Raiffeisen Research Report

Number 62
July 2016

Overshadowed by politics

- Recovery continues
- Snap elections in September
- Brexit in focus
- CROBEX stagnating again

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	44,917	46,213	47,937
GDP per capita at current prices (EUR)	10,471	10,479	10,451	10,301	10,225	10,156	10,381	10,654	10,972	11,387
Retail trade, % real annual changes	–11.6	–2.1	0.6	–4.1	–0.6	0.4	2.4	3.9	2.5	2.7
Industrial production, % annual changes	–9.2	–1.4	–1.2	–5.5	–1.8	1.2	2.6	4.8	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	–1.0	1.5	2.2
Producer Prices[1], %, end of period	1.6	5.7	5.8	6.9	–2.6	–3.4	–4.4	–1.1	2.0	2.3
%, average	–0.4	4.3	6.4	7.0	0.5	–2.7	–3.9	–3.9	2.0	2.5
Unemployment rate (official rate, avg)	14.9	17.4	18.0	19.1	20.3	19.7	17.0	16.7	17.0	16.5
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	44.5	45.5	46.5
External debt, as % of GDP[2]	101.1	104.2	103.7	103.0	105.6	108.4	103.7	99.1	98.5	97.0
External debt, as % export of goods and services[2]	292.7	275.8	256.2	247.3	244.9	233.6	207.1	190.0	184.7	181.3
Monetary and Financial Data										
Exchange rate, eop, USD / HRK	5.09	5.57	5.82	5.73	5.55	6.30	6.99	7.24	7.50	6.95
avg, USD / HRK	5.28	5.50	5.34	5.85	5.71	5.75	6.86	6.87	7.50	7.17
Exchange rate, eop, EUR / HRK	7.31	7.39	7.53	7.55	7.64	7.66	7.64	7.60	7.65	7.65
avg, EUR / HRK	7.34	7.29	7.43	7.52	7.57	7.63	7.61	7.56	7.57	7.60
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	1.0	1.6
Treasury bills rate 12m, %, avg	7.5	4.0	3.9	3.9	2.5	1.9	1.5	1.0	1.1	1.5

[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/RBA
Sources: CNB, MoF, CBS

Real GDP (% yoy)

	2014	2015	2016e	2017f
Poland	3.3	3.6	3.5	3.8
Hungary	3.7	2.9	2.2	2.7
Czech Rep.	1.9	4.3	2.3	2.7
Slovakia	2.5	3.6	3.5	3.3
Slovenia	3.0	2.9	2.2	2.1
CE	**3.0**	**3.6**	**3.0**	**3.3**
Croatia	**–0.4**	**1.6**	**1.5**	**1.5**
Bulgaria	1.5	3.0	2.5	3.0
Romania	3.0	3.8	4.0	3.6
Serbia	–1.8	0.5	2.5	3.0
BiH	1.1	2.8	3.0	3.5
Albania	2.0	2.6	3.5	4.0
SEE	**1.6**	**2.9**	**3.2**	**3.2**
Russia	0.7	–3.7	–0.5	1.0
Ukraine	–6.6	–9.9	1.5	2.0
Belarus	1.7	–3.9	–2.0	1.0
EE	**0.3**	**–4.1**	**–0.4**	**1.1**
CEE	**1.2**	**–1.1**	**0.9**	**1.9**
Austria	0.4	0.9	1.4	1.3
Germany	1.6	1.4	1.8	1.7
Euro area	**0.9**	**1.7**	**1.6**	**1.5**
USA	**2.4**	**2.4**	**2.5**	**2.4**

Source: Raiffeisen RESEARCH/RBI

Consumer prices (avg, % yoy)

	2014	2015	2016e	2017f
Poland	0.0	–0.9	–0.4	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**	**0.0**	**1.8**
Croatia	**–0.2**	**–0.5**	**–1.0**	**1.5**
Bulgaria	–1.4	–0.1	0.3	1.6
Romania	1.1	–0.6	–1.2	2.3
Serbia	2.9	1.4	1.2	2.5
BiH	–0.9	–1.0	0.0	1.5
Albania	1.6	1.8	1.5	2.2
SEE	**0.7**	**–0.2**	**–0.5**	**2.1**
Russia	7.8	15.6	7.5	7.2
Ukraine	12.1	48.7	15.5	12.0
Belarus	18.1	13.5	16.0	13.5
EE	**8.4**	**17.5**	**8.3**	**7.7**
CEE	**5.2**	**10.5**	**5.0**	**5.4**
Austria	1.5	0.8	1.2	2.2
Germany	0.8	0.1	0.7	2.7
Euro area	**0.4**	**0.0**	**0.3**	**1.5**
USA	**1.6**	**0.1**	**1.4**	**2.7**

Source: Raiffeisen RESEARCH/RBI

Fixed capital formation (% yoy)

	2014	2015	2016e	2017f
Poland	9.8	6.1	3.0	7.1
Hungary	11.7	1.9	–0.8	4.7
Czech Rep.	2.0	7.4	–2.4	4.7
Slovakia	3.5	14.0	1.0	4.8
Slovenia	5.5	4.8	3.0	n.v.
CE	**7.7**	**6.5**	**1.2**	**5.7**
Croatia	**–3.6**	**1.6**	**2.5**	**3.5**
Bulgaria	3.4	2.5	1.7	4.0
Romania	2.5	8.8	7.0	8.0
Serbia	n.v.	n.v.	n.v.	n.v.
BiH	5.9	4.0	7.5	7.2
Albania	–0.8	n.v.	n.v.	n.v.
SEE	**1.5**	**5.4**	**4.6**	**5.4**
Russia	–0.6	–7.6	–4.0	3.0
Ukraine	–23.0	–9.3	5.0	5.0
Belarus	–5.3	–15.9	n.v.	n.v.
EE	**–2.1**	**–8.0**	**–3.3**	**3.0**
CEE	**1.1**	**–2.4**	**–1.2**	**4.1**
Austria	–0.2	0.5	2.2	2.0
Germany	3.5	1.6	2.9	2.1
Euro area	**1.3**	**2.2**	**3.1**	**3.1**
USA	**5.3**	**4.0**	**6.8**	**n.v.**

Source: Raiffeisen RESEARCH/RBI

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	4.1
Czech Rep.	0.2	0.9	1.4	1.0
Slovakia	0.1	–1.3	–0.9	–0.7
Slovenia	7.0	6.5	5.5	4.8
CE	**–0.2**	**1.0**	**0.7**	**0.3**
Croatia	**0.9**	**5.2**	**2.0**	**2.2**
Bulgaria	1.2	1.1	1.1	0.4
Romania	–0.5	–1.1	–2.8	–3.3
Serbia	–6.0	–4.6	–4.3	–4.5
BiH	–7.5	–5.6	–7.0	–7.6
Albania	–12.9	–13.6	–13.5	–14.3
SEE	**–1.5**	**–1.0**	**–2.4**	**–2.8**
Russia	3.2	5.0	4.0	4.5
Ukraine	–3.5	–0.1	–3.3	–3.4
Belarus	–6.8	–3.8	–5.7	–5.4
EE	**2.5**	**4.4**	**3.2**	**3.7**
CEE	**1.3**	**2.5**	**1.6**	**1.8**
Austria	1.9	2.6	2.5	2.2
Germany	7.3	8.5	7.5	7.5
Euro area	**2.4**	**3.2**	**3.0**	**2.9**
USA	**–2.2**	**–2.6**	**–3.2**	**–3.5**

Source: Raiffeisen RESEARCH/RBI

General budget balance (% of GDP)

	2014	2015	2016e	2017f
Poland	–3.3	–2.6	–2.9	–3.4
Hungary	–2.5	–2.0	–2.2	–2.7
Czech Rep.	–1.9	–0.4	–0.3	–0.2
Slovakia	–2.7	–3.0	–2.1	–1.3
Slovenia	–4.9	–2.9	–2.7	–2.5
CE	**–2.9**	**–2.1**	**–2.2**	**–2.4**
Croatia	**–5.5**	**–3.2**	**–3.0**	**–2.9**
Bulgaria	–3.6	–2.9	–2.5	–2.0
Romania	–0.9	–0.7	–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	**–2.8**	**–2.0**	**–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	1.8	0.5	0.0
EE	**–1.2**	**–3.3**	**–4.2**	**–3.2**
CEE	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Austria	–2.7	–1.2	–1.9	–1.8
Germany	0.3	0.7	0.5	0.5
Euro area	**–2.6**	**–2.1**	**–1.7**	**–1.2**
USA	**–2.8**	**–2.4**	**–2.9**	**–2.9**

