Raiffeisen Research Report

Number 65
April 2017

Growth continues overshadowed by Agrokor

- Personal consumption and exports as growth drivers
- Low interest rates and return of inflation
- Demographic scattering as medium-term risk
- CROBEX affected by the Agrokor crisis

Raiffeisen RESEARCH

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Contents

Selected macroeconomic indicators

	2010	2011	2012	2013	2014	2015	2016	2017e	2018f
GDP & Production									
Gross Domestic Product, % (constant prices)	-1.7	-0.3	-2.2	-1.1	-0.5	1.6	2.9	3.3	2.8
GDP at current prices (EUR millions)	45,022	44,737	43,959	43,516	43,002	43,870	45,581	45,577	49,601
GDP per capita at current prices (EUR)	10,479	10,451	10,301	10,220	10,147	10,352	10,771	10,849	11,810
Retail trade, % real annual changes	-2.1	0.6	-4.1	-0.6	0.4	2.4	4.0	4.5	3.0
Industrial production, % annual changes	-1.4	-1.2	-5.5	-1.8	1.2	2.7	5.3	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	1.4	2.1
%, average	1.1	2.3	3.4	2.2	-0.2	-0.5	-1.1	1.9	1.6
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	1.5	2.2
Unemployment rate (official rate, avg)	17.4	17.8	18.9	20.2	19.6	17.0	14.8	14.2	13.7
Unemployment rate (ILO, avg)	11.6	13.7	15.9	17.4	17.3	16.3	13.1	12.2	11.2
Average net wage, in Kuna	5,343	5,441	5,478	5,515	5,534	5,594	5,685	5,827	5,932
General Government Balance, % of GDP, ESA 2010	-6.2	-7.8	-5.3	-5.3	-5.4	-3.4	-0.8	-1.9	-2.0
Public Debt, HRK bn, ESA 2010	191.3	216.7	233.6	270.8	284.2	289.6	289.1	295.8	302.0
% of GDP, ESA 2010	58.3	65.2	70.7	82.2	86.6	86.7	84.2	82.6	80.6
Balance of Payment and External Debt									
Good's and Services Exports, EUR million	17,007	18,126	18,336	18,771	19,691	21,512	22,801	24,308	25,530
% change	9.2	6.6	1.2	2.4	4.9	9.3	6.0	6.6	5.0
Good's and Services Imports, EUR million	17,158	18,302	18,116	18,573	18,843	20,414	21,366	22,567	23,820
% change	-0.5	6.7	-1.0	2.5	1.4	8.3	4.7	5.6	5.6
Current Account Balance, % of GDP[2]	-1.1	-0.7	0.0	1.0	2.1	4.8	2.6	2.5	2.2
Official International Reserves, EUR millon, eop	10,660	11,195	11,236	12,908	12,688	13,707	13,514	13,700	14,000
Official International Reserves, in terms of months of imports of goods and services, eop[1]	7.5	7.3	7.4	8.3	8.1	8.1	7.6	7.3	7.1
Foreign Direct Investment, EUR million[3]	1,066	1,017	1,150	737	2,292	192	1,706	1,600	1,800
Tourism – nightstays, % change	2.6	7.0	4.0	3.3	2.6	7.7	9.0	4.0	3.0
External debt, EUR billion	46.9	46.4	45.3	45.8	46.4	45.4	41.7	40.9	41.9
External debt, as % of GDP[2]	104.2	103.7	103.0	105.3	107.9	103.4	91.4	89.7	84.4
External debt, as % export of goods and services[2]	275.8	256.0	247.0	244.0	235.7	211.0	182.7	168.1	164.0
Monetary and Financial Data									
Exchange rate, eop, USD / HRK	5.57	5.82	5.73	5.55	6.30	6.99	7.17	7.35	7.01
avg, USD / HRK	5.50	5.34	5.85	5.71	5.75	6.86	6.80	7.23	7.10
Exchange rate, eop, EUR / HRK	7.39	7.53	7.55	7.64	7.66	7.64	7.56	7.50	7.50
avg, EUR / HRK	7.29	7.43	7.52	7.57	7.63	7.61	7.53	7.45	7.46
Money (M1), Kuna billion, eop	48.0	51.5	51.9	57.9	63.4	70.7	83.5	86.8	90.5
% change	1.7	7.3	0.9	11.5	9.6	11.4	18.1	4.0	4.3
Broadest money (M4), Kuna billion, eop	232.8	246.0	254.7	264.9	273.3	287.4	300.9	312.3	320.5
% change	1.9	5.6	3.6	4.0	3.2	5.1	4.7	3.8	2.6
Credits, Kuna billion	245.6	257.4	242.1	240.8	237.0	230.0	221.5	218.2	221.5
% change	4.7	4.8	-5.9	-0.5	-1.6	-2.9	-3.7	-1.5	1.5
ZIBOR 3m, %, avg	2.4	3.2	3.4	1.5	1.0	1.2	0.9	0.6	0.8
Treasury bills rate 12m, %, avg	4.0	3.9	3.9	2.5	1.9	1.5	1.0	0.6	0.7

[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)

	2015	2016	2017e	2018f
Poland	3.9	2.8	3.3	3.0
Hungary	3.1	2.0	3.2	3.4
Czech Rep.	4.6	2.3	2.7	2.5
Slovakia	3.8	3.3	3.3	4.0
Slovenia	2.3	2.5	2.7	2.5
CE	**3.9**	**2.6**	**3.1**	**3.0**
Croatia	**1.6**	**2.9**	**3.3**	**2.8**
Bulgaria	3.6	3.4	3.3	3.3
Romania	3.9	4.8	4.2	3.5
Serbia	0.7	2.8	3.0	3.0
BiH	3.0	2.5	3.0	3.5
Albania	2.6	3.5	4.0	4.0
SEE	**3.1**	**3.9**	**3.7**	**3.3**
Russia	–2.8	–0.2	1.0	1.5
Ukraine	–9.9	2.2	2.0	3.0
Belarus	–3.8	–2.6	–0.5	1.5
EE	**–3.3**	**–0.1**	**1.0**	**1.6**
Austria	1.0	1.5	1.7	1.5
Germany	1.5	1.8	1.7	1.5
Euro area	2.0	1.8	1.9	1.7
USA	**2.6**	**1.6**	**2.4**	**2.2**

Source: Raiffeisen RESEARCH/RBI

Consumer prices (avg, % yoy)

	2015	2016	2017e	2018f
Poland	–0.9	–0.6	1.9	2.2
Hungary	0.0	0.3	3.3	3.0
Czech Rep.	0.3	0.7	2.4	1.5
Slovakia	–0.3	–0.5	1.1	2.0
Slovenia	–0.8	–0.2	1.5	1.9
CE	**–0.5**	**–0.2**	**2.1**	**2.1**
Croatia	**–0.5**	**–1.1**	**1.9**	**1.6**
Bulgaria	–0.1	–0.8	1.3	2.0
Romania	–0.6	–1.5	0.9	2.9
Serbia	1.4	1.2	2.5	2.9
BiH	–1.0	–1.1	2.0	2.0
Albania	1.8	1.3	2.5	2.7
SEE	**–0.2**	**–0.9**	**1.4**	**2.5**
Russia	15.6	7.1	4.7	4.5
Ukraine	48.7	13.9	10.7	7.5
Belarus	13.5	12.0	12.0	11.0
EE	**17.5**	**7.7**	**5.3**	**4.9**
Austria	0.8	1.0	2.0	2.1
Germany	0.1	0.4	1.9	2.2
Euro area*	0.0	0.2	1.8	1.5
USA	**0.1**	**1.2**	**2.5**	**2.5**

Source: Raiffeisen RESEARCH/RBI

Fixed capital formation (% yoy)

	2015	2016	2017e	2018f
Poland	6.1	–5.5	5.5	5.4
Hungary	1.9	–15.5	6.4	7.0
Czech Rep.	9.1	–3.6	4.0	3.1
Slovakia	16.9	–9.3	4.5	4.0
Slovenia	1.0	–3.1	n.v.	n.v.
CE	**6.9**	**–6.7**	**5.0**	**4.8**
Croatia	**1.6**	**4.6**	**5.8**	**6.0**
Bulgaria	2.7	–4.0	2.4	4.5
Romania	8.3	0.0	6.5	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	**5.1**	**0.4**	**4.9**	**5.5**
Russia	–9.4	–1.4	3.0	4.0
Ukraine	–9.3	5.0	5.0	5.0
Belarus	–15.9	n.v.	n.v.	n.v.
EE	**–9.6**	**–1.0**	**3.0**	**3.9**
Austria	**0.7**	**2.9**	**2.5**	**2.2**
Germany	1.1	2.1	2.1	n.v.
Euro area	2.2	3.0	3.3	3.3
USA	**4.0**	**0.7**	**n.v.**	**n.v.**

Source: Raiffeisen RESEARCH/RBI

Current account balance (% of GDP)

	2015	2016	2017e	2018f
Poland	–0.6	–0.5	–0.8	–1.0
Hungary	4.3	3.5	3.2	3.0
Czech Rep.	0.2	1.1	1.1	1.2
Slovakia	0.2	–0.6	0.5	1.4
Slovenia	5.2	6.8	6.6	6.2
CE	**0.5**	**0.4**	**0.3**	**0.2**
Croatia	**4.8**	**2.6**	**2.5**	**2.2**
Bulgaria	0.4	3.8	3.4	1.0
Romania	–1.2	–2.4	–3.6	–3.8
Serbia	–4.6	–3.9	–3.7	–3.5
BiH	–5.6	–5.4	–7.0	–7.7
Albania	–13.6	–13.6	–13.6	–12.1
SEE	**–1.2**	**–1.6**	**–2.4**	**–2.8**
Russia	5.1	1.7	4.9	5.5
Ukraine	–0.1	–3.7	–4.6	–3.8
Belarus	–3.8	–3.6	–3.7	–3.6
EE	**4.4**	**1.1**	**4.1**	**4.7**
Austria	1.9	1.7	2.1	2.2
Germany	8.3	8.3	8.5	8.0
Euro area	3.0	3.3	3.3	3.1
USA	**–2.6**	**–2.6**	**–3.5**	**–3.5**

Source: Raiffeisen RESEARCH/RBI

General budget balance (% of GDP)

