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Macroeconomic Developments and Outlook

Year X · Number 18 · June 2025

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Summary

Towards the end of 2024 and at the beginning of 2025, growing uncertainty related to the trade policy of the US administration placed a considerable strain on the global economy. This resulted in the slowdown of global economic activity, particularly in emerging market countries, although the bulk of the adverse effects is expected in the coming quarters. The Chinese economy continued to grow, greatly owing to fiscal incentives and temporary effects of the front-loading of exports to the USA in anticipation of tariff hikes. In contrast, the US economy began to show signs of slowdown, although such developments could partly stem from the acceleration of imports of goods ahead of the announced tariffs, which may not be fully reflected in the recorded positive contribution of changes in inventories. In response to the announced increase of US tariffs, global trade temporarily picked up in early 2025, but the manufacturing sector remained under the pressure of high costs and weak demand and early signs of slowdown began to emerge in the services sector. In the meantime, prices of raw materials and energy began to fall due to the increasing concerns related to the outlook for global demand. Against such a backdrop, an increasing number of central banks continued with a gradual monetary policy easing despite the uncertainty regarding the global effects of US tariffs.

The euro area economy strengthened noticeably at the beginning of 2025. Such developments resulted from accelerated exports, primarily of pharmaceutical products, to the USA, ahead of tariff increases. Although the quarterly growth of economic activity was stronger than anticipated, according to high-frequency indicators, it is expected to weaken in the remaining part of the year. This is partly due to the unfavourable effects of temporary factors related to the increased exports to the USA in the first quarter and to elevated uncertainty surrounding global trade policies. Negative short-term effects of these factors could be more pronounced than the positive effects of the announced increase of investments in defence and infrastructure, which should materialise more strongly in the years ahead. The euro area labour market remained relatively robust, exhibiting historically low unemployment rates, but demand for labour is steadily decreasing. Euro area inflation slowed down significantly in the first five months of 2025, mainly under the influence of the decelerated inflation of prices of energy and services. Under the influence of developments in the prices of services, in May, core inflation dropped to its lowest level in the past three years.

The ECB's Governing Council lowered key interest rates by 25 basis points at the meeting on 5 June, thus continuing the gradual easing of the monetary policy stance that started in June last year. The Governing Council lowered the deposit facility rate eight times in the past twelve months, which, in the current conditions of high liquidity surpluses, is a relevant indicator of the ECB's monetary policy. The rate was lowered by a total of 200 basis points to 2.00%, after key interest rates had been kept steady since September 2023. The Governing Council is determined to ensure that inflation stabilises sustainably at its 2% medium-term target and, in current conditions of exceptional uncertainty, it will continue to base its decisions on a meeting-by-meeting and data-dependent approach.

Corporate and household financing conditions continued to improve in the first four months of 2025 and interest rates on corporate and household time deposits dropped. Interest rates on pure new corporate loans continued the downward path that began in early 2024. Interest rates on household loans also decreased noticeably, particularly for house purchase, after the absence of any significant changes in 2024. Bank lending survey results also point to the easing of household financing conditions. Corporate and household loans grew in early 2025, while total deposits fell, reflecting a drop in overnight deposits, particularly corporate ones, but also, to a lesser extent, of time deposits, mainly those of households.

European bond prices were particularly volatile in March and April. However, at the end of May, the prices were similar to those at the beginning of the year. The exchange rate of the euro against the US dollar appreciated strongly from the end of 2024 and reached its highest level in the past three years. Since the beginning of the year, the interest rates on the money market have been trending downwards, fully reflecting the multiple reduction of the ECB's key interest rates. Market participants expect to see a further rate reduction until the end of the year, in line with lower inflationary expectations prompted by the fall in the prices of energy and the strengthening of the euro. Yields on long-term government bonds of European countries increased sharply in March in the wake of the announced increase in German spending on defence, and potentially in the rest of Europe, after the European Commission unveiled a plan to streamline borrowing regulations and boost defence spending. However, as early as April, the yields began to decline in response to the announcement made by the US president of the imposition of additional "reciprocal" tariffs over and above what market participants had been anticipating, which caused investor unease. Ten-year US Treasury yields increased in the initial weeks following the announcement of tariffs, while the euro strengthened against the US dollar, potentially pointing to the greater focus of investors on European financial markets, perceived as a safer haven in the current environment. The deferral of tariff application for 90 days and the beginning of bilateral talks, including those with China, which resulted in an agreement on a substantial reduction of tariffs from those initially planned, eased the tension on the markets. In May, yields on long-term bonds of European countries fluctuated around levels recorded at the end of April, i.e. around levels similar to those seen in early 2025. The exchange rate of the euro against the dollar appreciated further, reaching the highest level in the past three years.

Real GDP growth in Croatia is expected to decelerate gradually in the following two years amid extremely heightened uncertainty generated by trade tensions, but it will remain relatively strong. Following the strong expansion in 2024, the Croatian economy increased only slightly at the beginning of 2025 but could strengthen again towards the end of the year against the backdrop of robust growth in employment and income. According to the first CBS estimates, in the first quarter, real GDP edged up by only 0.3% from the end of 2024. Such trends partly reflect temporary factors related to the boycott of retail chains, which caused personal consumption in the first quarter to shrink from the end of the preceding year. Current growth is expected to gradually intensify by the end of the year, but the anticipated annual growth could slow down to 3.3% from the relatively high 3.9% of 2024. Personal consumption should, again, contribute the most to growth in 2025, but to a slightly lesser extent because of the gradual slowdown in employment and wage growth. Employment growth could slow down from 3.3% in 2024 to 2.8%

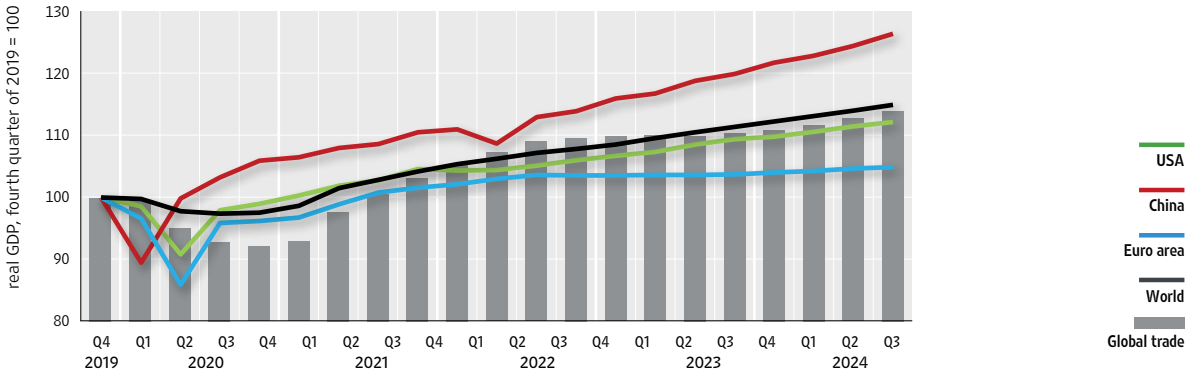
in 2025 and the LFS unemployment rate could continue to decline below 5%. Following the strong increase in the average nominal gross wage of 15% in 2024, a slowdown to 9.5% is expected in the current year, while real wages could grow by some 6.5% compared with 11.4% in 2024. At the same time, heightened uncertainty related to the clouded outlook for the global economy could spur increased consumer caution, causing the savings rate to rise further from an already high level. Other components of domestic demand are also expected to grow, however, at a slower pace than in 2024. Foreign demand could increase despite trade tensions, which could, to an extent, bolster the growth in exports of goods and services. It is necessary to note that this outlook is subject to significant uncertainty, as it rests on the assumption that the US tariffs introduced before 2 April will remain in force for the rest of the year with "reciprocal" tariffs at a reduced rate of 10%. In such a scenario, the direct effects of a decrease in the Croatian exports of goods to the US markets and the indirect effects attributable to the weaker demand of major trading partners could be relatively limited. Strong domestic demand will support the increase in imports, which should significantly exceed the growth in exports, so that the contribution of net exports to growth could remain negative in 2025. The relatively strong growth in economic activity is expected to continue in 2026 as well, at a level of almost 3.0%, supported by a further increase in foreign demand and the continued strong inflow of EU funds. Real wage growth could moderate further, but will remain relatively strong, which will support personal consumption growth.

Inflation could slow down in 2025 for the third year in a row, reaching 3.6% as measured by the harmonised consumer price index (HCPI), after which it could decelerate to 2.6% in 2026. Inflation measured by the national consumer price index (CPI) could slow down to 2.8% in 2025 and 2.2% in 2026. The slowdown in inflation expected in 2025 should mainly reflect the moderation of core inflation (excluding energy and food prices), affected by the expected deceleration in the growth of wages and personal consumption, the subdued growth in foreign demand for tourism-related services amid a pronounced increase in prices, which came close to the euro area average, and the weakening of cost pressures due to the strengthening of the euro and the spillover of a recent decrease in energy prices to other inflation components. In addition, the CNB's new macroprudential measures could lead to the alleviation of inflationary pressures. The decline in the prices of food could also, to a lesser extent, contribute to the slowdown in overall inflation in 2025. On the other hand, the average annual energy inflation rate could accelerate due to the increase in the administered prices of gas, electricity and heat energy towards the end of 2024 and in early 2025. Overall inflation is expected to decelerate further in 2026 thanks to a slowdown in all the major components of inflation.

1 Global economy

Global economic developments in late 2024 and early 2025 were marked by heightened uncertainty and trade tensions that escalated into a trade war between the US and China in April, with increased tariffs on US imports from other countries. Against this background, global economic activity increase at a somewhat slower pace than in the previous year, especially in emerging market countries (Figure 1.1). Nevertheless, thanks to fiscal stimulus and stronger exports, the Chinese economy accelerated towards the end of the year and reached the planned annual growth rate of 5%. While waiting for tariffs to be imposed, the Chinese export sector continued to contribute to stronger than expected economic activity in the first quarter of 2025. At the same time, the US economy, having risen strongly in 2024, began to show signs of cooling down at the beginning of 2025, as a result of the deteriorated confidence and growing uncertainty about the impact of the new customs policy on economic activity and inflation. On a global level, the services sector remains the main driver of economic growth in most countries, although the first signs of cooling down can be seen there as well, primarily due to weakening consumer optimism. The manufacturing sector, previously faced with the challenges of the energy crisis, was exposed to the growing uncertainty due to the trade policy and its impact on the US and the global economy.

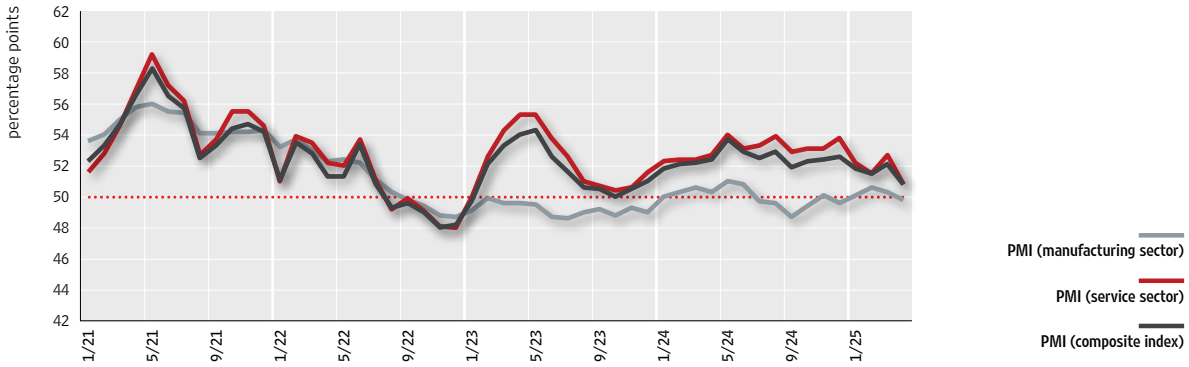
Figure 1.1 Economic activity in major markets and global trade



Sources: Eurostat, BEA and NBS.

The global composite purchasing managers' index (PMI) decelerated strongly at the beginning of the second quarter, with uncertainty about the global trade policy remaining a key obstacle to more stable economic growth. After a slight recovery in March, which signalled modest growth of the global economy, in April the global PMI fell to its lowest level in the past year and a half (Figure 1.2). The slowdown was particularly pronounced in the services sectors, while manufacturing registered a very slight growth. Particularly worrying is the fall in foreign orders, the most pronounced since the end of 2022. Such developments further confirm the continued marked uncertainty and the weak outlook for stronger global economic momentum at the beginning of the second quarter.

Figure 1.2 Confidence indicators for the global economy

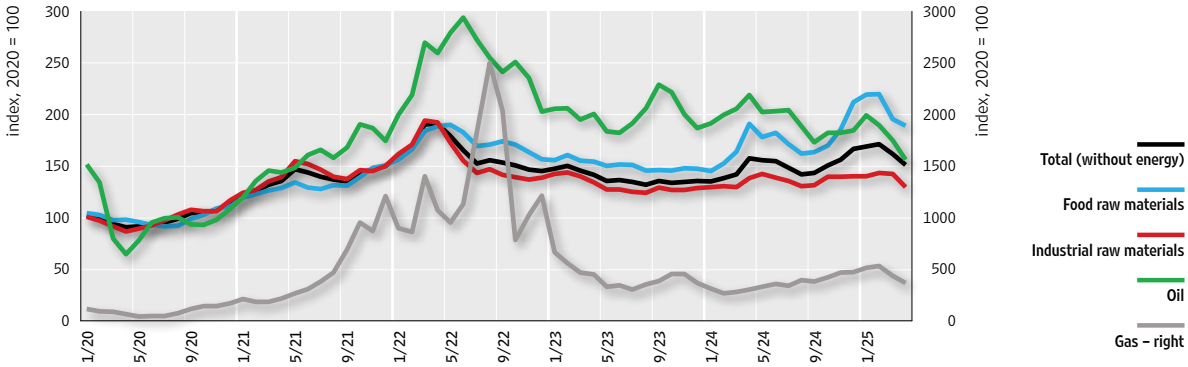


Notes: PMI value above 50 indicates expansion, while PMI value below 50 indicates contraction of economic activity. Data are up to April.
Source: S&P Global.

The dynamics of global trade increased further at the end of 2024 and in the beginning of 2025, mainly due to announcements of the increase in US tariffs and the widening of their scope. A partial recovery in global demand, particularly for goods related to energy transition, continues to support trade. The demand for internationally tradable services, such as tourism, remained relatively strong. Supply chains have been largely stabilised, although the beginning of the year was marked by occasional disruptions related to extreme weather conditions which briefly increased pressures in the logistics sector. However, the biggest impact on the dynamics of global trade at the end of 2024 and in the beginning of 2025, came from the announcements of the new U.S. administration that it would expand tariffs and tighten its trade policy, which prompted US companies to import additional goods in an attempt to secure supplies before the new measures came into effect. The US trade policy thus had a twofold impact on global trade, spurring activity in the short run while at the same time increasing uncertainty about future global market developments.

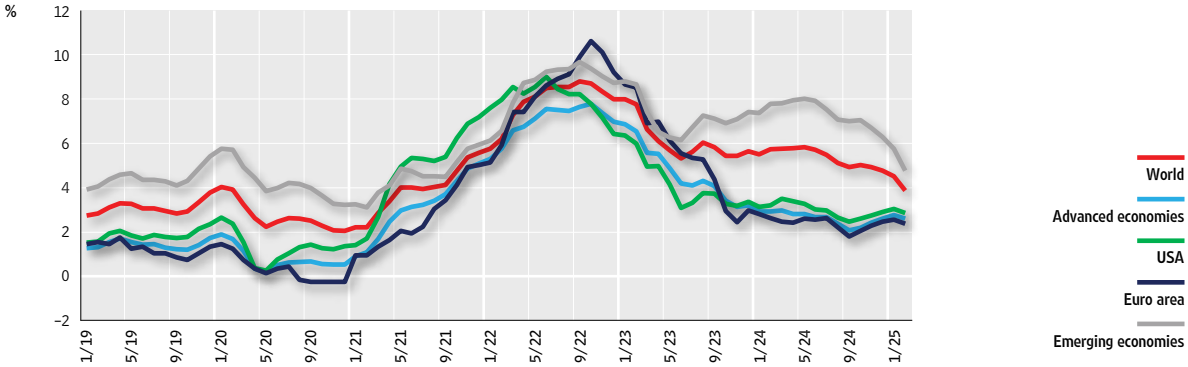
Energy prices in the world market remained volatile at the beginning of 2025, a situation that was additionally exacerbated after the escalation of the trade war and rising uncertainty about the impact of the US trade policy on the global economy. After a temporary growth in January, driven by optimism surrounding global growth and demand from China, oil prices started to fall, declining to below 60 USD/barrel at the beginning of May (Figure 1.3). The main factors contributing to the decline in prices include the surplus supply in the global market due to increased production from non-OPEC producers (US, Brazil, Canada) and weakening demand amid decreased geopolitical uncertainties and trade tensions. The escalation of the trade war early in April additionally fuelled uncertainty and increased concerns about the possible consequences of the US tariffs on global economic activity, which resulted in oil prices falling by as much as 20% in just a few days. Similar developments were recorded in gas prices in the European market. With price pressures increasing at the beginning of the year due to forecasts of a colder winter in north-western Europe, prices started declining again and. thanks to very high levels of stored gas and the expected increase in LNG capacity, dropped to below EUR 35/Mwh in the middle of May.

Figure 1.3 Prices of energy and other raw materials



Source: HWWI (Euroland, EUR).

Figure 1.4 Global inflation



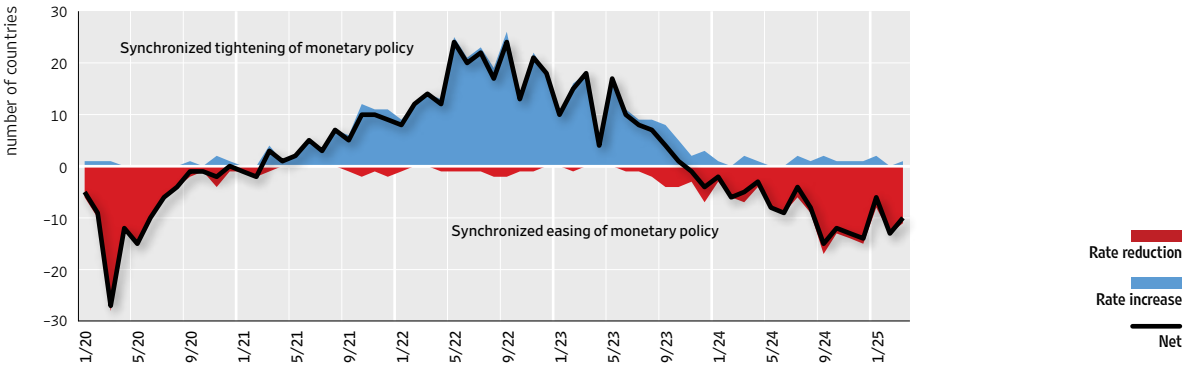
Source: Federal Reserve Bank of Dallas (adjusted by the CNB).

After surging at the end of last year, the prices of most non-energy raw materials in the global market decreased in the first and early second quarter of 2025, especially those of food raw materials. A review of the most important agricultural crops showed subdued growth in the prices of wheat and corn and continued decline in the prices of rice after the lifting of restrictions on exports from India, the world's largest exporter of the crop, leading to an increase in supply on the global market. As for cocoa prices, which peaked in January 2025 under the influence of supply-side constraints caused by unfavourable climate conditions, in the months to come they partially levelled but remained elevated in historic terms. The same happened with coffee prices which were only slightly corrected in March. The increase in prices of industrial raw materials, especially metals, slowed down as well, under the influence of mounting uncertainties surrounding global economic growth (Figure 1.3).

The trend of global disinflation additionally intensified at the end of 2024 and in the beginning of 2025, although the risks associated with trade and geopolitical tensions remained only moderately elevated. The trend is particularly evident in emerging market countries (Figure 1.4) where, in addition to positive effects of the fall in prices of energy and raw materials, the negative effects of the previous depreciation of their currencies, which had previously contributed to price growth, began to fade as well. As for developed countries, the downward trend

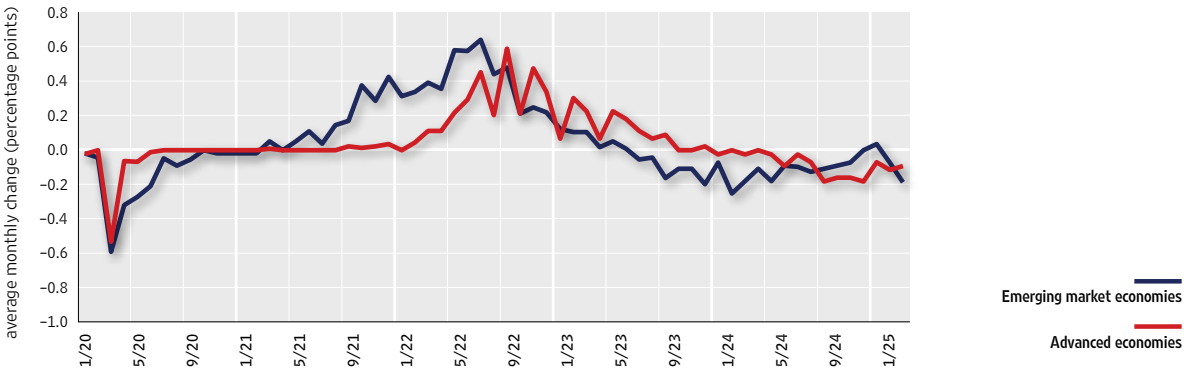
in inflation observed since the beginning of 2023 continued in early 2025, although at a slower pace as inflation neared the target level. Services price inflation in developed countries remained relatively persistent, driven by cost pressures from the labour market and the still high demand for services. At the same time, the global industrial goods inflation stabilised at very low levels. Against such a background, an increasing number of central banks continued to ease their monetary policies (Figure 1.5), with the intensity of the easing slowing down as inflation neared the target levels and concerns about the possible impact of US tariffs on global inflation increased (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.

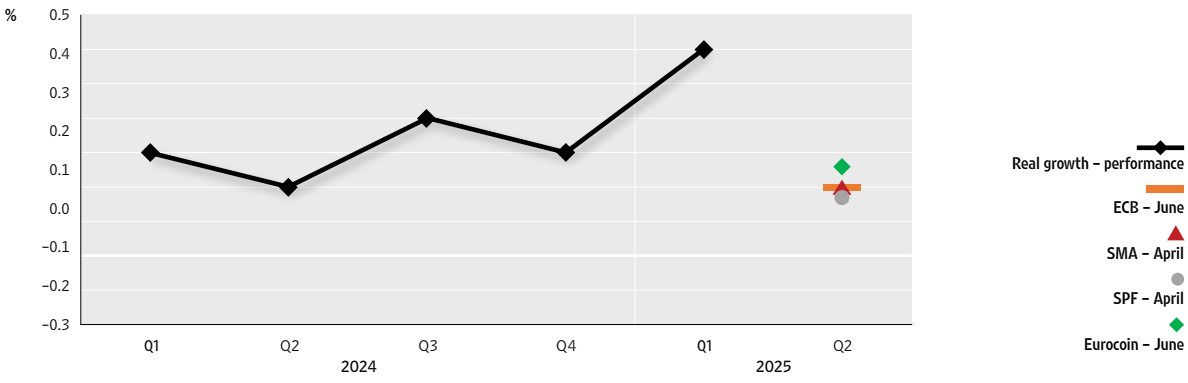
2 Euro area

2.1 Real developments

Euro area economic activity increased noticeably in the first quarter of 2025. Such developments were largely due to the acceleration of exports, most notably of pharmaceutical products, to the USA ahead of tariff hikes. According to preliminary Eurostat data, euro area real GDP grew by 0.6% on a quarterly basis. If the four largest euro area economies are observed, Spain saw the fastest growth (0.6%), while Germany (0.4%), Italy (0.3%) and France (0.1%) grew at a somewhat slower pace. The quarterly growth in economic activity was stronger than expected in the first three months of the current year, primarily owing to the strong contribution of Ireland (Figure 2.1.1). If Ireland is excluded, real GDP growth only slightly exceeded that anticipated in the previous official projection of the ECB.

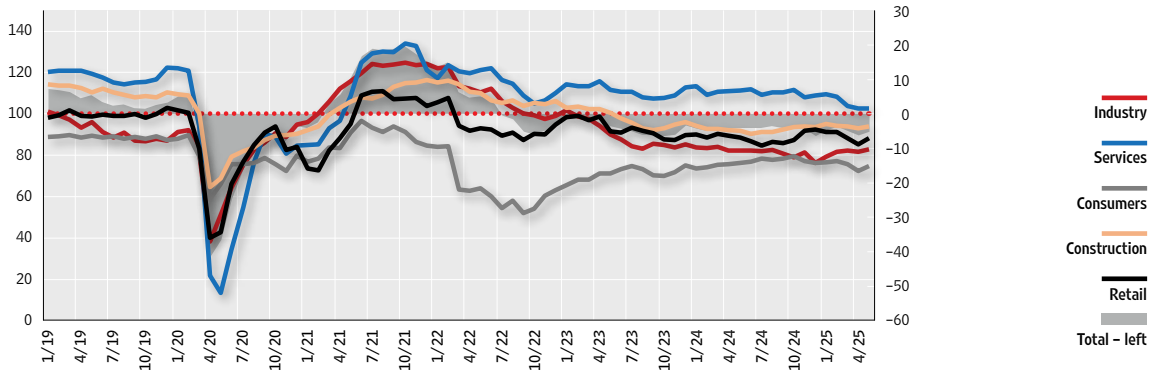
Most estimates for the second quarter suggest that the growth could slow down noticeably amid growing uncertainty and intensifying trade tensions. Available high-frequency indicators also point to economic slowdown around the middle of the year. The services sector purchasing manager index (PMI) entered contractionary territory in April, while the economic sentiment index (ESI) in the same sector worsened further, reflecting the relatively weak performance in services in the second quarter. In contrast, the recovery of the purchasing manager index in industry that started in January continued in the second quarter, which can probably, to a degree, be attributed to the announced increase in investments in defence and infrastructure.

Figure 2.1.1 Economic activity in the euro area



Notes: Abbreviation ECB – June refers to ECB – June 2025 projection. Abbreviations SMA (Survey of Monetary Analysts) and SPF (Survey of Professional Forecasters) refer to the results of the April 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 (May estimate).
Source: Eurostat.

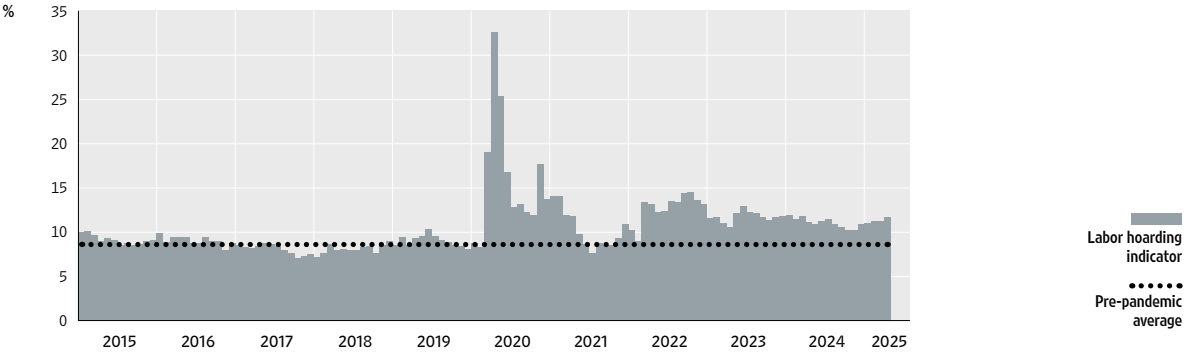
Figure 2.1.2 Euro area economic sentiment indicators



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

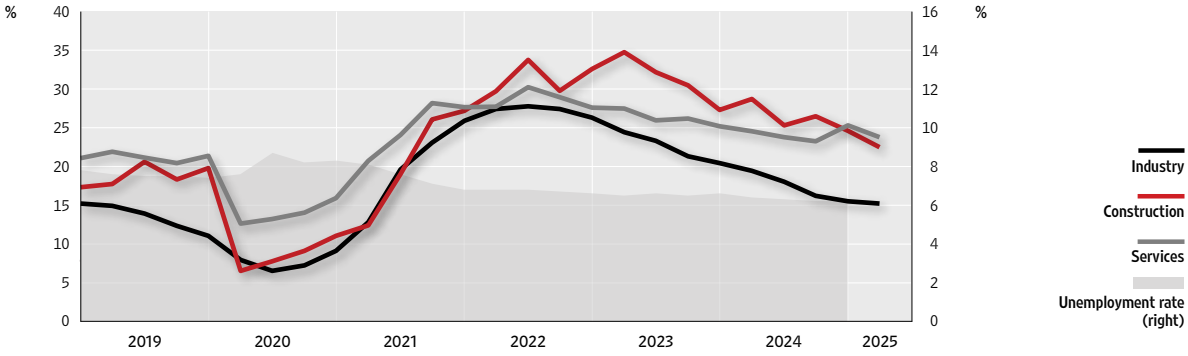
Euro area labour market remained robust at the beginning of the year, but showed signs of further weakening in demand for labour. Unemployment has remained historically low, with the unemployment rate having gone further down in the first quarter (6.2% at the end of March), while the employment growth picked up slightly from 2024. At the same time, the number of firms reporting labour shortage as the main obstacle to business activity continued to decline, most notably in services, where a worsening of economic sentiment was noticeable as well (Figure 2.1.4). Nominal wage growth remained elevated relative to historical levels, with the average compensation per employee having grown by 4.5% in 2024 from 2023 (5.3%). An ongoing slowdown is noticeable in nominal wage growth (from 4.8% at the beginning of the year to 4.1% in the fourth quarter), and the slower growth of negotiated wages in the euro area in early 2025 also shows signs of further deceleration.

