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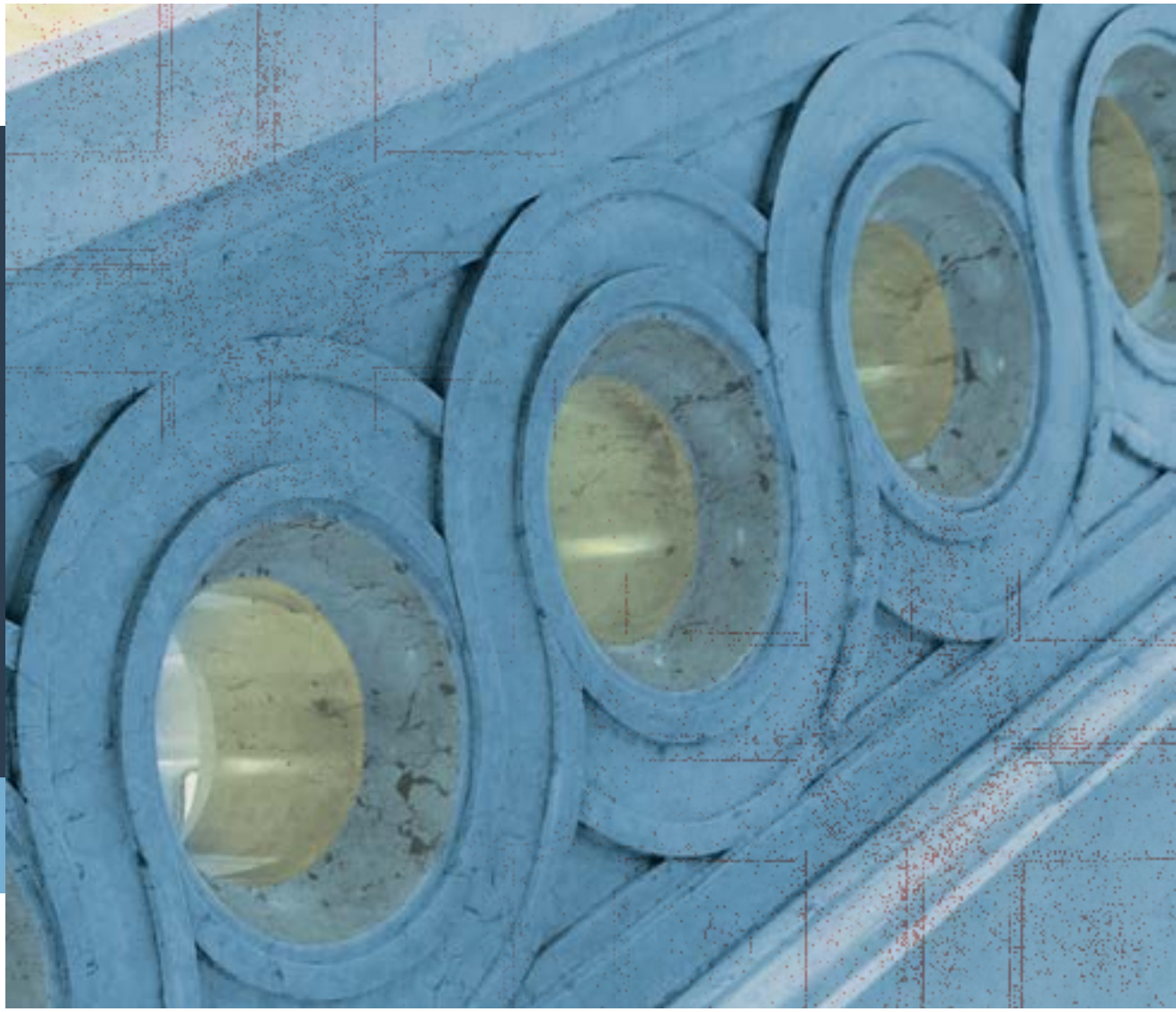
Macroeconomic Developments and Outlook

Year IX · Number 17 · December 2024



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Contents

Summary

The stable growth of real GDP of the global economy continued in 2024, again at unequal dynamics across sectors. The manufacturing sector continued to lag behind the services sector due to the still relatively low demand for goods, trade tensions and geopolitical uncertainties. The largest global economy, that of the US, grew sharply owing to household consumption and investments, while China's economic growth was hampered by problems in the real estate sector. Global trade continued to grow, albeit at historically low rates. The energy market was relatively stable in 2024, with occasional periods of increased volatility associated with geopolitical tensions. In contrast, the prices of food and industrial raw materials continued to grow, fuelled by adverse weather conditions and disruptions in supply. Global disinflation continued, but services inflation remains persistent, particularly in the developed countries, driven by high demand and pressures on the labour market. Most central banks have been easing their monetary policies, the intensity of easing depending on the level of inflation and economic developments in individual countries.

Economic growth in the euro area revived in 2024, following stagnation in the year before. The main drivers were the services sector in countries such as Spain and France, where the growth during the summer months was further fuelled by travel and consumption associated with the Olympic games. In contrast, the momentum of economic growth was smaller in countries with more prominent manufacturing sectors, such as Germany. The mid-term recovery of European industry is uncertain due to structural weaknesses such as high energy intensity and poor competitiveness. The exports sector might also be further hit by growing protectionism in major trading partner countries. The services sector remains the main generator of growth, despite sentiment deterioration towards the end of the year. The euro area labour market remains robust, with a record low unemployment rate, while labour shortages have been declining gradually, particularly in industry. Despite persistent services inflation, largely supported by the buoyant labour market and steadily accelerating wage growth, euro area inflation slowed down additionally in the first eleven months of 2024 owing to a slowdown in food and industrial products inflation, due also to a restrictive monetary policy.

The ECB's Governing Council lowered key interest rates by 25 basis points at the meeting on 12 December, thus continuing the gradual easing of monetary policy restriction that started in June. From June to December 2024, the Governing Council thus lowered the deposit facility rate, which, in current conditions of high liquidity surpluses is a relevant indicator of the monetary policy of the ECB, by 100 basis points to 3.00%, after having kept key interest rates steady since September 2023. The Governing Council is determined to ensure that inflation stabilises sustainably at its 2% medium-term target and it will continue to base its decisions on a data-dependent approach.

The easing of the restrictive ECB monetary policy in the second half of the year led to more favourable financing conditions for corporations in Croatia, while the cost of household borrowing remained almost unchanged during that period. The interest rates on corporate time deposits fell while those on household deposits hovered around levels seen in the first half of the

year. The interest rates on pure new corporate loans have been falling while those on household loans remained stable at the levels seen towards the end of last year. Bank lending survey results also suggest that the tightening of corporate and household financing conditions came to an end in contrast with the slightly tightened conditions for consumer spending financing due to the negative perception of customer creditworthiness and a smaller risk tolerance. According to survey results, corporate demand for loans remained subdued while household demand for housing and consumer and other loans fell slightly. Corporate loans rose only modestly in the second half of the year, signalling mild recovery, after having stagnated since the end of last year. Loans to households continued to grow relatively strongly. As regards deposits, the amount of funds to be deposited as time deposits by corporates and households declined, reflecting a gradual fall in the interest rates on corporate time deposits, while the fall in deposit inflows from households may partly be explained by depositor inertia, which contributed to keeping the deposit rates at relatively low levels.

The poor economic outlook for the euro area led to a change in market expectations towards a bigger reduction of ECB key interest rates, which, combined with the change in market expectations of a smaller reduction in Fed's key interest rates led to a depreciation of the exchange rate of the euro against the US dollar. The October reduction in key ECB interest rates soon spilled over to interest rates on the money market. In October, the €STR fell by the amount of the reduction in key interest rates, to 3.2% and held steady at that level until end-November. Yields on euro area long-term government bonds rose gradually following the Governing Council meeting in October, mostly mirroring the growth in long-term yields in the US but started falling gradually after the US elections due to concerns regarding the possible impact of economic policies of the new US administration on the euro area economy. Poor economic indicators for the euro area issued towards end-November also led to a change in market expectations of a bigger reduction of key interest rates of the ECB. The exchange rate of the euro against the US dollar depreciated strongly after September. This was mostly due to the change in market expectations of a smaller reduction of key interest rates in the US and a bigger reduction in key interest rates in the euro area, since the US economy proved more resilient than expected while the economic outlook for the euro area worsened.

The growth of the Croatian economy might accelerate in 2024 and slow down in the following two years, nevertheless remaining relatively strong. Economic expansion, which marked the first half of 2024 continued into the third quarter and high-frequency indicators suggest that robust growth will continue towards the end of the year, with the GDP in 2024 as a whole possibly rising to 3.7%. Faster growth in economic activity this year largely reflects strong domestic demand, supported by favourable developments in the labour market, expansionary fiscal policy and strong investment activity in the private sector. Goods exports strengthened too, while services exports might shrink. Real GDP is again expected to grow relatively strongly in the following two years, although the expansion might slow down slightly. A greater contribution is expected from goods and services exports owing to the expected strengthening of foreign demand, to be facilitated also by monetary policy easing. The dynamics of domestic demand growth might

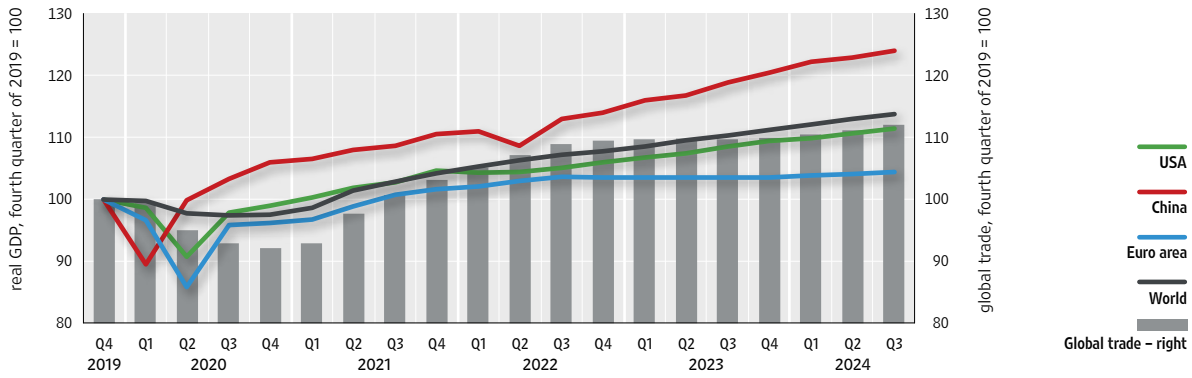
weaken, in particular with regard to investment growth, which, after witnessing a two-digit growth in the past three years, might still remain relatively strong.

Despite acceleration between September and November 2024, the average annual rate of inflation in the 2024 as a whole might fall by more than a half from the year before, and continue to slow down in the following two years. After falling to 3% in August (measured by the harmonised index of consumer prices), the lowest level since August 2021, inflation accelerated in the following three months and stood at 4.0% in November 2024. Inflation acceleration in the last three months was due to the unfavourable base effects, the increase in administered prices of electricity, gas and district heating and higher current pressures in food inflation. Nevertheless, the average annual rate of inflation in 2024 might be noticeably lower than in the year before and stand at 4.0%, down from 8.4% in 2023, and slow down further to 3.5% in 2025 and 2.5% in 2026. The expectation of a continued slowdown in inflation rests on the assumption of an absence of external shocks and decreasing pressures on the demand side (slowdown in wage and personal consumption growth), partly influenced by the restrictive monetary policy.

1 Global economy

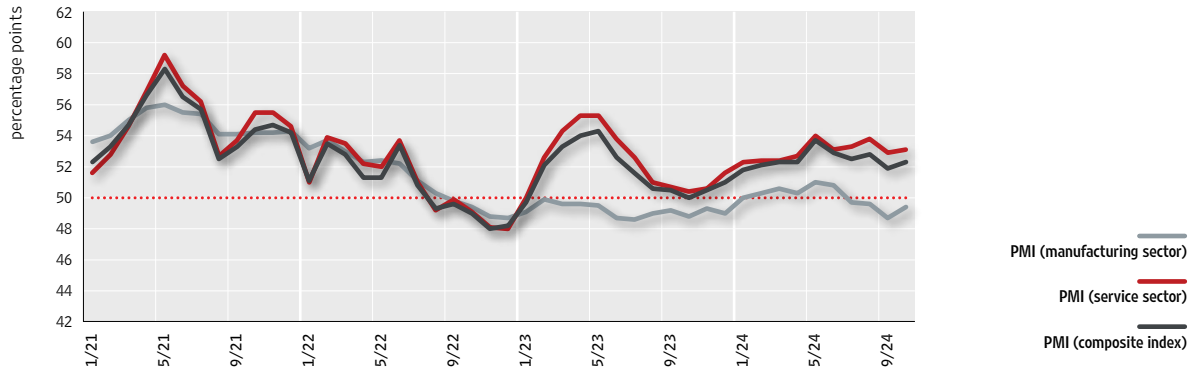
The steady growth in the real GDP of the global economy continued into 2024, but again at different paces across sectors. Manufacturing continued to lag behind the services sector as a result of a relatively small demand for goods and growing geopolitical risks, and mounting trade tensions and fragmentation of the global market. Despite increased uncertainty, the American economy continued to grow strongly. rising 0.7% in the third quarter of 2024 from the previous three months (Figure 1.1). The consumption by American households, supported by rising disposable income and robust labour market growth, and private sector investments were the main generators of economic growth. During the same period, China's economy witnessed a GDP growth of 0.9% on a quarterly basis, fuelled by growing retail sales and exports at the beginning of the fourth quarter. Despite difficulties in the real estate sector, industrial production in China continued to grow steadily.

Figure 1.1 Economic activity in major markets and global trade



SOURCES: Eurostat, BEA, NBS and UNCTAD.

Figure 1.2 Confidence indicators for the global economy



Notes: Index value above 50 indicates expansion, while index value below 50 indicates contraction of economic activity. Data are up to October.
SOURCE: S&P Global.

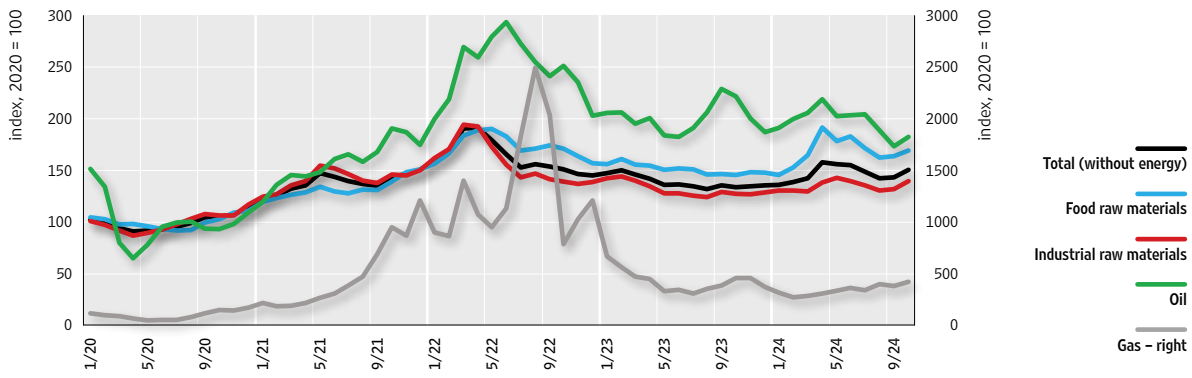
The global composite purchasing managers' index (PMI) improved at the beginning of the fourth quarter, signalling a further strengthening of global economic activity. The recovery of the production sector, particularly in China, was the main factor behind the improvement in the composite index (Figure 1.2). However, in contrast with the indicators of the services sector,

which remained elevated, the PMI for the manufacturing sector was again in contraction territory in the past several months, following a brief period of expansion at the beginning of the year. This reflects a pronounced uncertainty as regards the recovery of the manufacturing sector, despite a fall in energy prices and the normalisation of global supply chains. The uncertainty surrounding global trade policy is increasingly becoming a limiting factor for the recovery of the manufacturing sector, particularly in export-oriented activities.

Global trade continued to grow in 2024, albeit at historically low rates. Apart from the evident signs of partial recovery in global demand for goods, particularly in the segment of goods related to energy transition, the growth in global trade continues to be driven by the still relatively strong demand for trade-intensive services, such as tourism. Supply chains have largely fully normalised, although the pressures rose again during the summer months following short-term disturbances caused by adverse weather conditions. The growth in global trade further strengthened in the third quarter, with the US being the main driver with increased imports mirroring trade policy uncertainties. The announced tightening and extension of trade barriers by the newly-elected US administration has continued to fuel trade over a short term.

The global energy market has been relatively stable in 2024, with occasional periods of increased volatility associated with geopolitical tensions. After a noticeable spike in crude oil prices at the beginning of the year due to the exacerbation of conflicts in the Middle East, by mid-year they mostly stood at slightly lower levels (Figure 1.3). The downward price pressure was driven by concerns about the weakening of global demand, particularly demand from China. The Iranian attack on Israel in early October raised concerns about global oil supply security and led to a new temporary price jump. This increase was further driven by an improvement in global sentiment, for instance by the lowering of interest rates by the US Fed. As a result, by end-November, the price of crude oil returned to USD 75 per barrel, a level equal to that at the beginning of 2024. In early 2024, gas prices in Europe stood at lower levels than in the year before (approximately EUR 30/MWh), owing to very high levels of stored gas and the expected increase in LNG capacity. However, the pressures on price growth heightened again in the past months, mostly fuelled by concerns regarding the absence of any agreement between Ukraine and Russia about gas transit, the existing arrangement expiring at the end of the year. Price pressures also arise from the expectations of a somewhat colder winter in Northwestern Europe and faster consumption of stored gas.

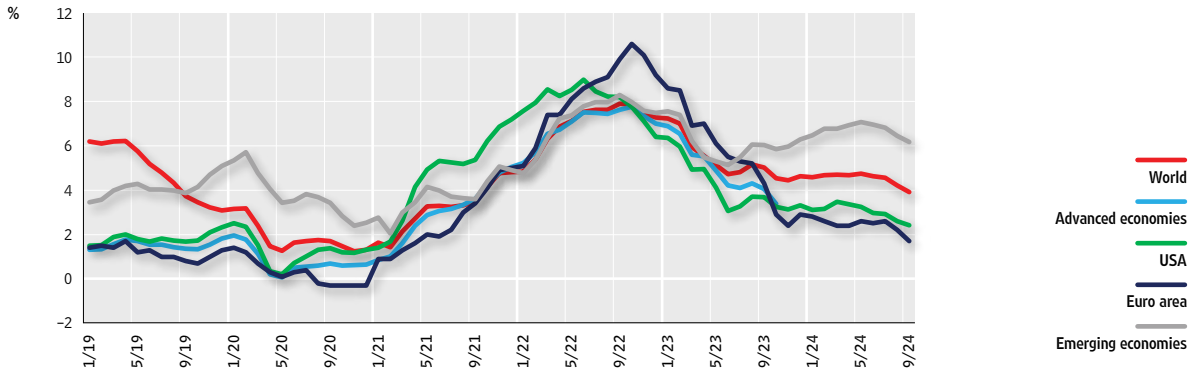
Figure 1.3 Prices of energy and other raw materials



SOURCE: HWWI (Euroland, EUR).

The prices of other raw materials on the global market mainly increased, particularly the prices of food raw materials. The increase in the prices of food raw materials accelerated in mid-2024 as a result of a cocoa price spike caused by major shortages in the supply from West Africa. Their partial normalisation in the second half of the year was followed by an increase in the prices of other agricultural and food products, also triggered by adverse weather conditions. Intense drought in Brazil during the summer months led to coffee and soybean price pressures in Brazil, the world's largest producer and supplier of these commodities. The prices of industrial raw materials, particularly metals, continued to rise slightly, spurred by improved market sentiment in the wake of the Fed's interest rate cuts (Figure 1.3).

Figure 1.4 Global inflation

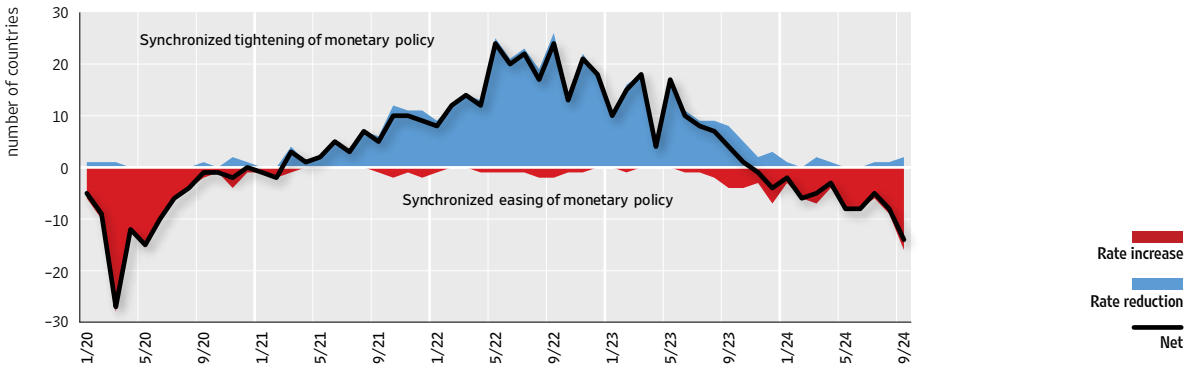


SOURCE: Federal Reserve Bank of Dallas (adjusted by the CNB).

The trend of global disinflation continued throughout 2024, although the risks associated with trade and geopolitical tensions remained moderately elevated. With the exception of several African countries, most emerging market countries continued to witness a slowdown in inflation (Figure 1.4). However, in some cases this trend was limited by the unfavourable effects of past depreciations of the exchange rate of their currencies, the pronounced weakening of which against the US dollar seen after the US elections might heighten the imported inflationary pressures in the forthcoming period. The trend of disinflation was more pronounced in developed

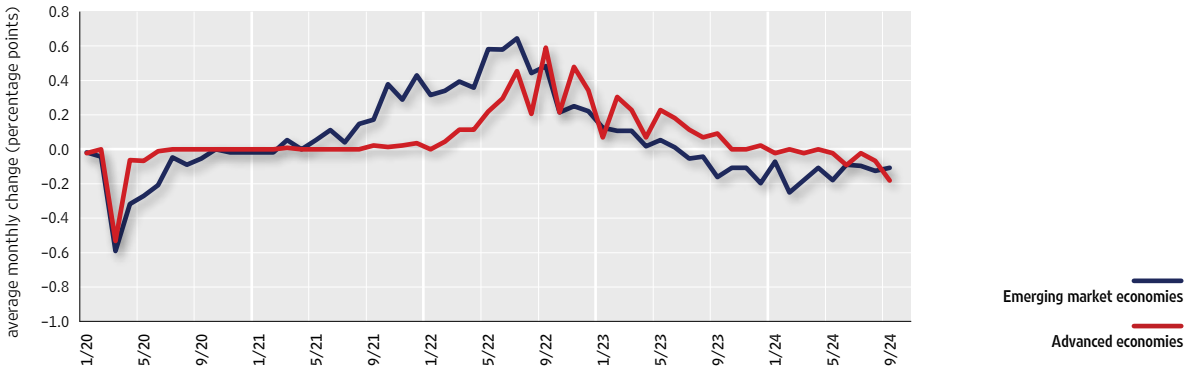
countries but they witnessed a particularly persistent services price inflation driven by cost pressures from the labour market and the still high demand for services. At the same time, industrial goods inflation on the global level stabilised at very low levels. Against such a background, an increasing number of central banks started or continued easing their monetary policies (Figure 1.5), with the intensity of the easing in emerging market economies slowing down (Figure 1.6).

Figure 1.5 Shifts in the course of monetary policies of selected central banks



Note: Data show changes in key interest rates of 38 central banks.
SOURCE: BIS.

Figure 1.6 Changes in central bank key rates by country groups



Note: Data show the average monthly change in key interest rates of 38 central banks.
SOURCE: BIS.

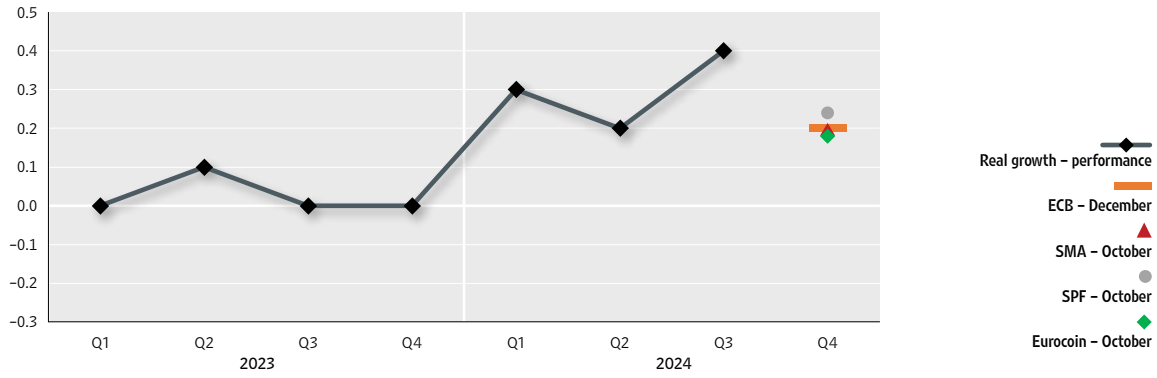
2 Euro area

2.1 Real developments

After having stagnated last year, the euro area economy recovered noticeably in the first nine months of 2024. The growth picked up additionally during the summer months, reaching 0.4% on a quarterly level, according to preliminary Eurostat data (Figure 2.1.1). The growth in economic activity both in the third quarter and the first half of the year was mostly driven by countries with a strong services sector such as Spain and France, in which growth accelerated noticeably during the summer due to the Olympic games. By contrast, growth was noticeably slower in countries with more prominent manufacturing such as Germany. Most estimates for the last quarter suggest that growth might continue, albeit at a somewhat slower pace than during the summer.

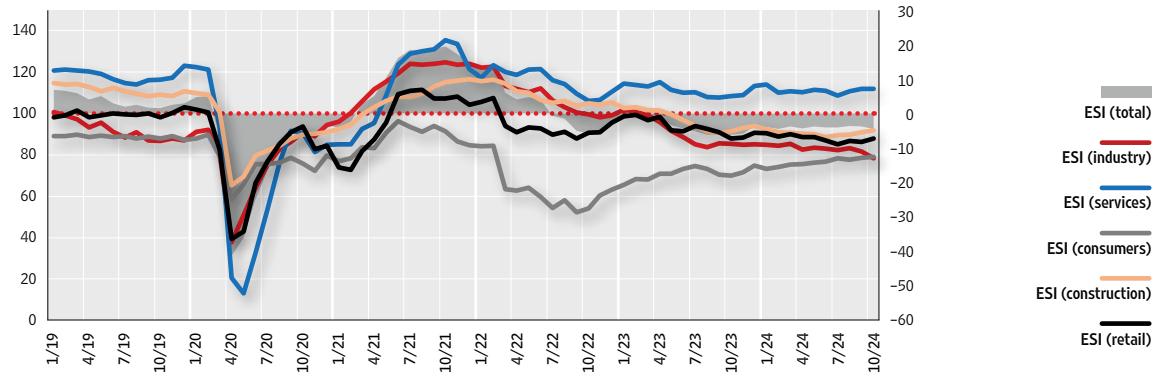
The weakness in the industrial sector continued to have a negative effect on euro area growth. The available high-frequency indicators, such as the purchasing manager index (PMI) and the economic sentiment index (ESI), suggest a further contraction in industry in the fourth quarter of 2024 (Figure 2.1.2). Also, mid-term recovery in European industry is uncertain due to structural weaknesses such as high energy intensity and poor competitiveness. In addition, the exports sector might be further hit by growing protectionism in major trading partner countries. Meanwhile, the services sector continued to compensate for the weaknesses in the production sector and thus remained the main generator of economic growth in the euro area, although the latest high-frequency indicators (PMI) suggest a noticeable deterioration in services sentiment towards the end of the year.

Figure 2.1.1 Economic activity in the euro area



Notes: Abbreviation ECB – December refers to ECB – December 2024 projection. Abbreviations SMA (Survey of Monetary Analysts) and SPF (Survey of Professional Forecasters) refer to the results of the October ECB survey of market participants. The Eurocoin indicator developed by Banca d'Italia refers to the model for nowcasting the quarterly rate of change in the real GDP of the euro area derived from the available high-frequency data (October estimate).
SOURCE: Eurostat.

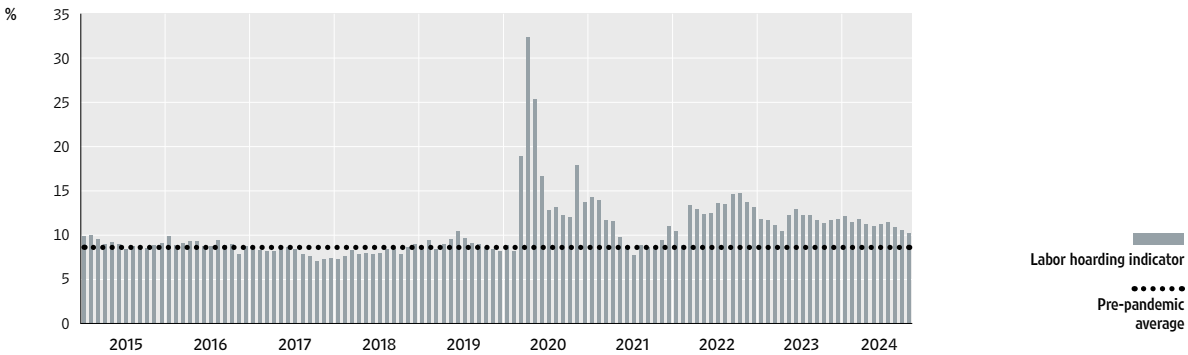
Figure 2.1.2 Euro area confidence indicators



Note: Index value above (below) 100 refers to values higher (lower) than the long-term average.
SOURCE: Eurostat.

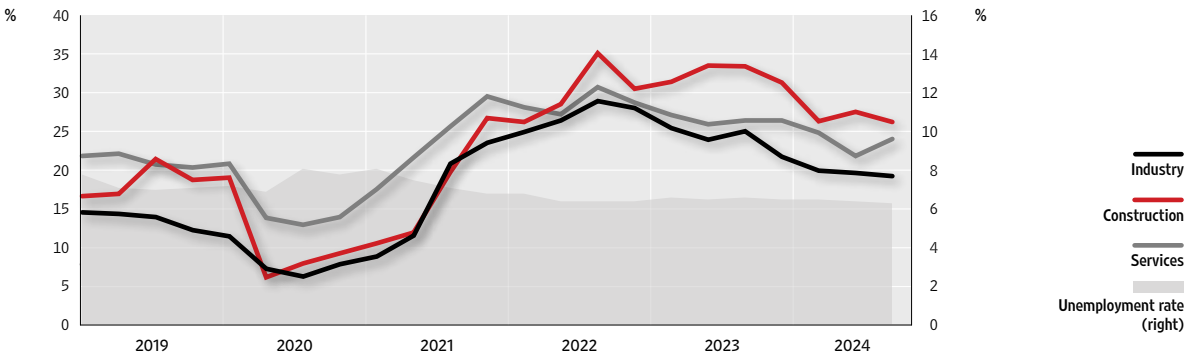
The euro area labour market remained very robust with labour shortages and record low unemployment still present. The unemployment rate fell further, standing at 6.3% of the labour force at end-September and held steady at that level in October. The favourable developments in the real sector had an impact not only on the unemployment rate but also on other labour market indicators, with the labour hoarding indicator falling markedly by October 2024, coming very close to the pre-pandemic average (Figure 2.1.3) and the growth in nominal wages remained robust in all activities. Labour shortage indicators continued to fall, mostly in industry, which may be associated with weaknesses in the industrial sector (Figure 2.1.4). Also, employment growth, though positive, was somewhat slower than GDP growth and slowed down noticeably from the previous periods, suggesting some waning of the cyclical factors such as labour shortages, which had previously contributed to fast growth.

Figure 2.1.3 Labour hoarding indicator in the euro area



Notes: Labour hoarding indicator is based on a business survey (expectations regarding the domestic product and employment). The pre-pandemic average relates to the average indicator in the period from 2015 to 2019.
SOURCE: European Commission.

Figure 2.1.4 Labour shortage and unemployment rate in the euro area

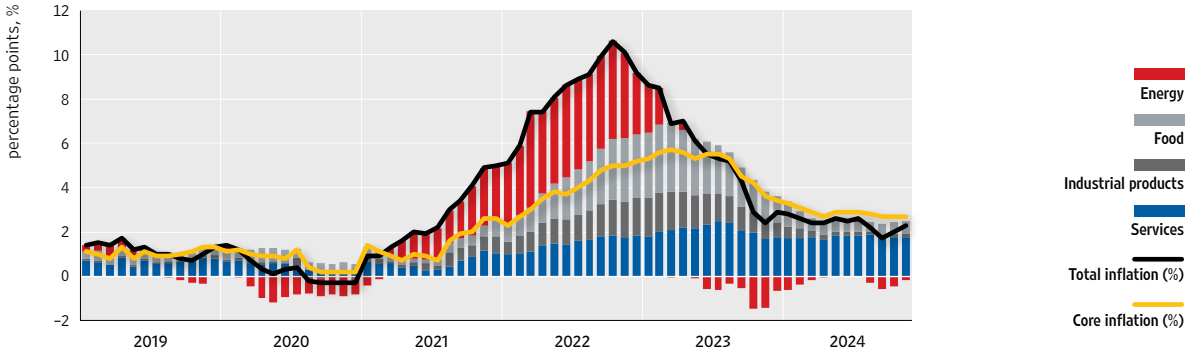


Note: Labour shortage is measured by a quarterly survey and indicates the percentage of firms reporting a labour shortage as the main obstacle to business activity.
SOURCE: Eurostat.

