Republic of Croatia
Rating Report

BBB+ STABLE OUTLOOK

Credit strengths
• Robust fiscal consolidation prospects
• Structural reform momentum
• Euro area membership since January 2023

Credit challenges
• Relatively high public debt ratio
• Modest growth potential despite lower wealth levels
• Lack of economic diversification

Rating rationale:

Robust downwards public debt trajectory: Croatia holds a good record of fiscal consolidation, characterised by primary fiscal surpluses and robust debt reduction in the years leading up to the pandemic. Commitment to fiscal discipline, a robust growth outlook and good debt affordability underpin a favourable debt trajectory, with debt projected to stand below the 60% of GDP Maastricht threshold by end-2027.

Sound structural reform momentum: The Croatian government has shown an ongoing commitment to structural reform and fiscal prudence in line with the euro area accession process. The implementation of the reforms agreed under its Recovery and Resilience Plan, supported by sizable EU grant-funding, is expected to yield further improvements for Croatia's economic resilience and long-term growth prospects.

Euro area membership: Croatia, a member of the euro area since 1 January 2023, benefits from the highly credible monetary policy and rigorous financial sector oversight of the Eurosystem. Euro adoption has significantly curtailed external and financial sector foreign-exchange risks and is expected to support economic momentum over the medium-term.

Rating challenges include: i) an elevated public debt stock; ii) a modest growth potential, reflecting low investment and productivity growth and unfavourable demographics; and iii) the economy's relative lack of diversification and high reliance on tourism, which caused large swings in economic activity in 2020 and 2021 during the Covid-19 pandemic.

Croatia's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	bbb-	EUR [+1]	-1/3	BBB+
Public Finance Risk		20%	aaa		-1/3	
External Economic Risk		10%	bbb-		-1/3	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental Factors	5%	aa		0	
	Social Factors	7.5%	ccc		-1/3	
	Governance Factors	12.5%	bb		0	
Indicative outcome			**a-**		**-1**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve-currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12-18 months.

Positive rating-change drivers
• Structural reforms raise growth potential and improve economic diversification
• Faster-than-expected debt-to-GDP decline

Negative rating-change drivers
• Deterioration in the growth outlook
• Lasting deterioration in fiscal dynamics

Ratings and Outlook

Foreign currency

Long-term issuer rating BBB+/Stable

Senior unsecured debt BBB+/Stable

Short-term issuer rating S-2/Stable

Local currency

Long-term issuer rating BBB+/Stable

Senior unsecured debt BBB+/Stable

Short-term issuer rating S-2/Stable

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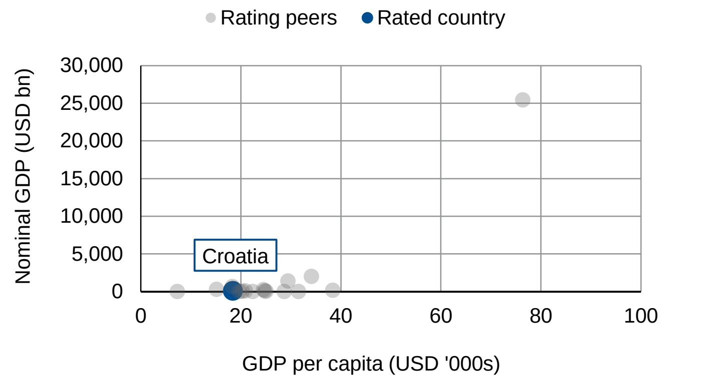
Domestic Economic Risks

