Republic of Croatia Rating Report

BB+ STABLE OUTLOOK

Credit strengths

- EU membership since 2013
- Improved budgetary performance
- Strengthening external position

Credit weaknesses

- High debt levels, elevated share of foreign-currency debt
- Low potential-growth outlook
- Institutional weaknesses

Rating rationale and Outlook: The upgrade of Croatia's rating to BB+ reflects: i) the successful conclusion of the debt settlement for Agrokor (the country's largest and most systemically important private company (in financial distress since 2017)), mitigating economic and fiscal risks that previously constrained the rating; ii) fiscal consolidation efforts, leading to a sustained outperformance of the EU Convergence Programme target and compliance with the debt reduction benchmark; and iii) declining external indebtedness and build-up of foreign-exchange reserves, supported by current-account surpluses and the take-up of EU funds. However, the rating remains constrained by: i) high debt levels combined with an elevated foreign-currency exposure; ii) major headwinds to growth such as low productivity and adverse demographics; and iii) institutional shortcomings that result in a burdensome business environment. The Stable Outlook reflects Scope's assessment that risks are balanced.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Croatia	Peer comparison		
		Average	Bulgaria	Hungary
Domestic economic risk				
Public finance risk				
External economic risk				
Financial risk				
Political and institutional risk				
Qualitative adjustment (notches)	-2		-	-
Final rating	BB+		BBB	BBB

AAA AA A BBB BB B CCC CC C

Source: Scope Ratings GmbH

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by the relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with two selected countries chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Structural reform improving growth potential
- Sustained reduction in indebtedness
- Concrete steps to enter ERM II

Negative rating-change drivers

- Reversal of public- and external-debt deleveraging
- Postponement of reforms
- Exchange rate volatility

Ratings and outlook

Foreign currency

Long-term issuer rating	BB+/Stable
Senior unsecured debt	BB+/Stable
Short-term issuer rating	S-3/Stable

Local currency

Long-term issuer rating	BB+/Stable
Senior unsecured debt	BB+/Stable
Short-term issuer rating	S-3/Stable

Lead analyst

Levon Kameryan
+49 69 6677389-21
l.kameryan@scoperatings.com

Team leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone +49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

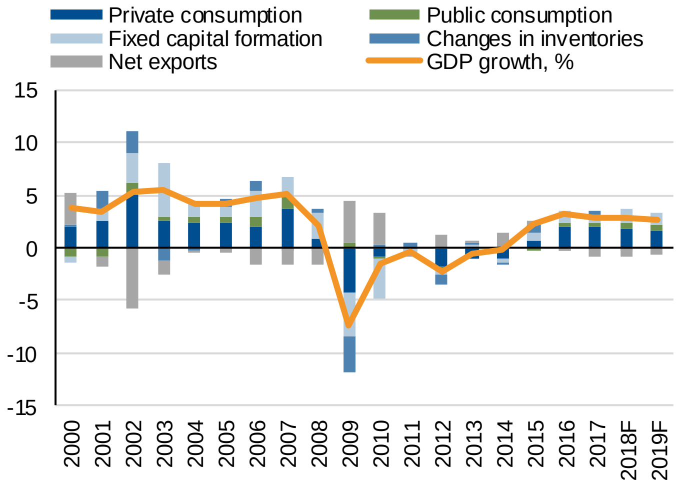
Domestic economic risk

Growth potential of the economy, and macroeconomic stability/sustainability

Slow recovery from the six-year recession

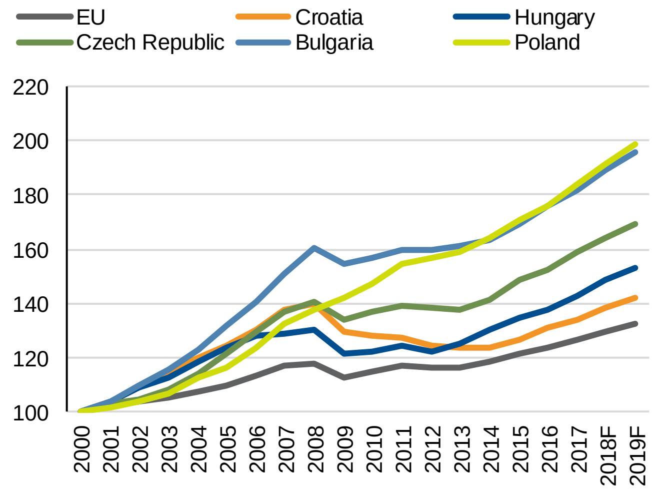
After a six-year recession (2009-14) in which GDP contracted by around 12% cumulatively, real GDP growth finally turned positive in 2015 and is expected to range between 2.5% and 3% over the coming years. Scope expects the cyclical recovery to continue into the medium to long term, driven by stronger consumption through an improving labour market, higher investment (due to expected higher absorption of EU structural funds), credit growth, and robust export and tourism sectors.

Figure 2: Percentage-point contribution to real growth



Source: European Commission

Figure 3: Real GDP, 2000=100



Source: European Commission, Scope Ratings GmbH

Potential growth dragged down by adverse demographics and low productivity

Croatia's economy, despite its recovery, remains more vulnerable than that of peers. Real GDP growth is still well below the pre-crisis level, and GDP per capita (based on purchasing power parity) remains significantly below that of peers, at around 60% of the EU-28 average. The country's growth potential is also estimated at around 1.5%, which is especially weak compared to other transition economies.

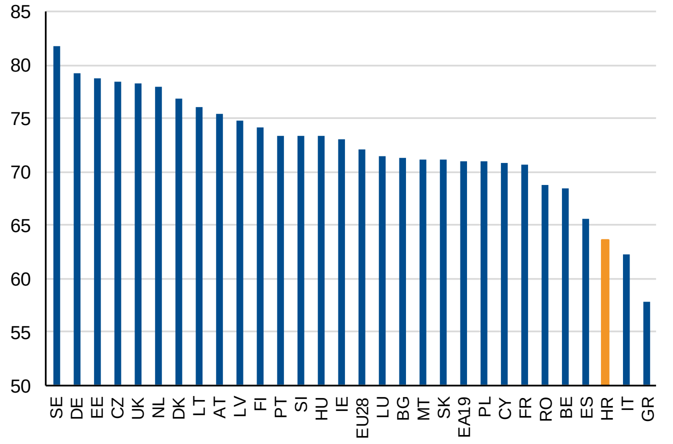
Croatia's growth potential is impeded by labour trends. While the unemployment rate has fallen from its 19.8% peak in 2013 to around 12.2% in 2017, this was mainly due to negative demographics and emigration leading to a shrinking pool of workers. In addition, Croatia's employment rate, though improving, is still one of the EU's lowest at around 64%, driven by a low activity rate after the age of 50 (37% in 2017) due to early-retirement trends.

Low productivity growth remains a challenge; output per employee remains significantly below EU averages. Investment is substantially below pre-crisis levels and fell by around 10pp to 19.4% of GDP between 2007 and 2017. Another reason is the relatively large share of state-owned enterprises, which are less productive than private-sector entities, according to the European Commission (EC)[1]. Finally, the country's business environment is less competitive versus peers', ranking 51st among the 190 countries (23rd in the EU-28) analysed by the World Bank in its 2018 Doing Business report. Croatia scored particularly poorly on dealing with construction permits, paying taxes and starting a business.

