Republic of Croatia
Rating Report

SCOPE BBB+ STABLE OUTLOOK

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:

Upcoming euro area membership: Croatia is set to formally join the euro area on 1 January 2023, with multiple, significant credit positive implications through the use of a global reserve currency, and stronger governance and flexibility of monetary policy.

Commitment to reform and fiscal discipline: The Croatian government has shown an ongoing commitment to structural reforms and fiscal prudence in line with the euro 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.

Reduced external and financial sector risks: Reforms adopted ahead of Croatia's Exchange Rate Mechanism II and the European Banking Union accessions have markedly improved the supervision of the financial sector. 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.

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+	HRK [+0]	-2/3	BBB+
Public Finance Risk		20%	aa		-1/3	
External Economic Risk		10%	a		-1/3	
Financial Stability Risk		10%	aa+		0	
ESG Risk	Environmental Factors	5%	aa+		0	
	Social Factors	7.5%	ccc		-1/3	
	Governance Factors	12.5%	bb		0	
Indicative outcome		**a-**			**-2**	
Additional considerations*					**+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.

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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Bloomberg: RESP SCOP

Domestic Economic Risks

- **Growth outlook:** Following a buoyant post-pandemic recovery, with real GDP up by 13.1% in 2021, economic growth remained strong in the first half of 2022, bringing seasonally adjusted quarterly GDP more than 10pps above its end-2019 level by end-Q2 2022. This dynamism was supported by a marked rebound in goods and tourism exports, as well as by robust private consumption and investment growth. Quarterly growth turned negative in Q3 2022 (-0.4% QoQ), however, signalling a weakening of the economic momentum. We anticipate a further slowdown over coming quarters, primarily due moderation in private consumption amid elevated prices, tightening funding conditions and heightened uncertainty. We estimate growth will remain robust this year, at 6.3%, primarily thanks to significant carry-over from H1 2022. It should then decelerate to 1.8% in 2023, due to subdued household consumption growth and weaker external demand and despite rising public investment, before gradually trending back to the medium-term potential in subsequent years, which we estimate at around 3% annually. Weak productivity growth, limited economic diversification and adverse demographic trends constitute material drags to the long-term growth outlook.

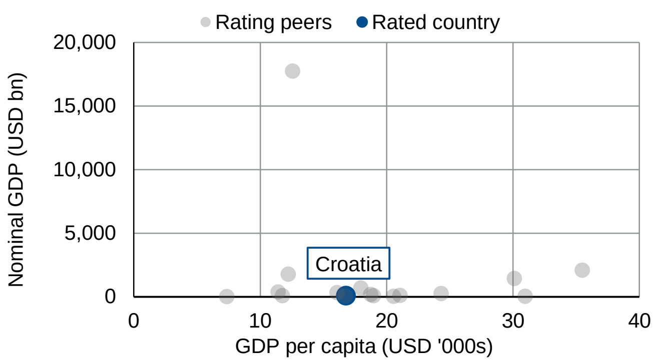
- **Inflation and monetary policy:** HICP inflation has stabilised at very elevated levels in recent months, rising to 12.7% YoY in October, well above the euro area average (10.6%). While energy and food prices remain the main drivers of price dynamics, core inflation has increased markedly as well (9.7%), signalling a broadening of price pressures. Despite a significant pick up in nominal wage growth, it has been outpaced by that of consumer prices, resulting in a sharp dip in real wages. The European Commission's latest Convergence Report, published in June 2022, confirmed Croatia's fulfilment of the price stability criterion, with its inflation rate averaging at 4.7% in the year to April 2022, below the reference value of 4.9%.

- **Labour markets:** Croatia's labour market recovered well from the Covid-19 shock, producing steady employment gains over the past year, bringing the employment rate (aged 15-64 years) to historical highs, at 64.9% as of Q2 2022. Despite a recent moderate uptick, the unemployment rate remains moderate, below pre-pandemic levels, at 6.5% as of October, having declined from January 2022 peaks of 9.8%. 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*

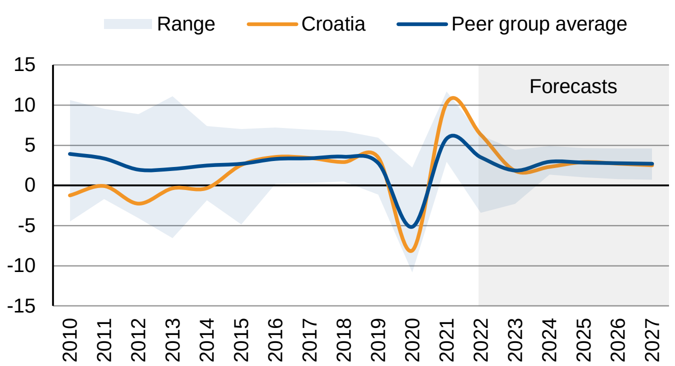
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Growth potential of the economy	Weak	-1/3	Modest growth potential due to low productivity growth and adverse demographics
	Monetary policy framework	Neutral	0	Credible central bank, exchange-rate flexibility limited 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

