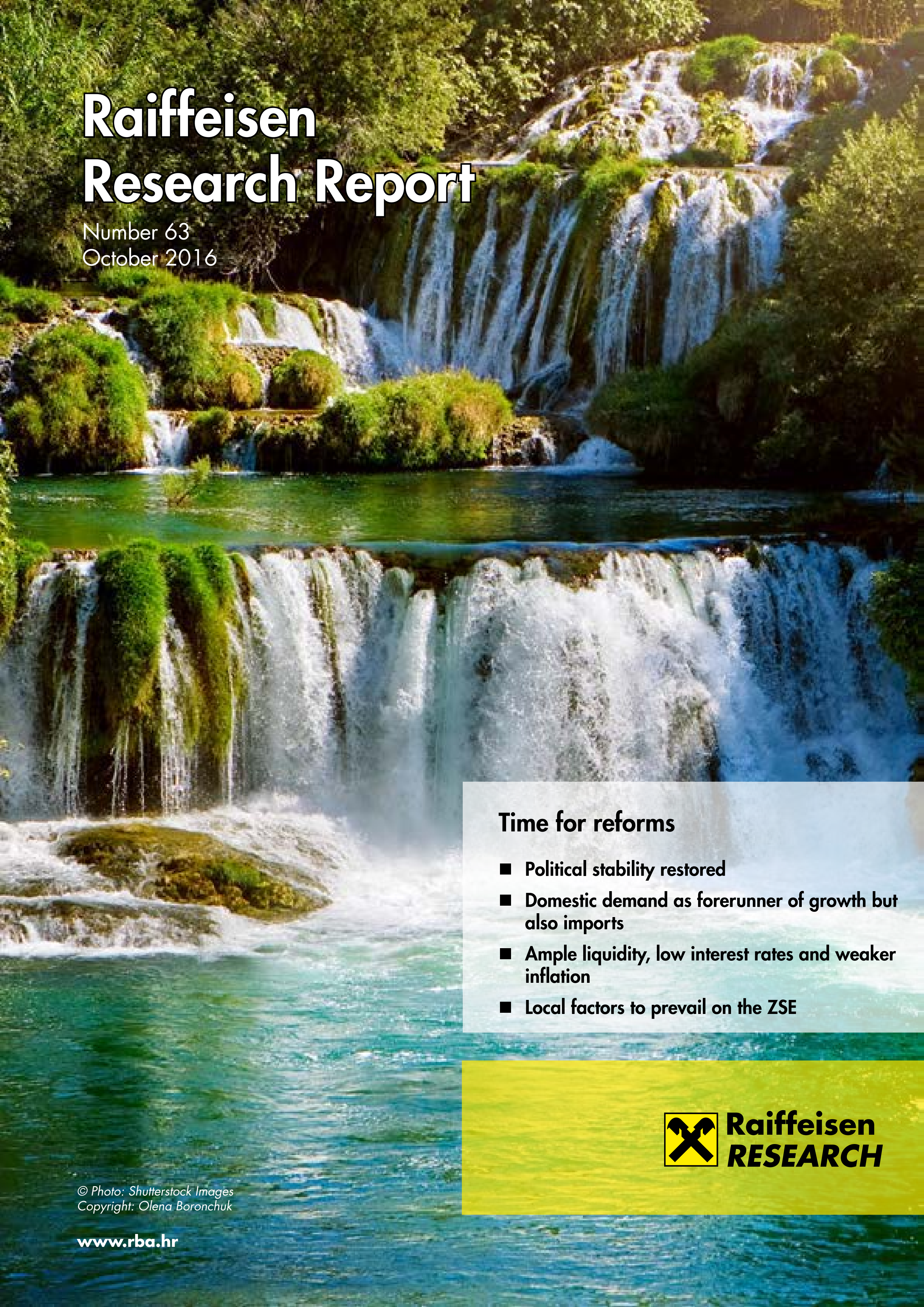

Raiffeisen Research Report

Number 63
October 2016

Time for reforms

- Political stability restored
- Domestic demand as forerunner of growth but also imports
- Ample liquidity, low interest rates and weaker inflation
- Local factors to prevail on the ZSE

Raiffeisen RESEARCH

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Contents

Selected macroeconomic indicators

	2010	2011	2012	2013	2014	2015	2016e	2017f	2018f
GDP & Production									
Gross Domestic Product, % (constant prices)	–1.7	–0.3	–2.2	–1.1	–0.5	1.6	2.3	2.5	2.0
GDP at current prices (EUR millions)	45,022	44,737	43,959	43,516	43,045	43,921	45,008	46,701	48,396
GDP per capita at current prices (EUR)	10,479	10,451	10,301	10,225	10,156	10,448	10,707	11,110	11,513
Retail trade, % real annual changes	–2.1	0.6	–4.1	–0.6	0.4	2.4	3.9	4.0	3.0
Industrial production, % annual changes	–1.4	–1.2	–5.5	–1.8	1.2	2.6	4.8	4.2	3.8
Prices, Employment and Budget									
Consumer Prices, %, end of period	1.8	2.1	4.7	0.3	–0.5	–0.6	–0.2	1.5	2.5
%, average	1.1	2.3	3.4	2.2	–0.2	–0.5	–1.2	1.3	2.2
Producer Prices[1], %, end of period	5.7	5.8	6.9	–2.6	–3.4	–4.4	–3.0	1.5	2.5
%, average	4.3	6.4	7.0	0.5	–2.7	–3.9	–4.8	0.5	2.4
Unemployment rate (official rate, avg)	17.4	18.0	19.1	20.3	19.7	17.0	15.0	14.5	14.0
Unemployment rate (ILO, avg)	11.6	13.7	15.9	17.4	17.3	16.3	14.9	14.2	13.7
Average net wage, in Kuna	5,343	5,441	5,478	5,515	5,534	5,594	5,692	5,817	5,945
General Government Balance, % of GDP, ESA 2010	–6.2	–7.8	–5.3	–5.3	–5.4	–3.3	–2.7	–2.9	–2.8
Public Debt, HRK bn, ESA 2010	191.3	216.7	233.6	270.9	284.2	289.6	294.3	303.8	314.0
% of GDP, ESA 2010	58.3	65.2	70.7	82.2	86.6	86.7	86.5	85.8	85.2
Balance of Payment and External Debt									
Good's and Services Exports, EUR million	17,007	18,110	18,315	18,764	19,982	21,953	23,380	24,638	25,648
% change	9.2	6.5	1.1	2.5	6.5	9.9	6.5	5.4	4.1
Good's and Services Imports, EUR million	17,158	18,297	18,097	18,573	19,106	20,705	21,719	22,767	23,720
% change	–0.5	6.6	–1.1	2.6	2.9	8.4	4.9	4.8	4.2
Current Account Balance, % of GDP[2]	–1.1	–0.7	0.0	1.0	0.9	5.2	2.0	2.2	2.1
Official International Reserves, EUR millon, eop	10,660	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]	7.5	7.3	7.5	8.3	8.0	7.9	7.5	7.0	7.0
Foreign Direct Investment, EUR million[3]	1,065	1,017	1,142	710	2,910	128	1,700	1,900	1,800
Tourism – nightstays, % change	2.6	7.0	4.0	3.3	2.6	7.7	7.5	4.0	3.0
External debt, EUR billion	46.9	46.4	45.3	46.0	46.7	45.5	44.1	45.0	46.1
External debt, as % of GDP[2]	104.2	103.7	103.0	105.6	108.4	103.7	97.9	96.4	95.3
External debt, as % export of goods and services[2]	275.8	256.2	247.3	244.9	233.5	207.4	188.4	182.6	179.7
Monetary and Financial Data									
Exchange rate, eop, USD / HRK	5.57	5.82	5.73	5.55	6.30	6.99	7.04	7.29	6.65
avg, USD / HRK	5.50	5.34	5.85	5.71	5.75	6.86	6.80	7.21	6.97
Exchange rate, eop, EUR / HRK	7.39	7.53	7.55	7.64	7.66	7.64	7.60	7.65	7.65
avg, EUR / HRK	7.29	7.43	7.52	7.57	7.63	7.61	7.55	7.57	7.60
Money (M1), Kuna billion, eop	48.0	51.5	51.9	57.9	63.4	70.7	79.5	82.7	86.2
% change	1.7	7.3	0.9	11.5	9.6	11.4	12.5	4.0	4.3
Broadest money (M4), Kuna billion, eop	232.8	246.0	254.7	264.9	273.3	287.4	300.3	308.7	316.7
% change	1.9	5.6	3.6	4.0	3.2	5.1	4.5	2.8	2.6
Credits, Kuna billion	245.6	257.4	242.1	240.8	237.0	230.0	220.8	213.1	217.2
% change	4.7	4.8	–5.9	–0.5	–1.6	–2.9	–4.0	–3.5	0.5
ZIBOR 3m, %, avg	2.4	3.2	3.4	1.5	1.0	1.2	0.9	0.9	1.2
Treasury bills rate 12m, %, avg	4.0	3.9	3.9	2.5	1.9	1.5	1.0	0.9	1.3

Note: Forecasts do not include possible tax revisions as the details of the comprehensive tax reform were announced on the date when the publication was finished.
[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)

	2016	2016e	2017f	2018f
Poland	3.6	3.3	3.7	3.1
Hungary	2.9	2.3	2.7	2.9
Czech Rep.	4.6	2.5	2.7	2.5
Slovakia	3.6	3.5	3.3	4.0
Slovenia	2.3	2.0	2.1	2.2
CE	**3.6**	**3.0**	**3.3**	**3.0**
Croatia	**1.6**	**2.3**	**2.5**	**2.0**
Bulgaria	3.0	3.0	3.0	3.3
Romania	3.8	5.2	3.6	3.0
Serbia	0.7	2.5	3.0	3.0
BiH	3.0	3.0	3.5	4.0
Albania	2.6	3.5	4.0	4.0
SEE	**3.0**	**4.0**	**3.3**	**3.0**
Russia	–3.7	–0.5	1.0	1.5
Ukraine	–9.9	1.0	2.0	3.0
Belarus	–3.9	–3.0	0.0	1.5
EE	**–4.1**	**–0.5**	**1.0**	**1.6**
CEE	**–0.6**	**1.2**	**2.1**	**2.2**
Austria	1.0	1.4	1.3	1.5
Germany	1.5	1.8	1.7	1.5
Euro area	**2.0**	**1.6**	**1.5**	**1.7**
USA	**2.6**	**1.6**	**2.4**	**2.2**

Source: Raiffeisen RESEARCH/RBI

Consumer prices (avg, % yoy)

