Croatia

Excessive imbalances

After six years of recession, the Croatian economy should swing back into positive, albeit mild, growth in 2015 and 2016. The country still faces major imbalances: public finances are deteriorating, non-performing loans continue to rise, and the unemployment rate has levelled off but remains very high. Although the central bank has the financial capacity to maintain the peg to the euro in the short term, the country's heavy foreign-currency debt makes it vulnerable to the international financial environment. The upcoming legislative election raises uncertainty over the continuation of structural reforms.

Struggling to recover

Before the 2008 crisis, Croatia, like its European neighbours who joined the EU, benefited from very strong capital inflows, which fuelled domestic demand and growth. Yet unlike the other countries of central and Eastern Europe, the Croatian economy is struggling to pull out of recession. Lacking a sufficiently developed industrial sector and suffering from significantly lower productivity and competitiveness than its neighbours, Croatia was unable to swing back into growth on an export-driven recovery, as was the case for the central and eastern European countries as of 2011. Between 2008 and 2014, Croatia's GDP contracted 12.5% in real terms. After six years of recession, the economy should swing back into positive albeit feeble growth, estimated at 0.5% in 2015 and 1% in 2016.

Tourism is the main growth engine, generating 20% of GDP. Household consumption is still restrained by an unemployment rate above 19%, while corporate and government investments continue to be hampered by excessive debt servicing charges. In Q1 2015, the debt of non-financial companies continued to rise, reaching the equivalent of 81.3% of GDP. This was mainly due to the increase in private corporate debt, which amounted to 73.5% of GDP, while debt for public companies diminished slightly, to 7.8% of GDP.

This environment has made it difficult for the economy to begin to recover.

Fragile fundamentals

Public finances have deteriorated continuously since 2008, due not only to the increase in interest charges (estimated at 3.6% of GDP in 2015), but above all to the contraction in GDP. Public debt hit 85% of GDP at year-end 2014, and could rise to nearly 90% of GDP in 2015. The general government deficit was 5.7% of GDP at year-end 2014 and is likely hold above 5% in 2015. Refinancing risks on public debt are reduced by the fact that 80% of its financing needs are covered by domestic institutional investors, and that the debt is in medium to long-term instruments (debt maturing in less than 1 year accounts for less than 10% of total debt). The main risk is that 78.5% of Croatia's public debt is denominated in foreign currencies (mainly the euro). There is high risk that this debt could be revalued if the kuna depreciates against the euro.

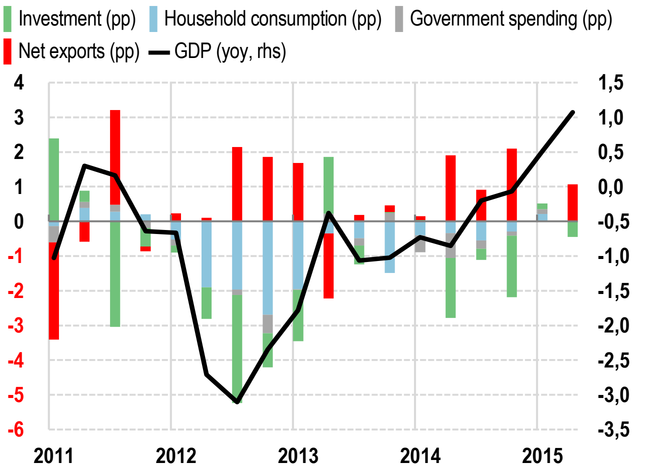
Although refinancing rates are relatively low (3.3% interest rate on the most recent 10-year bond issue), they are still higher than the country's GDP growth rate. With debt refinancing needs estimated at 19.5% of GDP in 2015 (the current budget deficit plus the rolling over of maturing debt), there will be a major snowball effect, and the debt to GDP ratio should continue to rise, at least until 2017 (to 93% of GDP according to the IMF).

