Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information		
REPUBLIC OF CROATIA	Assigned Ratings/Outlook: **BBB /stable**	Type: Initial rating, 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 - “Sovereign Ratings” “Rating Criteria and Definitions”	

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Rating Action

Neuss, 10 February 2023

Creditreform Rating has published the unsolicited long-term sovereign rating of “BBB” for the Republic of Croatia. Creditreform Rating has also published Croatia’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “BBB”. The outlook is stable.

Key Rating Drivers

1. Robust GDP growth performance and strongly declining unemployment since EU accession, while income convergence towards EU levels has progressed rather gradually; stronger-than-expected recovery following the pandemic points to increased economic resilience, with a comparatively moderate level of private indebtedness offering some shock-absorbing capacity; high commodity prices and a weaker external environment are likely to weigh on economic growth in the near-term, whereas direct trade exposure to Russia is relatively low
2. We expect medium-term prospects to be supported by recovering tourism, sizable EU financing, and structural reforms set out in the national Recovery and Resilience Plan (RRP), with tangible progress hinting at fund absorption becoming more effective; continued following through on the RRP should be instrumental to lifting potential growth, as structural weaknesses related to Croatia’s business environment, unfavorable demographics, and slow productivity growth present challenges to its growth outlook
3. Despite substantial headway being made over the course of its EU and EMU accession, the sovereign’s institutional framework leaves ample room to improve as compared to EU peers; considerable advantages associated with EMU/EU membership, not least due the adoption of common standards and codes; continued access to EU funding and prospective, RRP-related, advancements in terms of enhancing the public administration and the justice system should be conducive to further strengthening institutional quality
4. Limited risks to fiscal sustainability, supported by a prudent fiscal track record over recent years, sound debt management, as well as positive implications for the sovereign debt profile and financing conditions due to the adoption of the reserve currency euro; public debt ratio expected to shrink over the medium term; while the banking sector appears relatively resilient, developments around recently dynamic lending to the private sector and vigorous house price increases should be monitored

5. External vulnerabilities have decreased over the last decade as indicated by a strengthening, albeit negative net international investment position, with expected considerable inflow of EU funding contributing to a strengthening position alongside a relatively high level of international reserves as well as an improving current account, which is likely to remain in deficit in the short term, dragged down by the energy balance

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

The sovereign's favorable macroeconomic profile is underpinned by a phase of strong and above-EU level growth, as well as significantly improved labor market conditions prior to Covid-19, whilst displaying some catching-up potential regarding its upward trending per capita income and concurrent income convergence towards EU levels. The strong growth rebound following the acute pandemic phase, bolstered by recovering tourism, illustrates increasing resilience. A good degree of economic diversification somewhat mitigates sensitivity to disruption in global supply chains. While direct trade exposure to Russia, including energy imports, is relatively low, downward pressure on economic performance mainly stems from high commodity prices and the weaker external backdrop. If absorbed in a timely manner and implemented effectively, extensive EU funding, in particular NextGenerationEU (NGEU), should be key to lifting Croatia's potential growth. RRP measures are set to tackle longer-standing weaknesses inter alia pertaining to comparatively low productivity growth, shortcomings in its business environment as well as unfavorable demographic developments, which weigh on the medium-to-longer-term growth outlook.

After its 2013 accession to the EU and following the end of a prolonged recessionary phase in the years after the global financial crisis, Croatia's small, open economy posted an expansion rate well above the EU level over the years 2015-2019, averaging 3.1% (EU: 2.2%). To be sure, this compares as somewhat moderate against Central and Eastern European (CEE) peers over this period, also illustrating some catching-up potential of the sovereign, which joined the EU at a later stage than these.

Given tourism's significance for the Croatian economy, the pandemic caused a more pronounced slump in Croatia's real GDP than in the EU as a whole in 2020, when the country additionally suffered two devastating earthquakes, with total output plummeting by 8.6% (EU: -5.7%). According to OECD estimates, the direct contribution of tourism to GDP amounts to approx. 11.8% (2019), while accounting for about 6.8% of total employment. At the same time, Croatia's somewhat lower exposure to the industrial sector in terms of GVA share when compared to the euro area (EA) as a whole and some of its CEE peers has also helped to limit negative effects from global supply bottlenecks.

The Croatian economy rebounded strongly in 2021, with real GDP expanding by 13.1%. Measured against the pre-pandemic level in Q4-19, quarterly real GDP had already exceeded its pre-pandemic level from Q1-21. The strongest growth contribution was made by net exports amid resuming tourism in 2021 (6.6 p.p.), followed by the rebound in private consumption (5.9 p.p.).

