Raiffeisen Research Report

Number 64
January 2017

2017 – the year of opportunities

- Growth continues
- Ample liquidity and low interest rates
- Return of inflation
- A dynamic year with M&A deals ahead

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	2.7	2.8	2.8
GDP at current prices (EUR millions)	45,022	44,737	43,959	43,516	43,002	43,870	45,304	47,334	49,601
GDP per capita at current prices (EUR)	10,479	10,451	10,301	10,225	10,146	10,436	10,776	11,267	11,810
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	3.7	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	–1.1	1.3	2.2
Producer Prices[1], %, end of period	5.7	5.8	6.9	–2.6	–3.4	–4.4	–0.1	1.5	2.5
%, average	4.3	6.4	7.0	0.5	–2.7	–3.9	–4.1	0.5	2.4
Unemployment rate (official rate, avg)	17.4	18.0	19.1	20.3	19.7	17.0	15.0	14.2	13.7
Unemployment rate (ILO, avg)	11.6	13.7	15.9	17.4	17.3	16.3	13.6	12.5	11.2
Average net wage, in Kuna	5,343	5,441	5,478	5,515	5,534	5,594	5,670	5,812	5,916
General Government Balance, % of GDP, ESA 2010	–6.2	–7.8	–5.3	–5.3	–5.4	–3.3	–2.4	–2.9	–2.8
Public Debt, HRK bn, ESA 2010	191.3	216.7	233.6	270.9	284.2	289.6	291.0	300.8	308.8
% of GDP, ESA 2010	58.3	65.2	70.7	82.2	86.6	86.7	85.3	84.5	82.9
Balance of Payment and External Debt									
Good's and Services Exports, EUR million	17,007	18,110	18,316	18,765	19,982	21,951	23,182	24,308	25,530
% change	9.2	6.5	1.1	2.5	6.5	9.9	5.6	4.9	5.0
Good's and Services Imports, EUR million	17,158	18,297	18,097	18,573	19,114	20,717	21,680	22,767	23,820
% change	–0.5	6.6	–1.1	2.6	2.9	8.4	4.6	5.0	4.6
Current Account Balance, % of GDP[2]	–1.1	–0.7	–0.1	1.0	2.1	5.1	3.1	2.5	2.2
Official International Reserves, EUR millon, eop	10,660	11,195	11,236	12,908	12,688	13,707	13,200	13,500	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]	1,066	1,018	1,145	728	2,281	187	1,000	1,300	1,800
Tourism – nightstays, % change	2.6	7.0	4.0	3.3	2.6	7.7	8.7	4.0	3.0
External debt, EUR billion	46.9	46.4	45.3	45.8	46.4	45.4	43.7	44.5	45.4
External debt, as % of GDP[2]	104.2	103.7	103.0	105.3	107.9	103.4	96.5	94.0	91.5
External debt, as % export of goods and services[2]	275.8	256.2	247.3	244.1	232.3	206.8	188.5	183.1	177.8
Monetary and Financial Data									
Exchange rate, eop, USD / HRK	5.57	5.82	5.73	5.55	6.30	6.99	7.17	7.19	6.57
avg, USD / HRK	5.50	5.34	5.85	5.71	5.75	6.86	6.80	7.30	6.89
Exchange rate, eop, EUR / HRK	7.39	7.53	7.55	7.64	7.66	7.64	7.56	7.55	7.55
avg, EUR / HRK	7.29	7.43	7.52	7.57	7.63	7.61	7.53	7.52	7.51
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	301.3	312.8	320.9
% change	1.9	5.6	3.6	4.0	3.2	5.1	4.8	3.8	2.6
Credits, Kuna billion	245.6	257.4	242.1	240.8	237.0	230.0	220.8	217.5	220.8
% change	4.7	4.8	–5.9	–0.5	–1.6	–2.9	–4.0	–1.5	1.5
ZIBOR 3m, %, avg	2.4	3.2	3.4	1.5	1.0	1.2	0.9	0.9	1.1
Treasury bills rate 12m, %, avg	4.0	3.9	3.9	2.5	1.9	1.5	1.0	0.8	1.1

[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	3.9	2.5	3.0	2.5
Hungary	2.9	2.3	3.2	3.4
Czech Rep.	4.6	2.5	2.7	2.5
Slovakia	3.8	3.3	3.3	4.0
Slovenia	2.3	2.6	2.7	2.2
CE	**3.8**	**2.6**	**3.0**	**2.7**
Croatia	**1.6**	**2.7**	**2.8**	**2.8**
Bulgaria	3.6	3.3	3.0	3.3
Romania	3.8	4.7	3.6	3.0
Serbia	0.7	2.7	3.0	3.0
BiH	3.0	2.5	3.0	3.5
Albania	2.6	3.5	4.0	4.0
SEE	**3.0**	**3.8**	**3.3**	**3.1**
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	**–0.5**	**1.1**	**2.0**	**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	2016	2017f	2018f
Poland	–0.9	–0.7	1.1	2.0
Hungary	–0.1	0.4	2.5	3.0
Czech Rep.	0.3	0.7	2.0	2.0
Slovakia	–0.3	–0.6	1.1	2.0
Slovenia	–0.8	–0.2	1.3	1.5
CE	**n.v.**	**n.v.**	**1.5**	**2.1**
Croatia	**–0.5**	**–1.1**	**1.3**	**2.2**
Bulgaria	–0.1	–0.8	1.6	2.0
Romania	–0.6	–1.6	1.2	2.4
Serbia	1.4	1.1	2.5	2.9
BiH	–1.0	–0.9	2.0	2.0
Albania	1.9	1.3	2.2	2.7
SEE	**n.v.**	**n.v.**	**1.5**	**2.4**
Russia	15.6	7.1	5.4	5.2
Ukraine	48.7	13.9	10.7	7.5
Belarus	13.5	11.8	12.0	11.0
EE	**n.v.**	**n.v.**	**6.0**	**5.6**
CEE	**n.v.**	**n.v.**	**3.9**	**4.0**
Austria	0.8	1.2	2.0	2.1
Germany	0.1	0.4	1.9	2.2
Euro area*	**0.0**	**0.2**	**1.5**	**1.5**
USA	**0.1**	**1.3**	**2.2**	**2.5**

** 2016 estimate; Source: Raiffeisen RESEARCH/RBI*

Fixed capital formation (% yoy)

	2016	2016e	2017f	2018f
Poland	6.1	–5.2	4.3	1.8
Hungary	1.9	–6.3	6.5	7.0
Czech Rep.	9.1	–1.8	4.0	3.1
Slovakia	16.9	–8.0	4.5	4.0
Slovenia	4.8	n.v.	n.v.	n.v.
CE	**7.1**	**–4.7**	**4.3**	**2.9**
Croatia	**1.6**	**4.5**	**5.8**	**6.0**
Bulgaria	2.5	–0.1	3.0	4.5
Romania	8.8	4.8	7.0	7.0
Serbia	n.v.	n.v.	n.v.	n.v.
BiH	3.0	3.5	8.5	10.0
Albania	7.9	7.0	n.v.	n.v.
SEE	**5.4**	**3.4**	**5.2**	**5.5**
Russia	–7.6	–4.0	3.0	4.0
Ukraine	–9.3	5.0	5.0	5.0
Belarus	–15.9	n.v.	n.v.	n.v.
EE	**–8.0**	**–3.3**	**3.0**	**3.9**
CEE	**–1.2**	**–2.9**	**3.7**	**3.8**
Austria	0.7	3.2	2.7	2.4
Germany	1.1	2.9	2.1	n.v.
Euro area	**2.2**	**3.0**	**3.1**	**2.7**
USA	**4.0**	**6.8**	**n.v.**	**n.v.**

Source: Raiffeisen RESEARCH/RBI

Current account balance (% of GDP)

	2016	2016e	2017f	2018f
Poland	–0.2	–0.5	–0.8	–1.1
Hungary	4.4	3.5	3.2	2.9
Czech Rep.	0.9	2.4	1.5	1.2
Slovakia	–1.3	–0.7	–0.7	0.2
Slovenia	5.2	7.0	6.8	6.4
CE	**0.5**	**0.6**	**0.3**	**0.1**
Croatia	**5.1**	**3.1**	**2.5**	**2.2**
Bulgaria	1.1	2.1	0.4	1.0
Romania	–1.2	–2.6	–3.3	–3.5
Serbia	–4.6	–3.7	–3.7	–3.5
BiH	–5.6	–5.4	–7.0	–7.7
Albania	–13.6	–13.6	–14.5	–12.9
SEE	**–1.1**	**–1.9**	**–2.7**	**–2.7**
Russia	5.0	2.1	5.2	5.7
Ukraine	–0.1	–3.3	–4.7	–3.9
Belarus	–3.8	–4.3	–3.9	–3.5
EE	**4.3**	**1.5**	**4.3**	**4.9**
CEE	**2.4**	**0.8**	**2.2**	**2.3**
Austria	1.8	1.9	1.5	1.7
Germany	8.3	9.0	8.5	8.0
Euro area	**3.0**	**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	–2.5	–3.1	–3.4
Hungary	–2.0	–1.5	–2.5	–3.0
Czech Rep.	–0.6	0.0	–0.2	0.0
Slovakia	–2.7	–2.5	–2.0	–2.0
Slovenia	–2.7	–2.5	–2.1	–1.9
CE	**–2.1**	**–1.9**	**–2.3**	**–2.5**
Croatia	**–3.3**	**–2.4**	**–2.9**	**–2.8**
Bulgaria	–2.8	0.3	–1.5	–2.0
Romania	–0.8	–2.5	–3.2	–3.0
Serbia	–3.7	–2.1	–1.8	–1.8
BiH	0.7	–1.5	–1.0	–1.0
Albania	–4.0	–2.5	–2.0	–1.0
SEE	**–1.8**	**–2.0**	**–2.6**	**–2.5**
Russia	–3.6	–4.4	–3.3	–2.4
Ukraine	–2.3	–3.5	–4.0	–3.0
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	–1.0	–1.3	–1.2	–1.1
Germany	0.7	0.2	0.1	0.0
Euro area	**–2.1**	**–1.8**	**–1.5**	**–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	53.3	54.9
Hungary	75.5	74.1	73.4	72.6
Czech Rep.	40.3	39.2	38.2	37.0
Slovakia	52.5	52.6	52.5	52.2
Slovenia	83.1	81.3	79.5	78.2
CE	**53.9**	**54.0**	**54.2**	**54.6**
Croatia	**86.7**	**85.3**	**84.5**	**82.9**
Bulgaria	25.6	29.0	29.0	31.0
Romania	37.9	38.2	39.3	40.2
Serbia	74.7	72.8	70.5	66.4
BiH	42.8	42.5	42.8	42.5
Albania	72.2	70.5	69.0	65.0
SEE	**47.7**	**48.0**	**48.1**	**48.0**
Russia	12.7	13.5	14.0	14.5
Ukraine	72.6	77.5	78.4	73.0
Belarus	33.0	39.0	38.7	36.5
EE	**17.2**	**18.4**	**18.9**	**18.9**
CEE	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Austria	85.5	83.4	81.1	79.5
Germany	71.2	68.6	66.3	64.0
Euro area	**90.4**	**89.4**	**88.5**	**87.4**
USA	**101.9**	**105.5**	**105.6**	**104.9**