	2015	2016	2017e	2018f
Poland	–2.6	–2.6	–3.0	–3.2
Hungary	–2.0	–2.0	–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	–1.7
CE	**–2.1**	**–2.0**	**–2.2**	**–2.3**
Croatia	**–3.4**	**–0.8**	**–1.9**	**–2.0**
Bulgaria	–2.8	1.6	–1.5	–2.0
Romania	–0.8	–2.6	–3.6	–3.8
Serbia	–3.7	–1.3	–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**	**–1.6**	**–2.7**	**–2.8**
Russia	–3.6	–3.7	–2.6	–2.4
Ukraine	–2.3	–3.0	–4.0	–3.0
Belarus	1.8	1.5	0.0	0.0
EE	**–3.3**	**–3.5**	**–2.6**	**–2.3**
Austria	–1.1	–1.6	–1.2	–1.1
Germany	0.7	0.2	0.1	0.0
Euro area	–2.1	–1.7	–1.4	–1.4
USA	**–2.4**	**–3.2**	**–3.5**	**–2.6**

Source: Raiffeisen RESEARCH/RBI

Public debt (% of GDP)

	2015	2016	2017e	2018f
Poland	51.1	52.8	53.2	53.7
Hungary	75.2	73.9	73.2	72.4
Czech Rep.	40.3	37.9	36.8	35.8
Slovakia	52.5	52.6	52.5	52.2
Slovenia	83.1	81.3	79.9	77.9
CE	**53.8**	**53.9**	**53.7**	**53.5**
Croatia	**86.7**	**84.2**	**82.6**	**80.6**
Bulgaria	25.6	29.1	29.0	31.0
Romania	38.0	37.6	38.7	40.1
Serbia	74.7	71.6	70.5	66.4
BiH	42.8	42.5	42.8	42.5
Albania	72.2	70.5	69.0	65.0
SEE	**47.8**	**47.4**	**47.6**	**47.7**
Russia	12.7	13.5	14.0	14.5
Ukraine	72.6	76.5	78.4	73.0
Belarus	36.5	39.0	38.7	36.5
EE	**17.2**	**18.2**	**18.8**	**18.8**
Austria	85.5	84.6	81.4	79.8
Germany	71.2	68.6	66.3	64.0
Euro area	90.4	89.3	88.3	87.2
USA	**101.9**	**105.5**	**105.6**	**104.9**

Source: Raiffeisen RESEARCH/RBI

Gross foreign debt (% of GDP)

	2015	2016	2017e	2018f
Poland	70.3	74.4	74.8	74.2
Hungary	106.2	98.3	89.1	83.5
Czech Rep.	69.4	73.2	76.2	74.0
Slovakia	85.4	88.8	87.4	84.8
Slovenia	116.6	108.8	104.1	103.0
CE	**64.8**	**66.6**	**66.4**	**65.0**
Croatia	**103.5**	**91.4**	**85.0**	**83.3**
Bulgaria	75.3	73.3	69.3	68.6
Romania	56.5	54.7	53.0	52.8
Serbia	81.6	74.2	70.7	66.6
BiH	53.4	54.7	54.9	54.2
Albania	72.6	71.7	68.8	67.0
SEE	**68.4**	**64.8**	**61.9**	**60.9**
Russia	37.9	39.1	30.5	26.0
Ukraine	131.5	131.8	124.4	118.2
Belarus	70.2	79.2	73.1	74.8
EE	**44.7**	**46.4**	**37.4**	**32.9**
Austria	n.v.	n.v.	n.v.	n.v.
Germany	n.v.	n.v.	n.v.	n.v.
Euro area	126.2	126.2	n.v.	n.v.
USA	**n.v.**	**n.v.**	**n.v.**	**n.v.**

Source: Raiffeisen RESEARCH/RBI

EUR/LCY (avg)

	2015	2016	2017e	2018f
Poland	4.18	4.36	4.33	4.23
Hungary	309.93	311.47	311.81	316.88
Czech R.	27.28	27.03	26.50	25.53
Slovakia	Euro	Euro	Euro	Euro
Slovenia	Euro	Euro	Euro	Euro
CE				
Croatia	**7.61**	**7.53**	**7.45**	**7.46**
Bulgaria	1.96	1.96	1.96	1.96
Romania	4.45	4.49	4.50	4.50
Serbia	120.73	123.13	123.78	124.88
BiH	1.96	1.96	1.96	1.96
Albania	139.72	137.33	136.90	139.38
SEE				
Russia	68.01	74.14	61.95	64.31
Ukraine	24.33	28.27	27.92	29.60
Belarus	1.77	2.20	2.11	2.50
EE				
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–	Ba3	BB–
BiH	B	B3	NR
Albania	B+	B1	NR
Russia	BB+	Ba1	BBB–
Ukraine	B–	Caa3	B–
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

Raiffeisen RESEARCH

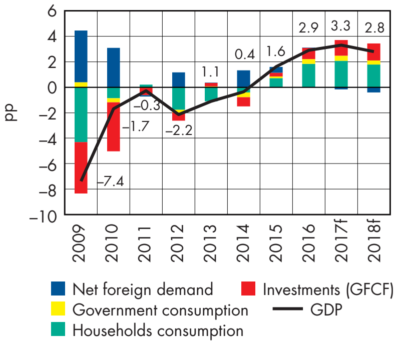
Overshadowed by Agrokor the economy continues to grow

Restored political stability, better-than-expected economic growth and, last but not least, much more favourable fiscal indicators in 2016 were rewarded by the top three rating agencies stabilising Croatia's credit rating. It is still far below the investment grade and clearly signalling that much still needs to be done to return to the coveted "wanted club". In contrast to the pre-crisis period, growth is still achieved amid nominal deleveraging by all sectors but also amid the (re) financing of financial liabilities being redirected towards domestic sources. This has slowly been changing the debt currency structure in favour of the domestic currency. Despite the slowdown in economic activity at a quarterly level, it is likely that the first Q117 GDP data will reflect healthy real annual growth. In the first quarter, growth will be generated by personal consumption but also by the exports of goods and services. High growth rates in the exports of goods confirm the positive effects of joining the common European market, but primarily also the fact that an increasing number of Croatia's companies (especially SMEs) has turned to the foreign market. Expectations that the economies of the EU and Croatia's other important trade partners will register a rise in demand in the remainder of the year will provide impetus to growth of Croatia's exports in goods, while on the other hand, the exports of services (tourism) as well as the strengthening of domestic demand will generate imports. Household consumption is encouraged by tax alleviation, signs of an exceptional tourist low and high season ahead and stabilisation in the labour market. A mild slowdown may be seen in investments, although they are expected to continue to grow and contribute substantially at the entire year level. Investments have slowly been gaining momentum as a result of EU funds and the period in the eve of local elections is usually that of lively investment activity in the public sector. However, it is precisely investments that are, in our opinion, the most sensitive component to the possible influences arising from the events related to Agrokor. The influence of Agrokor and its affiliated suppliers on the overall economy is very hard to estimate due to the absence of reliable data and information and the manner and speed at which the restructuring is done. And while the direct gross value added of the Agrokor Group may roughly be estimated, the problem largely lies in, and is exacerbated by, the large number of entities relying on the Group. Their future operation being largely dependent on the success of restructuring. In the short-term the resolution of Agrokor's liquidity problems provided the economy with a moment to pause, probably without a more significant influence on personal consumption but causing the postponement of individual investments. However, the "Agrokor-case" again warned against persistent deficiencies in Croatia's economy by drawing new attention to the problem of inability to collect overdue receivables.

The growth dynamics of consumer prices accelerated to around 1% in Q1, largely influenced by the prices of energy and food in consequence of spill-overs from foreign commodities markets. The same factors will continue to drive prices up in the remainder of the year. Amid such conditions, inflation is expected to remain modest and acceptable to central banks when continuing to pursue their extremely expansive monetary policies. As a result, in the upcoming quarters interest rates will continue to move at their historical lows. All this is not a reason to relax the fiscal policy. Despite significant fiscal improvements in 2016, in order to meet long-term sustainability, efforts to implement more targeted structural measures in selected public policies should be stepped up.

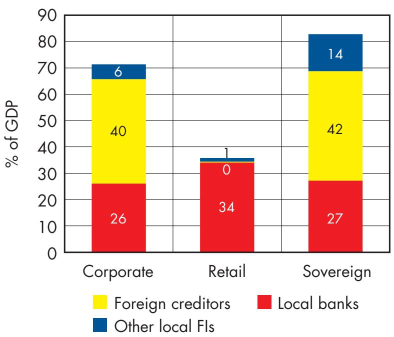
Zrinka Živković Matijević

GDP contributions



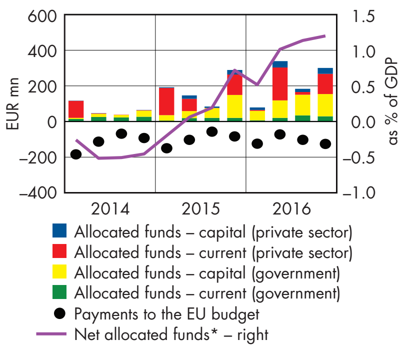
Sources: CBS, Economic RESEARCH/RBA

Debt structure by sectors



Sources: CNB, Economic RESEARCH/RBA

Transactions with the EU budget

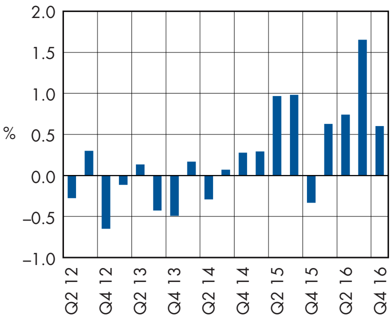


Sources: CNB, Economic RESEARCH/RBA

Good beginning of the year and encouraging indicators of the next tourist season

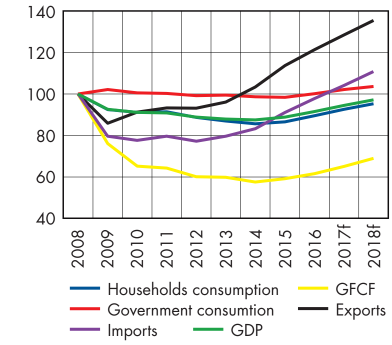
- **Growth continues propelled by personal consumption and exports**
- **Return of moderate inflation**

