15 July 2022

Sovereign and Public Sector

Republic of Croatia
Rating Report

STABLE

BBB+

Credit strengths

- ERM II and Banking Union memberships, euro area membership from 1 January 2023
- Commitment to reform
- Reduction of risks in external and financial sectors

Credit challenges

- Elevated public debt ratio
- Modest growth potential despite lower wealth levels
- Lack of economic diversification

Rating rationale:

The rating upgrade reflects Croatia's recently formalised entry into the euro area on 1 January 2023 and adoption of the euro as local currency, with multiple credit-positive implications through the use of a global reserve currency, and stronger governance and flexibility of monetary policy. The replacement of the Croatian kuna with the euro will significantly curtail foreign-currency risks evident in its widely euroised economy, banking system and public debt stock.

The fact that Croatia stands ready to join the euro area next year at the earliest possible date under Exchange Rate Mechanism II (ERM II) agreements underlines the authorities' commitment to their reform agenda and the broad political backing for Croatia's accession across Europe. This is despite disruptions due to Covid-19 and Russia's full-scale invasion of Ukraine, which have driven inflationary developments in Croatia and Europe and caused budgetary deterioration as fiscal support was extended to mitigate the shocks.

Despite this, Croatia's ratings remain constrained by: 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 scorecard: Weight	Quantitative scorecard: Indicative rating	Reserve currency adjustment (notches)	Qualitative scorecard: Notches	Extraordinary adjustment* (notches)	Final rating
Domestic Economic Risk		35%	a-		-2/3		
Public Finance Risk		25%	bbb		-1/3		
External Economic Risk		10%	a+		-1/3		
Financial Stability Risk		10%	aa		0		BBB+
ESG Risk	Environmental Risk	5%	aaa		0		
	Social Risk	5%	bb-		-1/3		
	Governance Risk	10%	bb-		0		
Overall outcome			a-	0	-2	+1	

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. *This reflects a one-notch positive adjustment made at the rating committee level to account for Scope's expectation that Croatia will be issuing its local-currency debt in euros from 1 January 2023, and therefore benefit from a one-notch reserve currency adjustment to its indicative ratings as per Scope's sovereign ratings methodology. 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 to 18 months.

Positive rating-change drivers

- Structural reforms raise growth potential and improve economic diversification
- Improvements in fiscal performance, resulting in public debt ratio decline

Negative rating-change drivers

- Deterioration in the growth outlook
- Significant 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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Bloomberg: RESP SCOP

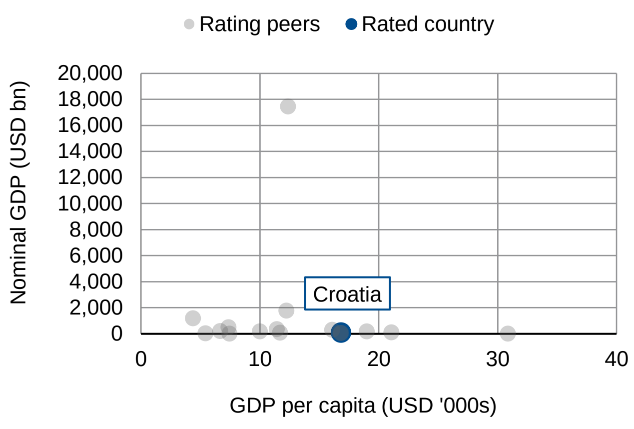
Domestic Economic Risks

- **Growth outlook:** We forecast Croatia's GDP will grow by 3.5% in 2022 and 3.7% in 2023 in real terms. This comes after the economy rebounded by 10.2% in 2021, which was supported mainly by domestic demand, encouraging prospects in tourism, and investments. In the medium-run, Croatia's economic prospects are held back by low productivity growth, limited economic diversification and adverse demographics. Some improvements should come from the inflow of sizeable EU funds, even though Croatia has been relatively slow in spending EU funds under the 2014-2020 multiannual financial framework. We estimate Croatia's growth potential at around 3% annually. Economic repercussions from the war in Ukraine are more limited than for other peers in the Central and Eastern European region given few direct linkages to Russia and Ukraine and a diversified network of energy imports limiting energy supply concerns.
- **Inflation and monetary policy:** HICP inflation was 10.8% YoY in May 2022, above the euro area average of 8.1%. High inflation has been driven by rapidly increasing energy and food prices and base effects due to low price levels in H1 2021. The 2022 Convergence Report confirms Croatia's fulfilment of the price stability criterion, as its inflation rate stayed below the reference value (which was 4.9% in April 2022, versus Croatia's 12-month average rate of 4.7%) over the assessment horizon.
- **Labour markets:** Croatia's labour market performance has been robust during the pandemic shock, and the unemployment rate declined further to 6.5% as of May 2022, after a peak of 9.8% in January 2021. The total number of employed persons stood at around 1.6m, or 2% higher than in December 2019. However, there are still some structural rigidities in the Croatian labour market, as evidenced by relatively low participation rates, especially among women and persons aged 55-64.

