

Struggling to exit recession



General Information

GDP	USD62bn (World ranking 68, World Bank 2011)
Population	4.41 million (World ranking 122, World Bank 2011)
Form of state	Presidential/Parliamentary Democracy
Head of government	Zoran MILANOVIC
Next elections	2014, presidential



Strengths

- Good international relations; impending accession to the EU in July 2013
- Track record of comparatively low inflation
- Exchange rate stability thanks to "managed float"

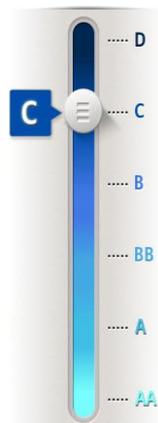
Weaknesses

- Vulnerability to EU business cycle
- Protracted recession since 2009
- 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

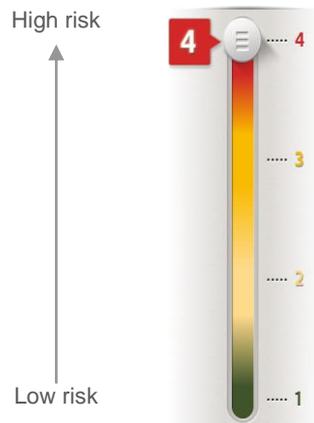
Country Rating

C4

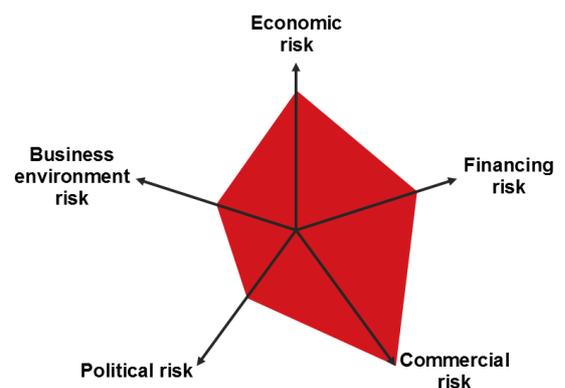
Country Grade



Country Risk Level

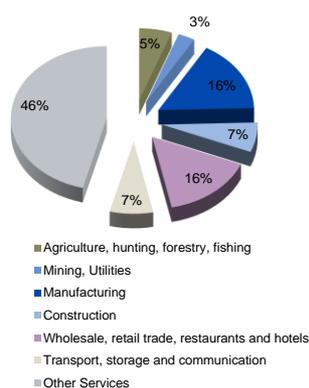


Risk Dimensions



Economic Structure

GDP breakdown (% of total, 2010)



Sources: Chelem, IHS Global Insight, Euler Hermes

Trade structure (% of total, 2010)

By destination/origin

Exports	Rank	Imports	Rank
Italy	1	Italy	1
Bosnia and Herzegovina	2	Germany	2
Slovenia	3	Austria	3
Germany	4	Russia	4
Austria	5	Slovenia	5

By product

Exports	Rank	Imports	Rank
Refined Petroleum Products	9%	Crude Oil	9%
Ships	7%	Refined Petroleum Products	4%
Electrical Apparatus	5%	Plastic Articles	4%
Pharmaceuticals	4%	Miscellaneous Hardware	4%
Plastic Articles	4%	Leather	3%

Economic Forecasts

	Average 2000-08	2009	2010	2011	2012	2013f	2014f
GDP growth (% change)	4.2	-6.9	-2.3	0.0	-2.0	-0.2	1.0
Inflation (% end-year)	3.2	1.9	1.9	2.0	4.7	2.7	4.0
Fiscal balance (% of GDP)	-3.2	-4.2	-5.1	-5.2	-4.1	-4.0	-4.5
Public debt (% of GDP)	34.8	35.8	42.2	46.7	56.3	59.5	61.9
Current account (% of GDP)	-5.6	-4.9	-1.5	-0.7	0.1	0.0	-0.5
External debt (% of GDP)	69.6	104.5	103.9	94.7	102.7	102.0	100.7

Sources: IHS Global Insight, national sources, Euler Hermes

Economic Growth

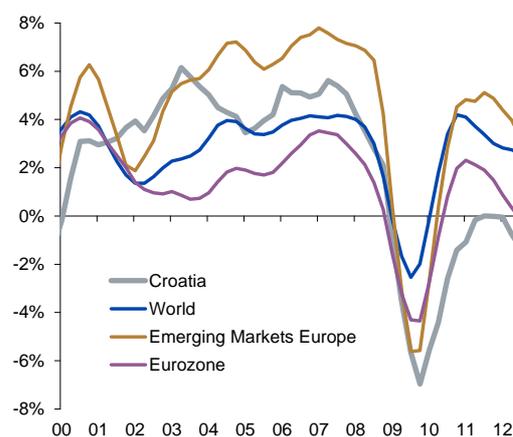
2012 was the fourth consecutive year without economic growth ...