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

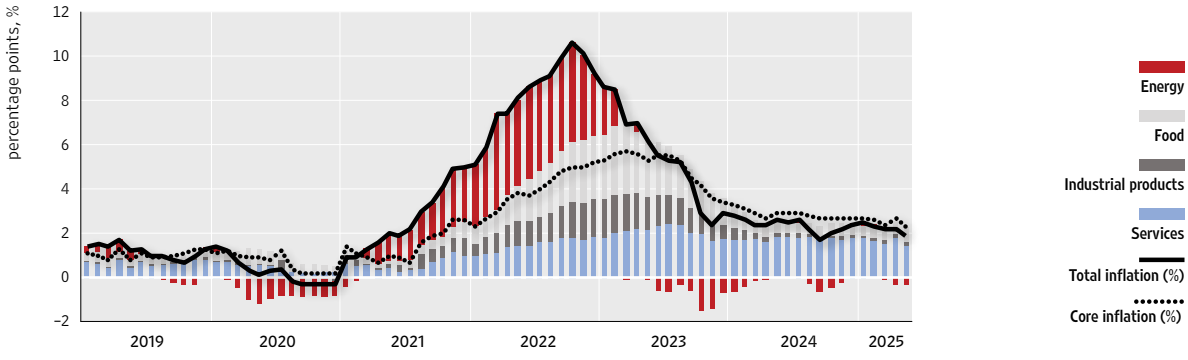


Note: Labour shortage is measured by a quarterly survey and indicates the percentage of firms reporting labour shortage as the main obstacle to business activity.
Sources: European Commission and Eurostat.

2.2 Price developments

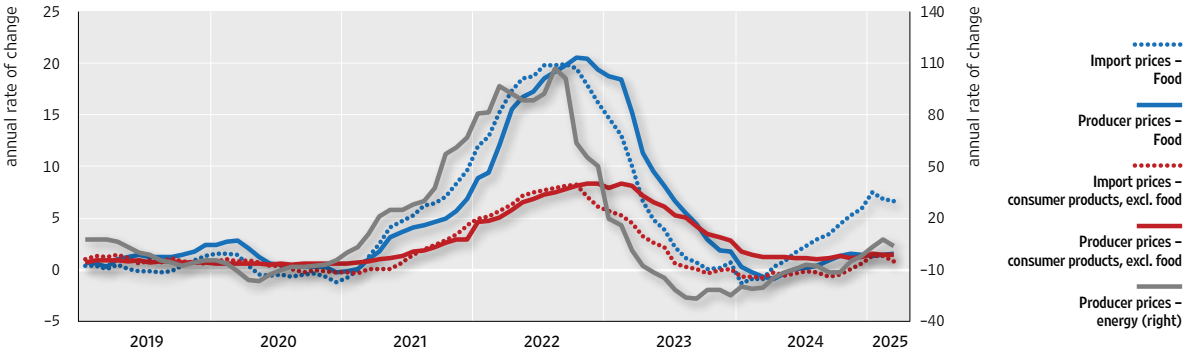
In the first five months of 2025, euro area inflation slowed down markedly. Inflation, measured by the harmonised index of consumer prices, decreased from 2.4% in December 2024 to 1.9% in May 2025 (Figure 2.2.1), which primarily reflects the slowdown in energy price inflation (from 0.1% to –3.6%), resulting from the decrease in crude oil prices on the global market, and the slowdown in services inflation (from 4.0% to 3.2%). In contrast, food price inflation increased from the 2.6% recorded in December to 3.3%, which is entirely attributable to the greater contribution of unprocessed food prices. The pick-up in unprocessed food price inflation partly reflects the unfavourable base effects, i.e. the gradual exclusion of uncommonly low monthly inflation rates recorded in the same period in 2024 from the calculation of the annual inflation rate.

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.

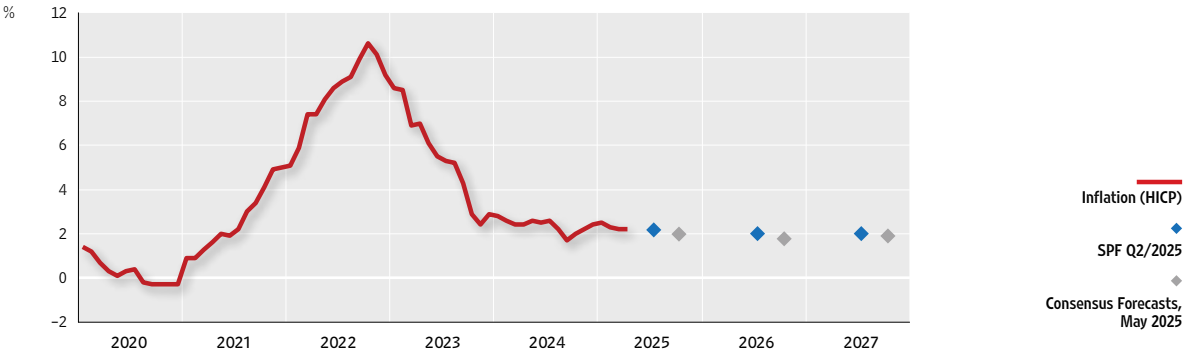
Figure 2.2.2 Indicators of inflationary pressures along the euro area pricing chain



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

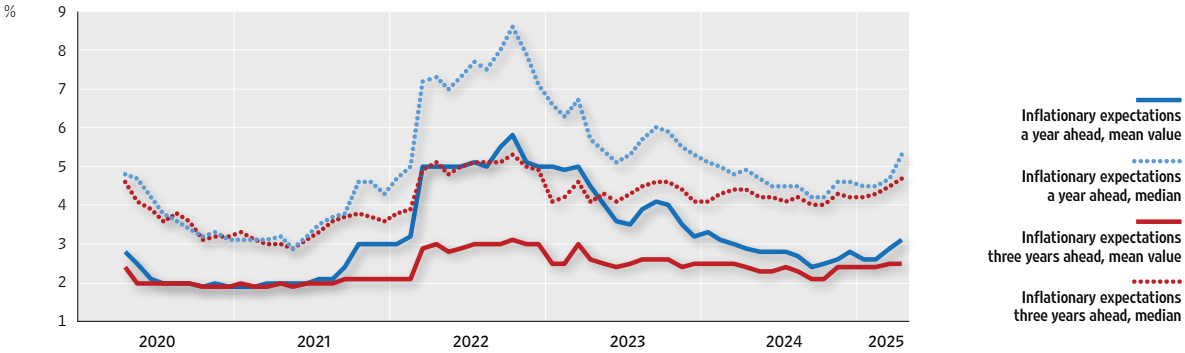
In the first five months of 2025, core inflation (excluding energy and food prices) in the euro area slowed down from 2.7% in December 2024 to 2.3% under the influence of services inflation trends. Services inflation slowed down in the first three months of 2025 and in May amid the gradual slowdown in wage growth, which has an easing effect on inflationary pressures, particularly in labour-intensive service activities. A temporary rise in services price inflation in April to 4.0% from the end of 2024 was linked to a significant acceleration in the inflation of prices of passenger transport by air and package holidays. In May, services inflation dropped to 3.2%, its lowest level in the past three years. In contrast, the inflation of industrial prices was low and stable in the first five months of 2025, hovering around its pre-pandemic long-term value of 0.6%. The low inflation of industrial prices is a result of mild inflationary pressures in the supply chain (Figure 2.2.2), reflected in low growth rates in producer and imported prices of consumer goods (excluding food and energy).

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



Note: SPF Q2/2025 (Survey of Professional Forecasters) refers to the results of the ECB survey of professional forecasters conducted from 1 to 4 April 2025.
Sources: Survey of professional Forecasters, ECB and Consensus Forecasts.

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



Source: Consumer Expectations Survey (CES) April 2025, ECB, 28 May 2025

The results of the ECB's second quarter of 2025 survey suggest that professional forecasters expect inflation in the euro area to slow down to 2.2% in 2025 and 2.0% in 2026 and 2027 (Figure 2.2.3). Forecasters expect that the increase in US tariffs could have a small upward impact on euro area inflation in the short term, with significant risks associated with the intensity of the impact, as it greatly depends on the scope and intensity of possible EU countermeasures. Moreover, the increase in defence spending could have a slight upward impact on inflation in the medium term. As regards the inflationary expectations of consumers, the ECB survey (Figure 2.2.4) shows that short-term expectations in the euro area (for a year in advance, median) stood at 3.1% in April and medium-term expectations (for three years in advance, median) at 2.5%, with both indicators being higher than those recorded in late 2024.

2.3 Monetary policy

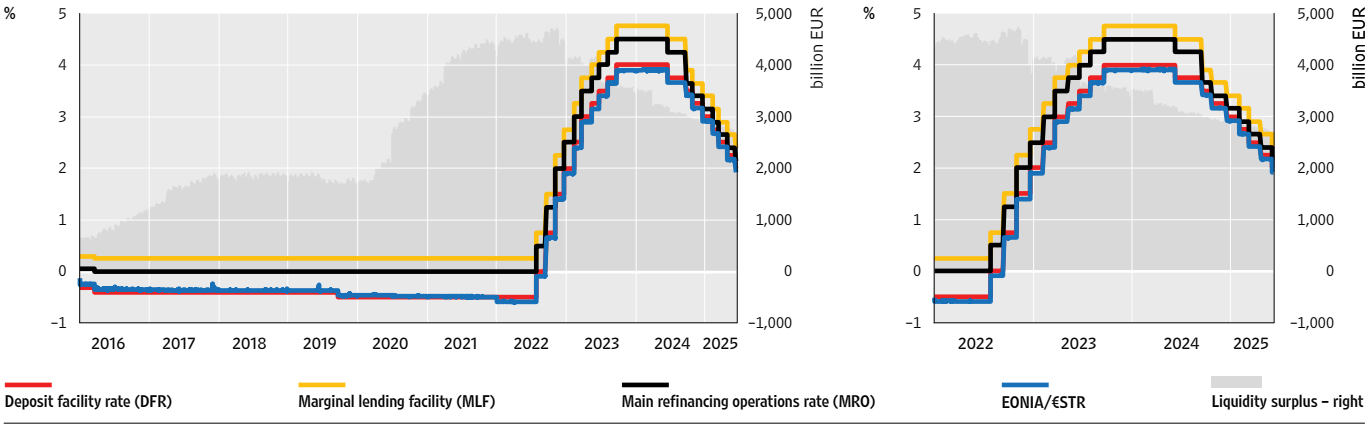
The Governing Council of the ECB lowered key interest rates by 25 basis points at the meeting on 5 June, thus continuing the gradual easing of the monetary policy started in June last year. In the last twelve months, then, the Governing Council lowered the deposit facility rate (DFR) on eight occasions by 200 basis points, which, in the current conditions of high liquidity surpluses, is a relevant indicator of the monetary policy of the ECB, after it kept key interest rates stable since September 2023. The decision to moderate the monetary policy followed the most rigorous cycle of tightening since the introduction of the euro, with key interest rates rising by 450 basis points from July 2022 to September 2023.

In the explanation to its decision, the Governing Council stressed that inflation is currently at levels close to the medium-term target of 2% and that most measures of core inflation suggest that it will stabilise at these levels. Wage growth has been declining noticeably, although it is still elevated, and profits have counteracted the impact of rising labour costs on inflation. It is expected that uncertainty surrounding the trade policy of the US Administration will unfavourably affect business investments and exports, particularly in the short term. However, the recovery in the prices of securities and compression of spreads on bonds of European countries reduced the danger that elevated uncertainty and price volatility in financial markets would tighten financing conditions. In addition, rising government investments in defence and infrastructure

will increasingly support growth over the medium term. The noticeable growth of real income in recent years and a strong labour market combined with the increased savings accumulated over the past period will enable higher household consumption, which. together with supportive financing conditions, should contribute to the resilience of the economy to global shocks.

With its June decision, the Governing Council lowered the deposit facility rate (DFR) from 2.25% to 2.00%, the main refinancing operations (MRO) rate from 2.40% to 2.15% and the marginal lending facility (MLF) rate from 2.65% to 2.40%. The Governing Council is determined to ensure that inflation stabilises sustainably at its 2% medium-term target. In the current conditions of exceptional uncertainty, decisions on the appropriate level of interest rate at each meeting will continue to be based on data-dependent and meeting-by-meeting approach. In doing so, the Governing Council is not pre-committing to a particular rate path.

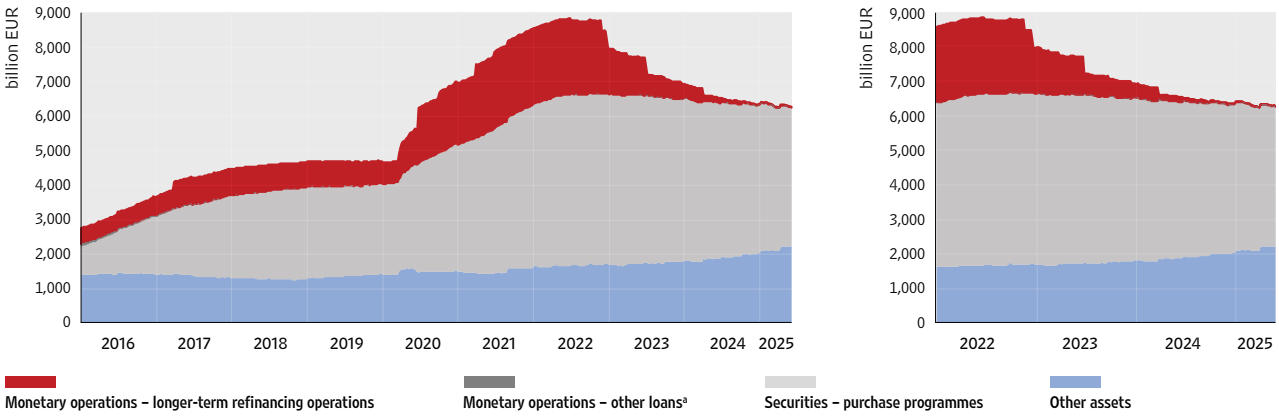
Figure 2.3.1 Key ECB interest rates



Source: ECB.

The Eurosystem's balance sheet has continued its gradual decrease. In mid-December 2024, the banks repaid the remaining amounts borrowed under the targeted longer term refinancing operations, completing that part of balance sheet normalisation. The portfolio of securities purchased within the asset purchase programme (APP) and the portfolio of the pandemic emergency purchase programme (PEPP) of the Eurosystem are declining steadily at a measured and predictable pace, with the principal payments from maturing securities purchased under the APP not being reinvested since July 2023 and the reinvestment of PEPP portfolio having been brought to a halt at the end of last year. On the other hand, the decrease in the balance sheet mitigates the growth of other assets, which is not linked to the conduct of the monetary policy. The rise in non-monetary assets was marked especially by gold, the value of which on the Eurosystem's balance sheet has increased pronouncedly since the beginning of 2024 due to the rise in gold prices in financial markets.

Figure 2.3.2 Eurosystem balance sheet



[a] Other loans include MROs, fine-tuning reverse operations, structural reverse operations, MLFs 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.

2.4 Financial markets and the banking system

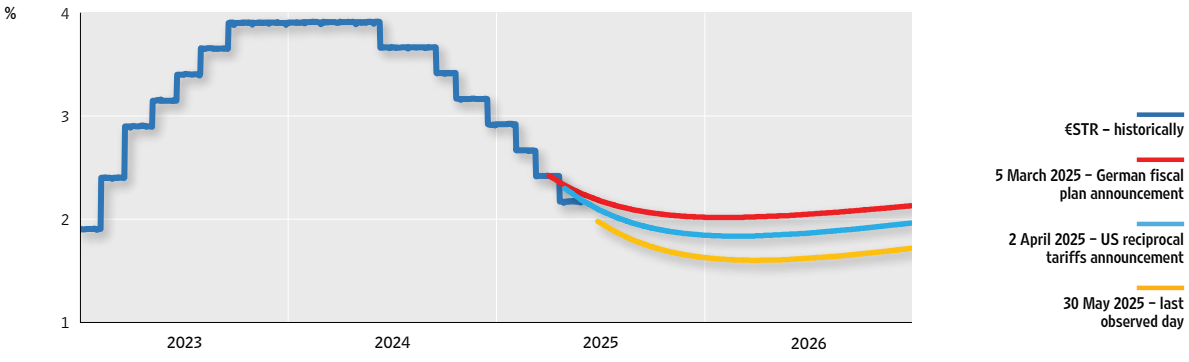
Since the beginning of the year, the interest rates on the money market have been trending downwards, fully reflecting multiple reductions in key interest rates of the ECB. After the ECB again lowered the key interest rates by 25 basis points in April, the €STR rate, which is the reference rate for the money market, fell to 2.2% and held steady at that level until the end of May, in contrast with 2.9% at the end of last year. Market participants expect to see a further reduction in interest rates until the end of this year. The €STR forward curve moved to lower values in April (a shift to the yellow line, Figure 2.4.1) following the announcement by the US administration of the introduction of "reciprocal" tariffs. This change was primarily brought about by a fall in the prices of energy and the strengthening of the euro, prompting lower inflationary expectations on the part of market participants.

European bond prices were particularly volatile in March and April, recording record large daily and weekly shifts; however, at the end of May the prices were similar to those at the beginning of the year. In early March, Germany's parliament proposed a fiscal plan allowing for an increase in defence borrowing and providing for a EUR 500bn fund for infrastructure and climate investments. Changes to the Constitution needed to implement such a plan were adopted by the German parliament in March. The announced increase in fiscal spending in early March spurred a sharp increase in yields on ten-year German bonds, which rose by about 30 basis points to 2.8% on 5 March, the biggest daily jump since the unification of Germany in 1990. Euro area GDP-weighted long-term government bond yields rose by a slightly lower 27 basis points on that day and reached 3.3%, owing to relatively stable spreads of euro area countries relative to German yields. European long-term yields changed direction and started falling early in April in response to the announcement made by the US president on the introduction of the "reciprocal" tariffs. Although this decision had been announced earlier, the tariffs introduced were higher than expected by market participants. Investor anxiety was also seen in a greater allocation of funds into asset classes traditionally perceived as safe havens. Accordingly, the yield on the 10-year German bond fell from 2.7% at the end of March to close to 2.4% at the end of April, while the yield on

long-term government bonds of the euro area weighted by GDP fell from 3.2% at the end of March to 2.9% at the end of April. The ten-year yield on Croatian bonds moved at a similar pace, falling from 3.4% at the end of March to 3.1% at the end of April (Figure 2.4.3). The suspension of the implementation of US reciprocal tariffs for 90 days and the beginning of bilateral talks, including those with China, which resulted in an agreement on a substantial reduction in tariffs from those initially planned, eased the tension on the markets with yields in May fluctuating around the levels seen at the end of April.

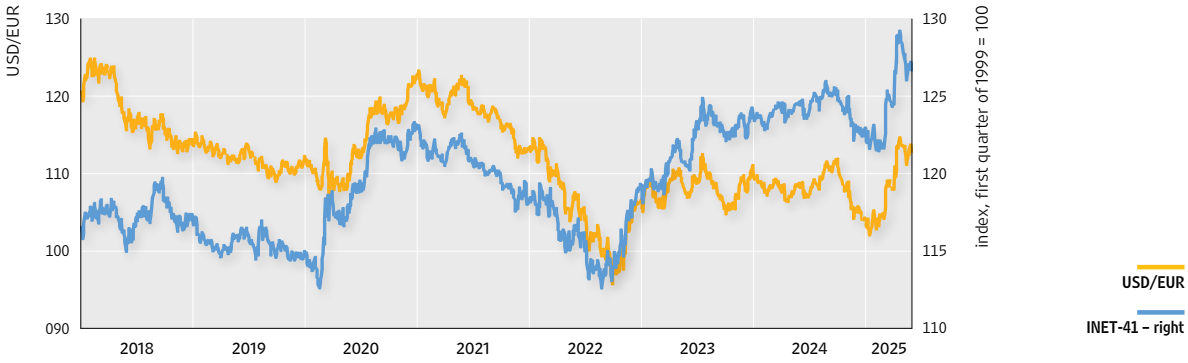
The exchange rate of the euro against the US dollar appreciated strongly since the end of last year, reachingthe highest level in the past three years. The appreciation of the exchange rate of the euro against the US dollar was largely driven, among others, by the growing concern among market participants that the US economy might enter a recession. The euro appreciated very strongly in early March in the wake of the announced increase in defence spending in Germany, and potentially in the rest of Europe, after the European Commission unveiled a plan to streamline borrowing regulations and boost defence spending. Another episode of a sharp strengthening of the euro took place immediately after the announcement of the US president of the introduction of reciprocal tariffs, despite the growth in US yields. It is possible that it was fuelled, among others, by the unpredictable nature of US policy, with investors demanding higher risk premiums and turning increasingly to European assets. The exchange rate of the euro for the US dollar stood at USD/EUR 1.13 at the end of May, its highest level in the last three years, having depreciated 9% from the end of last year. Over the same period, the nominal effective exchange rate of the euro against a basket of currencies of the euro area main trading partners appreciated by almost 4% (Figure 2.4.2). As well as against the US dollar, the euro appreciated against most currencies of the euro area main trading partners, with the strengthening of the nominal effective exchange rate of the euro being counteracted particularly by the weakening of the euro against the Swiss franc, the Czech koruna and the Swedish krona.

Figure 2.4.1 €STR forward curve



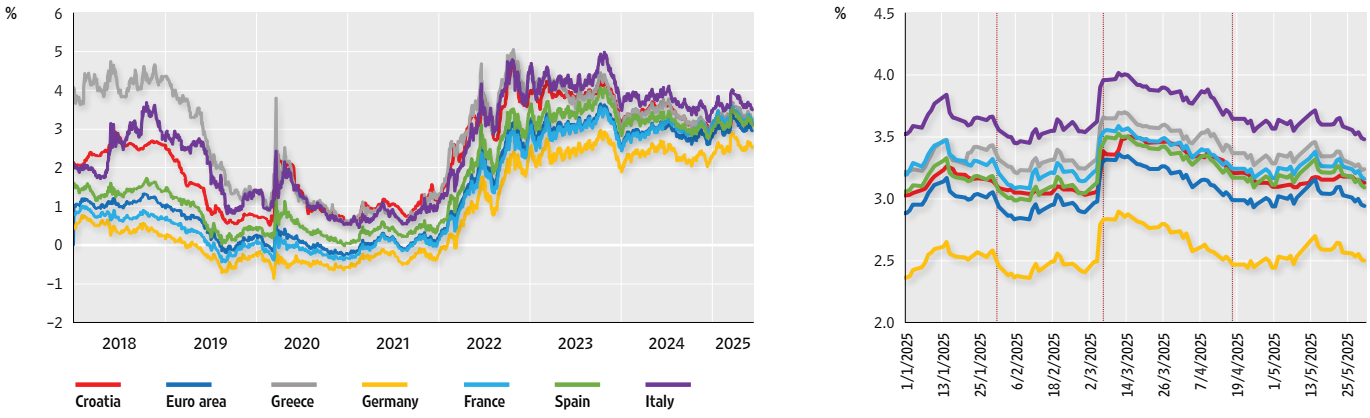
Notes: The forward curve is estimated using the overnight indexed swap rate (OIS). Forward curves show the selected forward curves formed on selected dates around key events and on the last observed date (30 May 2025).
Sources: Bloomberg and CNB calculations.

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 the 41 major trading partners of the euro area. Exchange rate increase indicates euro appreciation. Last data are for 30 May 2025.
Source: ECB.

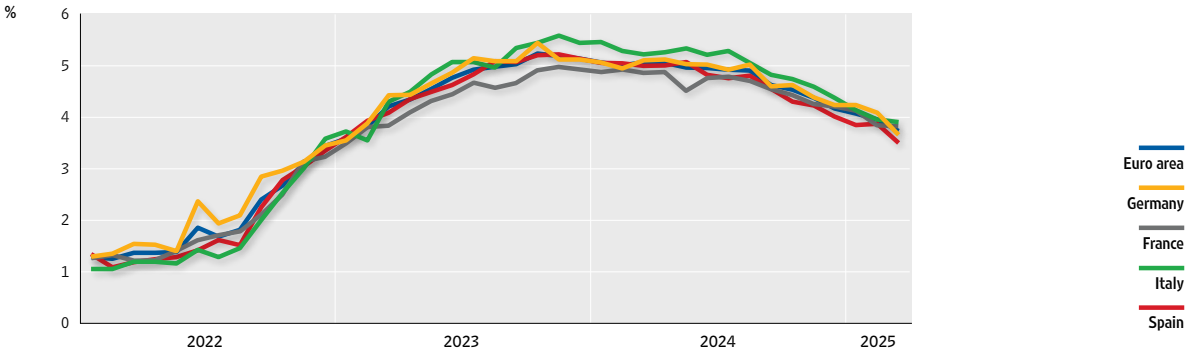
Figure 2.4.3 Yields on long-term government bonds with the remaining maturity of approximately 10 years



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 Lithuania, Latvia, Estonia, Luxembourg and Malta. The red dotted lines denote ECB Governing Council meetings in the shown period of time.
Sources: Bloomberg, Eurostat and CNB calculations.

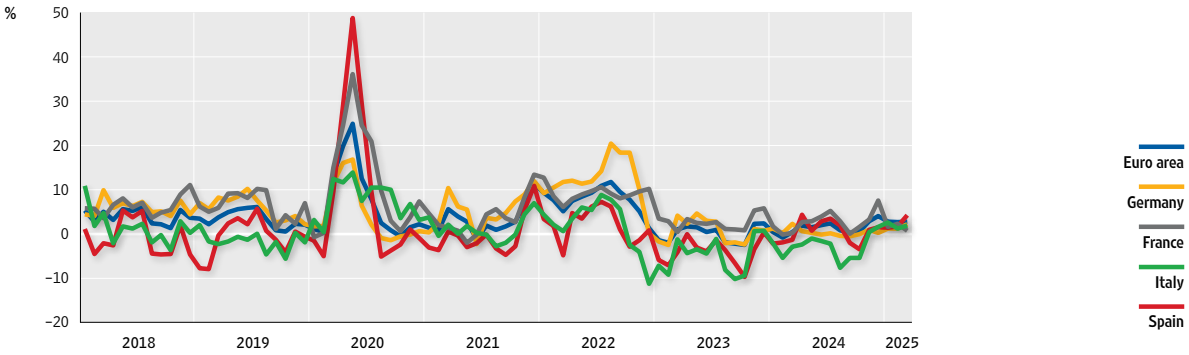
The interest rates of banks on corporate and household loans in the euro area continued to fall and credit activity continued to recover gradually. At euro area level, the average interest rate on pure new loans granted to non-financial corporations in March was 3.7% (Figure 2.4.4), down by 44 basis points from December of 2024. As regards households, the average interest rate on pure new housing loans granted to households in March was 3.3% (Figure 2.4.6), down by 2 basis points from the end of the preceding year. The increase in long-term interest rates on the financial markets in the first half of the year slowed down the transmission of key ECB interest rates on the costs of housing financing relative to corporate loans as housing loans have a longer average maturity and predominantly carry fixed interest rates. Quarterly annualised growth rates of loans to non-financial corporations (Figure 2.4.5) were positive in the first three months of 2025 in all the four largest euro area countries and housing lending also continued to recover gradually (Figure 2.4.7).

Figure 2.4.4 Interest rates on pure new corporate loans



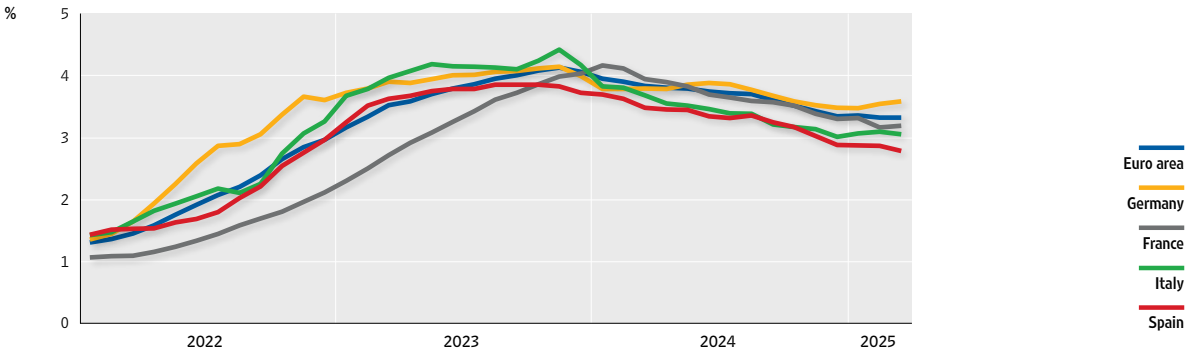
Source: ECB.

Figure 2.4.5 Lending momentum in the euro area (corporations)



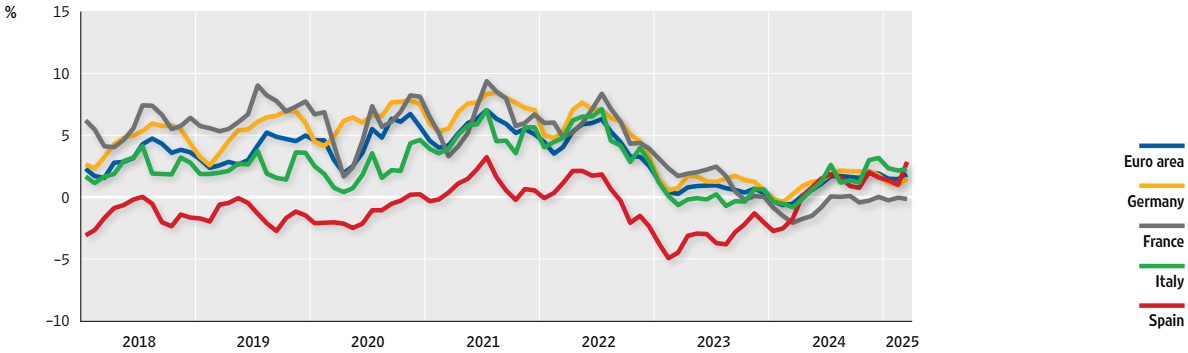
Sources: ECB and CNB calculations.