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

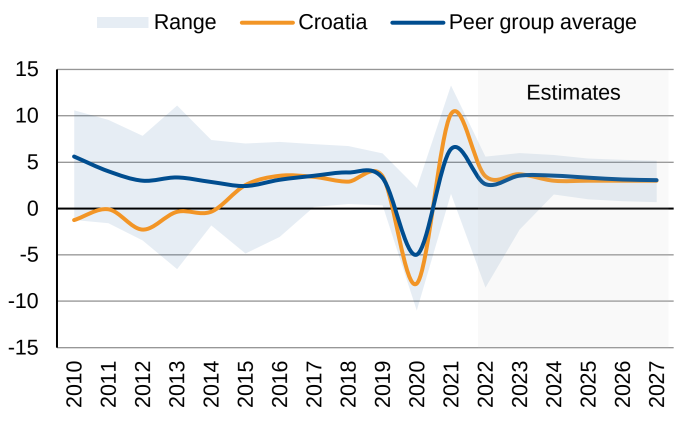
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Growth potential of the economy	Weak	-1/3	Modest growth potential due to low productivity growth and adverse demographics
	Monetary policy framework	Neutral	0	Credible central bank, exchange-rate flexibility limited under ERM II, entry into the eurosystem from 1 January 2023
	Macro-economic stability and sustainability	Weak	-1/3	Limited economic diversification, shortages of skilled labour

Nominal GDP and GDP per capita, USD '000s



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

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

Public Finance Risks

- **Fiscal outlook:** Croatia fulfilled the public finance convergence criterion, as assessed in the June 2022 Convergence Report, since it is not subject to an Excessive Deficit Procedure. The general government deficit was 2.9% of GDP in 2021, below the 3% Maastricht threshold. We expect a fiscal deficit of 2.8% of GDP in 2022 and 2.5% in 2023. The amended 2022 budget incorporates measures in response to the Russian full-scale invasion of Ukraine, such as counteracting cost-of-living pressures, support to businesses, and higher expenditure for hosting Ukrainian refugees, among others, with an overall cost increase relative to the original budget of HRK 10.9bn, or 6.3%.

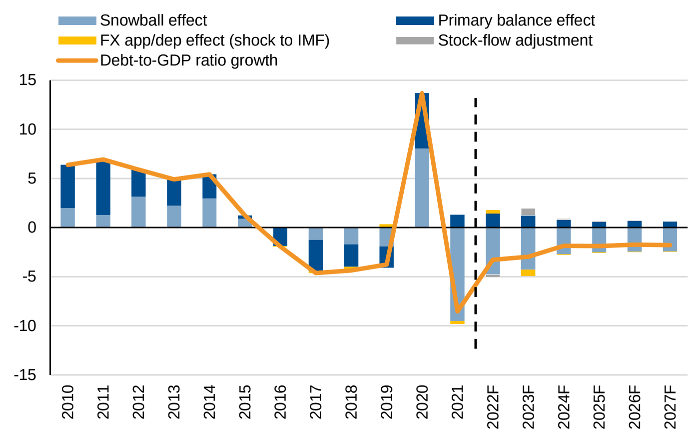
- **Debt trajectory:** The general government debt-to-GDP ratio stood at 79.8% in 2021, down from a peak at 87.3% in 2020. It is projected to decline to 71.7% by 2024 and 66.3% by the end of 2027, driven by high nominal GDP growth and fiscal deficits gradually recovering after pandemic-induced highs. Downside risks relate to worse-than-expected growth, due to travel restrictions amid a resurgence of Covid-19 cases, as well as higher-than-expected deficits to mitigate the dual shock of Covid-19 and the war in Ukraine.