- **Growth outlook:** After robust growth in the first half of 2022, with real GDP up by around 8% YoY, the economic momentum decelerated in H2 2022. Quarterly growth turned negative in Q3 2022, at -0.5% (QoQ, SA), before edging up to a moderate 0.6% in the final quarter of the year. The slowdown was primarily driven by rising inflation, tightening funding conditions and heightened uncertainty on private demand. We expect these headwinds to continue to weigh on economic activity in 2023. At the same time we anticipate growth will gradually gain momentum over the course of the year, amid improving real income dynamics and recovering private sector confidence. After reaching 6.2% in 2022, we expect growth at around 1.8% in 2023, before trending back to the medium-term potential in subsequent years, which we estimate at around 3% annually. Croatia's growth outlook benefits from expected gains in trade and tourism flows related to entry into the euro and Schengen area, as well as from rising EU-funded public investment. Weak productivity growth, limited economic diversification and adverse demographic trends constitute material drags on medium-term growth.
- **Inflation and monetary policy:** HICP inflation has eased in recent months to 8.8% YoY in April (1.8 pp above the euro area average), off a November 2022 high of 13%. This moderation was primarily driven by lower energy prices and favourable base effects. However, core inflation remains high at 9.3% in April, highlighting persistent underlying price dynamics. Wage dynamics have accelerated in recent months, with real gross earnings growth turning positive in January 2022. As such, we expect price pressures to moderate only gradually over the medium term.
- **Labour markets:** Croatia's labour market has so far remained resilient to slowing economic momentum with steady employment gains in recent quarters, leading to a record-high employment rate (aged 15-64 years) of 65.6% as of Q4 2022. The unemployment rate remains moderate, at 6.1% as of April 2023, having declined from January 2021 peaks of 9.7%. Significant, structural rigidities remain in the labour market, however, limiting labour mobilisation, as reflected in some of the lowest participation rates for women and persons aged 55-64 in the EU.

Overview of Scope's qualitative assessments for Croatia's *Domestic Economic Risks*

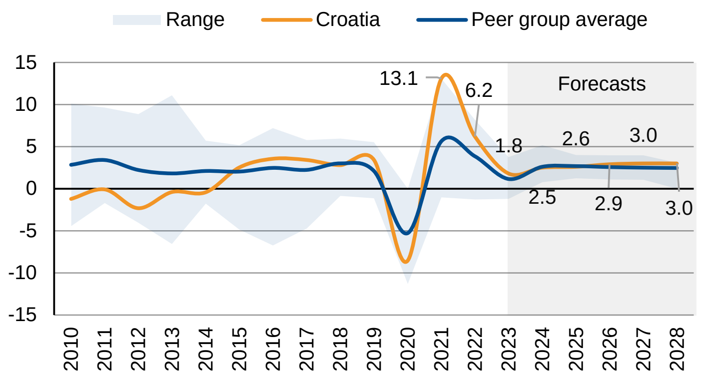
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Growth potential of the economy	Neutral	0	Modest growth potential due to low productivity growth and adverse demographics, comparable to peers.
	Monetary policy framework	Neutral	0	Entry into the Eurosystem on 1 January 2023. The ECB is a credible and effective central bank.
	Macro-economic stability and sustainability	Weak	-1/3	Limited economic diversification, shortages of skilled labour.

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

Public Finance Risks

- **Fiscal outlook:** Croatia's general government (GG) fiscal balance swung to a 0.4% of GDP surplus in 2022, from a deficit of 2.5% of GDP in 2021. This sharp improvement resulted from a significant rebound in revenue in a context of high nominal growth and the phase out of pandemic-era policies. These developments outweighed increased spending to tackle the energy crisis, including cuts to VAT on energy products, increased social transfers and the introduction of a cap on energy and food prices, for a total budgetary cost of 1.5% of GDP in 2022. We expect the fiscal balance to return to a deficit in 2023, amid slowing economic activity and continued pressures on public wages and social expenditures amid persistent high inflation. The government announced an additional EUR 1.7bn (2.5% of GDP) support package aimed at alleviating the impact of price pressures on the Croatian economy in March. We expect the GG fiscal deficit to reach 0.8% of GDP this year and 1.4% in 2024, before trending down to about 1.0% by 2028.

