Republic of Croatia
Rating Report

SCOPE BBB- POSITIVE OUTLOOK

Credit strengths

- ERM II and Banking Union memberships
- Commitment to reform
- Reductions in external sector and financial-system risk

Credit challenges

- Elevated public debt ratio
- External vulnerabilities
- Low growth potential

Rating rationale:

The Outlook revision to Positive on Croatia's ratings reflects an ongoing commitment to euro-area accession reform, facilitated by Croatia's participation in the EU's Banking Union and the presence of the Croatian kuna in the Exchange Rate Mechanism (ERM II).

Croatia is likely to be ready to adopt the euro by 2023 despite the disruption caused by the pandemic shock. The progress towards euro adoption is supported by the eurozone authorities' commitment to enlargement and political backing for Croatia's membership. Joining the eurozone would enhance several rating-relevant areas by bringing about improvements in Croatia's level of institutional strength, monetary policy flexibility and enabling it to issue debt in a reserve currency that is also its national currency (the euro), while curbing exchange-rate risk for public and private balance sheets.

However, Croatia's ratings remain constrained by several medium-to-longer term credit challenges relating to: i) elevated public debt, which has resulted in government medium-run financing needs being among the highest among the peers; ii) low growth potential, reflecting low investment and productivity growth and adverse demographics; and iii) the economy's relatively high reliance on tourism revenues, making it more vulnerability to Covid-19 shock. In addition, the currency risk remains a vulnerability for the economy and fiscal dynamics, given substantial share of public and private debt denominated in euro.

Croatia's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	bbb+		-2/3	BBB-
Public Finance Risk		25%	bbb		-1/3	
External Economic Risk		10%	bbb+		-1/3	
Financial Stability Risk		10%	aa+		-1/3	
ESG Risk	Environmental Risk	5%	aaa		0	
	Social Risk	5%	bb-		-1/3	
	Governance Risk	10%	bb-		0	
Overall outcome		**bbb+**		**0**	**-2**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and 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 GmbH.

Outlook and rating triggers

The Positive Outlook represents Scope's opinion that risks to the sovereign ratings are tilted to the upside over the next 12 to 18 months.

Positive rating-change drivers

- Additional progress was made under the euro-area accession
- Growth potential was raised with the help of structural reforms
- Public debt-to-GDP declined faster-than-expected, helped by fiscal consolidation

Negative rating-change drivers

- There was a considerable postponement to the timetable for euro-area accession
- There was lasting deterioration in fiscal dynamics due, for example, to a failure to narrow budget deficits

Ratings and Outlook

Local and foreign currency

Long-term issuer rating	BBB-/Positive
Senior unsecured debt	BBB-/Positive
Short-term issuer rating	S-2/Stable

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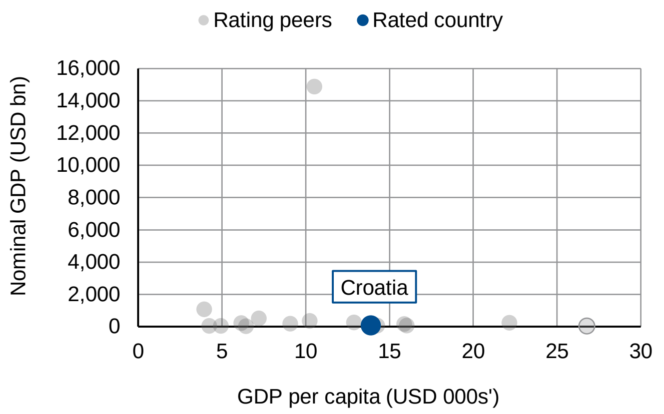
Domestic Economic Risks