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[1] This rating update takes into account information available until 03 February 2023.

In order to help stabilize the economy and employment during the Covid-19 crisis, the government provided financial support to the tune of roughly 3.3% of GDP in 2020 and 2.1% of GDP in 2021 (European Commission, EC, intelligence).

The pandemic thus temporarily interrupted the trend of gradual convergence towards the EU level in terms of GDP per capita since Croatia's EU accession. From an estimated 67% of the EU level in 2021, Croatian GDP per head is estimated to have climbed to 70% in 2022, resuming its upward trajectory. That said, at an estimated USD 37,550 in 2022 (PPP terms, IMF), Croatia exhibits the third-lowest per-capita income in the EU.

Against the backdrop of Russia's military aggression against Ukraine and the associated surge in energy and food prices, the near-term outlook for the economy has clouded. Whilst Croatia's direct trade exposure to Russia - including for energy imports and considering its energy mix - is relatively low, soaring commodity and consumer prices place a heavy burden on private households and businesses, prompting the government to step in to cap electricity prices and provide further financial assistance to the private sector. Monthly HICP inflation rates have been in double-digit territory from May-22, averaging 10.7% over last year and standing at 12.5% in Jan-23, with core inflation recording equally high and rising rates (Jan-23: 11.3%).

Following eight consecutive quarters of expansion, real GDP declined in Q3-22 (-0.4%), as quarterly exports fell in Q3-22 after a series of strong increases, and together with a marked rise in imports caused net trade to drag on total output. That said, both private consumption and investment still increased, and sentiment indicators overall did not suggest a major slowdown of economic activity at the end of last year. To be sure, expected positive effects associated with the adoption of the euro on 1 January 2023 may play their part here, possibly acting as a balancing factor in an otherwise worsening economic environment.

With a view to private consumption, Croatia's tight labor market provides some cushioning effect at this stage. Having edged up to an annual average of 7.6% in 2021, the monthly unemployment rate appears to have bottomed out more recently, coming in at 6.5% in Nov-22, matching the rate recorded for the euro area as a whole, while comparing less favorably against CEE peers. Since Croatia's EU accession, the unemployment rate has dropped substantially, more than halving from 17.3% in 2013 to 6.6% in 2019 and falling below the euro area level (2019: 7.6%, Eurostat data) prior to the outbreak of the coronavirus.

Moreover, employment expanded vividly over recent years, briefly interrupted by the pandemic and showing unabated robust growth since Q1-21 (Q3-22: 2.4% y-o-y, EA: 1.7%). Labor participation has gradually trended upwards, but at 69.4% as of Q3-22 maintains a pronounced gap towards the euro area overall (Q3-22: 74.6%, 15-64y, Eurostat) and ranges among the lower readings among CEEs. Looking at the EC's Social Scoreboard, Croatia has marked scope for improvement when it comes to social protection and inclusion, and partly with regard to fair working conditions. That said, the RRP addresses such deficiencies, aiming to enhance/update skillsets of the Croatian labor force, as well as to strengthen active labor market policies.

Prospects for investment have become somewhat more uncertain in light of tightening financing conditions on financial markets amid monetary policy tightening. Drawing on Croatian central bank (HNB) intelligence, the effect is being felt among businesses by now; however, demand for credit among enterprises has continued to go up. Aided by likely knock-on effects from substantial amounts of investment to be financed by the Recovery and Resilience Facility (RRF), and flanked by EU funding related to its Multiannual Financial Framework (MFF), we expect investment to remain an important growth pillar this year and next, alongside recovering private consumption if, as we assume, energy prices continue to moderate.

More generally, incentives for investment are shaped by efforts to improve the comparatively unfavorable business environment (see below), including improvement of insolvency procedures. As of the end of March 2022, changes to the Bankruptcy Act are in force, implementing the EU Directive on preventive restructuring frameworks and on measures to enhance the efficiency of restructuring and insolvency procedures, as well as discharge of debt.

Exports remain subject to downside risks for now, as Croatia's open economy remains rather exposed to a slowdown of the euro area's economic performance, given its relatively high share of intra-EU exports (2021 goods: 70%, services: 68%, Eurostat). That said, some of Croatia's main CEE trade partners are less sensitive to disruptions in global supply chains, and recovering tourism partly offsets any negative effects. Prospectively, Croatia might also benefit from nearshoring processes among businesses of its main trade partners, e.g. in the field of ICT or business services. In addition, due to an envisaged increase in capacity of its recently built LNG terminal, Croatia may become a hub for gas supply in the CEE region.