2.2 Price developments

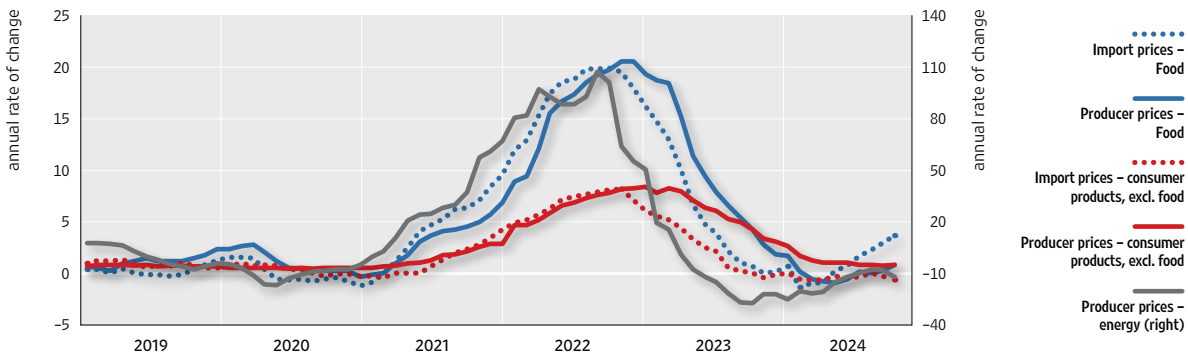
After having slowed down noticeably in 2023, in the first eleven months of 2024, euro area inflation slowed down further with little volatility from 2.9% in December 2023 to 2.3% in November 2024. The slowdown in inflation primarily reflects a fast deceleration of food and industrial products inflation (Figure 2.2.1). In contrast, energy inflation increased, mostly as a result of unfavourable base effects (taking it into account that considerable monthly energy price decreases in the major part of 2023 were gradually excluded from the calculation of the annual rate of change in energy prices in 2024) and the phasing out of some of the fiscal measures aimed at mitigating the effects of previous energy price increases.

Figure 2.2.1 Euro area inflation indicators



Note: Core inflation is measured by the harmonised index of consumer prices, which excludes energy, food, alcoholic beverages and tobacco prices.
SOURCES: Eurostat and CNB calculations.

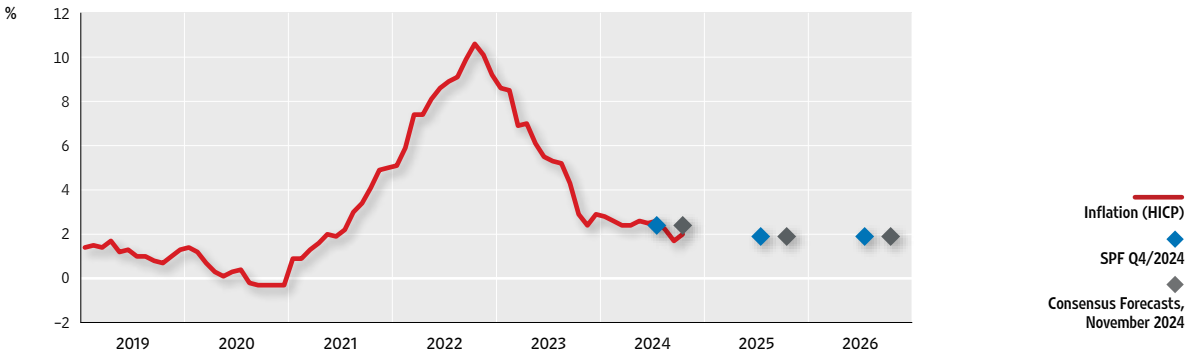
Figure 2.2.2 Indicators of inflationary pressures along the euro area pricing chain



Notes: Producer prices refer to the domestic market. Food prices include alcoholic beverages and tobacco.
SOURCE: Eurostat.

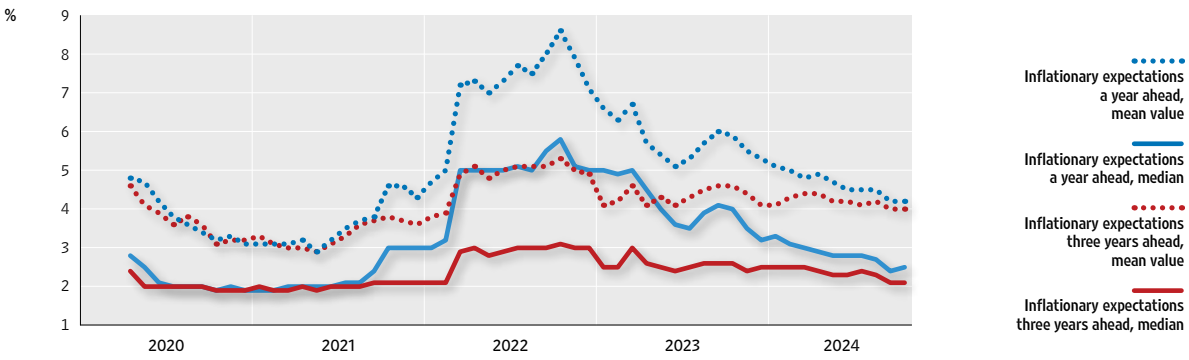
Euro area core inflation (energy and food prices excluded) also slowed down in the first eleven months of 2024, from 3.4% in December 2023 to 2.7% in November 2024, supported by the relaxation of inflationary pressures on the supply side and by pressure easing on the demand side, partly influenced by a restrictive monetary policy. The slowdown almost entirely reflects the fall in industrial products inflation from 2.5% in December to 0.7% in November. Industrial products inflation has been slowing down largely owing to cheaper energy and lower and more stable prices of other raw materials in the global market as well as lower freight rates relative to the peaks recorded in 2022, which is reflected in a fall in imported prices and lower annual growth rate of producer prices for consumer goods (Figure 2.2.2). Services price inflation has been moving within a narrow range of an average 4.0% since end-2023, and stood at a slightly lower 3.9% in November. Continued elevated growth of nominal wages in the euro area and price adjustments in those subcomponents of services that are partly or fully indexed to previous inflation are the main factors contributing to keeping services inflation on an elevated level.

Figure 2.2.3 Short-term and mid-term inflationary expectations of professional forecasters in the euro area



Note: SPF Q2/2024 (Survey of Professional Forecasters) refers to the results of the ECB survey of professional forecasters conducted from 1 to 3 October 2024.
SOURCES: Survey of professional Forecasters, ECB and Consensus Forecasts.

Figure 2.2.4 Short-term and mid-term consumer inflationary expectations in the euro area



SOURCE: Consumer Expectations Survey (CES) – October 2024, ECB, 29 November 2024.

The results of the ECB's fourth quarter 2024 survey suggest that professional forecasters expect the average annual inflation rate in the euro area to slow down to 2.4% in 2024 and 1.9% in 2025 and 2026 (Figure 2.2.3). Economic experts expect that further slowdown in wage growth will largely contribute to inflation returning to the target level. Such expectations are almost entirely in line with the latest ECB projection according to which the average annual inflation rate in the euro area could stand at 2.4% in 2024, 2.1% in 2025 and 1.9% in 2026. As regards consumers, the ECB survey (Figure 2.2.4) shows that short-term inflationary expectations in the euro area (for a year in advance, median) stood at 2.5% in October and mid-term expectations (for three years in advance, median) stood at 2.1%, with both indicators being lower than those recorded in mid-2024.

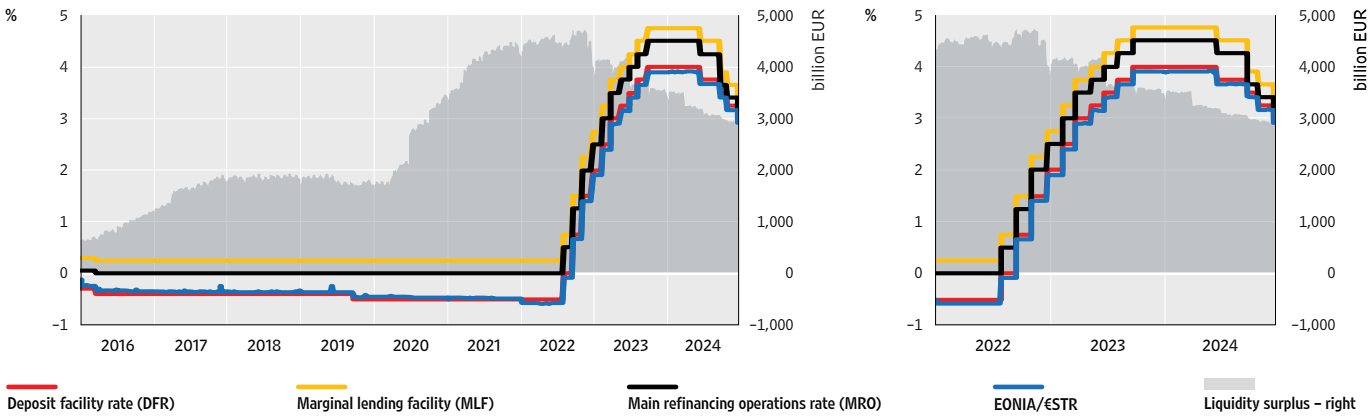
2.3 Monetary policy

The ECB's Governing Council lowered key interest rates by 25 basis points at the meeting on 12 December, thus continuing the gradual easing of monetary policy restriction that started in June. From June to December 2024, the Governing Council lowered the deposit facility rate (DFR), which, in the current conditions of high liquidity surpluses, is a relevant indicator of the monetary policy of the ECB, by 100 basis points, after having kept key interest rates steady since September 2023. The decision to moderate the degree of monetary policy restriction followed the most rigorous cycle of tightening since the introduction of the euro, during which cycle key interest rates rose by 450 basis points from July 2022 to September 2023.

In explaining its decision, the Governing Council has stressed that disinflation is well on track and that most measures of underlying inflation suggest that inflation will settle at around the Governing Council's 2% medium-term target on a sustained basis. Domestic inflation has edged down but remains high, mostly because wages and prices in certain sectors are still adjusting to the past inflation surge with a substantial delay. Financing conditions are easing as the recent interest rate cuts gradually make new borrowing less expensive for firms and households. But they continue to be tight because monetary policy remains restrictive and past interest rate hikes are still being transmitted to the outstanding stock of credit.

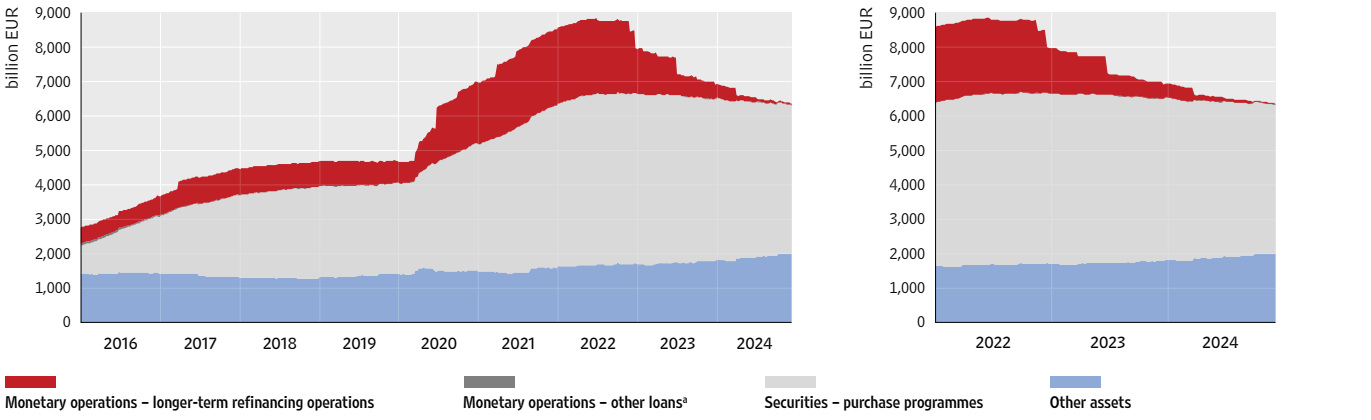
With its December decision, the Governing Council lowered the deposit facility rate (DFR) from 3.25% to 3.00%, the main refinancing operations (MRO) rate from 3.40% to 3.15% and the marginal lending facility (MLF) rate from 3.65% to 3.40%. The Governing Council is determined to ensure that inflation stabilises sustainably at its 2% medium-term target and it will continue to base its decisions on a data-dependent approach. The Governing Council is not pre-committing to a particular rate path.

Figure 2.3.1 Key ECB interest rates



SOURCE: ECB.

Figure 2.3.2 Eurosystem balance sheet



[a] Other loans include main refinancing operations, fine-tuning reverse operations, structural reverse operations, marginal lending facility and credits related to margin calls.
Note: The Eurosystem monetary balance sheet asset items are shown in grey and red and non-monetary in blue.
SOURCE: ECB.

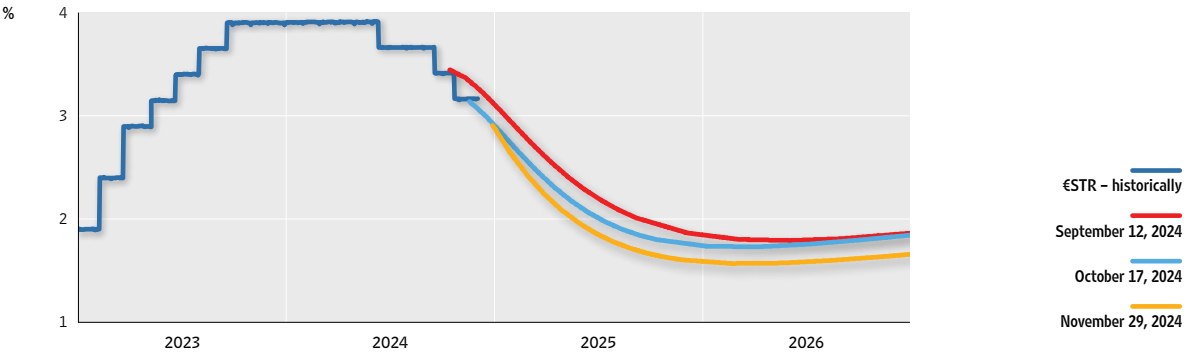
At the same time, the Eurosystem balance sheet continued to decrease gradually. The portfolio of securities purchased within the asset purchase programme (APP) is declining steadily at a measured and predictable pace, given that from July 2023 the Eurosystem is no longer reinvesting the principal payments from maturing securities. As regards the pandemic emergency purchase programme (PEPP), principal payments from maturing securities purchased under the PEPP are no longer reinvested in full as of July 2024, with the PEPP portfolio expected to decline monthly

by EUR 7.5bn on average over the second half of 2024. The Governing Council will discontinue reinvestments under the PEPP at the end of 2024.

2.4 Financial markets and the banking system

The reduction in key ECB interest rates in October soon spilled over to interest rates on the money market, and the poor economic outlook for the euro area led to a shift in market expectations towards a bigger reduction in ECB interest rates. In October, the €STR fell by the amount of the reduction in key interest rates (25 basis points) to 3.2% and held steady at that level until end-November. Similar developments were seen in the Croatian money market where the overnight interest rate on demand deposit trading fell to 3.0% in October and stood at a similar level until end-November. As regards market expectations, the €STR forward-curve fell towards lower values following the October meeting of the ECB's Governing Council (Figure 2.4.2). This was mostly due to the much worse than expected purchasing manager index for the euro area issued at end-November, which led to a shift in market expectations towards a sharper reduction in key interest rates of the ECB. The change in market expectations was also triggered by concerns about the possible negative impacts of the economic policies of the new US administration on the euro area economy.

Figure 2.4.1 €STR forward curve



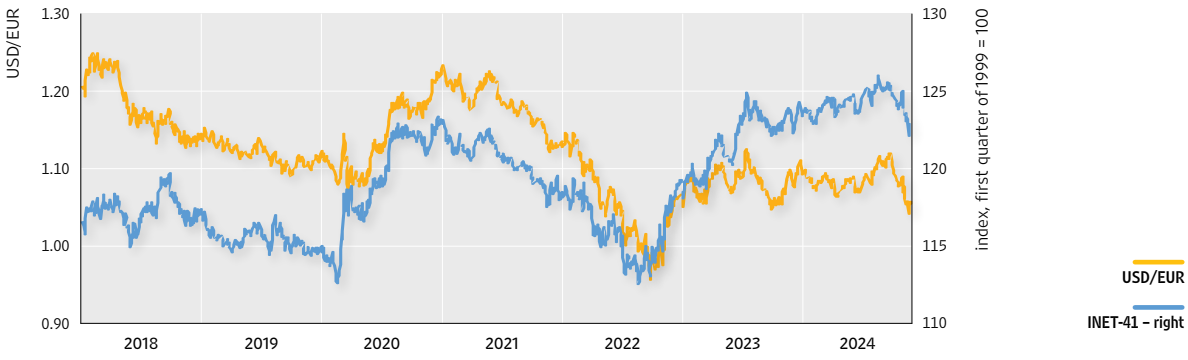
Notes: The forward curve is estimated using the overnight indexed swap rate (OIS). Forward curves show the selected forward curves formed on the day of the ECB Governing Council meeting in September and October 2024 and on the last day of November 2024.
SOURCES: Bloomberg and CNB calculations.

The yields on euro area long-term government bonds rose slightly following the ECB meeting in October, mostly mirroring the growth in long-term yields in the US but started falling gradually after the US elections as the expectations regarding future economic developments in the euro area worsened. The yields on euro-area long-term government bonds grew gradually following the October ECB meeting, mainly mirroring the growth in long-term yields in the US, and reached 3.0% at the beginning of November (Figure 2.4.3). After the US elections, the yields on euro area long-term government bonds started falling gradually, reaching 2.6% by end-November, the same level as in early October. This was mostly due to the concerns regarding the possible impacts of the economic policies of the new US administration on the euro area economy, as well as poorer economic activity indicators for the euro area released towards the end of November. Towards the end of November and in early December, growing uncertainty

regarding the direction of fiscal policy in France increased the yield spread on government bonds of France and Germany by around 15 basis points and led to this spread reaching its highest level since 2012. The yield on long-term government bonds of Croatia rose only slightly from mid-October and stood at 3.1% at the end of November.

The exchange rate of the euro against the US dollar depreciated strongly after September and by end-November dropped to its lowest level in the past two years. The depreciation of the exchange rate of the euro against the US dollar was mostly fuelled by a change in market expectations towards a smaller reduction in key interest rates in the US and a bigger reduction in key interest rates in the euro area, as the American economy proved more resilient than expected, while the economic outlook for the euro area worsened. Such divergent expectations further widened in the wake of the US elections, reflecting concerns that a shift by the incoming US administration in the direction of new protectionist measures might increase inflationary pressures in the US and have an unfavourable impact on the euro area economy. The exchange rate of the euro for the US dollar stood at USD/EUR 1.06 at end-November, its lowest level in the last two years, having depreciated around 6% from end-September. Over the same period, the nominal effective exchange rate of the euro against a basket of currencies of the euro area main trading partners depreciated by around 2% (Figure 2.4.2). The weakening of the euro against the US dollar was mitigated mainly by the euro strengthening against the Japanese yen, the Swedish krona and the Hungarian forint.

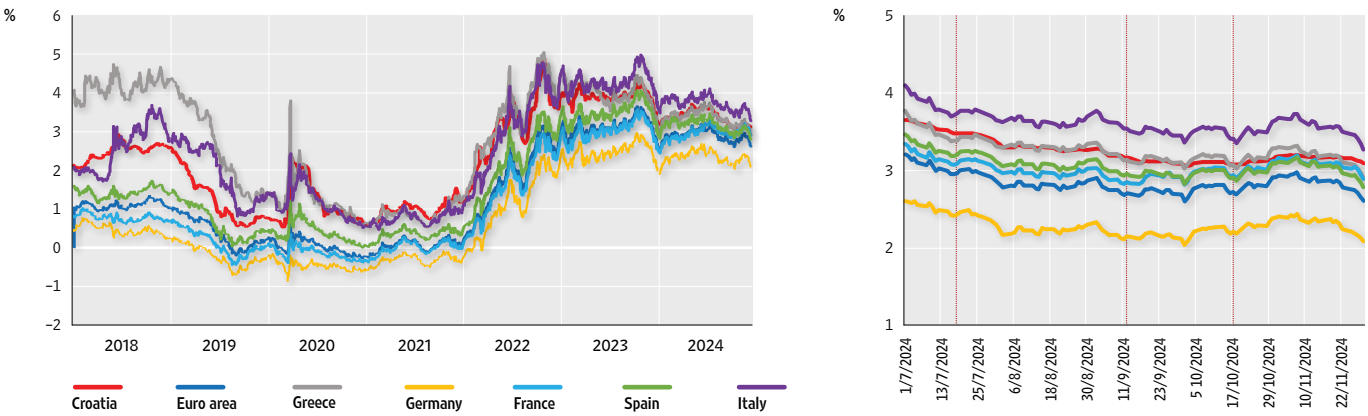
Figure 2.4.2 Exchange rates of selected currencies against the euro and the nominal effective exchange rate of the euro



Notes: EER-41 is the nominal effective exchange rate index of the euro against 41 major trading partners of the euro area. Exchange rate increase indicates euro appreciation. Last data is for 29 November 2024.
SOURCE: ECB.

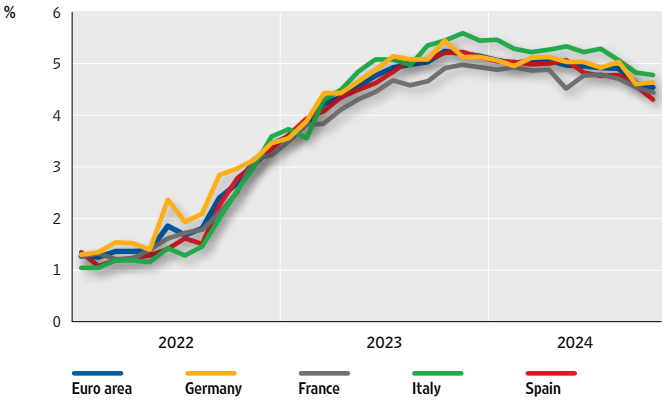
The interest rates of banks on corporate and household loans in the euro area continued to fall gradually. As a result, housing loans rose slightly while corporate loans remained subdued. At euro area level, the average interest rate on pure new loans granted to non-financial corporations in October was 4.5% (Figure 2.4.4), down by 60 basis points from December of 2023. As regards households, the average interest rate on pure new housing loans granted to households in October was 3.5% (Figure 2.4.6), down by 55 basis points from the end of the preceding year. Quarterly annualised growth rates of loans to non-financial corporations (Figure 2.4.5) were negative in the second half of the year or slightly above zero, with corporate lending remaining subdued. In contrast, the growth in housing loans (Figure 2.4.7) picked up slightly in the second from the first half of the year, again recording positive growth rates.

Figure 2.4.3 Yields on long-term government bonds with the remaining maturity of approximately 10 years



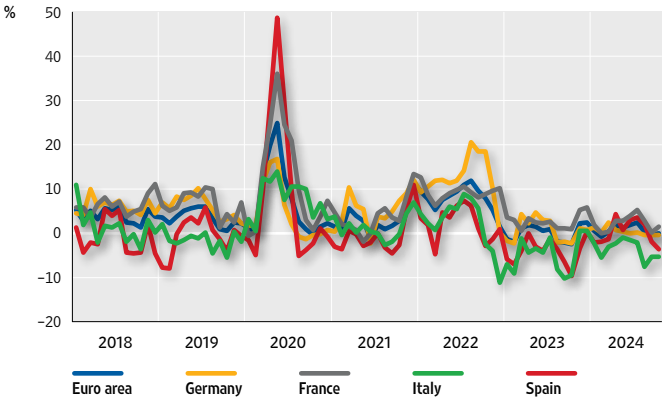
Notes: Yields for the euro area have been weighted by the share of GDP of the countries included. Data from the euro area do not include those from Estonia, Latvia, Luxembourg and Malta. The red dotted lines denote ECB Governing Council meetings in the shown period of time.
SOURCES: Bloomberg, Eurostat and CNB calculations.

Figure 2.4.4 Interest rates on pure new corporate loans



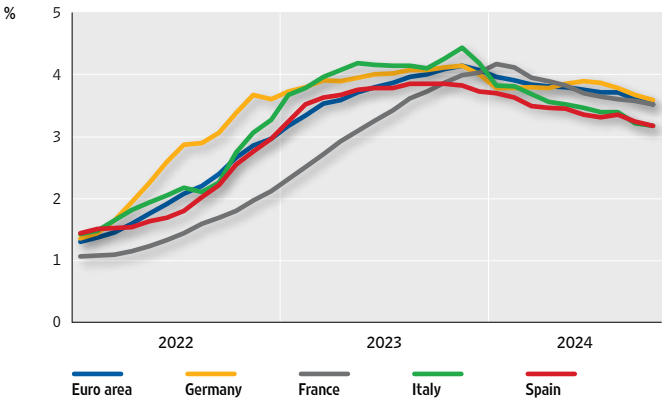
SOURCE: ECB.

Figure 2.4.5 Lending momentum in the euro area (corporations)



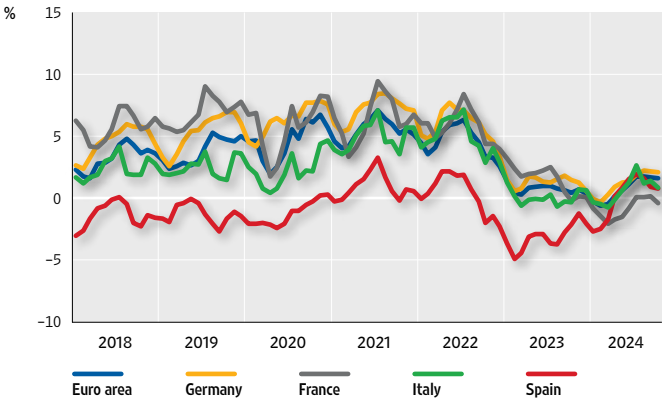
SOURCES: ECB and CNB calculations.

Figure 2.4.6 Interest rates on pure new housing loans to households



SOURCE: ECB.

Figure 2.4.7 Lending momentum in the euro area (housing loans to households)



SOURCES: ECB and CNB calculations.

BOX 1

When did Croatian sovereign bonds enter an A-rated bond category from the perspective of investors?

Towards the end of 2024, all global rating agencies put Croatia in the group of countries with upper medium investment grade, its highest rating since the country first started being assigned credit ratings in 1997. This Box examines when the yields on Croatian bonds came to equal yields of countries holding an A rating, and how the markets implicitly put Croatia in that group, with the formal confirmation of such a rating by the agencies coming in the last quarter of 2024. As shown in the literature, rating agencies typically lag behind the market, i.e. by the time new ratings are published, the investors have usually already built them into bond market prices. Investors and rating agencies use the same set of information to assess sovereign credit risk. such as economic growth, fiscal position and macroeconomic imbalances, that are used in the assessment of public debt sustainability. While investors tend to respond almost immediately to changes in economic parameters by purchasing or selling bonds, rating agencies typically revise their assessments with a time lag relative to changes in market sentiment, as confirmed in different empirical surveys. The results of the analysis suggest a narrowing of yield spreads on Croatian bonds towards an implicit threshold separating A-rated from B-rated countries even before entry into the euro area, in the period marked by very favourable macroeconomic developments, much before official rating agency decisions.

The decisions by three global rating agencies (S&P, Fitch and Moody's) to upgrade Croatian government bonds towards the end of 2024 and the inclusion of Croatia in the group of countries with upper medium rating (A rating comprises ratings A- to A+) is based on a number of favourable developments including fast economic growth, considerable improvement in fiscal position, living standard convergence with the EU average, political stability and institutional improvements in many areas. Owing to these factors, Croatia has joined the group of countries with an upper medium investment grade, implying a strong capacity to meet its financial obligations, albeit with a certain sensitivity to adverse economic conditions and changes in circumstances.[1] The last round of the credit rating upgrade thus builds on the improvements arising from the formal decision to introduce the euro: currency risk elimination, higher credibility of economic policies and institutional improvement following the reforms Croatia undertook to make by entering the ERM II (the so-called waiting room to join the euro) and higher financial security due to access to the European Stability Mechanism.[2]

1 For more information on individual ratings, see Standard&Poors (2024): Guide to Credit Rating Essentials What are credit ratings and how do they work? available at: https://www.spglobal.com/ratings/_division-assets/pdfs/guide-to-credit-rating-essentials.pdf

2 The European Stability Mechanism is a part of an EU strategy to ensure financial stability in the euro area. It provides financial support to euro area countries in or facing financial difficulties. For more information, see https://www.consilium.europa.eu/hr/policies/financial-assistance-eurozone-members/

Rating agencies' decisions were no surprise since yield spreads relative to the benchmark German bonds suggest that investors had for a while treated Croatian bonds as A-rated (**Figure 1**). Financial markets typically respond quickly to information they find might affect the ability to service a debt, which includes reaction to cyclical factors. In contrast, rating agencies base their decisions on longer-term trends, change their ratings less often and make decisions on rating changes with a time lag, when a range of indicators has become available to support an individual rating. In technical terms, one could say that market risk assessments are based on a point-in-time (PIT) approach, while rating agencies tend to make decisions using a through-the-cycle approach (TTC).[3] So markets often change a country's solvency rating much before rating agencies, and such market implied ratings may very often differ from those of rating agencies.

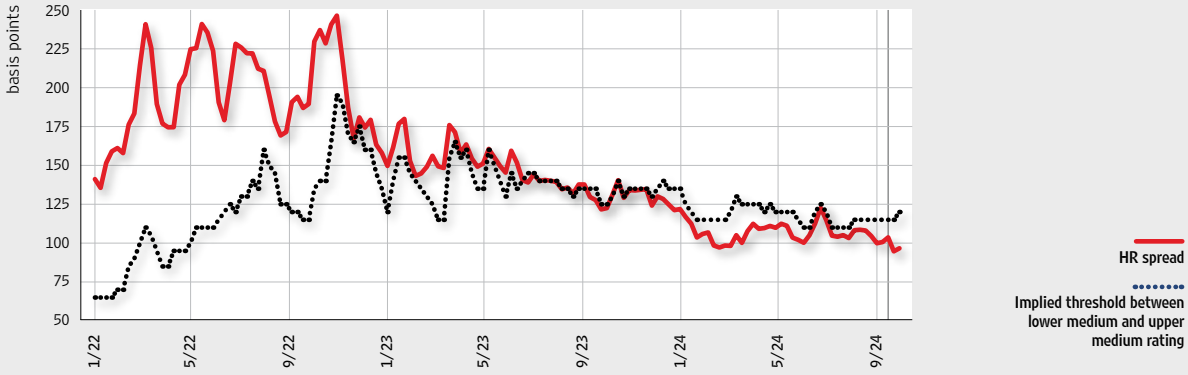
To capture the precise moment when the markets started rating Croatian bonds as those issued by A-rated bond issuers, an implied yield spread has been identified separating A-rated from B-rated country groups by minimising the difference between rating agency ratings and actual market spread (for more information, see the paper by Kunovac and Ravnik (2017)), whichis based on the approach of Berger et al. and of Kou and Varotto, 2005).[4] In other words, the method examines different values of yield spreads representing the threshold between these two credit rating categories and checks for each potential threshold the measure to which it adjusts credit rating with market perception of the observed countries' solvency.[5]

3 *Complementing Agency Credit Ratings with MIR (Market Implied Ratings)*, Moody's Analytics. Available at: https://www.moodys.com/sites/products/ProductAttachments/Complementing_Ratings_with_MIR.pdf

4 Kunovac, D. Ravnik, R. (2017): *Are sovereign credit ratings overrated?* Comparative Economic Studies, 59(2), 210 – 242; Breger, L. L., Goldberg, L. R. and Cheyette, O. (2003): *Market implied ratings*, Risk Magazine; Kou, J. and Varotto, S. (2004): *Predicting agency rating migrations with spread implied ratings*.

5 The following function is minimised: $P(g) = \frac{1}{m}\sum_{i=1}^{m} \max(S_{i,R_1} - g, 0) + \frac{1}{n}\sum_{i=1}^{n} \max(g - S_{j,R_2}, 0)$ where g represents the implied threshold, the spread of i-th country with rating R1 (upper rating), represents the spread of the j-th country with rating R2 (i.e. one category below R1), m is the number of countries which had rating R1 in the observed period, while n is the number of countries that had rating R2 in the observed period. The equation clearly shows that the value of the function will increase due to an increase in the first term, when the selected g is below the optimum level, while total value of the function will increase due to an increase in the second term when the selected g is above the optimum level. In this way, the method comes to a threshold between two credit rating categories, adjusting them with market data.

