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Croatia: economic growth path remains unchanged

The first quarter of 2007 witnessed a substantial expansion of GDP (7%). Buoyant domestic demand was the main driver of growth: gross fixed capital formation rose by 11.2% and private consumption surged by 7% (reporting the highest growth since 2002). The latter was backed by rising wages and increased household lending. Growth of construction output slowed somewhat in the first quarter of the year. Consumer price inflation diminished as compared to a year earlier, averaging 2.5% during the first five months of 2007. The external imbalances continued to widen.

Industrial production rose by 8% during the first quarter of 2007, of which mining and quarrying by 14% and manufacturing by 10%. Within the latter, the production of office machinery and computers and the manufacture of radio, TV and communication equipment was rising rapidly; also the output of food and beverages performed particularly well. Only three out of 23 reporting branches recorded an output decline. Labour productivity rose by 7.8% during the first quarter of the year, even along with a small employment increase. Growth of construction decelerated to 6.5% in the first quarter; about half of the total is accounted for by motorway construction, which developed less dynamically than in previous years. The slowdown of production is also reflected by a decreasing number of building permissions.

Final data from the Labour Force Survey indicate an 0.8% employment increase in 2006 against a year earlier and a further decline in the unemployment rate to 11.1%. Labour market data, available both from registration and the Croatian Pension Insurance Institute, show a 2.7% increase in employment in the first three months of 2007. At the same time unemployment continued its downward trend (due to rising employment from the register), but was still high, at 15.9% in April.

On the external side, imports were again growing faster than exports during the first four months of 2007, with exports up by 6% and imports by 10% in euro terms (based on customs statistics). This resulted in a further deterioration of the trade deficit to EUR 3.3 million, a 13.5% increase as against the same period in 2006. After a strong rise in 2006, shipbuilding (Croatia's major single exporter) reported a substantial contraction of exports, as did the manufacture of coke and refined petroleum products. On the positive side, exports of machinery and equipment, basic metals and wood products expanded by more than one third. Exports to EU countries grew below average, those to Italy, Croatia's main trading partner, even registered a significant decline. In trade with the successor states of the former Yugoslavia, both exports and imports performed most dynamically in trade with Bosnia and Herzegovina. Considering the further deterioration of the merchandise trade deficit, on the one hand, and the rise in tourist overnight stays, on the

other, the current account deficit may have reached about EUR 2 billion during the first quarter of the year. As for FDI, 2006 saw a record inflow worth EUR 2.8 billion, mostly due to the sale of the pharmaceutical company Pliva to the US-based company Barr.

The restrictive measures set by the Croatian National Bank (CNB) to curb the growth of foreign debt (credit growth limit of 12% a year on commercial banks) yielded some results, at least with respect to the limitation of bank credits. Overall, from December 2006 foreign debt rose by EUR 640 million and reached EUR 29.6 billion by March 2007, equal to 86% of the GDP. The bulk of the increase was borne by enterprises, accounting for one third of total debt, while foreign debt of the government was further reduced and bank debt increased only modestly. In June modified measures to restrict credit growth were introduced by the CNB.

The next parliamentary elections will be held in November this year. Recent opinion polls show the Social Democrats in the lead, closely followed by the ruling HDZ. Only recently Zoran Milanović was elected new president of the Social Democrats, succeeding long-time leader Ivica Račan, who died in April this year. However, for the upcoming elections Ljubo Jurčić, a former minister of economy, will be the top candidate for prime minister.

Croatia's goal to join the EU as a full member in 2009 – i.e., before the European Parliamentary elections – is very ambitious. By contrast, members of the European Parliament stressed that 'the current EU institutional framework (Nice Treaty) needs to be reformed before any further enlargements take place'. So far, Croatia has opened six chapters, out of which two ('science and research' and 'education and culture') have been closed provisionally. Another six chapters should be opened by the end of June. None of the eleven chapters with opening benchmarks has been opened for negotiation.¹ From 2007 onwards Croatia is being eligible for Pre-Accession Assistance (IPA), replacing programmes such as PHARE or SAPARD. Out of the EUR 139 million earmarked for 2007, about one third each is earmarked for regional development, transition assistance and institution building.

Economic prospects have changed little against our previous forecast. Provided that Croatia does not slip into a severe debt crisis, the economic outlook will remain favourable. Driven mainly by domestic demand, GDP should grow by around 5% annually in the period 2007-2009. Household consumption is expected to remain quite strong. Rising employment and wages as well as bank lending will support consumption. Growing imports, responding to rising domestic demand, will reduce the overall contribution of trade

¹ Opening benchmarks, for example strategies or action plans, are a new tool. Their purpose is to improve the quality of negotiations by providing incentives for the candidate countries to undertake necessary reforms at an early stage. For details see European Commission (2006), 'Enlargement Strategy and Main Challenges 2006-2007 including annexed special report on the EU's capacity to integrate new members' (COM 2006) 649.

to GDP growth. Apart from the increase in employment, improvements on the labour market should continue in the form of falling unemployment rates. Given the continued widening of the trade deficit, the current account deficit will remain at high levels, thus implying a further increase in foreign debt.