Source: Raiffeisen RESEARCH/RBI

Gross foreign debt (% of GDP)

	2016	2016e	2017f	2018f
Poland	70.1	74.3	77.2	77.5
Hungary	107.1	97.8	89.0	83.2
Czech Rep.	69.4	73.0	77.1	73.9
Slovakia	85.4	86.1	85.1	83.5
Slovenia	116.6	110.0	104.1	103.0
CE	**64.9**	**66.5**	**67.7**	**66.5**
Croatia	**103.4**	**96.5**	**94.0**	**91.5**
Bulgaria	75.3	73.7	73.4	71.5
Romania	56.4	54.5	53.1	53.6
Serbia	81.6	74.3	70.6	66.6
BiH	53.4	54.7	54.9	54.2
Albania	72.6	71.7	69.1	67.0
SEE	**68.4**	**65.2**	**63.7**	**62.8**
Russia	39.1	40.7	32.6	27.0
Ukraine	131.5	133.4	126.6	119.6
Belarus	70.2	77.6	77.3	73.3
EE	**45.9**	**48.0**	**39.8**	**34.1**
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**	**125.2**	**n.v.**	**n.v.**
USA	**n.v.**	**n.v.**	**n.v.**	**n.v.**

Source: Raiffeisen RESEARCH/RBI

EUR/LCY (avg)

	2016	2016	2017f	2018f
Poland	4.18	4.36	4.42	4.33
Hungary	309.93	311.44	312.49	316.88
Czech R.	27.28	27.03	26.87	25.53
Slovakia	Euro	Euro	Euro	Euro
Slovenia	Euro	Euro	Euro	Euro
CE				
Croatia	**7.61**	**7.53**	**7.52**	**7.51**
Bulgaria	1.96	1.96	1.96	1.96
Romania	4.45	4.49	4.47	4.50
Serbia	120.73	123.13	123.56	124.88
BiH	1.96	1.96	1.96	1.96
Albania	139.72	137.33	137.48	139.38
SEE				
Russia	68.01	74.14	63.70	66.76
Ukraine	24.33	28.27	28.08	30.73
Belarus	1.77	2.20	2.29	2.61
EE				
CEE				
Austria	Euro	Euro	Euro	Euro
Germany	Euro	Euro	Euro	Euro
Euro area	**Euro**	**Euro**	**Euro**	**Euro**
USA	**1.11**	**1.11**	**1.03**	**1.09**

Source: Raiffeisen RESEARCH/RBI

Ratings

	S&P	Moody`s	Fitch
Poland	BBB+	A2	A–
Hungary	BBB–	Baa3	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	B–
Belarus	B–	Caa1	B–
Austria	BB	Ba1	BBB–
Germany	AA+	Aa1	AA+
	AAA	**Aaa**	**AAA**
USA	**AA+**	**Aaa**	**AAA**

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

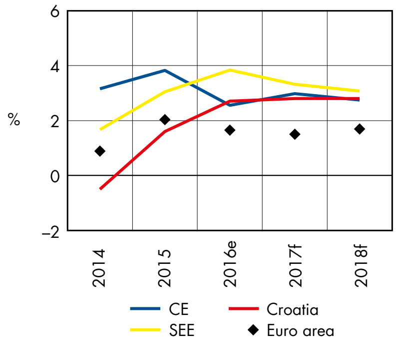
2017 – the year of opportunities to be seized

Economic growth in 2016 exceeded even the most optimistic expectations. Croatia finally caught up with the recovery dynamics of its CEE peers, and these positive developments are expected to continue over 2017. The biggest positive impact will come from domestic demand, primarily from household consumption and investments, both public and private. These GDP components will be positively influenced by the new tax reform that passed through the parliamentary procedure in Q4 2016. The aim was to create a stable, simple, and sustainable tax system, reducing the tax burden on entrepreneurs and households at the same time. In addition to alleviating the tax burden the reform increases the potential GDP growth. The cost of the tax reform in terms of lower budget revenues is expected to be compensated through higher consumption and investments. Beside the elimination of certain exemptions, the reduction will spur consumer optimism, while the alleviation of the tax burden from entrepreneurs will enhance their competitiveness. Based on subdued inflation and the expectation that the year 2017 could bring another excellent tourist season, we project that household consumption will continue the growth trend seen in 2016. The importance of tourism is reflected in the structure of accommodation, where the share of private accommodation is significant. According to our expectations, tourism will continue to generate investments. Amid the start of a positive business cycle, investments have gained momentum also from the improved utilisation of EU funds. The latter pertains to both private and public investments. The expected strengthening of domestic demand and the relatively strong growth in exports of services (primarily tourism) entails stronger growth of imports of goods. Therefore, we expect a slightly negative effect of net foreign demand. In this context, the low competitiveness of the Croatian real sector (industry) and the consequently high import dependence comes to the foreground. Actually, despite the positive changes and the fact that Croatian companies (especially SMEs) turned to foreign markets, the exports of goods and their importance in Croatia remain too minor and weak to be a serious growth driver. Moreover, it clearly emphasises the structural problems of the local market. In addition to strengthening the rule of law, the problem of the large public systems should be the key issues that the government has to tackle in the first year of their mandate. Amid much improved fiscal indicators, in 2017 the government has a chance to make economic growth stable and sustainable. Despite the realistic appearance of the revenue side of the budget for the three-year period from 2017 to 2019, the chance to reduce and structurally change the expenditures was again squandered. Namely, the significant pressures of different budget users increase the risk of further expenditure growth and also the risk of postponement of the necessary measures. Therefore, our assessment of the deficit in the state budget remains more conservative compared with the government's forecasts but still sufficient to achieve a primary surplus and slowly reduce public debt.

The year 2017 is probably the last year of lower interest rates in the European market. Amid subdued inflation and modest recovery rates, the ECB, as well as the CNB, are most likely to continue their expansive monetary policies. The exit strategy, however, which is expected to start in 2018 at the latest, remains a bit of a mystery. It is the point when financing costs are expected to grow, impacting the countries with the worst fundamentals that failed to use the period of ample liquidity and low interest rates to adjust and make positive changes.

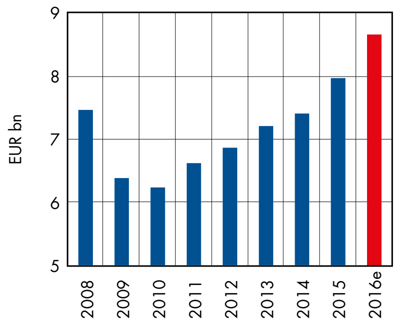
Zrinka Živković Matijević

Real GDP (% yoy)



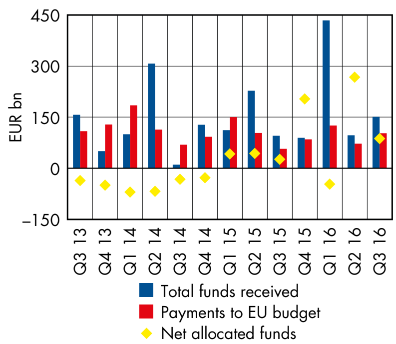
Sources: Eurostat, Raiffeisen RESEARCH/RBI

Travel receipts (tourism)



Sources: CNB, Economic RESEARCH/RBA

Transactions with the EU budget

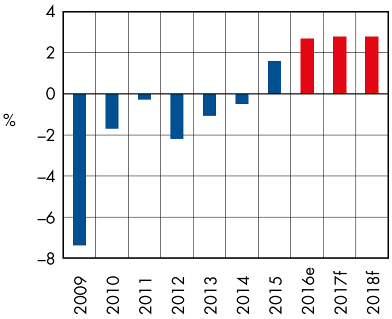


Sources: CNB, Economic RESEARCH/RBA

Growth propelled by domestic demand

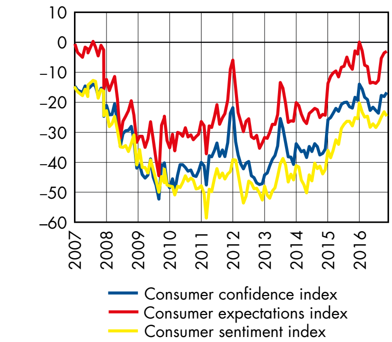
- **Personal consumption and investment continue to grow**
- **High import dependence diminishes positive impact of goods and services exports**

Real GDP (% yoy)



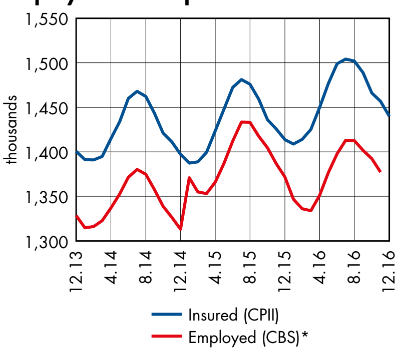
Sources: Eurostat, Raiffeisen RESEARCH/RBI

Consumer sentiment indicators



Sources: CNB, Economic RESEARCH/RBA

Employment and persons ensured



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

After the better-than-expected GDP growth in the period from January to September the first high-frequency indicators show a continuation of economic growth again in the last quarter of 2016. As a result, we expect real annual growth over the last year to reach 2.7%. A healthy growth of personal consumption is also reflected in the data on real retail turnover and growing consumer optimism. Consumer confidence, consumer expectations and consumer sentiment index neared the levels before the big recession. The more positive outlook of households is surely based on two key factors: extended tourist season and taxation changes. The latter already in the first month of the year alleviated the burden from income so personal consumption in 2017 will again be propelled by the relatively high growth of real salaries given that inflation is expected to remain quite subdued. Due to expectations of a prolonged tourist season, but also its excellent results, we expect that the largest component of gross domestic product, personal consumption will have a noticeably positive effect on GDP throughout 2017. While this model reminds of pre-crisis period it is noteworthy that the new household borrowing cycle is still in its infancy given that loan demand is recovering slowly. The years-long household deleveraging neared its end, but 2017 is expected to bring about only a modest demand for loans. Therefore, a more substantial growth in personal consumption induced by borrowing is not to be expected. Namely, household indebtedness remains high (35% of GDP), with the weak labour market remaining a limiting factor (especially for long-term borrowing). Labour market trends are not encouraging in terms of creditworthy debtors (due to modest employment growth), while the expected growth of average creditworthiness (based on salary growth) currently indicates only a mild growth in demand for loans in the household segment.