Real GDP (% yoy)



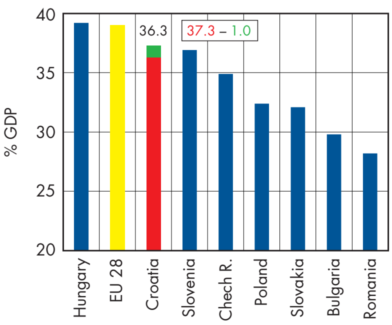
Sources: Eurostat, Raiffeisen RESEARCH/RBI

Real GDP and components (2008 = 100)



Sources: Eurostat, Raiffeisen RESEARCH/RBI

Tax burden, as % of GDP, 2015*



** the amount of tax relief is marked in green (1 pp)*
Sources: Eurostat, Raiffeisen RESEARCH/RBI

With industrial production and construction falling at a quarterly level, it is now obvious that the first months of 2017 started with a mild slowdown in economic activity. Nevertheless, annual growth rates remain positive and the growth of optimism in most activities suggest that positive trends will continue over the months to come. The three-months-long stagnation in retail trade is not worrying since it is accompanied by continued growth in the consumer confidence index, giving rise to expectations of continued growth in household spending. As expected, this optimism is largely supported by the tax alleviation, increase in minimum wages and adjustment of pensions, but also by first tourism indicators which point towards another great low and high season. Tourism will again this year remain the main driver of healthy economic results, generating additional investments directed at increasing both capacities and quality. However, a share of tourist arrivals should be attributed to the instability in the competitive Mediterranean markets of Turkey and North Africa. According to Q1 preliminary results, both the number of arrivals and the number of overnight stays rose by two-digit rates and similar dynamics continued in April. As a result, we estimate that 2017 might exceed even the most optimistic forecasts and have a multiplicative effect on the rest of the economy, holding the rate of economic growth at above 3 percent.

The first data on trade in goods (January and February) indicate two-digit growth of exports paired with a much lower growth of imports so the figures on real contribution of net foreign demand to GDP will surely be positive. The growth in the exports of goods, uninterrupted since Q2 2013, is particularly encouraging. Namely, this GDP component largely reflects improvements in the competitiveness of an economy. Expectations that EU economies and other Croatia's important foreign trade partners will continue to witness rising demand in the upcoming part of the year speak in favour of growth in Croatia's exports of goods. However, exports of services (tourism), as well as the strengthening of domestic demand will generate imports.

Accordingly, the publication of initial data on Q1 GDP is expected to reflect a positive contribution of all GDP components. As for individual components, the greatest contribution to growth is to come from the exports of goods and personal consumption. A slight slowdown is possible in investments, although we expect them to grow and make a significant contribution at the annual level. Namely, investments are gaining momentum due to EU funds and the period in the wake of local elections is usually accompanied by active investments in the public sector. Favourable financing conditions but also a low base (due to strong decline during the crisis) speak in favour of a recovery in investments, so we see potential both in the private and public sector.

However, according to our opinion, it is precisely investments that are the most sensitive component to the possible influences that arise from the situation surrounding Agrokor. The influence of Agrokor and affiliated suppliers on the overall economy is hard to estimate due to the unavailability of reliable data and information and the manner and speed at which its restructuring is handled.

While the direct gross value added of the Agrokor Group is estimated at some 2% of total gross value added[1], the problem is greatly exacerbated by the great number of entities that rely on the group and whose future operations rely on the success of the restructuring process. In the short-term the resolution of Agrokor's liquidity problems provided the economy with a moment to pause, probably without a more significant influence on personal consumption but causing the postponement of individual investments. However, the "Agrokor-case" again warned against the persistent deficiencies of Croatia's economy by drawing new attention to the problem of inability to collect overdue receivables. This is the problem that has over the years been stressed by all market participants as one of the main hurdles to successful operation and competitiveness. In the end, we expect a moderate but still positive growth in real government spending throughout all quarters.

The risks for our projections remain balanced because the possible stronger influence of tourism and stronger EU recovery could be moderated by the already mentioned negative effect of the Agrokor situation. Our basic GDP growth projection builds on assumption of a coordinated restructuring with modest influence on the rest of the economy to be felt more in the H217.

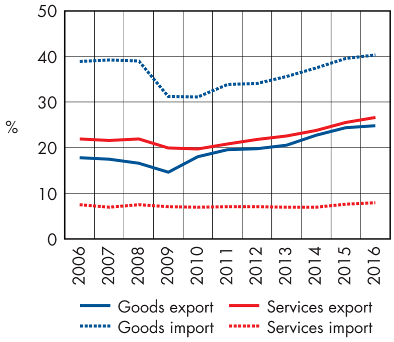
Although the unemployment rate continued on its downward path, its reduction (to 12.8% in 2016) was only partly caused by the rise in employment, while a portion of the fall is accounted for by the shrinking of the work force. The reasons for this are to be found in negative net migration that undermines the potential for sustainable growth in the long run. Although positive trends in the labour market, in the form of declining unemployment and a slight growth in employment, are expected in the upcoming months, continued outflow of young, productive population is expected to continue. A partial reason for this is the slow creation of new jobs, not to mention the structure of new vacancies that are constituted mainly of seasonal jobs and/or fixed term jobs. After the usual growth of the registered unemployment rate in Q4 2016 and Q1 2017, the beginning of Q2 brought about a decline in the number of the unemployed and the unemployment rate. This trend is likely to hold until the end of Q3. The average growth of net salaries is expected to come in at 2.5%, while the real growth of average net salaries will slow down from the relatively high 2.7% in 2017 to some 1% due to the strengthening of inflationary pressures.

As expected, inflation measured by the CPI continued accelerating at the average annual rate of over 1%. Higher rates are predominantly a result of the strengthening of imported inflationary pressures which, in contrast to the last three years, now bring upward pressure on prices in the domestic market. A spur to the increase in prices will also be seen in the remainder of the year from imported inflationary pressures, primarily from the commodities markets of crude oil and food raw materials. To an extent it could also come from the effects of the tax reform (increase in VAT on certain services and excise duties). To a lesser extent growth in the prices of consumer goods and services will also come from the growth in domestic demand.

Zrinka Živković Matijević

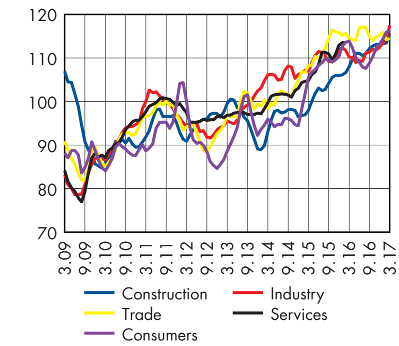
1 www.arhivanalitika.hr

Exports and imports as % of GDP



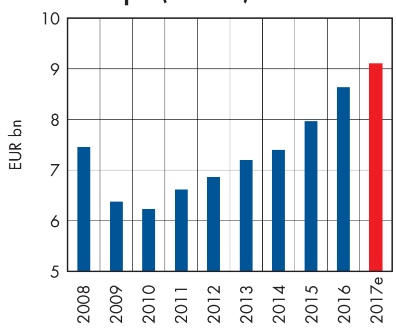
Sources: Bloomberg, Raiffeisen RESEARCH/RBI

Confidence indicators



**Standardized values, seasonally adjusted index*
Sources: CNB, Economic RESEARCH/RBA

Travel receipts (tourism)

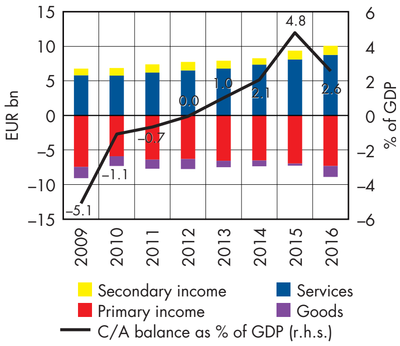


Sources: CNB, Economic RESEARCH/RBA

External vulnerability reduces

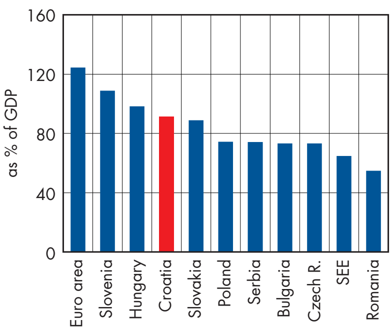
- Healthy current and capital account surplus
- Gross external debt to continue to decrease

Balance of payments/ current account



Sources: CNB, Economic RESEARCH/RBA

Gross foreign debt, 2016



Sources: CNB, Economic RESEARCH/RBA

External debt and ratios

Quarters	External debt (EUR mn)	External debt as % of: GDP	External debt as % of: Exports of goods and services	International reserves (% of external debt)
Q1 13	46.908	104,1%	275,8%	22,7%
Q2 13	46.397	103,0%	256,0%	24,1%
Q3 13	45.297	101,3%	247,0%	24,8%
Q4 13	45.803	104,2%	244,0%	28,2%
Q4 14	46.416	107,9%	235,7%	27,3%
Q1 15	49.048	113,9%	245,8%	28,9%
Q2 15	48.709	112,6%	237,4%	28,2%
Q4 15	46.832	107,3%	221,9%	28,7%
Q4 15	45.384	103,4%	211,0%	30,2%
Q1 16	44.283	100,2%	204,3%	29,8%
Q2 16	43.440	97,4%	198,7%	29,8%
Q3 16	42.435	94,1%	188,9%	30,7%
Q4 16	41.662	91,4%	182,7%	32,4%

As of 22.4.2016.
Sources: CNB, Economic RESEARCH/RBA

Croatia's external vulnerability continued to decrease in 2016, paired with a decline in gross external debt and continuation of a stable balance of payments current and capital account surplus (3.7% of GDP). The 2016 gross external debt went down to EUR 41.7bn or 91.4% of GDP, which was the first time in seven years that gross external debt went below the 100%-level. The greatest contribution to this decline on annual level came from continued deleveraging of the financial sector, i.e. of banks, resulting from relatively cheaper domestic deposits, ample liquidity and still modest demand for loans. We think that bank deleveraging has neared its end, which means that the level of their external indebtedness should hold at the current level. A considerable contribution to the reduction in the 2016 total gross debt came from the reduction in the external indebtedness of the public sector. Namely, at the end of December, gross external debt of the general government totalled EUR 14.8bn, almost EUR 1.1bn or 6.8% less than in the same month of 2015. Postponed Eurobond issue paired with significantly reduced current financing needs resulted in the decrease of the general government's external debt and a proportionally greater orientation of the government towards domestic financing. Although Q1 statistics will show a relatively strong growth of the general government's external debt due to the Eurobond issue, fact remains that already in April external debt of the government will reduce due to the maturity of the international bond issued in US dollars ten years ago (USD 1.5bn). We estimate total repayments pursuant to issued Eurobonds at some EUR 2bn so gross external debt under this item is expected to decrease. We are not ruling out the possibility of the corporate sector again this year refinancing a share of its foreign liabilities in the domestic market due to more favourable and more competitive financing conditions. Given the economic growth forecasts, the share of gross external debt in GDP could continue to decline in 2017. The return of inflation and the strengthening of the kuna against the euro are additional factors expected to contribute to the reduction of the public debt to GDP ratio, which might go below 90% this year.

