of energy prices might continue to slow down in 2020, to –0.5%. This could largely be the result of the projected fall in Brent crude oil prices on the global market of approximately 7% (expressed in kuna) and the diminution of the effect of the rise in the prices of natural gas and solid fuels in 2019. As regards the estimated net effect of the announced administrative decisions on developments in the projected consumer price inflation in 2020, it is estimated to be slightly negative, with the possible effect of the cut in the general VAT rate of one percentage point (from 25% to 24% at the beginning of 2020) standing at approximately –0.3 percentage points and the effect of the announced reintroduction of compensation for the return of milk packaging standing below 0.1 percentage point.

It is estimated that the risks of lower than projected or higher than projected inflation are balanced. The possible faster growth in crude oil prices on the global market as a result of heightened geopolitical tensions and possible disturbances in the delivery of crude oil is a risk that might fuel higher than projected inflation. Also, unfavourable weather conditions might spur a faster growth in the prices of agricultural products and there is a possibility of a rise in some administered prices. In addition, the pass-through of the general VAT rate cut could be weaker than expected in the current projection. On the other hand, risks that might lead to a lower than projected inflation include possible lower prices of crude oil and other raw materials (in the event of a possible slump in global economic growth and/or a larger than expected increase in oil production) and a stronger pass-through of the VAT rate cut onto the retail prices.

Box 1 Estimation of the impact of the VAT rate cut for certain products on short-term consumer price movements

The findings of the analysis using a detailed database of product prices show that the estimated pass-through of tax changes to consumer prices was significant for most products, but not full, and that it mostly took place in January 2019. Furthermore, results suggest that there was also a certain spillover of reduced VAT rates to those food products to which the tax changes did not apply, although such a spillover was lower in intensity. The total direct effect of the VAT rate cut in the period from December 2018 to February 2019 is estimated to be –0.6 percentage points, of which –0.5 percentage points refers to food products. As a result, the pass-through of tax changes to this group of products was around 50%.

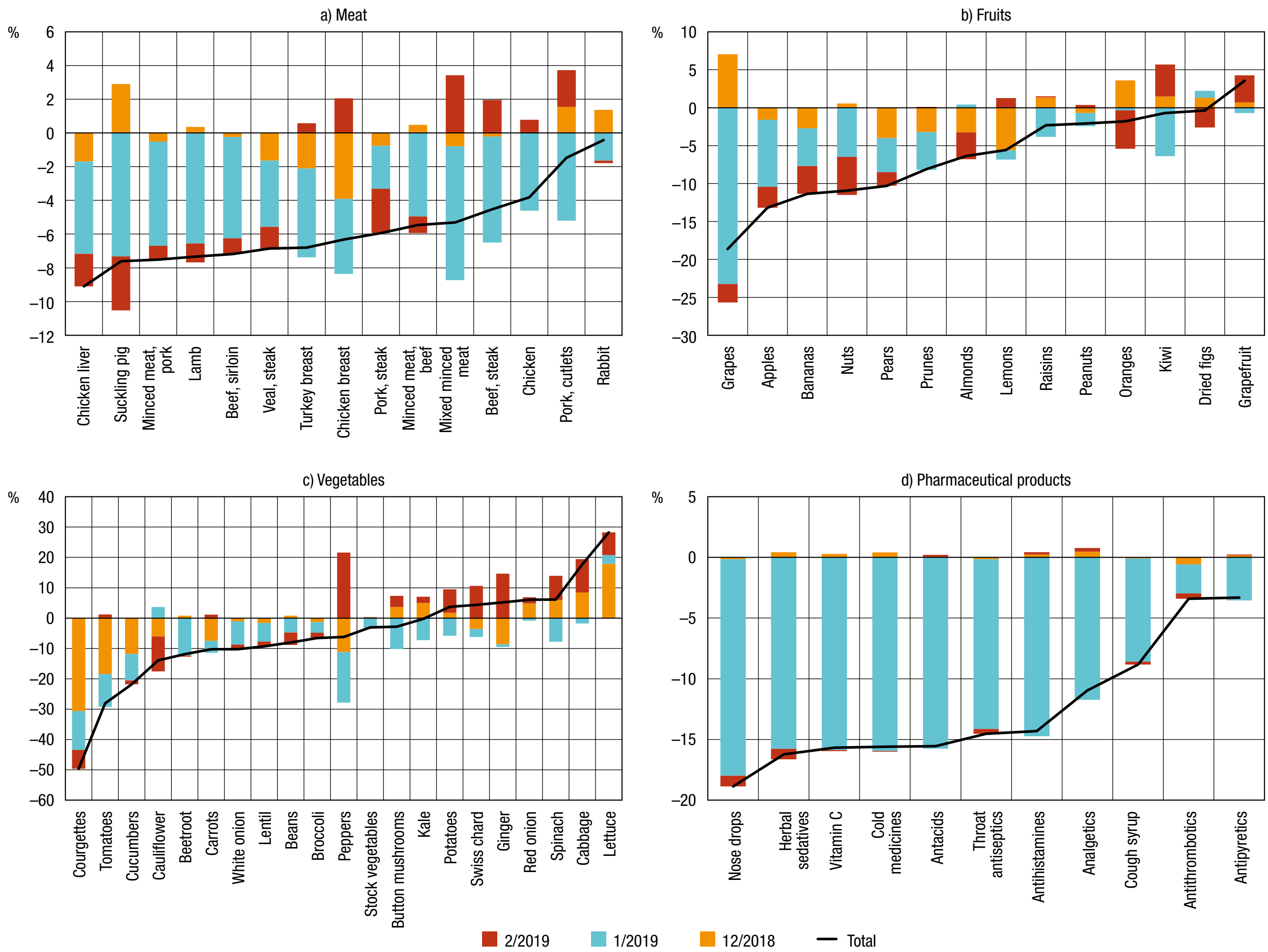
In January 2019, the value added tax (VAT) rate was reduced for certain food products[1] and napkins for babies from 25% to 13% and for over-the-counter drugs from 25% to 5%. Domestic experience and experiences of other countries[2] suggest that the pass-through of the VAT rate change to consumer prices is, as a rule, not full, and that the price change driven by tax changes does not appear only in the month in which tax changes take effect. Furthermore, research findings suggest that the pass-through of tax changes to prices is lower in cases in which tax is reduced instead of increased.[3] Had the lowered VAT rates been transferred to consumer prices in full, the prices of food products covered by the legislative change would have dropped by 9.6% and the prices of over-the-counter drugs would have fallen by 16%. However, the actual pass-through is most often not full and needs to be estimated. There are several reasons that may explain the partial spillover of tax changes to consumer prices. The intensity of the VAT rate cut pass-through to prices depends on the degree of competition in the market. Some retailers will reduce prices only partially so as to increase profits as long as they think that such a practice will not result in the loss of their market share. Among other things, the relatively strong increase in personal consumption is a factor that may affect the reduced pass-through of VAT rate cuts to consumer prices, since retailers tend to be less motivated to let reduced tax rates spill over to product price cuts. Moreover, agricultural product prices are not only monitored in shops, but also on farmers' markets, and

1 Fresh or chilled meat, sausages, fish, crayfish, vegetables, roots and tubers, including dry leguminous vegetables, fresh and dried fruits and nuts, eggs and napkins for babies.

2 See, for example, *Price and volume effects of VAT increase on January 2007*, Monthly report, Deutsche Bundesbank, April 2008; *Impact of the VAT rate increase in January 2012 on inflation*, Quarterly Report on Inflation, Box 3-2, Magyar Nemzeti Bank, March 2012; *Impact of the rise in VAT rates on inflation*, Macroeconomic Developments and Projections, Box 6.1, Banka Slovenije, October 2013.

3 See, inter alia, Benkovskis, K., and L. Fadejeva (2014): *The effect of VAT rate on inflation in Latvia: evidence from CPI microdata*, Applied Economics, Vol. 46, No. 21, pp. 2520-2533.

Figure 1 Estimated impact of tax changes on the prices of certain groups of products, calculated according to the difference between actual and forecast changes in the prices of products subject to the reduced VAT rate between December 2018 and February 2019



Source: CNB calculations.

because many family farms are not included in the VAT system, it is questionable whether they have the option of reducing prices.

The main difficulty in analysing the impact of tax changes on prices lies in the fact that price movements at the time the tax changes took effect were also under the influence of numerous other factors such as seasonal fluctuations and changes in import prices. In practice, it is very difficult to separate the effect of such usual generators of price changes from those caused by tax changes alone. Furthermore, certain retail chains reduced prices as early as in December 2018, i.e. before the tax changes entered into force, additionally blurring the impact of changes on inflation.

Considering the facts mentioned above, the pass-through of tax changes to prices in Croatia is analysed using the detailed database of the average prices of all products used by the Croatian Bureau of Statistics to create the consumer price index. The analysis of inflation on a disaggregated level is useful for gaining a better understanding of the formation of consumer prices, the monitoring of which is an important task of the central bank in the context of its primary objective, which is to support low and stable inflation. In the micro approach to the estimation of the impact of the VAT rate cut on prices, a univariate statistical model (ARIMA (0,1,1)(0,1,1))[4] was developed for each of the 128 products from the group of products to which tax changes apply based on the data from September 2013 to November 2018, after which, using the model, a forecast of prices of particular products was made for the following three-month period.[5] The month preceding the month in which the tax changes took effect was also included in the analysis as some retailers lowered prices as early as in December 2018. The forecast prices represent anticipated prices in the hypothetical scenario assuming that no tax changes occurred. The difference between the actual and the forecast price of a particular product represents the estimation of the impact of the VAT rate cut on the price of the product.

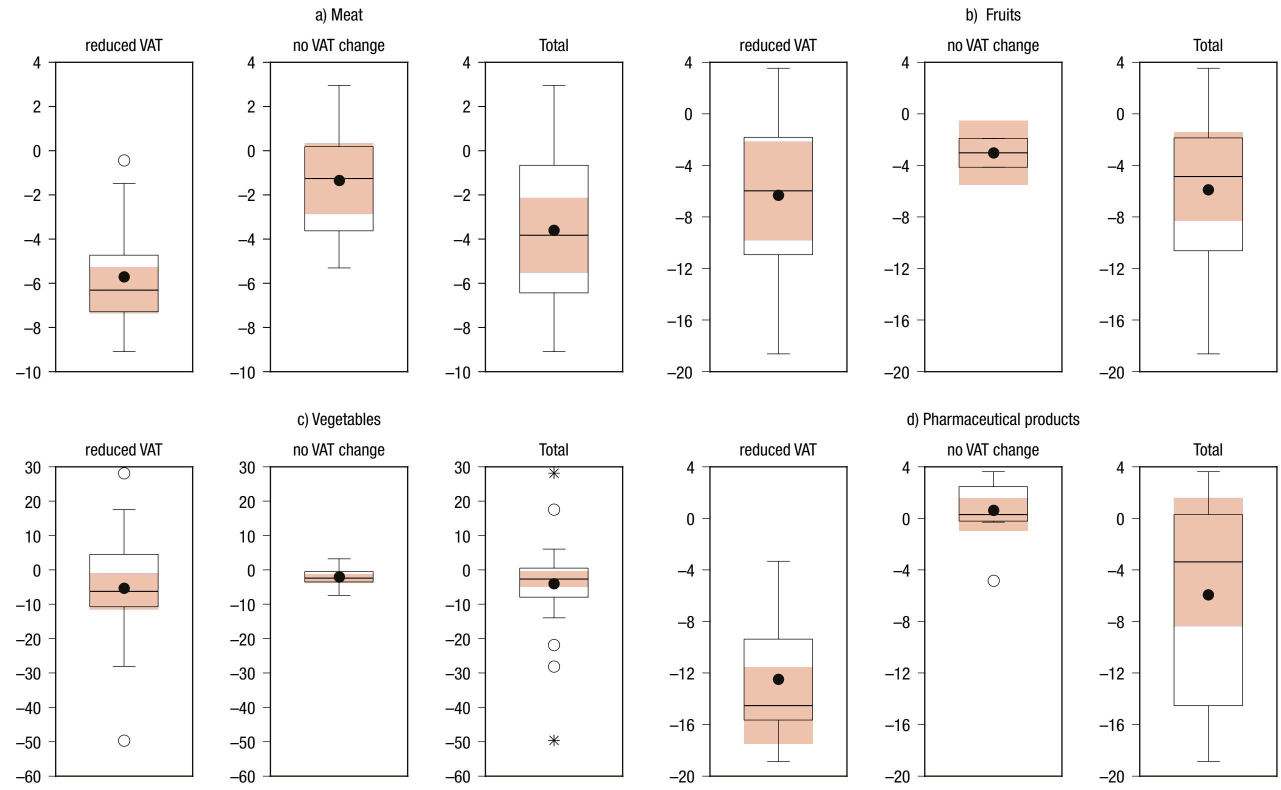
Results are shown as the difference between the actual and the forecast change in the price of a particular product in the period between November 2018 and February 2019[6] (Figure 1,

4 The aforementioned model is also known as the airline model and is frequently used as a part of seasonal adjustment procedures (TRAMO/SEATS and X-13 ARIMA-SEATS), as it proved to be a good benchmark model for modelling series with a pronounced seasonal component.

5 A calculation was made in which actual prices in corresponding product categories in the EU were controlled for in the airline model; however, this had no effect on the results, which proves that the aforementioned price adjustment is not a result of a price change in the external market.

6 Even though tax change can be estimated in the longer term, the specified period was chosen because the model used to forecast prices is more suitable for short-term forecasts.

Figure 2 Estimated impact of tax changes for certain groups of products in the period between December 2018 and February 2019
in %



Note: The boxplot diagram provides a clear overview of the distribution of the observed measure. In addition to the median and the lower and upper quartile, the arithmetic mean (indicated by a dot) and atypical values are shown. Shaded areas indicate limits of median reliability that are quite wide due to a small number of products.
Source: CNB calculations.

Total), whereby the total difference broken down by monthly contributions is shown. Negative values in Figure 1 reflect cases wherein actual price changes in the observed period were lower than the forecast price changes. Results obtained[7] show that the pass-through of tax changes to consumer prices was significant, but not full for most of the products. In addition, it is evident that the effect of VAT reduction on prices varied significantly across analysed products and categories, and that the largest part of the pass-through occurred in January. The median of the estimated impact of VAT reduction on the prices in the category "Meat" was –6.3%[8], in "Fruits" –6%, in "Vegetables" –6.2%, in "Fish" –2.7%[9], in "Eggs" –12.1%[10], in "Napkins" –5.3% and in

Table 1 Difference between the actual and the forecast contribution of individual groups of products (subject to the reduced VAT rate) to the monthly CPI rate of change
in %

	Estimated contribution of reduced VAT rate impact			Total
	December 2018	January 2019	February 2019	
Meat	–0.02	–0.15	–0.05	–0.22
Fish	0.01	–0.01	0.01	0.02
Eggs	–0.03	–0.04	–0.02	–0.09
Fruits	–0.01	–0.09	–0.08	–0.18
Vegetables	–0.01	–0.13	0.10	–0.04
Pharmaceutical products	0.00	–0.06	0.00	–0.06
Total (CPI)	**–0.05**	**–0.48**	**–0.05**	**–0.58**

Note: The elementary aggregate comprising napkins contains more than a single product, but there is no special weight for napkins, which is why they were excluded from calculations.
Source: CNB calculations.

7 Since analysis findings largely depend on forecast quality, the same calculation was carried out using an alternative forecast method to test the robustness of the conclusions. If, instead of using airline models, product prices over the analysed period are forecast using the actual average inter-monthly rate in the relevant month obtained from the available database, the findings change only slightly.
8 Since the weights for this level of disaggregation do not exist (there is no weight for, say, suckling pig), the average impact is shown as a median for all products in a particular group, whereby a rough estimate of the total pass-through of tax change to a group of products is obtained.

"Over-the-counter drugs" –14.5%.

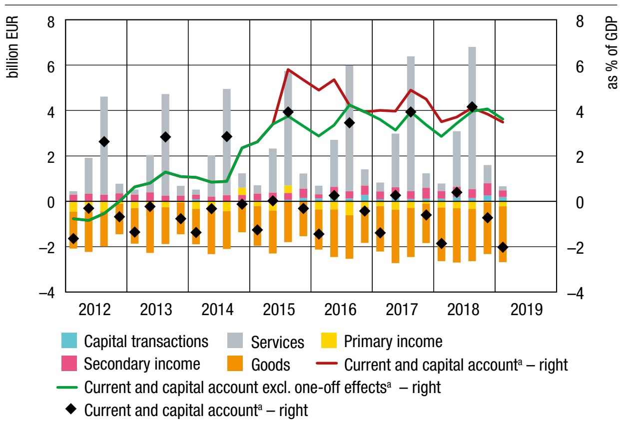
The credibility of the findings may be tested by comparing the change in the prices of products for which the VAT rate was cut with those from the "control group" of products for which the rate remained the same. The diagram in Figure 2 clearly shows that the difference between actual and forecast rates of change in prices was significantly higher for products included in the tax change, suggesting that reduced VAT rates did pass through onto product prices. In most categories, the pass-through was significant, but not full. In addition, Figure 2 suggests that, as a result of the VAT rate cut, the prices for groups of products for which the VAT rate remained the same were also reduced, but significantly less than the prices of products to which the tax change applied. There are two possible explanations for such developments. First, there is probably a certain effect of price change spillover between the two groups of products. For instance, it is reasonable to expect that the reduction of VAT on fresh pork would be reflected in the prices of bacon. Secondly, against the backdrop of vigorous competition, prices of food products for which the VAT rate was not cut may be lowered as well in order to attract customers.

The pass-through of the VAT rate cut to overall consumer price inflation has been analysed on the basis of data released by the CBS in relation to which it was possible to estimate weights for products with reduced VAT rates in the overall consumer price index (CPI). As a result, the impact of tax changes on inflation may be expressed in percentage points. In the approach to the estimation of the impact of VAT rate cut on a higher aggregation level, a univariate ARIMA model was estimated for particular CPI components to which tax changes apply, in a similar way as in the micro approach. The aforementioned model was used as a basis for the forecast of the price index movement in individual product groups. When interpreting analysis results, it is important to bear in mind that they refer only to the direct impact of VAT reduction on the changes in the prices of products subject to tax changes. The contribution of the impact of VAT reduction was calculated by multiplying the difference between the actual and the forecast change in the price index of a particular product group with the estimated share of products subject to lower VAT rates. Accordingly, the total direct impact of VAT reduction in the period between December 2018 and February 2019 is estimated at –0.58 percentage points (Table 1), of which –0.52 percentage points refer to food products[11], which means that the pass-through of tax changes to this group of products was around 50%. The most significant estimated contributions to the impact of the VAT rate cut to the overall CPI came from the categories "Meat" and "Fruits". Furthermore, the analysis has shown that the largest part (around 83%) of the total estimated pass-through of tax changes to consumer prices occurred in January 2019.

6 Current and capital account

The current and capital account deficit widened by 8.6% in the first quarter of 2019 over the same period in 2018. Unfavourable developments were a result of the deteriorated balance in the international trade of services (primarily caused by a surge in tourist consumption of residents abroad), and, to a slightly smaller extent, by the increase in the goods trade deficit. In contrast, better business performance of foreign enterprises in domestic ownership contributed to the improvement of the primary income account balance, while the surplus in the secondary income and capital transactions accounts was slightly larger than in the same period in 2018. Observing the cumulative value in the past year, the current and capital account surplus stood at 3.5% of GDP in the first three months of 2019, which is a slight decrease from the results recorded at the entire-2018 level[12].

Figure 6.1 Current and capital account balance and its structure



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

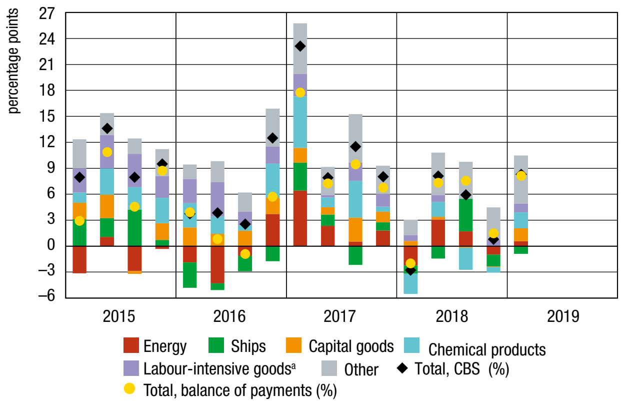
Foreign trade and competitiveness

In the first quarter of 2019, foreign trade in goods saw a noticeable pick-up in exports. The annual rate of growth in exports was 9.4%, in contrast to the decrease of 1.6% seen in the same period in 2018. At the same time, imports growth was slower at 6.9%, having accelerated only slightly from the first three months in 2018 (6.7%). If cumulative values recorded in the course of the past year are observed, the goods trade deficit in the first quarter was 18.1% of GDP, which equals the value recorded in the whole of 2018.

According to CBS data[13], better export performance is mainly attributable to the increased exports of food products to Italy, road vehicles to Germany and China and metal industry

9 The movements in the prices of fish at the time the tax changes took effect were significantly influenced by other factors (such as the small oily fish close season).
10 A pass-through exceeding 100% was calculated for eggs. It is possible that eggs were included in some promotional activity over the observed period, resulting in a drop in prices more substantial than what would have been anticipated on account of VAT reduction alone.
11 The share of food products subject to a lower VAT rate in the CPI basket was estimated at around 10% in 2019, while the share of pharmaceutical products was estimated at around 1%.
12 Compared to data released at the end of March 2019, this release revises the balance of payments data for the period from early 2015 to end-2018 in accordance with the revised financial statements of the reporting entities and the ensuing decrease in retained earnings on the revenue and expenditure side of the primary income account, i.e. retained earnings on the assets and liabilities side of the account of direct investment. The values of assets and liabilities based on equity investments in international investment position were also revised.
13 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.