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)



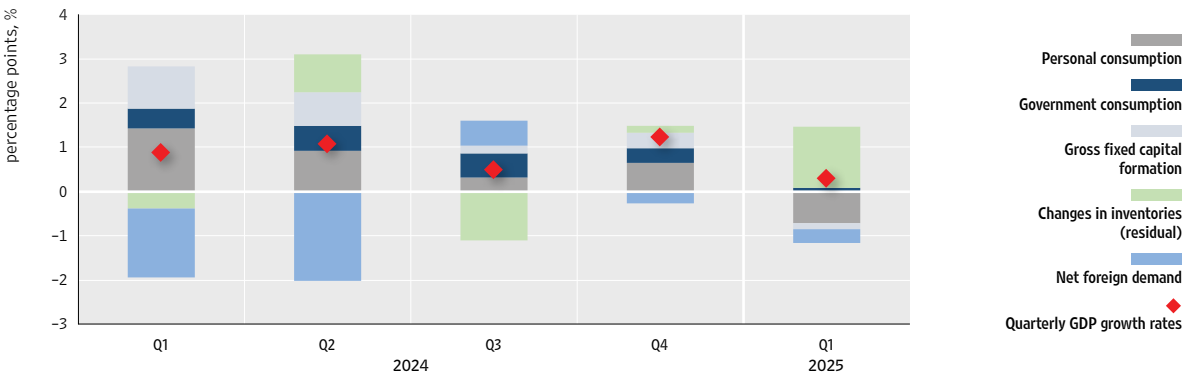
Sources: ECB and CNB calculations.

3 Croatian economy

3.1 Real developments

After real GDP growth had picked up to a relatively high level of 3.9% in 2024 as a whole, economic activity slowed down considerably at the beginning of 2025. In the first three months, real GDP increased by a relatively modest 0.3% on a quarterly level (Figure 3.1.1), or by 2.9% relative to the same period in the preceding year. The slowdown in the growth may be attributed to temporary factors related to the boycott of retail chains, which resulted in a drop in personal consumption from the preceding quarter despite the continued sharp increase in the real disposable income of households. Furthermore, investments decreased from the preceding quarter, while the contribution provided by the strong rise in exports was offset by the accelerated growth in imports, resulting in a negative quarterly contribution from net foreign demand. The growth in government consumption decelerated as well, while inventories, which include statistical discrepancies, contributed positively to overall growth, which could be a result of the retail chain boycotts. Broken down by main activities, the slowdown in the first quarter mainly reflects a decline in trade, although most other activities also recorded unfavourable trends. Still, available data for the beginning of the second quarter point to a distinct renewed strengthening of economic growth.

Figure 3.1.1 Contributions to the quarter-on-quarter change in real economic activity

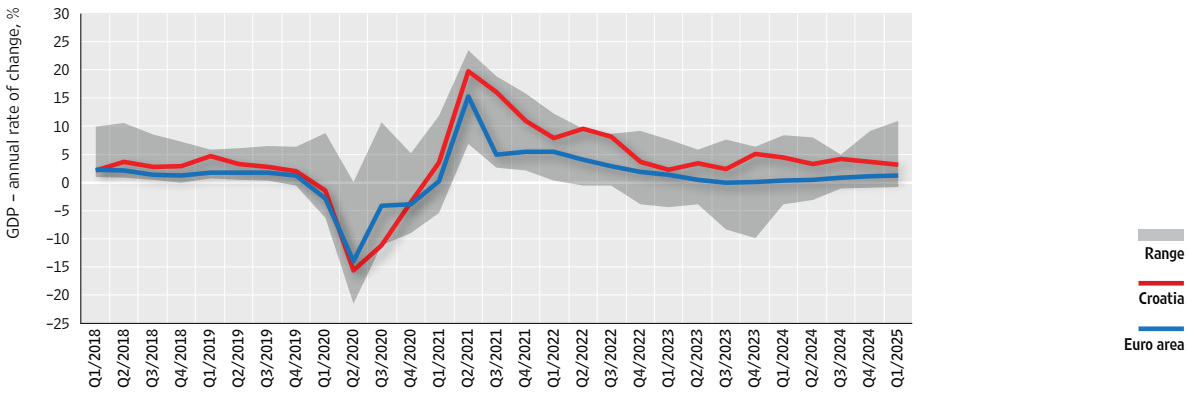


Source: Eurostat.

Following two years of continuous growth, personal consumption dropped relatively sharply in the first quarter of 2025 (1.2%) from the average of the preceding three months (Figure 3.1.4). The drop reflects the effect of the retail chain boycott, which was particularly pronounced in January and February, but waned in March. Real retail trade turnover dropped by 0.9% in the first quarter from the average of the last quarter of 2024, which is attributable to the decrease seen in January and February, while in March, retail trade recovered noticeably. At the same time, the real disposable income of households continued to increase strongly against the backdrop of a robust labour market and a noticeable increase in employment and wages accompanied by a slowdown in inflation. The growth in wages seen at the beginning of the year was also affected by a significant increase in the minimum wage. Because of the rise in income and the

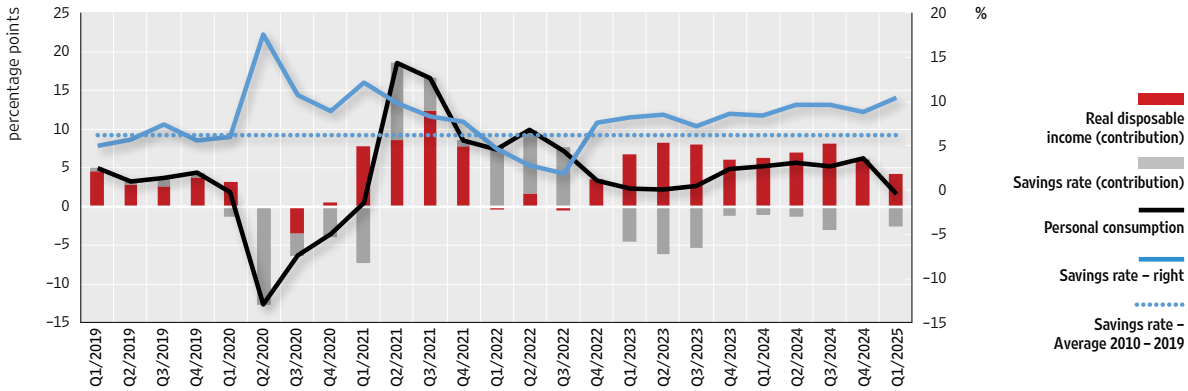
drop in personal consumption, the savings rate, which had increased substantially in 2024 and reached a high level, grew even further in early 2025.

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



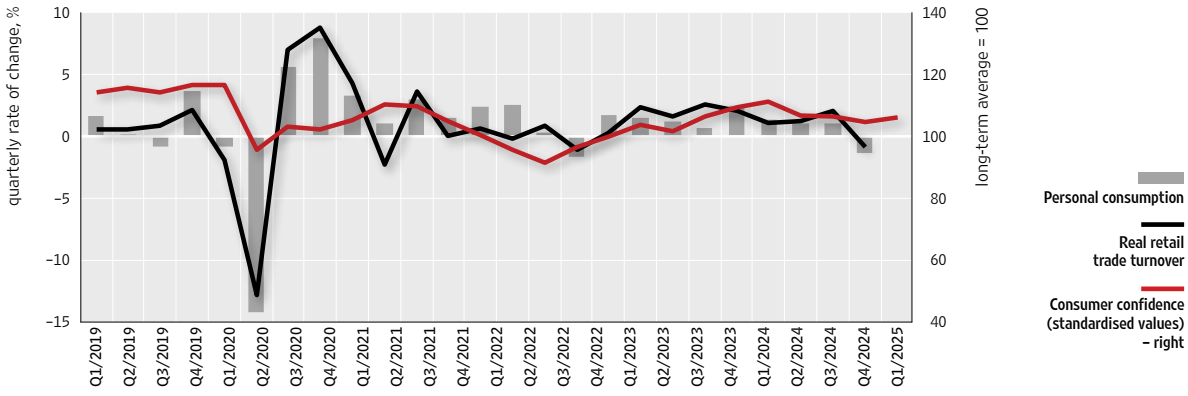
Note: The figure shows the range of values of real GDP growth of individual euro area member states.
Source: Eurostat.

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

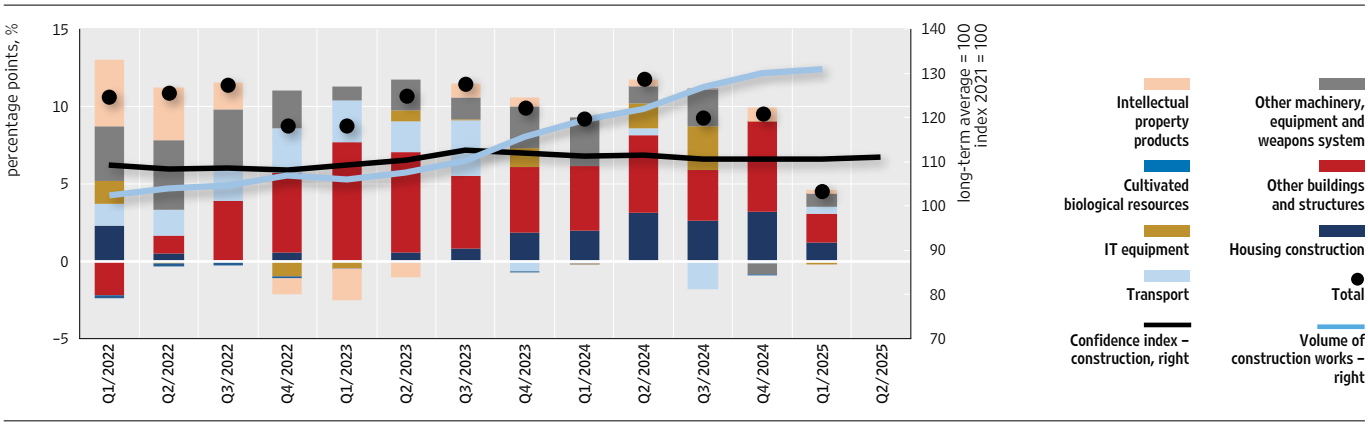


Sources: CBS and Ipsos.

Not only did personal consumption decline, but investments also shrank in early 2025, ending more than two years of strong quarterly growth. Such dynamics seem, in part, to be determined by the decline in public investments, as suggested by the quarterly drop in investments in other buildings and structures. However, investments in residential construction and in IT equipment also fell. On the other hand, investments in machinery and equipment increased noticeably following a considerable drop at the end of 2024. The aforementioned trends were reflected in the significant slowdown in the annual rise of total investments (Figure 3.1.5).

The strong current growth in goods exports continued in early 2025, while real exports of services contracted sharply. Following the steady growth seen from mid-2024, exports of goods increased by 3.8% on a quarterly basis in the first three months of 2025. Compared with the modest rise in activity seen in Croatia's main trading partners, the increase in the exports of goods picked up at a significant pace. Detailed goods trade data available for January and February show that the growth in exports was broadly based, with exports of energy, food products, ships and chemical products increasing the most. In contrast, following the weak performance seen in 2024, exports of services dropped by 2.7% on a quarterly basis in the first three months of 2025. It would appear that, in addition to the weak tourism performance in the first quarter, the trend was also due to weaker exports of other services. Despite lower services exports, total exports of goods and services rose both annually and quarter-on-quarter; however, the negative contribution of net exports to growth remained relatively high given the strong growth in imports in the first three months of the year. Imports of goods thus saw a relatively strong increase despite the weak rise in domestic demand, and imports of services also continued to grow.

Figure 3.1.5 Investment activity indicators and confidence in the construction sector

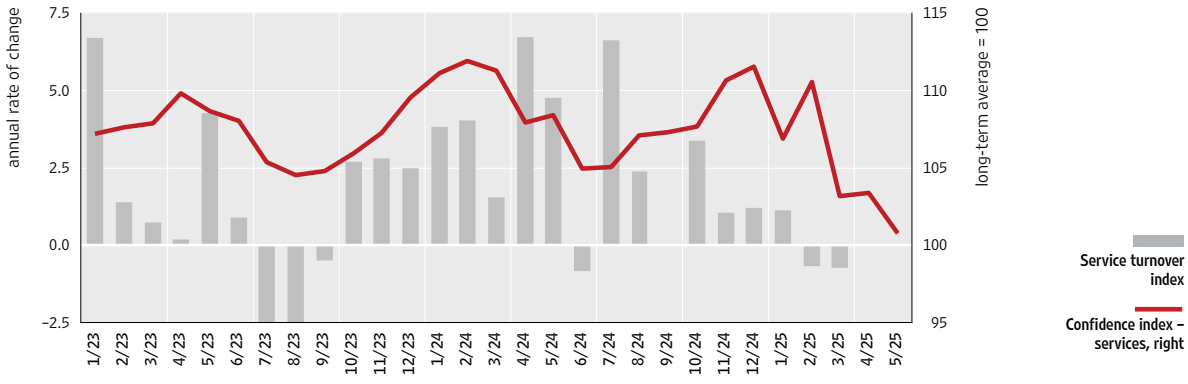


Note: Data on confidence in the construction sector for the second quarter of 2024 refer to October and November.
Sources: CBS, Ipsos and CNB.

The rise in gross value added in the first quarter was in line with GDP growth, with most activities recording less favourable trends than in the preceding quarter. The drop in personal consumption and exports of services was reflected in the noticeable decline in gross value added in trade and tourism-related activities. As regards other services, even though trends in most activities were, by and large, more favourable than in the preceding quarter, this was offset by unfavourable trends in tourism-related activities, so that the total turnover volume in services ultimately shrank (Figure 3.1.6). Furthermore, despite the rise in the exports of goods, in the first

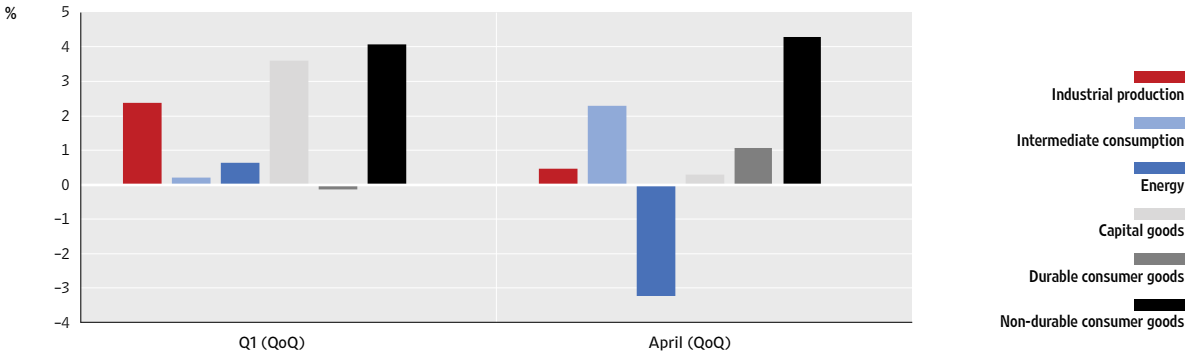
quarter, industrial activity dropped, while the decline in investments noticeably slowed down the growth in construction, so that the level of construction activity was only slightly higher than in late 2024.

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



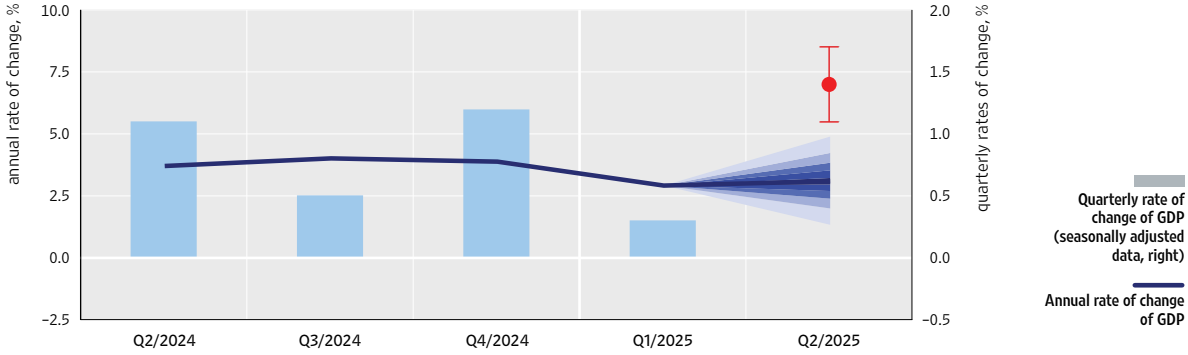
Note: Services include sectors H, I, J, L, M and N.
Sources: CBS, Ipsos and CNB.

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 second quarter of 2025 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 May 2025. 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.

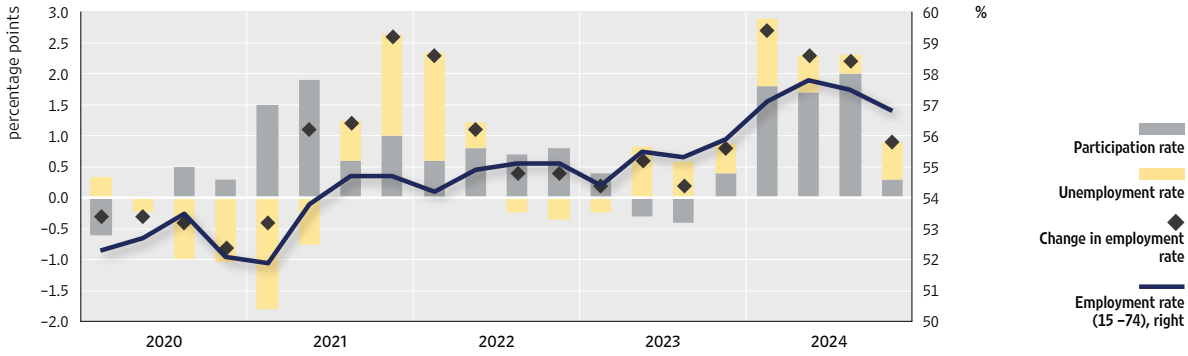
High-frequency indicators for the second quarter of 2025 point to a noticeable acceleration of economic growth on a quarterly basis. According to the CNB's nowcasting model of economic activity, real GDP growth in the second quarter could stand at 1.4% on a quarterly level (after 0.3% in the first quarter), while, observed on an annual basis, it could pick up to 3.1% from the 2.9% of the first quarter (Figure 1). Real retail trade turnover was 1.0% up in April from March, while, relative to the preceding quarter, there was an increase of 1.5%. At the same time, the volume of industrial production increased by 2.5% in April on a monthly basis and by 0.5% from the first quarter of 2025. Business optimism in industry also edged up slightly in April and May. The rise in industrial production in April from the previous quarter was fairly broadly based, except in the categories of energy, mining and quarrying and gas, steam and air conditioning supply. On the other hand, business confidence in services dropped sharply in April and May and almost returned to its long-term average, which could reflect the relatively steep fall in volume indicators in tourism in the first twenty days of May.

3.2 Labour market

Survey data on labour market trends for the end of 2024 still point to a relatively strong rise in employment and labour market participation and to a decline in unemployment. The employment rate (15–74) increased to 56.8% in the fourth quarter from 55.9% in the fourth quarter of 2023. In the whole of 2024, the employment rate stood at 57.3%, a two-percentage-point increase from 2023. The increase reflects primarily a further decline in the number of unemployed persons, but also the inclusion of the previously inactive population in the labour force (Figure 3.2.1). The participation rate (15+) in the fourth quarter of 2024 increased to 53.4% from 53.2% at the end of 2023, solely influenced by the higher participation in the middle working age population segment (25–49), while other age groups contributed negatively to the overall participation rate (Figure 3.2.2). At the level of 2024 as a whole, the participation rate was 53.9%, or down 1.2 percentage points from 2023. The middle working age population (25–49) provided the largest positive contribution to the trend, but older age groups (50–64 and 65+) also provided significant contributions, considering the increasing number of pensioners working half time. In 2024, an average of around 31 thousand pensioners worked half time, accounting for slightly less than 1.8% of total employment; this number could increase further following the announced legislative changes.[1] On the other hand, young people (15–24) are increasingly more absent from the labour market, which is reflected in the lower participation rate.

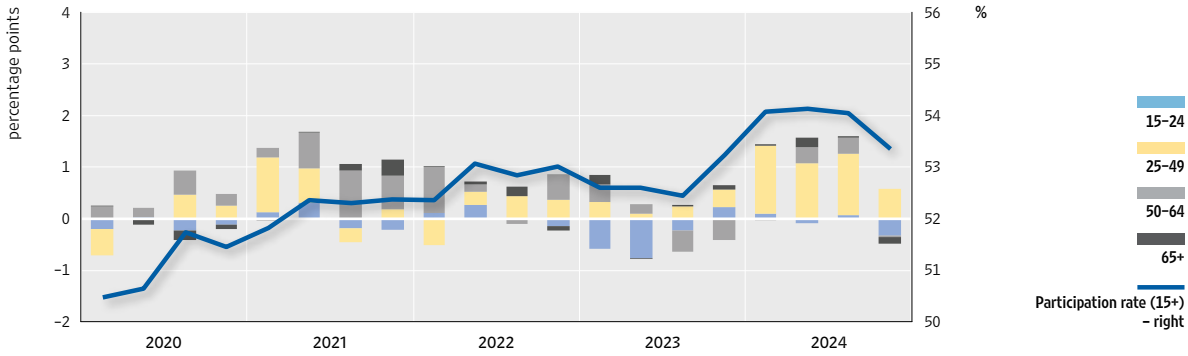
1 As of July 2025, the amended Pension Insurance Act will allow pensioners to work full time while retaining their right to receive 50% of the amount of their pension.

Figure 3.2.1 Contributions to the rate of year-on-year change in employment (15–74)



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

Figure 3.2.2 Participation rate (15+) and contributions to change by age groups

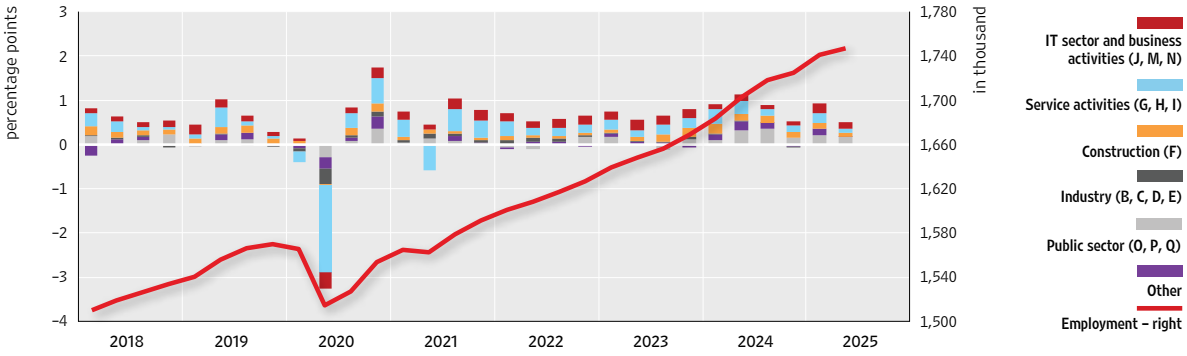


Notes: The participation rate is calculated for the population aged 15+. Data shown are based on the 2021 census data.
Sources: CBS and CNB calculations.

Employment growth continued to slow down gradually in the first four months of 2025. At the level of the first quarter, employment growth picked up to 0.9% (from 0.4% at the end of 2024) according to administrative data. The acceleration reflects the carry-over effect related to the surge in the number of employed persons in December 2024, immediately before the termination of fiscal relief granted for the employment of young people, preceded by a temporary decline in employment in November.[2] However, if the above-mentioned statistical effects are excluded, the annual employment growth continued to decelerate. The continuation of the trend was noticeable in April 2025 as well, when monthly employment growth dynamics similar to those of the first quarter (0.2%) were recorded and the number of employed persons was 0.5% higher than in January and 3% higher than in April 2024. Broken down by NCA, in the period from January to April this year, employment increased the most in service activities and construction. Furthermore, employment continued to increase strongly in education, human health and social work activities (activities O, P and Q, hereinafter: the public sector), after being subdued in the period up to 2024 (Figure 3.2.3).

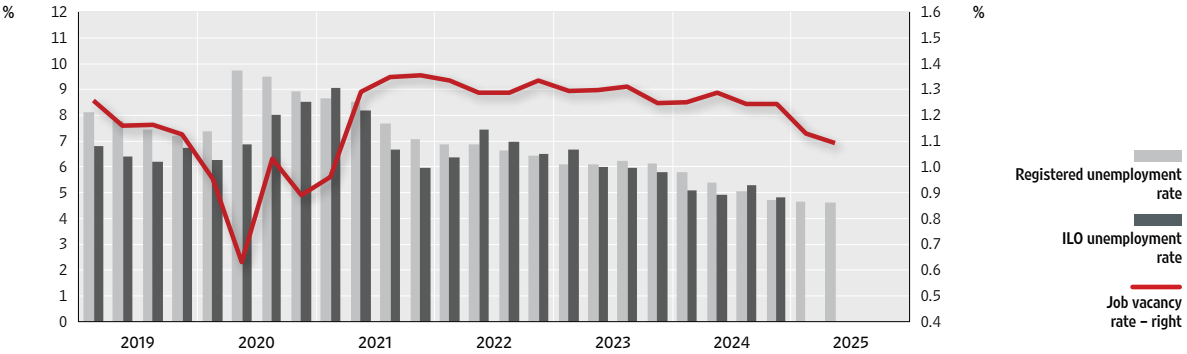
2 As of January 2025, the tax relief that allowed employers to be exempt from the payment of contributions on wages for a period of five years when employing a young person (up to 29 years) as permanent staff is no longer applied.

Figure 3.2.3 Employment by NCA, seasonally adjusted data, contributions to the quarterly rate of change



Note: Data for the second quarter of 2025 refer to April and show contributions to the rate of change relative to January of the same year.
Source: CPII (seasonally adjusted by the CNB).

Figure 3.2.4 Unemployment and job vacancy rates, seasonally adjusted data



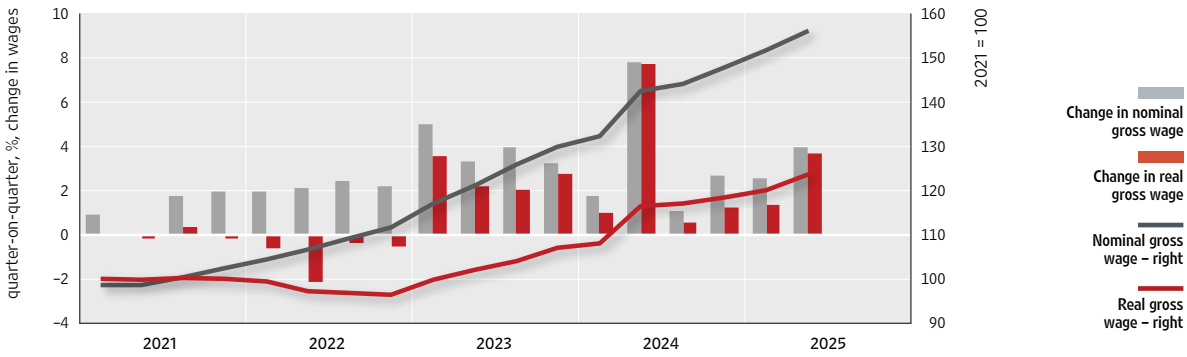
Note: Data for the second quarter of 2025 refer to April.
Sources: CBS, CES, Eurostat and CNB calculations (seasonally adjusted by the CNB).

The decline in unemployment slowed down noticeably at the beginning of the year amid weaker demand for labour, but in April, unemployment decreased sharply again. The slowdown in the monthly pace of employment growth in early 2025 and the drop in job postings (Figure 3.2.4) were reflected in the slower unemployment decrease. In the first three months, unemployment was 1.6% lower than in the fourth quarter of 2024, when a drop of 6.2% was recorded. However, in April 2025, the drop in the number of unemployed persons intensified (having gone down by 1.8% from January), so that at the end of the month, 83 thousand persons were unemployed (according to seasonally adjusted data), i.e. down 18% from the same month in 2024. The internationally comparable ILO unemployment rate, according to the latest available data for the fourth quarter of 2024, fell to 4.8%, down from 5.3% in the previous quarter.

In the first quarter of 2025, wages continued to grow relatively strongly, and their increase picked up further in April, largely on account of one-off payments in information and communication activities. The average nominal gross wage continued to increase steadily at high rates at the beginning of the current year. In the first quarter of 2025, the average nominal gross wage was 2.6% higher than in the fourth quarter of 2024 (Figure 3.2.5). In the public sector, quarterly wage growth accelerated (1.8% versus 0.7%) due to the increase in the wage-calculation base

for civil servants and government employees of 3% for wages disbursed in March. Wage growth in the rest of the economy remained strong and broadly based across activities, showing only slight signs of slowing down (2.7% in the first quarter of 2025 relative to 3.3% in the last quarter of 2024). In April 2025, the rise in the average nominal gross wage picked up considerably owing to the stronger wage growth in the rest of the economy, which primarily reflects one-off payments in the broadcasting sector.[3] The average nominal gross wage in the total economy was 3.9% higher in April 2025 than in January, while real wages increased by 3.7% (versus 1.4% in the first quarter) in the same period. On the other hand, the annual growth rate of the average nominal gross wage slowed down considerably in April 2025 (from 14.7% in the first quarter to 9.9% in April) due to the waning of the base effect of the sharp rise in public sector wages resulting from the wage system reform of April 2024, while in the rest of the economy, the annual wage growth slowed down only slightly from the first quarter.

Figure 3.2.5 Average nominal and real wage, seasonally adjusted series



Note: Data for the second quarter of 2025 refer to April, while the rate of change was calculated relative to January of the same year.
Sources: CBS and CNB calculations (seasonally adjusted by the CNB).

