# Raiffeisen Research Report

Number 60
January 2016

## New Government, Old Challenges

- Recovery continues
- The 2016 Budget – the first test of the new Government
- New monetary policy measures, exchange rate stability beyond question
- Sale of non-strategic assets/holdings announced

Raiffeisen RESEARCH



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# Contents

## Selected macroeconomic indicators

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015e | 2016f | 2017f | 2018f |
|---|---|---|---|---|---|---|---|---|---|---|
| **GDP & Production** | | | | | | | | | | |
| Gross Domestic Product, % (constant prices) | –7.4 | –1.7 | –0.3 | –2.2 | –1.1 | –0.4 | 1.5 | 1.0 | 1.5 | 2.0 |
| GDP at current prices (EUR millions) | 45,093 | 45,022 | 44,737 | 43,959 | 43,516 | 43,045 | 43,550 | 44,274 | 45,553 | 47,502 |
| GDP per capita at current prices (EUR) | 10,480 | 10,495 | 10,452 | 10,301 | 10,220 | 10,157 | 10,293 | 10,501 | 10,843 | 11,307 |
| Retail trade, % real annual changes | –11.6 | –2.1 | 0.6 | –4.1 | –0.6 | 0.4 | 2.3 | 2.1 | 2.5 | 2.7 |
| Industrial production, % annual changes | –9.2 | –1.4 | –1.2 | –5.5 | –1.8 | 1.2 | 2.6 | 2.5 | 3.4 | 3.8 |
| **Prices, Employment and Budget** | | | | | | | | | | |
| Consumer Prices, %, end of period | 1.9 | 1.8 | 2.1 | 4.7 | 0.3 | –0.5 | –0.6 | 1.5 | 1.8 | 2.5 |
| %, average | 2.4 | 1.1 | 2.3 | 3.4 | 2.2 | –0.2 | –0.5 | 1.1 | 1.5 | 2.2 |
| Producer Prices[1], %, end of period | 1.6 | 5.7 | 5.8 | 6.9 | –2.6 | –3.4 | –4.4 | 2.2 | 2.5 | 2.3 |
| %, average | –0.4 | 4.3 | 6.4 | 7.0 | 0.5 | –2.7 | –3.9 | 0.5 | 2.2 | 2.5 |
| Unemployment rate (official rate, avg) | 14.9 | 17.4 | 18.0 | 19.1 | 20.3 | 19.7 | 17.7 | 17.4 | 17.0 | 16.5 |
| Unemployment rate (ILO, avg) | 9.2 | 11.6 | 13.7 | 15.9 | 17.4 | 17.3 | 16.2 | 16.0 | 15.8 | 15.5 |
| Average net wage, in Kuna | 5,311 | 5,343 | 5,441 | 5,478 | 5,515 | 5,534 | 5,742 | 5,908 | 6,026 | 6,110 |
| General Government Balance, % of GDP, ESA 2010 | –5.9 | –6.0 | –7.5 | –5.3 | –5.4 | –5.7 | –5.0 | –4.5 | –4.1 | –3.6 |
| Public Debt, HRK bn, ESA 2010 | 158.9 | 186.9 | 211.9 | 228.8 | 266.1 | 279.6 | 298.4 | 315.4 | 331.1 | 345.6 |
| % of GDP, ESA 2010 | 48.0 | 57.0 | 63.7 | 69.2 | 80.8 | 85.1 | 89.9 | 93.1 | 94.9 | 95.1 |
| **Balance of Payment and External Debt** | | | | | | | | | | |
| Good's and Services Exports, EUR million | 15,577 | 17,007 | 18,109 | 18,314 | 18,756 | 20,025 | 22,348 | 23,800 | 25,038 | 26,064 |
| % change | –15.9 | 9.2 | 6.5 | 1.1 | 2.4 | 6.8 | 11.6 | 6.5 | 5.2 | 4.1 |
| Good's and Services Imports, EUR million | 17,236 | 17,156 | 18,294 | 18,092 | 18,547 | 19,141 | 20,232 | 20,900 | 21,548 | 22,129 |
| % change | –22.9 | –0.5 | 6.6 | –1.1 | 2.5 | 3.2 | 5.7 | 3.3 | 3.1 | 2.7 |
| Current Account Balance, % of GDP[2] | –5.1 | –1.1 | –0.7 | –0.1 | 1.0 | 0.8 | 4.7 | 1.5 | 1.5 | 1.0 |
| Official International Reserves, EUR millon, eop | 10,376 | 10,660 | 11,195 | 11,236 | 12,908 | 12,688 | 13,000 | 13,100 | 12,900 | 13,550 |
| Official International Reserves, in terms of months of imports of goods and services, eop[1] | 7.2 | 7.5 | 7.3 | 7.5 | 8.4 | 8.0 | 7.7 | 7.5 | 7.2 | 7.3 |
| Foreign Direct Investment, EUR million[3] | 2,278 | 1,064 | 1,015 | 1,133 | 703 | 2,893 | 1,450 | 1,700 | 1,900 | 1,800 |
| Tourism – nightstays, % change | –1.3 | 2.6 | 7.0 | 4.0 | 3.3 | 2.7 | 7.5 | 3.8 | 3.0 | 2.5 |
| External debt, EUR billion | 45.6 | 46.9 | 46.4 | 45.3 | 46.0 | 46.7 | 47.5 | 48.5 | 50.0 | 51.1 |
| External debt, as % of GDP[2] | 101.1 | 104.2 | 103.7 | 103.0 | 105.6 | 108.4 | 109.1 | 109.5 | 109.8 | 107.6 |
| External debt, as % export of goods and services[2] | 292.7 | 275.8 | 256.2 | 247.3 | 245.0 | 233.0 | 212.6 | 203.8 | 199.7 | 196.1 |
| **Monetary and Financial Data** | | | | | | | | | | |
| Exchange rate, eop, USD / HRK | 5.09 | 5.57 | 5.82 | 5.73 | 5.55 | 6.30 | 6.99 | 7.60 | 6.65 | 5.88 |
| avg, USD / HRK | 5.28 | 5.50 | 5.34 | 5.85 | 5.71 | 5.75 | 6.86 | 7.50 | 6.96 | 6.24 |
| Exchange rate, eop, EUR / HRK | 7.31 | 7.39 | 7.53 | 7.55 | 7.62 | 7.66 | 7.64 | 7.68 | 7.65 | 7.65 |
| avg, EUR / HRK | 7.34 | 7.29 | 7.43 | 7.52 | 7.57 | 7.63 | 7.61 | 7.65 | 7.66 | 7.65 |
| Money (M1), Kuna billion, eop | 47.2 | 48.0 | 51.5 | 51.9 | 57.9 | 63.4 | 69.5 | 73.0 | 75.9 | 79.1 |
| % change | –14.6 | 1.7 | 7.3 | 0.9 | 11.5 | 9.6 | 9.6 | 5.0 | 4.0 | 4.3 |
| Broadest money (M4), Kuna billion, eop | 228.5 | 232.8 | 246.0 | 254.7 | 264.9 | 273.3 | 287.2 | 293.0 | 299.7 | 307.5 |
| % change | –1.0 | 1.9 | 5.6 | 3.6 | 4.0 | 3.2 | 5.1 | 2.0 | 2.3 | 2.6 |
| Credits, Kuna billion | 234.5 | 245.6 | 257.4 | 242.1 | 240.8 | 237.0 | 232.3 | 229.9 | 233.7 | 237.7 |
| % change | –0.6 | 4.7 | 4.8 | –5.9 | –0.5 | –1.6 | –2.0 | –1.0 | 1.6 | 1.7 |
| ZIBOR 3m, %, avg | 8.9 | 2.4 | 3.2 | 3.4 | 1.5 | 1.0 | 1.2 | 1.3 | 2.0 | 3.5 |
| Treasury bills rate 12m, %, avg | 7.5 | 4.0 | 3.9 | 3.9 | 2.5 | 1.9 | 1.5 | 1.6 | 2.1 | 3.5 |

*[1] on domestic market; [2] in euro terms; [3] including round tripping*
*e – estimate; f – forecast; eop – end of period; avg – period average*
*Forecasts: Economic Research Department – Raiffeisenbank Austria d.d. Zagreb*
*Sources: CNB, MoF, CBS*

## Real GDP (% yoy)

| | 2014 | 2015e | 2016f | 2017f |
|---|---|---|---|---|
| Poland | 3.3 | 3.5 | 3.6 | 3.4 |
| Hungary | 3.7 | 2.8 | 2.2 | 2.9 |
| Czech Rep. | 2.0 | 4.3 | 2.4 | 2.4 |
| Slovakia | 2.5 | 3.5 | 3.5 | 3.5 |
| Slovenia | 3.0 | 2.7 | 2.2 | 2.1 |
| **CE** | **3.0** | **3.5** | **3.1** | **3.1** |
| **Croatia** | **–0.4** | **1.5** | **1.0** | **1.5** |
| Bulgaria | 1.7 | 2.7 | 2.1 | 3.0 |
| Romania | 2.8 | 3.7 | 4.0 | 3.6 |
| Serbia | –1.8 | 0.5 | 2.5 | 3.0 |
| BiH | 1.0 | 2.0 | 3.0 | 3.5 |
| Albania | 2.0 | 2.7 | 3.5 | 4.0 |
| **SEE** | **1.5** | **2.8** | **3.0** | **3.2** |
| Russia | 0.6 | –4.0 | 0.0 | 1.5 |
| Ukraine | –6.8 | –10.0 | 1.5 | 3.0 |
| Belarus | 1.6 | –4.0 | 0.0 | 1.5 |
| **CIS** | **0.2** | **–4.4** | **0.1** | **1.6** |
| **CEE** | **1.2** | **–1.2** | **1.3** | **2.2** |
| Italy | –0.4 | 0.7 | 1.7 | 1.5 |
| Austria | 0.4 | 0.9 | 1.8 | 1.5 |
| Germany | 1.6 | 1.5 | 2.2 | 1.8 |
| **Euro area** | **0.9** | **1.4** | **1.9** | **1.7** |
| **USA** | **2.4** | **2.5** | **2.5** | **2.2** |

*Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH*

## Consumer prices (avg, % yoy)

| | 2014 | 2015e | 2016f | 2017f |
|---|---|---|---|---|
| Poland | 0.0 | –0.9 | 1.3 | 2.0 |
| Hungary | –0.2 | 0.0 | 1.9 | 2.7 |
| Czech Rep. | 0.4 | 0.4 | 1.3 | 2.0 |
| Slovakia | –0.1 | –0.2 | 0.7 | 2.5 |
| Slovenia | 0.2 | –0.1 | 0.2 | 0.9 |
| **CE** | **0.1** | **–0.4** | **1.3** | **2.1** |
| **Croatia** | **–0.2** | **–0.5** | **1.1** | **1.5** |
| Bulgaria | –1.4 | 0.1 | 2.2 | 3.0 |
| Romania | 1.1 | –0.6 | –0.3 | 2.7 |
| Serbia | 2.9 | 1.4 | 4.0 | 4.5 |
| BiH | –0.9 | –0.5 | 1.0 | 2.0 |
| Albania | 1.6 | 1.8 | 2.5 | 3.0 |
| **SEE** | **0.7** | **–0.2** | **0.9** | **2.7** |
| Russia | 7.8 | 15.6 | 8.8 | 8.4 |
| Ukraine | 12.1 | 48.5 | 16.0 | 10.0 |
| Belarus | 18.1 | 17.0 | 16.0 | 16.0 |
| **CIS** | **8.5** | **17.7** | **9.5** | **8.8** |
| **CEE** | **5.1** | **10.3** | **6.1** | **6.1** |
| Italy | 0.2 | 0.1 | 1.1 | 1.5 |
| Austria | 1.5 | 0.8 | 1.6 | 2.0 |
| Germany | 0.8 | 0.3 | 1.9 | 2.7 |
| **Euro area** | **0.4** | **0.0** | **1.4** | **1.6** |
| **USA** | **1.6** | **0.1** | **2.0** | **2.7** |

*Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH*

## Unemployment rate (avg, % yoy)

| | 2014 | 2015e | 2016f | 2017f |
|---|---|---|---|---|
| Poland | 12.3 | 10.5 | 9.4 | 9.0 |
| Hungary | 7.9 | 7.0 | 6.2 | 5.7 |
| Czech Rep. | 7.7 | 6.5 | 6.1 | 5.9 |
| Slovakia | 13.2 | 11.7 | 11.0 | 10.3 |
| Slovenia | 9.7 | 9.1 | 8.5 | 8.2 |
| **CE** | **10.8** | **9.3** | **8.4** | **8.0** |
| **Croatia** | **17.3** | **16.2** | **16.0** | **15.8** |
| Bulgaria | 11.4 | 11.0 | 10.7 | 9.8 |
| Romania | 6.8 | 6.8 | 6.5 | 6.5 |
| Serbia | 19.4 | 19.8 | 22.0 | 19.0 |
| BiH | 27.5 | 27.0 | 25.0 | 22.5 |
| Albania | 18.0 | 17.0 | 15.0 | 13.0 |
| **SEE** | **12.2** | **12.0** | **11.8** | **11.1** |
| Russia | 5.3 | 5.5 | 5.5 | 5.5 |
| Ukraine | 9.3 | 11.5 | 11.0 | 10.0 |
| Belarus | 0.5 | 1.0 | 1.5 | 2.0 |
| **CIS** | **5.4** | **5.7** | **5.7** | **5.7** |
| **CEE** | **7.8** | **7.5** | **7.2** | **7.0** |
| Italy | 12.8 | 11.7 | n.v. | n.v. |
| Austria | 5.6 | 5.7 | 5.7 | 5.6 |
| Germany | 5.0 | 6.4 | 6.7 | 6.9 |
| **Euro area** | **11.6** | **11.0** | **10.7** | **10.5** |
| **USA** | **6.2** | **5.3** | **4.6** | **4.0** |

*Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH*

## Current account balance (% of GDP)

| | 2014 | 2015e | 2016f | 2017f |
|---|---|---|---|---|
| Poland | –2.0 | –0.1 | –1.1 | –1.7 |
| Hungary | 3.9 | 3.7 | 3.7 | 3.6 |
| Czech Rep. | 0.6 | 1.0 | 1.1 | –0.4 |
| Slovakia | 0.1 | –1.4 | –0.7 | –0.5 |
| Slovenia | 7.0 | 6.5 | 5.6 | 4.9 |
| **CE** | **–0.1** | **0.8** | **0.3** | **–0.3** |
| **Croatia** | **0.8** | **4.7** | **1.5** | **1.5** |
| Bulgaria | 0.0 | 3.9 | 0.8 | –0.5 |
| Romania | –0.5 | –1.0 | –2.5 | –3.3 |
| Serbia | –6.0 | –4.6 | –5.2 | –5.7 |
| BiH | –7.6 | –7.0 | –7.6 | –8.1 |
| Albania | –12.6 | –12.9 | –13.0 | –13.7 |
| **SEE** | **–1.7** | **–0.7** | **–2.5** | **–3.2** |
| Russia | 3.5 | 5.2 | 5.5 | 5.0 |
| Ukraine | –4.0 | –0.8 | –1.0 | –1.2 |
| Belarus | –6.6 | –5.2 | –6.7 | –6.7 |
| **CIS** | **2.6** | **4.4** | **4.7** | **4.3** |
| **CEE** | **1.3** | **2.5** | **2.3** | **1.7** |
| Italy | 1.9 | 2.1 | 2.2 | 2.0 |
| Austria | 2.0 | 2.8 | 2.7 | 2.6 |
| Germany | 7.3 | 7.7 | 7.5 | 7.5 |
| **Euro area** | **2.4** | **2.9** | **3.0** | **2.9** |
| **USA** | **–2.2** | **–2.6** | **–3.1** | **–2.7** |

*Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH*

## General budget balance (% of GDP)

| | 2014 | 2015e | 2016f | 2017f |
|---|---|---|---|---|
| Poland | –3,2 | –2,7 | –2,3 | –2,0 |
| Hungary | –2,6 | –2,6 | –2,5 | –2,4 |
| Czech Rep. | –2,0 | –2,1 | –1,5 | –1,6 |
| Slovakia | –2,9 | –2,5 | –1,9 | –0,9 |
| Slovenia | –4,6 | –3,5 | –3,1 | n.a. |
| **CE** | **–2,9** | **–2,6** | **–2,2** | **–1,8** |
| **Croatia** | **–5,7** | **–5,4** | **–5,0** | **–4,5** |
| Bulgaria | –3,8 | –2,8 | –2,5 | –2,0 |
| Romania | –1,5 | –2,0 | –3,0 | –2,3 |
| Serbia | –6,6 | –3,7 | –3,7 | –3,0 |
| BiH | –2,1 | –2,5 | –2,0 | –1,0 |
| Albania | –5,1 | –4,5 | –3,5 | –3,0 |
| **SEE** | **–3,2** | **–2,9** | **–3,3** | **–2,6** |
| Russia | –1,2 | –3,6 | –3,5 | –2,0 |
| Ukraine | –11,0 | –7,0 | –5,5 | –3,0 |
| Belarus | 1,0 | –1,0 | 0,0 | 0,0 |
| **CIS** | **–1,7** | **–3,7** | **–3,5** | **–2,0** |
| **CEE** | **–2,3** | **–3,3** | **–3,1** | **–2,0** |
| Italy | –3,0 | –2,6 | –1,8 | –0,8 |
| Austria | –2,4 | –1,9 | –1,8 | –1,5 |
| Germany | 0,7 | 0,5 | 0,5 | 0,5 |
| **Euro area** | **–2,4** | **–2,0** | **–1,7** | **–1,2** |
| **USA** | **–2,8** | **–2,4** | **–2,2** | **–2,1** |

*Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH*

## Public debt (% of GDP)

| | 2014 | 2015e | 2016f | 2017f |
|---|---|---|---|---|
| Poland | 50.4 | 51.9 | 52.9 | 52.9 |
| Hungary | 76.2 | 75.8 | 75.0 | 71.5 |
| Czech Rep. | 42.6 | 40.7 | 40.1 | 40.2 |
| Slovakia | 53.6 | 53.4 | 52.8 | 51.9 |
| Slovenia | 80.8 | 82.0 | 81.9 | 81.2 |
| **CE** | **54.0** | **54.4** | **54.7** | **54.1** |
| **Croatia** | **85.1** | **89.9** | **93.1** | **94.9** |
| Bulgaria | 27.1 | 28.5 | 29.5 | 30.0 |
| Romania | 39.9 | 38.9 | 39.7 | 40.4 |
| Serbia | 68.8 | 74.0 | 78.5 | 81.3 |
| BiH | 42.2 | 44.6 | 45.0 | 43.0 |
| Albania | 71.6 | 73.7 | 72.5 | 71.0 |
| **SEE** | **48.5** | **49.7** | **51.2** | **52.0** |
| Russia | 11.5 | 12.7 | 13.5 | 14.0 |
| Ukraine | 70.5 | 87.0 | 94.0 | 93.0 |
| Belarus | 34.1 | 36.0 | 37.0 | 37.0 |
| **CIS** | **16.1** | **18.3** | **19.5** | **19.9** |
| **CEE** | **31.0** | **32.6** | **33.5** | **33.7** |
| Italy | 132.3 | 133.0 | 132.2 | 130.0 |
| Austria | 84.2 | 86.2 | 85.3 | 84.2 |
| Germany | 74.9 | 71.4 | 68.5 | 65.6 |
| **Euro area** | **92.1** | **91.8** | **90.8** | **89.2** |
| **USA** | **103.2** | **101.9** | **102.5** | **101.3** |

*Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH*

## Gross foreign debt (% of GDP)

| | 2014 | 2015e | 2016f | 2017f |
|---|---|---|---|---|
| Poland | 71.1 | 70.3 | 71.2 | 71.2 |
| Hungary | 113.9 | 104.6 | 96.9 | 89.8 |
| Czech Rep. | 66.6 | 65.6 | 63.6 | 63.4 |
| Slovakia | 89.7 | 95.8 | 96.3 | 81.5 |
| Slovenia | 124.1 | 116.0 | 111.5 | 106.2 |
| **CE** | **80.2** | **78.5** | **77.3** | **74.4** |
| **Croatia** | **108.5** | **108.9** | **109.5** | **109.8** |
| Bulgaria | 94.7 | 92.3 | 90.9 | 85.0 |
| Romania | 63.2 | 59.3 | 57.8 | 56.1 |
| Serbia | 78.6 | 81.6 | 80.6 | 79.4 |
| BiH | 63.1 | 62.7 | 62.7 | 59.1 |
| Albania | 67.7 | 68.9 | 68.2 | 65.4 |
| **SEE** | **75.5** | **73.3** | **72.0** | **69.6** |
| Russia | 32.2 | 41.1 | 37.1 | 32.3 |
| Ukraine | 96.4 | 128.7 | 133.3 | 134.0 |
| Belarus | 57.8 | 61.5 | 67.5 | 63.3 |
| **CIS** | **37.2** | **47.7** | **44.5** | **39.7** |
| **CEE** | **54.3** | **61.7** | **58.9** | **55.5** |
| Italy | n.a. | n.a. | n.a. | n.a. |
| Austria | n.a. | n.a. | n.a. | n.a. |
| Germany | n.a. | n.a. | n.a. | n.a. |
| **Euro area** | **119.1** | **122.8** | **n.a.** | **n.a.** |
| **USA** | **n.a.** | **n.a.** | **n.a.** | **n.a.** |

*Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH*

## EUR/LCY (avg)

| | 2014 | 2015e | 2016f | 2017f |
|---|---|---|---|---|
| Poland | 4.19 | 4.18 | 4.22 | 4.13 |
| Hungary | 308.7 | 309.9 | 314.7 | 324.4 |
| Czech R. | 27.5 | 27.3 | 27.0 | 26.1 |
| Slovakia | euro | euro | euro | euro |
| Slovenia | euro | euro | euro | euro |
| **CE** | | | | |
| **Croatia** | **7.63** | **7.61** | **7.65** | **7.66** |
| Bulgaria | 1.96 | 1.96 | 1.96 | 1.96 |
| Romania | 4.44 | 4.45 | 4.43 | 4.35 |
| Serbia | 117 | 121 | 123 | 125 |
| BiH | 1.96 | 1.96 | 1.96 | 1.96 |
| Albania | 140 | 140 | 140 | 140 |
| **SEE** | | | | |
| Russia | 51.0 | 68.0 | 67.0 | 71.2 |
| Ukraine | 15.9 | 24.3 | 26.0 | 31.2 |
| Belarus | 13597 | 17706 | 22008 | 27060 |
| **CIS** | | | | |
| **CEE** | | | | |
| Italy | euro | euro | euro | euro |
| Austria | euro | euro | euro | euro |
| Germany | euro | euro | euro | euro |
| **Euro area** | **euro** | **euro** | **euro** | **euro** |
| **USA** | **1.33** | **1.11** | **1.02** | **1.10** |

*Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH*

## Ratings

| | S&P | Moody`s | Fitch |
|---|---|---|---|
| Poland | BBB+ | A2 | A– |
| Hungary | BB+ | Ba1 | BB+ |
| Czech Rep. | AA– | A1 | A+ |
| Slovakia | A+ | A2 | A+ |
| Slovenia | A– | Baa3 | BBB+ |
| | | | |
| **Croatia** | **BB** | **Ba1** | **BB** |
| Bulgaria | BB+ | Baa2 | BBB– |
| Romania | BBB– | Baa3 | BBB– |
| Serbia | BB– | B1 | B+ |
| BiH | B | B3 | NR |
| Albania | B | B1 | NR |
| | | | |
| Russia | BB+ | Ba1 | BBB– |
| Ukraine | B– | Caa3 | CCC |
| Belarus | B– | Caa1 | NR |
| | | | |
| Italy | BBB– | Baa2 | BBB+ |
| Austria | AA+ | Aaa | AA+ |
| Germany | AAA | Aaa | AAA |
| **USA** | **AA+** | **Aaa** | **AAA** |

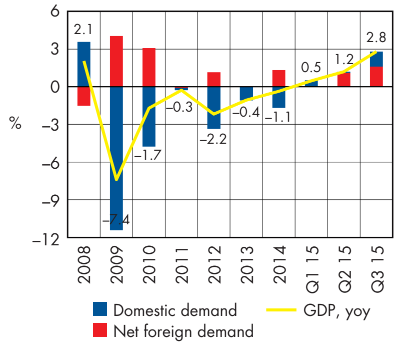
*for FCY, long-term debt*
*Sources: Bloomberg, Raiffeisen RESEARCH*

# New Government, Old Challenges

In 2015, for the first time since 2008, Croatia will boast a positive annual GDP growth rate. The major contribution to this growth comes from the increase in the positive balance in foreign trade, achieved amid improved trading conditions and the growth in foreign demand. The final data should also confirm positive impetus from domestic factors, especially personal consumption. Deflationary pressures on the import supply side increased net disposable income, while additional impetus to spending came from revenues realised during an excellent tourist season. Problems in competitive tourist destinations were paired with improvements in the quality of services offered to tourists and the prolongation of the tourist season and had an evident synergic and multiplicative effect on the rest of the economy. The positive trend in the service sector was confirmed also by increased investments, while indicators for the second half of the year suggest that deep and long recession in construction is nearing its end. Finally, access to the common European market paired with strengthening foreign demand and market restructuring, especially in the SME segment resulted in the continuation of the relatively strong growth of goods exports. Nevertheless, this recovery is not sufficient to generate new jobs. The labour market is burdened by the too low share of active population and decreased employment, reflected in high long-term unemployment and unemployment among the young. The problem in growth sustainability is structural in nature and as such can be solved by structural measures, primarily in the segment of fiscal policy, where rising public debt increases the financing costs and makes fiscal adjustment difficult. Oversized, sluggish and inefficient public sector burdens the economy with excess fiscal burden so the business environment is not conducive to more significant private sector investments. With all this said, the new Government is faced with old challenges but also shorter time available to implement efficient measures aimed at dealing away with structural weaknesses. Any postponement or sluggishness in the implementation of already indentified measures needed to spur sustainable growth would be detrimental for the private sector and younger generations and consequently for the medium- and long-term perspective of the society as a whole. On the other hand, the Fed starting to raise its key interest rate warns us that the period of low interest rates end unconventional monetary policy measures implemented by the ECB will once end. For the time being, the absence of inflation and unequal recovery in the euro area member states supports expectations that the ECB is likely to continue its expansive monetary policy at least until mid-2017. The reform oriented rhetoric and promises made by the new Government together with favourable conditions in the financial markets provided the Government with the opportunity to implement reforms within a relatively short period. Only in this way Croatia can return to investment grade rating. This would ensure the key prerequisite for reducing the country risk premium, for facilitating public debt financing, accelerating fiscal adjustment and consequently decrease financing costs for all sectors. The central bank will provide support to the adjustment of fiscal policy and economic competitiveness through the announced long-term repo operations thus responding to increased demand for loans in domestic currency. However, the stability of EUR/HRK remains beyond question. Finally, the credibility of each economic policy is acquired through stability in the implementation of the necessary measures. However, in order to win back the investment rating the implemented reforms will have to show results. The 2016 budget will show soon whether the Government has the necessary decisiveness to deal with it.

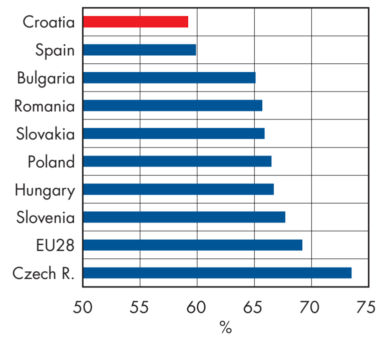
*Financial analyst: Zrinka Živković Matijević*

**Contributions to GDP growth**



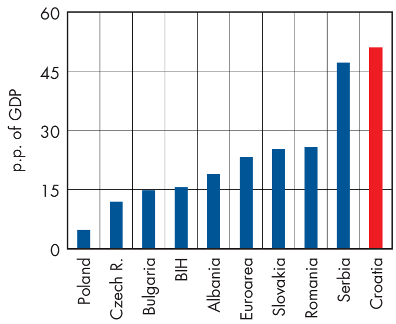

*Sources: CBS, Raiffeisen RESEARCH*

**Employment rate (%), 2014***




** age group 20–64*
*Sources: Eurostat, Raiffeisen RESEARCH*

**Public debt increase 2008/2015.e**

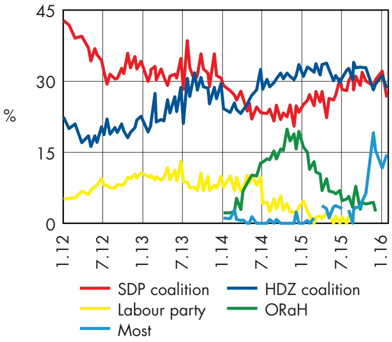



*Sources: Eurostat, RBI, Raiffeisen RESEARCH*

# Optimistic but not impossible

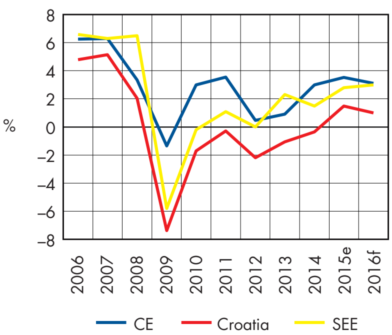
- New government, new hope
- Mild economic recovery continues

### Opinion pools



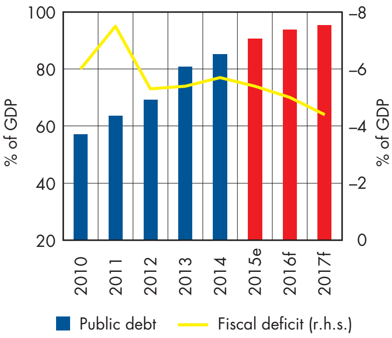

*15-day average trend line of poll results from Jan 2012 to Jan 22 2016
*Source: Promocija plus, IPSOS PULS, Raiffaiesen RESEARCH*

### Real GDP growth, yoy




*Sources: Eurostat, Raiffeisen RESEARCH*

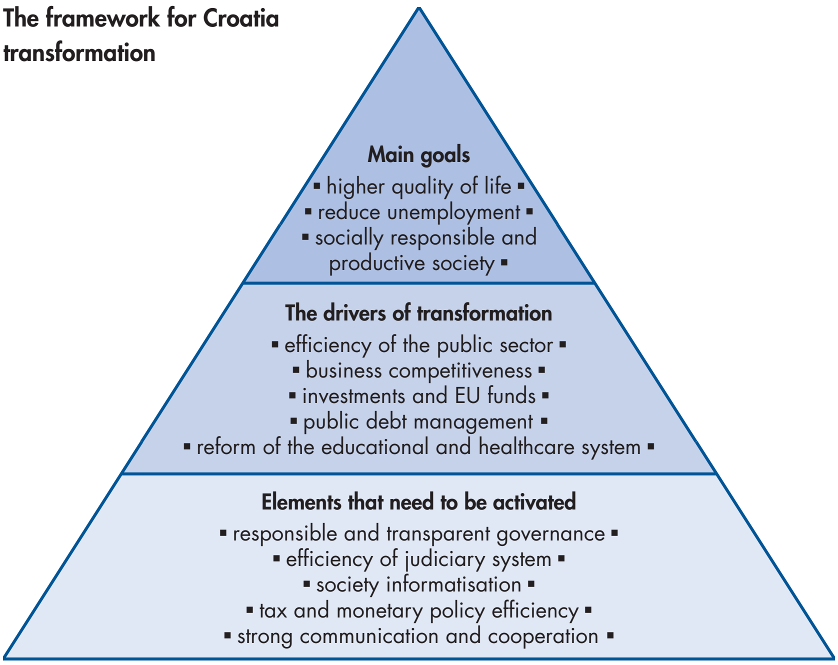
### Public debt and fiscal balance




*Sources: CNB, MoF, Raiffeisen RESEARCH*

Two and a half months after the tightest result of the parliamentary elections ever and long, hard negotiations between the Bridge party (MOST) and the Patriotic Coalition (Domoljubna koalicija) and the Croatia is Growing (Hrvatska raste) coalition, the new Croatian government was confirmed on 22 January 2016. With a frail majority of 83 votes of a 151 in total, Croatia elected its first nonpartisan prime minister proposed by the Patriotic Coalition (led by the HDZ) and supported by the Bridge party. In the short run, the political uncertainty thus ended. However, fact remains that Croatia has no experience with a nonpartisan prime minister and that reforms are, as a rule, harder to implement in multi-party (coalition) governments relying on frail majorities. All this can reflect a very difficult environment to implement reform, higher degree of insecurity and instability. On the other hand, it is precisely a nonpartisan prime minister without a political background and with plans, at least nominally, of change and reform in the Croatian economy that gives rise to the belief and hope that the necessary turnaround will be achieved. In his first address before the Croatian Parliament the Prime Minister concisely presented the strategy for "transforming Croatia". According to the new government's vision Croatia should until 2020 undergo transformation in three key segments: economic growth, competitiveness and quality of life. An exact time framework for the transformation was also given. The transformation is divided into fast results to be seen in 2016, medium-term results to be achieved until 2017, and the long term vision for the period after 2018. The presented basic macroeconomic projections seem ambitious (average GDP growth at 3% of GDP; exports growth for more than 30%; fiscal deficit below 3% of GDP by 2017; public debt decrease below 80% of GDP by 2020; significant inflows from FDI and EU funds) but not unattainable under the condition that structural

### The framework for Croatia transformation

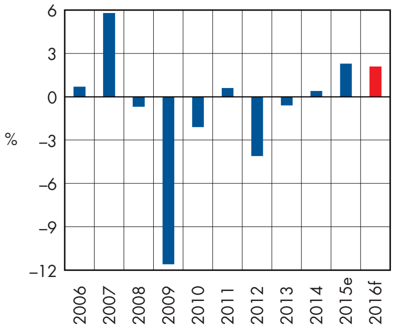



*Sources: PM's presentation in the Parliament, January 22th 2016, Raiffeisen RESEARCH* reforms are implemented in the mentioned areas. The high-frequency indicators for the last quarter 2015 confirmed that the trend of economic recovery continued. The growth of the consumer sentiment and consumer confidence indices was confirmed by data on retail trade with continued trending upwards, reflecting that personal consumption, as the largest constituent of GDP, might, for the fourth quarter in a row, positively contribute to economic recovery. In addition to alleviating the burden from personal income, which was achieved by tax amendments and absence of inflationary pressures, this is surely a consequence of the extended tourist season and slowed down of negative trends in the labour market, as well as improved expectations. These mild growth rates should continue in this year's first quarter with additional momentum to come from earlier employment of seasonal workers before the onset of the tourist season. Significant growth rates of recovery in personal consumption may be expected only after the start of the employment growth cycle and the end of the process of households deleveraging. And while this last factor has probably neared its end, the growth of employment largely depends on private sector recovery, the only sector which can generate sustainable growth and employment in the future. Assuming that the adjustment will go beyond one-off cuts and will be accompanied by structural changes of large public systems and state administration, aided by increased efficiency and a rule of law, impetus could be provided for the private sector and economic growth could be made sustainable. This would largely offset the possible one-off negative effect of the expected fiscal consolidation, ensuring continued growth in 2016. The main growth drivers could be the exports of goods and services and investments. The projected growth in Croatia's most important trading partners, continued instability in competitive tourist destinations and a noticeable improvement in the quality of Croatia as a tourist destination encourage positive expectations. Investment activity registered first signs of recovery in Q3 2015. In this regard, however, there is still no positive contribution from the construction sector which hit rock bottom. Nevertheless, although the number of construction permits is still in decline, completed works and growth of new orders imply that construction might show positive growth in 2016. However, the projected continuation of economic recovery is exposed to both external and internal risks both in the short and in the long run. A slowdown in recovery in the EU, that is, Croatia's main trading partners, would have unfavourable effects on exports.