Figure 1 Market implied threshold between lower medium and higher medium credit rating and the actual spread on Croatian 10-year bond relative to German 10-year bond



Notes: The black dotted line represents the implied threshold between yield spreads of countries with lower medium rating (BBB-, BBB, BBB+) and those with upper medium ratings (-A, A, A+). The vertical line represents the moment in which the first rating agency classified Croatia in the A- category (16 September 2024). The yield spread is calculated as the yield spread on a ten-year government bond of an individual country denominated in euro relative to the yield on a ten-year German government bond. A country is classified as investment grade if it has been rated in this grade by at least two of the three rating agencies (S&P, Moody's, Fitch). According to this criterion, countries with an upper medium credit rating since November 2023 include Slovakia, Lithuania, Spain and Portugal and countries with lower medium rating include Romania, Hungary, Italy, Cyprus and Portugal until November 2023. The analysis was made on a sample of European countries only.
SOURCES: CNB calculations and Bloomberg.

Figure 1 shows how the yield spreads between Croatia and the implied threshold narrowed considerably already in the period leading to entry in the euro area, which activated the effect of the so-called 'europremium'[6] when the markets placed Croatia right on the threshold between A and B categories. The convergence in yield spreads to levels observed by bonds of A-rated countries suggests that it is possible that financial markets already at that time implicitly considered Croatia as a member of the A-group, with the continuity of favourable macroeconomic, fiscal and institutional developments soon supporting such a rating. It is interesting to note that this year's developments, including the official upgrade to A category by all rating agencies, have not had any significant impact on Croatia's implied position.

It can be concluded that although rating agencies play an important role in the financial market, it is worth noting that fundamentals ultimately more closely and actively monitored by investors than rating agencies are crucial for developments in borrowing costs and risk perception of investments. Thus. in the eyes of investors, the entry in the euro area and favourable developments had already put Croatia in an A category towards the end of 2022, much before its official assignment to that category by the rating agencies.

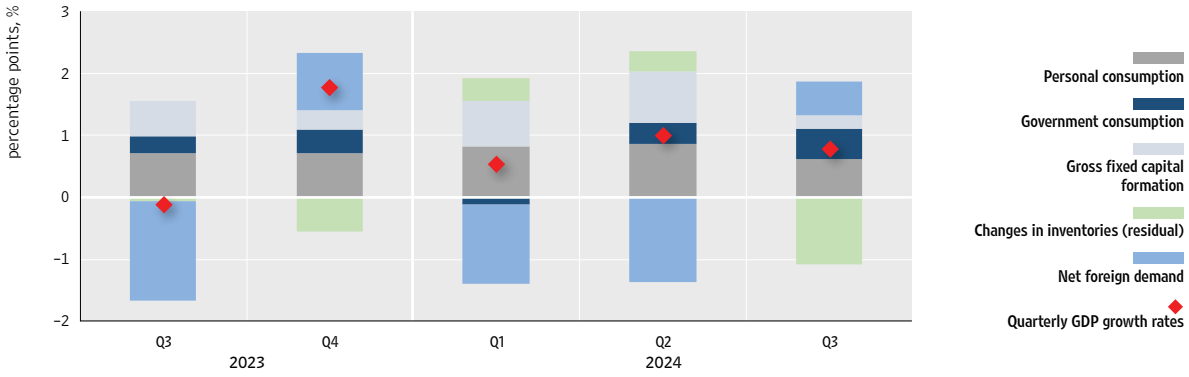
6 For more information, see Zrnc, J. (2022): *Skorašnje usvajanje eura već je povoljno utjecalo na troškove zaduživanja Hrvatske*, available at: https://www.hnb.hr/-/skorasnje-usvajanje-eura-vec-je-povoljno-utjecalo-na-troskove-zaduzivanja-hrvatske

3 Croatian economy

3.1 Real developments

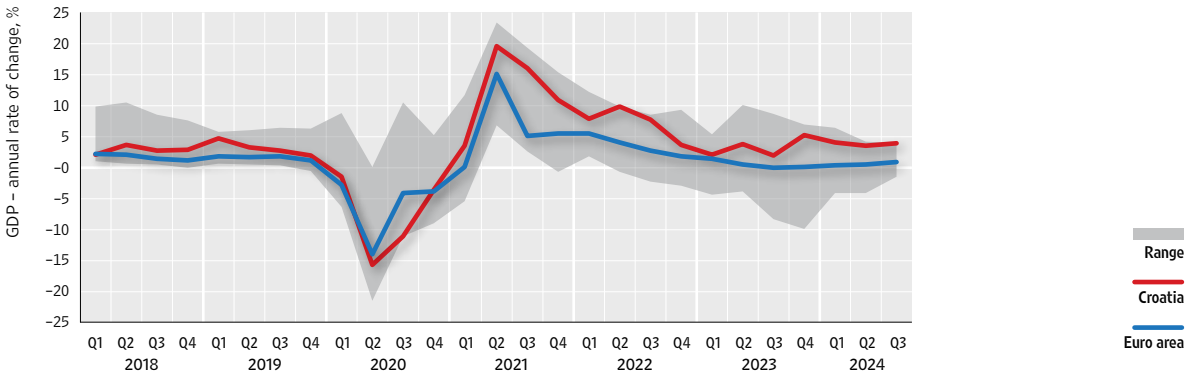
The economic expansion that marked the first half of 2024 continued into the third quarter, and high-frequency indicators point to continued robust growth towards the end of the year. Croatia's real GDP rose by 0.8% during the summer months on a quarterly level, which is on track with the average in the first half of the year, having risen by almost 4.0% from the same period of 2023. The favourable developments mainly reflect strong domestic demand and strengthening of goods exports, while real exports of services fell (Figure 3.1.1). Data available for the beginning of the fourth quarter suggest a further growth at an intensity similar to that seen in the preceding part of the year, with the growth rate of real GDP in 2024 as a whole possibly reaching 3.7%. This growth rate continues to be in the range of the top rates of growth in the euro area economy.

Figure 3.1.1 Contributions to the change in real economic activity



SOURCE: Eurostat.

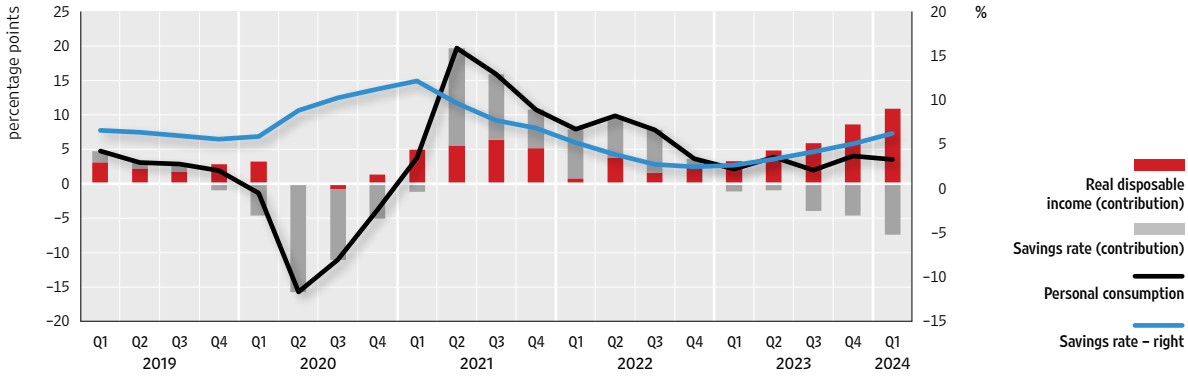
Figure 3.1.2 Trends in economic activity in Croatia and the euro area



Note: The figure shows the range of values of real GDP growth of individual euro area member states.
SOURCE: Eurostat.

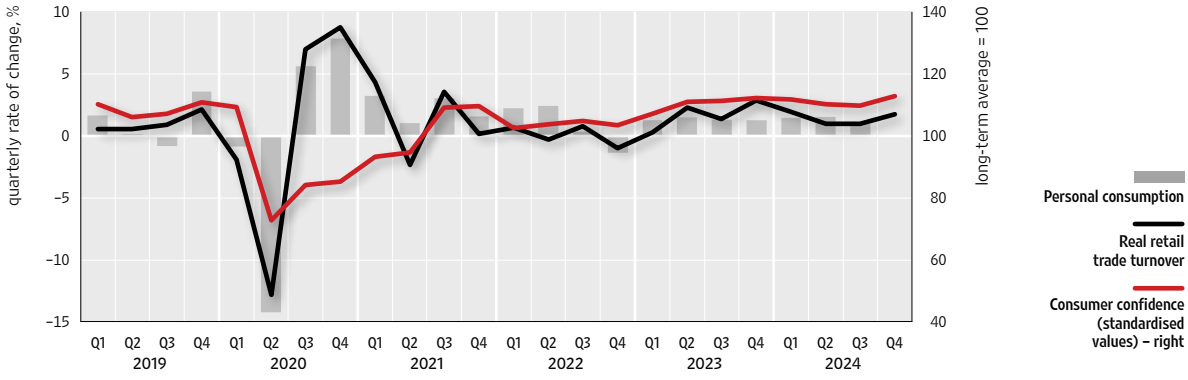
Personal consumption continued to grow relatively sharply owing to favourable developments in the labour market (Figure 3.1.3) and the increase in real disposable income of households. The current growth in nominal wages in the private sector strengthened again in the third quarter of the year, after having stagnated during the second quarter, while wages in the public sector held steady at the level reached following a very steep growth in April this year. Relatively strong employment growth continued and was mostly concentrated in services activities, the public sector and construction, while the number of employed persons in industry remained almost unchanged from the previous quarter. Amid falling inflation, such developments resulted in a growth in real income and a noticeable growth in personal consumption, albeit at a somewhat slower intensity than in the first half of the year. The growth in real disposable income is increasingly exceeding the growth in personal consumption, leading to a further increase in the savings rate from the pre-pandemic level it reached in the second quarter.

Figure 3.1.3 Contribution of disposable income and savings rate to the annual change in personal consumption



Notes: Quarterly disposable income values have been estimated using the Chow-Lin method and a series of employee compensation and gross operating surplus and mixed income as indicators. The savings rate is calculated as the ratio of the estimated nominal amount of savings and estimated disposable income and excludes adjustments for changes in pension rights.
SOURCES: Eurostat and CNB calculations.

Figure 3.1.4 Personal consumption, retail trade and consumer confidence

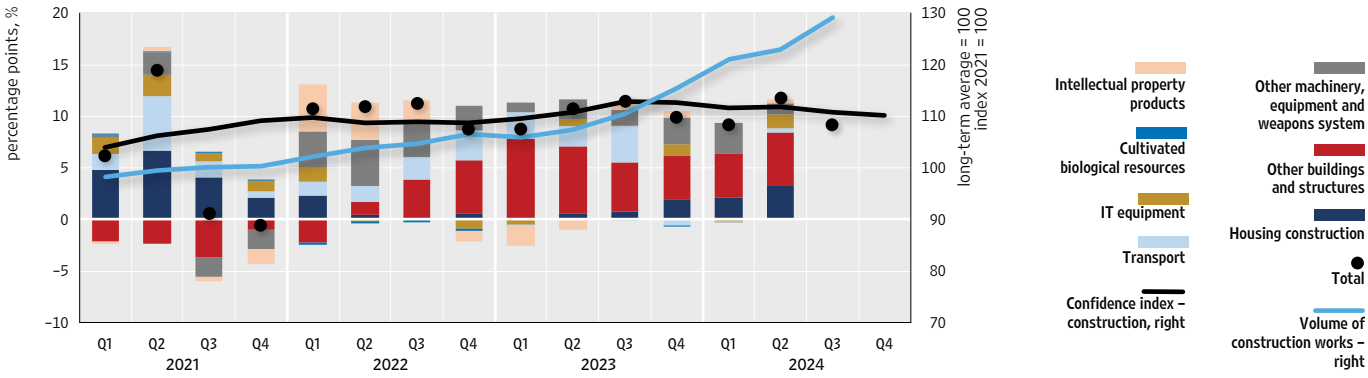


SOURCES: CBS and Ipsos.

Investments also rose sharply. Although gross fixed capital formation slowed down visibly in the third quarter from the first half of the year, investment activity continued to be relatively strong. Data for the first half of the year show a broad-based investment growth by asset type, with the largest contribution coming from investment in residential real estate and other civil engineering works, mainly private sector investment; it appears that similar developments continued in the third quarter. Data on construction work volume from July to September suggest a further considerable growth in investments in buildings, and investments in other civil engineering works, typically associated with public sector investments, also increased. The developments in imports of capital goods also indicate further growth in corporate investment in machinery and equipment.

Current growth in goods exports strengthened again during the summer months, after having stagnated in the preceding quarter, while real exports of services fell on an annual level. Following a relatively robust growth at the beginning of the year and stagnation in the second quarter, goods exports again rose sharply during the summer months and were 6.3% higher than in the same period of the year before. However, nominal data for July and August suggest that the current growth in goods exports is largely the result of exports of energy products, while the exports of most other products, except medical and pharmaceutical products and individual capital goods, were relatively subdued, which may be attributed to smaller foreign demand. The real services exports also fell on an annual level, which can partly be attributed to worsened competitiveness arising from price increases in tourism-related service activities and poorer economic developments in the main outbound markets.[1] All this was reflected in a fall in the number of nights stayed and in real consumption by foreign tourists. Adverse weather conditions also contributed to poor volume indicators in September. Despite the modest services exports, total exports of goods and services rose on an annual level, however, the negative contribution of net exports to growth remained relatively high given the strong domestic demand, which fuelled a considerable growth in imports in the first nine months of the year.

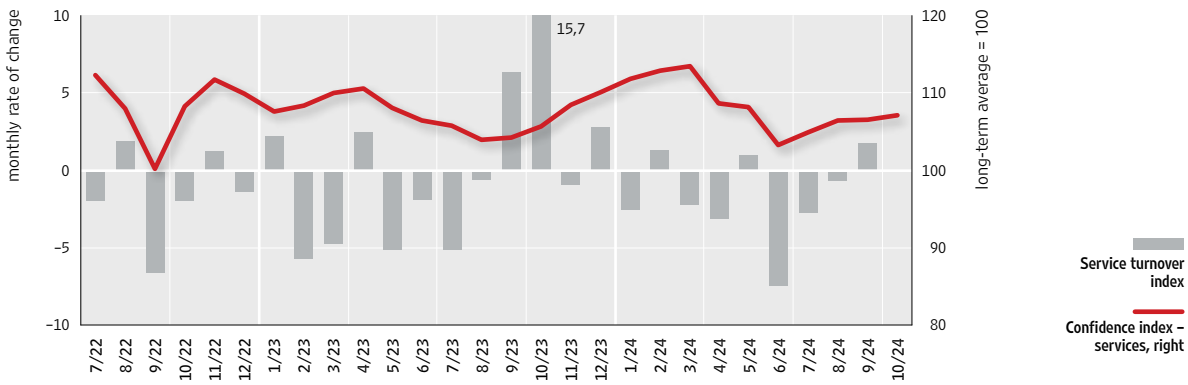
Figure 3.1.5 Investment activity indicators and confidence in the construction sector



Notes: Data on confidence in the construction sector for the second quarter of 2024 refer to October and November.
SOURCES: CBS, Ipsos and CNB.

1 For more details, see Box 5 Price competitiveness of the Croatian tourist sector in the Mediterranean market.

Figure 3.1.6 Developments in turnover volume of service activities and confidence in the services sector



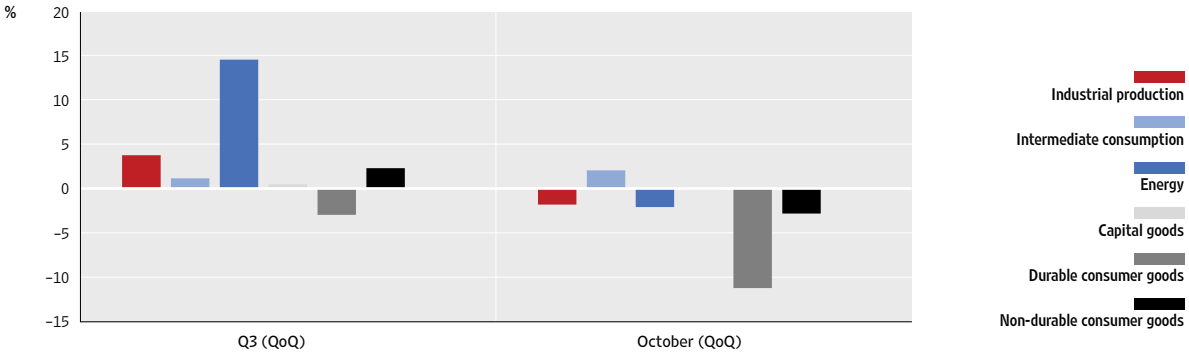
Note: Services include sectors H, I, J, L, M and N.
SOURCES: CBS, Ipsos and CNB.

If analysed by main activities, the continuation of favourable economic developments in the third quarter largely reflects growth in construction and manufacturing while the contribution of service activities decreased slightly. However, this growth structure could change towards the end of the year. With developments in construction activity continuing to be exceptionally favourable, growth, already relatively strong, again accelerated on a quarterly level in the third quarter. This can be attributed to the earlier mentioned strong investment activity in residential real estate and other civil engineering works. Confidence in the construction sector remained relatively high in the fourth quarter. The growth in manufacturing accelerated in the third quarter, with seasonally adjusted values showing that it fully offset the previous year's losses. However, a sharp drop in industrial production in October, accompanied by a considerable decline in confidence in industry, suggests that such favourable developments might only be temporary. As regards services, the developments in most activities were generally more unfavourable than in the first half of the year. Tourism-related activities fell from the previous quarter, but this could change towards the end of the year given the increase in real retail trade turnover and relatively favourable indicators of foreign tourist arrivals and nights stayed in October and November.

The available monthly indicators for the fourth quarter of 2024 point to further solid economic growth towards the end of the year. According to the CNB's nowcasting model of economic activity, which draws on data available mostly for October, in the last quarter of 2024, real GDP could grow 0.9% from the previous quarter while the annual growth rate could slow down to 3.1% because of the base effects, i.e. a sharp growth towards the end of the previous year. Such developments largely continue to be influenced by exceptionally favourable developments in trade, supported by further growth in domestic demand and a sharp increase in foreign tourist arrivals and night stayed. In October, the real retail trade turnover rose 0.6% from the previous month, or 1.7% from the previous quarter's average, thus continuing its growth on a quarterly level present since the beginning of last year, which mirrors exceptionally favourable trends in the labour market and further growth in employment and real wages. Also, after much worse results in the main part of the tourist season, in October and the first 20 days of November the

number of nights stayed rose by approximately 9% and 21%, respectively, from the same period of the year before. In contrast, after industrial production had grown sharply in September, its volume slumped in October by 3.9% on a monthly and 1.8% on a quarterly level. A broadly based fall was recorded in all the main industrial groupings except intermediate and capital goods.

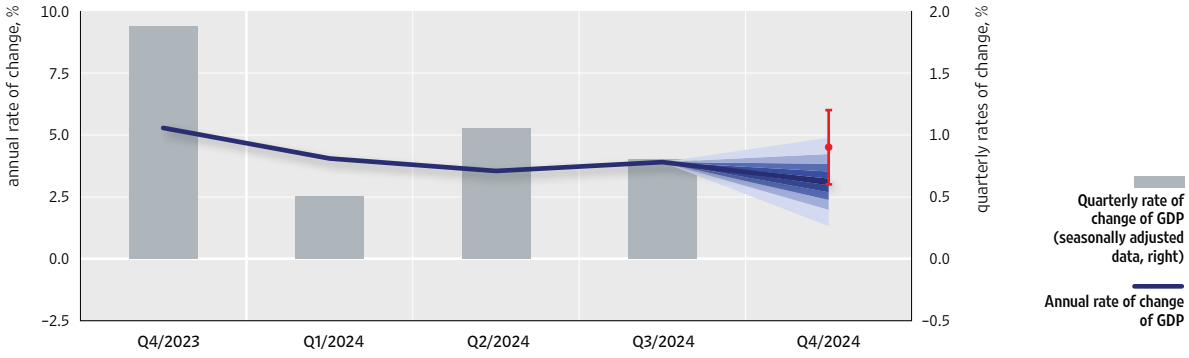
Figure 3.1.7 Industrial production



Note: (QoQ) signifies growth relative to the average of the preceding quarter.
SOURCE: CBS.

Figure 3.1.8 Quarterly GDP

seasonally adjusted real values



Notes: The estimate for the fourth quarter of 2024 refers to the Monthly indicator of real economic activity of the CNB (for more details on the calculation of the MRGA indicator, see CNB survey Kunovac, D., and B. Špalat: *Nowcasting GDP Using Available Monthly Indicators*). The models are estimated on the basis of data published up to 29 November 2024. The red dot denotes an estimate of the quarterly change in real GDP, with historical errors of estimates within ±1 standard deviation.
SOURCES: Eurostat, CBS and CNB.

BOX 2

How did the excessive deficit procedure influence fiscal policy direction in the EU?

The excessive deficit procedure has often been criticised with reference to two opposing views: one holds that insufficient stringency in implementation leads to the questioning of its effectiveness in ensuring fiscal discipline, and the other that insufficient stringency in the implementation of rules in the upward phase of the cycle results in the need to restrict fiscal policy in the downward phase, which results in procyclical effects with the capacity to deepen a recession. This Box analyses the effect of EDP activation on fiscal consolidation in EU member states between 2005 and 2019. Using more recent methods of difference-in-differences we estimate the causal effect of the EDP on the cyclically adjusted primary balance based on quarterly data. The results suggest that entry in the EDP and the time spent in the EDP up to ten quarters led to a significant fiscal consolidation in the EU and an improvement in fiscal position by an average of 1.69 percentage points. However, the required consolidations in not so few cases took place in periods of below par economic activity and the countries under EDP often had to pursue restrictive, procyclical policies in unfavourable economic conditions, as was the case during the global financial crisis. The new fiscal framework adopted on 30 April 2024 offers greater flexibility over a longer period of adjustment and enables individualised approaches for member states based on structural investment and reform plans, thus partly alleviating the procyclical nature of the rules, particularly in recession years. However, the activation of fiscal rules, after a four-year suspension, should, irrespective of reform, trigger a more restrictive fiscal policy direction on the EU level in subsequent years.

Fiscal rules in the European Union have been devised to ensure sustainable public finances and coordination of fiscal policies and avoid the spillover of their negative effects to member states as it is not likely that a fully decentralised fiscal policy on a national level can completely internalise all its implications for other EU member states. National fiscal measures thus influence fiscal policy direction at the euro area level and unfavourable effects do spill over if member states pursue a procyclical fiscal policy, have an unsustainable fiscal position or decrease potential growth with structural policies that have a negative impact on GDP (Lane, 2021)[1]. The implementation of fiscal rules should also enable the pursuit of a countercyclical fiscal policy, i.e. the creation of fiscal room in periods of expansion that will ensure fiscal stimuli to economic activity in times of crisis. It has been shown in practice that member states at times pursued procyclical expansive fiscal policies in a period of economic upswing, which put the fiscal position in the downward phase of the cycle in conflict with the rules, i.e. led to the activation of the excessive deficit procedure, which imposed austerity measures.

1 Lane, P. (2021): *The future of the EU fiscal governance framework: a macroeconomic perspective*, panel at the European Commission webinar on 'The future of the EU fiscal governance framework'.

To analyse the effect of the EDP on the fiscal consolidation of member states, quarterly Eurostat data from 2005 to 2019 for 26 EU member states were used. This period is chosen because of the 2005 fiscal rules reform, when a mid-term objective based on structural balance was introduced and the final period, i.e. end-2019. because of the fiscal rules suspension in 2020 due to the pandemic. The change in fiscal policy direction, i.e. a discretionary fiscal policy response in the EDP period is estimated using a cyclically adjusted primary balance of the general government, thus eliminating the impact of the business cycle on the fiscal position. To analyse the effect of the EDP on fiscal policy direction an estimator from a research by De Chaisemartin and d'Haultfoeuille (2024)[2] is used, which assumes that the EDP is activated in countries at different times and that it is possible to activate and close the EDP several times in an individual country. This analysis builds on the work by De Jong and Gilbert (2020.)[3] who concluded that the corrective arm of the EDP had a considerable impact on the direction of fiscal policy in the EU, i.e. that for each percentage point of GDP in the context of the recommended fiscal adjustment only 0.6–0.7 percentage points of consolidation were ultimately implemented. Similar research into the response function of fiscal policy (Cimadomo, 2008[4]; Nerlich and Reuter, 2016[5]; Gootjes and de Haan, 2022[6]) also confirm fiscal policy procyclicality in the EU, despite the implementation of fiscal rules.

Figure 1 shows the effect of the EDP on the direction of fiscal policy in EU countries, demonstrating that in the period prior to EU-level treatment there were no consolidation effects by fiscal policy makers before the EDP was initiated. However, Croatia may be singled out as an exception among EU countries, although the consolidation efforts at the time were not sufficient to prevent the activation of the EDP.

2 De Chaisemartin, C. and d'Haultfoeuille, X. (2024): *Difference-in-differences estimators of intertemporal treatment effects*, Review of Economics and Statistics, p. 1-45.

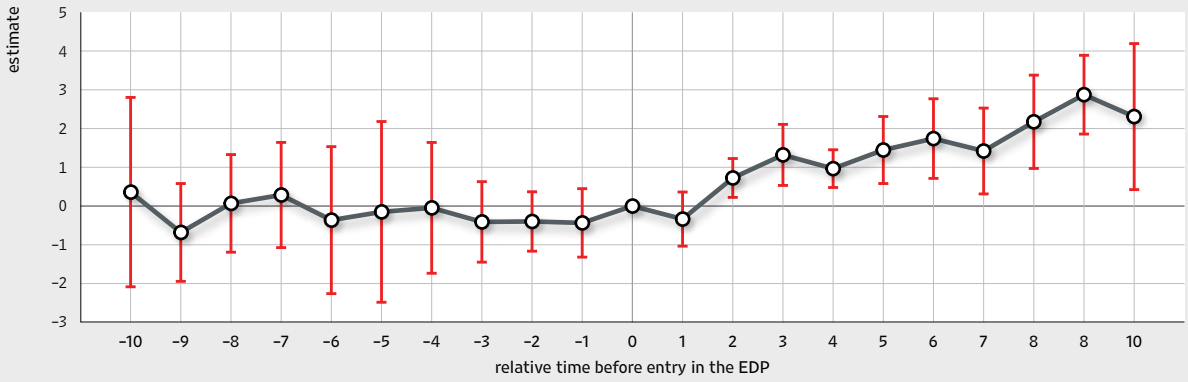
3 De Jong, J. F. and Gilbert, N. D. (2020): *Fiscal discipline in EMU? Testing the effectiveness of the excessive deficit procedure*, European Journal of Political Economy, 61: 101822.

4 Cimadomo, J. (2008): *Fiscal policy in real time*, European Central Bank, Technical report, Working Paper Series, No 919.

5 Nerlich, C. and Reuter, W. H. (2016): *Fiscal rules, fiscal space, and the procyclicality of fiscal policy*, FinanzArchiv/Public Finance Analysis, p. 421-452.

6 Gootjes, B. and de Haan, J. (2022): *Procyclicality of fiscal policy in European Union countries*, Journal of International Money and Finance, 120: 102276.

Figure 1 EDP effect on the cyclically adjusted primary balance of general government in the EU



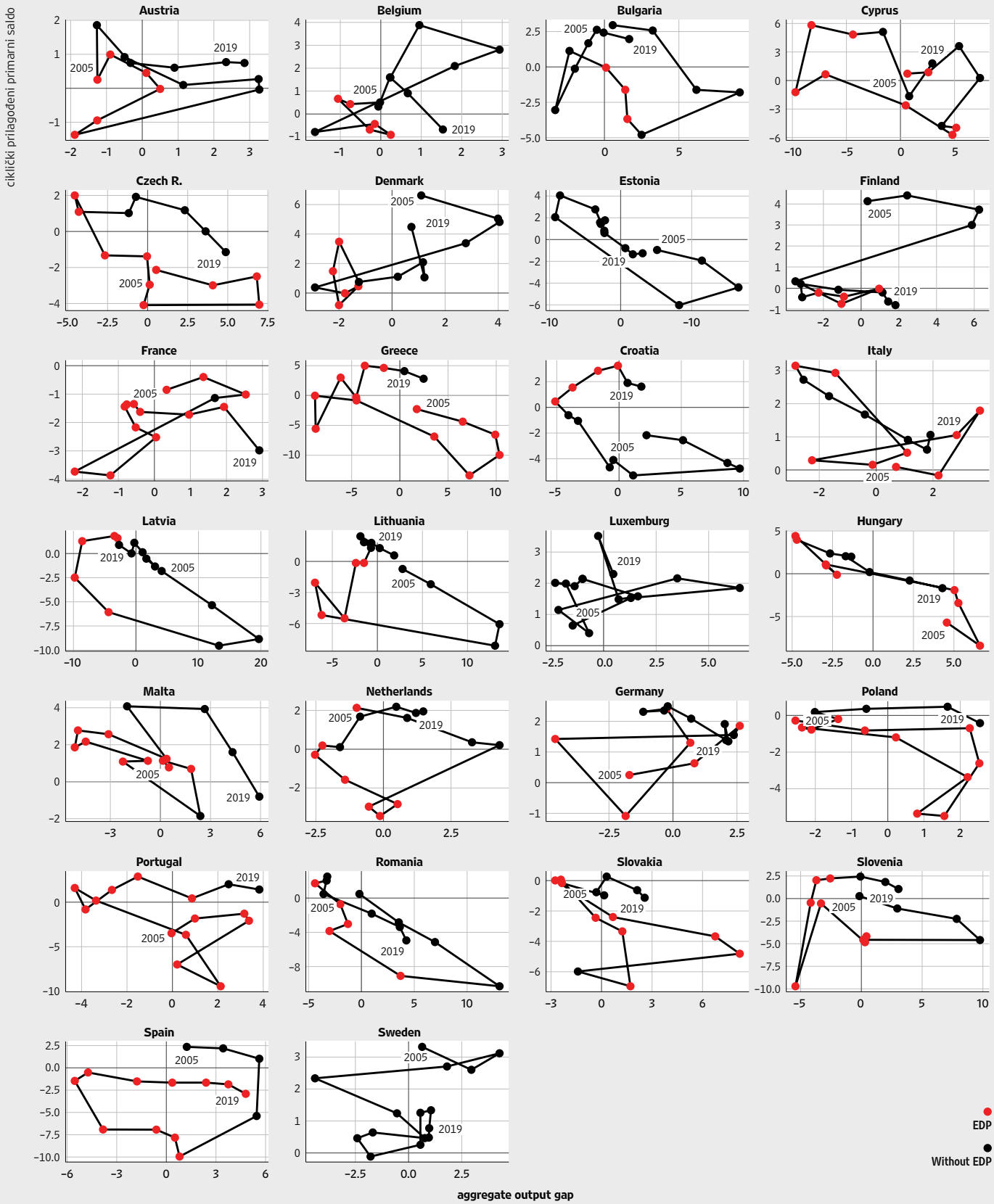
Notes: Black dots show estimates of EDP impact on CAPB within a range of –10 to 10 quarters using the De Chaisemartin and d'Haultfoeuille (2024) estimator. Values from –10 to –10 represent placebo estimates, while those from 1 to 10 show the non-normalised estimations of EDP effects during quarter l. Red columns represent the 90% confidence interval of the effect, based on standard errors clustered at country level. The specification has no covariant.
SOURCES: Eurostat and CNB.

The main results of the analysis indicate a positive and statistically significant effect of the EDP on the cyclically adjusted primary balance at EU level. If up to 10 quarters spent in the EDP are observed, which also includes longer episodes, but only up to 10 quarters, discretionary fiscal position improved on average by 1.69 percentage points (the confidence interval of 90% is between 1.07 and 2.32 percentage points). When the time spent in the EDP is extended up to 20 quarters, the average effect is 2.77 percentage points, albeit with a higher imprecision of the estimate (confidence interval of 90% is between 1.57 and 3.98 percentage points).

In the first quarter following EDP activation, typically no visible effect on the direction of fiscal policy can be observed, which is largely attributable to the legislative procedure regarding the implementation of consolidation measures (Figure 1). However, over time the effects increase and become statistically significant. There is also a noticeable relatively wide range of confidence intervals, largely mirroring the different dynamics and effectiveness of fiscal adjustment over the years and different fiscal starting positions.

In some cases fiscal consolidation under the EDP was carried out during periods of crisis, which means that the restrictive policy added to the unfavourable economic developments (Figure 2). The implementation of fiscal adjustment in periods of a negative gap in aggregate production mainly relates to the time of the global financial crisis and European debt crisis, resulting in a restrictive procyclical action. Over 40% of the cases of fiscal consolidation under the EDP took place in periods of a below par economy, suggesting a relative diffusion of the procyclical policy action in an unfavourable phase of the economic cycle.

