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Croatia hits fever pitch

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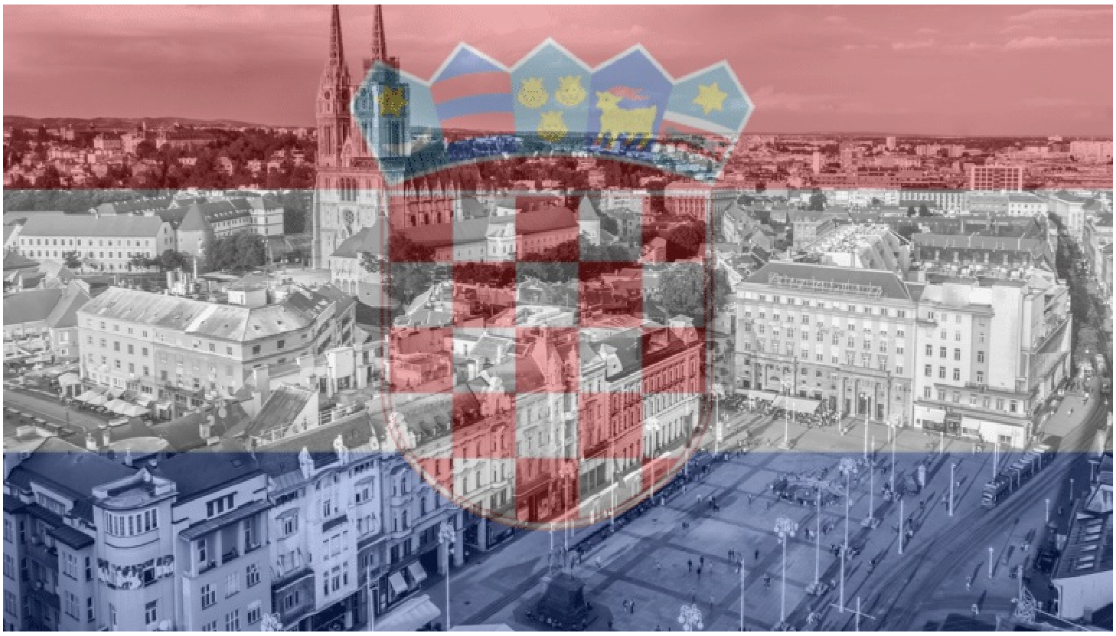

No, this is not an article on football, and any football reference is purely coincidental. This is an article on the football nation whose economy is (finally) showing positive trends and has (finally) been awarded a one-notch rating upgrade by two rating agencies, S&P and Fitch, this year. Only one notch away from the much-desired investment grade rating, the Croatian economy remains on sound footing before tackling its last challenge.

Long story short

When compared to its peer group of SEE countries, Croatia could very well be labelled a laggard. While most of its peers have experienced a double dip recession in the past ten years (exhibiting positive growth rates in between), Croatia's GDP remained below the line of positive growth for most of that time. Structural imbalances, political instability, high public debt coupled with a high budget deficit and rising interest rate costs due to the lost investment rate rating back in 2013 brought the economy to the tipping point where radical change was needed to reverse existing trends.

Recipe for success

Change (although far from radical) came in the shape of a mini tax reform, record-beating tourist seasons, and improved exports dynamics. The mini tax reform targeted middle class workers by increasing the tax-deductible part of their income and introducing a lower tax rate for their income bracket. This way household demand, which makes up almost 60% of the Croatian GDP, was able to restore its pre-recession growth rate of 3.5%. Exports made huge progress as well, considering that net exports as part of GDP was deep in the red until 2012. This was the result of both booming economies among Croatia's main trading partners and a hefty 20% contribution of Croatia's main export product, i.e. tourism, to GDP.

SEE-ing is believing

Macro numbers of all our SEE peers look seemingly alike, showing robust growth rates but also a build-up in inflation numbers for those that are financing their growth through higher budget deficits. Croatia is far from it, though. Households are still deleveraging, inflation is anchored around a tame 1.5% level, which supports the ongoing loose CNB monetary policy, banks remain well-capitalised with NPL ratios falling below 10%, and everything looks set for another good year. Public finance dynamics are also improving. Public debt has finally reversed its trend and is currently at 78% of GDP. Government officials expect it to decrease by an annual rate of 2.5%, ambitiously setting their target at 70% for 2020. The EU Commission acknowledged those positive trends by allowing Croatia to exit EU's Excessive Deficit Procedure in June last year. Most analysts expect the government to be able to maintain fiscal deficits below 3% going forward.

Looking ahead

Current macro and fiscal dynamics coupled with announcements of yet another stellar tourist season lay a solid basis for Croatia to reclaim its lost investment grade rating. It goes without saying that the all-time low spreads show that markets are (once again) way ahead of rating agencies. It remains to be seen whether we will keep up with the pressure. As always, the ball is in our court.

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