

Croatia economy: Quick View - Output growth eases July 20th 2007

COUNTRY BRIEFING

FROM THE ECONOMIST INTELLIGENCE UNIT

Croatia's industrial production growth slowed to 4.4% year on year in June, a six-month low. Output from manufacturing--which accounts for almost 80% of overall production--expanded by 5.3%, the weakest performance this year. The slowdown was mainly due to a weaker performance in the production of intermediate goods, non-durable consumer goods and capital goods. Production of intermediate goods was constrained by a 2.3% fall in the non-metallic minerals category (including cement and bricks), consistent with the gradual slowing of construction activity since the beginning of the year. There was also weaker growth in capital goods, owing to lower production of machinery and other transport equipment (ships). Growth in the main component of consumer non-durables (and manufacturing)--food and drink--decelerated to 2.4%, compared with 5.3% in May. Mining output edged up by just 0.2%, the weakest performance in 18 months, whereas utilities output expanded by 3.3% after seven consecutive months of decline.

THE EIU VIEW

Industrial activity usually expands at a slower pace over the summer months. Furthermore, a slowdown in second-quarter output growth is not surprising, given the strong first-quarter performance when production shot up by 7.9% year on year. The decline in output of machinery and equipment may be related to the disappointing performance in trade so far this year--merchandise exports increased by just 2.2% in the first quarter, although export growth did begin to recover in the two months to May. The manufacture of inputs used by the construction industry, such as non-metallic mineral products, has fallen recently; this suggests the construction sector is struggling to maintain the rapid pace of expansion achieved in 2006. Even so, the Economist Intelligence Unit expects industrial production growth to accelerate to an average of 6.5% in 2007 from 4.5% in 2006.

Croatia: Industrial production
(% change, year on year)

| Dec 06 | Jan 07 | Feb 07 | Mar 07 | Apr 07 | May 07 | Jun 07 |
|--------|--------|--------|--------|--------|--------|--------|
| 3.1 | 9.0 | 5.7 | 9.0 | 9.4 | 7.7 | 4.4 |

Source: Department of Statistics; Haver Analytics

Economic policy outlook

Following higher than expected tax receipts generated by a first-quarter surge in economic activity, the government is planning to make a modest downward revision to its target for the general government deficit, to 2.6% of GDP (from 2.8% of GDP previously).

Economic forecast

The strength of investment and consumption data in the first quarter, and of industrial output over the first five months of 2007, have led us to revise our 2007 real GDP growth forecast upwards significantly, from 4.7% to 5.7%.

Outlook for 2007-08: Economic growth

Gross domestic product by expenditure

(HRK m at constant 1997 prices where series are indicated; otherwise % change year on year)

| | 2005 ^a | 2006 ^a | 2007 ^b | 2008 ^b |
|-----------------------------|-------------------|-------------------|-------------------|-------------------|
| Private consumption | 98,849 | 102,282 | 106,578 | 110,521 |
| | 3.4 | 3.5 | 4.2 | 3.7 |
| Public consumption | 33,380 | 34,103 | 34,376 | 34,720 |
| | 0.8 | 2.2 | 0.8 | 1.0 |
| Gross fixed investment | 47,452 | 52,610 | 55,241 | 58,003 |
| | 4.9 | 10.9 | 5.0 | 5.0 |
| Final domestic demand | 179,681 | 188,995 | 196,194 | 203,243 |
| | 3.3 | 5.2 | 3.8 | 3.6 |
| Stockbuilding | 4,718 | 5,040 | 5,900 | 7,100 |
| | 0.6 ^c | 0.2 ^c | 0.5 ^c | 0.7 ^c |
| Total domestic demand | 184,399 | 194,035 | 202,094 | 210,343 |
| | 3.7 | 5.2 | 4.2 | 4.1 |
| Exports of goods & services | 80,320 | 85,850 | 92,203 | 99,395 |
| | 4.6 | 6.9 | 7.4 | 7.8 |
| Imports of goods & services | 101,229 | 108,608 | 115,016 | 122,492 |
| | 3.5 | 7.3 | 5.9 | 6.5 |
| Foreign balance | -20,909 | -22,758 | -22,813 | -23,097 |
| | 0.1 ^c | -1.1 ^c | 0.0 ^c | -0.2 ^c |
| GDP | 163,490 | 171,277 | 179,281 | 187,246 |
| | 4.3 | 4.8 | 4.7 | 4.4 |

^a Actual. ^b Economist Intelligence Unit forecasts. ^c Contribution to real GDP growth (as a percentage of real GDP in previous year).

Real GDP growth was 4.8% in 2006, a three-year high. A sharp upturn in construction activity (registering 9.3% growth in volume terms, compared with 0.8% in 2005) and higher investment in machinery and equipment (production of which increased by 27%) supported double-digit growth in fixed capital formation, which contributed 3.2 percentage points to overall growth. Although the share of investment in GDP growth is unlikely to be sustained, consumer spending will continue to grow relatively robustly, and improving productivity in Croatia's export sector should help to drive a steady upturn in foreign sales. Real GDP growth is forecast at 4.7% in 2007. Growth in 2008 will be slower, but will remain well above 4%. Preliminary indicators of economic activity suggest that real GDP growth in the first quarter of 2007 will be higher than the 4.8% year-on-year rate recorded in the final three months of 2006. *W*

International assumptions

International assumptions summary
(% unless otherwise indicated)

| | 2005 | 2006 | 2007 | 2008 |
|---|-------|-------|-------|-------|
| Real GDP growth | | | | |
| World | 4.8 | 5.3 | 4.8 | 4.7 |
| OECD | 2.6 | 3.2 | 2.5 | 2.6 |
| EU27 | 1.8 | 3.0 | 2.7 | 2.3 |
| Euro area | 1.4 | 2.8 | 2.5 | 2.1 |
| Exchange rates | | | | |
| US\$:€ | 1.246 | 1.256 | 1.360 | 1.383 |
| SDR:US\$ | 0.677 | 0.680 | 0.651 | 0.640 |
| Financial indicators | | | | |
| US\$ 3-month Libor | 3.56 | 5.19 | 5.24 | 5.12 |
| € 3-month interbank rate | 2.18 | 3.08 | 4.10 | 4.30 |
| Commodity prices | | | | |
| Oil (Brent; US\$/b) | 54.7 | 65.3 | 65.0 | 60.3 |
| Natural gas (Europe; % change in US\$ terms) | 48.0 | 29.9 | -7.7 | 1.9 |
| Food, feedstuffs & beverages (% change in US\$ terms) | -0.5 | 16.1 | 10.6 | -0.2 |
| Industrial raw materials (% change in US\$ terms) | 10.2 | 49.9 | 6.3 | -14.2 |

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

Real GDP growth in both Italy and Germany, Croatia's largest euro zone export markets, recovered to a six-year high in 2006. Growth across the euro area will slow to 2.5% in 2007, and we expect it to decelerate again to 2.1% in 2008. Croatian export competitiveness may be dented by the exchange rate, with our research indicating that the kuna is one of the most overvalued currencies in central and eastern Europe. In addition to persistently high oil prices over the forecast period, more expensive electricity imports will boost inflationary pressures.