



Summary

After two years of GDP contraction, Croatia's economy stagnated in 2011, growing by a meagre 0.2%. For 2012, the situation in the eurozone, Croatia's main export market, and sluggish domestic demand (partly the result of high unemployment) are expected to result in another recession, as GDP is expected to contract by between 0% and 1%. Although the expected recession will keep import demand low, the current account is expected to remain in deficit (of 1% of GDP), which is partly financed with debt. As a result, external debt is expected to increase to 106% of GDP (from 101% of GDP in 2011). The recession will also reduce public revenues, forcing the government to implement more stringent austerity measures if it is to bring down the public deficit, which stood at 5% of GDP in 2011.

Things to watch:

- Slowing demand in the eurozone (Croatia's main export market)
- High external debt level
- High unemployment and impact on domestic demand

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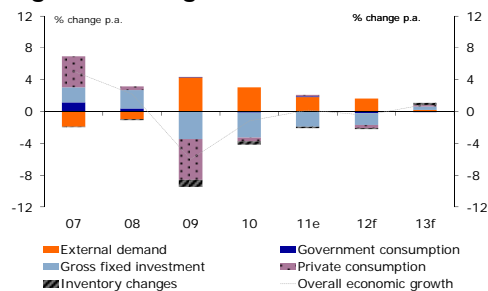
Croatia			
National facts		Social and governance indicators rank / total	
Type of government	Democratic Republic	Human Development Index (rank)	46 / 187
Capital	Zagreb	Ease of doing business (rank)	80 / 183
Surface area (thousand sq km)	57	Economic freedom index (rank)	83 / 179
Population (millions)	4.5	Corruption perceptions index (rank)	66 / 183
Main languages	Croatian (96%) Serbian (1%)	Press freedom index (rank)	68 / 178
Main religions	Roman Catholic (88%) Orthodox (4.4%) Muslim (1.3%)	Gini index (income distribution)	33.7
Head of State (president)	Ivo Josipovic	Population below \$1 per day (PPP)	0%
Head of Government (prime-minister)	Zoran Milanovic	Foreign trade 2010	
Monetary unit	kuna (HRK)	<i>Main export partners (%)</i>	<i>Main import partners (%)</i>
Economy 2011		Italy	19
<i>Economic size</i>		Bosnia	12
Nominal GDP	bn USD % world total	Germany	10
Nominal GDP at PPP	64 0.09	Austria	5
Export value of goods and services	79 0.10	<i>Main export products (%)</i>	
IMF quatum (in mln SDR)	25 0.11	Machines & transport equipment	32
<i>Economic structure</i> 2011 5-year av.		Chemical products	12
Real GDP growth	0.2 1.0	Mineral fuels & lubricants	11
Agriculture (% of GDP)	6 5	Food, live animals, beverages % tobacco	11
Industry (% of GDP)	25 27	<i>Main import products (%)</i>	
Services (% of GDP)	69 68	Machines & transport equipment	26
<i>Standards of living</i> USD % world av.		Chemical products	19
Nominal GDP per head	14308 133	Mineral fuels & lubricants	14
Nominal GDP per head at PPP	17684 143	Food, live animals, beverages % tobacco	10
Real GDP per head	10390 128	<i>Openness of the economy</i>	
		Export value of G&S (% of GDP)	39
		Import value of G&S (% of GDP)	38
		Inward FDI (% of GDP)	1.7

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

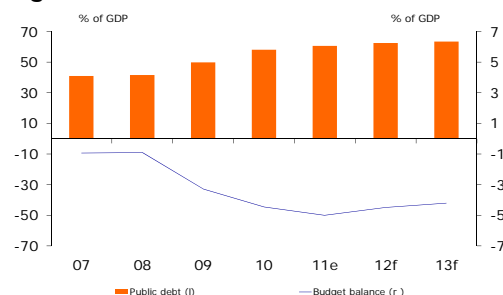
The good news of Croatia's acceptance into the European Union, which was the result of years of negotiations and political struggle, is largely overshadowed by the country's disappointing economic performance. After the economy contracted by over 6% in 2009 and 1.2% in 2010, it stagnated in 2011 (when it grew by a meagre 0.2%). In 2012, with over 20% of the population unemployed, domestic demand is expected to remain slow. At the same time, external demand for Croatian goods is reduced, on account of the ongoing crisis in the eurozone (Croatia's main export market). Consequently, we expect GDP to contract by between 0% and 1% in 2012. Indeed, fears of a new recession were confirmed in the first two months of 2012, as industrial production (IP) contracted by 4.9% in January (y-o-y) and over 5% in February (y-o-y).