- **Growth outlook**: Scope forecasts Croatia to grow 4.8% in 2022 and 4.0% in 2023, from an estimated 10.5% in 2021. For the medium-run, Scope projects Croatia's growth potential at a tepid 2.5-3% annually despite relatively low income levels. This is the outcome of insufficient economic and labour market reform and, resultingly, weak productivity growth, limited economic diversification and adverse demographics. The front-loading of EU monies starting from 2022, following the European Commission's endorsement of Croatia's Recovery and Resilience Plan (EUR 6.3bn in grants or 12.5% of 2020 GDP), support medium-term public investment and economic growth. Scope, however, notes that Croatia has a weak track record of EU fund absorption (only around 50% absorption rate over the 2014-20 EU multi-annual period as of September 2021). The low fund take-up contributed to low investment made in the economy, at 21% of GDP over the last five years. This rate is particularly weak when compared to other regional peers and remains an important growth bottleneck.
- **Inflation and monetary policy:** Croatia's meeting of price stability criterion (12-months average inflation rate cannot be higher than 1.5 percentage points above that of the three member states with the lowest inflation rate) will importantly depend on price developments in the rest of the EU. As of December 2021, Croatia's 12-months average inflation rate was 2.7%, compared to 0.8% of the average of the three countries with the lowest inflation rate (Greece, Malta and Portugal), and to 2.9% for the EU as a whole. In the context of the coronavirus pandemic, there is a high level of uncertainty as to how these rates will evolve in the coming months.
- **Labour market:** Labour market situation has been improving with a continuing economic recovery**.** Unemployment rate declined to 7.1% as of November 2021, remaining above the pre-Covid-19 rate of 6%.

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

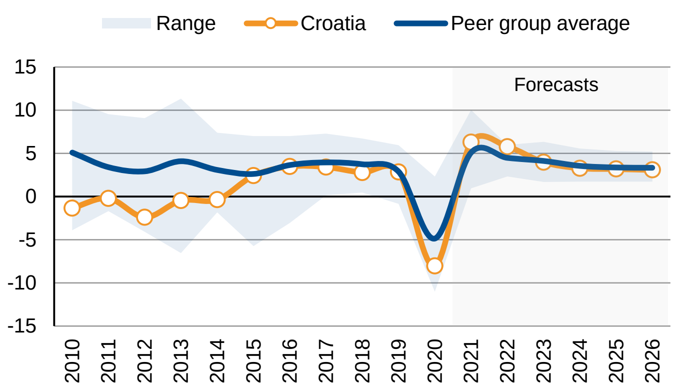
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Growth potential of the economy	Weak	-1/3	Weak growth potential due to low productivity growth and adverse demographics
	Monetary policy framework	Neutral	0	Credible central bank, adequate monetary-policy response during the pandemic crisis, exchange-rate flexibility limited under ERM II
	Macro-economic stability and sustainability	Weak	-1/3	Limited economic diversification, skilled labour shortages

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

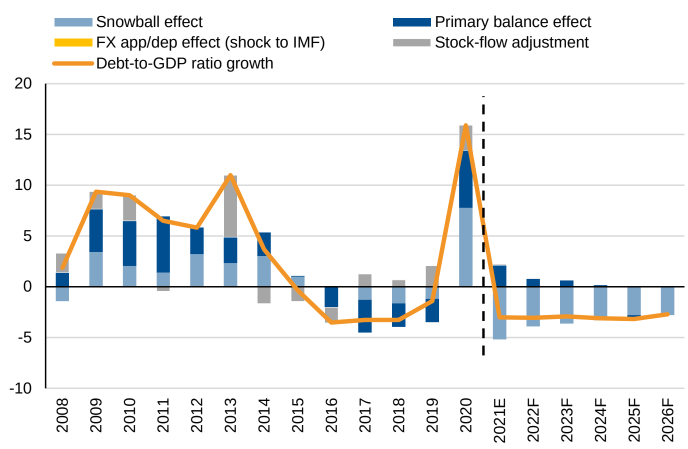
Public Finance Risks

- **Fiscal outlook**: Scope expects that the government will aim to keep the fiscal deficit below 3% of GDP Maastricht criteria over 2022-24 to qualify for the euro adoption. Our expectation is supported by Croatia's record of pre-pandemic prudent fiscal policies, resulting in fiscal surpluses over 2017-19. We project a gradual narrowing of fiscal deficit to 2.7% of GDP in 2022, 1.8% of GDP in 2023, and further to 1.5% of GDP in 2024, from an estimated 4.1% of GDP in 2021. The projected improvements in budget position and debt dynamics are being actively assisted by an improved outlook for tax revenue growth on the back of recovery in indirect taxation caused primarily by recovery of personal consumption and tourism activities, as well as the gradual expiry of Covid-19-related temporary support measures and Croatia's near-term solid economic recovery prospects.
- **Debt trajectory**: General government debt-to-GDP ratio is projected to diminish at a sufficient pace (the gap between a debt level and the 60% of GDP reference needs to be reduced by at least 5% annually on average over three years) to 77% by 2024, from an estimated 84% in 2021, enabling Croatia to avoid an excessive deficit procedure.
- **Market access**: The 12-months average secondary market yield on Croatian government bonds with maturities of ten years stood at 0.45% as of December 2021. The average yield on German bonds with comparable maturities was around -0.4% for the same period, representing the lowest such rate in the EU. This puts Croatia well within the reach of the interest rate convergence criterion, which stipulates that the long-term interest rate should not be higher than two percentage points above that of the three best-performing member states in terms of price stability.

