Raiffeisen Research Report

Number 67
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On the road to sustainable recovery?

- Growth continues
- Public debt – on the way down
- Low interest rate environment to continue
- ZSE remains under Agrokor's influence

Raiffeisen RESEARCH

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Selected macroeconomic indicators

	2010	2011	2012	2013	2014	2015	2016	2017e	2018f	2019f
GDP & Production										
Gross Domestic Product, % (constant prices)	–1.4	–0.3	–2.2	–0.6	–0.1	2.3	3.0	2.9	2.3	2.5
GDP at current prices (EUR millions)	45,146	44,837	44,022	43,754	43,416	44,525	46,284	48,641	50,588	52,696
GDP per capita at current prices (EUR)	10,524	10,473	10,314	10,281	10,249	10,511	11,009	11,698	12,205	12,738
Retail trade, % real annual changes	–2.1	0.6	–4.1	–0.6	0.4	2.4	4.0	4.5	3.0	3.5
Industrial production, % annual changes	–1.4	–1.2	–5.5	–1.8	1.2	2.7	5.3	2.0	2.5	2.8
Prices, Employment and Budget										
Consumer Prices, %, end of period	1.8	2.1	4.7	0.3	–0.5	–0.6	0.2	0.9	1.3	1.5
%, average	1.1	2.3	3.4	2.2	–0.2	–0.5	–1.1	1.2	1.4	2.0
Producer Prices[1], %, end of period	5.7	5.8	6.9	–2.6	–3.4	–4.4	–0.1	1.5	2.5	2.1
%, average	4.3	6.4	7.0	0.5	–2.7	–3.9	–4.1	2.2	2.4	2.0
Unemployment rate (official rate, avg)	17.4	17.8	18.9	20.2	19.6	17.0	14.8	11.7	11.1	10.2
Unemployment rate (ILO, avg)	11.6	13.7	15.9	17.4	17.3	16.3	13.1	11.7	11.1	10.2
Average net wage, in Kuna	5,343	5,441	5,478	5,515	5,534	5,594	5,685	6,015	6,153	6,264
General Government Balance, % of GDP, ESA 2010	–6.2	–7.8	–5.3	–5.3	–5.1	–3.3	–0.9	–1.2	–1.6	–1.5
Public Debt, HRK bn, ESA 2010	191.3	216.7	233.6	270.8	284.2	289.6	289.1	294.0	301.3	303.4
% of GDP, ESA 2010	58.3	65.2	70.7	81.7	85.8	85.4	82.9	81.1	79.8	77.0
Balance of Payment and External Debt										
Good's and Services Exports, EUR million	17,007	18,128	18,319	18,768	19,677	21,472	22,776	24,958	26,530	28,387
% change	9.2	6.6	1.1	2.5	4.8	9.1	6.1	9.6	6.3	7.0
Good's and Services Imports, EUR million	17,158	18,314	18,125	18,599	18,849	20,439	21,429	23,554	24,820	26,433
% change	–0.5	6.7	–1.0	2.6	1.3	8.4	4.8	9.9	5.4	6.5
Current Account Balance, % of GDP[2]	–1.1	–0.7	–0.1	1.0	2.0	4.6	2.5	3.7	2.2	2.5
Official International Reserves, EUR millon, eop	10,660	11,195	11,236	12,908	12,688	13,707	13,514	14,800	15,100	15,300
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	8.0	7.6	7.5	7.3	6.9
Foreign Direct Investment, EUR million[3]	1,066	1,022	1,153	737	2,297	196	1,694	1,750	1,104	2,000
Tourism – nightstays, % change	2.6	7.0	4.0	3.3	2.6	7.7	9.0	10.5	4.8	4.5
External debt, EUR billion	46.9	46.4	45.3	45.8	46.4	45.4	41.7	40.3	40.5	40.4
External debt, as % of GDP[2]	103.9	103.5	103.0	105.3	107.9	101.9	90.0	82.9	80.1	76.7
External debt, as % export of goods and services[2]	275.8	255.9	247.3	244.1	235.9	211.4	182.9	161.5	152.7	142.3
Monetary and Financial Data										
Exchange rate, eop, USD / HRK	5.57	5.82	5.73	5.55	6.30	6.99	7.17	6.36	6.05	5.68
avg, USD / HRK	5.50	5.34	5.85	5.71	5.75	6.86	6.80	6.54	6.22	5.84
Exchange rate, eop, EUR / HRK	7.39	7.53	7.55	7.64	7.66	7.64	7.56	7.50	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	7.48
Money (M1), Kuna billion, eop	48.0	51.5	51.9	57.9	63.4	70.7	83.5	97.2	101.4	104.7
% change	1.7	7.3	0.9	11.5	9.6	11.4	18.1	16.5	4.3	3.3
Broadest money (M4), Kuna billion, eop	232.8	246.0	254.7	264.9	273.3	287.4	300.9	312.3	320.5	327.8
% change	1.9	5.6	3.6	4.0	3.2	5.1	4.7	3.8	2.6	2.3
Credits, Kuna billion	245.6	257.4	242.1	240.8	237.0	230.0	221.5	218.2	221.5	226.1
% change	4.7	4.8	–5.9	–0.5	–1.6	–2.9	–3.7	–1.5	1.5	2.1
ZIBOR 3m, %, avg	2.4	3.2	3.4	1.5	1.0	1.2	0.9	0.6	0.7	1.2
Treasury bills rate 12m, %, avg	4.0	3.9	3.9	2.5	1.9	1.4	0.9	0.9	1.1	1.5

[1] on domestic market; [2] in euro terms; [3] including round tripping
e – estimate; f – forecast; eop – end of period; avg – period average
Forecasts: Economic Research/RBA
Sources: CNB, MoF, CBS

Real GDP (% yoy)

	2015	2016	2017e	2018f
Poland	3.8	2.7	4.0	3.2
Hungary	3.1	2.0	3.8	3.6
Czech Rep.	4.6	2.3	4.3	3.4
Slovakia	3.8	3.3	3.3	4.0
Slovenia	2.3	3.1	4.8	3.5
CE	**3.8**	**2.6**	**4.0**	**3.4**
Croatia	**2.3**	**3.0**	**2.9**	**2.3**
Bulgaria	3.6	3.4	4.0	3.7
Romania	3.9	4.8	5.7	4.0
Serbia	0.7	2.8	1.8	2.5
BiH	3.1	3.1	2.5	3.0
Albania	2.2	3.5	4.0	4.0
SEE	**3.2**	**4.0**	**4.4**	**3.5**
Russia	–2.8	–0.2	1.2	1.5
Ukraine	–9.8	2.3	1.5	3.0
Belarus	–3.8	–2.6	1.5	1.5
EE	**–3.3**	**–0.1**	**1.2**	**1.6**
CEE	**0.0**	**1.4**	**2.6**	**2.5**
Austria	1.0	1.5	2.8	2.2
Germany	1.5	1.9	2.1	1.8
Euro area	2.0	1.8	2.2	2.2
USA	**2.6**	**1.5**	**2.4**	**2.2**

Source: Raiffeisen RESEARCH/RBI

Consumer prices (avg, % yoy)

	2015	2016	2017e	2018f
Poland	–0.9	–0.6	1.8	2.4
Hungary	0.0	0.2	2.5	3.4
Czech Rep.	0.3	0.7	2.5	2.1
Slovakia	–0.3	–0.5	1.1	2.0
Slovenia	–0.8	–0.2	1.6	2.1
CE	**–0.5**	**–0.2**	**2.0**	**2.4**
Croatia	**–0.5**	**–1.1**	**1.2**	**1.4**
Bulgaria	–0.1	–0.8	1.8	2.6
Romania	–0.6	–1.5	1.1	3.7
Serbia	1.4	1.2	3.1	2.9
BiH	–1.0	–1.1	1.5	1.5
Albania	1.8	1.3	2.2	2.7
SEE	**–0.2**	**–0.9**	**1.5**	**3.0**
Russia	15.6	7.1	4.0	4.5
Ukraine	48.7	13.9	13.6	7.8
Belarus	13.5	12.0	8.5	8.5
EE	**17.7**	**7.7**	**4.8**	**4.8**
CEE	**9.1**	**3.9**	**3.4**	**3.8**
Austria	0.8	1.0	2.0	2.1
Germany	0.1	0.4	1.7	2.2
Euro area	0.0	0.2	1.5	1.3
USA	**0.1**	**1.2**	**2.2**	**2.5**

Source: Raiffeisen RESEARCH/RBI

Fixed capital formation (% yoy)