According to the Croatian Bureau of Statistics (CBS), foreign tourist arrivals came to about 15.1mn in the first eleven months of 2022, corresponding to an increase of 43.8% compared to the same period in 2021, while representing about 88.4% of the respective level in 2019. German tourists accounted for the lion's share of foreign tourists last year (28.7%). In terms of overnight stays, Croatia registered an increase of 30.8% y-o-y in Jan-Nov-22 to roughly 81.8mn stays, falling just short of the respective 2019 level (97.8% of 2019 level). With its Sustainable Tourism Development Strategy, the Croatian government aims to further increase attractiveness of the sector.

While rising service exports, dominated by travel exports, thus registered a year-on-year increase of 37.1% in the first three quarters of 2022, exports of goods, the usual drivers of which are machinery, transport, chemicals and food, posted an exceptionally strong increase over the same period. Thanks to a major boost stemming from increased export of manufactured coke and refined petroleum products (nominal terms), goods exports rose by 42.7%. Nevertheless, the goods trade balance turned significantly more negative up to the third quarter in 2022 (see below) as imports of energy carriers grew even stronger. Overall, we expect net trade to have exerted a drag on GDP growth in 2022. For the current year, we anticipate a negative growth contribution via net trade as well.

Ultimately, we expect Croatia's real GDP to have expanded by about 6.4% in 2022, followed by a significant slowdown to about 0.9% in 2023 due to a likely weak winter half 2022/2023. Amid an assumed further moderation of energy prices in the course of the current year, private consumption could pick up going forward, adding to an overall accelerated pace of economic activity, which could lift GDP growth to about 2.7% in 2024.

The medium-term growth outlook remains constructive in view of RRF-funded reforms and initiatives as set out in the RRP. While it has not yet requested a potential EUR 3.6bn in loans via the RRF, Croatia stands to receive a total of EUR 6.3bn in grants from the facility by 2026, corresponding to the largest allocation among EU member states as measured by 2019 GDP (11.3%). Forty percent of these are allocated to climate objectives, with the largest share going towards reconstruction following the devastating earthquakes, and renovation of buildings to enhance their energy efficiency. Following the pre-financing of EUR 818mn disbursed in September 2021, two payments over EUR 700mn each were disbursed in June and December 2022, respectively. Judging by EC estimates, NGEU could lift the Croatian GDP by about 2.9% by 2026.

A further significant amount of EU funding via the MFF 2021-2027 (EUR 9.26bn) and the Common Agricultural Policy (EUR 3.4bn) for the period 2023-27 additionally backs a constructive growth outlook over the medium term. To be sure, a timely absorption of those funds, as well as effective implementation remain key here (see below). While the absorption rate of European Structural and Investment Funds over the period 2014-2020 suggests room for improvement in this respect, early progress in terms of rolling out RRP measures seem to point to advancements on this front.

Judging by recent developments in real unit labor costs, which by and large compare favorably against the euro area as a whole as well as against main trade partners, Croatia has remained competitive from a cost perspective. This is also reflected by its gradually increasing global export market share (2021: 0.13%, 2013: 0.10%), more pronounced in terms of services (2021: 0.29%). In fact, its share in global service exports reached a new high since Croatia's EU accession in 2013, although the years 2020 and 2021 are likely subject to pandemic-related distortions.

By contrast, non-cost factors such as a relatively weak business environment weigh somewhat on its competitive stance. In this regard, we also pay some attention to developments around payment discipline between businesses, as this may have some negative repercussions on the performance and resilience of SMEs. With regard to the World Bank's Ease of Doing Business ranking (2020), which we still take into account while awaiting the envisaged relaunch later this year, Croatia was among the lower third of the EU members, partly due to underperformance when it comes to starting a business and granting construction permits. Regarding the 2022 edition of the IMD global competitiveness index, Croatia stood at a relatively poor rank 46 out of 63 economies considered, albeit having moved up, also indicating scope to improve. The latter also holds for the digital transformation, as suggested by rank 21 among the 27 EU members in the EC's 2022 Digital Economy and Society Index.

Alongside these challenges, also recalling the abovementioned deficiencies regarding the labor market, lagging efficiency on the part of the public administration appears to have hitherto weighed on Croatia's productivity and ultimately on potential growth. To be sure, considerable regional disparities within the country are at play here, too. Nominal labor productivity per hour worked and per person measured in percentage of the EU level, was at a relatively weak 65.8% and 76.0% in 2021, respectively.

