Rating Object	Rating Information	
REPUBLIC OF CROATIA	Assigned Ratings/Outlook: **BBB+ /positive**	Type: Monitoring, Unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	10-02-2023 09-02-2024 "Sovereign Ratings" "Rating Criteria and Definitions"

Contents

Rating Action

Neuss, 09 February 2024

Creditreform Rating has raised its unsolicited long-term sovereign rating on the Republic of Croatia to "BBB+" from "BBB". Creditreform Rating has also raised Croatia's unsolicited ratings for foreign and local currency senior unsecured long-term debt to "BBB+" from "BBB". The outlook is revised to positive from stable.

The rating upgrade on the Republic of Croatia reflects

(i) its robust economic recovery and its outperformance of growth expectations following successive global crises, which has led to a significant increase in GDP per capita, pointing to an acceleration of Croatia's convergence process towards EU income levels after ;

(ii) good progress in terms of implementation of the Recovery and Resilience Program (RRP) and related disbursements of NextGenerationEU funds, maintaining confidence for this to continue; and

(iii) repeated outperformance of public finance targets, supporting a faster-than-expected decline of its debt-to-GDP ratio on the back of strong nominal growth

The outlook revision on the Republic of Croatia reflects

(i) our expectation of robust economic growth over the medium term, likely boosted by substantial EU funds, as well as by tourism, fostering further convergence towards EU income levels;

(ii) an improving outlook for potential growth on the back of progressing RRP implementation and related expected strengthening of the institutional framework; and

(iii) an expected continued downward trajectory of the debt-to GDP following the swift decline below its pre-pandemic level, likely driven by robust growth and partly supported by EU financing

Key Rating Drivers

1. Recent GDP growth outperformance underscoring improving economic resilience, also backed by strong tourism; signs for an accelerated convergence towards the EU income level; GDP expansion has slowed in 2023, but should continue at a robust rate this year and next, notwithstanding risks linked to a challenging international backdrop

2. Well-progressing implementation of the RRP maintains a favorable medium-term growth outlook on the back of substantial EU funding and of advancing reforms suitable to lift productivity and improve the business environment; unfavorable demographics highlight headwinds as regards the longer-term outlook
3. Notwithstanding the significant advantages linked to the EU/EMU's membership, there remains ample room to improve the quality of the institutional framework, as also suggested by the latest set of Worldwide Governance Indicators; a range of reforms and initiatives to strengthen the institutional quality are under way, with recent progress registered in terms of reforms of the justice system, while efforts to be removed from the Financial Action Task Force's (FATF) grey list are to be monitored
4. Risks to fiscal sustainability remain limited; while we expect public finances to deteriorate somewhat in the short term, largely driven by expenditure to mitigate high inflationary pressure and social spending, we consider a further downward trajectory of the debt-to-GDP ratio over the medium term to be likely; we deem the banking sector to be resilient, although hardly abating house price dynamics should be monitored; the positive implications of the adoption of the euro and sound debt management add to a track record of fiscal prudency as risk-mitigating factors
5. External risks appear manageable, with the negative net international investment position continuing to improve; amid retreating energy prices, the current account balance is set to return to positive territory this year, benefiting from tourism-dominated service exports

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

Croatia's favorable macroeconomic profile is buttressed by a continued phase of strong, above-EU-level growth, fostering progress in converging towards the EU income level. While tourism remains a vital driver for growth, service exports are becoming more diversified, contributing to economic resilience against the backdrop of a challenging international environment. Relatively moderate levels of private indebtedness continue to offer some shock-absorbing capacity. Well-advancing RRP implementation and disbursement of associated EU funds strengthen, in our view, the positive outlook for medium-term economic growth, with potential growth standing to benefit from measures suitable to lift low productivity and address shortcomings in Croatia's business environment, which have been long-standing deficiencies. Increasing productivity would prospectively also contribute to mitigating challenges stemming from unfavorable demographic developments.

Following the strong rebound in 2021 after the initial pandemic shock, Croatia's economy performed well in 2022, despite the headwinds presented by soaring energy prices linked to Russia's invasion of Ukraine. With an expansion of 6.3% in 2022, primarily driven by private consumption and changes in inventories, Croatia's real GDP continued to markedly outperform EU

[1] This rating update takes into account information available until 02 February 2024.