Although Croatia reduced the level of its external indebtedness in 2016, it should be noted that it continues to clearly warn against high external vulnerability. Namely, with the share of public debt in GDP of 91.4% Croatia greatly exceeds the average among its CEE and SEE peers. As expected, even after the effects of the CHF conversion wearing off, the balance of payments C/A surplus in 2016 (estimated at some 2% of GDP) reached 2.6% of GDP. Deterioration in the goods account caused by a stronger growth of imports and better performance of foreign companies will be moderated by the expected increase in the services account and higher income in the secondary income account, where allocated EU funds are recorded. Foreign currency inflow from tourism, but also from other services, should continue growing, although at more moderate levels. In the medium term, interest expenses to non-residents amid high liquidity in the world have the potential to decrease, given that possible refinancing of maturities over the next year should be realised at historically low interest rates.

Zrinka Živković Matijević

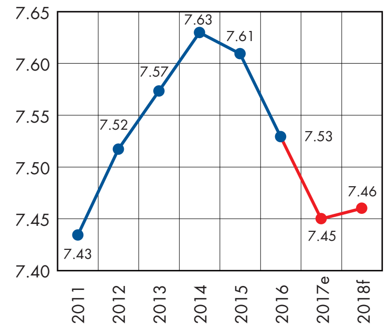
HRK strengthening amid high liquidity and low interest rates

- **Kuna strengthening against the euro**
- **Expansionary monetary policy remained**

Short-term depreciation pressures on the kuna seen at the beginning of the year were soon substituted by the kuna strengthening against the euro. Upward pressures remained dominant until the second half of March when EUR/HRK started slightly depreciating. For almost the entire quarter the kuna was supported by the inflow of foreign currency amid improved macroeconomic fundamentals and encouraging expectations, positive banks' net external position and the increasing, albeit slowly, demand for kuna loans. The trend was halted as soon as the uncertainty surrounding the problems of Croatia's largest privately owned company started mounting. Amid these circumstances the market exchange rate recovered from its lowest level since 2012 to the level of above HRK 7.47 for one euro, which it held for a short while. Although consistent in the implementation of its stable exchange rate policy, the central bank did not find it necessary to intervene in the FX market. Under these conditions, the average EUR/HRK mid-point exchange rate was, expectedly; lower than in the same period last year, fluctuating within a range of –0.9% to +1.4% and around the average value of HRK 7.47 for one euro. Namely, the period before the holidays that are normally connected with increased demand for the HRK and the situation surrounding the said company settling down (after the consortium of local banks ensured its liquidity through a credit line) stabilised the exchange rate at approximately 7.45 kuna for one euro. It is worth noting that the shallowness of the domestic FX market and occasional speculative sales/purchases sometimes determine the direction and the strength of the EUR/HRK exchange rate developments without fundamental reasons. As usual, the Q217 should see the strengthening of the domestic currency against the euro. The kuna will find support in the excellent low season results. There are also expectations of the continued rise in the exports of goods, as well as investments, the confirmation of reduced fiscal risk and increased demand for HRK loans. On the other hand, the HRK strengthening should be softened by the corporate demand for the euro which is aimed at settling due foreign liabilities arising from loans and import activities which usually gain strength as domestic demand and tourism grow. It is not to be ruled out that a share of demand for FCY will be spurred by the need to pay out dividends to non-resident company owners. Possible deviations from usual developments are hard to predict, although they are predominantly expected to be linked to the resolution of the situation surrounding Agrokor's restructuring whose liquidity largely depends on the support from domestic commercial banks. We should not see a divergence from the usual seasonal developments throughout the summer months. However, possible government borrowing via a HRK bond issuance in the domestic capital market could disrupt the usual growth of the EUR/HRK exchange rate. Nevertheless, fact remains, that the stable exchange rate and modest inflation will keep the domestic market's liquidity at exceptionally high levels, thus diminishing the impact of the increased demand for the kuna. The expansive nature of the monetary policy has all but been announced by the central bank's officials. The average surplus in daily liquidity in Q117 reached its historical high, while money market interest rates continued to fall. Low interest rates are likely to hold throughout 2017.

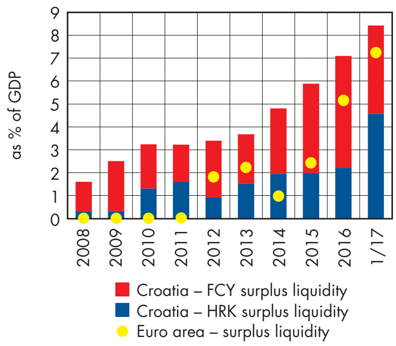
Zrinka Živković Matijević

Mid EUR/HRK, annual avg



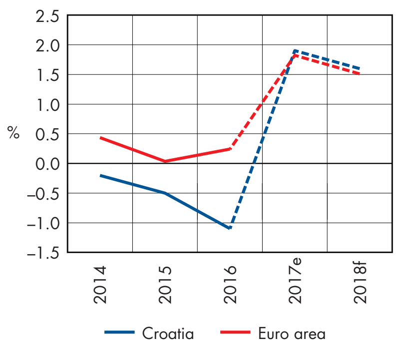
Sources: CNB, Economic RESEARCH/RBA

Excess liquidity



Source: CNB, Economic RESEARCH/RBA

CPI, annual changes



Sources: CNB, Economic RESEARCH/RBA

Medium-term focus: sustainability of the fiscal adjustment

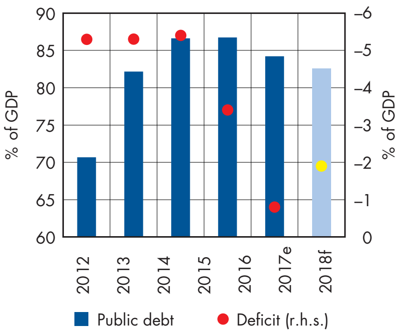
- **Better-than-expected fiscal indicators in 2016**
- **Year of local elections – are structural changes possible?**
- **Demographic scattering – medium-term risk for Croatia's state treasury**

Croatia's ratings*

Agency	Rating	Outlook	Last revision
Moody's	Ba2	Stable	10.3.2017
Fitch	BB	Stable	27.1.2017
S & P	BB	Stable	16.12.2016

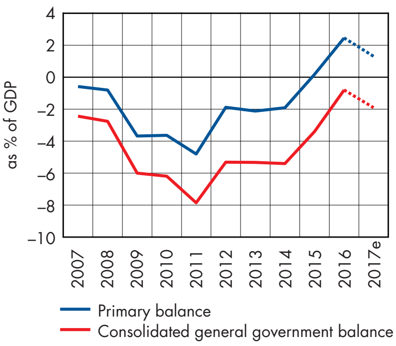
** LT debt in FCY*
Sources: Eurostat, Economic RESEARCH/RBA

Consolidated General Government (ESA 2010)



Sources: Eurostat, CBS, Economic RESEARCH/RBA

Consolidated General Government balance (ESA 2010)



Sources: CBS, Economic RESEARCH/RBA

The April EDP notification positively surprised experts and the general public alike. By reducing fiscal deficit in 2016 to the historic low levels (HRK 2.8 bn or 0.8% of GDP), Croatia was among the EU members with its lowest share in GDP. The 2016 reported fiscal deficit decreased by HRK 8.6 bn or 2.6 pp of GDP. Improved fiscal metrics in the previous year are generated by several key factors which largely reflect favourable cyclical developments. Namely, according to the latest EDP report, the biggest positive contribution to fiscal deficit reduction in 2016 came from increased tax revenues, so VAT revenues were collected in the amount of HRK 46.4 bn. Exceeding the planned values, VAT revenues rose by more than HRK 3 bn, thus recording a significant growth rate of 7.1% as compared to 2015. The latter is the result of positive economic trends i.e. better-than-expected economic growth, strongly driven by record-high tourist season. On the expenditure side (which recorded nominal and relative growth of HRK 3.8 bn and 2.3% yoy respectively), the positive contribution to fiscal deficit reduction came from lower interest expenses which amounted to HRK 11.2 bn. In addition to its annual decline by 6.4%, a significant improvement in the primary balance was recorded, which brought a surplus for the second consecutive year (2.5% of GDP).

Obviously, the reduction of budget deficit (also supported by the last year's discontinuity on the political scene) opened up space for significantly lower demand for government borrowing. Consequently, for the first time in eight years, the nominal as well as the relative decrease of public debt in GDP has been recorded. Therefore, the total public debt by the end of 2016 fell to the level of HRK 289.1 bn or 84.2% of GDP. Compared with the previous year, the share of public debt in GDP fell by 2.5 pb, partly reflecting the "denominator effect" resulting from the upward cyclical movement in the economy. In addition, the year behind us brought some strengthening of the kuna against the euro, which also contributed to the public debt reduction (denominated in the domestic currency).

Although fiscal statistics for the first months of 2017 are missing, the continuation of positive economic indicators suggests that revenues should be generous, or at least consistent with the planned figures. Although we expect fiscal deficit to deepen this year, it should remain at levels below 2% of GDP, with the surplus in primary balance for the third year in a row.