Table of contents

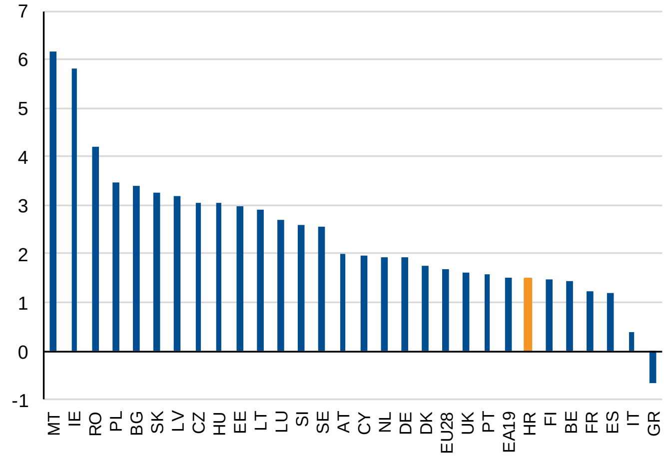
[1] European Commission. Country Report Croatia 2018, SWD (2018) 209 final, March 2018.

Figure 4: Employment rates, 2017 (%)



Source: Eurostat

Figure 5: Potential GDP growth (3Y avg., 2017-2019F, %)



Source: European Commission

Economic policy framework

The accommodative monetary policy of the Croatian National Bank (HNB) has aided economic recovery. During the country's six-year recession and slow recovery, which included three years of deflation, the HNB reduced key policy rates and ensured ample liquidity for banks. The expansionary stance has not only led to lower loan rates and faster loan growth after years of deleveraging, but also allowed banks to pool collateral[2] and add securities eligible for HNB facilities, adjusting required reserves and introducing a quarterly four-year structural reverse-repo facility[3].

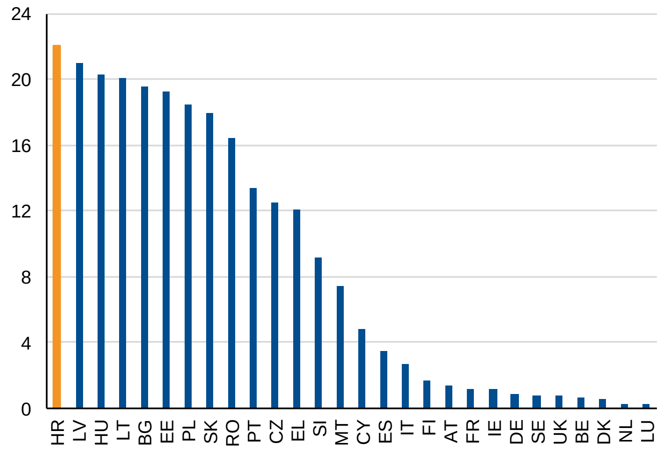
Croatia has committed to adopting the euro, introducing a strategy[4] to advance structural reforms and enhance policy effectiveness in order to improve economic resilience and public finance sustainability. The HNB believes Croatia will benefit considerably from adopting the euro given its close economic and financial integration to the euro area.

Compliance with three convergence criteria; not yet part of ERM II

According to the EC 2018 assessment of non-euro area member's economic convergence and legislative compatibility[5], Croatia meets three of the four economic criteria for joining the euro area (price stability, long-term interest rates and public finances but not yet on the exchange rate criterion). The Croatian kuna is not yet a part of the Exchange Rate Mechanism II[6] (ERM II), the precursor to euro area entry in which a member state's currency is fixed to the euro, with fluctuations permitted within a set range. Croatian Prime Minister Andrej Plenković has targeted 2020 for entry into ERM II. Scope would view the entry into ERM II as credit positive, curtailing risks from the government and economy's high exposure to the euro.

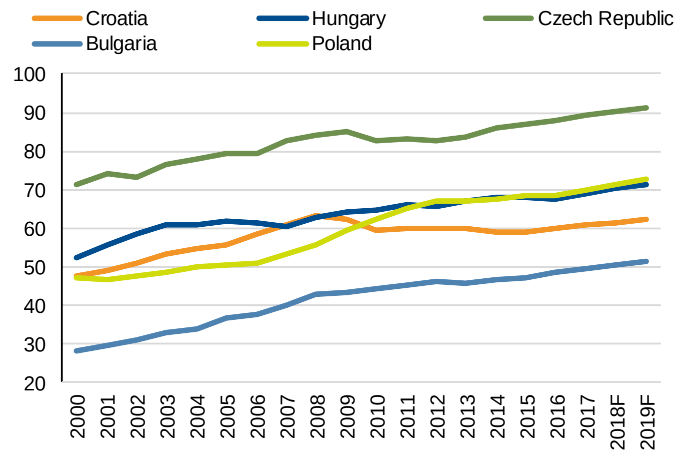
[2] IMF, 2018 Article IV Consultation for the Republic of Croatia, January 2018.
[3] IMF, 2016 Article IV Consultation for the Republic of Croatia, June 2016.
[4] https://euro.hnb.hr/documents/2070751/2104255/e-strategy-for-the-adoption-of-the-euroin-Cro.pdf/9e02b33f-665a-46a9-a1b6-ac63f9af3c95
[5] https://ec.europa.eu/info/sites/info/files/economy-finance/ip078_en.pdf
[6] Participation in ERM II is voluntary. Although, as one of the convergence criteria for entry to the euro area, a country must participate in the mechanism without severe tensions for at least two years before it can adopt the euro. https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/introducing-euro/adoption-fixed-euro-conversion-rate/erm-ii-eus-exchange-rate-mechanism_en

Figure 6: EU structural funds allocations, 2014-20 (% 2017 GDP)



Source: European Commission, Scope Ratings GmbH

Figure 7: GDP per capita (purchasing power standards, % of EU-28 average)



Source: European Commission

Like Central and Eastern Europe (CEE) peers, Croatia is a major beneficiary of EU structural funds with an allocation of EUR 10.7bn for 2014-20, amounting to 22% of GDP in 2017. This makes Croatia the largest beneficiary of EU funds in terms of GDP. Although Croatia's EU fund take-up is increasing, the country is unlikely to see the full benefit – according to the EC[7]. This is because the country's weak administrative capacities and strategic planning are impeding effective absorption of funds.

Scope considers Croatia's EU membership to be an important credit strength, providing investment funding, crisis assistance (via the EU's Balance of Payments assistance facility), and programmes fostering fiscal discipline and structural reform.

Public finance risk

Fiscal policy framework

Ongoing fiscal consolidation with deficits below the 3% Maastricht criterion

Significant fiscal consolidation enabled Croatia to exit the EU's Excessive Deficit Procedure in June 2017. The six-year recession led to high deficits, a consequence of low revenue collection and high automatic expenditure. The deficit fell sharply to 0.9% of GDP in 2016, after a record of 7.8% in 2011. However, the consolidation effort consisted largely of reductions in public investment, social benefits and interest expenses.

In 2017, the fiscal balance improved to a surplus of 0.8% of GDP, outperforming the 2017 Convergence Programme target by more than 2pp, boosted by higher-than-expected tax revenues and constrained spending.

The government's Convergence Programme[8] for 2018-21 foresees a budget deficit to GDP of 0.5% in 2018 and 0.4% in 2019. This is in line with the IMF's expectations, but more cautious than the EC's spring forecast for a 0.8% of GDP fiscal surplus, reflecting consideration of the better-than-anticipated budgetary performance in 2017.

