Republic of Croatia Rating Report

STABLE OUTLOOK

BB

Credit strengths

- EU membership since July 2013
- Cyclical recovery, exiting recession
- Reduced fiscal deficits and exit from EU's Excessive Deficit Procedure

Credit weaknesses

- High public and private debt levels
- High foreign-currency exposure
- Low potential-growth outlook
- Institutional weaknesses

Rating rationale and Outlook: Croatia's BB rating reflects the country's EU membership, recovery from a six-year recession and fiscal consolidation efforts leading to an exit from the European Union (EU)'s Excessive Deficit Procedure. At the same time, the rating remains constrained by i) the country's low growth potential, ii) high public-finance risk, given an elevated debt level combined with a high foreign-currency exposure, iii) the private sector's high external and foreign-currency-denominated debt, and iv) institutional shortcomings resulting in a burdensome business environment. The Stable Outlook reflects Scope's assessment that risks remain broadly balanced.

Figure 1: Sovereign rating categories summary

Positive rating-change drivers

- Higher economic growth potential
- Public and external debt reduction
- Improvements in the business climate

Negative rating-change drivers

- Reversal of public and external debt deleveraging
- Postponement of reform programme
- Exchange rate volatility

Ratings and outlook

Foreign currency

Long-term issuer rating	BB/Stable
Senior unsecured debt	BB/Stable
Short-term issuer rating	S-3/Stable

Local currency

Long-term issuer rating	BB/Stable
Senior unsecured debt	BB/Stable
Short-term issuer rating	S-3/Stable

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Bloomberg: SCOP

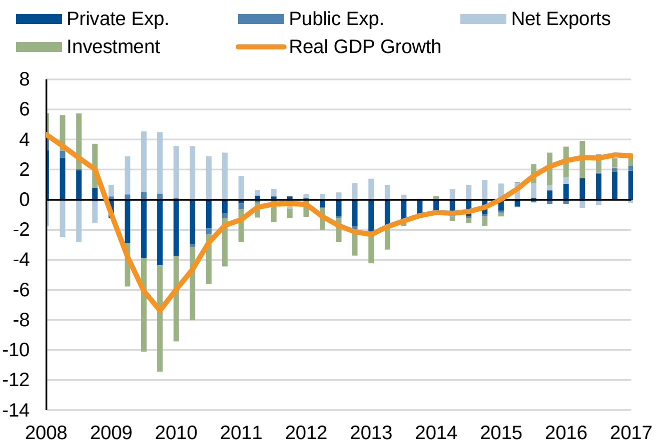
Domestic economic risk

Slow emergence from six-year recession

After six years of recession, with GDP contracting by more than 12% between 2008 and 2014, real GDP growth turned positive in 2015 and is now expected to range between 2.0% and 2.5% over the coming years. The cyclical recovery, which Scope expects to continue in the coming years, is driven by stronger consumption due to an improving labour market, higher investment given an expected higher absorption of EU structural funds and a reversal in the credit cycle, and net exports driven mainly by tourism, manufacturing, trade and transportation.

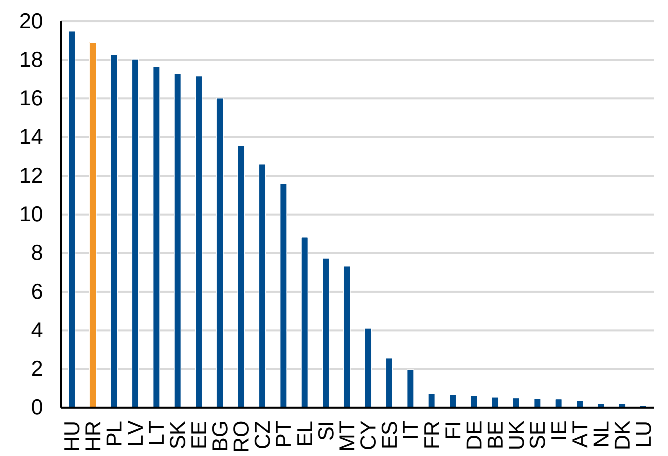
In line with its CEE peers, Croatia is a large beneficiary of EU structural funds with an allocation of about EUR 9bn for the 2014-2020 period. This is equivalent to around 3% of GDP annually, making Croatia the second-largest beneficiary of EU funds after Hungary in terms of GDP. However, the full benefits of this fund allocation are unlikely to materialise since, as noted by the European Commission (EC)[1], effective absorption of EU funds is impeded by limited administrative capacities and an insufficient number of implementable projects.

Figure 2: Contributions to real GDP growth (% YoY)



Source: Croatia Bureau of Statistics

Figure 3: EU structural funds allocations 2014-20 (% GDP)



Source: European Commission

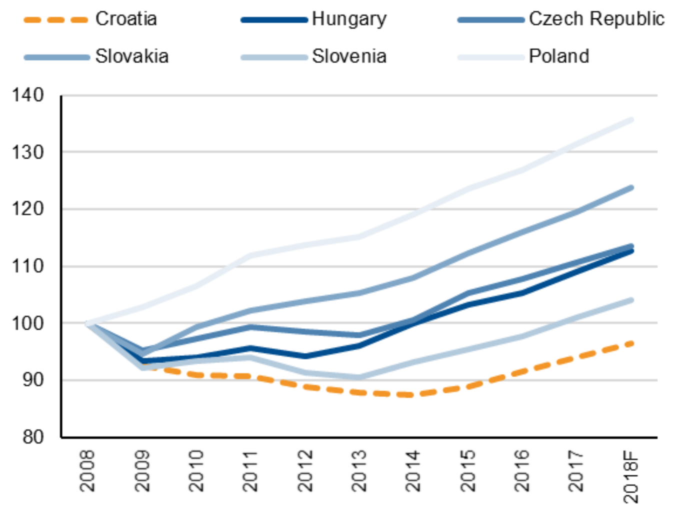
Table of contents

The economic recovery is also being facilitated by the Croatian National Bank's (CNB) accommodative monetary policy stance. During the six-year recession, which included three years of deflation, the CNB has continued to reduce its key policy rates and ensured ample liquidity in the banking system. Its expansionary monetary policy, which included reducing rates, broadening the list of securities eligible for CNB facilities, adjusting required reserves, and a quarterly four-year structural reverse-repo facility introduced in February 2016[2], led to falling loan rates as well as a pickup in loan growth after several years of deleveraging.

Despite its emergence from a six-year recession, Croatia remains significantly more economically vulnerable than its peers. Real GDP growth is still well below the pre-crisis level and GDP per capita on a purchasing power standard basis remains significantly below that of peers, at around 60% of the EU-28 average. In addition, the country's growth potential is estimated at only around 1%, a particularly weak outlook compared to other transition economies.

