



Macroeconomic Developments and Outlook

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General information on Croatia

Economic indicators

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

^a The population estimate of the Republic of Croatia for 2000 is based on the 2001 Census and that for the 2001-2017 period on the 2011 Census. Data for 2019 are preliminary.

^b The GDP data are presented according to the ESA 2010 methodology. Data for 2018 and 2019 are preliminary.

^c Balance of payments and external debt data are compiled in accordance with the methodology prescribed by the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) and the new sector classification of institutional units in line with ESA 2010. Balance of payments and external debt data are based on the most recent available balance of payments data up to the first quarter of 2020 and data on the gross external debt position as at the end of March 2020.

^d Includes principal payments on bonds, long-term trade credits and long-term loans (excluding liabilities to affiliated enterprises), as well as total interest payments (including FISIM), without interest payments on direct investment.

^e Fiscal data is shown according to the ESA 2010 methodology.

Sources: CBS, MoF and CNB.



Macroeconomic Developments and Outlook

1 Introduction

The novel coronavirus pandemic is a health and economic shock that has had a profound impact on the global and domestic economy. The first quarter of 2020 thus witnessed a widespread downturn in global economic developments, one that was not of the same intensity across the world due to the differences in epidemiological situations and the different timing of coronavirus containment measures. Notwithstanding the unprecedented deterioration in economic developments, financial markets remained stable and financing conditions were relatively favourable owing to the strong response by central banks and an extremely expansionary monetary policy. As in many other countries worldwide, in Croatia, real GDP shrank on a quarterly basis in the first three months of 2020, with a slowdown also recorded on an annual level. This was particularly due to the performance seen in March, when negative developments were fuelled by the pandemic outbreak in Croatia and the effects of measures to prevent the virus from spreading among the domestic population. Available monthly data, mostly for April and May, when a substantial part of domestic economic activity was constrained by epidemiological measures, point to a significant downturn in the second quarter. Croatia's real GDP might thus fall by 9.7% in the whole of 2020, which is a stronger contraction than during the economic slump following the escalation of the global financial crisis. All components of domestic and foreign demand are expected to decrease. Economic activity is expected to grow at an annual rate of 6.2% in 2021, which to a large extent reflects the base effect. However, it should be noted that this rate is exposed to negative risks (particularly the occurrence of a second wave of the pandemic) and it would not enable the attainment of the pre-crisis level of economic activity. Although a notable decrease in employment and an increase in unemployment are expected, the labour market's response to the sharp economic slump in the current year will be mitigated by the economic policy measures activated, whereas a gradual recovery in labour market indicators is expected in the remainder of the projection horizon. Limits to economic activity and consumption capacities, coupled with potential changes in the behavioural patterns of economic agents, had an impact on expected inflation developments. The average annual consumer price inflation rate in Croatia is expected to slow to -0.1% in 2020, and pick up to 0.7% in 2021. In both years, the largest impact on the inflation dynamics should come from movements in energy prices, i.e. changes in the prices of refined petroleum products. As for foreign economic relations, the surplus in the current and capital account is expected to drop notably due to the sharp fall in tourism revenues, while it might increase in 2021 as tourism recovers. The downward trend in the relative indicator of gross external debt might be temporarily halted in 2020 due to the drop in nominal GDP, while the improvement trend from the pre-crisis period should be resumed in the following year. The CNB's prompt and strong monetary policy response to negative developments included a number of measures to ensure the stable exchange rate of the kuna against the euro and to create additional liquidity to sustain credit activities of domestic banks and maintain favourable financing conditions for all domestic sectors, while stabilising the government bond market. In the first five months of 2020, lending to households lost momentum, largely due to the decrease in general-purpose cash loans. On the other hand, corporate loans grew sharply in February and March driven by the upward trend in investment and working capital loans, which came to an end in April and May. The central bank will maintain the expansionary character of its monetary policy in the remainder of the projection horizon, while ensuring a stable exchange rate of the kuna against the euro and supporting sufficient foreign currency and kuna liquidity in the financial system. The slowdown in household loans and the pick-up in corporate loans are expected to continue in the remainder of the year, supported also by the measures to alleviate the negative consequences of the pandemic. The Government of the Republic of Croatia also reacted swiftly to the shock by implementing a package of measures, which, among other things, include job preservation grants, write-offs and deferral of taxes and contributions, as well as acquisition of additional medical supplies. In view of extraordinary circumstances, that is, the anticipated decrease in budget revenues and the rise in budget expenditures, amendments to the 2020 budget suggest that the general government deficit might come to 6.8% of GDP in the current year, with a much lower deficit being expected in 2021 (2.4% of GDP). Following a sharp increase in 2020, the general government debt-to-GDP ratio might resume its downward trend in 2021.

Real GDP dropped by 1.2% from the last three months of 2019 to the first quarter of 2020, with a growth slowdown also seen on an annual level (0.4%). Looking by months, economic deterioration in the first quarter was largely evident in March 2020 data, which first exhibited the negative developments brought on by the outbreak of the novel coronavirus pandemic and the effects of restrictive measures imposed to prevent the virus from spreading among the domestic population. Broken down by components, the low real GDP growth rate was mostly due to the fall in exports of goods and services and the decrease in inventories from the same period of the year before. Exports of services plummeted as a result of the plunge in exports of tourist services. Personal consumption and gross fixed capital formation made a positive contribution to annual GDP growth, but their growth lost much of its momentum in the first quarter of 2020, so that the largest positive contribution to overall

economic growth came from a drop in imports of goods and services. Net foreign demand also provided a boost to growth.

Available data, mostly for April and May, when a substantial part of domestic economic activity was constrained by epidemiological measures, suggest that economic dynamics deteriorated further from March to the second quarter of the year, so that real GDP is expected to drop by 9.7% in 2020 as a whole. Unfavourable trends are projected for all components of aggregate demand, but the largest negative contribution might come from exports of goods and services. Furthermore, a sharp contraction in investment and a fall in personal consumption are also expected. By contrast, government consumption is projected to rise. As a result of the fall in domestic and foreign demand, imports of goods and services are also expected to shrink sharply, so that the contribution of net foreign demand to real GDP in 2020 might be extremely negative. Economic activity might expand by

6.2% from 2020 to 2021, largely due to the base effect of the recovery expected in late 2020. Though a high growth rate is anticipated, it will not be sufficient to bring economic activity back to the pre-pandemic level. Economic recovery in 2021 might be provided the strongest boost by a rise in total exports, with an increase expected also in all components of domestic demand. Imports are also expected to rise with the recovery in domestic and foreign demand, so that the contribution of net foreign demand to overall economic growth might be positive. According to the central estimates and projections of real GDP growth in 2020 and 2021, the risks are predominantly tilted to the downside. Estimated and projected GDP and its components are subject to a very high degree of uncertainty associated mostly with the development of the epidemiological situation and the success in containing the virus's spread while reactivating economic activity, as well as the possibility of another wave of the pandemic before an effective medical solution is found or before the virus loses much of its power through mutations. Examined in this context was the pessimistic scenario that includes a second wave of the epidemic and projects that Croatia's real GDP would fall by 11.4% in 2021. It should be noted that neither the baseline nor the pessimistic scenario of the CNB's monetary policy projection included possible effects of the European Commission's proposal to establish a fund to finance measures for economic recovery from the pandemic, which would, if adopted, speed up the economic recovery of EU member states in the following years.

The labour market response to the estimated economic fall in

2020 is expected to be mitigated primarily by the Croatian government's measures to preserve jobs. Following a several-year trend of favourable developments in the labour market, employment is expected to fall by 3.2% in 2020, while the ILO unemployment rate might go up from 6.6% in 2019 to 9.1% of the labour force. Wages are expected to decrease, mostly due to a fall in private sector wages. Labour market indicators are expected to recover gradually in 2021.

The average annual consumer price inflation rate decelerated from 0.8% in 2019 to an estimated – 0.1% in 2020 largely as a result of the anticipated significant decrease in energy prices, triggered by the drop in the prices of refined petroleum products. To a smaller extent, the inflation slowdown expected in 2020 might be a result of the lower forecast annual growth rate of the consumer price index excluding food and energy due to lower demand amid the pandemic conditions expected particularly in the segment of tourism-related services, recreational and cultural services and some semi-durable and durable consumer goods (e.g. clothes and footwear, furniture, cars, etc.). The expected deceleration in the annual growth of the consumer price index excluding food and energy in 2020 is somewhat offset by the rise in the prices of cigarettes, and sugary and alcoholic beverages driven by the April 2020 increase in excise duties. Also, the increase in unit labour costs fuelled by the sharp fall in productivity will cushion downward pressures on prices. In contrast with the prices of energy and non-food products, the average annual growth rate of food prices is expected to pick up in 2020 due to larger demand, as well as food supply-side

Table 1.1 Summary table of projected macroeconomic measures

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|--|-------|-------|-------|-------|-------|------|------|------|------|-------|------|
| National accounts (real rate of change, in %) | | | | | | | | | | | |
| GDP | -0.3 | -2.2 | -0.5 | -0.1 | 2.4 | 3.5 | 3.1 | 2.7 | 2.9 | -9.7 | 6.2 |
| Personal consumption | 1.0 | -2.4 | -1.6 | -2.5 | 0.2 | 3.1 | 3.2 | 3.2 | 3.6 | -5.3 | 4.6 |
| Government consumption | 0.5 | -1.4 | -0.1 | 1.8 | -0.9 | 0.5 | 2.2 | 1.3 | 3.3 | 1.9 | 3.4 |
| Gross fixed capital formation | -2.7 | -3.3 | 1.4 | -2.8 | 3.8 | 6.5 | 5.1 | 4.1 | 7.1 | -12.1 | 6.8 |
| Exports of goods and services | 2.3 | -1.5 | 2.5 | 7.4 | 10.3 | 7.0 | 6.8 | 3.7 | 4.6 | -38.1 | 44.5 |
| Imports of goods and services | 3.2 | -2.9 | 3.3 | 3.2 | 9.4 | 6.5 | 8.4 | 7.5 | 4.8 | -30.8 | 36.5 |
| Labour market | | | | | | | | | | | |
| Number of employed persons (average rate of change, in %) | -1.1 | -1.2 | -1.5 | -2.0 | 0.7 | 1.9 | 1.9 | 2.3 | 2.3 | -3.2 | 2.0 |
| Registered unemployment rate | 17.8 | 18.9 | 20.2 | 19.6 | 17.0 | 14.4 | 11.6 | 9.2 | 7.6 | 10.6 | 9.2 |
| ILO unemployment rate | 13.7 | 15.9 | 17.3 | 17.3 | 16.2 | 13.1 | 11.2 | 8.4 | 6.6 | 9.1 | 7.8 |
| Prices | | | | | | | | | | | |
| Consumer price index (average rate of change, in %) | 2.3 | 3.4 | 2.2 | -0.2 | -0.5 | -1.1 | 1.1 | 1.5 | 0.8 | -0.1 | 0.7 |
| Consumer price index (rate of change, end of period, in %) | 2.1 | 4.7 | 0.3 | -0.5 | -0.6 | 0.2 | 1.2 | 0.8 | 1.4 | -0.6 | 1.1 |
| External sector | | | | | | | | | | | |
| Current account balance (as % of GDP) | -1.8 | -1.8 | -1.1 | 0.2 | 3.3 | 2.1 | 3.5 | 1.8 | 2.8 | -0.4 | 0.5 |
| Current and capital account balance (as % of GDP) | -1.6 | -1.5 | -0.9 | 0.6 | 4.0 | 3.6 | 4.6 | 3.3 | 4.8 | 2.0 | 2.7 |
| Gross external debt (as % of GDP) | 109.6 | 108.2 | 110.8 | 113.1 | 108.0 | 95.9 | 88.9 | 82.7 | 75.7 | 81.7 | 76.5 |
| Monetary developments (rate of change, in %)^a | | | | | | | | | | | |
| Total liquid assets – M4 | 5.6 | 3.6 | 4.0 | 3.2 | 5.2 | 4.7 | 2.1 | 5.5 | 2.9 | 8.1 | 2.7 |
| Total liquid assets – M4 ^b | 4.4 | 3.5 | 3.8 | 2.4 | 4.6 | 5.3 | 3.2 | 6.1 | 3.5 | 6.5 | 2.8 |
| Credit institution placements to the private sector | 4.8 | -5.9 | -0.5 | -1.6 | -3.0 | -3.7 | -1.2 | 2.0 | 2.8 | 4.8 | 2.9 |
| Credit institution placements to the private sector ^b | 3.5 | -1.2 | 0.8 | -1.5 | -2.3 | 1.1 | 2.9 | 4.4 | 4.2 | 3.7 | 3.1 |
| Credit institution placements to corporates ^b | 7.6 | -1.5 | 1.8 | -3.7 | -3.0 | 3.2 | 2.5 | 1.9 | 0.4 | 6.9 | 3.4 |
| Credit institution placements to households ^b | -0.7 | -1.1 | -1.2 | -0.7 | -1.8 | 0.5 | 4.0 | 6.2 | 7.4 | 1.5 | 3.3 |

^a Indicators of monetary developments exclude the effect of repo loans. ^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.

shocks triggered by the pandemic and associated with interruptions in supply chains due to border closure, possible restrictions on food exports from some countries, etc. In addition, the faster annual increase in food prices in 2020 is also a result of a positive base effect coming from the waning of the impact of changes in the VAT system in early 2019 on the annual rate of inflation, and the rise in the prices of food raw materials in the world market. Consumer price inflation is expected to accelerate to 0.7% in 2021 as a result of the rise in the annual rate of change in energy prices, mainly on the back of the expected increase in global crude oil prices. It is estimated that the risks of lower than projected or higher than projected inflation are balanced.

The surplus in the current and capital account might be notably smaller in 2020 than in 2019 owing to the sharp fall in tourism revenues and the associated lower net exports of services. By contrast, unfavourable developments could be mitigated by an improvement in all other sub-accounts, particularly the trade in goods, as goods imports are expected to contract more than goods exports. While a decrease in the foreign demand of the main trading partners will adversely affect goods exports, a drop in imports expected to be even sharper will be the outcome of the projected fall in personal and investment consumption and import dependence of exports. As regards capital flows, even though a further deleveraging of domestic sectors is anticipated, the relative indicator of gross external debt might deteriorate due to the fall in nominal GDP. The surplus in the current and capital account might grow in 2021 triggered by a recovery in tourism revenues, while the pre-crisis improvement trend in the relative indicators of external debt, temporarily interrupted in 2020, should be resumed.

In response to the deterioration of economic and financial conditions caused by the coronavirus pandemic, the CNB took a number of measures to preserve the stability of the exchange rate of the kuna against the euro and maintain favourable financing

conditions for domestic sectors. In efforts to prevent the weakening of the kuna and secure sufficient foreign currency liquidity, the CNB sold EUR 2.7bn to banks, most of it in late March and early April, after which the exchange rate was generally stable. The kuna liquidity withdrawn through the sale of foreign currency was more than offset by other monetary policy measures of the CNB, including structural and regular operations, a cut in the reserve requirement rate and the secondary market purchase of government bonds starting from March to stabilise the market for government securities. As a result, kuna liquidity remained at high levels, while yields on government bonds and borrowing costs at domestic banks did not grow much overall. Nevertheless, sluggish economic activity was reflected in the tightening of credit standards for household and corporate loans and a slowdown in household loans. On the other hand, corporate loans grew sharply in February and March due to an upward trend in investment and working capital loans, which came to an end in April and May. The slowdown in household loans and the pick-up in corporate loans are expected to continue in the remainder of the year, supported also by the measures to alleviate the negative consequences of the pandemic.

As regards fiscal policy, the Convergence Programme of the Republic of Croatia for 2020 and 2021 and amendments to the 2020 budget suggest that, following a 0.4% surplus recorded in 2019, the general government might run a deficit of 6.8% of GDP in 2020 due to the impact of the global and domestic recession. General government deficit is expected to stand at 2.4% of GDP in 2021. The spring projections of the European Commission from May 2020 show a somewhat wider deficit in 2020 (7.1% of GDP), but also a narrower deficit in 2021 (2.2% of GDP). At the same time, the general government debt-to-GDP ratio, which will grow sharply in 2020, should resume its downward path in 2021.

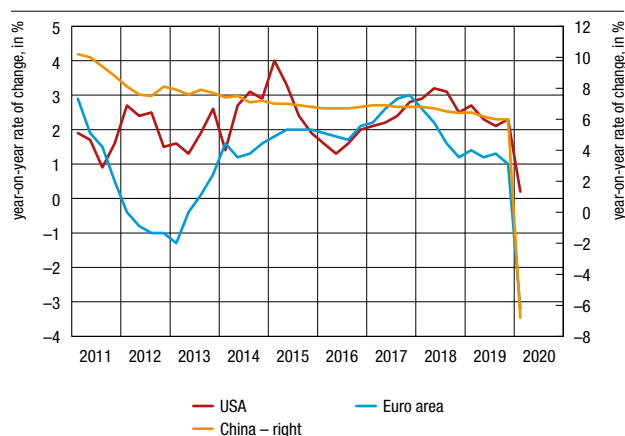
2 Global developments

The coronavirus pandemic had a profound impact on the global economy so that a widespread deterioration in global developments was seen in the first quarter of 2020. Nevertheless, the deterioration was not of the same intensity across the world due to the differences in epidemiological situations and the different timing of epidemiological measures (Figure 2.1). The most severe economic slump was seen in China, where the strictest epidemiological measures were imposed throughout most of the country during the first three months of 2020, while the fall in the euro area was notably less intense as most member states imposed a lockdown only towards the end of the quarter. By contrast, as the US was the last among the developed countries to impose the most stringent measures, it recorded modest annual growth in the first quarter. Nevertheless, early indicators suggest that economic activity in developed countries recorded a sharpest-ever fall in the second quarter. The unprecedented deterioration in economic developments led to a sharp tightening of financing conditions in money markets and a plunge in the value of major stock exchange indices. However, thanks to the strong response by central banks worldwide and an extremely expansionary monetary policy, financial markets stabilised very quickly and financing conditions remained relatively favourable, particularly in terms of government bond yields.

The very good performance of the US economy in late 2019

pointed to an end of the slower growth trend, which had been present since spring 2018, driven by heightened trade tensions

Figure 2.1 Economic growth in selected markets



Sources: Eurostat, BEA, NBS and IMF.

with the main trading partners, in particular China. Nevertheless, after the pandemic's outbreak in developed countries, the US economy slowed down perceptibly on an annual level, from 2.3% in the last quarter of 2019 to only 0.2% in the first three months of 2020. The contraction is expected to be particularly severe in the second quarter due to restrictive epidemiological measures in force through most of April and May. All components of aggregate demand contributed to unfavourable developments in the first three months, with a sharp fall seen in investments and exports.

The euro area economy was burdened by problems in manufacturing industry throughout 2019, particularly in export-oriented member states, owing to the major slump in foreign demand, with the spillover of negative trends onto the service sector becoming increasingly perceptible towards the year-end (Figure 2.2). As a result, the economic shock triggered by the coronavirus pandemic hit the European economy in very unfavourable circumstances, particularly bearing in mind that Italy was the country hit the most by the pandemic, i.e. a member state already burdened by macroeconomic and structural weaknesses. Viewed on an annual level, the euro area recorded a fall of 3.2% in the first three months. Though the decrease was seen in all euro area members, it was the sharpest in the largest member states, such as Italy, Spain and France, although somewhat smaller in Germany, thanks in part to a more favourable epidemiological situation. However, early economic indicators for the second quarter suggest that the contraction in the euro area deepened further as the epidemiological situation worsened and that it might be much sharper than during the global financial crisis (2008-2009) and the public debt crisis in Europe (2010-2012).

After growing steadily for several decades, the Chinese economy saw an annual fall of 6.8% in the first quarter. More specifically, after the epidemic outbreak early in the year, the Chinese authorities imposed restrictive epidemiological measures as early as January, which prevented the normal operation of Chinese manufacturing and had a negative impact on global value chains. The sharp fall of the Chinese economy was further exacerbated by the fact that measures restricting the movement of persons coincided with New Year's holidays, i.e. a period when the local population traditionally spends and travels the most.

Figure 2.2 Euro area confidence indicators

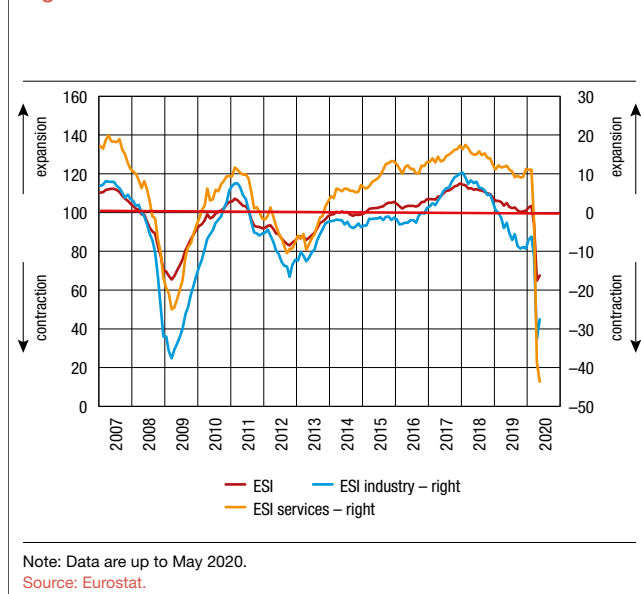
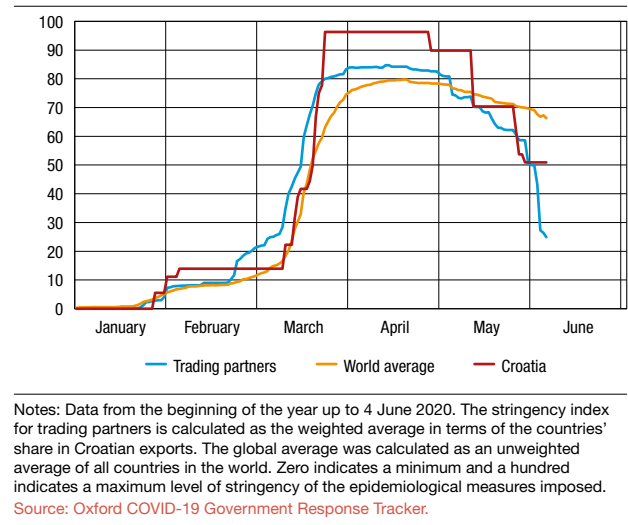


Figure 2.3 Stringency index of epidemiological measures in Croatia's main trading partners relative to the world average



Croatia's main trading partners

All Croatia's main trading partners recorded extremely unfavourable economic developments in the first three months of 2020. This particularly refers to trading partners in the euro area, in particular Italy, which was one of the countries most severely affected by the pandemic. The economic downturn in other major trading partners in the euro area, such as Slovenia, Austria or Germany, was much more moderate. On the other hand, unfavourable trends were much less pronounced in trading partners outside the euro area and in the immediate vicinity, such as Hungary, or in the SE region, such as Bosnia and Herzegovina and Serbia, which is attributable to the fact that their epidemiological situation at the time was much more favourable than that in the euro area. Though Croatia's main trading partners are expected to witness the sharpest-ever economic decline in the second quarter, this group of countries started to ease epidemiological measures in May at a much faster pace than the rest of the world (Figure 2.3), which might have a positive impact on the speed of the economic recovery.

Prices, exchange rates and monetary and fiscal policy

As regards the prices of raw materials, early 2020 was marked by a trend of fall in crude oil prices on the global market. The price of a barrel of Brent crude oil reached USD 24 in late April, having fallen by 65% from the end of 2019. The decline in prices in the first four months is attributable to both demand- and supply-side factors. Demand-side factors are associated with a drop in global demand triggered by the coronavirus pandemic, whereas the supply-side factors include the failure of the Saudi Arabia and Russia to reach an agreement on the reduction of crude oil output and increasingly larger stocks held by the largest crude oil producers in the world.

The downward slope of crude oil prices came to a halt in early May and the price per barrel grew to USD 37 by the end of the month. The increase was mostly due to the agreement among OPEC countries and other oil producers to reduce production in response to the decline in demand brought on by the coronavirus pandemic. The price increase was also spurred by the earlier-than-expected easing of the restrictions imposed in response to the pandemic, which fuelled a rise in oil demand.

The price of raw materials excluding energy decreased in the first five months of 2020. This was mostly due to the fall in the

prices of metals and food raw materials caused by the coronavirus pandemic. Metal prices fell sharply in the first four months of 2020, but partly recovered later on, thanks to the resumption of industrial production in China and larger demand. At the same time, the majority of food raw materials recorded a drop in prices, particularly those of oils and fats and cereals. Among the rare products whose prices increased were sugar, due to the lower-than-anticipated output in India, the world's largest producer, and rice.

Following a gradual normalisation in recent years, US monetary policy moved back into the area of unconventional policy with its swift response. To mitigate the negative economic consequences of the pandemic, the Fed responded strongly to the first signs of deterioration in the global epidemiological situation and reduced the range for its benchmark interest rate to the minimum at several extraordinary meetings and introduced several funding programmes that sharply increased the Fed's balance sheet. At the same time, the ECB also responded strongly by a series of monetary policy measures to maintain financial stability and favourable financing conditions for all sectors of the economy, such as the additional programme to purchase government and corporate bonds and additional long-term financing operations for banks. Also, the Fed and the ECB concluded currency swaps with a large number of central banks to secure sufficient dollar and euro liquidity for the global economy.

The current movements in financial markets, particularly the trends in government bond yields, indicate that central banks for the most part succeeded in maintaining financial stability and favourable financing conditions. Financing conditions in terms of the EMBI index for European emerging markets, including Croatia, somewhat recovered following the initial sizeable deterioration, thus remaining relatively favourable. Furthermore, global financing conditions also remained relatively favourable despite a dramatic worsening of the fiscal positions of most countries worldwide due to the drop in budget revenues during the economic lockdown and a hike in expenditures for the purpose of funding measures to contain the economic consequences of the pandemic, mostly directed at the labour market. Though the fiscal policy response was very strong and amounted to around USD 9 trillion¹ on a global level, it differed notably across countries in terms of its relative impact and structure of the fiscal package. There were also large differences between the fiscal packages of the USA and euro area member states.²

The global foreign exchange market has also been strongly affected by recent international developments. During the first five months of 2020, the exchange rate of the US dollar against the euro strengthened sharply and stood at EUR/USD 1.09 in late May, which is a decrease of 1.9% from the end of 2019. The strengthening of the dollar is a reflection of the specific role of that currency in the global economy, of the heightened risk aversion of investors following the epidemic outbreak and the related larger demand for safe assets, including the US dollar. The trend of the strengthening of the dollar came to a halt only after the Fed concluded currency swap agreements with a large number of central banks, thus securing sufficient dollar liquidity for the global economy. Similar trends were seen in the exchange rate of the Swiss franc. The exchange rate of the Swiss franc against the euro was 3.2% lower at end-May than at the end of December 2019 and stood at EUR/CHF 1.06.

¹ According to Deutsche Bank Research data.

² The fiscal rules of the Stability and Growth Pact are currently not applied in the EU. As the COVID-19 crisis is an event outside control of the member states that has a major impact on public finance, the Pact's "unusual events clause" is being applied.

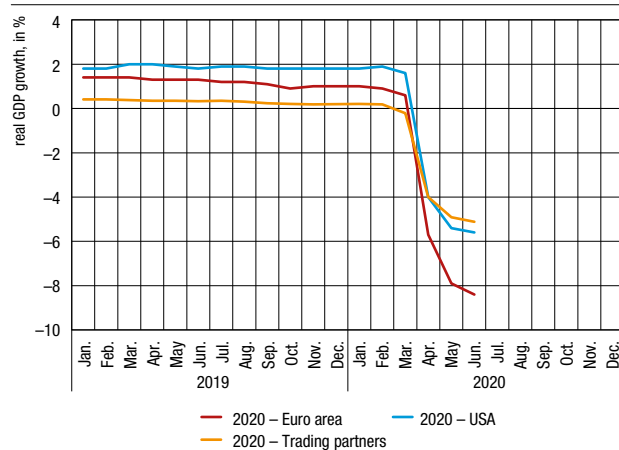
Projected developments

Expectations for global economic growth worsened dramatically following the outbreak of the coronavirus pandemic. As late as in March, a positive rate was expected for the US and euro area real GDP growth in 2020 and a stagnation of Croatia's main trading partners, while a month later, expectations showed the strongest contraction since the global financial crisis (Figure 2.4).

The projection is based on the assumption of stabilisation of the global epidemiological situation in the second half of 2020 and gradual normalisation and recovery of economic activity and global trade. The ECB and the Fed are expected to maintain their exceptionally expansionary monetary policy. Furthermore, crude oil prices are expected to recover gradually, while the prices of other raw materials excluding energy might edge down in 2020.

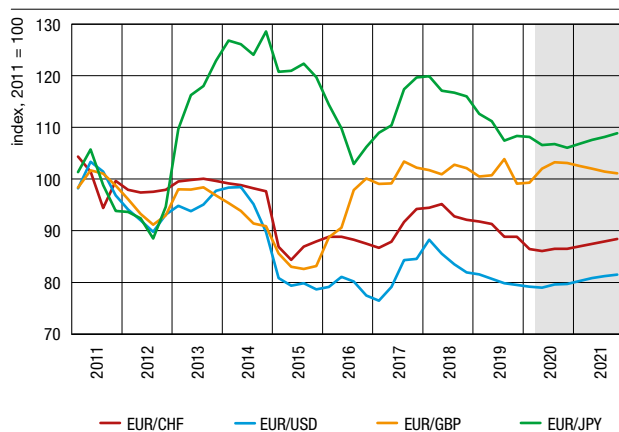
According to the expectations published in the June 2020 Foreign Exchange Consensus Forecasts, following the weakening in 2020, a recovery of the euro on the global foreign exchange market might be seen in 2021 (Figure 2.5). The average exchange rate of the US dollar against the euro might stand at

Figure 2.4 Expected real GDP growth for 2020 in selected countries



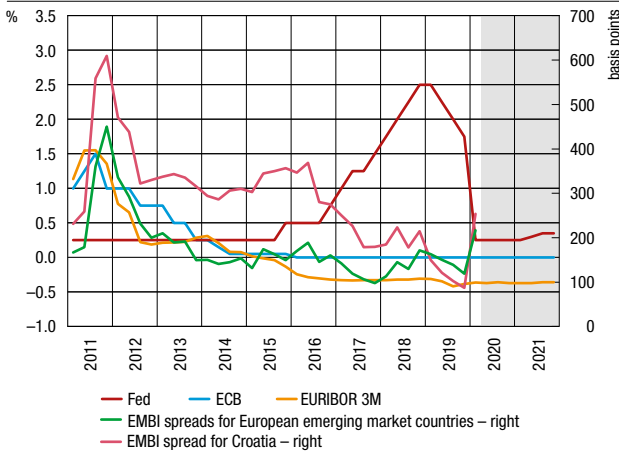
Source: Consensus Forecasts.

Figure 2.5 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 2020).

Figure 2.6 Benchmark interest rates and the average yield spread on bonds of European emerging market countries end of period



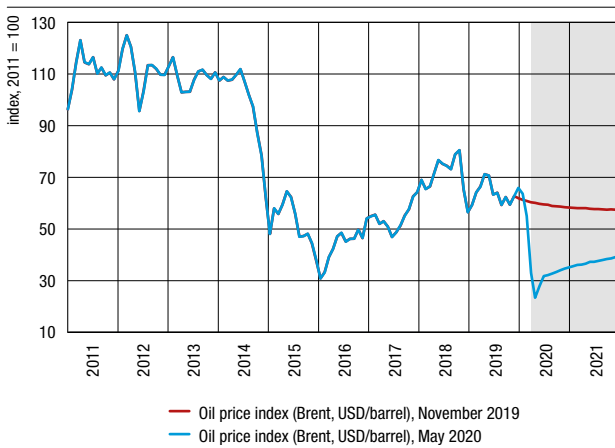
Source: Bloomberg.

EUR/USD 1.11 in 2020, a decrease of 1.3% from EUR/USD 1.12 in 2019. As regards the Swiss franc, the average exchange rate in 2020 might stand at EUR/CHF 1.07, a decrease of 4.2% from 2019.

Markets expect that exceptionally expansionary monetary policy will be maintained for the time being. Benchmark interest rates might stay at current very low levels during most of the projection period, particularly in 2020 and 2021 (Figure 2.6). At present, a marginal increase in the range for the Fed's benchmark interest rate is expected in the second half of 2021. As regards monetary policy normalisation, the first step might again be made by the Fed, with the termination of unconventional measures, such as various programmes to finance all sectors of the economy, but there are yet no clear signs when this might happen.

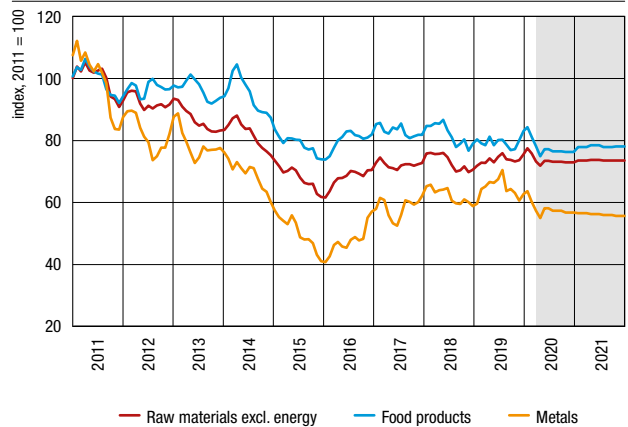
As regards the prices of raw materials on the global market, market expectations suggest that crude oil prices might somewhat recover in the rest of the year and in 2021 (Figure 2.7). The recovery might be influenced by further cuts in crude oil production by OPEC countries and other global oil producers and a faster-than-projected recovery of global oil demand.

Figure 2.7 Crude oil prices on the global market



Sources: Bloomberg (Brent crude oil futures) and CNB estimates.

Figure 2.8 Prices of raw materials excluding energy on the international market



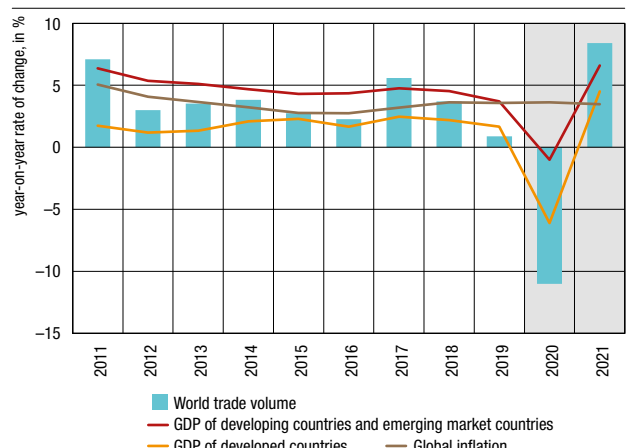
Source: IMF.

Notwithstanding the expected rebound, oil prices might be almost one third lower at the end of 2021 than those forecast in November 2019.

By contrast, the prices of other raw materials might edge down in 2020 as a whole (Figure 2.8). The reduction in the prices of metals, food products and agricultural raw materials might be only partly offset by the rise in the prices of beverages. In the rest of the projection period, the prices of raw materials excluding energy might fall only slightly, mostly due to the expected decrease in the prices of metals and, to a lesser extent, agricultural raw materials.

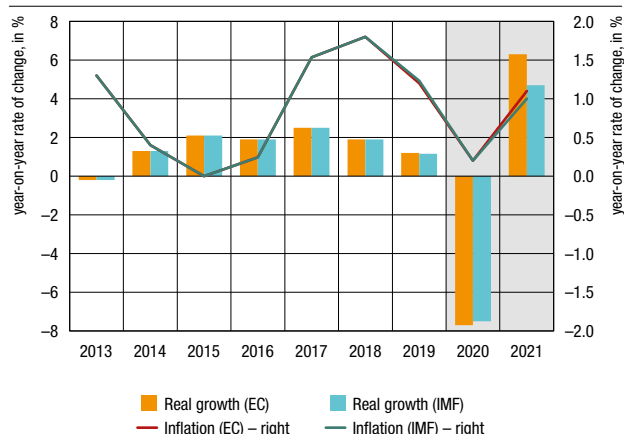
IMF projections (WEO, April 2020) suggest that, assuming the pandemic is contained and disappears in the second half of the year, the global economic downturn might come to 3.0% in 2020, which is a much stronger contraction than at the time of the global financial crisis of 2008 and 2009 (Figure 2.9). The economic slump might be broad-based, both across developed countries and emerging market countries. Exceptions are China and India, whose economies are expected to grow slightly on an annual level, but at a much slower pace than in the pre-crisis periods. By contrast, the global economy is expected to rebound

Figure 2.9 Global economic developments



Source: IMF (WEO, April 2020).

Figure 2.10 Economic growth and inflation in the euro area



Sources: IMF (WEO, April 2020) and European Commission (May 2020).

