

Five consecutive years of economic decline

General Information



GDP	USD56.44 billion (World ranking 73, World Bank 2012)
Population	4.27 million (World ranking 125, World Bank 2012)
Form of state	Parliamentary Democracy
Head of government	Zoran MILANOVIC
Next elections	December 2014, presidential



Strengths

- Good international relations; EU membership
- Track record of comparatively low inflation
- Exchange rate stability thanks to "managed float"

Weaknesses

- Vulnerability to EU business cycle
- Protracted recession since 2009 (5 years)
- Sharp credit contraction as a result of bank deleveraging
- Rapidly deteriorating public finances have resulted in sovereign downgrades to speculative grade
- Very high external debt
- Considerable refinancing risk of companies and banks

Country Rating

C4

Country Grade



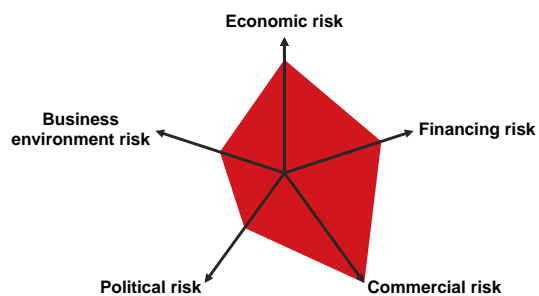
High risk

Low risk

Country Risk Level

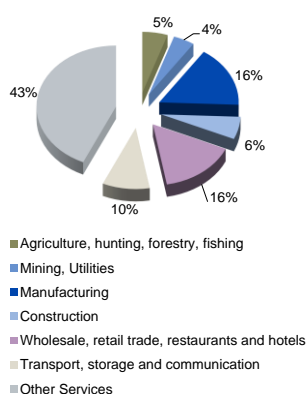


Risk Dimensions



Economic Structure

GDP breakdown (% of total, 2011)



Sources: Chelem, IHS Global Insight, Euler Hermes

Trade structure (% of total, 2011)

By destination / origin

Exports	Rank	Imports
Italy	16%	13%
Bosnia and Herzegovina	12%	13%
Slovenia	10%	8%
Germany	9%	8%
Austria	6%	7%

By product

Exports	Rank	Imports
Refined Petroleum Products	10%	9%
Ships	7%	6%
Pharmaceuticals	4%	4%
Electricity	4%	4%
Electrical Apparatus	4%	4%

Economic Forecast

	2010	2011	2012	2013	2014f	2015f
GDP growth (% change)	-2.3	-0.2	-1.9	-1.0	0.2	1.2
Inflation (% end-year)	1.9	2.0	4.7	0.3	1.0	1.4
Fiscal balance (% of GDP)	-6.4	-7.8	-5.0	-4.9	-4.5	-4.0
Public debt (% of GDP)	45.0	52.0	55.9	67.1	69.0	70.0
Current account (% of GDP)	-1.2	-0.9	-0.0	1.2	1.0	0.5
External debt (% of GDP)	104.7	96.5	102.4	106.4	105.5	105.0

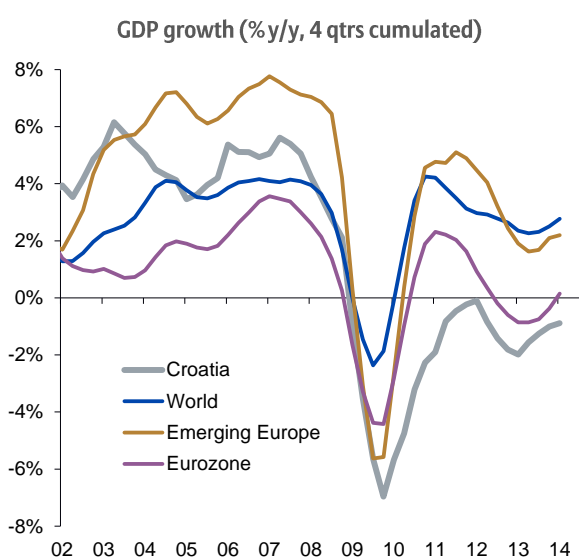
Source: IHS Global Insight, national sources, Euler Hermes

Economic Growth

Return to meagre growth in 2014 after five consecutive years of economic decline?