Croatia is caught in a protracted recession. Real GDP decreased by -2.3% y/y in Q4 2012, marking the fifth consecutive quarter of decline. Full year GDP in 2012 contracted by -2% and, after also declining in 2009-2010 and stagnating in 2011, the level of real GDP was -11% lower than at its peak in 2008. Domestic demand was particularly weak in 2012, with private consumption decreasing by -3%, government consumption by -0.8% and fixed investment by -4.6%. Weak domestic demand also affected imports, which declined by -2.1% in 2012. Exports managed to grow, but only marginally at +0.4%, so that external demand mitigated the overall fall in GDP somewhat.

... and the decline is forecast to continue in 2013

EU economic weakness, tight monetary policy and limited scope for fiscal stimulus will continue to dent growth prospects for some time. The economy is likely to decline further in H1 2013 before, possibly, a gradual recovery may begin in H2. We expect full year real GDP to contract by -0.2% in 2013 and to grow by about +1% in 2014.

GDP growth (% y/y, 4 qtrs cumulated)



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 should continue in 2013

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.

Inflation will remain in check in 2013-2014

Inflation picked up from 2% at end-2011 to 4.7% at end-2012, mainly as a result of higher global food prices and increased VAT rates in March 2012. The implementation of new VAT rates on basic goods and services at the start of 2013 pushed inflation further up to a peak of 5.3% in January. Since then it has fallen to 3.7% in March. Base effects should lead to a further moderation in the course of 2013 (as the 2012 VAT increases fall out of the calculation).

More generally, ongoing weak domestic demand and very tight domestic credit conditions will keep inflationary pressures low in 2013-2014.

Domestic credit declines as banks continue to deleverage and NPLs rise

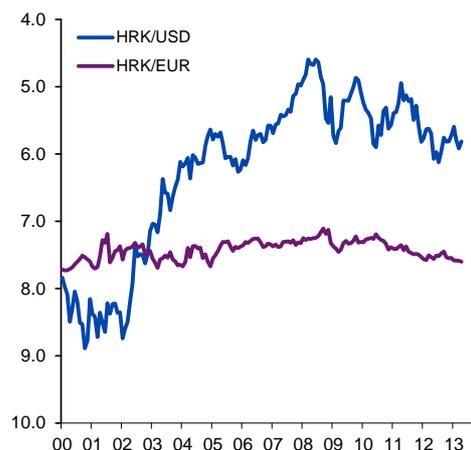
The Croatian banking sector was resilient in 2009 but is now extremely exposed to the Eurozone financial crisis, as subsidiaries of Eurozone banks dominate the sector (48% Italy, 36% Austria). Croatian banks are still adequately capitalised so far, but credit quality and profitability have deteriorated 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 13.6% in 2012 (corporate NPLs 23%). Since parent banks are consolidating and extremely cautious now, credit conditions in Croatia have tightened in 2012 and will remain squeezed for some time. Real domestic credit contracted by 7% in 2012, after it had still grown by 7.3% in 2011.

Public finances remain worrisome

Annual fiscal deficits (ESA-95 basis) have accounted for 4.0-5.2% of GDP since 2009 and will remain in that range in 2013-2014. This excludes the combined deficit of HBOR (state-owned Development Bank) and HAC (state-owned motorway operator) which is projected at an annual 1% of GDP in the next two years. Public debt has rapidly increased from 29% of GDP in 2008 to 56% in 2012 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.