	2016	2016e	2017f	2018f
Poland	–0.9	–0.6	1.3	2.0
Hungary	0.0	0.3	1.8	2.3
Czech Rep.	0.3	0.6	1.7	2.0
Slovakia	–0.3	–0.5	1.1	2.0
Slovenia	–0.8	–0.2	1.3	1.5
CE	**–0.5**	**–0.2**	**1.4**	**2.0**
Croatia	**–0.5**	**–1.2**	**1.3**	**2.2**
Bulgaria	–0.1	0.0	1.6	2.0
Romania	–0.6	–1.6	1.2	2.4
Serbia	1.4	1.2	2.5	2.9
BiH	–1.0	–0.9	1.5	2.5
Albania	1.8	1.3	2.2	2.7
SEE	**–0.2**	**–0.9**	**1.5**	**2.4**
Russia	15.6	7.2	6.1	5.3
Ukraine	48.7	13.3	10.7	7.5
Belarus	13.5	14.0	12.0	11.0
EE	**17.6**	**8.0**	**6.6**	**5.6**
CEE	**9.2**	**4.1**	**4.2**	**4.0**
Austria	0.8	1.0	2.0	2.1
Germany	0.1	0.7	2.7	2.0
Euro area	**0.0**	**0.3**	**1.3**	**1.6**
USA	**0.1**	**1.4**	**2.7**	**2.5**

Source: Raiffeisen RESEARCH/RBI

Fixed capital formation (% yoy)

	2016	2016e	2017f	2018f
Poland	6.1	0.4	6.3	5.0
Hungary	1.9	–5.6	5.0	7.0
Czech Rep.	9.1	–1.8	4.0	3.1
Slovakia	14.0	0.0	4.5	4.0
Slovenia	4.8	–4.4	n.a.	n.a.
CE	**6.8**	**–0.8**	**5.2**	**4.5**
Croatia	**1.6**	**3.8**	**4.5**	**3.5**
Bulgaria	2.5	0.8	3.0	4.5
Romania	8.8	6.5	7.0	7.0
Serbia	n.a.	n.a.	n.a.	n.a.
BiH	4.0	4.5	10.0	7.0
Albania	n.a.	n.a.	n.a.	n.a.
SEE	**5.4**	**4.3**	**5.1**	**5.0**
Russia	–7.6	–4.0	3.0	4.0
Ukraine	–9.3	5.0	5.0	5.0
Belarus	–15.9	n.a.	n.a.	n.a.
EE	**–8.0**	**–3.3**	**3.0**	**3.9**
CEE	**–1.3**	**–1.5**	**4.0**	**4.3**
Austria	0.7	3.2	2.7	2.4
Germany	1.1	2.9	2.1	n.a.
Euro area	**2.2**	**2.2**	**3.0**	**2.7**
USA	**4.0**	**6.8**	**n.a.**	**n.a.**

Source: Raiffeisen RESEARCH/RBI

Current account balance (% of GDP)

	2016	2016e	2017f	2018f
Poland	–0.3	0.1	–0.7	–1.0
Hungary	4.4	4.4	4.1	3.8
Czech Rep.	0.9	1.9	1.3	0.8
Slovakia	–1.3	–0.7	–0.7	0.2
Slovenia	5.2	7.2	6.8	6.4
CE	**0.5**	**1.0**	**0.4**	**0.2**
Croatia	**5.2**	**2.0**	**2.1**	**2.1**
Bulgaria	1.1	1.1	0.4	1.0
Romania	–1.1	–2.8	–3.3	–3.5
Serbia	–4.6	–3.7	–3.7	–3.5
BiH	–5.6	–5.4	–7.5	–7.7
Albania	–13.6	–13.7	–14.6	–13.0
SEE	**–1.1**	**–2.3**	**–2.8**	**–2.7**
Russia	5.0	2.0	3.9	4.3
Ukraine	–0.1	–1.7	–2.8	–3.1
Belarus	–3.8	–5.7	–5.7	–4.5
EE	**4.4**	**1.5**	**3.2**	**3.6**
CEE	**2.4**	**0.8**	**1.6**	**1.7**
Austria	1.8	2.5	2.2	2.3
Germany	8.4	9.5	8.5	8.0
Euro area	**3.1**	**3.3**	**3.3**	**3.1**
USA	**–2.6**	**–3.2**	**–3.5**	**–3.5**

Source: Raiffeisen RESEARCH/RBI

General budget balance (% of GDP)

	2016	2016e	2017f	2018f
Poland	–2.6	–2.9	–3.4	–3.4
Hungary	–2.0	–2.0	–2.5	–3.0
Czech Rep.	–0.4	–0.3	–0.2	0.0
Slovakia	–3.0	–2.5	–2.0	–2.0
Slovenia	–2.9	–2.7	–2.5	–2.3
CE	**–2.1**	**–2.2**	**–2.5**	**–2.5**
Croatia	**–3.3**	**–2.7**	**–2.9**	**–2.8**
Bulgaria	–2.9	–1.5	–2.0	–2.0
Romania	–0.7	–3.0	–3.2	–2.5
Serbia	–3.7	–2.5	–2.3	–1.9
BiH	0.7	–1.5	–1.0	–1.0
Albania	–4.0	–2.5	–1.5	–1.0
SEE	**–1.8**	**–2.6**	**–2.7**	**–2.3**
Russia	–3.6	–4.4	–3.3	–2.4
Ukraine	–2.3	–3.5	–3.0	–2.5
Belarus	1.8	0.5	0.0	0.0
EE	**–3.3**	**–4.2**	**–3.2**	**–2.3**
CEE	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Austria	–1.2	–1.5	–1.4	–1.3
Germany	0.7	0.2	0.1	0.0
Euro area	**–2.1**	**–1.9**	**–1.6**	**–1.5**
USA	**–2.4**	**–3.2**	**–3.5**	**–2.6**

Source: Raiffeisen RESEARCH/RBI

Public debt (% of GDP)

	2016	2016e	2017f	2018f
Poland	51.3	52.2	52.6	53.5
Hungary	75.5	74.6	74.1	73.7
Czech Rep.	40.3	39.5	38.4	37.2
Slovakia	52.9	53.2	52.8	51.3
Slovenia	83.2	81.7	80.5	79.6
CE	**53.9**	**54.1**	**53.9**	**53.9**
Croatia	**86.7**	**86.5**	**85.8**	**85.2**
Bulgaria	26.3	29.5	30.0	31.0
Romania	38.4	39.0	39.9	40.2
Serbia	74.7	72.8	67.9	62.7
BiH	42.8	42.5	42.8	42.5
Albania	72.2	70.5	67.8	64.0
SEE	**48.2**	**48.6**	**48.5**	**48.0**
Russia	12.7	13.5	14.0	14.5
Ukraine	72.6	77.5	78.4	73.0
Belarus	48.5	49.9	46.4	45.0
EE	**17.8**	**18.8**	**19.2**	**19.3**
CEE	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Austria	86.2	84.3	82.7	81.1
Germany	71.2	68.6	66.3	64.0
Euro area	**90.4**	**90.0**	**89.0**	**88.0**
USA	**101.9**	**105.5**	**105.6**	**104.9**

Source: Raiffeisen RESEARCH/RBI

Gross foreign debt (% of GDP)

	2016	2016e	2017f	2018f
Poland	70.5	73.9	74.2	73.0
Hungary	107.1	98.1	88.4	82.1
Czech Rep.	69.4	73.0	77.1	73.9
Slovakia	86.1	85.5	84.6	81.5
Slovenia	116.6	110.0	104.1	103.0
CE	**65.1**	**66.4**	**66.3**	**64.4**
Croatia	**103.7**	**97.8**	**96.2**	**95.1**
Bulgaria	77.2	n.v.	n.v.	72.5
Romania	56.7	52.8	52.6	52.4
Serbia	81.6	74.5	70.8	66.8
BiH	53.4	54.8	55.0	54.3
Albania	72.6	71.9	69.5	67.3
SEE	**68.8**	**64.9**	**63.8**	**62.6**
Russia	39.3	39.7	32.2	26.0
Ukraine	131.5	135.4	137.7	125.7
Belarus	70.2	76.0	74.4	73.0
EE	**46.1**	**47.1**	**39.5**	**33.1**
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	**124.4**	**124.8**	**n.v.**	**n.v.**
USA	**n.v.**	**n.v.**	**n.v.**	**n.v.**

Source: Raiffeisen RESEARCH/RBI

EUR/LCY (avg)

	2016	2016e	2017f	2018f
Poland	4.18	4.35	4.29	4.19
Hungary	309.93	312.29	308.75	309.38
Czech R.	27.28	27.03	26.86	25.53
Slovakia	euro	euro	euro	euro
Slovenia	euro	euro	euro	euro
CE				
Croatia	**7.61**	**7.55**	**7.57**	**7.60**
Bulgaria	1.96	1.96	1.96	1.96
Romania	4.45	4.49	4.47	4.45
Serbia	120.73	123.26	123.63	124.88
BiH	1.96	1.96	1.96	1.96
Albania	139.72	137.72	138.31	140.00
SEE				
Russia	68.01	74.69	65.50	66.36
Ukraine	24.33	28.79	30.85	32.02
Belarus	1.77	2.25	2.40	2.58
EE				
CEE				
Austria	euro	euro	euro	euro
Germany	euro	euro	euro	euro
Euro area	**euro**	**euro**	**euro**	**euro**
USA	**1.11**	**1.11**	**1.05**	**1.09**

Source: Raiffeisen RESEARCH/RBI

Ratings

	S&P	Moody`s	Fitch
Poland	BBB+	A2	A–
Hungary	BBB–	Ba1	BBB–
Czech Rep.	AA–	A1	A+
Slovakia	A+	A2	A+
Slovenia	A	Baa3	A–
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+	Aa1	AA+
Germany	AAA	Aaa	AAA
USA	**AA+**	**Aaa**	**AAA**

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

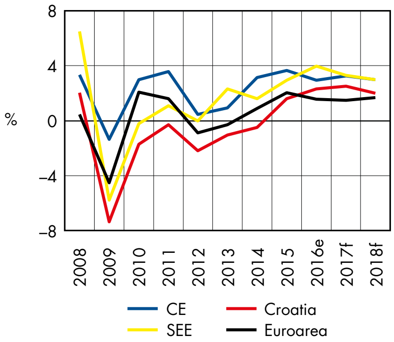
Time to put reforms at the fore

Economic growth that continued throughout the Q216 is predominantly spurred by domestic demand, while the positive impact of the growth of exports of goods and services was mitigated by import of goods. The first indicators for the Q3 encouraged us to expect that this rise, headed primarily by personal consumption and investments, will continue. On the other hand, the positive effect of net foreign demand might be largely diminished by the strong dependence on imports which became especially noticeable with the growth of the exports of services, i.e. tourism. Personal consumption will continue to find support in the absence of inflationary pressures, slightly more favourable indicators from the labour market and the strong growth of tourism indicators, which have a great impact on household income. Investment activity, whose growth dynamics accelerated in the Q2 gained momentum both in the public and the private sectors, with encouraging data coming from better utilisation of EU funds. Amid the good realisation of budget revenues, despite political uncertainty, investment growth continued as well. On the demand side, positive contribution to the GVA came from all activities, especially those related to trade and the hospitality industry. Although registering a more modest growth, industry also made a positive contribution, while recovery in construction slightly accelerated. We expect similar developments in the Q3 but with a stronger contribution of activities connected to tourism. Amid such conditions the projected real 2016 economic growth of 2.3% is exposed to positive risks, even in the case of growth slowdown in the Q4.