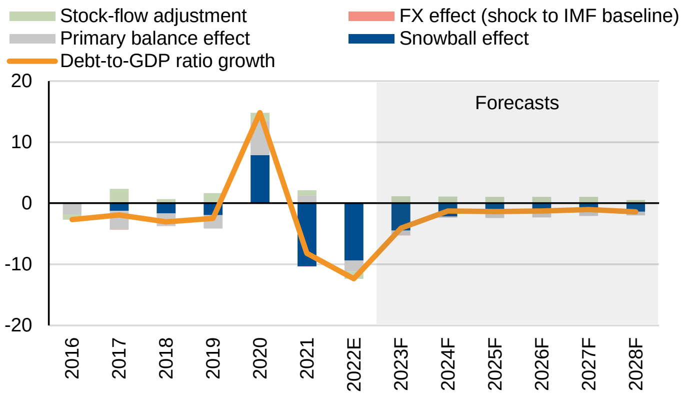
- **Debt trajectory:** The GG debt-to-GDP ratio stood at 68.4% at end-2022, down from 78.4% in the previous year and 2.7pp below its pre-pandemic level at YE 2019. We expect it to trend down to around 58% by end-2028, driven by robust nominal GDP growth and improving budget balances. The debt trajectory should also benefit from moderate interest payments relative to pre-pandemic averages, despite a tightening of funding conditions, in part supported by Croatia's recent entry into the euro area. Contingent liabilities constitute a challenge to the debt outlook, as reflected in IMF estimates of the net present value of health care spending changes over 2022-50 totalling 48.2% of GDP.

- **Debt profile and market access:** Croatia's GG interest expenditure as a share of GDP has declined sharply over recent years, from 3.4% in 2015 to 1.4% in 2022, though we expect this trend to ease somewhat over coming years, as a result of higher market funding rates. The yield on ten-year bonds averaged 3.7% in April 2023, up 1.3pps from the same period last year despite having moderated from 4.0% in October 2022. The Croatian government's funding outlook will be supported by the disbursement of funds allocated under the country's Recovery and Resilience Facility (RRF), including grant funding amounting to 1.6% of GDP on average over 2023-26. Additionally, Croatia will access additional EU funding amounting to about EUR 3.7bn in the form of preferential loans under the country's RRF from 2024.

Overview of Scope's qualitative assessments for Croatia's *Public Finance Risks*

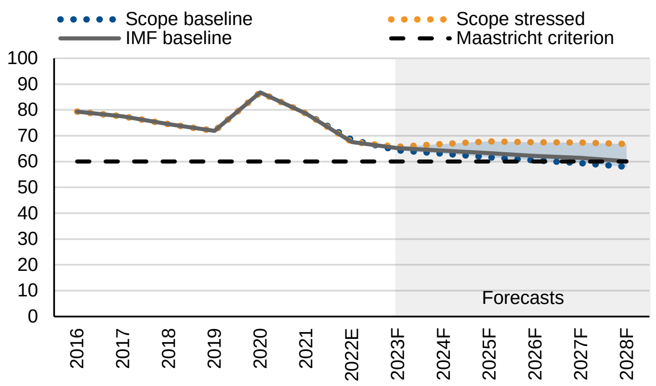
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Neutral	0	Pre-crisis fiscal surpluses, record of commitment to fiscal discipline, but comparatively restricted tax base
	Debt sustainability	Weak	-1/3	Elevated public-sector debt, gradual debt reduction over the medium run, costs of an ageing society
	Debt profile and market access	Neutral	0	Favourable financing conditions, foreign-exchange risks in the public debt stock curtailed following euro adoption