Table HR

Croatia: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008 forecast
Population, th pers., mid-year	4443	4442	4439	4442	4442	.	.	.	.
Gross domestic product, HRK mn, nom.	181231	198422	214983	231349	250590	56721	62561	270500	290600
annual change in % (real)	5.6	5.3	4.3	4.3	4.8	6.0	7.0	5	5
GDP/capita (EUR at exchange rate)	5507	5906	6462	7038	7704	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	9380	9930	10680	11380	12400	.	.	.	.
Gross industrial production ²⁾									
annual change in % (real)	5.4	4.1	3.7	5.1	4.5	6.4	8.0	6	5
Gross agricultural production									
annual change in % (real)	7.7	-15.9	11.9	-8.7	.	.	.	.	.
Construction industry, hours worked ²⁾									
annual change in % (real)	12.8	22.8	2.0	-0.8	9.3	15.9	6.5	.	.
Consumption of households, HRK mn, nom.	108027	115081	123123	131671	140261	33453	36391	.	.
annual change in % (real)	7.7	4.6	4.8	3.4	3.5	4.0	7.1	4.5	4
Gross fixed capital form., HRK mn, nom.	44105	56662	60512	65008	74792	17131	19530	.	.
annual change in % (real)	13.9	24.7	5.0	4.8	10.9	18.1	11.2	8	7
LFS - employed persons, th, avg.	1528	1537	1563	1573	1586	.	.	.	.
annual change in %	.	0.6	1.7	0.7	0.8	.	.	.	.
Reg. employees in industry, th pers., avg.	281.0	282.6	281.7	278.9	284.1	280.5	281.1	.	.
annual change in %	-2.2	0.6	-0.3	-1.0	1.9	0.8	0.2	.	.
LFS - unemployed persons, average	266.0	256.0	249.5	229.0	198.5	.	.	.	.
LFS - unemployment rate in %, average	14.8	14.3	13.8	12.7	11.1	.	.	10.8	10.3
Reg. unemployment rate in %, end of period	21.3	18.7	18.5	17.8	17.0	18.1	16.6	16	15.5
Average gross monthly wages, HRK	5366	5623	5985	6248	6634	6454	6854	.	.
annual change in % (real, net)	3.1	3.8	3.7	1.6	1.9	1.5	3.6	.	.
Consumer prices, % p.a.	1.7	1.8	2.1	3.3	3.2	3.5	1.6	2.8	2.3
Producer prices in industry, % p.a.	-0.4	1.9	3.5	3.0	2.9	3.5	1.9	2.5	2.4
General governm.budget, IMF-def., % GDP									
Revenues	46.3	45.1	45.4	44.9	.	.	.	.	.
Expenditures	51.4	51.3	50.2	49.0	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-5.0	-6.2	-4.9	-4.1	-3.0	.	.	-3	-2.5
Public debt in % of GDP% ³⁾	50.7	51.2	52.0	52.7	50.0	.	.	53	54
Discount rate % p.a., end of period	4.5	4.5	4.5	4.5	4.5	4.5	4.5	.	.
Current account, EUR mn	-2095.3	-1865.7	-1404.2	-1984.9	-2617.4	-2053.3	.	-2800	-2800
Current account in % of GDP	-8.6	-7.1	-4.9	-6.3	-7.6	.	.	-7.7	-7.1
Gross reserves of NB excl. gold, EUR mn	5651.3	6554.1	6436.2	7438.4	8725.3	8088.5	9519.8	.	.
Gross external debt, EUR mn	15054.8	19810.6	22780.7	25540.8	28975.1	26542.8	29610.3	.	.
Gross external debt in % of GDP	61.5	75.5	79.4	81.7	84.7	.	.	.	.
FDI inflow, EUR mn	1196.8	1784.5	990.4	1424.9	2837.6	527.6	.	.	.
FDI outflow, EUR mn	601.3	106.1	281.9	194.5	167.6	25.5	.	.	.
Exports of goods, BOP, EUR mn	5293.1	5571.7	6603.1	7216.6	8433.6	2004.8	.	9200	10200
annual growth rate in %	-0.5	5.3	18.5	9.3	16.9	32.7	.	9	11
Imports of goods, BOP, EUR mn	11253.4	12545.9	13330.9	14738.3	16797.5	3865.2	.	18500	20700
annual growth rate in %	13.4	11.5	6.3	10.6	14.0	25.0	.	10	12
Exports of services, BOP, EUR mn	5832.3	7565.9	7636.7	8052.6	8533.2	663.2	.	9100	9700
annual growth rate in %	6.4	29.7	0.9	5.4	6.0	1.6	.	7	7
Imports of services, BOP, EUR mn	2547.5	2632.9	2867.8	2734.9	2820.2	706.4	.	2950	3100
annual growth rate in %	16.9	3.4	8.9	-4.6	3.1	9.0	.	4.5	5
Average exchange rate HRK/USD	7.86	6.70	6.04	5.95	5.84	6.11	5.62	.	.
Average exchange rate HRK/EUR (ECU)	7.41	7.56	7.50	7.40	7.32	7.34	7.36	7.4	7.4
Purchasing power parity HRK/USD, wiiw	3.75	3.81	3.82	3.84	3.83	.	.	.	.
Purchasing power parity HRK/EUR, wiiw	4.35	4.50	4.54	4.58	4.55	.	.	.	.

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

1) Preliminary. - 2) Enterprises with more than 20 employees. - 3) Including guarantees.

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