	2015	2016	2017e	2018f
Poland	6.1	–5.5	5.9	9.8
Hungary	1.9	–15.5	19.8	8.0
Czech Rep.	9.1	–3.6	6.5	8.5
Slovakia	16.9	–9.3	–1.5	4.0
Slovenia	–1.6	–3.6	n.v.	n.v.
CE	**6.8**	**–6.7**	**6.9**	**8.2**
Croatia	**3.8**	**5.1**	**4.5**	**6.0**
Bulgaria	2.7	–4.0	2.3	4.5
Romania	8.3	–3.3	3.0	6.0
Serbia	n.v.	n.v.	n.v.	n.v.
BiH	3.0	3.5	4.0	7.0
Albania	4.0	7.1	n.v.	n.v.
SEE	**5.6**	**–1.0**	**2.7**	**4.9**
Russia	–9.4	–1.4	3.0	4.0
Ukraine	–9.2	20.1	15.0	7.0
Belarus	–15.9	n.v.	n.v.	n.v.
EE	**–9.6**	**0.1**	**3.7**	**4.1**
CEE	**–2.0**	**–2.4**	**4.6**	**5.6**
Austria	**0.7**	**3.7**	**4.3**	**3.4**
Germany	1.1	2.9	2.1	n.v.
Euro area	2.2	3.0	2.9	3.8
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	–0.3	–0.2	–0.9
Hungary	3.4	5.4	3.2	2.9
Czech Rep.	0.2	1.1	1.0	1.1
Slovakia	0.2	–0.6	–0.6	0.3
Slovenia	4.4	5.2	5.0	4.8
CE	**0.2**	**0.7**	**0.5**	**0.2**
Croatia	**4.6**	**2.5**	**3.7**	**2.2**
Bulgaria	0.4	3.8	3.4	0.9
Romania	–1.2	–2.4	–3.6	–4.0
Serbia	–4.6	–3.9	–5.0	–4.3
BiH	–5.5	–4.4	–6.0	–6.2
Albania	–10.8	–9.1	–9.2	–9.4
SEE	**–1.1**	**–1.4**	**–2.2**	**–2.9**
Russia	5.1	1.7	4.7	5.3
Ukraine	–0.2	–4.1	–4.0	–3.6
Belarus	–3.8	–3.6	–3.5	–3.1
EE	**4.4**	**1.2**	**3.9**	**4.5**
CEE	**2.3**	**0.7**	**2.0**	**2.1**
Austria	1.9	2.1	2.1	2.3
Germany	8.3	8.3	7.5	7.5
Euro area	3.0	3.3	3.0	2.8
USA	**–2.6**	**–2.4**	**–2.5**	**–2.5**

Source: Raiffeisen RESEARCH/RBI

General budget balance (% of GDP)

	2015	2016	2017e	2018f
Poland	–2.6	–2.4	–2.0	–2.6
Hungary	–2.0	–2.0	–2.5	–3.0
Czech Rep.	–0.6	0.6	–0.2	0.0
Slovakia	–2.7	–1.7	–1.5	–1.5
Slovenia	–2.9	–1.8	–1.3	–1.1
CE	**–2.1**	**–1.6**	**–1.6**	**–1.9**
Croatia	**–3.3**	**–0.9**	**–1.2**	**–1.6**
Bulgaria	–2.8	1.6	–0.5	–1.0
Romania	–0.8	–3.0	–3.0	–4.0
Serbia	–3.7	–1.3	–1.3	–1.8
BiH	0.7	1.2	1.0	–0.5
Albania	–4.0	–2.5	–2.0	–1.5
SEE	**–1.8**	**–1.6**	**–2.0**	**–2.7**
Russia	–3.6	–3.7	–2.5	–2.0
Ukraine	–2.3	–2.9	–3.2	–2.7
Belarus	1.8	1.5	1.0	1.0
EE	**–3.3**	**–3.5**	**–2.4**	**–1.9**
CEE	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Austria	–1.1	–1.6	–0.9	–0.7
Germany	0.7	0.8	0.5	0.3
Euro area	–2.1	–1.5	–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	54.3	53.8	53.9
Hungary	75.2	73.9	73.2	72.4
Czech Rep.	40.3	37.9	36.2	34.9
Slovakia	52.5	51.9	52.0	50.9
Slovenia	83.1	79.7	75.4	73.5
CE	**53.7**	**54.5**	**53.6**	**53.0**
Croatia	**85.4**	**82.9**	**81.1**	**79.8**
Bulgaria	25.6	29.1	25.0	26.0
Romania	38.0	37.6	37.1	38.3
Serbia	74.7	71.6	62.8	60.5
BiH	41.8	40.4	41.0	41.5
Albania	72.7	71.0	69.0	65.0
SEE	**47.7**	**47.2**	**45.3**	**45.5**
Russia	12.7	13.5	14.0	14.5
Ukraine	72.3	76.1	71.4	65.9
Belarus	36.5	39.9	39.0	41.5
EE	**17.4**	**18.5**	**18.6**	**18.8**
CEE	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Austria	85.5	84.6	80.2	77.9
Germany	71.2	68.3	65.8	63.3
Euro area	90.3	89.2	88.2	87.0
USA	**101.9**	**105.5**	**105.6**	**104.9**

Source: Raiffeisen RESEARCH/RBI

Gross foreign debt (% of GDP)

	2015	2016	2017e	2018f
Poland	70.2	74.5	73.2	72.2
Hungary	106.2	98.3	88.0	81.8
Czech Rep.	69.5	73.9	89.9	80.3
Slovakia	85.4	88.8	89.6	86.2
Slovenia	120.1	110.9	103.5	102.0
CE	**64.7**	**66.7**	**68.8**	**65.3**
Croatia	**101.9**	**90.0**	**82.9**	**80.1**
Bulgaria	75.3	73.3	68.7	65.7
Romania	56.5	54.6	52.3	52.1
Serbia	81.6	74.2	70.3	66.7
BiH	53.4	54.4	55.1	54.3
Albania	73.2	71.7	67.4	64.7
SEE	**68.4**	**64.6**	**61.2**	**59.7**
Russia	37.9	39.0	29.4	24.8
Ukraine	130.9	121.7	112.7	106.9
Belarus	70.2	79.3	73.0	69.9
EE	**44.7**	**45.8**	**35.9**	**31.2**
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	126.2	127.9	124.9	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	4.26	4.15
Hungary	309.93	311.47	308.58	311.88
Czech R.	27.28	27.03	26.39	25.29
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	4.57	4.63
Serbia	120.73	123.13	121.67	123.06
BiH	1.96	1.96	1.96	1.96
Albania	139.72	137.33	134.23	134.63
SEE				
Russia	68.01	74.14	66.39	70.50
Ukraine	24.33	28.27	30.20	33.23
Belarus	1.77	2.20	2.19	2.40
Austria	Euro	Euro	Euro	Euro
Germany	Euro	Euro	Euro	Euro
Euro area	**Euro**	**Euro**	**Euro**	**Euro**
USA	**1.11**	**1.11**	**1.14**	**1.20**

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+	Baa1	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–	Caa2	B–
Belarus	B–	Caa1	B–
Austria	AA+	Aa1	AA+
Germany	AAA	Aaa	AAA
Euro area			
USA	**AA+**	**Aaa**	**AAA**

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

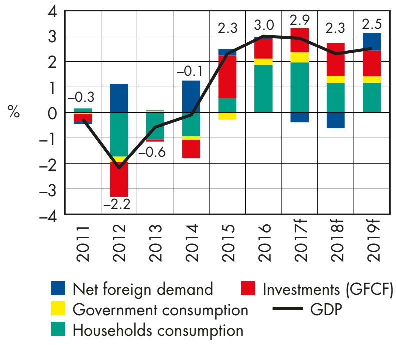
Modest steps towards sustainable recovery

Economic growth picked up in Q2, lead by personal consumption, while previously healthy growth rates of exports were greatly subdued by the once again confirmed high import dependence of Croatia's economy. Structurally, there were positive improvements over the past few years. However, they were modest and insufficient to be able to confirm that Croatia is on the road to sustainable recovery. Namely, hiding behind great exports results of goods and services is the still relatively low share of goods of medium to high technological complexity, while the structure of services remains dominated by services connected to travel (tourism). Investment continued to grow but it remains predominantly linked to tourism while the room for more successful withdrawal and use of funds from EU funds still exists. Private consumption as the main generator of the latest positive trends has been supported by several factors, such as the alleviation of tax burden, lower costs of (re)financing and ample inflow of foreign currency from tourism. However, in the medium to long run it is precisely private consumption and thus connected human capital and technological advancement that could pose the greatest obstacle to faster and more stable growth. Namely, despite continued decline in unemployment, more important indicators, such as the size of the working-age population, the employment and the activity rate do not reflect significant improvements. Moreover, migration and demographic trends and their long-term projections are not optimistic. In addition to external factors (single EU market), the reasons for this need to be sought in internal, deeply rooted domestic factors (institutional environment, rule of law, public systems – education and health care, etc.). For the time being at least, the Agrokor crisis had a limited influence on macroeconomic trends. However, we remain firm in our estimate that 2018 will be the more challenging year, more exposed to negative risks. This, at the same time, is the main factor for the projected slowdown in economic growth in 2018, which, apart from investments, might also be felt in personal consumption through the (un)employment channel. However, the final resolution of the situation surrounding Agrokor remains a big mystery.

Last but not least, the state budget also registered favourable developments amid above-potential growth and lower costs of debt servicing, making it highly likely that the budget deficit will be noticeably lower than initially projected. Moreover, ample surplus in the primary balance (excluding interest rate expenses from the budget statistics) encourages expectations of a declining trend in public debt. Amid these conditions, the Government announced the presentation of its Eurostrategy document for late October. The document includes the calculations of benefits and possible risks of joining the euro area and serves as a base for reasoned public debate. In addition, although the 2020 has already been set as the target year for joining the European Exchange Rate Mechanism II (ERM II), it should be noted that meeting the economic convergence criteria alone (laid down in the Maastricht Treaty) will not suffice for the adoption of the euro as a single currency. Namely, key for the assessment of compliance with convergence criteria is sustainability because convergence needs to be permanent and not only temporary. This means that in addition to economic and legal criteria, special attention will surely be paid to the creation of effective institutions and a stimulating business environment as preconditions for sustainable convergence together with appropriate economic policies. Until then our ticket to the euro area remains elusive.