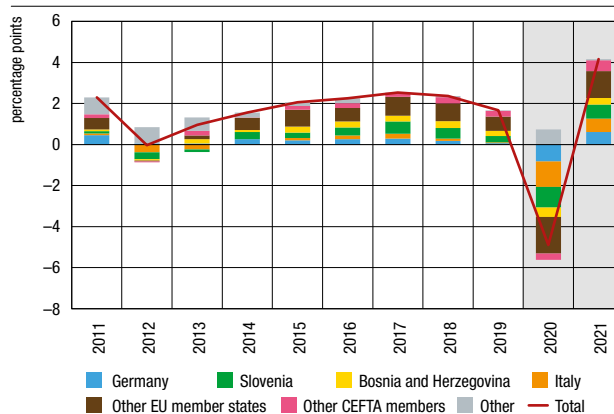
strongly in 2021, by 5.8%, again mostly thanks to the growth in emerging markets. However, it should be noted that the projection is mostly exposed to downside risks, particularly in terms of possible new waves of the infection that would further stifle recovery dynamics.

According to IMF estimates, the euro area economy might fall by 7.5% in 2020, which would be, notwithstanding the strong and rapid response of monetary and fiscal policy, the sharpest ever economic downturn in developed countries (Figure 2.10). At the same time, the IMF predicts that the economy might rebound by 4.7% in 2021. On the other hand, in May 2020 the European Commission estimated that the euro area economy would fall by 7.5% in 2020, but, in contrast to the IMF, it predicted a notably stronger recovery in 2021, of 6.3%. Along the lines of the projections of these institutions, the CNB's monetary policy projection assumes that the euro area activity will fall by 7.5% in 2020 as a whole and grow by 5.5% in 2021. It should be noted that none of the baseline scenarios of the mentioned institutions project a fast return to the 2019 GDP level.

In accordance with the described trends in the global economy, demand for Croatian exports is expected to plunge in 2020 (Figure 2.11). This might be mostly due to sluggish imports of key partners from the euro area, such as Slovenia, Italy and Germany. On the other hand, a leap in foreign demand is expected in 2021, which, in addition to euro area members, may be attributable to non-euro area EU member states.

The greatest current risk for the global economy are high uncertainties about the developments of the pandemic, particularly

Figure 2.11 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 2020).

regarding any new waves, the effects of possible epidemiological measures and the finding of an effective medical solution (a cure or a vaccine). Should new waves of infection emerge, it is possible that social distancing measures would be reintroduced and/or tightened. Publications of the leading international financial institutions, such as the IMF and the ECB, published following the end of the projection cycle, show a steady downward trend in expectations for global economic developments⁵. On the other hand, in addition to the risks directly associated with the pandemic, the deterioration in the global economic situation is further aggravated by the possibility of materialisation of other risks and idiosyncratic economic shocks due to accumulated macroeconomic imbalances in all major global economies. This further raises the risk of a more vigorous trend of a slowdown or recession in the Chinese economy burdened by the high and rising debt levels of all economic sectors. While the Fed has so far managed to stabilise financial markets, the expected recession in the US raises the possibility of a sharp correction in the US corporate bond market, which has grown strongly in recent years on the back of very favourable financing conditions and investor demand for yields. The dramatic rise in fiscal imbalances in the euro area again threatens the public debt sustainability of some member states, in particular Italy. Also, the pandemic-triggered crisis might reinforce deglobalisation and protectionist trends, notwithstanding the fact that such risks were eased prior to the epidemic outbreak as the UK formally left the EU under a limited agreement with the European authorities, while the US and China adopted the first part of the trade agreement.

3 Aggregate supply and demand

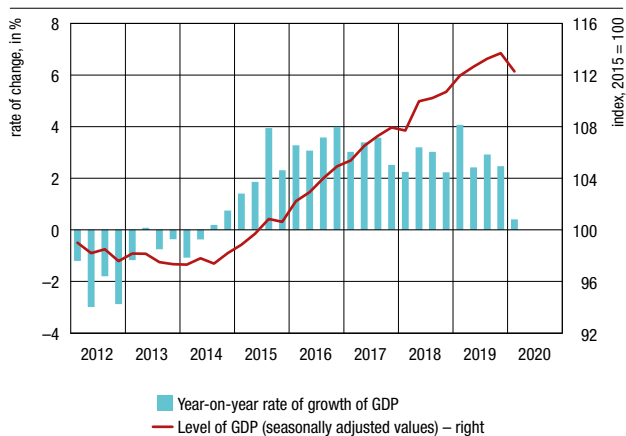
In early 2020, real GDP decreased by 1.2% from the previous quarter, recording the sharpest quarterly fall since 2012. Such developments were the outcome of the strong negative impact of the coronavirus pandemic on the global and, towards the quarter's-end, domestic economic activity. Worse results than in the previous quarter were seen for most GDP components, with the sharpest decline being recorded in the exports of goods and services, and personal consumption. Government consumption

expanded at the same time, while investment activity edged up from the end of the previous year.

The available monthly indicators for the second quarter suggest that economic trends steadily deteriorated, so that a sharp

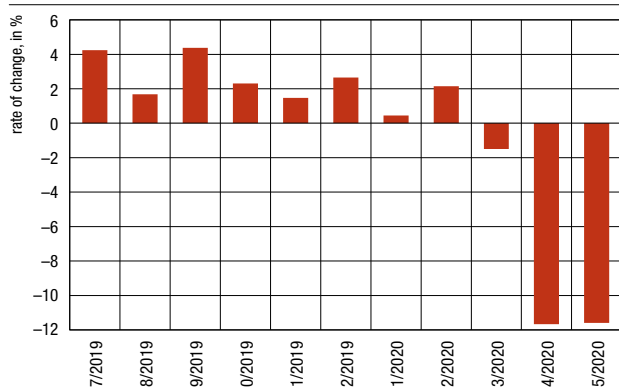
⁵ For example, in its updated June WEO, the IMF suggests that economic contraction in 2020 might come to 4.9%, up 1.9 percentage points from the April projection.

Figure 3.1a Gross domestic product real values



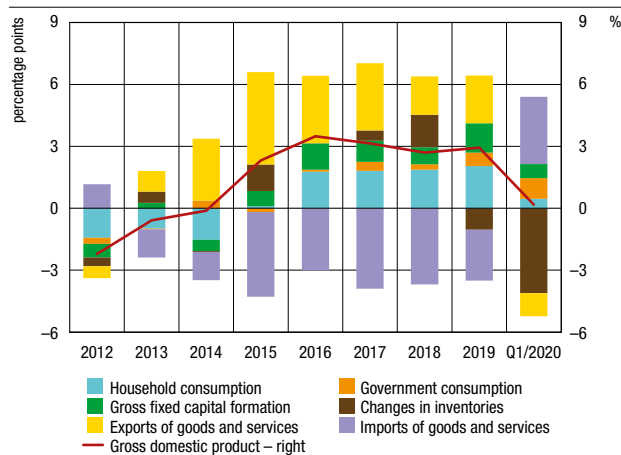
Source: CBS (seasonally adjusted by the CNB).

Figure 3.1b Estimate of change in GDP by month relative to the same period of the previous year



Source: CNB.

Figure 3.2 Change in GDP contributions by components



Note: Data for 2020 refer to the first quarter.
Source: CBS.

GDP downturn is expected on a quarterly level.

The economic downturn from the end of 2019 to the beginning of 2020 resulted in a sharp deceleration of the economic growth rate on an annual level. Real GDP was only 0.4% higher in the first quarter than in the same period of 2019, which is the average of positive annual growth rates in January and February and the negative annual growth rate in March (Figure 3.1b). Annual GDP growth was given a positive contribution by the sharp fall in imports of goods and services and the rise in domestic demand components. By contrast, total exports and changes in inventories made a large negative contribution (Figure 3.2).

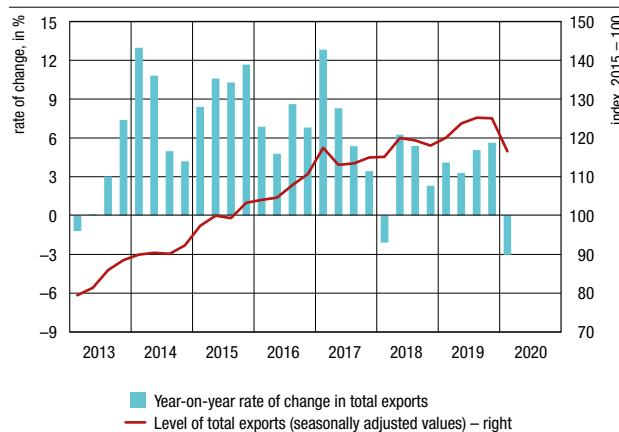
The production side of GDP calculation shows that gross value added (GVA) dropped by 0.7% from the previous quarter, with a particularly strong GVA decrease seen in wholesale and retail trade, transportation and storage, accommodation and food service activities, followed by industry, financial activities and other services. Such developments resulted in an annual slowdown, so that real GVA was 1.0% higher in the first quarter of 2020 than in the same period of 2019. The negative difference between the GDP and GVA growth rates probably reflects smaller revenues from indirect taxes relative to the previous year.

Aggregate demand

In the first quarter of 2020, the real exports of goods and services fell by 6.8% from the previous quarter, after holding steady in late 2019. Such developments were the result of very poor performance in the exports of services, which were 15.8% lower in the first quarter than in the quarter before. The drop was largely a result of unfavourable trends in tourism, due mostly to limited travel in response to the coronavirus pandemic, leading to a 32.1% annual decrease in the number of nights stayed by foreign tourists in the second quarter (72.7% in March alone). Exports of goods also decreased on a quarterly basis (-0.5%), so that the annual rate of growth slowed to 0.3%. The nominal data on goods trade show that in March exports decreased on a monthly basis in all main industrial groupings except energy. Exports of non-durable consumer goods and energy plummeted from the last quarter of 2019 to the first quarter of 2020, while other MIG components went up on account of the better performance at the turn of the year. Real exports dropped by 3.0% annually in the first quarter, making a negative contribution to movements in overall economic activity.

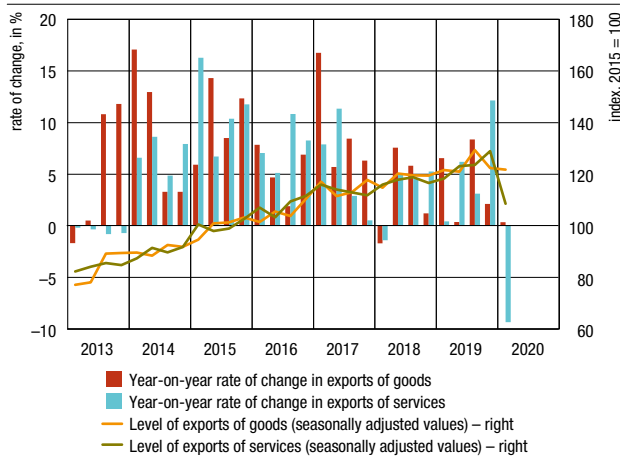
Personal consumption was 2.1% down in the first quarter of

Figure 3.3 Exports of goods and services real values



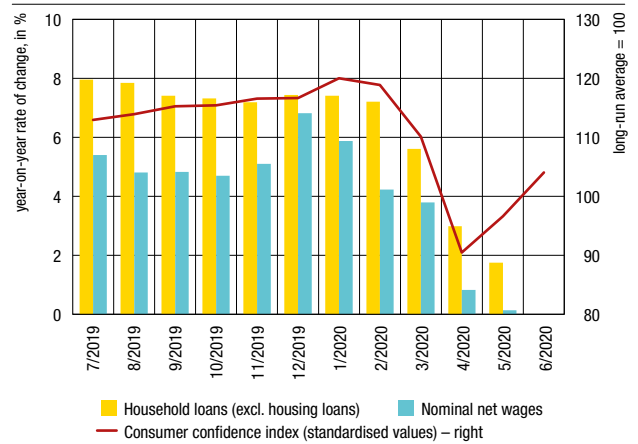
Source: CBS (seasonally adjusted by the CNB).

Figure 3.4 Exports of goods and exports of services
real values



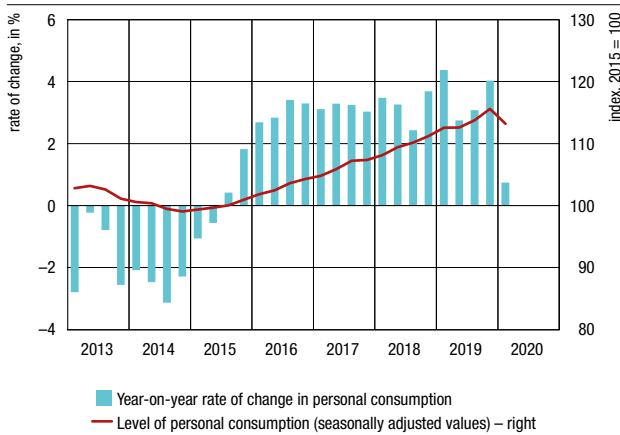
Source: CBS (seasonally adjusted by the CNB).

Figure 3.6b Determinants of personal consumption
nominal values and index



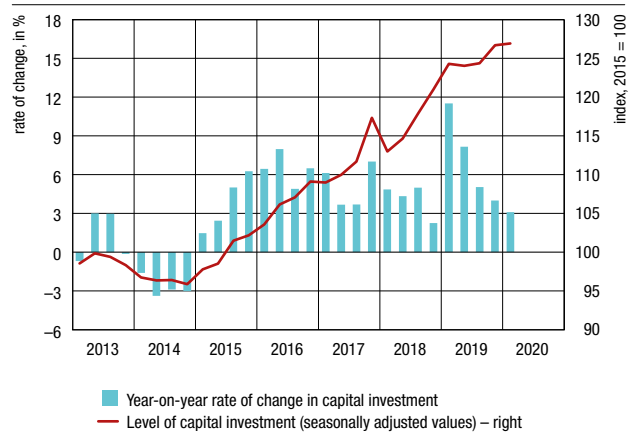
Note: The most recent data on nominal net wages and household loans refer to May. Sources: CBS and Ipsos.

Figure 3.5 Personal consumption
real values



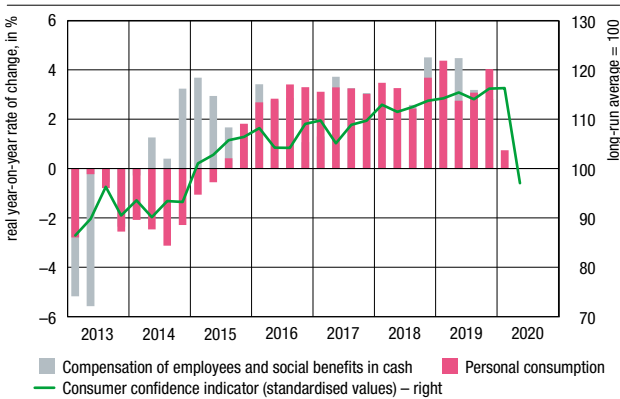
Source: CBS (seasonally adjusted by the CNB).

Figure 3.7 Gross fixed capital formation
real values



Source: CBS (seasonally adjusted by the CNB).

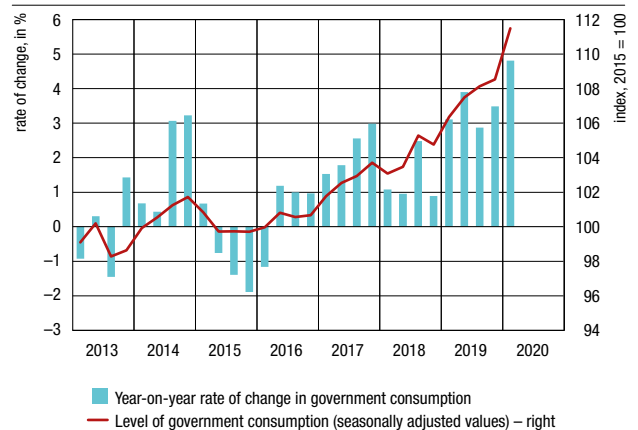
Figure 3.6a Determinants of personal consumption
real values and index



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 June 2020.

Sources: CBS, Ipsos and CNB.

Figure 3.8 Government consumption
real values



Source: CBS (seasonally adjusted by the CNB).

2020 from the previous three months, which was the first quarterly decrease since 2014, reflecting the growing insecurity and unfavourable labour market developments associated with the coronavirus. Amid such conditions, the consumer confidence index fell very sharply. Nevertheless, household consumption provided a boost to overall economic activity, growing by 0.7% annually thanks to good results seen very early in the year.

Investment activity rose marginally in the first quarter of 2020 (0.2% from the previous quarter). As a result, gross fixed capital formation grew by 3.1% annually. The slower annual growth in capital investment (4.0% in the previous quarter) probably reflects the slower growth in investment activity in the private sector and the general government in the first three months of 2020, as suggested by the data on other civil engineering works and construction works on buildings, while a slump in imports of capital goods reflects unfavourable developments in the private sector.

The rise in government consumption intensified in early 2020, by 2.7% from the previous three months, accelerating to 4.8% on an annual basis. Of all domestic demand components, government consumption thus gave the largest positive

contribution to real annual GDP growth.

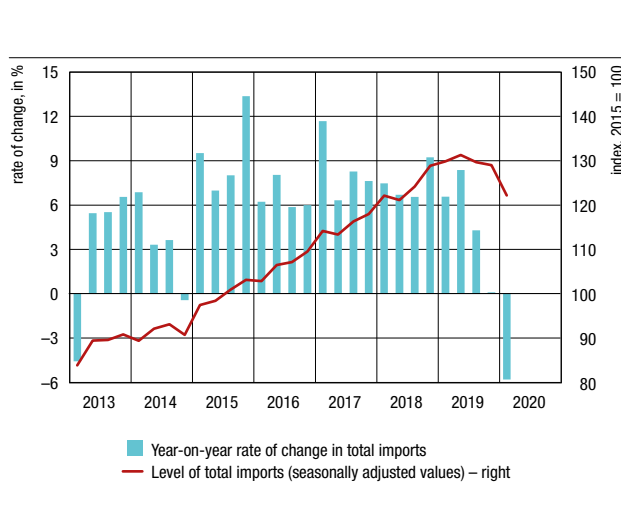
Imports of goods and services decreased sharply in early 2020, and were 5.3% lower than in the previous quarter, reflecting the fall in total exports and personal consumption, as well as weaker investment activity. Imports of goods dwindled by 3.8%, with nominal data showing that, within the main industrial groupings (MIGs), imports of energy, capital goods and durable consumer goods dropped on an annual level. Imports of services decreased by 16.5% from the previous quarter. Such developments resulted in an annual decrease in total imports of 5.8%, the sharpest fall seen since 2010. As the positive contribution of the fall in imports exceeded the negative contribution of the fall in exports, the contribution of net foreign demand to total economic growth was positive in the first quarter (2.1 percentage points).

Aggregate supply

Gross value added fell by 0.7% from the previous three months. The fall from the end of 2019, when GVA grew by 0.5%, was largely the outcome of smaller GVA in retail trade, transportation and storage activities. In addition, a quarterly decrease in GVA was seen in industry, financial activities and other service activities. As a result of such developments, GVA growth slowed down to 1.0% on an annual basis (being 2.5% in late 2019).

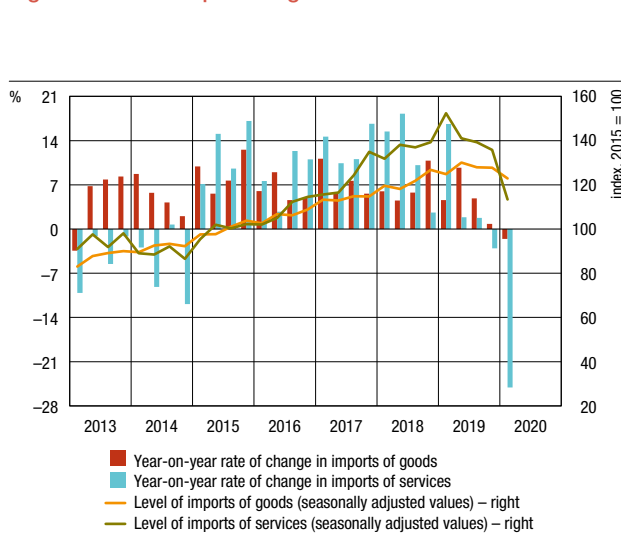
The GDP nowcasting model based on monthly data that are mainly available for April and May shows that economic activity was much slower in the second quarter than in the previous three months. Industrial production fell by 3.5% from April to May and by 8.2% in April and May combined from its average volume in the first quarter of 2020. Broken down by MIGs, production decreased in all groups of goods except energy, with the sharpest quarterly fall (of almost 50%) seen in the production of durable consumer goods. Real retail trade turnover fell by a record 19.8% from March to April, but it recovered in May, growing by 23.5%. Observed on a quarterly level, retail trade turnover was 17.3% lower in April and May than in the first quarter. Such negative trends outpaced even those seen during the global financial crisis. Construction continued to fall in April 2020 for the second consecutive month, by 1.9% from the previous month and by 9.5% from the average performance in the first quarter. The volume of construction works on buildings and civil engineering works fell on a monthly level (by -3.8% and

Figure 3.9 Imports of goods and services
real values



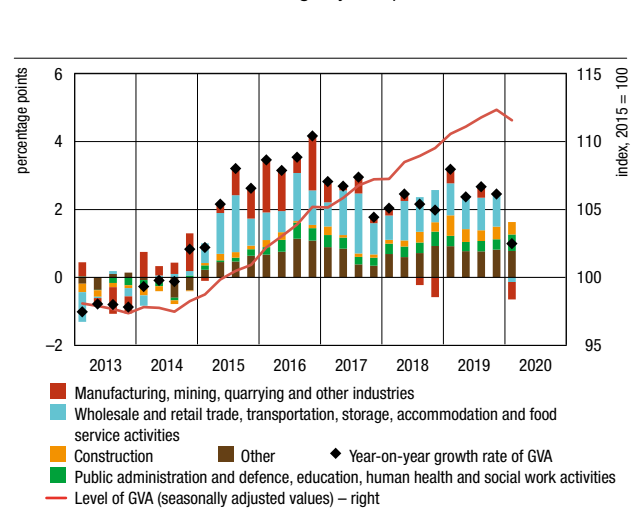
Source: CBS (seasonally adjusted by the CNB).

Figure 3.10 Real imports of goods and services



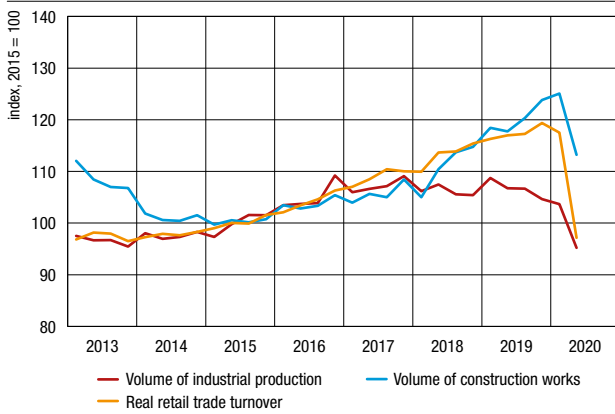
Source: CBS (seasonally adjusted by the CNB).

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



Source: CBS (seasonally adjusted by the CNB).

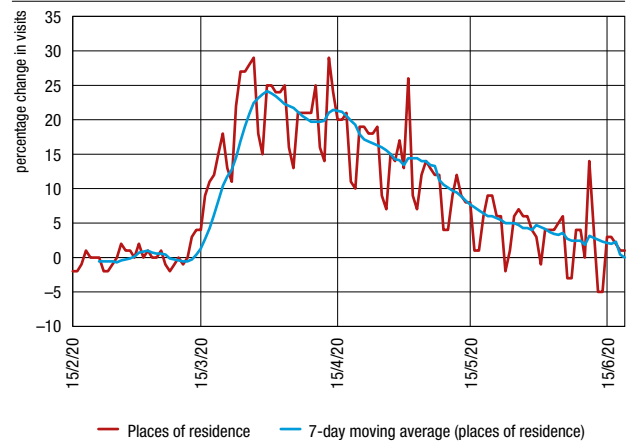
Figure 3.12a Short-term economic indicators
seasonally adjusted values



Notes: Quarterly data are calculated as an average of monthly data. Data on construction in the second quarter of 2020 refer to April and data for industry and trade refer to April and May.

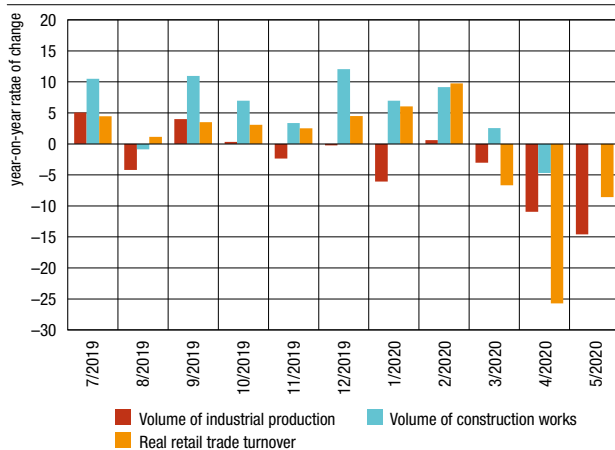
Source: CBS (seasonally adjusted by the CNB).

Figure 3.12d Mobility trends for places of residence



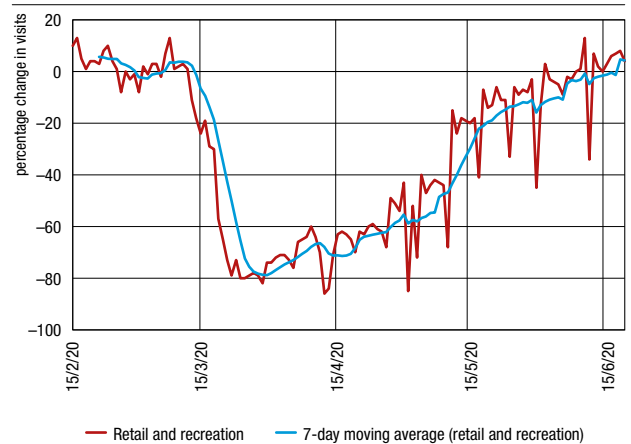
Source: Google, Covid-19 Community Mobility Reports.

Figure 3.12b Short-term economic indicators
year-on-year rate of change



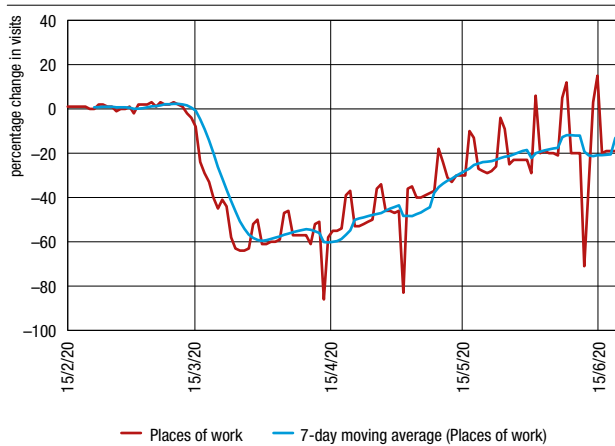
Note: The most recent data for the total volume of construction works refers to April.
Source: CBS.

Figure 3.12e Mobility trends for retail and recreation



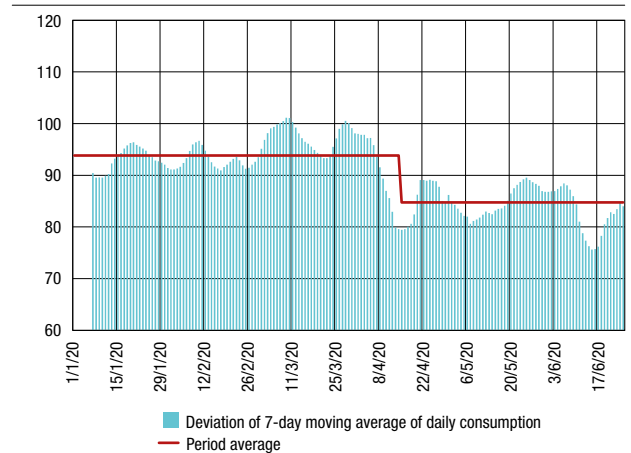
Source: Google, Covid-19 Community Mobility Reports.

Figure 3.12c Mobility trends for places of work



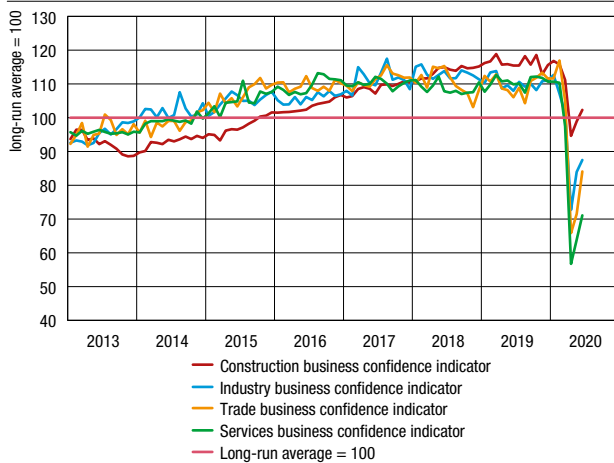
Source: Google, Covid-19 Community Mobility Reports.

Figure 3.12f Deviation of the average electricity consumption relative to the same period in the previous year



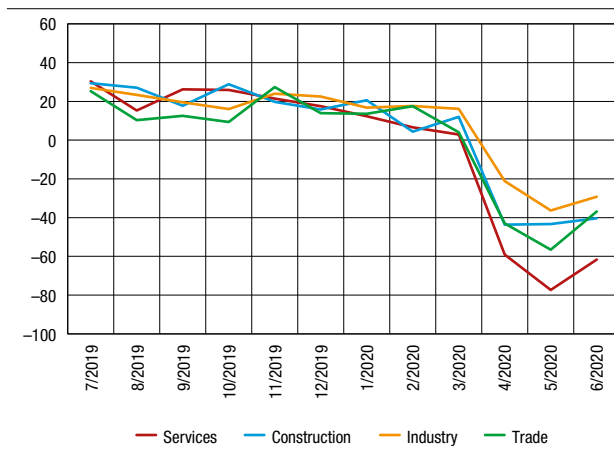
Sources: ENTSOE Transparency Platform and CNB calculations.

Figure 3.13a Business confidence indicators
standardised seasonally adjusted values



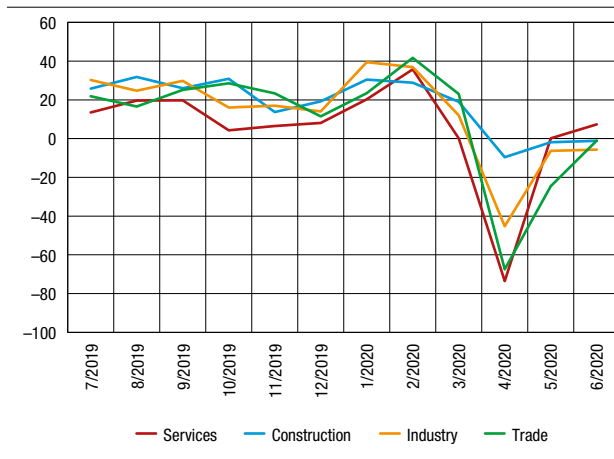
Sources: Ipsos and CNB (seasonally adjusted by the CNB).

Figure 3.13b Business confidence indicators
Business situation in your company in the last three months
balance of responses



Sources: Ipsos and CNB.

Figure 3.13c Business confidence indicators
Business situation in your company in the next three months
balance of responses



Sources: Ipsos and CNB.

–2.2% respectively), but its rates of decrease were much smaller than in March (–10.6% and –12.5% respectively).

The results of the Consumer Confidence Survey for June 2020 show that the confidence index only began to recover, with improvements seen in all subcomponents of the index.⁴ The respondents expected that the financial situation of households would improve in 12 months from now, with a significant improvement in the general economic situation in Croatia also being expected. Consumer Confidence Survey data for June 2020 also show that expectations of business entities improved in all activities, though the confidence index remained at very low levels. Relative to May expectations, the recovery was most evident in trade and least evident in industry.

In view of the great uncertainty regarding the pandemic's economic impact, some non-traditional indicators were also considered in the assessment of current developments. The data suggest that the economic downturn followed the imposition of restrictive measures, i.e. it occurred in parallel to their introduction and was relatively steep. Most such indicators point to the sharpest fall in April and a gradual recovery in May, also following the gradual lifting of restrictive measures. It should be noted that interpretation of these indicators requires that their specificities are taken into account (e.g. for Google mobility indicator, the baseline reference period is the five-week period in January and February before the pandemic outbreak), so they should not be directly associated with economic developments and should instead be treated only as indicative.

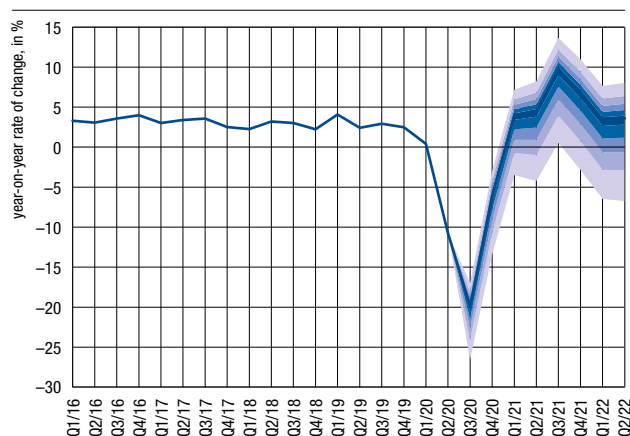
Projected developments

The novel coronavirus pandemic triggered a synchronised and strong economic shock, fuelling expectations of a sharp economic contraction in 2020. The estimated 9.7% annual decline in real GDP might be largely a result of the fall in exports of goods and services, with a negative contribution expected also from the drop in investment activity and household consumption.

Exports of goods and services might plunge by more than 38% in 2020 from 2019, reflecting the anticipated decline in the exports of tourist services in the second and third quarters, as well as the decrease in goods exports due to dwindling foreign demand and difficulties in cross-border transactions. Gross fixed capital formation might see the sharpest decrease (–12.2%) of all domestic demand components, mostly due to the fall in investment activity of the private sector and, to a lesser extent, the dynamics of public sector investments. Such developments are also indicated by the latest available data for April and May on worsened business expectations in the upcoming short-term period. The projected slump in household consumption largely reflects the direct negative impact of the sharp economic contraction (lockdown) on the labour market, i.e. developments in employment, unemployment and wages. Just as they do for enterprises, the Consumer Confidence Survey data for March and April 2020 suggest that household expectations regarding the economic situation in the country and the financial situation of households in the following year deteriorated significantly from the beginning of the year, which might push down personal consumption even more. Household consumption might fall by 5.3% on an annual basis and, given its large share in GDP, make the strongest negative contribution to the fall in overall economic activity of all domestic demand components. Government consumption is expected to edge up at the

⁴ The Survey was taken in the first half of June after the lifting of many restrictive measures, that is, at the time when the epidemiological situation was very good.

Figure 3.14 Projection of real GDP dynamics



Sources: CBS and CNB.

same time. Imports of goods and services might fall sharply in 2020 as a whole (-30.2%) on the back of the slump in domestic demand, the drastic projected fall in tourism activities and smaller exports of goods (which are strongly import dependent in the case of Croatia). In line with expectations about developments in total exports and imports, the contribution of net

foreign demand to the change in real GDP might be -3.9 percentage points in 2020.

Economic activity might expand by 6.2% from 2020 to 2021, largely due to the base effect. Despite this relatively high rate, it is not expected to be sufficient to bring economic activity back to the pre-pandemic level, as evident in the expected lower rate of potential GDP growth incorporated in the projection. Economic recovery in 2021 might be primarily driven by exports of goods and services, with an increase also expected in all components of domestic demand. Imports are also expected to rise with the recovery in domestic and foreign demand, so that the contribution of net foreign demand to overall economic growth might be positive.

It is estimated that the risks associated with the central projected measure in the GDP projection are very much tilted to the downside. Estimated and projected GDP and its components are subject to a very high degree of uncertainty, associated largely with the evolution of the epidemiological situation, that is, the success in containing the novel coronavirus's spread and a parallel gradual reactivation of economic activity, and the possibility of another wave of the pandemic before an effective medical solution is found or before the virus loses much of its power through mutations. Developments, and possible deviations, of quantifications in the projections related to the real sector will depend on pandemic-triggered changes in the behavioural patterns of economic agents (household consumption and behaviour of private sector investors), which are very difficult to assess at the moment.

Box 1 Alternative scenario for the monetary policy projection assuming a second pandemic wave

Under the assumption that a second wave of the pandemic strikes in the fourth quarter of the current year, the fall in real GDP might be more pronounced in the whole of 2020 than under the baseline projection scenario and reach 11.4%. As the negative shock from the last quarter of 2020 would partly spill over into 2021, the GDP growth rate in 2021 is only slightly higher than that under the baseline scenario, notwithstanding the steeper fall in 2020. Under the pessimistic scenario, economic activity is expected to return to the 2019 level no sooner than in 2023.

The coronavirus pandemic has strongly affected current economic activity. The uncertainty surrounding the further evolution of the pandemic, both in Croatia and its trading partners, and the uncertainty about the scope and duration of pandemic containment measures make the preparation of macroeconomic projections much more difficult. This is why a pessimistic scenario assuming a second pandemic wave is considered in addition to the baseline scenario.

Key differences between the scenarios relate to epidemiological assumptions and intensity of shocks to domestic and foreign demand that are consequences of the pandemic and lockdown, that is, the imposition of strict virus containment measures. Virtually all non-essential economic activities were brought to a halt in that period. Scenarios thus have different starting assumptions on expected economic developments in the euro area, different trends are expected in tourism exports, a different intensity of the shocks to personal consumption and investment and a different negative impact of shocks to potential GDP growth.