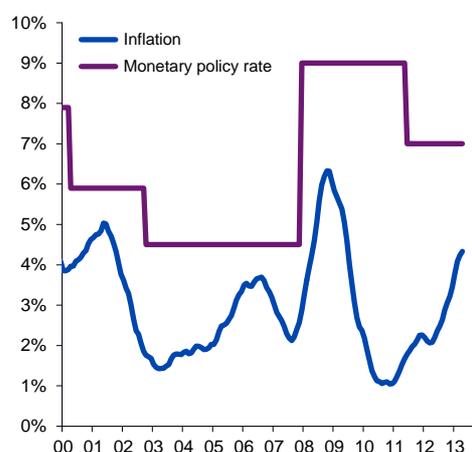
Fiscal consolidation is urgently needed and the government appears to be committed to it, however, it will be difficult to achieve in the persistent low-growth environment. Recently, Croatia's foreign currency LT rating has been downgraded to speculative grade by S&P (BB+ in December 2012) and Moody's (Ba1 in February 2013). Fitch has maintained its lowest investment grade rating (BBB-) for the country for now.

Exchange rate (end of month values)



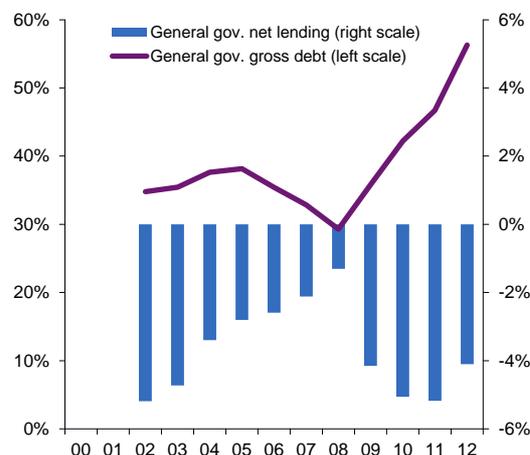
Sources: Croatian National Bank, Euler Hermes

Inflation rate (12-month moving average, %)



Sources: IHS Global Insight, national sources, Euler Hermes

Fiscal balance and public debt (% of GDP)



Sources: IMF, national sources, Euler Hermes

Current account has improved ...

The current account has moved close to balance in recent years, 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 2013-2014, very tight credit conditions will continue to restrain imports and help keep the current account in check.

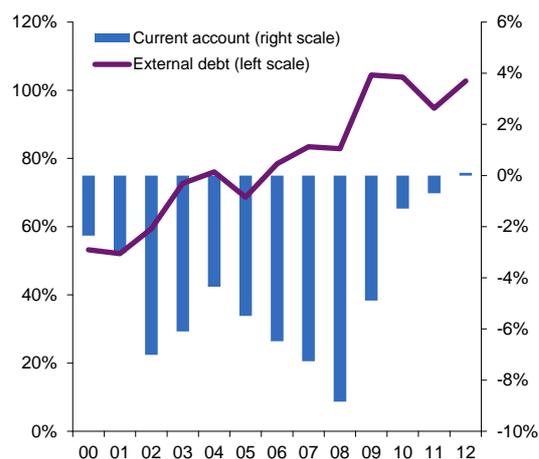
... but external debt remains very high

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 EUR45bn at end-2012, equivalent to a worrisome 103% of GDP or 240% of exports. Some 3% of this debt is in arrears. The external debt-service ratio has surged to a hefty 58% in 2012 and is forecast to remain above 40% in 2013, reflecting huge debt amortisation obligations that are likely to constrain financing for private investment.

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

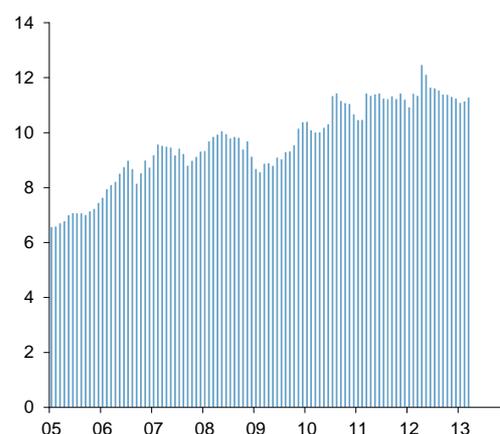
Ongoing central bank intervention in FX markets to keep the HRK/EUR exchange rate fairly stable have reduced FX reserves to EUR11.3bn in March 2013, from a peak of EUR12.5bn in April 2012, a trend that may continue. The current level of FX reserves is still comfortable with regard to import cover (around seven months). In other terms, however, reserves cover just about 85% of the estimated external debt payments falling due (ST debt plus principal repayments on M/LT debt) in the next 12 months, which is well below an adequate level of at least 100%.

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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