Raiffeisen Research Report

Number 61
April 2016

A year of growing expectations

- Favourable indicators in Q1
- No fears of deflationary spiral
- The kuna started gaining strength early
- Neutral performance of ZSE indices

Raiffeisen RESEARCH

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Contents

Selected macroeconomic indicators

	2009	2010	2011	2012	2013	2014	2015	2016e	2017f	2018f
GDP & Production										
Gross Domestic Product, % (constant prices)	–7.4	–1.7	–0.3	–2.2	–1.1	–0.4	1.6	1.5	1.5	2.0
GDP at current prices (EUR millions)	45,093	45,022	44,737	43,959	43,516	43,045	43,921	44,741	46,094	47,814
GDP per capita at current prices (EUR)	10,471	10,479	10,451	10,301	10,225	10,156	10,381	10,612	10,943	11,357
Retail trade, % real annual changes	–11.6	–2.1	0.6	–4.1	–0.6	0.4	2.4	2.5	2.5	2.7
Industrial production, % annual changes	–9.2	–1.4	–1.2	–5.5	–1.8	1.2	2.6	3.0	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	0.5	1.6	2.5
%, average	2.4	1.1	2.3	3.4	2.2	–0.2	–0.5	–0.6	1.5	2.2
Producer Prices[1], %, end of period	1.6	5.7	5.8	6.9	–2.6	–3.4	–4.4	0.2	2.0	2.3
%, average	–0.4	4.3	6.4	7.0	0.5	–2.7	–3.9	–2.7	2.0	2.5
Unemployment rate (official rate, avg)	14.9	17.4	18.0	19.1	20.3	19.7	17.0	15.5	15.3	15.1
Unemployment rate (ILO, avg)	9.2	11.6	13.7	15.9	17.4	17.3	16.3	15.9	15.5	15.1
Average net wage, in Kuna	5,311	5,343	5,441	5,478	5,515	5,534	5,594	5,678	5,803	5,930
General Government Balance, % of GDP, ESA 2010	–6.0	–6.2	–7.8	–5.3	–5.3	–5.5	–3.2	–3.0	–2.9	–2.8
Public Debt, HRK bn, ESA 2010	162.1	191.3	216.7	233.6	270.9	284.2	289.7	297.3	307.9	320.0
% of GDP, ESA 2010	49.0	58.3	65.2	70.7	82.8	86.5	86.7	87.2	87.6	87.5
Balance of Payment and External Debt										
Good's and Services Exports, EUR million	15,577	17,007	18,110	18,315	18,764	19,978	21,991	23,420	24,638	25,648
% change	–15.9	9.2	6.5	1.1	2.5	6.5	10.1	6.5	5.2	4.1
Good's and Services Imports, EUR million	17,244	17,158	18,297	18,097	18,573	19,106	20,757	21,691	22,667	23,370
% change	–23.0	–0.5	6.6	–1.1	2.6	2.9	8.6	4.5	4.5	3.1
Current Account Balance, % of GDP[2]	–5.1	–1.1	–0.7	0.0	1.0	0.9	5.2	2.0	2.2	2.1
Official International Reserves, EUR millon, eop	10,376	10,660	11,195	11,236	12,908	12,688	13,707	13,500	13,300	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	8.3	8.0	7.9	7.5	7.0	7.0
Foreign Direct Investment, EUR million[3]	2,279	1,065	1,017	1,142	710	2,910	128	1,700	1,900	1,800
Tourism – nightstays, % change	–1.2	2.6	7.0	4.0	3.3	2.6	7.7	3.8	3.0	2.5
External debt, EUR billion	45.6	46.9	46.4	45.3	46.0	46.7	45.5	46.1	47.2	48.0
External debt, as % of GDP[2]	101.1	104.2	103.7	103.0	105.6	108.4	103.7	103.0	102.4	100.4
External debt, as % export of goods and services[2]	292.7	275.8	256.2	247.3	244.9	233.6	207.1	196.8	191.6	187.1
Monetary and Financial Data										
Exchange rate, eop, USD / HRK	5.09	5.57	5.82	5.73	5.55	6.30	6.99	7.29	6.83	5.88
avg, USD / HRK	5.28	5.50	5.34	5.85	5.71	5.75	6.86	6.90	7.19	6.32
Exchange rate, eop, EUR / HRK	7.31	7.39	7.53	7.55	7.64	7.66	7.64	7.65	7.65	7.65
avg, EUR / HRK	7.34	7.29	7.43	7.52	7.57	7.63	7.61	7.59	7.62	7.65
Money (M1), Kuna billion, eop	47.2	48.0	51.5	51.9	57.9	63.4	70.7	73.8	76.8	80.1
% change	–14.6	1.7	7.3	0.9	11.5	9.6	11.4	4.5	4.0	4.3
Broadest money (M4), Kuna billion, eop	228.5	232.8	246.0	254.7	264.9	273.3	287.4	297.4	305.8	313.7
% change	–1.0	1.9	5.6	3.6	4.0	3.2	5.1	3.5	2.8	2.6
Credits, Kuna billion	234.5	245.6	257.4	242.1	240.8	237.0	230.0	228.9	234.7	239.2
% change	–0.6	4.7	4.8	–5.9	–0.5	–1.6	–2.9	–0.5	2.5	1.9
ZIBOR 3m, %, avg	8.9	2.4	3.2	3.4	1.5	1.0	1.2	0.9	1.4	2.4
Treasury bills rate 12m, %, avg	7.5	4.0	3.9	3.9	2.5	1.9	1.5	1.0	1.2	2.4

[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	2015	2016e	2017f
Poland	3.3	3.6	3.8	3.4
Hungary	3.7	2.9	2.2	2.9
Czech Rep.	2.0	4.3	2.0	2.9
Slovakia	2.5	3.6	3.5	3.5
Slovenia	3.0	2.9	2.2	2.1
CE	**3.0**	**3.6**	**3.1**	**3.2**
Croatia	**–0.4**	**1.6**	**1.5**	**1.5**
Bulgaria	1.5	3.0	2.1	3.0
Romania	3.0	3.7	4.0	3.6
Serbia	–1.8	0.5	2.5	3.0
BiH	1.1	2.0	3.0	3.5
Albania	2.0	2.7	3.5	4.0
SEE	**1.6**	**2.8**	**3.1**	**3.2**
Russia	0.7	–3.7	–2.0	1.5
Ukraine	–6.6	–9.9	1.5	2.0
Belarus	1.7	–3.9	–2.0	1.5
CIS	**0.3**	**–4.1**	**–1.8**	**1.5**
CEE	**1.2**	**–1.2**	**0.1**	**2.2**
Italy	–0.4	0.6	1.1	1.2
Austria	0.4	0.9	1.4	1.4
Germany	1.6	1.4	1.8	1.8
Euro area	**0.9**	**1.6**	**1.4**	**1.7**
USA	**2.4**	**2.4**	**2.5**	**2.2**

Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH

Consumer prices (avg, % yoy)

	2014	2015	2016e	2017f
Poland	0.0	–0.9	0.0	1.7
Hungary	–0.2	0.0	0.4	2.2
Czech Rep.	0.4	0.3	0.7	1.7
Slovakia	–0.1	–0.3	–0.1	2.2
Slovenia	0.2	–0.5	0.2	0.9
CE	**0.1**	**–0.5**	**0.2**	**1.8**
Croatia	**–0.2**	**–0.5**	**–0.6**	**1.5**
Bulgaria	–1.4	–0.1	0.8	2.0
Romania	1.1	–0.6	–0.5	2.7
Serbia	2.9	1.4	2.1	2.5
BiH	–0.9	–1.0	0.5	1.5
Albania	1.6	1.8	1.8	2.2
SEE	**0.7**	**–0.2**	**0.1**	**2.3**
Russia	7.8	15.6	8.4	7.9
Ukraine	12.1	48.7	14.1	12.9
Belarus	18.1	13.5	16.0	16.0
CIS	**8.4**	**17.5**	**9.0**	**8.5**
CEE	**5.2**	**10.5**	**5.5**	**5.9**
Italy	0.2	0.1	0.2	1.1
Austria	1.5	0.8	1.4	2.0
Germany	0.8	0.1	0.7	2.7
Euro area	**0.4**	**0.0**	**0.7**	**1.5**
USA	**1.6**	**0.1**	**1.4**	**2.7**

Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH

Unemployment rate (avg, % yoy)

	2014	2015	2016e	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	5.9	5.7
Slovakia	13.2	11.5	10.7	10.1
Slovenia	9.7	9.1	8.5	8.2
CE	**10.8**	**9.3**	**8.4**	**8.0**
Croatia	**17.3**	**16.3**	**15.9**	**15.5**
Bulgaria	11.4	9.2	8.4	8.0
Romania	6.8	6.8	6.5	6.5
Serbia	20.1	17.9	20.0	22.0
BiH	27.5	27.7	26.0	25.0
Albania	18.0	17.0	15.0	13.0
SEE	**12.3**	**11.6**	**11.4**	**11.3**
Russia	5.1	5.6	6.5	6.0
Ukraine	9.7	11.5	11.0	10.0
Belarus	0.5	1.0	1.5	2.0
CIS	**5.2**	**5.8**	**6.6**	**6.1**
CEE	**7.6**	**7.4**	**7.6**	**7.2**
Italy	12.8	11.6	n.a.	n.a.
Austria	5.6	5.7	6.4	6.7
Germany	5.0	4.6	6.3	6.4
Euro area	**11.6**	**10.9**	**10.2**	**10.0**
USA	**6.2**	**5.3**	**4.6**	**4.0**

Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH

Current account balance (% of GDP)

	2014	2015	2016e	2017f
Poland	–2.0	–0.2	–0.9	–1.2
Hungary	3.9	4.4	4.5	4.2
Czech Rep.	0.6	1.4	1.5	0.8
Slovakia	0.1	–1.3	–0.9	–0.7
Slovenia	7.0	6.5	5.5	4.8
CE	**–0.1**	**1.0**	**0.6**	**0.2**
Croatia	**0.9**	**5.2**	**2.0**	**2.2**
Bulgaria	1.2	1.1	1.2	–0.5
Romania	–0.5	–1.1	–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	–12.8	–13.6
SEE	**–1.5**	**–1.1**	**–2.4**	**–3.1**
Russia	3.2	5.0	4.1	4.6
Ukraine	–3.5	–0.2	–3.4	–4.7
Belarus	–6.8	–3.9	–6.4	–6.4
CIS	**2.5**	**4.4**	**3.3**	**3.7**
CEE	**1.3**	**2.5**	**1.6**	**1.6**
Italy	1.9	2.1	1.3	1.7
Austria	1.9	2.6	2.6	2.4
Germany	7.3	8.5	7.5	7.5
Euro area	**2.4**	**3.2**	**3.0**	**2.9**
USA	**–2.2**	**–2.7**	**–3.1**	**–2.7**

Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH

General budget balance (% of GDP)