The baseline scenario assumes a milder combination of negative shocks. A shock to autonomous personal consumption (a decrease of 30.0%) and investment (25.0%) is assumed in the second quarter of 2020 relative to the baseline projection from December 2019. As regards foreign demand, the estimated fall

in euro area economic activity in 2020 might come to 7.5% on an annual level, while a recovery of 5.5% is expected in 2021. However, in view of the nature of the shock (a global public health crisis), which disproportionately affects global trends in tourism relative to some other industries, and bearing in mind the relatively large significance of tourism, the domestic economy might be particularly strongly hit by the slump in tourism revenues, which are mostly generated from foreign tourists. Revenues from tourism consumption of foreign tourists are expected to plummet annually by 70% in 2020 and to grow perceptibly in 2021, but they should remain below those seen in 2019. Finally, it is assumed that the economic crisis triggered by the pandemic might have long-lasting consequences for the domestic economy, with a slight decrease in the potential growth rate of GDP.

The pessimistic scenario assumes that a new pandemic wave might occur in the fourth quarter of 2020 and provoke a milder response from economic policymakers compared with the restrictive measures taken during the first wave because of prior experience in containing the pandemic. More specifically, the second quarter shocks calibrated under this scenario are the same as under the baseline scenario, while fourth quarter shocks are one-half less intensive (a decrease of 15% for autonomous personal consumption and 12.5% for investment from the baseline projection in 2019). In view of the expected new wave of the pandemic, the fall in euro area real GDP might be steeper and come to 10% on an annual level, with a somewhat sharper recovery in 2021 (of 7.0%) than under the baseline scenario, largely due to the base effect. As regards the decrease in revenues from tourism consumption of foreign tourists, assuming that measures to limit travelling abroad effective in main outbound markets were imposed in the fourth quarter as well, it is predicted that revenues from tourism services would fall

Table 1 Results of the model evaluation under different scenarios

| | Baseline | | | | Pesimistic | | | |
|-----------|----------|------|------|------|------------|------|------|------|
| | 2020 | 2021 | 2022 | 2023 | 2020 | 2021 | 2022 | 2023 |
| GDP | -9,7 | 6,2 | 3,7 | 3,0 | -11,4 | 6,3 | 4,3 | 3,3 |
| Inflation | -0,1 | 0,7 | 1,7 | 2,1 | 0,0 | 0,6 | 2,0 | 2,3 |

Source: CNB projections.

even more, by 75% on an annual level. It follows that long-term effects of the crisis on the domestic economy would be more severe under this scenario, which would result in a sharper decrease in the potential GDP growth rate.

Fiscal policy shocks were included in both scenarios. The shocks related to the deferral of VAT payment (calculation after collection in the second quarter), exemption from income and profit tax up to a maximum of three months, the rise in government transfers in the form of wages and contributions for a maximum of three months and the estimated shock of a decrease in government consumption driven by austerity measures (for more details, see Box 6 Fiscal policy measures aimed at alleviating the negative consequences of the pandemic). Implemented fiscal measures might ease the GDP downturn in 2020 by around 0.8 percentage points. The strongest impact of fiscal measures is evident in a less pronounced decrease in personal consumption and, to a lesser extent, in investment. Results of the model evaluation of the scenarios, including fiscal measures, are shown in Table 1.

To gain a better insight into economic developments under alternative scenarios, Figure 1 shows developments in real GDP

4 Labour market

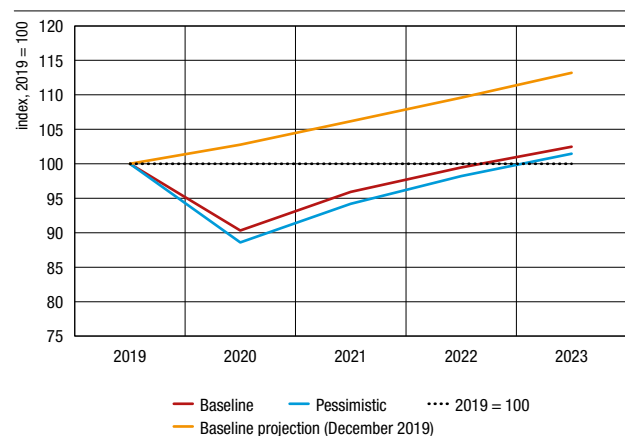
Employment and unemployment

The continuation of favourable labour market trends characterised the beginning of 2020, while a deterioration was seen in March, amid the coronavirus pandemic and stringent containment measures. Viewed on a quarterly basis, the number of employed persons (seasonally adjusted data) was slightly lower in the first quarter (-0.1%) than in late 2019. The number of employed persons continued to slide in April and May, and was 3.6% lower on average than in the first quarter (Figure 4.1). Most of the decrease related to accommodation and food service activities, and trade and transportation, which are the most vulnerable to social distancing measures.

Unemployment continued to fall in early 2020, but due to the strong inflow of new unemployment entries into the CES register unemployment increased in March 2020 despite continued clearings from the register (Figure 4.2). The number of unemployed persons went up 8% from December 2019 to the end of the first quarter of 2020. Unemployment growth picked up pace in April due to increasingly stronger inflows of new unemployed persons in the CES register. It continued to rise in May, though at a slower pace, being only marginally higher in late June (Figure 4.2a). The slowdown in unemployment growth was due to Croatian government measures to preserve jobs and the relaxation of containment measures thanks to the more favourable epidemiological situation.

The increase in unemployment was reflected in the registered unemployment rate, which went up from an average of 6.9% of

Figure 1 GDP trends under the baseline and alternative scenarios



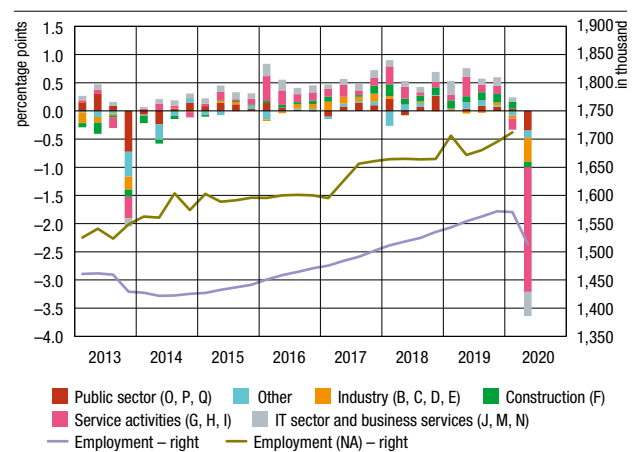
Source: CNB projections.

relative to its 2019 level and relative to the baseline scenario from December 2019.

The figure shows that under the baseline scenario a return to the 2019 level might be expected no sooner than 2022, while under the pessimistic scenario, the return would not occur before 2023. Such trends indicate a shorter or longer recovery in the form of letter “U”. On the other hand, neither scenario predicts convergence to the projected GDP level under the end-2019 baseline scenario during the projection horizon.

the labour force in January and February to 7.7% in March and 9.3% in April. According to the latest data for May, the registered unemployment rate stood at 10.4% and is expected to hold steady in June. The most recent data available show that the ILO unemployment rate stood at 6.3% of the labour force in the first

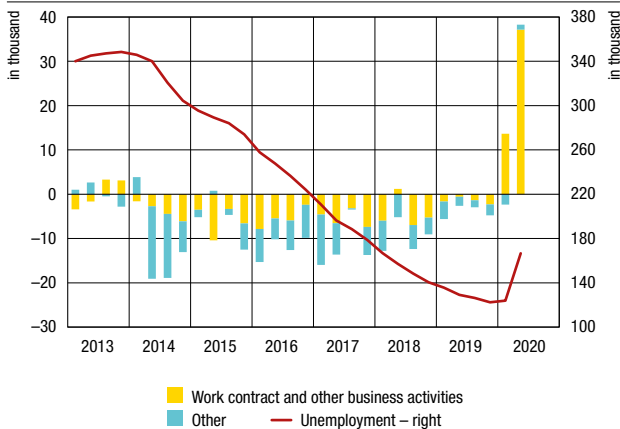
Figure 4.1 Employment by NCA activities
seasonally adjusted data, contributions to the quarterly rate of change



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

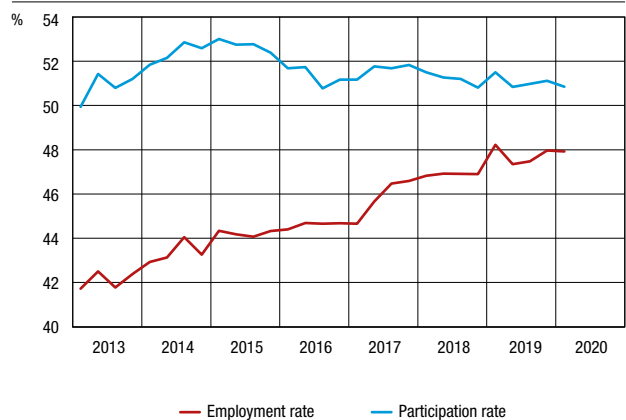
Source: CPII (seasonally adjusted by the CNB).

Figure 4.2 Total unemployment and net unemployment inflows
seasonally adjusted data



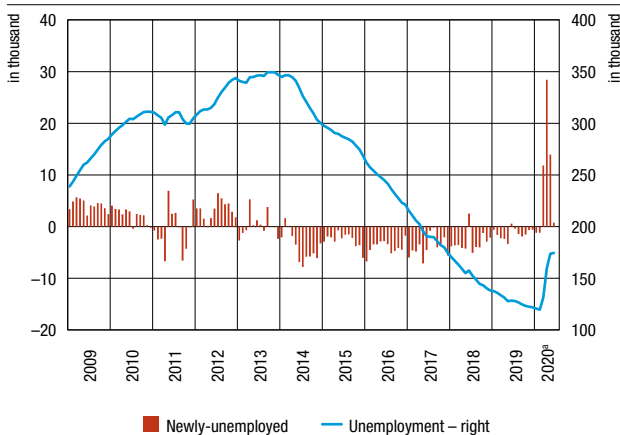
Note: Data for the second quarter of 2020 refer to April and May.
Source: CES (seasonally adjusted by the CNB).

Figure 4.4 Labour Force Survey
seasonally adjusted series



Source: CBS (seasonally adjusted by the CNB).

Figure 4.2a Unemployment and the number of newly unemployed persons
seasonally adjusted monthly data



^a Data for June refers to the situation as at 23 June 2020.
Source: CES (seasonally adjusted by the CNB).

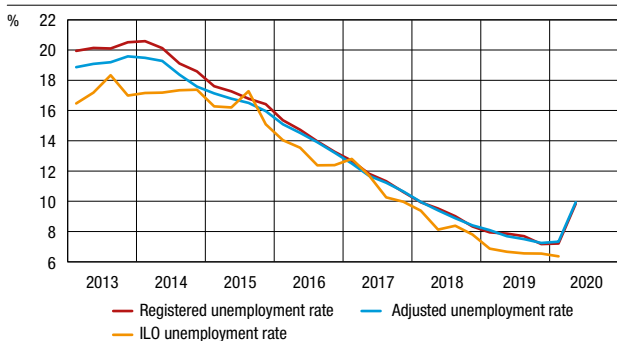
quarter (Figure 4.3).

The latest Labour Force Survey data available for the first quarter of 2020 suggest that the employment rate remained almost unchanged, while the participation rate decreased from the end of 2019 as a result of the unchanged number of persons classified as employed and a parallel fall in the number of persons classified as unemployed under the ILO methodology. The Labour Force Survey unemployment rate in the first quarter of 2020 stood at 47.9% of the working age population, while the rate of participation (labour force in relation to working age population) stood at 50.8% (down from 51.1% in late 2019) (Figure 4.4).

Wages and unit labour cost

Wage growth picked up from the end of 2019 to the first quarter of 2020. The average nominal gross wage rose by 1.4%, with the wage increase being broadly based. However, the coronavirus pandemic affected wage developments. The average nominal gross wage fell sharply in April, and continued to decrease in May, though at a lower rate (seasonally adjusted data). On average, wages were 2% lower in the second quarter than early in the

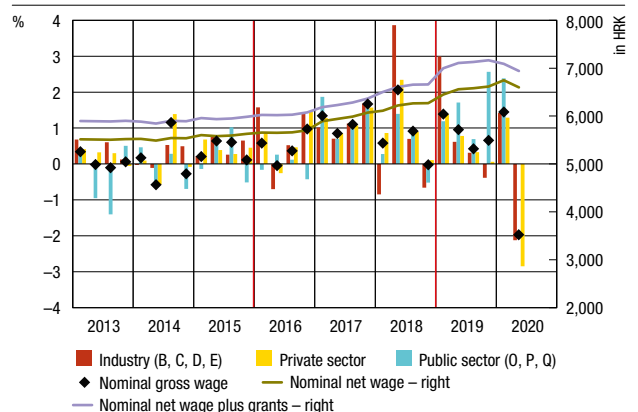
Figure 4.3 Unemployment rates
seasonally adjusted data



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. Data for the second quarter of 2020 for the registered and the adjusted unemployment rate refer to April and May.

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

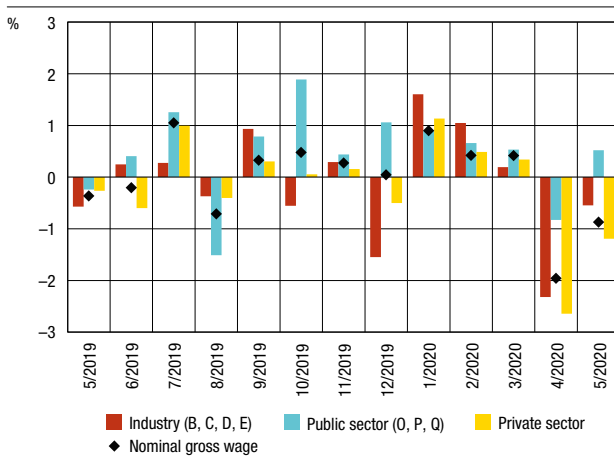
Figure 4.5 Average nominal gross wage by NCA activities
seasonally adjusted data, quarterly rate of change



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 2020 refer to April and May.

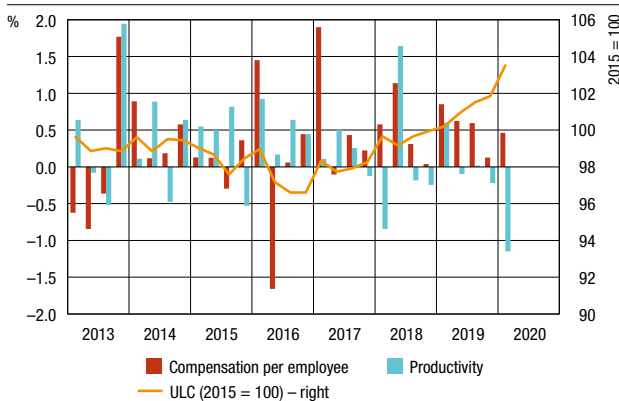
Sources: CBS and CNB calculations (seasonally adjusted by the CNB).

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



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

Figure 4.6 Compensation per employee, productivity and unit labour costs
seasonally adjusted data, quarterly rate of change and levels (2015 = 100)



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

Sources: CPII and Eurostat (seasonally adjusted by the CNB).

year. The drop was more pronounced in the private sector, while public sector wages held steady (Figures 4.5 and 4.5a).

As regards the purchasing power of wages, real wages went up in the first quarter of 2020 and in April and May the decline was only slight because of the cuts in consumer prices. The fact that real wages fell much less than nominal wages is actually attributable to the cuts in the prices of refined petroleum products, for which demand dropped strongly due to the lockdown.

Unit labour costs picked up noticeably from the end of 2019 to the first quarter of 2020. More specifically, compensation per employee according to the national accounts data grew moderately, while labour productivity decreased proportionately (real GDP fell more than employment) (Figure 4.6).

Projected developments

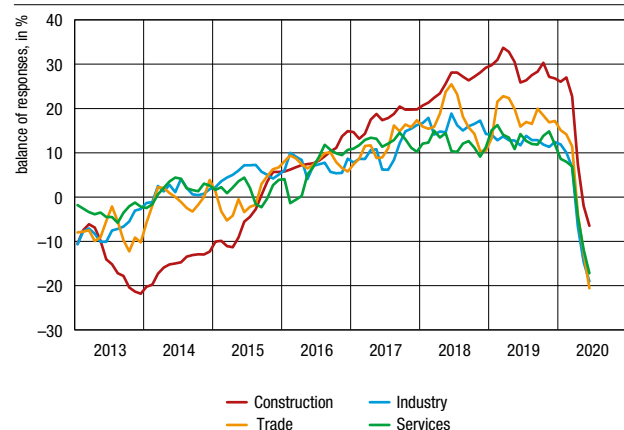
It is expected that the reaction of the labour market to the sharp economic slump will be relatively mild, because, among other things, of Government measures aimed at preserving jobs (for more on the characteristics of the business entities that received Government grants for job preservation, see Box 2 Analysis of the business entities that received Croatian government

grants for job preservation). Taking into account the performance in the first five months, employment is expected to decrease by 3.2% by the end of the year. The average decrease on an annual level also reflects the anticipated much lower intensity of seasonal employment in activities that normally employ seasonal labour force, that is, accommodation and food service activities, and trade and transportation.

Having worsened substantially in April, expectations regarding employment trends improved in May and June in all activities, but remained much more pessimistic than in the same period of 2019 (Figures 4.7 and 4.7a). Parallel to the expected decrease in the number of employed persons, an increase of similar proportions is expected to be seen in unemployment figures, so that the ILO unemployment rate might grow to 9.1% of the labour force in 2020.

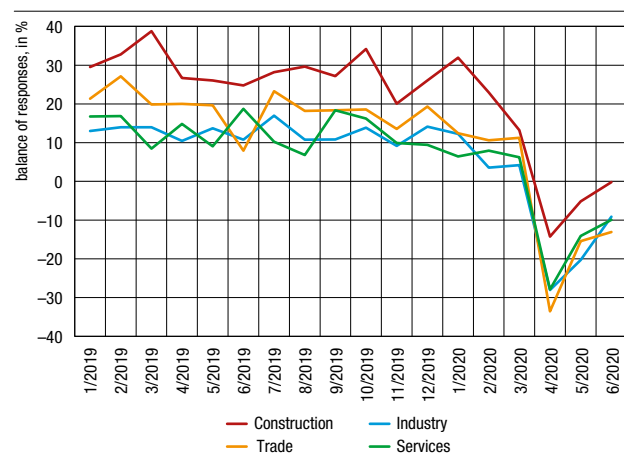
The average nominal gross wage is expected to dip by around 0.5% in 2020, largely due to the decline in private sector wages, while public sector wages are expected to edge up (assuming that the rest of the agreed increases in the wages of civil servants and the agreed increases in the wages of teachers will not materialise).

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 4.7a Employment expectations by sectors (in the following three months)
seasonally adjusted data



Source: Ipsos (seasonally adjusted by the CNB).

Table 4.1 Projection of labour market indicators for 2020 and 2021

year-on-year rates of change, in %

| | 2017 | 2018 | 2019 | 2020 | 2021 |
|--|------|------|------|------|------|
| Number of employed persons – CPII | 1.9 | 2.3 | 2.3 | -3.2 | 2.0 |
| Number of employed persons – national accounts | 2.2 | 1.8 | 1.4 | -3.2 | 2.0 |
| Participation rate (ILO) | 51.6 | 51.2 | 51.2 | 51.2 | 51.7 |
| Unemployment rate (ILO) | 11.2 | 8.4 | 6.6 | 9.1 | 7.8 |
| Average nominal gross wage | 3.9 | 4.9 | 3.8 | -0.5 | 1.3 |
| ULC | -0.7 | 1.4 | 1.9 | 6.6 | -2.7 |
| Productivity | 0.9 | 0.8 | 1.5 | -6.7 | 4.1 |

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

Sources: CBS, Eurostat, CPII and the CNB projection.

The labour market is expected to recover gradually in 2021. Employment might grow by 2% annually, while the expected ILO unemployment rate might be 7.8% of the labour force in 2021. At the same time, the average nominal gross wage might grow by 1.3%.

Box 2 Analysis of the business entities that received Croatian government grants for job preservation

The Croatian government's measure to preserve jobs, introduced amid the novel coronavirus epidemic, was used in March 2020 by slightly more than 85 thousand business entities, to which HRK 1.61bn was paid out for around 500 thousand of their employees, while in April the same grants were used by 98 thousand entities, to which HRK 2.2bn was paid out for more than 550 thousand employees. The largest number of the business entities that applied for grants in at least one month came from entities in accommodation and food service activities, art, entertainment and recreation, and education, while the largest nominal amount of grants was paid to manufacturing industry. Most of the business entities that received support in at least one month were those with up to ten employees, accounting for only a third of the total funds paid. On the other hand, business entities with more than 50 employees, while fewer in numbers, accounted for slightly less than half of the total grants paid.

Due to the spread of the novel coronavirus pandemic in Croatia and the introduction of containment measures, a large number of business entities were faced with major difficulties in their operations or even had to suspend operations, particularly in activities characterised by intensive social contacts. To preserve jobs, the Croatian government, like many others, adopted a measure aimed at preserving jobs in pandemic-affected activities by subsidising the wages of their employees.⁵

Applications for grants were received and processed by the Croatian Employment Service (CES), which was also in charge of disbursing the funds. The measure included a grant in the amount of HRK 3,250.00 per full-time employee for March and HRK 4,000.00 for April and May, and a proportionate share for part-time employees, depending on the number of working hours. The right to receive the funds was granted to business entities whose monthly revenues were at least 20% lower in the current month than in the same month of the previous year (for those that had operated for less than a year, the reference period was February 2020). In addition, the Government committed

itself to pay corresponding pension and health contributions on these grants.

Grants for March were paid in April 2020 to more than 85 thousand business entities with around 500 thousand employed persons, amounting to a total of HRK 1.61bn.⁶ Grants for April were paid to around 98 thousand enterprises with more than 550 thousand employed persons, amounting to a total of HRK 2.2bn (Table 1). Most enterprises that received grants for April had also received them in March (97%), whereas a small number of enterprises (15 thousand) that received grants in April did not receive them in the preceding month. Also, around 2 thousand enterprises received grants for March, but not for April.

Table 1 Results of the processing of data on CES grants paid for March and April 2020

| | March | April |
|-------------------------------|---------|---------|
| Number of business entities | 85,135 | 98,528 |
| Number of workers | 501,467 | 557,949 |
| Grants paid out (billion HRK) | 1.61 | 2.20 |

Source: CES data processed by the CNB.

Table 2 Enterprises identified in the FINA database that received grants at least in one month

| | |
|--|---------|
| Number of business entities | 50,668 |
| Number of workers | 480,790 |
| Share of workers in the FINA database that received CES grants | 83% |

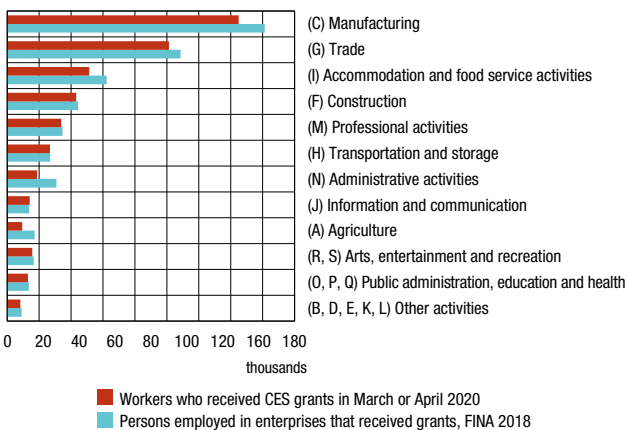
Sources: CES and FINA data processed by the CNB.

The correlation of CES data on the business entities that received grants for March and /or April 2020 with those in the database of the Financial Agency (FINA) showed that around 50 thousand business entities in the FINA database received grants

⁵ The Croatian government adopted the first package of measures to support the economy, including the measure of job preservation grants, on 17 March 2020.

⁶ Data on paid grants were taken from the official CES website as at 1 July 2020 and they may differ from the official data on another date as the database on the grants paid is updated on a daily basis.

Figure 1 Comparison of data on the number of employees in business entities in the FINA database and the number of persons receiving grants according to CES data, by NCA activities in March and April



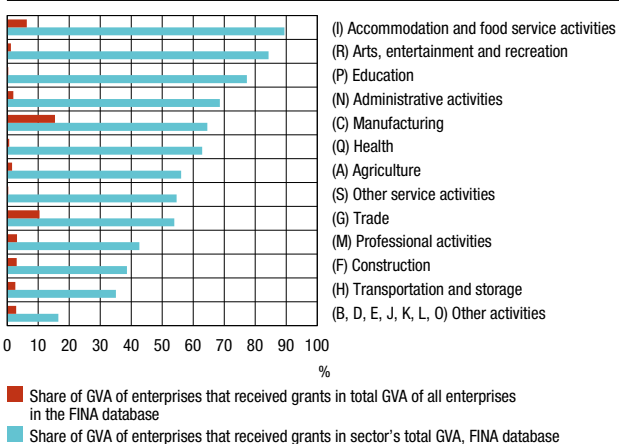
Sources: FINA and CES data processed by the CNB.

at least in one month.⁷ Enterprises in the FINA database received grants for 480 thousand employed persons, accounting for almost 83% of the workers that received CES grants (Table 2).

Based on the data in the FINA database, it is possible to gain an insight into the structure and characteristics of enterprises whose employees received government support to preserve jobs (Figure 1).

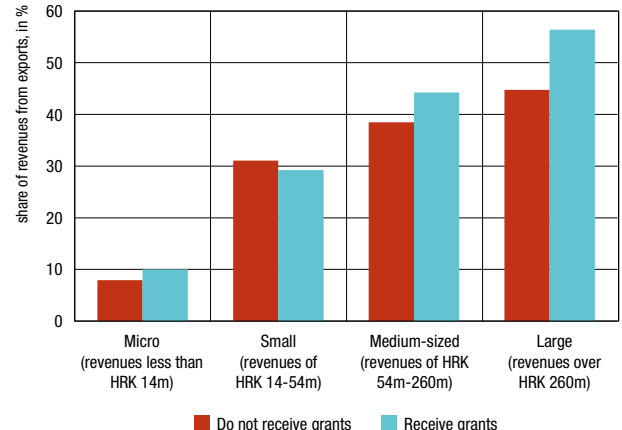
Observed according to the share of gross value added (GVA)⁸ of the business entities that received grants in total gross value added of a particular activity, accommodation and food service activities recorded the largest share of received grants, of around 90% of this activity's GVA (Figure 2). The Croatian government's support programme for the most part covers business entities engaged in art, entertainment and recreation, education,

Figure 2 GVA of the business entities that received CES grants by NCA activities



Source: FINA data processed by the CNB.

Figure 3 Export revenues of manufacturing business entities by size



Source: FINA data processed by the CNB.

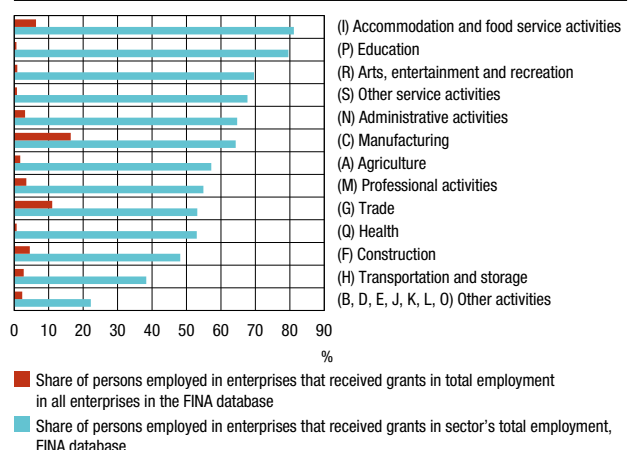
administration, health (private providers) and agriculture. Substantial support was also provided to manufacturing and trade, where business entities that received support accounted for around 60% and 55% respectively of GVA of the activities.⁹

Looking at manufacturing business entities alone, the business entities that generate a larger share of revenues from exports were generally exposed to higher risk of impeded operation than those with a lower share of revenues from exports (except from the segment of small enterprises) (Figure 3).¹⁰

As regards employment, the situation is similar to GVA. Business entities in accommodation and service activities and manufacturing that received support employed around 80% and 60% respectively of all employees in the sector (Figure 4).

Table 3 shows that the majority of the business entities that

Figure 4 Persons employed in business entities that received grants by NCA activities



Source: FINA data processed by the CNB.

7 The CES and FINA data show a different number of enterprises that received grants as the FINA database comprises data based on the annual statements of entrepreneurs that are profit tax payers. The FINA database used does not contain annual statements of financial institutions, non-profit associations and budgetary users. Furthermore, the most recent data available in the FINA database refer to 2018 and do not cover enterprises established in 2019 and 2020.

8 GVA is calculated from the data in the FINA database, including profit before taxes, increased by depreciation and employee expenses.

9 Business entities dealing in manufacturing and trade that received support together account for 26% of total economy GVA, whereas those engaged in art, entertainment and recreation, education, administrative activities, health (private providers) and agriculture together account for only 5% of total economy GVA.

10 The T-test showed that the difference is statistically significant at all levels of significance for micro enterprises, at 10% for medium-sized enterprises and at 5% for large enterprises, while it is not significant for small enterprises.

Table 3 Grants paid to business entities for March and April by size

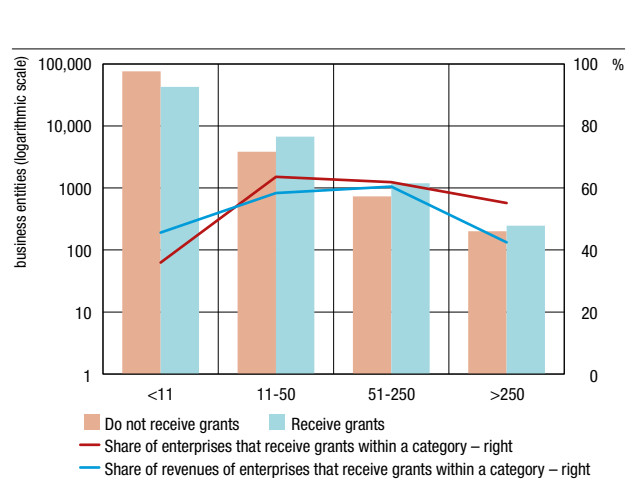
| Size of business entities | Business entities (in thousand) | Workers (in thousand) |
|---------------------------|---------------------------------|-----------------------|
| Micro (< 11) | 42.5 | 143 |
| Small (11-50) | 6.7 | 127 |
| Medium-sized (51-250) | 1.2 | 105 |
| Large (>250) | 0.2 | 105 |

Note: The size of a business entity is determined according to the number of persons employed.

Sources: FINA and CES data processed by the CNB.

received grants employed up to ten employees (84% of total 50 thousand business entities that received grants at least in one month, identified in the FINA database) and that they account for 30% of paid government grants included in the FINA database. A slightly smaller share of grants (27%) was paid to small business entities (11 to 55 employees), which account for slightly more than one tenth of all business entities that received grants. On the other hand, medium-sized and large business

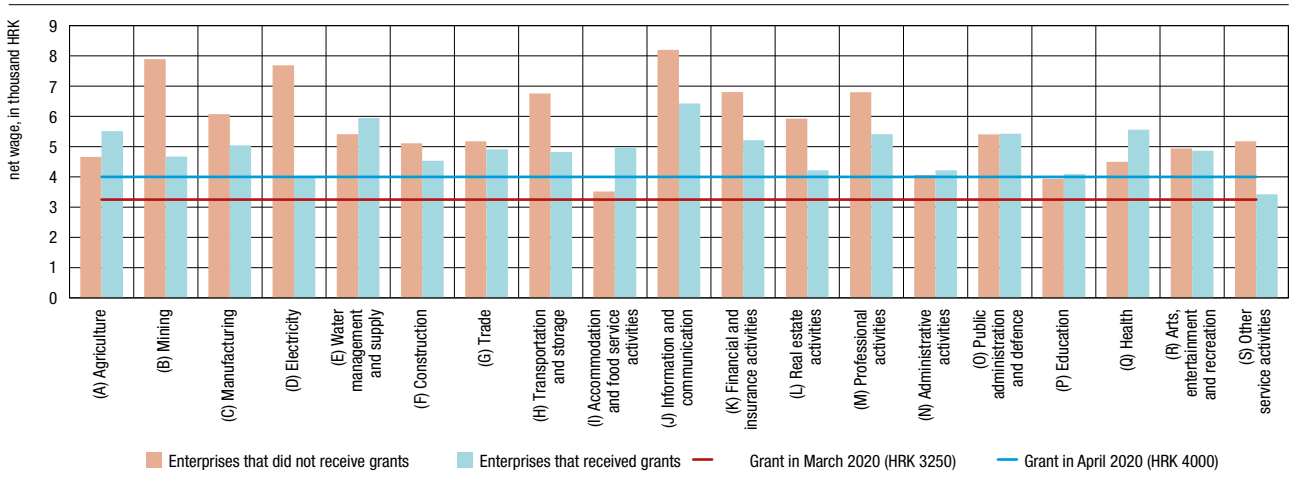
Figure 5 Number of business entities by size and use of CES grants



Note: The size of a business entity is determined according to the number of persons employed specified in Table 3.

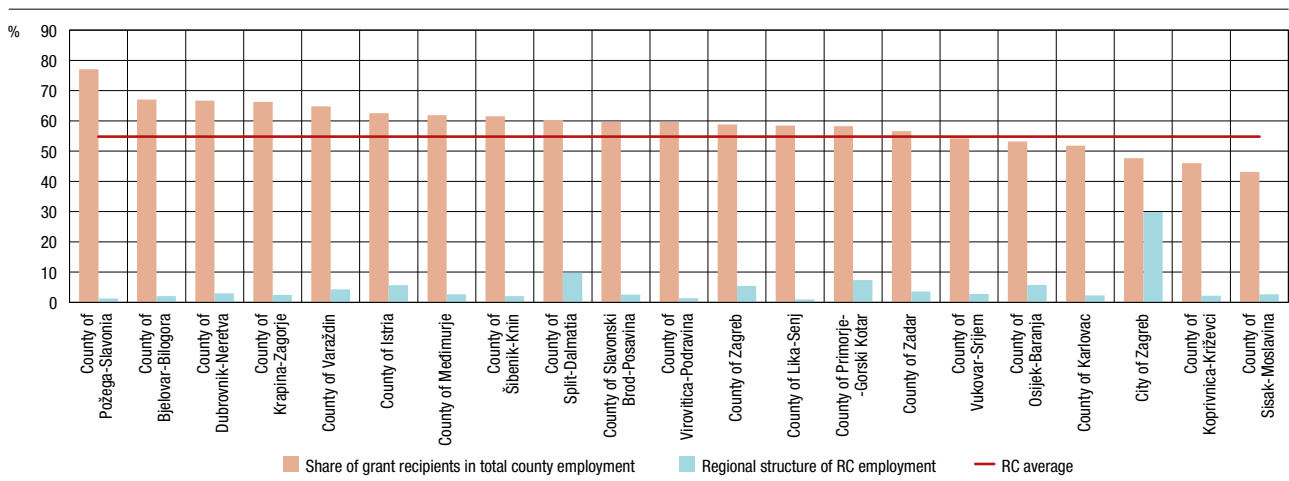
Sources: FINA and CES data processed by the CNB.

Figure 6 Average net wages by NCA activities



Sources: FINA and CES data processed by the CNB.

Figure 7 Employment in Croatia in December 2019 and subsidised workers per county



Sources: FINA, CES and CPII data processed by the CNB.

entities, which account for a small share of all enterprises receiving grants, account for slightly less than half of total grants paid.

In terms of the share of grant recipients in particular categories of business entities by size (Figure 5), most micro business entities did not receive grants.¹¹ On the other hand, grants were received by more than half of small, medium-sized and large enterprises. Also, recipients in the category of micro and large business entities account for slightly less than half of total revenues in the category, while in the category of small and medium-sized enterprises, they account for almost 60% of all enterprises in those categories.

Average wages in most activities were higher in business entities that did not receive grants than in those that received grants. The exception were business entities dealing in agriculture, water supply and management, accommodation and food service activities, administration, public administration, education and health (Figure 6).¹²

5 Inflation

The annual rate of consumer price inflation slowed down considerably in the first five months of 2020 (from 1.4% in December to -0.6% in May), driven by a fall in energy prices, most notably petroleum products. A sharp fall in crude oil prices on the global market was mostly due to decreased demand as a result of the worsening of the global economic growth outlook as a result of the coronavirus pandemic and the failure to achieve an agreement on the reduction of crude oil output. The price of a barrel of Brent crude oil reached USD 24 at the end of April, down 65% from the end of 2019. As a result, the indicator of current trends in overall inflation fell considerably in the first five months of 2020 (Figure 5.1). In addition, the last three

Looking at counties, the share of persons employed in enterprises that received grants in the total number of employed persons was smaller than the country's average in the County of Vukovar-Srijem, the County of Osijek-Baranja, the County of Karlovac, the County of Koprivnica-Križevci, the County of Sisak-Moslavina and the City of Zagreb. The largest share of employed persons covered by support in a single county was seen in the County of Požega-Slavonia, followed by the County of Bjelovar-Bilogora and the County of Dubrovnik-Neretva (Figure 7).