In the same vein, potential growth is estimated to have averaged 1.6% over the period 2015-2019, relatively sluggish when compared to CEE peers. That said, drawing on EC forecasts, the economy's potential growth could have risen to 3.3% in 2022, but is estimated to edge down to 2.8% and 2.6% in 2023 and 2024, respectively.

Accentuating pressure to augment productivity and potential growth, there are downside risks to longer-term growth with a view to relatively unfavorable demographic prospects. Croatia's old-age dependency ratio counts among the higher ones in the EU (2021: 33.3%, Eurostat) and is projected to experience a comparatively strong increase by 2030. Driven by emigration and ageing, Croatia's population has been shrinking for a prolonged period, and is forecast to see the strongest decrease among the EU countries between 2021 and 2031 (Eurostat), with net migration expected to remain outward-bound.

Institutional Structure

Croatia's institutional framework is significantly bolstered by the benefits associated with EU/EMU membership, including access to substantial EU funding, broad and deep capital markets, and the trade opportunities both within the EU and with third parties. Prior to adopting the euro, including two years of participating in the ERM II, Croatian authorities have demonstrated firm commitment to pursuing sound policies, which in our view pays testament to the quality of its institutions. Nevertheless, there is significant room to improve on the institutional conditions, as illustrated by the World Bank's worldwide governance indicators (WGIs). Apart from adopting a reserve currency as a member of the EMU, the sovereign will also be able to benefit from the ECB's highly credible and accountable monetary policy-making. Advancements made in the initial implementation phase of the RRP generally strengthen our confidence in the sovereign's ability to manage a timely and effective implementation. However, we will vigilantly monitor further progress in RRP implementation and the absorption of EU financing, as relative weaknesses in the effectiveness of public administration and policy implementation may undermine the achievement of deliverables and in turn, curtail vital effects of the RRP.

Drawing on the four WGIs we consider particularly relevant for our assessment of the sovereign's institutional set-up, we note that Croatia largely trails its CEE peers with regard to the reference year 2021, with the exception of 'government effectiveness'. Regarding the latter, the sovereign comes in 63rd out of 209 sovereigns, against a median rank of 60 of the CEE countries. However, Croatia is perceived as performing markedly weaker when it comes to 'rule of law' (84 vs. CEE median of 54), 'control of corruption' (86 vs. CEE median of 63) and 'voice and accountability' (74 vs. CEE median of 52). Moreover, we observe that perceptions of 'voice and accountability' have tended to improve over the preceding three years, whereas perceptions of 'rule of law' have tended to deteriorate.

Overall, there remains scope for enhancing the quality and efficiency of the justice system. Indeed, the EC's Rule of Law report (Jul-22) mentions some persisting deficiencies regarding criminal proceedings and points to challenges, including some concerning the appointing process for the president of the Croatian Supreme court. According to the EC's Justice Scoreboard (May-22), the estimated time needed to resolve litigious civil and commercial cases at first instance compares as relatively high. When it comes to the independence of the media, the Rule of Law Report expresses some concern pertaining to abusive lawsuits against journalists.

On the other hand, further progress as regards the institutional quality includes Croatia's new framework on whistleblowers, which entered into force in Apr-22. While a public register of lobbyists remains to be established, the government adopted a code of conduct for government members and certain officials in high-level executive functions (May-22). A draft new legal act regarding lobbying activities was to be finalized by the end of last year. Already in Oct-21, a strategy on the prevention of corruption until 2030 was adopted, and we gather that a plan covering the phase of 2022-2024 was adopted in the summer of 2022.

In this context, we will monitor progress regarding the (full) implementation of GRECO recommendations from December 2021. The report concluded that Croatia had only partly implemented eight out of 17 recommendations considered in the 5th evaluation round, whereas the remaining recommendations were deemed as not implemented, calling for an update on compliance with the recommendations by 30 June 2023. With regard to the combat against money laundering and against the financing of terrorism, we recall that the Dec-21 Moneyval report highlighted remaining issues in terms of AML and CFT, e.g. concerning cooperation on the international level or perquisites thereof, and the legal basis for some competences of the tax authorities.