The 2017 tax reform is expected to boost investment and consumption, though at the expense of public finances. The reform simplified and reduced personal income taxation, but the EC notes that this will decrease the number of people taxed by 560,000, reaching 1.5 million (over half of income earners) and reduce the tax rate significantly in higher-income brackets. The corporate income tax rate was also cut from 20% to 18%, with a

[7] European Commission. Country Report Croatia 2018, SWD (2018) 209 final, March 2018.
[8] European Commission. Assessment of the 2018 Convergence Programme for Croatia, May 2018.

new 12% rate for small- and medium-sized enterprises, which will lower expected revenues[9]. Despite this, Scope expects sustained moderate GDP growth to keep public balances well within the 3% Maastricht deficit criterion over the coming years.

Fiscal policy framework has several shortcomings

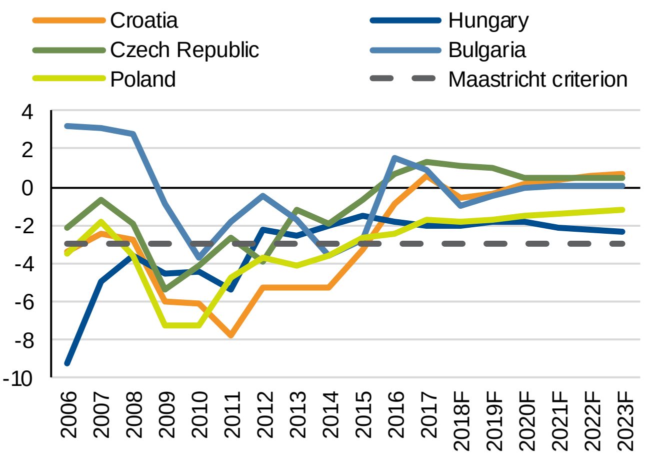
Croatia's fiscal policy has weaknesses in several areas. According to the EC, the country has made limited progress in strengthening its budgetary planning, multi-annual budgetary framework and the independence of the Fiscal Policy Commission. The adoption of the Fiscal Responsibility Act[10] and Budget Act[11], aimed at improving fiscal governance, has again been postponed. The EC furthermore highlights the need to amend pension scheme rules to discourage early retirement. Finally, high territorial fragmentation results in complex fiscal relations across several levels of government. However, the EC expects the new fiscal acts to make central and local government budgets more binding, which should reduce the size and frequency of revisions.

Debt sustainability

High debt level remains a rating constraint

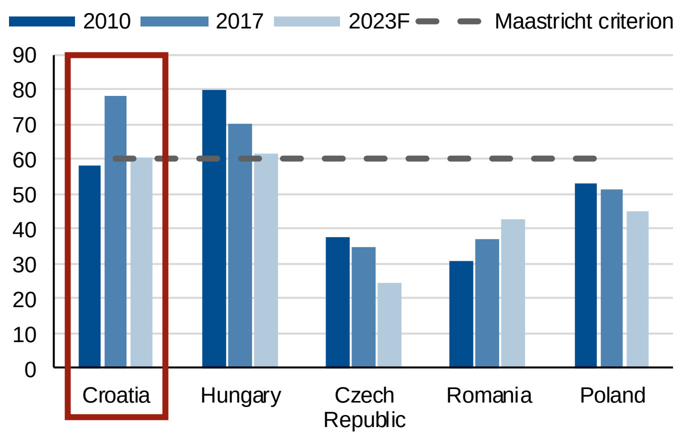
As a result of an accumulation of high deficits during the six-year recession, public debt more than doubled from 40% of GDP in 2004 to 86%[12] in 2014. Debt-to-GDP finally fell in 2015, driven by primary surpluses, positive economic growth, and lower foreign-currency debt valuations through a slight appreciation in the kuna. Nevertheless, the ratio at 78% of GDP in 2017 remains elevated compared to that of peers, constituting a major rating constraint.

Figure 8: Fiscal balances, % of GDP



Source: IMF

Figure 9: Debt levels, % of GDP



Source: IMF

High foreign-currency exposure in public debt

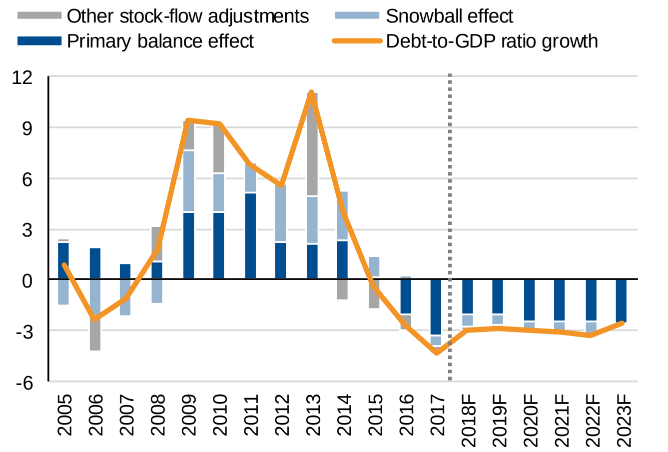
Croatia's high share of foreign-currency public debt further increases public finance risk. About 73% of issued government debt is linked to the euro, a consequence of the domestic market's limited absorption capacity and high level of euroisation. However, Scope considers the risk to be mitigated partly by the HNB's de-facto peg of the kuna to the euro.

Scope has a mixed opinion on Croatia's contingent liabilities. While active government guarantees are high at around 3% of GDP[13] due to a large number of state-owned enterprises, ageing-related expenditures are, on the other hand, manageable. Furthermore, legal proceedings surrounding the legislated conversion of Swiss-franc-

[9] European Commission, Country Report Croatia 2017, SWD (2017) 76 final, February 2017.
[10] The structural budget balance has to be set at a level ensuring the general government deficit-to-GDP ratio stays below 3% and the debt-to-GDP ratio is under 60%. The expenditure rule constrains general budget expenditure, which cannot exceed a reference potential GDP growth rate adjusted for the expected price growth and revenue increases mandated by law (EC, 2016).
[11] The deficit rules mandate that the national parliament or a local representative body cannot endorse a budget for the following year with a higher planned deficit than that projected for that same year with the previous (multi-year) budget (EC, 2016).
[12] The inclusion of the Croatian Bank for Reconstruction and Development added 4.4% of GDP to public debt in 2014 (IMF Article IV, 2016).
[13] European Commission, Country Report Croatia 2018, SWD (2018) 209 final, March 2018.

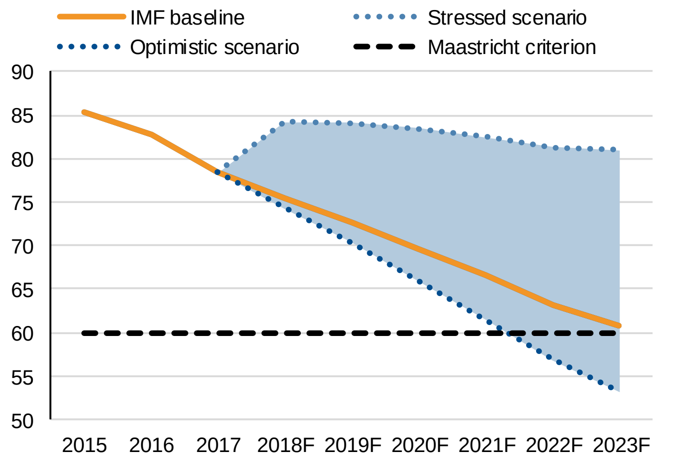
denominated loans into euros at historical currency and interest rates could also result in direct budgetary liabilities.