- **Debt profile and market access:** Croatia fulfilled the interest rate convergence criterion, as confirmed in the Convergence Report. The reference value of a maximum 2.6% 12-month average yield on a single bond with a residual maturity of 7.5 years was met in April 2022, with Croatia's rate calculated at 0.8%. Overall, Croatia's general government interest expenditure as a percentage of GDP has declined markedly over recent years, from 3.4% in 2015 to 1.6% in 2021.

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

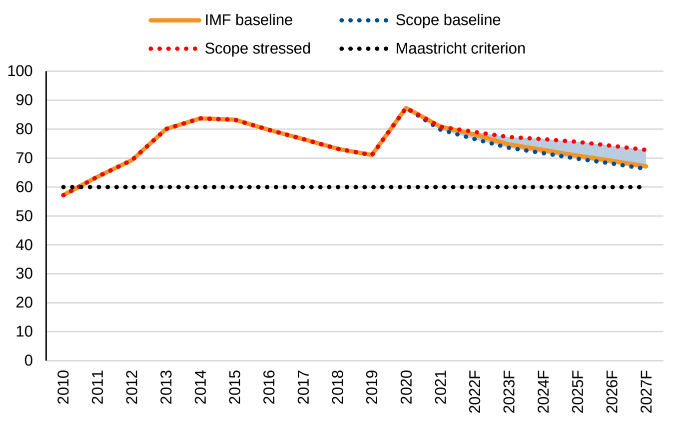
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Fiscal policy framework	Neutral	0	Pre-crisis fiscal surpluses, record of commitment to fiscal discipline, but comparatively restricted tax base
	Debt sustainability	Weak	-1/3	Elevated public-sector debt, gradual debt 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 to be mitigated by 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

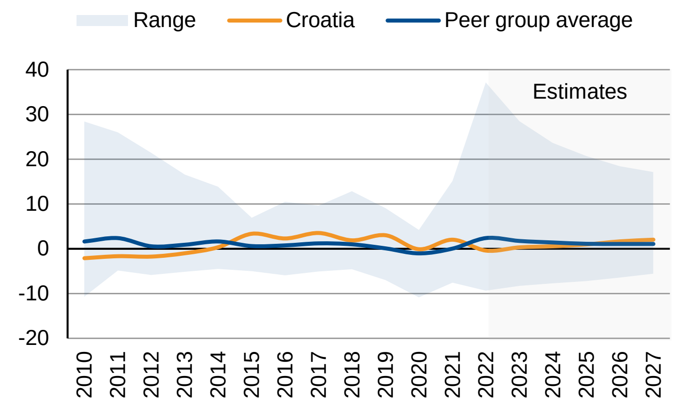
External Economic Risks

- **Current account:** Croatia's current account recorded a surplus of 3.4% of GDP in 2021 after -0.1% in 2020, due to its service balance returning to 17.2% of GDP from just 10.6% in 2020. The current account balance is expected by the IMF to turn slightly negative (-0.4% of GDP) in 2022 before recovering thereafter. However, Croatia's small, open economy remains vulnerable to external shocks and is reliant on external demand, especially tourism receipts. Expected positive developments in the tourism and travel sector - representing around a quarter of GDP (including indirect impact on other economic sectors) – should support a recovery in the current account over the medium term.
- **External position:** Croatia's external debt has declined to around 76.7% of four-quarter GDP as of Q1 2022, from around 100% of four-quarter GDP in Q1 2017. Most of external debt is incurred by the government and other sectors, and is long term. The country's net international investment position stood at a negative 37.5% of four-quarter GDP in Q1 2022, down from a negative 46.6% in 2019. Currency risk, a major vulnerability for Croatia (more than half of all bank loans and over two-thirds of public are denominated in foreign currency), is mitigated by the current exchange rate arrangements and will be significantly curtailed by adopting as local currency the euro on 1 January 2023.
- **Resilience to shocks:** The Croatian central bank uses a floating exchange-rate regime with a nominal peg to the euro as its primary monetary policy tool. Under ERM II, The Croatian kuna had to fluctuate within a 15%-band to a 7.53450 rate to the euro. Croatia has also met the exchange rate convergence criterion in the 2022 Convergence Report. Croatia's foreign exchange reserves stood at EUR 24.85bn as of end-May 2022, broadly stable from EUR 25bn at YE 2021.