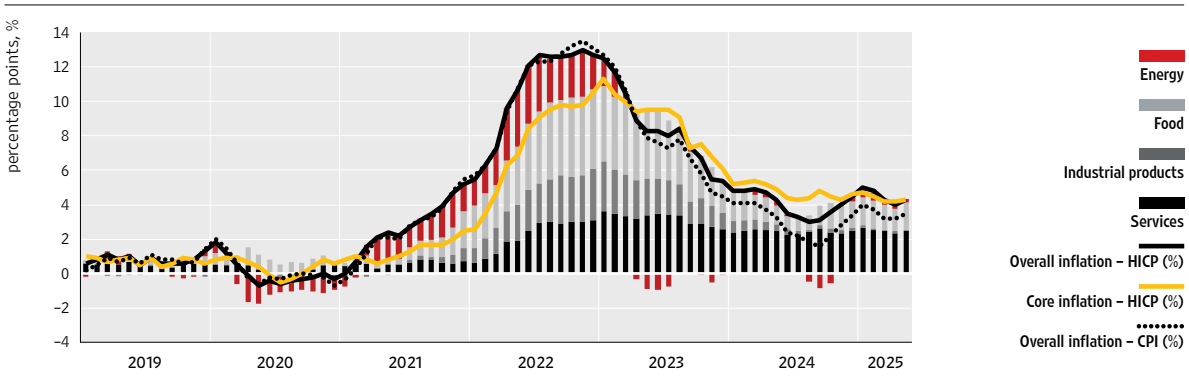
3.3 Price developments

After accelerating at the end of 2024 and in January 2025, the annual consumer price inflation rate slowed down in the following three months, remaining lower than at the beginning of the year despite a spike in May. The slowdown in inflation from February to April reflected the decrease in the price of energy and food raw materials in the global market, with the still present impacts of monetary policy tightening, as well as the statistical influence of the favourable base effect on service price inflation (the relatively high current inflation of these prices in the same period last year is no longer included in the calculation of the annual inflation rate). Accordingly, the overall inflation measured by the harmonised index of consumer prices (HICP) went down in April 2025 to 4.0% after increasing from 3.0% to 5.0% from August last year to January this year (Figure 3.3.1). During this period, inflation measured by the national consumer price index (CPI, which does not cover the consumption by foreign tourists and institutional households such as educational, health and religious institutions) also slowed down from, 4.0% in January 2025 to

3 In early 2025, the Croatian Radiotelevision (HRT) was consolidated in line with the Government's Plan for the Consolidation of Work and Business Operations of HRT, and on 31 March, a significant share of employees accepted the agreed upon severance packages.

3.2% in April. Despite the May increase (to 4.3%, measured by the HICP, or 3.5%, measured by the CPI) as a result of the increase in the annual food and services price inflation, inflation remained lower than at the beginning of the year and the core inflation momentum remained unchanged from the previous month, reflecting stable and moderate current pressures if the last several months are observed. Inflation is substantially higher when measured by the harmonised index than by the national indicator. This reflects differences in the structure of the basket of goods and services used for each calculation (Table 3.3.1). The share of services, especially food and accommodation services, which are heavily consumed by foreign tourists, the prices of which have been growing particularly steeply, is much higher in the consumer basket for the calculation of the HICP than in that for the CPI, while the share of food and energy is much lower than for the CPI). Accordingly, service prices contribute much more to the overall inflation under the harmonised index than under the national indicator (Figure 3.3.2).

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.

Table 3.3.1. Structure of the harmonised and the national consumer indices, 2025

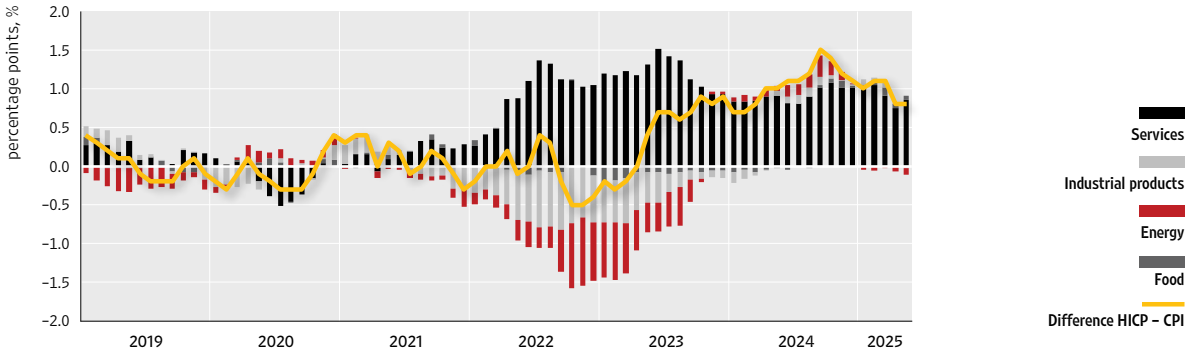
in %	HICP	CPI
Energy	12.3	15.8
Food	28.4	31.6
Processed food	22.2	23.0
Unprocessed food	6.2	8.6
Core inflation	59.3	52.5
Industrial products	26.8	26.5
Services	32.5	26.0
Catering services	8.1	4.4
Accommodation services	4.1	0.7
Other services	20.3	20.9

Notes: Food includes beverages and tobacco, while industrial goods exclude energy. Core inflation excludes energy, food, alcoholic beverages and tobacco prices.
Sources: Eurostat and CBS.

The slowdown in the overall inflation from January to April 2025 primarily derived from the prices of energy, while the acceleration in May was predominantly the result of the prices of

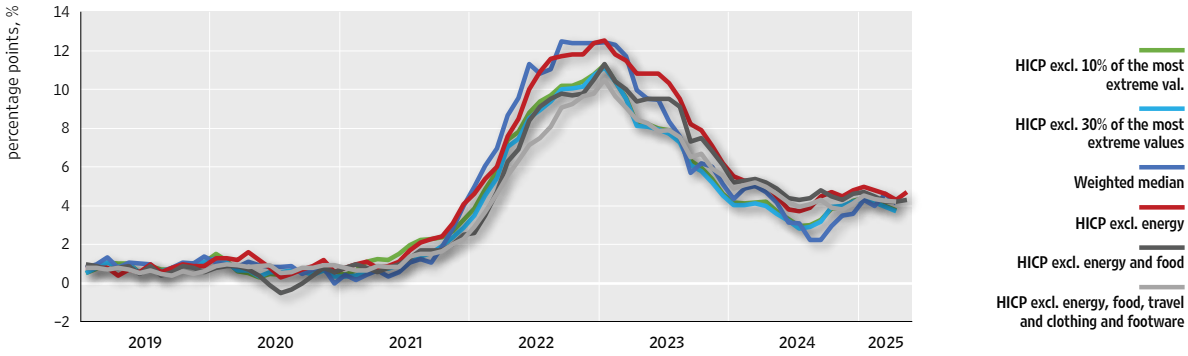
food and services. The energy price inflation accelerated considerably at the end of 2024, reaching its highest level in almost two years in January 2025, having risen to 5.1% (measured by HICP) due to the increase in the price of refined petroleum prices and administrative prices of gas, electricity and heat energy, connected to the withdrawal of a part of fiscal support. However, in the months to come energy inflation noticeably decelerated (to 1.5% in May) thanks to the spillover of the decrease in crude oil prices in the global market to refined petroleum product prices in the domestic market. Despite the acceleration in May, the annual rates of food and services price inflation, due to their slowdown in the period from February to April, continued to register levels below those from the beginning of the year.

Figure 3.3.2 Difference between the contributions of the main components to the overall HICP and CPI



Note: 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: Eurostat, CBS and CNB calculations.

Figure 3.3.3 Core inflation indicators in Croatia

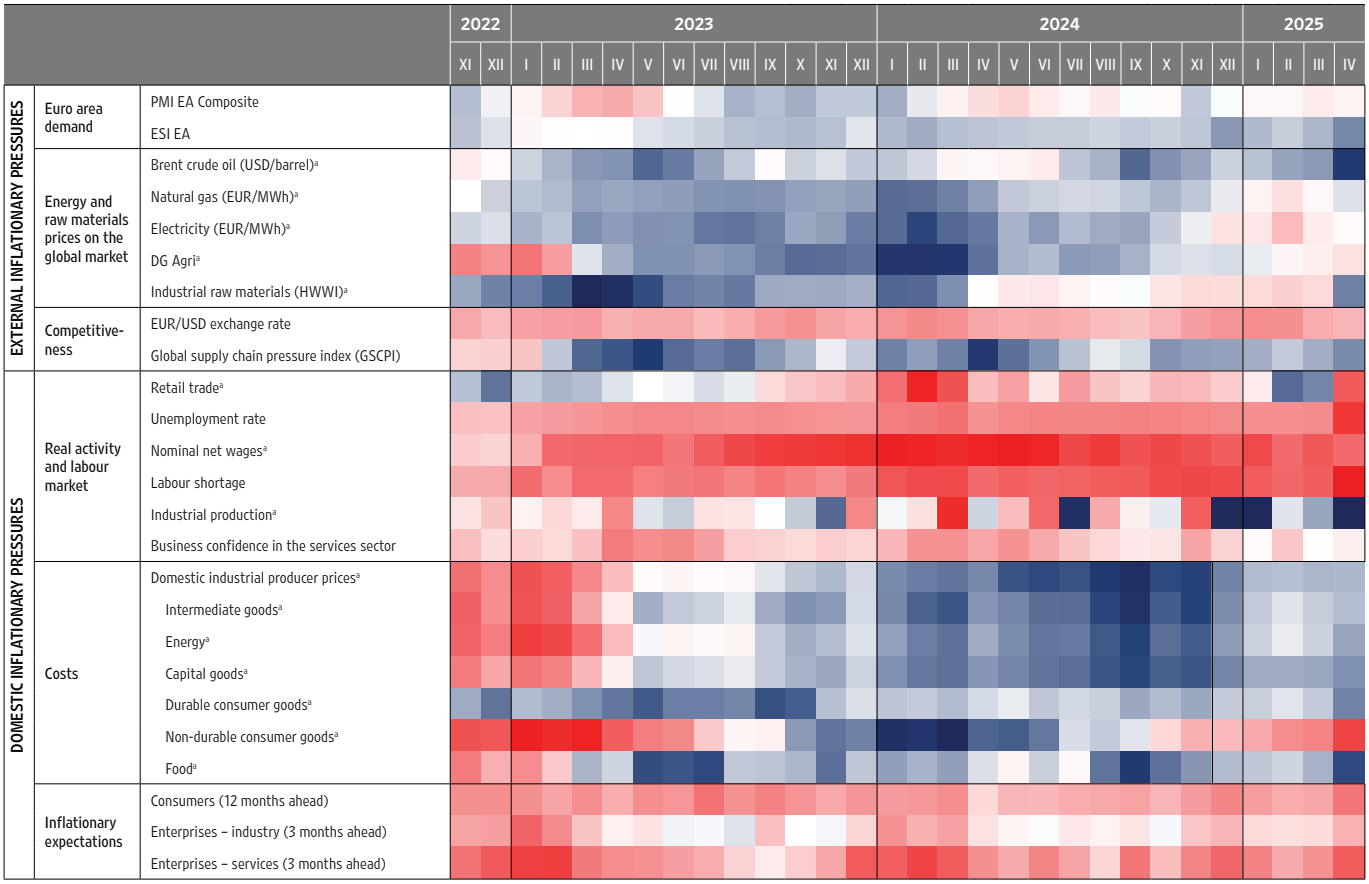


Notes: Trimmed mean eliminates 5% (15%) of components (out of a total of 87 components) with maximum and minimum annual rates of change. The weighted median excludes all values except the weighted median of the distribution of price change.
Sources: Eurostat and CNB calculations.

Core inflation (excluding energy and food prices) edged down in the first half of 2025, but remained elevated, particularly in the segment of services price inflation. After peaking in January 2023, at 11.3% (measured by HICP), core inflation had been slowing down uninterruptedly until mid-2024 when it started averaging at some 4.4%, reaching 4.3% in May 2025. The inflation of the prices of industrial products, one of the two components of core inflation, has been recording levels below the long-term pre-pandemic average of 1.0% since the second half of 2024,

which is at the same time ten percentage points below its peak from the end of 2022. Services price inflation, the second component of core inflation, has been oscillating around the average of 7.6%, the value recorded in the latest data for May. Thus, services remain the component with the highest individual holding in the overall inflation. They accounted for more than a half of the overall inflation in May 2025 and proved to be the most persistent component of inflation. The persistence of services inflation largely mirrors robust domestic demand and a tight labour market coupled with continued high wage growth (Figure 3.3.4). Alternative indicators of core inflation, which exclude certain volatile components, were higher than in the second half of last year, although most of them decreased slightly from the very end of the previous year (Figure 3.3.3). In addition, the dispersion among indicators of core inflation decreased, indicating lower price inflation heterogeneity among individual inflation sub-components.

Figure 3.3.4 Indicators of external and domestic price pressures



[a] Annual rate of change

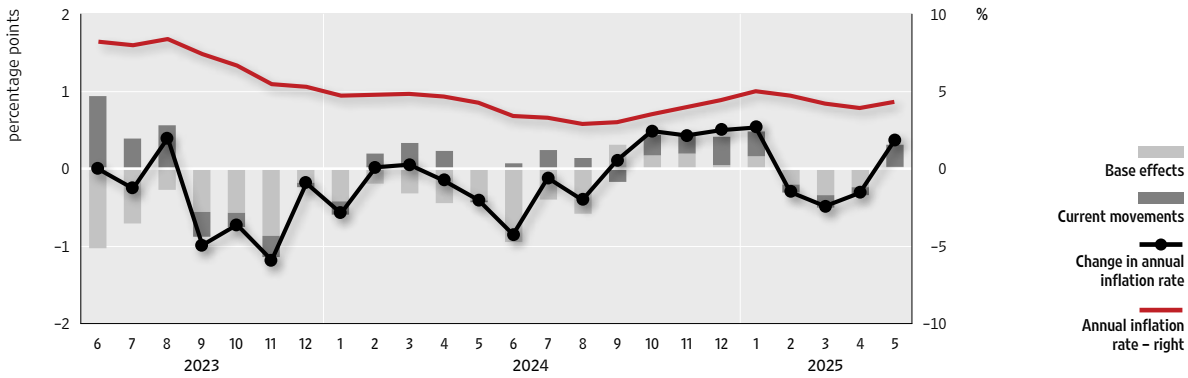
Notes: Labour shortage is the ratio between the vacancy rate and the registered unemployment rate. The PMI EA Composite and ESI EA series have been corrected after standardisation so as to show the neutral value in white. The red (blue) colour indicates a positive (negative) deviation in the value in a given month relative to the 2010–2024 average (expressed by the number of standard deviations), where the intensity of the shade of the colour indicates the size of an upward (downward) deviation from the average.

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

The slowdown in the annual rate of overall inflation from February to May 2025 predominantly reflects favourable base effects, i.e. the non-inclusion of high monthly growth rates from the first half of 2024 in the calculation of the annual rate, followed by moderate current pressures this year. 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

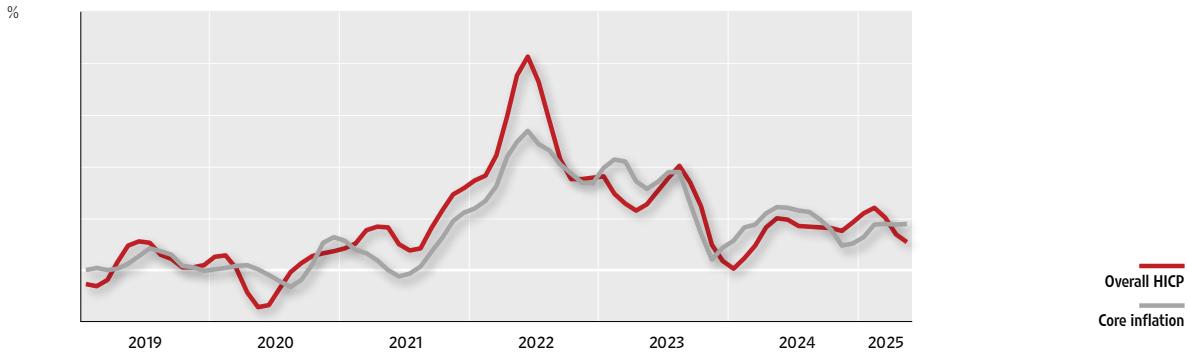
in prices in the same month of the year before ("base effects").[4] The annual rate of overall inflation increased in the period from September 2024 to January 2025 due to the strengthening of current inflationary pressures and an unfavourable base effect (Figure 3.3.5). In contrast, the decrease in the annual rate of overall inflation in the period from February to April 2025 reflected the favourable base effect from the high monthly increase in prices in the same period last year, especially of services, paired with low current pressures on prices of energy and food. The May increase in inflation was a result of the pronounced strengthening of current pressures in the components of food and services, which are estimated to be probably only temporary. The short-term indicator of the overall inflation (Figure 3.3.6), the "momentum" (or quarterly rate of change calculated from the seasonally adjusted data and expressed on an annual level) also suggests a decrease in the current inflationary pressures over the previous months.

Figure 3.3.5 Contributions of base effects and current developments to a change in annual inflation



Notes: 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.

Figure 3.3.6 Momentums of overall and core inflation



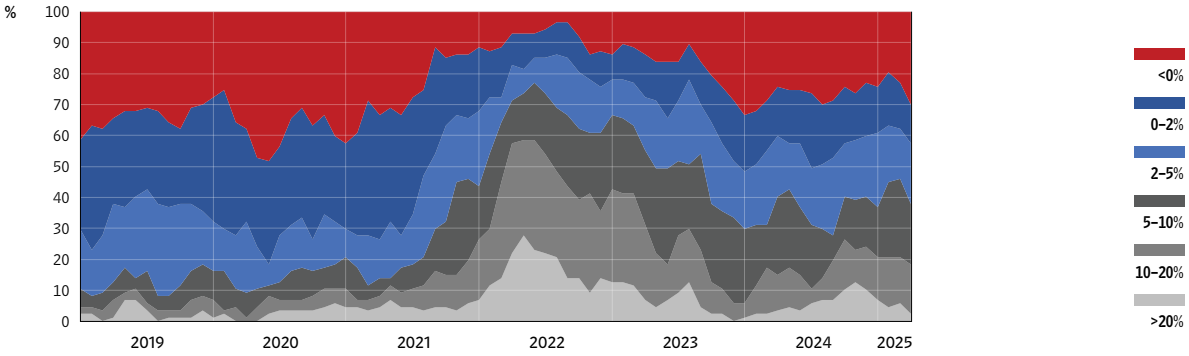
Notes: The quarterly rate of change on an annual level is calculated from the quarterly moving average of seasonally adjusted harmonised consumer price indices.
Sources: Eurostat and CNB calculations.

Inflation diffusion edged up (Figure 3.3.7), with the share of sub-components in the consumer price index, whose quarterly rate of change expressed on an annual basis increased by more

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

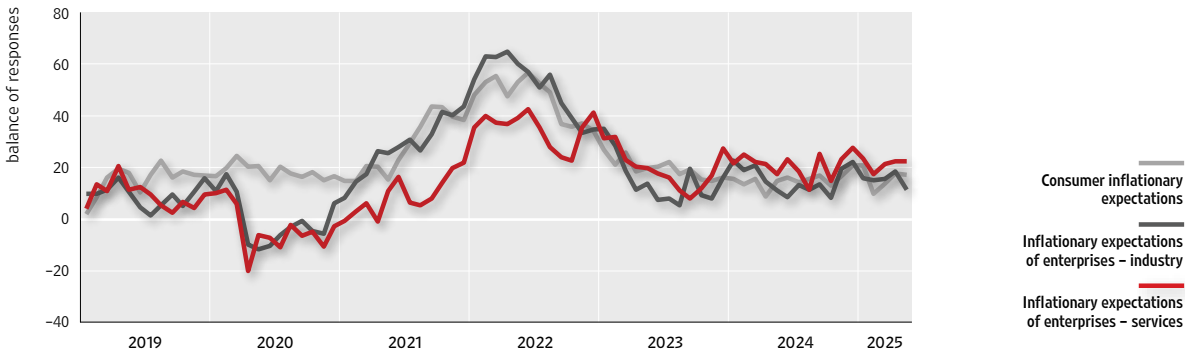
than 2% in the first four months of 2025, amounting to some 61%, slightly more than last year. However, this was still well below the approximately 85% registered in mid-2022. Short-term consumer and corporate inflationary expectations (Figure 3.3.8) went down slightly in the first five months of 2025 from the end of 2024, but remain elevated compared with the pre-pandemic period, which particularly applies to corporates from the services sector.

Figure 3.3.7 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 the annualised quarterly rate of change of seasonally adjusted price indices of 87 components of the harmonised consumer price index.
Sources: Eurostat and CNB calculations.

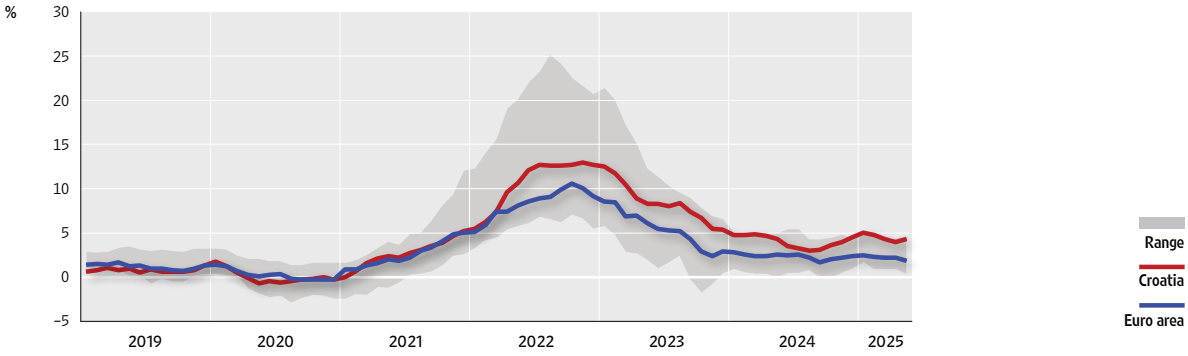
Figure 3.3.8 Short-term inflationary expectations of consumers and corporates



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

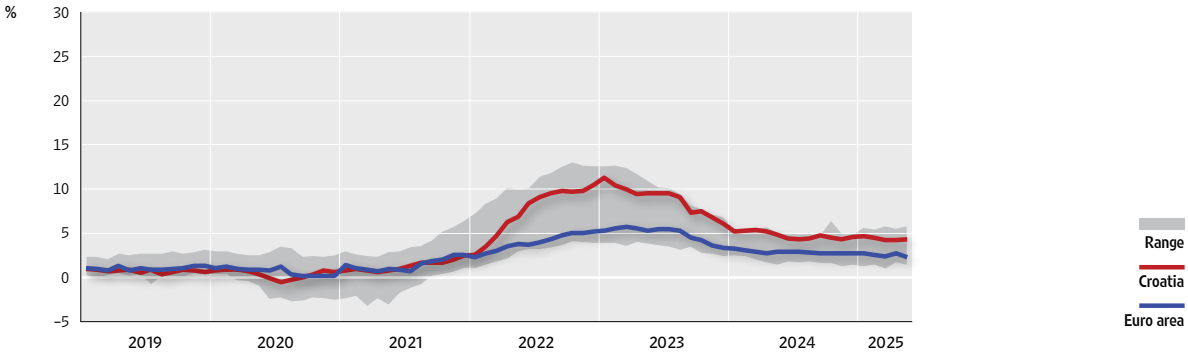
Difference between overall inflation in Croatia and at euro area-wide level was slightly lower in May 2025 than at the beginning of the year. After having increased in the second half of 2024 and January 2025 the difference between inflation in Croatia and in the euro area as a whole decreased again in the period from February to April 2025 and despite the increase in May continued to be lower than at the beginning of 2025 (for more detail see Box 1: Recent developments in the inflation differential between Croatia and the euro area average). Thus, in May 2025 the overall inflation in Croatia outstripped the euro area average by 2.4 percentage points (Figure 3.3.9), down 0.1 percentage point from January 2025. The core inflation in Croatia in May 2025 exceeded the euro area average by 2.0 percentage points (Figure 3.3.10), unchanged from January 2025.

Figure 3.3.9 Synchronisation of overall 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 3.3.10 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.

BOX 1

Recent developments in the inflation differential between Croatia and the euro area average

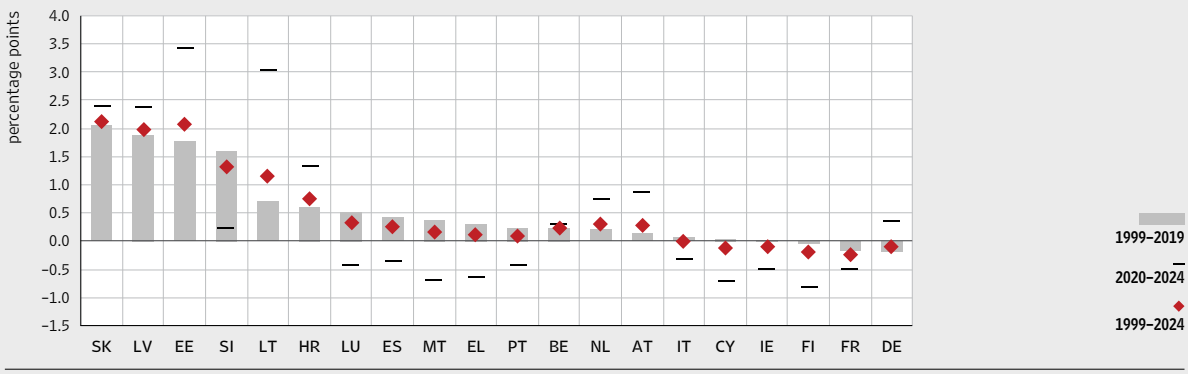
Inflation in Croatia remains noticeably higher than the average inflation in the euro area, but in 2024 and in early 2025 the inflation differential decreased from the previous two years. The still elevated inflation differential reflects the large contribution of food, services and energy prices in Croatia as compared to the average of the euro area. Part of the inflation differential stems from the process of price convergence in Croatia to the euro area average associated with the gradual convergence of per capita income to EU levels. Croatia's above-average inflation within the euro area can also be attributed to some other factors such as faster economic growth, faster wage and personal consumption growth, a supportive fiscal stance, inflows from the EU funds and a withdrawal of energy support to households slower than in the other observed countries. However, in 2026 we expect to see a faster slowdown in inflation in Croatia relative to the euro area average, and a fall in the inflation differential.

Differences in inflation rates among euro area member states are due to different factors. The economic literature[5] lists many factors that may lead to differences in inflation rates among the countries in the monetary union. Inflation differentials in the monetary union typically occur with real convergence, i.e. the gradual convergence of per capita income to the average union level. Thus inflationary pressures associated with price and income convergence to the higher average level within the union may be present for a while in lower-income countries that have joined the monetary union. The process of catching up with developed economies is a structural process of adjustment within the economic area and, to the extent it is associated with this process, should not be a cause for concern among economic policy makers. However, differences in inflation rates may also arise from different economic structures that may lead to higher exposure to asymmetric shocks and differences in responses to common shocks, such as changes in the prices of energy or the nominal exchange rate of the euro. Countries with energy-intensive production are more sensitive to changes in energy prices while economies that rely more on trade outside the union are more sensitive to changes in the nominal exchange rate of the common currency. Differences in labour market institutions among countries (for instance, the degree of centralisation of the system of collective wage bargaining) may also have a different inflation outcome. Differences in inflation among countries may also stem from a different consumption structure, as seen in different shares of individual goods and services in the consumer basket of individual countries.

5 For a comprehensive overview, see, for example, *Inflation differentials in the euro area: potential causes and policy implications*, ECB, September 2003; Egert, B. et al., *Inflation differentials in Europe: Past Experience and Future Prospects*, Monetary Policy and the Economy, OeNB, Q1/2004; *Monetary policy and inflation differentials in a heterogenous currency area*, ECB Monthly Bulletin, May 2005; *Inflation differentials in the euro area during the last decade*, ECB Monthly Bulletin, November 2012; *The dynamics of inflation differentials in the euro area*, ECB Economic Bulletin, Issue 5/2024; Coutinho, L. and Licchetta, M. (2023), *Inflation Differentials in the Euro Area at the Time of High Energy Prices*, European Commission, Discussion Paper 197, November 2023; Falagiarda, M. (2024), *Inflation in the eastern euro area: reasons and risks*, ECB Blog, 10 January 2024.

Inflation differentials often fluctuate driven by different short-term factors. The cyclical position of the economy is one of the key short-term factors influencing inflationary trends. Different cyclical developments in monetary union members may cause different rates of inflation. Cyclical overheating of the economy typically leads to faster wage growth and higher cost pressures that can easily be shifted to prices amid high demand for goods and services. The differences in the development of the nominal unit labour costs, i.e. average wages adjusted for productivity growth, among countries are an important indicator of cost pressures and a key source of inflation differentials. Also, countries pursuing a more expansive fiscal policy (in relation to other member states) and thus fuelling demand, may expect a faster price growth and a positive inflation differential. The short-term factors that lead to differences in inflation include changes in administered prices and indirect taxes (e.g. changes in the VAT). As mentioned earlier, some of the inflation differences among countries stem from the equilibrium adjustments of relative prices, which are a part of the convergence processes within the monetary union. However, a positive difference in inflation rates arising from excessive wage and/or loan growth and structural problems as reflected in a rigid labour and product market or inappropriate fiscal policy is considered undesirable, as it may distort an economy's competitiveness over the long term. As shown in Figure 1, even in the pre-pandemic period, the inflation rates in euro area countries differed greatly, with inflation in Croatia for a long time, between 1999 and 2019, exceeding the average in the euro area by 0.6 percentage points. The Baltic countries, Slovakia and Slovenia had an even bigger inflation differential during that period. After the outbreak of the pandemic, the difference between inflation in Croatia and the euro area average widened and the text below describes the developments in the inflation differential in 2024 and in the first months of 2025.

Figure 1 The average difference between the annual rate of inflation in individual euro area member states and the average rate of inflation in the euro area

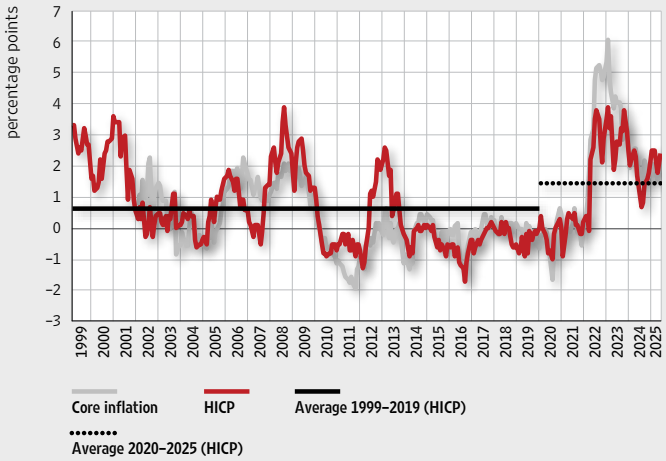


Sources: Eurostat and CNB calculations.

