



CROATIAN NATIONAL BANK

Croatia – economic developments and outlook

Boris Vujčić

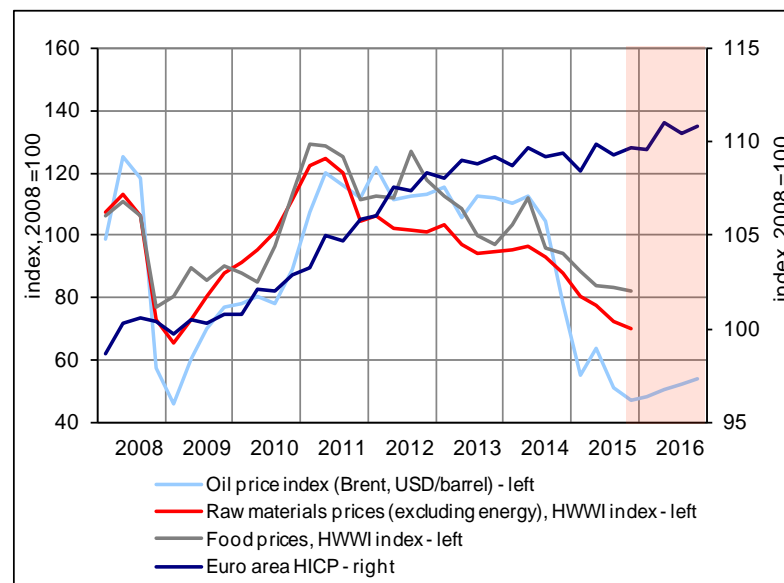
16 December 2015

International environment and raw material prices

	2014	2015		2016	
		Current projection	Δ Previous projection	Current projection	Δ Previous projection
GDP (real rates of change, in %)					
World	3.4	3.1	-0.3	3.6	-0.2
Euro area	0.9	1.5	0.0	1.6	0.0
Main trading partners of the RC	1.4	1.6	0.0	2.0	0.0
Italy	-0.4	0.8	0.3	1.3	0.2
Germany	1.6	1.5	-0.1	1.6	-0.1
Slovenia	3.0	2.3	0.2	1.8	-0.1
Austria	0.4	0.8	-0.1	1.6	0.0
Bosnia and Herzegovina	1.1	2.1	-0.3	3.0	-0.1
Serbia	-1.8	0.5	1.0	1.5	0.0
Real imports of trading partners ^a	3.8	3.0	0.3	4.5	0.1

Sources: IMF (World Economic Outlook, WEO), October 2015.

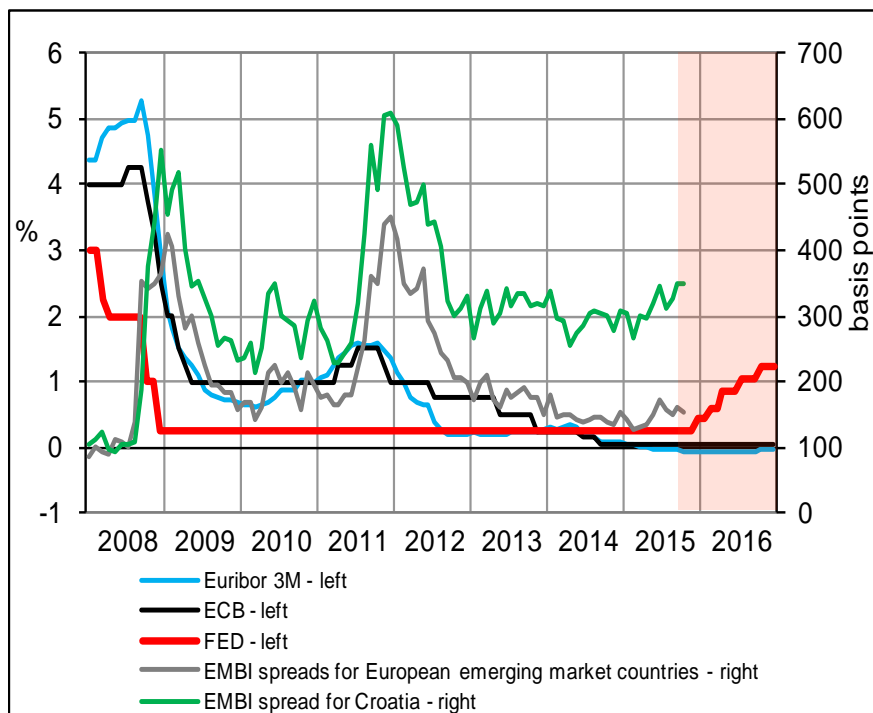
^a IMF (Global Economic Environment, GEE), June 2015.



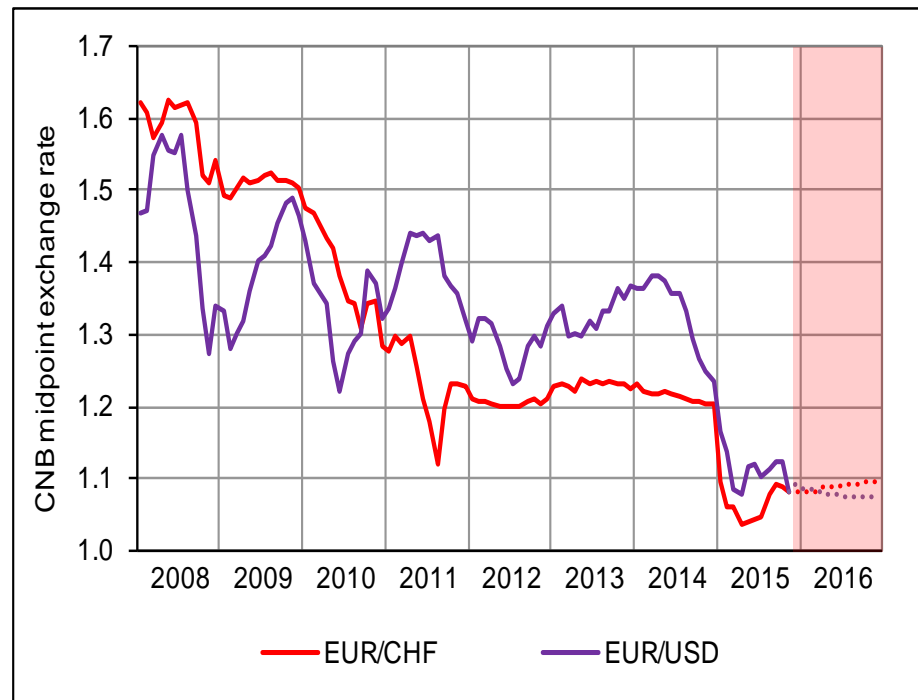
Note: Q4 2015 data refer to October.

Sources: Eurostat, HWWI, Bloomberg and ECB projections.

Benchmark interest rates and exchange rates

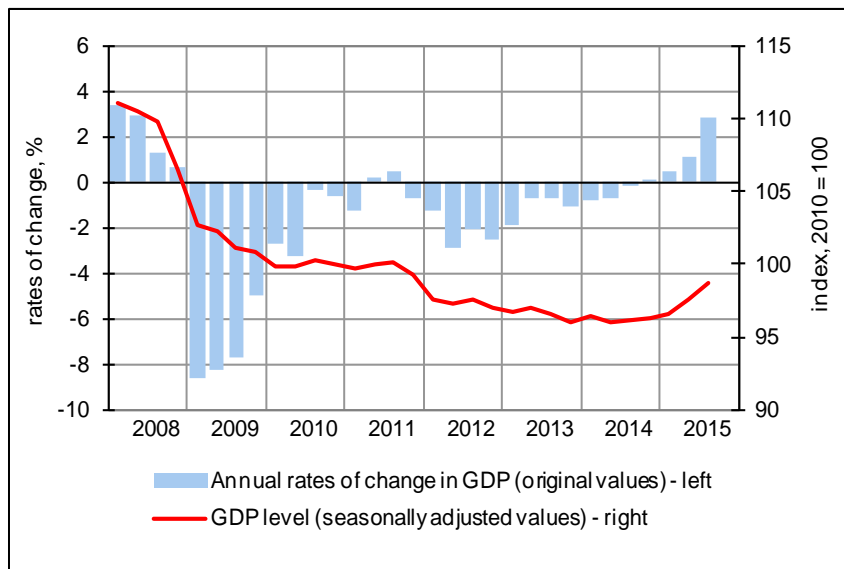


Source: Bloomberg, 17 November 2015.



Source: Projections of Foreign Exchange Consensus Forecasts (November 2015).

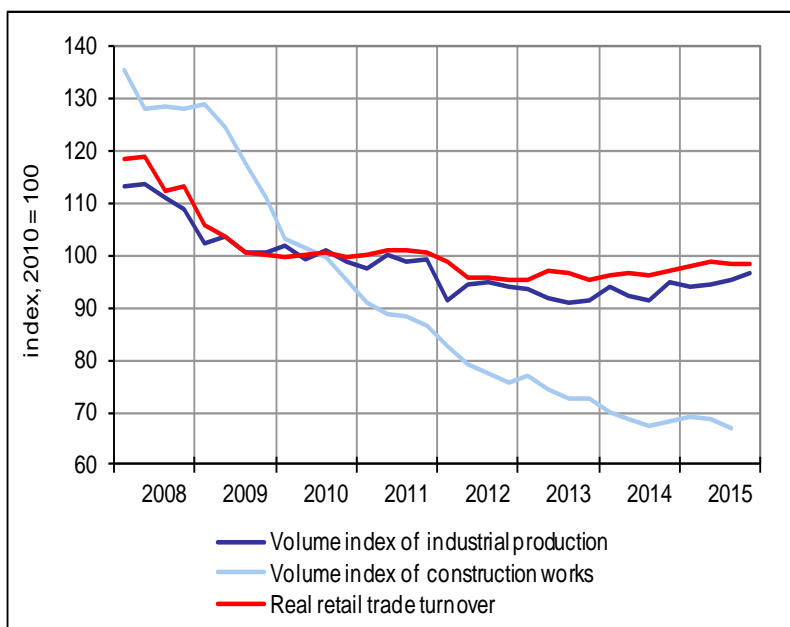
Unexpected sharp rise in economic activity in Q3



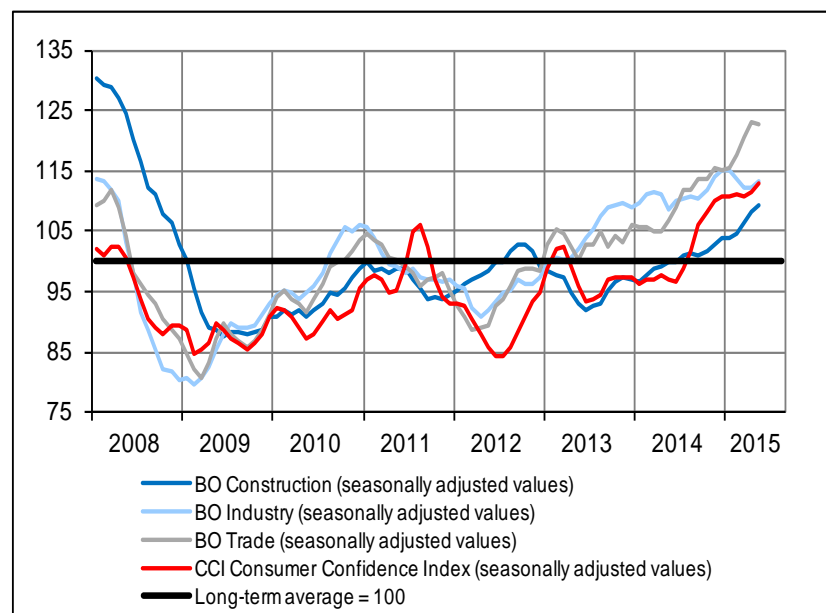
Sources: CBS; CNB (seasonal adjustment).