Croatia's external vulnerability also reduced in the first six months which is reflected in the fall of gross external debt and C/A surplus. In addition, the analysis of total assets and liabilities of all sectors showed that international imbalances continued reducing. Still, Croatia's net international investment position of 78% of GDP clearly indicates the need to further reduce macroeconomic imbalances. One of the ways for this is to increase competitiveness and exports. Inflows to the budget have grown amid economic recovery. With the government spending reigned in, the budget deficit fell to below 3% of GDP. Expectations show it will remain there in the years to come. Namely, the government placed its focus on further fiscal consolidation paired with tax burden alleviation and the creation of a stimulating business environment. Assuming that external conditions remain unchanged, growth projections until 2018 are thus exposed to positive risks. However, medium to long-term sustainability is largely conditioned by the implementation of reforms in the public systems (health care, education, welfare and the pension system), stronger rule of law and improved efficiency of the public administration. Otherwise, changes in the external environment such as increased financing costs, slowdown in the growth of Croatia's most important trade partners or in an extreme case a sudden and unforeseen fall in tourism would jeopardise Croatia's recovery but also the sustainability of public finances. For the time being, external environment remains encouraging given that we do not expect the ECB's monetary policy to tighten. Moreover, the QE programme might be extended until September 2017. After that time, the exit strategy from an extremely expansive policy should take the form of gradual reduction in the volume of bond purchase and the maintenance of the key interest rate at current levels until the H118. The said projections are, of course, based on the modest recovery of consumer prices which depend on developments in the commodities market, especially on the prices of crude oil and food.

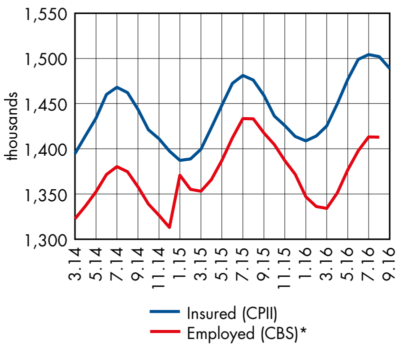
Zrinka Živković Matijević

Real GDP (% yoy)



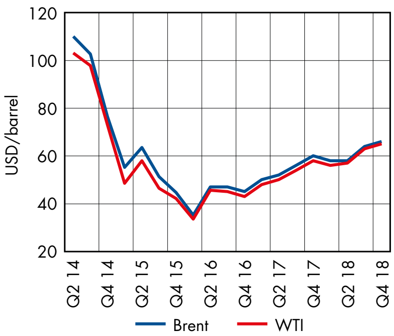
Sources: Eurostat, Raiffeisen RESEARCH/RBI

Employment and persons insured



** new methodology as of January 1, 2015 (series broken)*
Sources: CBS, CPII, Economic RESEARCH/RBA

Crude oil

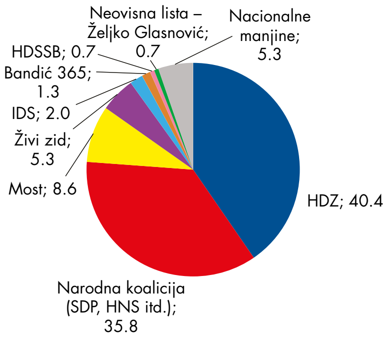


Sources: CBS, Raiffeisen RESEARCH

New government, old challenges and more favourable macroeconomic environment

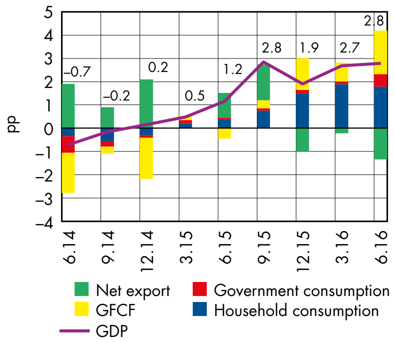
- **End of political uncertainty**
- **The projected 2016 and 2017 growth exposed to greater positive risks**
- **Medium term growth sustainability yet to be achieved**

Seats in the Croatian Parliament (151), September 2016



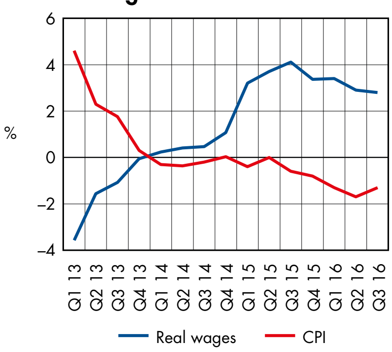
Sources: State Electoral Commission, Economic RESEARCH/RBA

GDP contributions



Sources: CBS, Economic RESEARCH/RBA

Real net wages



Sources: CBS, Economic RESEARCH/RBA

The snap parliamentary elections in the Republic of Croatia ultimately brought back a sense of certainty to the political arena. After a month-long negotiations with *Most*, the representatives of national minorities and smaller parliamentary parties it seems that the *HDZ* ensured stability in its upcoming four-year term. Having won 61 seats, and ensuring the support of the mentioned political actors, the new government counts on the support of 91 of the total of 151 representatives in the Parliament.

The Government's programme for the upcoming four years envisages a comprehensive tax reform (focusing on the alleviation of the tax burden), institutional strengthening and an increase in the efficiency of the public sector with an aim to improve the business environment, fiscal responsibility and the utilisation of EU funds.

In view of all this, the response of the investment community is likely to be positive. The better-than-expected recovery, improved fiscal metrics and political certainty could improve Croatia's outlook from negative to stable when Moody's and S&P make their revisions. On the other hand, experience shows that a well-prepared programme does not necessarily equal a consistent and successful implementation of (reform) measures. Therefore, Croatia's rating will remain two levels below investment grade and its risk premium above that of comparable CEE peers thus reflecting investor caution and the fact that restoring investor confidence will strongly depend on the implementation of the presented plan. Currently, macroeconomic and market environment provides good support for stronger implementation of reforms already in the first year of mandate.

Partly overshadowed by political developments, the country's economy continued recovering in Q2. This growth was headed primarily by domestic demand and continued at the same pace as in Q1 (+0.5% at the quarterly level), while real annual growth reached the above-expected 2.8%. Nevertheless, net foreign demand has made a negative contribution for the third quarter in a row. Namely, despite exports of goods and services continuing to raise, due to high dependence on imports the recovery of domestic demand (consumption and investments) and the growth of the exports of services had as a consequence the increase in the demand for imported goods.

On the other hand, healthy growth rates of personal consumption continued to find support in the increase of the real disposable income amid the decline in consumer prices and interest rates. Tourism has an especially significant role because the high share of private accommodation positively contributes to the purchasing power of the household sector due to the generated rental income. There is seasonal employment as well. The growth of investments for the fifth quarter in the row is encouraging, especially in the view of its acceleration. The real annual rate of gross fixed capital formation growth, totalling 6.3%, is the highest since 2008. This is not surprising, given that during the crisis investments lost over 30% of their real value, predominantly through the construction sector. The growth of investments observed in 2016 is also visible in the public and private sector, with a positive influence also coming from better utilisation of EU funds.

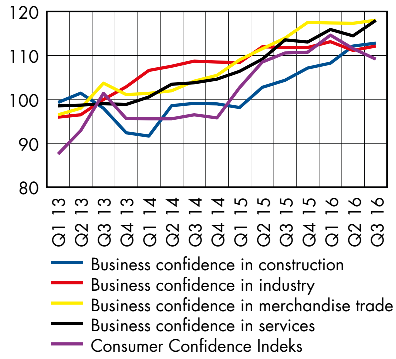
On the supply side, growth continued in activities closely connected to tourism and trade. Growth in construction accelerated as well. Despite the slowdown, (manufacturing) industry also contributed positively to the growth of the gross value added.

The initial high-frequency indicators for the third quarter confirm the continuation of similar developments. Summer months brought exceptionally good tourism results. With the growth of overnight stays of 12.2% in July and 8.2% in August, a relatively strong growth of retail trade turnover is not surprising. However, fact remains that a noticeable share (some 40% of the nominal turnover) is directed at satisfying life's basic needs. With the (seasonal) decline in unemployment, healthy growth of personal consumption, which is the largest component of the gross domestic product, is certain. Data from the construction sector indicate further recovery and further growth of production and imports of capital equipment. On the other hand, a stronger growth of imports over exports continued, which will diminish the positive effect of the exports of goods and services. Amid such conditions the projected real growth of the economy in 2016, of 2.3%, is exposed to positive risks even in case of a slowdown in growth in the last quarter. The last quarter will be marked by the return of seasonal workers to the unemployment lists and lower employment at quarterly level. In addition, we may expect quarterly reductions in investment activity in the construction sector.

External vulnerability continued reducing in the first six months of the year through the decline in gross external debt and the surplus in the balance of payments current account. The fall of external debt to levels below 100% of the gross domestic product is a consequence of all sectors deleveraging, especially that of the government and financial institutions, i.e. banks. The below-100% level of GDP was last observed in Q3 2009. While the government postponed its spring issue of the Eurobond, banks deleveraged due to relatively cheap domestic deposits, high liquidity and the still-modest demand for loans. Further, much more favourable conditions in the domestic market motivated the corporate sector to substitute a portion of its debt to foreign creditors by borrowing domestically.

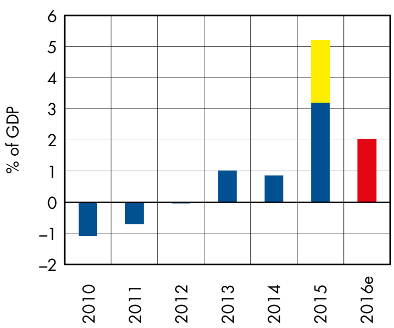
According to our expectations, the balance of payments current account surplus (estimated at some 2% of GDP) will remain at some 2% of GDP even after the effects of the conversion of loans indexed to the Swiss franc have vanished. A deterioration in the goods accounts arising from a stronger growth of imports and better operating results of foreign companies (which thus increase the expenditures of the primary income) will be softened by the expected increase in the surplus on the goods account and higher income in the secondary income account where the allocated funds received from EU funds are registered. Foreign exchange income from tourism for the year as a whole might exceed EUR 8.5bn, the historical nominal high. Viewed in the medium-term, interest expenses related to non-residents have a high potential to decline amid high global liquidity given that possible refinancing at maturity should be realised at the historically lowest interest rate levels.