However, while the County of Požega-Slavonia accounted for the biggest share of employed persons who received grants, the persons employed in that county account for a mere 1.3% of total employment in Croatia. On the other hand, the share of subsidised workers was the smallest in the City of Zagreb, which employs the largest number of workers in Croatia.

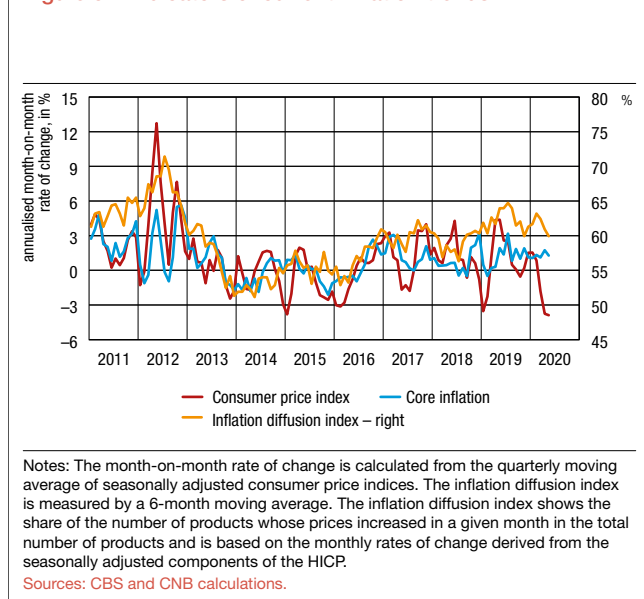
months of the observed period also witnessed a trend of decline in the inflation diffusion index that shows the share of the number of products that have gone up in price in the total number of products.

The contribution of energy prices to the annual consumer price inflation thus fell from 0.6 percentage points in December 2019 to -1.8 percentage points in May 2020 (Figure 5.2). In addition to refined petroleum products the price of which went down 22% from the same period of the previous year, the mentioned fall in the contribution of energy was slightly influenced by a fall in the prices of solid fuels and natural gas (which are administered prices). As at the end of 2019, the contribution of industrial products (food and energy excluded) was slightly negative in May and stood at -0.1 percentage point.

By contrast, the contribution of food products to overall inflation rose from 0.3 percentage points in December 2019 to 0.9 percentage points in May 2020. The annual growth in the prices of unprocessed food products accelerated strongly at the beginning of the year (from 0.7% in December to 5.6% in January). This was due to the base period effect (the fall in the prices of these products in January 2019 that followed the reduction in the VAT rate) and an increase in the prices of these products in January this year. In March and April, the annual growth rate of the prices of unprocessed food products held steady at a high level from the beginning of the year and then slowed down to 3.1%. Fruit and meat prices continued to grow the fastest on an annual level (12% and 6%, respectively). The acceleration in the annual growth rate of the prices of processed food products (including alcohol and tobacco) from 1.7% in March to 3.3% in April was mostly due to increased excises on tobacco and sugary and alcoholic beverages.

The contribution of services prices to inflation in May stood at 0.5 percentage points, a slight increase from the end of 2019. The increased contribution of telephone services and insurance connected with transport to overall inflation was largely offset by the smaller contribution of hotel and restaurant services. It should be noted that no field price collections were made in April 2020 and that a large number of commercial and catering facilities were closed so to calculate the consumer price index, it was necessary to construct the missing prices (imputed prices). Services prevail in the list of indices having low reliability and

Figure 5.1 Indicators of current inflation trends



11 Limitations of the FINA database should be taken into account in interpreting the results. More specifically, micro business entities have the greatest dynamics of establishment and dissolution, where the latest available list of enterprises in the FINA database refers to 2018. In other words, it is possible that a substantial number of micro enterprises that operated in 2018 are no longer active and, therefore, could not apply for grants.

12 The scope of the FINA database should be taken into account (see note 3).

Table 5.1 Price indicators

year-on-year rate of change

| | 12/2018 | 3/2019 | 6/2019 | 9/2019 | 12/2019 | 3/2020 | 5/2020 |
|---|---------|--------|--------|--------|---------|--------|--------|
| Consumer price index and its components | | | | | | | |
| Total index | 0.8 | 0.9 | 0.6 | 0.8 | 1.4 | 0.6 | -0.6 |
| Energy | 0.9 | 4.0 | 1.4 | 0.2 | 3.4 | -3.8 | -10.9 |
| Unprocessed food | -0.6 | -5.7 | -4.7 | -2.7 | 0.7 | 5.6 | 3.1 |
| Processed food | 1.9 | 2.6 | 2.6 | 2.6 | 2.3 | 1.7 | 2.8 |
| Non-food industrial goods without energy | 0.1 | -0.4 | -0.3 | 0.4 | -0.6 | -0.1 | -0.4 |
| Services | 1.2 | 1.2 | 1.3 | 1.2 | 1.5 | 1.6 | 1.8 |
| Other price indicators | | | | | | | |
| Core inflation | 1.0 | 0.9 | 1.1 | 1.6 | 1.2 | 1.3 | 1.4 |
| Index of industrial producer prices on the domestic market | 0.5 | 2.3 | 0.4 | -0.3 | 1.4 | -1.2 | -4.7 |
| Index of industrial producer prices on the domestic market (excl. energy) | -0.3 | 0.1 | 1.0 | 0.8 | 0.5 | 0.5 | 0.2 |
| Harmonised index of consumer prices | 1.0 | 1.1 | 0.5 | 0.6 | 1.3 | 0.5 | -0.7 |
| Harmonised index of consumer prices at constant tax rates | 0.8 | 1.7 | 1.1 | 1.1 | 2.1 | 1.0 | -0.6 |

Note: Processed food products include tobacco and alcohol.

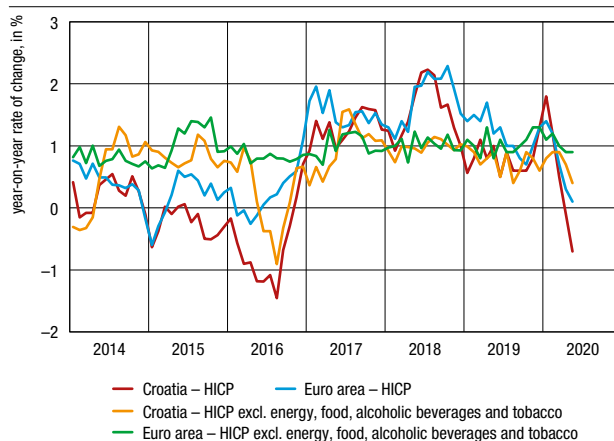
Source: CBS.

over 50% of imputed prices. The issue of measuring the consumer price index is analysed in more detail in Box 3 Methodological approach to the calculation of the consumer price index during the Covid-19 pandemic.

Core inflation (the calculation of which excludes energy and agricultural products prices and administered prices) accelerated to 1.7% in the first four months, up 0.5 percentage points from December. This was mostly driven by acceleration in the annual growth rate of prices of individual food products (particularly meat, milk, cheese and eggs), tobacco, clothing, pharmaceutical products and telephone services. However, core inflation slowed down to 1.4% in May, mostly driven by a fall in the annual growth rate of the prices of processed food products and accommodation services.

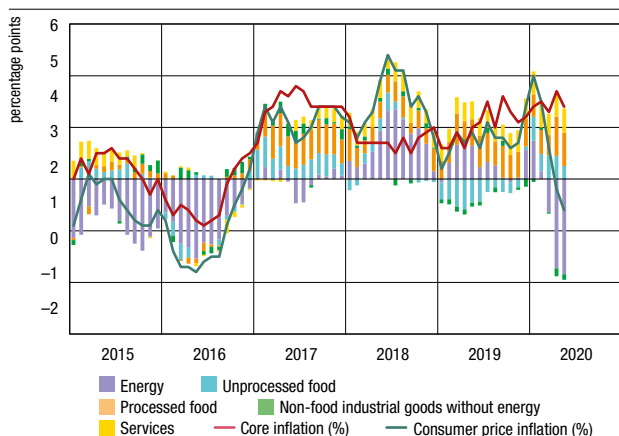
The annual rate of inflation in the euro area measured by the harmonised index of consumer prices slowed down from 1.3% in December to 0.1% in May (Figure 5.3), mostly as a result of a fall in the annual rate of change in energy prices from 0.2% in December to -11.9% in May. Also, the annual growth of services and industrial products prices (excluding food and energy) slowed down in the euro area in the first five months of the year.

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



Sources: CBS and Eurostat.

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



Note: Core inflation excludes agricultural product prices, energy prices and administered prices.

Sources: CBS and CNB calculations.

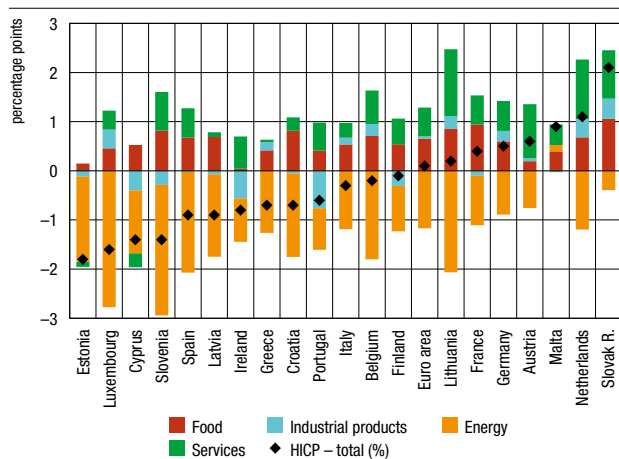
The slowdown in inflation was partly mitigated by an increased contribution of the prices of unprocessed and processed food products to overall inflation. Core inflation, which excludes the prices of energy, food, alcoholic beverages and tobacco, fell from 1.3% in December to 0.9% in May in the euro area, spurred mostly by the mentioned fall in the annual growth of services and industrial products prices.

Croatia's annual inflation rate measured by the HICP declined from 1.3% in December 2019 to -0.7% in May. The fall in energy prices was only to a lesser extent offset by the growth in the prices of unprocessed and processed food products. The annual inflation in Croatia in May 2020 was 0.8 percentage points lower than that in the euro area, which is mostly the result of a more pronounced fall in energy prices¹⁵ and lower annual growth rates of services prices¹⁴ in Croatia than in the euro area. Due to a slowdown in the annual growth rate of services

15 And a larger share of energy in the basket for the calculation of the HICP in Croatia.

14 And a smaller share of services in the basket for the calculation of the HICP in Croatia.

Figure 5.4 Year-on-year inflation rate in May 2020 and contributions of components to consumer price inflation in Croatia and euro area member states



Sources: Eurostat and CNB calculations.

prices, core inflation measured by the HICP fell from 0.6% in December 2019 to 0.4% in May this year, and was 0.5 percentage points lower than that in the euro area.

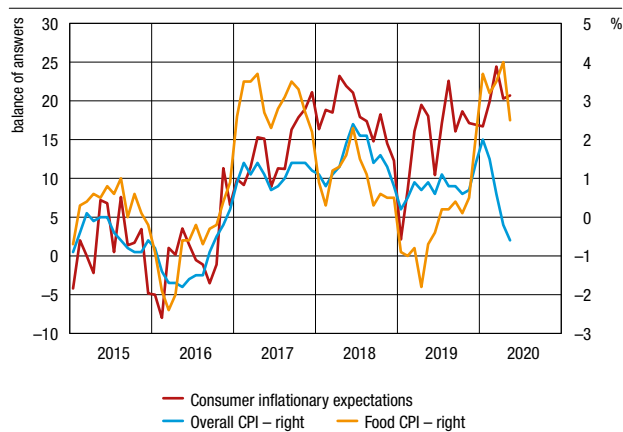
In addition to Croatia, the annual inflation rate of -0.7% in May was also recorded in Greece and this level of inflation placed Croatia in a group of six countries of the euro area whose overall inflation ranged between -0.9% and -0.6% (Figure 5.4). The contribution of energy prices to annual inflation in most of the countries of the euro area was negative in May, mostly as a result of a fall in the price of refined petroleum products. The lowest inflation rate in May was recorded in Estonia (-1.8%). In addition to energy prices, industrial products and services prices also made a negative contribution to overall inflation, while the contribution of the prices of food was only slightly positive. By contrast, food and services prices, and to a lesser extent industrial products prices, made the biggest positive contribution to overall inflation of 2.1% in Slovakia, while the contribution of energy prices was negative but owing to the increased price of electricity it was less pronounced than in other countries of the euro area.

Inflationary expectations

The dynamics of consumer inflation expectations in Croatia as usual followed the developments in the current rate of consumer price inflation. As mentioned earlier, overall consumer price inflation fell steadily in the past four months. However, inflationary expectations rose in February and March of this year, i.e. the share of consumers expecting that prices will grow in the following twelve months has risen compared to those who expect that the prices will fall or remain unchanged (Figure 5.5). In April and May, the balance of answers to the question on the expected developments in prices in the following twelve months remained higher than the average recorded in the second half of 2019.

Different developments in consumer inflationary expectations and consumer price inflation were also recorded in the euro area in the first five months of 2020. Rising consumer inflationary expectations are probably associated with acceleration in food price growth, with food selling rather rapidly during the pandemic when compared with other products such as for instance, refined petroleum products (the price of which went down in the past months) since travel fell significantly. Also, some products and services were not even available. As a result, during this

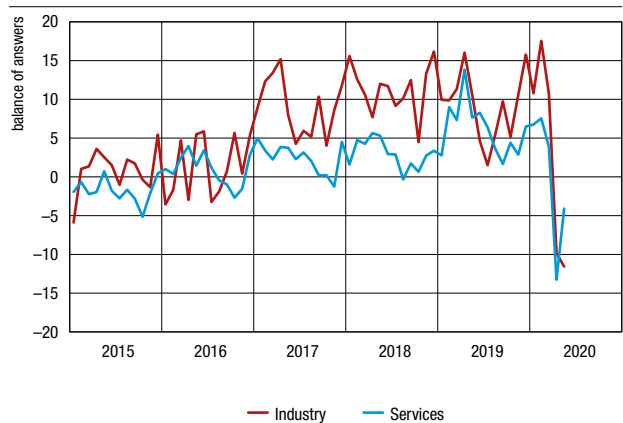
Figure 5.5 Consumer inflationary expectations



Note: The expectations refer to a twelve-month period ahead.

Sources: CBS, Ipsos and CNB.

Figure 5.6 Corporate inflationary expectations



Note: The expectations refer to a three-month period ahead.

Source: Ipsos Puls.

period food accounted for a larger share of the consumer basket than it would normally do.

By contrast, the first five months of this year witnessed a downward trend in corporate inflationary expectations (Figure 5.6). However, the share of enterprises that expect a fall in sales prices declined considerably in the services sector towards the end of the period.

Projected developments

The slowdown in the average annual consumer price inflation from 0.8% in 2019 to an estimated -0.1% in 2020 (Figure 5.8) was mostly the result of the expected considerable fall in the annual rate of change of energy prices, from 1.8% in 2019 to -6.7% in 2020. The fall in the contribution of energy prices to overall inflation from 0.3 percentage points in 2019 to -1.1 percentage point in 2020 was mostly driven by a fall in the retail prices of refined petroleum products that could amount to approximately 14% in 2020, which reflects developments in the global market, i.e. the fall in the price of crude oil mostly driven by a fall in the demand following the outbreak of the coronavirus pandemic and failure to reach an agreement to reduce crude oil

Figure 5.7 Domestic and foreign inflation indicators

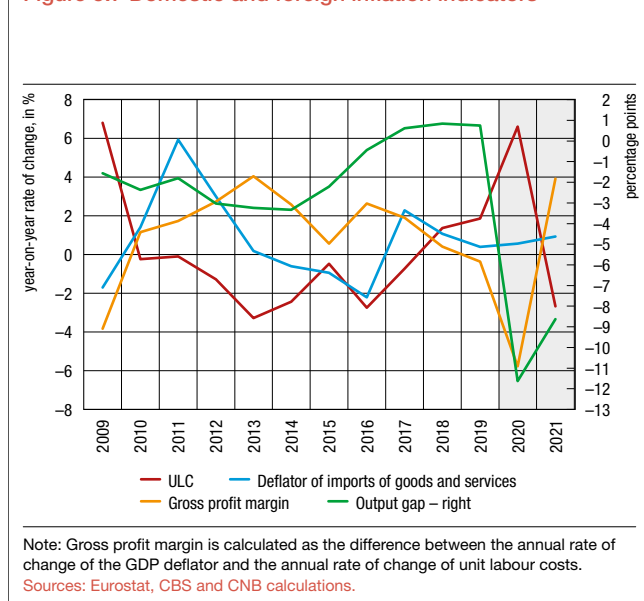
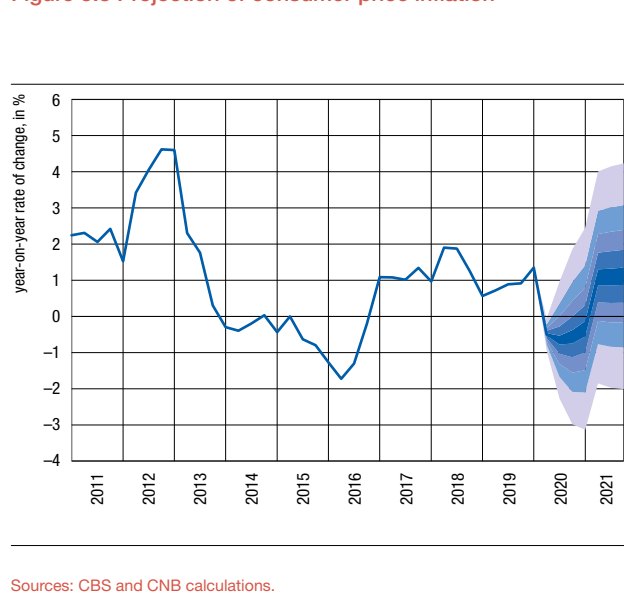


Figure 5.8 Projection of consumer price inflation



output. To a lesser extent, the expected slowdown in inflation in 2020 might also be due to a fall in the projected annual growth rate of the consumer price index excluding food and energy from 0.9% in 2019 to 0.3% in 2020. This could be the result of the effect of smaller demand on prices due to the pandemic, expected to take place particularly in the segment of tourism-related services (package holidays, accommodation services and transport services, air transport in particular), recreation and culture and individual semi-durable and durable consumer goods such as clothing and footwear, furniture, household appliances, cars, etc.). The expected slowdown in the annual growth of the consumer price index excluding food and energy in 2020 is somewhat mitigated by increased unit labour costs (given a considerable fall in labour productivity) and increased prices of cigarettes, sugary and alcoholic beverages following the increase in excises in April 2020.

By contrast, it is estimated that the average annual growth rate of food prices in 2020 might accelerate to 3.6% (from -0.2% in 2019) as a result of increased demand (stocking up) and shocks on the food supply side caused by the pandemic and relating to interruptions in supply chains, possible restrictions on certain countries' food exports, etc. In addition, the acceleration in the annual growth rate of food in 2020 can also be attributed to the positive effect of the base period and the expected increase in the prices of food raw materials on the global market.

The consumer price inflation is expected to accelerate from -0.1% in 2020 to 0.7% in 2021. This should result from an increase in the annual rate of change in energy prices from -6.7%

in 2020 to 0.4% in 2021, mostly attributable to the expected increase in crude oil prices on the global market. The expectation is that the average annual rate of growth of the CPI excluding food and energy might stand at approximately 0.2% in 2021 (0.3% in 2020). Viewed by quarters, it is evident that the expected recovery in demand might lead to a gradual acceleration in the annual rate of change of the CPI excluding food and energy from -0.2% in the first quarter of 2021 to 0.7% in the fourth quarter of 2021. The projections also point to a slowdown in the average annual growth rate of food prices to 2.3% in 2021 from 3.6% in 2020, mostly as a result of the waning of the shock on the supply side, i.e. normalisation of the supply chain. The prices of food raw materials on the global market are also expected to go down in 2021.

It is estimated that the risks of lower than projected or higher than projected inflation are balanced. The risks that might contribute to a lower than projected inflation rate in 2020 lie in the possible more pronounced fall in demand, which could increase downward pressures on core inflation. In addition, the fall in the price of crude oil on the global market might be more pronounced in the case of a possible more pronounced slowdown in global economic activity and/or failure by some OPEC+ countries to comply with the agreement to reduce output. The risks that might lead to a higher than projected inflation lie in a less pronounced diminution of demand, higher crude oil prices and other raw materials prices on the global market and a possible faster growth in the prices of agricultural products due to unexpectedly adverse weather conditions.

Box 3 Methodological approach to the calculation of the consumer price index during the Covid-19 pandemic

Due to the new coronavirus pandemic, no field price collections took place in April 2020, and when they did take place in March in May, they were collected with difficulty. When it was not possible to collect product prices in alternative ways (from websites and submitted price lists, by means of scanner data, etc.), the CBS followed the recommendation of the Eurostat and used several methods to construct the missing (imputed) prices, such as carrying forward the last observed price, imputing the price with its monthly change in the same month in the previous

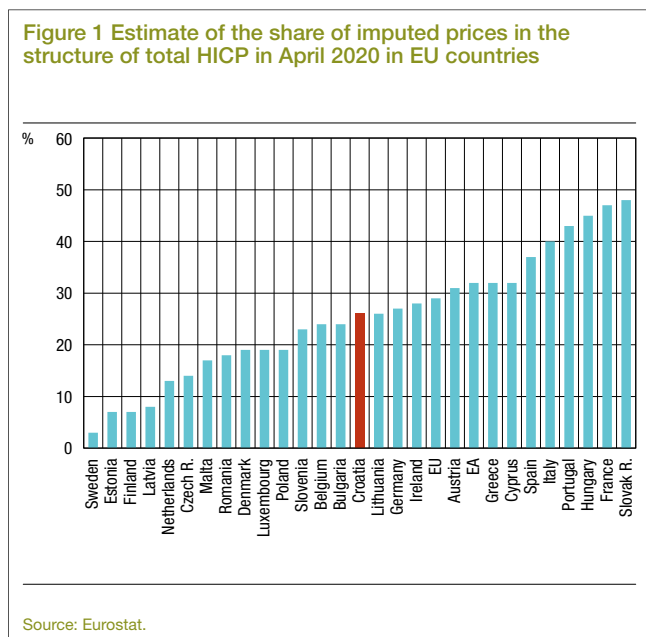
year or imputing the price on the basis of the average change in the available prices of the product within the same or similar elementary aggregate, etc. All sub-indices with a share of imputed prices/weights exceeding 50% are marked as having low reliability. The total contribution of these sub-indices to the overall monthly change in consumer prices in Croatia in April and May was not significant. The indices having low reliability are mostly those for services such as hotels and restaurants, accommodation, recreational services, package holidays, transport services,

Table 1 Sub-indices of consumer prices marked in April 2020 as having low reliability

| | COICOP | Structure | Monthly rate of change | | Annual rate of change | | Imputing methods |
|--------|--|-----------|------------------------|--------|-----------------------|--------|---|
| | | | 2020 | 4/2019 | 4/2020 | 3/2020 | |
| 03.1.1 | Clothing materials | 0.01 | 0.2 | 4.9 | -2.5 | 2.0 | imputing based on the available prices of the same elementary aggregate |
| 06.2.3 | Paramedical services | 0.14 | 0.0 | 0.0 | 1.8 | 1.8 | carrying forward of the last observed price |
| 06.3 | HOSPITAL SERVICES | 0.14 | 0.0 | 0.0 | -0.2 | -0.2 | carrying forward of the last observed price |
| 07.3 | TRANSPORT SERVICES | | | | | | |
| 07.3.1 | Passenger transport by railway | 0.16 | 0.0 | 0.0 | 1.8 | 1.8 | carrying forward of the last observed price |
| 07.3.2 | Passenger transport by road | 0.83 | -1.1 | 0.1 | -2.1 | -0.9 | carrying forward of the last observed price |
| 07.3.3 | Passenger transport by air | 0.24 | 16.6 | 16.5 | -6.3 | -6.4 | imputing with a monthly price change in the previous year |
| 07.3.4 | Passenger transport by sea and inland waterway | 0.05 | 11.4 | 0.0 | 0.0 | -10.2 | carrying forward of the last observed price |
| 07.3.5 | Combined passenger transport | 0.20 | 0.0 | 0.0 | 0.0 | 0.0 | carrying forward of the last observed price |
| 09.4 | Recreational and cultural services | | | | | | |
| 09.4.1 | Recreational and sporting services | 0.44 | -1.6 | 0.0 | 5.9 | 7.6 | carrying forward of the last observed price |
| 09.4.2 | Cultural services | 1.66 | 0.1 | 0.0 | 0.8 | 0.7 | carrying forward of the last observed price |
| 09.6 | Package holidays | 0.58 | 1.5 | 1.4 | -0.3 | -0.3 | imputing with a monthly price change in the previous year |
| 10 | EDUCATION | 0.87 | 0.0 | 0.0 | -0.6 | -0.6 | carrying forward of the last observed price |
| 11 | RESTAURANTS AND HOTELS | | | | | | |
| 11.1.1 | Restaurants, cafés and the like | 3.86 | 0.6 | 0.0 | 2.7 | 2.1 | carrying forward of the last observed price |
| 11.1.2 | Canteens | 0.36 | 0.6 | 0.0 | 5.4 | 4.7 | carrying forward of the last observed price |
| 11.2 | ACCOMMODATION SERVICES | 0.60 | 4.6 | 4.7 | 1.4 | 1.5 | imputing with a monthly price change in the previous year |
| 12.1.1 | Hairdressing salons and personal grooming establishments | 0.99 | 0.0 | 0.0 | 3.1 | 3.1 | carrying forward of the last observed price |
| 12.3.1 | Jewellery, clocks and watches | 0.04 | 0.0 | 0.6 | 4.0 | 4.6 | imputing based on the available prices of the same elementary aggregate and carrying forward of the last observed price |

Note: Indices are marked as having low reliability if the weight of the imputed part of the aggregate exceeds 50% or if the number of imputed prices for the aggregate exceeds 50%.

Source: CBS.



hairdressing services, etc.

To contain the spread of the pandemic caused by the new coronavirus, many countries introduced epidemiologic measures that included, among others, restrictions on movement of

people, closing stores, coffee shops and restaurants, museums, theatres, hairdressing salons, gyms, tourist accommodation facilities, etc. In such circumstances, many statistical offices suspended field price collections. These measures also had a considerable impact on the method of collecting prices for individual products that are included in the basket for the calculation of the consumer price index (CPI) and on the structure of household consumption in comparison with the usual conditions.

As a result, Eurostat issued a guidance note in early April of this year¹⁵ on the compilation of the HICP amid such extraordinary circumstances. Eurostat stresses that the compilation of the HICP should be guided by three key principles: 1. stability of the HICP weights, i.e. no change in the sub-index weights; 2. inclusion of all categories of ECOICOP classification (regardless of the fact that some products are not available on the market); and 3. minimising the number of missing price observations (imputed prices). Where no field price collection is possible, the recommendation for products that are available on the market is to use outlet website data and scanner data and make telephone and email enquiries. In the cases where product prices cannot be obtained in any of these ways, i.e. when goods/services are not available to consumers (for instance, hairdressing services,

¹⁵ *Guidance on the Compilation of the HICP in the Context of the COVID-19 Crisis* (2020), Methodological note, Eurostat, 3 April. https://ec.europa.eu/eurostat/documents/10186/10693286/HICP_guidance.pdf

theatre tickets, flights), Eurostat suggests the use of several methods to construct the missing prices, i.e. to impute prices, such as for instance carrying forward the last observed price (i.e. unchanged price), imputing with a monthly price change in the same month of the previous year (in the case of products with a pronounced seasonal component), imputing the price based on an average price change of the available product price of the same or similar elementary aggregate, etc. All sub-indices with a share of imputed prices/weights exceeding 50% are marked as having low reliability, i.e. their quality is considered to be lower than usual.

The mentioned epidemiological measures were introduced in Croatia in mid-March 2020 so that that month was somewhat atypical already because field price collection was suspended in the midst of an observation cycle. However, by then the Croatian Bureau of Statistics had received a wealth of data; some of the prices were later taken from websites, price lists were obtained from chain stores and scanner data were used as well. Where the price imputation procedure was necessary, it was fully compliant with Eurostat guidance.¹⁶ Ultimately, in March 2020, not one group of products (sub-index) had more than 50% of imputed prices/weights, i.e. was not marked as having low reliability. In April 2020, there were no field price collections at all (since many stores remained closed), so more price imputations were made than in March. The list of indices having low reliability where the share of imputed prices within an index or the share of weights in the imputed index exceeds 50% includes the following services: catering services, accommodation services, recreational services, package holidays, transport services, hairdressing services, etc. (Table 1) In May 2020, field price collection mostly normalised and only two CPI sub-indices were marked as having low reliability (passenger transport by air and package holidays).

The share of imputed prices in the structure of the consumer price index in Croatia stood at 17.6% in April 2020, while the share of these prices in the basket for the calculation of the HICP was greater and stood at 26%.¹⁷ By contrast, the mentioned share of the imputed prices in the basket for the calculation of the HICP in Croatia was lower than the EU average of 29% (Figure 1) and the share of over 40% recorded in the group of countries consisting of Slovakia, France, Hungary and Portugal. In contrast with April, the share of imputed prices in May 2020 accounted for only 3% of the structure of the HICP in Croatia (i.e. 1.7% in the case of the CPI), in contrast with the EU

where this share was much higher and stood at 20%. Taking into account that a significant portion of monthly price changes in April was estimated and that there was a considerable change in the structure of household consumption, with a significant increase in the consumption of essential products such as food and toiletries (not taken into account in the calculation of the current consumer price index)¹⁸, the analysis of data on inflation developments in April 2020 should be approached with greater caution.

Consumer prices in Croatia in April fell by 0.2% from the previous month. As regards the contribution of sub-indices having low reliability to monthly developments in consumer prices in April, it was mostly neutral (zero percentage points). It is evident that of the recommended price imputation methods, the most frequently used method in the calculation of the CPI in April this year was the method of carrying forward the last observed price, i.e. the method of unchanged price (Table 1). Therefore the contribution of sub-indices to which this method applies (most transport services, recreational and sports services, catering services, hairdressing services, etc.) to the monthly change in the CPI was neutral. Also used, though to a lesser extent, was the method of imputing based on available prices of the same elementary aggregate (materials used for the manufacture of clothing, jewellery and watches) and the contribution of these components to monthly inflation in April was also neutral (due to a small weight, and given the monthly price increase). In addition, in the case of sub-indices having low reliability and a pronounced seasonal component (passenger transport by air, accommodation services and package holidays), the method of imputing with a monthly change in the price of these services in April of the previous year was used, and the total contribution of the mentioned sub-indices to the monthly change in consumer prices was only slightly positive and stood at 0.08 percentage points. Overall, the contribution of sub-indices having low reliability to the monthly change in consumer prices in April 2020 was not significant. Also, the total contribution of indices marked in April as having low reliability to the annual rate of change in the CPI fell slightly, from 0.17 percentage points in March to 0.16 percentage points in April.

As regards the developments in food prices whose share in household consumption rose considerably during the halting of economic activities during the lockdown, their annual growth rate accelerated slightly, from 3.2% in February to 4.0% in April, but slowed down again to 2.5% in May.

6 Current and capital account

The current and capital account deficit fell considerably in the first quarter of 2020 from the same period of the previous year. The fall in the deficit was due almost equally to the improvement in the balance in the primary income account caused by the rising profitability of foreign enterprises owned by residents, the rising net export of services as a result of a more pronounced fall in imports than exports and the growing surplus

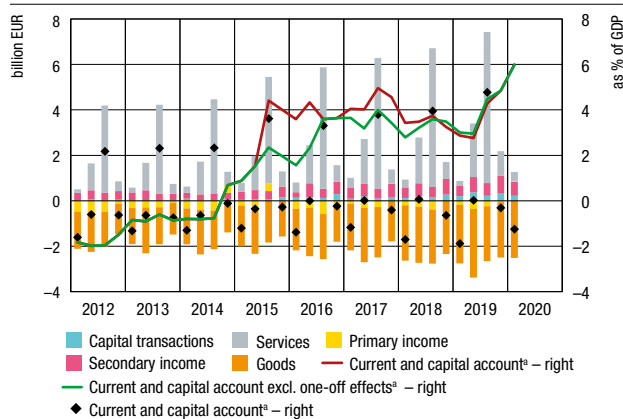
in the secondary income and capital transaction accounts as a result of a more intensive use of EU funds. At the same time, although to a smaller extent, the foreign trade deficit also recorded a fall. Hence, observing cumulative values over the past year, the surplus in the current and capital account stood at 6.0% of GDP in the first quarter of 2020, a substantial improvement from the 4.8% of GDP reported for 2019 (Figure 6.1).

¹⁶ This also refers to the calculation of the national CPI and the HICP

¹⁷ The HICP and the national CPI are calculated on the basis of the same basket of goods and services. One of the key differences between the HICP and the CPI lies in the fact that the HICP includes total consumption by institutional households and non-residents (for instance, tourists) and that consumption is not included in the CPI. Therefore, for example, accommodation services account for 5.2% of the HICP and for only 0.6% of the national CPI.

¹⁸ Some products the consumption and prices of which went up considerably during the pandemic, such as protective masks and gloves and hand disinfectants are not included in the standard basket for the calculation of the CPI.

Figure 6.1 Current and capital account balance and its structure

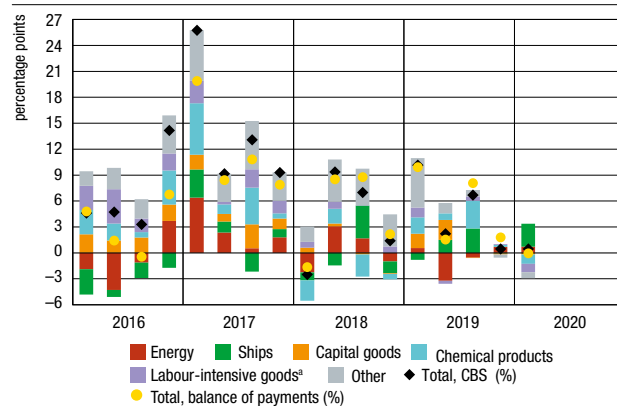


^a Sum of the last four quarters.

Note: One-off effects include the conversion of CHF-linked loans in 2015 and bank provisions for loans to the Agrokor Group in 2017 and 2018.

Source: CNB.

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



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

Sources: CBS and CNB.

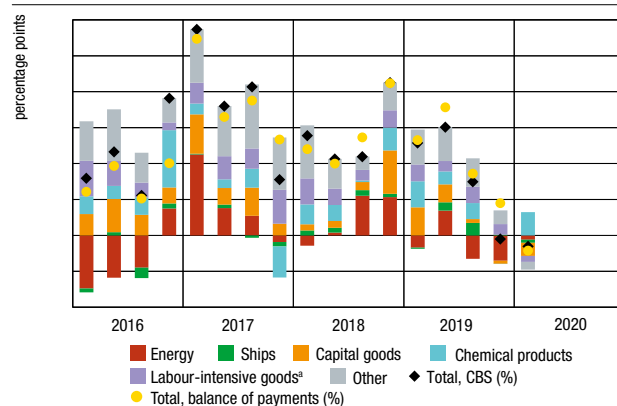
Foreign trade and competitiveness

Foreign trade dynamics slowed down strongly in the first quarter of 2020 from the previous year. According to CBS data¹⁹ goods exports rose only slightly on an annual level in the first three months of 2020 (0.5%), after having grown strongly by 10.2% in the same period of 2019. At the same time, goods imports fell by 0.9%, after having grown by 7.7% in the same period of the previous year. The slowdown in trade flow dynamics mirrors the effects of the coronavirus pandemic, which caused a considerable fall in exports and imports on an annual level in March (8.6% and 11.4%, respectively), neutralising the growth recorded in the first two months. Consequently, the foreign trade deficit fell by 2.9%²⁰ in the first quarter, after growing by 4.3% in the same period of the previous year. The first data for April point to an even stronger contraction of trade in goods, with total goods exports falling by 24.5% in April and total goods imports by 37.5%, while the deficit more than halved (having fallen by 52.8%) from April last year.

As regards the structure of trade in goods, the unfavourable export results in the first quarter of 2020 were mostly the result of a fall in exports of medical and pharmaceutical products to the USA and Italy, followed by exports of road vehicles to Germany and China and exports of metal industry products to Italy (Figure 6.2). By contrast, one of the rare categories that recorded considerable growth is the export of other transport equipment (ships) to Luxembourg. Exports of energy products also rose since the noticeable growth in exports of oil and refined petroleum products more than offset the decline in exports of electricity to Bosnia and Herzegovina.

The annual fall in total goods imports in the first quarter of 2020 was mostly due to smaller imports of road vehicles from Germany and Hungary, metal industry products from Italy and China and capital goods (mainly general industrial machinery and machinery specialised for particular industries) from Italy and Germany (Figure 6.3). Imports of energy products,

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.