GDP is expected to grow at a relatively high annual rate in Q4

Short-term economic indicators



Indicators of business and consumer optimism

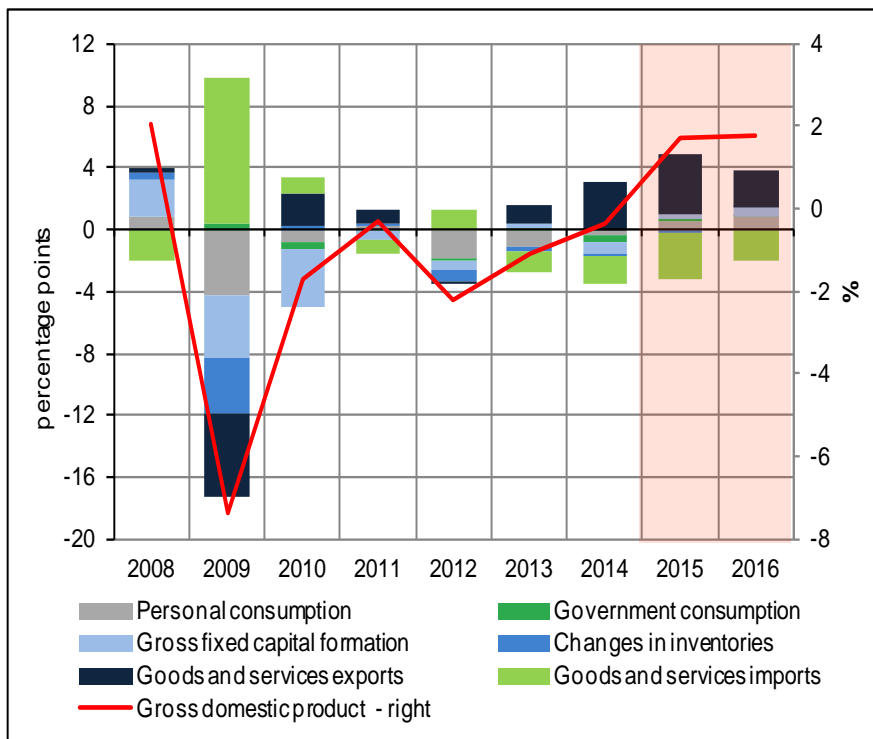


Note: Quarterly data are calculated as an average of monthly data. Q4 data for industry and trade refer to October.

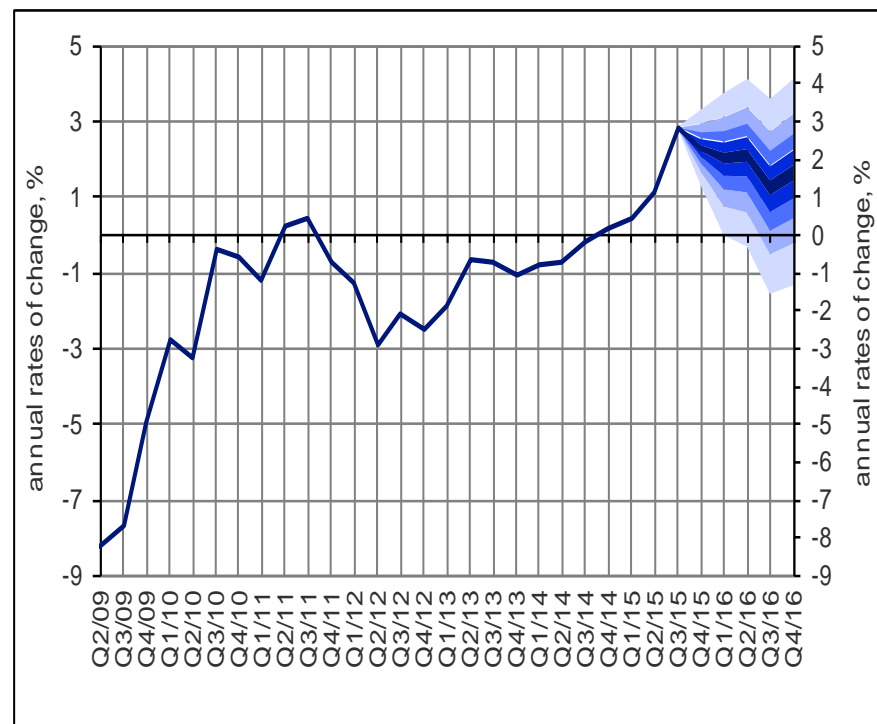
Sources: Eurostat, Ipsos and European Commission (seasonal adjustment).

Sources: Eurostat, Ipsos and CNB (seasonal adjustment).

Real growth assessment and projection: 1.7% in 2015 and 1.8% in 2016



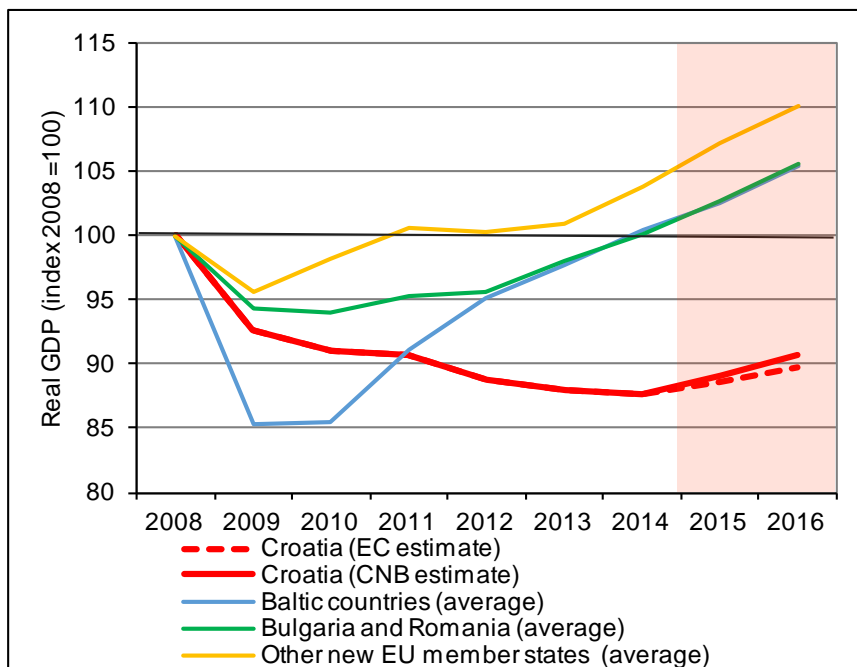
Sources: CBS and CNB.



Sources: CBS and CNB calculations.

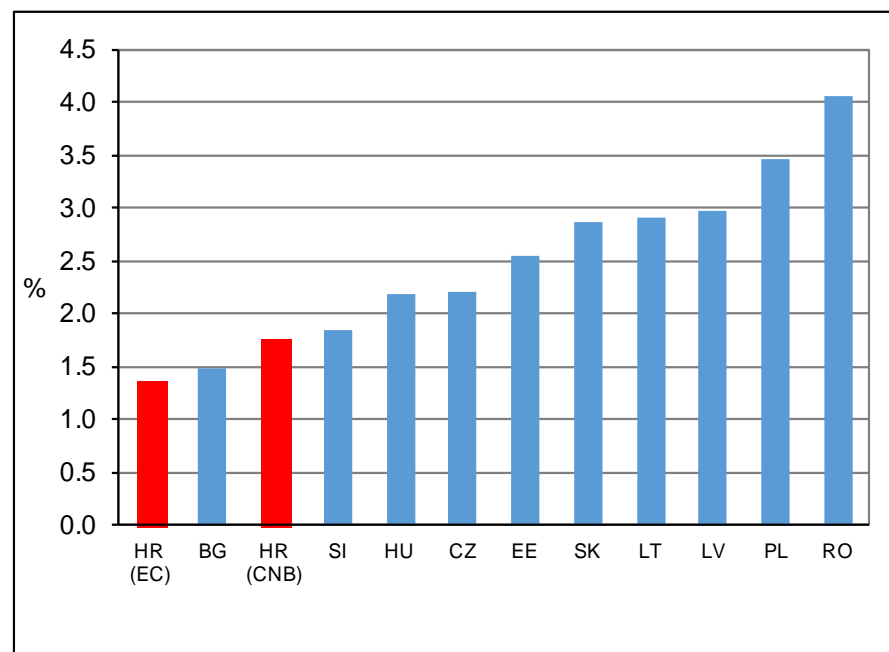
GDP growth projection for Croatia and peer countries in 2016

Real GDP trends in Croatia and peer countries



Sources: AMECO and CNB.

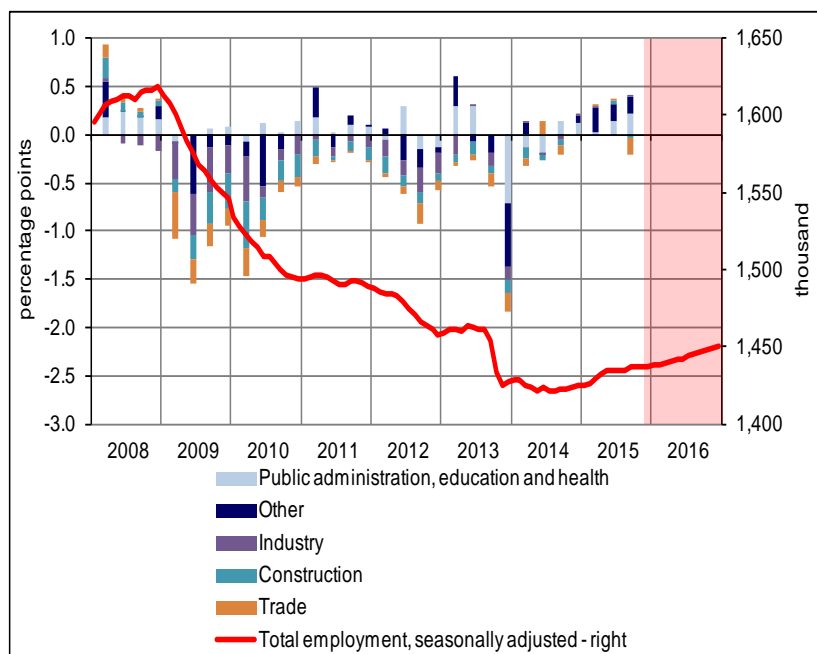
Real GDP trend projection for 2016



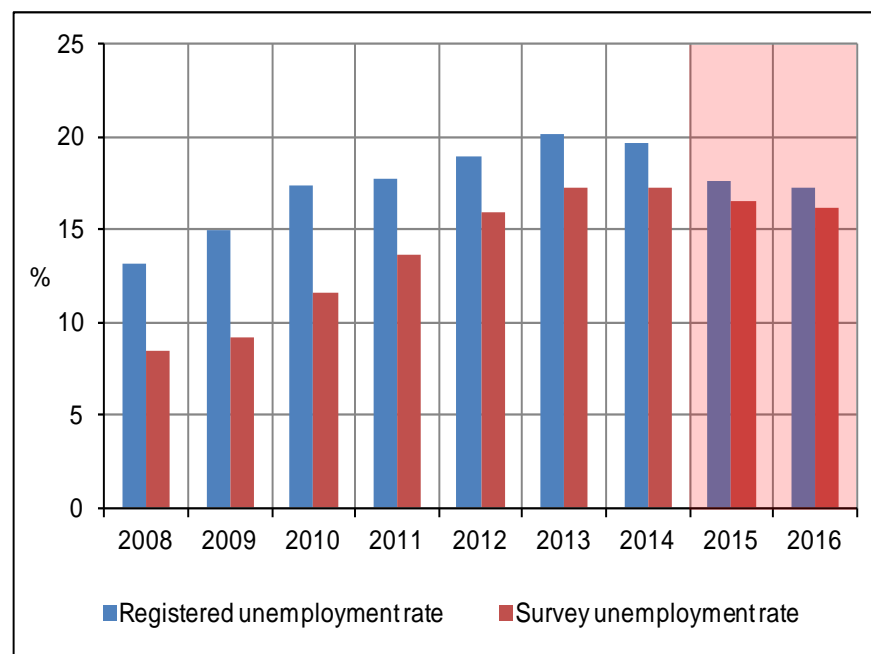
Sources: AMECO and CNB.