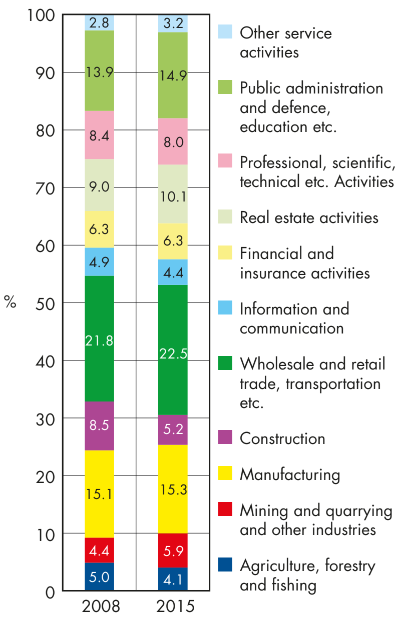
Zrinka Živković Matijević

GDP contributions



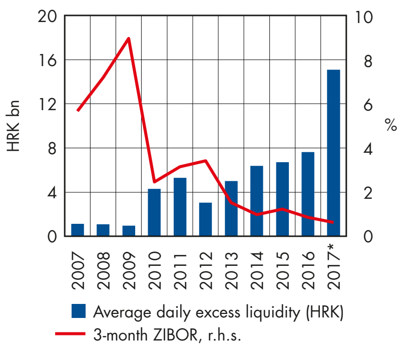
Sources: CBS, Economic RESEARCH/RBA

GVA structure



Sources: CNB, Economic RESEARCH/RBA

HRK liquidity and MM intrest rates

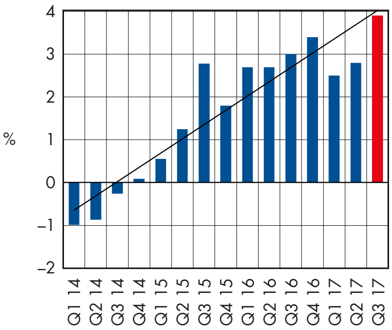


** until September 30th*
Sources: CNB, Economic RESEARCH/RBA

Healthy growth fueled by domestic demand

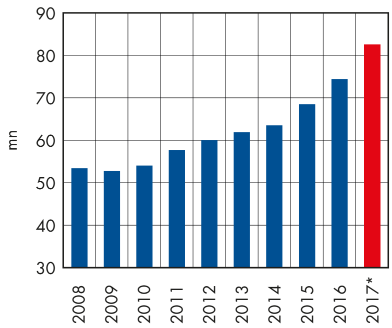
- Widespread growth driven by personal consumption
- Positive effects of exports of goods diminished by goods imports
- Optimism and solid short-term economic activity expectations to continue, long-term challenges remain unchanged

Real GDP growth rates



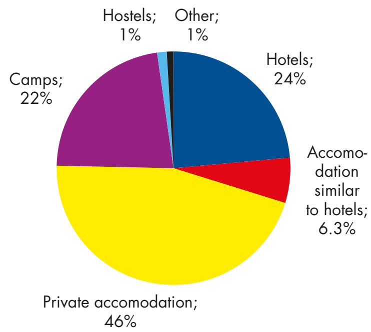
Sources: CBS, Economic RESEARCH/RBA

Realised tourist nights in the first 9 months



** forecast*
Sources: CBS, Economic RESEARCH/RBA

Tourist overnights in the main accomodation categories, 2016



Sources: CBS, CNB, Institute for tourism, Raiffeisen RESEARCH

Economic growth in Q2 accelerated, mainly driven by domestic demand, whose contribution to real growth reached relatively high 3.3 percentage points. On the other hand, despite solid growth rates of exports of goods and services the contribution of net foreign demand was negative (–0.5 percentage points). Namely, the exports of services (primarily tourism services) and the growth of domestic demand generated an increase in the imports of goods, underlining the need to strengthen the competitiveness of Croatia's real sector further. Viewed individually, the largest GDP component, personal consumption, maintained its real growth rate at 3.9%, the highest rate since 2008. This is a consequence of higher disposable income amid the alleviation of individual income tax burden, of the decline in unemployment, the growth in employment and lower costs of refinancing. The exports of services were affected by Easter holidays falling on a later date this year. However, the pre-season period surpassed even the most optimistic expectations. At least for the time being, the Agrokor financial crisis has had a limited impact on macroeconomic developments. We remain firm in our forecast that 2018 will be more challenging in this respect and more exposed to negative risks. This, at the same time, remains the main factor for the projected slowdown in economic growth in 2018, which could, apart from investments, also be felt in personal consumption through the channel of (un)employment. However, the final resolution of the Agrokor situation still remains a big unknown.

We estimate the slowdown in the investment growth registered in Q2 is partly a consequence of the situation in this corporation. However, projects supported by EU funds, as well as private sector investments (primarily in tourism) remain the generators of investment growth. Similar trends should be seen in the upcoming quarters. We expect the moderately positive growth of real government spending to continue in the second half of 2017, with a slight acceleration of the pace in 2018.

The available high-frequency indicators for Q3 point to further intensification in economic activity so the annual real growth rate could approach 4%, a rate last seen ten years ago. We base our expectations on the fact that retail trade increased in the period from July to September by a high 5,5% on an annual level, pointing to a continuation of personal consumption growth.

Although the fall in unemployment slowed down, as did the growth in employment, fact remains that average net wages have continued to grow at the annual rate around 6%, costs of financing are at their historical lows, and the possibly greatest impetus comes from record tourist season results. In addition to it being a labour-intensive sector of the economy, given the structure of accommodation capacities, income from tourism significantly increases the income of households. The peak season (July – September) registered over 62 million overnights, up 7.4% on the already exceptional 2016. These trends also suggest an ample inflow of foreign currency and an increase in available household income. Private accommodation (rooms and apartments) accounts for almost 50% of accommodation capacities.

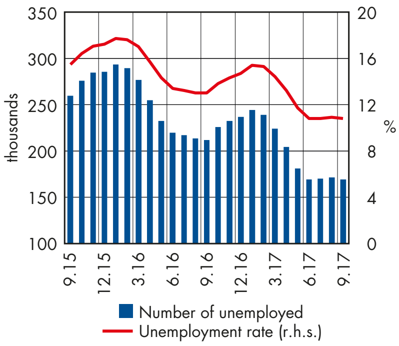
More than two thirds of Croatian services are related to tourism, meaning these developments imply high growth in the exports of services in Q3. Comparing Croatia to other EU member states by the share of the exports of knowledge-intensive services in the overall exports of services, Croatia is at the back of the list with a share below 20%. We expect and also wish for the growth of other service categories because the current structure of services in Croatian economy resembles more those of small island states and exposes the overall economy to excessive negative risks in case of unfavourable geopolitical incidents. Nevertheless, as long as Croatia is perceived as a safe destination it will maintain its status of an attractive destination which brings along a series of positive multiplicative effects on the rest of the economy through new investments and employment.

The rising optimism in the European and regional markets paired with upwardly revised growth forecasts of Croatia's main trading partners spurs expectations that Croatia's exports of goods will maintain its healthy growth in the upcoming quarters. However, this is a segment where Croatia is still lagging substantially behind, not only by the share of the exports of goods in GDP but also by the relatively unfavourable structure of international trade. Namely, the share of exports of medium-high and high technology products in the structure of exports is relatively modest and accounts for 38%.

This is a consequence of the historically inadequate use of basic production resources – primarily labour force. The structural problems of the labour market which linked to the inadequate adjustment of the education system amid the increasingly dynamic and demanding global environment have diminished the potential for growth. In addition, poor and slow technological progress linked to problems in higher education and the scientific research system, public administration and research and development require stronger, more decisive and faster structural changes or Croatia will continue to lag behind the majority of European member states. The registered number of the unemployed went down to its historical low in September (below 170 000), while the registered unemployment rate remained below 11%, confirming expectations of the decline in the average unemployment rate to historical lows. However, more significant indicators, such as the size of the working-age population, employment and activity rates do not reflect more significant improvements. Moreover, migratory and demographic trends and their long-term projections do not look optimistic. With the exception of a few activities (such as information technology and communications) the labour market registered a slight decline in employment in Q3. This is not surprising given the seasonality and the influence of tourism. It is encouraging that cumulatively in the first nine months the generator of new jobs, apart from the accommodation and hospitality activities, was the manufacturing industry. On the supply side, the Q3 data are expected to register a continuation of growth, especially in activities closely linked to tourism, trade and IT industry. A moderate recovery will be registered in the construction sector. Manufacturing, as one of the most important industries (with a share of 13% in the entire economy) will slow down its recovery. After the real annual growth rate of gross value added of the manufacturing industry totalled 2.5% in the first half of the year, the growth rate over the upcoming quarters is expected to remain around 2%.

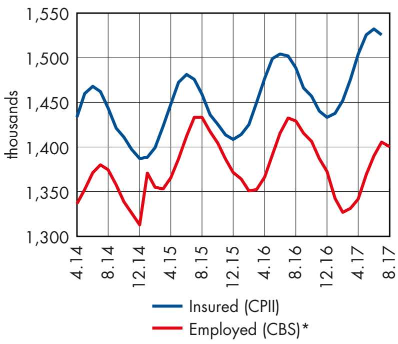
Zrinka Živković Matijević

Number of unemployed and unemployment rate



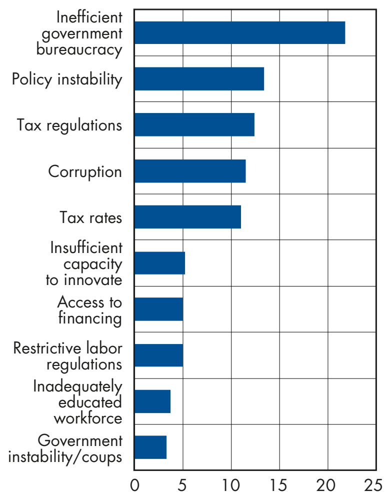
Sources: CBS, CES, Raiffeisen RESEARCH/RBI

Employed and insured persons



** change of methodology used since January 2015*
Data since January 2017. is preliminary.
Sources: CBS, CPII, Economic RESEARCH/RBA

Business obstacles in Croatia

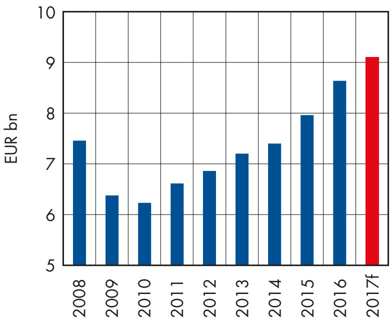


Sources: WEF: Global Competitiveness Report 2017–2018, Economic RESEARCH/RBA

EU funds absorption rate to increase in 2018?