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

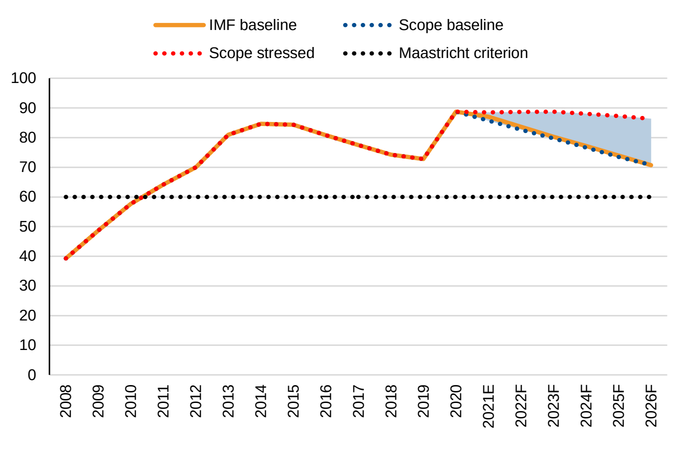
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Fiscal policy framework	Neutral	0	Pre-crisis fiscal surpluses, record of commitment to fiscal discipline, but comparatively restricted tax base
	Debt sustainability	Neutral	0	Elevated public-sector debt but projected gradual debt reduction over the medium run
	Debt profile and market access	Weak	-1/3	Favourable financing conditions, but significant foreign-currency exposure in public debt

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

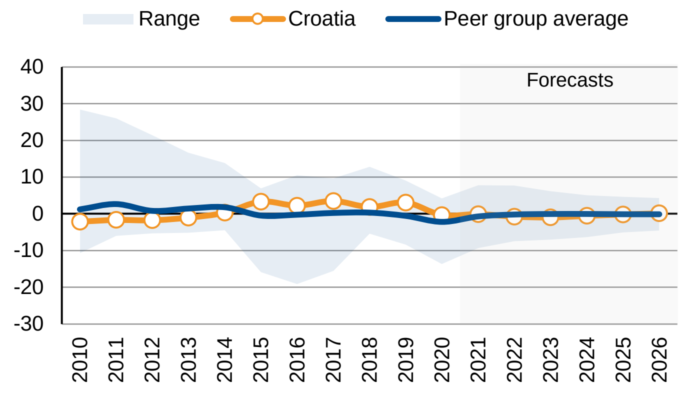
External Economic Risks

- **Current account**: Scope expects Croatia's current account deficit to be contained in the medium-term. However, Croatia's small, open economy remains vulnerable to external shocks and is reliant on external demand. Croatia's high reliance on the tourism and travel sector, which represents around quarter of GDP (including indirect impact on other economic sectors), makes the export outlook more exposed to pandemic-related developments.
- **External position**: Croatia's net external debt declined to around 5% of GDP in Q3 2021, from 14% of GDP on year before. However, currency risk is a vulnerability for the economy of Croatia, with more than half of all bank loans and over two-thirds of public debt denominated in foreign currency, almost entirely in euros. Scope considers these risks to be mitigated by the ERM II participation and a record of kuna's credible de-facto peg to the euro.
- **Resilience to shocks:** The presence of the Croatian kuna in the ERM II enhances Croatia's resilience to shocks. The exchange-rate criterion is expected to be fulfilled after the minimum two-year phase under ERM II, during which the kuna is allowed to fluctuate against the euro within stringent limits. Croatia's record of credible de-facto peg of the kuna to the euro and the Croatian National Bank's (CNB) sufficient reserves back the credibility of the exchange rate during the current period of participation in ERM II. International reserves increased to EUR 24.2bn as of end-November 2021, from EUR 18.6bn one year before. In addition, the CNB can borrow up to EUR 2bn from the ECB4 through a swap line agreement until March 2022.