	2014	2015	2016e	2017f
Poland	–3.2	–3.1	–3.2	–3.4
Hungary	–2.5	–2.0	–1.5	–1.0
Czech Rep.	–2.0	–1.3	–0.9	–0.8
Slovakia	–2.9	–2.5	–1.9	–0.9
Slovenia	–4.9	–2.9	–2.7	–2.5
CE	**–2.9**	**–2.5**	**–2.4**	**–2.3**
Croatia	**–5.5**	**–3.2**	**–3.0**	**–2.9**
Bulgaria	–3.6	–2.9	–2.5	–2.0
Romania	–1.4	–1.2	–3.0	–3.2
Serbia	–6.6	–3.7	–3.7	–3.0
BiH	–2.1	–2.5	–2.0	–1.0
Albania	–5.1	–4.0	–2.5	–1.5
SEE	**–3.1**	**–2.2**	**–2.9**	**–2.8**
Russia	–1.0	–3.6	–4.4	–3.3
Ukraine	–4.9	–2.3	–3.5	–3.0
Belarus	1.0	1.5	0.0	0.0
CIS	**–1.2**	**–3.3**	**–4.2**	**–3.2**
CEE	**–1.9**	**–3.0**	**–3.5**	**–2.9**
Italy	–3.0	–2.6	–2.5	–1.5
Austria	–2.7	–1.2	–1.9	–1.8
Germany	0.3	0.7	0.5	0.5
Euro area	**–2.6**	**–2.1**	**–1.8**	**–1.5**
USA	**–2.8**	**–2.4**	**–2.9**	**–2.9**

Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH

Public debt (% of GDP)

	2014	2015	2016e	2017f
Poland	56.0	51.9	52.9	53.6
Hungary	76.2	75.5	74.3	71.5
Czech Rep.	42.6	40.9	39.9	39.3
Slovakia	53.6	53.4	52.8	51.9
Slovenia	80.8	83.5	81.9	81.2
CE	**57.0**	**54.5**	**54.6**	**54.3**
Croatia	**86.5**	**86.7**	**87.2**	**87.6**
Bulgaria	26.9	26.3	29.5	30.0
Romania	39.8	38.5	39.3	40.0
Serbia	68.8	74.7	78.5	81.3
BiH	42.2	44.6	46.0	45.0
Albania	71.6	73.7	72.5	71.0
SEE	**48.0**	**48.7**	**50.1**	**50.8**
Russia	11.5	12.7	13.5	14.0
Ukraine	52.9	72.6	81.3	84.9
Belarus	34.1	48.5	52.0	49.0
CIS	**14.7**	**17.5**	**18.8**	**19.4**
CEE	**30.3**	**31.3**	**32.3**	**32.7**
Italy	132.3	132.8	132.4	130.6
Austria	84.2	86.2	85.7	84.9
Germany	74.7	71.2	68.5	65.6
Euro area	**92.0**	**90.7**	**90.6**	**89.2**
USA	**103.2**	**101.9**	**104.5**	**104.1**

Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH

Gross foreign debt (% of GDP)

	2014	2015	2016e	2017f
Poland	71.1	70.1	72.9	73.1
Hungary	113.9	105.7	98.3	89.2
Czech Rep.	66.6	70.6	74.3	76.4
Slovakia	89.7	86.7	85.4	82.6
Slovenia	124.1	114.8	110.0	104.1
CE	**80.2**	**78.6**	**79.5**	**78.2**
Croatia	**108.5**	**103.8**	**102.7**	**102.5**
Bulgaria	93.1	77.2	76.9	75.1
Romania	63.1	56.9	55.2	53.6
Serbia	78.6	81.6	80.6	79.4
BiH	51.9	54.6	55.1	54.9
Albania	67.7	68.9	67.5	64.7
SEE	**74.7**	**68.9**	**67.5**	**65.7**
Russia	29.5	39.3	39.5	32.2
Ukraine	95.2	131.5	142.9	142.5
Belarus	52.6	70.3	84.8	79.7
CIS	**34.2**	**46.1**	**47.7**	**40.4**
CEE	**51.6**	**59.9**	**61.7**	**56.6**
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	**120.3**	**120.2**	**n.a.**	**n.a.**
USA	**n.a.**	**n.a.**	**n.a.**	**n.a.**

Sources: Thomson Reuters, wiiw, Raiffeisen RESEARCH

EUR/LCY (avg)

	2014	2015	2016e	2017f
Poland	4.19	4.18	4.32	4.24
Hungary	308.7	309.9	314.2	316.9
Czech R.	27.5	27.3	27.0	26.4
Slovakia	euro	euro	euro	euro
Slovenia	euro	euro	euro	euro
CE				
Croatia	**7.63**	**7.61**	**7.59**	**7.62**
Bulgaria	1.96	1.96	1.96	1.96
Romania	4.44	4.45	4.45	4.35
Serbia	117	121	123	125
BiH	1.96	1.96	1.96	1.96
Albania	140	140	138	138
SEE				
Russia	51.0	68.0	76.4	70.0
Ukraine	15.9	24.3	29.5	31.1
Belarus	13,597	17,706	25,627	28,090
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**	**1.10**	**1.06**

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**	**Ba2**	**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**

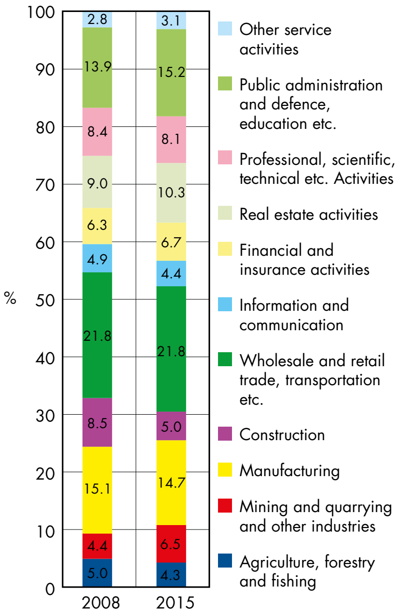
for FCY, long-term debt
Sources: Bloomberg, Raiffeisen RESEARCH

A year of growing expectations

The insecurity around government formation in the Q1 did not jeopardise recovery that started in 2015. Moreover, positive, although still modest, trends are expected to continue, including increased consumer and business optimism. This growth is predominantly based on domestic demand, while high dependence on imports reduces the positive effects of external demand. This stresses the need to increase the share of goods with higher added value (better quality) that are at the same time less sensitive to costs (especially that of labour) but also to improve the quality of services offered to tourists and link them to domestic production. All of this is possible only by alleviating the burden on doing business, implementing structural measures and by better reallocation of budget expenditures. A positive impact comes also from the absence of inflation, which, due to specific circumstances, creates the effect similar to the alleviation of the tax burden, given that it increases the real available income but does not postpone consumption which is still predominantly directed at meeting life's basic needs. Although short-term economic growth outlook improved and external vulnerability reduced due to the positive balance in foreign trade, structural weaknesses remain present. As over the previous years they, as well as measures necessary to soften and fight them, are addressed and clearly defined in the new National Reform Programme, which is expected to be consequently and decisively implemented. The latter is at the same time the key for increasing the potential growth rate and regain Croatia's investment rating. As a result, the focus remains primarily on fiscal and structural policies. The first signs of success should be seen in the next budget cycle for 2017, which begins with the July design of the three-year economic and fiscal policy guidelines that are partly to be visible in the qualitative structure of budgetary expenditures for the next year. The positive surprise that came from the last EDP Report, that is, from the sizeable reduction of the consolidated general government deficit (to 3.2%) together with the primary surplus and relative modest and lower-than-expected public debt growth confirms that fiscal policy adjustments are possible even with minimum efforts. However, sustainable growth and increase in the overall welfare will require much more. In the meantime, financial markets continued enjoying ample liquidity, lowering interest rates and yields to historical lows. In the European market these conditions are bound to last in the upcoming one-year period which increases the attractiveness of government issues and private sector debt. However, the expansive character of monetary policies is temporary and in essence serves to buy time necessary for adjustment. The key issue thus remains the transfer of surplus liquidity towards the real sector which should generate growth and new employment. For the time being, at least in Croatia, the process remains partly limited due to high indebtedness by all sectors (exceeding 200% of GDP). However, announced support to SMEs through investment schemes of development banks and better utilisation of EU funds gives rise to expectations that despite deleveraging growth on healthier grounds might continue. Improved fiscal outlook and greater inflow of foreign exchange will support the domestic currency which usually tends to trend upward at a stronger rate during periods of growth. However, we are confident that the CNB will remain consistent in its policy of preserving the stability of the domestic currency given the still-high degree of euroisation, that is, of the currency risk for all segments of the economy.

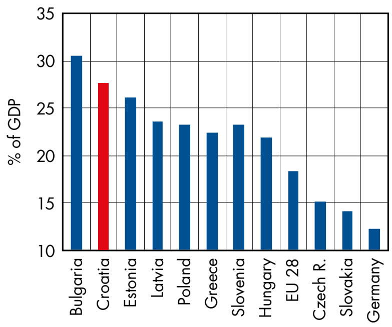
Financial analyst: Zrinka Živković-Matijević

GVA structure



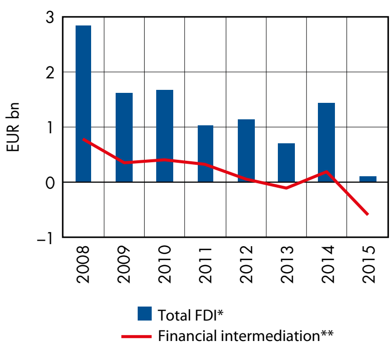
Sources: CBS, Economic RESEARCH/RBA

Shadow economy in GDP, 2015



Sources: Schneider, F (2015), A.T. Kearney, Economic RESEARCH/RBA

FDI

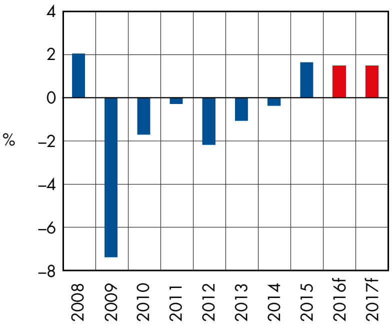


** excl. round tripping*
*** excl. pension and insurance funds*
Sources: CNB, Economic RESEARCH/RBA

Growth continues

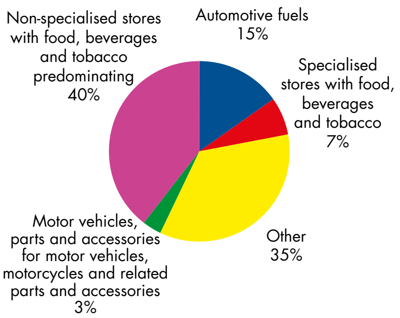
- **Domestic demand as main growth generator**
- **Growth potential and sustainability depend on efficient reform implementation**

GDP, annual growth



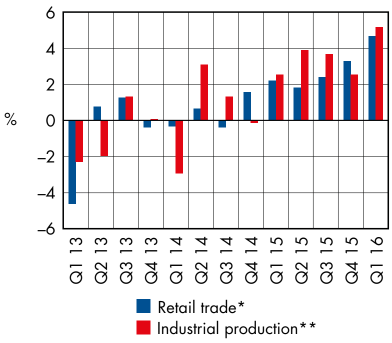
Sources: CBS, Economic RESEARCH/RBA

Retail trade by structure, Feb 2016



Sources: CBS, Economic RESEARCH/RBA

Retail trade and industrial production, yoy



** Retail trade – real changes*
*** Industrial production – volume changes*
Sources: CBS, Economic RESEARCH/RBA

The Q1 GDP data will probably confirm continued economic growth on a quarterly and on an annual level. High-frequency indicators seen at the beginning of 2016 suggest that growth is spurred primarily by domestic demand. Stronger annual growth rates of the imports of goods, however, reduce the positive contribution of the growth of exports of goods and services, thus confirming the high share of imports in the exports of goods and services. A portion of imports is surely generated by the expected recovery in gross fixed capital formation. A stronger rise of this component is expected in the upcoming quarters, spurred by the inflow of capital from foreign sources (EU funds and other investment schemes). On the other hand, heightened uncertainties in the period before and immediately after the formation of the new government discouraged investments by the public sector, as well as government consumption in the Q1. The fall in government spending in the first and the expected stagnation in the remaining quarters should result in a mildly-negative contribution to economic growth on an annual level.