Croatia remains caught in an unusually protracted recession. Real GDP decreased by -1% in 2013, marking the fifth consecutive year of contraction and leaving the level of annual real GDP -12% lower than at its peak in 2008. Both domestic and external demand remained weak in 2013. Some fiscal stimulus helped government consumption to pick up by +0.5%, but private consumption and fixed investment declined by -1.2% and -1.3%, respectively. Weak domestic demand also affected imports, which shrank by -2%. Exports – which had still managed to grow modestly in the previous three years – also fell, by -1.2%, but the smaller decline as compared to imports meant that net exports made a positive contribution to full-year growth.

Real GDP continued to decrease by -0.4% y/y in Q1 2014 – marking the tenth consecutive quarter of decline – albeit at a lower pace than in Q4 2013 (-1.2% y/y). Domestic demand continued to be weak, with private consumption down by -0.5% y/y, government consumption -1.9% y/y and fixed investment -3.6% y/y. But external trade activity gained momentum, with exports increasing by +6.1% y/y and imports +2.5% y/y, so that net exports contributed +1pp to Q1 growth. EH expects that the EU recovery will help the Croatian economy to return to modest expansion in H2 2014, possibly enabling full-year real GDP growth of +0.2% or so, followed by +1.2% in 2015.



Sources: IHS Global Insight, national sources, Euler Hermes

Economic Policies

The monetary policy framework is based on a “managed” exchange rate float which has helped insulate the economy from overly inflationary pressures.

Broad HRK/EUR stability to continue in 2014

Despite frequent downward pressure on the Croatian kuna (HRK) in recent years, the central bank has maintained broad stability in the HRK/EUR exchange rate through intervention in the foreign exchange (FX) market, allowing only a gradual depreciation. Since official FX reserves are still at a comfortable level, we expect the central bank to continue to intervene in order to minimise currency volatility, if needed. Stability of the HRK/EUR rate is important because of a high level of euroisation in the economy and the banking system. For example, around 60% of bank lending to the private sector is denominated in EUR. Positively, the real effective exchange rate is currently not overvalued.

Deflation risk

Headline inflation has fallen from 4.7% at end-2012 to just 0.3% at end-2013 and shifted to deflation in 2014 (-0.5% y/y in April), as VAT increases from 2012 fell out of the calculation while ongoing weak domestic demand and very tight domestic credit conditions have kept price pressures low. As this background will improve only gradually and because the central bank is unlikely to lower interest rates markedly as this would jeopardise exchange rate stability, EH expects several more months of deflation. If the economy eventually moves out of recession in the course of 2014 – as assumed in our current central case forecast – inflation should return to positive territory and reach about 1% at end-2014.