Figure 10: Contribution to gov't debt changes, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

Figure 11: General government debt, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

Scenario	Period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt, end period (% of GDP)
History	2013-17	1.5	0.1	3.2	78.4
IMF baseline	2018-23	2.4	2.3	1.6	60.7
Optimistic scenario		3.2	2.8	1.3	53.2
Stressed scenario		1.4	1.3	2.4	81.0

Agrokor settlement mitigates direct risks to the budget

Scope views positively the successful conclusion of the Agrokor Group debt settlement[14]. The group, in financial distress since 2017, is systemically important as it is the largest private enterprise in Croatia – group revenues in 2017 corresponded to around 11% of GDP[15]. The debt settlement mitigates adverse economic and financial impacts that previously constrained Croatia's rating. The deal includes debt-to-equity swaps and loan write-offs and eliminates the risk of a disorderly restructuring. This contains the direct risk to the budget stemming from the state's de facto guarantee of debt of Agrokor's suppliers, which amounts to more than EUR 2bn and is treated senior to debt owed to the financial sector. In addition, the risk of material volatility in tax revenues is reduced in view of Agrokor's large contribution to the national budget. However, any future operational restructuring that lowers investment or increases unemployment could still weigh on Croatia's economic performance.

Manageable ageing-related expenditures

According to the EC's 2018 Ageing Report, long-term health- and pension-related expenditures amounted to around 16% of GDP in 2016, slightly above Croatia's CEE peers but below the EU-28 average. EC projections to 2070 foresee a moderate increase in health-related expenditures of 1pp of GDP, but this is more than offset by a 3.8pp reduction in pension-related expenditures. In fact, according to a recent Stiftung

[14] The settlement plan received the affirmative vote at the settlement plan voting hearing on 4 July 2018. http://nagodba.agrokor.hr/en/settlement-plan-agrokors-creditors-voted-favor-80-20-per-cent-total-claims/
[15] The Agrokor Group has around 53,000 employees. The consolidated group's revenue of around EUR 5.3bn in 2017 amounted to approximately 11% of Croatia's GDP. http://nagodba.agrokor.hr/wp-content/uploads/2018/06/Settlement-Plan-Amended-25-June-2018.pdf

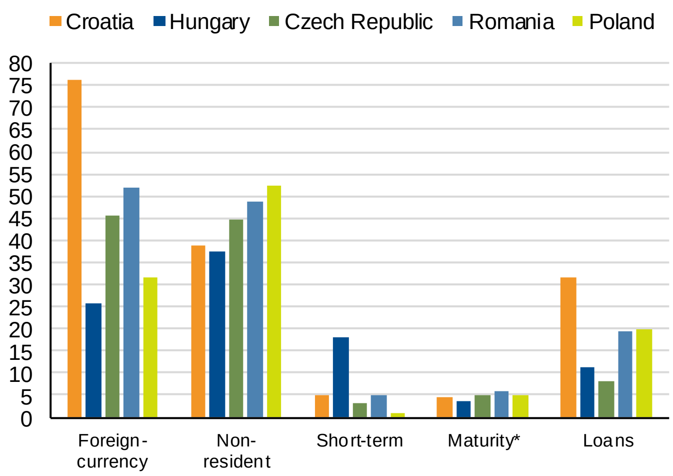
Marktwirtschaft study[16], Croatia ranks first in the EU-28 for long-term sustainability of public finances once implicit debt is accounted for.

Against this backdrop, Scope's public-debt sustainability analysis, which includes an IMF baseline plus a Scope stressed scenario incorporating a combined growth, interest-rate, primary-balance and foreign-currency shock, points to a high sensitivity to exchange rate developments given Croatia's large share of foreign-currency-denominated debt.

Projected compliance with debt benchmark but risks remain

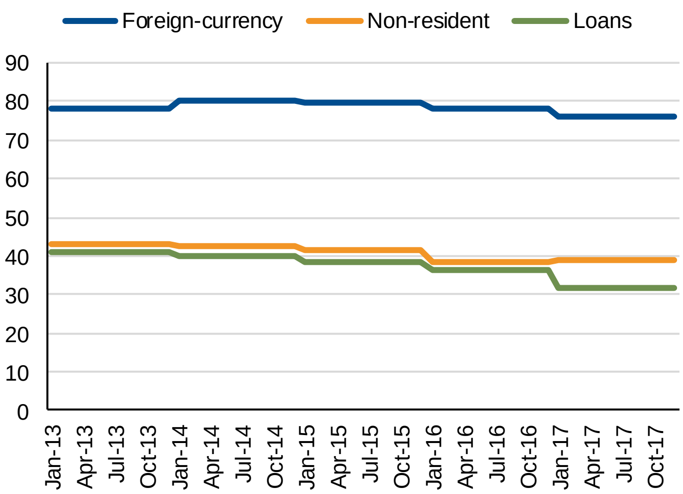
Scope's baseline scenario, in line with the IMF forecast, foresees a decline in debt over the projection horizon (until 2023) while remaining slightly higher than the convergence criterion of 60% of GDP, supported by expectations of primary surpluses and moderate real GDP growth. This is broadly in line with the government's 2018 Convergence Programme projections, implying comfortable compliance with the debt benchmark of the Stability and Growth Pact, but conservative compared to the EC's macroeconomic assumptions in its 2018 spring forecast.

Figure 12: Government debt structure, % of total public-debt stock, end-2017



Source: Eurostat, ECB. *Average maturity in years as of June 2018.

Figure 13: Development of Croatian government debt structure, % of total public-debt stock



Source: Eurostat

Scope's adverse scenario sees Croatia's debt-to-GDP ratio rising to 81% by 2023. This assumes for each year in the forecast horizon a combined 1pp shock to real GDP growth (lower), the primary balance (lower), and interest rates (higher), as well as a one-off 10% depreciation in the kuna. This is better than the debt-to-GDP performance in Scope's adverse scenario from 2017 owing to improved budgetary performance and declining financing costs.

Market access and funding sources

Improved debt profile, but lack of track record in market communication

Scope notes positively the government's effort to improve debt management, which supports a sustained reduction in debt servicing costs and increasing maturities. The declining share of short-term government debt, at 4.8% of total debt in 2017, compares well with the peer average, as does the average residual maturity of debt at 4.5 years. In addition, the share of non-residents holding Croatian government debt fell from about 50% in 2008 to around 39% at the end of 2017, now in line with that of peers. The share of loans as a government funding instrument, while decreasing, remains high at 31.5% at the end of 2017. The strong reliance on bank lending is credit-negative as it amplifies the sovereign-banking nexus by exposing the government to the domestic banking sector.

[16] https://www.stiftung-marktwirtschaft.de/inhalte/themen/generationenbilanz/

Despite the government's new debt-management strategy in 2017, three years after the previous one expired, Croatia has a weak track record of continuous communication with the market.