Figure 2 Fiscal policy direction in the EU



Note: The first quadrant refers to a restrictive countercyclical direction, the second to a restrictive procyclical direction, the third to an expansively countercyclical direction and the fourth to an expansive procyclical direction.

SOURCES: Eurostat and CNB.

Fiscal rules in the EU were activated in 2024 following a four-year suspension and changes were also introduced aimed at reducing the risks of pursuing a procyclical expansive policy in the upward phase of the cycle that prevents an active implementation of fiscal policy in the downward phase of the cycle because of the insufficiency of the fiscal room created. This is supposed to be achieved by strengthening the preventive arm of the EDP through the introduction of protective deficit and debt limits. The reference values of the general government deficit of 3% of GDP and general government debt of 60% of GDP remain unchanged. Also, the new framework has been designed to ensure in the corrective part a greater flexibility over a longer period of adjustment (4 + 3 years), with the aim of preventing self-defeating consolidation and to enable an individualised approach for each member state based on structural investment and reform plans. The corrective arm of the new rules should base mid-term adjustment on restrictions of excessive increase in net primary expenditures derived from a debt sustainability analysis. Allowance is also made for the composition of adjustment so as to maintain public investment, which, combined with reforms fuel long-term economic growth. Taking into account the activation of fiscal rules at the EU level, in the forthcoming period we expect to see a restrictive fiscal policy direction, although probably less stringent than during the previous fiscal rules. However, the ex ante analyses of the changed fiscal rules made so far (e.g. Darvas et al., 2024)[7] cannot determine indisputably the extent to which the new rules will ensure long-term fiscal sustainability.

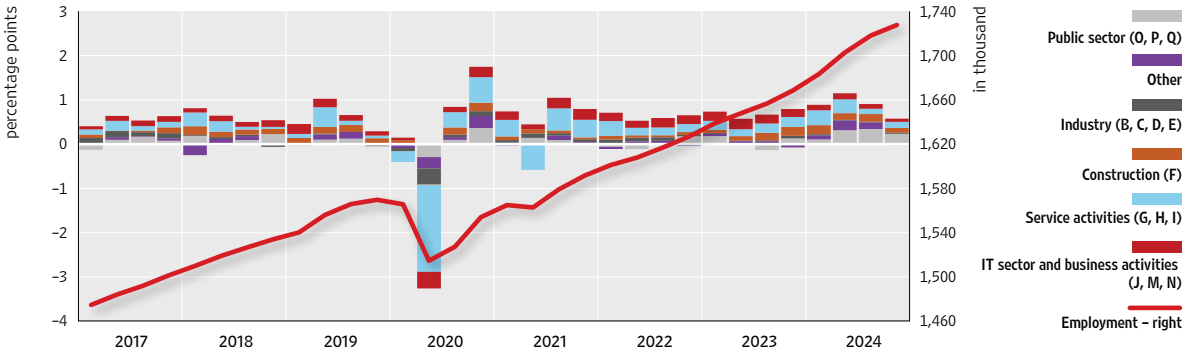
7 Darvas, Z., Welslau, L. and Zettelmeyer, J. (2024): *The implications of the European Union's new fiscal rules* Policy Brief 10/2024, Bruegel.

3.2 Labour market

The number of employed persons in Croatia continued to rise in the third and early fourth quarter, again fuelled by strong domestic economic activity. Total employment growth slowed down slightly in the third quarter of 2024 but rose by 0.9% from the previous quarter (1.1% in the second quarter). For the second consecutive quarter, employment in public administration, education, human health and social work activities (activities O, P and Q, hereinafter 'the public sector') has been the main generator of growth in total employment (Figure 3.2.1). In the rest of the economy, employment continued to grow strongly in construction and considerably in transportation and storage, real estate activities and business services (activities M and N). Employment continued to grow in October, having risen 0.8% from the first month of the third quarter, and reached approximately 1.73m employed persons (seasonally adjusted data), an increase of 3.8% from October last year, which slightly accelerated the annual rate of change.

Figure 3.2.1 Employment by NCA

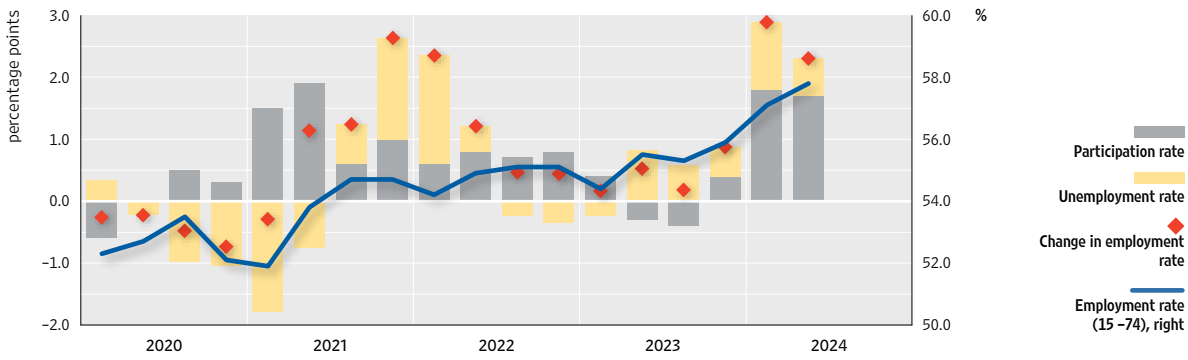
seasonally adjusted data, contributions to the quarterly rate of change



Note: Data for the fourth quarter of 2024 refer to October and show contributions to the rate of change relative to July of the same year (first month of the third quarter).
SOURCE: CPII (seasonally adjusted by the CNB).

The employment rate rose markedly in early 2024 (57.1% from 54.4% in the first quarter of 2023) due to increased activation of the previously inactive population and a steady fall in unemployment (Figure 3.2.2). According to last available data for the second quarter of 2024, the employment rate stood at 57.8% (up from 55.5% in the second quarter of 2023).

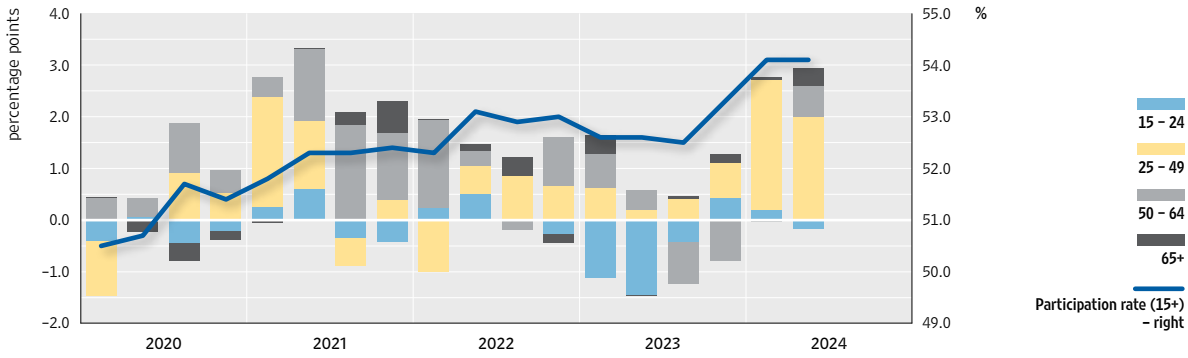
Figure 3.2.2 Contributions to the rate of change in employment (15 – 74)



Notes: The employment rate is calculated for the population aged 15 – 74. Data shown are based on the Census 2021 data.
SOURCES: CBS and CNB calculations.

The activation of the previously inactive population in the first half of 2024 relative to the same period of the year before was most pronounced in the peak working age population group (aged 24 – 49) (Figure 3.2.3). In the second quarter of 2024 the higher employment of older people (aged 50 – 64 and 65+) contributed considerably to the growth in the participation rate relative to the same period of the year before. The steady increase in the number of pensioners working half time can be attributed to the need to meet the pronounced demand for labour. In the third quarter of 2024, around 33 thousand pensioners (or slightly fewer than 2% of all employed) worked half time, an increase of 15.8% from the same period of the year before. In the second quarter of 2024, the participation rate (15+) stood at 54.1%, the same as in the first quarter. The participation rate rose by 1.5 basis points from the same period of 2023.

Figure 3.2.3 Participation rate (15+) and contributions to change by age groups



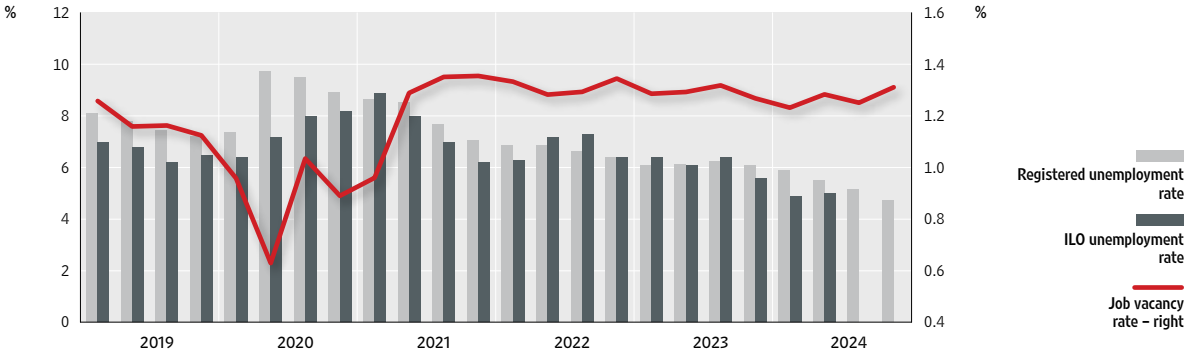
Notes: The participation rate is calculated for the population aged 15+. Data shown are based on the Census 2021 data.
SOURCES: CBS and CNB calculations.

Increased employment led to a reduction in the unemployment rate, with the demand for labour remaining strong, reflecting high job vacancy rates. In the third quarter of 2024, unemployment continued to fall strongly while early in the fourth quarter the fall in unemployment moderated slightly. At the end of October, there were 86 thousand unemployed persons

(according to seasonally adjusted data), down 20% from the end of the previous year. In the third quarter, the seasonally adjusted registered unemployment rate stood at 5.2% of the work force and in October it fell to 4.8%. The internationally comparable ILO unemployment rate, according to the last available data for the second quarter of 2024, fell to 4.7% of the labour force, down from 5.2% in the previous three months (Figure 3.2.4). In the third quarter, the job vacancy rate stood at 1.25% and in October it rose to 1.31%.

Figure 3.2.4 Unemployment and job vacancy rates

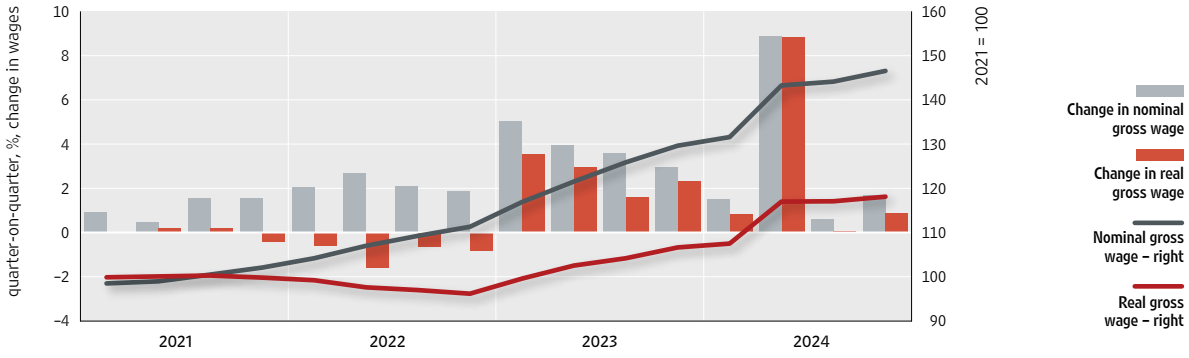
seasonally adjusted data



Note: Data for the fourth quarter of 2024 refer to October.
SOURCES: CBS, CES, Eurostat and CNB calculations (seasonally adjusted by the CNB).

Figure 3.2.5 Average nominal and real wage

seasonally adjusted data



Note: Data for the fourth quarter of 2024 refer to October.
SOURCES: CBS and CNB calculations (seasonally adjusted by the CNB).

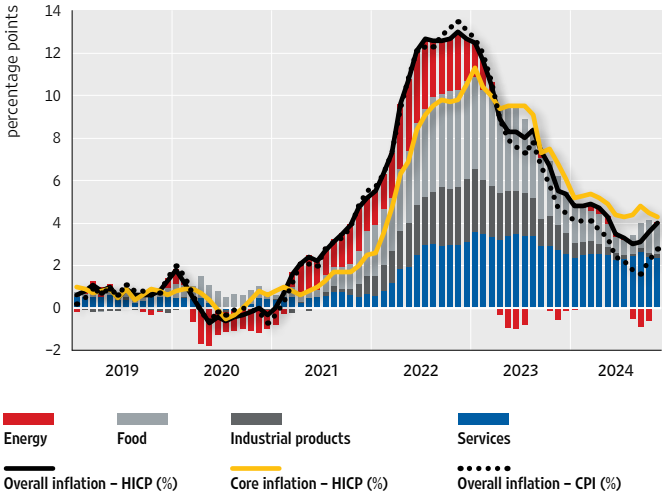
Following a steep growth in the second quarter, wages grew only modestly in the third quarter but their growth picked up again in October. Amid low unemployment, the developments in nominal gross wages continue to be influenced by the pronounced demand for labour. Following robust wage growth in the second quarter of 2024 (up 8.9% from the previous quarter), the third quarter recorded only a modest growth of 0.6% (Figure 3.2.5). While the average nominal gross wage in the public sector remained almost unchanged (following rapid

growth in the second quarter), in the rest of the economy the average nominal gross wage rose further, albeit at a lower intensity of 1.1% (down from 4.5% in the second quarter). Broken down by the NCA, wage growth slowed down in most activities and fell in the IT sector and accommodation and food service activities. In October, wage growth accelerated considerably in financial and trade activities and also increased in industry, while wages in the IT sector offset the decrease seen in the previous quarter. Thus overall the rest of the economy saw accelerated wage growth (2.1%), which, with almost unchanged wages in the public sector, resulted in an acceleration of the growth in the average nominal gross wage to 1.7% from the average in the preceding three months. The real average gross wage remained unchanged in the third quarter of 2024, after having grown steadily from the beginning of 2023. In October, its growth accelerated to 0.9% from the average in the preceding three months. When compared to the same period last year, the annual growth rate of wages slowed down in the third and early fourth quarter, largely owing to the base effect of a substantial rise in the wages in the public sector in mid-2023, which since July has no longer affected the annual rate of wage growth. Thus the average nominal gross wage in the third quarter was up 14.5% and the real wage 12.4% from 11.9% and 9.1%, respectively, in early fourth quarter.

3.3 Price developments

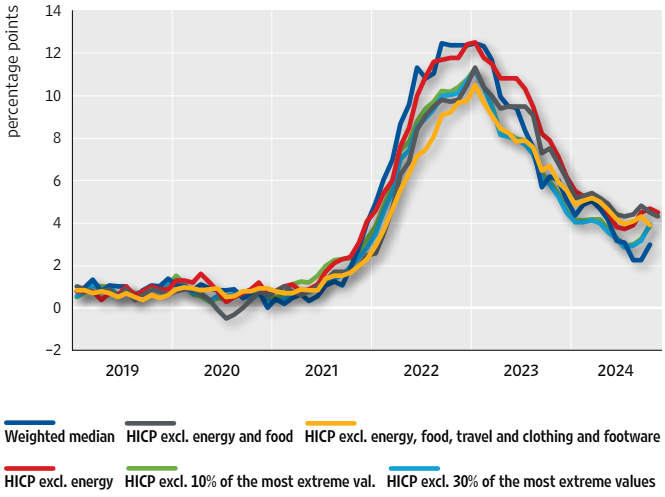
The slowdown in consumer price inflation that started towards the end of 2022 continued almost without interruption into the first eight months of 2024 but inflation accelerated noticeably in the following three months, largely influenced by unfavourable base effects. Inflation more than halved in 2023, having fallen from 12.7% in December 2022 to 5.4% in December 2023, measured by the harmonised index of consumer prices (HICP) and continued to decline at a slower pace until August 2024 when it fell to 3%, the lowest level recorded since August 2021 (**Figure 3.3.1**). The slowdown in inflation was due to the restrictive monetary policy and lower inflationary pressures on the supply side amid easing of the effects of past inflationary shocks and the absence of new shocks on the global market, which led to lower prices of energy and other raw materials and the stabilisation of global supply chains. However, due to persisting pronounced pressures associated with robust real domestic activity and with the labour market and despite a relatively subdued foreign demand, inflation remained elevated. The unfavourable base effects (elimination of the effects of lower than usual monthly rates of change in the prices of all the main components of inflation towards the end of 2023 on the annual consumer price inflation), the increase in administered prices of electricity, gas and district heating, as well as higher current pressures on food inflation led to inflation acceleration between September and November when it stood at 4.0%. Inflation measured by the national consumer price index, which does not cover consumption by foreign tourists and institutional households (such as educational, health and religious institutions, etc.) slowed down in 2024 from 4.5% in December 2023 to 2.8% in November (for differences between the national and harmonised index of consumer prices, see Box 3 Why has the difference between the harmonised and the national inflation indicators increased?

Figure 3.3.1 Inflation indicators in Croatia



Note: Core inflation is measured by the harmonised index of consumer prices, which excludes energy, food, alcoholic beverages and tobacco prices.
SOURCES: Eurostat, CBS and CNB calculations.

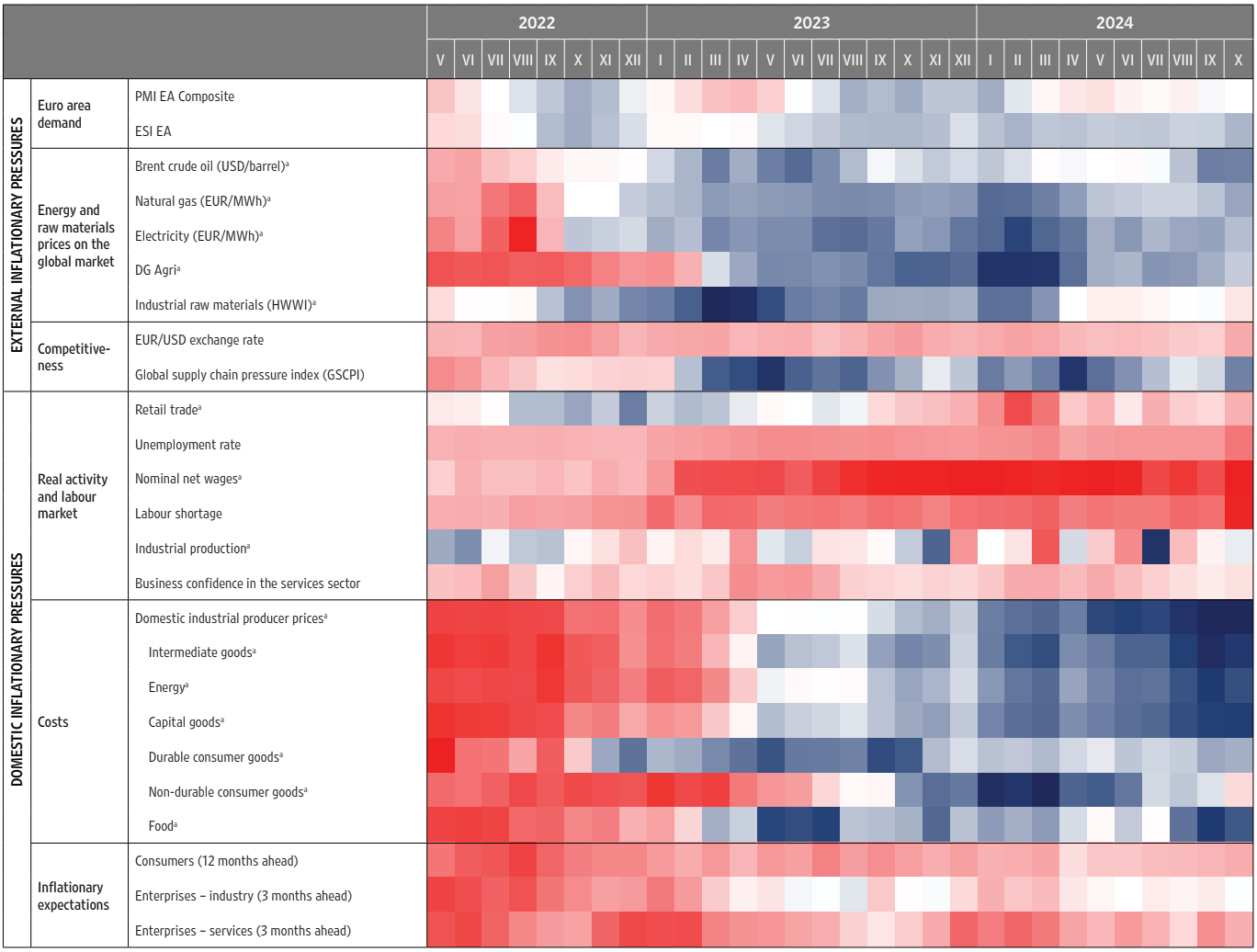
Figure 3.3.2 Core inflation indicators in Croatia



Notes: Trimmed mean eliminates 5% (15%) of components (out of a total of 87 components) with maximum and minimum annual rates of change. The weighted median excludes all values but the weighted median of the distribution of price change.
SOURCES: Eurostat and CNB calculations.

Core inflation also moderated noticeably in the first eleven months of 2024, although it remained elevated. Core inflation, which excludes food and energy prices, slowed down from 6.1% in December 2023 to 4.3% in November 2024. The bulk of the slowdown took place in the first half of the year after which it hovered around an average of 4.5%. Broken down by core inflation components, the inflation of the prices of industrial products continued to slow down owing to lower imported inflationary pressures and stood at 0.7% in November, thus falling below its pre-pandemic long-term average. Although to a smaller extent, services also contributed to the slowdown in core inflation with their annual price inflation falling from 8.1% in December 2023 to 7.3% in November 2024. Nevertheless, services remain the main component with the largest individual contribution to overall inflation (2.3 percentage points of the total of 4.0). Elevated and persistent inflation in services is the result of their higher sensitivity than other components to nominal wage increases and of strong domestic demand. Services inflation held steady at an elevated level despite subdued foreign demand for services (for more details, see Box 5 Price competitiveness of the Croatian tourist sector in the Mediterranean market), particularly those related to tourism. Alternative indicators of core inflation, which are sometimes used as signals of future overall inflation developments, also fell further in the first eleven months of 2024, with a recent increase in the value of individual indicators mainly due to increased inflation of individual food components (Figure 3.3.2). Such developments reflect the easing of the bulk of inflationary pressures, even though in the conditions of persisting pressures arising from robust real domestic activity and the domestic labour market, the indicators of core inflation are still elevated (Figure 3.3.3).

Figure 3.3.3 Indicators of external and domestic price pressures



[a] Annual rate of change

Notes: Labour shortage is the ratio between the vacancy rate and the registered unemployment rate. The PMI EA Composite and ESI EA series have been corrected after standardisation so as to show the neutral value in white. Red (blue) indicates a positive (negative) deviation in the value in a given month relative to the 2010 – 2023 average (expressed by the number of standard deviations), where the intensity of the colour shade indicates the size of an upward (downward) deviation from the average.

SOURCES: ECB, Eurostat, Bloomberg, NY Fed, HWWI, CBS and Ipsos.

After rising in the first half of the year, short-term indicators of overall and core inflation shrank noticeably from July to November. In the first half of the year, short-term inflation indicators (so-called momentums or quarterly rates of change calculated from seasonally adjusted data and expressed on an annual level) rose noticeably (Figure 3.3.4), mainly reflecting increased momentum of services and food inflation (Figure 3.3.5). After that, the momentums of overall and core inflation decreased, mainly mirroring the fall in current inflationary pressures in the services and energy components. In contrast, the momentum of food inflation steadily increased, reaching a relatively high level in November, which suggests that current inflationary pressures are presently most pronounced in the food component.

Figure 3.3.4 Momentums of overall and core inflation

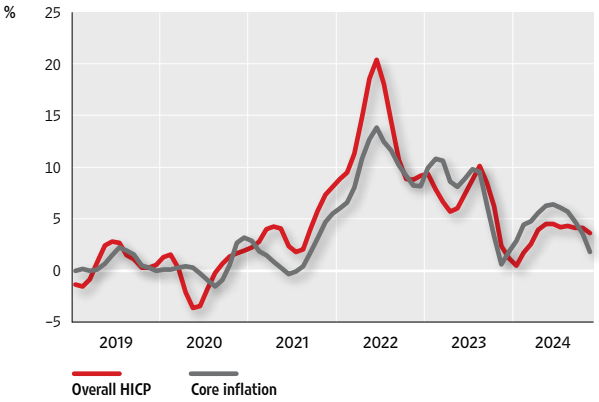
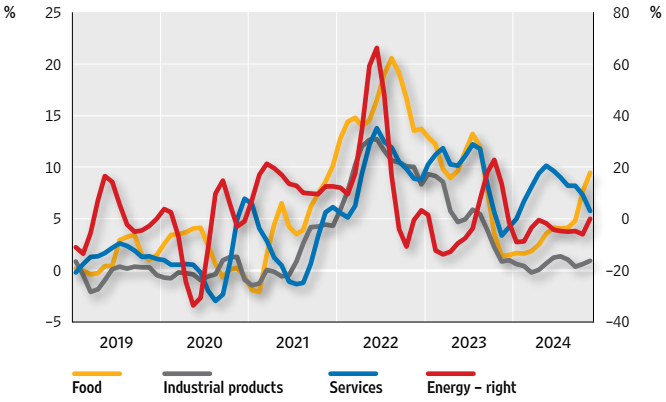


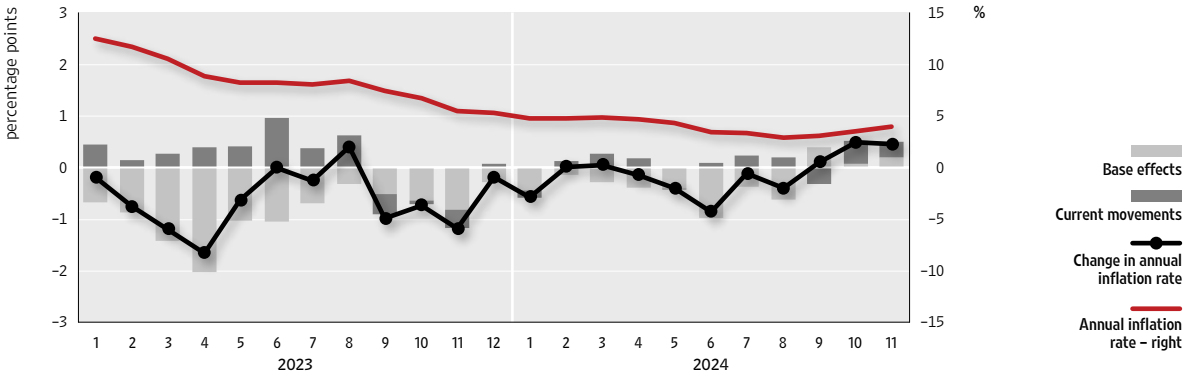
Figure 3.3.5 Momentums of main inflation components



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

The acceleration in the annual rate of inflation between September and November 2024 reflects unfavourable base effects and the strengthening of inflationary pressures in food and energy. The change in the annual rate of inflation month-on-month depends on the change in retail prices from the month before (current inflation) and the monthly rate of change in prices in the same month of the year before (base effects).[1] Thus the slowdown in the annual rate of inflation in the first eight months mainly mirrored the favourable effect of the base period. As of September, the base effects became unfavourable and had the opposite effect on inflation (Figure 3.3.6). Current inflationary pressures in individual inflation components also grew with the increase in current pressures in the food component standing out in particular. Their deviations from the typical values increased noticeably in the past few months (Figure 3.3.7). In addition, the increase in administered prices of electricity, gas and district heating has, together with the increase in refined petroleum products, led to an increase in energy inflation.

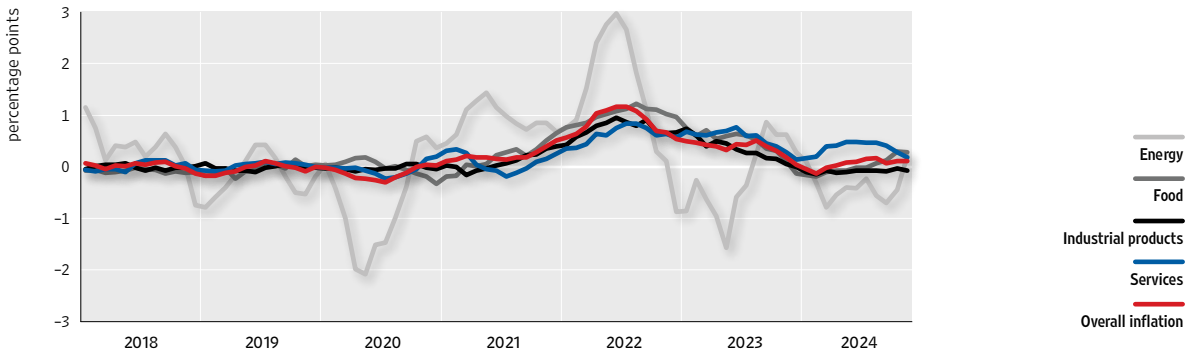
Figure 3.3.6 Contributions of base effects and current developments to a change in annual inflation



Note: The base effects and current developments were adjusted for the usual developments that are relatively stable and do not affect annual inflation considerably.
SOURCES: Eurostat and CNB calculations.

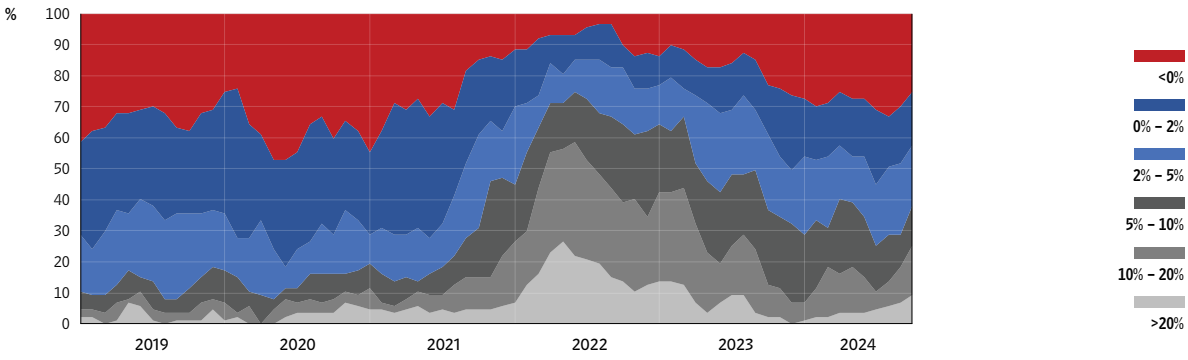
1 For more details, see HNBlog D. Kunovac and M. Luketina, *On the way down – the role of base effects in the slowdown of consumer inflation*.

Figure 3.3.7 Deviations of the monthly rate of change of inflation from the usual developments



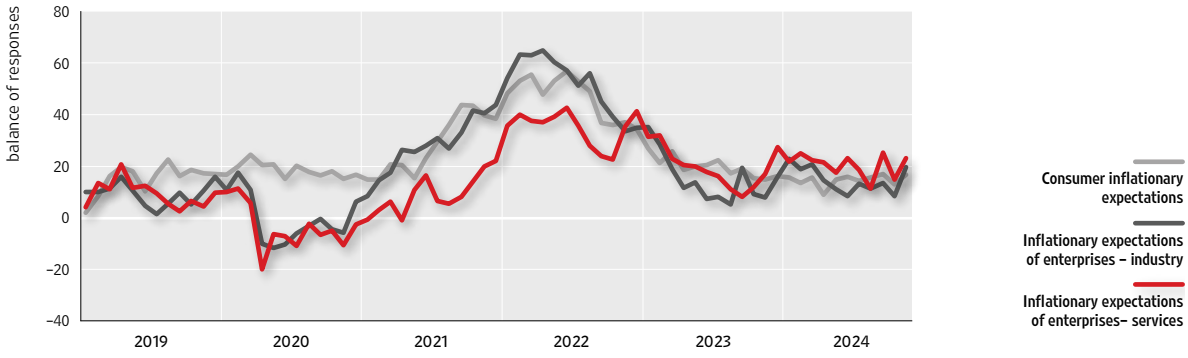
Note: Data refer to six-month averages of the contributions of the unusual developments to the monthly rate of change.
SOURCES: Eurostat and CNB calculations.

Figure 3.3.8 Diffusion of consumer price inflation



Note: The figure shows the share of the number of products whose prices changed within a defined range in the total number of products, according to quarterly moving averages of the annual rates of change of seasonally adjusted price indices of 87 components of the harmonised consumer price index.
SOURCES: Eurostat and CNB calculations.