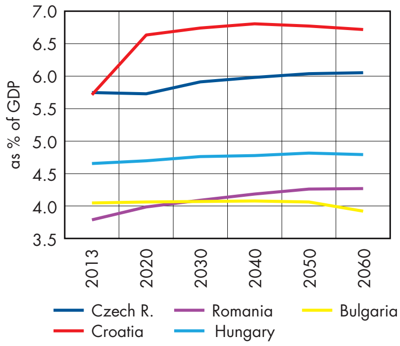
Nevertheless, it is clear that recent improvements in fiscal indicators are encouraging; however they are not primarily results of necessary structural measures. In other words, the rigid structure of public expenditures was maintained and as such it does not create sufficient impetus for overall economic growth and employment in the medium term. Namely, according to the latest data by the EC, a relatively high intermediary consumption and expenses on salaries account for almost 20% of the country's GDP. All of this points to a conclusion that the functioning of the state is expensive in comparison to other peer countries in the region but also in relation to the EU average. Moreover, this year envisages a growth of expenses on salaries due to the new agreement on the conditions from the collective agreement with the civil service trade union. In addition, pronounced territorial fragmentation additionally supports the increase in expenses on salaries without bringing a noticeable improvement in the quality of service on the local level.

Therefore, regardless of the registered decline in public debt, high costs of debt servicing in the upcoming period will continue to pressure Croatia's public finances. Amid these conditions, the narrowed fiscal room for productive investments (such as education) will depend on the improvement in the efficiency of public spending based on structural reforms.

One of the crucial fiscal policy challenges in the medium term is undoubtedly the system of social benefits which is under a strong influence of negative demographic developments. The belated consolidation and centralisation of social benefits additionally contributes to the lack of transparency in the system. According to the last evaluation by the EC, no progress was made in the improvement of the social protection system. In addition, the regular Report of the EC within the *European Semester* states that Croatia failed to make progress in the reform of its pension system. Namely, the previously announced measures aimed at incentivising longer working life and rationalisation of provisions on pensions did not materialise. The paradox of the short working life is negatively reflected in the insufficient amount of pensions, warning against the potentially increasing risk of poverty and social exclusion at old age. Given the exceptionally low age threshold for pension entitlement, expenses on pensions are bound to become one of the leading generators of fiscal deficit. Moreover, risks arising from the intensification of negative demographic developments are reflected in other big public systems.

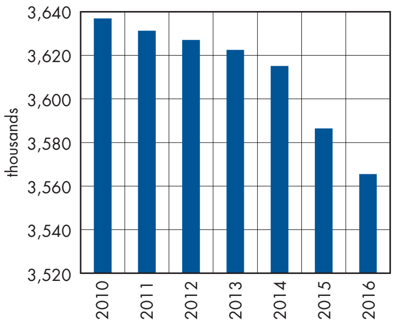
Thus, the latest *Ageing Report* report envisages an increase in expenses on health care by 1.7 ppts in the reference scenario due to the unfavourable population aging trend, which is much higher than the EU average of 0.9 ppts. Given the way in which health care is financed (dominated by the intergenerational solidarity system), the greatest risk in the short and the long term could arise precisely from the weak labour market, which limits the potential of the system to realise special purpose revenues. The decline in the working-age population to new, record-low is a consequence not only of population ageing but also of increased emigration. All of this means that the issue of fiscal sustainability will remain in the focus of economic policy-makers in the medium term. Therefore, Croatia should use the improved fiscal metrics in the currently favourable environment in the financial markets for adjustment and sustainability of the primary structural balance. The interventions needed in large public systems (pension, health care and education) have been defined in detail in the recommendations of the EC and have repeatedly been offered as solutions in the *National Reforms Programme* and the *Convergence Programme*. It is noteworthy that Croatia has been participating in the so-called *European Semester* since 2014 and that the majority of recommendations actually remained unchanged ever since. A more noticeable progress was made in terms of reducing the excessive fiscal deficit and public debt. However, as already mentioned, the latter was primarily a consequence of better-than-expected circumstances, while at the same time progress in the segment of structural reforms remained mainly limited or, in some areas, completely absent. It is therefore sure that again this year within the cycle of the

Health care spending – LT projections*



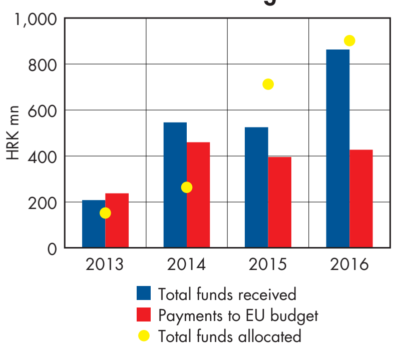
** The Ageing report, 2015*
Sources: EC, Economic RESEARCH/RBA

Working-age population



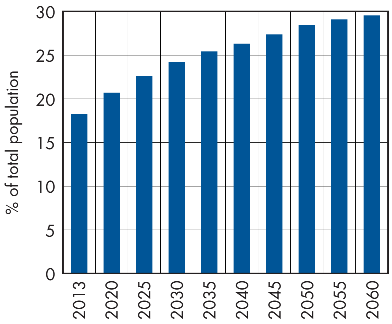
Sources: CBS, Economic RESEARCH/RBA

Transactions with EU budget



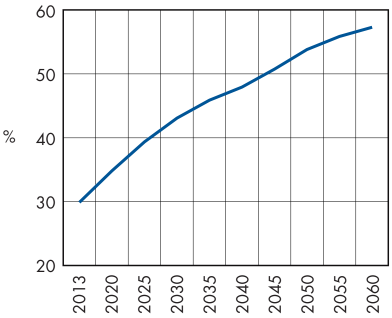
Sources: CNB, Economic RESEARCH/RBA

Elderly population (65 and over) – LT projections*



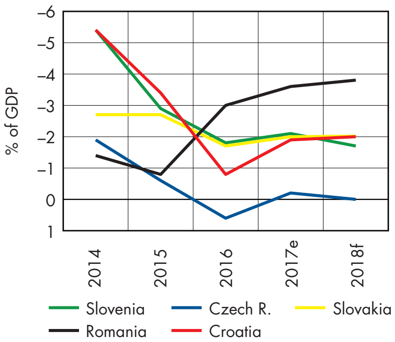
** (as % of total population, The Ageing report, 2015)*
Sources: EC, Economic RESEARCH/RBA

Old-age dependency ratio 20–64



** The Ageing report, 2015*
Sources: EC, Economic RESEARCH/RBA

Consolidated General Gov't balance, as % of GDP



Sources: Eurostat, Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

new European Semester the European Commission will welcome the presented fiscal efforts in the two mentioned documents. While the exit from the so-called EDP procedure seems highly likely, a stronger momentum in the implementation of structural reforms would be quite unusual, to say the least, given that this is the eve of another local election. To the contrary, experience teaches us that this is the time in which public spending is additionally fuelled, both as regards current and capital items. On the other hand, the presence of positive risks arising from greater use of EU funds should also not be neglected, although absorption is still difficult due to limited administrative capacities. The latter represents a certain risk to the realisation of planed revenues and expenditures under this item within the framework of the three-year fiscal projection, while in the upcoming period the greatest challenge is to use funds awarded in the programme period 2014 – 2020.

If we take into account that the latest Competitiveness Report from the World Economic Forum for the period 2016 – 2017 underlined inefficient public bureaucracy as the greatest problem for doing business in Croatia, it is clear that in the upcoming period attention should finally be directed at resolving the deficiencies in the public sector. The revised Action Plan for the period 2017 – 2020 (adopted late last year) goes in this direction, encompassing three key areas: efficiency of the public administration system, de-politicization and efficient human resources management and digitalisation of public services. In addition, the Public Debt Management Strategy for the period 2017 – 2019 was recently adopted, reflecting awareness of high public debt and high exposure to currency risk, pointing towards the need for better structure in the management of Croatia's public debt. The T-bill issuance calendar, as well as the plan of government bond issues in the primary market contributes to greater transparency of public finances, while, on the other side, focusing primarily on the debt of the central budget compromises transparency requirements in terms of the scope of the overall public debt. Namely, in the past period, the bulk of public debt was generated precisely in the segment of extra-budgetary users and local units. Therefore, it would be desirable if in the upcoming period, in addition to updating data on public debt, its scope of coverage would be widened to encompass the consolidated general government level.

The latter is linked to the issue of state-owned enterprises, whose poor corporate governance and low productivity generates new potential liabilities thus creating pressure on the system of public finances. Since the last year's ambitious plan presented in the National Reforms Programme (which aimed to speed up the privatisation process and strengthen performance monitoring of state-owned enterprises) only limited improvements have been made: a few enterprises were removed from the list of enterprises of strategic importance and the sale of shares in non-strategic enterprises yielded an income of 0.2% of GDP.

In conclusion, visible progress was made in defining the key segments for structural reforms. However, a step towards their more decisive implementation would be a welcome change. Otherwise, given the country's relatively high external vulnerability, its long-term fiscal sustainability would be called into question.

Tomislava Ujević

New borrowings in line with plans

- **Stable credit outlook confirmed**
- **One more HRK issue by year-end?**
- **Ample liquidity supports low yields**

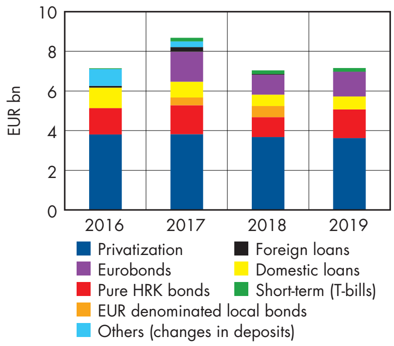
The stabilisation process for Croatia's credit rating ended early in March, when Moody's, the last of the top three rating agencies, changed Croatia's outlook to stable affirming its rating for long-term borrowing. This laid the foundations for future positive outlook. Namely, improved economic and fiscal metrics have met with approval from rating agencies and investors, so if the announced and much-awaited public system reforms really do see the light of day we would not rule out a possible outlook upgrade to positive in the next year. This will undoubtedly have a positive impact on the price of Croatia's borrowing.