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

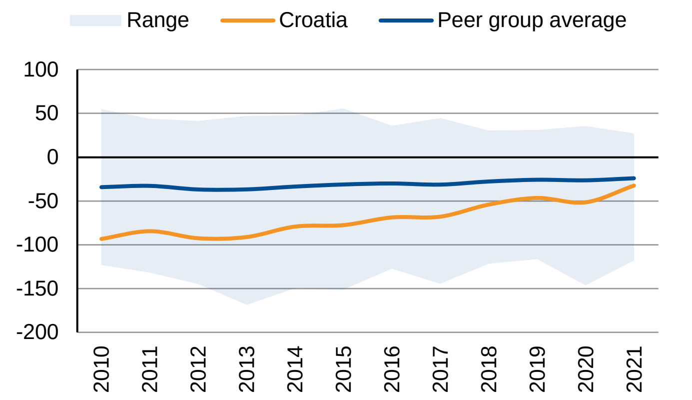
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Current account resilience	Weak	-1/3	High reliance on tourism revenues weakens exporting-sector resilience
	External debt structure	Neutral	0	Narrowing net external debt, but sizable share of debt-creating flows in external liabilities
	Resilience to short-term shocks	Neutral	0	Improved reserve adequacy, ERM-II and euro area membership from 2023 mitigate external-sector risks

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, with the system-wide Tier 1 capital ratio at about 25.2% of risk-weighted assets at the end of September 2021, which compares favourably to peers. After a small increase in 2020, the share of NPLs in gross loans has dropped to 4.3% at YE 2021, although the share of NPLs in total loans to non-financial corporates remains high at 9.9%.

  Croatia's ratings benefit from reforms made to banking-sector governance, underscored by successful entry to Banking Union, the Single Resolution Mechanism and the Single Resolution Fund. Starting from 1 October 2020, the ECB assumed direct supervisory responsibilities over significant Croatian banks and oversight over less significant institutions.

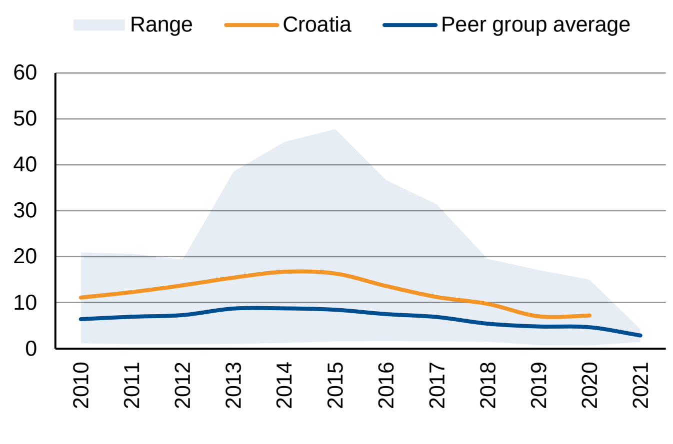
- **Private debt:** Household debt amounted to 36.1% of GDP at YE 2021, while total debt incurred by non-financial corporates stood at 83.4% of GDP at YE 2021, broadly unchanged from pre-pandemic levels. Around half of household debt is denominated in foreign currency, however currency risks are significantly mitigated by ERM II membership and the upcoming entry into the euro area.

- **Financial imbalances:** We observe a relatively strong sovereign-bank nexus in Croatia, with Croatian central government debt securities making up over 20% of total bank assets. Further, there is high exposure to the real estate market, as 45% of bank loans are classified as mortgages, increasing sensitivity to housing market developments. Mortgage lending in Croatia has moderated recently to 8% YoY in March 2022, from 11.3% in October 2021.