GDP growth (3.4%), as well as that of respective CEE peers, and it displayed the strongest increase of real GDP among the CEE peers compared to the pre-pandemic year 2019 (10.6%). Over the same period (2022 vs. 2019), real exports grew by 29.5% (EU: 9.4%).

Following a rather gradual income convergence towards EU levels prior to the pandemic, a marked acceleration can be observed for 2022 (14.4%, IMF data, PPP terms). For 2023, Croatia's GDP per capita is estimated to have climbed further, to 75% of the EU level. To be sure, at an estimated GDP per head of USD 42,873, the respective metric moves among the lower ones in the EU.

In the course of last year, Croatia as an open economy was not spared from adverse effects under the influence of inflationary pressure and tighter monetary policy that weighed on both foreign and domestic demand. Real exports posted consecutive declines from Q1-23. That said, together with private consumption, investment acted as a counterweight, illustrating the vital role of public investment in connection with the advancing RRP. Nevertheless, GDP growth slowed to 0.3% q-o-q in Q3-23.

Drawing on balance of payment data, (nominal) service exports expanded by 13.5% y-o-y from Q1-Q3 2023, boosted mainly by tourism-related services. Croatia saw tourist arrivals rise by 9% in 2023 as a whole, with a 3% increase in overnight stays (Tourist Board). According to data from the Croatian Bureau of Statistics (CBS), tourist arrivals over the period Jan-Nov-23 came to 97.6% of the respective arrivals in the whole pre-pandemic year 2019. At the same time, it has to be stressed that ICT and business services registered very strong increases over Q1-Q3 2023 (Eurostat data), pointing to an increasing diversification of service exports, and contributing to the underlying resilience of the economy. The structure of goods exports remains dominated by low-to-medium-tech-level goods.

With regard to Q4-23, GDP growth could see some acceleration, supported by robust domestic demand. Sentiment indicators for the industry and the service sector (European Commission, EC) back this expectation. As to the current year, we expect the economy to grow robustly, as adverse effects from monetary policy tightening start to fade, and inflationary pressure should continue to tail off, both of which would also offer scope for strengthening foreign demand, notwithstanding persistent risks due to the geopolitical situation.

We see private consumption as well-supported by the ongoing tight labor market, strong nominal wage growth and fiscal support, with the latter likely to become weaker in the course of the year, as energy support is to be cut back. In Sep-23, the government announced a fifth package of support measures with a volume of roughly EUR 464mn (Fiscal policy council). Pension increases and another substantial rise in the minimum wage from EUR 700 to EUR 840 from Jan-24 (+20.0%) add to positive expectations as regards household expenditure. Croatia's HICP inflation rate decreased from an average 10.7% in 2022 to 8.5% in 2023, with the rate dropping to 5.4% by Dec-23, while core inflation remained higher, at 6.1% in Dec-23.

Looking at recent labor market developments, Croatia's unemployment rate remains close to that of the euro area (EA). Having recorded an average of 7.0% in 2022 (EA: 6.8%, Eurostat), in Q3-23 the rate stood at 6.4%, slightly below the euro area level. Employment growth in 2022 was similar to that of the EA (+2.3%) and continued in 2023, albeit at a somewhat slower pace. At 69.3% as of Q3-23, notwithstanding a positive trend, labor participation displays ample room to catch up with the EA level (Q3-23: 75.1%), but the gap has narrowed. Compared to the CEE peers, Croatia's participation rate also counts among the lower ones. Progress can also be observed regarding the labor market integration of the elderly (age group 55-64y), which still compares as relatively low. Apart from that, some structural deficiencies remain visible when it comes to the EC's social scoreboard, including with regard to the share of young people neither in employment nor training (NEET), and the impact of social transfers excluding pensions on reducing poverty.

The share of companies reporting shortages of labor as a factor limiting production compares as relatively high in the European context (EC, Q4-23 survey), with regard to both the service sector and industry, and has tended to rise over 2023, adding to wage pressure. Average monthly gross earnings rose by 12.0% from Jan-Dec-23 (CBS), driven by both public and private sector wage increases. Sharp increases in public sector wages are also linked to a wage reform for civil and public servants included in the RRP, with new legislation entering into force from 2024.