In our baseline scenario, a relatively strong growth of manufacturing, trade and the hospitality industry on the supply side should support the positive rate of overall growth, while construction, regardless of its quarterly growth, might register stagnation on annual level.

Continued growth in personal consumption is based on the increase in retail trade, which reflects mildly-positive consumer expectations. However, a structural review of the turnover shows that the majority of consumption is directed at meeting life's basic needs. The recovery of personal consumption is supported by mild employment growth (according to the data on the number of persons insured with the CPII) and nominal salaries, which, paired with the absence of inflation and reduced interest rates on loans provides for the alleviation of the burden on the personal income of consumers. However, the increase in real income is also used for continued deleveraging of the household sector and is not sufficient for stable recovery of personal consumption.

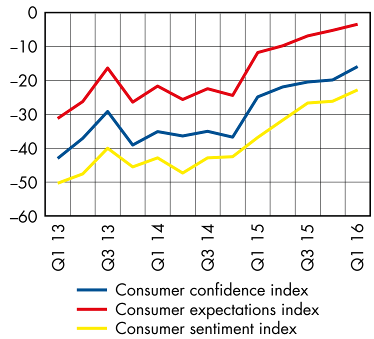
The sustainability of the positive rate of potential growth is jeopardised by the strengthening of the negative migration balance. The issue of the outflow of the most productive share of the population (the prime age population) and demographic aging pose the greatest threat to the sustainability of Croatia's economic policies (pension, social welfare, fiscal and other). Therefore, the implementation of structural reforms directed at improving the functioning of market economy is necessary in order to halt negative trends. The key issue of growth sustainability may be resolved by efficient implementation of measures addressed in the new set of reforms. Namely, due to the obligation under the European semester, the Government endorsed the new National Reform Programme and Convergence Programme for the period 2016 – 2019. Two main structural policy goals are to increase public debt sustainability and to improve economic growth and job creation. Sustainable economic growth in the long run is based on 60 reform measures which clearly emphasise a few crucial reforms in the following areas: pension, health, social security, education and inefficient public administration.

Also set of a several measures is proposed in order to improve business climate (such as merging of the land registry and cadastre, reduction of para-fiscal charges and e-Government strengthening).

As over the previous years, it is uncertain whether the said measures will be implemented within set deadlines. The postponement of the consolidation of public finances and the already identified structural measures, as well as the continuation of the unfavourable investment climate might jeopardise medium- and long-term growth outlook. In the short run the main negative risk is associated with the possibility of further rating downgrade and higher costs of financing, not to mention discouragement of investments. Under such a scenario, Croatia would enter a period of stagnation and lag behind. In addition, the expected economic recovery is exposed to risk of changes in external markets, as well as to domestic political risks. Under a stress scenario, external shocks might negatively affect the exports of goods and services, particularly in the form of a slowdown in the EU and other Croatia's foreign trade partners, not to mention the strengthening of geopolitical tensions with negative impact on tourism. The indirect negative effect would then spill over to other segments of the economy (through lower disposable income, weaker employment, lower corporate gains, lower budget revenues, etc.). However, the time to implement measures aimed at softening the negative effect of possible external shocks is still not up. We are to find out whether it will be used appropriately in the months to come.

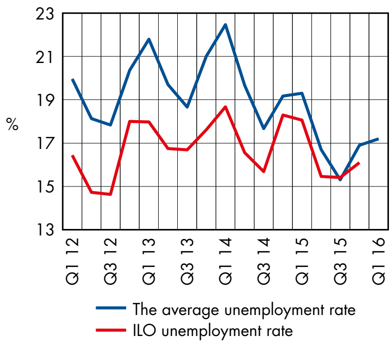
Financial analyst: Zrinka Živković-Matijević

Consumer Confidence Survey



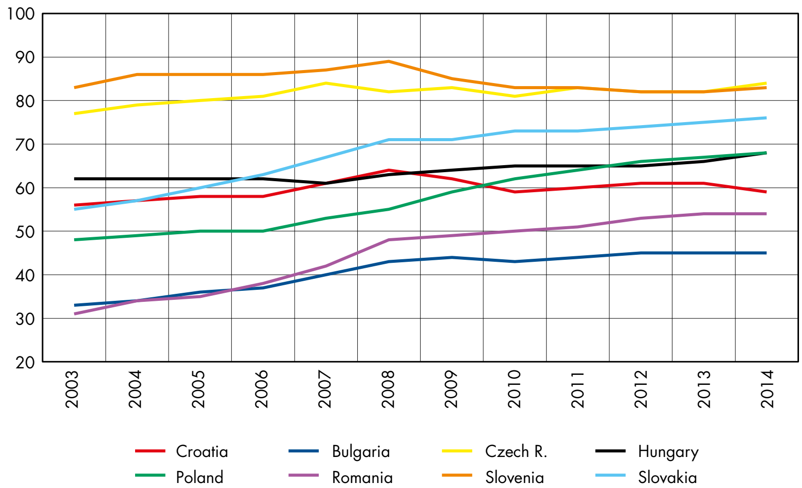
Sources: CNB, Economic RESEARCH/RBA

Unemployment rate



Sources: CBS, Economic RESEARCH/RBA

GDP per capita in PPS, EU28=100

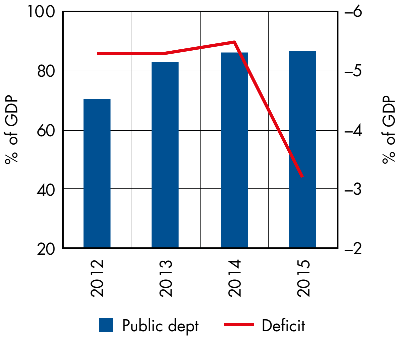


Sources: Eurostat, Economic RESEARCH/RBA

Risks arising from the environment and possible lacklustre reform implementation

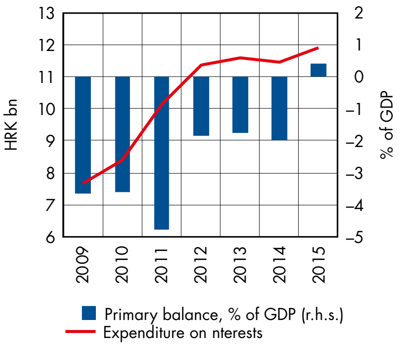
- **First quarter: fiscal inertia shadowed by politics**
- **Ambitious fiscal consolidation plan in the medium run**

Consolidated General Government (ESA 2010)



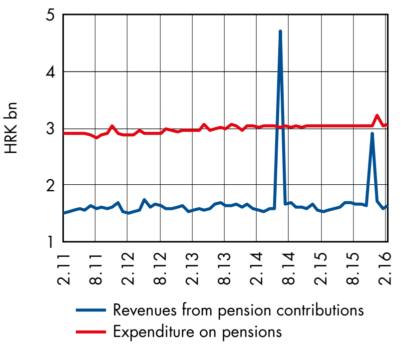
Sources: CBS, Economic RESEARCH/RBA

Primary balance of Consolidated General Gov't (ESA 2010)



Sources: CBS, Economic RESEARCH/RBA

Revenues from pension contributions and expenditures on pensions



** data from Dec2015 are preliminary*
Sources: MoF, Economic RESEARCH/RBA

The start of the new fiscal year was marked by temporary financing the inertia of which determined the budgetary flow in the first three months. Paired with the simultaneous repositioning of power in the political arena, the proposed state budget for a three-year period of 2016 – 2018 was finally adopted. A clear orientation towards the reduction of the fiscal deficit and public debt stabilisation already this year seems quite ambitious (although not impossible). However, there are several key risks that could jeopardise the convergence plan within the framework of the proposed fiscal consolidation. Namely, the assumption of economic growth based on stronger domestic demand leaves room for fears that personal consumption, as the main constituent of GDP will remain under the influence of the still-unfavourable situation in the Croatian labour market. On the other hand, apart from the absence of inflationary pressures, real income growth will surely be affected by positive expectations regarding one more successful tourist season. It could partially be channelled through higher personal consumption. For the time being, high-frequency macroeconomic indicators for the first quarter indicate a positive correlation with the movement of overall budgetary revenues. At the same time, lower public expenditures during the first months of the year are primarily a reflection of the postponed government spending due to the Decision on temporary financing. Amid such conditions, the envisaged fiscal activity in 2016 foresees a significant increase in expenditure to be financed from the expected inflow of EU funds (with a neutral impact on the fiscal deficit). Regardless of improvements in the absorption capacity, possible risks still arise from complex procedures and lack of human resources with specific skills necessary for withdrawal of EU funds.

As for the expenditure side, even with the "freezing" of total expenditures financed from general sources (where the largest portion of the deficit is generated), this year is expected to see a substantial growth in interest and pension expenses. Therefore we expect a higher fiscal deficit in 2016 compared to the Government's projection (at the level of 3% of GDP). In addition, the budget failed to provide funds for the increase in salaries of civil servants and government employees which implies the risk of inherited collective agreements being activated [1]. Ultimately, the policy of maintaining a rigid structure of budgetary expenses paired with the realisation of positive trends in the environment may result in the statistically lower share of deficit in the GDP but real fiscal consolidation should reflect much lower dependence on global economic and political trends. The implementation of reforms within the framework of the National Reform Programme and the Convergence Programme will be additionally strengthened by positive pressures from the EC through the MIP and the EDP procedures. The reforms necessary in the pension and health care systems are a consequence of the unsustainable socio-economic developments that create continued pressure on public debt.

Financial analyst: Tomislava Ujević

1 According to the 2009 Agreement when GDP rises for two consecutive quarters in a row by two or more percent, civil servants and government employees are entitled to a 6% increase of the basic portion of their salaries. It might increase budget expenditure by additional HRK 1.8bn.

And the borrowing goes on...

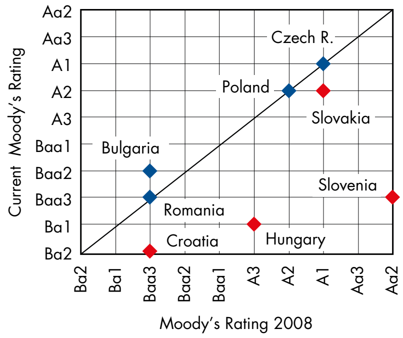
- **A foreign market issue already in the first half of the year?**
- **Increased interest at the shorter end of the pure kuna yield curve**

As expected, at the beginning of March Moody's lowered the credit rating for Croatia's long term borrowing by one category (to Ba2) with a negative outlook, that is, two notches below the investment grade. The main reason for this rating downgrade is high and rising public debt with poor chances of change until the end of the decade, as well as continued poor chances of growth due to low investments and structural weaknesses, low employment and bottlenecks in attracting EU funds. Although the Government ambitiously recommended a set of necessary structural reforms, negative outlook reflects doubt into their realisation, stressing the political risk of the lack of parliamentary majority. The adjustment of Moody's credit rating for Croatia with that of the other two agencies (S&P and Fitch) had no significant negative influence on the movement of the prices of Croatian bond issues.

