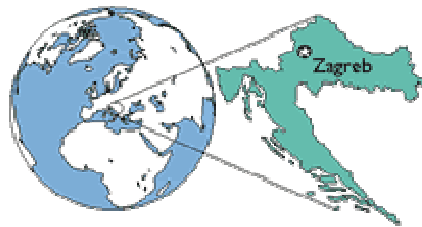


# COUNTRY REVIEW

## Croatia



3 September 2010

**ANALYST: Dr. Manfred Stamer**

**EULER HERMES COUNTRY RISK GRADE: B**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.

## Strengths

- Good international relations
- Comparatively low inflation
- Exchange rate stability thanks to managed float.

## Weaknesses

- Vulnerability to EU business cycle..
- Recovery from deep recession in 2009 is taking a long time to arrive.
- Very high external financing requirement.
- Accumulation of substantial external debt (97% of GDP in 2009)
- Administrative barriers and slow judicial system affect doing business.

## Country Risk Assessment

Ratings	Croatia		Median Grade B	Philippines	Peers Uruguay	Costa Rica
	Latest	Previous				
<b>Systemic Political Risk:</b>	<b>P2-</b>	<b>P2-</b>	<b>P2-</b>	<b>P3+</b>	<b>P2+</b>	<b>P2+</b>
<b>Systemic Economic Risk:</b>	<b>E4</b>	<b>E4</b>	<b>E4</b>	<b>E4</b>	<b>E4</b>	<b>E4</b>
ME rating:	ME4	ME4	ME4	ME4	ME4	ME4
<i>Structure</i>	3.3	2.3	5.0	5.0	4.0	2.3
<i>Policy</i>	2.9	2.8	4.2	5.2	5.6	5.8
<i>Solvency</i>	4.8	4.8	2.3	2.8	3.8	1.3
<i>External Liquidity</i>	5.2	6.0	3.7	1.3	3.2	5.5
SBE rating:	SBE3	SBE3	SBE3	SBE4	SBE3	SBE3
<b>COUNTRY GRADE:</b>	<b>B</b>	<b>B</b>		<b>B</b>	<b>B</b>	<b>B</b>

**Nomenclature:**

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

## ECONOMIC STRUCTURE

<b>Country Profile</b>	
Capital city:	Zagreb
Population:	4.436 mn (2009)
GDP:	USD 63080 mn (2009)
Currency:	Kuna (HRK)
Form of state:	Parliamentary democracy
Head of government:	Prime Minister Jadranka KOSOR
Next elections:	Legislative: 2011 / Presidential: 2015

<b>Major Industries (% of GDP at market prices, 2009)</b>	<b>Global Assumptions</b>	2010	2011	
Services	66.0%	Real GDP grth (% yr/yr)	3.3	2.9
Industry	27.0%	Inflation (% av) *	1.2	1.4
Agriculture	7.0%	Dated Brent (USD/b)	75	70
		* Major economies		

<b>Main Exports (% of total, 2009)</b>		<b>Main Imports (% of total, 2009)</b>	
Machines & transport equipment	29.5%	Machines & transport equipment	28.5%
Mineral fuels & lubricants	13.0%	Mineral fuels & lubricants	17.0%
Food, beverages & tobacco	12.0%	Chemicals	12.5%
Chemicals	9.5%	Food, beverages & tobacco	9.5%
<b>Lead Export Markets (% of total exports, 2009)</b>		<b>Lead Import Markets (% of total imports, 2009)</b>	
Italy	19.0%	Italy	15.5%
Bosnia & Herzegovina	13.0%	Germany	13.5%
Germany	11.0%	Russia	9.5%
Austria	5.5%	Austria	5.0%