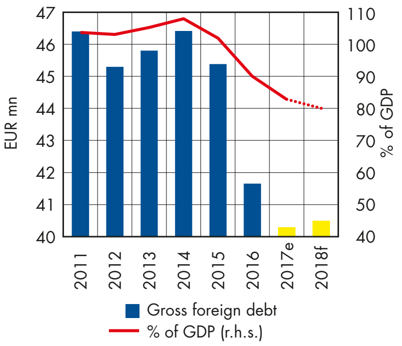
- **Q2 C/A surplus for the second year in succession**
- **Gross external debt decreases**

Travel receipts (tourism)



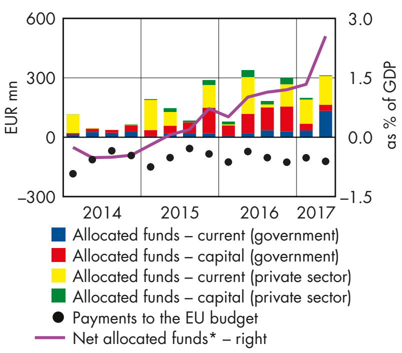
Sources: CNB, Economic RESEARCH/RBA

Gross foreign debt



Sources: CNB, Economic RESEARCH/RBA

Transactions with the EU budget



Sources: CNB, Economic RESEARCH/RBA

The reduction in external vulnerability expressed through continued decrease in external debt paired with continued stable surplus in the balance of payments current and capital accounts (3.6% of BDP) are the main characteristics of developments in Croatia's international relations in the H12017. The country's total gross external debt declined to EUR 40.4bn at the end of June, which lowered its share in GDP to the lowest level since Q1 2009 (86.1%) due to continued deleveraging and improvements in fiscal statistics. The decline in external debt on annual level was headed by the deleveraging of other monetary financial institutions (banks) whose debt has been uninterruptedly declining for 62 successive months and is followed by other domestic sectors whose debt has been continuously declining for the past 18 months. Next to follow is the general government, which has seen a reduction for the past 15 months. It is obvious that reduced needs for foreign borrowing paired with the fact that interest rates in the domestic market, amid exceptionally high liquidity and improved fundamentals, became competitive with European interest rates, which lowered the interest and the need for foreign borrowing. We are expected to see similar trends until the end of the year. For some time now, an especially demanding and challenging task faced by the Government has been the financial restructuring of Croatia's road sector which accounts for a relatively high share of public debt (EUR 5.2bn or more than 13.5% of the total public debt). Therefore, partial refinancing and financial restructuring, through HRK10.4 Eurobond issuance, announced in 2017 Budget revision, will definitely improve the public debt profile. Given the projected economic growth, the share of gross external debt of the RC in GDP should decrease to some 83% until the end of the year. The balance of payments data confirmed a surplus in the balance of payments C/A in this year's Q2 for the second successive year. A positive contribution to improvements in the C/A came from the services account as a result of income from travel (tourism). Although the secondary income account also made a positive contribution, the sum of the balance in the secondary income account and the capital transactions account slightly deteriorated. This was a result of greater payments to the EU budget but also of the weaker withdrawal of EU funds. And while the usual negative balance was registered in the goods account amid a relatively stronger growth of imports over exports, a mild deterioration from Q2 2016 was registered also in the primary income account as a consequence of the increase in the income of non-residents from their direct investments in the country. At the 2017 level, we expect the C/A surplus of 3.7% of GDP primarily based on the improvements in the services account. Income from tourism is expected to exceed EUR 9bn and the EU funds absorption rate is expected to improve. These projections include the influence of bank provisions for placements linked to Agrokor which have a one-off upward effect. In the year ahead we expect the main reason for the decrease in the surplus of the current and capital account to come from further deterioration in the goods account, while the growth of income from tourism will remain the most important factor contributing to the improvement in C/A balance. Expectations of continued stronger withdrawal of funds from EU funds will support the growth of the balance in the secondary income and capital transactions accounts.

Elizabeta Sabolek Resanović

HRK weakening towards the end of the year

- **Ample liquidity, low interest rates and stable exchange rate**
- **Euro adoption – more than just nominal fulfilment of criteria**

As expected and as usual, the increased inflow of foreign currency from tourism, further recovery of the economy and increased demand for the kuna supported the strength of the kuna against the euro over the summer months. Nevertheless, the EUR/HRK exchange rate did not deviate significantly from the 7.40 kuna per euro level, where it predominantly held until mid-September. Moreover, this level became a psychological threshold of sorts at which the central bank stood ready to intervene in the foreign exchange market by purchasing foreign currency from commercial banks. After two June interventions, one intervention was held in July and another one in August. Altogether, the CNB purchased EUR 227m, injecting almost HRK 1.7bn to the already highly liquid system. Consequently, interest rates on the money market remained subdued at historically low levels. All this was seen in the circumstances of modest inflation which stood at 1.1% in Q3.

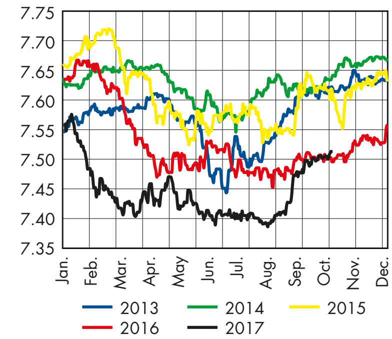
The second half of September brought about a sudden shift in the exchange rate toward higher levels. However, the EUR/HRK exchange rate stabilised at around 7.50 kuna per euro, the level we expected to see at the year-end. The usual pressures on the weakening of the kuna in the remainder of the year will surely be moderated by the ample amount of foreign currency in the system (which apart from investments is supported by the extension of the tourist season), by improved fiscal metrics and the reduction in external vulnerability.

According to current projections, the 2018 should not bring about more significant deviations from the levels seen this year. Thus, the EUR/HRK exchange rate will follow its usual seasonal trends, holding on to the average exchange rate levels in 2017. The continuation of the above-expected economic growth creates the possibility of continued appreciation pressures, but the CNB's commitment to maintaining the stability of the exchange rate as the main anchor of monetary policy remains unquestionable. Amid the conditions of still moderate growth of consumer prices the monetary policy will thus maintain is expansionary character, supporting, at least for one more year, low interest rates.

In the meantime, inflationary pressures in the last quarter will strengthen due to the growth of administratively regulated prices (electricity), so this year's significant growth of the prices of food will slightly lose it's influence. In Q2 and Q3 we expect the contribution of the prices of energy to grow in the overall index of consumer prices. This is a consequence of the base effect of the already mentioned increase in prices of electricity. The average inflation rate should speed up from the expected 1.2% in 2017 to 1.4% in 2018. Apart from supply side inflation, i.e. the positive contribution of the growth of prices of food and energy, we expect the contribution of stronger domestic demand in pushing prices towards slightly higher levels.

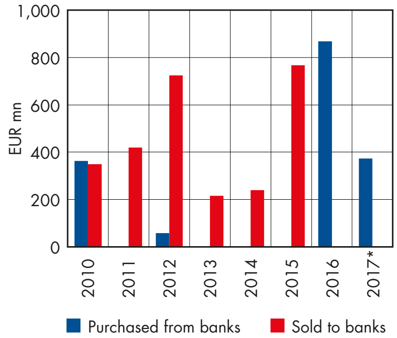
The Government introduced the Strategy for the Adoption of the Euro at the end of October. It contains the calculation of benefits and possible risks of joining the euro area and should serve as the basic document for a reasoned public discussion. Although 2020 has already been set as the target year for joining the

Mid EUR/HRK



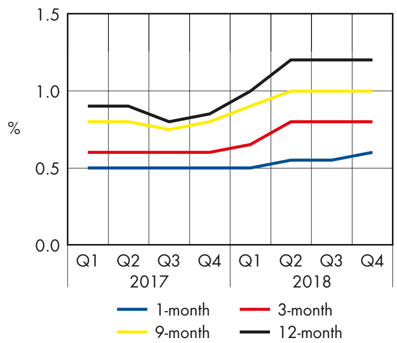
Sources: CNB, Economic RESEARCH/RBA

Open market operations – CNB`s FX interventions



** Until July 5th; Sources: CNB, Economic RESEARCH/RBA*

ZIBOR, eop



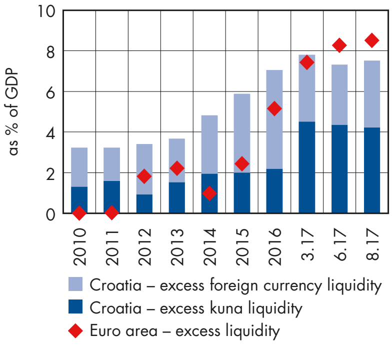
Sources: Bloomberg, Economic RESEARCH/RBA

Middle exchange rate of the CNB

Currency	Middle exch. r. 30.10.17	Change compared to: 31.12.2016 Exch. rate	Movements	%
EUR	7.5133	7.5578	↓	–0.59
USD	6.4580	7.1685	↓	–9.91
CHF	6.4630	7.0357	↓	–8.14
GBP	8.4552	8.8158	↓	–4.09

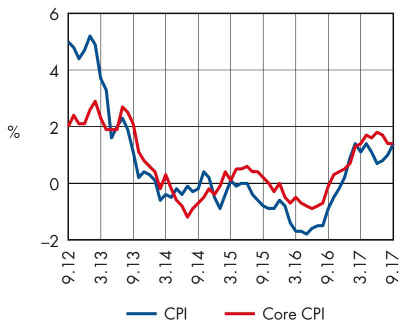
Sources: CNB, Raiffeisen RESEARCH

Excess liquidity as a % of GDP



The excess liquidity in the euro area represents a surplus of reserves in relation to the regulatory reserve requirement.
Sources: CNB, ECB, Eurostat, CBS

Inflation, average annual changes



Sources: CNB, Economic RESEARCH/RBA

European Exchange Rate Mechanism II (ERM II), it should be stressed that simply meeting the economic convergence criteria (set by the Maastricht agreement) will not suffice to adopt the euro as a single currency. Namely, sustainability is the key in assessing compliance with the convergence criteria because convergence needs to be permanent and not only temporary. This means that in addition to economic and legal criteria, particular attention will be awarded to creating efficient institutions and a stimulating business climate because, in addition to appropriate economic policies, they are a precondition for sustainable convergence. Until then the ticket to the euro area will remain elusive.