Figure 3.3.9 Short-term inflationary expectations of consumers and corporates



Note: Consumer expectations refer to a twelve-month period ahead and corporate expectations refer to a three-month period ahead.
SOURCE: Ipsos.

The easing of inflationary pressures can also be seen in a smaller inflation diffusion (Figure 3.3.8), especially when compared to 2022 and 2023. However, when compared to the pre-pandemic period, the share of components whose annualised seasonally adjusted quarterly rate of change was below 5% is still much smaller. In contrast, short-term consumer and

corporate inflationary expectations in industry in the second half of 2024 were close to the pre-pandemic level while short-term corporate inflationary expectations in the services sector were still noticeably above the pre-pandemic level (Figure 3.3.9).

In the first eleven months of 2024, inflation in Croatia slowed down more than inflation in the euro area, with the inflation differential decreasing noticeably. In November, inflation in Croatia was 1.7 percentage points higher than the average in the euro area, down from 2.5 percentage points from the end of 2023 (Figure 3.3.10). The difference between core inflation also fell; in November it was 1.6 percentage points higher than the euro area average, down from 2.7 percentage points in December 2023 (Figure 3.3.11). The decrease in inflation differential is the result of a fall in the difference in the contributions of the main inflation components, except food (Figure 3.3.12). The higher level of inflation in Croatia relative to the euro area average is fuelled, among other things, by tourist demand accompanied by a faster growth in economic activity and personal consumption and a faster growth in labour costs, which spill over particularly to higher services inflation. Higher inflation is also driven by differences in the structure of the consumer basket with a higher share of food amid the still relatively steep food price increase.

Figure 3.3.10 Synchronisation of overall inflation in Croatia and the euro area

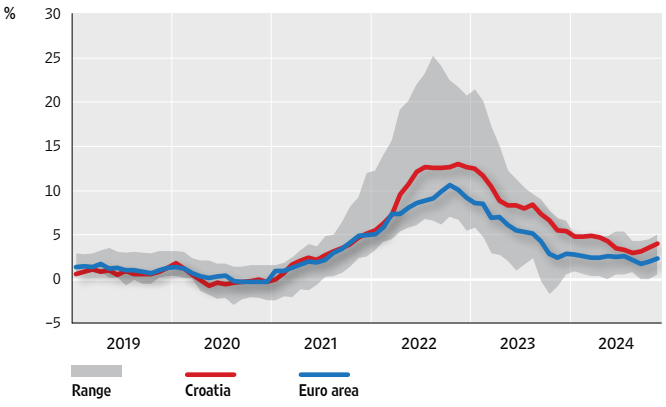
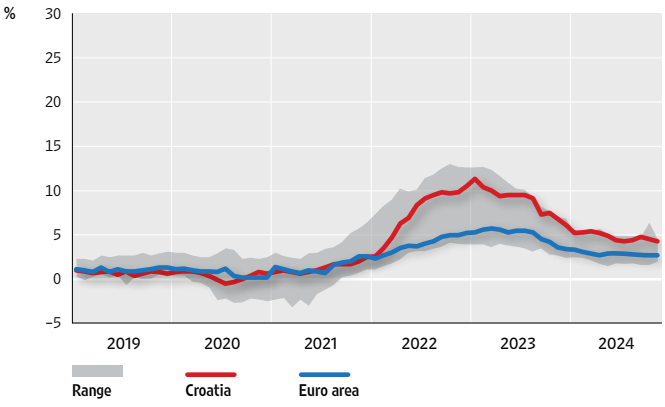
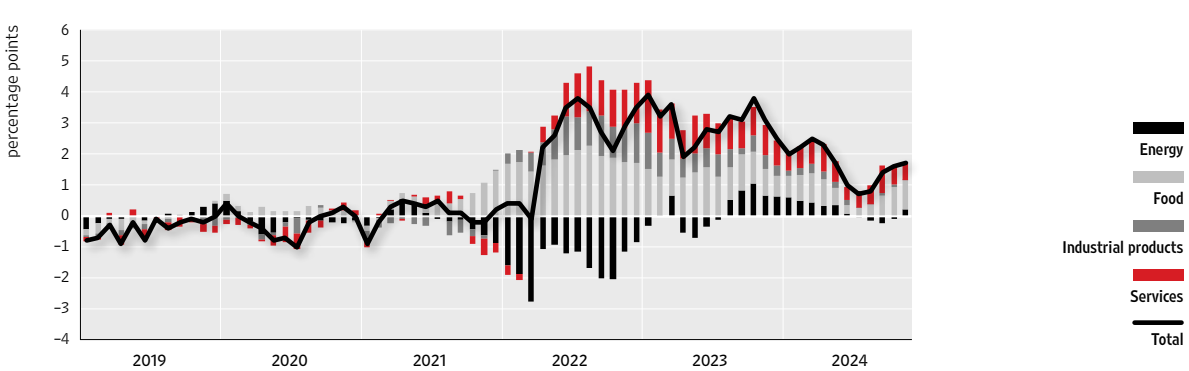


Figure 3.3.11 Synchronisation of core inflation in Croatia and the euro area



Note: Grey areas show the range of values of individual member states of the euro area.
SOURCE: Eurostat.

Figure 3.3.12 Difference between overall inflation and the contributions of individual components to consumer price inflation in Croatia and in the entire euro area



SOURCES: Eurostat and CNB calculations.

BOX 3

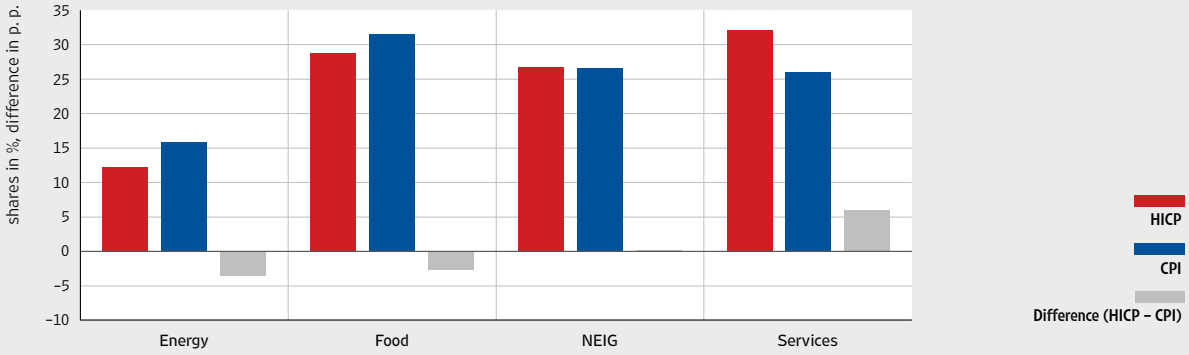
Why has the difference between the harmonised and the national inflation indicators increased?

Although the CNB focuses its analyses and projections on the harmonised inflation indicator, it continues to monitor the national indicator, using it for various purposes in the national context. While usually relatively small, the differences between the harmonised and the national indicators increased considerably from mid-2023 until September 2024, when they reached their peak. The main reason why inflation measured by the harmonised indicator is higher than the one measured by the national indicator is the strong growth of services prices, and in particular of hotel and restaurant and accommodation services prices, which account for a much larger share in the consumer basket used for the calculation of the harmonised indicator, as it includes consumption by foreign tourists. The difference between the harmonised and the national inflation indicators may gradually decrease due to the expected slowdown in services prices.

In advance of Croatia's entry to the euro area, the focus of CNB analyses and projections shifted from the national consumer price index (CPI) to the harmonised index of consumer prices (HICP).[1] The HICP is a key inflation rate targeted by the ECB, which is used to define price stability in the euro area and compare EU member states' inflation rates. The CNB's HICP projections for Croatia are thus an integral element of the Eurosystem's projections for the euro area as a whole. The CPI still continues to be published and used for specific purposes, such as the indexation of pensions and the adjustment of prices of some goods and services, such as telecommunications services, with the annual inflation rate. The CNB also continues to use the CPI to deflate particular statistical series, where appropriate, for example to calculate real wages or deflate particular national account categories, such as household disposable income. The calculations of both the HICP and the CPI are based on the same basket of goods and services and their calculation methodologies are very similar, as the CBS calculates the CPI following the Eurostat guidelines for the compilation of the HICP. The main difference is in the coverage of the population used to calculate the consumer basket structure and the share of specific components. The CPI covers the consumption of domestic private households, while the HICP also covers the consumption of non-residents (mostly foreign tourists) and institutional households (including persons provided with accommodation and food by an institution, such as a retirement home, etc.). This results in the individual components of the HICP and CPI baskets having different shares, which sometimes leads to differences between these two inflation measures. For example, the share of services, featuring heavily in tourist spending, is as a rule much higher in the HICP basket than the share of services in the CPI basket, while the share of food and energy in the HICP basket is lower than the equivalent in the CPI basket. The shares of industrial goods in the baskets of both indices are the same (Figure 1).

1 For more information on the methodological differences between the calculations of the harmonised and the national consumer indices, see Box 2 Comparison of the national and harmonised index of consumer prices in Croatia, Macroeconomic Developments and Outlook No 12, Croatian National Bank, July 2022.

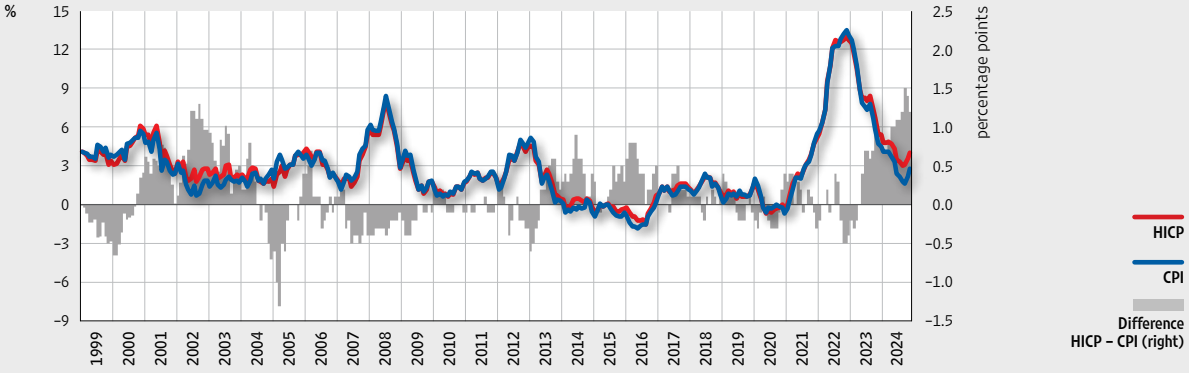
Figure 1 Structure of the basket of goods and services in the harmonised and the national inflation indicators in 2024



Notes: The figure shows the shares of the main components in the overall harmonised and the national indices of consumer prices. Food includes beverages and tobacco, while industrial goods exclude energy.
SOURCES: CBS, Eurostat and CNB calculations.

Although usually relatively small, especially if observed on an annual level, the differences between the harmonised and the national indicators have increased considerably since mid-2023. In the period from January 1999 to December 2023, the difference between the harmonised and the national indicators of overall inflation ranged between –1.3 and +1.3 percentage points. The average (absolute) difference was 0.3 percentage points, while the largest positive differences were observed in 2002. The harmonised indicator exceeded the national indicator by 1.5 percentage points in September 2024, accounting for the largest difference so far (Figure 2). The latest available data show that this difference narrowed slightly in November 2024 (to 1.2 percentage points), with HICP inflation standing at 4.0% and CPI inflation at 2.8%. The differences between the harmonised and the national inflation indicators are somewhat smaller if data are observed on an annual level. In the period from 1999 to 2023, the difference between the average annual inflation rate measured by the harmonised indicator and the one measured by the national indicator ranged between –0.3 and +0.8 percentage points. There were slightly more years in which the harmonised indicator exceeded the national indicator. The average (absolute) difference between the harmonised and the national inflation indicators was 0.2 percentage points.

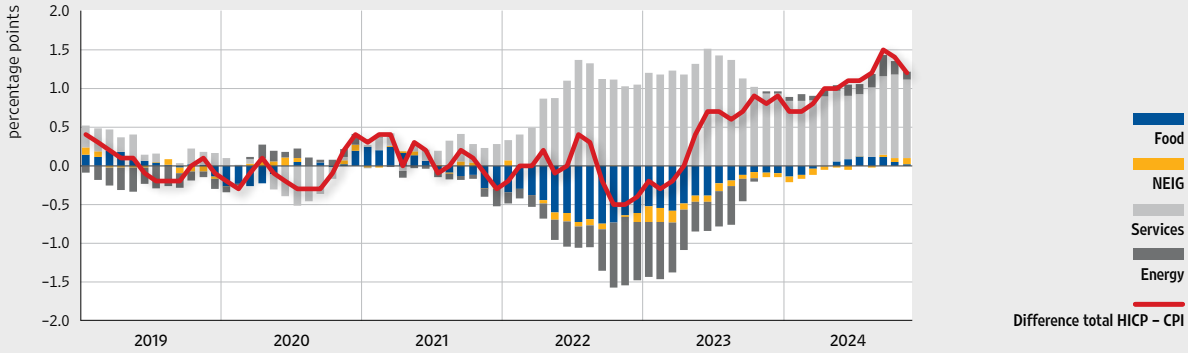
Figure 2 Annual inflation rate according to the harmonised and the national indicators



Note: The latest observation is for the first inflation estimate in November 2024.
SOURCES: CBS, Eurostat and CNB calculations.

The uncommonly large difference between the harmonised and the national indicators reflects the increasingly large weight of services in the HICP basket, in particular of tourism-related services (Figure 4), whose prices have grown much faster than the prices of other components of the basket. The share of services, with an accent on accommodation and hotel and restaurant services, in the total HICP, is significantly higher than their share in the CPI because it also includes non-residents' consumption of these services in Croatia. Accordingly, services inflation amounted to 7.3% in November 2024 as measured by the harmonised indicator, while it was considerably lower (5.1%) according to the national indicator, with the result that the contribution of services prices to overall HICP inflation was one percentage point higher than their contribution to the CPI (2.3 percentage points compared with 1.3 percentage points). In contrast with services, the contribution of energy and industrial goods prices to the HICP in November 2024 only slightly exceeded their contribution to the CPI, whereas the contribution of food prices was equal (Figure 3). Services prices have been growing strongly ever since the second quarter of 2022 on the back of the recovery of domestic and foreign demand for tourist services following the lifting of containment measures and a sharp increase in wages. The increasing contribution of services prices to the difference between the overall HICP and CPI was until mid-2023 strongly offset by the negative contribution of energy and food prices, so that the difference between the HICP and the CPI started to exceed 0.5 percentage points as late as in June 2023.

Figure 3 Difference between the contributions of the main components to the overall HICP and CPI



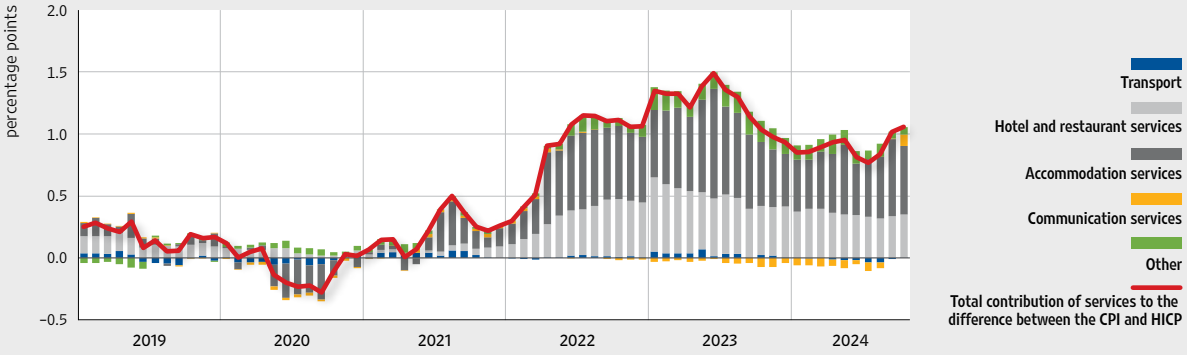
Notes: The latest observation is for the first inflation estimate in November 2024. A positive (negative) value denotes a larger (smaller) contribution of the inflation of prices of a specific component to overall HICP inflation than to CPI inflation.
SOURCES: CBS, Eurostat and CNB calculations.

Finally, differences between the harmonised and the national inflation indicators are common in other EU countries too, Croatia being no exception. In addition to the (non) inclusion of the consumption of non-residents and institutional households, much of the difference between the harmonised and the national inflation indicators can be attributed to the treatment of expenditures related to the acquisition and ownership of residential real estate. The harmonised inflation indicator, for example, still does not include all households' housing expenditures, that is, all owner-occupied housing expenditures,[2] while these expenditures are included in the

2 The HICP so far includes owner occupier's expenditures pertaining to maintenance and minor repairs as well as other current expenditures (water supply, electricity, gas and home insurance) and does not include expenditures paid for the purchases of houses and flats or all expenditures related to the consumption of housing services (for example, large construction works or imputed rent, that is, the estimated rent owner-occupiers would be paying to rent their homes). For more details, see: Eiglsperger et al. (2024), Owner-occupied housing and inflation measurement, ECB Statistics Paper Series, No. 47, revised June 2024.

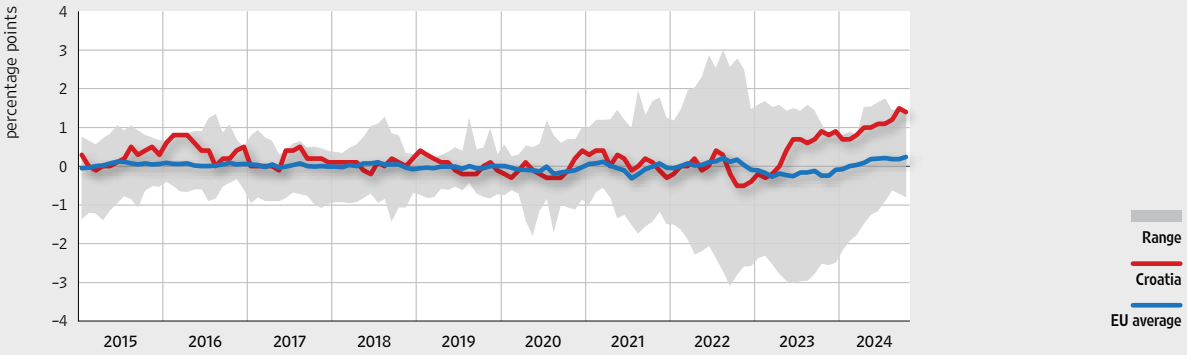
national inflation indicators of some EU countries. The differences between the harmonised and the national indicators have increased in most EU member states in the last three years, so that some EU member states have even recorded a higher difference, positive or negative, than that currently observed in Croatia (Figure 5). The easing of current inflationary pressures in the service sector and the expected slowdown in services price inflation should bring this difference in Croatia back to the historical averages

Figure 4 Difference between the contributions of the main sub-components of services to the overall HICP and CPI



Notes: The latest observation is for October 2024. A positive (negative) value denotes a larger (smaller) contribution of the inflation of prices of a specific sub-component to overall HICP inflation than to CPI inflation.
SOURCES: CBS, Eurostat and CNB calculations.

Figure 5 Difference between the harmonised and the national inflation indicators



Note: The latest observation is for October 2024.
SOURCES: OECD and national statistical offices (for national indicators), Eurostat (for harmonised indicators) and CNB calculations.

BOX 4

Price levels and entry to the euro area: lessons from an analysis of the prices of a retail chain

Both the expert and the general public in Croatia take a strong interest in developments in the levels of prices in Croatia as compared with those in other European countries and in the question of whether Croatia's entry to the euro area has influenced the relative price level. This analysis aims to shed more light on this topic by comparing the prices of several thousand products offered by DM (Drogerie Markt) in Croatia, Austria, Italy and Slovenia, observed at three points of time: in September 2022, September 2023 and October 2024. The results show that the differences between the prices of identical products in DM stores in Croatia and those abroad are decreasing, while the share of products with identical prices, albeit still low, is gradually rising. For example, DM in Croatia was on average 4.4% more expensive in 2022 than DM in Austria, while in 2024 it was 1.6% cheaper. DM in Croatia was also 8.4% and 7% cheaper in 2022 and 2024, respectively, than DM in Italy. In comparison with DM in Slovenia, DM in Croatia was 4.3% cheaper in 2022 and 2.4% in 2024. Such price adjustments are not typical only of Croatia. Similar trends are evident among the countries that were part of the euro area throughout the observed period, which shows that there are pressures towards price adjustment in the euro area. However, the analysis has some limitations. The results can neither be generally applied to the whole economy nor provide a comprehensive insight into a broader convergence of price levels during Croatia's entry to the euro area because the analysis is focused on a small portion of the consumer basket, limited to a certain number of countries and based on data collected at three points of time. Future analyses could include a wider range of products and additional factors that affect price adjustment in order to provide a more comprehensive view of this process.

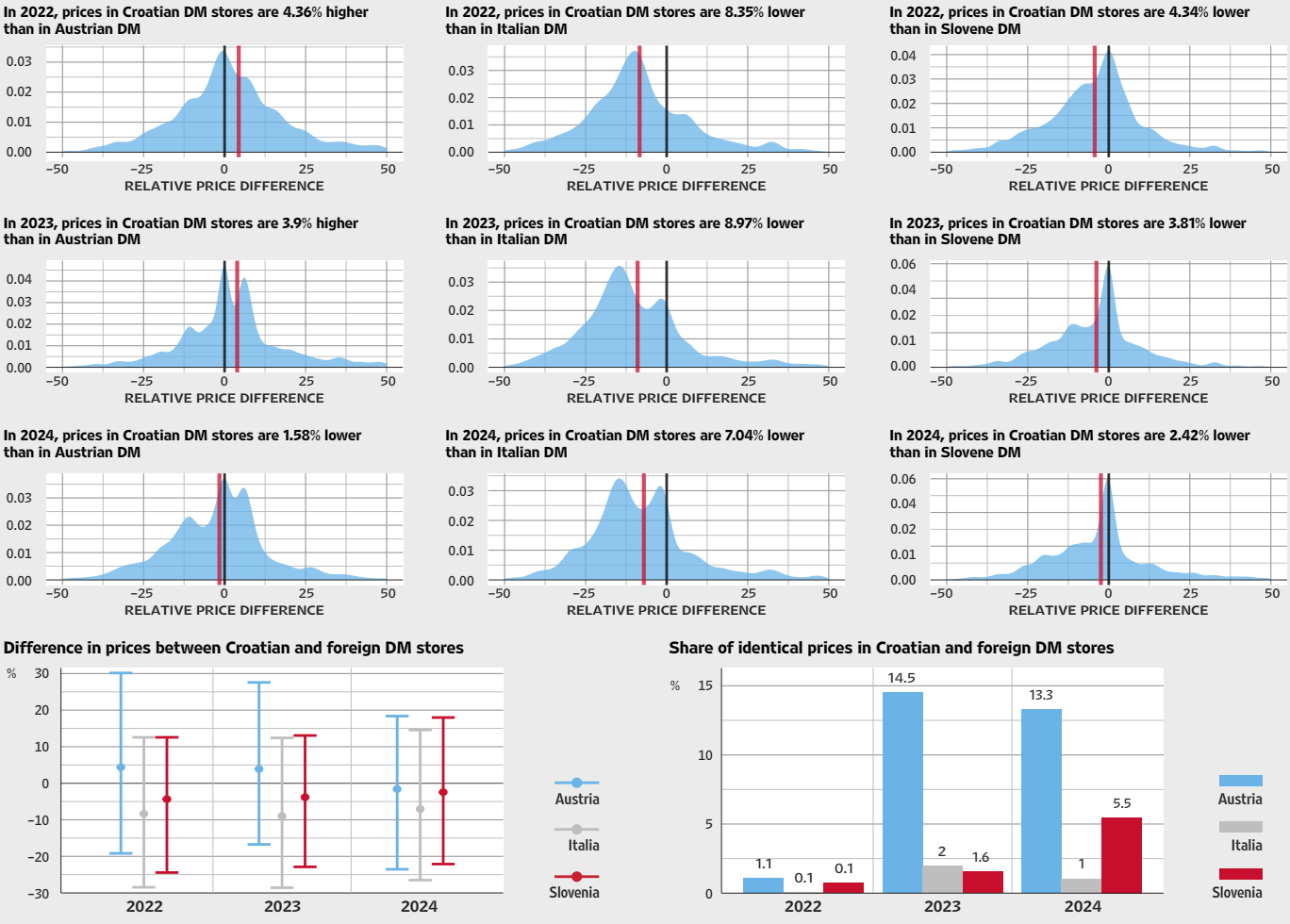
There have been increasingly more comparisons in the Croatian public sphere between domestic price levels and price levels in other European countries, especially after Croatia's entry to the euro area. These comparisons are made possible primarily due to the direct comparability of prices of identical products. In mid-November 2024, the CNB's weblog, HNBlog, published the analysis Are prices in Croatia really higher than in more developed countries? A detailed glance at prices in a retail chain[1]. The analysis concludes that at the end of November 2024, the prices of selected DM products in Croatia were 16% higher than the prices of identical DM products in Germany, but 7%, 1.6% and 2.4% cheaper than in Italy, Austria and Slovenia respectively. However, this analysis comprises the comparison of prices at only one point of time. The question left unanswered is how Croatia's entry to the euro area has influenced price trends.

In this analysis, the existing comparison of DM prices is extended over a period of three years. To this end, on 26 September 2022, 29 September 2023 and 31 October 2024, the prices of all products were collected from DM's internet shops in Croatia and other European countries. As the coverage of countries changed over time, the analysis is based on the comparison of prices in DM stores in Croatia, Austria,

1 Mužić, I. and Žilić, I. (2024): *Jesu li cijene u Hrvatskoj zaista više nego u razvijenijim zemljama? Detaljniji pogled na cijene u maloprodajnom lancu*, HNBlog, Croatian National Bank: https://www.hnb.hr/-/jesu-li-cijene-u-hrvatskoj-zaista-vise-nego-u-razvijenijim-zemljama-detaljniji-pogled-na-cijene-u-maloprodajnom-lancu

Italy and Slovenia for which data were available for all three years. Prices in DM stores in Germany, which were part of a previous analysis published at HNBLog, were not available for 2022 and 2023, because the CNB, in order to monitor the impacts of Croatia's entry to the euro area on price developments, started to collect prices from internet shops in mid-2022. Prices were collected for Croatia and several European countries, so that any potential differences in the dynamics of price changes could be compared. As the analysis focused on geographically closer countries, the original group of countries for which data were collected excluded Germany, whose DM prices were on average 16% lower than DM prices in Croatia in 2024. Since part of the product range is identical in all countries, global product identifiers were used to identify products available both in Croatia and in other markets and compare their prices. The total number of DM products in Croatia was 13,430 in 2022, 14,683 in 2023 and 15,560 in 2024. The largest number of identical products was found in Slovenia: 5,350 in 2022, 5,616 in 2023 and 6,389 in 2024. In Austria, 4,153 matches were found in 2022, 4,464 in 2023 and 4,801 in 2024, while the number of matches made in Italy was 1,300, 2,984 and 3,308 respectively. The increase in the number of identical products points to the harmonisation of the range of products offered among the countries.

Figure 1 Comparison of prices of identical DM products in Croatia, Austria, Italy and Slovenia in 2022, 2023 and 2024

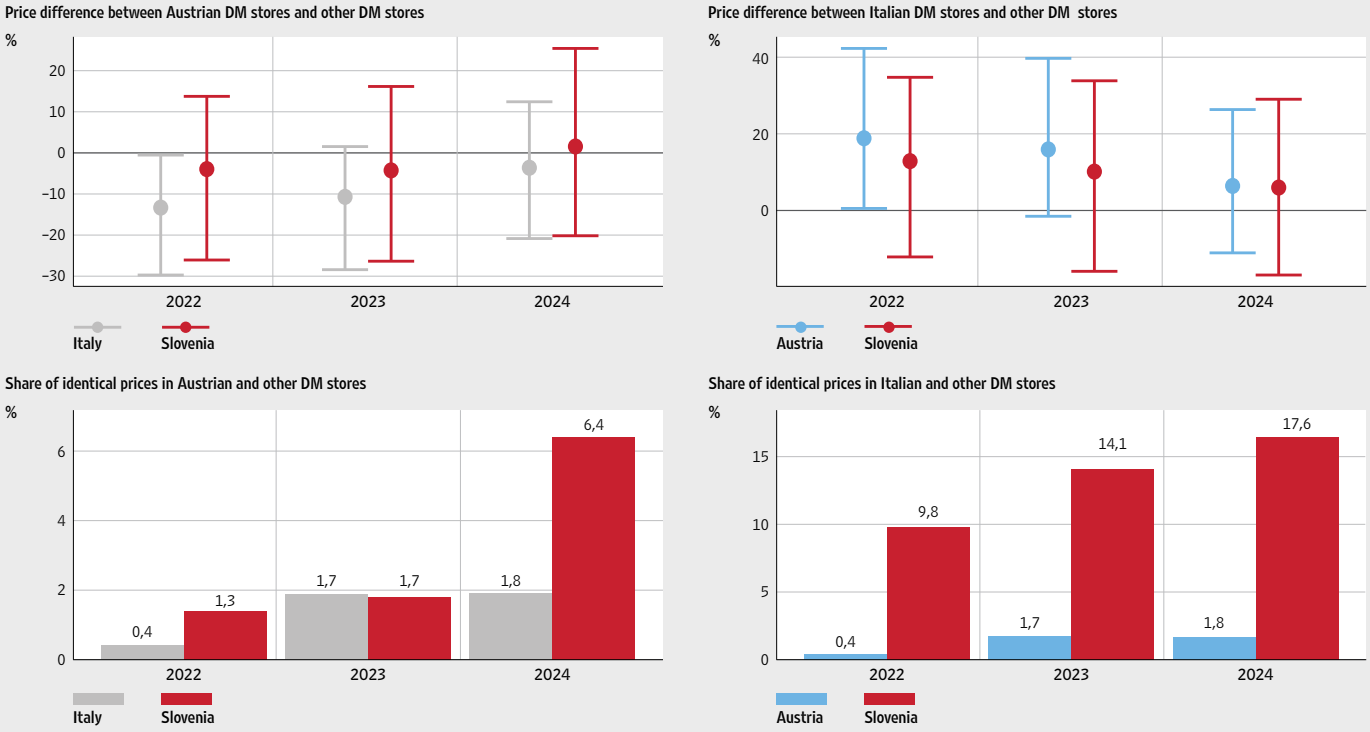


Notes: The histograms (first nine figures) show relative differences between the prices of identical products in DM stores in Croatia and other countries on 26 September 2022, 29 September 2023 and 31 October 2024. Average differences (red line) and zero (black line) are shown. The lower left figure shows the average difference between the prices of identical products in Croatian and foreign DM stores (points) and the 10th and 90th percentile of the difference (columns), while the lower right figure shows the share of products that have the same prices in Croatian and foreign DM stores in the total number of products matched.

SOURCES: DM and CNB calculations.

The differences between the prices of identical products in DM stores in Croatia and those abroad are decreasing, while the share of products with identical prices, albeit still low, is rising. Prices in DM stores in Croatia have become more equal to prices in foreign DM stores. For example, DM in Croatia was 4.4% more expensive in 2022 than DM in Austria, while in 2024 it became 1.6% cheaper (Figure 1). Comparisons with DM stores in Italy and Slovenia reveal similar trends. DM in Croatia was 8.4% cheaper than DM in Italy in 2022 and 7% in 2024. In comparison with DM stores in Slovenia, the average price differential decreased from –4.3% in 2022 to –2.4% in 2024, which means that DM in Croatia has become relatively less cheap. The histograms in Figure 1 show that, despite a significant heterogeneity in the prices of identical products among countries, the price differential has become more and more concentrated around zero. This points to the growing uniformity of prices, with increases in the share of products in Croatian DM stores that have prices the same as those products in foreign stores (lower left panel in Figure 1). For example, in 2022, the share of products with identical prices was 1.1%, 0.1% and 0.7%, compared with Austria, Italy and Slovenia respectively. Only a year later, following Croatia's entry to the euro area, the share of identical prices increased considerably: reaching 14.5% in comparison with Austria and growing to 2% and 1.6% in comparison with Italy and Slovenia respectively.

Figure 2 Differences between prices of identical DM products and the share of identical prices in Austria, Italy and Slovenia in 2022, 2023 and 2024



Notes: The upper panels show the average difference between the prices of identical products in Austrian and Italian DM stores in comparison with other DM stores (points) and the 10th and 90th percentile of the difference (columns), while the lower ones show the share of products having the same prices in Austrian and Italian DM stores in comparison with other DM stores. The average price differentials Austria-Italy and Italy-Austria are not identical because different bases were used. The analysis used DM data as at 29 September 2022, 26 September 2023 and 31 October 2024
SOURCES: DM and CNB calculations.