## Basic indicators

<b>Selected economic indicators</b>	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	58,624	69,263	63,080	57,413	58,429
Population (mn)	4.44	4.44	4.44	4.44	4.44
GDP per capita (USD)	13,215	15,614	14,220	12,943	13,172
Real GDP growth (% yr/yr)	5.5	2.4	-5.8	-1.5	2.0
Inflation (% eop)	5.8	2.8	1.9	1.5	2.5
Fiscal balance (% of GDP)	-2.4	-1.3	-4.1	-4.2	-4.0
Current account balance (% of GDP)	-7.6	-9.0	-5.0	-4.3	-4.5
External debt/GDP (%)	77.6	85.1	97.4	105.0	110.0
External debt/Exports of goods & services (%)	181.3	199.0	272.3	263.8	270.2
Debt-service ratio (%)	40.5	32.0	52.3	60.5	58.1
Foreign exchange reserves (USD mn)	13,674	12,957	14,419	12,766	12,066
Import cover (months)	5.6	4.4	7.0	6.3	5.6
Exchange rate assumption, HRK:USD (av)	5.36	4.94	5.28	5.80	5.96
Exchange rate assumption, HRK:EUR (av)	7.34	7.22	7.34	7.25	7.15
f: CRU central forecast					

Sources: National figures, IMF, World Bank, ECB, European Commission, Euler Hermes Economic Studies

## Political Stability

Croatia's 1991 declaration of independence began a decade marked by civil war, conflicts and instability which came to an end only in 1999 after the NATO campaign against Serbia. Domestic politics changed significantly after the death of Franjo Tudjman, a former communist turned nationalist who had led Croatia since 1990, in early 2000. Constitutional amendments strengthened the role of parliament and government at the expense of the presidency, which now has a largely ceremonial role and a fairly stable democracy has been established with peaceful transfers of power through widely accepted elections. Successive governments have pursued political and economic reform and led the country out of international isolation. Croatia obtained membership of the NATO Partnership for Peace, the WTO and CEFTA in 2001 and joined NATO in 2009. A long lasting uncooperative stand vis-à-vis the International Criminal Tribunal for the former Yugoslavia (ICTY) delayed the formal start of membership talks with the EU until October 2005. However, A long-running maritime border dispute with Slovenia, which interrupted the EU accession process for most of 2009, has now been passed over to international arbitration, thus allowing the talks to proceed. In June 2010, Croatia opened the final three of the 35 chapters of the *acquis communautaire* (the body of EU law), and it has provisionally closed negotiations on 22 of the chapters. Generally, Croatia's international relations are good and relations with neighbouring states are continuing to improve.

The latest parliamentary election in November 2007 resulted in a coalition government which includes the Croatian Democratic Union (HDZ), the Croatian Peasants Party (HSS) and the Social Liberal Party (HSL). Despite a working majority in parliament (82 out of 153 seats), government effectiveness has been weak at times. Nonetheless, given the broad-based support for EU accession among all political parties, the government remains committed to an agenda of EU-mandated reforms, though public support of EU integration has diminished in recent years according to surveys.

Overall systemic political stability risk is moderate.

## Economic Stability

The economy is quite diversified, with services accounting for about 66% of GDP, industry 27% and agriculture 7%. However, tourism accounts for more than one third of exports of goods and services and over 70% of external trade is with the enlarged EU, leaving Croatia vulnerable to the European business cycle. Average annual growth of real GDP of 3.5% in the past ten years has raised GDP per capita to about EUR10,000, which classifies Croatia as a high income country on World Bank definitions.

The economy fell into deep recession in 2009 in the wake of the global financial crisis and recovery is taking a long time to arrive. Despite base effects, real GDP contracted by 2.5% yr/yr in Q1 2010, after declining by 4.5% in Q4 2009 and 5.8% in full year 2009. Domestic demand was particularly weak in Q1, with investment shrinking by 14%, private consumption 4% and public spending 1%. A flash estimate suggests that real GDP contracted again by 2.5% yr/yr in Q2 2010. The pace of decline in industrial output accelerated to about 3.3% yr/yr in Q2 from 0.5% in Q1. Retail sales shrank by 5.7% yr/yr in Q2 after a 4.2% contraction in Q1. Unemployment remained high at 16.6% in June. As a result, we expect real GDP to decline by about 1.5% in calendar 2010 before returning to modest growth of 2% or so in 2011.