Seemingly, the labour market is improving. According to our expectations, the year-on-year employment growth, i.e. the growth of the number of insured persons with the CPIA, at the rate of above 1.5% is expected to continue in 2017. At the same time, the average Labour Force Survey unemployment rate, including the usual seasonal fluctuations, should decline from the estimated 13.6% to 12.5%. Nevertheless, the known structural weaknesses of the labour market, such as the mismatch between supply and demand, low level of employment and activity, have still not been addressed. In addition, Croatia is faced with accelerating emigration of the working age population. Should these trends continue in the mid and long term they will be connected with a series of negative consequences and will diminish the growth potential.

Although at a slower pace, the continuation of the growth in GFCF continued in the second half of 2016 is encouraging. Investments gained momentum through EU funds so our projections indicate that they will be one of the key growth factors this year. According to the latest data, net funds received and net funds allocated to ultimate beneficiaries of EU funds have grown, nearing 1% of GDP in 2016. The potential for utilising EU funds is seen both in the private and the public sector. It is noteworthy that local elections are due in 2017, which normally means stronger investments from public funds.

This growth in domestic demand is bound to increase the imports of goods. Its higher volume will also be a result of the contribution made by the expected growth in the prices of energy and food products. This will greatly diminish the positive effect of the exports of goods and services. Therefore, despite the expected continuation in the growth of the exports of goods and services we expect the contribution of net foreign demand to be slightly negative. This will again bring the low competitiveness of Croatia's real sector (industry) and consequently high import dependence into the spotlight. Namely, despite positive changes and the fact that Croatian companies (especially SMEs turned to foreign markets), the export of goods and services and its significance remains small and insufficient to spur growth. Moreover, it clearly stresses the problems of the local market, which are primarily structural in nature. They include an expensive and inefficient public administration whose frequent changes of regulations hinder the functioning of the market economy. In other words, increasing competitiveness solely by reducing the tax burden will not suffice. In order to ensure stronger and also more sustainable growth the government will need to reach for long-postponed reforms. This is clearly indicated by competitiveness indicators which remained unchanged over time or even deteriorated (health care, primary education and innovation). Finally, government consumption is expected to rise as can be understood from the adopted 2017 Budget.

On the supply side, growth is expected to continue especially in activities closely related to tourism and trade. A modest recovery is expected in construction as well, while manufacturing, after having slowed down in Q3 is expected to see slightly stronger annual growth rates. Paired with the projected growth in Croatia's most important trading partners, the upward cycle in manufacturing will continue throughout 2017.

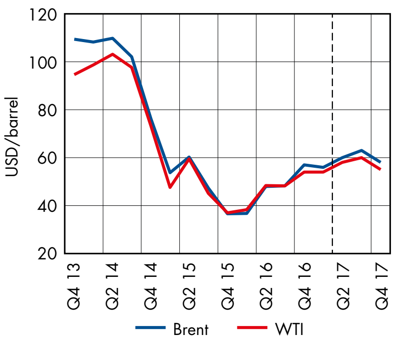
The risks for the realisation of the expected economic growth at the real rate of 2.8% in 2017 are balanced. Positive risks come from the higher impact of the tax reform on consumer spending and possible noticeable improvement of the business climate which would together with the alleviation of the taxation burden from corporates encourage entrepreneurs to invest and hire workers.

As for short-term negative risks, there is the possibility of a slowdown in the recovery of our main trading partners and the great exposure to tourism, which in case of any incidents may greatly deteriorate and jeopardise recovery. Namely, the materialisation of negative risks would directly lead to a decline in the export of services, personal consumption and consequently to much lower budget revenues.

In order to achieve long-term sustainability and stability, as well as an increase in the potential growth rate, it is necessary to implement the widely known measures aimed at improving the investment climate, reform public systems, strengthen the rule of law and increase the efficiency of the public administration. Otherwise, changes in the external environment will push Croatia back to stagnation and comparable falling behind the rest of Europe.

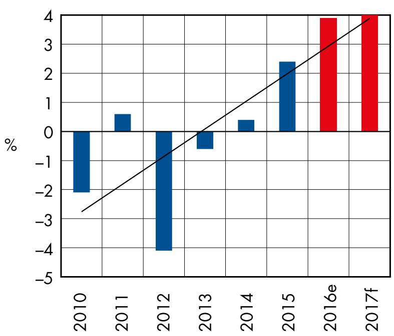
External vulnerability continued decreasing in Q3 through the fall in gross external debt and stable surplus in the balance of payments current account.

Crude oil



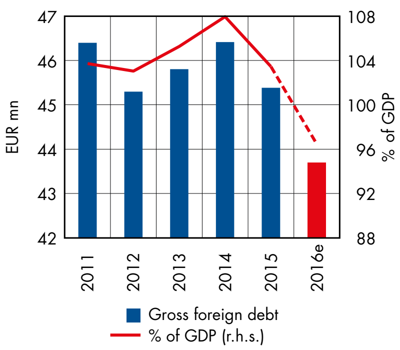
Sources: CBS, Raiffeisen RESEARCH

Retail trade, real annual changes



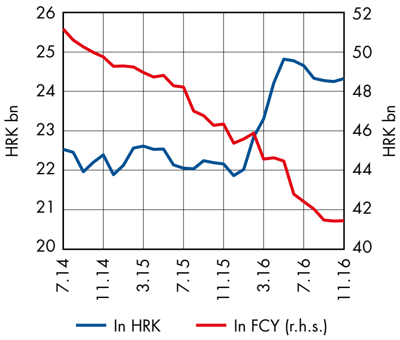
Sources: CNB, Economic RESEARCH/RBA

Gross external debt



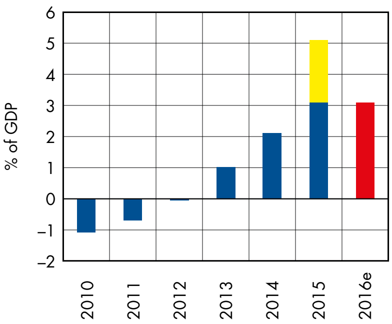
Sources: CNB, Economic RESEARCH/RBA

Working capital and investment loans to non-financial corporations



Sources: CNB, Economic RESEARCH/RBA

C/A balance



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

The fall of gross external debt to below 95% of GDP was, in addition to the growth of the economy, a result of the deleveraging by all sectors towards their foreign creditors, especially by the government and financial institutions, more precisely by banks. The below 100%-level was last recorded in Q3 2009. While the government postponed the issue of its Eurobond in the spring, banks have deleveraged due to relatively cheaper domestic deposits, high liquidity and still modest demand for loans. Further, much more favourable conditions in the domestic market have motivated the corporate sector to substitute a share of debt to foreign creditors by borrowing domestically. Historically, corporates preferred borrowing in euros due to lower interest rates. However, the supply of loans in kuna offered by domestic banks had competition from foreign banks and other types of financial debt instruments. Therefore a half of total corporate debt is accounted for by direct borrowing abroad, which, of course, is denominated in foreign currency, predominantly euros. The supply of kuna loans at interest rates that can compete with borrowing in euros has contributed to a change in the currency structure of loans in domestic banks but also to a change in the trend of corporate borrowing. Due to the growth of kuna loans, borrowing aboard has decreased and borrowing with domestic banks increased. This trend is expected to continue and gain strength in 2017. Corporate demand for loans is expected to grow even more and gradually absorb surplus liquidity.

We expect the surplus in the balance of payments current account, even after the effects of the conversion of loans indexed to the Swiss franc (estimated at some 2% of GDP) have worn away, to remain at some 3% of GDP in 2016, trending down to 2% throughout this year. The deterioration in the goods account, caused by the stronger growth of imports and better business results of foreign companies (which thus increase the expenses of the primary income account) will be softened by the expected increase in the surplus in the services account and higher income in the secondary income account where allocated funds received from EU funds are registered. Foreign currency inflow from tourism might exceed EUR 8.5bn at the 2016 level, which is nominally an all-time high, while in 2017 we expect positive trends to continue but at more moderate pace.

In the medium-term, interest expenses to non-residents have the potential to reduce amid high global liquidity, given the fact that possible refinancing over the next year is to be realised at historically low interest rates.

Zrinka Živković Matijević

Expectations from tax reform too high?

- Fiscal indicators for 2016 better-than expected
- 2017 Budget: no structural changes
- Constant fiscal risks in the year of record government debt maturities

Under the conditions of rising instability during the politically tumultuous 2016 during which Croatia counted as many as three PMs, the real sector of the economy on one side and the "frozen" public sector on the other proved to be the winning combination. At least in the short run.

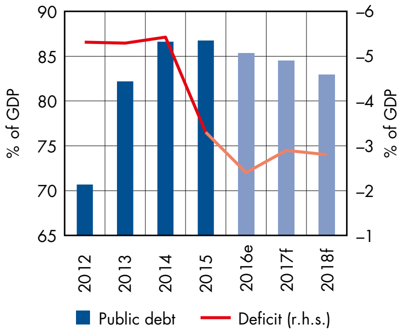
Propelled by a record tourist season, ample excise duty and VAT revenues that poured into the budget accounted for the bulk of budget revenues. On the other hand, temporary financing and later on the legally restricted public spending during the period of a technical Government created a good foundation for the 2017 Budget. Namely, this led to the better-than-expected fiscal consolidation reflected in a substantial deficit reduction which consequently also contributed to the decrease in public debt that went down to HRK 289bn at the end of Q316. Since economic growth accelerated to 2.9% in this period (reaching the highest real growth rate since Q208), public debt as a share of GDP decreased to below 85%. Due to the currency structure, the HRK strengthening additionally contributed to the decline in indebtedness so the awaited data for the end of 2016 will surely show a decline in public debt as a share of GDP, for the first time after six consecutive years.

Although the snap parliamentary elections left relatively little time to propose the 2017 Budget, the focus of the fiscal policy to be pursued by the new Government has been set on the tax reform that had been prepared much earlier. Pressed by time in December of last year, the Croatian Parliament adopted a whole array of regulations with a significant majority of votes, thus regulating the new tax reform and subsequently adopting the state budget for the upcoming three-year period. Within the framework of the forecasted economic growth at real rates exceeding 3% in the period 2017–2019 the Government envisaged a gradual reduction of the fiscal deficit to below 1% of GDP by the end of the projection period. However, below the surface of the main assumptions it is evident that this expectation of a deficit reduction relies heavily on the forecasted economic growth that is expected to be strongly influence by the tax reform[1]. Although the business community, as well as the greater public greeted the alleviation of the tax burden aimed at increasing income and profit, the risk for the expected GDP growth (and thus the associated tax income) arise from the partial failure to channel the freed income and/or profit into consumption or investments. While higher investment stimulus spurred by better utilisation of EU funds is encouraging, personal consumption (spurred by tax changes) has been hailed as the main driver of domestic demand in the medium term. The additional risk regarding the desired growth comes from net foreign demand which has been, during the entire projection period, warning of the heavy reliance of Croatia's economy on import.