In mid-2024, the inflation differential between Croatia and the euro area average temporarily fell to its lowest level since March 2022 but then rose again by January 2025, largely driven by a steep rise in food prices. In the first seven months of 2024, overall inflation (measured by the harmonised index of consumer prices, HICP) slowed down faster in Croatia than in the euro area, primarily due to a more pronounced fall in the inflation of energy prices. As a result, in July 2024, the inflation differential, after over two years, again came close to the pre-pandemic long-term

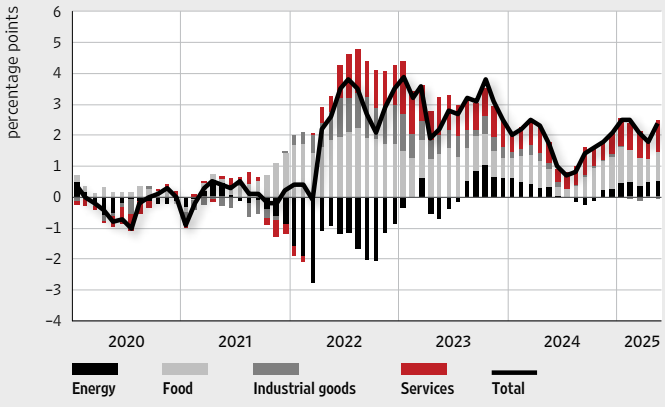
average (Figure 2).[6] However, in the remaining part of 2024 and in early 2025, the increase in inflation in Croatia was more marked than the euro area average, with the inflation differential rising again to 2.5 percentage points in early 2025. This divergence of the annual inflation rate in Croatia from the euro area average mostly reflected a faster acceleration in food price inflation (alcohol and tobacco included) in Croatia (Figure 3 and Figure 4), with the total differential being further boosted by a larger share of food in the consumer basket in Croatia than its average share in the euro area (Table 1). The acceleration of the annual inflation rate of food prices in Croatia from 2.5% in July 2024 to 5.7% in January 2025 largely reflected the strengthening of current pressures on food prices (particularly in September and October 2024), i.e. an upwards deviation of the monthly growth rate of food prices from the typical values in some food components (Figure 5). This appears to be attributable to several factors: higher input costs due to wage growth; the growth in energy and food raw materials prices in the global market (most notably cocoa and coffee), the transfer of which to final goods was faster in Croatia; and to adverse weather conditions, particularly droughts during the summer months.

Figure 2 Inflation differential between Croatia and the euro area



Note: Core inflation excludes prices of energy, food, alcohol and tobacco.
Sources: Eurostat and CNB calculations.

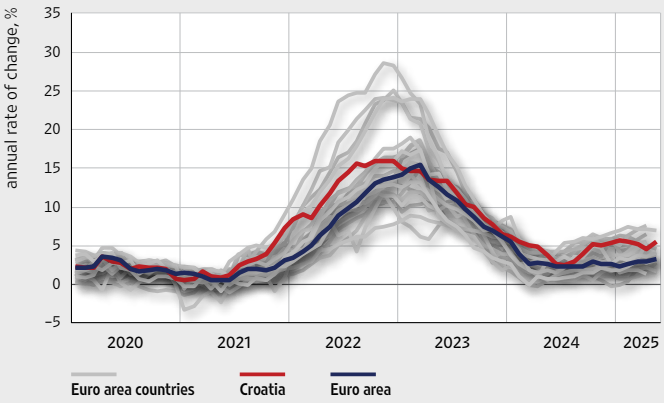
Figure 3 Difference between overall inflation and the contributions of the main components to overall inflation in Croatia and the euro area



Sources: Eurostat and CNB calculations.

6 For more information on the inflation differential in 2022, see Box 3 Why is inflation higher in Croatia than in the euro area?, Macroeconomic Developments and Outlook No. 13, December 2022. For more information on the inflation differential in 2023, see Box 4 Inflation differential between Croatia and the euro area average, Semi-annual Information about the second half of 2023, May 2024.

Figure 4 Food price inflation in Croatia and in the euro area



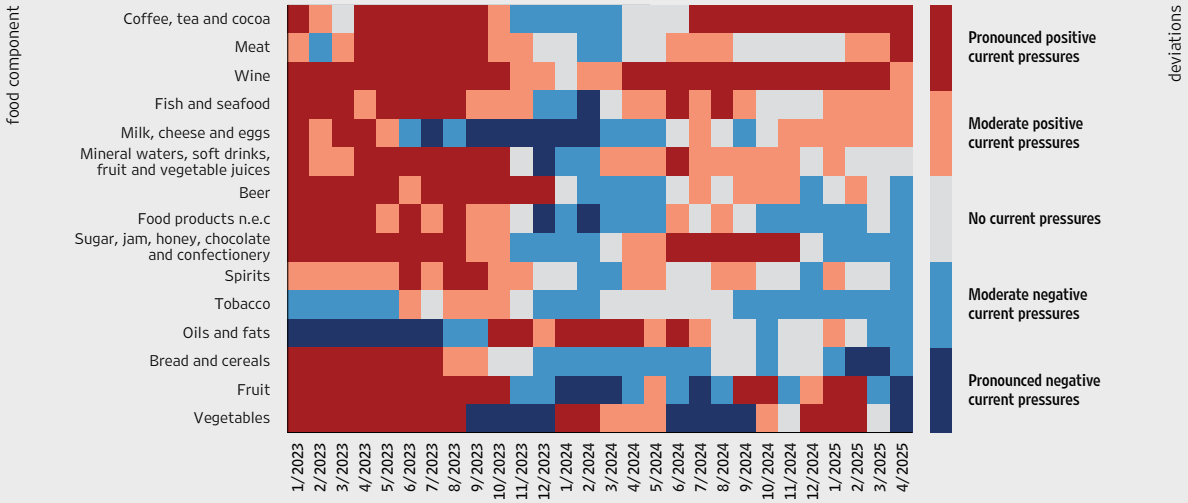
Source: Eurostat.

Table 1 Structure of consumer price indices in Croatia and the euro area, 2025

in %	Croatia	Euro area
Energy	12.3	9.4
Food	28.4	19.3
Processed food products	22.2	15.1
Unprocessed food products	6.2	4.3
Core inflation	59.3	71.3
Industrial goods	26.8	25.6
Services	32.5	45.6
Food service activities	8.1	9.0
Accommodation services	4.1	2.4
Housing services	2.4	9.7
Other services	17.8	24.6

Source: Eurostat.

Figure 5 Current pressures in food and beverages price inflation



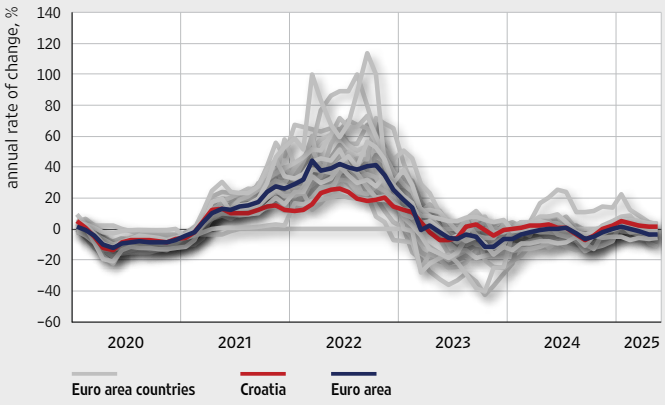
Notes: The figure shows a six-month moving average of the deviation of the seasonally adjusted monthly rates of change from its long-term average. The components are classified according to the sum of the value of the deviation in the past six months, from the highest to the lowest. Ranges: pronounced positive current pressures are deviations >0.5 bp, moderately positive from 0.1 to 0.5, with no current pressures from 0.1 to 0.1, moderately negative from 0.5 to 0.1 and pronounced negative current pressures are deviations < 0.5 percentage points.

Sources: Eurostat and CNB calculations.

To a lesser extent, the increase in the inflation differential between Croatia and the euro area average in the second half of 2024 and in early 2025 stemmed also from developments in the inflation of energy and services prices. Next to food, the developments in energy prices during that period had the biggest impact on the increase in the inflation differential (Figure 6). The increase in administered prices of gas, electricity and heat energy in October and November 2024 and in January 2025 led to a more pronounced increase in the inflation of energy prices in Croatia than in the euro area. These increases came later than in most euro area countries that had withdrawn fiscal support earlier. In addition, the difference in the inflation of services prices also widened in Croatia relative to the euro area (Figure 7), particularly the prices in accommodation and food service activities. The factors fuelling growth in the prices of these services

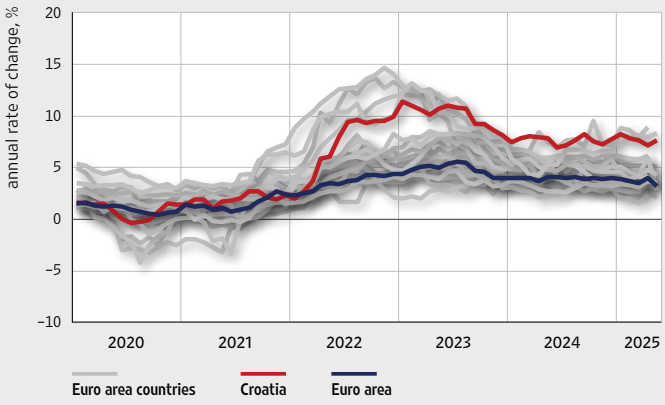
include primarily a marked wage growth in 2024, the spillover of the previous growth in input costs caused by the increase in energy and food prices amid strong domestic demand and steady demand from foreign visitors for food service activities and accommodation services as well as a steep rise in domestic demand driven by marked wage increases. In contrast, the inflation of the prices of industrial products or tradeables that are largely traded in the conditions of tougher competition, was almost on par in Croatia and the euro area during that period and stood at low levels, with almost no contribution of this group of products to the inflation differential.

Figure 6 Energy price inflation in Croatia and euro area countries



Source: Eurostat.

Figure 7 Services price inflation in Croatia and euro area countries



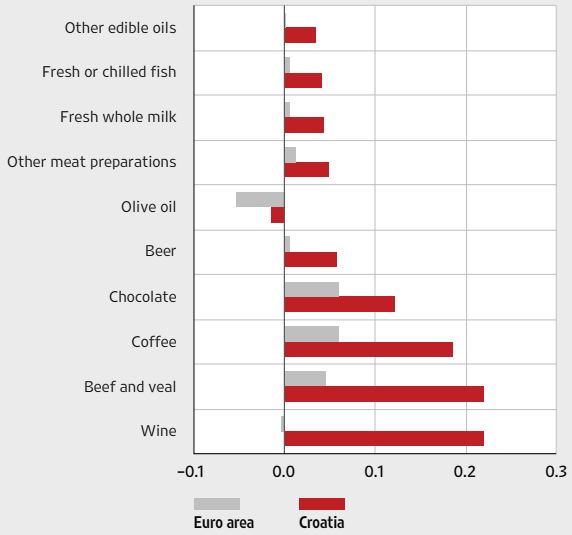
Source: Eurostat.

Recent data suggest a decrease in the inflation differential in March and April owing to a faster slowdown in food and services price inflation in Croatia than the euro area average, but such developments came to a halt in May when the inflation differential increased again, driven by relative developments in services and food prices. Although inflation in Croatia in January and February 2025 was 2.5 percentage points higher than the euro area average, by April this difference had narrowed to 1.8 percentage points. This decrease was the result of a narrowing of the difference in the contributions of food and services prices (0.3 percentage points each) to overall inflation in Croatia and the euro area. This decrease notwithstanding, food prices in April again contributed the most to the remaining inflation differential – of 1.8 percentage points of the overall inflation differential, food prices accounted for 0.7 percentage points. The differences in the contributions to overall inflation of the individual subcomponents of food in Croatia and the euro area in April[7] were mostly concentrated in a group of only some 10 of the total of about seventy groups of products (Figure 8), mostly wine, beef and veal, coffee, chocolate and beer. The decrease in inflationary pressures on food prices in Croatia was also due to new government measures aimed at limiting retail prices of certain products (mostly food), which came into effect in February 2025. Next to food prices, in April the prices of services and energy each contributed 0.5 percentage points to the total inflation differential. The bigger contribution of services prices to the greater overall inflation in Croatia than in the euro area largely arises from the bigger contributions of the prices of food service activities and accommodation services (Figure 9). The

7 The latest available detailed data are for April 2025.

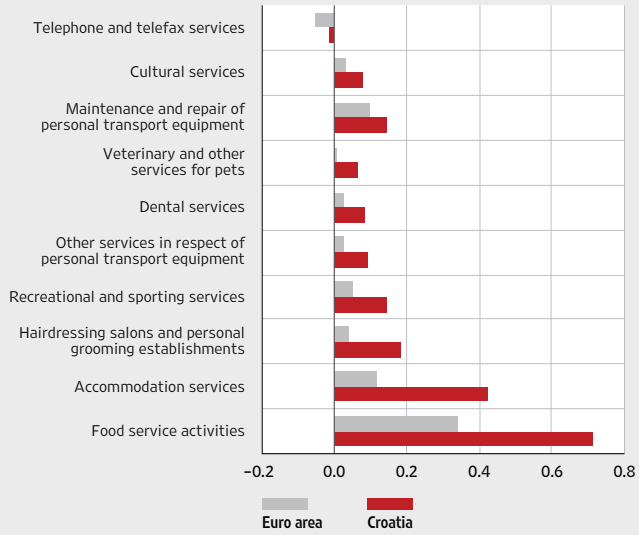
bigger contribution of energy prices to overall inflation in Croatia than in the euro area in April largely reflected a bigger contribution of electricity prices and, to a much lesser extent, gas prices associated with a phasing out of the fiscal support that kept energy prices stable. Of the total inflation differential of 2.4 percentage points in May 2025, food prices and services prices each accounted for 1.0 percentage point and energy prices accounted for 0.5 percentage points.

Figure 8 Contributions of subcomponents of food price inflation to overall inflation in Croatia and in the euro area in April 2025



Note: Shown are subcomponents with the biggest positive difference in contributions.
Sources: Eurostat and CNB calculations.

Figure 9 Contributions of subcomponents of services price inflation to overall inflation in Croatia and in the euro area in April 2025



Note: Shown are subcomponents with the biggest positive difference in contributions.
Sources: Eurostat and CNB calculations.

Overall, inflation differentials are influenced by various structural and cyclical factors, with the higher level of inflation in Croatia than the euro area average largely being the result of a faster economic growth in Croatia, attributable mainly to a more pronounced increase in domestic demand coupled with a strong wage growth. Croatia belongs to the group of countries with the highest wage growth rates, and developments in wages continue to be driven by a marked demand for labour amid record low unemployment and unfavourable demographic trends. A strong growth in real disposable income resulted in a marked increase in personal consumption in Croatia, which outpaced the euro area average. The demand in Croatia was also propelled by an expansive fiscal policy and a marked increase in public sector wages and an inflow of EU funds. Against the backdrop of a relatively strong demand, companies tended to pass on some of the increase in labour costs to end consumers through higher prices of goods and services.[8] A larger contribution of food prices to inflation in Croatia reflects a higher growth in food prices as well as a higher share of that component in the consumer basket in Croatia relative to the euro area average, which may be explained also by a lower degree of economic development and a relatively high level of food prices. By contrast, the share of services in the consumer basket is smaller in Croatia and diminishes the contribution of a stronger growth in services prices to

8 For more information on how wage growth can lead to higher rates of inflation in an environment dominated by demand shocks, see CNBlog: Ivanac, F., Kunovac, D. and O. Nadoveza (2024), *How does wage increase affect inflation?*, 29 August.

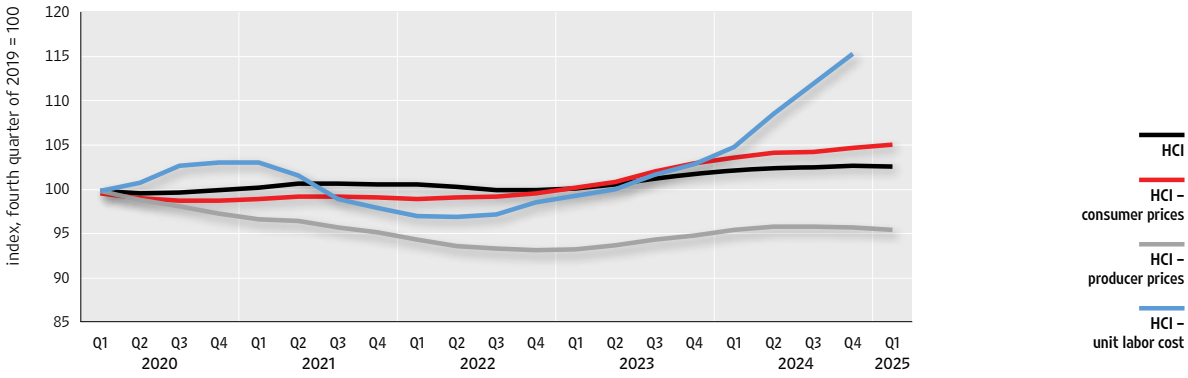
overall inflation. However, the higher weight of accommodation services due to the large demand from foreign tourists amplifies the contribution of a sharp increase in their prices to the inflation differential. Also, the withdrawal of energy support to households in Croatia took place later than in other countries. With Croatia approaching the euro area average in terms of economic development, higher inflation is also the result of the accompanying price convergence.

Next year, inflation is expected to slow down rapidly in Croatia relative to the euro area average. According to the latest forecasts of the Croatian National Bank and the European Central Bank of June 2025, the difference between the average annual rate of inflation in Croatia and the euro area average might remain at a similar level in 2025 as in the year before and stand at 1.6 percentage points. However, the inflation differential is expected to fall to 1.0 percentage point, slightly above the long-term average level in the period before the pandemic.

3.4 Economic relations with foreign countries

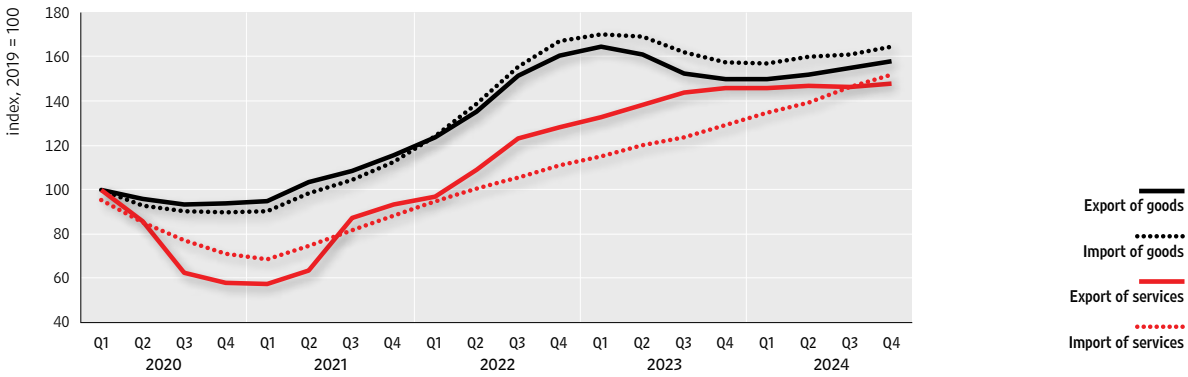
Most indicators suggest a further worsening of the competitiveness of the Croatian economy relative to the main trading partners in early 2025. The cost competitiveness indicator, which takes into account changes in unit costs in Croatia relative to trading partners (HCI-ULC) suggests a further strong worsening that started in mid-2022 (Figure 3.4.1). A relatively sharp wage growth, particularly in the public sector played a large role, largely outpacing labour productivity growth. Not only were there unfavourable developments in the cost competitiveness of the Croatian economy, but adverse movements were also seen in the price competitiveness indicator deflated by relative consumer prices (HCI-CPI), although the intensity of this deterioration eased as inflationary pressures subsided over the year. The indicator deflated by consumer prices (HCI-PPI) stabilised at below pre-pandemic levels.

Figure 3.4.1 Harmonised competitiveness indicators



Notes: The increase in 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

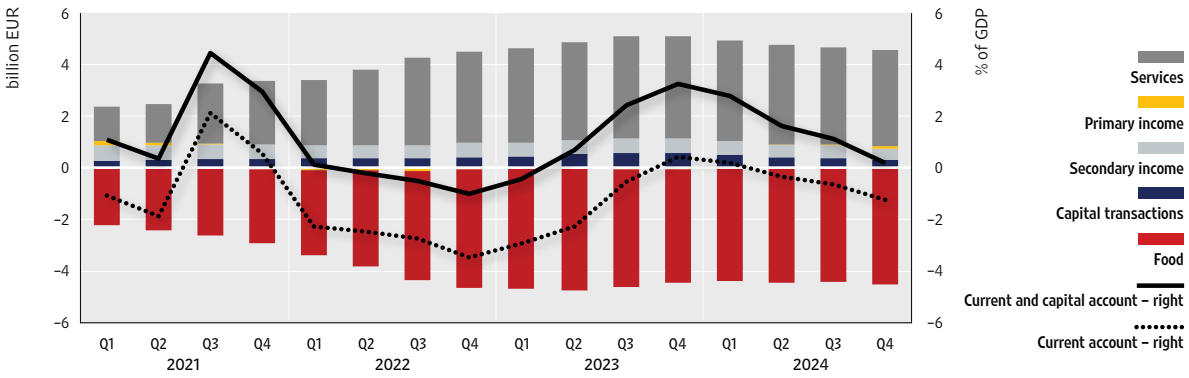


Note: Series are shown as the moving average of four quarters.
Source: CNB.

The deterioration in the price and cost competitiveness of the domestic economy also affects foreign trade, particularly in the services segment. The annual growth in goods exports accelerated gradually towards the end of 2024, reaching 7.4% in the last quarter. This is somewhat

faster than the average growth in exports of other EU member states so the market share of Croatian exports in the European market continued to grow. Goods imports grew at a similar rate, with the growth accelerating to 8.8% by the end of the year. As a result, the foreign trade deficit rose by 10.7%, but due to an even faster growth in the gross domestic product its share in GDP fell to 22.4%. In early 2025, foreign trade exhibited a similar trend, with a broad-based growth in goods exports and a gradual slowdown in the growth in goods imports as a result of a deceleration in the growth of domestic demand. While the improvement of the services exports balance largely offset the deterioration in the goods balance in the previous years, the positive balance in the services trade has declined in the last several quarters (Figure 3.4.2). According to the balance of payments data, services exports grew by a modest 1.4% on an annual level, mostly influenced by a fall in the exports of manufacturing services on physical inputs, following their above-average performance in 2023, and a modest growth in the exports of tourism services (2.7%) as a result of a post-pandemic fall in price competitiveness in that sector. In 2024, services imports rose 17.6%, mostly driven by tourist consumption of residents abroad, which resulted in a noticeable deterioration in the services balance. As a result, the positive services balance fell from 20.3% of GDP to 17.6% of GDP.

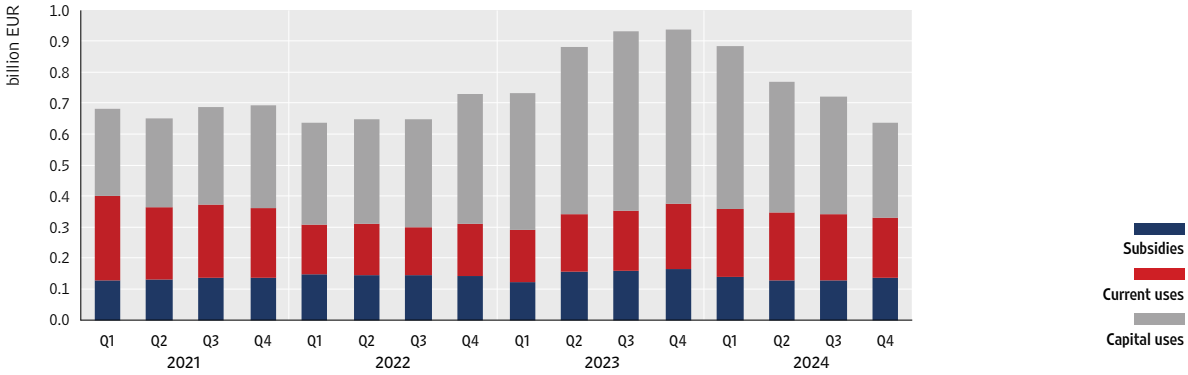
Figure 3.4.3 Balance of payments (b.o.p.)



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

The trends in foreign trade in goods and services described were the main driver of the deterioration in the total current and capital account balance in 2024. After falling from 3.3% of GDP at the end of 2023 to 1.6% of GDP in mid-2024, the current and capital account surplus continued to decrease at the same pace in the second half of last year, reaching only 0.2% of GDP in the whole of 2024 (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 greatly to the unfavourable trends, since 2023 was the last year for the use of the funds allocated under the previous financial envelope (for the period from 2014 to 2020) and the EU Solidarity Fund for the reconstruction after the earthquake (Figure 3.4.4).

Figure 3.4.4 Utilisation of EU funds



Note: Series are shown as the moving average of four quarters.
Source: MoF.

In line with the narrowing of the current and capital account surplus, in 2024, the financial account of the balance of payments of Croatia recorded a much smaller net capital outflow than in the year before. Despite a reduction in net outflows (from EUR 3.8bn in 2023 to EUR 0.8bn in 2024), the changes in the foreign assets and liabilities of domestic sectors were much bigger than in 2023. These changes were largely associated with the central bank whose financial assets management and financial transactions intermediation between Croatian and other banks in the euro area largely influence changes in total foreign assets and liabilities but are neutral on the level of the total financial account balance. Other sectors, the central bank excluded, recorded a net capital outflow, exclusively as a result of their further external deleveraging while their equity investments generated net inflows of around EUR 2bn, an increase of a quarter from the year before.

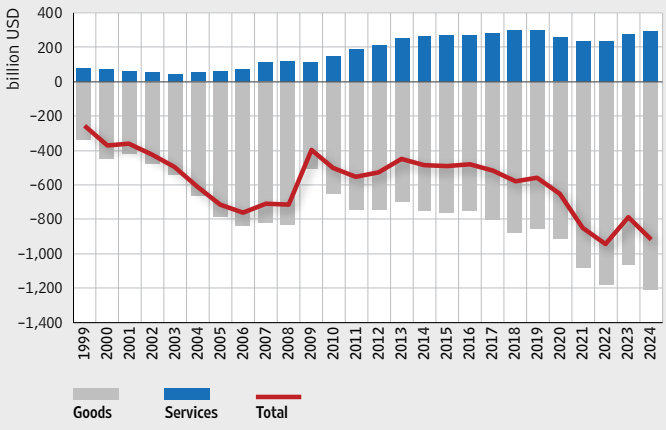
BOX 2

Trade relations between the European Union and the USA and the possible impact of the new US trade policy on the European economy

Uncertainty surrounding the US trade policy, which has lasted for quite some time, culminated in April 2025 with the imposition of high tariffs on imports from China and the significant tightening of trade relations with most of the key US trading partners, the European Union included. This rapid deterioration of global trade relations caused short-term turbulence on the financial markets and a worsening of the global business sentiment. Changes to the US trade policy might, at least in the short term, be reflected in a slowdown of global economic growth and stronger inflationary pressures. The economy of the EU, one of the most significant US trading partners, could face falling exports and lower investments, particularly in sectors that rely heavily on the US market. Although Croatia is one of the less exposed EU member states in that regard, the negative impact of elevated uncertainty on economic activity and the possible indirect effects of weakening demand from partner countries should not be neglected. The impact of US tariffs on euro area inflation is estimated as very low, particularly in the event of a possible trade deal and the absence of retaliatory measures.

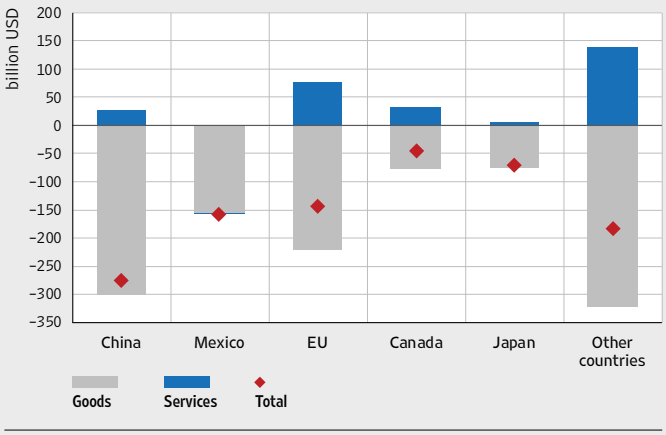
In early 2025, the US administration intensified its protectionist policy by tightening its trade regime vis-a-vis the rest of the world. The US foreign goods trade deficit stood at USD 1,213bn or 4.2% of the US GDP in 2024 (Figure 1), primarily stemming from the trade with China, Mexico, Canada and European Union countries. The USA is the world's largest net importer of various capital goods (industrial machinery, apparatus and appliances) as well as of consumer electronics, cars and pharmaceutical products. A part of the goods trade deficit is offset by the surplus in the services trade, which stood at USD 295bn or 1% of US GDP in 2024 and which is mainly achieved by the export of tourist, business, financial and IT services. European Union countries are the largest net importer of services from the US (Figure 2).

Figure 1 US foreign trade balance in the trade of goods and services



Source: Bureau of Economic Analysis.

Figure 2 US foreign trade balance vis-a-vis major trading partners, 2023



Source: UN.