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

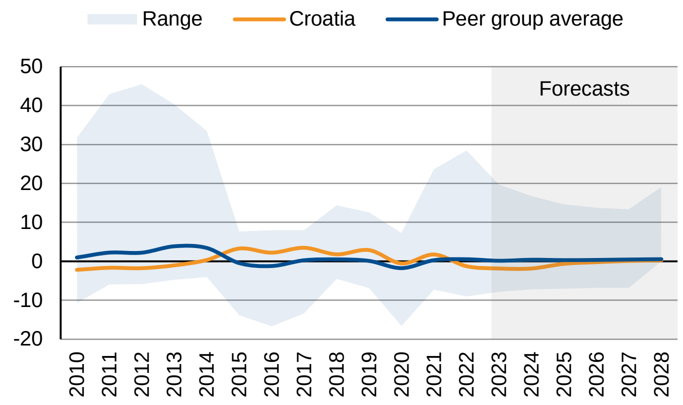
External Economic Risks

- **Current account:** Croatia entered the pandemic after a period of steady current account surpluses, averaging 2.7% of GDP over 2015-19. After a small deficit in 2020, it rebounded to a 1.8% of GDP surplus in 2021 thanks to a robust recovery in international tourism receipts and strong goods exports performance. It dipped to a 1.6% of GDP deficit in 2022, amid soaring energy and raw material imports. Moving forward, weaker external demand from key European trading partners and still-elevated global energy and commodity prices will weigh on the recovery of trade balance, despite expectations of a continued robust recovery in foreign tourism.
- **External position:** Croatia's external debt edged back to its pre-pandemic level by end-2022 to around 75% of GDP. Its composition is favourable, being mostly long term (53% of total) as well as being primarily comprised of public sector liabilities (46%) and intercompany lending (19%). The country's net international investment position stood at a negative 26% of GDP at end-2022, having improved markedly from a negative 63% at end-2017. Foreign-currency risks were largely eliminated following the country's euro adoption on 1 January 2023.
- **Resilience to shocks:** Croatia's small, open economy remains vulnerable to external shocks and is reliant on external demand, especially tourism receipts. Nevertheless, the country's recent euro area accession provides a strong mitigant against external shocks. Furthermore, the country's moderate dependence on external funding for the government and banking sectors limits risks of financial spill-overs.

Overview of Scope's qualitative assessments for Croatia's *External Economic Risks*

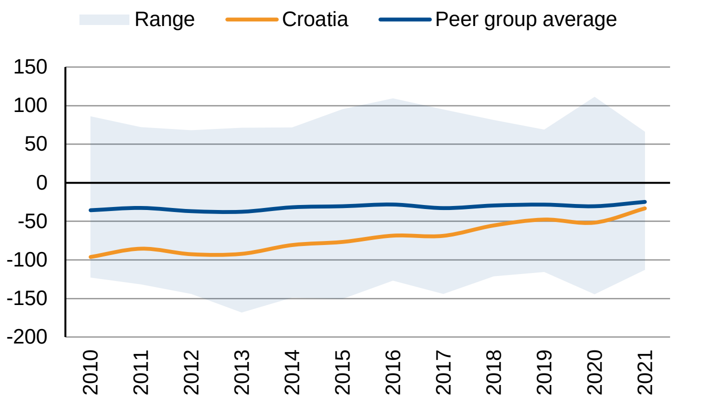
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Current account resilience	Weak	-1/3	High reliance on tourism revenues weakens exporting-sector resilience
	External debt structure	Neutral	0	Narrowing net external debt, but sizable share of debt-creating flows in external liabilities
	Resilience to short-term external shocks	Neutral	0	Small and open economy; euro-area membership mitigates exposure to international markets fluctuations

