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Croatia: strong GDP growth and resurgent inflation

In 2007 Croatia recorded the fastest GDP growth rate in the past ten years, up 6%. The economic expansion was driven by domestic absorption, particularly rising household consumption, and to a lesser extent by investments. Growth of private demand nearly doubled compared to a year earlier and was boosted by rising disposable income due to growing employment and rising wages, repayment of pensioners' debt (debt arrears) and bank credits. In anticipation of the parliamentary elections, government consumption climbed noticeably. Foreign demand contributed negatively to GDP growth. The deceleration of investment went along with slowing activities in construction. Industrial output growth decelerated in the course of the year, but was still substantially higher than in 2006.

Inflation was accelerating in 2007 and reached its highest level since the year 2000. The consumer price index rose by 5.6% in December year on year, indicating an annual inflation rate of 2.9%. Inflation was mainly fuelled by rising food prices (of both domestic and imported goods) and energy prices.

In 2007, employment growth benefited from the strong GDP expansion and rose by more than 3% based on registration data. New job creation was reported mainly in tourism and manufacturing. Registered unemployment, after a steady decline for six months, started to rise in September and reached 14.8% by the end of December. The LFS unemployment rate fell to 9.8% in the first three quarters of the year; youth unemployment fell to 23.5% and was 10 percentage point lower than in 2006.

Persisting external imbalances

On the external side, the deficit in merchandise trade continued to widen, while the surplus in services trade rose slightly due to increasing earnings from tourism. Expectedly, the current account deficit remained high, at about 7.5% of the GDP. Favourable FDI trends continued in 2007, with inflows worth EUR 3 billion, double the amount invested in 2006. A sectoral breakdown for the first three quarters of the year shows that the largest portion went into financial intermediation (mostly recapitalization of local banks by foreign owners). Croatian investment abroad averaged EUR 200 million p.a. over the period 2003-2007 and focused on the countries of the Western Balkans, in particular Serbia and Bosnia and Herzegovina.

Croatia's foreign debt grew at a lower pace than in earlier years and stood at EUR 32.6 billion by the end of December. Overall, from December 2006 foreign debt rose by EUR 3.4 billion, equalling around 87% of the GDP. Enterprise debt accounted for the bulk of the increase, with a share of over 40% of total debt, while the debt of the government

and banks decreased further. The decline of the latter was first of all due to the restrictive measures set by the Croatian National Bank with respect to the limitation of bank credits.

Thanks to the favourable overall economic performance, the general government deficit was cut significantly: to 2.3% of GDP, from 3% in 2006. This is even lower than anticipated by the budget revision in June last year. Because of the parliamentary elections the 2008 budget has not yet been adopted and its basic assumptions are unknown. First conclusions can however be drawn from the coalition document, anticipating a gradual reduction of the budget deficit with fiscal balance being reached in 2010. This goal is apparently based on very optimistic assumptions (GDP growth above 6% and a relatively low inflation rate of close to 2% p.a.) and will probably not be met.

Following the parliamentary elections in November last year, a new government was introduced at the beginning of 2008. It is again headed by Ivo Sanader from the Croatian Democratic Union (HDZ), who formed a coalition with the Peasant Party (HSS), the Social Liberal Party (HSLs) and the Independent Serb Party (SDSS). Joining the EU and NATO membership are the two key priorities.

EU negotiations progressed only slowly in 2007. Altogether Croatia has opened 16 chapters out of 35 in its EU accession talks, with two of them temporarily closed. Provided that the negotiations are completed by 2009, Croatia might join the Union realistically by 2011.

GDP growth at a lower pace

In 2008 GDP growth will slow down from the very high rate achieved in 2007, to below 5%, due to dampened private consumption as a consequence of shrinking debt repayments to pensioners and credit restrictions set by the National Bank. Government consumption will slow to 'normal' levels in the post-election year. The Croatian National Bank will remain focused on fighting inflation with restrictions on banking placements and foreign borrowing, significant reduction of existing operations on the open market and defending the kuna's nominal exchange rate against possible depreciation. In response to the strong increase in food prices globally, as well as rising energy prices, inflation will remain high, especially in 2008. This has recently been confirmed by the National Bank Governor, who expects annual inflation of 6% in 2008.

The pace of GDP growth will decelerate further in 2009, associated with declining investment and the assumed weakening of private consumption growth; government consumption is expected to remain flat. Croatia's external performance will largely depend on the economic environment in its main trading partners. Import growth is expected to decelerate in line with declining investment growth. We expect the trade deficit to GDP ratio to exceed the 20% mark; consequently the current account deficit will remain at high levels. Further privatization deals, involving shipyards in particular, are in the pipeline and should contribute to substantial FDI inflows, thus covering part of the current account deficit.