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



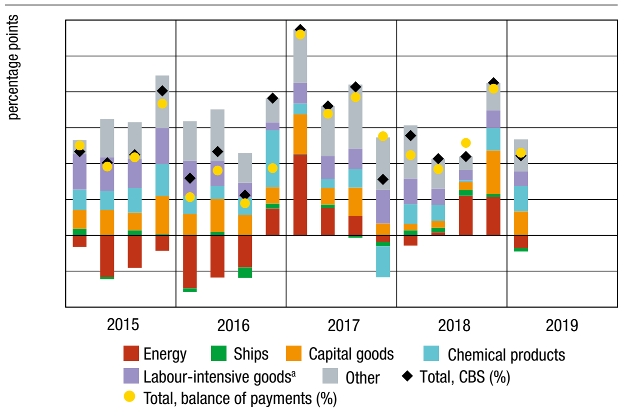
[a] Labour-intensive goods (according to the SITC) include: textile, wearing apparel, footwear, leather, paper, cork and wood, furniture, manufactures of metals and non-metallic mineral manufactures, prefabricated buildings and manufactured articles n.e.c.
Sources: CBS and CNB.

products to Slovenia. Exports of energy products, notably oil and refined petroleum products, also went up. In contrast, a decrease was seen in the exports of other transport equipment, largely ships, to Canada and in the exports of scientific and control instruments to South Korea.

The increase in the imports of metal industry products from China, Italy and Slovenia and capital products from Germany, Italy and Slovenia, which may partly be associated with the strong acceleration in investment activity seen in early 2019, contributed the most to the annual rise in the total imports of goods recorded in the first quarter of the current year. In addition, a sharp increase was seen in the imports of medical and pharmaceutical products from Israel, Germany and Hungary. On the other hand, imports of energy products went down due to a decline in the imports of oil and refined petroleum products from Iraq and Azerbaijan.

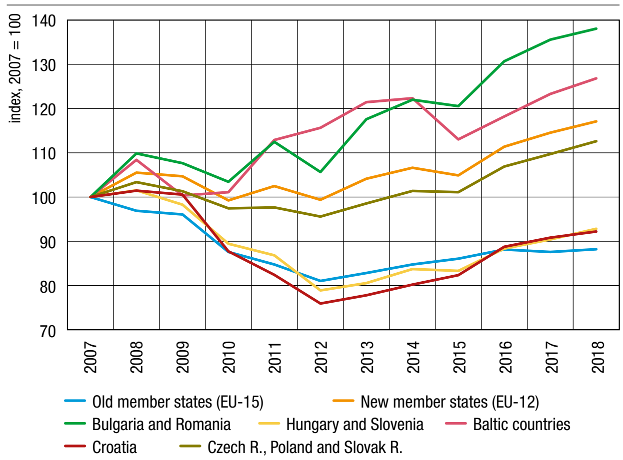
The first quarter of 2019 witnessed less favourable results in the international trade in services than in the same period in 2018. A strong decline in the net exports of services was primarily a result of the noticeably more vigorous tourist consumption of residents abroad and, to a lesser extent, of the deterioration of

Figure 6.3 Imports of goods
year-on-year rate of change and contributions



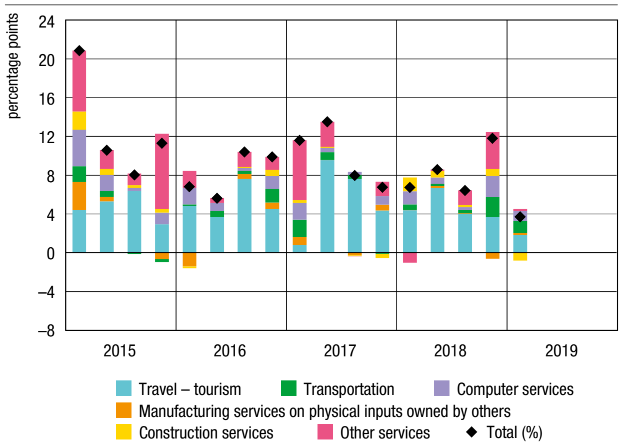
[a] Labour-intensive goods (according to the SITC) include: textile, wearing apparel, footwear, leather, paper, cork and wood, furniture, manufactures of metals and non-metallic mineral manufactures, prefabricated buildings and manufactured articles n.e.c.
Sources: CBS and CNB.

Figure 6.5 World market share of exports of goods and services



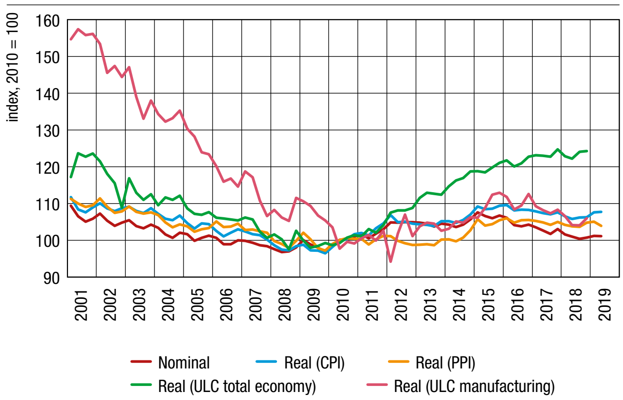
Source: Eurostat.

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



Source: CNB.

Figure 6.6 Nominal and real effective exchange rates of the kuna



Notes: A fall in the index indicates an effective appreciation of the kuna. In the second quarter of 2019, data on the real exchange rate deflated by consumer and producer prices refer to April and data on the nominal exchange rate to April and May.
Source: CNB.

the balance in the trade of other services (particularly financial services and advertising and market research services). A noticeable rise in the imports of tourist services reflects residents' increased propensity to travel abroad amid relatively favourable domestic economic developments and growing income, as well as increased emigration flows following Croatia's accession to the EU, which resulted in the increased consumption of temporary seasonal and cross-border workers abroad and in frequent visits of residents to family and friends abroad. Observing the cumulative values recorded over the past year, the surplus trade in services went down from 19.1% of GDP at the entire-2018 level to 18.6% of GDP in the first quarter of the current year.

Unfavourable developments in the international trade of services were mitigated by the continued rise in tourism revenues. However, the annual growth rate of tourism revenues was noticeably lower in the first quarter of 2019 than in the same period in 2018 (5.4% versus 13.7%). The slowdown in tourism revenues may be due to later Easter holidays, which fell in April this year, as opposed to 2018, when they started in March. The available data on volume indicators for tourism for the first four months of 2019 point to an annual rise of over 10% in the number of arrivals and overnight stays of foreign tourists. Still, this year's tourism performance is likely to be strongly influenced by the increased competition in the Mediterranean market. For more details on the factors influencing tourism developments, see Box 2 Exports of tourist services – recent developments and expectations.

Croatia's total market share in the global exports of goods and services grew for the sixth consecutive year, albeit at a slower pace than in the preceding years. Observing only the exports of goods, Croatia's market share decreased slightly in 2018, putting an end to a five-year positive trend. On the other hand, Croatia's market share in the global exports of services continued to grow, exceeding the decline in the exports of goods. Despite the steady growth in the market share, the losses seen in the 2009-2012 period have not yet been compensated for, with the overall market share of Croatian exports of goods and services still lower than in the pre-crisis years.

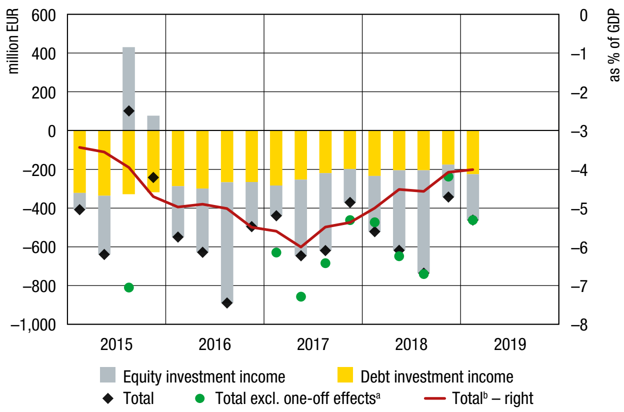
Indicators of price competitiveness improved slightly in the first quarter of 2019, in contrast to the deterioration seen in 2018. In addition to the nominal effective depreciation of the kuna exchange rate, the trend was also driven by the somewhat slower growth seen in domestic prices compared with the prices of Croatia's main trading partners. At the beginning of the second quarter, the indicator deflated by producer prices appreciated slightly as a result of the relatively more pronounced increase in domestic producer prices, dropping to a level recorded in mid-2018. Data on the trends in the real effective kuna exchange rates deflated by unit labour costs suggest that cost competitiveness deteriorated in 2018, as the improvement seen in the second half of the year did not suffice to offset the deterioration in the first half.

Income and transactions with the EU

The deficit in the primary income account narrowed in the first three months of 2019 from the same period of the previous year, mainly influenced by increased revenues from direct equity investment. Specifically, the performance of foreign enterprises in resident ownership improved, particularly in research and development. Total expenditures on direct equity investment, i.e. the profit of domestic enterprises in foreign ownership remained at the level recorded in the same period in 2018.

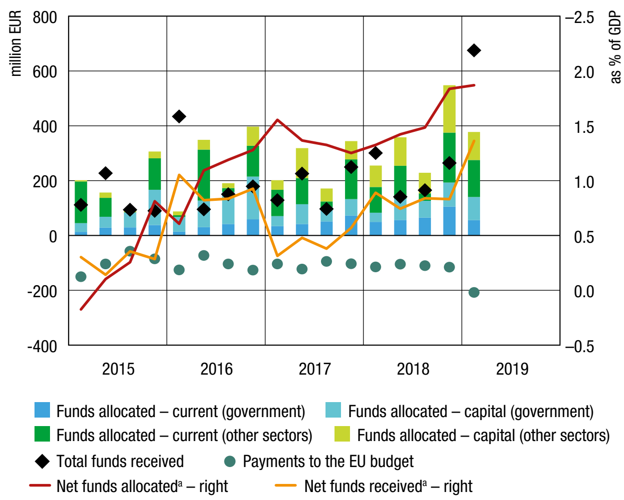
Net revenues arising from transactions with the EU budget were higher in the first quarter of 2019 than in the same period the year before. The uptake of EU funds intensified considerably, but at the same time, payments to the common budget grew as a result of an earlier payment of a rather large portion of the annual contribution. As regards the structure of the use of EU funds, the use of capital funds grew slightly faster than current transfers, while the increase in the total amount of funds used was equally distributed across the government and other sectors. The surplus of EU funds utilised over the payments to the EU budget, reported as the sum of the last four quarters, increased slightly from 1.8% of GDP at end-2018 to 1.9% of GDP at the end of March 2019. Net inflow of other income, which excludes income from equity and debt investment and transactions with the EU budget, recorded in the first quarter of 2019 remained at the level seen in the same period the year before.

Figure 6.7 Investment income



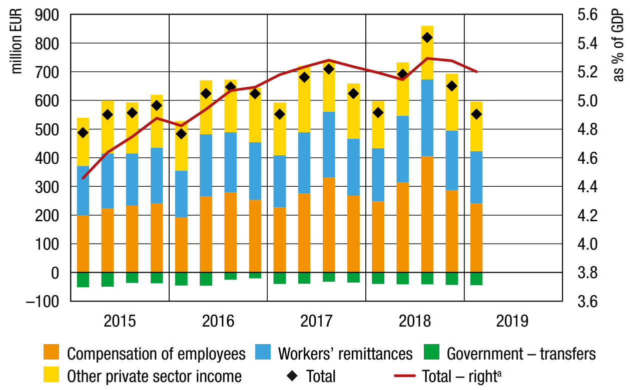
[a] One-off effects include conversion of CHF-linked loans in 2015 and bank provisions for loans to the Agrokor Group in 2017 and 2018.
[b] Sum of the last four quarters, excluding one-off effects.
Source: CNB.

Figure 6.8 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 6.9 Other income, excluding investment income and transactions with the EU



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

Projected developments

In the whole of 2019, the current and capital account could run a surplus of 3.1% of GDP, compared with 3.8% of GDP in 2018. The expected narrowing of the current and capital account surplus is a result of a continued noticeable widening of the foreign goods trade deficit. At the same time, the primary income account deficit could deteriorate only slightly. On the other hand, unfavourable developments could be mitigated by the continued increase in the net exports of services and the increase in the secondary income and capital transactions accounts brought about by the more vigorous utilisation of EU funds.

As for the assessment of foreign trade developments, expectations regarding economic developments in the main trading partners have been lowered, particularly in relation to Italy and Germany. The foreign trade deficit is therefore expected to continue to widen noticeably in 2019 despite favourable export results in the first quarter. The growth in the exports of goods could be similar to that recorded in 2018 (according to balance of payments data), while the imports of goods could increase more slowly than in the previous year. On the other hand, unfavourable developments in the current and capital account could be mitigated by an increase in the net exports of services, primarily thanks to a rise in tourism revenues. Still, year-on-year tourism revenues growth is expected to slow down slightly from 6.6% in 2018 to 4.0% in the current year amidst the stronger competition in the global tourism market and the slowdown in the growth of main outbound markets.

Furthermore, secondary income and capital account surplus may improve in 2019 owing to the continued strengthening of EU funds uptake. Net revenues from transactions with the EU budget could go up from 1.8% of GDP in 2018 to 2.3% of GDP in 2019. At the same time, the primary income account deficit could widen only slightly in 2019 as the expected growth in expenditures on direct equity investments could, for the most part, be offset by increased revenues from resident direct equity investments abroad and growing revenues from compensation of persons temporarily employed abroad.

The current and capital account surplus is expected to decrease to 2.2% of GDP in 2020 as a result of the increased foreign goods trade deficit. On the other hand, the growth in net exports of services is expected to continue and EU funds use is expected to intensify further. No significant changes are expected in the primary income account.

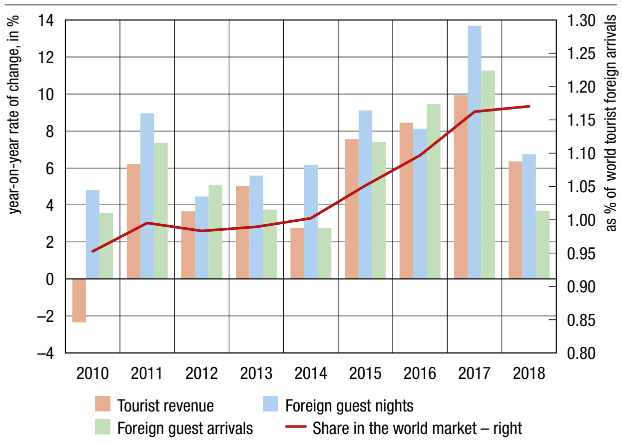
As regards risks to the projected current and capital account balance, negative risks prevail. Particularly noteworthy in that regard is the possible noticeable slowdown in foreign demand of the main trading partners, partly as a result of the further strengthening of trade protectionism. Moreover, the continued strengthening of competition in the Mediterranean tourism market could additionally hamper the growth in tourism revenues. At the same time, the risk associated with a possible pronounced rise in interest rates on the global financial markets declined. On the other hand, certain positive risks are present as well, mainly in relation to the more vigorous use of EU funds.

Box 2 Exports of tourist services – recent developments and expectations

In 2018, export results of the domestic tourist sector, after a number of years of much intensified growth, recorded a noticeable slowdown in the dynamics of growth of both physical and financial indicators. Such developments reflect more favourable security conditions in the competitive markets, a faster growth in the prices of tourist services compared with the majority of competitors in the period from 2010 and lower competiveness when compared with the West Mediterranean. The same factors might also have a negative impact on the dynamics of tourism in the next several years.

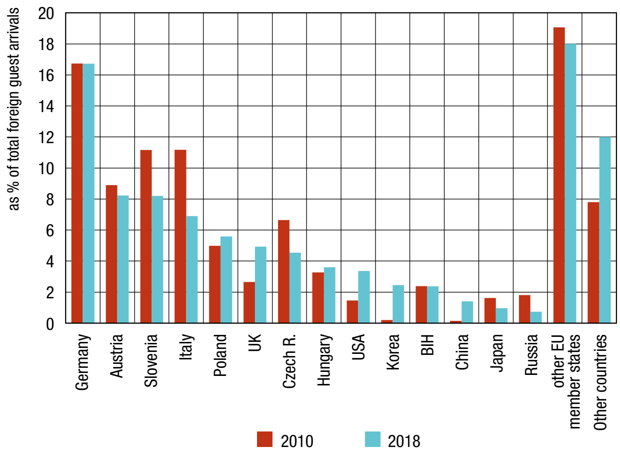
In 2018, Croatia recorded the best tourist export result since its independence, reaching EUR 10.1bn in foreign currency income (19.6% of GDP), or 16.6 million arrivals of foreign guests who spent 83.1 million nights in the country. After the global financial crisis, which had only a short-term negative impact on tourist turnover and consumption by foreign tourists in Croatia, in the period from 2010 to 2018, tourism revenue on average grew by 6.2% and foreign tourist arrivals by 7.9% annually. The dynamics of revenue growth and growth in foreign tourist arrivals was the strongest in the period from 2015 to 2017 and in 2018 it slowed down to 6.4% and 3.7% respectively (Figure 1). Growth

Figure 1 Physical and financial indicators of tourism in Croatia and the share in the world market



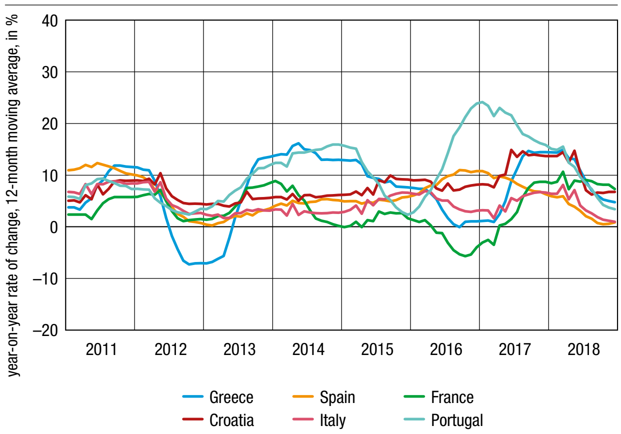
Note: The share in the world market was calculated as the ratio of tourist arrivals to Croatia and total tourist arrivals on a global level.
Sources: CBS, World Bank and CNB.

Figure 2 Structure of foreign guest arrivals to Croatia, according to the country of origin



Source: CBS.

Figure 3 Arrivals of foreign guests to European Mediterranean countries



Source: Eurostat.

was particularly weak during the summer months of 2018, but it had recovered by the end of the year. Since the dynamics of growth of tourist arrivals remained strong on a global level in 2018, the growth of Croatia's share in the world tourism market slowed down.

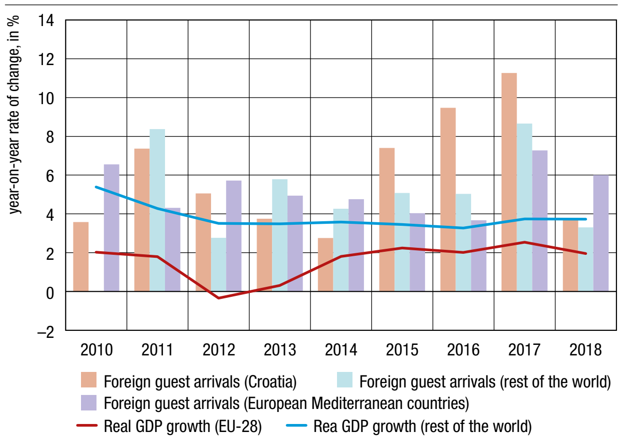
Over the past years, changes in the geographic structure of foreign guests visiting Croatia were observed. On the one hand, the share of guests from the traditional outbound markets (Figure 2) is decreasing, in particular Italy, Slovenia and the Czech Republic, arrivals from which are growing slower than average. At the same time, the share of the arrivals of guests from non-EU countries to which Croatia is not the primary tourism market, such as Korea, the USA and China, is growing. This has partially counteracted the high seasonality of the Croatian tourism and prolonged the tourist season.

Croatia is no exception to the recent trends in tourism. After several years of accelerated growth, in 2018, the majority of the European Mediterranean countries recorded unexpectedly weak tourism results, Spain and Italy in particular (Figure 3).

Although the tourist sector of each country in the Mediterranean has its peculiarities, there are still certain common factors that have contributed to the deceleration of the tourist turnover in these countries. If analysed from the demand perspective, it seems that the tourist turnover dynamics in the Mediterranean countries can only partially be explained by changes in demand (Figure 4). In the past years, both in Europe and in the rest of the world, the growth in tourist arrivals of foreign guests has exceeded real economic developments, which partially points to the growing tendency towards foreign travel, i.e. the increasing importance of tourism in the global economy.