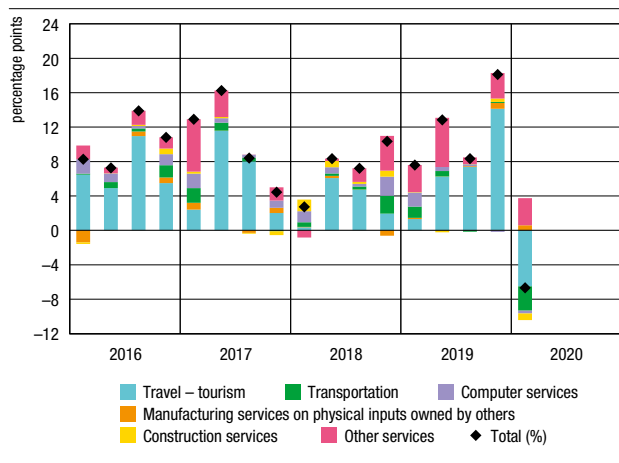
particularly electricity from Hungary, also fell. By contrast, the imports of medical and pharmaceutical products from Belgium and food products from Germany and the Netherlands rose.

As in foreign trade in goods, the improvement in the balance in the services account in the first quarter of 2020 was the result of a more pronounced fall in expenditures (22.6%) than in income (6.7%). The balance improved the most in the trade in financial services and travel services. A bigger net export of tourist services is the result of a more pronounced fall in resident tourists' consumption (40.9%) than in revenues from tourism (19.4%). The fall in tourist activity (Figure 6.4) mirrors the strict epidemiological measures introduced at the end of the first quarter, which included, among other things, restrictions on entry of foreign nationals into the territory of Croatia. According to data provided by eVisitor, at the end of March overnight stays of foreign tourists stood at only some ten percent of their overnight stays in the previous year (Figure 6.5), and further deteriorated to only one to two percent of the same period of the previous year level. A small recovery in volume indicators took place only at end-May, after Croatia started gradually opening up its borders to foreign tourists.

19 According to the balance of payments data, goods exports held steady, goods imports shrank by 1.3% and the deficit in the goods account narrowed by 2.7% from the same period of the previous year. The cumulative values in the past year show that the deficit in the goods account stood at 19.2% of GDP, an improvement of 0.2 percentage points from the whole of 2019.

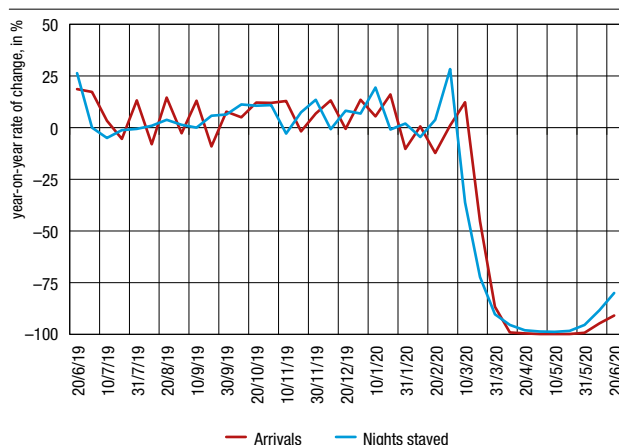
20 The narrowing of the deficit in goods trade was the result of the mentioned faster annual rate of fall in Croatian goods imports than goods exports as well as the fact that the absolute value of goods imports is much bigger than the absolute value of goods exports.

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



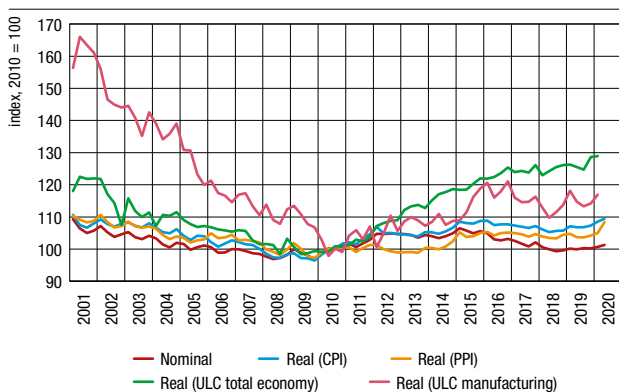
Source: CNB.

Figure 6.5 Year-on-year rate of change in the number of arrivals and nights stayed by foreign tourists



Note: The figure shows year-on-year rates of change of ten-day data.
Source: eVisitor.

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. Data for the second quarter of 2020, relating to the nominal and real exchange rate deflated by consumer prices refer to April and May and those relating to real exchange rate deflated by producer prices refer to April.

Source: CNB.

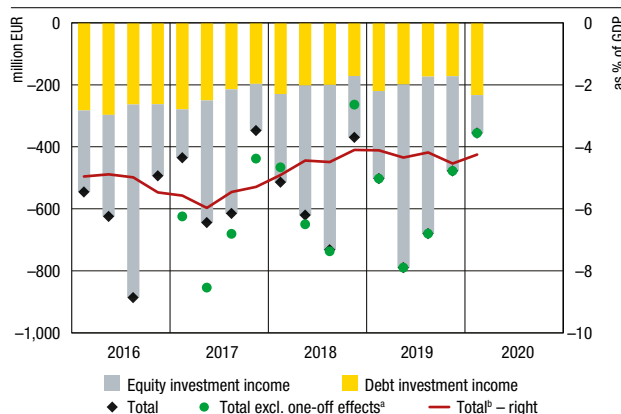
In early 2020, the price and cost competitiveness of Croatian exports improved (Figure 6.6). The depreciation of the real effective exchange rates²¹ deflated by consumer and producer prices and unit labour costs partly reflects the weakening of the kuna against the basket of currencies for the calculation of the effective exchange rate and partly a more favourable trend in domestic prices and costs developments in comparison with prices and costs of the country's main trading partners.

Income and transactions with the EU

The balance in the primary income account improved considerably in the first quarter of 2020 from the same period of the previous year, mainly influenced by greater income from direct equity investment (Figure 6.7). The business results of foreign enterprises owned by residents improved the most in management activities and, to a lesser extent, in transportation activities. By contrast, total expenditures on equity investments fell slightly but worth noting is that their structure underwent a significant change from the same period of the previous year. Following the outbreak of the pandemic, the CNB banned dividend payouts by banks, which increases the share of reinvested earnings²² and decreases the share of dividends in the structure.

Total net income from transactions with the EU budget rose considerably in the first quarter of 2020 from the same period of the previous year, mainly as a result of more intensive use of EU funds. As regards the structure of the use of funds, a larger share related to current than to capital revenues, with other domestic sectors receiving more funds than the government. Payments to the EU budget also declined, after Croatia exceptionally paid a somewhat greater amount of the annual obligation in the first quarter of the previous year. The surplus of EU funds utilised over the payments to the EU budget, reported as the sum of the last four quarters, thus increased from 2.6% of GDP

Figure 6.7 Investment income



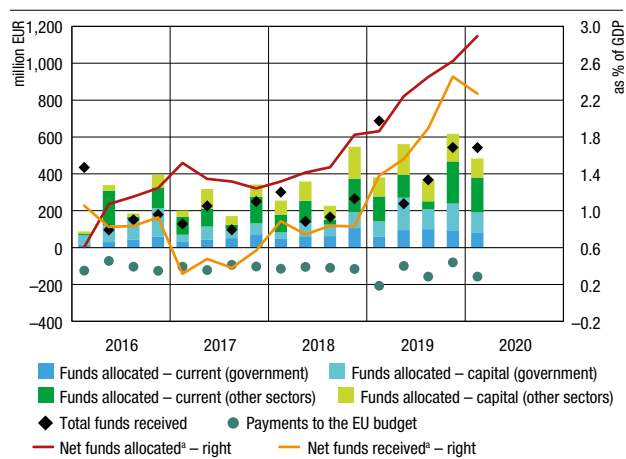
^a One-off effects include conversion of CHF-linked loans in 2015 and bank provisions for loans to the Agrokor Group in 2017 and 2018.
^b Sum of the last four quarters, excluding one-off effects.

Source: CNB.

21 Starting with this issue of Macroeconomic Developments and Outlook, the series of effective kuna exchange rates have been revised. The list of trading partner countries that are included in the basket for the calculation of the effective exchange rates (currently 22 countries) has been expanded, the weights for earlier reference periods have been updated and weights for a new three-year reference period (2016 – 2018) have been calculated. The revision of the effective exchange rates has not resulted in their significant changes.

22 The methodology for recording reinvested earnings is explained in CNB Bulletin No.149 of June 2009, Box 1 The Change in the Statistical Monitoring of Reinvested Earnings in the Balance of Payments of the Republic of Croatia

Figure 6.8 Transactions with the EU budget

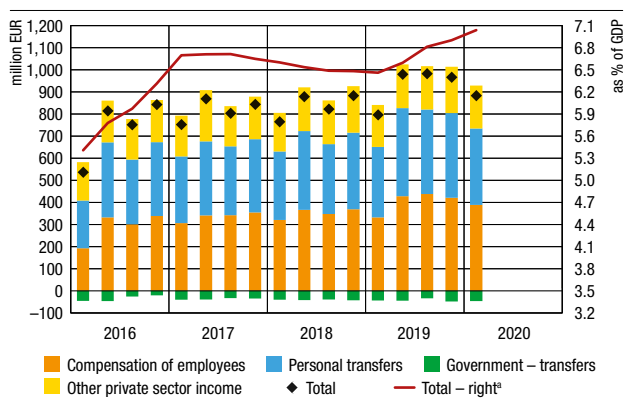


^a Sum of the last four available quarters.

Notes: As regards total funds received from EU funds, only funds allocated and paid out to beneficiaries are recorded in the current and capital account, while the 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 (personal transfers, other private sector income and government transfers) are recorded in the secondary income account.

Source: CNB.

at end-2019 to 2.9% of GDP at the end of March 2020 (Figure 6.8). The net inflow from other income, which excludes income from equity and debt investments and transactions with the EU budget, also rose, owing to a growth in net revenues from compensation of persons temporarily employed abroad and personal transfers (Figure 6.9).

Projected developments

Unlike the first quarter, the rest of the year is expected to see a deterioration in the current and capital account balance, which could be particularly concentrated in the third quarter of the year as a result of a sharp fall in revenues from tourism. Consequently, the surplus in the current and capital account could amount to approximately 2.0% of GDP in 2020, a considerable decline from the previous year's surplus of 4.8% of GDP. At the same time, the current account considered separately could see a small deficit of approximately 0.4% of GDP, in contrast with the surplus of 2.8% of GDP in the previous year. The worsening

of the balance is due to a sharp fall in net exports of services, primarily tourism, while unfavourable developments might be mitigated by an improvement in other sub-accounts.

The net exports of services are expected to fall sharply in 2020. This relates in particular to travel services, with the expectations for this year's revenues from tourism standing at only some thirty percent of those achieved last year. Exports of other services are also expected to fall, although at a slower rate. Tourist consumption of residents abroad and imports of other services are also expected to fall, mitigating the strong unfavourable impact of the fall in revenues from tourism on the current account balance.

Unlike foreign trade in services, developments in foreign trade in goods in 2020 might be marked by a fall in the deficit as a result of a more pronounced contraction of imports than exports. The fall in foreign demand of the main foreign trade partners will have a negative impact on goods exports while the expected even faster fall in imports will be the result of the projected fall in personal and investment consumption and exports. The fall in the disposable income of households and worsened conditions on the labour market could particularly lead to a fall in imports of certain categories of luxury goods, such as for instance road vehicles, due to their deferred consumption. Net imports of energy products, particularly oil and refined petroleum products might fall too, mainly due to a marked fall in their prices.

The reduction of the surplus in the current and capital account in 2020 might, like the trade in goods, be mitigated by the improvement of the balance in the accounts of primary and secondary income and capital transactions. Particular note should be taken of the further growth in net inflows from transactions with the budget of the EU, largely supported by the EU financial assistance package to help ease the impact of the pandemic. Also expected is a noticeable fall in the profit of banks and enterprises in foreign ownership, which would result in lower expenditures on direct equity investments. By contrast, net income from personal remittances (which include compensation of employees in the primary income account and personal transfers in the secondary income account), after growing for five consecutive years, could fall in the following year.

After falling in 2020, the surplus in the current and capital account is expected to rise in the following year owing to the growth in net services exports. This relates in particular to revenue from travel services, which could, owing to a particularly low base in the previous year, record an exceptionally high annual growth rate in 2021, although its financial result is not expected to reach the pre-crisis level. Economic recovery is expected to be accompanied by a growth in tourism consumption of residents abroad. By contrast, other sub-accounts could have an unfavourable impact on the total current and capital account balance in 2021, which is particularly true of developments in foreign trade in goods.

Under the assumption of recovery in global trade and foreign demand of the main foreign trade partners in 2021, goods exports are expected to grow strongly. Recovery in personal and investment consumption could also fuel faster growth in goods imports and lead to the widening of the goods trade deficit. In the same way as the trade in services, goods exports and imports are not expected to reach the 2019 level.

The projected growth in the primary income account deficit in 2021 will mostly be driven by the expected recovery in the profit of banks and enterprises in foreign ownership. The surplus in the secondary income and capital transactions accounts could fall, exclusively as a result of an unfavourable effect of the base period, i.e. the currently projected assumption of a one-off

effect of use of EU financial assistance to help ease the impact of the pandemic in 2020.

The projection of developments in the current and capital account is exposed to significant risks and uncertainties. The projected developments are largely determined by the assumed dynamics of revenues from tourism, which depends on the uncertain epidemiological picture in Croatia and outbound markets. The developments in foreign demand of the main foreign trade partners also pose a significant risk, with implications on the dynamics of goods exports. By contrast, the depth of the crisis and the trajectory of recovery in domestic investment activity

and personal consumption will determine imports growth. Also to be noted is that the current projection does not include the possible effects of the proposal put forward by the European Commission to establish an economic recovery fund to finance economic recovery measures related to the damage caused by the pandemic. If this proposal is adopted, Croatia would have access to a much bigger amount of EU funds and the successful use of these funds would have a great impact on the balance of net transactions with the EU budget. Consequently, the projection of developments in the current and capital account in this segment is exposed to positive risks.

Box 4 Economic significance of European funds in Croatia and other new EU member states

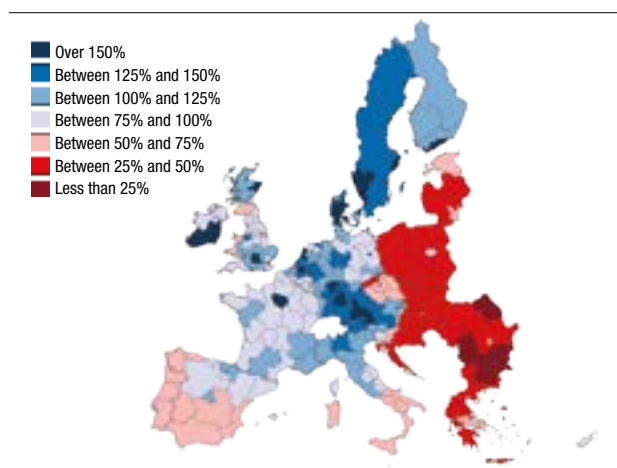
This Box analyses the macroeconomic significance of European funds in Croatia and other new EU member states and the success in the use of these funds from the current financial perspective covering the 2014-2020 period. In view of the growing economic significance of European funds, the Box also shows the projection of the utilisation of funds for Croatia, which is included in the current Monetary policy projection of the CNB and includes an assessment of the final success under the current financial perspective.

In terms of the degree of development, there are considerable differences between old and new EU member states²³. Figure 1 shows GDP per capita by regions according to the NUTS2²⁴ classification in percentage of the average GDP per capita in the EU, which shows new member states as generally standing between 25% and 50% of the said average and lagging considerably behind the old member states. The only exceptions in this

regard are the Czech Republic, Estonia and Slovenia. Of the old member states, Greece, Portugal, Central and Southern Spain and South Italy stand out with a somewhat lower degree of development.

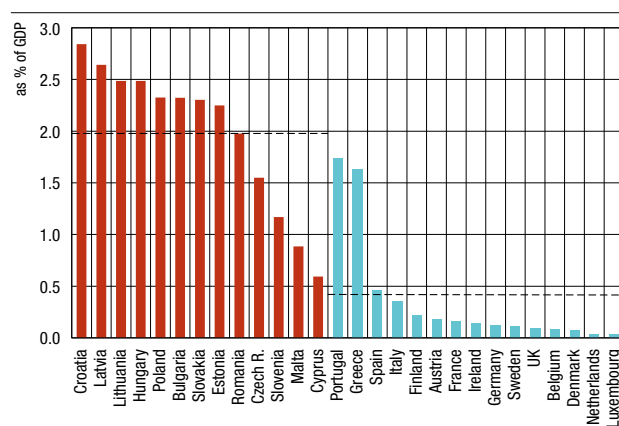
Since such large differences in the degree of development weigh heavily on the functioning of the economic and monetary union, a third of the funds from the European budget are earmarked for cohesion policy financing with the aim of reducing regional differences and ensuring the uniform development of all parts of the Union. As a result, new member states are significant beneficiaries of European funds²⁵, particularly of the European Structural and Investment Funds (ESI Funds), which are one of the main instruments of cohesion policy financing. Therefore, the relative importance of ESI Funds differs greatly between old and new member states, with the annual amount of available funds from ESI Funds in new member states standing at 2.0% of

Figure 1 GDP per capita by regions according to the NUTS2 classification in percentage of EU average



Sources: Eurostat and CNB calculations and design.

Figure 2 Available annual ESI Funds by member states



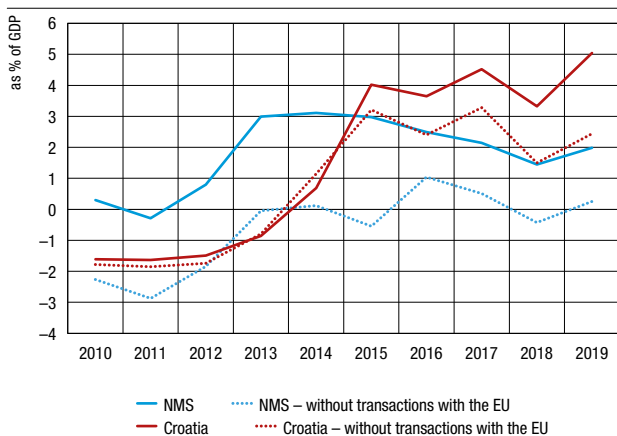
Notes: New member states are shown in red and old member states in blue. Dotted lines mean the unweighted average of the old and new member states, respectively.
Sources: Eurostat, European Commission and CNB calculations.

²³ New member states are countries that joined the EU in 2004, 2007 and 2013, i.e.: Slovenia, Hungary, the Czech Republic, Slovakia, Poland, Latvia, Lithuania, Estonia and Romania and Bulgaria and Croatia. Cyprus and Malta have been excluded from the analysis. The mentioned group of countries is referred to as NMS (new member states) in this Box. Old member states are countries that joined the EU prior to 2004, i.e.: Germany, France, Italy, Spain, Greece, the United Kingdom, Belgium, the Netherlands, Luxembourg, Austria, Finland, Sweden and Denmark.

²⁴ The NUTS classification (Nomenclature of territorial units for statistics) is a hierarchical system for dividing up the economic territory of the EU for the purpose of the collection, development and harmonisation of European regional statistics, socio-economic analysis of the regions and framing of EU regional policies. See: <https://ec.europa.eu/eurostat/web/nuts/background>.

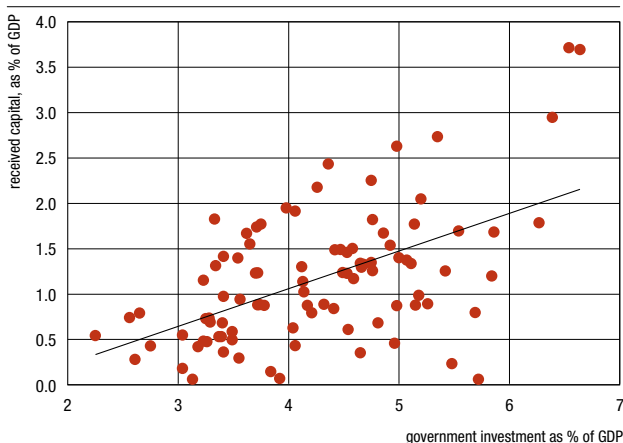
²⁵ The term European funds is most commonly understood to mean the European structural and investment funds, i.e. the five funds from which Croatia may utilise EUR 10.7bn from 2014 to 2020. However, transactions with the EU budget that may be followed in the statistics of international economic relations or fiscal statistics also include some other European funds, most notably the European Agricultural Guarantee Fund, as the most significant fund, which is used to finance the second pillar of the common agricultural policy on EU level.

Figure 3 Developments in the capital and current account balance in Croatia and other new member states



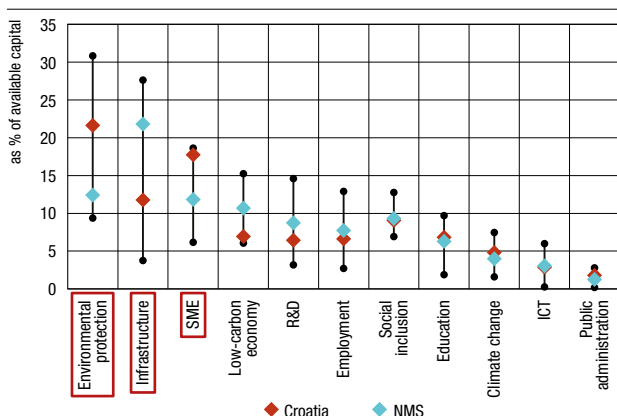
Note: Indicators for new member states are calculated as an unweighted average. Sources: Eurostat, ECB and CNB calculations.

Figure 4 Relationship between the capital received by the government and government investments in new member states, including Croatia, from 2010 to 2018



Sources: Eurostat, ECB and CNB calculations.

Figure 5 Structure of available ESI Funds under current financial perspective by priority areas (comparison between Croatia and new member states)



Notes: Black dots in the Figure indicate minimum and maximum values, respectively. Data for NMS show the total available amount of funds by areas for all new member states excluding Croatia. Sources: European Commission and CNB calculations.

GDP on average, in contrast with the old member states where this amount averages only 0.4%. As shown in Figure 2, under a seven-year financial perspective covering the 2014-2020 period, Croatia will have a total of EUR 10.7bn at its disposal, or on average EUR 1.5bn annually, which accounts for approximately 2.8% of GDP in 2019. Therefore, in terms of the share in GDP, Croatia has at its disposal the largest amount of available funds from ESI Funds of all the new member states. Latvia, Hungary and Lithuania also have considerable funds at their disposal, while the available funds for the economically more developed Czech Republic, Slovenia, Malta and Cyprus are below the average of the new member states. By contrast, of the old member states, economically less developed countries such as Greece and Portugal stand out in terms of a somewhat greater relative importance of ESI Funds.

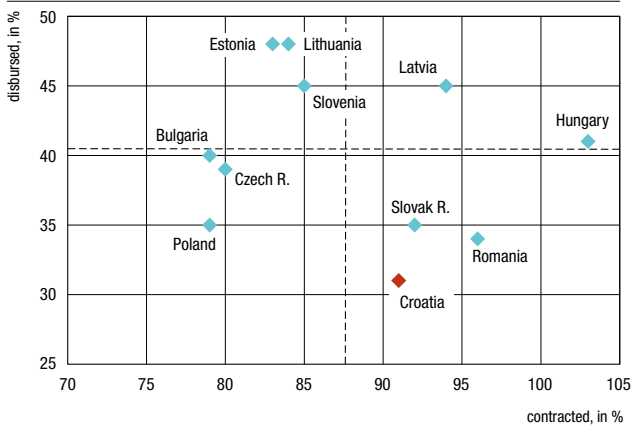
The economies of the new member states are therefore characterised by the specific role and macroeconomic significance of European funds, which not only sets them apart from the old EU member states but also makes them unique globally. Namely, hefty European funds help new member states, Croatia included, to generate a considerable positive balance (inflows exceeding payments) in total transactions with the EU budget, which ultimately has a noticeable effect on their overall international position. Since the outbreak of the global financial crisis in 2008, new member states have visibly reduced their external imbalances and since 2012 have continuously generated a surplus in the current and capital account of the balance of payments, largely owing to the use of European funds (Figure 3). If transactions with the EU budget are excluded, the developments in the current and capital account of the new member states would be much more unfavourable. By contrast, due to the later accession to the EU, the significance of European funds for the Croatian international position did not become evident until 2015 when the use of European funds intensified.

In addition to their exceptional importance for the international position of new member states, European funds are often one of the key sources of investment activity financing, particularly of the government. Due to limited fiscal capacity, many new member states, Croatia included, use European funds to co-finance a large part of public investment. As shown in Figure 4, the data for new member states (Croatia included) point to a positive relationship between the relative level of the capital received from the European budget and government investments. All major infrastructural projects in road, railway and public utilities infrastructure in Croatia are mostly co-financed by European funds.

Despite a relatively large financial importance of European funds in all member states, there are noticeable differences between countries in terms of the structure of envelopes by priority areas (Figure 5). While some countries, particularly Poland, decided to use the bulk of the funds received for infrastructural projects, Croatia decided to use a below average amount of funds for such purposes. Unlike the average of other new member states, Croatia decided to use a much bigger amount of the funds to improve the competitiveness of small and medium-sized enterprises and for environmental protection. The described differences can partly be explained by the fact that Croatia has made great investments in road infrastructure since 2000 so it is possible that the intention was to use ESI Funds for other development priorities. In addition, some domestic non-financial corporations have a problem with access to capital, and great investments need to be made in waste management systems to achieve compliance with the relevant EU legislation. This is also a possible explanation of the differences in the allocation of funds in comparison with other new member states.

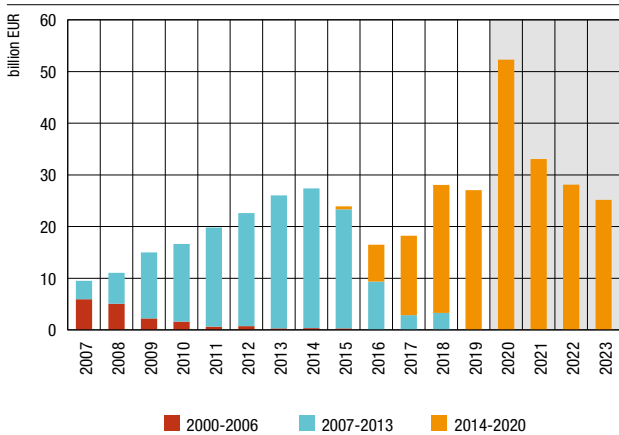
As regards the success in the use of funds thus far, data for

Figure 6 Contracted and disbursed funds under ESI Funds by countries



Notes: Dotted lines indicate the average of the disbursed and contracted funds, respectively, in new member states. Data as at 31 December 2019.
Sources: European Commission and CNB calculations.

Figure 7 Historical dynamics and projection of disbursements from ESI Funds to new member states

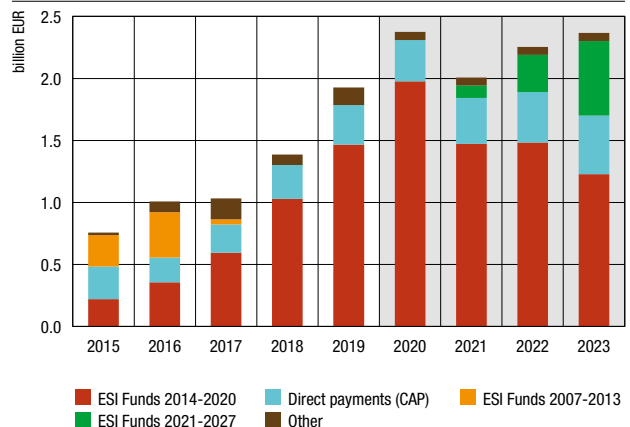


Source: European Commission; the projection is a CNB simulation based on the scenario of full utilisation by new member states of all the available funds.

end-2019 show that Croatia, with a contracting rate of approximately 90%, ranks above the new member states average (Figure 6). However, if the overall level of disbursements to beneficiaries is taken into account (a little over 30%), Croatia ranks the last of all the new member states. However, the slower dynamics of disbursements of funds in the case of Croatia may be explained by lack of experience in funds utilisation, both on the part of beneficiaries and government bodies and the inadequate initial administrative capacity associated with the country's later accession to the EU compared to other new member states.

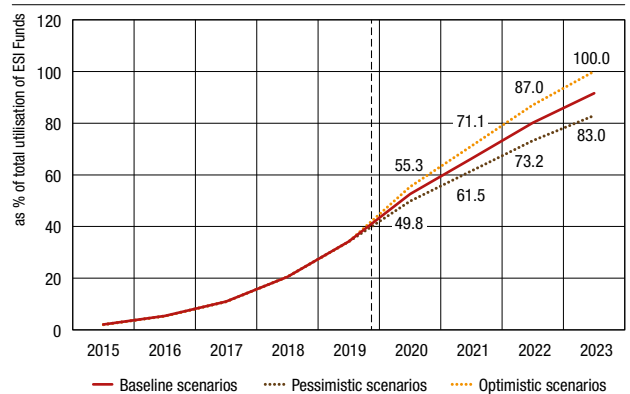
Given a relatively high contracting rate that has thus far been accompanied by a noticeably slower disbursement dynamics, disbursements are expected to intensify until the end of the projection period. This view is supported by the experience of new member states in the use of funds in the previous seven-year financial perspectives, for instance from 2007 to 2013, which witnessed the highest level of disbursements at the very end of the period of use (Figure 7). Figure 7 shows the projection of disbursements for new member states that is based on the assumption that the new member states will use all the funds available to them under ESIF because of the possibility to rechannel

Figure 8 Projection of disbursements to beneficiaries in Croatia from ESI Funds and other European funds and programmes



Sources: MoF, Ministry of Regional Development and EU Funds and CNB projection.

Figure 9 Projection of developments in cumulative disbursements to beneficiaries from ESI Funds in Croatia until the end of the projection period as % of total funds available under the financial perspective 2014-2020



Notes: The baseline scenario mirrors the expectations imbedded in the current monetary policy projection of the CNB. The more favourable scenario assumes a 15% increase and the less favourable a 15% decrease in annual use of funds in relation to the baseline scenario.
Source: CNB projection.

the funds thus far uncontracted into financing of the measures for mitigating the economic consequences of the new coronavirus pandemic. This projection is based on the use of funds in the same period of the previous seven-year financial perspective with somewhat bigger disbursements in 2020 because of the mentioned change regarding the rechanneling of funds.

As shown in Figure 8, it is exactly the dynamics of disbursements from ESI Funds that is the main determinant of the projected developments in total disbursements from the European budget to beneficiaries in Croatia, which are included in the Monetary Policy Projection of the CNB²⁶. In accordance with the earlier described current level of total funds disbursed and taking into account past experience of some of the new member states that showed that the highest level of disbursements took place towards the end of the period of use, the biggest disbursements to beneficiaries in Croatia are expected to take place in the forthcoming years. By the end of the projection period the

26 In addition to the five ESI Funds, total disbursements also include direct payments in agriculture under the second pillar of the Common agricultural policy on EU level and disbursements from all other European funds and programmes as well as financial instrument.

average level of disbursements might stand at approximately EUR 2.3bn, which could on average account for approximately 4.0% of GDP. If the described dynamics of disbursements materialises, the final level of Croatia's success in withdrawing ESI Funds under the current financial perspective (2014-2020) would stand at approximately 92% of the total available EUR 10.7bn at the end of 2023, which is close to the current contracting rate and very close to the final results of the new member states under the previous financial perspective (2007-2013).

The projection shown is exposed to positive and negative

risks over the next short-term period. Thus, there is a risk that the circumstances caused by the pandemic will lead to a lower level of utilisation as a result of inability to execute the co-financing agreements entered into, such as those in the segment of infrastructural projects. In the case of a 15% slower dynamics of disbursements, the final level of success might amount to 83% at the end of 2023. Should the dynamics of utilisation accelerate by 15% in relation to the baseline scenario, Croatia would utilise all the available funds from ESI Funds (Figure 9).

7 Private sector financing

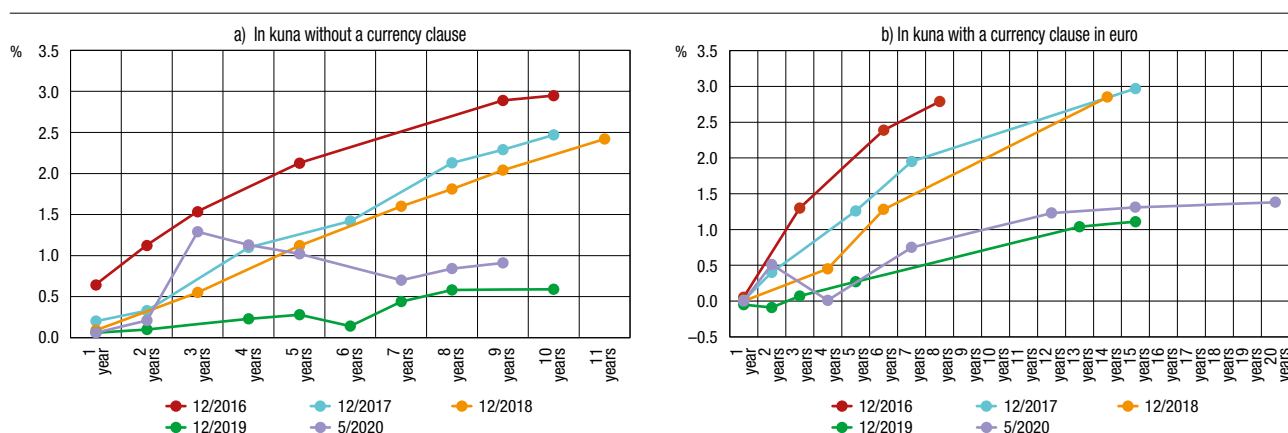
Domestic sectors' financing conditions mostly remained at favourable levels in the first half of 2020. Interest rates on the short-term borrowing of all sectors remained virtually the same as in the period before the coronavirus pandemic, while the costs of long-term debt financing increased very slightly under the impact of uncertainty caused by the pandemic.

Government borrowing costs, one of the determinants of the costs of borrowing of other domestic sectors, remained relatively favourable. The government's foreign borrowing cost, estimated by the sum of the EMBI for Croatia and the yield on the German government bond, increased from 0.7% at the end of February to 2.1% at the end of March (Figure 7.3) amid uncertainty caused by the pandemic. However, the EMBI for Croatia fell by the end of June, so that the estimated government borrowing cost decreased to 1.2%. A temporary increase was also observed in the credit default swap (CDS) due to the pandemic. Thus the CDS almost doubled and reached 91 basis points in the first 20 or so days of March, and then dropped to 75 basis points by the end of June, the average in the last quarter of 2019. Credit rating agencies, Standard & Poor's and Fitch, maintained Croatia's BBB- investment rating, with Fitch changing the country's outlook from positive to stable in the beginning of April and S&P

confirming the outlook as stable at the end of May. Since 2016, the Moody's rating for Croatia has been unchanged at Ba2, two notches below investment grade with stable outlook.

In order to prevent any considerable growth in yields in the domestic market, which could increase the costs of borrowing of both the government and other domestic sectors, the CNB started purchasing government bonds in the secondary market and thus contributed to maintaining the government securities market stability. Therefore, the government continued to borrow under relatively favourable conditions (Figures 7.1a and b). Thus, the interest rate on one-year kuna T-bills in the domestic market held steady from October 2019 and stood at 0.06% in June 2020 (Figure 7.2), while the interest rate on euro T-bills of the same maturity in May stood at 0.00%. In addition, at the end of April, the government conducted an auction to refinance EUR 1.0bn in matured treasury bills from January 2019 with a 455-day maturity by a new issue in the same amount with a 364-day maturity and the interest rate of 0.06%. As regards the costs of long-term government financing, at the end of February, the MoF issued three bond tranches in the domestic market worth a total of almost HRK 15bn at the most favourable borrowing conditions and the longest maturity period to date²⁷. When the pandemic

Figure 7.1 Yield-to-maturity on RC bonds



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

Source: CNB.

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

Source: CNB.

27 These included a 5-year HRK 5bn bond with a yield at issue of 0.37%, the second tranche of a HRK 4bn bond indexed to trends in the kuna to euro exchange rate that matures in 2034, with a yield of 1.12% and a EUR 800m worth bond indexed to foreign currency, with a yield of 1.28% and 20 year maturity, the longest maturity for a bond issue so far. The bulk of the collected funds were mostly used for the refinancing of the two bonds maturing in early March.

broke out, government needs to finance measures aimed at assisting the economy increased, so that a seven-year bond worth EUR 1.445bn indexed to foreign currency and a 0.75% yield was issued in May and a eurobond worth EUR 2.0bn, with maturity in 2031 and a 1.643% yield, was issued on the international capital market in mid-June. In addition to assisting the economy, the funds raised through the June issue will also be used for refinancing the eurobond maturing in July 2020.

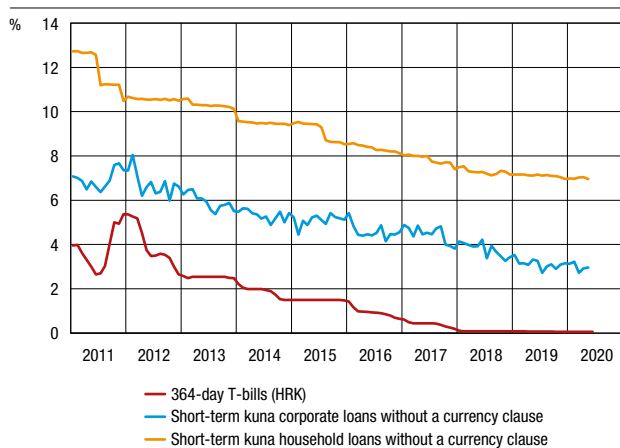
Short-term corporate financing costs remained stable, while interest rates on long-term financing increased very slightly. Thus, the interest rate on short-term corporate borrowing from banks in kuna without a currency clause did not change significantly in the first five months of 2020 (Figure 7.2). By contrast, the interest rate on long-term loans with a currency clause increased by 0.8 percentage points until the end of May from the end of 2019, with the largest increase being recorded in April (Figure 7.3). This was mostly attributable to the renegotiation of loans due to the deferral of payment and restructuring (Figure

7.15) because, as a rule, interest rates on such loans are higher than the interest rates currently applicable on pure new loans. In addition, interest rates on newly negotiated loans also increased very mildly. The costs of financing increased equally for large and for small loans (Figure 7.4).

