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Croatia: inflation peaks, GDP growth moderates

Economic activities continued to expand, but at a lower pace than in 2007. Industrial output increased by 5.3% during the first four months of the year; construction activities rose by 10%, implying continued investment growth. On the other hand, retail trade turnover grew by only 2.2% in real terms. GDP data for the first quarter are not available but based on the above results we may assume that it grew close to 5%.

Curbing inflation is a key priority

Consumer price inflation accelerated to 6.5% in May year-on-year and reached its highest level since the introduction of the stabilization programme in 1993. Food and particularly energy price hikes on the world market had a strong inflationary impact. On top of that, some administered prices (such as for medical services) rose significantly. Only recently it has been announced that prices for electricity will be raised by 20% from July. Real wage growth was only moderate and has had no impact on inflation so far. In order to reduce inflationary expectations, the governor of the National Bank has urged the government repeatedly to reduce public spending, cut down state expenses, control prices in the public sector and restrict growth of salaries.

The situation on the labour market has continued to improve. Registration data point to a substantial rise in employment (4.1%) and a further decline of unemployment during the first four months of 2008. Except electricity and mining, all sectors reported employment gains, with above-average job creation in the services sector, such as in business services, trade and tourism, and in construction. Final Labour Force Survey data for 2007 indicate a decline of the overall unemployment rate to 10% and a reduction of youth unemployment by 5 percentage points to 24%; long-term unemployment (unemployed for more than one year in total unemployment) accounts for almost 60%.

The general government deficit was further reduced, from 3% of GDP in 2006 to 2.3%, according to final 2007 data. Based on the ESA 95 methodology, the deficit was even lower, at 1.6%. However, including pension debt repayments the deficit stood at an estimated 2.8%.

On the external side, merchandise imports grew again much faster than exports during the first months of 2008, resulting in a further widening of the trade deficit. Considering the continued deterioration of the trade deficit and rising interest payments, the current account deficit reached an estimated EUR 2.4 billion during the first quarter of the year. As for FDI, 2007 saw a record inflow worth EUR 3.6 billion, the bulk of which was oriented towards the services sector. However, greenfield investments are rare. Growth of foreign debt slowed down following the introduction of

restrictive measures set by the National Bank at the beginning of 2007, e.g. limiting credit growth of commercial banks to 12% per year. Additional measures curbing credit growth were implemented in the course of last year and extended to 2008.

Recently the authorities have announced restructuring plans concerning the shipbuilding industry, one of the country's main industrial branches, envisaging the sale of two shipyards by the end of 2008. Shipbuilding accounts for about 15% of total exports, but is also one of the biggest loss makers and is highly subsidized.

EU negotiations progressed only slowly in 2007. In March Commission President M. Barroso said that Croatia could complete its membership talks with the EU by November 2009. The EU will present an 'indicative timetable' for the technical conclusions, provided Croatia meets a number of conditions. These comprise complying with all legal obligations of the Stabilization and Association Agreement (SAA) including (i) cooperation with the International War Tribunal in The Hague, (ii) 'urgent' improvement of the management of EU financial assistance under the Phare and IPA programmes (the endorsement and approval of new projects under the Phare programme had been temporarily suspended at the beginning of the year due to institutional weaknesses), and (iii) the suspension of all aspects of Croatia's Ecological and Fisheries Protection Zone (ZERP), which envisaged fishing restrictions in a protected zone in the Adriatic Sea (affecting mostly neighbouring countries). ZERP was suspended already in March pursuant to hefty protests from Italy and Slovenia.

Moderate growth slowdown

Economic prospects have changed little against our previous forecast. Driven mainly by domestic demand, GDP should grow by slightly over 4% in 2008. Household consumption is expected to rise by 3.5%, while government expenditures should be lower after the election year. The rise in GDP growth will translate into moderate employment growth and a further reduction of unemployment. wiiw expects an average annual inflation rate of around 6% in 2008 and a gradual deceleration in the coming years.

The pace of GDP growth will decelerate further in 2009, associated with declining investment and the assumed weakening of private consumption growth (3-4%); government consumption is expected to remain flat. Croatia's external performance will largely depend on the economic environment in its main trading partners. We expect the trade deficit to remain at high levels, at about 25% of the GDP. Given the continued widening of the trade deficit, the current account deficit will further increase, despite higher earnings from tourism. A reversal of this trend is not in sight in the medium run. Prospects of joining the EU in the foreseeable future may help speeding up structural reforms.