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

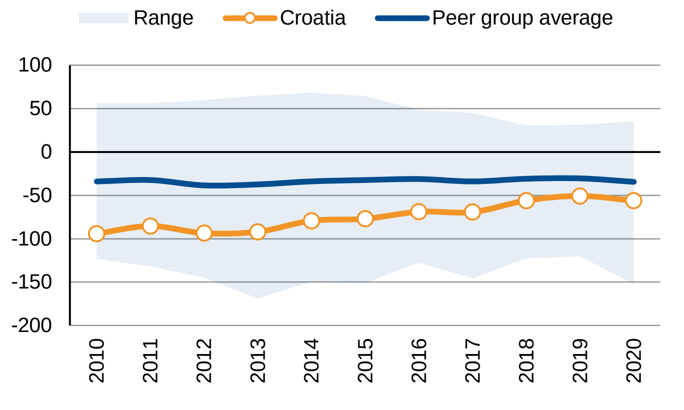
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Current account resilience	Weak	-1/3	High reliance on tourism revenues weakens exporting-sector resilience
	External debt structure	Neutral	0	Narrowing net external debt, but sizable share of debt-creating flows in external liabilities
	Resilience to short-term shocks	Neutral	0	Improved reserve adequacy and ERM-II admission support reduction of external-sector risks

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

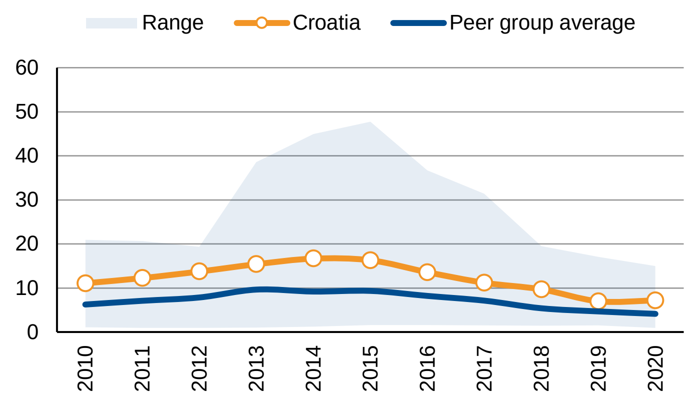
Financial Stability Risks

- **Banking sector**: Croatia's banking sector is well-capitalised and liquid, with the system-wide Tier 1 capital ratio at about 25% of risk-weighted assets, comparing favourably when looked at against the peers. Croatia's ratings benefit from reforms made to banking-sector governance, underscored by successful entry to the Banking Union. Starting from 1 October 2020, the ECB assumed direct supervisory responsibilities over eight "significant" Croatia banks. Maintenance of a commitment to reform in financial system governance is crucial over the period ahead.
- **Private debt**: More than half of all banking-system deposits and loans are in foreign currency, constituting a risk for the bank balance sheets. As foreign-currency bank deposits and loans are mostly denominated in euro, FX risk will be mainly eliminated upon event of euro adoption; however, the recent reduction in foreign currency in the banking system is nonetheless credit positive during the transitory phase in ERM II. In addition, non-financial private-sector debt stood at 98% of GDP as of end-2020, above end-2019 lows (88%) but below peaks of 122% of GDP in 2010.
- **Financial imbalances**: While the share of non-performing loans in total loans has continued to gradually fall to 6.3% in Q3 2021, down from over 10% in Q3 2018 supported by non-performing loan sales, it remains higher than in the peers. Via entrance to Banking Union, Croatia has joined the Single Resolution Mechanism (and Single Resolution Fund) in October 2020 – supporting institutional capacity to respond to banking failures more effectively in the future.

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

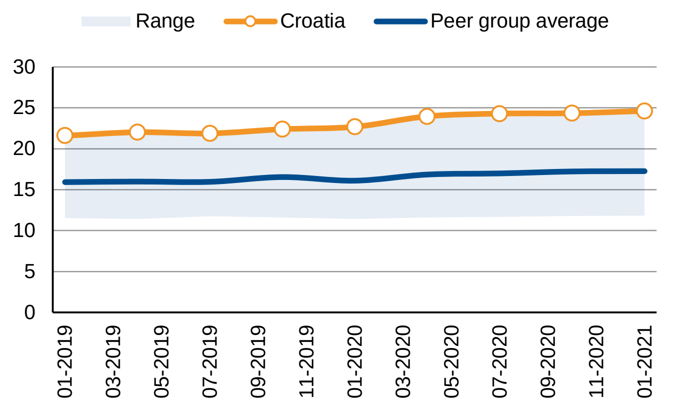
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Banking sector performance	Neutral	0	Well-capitalised and liquid banking sector; profitability and asset quality impacted by Covid crisis
	Banking sector oversight	Neutral	0	Effective supervision supported by the central bank's "close cooperation" with the ECB under European Banking Union
	Financial imbalances	Weak	-1/3	Significant foreign-currency exposure in the banking and private sectors mitigated by kuna's de-facto peg to the euro under ERM II