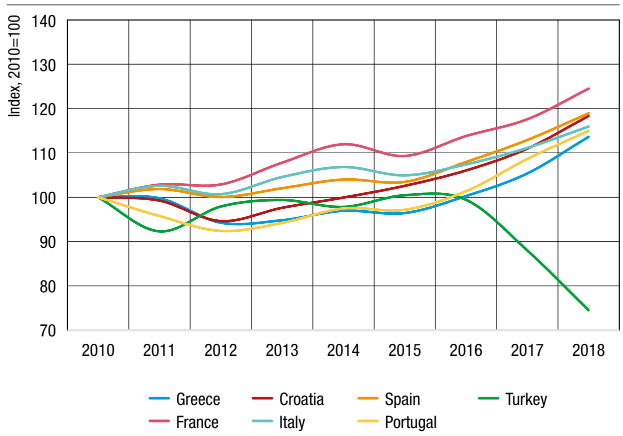
No significant changes in terms of the price competitiveness of Croatia and other European Mediterranean countries have been recorded that could explain the recent trends in tourism. It was precisely during the years of high growth in arrivals of foreign tourists that the majority of the Mediterranean countries, including Croatia, recorded the largest increase in the prices related to tourism, i.e. the decline in price competitiveness. As shown in Figure 5, the above mentioned countries recorded a constant increase in the prices of accommodation and restaurant food and beverages, and the trend did not subside in 2018. The growth trend was the least expressed in Greece, which partially offset the increased uncertainty in the tourism market by the correction of prices during the political and economic crisis.

Figure 4 Economic growth and tourist arrivals



Note: European Mediterranean countries include Italy, France, Portugal, Spain, Greece and Croatia.
Sources: Eurostat, World Bank and IMF.

Figure 5 Prices of accommodation and restaurant food and beverages adjusted by the change in the nominal effective exchange rate



Sources: Eurostat and CNB estimates.

Figure 6 Arrivals of foreign guests in selected countries and regions

Notes: West Mediterranean includes France, Italy, Portugal and Spain. South Mediterranean includes Egypt, Morocco and Tunisia.
Sources: Eurostat and WTO.

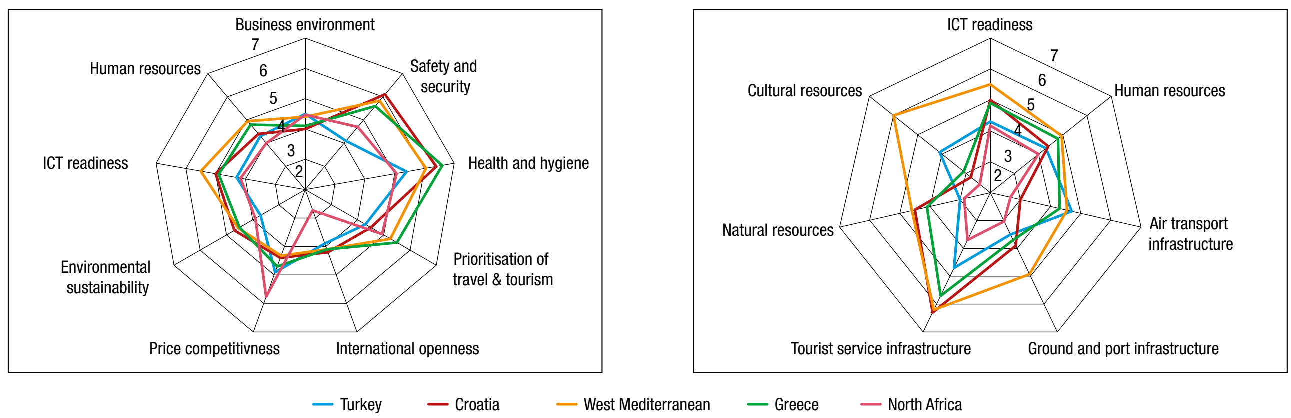
Croatia, alongside France and Spain, is among the countries in which prices have increased most since 2010. In Croatia, it was also attributed to the increase in the VAT rate on restaurant food and beverages from 13% to 25% in the beginning of 2017. By contrast, Turkey decreased the prices of accommodation and restaurant food and beverages by about 30% in real terms (adjusted by changes in the nominal exchange rate) from 2016 to 2018.

Since the favourable historical movements in the export tourist sector of the European Mediterranean countries cannot be explained by changes in demand or price competitiveness, the conclusion is reached that other factors also had a positive impact on them, some of which were one-off factors, and others were structural and potentially permanent. It is very likely that the recovery of the markets that are direct competitors to the European summer destinations, which were hit by security crises in the previous years (Figure 6), has had a significant impact on the slowdown in the growth of tourism in 2018. Taking into account the market size, the largest individual impact was attributed to the recovery of the Turkish market, which, due to the political instability in 2016, lost almost 11 million visitors (a decline of 30%), but which saw a full recovery in the subsequent two years, the pre-crisis level being even exceeded. This was also assisted by the strong depreciation of the lira in 2018, by which Turkey gained significantly in price competitiveness. The situation is similar in the markets of North Africa, which for security reasons, as far back as from 2011 and the start of the Arab Spring, suffered a considerable decrease in tourist turnover, which has partially stabilised in the recent period. For instance, Egypt and Tunisia alone, in the period from 2011 to 2016, lost about a half (11 million) of foreign guest arrivals. European Mediterranean countries, including Croatia, benefited from the times of instability because they are generally viewed as very safe destinations, but in the past years, this positive impact has been diminishing gradually.

Security, accompanied by cultural heritage and a developed infrastructure, is the largest competitive advantage of the West Mediterranean countries compared with other destinations. However, if Croatia is observed in this group of countries, in the broad spectrum of indicators covered by the Travel and Tourism Competitiveness Index[14], Croatia is considerably lagging behind with regard to the quality of the business environment and transport infrastructure, in particular air and maritime infrastructure (Figure 7), which would connect it better with the outbound markets. Accordingly, in its latest tourism competitiveness report from 2017, the World Economic Forum ranks Croatia the 32nd in the world, lower than the West Mediterranean countries, and its position has only slightly improved in the past years (in 2011 it was ranked the 34th). This results in Croatia being much less competitive when compared with other countries in the region, which noticeably reduces its long-term potential for growth in the domestic tourist sector.

Taking into account these structural limitations, as well as the described trends in the Mediterranean market, the recorded

Figure 7 Score of Croatia and competitive countries in the categories covered by the Travel and Tourism Competitiveness Index



Notes: West Mediterranean includes Italy, France, Spain and Portugal. North Africa includes Egypt, Morocco and Tunis. On the scale of scores from 1 to 7, the higher score marks higher competitiveness.
Source: The Travel & Tourism Competitiveness Report 2017, World Economic Forum.

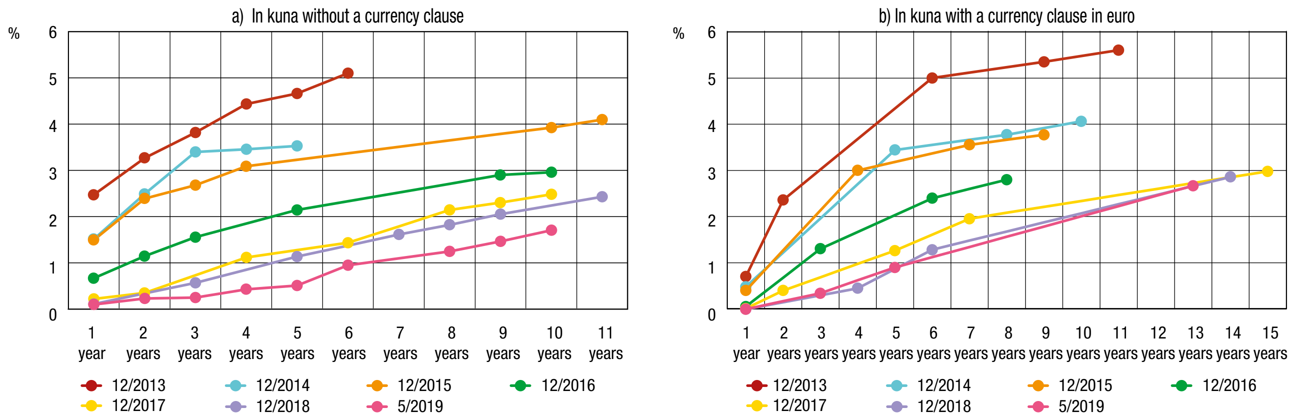
14 The Travel and Tourism Competitiveness Index (TTCI) is constituted as the composite rating based on scores of different areas of competitiveness of the tourist sector, which comprise legislation, business environment, price competitiveness, infrastructure and the quality of human, cultural and natural resources. The scores are based on World Economic Forum's research and information obtained from different international and national institutions, and are prepared in cooperation with national partner institutions.

slowdown of growth in the export results of the domestic tourist sector in 2018 cannot be deemed to be temporary. Although there are positive factors, primarily in the form of the increase in the tendency towards tourist consumption on a global level, which might be beneficial for Croatia, limiting factors for the growth of exports of tourist services might prevail in the medium term. This mostly refers to the absence of the effect of tourism being diverted from less stable regions, under the assumption that security conditions in competitive markets will continue to improve. In addition, lower competitiveness will also have a negative impact on tourism. Therefore, the CNB expects that tourism revenues in the forthcoming period will grow less slowly than in the previous years.

7 Private sector financing

The several-year trend of improved financing conditions of domestic sectors continued in the first half of 2019. The interest rate on short-term government borrowing through the issue of one-year kuna T-bills in the domestic market dropped from 0.09% in February 2018 to 0.08% in April 2019, while the interest rate on one-year euro T-bills held steady at 0.00% from May 2018. At the end of January, the government issued T bills of EUR 1.1bn with a maturity of 455 days at an interest rate of 0.00% to partly refinance the EUR 1.5bn worth of maturing T-bills issued in November 2017 at the interest rate of 0.1%. The remaining part of the maturing T-bills was refinanced by the domestic issue of the three-year bond in the amount of EUR 500m with a yield of 0.66%. In early February, the government issued the second tranche of the ten-year kuna bond worth HRK 5.0bn with a yield of 2.41% in the domestic capital market, while in mid-June it issued a ten-year euro bond worth EUR 1.5bn with a yield of 1.32% in the international market with a view to refinancing the dollar bond maturing in November. The yield curve

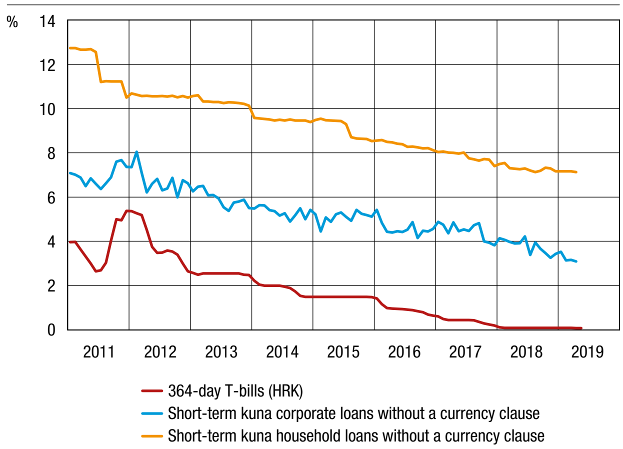
Figure 7.1 Yield-to-maturity on RC bonds



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.

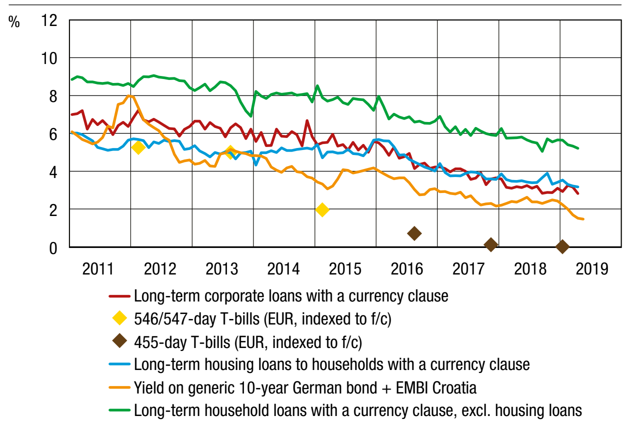
Notes: The dots show the achieved yields, while other values have been interpolated. Data for a one-year yield refer to the achieved interest rate on one-year kuna T-bills with a currency clause in euro, while data for the end of 2016 and the end of 2017 refer to November and October respectively.
Source: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

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



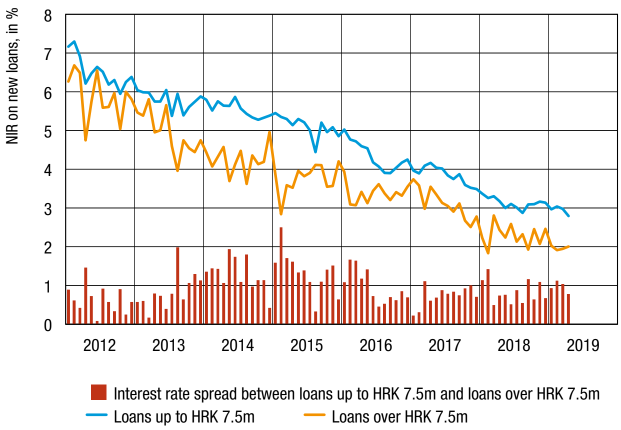
Sources: MoF and CNB.

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



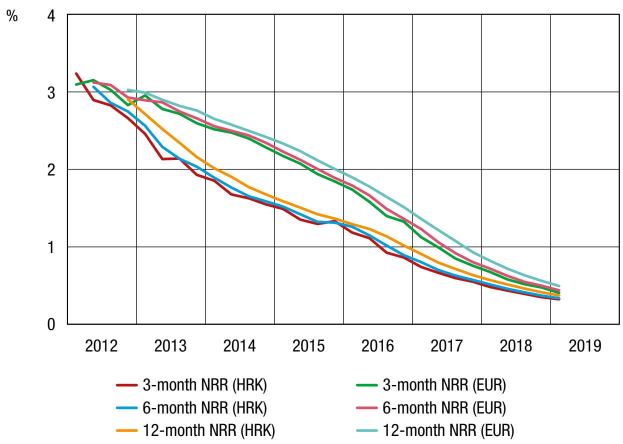
Note: EMBI, or the Emerging Market Bond Index, shows the spread between yields on government securities of emerging market economies, Croatia included, and risk-free securities issued by developed countries.
Sources: MoF, Bloomberg and CNB.

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



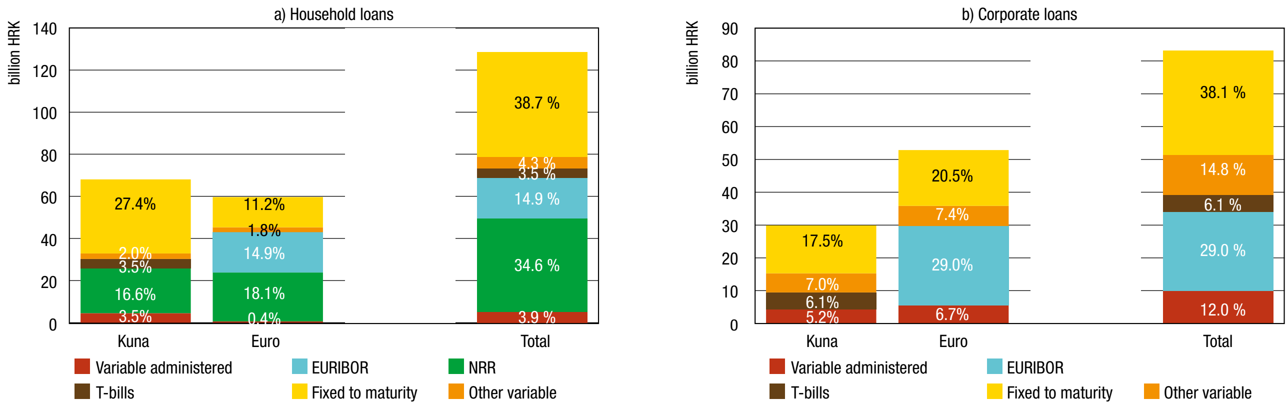
Source: CNB.

Figure 7.5 National reference rate (NRR)



Note: The rates shown refer to the rates for all natural and legal persons.
Source: HUB.

Figure 7.6 Structure of interest rates, April 2019



Notes: Percentages show shares in total household loans. Loans currently undergoing initial interest rate fixing are included in a category in accordance with the relevant parameter that will be applicable following the expiry of the fixing period.
Source: CNB.

Notes: Percentages show shares in total corporate loans. On account of its small share, the amount of corporate loans tied to the NRR is included in the category "Other variable". Loans currently undergoing initial interest rate fixing are included in a category in accordance with the relevant parameter that will be applicable following the expiry of the fixing period.
Source: CNB.

for kuna bonds without a currency clause also points to more favourable government financing conditions (Figure 7.1a), having dropped considerably in May 2019 from the end of 2018, while the yield curve for kuna bonds with a currency clause in euro remained virtually unchanged (Figure 7.1b).

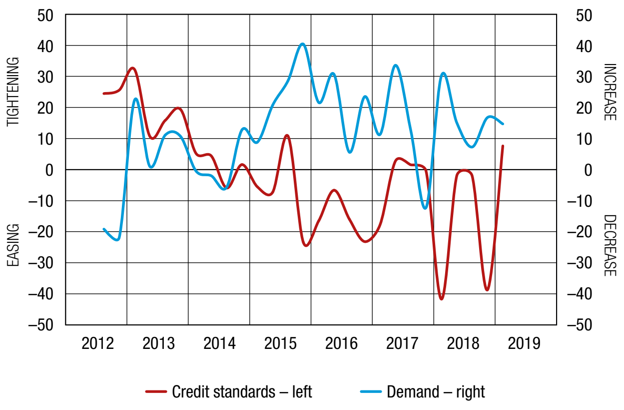
The average cost of government borrowing on the foreign market estimated on the basis of the sum of the EMBI for Croatia and the yield on German government bonds shrank noticeably from 2.4% at the end of 2018 to 1.5% at the end of May 2019 (Figure 7.3), with the decline in the EMBI for Croatia contributing to the trend by 0.6 percentage points. The CDS spread saw only a slight decrease in the first five months of 2019, standing at 89 basis points at the end of May. As regards credit rating agencies' perception of Croatia's risk, in the first half of the year, two agencies, Standard & Poor's and Fitch, upgraded Croatia's credit rating from BB+ to BBB–, putting the country's rating back into investment category after a several-year long period. At the end of April, Moody's changed Croatia's outlook from stable to positive, maintaining the rating two grades below investment category, at Ba2, unchanged from March 2016.

Costs of corporate financing continued to decline. The interest rate on short-term kuna loans without a currency clause was 0.3 percentage points lower in April than in late 2018 (Figure 7.2), and the interest rate on long-term corporate loans with a currency clause saw the same decrease in the aforementioned period (Figure 7.3). Favourable developments in corporate financing costs in the first half of 2019 do not vary substantially with regard to loan amount (Figure 7.4). Interest rates on loans exceeding HRK 7.5m are significantly lower and more volatile, because corporations taking out such loans are fewer in number and have more collateral and alternative financing options.

Household financing costs also continued their downward trend. The interest rate on long-term loans with a currency clause, excluding housing loans, was 0.4 percentage points lower in April than at the end of 2018 (Figure 7.3), while costs of financing associated with long-term housing loans with a currency clause dropped by 0.2 percentage points. At the same time, the interest rate on short-term kuna loans without a currency clause remained almost unchanged after the considerable decline seen in the previous years.

The continued favourable interest rate movements in private sector financing are attributable to exceptionally high financial

Figure 7.7 Credit standards and corporate demand for loans



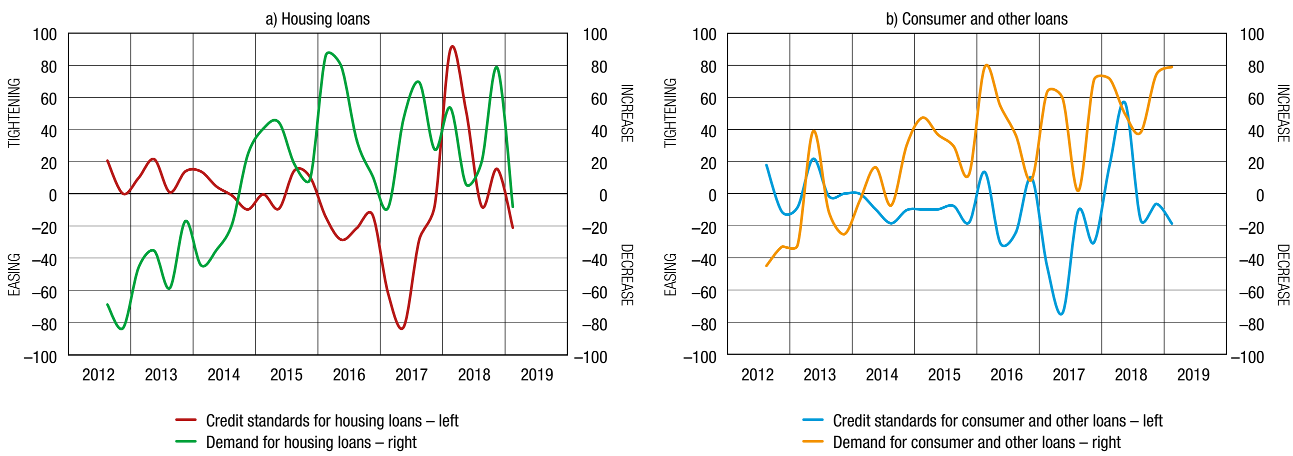
Note: Data show the net percentage of banks weighted by the share in total corporate loans.
Source: CNB.

increased the most, by 5.0 percentage points in household loans and 6.0 percentage points in corporate loans.

According to bank lending survey findings, credit standards for corporate loans tightened in the first quarter of 2019 after a several-year period mostly marked by favourable developments (Figure 7.7). The tightening of the standards seen at the beginning of the year was primarily influenced by the negative outlook of the industry or of a particular corporation. On the other hand, in the first quarter of 2019, corporate demand for loans continued its several-year upward trend (only briefly interrupted in the last quarter of 2017) with small and medium-sized enterprises exhibiting the highest demand and long-term loans being the most sought after form of lending. The most significant factors driving the demand for loans upwards in the first quarter of 2019 were the same as in the previous years, including corporate needs for financing inventories and working capital as well as gross fixed capital formation.