Recovery in real activity had a positive impact on the labour market

Total employment and contributions of individual sectors to the quarterly change in employment



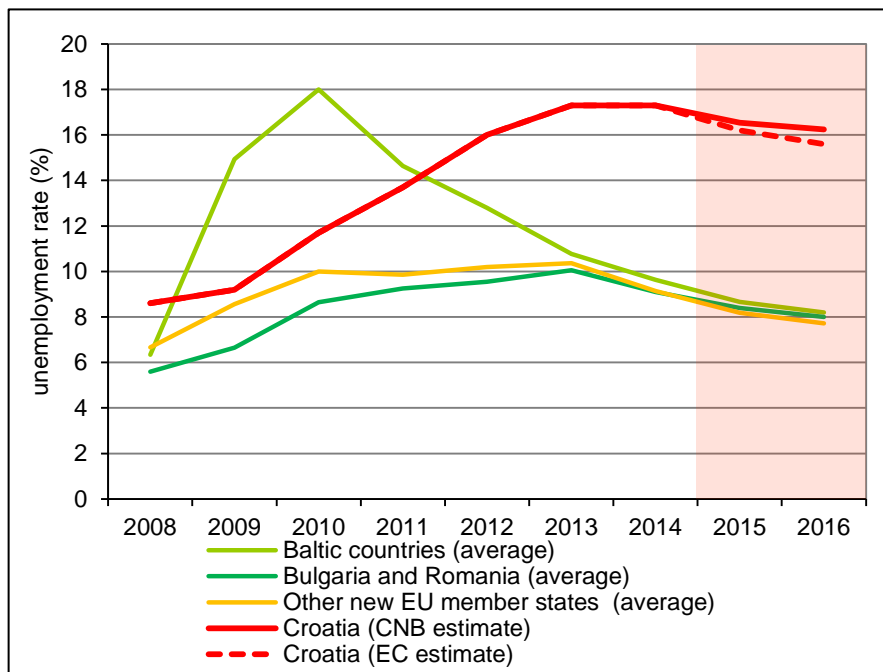
Registered and survey unemployment rates



Sources: CPII, CBS and CNB (seasonal adjustment).

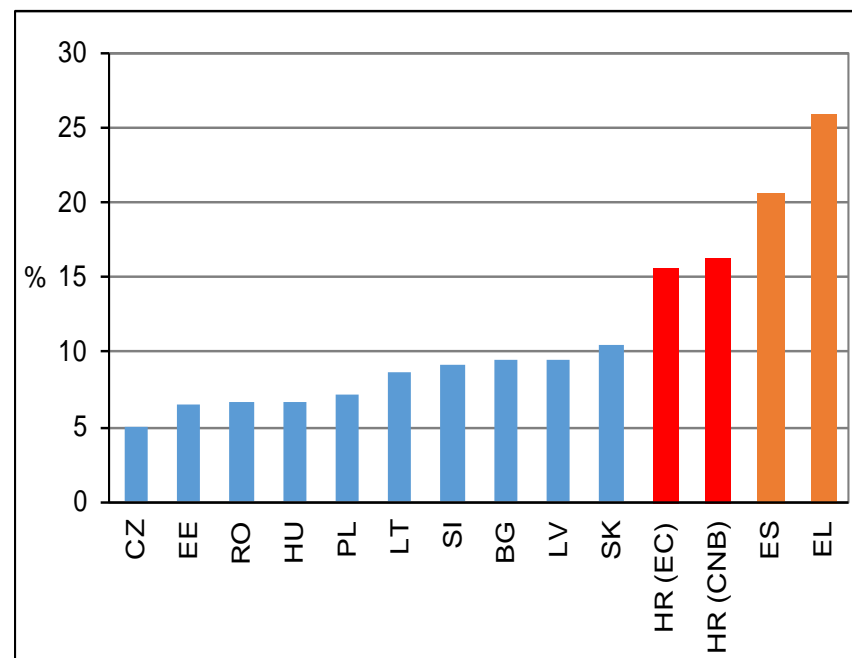
Croatia has the highest unemployment rate among peer countries

Unemployment rate – Croatia and peer countries



Sources: AMECO and CNB.

European Commission's unemployment rate projection for 2016



Sources: AMECO and CNB.

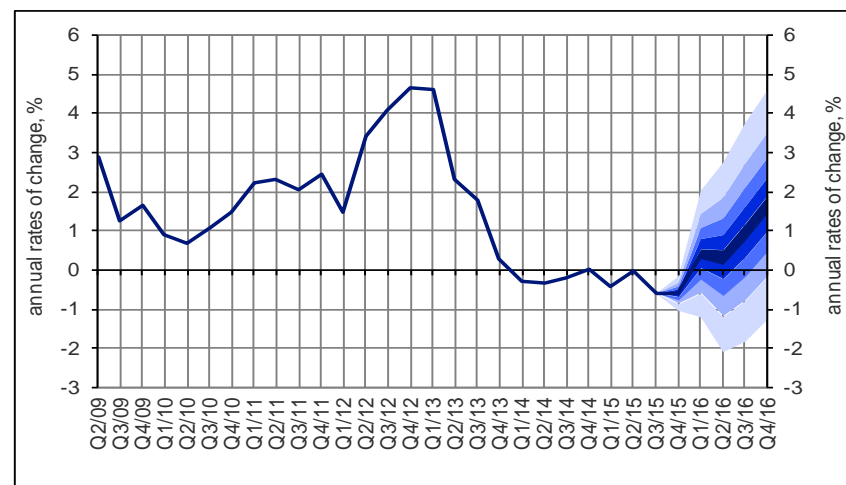
General price level to edge down by 0.4% in 2015 and inflation to rise to 0.9% in 2016

Price indicators

	2013	2014	6/2015	9/2015	10/2015
Consumer Price Index and its components					
Total index	2.2	-0.2	0.0	-0.8	-0.9
Energy	3.1	0.9	-3.0	-6.6	-7.3
Unprocessed food	3.8	-2.8	1.3	0.0	0.8
Processed food	4.9	0.2	0.8	0.6	0.9
Industrial non-food without energy	-0.4	-1.0	0.0	0.4	0.8
Services	0.8	0.8	1.0	1.0	0.1

Source: CBS.

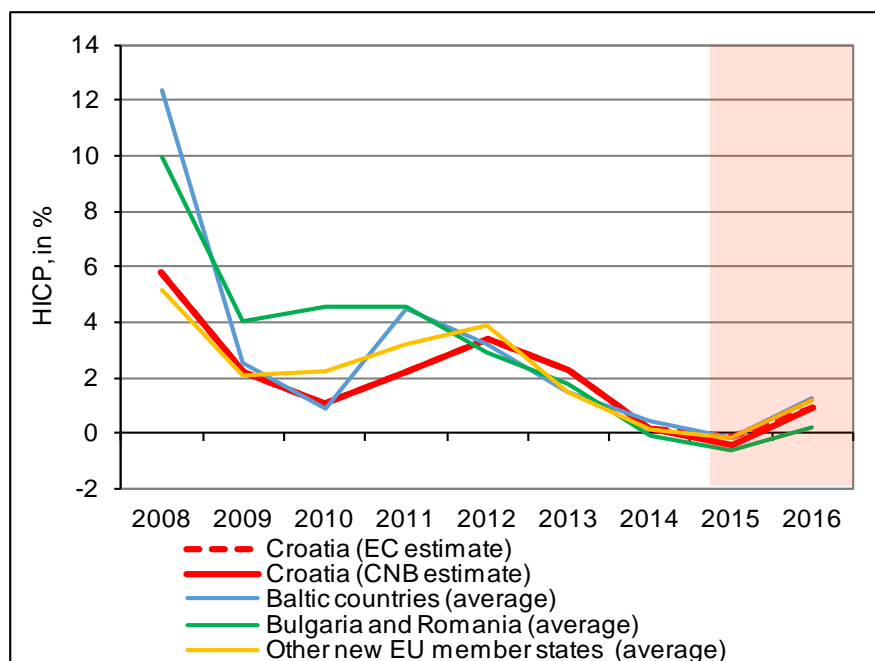
Inflation projection



Sources: CBS, CNB calculations.

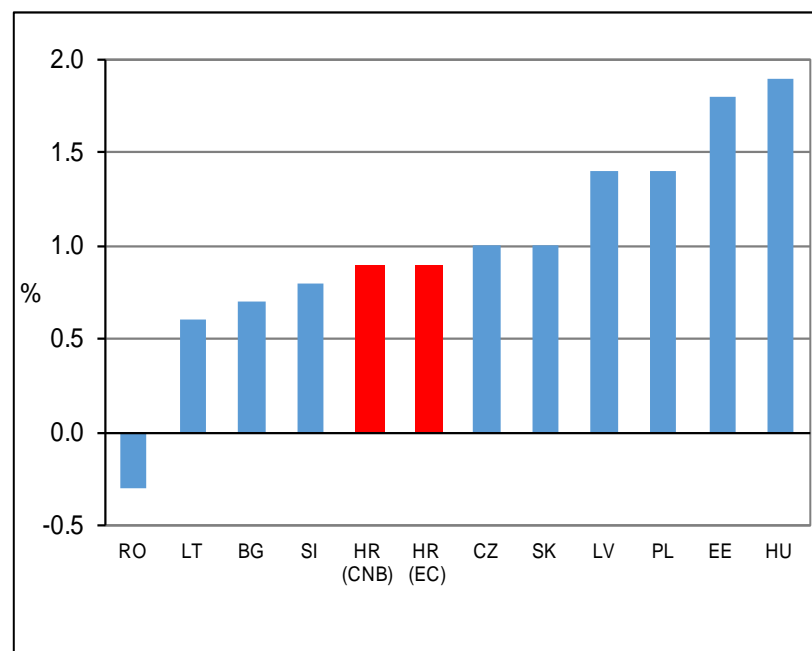
Inflation – a comparison

Inflation trends in Croatia and peer countries



Note: CNB estimate for 2015 and 2016 refers to CPI inflation.
Sources: Eurostat and CNB.

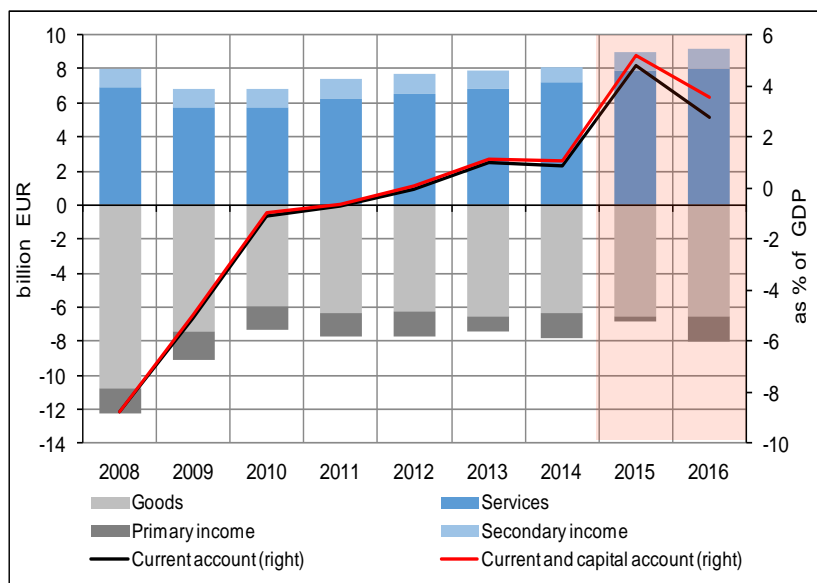
Average inflation rate projection for 2016 (HICP)



Note: CNB estimate for Croatia refers to CPI inflation.
Sources: Eurostat; CNB.