Source: Raiffeisen RESEARCH/RBI

Public debt (% of GDP)

	2014	2015	2016e	2017f
Poland	50.5	51.3	52.1	52.6
Hungary	76.2	75.5	74.9	74.5
Czech Rep.	42.7	41.1	40.3	39.1
Slovakia	53.9	52.9	52.8	52.1
Slovenia	80.8	83.5	81.9	81.2
CE	**54.2**	**54.2**	**54.3**	**54.2**
Croatia	**86.5**	**86.7**	**87.2**	**87.6**
Bulgaria	26.9	26.3	29.5	30.0
Romania	39.8	38.4	39.2	39.9
Serbia	68.8	74.7	78.5	81.3
BiH	42.2	42.4	46.0	45.0
Albania	71.6	72.2	70.5	67.8
SEE	**48.5**	**48.5**	**50.0**	**50.6**
Russia	11.5	12.7	13.5	14.0
Ukraine	52.9	72.6	79.3	78.9
Belarus	34.1	48.5	49.9	46.4
EE	**14.7**	**17.5**	**18.6**	**19.0**
CEE	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Austria	84.2	86.2	85.3	84.0
Germany	74.7	71.2	68.5	65.6
Euro area	**92.0**	**90.7**	**90.5**	**89.0**
USA	**103.2**	**101.9**	**104.5**	**104.1**

Source: Raiffeisen RESEARCH/RBI

Gross foreign debt (% of GDP)

	2014	2015	2016e	2017f
Poland	71.1	70.1	74.2	73.9
Hungary	113.9	105.7	98.5	87.2
Czech Rep.	66.6	70.7	74.6	78.1
Slovakia	89.7	86.1	84.9	83.1
Slovenia	124.1	114.8	110.0	104.1
CE	**71.5**	**70.4**	**72.0**	**71.0**
Croatia	**108.4**	**103.7**	**99.1**	**98.5**
Bulgaria	93.1	77.2	76.6	74.8
Romania	63.1	56.7	53.3	52.7
Serbia	78.6	81.6	80.6	78.3
BiH	51.8	54.2	55.5	55.7
Albania	69.2	72.6	71.1	68.2
SEE	**74.7**	**68.8**	**66.1**	**64.9**
Russia	29.5	39.3	38.0	31.9
Ukraine	95.2	131.5	140.0	140.4
Belarus	52.6	70.2	75.6	70.4
EE	**34.2**	**46.1**	**45.8**	**39.7**
CEE	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Austria	n.v.	n.v.	n.v.	n.v.
Germany	n.v.	n.v.	n.v.	n.v.
Euro area	**120.3**	**124.6**	**n.v.**	**n.v.**
USA	**n.v.**	**n.v.**	**n.v.**	**n.v.**

Source: Raiffeisen RESEARCH/RBI

EUR/LCY (avg)

	2014	2015	2016e	2017f
Poland	4.19	4.18	4.38	4.29
Hungary	308.7	309.9	314.8	308.8
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**	**7.56**	**7.57**
Bulgaria	1.96	1.96	1.96	1.96
Romania	4.44	4.45	4.50	4.47
Serbia	117	121	123	124
BiH	1.96	1.96	1.96	1.96
Albania	140	140	138	138
SEE				
Russia	51.0	68.0	74.6	66.7
Ukraine	15.9	24.3	28.9	29.7
Belarus	13597	17706	22845	23129
EE				
CEE				
Austria	euro	euro	euro	euro
Germany	euro	euro	euro	euro
Euro area	**euro**	**euro**	**euro**	**euro**
USA	**1.33**	**1.11**	**1.10**	**1.01**

Source: Raiffeisen RESEARCH/RBI

Ratings

	S&P	Moody`s	Fitch
Poland	BBB+	A2	A–
Hungary	BB+	Ba1	BBB–
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	BB–
BiH	B	B3	NR
Albania	B+	B1	NR
Russia	BB+	Ba1	BBB–
Ukraine	B–	Caa3	CCC
Belarus	B–	Caa1	B–
Austria	AA+	Aaa	AA+
Germany	AAA	Aaa	AAA
USA	**AA+**	**Aaa**	**AAA**

for FCY, long-term debt
Source: Raiffeisen RESEARCH/RBI

Raiffeisen RESEARCH

Economy recovers overshadowed by politics

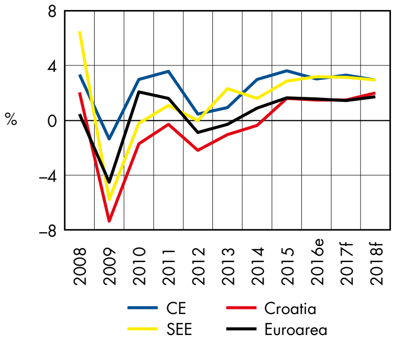
The recovery that had started in 2015 continued in the first half of 2016 pushed predominantly by domestic demand. Personal consumption found footing in the continued price decline, stabilisation in the labour market and healthy tourism indicators. Favourable developments as regards the withdrawal of EU funds and the positive growth rate in construction were encouraging. On the other hand, the positive effect of the goods and services exports was diminished by the growth of imports, thus warning of the necessity to strengthen competitiveness in order to reduce the relatively high dependence on imports. Developments in the economies of Croatia's most important trading partners, high-frequency indicators from the beginning of the second quarter, as well as third-quarter expectations suggest that 2016 growth might exceed the currently expected 1.5 percent. In contrast to the pre-crisis period, growth is paired with deleveraging and higher degree of orientation towards international markets. Weak demand for loans with a parallel growth of deposits diminishes the need for foreign sources of bank financing. Gross external debt consequently decreased, which together with the surplus in the balance of payments current account (for the fourth year in a row) diminishes Croatia's external vulnerability.

Positive trends remained largely overshadowed by political bickering which ended in the snap parliamentary elections being scheduled for September. Despite the short-term positive influence on the reigning in of government spending, fact remains that an unstable political environment causes negative perception among investors and rating agencies. Moreover, it postpones the creation of the necessary preconditions for sustainable and greater growth, especially given that the time during the long recession was not used for more important structural reforms. The postponement of the May issue of an international EUR-denominated bond due to political uncertainty was the first sign of how sensitive financial markets can be. For the time being, Croatia enjoys the continuation of ECB's unconventional monetary policy measures, which are likely to be extended due to UK's decision to leave EU membership. Moreover, the impact of the referendum will probably be seen in the FOMC's July decision to postpone interest rate increasing. The environment of high liquidity and low interest rates is favourable for the attractiveness of Croatia's debt. Nevertheless, a comparison of its risk premium clearly indicates higher costs it sustained and lost chances to be paid for by future generations.

In the meantime, the central bank's monetary policy maintained its expansive character by preserving high liquidity enjoing the absence of inflation. High liquidity of the domestic market is especially beneficial for the government, which, with its second HRK issue this year, raised HRK 10bn thus far. The exchange rate stability remains the central bank's unquestionable priority due to the still-high degree of eurisation, that is, currency risk, all sectors are exposed to.

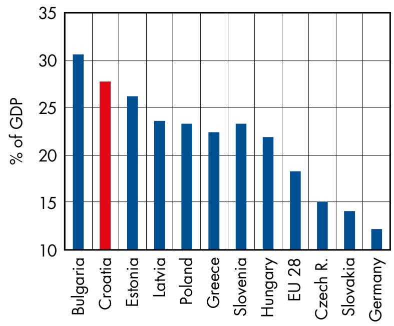
Economic analyst: Zrinka Živković Matijević

Real GDP (% yoy)



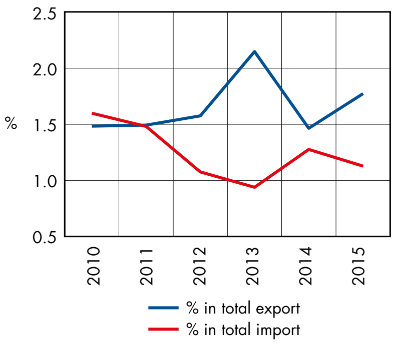
Sources: Eurostat, Raiffeisen RESEARCH/RBI