While private investment has been hampered by tighter financing conditions, as also underscored by the latest ECB Bank Lending Survey relating to Q4-23, which hinted at lower demand for loans on the part of NFCs, as well as stricter lending conditions, gross fixed capital formation remains backed by public investment. The substantial EU funds accessible via the RRF, but also funds linked to the Multiannual Financial Framework (MFF), with the period covering the MFF 2014-2020 ending in 2023 and MFF 2021-2027 coming to the forefront, support a positive outlook.

In this respect, we highlight the progress made by Croatia in fulfilling agreed targets and milestones as positive, which are the prerequisites for unlocking the RRF funds. In Dec-23, Croatia submitted its fourth payment request, asking for EUR 162.5mn. Also in Dec-23, the Council of the EU approved Croatia's modified RRP, now worth EUR 10bn, with EUR 5.8bn in grants and EUR 4.2bn in loans, and including a REPowerEU chapter which places great emphasis on reducing energy import dependency and diversifying the energy mix towards greater use of renewables. Overall, 39% of the modified plan is allocated to climate objectives, while 20% is directed towards driving the digital transition.

Having achieved a third disbursement of RRF grants in Nov-23, Croatia moves in the group of frontrunners among the EU members. Including disbursements of pre-financing, with the latest obtained in Jan-24 in the context of REPowerEU, approx. EUR 2.97bn in grants and EUR 529.9mn in loans have been paid out so far. We gather that the government plans to stick with two submittals for disbursement per year for the time being.

Export prospects may be about to brighten amid downward-trending inflation rates and prospective easing of monetary policy later in the year, while persistent geopolitical tensions highlight remaining downside risks. As mentioned above, export diversification seems to be progressing, possibly in part a reflection of nearshoring efforts by businesses located in its main trade partners.

Overall, we expect Croatia's real GDP to expand by about 2.7% in 2024 and by 2.5% in 2025, following likely growth to the tune of 2.5% in 2023. The latter would be significantly higher than we anticipated in our last rating review (Feb-23), underscoring underlying resilience. The significant advancements in rolling out the RRP maintain a constructive medium-term growth outlook, with continued timely absorption and effective execution remaining key factors for this to materialize.

Prospects for potential growth remain positive as there are tentative signals that structural reforms and measures to augment productivity are starting to show some effect. While estimates by the EC suggest that the rate might moderate somewhat over 2024 and 2025, to 3.5% and 3.1%, respectively, from an estimated 3.9% in 2023 (AMECO data), Croatia would remain well ahead of its CEE peers in this regard and well above the average annual potential growth in the period 2015-2019 (1.7%). As a side note, we are aware of the suggestion expressed by the Central Bank of Croatia (HNB, Dec-23) that employment of foreigners is possibly underestimated, and a correction might tend to increase potential growth in the period from 2018-2024.

More generally, unfavorable demographics (see below) could constrain potential growth in the longer term, thus highlighting pressure to address labor/skill shortages and step up productivity levels. In this context, we flag pronounced increases of both nominal and real labor productivity per hour worked in 2022 - albeit from a low level - as positive, and as possible pointers for reform measures starting to pay off. To some degree, pandemic-related distortions may also still be at play here.

From a cost perspective, it appears that Croatia managed to slightly improve its competitiveness, judging by a stronger decline in unit labor costs than most of its main European trading partners in 2022. While real compensation per employee saw a stronger y-o-y increase compared to the trading partners in 2022, a significant leap in real labor productivity per person seems to have overcompensated for this. Adding to the positive reading in terms of cost competitiveness, Croatia's share in the global export market rose in 2022 (0.14%), exceeding its pre-pandemic level (2019: 0,12%). Service exports were the main driving force behind this, reaching a multi-year high at 0.30%, while the share of goods exports also moved up. Further out, Croatia's cost competitiveness may have to be monitored with a view to wage and productivity developments.

With regard to aspects pertaining to Croatia's non-cost competitiveness, there remains significant room to improve. In the 2023 edition of the IMD's World Competitiveness Yearbook, Croatia slipped to rank 50 out of 64 countries considered in the assessment (2022: 46), representing one of the weakest rankings among the EU members. Similarly, rank 44 out of 132 as regards the UN's Global Innovation Index, likewise one of the lowest ranks among the EU countries, highlights ample scope to catch up. Comparatively low R&D intensity serves as part of the explanation for current poor scorings, as does a fragmented R&D system. That said, the innovation gap to the EU is decreasing, as the EC highlights in its recent innovation scoreboard.

