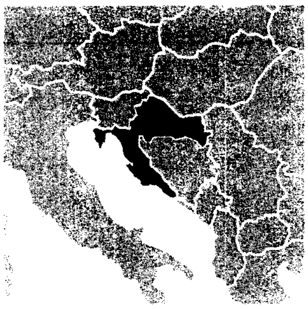
Croatia



Outlook

External imbalances adjusting quickly, but lack of adequate fiscal policy response to date raises concerns. However, the new, Kosor led, government has the freedom to implement decisive measures, one of which would be asking for help from the IMF. For now, public sector borrowing requirements are crowding out private sector access to credit, and prolonging the GDP contraction.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	**Baa3 stable**	**BBB negative**	**BBB- stable**

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	42.9	46.4	43.4	45.3	48.0
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	9662	10462	9787	10209	10832
GDP (constant prices yoy %)	5.5	2.4	-4.9	-0.2	1.7
Private Consumption, real, yoy (%)	6.2	0.8	-5.2	0	1.2
Fixed Investment, real, yoy (%)	6.5	8.2	-9.1	-1.5	3.2
Public Consumption, real, yoy (%)	3.4	1.9	1.3	-0.9	1.0
Exports, real, yoy (%)	4.3	1.7	-12.3	-3.0	1.5
Imports, real, yoy (%)	6.5	3.6	-14.6	-2.4	2.2
CPI (average, yoy %)	2.9	6.1	3.2	3.3	3.1
Monthly wage, nominal (EUR)	961	1044	1021	1048	1092
Unemployment rate (%)	9.6	8.4	10.5	11.0	9.8
Budget balance/GDP (%)	-2.0	-0.8	-3.9	-2.8	-2.5
Current account balance (EUR bn)	-3.2	-4.4	-2.3	-2.1	-1.9
Current account balance/GDP (%)	-7.6	-9.6	-5.4	-4.6	-3.9
Net FDI (EUR bn)	3.5	3.2	1.5	1.7	2.0
FDI % GDP	8.1	6.9	3.5	3.8	4.2
Gross foreign debt (EUR bn)	33.3	39.0	40.0	42.0	45.0
Gross foreign debt (% of GDP)	77.6	84.2	92.2	92.8	93.7
FX reserves (EUR bn)	9.3	9.1	8.5	8.0	8.5
(Cur Acc-FDI)/GDP (%)	0.6	-2.7	-1.9	-0.9	0.3
FX reserves/Gross foreign debt (%)	28.0	23.4	21.3	19.0	18.9
Exchange rate to USD eop	5.03	5.29	5.34	5.63	5.56
Exchange rate to EUR eop	7.33	7.37	7.75	7.60	7.50
Exchange rate to USD AVG	5.35	4.91	5.48	5.36	5.32
Exchange rate to EUR AVG	7.34	7.22	7.50	7.50	7.45

Source: UniCredit Research

STRENGTHS

- External imbalances adjusting quickly
- Well capitalized banking sector
- New government free from legacy – free in policy choice

WEAKNESSES

- Widening fiscal deficit is crowding out private sector
- High FX leverage in household and private sector
- Rising unemployment not accounted for properly in budget

Can the new government reduce public spending?

Sharp contraction in domestic demand evident from high frequency data

1Q GDP contracted 6.7% yoy. Domestic demand fell sharply as private consumption plummeted 9.9% yoy and gross fixed capital investment fell 12.4% yoy. At the same time, the rundown in inventories contributed 4 percentage points to the fall in GDP, while imports fell 14.2% yoy and exports fell 20.9% yoy. The collapse in demand for imports was reflected in the balance of payments data for 1Q09, which revealed a 28.2% yoy reduction in the current account deficit to EUR 1.82bn, largely as a result of the reduced merchandise trade deficit. In the first 5 months of the year, the merchandise trade deficit has narrowed by almost EUR 1.7bn, with imports of motor vehicles down by approximately EUR 400mn.

Headline GDP forecast consistent with high frequency data, but composition of growth changes...

...Inflation forecast upped to 3.2% on higher 1Q outcome

GDP forecast revised down to 4.9% contraction, inflation forecast upped to 3.2% yoy. Given the sharper-than-expected fall in inventories and gross fixed capital investment, we lower our GDP forecast from a 3.7% to 4.9% contraction. The risks remain to the downside given that rising public sector borrowing requirements are crowding out private sector access to credit. Although inflation is heading seasonally lower over the summer, the increases seen in 1Q09 will flow into the full-year figure, which we raise to 3.2% yoy, with a year-end figure of 4.0% yoy.

Still waiting for an appropriate adjustment in public spending...

Monetary conditions stable in recent months, budget revenue figures weak while expenditures rise substantially. 1W money market rates have oscillated between 6-9% since mid-March and look set to remain stable during 3Q. 1Q budget figures revealed a very weak fiscal position with expenditures rising over 10% yoy and revenues down 4.8% yoy. VAT revenues were down almost 19% yoy in 1Q and were it not for the 1.5% increase in social welfare contributions, the HRK 3.5bn deficit recorded in 1Q would have been substantially higher. Current expenditures in 1Q rose 10.7% yoy, with wages up 11.3% yoy to HRK 8.9bn, and the purchase of other goods and services rising 23.3% to HRK3.65bn. The 12.7% increase in social welfare spending is also worrying given that the expected impact of higher unemployment is yet to be fully felt in the budget. Compared to the government's HRK 5.5bn budget deficit forecast, we look for a deficit of HRK13bn (3.9% of GDP), underlining that this does not include the Motorway Authority (HAC), development bank (HBOR) or pensioner debt repayments.

...the only question is will the government muster the courage to cut spending on its own, or will it need to call in the IMF to help?

Another budget rebalance is likely in the autumn months. In April, the central bank governor criticized the lack of adjustment in fiscal policy and has since repeated calls for the government to cut public spending or call in the IMF to assist. He also repeated that the bank will not loosen monetary policy any more this year. Moral suasion by the governor to kick-start the fiscal adjustment process has become increasingly evident in recent weeks. The new government is planning a budget rebalance before parliament breaks for summer (it may well sit beyond 15 July to ensure the budget rebalance is passed) but is also flagging the possibility of another rebalance in September.

Surprise resignation of PM Sanader

PM Sanader resigns, new government installed 4 days later. After PM Sanader's surprise resignation on 1 July, his deputy Jadranka Kosor was confirmed as prime minister of a new government. This has allayed any immediate fears of political instability with the new government gaining the support of 83 of the 153 MPs.

FX and sovereign credit rating outlook revolve around fiscal policy developments

Fiscal developments the main factor for FX and credit rating outlook. During 3Q, tourism-related inflows will see the EUR/HRK near current levels; however, after the peak tourist season, depreciation pressures on the currency are likely to resurface, especially if there is no fiscal adjustment. Given that public external debt obligations are minimal in the remainder of the year, the sovereign credit rating should remain stable in the near term, but with public debt redemptions rising again in 1Q10, a cut in public spending will be the key factor going forward for Croatia's sovereign rating.