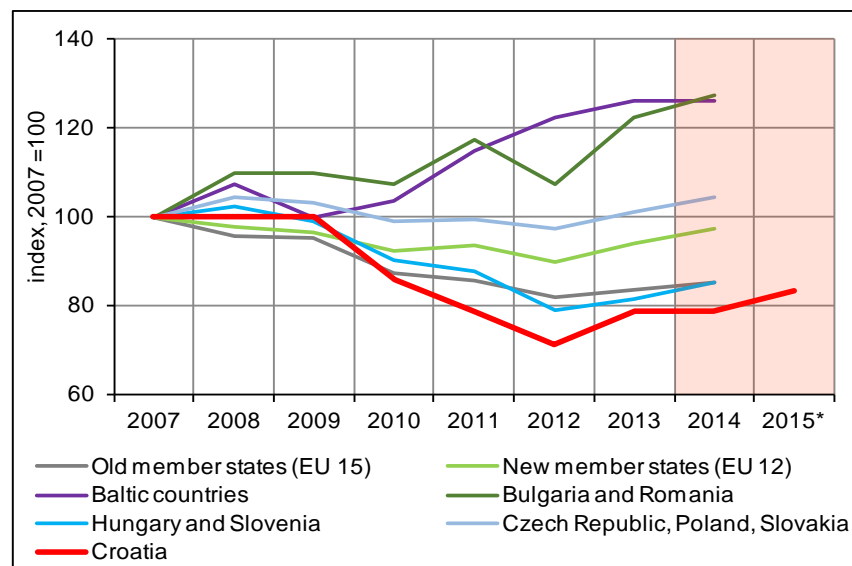
Current account surplus increased in 2015 primarily due to the conversion of CHF loans and tourism revenue growth

Structure of the current and capital account balance



Source: CNB.

Global market share of goods and services exports



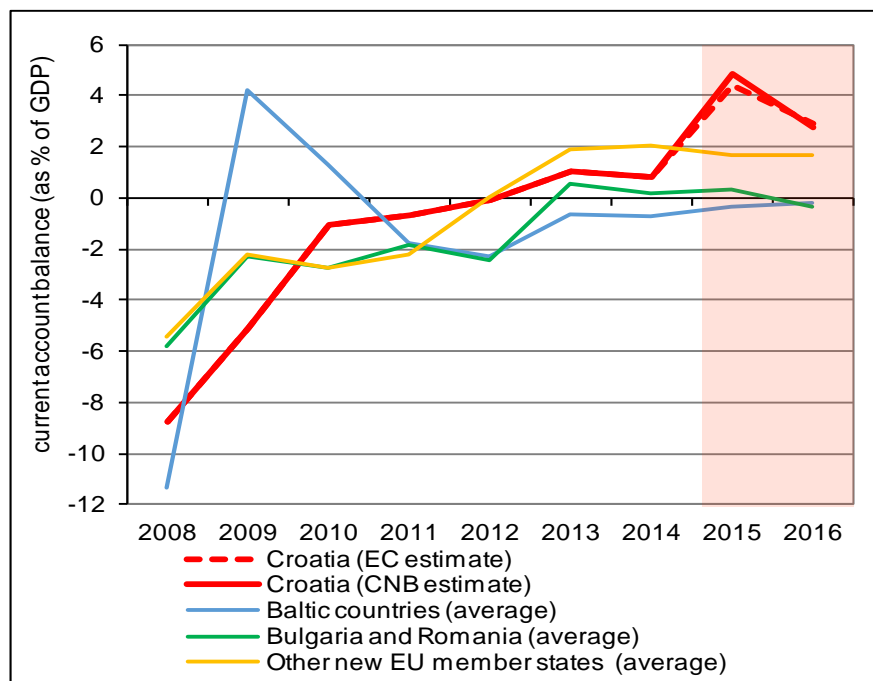
Note: Baltic countries include Estonia, Latvia and Lithuania.

* The assessment of Croatia's market share in 2015 is based on the IMF's projection of global trade growth in 2015 and the CNB's assessment of Croatia's goods and services export growth.

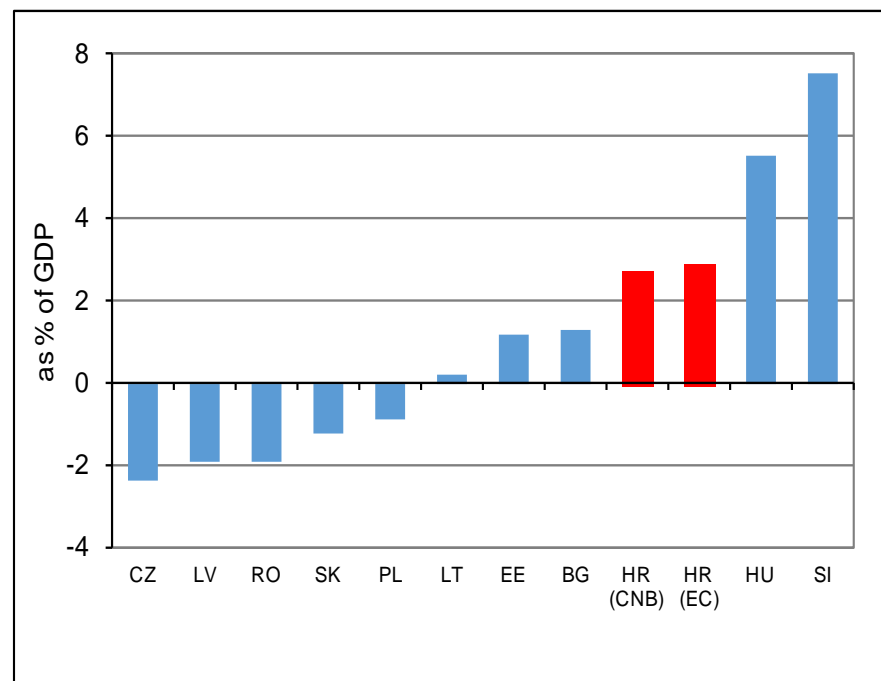
Sources: Eurostat, IMF and CNB.

Projected Croatia's and peer countries' current account balances for 2016

Current account balance 2008 - 2016



2016 current account balance

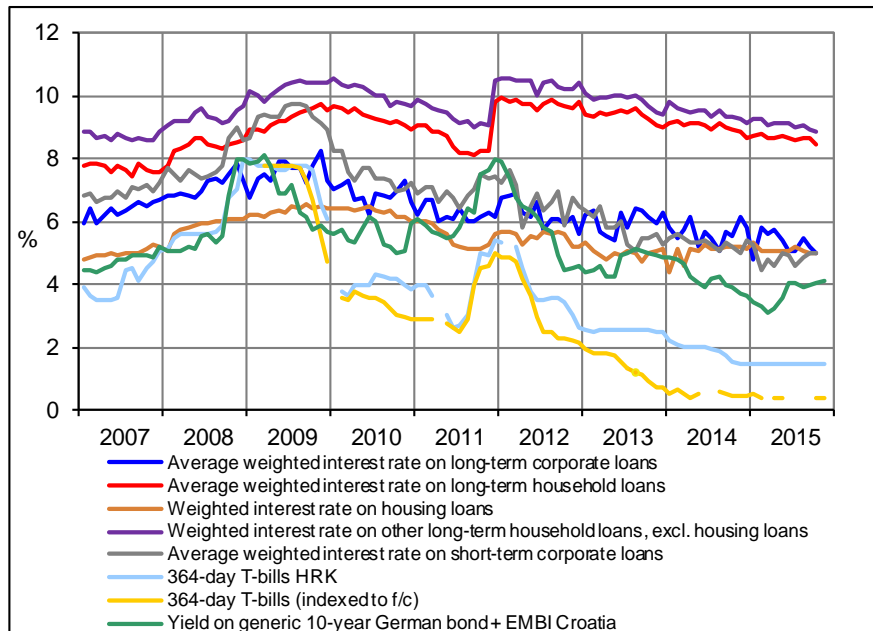


Note: Baltic countries include Estonia, Latvia and Lithuania.
 The source of estimates for 2015 and 2016 for other countries is the European Commission.
 Sources: Eurostat, EC and CNB.

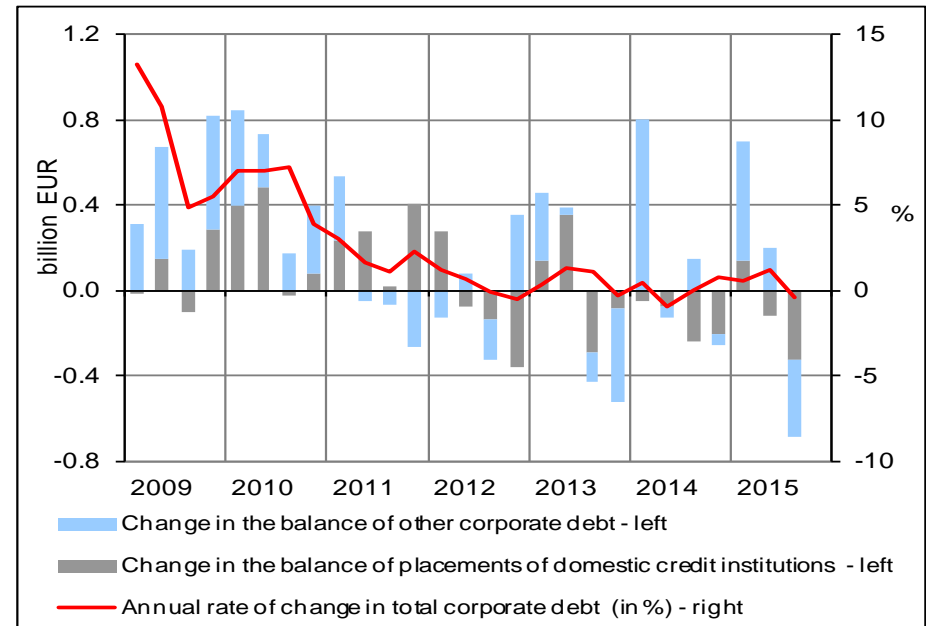
Sources: EC and CNB.

