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Croatia: growth continues but external imbalances remain

The first quarter of 2006 was characterized by high, though abating industrial output growth, moderately growing retail trade turnover and further increasing external imbalances. The jump in construction activities implies a resumption of investment growth after only modest increases in the past two years. Spurred by high oil prices and public utility price hikes, consumer price inflation continued to increase, averaging 3.5% in the first four months of the year and 3.5% in April respectively. On 12 May the EU approved the start of detailed membership talks with Croatia (having formally agreed already in October last year).

Industrial production growth lost momentum from month to month; in the period January-April it was up 3.7%. Within manufacturing, output grew above average in the manufacture of machinery and equipment, other non-metallic mineral products, radio, television and communication equipment as well as in the production of food and beverages. By contrast, the output of the shipbuilding industry – reporting a surge in exports – dropped by 6%. The production of textiles has continued its downward trend: within the past five years the output level in the textile industry fell by about one third; over that period an average 200 jobs were lost per month.

Final data obtained from the Labour Force Survey indicate a 0.7% employment increase in 2005 as compared to a year earlier and a decline of the unemployment rate to 12.7%. Labour market data available from registration point to a further employment rise by 0.7% – particularly in construction, distribution and financial and business services – in the first four months of 2006, while unemployment stood at 17.8 % in April. A special programme launched by the government in March should help to employ the low-educated, long-term unemployed, older workers, young people with no working experience and members of vulnerable groups, such as disabled persons or war veterans.

On the external side, customs statistics data indicate a dynamic performance in the first four months of the year, with exports up 19.6% and imports by 20.4% in euro terms. This resulted in a widening of the trade deficit to EUR 2.8 billion, EUR 480 million more than in the same period a year earlier. After a slump in 2005, shipbuilding (Croatia's main single exporter) reported remarkable export growth during the first four months of the year, as did the manufacture of coke and refined petroleum products. Exports to the EU countries grew above average, with outstanding results in trade with Italy, Croatia's major trading partner. After years of strong expansion, exports to the successor states of former Yugoslavia (excluding Slovenia) rose only modestly, whereas imports from that region performed above average. Considering the increased deficit in merchandise trade and a substantial drop in overnight stays during the first quarter of 2006, the current account deficit has reached almost EUR 2 billion.

Despite several attempts of the Croatian National Bank (CNB) to counteract a further increase in foreign debt, the latter's upward trend has not yet come to a halt. Over the past couple of years, the CNB repeatedly increased the marginal reserve requirement on new bank borrowing from abroad. From January 2006 it was set at 55% and applicable to the rise in banks' foreign liabilities relative to November 2005. This new measure includes corporate borrowing guaranteed by Croatian banks and banks' borrowing from domestic leasing companies. Overall, from December 2005 foreign debt increased by another EUR 1.3 billion and reached EUR 26.3 billion by March 2006. The bulk of the increase was again borne by the banking sector, accounting for almost 38% of total debt, while foreign debt of the government could be somewhat reduced. In a recent study on the foreign debt situation in Croatia, the CNB stated that foreign debt is currently still within the limits of sustainability, but that a continuation of the current tendencies (meaning without effective measures on the fiscal side) may very quickly lead to a debt crisis.

Stabilizing external debt and keeping the public debt below the Maastricht reference value are the key goals stressed in the second Pre-Accession Economic Programme for the period 2005-2008, updated in December last year. These objectives should be reached by further fiscal consolidation through the reduction of subsidies, saving in public administration and on social benefits, a health sector reform and a gradual reduction of taxes. The monetary and exchange rate policies are envisaged to remain unchanged. To support these policies, the Croatian authorities had asked the IMF to extend the Stand-by arrangement (from August 2004) by seven months, until November 2007. Another (draft) document presenting the long-term economic strategy was launched in mid-May, aiming at achieving 'social prosperity through development and employment in a competitive market economy within a European welfare state of the 21st century'. The strategy foresees, among other things, a fast catching-up process up to 2013 which should be facilitated by (very ambitious) annual GDP growth rates of 6%. The strategy stresses again the importance of reducing the external vulnerability and proposes measures for a quick introduction of the euro after EU accession.

Economic prospects for the coming two years are relatively good. Driven primarily by domestic demand, GDP may grow by about 4% in both 2006 and 2007. Private consumption growth will be supported by the credit expansion to the enterprise and household sectors and the repayment of pension arrears starting this year; investments should come primarily from the private sector. Inflation may reach 3.7% on an annual average due to increasing energy prices and a further adjustment of administered prices. Assuming that earnings from tourism will remain at their 2005 level and that the trade deficit will widen again, the current account may close with a higher deficit than last year, at over 6% of the GDP. The big uncertainty, however, remains foreign indebtedness: it may only come to a halt if the Croatian authorities pursue a very strict fiscal consolidation strategy; otherwise the country may face a serious debt crisis.