Shadow economy in GDP, 2015



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

Foreign trade with United Kingdom

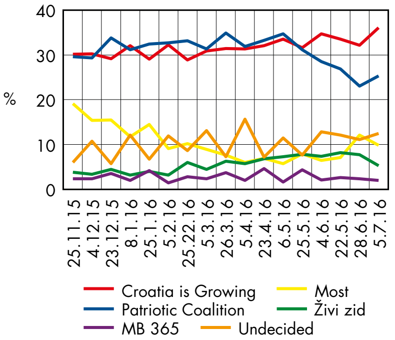


Sources: CBS, Economic RESEARCH/RBA

Snap elections to be held in September

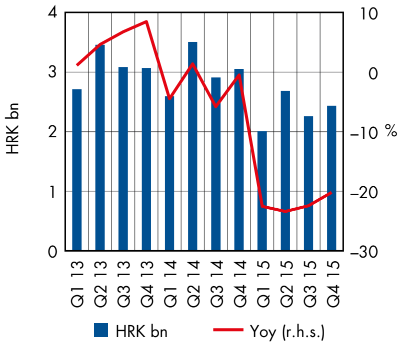
- **Likelihood of political uncertainty still high**
- **Credit rating maintained**

Opinion polling for the Croatian parliamentary election, 2015



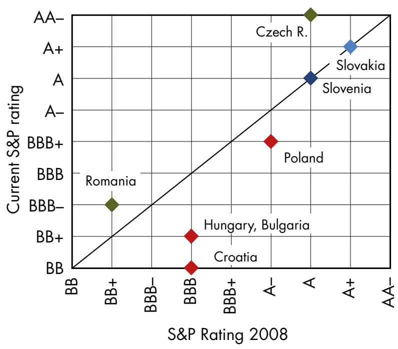
Sources: Promocija plus, IPSOS PULS, Economic RESEARCH/RBA

GFCF, General Government



Sources: Eurostat, Economic RESEARCH/RBA

S&P sovereign credit rating 2008/2016*



** on 15th July*
Sources: Bloomberg, Economic RESEARCH/RBA

The disagreements among (the officials of) political parties making up Croatia's government finally resulted in the non-confidence vote against the Prime Minister, dissolving of the Parliament and the date being set for snap elections in the first half of September 2016. However, opinion pool continue to point towards political uncertainty, indicating that we are unlikely to see a clear cut winner of parliamentary elections in September as well. Namely, political bickering and the uncertainty created as a result made the coalition *Croatia is growing*, headed by the social democrats (SDP), the favourite of Croatian voters, noticeably diminished the popularity of the *Patriotic Coalition*, headed by the Croatian Democratic Union (HDZ), and restored (although not entirely) the party MOST to popularity. Fact remains that some 30% of votes remain scattered among undecided voters and the so-called smaller parties. On the other hand MOST proved to be a tough negotiator and a political partner that does not back off when faced with demands of leading parties commanding stronger electoral support. As for economic programmes of political parties we do not expect (much) divergence from the programmes introduced at regular parliamentary elections in November last year. However, it will be interesting to see their stance on the reform of local and regional self-government units, especially given the fact that local elections are envisaged sometime in the spring of 2017. In addition, when other things are made equal, one should not rule out the parties being more prone to populist measures in order to win votes. Populist measures normally mean more spending to be financed. It is thus unlikely that autumn will bring much stability as far as the formation of the government and parliamentary majority are concerned. Until then the technical Government will hold on to executive power. One of the key documents "Economic and fiscal policy guidelines" for the upcoming three-year period are on the agenda already in July. They should be the foundation for the 2017 budget and the indicator of the government's readiness for reform. After the falling of the government, the evaluation of such documents becomes irrelevant and the financing and execution of the state budget proceed without amendments to regulations and structural changes. The data for Q4 2015 and Q1 2016 confirm that political uncertainty reigned in government spending, especially in relation to the material costs item and capital investments. This, amid the economic growth and cyclical inflow to the state budget leads to deficit reduction and a "natural" fiscal consolidation. Paired with a smaller deficit, primary surplus and continued privatisation of the remaining government portfolio, public debt growth slows down or even stabilises. However, although fiscal metrics improves under such conditions, deeply rooted structural problems remain (healthcare, education, pension system, public administration, etc.) and the creation of the conditions for stable and stronger recovery is postponed. Moreover, in the context of a small, open and vulnerable economy such as Croatia's, political uncertainty signals investors and rating agencies away. The S&P's warned against this in its latest assessment by indicating the country risk which ultimately determines the costs of financing for all segments of the economy.

Economic analyst: Zrinka Živković Matijević

Growth boosted by domestic demand

- **Macroeconomic indicators remain healthy**
- **Gross external debt lowered – banking sector deleveraging continues**

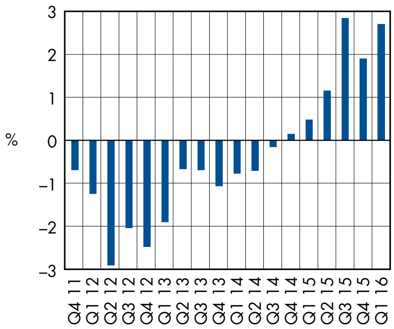
The final GDP Q1 2016 indicators confirmed the real annual growth rate of 2.7% with a positive contribution of domestic demand headed by the growth of personal consumption and also encouraging recovery of gross capital formation. Despite the fact that the greatest contribution to the increase in GDP volume came from goods exports, the effect of net foreign demand was ultimately negative, primarily thanks to relatively strong growth of the imports of goods and services.

Solid high-frequency macroeconomic indicators pointed to a further continuation in positive GDP developments over this year's second quarter. Although at a slower pace relative to the first quarter, the growth of industrial production will continue over the upcoming months, paired with the expected continuation of favourable trends in external demand which will surely positively contribute to the continuation of healthy growth rates by the export of goods. On the other hand, the envisaged recovery of investments (spurred by better utilisation of EU funds) might at the same time spur stronger imports, thus consequently diminishing the positive contribution of the growth of exports of goods and services.

At the same time, the projected continuation of negative annual inflation rates (predominantly caused by imported price pressures from the world's commodities market) will be additionally underlined by the effects of the administrative reduction in the price of gas[1], thus causing the effect of "tax alleviation", that is, higher available income. Consequently, over the next months positive annual growth of average wages in real terms will continue. However, in contrast to 2015, this year will show a relatively higher annual growth of average gross wages relative to net wages which is partially consequence of the base period effect, given that growth of net wages registered last year was spurred by changes in income taxation. The effect of these tax changes vanished[2] at the beginning of 2016.

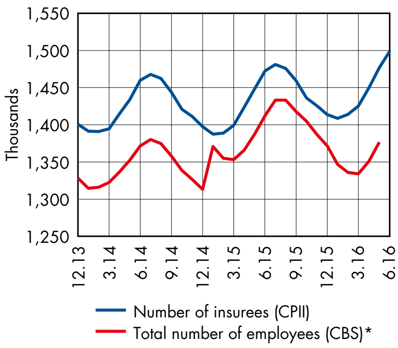
In addition to improved development in employment, aided by rising demand for seasonal workers in tourism, the positive influence of personal consumption on GDP growth is expected to continue. According to our estimates, it could come in higher than initially expected on an annual level. Positive risks over the short-term largely come from expectations of a one more record tourist season that might positively affect the economy in multiple segments. At the same time, however, Croatia's large dependence on tourism is worrying. Its share in the country's economy, by income, reaching almost 20% of GDP. Namely, amid relatively high geopolitical risks, overreliance on tourism may ultimately have a negative effect. Therefore, negative effects on the sustainability of economic

GDP, real annual changes



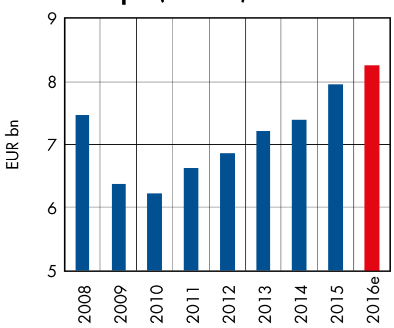
Sources: CNB, Economic RESEARCH/RBA

Trends in employment



** series is broken as of Jan 2015 (due to the new methodology)*
Sources: CPII, CBS, Economic RESEARCH/RBA

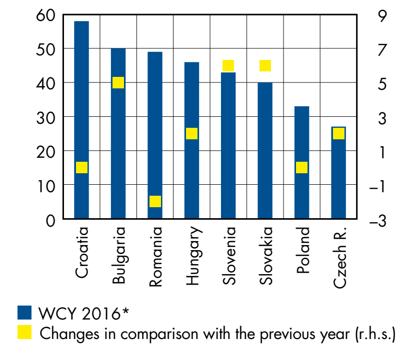
Travel receipts (tourism)



Sources: CNB, Economic RESEARCH/RBA

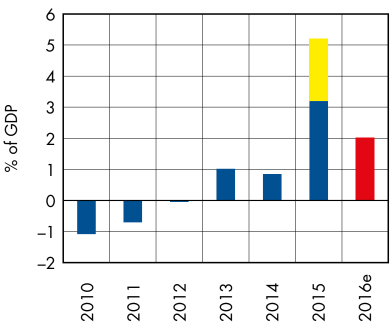
1 Since 1 April 2016.
2 As for more substantial methodological changes, starting from January this year the CBS published data on average wages in accordance with a new methodology which resulted in relatively lower expressed amounts of average wages relative to the previous statistics. The new methodology is based on a new data source the so-called JOPPD form which provides for a more comprehensive coverage of the data on salaries and wages in compared with the previous statistical research that covered 70% of the persons employed in each section of the NCA collected via the statistical form RAD-1.