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

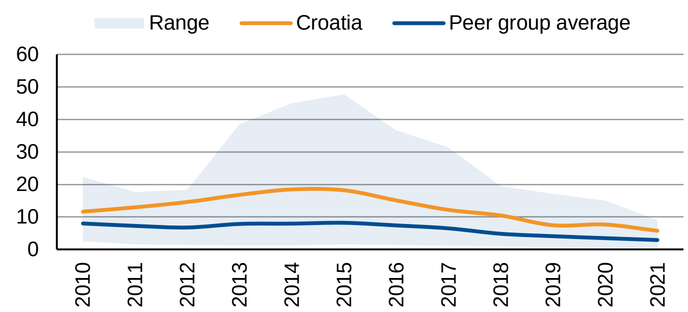
Financial Stability Risks

- **Banking sector:** Croatia's banking sector is well capitalised and profitable, as reflected in aggregate tier-1 capital and return-on-equity ratios of 23.6% and 8.8% as of Q4 2022, respectively, both among the highest within the peer group. After a moderate uptick during the pandemic, the non-performing loans ratio resumed its pre-crisis declining trend, down to historically low levels (3.0% as of Q4 2022). At the same time, it remains well above the euro area average (1.6%), with still elevated ratios for borrower segments including non-financial corporates (6.4%) and households (5.0%). Profitability should remain strong, supported by higher interest rates and comparatively moderate cost-to-income ratios. Croatia's ratings benefit from recent reforms made to banking-sector governance ahead of euro area accession, underscored by successful entry to the Banking Union, the Single Resolution Mechanism and the Single Resolution Fund. In a context of robust lending growth, the Croatian National Bank announced it would raise the countercyclical buffer rate from 0.5% to 1% from December 2023.
- **Private debt:** Household debt amounted to around 31% of GDP at end-2022, while total debt incurred by non-financial corporates stood at 77% of GDP. Both ratios are markedly down from their pre-pandemic levels, owing to the robust recovery in economic output. Risks related to the high share of euro-denominated private debt have been curtailed following Croatia's accession to the euro area on 1 January 2023. Croatia counts among the European countries whose households are most vulnerable to unexpected shocks with 45% of households reportedly unable to meet an unexpected financial expense.
- **Financial imbalances:** We observe a relatively strong sovereign-bank nexus in Croatia, with banks' claims on the Croatian general government making up around 20% of total bank assets. Additionally, mortgages represent around half of total bank loans, constituting a material exposure to real estate market developments for the banking system. After moderating somewhat during the pandemic, residential real estate price growth picked up markedly from 2021 H2 and has not shown signs of decelerating since, reaching 17.3% YoY in Q4 2022. Mortgage loan growth remains robust (+10.3% YoY in Q3 2022), in part reflecting the slow feedthrough of higher policy rates on mortgage rates which still remain below pre-pandemic averages. In February 2022, the European Systemic Risk Board identified vulnerabilities in the Croatian housing market, pointing to signs of overvaluation following a period of rapid price growth. At the same time, these trends appear to largely reflect tight supply and increased presence of foreign buyers, while mortgage growth remained broadly in line with fundamentals.

Overview of Scope's qualitative assessments for Croatia's *Financial Stability Risks*

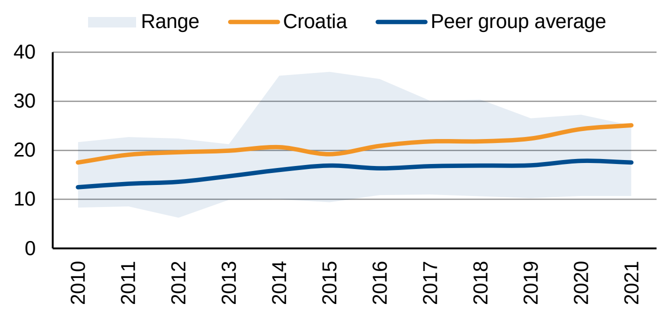
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector
	Banking sector oversight	Neutral	0	Oversight under the Croatian National Bank and the ECB as part of the Banking Union
	Financial imbalances	Neutral	0	Moderate savings and low private sector indebtedness