Financing conditions have been improving slightly, but corporate debt has been stagnating on an annual level

Financing costs



Corporate financing



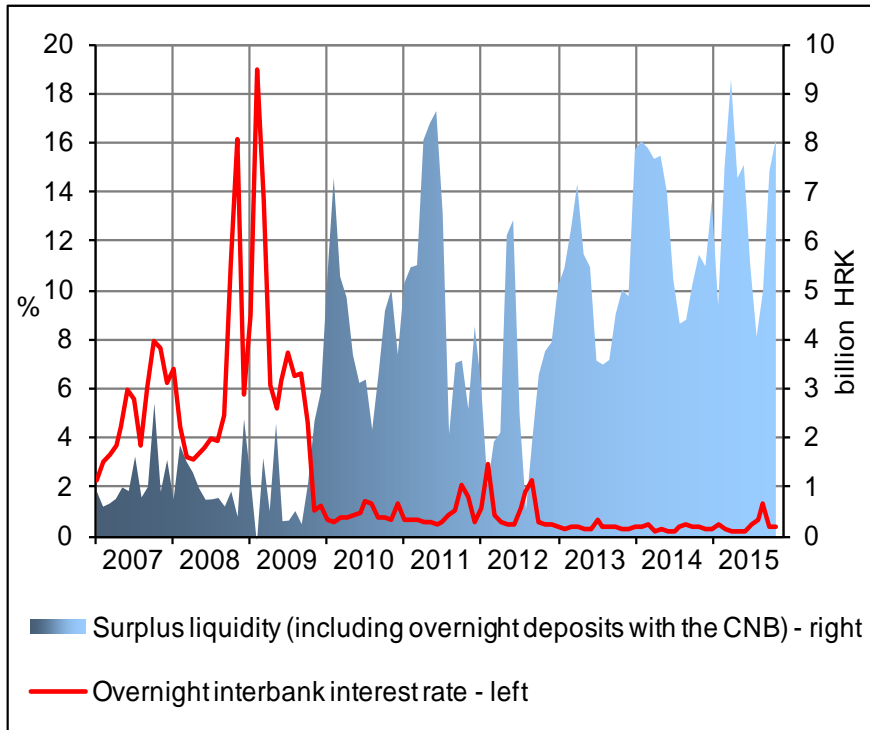
Sources: MF, Bloomberg and CNB.

Notes: Other financing includes corporate borrowing from domestic leasing companies and the CBRD as well as foreign borrowing. The changes exclude the exchange rate effect, a transfer of claims to another company, the bankruptcy of Centar banka and methodological changes in the recording of fees.

Sources: Hanfa, CNB and CNB calculations.

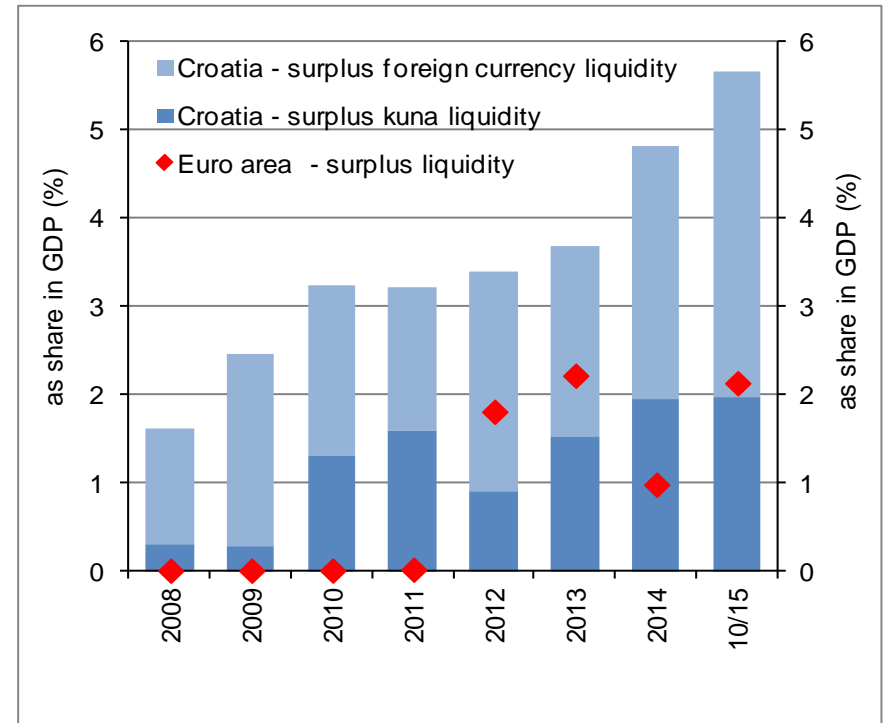
Continuation of expansionary monetary policy

Bank liquidity and overnight interbank interest rate



Source: CNB.

Surplus liquidity – Croatia vs. the euro area



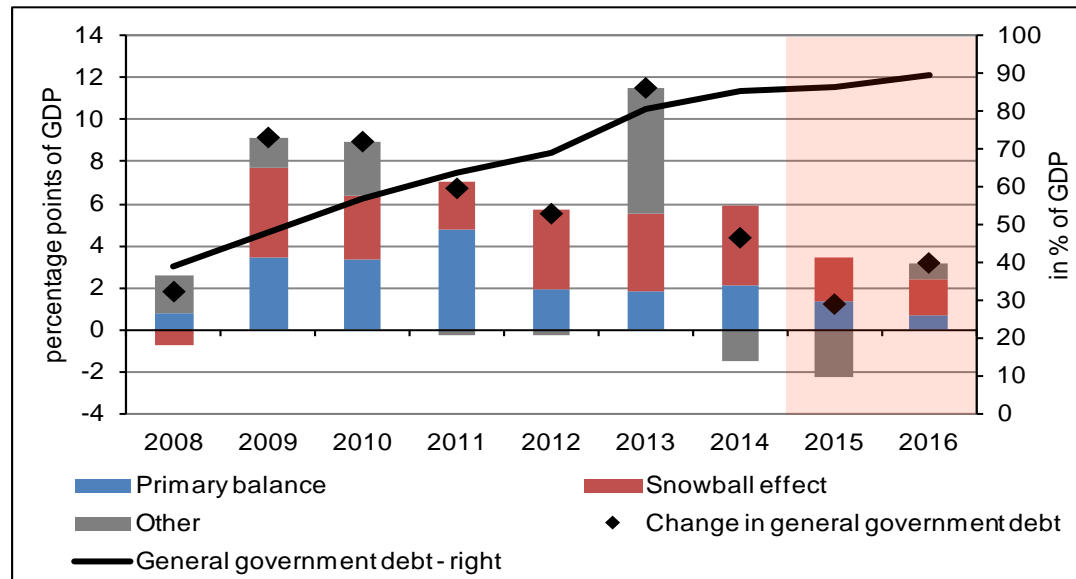
Note: Surplus liquidity in the euro area is the amount of excess reserves in relation to required reserves.

Sources: ECB, Eurostat, CBS and CNB.

Structural repo operations

- The potential introduction of structural repo operations in 2016 could further strengthen CNB's expansionary monetary policy.
- The aim is to provide banks with longer-term sources of kuna liquidity at an interest rate lower than the market rate.
- Structural repo operations could contribute to:
 - the lowering of the kuna yield curve at the medium/long end of the maturity spectrum;
 - the development of the domestic government securities market;
 - encouraging banks to increase lending in kuna.
- The use of this instrument could potentially be adjusted in line with the dynamics of fiscal adjustment and loan demand depending on the strengthening of economic growth.

Snowball effect could remain the key driver of general government debt growth



Sources: CBS and CNB.

Thank you for your attention.

Selected issues (Boxes)

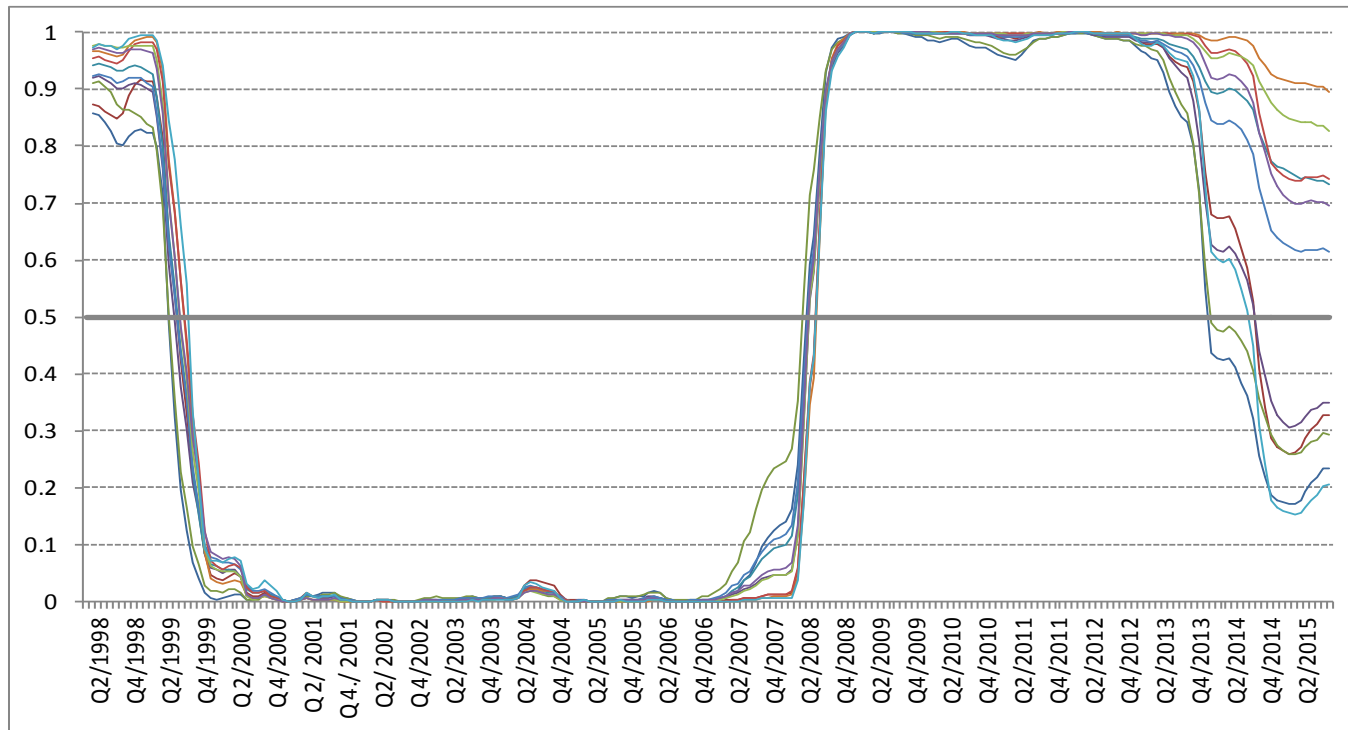
Box 1

Has the Croatian economy exited recession?

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- How to identify an exit from recession?
 - The use of year-on-year (YOY) GDP growth rates is wrong – it fails to reflect the current dynamics.
 - The ad hoc rule of two positive quarter-on-quarter (QOQ) GDP growth rates.
 - The committees such as the NBER's US Business Cycle Dating Committee or the CEPR's Euro Area Business Cycle Dating Committee identify the phases of the business cycle based on a wider range of economic indicators.
- The work of such committees is simulated for the Croatian economy by means of the factor Markov-switching model.
 - The probability of being in recession is estimated for 11 different models based on a wide range of monthly economic indicators.

Estimated probability of being in recession for 11 different models



- The first signs of coming out of the several-year recession appeared in late 2014 and continued throughout 2015. However, these findings are surrounded by considerable uncertainty.
- Too early for a final conclusion about a turning point in the business cycle.