As regards credit standards for household loans, the standards for both types of household loans were eased to almost the same extent in the first quarter of 2019 (Figure 7.8). Such developments were primarily affected by competition among banks

Figure 7.8 Credit standards and household demand for loans



Note: Data show the net percentage of banks weighted by the share in total household loans.
Source: CNB.

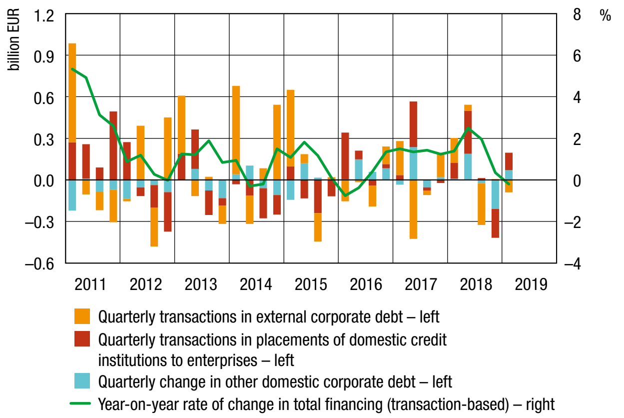
market liquidity coupled with the further decline in the costs of funding of the Croatian banking system, with EURIBOR still in negative territory (Figure 2.3) and the national reference rate (NRR)[15] continuously decreasing.

As regards interest rate structure, at the end of April, the most widespread type of household loans were loans with a fixed-to-maturity interest rate (38.7%), followed by loans linked to the NRR and EURIBOR (Figure 7.6.a). Furthermore, 15.9% of household loans are loans with interest rates fixed over a period of time shorter than loan maturity, more than two thirds of which are loans with interest rates fixed over a period longer than three years. Loans with interest rates fixed to maturity prevail in corporate loans as well (38.1%), followed by loans linked to the EURIBOR, in line with the currency structure in which the euro accounts for the largest share (Figure 7.6.b). Compared with the end of 2017, shares of interest rates fixed to maturity and positive expectations regarding overall economic trends. On the other hand, trends in demand seen in the first quarter varied. There was a surge in 2018, but the demand for housing loans slowed down at the beginning of the year, although consumer confidence and housing market prospects continued to have a positive effect on demand. On the other hand, the several year upward trend in demand for consumer and other household loans continued, reaching an all-time high since the survey was introduced. The more vigorous demand was primarily driven by the consumption of durable consumer goods, but also by strong consumer confidence.

The total debt of non-financial corporations[16] increased in the first quarter of 2019. This was brought about by the increase in domestic financing, while external debt decreased (Figure 7.9). On an annual basis, total corporate debt was 0.2% lower at the end of March 2019 (transaction-based) due to the deleveraging

15 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).
16 Non-financial corporations do not include public enterprises included in the general government sector.

Figure 7.9 Corporate financing



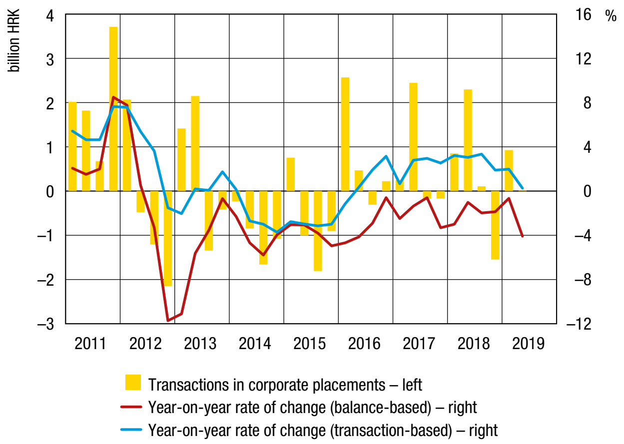
Notes: Other domestic financing includes borrowing from domestic leasing companies and the CBRD. Foreign debt excludes the effect of debt-equity swaps. All changes were calculated according to transactions (except for other domestic debt).
Sources: HANFA, CNB and CNB calculations.

of public and private enterprises vis-a-vis lenders abroad, while loans from domestic credit institutions and other domestic debt grew. Under the exclusion of activated government guarantees for loans to certain shipyards, total corporate debt was 0.7% higher at the end of March observed on an annual basis.

Domestic credit institutions' placements to non-financial corporations rose by HRK 0.9bn (1.1%) in the first five months of 2019 (transaction-based, Figure 7.10). The annual growth slowed down noticeably, standing at 0.3% at the end of May as a result of a slowdown in lending activity and the activation of government guarantees for loans to certain shipyards (by which the annual growth rate was reduced by 1.9 percentage points). Accordingly, the annual rate of change in corporate placements calculated on the basis of nominal values sank to –4.1%, a consequence not only of the aforementioned factors but also of the sale of non-performing loans.

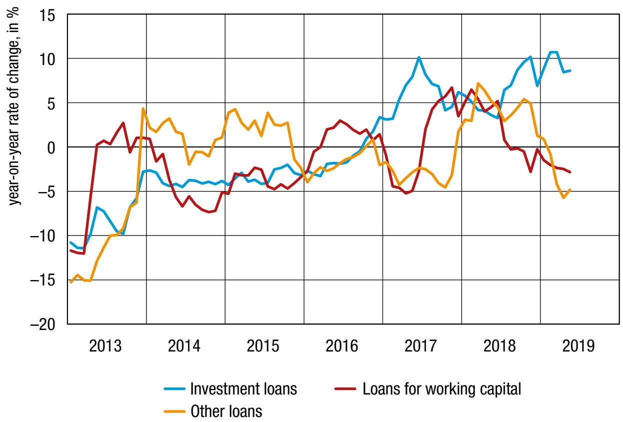
Broken down by activities, in spite of the slower growth in total corporate placements, the positive contribution of companies engaged in accommodation and food service activities was similar to that recorded in 2018, with the bulk of the annual growth in placements in May attributable to this activity (Figure

Figure 7.10 Corporate domestic placements of credit institutions



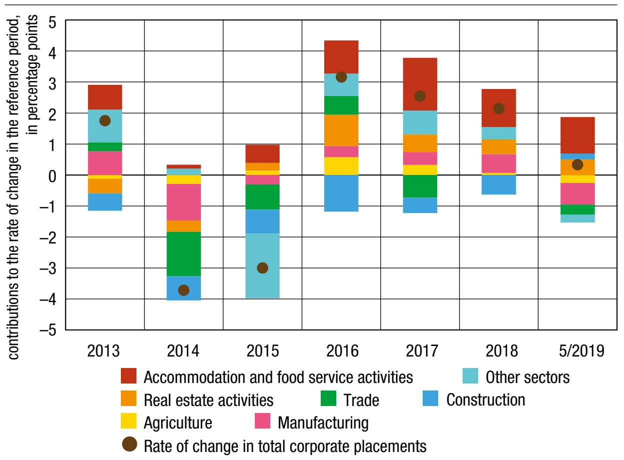
Note: Data for the second quarter of 2019 refer to April and May.
Source: CNB.

Figure 7.12 Growth of corporate loans by purpose
transaction-based



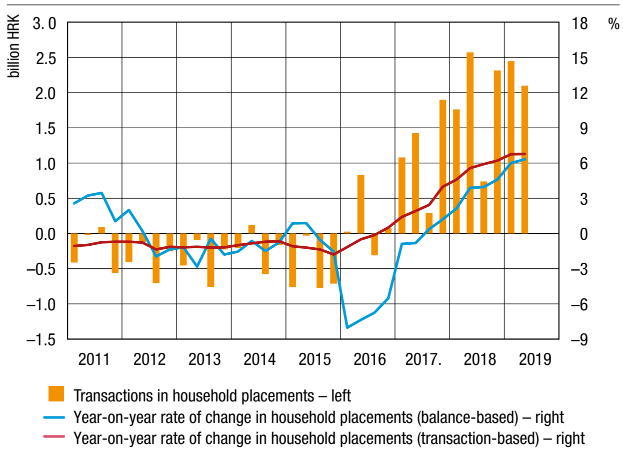
Source: CNB.

Figure 7.11 Growth of corporate placements by activity
transaction-based



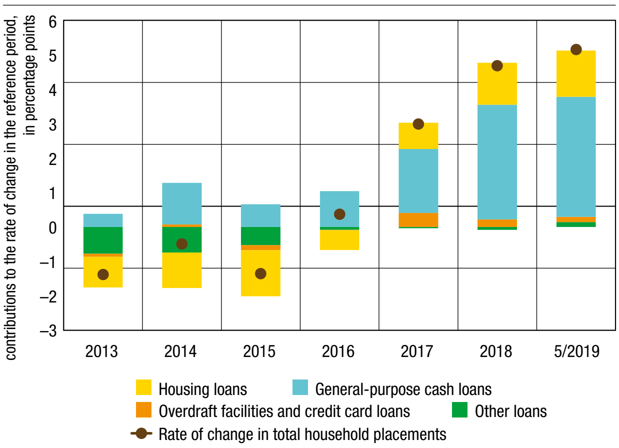
Source: CNB.

Figure 7.13 Household placements



Note: Data for the fourth quarter of 2018 refer to October.
Source: CNB.

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



Source: CNB.

7.11). Moreover, after a several-year long deleveraging trend, construction witnessed moderate growth. In contrast to the past several years, manufacturing provided a negative contribution to the growth in placements, which was partly due to the activation of government guarantees for loans to shipyards. Excluding that effect, lending to the manufacturing industry intensified in 2018, which primarily refers to the foreign currency financing of exporters (see Box 3 Developments in kuna and foreign currency corporate placements from 2011 to 2018). Observing corporate loans by purpose, the slowdown in the growth of total placements was brought about by the annual drop in the loans for working capital and other loans, while the annual growth in investment loans stood at 8.6% at the end of May (Figure 7.12).

The annual growth in household placements continued to accelerate steadily, reaching 6.8% in May 2019 (transaction-based, Figure 7.13). In addition to the continued decline in financing costs, acceleration in household lending was further spurred by growing employment and strong consumer confidence. Observed by loan structure, general-purpose cash loans remained the main driver of growth (Figure 7.14); however, their annual growth began slowing down in March 2019, standing at 12.4% in May (transaction-based). Among other factors, the slowdown was also prompted by the Recommendation on actions in granting non-housing consumer loans by which the CNB recommends that credit institutions apply more cautious conditions when granting new general-purpose cash loans, particularly those with longer maturities, while consumers are encouraged to be prudent when borrowing. The continued moderate acceleration in the growth of household placements was mainly due to the pickup in the annual growth in housing loans to 4.1% in May (transaction-based).

Projected developments

Total placements (government excluded) are estimated to grow by 4.3% annually in 2019 (transaction-based), which is almost the same as the growth rate of 4.4% seen in 2018. The slightly slower growth in total placements could be due to the slowdown in the growth of household placements under the influence of decelerated growth in general-purpose cash loans, considering that the banks need to comply with the CNB's Recommendation on actions in granting non-housing consumer loans. The growth in corporate lending could remain modest. In nominal terms, the increase in total placements will still be lower in 2019 than the transaction-based growth due to the continued effect of the sale of non-performing loans. The risks to the realisation of the projected credit growth dynamics are estimated to be balanced.

Box 3 Developments in kuna and foreign currency corporate placements from 2011 to 2018

An analysis of developments in placements to non-financial corporations from 2011 to 2018 has shown that exporting companies borrowed from the banks while non-exporters' borrowing held steady. In addition, exporting companies, primarily manufacturing enterprises and accommodation and food service activities, borrowed in foreign currency, leading to the domestic corporate placements of credit institutions in 2017 and 2018 being increasingly euroised.

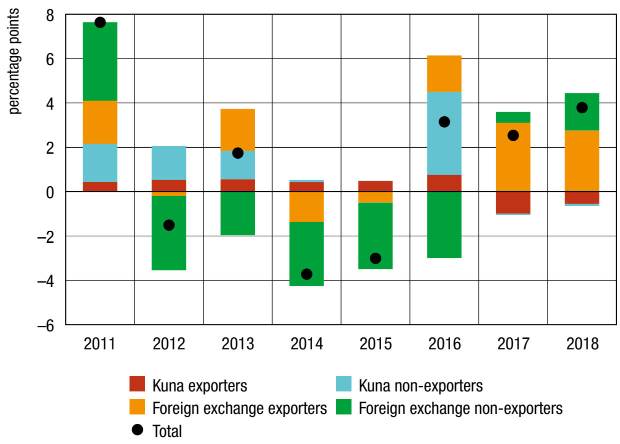
The trend of growth in kuna and a decline in foreign currency[17] placements of domestic credit institutions to non-financial corporations present for many years came to a halt in 2017 and 2018 when considerable borrowing in foreign currency and a small decline in kuna placements were observed. From 2011 to 2016, non-exporters accounted for the bulk of the growth in kuna placements and an almost equal level of foreign currency deleveraging. By contrast, exporters'[18] foreign currency financing mostly increased, particularly in 2017 and 2018 (Figure 1).[19]

As regards the cumulative developments over the eight-year period, account should be taken of the fact that the big difference between changes in the stock and changes based on transactions arises primarily from the sale of partly and fully irrecoverable loans and from reclassifications. Almost the entire fall in the stock is accounted for by the decline in foreign currency placements to non-exporters (Figure 2). In other words, sold non-performing loans mostly involve loans to non-exporters.

These developments were also reflected in the euroisation of corporate placements. Until 2015, placement euroisation was trending downwards generally, with no significant difference between exporters and non-exporters (Figure 3). However, in 2016 exporters' euroisation started trending upwards and at the end of 2018 was almost equal to that at the end of 2010. By contrast, non-exporters' euorisation declined by almost 13 percentage points from the end of 2010. If the share of foreign exchange debt in GDP is observed, their foreign exchange exposure fell even more – the share of foreign currency placements of non-exporters almost halved over the eight-year period and stood at

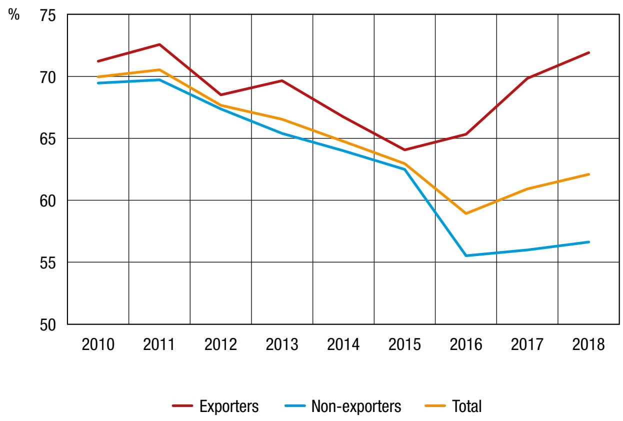
17 Foreign currency financing includes placements in kuna with a currency clause and placements in a foreign currency.
18 Exporters are enterprises with a minimum exports to total operating revenue of 10%, based on data provided by FINA. For exporter status in 2018, data for 2017 were used, since FINA data for 2018 are currently unavailable. The exporter category in individual years includes 52 enterprises whose data on exports provided by FINA were either considered unrealistically low or equalled zero. A large majority of these enterprises belong to the accommodation and food service activities.
19 Unless otherwise specified, the figures show rates of change and contributions based on transactions. The rate of growth of total placements in 2018 shown in Figure 1 excludes the effect of activation of government guarantees for loans to shipyards and is therefore higher than the growth rate shown in Figure 7.11.

Figure 1 Contributions to change in total corporate placements



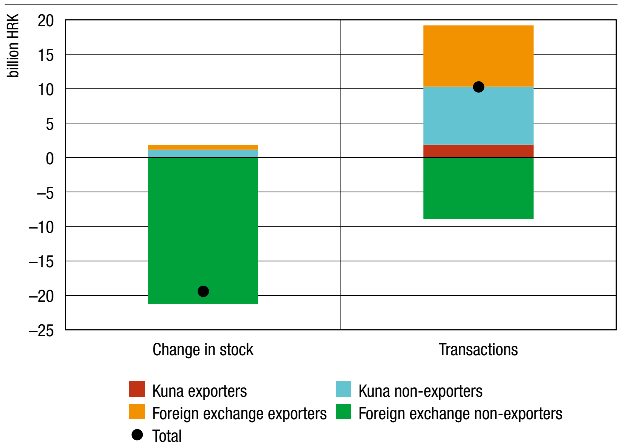
Sources: FINA and CNB.

Figure 3 Euroisation of corporate domestic placements of credit institutions



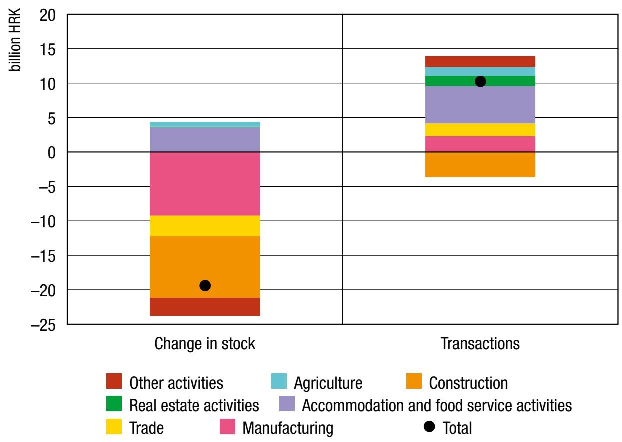
Sources: FINA and CNB.

Figure 2 Cumulative changes in corporate placements from 2011 to 2018
by currencies



Sources: FINA and CNB.

Figure 4 Cumulative changes in corporate placements from 2011 to 2018
by activities



Sources: FINA and CNB.

8.4 of GDP at the end of 2018, in contrast with that of exporters which fell only slightly, to 5.9% of GDP.

Cumulative changes by activities[20] suggest that the largest fall in the stock was seen in manufacturing and construction, which recorded the fastest sale of placements (Figure 4). Deleveraging was recorded only in construction (based on transactions), while the fastest growth was recorded in accommodation and food service activities.

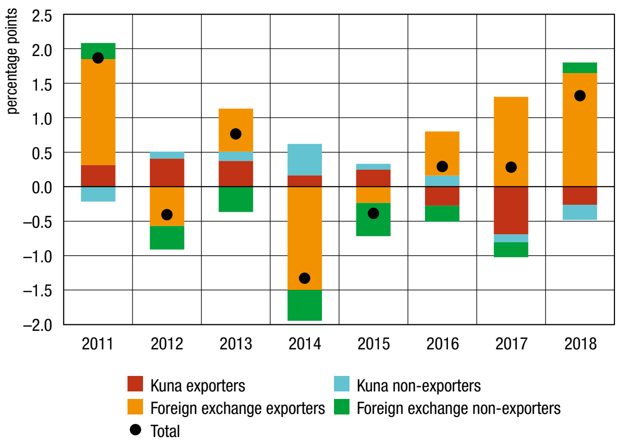
As regards the annual developments in placements on the level of individual activities, towards the end of 2018, placements to manufacturing were the most widely represented and accounted for almost 22% of total corporate placements, as was the case in most of the preceding years. The fact that credit activity focuses on this activity shows a clear export orientation since most changes in financing, irrespective of whether it is debt growth or deleveraging, involve exporters (Figure 5). Until 2015, foreign currency lending to exporters in manufacturing was volatile, cumulatively recording a small fall, in contrast with a steady rise in kuna financing. However, foreign currency placements to exporters started trending upwards in 2016 accompanied by a simultaneous kuna deleveraging that was particularly pronounced in 2017.

Towards the end of 2018, as in most previous years, the share of placements to trade in total corporate placements was almost equal to the share of manufacturing, making trade the second most widely represented activity. However, in contrast with manufacturing, the dynamics of the credit activity of trade involves almost exclusively non-exporters[21] (Figure 6). Kuna placements of non-exporters grew at a record rate in 2016 but kept falling in the following two years, influenced, among

20 Activities refer to one letter codes for NCEA 2007 areas, with the names of individual activities being abbreviated so that, for instance, "Trade" refers to activity "G-Wholesale and retail trade and repair of motor vehicles and motorcycles".

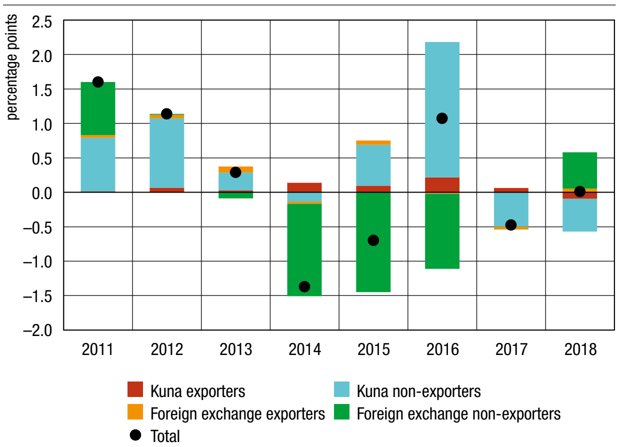
21 Although Figure 6 shows only enterprises in trade activities with placements from domestic credit institutions, official data probably underestimate the export component of trade. It is difficult for enterprises in that activity to determine the share of their operations that involves non-residents, which is very important in Croatia because of the large consumption by foreign tourists. By contrast, exports of goods are much more easily captured in hotels and camps (exports of services) and in particular in manufacturing (exports of goods).