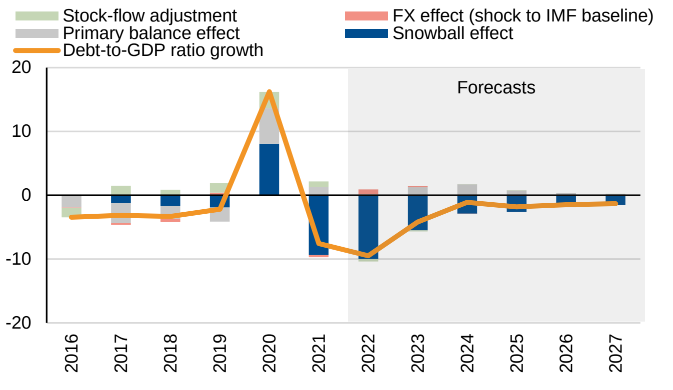
Public Finance Risks

- **Fiscal outlook:** Croatia's fiscal deficit narrowed to 2.6% of GDP in 2021 from 7.3% in 2020, and we anticipate a further reduction of the headline budget deficit to about 1.4% of GDP this year. High nominal economic growth led to a significant rebound in revenue, while spending on Covid-19 support measures declined, resulting in small surplus in the first half of the year. The government has adopted a number of temporary and structural measures aimed at cushioning the impact of price pressures on the private sector, including cuts to VAT on energy products, increased social transfers and the introduction of a cap on energy and food prices, for a total estimated cost of 0.8% and 1.1% of GDP in 2022 and 2023, respectively. We expect the impact of these policies, combined with growing spending pressures from public wages and social benefits in the current inflationary environment, and weakening real growth from next year, will lead to an increase in the headline deficit over the next two years – to about 2.5% and 2.9% of GDP in 2023 and 2024 (thus remaining below the 3% Maastricht threshold), respectively, before gradually declining in subsequent years, down to around 1.3% by 2027.
- **Debt trajectory:** The general government debt-to-GDP ratio stood at 78.4% in 2021, down from a peak at 87.3% in 2020. It is projected to edge back to its pre-pandemic level this year, at 70.3%, and to trend down to around 60% by the end of 2027, driven by high 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 entry into the euro area from next year.
- **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%. Croatia's general government interest expenditure as a share of GDP has declined sharply over recent years, from 3.4% in 2015 to 1.6% in 2021, though we expect this trend to ease markedly over coming years, as a result of rising market funding rates. The yield on 10-year bonds averaged at 4.02% in October 2022, up 3.7pps from the same period last year. The Croatian government's funding outlook will be supported by the disbursement of grants from the country's Recovery and Resilience Facility, expected to fund expenditures amounting to 0.5% and 1.2% of GDP in 2022 and 2023, respectively.

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

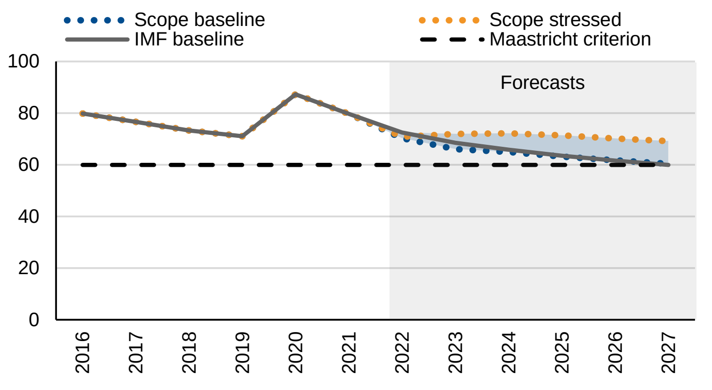
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Fiscal policy framework	Neutral	0	Pre-crisis fiscal surpluses, record of commitment to fiscal discipline, but comparatively restricted tax base
	Debt sustainability	Weak	-1/3	Elevated public-sector debt, gradual debt 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 entered the pandemic after a period of steady current account surpluses, averaging 2.8% of GDP over 2015-19. After a small deficit in 2020, it rebounded to a 3.2% surplus in 2021 thanks to a robust recovery in international tourism receipts and strong goods exports performance. It had declined sharply in recent months however, down to 0.2% in the year to Q2 2022, amid soaring nominal energy and raw material imports. Direct exposure to the war in Ukraine is limited, with Russia and Ukraine accounting for 1.6% of Croatian goods exports and around 2% of international tourists in 2021. Moving forward, weaker external demand from key European trading partners and still-elevated global energy and commodity prices will weigh on the recovery of the external balance over the medium-term, despite expectations of a continued recovery in foreign tourism.