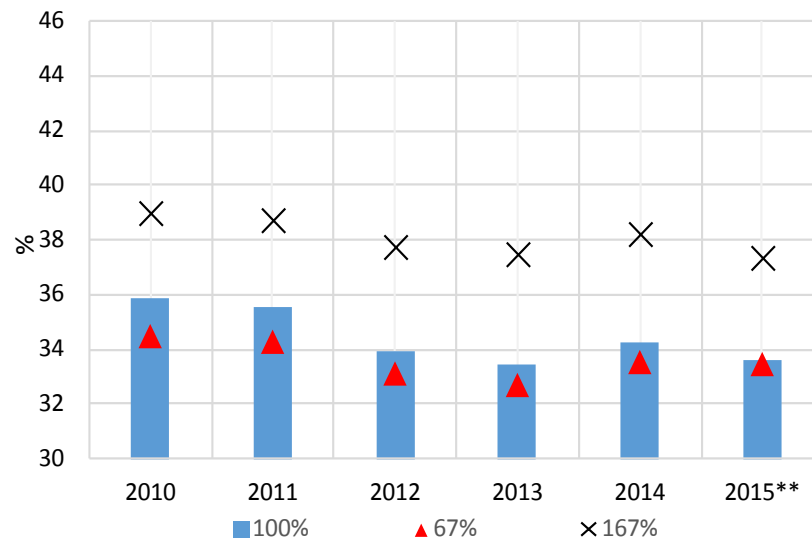
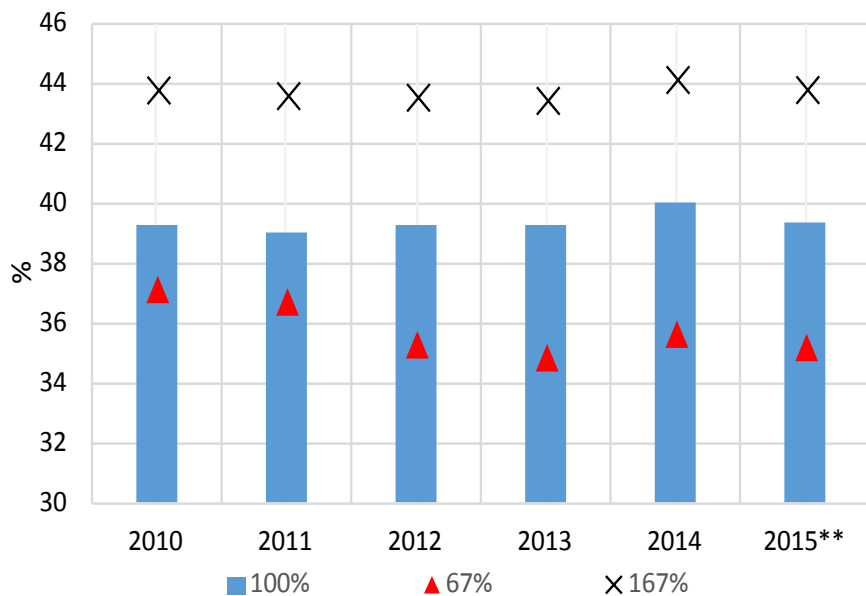
Box 2
**Tax wedge and income tax progressivity in
Croatia**

Tax burden on labour income

- ❑ High tax burden placed on labour income may have an adverse effect on the labour market and, in turn, on economic growth.
- ❑ International institution, such as the European Commission, the IMF and the OECD recommend countries to reduce the tax burden on labour and, if necessary, to increase the taxation of consumption or property.
- ❑ The tax wedge as a measure of the tax burden shows which portion of the overall cost of labour for the employer goes to the state and how much it remains at the disposal of the worker.

Tax burden alleviation for lower income levels in the 2010 to 2015 period

Tax wedge at different income levels in Croatia (2010 – 2015) for single persons (figure to the left) and a two children family*



Note: The percentage represents the level of income in relation to the wage of an average worker (AW). The tax wedge for 2010 does not include the special tax on salaries, pensions and other receipts given the temporary nature of this measure.

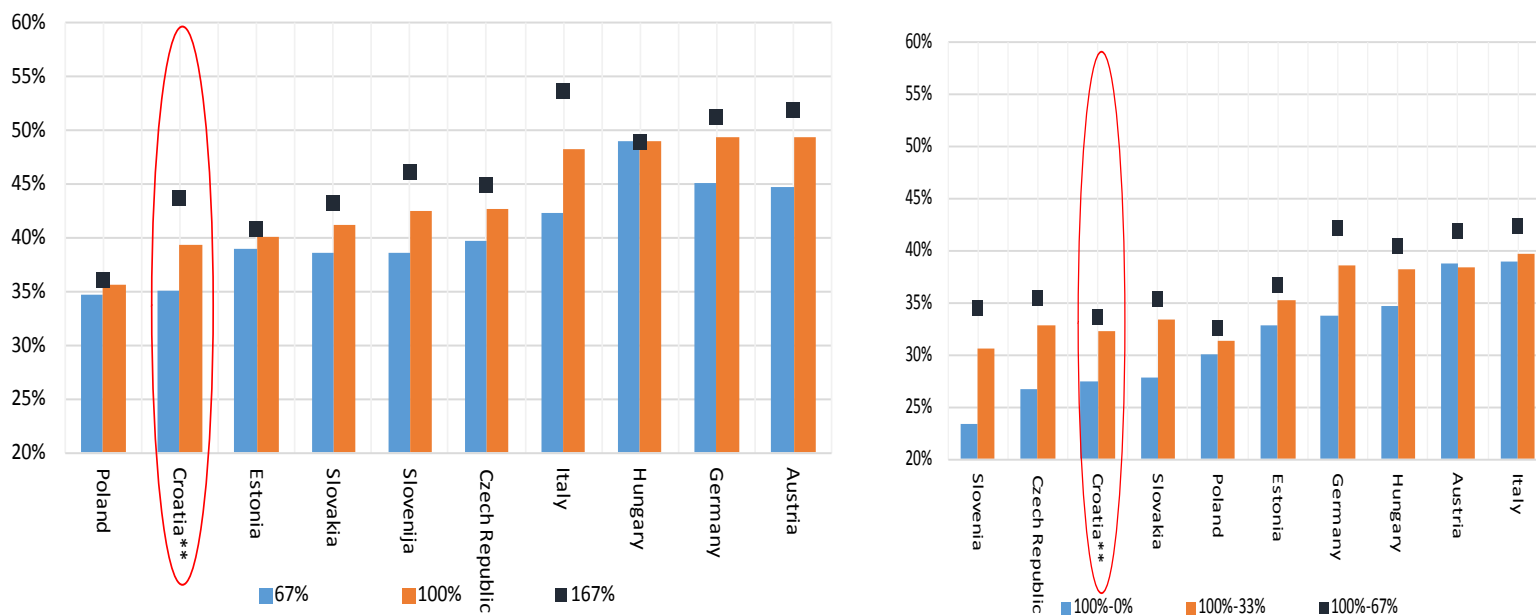
* As regards families with two children, the income of one earner varies from 67% to 167% of AW while the income of the other is fixed to 67% of AW.

** The tax wedge value in 2015 after the amendments to the Income Tax Act.

Source: Authors' calculations.

Croatia's tax wedge is relatively low at lower and medium income levels, but one of the highest at higher income levels

Tax wedge at different income levels in Croatia and in selected EU countries*



Note: The percentage represents the level of income in relation to the wage of an average worker.

* The values of the tax wedge in the figure to the left refer to 2014 and in the figure to the right to 2012.

** The tax wedge value in 2015 after the amendments to the Income Tax Act.

Sources: OECD Taxing Wages 2014, OECD Taxing Wages 2015 and authors' calculations.

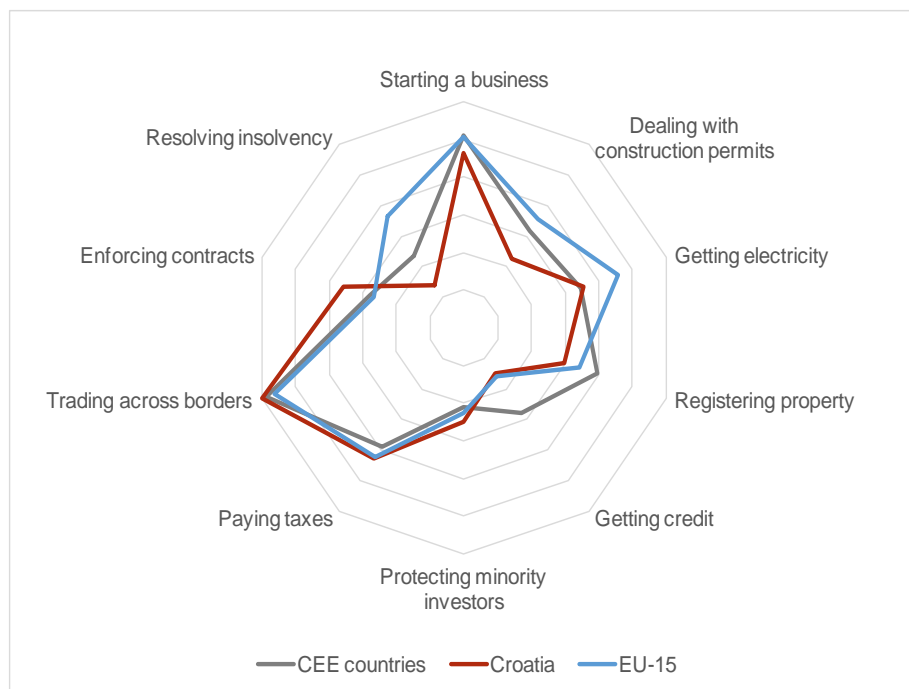
Box 3

Ease of doing business in Croatia

Doing Business ranked Croatia in 2015 as the 40th out of 189 countries

- Croatia was at the 65th position in the previous Report → the ranking improvement is primarily due to changes in the methodology.
- According to comparable data, Croatia **fell** by one position relative to 2014 (39th).
- Compared with EU-15, Croatia lags the most in resolving insolvency.

Comparison of Croatia with EU-15 and Central and Eastern European countries by area



Note: A higher number represents better performance.

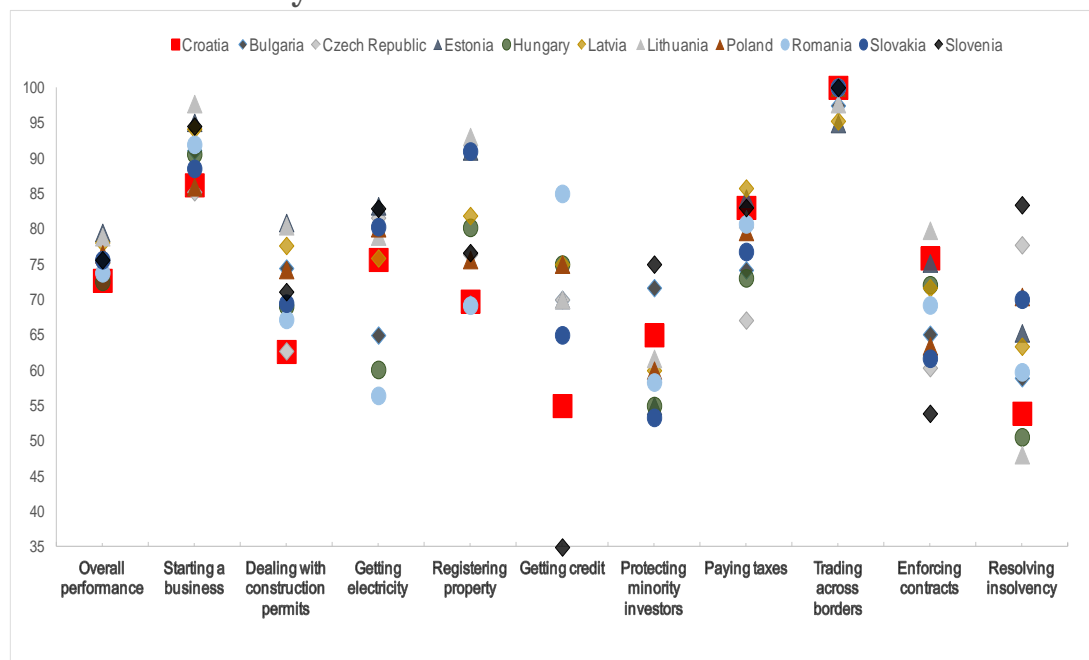
Source: Doing Business.