A quiet and stable period with lower trading volumes marked the situation in the domestic bond market in the year thus far. Trading was livelier at the shorter end of the yield curve which consequently led to a mild decline in yields. Given the fact that the yield on one-year kuna T-bills went down gradually to its historic low of 0.97% until the end of March, it is understandable that market participants turned towards kuna bond issues of similar maturity which offer more attractive yields. Considering that monetary policy will continue to provide support to ample liquidity in the remainder of the year, the yields of short-term securities will surely hold at low levels. In the middle of February the CNB held the first of its four structural repo operations planned this year. The announcement contributed to a mild decline in yields since the CNB included all debt securities of issuers from the RoC (in all currencies) to the list of eligible collateral. After the domestic issue in December last year which extended the kuna yield curve to 2026, a new government issue, that is, the second tranche of the said bond, was seen in the middle of March in the primary market, totalling HRK 4 billion and yielding 3.99%. We expect this quiet period to continue until the end of the year, supported by high market liquidity paired with stable movement of prices and yields of domestic bond issues. This is supported by the projected economic recovery and expected consolidation of public finances.

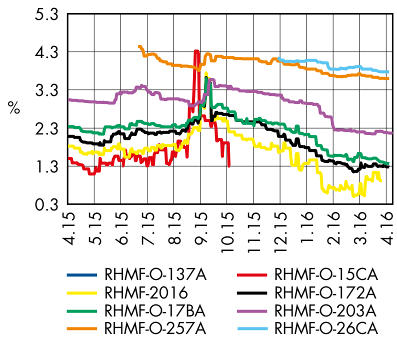
Croatia's Eurobonds followed the trends set by the bonds of CEE countries. Although, macroeconomic developments in the domestic market influence the movements of Croatian Eurobonds in the long run, as is visible from the relatively higher risk premium vis-à-vis comparable countries, the sentiment in the CEE bond market still has more influence on their movement than the domestic macroeconomic indicators. Thus, in the first quarter of this year, Croatian Eurobonds registered a mild decline in yields on the wings of the decline in spreads in the CEE bond markets and supported by favourable business results in the European and American economies, while the spread fluctuated within a band of 20 bps relative to benchmark issues (between 360 and 380 bps). In the middle of April, spreads narrowed by almost 10 bps compared to benchmark issues and hit record values this year (the yield of eurobonds maturing in 2025 went down to 3.55%). Favourable developments were also confirmed by the

Moody's sovereign credit rating



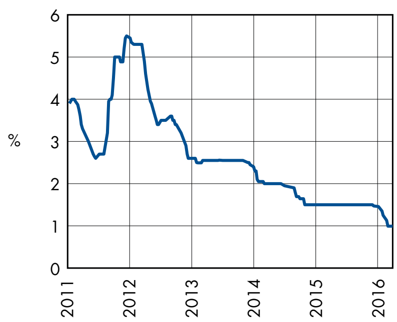
Sources: Bloomberg, Economic RESEARCH/RBA

Croatian government bonds yields (HRK)



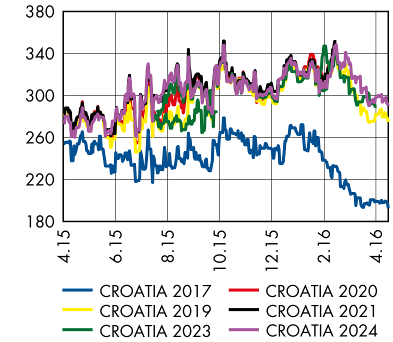
Sources: Bloomberg, Economic RESEARCH/RBA

1-y T-bill yield (HRK)



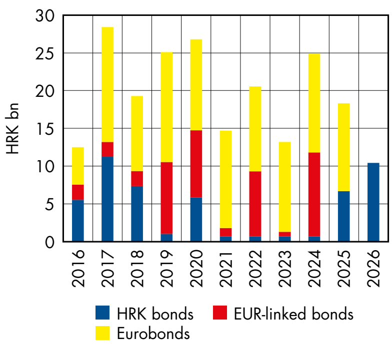
Sources: MoF, Economic RESEARCH/RBA

Spreads over benchmark (USD Eurobonds)



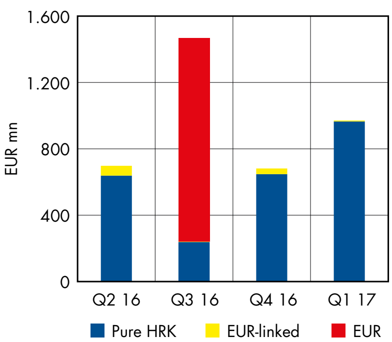
Sources: Bloomberg, Economic RESEARCH/RBA

Government debt maturities (bonds)*



** converted at mid-FX rate on 31th March 2016*
Sources: MoF, Raiffeisen RESEARCH/RBA

T-bills Outstanding amounts



Sources: MoF, Economic RESEARCH/RBA

movements of the five-year USD CDS which went down to 262 bps late in April, the lowest level since July 2015.

In the remainder of the year, ample liquidity, as a consequence of the expansive nature of the ECB's monetary policy paired with historically low yield levels will continue to positively affect CEE bond movements. This will reflect itself in the movements of Croatian issues, although Croatia's risk premium will remain substantially above that of comparable countries in the region, clearly indicating that in order to gain investor confidence the Government will need to execute its ambitious plans.

There is only one bond maturity this year, a domestic kuna issue maturing in July (HRK 3.5bn). The EUR T-bill issued in February 2015, matures in August, as a result of its 18-month maturity. The plans for its refinancing are yet unknown, through new bond issuance or rolled-over T-bills auction. According to our estimates, the overall liabilities maturing this year as a result of issued securities and general government loans exceed EUR 7.1bn. In addition to the estimated general government deficit which exceeded 3.0% of GDP, total liabilities arising from refinancing neared 20% of GDP. They include liabilities arising from issued T-bills which are normally rolled-over at maturity.

According to the financing account, published by the Government within the framework of the 2016 Budget proposal security (bond) issues are planned to raise HRK 17.65bn of budget revenues. Of which HRK 7.65bn are hoped to be raised by borrowing in the domestic capital market, while the remaining amount of its financial needs the government plans to settle by issuing an international bond, most likely in the European market. We do not exclude the possibility of an issue in the foreign market already in the first half of this year. Since the Fed started normalising the interest rate at the end of 2015, and the upward cycle of the reference interest rate, although at a slower pace, is expected to continue until 2017, we think that the US market is not a likely (but also not impossible) option. In the middle of summer, in line with the published financing plan, we are bound to see a one more domestic issue.

Financial analyst: Elizabeta Sabolek-Resanović

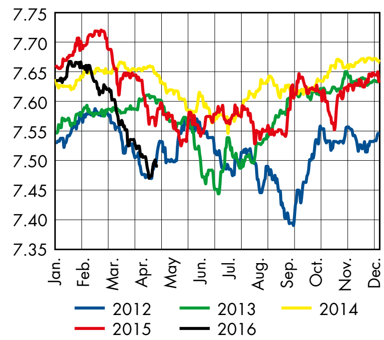
The kuna started gaining strength early

- No fears of the kuna depreciating
- High kuna liquidity paired with relatively weak interest for repo operations

Stronger foreign currency inflow due to this year's earlier start of the low tourist season paired with the stronger demand for the kuna, common before the Easter holidays, contributed to earlier seasonal strengthening of the kuna this year. The recovery in economic activity is commonly accompanied by the strengthening of the domestic currency which was probably additionally underlined by the capital inflow from foreign sources. Additional support to the growth of the kuna has surely come from the reduction in political uncertainty and slightly more favourable fiscal outlook. The first quarter ended at HRK 7.52 for one euro, that is, 1.5 p. p. lower than the year before. One should remember that last year's relatively high EUR/HRK exchange rate was strongly influenced by the Government's unilateral decision to fix the EUR/CHF exchange rate for the repayment of loans. At the beginning of this year's second quarter, the EUR/HRK exchange rate continued gradually slipping to even lower levels.
As the peak tourist season approaches and the exports of goods continue growing, we expect the inflow of foreign currency to continue and the kuna to continue strengthening against the euro, as usual. A possible government issue in the foreign capital markets in the second quarter in the form of a Eurobond should have a neutral impact on the exchange rate, given that the inflow of foreign currency from this source and the possible conversion of the kuna are commonly carried out with the central bank thus strengthening the foreign currency reserves. Reform implementation and improvement of the investment climate would surely provide support to the domestic currency through a stronger inflow of investments and more stable recovery. In view of the fact that the ECB will continue to provide for favourable borrowing conditions in 2016, we do not rule out the possibility of the corporate sector continuing to be oriented towards the foreign capital market and of a foreign currency inflow from this source. Given the unwavering commitment of the Croatian central bank to preserving the stability of the kuna exchange rate against the euro, in case of stronger and more sudden upward pressures on the kuna we do not rule out the possibility of the CNB intervening in the foreign exchange market. At the end of summer, the kuna should depreciate slightly. However, an upward EUR/HRK trend is expected to be observed until the end of the year. Nevertheless, the average kuna exchange rate against the euro at the level of the whole of 2016 should be lower than in 2015.
In addition to pressing ahead with the policy of the stable exchange rate of the kuna against the euro, the monetary policy will continue to support high kuna liquidity. Amid these conditions, money market interest rates have gone down across the curve keeping yields on T-bills in their record lows. This must have also been influenced by the first structural long-term repo operation in the middle of February. However, the still insufficient demand for loans was most probably one of the causes for the relatively weak interest exhibited by credit institutions. We do not expect changes by the end of the second quarter, either in terms of the volume of kuna liquidity or in terms of the consequent changes in interest rates. The issue of a kuna bond in the domestic capital market (most likely in the summer) should not significantly affect interest rates.