Reform of the state-owned enterprises (SOEs) is a work in progress, and we will monitor further advancements around this issue. Croatia's RRP envisages the creation of a new legal framework for SOEs, incorporating the OECD recommendations (2021) and a reduction of the number of strategic companies. Moreover, 90 SOEs from the state-owned fund for enterprise restructuring and privatization (CERP) list are to be sold by 2026. We gather that the preparation of a new law on SOEs was in the final stages as of Dec-22, e.g. addressing centralization of the management model of these companies, the establishment of a system of clear and measurable financial and non-financial objectives and their monitoring by ownership bodies, as well as a transparent process for electing members of supervisory boards.

Looking at the domestic political environment, we expect the phase of relative political stability to continue with a respective coherent policy formulation, potentially improving prospects of a timely follow-through on the ambitious reform agenda. The current government coalition is led by prime minister Plenkovic of the conservative Croatian Democratic Union (HDZ), the party which also led the former coalition and which in the July 2020 parliamentary election obtained 66 seats in the 151-seat parliament. HDZ is supported by smaller parties and representatives of the national minorities, with the coalition commanding over a very thin majority (76 seats). Notwithstanding some changes in the composition of the coalition, HDZ has been at the helm of government since 2016.

Authorities remain committed to green goals such as phasing out coal for electricity production by 2033. Judging by the EC's Eco Innovation Index (2022), according to which Croatia moves in the lower third among the EU countries, there is some room to catch up with better-performing economies concerning the green transition. That said, there has been some improvement over the last few years, and the emission of greenhouse gas per capita compares as relatively low against most EU members (2020, Eurostat).

While the uptake of wind and solar power seems partly hampered by red tape, Croatia's overall share of energy from renewable sources was well above the EU level in 2021 (31.3% vs. EU 21.8%, Eurostat), mainly driven by the use of renewables in electricity consumption. Apart from the abovementioned plans for the renovation of buildings with a view to the enhancement of energy efficiency, RRP initiatives under the heading of climate objectives include upgrading railway lines, boosting electric mobility and modernizing infrastructure to better integrate renewable energy.

Fiscal Sustainability

We view fiscal sustainability risks as contained. While Croatia's public debt ratio rose significantly due to the pandemic, it remains well below the euro area level, albeit elevated when set against CEE peers. In the wake of the post-Covid-19 economic recovery, the sovereign's public finances have been improving and we expect the debt-to-GDP ratio to shrink significantly over the medium term, while acknowledging a high level of uncertainty around this in light of possibly higher fiscal spending to alleviate negative effects from soaring energy costs. Croatia's prudent fiscal policy-making and repeated outperformance of fiscal targets in recent years, combined with sound debt management and the positive implications for funding conditions and foreign currency risk from EMU accession represent *key risk-mitigating factors. Still, the estimated share of the shadow economy is relatively high, pointing to scope for improvement as regards structural features of the fiscal system. We see some risks from contingent liabilities relating to SOEs and in connection with some healthcare arrears. While the banking sector appears rather solid at this stage, having seen continuously improving asset quality in terms of non-performing loans, we would monitor potential risks linked to strongly increasing residential property prices and dynamic lending to the private sector against the backdrop of tightening monetary policy.*

Coming from a deficit of 5.5% of GDP at the time of Croatia's EU accession in 2013, authorities pursued a path of fiscal consolidation, aided by robust economic growth and resulting in a small average surplus of 0.2% of GDP p.a. in the three years prior to the pandemic (2017-2019). Hit hard by the pandemic recession, Croatia's headline balance turned into a large deficit to the tune of 7.3% of GDP in 2020, which, however, narrowed substantially amid the strong economic recovery in 2021 to 2.6% of GDP, outperforming the budgetary target for that year (-4.5% of GDP).

In a context of expiring pandemic support, falling interest outlays, and ongoing GDP growth, which boosted tax revenue and social contributions, public finances have improved further in 2022, notwithstanding a new wave of government support to alleviate the negative effects from high energy prices on private households and businesses.

Monthly state budget execution data until November 2022 seem to underscore this, showing that total expenditure fell by 9.4% y-o-y in the first eleven months of 2022 (cash basis), with a massive decrease in Covid-19-related expenditure driving down subsidies, as well as further declining interest payments (-8.8%). Total revenue posted a small increase of 0.4% over the same period, with tax revenue rising by 7.0% and contributions climbing by 3.7%.

The budgetary effect of pandemic-related measures came in at about 1.7% of GDP in 2021, and is estimated to have dropped to about 1.4% of GDP in 2022 and to fall further to 0.4% of GDP in 2023 (EC intelligence). In April and September 2022, the government adopted two fiscal packages in the amount of approx. HRK 4.8bn and HRK 21bn (roughly EUR 637mn and EUR 2.8bn), respectively, aimed at providing support to the private sector in view of inflationary pressure from soaring energy and food prices. Larger fiscal effects of the second package will be felt in 2023.