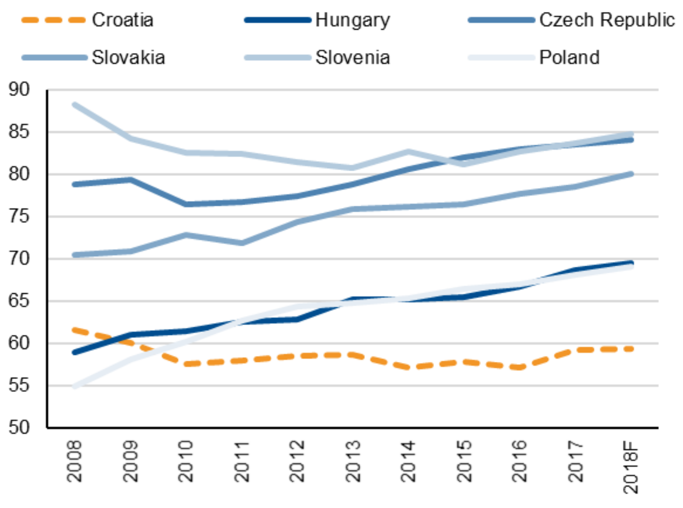
[1] European Commission, Country Report Croatia 2017, SWD (2017) 76 final, February 2017.
[2] IMF, 2016 Article IV Consultation for the Republic of Croatia, June 2016.

Figure 4: Real GDP growth (2008=100)



Source: European Commission

Figure 5: GDP per capita (PPS, % of EU-28 average)



Source: European Commission

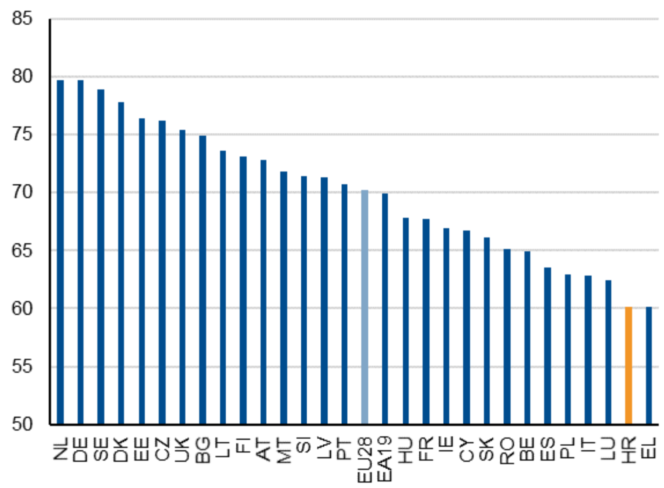
Low growth potential given adverse developments in labour force and productivity

Croatia's low growth potential is mainly the result of adverse developments in the labour force and subdued total factor productivity growth. While the unemployment rate has fallen from its 17% peak in 2013 to around 13% in 2016, and employment has increased by about 75,000 over the same period, although mostly due to an increase in temporary contracts, the continuously shrinking labour force accounted for more than half of the reduction in unemployment. In fact, at around 60%, Croatia's employment rate is one of the lowest in the EU, driven by low activity rates after the age of 50 due to early retirement trends.

The country's low growth potential is further exacerbated by low productivity growth, with productivity levels remaining significantly below that of peers when measured by output per employee. This may be driven by factors such as subdued investment and capital formation, which remain substantially below their pre-crisis levels. In fact, investment dropped cumulatively by around 45% between 2008 and 2015. Also constraining Croatia's growth potential is the relatively large share of state-owned enterprises, which have a lower level of productivity than the private sector according to the European Commission[3]. Finally, Croatia's cumbersome business environment is underscored by its low competitiveness rankings versus peers. According to the World Bank's 2017 Doing Business report, Croatia ranked 43rd among 190 countries (24th in the EU-28), and it scored particularly poorly on dealing with construction permits (128th) and starting a business (95th). Similarly, the World Economic Forum's competitiveness indicator ranks Croatia 74th among 138 countries (26th in the EU-28, ahead of only Cyprus and Greece), highlighting inefficient government bureaucracy, tax rates and policy instability as the most problematic factors for doing business.

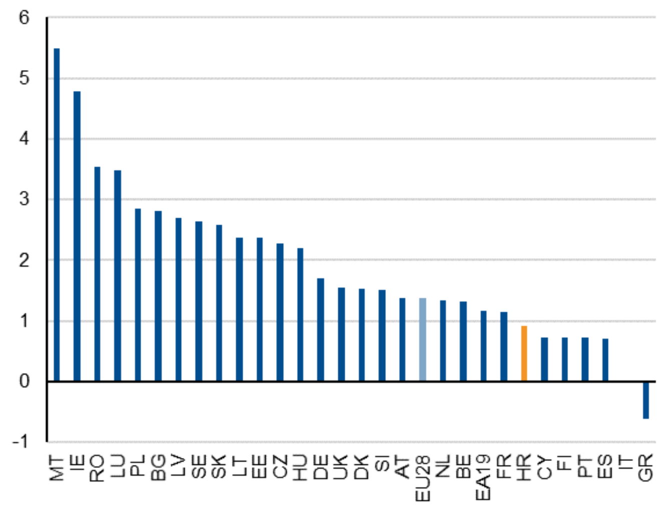
[3] European Commission, Country Report Croatia 2017, SWD (2017) 76 final, February 2017.

Figure 6: Employment rates (%)



Source: European Commission

Figure 7: Potential GDP growth (3Y avg., 2016-2018F, %)



Source: European Commission

Public finance risk

Ongoing fiscal consolidation with deficits below 3% Maastricht criteria

In Scope's assessment, Croatia's public finance risk is elevated, despite having exited the EU's Excessive Deficit Procedure in June 2017. The six-year recession led to high deficits in the 2009-2013 period, given low revenue collections and large increases in automatic expenditures. While the deficit fell sharply to 0.8% of GDP in 2016, after hitting a record high of 7.8% in 2011, this consolidation effort was driven largely by lower public investment as well as a reduction in social benefits and lower interest expenses. Going forward, the government's Convergence Programme for 2017-2020[4] foresees a budget deficit of 1.3% of GDP in 2017 and 0.8% of GDP in 2018, broadly in line with the EC's Spring Forecast, but significantly more favourable than the IMF's expectation of around 2%. The IMF's caution is rooted in the high level of implementation risk associated with the numerous suggested legislative changes to achieve fiscal consolidation.

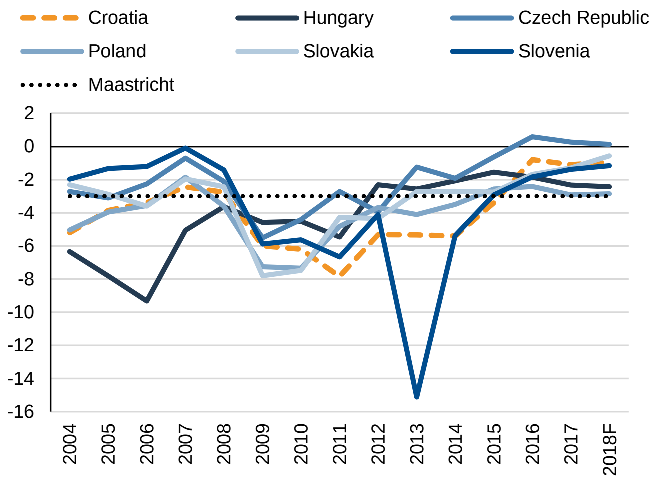
The recently adopted tax reform is expected to boost investment and consumption at the expense of public finances. While the reform simplified and reduced the personal income tax (PIT) rate, the EC notes that as a consequence, the number of persons who will no longer pay any PIT will increase by 560,000, reaching 1.5 million (more than 50% of all persons with income), while higher-income earners will face a significantly lower tax liability. In addition, the corporate income tax rate was also cut from 20% to 18% and a new 12% rate for SMEs was introduced, reducing expected revenues[5]. Despite these measures, Scope expects a sustained moderate growth rate to keep public deficits below the 3% Maastricht threshold over the coming years.