Therefore, the proposed fiscal adjustment aimed at reducing the budget deficit, which should find its main foothold in the expected GDP growth reminds of the

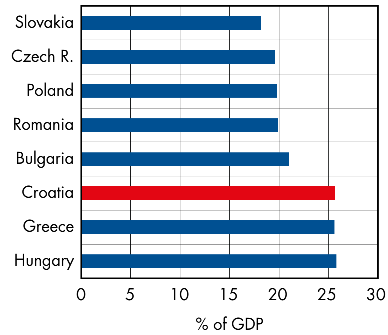
1 The Government assessed the multiplicative effect of the tax reform at 0.5% of GDP.

Consolidated General Government (ESA2010)



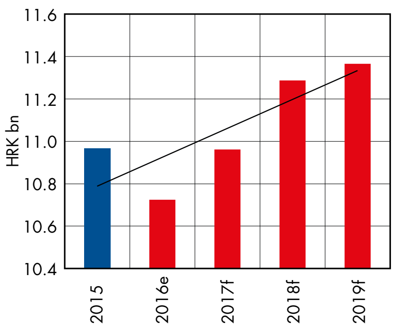
Sources: CBS, Economic RESEARCH/RBA

Total tax receipts, as % of GDP*



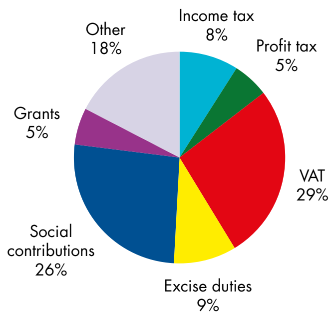
** in 2015*
Sources: Eurostat, Economic RESEARCH/RBA

Expenses on interests*



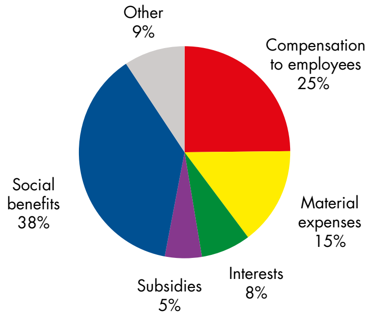
** Central Gov't budget*
Sources: MoF, Economic RESEARCH/RBA

Consolidated Central Government revenues I–IX 2016*



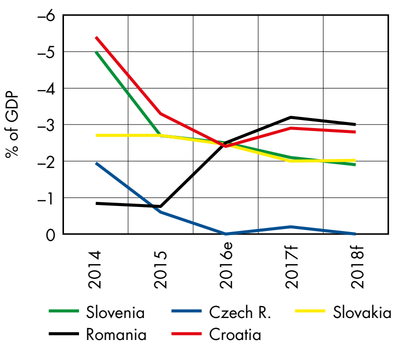
* GFS 2010 metodology
Sources: MoF, Economic RESEARCH/RBA

Consolidated Central Government expenses I–IX 2016*



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

Consolidated General Gov't balance, as % of GDP



Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

scenarios we have already seen and in which the projected economic recovery was an alternative to the necessary structural changes. The later is confirmed by the expenditure items of the state budget which reflect the already familiar rigid structure dominated by expenditures for social benefits, employees and interest rates. Taking into account the unwavering demographic trends (additionally exacerbated by strong outflow of working-age population), fiscal risks pertaining to the sustainability of social expenditures have been gaining strength, especially in the segment of expenditures on pensions and health care. Namely, this year alone is expected to see an increase in the total number of pension beneficiaries by some 5000, which added to the costs of pension adjustments results in a relatively strong increase of total expenses on pensions which are about to exceed HRK 37bn on an annual level (accounting for a third of the overall budget expenditures).

Even with greater political awareness concerning the problem of depopulation and demographic dispersal (which is currently reflected in several different channels striving to support demographic revival), population ageing and uninterrupted decline in the share of the working-age population creates considerable pressure on the sustainability of public finances in the medium and long-term. The outflow of the young, working-age population is a consequence not only of the open EU market (with a rising need for specialised highly-educated employees) but also of the period of years-long recession which was not used to carry out the key economic structural changes. In this context, the risks that arise from the missed opportunities to turnaround the fiscal policy toward reducing unproductive expenditures aiming at the rationalisation of the public bureaucracy and freeing more space for the private sector have been gaining strength. Although increased reliance on EU funds is welcome, procedural risk in this segment should not be ignored.

In the meantime, the pressure from the union of Croatia's public sector workers to increase the basic salary resulted in a new blow to government expenditures on employees which, in line with this year's budget plan, went up by HRK 700m (+2.7%). However, the agreed gradual increase by 6% on three occasions in 2017 renders it almost certain that the budget will need to come up with the difference in funds, according to the latest agreement with the unions, as compared to the initially budgeted figures for this year.

In addition, arrears in the health care sector over the upcoming period will represent a burden for Croatia's public finances (reflecting not only more expensive health care services but also the unfavourable structure of the system's beneficiaries paired with the still weak private sector). At the same time, in view of the upcoming local elections it is unlikely that the growing appetite of different budget users will remain unsatisfied. Accordingly, our projections for this fiscal year are much more conservative. With the annual interest expenses reaching HRK 11bn Croatia's state treasury will this year be faced with exceptionally high liabilities arising from the matured government debt. Last year's consolidation has, in a way, already been awarded by the S&P (that revised its outlook for Croatia's sovereign credit rating from negative to stable). However, for its credit rating to re-enter the investment grade it is necessary to carry out the reform of the public system.

Tomislava Ujević

The year of large maturities

- **Credit outlook upgraded to stable**
- **Yields remain at low levels**

Political stability, stronger-than-expected economic growth and favourable fiscal metrics confirmed our expectations regarding the improvement of the credit outlook when in the mid of December 2016 the S&P changed Croatia's outlook from negative to stable. However, the country's credit rating remains two levels below investment level and its risk premium above that of its CEE peers. This clearly reflects investor caution and the fact that restoring investor confidence and a rating upgrade require much effort and strongly depend on solid and successful implementation of comprehensive reforms.

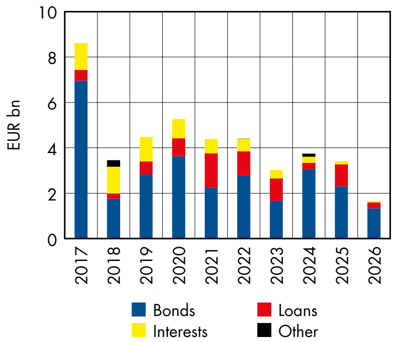
Last year's postponed issue of a government bond in the international market contributed to noticeable changes in the financing structure of government debt. According to the latest data for the end of Q3, the foreign component of public debt fell at the monthly and annual level, while the parallel growth of the domestic public debt received support from the improved borrowing conditions in the domestic financial market. The already high liquidity received additional boost from the central bank's expansionary measures thus continued to create additional downward pressure on borrowing costs and also on the longer end of the government bonds' yield curve.

The year ahead will not be an easy one in terms of liabilities due: HRK 18.4bn, maturing under issued government securities and HRK 8.9bn required for the repayment of the principal under received loans. Gross financing needs (including short term debt) in 2017 exceed 17% of the estimated GDP. Therefore, we expect the government to assume a more active role in the primary capital market, both domestic and international. A pure kuna issue, worth HRK 5.5bn falls due already in February. In a shallow market, i.e. when securities in the domestic market are scarce, we expect the government to feed the hunger of large local market participants (primarily compulsory pension funds) for pure kuna issues. An issue denominated in domestic currency is also in the interest of banks given the upcoming application of European Regulation on prudential requirements for credit institutions and investment firms[1] that brings changes in terms of risk weighting and exposure limitation given the foreign currency exposure to the government.

On the other side, after the Brexit and the unexpected win of Donald Trump in the US presidential elections, the global market started the New Year in a relatively peaceful tone. The quiet period in the global market and an improvement in the credit outlook make the government's issue in the international market seem like a good opportunity. Early in April, the principal, worth USD 1.5bn, of a bond issued in 2013 falls due. In case the Government decide to tap the international market it will be the first government Eurobond issue in two years. Given that the ECB announced a continuation of its unconventional policy, and that the Fed announced the raising of its interest rates, market situation and expectations speak

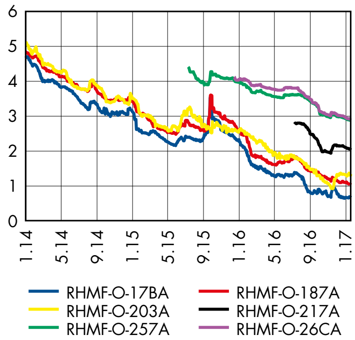
1 Regulation (EU) No 575/2013 of the European Parliament and the Market of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (Official Journal EU L 176/2013).

Governement debt maturity



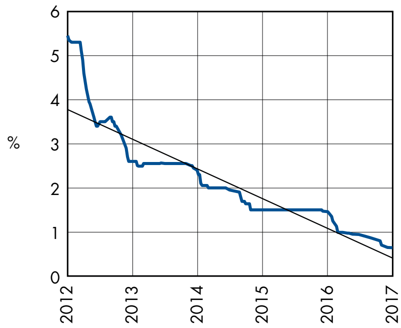
Sources: Bloomberg, Economic RESEARCH/RBA

Croatian government bonds yields (HRK)



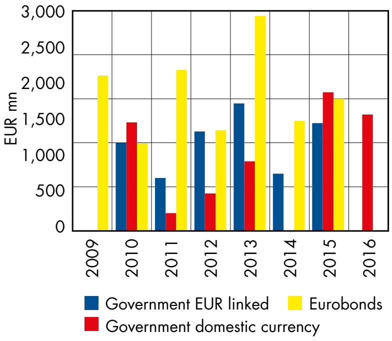
Sources: Bloomberg, Economic RESEARCH/RBA

1-Y HRK T-bills yield



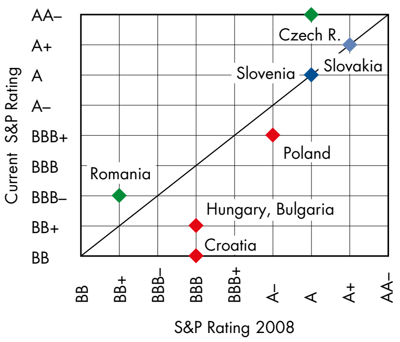
Sources: MoF, Economic RESEARCH/RBA

Governement bond issues



Sources: MoF, Economic RESEARCH/RBA

S&P sovereign credit rating 2008/2016*



Sources: Eurostat, Economic RESEARCH/RBA

of a likely issue in the European market.

Bond prices in the secondary market might remain relatively high in this year's first half, and yields low, additionally supported by ample liquidity in the system. The historic lows of yields on T-bills and their uninterrupted downward tendency continue to direct investors towards shorter kuna maturities of government bonds. In the current market conditions they represent a more attractive form of investment than T-bills. The CNB's continued expansive monetary policy will again pressure interest rates in the money market so an upward change in yields of short-term debt securities in 2017 would be hard to expect.