Therefore, in addition to the fulfilment of fiscal criteria (3% of GDP of the general government budget balance and 60% for the general government debt), the implementation of structural reforms required for creating sustainability remains a special challenge. Under these conditions, we expect that monetary policy (and consequently the exchange rate policy) will have no difficulties adjusting to the strategic objective of introducing the euro, with precisely the current or mildly higher EUR/HRK exchange rate level seen as the central parity in the ERM II.

Zrinka Živković Matijević

Public debt – on the way down

- **Public debt decreases**
- **Outlook improvement suggests that a rating upgrade is soon to follow**
- **Low interest rate environment continues**

Economic growth and continued fiscal consolidation, as confirmed by the fiscal indicators for the first half of this year were recognised by S&P, which improved Croatia's outlook from stable to positive at the end of September. The improvement in the risk perception of our country is also evident in the lowering of its sovereign risk (measured by CDS). From the beginning of the year it went down from 200 basis points to 100 basis points, thus reaching levels seen by comparable countries. This opened up the door to the possible improvement in the country's credit rating in the near future.

According to the data by the Ministry of Finance, budget deficit in the first six months of this year was HRK 1.6bn (0.4% of projected GDP), down HRK 800m from the same period last year. In the period under review budget revenues were 3.5% higher, with tax revenues rising by 2.4%. Total budget expenditures in the first half of the year were some 2% higher than last year. The growth of employee expenses (by HRK 336m) was a result of the agreement with the unions of government employees and the Government's decision from February to increase the basic salary of those employed in the public sector by 2%. It is encouraging that financial expenses were reduced by HRK 226m to 5.2bn. The decrease had mostly to do with interest on government debt. At the general government level or when the budget is viewed together with the results of extra-budgetary users and local government units, we saw a surplus of HRK 35m. As for this year's fiscal expectations, we remain cautious and expect the fiscal deficit to widen, mostly due to the increase on the expenditure side. Namely, at the beginning of August the Government adopted a new Act on Croatian Homeland War Veterans and Members of their Families which introduced significant changes in terms of greater rights in these segments. In order to provide for these rights additional almost half a billion kuna were envisaged in the budget in this year and the next. Given the fragility of the governing coalition which does not have a stable majority in the Croatian Parliament but has to round up all the votes from members of different political options to support the Government's proposals, such an amendment in favour of extending the rights of Homeland War veterans opens up room to other interest groups to voice their demands. In this context, the latest negotiations of the Government with the unions of public administration employees, which have, among other things, requested a 15.2% increase in basic salary, create additional pressure on the expenditure side of the budget. When speaking of the necessity to make reforms on the expenditure side, we see the fragile structure of the Government as the greatest obstacle. The heterogeneity of the governing coalition does not leave sufficient room for the implementation of structural reforms in public interest given that this depends on the support of political parties with different political agendas that are oftentimes directed against reform. This limits the potential for the implementation of necessary reforms. Considering that we expect the Government to make it through its four-year mandate, the period of economic growth and recovery and the phase of the expansion of the business cycle when reforms are easier to implement might again be squandered.

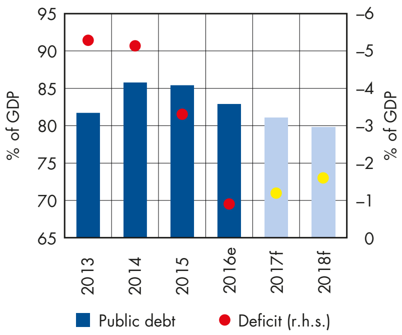
On the other hand, the revenue side of the budget is supported by favourable

Croatia's ratings*

Agency	Rating	Outlook	Last revision
Moody's	Ba2	Stable	10.3.2017
Fitch	BB	Stable	27.1.2017
S & P	BB	Positive	22.9.2017

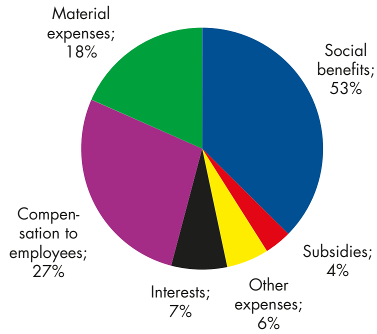
** LT debt in FCY*
Sources: Eurostat, Economic RESEARCH/RBA

Consolidated General Government (ESA 2010)



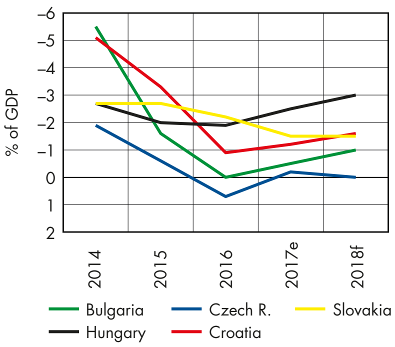
Sources: Eurostat, CBS, Economic RESEARCH/RBA

Consolidated Central Governement Expenses, 2016



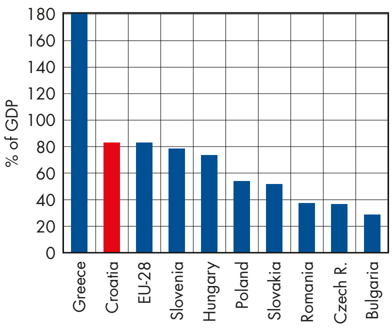
** GFS 2010 metodology*
Sources: MoF, Economic RESEARCH/RBA

Consolidated General Gov't balance



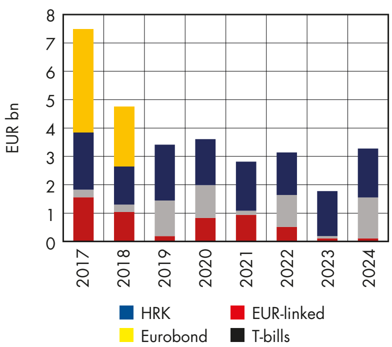
Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

General government debt, 2016



Sources: Raiffeisen RESEARCH/RBI, Economic RESEARCH/RBA

Public debt maturity (Bonds and T-bills)



Sources: MoF, Economic RESEARCH/RBA

developments in personal consumption as the main generator of tax revenues, i.e. income from VAT as the most ample budget revenue source. Although the comprehensive reform of the tax system, which entered into force on 1 January this year, included a regulation that should have included real estate property tax as a substitute for municipal fees, which included the repealing of the tax on holiday homes and monument annuity, to be introduced as of 1 January 2018, the significant pressure postponed its implementation. The recommendation to introduce this type of tax came from the European Commission. However, due to relatively weak communication by the Government this new tax was perceived by the public as an increase in tax burden and thus, as any other unpopular reform measure, automatically met with great resistance. We see the introduction of this regulation as an attempt to introduce some order into the real estate property market and put unused real estate to use as a positive characteristic of the introduction of this regulation, as well as the increase in availability of real estate property, which ultimately affects demographic developments. As one of the advantages of the introduction of tax on real estate property we see the potential spill-over from the taxation of labour to the taxation of capital. Namely, it could be expected that greater burden on real estate property would create room for alleviation of the tax burden on income from labour which could result in higher net salaries and/or lower cost of labour for employers. In addition, taxation pressure is an incentive for property owners to rent or sell empty real estate property which leads to more affordable housing prices. It remains unknown to which extent the announced tax was really ready to see the light of day. At the same time, it should be stressed that the postponement of the implementation of this tax increases the possibility that it will not enter into force during this administration given that it is the second half of the Government's mandate. Finally, we expect this year's deficit to remain slightly above 1% of GDP, boasting a surplus in the primary balance for the third year in succession.

Favourable developments and economic recovery were also confirmed by the recently published, so-called, October Report of the CBS on excessive budget deficit and general government debt. According to the report, the total consolidated general government deficit in 2016 totalled 0.9% of GDP (in accordance with ESA 2010 methodology). According to the same report, last year registered a further growth of the primary surplus of the general government to HRK 7 959m (2.3% of GDP). The latter is especially encouraging since it points to the stabilisation of public debt (which in reality represents the sum of budget deficits) so the decrease in deficit is a precondition for sustainable public debt.