Still worrying is the high dependence on tourism, with its share in the economy, in terms of revenues, reaching almost 19% of GDP. Amid relatively high negative geopolitical factors, overdependence on tourism may have quite a negative effect. On the other hand, postponing the consolidation of public finances and maintaining the unfavourable business environment would surely negatively affect the country's credit rating and investments, and indirectly borrowing costs, contribute to possible return of recessionary developments and to renewed decline of employment. Therefore, however fragile support this new Croatian government might have, it should finally face the country's old and by now deeply-rooted problems.

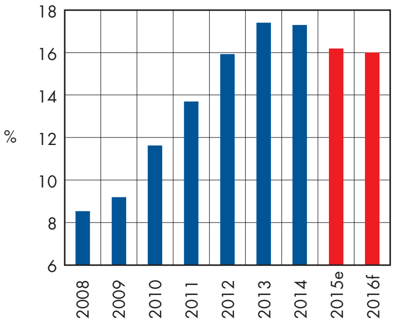
*Financial analyst: Zrinka Živković-Matijević*

**Retail trade, annual change**



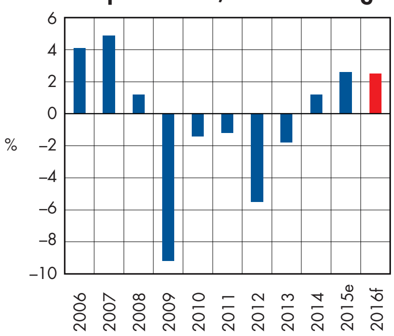

*Sources: CBS, Raiffeisen RESEARCH*

**Unemployment rate, avg. (ILO)**




*Sources: CBS, Raiffeisen RESEARCH*

**Industrial production, annual change**




*Sources: CBS, Raiffeisen RESEARCH*

# The 2016 Budget – a mirror of the new government direction

- **Ample VAT revenues stemming from a good tourist season**
- **Fiscal transparency undermined**
- **Rising public debt – a reflection of the absence of fiscal consolidation**

### EC's key findings on implementation of reforms (December, 2015)*

**1. "On track"**
- Insolvency framework
- Support measures for youth employment
- Reduction in administrative burden on business
- Improving tax compliance

**2. "Wait and see"**
- Budgetary planning
- Revision of fiscal rules
- Healthcare efficiency
- Wage-setting framework
- Reduction in inflows into early retirement
- Reductions of parafiscal charges
- Improvements in the transparency and accountability in the public corporate sector
- Improving the efficiency and quality of the justice system
- Strengthening governance in HBOR

**3. "Action wanted"**
- Fiscal consolidation to enable reduction of public debt
- Public debt management reinforcement
- Reform of public administration
- Introduction of a recurrent property tax
- Improvements to legislative planning
- Listing of minority packages of SOE shares and privatisations
- Streamlining of social benefits

*"**On track**" – measures for which the legislative or implementation process has been completed or is on schedule, and which are expected to be sufficiently effective;*

*"**Wait and see**" – measures for which the legislative process is ongoing, but is still in a relatively early phase, or for which there is still uncertainty as to complete implementation and effectiveness;*

*"**Action wanted**" – measures for which limited or no action has been taken, or which have been announced but are as yet insufficiently detailed to be assessed.*

** EC's Review of progress on policy measures relevant for the correction of macroeconomic imbalances (MIP)*
*Sources: EC, Raiffeisen RESEARCH*

Although overshadowed by turbulent post-election events in Croatia's political arena, the fiscal activity of last-year's December was quite dynamic. Until the end of 2015, Croatia's technical government adopted a series of decisions on new borrowings and extended new government guarantees, while we have greeted the new fiscal year with a matrix of temporary financing that scheduled until late March of this year. In the meantime, we have been awaiting the most important consolidated budget report (at general government level) which will show what happened with Croatia's public finances in the past year. The answer to this question can only partially be found in the recent report on the work of the government in the period between 2011 and 2015. At the same time, publicly available fiscal data are abundant in already known deficiencies that have significantly undermined fiscal transparency (primarily in relation to the exclusion of the Croatian Health Insurance Fund from the single treasury account). Therefore, although it is not possible to precisely quantify the divergence from the fiscal goals set in the latest Convergence Programme (linked to the requirements under the EDP), the available data are sufficient to reach the most important conclusions.

The better VAT collection reflects, in addition to positive effects of fiscalisation, a splendid tourist season which resulted in multiplicative effects on the overall economic activity last year. Almost all constituents of revenues from excise duties indicate an annual growth, while a positive contribution was registered from the increase in excise duties on energy products and electricity, and from the implementation of the gradual increase in the minimum excise duties on cigarettes as required by relevant EU regulations. On the other hand, revenues from contributions clearly reflect the main malady of the Croatian fiscus: indicating drop on annual level they warn of the growing insufficiency of the purposely collected funds (primarily in the segment of the pension and health care systems). This is underlined by the fact that last year Croatia required on average more than HRK 3bn per month only for pensions, while at the same time revenues from pension contributions came in at almost half that figure. Therefore, the government opted for transferring funds from the second pension pillar, in the amount of HRK 1.3bn (following the HRK 3.1bn transferred the year before), in November last year. It is worth noting, however, that such a one-off transfer is not treated as budget revenue under the ESA 2010 methodology.

At the same time, the calcified, rigid structure of swollen public expenditures results in cumulative deficits that lead to new growth of public debt that neared 90% of GDP. Interest expenses (at HRK 11bn) warn of a possible *snowball* effect. Therefore, the new Croatian government is faced with the absolute necessity of intervening with expenditures which should finally become the focus of the fiscal consolidation process. The 2016 Budget (which is expected to be adopted during March) will be the first indicator of how serious those intentions are. Until it is adopted we maintain all our macroeconomic and fiscal projections at current levels.

*Financial analyst: Tomislava Ujević*

# One more chance

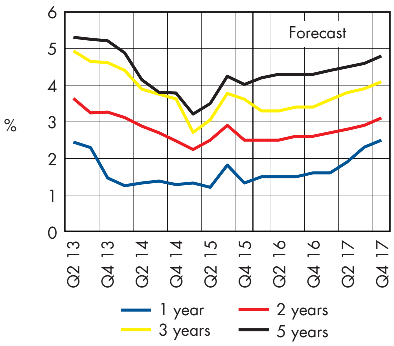
- **Rating maintained**
- **Yields decline on the wings of belief in forecasted reforms**

In the midst of the formation of a new government, headed by a nonpartisan Prime Minister and, at least nominally, committed to reform, the credit rating agency Standard & Poor's reaffirmed Croatia's long-term rating at two notches below the investment level, with a negative outlook. The agency's report clearly stressed that although acknowledging that recovery had started, key measures to contain public debt growth had not been implemented. It is our impression that S&P's provided the new government with a one more chance to address the country's key issues, propose necessary measures and start implementing them. The negative risks (closely linked with the implementation of the said measures) continue to pose a threat both to debt sustainability and stable recovery. It remains certain that in order to win back the stable outlook a much greater effort will have to be invested.

This is also confirmed by the latest report of the European Commission on Croatia's progress in correcting macroeconomic imbalances, according to which "the rising public debt is a source of concern". Namely, despite the decline in fiscal deficit it remains among the highest in the EU, consequently leading to further rise of public debt that grew close to 90% of GDP. In addition, the Commission's report confirmed that thus far no steps have been taken to reinforce public debt management. In the meantime, post-election uncertainty and widening of the spreads that had started already in the third-quarter of 2015 were finally halted late in the year. A mild correction of both the spreads and the yields that was seen in the first half of January was probably a consequence of the expectations that the Government would use 2016 to remove deeply rooted structural problems and to improve the investment climate. Croatia's risk premium will remain much higher than that of comparable countries of the region, clearly reflecting that in order to gain investor confidence ambitious plans need to be translated into reality.

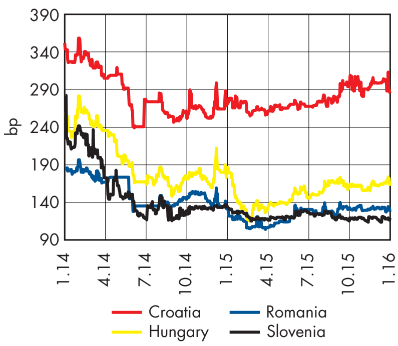
By issuing a HRK government bond (worth HRK 6bn, with a 4.25% coupon and the average yield at issue of 4.40%) in the domestic capital market, the Ministry of Finance extended the kuna curve until 2026, concurrently ensuring a portion of funds needed for the first quarter of 2016. In view of the fact that the government had HRK 9.7bn available at its deposit account with the central bank at the end of November, it is quite certain that the borrowing envisaged for the first quarter of 2016 under the decision on temporary financing will not be realised. The aforementioned data make it clear that a portion of funds (some HRK 7bn) from 2015 were transferred to the next fiscal year (despite the ten-year kuna bond, worth HRK 5.5bn, maturing in December). There are no international bonds maturing in 2016, while the first domestic issue is to becomes due in July. According to our estimates, the overall amount of liabilities under securities issued and general government loans exceeds EUR 7.1bn. In addition to the estimated general government deficit at 4.5% of GDP, the aggregate refinancing obligations reach 21% of GDP. They include liabilities under short-term liabilities which are usually rolled over at maturity. In 2015, the central government directed almost all of its short-term instruments towards kuna borrowing thus sub-