A wave of tightened tariff measures began in February 2025 with the imposition of a 25% tariff on imports from Mexico and Canada (with some exemptions), while products imported from China were hit by an additional tariff of 10%. China quickly retaliated by imposing 10–15% tariffs on certain US agricultural goods and energy products, while Canada responded with a 25% tariff on around 40% of imports from the US. In March, 25% tariffs were imposed on steel and aluminium imports from all countries, after which a 25% tariff on the imports of cars and auto components was announced. In early April, the US administration presented a plan of trade measures which included a universal tariff of 10% (for all countries except Canada and Mexico) and special, "reciprocal" tariffs laid down specifically for each country[9], with exemptions for strategic goods[10]. A strong reaction ensued from China, after which the USA raised tariffs on imports from China to as high as 145%, prompting China to respond by imposing a tariff of 125%. Effective tariff rates[11] on imports from the US thus reached levels unprecedented in modern history (Figure 3), accompanied by a drastic increase in tariffs on imports from all major trading partners (Figure 4). Soon after that, tariffs were eased, first by exempting Chinese electronic appliances from tariffs, and after that by deferring the application of "reciprocal" tariffs for 90 days for other countries. In mid-May, negotiations with China resulted in a temporary reduction of US and Chinese tariffs to 30% and 10% respectively, marking yet another turn in the US trade policy; however, a further increase of "reciprocal" tariffs on EU products of 30% was announced for the period after the deferral expires, along with a raised tariff of 50% on aluminium and steel imports. In the meantime, bilateral negotiations resumed, with the framework of the US trade policy towards specific countries yet to be established, while the application of "reciprocal" tariffs was brought into question after the U.S. Court for International Trade ruled, in late May, that the president had overstepped his authority by the imposition of 2 April tariffs. However, tariffs are

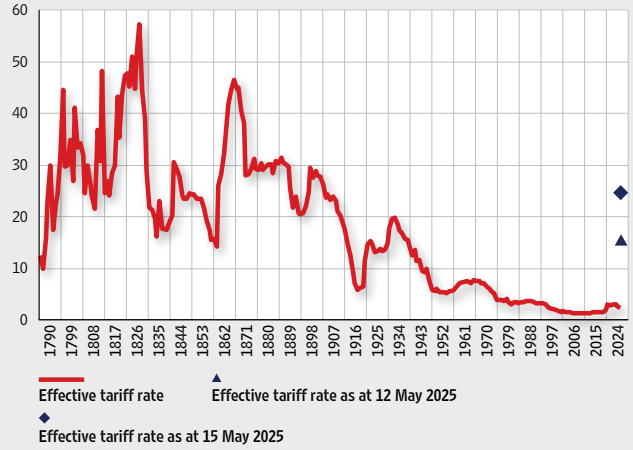
9 For member states of the European Union, the "reciprocal" tariff is 20%.

10 Pharmaceutical products, microchips, energy products, wood, copper and specific minerals.

11 The effective tariff rate is the weighted average of tariff rates in actual application, with weights based on the shares of individual products and countries in total imports.

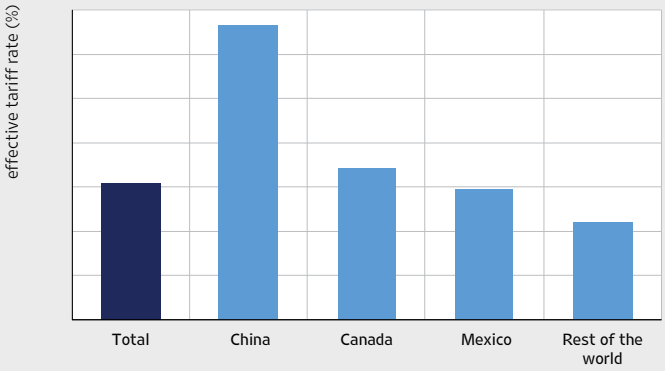
still in force while the U.S. Court of Appeals for the Federal Circuit is considering the appeal of the US administration against the decision of the U.S. Court for International Trade.

Figure 3 Effective tariff rates on US imports



Notes: The effective tariff rate as at 15 April includes the 145% tariff on imports from China, the 25% tariff on steel, aluminium and cars and the temporarily reduced "reciprocal" rate of 10%. The rate as at 12 May includes the rate applied to imports from China of 30%, concessions on car tariffs and the trade deal with the UK.
Source: The Budget Lab at Yale.

Figure 4 Effective tariff rates on US imports from selected countries

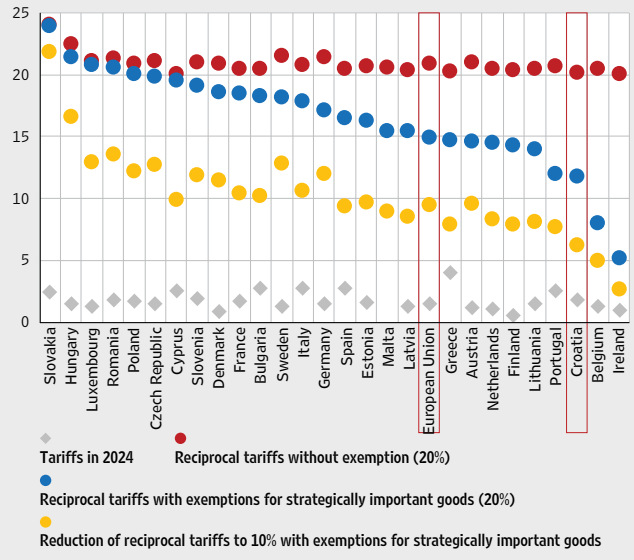


Note: Effective tariff rates as at 15 May 2025 are shown, with the total rate indicating the weighted average of effective rates for individual countries.
Source: The Budget Lab at Yale.

Effective tariff rates on US imports from most EU member states were quite low until April 2025, mostly hovering below 2–3% (Figure 5). Rates were somewhat higher for countries such as Greece, which exports agricultural goods and processed food that is subject to higher tariffs. In contrast, Scandinavian countries, Germany and Netherlands export more industrial machinery, pharmaceutical products and cars, which, until now, had zero or low tariffs. The increase in effective rates for individual member states after April depends on the structure of their exports to the US. Hence, the increase in the effective tariff rate is relatively high for countries whose exports of strategic products exempt from tariffs are relatively low and whose exports of products to which higher tariffs now apply (cars and auto components and iron and aluminium) are relatively high. As a result, the increase in the effective rate is the highest for Slovakia and Hungary, which export automotive products, and the lowest for Ireland, Belgium and Croatia, whose exports of strategic products, most notably pharmaceutical products, are relatively high.

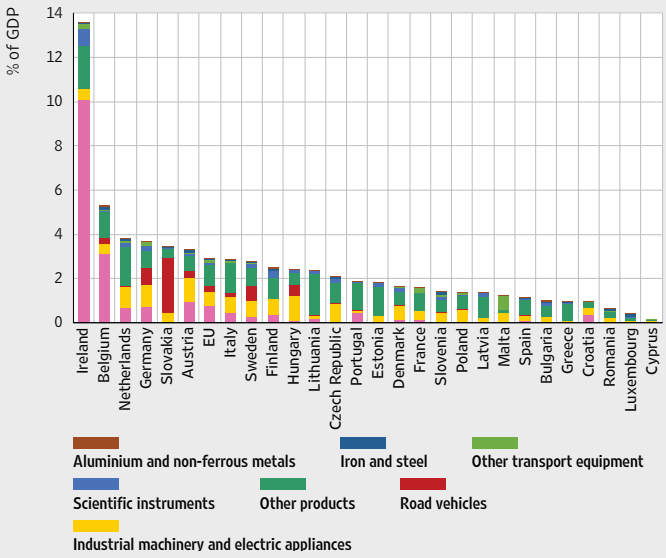
US tariffs could negatively affect the global economy through direct and indirect channels. Directly, they increase the prices of foreign goods on the US market, reducing their competitiveness, which may lead to falling exports, decreasing employment and growth slowdown, particularly in countries that are relatively more exposed to the US market. Indirectly, they lead to the weakening of global demand and increased uncertainty that discourages investment and spending, even in countries that do not depend on the US market. In addition to negatively impacting economic activity, tariffs may also affect global inflation. On the one hand, they increase operating expenses and may trigger consumer price increases, but on the other, weakened global demand may lead to a drop in the prices of energy and raw materials, easing inflationary pressures.

Figure 5 Effective tariff rates on the imports of goods from the European Union to the USA



Notes: On 2 April 2025, a "reciprocal" tariff of 20% was introduced, which exempts strategic goods and products already subject to tariffs. The application of tariffs was deferred for 90 days on 9 April, with a universal rate of 10% in force during the transitional period.
Sources: WITS, Eurostat and CNB calculations.

Figure 6 Exports of goods of EU member states to the USA by type of goods

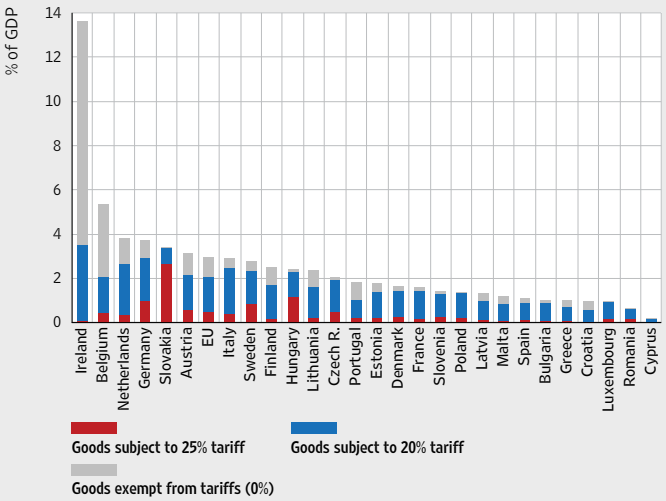


Note: Data refer to 2024.
Source: Eurostat.

As for the European economy, direct effects of tariff increases should not be pronounced due to the relatively small exposure to the US market. Specifically, even though the USA is one of the major trading partners of the European Union, total exports to the USA account for 3% of EU GDP (Figure 6), and, if exemptions of strategic goods are taken into account, tariffs would hit an export value of only 2% of GDP (Figure 7). However, elevated uncertainty and weakened foreign demand could increase the vulnerability of individual firms, particularly those whose exports are mostly tied to the US market (Figure 8). Still, there are positive risks for the growth of the European economy which will mostly depend on the course of negotiations between the US major trading partners. Should tariffs imposed on the EU remain relatively lower than those applied to other countries, its price competitiveness could increase and it could expand its share of the US market.

Risks to inflation in the euro area associated with the trade war are two-fold. In the short term, risks of lower inflation prevail, as a drop in the prices of energy and raw materials, which has partly materialised already, could mitigate pressures associated with growing operating costs of enterprises. Positive inflationary pressures may only be expected should trade negotiations between the USA and the European Union fail. To elaborate, the introduction of European tariffs on US imports could increase the price of certain imported agricultural and food products, alcoholic beverages and motor vehicles. In the medium term, risks of higher inflation prevail due to persistent uncertainty, although the redirection of Chinese exports to Europe could have a deflationary effect, particularly in the event that barriers for the imports of Chinese products on the US market remain very high.

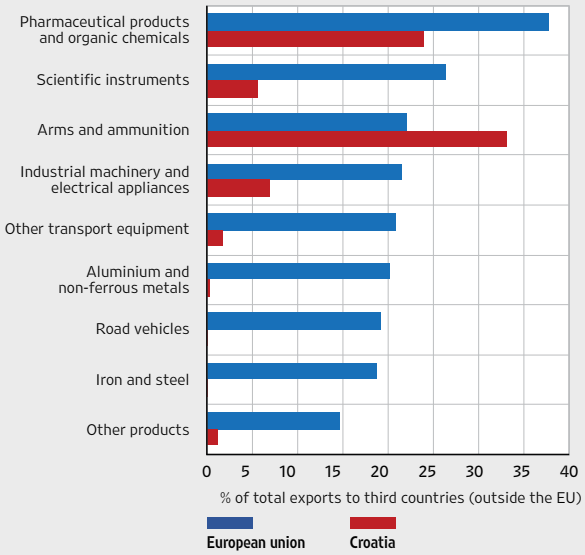
Figure 7 Exports of goods of EU member states to the USA by tariff burden



Notes: The tariff rate of 25% applies to iron, steel and car and auto components. Products exempt from tariffs include pharmaceutical and chemical products, semi-conductors, energy, wood, copper, rare minerals and similar goods. All other products are subject to the "reciprocal" rate of 20%. The figure shows rates announced until mid-May.

Sources: Eurostat, Federal Register and CNB calculations.

Figure 8 US share in total exports outside the EU



Note: Data refer to 2024.

Source: Eurostat.

3.5 Banking system

Corporate and household financing conditions continued to improve in the first four months of 2025. The average interest rates on newly granted loans to non-financial corporations continued the downward trend present since the beginning of 2024 and reached 3.7% in April 2025, down 40 basis points from the end of the previous year and 169 basis points down from the end of 2023, the highest recorded level during the last cycle of increases in key ECB interest rates (Figure 3.5.1). The fall in interest rates on corporate loans mirrors developments in the EURIBOR, given that around a half of all newly granted loans to corporates are linked to this benchmark rate. To a lesser extent the drop also reflects a reduction in the average fixed interest rate used for around one half of new loans to corporates. The fall in market interest rates is also seen in a gradual and small reduction in the average interest rate on existing loans, which stood at 4.0% in April (Figure 3.5.2). With no major changes in the cost of household lending in 2024, in April this year households borrowed at a lower interest rate than at end-2024; the interest rate on new general-purpose cash loans was down 18 basis points (at 5.77%) and that on housing loans was down 92 basis points (2.90%). First a systemically important bank cut the interest rates on housing loans in January and in February and March other systemically important banks followed suit. If compared with its highest level in April 2024, the average interest rate on pure new housing loans in April this year was 99 basis points lower and that on general-purpose cash loans was 50 basis points lower than the highest rate recorded in January 2024.

Figure 3.5.1 Interest rates on pure new loans and corporate and household time deposits

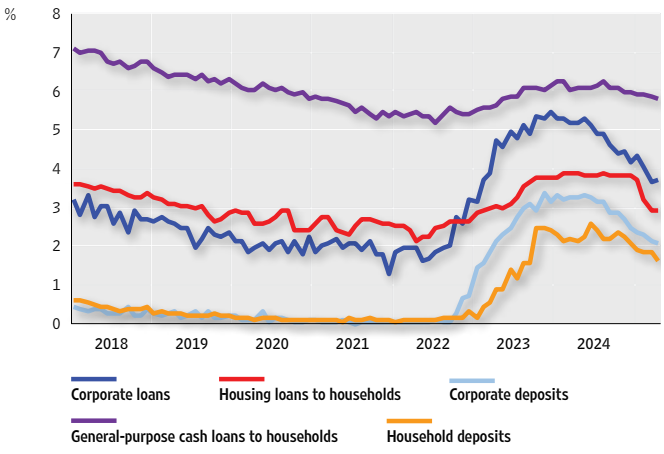
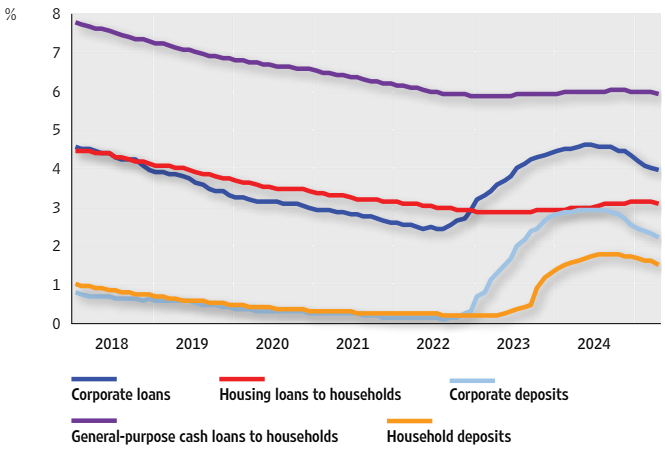


Figure 3.5.2 Interest rates on existing loans and corporate and household time deposits



Notes: Data up to December 2022 refer to loans and deposits in kuna and 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 1 month have been excluded.
Source: CNB.

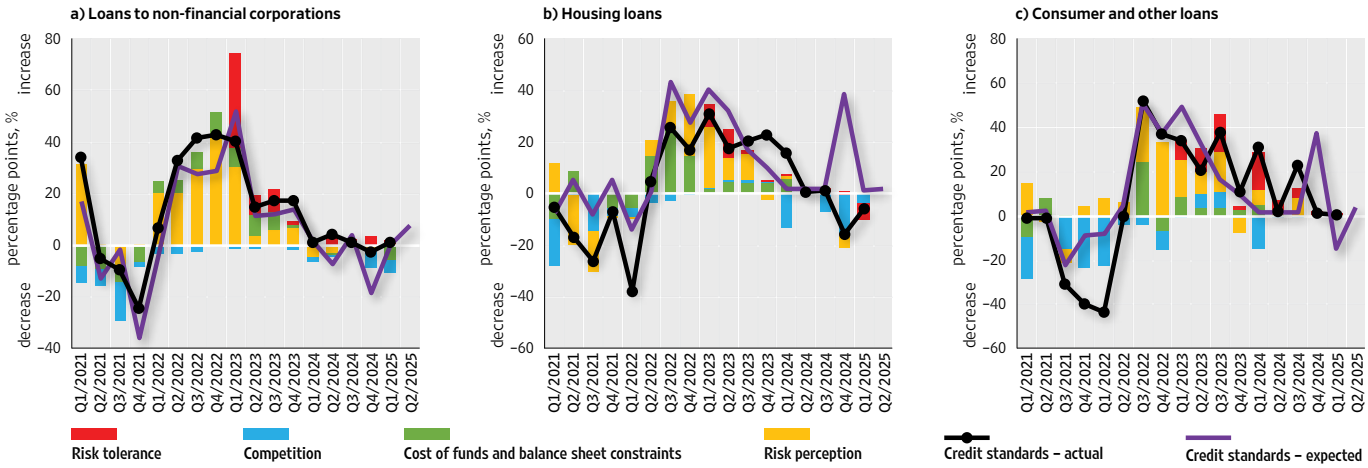
The interest rates on corporate and household time deposits also fell in 2025. Mirroring the fall in market interest rates amid the moderation of monetary policy restrictiveness, the average interest rates on pure new corporate time deposits also continued to trend downwards and stood at 2.1% in April, a decrease of 43 basis points from the end of last year and 130 basis points from their highest level in November 2023 (Figure 3.5.1). At the same time, the interest rate on pure new household time deposits fell to 1.6% in April, after fluctuating around the level of 2.1% to 2.7%

almost throughout 2024, driven mostly by higher interest rates offered by some banks for time deposits and larger amounts of time deposit rollovers.

Bank lending survey results also suggest an easing of corporate and household financing conditions. Higher risk tolerance and growing competition among banks led to an easing of housing lending standards, while the standards for consumer and other household loans did not change much. In the first quarter of 2025, the banks kept the lending standards for corporates unchanged after easing them in the previous year (Figure 3.5.3). In the second quarter of 2025, the banks expect to see a small tightening of lending standards for corporates and for consumer and other loans and minor changes in lending standards for housing loans to households.

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 "Impact of bank competition" and "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.

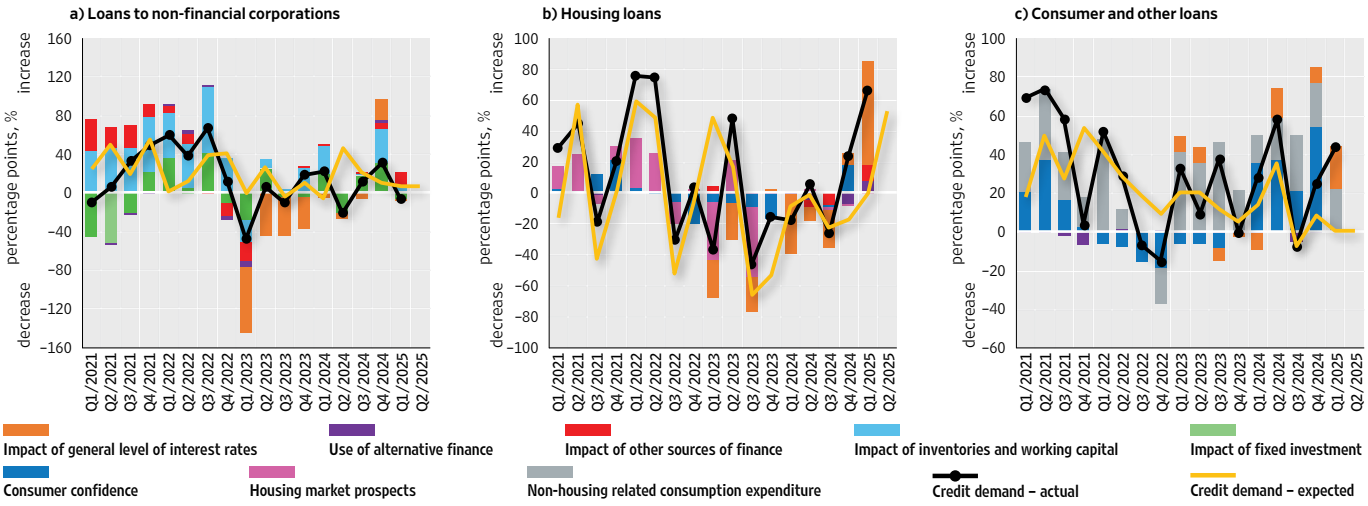
Notes: "Risk tolerance" was introduced in the first quarter of 2023 and reflects a bank's tolerance to risk in its lending policy, which can change depending on changes in the bank's general business strategy. "Cost of funds and balance sheet constraints" are the unweighted average of the "Impact of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

More favourable financing conditions propelled the demand for loans, particularly housing loans. Bank lending survey results for the first quarter of 2025 suggest a growing household demand for loans, mostly driven by lower interest rates (Figure 3.5.4). In addition, the increased demand for consumer and other loans also mirrors greater consumption of durable goods. By contrast, the smaller demand of corporates for investment financing led to a small decline in corporate demand for loans, following an increase in the second half of 2024. In the second quarter of 2025, the banks expect to see a further increase in the demand for housing loans and almost no changes in the demand for consumer and other loans and corporate loans.

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" is 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 "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" is 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.

Corporate and household loans rose sharply in early 2025. In the first four months of 2025, corporate loans rose by EUR 1.0bn, almost equalling their growth in the whole of 2024[12] (Figure 3.5.5). Loans to corporates in the manufacturing sector account for almost a half of that growth and those to corporates in trade and real estate activities also rose considerably. In terms of loan purpose, loans for working capital made the biggest contribution to this growth. On an annual level, the growth in loans to corporates reached 11.9% in April, almost doubling its growth rate at the end of the previous year. Loans to households also rose by EUR 1.0bn during that period, with housing loans and general-purpose cash loans each accounting for almost the same amount (EUR 0.5bn). Growth in household loans accelerated on an annual level from 12.1% in December 2024 to 12.7% in April 2025, owing to a rapid acceleration in the growth of housing loans from 9.1% to 10.7%, while the growth in general-purpose cash loans decelerated from 15.9% to 15.2%. The acceleration in the growth in corporate loans is also suggested by a momentum[13] that reached some 20% in early 2025. The momentum of housing loans held steady at the level of around 10% from mid-last year but accelerated to 13.3% in April 2025. The indicator of short-term dynamics of general-purpose cash loans is also strong (17.2% in April), however it is still below the indicator's value of 20% in 2024 (Figure 3.5.6).

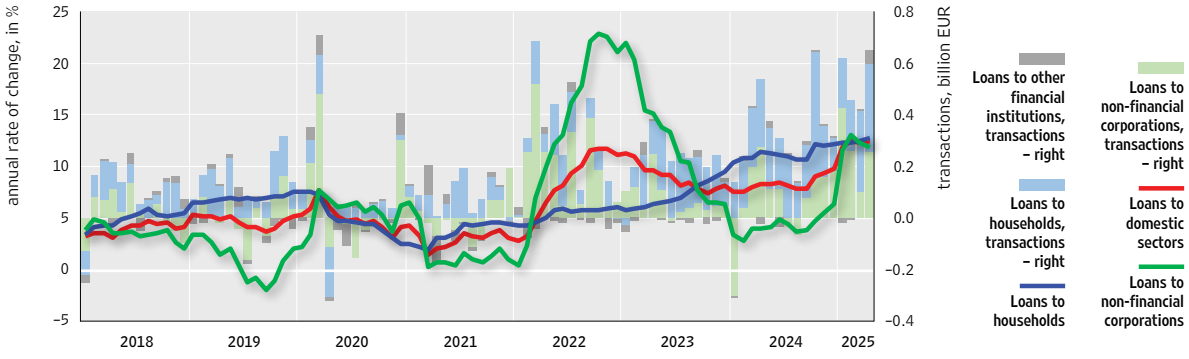
12 A syndicated loan of a large enterprise was paid off in January 2024 (paid by the Government of the Republic of Croatia), in the amount of EUR 0.3bn and in January 2025 a syndicated loan of EUR 0.3bn was paid to a large enterprise.

13 Momentum is a short-term indicator of lending activity which shows annualised three months-on-three months rates of change in loans.

Figure 3.5.5 Loans

transactions and annual rates of change

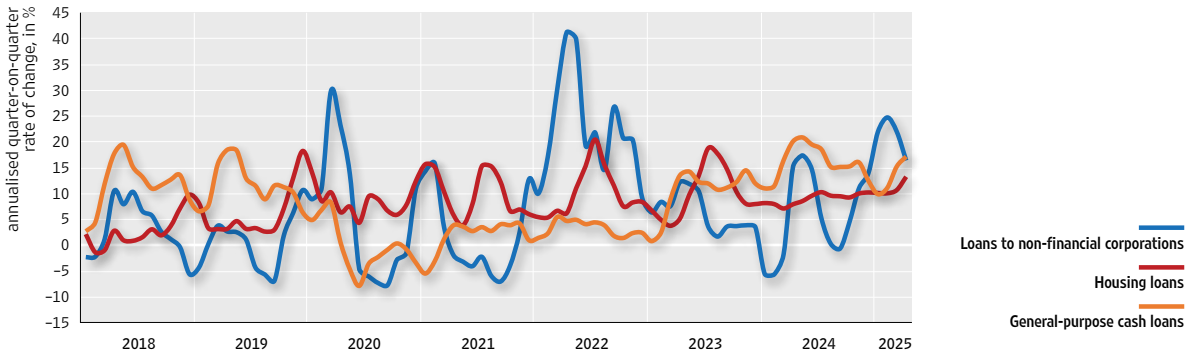
transaction-based



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

Figure 3.5.6 Lending momentum, corporates and households

transaction-based

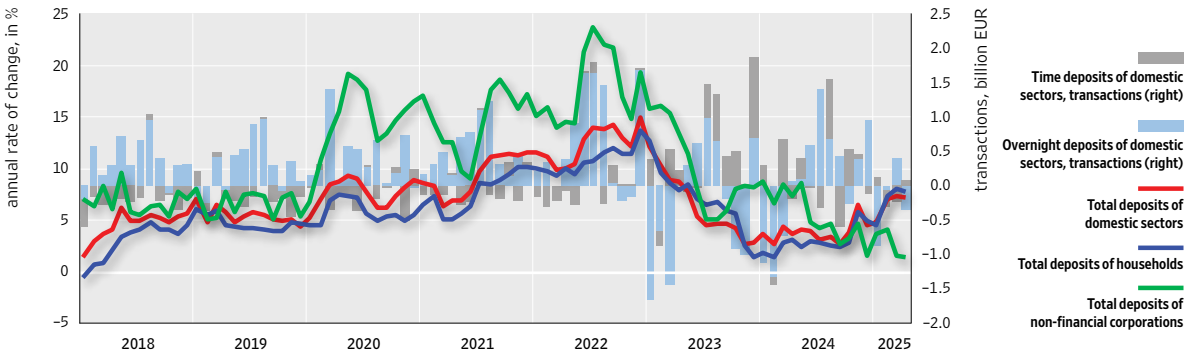


Sources: CNB and CNB calculations.

Total deposits of domestic sectors (general government excluded) fell by EUR 1.1bn in the first four months of 2025. The fall in deposits was due to a fall in net foreign assets of monetary institutions, while the claims from domestic sectors rose. As regards the structure of total deposits, overnight deposits rose by EUR 0.9bn, reflecting a steep fall in deposits of non-financial corporations (EUR 1.7bn), while households increased their overnight deposits by EUR 0.8bn (Figure 3.5.7). Time deposits also fell (EUR 0.2bn), mirroring the fall in household time deposits (EUR 0.3bn). Thus the share of household time deposits in total deposits continued to fall steadily, while the share of corporate time deposits in total deposits remained relatively stable with minor fluctuations at levels slightly below 30% (Figure 3.5.8).

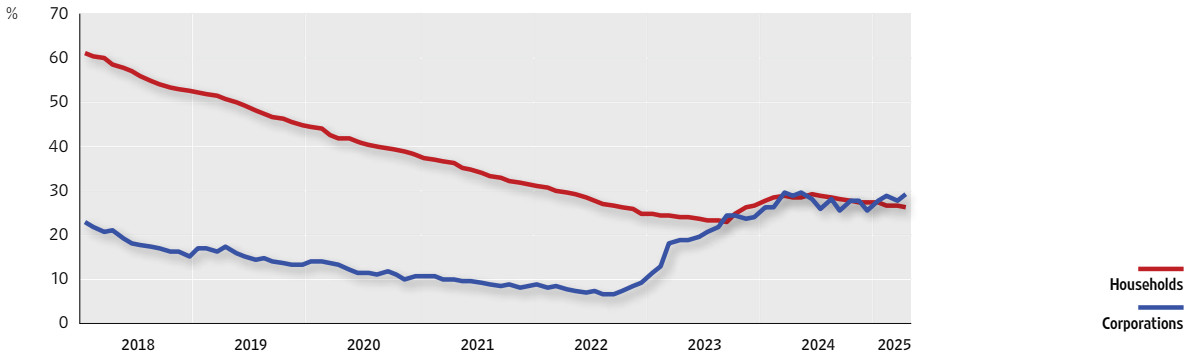
Figure 3.5.7 Deposits

transactions and annual rates of change, transaction-based



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 3

Survey on the access to finance of small and medium-sized enterprises

According to the results of the fourth round of the survey on the access to finance of small and medium-sized enterprises, regulations remain the key obstacle to doing business; however their importance is decreasing from the previous rounds of the survey while there has been an increase in the number of companies faced with the problems of production costs, the labour force and the availability of skilled staff or experienced managers. In contrast, companies again rarely cited access to financing as a frequent obstacle to doing business. They continue to rely on deferred payments and leasing to finance their business with less than one third of the companies in the survey relying on bank loans, which is a small decline from the previous rounds of the survey. The companies quote sufficient own funds and the availability of other external sources of financing as the main reasons for not using loans. However, in 2024 full loan amounts were granted more frequently than in the previous survey rounds. Companies stress the importance of improved business environment, tax reliefs and more flexible labour legislation for the future of their business operations. Companies expect labour costs and the costs of raw materials, materials and energy, the demand for products and services and the expected inflation to have the biggest impact on changes in their retail prices in 2025.

