BMI Research
A FitchGroup Company

# Croatia

## Country Risk Report

Includes 10-year forecasts to 2027

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Q2 2018

# Contents

# Executive Summary

## Core Views

- Croatia's short-term economic outlook has improved considerably as domestic demand has recovered faster than anticipated and robust growth has eased some of the country's macroeconomic imbalances. Despite this, real GDP is only expected to regain pre-crisis levels by 2020.

- Public debt remains high by both emerging and developed market standards, leaving the country vulnerable to shocks. While the public debt ratio peaked in 2015 and will continue to fall gradually, reforms to boost medium-term growth will be vital to ensure debt remains on a sustainable path once global interest rates begin to rise.

- The Croatian National Bank will maintain its quasi euro peg, which we view as stable, and thus continue to track European Central Bank monetary policy.

- The country's ambition to join the eurozone will remain elusive for the foreseeable future, in part due to rising euroscepticism within core countries which will lessen the willingness to absorb new members. That said, Croatia is already a very euro-ised economy, with a large chunk of banking sector activity conducted in the common currency.

- After a volatile 2017, we expect a return to relative political calm in the coming quarters, though caution that the government coalition remains vulnerable to internal divisions over sensitive reform issues.

## Key Risks

- The burdensome debt pile leaves the country highly exposed to shocks in financial markets or interest rate hikes that raise the cost of servicing debt.

- If the government does not implement structural reforms that draw fresh investment in, the country's medium-term growth outlook will become more gloomy.

- The need to take unpopular political decisions could once again lead to divisions within the governing coalition, endangering the progress of reforms.

- A default of the country's agricultural and retail giant **Agrokor** would weigh on the country's sovereign risk profile.

# Chapter 1:
# Economic Outlook

## SWOT Analysis

### Strengths

- The country has enjoyed a long period of exchange rate stability thanks to a quasi currency peg with the euro
- EU accession and movement towards eurozone are raising the country's attractiveness for foreign investors.

### Weaknesses

- Foreign direct investment into Croatia has yet to recover from the financial crisis. We attribute this to investor aversion following almost six years of negative real GDP growth, a relatively muted economic outlook, and the precarious state of public finances.
- Expenditure on social services is extremely high by regional standards. We expect budgetary tightening to remain a challenge over the forecast period, especially since growth will remain slow.
- Croatia's labour force is expensive and uncompetitive by regional standards. It is unlikely to improve unless significant structural reforms are implemented by the government, which looks unlikely.

### Opportunities

- The country's robust tourism sector has the potential to grow even further over the next few years, taking advantage of increased security risks in rival destinations such as Turkey and Greece.
- Recent tax reform is a positive first step towards simplifying the system and improving the business climate.

### Threats

- The external accounts remain vulnerable to exogenous shocks, such as a sharp decline in tourism, which occurred in 2009.
- Croatia's high public debt load and persistent budget deficits means that the country remains highly exposed to external or financing shocks.
- The country faces a long-term demographic crisis, with low birth rates and high levels of emigration.
- A default of the country's troubled agricultural and retail giant Agrokor would weigh on the country's sovereign profile.

## BMI Economic Risk Index

Croatia's short-term economic outlook has improved as domestic demand recovers and record tourism continues to drive solid export growth. The cyclical upswing will help unwind some of the macroeconomic imbalances that had built up during the pre-crisis boom and, especially, six-year recession that followed. Most significantly, a reduced budget deficit will ease the immediate risks to stability and set public debt on a downward trajectory. Nonetheless, it will take several years just to make up the ground lost during the prolonged downturn, and the debt pile will remain uncomfortably high over the medium term, undermining efforts to boost the country's long-term growth potential.