The prices of identical products in the euro area countries were also adjusted in the observed period. The prices of identical products in DM stores in Austria have converged towards those

in Italy and Slovenia (left panel in Figure 2): DM in Austria has become increasingly less cheap than DM in Italy and Slovenia and the share of identical prices has risen. Specifically, the share of products with the same prices in Austrian and Slovene DM stores increased from 1.3% in 2022 to 6.4% in 2024. At the same time, DM in Italy has become increasingly less expensive than DM in Austria and Slovenia (right panel in Figure 2) and the share of identical prices has grown too. The share of products with the same prices in Italian and Slovene DM stores increased from 9.8% in 2022 to 17.6% in 2024. Such adjustment of the prices of identical products within the euro area is already known in the literature. Although the prices of identical products are not the same among countries (for example, Gopinath et al. (2005)[2] and Messner et al. (2024)[3]) and the law of one price often does not apply, the use of a common currency creates pressures to adjust the prices of identical products. Cavallo et al. (2014)[4] analysed the prices of more than 10,000 Apple, Ikea, Zara and H&M products sold in several dozens of countries before concluding that the prices of identical products are in general more uniform among euro area countries than among countries with different currencies. In addition, Cavallo et al. (2015)[5] analysed the impact of Latvia's entry to the euro area in 2014 to the adjustment of prices of identical products. Having compared prices from Zara in Latvia and in Germany, they established that the share of identical prices grew from 6% before Latvia's entry to the euro area to 89% after the entry.

The final results of the analysis show that the differences between the prices of identical products in DM stores in Croatia and those abroad are decreasing, while the share of products with identical prices, albeit still low, is rising. Prices in DM stores in Croatia are converging towards prices in other countries' DM stores. The share of products with identical prices grew after Croatia's entry to the euro area. The adjustment of prices and product ranges can also be observed in the countries already using the euro, which is an indication that there are pressures to equalise the prices of identical products in the euro area. Although informative, this analysis is not representative, and its results must not be broadly applied to the overall economy. The results of the analysis of price differences are not representative because the analysis compares only the products offered in a foreign retail chain from a relatively narrow consumption segment, mainly including cosmetics and hygiene products, which account for a relatively small part of the total consumer basket (less than 5%). In addition, prices were compared only at three points of time, which is why some factors, such as time limited discounts, can result in divergences from the main findings. In order to obtain a more comprehensive documentation of the impact of the euro area entry on the price level adjustment other factors that may influence price convergence should also be included in the analysis.

2 Gopinath, G., Gourinchas, P. O., Hsieh, C. T., and Li, N. (2011): International prices, costs, and markup differences, *American Economic Review*, 101(6), 2450 – 2486

3 Messner, T., Rumler, F. and Strasser, G. (2024): Cross-country price dispersion: Retail network or national border? *Journal of International Economics*, 152, 103996

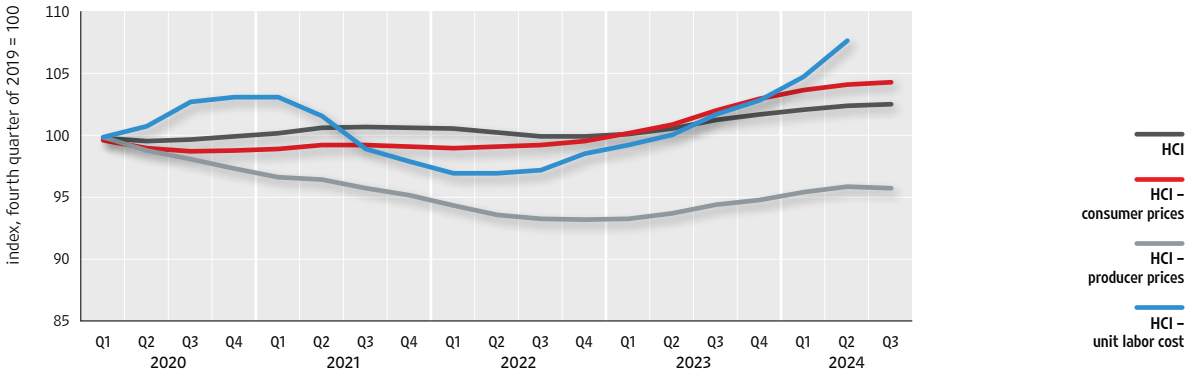
4 Cavallo, A., Neiman, B. and Rigobon, R. (2014): Currency unions, product introductions, and the real exchange rate, *The Quarterly Journal of Economics*, 129(2), 529 – 595

5 Cavallo, A., Neiman, B. and Rigobon, R. (2015): The Price Impact of Joining a Currency Union: Evidence from Latvia, *IMF Economic Review*, 63(2), 281 – 297

3.4 Economic relations with foreign countries

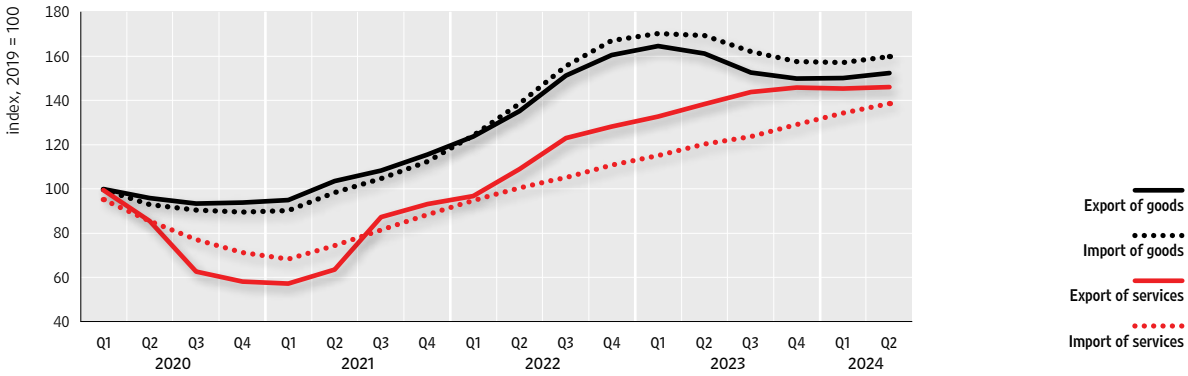
Harmonised competitiveness indicators, which monitor changes in the country's price and cost competitiveness in relation to the main competitors in the international market, point to a continued deterioration in the competitiveness of the Croatian economy in 2024. However, various indicators suggest that the intensity of the deterioration varied considerably (Figure 3.4.1). The cost competitiveness of the Croatian economy, measured by relative unit labour costs (HCI-ULC) in relation Croatian trade partners, has exhibited extremely unfavourable trends ever since mid-2022, worsening additionally in the first half of the current year as a result of a relatively faster price growth. Price competitiveness also deteriorated in 2024. The competitiveness indicator deflated by relative consumer prices (HCI-CPI) deteriorated more than the indicator deflated by producer prices (HCI-PPI), which stabilised below the pre-pandemic levels.

Figure 3.4.1 Harmonised competitiveness indicators



Notes: An increase in the indicators denotes appreciation. Series are shown as the moving average of four quarters.
SOURCE: CNB.

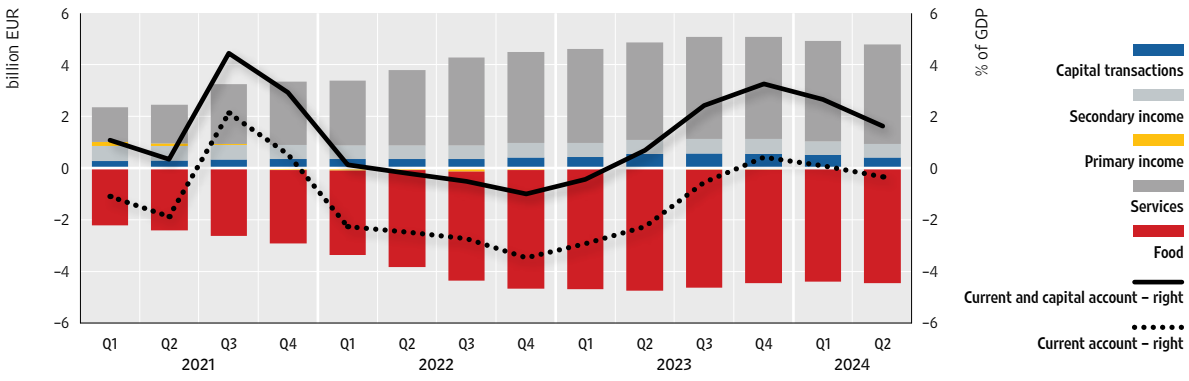
Figure 3.4.2 Exports and imports of goods and services



Note: Series are shown as the moving average of four quarters.
SOURCE: CNB.

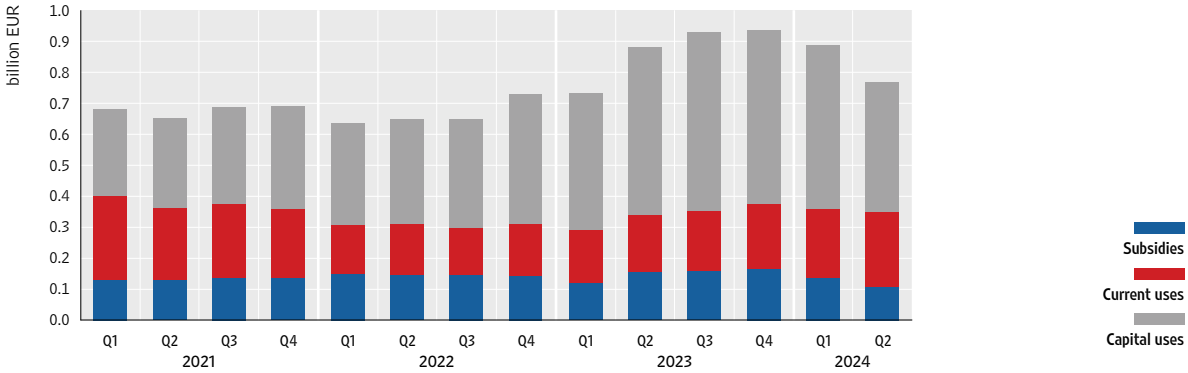
The continued deterioration of the competitiveness of the domestic economy has an effect on foreign trade, the services segment especially. According to the balance of payments data, goods exports grew 3.3% annually in the first six months of 2024, while goods imports increased slightly less (2.8%). As both goods exports and imports increased despite a very strong domestic demand and subdued foreign demand, Croatia was able to maintain the stable market share in world goods exports held in the previous year. The trade in goods deficit widened by 2.3% because imports increased. While the improvement of the services exports balance strongly offset the deterioration of the goods balance in the previous years, the positive trade in services balance has declined in the last several quarters (Figure 3.4.2). According to the available balance of payments data, services exports stagnated in the first six months of 2024, while services imports increased by 16.2%, which resulted in a strong deterioration in the services balance. The large difference between the growth rates and the services imports rates can be partly attributed to the divergent trends of a strong domestic demand and relatively subdued foreign demand. However, stagnant trends in services exports primarily reflect tourism performance. Nominal revenues generated by foreign tourist consumption, after having surged for several years, grew only slightly, owing to a drop in foreign demand and, in particular, to the loss of price competitiveness (for more details, see Box 5 Price competitiveness of the Croatian tourist sector in the Mediterranean market).

Figure 3.4.3 Balance of payments



Note: Series are shown as the moving average of four quarters.
SOURCE: CNB.

Figure 3.4.4 Utilisation of EU funds



Note: Series are shown as the moving average of four quarters.
SOURCE: Ministry of Finance

The trends in foreign trade in goods and services described were the main cause of the deterioration in the total current and capital account balance in the first half of 2024. If the sum of the last four quarters is observed, the overall surplus recorded until the end of June 2024 was EUR 1.3bn (1.6% of GDP), a decrease of EUR 1.2bn (1.6 percentage points) from the whole of 2023 (Figure 3.4.3). In addition to foreign trade in goods and services, a cyclical decline in the use of EU funds has also contributed to the unfavourable trends. In the first half of 2024, end beneficiaries were allocated EUR 0.7bn less than in the same period in the previous year, which is not surprising given that 2023 was the record high year — the last year for the simultaneous use of funds allocated under the multi-year financial envelope (for the period from 2014 to 2020) and the EU Solidarity Fund. Capital utilisations continued to dominate total disbursements, but their share decreased sharply from 2023, when disbursements from the EU Solidarity Fund were channelled to capital investments related to the reconstruction of earthquake-hit areas in Croatia (Figure 3.4.4). In line with the narrowing of the current and capital account surplus, the financial account of the balance of payments recorded a net capital outflow of EUR 2.6bn until the end of June 2024, which is EUR 1.2bn less than in 2023.

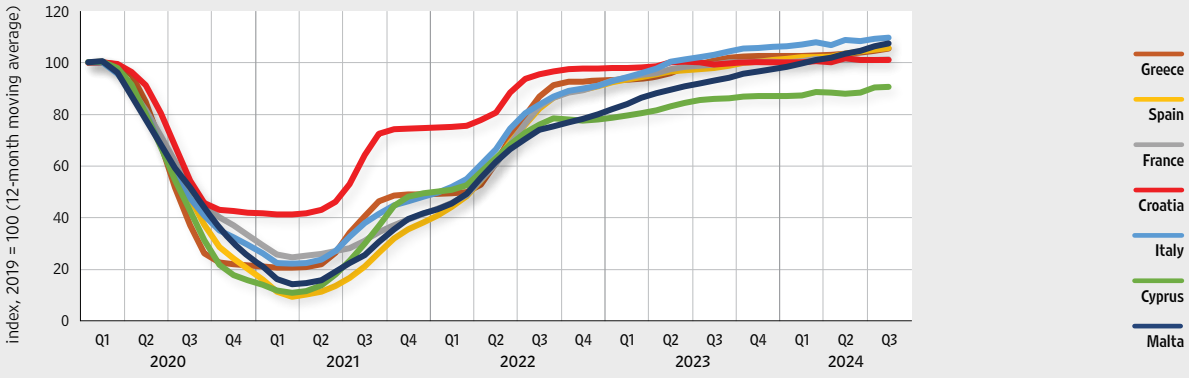
BOX 5

Price competitiveness of the Croatian tourist sector in the Mediterranean market

Some of the key determinants of the speed of recovery of the domestic economy include a relatively mild decrease in tourism revenues in the pandemic and their strong growth afterwards. However, this year the volume indicators of tourist turnover in Croatia started to fall behind trends in other Mediterranean countries at peak season and financial results were relatively weak. The prices of accommodation and hotel and restaurant services increased considerably amid growing labour costs, while productivity in these activities rose very little compared with competitor countries. Should price competitiveness continue to deteriorate, this could restrict the future contribution of tourism to Croatia's economic growth and foreign trade balance.

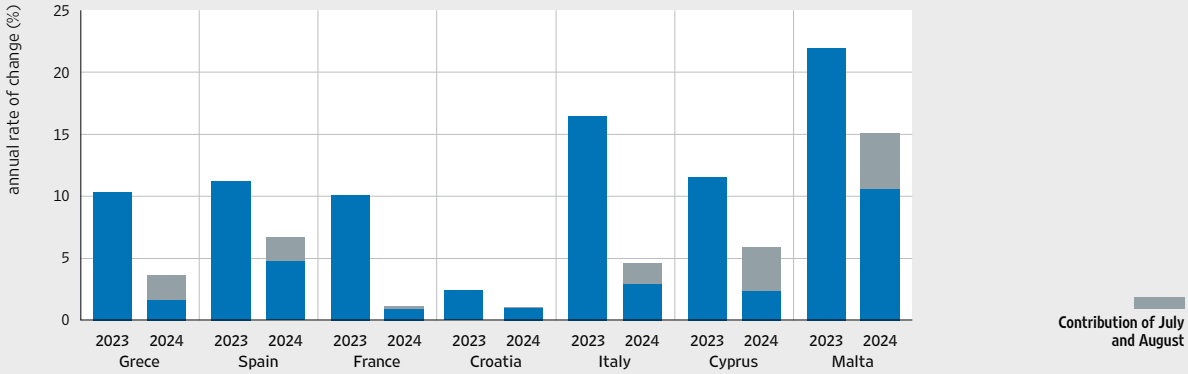
This summer tourist season in Croatia recorded an annual decrease in foreign tourist nights, for the first time since the pandemic. Following a very good pre-season, the number of foreign tourist nights dropped in the peak tourist season (third quarter of 2024) by 0.6% from the same period in the previous year and revenues are likely to have decreased slightly in the summer months. The number of nights stayed by tourists from some important outbound markets, such as Germany and Italy, fell significantly. This is partly related to strong consumer pessimism resulting from growing insecurity in these markets and to the fact that some tourists attended the European Football Championship and the Olympics and stayed at other destinations. However, the prices of tourist services increased sharply in the same period, which could have also dissuaded some tourists from visiting Croatia.

Figure 1 Foreign tourist nights in selected countries



Notes: Data are up to August 2024.
SOURCE: Eurostat.

Figure 2 Annual rate of change in the number of foreign tourist nights

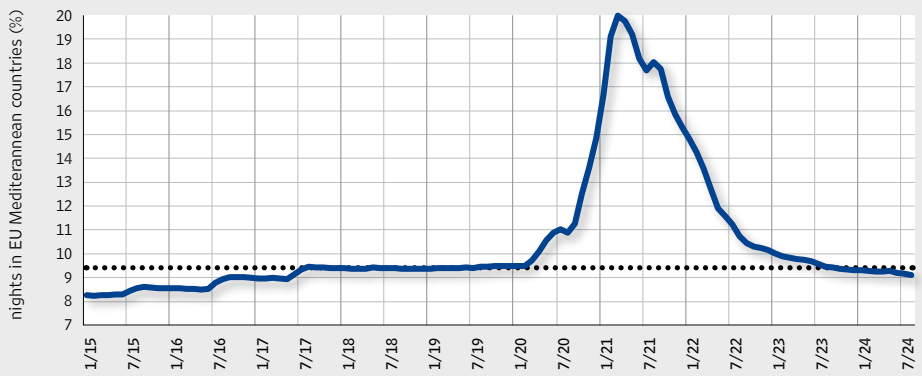


Note: Data are up to August 2024.
SOURCE: Eurostat.

While Croatia's share in the Mediterranean tourist market considerably exceeded its pre-pandemic level in the last few years, this year it fell below this level. In the group of peer Mediterranean countries, the decrease in tourism volume indicators during the pandemic in Croatia was the least pronounced and the recovery was much faster than in other countries (Figure 1). Consequently, Croatia's market share surged in the pandemic period, reflecting more lenient containment measures, marked seasonality, the accommodation structure and the fact that for many tourists Croatia is a destination that can be reached by car.[1] However, volume indicators decreased last year, while in most other Mediterranean countries the number of foreign tourist nights continued to grow, albeit at a considerably slower pace (Figure 2). France is the only other country besides Croatia that recorded a stagnation in tourist nights in the summer months, despite hosting the Olympics. Malta and Cyprus, on the other hand, the countries that reached the pre-pandemic levels relatively late or are still to reach them, boasted a strong growth in tourist nights this year. Consequently, Croatia' share in the Mediterranean tourist market fell slightly below the pre-pandemic level of about 9% (Figure 3). Italy's market share increased moderately relative to that in the pre-pandemic period, while France's share decreased slightly (Figure 4).

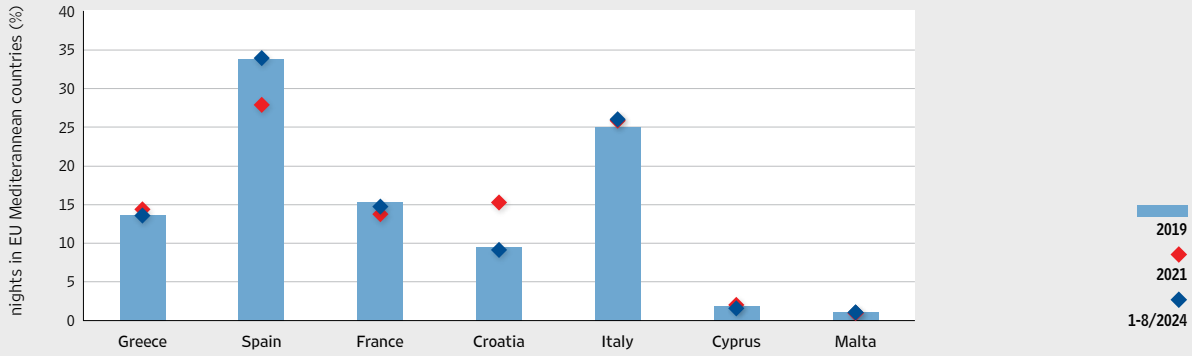
1 For more information, see Box 4 What is behind the surprising recovery of Croatian tourism?, Macroeconomic developments and Outlook, No 11, December 2022, Croatian National Bank.

Figure 3 Croatia's share in the Mediterranean tourist market



Notes: The dotted line refers to the average share in the period from 2017 to 2019. Data are up to August 2024.
SOURCE: Eurostat.

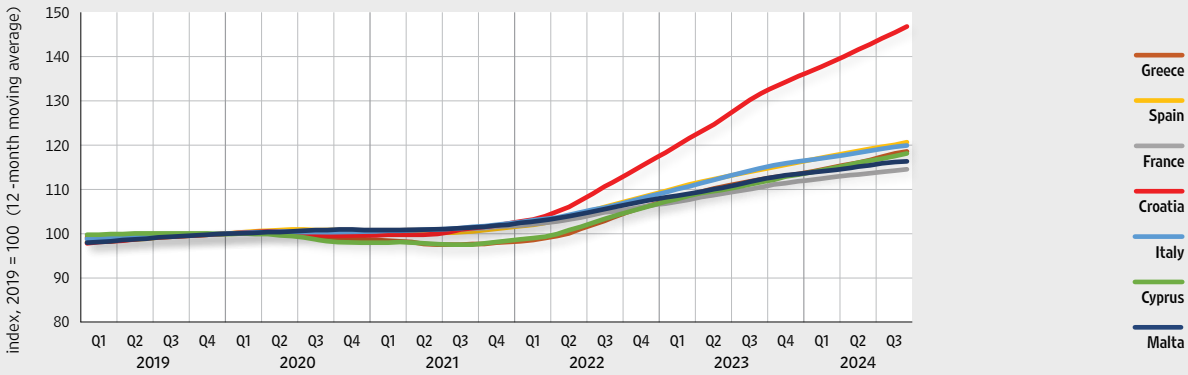
Figure 4 Shares of selected countries in the Mediterranean tourist market



SOURCE: Eurostat.

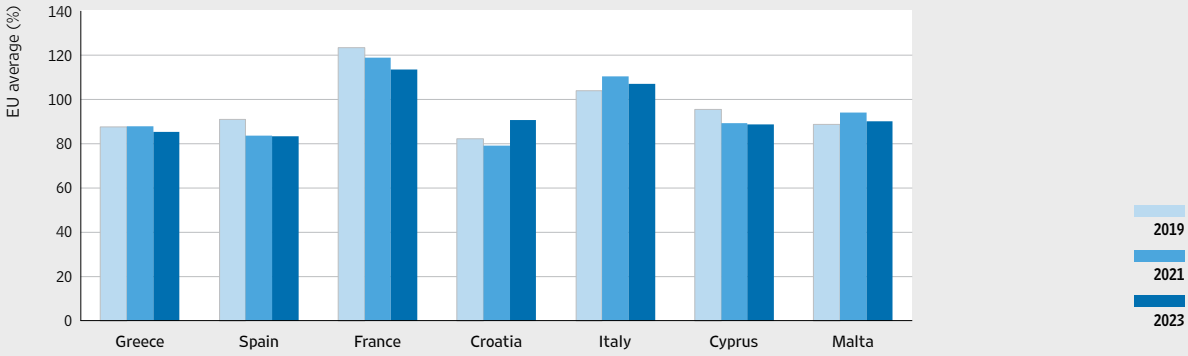
The number of foreign tourist nights held steady in Croatia in the last tourist season against a background of a strong growth of prices of tourism-related services. Although the inflation of other goods and services prices has also been somewhat higher in Croatia than in other Mediterranean countries in the last two years, the largest difference in the inflation rate has been observed when it comes to tourist services prices. In the period from early 2022 to late September 2024, Croatia's cumulative growth of tourism-related prices (restaurants and hotels) amounted to almost 50% and was twice as high as in most other countries, with accommodation and hotel and restaurant services prices rising at equally high rates (Figure 5). Italy and Spain also recorded a somewhat stronger growth in accommodation prices (about 30%), which has, however, decelerated visibly in the last few months, in contrast with the growth in Croatia. Croatian hotel and restaurant services prices followed similar trends, growing at a cumulative rate of about 45%, considerably higher than the same rates in peer countries. Malta is the only other country besides Croatia where hotel and restaurant services prices increased at such high rates. Consequently, the level of tourism-related services prices in Croatia rose markedly and came close to the average in EU member states, exceeding the price levels in Spain and Greece and equalling those in Malta and Cyprus (Figure 6).

Figure 5 Developments in tourism-related services prices



Note: Data refer to prices in hotels and restaurants. Data are up to September 2024.
SOURCE: Eurostat.

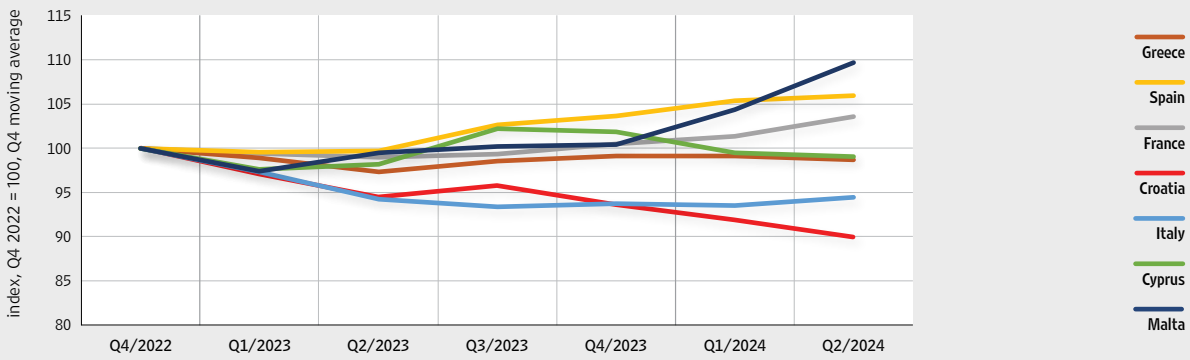
Figure 6 Level of tourism-related services prices



Note: Data refer to prices in hotels and restaurants.
SOURCE: Eurostat.

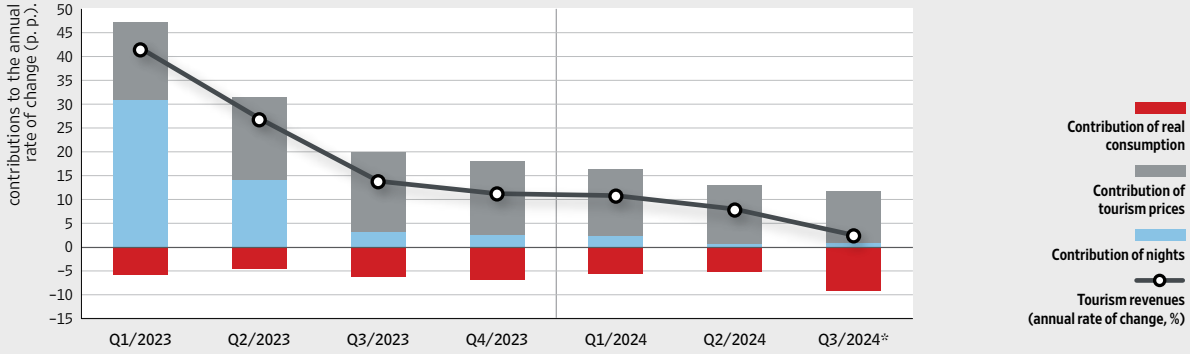
Under such circumstances, consumption by foreign tourists in Croatia has decreased for the second consecutive year, unlike consumption in other Mediterranean destinations (Figure 7). Croatia's real foreign tourist consumption per night has declined by approximately 10% in the previous two years. Italy is the only other country recording a decrease in real consumption, a considerably smaller one, in addition. Real foreign tourist consumption per night in other countries has held steady or even increased considerably (Malta, Spain and France). The decrease in real consumption has offset the positive price effect and contributed to the deceleration of growth of nominal tourism revenues in Croatia (Figure 8). Any further deterioration in the price competitiveness of Croatian tourism could result in an additional decrease in average consumption by foreign tourists and/or a decrease in their arrivals, which could have a significant effect on future tourism revenues and cause the market share to drop even more.

Figure 7 Real consumption per night



Note: Real consumption per night is calculated as a ratio of tourism revenues in the balance of payments to foreign tourist nights, deflated by the prices of hotel and restaurant services.
SOURCE: Eurostat.

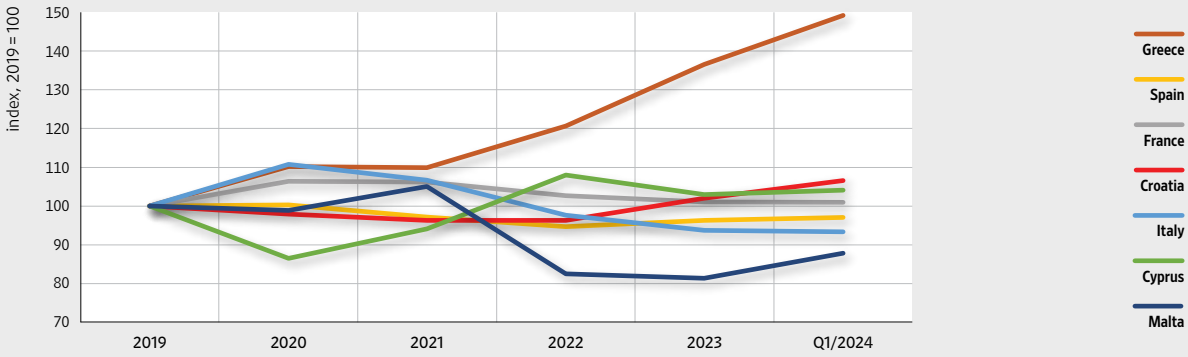
Figure 8 Tourism revenues in Croatia



[a] Preliminary assessment of the CNB.
Notes: Real consumption per night is calculated as a ratio of tourism revenues in the balance of payments to foreign tourist nights, deflated by the prices of hotel and restaurant services. Series are shown as the moving average of four quarters.
SOURCE: Eurostat.

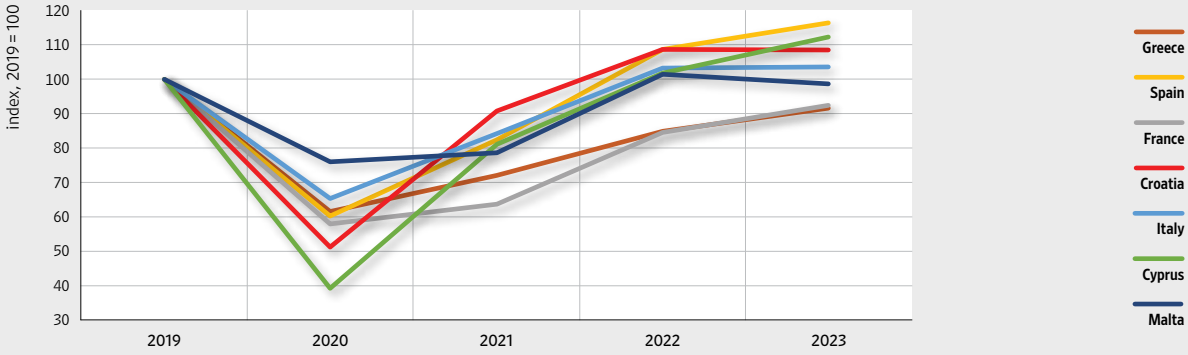
In contrast with price competitiveness indicators, cost competitiveness indicators do not point to any visible deterioration in the competitive position of the Croatian tourism when compared with other European Mediterranean countries. Specifically, while Croatia's nominal and real wages in tourism-related activities have grown strongly in the last two years (Figure 9), with Greece recording the same trends, this growth has been coupled with a sharp increase in labour productivity (Figure 10). In addition to nominal wages recording two-digit growth rates since the beginning of 2022, real wages in accommodation and food and beverage service activities in Croatia exceeded the pre-pandemic level by about 3% up to the end of 2023, growing at the same rate in the first half of 2024. Real labour productivity per employee in these activities was 8% higher at the end of 2023 than in the pandemic period, which is the largest productivity growth rate after those of Spain and Cyprus. Real labour productivity in tourism-related activities in France and Greece is still below the pre-pandemic levels.

Figure 9 Real wages in tourism-related activities



Notes: Real wages in accommodation and food and beverage service activities deflated by the overall HICP. Data represent the annual average.
SOURCE: Eurostat.