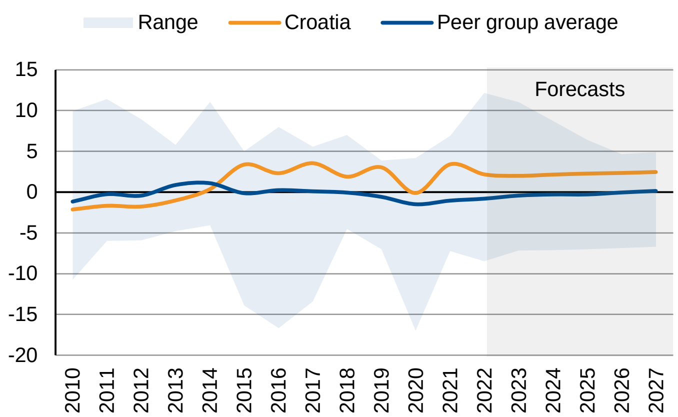
- **External position:** Croatia's external debt has declined to around 75% of four-quarter GDP as of Q2 2022, down from around 90% of four-quarter GDP in Q2 2017. Its composition is favourable, being mostly long term (57% of total) as well as being primarily comprised of public sector liabilities (42%). The country's net international investment position stood at a negative 34% of four-quarter GDP in Q2 2022, having improved markedly from a negative 73% in Q2 2017. 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 following the adoption of the euro as local currency from 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. 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 above EUR 26bn as of September 2022, having increased slightly from year-end 2021 (+5%).

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

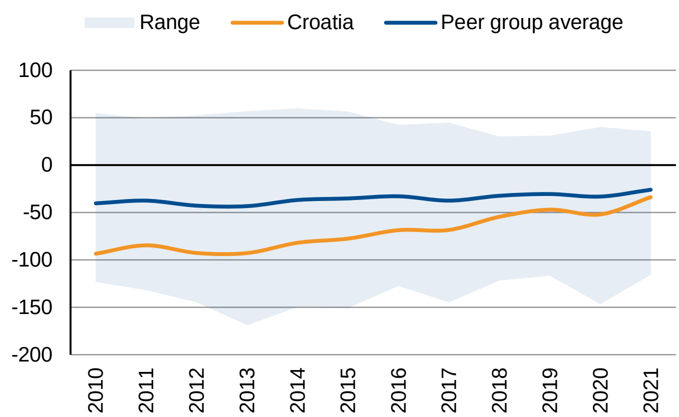
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Current account resilience	Weak	-1/3	High reliance on tourism revenues weakens exporting-sector resilience
	External debt structure	Neutral	0	Narrowing net external debt, but sizable share of debt-creating flows in external liabilities
	Resilience to short-term external 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

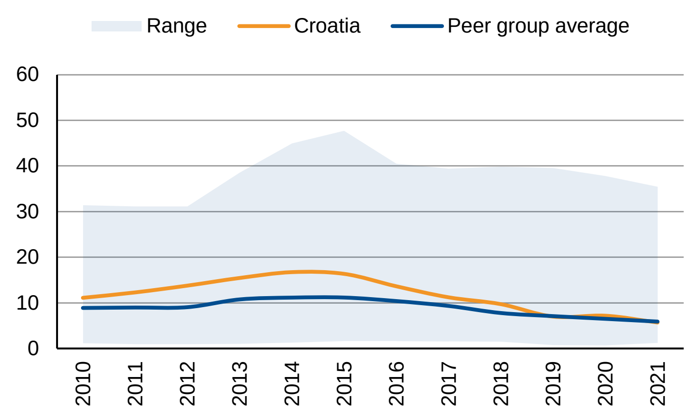
Financial Stability Risks

- **Banking sector:** Croatia's banking sector is well capitalised and profitable, as reflected in aggregate tier 1 capital and return-on-equity ratios of 23.5% and 10.2% as of Q3 2022, respectively - both among the highest within Croatia's rating 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 (3.3% as of Q3 2022). At the same time, it remained well above the euro area average (1.8%), with still elevated ratios for individual borrower segments such as non-financial corporates (6.5%) and households (5.5%). Profitability should remain strong, supported by the rise in interest rates and by comparatively moderate cost-to-income ratios. Croatia's ratings benefit from reforms made to banking-sector governance, underscored by successful entry to the 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 around 33% of GDP at end-H1 2022, while total debt incurred by non-financial corporates stood at 82% of GDP, broadly unchanged from pre-pandemic levels. While around half of household debt is denominated in foreign currency, 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. Additionally, mortgages represent around 45% 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 H2 2021. 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*