External economic risk

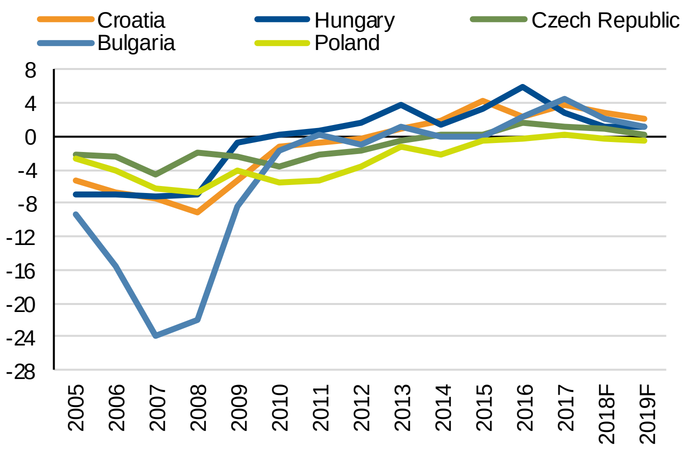
Current-account vulnerabilities

Robust performance in exports reducing external liabilities

After a record current-account deficit of around 9% of GDP in 2008, private-sector deleveraging led to lower imports and a current-account surplus in 2013. More recently, an increase in the export of goods and, especially, services, partly from regaining some lost market share (Croatia's share in world goods exports is up by 24% since 2014), contributed to a strong current-account surplus of 3.7% of GDP in 2017. The lower repatriation of profits in the banking sector associated with the Agrokor crisis supported the surplus in 2017, which Scope expects to be a one-off event.

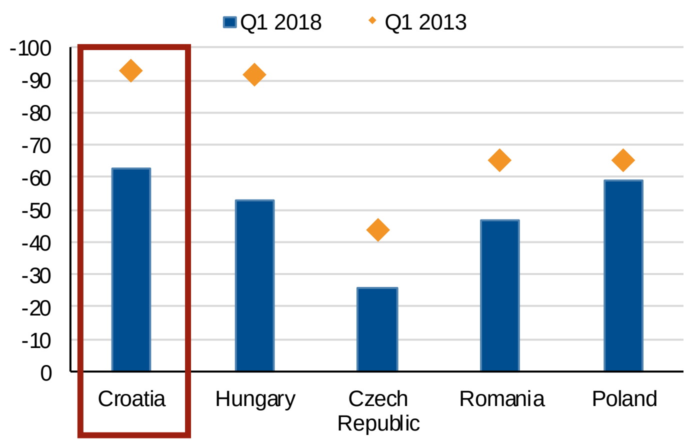
Going forward, Scope expects the current-account surplus to continue reducing Croatia's negative net international investment position – which was -62% of GDP in Q4 2017, more than 7pp up from Q4 2016 levels – albeit at a more moderate rate given higher domestic demand.

Figure 14: Current account balances, % of GDP



Source: European Commission

Figure 15: Net international investment positions, reversed scale, % of GDP



Source: European Commission

External debt sustainability and vulnerability to short-term external shocks

High, albeit declining, foreign-currency exposure

Croatia's external debt has declined significantly over the past two years, supported by kuna appreciation. However, it remains somewhat higher compared to peer levels, at around 83% of GDP in 2017, thereby creating a vulnerability alongside the high, albeit declining, foreign-currency exposure, which accounts for over 90% of external debt. The high level of foreign-currency debt in the private sector was driven by an investment spree leading up to the crisis, during which a large portion of debt[17] was financed externally due to a limited domestic banking system. However, these risks have been thus far tempered by the quasi-peg of the kuna to the euro, which the HNB preserves through foreign-exchange liquidity regulation and occasional interventions.

Deleveraging in both corporate and household sectors has significantly reduced their foreign-currency exposures over the past five years. Risks remain, however, as around 60% of total loans is denominated in foreign currency. According to the EC, the risk is

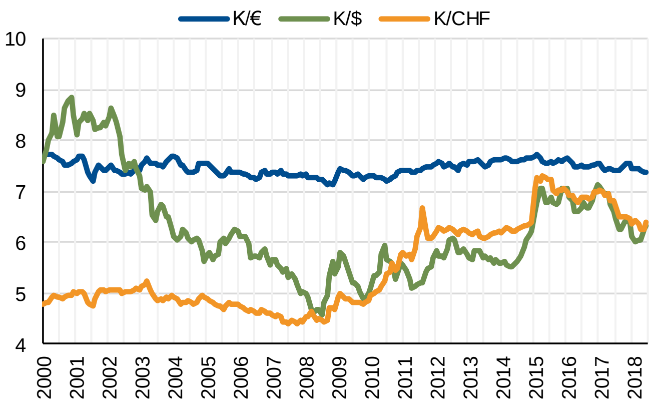
[17] Between 2002 and 2008, investment more than doubled, increasing the indebtedness of nonfinancial corporations from around 40% of GDP in 2002 to 84% in 2010. Similarly, over the same period, household indebtedness rose from 22% of GDP to about 43%.

mitigated somewhat by currency matching between revenue and expenditure flows by companies in the tradeable sector. Despite increased kuna lending – driven by lower interest rates, greater awareness of currency risk among households (possibly due to negative experiences with Swiss-franc-indexed loans) and higher demand from banks for domestic deposits – the HNB has noted a recent rise in long-term euro-denominated borrowing, potentially due to the introduction of the euro adoption strategy and slightly lower interest rates on euro borrowings[18].

Sizable accumulation of reserves by HNB

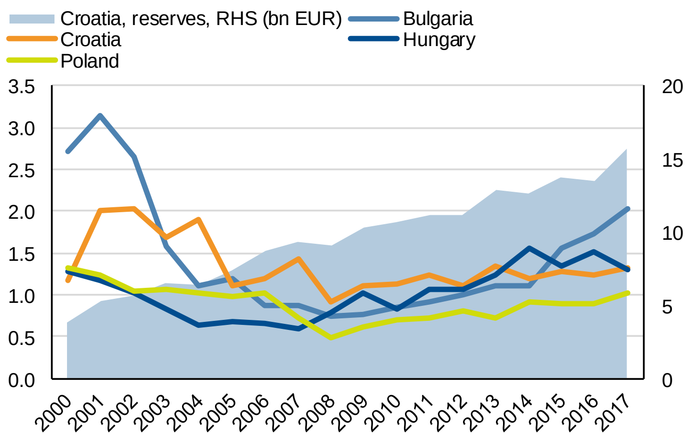
In view of moderate upward pressures on the currency due to robust performance in exports and inflows of EU funds, the HNB has accumulated sizeable reserves worth EUR 15.7bn at end-2017, up from EUR13.5bn in 2016. According to recent IMF estimates[19], Croatia's official reserves amounted to around 130% of short-term external debt in 2017 and are expected to increase to 160% in 2019, comfortably above the 100% adequacy benchmark. However, medium-term gross external financing needs of around 30%[20] of GDP annually is high compared to those of peers. In addition, the quasi-currency peg could lead to higher interest costs for large public and private projects should global monetary conditions tighten.

Figure 16: Exchange rates



Source: Croatian National Bank

Figure 17: Reserves and reserve coverage ratios



Source: IMF, Croatian National Bank

Financial stability risk

Banking sector performance

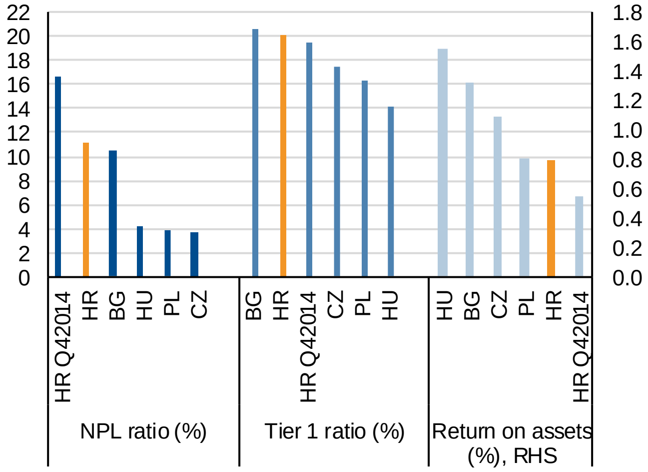
Improved banking sector capitalisation and profitability