Q1 was marked by the Government's increased activity as regards public debt management – in addition to new borrowings in the capital market, in January the Government presented its **Public Debt Management Strategy** for the period 2017 – 2019. A review of historical data in this document, which covers the level of the general government, indicates that a noticeable share of public debt has been generated in the road infrastructure segment (Croatian Motorways, Croatian Roads and Rijeka-Zagreb Motorway) and by the CBRD. Although information on the structure of Croatia's debt by instrument, maturity and currency structure is welcome, fact remains that there are still no transparent data on debt repayment projections related to individual public debt generators. Although this document clearly states that ''a need to strengthen control over the operation of public enterprises, included in the general government sector under the ESA2010 methodology, has been established during the past period'', the published Strategy envisages further changes in the structure of Croatia's debt, in terms of currency, interest maturity, and an increase in the substitution of borrowing in foreign markets by domestic borrowing. In other words, it envisages further growth of the kuna component in total government debt through primary issues in the domestic market, as well as possible substitution of a share of existing foreign currency instruments by those in kuna.

Given that the existing level of public debt paired with the liabilities arising from maturing principal creates the need for stronger refinancing (which comes closely to 20% of GDP on an annual level) we think that structured data must be regularly updated and publicly disclosed. Moreover, aiming at greater transparency, efforts should be stepped up to make data more detailed and more comprehensive, reflecting balances, repayments and planed borrowings, not only at the state-budget level but including state enterprises and the CBRD, which account for a substantial portion of Croatia's public debt.

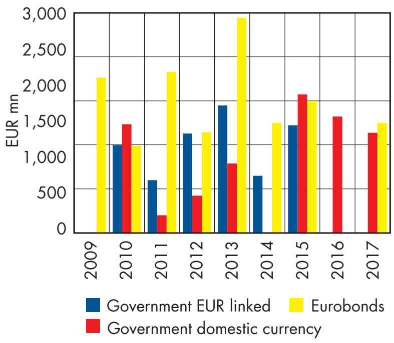
On the other side, the Government was also active in the primary capital market, both domestic and foreign in Q1. After Croatia placed two kuna issues (HRK 3bn and HRK 5.5bn) maturing in 2022 and 2028 in the local market, which attracted exceptional investor interest that much surpassed the planed issue volume, it came to an issue in the international capital market. Amid exceptionally high liquidity and low interest rates, supported by the unconventional monetary policy currently pursued by the European Central Bank, Croatia took advantage of the favourable conditions and for the first time in two years issued EUR 1.25bn-worth

Budgetary financing plan-sources



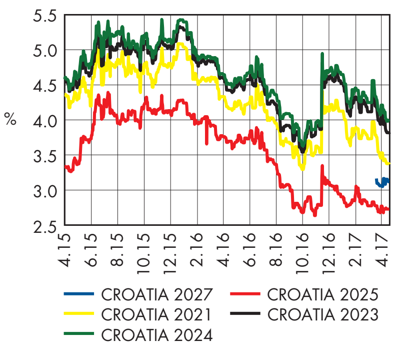
Sources: MoF (Strategy of Public Debt 2017 – 2019), Economic RESEARCH/RBA

New government bond issues



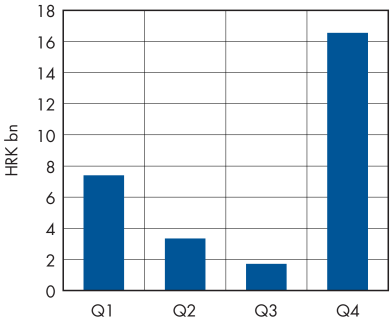
Includes T-bills with maturity longer than 1y
Sources: MoF, Economic RESEARCH/RBA

Croatian Eurobonds*



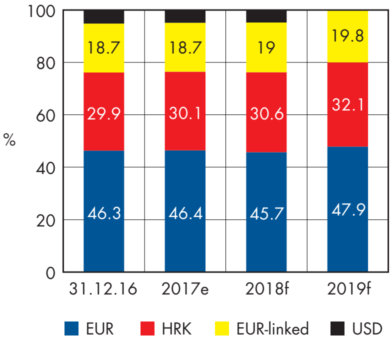
** bid ytm*
Sources: MoF, Economic RESEARCH/RBA

T-bills maturity in 2017 (quartely)



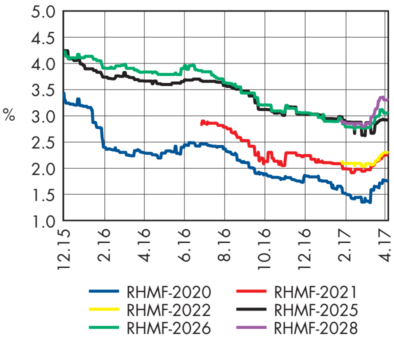
Sources: MoF, Economic RESEARCH/RBA

Currency composition of budgetary debt



Sources: MoF (Strategy of Public Debt 2017 – 2019), Economic RESEARCH/RBA

Croatian government bonds yields (HRK)



Sources: Bloomberg, Economic RESEARCH/RBA

of Eurobonds denominated in euros. Increased investor interest was confirmed by the initial price of the issue which was cut two times so the issue was realised at the spread of 230 bp on the reference midswap, which was Croatia's most favourable borrowing in international capital markets to date. By the end of the year, in line with the announced bond issuance plan, which reflects plans for this year's borrowings in the domestic bond market of HRK 14bn, we expect one more domestic issue, which would satisfy the needs for securities financing this year.

Developments in the secondary market of local issues were largely marked by the situation surrounding Croatia's largest private retailer – Agrokor. Namely, amid growing uncertainty domestic government bonds reacted with increased volatility and yield growth. In comparison to the beginning of the year, yields on kuna issues went up by 30 bps on average, which is fully attributable to the market situation concerning the Agrokor Group, which was reflected in increased risk aversion in all segments of the domestic financial market. Yield growth was especially pronounced at the longest end of the kuna yield curve, i.e. in relation to the bond maturing in 2028, whose yield went up by as much as 40 bps. However, amid ample market liquidity, the prices of domestic issues showed signs of gradual recovery already in mid-April.

As the year goes on, high liquidity surplus in the system will continue to support current yield levels. We expect the situation to quiet down at current levels. We do not exclude a possibility of slight yield growth at the end of the year, largely depending on a new local issue (which according to the bond issuance plan for this year is envisaged in the last quarter). Institutional investors, here we primarily mean, pension funds, will continue to generate the most demand at the longer end of the domestic yield curve.

Yields on T-bills continued to move at record lows in the short-term debt securities market. Thus, at the end of March the one-year kuna T-bill dropped to a new historical low of 0.45%. Such developments pushed a share of market participants to shorter-term kuna securities which, in comparison to similar maturity T-bills, offer higher returns. Amid exceptionally high system liquidity and modest alternative investment possibilities, we expect the yield curve of short-term debt securities to hold at low levels until the end of the year, additionally supported by continued expansive monetary policy of the CNB. According to the T-bill issuance calendar, the Government plans to roll-over all issues at maturity.

As for Croatian Eurobonds and their movements in the secondary market, Q1 was relatively quiet, with the absence of more significant changes in prices. Regional developments and market sentiment in the CEE countries will also influence Croatian issues. The possible narrowing of spreads will primarily depend on macroeconomic and fiscal developments. The improved fiscal metrics, implementation of reforms and continued economic growth would surely positively reflect themselves on the country's credit rating and consequently the risk premium expressed in the spread vis-à-vis the referent international issues.

Elizabeta Sabolek Resanović

New challenges for bank operations

- **Lower deposit yields change client preferences**
- **Growth of kuna lending increases structural imbalances**
- **Rising risks in the corporate lending segment jeopardise bank profitability**

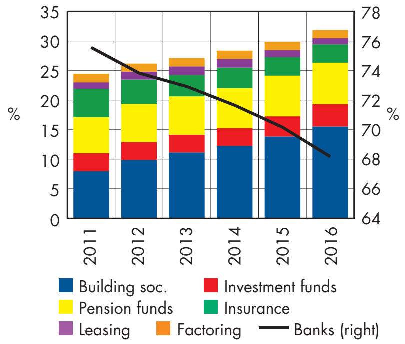
The share of assets of credit institutions in total financial sector assets dropped to below 70% at the end of last year, with the downward trend likely to continue this year. At the beginning of the year we noticed a reduction in bank deposits. Pressured by rising surplus liquidity banks lowered their deposit rates. Due to lowered yields, some of the clients decided not to renew their time deposits but opt for sight deposits and seek higher yields in alternative investments. Amid lower yields from risk-free investments the assets of money funds followed on the downward path observed in bank deposits. A positive change in client preferences was observed in connection to investment funds whose investment strategy is to invest in higher-risk assets. The assets of bond funds boasted strong growth and the assets of equity funds increased as well.

The reduction in the loan portfolio paired with a stable level of bank deposits created a liquidity surplus that was used to pay off secondary sources of financing. However, the room for bank deleveraging was used up last year so banks strive to invest their excess liquidity in new loans to clients. There is room for credit growth in the corporate sector, where less than a half of corporate borrowing is financed by bank placements. Direct borrowing abroad accounts for a bulk of the corporate debt. On the other side, surplus liquidity lowered the price of financing of kuna loans to the level of the dominant form of lending, lending in euros. Therefore banks strengthened their supply of kuna loans to corporate, aiming at refinancing corporate foreign debts.

The regular habit of clients to hold their time deposits in euros paired with the parallel increase in long-term loans in kuna resulted in the growth of the currency and maturity imbalance and imbalance in the variability of interest rates on banks' balance sheets. In 2017, the increase in imbalances on banks' balance sheets will not restrict the strategy of increased corporate lending because the accumulated liquidity surplus is sufficient to finance this process. However, the crisis in the greatest domestic company (Agrokor), which includes Croatia's largest retail chain (Konzum) might jeopardise banks' plans. A halt in the collection of receivables spread over affiliated and commercially associated companies and may thus jeopardise the operation of a substantial portion of the economy. At the end of the first quarter it is clear that Agorkor's restructuring will result in the partial value adjustment of receivables by its creditors. However, the extent to which the crisis spread to companies commercially associated with Agrokor can still not be estimated with certainty. This year we expect banks to suffer an increase in the loss of value of their loan portfolios, which will in turn negatively affect their profitability. The extent of this negative influence will depend on the success in Agrokor's restructuring.