The stable growth of demand for long-term kuna bonds and the ever present shortage of long-term securities paired with improved economic fundamentals are expected to exert pressure on the longer end of the kuna curve in the first half of 2017. This is supported by the continuation of CNB's long-term structural operations. Under the assumption of unchanged market condition, but increased inflationary pressures, the expected withdrawal of liquidity from the system is to be expected at the very end of the year when yields could also registered a slight upward shift.

Croatian Eurobonds continued following in the path of bonds from the CEE region. Again this year, ample liquidity in the European markets, as a consequence of the expansionary monetary policy pursued by the ECB with historically low yields will continue to positively affect developments relating to CEE bonds which will reflect itself in the movements of Croatian issues.

Elizabeta Sabolek Resanović

Government bonds in domestic market

Bond	Currency	Volume (mn)	Maturity	Coupon (%)	YtM (ask, %) 16.1.17	*Spread to Bund* 16.1.17	*Spread to EUROSWAP* 16.1.17	YtM (ask, %) 30.9.16	YtM (ask, %) 30.6.16	YtM (ask, %) 31.12.15
RHMF-O-19BA	EUR*	1,000	29.11.19	5.375	1.05	198	139	0.94	1.63	2.44
RHMF-O-203E	EUR*	1,000	5.3.20	6.500	1.15	207	148	1.01	1.63	2.49
RHMF-O-227E	EUR*	1,000	22.7.22	6.500	2.25	279	227	2.63	3.22	3.49
RHMF-O-247E	EUR*	1,400	10.7.24	5.750	2.61	290	148	2.96	3.37	3.81
RHMF-O-172A	HRK	5,500	8.2.17	4.750	1.65	–	–	0.29	0.68	1.63
RHMF-O-17BA	HRK	4,000	25.11.17	6.250	0.63	–	–	0.67	1.19	1.97
RHMF-O-187A	HRK	6,000	10.7.18	5.250	0.89	–	–	1.18	1.64	2.23
RHMF-O-203A	HRK	5,000	5.3.20	6.750	1.49	–	–	1.62	2.13	2.73
RHMF-O-217A	HRK	6,000	8.7.21	2.750	1.93	–	–	2.00	–	–
RHMF-O-257A	HRK	6,000	9.7.25	4.500	2.82	–	–	3.12	3.53	3.87
RHMF-O-26CA	HRK	10,000	14.12.26	4.250	2.79	–	–	3.21	3.74	3.99

** indexed to euro; secondary trading, interest and principal payment mid rate of CNB on trading day or maturity day*
Sources: MoF, ZSE, Bloomberg, Economic RESEARCH/RBA

HRK strenghtening boosted by improved fundamentals

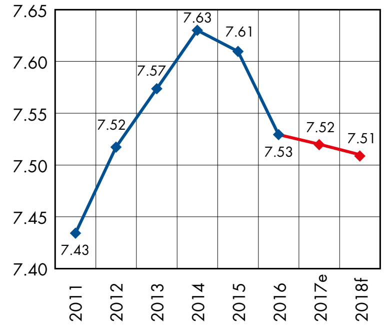
- **Expansive monetary policy continues paired with stable EUR/HRK**
- **Return of the positive inflation rates**

The weakening of the kuna against the euro characteristic for the last quarter of the year was less intensive compared to the previous periods. In the observed period, the exchange rate was exceptionally stable with a rising tendency of the domestic currency. Consequently, the CNB intervened three times in the FX market by purchasing foreign currency worth EUR 785m from commercial banks. As a result the central bank created liquidity in the amount of HRK 5.9bn. The movements of the exchange rate were relatively modest so the EUR/HRK was again at the end of the year lower than in the same period over the past four years. The strengthening of demand for the kuna in the last quarter was related to the extension of the tourist season, holiday spending but also solid economic fundamentals.

Slight depreciation pressures on the kuna paired with increased trading volumes marked the first weeks of 2017. They were caused primarily by corporate and bank demand for foreign currency thus the EUR/HRK exceeded the level of 7.58 for the first time in almost ten months. The settlement of liabilities arising from the imports of goods and services and the consequent demand for foreign currency paired with ample kuna liquidity and low interest rates do not allow room for the HRK strengthening in longer period. The demand of euros in the Q1 17 should also be spurred by the expected higher payments of dividends to non-residents as compared to the previous year. On the other hand, domestic currency will continue to be supported by the healthy surplus in the balance of payments current account, by reduced fiscal risks, inflow of foreign currency from tourism, the revival of investment activity, positive net foreign position of banks and the growing demand for HRK loans. This means that it is likely that the majority of the first quarter in the FX market will be marked by the EUR/HRK trading range between 7.52 and 7.58 with the majority of the trade being concluded at the mid-point of the range. It is possible to see a decline in the EUR/HRK exchange rate as the quarter nears its end due to expectations of stronger holiday demand for the kuna and the inflow of foreign exchange from the beginning of the low season. A possible government's Eurobond issue should not affect market developments because of the foreign liabilities that will have to be settled so the effect on foreign currency reserves will be relatively neutral. A domestic issue (most probably denominated in the HRK) would provide support to the kuna despite the ample liquidity continued to be ensured by the expansive monetary policy of the central bank. Without prejudice to its commitment of the EUR/HRK stability, the central bank announced that it would continue its expansive monetary policy via repo operations. According to initial expectations the amount of this-year's structural operations will be some HRK 0.5bn (a half of the last year's amount). Ample liquidity in the system continues to push down interest rates along the curve, with the absence of the negative impact on inflation. Although positive figures regarding the growth of consumer prices could be seen already in the first months of 2017, inflation will remain subdued. A spur to higher prices will come from the strengthening of imported inflationary pressures, primarily from the commodities market of crude oil and food raw materials, and might partly arise from the effects of the tax reform (growth of VAT on certain services and excise duties).

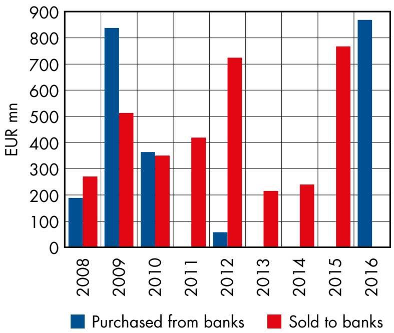
Zrinka Živković Matijević

Mid EUR/HRK, annual avg



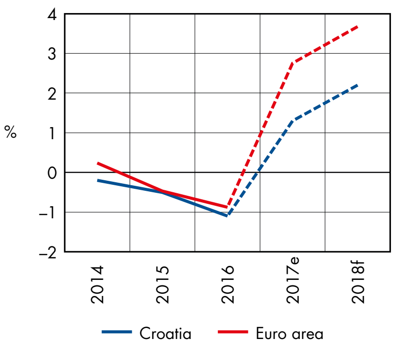
Sources: CNB, Economic RESEARCH/RBA

FX interventions



Sources: CNB, Economic RESEARCH/RBA

CPI, annual changes

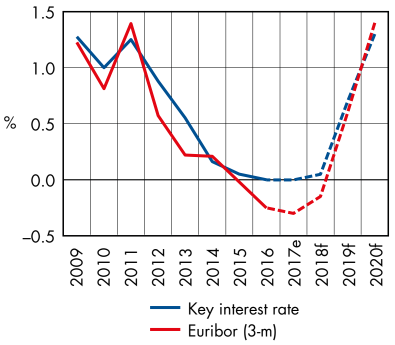


Sources: CNB, Economic RESEARCH/RBA

Divergence between the leading central banks

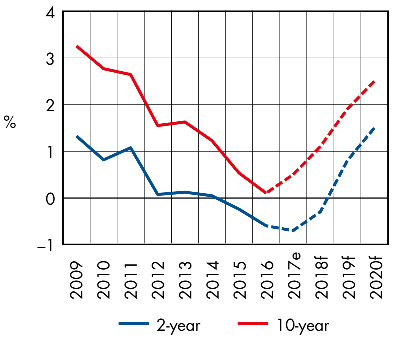
- **Fed: first steps towards interest rate normalisation**
- **ECB: bond purchase programme extended**

Interest rates in eurozone, avg



Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

German bonds, average yields



Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

Overview of USA rate forecasts, eop

Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

At the meeting of the ECB's Governing Council held early in December, the ECB decided that its interest rates will remain unchanged and that it will continue its monthly asset purchase programme at EUR 80 billion until the end of March. The programme is intended to continue until the end of 2017 but with a gradual reduction of the monthly pace of purchase to EUR 60bn (starting from April this year). However, the ECB clearly stressed that if economic of financial conditions become less favourable the Governing Council intends to readjust its QE programme. In other words, an abrupt termination of the programme is not scheduled for the end of the year although its extension for a much longer period is also not expected. We expect that with continued economic growth and inflation nearing the target (strongly driven by the latest agreement by OPEC members regarding cuts to production quotas in the crude oil market), fundamentals registered at the end of this year might ultimately prove to be a good foundation for gradual tightening of the ECB's monetary policy. Apart from the mentioned economic criteria, there are several others indicating that after 2017 the time has come to soften the expansive character of the monetary policy currently pursued by the ECB. Primarily, one should take into account that the current combination of measures within the framework of monetary easing will become less effective over time, at the same time increasing the risk of possible negative impacts (asset price bubbles and rising debt levels). In addition, a longer extension of the asset purchase programme might lead to the problem of a scarcity of securities (primarily along the shorter end German yield curve). We also think that the ECB has no intention of taking over a dominant creditor role, which would ultimately reduce the effectiveness of the free market over the long run. Finally, one should not forget the fact that 2017 will be politically an exceptionally significant year given the upcoming presidential and parliamentary elections in the Netherlands, France, Germany (and possibly Italy). Therefore, taking all this into consideration, we think that in the first half of 2018 the ECB will opt for gradual tightening of its monetary policy, with the first interest rate hikes expected at the end of next year. However, 2017 will be marked by ample system liquidity and low interest rates holding Euribor at approximately current levels. Consequently, pressure on yields at the shorter end of German bonds will remain relatively weak. Nevertheless, rising expectations relating to inflation might, as the year nears its end, reflect themselves in the mild growth of yields on longer- term German issues.

On the other side of the Atlantic, the latest FOMC meeting, as expected, ended in the decision to raise the key interest rate by 0.25pp and announcement of accelerated increase dynamics over this year. However, given the Fed's caution thus far we stand by our expectations that interest rates will be increased twice in 2017 (perhaps the hike in March will be skipped). In the meantime, the beginning of the Trump presidency (who announced a more expansive fiscal policy) paired with market expectation of higher inflation rates and healthy US labour market indicators are expected to bring a continuation in the rise of yields on the US government bonds this year.