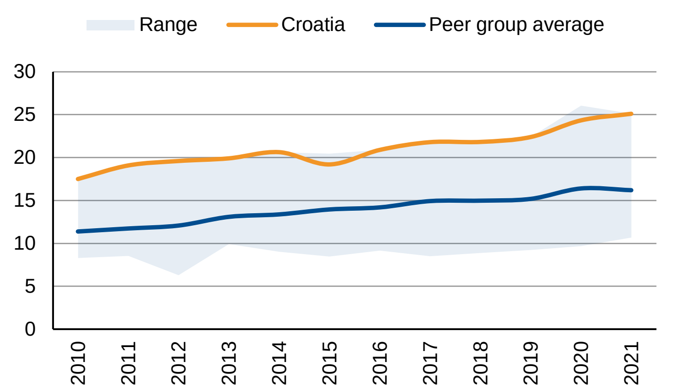
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Banking sector performance	Neutral	0	Well-capitalised and profitable banking sector
	Banking sector oversight	Neutral	0	Effective supervision supported by the central bank's close cooperation with the ECB under Banking 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, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

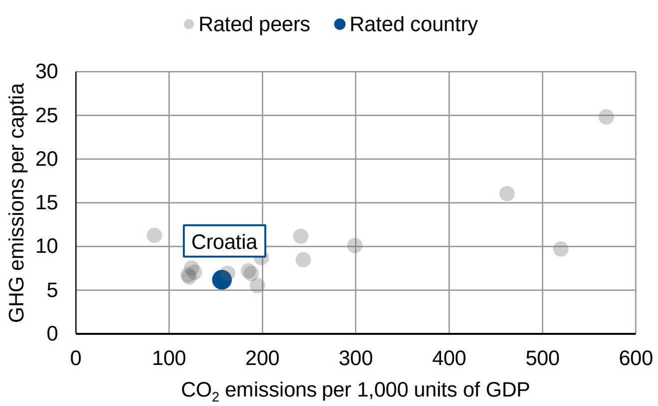
ESG Risks

- **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 amounting to EUR 6.3bn, or about 11.6% 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 2020, higher than the EU average of 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 (19.2% in 2021) has declined in recent years, albeit remaining 2.4pps above the euro area 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*

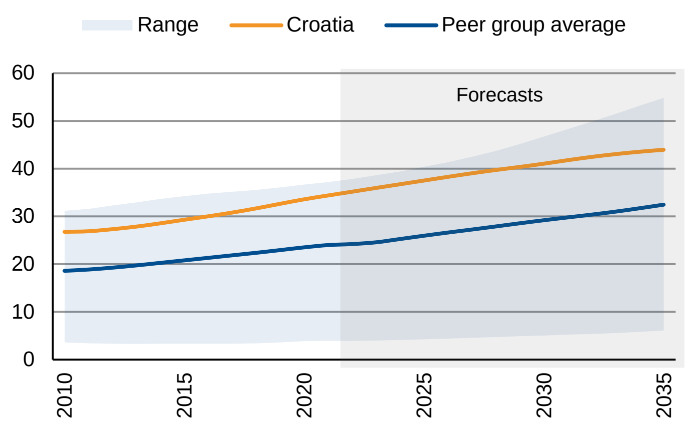
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Environmental factors	Neutral	0	Transition risks in line with peers, above-EU-average share of renewable energy in total energy consumption
	Social factors	Weak	-1/3	Relatively high human development, but low employment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