To be sure, actions to tackle issues hampering the business environment are underway, and include measures to digitalize public services for businesses, improve access to finance, and cut red tape. In addition, steps have been taken to make insolvency proceedings more efficient. The simplification of regulatory requirements for the provision of services by regulated professions also counts among key deliverables in the RRP for 2023-2024.

Tying in with the above, the EC's recent Digital Decade report (2023) testifies to headway made with regard to the digital transition on the level of government and public administration. Furthermore, in a bid to address skill shortages, especially in the ICT sector, Croatia is pursuing a multi-pronged approach to incentivize forming and attracting respective talent, including the enhancement of curricula and offering scholarships. At the same time, the SME sector has room to catch up when it comes to a basic level of digital intensity. As mentioned by the abovementioned report, Croatia trails the EU average in this respect (58% vs. EU 69%).

Against the backdrop of unfavorable demographic prospects, the pressure to raise productivity in order to strengthen potential growth remains pronounced. At 35.6%, Croatia's old age dependency ratio counts among the highest in the EU. We note that net immigration turned sharply positive in 2022 (+11,685 persons), for the first time in more than a decade. While this was chiefly driven by displaced persons from Ukraine, we will continue to monitor developments, as the net migration trend has been less negative in the preceding years.

Institutional Structure

The institutional set-up benefits significantly from Croatia's EU/EMU membership, which, among other things, entails access to the single market, to substantial EU funding, as well as to broad and deep capital markets including cost advantages linked to using the reserve currency euro. As suggested by the latest set of worldwide governance indicators (WGIs), there remains ample room to further enhance the institutional quality. This is also illustrated by the Financial Action Task Force's (FATF) decision in June 2023 to include Croatia on its list of jurisdictions under increased, vigilant monitoring, underpinning scope to improve on AML/CFT issues. We understand that Croatian authorities remain committed to addressing these. Since an effective public administration constitutes a vital catalyst for a successful execution of the RRP, we will also continue to monitor respective progress. We expect political commitment to a continued timely roll-out of the RRP to remain high following the upcoming parliamentary election, notwithstanding some potential slowdown during this phase.

In connection with the RRP, Croatia has unleashed a number of measures aimed at increasing the efficiency of its public services and, more generally, the effectiveness of the public administration, which should prospectively strengthen the overall governance framework. Measures include, e.g., the establishment of a digital registry of the population, families and households, benefiting the work of public bodies, including tax administration. The use of an IT platform for electronic public procurement is mandatory for all purchasers from 1 Jan 2024. Apart from initiatives aimed at fostering a smooth execution of the RRP in terms of governance, public infrastructure is to be improved by a multi-annual water and wastewater construction program and an energy efficiency program prioritizing investments. The railway sector is also to be overhauled, and the expansion of 5G and broadband is to be driven forward. Steps for reforms to improve the quality and accessibility of the health system are also under way.

Focusing on the four WGI pillars which we consider particularly relevant when assessing the institutional quality of a sovereign, we find that Croatia largely continues to trail CEE peers, apart from displaying a wider gap toward respective euro area median ranks in the respective categories, notwithstanding a positive tendency across all four categories in the reference year 2022. More specifically, Croatia ranks 86th (out of 213) in terms of 'control of corruption', compared to a CEE median rank of 68, and 83rd in terms of 'rule of law' (CEE median: 64). When it comes to 'voice and accountability', Croatia's relative rank of 71 (out of 208) is also well below the CEE median rank of 52. Regarding 'government effectiveness', it is notably more in line with the CEE group of the EU (rank 64).

Picking up on recent developments pertaining to rule of law, we flag the EC's Jul-23 Rule of Law report highlighting progress on improving the justice system as positive. At the same time, there remain challenges, among others the relatively long duration of proceedings in first instance courts, which count among the longest in the EU, and a high level of backlogs. According to the 2023 EU Justice Scoreboard, proceedings in first instance courts increased in the reference year 2022 for the majority of case classes.