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

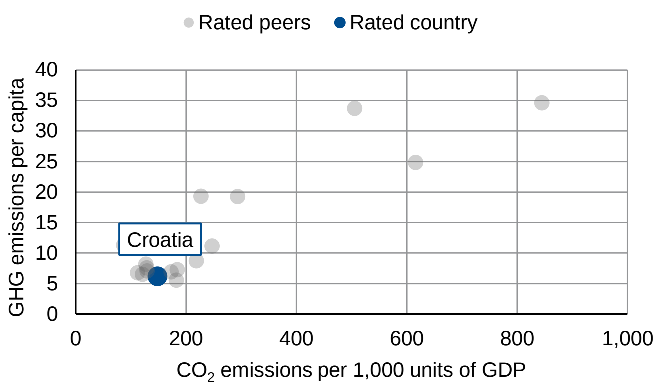
ESG Risks

- **Environment:** Despite generating some of the lowest levels of greenhouse gas (GHG) emissions per capita among EU countries, Croatia's economy remains more GHG-intensive than the EU average. The government aims to cut carbon emissions by 45% by 2030 relative to 1990 levels. The roll-out of Croatia's Recovery and Resilience Plan (with grants and loans amounting to EUR 6.3bn and EUR 3.6bn respectively, totalling about 15% of GDP) will support progress towards these targets, both through EU-funded investments and the implementation of reforms aimed at increasing the country's renewable energy generation capacity and raising energy efficiency. Croatia's share of renewable energy in final energy consumption was estimated at 31% in 2021, higher than the EU average of 22%. A full phase-out for coal is planned for 2033. Nearly 70% of Croatia's electricity was generated by renewable sources in 2021, mainly from hydropower.
- **Social:** The share of the population at risk of poverty (18.0% in 2022) has declined in recent years, albeit remaining 1.2pps above the EU average, in part reflecting regional disparities with significantly higher poverty rates in rural areas. The European Commission's Digital Economy and Society Index 2022, which ranks the EU-27 countries for digital competitiveness, placed Croatia 22nd, highlighting issues in human capital development for crucial digital skills. In addition, Croatia is experiencing a pronounced demographic decline, with an increasing and high old-age dependency ratio, low birth rates and net negative migration over recent years, although this trend has slowed down recently.
- **Governance:** Under governance-related factors, Croatia shows average performance compared to peers in central and eastern Europe as assessed under the World Bank's Worldwide Governance Indicators. EU membership enhances the country's credible macroeconomic policymaking and a stable governance framework. In general, policymaking in Croatia has enjoyed relative continuity.

Overview of Scope's qualitative assessments for Croatia's *ESG Risks*

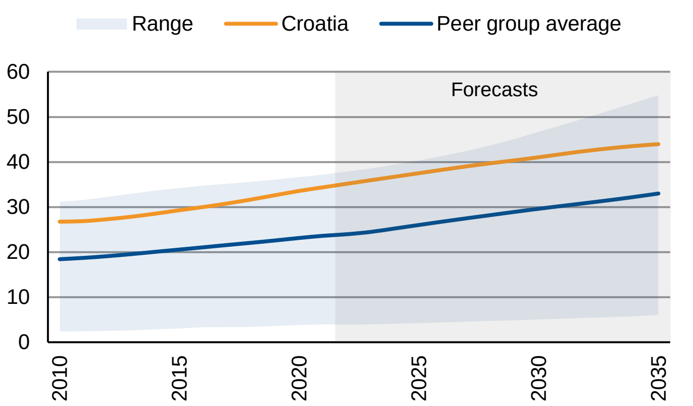
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Environmental factors	Neutral	0	Transition risks in line with peers, above-EU-average share of renewable energy in total energy consumption
	Social factors	Weak	-1/3	Relatively high human development, but low employment rate, unfavorable demographics
	Governance factors	Neutral	0	Track record of political stability, moderate institutional capacity