The packages include tax relief through lowered VAT rates, gas subsidies and additional benefits. Caps on electricity and gas prices for private households are to remain in place until end of March 2023. For 2022, the Ministry of Finance (MoF) estimates a fiscal impact of approx. HRK 5.05bn, roughly 1% of GDP. New discretionary measures for 2022, mentioned in the Draft Budgetary Plan 2023 (DBP23), also included a settlement over EUR 0.24bn to a Hungarian oil and gas company.

In 2023, the budgetary impact from the inflationary support could come to about HRK 4.36bn (~0.8% of our estimated 2023 GDP). Apart from further aid to displaced people from Ukraine, the DBP23 also comes with an increase of the personal income tax exemption for dependent people and an increase in the minimum pension in excess of the regular adjustment.

Overall, we expect the general government balance to deteriorate in 2023 on the back of the expected marked slowdown in GDP growth and the energy support. Acknowledging a high level of uncertainty around the forecasts, not least as further government support may be deemed necessary beyond March 2023, we expect a balanced budget (0.0% of GDP) for 2022 and a headline deficit of about 2.5% for 2023 at this stage, before public finances should start to improve again.

While the medium-term fiscal outlook remains blurred by geopolitical developments and related challenges to energy markets, the assumed gradual acceleration of economic activity beyond 2023 as well as RRF-financing should be supportive to Croatia's fiscal prospects. We note that the Fiscal Policy Commission expressed some concern over future expenditure developments with regard to the healthcare system. Taking a more institutional view, we regard Croatia's fiscal framework as strengthened by the budget act adopted in December 2021, stipulating more details on medium-term fiscal plans and aiming at enhancing forecasting processes.

Looking at Croatia's general government debt-to-GDP, which had been on a declining path since 2015, dropping by 12.2 p.p. to 71.0% of GDP by 2019, the ratio was pushed up to 87.0% of GDP due to the pandemic fallout in 2020. Given the strong recovery and shrinking headline deficit, as well as an upward revision of nominal GDP, public debt fell back to 78.4% of GDP in 2021, plunging further to 70.4% of GDP as of Q3-22 (Eurostat). At this level, it remains well below the euro area level (Q3-22: 92.9% of GDP), but compares as relatively high against most CEE peers. Against the backdrop of our estimates for nominal GDP growth and the general government balance, we expect public debt to dwindle to roughly 67.5% of GDP at the end of 2022. It should shrink further to about 64.7% of GDP in 2023 and continue its downward path in 2024, also due to robust nominal GDP growth.

Contingent liabilities in the form of state guarantees stood at about 1.9% of GDP in 2021, according to the DBP23, comparing as relatively low. That said, state-owned energy company HEP was reportedly granted loan guarantees amounting to about EUR 1bn (approx. 1.5% of our estimated 2022 GDP). Whilst contingent liabilities linked to SOEs may have to be monitored, public guarantees related to Covid-19 come to a maximum of 1.56% of GDP, of which 0.75% of GDP has been taken up (MoF data).

Croatia's banking sector appears relatively sound at this stage, drawing on key metrics of capitalization, asset quality and profitability. A recent stress tests suggests a satisfying level of resilience (HNB intelligence). With an asset-to-GDP ratio of 127.9% of GDP (Q2-22, ECB data), largely dominated by foreign-controlled subsidiaries, the sector's size ranges among the larger ones among CEE peers but compares as relatively moderate from a European angle.

Having come down somewhat from the peaks seen during the acute pandemic phase, Croatian banks' CET1 ratio counts among the highest in the EU, standing at 22.8% as of Q3-22 (EU: 15.0%, EBA data), thus providing a comfortable buffer against risks. The NPL ratio has continued to fall, standing at 2.4% as of Q3-22 (EU: 1.8%), compared to a reading of 4.8% in Q3-19. At this level, it moves within the middle-range among CEE peers, while narrowing the gap to the EU as a whole. Croatian banks remain profitable, moving well above the EU level as measured by return on assets (EBA data) and comparing relatively favorably in the CEE space.

In the context of monetary policy tightening and weakening economic growth, we will pay some attention to developments of debt servicing capacities in view of increasingly dynamic bank lending to the private sector, also bearing in mind a comparatively high level of stage 2 loans versus other EU countries (EBA data). Outstanding bank credit to NFCs has risen significantly over the course of 2022, posting a year-on-year increase of 21.6% in Nov-22 (ECB data), considerably spurred by growth in loans for working capital and loans in the energy sector.