Emissions per GDP and per capita, $mtCO_2e$



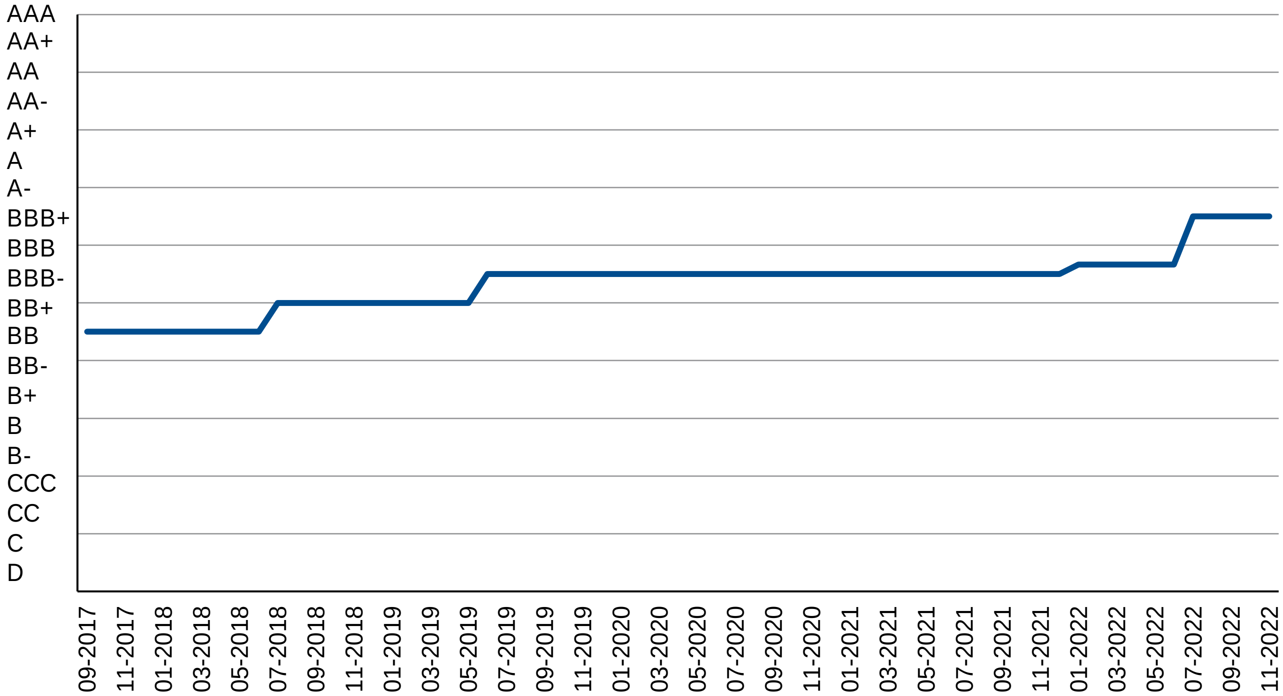
Source: European Commission, Scope Ratings

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*
Bulgaria
China
Cyprus
Hungary
Italy
Latvia
Poland
Portugal
Slovakia
Spain

*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	2017	2018	2019	2020	2021
Domestic Economic	GDP per capita, USD '000s	IMF	13,628	15,227	15,313	14,131	16,785
	Nominal GDP, USD bn	IMF	56.2	62.2	62.2	57.2	67.7
	Real growth, %	IMF	3.4	2.9	3.5	-8.1	10.2
	CPI inflation, %	IMF	1.1	1.5	0.8	0.1	2.6
	Unemployment rate, %	WB	11.2	8.4	6.6	7.5	8.7
Public Finance	Public debt, % of GDP	IMF	76.7	73.3	71.1	87.3	79.8
	Interest payment, % of revenue	IMF	5.3	4.5	4.2	3.7	2.9
	Primary balance, % of GDP	IMF	3.2	2.0	2.2	-5.6	-1.6
External Economic	Current account balance, % of GDP	IMF	3.5	1.9	3.0	-0.1	3.4
	Total reserves, months of imports	WB	7.9	7.0	7.1	9.4	8.6
	NIIP, % of GDP	IMF	-68.3	-54.4	-46.9	-51.9	-33.7
Financial Stability	NPL ratio, % of total loans	IMF	11.2	9.7	7.0	7.2	-
	Tier 1 ratio, % of risk-weighted assets	IMF	21.6	21.7	21.6	22.7	24.6
	Credit to private sector, % of GDP	WB	56.3	54.6	53.1	59.8	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	172.2	158.6	155.0	156.8	148.7
	Income share of bottom 50%, %	WID	18.5	18.4	18.4	18.4	18.4
	Labour-force participation rate, %	WB	66.5	66.6	67.0	-	-
	Old-age dependency ratio, %	UN	30.6	31.4	32.3	33.1	33.9
	Composite governance indicators*	WB	0.4	0.5	0.4	0.4	-

* 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 5 December 2022	104

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