The IMD's World Competitiveness



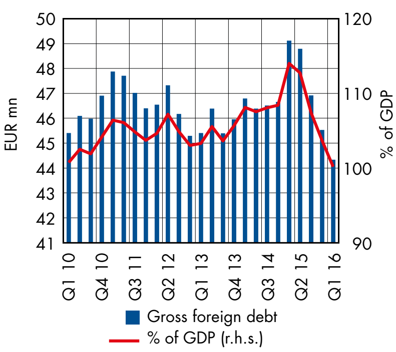
** higher scale values imply lower competitiveness*
Sources: IMD World Competitiveness Yearbook 2016, Economic RESEARCH/RBA

C/A balance



** yellow implies impact of mandatory CHF conversion*
Sources: CNB, Economic RESEARCH/RBA

Gross external debt



Sources: CNB, Economic RESEARCH/RBA

growth in the mid-term should be stressed. They are also linked to the political uncertainty that resulted in the discontinuity in the operation of the government. In other words, a slowdown or postponement of structural reforms defined within the framework of the National Reform Programme and Convergence Programme for the medium term may cause the unfavourable investment environment to continue and thus jeopardise the long-term growth outlook. Negative risks arising from the external environment should also not be neglected (such as the slowdown in the countries that are Croatia's main foreign trade partners, especially in the context of concerns arising from direct and/or indirect consequences of Brexit).

The CNB's latest indicators of Croatia's foreign relations confirmed the usual deficit in the **balance of payments** current account in this year's first quarter (HRK 1.6bn). It widened by almost 26% on annual level, the negative contribution coming from the primary and secondary income account and the deterioration in the account of goods and services (regardless of the two-digit annual growth, exceeding 16% of total income from tourism). However, viewed cumulatively, the last four quarters saw a relatively high surplus balance in the current account balance of 4.4% of GDP (receiving a strong boost by bank losses caused by the CHF conversion). On an annual basis, in addition to a one more sucessful tourist season, 2016 is to bring about a higher income arising from EU funds. This, together with lower prices of oil on an annual level, could result in the positive current account balance for the fourth year in a row. Given the absence of the ample effect of the CHF conversion this year, the expected surplus will be much lower.

On the other hand, the compulsory CHF conversion increased client risk aversion which consequently additionally contributed to the reduction in demand for loans. Due to the parallel growth of cheaper domestic deposits and high liquidity in the domestic market, banks continued deleveraging abroad (the trend that started in April 2012). Consequently, at the end of this-year's first quarter the overall **gross external debt** totalled EUR 44.3bn, thus lowering its share in GDP to 100.2% (from 103.7% at the end of last year). Apart from banking sector deleveraging, the decrease in gross external growth was aided by the slowdown in general government borrowing in the first three months of the year. However, after the period of temporary financing, let us be reminded that recent postponement of a government bond issue in the foreign financial market was successfully substituted by domestic borrowing, a similar trend might be expected in the corporate sector. Therefore, in the upcoming months we are expected to see a subdued bank need for foreign sources of funds. Consequently, given the envisaged economic growth, the share of gross external debt in GDP might come in lower than last year.

Economic analyst: Tomislava Ujević

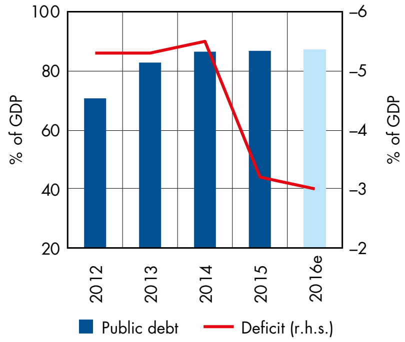
Financing needs grow

- Risk of stronger fiscal consolidation in the medium term
- New local issue

The uncertain and complicated political situation, including the status of a technical government, increased the risk of a slowdown or even postponement in the much awaited implementation of reforms within the framework of the National Reform Plan and the Convergence Programme. The reform implementation should reign in public expenditures in the short term, while economic recovery should continue to positively affect revenues. In addition, one more successful tourist season, according to preliminary indicators, will reflect itself in more ample VAT revenues which will, in addition to the short-term positive fiscalisation effect, result in the multiplicative effect on the overall economic activity. Nevertheless, in the long-term, Croatia absolutely needs a stable government, laying stress on reforms and meeting the needs of the private sector for the purpose of achieving sustainable fiscal metrics.

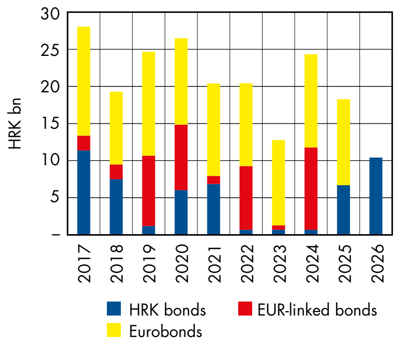
In addition to this year's estimated general government deficit of some 3% of GDP, total refinancing needs neared some 20% of GDP (which includes liabilities arising from the issued T-bills which are usually rolled-over at maturity). According to the financing account, published by the Government within the framework of the proposed 2016 Budget, the securities issues, that is, bond issues, are planned to raise HRK 17.56bn of budget receipts. The expected exit to the foreign capital market with an international bond issue, which aimed to raise a share of budget receipts, was postponed early in June. Amid domestic political bickering the Ministry of Finance announced that it decided to monitor developments in international financial markets in order to issue this year's only planned Eurobond after the domestic political uncertainties have been removed. New borrowing in the domestic market was undertaken in the middle of July. With healthy investor interest and yield to maturity of 2.85%, Croatia successfully placed HRK 6bn, maturing in 2021, thus completely covering the bond maturing in July, worth HRK 3.5bn. Together with the HRK 4bn issue from the mid-March this resulted in the HRK 10bn raised in the domestic capital market thus far. As for the remainder of the year, an 18-months EUR T-bill issued in February 2015 is maturing in August. According to the latest available data, central government deposits at the account with the CNB totalled HRK 5.9bn in May, indicating the need for additional government borrowing until the end of the year. It is likely that this year's refinancing needs will be met in the local market, abundant in surplus liquidity, while at the same time market participants (especially large institutional investors such as pension funds) are capable of catering for this year's possible increase in supply of government issues. However, the first greater challenge having to do with the financing of maturing liabilities to be faced by the new future government will be the one in the first quarter next year when the lion's share of 2017 maturities becomes due (HRK 5.5bn in February and USD 1.5bn in April). According to our expectations, regardless of ample liquidity in the system, it is unlikely that the government will be able to meet its financing needs in the domestic market. To be more exact, some 20% of refinancing needs over the years to come cannot be absorbed only by the local market. New potential borrowing in the international market will, to the largest extent, depend on the stabilisation in the domestic political arena. Therefore, we

Consolidated General Government (ESA2010)



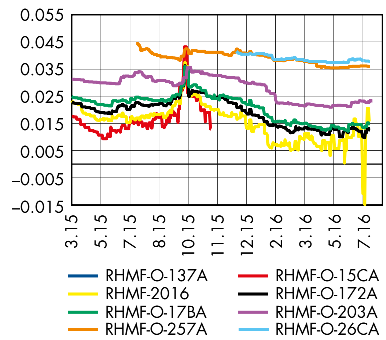
Sources: CBS, Economic RESEARCH/RBA

Government debt maturities (bonds)