Tomislava Ujević

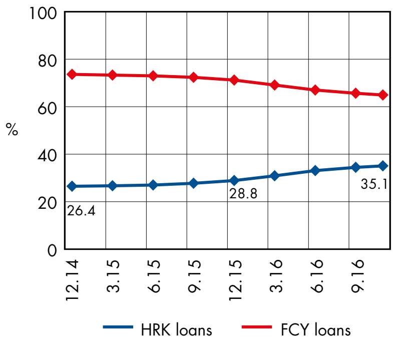
Structural changes in demand spur credit growth

- **Reduction of foreign currency loans accelerates bank deleveraging abroad**
- **Share of non-performing in total loans declines**
- **Risk reduction increases bank profitability**

The central bank's structural operations increased banks' long-term kuna sources of finance. Consequently, interest rates on banks' kuna loans reduced, while the positive interest differential of loans in euros vis-a-vis kuna loans melted away. The increase in the attractiveness of borrowing in kuna reflected itself on the currency structure of the loan demand. Demand for kuna loans in the corporate sector increased, while the demand for loans in euros decreased. Given that a half of the overall corporate debt pertains to direct borrowing abroad, the decline in demand for loans in euros reflected itself in the reduction of foreign indebtedness. The increase in the attractiveness of supply of kuna loans prompted corporates to start substituting their euro denominated debt with foreign creditors by kuna loans with domestic banks. As for the household sector, a conversion of loans in the Swiss franc into loans in euros was conducted in the H116. One of the consequences was the strengthening of aversion to currency risk which reflected itself in the reduction of demand for loans in euros. Therefore, although the overall amount of loans to households has stagnated, the share of kuna loans increased. We expect the currency structure of loans to continue changing throughout 2017. New loans are predominantly granted in kuna, so the share of kuna in total loans increases in accordance with the loan repayment maturity. In the past four years banks decreased their reliance on secondary sources of financing. Deposit growth paired with loan stagnation enabled them to use surplus liquidity to deleverage abroad. However, the fall in the share of foreign borrowing in total bank assets to below 10% indicates that the deleveraging process is close to its end. In addition to the observed trends in banks' balance sheets, 2017 is expected to bring about further growth of surplus liquidity. Given that the deleveraging of banks abroad neared its end we are expected to see central bank's interventions aimed at stabilising banks' currency structure. The strengthening of corporate demand for loans and stagnation of demand in the household sector should result in the rise of overall loans. However, the process of banks cleaning their balance sheets from NPLs had an opposite effect. The year 2017 is the year when the one-year period during which the write-off of receivables qualifies as a tax reduction enters into force. Therefore, we expect a greater influence of write-offs of receivables and sale of placements on overall loan figures. As a result, despite the increase in demand for loans in the corporate sector, total loans might even reduce. The cleaning up of banks' balance sheets might have a positive influence on the share of NPLs in total loans. Late in Q3 this ratio went down to below 15%. Should the activities in 2017 remain in line with expectations it might near 10%. The greatest room for improvement is found in the real-estate sector where the ratio on NPLs to total loans exceeds 50%. In 2016 banks increased their operating profitability to two digit levels. The increase in profit resulted from one-off gains from relaxing risk provisions after the reduction of the calculation basis in the process of CHF loan conversion and from the sale of bank shares to international card companies. There are no expected one-off gains that might positively affect bank operating results in 2017. The expected return on bank capital should range at levels average in the past years, i.e. within a band from 5% to 10%.

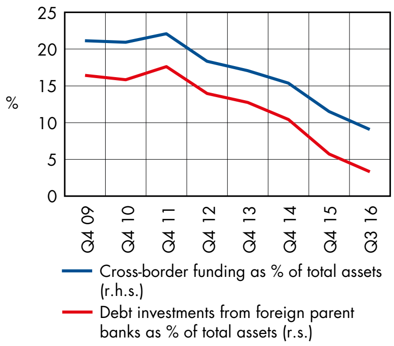
Anton Starčević

Loans – currency structure in %



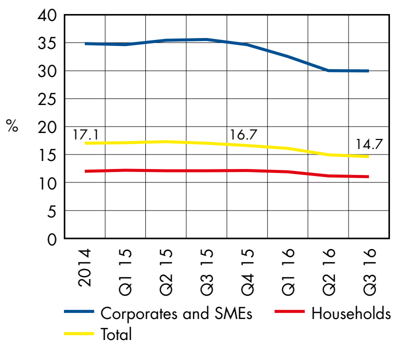
Sources: CNB, Economic RESEARCH/RBA

Debt investments in Croatian banks



Sources: CNB, Economic RESEARCH/RBA

NPLs ratio, eop

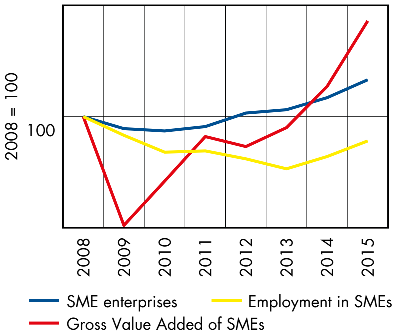


Sources: CNB, Economic RESEARCH/RBA

SME recovery continues

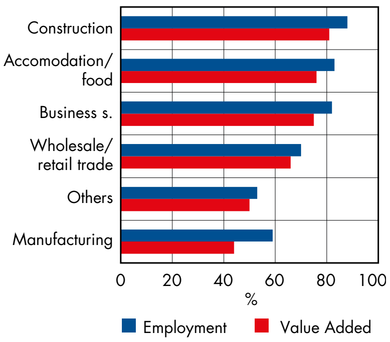
- **Croatian SMEs follow developments in EU**
- **Value added and employment on the increase**
- **Stronger growth in information and communication sectors, construction and manufacturing still lagging behind**

Number of SMEs in the EU28 (SME value added and employment in the non-financial business sector)



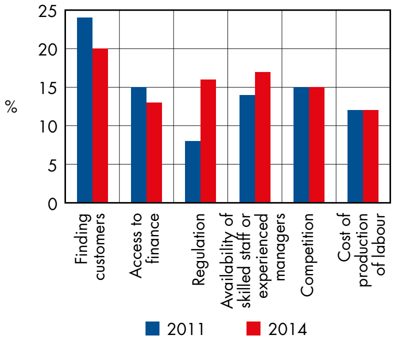
Sources: Eurostat, EC, Economic RESEARCH/RBA

Relative contribution of SMEs to total non-financial business sector value added and employment in the five largest SME sectors in 2015, EU28



Sources: Eurostat, EC, Economic RESEARCH/RBA

Most pressing problems faced by SMEs



Sources: Eurostat, EC, Economic RESEARCH/RBA

In the EU small and medium enterprises are omnipresent, characterised by strong diversity they are dispersed across all sectors of the economy. In accordance with the latest report of the European Commission, SMEs accounted for over 67% of total employment in the non-financial business sector[1] in 2015. They accounted for a high 99.8% of all enterprises and employed 90 million people, generating 58% of the value added. Almost all SMEs (as many as 93%) are micro enterprises (with less than 10 employees). Three quarters of all SMEs are active in the five key sectors: wholesale and retail trade, manufacturing, construction, business services, accommodation and food services, and construction which account for 79% of SME employment and 71% of SME value added in the EU.

The EC established that the recovery of EU SMEs from the consequences of the economic and financial crisis started in 2013. After a long period of unfavourable economic developments, value added grew in 2015 for the second year in a row. For the first time since the recession, employment grew in 2014. As a result of the strong growth, in 2015 the value added generated by EU SMEs in the non-financial business sector grew by almost 9% on 2008. However, employment in this sector is still some 2% below the 2008 level. The business service sector boasted the best results among EU countries across all three SME performance indicators (increase in employment, value added and number of enterprises). Value added in this sector grew by more than 7.6% in 2015. The other four key sectors and the 'other sectors' also recorded value added growth, while employment growth in these sectors was much weaker, especially in *construction* where the growth rate again slowed down. Namely, SMEs in construction, and, to a somewhat lesser extent, in manufacturing, were hit hard by economic and financial crisis. Employment in these two sectors in 2014 continued was respectively 17% and 11% below 2008 levels, whereas value added in *construction* remained 18% below the 2008 level. In manufacturing it has almost reached the level it stood at in 2008. A more detailed analysis might show that in most Member States full recovery in terms of the number of SMEs was achieved in *service sectors* while the reverse was true in *manufacturing* and *construction*. The general economic conditions faced by SMEs are slowly recovering. Finding customers remained the most pressing problems for SMEs but relatively less so than in the previous years. A big problem of access to finance also decreased in importance in 2014 according to the survey carried out across the EU. On the other hand, most entrepreneurs listed availability of skilled staff or experienced managers and regulatory framework as the most pressing problems disrupting or halting regular operation. An exception to this are Croatia, Cyprus, Finland, Greece and Slovenia where access to finance is most frequently cited as the biggest problem for SMEs. Positive developments for SMEs continued in 2016 and are expected to gain additional momentum this year. According to forecasts of the EC, SME growth is expected to be more balanced in terms of sectorial growth, with all the major SME sectors participating in the overall upswing of SME activity. *Construction* and *manufacturing* will most likely continue to lag behind other sectors.

1 The non-financial business sector consists of all sector of the economy, except for financial services, government services, education, health, arts and culture, agriculture, forestry and fishing.

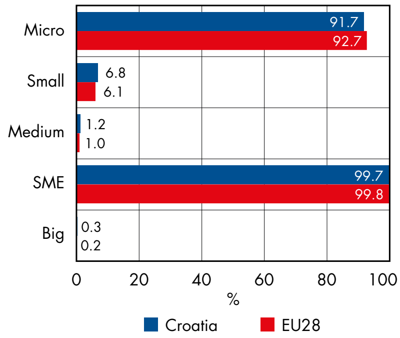
Member States are projected to continue to exhibit a great deal of diversity in terms of their performance and results.

As part of its efforts the EC harmonises and monitors SME movements in all Member States. By adopting the Strategy for Development of Entrepreneurship in Croatia 2013 – 2020 the Croatian Government attempted to align its efforts with the EU in all strategic areas. The Small Business Act is a milestone in the European policy for small and medium-sized enterprises. It consists of a set of measures organised around ten principles, from responsive public administration to expanding to the international market. Comparing Croatia with the EU according to the defined principles makes us realise that Croatia's profile is relatively weak and below the EU average in relation to most principles. In 2014, the Government started implementing several important measures aimed particularly at entrepreneurs. According to the analysis carried out by the EC, Croatia has made visible progress in alleviating the administrative burden. However, additional efforts are required to achieve further reductions. The industrial framework for promoting trade needs to be strengthened and a comprehensive strategy adopted aimed at assisting SMEs in their exporting efforts. Croatia also registered weaker-than-average results pertaining to access to finance. At the same time the total time Croatia's enterprises need to settle their invoices also increased, together with the borrowing costs for small loans as compared to the costs for large loans (in 2012 the costs of small loans were 9% higher than the costs of large loans, while in 2014 this figure was almost 27% higher than in relation to borrowing sums exceeding EUR 1m). However, the banks' readiness to lend, evaluated in accordance with the results of the survey conducted among entrepreneurs, improved significantly in the last two years. As for exports, costs continue to be higher and the period required for its realisation is still longer than in the most of EU. The number of documents required for export or import remains the highest among all EU Member States.