High level of debt remains a rating constraint

As a result of accumulating high deficits and the six-year recession, Croatia's public debt more than doubled from 40% of GDP in 2004 to 87%[6] in 2015. Granted, debt-to-GDP fell for the first time in 2016, driven by primary surpluses achieved since 2015, and there has been positive growth plus a slight 1% appreciation in the kuna (which in itself supported debt reduction by 0.7 percentage points, according to the EC). Nevertheless, Croatia's debt remains elevated compared to peers, and hence constitutes a major rating constraint.

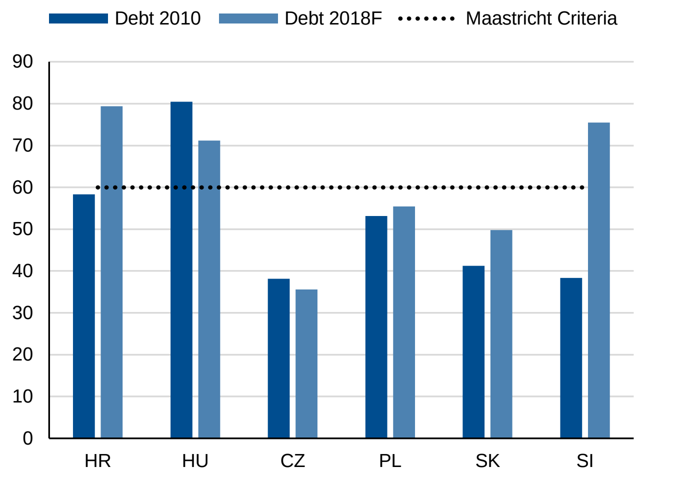
[4] European Commission, Council Recommendation on the 2017 National Reform Programme of Croatia, May 2017.
[5] European Commission, Country Report Croatia 2017, SWD (2017) 76 final, February 2017.
[6] The inclusion of the Croatian Bank for Reconstruction and Development added 4.4% of GDP to public debt in 2014 (IMF Article IV, 2016).

Figure 8: Fiscal balances, % of GDP



Source: European Commission

Figure 9: Debt levels, % of GDP

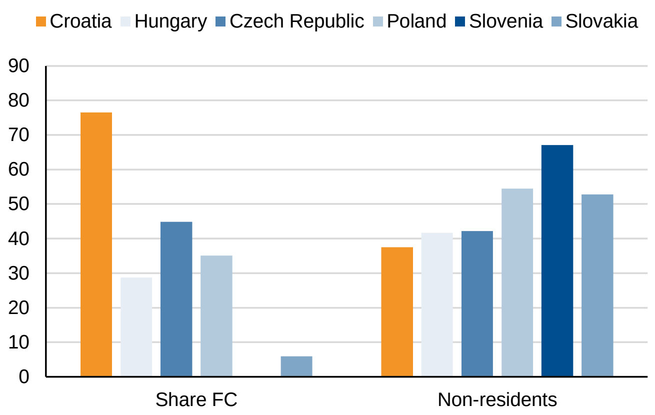


Source: European Commission

High public debt foreign-currency exposure and high reliance on bank loans are concerns

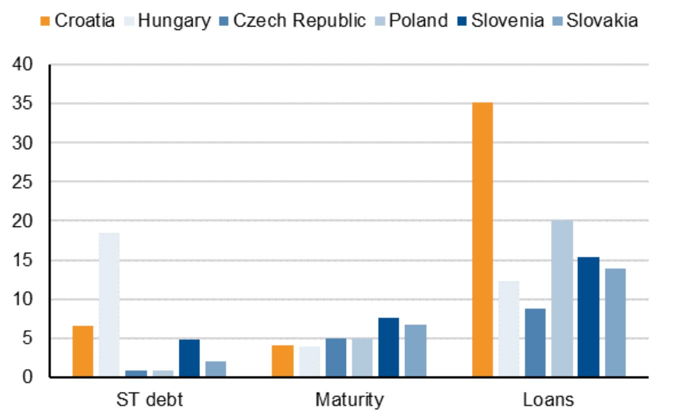
In addition, Croatia's high share of foreign-currency-denominated public debt further exacerbates the sovereign's public finance risk. As a result of the limited absorption capacity of the domestic market, about 76% of total issued government debt is linked to a foreign currency (the euro). However, it is Scope's view that some of this currency risk exposure is mitigated by the de-facto peg of the kuna to the euro successfully pursued by the Croatian central bank. In addition, the share of non-residents holding Croatian government debt fell from about 50% in 2008 to around 38% at the beginning of 2017, now in line with peers. Similarly, the share of short-term government debt is in line with peers at around 6%, as is the government's average residual maturity of around four years. However, at about 35%, the share of loans as a government funding instrument is significantly above peers. Scope assesses this high bank lending reliance as credit negative, as it amplifies the sovereign-banking nexus by exposing the government to its banking sector as a necessary funding source. While the government adopted a debt-management strategy again in early 2017, three years after the expiry of the previous strategy, Croatia lacks a track record of continuous communication with the markets.

Figure 10: Foreign currency (FC) and non-resident-held debt, % of total general government (GG) debt



Source: Statistical Office of the European Communities

Figure 11: Short-term debt (% of total GG debt), maturity (years), loans (% of total GG debt)



Source: Statistical Office of the European Communities

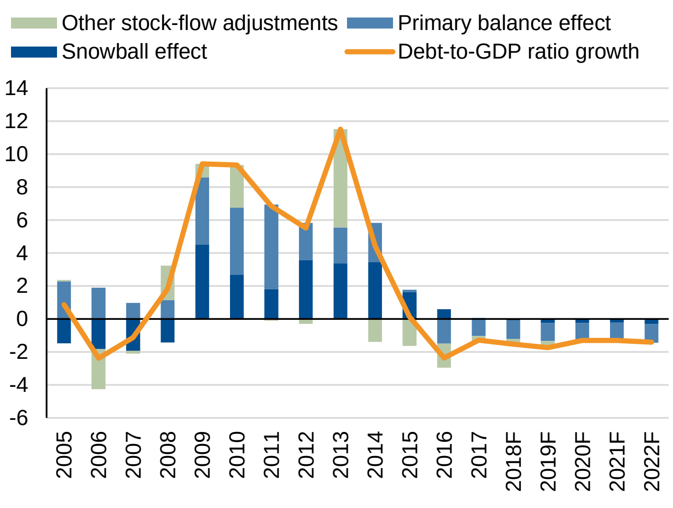
High government guarantees but manageable ageing-related expenditures

Scope's assessment of Croatia's contingent liabilities is mixed, with relatively high government guarantees due to the substantial number of state-owned enterprises but manageable additional expenses resulting from an ageing population. According to the IMF, outstanding government guarantees to state-owned enterprises amount to 3-4% of GDP. In fact, the financial difficulties of Croatia's largest private company Agrokor pose direct risks to the budget. While the government has not explicitly assumed the debts of the company, it has de facto guaranteed debts to suppliers, which amount to more than EUR 2bn, by specifically treating debts to suppliers as superior to debts owed to the financial sector. This unequal treatment of creditors, stipulated in the 'Lex Agrokor', may also result in costly lawsuits to the government. Similarly, the legal proceedings surrounding the legislated conversion of Swiss-franc-denominated loans into euros at historical currency and interest rates could also result in a direct budgetary liability.