| | S-T Economic | Trend | Regional Rank | Global Rank |
|---|---|---|---|---|
| Poland | 72.3 | - | 1 | 24 |
| Lithuania | 70.6 | - | 2 | 28 |
| Latvia | 68.5 | = | 3 | 35 |
| Hungary | 67.9 | - | 4 | 39 |
| Romania | 65.6 | - | 5 | 43 |
| Russia | 64.8 | + | 6 | 46 |
| Bulgaria | 63.3 | + | 7 | 53 |
| **Croatia** | **63.3** | **-** | **7** | **53** |
| Kazakhstan | 57.3 | + | 9 | 71 |
| Macedonia | 53.8 | + | 10 | 84 |
| Turkey | 51.7 | - | 11 | 92 |
| Azerbaijan | 50.0 | + | 12 | 99 |
| Moldova | 49.0 | - | 13 | 105 |
| Uzbekistan | 49.0 | - | 13 | 105 |
| Ukraine | 48.3 | + | 15 | 110 |
| Kyrgyzstan | 47.5 | + | 16 | 114 |
| Serbia | 47.5 | + | 16 | 114 |
| Montenegro | 47.3 | + | 18 | 116 |
| Georgia | 46.3 | + | 19 | 122 |
| Albania | 41.5 | + | 20 | 142 |
| Kosovo | 41.3 | = | 21 | 143 |
| Tajikistan | 41.0 | + | 22 | 145 |
| Armenia | 40.0 | + | 23 | 149 |
| Turkmenistan | 38.3 | + | 24 | 155 |
| Bosnia-Herzegovina | 35.8 | = | 25 | 166 |
| Belarus | 32.7 | - | 26 | 178 |

***Regional ave 52.1 / Global ave 53.4 / Emerging Markets ave 49.2***

| | L-T Economic | Trend | Regional Rank | Global Rank |
|---|---|---|---|---|
| Poland | 70.2 | - | 1 | 35 |
| Lithuania | 69.2 | + | 2 | 38 |
| Hungary | 68.3 | - | 3 | 40 |
| Romania | 65.9 | - | 4 | 44 |
| Russia | 64.9 | + | 5 | 49 |
| Turkey | 64.3 | + | 6 | 52 |
| Bulgaria | 64.1 | + | 7 | 55 |
| Latvia | 63.4 | + | 8 | 56 |
| **Croatia** | **62.0** | **+** | **9** | **60** |
| Kazakhstan | 57.6 | - | 10 | 76 |
| Macedonia | 55.8 | + | 11 | 85 |
| Serbia | 54.4 | + | 12 | 91 |
| Azerbaijan | 52.6 | - | 13 | 100 |
| Uzbekistan | 52.4 | - | 14 | 101 |
| Montenegro | 50.6 | + | 15 | 113 |
| Moldova | 50.1 | = | 16 | 115 |
| Georgia | 50.0 | + | 17 | 116 |
| Albania | 49.5 | + | 18 | 119 |
| Bosnia-Herzegovina | 45.7 | + | 19 | 137 |
| Ukraine | 44.9 | + | 20 | 140 |
| Kyrgyzstan | 42.3 | + | 21 | 151 |
| Turkmenistan | 42.1 | + | 22 | 152 |
| Armenia | 41.3 | + | 23 | 153 |
| Belarus | 39.8 | + | 24 | 162 |
| Kosovo | 38.4 | + | 25 | 168 |
| Tajikistan | 37.2 | = | 26 | 173 |