Steps are underway to enhance the effectiveness of the anti-corruption system. In Jan-24, Croatia became a party to the OECD convention on combating bribery of foreign public officials in international business transactions. The OECD's recent evaluation report on the first phase of implementation of the convention (Dec-23) recognizes that Croatia's legislation largely conforms to the standards of the Convention, while also mentioning some issues to be followed up on in phase 2, among others concerning money laundering offences.

We think that Croatia's relatively stable political context and coherent policy formulation over recent years have been conducive to the process of joining the EMU. We expect ongoing high commitment to following through on the RRP after the parliamentary election, which is to be held by 22 Sep-24. Following the constitutional court's repeal of the previous electoral law in Feb-23, parliament passed a new electoral law which included a reorganization of electoral districts, and which came into effect in Nov-23. Current polls see the conservative Croatian Democratic Union (HDZ), senior party in the present government coalition, in the lead (ca. 33% of the vote), although unlikely to obtain an outright majority of at least 76 seats in the 150-seat Sabor. The main opposition party, the Social Democratic Party (SDP), would come second, with a share of the voting intentions of around 17%. Croatia also elects its president in 2024.

In terms of policies to foster the green transition, the REPowerEU chapter of Croatia's modified RRP strengthens the goal to decarbonize the economy and reduce its reliance on fossil fuels, involving, among other measures, the promotion of energy efficiency in buildings and the increase of the production and uptake of renewables like biomethane and geothermal energy. Tying in with this, the Croatian hydrogen strategy for 2050 is to take shape going forward. Moreover, in Jul-23, parliament adopted the new waste management plan for the period 2023-2028.

Croatia's overall share of renewable energy sources stood at 29.4% in 2022, remaining above the EU level (2022: 23.0%, Eurostat), with the share of renewables in gross electricity consumption representing one of the highest in the EU. That said, there is considerable potential for the transport sector to catch up in terms of using renewable energy sources. Part of the RRP funds are thus intended to finance a greener fleet, as set out in the Draft Budgetary Plan 2024 (DBP24). Similarly, Croatia moves in the lower third among the EU members when it comes to eco innovation performance, judging by the respective index compiled by the EC. As far as vulnerability to climate risks is concerned, Croatia is regarded as an EU member with a relatively high exposure (EC intelligence).

Fiscal Sustainability

Fiscal sustainability risks remain contained in our view. Croatia's debt-to-GDP remains well below the euro area level and, although elevated compared to CEE peers, it was the only country among the CEE group in the EU whose public debt ratio fell below its pre-pandemic level already in 2022. We expect the debt ratio to continue to decline, on the back of still strong nominal GDP growth, while the general government balance is likely to post deficits this year and next, having repeatedly outperformed fiscal targets. Spending dynamics may have to be monitored going forward. We regard a track record of prudent fiscal policy-making as a factor mitigating fiscal risks, alongside sound debt management and the positive implications for funding conditions linked to the adoption of the euro. Despite slight improvements, the estimated share of the informal economy is high by European comparison. While we will continue to pay attention to contingent liabilities associated with state-owned enterprises (SOEs) and healthcare arrears, although risks related to these appear manageable. The banking sector *gives a solid impression, although risks associated with house price developments and mortgage lending continue to require attention.*

Amid strong GDP growth boosted by the ongoing recovery in the tourism sector, Croatia's general government balance became slightly positive in 2022 (+0.1% of GDP), following two years of exhibiting a deficit in the main pandemic phase. Against the backdrop of vividly rising tax revenue and net social contributions, general government revenue grew by 13.8% y-o-y in 2022. The increase in total government outlays was less pronounced by comparison (7.7% y-o-y), driven by further rising public wages and support measures to cushion high energy prices, while pandemic support faded. Contrary to the preceding years, interest rate payments rose in 2022.

Public finance developments in 2023 continued to be dominated on the revenue side by relatively robust economic development and labor market resilience, spurring tax revenue and social contributions. Drawing on quarterly data (Eurostat), total government revenue mounted by 19.1% in Q1-Q3-23 compared to the same period in 2022. As regards total government outlays, which rose by 19.2% y-o-y in the first three quarters of 2023, higher pension spending on the back of indexation mechanisms and a higher minimum pension was among the major drivers, as were higher public wages as a consequence of a reform to the remuneration of civil and public servants. Moreover, in March and September of 2023, the government announced a fourth and fifth fiscal support package, together coming to EUR 2.164bn (approx. 2.8% of our estimated GDP in 2023), to mitigate adverse effects from high energy prices and high inflation rates.