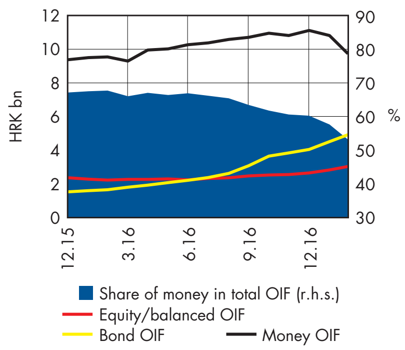
Anton Starčević

Croatian financial sector, structure



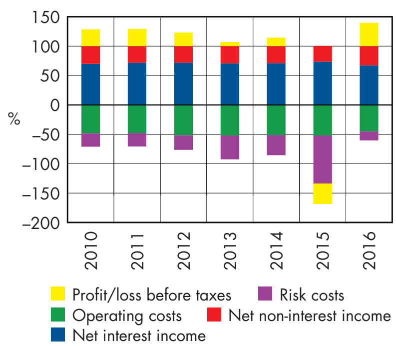
Sources: CNB, CFSSA, Economic RESEARCH/RBA

Open-end investment funds, net assets in HRK bn



Sources: CFSSA, Economic RESEARCH/RBA

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

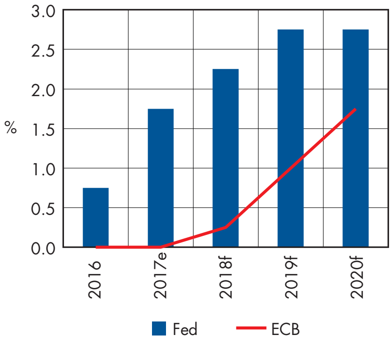


** – formation of Gross income (from 0% to 100%)*
– distribution of GI, except Pbt (below 0%)
– Profit bt as % of GI (over 100%)
Sources: CNB, Economic RESEARCH/RBA

Fed's restrictive and ECB's expansionary monetary policy

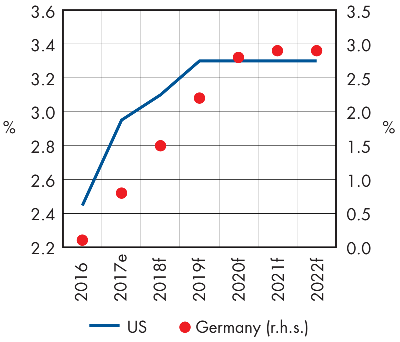
- **Normalisation of Fed's interest rates**
- **ECB's monetary easing continues**

Key rates, eop



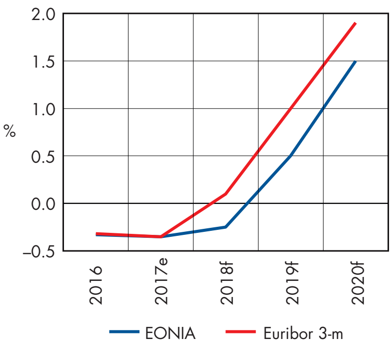
Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

10-y Government bond yields



Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

Interest rate forecast, eop



Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

It was decided at the latest FOMC meeting in mid-March that the benchmark rate will be raised by 0.25 ppts to a range between 0.75% and 1.00%, with two more hikes being announced by the end of this year. A gradual normalisation of interest rates will continue in the next two years, which is ultimately planned to result in the benchmark rate at the level of 3.0% by the end of 2019. The key macroeconomic variables (GDP, inflation and the unemployment rate) remained mostly unchanged over the three-year forecasting period. However, the chair of the Fed, Janet L. Yellen, clearly stated that for the time being they do not include changes to the economic and fiscal policy, saying that it is currently not possible to estimate their impact on the economy, the labour market and inflation. According to our estimates, the published decisions from the FOMC meeting seem quite balanced. On one side, the target inflation stresses the importance of developments in the *core* inflation, while on the other side there is a clear commitment to the gradual interest rate normalisation. Therefore, we think that under the scenario of President Trump's announced moves being realised (primarily those directed at significantly alleviating the tax burden from households), the likelihood of an increase in the key rate goes up too. Given that the latest US labour market data point toward full employment, we do not exclude the possibility of a more dynamic normalisation of the interest rate, of which the first might be seen already in June.

On this side of the Atlantic, at its meeting in March, the Governing Council of the ECB confirmed that based on the regular macroeconomic analyses high flexibility of the monetary policy should be maintained with an aim to firmly push inflation to the level of some 2%. As expected, the ECB kept its key rates remained unchanged, stating that they are to remain at present or lower levels for an extended period of time (and well past the horizon of the *QE programme*). The ECB confirmed it would continue its expansionary *QE programme* through net purchases at a monthly pace of EUR 60bn until the end of December 2017, or beyond, if necessary. In other words, the ECB stressed it was ready to possibly extend the size of securities purchases and/or the duration of the programme's implementation in case of a deterioration in the outlook or in case of poorer financial conditions which would jeopardise consistent adjustment of inflationary developments. It is noteworthy here that the growth in overall inflation is for the time being primarily a consequence of the growth in the prices of energy and unprocessed food products, while *core* inflationary pressures are still weak. Therefore, in the medium term, the ECB continues to expect only a gradual rise in *core* inflation, aided by expansionary momentary measures, expected economic growth and the appropriate gradual reduction of unused capacities. In this context, we think that the first increase of its key rates by the ECB should not be expected until the end of next year. Firmer projections of future securities purchases under the *QE programme* might be announced already at the ECB's meeting in September. An announcement of a gradual decrease in purchases at a monthly level is expected in the first half of 2018, which might consequently push up yields on the ten-year German Bund.

Tomislava Ujević

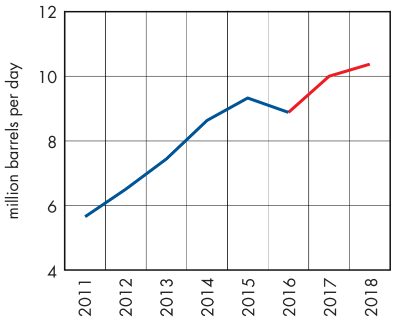
OPEC to additionally cut production quotas?

- **Rising uncertainty about production quota cuts amid market saturation**
- **OPEC fully implemented announced production cuts**

The euphoria caused by the OPEC cuts at the end of November of last year seems to have evaporated again at the end of this year's Q1. Whereas, at the start of the year, the price for a barrel Brent reached roughly USD 58 and thus the highest level in 18 months, it has since dropped again to USD 50 in March. From our perspective this seems to be caused by rising uncertainty among investors about the alleged drastic increase in the production of oil from slate in the US, which might result in the increase in crude oil stocks and thus render OPEC's efforts to maintain balance in the market unsuccessful. On the other hand, uncertainty in the market is caused by expectations whether and to what extent OPEC members and some non-members will expand their agreement regarding cuts to production quotas. Although the production of oil from slate is undeniably growing, when figures from the end of September until the end of 2016 are reviewed, US production did not increase by more than some 2.5%. According to the US Energy Agency (EIA) the production of oil in the first months of this year went up by approximately 3.5%. By the end of the year this growth might reach a rate of 8 – 9% as compared with the end of 2016. On an annual level this constitutes an average increase in the production of oil from slate of approximately 350 – 400 ths. b/d. In this regard, question remains will such growth rates in the production of oil from slate in the US be enough to jeopardise the adjustment of very high global stocks. In our opinion, the answer is clearly no. On one hand, the production of oil from slate accounts for only 5% of global production. On the other, it seems very likely that production by OPEC member (except the US) will stagnate at best given the voluntary limits on production imposed by 11 countries, such as Russia and Kazakhstan. In view of historical comparisons, we expect that the increase in production by all non-OPEC members (including the US) will remain far below the average of 0.4m b/d this year. At the same time, OPEC production will slightly decrease compared to 2016. It already cut its production by some 1.2m b/d which raised its compliance rate to 100%. It would be naive to assume at this point that this level of "discipline" will remain unchanged until the end of the year. Moreover, there is the risk of the OPEC agreement not being extended beyond the first half of the year. In addition, history has taught us that production discipline among some members deteriorates in the long run. We expect OPEC to extend its production cuts agreement once this year. Amid the rise in oil production in the US it is estimated that global oil production will go up by some 0.2m b/d (to a total of 97.2m b/d) relative to the previous years. This increase, in the context of global demand for oil, which should, according to the International Energy Agency, grow by 1.4m b/d this year, will result in the narrowing of supply and demand by 1.2m b/d this year, as compared to 2016. In these circumstances the level of global crude oil stocks would return to healthy levels held in the period from 2010 – 2014. We expect the price of oil to rise to USD 60 per barrel by mid-year. At the annual level we expect the Brent crude oil price to average at USD 58 per barrel.