A review of the number of enterprises, total employment and value added shows that the SME figures in Croatia do not differ considerably compared to this sector in other EU Member States. Croatia's SMEs account for 55% of total value added (compared with 58% in the EU) and 67% of total jobs, which is close to the EU average. However, productivity, expressed as value added per capita, remains low, especially in micro enterprises with 0–9 employees. On the other hand, the hospitality industry contributes more to value added and employment in SMEs than the EU average. This sector accounts for more than 9% of value added of Croatia's SMEs and almost 12% of jobs. Poor SME results predominantly reflect the results of small enterprises with 10–49 employees because their value added shrank by 32% in 2015 from 2008, and the number of their jobs by 15%. However, individual sectors have seen positive developments. For example, value added in the information and communications sector increased by almost 27% since 2008 and the number of jobs by more than 22%, probably as a consequence of these sectors turning exceedingly to exports and thus being able to overcome the crisis that dominated the domestic market more successfully. In this context it is important to stress their competitiveness in terms of product quality and human resources.

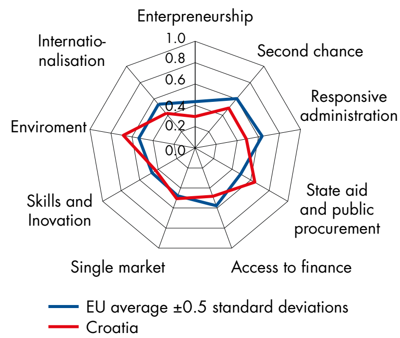
Financial results of Croatia's entrepreneurs for the period from 2008 to 2015 shows that 2008 was a successful year for all groups of enterprises. While large

Number of SMEs (% of total number of enterprises)



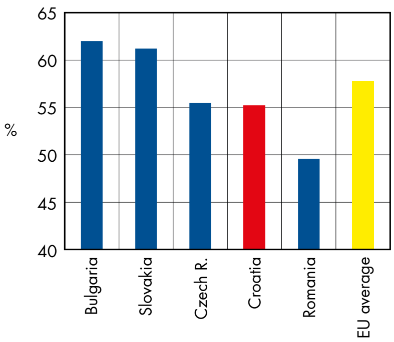
Sources: Eurostat, EC, Economic RESEARCH/RBA

Croatia and EU – according to Small Business Act for Europe principles



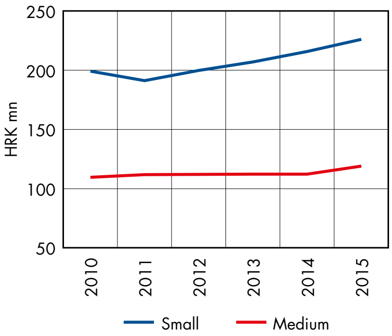
Sources: EC, Economic RESEARCH/RBA

Value added (% of total value added by enterprises)



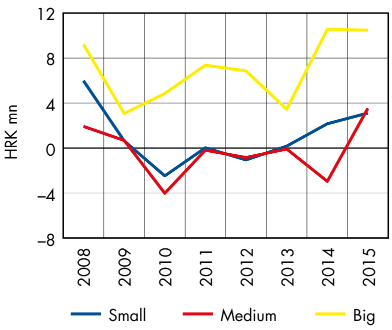
Sources: Eurostat, EC, Economic RESEARCH/RBA

Total revenues (Croatia)



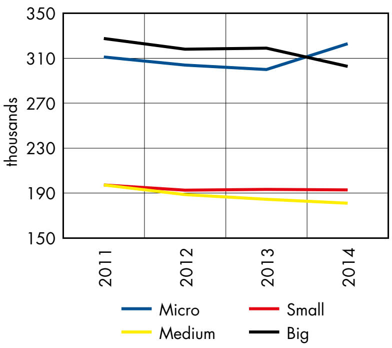
Sources: Financial Agency, Economic RESEARCH/RBA

Consolidated financial results (Croatia)



Sources: Financial Agency, Economic RESEARCH/RBA

Number of employees (Croatia)



Sources: Financial Agency, Economic RESEARCH/RBA

enterprises continued to operate positively, in the period from 2010 to 2013 SME results deteriorated. Since 2008 SME value added shrank by over 25% and the number of related jobs by almost 13%. A stronger recovery of small enterprises was noticed in 2014, while it was not until 2015 that all categories recorded positive financial results. According to the data provided by FINA, Croatia's financial agency, the SME sector (which includes enterprises that submit their financial statements to FINA) has been showing signs of recovery or growth of export activity uninterruptedly since 2010. In 2015, 106 221 micro, small and medium-sized enterprises operated in Croatia, accounting for 99.7% of all registered companies, and for 54% of the total income and 50.3% of Croatia's exports. The majority of Croatia's enterprises is concentrated in the service sector (65%). According to CBS data for 2014, 47% of all enterprises were enterprises falling within the category of retail trade except, retail sale of cars and motor vehicles. Of the total number of enterprises in these categories, 99.8% were SMEs, of which the greatest number, 92.7%, were those belonging to the segment of micro enterprises. Next to follow were the categories of professional, scientific and technical activities and accommodation and food service activities, accounting for 15.8% and 13.3%, respectfully, of the overall number of SMEs. Manufacturing accounts for 13.6% of Croatia's enterprises. Small enterprises are concentrated in the following sub-sectors: manufacture of fabricated metal products, except machinery and equipment, manufacture of food products, manufacture of products of wood and cork, except furniture, printing and reproduction of recorded media, manufacture of rubber and plastic products. Only 3.4% of small enterprises engaged in the manufacturing of computer, electronic and optical products, the most perspective sector registering the best results.

SME owners in Croatia have traditional sources of finance at their disposal in the form of banks and credit lines, and government programmes of incentives and subsidised credit lines. The capital market, i.e. financing via securities issuance, weather debt or equity, is still reserved for large enterprises. Alternative and informal forms of financing, as well as venture capital supply are still very limited in Croatia's market. As part of its research, the international GEM project assesses access to finance. In all the years covered by the research (2002 – 2015) Croatia was rated below 3 on a scale of 1 to 5, which shows that access to finance is more of a hurdle than a stimulus in the development of entrepreneurial activity.

The analysis of data on business demographic led to the conclusion that there are no meaningful and reliable data on newly-established and closed enterprises in Croatia. Data on newly-established enterprises are relatively good due to the regulated registration procedure. Data on closed enterprises, however, are not easy to come by. The closing of an enterprise should be reported when the enterprise ceases to engage in the economic activity that contributes to GDP. However, this is not easily recorded, especially when the closing of an enterprise is not compulsory, as is the case in bankruptcy proceedings. The decline in the number of active enterprises recorded between 2010 and 2013 was halted by a slow growth in 2014 that continued in 2015. An increase in active enterprises was registered in most activities between 2013 and 2015, although it was most prominent in the activities of information and communication, and arts, entertainment and recreation. A constant decline in the number of active enterprises was most prominent in construction, trade and transport and storage, which was accompanied by the decline in the number of persons employed in these activities.

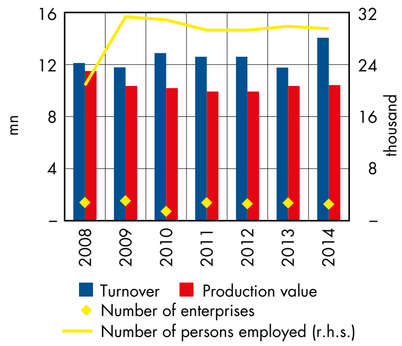
Raiffeisen RESEARCH

The number of enterprise births still does not reflect a more long-term trend. However, the total number of births increased by 20% in 2015 relative to 2014. The increase was most visible in the segment of service activities. Enterprise deaths were in decline until 2014 when a minor spike in their number was recorded as compared to 2013. In a significant number of cases the termination in business activity occurred because owners of enterprises decided to focus on other business opportunities, without selling the enterprise or ensuring is existence in some other way.

SMEs have an indispensable role in every economy. They are the driving force, the most dynamic and the riskiest segment of any economic culture. Their role is twofold: they are the key source of employment while, at the same time, this important link in the economic chain is the source of entrepreneurial spirit and innovation, incubator for new ideas, firms and products. Thousands of entrepreneurs test their ideas and skills and many try it out as entrepreneurs only to survive or supplement their small income. Economic recovery is likely to continue in the year ahead of us. We expect further growth in the number of the employed and the number of enterprises paired with the acceleration in the growth of value added. The strongest growth is expected in the segment of micro enterprises. *Information and communication* are expected to see prominent growth, while *construction* and *manufacturing* will continue to lag behind other sectors. Positive developments are also expected as a consequence of the decrease in the Profit tax (12% for farmers, craftsmen and small enterprises with annual income below HRK 3m). Financing conditions are getting better by the day for all sectors in the domestic market. Bank interest rates in the household and corporate segment have been in decline and at historical lows. Favourable developments are also recorded in relation to loan approval standards which have been relaxed. There is also a noticeable spike in demand for loans. We expect continued improvement in lending conditions supported by further interest rate decline to positively affect further development and growth of SMEs and consequently of the overall economic activity.

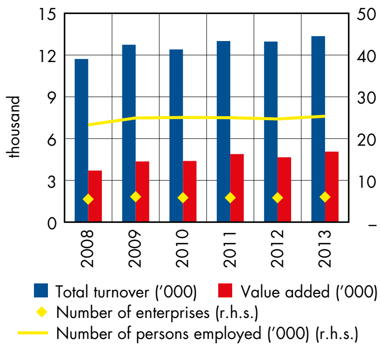
Elizabeta Sabolek Resanović

Manufacture of food products (Croatia)



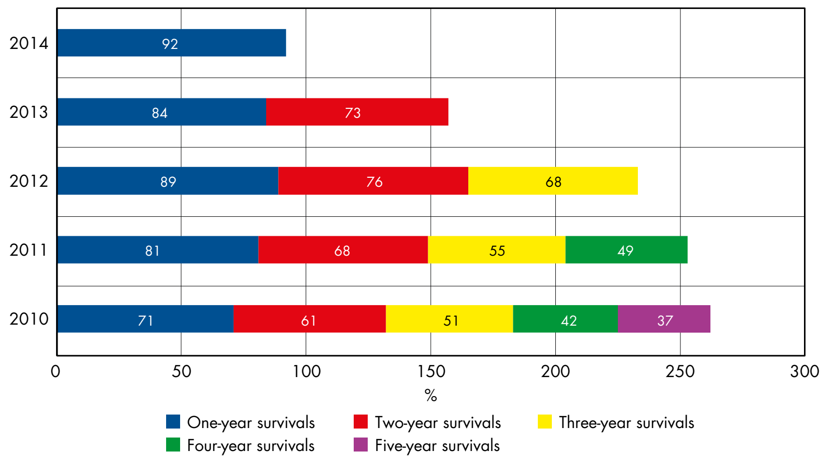
Sources: CBS, Economic RESEARCH/RBA

Information and communication (Croatia)