1- Summary of forecasts

	2013	2014	2015f	2016f
Real GDP growth (%)	-0.9	-0.4	0.5	1.0
Inflation (CPI, year average, %)	2.2	-0.2	-0.4	1.1
Gen. Gov. balance / GDP (%)	-5.4	-5.7	-5.1	-4.4
Gen. Gov. debt / GDP (%)	80.6	85.0	89.5	92.1
Current account balance / GDP (%)	0.8	0.7	1.2	1.6
External debt / GDP (%)	105.4	105.5	104.0	100.0
Forex reserves (USD bn)	12.9	12.6	16.0	16.0
Forex reserves, in months of imports	8.1	7.9	7.4	7.0
Exchange rate EUR HRK (year end)	7.6	7.6	7.6	7.6

f: BNP Paribas Group Economic Research estimates and forecasts

2- GDP and the components of growth
Percentage points



Sources: CNB

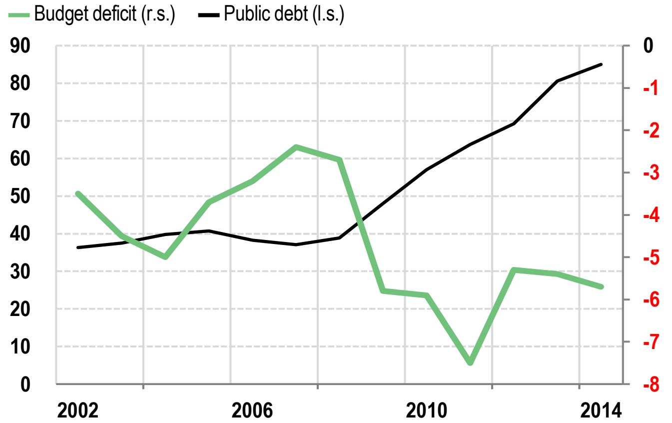
Croatia is unlikely to meet the deficit reduction targets set by the European Union as part of the excessive deficit procedure: 3.5% in 2015 and 2.7% in 2016. According to the central bank, it will take more than 3 years for the country to reduce its deficit.

Banking sector risks tend to be on the rise, even though they seem to be under control for the moment. Although the doubtful loan ratio is rising constantly (to more than 17% in Q1 2015), the banking sector is still liquid and well capitalised on the whole. Provisions cover 50% of doubtful loans, and banks are capable of covering the unfunded part of loans thanks to a particularly high bank capitalisation rate (23.5% at year-end 2014). Banking sector risks are also offset by the fact that 90% of bank assets are held by foreign groups, the majority of which are Austrian or Italian. Only 5% of total bank assets are held by the two banks in which the State has a majority stake. Even so, the situation could become more delicate following the government's recent decision to require banks to convert Swiss franc-denominated loans into euros.

The biggest fears concern the scale of foreign-currency loans in the banking sector (73% of total loans outstanding in Q2 2015, 63% of GDP), and consequently, the risks of excessive indebtedness if the kuna is depreciated. Last January, the debt servicing charge on loans denominated in Swiss francs (which account for the equivalent of 7% of GDP) increased by 15% after the Swiss franc was revalued against the euro. Yet the Croatian government decided that banks rather than households would bear the full cost of the revaluation of these loans. Banks will have to convert all of their loans initially denominated in Swiss francs into euros at the exchange rate that prevailed at the time when the loan originated. The Croatian central bank evaluates the cost of this measure at 8 billion kunas, triggering a de facto decline in the bank capital adequacy ratio of 3.8 points, to 19.7%. Although this decision is good news for Croatian households (which hold 95% of Swiss franc denominated loans), it will not be without consequences for the economy as a whole. First, investors, notably foreign investors, could lose confidence concerning the business environment. Second, it could indirectly trigger a decline in foreign reserves as banks increase their demand for euros in order to consolidate their balance sheets, placing downward pressure on the kuna, eventually requiring central bank intervention. Unless the euro is adopted, the country's external vulnerability will remain a weak point in the medium term. The debt of all economic agents denominated in foreign currency is estimated at about EUR77bn, equivalent to 177% of GDP, and the net external position is largely negative (89% of GDP). In the short term, the central bank has the financial capacity to maintain the kuna's peg to the euro. In 2014, Croatia reported a current account surplus of 0.7% of GDP, which should rise to roughly 1.2% of GDP in 2015. The absence of portfolio investments also sharply limits the risks of capital flight. Foreign reserves amounted to USD16bn at the end of July, and covered more than 97% of the country's short-term external financing needs (up from only 50% one year ago).

Excluding currency risks, households and companies are both vulnerable to interest rate risk, as 95% of household loans and 97% of corporate loans are in variable rate instruments. Consequently, the country is particularly vulnerable to the international financial environment.

3- General government finances
(% of GDP)



Source: CNB

Uncertain election results

The economic situation will weigh on the legislative elections that will be held in November 2015. The opposition HDZ party could win the election, beating the central left SDP party that is currently in power, but it would probably have to form a new coalition in order to govern. The biggest uncertainty about the election's outcome is the implementation of structural reforms, which are needed to ensure that the fiscal deficit is brought below the 3% threshold.

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