The latest available data on public debt movements in the first half of the year, as published by Eurostat at the end of October, indicate a continuation of favourable developments in public debt that positively contribute to the reduction in external vulnerability and improved maturity, interest rate and currency structure of the debt. In the period under review, the share of public debt in GDP went down by 1.8 percentage points to 81.9%. These trends are also a consequence of very favourable developments in budget statistics. In addition, the strengthening of the domestic currency against the euro affected the nominal amount of the debt since 70% of the general government's liabilities is in euro or indexed to the euro. Apart from the absolute reduction of the government's liabilities, the lower ratio is also a consequence of continued economic growth. However, despite the relative improvements in public debt trends, high costs of debt servicing in the

Raiffeisen RESEARCH

upcoming period will continue to pressure public finances. Using the period of favourable economic developments as an opportunity to create budget surplus and reduce public debt would create greater room for countercyclical activity at times of negative economic developments. Under the conditions of economic growth and healthy inflow into the budget, the general government deficit in 2017 should, according to our expectations, fall to the level of some 81% of GDP (from the 82.9% at the end of 2016). Consequently, Croatia should, with healthy primary surplus, register a fall in the share of public debt in GDP. It is noteworthy here that public debt at its current level remains a substantial obstacle to the start of negotiations regarding Croatia's participation in the European Monetary Union. In order to start negotiations, Croatia needs to lower its public debt by 1/20 difference above 60% of GDP per annum.

Stable EUR/HRK exchange rate and modest inflationary pressures (well below the 2%) continue to support the accommodative monetary policy of the central bank. Amid these conditions yields in the secondary market for government debt remained at low levels. A similar pattern is expected to be seen until the end of the year. This means that money market interest rates, as well as long-term yields will be supported by sufficient liquidity in the system which remains at current historical lows. Low interest rates paired with improved fiscal indicators make a favourable environment for the upcoming issue of local kuna bonds. The issue is expected in the last quarter. Institutional investors, primarily pension funds will continue to be the main drivers of demand at the longer end of the domestic yield curve.

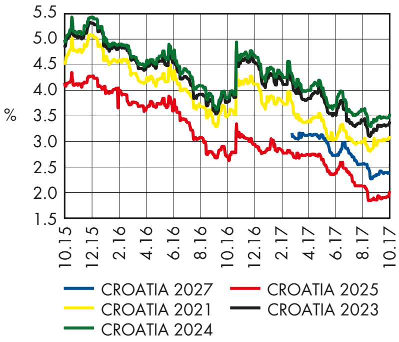
Stable yields at currently low level will probably be maintained until the end of the year. We do not expect a new issue affecting their movements. Interest rates are expected to remain low in 2018. Normalisation of interest rates in Croatia will be gradual with a more pronounced lag compared to the leading EU Member States. A HRK 1.5bn T-bill, issued in August 2016, having a yield of 0.7%, is maturing in November. As usually, the Government will roll-over the issue with an expected decline in yield to some 0.3%.

Croatian Eurobonds continued to follow developments and the sentiment in the SEE market in this year's Q3, which will continue until the end of the year.

The improvement in lending outlook did not have a more significant effect on developments in yields of Croatian foreign issues. The expansionary character of the ECB's monetary policy with historically low yields will continue to positively affect CEE bonds, also reflecting itself on the movements of Croatian issues. Continued positive developments in fiscal indicators and economic growth, paired with the implementation of reforms would positively reflect itself on the country's credit rating and consequently its risk premium expressed in the spread on benchmark international issues. After the S&P's we expect Moody's to also improve its outlook to positive, maintaining its rating at current levels.

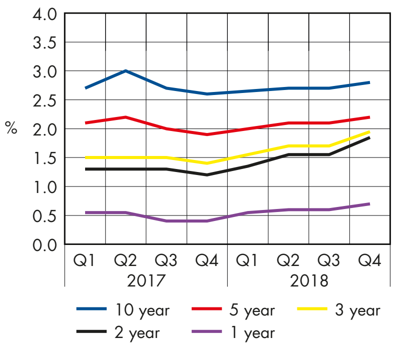
Elizabeta Sabolek Resanović

Croatian Eurobonds*



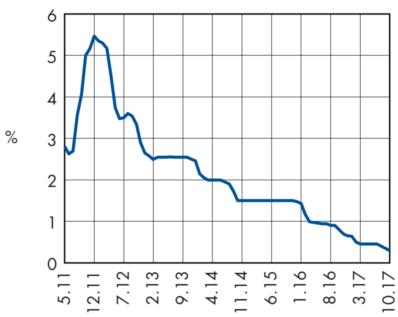
** bid ytm*
Sources: MoF, Economic RESEARCH/RBA

Domestic bonds, eop



Sources: Bloomberg, Economic RESEARCH/RBA

Yield on HRK 1Y t-bill

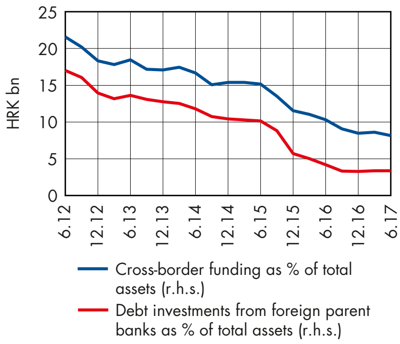


Sources: MoF, Economic RESEARCH/RBA

Bank profitability reduced

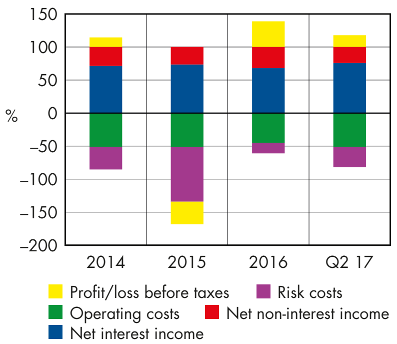
- **Bank regulator recommends – offer customers long-term loans with fixed interest rates**
- **Losses caused by Agrokor cut bank operating results for the first half of the year**
- **The share of non-performing loans continues to decrease**

Debt investments in Croatian banks



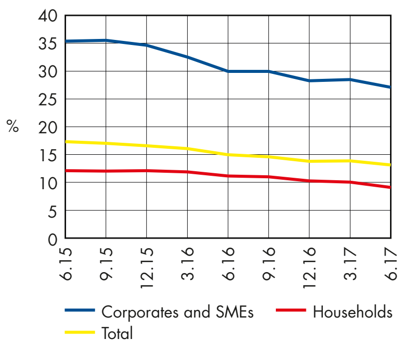
Sources: CNB, Economic RESEARCH/RBA

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



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

NPLs ratio, eop in %



Sources: CNB, Economic RESEARCH/RBA

At the end of September, the local bank regulator (CNB) published a *Recommendation to mitigate interest rate (for consumers) and interest rate-induced (for banks) credit risk in long-term consumer loans*. It recommended banks to offer clients with variable interest rate loans and remaining maturity longer than seven years an opportunity to replace the variable interest rate with a fixed rate without additional charges or to offer them early repayment of contracted loans. In addition, new loans offered to consumers should always include an offer with a fixed interest rate, regardless of the repayment period. The said recommendations reflect the regulators concern for the maintenance of financial stability in case market interest rates should increase substantially. As for loans with repayment periods longer than seven years, the difference in the amount of offered fixed vis-à-vis variable interest rates has been growing along with the length of the repayment period. Therefore, consumers have been opting for variable interest rate contracts. In the initial repayment periods, while the hedge price is still low, they make use of the temporarily fixed interest rate as protection from interest rate risk. After the expiry of the contracted hedge, loan users might face significant spikes in loan instalments if market interest rates increase.

Consumers' choice depends on the price and risk ratio so we do not expect that the CNB's recommendations will change the structure of loan demand in terms of contracted interest rates. However, if the CNB increases structural repo auctions, extends the time to maturity and relaxes collateral requirements and thus significantly increases banks' long-term sources of financing with fixed interest rates, then the supply of loans with fixed interest rates and repayment maturity from 10 to 30 years might become more competitive in terms of prices compared to the the supply of loans with variable interest rates.

After the initial shock caused by the debt crisis in Croatia's largest privately-owned company (Agrokor) and the appointment of the extraordinary commissioner for the period not longer than 15 months, during which a moratorium was placed on repayment of all of the company's debts, Agorkor's operations have stabilised. In compliance with the regulator's recommendations banks made additional provisions for losses from claims on members of the Agrokor group and for losses from claims on its commercially dependent companies. This caused bank operating results in the first half of the year to be 2/3 lower than the results in the same period last year. At the beginning of October, Agrokor's revised audit report was published, confirming that its losses exceed its equity. Next to follow is the publication of the group's overall debts. After that the extraordinary commissioner can start negotiating with creditors regarding the settlement of their claims. Should these negotiations be successful, the impact of dealing with Agrokor's problems on the stability of the financial system may remain contained to the already established level. In that case we do not expect additional provisions for claims on Agrokor and its commercially dependent companies. However, negotiations with creditors may have a different outcome.