Business and consumer confidence



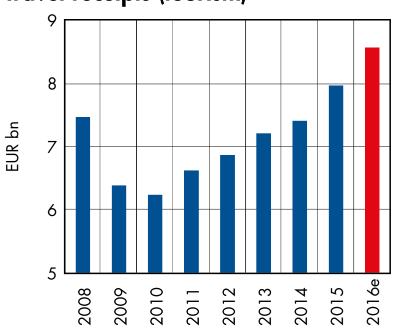
Sources: CBS, Economic RESEARCH/RBA

C/A balance



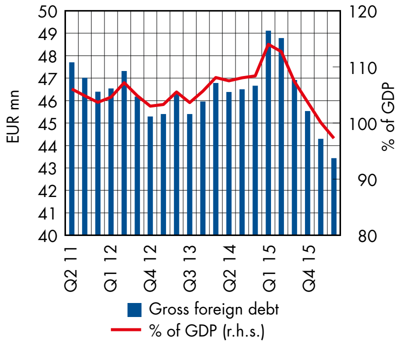
** yellow implies impact of mandatory CHF conversion*
Sources: CNB, Economic RESEARCH/RBA

Travel receipts (tourism)



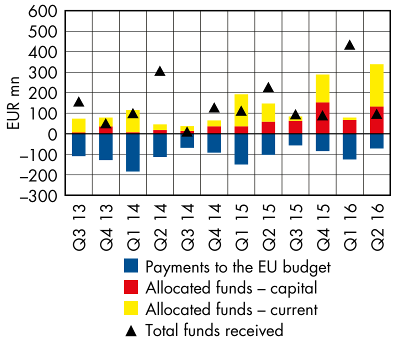
Sources: CNB, Economic RESEARCH/RBA

Gross external debt



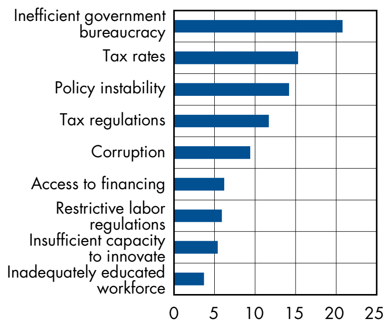
Sources: CNB, Economic RESEARCH/RBA

Withdrawal of EU funds (intensified in late 2015)



**Average for the last four available quarters*
Sources: IMF, CNB.

The most problematic factors for doing business in Croatia



Source: WEF: Global Competitiveness Report 2016–2017

For the time being, we will keep our 2017 economic growth projections at 2.5%, provided that external factors remain the same. This assumes a moderate growth of the EU economy and other Croatia's most important trade partners, a more successful, and longer, tourist season and investment growth. We expect investments to grow both in the private and the public sector. They are to be based on stronger withdrawal of funds from EU funds and local elections due in the spring of 2017. In addition, mild optimism is being restored amid much lower costs of borrowing which are supportive of investments.

At the time of crisis, Croatia's private sector turned to foreign markets so we assume that the exports of goods will continue growing. Taking into consideration the structure of goods and services (predominantly relying on work- and labour-intensive products and tourism) we think that there is sufficient room for more sophisticated products and services of higher value added. Apart from the ability and adaptability of the private sector, changes will largely depend on the government's measures aimed at removing the most problematic factors for doing business in Croatia. According to the last Global Competitiveness Report 2016 – 2017 they relate predominantly to the public sector and include low efficiency of public administration, taxation burden, unstable policies, tax regulations, corruption, etc.

On the other hand, growth projection in 2017 is exposed to the positive risk of an increase in personal consumption given that measures to alleviate the burden on personal income are under way. Alleviation of taxation burden on companies and possible improvement of investment climate paired with the reform of large public systems and the improvement of the efficiency of public administration would surely positively contribute to growth sustainability and to an increase in the potential GDP rate. This is especially important for creating conditions which would facilitate the creation of new jobs, which would influence not only the structural weaknesses of the labour market (reduce seasonality, match labour force supply and demand, etc) but also halt the exceptionally negative trend of the outflow of the most productive portion of the population. Viewed in the long-term, the ageing of the population and the loss of the younger portion of the population represent a big risk for the growth and sustainability of public finances (the pension and health care systems).

As for short-term negative risks, there is a large exposure to tourism, which would, in case of incidents, greatly deteriorate and jeopardise recovery given that the materialisation of negative risks would directly affect the exports of services, personal consumption and ultimately budget revenues.

In short, Croatia finally caught up with the EU and the CEE average by the dynamic of its growth. In this year and the next, this growth will be exposed to positive risks while for its long-term sustainability and stability, and for an increase in its potential rate, it would be necessary to implement the long-known measures aimed at improving the investment climate, reform the public system, strengthen the rule of law and improve the efficiency of public administration. Otherwise, changes in its environment will push Croatia back to stagnation and cause further comparative lagging behind the rest of Europe.

Zrinka Živković Matijević

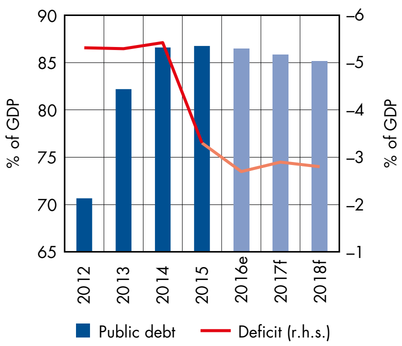
General government deficit below 3% of GDP

- Fiscal indicators improve in Q2
- Risk of stronger fiscal consolidation in the medium-term
- What could we expect from the comprehensive tax reform?

The uncertainty associated with the unstable and complicated political situation surrounding the period of a technical government is finally behind us. The forming of a new government that received confirmation from a strong majority of the members of the Parliament implies that Croatia finally entered a stable political period. This also restores hope that the government will direct its efforts at reforms aimed to achieve sustainable fiscal metrics and economic growth. This is to be translated from the published economic plan for the upcoming four years.

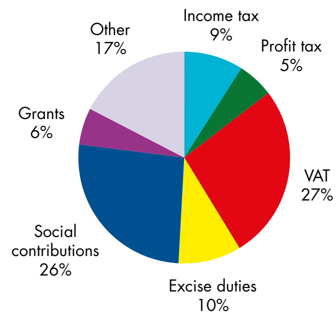
Positive developments in the fiscal statistics continued this year, receiving strong support from the great outturn in tourism and the fact that the reduction in government spending was conditioned by the temporary financing in this year's Q1 and later by the period in which the technical government was restricted by law regarding the amount and structure of budget expenses. The better-than-expected economic recovery and improved fiscal metrics provide a good foundation for strong implementation of reforms already in the first year in office of the new government. This is confirmed by the so-called October Report of the CBS on excessive budget deficit and general government debt, according to which the overall consolidated general government deficit in 2015 totalled 3.3% of GDP (in accordance with ESA 2010 methodology). According to the Report, last year, for the first time, we registered a primary general government surplus of HRK 897m (GDP 0.3%). The latter is especially encouraging as it indicates the stabilisation of public debt (which actually represents cumulative budget deficit). Therefore, a deficit reduction is a precondition to achieve public debt sustainability. In the last 15 years or so Croatia has been registering an exceptionally high, uninterrupted and at the same time unsustainable growth of public debt. Countries with high public debt levels are exposed to great risks and are vulnerable to changes in their environment (especially relating to interest rate changes or absence of stronger economic growth). Therefore, in addition to the fact that Croatia is currently in the EDP, the realised primary surplus returns it to the path to stability by balancing current consumption. On the other hand, this also points to a conclusion regarding the relatively high level of interest expenses, which reached HRK 12bn last year, registering an annual rise of over 4%. According to the October Report, total public debt at the end of last year totalled HRK 289.6bn or 86.7% of GDP. The significant reduction in the consolidated general government deficit last year contributed positively to the slowdown in the nominal growth of public debt. According to Eurostat data, the Q12016 deficit of 4.3% of GDP was followed by a general government surplus of 1.6% of GDP in the period from April to June. Here we should stress the uneven dynamics of budget revenue and expenditure realisation over different months of the fiscal year. This warrants caution when making conclusions based on quarterly data. However, the annual growth of revenues over expenditures is encouraging, since it could possibly result in the additional reduction of the fiscal deficit, which could go down to 2.7% of GDP this year (down 0.6 pp on 2015). Consequently, the effect of lower deficit will have a positive influence on public debt, which could, given the expected economic growth, lower its share in GDP to the level slightly below the one at the end of 2015.

Consolidated General Government (ESA2010)



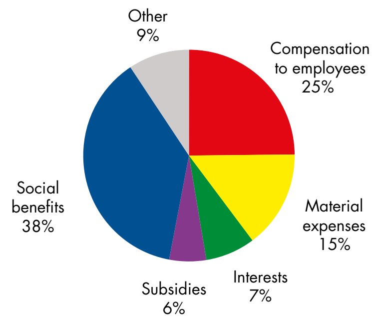
Sources: CBS, Economic RESEARCH/RBA

Consolidated Central Government revenues H1 2016*



* *GFS 2010 metodology*
Sources: MoF, Economic RESEARCH/RBA

Consolidated Central Government expenses H1 2016*



* *GFS 2010 metodology*
Sources: MoF, Economic RESEARCH/RBA

The latest data issued by the Ministry of Finance for the period from January to August (according to national methodology, based on the so-called cash principle) also indicate a continuation of the fiscal consolidation this year since the primary surplus increased by as much as HRK 7bn in the period under review. Here we should especially stress the exceptionally high interest expenses which exceeded HRK 8bn in the eight months of the year. Positive expectations arise from the recently published plans of a comprehensive tax reform. Additional alleviation of tax burden in the segment of income tax will contribute to the releasing of a larger available income, the effects of which are bound to spill over to the growth of personal consumption as the largest GDP component. Additionally, apart from the announced reduction of the parafiscal burden we expect reforms of the tax brackets in the segment of income tax to spur private sector growth, i.e. the growth of investments necessary for the new upswing in economic activity. On the other hand, the lowered income tax rate should increase competitiveness and thus contribute to economic revival. Nevertheless, the comprehensive effect may be achieved only through clear and decisive implementation of structural reforms and improvement of the business and investment climate. According to estimates, the effects of the proposed taxation changes should lower budgetary revenues by between HRK 1.8 and 2bn, which we assume the government intends to replace by the increase in household spending. The Finance Minister stressed that in 2017 general government deficit might go own additionally, to 2% of GDP. Given the expected continuation in economic growth, over the projection horizon until 2018 we are expected to see a further reduction in the share of public debt in GDP (regardless of its nominal growth). Therefore the intensity of stabilisation of and of controlling/reducing public debt growth will primarily depend on the implementation of the necessary public sector reforms within the framework of the announced fiscal consolidation.