Table HR

Croatia: Selected economic indicators

	2002	2003	2004	2005	2006	2007 ¹⁾	2008	2009	2010
	Forecast								
Population, th pers., mid-year	4,443	4,442	4,439	4,442	4,440	4,440	.	.	.
Gross domestic product, HRK mn, nom.	181,231	198,422	214,983	231,349	250,590	273,300	300,700	326,800	355,100
annual change in % (real)	5.6	5.3	4.3	4.3	4.8	6	4.8	4.5	5
GDP/capita (EUR at exchange rate)	5,507	5,906	6,462	7,038	7,708	8,390	.	.	.
GDP/capita (EUR at PPP - wiiw)	9,320	9,830	10,570	11,200	12,130	13,180	.	.	.
Gross industrial production ²⁾									
annual change in % (real)	5.4	4.1	3.7	5.1	4.5	5.7	5	4.5	5
Gross agricultural production									
annual change in % (real)	7.7	-15.9	11.9	-8.7	4.4	.	.	.	.
Construction industry, hours worked ²⁾									
annual change in % (real)	12.8	22.8	2.0	-0.8	9.3	2.4 ^{I-XI}	.	.	.
Consumption of households, HRK mn, nom.	108,027	115,081	123,123	131,671	140,261	153,000	.	.	.
annual change in % (real)	7.7	4.6	4.8	3.4	3.5	6	4	3.5	4
Gross fixed capital form., HRK mn, nom.	44,105	56,662	60,512	65,008	74,792	82,700	.	.	.
annual change in % (real)	13.9	24.7	5.0	4.8	10.9	7	6	5	5.5
LFS - employed persons, th, avg.	1,528	1,537	1,563	1,573	1,586	1,600	.	.	.
annual change in %	.	0.6	1.7	0.7	0.8	1	.	.	.
Reg. employees in industry, th pers., avg.	281.0	282.6	281.7	278.9	284.1	283.7 ^{I-XI}	.	.	.
annual change in %	-2.2	0.6	-0.3	-1.0	1.9	-0.1 ^{I-XI}	.	.	.
LFS - unemployed persons, average	266.0	256.0	249.5	229.0	198.5	182	.	.	.
LFS - unemployment rate in %, average	14.8	14.3	13.8	12.7	11.1	10	9.8	9.4	9
Reg. unemployment rate in %, end of period	21.3	18.7	18.5	17.8	17.0	14.8	14	.	.
Average gross monthly wages, HRK	5,366	5,623	5,985	6,248	6,634	7,028	.	.	.
annual change in % (real, net)	3.1	3.8	3.7	1.5	1.9	2.6	.	.	.
Consumer prices, % p.a.	1.7	1.8	2.1	3.3	3.2	2.9	5	4	3.5
Producer prices in industry, % p.a.	-0.4	1.9	3.5	3.0	2.9	3.4	3.5	.	.
General governm.budget, nat.def., % GDP ³⁾									
Revenues	46.3	45.1	44.9	44.5	44.8	.	.	.	.
Expenditures	50.6	50.1	49.5	48.3	47.0	.	.	.	.
Deficit (-) / surplus (+), % GDP ⁴⁾	-5.0	-6.2	-4.8	-4.0	-3.0	-2.3	-3	-2.5	-2
Public debt in % of GDP ⁵⁾	50.7	51.2	52.0	52.7	50.0	53	.	.	.
Discount rate % p.a., end of period	4.5	4.5	4.5	4.5	4.5	9.0	.	.	.
Current account, EUR mn	-2,099	-1,889	-1,454	-1,988	-2,644	-2,800	-2,900	-3,250	-3,500
Current account in % of GDP	-8.6	-7.2	-5.1	-6.4	-7.7	-7.5	-7.1	-7.3	-7.3
Gross reserves of NB excl. gold, EUR mn	5,651	6,554	6,436	7,438	8,725	9,307	.	.	.
Gross external debt, EUR mn	15,143	19,884	22,933	25,748	29,258	32,610	.	.	.
Gross external debt in % of GDP	62.2	76.6	81.8	82.1	85.6	87.4	.	.	.
FDI inflow, EUR mn	1,138	1,762	950	1,468	2,747	3,000	2,000	.	.
FDI outflow, EUR mn	607	106	279	192	163	220	200	.	.
Exports of goods, BOP, EUR mn	5,296	5,575	6,607	7,220	8,464	9,300	10,000	10,700	11,400
annual growth rate in %	-0.6	5.3	18.5	9.3	17.2	10	8	7	7
Imports of goods, BOP, EUR mn	11,254	12,546	13,331	14,738	16,808	18,500	19,900	21,000	22,200
annual growth rate in %	13.4	11.5	6.3	10.6	14.0	10	8	6	6
Exports of services, BOP, EUR mn	5,832	7,566	7,637	8,053	8,534	9,100	9,600	10,400	10,900
annual growth rate in %	6.4	29.7	0.9	5.4	6.0	7	5	8	5
Imports of services, BOP, EUR mn	2,548	2,633	2,868	2,735	2,824	2,770	2,900	2,950	3,000
annual growth rate in %	16.9	3.4	8.9	-4.6	3.2	-2	5	2	2
Average exchange rate HRK/USD	7.86	6.70	6.04	5.95	5.84	5.36	.	.	.
Average exchange rate HRK/EUR (ECU)	7.41	7.56	7.50	7.40	7.32	7.34	7.33	7.33	7.34
Purchasing power parity HRK/USD, wiiw	3.74	3.84	3.85	3.94	3.91	3.82	.	.	.
Purchasing power parity HRK/EUR, wiiw	4.38	4.54	4.58	4.65	4.65	4.67	.	.	.

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.

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