***Regional ave 53.7 / Global ave 55.3 / Emerging Markets ave 51.1***

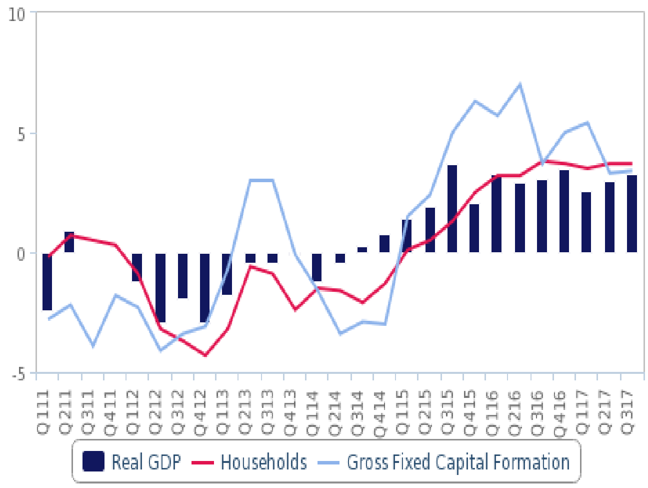
# Economic Growth Outlook

## Growth To Cool As External Demand Softens

**BMI VIEW**

*Following a strong 2017, Croatian real GDP growth will slightly decelerate over the next two years as a strong outlook for consumption and construction compensate for weaker external dynamics. That said, in order to boost long-term growth potential, structural reform implementation needs to be accelerated.*

**Domestic Demand Driving Growth**
Real GDP & Expenditure Components, % chg y-o-y



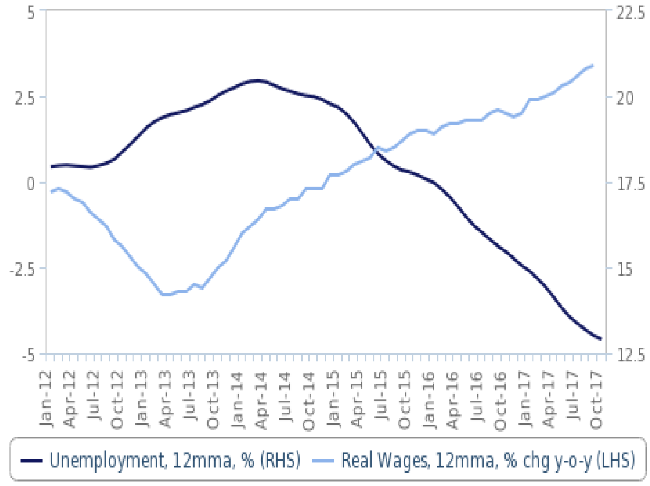

*Source: Croatian Bureau of Statistics, BMI*

We have slightly revised up our Croatian headline real GDP growth forecast for 2017 from 2.9% to 3.1%, reflecting the ongoing strength of domestic demand and favourable external conditions. The flash estimate of real GDP growth for Q317 came in at 0.9% q-o-q and 3.3% y-o-y, accelerating from 3.0% y-o-y in Q217, marking the strongest rate of growth since Q416. Looking ahead, buoyant domestic demand will continue to drive economic activity, although weakening external demand will see headline growth slow to 2.7% and 2.6% in 2018 and 2019, respectively. That said, real GDP will remain well below pre-crisis levels until 2020, making it an imperative that the government ramps up structural reform implementation against a backdrop of poor demographics and elevated public debt.

### Domestic Demand To Remain At The Forefront Of Economic Activity

Domestic demand will continue to drive Croatian economic activity over the next two years, as the outlook for household consumption and fixed investment growth remains favourable. After expanding by an average of 3.6% y-o-y in the first three quarters of 2017, we believe that household consumption growth will remain robust in the quarters ahead. Indeed, the consumer confidence index is at a multi-year high, which coupled with a tightening labour market and subdued inflation will continue to exert upward pressures on real wages, which have risen by an average of 3.7% y-o-y in January to September 2017. Labour productivity has risen alongside nominal wages, meaning that Croatia's unit labour cost has thus far remained in a downtrend since Q110. This is in contrast to a wider regional trend (*see 'Full Employment A Headwind For Growth', September 14*). As such, rising wages have not necessarily been a drag on corporate profit margins.