Financial analyst: Zrinka Živković-Matijević

Mid EUR/HRK



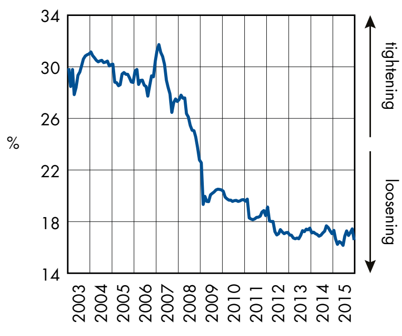
Sources: CNB, Economic RESEARCH/RBA

Middle exchange rate of the CNB

	Middle exchange rate	Change compared to: 30.3.2015		
	30.3.16	Exch. rate	Movements	%
EUR	7.5237	7.6446	↓	–1.58
USD	6.6481	7.0503	↓	–5.70
CHF	6.8968	7.3084	↓	–5.63
GBP	9.5685	10.4563	↓	–8.49

Sources: CNB, Raiffeisen RESEARCH

Monetary policy indicator



Note: Monetary policy indicator = Credit institutions' assets required by regulation/Credit institutions' liabilities. Assets required by regulation include calculated reserve requirement in kuna, allocated reserve requirement in f/c, marginal reserve requirement, CNB bills and minimal f/c liquidity.
Sources: CNB, Economic RESEARCH/RBA

Exchange rate forecast

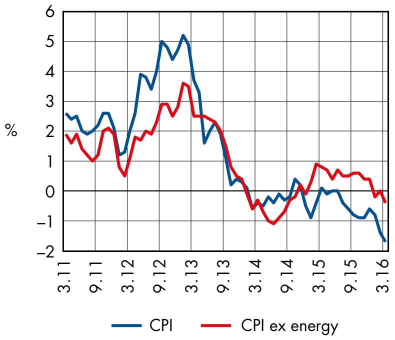
	2016e	2017f
EUR/HRK, avg	7.59	7.62
EUR/HRK, eop	7.65	7.65
USD/HRK, avg	6.90	7.19
USD/HRK, eop	7.29	6.83
CHF/HRK, avg	6.90	6.74
CHF/HRK, eop	6.95	6.65

Source: Raiffeisen RESEARCH

No fears of deflationary spiral

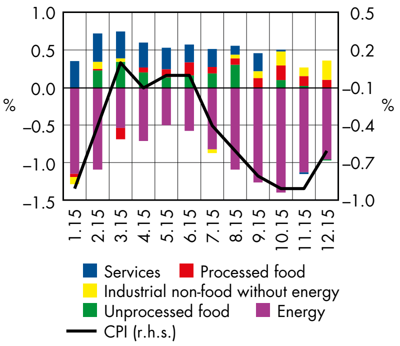
- **Deflationary pressures in the domestic market continue**
- **Price fall not yet a structural problem**

CPI, yoy



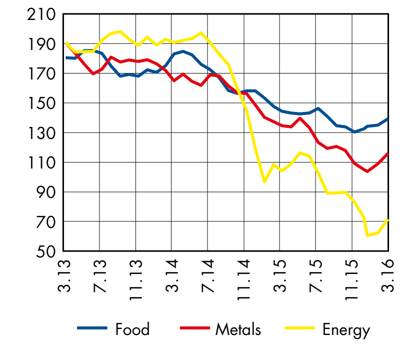
Sources: CBS, Economic RESEARCH/RBA

CPI contributions



Izvori: CNB, Economic RESEARCH/RBA

Commodity Price Indices (2005 = 100)



Izvori: IMF, Economic RESEARCH/RBA

The continuation of the period of low prices in the commodities markets, with the focus on the price of oil remains the main determinant of the price levels. The latest data on inflation in the euro area at the end of Q1 indicate a slowdown in deflationary pressures (annual stagnation in March). Broken down by main components, inflation is kept in the negative territory predominantly by prices of energy. On the other hand, during the period in question, the growth of the prices of services, food, alcohol and tobacco accelerated.

Consumer prices in the domestic market went down at a faster pace in this year's first quarter (–1.3%yoy vs –0.8%yoy in Q4 2015) yoy. Namely, consumer prices went down by 1.7% in March yoy, thus continuing the trend started in February 2014 with sporadic interruptions. This was at the same time the strongest annual decline since the CBS started tracking price developments with the consumer price index. The acceleration of deflationary pressures and lower prices on annual level were to the largest extent supported by lower prices of fuels and lubricants, and food. Namely, the decline in crude oil prices on global markets to its lowest level since 2003 (below 30 USD per barrel) at the beginning of the year spilled over to domestic prices as well, so at the end of Q1 the prices of fuels and lubricants for passenger vehicles went down by as much as 13.1%yoy. This means that the current inflation is generated by the reduction in the costs of production, transport and other input costs, which directly contributes to the lower prices of a wide array of goods and services. A negative contribution to the decline in prices on annual level came also from the decline in the prices of food (2%), which account for almost 30% in the structure of the consumer basket. However, if we exclude the volatile components of the prices of energy and food, which account for over 50% in the consumer price basket, the core inflation rate registered a growth rate of 0.6%yoy in the same period.

Thus far, the decline in prices has not become a structural problem in Croatia and the risk of a deflationary spiral is still not on the horizon. Namely, the decline in prices of energy (crude oil) is temporary and is not embedded in inflationary/deflationary expectations. However, the decline in the prices of food by itself does not postpone production and consumption given the necessity to meet the basic life's needs. The effect created in this case is similar to the tax burden alleviation because it increases the real disposable income. However, fact remains that the decline in prices contributes to lower budgetary revenues and reduces nominal GDP, thus deteriorating the relative value (as a percentage of GDP) of the budget deficit, public and external debt.

In addition to imported deflationary pressures, the absence of inflationary pressures this year should be additionally supported by the administrative reduction in the price of gas as of April this year, which will be reflected in the category of housing, water, electricity, gas and other fuels. For the time being, we also do not expect stronger inflationary pressures from domestic demand, given that is still suppressed by the lacklustre recovery in the labour market. On the other hand, the expected rise in crude oil prices on global markets (later in the year) together with the base effect might soften deflationary pressures.

Financial analyst: Mate Rosan

Record 2015 surplus in the Current Account

- **Great tourist season and strong impact of CHF conversion**
- **Lower external debt – continuation of deleveraging of credit institutions**

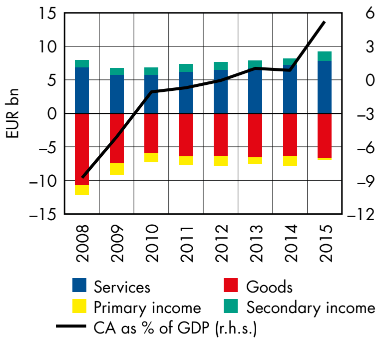
For the third year in a row, Croatia registered a positive current account balance. The historical high surplus, totalling EUR 2.3bn or 5.2% of GDP with slight structural improvements is to the largest extent a consequence of recorded losses by banks in foreign ownership resulting from the compulsory CHF conversion. On the other hand, a positive contribution to the improvement in the balance of payments came, as expected, as a direct consequence of a great tourist season which yielded almost EUR 8bn. Consequently, for the third year in a row, the surplus in the service sub-account exceeded the usual deficit in the trade balance, which even deteriorated on an annual level. This points to the structural weaknesses of the real sector, which will generate trade deficit in the upcoming period with a high import component present of Croatian exports. Although, high-frequency macroeconomic indicators (like industrial production) indicate certain improvements registered at the beginning of the year, continued growth of the export and import rates might slow down in annual terms. Regardless of the solid indicators for the low tourist season, we expect deficit in the goods account to substantially exceed the surplus in the services account in the Q1. However, a positive contribution might come from growing foreign remittances, indicating an upward trend in the outflow of the active population during this year's first quarter.[1] On an annual level, apart from a good tourist season we are expected to see substantially higher inflow of EU funds, which, in addition to lower oil prices yoy might result in one more positive CA balance for the fourth year in a raw. However, it will be much lower since the one-off effect of the compulsory CHF conversion will not be present again.

Apart from the consequential losses, the past year in the banking sector was marked by the continued process of deleveraging abroad, especially in H2. The two-digit annual decline in the external debt of credit institutions (by 25%) had a strong effect on the decline of the overall gross external debt, which at the end of 2015 totalled EUR 45.5bn or 103.7% of GDP (declined by 2.4%yoy). The process of bank deleveraging abroad that started in 2012 might continue in the upcoming period, additionally supported by the demand for loans in the domestic currency. On the other hand, external debt of the public sector (in its widest coverage accounting for over 40% of the overall gross external indebtedness) went up significantly last year, by 9.7%. As a result of ample liquidity in foreign financial markets, additionally spurred by the latest ECB's expansive monetary policy measures, we expect the foreign component of government debt to grow further by the end of the year. Favourable borrowing conditions abroad might additionally contribute to the growth of external debt in the segment of private non-financial enterprises with better creditworthiness, which will thus substitute for less attractive conditions in the domestic financial market.

Financial analyst: Tomislava Ujević

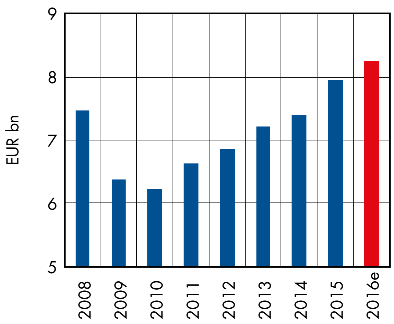
1 According to the CES data, last year 4.770 persons were removed from Croatia's official register of unemployed persons as a result of being employed abroad. In Q1 2016, their number increased by almost 24%yoy.

C/A balance



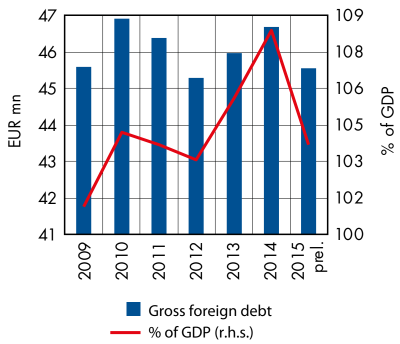
Sources: CNB, Economic RESEARCH/RBA

Travel receipts (tourism)



Sources: CNB, Economic RESEARCH/RBA

Gross external debt, eop

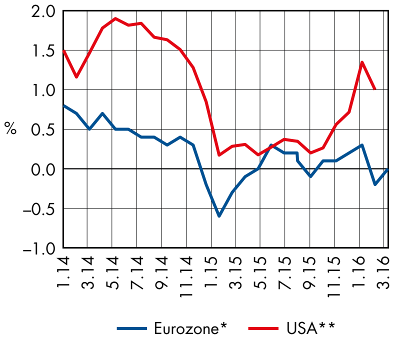


Sources: CNB, Economic RESEARCH/RBA

Fed reluctant, ESB generous

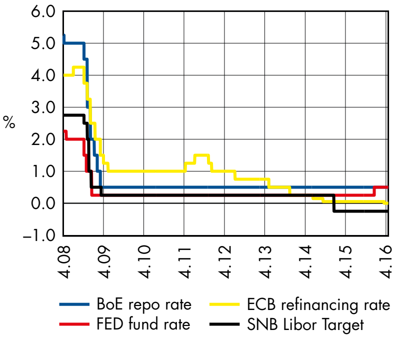
- ECB includes corporate bonds in its bond purchase programme
- Fed to increase its key interest rate only once by the end of the year?