For some ten years, the CNB has been conducting a special survey to examine the specific challenges to doing business faced by small and medium-sized enterprises, particularly the challenges related to financing. Small and medium-sized enterprises are an important segment of European economies (European Commission, 2023[14]), providing new jobs and promoting the dynamics of the economy. The same applies to Croatia where small and medium-sized enterprises account for 99% of all non-financial corporations, employing around 70% of the total number of employees in non-financial corporations[15] and generating around 70% of value added in the economy. These companies face specific challenges, which tend to be much more complex than those faced by large firms. For a better understanding of the conditions under which they do business, particularly the challenges in financing, since 2016 the CNB has been conducting a survey on the access to finance of small and medium-sized enterprises. In the second half of 2024[16], the fourth round[17] of the survey was conducted on a sample of 1 775 companies, 82% small, 8% medium-sized and 10% large enterprises, serving as a control group.

14 European Commission (2023): Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, SME Relief Package, Strasbourg, 12. 9. 2023, COM(2023) 535 final

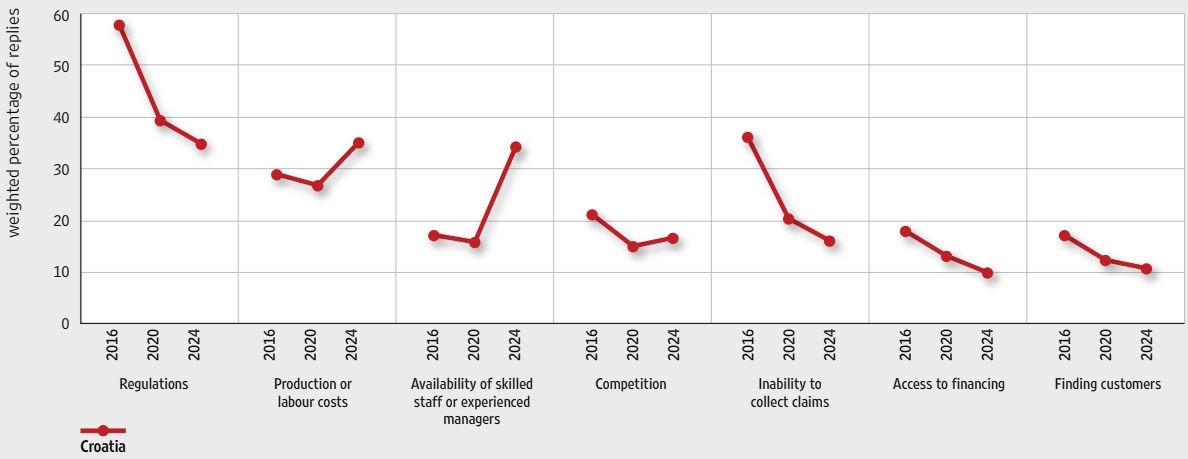
15 Based on the report of the Financial Agency on the financial results of Croatian entrepreneurs in 2023 by entrepreneur size https://www.fina.hr/ngsite/content/download/15082/238959/1.

16 The survey was conducted from September to November 2024; questions on past developments refer to 2024 and those on expected developments to 2025.

17 The first round of the survey was conducted in 2015 as a pilot project, the second in 2017 (questions on past developments refer to 2016 and those on expected developments to 2017), and the third round was conducted in 2021 (questions on past developments refer to 2020 and those on expected developments to 2021).

The unfavourable institutional and business environment, in particular complex regulations and the frequent changes to them (Figure 1), was singled out by small and medium-sized enterprises as the biggest obstacle to doing business. However, these factors lost some of the significance they had in the last round when a considerably larger number of companies identified production or labour costs and the availability of skilled staff or experienced managers as the main obstacles hindering their business operations. In 2020, some 16% of small and medium-sized enterprises identified the absence of skilled staff or experienced managers as a large hindrance to doing business in contrast with the most recent survey round when this percentage more than doubled. In contrast, access to financing and finding customers were the least commonly listed hindrances to doing business. Only 10% of companies gave these factors as a significant obstacle, a decrease of one half from 2016.

Figure 1 Obstacles largely affecting business operations of small and medium-sized enterprises in Croatia



Note: Regulations are the average of the problems of doing business defined as "regulations – complexity and lack of mutual coordination" and "regulations – frequency of change".
Source: Survey on the access to finance of small and medium-sized enterprises, CNB and Ipsos.

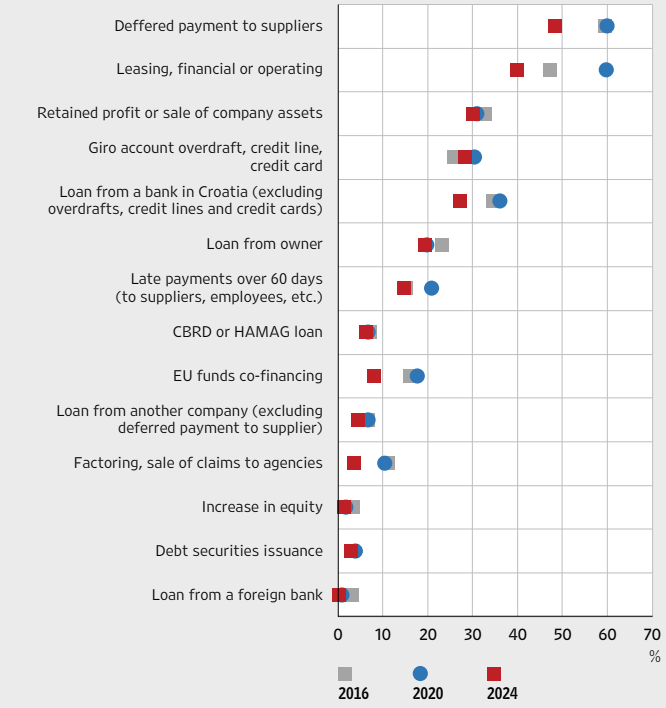
Small and medium-sized enterprises mostly continue to rely on deferred payment up to 60 days to suppliers (almost one half of them) and leasing[18] (around 40%), however, less than reported under previous survey rounds (Figure 2). Retained earnings or sale of enterprise assets were reported by some 30% of companies as the source of financing in all three survey rounds. Bank loans lost in importance in 2024, being used by 28% of small and medium-sized enterprises, down by some 10 percentage points from 2016 and 2020. In 2024, companies relied less on financing from the EU funds and factoring and sale of claims to agencies.

The enterprises that did not use domestic bank loans mostly signalled that they did not need a loan because they either had sufficient own funds or had access to other external sources of financing (Figure 3). Sufficient own funds thus remained the main reason for not using bank loans for over 60% of companies in 2024, with this percentage steadily rising since 2016.

18 Although the share of enterprises using leasing was larger than the share of those using loans, the total amount of bank financing was considerably higher. Towards the end of 2024, the total amount of financial and operating leases extended by leasing companies to non-financial corporations stood at EUR 2.7bn and bank placements at EUR 15.9bn, with micro, small and medium-sized enterprises accounting for EUR 9.1bn.

Conversely, the number of companies citing the availability of other external sources of financing as the main reason for not using loans has fallen. In 2024, the number of companies that found loan collateral requirements unacceptable and those whose loan applications were rejected, formally or informally, decreased from the previous survey rounds.

Figure 2 Which of the following sources did you use to finance your operations?



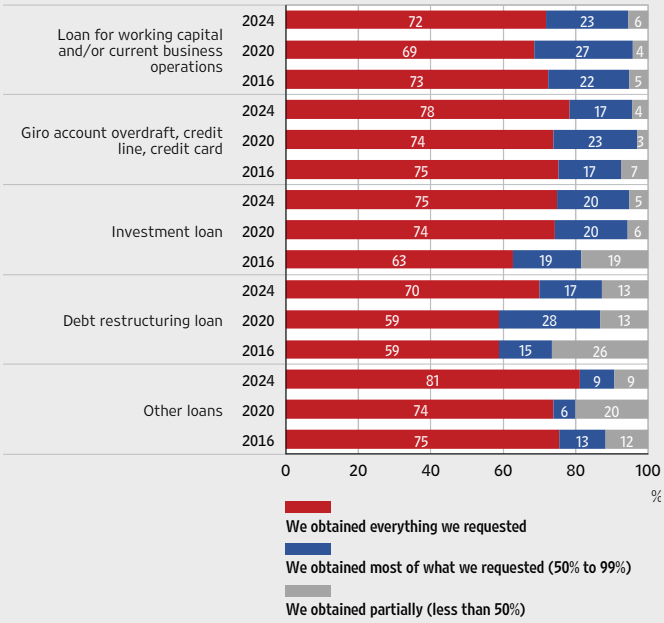
Source: Survey on the access to finance of small and medium-sized enterprises, CNB and Ipsos.

Figure 3 Reasons for not using domestic bank loans

Source: Survey on the access to finance of small and medium-sized enterprises, CNB and Ipsos.

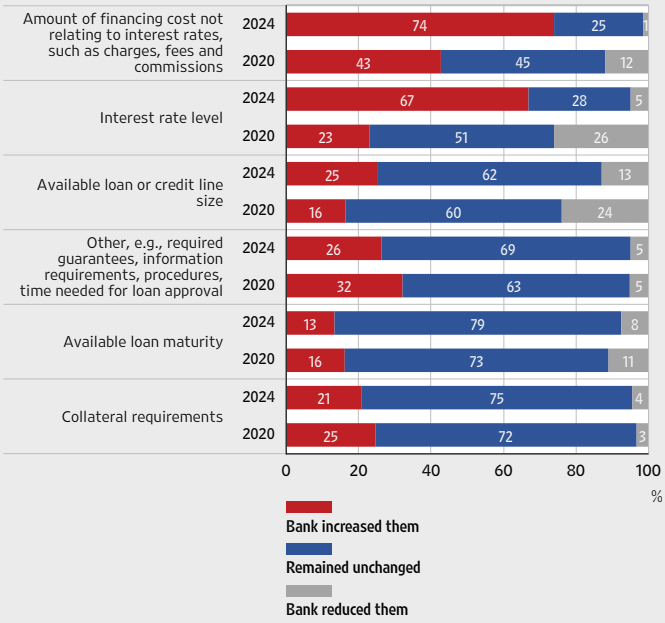
Although the companies surveyed reported a worsening of financing conditions, there was an increase in the number of companies that had been granted loans in the amounts requested from the previous survey rounds, with the number of companies that received the full amount requested increasing and the number of companies that received most of the amount requested decreasing (Figure 4). Small and medium-sized enterprises reported a worsening of the conditions of bank financing, almost equally as regards the interest rate level and the cost of financing relating to charges, fees and commissions (Figure 5). Compared with the previous survey round, there was a visible difference in responses by companies on changes in financing costs. The improvement in the amounts of loans granted in full in 2024 from 2020 and 2016 involved debt restructuring loans, particularly in small enterprises.

Figure 4 Can you provide an estimate as to how much of the requested funds you actually obtained in 2024?



Source: Survey on the access to finance of small and medium-sized enterprises, CNB and Ipsos.

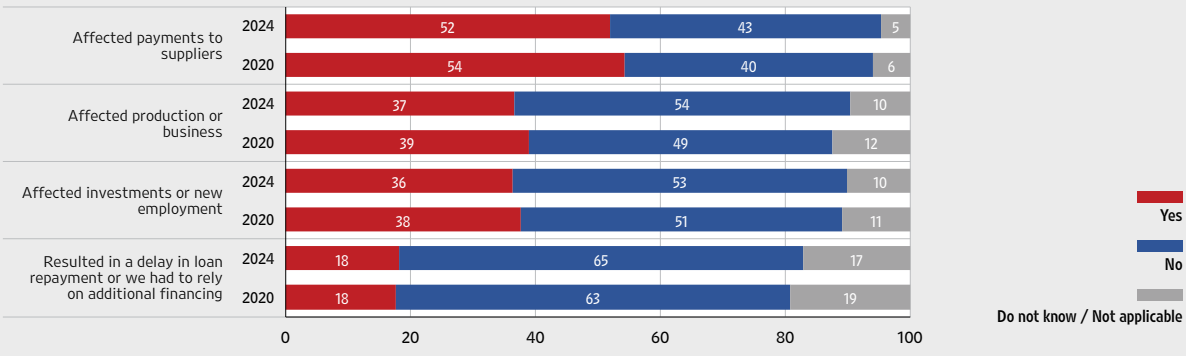
Figure 5 How did the terms and conditions of bank financing change in 2024?



Source: Survey on the access to finance of small and medium-sized enterprises, CNB and Ipsos.

Late payments continue to be a relatively common problem for companies although their frequency decreased slightly from the previous survey rounds. Around 30% of companies have listed late payments by public entities as troublesome, with the percentage increasing to approximately 50% with respect to late payments by private companies. Late payments affect the business operations of companies; the most frequently reported problem stemming from late payments was that of their effect on payments to suppliers (Figure 6). Small enterprises found it harder to deal with the effects of late payments as they affect their production and operations, investment and new employment more than they affect medium-sized enterprises. However, in 2024, the share of companies faced with problems due to late payments was slightly smaller than in 2020.

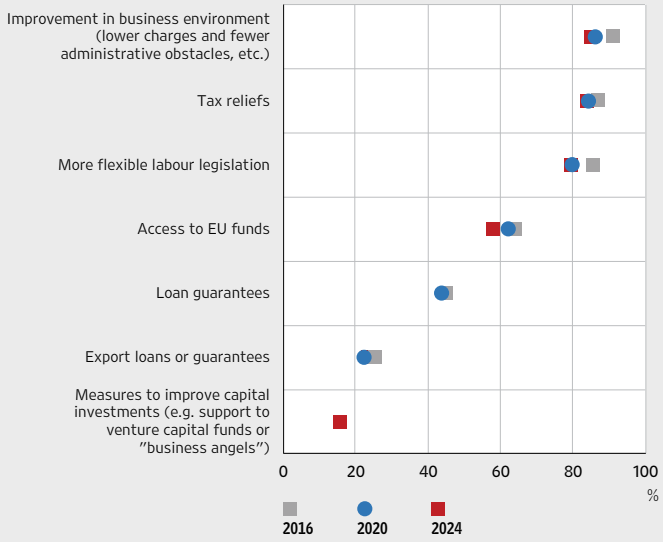
Figure 6 What were the consequences of late payments?



Note: This question was first introduced in the 2021 survey questionnaire.
Source: Survey on the access to finance of small and medium-sized enterprises, CNB and Ipsos.

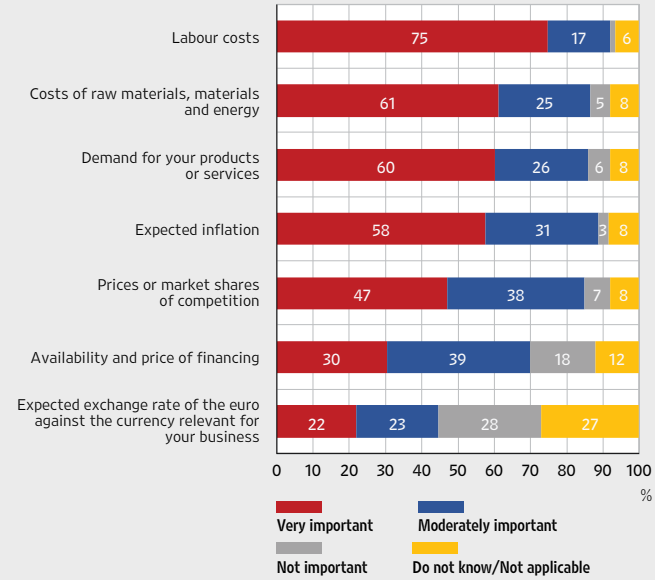
More than 80% of small and medium-sized enterprises find the improvement in the business environment, tax reliefs and a more flexible labour legislation important for doing business in the future (Figure 7). There were generally no changes in what small and medium-sized enterprises perceived to be important for future operations from the previous survey round. The importance of access to EU funds was found to be slightly less important for both small and medium-sized enterprises, while the share of medium-sized enterprises that find bank guarantees important rose from the previous survey round.

Figure 7 Factors important for future business operations



Source: Survey on the access to finance of small and medium-sized enterprises, CNB and Ipsos.

Figure 8 How do you estimate the importance of the following factors for the determination of your retail prices or their change in 2025?



Note: This question was first introduced in the 2024 survey questionnaire.
Source: Survey on the access to finance of small and medium-sized enterprises, CNB and Ipsos.

The companies surveyed stressed the importance of labour costs for their price policy. The question about the importance of the factors that will determine or affect the changes in their retail prices in 2025 was introduced in the last round of the survey. Small and medium-sized enterprises found these factors equally important, but gave the highest ranking to labour costs and the costs of raw materials, materials and energy, followed by the demand for products/services and the expected inflation. Ranked as least important were the expected exchange rate of the euro and the availability and price of financing (Figure 8).

Lack of qualified labour was reported as a major challenge for companies in the euro area[19] with around one third of companies stating the lack of skilled staff or experienced managers as the biggest obstacle to doing business in 2024. The number of companies affected by this challenge rose in 2024 from 2020 and 2016 when finding customers was reported as the biggest obstacle. In contrast, access to finance remains the least common obstacle. As regards the sources

19 Based on the results of the survey conducted twice a year by the European Central Bank and the European Commission. More precisely, the survey is conducted once a year by the ECB covering euro area countries, and once in cooperation with the European Commission covering all EU countries plus some neighbouring countries.

of financing, companies in the euro area most often relied on giro account overdrafts, credit lines or credit cards, leasing or hire purchase and own funds from retained earnings or sale of assets. The most frequent reply provided by companies to the question of why they did not use bank loans in the past and were not planning to use them in the future was that they did not need this type of financing. A little over two-thirds of companies that applied for a bank loan were granted either the full or most of the amount requested. Late payments were less frequent than in Croatia so there were also fewer consequences. In about one-third of companies late payments impacted payments to suppliers and in about one-fifth of companies they affected investments or new employment and production or business activities.

4 Projections for Croatia

4.1 Baseline assumptions

The CNB June projection is based on noticeably worsened expectations for the global economy amid increased trade tensions and growing uncertainty.[20] The heightened uncertainty regarding the trade policy of the US administration and the potential retaliatory measures of other countries negatively affected economic sentiment and slowed down economic growth right at the beginning of the year. As US trade policy tightening is expected to be detrimental to the global economy, particularly in the short term, the outlook for global economic growth (excluding the euro area) has been reduced by 0.3 p. p. for 2025 and 2026. Expectations have worsened the most for the USA, and as a result of tariffs, the expected growth in global trade was noticeably revised downwards, which will have negative implications for foreign demand for the imports of goods and services from the euro area, Croatia included.

Prices of energy and raw materials have been revised downwards, mainly due to the lower-than-expected performance in the past two months and the expected weakening of global demand. According to market expectations, crude oil prices could range around USD 67 per barrel in 2025, which is a decrease of USD 8 per barrel (around 10%) from the March projection and considerably lower than the average level in 2024, when prices mostly hovered above USD 80 per barrel. Prices of electricity and natural gas in 2025 are expected to be some 20% lower than anticipated in the previous projection and according to forward agreements, they are expected to continue to decline by the end of the projection horizon. Furthermore, a more favourable path of prices of other raw materials is also expected, as their further increase is limited by weak foreign demand amid heightened uncertainty.

Expectations about euro area economic growth remained almost unchanged from the March projection, while inflation in 2025 and 2026 was revised downwards. Economic growth in the euro area is estimated to come to 0.9% in 2025, as expected in the previous projection, while the estimate for 2026 has been reduced to 1.1%. The unchanged projection for 2025 is a result of the combined effects of a positive pass-through of stronger-than-expected growth in the first quarter of 2025, accompanied by an expected slowdown in growth in the rest of the year in an environment of effective tariff rates higher than in the period before trade tensions escalated and uncertainty rose. In 2026 and 2027, higher fiscal spending on defence and infrastructure is expected to largely mitigate the negative effects of higher tariffs and rising uncertainty. Projected euro area real GDP growth has been therefore revised only slightly downwards for 2026, while for 2027, it has remained the same as before. In the current and the upcoming year, inflation could be somewhat lower than earlier anticipated due to the decline in energy prices and the appreciation of the euro exchange rate and could fall below the target temporarily. Risks to economic growth and inflation stem mostly from the uncertainty surrounding the level and the related effects of tariffs; the risks are estimated to be slightly negative with regard to economic growth and balanced with regard to inflation.

20 The external and technical assumptions of the projection were taken over from the ECB and finalised on 16 May 2025.

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	2027	2024	2025	2026	2027
International environment									
Global economic growth (excl. EA)		3.6	3.1	2.9	3.2	0.1	−0.3	−0.3	0.0
USA		2.8	1.4	1.4	2.1	0.0	−0.8	−0.3	0.4
China		5.0	4.3	3.4	3.6	−0.1	−0.3	−0.3	−0.1
Global trade		4.2	3.1	1.7	3.1	−0.2	−0.4	−1.4	0.0
Foreign demand (EA)		3.5	2.8	1.7	3.1	0.1	−0.4	−1.4	0.0
Foreign demand (HR)		1.3	2.0	2.5	3.2	0.2	−0.7	−0.9	0.0
Prices of raw materials									
Prices of oil	USD	82.0	66.7	62.8	64.2	0.0	−8.0	−7.4	−4.5
Prices of electricity	EUR/MWh	77.7	82.3	77.5	71.8	0.0	−18.3	−8.7	−4.0
Prices of gas	EUR/MWh	34.4	38.0	33.2	29.3	0.0	−12.3	−7.1	−2.4
Prices of raw materials (excl. energy) % of change	USD	9.2	6.8	−0.4	0.6	0.0	−5.2	0.9	3.4
prices of food raw materials	USD	17.7	13.9	−5.2	−3.2	0.0	−12.1	3.3	7.6
prices of other raw materials	USD	3.7	1.5	3.3	3.5	0.0	−0.3	−1.1	0.0
Euro area									
Economic growth		0.8	0.9	1.1	1.3	0.0	0.0	−0.1	0.0
Inflation		2.4	2.0	1.6	2.0	0.0	−0.3	−0.3	0.0

Note: Projection assumptions refer to the ECB June projection cycle (June 2025 BMPE) as at 16 May 2025.
Source: ECB.

As regards assumptions related to the application of tariffs, the projection assumes that the US administration will not impose "reciprocal" tariffs, but rather that the lower universal tariffs currently in force will continue to apply. The current macroeconomic projection incorporates tariffs of 10% for all US partner countries, including the EU, with the exception of China, and tariffs applied before 2 April this year. It is assumed that the 10% universal tariff will remain in force even after the expiry of the 90-day deferral of reciprocal tariffs for individual countries and that the EU will not introduce countermeasures. As for the trade between the USA and China, the easing of trade tensions and the reduction of effective tariffs are expected, in line with the agreement reached in May.

4.2 Macroeconomic variable projections

Real GDP could continue to grow at relatively high rates, albeit somewhat lower than the very high rates reached in 2024. The negative effects of geopolitical tensions and increased US tariffs on EU products should not have any very significant impact on the Croatian economy if tariffs remain at their current low level. Croatia's relatively low exposure to the US market (see Box 2 Trade relations between the European Union and the USA and the possible impact of the new US trade policy on the European Economy) limits the negative impact of tariffs on exports. Thus, despite the US introducing tariffs on European exports, it is expected that external demand will exceed that of last year, which should be supported by further strengthening of the exports of goods and services. The high level of uncertainty could partly result in an increase in household savings and postponement of business investments with the contribution of domestic demand to growth gradually weakening. Nevertheless, it is expected that the robust labour market, inflows

from EU funds and the decline in financing costs will continue to support a relatively strong growth of domestic demand.

Table 4.2.1 Key macroeconomic variable projections

annual growth rates

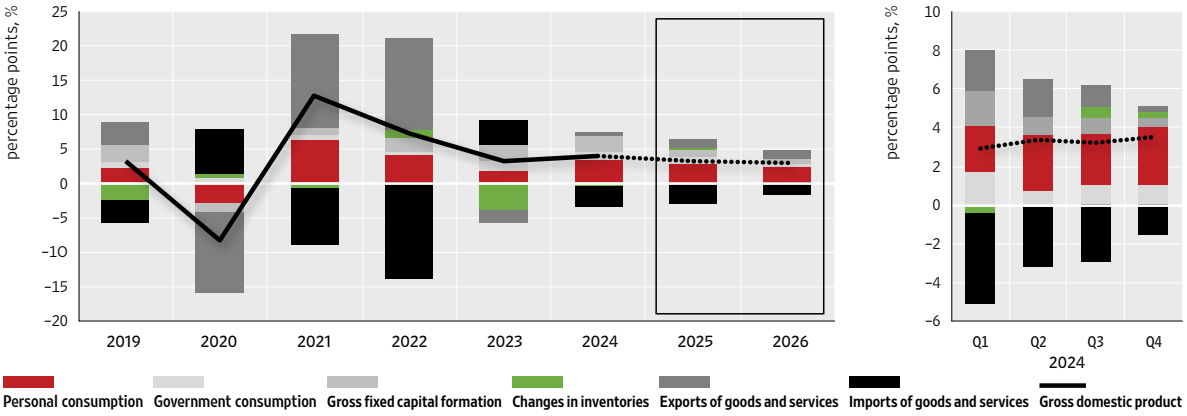
	2024	2025	2026
Real GDP	**3.9**	**3.3**	**2.9**
Personal consumption	5.8	4.9	4.0
Government consumption	7.0	4.9	2.7
Capital investments	9.9	4.2	3.0
Exports of goods and services	0.9	2.6	2.2
Imports of goods and services	5.3	5.7	3.4
Contributions to GDP growth[1]			
Domestic demand	6.9	4.9	3.7
Exports of goods and services	0.5	1.3	1.1
Imports of goods and services	–2.9	–3.0	–1.8
Inventories	–0.5	0.7	0.0
Labour market			
Change in employment	3.3	2.8	1.8
Unemployment rate (ILO)[2]	5.1	4.7	4.5
Nominal gross wage	15.0	9.5	5.7
Real gross wage	11.4	6.5	3.4
Inflation (HICP)			
Total	**4.0**	**3.6**	**2.6**
HICP excl. energy and food	4.8	3.6	2.8
Food	4.4	4.0	2.3
Energy	–0.3	2.9	2.2
Inflation (IPC)	**3.0**	**2.8**	**2.2**

[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 increase by 3.3% in 2025, having risen by 3.9% in the previous year. Private consumption growth could slow down slightly amid the gradual slowdown in the growth of employment and wages. However, it will continue to contribute strongly to growth given the still increased rise in real disposable income amid the slowdown in inflation. It is expected that heightened uncertainty might prompt consumers to caution, thus increasing the savings ratio. Other components of domestic demand are also expected to grow, even if at a lower intensity than in 2024. The investment growth might decrease by more than a half, after, on average, having registered two-digit growth rates in the past three years. This goes primarily for private investments, while public investments might gain momentum given the expected more intensive utilisation of the funds under the current financial envelope and the Resilience and Sustainability Trust. The recovery in foreign demand might result in further growth of goods imports, with the direct impact of the decrease in Croatia's exports of goods to the US market and the indirect effects of

weaker exports of its main foreign trade partners being assessed as relatively minor. In addition, real exports of services are also expected to grow, following last year's fall, although this growth could be relatively subdued given the already high activity levels reached in tourism and worsened price competitiveness. With imports expected to grow much stronger than exports due to relatively strong domestic demand, net exports could make a negative contribution to growth in 2025.

Figure 4.2.1 GDP and GDP components, contributions



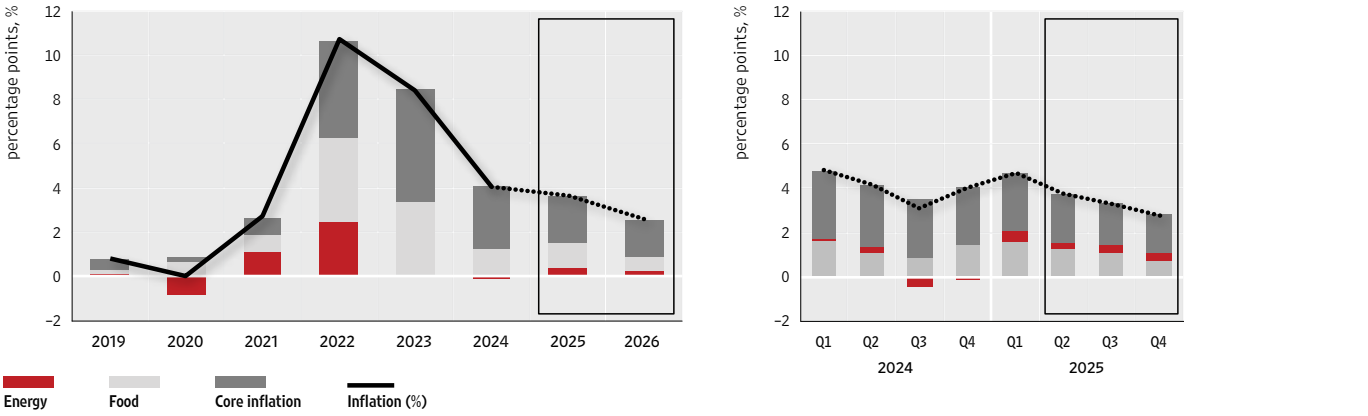
Sources: CBS and CNB estimations and projections.