Figure 5 Contributions of manufacturing to change in total corporate placements



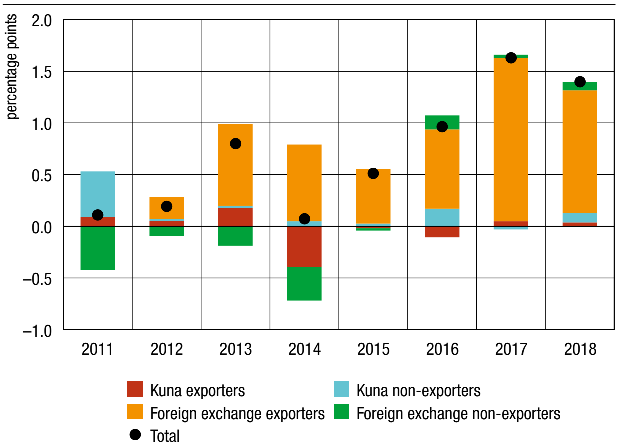
Sources: FINA and CNB.

Figure 6 Contributions of trade to change in total corporate placements



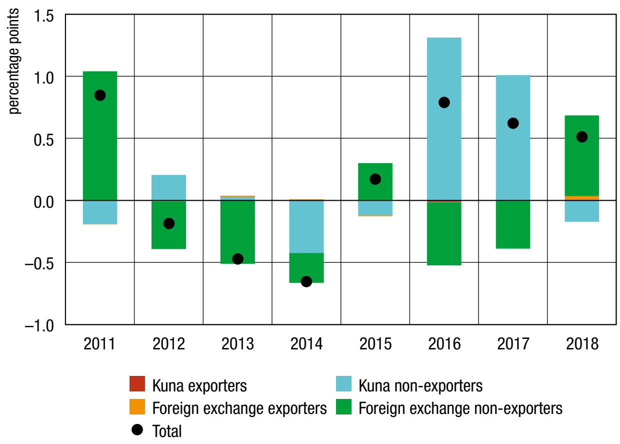
Sources: FINA and CNB.

Figure 7 Contributions of accommodation and food service activities to change in total corporate placements



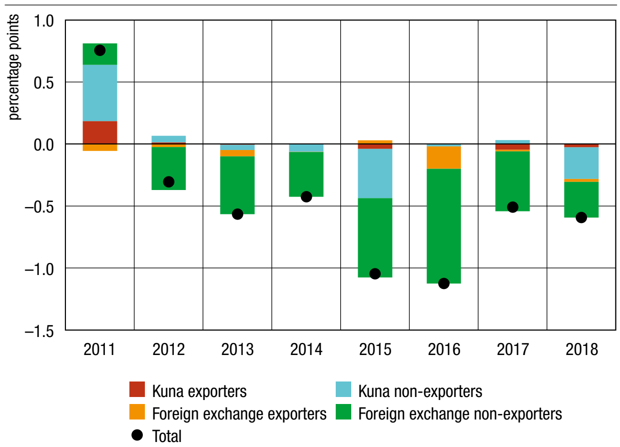
Sources: FINA and CNB.

Figure 8 Contributions of real estate activities to change in total corporate placements



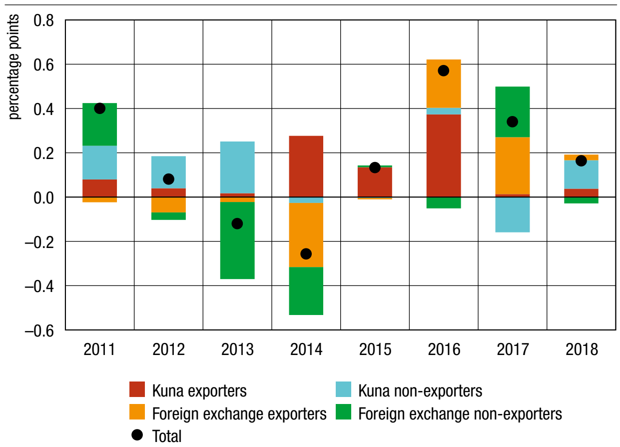
Sources: FINA and CNB.

Figure 9 Contributions of construction to change in total corporate placements



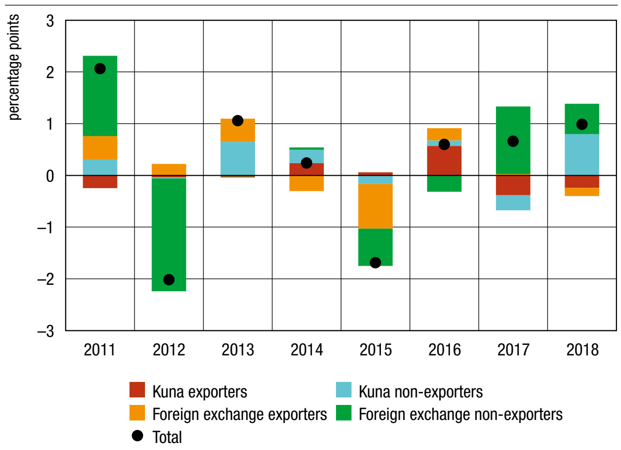
Sources: FINA and CNB.

Figure 10 Contributions of agriculture to change in total corporate placements



Sources: FINA and CNB.

Figure 11 Contributions of other activities to change in total corporate placements



Sources: FINA and CNB.

other things, by the crisis in the Agrokor Group. Foreign currency placements to non-exporters mainly fell, particularly from 2014 and 2016, and after many years of deleveraging, did not grow until 2018.

Of all activities, only those of accommodation and food service and trade recorded a growth in placements in all the years observed (Figure 7). Such developments were driven by a very fast recovery in tourist demand, in 2010 the number of nights spent in Croatia by foreign tourists exceeding that of the pre-crisis 2008. Since consumption by foreigners in Croatia is considered exports of services, most of the credit activity in this activity involves exporters. In accordance with the importance of foreign demand, exporters increased foreign currency financing in all the years except during the 2011 stagnation, particularly in the last two years of the observed period. Thus, the total transactions of foreign currency placements of exporters stood at HRK 2.5bn in 2017 and 2018, accounting for almost 44% of the transaction growth of total corporate placements during that period. Fast lending to this activity, accompanied by considerable sales of bank placements in other activities, led to a growth in the share in total corporate placements. This share reached 12% at the end of 2018, having almost doubled, and thus became the third most widely represented activity in the stock of placements of credit institutions.

The share of credit activities of exporters in real estate activities is unsurprisingly negligible (Figure 8). After three years of deleveraging, the growth of placements to this activity continued into 2015, with an especially fast increase in kuna financing taking place in 2016 and 2017, mainly as a result of the borrowing of one large municipal company.

The investment crunch that followed the global economic crisis was particularly hard on the construction activity, in which the amount of non-performing loans reached the highest levels ever in comparison with other activities. Because of the sale of non-performing placements and deleveraging, the stock of placements to construction more than halved from the end of 2010 and stood at HRK 7.2bn at the end of 2018. If only changes based on transactions are taken into account, this activity has been deleveraging since 2012 (Figure 9). In the same way as in the real estate activity, credit activity involves mainly non-exporters, which reflects the poor tradability of goods and services in this activity. As regards the currency structure, deleveraging mainly involved foreign currency financing as a result of the predominantly foreign currency borrowing in the previous years and limited new borrowing.

In contrast with the previous activities in which most changes in placements referred either to exporters or to non-exporters, in agriculture, both types of enterprises were widely represented (Figure 10). A considerable share of exporters in transactions has been recorded since 2014 when the increase in kuna and a decrease in foreign currency placements to these enterprises were almost equal while in the following years they increased both types of financing.

Another thirteen activities accounted for approximately 23% of total corporate placements at the end of 2018. Taking account of the diversity of the activities that make up this group, developments in placements were relatively volatile, while the bulk of credit activity involved non-exporters (Figure 11). After a small cumulative decline until 2015, the following three years recorded a growth in placements to other activities, in particular to professional, scientific and technical activities.

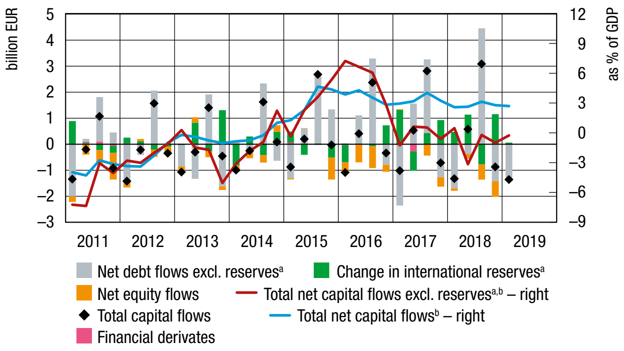
8 Foreign capital flows

The financial account of the balance of payments[22] saw a strong net capital inflow of EUR 1.4bn in the first quarter of 2019, almost completely as a result of the increase in net foreign debt liabilities of domestic sectors. The increase in net debt liabilities mostly referred to banks, which experienced the usual seasonal deterioration of their net foreign position, and, to a lesser extent, to other domestic sectors. In the same period, net equity investments in Croatia, as well as international reserves (excluding CNB liabilities) increased only slightly.

In the first three months of 2019, a modest net inflow of equity investments (EUR 0.1bn) was recorded, as a result of the growth of the liabilities of domestic sectors being more expressed than that of their assets. The increase in foreign assets was driven mostly by reinvested earnings of foreign enterprises owned by residents owing to the rise in their profitability, mostly in the activity of research and development. At the same time, in contrast to the same period of the previous year, when most of the growth of net liabilities referred to reinvested earnings of domestic enterprises in foreign ownership, the largest share of growth in net liabilities in the first quarter of 2019 was generated by new equity investments in Croatia, in particular in real estate, accommodation and construction activities (for more details on the characteristics of equity investments in Croatia, see Box 4 Analysis of foreign direct equity investments in Croatia).

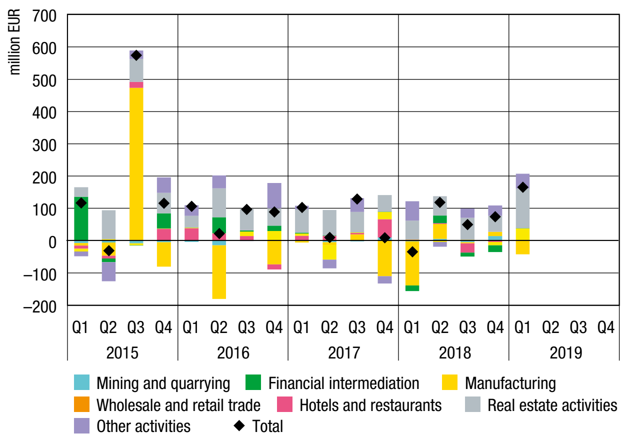
22 With respect to the balance of payments data published at the end of March 2019, with this disclosure the balance of payments data have been revised for the period from the beginning of 2015 until the end of 2018, in accordance with the audited financial reports of the reporting entities, with effects on the decrease in the value of reinvested earnings on the side of assets and liabilities in the direct investment account, i.e. reinvested earnings on the side of revenues and expenditures in the primary income account. The values of assets and liabilities based on equity investments in the international investment position have also been revised.

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



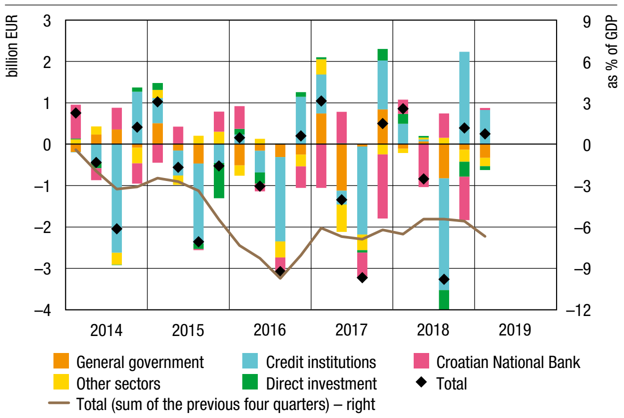
[a] Changes in gross international reserves net of CNB liabilities.
[b] Sum of the previous four quarters.
Notes: Net flows mean the difference between changes in assets and liabilities. Equity flows comprise changes in foreign direct equity investments, reinvested earnings and portfolio equity investment, 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



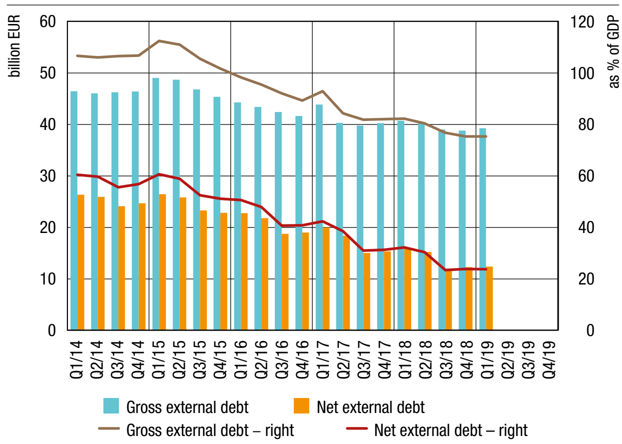
Note: Equity investment net of debt-to-equity transactions and round-tripping investments.
Source: CNB.

Figure 8.3 Net external debt transactions by sectors



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



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

The considerable rise in net debt liabilities in the first quarter of 2019 (by EUR 1.3bn, change in international reserves and CNB liabilities excluded) was the result of a simultaneous increase in domestic sectors' foreign liabilities and a decrease in their foreign assets. The net foreign position of banks deteriorated the most, primarily as a result of the decrease in foreign assets because of the sale of foreign exchange to the central bank and, to a lesser extent, the growth of liabilities with respect to foreign creditors. Other domestic sectors also increased their net debt liabilities, which was partially linked to the growth in liabilities of domestic corporations with regard to foreign owners due to the adoption of the decision to pay the dividend that was not paid until the end of the quarter. By contrast, in the first quarter of 2019, the government reduced its net debt liabilities with regard to foreign creditors, as a result of transactions in the secondary securities market, in which domestic institutional investors purchased a share of government bonds from foreign creditors. At the same time, the net foreign position of the central bank improved very moderately, since the growth in international reserves, as a result of the purchase of foreign exchange through foreign exchange interventions, was accompanied by the sale of foreign exchange to the central government.

Despite the increase in debt liabilities of domestic sectors, the relative indicators of external debt in the first quarter of 2019 did not deteriorate, thanks to a surge in nominal GDP growth. Thus, at the end of March 2019, gross external debt stood at EUR 39.3bn or 75.4% of GDP. The value of the relative indicator of gross external debt did not change from the end of the previous year. At the end of March 2019, net external debt stood at EUR 12.4bn or 23.8% of GDP, down by 0.1 percentage points from the end of 2018.

The international investment position deteriorated moderately, from –55.8% of GDP at the end of 2018 to –56.2% of GDP at the end of the first quarter of 2019. Such developments were the result of the deterioration in the foreign positions of banks, which was partially offset by the improvement in the position in other sectors.

Projected developments

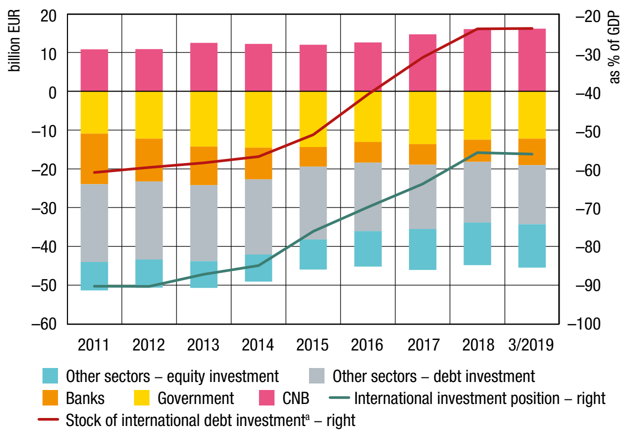
In the financial account of the balance of payments, in 2019 as a whole, net capital outflow could continue, albeit at a much lower intensity than in 2018. Total net capital outflow reflects the continuation of the decrease in net foreign debt liabilities of domestic sectors and a significant increase in international reserves. At the same time, the net inflow of equity investments is expected, but it could be weaker than in the previous year.

The estimate of the net inflows of equity investments in the whole of 2019 is lower than last year's performance, due to the projected weaker growth of liabilities, as well as the more pronounced growth of assets. The expected weaker growth of liabilities based on equity investments is the consequence of the assumption that in the current year the value of debt-to-equity transactions (which in the same amount increase equity and decrease debt investments) might be lower than in 2018. If transactions are excluded, a slightly larger inflow of new equity investments in Croatia is expected, compared with the previous year, which, based on the performances in the past several years, might mostly be recorded in non-tradable goods and services sectors. At the same time, the higher estimate of growth in foreign assets is mostly correlated with better business results of foreign enterprises owned by residents and the increase in equity investments abroad.

Although at the beginning of the year net foreign debt liabilities of domestic sectors increased, in 2019 as a whole, the trend of deleveraging and of improvement in relative indicators of external debt is expected to continue. All domestic sectors might reduce their debt liabilities, which, coupled with the favourable effect of nominal GDP growth, could result in a decrease in the gross debt-to-GDP ratio to about 70%; this does not include the effects of the settlement in the Agrokor Group, which will reduce external debt still further. The relative indicators of net external debt and the international investment position should also improve additionally.

Net capital outflow might decrease additionally in 2020. A further deleveraging of domestic sectors is anticipated, although at a noticeably slower pace than in the previous year, accompanied by an improvement of relative indicators of external debt. Thus, gross external debt might decline to about 65% of GDP by the end of the mentioned year. By contrast, the net inflow of equity investments in Croatia might be approximately at the level of the previous year, since higher growth is equally expected on both the assets and the liabilities side. At the same time, international reserves are expected to continue growing.

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.

Risks related to the projection of capital flows mostly refer to the potential worsening of the investment climate, while risks linked to the potential deterioration in financing conditions are reduced relative to the previous projection. Further strengthening of trade protectionism and geopolitical tensions might additionally reduce the already modest expected growth in global foreign direct investments. Due to the high foreign liabilities accumulated earlier, the risks to Croatia's external position remain elevated despite their gradual decline over the past several years.

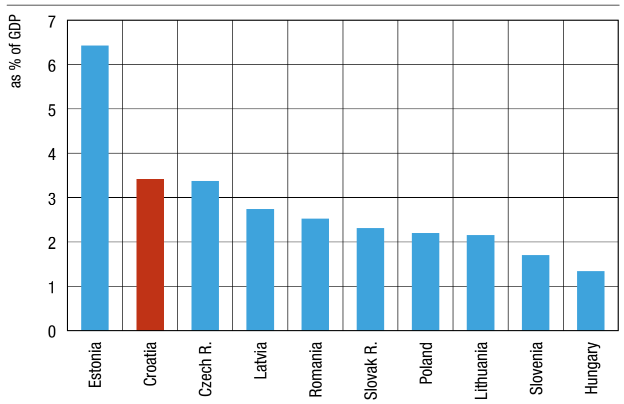
Box 4 Analysis of foreign direct equity investments in Croatia

An analysis of direct equity investments in Croatia between 2002 and 2017 points to a lack of international competitiveness of the domestic economy during that period. Equity investments in non-financial corporations were relatively modest and mostly driven by domestic market seeking. Equity investments in manufacturing mostly involved investments in low-technology activities, which curbed their contribution to domestic economic growth.

If aggregate indicators of foreign direct equity investments[23] are observed, with the average annual inflow of 3.4% of GDP in the past fifteen years or so, Croatia ranks among the top new EU member states (Figure 1).

However, data on Croatian enterprises[24], which enable a more detailed analysis of the aggregate indicators, give a slightly different picture of the ostensibly favourable results of equity investments in Croatia. Firstly, the total foreign direct equity investments in Croatia largely involve investments in the financial sector, which resulted in the high share of foreign ownership in the domestic financial system. As shown in Figure 2, at the time of a fast growth in bank placements before the financial crisis, inflows from equity investments in the form of recapitalisation of

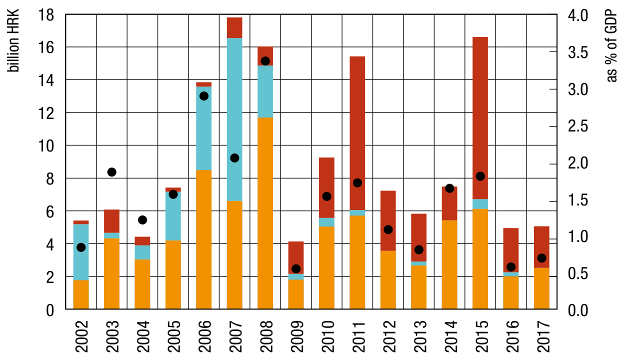
Figure 1 The average annual inflow of foreign direct equity investments in selected countries from 2002 to 2017



Note: Data for Hungary exclude round-tripping investments.
Sources: Eurostat and MNB.

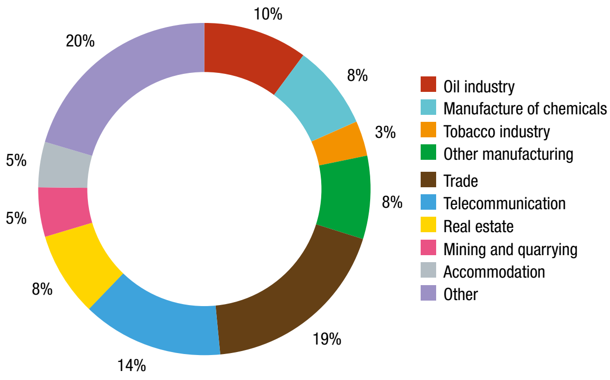
23 Foreign direct equity investments do not include reinvested earnings or borrowing from affiliated enterprises abroad.
24 Data on direct equity investments on a corporate level used in this box may differ from official CNB data due to methodological and other adjustments.