The interest rate on short-term kuna household loans without a currency clause remained almost unchanged in the first five months of 2020 (Figure 7.2). By contrast, the interest rate on long-term household loans with a currency clause, including housing, consumer and other loans, was slightly higher at the end of May than at the end of the previous year (Figure 7.3), also under the impact of renegotiated loans.

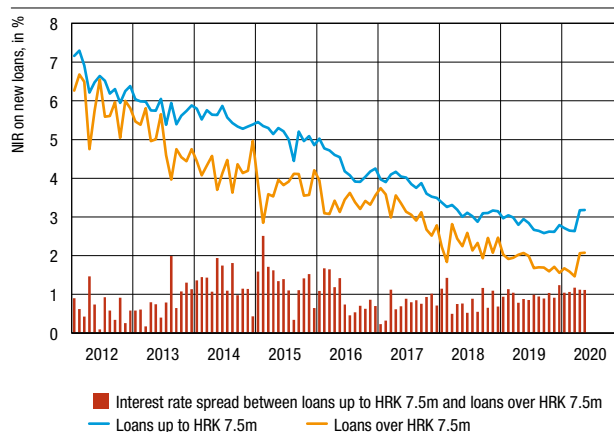
The fall in the cost of sources of funds of the Croatian banking system contributed to the continued favourable financing conditions for the private sector. Despite the recent increase, EURIBOR remained in negative territory (Figure 2.3), while the national reference rate (NRR)²⁸ continued to decline steadily (Figure 7.5).

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



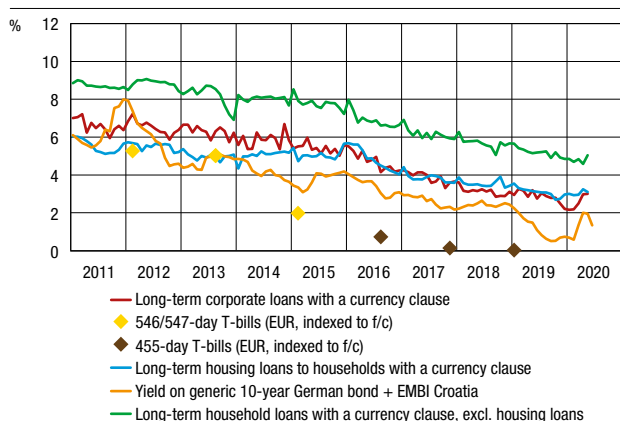
Sources: MoF and CNB.

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



Source: CNB.

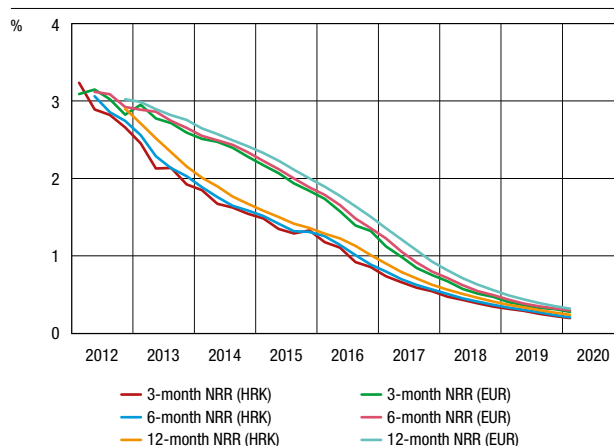
Figure 7.3 Long-term financing costs in kuna with a currency clause and in foreign currency



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 7.5 National reference rate (NRR)

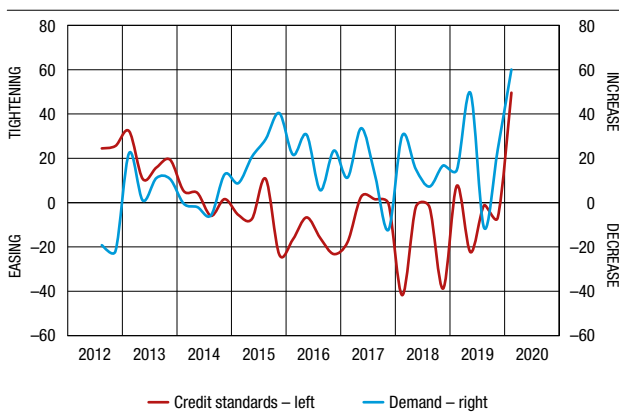


Note: The rates shown refer to the rates for all natural and legal persons.

Sources: HUB and CNB.

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

Figure 7.6 Credit standards and corporate demand for loans



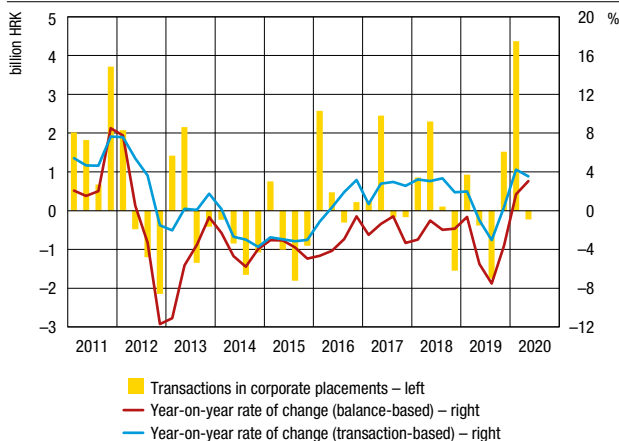
Note: Data show the net percentage of banks weighted by the share in total corporate loans.

Source: CNB.

According to the bank lending survey, in the first quarter of 2020, corporate demand for loans recorded the most widespread increase and the strongest tightening of credit standards for corporate loans since the survey was first introduced (Figure 7.6). The tightening in standards was mainly affected by the worsened outlook of industry or the individual corporation, as well as by negative expectations related to overall economic trends.

In such circumstances, credit institutions increased placements to non-financial corporations by HRK 3.7bn in the first five months of 2020, with their annual growth rate at the end of May reaching 3.6% (transaction-based, Figure 7.7). The annual increase in corporate placements was still negatively affected by the decrease in claims on the Agrokor Group and, to a lesser extent, the activation of government guarantees to shipyards, which was estimated at slightly over 2 percentage points in May (Figure 7.8). Corporate lending (transaction-based, excluding the one-off effects of shipyards and Agrokor) grew steadily in the past three years by almost 3% on an annual basis, and accelerated to about 4% in February and 6% in the period from March to May. The accelerated growth of placements was driven by investment loans with the annual growth at the end of May

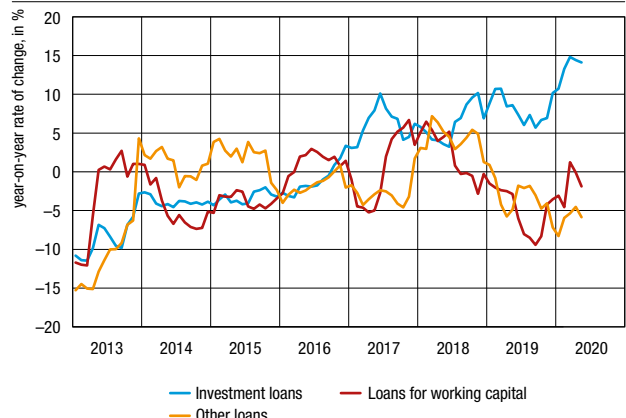
Figure 7.7 Corporate domestic placements of credit institutions



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

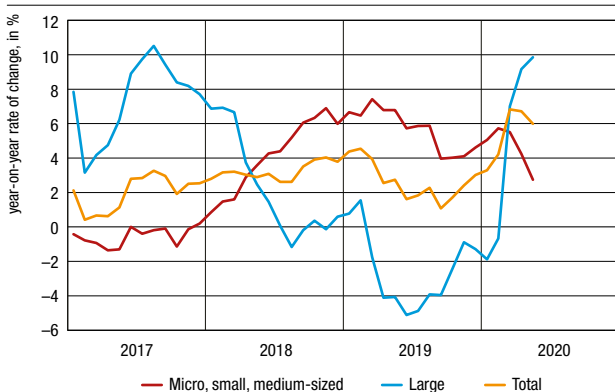
Source: CNB.

Figure 7.9 Growth of corporate loans by purpose transaction-based



Source: CNB.

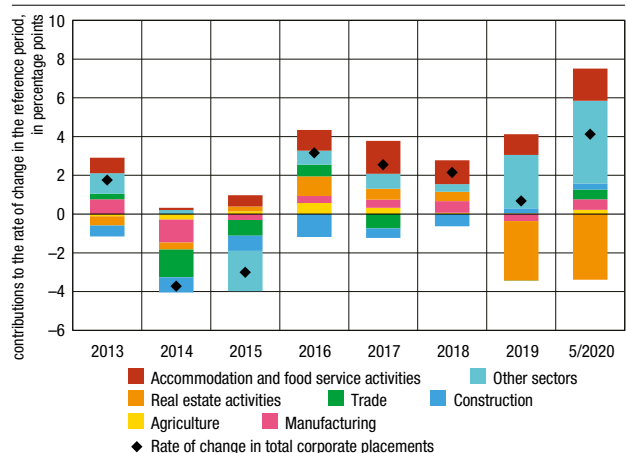
Figure 7.8 Growth of corporate placements by size transaction-based



Note: The data were adjusted for the assessment of the effect of activated government guarantees for loans to particular shipyards and the decrease in the claims on the Agrokor Group linked to the operational implementation of the settlement.

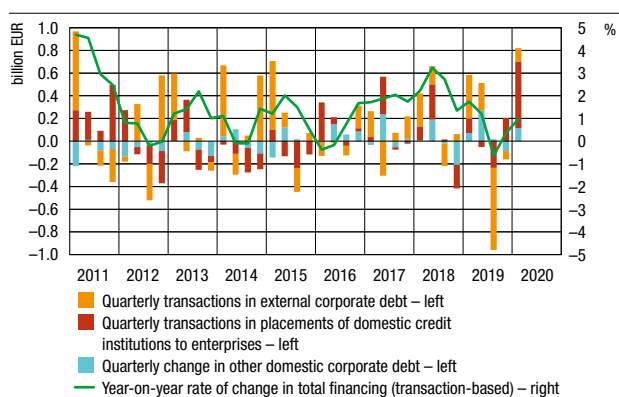
Source: CNB.

Figure 7.10 Growth of corporate placements by activity transaction-based



Source: CNB.

Figure 7.11 Corporate financing



Notes: Other domestic financing includes borrowing from domestic leasing companies and the CBRD. The estimate for borrowings from leasing companies was used for the first quarter of 2020. Foreign debt excludes the effect of debt-equity swaps. All changes were calculated according to transactions (except for other domestic debt).

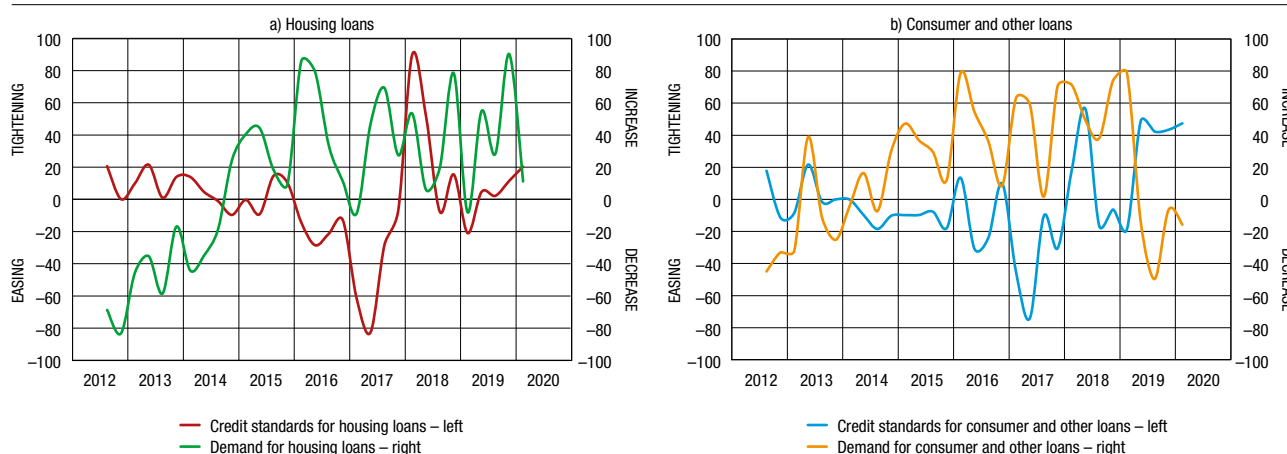
Sources: HANFA, CNB and CNB calculations.

increased financing abroad, as well as other domestic financing. Thus, the total debt of non-financial corporations, in particular private non-financial corporations, increased in the first quarter of 2020 (Figure 7.11). If viewed on an annual level, total corporate debt increased by 1.0% (transaction-based), as a result of growth in domestic financing, while external debt decreased, driven by the deleveraging of private corporations.

Household demand for loans stagnated, while banks continued to tighten credit standards for household loans because of weakening economic activity, uncertainty regarding the consequences of the outbreak of the pandemic and negative expectations concerning economic developments (Figure 7.12). The worsening of standards was additionally driven by customer creditworthiness in consumer and other loans and real estate market prospects in housing loans.

In the first five months, household placements increased by only HRK 0.2bn. For the first time in almost three years, a monthly decline in placements was recorded in March, which also continued to a considerable extent in April. Such developments contributed to a significant deceleration of the annual growth in household placements, which at the end of May stood

Figure 7.12 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.

reaching 14.1%, while loans for working capital also increased sharply in March (Figure 7.9). Lending to large corporations accelerated noticeably, while the annual growth of placements to micro, small and medium-sized enterprises slowed down. In addition to the financing of investments and working capital, the strong intensification of corporate demand for loans was attributed to the need of corporations for debt restructuring.

If corporate loans are broken down by activities (Figure 7.10), it is evident that placements grew in almost all activities. Accommodation and food service activities, manufacturing and trade stand out by their positive contribution. A negative contribution came only from real estate activities, although this was exclusively a result of a change in the activity of one large corporation.²⁹

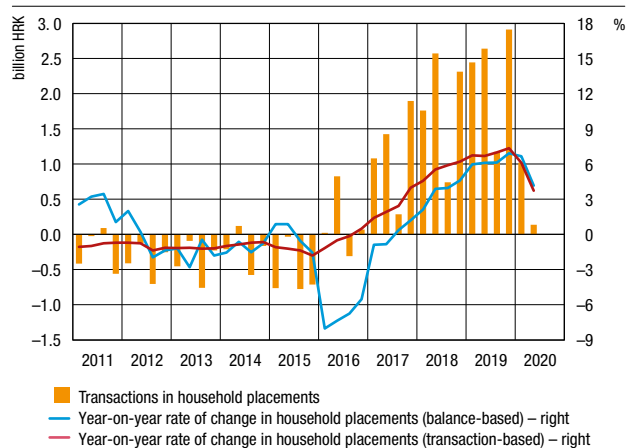
In addition to the growth in borrowing from domestic credit institutions, in the first quarter of 2020, corporations also

at 3.7% (transaction-based), only a half of the growth generated at the end of the previous year (Figure 7.13). The weaker lending to households was mostly the consequence of the decrease in general-purpose cash loans, the annual growth of which declined continuously from 11.5% at the end of the previous year to 4.7% at the end of May (according to the bank lending survey, the decline in demand for these loans was the result of the drop in consumption of durable consumer goods). Thus, for the first time since the end of 2012, in May 2020, the contribution of this type of loan to the annual growth of total placements to households was lower than the contribution of housing loans (Figure 7.14). The annual growth rate of housing loans in May (6.2%) slowed down only slightly from the end of 2019, as indicated by the survey, according to which the demand for housing loans continued to grow, albeit at a much lower intensity than in the last quarter of 2019, under the effect of less favourable expectations for the real estate market and a slight decline in consumer confidence (Figure 7.12).

The measures directed at households and corporations affected by the crisis include programmes for the deferral and restructuring of existing credit liabilities. Thus, up to 10 June

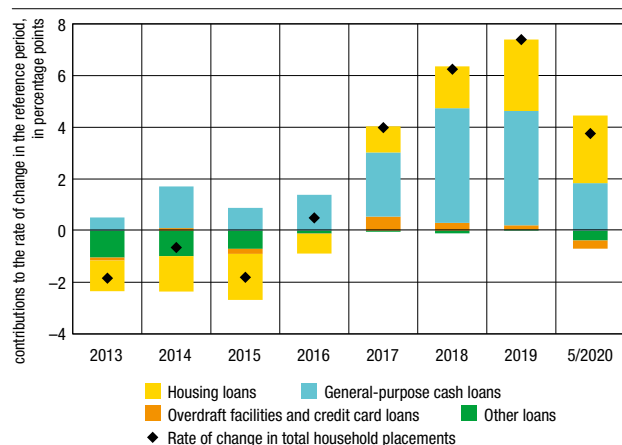
29 In October 2019, a large corporation switched from Section L Real estate activities to Section E Water supply, sewerage, waste management and remediation activities. This is why a sharp decrease in placements was recorded in Real estate activities, and a substantial rise was seen in Other sectors,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

Figure 7.13 Household placements



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

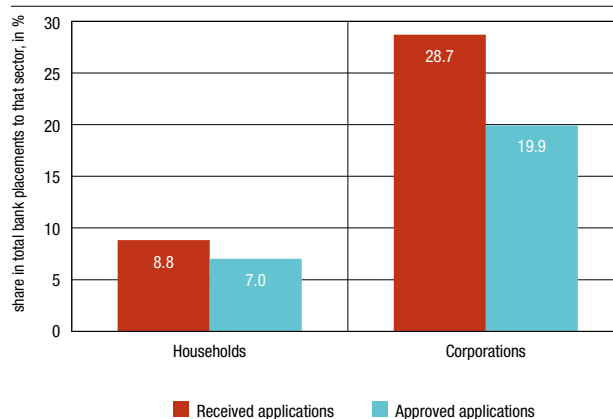
Figure 7.14 Growth of household placements by loan type transaction-based



Source: CNB.

2020, banks received a large number of applications from corporations and households for some form of the measures. The applications received from corporations accounted for almost one third of total bank placements to corporations, while approved

Figure 7.15 Received and approved loan payment deferral or restructuring applications



Note: The data as at and including 10 June 2020.
Source: CNB.

applications accounted for almost 20% of total placements. In the case of households, the share is significantly smaller and the approved applications accounted for 7.0% of the total placements to this sector (Figure 7.15).

Projected developments

It is estimated that total placements (excluding the government) could see a rise of 3.7% (transaction-based) in 2020. Most of the credit growth would be driven by placements to corporations, which might rise by 6.9% after the previous year's modest growth. The acceleration of growth of placements to corporations results from a strong increase in corporate demand for loans in the period in which the pandemic is impairing their revenues. The measures aimed at mitigating the negative consequences of the pandemic might contribute to the growth of corporate financing (e.g. loans from HAMAG-BICRO, CBRD and banks with more favourable interest rates) that would enable more favourable lending for working capital to corporations. In contrast, lending to households could slow down noticeably to only 1.5% of growth in the whole of 2020, mainly because of the reduced growth of general-purpose cash loans as a result of the drop in employment, consumption and consumer confidence. The risks to the realisation of the projected credit growth dynamics are negatively inclined and exposed to a large degree of uncertainty, which is mostly related to the consequences and the future development of the epidemiological situation.

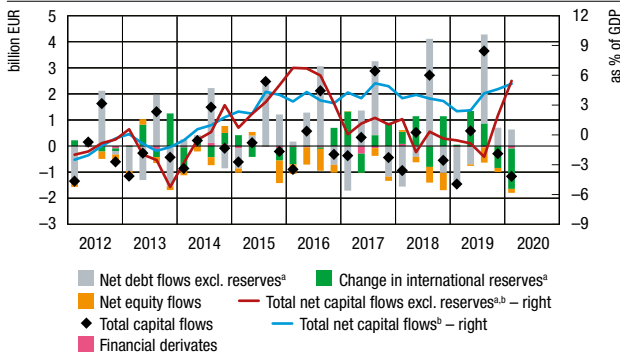
8 Foreign capital flows

The financial account of the balance of payments recorded a net capital inflow of EUR 1.2bn in the first quarter of 2020 (Figure 8.1), mainly as a result of a fall in international reserves. Strong depreciation pressures that followed the outbreak of the coronavirus pandemic prompted the CNB to respond by selling foreign exchange on several occasions in March, which led to a noticeable decline in international reserves. If the change in gross international reserves and liabilities of the CNB are excluded, the first three months of the year saw a net capital outflow of EUR 0.4bn as a result of a fall in net debt liabilities of the

domestic sectors, particularly banks, while net equity liabilities rose.

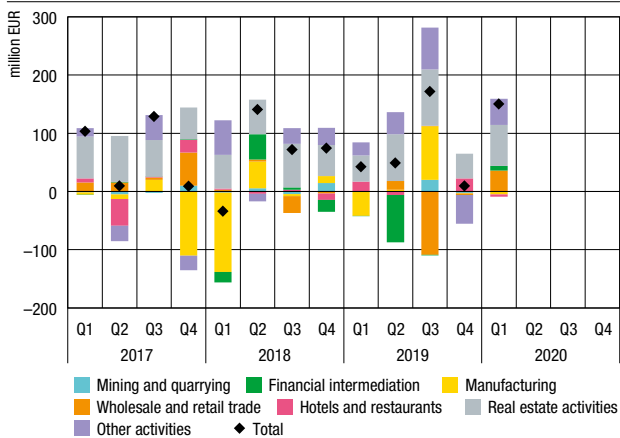
The net inflow from equity investments of EUR 0.2bn in the first three months of 2020 was the result of a faster growth in liabilities than assets of the domestic sectors. The growth in foreign assets was mostly driven by reinvested earnings of foreign enterprises owned by residents, which were the biggest in financial activities and transport and trade activities. By contrast, the increase in liabilities was equally due to new foreign direct investments in Croatia, mostly in the real estate sector (Figure 8.2)

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



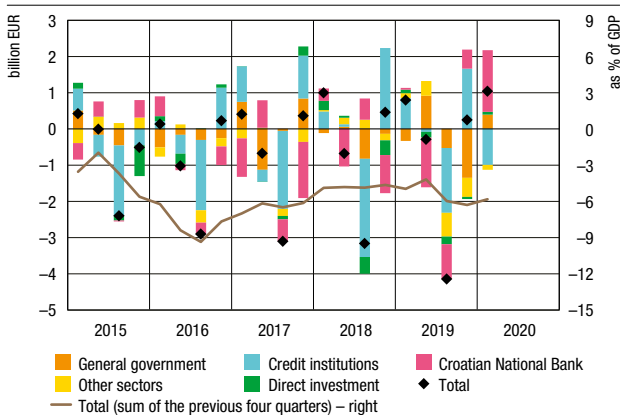
^a Changes in gross international reserves net of CNB liabilities.
^b Sum of the previous four quarters.
 Notes: Net flows mean the difference between changes in assets and liabilities. Equity flows comprise changes in foreign direct equity investments, reinvested earnings and portfolio equity investment,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

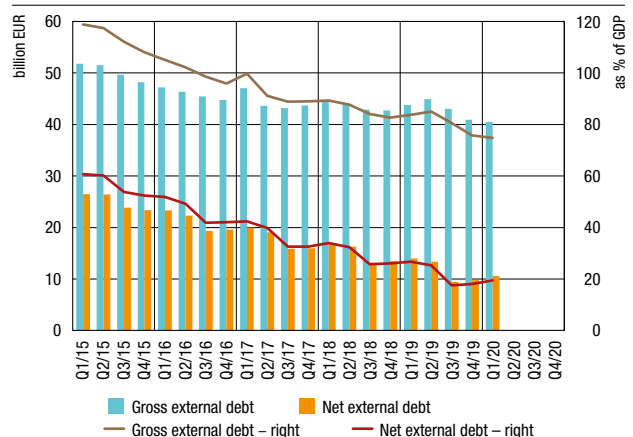
and reinvested earnings. In the first quarter of 2020, reinvested earnings were considerably bigger than in the same period of the previous year, which is exclusively due to reduced dividends, while overall profitability of domestic entities in foreign ownership remained almost the same; following the outbreak of the coronavirus pandemic, the CNB banned dividend payouts by banks.

A fall in net debt liabilities in the first quarter of 2020 of EUR 0.6bn, excluding the change in international reserves and liabilities of the CNB was due to a two times greater increase in foreign assets of the domestic sectors than liabilities. The net foreign position of banks improved the most (Figure 8.3), mostly as a result of an increase in foreign assets following the purchase of foreign exchange from the central bank. Other domestic sectors also improved their net foreign position considerably. By contrast, the government increased its net debt liabilities to foreign creditors, exclusively as a result of transactions in the secondary securities market, with domestic institutional investors purchasing a share of government bonds from domestic creditors. Amid great market uncertainty following the outbreak of the coronavirus pandemic, which resulted in strong depreciation pressures, the CNB intervened in the foreign exchange market on several occasions in March by selling foreign currency. This led to a strong deterioration in the net foreign position of the central bank (EUR 1.5bn) while, as mentioned earlier, these purchases led to a considerable improvement in the net foreign position of banks.

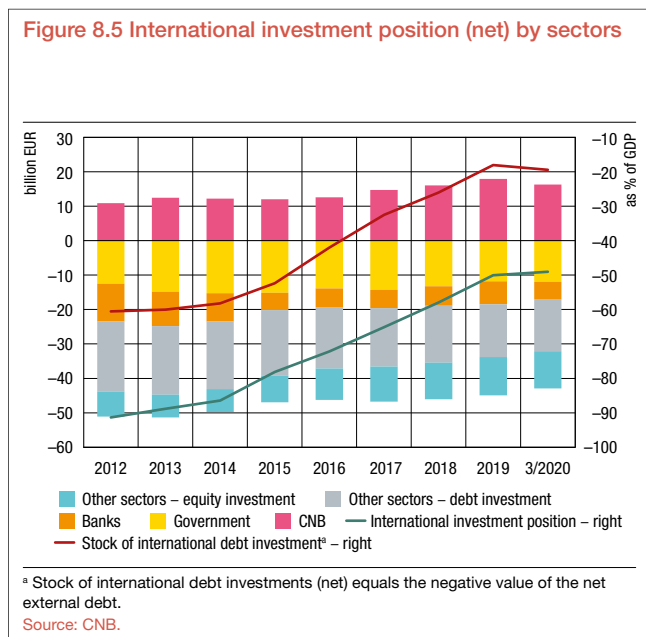
As regards the relative indicators of external debt, gross external debt stood at EUR 40.5bn at the end of March 2020, or 74.7% of GDP (Figure 8.4), a decline of 1.0 percentage point from the end of 2019, and is mostly the result of a favourable impact of statistical adjustments (such as a subsequent registration of earlier assumption of a share of foreign debt by domestic creditors and debt repayment) and to a lesser extent, cross-currency changes. At the same time, the net external debt of the domestic sectors rose. Thus, at the end of March 2020, the net external debt stood at EUR 10.5bn, or 19.4% of GDP, an increase of 1.4 percentage points from the end of 2019.

Favourable price, exchange rate and other adjustments led to an improvement in the net international investment position from -50.0% of GDP at the end of 2019 to -49.0% of GDP at the end of the first quarter of 2020 (Figure 8.5).

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.



Projected developments

In line with the expected noticeable fall in the current and capital account surplus, the net capital outflow in the financial account of the balance of payments could also be much smaller in 2020 than in the previous years. The net capital outflow relates to a further decline in net foreign debt liabilities of the domestic sectors while equity investments are expected to bring a net capital inflow, although smaller than in the previous years.

As regards equity investments, rising uncertainty and worsening of global economic developments caused by the coronavirus pandemic will reduce the global flows of foreign direct investments. There is a likelihood of postponement or even abandonment of some of the planned investments amid disturbances in global supply chains, strong demand contraction and fall in company profits. Consequently, the already relatively modest inflow of direct equity investments in Croatia might see a further fall.

As regards debt investments, the trend of external deleveraging by domestic sectors is expected to continue in 2020, mainly owing to a growth in foreign assets of credit institutions and a fall in the liabilities of other domestic sectors. Particularly worth noting is also the possible reduction in the liabilities of private non-financial corporations arising from short-term trade credits

as a result of a sharp fall in goods imports. By contrast, the government is expected to meet some of the increased financing needs by foreign borrowing so that, after falling for two consecutive years, government foreign liabilities, particularly those under long-term securities, are expected to rise in 2020. In June, the government issued new bonds worth EUR 2bn, partly earmarked to cover the July repayment of the USD 1.25bn worth of bonds issued in 2010 and partly to finance the anti-crisis measures aimed at mitigating the negative impacts of the coronavirus pandemic. The net foreign position of the central bank is expected to deteriorate further as a result of a noticeable fall in international reserves following the outbreak of the coronavirus pandemic. On the entire year level, the fall in net foreign assets (NFA) of the CNB might be more pronounced than the growth in the NFA of credit institutions, which leads to the expectation of a fall in the NFA, i.e., the net capital inflow of monetary institutions.

Despite the expected fall in the gross external debt in an absolute amount, the relative indicator might exceed 80% at the end of the year, exclusively as a result of a fall in the nominal GDP. This would bring to a halt the five-year-long trend of decline in the gross external debt to GDP ratio and the international investment position to GDP ratio, but only temporarily. By contrast, the relative indicator of the net external debt might improve slightly.

The expected economic recovery and improvement in the balance in the current and capital account might increase the net capital outflow in 2021, mainly owing to international reserves growth. At the same time, gross debt liabilities are expected to rise slightly as a result of borrowing by other domestic sectors, mainly associated with an increase in liabilities under short-term trade credits following import recovery. By contrast, the liabilities of the government and the banks are expected to fall. The pre-crisis trend of improvement in the relative indicators of foreign liabilities temporarily suspended in 2020 is expected to continue.

Despite a long-term trend of decline in external imbalances, there are still risks to Croatia's external position due to the large foreign liabilities accumulated earlier. The risks to the achievement of capital flow projections are mostly associated with a possible more pronounced worsening of the global investment climate, while the risks involving a possible worsening of financing conditions are smaller.

9 Monetary policy

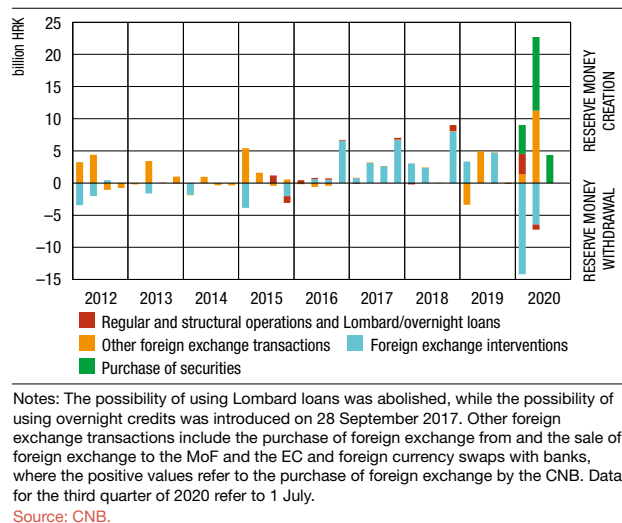
In the first half of 2020, the CNB continued to pursue an expansionary monetary policy and maintain a stable kuna/euro exchange rate. The central bank responded to deteriorating economic and financial conditions caused by the coronavirus pandemic with a series of measures aimed at securing the foreign exchange and kuna liquidity and maintaining the stability of the financial system.

Growing uncertainty regarding the effects of the pandemic gave rise to increased demand by domestic sectors for foreign exchange. The increased demand was partially the result of adjustments to the portfolios of domestic sectors due to a change in their expectations about future movements of the exchange rate. In addition, the rise in demand for foreign exchange was, to a significant extent, brought about by investment funds, which

were faced with strong deposit withdrawal at the outbreak of the pandemic due to a deterioration in investor expectations regarding the developments in the value of financial assets. To pay off investors, investment funds vigorously sold their assets, which mainly included government bonds. This in turn led to a fall in their prices and growing yields. Furthermore, since most deposit payments were linked to euro deposits, this additionally increased the demand for foreign exchange and resulted in a surge in foreign exchange deposits in banks in March.

Stronger demand for foreign exchange led to kuna depreciation as the domestic currency weakened by 2.5% relative to the euro from late February to mid-April. To prevent further kuna weakening, the CNB intervened strongly on the foreign exchange market, selling a total of EUR 2.7bn. The bulk of the

Figure 9.1 Flows of reserve money (M0) creation



foreign exchange was sold in the second half of March and at the beginning of April, after which the exchange rate stabilised from the middle of April onwards. As regards other foreign exchange transactions, from the beginning of the year to the end of June, the CNB purchased EUR 1.7bn from the Ministry of Finance, creating HRK 12.6bn. A net total of HRK 8.0bn in reserve money was thus withdrawn by foreign exchange transactions in the first six months of 2020 (Figure 9.1).

To maintain stability in the government bond market, in March, the CNB began purchasing the government bonds of the Republic of Croatia (Figure 9.3.). The scope of potential participants in securities purchase and sale operations was extended to pension companies, pension insurance companies, companies managing open-ended investment funds, insurance companies and housing savings banks. At two auctions held in March, one auction held in April and two auctions held in June, the CNB purchased bonds with a total market value of HRK 20.3bn, thus preventing the freezing of the bond market and supporting its liquidity and securing favourable financing conditions for all sectors.

In order to maintain favourable financing conditions, in addition to the purchase of government bonds, the CNB also used other monetary policy measures. In March, the central bank conducted a structural open market operation placing HRK 3.8bn to banks for a five-year term at an interest rate of 0.25%, the highest amount supplied in structural operations thus far. A part of the funds was used by banks for the early repayment of existing structural loans, so that their balances went up by HRK 2.4bn at the end of May from the beginning of the year. Moreover, in March, the CNB initiated the placement of short-term kuna funds via regular weekly operations for the first time since 2017. The interest rate on such loans was cut from 0.3% at the first auction in March to 0.05% in all subsequent auctions. The banks' demand at weekly auctions peaked in April, when the average amount of funds placed reached HRK 1.1bn, after which the banks' interest began to wane and disappeared completely by mid-May. Finally, in March, the CNB lowered the reserve requirement rate from 12% to 9%, releasing to banks HRK 6.34bn of the funds previously allocated to a special statutory reserve account held with the CNB.

Thanks to measures described above, which supplied banks with a total of HRK 29.1bn of kuna liquidity, the liquidity surplus of the monetary system remained high, standing at HRK

Figure 9.2 Bank liquidity and reserve money

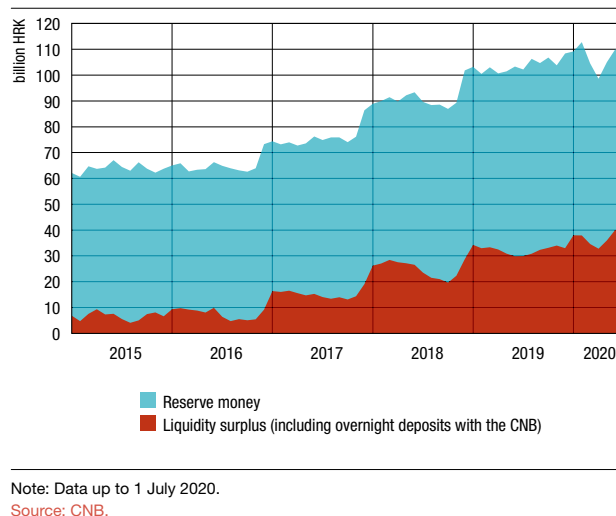
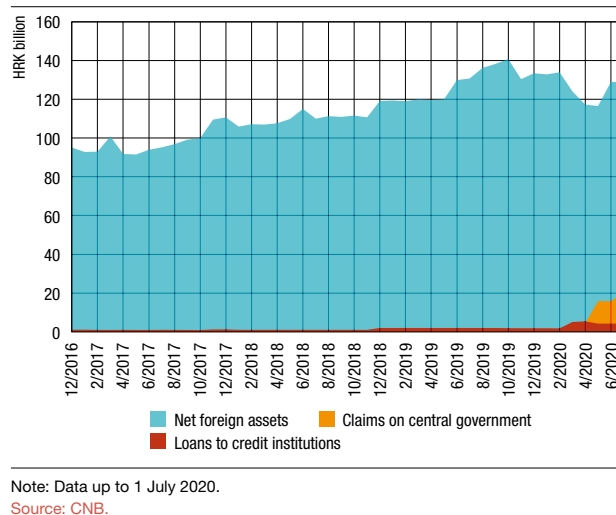


Figure 9.3 CNB balance sheet structure

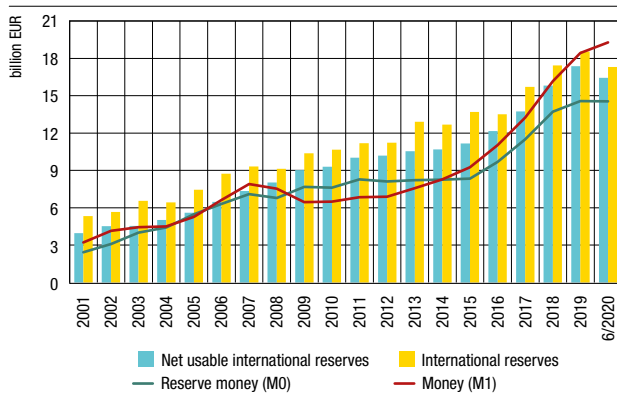


38.1bn at the beginning of July, up by 18.2% from the average liquidity surplus in 2019 (Figure 9.2). By maintaining ample liquidity surpluses, the CNB is striving to contribute to the preservation of favourable domestic financing conditions.