Figure 1: GDP growth



Source: EIU

Figure 2: Public finances



Source: EIU

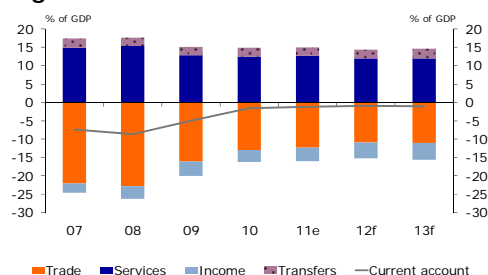
On a more positive note, with domestic demand slowing, we expect the current account deficit to remain small at 1% of GDP in 2012 (from 1.2% of GDP in 2012).

The previous recession laid bear and worsened Croatia's three economic risks: a high unemployment rate, a large public debt, as well as a high external debt. These issues are addressed below.

Not a great time to be in government

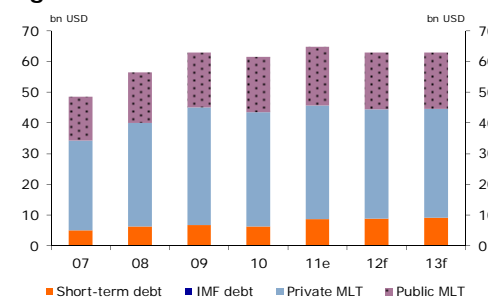
Given Croatia's fragile economic outlook, the country's coalition, led by the Social Democratic Party (SDP), has been saddled with the ungrateful task of spurring economic growth and creating jobs, while simultaneously cutting expenditure. To this end, it already voiced some ambitious plans. For one, the government aims to battle the country's high unemployment rate (which surpassed 20% in February 2012), by creating no less than 50,000 jobs by 2013. The various tax incentives and programs needed to achieve this result are estimated to cost the government USD 57mIn. While these plans will add to public spending, the government also announced that it plans to cut its spending by USD 0.7bn (or roughly 1% of GDP), in 2012. If it succeeds, these plans would go a long way in convincing both rating agencies and investors that Croatia is on the right track. Still, whether the government can be successful remains to be seen. For one, it assumes a 0.8% growth rate, which is well above our expectations. Secondly, the austerity measures are likely to fuel protests, which would test the government's endurance and could force it to postpone some of the austerity measures. Finally, many of the measures proposed involve superficial budget cuts, rather than the structural reforms necessary to bring the budget in balance in the long term as well. In light of these doubts and concerns, we expect a budget deficit of 4.5% of GDP in 2012 (from 5% of GDP in 2011), which will push public debt to 63% of GDP, from 61% of GDP in 2011.

Figure 3: Current account



Source: EIU

Figure 4: External debt



Source: EIU

External finances weakest link

Croatia's external position constitutes one of the largest risks to the country's overall stability. Despite hopes that the external debt level would fall in 2011, it remained at a high 101% of GDP. In 2012, we expect external debt to grow to 106% of GDP, the majority of which is held by the private sector. In fact, roughly half of all private sector loans are denominated in euros, while over 70% is denominated in non-local currencies (including the euro). Fortunately, in the last few years the central bank helped keep debt repayment costs stable, by stabilizing the exchange rate of the kuna vis-à-vis the euro. The USD 1.7bn increase in foreign exchange reserves in 2011, to USD 15.8bn, should allow the central bank to keep this policy in place in 2012 as well.