Figure 2 Developments in foreign direct equity investments in Croatia



Note: Excluding round-tripping investments.
Sources: CNB and FINA.

Figure 3 Structure of foreign direct equity investments in non-financial corporations by activities (cumulatively 2002-2017)



Note: Round-tripping investments and debt-equity swaps are excluded.
Sources: CNB and FINA.

banks and insurance companies were noticeable. After the outbreak of the crisis and a fall in credit activity, these inflows vanished almost completely.

Secondly, significant investments were also made in the form of debt-equity swaps with affiliated enterprises abroad. Such transactions were most common in trade and manufacturing and they gained momentum after the outbreak of the crisis, creating the impression of a higher level of foreign equity investments. In reality, they mostly involved the company restructuring of distressed foreign-owned enterprises where debt to parent companies abroad was transformed into equity. Thirdly, several round-tripping investments were also made in Croatia, affecting investments in Croatia and abroad in the same amount.

If equity investments in the financial sector, debt-equity swaps and the effects of round-tripping investments are excluded, the average value of the narrow aggregate of foreign equity investments in Croatia from 2002 to 2017 is two times lower than the total aggregate and stands at 1.5% of GDP annually. Only a few years stand out in terms of significant equity investment inflows: the years 2006 and 2008, which were marked by large privatisation processes in two enterprises in the oil and pharmaceutical industry.

Not only are foreign direct equity investments in non-financial corporations relatively modest; their structure by activities (Figure 3) is dominated by investments in trade, telecommunications, real estate activities and so on, which are commonly included in the non-tradable sector, i.e. the sector that does not participate in international trade. At the same time, with regard to the sector of tradable goods and services, slightly more considerable investments were made only in the oil, chemical and tobacco industries with several large enterprises dominating in the total value of foreign equity investments. Other manufacturing and accommodation can also be singled out as activities of tradable goods and services, which recorded investments with a slightly bigger export potential.

Not only is just a little over one fourth of total equity investments in non-financial corporations accounted for by manufacturing, but their structure too is unfavourable in terms of technological intensity. Namely, almost two thirds of investments in manufacturing involve low-technology or medium-low-technology activities[25].

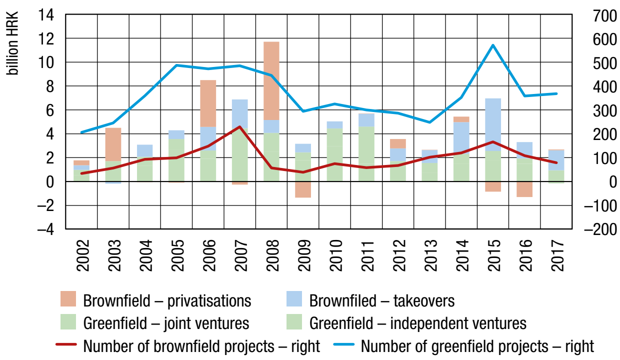
Figure 4 shows the developments in foreign direct equity investments in non-financial corporations with regard to the foreign investor's mode of entry into the domestic market. Each foreign investment is preceded by a decision on whether the business is to be started from the beginning by establishing a new company or by taking over an existing company. Investments that imply the establishment of a new company are called greenfield investments and investments that imply the taking over of an existing company owned by a resident or the privatisation of a public company are called brownfield investments. An investor deciding to establish a new company can decide to start the business in the form of an independent venture or in cooperation with another investor (joint venture), local or foreign, the key difference being that a joint venture, in addition to its possible advantages, carries certain risks to the foreign owner as a result of a lower level of control.

The shares of greenfield and brownfield investments in Croatia were almost equal throughout the entire observed period (Figure 4). There were slightly more takeovers in the years before the crisis (they accounted for approximately 53% of the value of all foreign direct equity investments prior to the crisis), mostly due to the privatisation of several state-owned enterprises. However, the share of takeovers declined after the crisis (they accounted for 35% of all equity investments), reflecting the absence of any major privatisation of state-owned enterprises by foreign investors during that period.

If investments in newly established enterprises are observed, it can be seen that those established as independent ventures are predominant, while joint ventures, most commonly with a domestic entrepreneur, are considerably less frequent. Each type of investment has its advantages. For instance, the reason for entering into a joint venture with a local entrepreneur may lie in the sharing of technology, know-how, and the resources or knowledge of the local business practices and distribution channels. The reason for that may also lie in the fact that the host country has a high level of administrative and other barriers which may present too big an obstacle for a foreign investor to handle on their own. However, the advantage of an independent venture lies in a higher level of control over the enterprise.

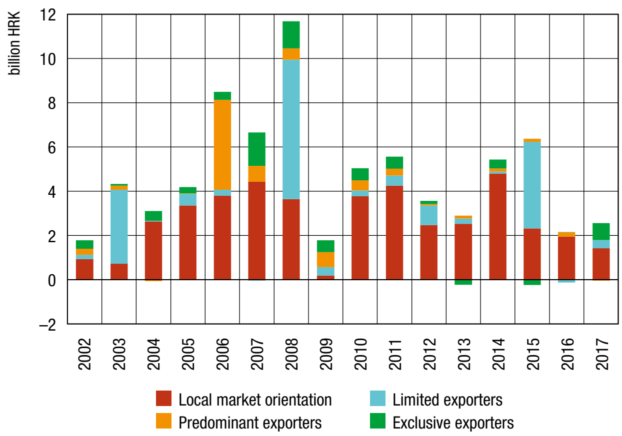
25 The sectoral distribution of manufacturing industry according to the degree of technological intensity is based on Eurostat classification (investment in research and development / value added). http://ec.europa.eu/eurostat/statisticsexplained/index.php/Glossary:Hightech_classification_of_manufacturing_industries

Figure 4 Developments in non-resident greenfield and brownfield investments



Notes: Only data for non-financial corporations are included. Round-tripping investments and debt-equity swaps are excluded. Data on greenfield investments relate to the number of newly established enterprises by a foreign investor (either in an independent or a joint venture with a domestic investor), while the data on brownfield investments relate to the number of new takeovers and privatisations in the observed year.
Sources: CNB and FINA.

Figure 5 Foreign direct equity investments in non-financial corporations by export intensity



Note: Round-tripping investments and debt-equity swaps are excluded.
Sources: CNB and FINA.

The structure of investments may be viewed from the perspective of foreign investors' motives. The three motives commonly identified in literature include market-seeking, efficiency-seeking and resource-seeking[26]. While it is rather difficult to determine investments driven by strategic resource-seeking, the share of exports in total revenues from sale may be a good indicator of whether the motive behind the investment is market-seeking or efficiency-seeking. A higher share of export revenues in foreign-owned enterprises may suggest that these enterprises were taken over or established for the purpose of raising the efficiency of a multinational corporation (lower operating expenses, proximity of foreign markets, strategic resources, etc.) in the manufacture of goods and services which are generally not intended for the Croatian market but for export to third markets.

Based on the share of exports in total revenues, enterprises can be classified as market-oriented enterprises that are mostly not exporting or are occasional exporters, with the share of sales on foreign markets in total sales revenues under 20%; limited exporters whose share of sales on foreign markets ranges between 20% and 50%, predominant exporters whose export revenues account for between 50% and 75% of revenues and almost exclusive exporters whose exports account for over 75% of revenues. In accordance with the described classification, Figure 5 shows the developments in foreign direct equity investments with respect to export intensity in an enterprise as an indicator of the predominant orientation of an enterprise to a local or foreign market and the motivation of foreign investors for entry in the Croatian market.

Foreign direct equity investments in enterprises with a local market orientation were predominant in almost all the observed years. The only exceptions were the years 2003, 2006, 2008 and 2015 but the transactions that took place in these years were associated with the previously mentioned privatisations of two enterprises in the oil and pharmaceutical industries and a big takeover in the domestic tobacco industry, all of which are large exporters. Therefore, it can be concluded that the inflow of equity investments during the observed period was only to a smaller degree associated with efficiency-seeking, suggesting that the domestic economy lacks the competitiveness needed to attract export-oriented investors. This kind of investment would certainly contribute to a greater inclusion in global value chains and a stronger trade integration of Croatia and, generally, to the strengthening of the export sector.

The reasons for the modest inflow of equity investments in Croatia in the period from 2002 to 2017 are numerous, but several need to be mentioned. Croatia joined the EU much later than peer EU member states, in 2013, most of the new member states having joined the EU in 2004, which gave them years of advantage in attracting foreign-oriented investments due to their much easier access to the single market. Also, it is a well-known fact that some export-oriented investments are driven by efficiency-seeking through reduced labour costs and that Croatia has never been known for basing its policy of attracting foreign investment on labour costs. And most importantly, some internal factors such as the unpredictable tax policy, legal uncertainty and other structural limitations made doing business in the country difficult, as confirmed by Croatia's poor ranking in the World Bank Doing Business and the World Economic Forum's Global Competitiveness Report. The poor inflow of export-oriented investments could not compensate for investments directed to the local market since it is a relatively small market with a low purchasing power, which explains why the inflow of equity investment into the non-financial sector has been so modest.

26 Dunning, J. (1993): *Multinational Enterprises and the Global Economy*, Addison-Wesfey, Harlow.

9 Monetary policy

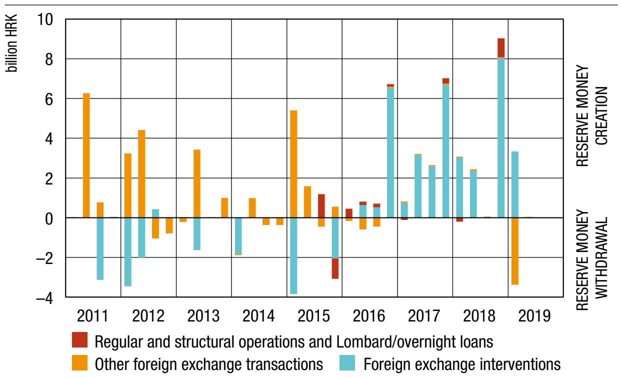
In the first half of 2019, the CNB continued to support high monetary system liquidity and maintain the relatively stable kuna/euro exchange rate. Accordingly, the CNB intervened in the foreign exchange market in the beginning of February by purchasing a total of EUR 450.3m from banks to prevent the domestic currency appreciating excessively. However, as the CNB sold EUR 449.6m to the Ministry of Finance, from the beginning of 2019 until the end of May, the CNB purchased only a total of EUR 0.7m net (Figure 9.1) in foreign exchange transactions, the effect on reserve money creation being almost neutral.

As regards kuna operations, the CNB continued to conduct regular weekly repo auctions at a fixed repo rate of 0.3%. However, due to the low interest, in the conditions of very large kuna liquidity surpluses, shown by banks, the CNB did not place any funds through this instrument of monetary policy from the beginning of the year. In the first half of 2019, no additional funds were created by structural repo operations, so that their balance held steady at the end of May, and it was the same as at the end of previous year (HRK 2.0bn).

The surplus kuna liquidity in the system remained at a very high level, and at the end of May 2019 reached HRK 30.3bn (Figure 9.2). The consequence of high liquidity was a very modest turnover in the domestic interbank overnight market. Thus, in April 2019, after eight months of inactivity, there was turnover at which the average interest rate for the first time dropped into negative territory and stood at –0.24%. A turnover at the interbank interest rate of 0.30% was also recorded in May. The average interest rate is calculated from a small number of transactions, so that it does not mirror the market situation well. Thus, in April, it was a reflection of three transactions, while in May, only two transactions were made.

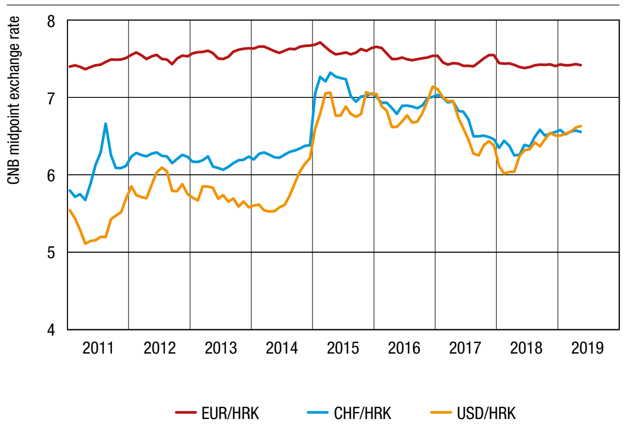
The exchange rate of the kuna against the euro stood at EUR/HRK 7.42 at the end of May 2019, the same as at the end of December 2018 (Figure 9.3). The average exchange rate of the kuna against the euro in the first five months of 2019 also stood at EUR/HRK 7.42, and was the same as the average

Figure 9.1 Flows of reserve money (M0) creation



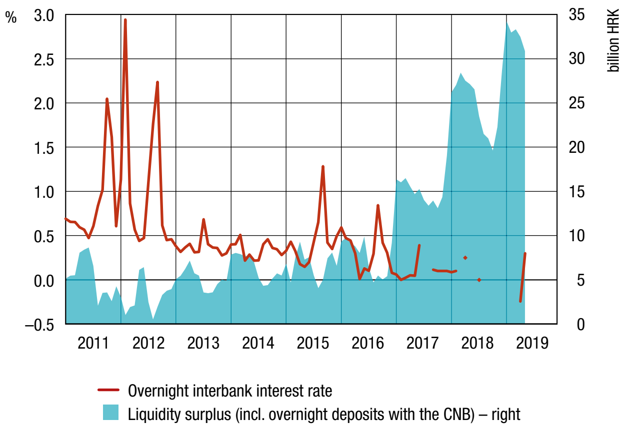
Notes: The possibility of using Lombard loans was abolished, while the possibility of using overnight credits was introduced on 28 September 2017. Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and the EC and foreign currency swaps with banks, where the positive values refer to the purchase of foreign exchange by the CNB. Data for the second quarter of 2019 are up to May.
Source: CNB.

Figure 9.3 Nominal exchange rates of the kuna against selected currencies



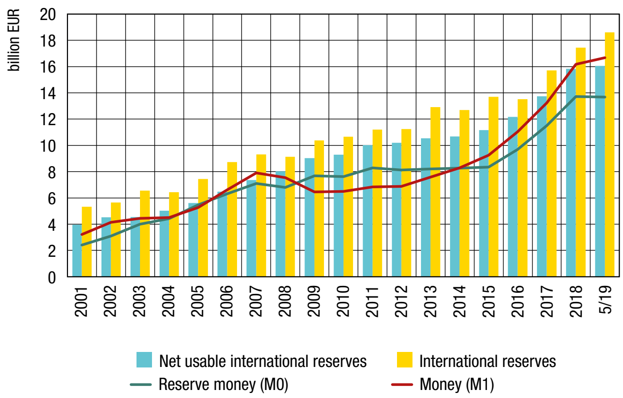
Source: CNB.

Figure 9.2 Bank liquidity and overnight interbank interest rate



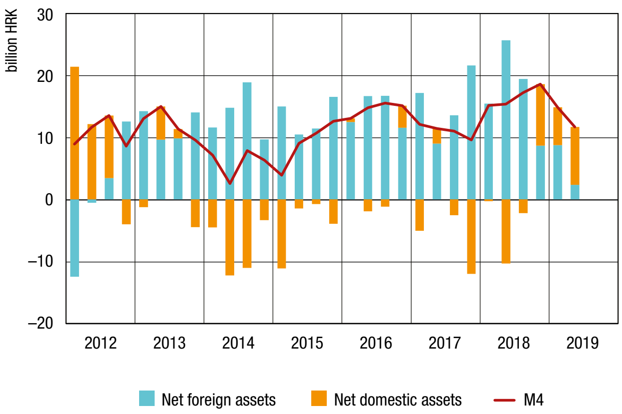
Source: CNB.

Figure 9.4 International reserves of the CNB and monetary aggregates



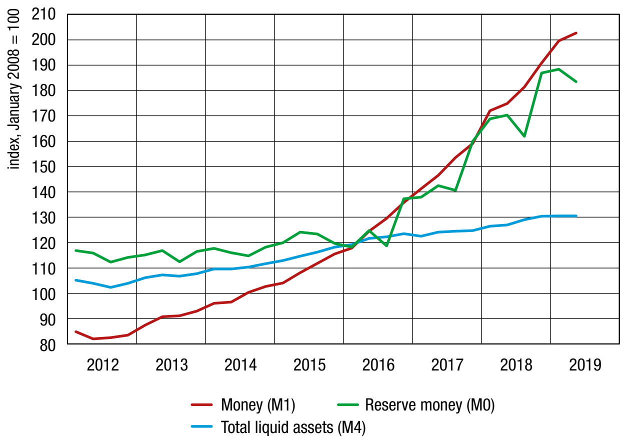
Notes: Net usable international reserves are defined as international reserves net of CNB foreign liabilities, reserve requirements in f/c, government foreign currency deposits and off-balance sheet liabilities (swaps).
Source: CNB.

Figure 9.5 Net foreign assets, net domestic assets and total liquid assets (M4)
absolute changes in the last 12 months



Notes: Absolute changes exclude the exchange rate effect. Data for the second quarter of 2019 are up to May.
Source: CNB.

Figure 9.6 Real monetary aggregates
index of developments in seasonally adjusted values, deflated by the consumer price index



Note: Data for the second quarter of 2019 refer to the end of May.
Source: CNB.

exchange rate in the first half of 2018. On the other hand, in the first five months of 2019, the kuna weakened slightly against the US dollar and the Swiss franc, reflecting the weakening of the euro against the two currencies on global financial markets.

Gross international reserves of the Republic of Croatia stood at EUR 18.6bn (Figure 9.4) at the end of May 2019, and were EUR 1.2bn (6.7%) higher than at end-2018. The increase in gross reserves was due to a level of agreed repo transactions that was higher than at the end of the previous year, and to a lesser extent, to the strengthening of the US dollar against the euro, since a portion of international reserves is held in US dollars. Net usable reserves went up in the same period by EUR 0.2bn, amounting to EUR 16.1bn at the end of May.

The annual growth of total liquid assets (M4) slowed down in the first five months of 2019 (Figure 9.5), particularly as a result of the deceleration of the increase in net foreign assets of credit institutions.

If real monetary aggregates are observed, their several-year upward trend continued in the first five months of 2019, albeit at a slower pace (Figure 9.6). In addition, the annual rise in the real value of reserve money (M0), after a considerable increase at the end of 2018, slowed down to 9.1% at the end of May.

In the conditions of low inflation, the CNB will continue to maintain the stable nominal exchange rate of the kuna against the euro by pursuing its expansionary monetary policy. Thus, the CNB will continue to support the high liquidity of the monetary system by creating conditions for the continuation of the intensification of credit activity.

10 Public finance

General government budget balance

In 2017, the first general government budget surplus according to the ESA methodology was recorded since data have been available, and in 2018 another positive balance was recorded, notwithstanding a growth on the expenditure side of the budget. The general government surplus stood at HRK 0.8bn or 0.2% of GDP in the previous year.

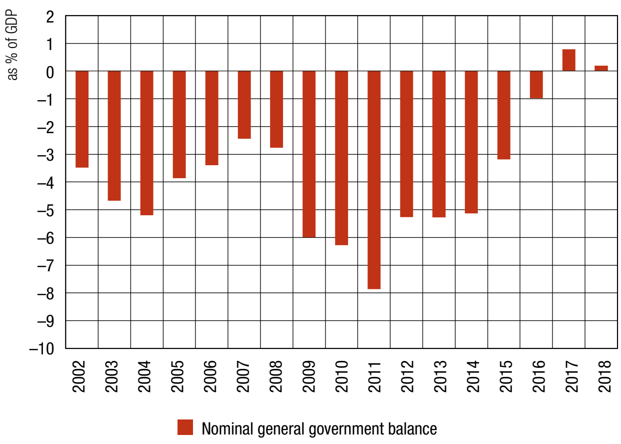
The decomposition of the change in the nominal general government balance shows that the decrease in the surplus in nominal terms in 2018 was brought about by adverse structural factors (mainly due to the growth of capital transfers driven by the activation of government guarantees issued to individual shipyards). By contrast, a positive contribution to the change in the balance came from a further decrease in interest expenditures and, to a lesser extent, from the continuation of favourable cyclical developments in economic activity.

With regard to the performance data available for 2019, the MoF cash-basis data for the first quarter suggest a budget deficit in early 2019 identical to that in the same period of 2018, due to revenues and expenditures growing equally strongly in annual terms.

The MoF data show that general government revenues (GFS 2001) grew annually by 8.0% in the first quarter of 2019. Revenues were boosted mostly by revenues from assistance from international organisations (capital being slightly more expressed than current revenues), which is probably associated with the funds received from the EU budget and tax revenues. Income tax revenues and VAT, as well as excise duties are noticeable in tax revenues.