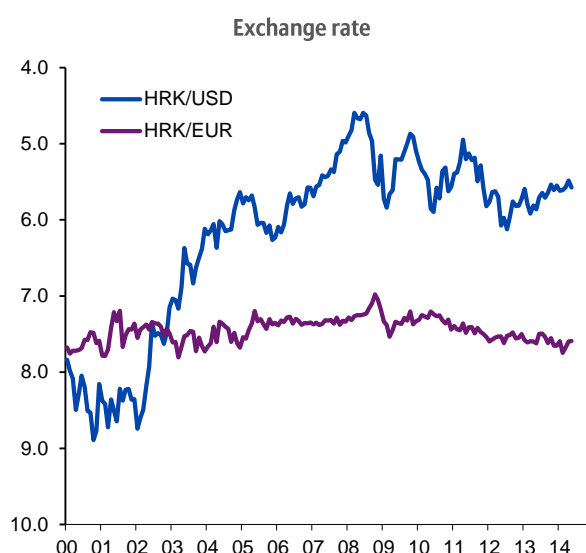
Banking sector weaknesses

The Croatian banking sector was resilient in 2009 but is now exposed to the Eurozone crisis, as subsidiaries of Eurozone banks dominate the sector (48% Italy, 36% Austria). Croatian banks are still adequately capitalised so far, but credit quality and profitability have deteriorated slowly as liquidity problems of the corporate sector have caused an increase in the share of non-performing loans (NPLs) to total loans from 4.8% in 2007 to 15.4% in 2013 (corporate NPLs 27%). Since parent banks are consolidating and extremely cautious now, credit conditions in Croatia have tightened since 2012 and will remain squeezed for some time. Real domestic credit contracted by 2.4% in 2013 and 5.1% in 2012, after it had still grown by 5.4% in 2011.

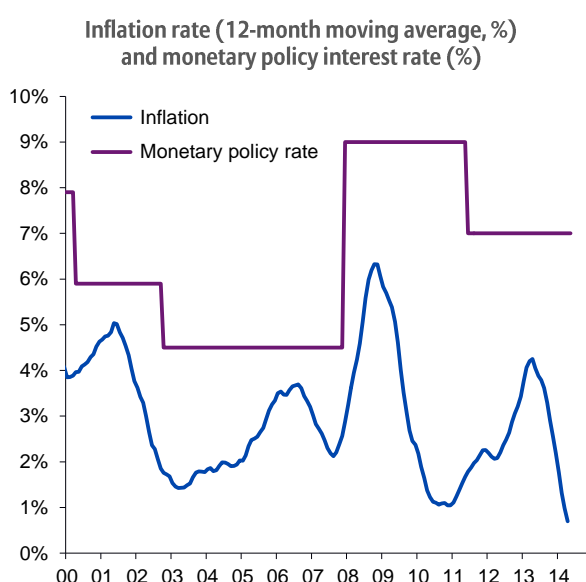
Public finances remain worrisome

The prolonged recession has put pressure on public finances. The fiscal deficit (ESA-95 basis) remained high at about 5% of GDP in 2013 and is forecast to improve only slightly to 4.5% in 2014 and 4% in 2015. Public debt has rapidly increased from 29% of GDP in 2008 to 67% in 2013 and is forecast to rise further. Additionally, government guarantees account for about 15% of GDP. Around 75% of public debt is denominated in or linked to foreign exchange. Reflecting these developments, all major rating agencies have downgraded Croatia to speculative grade in 2012-2013.

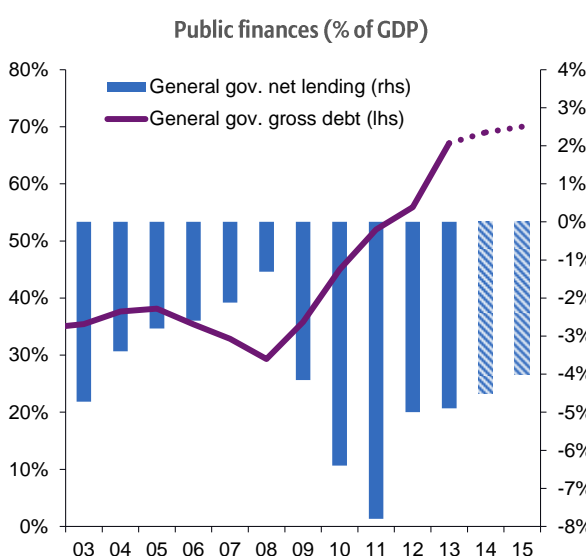
Nonetheless, external financing conditions have remained manageable thus far. Croatia has been only mildly affected by the bouts of emerging market turbulence in 2013-2014 and was able to issue international bonds in November 2013 (USD1.75 bn) and May 2014 (EUR1.25 bn). The government is largely pre-financed for 2014.