Conversely, according to the European Commission's 2015 Ageing Report, long-term health- and pension-related expenditures amounted to around 17% of GDP in 2013, slightly above Croatia's CEE peers but below the EU-28 average. The Commission's projections to 2060 foresee a non-negligible increase in healthcare-related expenditures of 1.7% of GDP, but this is more than offset by a 3.9% reduction in pension-related expenditures. In fact, according to a recent Stiftung Marktwirtschaft study[7], Croatia ranks first among the EU-28 in terms of long-term sustainable public finances once implicit debts are taken into account.

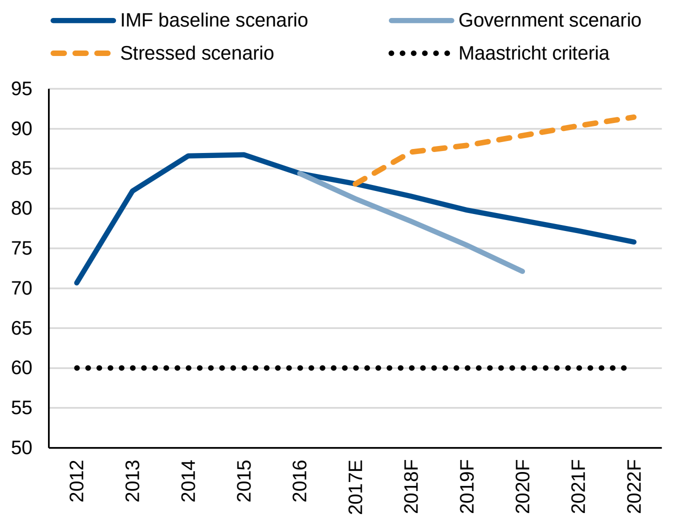
Against this backdrop, Scope's public-debt sustainability analysis, which includes an IMF baseline in addition to a Scope stressed scenario incorporating a combined growth, interest-rate, primary-balance and foreign-currency shock, points to debt-sustainability concerns. This is the case given Croatia's high debt level, expected fiscal deficits going forward, and high exchange-rate sensitivity given an elevated share of foreign-currency-denominated debt. Scope's baseline scenario is for the debt-to-GDP ratio to fall to around 79% by 2022.

Figure 12: Contribution to gov't debt changes, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 13: General government debt, % of GDP



NB. Assumptions for baseline, government and stressed scenarios for 2017-2022: Real GDP growth (2.4%, 2.7%, 1.6%), Primary balance (1.1%, 1.2%, 0.3%), Real effective interest rate (2.2%, NA, 3%)
Source: IMF, Ministry of Finance, Calculations Scope Ratings AG

[7] Stiftung Marktwirtschaft. 'Honourable states? EU Sustainability Index 2016', December 2016.

This is conservative compared to the government's 2017 Convergence Programme, which expects debt to decline to around 72% of GDP by 2020 based on more favourable macroeconomic assumptions. In Scope's adverse scenario, assuming a combined one-percentage-point shock for each year over the forecast horizon to real GDP growth (lower), interest rates (higher), and the primary balance (lower), as well as a one-off 10% depreciation in the kuna, Croatia's debt-to-GDP ratio would rise to around 90% by 2022.

Fiscal policy framework exhibits several shortcomings

Lastly, Croatia's fiscal policy framework exhibits several weaknesses. According to the EC, Croatia has made limited progress in enforcing numerical fiscal rules as stipulated in the Fiscal Responsibility Act[8] and the rigid Budget Act[9]. In addition, the EC's assessment continues to point to shortcomings in strengthening the independence of the Fiscal Policy Commission and improving budgetary planning and the multi-annual budgetary framework. The government's National Reform Programme commits to addressing some of these concerns. However, the EC's assessment of the 2016 Convergence Programme also points to a need to bolster the fiscal strategy with specific measures, particularly on the expenditure side. Moreover, the country exhibits high territorial fragmentation resulting in complex fiscal relations across several levels of government. Yet, according to the EC, the adoption of a new budget act is expected to make the budgetary framework of the central and local governments more binding, and should thus reduce the frequency and significance of revisions to targets throughout the year that were observed in the past.

External economic risk

Negative net international investment position (IIP) reduced by sustained current account surpluses

External economic risks remain elevated in Croatia, albeit with modest improvements. After a record current account deficit of 9% of GDP in 2008, simultaneous deleveraging of the government and private sector led to a contraction in imports and turned the current account balance positive in 2013. More recently, an increase in goods and especially services exports, partly as a result of regaining a portion of lost export market share (up 20% since 2014), contributed to Croatia posting a current account surplus of around 2.5% of GDP in 2016[10]. Going forward, Scope expects that the current account surplus will continue to reduce Croatia's external liabilities (although at a more moderate rate given higher domestic demand) and thus will continue to improve the country's negative net-international-investment position, which stood at -73% of GDP in 2016, in line with that of peers.

A major source of vulnerability is Croatia's private-sector external debt. Driven by an investment spree leading up to the crisis, the private sector accumulated significant debt, which, given the limitations of the domestic banking system, were largely externally financed[11]. While non-financial corporates (NFCs) have been deleveraging recently, household debt levels remain fairly constant owing to a long average maturity of mortgage loans and improved labour market conditions reducing pressures to deleverage. As a result, according to the IMF's latest analysis, gross external financing needs are projected to remain well above 20% of GDP over the rating horizon. Despite modestly declining over the past few years, the gross external debt ratio remains high, historically as well as compared to peers, and thus constitutes a source of vulnerability at slightly below 100% of GDP in 2016.

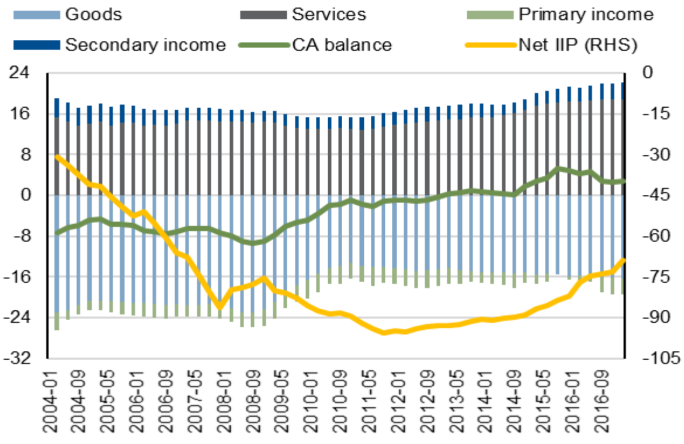
[8] The structural budget balance has to be set at a level ensuring that the general government deficit-to-GDP ratio is not higher than 3% and the debt-to-GDP ratio is not higher than 60%. The expenditure rule constrains the general budget expenditure, which cannot exceed a reference potential GDP growth rate adjusted for the expected price growth and revenue increases mandated by law (EC, 2016).

[9] The deficit rules mandate that the national parliament or a local representative body cannot endorse a budget for the following year with a higher planned deficit than that projected for that same year with the previous (multi-year) budget (EC, 2016).

[10] The increase in the current account surplus in 2015 was mostly due to a one-off decline in profits of foreign-owned banks related to the legislated conversion of Swiss-franc-denominated loans (IMF Article IV, 2016).