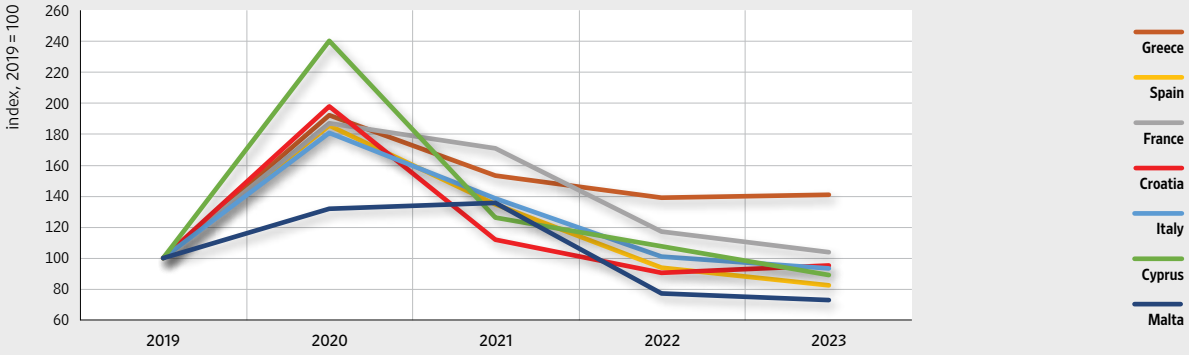
Figure 10 Labour productivity in tourism-related activities



Note: Real labour productivity in accommodation and food and beverage service activities.
SOURCE: Eurostat.

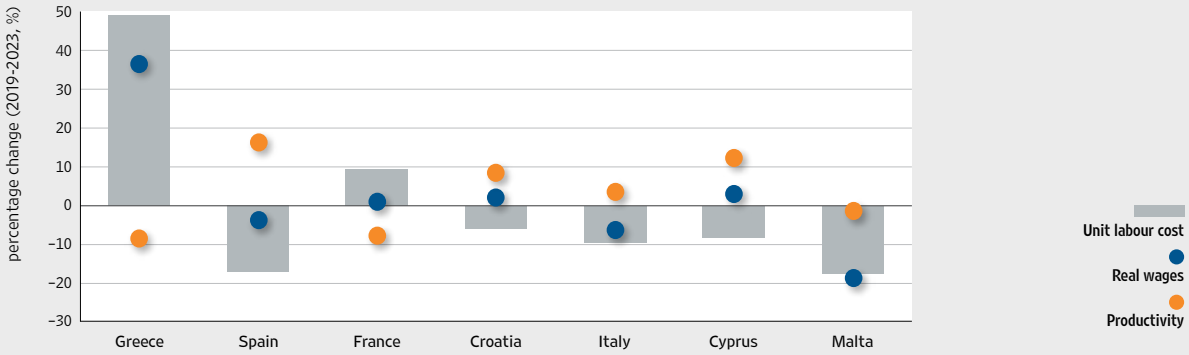
Having increased sharply due to a productivity decrease at the peak of the 2020 pandemic crisis, unit labour costs in accommodation and food and beverage service activities dropped in the following years, falling somewhat below the pre-pandemic levels by 2022 (Figure 11) and indicating a slight improvement in cost competitiveness. While unit labour costs are still below the pre-pandemic level, the positive gap between productivity growth and real wage growth started narrowing in 2023. Such trends, should they continue, could result in a deterioration of the cost competitiveness of the domestic tourist sector. For the sake of comparison, Malta recorded the highest increase in cost competitiveness among Mediterranean countries, due to a sharp decrease in real wages, and cost competitiveness in Spain and Cyprus has improved considerably, primarily as a result of real productivity growth. In contrast, unit labour costs grew at very high rates in Greece, where the strong nominal and real wage growth was coupled with a drop in labour productivity (Figure 12). The divergent trends between the indicators of price and cost competitiveness in accommodation and hotels and restaurants, in other words, a growth of tourist services prices considerably stronger than that of unit labour costs, lead to the conclusion that inflationary pressures in these activities in 2022 and 2023 did not stem from the growth of unit labour costs, but rather reflected the growth of other operating costs, such as the costs of energy and other inputs, or of profit margins.

Figure 11 Unit labour costs in tourism-related activities



Note: Unit labour costs relate to accommodation and food and beverage service activities.
SOURCE: Eurostat.

Figure 12 Cost competitiveness of tourism-related activities

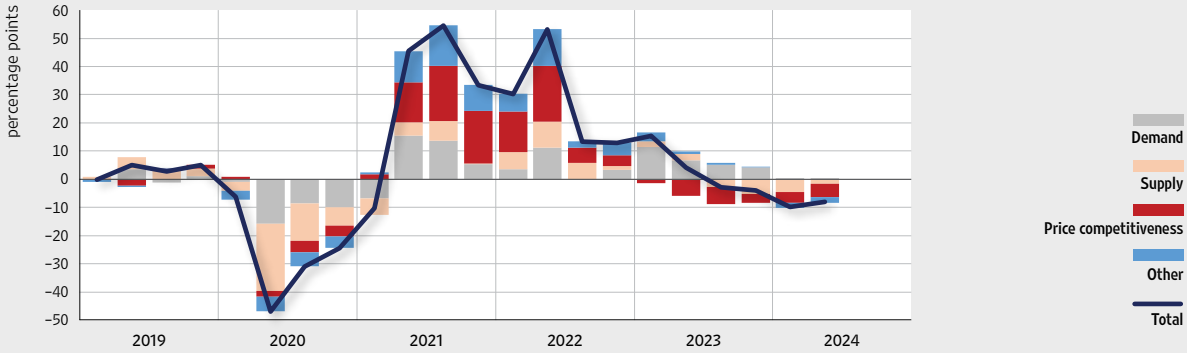


Notes: Indicators relate to accommodation and food and beverage service activities. An increase (decrease) in unit labour costs indicates the improvement (deterioration) of cost competitiveness.
SOURCE: Eurostat.

An econometric analysis of the impact of various shocks confirms the significance of the decrease of price competitiveness for the weakening of real services exports. In order to clarify the factors influencing trends in real services exports in Croatia, predominantly generated through tourism, an analysis according to the structural vector autoregressive model (SVAR) has been conducted. The results of a historical shock decomposition shown in Figure 13 confirm that during and immediately after the pandemic the supply-side shock caused by the restrictions imposed by containment measures in the country and abroad, which also partly reflects the effects of the weakening of demand under such conditions, was the key determinant of trends in real services exports. The strong post-pandemic demand for tourist services, driven by the accumulated savings and changed consumer preferences, supported the growth of Croatian exports until the end of 2023, when the positive effect started to wane amid growing uncertainty and foreign tourists' reduced propensity to spend. Price competitiveness, which had provided a positive contribution until the end of 2022, became the main limiting factor for the growth of services exports following the sudden increase in the relative prices of services in Croatia in comparison with other Mediterranean destinations. In addition, the positive contribution of other factors that may be associated with the structural advantages of Croatian tourism, such

as the geographical vicinity to outbound markets, which were very important in the pandemic period, has disappeared in the last two years. These trends indicate that the normalisation of global tourist flows is increasingly less beneficial to Croatia as a tourist destination, emphasising the need to preserve the price competitiveness of the tourist sector as an important precondition for the growth of tourist revenues and their contribution to economic growth and the foreign trade balance.

Figure 13 Historical decomposition of the change in Croatian services exports



Notes: The SVAR model is based on quarterly data for the period from the first quarter of 1999 to the second quarter of 2024 and includes the following variables: real exports of services of Croatia, real imports of services of the euro area, relative prices of tourist services (accommodation and hotels and restaurants) in Croatia and the euro area and the indicator of disruptions in global trade (GSCPI) as a proxy variable for pandemic restrictions. The assumed sign limitation includes: demand shock implies higher Croatian services exports (+), higher euro area imports (+), the growth of relative prices of tourism services in Croatia (+) and the existence of trade disruptions; supply shock implies lower Croatian services exports (−), lower euro area services imports (−), the growth of relative prices of tourism services in Croatia in comparison with those of the euro area (+) and the existence of pandemic restrictions (+); price competitiveness shock implies a decline in the prices of tourist services in Croatia relative to those in the euro area (−) and higher Croatian services exports (+). The results show the contribution of specific shocks to the annual rate of change in Croatia's real services exports.

SOURCES: Eurostat, CBS and CNB calculations.

3.5 Banking system

The easing of the ECB's restrictive monetary policy in the second half of the year favourably influenced corporate financing conditions, while household borrowing costs remained almost unchanged in the same period. The average interest rate on new loans to non-financial corporations was 4.4% in October 2024, a decrease of 71 basis points from June 2024. (Figure 3.5.1). Since about 60% of new corporate loans were granted with reference to the EURIBOR, the decrease in interest rates on new corporate loans also reflects a decrease in the EURIBOR. In contrast, the average interest rate on new general-purpose cash loans to households increased by 7 basis points (6.1%) in October relative to June, while interest rates on housing loans held steady at the levels recorded at the beginning of the year (3.8%). The increase in interest rates or their stagnation at the levels reached are definitely due to the continued strong growth of household loans, granted mainly at long maturities and fixed interest rates, which makes these loans less sensitive to changes in market conditions than shorter-maturity loans.

Interest rates on corporate time deposits dropped in the second half of 2024, whereas interest rates on household deposits hovered around the levels reached in the first half of the year. Having increased markedly in late 2023 and in June 2024, average interest rates on pure new household time deposits decreased in the second half of the year before rising in October. The rise was caused by the higher interest rates offered by some credit institutions and the higher amounts of renewed time deposits in October. Despite the rise, average interest rates on new household time deposits were 29 basis points lower in October than in June, standing at 2.4%. Interest rates on corporate time deposits dropped by 37 basis points from June to October, down to 2.9%.

Figure 3.5.1 Interest rates on pure new loans and time deposits of corporates and households

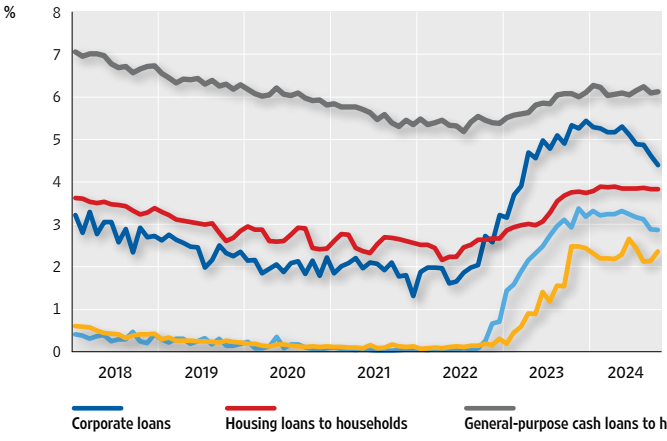
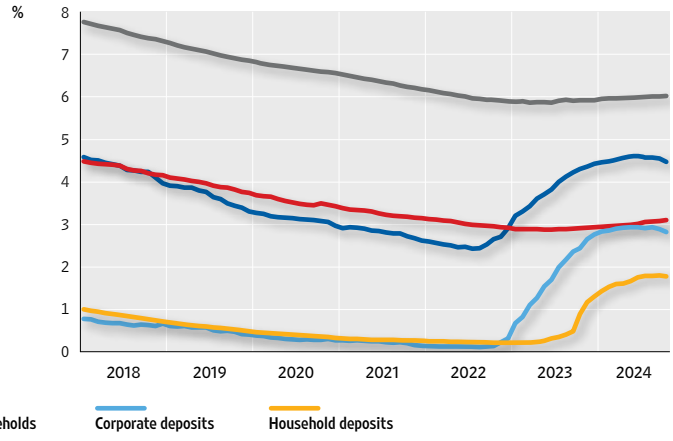


Figure 3.5.2 Interest rates on existing loans and time deposits of corporates and households



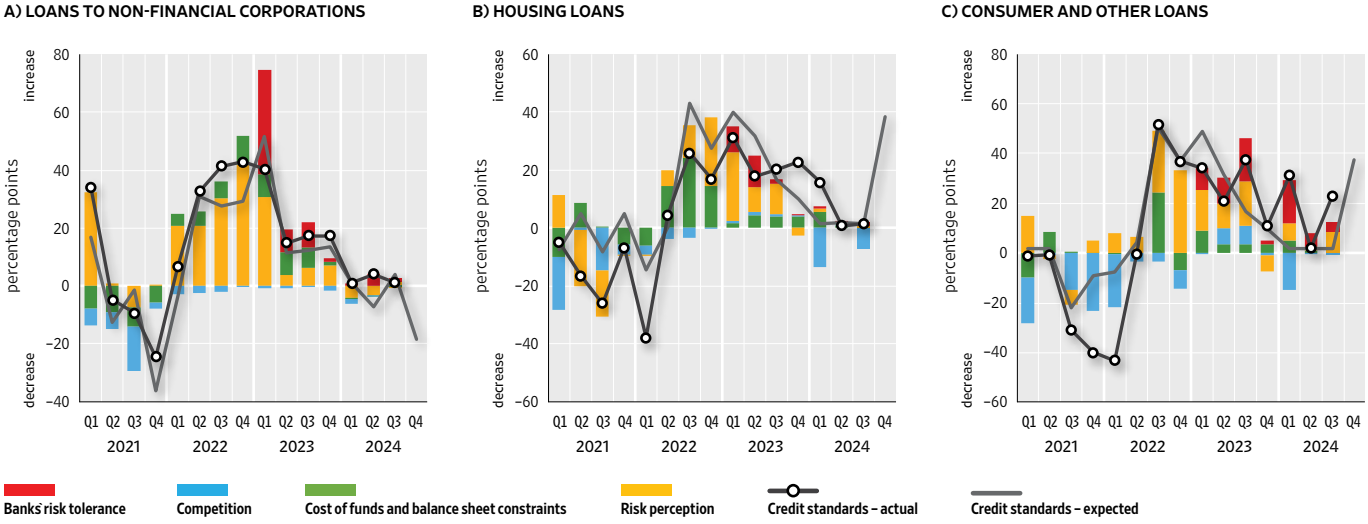
Notes: Data up to December 2022 refer to loans and deposits in kuna, in kuna with a currency clause in euro and in euro, and from January 2023 to loans and deposits in euro. Data refer to pure new loans and deposits. Deposits with a maturity of up to one month have been excluded.
SOURCE: CNB.

Interest rates on existing corporate loans also decreased, while interest rates on existing household loans edged up (Figure 3.5.2). Following a two-year steady growth, interest rates on existing corporate loans peaked at 4.6% in June 2024, before edging down gradually in the second half of the year and reaching 4.5% in October. As in the case of new loans, the decrease was also due to the large share of loans granted with reference to the EURIBOR in total existing loans. In contrast, interest rates on existing housing loans and general-purpose cash loans increased slightly, by 9 and 3 basis points respectively, reaching 6.0% and 3.1% in October. The steady growth of interest rates on existing household loans reflects the fact that interest rates on new loans are higher than those on existing loans as well as the impact of the statutory cap on interest rates on loans granted at variable interest rates linked to the EURIBOR. To put it more precisely, in the period of monetary policy tightening the statutory cap on interest rates on household loans prevented the spillover of the EURIBOR growth to interest rates on housing loans, keeping them at the levels lower than those at which they would have been had the statutory cap not been applied. Accordingly, these rates did not decrease as a result of the fall of the EURIBOR. In addition, the national reference rate (NRR), the main reference parameter in existing household loans granted at variable interest rates, started to rise as late as at the end of the previous year, which, given that banks mostly change interest rates every six months, resulted in a more pronounced increase in interest rates on existing housing loans in July this year. Interest rates on existing loans linked to the NRR stabilised from August to October. Interest rates on total household deposits almost held steady at 0.5% and interest rates on existing corporate deposits remained at 0.9% in the same period.

The results of the bank lending survey suggest that the tightening of corporate financing conditions and housing loan conditions ended, while household consumption financing conditions tightened slightly. As in the first half of the year, banks' corporate lending standards tightened very moderately in the third quarter of 2024. The intensity of tightening was much milder than in 2022 and 2023, predominantly due to banks' improved risk tolerance and risk perception (Figure 3.5.3). Lending standards for housing loans also remained largely unchanged in the third quarter this year, because competition among banks, which had resulted in the easing of lending standards, was offset by a slightly negative impact of risk perception and risk tolerance. In contrast, negative perception related to client creditworthiness and a lower risk tolerance caused lending standards for consumer and other loans to tighten considerably. Banks expect a further slight tightening of corporate lending standards and a stronger tightening of household lending standards.

Figure 3.5.3 Bank lending survey

lending standards and factor contributions



Notes: "Risk tolerance" was introduced in the first quarter of 2023 and reflects a bank's tolerance to risk in its lending policy, which can change depending on changes in the bank's general business strategy. "Cost of funds and balance sheet constraints" are the unweighted average of the "Impact of capital position", "Impact of ability to access market financing" and "Impact of liquidity". "Competition" is the unweighted average of the "Impact of bank competition", "Impact of non-bank competition" and "Impact of market financing competition". "Risk perception" is the unweighted average of the "Impact of general economic activity", "Impact of industry or firm specific situation" and "Impact of risk on the collateral".
SOURCE: CNB.

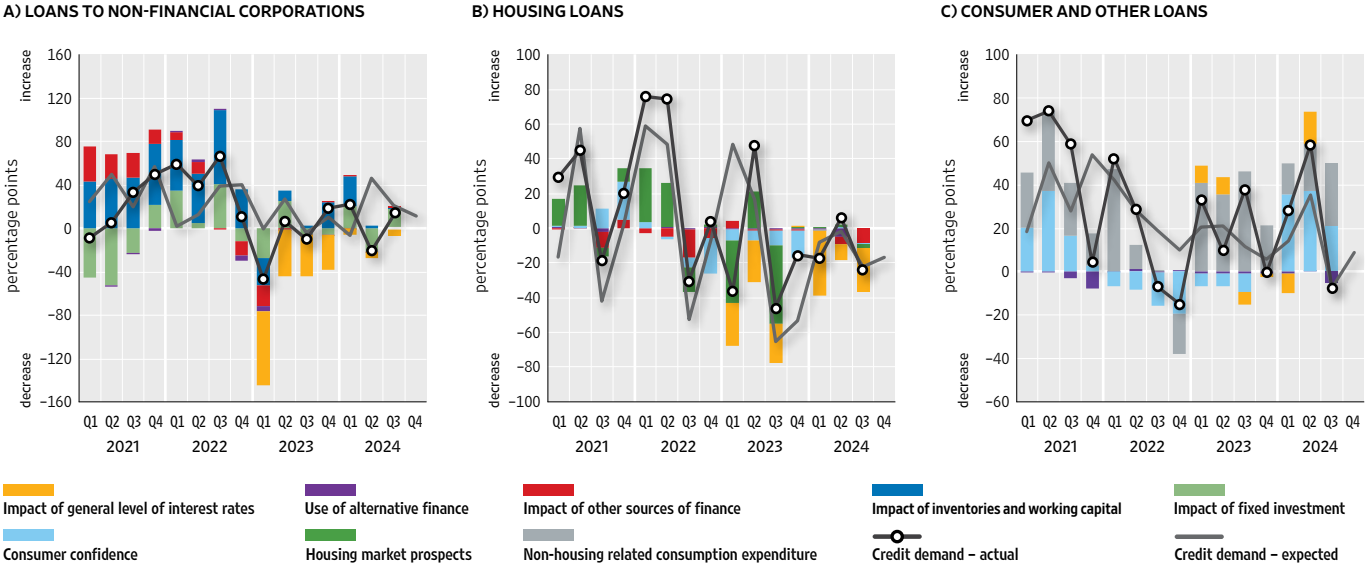
Notes: "Risk tolerance" was introduced in the first quarter of 2023 and reflects a bank's tolerance to risk in its lending policy, which can change depending on changes in the bank's general business strategy. "Cost of funds and balance sheet constraints" are the unweighted average of the "Impact of capital position", "Impact of ability to access market financing" and "Impact of liquidity". "Competition" is the unweighted average of the "Impact of bank competition" and "Impact of non-bank competition". "Risk perception" is the unweighted average of the "Impact of general economic activity", "Housing market prospects" and "Borrowers' creditworthiness".
SOURCE: CNB.

Notes: "Risk tolerance" was introduced in the first quarter of 2023 and reflects a bank's tolerance to risk in its lending policy, which can change depending on changes in the bank's general business strategy. "Cost of funds and balance sheet constraints" are the unweighted average of the "Impact of capital position", "Impact of ability to access market financing" and "Impact of liquidity". "Competition" is the unweighted average of the "Impact of bank competition" and "Impact of non-bank competition". "Risk perception" is the unweighted average of the "Impact of general economic activity", "Borrowers' creditworthiness" and "Impact of risk on the collateral".
SOURCE: CNB.

Banks' responses to the lending survey show that corporate demand for loans has remained subdued, coupled with a small drop in household demand for housing loans, consumer loans and other loans. The results of the survey suggest that there was only a slight increase in corporate demand for loans in the third quarter of 2024, which came after a short-lived decrease in the previous quarter. The increase in demand was mostly due to growing corporate demand for investment financing, while the increased level of interest rates continued to bring demand slightly down, although its impact on changes in demand in 2024 was much weaker than in 2023, when a strong cycle of interest rate hikes led to a large reduction of demand (Figure 3.5.4). Household demand for loans, housing loans in particular, decreased in the same period. Such trends were mainly driven by the high level of interest rates, compounded by pressures related to the regulatory and fiscal regime of the real estate market and its negative perspective. The financing of purchases of durable consumer goods, on the other hand, and the growth of consumer confidence, continued to boost demand for consumer and other loans. Banks expect a mild increase in corporate demand for loans and household demand for consumer and other loans as well as a drop in household demand for housing loans in the fourth quarter of 2024.

Figure 3.5.4 Bank lending survey

demand change and factor contributions



Notes: "Interest rate level" is a term introduced in the first quarter of 2023. "Other sources of finance" are the unweighted average of the "Debt restructuring and refinancing" and "Impact of mergers and acquisitions and corporate restructuring". "Use of alternative finance" is the unweighted average of the "Impact of internal financing", "Impact of loans from other banks", "Impact of loans from non-banks", "Impact of debt securities issuance" and "Impact of equity issuance".
SOURCE: CNB.

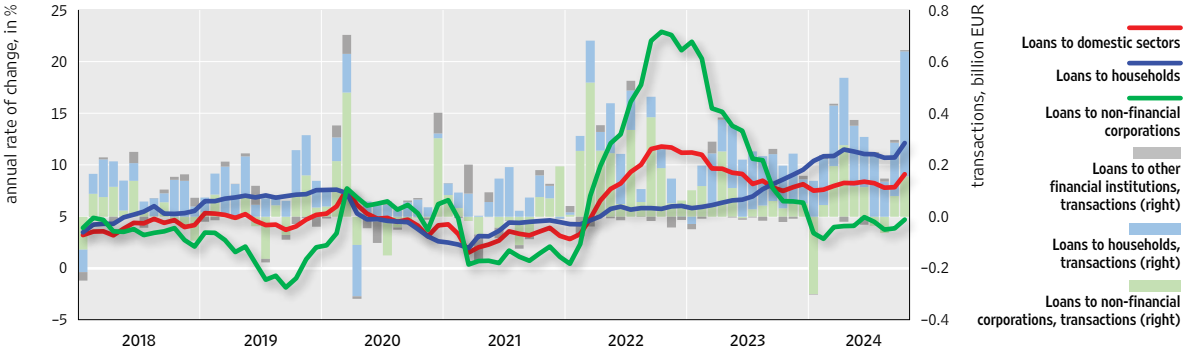
Notes: "Interest rate level" is a term introduced in the first quarter of 2023. "Other sources of finance" are the unweighted average of "Debt restructuring and refinancing" and "Regulatory and fiscal framework of the real estate market". "Use of alternative finance" is the unweighted average of the "Household savings", "Loans from other banks" and "Impact of other sources of finance".
SOURCE: CNB.

Notes: "Interest rate level" is a term introduced in the first quarter of 2023. "Use of alternative finance" is the unweighted average of the "Household savings", "Loans from other banks" and "Impact of other sources of finance".
SOURCE: CNB.

Despite the improved financing conditions, corporate loans grew modestly in the second half of the year, showing some signs of recovery. Household loans continued to grow relatively strongly. Corporate loans grew modestly by EUR 0.1bn (Figure 3.5.5) in the period from July to October 2024, up in September and October, after having fallen in July and August. Broken down by activity, corporate loans in construction, manufacturing and real estate activities increased the most, while with regard to loan purpose, the largest growth was seen in working capital loans. The annual growth of corporate loans remained somewhat below 5% in the second half of 2024, amounting to 4.7% in October. Loans to households increased by EUR 1.1bn in the same period, with this figure including an increase of EUR 0.4bn in cash general-purpose loans and housing loans respectively as well as an increase of EUR 0.2bn accounted for by credit card loans, because a credit institution acquired part of the operations related to credit card issuance in October. The annual growth of household loans continued to accelerate, rising from 11.1% in June to 12.1% in October, due to the sharply accelerated growth of cash general-purpose loans, up from 14.7% to 16.2% respectively. In contrast, the growth of housing loans decelerated slightly, down from 9.8% to 8.9%, to a large extent due to base effects stemming from the implementation of the government housing loans subsidy programme in 2023, which resulted in an increase in housing lending in the summer months of the year. The subdued corporate lending is also indicated by the lending momentum, which was even slightly negative in September before recovering in October. The momentum of general-purpose cash loans stabilised at the levels below the annual growth rate, but remained strong (15.3% in October), whereas the momentum of housing loans held steady at about 9% (Figure 3.5.6).

Figure 3.5.5 Loans

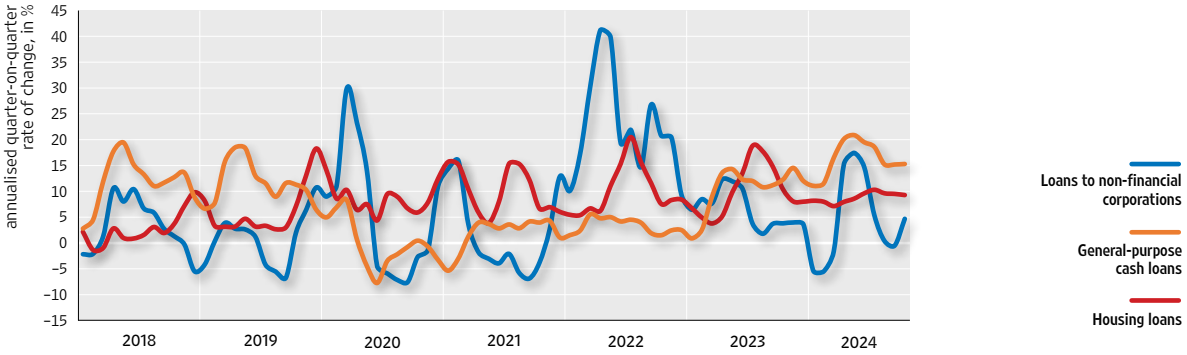
transactions and annual rates of change (transaction-based)



Note: Loans to domestic sectors exclude loans to general government.
SOURCE: CNB.

Figure 3.5.6 Lending momentum, corporates and households

(transaction-based)

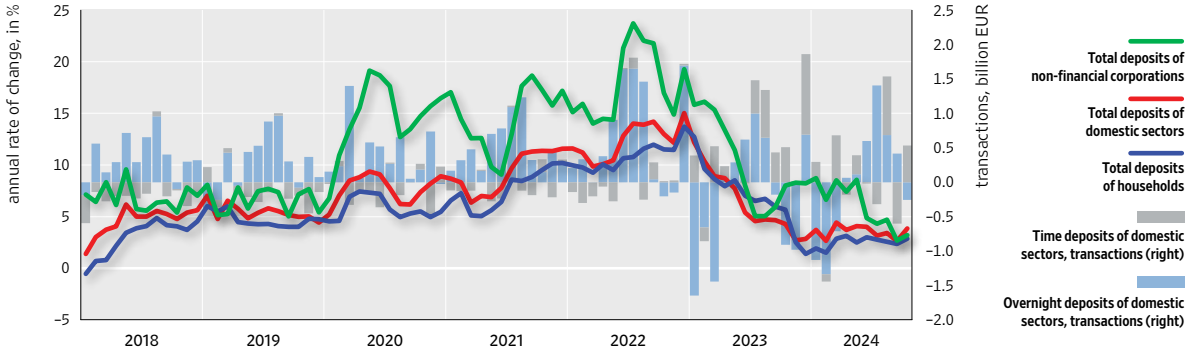


SOURCES: CNB and CNB calculations.

The inflows of corporate and household funds to banks' time deposits decreased in the second half of the year due to a gradual decline in interest rates on corporate time deposits and, in the case of household deposits, due to some extent to the inertia of depositors which contributed to keeping deposit rates at relatively low levels. Household time deposits decreased slightly by EUR 52m from July to October 2024, while overnight deposits surged by EUR 1.5bn. Citizens could also invest their funds into government securities (three-year bonds in July as well as three-month and one-year treasury bills in September and November); some of these investments matured, with the balance of these securities amounting to EUR 4.1bn at the end of November, an increase of EUR 0.3bn from the end of June. Corporate time deposits grew by EUR 0.2bn. Overnight deposits increased sharply by EUR 0.8bn (Figure 3.5.7). Therefore, the balance of total time deposits continued to rise slightly, while the share of time deposits in total deposits stabilised at just below 30% (Figure 3.5.8).

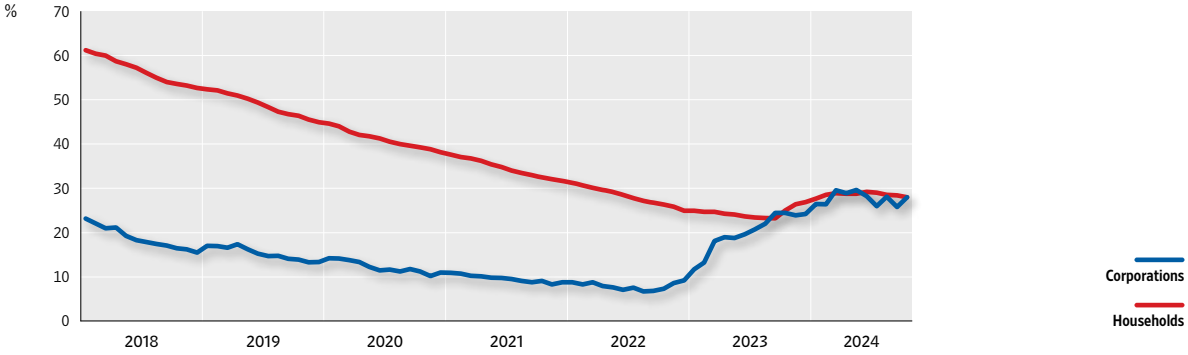
Figure 3.5.7 Deposits

transactions and transaction-based annual rates of change



Note: Deposits of domestic sectors exclude general government deposits.
SOURCE: CNB.

Figure 3.5.8 Share of time deposits in total deposits



Note: Total deposits include overnight and time deposits, deposits redeemable at notice and repurchase agreements.
SOURCE: CNB.

BOX 6

Why has deposit growth decelerated?

Bank deposit growth, having surged after the breakout of the pandemic, has decelerated considerably in the last two years. The surge in private sector deposits largely originated from the purchase of government securities by the central bank at the peak of the pandemic crisis, the recovery of foreign capital inflows and tourism revenues in the first post-pandemic year, strong corporate lending during the 2022 energy crisis and kuna cash deposits with banks made on the eve of the introduction of the euro. However, deposit growth more than halved in 2023, as a result of a slowdown in corporate lending and substantial foreign investments by domestic institutional investors as well as of the renewal of cash reserves after the introduction of the euro and an increase in government deposits with the CNB. Deposits continued to grow at a similar pace in 2024, with the growth returning to pre-pandemic levels. This box aims to show the key determinants of deposit trends in the period from the pandemic to the present.

Private sector deposits have been growing continuously in the last ten years. However, the period immediately after the pandemic year 2020 saw especially strong deposit growth, which started to accelerate sharply before peaking in 2022, immediately before the introduction of the euro as the official currency. In the nine-year period from 2011 to 2019, M3 deposits[1] grew by almost EUR 10bn, and by a high EUR 17bn in the following three years, up by EUR 8bn in 2022 alone. The key drivers of the growth were overnight household deposits, followed by non-financial corporations' deposits. Having peaked in 2022, the deposit growth more than halved in 2023 and followed a similar pace in the first six months of this year (Figure 1).

The key sources of deposit creation in the previous years were inflows of funds from abroad and lending to the private sector. Since 2021, deposits have been created primarily by inflows of funds from abroad. Inflows from net direct investments recorded an especially strong growth that year, generated primarily by increases in direct equity investments related to the purchase of real estate by non-residents and the retained earnings of domestic enterprises (Figure 3). In addition to direct investments, the current and capital account surplus also increased, primarily due to the recovery of tourism revenues after the lifting of containment measures.

1 M3 deposits comprise overnight deposits, deposits with an agreed maturity of up to two years, deposits redeemable at a period of notice of up to three months (domestic residents and residents from the rest of the euro area).