Consumer prices



* HICP for eurozone
** PCE deflator for USA
Sources: Bloomberg, Economic RESEARCH/RBA

Key interest rate



Sources: FED St. Louis, Economic RESEARCH/RBA

Financial market forecasts

	Jun-16	Dec-16	Mar-17
EUR/USD	1.10	1.05	1.01
Fed key rate	0.75	1.00	1.25
USD 3m LIBOR	0.7	0.9	1.2
USD 10y yield	2.2	2.5	2.6
ECB key rate	0.00	0.00	0.00
3m EURIBOR	–0.25	–0.25	–0.25
GE 10y yield	0.3	0.8	0.8

As of 22/04/2016.
Sources: Economic RESEARCH/RBA

The expected continuation in the stronger divergence among the monetary policies of the world's two largest central banks was confirmed at meetings of its officials in March. The ECB continues with its policy of flooding the market with central bank's money and it decided to additionally expand its accommodative monetary policy (among other things, it lowered its reference interest rate to 0.0%, while the monthly bond purchase programme was increased to EUR 80bn). In addition, quite unexpectedly, the ECB included corporate bonds in its bond purchase programme. In the middle of March, surplus liquidity in the banking system was EUR 700bn. The wider scope of bond purchase will increase the central bank's liquidity by some EUR 900bn more. In view of all this, we think that money market interest rates (Euribor) will continue sliding downwards in the upcoming month and remain within the negative territory in the next year. The ECB signalled it does not plan to raise reference interest rates for some time, even after the end of the bond purchase programme which is expected to continue at least until March next year. Nevertheless, the opinions of ECB's top officials on further economic development and the inflation rate voiced at the last ECB meeting late in April seem a bit more optimistic. They no longer talked about the potential risk of inflation declining even further. However, the announcement from the meeting once again included some key phrases that clearly indicate the tendency to additionally soften the ECB's monetary policy during the year. We believe that further easing of the monetary policy will not be necessary and that the ECB will continue its "wait-and-see" policy throughout 2016.

In line with ECB expectations, we expect moderate GDP growth in the eurozone (1,4%), while, according to our opinion, inflation might grow at a stronger rate in the second half of the year as compared to the central bank's expectations. In case our expectations are proven correct, the ECB will have no reason to fight deflationary risks by more aggressive monetary policy.

Across the pond, at its last meeting the US Federal reserve left its reference interest rate unchanged. It is slightly surprising that the only a smaller number of FOMC officials expect further increase of the key interest rate this year by only 50 bps. As the reasons for this milder-than-expected growth in interest rates, the governor Yellen sees, among other things, darker global economic outlook, rising premiums on loans to companies with good rating and, allegedly, very low real interest rates. Despite very positive developments in the labour market over the last quarters, Yelllen thinks that the labour market capacity is still not fully utilised and that stronger growth of core inflation should be attributed to extraordinary developments and not continued recovery of consumer prices. According to our opinion, there are numerous other indicators contradicting the opinion that the labour market is not yet fully used. Since it is clear that Fed wants to increase interest rate at a very slow pace (or not at all) regardless of the latest indicators of overuse of economic capacity and mounted inflationary risks, we have substantially lowered our expectations as regards the trajectory of the key interest rate hikes. This year we expect two hikes of 25 bp each (in June and December) Thus, at the end of the year interest rates would range from 0.75% to 1.0%.

Financial analyst: Elizabeta Sabolek-Resanović

Deal on production freeze goes bust

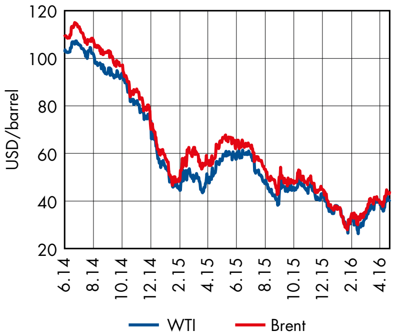
- **Saturation on global crude oil market continued**
- **Stronger recovery of oil prices in H2 is expected**

The prices of crude oil in the world's commodities market, type WTI and Brent (for the next month's delivery) grew to their highest level in the last four months (above USD 40 per barrel) after declining to below USD 30 per barrel earlier in the year. Lowered uncertainty regarding the slowdown of global growth, news of decline in US inventories paired with the possibility of the OPEC meeting in Doha resulting in a wider consensus over the production freeze at levels attained this January, contributed to the latest price growth. However, initiative on production freeze at the levels attained in January ended in failure since the OPEC's largest producer, Saudi Arabia, refused to cut oil production without Iran participating in the output freeze. Iran clearly declined the initiative, understandable so, since political sanctions against it were lifted in mid-January, allowing it to export oil to foreign markets after four years.

According to the data of the International Energy Agency (*IEA*), global oil output went down by 300 thousand barrel in Q1 to 96.1 b/d. The production fall in the United Arab Emirates due to maintenance at oil fields paired with lower production by Nigeria and Iraq, amid geopolitical instability, was compensated by further increase in production of Iran and Angola. Under the influence of new projects being postponed due to reduced money flow after the decline in prices in 2015, the IEA forecasted a decline in the output by non-OPEC members of 710 thousands b/d as compared to the 2015 average. A more significant decline is expected in the output from the US, China, Great Britain and Columbia. The US Energy Information Administration forecasted that the average US output this year should come in at 8.6 m b/d (decline by 800 thousand b/d yoy). On the other side, the global demand growth for oil in the year ahead is expected to slow down by 1.2mn b/d (according to IEA data). Negative risks come from challenges currently faced by the global economy, such as the slowdown in the emerging market economies, particularly China and Latin America. However, a positive contribution to the growth of demand could come from stronger economic activity in the US, India and the euro area.

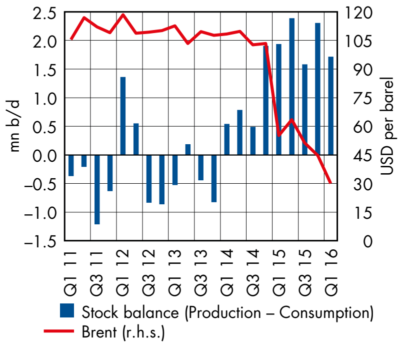
According to our expectations, the price of oil should gradually recover late in the year. Although the second quarter will face an excess of supply over demand (some 1.5mn b/d, it is evident that in the second half of the year the positive gap between supply and demand should narrow to 200 000 thousand b/d. Consequently, as the year draws to its end we expect the price of crude Brent oil to near the level of USD 50 per barrel. As the main reason for such expectations we see the decline in the production of oil from slate (US) and the rise in global demand for oil in Q3 and Q4 by 1.5mn b/d compared with the first half of the year. Namely, the number of active oil wells in the US went down in the middle of March to its lowest level since December 2009. Therefore, we feel that the projected decline of US output in 2016 will be even stronger than many market participants expect. Still, the situation should be monitored with caution because the rise of the market price of crude oil could contribute to the increase in the production of oil from slate.

Crude oil prices (next month delivery)



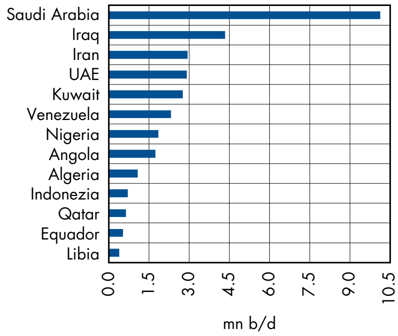
Sources: Bloomberg, Economic RESEARCH/RBA

Stocks of crude oil



**Brent – average quaterly price*
Izvori: EIA, Bloomberg, Economic RESEARCH/RBA

OPEC crude oil production, Januray 2016



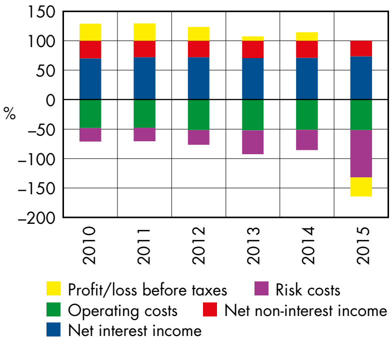
Sources: OPEC, Oil Market Report – April 2016, Economic RESEARCH/RBA

Financial analyst: Mate Rosan

Competition among banks increases after the CHF conversion

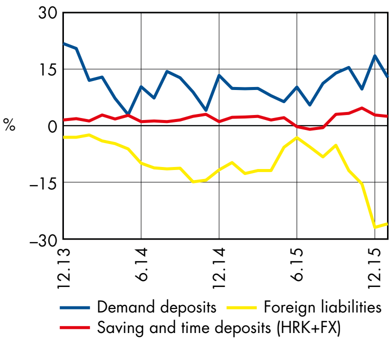
- **Increased demand for HRK loans at fixed interest rates**
- **After last year's conversion loss, positive bank's performance is expected in 2016**
- **Decreased NPL's share in total loans**

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



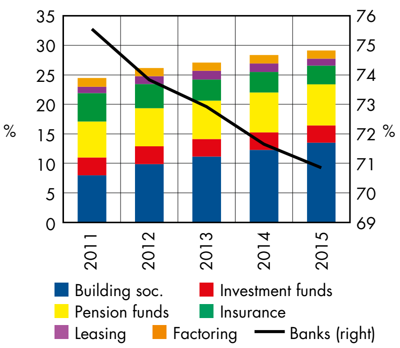
Legend:
– formation of Gross income (from 0% to 100%)
– distribution of GI, except Pbt (below 0%)
– Profit bt as % of GI (over 100%)
Sources: CNB, Economic RESEARCH/RBA

Foreign Liabilities and Deposits growth, annual level



Sources: CNB, Economic RESEARCH/RBA

Croatian financial sector, structure



Sources: CNB, CFSSA, Economic RESEARCH/RBA

The technically complex procedure of converting consumer loans from CHF into EUR that started on 30 September 2015 lasted until the first quarter of 2016. Although it mobilised substantial technical and human resources in eight largest banks, competition among banks intensified. Namely, in the course of conversion the contractual parties have to enter into an annex to the loan agreement, which is realised within the sales network of the creditor bank. This enables banks to offer loans and services directly without the added cost of client acquisition. On the other hand, peer banks attract clients participating in the conversion procedure with their offers to refinance their converted loans because conversion reduces client debt and thus improves their creditworthiness as measured by the debt to income ratio. Aware that this opportunity for easier access to clients will soon be gone, banks try to attract as many clients as possible with their attractive offers. Regardless, the realisation of new loan agreements to consumers did not increase substantially. Amid conditions of declining market interest rates, potential loan users wait for loan conditions to get even more favourable in the future and refrain from entering into new agreements. By doing this they prolong the period of lower demand for loans despite economic recovery and the increase in real salaries and the disposable income of consumers left over after the repayment of their matured loan liabilities.

Increased client awareness of currency and interest rate risk pushes down demand for foreign exchange loans with variable interest and increases demand for kuna loans at fixed interest rates in the initial repayment period for housing loans (up to 10 years) and during the entire life of the loan for non-purpose retail loans. Demand for kuna loans is on the rise in the corporate sector as well. However, bank kuna sources of finance are limited due to the preference of Croatian citizens to save in foreign currency. As much as four fifths of retail time deposits with Croatian banks are in euros. Consequently, the highly euroised financial system lacks long-term sources of finance in kuna. As a result of the rise in demand for kuna loan, the CNB introduced long-term repo operations by which it tends to increase kuna sources of funds maturing in four years.

Due to losses arising from the write-off of a part of claims in the process of conversion of CHF loans to EUR loans at the initial exchange rate as at the date the loan was granted, banks generated losses worth HRK 4.3bn. This is equivalent to the negative return on invested capital of 8 percent. However, thanks to the capitalisation levels attained earlier, the capital adequacy indicator held at 20 percent at the end of 2015. Banks will seek compensation by all available legal means so losses sustained by the banking sectors have not reflected themselves in the loan supply to clients. Positive impact on loan supply came from the direction of bank asset quality. In the last quarter of 2015 the share of non-performing loans to total loans went down from 17 to 16.5 percent, for the first time since 2008. This year we expect changes in the taxation treatment of write-offs, which should enable accelerated reduction of the ratio of non-performing loans and thus increase bank appetite for lending.