Anton Starčević

ECB and Fed are cutting bond purchase programmes

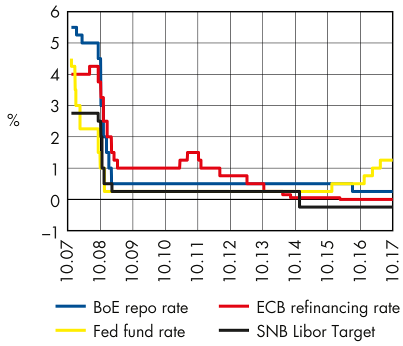
- **Euro area: ECB to cut its bond-buying programme in January 2018**
- **Interest rates to remain low**
- **US: One more rate hike possible in December, three expected in 2018**

The regular meeting of ECB members at the end of October went by as expected. The ECB left its key interest rates unchanged, stressing that they will remain at their current low levels for some time even after the end of the current monthly bond purchase programme. However, markets were not expecting any changes in interest rates, their focus was directed on future developments in the quantitative easing programme instead. Namely, the ECB created altogether over EUR 2 trillion in an attempt to stimulate credit activity and lower interest rates by providing additional liquidity. In addition, it continued working toward raising inflation in the euro area. As of January next year, the ECB will cut its bond purchase programme in half, from EUR 60bn to EUR 30bn per month until September 2018. This is one more step in the gradual normalisation of euro area monetary policy. The ECB stressed that it will continue to make its moves carefully in the future, leaving room for the extension of the programme, if necessary. The decisions reached at this meeting clearly reflected that the ECB will continue its expansionary monetary policy over the upcoming period and that interest rates will remain low. This means that monetary policy will continue to have a strong influence on the developments in the euro area for some time.

On the other side, in the US, at its end-September meeting, the Fed decided to keep its benchmark interest rates unchanged, between 1.00% and 1.25%. In addition, as expected, the Fed announced it would start trimming its balance sheet. Since the beginning of the crisis, its balance sheet increased roughly five times, currently totalling USD 4.5 trillion. The increase started in 2008 aiming to provide the US economy with additional liquidity at the time of the crisis. In accordance with sustainable economic recovery there were no new increases in the balance sheet size over the past three years, which means it was maintained at the same level. The Fed did not buy new bonds and assets received when bonds already held matured were simply reinvested, i.e. used for a new bond purchase in the equal amount. Favourable economic conditions in the US created upward pressure on consumer prices and the Fed started to normalise its monetary policy. As of October this year, the funds received from maturing government and mortgage-backed securities are no longer reinvested in their full amount. The overall amount reinvested each month is cut by USD 10bn. This reduction will grow by additional USD 10bn each quarter until the last quarter of 2018 when the overall amount Fed reinvests each month will be cut by USD 50bn. We believe the Fed aims to reduce its current bond portfolio of USD 4.3bn to a half of its current value. Pursuant to the current balance sheet reduction plan, this will be achieved in the spring of 2021. As for the interest rates, the majority of market participants expect another hike of 0.25% at the end of this year. The Fed is expected to raise its benchmark interest rate altogether three times in 2018. Inflationary pressures in the US are expected to temporarily subside in Q1 next year. Therefore, we expect the first of the three expected interest rate hikes at the June meeting, while the next two might be seen at September and December meetings.

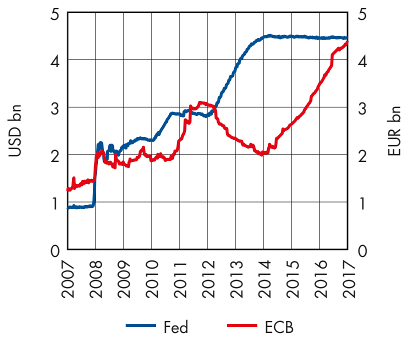
Viktor Viljevac, Gottfried Steindl, Jörg Angelé

Key interest rates



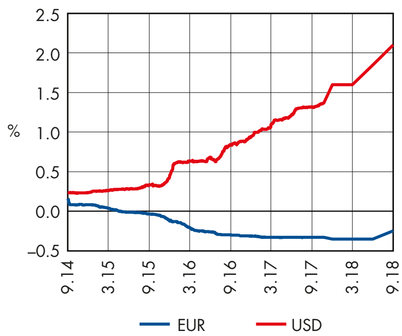
Sources: Fed, ECB, BoE, SNB, Economic RESEARCH/ RBA

Central bank balance sheets



Sources: Bloomberg, Economic RESEARCH/RBA

Money market rate 3M

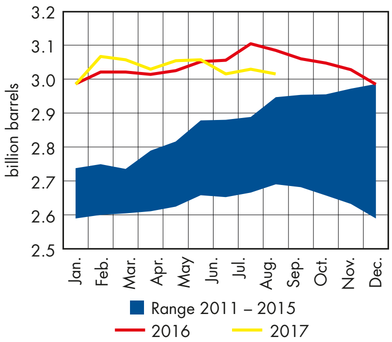


Sources: Thomson Reuters, Raiffeisen RESEARCH/RBI

Price of oil supported by high oil demand

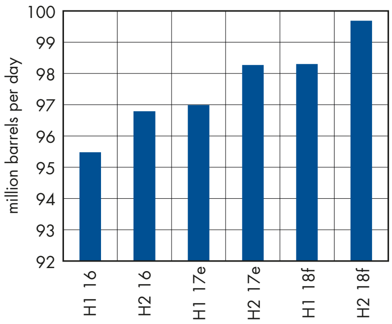
- **Very robust oil demand**
- **Crude oil inventories should continue to decrease until the year end**
- **A moderate increase in Brent prices expected in Q4**

Total OECD industry stocks*



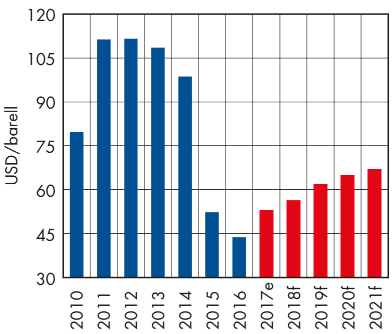
** OECD industry crude oil + product inventories*
Sources: International Energy Agency, RBI/Raiffeisen RESEARCH

Global oil demand



Sources: International Energy Agency, RBI/Raiffeisen RESEARCH

Oil price forecast – Brent*



** Year average*
Sources: Thomson Reuters, RBI/Raiffeisen research

After having been marked by almost continuous oversupply in the period 2014 to 2016, since the Q2 2017 the very full global reserves of crude oil have started to decline. Although inventories have been decreasing at a slower rate than market participants had expected at the beginning of the year, the OPEC's initiative directed at cutting oil production achieved notable results. The Brent crude oil price thus reached USD 58 per barrel at the end of October, its highest level in 2017 and USD 13 (almost 30%) higher than the price seen in June, when the lowest price this year was reached. Rising prices found support in the fact that the threat of some members breaching the agreement proved to be smaller than it was the case in the past. According to the International Energy Agency (IEA), the compliance rate for OPEC oil output cut agreement averaged 86%, which means that countries participating in the agreement, on average, cut production by 86% of the agreed amount. Some market participants base their expectations that OPEC's initiative will not reap the desired results on the current production growth in Libya and Nigeria, the two countries exempt from the Agreement. The two have increased their oil output since the beginning of the year and have thus slowed down the inventory reduction process. From the beginning of the year Libya increased its production by 60% and Nigeria by 15%. As a result, the overall effect of the targeted production cuts was reduced by around 40%. On the other hand, higher oil prices may partly be attributed to the demand side developments. With the exception of the first quarter of this year, demand has been very strong. The IEA recently once again upgraded its forecasts for global oil demand. For 2017, the Agency now projects that global oil demand will increase by around 1.7% compared to the previous year. This represents the second strongest increase in the last five years.

Since oil prices are exposed to a combination of factors that simultaneously contribute to their increase and their fall, markets are still rightly suspicious regarding the sustainability of higher prices. Understandably, the growth in US production which started in October 2016 also contributed to this. The US Energy Information Administration (EIA) has forecasted that the daily output in the US will be 900,000 barrels higher at the end of 2017 compared to the end of 2016, whereas a significantly more moderate yearly increase in production of 400,000 barrels per day is forecasted for the end of 2018. This development is mainly related to the current oil price level. An oil price higher than USD 50 per barrel for the oil in US allows the expansion of drilling activity to shale oil fields which are less cost-efficient. Finally, there is a great deal of uncertainty regarding the first half of 2018. Due to seasonal factors, global demand for oil will be much weaker in this period compared to the second half of the year. At the same time, despite speculations on the possible extension of the output cut agreement (supported by good relations between Saudi Arabia and Russia), the prevailing opinion in the market is that the agreement will not be extended after its expiry date in March 2018. Overall, we do not anticipate a sustained rise in the oil price to more than USD 60 per barrel of Brent before the second half of 2018.

Viktor Viljevac, Hannes Loacker

Sentiment on ZSE influenced by situation in Agrokor

- **Positive trends expected to continue for the majority of CEE indices**
- **Good operating results on the ZSE in Q3**
- **Resolution of the Agrokor situation to determine developments on the ZSE in the upcoming period**

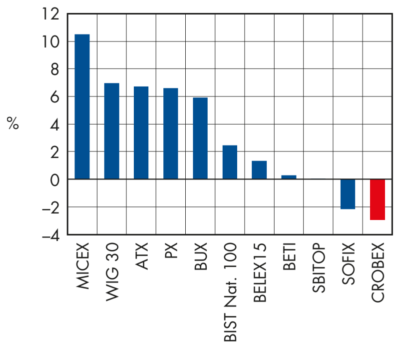
The growth of CEE equity indices mostly outstripped the growth of Western European and the US markets in the past period, with MICEX leading the way after slightly underperforming in the first half of the year. The growth of the Russian index was spurred by the growing price of oil, while the Polish WIG 30 profited from outstanding macroeconomic indicators and strong expectations of corporate profit growth. Negative developments were seen only by the Bulgarian BUX and the Croatian CROBEX.