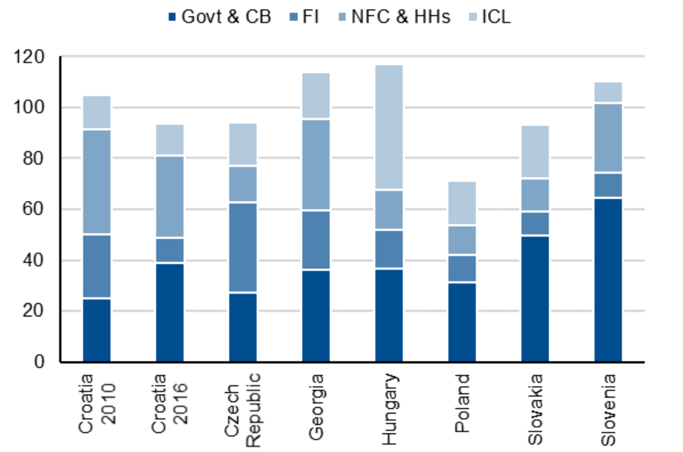
[11] Between 2002 and 2008, investment more than doubled, increasing the indebtedness of NFCs from around 40% in 2002 to 84% of GDP in 2010. Similarly, over the same period, household indebtedness rose from around 22% of GDP in 2002 to about 40% of GDP in 2010.

Figure 14: Current account & net IIP (% of GDP)



Source: Croatian National Bank

Figure 15: External debt by sector (% of GDP)



Source: World Bank
NB. Govt & CB = Government and central bank; FI = financial institutions; NFC & HHs = Non-financial corporates and households; ICL = intercompany loans

High but falling foreign-currency debt

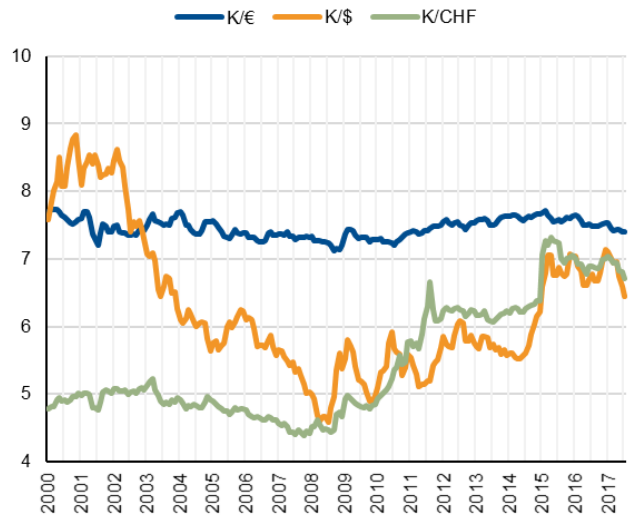
Another source of risk is the high, albeit declining, share of debt denominated in foreign currency, which currently constitutes more than 90% of external debt. While foreign-currency-linked corporate debt has fallen from about 70% in 2010 to around 60% in mid-2017, and similarly, the share of household loans denominated in a foreign currency has fallen from about 75% to around 55% over the same period, this exposure remains high compared to Croatia's CEE peers but in line with that in Georgia. However, according to the EC, some of this risk is mitigated by currency matching between revenue and expenditure flows by companies operating in the tradeable sector. In addition, the CNB[12] notes that the rise in kuna lending is due not only to lower interest rates but to greater awareness of currency risk among households, possibly as a result of negative experiences with loans indexed to the Swiss franc, and increased demand from banks for domestic deposits (with an associated decrease in external debt as a source of funding).

Stable kuna-euro exchange rate and adequate reserve coverage

Risks from the high foreign currency exposure have thus far been mitigated by the quasi-peg of the kuna to the euro, which the CNB continues to preserve through foreign-exchange liquidity regulation and occasional interventions. Gross international reserves increased by USD 1bn to USD 15bn in 2016 (based on WB data), and reserve coverage of short-term external-debt remains adequate at around 300%, also comparing well against peers. However, the currency peg could lead to higher interest rate costs for large public and private financing as a normalisation of global monetary conditions sets in[13].

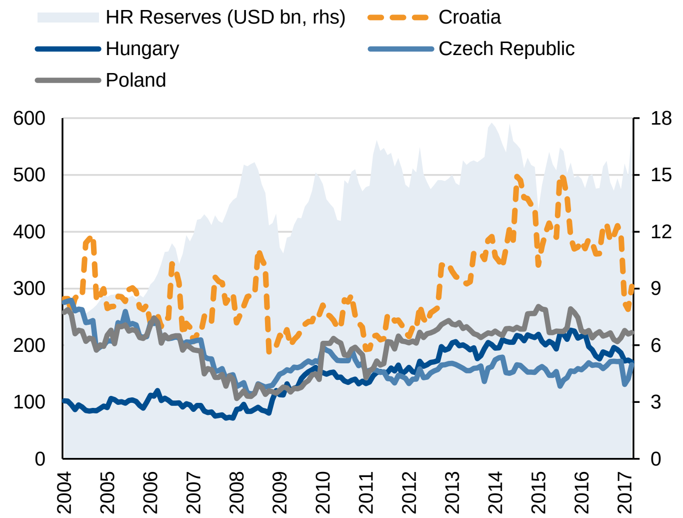
[12] CNB, Macroeconomic Developments and Outlook, December 2016.
[13] IMF, 2016 Article IV Consultation for the Republic of Croatia, June 2016.