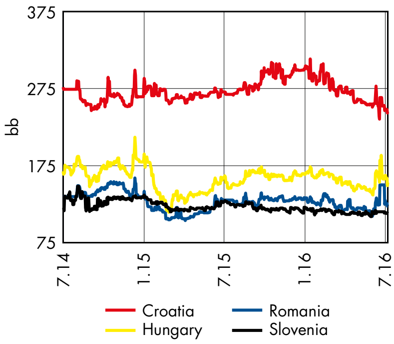
** converted at mid-FX rate on 11th July 2016*
Sources: MoF, Economic RESEARCH/RBA

Croatian government bonds yields (HRK)



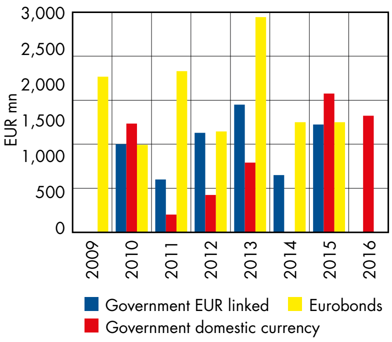
Sources: Bloomberg, Economic RESEARCH/RBA

5-y CDS (USD)



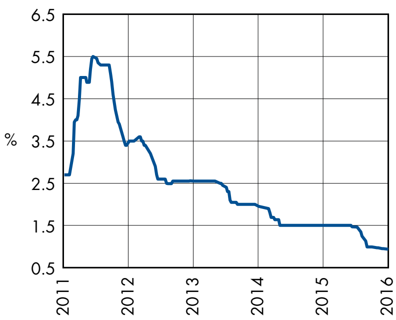
Sources: Bloomberg, Economic RESEARCH/RBA

New government bond issues



Sources: MoF, Economic RESEARCH/RBA

1-Y HRK T-bills yield



Sources: MoF, Economic RESEARCH/RBA

think that a more likely date for an international issue will be sometime at the beginning of next year when things are expected to stabilise politically. When this prerequisite is satisfied, good macroeconomic fundamentals, as well as favourable situation in the foreign markets supported by the continuation of the ECB's expansionary monetary policy on one hand and the postponed increase in FED's interest rates on the other, not to mention ample system liquidity, will facilitate successful borrowing. The key pricing factor will definitely be political stability, as one of the main factors in credit rating assessment by rating agencies. Given the interdependence of sovereign credit rating and the price of a country's borrowing it is interesting to compare yields on government bonds of Romania and Croatia today vis-à-vis the pre-crisis 2008. According to Moody's, Croatia and Romania had an equal rating in 2008 (Baa3), with the yield on the 10-year Croatian local bond being 6%, while the equivalent Romanian bond was traded at an average yield to maturity of 9.2%. Romania maintained the same credit rating, while Croatia's credit rating went down to Ba2 over the years. The average yield on the 10-year Romanian bond was 3.50% this year, while Croatian papers of the same maturity yielded 3.90%. However, difference in Eurobonds is even greater. While in 2008 the yield on the 8y Romanian Eurobond was 100bp higher than the yield of equivalent Croatian issue (6.65% vs. 5.65%) today the situation is significantly different. The current yield on the Croatian Eurobond maturity in 2025 is 125 bb higher in relation to the Romanian foreign issue of the same maturity (3.41% vs. 2.14%). All of the above leads to a conclusion that had Croatia only maintained its credit rating at the 2008-level, the price of its borrowing today would surely be much more favourable despite of the already favourable conditions and low benchmark interest rates in international markets. We expect a quiet period with stable price and yield movements of domestic bond issues to continue until the end of the year. Given that the monetary policy in the remainder of the year will support high liquidity, yields on short-term securities, whose one-year yields on kuna issues decreased additionally late in June, to 0.94%, will surely remain at their historical lows. As usual, Croatian Eurobonds mimicked the trends seen in bonds of CEE countries. The negative mood in the market and the sudden rise in risk aversion after the results of the United Kingdom EU membership referendum spilled over to Croatian issues whose spread widened to above 410bp for a short period. However, the calming of the situation in the international markets returned Croatian international issues to trends seen before the Brexit referendum. As the year goes on, ample liquidity in the European markets resulting from the expansive monetary policies of leading central banks paired with historically low yields will continue to positively affect CEE bond movements. However, with the spill-over of strong risk aversion and given the growth of risk premiums in the peripheral countries of the EU amid insecurity in the global markets amplified by the results of the Brexit referendum, Croatia might, given its fundamentals and political instability, pay a higher risk premium, which may negatively affect public debt and the urgently required fiscal consolidation.

Economic analyst: Elizabeta Sabolek Resanović

Stable exchange rate and low inflation continue to support expansive monetary policy

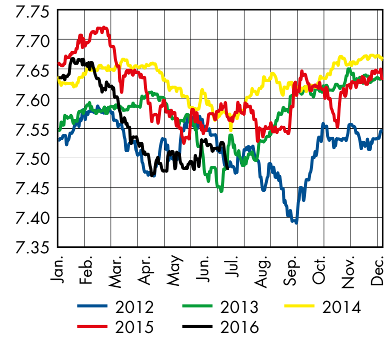
- **Stabile EUR/HRK exchange rate**
- **High kuna liquidity and further interest rate decline**

The strengthening of the kuna against the euro that had started in February was halted in the second half of April. It was only the short-term downward pressure late in May that prompted the central bank to a foreign exchange intervention. For the first time since 2012, the CNB purchased euros from commercial banks in the total amount of EUR 83.5m at the mid-point exchange rate of HRK 7.49 for one euro. Although relatively small by amount, this foreign exchange intervention was a clear message that the stability of the domestic currency remains one of the key monetary policy priorities. Moreover, the stability of the exchange rate was not even jeopardised by the inner political turmoil or the outcome of the UK European Union membership referendum, thus confirming the shallowness of the market and the absence of foreign investors that could potentially create the risk of a volatile exchange rate with their surplus exposure towards the kuna. The peak of the tourist season paired with slightly more favourable fiscal risks, the inflow of euros from foreign sources (from borrowing and/or EU funds) and positive net foreign position of banks are the factors that should provide support to the domestic currency in the upcoming months. Nevertheless, we do not expect EUR/HRK to fall below 7.45 kuna per euro, partly also due to the steady demand for euros that arises also with the growth of imports. At the end of summer, the kuna should register a commonly mild depreciation trend, with the upward EUR/HRK trend being expected to last until the end of the year. The average EUR/HRK exchange rate at the annual level should come in lower than in 2015, thus confirming the recovery of economic activity mostly accompanied by the strengthening of the kuna against the euro.

Amid such conditions the monetary policy remains expansive, thus ensuring the liquidity of the financial system and further lowering of interest rates. The "interest rate transfer" of monetary policy impulses strives to lower the financing costs of all sectors and aid the recovery of economic activity. However, despite the decline of the fixed interest rate during the third structural repo operation (from 1.8% to 1.4%), interest remained subdued by the absence of stronger demand for loans that, with the already existing high liquidity, may be satisfied from the available kuna sources. In case of a stronger and longer-lasting demand for kuna loans the role of the central bank remains key and providing for kuna sources. Namely, in the structure of bank assets, deposits account for a still stable majority source, with (despite the gradual decline) foreign exchange deposits prevailing with a share of some 70%. The expansive character of the monetary policy is also supported by the absence of inflationary pressures. The CPI decline that has been observed for the third year in a row gained additional strength thanks to the administrative decline in the price of gas early in the second quarter. The expected annual decline in consumer prices is one percent in annual terms, but there are no fears of a deflationary spiral. The decline in prices has a positive impact on consumption by alleviating the burden on personal income. Namely, the main generator of negative rates continues to be energy whose gradual recovery is expected later in the year, after the recovery in the prices (of oil) in the world's commodities markets.