The banking sector is both well capitalised, with a tier 1 capital ratio of 20% of risk-weighted assets, and liquid, with liquid assets covering 27%[21] of short-term liabilities at end-2017. The sector posted significant losses in 2015, driven by the legislated conversion of Swiss-franc-denominated loans into euros at historical currency and interest rates. The EC estimates that these conversions generated losses of HRK 7.6bn, or 2.3% of GDP. But the banking sector returned to profitability in 2016, posting a return on equity of around 6.4%, which reduced to 3.4% in 2017 due to losses from servicing Agrokor's debt. Asset quality and non-performing loan (NPL) levels have also improved despite the flow of new non-performing loans (due to the Agrokor crisis) alongside accelerated sales and provisioning requirements introduced by the central bank in 2013. Compared to peer levels, however, the NPL ratio remains high at around 11% of total

[18] Croatian National Bank, Financial Stability report No.19, 2018
[19] http://www.imf.org/external/datamapper/datasets/ARA
[20] Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period. IMF, 2018 Article IV Consultation for the Republic of Croatia, January 2018.
[21] According to IMF methodology, the ratio stood at 48% for the same period.

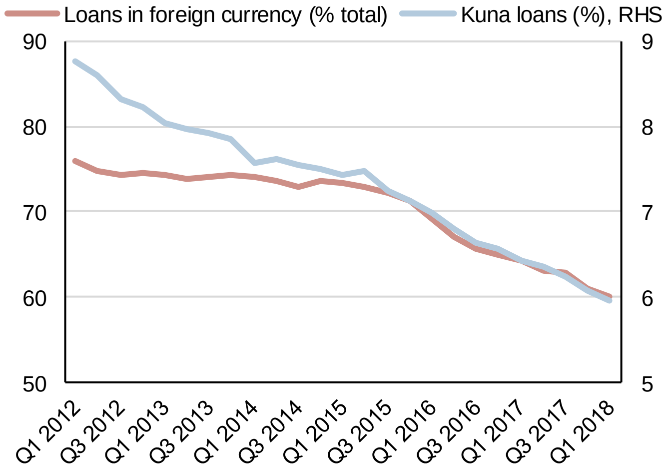
loans in 2017. Housing prices have also been stabilising after seven consecutive years of decline, totalling a cumulative around 20% drop between 2009 and 2015.

Figure 18: Banking sector capitalisation and performance



Source: ECB, IMF

Figure 19: Banking sector foreign exposure and average kuna-loan interest rate, %



Source: Croatian National Bank

While non-financial corporates continued to deleverage over 2017, household debt remained broadly unchanged after declining for years, owing to an easing of lending terms and an improved labour market. At the end of 2017, household debt-to-GDP stood at 35%, 7pp below its peak in 2010, while corporate debt dropped by around 19pp to 65% of GDP in the same period.

Financial imbalances/fragility, and banking sector oversight and governance

Risks to financial stability remain

As the Croatian economy remains heavily euroised, currency risk constitutes a major vulnerability for the banking sector. Banks are indirectly exposed to currency risk from the foreign-currency-denominated debt of their corporate and household clients. In addition, currency mismatches between bank assets and liabilities could emerge should clients again save more in euros[22]. However, the HNB's proven record of managing the exchange rate significantly reduces these risks.

In addition to currency risks, the banking sector remains vulnerable to a portfolio heavily concentrated in governments and certain non-financial corporates. Bank loans to the state constitute around 16% of total loans, down from 20% in 2016. The banking sector largely absorbed Agrokor's restructuring costs, due to the sector's high capital and liquidity buffers and the fact that most of Agrokor's borrowings were externally sourced. However, Agrokor's full impact on the financial sector will be determined by any future operational restructuring of the group.

The possible exposure of the Croatian banking sector to European banks is mitigated by the sector's continued substitution of cross-border funding for domestic funding, as well as the European supervisory framework and the framework for recovery and resolution of credit institutions. While growing reliance on domestic funding is perceived as less risky, according to the HNB this has increased the maturity mismatch in bank balance sheets, mostly due to the reduced maturity of deposits. In addition, as publicly expressed by the ECB[23], the HNB's independence could be undermined by the adoption of the Central

[22] Croatian National Bank, Financial Stability report No.19, 2018
[23] https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_52_en.pdf; https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_33_f_sign.pdf and https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2018_17_f_sign.pdf.

Bank Act, which would enable the state audit office audit powers, access to confidential information, and a right for parliament to vote on HNB reports.

Institutional and political risk

Perceived willingness to pay

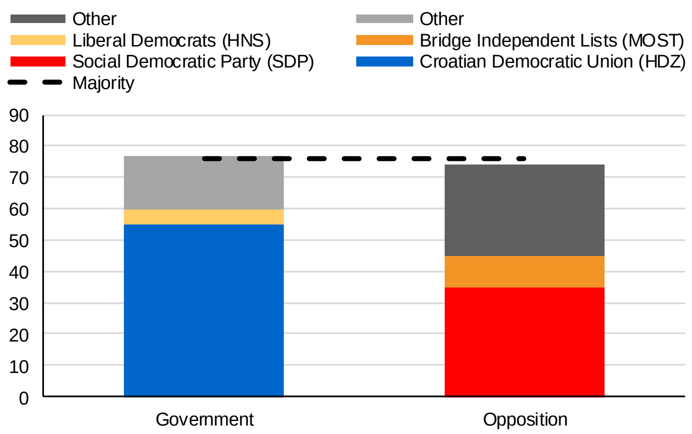
Croatia joined the EU in 2013 and has fully adopted the EU's regulatory framework (acquis communautaire) to provide an anchor for institutional stability and predictability. Since 2009, the sovereign has also been a NATO member, which supports Western alliances and underscores the country's geostrategic importance to the West. In Scope's view, Croatia is as willing as any EU peer to honour debt obligations in full and on time.

Recent events and policy decisions

Political instability and lack of policy continuity

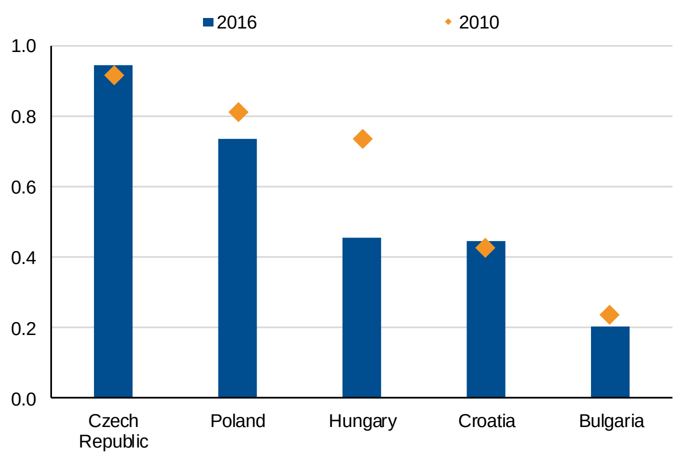
Croatia has been marred by political instability and fragmentation (20 parliamentary parties), with the ruling government already being the 14th since the first multi-party election in 1990. Parliamentary elections were held in November 2015 and again in September 2016, resulting in a relatively strong majority for the HDZ-Most (Croatian Democratic Union – Bridge of Independents) coalition with 91 of 151 parliamentary votes. Following the collapse of this government in June 2017, also because of the Agrokor crisis, HDZ now governs with HNS (Liberal Democrats) with a much narrower coalition majority with 77 seats. While the Agrokor settlement eases the potential for further political instability, structural reforms will be difficult to implement given the narrow majority. The next election is scheduled on or before December 2020.

