Croatia

After a strong growth rebound in 2021 (13.1% year-on-year) following the COVID-19 pandemic, the Croatian economy continued on a similar footing, recording an 8.2% year-on-year rise in 1H 2022. Surging goods exports and the tourism-driven recovery of services, together with the tight labor market, supported private consumption despite the inflationary environment. Both private and public investments also increased, thus enabling broad-based expected growth in 2022 at around 6% year-on-year. On the other hand, due to stubbornly high inflation, real wage growth turned negative, weighing on business and consumer sentiment. Due to the global nature of these factors, the EU growth outlook is hampering Croatia's expected export performance, especially in 1H 22023. Later in the year, as inflation moderates and real wage growth hopefully resumes, economic activity is expected to recover slightly, which should allow Croatia to expand by around 1% year-on-year in 2023.

Motivated by the desire to adopt the euro and meet the Maastricht criteria, Croatia already managed to slash the budget gap below 3% of GDP in 2021 (2.6% of GDP). The general government deficit is forecast to reduce further this year to 1.6% of the GDP, driven by the phasing out of COVID-19-related measures and strong nominal growth supporting the revenue side of the budget. On the revenue side, VAT intake will grow despite some tax cuts, backed by strong economic performance and high inflation, while direct taxes and contributions are set to benefit from the tight labor market and rising nominal wages. While the anti-inflationary package is reported at HRK 21bn (approx. 4% of GDP), the direct fiscal impact should be far more modest (in the 1% of GDP region), as the remainder will be a burden on state-owned energy producer profitability and incorporates EU-funded green transition projects and CBRD loan and guarantee facilities. The deficit is projected to increase in the following two years, as the government has adopted measures to support households and companies while the growth slowdown simultaneously curbs the revenue stream, but remains below 3% of GDP. Public debt levels are seen as settling below 70% of GDP, implying an approx. 20pp adjustment from the pandemic peak in 2020.

Inflation is forecasted to remain high and slightly above the EA average in 2022 and 2023, reaching levels close to 10.5% and 6.5% on average, respectively, as the increases in food and energy prices eventually pass through to core inflation. Price caps and the expected gradual normalization of energy prices, together with strong base effects, are expected to moderate inflation in 2023, although it will remain high relative to historical averages. In 2024, negative energy inflation is likely to push the inflation rate further down, and closer to the Euro area average.

As expected, CNB monetary policy actions ahead of euro adoption brought little surprise and an absence of restrictive actions. The CNB continued to maintain the tight peg with basically no effort, as we saw no stronger deviation from the conversion rate. Ample LCY liquidity received an additional boost from the prudential framework alignment and announced a two-step reserve requirement cut by 8 percentage points to 1%. As euro adoption nears, the focus is steadily turning toward ECB policy-making. Hence, global factors reshaped the inflation and risk profile and in turn the ECB policy stance and consequently led to the tightening of monetary conditions on both the EUR and LCY curves. In that sense, market volatility remains pronounced, as uncertainty regarding the outlook remains pronounced.

On the rating front, important integration steps were a strong tailwind in the recent period. Following the final green light for euro adoption, a two-notch upgrade from S&P and Moody's and one notch from Fitch, is now positioning Croatia deep within the investment grade region and aligning it closer to its EA CEE peers.

This year, mirroring strong economic activity, also brought a considerable surge in credit demand. Total credit growth accelerated to 8.1% YTD (September 2022). Looking at sector dynamics, corporate credit activity recorded especially strong dynamics (18.1% YTD). Part of such strong dynamics can be explained by prudent company actions as they seek to refinance before the expected rise in interest rates and higher working capital needs. The household segment also shows credit expansion, albeit at a more moderate pace (4.8% YTD), driven mostly by the vivid housing loans segment.

On the deposit side, overall deposits also recorded strong growth, rising 11.6% YTD (September 2022). The pace of corporate deposit growth is especially strong, rising 19.7% YTD, while household growth stands at 8.3% YTD, supported by a successful tourist season and stronger deposit inflow ahead of the conversion to euro.

Following the recovery throughout 2021, banking sector performance kept up a strong tone in 1H22 as well. On the profitability side, ROA remained virtually unchanged at 1.2, while ROE showed ongoing improvement at 9.5%. As far as efficiency is concerned, the CIR (Cost Income Ratio) remains close to pandemic levels at 53.3%, with the nearing euro adoption weighing on the near-term outlook. Risk metrics continued to improve owing to favorable macroeconomic conditions and lacking stronger effects from war developments, as NPL edged further down to 3.8% (-0.5 percentage points YTD) and coverage maintained a steady trend averaging close to 65%. Strong capitalization adds to resilience as the solvency ratio remains among the highest in the EU at 25%. The consolidation trend has been driven by the declining number of housing savings banks, with the total number of credit institutions being down to 21 (from 23). Also, due to the Russian invasion of Ukraine, the local subsidiary of Sberbank has been acquired by state-owned HPB bank. The competitive landscape favors ongoing consolidation, as achieving economies of scale remains a challenge for longer-term sustainability.

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