Elizabeta Sabolek Resanović

Basic changes to the tax system

Porez na dobit	
Current situation	**Proposed measures**
20%	18%
20%	12% for farmers, craftsmen and small entrepreneurs with annual income below HRK 3m
Other proposed measures:	
increase in entertainment expenses recognised for tax purposes from 30% to 50%	
recognition of value adjustments and tax expenses for uncollected receivables	
agreements with the TA on transferred prices – prices charged among affiliated companies within a group – regulation of group redistribution costs	
Income tax*	
Current situation	**Proposed measures**
12%	to be repealed
25%	24%
40%	36%
Other proposed measures:	
equalisation and increasing of personal deduction HRK 2 600 to 3 800 for all obligors	
introduction of a single tax bracket for income from HRK 0 to HRK 17 500 subject to a tax rate of 24%	
raising of personal deduction threshold for children and other dependants	
Contributions	
reduction of the difference between the minimum wage and the lowest base – increasing the coefficient from 0.35 to 0.38	
repealing of exemptions from the contribution payment requirement	
reduction of the contribution payment for all temporary and other activities in order to stimulate and facilitate employment: for pension insurance on the basis of generational solidarity, from 20% to 10%, for health insurance, from 15% to 7.5%	
Value added tax	
Current situation	**Proposed measures (as of 1 Jan 2017)**
25% general rate	lowering of VAT rate on individual products and services from 25% to 13%
5% and 13% lower rate	lower rate of 13% is to be raised back to 25% (services in the hospitality industry and sugar)
	lower rate of 5% is to be raised to 13% (cinema tickets)
	Proposed measures (as of 1 Jan 2018)
	24% general rate
	12% lower rate
Real estate transfer tax	
reduction of the real estate transfer tax rate from 5% to 4%	
repealing of exemptions from payment of real estate transfer tax aiming to equalise the tax treatment of all citizens, regardless of the real estate property	
the entire income arising under this item will become the income of local government units	
procedure simplification – determining the tax obligation without citizens having to file a request	
Excise duties	
the obligation to submit a form for excise duty calculation on annual basis for small producers of strong alcoholic beverages is to be (approx. 41 000 obligors)	
making vine export to other countries easier for small wineries (easier exports for 2 000 small wineries)	
repealing of the obligation to calculate the difference of excise duty on cigarette supplies if the amount of difference in excise duty is below HRK	
repealing of the obligation to mark alcohol and alcoholic beverages with a special (registration) stamp	

** Tax on income from employment. Sources: MoF, Economic RESEARCH/RBA*

Yields decline

- **Market reacts positively to New Government**
- **In the face of large maturities**

The period after the election and the formation of the New Government yielded an instant positive result in the markets by reflecting that the period of political uncertainty which contributed to market oscillations is finally behind us. Moreover, spurred by the record tourist season which had a synergic effect with lower expenditures on the decrease of the budget deficit public debt reduced, totalling HRK 288.9bn at the end of July. Thus, public debt fell for the fifth month in a row, on an annual level, spurred additionally by a mild appreciation of the kuna against the euro. In addition, the government's weaker need for borrowing arose from the use of its deposits with the CNB, while positive economic growth also contributed to the narrowing of the share of public debt in GDP.

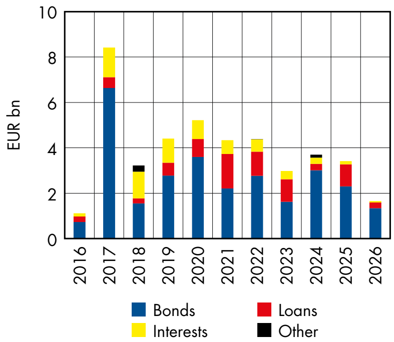
Although the local debt securities market did not see more significant reactions in terms of trading volumes, the focus of investors was on the government's kuna issues which were followed by the increased investors' interest at T-bill auctions. The lack of securities in the shallow domestic market should continue to mark the local market until the end of the year. Prices should remain relatively high and yields low, receiving additional boost from ample liquidity in the system (indicating their downward trend during the latest T-bill auctions as well).

At the same time, the positive sentiment on the Croatian Eurobond market is evident. It is additionally spurred by a more stable political environment and undoubtedly also by improved fundamentals. Consequently, Croatia's risk premium expressed by a 5-year USD CDS fell from more than 260 bps late in June to 200 bps at the end of September. Although it is still higher than that of comparable countries from the region, fact remains that it undoubtedly reflects the importance of market perception in connection to the economic and political developments in the country. It is therefore noteworthy that a short-term positive market reaction is also exposed to negative risks, primarily those related to the continuation of the started fiscal consolidation.

We would like to stress here that 2017 is the year of big maturities which requires active involvement within the framework of the fiscal strategy. To be more exact, next year we are to see the maturity of liabilities worth EUR 2bn arising from issued Eurobonds (of which EUR 0.6bn are interest payments). As a result, we expect the government's more active role in the primary market already in the first quarter 2017, without doubting that the government will meet its obligations. The latter is confirmed by solid international liquidity position: gross financing needs, defined as a sum of debt repayments and C/A balance, would be expected to reach 27% of GDP in 2017 vs. 33% of GDP in international reserves. Finally, we think that the key factor in the evaluation of reform implementation will be the proposed 2017 budget which should ultimately strive to improve Croatia's credit rating and thus to lower financing costs.

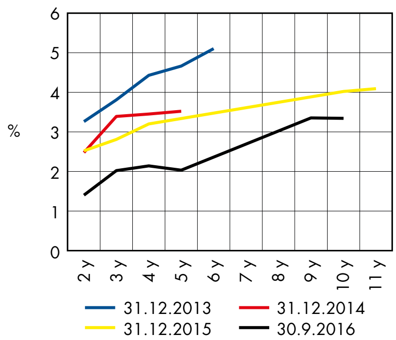
Tomislava Ujević

Public debt maturity



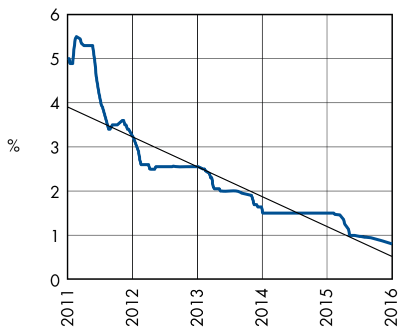
Sources: Bloomberg, Economic RESEARCH/RBA

Yield to maturity (HRK bonds)



Sources: CNB, Raiffeisen RESEARCH

1-Y HRK T-bills yield

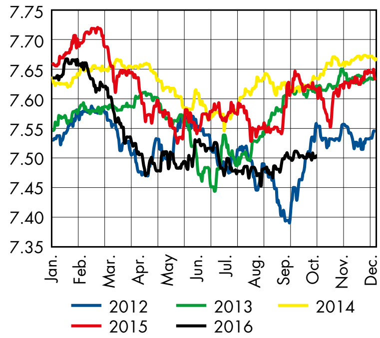


Sources: MoF, Economic RESEARCH/RBA

Stable EUR/HRK, no inflationary pressures

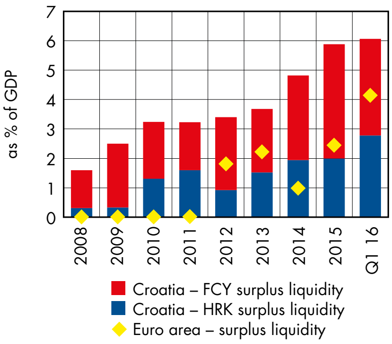
- **Continuation of expansive monetary policy with CNB's firm commitment to EUR/HRK stability**
- **Prices continue to fall**

Mid EUR/HRK



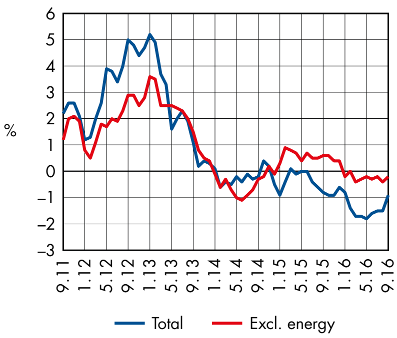
Sources: CNB, Economic RESEARCH/RBA

Surplus liquidity (comparison of the RC and the euro area)



Note: Surplus liquidity in the euro area is excess reserves relative to regulatory reserve requirement. The GDP for the euro area refers to 19 member states, while the data for surplus liquidity refers to the euro area changing composition.
Sources: ECB, Eurostat, CNB, CBS

CPI, annual changes (%)



Sources: CNB, Economic RESEARCH/RBA

The peak of the tourist season brought about the usual fall of EUR/HRK but also the continued stability. Namely, the mid-point FX rate at the CNB's exchange rate list moved ±0.2% around 7.48 kuna per euro. The slight upward tendency of EUR/HRK started in mid-September. The mild weakening of the kuna against the euro, which is common at this time of the year, is also supported by strong growth of imports, that is, the deterioration in the trades of goods. On the other hand, the expected exchange rate of 7.60 kuna per euro at the end of the year is at risk of being realised at lower levels given that the kuna has found support in a healthy C/A surplus, much reduced fiscal risks, inflow of foreign currency stemming from an extended tourist season, the strengthening of investment activity, positive net external position held by banks and growing demand for kuna loans. A lower average EUR/HRK in 2016 compared to previous years confirms that at the time when the economy is on the rise the kuna is more exposed to appreciation pressures. Therefore it is not surprising that for the first time after 2012 the central bank FX interventions are directed at purchasing euros.

In the Q117, EUR/HRK should maintain the levels reached in the Q416. As the quarter nears its end, we can expect a fall in EUR/HRK given the expected FCY inflow from the beginning of the tourist pre-season. The possible Eurobond issuance should not affect market developments because conversion to kuna would be made with the CNB as was the case with previous issues. This issuance would increase FX reserves of the central bank and the gradual inflow of funds from the issue to the market would not jeopardise the stability of EUR/HRK. A local bond issuance (most likely in pure HRK) would provide support to the kuna despite ample liquidity that is continued to be ensured by the monetary policy. With unwavering commitment to maintaining the stability of the EUR/HRK exchange rate the CNB is expected to continue with its long-term structural repo operations. By the end of the Q3 banks received HRK 0.9bn via three operations whereby the interest rate was lowered from 1.8% to 1.4% at the last auction. It is noteworthy, that the central bank planned to place more than HRK 3bn through four operations. The still relatively modest demand for loans paired with already high kuna (and FX) liquidity, as well as lack of collateral must have caused a shortage in demand for these sources of liquidity. The implementation of this type of monetary policy has been greatly facilitated by the stability of the exchange rate and absence of inflationary pressures. The latter has been observed for three years in succession, whereby the estimated decline of average consumer prices exceeded 1%. Only in the first months of this year, the general level of consumer prices declined by 1.4%, with the greatest contribution to the decline in prices coming from energy and food products, which account for over 40% of CPI. From the aspect of structure, the fall in these two categories has freed available income of households and eliminated the fear of a deflation spiral. A slow and mild recovery in prices at global commodities markets (primarily of crude oil and food) is expected to spill over to domestic prices so in addition to a base effect the average rate of inflation is expected to return to positive figures in 2017.

Zrinka Živković Matijević

In the face of divergent monetary measures

- **Fed to raise its benchmark rate in December**
- **ESB to extend its bond purchase programme at unchanged rates**

The autumn meetings of the Fed's and the ECB's top officials were in the focus of interest on both sides of the Atlantic. In accordance with expectations, at its latest meeting the FOMC decided to keep the key interest rate at the current levels (0.25% – 0.50%), Governor Yellen explaining that Fed needs more time to reach its key objectives (full employment and annual inflation rate of 2%). However, fact remains that at the September meeting three members voiced that they think the raising of interest rates should no longer be postponed given the accelerated economic activity in the US. The latter is confirmed by healthy macroeconomic indicators (especially in the labour market), which give rise to market expectations of an upcoming hike in the Fed's benchmark interest rate. The latest data confirm the continuation of healthy developments as regards (un)employment but also growing annual inflation rates observed in the first three quarters of this year. Consequently, there is a noticeable trend of rising yields on the benchmark US bond maturing in 10 years, which exceeded 1.85%, growing by 50 bps.