With regard to the current year, the government intends to focus on mitigating effects from high inflation on the population, continuing reconstruction after the earthquakes, and high levels of investment. An extension of a temporarily lower VAT rate, and parts of the tax reforms which entered into force in Jan-24, may tame revenue growth. While tax relief for low-income earners is set to negatively impact general government receipts, higher taxation of property and related income should partially make up for this. On the expenditure side, further increasing social spending, mainly pension costs, and upward pressure on public wages will continue to make themselves felt. Generally, spending inclinations may be somewhat strengthened by the upcoming parliamentary election. As regards gross fixed capital formation, the government envisages the investment-to-GDP ratio to be at 4.5% GDP this year.

Following its small positive result in 2022, we expect the headline balance to post a small surplus again in 2023 (0.3% of GDP), which would be a markedly better outturn than we had anticipated in our last review (Feb-23). For 2024, we expect the balance to turn into a deficit (-1.5% of GDP), on the back of the above described spending priorities. Whilst there remain downside risks from persisting geopolitical tensions and incentives for higher spending in view of the upcoming election in the short term, we think that the track record of prudent fiscal planning and greater emphasis on medium-term-oriented fiscal governance frameworks linked to EMU membership, which could assist in maintaining fiscal discipline, would offer reasons for a constructive view on fiscal prospects. That said, we recall that the Fiscal Policy Council (FPC, Nov-23) has argued in favor of restraining public expenditure going forward.

On the back of still strong nominal GDP and a more favorable headline balance, Croatia's debt-to-GDP ratio fell further in 2022, by almost 10 p.p., to 68.2% of GDP. With that, contrary to its CEE peers in the EU, its debt ratio dropped below the pre-pandemic level (2019: 70.9% of GDP), remaining well below the respective ratio of the euro area overall (2022: 90.9% of GDP). As of Q3-23, general government debt stood at 64.4% of GDP. We expect debt-to-GDP to conclude the year 2023 at slightly under 60% of GDP, and to shrink to 56.2% of GDP in 2024 and 53.5% in 2025, thus moving further below the Maastricht threshold.

Contingent liabilities in the form of state guarantees have gone up to 2.7% of GDP in 2022 (2021: 1.8% of GDP, DBP24), still comparing as relatively low. We understand that there are restructuring and privatization efforts regarding the state-owned enterprises, which could prospectively reduce some fiscal risks related to potential liabilities regarding this sector.

We assess fiscal risks associated with the banking sector, which plays the dominant role in the financial sector, as limited, as the sector is equipped with sizeable risk buffers. With regard to Croatia's greylisting by the FATF (see above), we will pay close attention to further developments, but currently do not expect that banks will experience material disadvantages from this.

Judging by relevant metrics, the banking sector remains well capitalized, with the CET1 ratio one of the highest in the EU as of Q3-23 (22.1%, EU: 15.9%, EBA data). The NPL ratio has continued to decline, matching the EU level in Q3-23 with a relatively low 1.8%. The somewhat broader NPE ratio was at 1.5% (EU: 1.6%, EBA data), adding to the impression of improving asset quality. Moreover, the sector's profitability continues to compare as favorable in the EU context. Having said that, the share of stage 2 loans in Croatia's banking sector in Q3-23 was higher than in Q3-22, but down compared to the preceding quarter. At 14.1%, it also exceeded the respective average share in the EU (Q3-23: 9.2), which we will continue to monitor.

In the face of still strong house price increases, presumably also boosted by foreign buyers and the housing loan subsidy program, and in light of vivid mortgage lending despite the higher interest rate environment, we will also pay close attention to respective developments, stressing that macroprudential levers have recently been strengthened. According to Eurostat data, the annual house price increase is slowing, but was still in double-digit territory in Q3-23 (10.9%). Outstanding volumes of mortgage loans to private households were up by 10.0% y-o-y in Nov-23. What is more, loans for consumption purposes have seen an accelerated increase (Nov-23: 7.8% y-o-y).