Economic activity is still expected to grow relatively strongly in 2026, at some 3.0%. The growth in 2026 might be spurred by further strengthening of foreign demand, favourable financing conditions and a still strong inflow of funds from EU funds. The growth of real wages could remain relatively strong, thus supporting the growth of private consumption. However, the dynamics of growth of real disposable income could slow down further. The expected slowdown is partly also a consequence of the structural limitations of the Croatian economy, especially in the sense of labour supply and output growth.

Risks to real GDP growth are assessed as slightly negative. Due to heightened geopolitical tensions and the prospect of their further escalation, global economic activity might be weaker than expected. The possibility of additional protectionist measures being introduced by the US administration on top of those already envisaged under the baseline scenario, as well as the possibility of EU trade retaliation might negatively impact Croatian exports, primarily through decreased demand from Croatia's major trading partners. On the other hand, if it comes to de-escalation of geopolitical tensions and the introduction of tariffs that are lower than envisaged under the baseline scenario or their complete elimination according to the proposal by the European Commission ("zero-for-zero"), external demand developments could be better than expected and favourably affect goods exports and real growth. In addition, the likely EU-wide increase in military expenditures aimed at strengthening security and raising defence capabilities, reducing the strategic dependence on the US, might constitute a positive risk on government consumption and GDP growth (see Box 4 EU defence spending and potential macroeconomic impacts of increased defence spending).

The average annual rate of inflation (measured by the harmonised index of consumer prices) might slow down to 3.6% in 2025, from the 4.0% recorded in 2024 (Figure 4.2.2). The expected slowdown in overall inflation for the third year in succession could result from the decline in core inflation and food inflation amid low supply-side inflationary pressures and the realised and expected further easing of demand-side pressures. In addition, it is also expected that new macroprudential measures of the CNB will contribute to the reduction in inflationary pressures in Croatia by additionally curbing the financing of household consumption through loans. Inflation is expected to continue to decelerate in 2026, when it could decrease to 2.6%, as a result of the slowdown in the inflation of the prices of all its main components.

Figure 4.2.2 Projection of harmonised index of consumer prices



Sources: Eurostat and CNB estimations and projections.

Core inflation (which excludes energy and food prices) could slow down to 3.6% in 2025, from 4.8% in 2024. After the increase at the beginning of 2025, which may partially be attributed to a one-off annual adjustment of prices in the services sector, which are usually based on past inflation or a rise in costs, especially labour costs, core inflation is expected to gradually decelerate in the remainder of the year due to the slowdown in the services inflation. The slowdown in price inflation projected is under the influence of an expected slowdown in the growth of wages, one of the largest expenses in service activities, of the expected slowdown in personal consumption and subdued growth of foreign demand for tourism-related services. In addition, the prices of tourism-related services, which make up a considerable share of total services, neared the euro area average during the period of high inflation, which limits the room for their further growth, especially amid conditions of weak overall inflationary pressures. At the same time, industrial goods inflation, the second component of core inflation, might stay below 1% throughout 2025. These expectations are based on low inflationary pressures, primarily low annual rates of change in producer and imported goods in the segment of intermediary and consumer goods.

Although to a lesser extent, another factor contributing to the overall inflation slowdown in 2025 could be food inflation decreasing to 4.0% from 4.4% in 2024. The expected slowdown in food price inflation reflects a significant fall in the prices of energy products and other raw materials (notably cocoa and sugar, but also cereals and oil, for example), which has gradually been spilling over to food prices, as well as favourable base effects. Nevertheless, due to elevated

inflation at the beginning of the year and the transfer from 2024 to 2025 might render the slowdown of average annual food price inflation appear less prominent compared with the reduction achieved during the year. Food price inflation in December 2025, then, might be substantially lower than at the end of 2024.

In contrast to other major components of inflation, energy price inflation might accelerate to 2.9% in 2025 from –0.3% in 2024. Although the most price increases, of approximately 10% in the sub-components of gas, electricity and heat, came into effect in October and November their effect will be predominantly reflected in the annual energy price inflation in 2025. The energy price inflation might thus be higher than in the previous year for the most part of the year, despite its significant decline in March and April, which reflected the decrease in the price of refined petroleum products associated with the noticeable decline in the prices of crude oil in the global market and the strengthening of the euro against the US dollar. If global crude oil prices remain relatively stable until the end of the year, as currently expected, energy price inflation could be approximately the same in December 2025 as in May.

Inflation might slow down additionally in 2026, to 2.6%. The slowdown in inflation in 2026 might come as a result of the slowdown in the inflation of all major components amid low inflationary pressures, with the expected impact of trade tensions on inflation being predominantly neutral.

The average annual rate of inflation, measured by the national consumer price index (CPI), could also slow down, from 3.0% in 2024 to 2.8% in 2025, and even further to 2.2% in 2026. The expected slowdown in the CPI, which excludes consumption by foreign tourists and institutional households, thus providing a clearer picture of inflation for residents, could result from a decrease in the average annual rate of core inflation and food price inflation. On the other hand, the average annual energy inflation rate in 2025 is expected to be higher than in 2024. Inflation measured by CPI is expected to slow down further in 2026, to 2.2%.

Risks to the projected inflation remain balanced, but pronounced. On one hand, inflation could go down in the event of a stronger than expected spillover of the recent fall in energy prices to other inflation components through secondary effects. In addition, additional exchange rate appreciation might diminish imported inflationary pressures. Inflation could also be lower if economic growth, due to the strengthening of trade tensions and thus the associated weakening of foreign demand, comes in lower than expected and if Chinese exports of goods are redirected towards the EU. On the other, retaliatory measures by the EU and higher tariffs on imports from the US might push in the opposite direction. In addition, inflation might be higher than expected if there is a stronger rise in wages than currently expected, especially amid a robust and tight labour market. Such developments might result in stronger and more persistent upward pressures on price growth, primarily in the services sector where labour costs account for the bulk of total expenses. Higher inflation could also potentially be fuelled by the situation in which companies faced with rising labour costs stop absorbing a share of this pressure at the expense of their own profit and transfer the cost entirely to consumers through higher prices. Additional inflationary risks arise from geopolitical tensions which could disturb the supply of energy and other raw materials in the global markets thus spurring the growth of energy and food prices. Possible

unfavourable weather also poses a risk for higher food price inflation, with higher defence spending than currently expected also potentially contributing to higher inflation.

Compared to the CNB March projection, Croatia's real GDP growth in the current year has been revised slightly upwards (Table 4.2.2) primarily due to stronger government consumption than earlier expected, reflecting higher intermediate consumption and growth of public sector employment. In addition, private consumption is also expected to be slightly up owing to stronger growth of disposable income early in the year than previously expected. In line with results in the first three months, the overall exports and imports might grow more strongly than under previous projections, with net foreign demand expected to provide a higher negative contribution. The 2026 growth has been revised slightly downwards, primarily due to a more pronounced unfavourable impact of trade tensions on investments and exports of goods.

Table 4.2.2 Deviations from the CNB projection of March 2025

	2024	2025	2026
Real GDP			
June 2025	3.9	3.3	2.9
March 2025	3.8	3.2	3.0
Difference (p. p.)	0.1	0.1	−0.1
Inflation (HICP)			
June 2025	4.0	3.6	2.6
March 2025	4.0	3.7	2.6
Difference (p. p.)		−0.1	0.0
Inflation (CPI)			
June 2025	3.0	2.8	2.2
March 2025	3.0	2.9	2.2
Difference (p. p.)		−0.1	−0.1

Sources: CBS, Eurostat and CNB estimations and projections.

In comparison to the previous projections of March 2025, the average annual rate of HICP inflation could come in 0.1 percentage points lower in 2025, while the projection for 2026 remains unchanged. The revision reflects lower-than-expected fuel outturn in March and April, which resulted in the substantial downward revision of the energy price inflation. Nevertheless, this was mostly offset by the higher expected core inflation due to higher-than-expected services price inflation. The projections for 2026 headline inflation remain the same, with negligible changes in different inflation components.

BOX 4

EU defence spending and potential macroeconomic impacts of increased defence spending

In the light of heightened geopolitical tensions and aiming to reduce dependence on US defence capacities, the European Commission proposed a series of measures to spur investments in the defence capacities of member states. The proposed measures are directed primarily at addressing the shortfall in defence capacities, supporting joint procurement, simplifying regulations and strengthening the defence industry, innovations and strategic partnerships. In order to enable higher national defence investments, member states will be granted the option to activate the fiscal escape clause, amounting to 1.5% of GDP. The empirical literature does not arrive at any clear conclusions on the macroeconomic impacts of increased defence spending. The impacts of higher spending on economic activities are highly uncertain and depend on a series of factors, including the volume and structure of spending, the degree of import dependence, how the spending is to be financed and the utilisation of production capacities. Higher investments in defence may have favourable long-term impacts on economic growth through spillovers to other sectors and growth of total factor productivity.

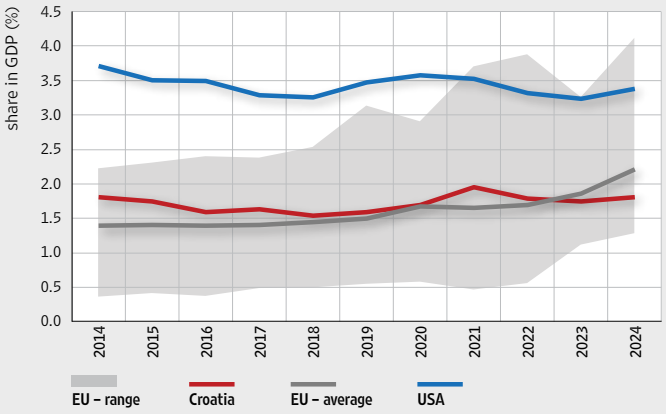
In mid-March this year, the European Commission presented the White Paper for European Defence – Readiness 2030[21], outlining the new approach to defence and identifying key needs for investments and the ReArm Europe plan, which proposes financial instruments for member states of the European Union to boost investments in defence capabilities. These initiatives aim to ensure substantial additional national defence financing at EU level by 2030. It plans to achieve EUR 650bn of additional defence spending by incentivising higher national spending, and in order to enable countries with budget deficits and debt above reference levels to increase their defence investment, it will allow for the activation of derogation provisions from the SGP fiscal rules, with each member state being able to increase defence spending by up to 1.5% of GDP over the four-year period of the activation of the clause. The derogation from fiscal rules would be monitored in the statistical "defence" category under the Classification of the Functions of Government (COFOG), registered in compliance with ESA 2020 standards. Also, EUR 150 billion is planned to fund member states' joint procurement in the defence sector, through the new Security Action for Europe (SAFE) instrument. Funds under the SAFE instrument are planned to be ensured by the issue of EU bonds with guarantees from the EU budget. In addition, in the current multiannual EU budget period (2021–2027), some additional support is available to boost research and development in the defence industry through the European Defence Fund. The estimates of analysts about the necessary investments in EU defence are in line with recommendations of the European Commission. According to the Burilkov and Wolf report, the possible reduction in military support to Europe from the US would require Europe to mobilise 300,000 soldiers and

21 *White Paper for European Defence – Readiness 2030*, European Commission (2025). Available at: https://defence-industry-space.ec.europa.eu/eu-defence-industry/introducing-white-paper-european-defence-and-rearm-europe-plan-readiness-2030_en

would necessitate at least EUR 250 billion per year more investments in defence to make up for lost capability, which would almost double defence spending from 2% to 3.5% of GDP.

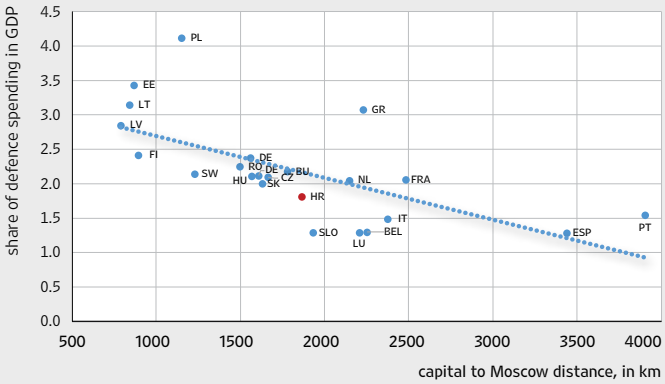
As for the current level of national defence spending, firstly it needs to be stressed that there is no single approach to its measurement. The NATO definition of defence spending casts a somewhat wider net than the COFOG definition used by Eurostat, partly because it includes pensions for retired military and civil personnel of military branches. In addition, under certain conditions, NATO's definition may include operations of other forces, such as forces in the realm of ministries of the interior, national police forces or coast guards, while it excludes spending on civil defence, which is included in the calculation under the COFOG classification. Additional differences arise from the different time frame for recording expenses, especially when military equipment is involved, since NATO reports do not apply the national accounts rules about the time of recording expenses, that is, NATO data are based on the "monetary principle", while COFOG data are recorded according to the accrual principle[22]. Further analysis is based on NATO data because they are more detailed in terms of the structure of expenditures and more up to date (NATO data are available for 2024, while the most recent Eurostat data available are for 2023). Therefore, NATO's expenditure threshold of 2% of GDP is usually used as a reference level in international comparisons.

Figure 1 Defence spending, as % of GDP



Sources: Eurostat, SIPRI and NATO.

Figure 2 Share of defence spending in 2024, as % of GDP



Source: NATO.

According to NATO data, defence expenditures of EU member states have risen considerably in the past years, measured as a share of GDP. In 2024, the total defence expenditure of EU member states, according to NATO indicators[23][24], was on average slightly above 2% of GDP, with differences among countries reaching almost three percentage points of GDP (Figure 1), given that defence funding falls within the competence of member states themselves. Defence spending in

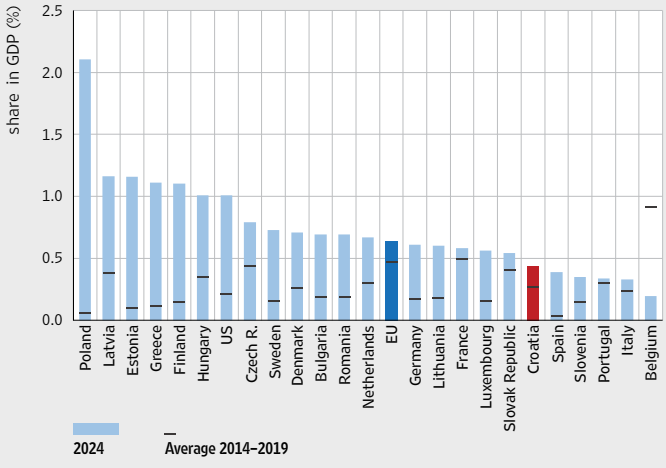
22 NATO data are based on a monetary principle, which takes into account the time period when the monetary transaction of a business activity was carried out (e.g. the date of the paid invoice for the military equipment), while COFOG data are based on an accrual principle, which means that the occurrence of the business activity (e.g. the date of delivery of military equipment) is relevant.

23 Data for non-NATO EU member states (Austria, Cyprus, Ireland, and Malta).

24 Eurostat data thus indicate EU-wide defence spending of 1.26% of GDP in 2022 or 0.4% of GDP less than NATO data for the same year.

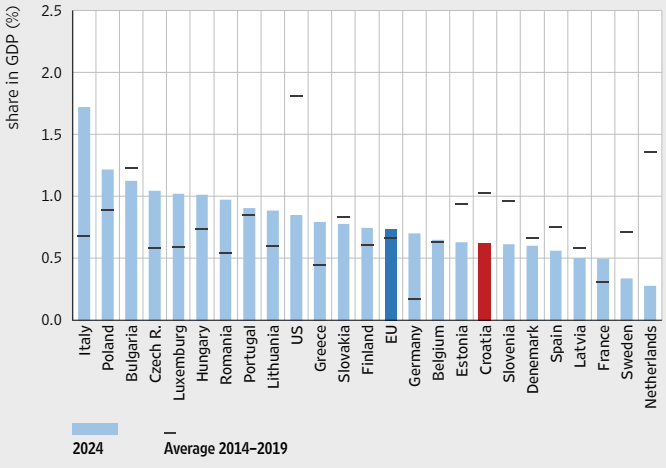
Poland exceeded 4% of GDP, while the lowest defence spending was recorded in Spain and Slovenia. Croatia spent slightly below the EU average in 2024, namely 1.8% of GDP. The increase in defence spending in EU members, particularly noticeable in the last two years is more geographically concentrated on countries bordering or close to the Russian Federation (Figure 2). The increase in spending was predominantly realised through investments in equipment (Figure 3), which together with spending on personnel, on average, accounts for slightly over two thirds of total defence spending (Figure 4). As a rule, Croatia invests slightly below the EU average in all major categories (Figure 5). It increased its investments in equipment and infrastructure, measured as a share in GDP, from the pre-pandemic average, while investments in personnel visibly decreased (Figure 6). However, it seems that such developments are a consequence of the fall in expenses on military pensions since, according to Eurostat data, Croatia in 2023 registered a very mild decline in expenses on employee compensations within its defence spending, measured as a share in GDP, while 2024 data, once they become available, could reflect a substantial increase in spending, considering the strong growth of wages in the public sector. It is worth mentioning that the Government estimated total defence spending in 2024 at 1.5% of GDP, slightly below NATO data, while the state budget for 2025 envisages some 1.6% of GDP[25].

Figure 3 Share of spending on equipment, as % of GDP



Sources: NATO and the European Commission.

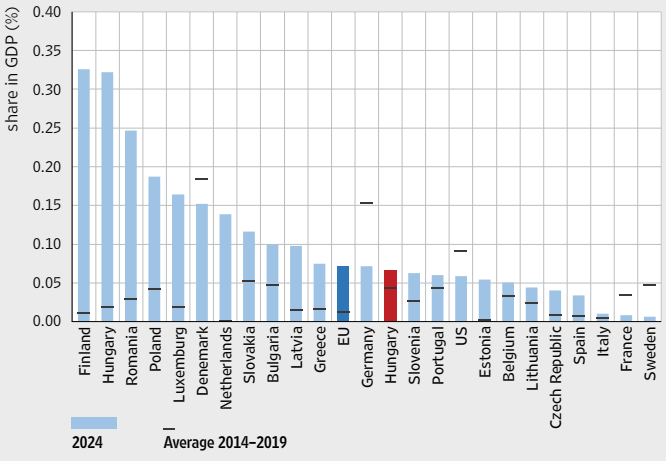
Figure 4 Share of personnel expenses, as % of GDP



Sources: NATO and the European Commission.

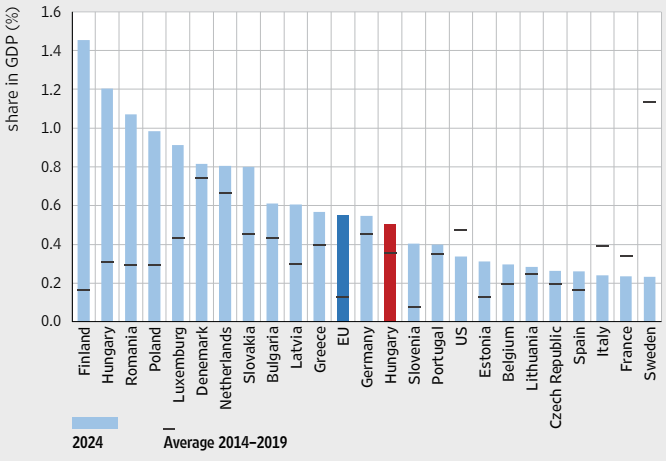
25 Ministry of Defence (2025): The 2024 Annual Defence Report.

Figure 5 Share of investments in infrastructure, as % of GDP



Sources: NATO and the European Commission.

Figure 6 Share of other defence spending, as % of GDP



Sources: NATO and the European Commission.

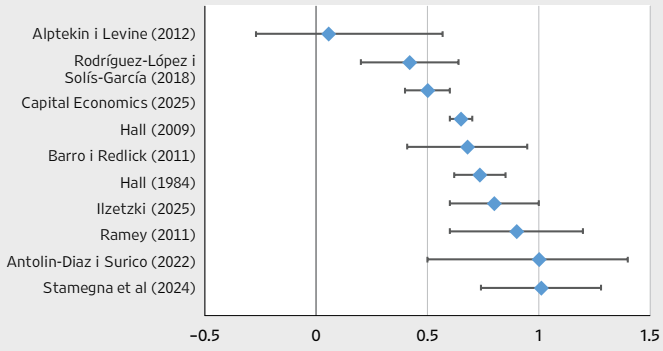
The empirical literature does not provide clear conclusions on the potential multiplicative effects of increased defence spending on the economy. The range of estimated multipliers is very wide, starting from a very low 0.1% to above 1%. Stamegna et al. (2024)[26] thus point to a significant variation of multipliers among EU countries although the research was confined to the period from 2013 to 2023 (Figure 9). The authors presented relatively high multiplicative effects on aggregate demand for Germany and Spain, with values of 1.23 and 1.28, respectively, while for Italy they estimated a lower multiplier of 0.74, explaining it by high import dependence. The Kiel Institute for the World Economy[27] estimates relatively high multipliers at EU level, with estimated impacts ranging from 0.6 to 1.0, depending on assumptions related to the way expenditure is financed and monetary policy assumptions. On the other hand, Alptekin and Levine (2012.)[28] conducted a meta-analysis of a larger number of papers based on the periods during which they were published and concluded that multipliers can also be negative. Namely, the redirection of resources into the defence sector may not only reduce the productivity of other sectors but also result in tax increases, which can offset the impact of the growth in aggregate demand and positive impacts arising from technological innovation and infrastructure development. As for potential impacts on the total factor productivity growth, estimates were visibly lower (Figure 10).

26 Stamegna, M., Bonaiuti, C., Maranzano, P., and M. Pianta (2024): *The economic impact of arms spending in Germany, Italy, and Spain*. Peace Economics, Peace Science and Public Policy, 30(4), 393–422.

27 Guns and Growth: *The Economic Consequences of Surging Defense Spending*, The Kiel Institute for the World Economy. Available at: https://www.ifw-kiel.de/publications/news/guns-and-growth-the-economic-consequences-of-surging-defense-spending/

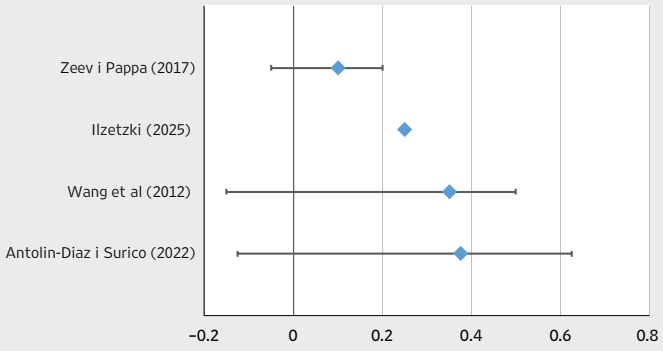
28 Alptekin, A., and P. Levine (2012): *Military expenditure and economic growth: A meta-analysis*, European Journal of Political Economy, 28(4), 636–650.

Figure 7 Multiplicative effects on GDP



Source: Reference list[29].

Figure 8 Multiplicative effects on total factor productivity



Source: Reference list[30].

The macroeconomic effects of increased defence spending will depend on a series of factors. In addition to the amount and time frame for the increase in expenditures the structure of the spending also plays a key role, particularly the share of spending on imported products. The manner in which they are financed also plays a role, for example, whether through borrowing or by the adjustment of taxes and other expenditures. Another concern is the utilisation of production capacities that determine to what extent increased demand will have an inflationary or crowding-in effect on the economy.

One of key objectives of the European Commission is to decrease the historically very high share of imported equipment in total procurements. In the past, EU member states relied heavily on imports from third countries in the procucrement of their military equipment. Moreover, following Russian aggression against Ukraine, the share of imports of military equipment from third countries rose to 78% at EU level[31] with available data indicating the dominance of imports

29 Barro, R. J., and C. J. Redlick (2011): *Macroeconomic effects from government purchases and taxes*, The Quarterly Journal of Economics, 126(1), 51–102.
Hall, R. E. (1984): *The role of consumption in economic fluctuations*, National Bureau of Economic Research.
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Rodriguez-Lopez, J., and M. Solis-Garcia (2018): *Defense spending and fiscal multipliers: it's all in the variance*, Munich Personal RePEc Archive.
Antolin-Diaz, J., and P. Surico (2022): *The long-run effects of government spending*. Centre for Economic Policy Research.
Ramey, V. A. (2011): *Identifying government spending shocks: It's all in the timing*. The Quarterly Journal of Economics, 126(1), 1–50.
Ilzetzki, E. (2025): *Waffen und Wachstum: Die wirtschaftlichen Folgen steigender Militärausgaben*, Kiel Report No. 2, The Kiel Institute for the World Economy, February 2025.
Stamegna, M., Bonaiuti, C., Maranzano, P., and M. Pianta (2024): *The economic impact of arms spending in Germany, Italy, and Spain*, Peace Economics, Peace Science and Public Policy, 30(4), 393–422.
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Europe Weekly: *How big a boost from defence?*, Capital Economics, Available at: https://www.capitaleconomics.com/publications/europe-economics-weekly/europe-weekly-how-big-boost-defence

30 Ben Zeev, N., and E. Pappa (2017): *Chronicle of a war foretold: the macroeconomic effects of anticipated defence spending shocks*, The Quarterly Journal, 127(6), 1568–1597.
Ilzetzki, E. (2025): *Waffen und Wachstum: Die wirtschaftlichen Folgen steigender Militärausgaben*, Kiel Report No. 2, The Kiel Institute for the World Economy, Februar 2025.
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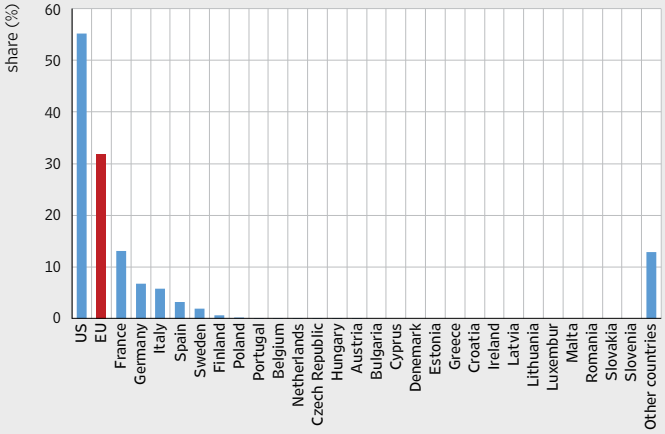
Wang, T. P., Shyu, S. H. P., and H. C. Chou (2012): *The impact of defense expenditure on economic productivity in OECD countries*. Economic Modelling, 29(6), 2104–2114.

31 European defence industrial strategy (2024).

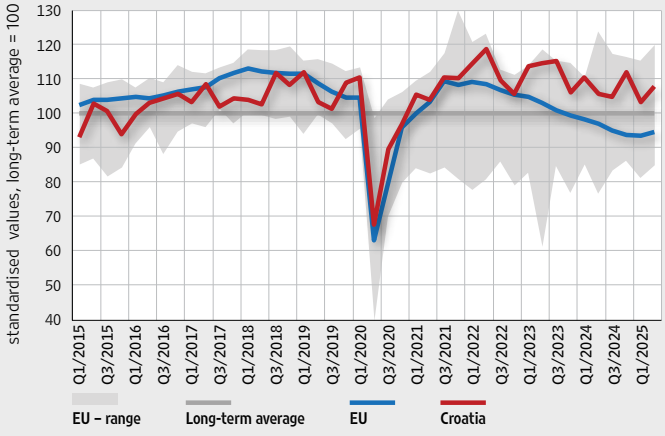
from the US (Figure 7). The European Defence Industrial Strategy (EDIS) proposes that by 2030 member states satisfy at least 50% of their defence needs within the EU, with a target of 60% by 2035.

Figure 9 The share of imports of military equipment by country in total EU imports of military equipment, average 2021–2024



Notes: EU refers to total import of military equipment by member states from other EU countries expressed as a share in total imports of EU member states. According to available data, SIPRI data do not include trade in all weapons so amounts by country may be underestimated.
Source: SIPRI.

Figure 10 Current level of industrial capacity utilisations



Source: European Commission.

When military spending is being financed, the experience of individual countries shows that apart from borrowing, countries relied on increasing taxes and reducing other expenditures, thus mitigating the macroeconomic effects. Johannes Marzian and Christoph Trebesch from the Kiel Institute for the World Economy in Kiel[32] studied how military buildups have been financed over the last 150 years and concluded that the countries under review (Germany, United Kingdom, US, South Korea) usually relied on the combination of deficit financing through debt and increased revenue from taxes. However, as expenditures grew, debt financing increased proportionally.

As for capacity utilisation in the EU, it is currently below the historical average in industry, thus suggesting the possibility of production capacities being repurposed for the military industry without creating additional inflationary pressures. Nevertheless, there are considerable variations across countries. The current capacity utilisation is also one of the key factors determining the influence of additional investments in defence on economic activity and inflation. In cases of insufficient capacities these investments may lead to inflationary pressures and result in a tighter monetary policy, pushing private consumption out. According to the data of the European Commission, the capacity utilisation in the industry across EU went below the historic average in 2023 and continued decreasing until the end of 2024 when it edged up. Considerable differences are visible among member states (Figure 8), with data for Croatia indicating capacity utilisation below long-term levels. In addition, the redirection of remaining capacities requires

32 Marzian, J., and C. Trebesch: *How to Finance Europe's Military Buildup? Lessons from History*, Kiel Policy Brief, 184.

a certain time and the labour shortage in the construction industry might constitute a considerable hurdle for the construction of military infrastructure.

Defence spending might also have long-term effects on economic growth. R&D investments might spill over from the defence industry to the rest of the economy and countries importing defence products from technologically more advanced countries may also improve their technological knowhow. On the other hand, there is the risk of the increase in R&D related to defence subduing private R&D investment, especially if there is limited and non-elastic supply of qualified workers in the area. In this context, the increase in domestic operating capacities in the defence sector and expansion of the possibility of equipment harmonisation and R&D investments should in the medium term lower dependence on imports and spur cross-country spillovers among member states, leading to higher fiscal multiplier by the end of the decade.

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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