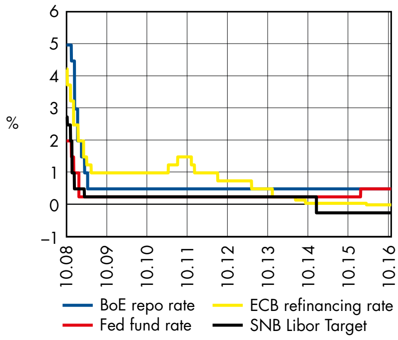
Given the reduction in oil production quotas aimed at stabilising the global oil market, which was announced at the informal September meeting of OPEC members held in Algeria, which surprised the market, its reaction is reflected through the increased expectations that the growth of energy prices will push up inflation growth across the world. Therefore, we remain firm in our expectations of the Fed raising its interest rate in December and project a mild growth in yields on the benchmark US issue, up to 1.90%.

According to our expectations, within the framework of the Fed's monetary policy normalisation it could come to a gradual interest rate increase on two occasions in 2017, which will increase the upward pressure in the sense of further strengthening of the dollar vis-à-vis the euro. Consequently, the yields on the 10-year US bond will also trend upwards towards 2.30% until the end of next year.

At the same time, market attention in the Old Continent is focused on future decisions of the ECB whose officials opted to maintain the benchmark interest rates at existing levels at their latest meeting in October. The monthly bond purchase programme within the ECB's expansive monetary policy framework remained at EUR 80bn. However, the ECB's president announced that monetary easing policy through bond purchase is not envisaged as an ever-lasting monetary stimulus.

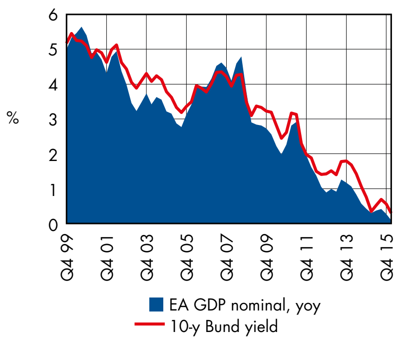
However, aiming to achieve its main objectives (primarily spurring a stronger economic uplift and achieving a target inflation rate) the ECB's officials decided to keep the key interest rates at current, low levels, if necessary, even after March 2017, until when the bond purchase programme was expected to last. Given that the ECB's president strongly excluded the possibility of an "abrupt" discontinuation of the bond purchase programme, it is our opinion that this monetary stimulus will see certain modifications next year, which might already be on the agenda of the meeting of ECB's officials in December. According to our forecasts, the key interest rate and the benchmark deposit rate are to be maintained at current levels (0.00% and 0.40% respectively). At the same time, the previously mentioned ne-

Key interest rates



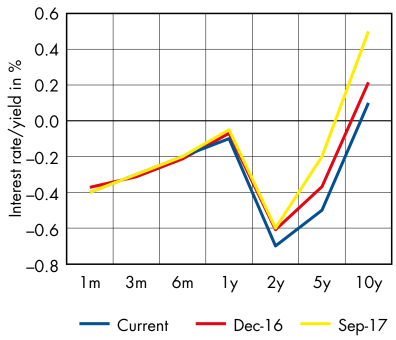
Sources: Fed, ECB, BoE, SNB, Economic RESEARCH/RBA

Historical correlation yields to GDP



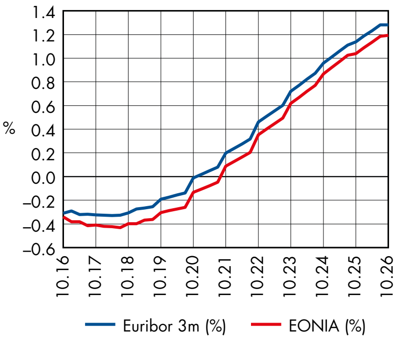
Sources: Thomson Reuters, Raiffeisen RESEARCH/RBI

Interest rate/yield curve*



1m –1y Euribor / 2y –10y yield on German benchmark bond
Sources: Thomson Reuters, Raiffeisen RESEARCH/RBI

Euribor (3m) and EONIA



Sources: Thomson Reuters, Raiffeisen RESEARCH/RBI

Financial market forecasts*

	Dec-16	Mar-17	Jul-17	Dec-17
EUR/USD	1.08	1.07	1.02	1.05
ECB key rate	0.00	0.00	0.00	0.00
ECB Deposit rate	–0.40	–0.40	–0.40	–0.40
EONIA	–0.40	–0.40	–0.40	–0.40
1m Euribor	–0.40	–0.40	–0.40	–0.40
3m Euribor	–0.30	–0.30	–0.30	–0.30
6m Euribor	–0.20	–0.20	–0.20	–0.20
12m Euribor	–0.10	–0.10	–0.10	–0.05
DE Yield 2y	–0.70	–0.70	–0.70	–0.60
DE Yield 5y	–0.50	–0.40	–0.40	–0.20
DE Yield 10y	0.10	0.30	0.30	0.50
DE Yield 30y	0.70	0.80	0.80	1.00
EUR Swaprate 2y	–0.30	–0.25	–0.25	–0.15
EUR Swaprate 5y	–0.15	0.00	0.00	0.20
EUR Swaprate 10y	0.45	0.70	0.70	0.90

** as of 27/10/2016*
Sources: Raiffeisen RESEARCH/RBI

gotiations among OPEC members regarding cuts in the oil production (for the first time after eight years) prompted markets towards expectations of higher inflation rates. However, although the price of crude oil registered two-digit relative growth from the end of July this year, it is not to be expected that its dynamics will accelerate given the experience thus far which warns of non-compliance with agreements by some members. Therefore, we remain cautious about the agreement on cuts of crude oil production as far as some of OPEC member states are concerned. Nigeria, Libya and Iran have for instance already been excluded from the plan to cut production quotas even before the meeting which has been scheduled for late November. If Iraq joins them in avoiding the reduction of production quotas (since it stresses the importance of its oil revenues in financing its fight against terrorism) we think that ultimately there will not come to a stronger reaction in the sense of a more substantial inflation growth.

Therefore, in the months to come we expect a slow disappearance of the effects of low oil prices which will gradually lead to higher inflation rates. On the other hand, in its public address after the latest meeting the ECB's President, Mario Draghi, stressed that core inflation (which excludes energy prices) has still not shown the signs of the wanted upward trend. This leads us to the conclusion that it is precisely the movement of core prices that will be the leading factor in terms of attaining the target inflation. In line with expectations that the price of Brent crude oil (as benchmark for the European market) could reach the average of USD 55 per barrel, the consequent slow growth of core inflation in the euro area might start in the second half of 2017.

In this context, we think that the ECB's monthly bond purchase programme will be maintained at its current level of EUR 80bn until the first half of 2017. After that we do not exclude its gradual reduction. We think that at its December meeting, at the latest, the ECB might also formally announce the extension of its QE programme. Given that the bond purchase programme might result in the lack (primarily of German) debt securities, we feel that the programme will be amended so as to allow the limits per issue or issuer to be abandoned or reduced. One of the possible options is also to repeal the minimum required yield (which currently equals the discount rate of –0.40%). This would redirect the purchased volume from shorter towards longer maturity issues. Consequently, yields at the shorter end of the curve could initially register a slight fall, while the longer end would trend upwards towards the end of 2017.

Money market interest rates should keep at their current levels at least until Q3 2017, while the first hike in the benchmark interest rate is not expected until Q2 of 2018.

Tomislava Ujević

Weak demand for loans despite economic recovery

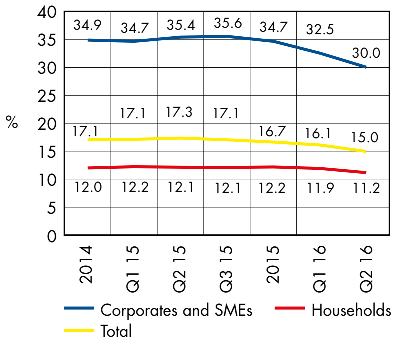
- **Deposits grow, loans fall**
- **Investments in bond funds on the rise**
- **Share of non-performing loans in total loans decreases**

Four and a half years ago the banking sector saw its loan-to-deposits ratio (LDR) reach a record level of 1.36. Since then, the amount of total loans has been steadily declining, while the amount of deposits with banks has been growing. As a result, the LDR fell to below 1 in August this year. In the course of last year we noticed changes in the deposit structure. Influenced by lower yields the amount of time deposits stagnated with only a-vista deposits registering an increase. We came to the conclusion that clients keep their money in banks due to lack of attractive alternative investments and not because of yields to be earned from time deposits. As for alternative investments in investment funds, the potentially higher yields relative to the yields on time deposits with banks are associated with higher risk from losing a portion of one's assets. However, amid record low money market interest rates yields on assets invested in money funds have declined substantially. Only investments in bond funds have increased. Due to higher yields on Croatia's long-term debt bonds have been yielding sufficiently for clients to earn higher yields than from time deposits with banks even after settling the management fees of fund managing companies.

Over the previous years, surplus liquidity in the system was created through loan repayment and deposit rise and it was used by banks to deleverage abroad. This year most banks completed the deleveraging. They have not even been successful at increasing their placements to the government, which started its fiscal consolidation process. The financing of the public debt falls within the realm of pension funds, whose assets have been constantly increasing due to compulsory investment of one-fourth of all pension insurance contributions of all employees in compulsory pension funds. Banks have been trying to halt liquidity growth by lowering their interest on time deposits and making their lending conditions more attractive. However, demand for loans has not gone up despite the fall in the price of capital. As a result, surplus liquidity in the system will significantly affect banks' business policies in the remainder of the year. We forecast further lowering of interest rates on time deposits, as well as of lending rates. The fall in lending rates has been facilitated by favourable developments in the portfolio quality. In the last four months we registered a drop in NPLs. Consequently, the risk premium embedded into lending rates fell down as well. During recession the costs of portfolio losses reduced banks' net income by a high 50%, on average. The absence of these losses in 2016 enabled a strong increase in banking sector profit. Net profit in the period, which totalled HRK 2.9bn, raised the ratio of return on invested capital in the first half of the year to two-digit level, unseen since 2007. The rise in profit resulted from one-off receipts at the beginning of 2016. Namely, from the releasing of risk provisions after the reduction of the calculation basis in the loan conversion process from loans in the Swiss franc into loans in euros and from the sale of banks' shares in international card companies. By the end of the year the positive effect of these one-off receipts on bank operating results will partially fade. At the annual level, we forecast one-digit returns on bank capital, although they will be well above the average during the recession period.