Figure 1 Changes in deposits by institutional sectors

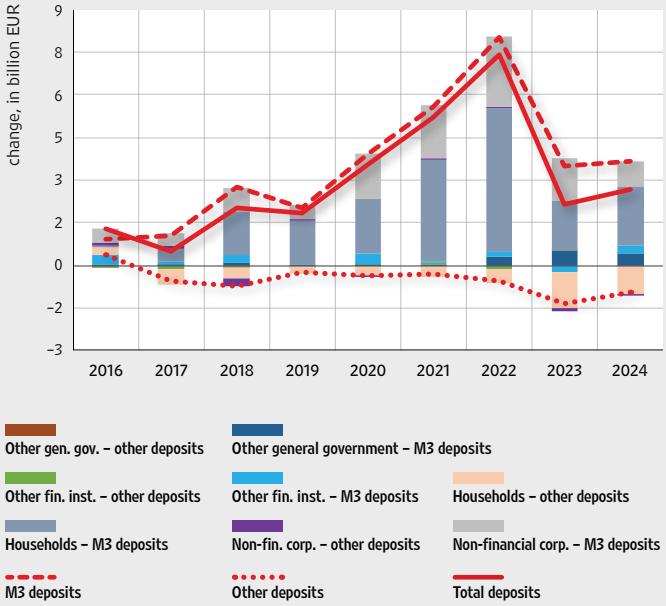
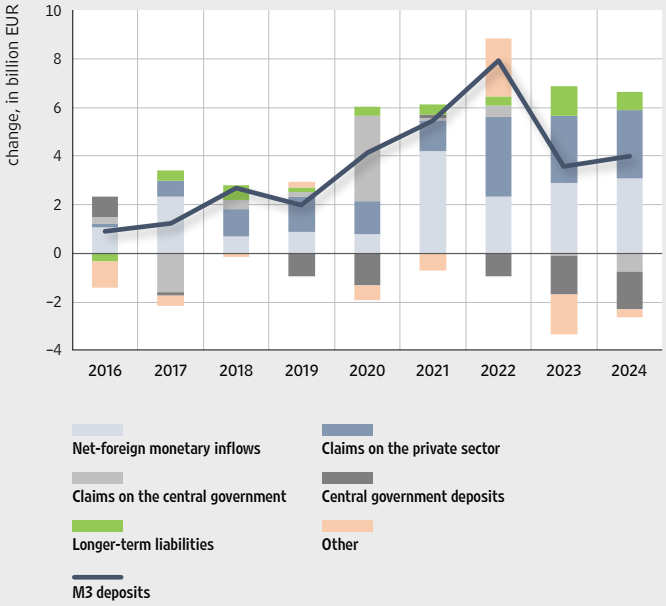


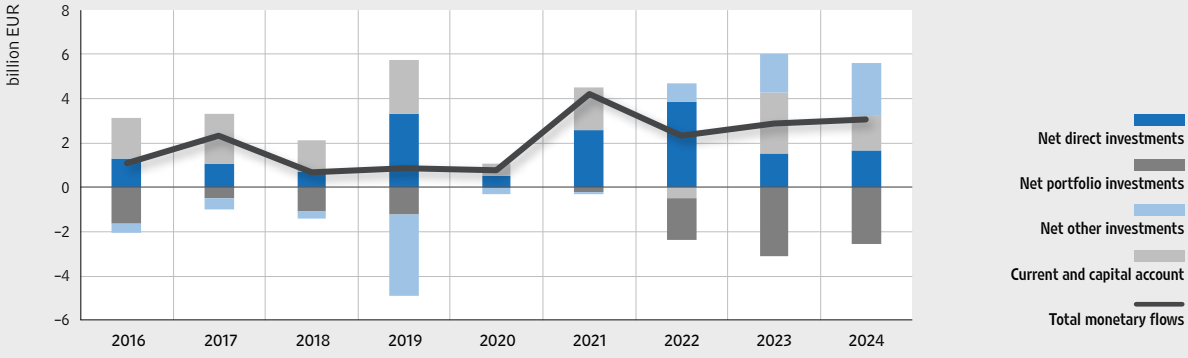
Figure 2 Contributions to the absolute change in private sector M3 deposits



Notes: M3 deposits comprise overnight deposits, deposits with an agreed maturity of up to two years, deposits redeemable at a period of notice of up to three months; domestic residents and residents from the rest of the euro area. The private sector refers to the household sector, non-financial corporations sector, non-bank financial institutions sector and other general government sector. Longer-term liabilities comprise deposits with an agreed maturity of over two years, deposits redeemable at a period of notice of over three months and securities issued with a maturity of over two years. Data for 2024 refer to the sum of the last twelve months up to June 2024.
SOURCE: CNB.

The contribution of inflows of funds from abroad dropped sharply in 2022 (Figure 2). Due to the energy crisis, net imports of energy rose sharply and the current account balance deteriorated considerably as a result in the same year. The stabilisation of energy prices early in 2023 and the record-high utilisation of EU funds boosted the surplus in the current and capital account in 2023. In contrast, foreign portfolio investments by domestic institutional investors have grown strongly since 2022, negatively influencing deposit growth. That year, domestic pension investment funds mostly invested in the government external debt traded in the international market.

Figure 3 Monetary presentation of the balance of payments



Notes: Data exclude monetary financial institutions. Data for 2024 refer to the sum of the last twelve months up to the second quarter of 2024.
SOURCE: CNB.

Foreign investments by domestic institutional investors increased additionally after some regulatory limitations related to currency risk had been eliminated by the adoption of the euro. This resulted in strong capital outflows based on portfolio investments. However, these outflows were offset by net inflows from other investments, which reflect the statistical records of the difference between the balances of amounts received from EU funds and amounts not yet disbursed to end beneficiaries.

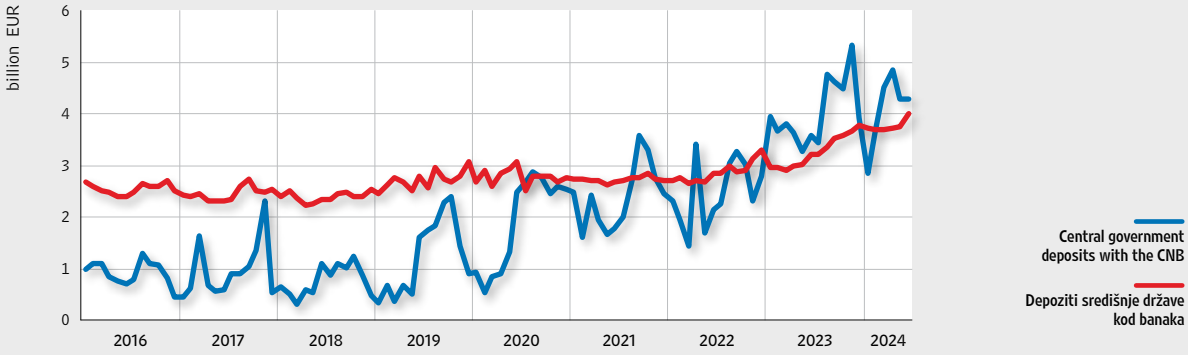
Lending to the private sector, especially corporate lending, increased at especially high rates in 2022, making an important contribution to deposit growth. Specifically, corporate sector needs for working capital financing increased owing to the energy crisis, which led to the strong growth of corporate lending, reaching 21.1% at the end of 2022 (transaction-based). However, corporate lending has slowed down since early 2023 as a result of higher borrowing costs, the tightening of credit standards and lower needs for working capital amid falling raw materials and energy prices. Corporate loans grew by EUR 0.9bn in 2023 (transaction-based), which is only slightly more than one third of the growth recorded in the previous year and represents an annual growth of 6.4%. Although financing conditions stabilised, and the bank lending survey points to a relatively stable corporate demand for loans, loans to the corporate sector increased by EUR 0.4bn in the first six months of this year, rising at an annual rate of 4.9% at the end of June. Household loans continued strong growth as far as housing loans are concerned, while cash general-purpose loans surged, boosted by the growth of consumer confidence, the need for financing the purchase of durable consumer goods and a relatively slight increase in interest rates on consumer and other loans.

Deposit trends were also considerably influenced by kuna cash being deposited with banks on the eve of the introduction of the euro. Kuna cash in circulation thus decreased by almost 60% in the second half of 2022. However, in the first few months following the introduction of the euro, citizens were again withdrawing cash, and deposit growth decelerated as a result. It is noteworthy that the amount of kuna in circulation was precisely recorded at all times. However, after the introduction of the euro, only the total amount of euro cash issued at the level of the Eurosystem is known, but not the amounts distributed among euro area member states or the amounts in circulation outside the euro area. The CNB, for the purpose of the compilation of the balance of payments, estimates the amount of euro cash in circulation (**Figure 5**). The available estimates point to a continued rise in this amount since the beginning of 2023.

Deposit trends were also affected by the activities of the government and central bank. During the pandemic, the CNB purchased government bonds in the domestic financial market to stabilise the market and preserve favourable financing conditions. This was the main channel of deposit creation in 2020 (**Figure 2**).[2] Government activities, on the other hand, decelerated deposit growth in the last two years. Net claims on the central government dropped in that period, while government deposits with banks and the central banks increased by EUR 1.6bn in 2023 and by another EUR 1.5bn in the first half of this year (**Figure 4**). The sharp rise in government deposits was largely brought about by inflows from national bonds and treasury bills, ample inflows from income tax and VAT as well as the inflows of EU funds.

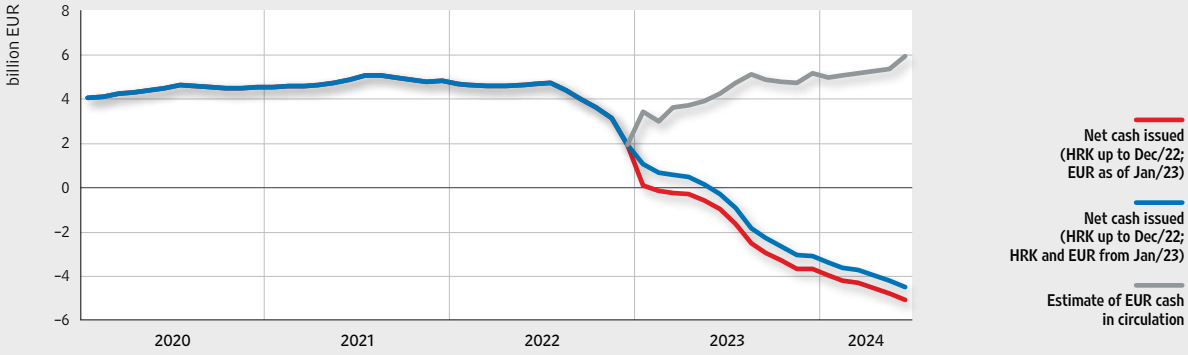
2 For more information on developments in financial markets and CNB's activities, see CNB's regular publications covering the period of the coronavirus pandemic.

Figure 4 Government deposits with banks and the central bank



SOURCE: CNB.

Figure 5 Cash in circulation



Note: The new estimate of euro cash in circulation is based on the fiscalised cash spending and the balance of household-owned deposits and debt securities.
SOURCES: CNB and IMF.

In addition to foreign inflows, a decrease in longer-term liabilities, that is, household deposits with a maturity of over two years, has also supported the growth of M3 deposits of the private sector. This especially refers to the period when some banks offered lower interest rates on shorter-term deposits, especially three to six months or six to twelve months deposits, which motivated households to reduce the maturity of their deposits.[3]

Given the expectations of continuing favourable developments in the current and capital account of the balance of payments and a fall in interest rates that could (additionally) boost or maintain household demand for loans and spur corporate lending, total deposits could continue to grow at a relatively high rate, remaining under the influence of changes in capital flows, lending activity and the government's financial operations.

3 For more details, see: Jukić, S., Mužić, I., Šošić, V. and Zrnc, J. (2024): *Uhvati me ako možeš: rast kamatnih stopa na oročene depozite*, HNBlog; https://www.hnb.hr/-/uhvati-me-ako-mozes-rast-kamatnih-stopa-na-orocene-depozite.

4 Projections for Croatia

4.1 Baseline assumptions

The CNB December projection is premised on continued stable global economic growth and receding inflationary pressures. Developments in the first nine months were mainly in line with expectations, with the third quarter economic growth in some countries, such as the USA and China, surprising to the upside. The growth of the global economy (excluding the euro area) could stand at 3.5% in 2024 and decelerate slightly towards the end of the projection horizon, primarily reflecting China's structural growth slowdown, caused by unfavourable demographic developments and problems in the real estate market. While the global economy seems to have weathered the monetary policy tightening cycle, retaining positive trends in the real sector, the forthcoming period is nevertheless expected to see a more moderate growth than in the previous projection cycle, given heightened uncertainty regarding the geopolitical situation, especially in Ukraine and the Middle East. At the same time, although expectations regarding global trade improved in the short term, another source of risk is the strengthening of protectionism after the US elections, which could indirectly spill over to Croatia's foreign trade.

Energy prices could be lower than expected, while food raw material prices could increase substantially. Crude oil prices could range around USD 71.8 per barrel in 2025, which is a decrease of 4.3% from the September projection and considerably lower than the average level in 2024, when prices mostly hovered above USD 80 per barrel. Electricity prices projected for 2025 are 3.4% lower than in the previous projection. However, despite the expected decrease across the projection horizon, they could fall below their 2024 level as late as in 2026. In contrast, the price path for natural gas and food raw materials is expected to be less favourable: the average price of food raw materials could be even 8.8% higher than expected, mainly due to changed expectations regarding the prices of cocoa, coffee and pork. Industrial raw material prices, metal prices in particular, remain elevated as a result of a continued strong demand, while the prices of some raw materials, such as aluminium, are additionally spurred by supply-side constraints.

Expectations regarding euro area economic growth and inflation have abated slightly compared with the September projection. According to the latest ECB projections, the overall euro area inflation is expected to be 2.5% in 2024 and decelerate further to 2.1% in 2025. Compared with September projections, the overall inflation has been revised downwards by 0.1 percentage point for both years, primarily due to lower results and a more favourable path of energy prices, which could be offset by a spike in the inflation of food raw material prices, in tune with the already mentioned unfavourable projection of food raw material prices. The overall inflation could thus come close to or equal the target level of 2%, although this projection remains exposed to considerable risks. The estimate of euro area economic growth for 2024 was reduced slightly to 0.7% (0.1 percentage point lower than in the September projection), primarily due to weaker than expected investment activity in the private sector. However, growth could strengthen to 1.1% in 2025 as the negative impacts of restrictive monetary policy disappear and real income growth supports personal consumption. The uncertainty caused by geopolitical tensions, including global trade policy, could continue to make a negative impact on private

investments. Finally, the increased uncertainty, coupled with the structural weaknesses of the euro area economy, could play a key role in restricting the total economy growth in the largest part of the projection horizon.

Table 4.1.1 Projection assumptions regarding the international environment and prices of raw materials

		Current projection			Deviations from the previous projection		
		2024	2025	2026	2024	2025	2026
International environment							
Global economic growth (excl. EA)		3.4	3.5	3.3	0.0	0.1	0.0
USA		2.8	2.2	1.8	0.2	0.3	–0.3
China		4.9	4.7	3.9	0.1	0.6	0.1
Global trade		4.0	3.6	3.3	0.9	0.2	0.0
Foreign demand (EA)		3.1	3.5	3.3	0.6	0.1	0.0
Foreign demand (HR)		0.7	2.9	3.4	–0.3	–0.6	–0.2
Prices of raw materials							
Prices of oil	USD	81.8	71.8	70.1	–1.4	–4.3	–3.1
	EUR	75.5	67.6	66.0	–1.0	–1.9	–0.9
Prices of electricity	EUR/MWh	76.7	89.9	79.5	–0.7	–3.4	–2.7
Prices of gas	EUR/MWh	34.3	42.9	34.9	0.1	1.8	–0.4
Prices of raw materials (excl. energy) % of change	USD	8.9	5.8	–0.4	1.6	4.5	–2.9
prices of food raw materials	USD	16.1	5.2	–6.5	2.3	8.8	–5.3
prices of other raw materials	USD	4.2	6.1	4.3	1.1	1.1	–1.0
Euro area							
Economic growth		0.7	1.1	1.4	–0.1	–0.2	–0.1
Inflation		2.4	2.1	1.9	–0.1	–0.1	0.0

Note: Projection assumptions refer to the ECB December projection cycle (December 2024 BMPE) as at 21 November 2024.
SOURCE: ECB.

4.2 Macroeconomic variable projections

Croatia's real GDP growth accelerated in 2024 despite a still subdued foreign demand, the delayed effects of tightened financing conditions and geopolitical tensions. Growth is expected to decelerate gradually in the following years, driven by an increased contribution of foreign demand and a lower contribution of domestic demand. Economic activity growth this year primarily reflects a strong domestic demand, supported by favourable labour market developments, a very stimulative fiscal policy and strong investment activity in the private sector. Exports of goods and services are expected to make a larger contribution to the growth in the remainder of the projection horizon due to the expected strengthening of foreign demand, which should also be supported by the lessening impact of restrictive monetary policy. Domestic demand could continue to provide a significant support to the growth, although at a weaker pace. This primarily refers to a decline in the growth of investments, which are however still expected to underpin economic activity relatively strongly in the following two years.

Table 4.2.1 Key macroeconomic variable projections

annual growth rates

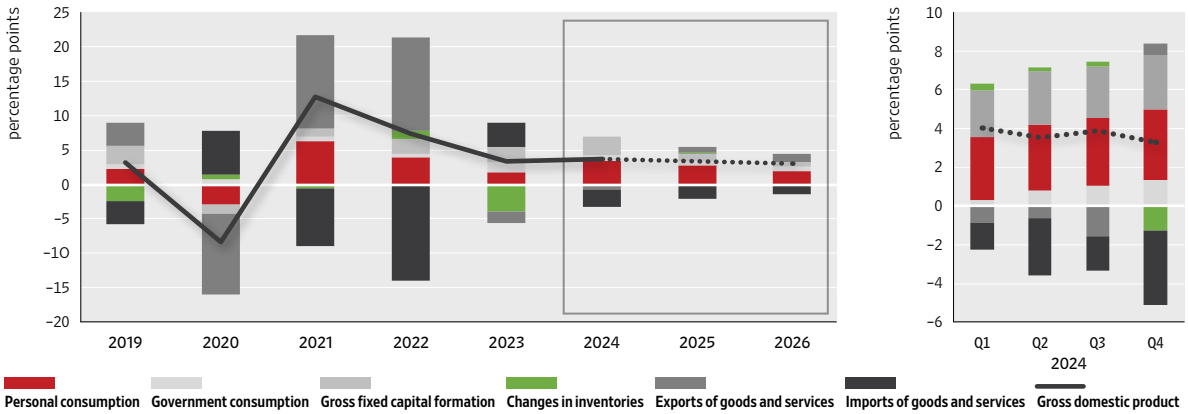
	2023	2024	2025	2026
Real GDP	**3.3**	**3.7**	**3.3**	**3.0**
Personal consumption	3.2	6.0	4.9	3.5
Government consumption	7.1	4.3	3.2	2.4
Capital investments	10.1	11.9	4.3	3.3
Exports of goods and services	−2.9	−1.2	2.0	2.5
Imports of goods and services	−5.3	4.6	4.1	2.8
Contributions to GDP growth[1]				
Domestic demand	5.5	7.0	4.5	3.3
Exports of goods and services	−1.7	−0.7	1.0	1.2
Imports of goods and services	3.5	−2.5	−2.2	−1.4
Inventories	−3.9	−0.1	0.0	0.0
Labour market				
Change in employment	2.5	3.4	2.0	1.5
Unemployment rate (ILO)[2]	6.1	4.9	4.7	4.5
Nominal gross wage	14.7	14.9	8.5	5.6
Real gross wage	6.2	10.7	4.9	3.1
Inflation (HICP)				
Total	**8.4**	**4.0**	**3.5**	**2.5**
HICP excl. energy and food	8.8	4.7	2.9	2.7
Food	11.5	4.5	4.7	2.5
Energy	0.1	−0.3	4.0	1.2

[1] In percentage points
[2] As % of labour force.
Note: Table 4.2.1 sums up the estimated and projected values of key variables for Croatia resulting from the inclusion of baseline assumptions and historical results in the short-term and medium-term macroeconomic models used by the Croatian National Bank, subject to corrections of model estimations based on the judgement of experts for individual economic areas.
SOURCES: CBS, Eurostat and CNB estimations and projections.

Real GDP could grow by 3.7% in 2024 and by 3.3% in 2025. GDP growth for 2024 as a whole could slightly exceed the 3.3% recorded in 2023. Such trends were mainly driven by strong personal consumption and by investments, particularly those of the private sector. Goods exports also recovered to some extent, while services exports could decline. The strong personal consumption reflects a strong wage growth and accelerated employment growth. The average nominal gross wage is expected to increase by about 15% and the real gross wage by almost 11% in 2024. In addition, employment growth is expected to accelerate to almost 3.5% in 2024, while the unemployment rate should fall to slightly below 5.0%. In 2025, GDP growth could decelerate, but remain relatively strong. The projected strengthening of foreign demand is expected to positively affect goods and services exports, although goods exports could grow at relatively moderate rates given the high level of tourism services exports. Domestic demand could continue to strongly support real GDP growth, albeit providing a smaller contribution than in 2024. This is partly due to the expected gradual deceleration of personal consumption growth, resulting from a mild real wage growth, which could, amid the tight labour market and announced minimum wage increases, still remain above pre-pandemic averages. Employment

growth is expected to slow down, coupled with productivity growth, while the unemployment rate could reach an all-time low of 4.7%. Given the expected productivity growth and decelerated wage growth, the growth of unit labour costs could slow down, but still remain relatively strong. Investments could continue to rise steadily, taking into account market expectations about a fall in financing costs and the expected increase in the contribution of EU funds. However, the growth rate could decelerate, following the average investment growth of above 10% in the previous three years.

Figure 4.2.1 GDP and GDP components, contributions



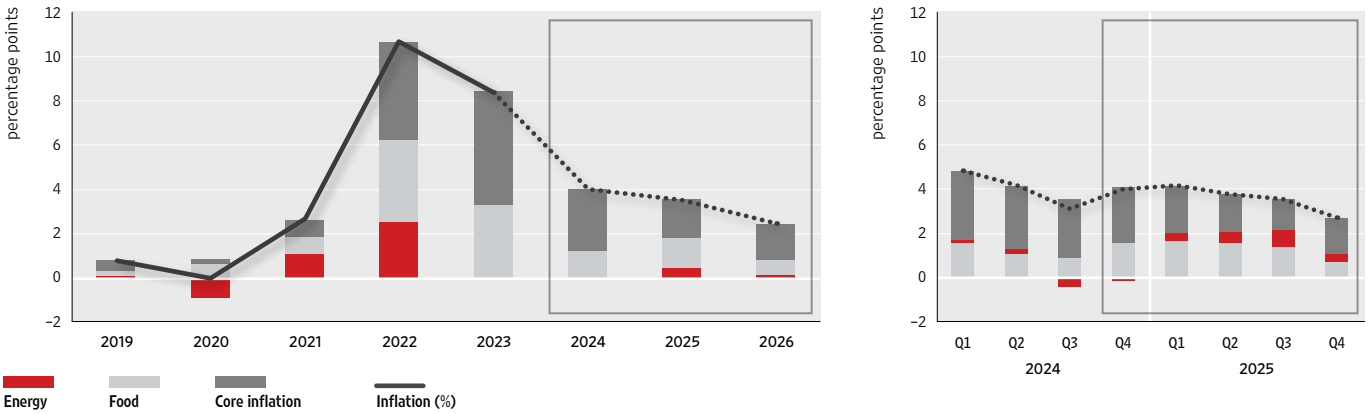
SOURCES: CBS and CNB estimations and projections.

The expansion of the Croatian economy is expected to decelerate slightly in 2026. However, economic activity is anticipated to continue growing at a relatively high rate of about 3.0%, primarily due to the continued strengthening of foreign demand, improved financing conditions and utilisation of EU funds. Against this background, expectations are that favourable developments in the labour market will continue and that domestic demand will be relatively robust. Economic growth could still be somewhat more moderate than in the previous year, given the structural limitations of the Croatian economy, especially regarding the supply of labour force and productivity growth.

Risks associated with Croatia's central real growth projection seem to be balanced. Due to ongoing and potentially escalating geopolitical tensions, economic developments in the international environment and developments in the prices of raw materials and energy have remained highly uncertain. It is possible that protectionist measures of some kind might be introduced, which could have a negative impact on Croatian goods exports due to diminishing foreign demand from Croatia's main trading partners. Moreover, the projected investment growth will largely depend on the successful absorption of EU funds primarily by the public, but also by the private, sector. However, should geopolitical tensions de-escalate, foreign demand trends could outstrip expectations and favourably affect goods exports. Consumer confidence could also improve, bringing down the household savings rate, currently projected to slightly exceed the pre-pandemic levels, and additionally propelling personal consumption growth.

HICP inflation could more than halve in 2024, falling to 4.0% from 8.4% in 2023, and continue to decelerate, although at a weaker pace, in the following two years. Slowing down steadily from the end of 2022 to August 2024, inflation speeded up in the following three months and is expected to continue accelerating slightly in the next few months, mainly reflecting unfavourable base effects related to the very low current inflationary pressures in late 2023 and early 2024. The annual inflation rate is likely to decelerate further once the impact of these base effects disappears in the first quarter of 2025 (Figure 4.2.2). The average annual inflation rate could stand at 3.5% and 2.5% in 2025 and 2026 respectively.

Figure 4.2.2 Projection of the harmonised index of consumer prices



SOURCES: Eurostat and CNB estimations and projections.

The inflation slowdown in 2024 and 2025 could primarily result from a decrease in core inflation, which, supported by the effects of restrictive monetary policy, could slow down from 8.8% in 2023 to 4.7% in 2024 and 2.9% in 2025. Core inflation, which excludes energy and food prices, was more persistent than other inflation components in 2024, mainly because of elevated services inflation, the main contributor to overall inflation. A tight labour market and high nominal wage growth, as well as the robust growth of domestic demand, could exert pressures on services inflation for some more time, although these pressures could be much less pronounced in 2025 than in the previous year. Additionally, although foreign demand is expected to grow relative to 2024, this growth could be subdued. Given the relatively high level of tourism-related services prices, services inflation could decelerate strongly in 2025, reflecting favourable base effects. Industrial goods inflation slowed down significantly in 2024 amid the relatively stable prices of energy and other raw materials that account for a large share in production costs, considerably alleviated uncertainty in global supply chains and, in turn, lower freight rates, as well as declining producer prices in the domestic and the non-domestic markets. In the absence of supply-side inflationary pressures and due to a switch in consumer preferences from goods to services, which led to a drop in demand, industrial goods inflation could be considerably lower than services inflation in 2025. Nevertheless, it could still be higher than in the previous year because of slightly unfavourable base effects.

In addition to core inflation, the decrease in overall inflation in 2024 strongly reflects food inflation slowing down to 4.5% from 11.5% in 2023. Following this slowdown, food inflation could accelerate mildly to 4.7% in 2025. Consumer food inflation slowed down markedly in the second half of 2023 and the first half of 2024 due to the global prices of energy, food and other raw materials falling sharply from the peaks reached in 2022. The fall spilled over with a time lag to food producer price inflation, reducing it, and, in turn, to consumer food inflation. However, food inflation speeded up in the second half of 2024, partly as a result of unfavourable base effects (sharp monthly increases in food prices in September and October 2023) and partly due to mounting current inflationary pressures brought about by the dry summer season and recent increases in the prices of some food raw materials in the world market, in particular of coffee, sugar and cocoa. Food inflation could accelerate slightly in the first months of the projection horizon, but it is expected to decelerate for most of 2025 and be lower in the last quarter than in the same period in 2024. Nevertheless, because of the increase in food inflation at the end of 2024, that is, the carry-over effect onto the next year, the average annual food inflation rate in 2025 could be somewhat higher than in 2024.

Energy inflation could drop to –0.3% in 2024 from 0% u 2023 and speed up significantly to 4.0% in 2025. Despite escalating geopolitical tensions and wars, the global crude oil price fell by more than one fifth from April to September 2024 in expectation of an economic downturn. Such developments in the world market caused a noticeable decrease in the inflation of refined petroleum product prices and overall energy inflation in Croatia. However, energy inflation accelerated sharply in October and November 2024 due to the spillover of the October crude oil price growth to retail refined petroleum prices and the first part of an increase in the administrative prices of electricity, gas and heat energy. As this price increase happened late in the year, most of its impact on the acceleration of the average annual energy inflation rate will not be visible until 2025. In addition, the second, smaller part of the announced price increase in administrative energy prices will take effect in early 2025.

Overall inflation is expected to continue decelerating and reach 2.5% in 2026. The 2026 inflation slowdown is based on the assumption of the absence of external shocks, the easing of supply-side pressures and a gradual slowdown of wage growth, as well as on restrictive monetary policy effects. Accordingly, the contributions of all main inflation components, food inflation in particular, are likely to decrease.

The risks surrounding the projected inflation path are still elevated, but generally balanced. The risks arising from the escalation of geopolitical tensions weigh especially heavily. Any difficulties or restrictions in the supply of energy and other raw materials in the world market could boost energy and food prices and spill over to other consumer basket components. The continuation of war in Ukraine, geopolitical tensions in the Middle East and potential shifts in economic policies, trade policies in particular, related to the change of the US administration, could set off deglobalisation and fragmentation processes and increase import prices due to the imposition of tariffs and other obstacles to trade throughout the world. As regards domestic factors, inflation could be higher should the growth of domestic demand or the spillover of the nominal wage growth to consumer prices, especially in the services sector, be stronger than

expected. Furthermore, against a background of historically low unemployment, limited labour supply caused by unfavourable economic developments and anticipated labour demand growth, upward pressures on wages could be stronger than expected. In contrast, risks that could bring inflation below the projected path include a weaker economic growth and, consequently, a weaker demand, a stronger impact of restrictive monetary policy and a more pronounced spillover of the decrease in global prices of energy and other raw materials occurring should the majority of geopolitical tensions be resolved.

In comparison with the CNB's September projection, Croatia's real GDP growth in the current year and over the remaining projection horizon has been revised mildly upwards (Table 4.2.2). The GDP's upward revision in 2024 reflects the revision of GDP data. Expectations are that investment activity and government consumption will be stronger and exceed the expected lower services exports. The upward revision of growth in 2025 and 2026 reflects more favourable labour market developments, that is, a stronger than expected wage growth, which could positively influence personal consumption trends.

Table 4.2.2 Deviations from the CNB projection of September 2024

	2023	2024	2025	2026
Real GDP				
December 2024	3.3	3.7	3.3	3.0
September 2024	3.1	3.6	3.2	2.7
Difference (p. p.)	**0.2**	**0.1**	**0.2**	**0.3**
Inflation (HICP)				
December 2024	8.4	4.0	3.5	2.5
September 2024	8.4	3.9	3.4	2.3
Difference (p. p.)		**0.1**	**0.1**	**0.2**

SOURCES: CBS, Eurostat and CNB estimations and projections.

In comparison with the September projection, the average annual rate of overall inflation could be slightly higher along the projection horizon. The inflation projection has been revised upwards by 0.1 percentage point for 2024 and 2025 and by 0.2 percentage points for 2026. Food inflation is expected to be higher along the projection horizon than anticipated in September, which reflects the mounting inflationary pressures that caused inflation to significantly outstrip expectations and the higher revised assumptions regarding the path of food prices in the world market. Also, core inflation is expected to decelerate at a slower rate in 2026 than projected in September. Energy inflation, however, could be lower than projected in September along the whole projection horizon, in line with the lower recent performance and lower expected global oil prices.

Abbreviations and Symbols

ABBREVIATIONS

APN	Agency for Transactions and Mediation in Immovable Properties
GDP	gross domestic product
BEA	U. S. Bureau of Economic Analysis
CBS	Central Bureau of Statistics
EA	eurozone, euroarea
ECB	European central bank
ESI	Economic Sentiment Indicator
EU	European Union
EU ETS2	Emissions Trading Scheme
EURIBOR	Euro Interbank Offered Rate
€STR	Eurupean short term rate
Fed	Federal Reserve System
GSCPI	Global Supply Chain Pressure Index
HIPC	Harmonized Index of Consumer Prices
CNB	Croatian National Bank
CIP	Harmonised index of competitiveness
HWWI	Institute for International Economics in Hamburg (Hamburgisches Weltwirtschaftsinstitut)
CPF	Croatian Pension Fund
CEA	Croatian Employment Agency
ILO	International Labour Organization
INET-41	Index of nominal efective exchange rate against 41 most important trade partners
CPI	Consumer Price Index
MF	Ministry of Finance
MLF	Marginal lending facility
mil.	million
bil.	billion
IMF	International Monetary Fund
MWh	megavats per hour
NACE	National clasification of activities
OECD	Organization for Economic Cooperation and Development
OOH	owner-occupied housing
p. p.	percentage points
VAT	Value added tax
PMI	Purchasing Manager Index
USA	United States of America
SMA	Survey of Monetary Analysts
SPF	Survey of Professional Forecasters
SVAR	structural vector autoregressive model

q	quarter
UNCTAD	United Nations Conference on Trade and Development

THREE-LETTER CURRENCY CODES

CHF	Swiss franc
CNY	Yuan Renminbi
EUR	euro
GBP	pound sterling
JPY	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	The Netherlands
PL	Poland
PT	Portugal

RO	Romania
SI	Slovenia
SK	Slovakia
UK	United Kingdom

SYMBOLS

–	no entry
....	data not available
0	value is less than 0.5 of the unit of measure being used
Ø	average
a, b, c,...	indicates a note beneath the table and figure
*	corrected data
( )	incomplete or insufficiently verified data

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