Croatia and Hungary at the rear of the peer country group

□ Croatia deviates unfavourably from peer countries in the following areas:

- starting a business
- dealing with construction permits
- registering property
- resolving insolvency
- getting credit

Comparison of Croatia with individual CEE countries by area



Note: A higher number represents better performance.
Source: Doing Business.

Source: Doing Business.

Getting credit

- An assessment of the transparency of data on credit users and collateral laws and bankruptcy regimes.
- Croatia and Slovenia at the rear of the group of peer countries.
- Possible changes in the regulatory framework that affect credit availability:
 - an integrated or unified legal framework for secured transactions in movable assets;
 - the modernisation of the collateral registry for movable assets;
 - strengthening the rights of secured creditors in the collection.

Some structural reforms to improve the ease of doing business

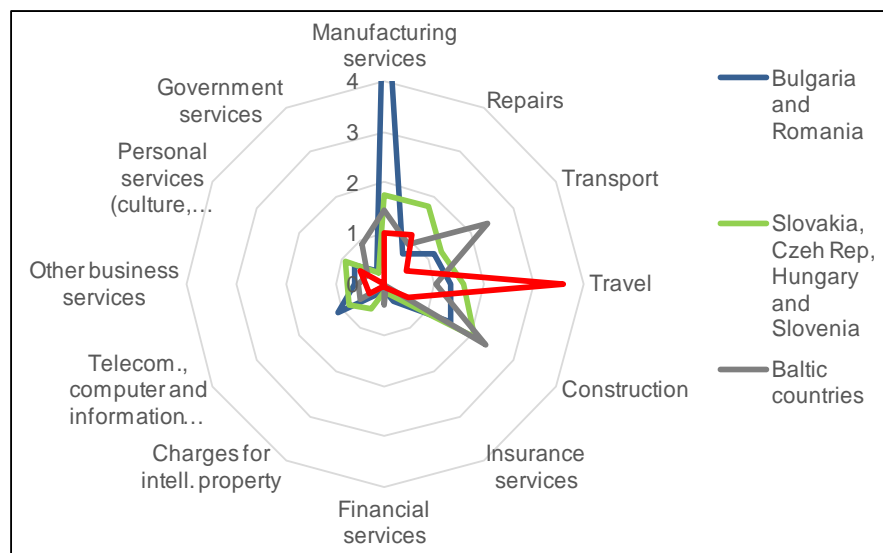
- ❑ An indicator of the ease of doing business for Croatia can reveal areas where there might be room for structural **reforms**.
- ❑ Croatia is relatively **expensive** for doing business due to high para-fiscal fees and other administratively imposed fees in the economy.
 - due to the relatively higher costs of dealing with construction permits, getting electricity, registering property and claims in the collection by creditors through courts.
- ❑ There is a relatively high degree of **bureaucratisation**, coupled with lower **efficiency** of the central and local government.
 - a relatively higher number of procedures in dealing with construction permits and starting a business;
 - a relatively higher number of days to register property and deal with construction permits, a longer period of collection by creditors through courts.

Box 4
**Trade in services between Croatia and the
rest of the world**

Significant comparative advantage in travel services

- Croatia's share of services exports in GDP exceeds the European and world average (although by a considerably lower degree than that of Luxembourg, Malta, Cyprus and Ireland).
- A larger share of travel services and a slightly smaller share of transport services and other services in GDP compared with the European average.
- A strong comparative advantage in the exports of travel services and, to a lesser extent, in goods-related services.

Relative specialisation in services exports

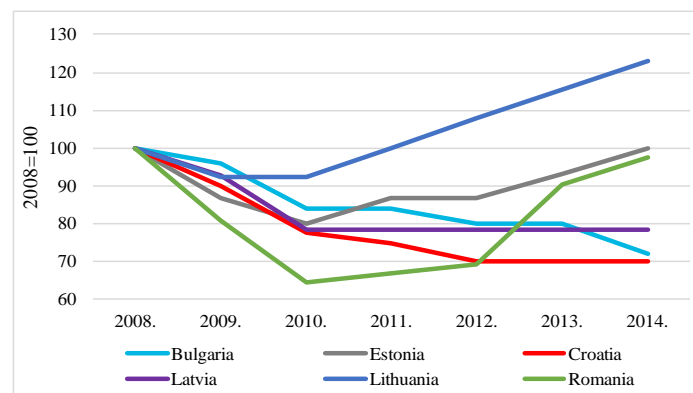
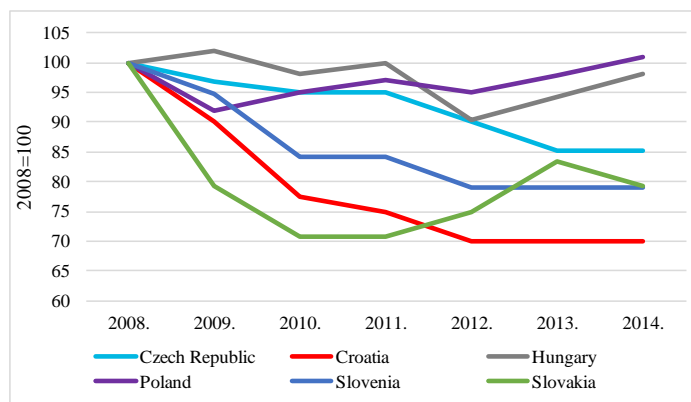


Note: Baltic countries include Estonia, Latvia and Lithuania. The index represents an average for the data in the 2010 to 2014 period. The average manufacturing services index for Bulgaria and Romania is 6.5. The figure shows the relative specialisation of countries in comparison with the average specialisation at the European level (Balassa's revealed comparative advantage index).

Sources: Eurostat and CNB.

Global market share of services exports

- An ongoing decline of Croatia's market share in the 2003 to 2012 period.
- Stagnation in 2013 and 2014.
- Such trends are due to the specialisation and slower growth of all types of services exports compared to the world average.
- The market share could recover in 2015, but it is unlikely to continue growing significantly.



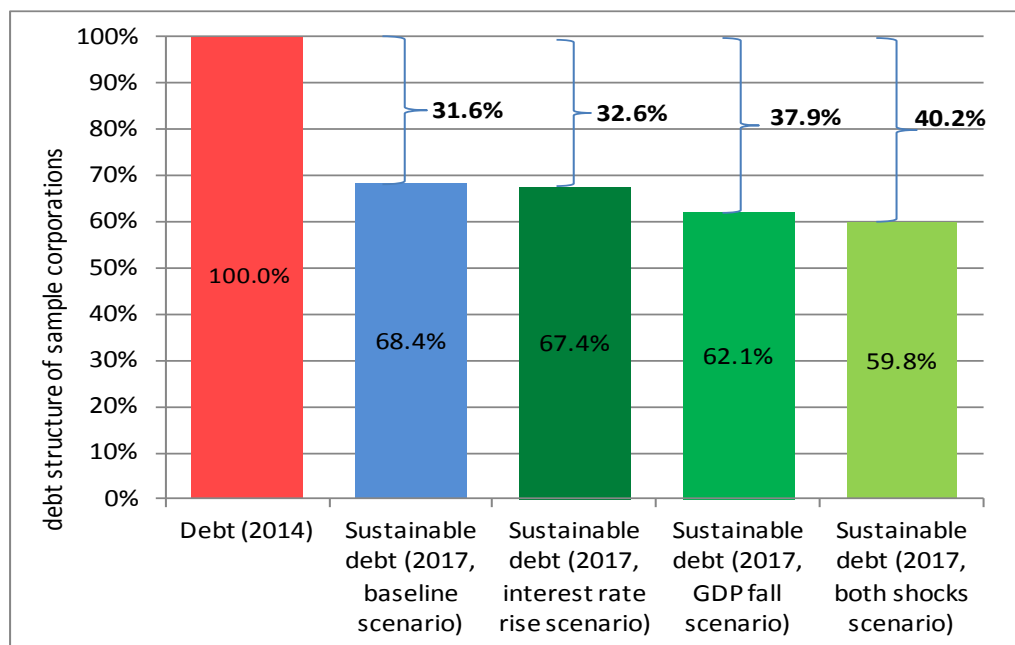
Source: Eurostat

Box 5
**Debt sustainability of non-financial
corporations**

Almost a third of corporate sector debt is excessive

- It is assessed that 31.6% of corporate sector debt cannot be financed from current operations.
- Should interest rates increase and GDP fall, 40% of corporate debt would be excessive.
- The activities with the highest excessive debt burden include construction, electricity supply and tourism.

Sustainability of corporate sector debt

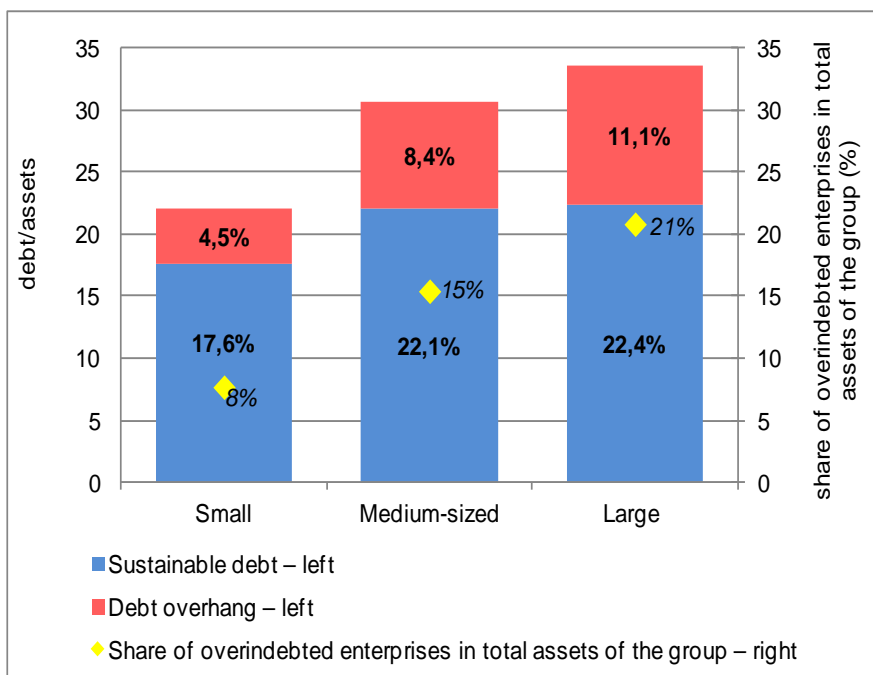


Note: The data next to the brackets show assessed deleveraging needs, expressed as % of corporate sector debt. A baseline scenario assumes projected GDP growth and interest rate stagnation. Alternative shocks include: (a) a 1 percentage point annual increase in interest rates, (b) an approximate 2 percentage point annual fall in GDP and (c) a combination of both shocks.