Economic analyst: Zrinka Živković Matijević

Mid EUR/HRK



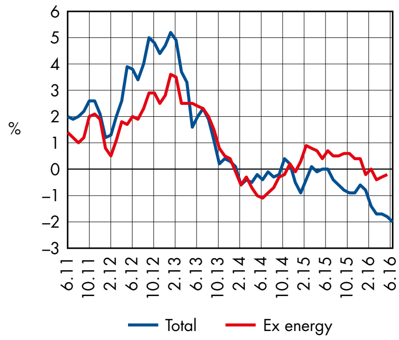
Sources: CNB, Economic RESEARCH/RBA

Middle exchange rate of the CNB

	Middle exchange rate	Change compared to: 31.12.2015		
	30.6.16	Exch. rate	Movements	%
EUR	7.5127	7.6350	↓	–1.60
USD	6.7915	6.9918	↓	–2.87
CHF	6.8968	7.0597	↓	–2.31
GBP	6.9293	10.3610	↓	–33.12

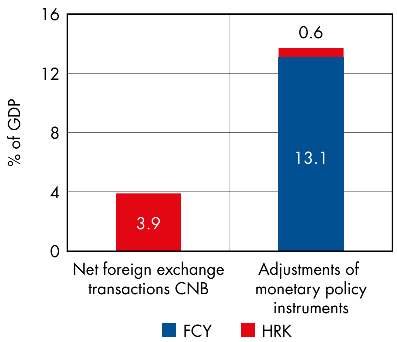
Sources: CNB, Raiffeisen RESEARCH

CPI, annual changes (%)



Sources: CNB, Economic RESEARCH/RBA

Creation and liquidity release in the crisis (Q4 2008–2015)



Sources: CNB, Economic RESEARCH/RBA

Brexit in focus

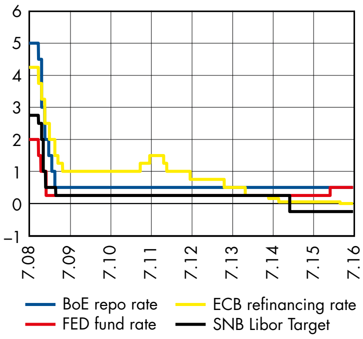
- **Monetary policies of leading central banks adjusting to new environment following Brexit**
- **Fed again postponed the raising of its benchmark rates**

FOMC Meeting Calendar

2016	
26–27 Jul	1–2 Nov
20–21 Sep	13–14 Dec
2017	
31 Jan–1 Feb	25–26 Jul
14–15 Mar	19–20 Sep
2–3 May	31 Oct–1 Nov
13–14 Jun	12–13 Dec

Sources: Federal Reserve System, Economic RESEARCH/RBA

Key interest rate



Sources: Fed, ECB, BoE, SNB, Economic RESEARCH/RBA

Financial market forecasts

	9.16	12.16	3.17	6.17
EUR/USD	1.10	1.05	1.03	0.99
ECB key rate	0.00	0.00	0.00	0.00
ECB Deposit rate	–0.40	–0.40	–0.40	–0.40
1m EURIBOR	–0.40	–0.40	–0.40	–0.35
3m EURIBOR	–0.30	–0.30	–0.30	–0.25
12m EURIBOR	–0.10	–0.10	–0.05	0.00
GE 10y yield	0.00	0.30	0.50	0.70

as of 11/07/2016
Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

This year's second quarter was marked by the United Kingdom EU membership referendum and assessments of potential consequences on global markets. Amid uncertainty, risk aversion and caution in the wake of referendum results, the leading central banks opted for the *wait-and-see* policy. At its regular meeting early in June, the ECB maintained its benchmark interest rate at 0.00% (deposit rate at negative 0.40% and its marginal interest rate at 0.25%). At the same time, there were no changes in the FOMC benchmark rates. The top official, J. Yellen stressed that the UK referendum was an important factor in the decision to keep stable interest rates. The latter was confirmed when the minutes from the Fed's meeting were published, which lead to the conclusion that the influence of Brexit is quite substantial and that next meeting of FOMC officials in July is also likely to end with the postponement of interest rate increasing.

June 23 marked a new milestone in the history of the European Union. It was equally surprising for both bookies and financial markets. The decision of the British hit financial markets and caused significant short-term changes in the movement of currency prices, equity markets and bond risk premiums. However, the noticeably wakened British pound is a clear reflection of the uncertainty that may easily spill over to other markets. Brexit is unprecedented so its consequences are hard to pin down. This pushed market participants to turn towards safest assets, while more risky ones came on sale. All this, of course, largely depends on the future of the legal relationship between the United Kingdom and the EU-27 once the UK membership in the EU ceases. Central banks are not unaware of the existing negative risks. Therefore, in order to avoid a collapse in the financial markets they intervened through foreign exchange interventions or asset repurchase programmes. One thing is certain, monetary policy will adapt.

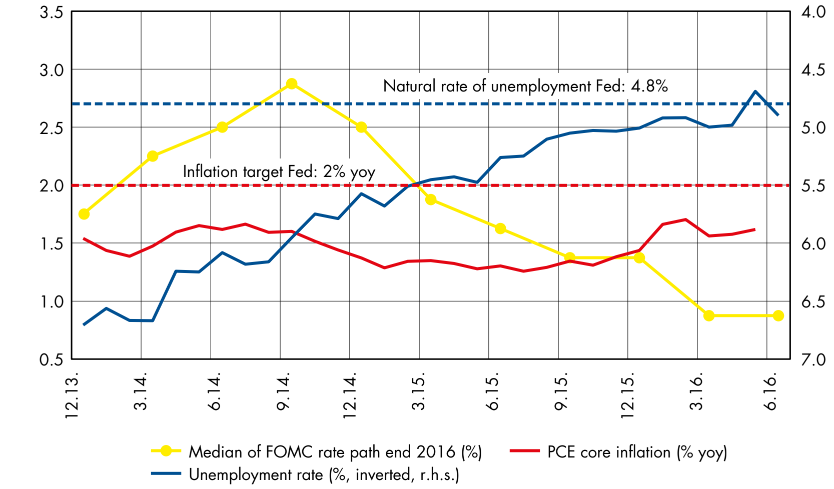
The experience of the last few years implies that interest rate raising in the US will be postponed. Given the results of the UK referendum, we expect that FOMC officials will decide against an intervention in the international financial market by raising interest rates despite good economic and labour market indicators at their meeting this month. The next increase in benchmark interest rates is possible in September, although more likely in December, when the situation in the markets quiets down. In line with FOMC expectations, we expect three more interest rate hikes by 25bp over the next year.

As for Europe, the extremely expansive monetary policy of the ECB will continue until the end of 2017. The ECB committed to repurchasing EUR 80bn until March 2017 as part of the Quantitive Easing policy. We do not expect a sudden halt. In addition, the ECB started with the purchase of selected corporative bonds in the estimated amount of EUR 5–7bn per month. In case of turbulence in the financial markets, the ECB will not hesitate to continue the bond purchase programme as a form of programme extension and/or to increase the monthly volume. Should the ECB opt for changes in its bond purchase programme, this will not significantly affect interest rate developments in the money market. On the other hand, under the scenario of further benchmark rate cuts changes would be more pronounced.

Namely, for some time now, the ECB deposit rate is the most important measure of the EURIBOR movement. In our opinion, further decline in the deposit rate will cause a proportional decline in the EURIBOR rate at the shorter end of the yield curve. Given that the Brexit situation is clearly correlated with banking sector uncertainty, EURIBOR rates for longer maturities (e. g. 12-month EURIBOR) will probably not go down proportionally. All in all, we expect further ECB benchmark rate cuts to lead to the decrease in EURIBOR rates, with the yield curve of money market interest rates becoming steeper.

Economic analyst: Elizabeta Sabolek Resanović

Feds' Monetary Policy



Sources: Thomson Reuters, FRB, Raiffeisen RESEARCH/RBI

Interest rates – long term forecast

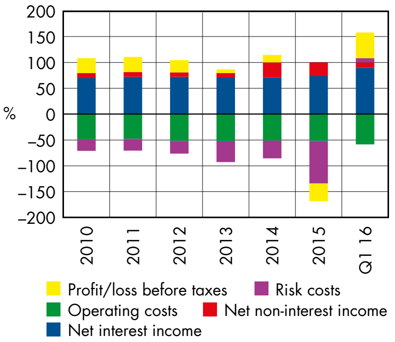
	1991 – 2005 eop	2013 avg	2013 eop	2014 avg	2014 eop	2015 avg	2015 eop	2016e avg	2016e eop	2017f avg	2017f eop	2018f avg	2018f eop
Fed key rate	4,06	0,25	0,25	0,25	0,25	0,26	0,50	0,63	0,75	1,13	1,50	1,88	2,25
Libor 1m	4,22	0,19	0,17	0,16	0,17	0,20	0,43	0,58	0,65	1,03	1,40	1,83	2,25
Libor 3m	4,31	0,27	0,25	0,23	0,26	0,32	0,61	0,78	0,85	1,23	1,60	2,03	2,45
Libor 6m	4,41	0,41	0,35	0,33	0,36	0,49	0,85	1,03	1,15	1,50	1,85	2,28	2,70
Libor 12m	4,64	0,68	0,58	0,56	0,63	0,80	1,18	1,28	1,45	1,80	2,15	2,58	3,00
Yield 2y	4,67	0,30	0,36	0,45	0,63	0,67	1,04	1,05	1,10	1,45	1,80	2,10	2,40
Yield 5y	5,31	1,16	1,71	1,63	1,64	1,52	1,65	1,70	1,60	1,95	2,30	2,45	2,60
Yield 10y	5,75	2,34	3,01	2,53	2,18	2,13	2,28	2,25	2,10	2,50	2,90	2,95	3,00