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

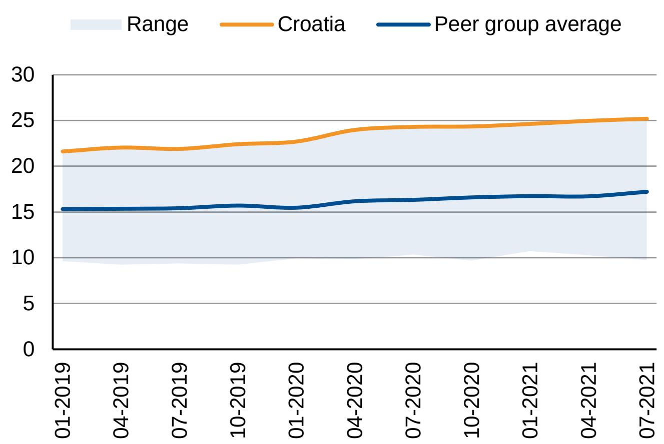
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector
	Banking sector oversight	Neutral	0	Effective supervision supported by the central bank's close cooperation with the ECB under Banking Union
	Financial imbalances	Neutral	0	Significant foreign-currency exposure in the banking and private sectors mitigated by kuna's de facto peg to the euro under ERM II, to be significantly curtailed by adoption of euro

Non-performing loans (NPLs), % of total loans



Source: World Bank, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

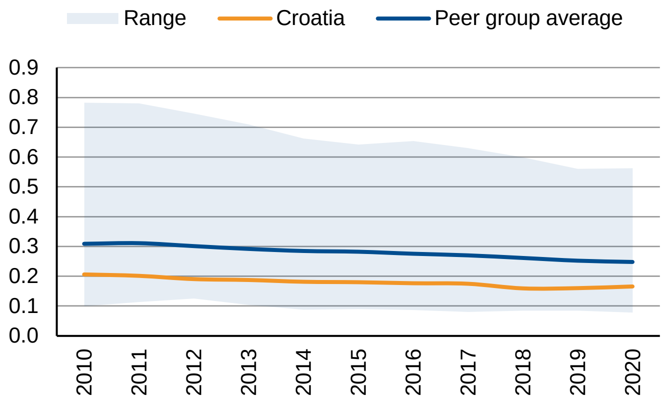
ESG Risks

- **Environment:** The government is aiming for a 45% reduction in carbon emissions by 2030 relative to 1990 levels and net carbon neutrality by 2050. Croatia's share of renewable energy in final energy consumption was estimated at 31% in 2020, higher than the EU's 22%. A full phase-out for coal is planned for 2033. Around 64% of Croatia's electricity came from renewables in 2020, mainly from hydropower.
- **Social:** The share of the population at risk of poverty (20.5% in 2020) has declined over time and stands below the euro area average. The European Commission's Digital Economy and Society Index 2021, which ranks the EU-27 countries for digital competitiveness, placed Croatia 19th, 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*

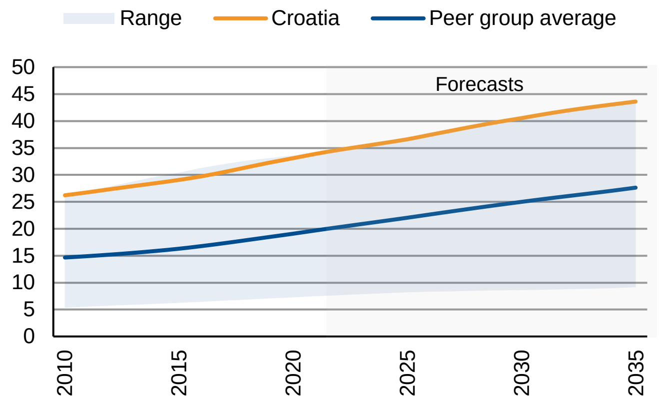
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Environmental risks	Neutral	0	Transition risks in line with peers, above-EU-average share of renewable energy in total energy consumption
	Social risks	Weak	-1/3	Relatively high human development, but low employment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