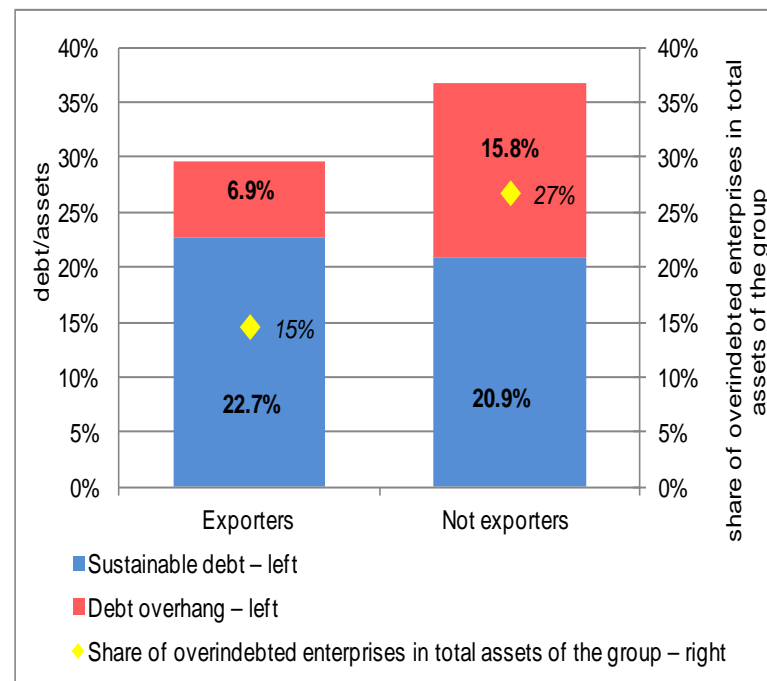
Sources: Amadeus; FINA.

Small enterprises and exporters have a lower excessive debt burden

Debt sustainability by enterprise size



Sustainability of corporate sector debt depending on participation in exports



Note: The categorisation by size was obtained from Amadeus.
Sources: Amadeus, FINA and authors' calculations.

Sources: Amadeus, FINA and authors' calculation.

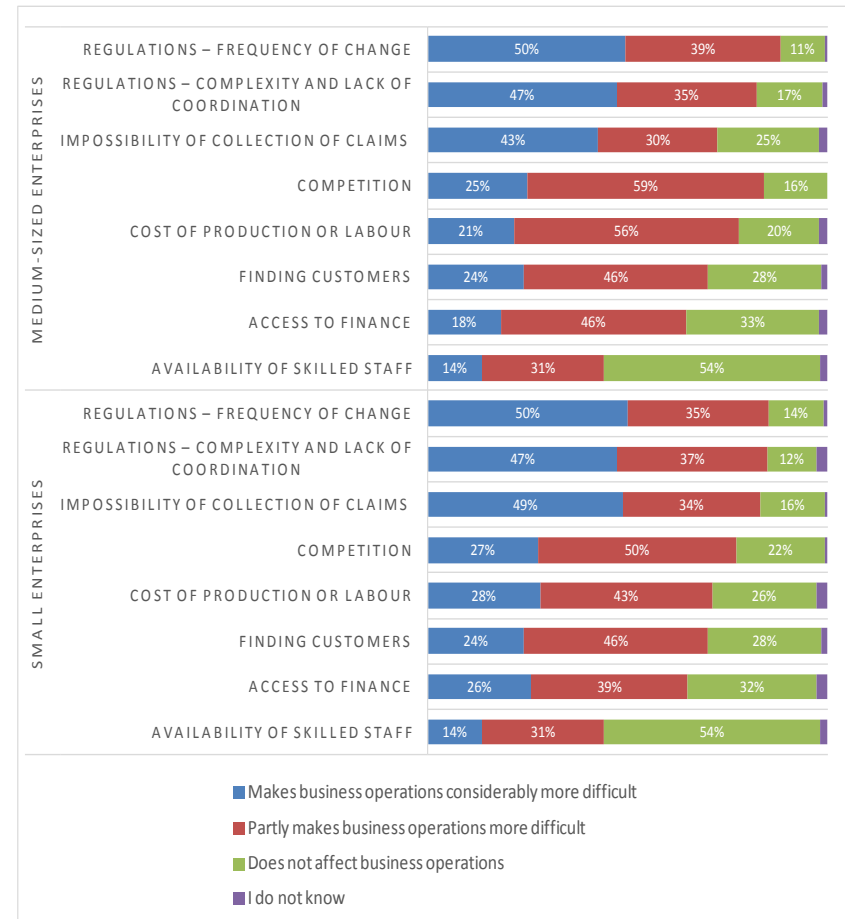
Corporate deleveraging will probably continue

- The assessed corporate sector's excessive debt points to a **possible continuation of corporate deleveraging in the medium term.**
- Large deleveraging needs weigh on investment recovery.
- Implications for economic policy – more active measures to:
 - stimulate debt restructuring for prospective corporations;
 - simplify the liquidation process for non-sustainable corporations.

Box 6
SMEs access to finance
– survey findings

Institutional environment is the greatest hindrance to doing business for small and medium-sized enterprises

- The greatest problem to doing business results from the frequency of changes in regulations and their complexity.
- The second important problem is the difficulty in collecting claims.
- The access to financing also makes business operation more difficult for small and medium-sized enterprises, but to a lesser extent than other factors.



Lack of collateral is the main obstacle to obtaining loans

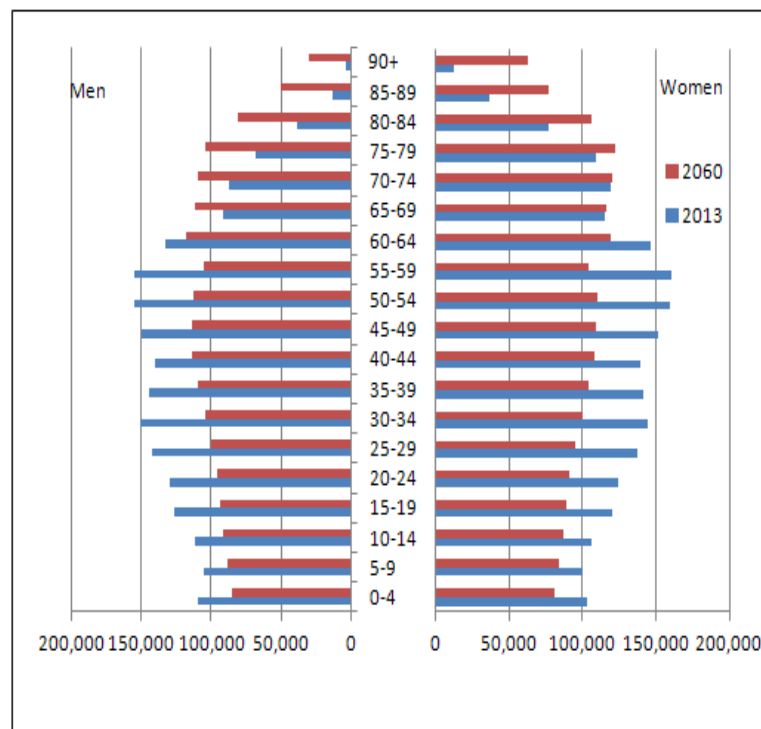
- ❑ The financing of small and medium-sized enterprises is primarily based on own sources and only partially on loans, which in turn leads to small investment capacity and slow enterprise growth.
- ❑ Lack of collateral is the main obstacle to obtaining loans
 - a potential for a more intensive use of guarantee schemes to offset the lack of collateral.
- ❑ Enterprises need better support in the use of EU funds and more diverse sources of funding, including venture capital funds.
- ❑ Limitations to a more dynamic recovery in lending to small and medium-sized enterprises are largely beyond the reach of monetary policy.

Box 7
**Fiscal impacts of population ageing in
Croatia**

According to Eurostat projections, Croatia faces adverse demographic trends

Population by age groups and gender

- ❑ The population is expected to decrease sharply in the 2013 – 2060 period.
- ❑ The share of elderly population could increase markedly in the same period.
- ❑ As a result, for each person above 65 years of age there would be two working age persons, while the current ratio is approximately one to four.

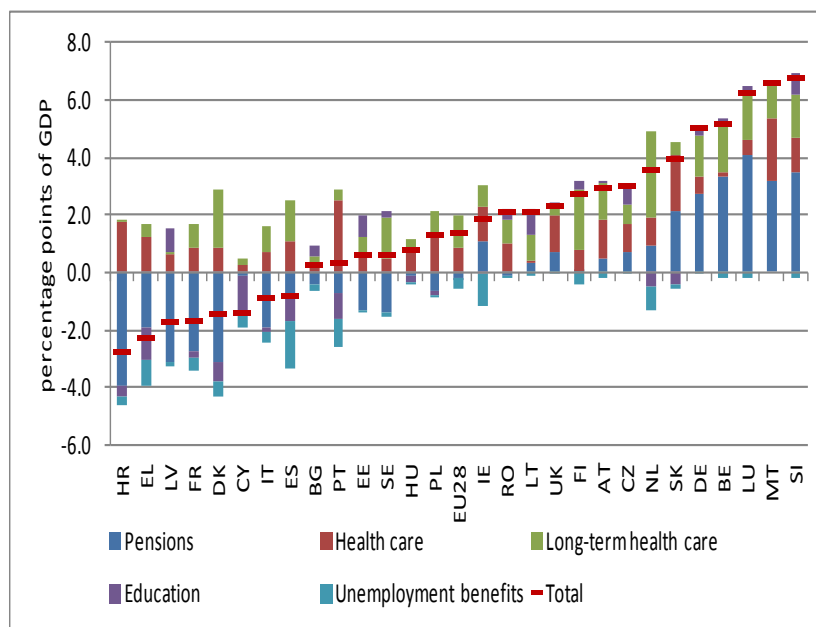


Source: Eurostat

Despite fiscal pressures caused by population ageing, Croatia's age-related expenditures are expected to fall

- ❑ In general, population ageing puts great pressure on public finances as a result of increased pension and health care expenditures.
- ❑ In most EU member states age-related expenditures are expected to increase.
- ❑ However, due to the mixed pension system currently in force, pension expenditures in Croatia are expected to decrease significantly and more than offset the expected increase in health care expenditures.

Change in age-related expenditures and unemployment benefits (2013 – 2060)

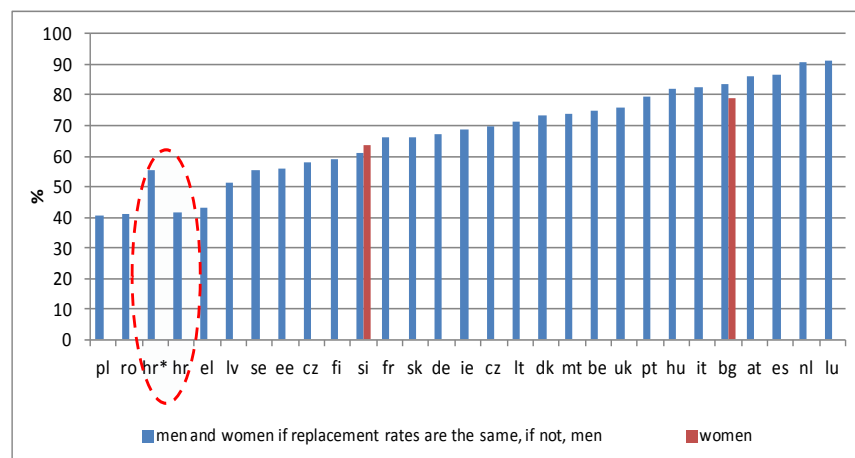


Source: 2015 Ageing Report, EC.

However, Croatia could encounter problems related to pension adequacy (sufficiency)

- ❑ The replacement rate measures the ratio between the first pension and the last wage and as such serves as an approximation of the impact of retirement on living standard of an individual (the so-called pension adequacy).
- ❑ The replacement rate in Croatia is expected to fall from an already low level in 2013.
- ❑ The fall is the result of the fall in the replacement rate in the first pillar of pension insurance, which should only partially be offset by income from the second pillar.
- ❑ The replacement rate could be one of the lowest in the EU.

Net replacement rates in the EU in 2053 for a hypothetical worker – a scenario of 40 yrs to the retirement age prescribed by law



Note: hr* refers to the net replacement rate for Croatia in 2013.
Source: 2015 Pension Adequacy Report.