**Croatian government bonds yields (HRK)**



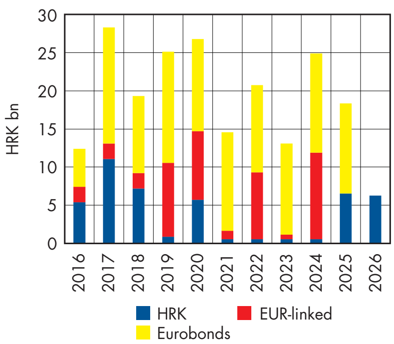

*Sources: Bloomberg, Raiffeisen RESEARCH*

**5Y CDS (USD)**



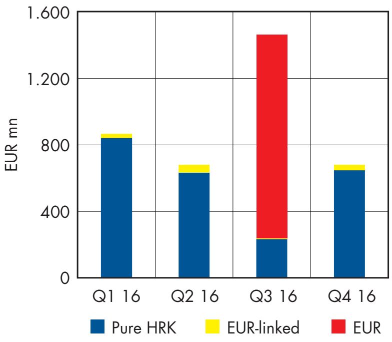

*Sources: Bloomberg, Raiffeisen RESEARCH*

**Government debt maturities (bonds)**



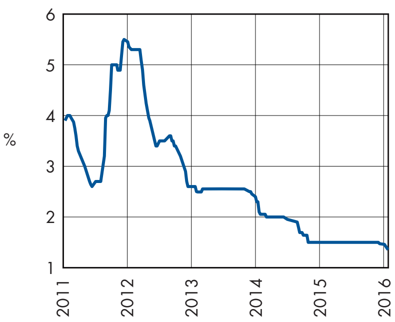

** converted at mid-FX rate on 22th January 2016*
*Sources: MoF, Raiffeisen RESEARCH*

**T-bills Outstanding amounts**




*Sources: MoF, Raiffeisen RESEARCH*

**1-y T-bill yield (HRK)**



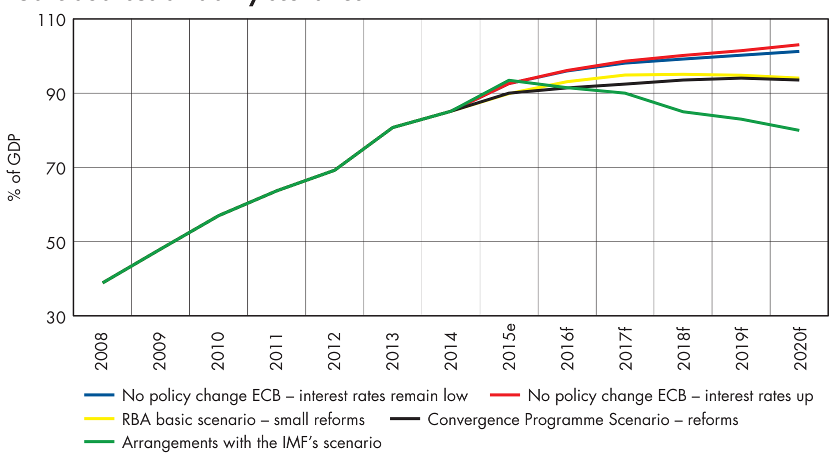

*Sources: MoF, Raiffeisen RESEARCH*

stantially diminishing the currency risk. Nevertheless, a portion of T-bills, worth EUR 1.225bn, falls on the T-bill issued in February 2015, which will, given its 18-month maturity, fall due in August this year. After maintaining a level of 1.5% for the most part of the year, the yields on T-bills saw a slight but indicative new fall at the latest auctions. Given that the monetary policy in 2016 will continue supporting high liquidity, the yields on short-term securities are bound to hold at least at their current level. Aided by the projected economic recovery and the expected consolidation of public finances, as well as the expansive character of monetary policies pursued by both the CNB and the ECB, Croatia's risk premium should trend slightly downward. Amid these conditions and continued ample liquidity both in the domestic and the foreign market, Croatia's debt will become attractive given the returns it offers. However, poor fiscal metrics and the behaviour of economic policy-makers thus far cause particular caution among market participants. Therefore, even the slightest departure from the expected consolidation of public finances may very soon be reflected in the growth of yields and the premium. This will also surely be underlined by rating agencies, with the first indicator of the new government's behaviour being the 2016 budget. Although there are no foreign issues maturing this year, we think that the government will nevertheless opt for issuing a Eurobond in the European market to finance some of its needs. The US market is not a likely option given the fact that the Fed started normalising its interest rate late in 2015 and is expected to continue raising its key interest rate throughout 2016 and 2017.

The domestic market will continue to be marked by steady demand, especially from big institutional investors, the pension funds. The bulk of activity is expected to be seen at the shorter end of the curve, while the positive effect in the longer segment is expected if the central bank starts carrying out long-term repo operations consistently and uninterruptedly which would also facilitate fiscal consolidation.

*Financial analyst: Zrinka Živković Matijević*

**Public debt sustainability scenarios**




*Sources: IMF, EC, Raiffeisen RESEARCH*

# New monetary policy measures no threat to kuna stability

- **No stronger depreciation pressures on the kuna**
- **High HRK liquidity paired with consistent FX policy**

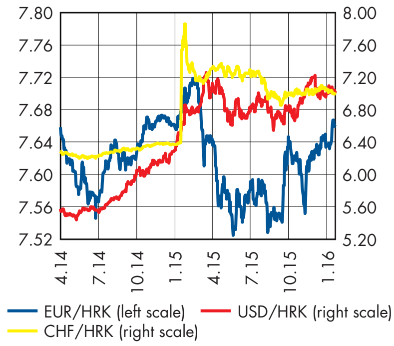
The stability of the HRK exchange rate against the euro remained preserved in the last quarter of 2015. Moreover, the absence of stronger depreciation pressures enabled the exchange rate of the HRK to edge up against the euro. The HRK was supported by a stronger pre-holiday demand for the domestic currency and favourable developments in foreign trade. The year ended with the exchange rate down 0.34%yoy, while the slow slippage of the average exchange rate on an annual level that has been observed since 2010 stopped. The average 2015 mid-point EUR/HRK exchange rate at the exchange rate list of the Croatian National Bank totalled 7.61 kuna for one euro, down 0.3%yoy. The reasons for this are to be sought in the first signs of economic recovery, FCY capital inflow and the much improved current account surplus.

Uneventful trading continued at the beginning of 2016 with only a mild volatility of the exchange rate of the HRK against the euro. As usual, we expect the EUR/HRK exchange rate to slowly slip towards higher levels, also supported by the balance sheet adjustments of banks due to the conversion of loans indexed to the Swiss franc into loans in euros. The weakening of the HRK was partly supported by the uncertainty surrounding the formation and future activities of the new government, and fiscal risks. The stable government and the credible plan, and later the implementation of reforms paired with improved investment climate would surely provide support to the domestic currency through stronger inflow of investments and more stable recovery. Otherwise we cannot exclude a slow growth of the EUR/HRK exchange rate. As spring approaches, partly due to pre-holiday spending (Easter) and partly due to the beginning of the low tourist season, we expect the domestic currency to gain strength against the euro and grow ever stronger as the first half of the year draws near. Given the fact that the ECB will continue to ensure favourable borrowing conditions in 2016 through its unconventional measures, we cannot exclude a possibility of the corporate sector continuing to turn towards foreign capital markets and an inflow of foreign currency from this source.

The monetary policy is expected to remain consistent in maintaining the stability of the EUR/HRK exchange rate but also directed towards ensuring high liquidity of the financial system. The announced long-term structural operations (repo auctions with maturities over one year) do not constitute a change in monetary policy instruments (from the exchange rate policy to an interest rate policy). The intention of new operations is to provide banks with more long-term sources of HRK liquidity. Ensuring high HRK liquidity in the domestic financial market enables low interest rates at the shorter-end of the HRK curve but creates potential pressure at the longer end of the curve, thus opening additional room for the implementation of the necessary fiscal consolidation measures that would surely support the domestic currency in the medium term. In case of exchange rate volatility and excessive pressures on the HRK, when choosing its measures the central bank will undoubtedly remain consistent in defending the exchange rate, even at the price of higher interest rates.

*Financial analyst: Zrinka Živković Matijević*

**Middle exchange rate of the CNB**



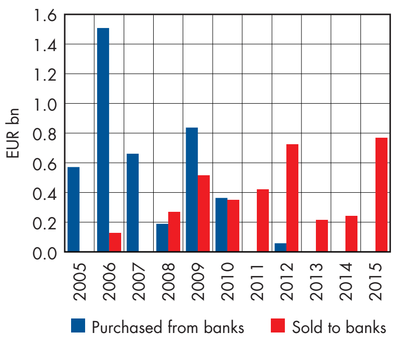

*Source: CNB, Raiffeisen RESEARCH*

**Middle exchange rate of the CNB**

| | Middle exchange rate | Change compared to: 31.12.2014 | | |
|---|---|---|---|---|
| | 31.12.15 | Exch. rate | Move-ments | % |
| EUR | 7.6350 | 7.6615 | ↓ | –0.34 |
| USD | 6.9918 | 6.3021 | ↑ | 10.94 |
| CHF | 7.0597 | 6.3681 | ↑ | 10.86 |
| GBP | 10.3610 | 9.7848 | ↑ | 5.89 |

*Sources: CNB, Raiffeisen RESEARCH*

**FX interventions of the CNB**




*Sources: CNB, Raiffeisen RESEARCH*

**Exchange rate forecast**

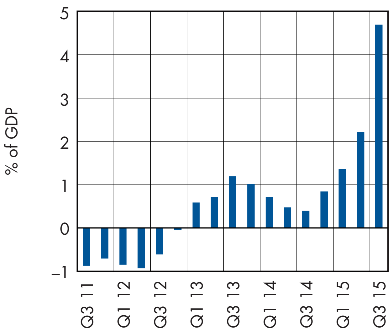
| | 2016e | 2017f |
|---|---|---|
| EUR/HRK, avg | 7.65 | 7.66 |
| EUR/HRK, eop | 7.68 | 7.65 |
| USD/HRK, avg | 7.50 | 6.96 |
| USD/HRK, eop | 7.60 | 6.65 |
| CHF/HRK, avg | 6.95 | 6.96 |
| CHF/HRK, eop | 6.98 | 6.95 |

*Source: Raiffeisen RESEARCH*

# Under the impact of the CHF conversion and good tourist season

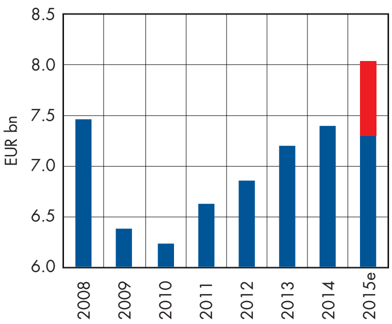
- **Surplus in the balance of payments current account continues increasing**
- **Strong impact of the CHF conversion on the external cash flows**
- **Total gross external debt continues growing on an annual level**

**C/A balance**



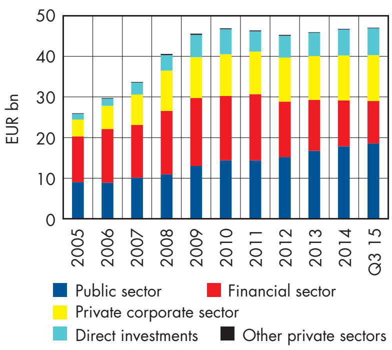

*Sources: CNB, Raiffeisen RESEARCH*

**Travel receipts (tourism)**




*Sources: CNB, Raiffeisen RESEARCH*

**Gross external debt, eop**




*Sources: CNB, Raiffeisen RESEARCH*

The EUR 3.9bn surplus registered at the balance of payments current account in the Q3 last year resulted also in the positive cumulative balance (over four consecutive quarters) of 4.7% of GDP. In addition to the inflow of foreign currency stemming from a good tourist season, this was also partly a consequence of banks registering losses in their accounts caused by the forced CHF conversion. Namely, the usual deficit in the primary income account had not been seen, i.e. the registered positive balance was a direct consequence of bank losses caused by the said conversion (EUR 389mn). At the same time, the expected positive contribution in the current account balance came from the surplus-generating services account, which was a result of exceptional tourism results. Namely, income from travel in the Q3 of last year reached its historical high, in nominal terms, of EUR 5bn, thus considerably increasing on an annual level, by 7.5%. On the other hand, the usual negative contribution came from the sub-account of goods (amid the widening of the trade deficit). As for the capital account, the negative effect of the CHF conversion was reflected in the data on foreign direct investments which registered a decline of almost 50% on an annual level in the first three quarters of 2015. Thus, the positive contribution to FDI generated by the sale of TDR to the British BAT was for the most part neutralised by the mentioned bank losses. At 2015-level, we expect the surplus in the balance of payments current account to hold at 4.7% of GDP (of which 2 percentage points are accounted for by one-off bank losses due to the CHF conversion), and a considerable positive contribution to come from revenues from tourism, which might (given the healthy volume indicators for the low season) exceed EUR 8bn.