The monetary policy framework is based on a managed exchange rate float which has helped insulate the economy from overly inflationary pressures. Despite depreciation pressure in Q4 2008 and Q1 2009, the central bank has maintained broad stability in the HRK/EUR exchange rate through intervention in the foreign exchange (FX) market. And in June 2010, the bank intervened in order to prevent further strengthening of the HRK. We expect the central bank to continue to intervene to minimise currency volatility. There are currently sufficient FX reserves to fend off potential depreciation pressures. Stability of the HRK/EUR rate is important because of a high level of euroisation in the economy. Inflation fell to 1% yr/yr in July 2010 from 1.9% at end-2009. Given subdued domestic demand and limited prospects for wage and credit growth, we expect inflation to remain low for the rest of the year, resulting in an annual average of about 1.1%. The real effective exchange rate is slightly, but not dramatically, overvalued.

A solid fiscal consolidation path since 2005 has been interrupted by the economic downturn. Despite several budget revisions and tax increases, the fiscal deficit increased from a modest 1.3% of GDP in 2008 to 4.1% in 2009. We expect similar ratios in 2010 and 2011 as there is little scope for further rapid consolidation. Public debt increased from a recent low of 33% of GDP in 2007 to 38.5% in 2009 and is set to rise to about 45% in 2011. Public finances are likely to remain under pressure, with downside risks on both the spending and revenue sides of the budget.

The external position remains a source of vulnerability. The current account deficit narrowed from 9% of GDP in 2008 to 5% in 2009 and should be 4-5% in 2010-2011. However, net foreign direct investment (FDI) inflows covered just 41% of the current account deficits in 2009, after 75% in 2008 and over 100% in 2006-2007. As a result, gross external debt has risen further in 2009 to about USD61bn, equivalent to a critical 97% of GDP and 272% of export earnings. The external debt-service ratio surged to a hefty 52% in 2009 and is expected to remain above 50% in 2010-2011, reflecting huge amortisations that are likely to constrain financing for private investment. Official FX reserves stood at EUR10bn in May 2010, covering about six months of imports in 2010 but less than 80% of external debt falling due (ST debt plus principal repayments on M/LT debt) in both 2010 and 2011. Overall, the external imbalances and concerning external debt ratios appear unsustainable and weigh heavily on the prospects for long-term growth.

### **Structural Business Environment**

The Structural Business Environment is adequate, just about average in our assessment overall. Croatia is ranked 96th out of the 210 countries monitored. Despite some improvement in recent years, a range of weaknesses continues to affect business activity and the investment climate adversely. These include institutional weaknesses and administrative barriers (lack of transparency, burdensome regulation, corruption, vested interests), frequent government interference in the economy, the perception of weak data transparency and payment habits at the corporate level. Property rights are fairly well protected on paper, but the judicial system is still regarded as slow and inefficient. Croatia generally fares well with regard to the freedom of trade and capital flows, infrastructure and the banking sector.

The banking sector is competitive and largely privately owned. The share of foreign ownership is around 90%. Banks have weathered the global financial crisis fairly well and maintained adequate capitalisation. Nonetheless, credit quality and bank profitability have deteriorated as liquidity problems of the corporate sector have caused an increase in the share of non-performing loans to total loans from 4.8% in 2007 to 7.8% in Q4 2009. Private sector credit growth, which was not been as excessive as in other Emerging European countries pre-global crisis, has fallen sharply and has been negative since Q4 2009. Expecting further losses, banks are likely to remain reluctant to increase lending in the near future, dampening macroeconomic growth prospects.

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Charts