**Consumer Spending Conditions Remain Favourable**
Unemployment And Real Wages



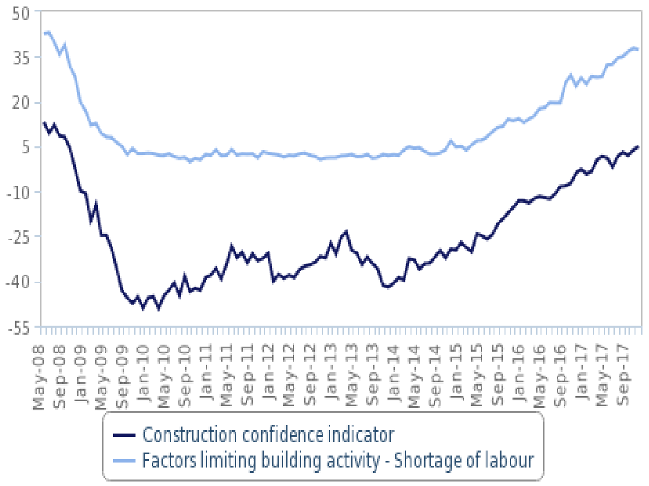

*Source: Croatian Bureau of Statistics, BMI*

On top of robust household consumption growth we also expect that gross fixed capital formation (GFCF) to expand at a healthy clip. Over the first nine months of 2017, GFCF expanded by an average of 4.0% y-o-y and we expect investment activity, particularity in the construction sector, to remain on a strong upward trajectory as a variety of EU co-financed infrastructure projects are due to enter the construction phase as we approach the end of the 2014-2020 funding round. Additionally, residential building permits have risen by an average of 25.0% y-o-y over the first ten months of 2017, supported by improving household balance sheets. Reflecting this, Croatia's construction confidence index in November 2017 reached its highest level since September 2008.

Meanwhile, we also expect investment into machinery and equipment to support gross fixed capital formation over the next two years. Indeed, the industrial confidence index is at a multi-year high, with capacity utilisation in Q317 having reached 73.9%, which is close to its pre-financial crisis high of 75.8% in Q308. Given that monetary conditions in Croatia will remain very loose over the next two years, investment can be financed at historically low rates of interest. Rebounding foreign currency lending since July 2017 (after five years of negative FX loan growth), suggests to us that business are now starting to take advantage of the favourable interest rate and demand conditions.

**Construction Sector To Boost Output And Investment**

Construction Survey



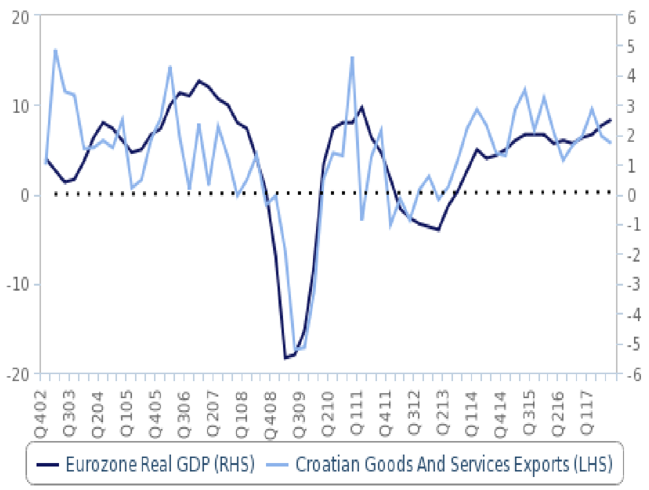

*Source: Eurostat, BMI*

## Eurozone Slowdown To Weigh On Croatian Export Growth

While Croatian real goods and services exports in January to October 2017 accelerated by an average of 7.2% (from 5.5% over the same time period of the previous year), we expect growth to slow over the next two years, as moderating eurozone demand and cooling tourism growth will weigh on exports.