Table HR

Croatia: Selected economic indicators

	2001	2002	2003	2004	2005 ¹⁾	2005 1st quarter	2006	2006 forecast	2007
Population, th pers., mid-year	4437	4443	4442	4439	4439	.	.	.	.
Gross domestic product, HRK mn, nom.	165640	181231	198422	212826	229031	50930	.	245300	261500
annual change in % (real)	4.4	5.6	5.3	3.8	4.3	1.8	.	4	4
GDP/capita (EUR at exchange rate)	4998	5507	5906	6397	6972	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	8630	9380	9980	10610	11450	.	.	.	.
Gross industrial production ²⁾									
annual change in % (real)	6.0	5.4	4.1	3.7	5.1	0.3	6.4	4	4
Gross agricultural production									
annual change in % (real)	8.5	7.7	-15.9	11.9	.	.	.	.	.
Construction industry, hours worked ²⁾									
annual change in % (real)	3.6	12.8	22.8	2.0	-0.8	-6.6	15.2 ^{III}	.	.
Consumption of households, HRK mn, nom.	98054	108027	115081	122100	130576	30975	.	.	.
annual change in % (real)	4.5	7.7	4.6	3.9	3.4	2.4	.	4	4
Gross fixed capital form., HRK mn, nom.	36984	44105	56662	60866	65391	14186	.	.	.
annual change in % (real)	7.1	13.9	24.7	4.4	4.8	0.3	.	7	6.5
LFS - employed persons, th, avg.	1469	1528	1537	1563	1573	.	.	.	.
annual change in %	-5.4	4.0	0.6	1.7	0.7	.	.	.	.
Reg. employees in industry, th pers., avg.	287.2	281.0	282.6	281.7	278.9	278.3	274.2	.	.
annual change in %	-1.6	-2.2	0.6	-0.3	-1.0	-0.7	-1.5	.	.
LFS - unemployed, th pers., average	277.0	266.0	256.0	249.5	229.0	236.0	.	.	.
LFS - unemployment rate in %, average	15.9	14.8	14.3	13.8	12.7	13.1	.	12.5	12
Reg. unemployment rate in %, end of period	23.1	21.3	18.7	18.5	17.8	19.0	18.1	17.5	17
Average gross monthly wages, HRK	5061	5366	5623	5985	6248	6087	6454	.	.
annual change in % (real, net)	1.6	3.1	3.8	3.7	1.6	1.7	1.5	.	.
Consumer prices, % p.a. ³⁾	4.9	1.7	1.8	2.1	3.3	3.3	3.5	3.5	3
Producer prices in industry, % p.a.	3.6	-0.4	1.9	3.5	3.0	4.8	3.5	2.7	2.4
General governm.budget, IMF-def., % GDP									
Revenues	44.7	45.2	44.9	.	.	.	.	.	.
Expenditures	51.5	50.0	49.5	.	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-6.8	-4.8	-6.3	-4.9	-4.2	.	.	-4	-3.8
Public debt in % of GDP ⁴⁾	50.3	50.4	51.7	53.2	54.5	.	.	55	56
Discount rate % p.a., end of period	5.9	4.5	4.5	4.5	4.5	4.5	4.5	.	.
Current account, EUR mn	-817.7	-2097.2	-1866.2	-1458.0	-1963.6	-1542.0	.	-2200	-2200
Current account in % of GDP	-3.7	-8.6	-7.1	-5.1	-6.3	.	.	-6.5	-6.2
Gross reserves of NB excl. gold, EUR mn	5333.6	5651.3	6554.1	6436.2	7438.4	6700.4	8088.5	.	.
Gross external debt, EUR mn	13458.3	15054.8	19810.6	22780.7	25540.8	23145.3	26314.5	.	.
FDI inflow, EUR mn	1502.5	1195.1	1788.4	989.3	1327.8	204.5	.	.	.
FDI outflow, EUR mn	175.7	598.3	93.0	280.3	142.9	29.9	.	.	.
Exports of goods, BOP, EUR mn	5318.8	5293.1	5571.7	6603.1	7244.3	1523.5	.	8300	9200
annual growth rate in %	7.0	-0.5	5.3	18.5	9.7	2.7	.	15	11
Imports of goods, BOP, EUR mn	9922.6	11253.5	12545.9	13330.9	14727.1	3092.7	.	16900	18900
annual growth rate in %	17.2	13.4	11.5	6.3	10.5	5.9	.	15	12
Exports of services, BOP, EUR mn	5481.3	5832.3	7565.9	7636.7	8051.8	652.6	.	.	.
annual growth rate in %	23.4	6.4	29.7	0.9	5.4	5.4	.	.	.
Imports of services, BOP, EUR mn	2178.5	2547.5	2632.8	2921.7	2734.7	648.4	.	.	.
annual growth rate in %	10.5	16.9	3.3	11.0	-6.4	2.0	.	.	.
Average exchange rate HRK/USD	8.34	7.86	6.70	6.04	5.95	5.73	6.11	.	.
Average exchange rate HRK/EUR (ECU)	7.47	7.41	7.56	7.50	7.40	7.51	7.34	7.3	7.4
Purchasing power parity HRK/USD	3.77	3.75	3.82	3.86	3.75	.	.	.	.
Purchasing power parity HRK/EUR	4.33	4.35	4.47	4.52	4.51	.	.	.	.

Notes: 1) Preliminary. - 2) Enterprises with more than 20 employees. - 3) In 2001 retail prices. - 4) Including guarantees.

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