Figure 20: Distribution of seats in parliament



Source: Croatian Parliament

Figure 21: Average World Bank governance indicators



Source: World Bank

NB. Croatian Democratic Union (55), Social Democratic Party of Croatia (35), Independent MPs (15), Bridge of the Independent Lists (10), Croatian People's Party - Liberal Democrats (5), Croatian Peasant Party (5), Civic Liberal Alliance (4), Istrian Democratic Assembly (3), Independent Democratic Serbian Party (3), Human Blockade (3), Croatian Demochristian Party (2), Bruna Esih - Zlatko Hasanbegović: Independent for Croatia (2), Let's Change Croatia (1), Power - People's and Civic Engagement Party (1), People's Party - Reformists (1), Croatian Pensioners Party (1), Croatian Social-Liberal Party (1), HRAST - Movement for Successful Croatia (1), Croatian Democratic Alliance of Slavonia and Baranja (1), Bandić Milan 365 - Labour and Solidarity Party (1), Independent List of Youth (1).

Prime Minister Andrej Plenković's government is focused on economic and public administration reform aimed at addressing challenges highlighted by the IMF, World Bank, and the EC, including improving competitiveness and labour market outcomes, and enhancing public-finance sustainability. Specifically, the EC has noted repeatedly that fragmentation in public administration, slow progress in the anti-corruption strategy, restrictive regulation in key infrastructure sectors, weaknesses in educational and health systems and the state's strong presence in the economy are weighing negatively on the business environment, hindering the implementation of public policies and weakening the efficient use of resources[24].

Geopolitical risk

Lastly, despite Croatia's ongoing territorial disputes with its neighbours, especially Slovenia, Scope believes these conflicts will not affect the country's economic prospects. Similarly, possible border disruptions due to a potential resurgence of the refugee crisis are not expected to adversely affect trade and tourism.

Methodology

The methodology applicable for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available at www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on at https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA.

Also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA) at http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default and definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is not automatically ensured, however.

[24] European Commission. Country Report Croatia 2018, SWD (2018) 209 final, March 2018.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative "BBB" ("bbb") rating range for the Republic of Croatia. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative analysis.

For the Republic of Croatia, the following relative credit weaknesses have been identified: 1) growth potential of the economy, 2) macroeconomic stability and sustainability, 3) fiscal policy framework, 4) debt sustainability, 5) market access and funding sources, 6) external-debt sustainability, 7) vulnerability to short-term external shocks, 8) banking-sector oversight and governance, and 9) financial imbalances and fragility. No relative credit strengths have been signalled. The combined relative credit strengths and weaknesses indicate a sovereign rating of BB+ for Croatia. A rating committee discussed and confirmed these results.

Rating overview

CVS category rating range	bbb
QS adjustment	BB+
Final rating	BB+

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 24 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score translates to an indicative rating range that is always presented in lower case.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, a review of debt sustainability, fiscal and financial performance assessments, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

The Republic of Croatia's foreign-currency denominated debt, which constitutes about three-quarters of its total debt, is held by both domestic and non-resident investors. Consequently, Scope sees no reason to believe that Croatia would differentiate between any of its contractual debt obligations based on currency denomination. Furthermore, the recent history of sovereign defaults does not provide a strong justification for a rating bias in favour of either local-currency or foreign-currency debt.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	**30%**
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	**15%**
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	**10%**
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	**10%**
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**bbb**
QS adjustment	**BB+**
Final rating	**BB+**

QS

Maximum adjustment = 3 notches

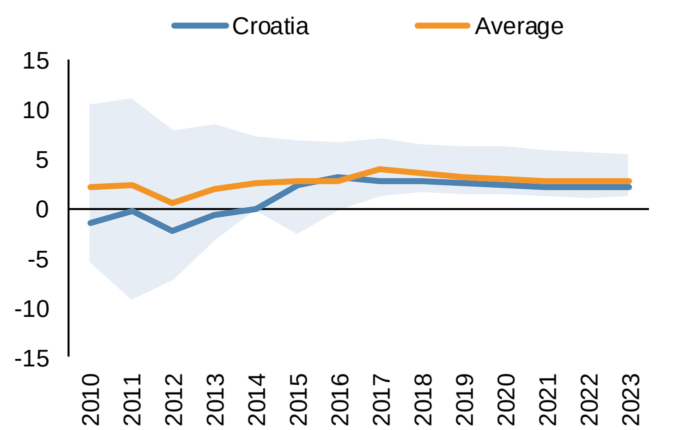
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	○ Neutral	◉ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential we under trend or negative
Economic policy framework	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Macro-economic stability and sustainability	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Fiscal policy framework	○ Exceptionally strong performance	○ Strong performance	○ Neutral	◉ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	○ Neutral	◉ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	○ Very good access	○ Neutral	◉ Poor access	○ Very weak access
Current account vulnerability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Vulnerability to short-term external shocks	○ Excellent resilience	○ Good resilience	○ Neutral	◉ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Geopolitical risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Financial imbalances and financial fragility	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings GmbH

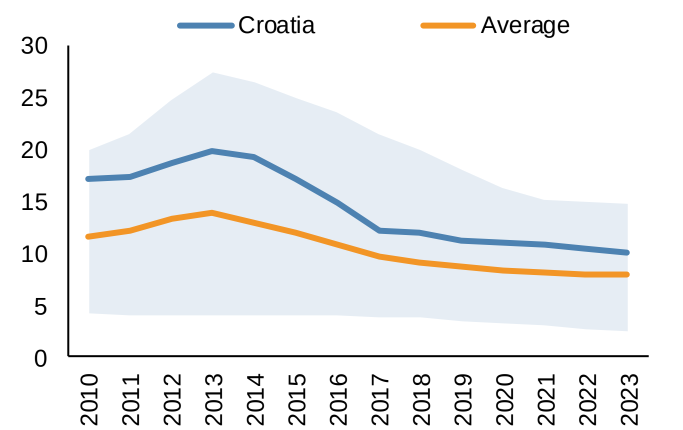
III. Appendix: Peer comparison

Figure 22: Real GDP growth, %



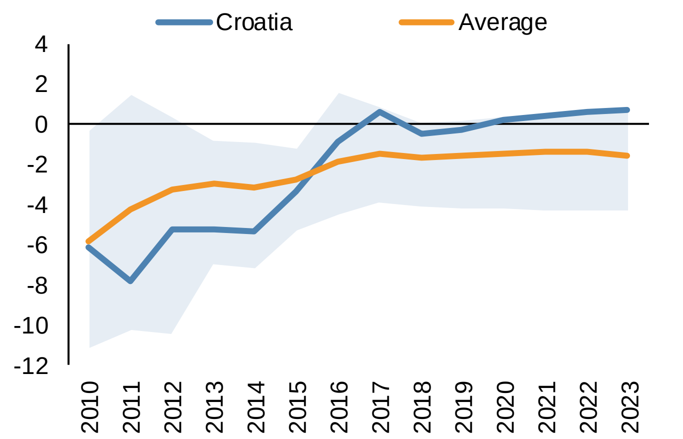
Source: IMF, Calculations Scope Ratings GmbH