Measures taken since the outbreak of the pandemic resulted in significant changes in the central bank's balance sheet structure. The share of domestic assets grew on the assets side, reflecting the increase in claims on domestic banks (open-market operations) and government bond purchase. On the other hand, the sale of foreign exchange to banks resulted in the drop in the share of foreign assets, i.e. international reserves. Nevertheless, they still constitute the dominant part of CNB assets (Figure 9.3).

Gross international reserves of the Republic of Croatia decreased by EUR 1.2bn (6.7%) in the first six months of 2020, ending June at EUR 17.3bn (Figure 9.4). Net usable reserves dropped by EUR 0.9bn over the same period, totalling EUR 16.6bn at the end of June. In addition to the sale of foreign exchange to banks, the decline in gross reserves was also a result of a smaller amount of concluded repo agreements, while the purchase of foreign exchange from the government worked in

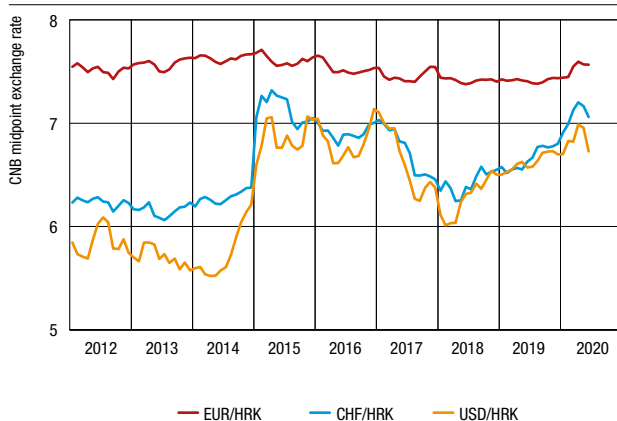
Figure 9.4 International reserves of the CNB and monetary aggregates



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). The most recent data available for M1 in 2020 refers to May.

Source: CNB.

Figure 9.5 Nominal exchange rates of the kuna against selected currencies

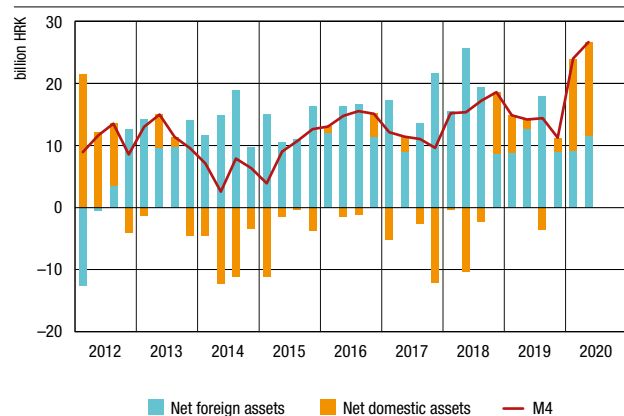


Source: CNB.

the opposite direction. Despite that, both gross and net reserves are still higher than reserve money (M0). Also worth noting is the swap line between the CNB and the European Central Bank, established in April, which enables the exchange of the kuna for the euro up to EUR 2bn. If necessary, this may be used to provide additional foreign exchange liquidity without the need for using international reserves.

The exchange rate of the kuna against the euro stood at EUR/HRK 7.56 at the end of June 2020, up by 2.2% relative to the end of the same month in 2019, while the average exchange rate in the first six months of 2020 stood at EUR/HRK 7.53, having increased by 1.5% on the same period in 2019 (Figure 9.5). The higher exchange rate of the kuna against the US dollar and the Swiss franc at the end of June 2020 relative to the same

Figure 9.6 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 2020 are up to May.

Source: CNB.

month in 2019 reflects the combined effect of the weakening of the kuna against the euro and the weakening of the euro against both of these currencies.

The CNB's foreign exchange transactions also resulted in changes to the structure of the net foreign assets (NFA) of the monetary system. Specifically, banks mainly placed the foreign currency funds purchased from the CNB abroad and thus neutralized the drop in the net foreign assets of the central bank, which is why the overall NFA dynamics of the monetary system did not change significantly from the end of 2019 (Figure 9.6). On the other hand, net domestic assets (NDA) of the monetary system grew substantially in the first five months of 2020 due to increased borrowing of the government from banks and the CNB's purchase of government bonds on the secondary market. As a result of stronger NDA growth, the growth of M4 intensified considerably relative to last year in the first five months of 2020. Among M4 components, foreign exchange deposits grew the most. This was a result of depositors' increased propensity to save liquid foreign currency funds in the conditions of growing uncertainty, the weakening of the kuna against the euro seen in March, which increased the kuna countervalue of foreign exchange deposits, and of the inflow of foreign exchange from investment funds. The noticeable increase in foreign exchange deposits in March put an end to the several-year long downward trend of the euroisation of the banking system; however, recent data suggest that the rise in deposit euroisation was only short-term.

The CNB will continue to pursue an expansionary monetary policy while maintaining a stable exchange rate of the kuna against the euro. Against the backdrop of the currently unfavourable economic situation and low inflation and increased uncertainty regarding the dynamics of economic recovery, the CNB will continue to maintain the high liquidity of the monetary system with the aim of securing favourable financing conditions for the domestic sectors.

Box 5 CNB monetary policy measures aimed at alleviating the negative consequences of the pandemic

The CNB adopted a series of monetary policy measures in response to unfavourable economic and financial circumstances caused by the outbreak of the novel coronavirus pandemic. The measures secured the stability of the kuna/euro exchange rate, created additional liquidity to enable domestic banks to continue with their lending activity and stabilised the domestic government bond market. The measures contributed to the continuation of the accommodative monetary policy aimed at maintaining favourable financing conditions for the domestic sectors over the future period in which the consequences of the pandemic will have a negative effect on economic activity.

Growing uncertainty and increasing concern over an unfavourable outcome of the Covid-19 pandemic resulted in extremely high volatility on international financial markets, and in Croatia in stronger demand for foreign exchange and increasing yields and decreasing prices of government bonds. The Croatian National Bank has therefore adopted a series of monetary policy measures since the beginning of March in order to stabilise the financial conditions on domestic financial markets. The measures comprised activities focused on three objectives:

(1) maintaining the stability of the kuna/euro exchange rate and securing sufficient foreign exchange liquidity to prevent the materialisation of exchange rate risks to the banking system and the economy as a whole;

(2) increasing the kuna liquidity of the banking system to help maintain low interest rates and enable banks to continue with their lending activity; and

(3) supporting the stability of the government securities market through the purchase of government bonds in the secondary market, thus creating the additional liquidity needed to normalise the functioning of that segment of the financial market and enabling the government, and, consequently, other economic sectors to

continue to acquire funds under acceptable conditions.

From 9 March to the beginning of July, the CNB placed EUR 2.7bn of foreign exchange to banks via foreign exchange interventions and bilateral foreign exchange transactions, which amounts to 5.7% of GDP. Furthermore, over the same period, it injected HRK 29.1bn (8% of GDP) of kuna liquidity into the financial system using other measures. Since a part of kuna funds was withdrawn from banks through the sale of foreign exchange to banks, observed in total, monetary policy action resulted in a net increase of HRK 8.4bn in kuna liquidity, which amounts to 2.3% of GDP. An overview of all monetary policy measures taken since the beginning of March to the beginning of July and their financial effect are shown in Table 1.

Despite strong interventions during the crisis caused by the coronavirus pandemic, the Croatian National Bank still has at its disposal sufficient funds to respond to any future disruptions on the financial markets. According to end-of-June data, the CNB has EUR 17.3bn of gross reserves, or EUR 16.6bn of net usable reserves at its disposal, which is an adequate level of reserves by any usual standard³⁰. It is further necessary to note that CNB entered a swap line agreement with the European Central Bank, which, should such a need arise, provides for the exchange of the kuna for the euro in the amount of EUR 2bn. Finally, according to data as at the end of May, credit institutions also have at their disposal over EUR 6bn of foreign assets which may be withdrawn from abroad if needed, while their free kuna reserves, i.e. kuna liquidity surpluses stand at very high levels as well (HRK 38.1bn at the beginning of July). Considering the above, monetary policy still has room for manoeuvre and instruments at its disposal to continue to meet its objectives of maintaining exchange rate stability and securing favourable financing conditions for domestic sectors.

Table 1 CNB monetary policy measures aimed at alleviating the negative consequences of the pandemic

| Objectives | Measures | Effect on foreign exchange liquidity (in EUR million) | Effect on kuna liquidity (in HRK million) | Effect on kuna liquidity (as % of GDP) |
|--|---|---|---|--|
| | Foreign exchange transactions | | | |
| Stabilising the exchange rate and ensuring foreign exchange liquidity | Sale of foreign exchange – interventions | 2,244 | -16,980 | -4.7 |
| | Sale of foreign exchange – bilateral transactions | 482 | -3,658 | -1.0 |
| | Foreign exchange transactions – total | 2,726 | -20,638 | -5.7 |
| | Other measures | | | |
| Ensuring kuna liquidity | Structural operations | | 3,800 | 1.0 |
| | – return | | -1,332 | -0.4 |
| | Regular operations | | 7,780 | 2.1 |
| | – return | | -7,780 | -2.1 |
| | Reserve requirement reduction | | 6,336 | 1.7 |
| Supporting the stability of the government bond market | Government bond purchase | | 20,275 | 5.6 |
| | Other measures – total | | 29,079 | 8.0 |
| Net effect on kuna and foreign exchange liquidity | | 2,726 | 8,441 | 2.3 |

Notes: Data from 9 March to 1 July 2020. Negative values indicate liquidity withdrawal and positive values indicate liquidity creation. 'GDP' is the GDP forecast for 2020 according to the official projection of the CNB. 'Return' indicates early and regular repayments of structural and weekly loans.

Source: CNB.

30 For more details on the adequacy of international reserves, refer to the HNBlog post of Gorana Lukinić Čardić entitled „Does Croatia have sufficient international reserves?“, available in Croatian only. (<https://www.hnb.hr/-/ima-li-hrvatska-dovoljno-me-unarodnih-pricuva>).

10 Public finance

General government budget balance

After a budget surplus was recorded under the ESA methodology in 2017 and 2018, 2019 also saw a positive budget balance. The surplus increased slightly (from HRK 0.8bn in the preceding year to HRK 1.6bn, or 0.4% of GDP) as a result of a somewhat stronger growth of the budget revenue side than that of the expenditure side. In 2020, budget balance developments will be greatly affected by the coronavirus pandemic. The original budget plan for 2020 envisaged a positive budget balance of 0.2% of GDP, while the revised budget adopted in May 2020 anticipates a deficit of 6.8% of GDP.

A breakdown of the change in the nominal general government balance suggests that in 2019, the change in the nominal balance was somewhat positively affected by cyclical factors and developments in interest expenditures. However, the latter category did not see a strong positive effect similar to that recorded over the preceding several years due to a stagnation of interest

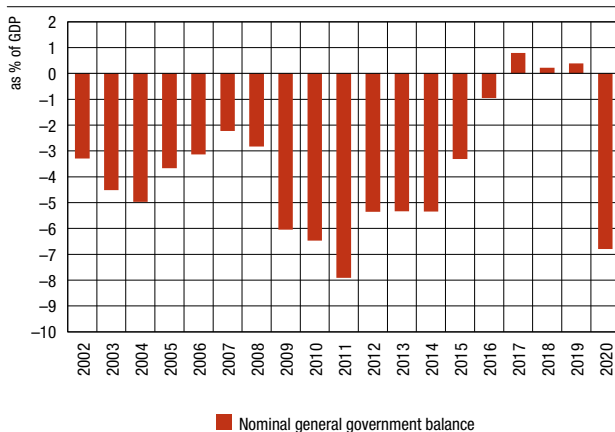
expenditures in 2019, measured by the share in GDP. The contribution of structural factors was neutral despite the slightly smaller amount of capital transfers in 2019 relative to 2018 due to the activation of government guarantees in the shipbuilding industry in the aforementioned years.

Considering the significant amount of anti-crisis measures and the strong deficit increase, fiscal policy will evidently be expansionary in 2020. However, a precise estimate of the cyclical component is difficult due to the uncertainty regarding the estimate of the output gap in 2020 resulting from the strong decline in economic activity brought about by the pandemic. The statistical treatment of certain fiscal measures is also not entirely clear yet, i.e. it remains to be seen which fiscal measures will be treated as one-off and temporary and which as structural, and to what extent. Interest expenditures should be lower owing to more favourable conditions for the refinancing of liabilities that previously fell due.

The annual growth in total general government revenues increased from 5.4% in 2018 to 6.7%. Such developments primarily reflect the significantly accelerated growth in the category of other revenues and mainly refer to the uptake of EU funds. Revenues from direct taxes grew at the same pace as in the preceding year, reflecting the improved business performance of economic entities and favourable labour market developments. Revenues from indirect taxes grew at a slightly slower pace than in the year before, but the growth nevertheless remained strong, which may be attributed to the favourable developments in tourism and the continued growth in personal consumption; the same held true for revenues from social contributions.

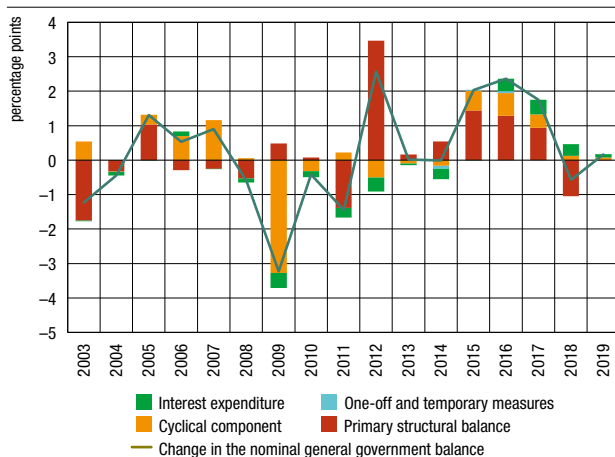
While the growth in revenues picked up, the annual growth in total expenditures decreased slightly from 6.7% in 2018 to 6.3% in 2019. Broken down by categories, as in the preceding year, the most significant rise (27.6%) was recorded in investments, while expenditures for intermediary consumption, employee compensation and social benefits increased noticeably as well. Stronger investment activity of the government and public enterprises included in the general government sector is based on the more vigorous utilisation of EU funds. The increase in expenditures for employee compensation is a result of the increase

Figure 10.1 General government deficit (ESA 2010)



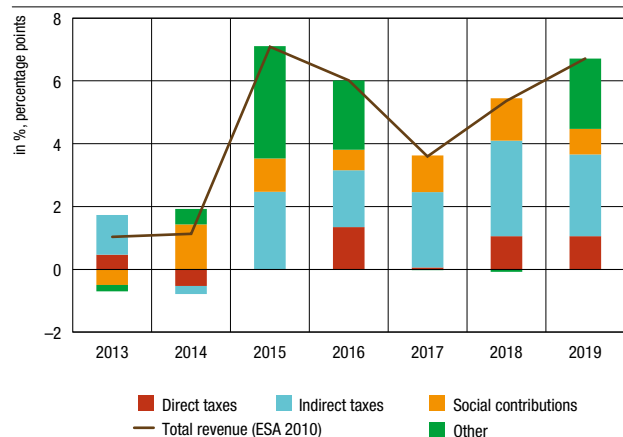
Source: Eurostat.

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



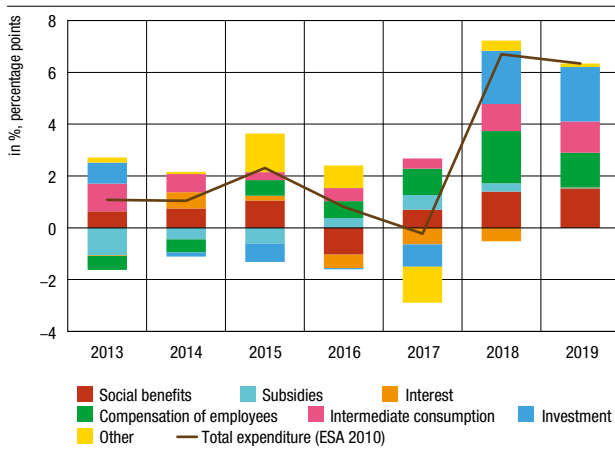
Source: CNB.

Figure 10.3 Consolidated general government revenues ESA 2010, year-on-year rate of change and contributions



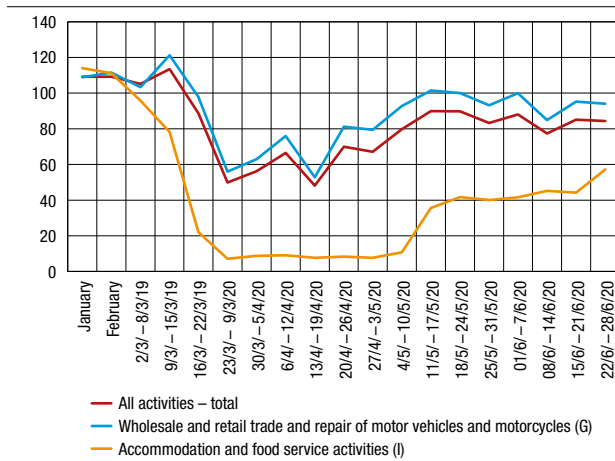
Source: Eurostat (CNB calculations).

Figure 10.4 Consolidated general government expenditure
ESA 2010, year-on-year rate of change and contributions



Source: Eurostat (CNB calculations).

Figure 10.5 Index of the amount of fiscalised receipts
relative to the comparable period in the preceding year



Sources: MoF and Tax Administration (CNB calculations).

in the wage calculation base for civil servants and government employees and of the increase arising from changes in the collective agreements of employees in health care, education, culture and social welfare. The rise in expenditures for intermediary consumption was a result of increased material expenses of hospital healthcare systems and methodological changes in the recording of the programme financing of public institutions of higher education and public scientific institutes. On the other hand, the growth in subsidies and other expenditures slowed down significantly in 2019 relative to the year before, mostly as a result of a decrease in capital transfers linked to the activation of guarantees issued to shipyards.

As regards the developments in budget revenues and expenditures in 2020, according to MoF data³¹, from January to April 2020, a negative central government budget balance of HRK

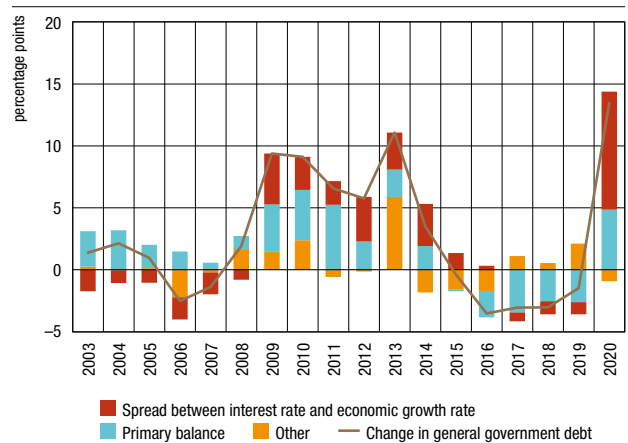
31 Monthly data for the central government, state government and social security sub-sectors which are required, under Council Directive 2011/85/EU, to be published before the end of the following month. The published data refer to general government units according to the scope of ESA 2010 statistical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

13.6bn was recorded, which is a fall of HRK 14.1bn from the same period in 2019, caused by a substantial increase in expenditures and a concurrent decrease in revenues. Of the total amount of the deficit recorded in the first five months, HRK 9bn is attributable to the deficit recorded in April and May 2020. Such developments were brought about by the slowdown in economic activity caused by the deterioration in the epidemiological situation, the epidemiological measures taken to prevent the spread of the pandemic and the fiscal measures adopted to alleviate the effect of the economic crisis. Available data from the fiscalisation system suggest that certain economic activities recovered partially in May; however, total activity is still significantly below the levels recorded in 2019.

Public debt

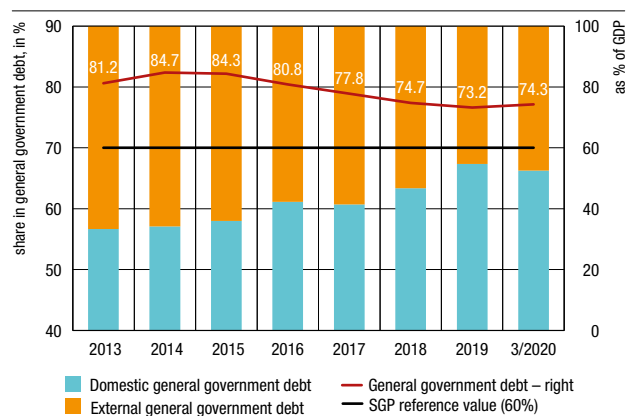
Economic growth and general government budget surplus resulted in the decrease of the public debt-to-GDP ratio from 74.7% at the end of 2018 to 73.2% at the end of 2019. The favourable effect of the primary surplus and the positive difference between the rate of economic growth and the interest rate was partly offset by the slight depreciation of the kuna and the

Figure 10.6 Decomposition of the change in general government debt



Sources: Eurostat and MoF (CNB calculations).

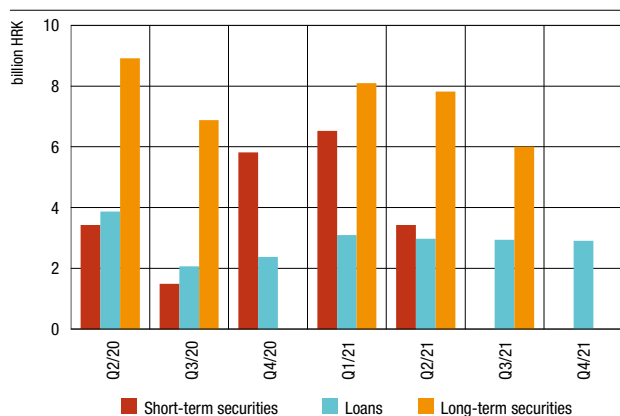
Figure 10.7 General government debt
stock, end of period



Note: Nominal GDP calculated as the sum of GDP for the first quarter of 2020 and the preceding three quarters was used to calculate the relative indicator as at the end of March 2020.

Source: CNB.

Figure 10.8 General government debt maturity



Note: Projection of the repayment of short-term and long-term securities is based on the balances as at 12 June 2020 and projection of the repayment of loans on the balance as at 31 March 2020.

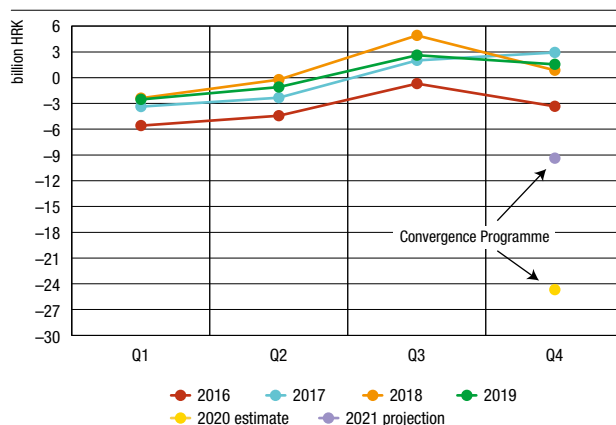
Sources: MoF and CNB.

accumulation of government deposits. In 2020, public debt increased to HRK 299.2bn by the end of March, having gone up by HRK 5.9bn from the end of 2019. Under the revised budget, the public debt-to-GDP ratio is expected to reach 86.7% of GDP in 2020 due to the borrowing needed to cover the budget deficit and the decrease in nominal GDP.

As regards borrowing, in late February 2020 the government issued, on the domestic market, three tranches of bonds worth almost HRK 15bn in total (five-year bonds maturing in 2025 with a nominal value of HRK 5bn, a second tranche of bonds indexed to the movement of the kuna/euro exchange, maturing in 2034, with a nominal value of HRK 4bn and twenty-year bonds maturing in 2040 with a nominal value of EUR 800m and a currency clause). The new issue of bonds maturing in 2025 was released with a yield-to-maturity of 0.37%, while the second tranche of bonds maturing in 2034 was issued with a yield-to-maturity of 1.12%. The bond with the historically longest maturity (2040) was issued with a yield-to-maturity of 1.28%. The maturity period for issued bonds was, for the first time, extended to 20 years, by which Croatia acquired funds for the longest term in its history. The aforementioned bond issues were used to refinance the two bonds with a total value of HRK 12.5bn maturing in March and to finance the government budget in general. Owing to the significantly more favourable borrowing conditions, interest savings resulting from the bonds issued could amount to HRK 716m on an annual basis.

The crisis caused by the pandemic has significantly increased the government's need for financing due to a sharp drop in revenues caused by unfavourable economic developments; additional funds will also be needed to finance economic measures to alleviate the crisis. In May, the government issued, on the domestic market, a seven-year bond worth EUR 1.445bn with a currency clause and a yield-to-maturity of 0.75%, favourable borrowing conditions despite the crisis. Furthermore, in June, the government borrowed EUR 2bn in the foreign capital market with a yield-at-issue of 1.64%. The issue was again favourable owing to the strong interest of investors, driven among other factors by Croatia's investment-grade credit rating. Collected funds

Figure 10.9 General government cumulative balance ESA 2010



Note: General government balance plan for 2020 and 2021 is taken from the Convergence Programme of the Republic of Croatia for 2020 and 2021.

Sources: Eurostat and MoF (CNB calculations).

will primarily be used to refinance the foreign bond worth USD 1.25bn maturing in mid-July, while the remaining funds will be used to finance measures implemented to alleviate the crisis.

Convergence Programme of the Republic of Croatia

According to this year's Convergence Programme, after the budget ran a surplus in 2019, the Government of the Republic of Croatia expects a general government budget deficit of 6.8% of GDP in 2020, after which the deficit could shrink considerably in 2021 (2.4% of GDP). The budget deficit in 2020 is a result of the projected drop in revenues due to unfavourable economic developments caused by the pandemic and the large fiscal stimulus package adopted to address the economic consequences of the crisis. Noteworthy among the anti-crisis measures are the measure enabling the deferred payment of public contributions (profit tax, income tax and social contributions) for enterprises experiencing a fall in revenues of more than 20%; the measure enabling the write-off of the same contributions for enterprises that have seen their revenues fall by more than 50% over the course of three months and a possible extension of that measure to six months; VAT payment deferral, whereby VAT is collected according to invoices settled, instead of invoices issued; and grants for wage expenses for companies that have recorded, due to operational difficulties, a fall in revenues of more than 20%, or 50% in June, in the amount of HRK 3,250 per employee in April and HRK 4,000 per employee in May and June.

In its spring forecast, the European Commission estimated that the 2020 general government balance in Croatia could be somewhat less favourable (-7.1% of GDP) than expected in the Convergence Programme of the Republic of Croatia (-6.8% of GDP) primarily due to the expected stronger effect of the fiscal stimulus package on the budget balance. It is necessary to note that, due to the pandemic, the European Commission temporarily suspended the application of fiscal rules set out in the Stability and Growth Pact (reducing public debt which exceeds 60% of GDP, limiting the general government deficit to 3% of GDP, and adhering to the medium-term budget target).

Box 6 Fiscal policy measures aimed at alleviating the negative consequences of the pandemic

In March and April, the Government of the Republic of Croatia adopted a package of fiscal policy measures worth 4.1% of GDP to address the negative consequences of the coronavirus pandemic. The package was upheld in the revised budget adopted by the Croatian Parliament in May. According to the estimates of the Croatian Ministry of Finance, published in the Convergence Programme of the Republic of Croatia for 2020 and 2021, the total cost of the measures related to job preservation grants in April, May and June will amount to some HRK 7.1bn (2.0% of the estimated GDP in 2020). Furthermore, the amount of deferred taxes and contributions falling due in April, May and June has been estimated to around HRK 4.6bn (around 1.3% of GDP), and the cost of write-off of taxes and contributions to HRK 2.5bn (or around 0.7% of GDP). Finally, the cost of the procurement of additional medical equipment amounts to some HRK 600m (around 0.2% of GDP). The effects of the aforementioned measures under the ESA methodology have been estimated to 2.8% of GDP, considering that revenues are recorded on an accrual basis. Deferred tax payments will not, therefore, reduce the amount of tax revenues recorded this year.

Fiscal policy measures implemented thus far in Croatia with the aim of alleviating the negative consequences of the coronavirus pandemic have had a direct effect on the developments in government budget revenues and expenditures. The Government of the Republic of Croatia is considering the extension of certain measures already implemented (under more stringent criteria) and the introduction of additional measures (subsidies for a shorter working week); however, as the specifics related to the implementation of these measures are still unknown, they were not included in this box.

Before highlighting the implemented measures it is necessary to note that fiscal measures adopted in Croatia are, by their characteristics, scope and intensity, mostly comparable to the measures adopted by the governments of other European Union member states³². In most countries, in addition to the increase in expenditures for the procurement of necessary medical equipment, the governments responded to the crisis with some form of stimulus or subsidies to pay out wages to workers employed in companies suffering the most severe consequences of the restrictive measures implemented. The goal was to prevent mass layoffs of workers amid collapsing economic flows, but also to accelerate the recovery of the economy following the abolition of restrictions. This was supported by experiences of certain countries following the global financial crisis, primarily Germany, which have shown that preventing layoffs and re-employment of workers has a positive impact on the speed of recovery once economic circumstances improve. In addition to job preservation measures, numerous governments, the Government of the Republic of Croatia included, introduced deferrals and/or write-offs of certain tax liabilities to improve the financial position and

liquidity of companies faced with sharply declining revenues due to the negative impact of restrictive measures on their output and/or demand for their products.

The Government of the Republic of Croatia reacted promptly and adopted the first package of measures addressing the crisis as early as on 17 March 2020, i. e. three weeks after the first patient infected with the virus had been registered in Croatia. Soon thereafter, on 2 April, the second package of measures was adopted, by which some of the measures included in the first package were adjusted and new ones introduced.

Government grants for job preservation may be highlighted as the most significant measure adopted by the Government of the Republic of Croatia (for more details on the measure, see Box 2 Analysis of the business entities that received Croatian government grants for job preservation). The measure envisages the subsidising of wage expenses in the amount of HRK 3,250 per employee in March (paid out in April) and HRK 4,000 for April and May. In addition, the costs of contributions for pension and health insurance of employees for whom grants were paid put will be borne by the government budget. According to the estimates of the Ministry of Finance published in the Convergence Programme of the Republic of Croatia for 2020 and 2021,³³ the cost of the aforementioned measure will amount to around HRK 7.1bn or around 2.0% of estimated GDP in 2020.

As for changes to tax regulations, the first package of measures allows business entities which experienced or estimated they would experience a decline in revenues greater than 20% to defer, free of interest, or pay in instalments their liabilities based on direct taxes and contributions. The measure was amended in the April package of economic measures so as to enable business entities with an annual turnover of up to HRK 7.5m (93% of all business entities) and a decline in revenues of over 50% to be fully exempt from paying public contributions (direct taxes and contributions) falling due in April, May and June 2020. Over the same period, business entities generating an annual turnover higher than HRK 7.5m and experiencing a fall in revenues of over 50% will be partially exempt from paying the contributions referred to above in proportion to the decrease in their revenues. According to the estimates of the Ministry of Finance published in the Convergence Programme, the total amount of deferrals and write-offs of tax liabilities for 2020 amounts to some HRK 7.1bn (around 2.0% of estimated GDP in 2020). Of this sum, the amount of deferred taxes and contributions is estimated at around HRK 4.6bn (around 1.3% of GDP) and the cost of write-offs of taxes and contributions to some HRK 2.5bn (or around 0.7% of GDP).³⁴

Finally, the estimated cost of the procurement of medical and protective equipment to fight the coronavirus pandemic amounts to around HRK 600m or around 0.2% of GDP according to the Convergence Programme.

32 Detailed overviews of fiscal and other measures implemented by individual countries may be found on the websites of IMF, OECD, while the same information for European countries may be found on the websites of the European Commission, the Network of EU IFIs, some audit firms, think tanks, etc. By comparing the list of measures, one may notice that the information included therein are continuously changing, which is why there is no definitive list and source of all measures implemented by individual countries. Furthermore, different overviews contain varying information related to the overall effect of implemented measures, depending on whether the effect is estimated on a gross or net basis, whether financial guarantees are included in full or realised amount, etc. See, for example:

<https://www.oecd.org/coronavirus/en/policy-responses>;

https://ec.europa.eu/info/sites/info/files/coronavirus_policy_measures_14_may.pdf;

<https://www.euifis.eu/eng/fiscal/266/june-2020-update-of-the-european-fiscal-monitor-on-the-fiscal-measure>;

<https://www2.deloitte.com/ro/en/pages/business-continuity/articles/EU-countries-measures-on-COVID-19-under-magnifying-glass.html>

33 Available at: <https://vlada.gov.hr/UserDocsImages/2016/Sjednice/2020/Travanj/227%20sjednica%20VRH/Novi%20direktorij/227%20-%202%20Program%20konvergencije%20Republike%20Hrvatske%20za%202020.%20i%202021.%20godinu.pdf>

34 To ensure additional liquidity of economic entities, the government also introduced the option of VAT payment upon the settlement of issued invoices; however, it seems that the majority of tax payers do not plan to use the aforementioned option.

Table 1 Fiscal policy measures aimed at alleviating the negative consequences of the pandemic

| The most significant measures | Fiscal effect, in HRK million | Fiscal effect, as % of GDP |
|--|--|-------------------------------|
| 1 Job preservation grants | 7,112.8 | 2.0 |
| | Income tax | 450.0 |
| Deferral of direct taxes and contributions | Pension insurance contributions | 949.4 |
| | Health insurance contributions | 889.6 |
| | Profit tax | 350.6 |
| | Deferred payment of profit tax based on the annual calculation for 2019 as at 31 July 2020 | 2,000.0 |
| 2 Total deferrals | 4,639.6 | 1.3 |
| | Income tax | 450.0 |
| Write-off of direct taxes and contributions | Pension insurance contributions | 949.4 |
| | Health insurance contributions | 889.6 |
| | Profit tax | 233.7 |
| | | |
| 3 Total write-offs | 2,522.7 | 0.7 |
| 4 Procurement of medical and protective equipment to fight COVID-19 | 600.0 | 0.2 |
| TOTAL | 14,875.1 | 4.1 |
| Total excluding deferrals | 10,235.6 | 2.8 |

Note: 'GDP' is the projected GDP for 2020 according to the projection of the Ministry of Finance of the Republic of Croatia.

Sources: MoF and the Convergence Programme of the Republic of Croatia for 2020 and 2021.

Although the revised government budget envisages the same amount of expenditures as originally planned, significant re-allocations were performed to secure the funds necessary to finance the measures and activities needed to fight the pandemic and its consequences; therefore, these changes have no effect on the budget balance.³⁵

The effects of individual measures under the ESA methodology will deviate from the figures specified earlier. Eurostat has published draft methodological notes on the statistical implications of policy measures in the context of the Covid-19 crisis.³⁶ Accordingly, the Explanation of Amendments to the Government Budget for 2020 states that the projected effect of measures of write-off of direct taxes and contributions amounts to HRK 2.5bn (around 0.7% of GDP) at the government budget level, which corresponds to the estimates of write-off of public contributions specified in the Convergence Programme. Adding to that the

cost of measures for job preservation (around 2.0% of GDP) and the procurement of medical and protective equipment (around 0.2% of GDP), the total amount of measures is estimated to some 2.8% of GDP.

By applying the fiscal measures referred to above, Croatia acted in line with the recommendations of the European Commission and the activation of the general escape clause of the Stability and Growth Pact.

Specifically, the Commission recommended EU member states to take whatever measures necessary to effectively respond to the pandemic, preserve the economy and support the ensuing recovery. At the same time, it is necessary to bear in mind that once economic conditions allow, member states will have to continue to implement fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability.

11 Deviations from the previous projection

Since the outbreak of the coronavirus pandemic had a strong impact on expectations regarding economic growth, the projection of real developments in the international environment for 2020 is significantly less favourable than anticipated in the December projection cycle. The global economy is expected to contract by 3.0% this year, which is a downward revision of 6.4% percentage points from the December 2019 projection. The pandemic caused an almost fully synchronised economic shock on a global scale, so that both developed and emerging economies contributed to deteriorating expectations. In addition, expectations regarding the monetary policies of key central banks also changed. The range of the Fed's benchmark interest rate at

the end of 2020 is expected to be significantly lower than previously projected, considering that the Fed cut its benchmark interest rate range to the lowest level recorded since the beginning of the pandemic and no further changes are expected in its monetary policy until the end of 2021.