Sources: Thomson Reuters, Raiffeisen RESEARCH/RBI

One-off profitability growth in Q1

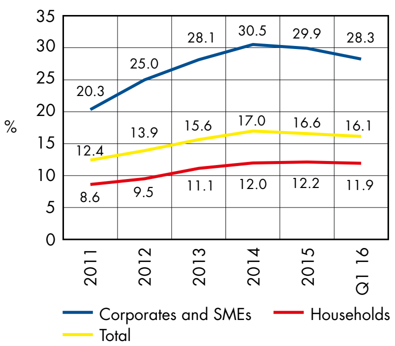
- **Positive reverse influence of conversion on credit risk**
- **Continued bank deleveraging abroad**
- **Diminished share of non-performing in total loans**

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



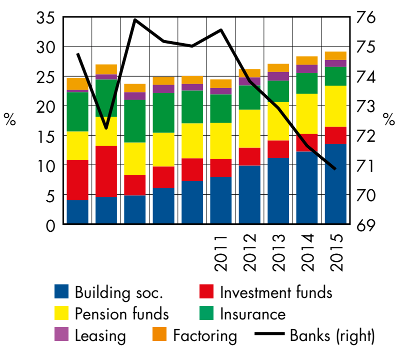
Legend:
– formation of Gross income (from 0% to 100%)
– distribution of GI, except Pbt (below 0%)
– Profit bt as % of GI (over 100%)
Sources: CNB, Economic RESEARCH/RBA

NPLs ratio, eop in %



Sources: CNB, Economic RESEARCH/RBA

Croatian financial sector, structure



Sources: CNB, CFSSA, Economic RESEARCH/RBA

As a result of the proscribed conversion of CHF loans in EUR loans, the banking sector incurred operating losses in Q3 2015 arising from the partial write-off of client receivables. The partial write-off of loans contributed to the reduction of the basis for the calculation of loan loss provisions, both in the portfolio for performing loans and individual for non-performing loans. Amid the calculation of provisioning costs at reduced basis, surplus provisions in the converted credit portfolio were released in Q1 this year. Therefore, instead of the usually negative we saw a positive contribution of provisions to period results making bank realised profit in Q1 substantially higher than over the previous years. The positive influence of provisioning costs on operating results is one-off and linked to the previously executed conversion procedure. Until the end of the year we do not expect additional extraordinary influence on bank operations and consequently no unusual contributions of provisioning costs on operating results, either positive or negative. Conversion effects had a positive influence on the portfolio of non-performing loans. The reduction of the overall amount of client debt in converted loans reduced the overall amount of non-performing loans. The decline in bank claims from clients, with collateral value maintaining the same level, led to an increase in coverage ratios, primarily as regards mortgage loans. Therefore, in addition to the reduction of the overall ratio of non-performing loans from 17.1% in Q3 2015 to 16.1% in Q1 2016 the coverage ratio of non-performing loans by value adjustments went up from 54.4% to 58.4% in the same period. Due to the expected economic recovery and the growth of real household income, the remainder of the year is expected to see positive tendencies expressed in the fall of the ratio of non-performing loans and the growth of coverage by value adjustments. The reduction in the ratio of non-performing loans in the remainder of the year might help bring back to life the credit activity of banks. A precondition for an increase in lending is to increase the attractiveness of the loans offered by domestic banks compared with those offered by their foreign competitors. Namely, under the influence of expansive monetary policy measures over the past few years in the dominant foreign market (the euro area) the direct borrowing on foreign markets was more attractive in terms of price than the loans offered by domestic banks. During the period, loans offered by domestic banks were dominated by loans indexed to the euro that arose from the structure of financing sources marked by a high degree of euroisation of domestic deposits. Differences in the interest rates of supplied loans were used by domestic enterprises deleveraging with domestic banks and borrowing abroad. However, the demand for loans in domestic currency increased in 2016 and the CNB started to use structural operation measures to increase medium term supply of funding in kuna at competitive prices. We expect this to result in a reversal of corporate lending trends, with corporate increasingly relying on kuna loans with domestic bank in the remainder of the year. As a consequence of the expected growth of lending the trend of banks deleveraging should stop in the medium term, even more so because bank potential for further deleveraging has been almost fully used.

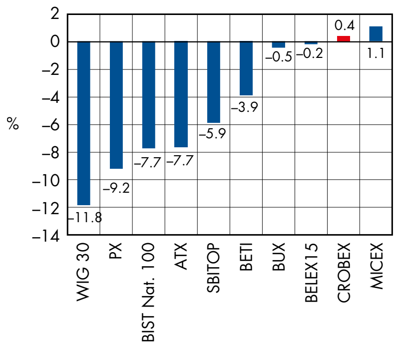
Anton Starčević, CEO Advisor

Equity markets were not in a good mood

- **Regional equity indices were in Q2 2016 mostly in red**
- **The ZSE indices posted an uptick**
- **Strong growth of ĐĐ Holding's shares thanks to new contracts**

The CEE equity indices registered predominantly negative returns in Q2 2016. Only the MICEX and the CROBEX ended the quarter with small gains. In general, some of the reasons for the pessimism on the regional equity markets were a slowdown of the Chinese economic growth, speculations about the interest rate hike in the US and uncertainty ahead of as well as the outcome of the referendum in United Kingdom related to European Union membership. In addition, the Polish market was affected by unfavourable local factors mostly related to political uncertainty. As a result, despite good macroeconomic indicators the WIG 30 index recorded the greatest fall among the regional indices. The Czech PX index also declined mostly due to drop of shares from financial sector. The Russian MICEX increased the most among the regional indices thanks to the overall sentiment improvement and the oil price rebound.

CEE indices – returns in Q2 2016

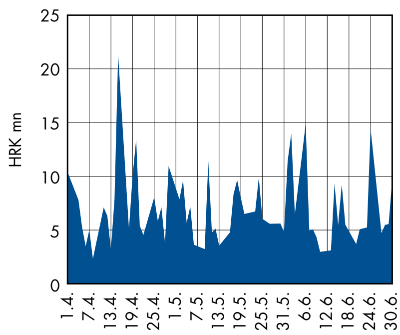


** in local currency, value on June 30, 2016 (6:30 PM)*
Sources: Bloomberg, Economic RESEARCH/RBA

The Croatian market managed to resist the negative sentiment and added 0.4% in Q2 2016. This was partly due to a small influence of Brexit on the domestic market but also because of local political headwinds. As a result, regular turnovers on the ZSE continued shrinking, coming at only HRK 5.6m on average daily, which is much below the same period in 2015, when the daily average amounted to HRK 8.4m and almost halved compared to Q2 2014. On the other hand, block turnovers were very high, so the total realised turnover actually increased compared to the first quarter 2016 largely thanks to sale of 20.5% stake in Končar El in June. Share of Hrvatski Telekom was the most traded with total of HRK 77m turnover in Q2 what makes 22% share in the total regular turnover. The majority of CROBEX constituents saw only small changes, while shares of Đuro Đaković Holding and Dalekovod were leading the way thanks to new contracts. The share of Kraš found itself on the back of the list. Shares of Ericsson NT were also on the rear due to the ex-dividend. Among the sector indices, indices of industrial and construction sector shares performed the best, while the greatest fall was realised by the index of F&B sector shares. Total market capitalisation on the ZSE at the end of the quarter stood at HRK 120.3bn, down by 1.9% compared to the end of March.