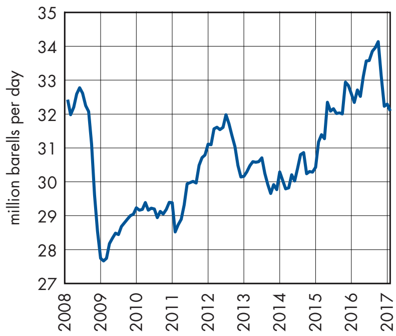
Elizabeta Sabolek Resanović

US oil production



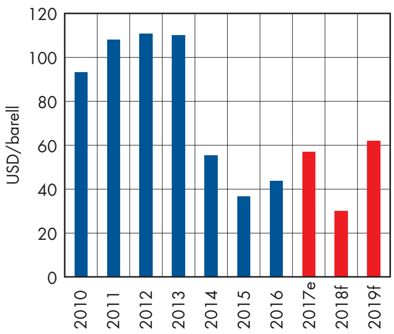
Sources: Bloomberg, Economic RESEARCH/RBA

OPEC crude production



Sources: Bloomberg, RBI/Raiffeisen RESEARCH

Oil price forecast – Brent*

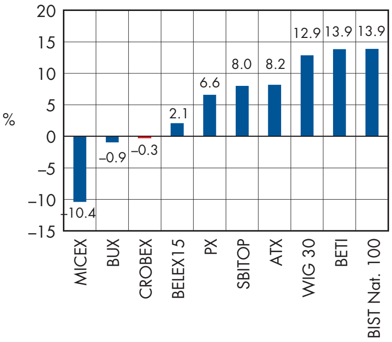


** year average*
Sources: Bloomberg, Economic RESEARCH/RBA

Beginning-of-the-year gains cancelled out

- Nice performance of most CEE regional indices
- Turbulent Q1 2017 on the ZSE
- CROBEXkonstrukt was the winner of the quarter growing over 57%

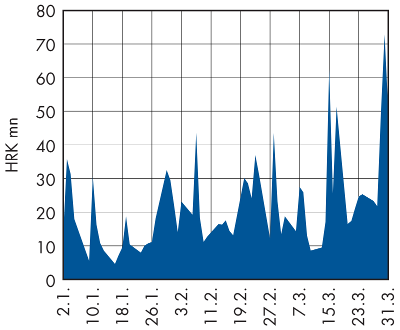
CEE indices – returns in Q1 2017*



** in local currency, value on 31.3.2017 (6:30 PM)*
Sources: Bloomberg, Economic RESEARCH/RBA

The CEE equity markets saw mostly positive developments in Q1 2017, in line with the positive sentiment in the developed markets. Impetus came from improved earnings in the US and Europe and a favourable macroeconomic environment, as well as announcements of simulative measures by the Trump administration. The highest returns among the regional indices were registered by the Turkish BISTNat 100 and the Romanian BET. BISTNat 100 profited from the relatively favourable valuation, while the BET was propelled by good macroeconomic expectations. On the other side, the Russian MICEX registered, by far, the greatest fall among the regional indices due to investor mistrust concerning the improvement in the Russia-US relations. Developments in the price of oil did not help either. The Bulgarian BUX also went down despite the favourable macroeconomic environment.

Equity turnover (mn HRK)

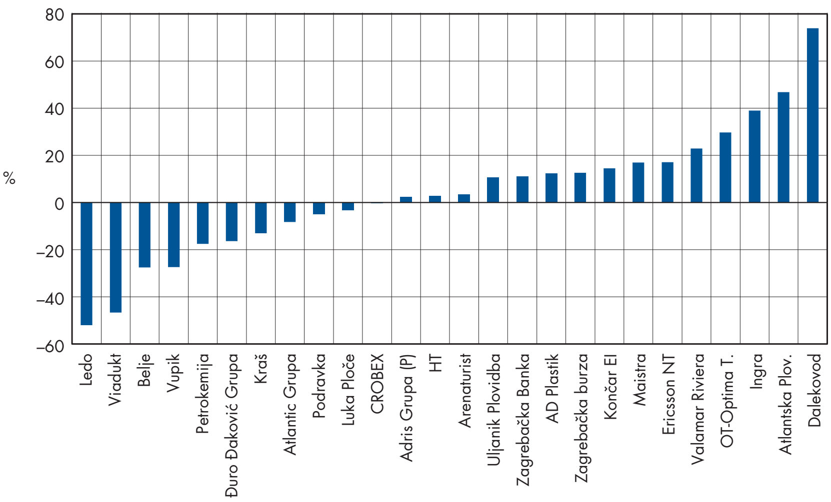


Sources: ZSE, Economic RESEARCH/RBA

After the strong growth of equity indices on the ZSE in January and February, spurred by improved macroeconomic outlook and growing optimism, in March the CROBEX fell sharply to below 2,000 points, erasing the gains since the beginning of the year (at –0.3%). The bearish sentiment was triggered by the crisis in Agrokor that spilled over to other shares of food companies in the CROBEX. Shares of Viadukt also had a substantial decline in price following the termination of the contract for building the Čiovo Bridge and the company's account being frozen. On the other side, the best performance among the CROBEX constituents was boasted by Dalekovod shares due to good operating results in 2016. It was followed by the shares of Atlantska Plovidba, which profited from the growth of the Baltic Dry Index of dry bulk carriers in March. Hence, CROBEXnutris lost the most among sector indices of the ZSE, while the construction sector index gained as much as 57.5% since the beginning of the year. Two-digit growth was also boasted by the transport sector index (+11% ytd). The overall equity turnover doubled compared to the same period 2016, with the daily average of HRK 20m. In the period under review, the most traded were shares of Jamnica (total turnover of HRK 128.9m), Valamar Riviera (total turnover of HRK 128.4m) and Hrvatski Telekom (total turnover of HRK 116.6m). The total market capitalisation of equities on the ZSE stood at HRK 142.3bn at the end of the quarter, down 0.6% from the end of 2016.

Ana Turudić and Nada Harambašić Nereau

Return of CROBEX constituents in Q1 2017 (dividends not included)*



** return calculated as on 31.3.2017 (6:30 PM)*
Sources: ZSE, Economic RESEARCH/RBA

Uncertainty over Agrokor

- Agrokor crisis expected to make ZSE trading volatile
- Crisis might negatively affect the performance of Agrokor's suppliers due to weaker sales, while hotel companies are expected to increase their profitability
- Except for CROBEX10, regional indices maintained moderate PER

The expectations regarding regional indices[1] outlook are predominantly optimistic amid expectations of continued expansionary monetary policy and still relatively moderate valuation, while political uncertainties might lead to rather temporary declines and not to a permanently negative sentiment. Despite their recent growth, it seems that the majority of regional indices are still moderately valued compared to the leading European and US indices, whose 2017e PERs stand at some 14x and 18x respectively. The lowest PER among the indices under review is still that of the Russian MICEX. Somewhat higher prices of oil expected by the end of the year could support the growth of that index as well as an improvement of economic indicators. The expected dividend yield of regional indices ranges from the 2.7% estimated for 2017e for the BUX to 5% estimated for the Czech PX and the Russian MICEX. The estimate for CROBEX10 (2.65% according to Bloomberg calculations) is at the lower end of the range and resembles the yield generated in 2016.

Although the earnings in 2016 mostly pointed towards an improvement: profit growth or lower loss yoy, the fall in equity prices amid the Agrokor crisis reflects investors' concern in relation to the collection of receivables and successful continuation of sales through this largest retail chain, especially in the context of Easter spending and the peak tourism season. Given the numerous uncertainties around the resolution of the situation in Agrokor and its suppliers, it is quite challenging to estimate an outlook for the equity indices on the ZSE. Hence, the bearish sentiment could continue for the next 15 months and longer. Namely, this is the time-frame of the extraordinary administration at Agrokor set by the so-called Lex Agrokor. After the stabilisation of operations the administration should reach a settlement with suppliers and creditors of the Group. Moreover, the CROBEX10 still trades at a premium in relation to 2018f PERs of most other regional indices (14,5x according to Bloomberg calculations). As for hotel companies, we expect their profitability and indicators to continue growing, partly due to extensive investments in the quality and supply of accommodation capacities. Although the M&A activities remained subdued and only the takeover of Crnogorski Telekom was completed so far, while the privatisation and sale of state-owned shares faded into the background, we reckon some of the expected activities could be resumed in the remainder of the year, after the situation around Agrokor hopefully stabilises.

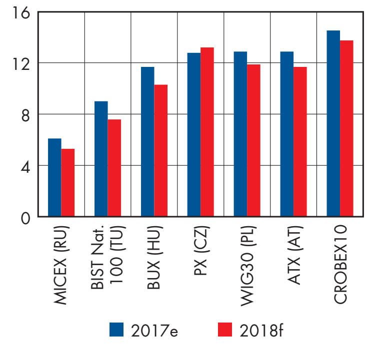
Ana Turudić and Nada Harambašić Nereau

CROBEX members multiples (results FY 2016)

Company	PER	EV/EBITDA
AD Plastik	13.7	7.4
Adris grupa	18.4	6.0
Arena Hospitality G.	neg.	neg.
Atlantic Grupa	16.4	8.9
Atlantska plovidba	neg.	54.3
Belje	neg.	8.7
Dalekovod	10.6	10.3
Đuro Đaković grupa	neg.	35.5
Ericsson Nikola Tesla	16.5	10.5
Hrvatski telekom	15.3	4.1
Ingra	82.1	neg.
Končar-elektroindustrija	14.2	7.5
Kraš	24.6	8.9
Ledo	4.61	1.39
Luka Ploče	neg.	neg.
Maistra	21.2	12.3
OT-Optima telekom	15.5	4.5
Petrokemija	neg.	23.2
Podravka	13.7	7.8
Uljanik plovidba	neg.	20.2
Valamar Riviera	15.3	13.4
Viadukt	77.9	4.3
Vupik	neg.	14.3
Zagrebačka banka	11.3	n.a.
Zagrebačka burza	neg.	neg.

** in local currency, prices on 20.4.2017 (6:30 PM)*
Sources: ZSE, Economic RESEARCH/RBA

PER of CEE indices



Sources: Thomson Reuters, IBES, Bloomberg, Raiffeisen RESEARCH/RBI

1 http://www.rbinternational.com/eBusiness/services/resources/media/829189266947841370-829189181316930732_829603300989963599-1230814665005830980-1-2-EN.pdf

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Abbreviations

avg – period average
bn – billion
bp – basic point
C/A – current account
CBS – Croatian Bureau of Statistics
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
e – estimate
EC – European Commission
ECB – European Central Bank
EDP – Excessive deficit procedure
EE – Eastern Europe
EONIA – Euro OverNight Index Average
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
FI – financial institution
FOMC – Federal Open Market Committee
FX – foreign exchange
FY – full year
GDP – gross domestic product
GFCF – Gross fixed capital formation
GI – gross income
H – half
HRK – Croatian Kuna
ILO – International Labour Organization
LCY – Local Currency
M, m – month
M&A – Mergers and Acquisitions
mn – million
MoF – Ministry of Finance
OIF – open investment fund
OPEC – Organization of the Petroleum Exporting Countries
Q – quarter
PER – price to earnings ratio
pp, ppt – percent point
r.h.s. – right hand scale
RBA – Raiffeisen bank
RBI – Raiffeisen Bank International
SEE – Southern and Eastern Europe
SMEs – Small and medium-sized enterprises
USA – United States of America
USD – US Dollar
VAT – value added tax
y – year
yoy – year on year
YtM – Yield to maturity
ZIBOR – Zagreb Interbank Offered Rates
ZSE – Zagreb Stock Exchange

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