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

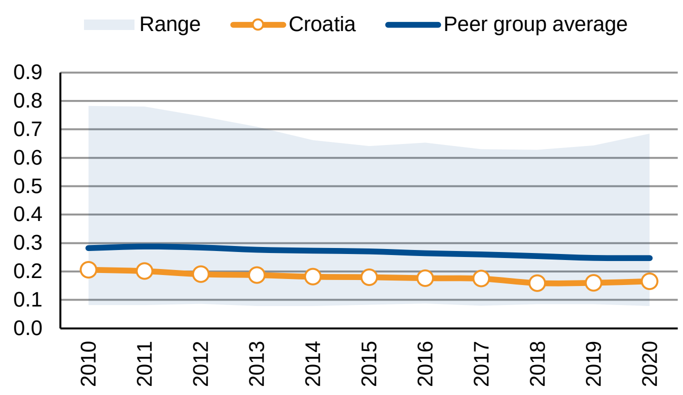
ESG Risks

- **Environment:** Environmental factors are explicitly considered in the rating process via the environment sub-category under the ESG risk pillar. The share of renewable energy in final energy consumption in Croatia is estimated at 31% in 2020, higher than the EU's 22%. Around 64% of Croatia's electricity was produced from renewables in 2020, primarily from hydropower.
- **Social:** Croatia's performance across key social factors is mixed. This is reflected in around-EU-average income inequality and poverty ratio (23% of the population was at risk of poverty or social exclusion in 2020, compared with the EU-27 figure of 22%); an unemployment rate (7.1% as of November) higher than the EU average (6.5%); and moderate labour participation rates. The European Commission's Digital Economy and Society Index 2021, which ranks the EU-27 countries for digital competitiveness, placed Croatia 19th (below-average).
- **Governance:** Under governance-related factors, Croatia has an average performance compared to the peer member states in central and eastern Europe as assessed under the World Bank's Worldwide Governance Indicators. Croatia's EU membership enhances 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*

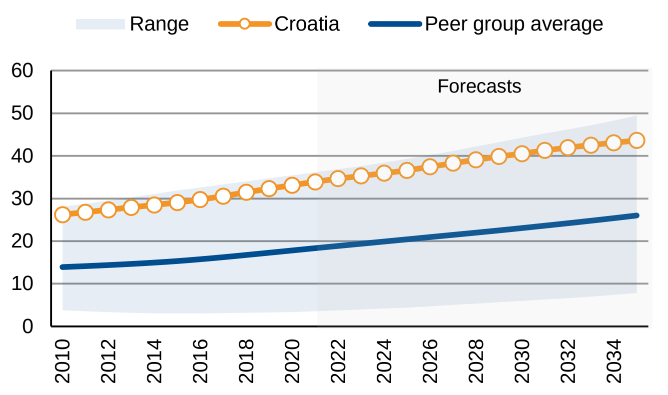
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Environmental risks	Neutral	0	Transition risks in line with peers, above-EU-average share of renewable energy in total energy consumption
	Social risks	Weak	-1/3	Relatively high human development, but low employment rate, adverse demographics in the form of an ageing population and net emigration
	Institutional and political risks	Neutral	0	Track record of political stability, moderate institutional capacity