Figure 16: Exchange rate crosses



Source: Croatian National Bank

Figure 17: Reserves and coverage ratio



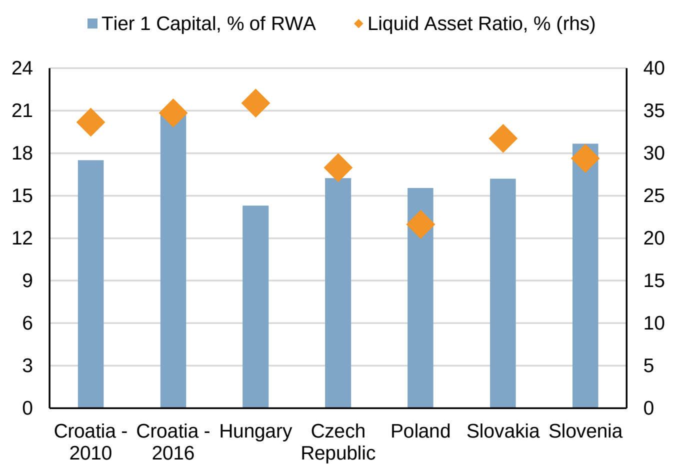
Source: IMF, World Bank

Financial stability risk

Banking sector is better capitalised and profitable again

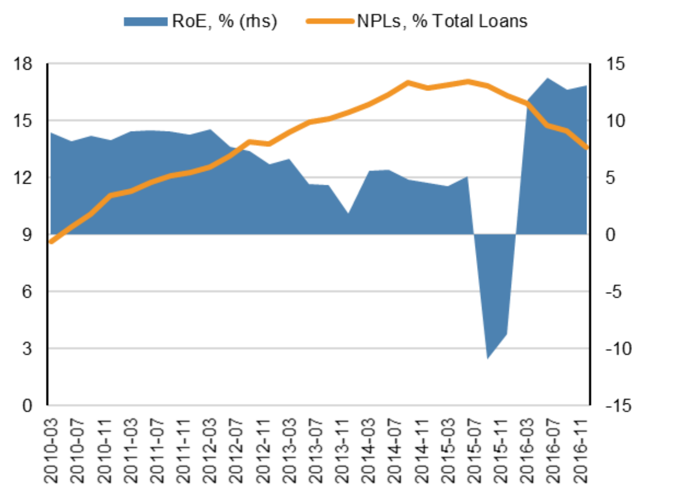
The banking sector is well capitalised with a CET1 ratio of 21%, and it is also liquid, recording a liquid-asset ratio of 35%. The sector posted significant losses in 2015, which were driven by the legislated conversion of Swiss-franc-denominated loans into euros at historical currency and interest rates. The EC estimates these conversions amounted to losses of HRK 7.6bn or 2.3% of GDP. But the banking sector returned to profitability in 2016, posting a return-on-equity of around 13%. Asset quality is also improving and NPLs are falling due to accelerated sales and provisioning requirements introduced by the central bank in 2013. Housing prices are also stabilising after falling for the past eight years, having dropped a cumulative 20% since 2008. Compared to peers, however, the NPL ratio remains high at approximately 13%.

Figure 18: Banking sector capitalisation and liquidity, %



Source: IMF

Figure 19: Banking sector asset quality and profitability, %



Source: IMF
NB. RoE = Return on Equity

As the Croatian economy remains heavily euroised, currency risk is an important source of vulnerability for the banking sector. Banks are indirectly exposed to foreign currency risks given their corporate and household clients' foreign-currency-denominated debt. However, the central bank's proven track record of managing the exchange rate significantly reduces this risk. In addition to indirect foreign currency risks, the banking sector remains vulnerable to a highly concentrated client exposure, particularly given its high exposure to the government and certain NFCs. In fact, bank loans to the government constitute around 20% of total loans. In this context, the restructuring process of the now state-managed Agrokor Group, whose 143 firms employ nearly 57,000 people in the region and generate EUR 6.5bn in annual revenues (around 15% of Croatian GDP[14]), could have systemic effects on banks' balance sheets. As of the date of this report, debt is around EUR 7bn, with EUR 3.5bn owed to private creditors, but given the company's admission that its past financial accounts are unreliable, the total amount of debt to be restructured could be higher.

In addition, risks associated with the maturity mismatch between assets and liabilities are increasing as long-term savings are mainly denominated in euros whereas deposits are mostly in the domestic currency[15]. The Croatian banking sector is also exposed to possible spillover effects from European banks, particularly Italian banks given their large ownership stake in the banking sector. However, some of these risks are mitigated by the banking sector's net positive foreign assets as well as the European supervisory framework and the framework for recovery and resolution of credit institutions. Finally, as publicly expressed by the ECB on two occasions[16], the independence of the central bank could potentially be undermined by the adoption of the Central Bank Act, which would enable audit powers by the State Audit Office, access to confidential information and enable parliament to vote on the CNB's reports.

Institutional and political risk

Political instability and lack of policy continuity

Croatia joined the European Union in June 2013 and has fully adopted the EU's regulatory framework (acquis communautaire) to provide an anchor for institutional stability and predictability. Since 2009, the sovereign is also a member of NATO, a development that supports the country's Western allegiances underscoring its geostrategic importance to its Western partners.

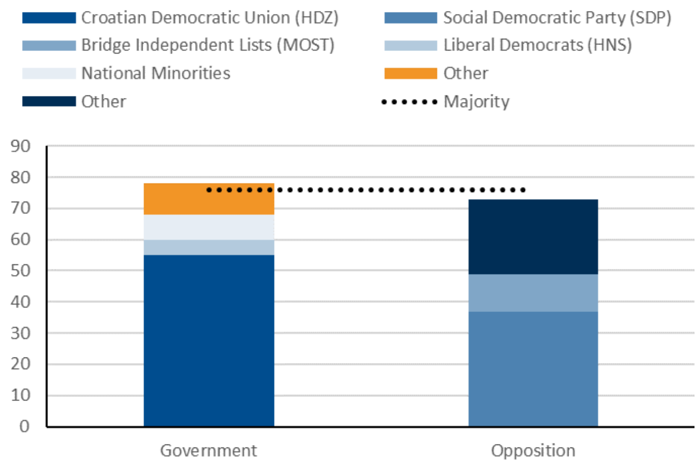
Domestically, Croatia has been marred by political instability and fragmentation (18 parliamentary parties), with the current government already being the 14th since the first multi-party elections were held in 1990. Parliamentary elections were held in November 2015 and again in September 2016, resulting in a relatively strong majority for the HDZ-MOST (Christian Democratic Union – Bridge of Independents) coalition with 91 of the 151 parliamentary seats. Following the collapse of this government in June of this year, also because of the Agrokor Group's restructuring, HDZ now governs with HNS (Liberals), and together hold a much narrower majority with just 78 seats. The next election is scheduled on or before December 2020.

The focus of Prime Minister Andrej Plenković's government is on economic and public administration reform to address several institutional shortcomings highlighted by the IMF, World Bank, and European Commission. Specifically, the European Commission has noted on several occasions that weaknesses in public administration, slow implementation of the anti-corruption strategy, restrictive regulation in key infrastructure sectors, frequent changes in regulation and substantial inconsistencies in how they are

[14] The Economist, Too many eggs in one basket, August 10, 2017.
[15] CNB, Macroprudential Diagnostics, July 2017.
[16] https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_52_en.pdf and https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_33_f_sign.pdf

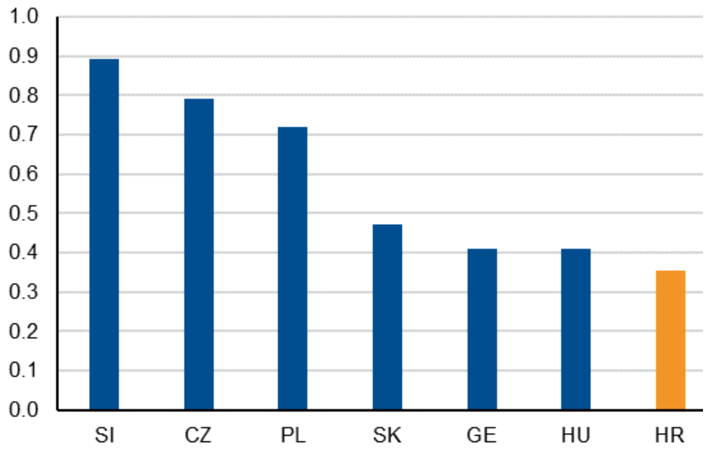
interpreted, as well as the strong presence of the state in the economy, weigh negatively on the business climate and weaken legal certainty and the predictability of the business environment[17] (EC, 2017).

Figure 20: Distribution of seats in parliament



Source: EIU, Croatian Parliament

Figure 21: World Bank governance indicators (+/- 2.5)



Source: World Bank

NB. Croatian Democratic Union (55), Social Democratic Party of Croatia (37), Bridge of the Independent Lists (12), Croatian People's Party - Liberal Democrats (5), Croatian Peasant Party (5), Civic Liberal Alliance (4), Istrian Democratic Assembly (3), Independent Democratic Serbian Party (3), Human Blockade (3), Let's Change Croatia (2), Croatian Demochristian Party (2), HRAST - Movement for Successful Croatia (1), Croatian Social-Liberal Party (1), Croatian Pensioners' Party (1), Croatian Democratic Alliance of Slavonia and Baranja (1), People's Party - Reformists (1), Power – People's and Civic Engagement Party (1) and Party of Croatian Intergenerational Solidarity (1).