Namely, the encouraging economic indicators again failed to play a role on the ZSE in Q3, which resulted in the poorest performance of the CROBEX across the CEE. Even tourism shares registered negative developments despite the record tourist season and good operating results. Valamar Riviera, after having grown strongly in July and August, lost more than 5% of its value following announcements that the company was giving up its investments announced for 2018 (Valamar Pinia Family Suites in Poreč) due to the uncertain tax policy. Broken down by sector, industry shares boasted the greatest growth, with double digit growth registered also by the transport sector shares, headed by Uljanik Plovidba and Atlanska Plovidba. On the other hand, the greatest looser among the sector indices was CROBEXkonstrukt because all of its constituents registered negative trends on the quarterly basis. However, the worst performer of the quarter was Viadukt where bankruptcy proceedings were opened.

The overall equity turnover significantly decreased from the same period in 2016, averaging HRK 6.6m per day. This may be attributed to the suspension of trading in shares of the Agrokor's member companies but also to investor reluctance regarding the uncertainty surrounding the Agrokor situation and its influence on broader economy. In the period under review, Valamar Riviera (total turnover of HRK 70.2m) and Hrvatski Telekom (total turnover of HRK 56.4m) were the most traded shares. At the end of June Hrvatski Telekom initiated a program of repurchase of own shares. Currently they own 136 065 shares, i.e. 0.17% of their share capital. The company plans to cancel the acquired own shares at the end of every business year. The overall market capitalisation of shares on the ZSE was HRK 141.3bn, which is 1.3% down on the end of 2016.

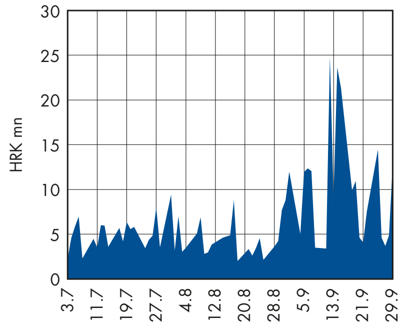
A record number of tourist overnights registered in the first eight months of this year resulted in good operating results not only of tourist companies but also of the companies from associated sectors. Nevertheless, the uncer-

CEE indices – returns*



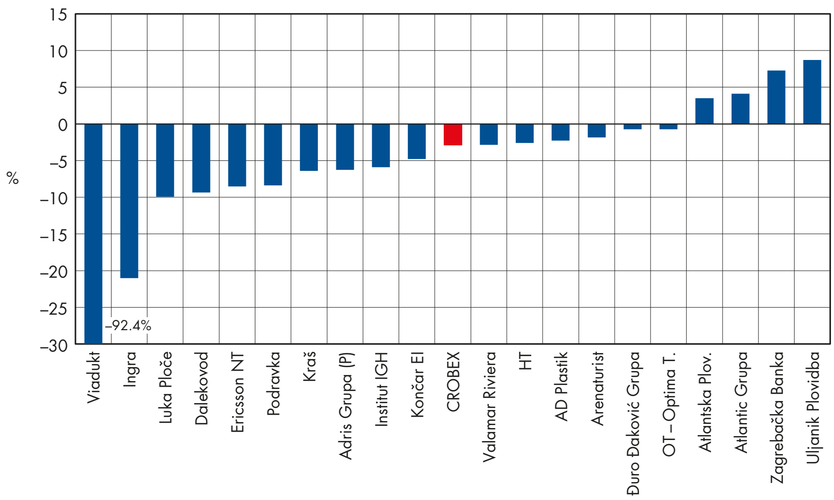
** in local currency, value on 30/09/2017 (6:30 PM)*
Sources: Bloomberg, Economic RESEARCH/RBA

Equity turnover



Sources: ZSE, Economic RESEARCH/RBA

Return of CROBEX constituents in Q3 2017 (dividends not included)*



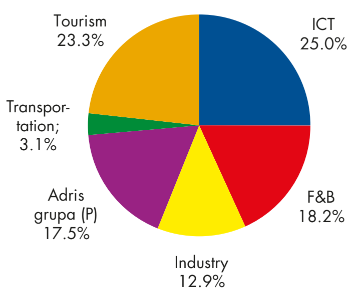
** Return calculated as on 30.9.2017 (6:30 PM)*
Sources: ZSE, Economic RESEARCH/RBA

CROBEX members multiples (results 1H 2017)

Company	PER	EV/EBITDA
AD Plastik	11.52	6.84
Adris Grupa (P)	16.41	4.49
Arena Hospitality Group	neg.	743.37
Atlantic Grupa	15.18	8.17
Atlantska Plovidba	neg.	15.17
Dalekovod	25.02	9.76
Đuro Đaković Holding	neg.	36.54
Ericsson Nikola Tesla	15.83	9.09
Hrvatski Telekom	15.13	4.22
Ingra	6.40	n.a.
Institut IGH	neg.	n.a.
Končar-Elektroindustrija	13.92	6.63
Kraš	21.68	9.62
Luka Ploče	neg.	n.a.
OT-Optima Telekom	13.95	4.17
Podravka	19.03	8.72
Uljanik Plovidba	neg.	14.29
Valamar Riviera	18.73	14.76
Viadukt	neg.	n.a.
Zagrebačka Banka	15.16	n.a.
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.

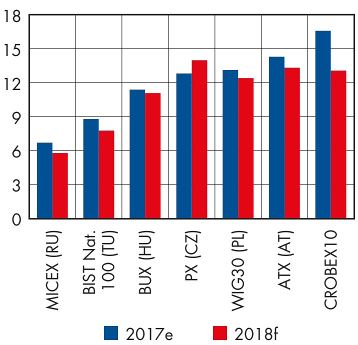
** in local currency, prices on 20/10/2017 (6:30 PM)*
Sources: ZSE, Economic RESEARCH/RBA

CROBEX10 composition by sector



Sources: ZSE, RBI/Raiffeisen RESEARCH

PER of CEE indices



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

tainty surrounding the outcome of the extraordinary administration of Agrokor, i.e. the collection of receivables by suppliers is still present due to the operating results of Agrokor's retail network which are not promising in the first eight months of the year. Although Agrokor's largest creditors and suppliers published the amounts of their exposures to Agrokor, only a few set aside provisions. Therefore we expect that a share of provisions for the write-off of receivables will burden their 2017 results, while part will possibly do so in 2018 when the settlement is expected to be made. In addition to one-off provisions, the results of food and beverages companies in 2017 might lower margins due to promotional sales in other retail chains but also due to costs of expansion to other markets. Given that the investment cycle in tourist capacities is still in relatively high phase, contracted construction companies are expected to profit as well, although experiencing pressure on their margins due to lack of workers.

Viewed by the expected P/E for the 2017 CROBEX10 (16.6x), Croatia's equity market is, relatively speaking, the least attractive in the CEE. In addition, the share of foreign investors in the equity segment on the ZSE has been declining since the beginning of the year, which we attribute to heightened perception of risk in the domestic market due to the Agrokor situation. Overall, we think that the resolution of the Agrokor crisis will largely determine the situation on the ZSE in the upcoming period, both in the sense of realised turnover (removal of suspension of trading in shares of companies member of the group) and in terms of index movements (final volume of write-offs). Since we think that the survival of the Agrokor group in its current form is highly unlikely, the results of the settlement will affect also the dynamics of potential mergers and takeovers in the retail and food and beverages sectors.

Corporate profitability improved globally, and the growth of economic indicators and the continuation of expansionary monetary policy indicate a continuation of positive developments in international equity markets, as well as CEE markets. As for the situation in the political arena, we expect its significant influence in the developed markets and only a small influence in the regional capital markets. Given the relatively favourable valuation and the expected growth in the prices of oil, we expect the Russian MICEX and the majority of other regional indices to grow until the end of 2017. In addition to the MICEX, the Turkish BIST Nat. 100 and the Polish WIG 30 are attractively valued in 2017 with expected P/E ratios of 8.8×, i.e. 13.1× respectively.

Ana Turudić

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Abbreviations

avg – period average
bn – billion
BSE – Budapest Stock Exchange
C/A – current account
CBS – Croatian Bureau of Statistics
CE – Central Europe
CEE – Central and Eastern Europe
CHF – Swiss Franc
CNB – Croatian National Bank
CPI – Consumer Price Index
CPII – Croatian Pension Insurance Institute
e – estimate
EBITDA – Earnings before interest, taxes, depreciation and amortization
EC – European Commission
ECB – European Central Bank
EDP – Excessive Deficit Procedure
EE – Eastern Europe
EIA – Energy Information Administration
eop – end of period
ESA – European System of Accounts
EU – European Union
EUR – Euro
Eurostat – Statistical Office of the European Union
f – forecast
FCY – Foreign Currency
Fed – Federal Reserve System
FX – foreign exchange
GBP – British Pound
GDP – gross domestic product
GFCF – Gross fixed capital formation
H – half
HRK – Croatian Kuna
ILO – International Labour Organization
LCY – Local Currency
M, m – month
mm – money market
mn – million
MoF – Ministry of Finance
NPL – non-performing loan
OPEC – Organization of the Petroleum Exporting Countries
PM – Prime minister
pp – percent point
Q – quarter
QE – quantitative easing
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
Ytd – yield to date
YtM – yield to maturity
ZIBOR – Zagreb Interbank Offered Rate
ZSE – Zagreb Stock Exchange

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"Hold": for stocks for which we expect a positive return up to 10% (up to 15% for stocks with high volatility risk) over next 12 months.

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

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

Target prices are based on calculated fair value which is derived by applying relative valuation tools (peer group analysis) or discounted cash flow DCF method. Detailed information on specific valuation methods applied is available at: https://www.rcb.at/en/the-bank/business-segments/cr/concept-and-methods/

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Overview of Raiffeisen recommendations:

	Buy	Hold	Reduce	Sell	Suspended	Under review
No. of recommendations	1	4	1	0	1	0
% of all recommendations	14%	58%	14%	0%	14%	0%
Investment banking services	0	0	0	0	0	0
% all IB services	0%	0%	0%	0%	0%	0%

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