While lending to private households remains somewhat more moderate compared to this, mortgage lending acts a key driver (Nov-22: 9.6% y-o-y). We will monitor the development of lending for house purchase in an environment of strongly rising house prices, although affordability indicators provided by the OECD do not point to any severe misalignments at this stage, and prices were partly fueled by the government's housing loan subsidy program more recently. Drawing on Eurostat data, house prices have continued to accelerate, with the y-o-y rate in double-digit territory (Q3-22: 14.8%) and the three-year rate of change at 33.8% as of Q3-22. In light of these lending dynamics and the current economic backdrop, HNB has adjusted macroprudential buffers, lifting the countercyclical capital buffer to 0.50% as of 31 March 2023 and to 1.00% as of 31 December 2023.

We view the introduction of the euro as having significantly strengthened Croatia's credit profile and as a mitigating factor to debt sustainability risks, notwithstanding the loss of monetary autonomy. Apart from lower regulatory costs for the banking sector, lower exposure to foreign exchange risks, lower borrowing costs, and lower transaction costs associated with adoption of the euro reserve currency, we would highlight Croatia's sound debt management as a further factor mitigating fiscal risks. The average debt maturity of the debt portfolio has lengthened over the last few years.

To be sure, prospects for monetary policy, and thus financial market conditions, remain skewed towards further tightening, notwithstanding the most recent increase by 50bp of the ECB's policy rates (02 Feb 2023). At this stage, we expect the ECB to hike by another 100bp overall in 2023, acknowledging that the central bank's decisions are highly data-dependent. The yield on 10-year Croatian government bonds climbed significantly in 2022, given the more restrictive course of relevant central banks. As of 20 Jan 2023, it stood at 3.65%, up by 3.02 p.p. versus year-end 2021 and marking the highest level since August 2016 (weekly data), whereas the spread versus 10-year German Bunds only increased by 67bp, standing at 1.47%.

While Croatia was not included in the ECB's asset purchase program or the PEPP due to the timing of its adopting the euro, at least the ECB's Transmission Protection Instrument (TPI) will be available immediately in case of any perceived unwarranted market disturbances, as would any renewed asset purchase program or emergency program in the future. More generally, adoption of the euro currency will otherwise include all monetary policy facilities, and in the near term, it will help to mitigate deteriorating financial market conditions, as adjustments to reserve requirements should free cash reserves in the banking sector in a significant way, as also pointed out by HNB.

Foreign Exposure

External risks appear manageable and are decreasing, also amid reduced foreign currency risks after adopting the euro. While generally subject to vulnerabilities associated with the status of a small, open economy, Croatia's pronounced negative net international investment position (NIIP) has significantly improved over recent years, benefiting from the absorption of EU funds, sustained current account surpluses up to the pandemic, as well as high and rising international reserves. While further absorption of EU funds should remain a positive factor for the development of the NIIP, the war in Ukraine and associated price increases for energy have led to a deteriorating balance in goods trade, dragging the current account position into deficit, although partly offset by the improving services balance amid recovering tourism. We expect this situation to persist more or less in the near term before further assumed energy price moderation could give way to a strengthening current account position.

Croatia's comparatively solid current account surplus, averaging 2.6% of GDP over 2015-2019, turned into a deficit in 2020 due to the pandemic and collapsing tourism. The current account shifted back into positive territory in 2021 (3.0% of GDP) as tourism started to recover, but has more recently deteriorated markedly again, driven by the widening deficit in goods trade on the back of a worsening energy balance amid soaring energy prices and adjustments to energy trade flows away from Russia. Measured as a four-quarter moving sum, the current account amounted to -0.2% of GDP as of Q3-22. We expect the position to post a deficit for 2022 as a whole, as well as for 2023, with an assumed moderation in energy prices giving space for more notable improvement in the following year.

Meanwhile, Croatia's negative NIIP has further improved. Standing at -89.8% of GDP in the year of its EU accession (2013), the NIIP rose to -34.5% of GDP in 2021 and has further improved to -25.9% of GDP as of Q3-22. Excluding non-defaultable instruments, the position (NENDI) posted at 16.0% of GDP as of Q3-22, corroborating the impression of a strengthening underlying development. International reserves held by HNB have increased significantly, standing at about EUR 25.0bn at the end of 2021, or roughly 44% of GDP. Apart from EU fund absorption and the build-up of reserves, we also highlight a higher level of net direct investment over recent years, with Croatia's euro adoption possibly encouraging further net inflow to some extent. Whether this would also include the tradable goods sector more broadly would have to be monitored.