Croatia							
Selection of economic indicators	2007	2008	2009	2010	2011e	2012f	2013f
<i>Key country risk indicators</i>							
GDP (% real change pa)	5.1	2.2	-6.0	-1.2	0.0	-0.5	0.9
Consumer prices (average % change pa)	2.9	6.1	2.4	1.1	2.3	2.5	2.4
Current account balance (% of GDP)	-7.3	-8.6	-5.0	-1.5	-2.6	-2.1	-2.2
Total foreign exchange reserves (mln USD)	13675	12957	14895	14133	15869	16150	17150
<i>Economic growth</i>							
GDP (% real change pa)	5.1	2.2	-6.0	-1.2	0.0	-0.5	0.9
Gross fixed investments (real % change pa)	7.1	8.2	-11.8	-11.3	-7.2	-6.1	1.9
Private consumption (real % change pa)	6.3	0.8	-8.5	-0.9	0.2	-0.5	0.4
Government consumption (real % change pa)	5.6	1.9	0.2	-0.8	-0.2	-0.6	-0.5
Exports of G&S (real % change pa)	3.7	2.2	-17.3	6.0	2.2	-1.9	3.1
Imports of G&S (real % change pa)	6.2	3.3	-20.4	-1.3	1.0	-5.8	1.9
<i>Economic policy</i>							
Budget balance (% of GDP)	-0.9	-0.9	-3.3	-4.5	-5.0	-4.5	-4.2
Public debt (% of GDP)	41	41	50	58	63	65	65
Money market interest rate (%)	5.1	6.1	7.5	1.0	0.9	1.7	2.3
M2 growth (% change pa)	18	4	-1	4	4	5	6
Consumer prices (average % change pa)	2.9	6.1	2.4	1.1	2.3	2.5	2.4
Exchange rate LCU to USD (average)	5.4	4.9	5.3	5.5	5.3	5.7	5.7
Recorded unemployment (%)	15.1	13.4	14.9	17.6	17.9	19.5	18.6
<i>Balance of payments (mln USD)</i>							
Current account balance	-4296	-6028	-3169	-919	-1651	-1270	-1390
Trade balance	-12933	-15956	-10290	-7886	-8812	-7390	-7620
Export value of goods	12623	14460	10736	12070	13765	13190	13770
Import value of goods	25556	30416	21026	19957	22577	20580	21390
Services balance	8699	10742	8147	7568	8159	7220	7410
Income balance	-1492	-2391	-2477	-2056	-2398	-2550	-2690
Transfer balance	1431	1576	1450	1455	1400	1440	1510
Net direct investment flows	4713	4710	1598	481	990	800	2600
Net portfolio investment flows	428	-865	-292	-308	100	-100	-150
Net debt flows	4901	8968	5455	806	4505	1050	-600
Other capital flows (negative is flight)	-3559	-7502	-1655	-823	-2207	-200	550
Change in international reserves	2187	-717	1937	-762	1737	280	1000
<i>External position (mln USD)</i>							
Total foreign debt	48584	56540	63012	61612	65935	65560	64980
Short-term debt	5099	6372	6827	6383	9388	9840	10240
Total debt service due, incl. short-term debt	17037	15780	17196	18040	17527	19660	20390
Total foreign exchange reserves	13675	12957	14895	14133	15869	16150	17150
International investment position	-59038	-49691	-56588	-56777	n.a.	n.a.	n.a.
Total assets	31799	31976	35076	30694	n.a.	n.a.	n.a.
Total liabilities	90837	81667	91665	87470	n.a.	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	-22.1	-22.8	-16.2	-13.0	-13.8	-12.1	-12.1
Current account balance (% of GDP)	-7.3	-8.6	-5.0	-1.5	-2.6	-2.1	-2.2
Inward FDI (% of GDP)	8.5	8.6	4.5	0.5	1.7	2.0	4.9
Foreign debt (% of GDP)	83	81	99	101	103	108	103
Foreign debt (% of XGSIT)	167	166	242	232	225	231	226
International investment position (% of GDP)	-100.8	-71.1	-89.2	-93.3	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	59	46	66	68	60	69	71
Interest service ratio incl. arrears (% of XGSIT)	10	5	6	6	5	5	5
FX-reserves import cover (months)	5.6	4.5	7.2	7.2	7.2	7.7	8.0
FX-reserves debt service cover (%)	80	82	87	78	91	82	84
Liquidity ratio	112	107	114	112	114	110	111

Source: EIU

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