CO2 emissions per GDP, mtCO2e



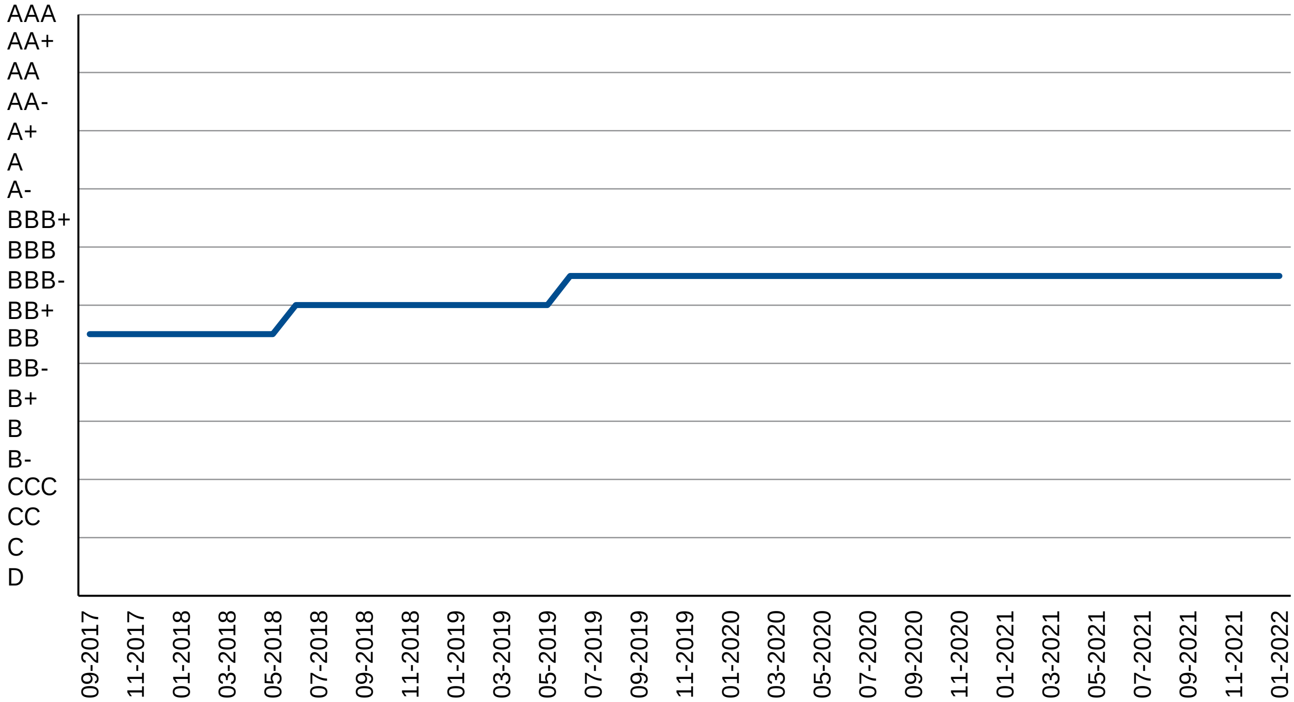
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



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.

Peer group
Hungary
Romania
Cyprus
Portugal
China

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 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s'	12.4	13.5	15.0	14.9	13.9	15.8	17.2
Nominal GDP, USD bn	51.6	55.5	61.4	60.8	56.2	63.4	68.5
Real growth, %[1]	3.5	3.4	2.9	3.5	-8.1	10.5	4.8
CPI inflation, %	-0.6	1.3	1.6	0.8	0.0	2.7	2.0
Unemployment rate, %[1]	13.1	11.2	8.4	6.6	7.5	8.0	7.0
Public Finance Risk							
Public debt, % of GDP[1]	80.8	77.5	74.3	72.8	88.7	84	81
Interest payment, % of government revenue	6.1	5.2	4.5	4.2	3.7	2.9	2.7
Primary balance, % of GDP[1]	2.0	3.2	2.3	2.3	-5.7	-2.6	-1.3
External Economic Risk							
Current account balance, % of GDP	2.3	3.5	1.9	3.0	-0.1	2.0	0.5
Total reserves, months of imports	6.7	7.9	7.0	7.2	9.4	-	-
NIIP, % of GDP	-72.4	-64.2	-55.7	-46.7	-47.8	-	-
Financial Stability Risk							
NPL ratio, % of total loans	13.6	11.2	9.7	7.0	7.2	-	-
Tier 1 ratio, % of risk weighted assets	20.9	21.8	21.8	22.4	24.3	25.2	-
Credit to private sector, % of GDP	59.4	56.3	54.6	53.1	59.8	-	-
ESG Risk							
CO^2 per EUR 1,000 of GDP, $mtCO^2e$	176.0	174.3	158.8	159.6	165.2	-	-
Income quintile share ratio (S80/S20), x	5.2	5.1	4.8	-	-	-	-
Labour force participation rate, %	65.6	66.5	66.6	67.0	-	-	-
Old age dependency ratio, %	29.7	30.6	31.4	32.3	33.1	33.9	34.6
Composite governance indicator[2]	0.4	0.4	0.5	0.4	0.4	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging Market and Developing Economy
5y USD CDS spread (bps) as of 28 January 2022	78

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