CO_2 emissions per GDP, $mtCO_2e$



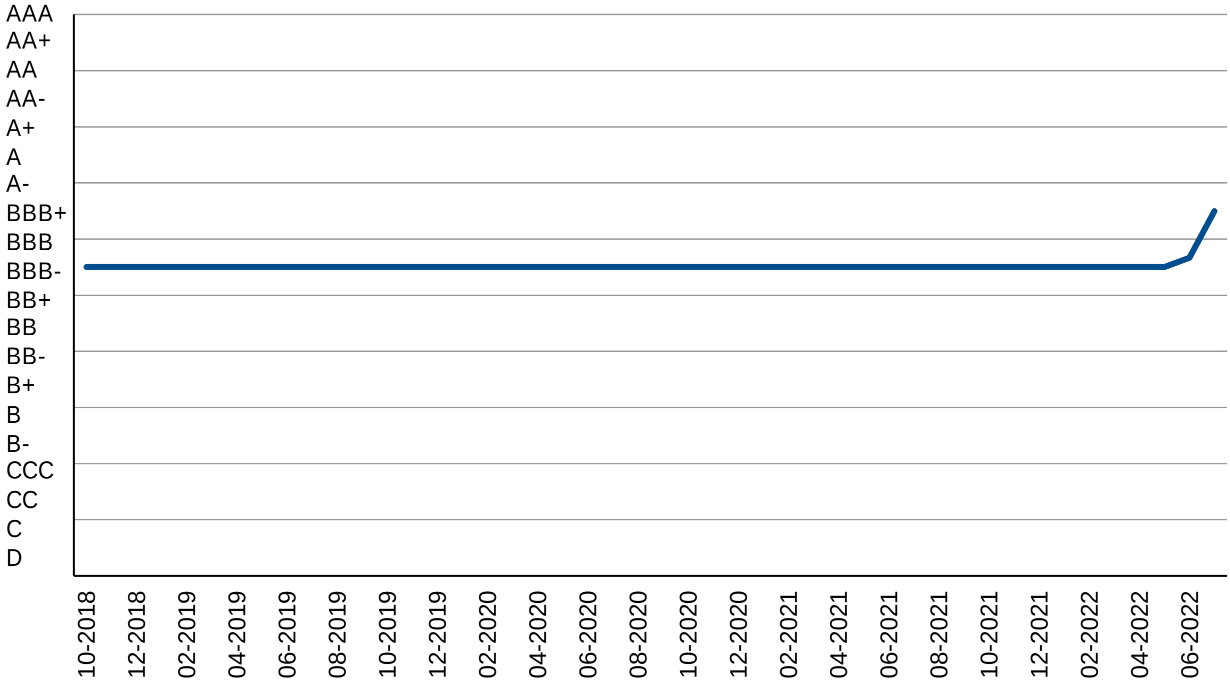
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



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 embedding a methodological reserve-currency adjustment.

Peer group*
Bulgaria
China
Croatia
Cyprus
Hungary
Russia
Slovakia

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 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021	2022E	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	12.5	13.6	15.2	15.3	14.1	16.8	17.3	19.0
Nominal GDP, USD bn	52.3	56.2	62.2	62.2	57.2	67.8	69.5	75.8
Real growth, %[1]	3.5	3.4	2.9	3.5	-8.1	10.2	3.5	3.7
CPI inflation, %	-1.1	1.1	1.5	0.8	0.1	2.6	5.9	2.7
Unemployment rate, %[1]	15.0	12.4	9.9	7.8	9.0	8.2	6.7	6.2
Public Finance Risk								
Public debt, % of GDP[1]	79.7	76.5	73.2	71.1	87.3	79.8	76.5	73.5
Interest payment, % of government revenue	6.1	5.2	4.5	4.2	3.7	2.9	2.6	2.4
Primary balance, % of GDP[1]	1.9	3.2	2.3	2.2	-5.6	-1.3	-1.4	-1.2
External Economic Risk								
Current account balance, % of GDP	2.3	3.5	1.9	3.0	-0.1	2.0	-0.4	0.3
Total reserves, months of imports	6.7	7.9	7.0	7.1	9.4	-	-	-
NIIP, % of GDP	-68.8	-68.0	-54.2	-46.6	-51.6	-32.5	-	-
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	4.6	-	-	-	-
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	35.3
Composite governance indicator[2]	0.4	0.4	0.5	0.4	0.4	-	-	-

[1] Forecasted values are produced by Scope
[2] Average of the six World Bank Worldwide Governance Indicators
Source: European Commission, IMF WEO, World Bank, Scope Ratings

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging Market and Developing Economy
5y USD CDS spread (bps), as of 14 July 2022	118

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