The annual growth of consolidated general government expenditures (GFS 2001) in the first quarter of 2019 stood at 7.9%. Such budget expenditures were mostly attributable to the expenditures for current assistance to international organisations, expenditures for social benefits, expenditures for the use of goods and services and expenditures for employee compensations. According to the available data, the growth of expenditures for current assistance to international organisations reflects the contribution of funds to the EU budget being made earlier and faster than usually, as requested by the European Commission in the current year (the total annual contributions liability did not change). The increase in expenditures for social benefits was due to the regular adjustment of pensions and the slight increase in the number of pensioners and, to some extent, the rise in child allowance expenditures. With regard to expenditures for the use of goods and services, a nominal increase in this category was announced in the budget for 2019 for a number of reasons, among which, in particular, there were: the changes in methodology with regard to the budget category of expenditures for the programme financing at the Ministry of Science and Education,

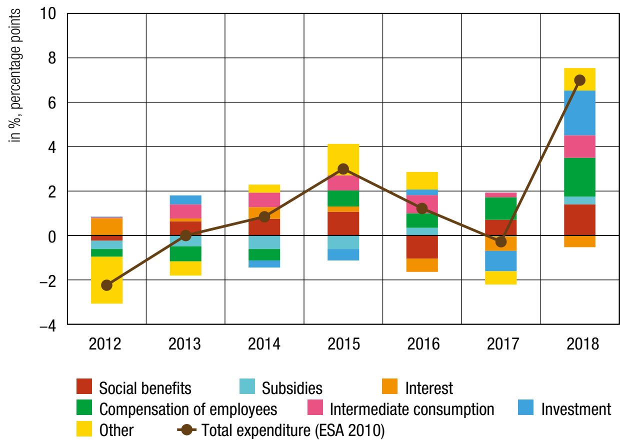
Figure 10.1 General government deficit (ESA 2010)



Source: CNB.

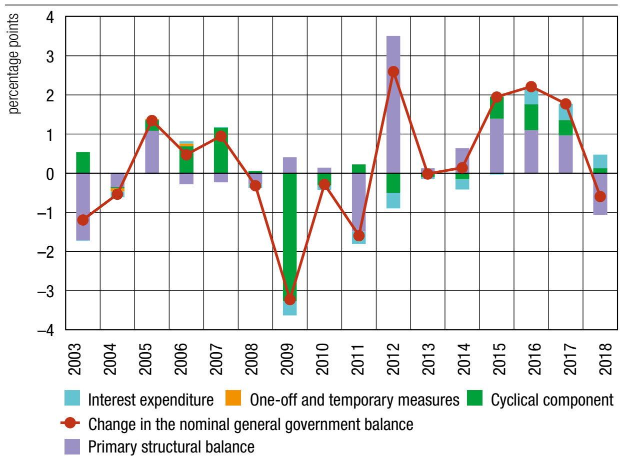
Figure 10.4 Consolidated general government expenditure

ESA 2010, year-on-year rate of change and contributions



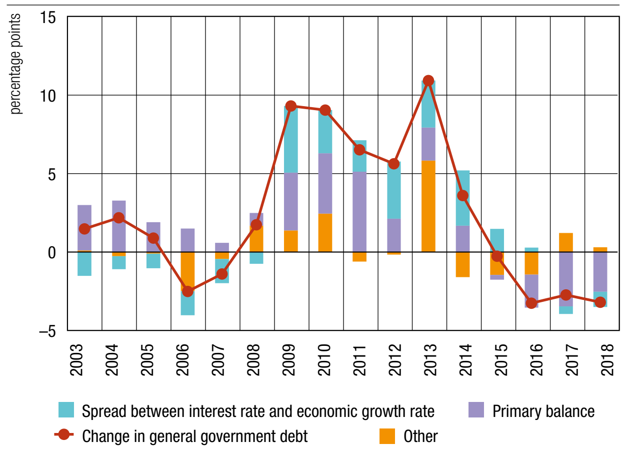
Source: Eurostat (CNB calculations).

Figure 10.2 Decomposition of the change in the nominal general government balance (ESA 2010)



Source: CNB.

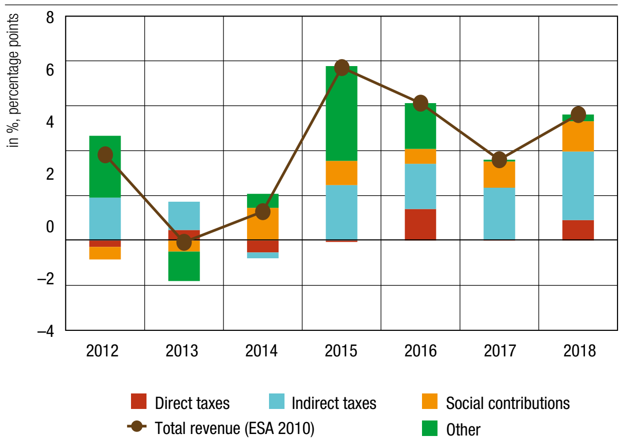
Figure 10.5 Decomposition of the change in general government debt



Source: Eurostat (CNB calculations).

Figure 10.3 Consolidated general government revenue

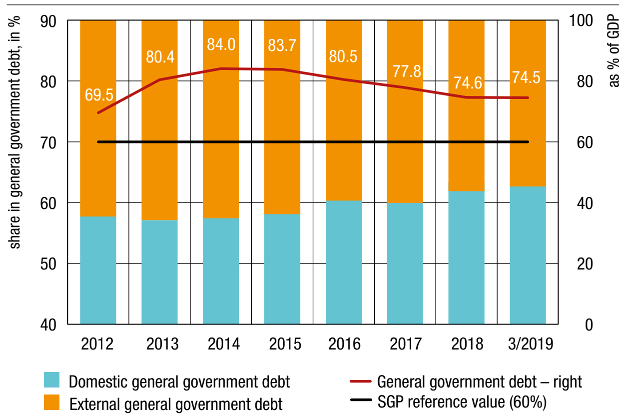
ESA 2010, year-on-year rate of change and contributions



Source: Eurostat (CNB calculations).

Figure 10.6 General government debt

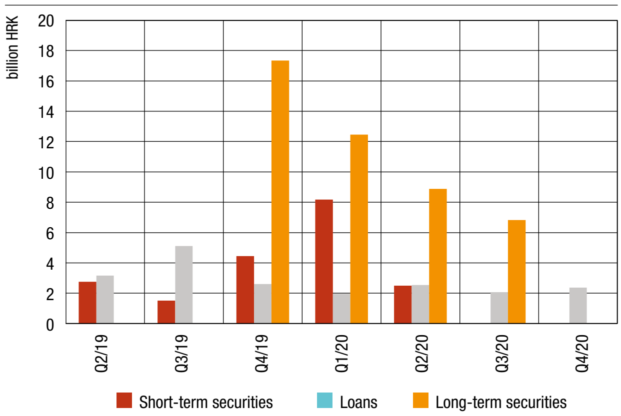
end-period stock



Note: Projection of the repayment of short-term and long-term securities is based on the balances as at 15 June 2019 and projection of the repayment of loans on the balance as at 31 March 2019.

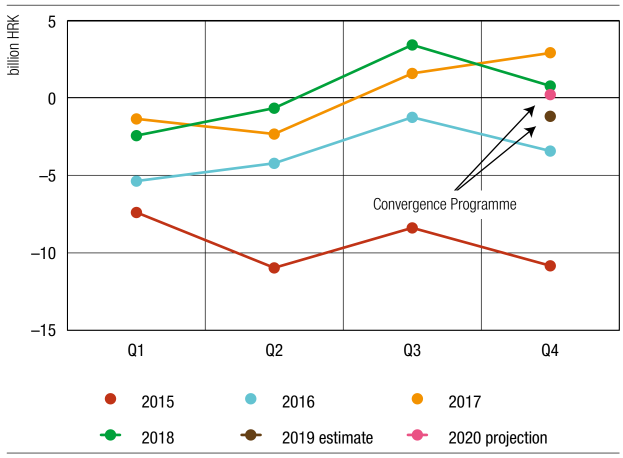
Sources: MoF and CNB.

Figure 10.7 General government debt maturity



Note: Projection of the repayment of short-term and long-term securities is based on the balances as at 15 June 2019 and projection of the repayment of loans on the balance as at 31 March 2019.
Sources: MoF and CNB.

Figure 10.8 General government cumulative balance (ESA 2010)



Sources: Eurostat and MoF (CNB calculations).

and the decrease in revenues from fees collected for real estate legalisation, which defines the change of the source of financing of material expenditures at the Ministry of Construction and Physical Planning. Finally, the growth in remunerations to general government employees can be explained by the increase in the number of employees in public and government services and the amendments to collective agreements for employees in the system of education, culture, social security, internal and foreign affairs, which were adopted in the course of 2018.

Public debt

As a result of the general government surplus and economic growth, the general government debt-to-GDP ratio continued to shrink on an annual basis in 2018, falling to 74.6% of GDP at the end of the year.

General government debt stood at HRK 287.3bn at the end of March 2019, an increase of about HRK 2.5bn from the end of 2018. The increase in debt primarily reflects the impact of realised bond issues in the domestic capital market in February, and, only to a smaller extent, the depreciation of the exchange rate of the kuna against the euro and the US dollar in the same period.

The government made use of the still favourable circumstances in the domestic and international financial markets in the first half of the year, the result of which will be a further decline in general government interest expenditures in the future periods. After the auction of 15-month T-bills worth EUR 1bn was held at the end of January, which ensured a part of the funds necessary to the government for the purposes of refinancing a maturing T-bill, which was realised without any cost of financing (yielding 0.0%), in early February, a bond in the nominal amount of EUR 500m maturing in 2022 was issued in the domestic capital market under favourable conditions, as well as the second tranche of the bond maturing in 2029 in the nominal amount of HRK 5.0bn. In addition, in mid-June, a eurobond worth EUR 1.5bn was issued in the international market, which with the annual coupon interest rate of 1.125% and the realised yield of 1.324% represents so far the most favourable foreign borrowing of the Republic of Croatia, which was also assisted by the better risk perception reflected in the upgrading of the credit rating to investment grade by yet another agency in the week before the issuance of the bond. The funds raised will be used for the refinancing of a dollar bond, which matures in November 2019, with the annual coupon interest rate of 6.75% (the only one not hedged against the change in the USD/EUR exchange rate).

General government liabilities equal to about 8% of GDP fall due in the second half of 2019. This mostly relates to liabilities arising from one domestic and one international bond issue, with the funds for the international bond repayment being already raised through the mentioned June issuance in the international capital market.

Convergence Programme of the Republic of Croatia

Under this year's Convergence Programme, following the budget surplus in 2018, the Government of the Republic of Croatia expects a budget deficit of 0.3% of GDP in 2019, after which it might turn to a surplus of 0.2% of GDP again in 2020. The projected deficit in 2019 is the result of the sharp increase in general government expenditures over revenues (in % of GDP). The dynamics of expenditures is under the impact of the growth of expenditures on investments and, to a lesser extent, of intermediate consumption and subsidies. On the other hand, revenues are expected to grow slightly more moderately than expenditures, despite the implemented tax unburdening. At the same time, general government debt might continue its downward path.

In its spring forecasts the European Commission assessed that the general government balance in 2019 might be more favourable than presented in the Convergence Programme, particularly since expenditures for investments and subsidies are expected to grow less, and interest expenditures are expected to decrease.

The European Commission in June estimated that Croatia met both criteria of the preventive arm of the Stability and Growth Pact (the benchmark for the reduction of debt and the mid-term budget objective). It is necessary to note that in the estimate of meeting the mid-term budget objective for 2020, the target of –1.0% of GDP was taken into account, which Croatia set for itself in the Convergence Programme of the Republic of Croatia for the period 2019-2022, as part of the preparations for joining the exchange rate mechanism, ERM II. The given objective is stricter than the minimum mid-term budget objective, which was determined by applying the joint methodology for Croatia, standing at –1.25%.

11 Deviations from the previous projection

The projection of real global developments for 2019 is less favourable than expected in the December 2018 projection. Due to unfavourable economic movements and worsened consumer sentiment at the very beginning of the year, the expected growth of the euro area in 2019 was revised downwards by as much as 0.6 percentage points, and by almost a whole percentage point in the case of Germany and Italy, which are among the most important Croatian trading partners. Expectations for the USA were also lower, to a smaller extent, partly also because of the prolonged federal government shutdown in the beginning of the year. Expectations regarding emerging market countries were also lowered, mostly for Turkey. With regard to monetary policy, the Fed's anticipated policy for 2019 changed significantly relative to the previous projection when tightening was still expected to continue, although it has now been put on hold. The first planned increase in the ECB's interest rate has been postpone by two more quarters relative to the previous projection, i.e. until mid-2020.

The expected total economic activity growth rate for 2019 is higher than in the December projection, so that real GDP might grow by 3.1% (vs the previously projected 2.7%). The most important correction was made in capital investments, which might grow at the rate of 8.0% instead of the previously anticipated 6.0%, reflecting better expectations regarding private and public sector investment activities. The revised expectations are the consequence of performances in the beginning of this year that were much better than in previous expectations, with a total growth of gross fixed capital formation in 2018 by 11.5% annually. Favourable developments are expected to continue in the remainder of 2019, with the general government's continued investments leading in overall investment activity due to further absorption of EU funds and the continued infrastructure development. However, the private sector is also expected to grow. Moreover, personal consumption might also grow faster than was expected in December 2018, from the previously projected 3.5% to 4.2%. The correction was mostly due to better results in early 2019 and slightly more favourable projected developments in the labour market. By contrast, expectations regarding foreign demand are slightly less favourable so that the real exports of goods and services might increase by 2.7% instead of the 3.4% anticipated in the December projection. The correction revised downwards reflects poorer results in the whole of 2018 and the slowdown in growth of the exports of services in early 2019. In accordance with the expected considerable growth in domestic demand relative to the previous projection, growth in imports of goods and services could also be higher (5.8% from 5.3%). Thus, it is expected that, with regard to better expectations regarding domestic demand and slightly worse expectations regarding foreign demand, in 2019, the negative contribution of net foreign demand will be much larger than projected in December of last year (–1.5 relative to –0.9 percentage points).

The average annual consumer price growth rate in 2019 is estimated at 0.7%, which is 0.1 percentage points lower than projected in December 2018. In the current projection, the projected average annual rate of change in the prices of food in 2019 was reduced (from 0.5% to –0.2%), mostly due to the lower results in the period from November 2018 to May 2019. Lower results in the beginning of this year can be attributed to a slightly more expressed pass-through of the reduced VAT rate, from 25% to 13%, than expected in the previous projection. In addition, the projected average annual rise in the consumer price index excluding food and energy in 2019 decreased slightly in the current projection (from 1.2% to 0.9%), also because of results that were lower than those projected in December 2018.

The surplus in the current and capital accounts of the balance of payments in 2019 might fall short of previous projection expectations by 0.3 percentage points. The correction of the estimate for 2019 largely refers to unfavourable expectations regarding the dynamics of goods trade. Exports might be weaker due to the more expressed slowdown in foreign demand, i.e. economic activity of the main foreign trade partners, in particular Italy and Germany. On the other hand, the estimate of goods imports increased due to the strong intensification of investment activity in the beginning of the year. In contrast, the net exports of services is expected to be slightly larger than in the previous projection, i.e. travel and other services, as a result of more

Table 11.1 Basic assumptions, deviations from the previous projection

	2019		
	Previous projection (12/2018)	Current projection	Deviation
GDP (real rate of change, in %)			
Rest of the world	3.7	3.3	–0.3
Euro area	1.9	1.3	–0.6
USA	2.5	2.3	–0.2
Developing countries and emerging market countries	4.7	4.4	–0.3
Central and Eastern European countries	2.0	0.8	–1.2
Main trading partners of the Republic of Croatia	2.3	1.8	–0.4
Prices			
Euro area HICP[a]	1.7	1.3	–0.4
Oil prices (USD/barrel)[b]	67.6	64.8	–2.8
Key interest rates			
EURIBOR 3M (end of year)[c]	–0.20	–0.31	–0.1
ECB main refinancing rate[c]	0.05	0.00	–0.1
US federal funds target rate[c]	3.10	2.50	–0.6

[a] ECB, June 2019. [b] Bloomberg, Brent crude oil futures. [c] Bloomberg.
Source: IMF (WEO), April 2019.

Table 11.2 Domestic indicators, deviations from the previous projection

	2018			2019		
	Previous projection (12/2018)	Outturn	Deviation	Previous projection (7/2018)	Current projection	Deviation
National accounts (real rate of change, in %)						
GDP	2.7	2.6	–0.1	2.7	3.1	0.3
Personal consumption	3.2	3.5	0.3	3.5	4.2	0.8
Government consumption	3.3	2.9	–0.4	2.6	2.7	0.1
Gross fixed capital formation	3.7	4.1	0.4	6.0	8.0	2.1
Exports of goods and services	3.6	2.8	–0.8	3.4	2.7	–0.7
Imports of goods and services	5.1	5.5	0.4	5.3	5.8	0.5
Labour market						
Number of employed persons (average rate of change, in %)	2.4	2.3	0.0	1.8	1.9	0.1
Registered unemployment rate	9.9	9.7	–0.2	8.8	8.6	–0.2
ILO unemployment rate	8.4	8.4	0.0	7.2	7.2	–0.1
Prices						
Consumer price index (rate of change, in %)	1.5	1.5	0.0	0.9	0.7	–0.1
External sector						
Current account balance (as % of GDP)	2.9	2.5	–0.4	2.0	1.3	–0.7
Current and capital account balance (as % of GDP)	4.1	3.8	–0.3	3.4	3.1	–0.3
Gross external debt (as % of GDP)	75.0	75.4	0.4	70.0	69.5	–0.5
Monetary developments (rate of change, in %)						
Total liquid assets – M4	5.2	5.5	0.2	5.4	2.9	–2.4
Total liquid assets – M4[a]	5.4	6.1	0.6	5.5	3.4	–2.0
Credit institution placements	2.7	2.0	–0.7	3.9	3.9	0.0
Credit institution placements[b]	4.7	4.4	–0.3	4.8	4.3	–0.4

[a] Exchange rate effects excluded. [b] Rates of change are calculated on the basis of data on transactions.
Source: CNB.

robust results in the previous year. Moreover, the deficit in the primary income account might be lower than the estimate from the previous projection, considering the continuation of favourable financing conditions, in particular of the government sector, and the expected lower interest expenditure for foreign debt of domestic sectors. Furthermore, the estimate of the secondary income and capital transaction accounts has been increased due to the expected further intensification of the absorption of EU funds. The slightly lower estimate of the relative indicator of gross external debt at the end of 2019, relative to the previous projection, mostly reflects the higher estimate of nominal GDP.

The projection for 2019 growth in credit institutions' placements (excluding the government) has been revised slightly downwards from previous expectations. Placements might grow by 4.3%, compared with the previously projected 4.8% (transaction-based). The correction downwards is the consequence of a notably smaller number of loans to non-financial corporations than expected, while household lending was slightly stronger than expected, mostly under the impact of somewhat faster growth in housing loans and the parallel only moderate slowdown in general-purpose cash loans. As regards changes in placements in nominal terms, the current projection shows growth in 2019 that is equal to the growth in the previous projection.

The projected growth of total liquid assets (M4) for 2019 is lower than was expected in the previous projection (3.4% vs 5.5% from the previous projection, transaction-based). The continued decrease in interest rates on deposits contributed to the accumulation of funds in transaction accounts to a larger extent than expected in the previous projection, while, at the same time, quasi money, in particular kuna and foreign currency deposits, fell considerably, which was reflected in the lower expected growth rate of total liquid funds.

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	
	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020
Croatian National Bank (July 2019)	**3.1**	**2.7**	**4.2**	**3.7**	**8.0**	**6.5**	**2.7**	**2.8**	**5.8**	**5.3**	**–**	**–**	**1.6**	**1.8**
World Bank (June 2019)	2.5	2.5	–	–	–	–	–	–	–	–	–	–	–	–
Eastern Europe Consensus Forecasts (May 2019)	2.5	2.5	3.1	2.7	5.4	4.6	–	–	–	–	2.0	2.2	1.1	1.7
European Bank for Reconstruction and Development (May 2019)	2.5	2.5	–	–	–	–	–	–	–	–	–	–	–	–
European Commission (May 2019)	2.6	2.5	3.3	3.2	6.0	5.4	3.2	3.3	5.3	5.0	–	–	1.5	1.6
Addiko Bank Economic Research[a] (May 2019)	2.5	2.8	3.0	2.8	6.3	6.0	5.6	3.9	4.1	7.6	2.4	2.7	1.2	1.2
International Monetary Fund (April 2019)	2.6	2.5	–	–	–	–	–	–	–	–	–	–	1.5	1.6
Ministry of Finance (April 2019)	2.5	2.4	3.7	3.3	6.4	5.3	2.7	3.2	5.3	5.2	–	–	1.4	1.8
Raiffeisen Research[a] (April 2019)	2.5	2.0	–	–	–	–	6.0	4.7	7.0	4.5	0.5	2.0	1.5	1.8

[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 Convergence Programme of the Republic of Croatia for the period 2019-2022.
Sources: Publications of the respective institutions.