Lastly, despite Croatia's unresolved territorial disputes with its neighbours, especially Slovenia, Scope believes that these conflicts will not affect the country's economic prospects. Similarly, possible border disruptions due to a potential resurgence of the refugee crisis are not expected to adversely affect trade and tourism.

Methodology

The methodology applicable for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available at www.scoperatings.com.

The historical default rates used by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/governance-and-policies/regulatory/esma-registration.

Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default and definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

[17] European Commission, Country Report Croatia 2017, SWD (2017) 76 final, February 2017.
European Commission, Review of progress on policy measures relevant for the correction of macroeconomic imbalances, December 2016.
European Commission, Council Recommendation on the 2017 National Reform Programme of Croatia, May 2017.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative "BBB" ("bbb") rating range for the Republic of Croatia. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative analysis.

For the Republic of Croatia, the following relative credit weaknesses have been identified: 1) growth potential of the economy, 2) economic policy framework, 3) macro-economic stability and imbalances, 4) fiscal performance, 5) public-debt sustainability, 6) market access and funding sources, 7) external debt sustainability, 8) vulnerability to short-term shocks, 9) recent events and policy decisions, 10) financial-sector oversight and governance, and 11) macro-financial vulnerabilities and fragility. No relative credit strengths have been signalled. Combined relative credit strengths and weaknesses generate an adjustment and signal a sovereign rating of BB for Croatia. A rating committee discussed and confirmed these results.

Rating overview	
CVS category rating range	bbb
QS adjustment	BB
Final rating	BB

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower case.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, a review of debt sustainability, fiscal and financial performance reviews and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

The Republic of Croatia's foreign-currency denominated debt, which constitutes about three-quarters of its total debt, is held by both domestic and non-resident investors. Consequently, Scope sees no reason to believe that Croatia would differentiate between any of its contractual debt obligations based on currency denomination. Furthermore, the recent history of sovereign defaults does not provide a strong justification for a rating bias in favour of either local-currency or foreign-currency debt.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	**30%**
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	**15%**
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	**10%**
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	**10%**
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**bbb**
QS adjustment	**BB**
Final rating	**BB**

QS

Maximum adjustment = 3 notches

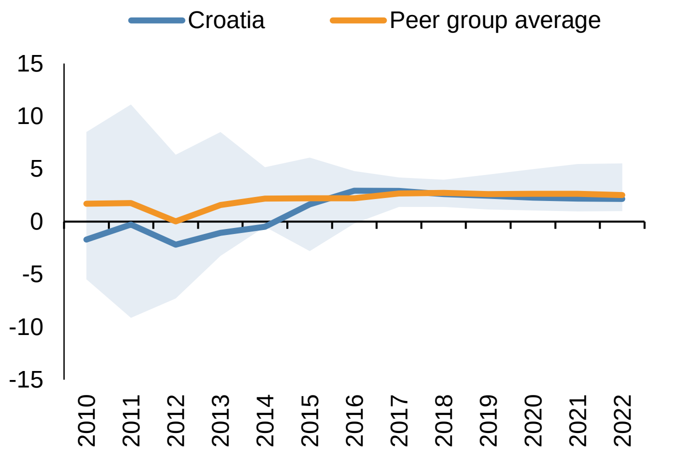
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	○ Neutral	◉ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negative
Economic policy framework	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Macroeconomic stability and imbalances	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Fiscal performance	○ Exceptionally strong performance	○ Strong performance	○ Neutral	◉ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	○ Neutral	◉ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	○ Very good access	○ Neutral	◉ Poor access	○ Very weak access
Current-account vulnerabilities	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Vulnerability to short-term shocks	○ Excellent resilience	○ Good resilience	○ Neutral	◉ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Geo-political risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Macro-financial vulnerabilities and fragility	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings AG

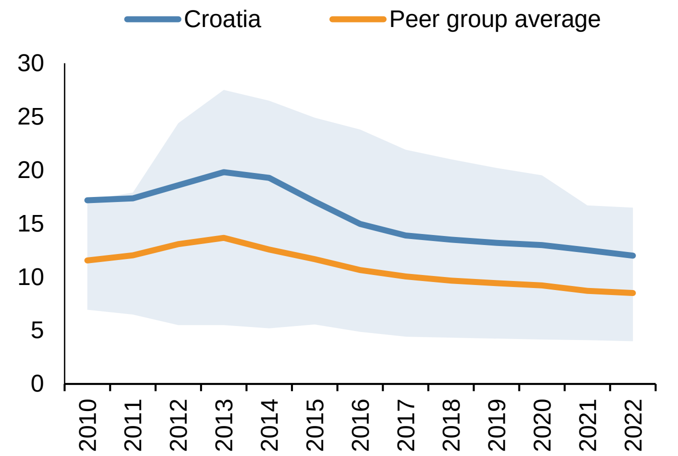
III. Appendix: Peer comparison

Figure 22: Real GDP growth



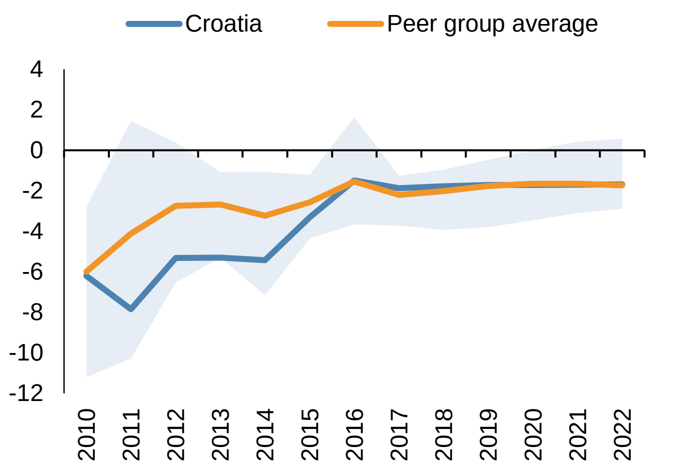
Source: IMF, Calculations Scope Ratings AG

Figure 23: Unemployment rate, % of total labour force



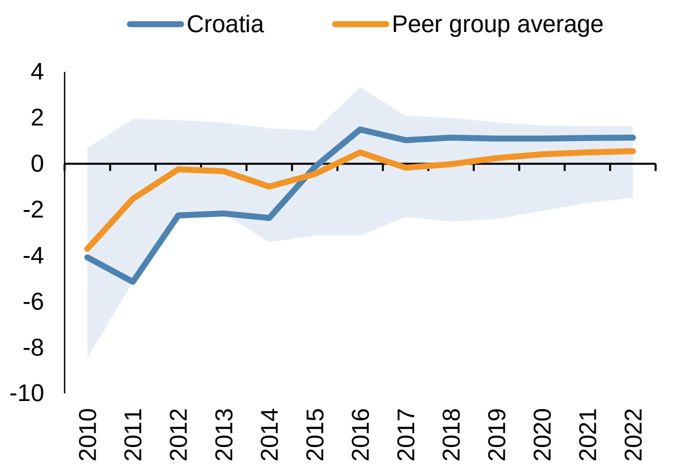
Source: IMF, Calculations Scope Ratings AG