Sources: IHS Global Insight, national sources, Euler Hermes



Sources: IHS Global Insight, national sources, Euler Hermes



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External Sector

Current account has shifted into surplus ...

The current account deficit narrowed sharply in 2010-2012 and shifted to a surplus of 1.2% of GDP in 2013, largely reflecting strong import contraction in the wake of continued weak domestic demand. However, the also limited export growth performance suggests that external competitiveness is still a problem for Croatia. This is supported by other indicators such as declining market shares and high wages relative to productivity. In 2014-2015, still tight credit conditions will continue to restrain imports and help to keep the current account in surplus.

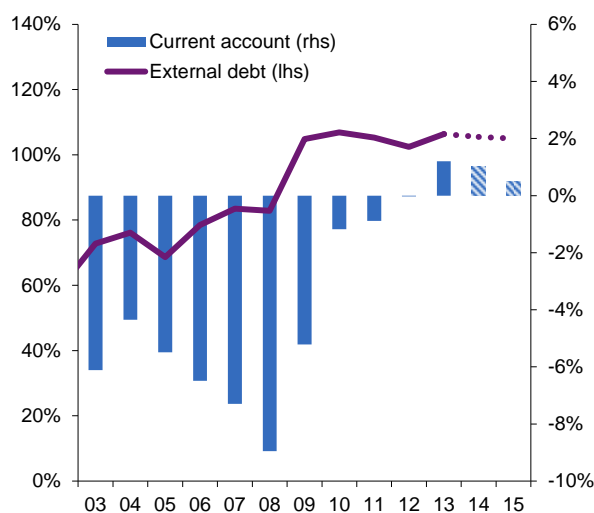
... but external debt remains very high

The legacy of mostly large current account deficits from 1995 to 2009 has left Croatia with a very high external debt burden. Gross external debt stood at EUR46bn in February 2014, equivalent to a worrisome 106% of GDP or 240% of exports. Some 4% of this debt is in arrears. The external debt-service ratio has surged to a hefty 62% in 2013 and is forecast to be close to 50% in 2014, reflecting huge debt amortisation obligations that are likely to constrain financing for private investment.

Foreign exchange reserves are adequate in the short term, but need close monitoring

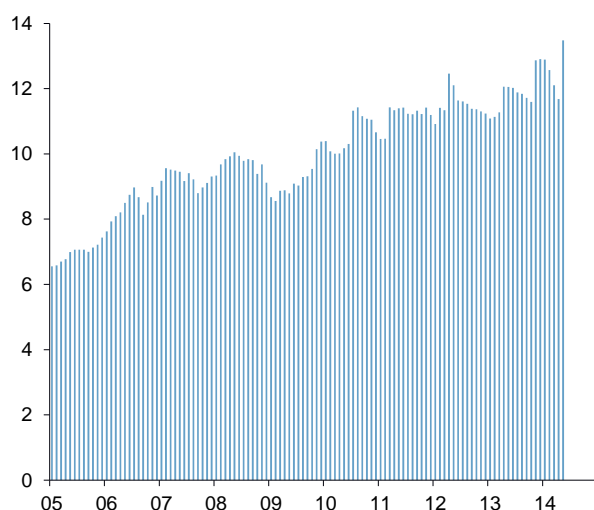
Ongoing central bank intervention in FX markets to keep the HRK/EUR exchange rate fairly stable had reduced FX reserves to EUR11.7bn in April 2014, from an earlier peak of EUR12.9bn at end-2013, before they surged to a new peak of EUR13.5bn in May 2014 as the government "parked" its bond auction proceeds at the central bank. Reserves are likely to decline again gradually over the next months. Currently, the level of FX reserves is comfortable with regard to import cover (more than eight months). In other terms, however, reserves cover just about 100% of the estimated external debt payments falling due (ST debt plus principal repayments on M/LT debt) in the next 12 months, which is below an adequate level of 120%.

Current account and external debt (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

Foreign exchange reserves (EUR bn)



Sources: Croatian National Bank, Euler Hermes

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