The latest data on gross external debt at the end of the Q3 2015 confirmed the continuation of the upward trend, in annual terms, predominantly caused by high obligations of the state towards external creditors. Thus, at the end of September, total gross external debt stood at EUR 47bn or 107.6% of GDP, rising on an annual level by EUR 480m (1%). Almost 40% of total gross external debt of the Republic of Croatia relates to public sector indebtedness, which at the end of the month under review reached EUR 18.6% (4.9%yoy). It is important to stress that foreign exchange differences, i.e. the appreciation of the dollar against the euro, made a negative contribution to the debt level presented in euros. This is particularly true for the general government debt since the external debt statistics does not reflect the embedded hedge against the currency risk (relating to USD issues of government bonds) as a result of which the nominal figure of the debt is higher than the actual balance. On the other hand, gross external debt of the private sector went down to EUR 28.4bn, predominantly as a result of the deleveraging of the financial sector started back in May 2012. However, private non-financial corporations recorded a continuation in the annual growth of external debt, which is not surprising given the more attractive financing conditions in external markets. The ECB's latest monetary measures give additional boost to expectations of continued borrowing of private enterprises in external financial markets until the end of 2015, while the government sector is to maintain its relatively high share in the total gross external debt.

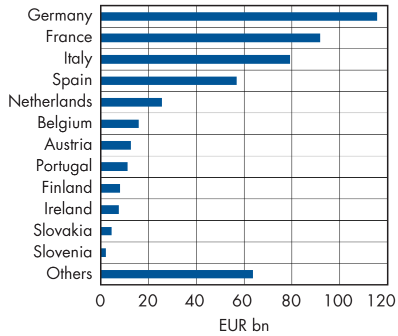
*Financial analyst: Tomislava Ujević*

# Monetary policy divergence – the key factor in 2016

- The Fed started raising its key interest rate in December
- The ECB continued its monetary policy easing early in December

At the end of last year, the main focus of the global markets was on the beginning of stronger divergence in monetary policies of the two of the major world's central banks. At its meeting in December 2015, the Fed decided to tighten its low interest rate policy and for the first time since June 2006 raise the target range for the federal funds rate by 25 b.p. to 0,25% to 0,50%. This ended an era of zero interest rates that began seven years ago. The majority of the Fed's officials expect to raise interest rates for 100 b.p. in 2016 and additional 100 b.p. in 2017 which they build on expectations that positive trends in the labour market will continue, and GDP will grow beyond its potential and that inflation will grow to 1,6% in 2016. In her address, the chair of the Federal Reserve J. Yellen stressed that further normalisation of interest rates would not be mechanical (in the same amount and/or in regular intervals) but rather will be carried out at a moderate pace, depending on the incoming economic data. If the Fed observes the envisaged dynamics of the increases, the journey to the "neutral" level might extend to 2018. Due to further improvements on the labour market (and in case of GDP growth beyond the potential), and with stronger than expected inflationary pressures, the process might be accelerated to end late in 2017. The next hike is not to be seen until the meeting in early March.

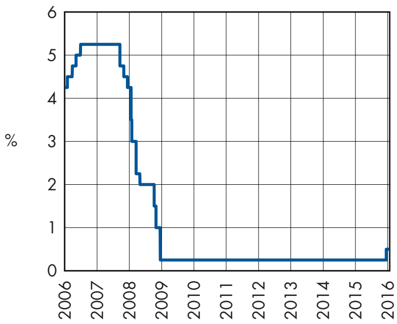
**Public sector purchase programme (PSPP)***




** till Dec 31 2015*
*Sources: ECB, Raiffeisen istraživanja*

On our side of the Atlantic, at its meeting in early December 2015, the ECB decided to further ease its monetary policy stance by expanding the set of its unconventional monetary policy measures. The interest rate on the deposit facility with the ECB was thus lowered to –0,30%, QE program is extended by the end of March 2017. Marketable debt securities of regional and local governments in the euro area were included in the programme. The ECB also decided to reinvest the principal payments on the securities purchased under the QE programme. It should be emphasized the readiness of the ECB to extend the extremely expansionary monetary policy based on inflation rate and the pace of recovery.

**Federal Funds Target Rate***




*as of 22 Jan 2016*
**from 16 Dec 2008, FOMC defines range*
*Sources: FED St. Louis, Raiffaiesen RESEARCH*

We expect the ECB to continue its *wait-and-see* policy throughout 2016. In the quarters to come, despite the new fall in crude oil prices, we expect its influence to wear down gradually and inflationary pressures to grow stronger, as well as the euro area economy to continue its moderate recovery boosted predominantly by domestic demand. According to our forecasts, further pressures on the ECB's monetary policy easing should ease this year. We believe that unlike of changes in the QE program, ECB will likely reduce interest rate on deposits facility (between –0.4% and –0.5%). Its monetary policy is expected to continue affecting the bond market in 2016. The relatively stable upward trend in the quarterly yield growth on medium–and long–term German bonds might continue in 2016. The yield on the 2–year German bond is expected to move around the interest rate on the ECB's deposit facility (–0,30%).

**Financial market forecasts**

| | Mar-16 | Jun-16 | Sep-16 | Dec-17 |
|---|---|---|---|---|
| EUR/USD | 1.05 | 1.03 | 1.01 | 1.01 |
| Fed key rate | 0.75 | 0.75 | 1.00 | 1.50 |
| USD 3m LIBOR | 0.80 | 0.75 | 1.05 | 1.55 |
| USD 10y yield | 2.20 | 2.40 | 2.70 | 3.10 |
| ECB key rate | 0.05 | 0.05 | 0.05 | 0.05 |
| 3m EURIBOR | –0.25 | –0.25 | –0.25 | –0.25 |
| GE 10y yield | 0.50 | 0.50 | 0.80 | 1.00 |

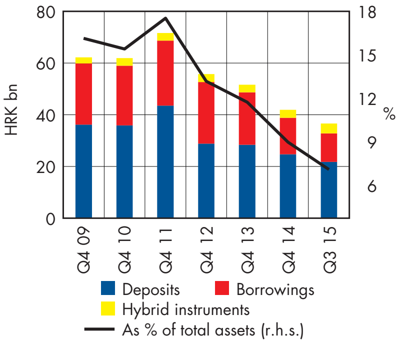
*as of 22.1.2016*
*Sources: Raiffeisen RESEARCH*

Financial analyst: Mate Rosan

# Banks highly capitalised despite sustained losses

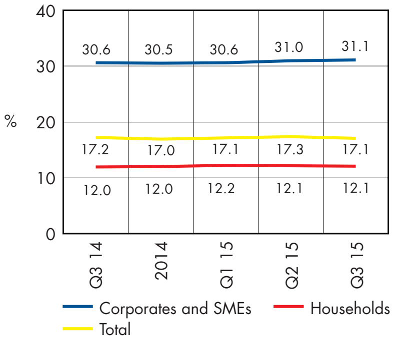
- Surplus FX liquidity strengthens the process of banks deleveraging abroad
- Share of non-performing in total loans stabilises
- Demand for loans in local currency strengthens

### Debt investments from foreign parent banks to Croatian banks



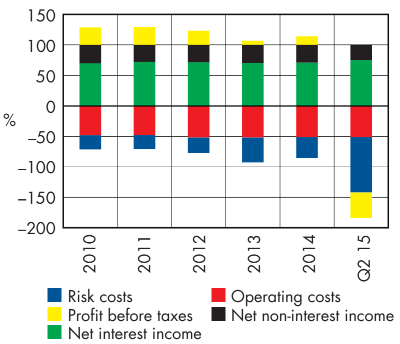

*Sources: CNB, Raiffeisen Research*

### NPLs ratio, eop (%)




*Sources: CNB, Raiffeisen Research*

### Gross Income structure of Croatian banking sector, in % of GI*




** Legend:*
*– formation of Gross income (from 0% to 100%)*
*– distribution of GI, except Pbt (below 0%)*
*– Profit bt as % of GI (over 100%)*
*– Loss bt as % of GI (low)*
*Sources: CNB, Raiffeisen Research*

The one-off loss sustained by banks last year due to the forced conversion of loans denominated in the Swiss franc into euros, in the amount equal to a two-year gross profit, resulted in the decrease of their capital adequacy to 20%. This remains a high rate of capitalisation so the sustained loss had no adverse effects on the loan supply. On the other hand, economic recovery resulted in the reversal of the years-long trend of the growing share of banks' non-performing loans. In the last four quarters they levelled-off at 17% of total loans. The coverage of non-performing loans by value adjustments went up to 55%. It is likely that the continuation of the favourable trend will result in the reduction of costs for covering credit risk, while the parallel decrease in the price of finance will enable banks to offer loans at lower interest rates. The turn of the year was marked by the process of forced conversion of loans. During the conversion period demand for new loans went down because banks and clients alike were focused on the outcome of the process. On the other hand, the prolonged period of political uncertainty following the parliamentary elections in November additionally reduced the aptitude for borrowing and investment. During the period of negotiations on the forming of the parliamentary majority, the majority of political parties announced the possibility of changes to monetary policy aimed at pushing down the price of capital. Therefore, potential borrowers expected more favourable borrowing conditions in the near future and postponed their decision to borrow.

Amid the circumstances of decreasing overall loan demand we have noticed changes in its currency structure. Demand for loans in the local currency increased, by both households and enterprises alike. Although the users of loans in the Swiss franc were in the end forgiven the negative exchange rate differences that arise from contractual relationships with creditors, the unfavourable effects of exchange rate changes in the period before the adoption of the regulation on the forced conversion raised the awareness of potential borrowers regarding currency risks. The consequential risk-aversion directed potential clients towards borrowing in the local currency. However, the awareness of currency risks did not have the same effect on the deposit structure. Deposits in euros are prevailing, which increases pressures on the currency structure in banks' balance sheets. Consequently, there is excess foreign exchange liquidity in the banking system which is used to decrease external secondary sources of funding. The process of banks deleveraging abroad started in 2012 and might receive additional momentum if bank clients continue leaning towards borrowing in the local currency. At the same time, the scarcity of long-term sources of funding in the local currency is to increase. Therefore, the monetary authorities have announced the introduction of structural operations directed at supplying long-term bank refinancing in the local currency against eligible collateral. However, should bank deleveraging continue at the projected pace, the process will be completed next year. Unless demand for loans increases in the meantime, banks will have to expose themselves to higher and higher currency risks or direct surplus foreign currency savings to placements abroad.

*Financial analyst: Anton Starčević*

# Commodities markets – main drivers behind consumer prices

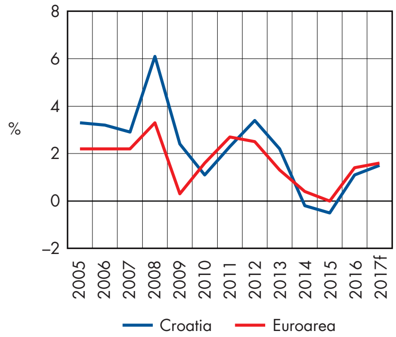
- **Consumer prices continue falling**
- **Prices in the euro area and Croatia under the influence of declining oil prices**
- **Inflationary pressures to grow stronger?**

The Croatian economy has been characterised by negative inflation rates for the second year in the row. In the year behind us, the average annual inflation rate went down by 0.5%, to its lowest level since the launching of the Stabilisation Programme in October 1993.

