Croatia: Good or very good news?

Following S&P's upgrade to BBB- on 22 March, we believe there is more good news in store for Croatia- and it could come on Friday

Close call

Despite the stable outlook and against Moody's typical rating change pattern, a direct one notch upgrade to Ba1 (from Ba2) is our base scenario for Moody's review on Friday (26 April). While achieving "only" a positive outlook revision would still be good news for Croatia, developments over the past year allow for greater expectations. It is still a close call between the two.

Weak long-term growth potential but sound fiscal discipline

Based on Moody's Credit Opinion from August 2018, the focus will be on Croatia's long-term economic potential and the trajectory of public indebtedness (see Table below):

- We consider the relatively weak long-term growth potential as Croatia's key problem, which is likely to act as a rating constraint for an extended period. Nevertheless, GDP growth has been pretty robust and stable In recent years, coming in at 2.9% in 2017, 2.6% in 2018 and likely somewhere around 2.5% in 2019 (ING forecast is 2.4%).
- On the other hand, the public indebtedness ratio has been falling even faster than envisaged and should close the year just above 70%. This was greatly helped by sound fiscal discipline over the last three years, with quasi-balanced budgets and primary surpluses above expectations. Some fiscal impulse (-0.5% of GDP budget deficit projected for 2019) is in the pipeline which should keep GDP growth afloat.
- In addition to the above factors, other positive developments could weigh sufficiently enough to trigger an upgrade. Chiefly, we note the political stability of the last two to three years, in a country traditionally prone to political volatility and relatively frequent snap elections. Furthermore, the external position has been constantly improving, with Croatia posting consistent current account surpluses, even if the result is very much dependent on the tourism sector. Meanwhile, the target of joining the Exchange Rate Mechanism (ERM II)

in 2020 ought to be an anchor for reforms that should transcend the electoral years ahead.

It's worth noting that even a direct upgrade to Ba1 would still keep Croatia one notch below S&P's BBB- rating. Fitch rates Croatia BB+ but with a positive outlook and we consider an upgrade to investment grade as likely at the next review on 7 June.

Fig 3 Rating drivers/Factors that could lead to an upgrade or downgrade

Agency (review date)	Upgrade Drivers	Downgrade Drivers
Moody's Ba2 sta (26 Apr)	• Economic reforms to improve the **long-term economic potential** • Fiscal reforms to secure downward **trajectory in public indebtedness** closer to the median of Ba-rated peers	• Inability to implement comprehensive **structural reforms** which would eventually lead to weaker growth and higher public debt • Deterioration of **external vulnerability metrics**
S&P BBB- sta (20 Sep)	• **Continued convergence with EU average income levels**, driven by resilient economic growth amid Europe's cyclical slowdown and possibly aided by removing structural impediments to growth • **Faster than anticipated reduction in public debt**	• Material economic downturn and reversal of recent fiscal gains, possibly driven by a **significant weakening in the external environment** • Sizeable fiscal drain or drag on the economy from **higher-than-expected contingent liabilities**
Fitch BB+ pos (7 Jun)	• Increased confidence in downward path of **public sector debt/GDP** • Increased resilience to external shocks through further reduction in **external indebtedness** and/or **progress towards euro adoption** • Strengthening of growth prospects and competitiveness including **structural reform implementation**	• Failure to reduce **government debt/GDP** (e.g. fiscal loosening) • Deterioration in **growth prospects** or emergence of **macroeconomic imbalances**

Source: Moody's, S&P, Fitch, ING

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