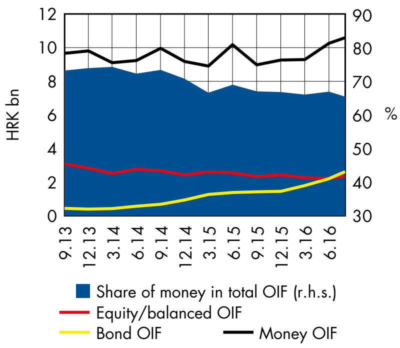
Anton Starčević

NPLs ratio, eop in %



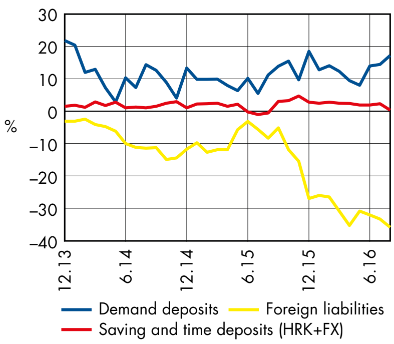
Sources: CNB, Economic RESEARCH/RBA

Open-end investment funds, net assets



Sources: CFSSA, Economic RESEARCH/RBA

Foreign Liabilities and Deposits growth, annual level

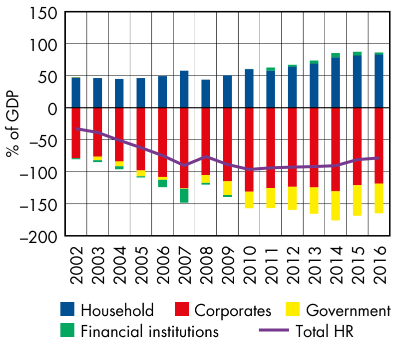


Sources: CNB, Economic RESEARCH/RBA

Balance sheet imbalances decline

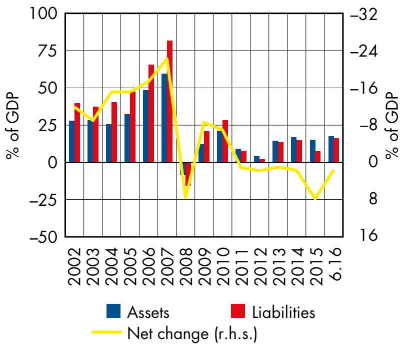
- Growth without borrowing since 2015
- Financial assets in the household sector on the rise
- Corporate and government financial liabilities in decline
- Net foreign investment position improves

Net financial assets per sector



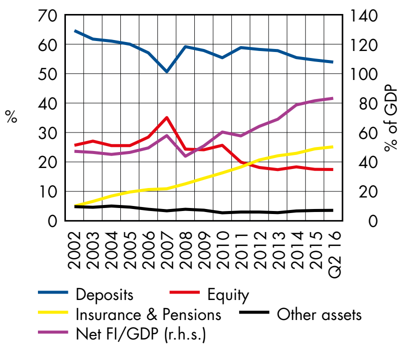
Sources: CNB, Economic RESEARCH/RBA

Financial assets and liabilities, yearly changes



Sources: CNB, Economic RESEARCH/RBA

Households sector – financial assets



net FI/GDP = net financial assets, households sector in % of GDP
Sources: CNB, Economic RESEARCH/RBA

Developments regarding financial assets and liabilities broken down by sector and financial instrument have been monitored in Croatia since 2001. The period of economic prosperity from 2002 to 2007 was marked by the increase in balance sheet imbalances caused by the growth model that was financed by imported capital. The following two years (2008 and 2009) were marked by shocks in external financial markets with the valuation of financial assets and liabilities significantly changing. In the period from 2010 to 2014 the financial markets gradually stabilised but Croatia's economy remained stuck in recession. The private sector adjusted to high levels of balance sheet imbalances and slowly started deleveraging, while the unadjusted government sector quickly increased its indebtedness. The economic recovery initiated by favourable influences in the environment started in 2015. The increase in income has been used by both the private and the public sector to deleverage and improve their international balance sheet positions.

The changes in the financial assets of the household sector resulted from savings and from the attractiveness of supply of financial instruments on the market, as well as from compulsory investments into pension funds. Negative experiences of exposures to price risk from the period of instability in the financial markets left a deep mark on household preferences. Investments in low-risk assets, primarily in foreign currency time deposits with banks are more appealing than investments in riskier instruments yielding better yields. A positive contribution to the selection falling on banks also came from the attractive interest rate yield banks offered in the period of increased aversion towards markets with growing public debt. On the other hand, negative developments regarding the economy, employment and real income of the employed during the period of recession limited the potential for saving. As a result, the growth of deposits with banks was based on growth realised from interest rates accrued on principals and exchange rate differences realised regarding foreign currency deposits. Banks' deposit rates have been declining since 2014 and the kuna started appreciating against the euro. As a result, it has not come to the growth of the kuna figure of deposits with banks, so the overall financial assets of households vis-à-vis the GDP stagnated at some 120%

A significant influence on the structure of financial assets of households comes from the statutory requirement to pay in one quarter of pension contributions of all employees to compulsory pension funds. The pension savings were introduced in 2002 and the assets of compulsory pension funds have been growing ever since. At the end of the first half of 2016 they reached 23% of GDP. In the upcoming period the expected alleviation of the tax burden from income should increase household receipts, while economic recovery should reflect itself positively in the number of persons employed.

The continuation of favourable developments in external markets for goods, services and capital gives us reason to expect a rise in the total financial assets of households.

The lowering of interest rates on time deposits towards negative values might redirect some of bank deposits towards higher-risk financial instruments.

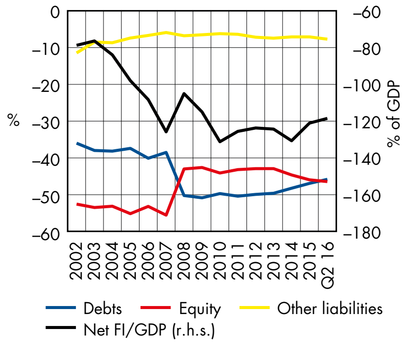
The liabilities of the household sectors arise from loans. Slow deleveraging of households with local banks started in 2010, with the indebtedness of the sector reducing from 42% to 39% of GDP by the end of 2015. The acceleration of the deleveraging process in the first half of 2016 was a result of the partial write-off of debt within the process of loan conversion from loans in the Swiss franc to loans in euros. Household debt arising from conversion went down by 2.3% of GDP. Thanks to continuing investments in pension funds, savings in banks and deleveraging, the positive net-financial assets of households has been continously increasing since 2008. At the end of H1 2016 it reached 83% of GDP.

In contrast to the household sector, the financial liabilities of non-financial enterprises exceed the value of their financial assets several times. In their operations non-financial enterprises predominantly us tangible and intangible assets, while financial assets represent only the liquid portion of total corporate assets. In 2015, corporate liquidity went up significantly. Negative experiences of entrepreneurs from the previous period increased their aptitude towards maintaining higher levels of liquidity in the corporate sector. The regulation on pre-bankruptcy settlement that was in force from 2012 to 2014 enabled the debtor company to initiate settlement proceedings with its creditors. In practice, these proceedings meant the resolution of the debtor company at the expense of its creditors. In creditor companies these proceedings unexpectedly reduced the amount of receivables and consequently the inflow of liquidity. Creditor companies had to resort to additional loans to consolidate their working capital. The loss of receivables reduced the value of assets of creditor companies and this in turn also reduced their creditworthiness. As a result the price of additional borrowing for creditor companies increased, causing them additional losses. After bad experiences with pre-bankruptcy settlements companies preferred to strengthen their stress resilience. The increase in liquidity of the corporate sector was also enabled by the drop in the prices of capital because a higher level of business security may be attained at minimum costs.

Financial liabilities of the corporate sector include equity and debt. Corporates have been deleveraging since 2010 when they reached the highest share in GDP, totalling 80%. In the deleveraging process that started in 2010 corporate debt was reduced by more than 10% of GDP until mid-2016. This debt reduction resulted from debt repayment but also from resolution and restructuring proceedings. As part of resolution of shipyards and public enterprises, banks and other financial institutions transferred some of their claims to the government. In pre-bankruptcy proceedings a share of corporate debt was written-off or transferred to equity. An additional channel for reducing corporate debt is the sale of creditor receivables to institutions specialising in collecting problem receivables at the cost of some of the debt being written-off.

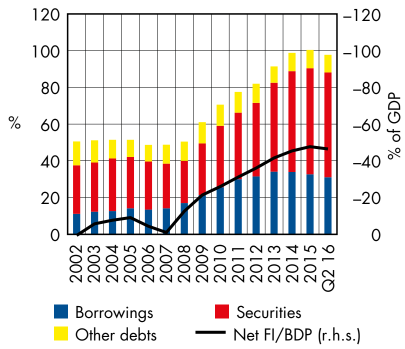
A half of the total debt of the corporate sector is accounted for by foreign liabilities. However, in the last two years the inclination of corporates to borrowing in the domestic currency is on the rise. The lowering of the price of borrowing in kuna reduced the attractiveness of alternative borrowing in euros. This increased the demand for kuna loans granted by local banks. In the upcoming period we

Corporate sector – financial liabilities



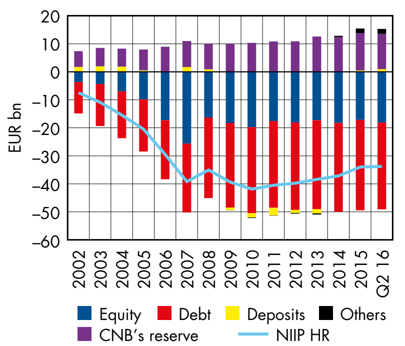
net FI/GDP = net financial assets, corporate sector in % of GDP
Sources: CNB, Economic RESEARCH/RBA

General government sector – financial liabilities



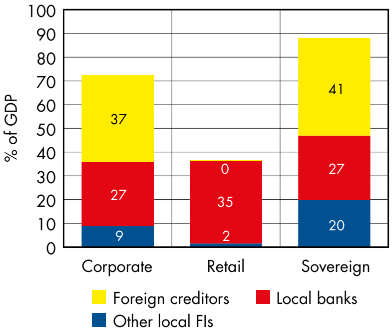
net FI/GDP = net financial assets, general govt. sector in % of GDP
Sources: CNB, Economic RESEARCH/RBA

Net International Investment position



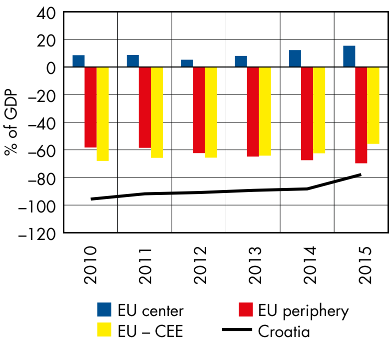
Sources: CNB, Economic RESEARCH/RBA

Total debt structure per sector, in mid 2016



Sources: CNB, Economic RESEARCH/RBA

EU – Net International Investment Position



Sources: Eurostat, Economic RESEARCH/RBA

expect corporate borrowing in kuna with domestic banks to increase and the share of direct lending from abroad to simultaneously decrease.