Financial analyst: Anton Starčević

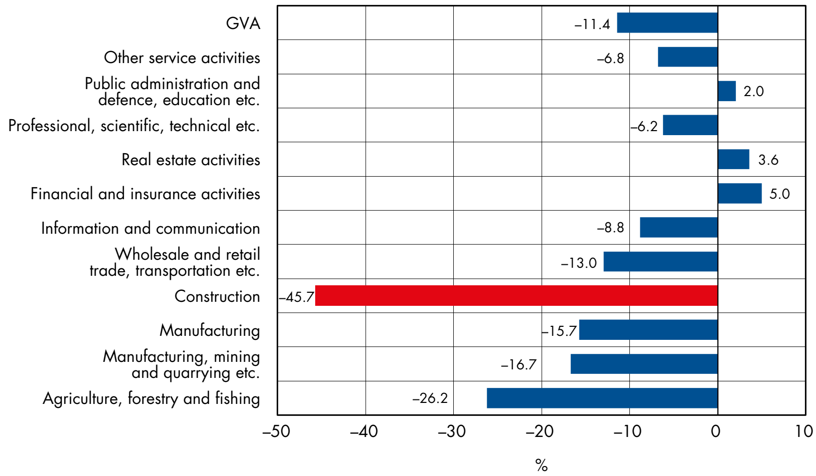
Still waiting for recovery

- **Negative trends halted, stabilisation at low levels**
- **No signs of a more substantial recovery in demand for housing loans**

Given its exceptional importance in Croatia's overall economic activity, changes in the construction sector are a reliable indicator of developments in investments and their indirect influence on many other related activities (such as mining and quarrying, manufacturing, architectural and planning services, etc.). In the last two decades, the construction sector has undergone several important phases which made a strong contribution to the developments in the Croatian economy as a whole.

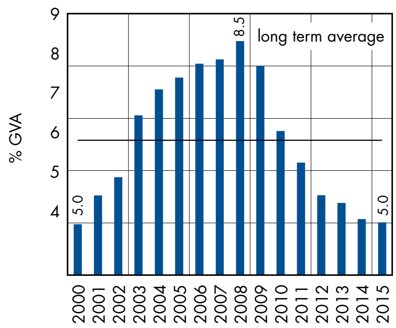
Thanks to investments into large infrastructure projects (like road building) and construction of residential property, the construction sector experienced a real boom in the period from 2000 to 2008. As a result of the average annual growth of construction activity of 7.4%[1], the share of construction in GVA went up from 5% in 2000 to 8.5% in 2008, thus exceeding the EU average of 6.4%. Favourable developments during the period resulted in the strong growth of the number of persons employed in the construction sector, with the number of those employed with legal persons increasing by over 40 thousand persons or 61% in the period from 2001 to 2008. Then came a period of a years-long recession during which the activity of the construction sector decreased considerably in annual terms for seven years in a row. Cumulatively, from 2008 to 2015 the GVA of the construction sector went down by as much as 44.3%, thus accounting for the largest negative contribution to the GVA decline in the observed period. At the EU level, a larger fall of the share of construction in GVA over the period under review was observed only in Greece, Cyprus, Spain and Ireland. Although its real annual decline slowed down to 0.6% in 2015 (from 6.7% yoy in 2014), the share of construction in GVA slid down to levels seen in 2000, totalling 5.0%. It went down to below the EU average which amounted to 5.4% last year. Negative developments are confirmed by the number of issued building permits that went down in the period from 2008 to 2015 by 48.5%, while the planned value of works went down by 49.6%. Given the steep fall in construction activity it is hardly surprising that the average annual number of persons employed in construction went down by over 31 thousand or 30.4% in the period between 2009 and 2015. The annual rates of decline, with several short-term interruptions have been seen almost uninterruptedly since September 2009. In the branch closely connected to construction, real-estate turnover, the number of persons employed went down by 72%.

Cumulative change components of GVA, 2008 – 2015



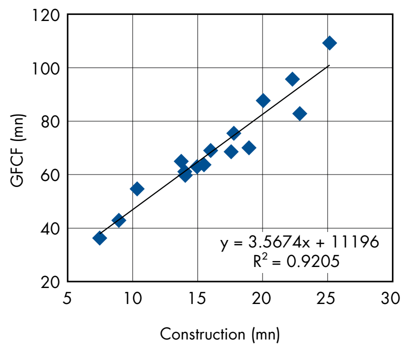
Sources; CBS, Economic RESEARCH/RBA

Share of construction sector in GVA



Sources; CBS, Economic RESEARCH/RBA

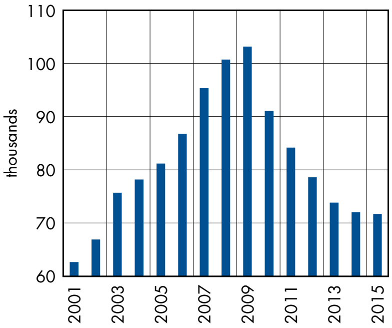
Consutruction and GFCF (2000–2015)



Sources; CBS, Economic RESEARCH/RBA

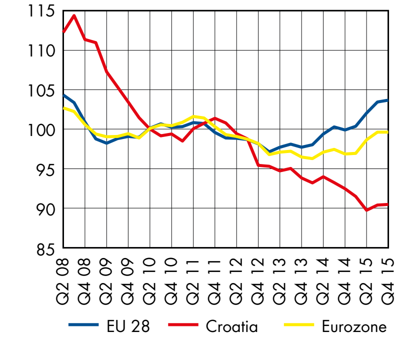
1 Measured by the volume index of construction works.

Employed in construction



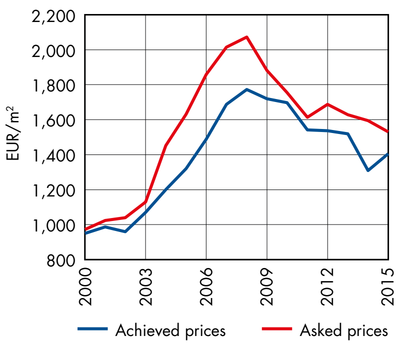
Sources; CBS, Economic RESEARCH/RBA

House price index (2010=100)



Sources: CBS, Eurostat, Economic RESEARCH/RBA

Achieved and asked prices



Sources: Burza nekretnina, Economic RESEARCH/RBA

Short-term construction activity indicators for 2015 show that, for the seventh year in a row, the volume of construction works, calculated on the basis of work hours of construction workers at building sites, continued declining. Nevertheless, the realised annual rate of decline slowed down in 2015, to 0.6%, from 7.3% in 2014, spurred by the decline in the number of hours of civil engineering works (by 1.8% yoy), while the volume of construction works on buildings went up by 0.9% yoy. The decline in the volume of construction works clearly reflects the lack of demand for housing but also the absence of investments into infrastructure. However, the value of new orders for construction projects indicates a rise of 1.3% on an annual basis in 2015, while at the same time the value of completed works with own workers went up by 7.3% in 2015 from a year earlier. On the other hand, the number of issued permits continued trending downwards in annual terms (4%). A contribution to the fall in the number of issued building permits on an annual basis came from the decline in the number of permits issued for the construction of buildings (8.1%), which account for over 82% of the overall number of issued permits in 2015. Despite this decline, the planned surface area of buildings which received permits in the period in question is 28.6% larger with the growth of planned value of works being 29.4% on an annual level. At the same time, the number of building permits for civil engineering works went up in the period by 19.3% yoy. However, despite the two-digit growth in the number of permits, the planned value of works for which permits were issued is lower by 22.9% per annum.

Although this year's outlook does not provide for optimism as regards more significant positive developments, we expect exceptionally negative trends to be reversed, that is, the construction sector to stabilise at exceptionally low levels given the fact that some of the latest indicators show that the construction sector might have finally hit rock bottom. The ability to utilise substantial funds to launch investments within the framework of EU funds largely depends on the stage of project preparation and administrative capacity to withdraw funds. In addition, the opportunity for better results is to be found in the programme of the energy renovation of buildings. Nevertheless, demand for residential property largely depends on the labour market that remains burdened by uncertain recovery and low employment. Consequently, demand for housing loans and long-term investments remain down. Namely, ever since the pre-crisis 2008, the residential property market indicates a substantially reduced liquidity level, reflected in much higher supply than demand. This is confirmed by the CBS data on the number of new dwellings sold in Croatia, which totalled 1672 last year. Compared to the record 2006, the number of transactions went down by almost a half (50.6%). It is evident that not even the improved financial availability of real estate[2] managed to spur more significant demand for housing loans. Interest rates on newly granted housing loans in the last two years, although stagnating, held at relatively high level, thus additionally contributing to the present weak demand for residential

2 The financial availability of real estate is defined as the ratio of the average loan rate to the available income of households.

real estate. In addition, they have not joined the noticeable downward in the comparable interest rates in the euro area, thus partially reflecting the higher sovereign risk premium (which increases the interest spread among countries). As a result, with the continued household deleveraging process, there are still no signs of a more substantial recovery in demand for housing loans.

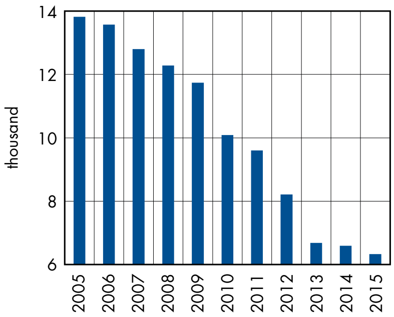
According to the CBS data, the trend of a mild rise of the average price of new dwellings sold continued last year. At the level of the Republic of Croatia as a whole, its growth rate accelerated to 1.6% (from 0.9% in 2014). However, since data indicates that the Zagreb area registered a decline in the average price of new dwellings on an annual level (by 1.3% from 2014), it is evident that rising prices of new dwellings in other settlements (especially in the coastal region) caused an upward trend at country level.

Regional differences are also confirmed by the latest Eurostat data on developments in the prices of residential property measured by the aggregate Residential Property Prices Index (RPPI) that is methodologically adjusted to the so-called House Price Index. According to this indicator, prices of real estate property in Croatia were 2.9% lower in 2015, on an annual basis, than in 2014. In addition to the reduction in the price of existing real estate property (1.4%), in annual terms, the overall decline in the price of residential property was greatly aided by the pronounced reduction in the price of newly-constructed real estate (6.1%). The prices of real estate in Zagreb registered an annual decline of 2.1%, while the prices on the Adriatic coast went down by 3.3% as compared to 2014. In contrast to Croatia, Eurostat data on the developments in real estate prices indicate a continuation of the annual price growth in the euro area and the EU, of 2.9% and 3.8% respectively, confirming the trend started early in 2013. Among the EU member states the greatest annual price growth in Q4 2015 was registered in Sweden (14.2%), Hungary (10.3%) and Great Britain (7.1%), while a more substantial decline, apart from Croatia (2.1%), was seen in Italy (0.9%) and on Cyprus (0.6%).