Figure 24: General government balance, % of GDP



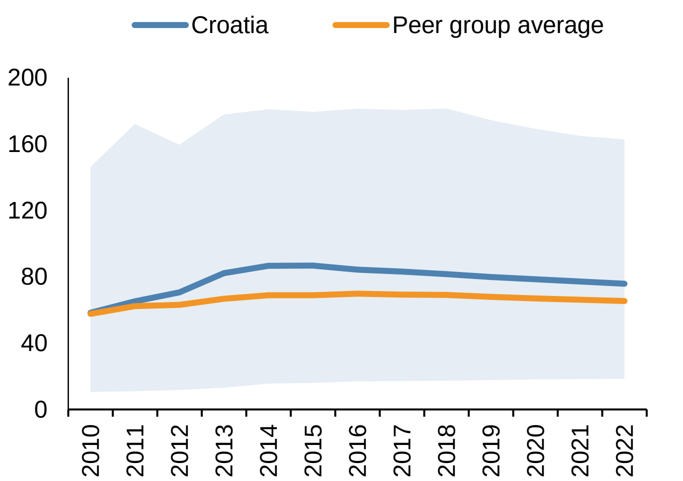
Source: IMF, Calculations Scope Ratings AG

Figure 25: General government primary balance, % of GDP



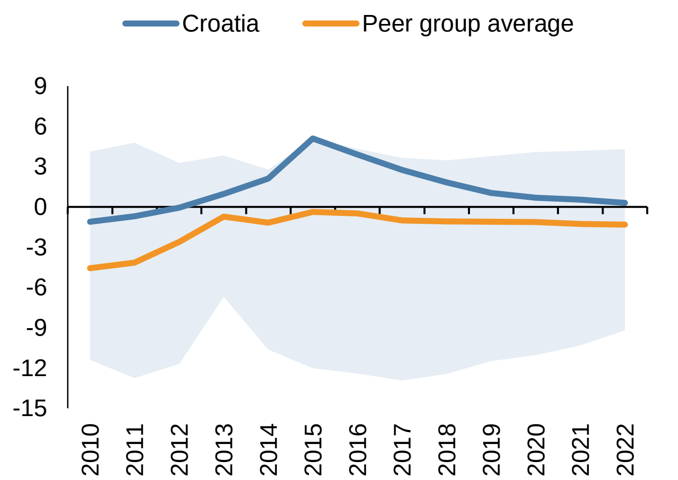
Source: IMF, Calculations Scope Ratings AG

Figure 26: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 27: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings AG

IV. Appendix: Statistical tables

	2012	2013	2014	2015	2016	2017E	2018F
Economic performance							
Nominal GDP (Bil.HRK)	330.5	329.6	328.1	333.8	343.2	355.0	368.1
Population (thous)	4,296.5	4,277.8	4,257.5	4,236.0	4,213.3	4,189.4	4,164.8
GDP-per-capita PPP (USD)	21,133.0	21,681.1	21,980.9	22,488.8	23,596.2	-	-
GDP per Capita (HRK)	77,426.7	77,436.6	77,420.5	79,409.1	82,295.3	85,378.8	88,798.7
Real GDP growth, % change	-2.19	-1.06	-0.49	1.64	2.93	2.93	2.61
GDP growth volatility (10-year rolling SD)	4.2	4.0	3.9	3.7	3.4	3.1	3.2
CPI, % change	3.41	2.22	-0.22	-0.46	-1.13	1.05	1.06
Unemployment rate (%)	15.8	17.4	17.2	16.1	13.3	11.6	9.7
Investment (% of GDP)	19.3	19.1	18.6	18.8	18.9	19.8	20.6
Gross national savings (% of GDP)	19.2	20.1	20.7	23.9	22.8	22.6	22.5
Public finances							
Net lending/borrowing (% of GDP)	-5.3	-5.3	-5.4	-3.4	-0.8	-1.1	-0.9
Primary net lending/borrowing (% of GDP)	-1.9	-2.1	-1.9	0.2	2.4	1.9	1.8
Revenue (% of GDP)	41.8	42.6	43.1	45.2	47.6	47.5	47.4
Expenditure (% of GDP)	47.1	48.0	48.5	48.6	48.4	48.6	48.4
Net interest payments (% of GDP)	3.4	3.2	3.5	3.6	3.3	3.0	2.8
Net interest payments (% of revenue)	8.2	7.5	8.1	7.9	6.8	6.2	5.9
Gross debt (% of GDP)	70.7	82.2	86.6	86.7	84.4	83.1	81.6
Net debt (% of GDP)	-	-	-	-	-	-	-
Gross debt (% of revenue)	169.1	192.7	201.0	191.9	177.4	174.8	171.9
External vulnerability							
Gross external debt (% of GDP)	102.9	105.8	108.6	103.8	91.4	-	-
Net external debt (% of GDP)	59.9	59.8	58.3	52.7	-	-	-
Current account balance (% of GDP)	-0.2	1.0	2.1	5.0	2.5	2.4	2.4
Trade balance [FOB] (% of GDP)	-	-15.1	-14.8	-15.2	-15.5	-16.5	-17.1
Net direct investment (% of GDP)	-2.8	-1.9	-1.9	-0.5	-3.9	-	-
Official Forex Reserves (EOP, Mil.USD)	13,763.4	13,909.6	14,138.2	10,820.9	12,368.4	-	-
REER, % change	-2.7%	1.2%	0.4%	-1.5%	1.2%	-	-
Nominal Exchange Rate (EOP, HRK/USD)	5.7	5.5	6.3	7.0	7.2	-	-
Financial stability							
Non-performing loans (% of total loans)	13.8	15.4	16.7	16.3	13.6	-	-
Tier 1 ratio (%)	19.6	19.9	20.6	19.2	20.9	-	-
Consolidated private debt (% of GDP)	120.2	118.5	119.3	114.4	-	-	-
Domestic credit-to-GDP gap (%)	-	-	-	-	-	-	-

Source: IMF, European Commission, European Central Bank, World Bank, United Nations, Scope Ratings AG

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.

Rating prepared by Rudolf Alvise Lennkh, Lead Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003. The subscription ratings/outlooks were last updated on 05.05.2017. The senior unsecured debt ratings as well as the short-term issuer ratings were assigned by Scope for the first time.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on the Republic of Croatia are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Sovereign Ratings Calendar of 2017" published on 21.07.2017 on www.scoperatings.com). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the deviation was due to the recent revision of Scope's Sovereign Rating Methodology and the subsequent placement of ratings under review, in order to conclude the review and disclose ratings in a timely manner, as required by Article 10(1) of the CRA Regulation.

The main points discussed by the rating committee were: i) Croatia's growth potential, ii) macroeconomic stability and imbalances, iii) EU membership and institutional framework, iv) fiscal performance, v) market access and funding sources, vi) public debt sustainability, vii) external debt structure and reserves adequacy, viii) the restructuring of the Agrokor Group and ix) peers.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party. The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: the Ministry of Finance of the Republic of Croatia, Central Bank of Croatia, BIS, European Commission, European Central Bank, OECD, IMF, WB, and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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