The financial liabilities of the government sector constitute public debt, while financial assets include equity in state enterprises, including enterprises in mixed ownership, as well as liquid assets. Public debt growth plummeted in 2008 to be halted in 2015 when the fiscal consolidation process started. Developments regarding the financial assets of the government did not follow the recent growth in borrowing that was used to finance the budget deficit and repayment of the debt of companies that underwent the resolution process. Consequently, the accumulated deficit of financial assets owned by the government relative to its liabilities grew to above 45% of GDP.

The difference of total financial assets and liabilities of all sectors represents the international balance sheet position. In the Macroeconomic Imbalance Procedure (MIP) Scoreboard the indicator of net international investment position (NIIP) provides an aggregate view of the balance sheet position of one Member State vis-à-vis the rest of the world. The indicative threshold of this indicator is –35% of GDP. At the end of 2015, out of 28 EU Member States 13 complied with the –35%-rule, while the remaining 15 realised higher negative positions and Croatia was among them. In 2015 Croatia made a significant improvement and developments in the first half of 2016 show that the process of reducing the negative international investment position is continuing.

Anton Starčević

Healthy growth of equity markets due to high liquidity

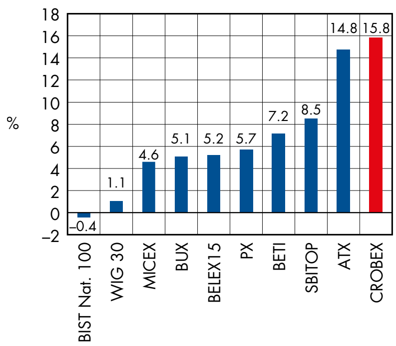
- **Rise of almost all equity indices in CEE**
- **CROBEX boasts the highest growth in the region – 15.8%**
- **Tourism sector shares lead the way**

Almost all CEE indices boasted healthy growth in Q3 2016 thanks to good macroeconomic indicators and high system liquidity, and the fact that there was no negative influence of Brexit. The only exceptions were the Turkish BIST Nat. which closed the quarter in the red, and the Polish WIG30 inching up only 1.1%. The reasons behind their weaker results were in both cases local factors, i.e. political uncertainty. By far the highest return among all regional indices was seen by the CROBEX (+15.8%), followed by the Austrian ATX. In addition to the generally positive sentiment among the equity indices, ATX was boosted by shares from real estate sector. Good macroeconomic indicators also spurred the healthy growth of the Romanian BET and the Czech PX, which was under the greatest influence of banking sector shares.

In addition to the spill-over of the global positive sentiment, the growth of the Croatian equity market was spurred by the onset of recovery in the domestic economy and a record tourist season. Since the beginning of 2016 the CROBEX gained 14.9%, one of the highest rates seen among regional indices. Broken down by sectors, the greatest winners were tourist shares. Imperial's shares registered the greatest growth as a result of accepting the Valamar Riviera's takeover bid for the state owned share in the company. Other sectors went up as well, whereas only two shares from the transport sector registered a decline in Q3. All of the CROBEX constituents went up in the period under review, with OT-Optima Telecom leading the way by gaining as much as 66.7%, while weakest returns were seen by the shares of Sunčani Hvar and Tankerska Next Generation. The optimism surge on the ZSE was followed also by a significant rise in turnover so the regular share turnover totalled HRK 591.9m, up 59.6% from Q2 2016 and almost as much as in Q3 2015. The total market capitalisation of the ZSE totalled HRK 139.3bn at the end of the quarter, up 15.8% from the end of Q2 and 12.7% on the same period in 2015. The most traded shares were HT shares, with total turnover of HRK 103.6m, and Valamar Riviera shares, with total turnover of HRK 73.8m.

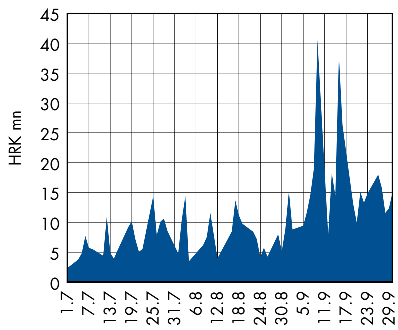
Ana Turudić and Nada Harambašić Nereau

CEE indices – returns in Q3 2016*



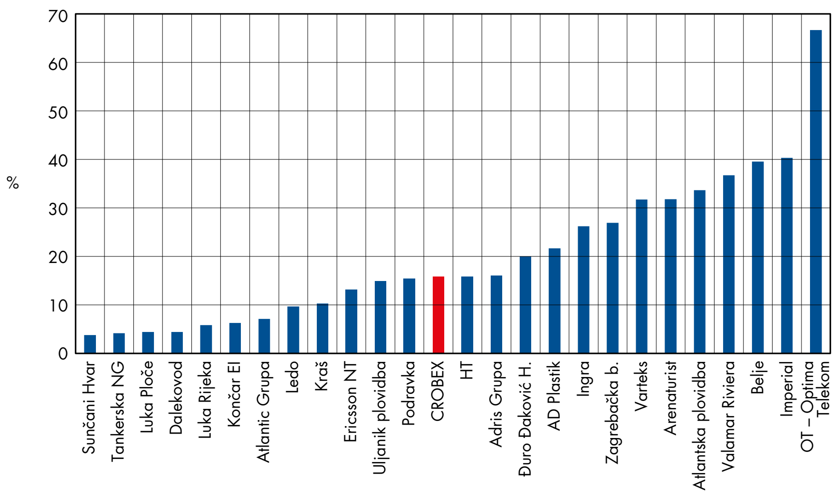
* in local currency, value on September 30, 2016 (6:30 PM)
Sources: Bloomberg, Economic RESEARCH/RBA

Regular turnover



Sources: ZSE, Economic RESEARCH/RBA

Return of CROBEX constituents in Q3 2016 (dividends not included)*

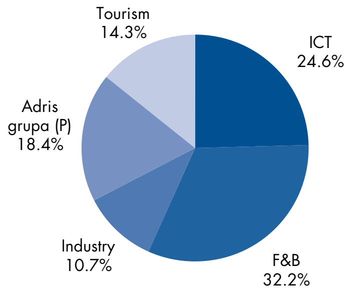


* return calculated as on September 30, 2016
Sources: ZSE, Economic RESEARCH/RBA

Growth slowdown in Q4 2016

- Liquidity and favourable macroeconomic forecasts work for CEE equity indices
- Relatively high CROBEX10 valuation
- Local factors to prevail on the ZSE

CROBEX10 composition by sector



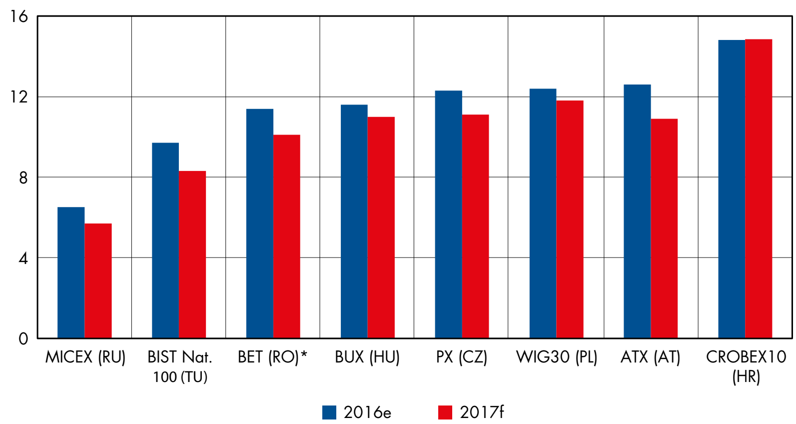
Sources: RBI/RBA Economic RESEARCH

Until the end of 2016.e the greatest spur to equity indices could come from expansive monetary policy and good macroeconomic data. Short-term instability could be caused by numerous referendums and elections ahead. Nevertheless, we do not expect their more substantial influence on global markets and consequently the CEE market. According to the expected P/E ratio 2016.e (8.1x)[1] the Russian MICEX is relatively most favourable valued index so we expect its healthy growth in the next year. A spur to the growth of this index could come from the growing price of oil and the exit of the Russian economy from recession. The Turkish index BIST Nat. 100 has been valued relatively low too. However, the realisation of its growth potential is limited by investors hesitation due to the political situation.

The high liquidity could continue to positively influence trading on the ZSE, while the focus should remain on local factors and expectations related to reforms from newly appointed Government. The economy started to recover, which is encouraging. However, we will have to wait for a more sustainable growth of the equity market. According to Bloomberg estimates, the CROBEX10 has by far the highest expected P/E ratio for 2016.e (14.8x) among the regional indices. As a result we expect the domestic equity market growth to slow down by the end of the year. As for a longer horizon, i.e. in the upcoming year, we expect index growth to be spurred by an improvement in the investment climate and continuation of economic growth. This is under the condition, of course, that the Government presses ahead with necessary reforms. In 2017.e we expect the profit of the CROBEX10 constituents to fall due to individual factors inherent to some of the constituents so we do not consider it a limitation.

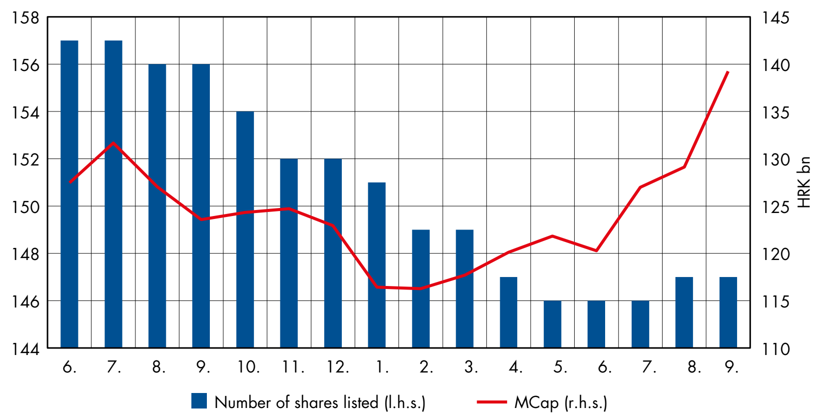
Ana Turudić and Nada Harambašić Nereau

P/E ratios in comparison



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

Number and market capitalisation of equities



Sources: ZSE, RBA Economic RESEARCH

1 Raiffeisen RESEARCH, Central & Eastern European Strategy 4rd quarter 2016, http://www.rbinternational.com/eBusiness/services/resources/media/829189266947841370-829189181316930732_829603300989963599-1189825811625145330-1-2-EN.pdf

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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
GVA – gross value added
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
pp – percentage points
Q – quarter
r.h.s. – right hand scale
RBA – Raiffeisen bank
RBI – Raiffeisen Bank International
RC – Republic of Croatia
SEE – Southern and Eastern Europe
SMEs – Small and medium-sized enterprises
SNB – Swiss National Bank
TA – tax administration
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

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