Rating Outlook and Sensitivity

Our rating outlook on the Republic of Croatia is stable. We consider current downside risks to the near-term macroeconomic outlook as mitigated by constructive medium-term growth prospects, an improved fiscal sustainability profile through the accession to the EMU, as well as an improving external position.

We could raise the sovereign's credit rating or outlook if negative repercussions from higher commodity prices and weaker external demand remain limited, resulting in significantly stronger economic growth than currently expected and accelerating the convergence process towards EU-level income. Timely and effective implementation of the RRP throughout the foreseen timeframe would additionally improve prospects for a positive rating action, as would a faster-than-expected decline in the public debt ratio.

Conversely, we could contemplate a negative rating action if current economic downside risks lead to a prolonged phase of near-stagnation, possibly compounded by lacking progress in terms of RRP implementation, and 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 outlook.

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Ratings*

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

*) 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

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	**Demographics**
Labor	Equality	Technology & Infrastructure	Saftey & Security	**Judicial system**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liberties/ Political Participation**	Market Access	**Business Environment**	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 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 have significant 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 concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2017	2018	2019	2020	2021	2022e	2023e
Macroeconomic Performance							
Real GDP growth	3.4	2.8	3.4	-8.6	13.1	6.4	0.9
GDP per capita (PPP, USD)	27,129	28,842	30,552	28,534	32,879	37,550	40,485
Credit to the private sector/GDP	57.1	55.4	53.5	60.2	53.8	n/a	n/a
Unemployment rate	11.2	8.5	6.6	7.5	7.6	n/a	n/a
Real unit labor costs (index 2015=100)	95.4	96.9	95.1	103.3	100.0	98.5	98.2
World Competitiveness Ranking (rank)	59	61	60	60	59	46	n/a
Life expectancy at birth (years)	78.0	78.2	78.6	77.8	76.8	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	0.3	0.3	0.4	0.3	0.3	n/a	n/a
WGI Control of Corruption (score)	0.1	0.1	0.1	0.2	0.1	n/a	n/a
WGI Voice and Accountability (score)	0.5	0.4	0.5	0.6	0.6	n/a	n/a
WGI Government Effectiveness (score)	0.6	0.5	0.5	0.5	0.6	n/a	n/a
HICP inflation rate, y-o-y change	1.3	1.6	0.8	0.0	2.7	10.7	7.2
GHG emissions (tons of CO2 equivalent p.c.)	6.3	6.1	6.2	5.9	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	0.6	-0.1	0.2	-7.3	-2.6	0.0	-2.5
General government gross debt/GDP	76.5	73.2	71.0	87.0	78.4	67.5	64.7
Interest/revenue	5.8	5.1	4.7	4.3	3.4	n/a	n/a
Debt/revenue	171.0	163.8	155.5	185.9	171.0	n/a	n/a
Total residual maturity of debt securities (years)	4.5	4.6	4.4	5.3	5.7	5.6	n/a
Foreign exposure							
Current account balance/GDP	3.4	1.7	2.8	-0.5	3.0	n/a	n/a
International reserves/imports	0.8	0.7	0.7	0.9	0.8	n/a	n/a
NIIP/GDP	-64.4	-55.9	-46.9	-47.9	-34.5	n/a	n/a
External debt/GDP	88.9	82.2	73.6	79.4	77.0	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

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, IMD Business School, European Center for Disease Prevention and Control (ECDC), Blavatnik School of Government, 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. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

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.

Disclaimer

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When assessing the creditworthiness of sovereign issuers, Creditreform Rating AG relies on publicly available data and information from international data sources, governments and national statistics. Creditreform Rating AG assumes no responsibility for the true and fair representation of the original information.

Future events are uncertain, and forecasts are necessarily based on assessments and assumptions. Hence, this rating is no statement of fact but an opinion. Neither should these ratings be construed as recommendations for investors, buyers or sellers. They should only be used by market participants (entrepreneurs, bankers, investors etc.) as one factor among others when arriving at investment decisions. Ratings are not meant to be used as substitutes for one's own research, inquiries and assessments. Thus, no express or implied warranty as to the accuracy, timeliness or completeness for any purpose of any such rating, opinion or information is given by Creditreform Rating AG in any form or manner whatsoever. Furthermore, Creditreform Rating AG cannot be held liable for the consequences of decisions made on the basis of any of their ratings.

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