Against the backdrop of these dynamics and elevated cyclical vulnerabilities, HNB decided to raise the countercyclical capital buffer rate further to 1.5% with effect from Jun-24, from currently 1.0% (Jan-24). The expiry of the housing loan subsidy program should add to taming house prices going forward, likely flanked by tightening credit standards for loans to households, as suggested by the latest ECB Bank Lending Survey (Jan-24). According to the latter, household mortgage demand is decreasing.

As the ECB's monetary policy cycle is likely about to turn in the middle of the year, the yield on 10-year Croatian government bonds has trended down lately, standing at 3.33% as of 26-Jan-24 (weekly data), down from a high of 4.11% in mid-November 2023. The Bund spread has decreased over recent months, to 103 bp as of 26-Jan-24. The ECB has kept its key policy rates unchanged starting from its Oct-23 monetary policy meeting, and we think that a first rate cut around the middle of 2024 is becoming a likely scenario, also given some expected inflation volatility over the next few months. While Croatia was not included in the ECB's asset purchase program or the PEPP, the ECB's Transmission Protection Instrument (TPI) would be available in case of any perceived unwarranted market disturbances.

Apart from advantages related to the adoption of the euro, including lower borrowing costs, fiscal risks are mitigated by sound debt management. In a bid to refinance maturing existing bonds, Croatia among others issued an inaugural 2-year bond aimed primarily at retail investors in Mar-23, raising an overall EUR 1.85bn with a coupon of 3.65% p.a. (Ministry of Finance), which can be seen as further diversifying its investor base.

Foreign Exposure

We continue to consider external risks as manageable, notwithstanding vulnerabilities associated with Croatia's status as a small, open economy and susceptibility to international trade dynamics. Recovering from successive global crises impacting tourism and the energy balance, Croatia's current account is on a recovery track and should prospectively add to positive effects on its net international investment position from EU fund absorption. With possibly increased attractiveness to foreign investors due to the adoption of the euro, we expect foreign direct investment to continue to be drawn into the country.

Having become negative once more in 2022 (-2.8% of GDP) amid the soaring energy prices and the deteriorating energy trade balance, Croatia's current account balance may have concluded 2023 with a small surplus. As of Q3-23, measured by the four-quarter sum, the current account deficit has shrunk to -0.1% of GDP, mainly on the back of a decreasing goods deficit. At -24.1% of GDP (Q3-23), the latter remains pronounced, but is also partly offset by the considerable surplus in the service balance, which, at 20.7% of GDP, moves at a higher level than prior to the pandemic.

Given expectations of some growth pickup in the course of 2024, and in the absence of another shock to the energy prices, we anticipate a moderate current account surplus for the current year, which could increase somewhat in 2025, when positive effects of expected monetary policy easing starting in the course of 2024 should strengthen impulses from foreign demand. Having said that, we would expect domestic demand in Croatia to become structurally stronger in the medium-to-longer term as a result of the expected RRP implementation and the ongoing income convergence process, likely putting constraints on the scope of positive current account balance positions.

Croatia's NIIP, meanwhile, has become less negative over recent years. As of Q3-23, the position has improved to -21.3% of GDP (Q3-22: -24.2% of GDP). The positive NIIP excluding non-defaultable instruments climbed further to 18.7% of GDP as of Q3-23, pointing to strengthening underlying developments. Going forward, we expect the overall NIIP to maintain its improving tendency.

Rating Outlook and Sensitivity

Our rating outlook on the Republic of Croatia is positive, as we expect risks related to the macroeconomic performance to decrease and the fiscal position to strengthen further over the next 12-24 months, flanked by anticipated improvements to the institutional framework.

We could raise Croatia's credit ratings if economic growth continues to outstrip expectations, possibly on the back of fast progress regarding the RRP implementation, resulting in a markedly accelerated convergence process towards EU-level income. A faster-than-expected further decline in the public debt ratio would also be conducive to a positive rating action. On the institutional side, a timely removal from the FATF grey list linked to marked progress when it comes to the AML/CFT framework would seem beneficial.

A negative rating action could be triggered by severe delays of or backtracking on progress in terms of RRP implementation, resulting in economic convergence coming to a halt or even reversing slightly. Such a scenario could also increase the significance of unfavorable demographic trends. A prolonged deterioration of fiscal metrics could also have us consider lowering the sovereign's credit rating or the outlook.