**Slowing Eurozone Growth To Weigh On Croatian Exports**

Eurozone – Real GDP And Croatian Goods And Services Exports, % chg y-o-y



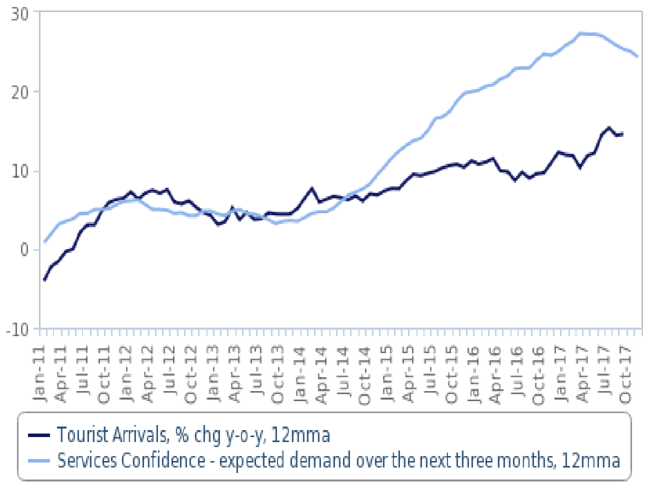

*Source: Eurostat, BMI*

With regards to eurozone demand (accounting for over 60.0% of Croatian goods exports), we believe that eurozone growth will peak in 2017 (*see 'BMI Vs Consensus: Eurozone Exuberance Going Too Far', December 5*). The European Commission's industry survey shows that export expectations among Croatian firms in Q417 dropped to a twelve month low.

In addition to moderating eurozone demand for Croatian goods exports, we also believe that slowing tourism growth will weigh on services exports (tourism accounted for 71.0% of services exports in 2016). We base this view on the stabilising security situation in rival tourist destinations such as Turkey, from whose instability the Croatian tourism industry has greatly benefitted in recent years. As such, after year-on-year tourist arrivals rose by 13.1% over the first nine months of 2017 we expect growth to peak in 2017. Reflecting this view, the European Commission's most recent services confidence survey shows that Croatian services providers are expecting demand to weaken over the next 12 months, albeit from a very high level.

**Tourism Growth To Moderate**

Tourist Arrivals And Services Confidence




*Source: Croatian Bureau of Statistics, Eurostat, BMI*

## Weak Reform Outlook Limiting Growth Potential

All that said, at a forecasted average growth rate of 2.6% over the next two years, Croatian real GDP will only return to its pre-crisis level by 2020. In order to boost mid-term growth prospects the country will need to boost structural reform implementation, which amid an unstable political backdrop (two snap elections in 2016 and a government reshuffle in mid-2017) has stalled over the past two years. Indeed, the IMF, in its concluding statement following the 2017 article four mission, reiterated that it is critical for Croatia to reduce the administrative burden on doing business, increase the flexibility of the labour market, improve efficiency of the public sector, and enhance property rights and the judicial process. Reflecting these shortcomings, Croatia's scores a relatively poor 63.6 out of 100 on our proprietary Operational Risk index, below the eurozone average of 68.1 out of 100.

Additionally, accelerated structural reform implementation and stronger economic growth is also warranted in order to reduce the country's high public debt load, which at an estimated 80.8% of GDP is still substantially above the EU's debt criterion for eurozone accession. As eurozone accession remains a primary goal of the government of prime minster Andrej Plenkovic, stronger growth and debt reduction will proof essential for the country's eurozone accession plans.

## GDP By Expenditure Outlook

Final consumption makes up the bulk of GDP in Croatia, with household consumption accounting for the vast majority of the total. Since 2009, net exports have played an increasingly important role in mitigating the scale of the six-year economic contraction. Furthermore, the large deficit in the goods account continues to be largely offset of the surplus in the services account, due to tourism.