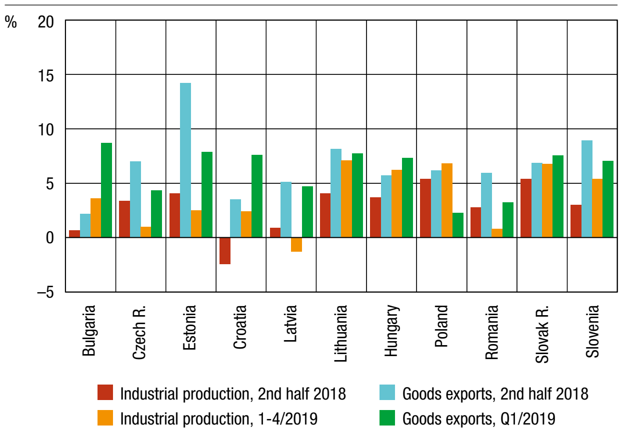
13 Annex B: Comparison of Croatia and selected countries

Table 13.1 Gross domestic product

	Year-on-year rate of change, original data			Quarter-on-quarter rate of change, seasonally adjusted data			
	2016	2017	2018	Q2/18	Q3/18	Q4/18	Q1/19
Bulgaria	3.9	3.8	3.1	0.8	0.7	0.8	:
Czech R.	2.5	4.4	2.9	0.5	0.7	0.8	0.6
Estonia	3.5	4.9	3.9	1.7	0.2	2.1	0.5
Croatia	3.5	2.9	2.6	1.2	0.6	0.2	1.8
Latvia	2.1	4.6	4.8	1.0	1.4	0.9	–0.1
Lithuania	2.4	4.1	3.5	0.9	0.4	1.4	1.0
Hungary	2.3	4.1	4.9	1.1	1.5	1.1	1.5
Poland	3.1	4.8	5.1	1.2	1.5	0.5	1.5
Romania	4.8	7.0	4.1	1.2	1.5	1.0	1.3
Slovak R.	3.1	3.2	4.1	–	–	–	–
Slovenia	3.1	4.9	4.5	0.8	1.3	0.7	0.8
Average[a]	3.1	4.4	4.0	1.0	1.0	1.0	1.0

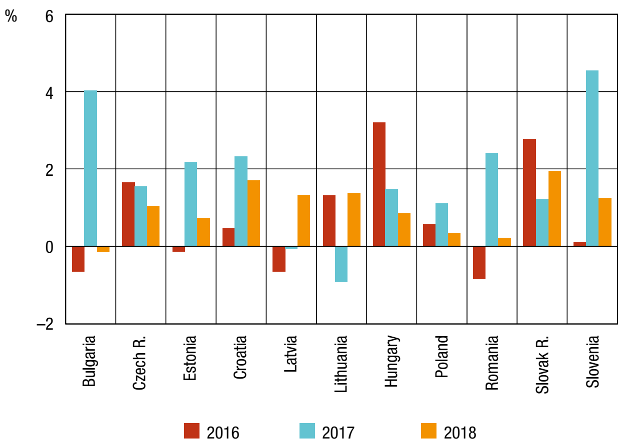
[a] Simple average.
Sources: Eurostat, EC, CBS and CNB.

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



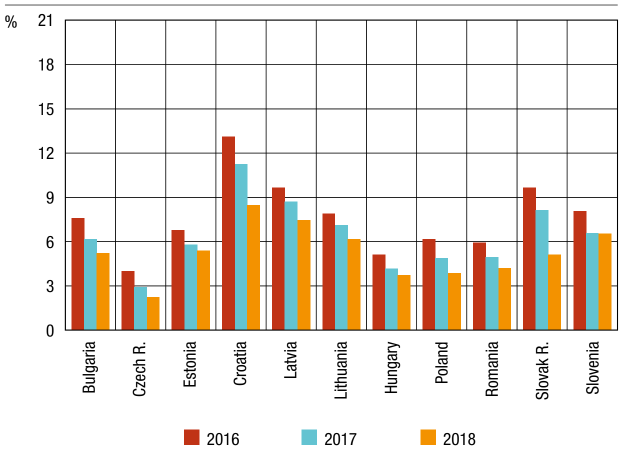
Sources: Eurostat and CBS.

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



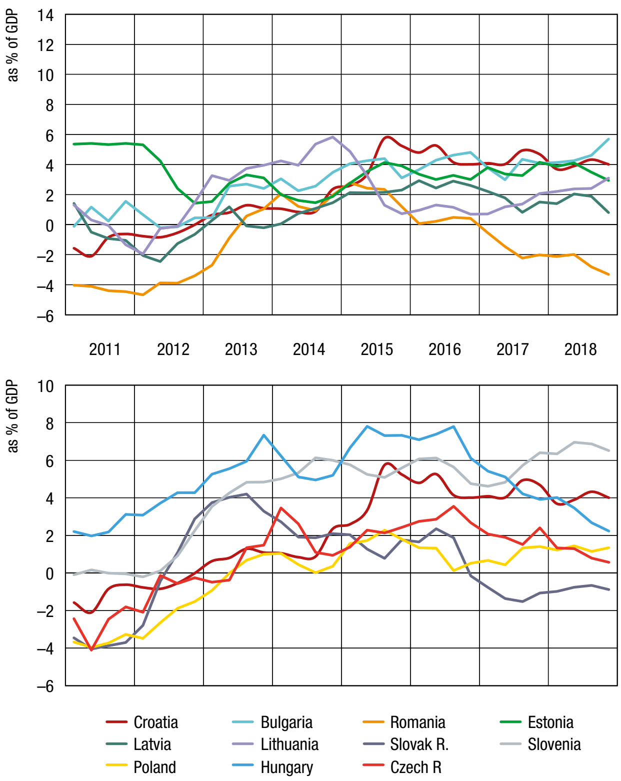
Source: Eurostat.

Figure 13.3 Labour Force Survey unemployment rate



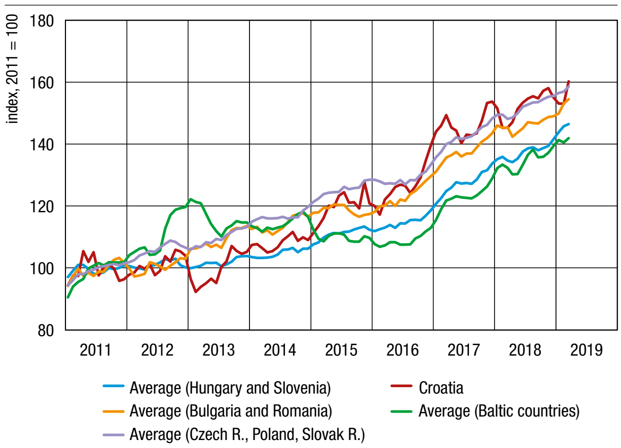
Source: Eurostat.

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



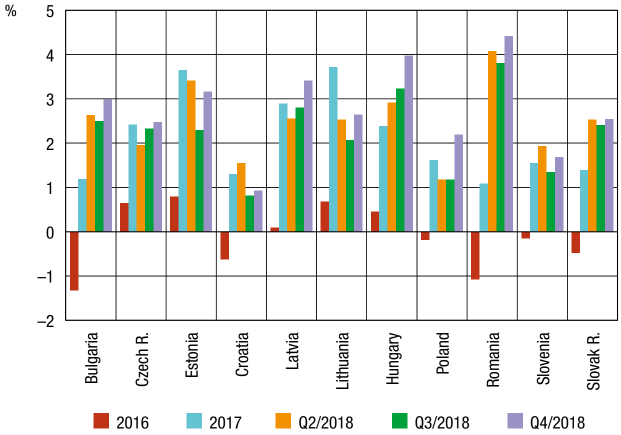
Sources: Eurostat and CNB.

Figure 13.5 Goods exports
quarterly moving average, seasonally adjusted data



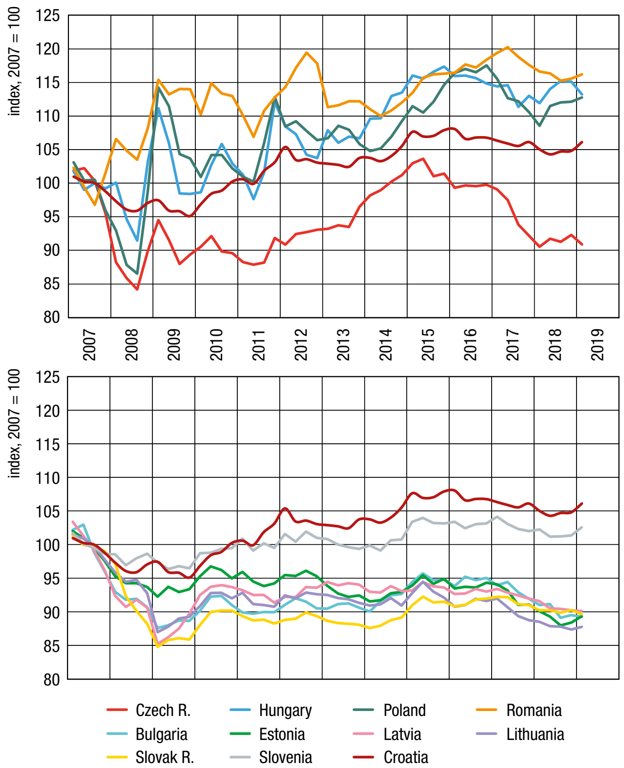
Note: Data for 2019 refer to the first quarter.
Sources: Eurostat and CNB.

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



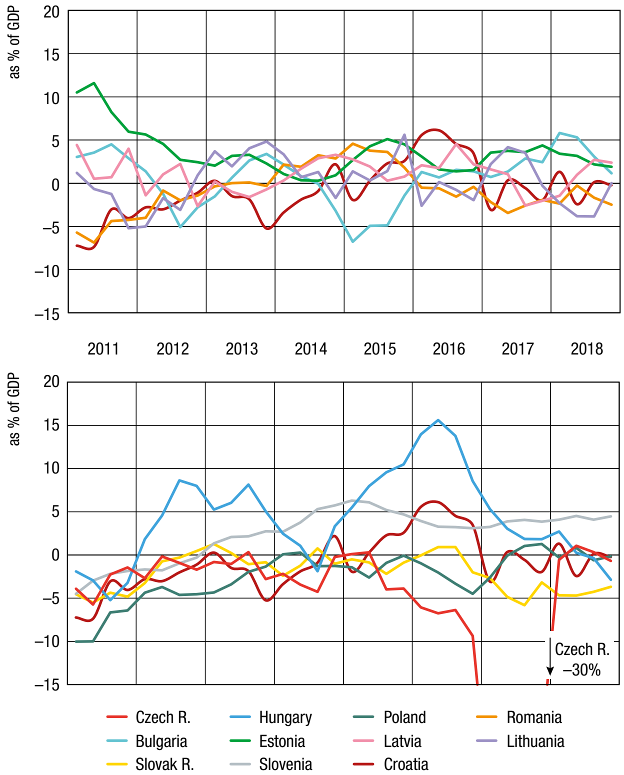
Note: Data for the second quarter of 2019 refer to April.
Source: Eurostat.

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



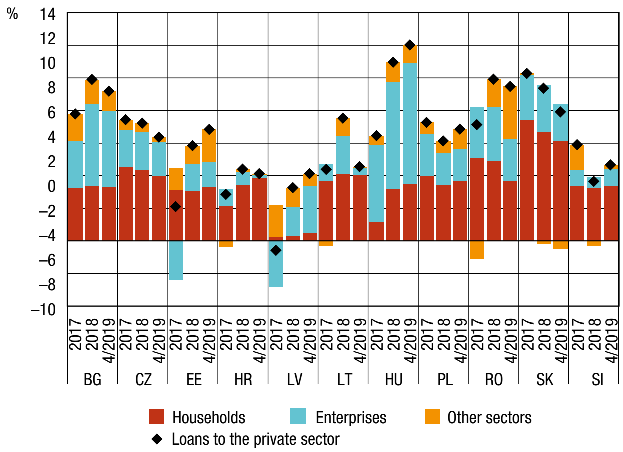
Notes: Data for 2019 refer to the first quarter. A fall in the index indicates a real effective appreciation.
Sources: BIS and CNB.

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.

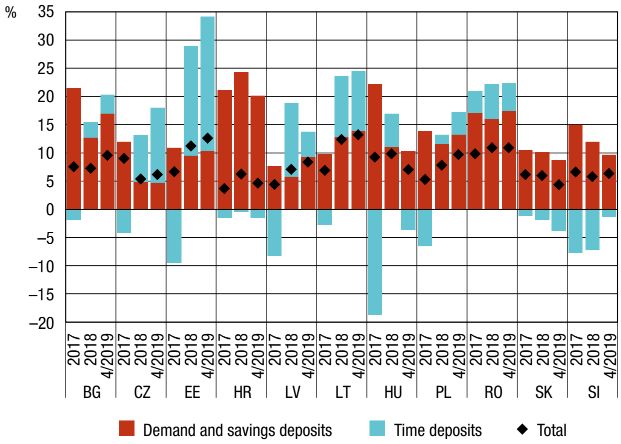
Figure 13.9 Bank loans to the private sector
contributions to the year-on-year rate of change, transaction-based



Sources: ECB and CNB.

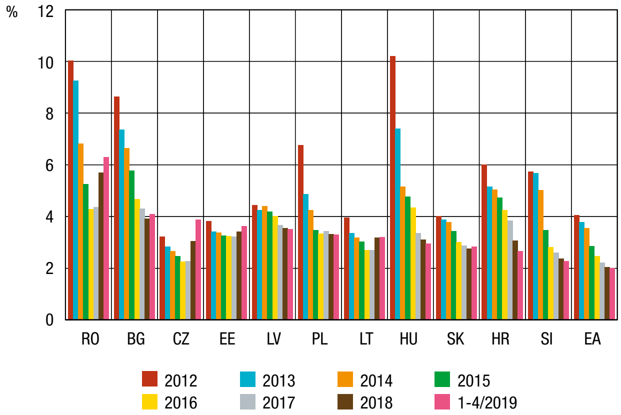
Figure 13.10 Private sector deposits

year-on-year rate of change, excluding the exchange rate effect



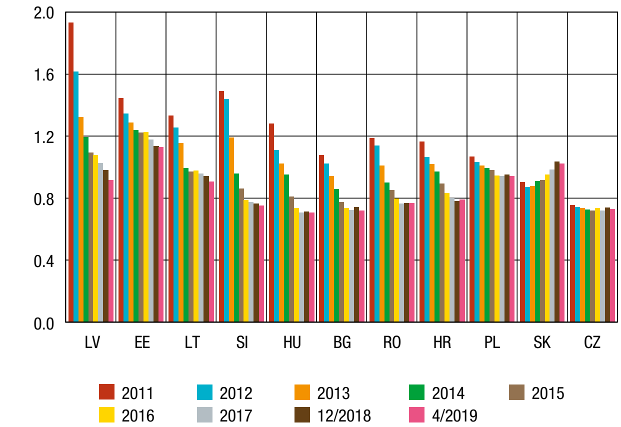
Sources: ECB and CNB.

Figure 13.13 Short-term interest rates on corporate loans



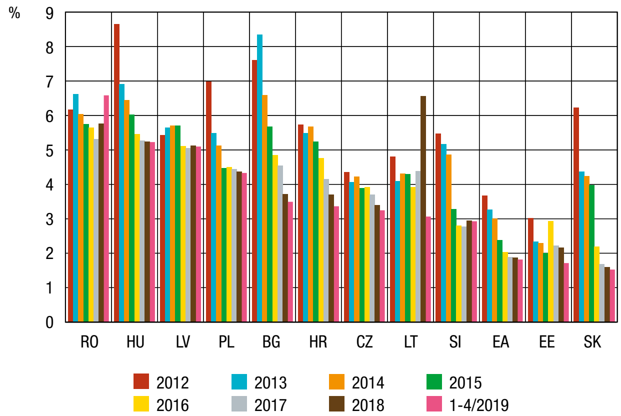
Note: Includes average interest rates on corporate loans up to EUR 1m and with a maturity of up to 1 year.
Source: ECB.

Figure 13.11 Placement to deposit ratio of the private sector



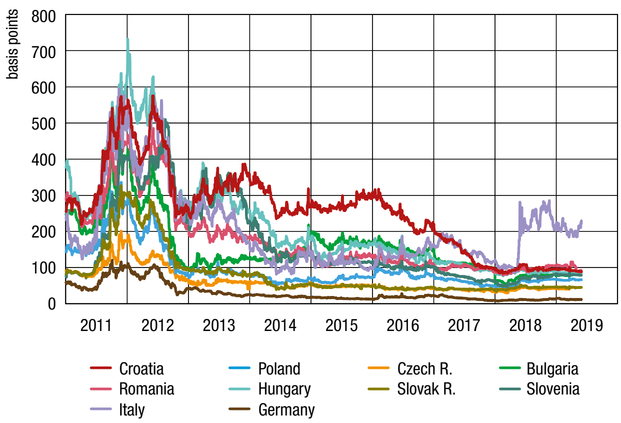
Sources: ECB and CNB.

Figure 13.14 Interest rates on housing loans



Sources: ECB and NCBs.

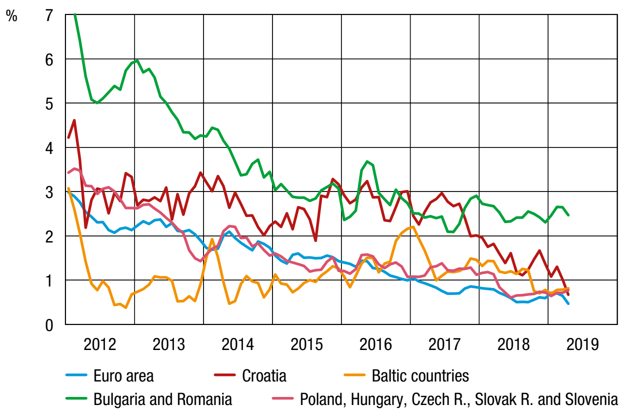
Figure 13.12 CDS spreads for 5-year government bonds of selected countries



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

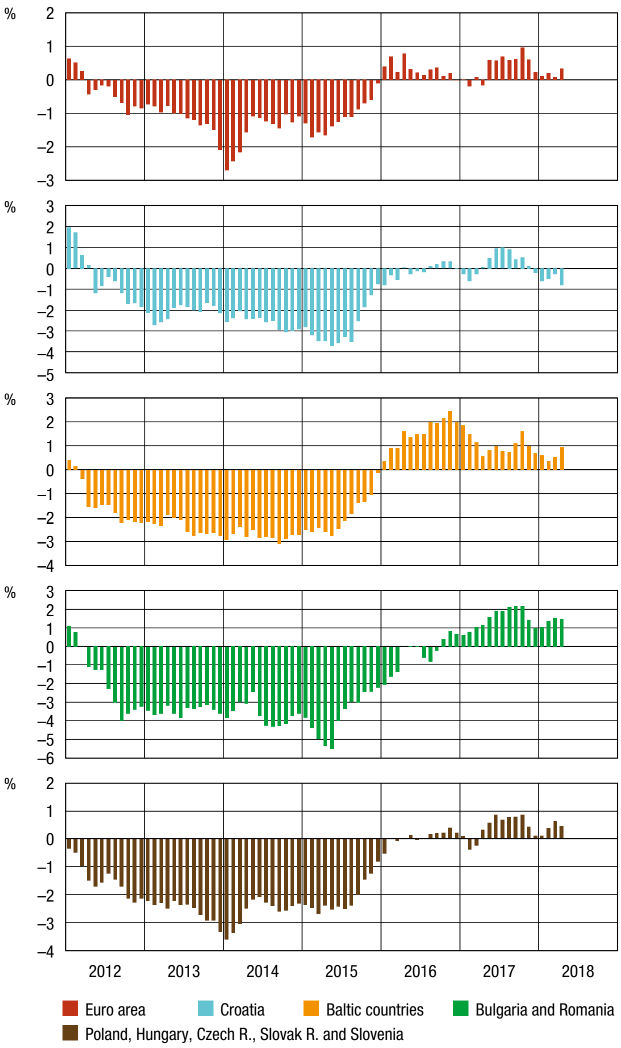
Figure 13.15 Expected real interest rate on corporate loans

up to EUR 1m and with maturity up to 1 year



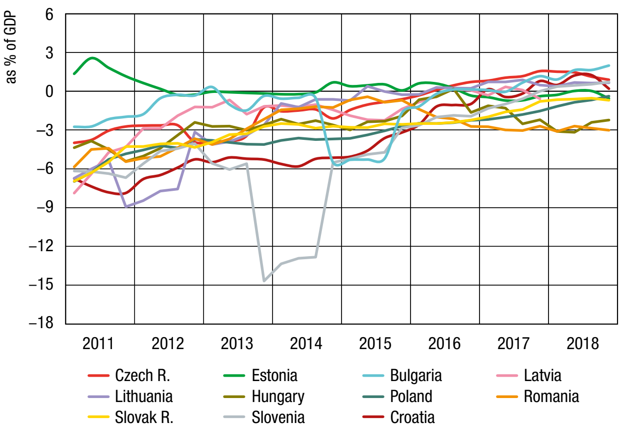
Notes: The expected real interest rate equals the nominal interest rate deflated by inflation projected for the next year from the Consensus Forecasts. Country group averages are not weighted.
Sources: ECB and Consensus Forecasts.

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



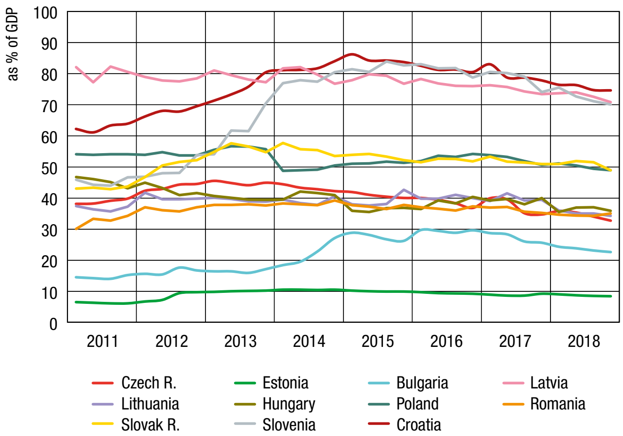
Notes: The expected real interest rate equals the nominal interest rate deflated by inflation projected for the next year from the Consensus Forecasts and the achieved real interest rate equals the nominal interest rate deflated by inflation achieved. Country group averages are not weighted.
Sources: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

Two-letter country codes

BG – Bulgaria
CZ – Czech R.
EE – Estonia
HR – Croatia
HU – Hungary
LV – Latvia
LT – Lithuania
PL – Poland
RO – Romania
SK – Slovak R.
SI – Slovenia

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

ISSN 2459-8607