The strong global economic shock affected the expectations regarding economic activity in Croatia in 2020 as well, and as a result, they significantly deviate from the December 2019 projection. Real GDP could decrease by 9.7%, while a rise of 2.8% was previously expected. The most significant revision is linked to the exports of goods and services, which could see a sharp fall of 38.1%, whereas they were previously expected to grow by

³⁵ A reallocation of HRK 1.8bn was performed in early April, while the Amendments of the Government Budget of the Republic of Croatia for 2020 secure an additional HRK 4.9bn (HRK 1.6bn from EU funds). Furthermore, HRK 100m has been set aside for the urgent, stage-one repair of family houses, residential and commercial buildings and multi-apartment buildings damaged in the earthquake that struck the city of Zagreb and its surroundings. To finance the measures specified above, funds have been set aside from the savings of ministries and other government bodies, in particular the Ministry of Finance, Ministry of Science and Education, Ministry of Defence and Ministry of the Interior.

³⁶ Available at: https://ec.europa.eu/eurostat/documents/10186/10693286/GFS_draft_note.pdf

Table 11.1 Basic assumptions, deviations from the previous projection

| | 2020 | | |
|--|----------------------------------|-----------------------|-----------|
| | Previous projection (12/2019) | Current projection | Deviation |
| GDP (real rate of change, in %) | | | |
| Rest of the world | 3.4 | -3.0 | -6.4 |
| Euro area | 1.4 | -7.5 | -8.9 |
| USA | 2.1 | -5.9 | -8.0 |
| Developing countries and emerging market countries | 4.6 | -1.0 | -5.6 |
| Central and Eastern European countries | 2.5 | -5.2 | -7.7 |
| Main trading partners of the Republic of Croatia | 1.9 | -4.9 | -6.8 |
| Prices | | | |
| Euro area HICP ^a | 1.1 | 0.3 | -0.8 |
| Oil prices (USD/barrel) ^b | 59.5 | 36.4 | -23.1 |
| Key interest rates | | | |
| EURIBOR 3M (end of year) ^c | -0.50 | -0.41 | 0.1 |
| ECB main refinancing rate ^c | 0.00 | 0.00 | 0.0 |
| US federal funds target rate ^c | 1.60 | 0.25 | -1.4 |

^a ECB, June 2020. ^b Bloomberg, Brent crude oil futures. ^c Bloomberg.
Source: IMF (WEO), April 2020.

3.3%. The aforementioned contraction of total exports primarily reflects the decrease in the exports of (tourist) services in the second and third quarter of the current year, but also the fall in the exports of goods due to global economic contraction and difficulties in cross-border operation as a result of the pandemic. Expectations regarding capital investments have also been revised downward significantly, with gross fixed capital formation likely to go down by 12.1%, while in the December 2019 projection, they were expected to grow by 7.1%. The considerable deviation in expectations mainly reflects the significantly less favourable projection of the investment activity of the private sector. Results of the survey on business expectations for the second quarter suggest that expectations deteriorated considerably across all activities. Business confidence began to deteriorate in March, while April saw the strongest deterioration on a monthly basis since the survey was introduced. May and June saw a slight improvement in business confidence, but this did not suffice to offset the fall recorded in March and April. Furthermore, the expected drop in personal consumption of 5.3% (versus the previously projected growth of 3.7%) is a result of the negative effect of the pandemic on the labour market, which is also evident from the consumer confidence survey, whose consumer confidence index plummeted in the second quarter. Finally, due to the fall in exports and the contraction of domestic demand, total imports are expected to decrease considerably at the entire 2020 level, by 30.8%, while according to the previous official projection, a rise of 5.3% was expected. Accordingly, the contribution of net foreign demand to GDP developments in 2020 is expected to be negative.

The projected average annual consumer price inflation of -0.1% in 2020 is 1.5 percentage points lower than that projected in December 2019. This is mainly a result of the significant decrease in the estimated average annual rate of change in the prices of energy (from 0.2% in the previous projection to -6.7% in the current one), which is primarily attributable to the significantly stronger annual drop in the prices of petroleum products. The previously expected annual rise in the consumer price index excluding food and energy has been revised downward as well (from 1.5% in the previous projection to 0.3% in the current

one), mainly due to the effect of lower demand on the prices of certain categories of services and consumer goods. In contrast, the estimated average annual growth in the prices of food products in 2020 has been increased (from 2.0% in the previous projection to 3.6% in the current one) as a result of the inclusion of expected effects of supply-side shocks linked with the outbreak of the coronavirus pandemic on the prices of food products and of the sharper rise in the prices of food products in December 2019 than the one expected in the previous projection.

As regards the external sector, the current projection anticipates a less favourable current and capital account balance in 2020 than the one expected in the previous projection as a result of a strong decrease in tourism revenues. The previous projection anticipated growth in tourism revenues, although it was expected to be slower than the one seen in the past several years. Unfavourable developments are alleviated by the concurrent narrower foreign goods trade deficit, considering that imports of goods are expected to contract faster than exports. The primary income account deficit is estimated to be less favourable than previously expected, bearing in mind that net revenues from compensation of residents temporarily employed abroad could be significantly lower than expected earlier, while lower expenditures on direct equity investment and the lower profitability of domestic banks and enterprises in foreign ownership act in the opposite direction. On the other hand, a more favourable balance of transactions with the EU budget is expected. As regards external debt, in contrast to the earlier projection, when relative indicators of gross external debt were expected to continue to improve, the current projection anticipates a temporary reversal of this trend, but only due to the sharp fall in nominal GDP.

The projected growth in placements (excluding the government) is expected to be somewhat lower in 2020 than earlier expected (3.7% versus 4.0% in the previous projection). Lending to households is expected to slow down under the influence of decelerated growth in general-purpose cash loans, while the rise in housing loans, driven by the continuation of the government's housing loans subsidy programme, could help maintain lending to households. At the same time, corporate lending could intensify, supported by measures aimed at alleviating the negative

Table 11.2 Domestic indicators, deviations from the previous projection

| | 2019 | | | 2020 | | |
|---|-------------------------------|---------|-----------|-------------------------------|--------------------|-----------|
| | Previous projection (12/2019) | Outturn | Deviation | Previous projection (12/2018) | Current projection | Deviation |
| National accounts (real rate of change, in %) | | | | | | |
| GDP | 3.0 | 2.9 | -0.1 | 2.8 | -9.7 | -12.5 |
| Personal consumption | 3.5 | 3.6 | 0.1 | 3.7 | -5.3 | -9.0 |
| Government consumption | 3.2 | 3.3 | 0.2 | 2.8 | 1.9 | -0.9 |
| Gross fixed capital formation | 8.2 | 7.1 | -1.1 | 7.1 | -12.1 | -19.2 |
| Exports of goods and services | 3.7 | 4.6 | 0.9 | 3.3 | -38.1 | -41.4 |
| Imports of goods and services | 5.3 | 4.8 | -0.5 | 5.3 | -30.8 | -36.1 |
| Labour market | | | | | | |
| Number of employed persons (average rate of change, in %) | 2.3 | 2.3 | 0.1 | 1.8 | -3.2 | -4.9 |
| Registered unemployment rate | 7.7 | 7.6 | -0.1 | 7.0 | 10.6 | 3.6 |
| ILO unemployment rate | 6.7 | 6.6 | 0.0 | 5.9 | 9.1 | 3.2 |
| Prices | | | | | | |
| Consumer price index (rate of change, in %) | 0.8 | 0.8 | 0.0 | 1.4 | -0.1 | -1.5 |
| External sector | | | | | | |
| Current account balance (as % of GDP) | 1.9 | 2.8 | 0.9 | 1.2 | -0.4 | -1.6 |
| Current and capital account balance (as % of GDP) | 3.9 | 4.8 | 0.9 | 3.2 | 2.0 | -1.2 |
| Gross external debt (as % of GDP) | 75.7 | 75.7 | 0.1 | 70.6 | 81.7 | 11.1 |
| Monetary developments (rate of change, in %) | | | | | | |
| Total liquid assets – M4 | 4.0 | 2.9 | -1.2 | 4.5 | 8.1 | 3.6 |
| Total liquid assets – M4 ^a | 4.6 | 3.5 | -1.1 | 4.6 | 6.5 | 1.9 |
| Credit institution placements | 2.0 | 2.8 | 0.8 | 3.6 | 4.8 | 1.2 |
| Credit institution placements ^b | 3.1 | 4.2 | 1.1 | 4.0 | 3.7 | -0.4 |

^a Indicators of monetary developments exclude the effect of repo loans. ^b Rates of change are calculated on the basis of data on transactions.

Source: CNB.

consequences of the pandemic, which could allow companies to finance working capital under more favourable conditions.

The growth in total liquid assets (M4) in 2020 is projected at 6.5% and has been revised upward from the earlier projection, which expected the growth to be 4.6% (transaction-based); this is mainly attributable to the surge in foreign exchange deposits

in March. The rise was mainly driven by concern over a possible significant depreciation of the kuna amid the uncertainty regarding the economic consequences of the pandemic; kuna deposits thus decreased and assets were being vigorously withdrawn from open-ended investment 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 | |
|---|-------------|------------|-----------------------|------------|-------------------------------|------------|-------------------------------|-------------|-------------------------------|-------------|-----------------------|------|-----------------|------------|
| | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 | 2020 | 2021 |
| Croatian National Bank (June 2020) | -9.7 | 6.2 | -5.3 | 4.6 | -12.1 | 6.8 | -38.1 | 44.5 | -30.8 | 36.5 | - | - | -0.1 | 0.7 |
| Eastern Europe Consensus Forecasts (June 2020) | -8.0 | 4.6 | -6.4 | 4.2 | -8.0 | 4.8 | - | - | - | - | -7.3 | 4.0 | 0.4 | 1.1 |
| European Bank for Reconstruction and Development (May 2020) | -7.0 | 6.0 | - | - | - | - | - | - | - | - | - | - | - | - |
| European Commission (May 2020) | -9.1 | 7.5 | -6.9 | 6.1 | -8.2 | 4.2 | -29.0 | 33.7 | -21.2 | 23.4 | - | - | 0.4 | 0.9 |
| International Monetary Fund (April 2020) | -9.0 | 4.9 | - | - | - | - | - | - | - | - | - | - | 1.3 | 1.2 |
| Raiffeisen Research* (June 2020) | -8.5 | 3.0 | - | - | - | - | -27.7 | 15.1 | -21.3 | 10.9 | -10.5 | 3.5 | 0.0 | 1.7 |
| Ministry of Finance (April 2020) | -9.4 | 6.1 | -7.0 | 5.8 | -9.0 | 5.6 | -30.0 | 32.5 | -23.4 | 27.6 | - | - | -0.3 | 0.9 |
| World Bank (June 2020) | -9.3 | 5.4 | - | - | - | - | - | - | - | - | - | - | - | - |

^a Rates of change in exports and imports of goods and services refer to the change in the nominal value.

Note: Projection of the Ministry of Finance was taken from the Convergence Programme of the Republic of Croatia for the period 2020-2021.

Sources: Publications of the respective institutions.

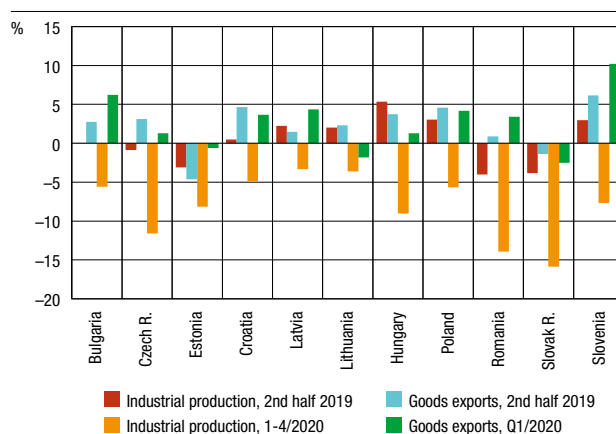
13 Annex B: Comparison of Croatia and selected countries

Table 13.1 Gross domestic product

| | Year-on-year rate of change, original data | | | Quarter-on-quarter rate of change, seasonally adjusted data | | | |
|----------------------------|--|------------|------------|---|------------|------------|-------------|
| | 2017 | 2018 | 2019 | Q2/19 | Q3/19 | Q4/19 | Q1/20 |
| Bulgaria | 3.5 | 3.1 | 3.4 | 0.7 | 0.7 | 0.8 | 0.3 |
| Czech R. | 4.4 | 2.8 | 2.6 | 0.5 | 0.4 | 0.5 | -3.3 |
| Estonia | 5.7 | 4.8 | 4.3 | 0.9 | 1.2 | 0.9 | -3.7 |
| Croatia | 3.1 | 2.7 | 2.9 | 0.6 | 0.6 | 0.4 | -1.2 |
| Latvia | 3.8 | 4.3 | 2.2 | 0.7 | 0.6 | 0.1 | -2.9 |
| Lithuania | 4.2 | 3.6 | 3.9 | 0.9 | 0.8 | 1.1 | -0.3 |
| Hungary | 4.3 | 5.1 | 4.9 | 0.8 | 0.9 | 0.7 | -0.4 |
| Poland | 4.9 | 5.3 | 4.1 | 0.7 | 1.2 | 0.2 | -0.4 |
| Romania | 7.1 | 4.4 | 4.1 | 0.6 | 0.5 | 1.2 | 0.3 |
| Slovak R. ^a | 3.0 | 3.9 | 2.4 | 0.4 | 0.4 | 0.6 | -5.2 |
| Slovenia | 4.8 | 4.1 | 2.4 | 0.0 | 0.8 | 0.4 | -4.5 |
| Average^b | 4.5 | 4.0 | 3.4 | 0.6 | 0.7 | 0.6 | -1.9 |

^a Simple average.

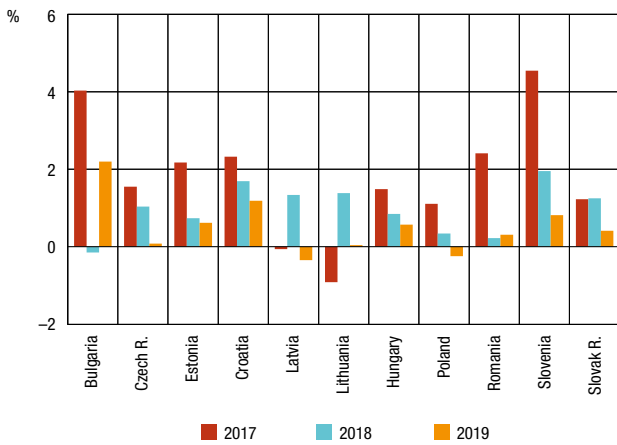
Sources: Eurostat, EC, CBS and CNB.

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


Note: Data on goods exports are available only for January 2020.

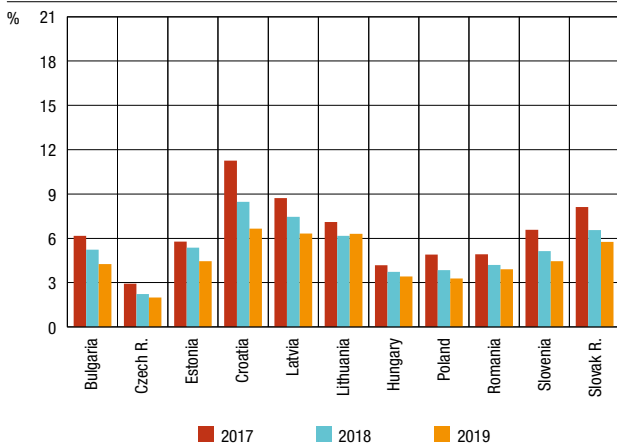
Sources: Eurostat and CBS.

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



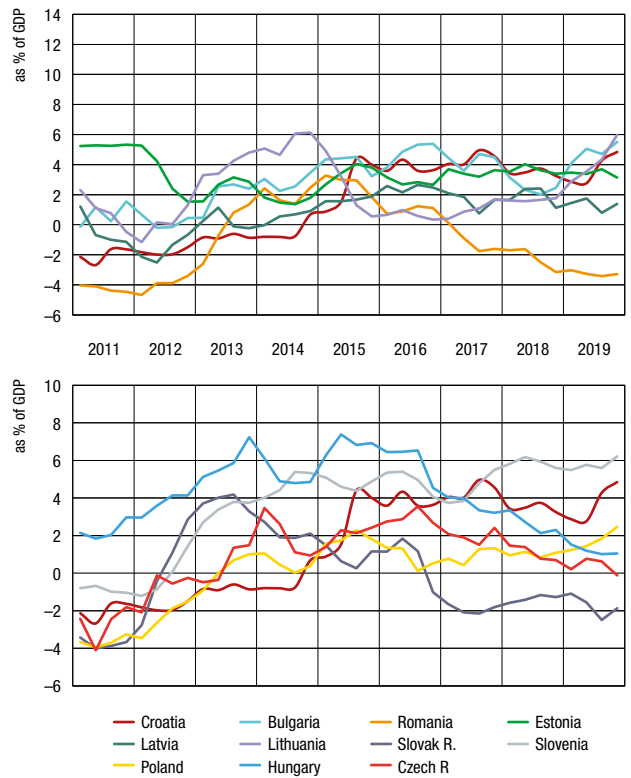
Source: Eurostat.

Figure 13.3 Labour Force Survey unemployment rate



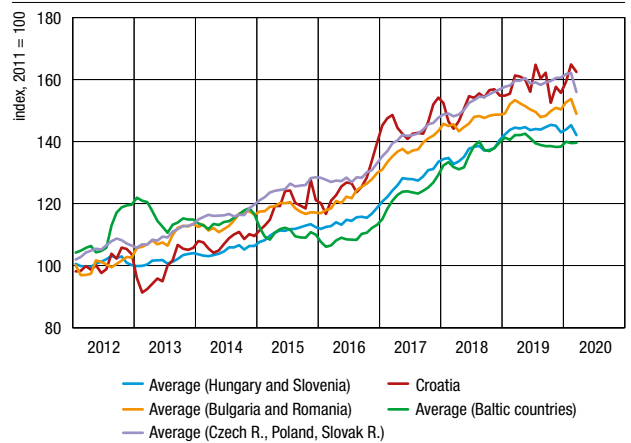
Source: Eurostat.

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



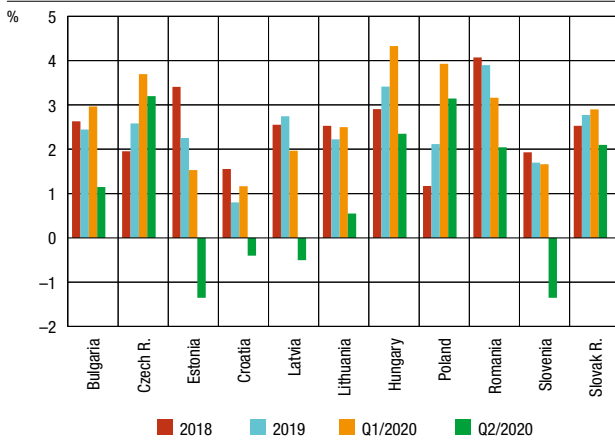
Sources: Eurostat and CNB.

Figure 13.5 Goods exports
quarterly moving average, seasonally adjusted data



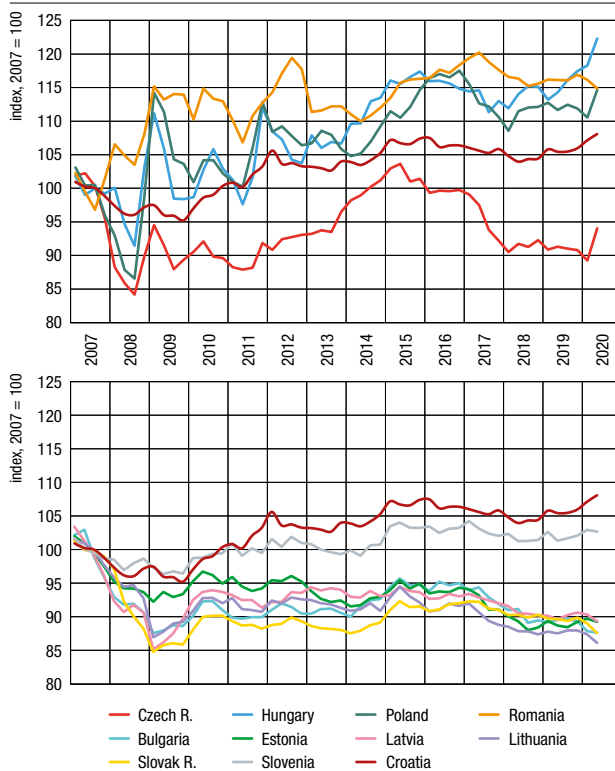
Sources: Eurostat and CNB.

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



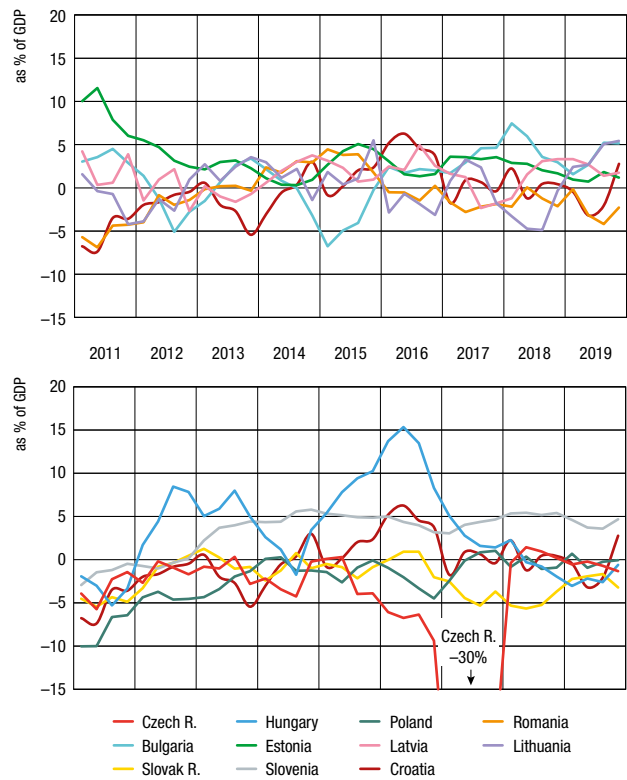
Note: Data for the second quarter of 2020 refer to April and May.
Source: Eurostat.

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



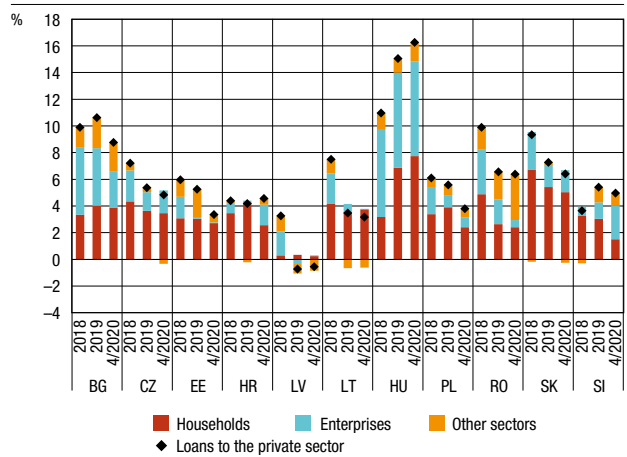
Notes: Data for 2020 refer to the January-May period. A fall in the index indicates a real effective appreciation.
Sources: BIS and CNB.

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



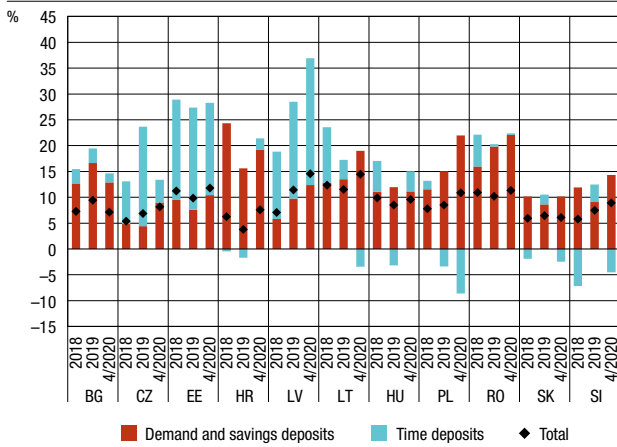
Sources: Eurostat and CNB.

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



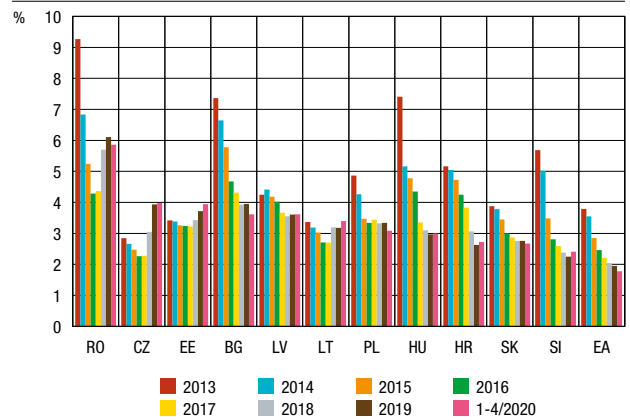
Sources: ECB and CNB.

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



Sources: ECB and CNB.

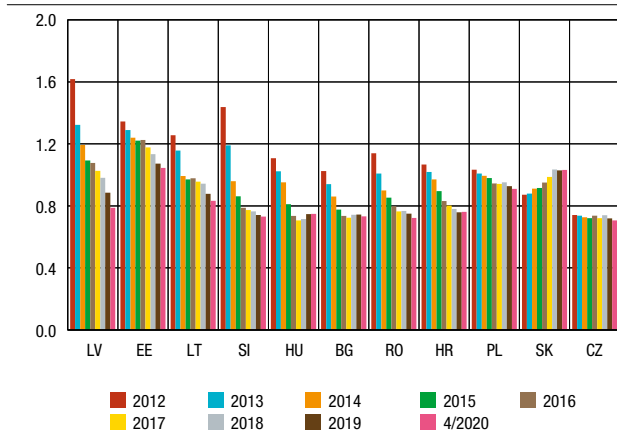
Figure 13.13 Short-term interest rates on corporate loans



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

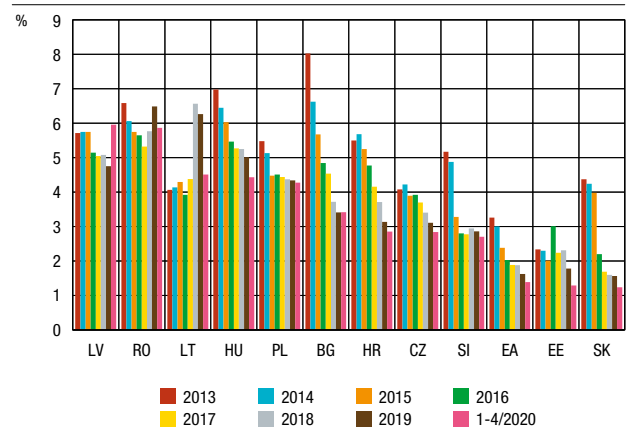
Source: ECB.

Figure 13.11 Placement to deposit ratio of the private sector



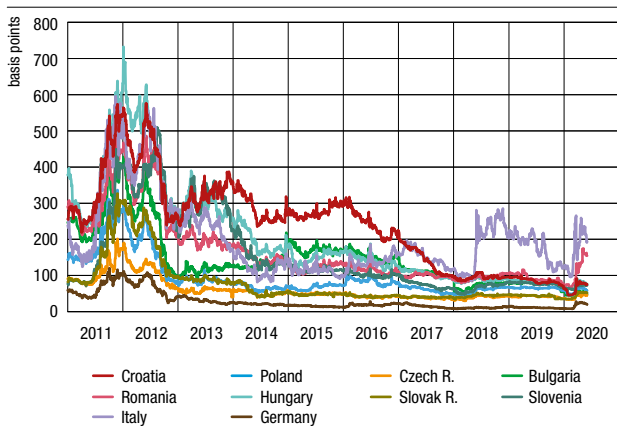
Sources: ECB and CNB.

Figure 13.14 Interest rates on housing loans



Sources: ECB and NCBS.

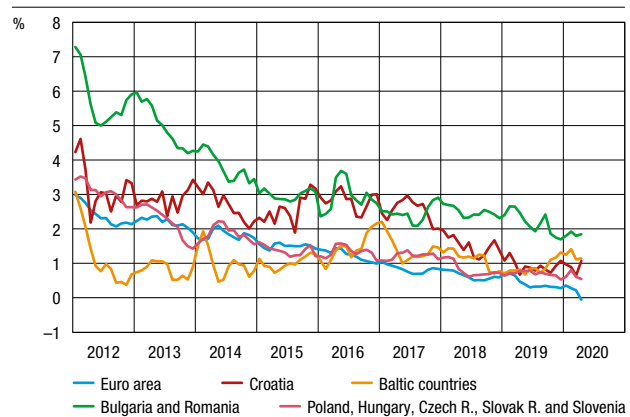
Figure 13.12 CDS spreads for 5-year government bonds of selected countries



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.

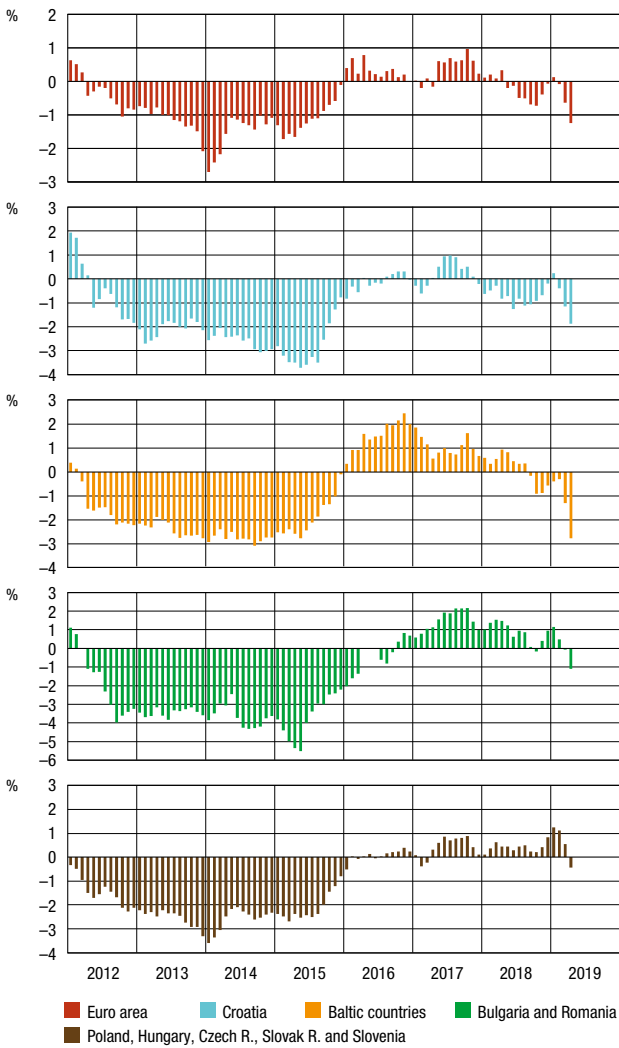
Figure 13.15 Expected real interest rate on corporate loans up to EUR 1m and with maturity up to 1 year



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.

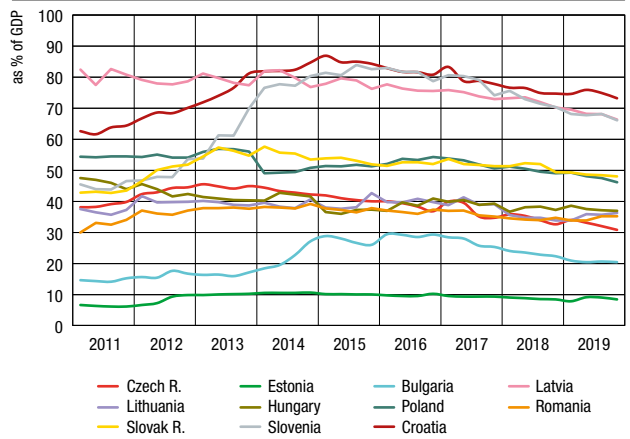
Sources: ECB and Consensus Forecasts.

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



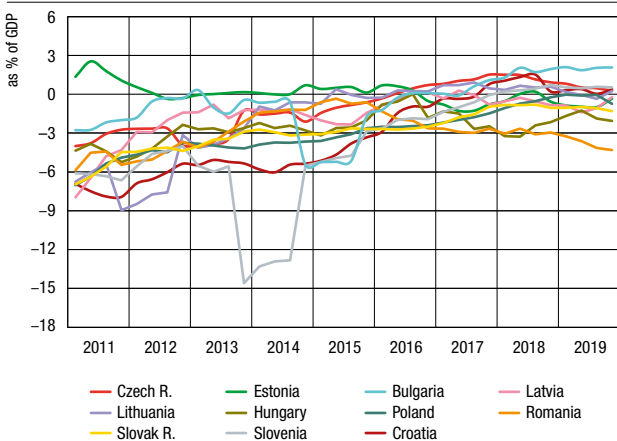
Notes: The expected real interest rate equals the nominal interest rate deflated by inflation projected for the next year from the Consensus Forecasts and the achieved real interest rate equals the nominal interest rate deflated by inflation achieved. Country group averages are not weighted.
Sources: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

Figure 13.18 General government debt end-quarter stock



Sources: Eurostat and CNB.

Figure 13.17 Consolidated general government balance four-quarter moving sums



Sources: Eurostat and CNB.

Abbreviations and symbols

Abbreviations

| | |
|--------|--|
| ARZ | – Rijeka-Zagreb Motorway |
| BIS | – Bank for International Settlements |
| bn | – billion |
| b.p. | – basis points |
| BEA | – U. S. Bureau of Economic Analysis |
| BOP | – balance of payments |
| c.i.f. | – cost, insurance and freight |
| CBRD | – Croatian Bank for Reconstruction and Development |
| CBS | – Central Bureau of Statistics |
| CCI | – consumer confidence index |
| CDCC | – Central Depository and Clearing Company Inc. |
| CDS | – credit default swap |
| CEE | – Central and Eastern European |
| CEFTA | – Central European Free Trade Agreement |
| CEI | – consumer expectations index |
| CES | – Croatian Employment Service |
| CHIF | – Croatian Health Insurance Fund |
| CM | – Croatian Motorways |
| CLVPS | – Croatian Large Value Payment System |
| CNB | – Croatian National Bank |
| CPF | – Croatian Privatisation Fund |
| CPI | – consumer price index |
| CPII | – Croatian Pension Insurance Institute |
| CR | – Croatian Roads |
| CSI | – consumer sentiment index |
| DAB | – State Agency for Deposit Insurance and Bank Resolution |
| dep. | – deposit |
| DVP | – delivery versus payment |
| EC | – European Commission |
| ECB | – European Central Bank |
| EFTA | – European Free Trade Association |
| EMU | – Economic and Monetary Union |
| ESI | – economic sentiment index |
| EU | – European Union |
| excl. | – excluding |
| f/c | – foreign currency |
| FDI | – foreign direct investment |
| Fed | – Federal Reserve System |
| FINA | – Financial Agency |
| FISIM | – financial intermediation services indirectly measured |
| f.o.b. | – free on board |
| GDP | – gross domestic product |
| GVA | – gross value added |
| HANFA | – Croatian Financial Services Supervisory Agency |
| HICP | – harmonised index of consumer prices |
| HUB | – Croatian Banking Association |
| ILO | – International Labour Organization |
| IMF | – International Monetary Fund |
| incl. | – including |
| IPO | – initial public offering |
| m | – million |
| MIGs | – main industrial groupings |
| MM | – monthly maturity |
| MoF | – Ministry of Finance |
| NA | – national accounts |
| NBS | – National Bureau of Statistics of China |
| NCA | – National Classification of Activities |
| NCB | – national central bank |
| NCS | – National Clearing System |
| n.e.c. | – not elsewhere classified |

| | |
|------|--|
| OECD | – Organisation for Economic Co-Operation and Development |
| OG | – Official Gazette |
| R | – Republic |
| o/w | – of which |
| PPI | – producer price index |
| RTGS | – Real-Time Gross Settlement |
| Q | – quarterly |
| RR | – reserve requirement |
| SDR | – special drawing rights |
| SE | – South-East |
| SITC | – Standard International Trade Classification |
| SGP | – Stability and Growth Pact |
| ULC | – unit labour cost |
| VAT | – value added tax |
| WTO | – World Trade Organization |
| ZMM | – Zagreb Money Market |
| ZSE | – Zagreb Stock Exchange |

Three-letter currency codes

| | |
|-----|--------------------------|
| ATS | – Austrian schilling |
| CHF | – Swiss franc |
| CNY | – Yuan Renminbi |
| DEM | – German mark |
| EUR | – euro |
| FRF | – French franc |
| GBP | – pound sterling |
| HRK | – Croatian kuna |
| ITL | – Italian lira |
| JPY | – Japanese yen |
| USD | – US dollar |
| XDR | – special drawing rights |

Two-letter country codes

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

Symbols

– – no entry
.... – data not available
0 – value is less than 0.5 of the unit of measure being used

∅ – average
a, b, c,... – indicates a note beneath the table and figure
* – corrected data
() – incomplete or insufficiently verified data

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