Table HR

Croatia: Selected Economic Indicators

	2004	2005	2006	2007 ¹⁾	2007 1st quarter	2008	2008 Forecast	2009 Forecast	2010 Forecast
Population, th pers., mid-year	4439	4442	4440	4440	.	.	.	.	.
Gross domestic product, HRK mn, nom.	214983	231349	250590	275078	62561	.	302400	328600	357100
annual change in % (real)	4.3	4.3	4.8	5.6	7.0	.	4.2	4.5	5
GDP/capita (EUR at exchange rate)	6462	7038	7708	8445	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	10570	11200	12130	13190	.	.	.	.	.
Gross industrial production ²⁾									
annual change in % (real)	3.7	5.1	4.5	5.7	8.0	4.8	4.5	4.5	5
Gross agricultural production									
annual change in % (real)	11.9	-8.7	4.4	.	.	.	.	.	.
Construction industry, hours worked ²⁾									
annual change in % (real)	2.0	-0.8	9.4	2.4	6.5	12.9 ^{I-II}	.	.	.
Consumption of households, HRK mn, nom.	123123	131671	140261	153421	36391	.	.	.	.
annual change in % (real)	4.8	3.4	3.5	6.2	7.1	.	4	3.5	4
Gross fixed capital form., HRK mn, nom.	60512	65008	74792	82386	19530	.	.	.	.
annual change in % (real)	5.0	4.8	10.9	6.5	11.2	.	6	5	5.5
LFS - employed persons, th, avg.	1563	1573	1586	1600	1563	.	.	.	.
annual change in %	1.7	0.7	0.8	0.9	.	.	.	.	.
Reg. employees in industry, th pers., avg.	281.7	278.9	284.1	293.0	290.0	290.7	.	.	.
annual change in %	-0.3	-1.0	1.9	3.1	3.4	0.3	.	.	.
LFS - unemployed persons, average	249.5	229.0	198.5	182	197	.	.	.	.
LFS - unemployment rate in %, average	13.8	12.7	11.1	10.0	.	.	9.8	9.4	9
Reg. unemployment rate in %, end of period	18.5	17.8	17.0	14.7	16.6	14.5	14	.	.
Average gross monthly wages, HRK	5985	6248	6634	7047	6854	7348 ^{I-II}	.	.	.
annual change in % (real, net)	3.7	1.5	1.9	2.2	3.6	0.6 ^{I-II}	.	.	.
Consumer prices, % p.a.	2.1	3.3	3.2	2.9	1.6	5.9	5.5	4	3.5
Producer prices in industry, % p.a.	3.5	3.0	2.9	3.4	1.9	7.6	3.5	.	.
General government budget, nat. def., % GDP ³⁾									
Revenues	44.9	44.5	44.8	46.3	.	.	45.2	.	.
Expenditures	49.5	48.3	47.6	48.6	.	.	47.6	.	.
Deficit (-) / surplus (+), % GDP ⁴⁾	-4.8	-4.0	-3.0	-2.3	.	.	-2.3	-2.5	-2
Public debt in % of GDP ⁵⁾	52.0	52.7	50.0	53	.	.	.	.	.
Discount rate % p.a., end of period	4.5	4.5	4.5	9.0	4.5	9.0	.	.	.
Current account, EUR mn	-1433.7	-1975.6	-2692.4	-3206.4	-2021.3	.	-3300	-3600	-3600
Current account in % of GDP	-5.0	-6.3	-7.9	-8.6	-23.8	.	-8.0	-8.0	-7.4
Gross reserves of NB excl. gold, EUR mn	6436.2	7438.4	8725.3	9307.4	9519.8	9841.7	.	.	.
Gross external debt, EUR mn	22933.0	25747.7	29273.9	32929.2	30149.4	34361.8 ⁶⁾	.	.	.
Gross external debt in % of GDP	81.8	82.1	85.8	87.7	.	.	.	.	.
FDI inflow, EUR mn	949.6	1467.9	2737.9	3625.9	1360.6	.	2000	.	.
FDI outflow, EUR mn	278.8	192.1	176.7	206.5	99.2	.	200	.	.
Exports of goods, BOP, EUR mn	6606.8	7220.3	8463.6	9192.5	2046.3	2215	10100	10900	11800
annual growth rate in %	18.5	9.3	17.2	8.6	1.9	8.2	10	8	8
Imports of goods, BOP, EUR mn	13330.9	14738.3	16807.8	18626.5	4205.5	4772	20900	23200	26000
annual growth rate in %	6.3	10.6	14.0	10.8	8.8	13.5	12	11	12
Exports of services, BOP, EUR mn	7636.7	8052.6	8534.1	9179.0	771.5	.	9600	10400	10900
annual growth rate in %	0.9	5.4	6.0	7.6	16.3	.	5	8	5
Imports of services, BOP, EUR mn	2867.8	2734.9	2823.7	2859.1	672.9	.	2900	2950	3000
annual growth rate in %	8.9	-4.6	3.2	1.3	-4.8	.	1	2	2
Average exchange rate HRK/USD	6.0355	5.9480	5.8378	5.3645	5.6204	4.8699	.	.	.
Average exchange rate HRK/EUR (ECU)	7.4952	7.4002	7.3226	7.3362	7.3622	7.2867	7.33	7.33	7.34
Purchasing power parity HRK/USD, wiiw	3.8542	3.9350	3.9108	3.9576	.	.	.	.	.
Purchasing power parity HRK/EUR, wiiw	4.5812	4.6520	4.6516	4.6965	.	.	.	.	.

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) Enterprises with more than 20 employees. - 3) On accrual basis. - 4) Including change in arrears and non-recorded expenditures. - 5) Including guarantees. - 6) From 2008 new reporting system.

Source: wiiw Database incorporating national statistics; IMF; wiiw forecasts.