Emissions per GDP and per capita, $mtCO_2e$



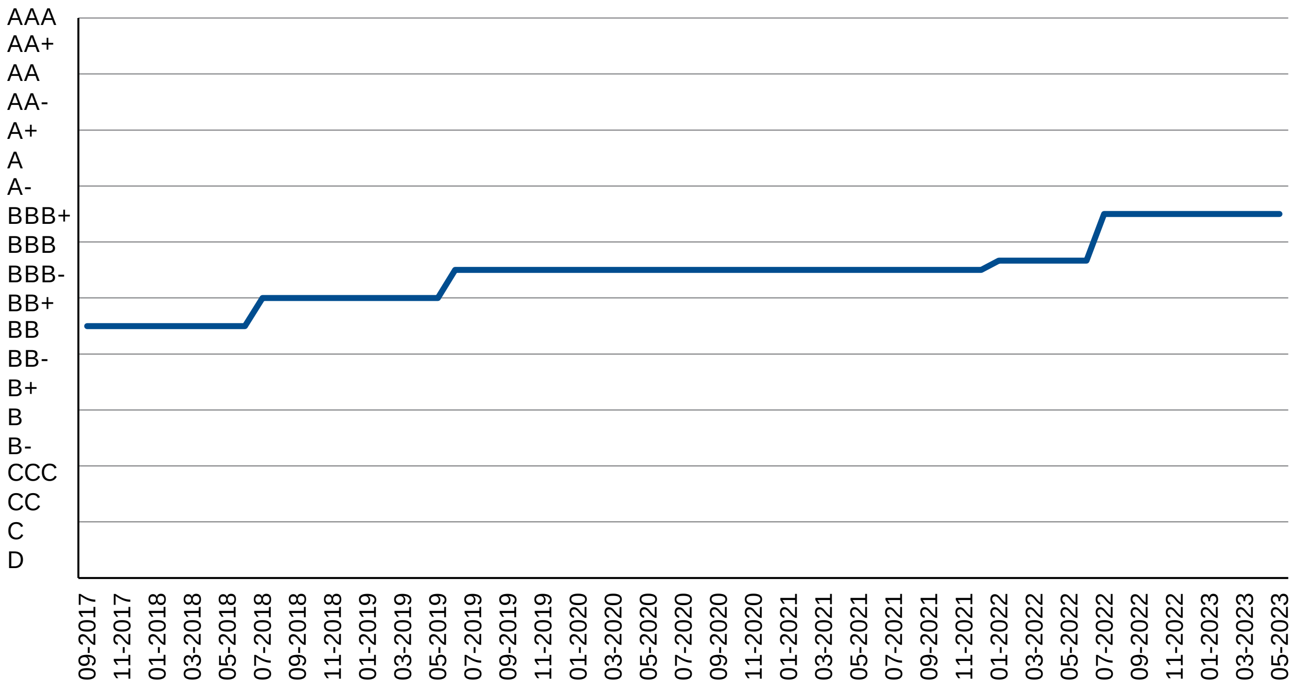
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history (foreign-currency long-term debt)



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Cyprus
Estonia
Italy
Latvia
Lithuania
Poland
Portugal
Slovakia
Spain
United States

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2018	2019	2020	2021	2022
Domestic Economic	GDP per capita, USD '000s	IMF	15.0	15.1	14.2	17.8	18.4
	Nominal GDP, USD bn	IMF	61.4	61.3	57.6	68.9	71.0
	Real growth, %	IMF	2.8	3.4	-8.6	13.1	6.3
	CPI inflation, %	IMF	1.6	0.8	0.0	2.7	10.7
	Unemployment rate, %	WB	8.4	6.6	7.5	7.6	-
Public Finance	Public debt, % of GDP	IMF	74.5	71.9	86.8	78.6	67.5
	Interest payment, % of revenue	IMF	4.5	4.3	3.8	3.0	3.2
	Primary balance, % of GDP	IMF	2.0	2.2	-5.6	-1.2	0.5
External Economic	Current account balance, % of GDP	IMF	1.8	2.9	-0.5	1.8	-1.2
	Total reserves, months of imports	IMF	7.0	7.1	9.3	8.5	-
	NIIP, % of GDP	IMF	-55.2	-47.6	-51.6	-33.2	-
Financial Stability	NPL ratio, % of total loans	IMF	10.4	7.4	7.6	5.7	-
	Tier 1 ratio, % of risk-weighted assets	IMF	21.7	21.6	22.7	24.6	25.2
	Credit to private sector, % of GDP	WB	54.6	53.0	59.5	-	-
ESG	CO_2 per EUR 1,000 of GDP, mtCO_2e	EC	158.6	155.0	156.8	148.7	-
	Income share of bottom 50%, %	WID	18.4	18.4	18.4	18.4	-
	Labour-force participation rate, %	WB	66.6	67.0	-	-	-
	Old-age dependency ratio, %	UN	31.7	32.6	33.6	34.4	35.2
	Composite governance indicators*	WB	0.4	0.4	0.4	0.5	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 25 May 2023	94

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