Figure 23: Unemployment rate, % of total labour force



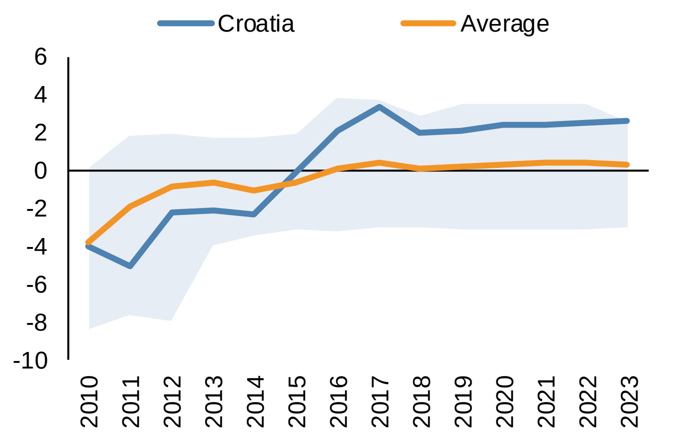
Source: IMF, Calculations Scope Ratings GmbH

Figure 24: General government balance, % of GDP



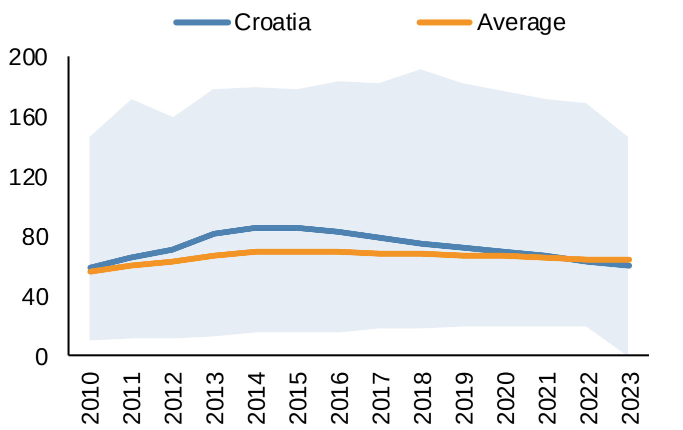
Source: IMF, Calculations Scope Ratings GmbH

Figure 25: General government primary balance, % of GDP



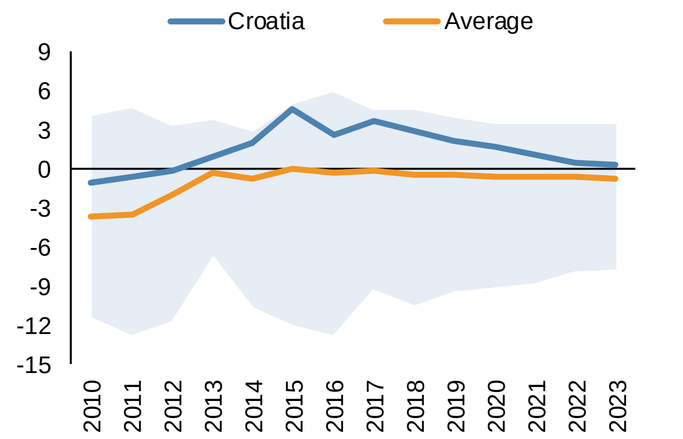
Source: IMF, Calculations Scope Ratings GmbH

Figure 26: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

Figure 27: Current-account balance, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

IV. Appendix: Statistical tables

	2013	2014	2015	2016	2017	2018E	2019F
Economic performance							
Nominal GDP (HRK bn)	331.4	331.3	339.0	349.4	363.5	378.9	394.2
Population ('000s)	4,256.0	4,238.0	4,204.0	4,170.0	4,149.0	4,129.0	4,108.0
GDP per capita PPP (USD)	21,780.0	22,057.0	22,723.6	23,710.4	25,264.4	-	-
GDP per capita (HRK)	77,860.4	78,165.4	80,630.8	83,786.1	87,613.9	91,767.6	95,968.8
Real GDP, % change	-0.6	-0.1	2.3	3.2	2.8	2.8	2.6
GDP growth volatility (10-year rolling SD)	4.0	3.8	3.7	3.5	3.1	3.2	2.0
CPI, % change	2.2	-0.2	-0.5	-1.1	1.1	1.5	1.5
Unemployment rate (%)	19.8	19.3	17.1	14.8	12.2	12.0	11.2
Investment (% of GDP)	19.3	18.8	20.0	20.2	19.4	19.9	20.6
Gross national savings (% of GDP)	20.3	20.8	24.5	22.7	23.1	22.9	22.7
Public finances							
Net lending/borrowing (% of GDP)	-5.3	-5.4	-3.3	-0.9	0.8	-0.5	-0.3
Primary net lending/borrowing (% of GDP)	-2.2	-2.3	-0.1	2.0	3.3	2.0	2.1
Revenue (% of GDP)	42.8	42.7	44.5	46.3	47.0	46.5	46.5
Expenditure (% of GDP)	48.1	48.0	47.9	47.1	46.3	47.0	46.8
Net interest payments (% of GDP)	3.1	3.0	3.2	2.9	2.5	2.5	2.4
Net interest payments (% of revenue)	7.3	7.0	7.2	6.2	5.4	5.4	5.2
Gross debt (% of GDP)	81.7	85.8	85.4	82.7	78.4	75.5	72.6
Net debt (% of GDP)	66.6	71.0	72.5	70.9	-	-	-
Gross debt (% of revenue)	191.0	201.0	191.9	178.8	166.7	162.4	156.2
External vulnerability							
Gross external debt (% of GDP)	105.1	106.9	101.7	89.3	82.6	-	-
Net external debt (% of GDP)	59.8	58.3	52.7	-	-	-	-
Current-account balance (% of GDP)	0.9	2.0	4.5	2.5	3.7	3.0	2.1
Trade balance (% of GDP)	-	-15.0	-15.7	-15.8	-16.8	-17.1	-17.5
Net direct investment (% of GDP)	-1.9	-1.6	-0.6	-4.0	-2.6	-	-
Official forex reserves (EOP, EUR mn)	12,566.7	12,323.4	13,318.8	13,121.7	15,340.4	-	-
REER, % change	1.2	0.4	-1.4	1.1	0.0	-	-
Nominal exchange rate (EOP, HRK/EUR)	7.6	7.7	7.6	7.6	7.5	-	-
Financial stability							
Non-performing loans (% of total loans)	15.4	16.7	16.3	13.6	11.2	-	-
Tier 1 ratio (%)	-	-	18.4	18.6	19.7	-	-
Consolidated private debt (% of GDP)	117.9	118.1	113.2	105.8	-	-	-
Credit-to-GDP gap (%)	-	-14.0	-16.9	-21.2	-25.7	-	-

Source: IMF, European Commission, European Central Bank, Croatian National Bank, World Bank, Scope Ratings GmbH

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

Rating prepared by Levon Kameryan, Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director, Public Finance

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003. The ratings/outlooks were last updated on 01.09.2017.

The senior unsecured debt ratings as well as the short-term issuer ratings were last updated by Scope on 01.09.2017.

The main points discussed by the rating committee were: i) Croatia's growth potential, ii) macroeconomic stability and imbalances, iii) the debt settlement of the Agrokor Group, iv) EU membership, convergence and institutional framework, v) fiscal consolidation, vi) debt management strategy, vii) debt sustainability scenarios, viii) external debt structure and reserve adequacy, and ix) peer analysis.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: The Ministry of Finance of the Republic of Croatia, Central Bank of Croatia, BIS, European Commission, European Central Bank, OECD, IMF, World Bank, and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to the issuance of the rating, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Conditions of use / exclusion of liability

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