Sources: CBS, Economic RESEARCH/RBA

Survival rate* of enterprises born from 2010 to 2014 (Croatia)

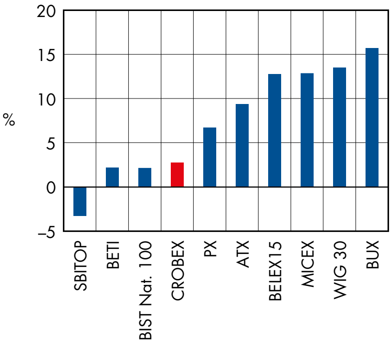


**Survival rate represents the percentage of enterprises that were constantly active after the year of birth*
Sources: CBS, Economic RESEARCH/RBA

It was a good year for the CROBEX

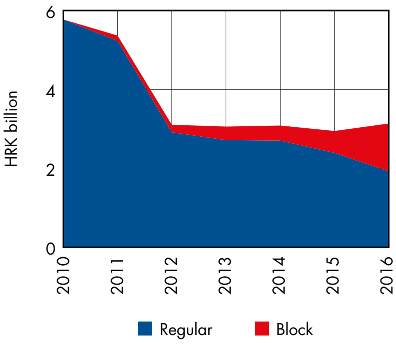
- **Regional equity indices continued to grow in Q4 2016**
- **Growing by 18% in 2016 the CROBEX was among top performers in the region**
- **Block transactions gain significance in equity trading on the ZSE**

CEE indices – returns in Q4 2016*



** in local currency, value on December 31, 2016 (6:30 PM)*
Sources: Bloomberg, Economic RESEARCH/RBA

Equity turnover



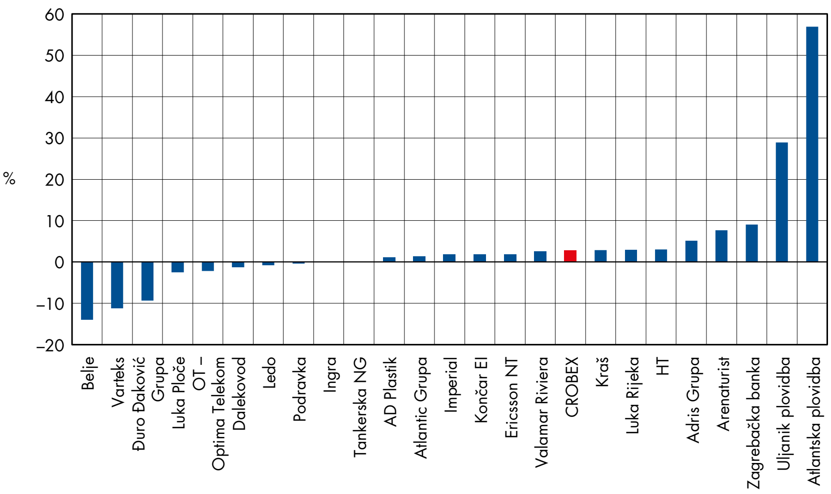
Source: ZSE, Economic RESEARCH/RBA

Almost all CEE equity indices saw a positive development in the last quarter of 2016, propelled primarily by good macroeconomic indicators and expansive monetary policy, as well as the expected strong growth of corporate earnings. The Hungarian BUX gained the most (+15.7%) thanks to the upgrade in the sovereign credit rating to the investment level. Next to follow were the Polish WIG30 and the Russian MICEX. The WIG30 was spurred predominantly by the constituents from the energy and metallurgic sector, while the macroeconomic data for Poland mostly deteriorated due to still present political uncertainty. The MICEX was boosted by rising oil prices as always. From the selection of regional indices, only the Slovene SBITOP ended the quarter in the red. The Turkish BIST 100, despite negative internal factors, managed to up the value, mostly due to the positive sentiment globally.

After a surge of the equities on the Zagreb Stock Exchange in Q3 2016, the growth of the CROBEX slowed down in the last quarter as expected, partially because of its high relative valuation. Thus, the CROBEX ended Q4 2016 with a gain of 2.8%, while its growth in 2016 totalled 18% placing it among the top performers in the region. The market capitalisation of equities listed on the ZSE at the end of the quarter amounted to HRK 143.2bn, also up by 2.8% qoq and 16.5% yoy. Among sector indices, only the food and industry indices went up in Q4 2016. On the full-year basis, however, all sector indices increased, headed by the CROBEXturist index. Of the 24 CROBEX constituents, only eight shares increased more than the index led by shares of Atlantska Plovidba and Uljanik Plovidba due to the growth of the Baltic Dry Index. Shares of Belje and Varteks found themselves at the back of the list. The most traded shares by turnover during the last quarter were the shares of Adris Group (total turnover with both regular and preferred shares of HRK 179m), Hrvatski Telekom (total turnover of HRK 93.8m) and the shares of Valamar Riviera (total turnover of HRK 77.6m). At the annual level, regular equity turnover amounted to HRK 1.9bn and continued to shrink yoy (down by 13.4%) but the block turnover doubled to HRK 1.2bn thus lifting up the total turnover sum in 2016 by 13.5% yoy.

Ana Turudić and Nada Harambašić Nereau

Return of CROBEX constituents in Q4 2016 (dividends not included)*



** return calculated as on December 31, 2016 (6:30 PM)*
Sources: ZSE, Economic RESEARCH/RBA

Optimistic expectations and bold announcements

- **We expect a dynamic year with M&A deals**
- **Positive sentiment on the ZSE could continue in 2017**
- **Liquidity and weakening of risk aversion are supporting for regional indices**

Judging by the announcements at the very beginning, this year could be a very dynamic one by the number of M&A deals. In this respect, Atlantic Grupa is pursuing an acquisition of a West-European company, Podravka is actively searching targets in the EU and Russia, Hrvatski Telekom announced a takeover of 76.5% stake in Crnogorski Telekom, while the government intends to buy out MOL's share in INA and finance the transaction with sale of 25% minus one share in HEP. We expect the government to continue selling minority shares in companies as well as its stakes in tourism companies to strategic buyers.

Readings of nine months 2016 reported indicators boil down to tourism firms improvements yoy as expected, with HUP-Zagreb leading the way by the growth of sales (+19.4% yoy) and EBITDA margin increase (+638bb yoy). Also, Plava Laguna and Valamar Riviera boasted both, an improvement of the operating result and a growth of the net margin of over 700bb yoy. Results of banks improved as well on the back of gains on sale of shares in Visa Europe Limited and lower financing costs yoy. Construction and shipping companies (except for Tankerska Next Generation) reported drop of sales and deterioration of profit margins (except for Dalekovod). The results of F&B and industrial companies were quite diverse per se. We expect strong development of key indicators of tourism companies to continue in Q4 2016 and in 2017 as well as improvement of top line of construction companies spurred by a massive investment cycle expected in tourism. In addition, new tax reform could drive the results of retail companies and producers of consumer goods, while the reduction in company income tax rate from 20% to 18% (above HRK 3m revenue) will positively affect the results of all profitable companies.

After already strong growth in 2016, CROBEX continued to trend upwards this year propelled by optimistic expectations regarding the tourism season and announced acquisitions. On the back of sustained positive sentiment on developed equity markets, high system liquidity and weakening of the risk aversion we expect regional indices (for the most part)[1] to continue advancing in Q1 2017. We are less optimistic as regards the growth of Polish and Turkish shares and more optimistic regarding Hungarian and Russian shares. On the other side, risk aversion and optimism will heavily depend on the measures undertaken by the new US administration.

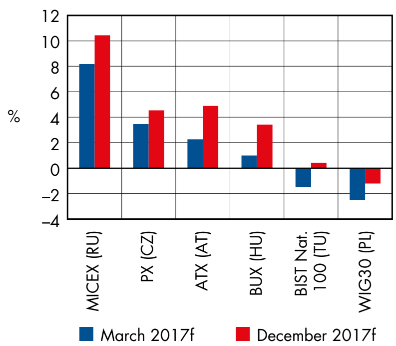
Ana Turudić and Nada Harambašić Nereau

Results in Q1–Q3 2016 (amounts in mn HRK)

Company	Sales	yoy chng	Net income
Ad Plastik	715.8	–6.0%	31.2
Adris Grupa	3,178.9	–26.0%	502.6
Arenaturist	404.0	17.9%	102.1
Atlantic Grupa	3,782.2	–4.9%	231.0
Atlantska Plovidba	215.1	–14.7%	–35.7
Belje	1,126.1	1.4%	–38.4
Croatia Osiguranje	2,334.0	0.3%	157.2
Dalekovod	771.8	–6.7%	44.4
Đuro Đaković G.	426.4	35.7%	–10.5
Ericsson N.T.	1,134.3	17.2%	58.2
Granolio	562.6	–2.0%	–3.1
HPB	634.8	3.2%	154.2
Hrvatski Telekom	5,184.4	–0.1%	751.9
Hup-Zagreb	245.0	19.4%	59.5
Ina	11,013.0	–26.3%	324.0
Jadranski Naftovod	524.9	11.3%	183.9
Jamnica	2,259.1	3.9%	307.4
Končar - El	1,929.9	–13.1%	69.1
Kraš	686.1	2.5%	5.0
Ledo	1,966.6	0.9%	336.4
Liburnia Riviera H.	233.0	5.5%	40.6
Maistra	925.9	8.7%	278.9
OT-Optima Telekom	340.7	2.9%	9.3
Petrokemija	1,376.4	–27.0%	–30.7
Plava Laguna	948.8	0.9%	362.0
Podravka	3,030.8	23.1%	142.2
PBZ	3,236.7	6.0%	1,216.2
Tankerska NG	189.9	139.3%	36.5
Tehnika	375.6	–20.1%	–16.3
Uljanik Plovidba	134.3	–22.6%	–39.3
Valamar Riviera	1,382.5	14.8%	499.2
Viadukt	456.3	–12.8%	–5.3
Viro T.Š.	537.9	–24.3%	–10.3
Vupik	267.4	1.6%	–5.4
Zagrebačka Banka	3,943.8	9.7%	1,407.5

Sources: ZSE, RBA Economic RESEARCH

Expected index performance*



** in relation to values as on December 31, 2016 (6:30 PM) in local currency*
Sources: Bloomberg, RBI/Raiffeisen RESEARCH

1 Raiffeisen RESEARCH, Central & Eastern European Strategy 1st quarter 2017, http://www.rzb.at/eBusiness/services/resources/media/832624473864488257-829189181316930732-1209747799742833060-1-2-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
UST – US Treasury
VAT – value added tax
WCY – World Competitiveness Yearbook
y – year
yoy – year on year
ZSE – Zagreb Stock Exchange

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Investment banking services	0	1	0	0	0	0
% all IB services	0%	29%	0%	0%	0%	0%

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