The reason of CPI decline in 2015 was to the greatest extent a consequence of imported deflationary pressures due to direct and indirect effects of the decline in crude oil prices on global markets. The decline in oil prices spilled over to the prices of other components of the consumer price index, such as the prices of travel or transportation services (cost-push inflation). Predominantly under the influence of the decline of oil prices in the global oil markets the average prices in the transport category went down by 6.7% on average in 2015, while the prices in the category of fuels and lubricants went down even more, by 10.6%. The fall was felt in most other consumption categories as well. The downward pressure on general price levels was softened by the increase in average prices in the categories of recreation and culture, alcoholic beverages and tobacco, health, restaurants and hotels, communications and the largest category, food and non-alcoholic beverages. On the other hand, there was no stronger impetus from aggregate domestic demand, which was hardly surprising given the modest recovery and the weak labour market.

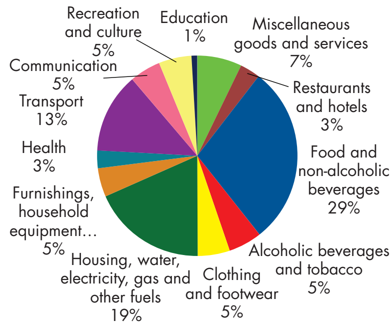
A review of the situation in the countries of the region, especially in the euro area, where Croatia's most important trading partners are from, reflects similar trends. Namely, the greatest contribution to the slowdown in the growth of consumer prices came from the accelerated annual decline in the prices of energy spurred by the fall in crude oil prices in global markets. However, support to price growth in the euro area came from demand (wages) and corporate margins. In the year under observation, the inflation rate measured by the Harmonised Index of Consumer Prices (HICP) moved at slightly above zero, with temporary periods of deflation. So according to the preliminary data, the 2015 ended in stagnation on an annual level. In contrast to the euro area, where it levelled off, in Croatia inflation declined under the strong influence of energy prices because the prices of oil products in the domestic market went down at a relatively steeper rate than in the euro area (25.4% vs 22.7%). In Croatia, the growth in the prices of services slowed down at the same time, which was not the case in the euro area. The weakness of core inflation (excluding the prices of energy and food) in the euro area (averaged below 1%, still under the historical low of 1.46%), largely reflects still the negative GDP gap which has yet to close since the crisis. Although low prices of energy and other goods contribute to low inflationary pressures, the growth of wages (and consequently of demand in the euro area) gives rise to mounting inflationary pressures on the demand side (demand pull inflation), which is not the case in Croatia. A review of the structure of the consumer basket in the euro area and in Croatia reveals its different composition which surely affects developments in the general average price level. In Croatia, the consumer basket is dominated by food and non-alcoholic beverages with a share of almost 30%, followed by housing costs (18.4%), while in the consumer basket in the

**CPI, % yoy**



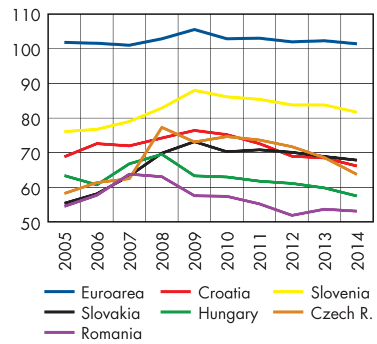

*Sources; CBS, Raiffeisen RESEARCH*

**Structure of basket of goods, Dec 2015**



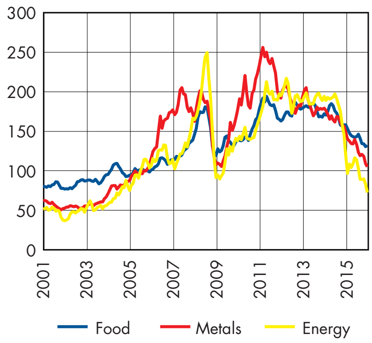

*Sources; CBS, Raiffeisen RESEARCH*

**CPI by PPP (EU28 = 100)**



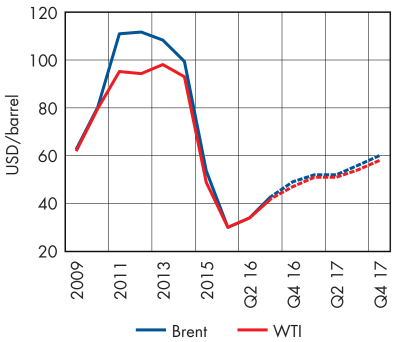

*Sources: Eurostat, Raiffeisen RESEARCH*

**Commodity Price Indices (2005=100)**



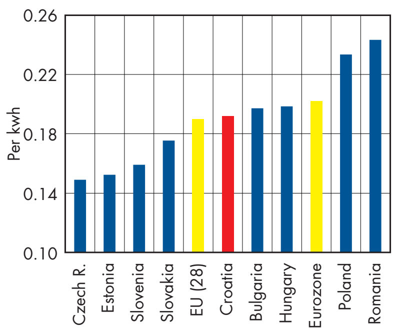

*Sources: IMF, Raiffeisen RESEARCH*

**Crude oil prices**




*Sources: Bloomberg, Raiffeisen RESEARCH*

**Electricity prices for domestic consumers (PPS)***




** as of June 2015*
*Sources: Eurostat, Raiffeisen RESEARCH*

euro area the said categories account for 15.6% and 16.5% respectively. In the euro area the share accounted for by the categories of clothing and footwear, and furniture in the basket of goods is larger than in Croatia, and so is the share of household equipment, health, transport, recreation and culture, education and restaurants and hotels.

With the beginning of 2000's and stronger demand from emerging markets, developments in the commodities market have grown to become more and more important, or maybe even became a key factor in the development of consumer prices (and thus linked expectations) at the global level. The change in the dynamics of the prices of goods over the last decade is visible in all categories, although somewhat more prominent in the prices of energy and metal (in comparison to the developments in the prices of food). In general, higher volatility and increased co-movement of prices in the commodities markets have been causing greater fluctuations of consumer prices year after year, as well as growth of uncertainty as regards future developments. These changes might substantially affect inflation in import-oriented economies such as Croatia. For example, after a period of relatively stable developments (in the early years of the new millennium), the prices in the commodities markets have trended upwards since 2003, spurred by the unexpectedly strong growth of demand from emerging markets such as China and India. New impetus to growth came over the next few years when unfavourable climate together with redirection to renewable sources of energy spurred a rise in the prices of food. Consequently, due to high import-orientation of the economy, the annual rate of inflation in Croatia in 2008 reached a high 6.1%. After the financial crisis of 2008, the decline in activity and demand for goods led to a strong growth in the prices of metal and oil, which soon stabilised at pre-crisis levels. In the past two years, the greatest influence has been exerted by developments in the oil market, which has in a relatively short period registered a strong two-digit decline in prices. From levels of over USD 100 per barrel registered in 2013, the price of crude oil (with delivery in three months) went down to its lowest level in the last 12 years (below USD 30 per barrel).

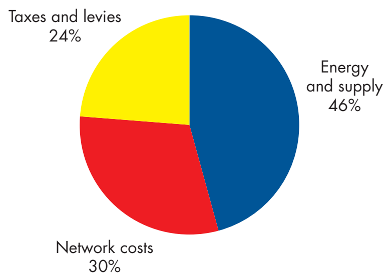
The reason for this fall is the strong output of OPEC members, the US and Russia, which are unwilling to give up their market shares even at the price of unprofitable production. Additional pressure came from Iran against which international sanctions were lifted early in 2016. At the same time, demand is not strong enough to absorb the increased supply. Weak economic growth in emerging markets, especially in the Chinese production sector and in Brazil (where GDP contracted by much more than expected in the Q3) contributed to a slowdown in global demand for crude oil. Regardless of the aforementioned, according to our expectations the price of oil should recover some of its strength as the year draws to its end. We base our forecasts on the decline in the production of shale oil (US) and the increase in global demand for oil in the Q3 and the Q4 2015 by 1.5m barrel per day compared with the first half of the year. This should weaken the influence of the price of oil on price levels until later in the year. The projections of mild recovery in the prices of oil are exposed to negative risks especially in case of a significant slowdown in China's economic growth, high level of supply maintained by non-OPEC members, etc.

In Croatia, the fall in prices has thus far not become a structural problem. To the contrary, the absence of inflation contributed positively to the increase in real income and consumption. However, the decline in prices also resulted in weaker budget revenues and diminished the nominal GDP, deteriorating relative values (such as the percentage of GDP) of the budget deficit, public and external debt. The seemingly attractive short-term decline in prices (so-called deflation) hides a whole array of negative consequences. Deflation is actually an unwanted phenomenon which usually leads to further deepening of recession, postponement of investments, growth of unemployment and a general fall in the welfare of a society. In addition, it is much easier for economic policy-makers to steer inflation than halt deflation and its negative consequences. Recovery in a deflationary environment is much harder and longer. Japan is often taken as an example. It fell into a similar deflation spiral and had fought to escape it during the entire 1990s because it prevented it from achieving higher GDP growth rates. On the other hand, mild inflation rates (of 2% to 4%) are considered a desirable phenomenon both in economic theory and practice because they spur economic growth.

In the year ahead we expect consumer price growth to intensify slightly with the annual inflation rate averaging at some 1%. Slight inflationary pressures should continue to be a consequence of relatively low prices on the commodities markets (primarily that of crude oil) but also of the absence of stronger stimulate from aggregate demand with stronger pressure on the consolidation of public finances under the EDP. The contribution of energy to inflation should turn positive in the Q3 2016. Imported inflationary pressures might mount due to the expected growth of inflation in the euro area. A contribution to stronger-than-forecasted growth could come from the growth in administratively set prices (although there are no indications for this at the time), potentially unfavourable weather conditions that could contribute to stronger growth in the prices of agricultural products, as well as possible stronger growth in the prices of crude oil due to geopolitical tensions and more pronounced weakening of the exchange rate of the euro against the dollar than previously anticipated. On the other hand, the projected inflation rate is also exposed to negative risks arising predominantly from developments in the commodities markets, as confirmed by January developments in the crude oil prices, which fell down to their lowest level since 2003. In addition to the halted decline in the prices of oil and goods, in the upcoming few years inflation will be to the greatest extent generated by the increase in prices on commodities markets and by Croatia's structural problems. In general, dependence on imports, high trade deficit, monopoles, the growth of wages outstripping labour productivity, state subsidies to uncompetitive companies and sectors, as well as excessive and inefficient public investments represent constant sources of cost-push inflation. Cost-push inflation is normally revealed more slowly but it is long lasting and harder to manage than demand-pull inflation.