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Ratings*

Long-term sovereign rating	BBB+ /positive
Foreign currency senior unsecured long-term debt	BBB+ /positive
Local currency senior unsecured long-term debt	BBB+ /positive

*) Unsolicited

ESG Factors

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down [key principles of the impact of ESG factors on credit ratings.]

ESG Factor Box

Environ-mental Quality	Ecological Risks	Ressource Management	Education	Health	**Demo-graphics**
Labor	Equality	Technology & Infrastructure	Saftey & Security	**Judicial system**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liber-ties/ Political Participation**	Market Access	**Business Environ-ment**	Data Transparency

Environment
Social
Governance
Highly significant
Significant
Less significant
Hardly significant

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

Since indicators relating to the assessment of an economy's competitive stance by e.g. the World Bank, the World Economic Forum, the European Commission, and IMD Business School and the World Intellectual Property Organization (UN) add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Indicators or projections providing insight into likely demographic developments and related cost represent a social component affecting our rating or adjustments thereof. We regard the ESG factor 'Demographics' as significant since it has a bearing on the economy's potential growth.

While Covid-19 may exert adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing on public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2018	2019	2020	2021	2022	2023e	2024e
Macroeconomic Performance							
Real GDP growth	2.8	3.4	-8.6	13.8	6.3	2.5	2.7
GDP per capita (PPP, USD)	28,875	30,570	28,446	35,078	40,128	42,873	45,087
Credit to the private sector/GDP	54.3	52.7	60.2	53.5	50.7	n/a	n/a
Unemployment rate	8.5	6.6	7.5	7.6	7.0	n/a	n/a
Real unit labor costs (index 2015=100)	96.9	95.1	103.3	96.3	94.3	94.8	94.6
World Competitiveness Ranking (rank)	61	60	60	59	46	50	n/a
Life expectancy at birth (years)	78.2	78.6	77.8	76.7	77.7	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	0.3	0.3	0.2	0.3	0.4	n/a	n/a
WGI Control of Corruption (score)	0.0	0.1	0.2	0.0	0.1	n/a	n/a
WGI Voice and Accountability (score)	0.4	0.5	0.6	0.6	0.6	n/a	n/a
WGI Government Effectiveness (score)	0.5	0.5	0.4	0.6	0.6	n/a	n/a
HICP inflation rate, y-o-y change	1.6	0.8	0.0	2.7	10.7	8.4	2.8
GHG emissions (tons of CO2 equivalent p.c.)	6.2	6.2	5.9	6.3	n/a	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	-0.1	0.2	-7.3	-2.5	0.1	0.3	-1.5
General government gross debt/GDP	73.1	70.9	86.8	78.1	68.2	59.7	56.2
Interest/revenue	5.1	4.7	4.3	3.3	3.0	n/a	n/a
Debt/revenue	161.5	152.8	185.7	169.6	151.4	n/a	n/a
Total residual maturity of debt securities (years)	4.4	4.7	5.4	5.5	5.5	5.3	n/a
Foreign exposure							
Current account balance/GDP	1.6	2.5	-1.0	1.0	-2.8	n/a	n/a
International reserves/imports	70.9	73.8	86.7	82.0	66.9	n/a	n/a
NIIP/GDP	-55.7	-46.7	-45.2	-32.5	-25.4	n/a	n/a
External debt/GDP	82.2	73.9	81.7	80.9	73.3	n/a	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Croatian Bureau of Statistics, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	10.02.2023	BBB /stable
Monitoring	09.02.2024	BBB+ /positive

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	NO
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models, and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, World Intellectual Property Organization (WIPO), IMD Business School, Republic of Croatia Ministry of Finance, Croatian National Bank, Croatian Financial Services Supervisory Agency (HANFA), Croatian Bureau of Statistics, Fiscal Policy Commission.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision."

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website.

No ancillary services in the regulatory sense were carried out for this rating object. Creditreform Rating AG ensures that the provision of ancillary services does not present conflicts of interest with its credit rating activities and discloses ancillary services provided for the rated entity or any related third party, if any, in its rating reports. For the complete list of provided rating and credit service ancillaries please refer to https://www.creditreform-rating.de/en/about-us/regulatory-requirements.html#non-core-busi-ness-activities.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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