Although the latest data indicate that the years-long downward trend in the prices of real estate in Croatia has neared its end, fact remains that the market remains poorly liquid and heavily fragmented (so high quality real estate at good locations find their buyers even at higher prices). In other words, it is clear that the surplus in supply of "lower quality'' properties at less attractive locations will continue to create downward pressure on average prices. Therefore, greater liquidity and a more noticeable demand that would cause an upswing in the real estate market may be expected only after stable recovery in the labour market. This means, above all, the growth of employment, especially among the young, which is not bound to happen in the short term and depends heavily on future moves of economic policy-makers.

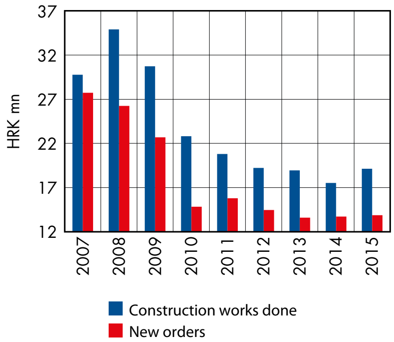
Financial analysts: Mate Rosan, Tomislava Ujević

Bulding permits



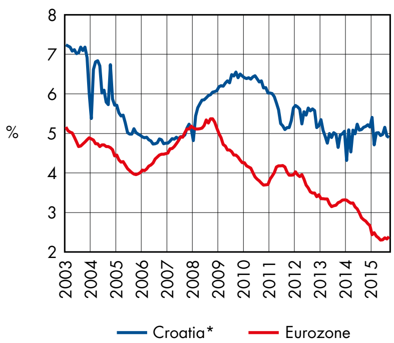
Sources: CBS, Economic RESEARCH/RBA

Construction works done and new orders



Sources: CBS, Economic RESEARCH/RBA

Housing loans interest rates

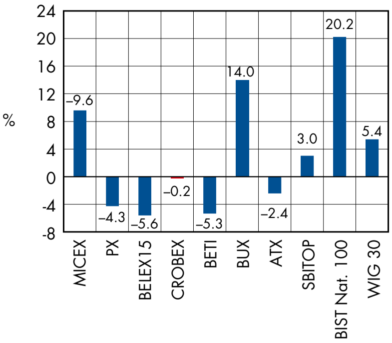


**with currency clause*
Sources: CNB, ECB, Economic RESEARCH/RBA

Changing sentiment

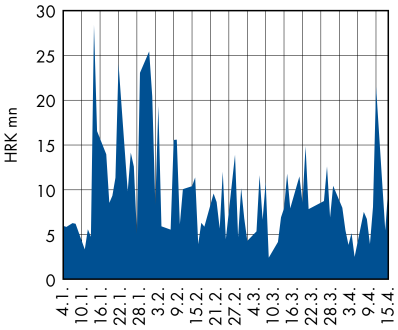
- Mixed returns on regional equity indices
- Neutral performance of ZSE indices since the beginning of the year
- Strong growth of ĐĐ Holding due to new contracts

CEE indices – performance since the beginning of 2016



** in local currency, value on April 19, 2016 (6:30 PM)*
Sources: Bloomberg, Raiffeisen RESEARCH/RBA

Regular turnover



Source: ZSE, Raiffeisen RESEARCH

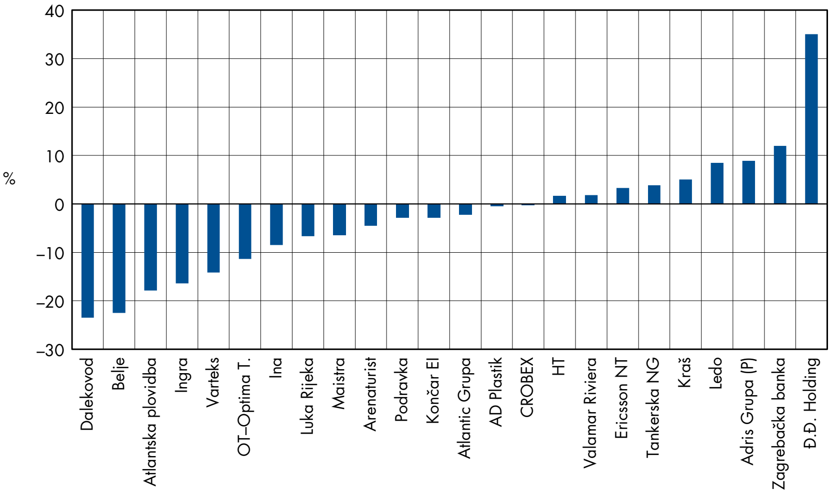
While global sentiment was mostly negative early in the first quarter due to concerns about the slowdown in the Chinese economy and low oil prices, the optimism was restored by the end of the period as a result of further easing of the ECB's monetary policy. Nevertheless, the sentiment from global markets was not equally reflected in the movements of the leading CEE indices as they registered mixed performance. The growth forerunner was the Turkish BIST National 100, which profited from the recent expansionary monetary policy measures. The Hungarian BUX also boasted a nice growth on the wings of global recovery. The Russian MICEX went up due to the rise in the oil prices. On the other side, the greatest fall was seen by the Czech PX, despite the high share of financial sector shares. Local factors prevailed in the Romanian market as well, pushing BET value down despite the growth of energy and financial sector shares.

Similarly as the majority of European indices, the ZSE indices, after having sharply fallen at the beginning of the year, recovered later on. The CROBEX thus almost stagnated since the beginning of 2016, with its fall coming in at only –0.2% while CROBEX10 added 0.5%. Broken down by sectors, CROBEXtransport went down the most due to the slowdown of the Chinese economy, while the lowest decline was seen by the shares of the industrial and tourist sectors. Of the CROBEX constituents, the best performance was posted by Đuro Đaković Holding, +35%, thanks to the entry into several new contracts. The greatest decline was registered by shares of Dalekovod and Belje.

Turnover on the ZSE was again quite low with a downward tendency so the average daily regular equity turnover totalled HRK 6.6 million. The most traded share was HT, HRK 84 million in total and 20% of the overall turnover. Total market capitalisation of shares on the ZSE at the end of the first quarter stood at HRK 122.6bn, down by 4.3% compared to the end of 2015.

Financial analyst: Ana Turudić

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



** return calculated as on April 19, 2016 (6:30 PM). Sources: ZSE, Raiffeisen RESEARCH*

Low liquidity expected to continue on the ZSE

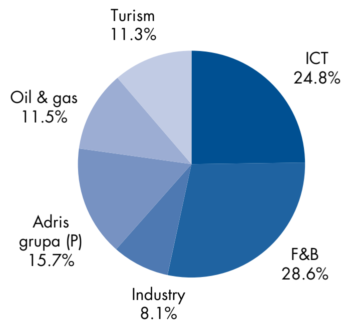
- **High liquidity and favourable macroeconomic forecasts expected to support CEE equity indices**
- **P/E 2016e of CROBEX10 high compared to other CEE equity indices**
- **Start of reform implementation could raise interest and liquidity on the ZSE**

Central banks' decisions will remain in the focus of investors in the next quarter since the ECB recently introduced additional measures of monetary policy easing. This means that high liquidity in the system and relatively favourable macroeconomic outlook could support equity indices so we expect CEE indices to grow. Relative to the estimated profit of constituents in 2016e, the Russian MICEX is the most attractively valued (P/E 2016e: 7.7x) among CEE equity indices. However, due to the disbalance between supply and demand in the oil market and still-strained political relations its growth potential is expected to be realised in the second half of the year. The greatest expected long-term growth rate of the earnings of its constituents, totalling 5.1%, is boasted by the Romanian BET.

The focus of investors in the domestic market will remain on the implementation of structural reforms and fiscal consolidation. Nevertheless, in the upcoming period we are counting on positive impulses from another successful tourist season and started recovery of consumer optimism resulting from the absence of inflationary pressures. Accordingly, developments on the ZSE will be predominantly influenced by local factors and only to a lesser extent by global developments. Therefore we expect the CROBEX to grow at a minimum rate in the second quarter. Much potential for growth is not given in the relative valuation either. Its expected P/E ratio for 2016 is 16.1x, while the estimated long-term growth rate of its earnings is only 2%. Still, we expect the government to adopt a plan of reforms and start implementing them as soon as possible, which would surely have a positive effect on investment climate and the equity market and raise optimism and liquidity by the end of the year.

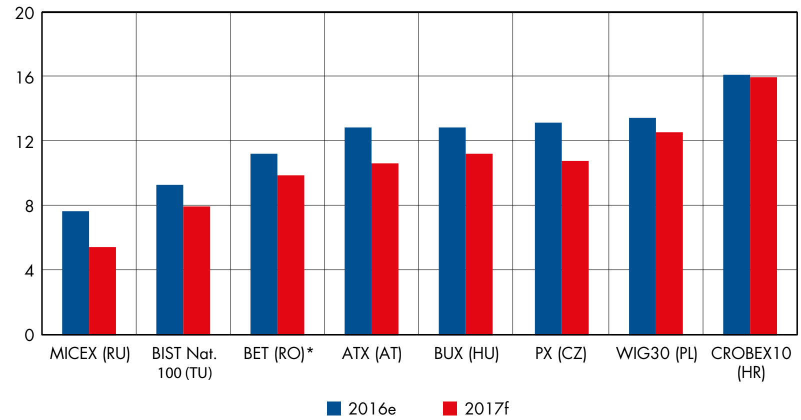
Financial analyst: Ana Turudić

CROBEX10 composition by sector



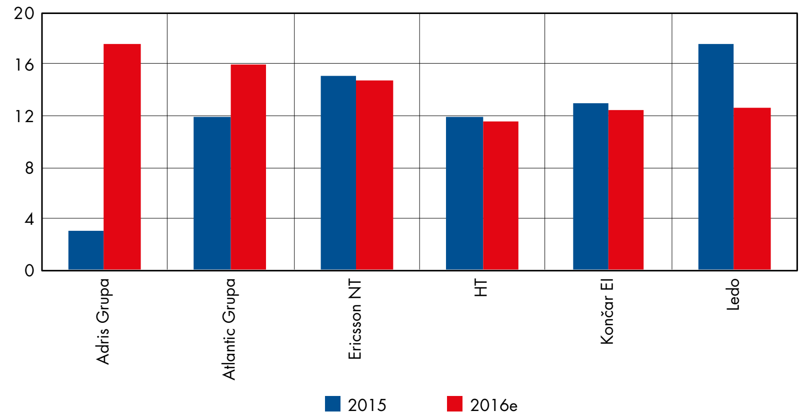
Sources: ZSE, RBI/Raiffeisen RESEARCH

P/E ratios in comparisson



** BET excl. Fondul Proprietatea*
Sources: Thomson Reuters, IBES, Bloomberg, RBI/Economic RESEARCH/RBA

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
CFSSA	– Croatian Financial Services Supervisory Agency
CHF	– Swiss Franc
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
IEA	– International Energy Agency
ILO	– International Labour Organization
IMF	– International Monetary Fund
LCY	– Local Currency
M, m	– month
MIP	– Macroeconomic Imbalance Procedure
MM	– money market
mn	– million
MoF	– Ministry of Finance
NPL	– non-performing loan
OPEC	– Organization of the Petroleum Exporting Countries
Pbt	– profit before taxes
PCE	– Personal Consumption Expenditures
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
WTI	– West Texas Intermediate
y	– year
yoy	– year on year
ZIBOR	– Zagreb Interbank Offered Rates
ZSE	– Zagreb Stock Exchange

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