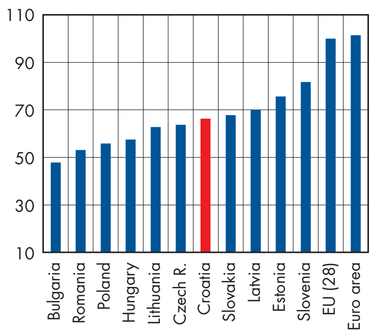
*Financial analysts: Mate Rosan, Elizabeta Sabolek-Resanović*

**Electricity prices components for households, 2014**



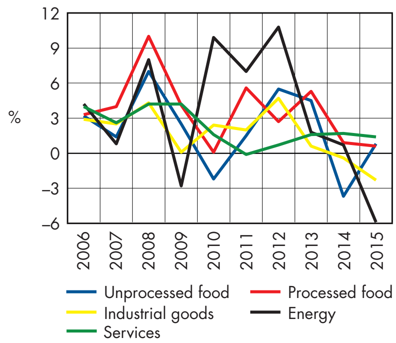

*Sources: Eurostat, Raiffeisen RESEARCH*

**Comparative price levels (EU28 = 100)***




** ratio between PPPs and market exchange rate*
*Sources: Eurostat, Raiffeisen RESEARCH*

**HICP components, annual change (2005 = 100), Croatia**

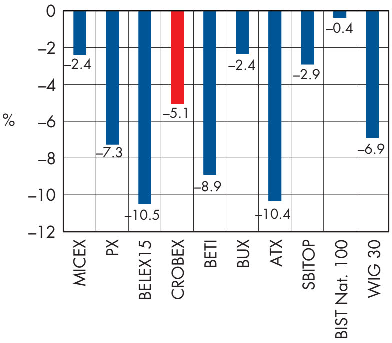



*Sources: Eurostat, Raiffeisen RESEARCH*

# A turbulent start of the year

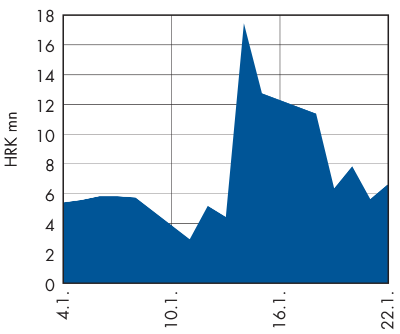
- After a bearish start to 2016, regional equity indices retreated part of the losses
- The negative global sentiment spilled over to the ZSE indices
- Turnover statistics on the ZSE continued shrinking

**CEE indices – performance for the first three weeks of 2016***




* in local currency, value on January 22, 2016 (6:30 PM)
Sources: Bloomberg, Raiffeisen RESEARCH

**Regular turnover**

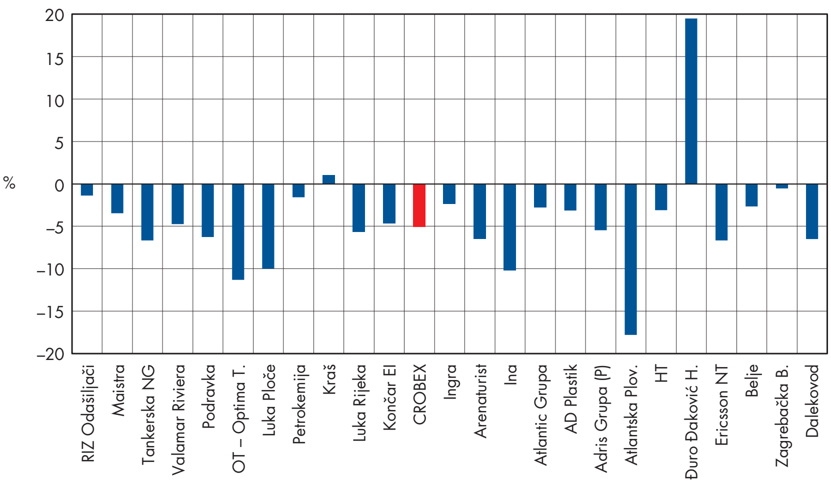



Source: ZSE, Raiffeisen RESEARCH

The year started with a strong correction of equity indices, primarily due to the slowdown in China's economic growth and the drop of the oil price to below USD 30 per barrel. The negative global sentiment spilled over to regional indices, all recording a drop, some over 10% in the first two weeks of the year. Still, expectations of additional monetary policy easing by the ECB reversed the negative trend and regional equity indices retreated part of the losses. In the year behind us, regional indices boasted different developments, predominantly influenced by local geopolitical and economic circumstances. Thus, the Hungarian BUX increased the most among regional indices in 2015, by as much as 42%, probably due to the announcement of the reduction of banking levies and the absence of surprises in fiscal policy measures. The Russian MICEX also boasted remarkable growth, while the Polish WIG30 and the Turkish BISTNat.100 were the leading laggards in 2015 most likely due to the growth of political uncertainty.

The negative global sentiment also hit equity indices of the ZSE. The CROBEX and the CROBEX10 fell by more than 6% in the first two weeks of the year, to recover subsequently to –5.1% and –5.5% respectively, since the beginning of the year. Among sector indices, the sharpest fall was that of the CROBEXtransport under the influence of China's economic growth slowdown while industrial and tourism shares had only a small correction. A similar pattern was seen in last year when shares of the transport sector went down by almost 30% and the CROBEXturist index, after the record tourist season last year, increased by 23.7%. In 2015, the CROBEX and the CROBEX10 lost 3.2% and 1.8%, respectively, while the return on the CROBEXtr, which includes dividends, totalled 0%. The total market capitalisation of shares on the ZSE at the end of December amounted to HRK 128.1bn, up by 1.5% yoy with 7 listings less. The trading statistics on the ZSE continued deteriorating. The average regular daily turnover since the beginning of the year of HRK 7.4m is down from the 2015 average of HRK 9.6m and from the 2014 average of HRK 10.8m.

**Return of CROBEX constituents in the first three weeks of 2016 (dividends not included)***




* return calculated as on January 22, 2016 (6:30 PM). Sources: ZSE, Raiffeisen RESEARCH

The most traded shares last year were common and preferred shares of Adris Group, accounting for 17.5% in the total regular turnover. The common shares surged by 49% in 2015 on the back of the successful sale of its tobacco and retail segment, the extraordinary dividend payment and the announcement of a progressive dividend policy in the upcoming years but also fuelled by the Czech fund J&T controlling package takeover ambition.

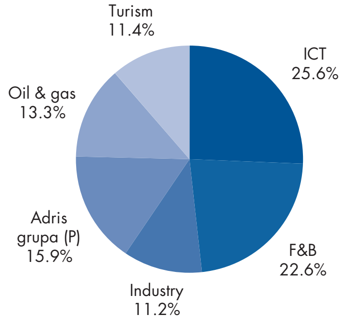
*Financial analyst: Damjan Sutlić*

# Focus on selling of non-strategic state holdings

- **The 2016e P/E ratios of regional indices at attractive levels, compared with the leading European equity indices**
- **New government announced sale of non-strategic assets/holdings to reduce debt**
- **We expect continuation of fundamentals improvement of CROBEX10 companies**

The pace of economic growth in China, FED's and ECB's moves in creating liquidity, the oil price and the economic recovery are expected to remain the most important driver of regional equity indices movements over the upcoming period. Further easing of the ECB's monetary policy resulting in increased liquidity of the financial system could thus positively affect equity indices in the broader region too. Compared with the leading European equity indices, the 2016e P/E ratios of regional indices are mostly at attractive levels. Among regional indices, the Hungarian BUX ranks the highest in our earnings growth estimates for 2016e (+25%) followed by the Turkish BISTNat.100 (+19%), potentially benefiting from the Iranian market opening as well as from low market price of the oil, provided the relations between Turkey and Russia do not deteriorate further.

**CROBEX10 composition by sector**

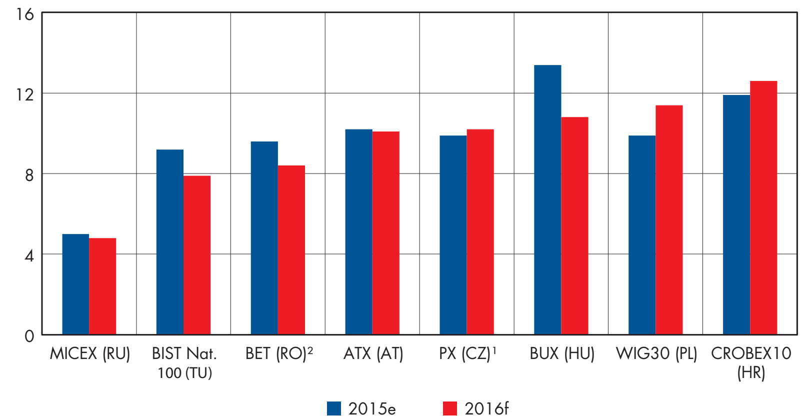



*Sources: ZSE, RBI/Raiffeisen RESEARCH*

And while we expect the global sentiment will continue to be main driving force on the domestic equity market, local developments in the second quarter could step in after the new government presents the state's budget and presents a more detailed plan for managing state assets. Considering that announcements made so far put the focus on strategic investments (energy an infrastructure) and the reduction of public debt, the sale of state's holdings in non-strategic sectors could be expected. However, a detailed plan by the new government remains to be seen. The emphasis on improving the country's rating may reflect itself in lowering of the risk premium and increase of liquidity on the ZSE, while fundamental indicators could continue the positive trend. In the nine months of last year, eight out of ten CROBEX10 constituents boasted a growth of net profit yoy due to improvements in operating but also financial results amid the reduction of net debt and/or lower borrowing costs. This year the earnings growth of CROBEX10 constituents is expected to exceed 12% on the wings of economic recovery in the region and expectations of one more successful tourist season.

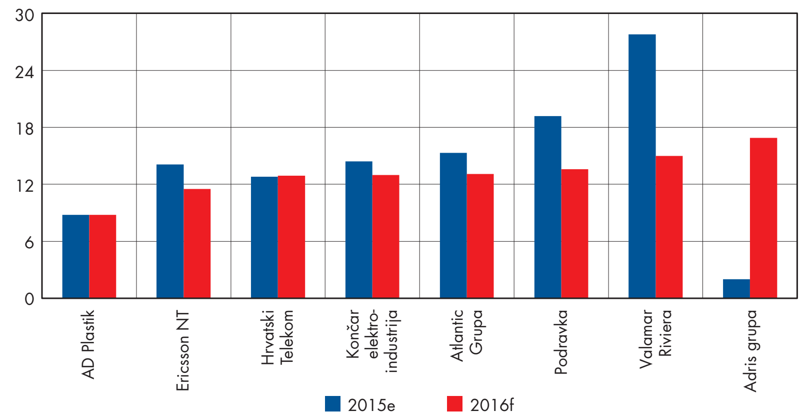
*Financial analyst: Nada Harambašić Nereau*

**P/E ratios in comparisson**




[1] *PX excl. CE Media Ernterprises, New World Resources and Erste Group;*
[2] *BET excl. Fondul Proprietatea*
*Sources: Thomson Reuters, IBES, Bloomberg, RBI/Raiffeisen RESEARCH*

**P/E ratios of CROBEX10 members***




**excl. INA and Kraš*
*Sources: Bloomberg, RBI/Raiffeisen RESEARCH*

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### Abbreviations
avg – period average
bn – billion
bp – basic points
C/A – current account
CBS – Croatian Bureau of Statistics
CDS – credit default swap
CE – Central Europe
CEE – Central and Eastern Europe
CHF – Swiss Franc
CHIF – Croatian Health Insurance Fund
CIS – Commonwealth of Independent States
CNB – Croatian National Bank
e – estimate
EDP – Excessive Deficit Procedure
ECB – European Central Bank
eop – end of period
ESA – European System of Accounts
EU – European Union
EUR – Euro
Eurostat – Statistical Office of the European Union
f – forecast
FCY – Foreign Currency
FDI – Foreign Direct Investment
Fed – Federal Reserve System
FOMC – Federal Open Market Commitee
FX – foreign exchange
GBP – British Pound
GDP – gross domestic product
GI – gross income
H – half
HICP – Harmonised Index of Consumer Prices
HRK – Croatian Kuna
IBES – Institutional Brokers' Estimate System
ILO – International Labour Organization
IMF – International Monetary Fund
LCY – Local Currency
M, m – month
MM – money market
mn – million
MoF – Ministry of Finance
NPL – non-performing loan
Pbt – profit before taxes
pp – percentage points
PPI – Producer Price Index
PPP – Purchasing Power Parity
PPS – Purchasing Power Standard
Q – quarter
QE – Quantitative easing
r.h.s. – right hand scale
RBA – Raiffeisen bank
RBI – Raiffeisen Bank International
SEE – Southern and Eastern Europe
USA – United States of America
USD – US Dollar
VAT – value added tax
wiiw – Wiener Institut für Internationale Wirtschaftsvergleiche
WTI – West Texas Intermediate
y – year
yoy – year on year
ZSE – Zagreb Stock Exchange


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