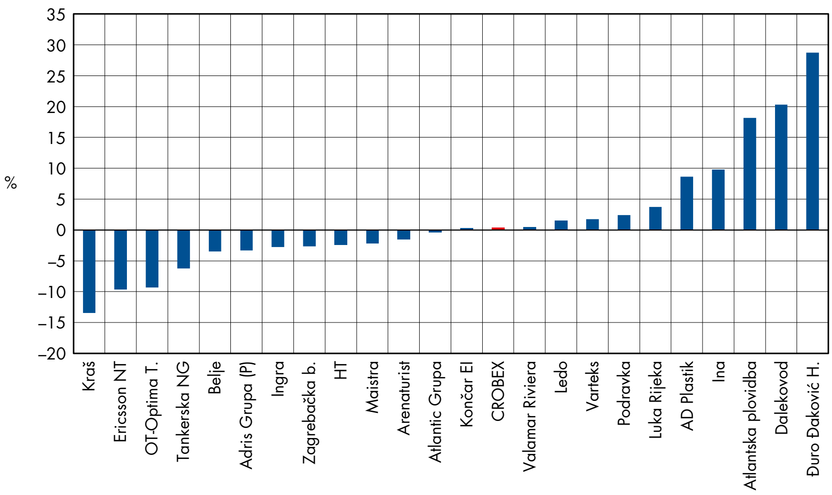
Financial analysts: Ana Turudić and Nada Harambašić Nereau

Regular turnover



Sources: ZSE, Economic RESEARCH/RBA

Return of CROBEX constituents in Q2 2016 (dividends not included)*

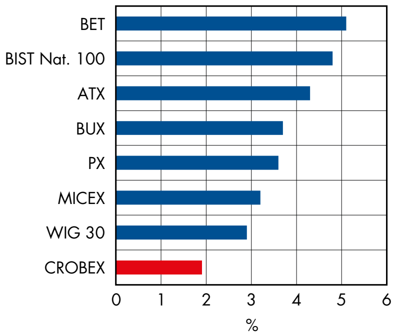


** return calculated as on June 30, 2016 (6:30 PM)*
Sources: ZSE, Economic RESEARCH/RBA

Cautious trading expected to continue in Q3 2016e

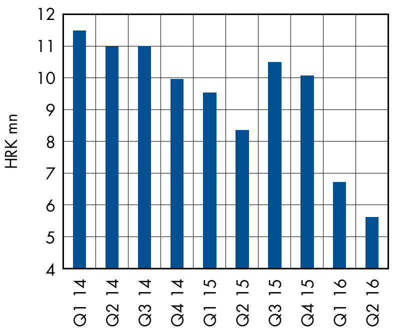
- High liquidity and favourable macroeconomic outlook supportive for CEE equity indices
- Introduction of reforms could result in more optimism and liquidity on the ZSE

Long-term earnings growth



Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

Average regular daily equities' turnover on ZSE



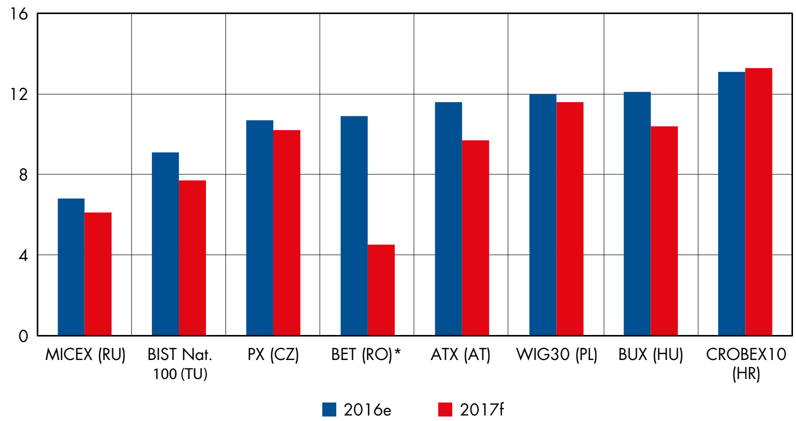
Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

In Q3 2016e we expect the positive impact of expansionary monetary policy on the CEE equity markets to continue, boosted by expected good macroeconomic results and rising oil prices. Brexit development is also to be factored in. However, given the two-year transitional period, actual implications are not expected in the short-term. Nevertheless, political insecurity and speculations about EU membership referendums in other member states could weight on the equity markets. The third quarter is expected with optimism but caution as regards developments at regional stock exchanges over the next year. According to the expected P/E ratio for 2016e (6.8×),[1] the Russian MICEX is most favourably valued, relatively speaking. Considering the expected growth in oil prices, the MICEX is at the same time an index with the highest expected growth in the region until the year end. A nice rebound is also expected from the Czech PX due to very good macroeconomic results and relatively favourable valuation (2016e: 10.7×). In addition, the PX also boasts the highest expected dividend yield among the regional indices (6.2% in 2016e).

For some time now, the low liquidity of shares limits the value growth of equity indices on the ZSE. Given the continued decline in regular turnover over the second quarter and traditionally low activity during the summer we expect only small changes in the value of equity indices and investors to focus on news and shares from the tourism sector. In addition, political uncertainty surrounding the extraordinary parliamentary elections scheduled for September will remain in the focus. According to Raiffeisen RESEARCH[1], CROBEX 10 continues to maintain the highest expected P/E ratio in 2016e among the regional indices (13.1×), as well as low long-term expected growth of earnings by its constituents (1.9%). Positive influences are expected from an anticipated good tourism season. However, for more substantial changes we will have to wait for autumn after the elections, i.e. for reforms to finally start being implemented.

Financial analyst: Ana Turudić

P/E ratios in comparison



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

1 Raiffeisen RESEARCH, Central & Eastern European Strategy 3rd quarter 2016, http://www.rbinternational.com/eBusiness/services/resources/media/829189266947841370-829189181316930732-1170550226796214632-1-2-EN.pdf

Raiffeisenbank Austria d.d. Zagreb

Economic Research
Zrinka Živković Matijević, MSc, Head of Department; tel: +385 1/61 74 338, email: zrinka.zivkovic-matijevic@rba.hr
Elizabeta Sabolek Resanović, Economic Analyst; tel: +385 1/46 95 099, email: elizabeta.sabole-resanovic@rba.hr
Tomislava Ujević, Economic Analyst; tel: +385 1/61 74 606, email: tomislava.ujevic@rba.hr

Financial Advisory
Nada Harambašić Nereau, MSc, Financial Analyst; tel: + 385 1/61 74 870, email: nada.harambasic-nereau@rba.hr
Ana Turudić, Financial Analyst; tel: +385 1/61 74 401, email: ana.turudic@rba.hr

Anton Starčević, MSc, CEO Advisor; tel: +385 1/61 74 338, email: anton.starcevic@rba.hr

Markets and Investment Banking
Robert Mamić, Executive Director; tel: +385 1/46 95 076, email: robert.mamic@rba.hr

Editor
Zrinka Živković Matijević, MSc, Head of Economic Research

Abbreviations

avg – period average
bn – billion
BoE – Bank of England
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
CNB – Croatian National Bank
CPI – Consumer Price Index
CPII – Croatian Pension Insurance Institute
e – estimate
ECB – European Central Bank
EE – Eastern Europe
eop – end of period
ESA – European System of Accounts
EU – European Union
EUR – Euro
EURIBOR – Euro Interbank Offered Rate
Eurostat – Statistical Office of the European Union
f – forecast
FCY – Foreign Currency
Fed – Federal Reserve System
FOMC – Federal Open Market Committee
FRB – Federal Reserve Board
FX – foreign exchange
GBP – British Pound
GDP – gross domestic product
GFCF – Gross fixed capital formation
GI – gross income
H – half
HRK – Croatian Kuna
IBES – Institutional Brokers' Estimate System
ILO – International Labour Organization
IMD – International Institute for Management Development
LCY – Local Currency
Libor – London Interbank Offered Rates
M, m – month
mn – million
MoF – Ministry of Finance
NPL – non-performing loan
OECD – Organisation for Economic Co-operation and Development
Pbt – profit before taxes
PCE – personal consumption expenditure
Q – quarter
r.h.s. – right hand scale
RBA – Raiffeisen bank
RBI – Raiffeisen Bank International
SEE – Southern and Eastern Europe
SMEs – Small and medium-sized enterprises
SNB – Swiss National Bank
USA – United States of America
USD – US Dollar
VAT – value added tax
WCY – World Competitiveness Yearbook
y – year
yoy – year on year
ZSE – Zagreb Stock Exchange

Design
SIBI obrt; OIB: 62606715155; I. B. Mažuranić 70, 10090 Zagreb

Publisher
Raiffeisenbank Austria d.d. Zagreb
Petrinjska 59, 10000 Zagreb
www.rba.hr
tel: +385 1/45 66 466, fax: +385 1/48 11 626

Publication finished on July 15, 2016
Publication approved by editor on July 20, 2016 at 12:10
First release scheduled for July 20, 2016 at 12:15

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"Reduce": expected negative return up to –10% over next 12 months.

"Sell": for stock with expected negative return by more than –10% u over next 12 months.

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Investment banking services	0	2	0	0	0	0
% all IB services	0%	29%	0%	0%	0%	0%

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