**Private Consumption:** Private consumption will remain the main component of GDP in the years ahead. Given the significant structural issues facing Croatia (emigration, high unemploy-

**TABLE: GDP GROWTH FORECASTS**

| | 2016 | 2017e | 2018f | 2019f | 2020f | 2021f |
|---|---|---|---|---|---|---|
| Nominal GDP, HRKbn | 345.2 | 362.2 | 377.8 | 394.5 | 411.8 | 430.4 |
| Real GDP growth, % y-o-y | 3.0 | 3.1 | 2.7 | 2.6 | 2.4 | 2.3 |
| GDP per capita, HRK | 81,923.7 | 86,468.9 | 90,721.3 | 95,283.4 | 100,049.9 | 105,180.1 |
| | **2022f** | **2023f** | **2024f** | **2025f** | **2026f** | **2027f** |
| Nominal GDP, HRKbn | 450.7 | 473.2 | 497.0 | 522.0 | 548.2 | 576.5 |
| Real GDP growth, % y-o-y | 2.2 | 2.2 | 2.1 | 2.1 | 2.1 | 2.2 |
| GDP per capita, HRK | 110,751.2 | 116,925.6 | 123,474.4 | 130,400.1 | 137,709.8 | 145,599.1 |

*e/f = BMI estimate/forecast. Source: Eurostat, BMI*

**TABLE: PRIVATE CONSUMPTION FORECASTS**

| | 2016 | 2017e | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f | 2026f | 2027f |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Private final consumption, HRKbn | 199.9 | 210.0 | 219.8 | 230.0 | 240.5 | 251.8 | 263.7 | 276.9 | 290.6 | 304.9 | 320.0 | 334.3 |
| Private final consumption, % of GDP | 57.9 | 58.0 | 58.2 | 58.3 | 58.4 | 58.5 | 58.5 | 58.5 | 58.5 | 58.4 | 58.4 | 58.0 |
| Private final consumption, real growth % y-o-y | 3.3 | 3.8 | 3.0 | 2.8 | 2.6 | 2.5 | 2.2 | 2.2 | 2.0 | 2.0 | 2.0 | 1.5 |

*e/f = BMI estimate/forecast. Source: Eurostat, BMI*

**TABLE: GOVERNMENT CONSUMPTION FORECASTS**

| | 2016 | 2017e | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f | 2026f | 2027f |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Government final consumption, HRKbn | 66.3 | 68.6 | 70.8 | 73.2 | 76.1 | 79.4 | 83.0 | 87.0 | 91.4 | 95.9 | 100.7 | 106.8 |
| Government final consumption, % of GDP | 19.2 | 18.9 | 18.7 | 18.6 | 18.5 | 18.4 | 18.4 | 18.4 | 18.4 | 18.4 | 18.4 | 18.5 |
| Government final consumption, real growth % y-o-y | 1.3 | 2.2 | 1.5 | 1.5 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 3.0 |

*e/f = BMI estimate/forecast. Source: National Sources, BMI*

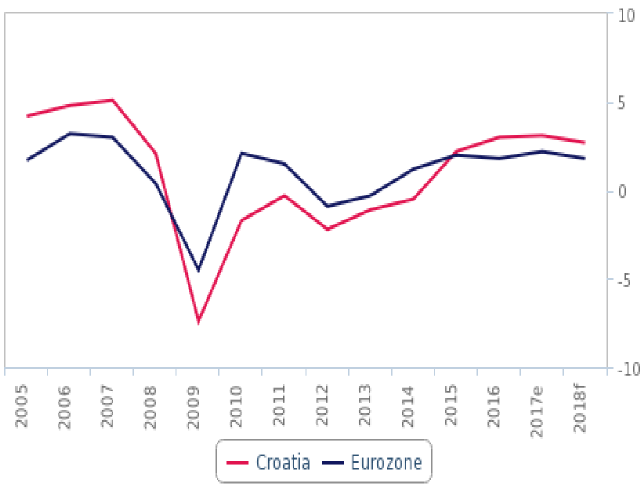
**TABLE: FIXED INVESTMENT FORECASTS**

| | 2016 | 2017e | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f | 2026f | 2027f |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Fixed capital formation, HRKbn | 68.4 | 72.3 | 77.4 | 81.9 | 86.4 | 91.2 | 95.7 | 100.8 | 106.3 | 112.1 | 118.2 | 125.8 |
| Fixed capital formation, % of GDP | 19.8 | 20.0 | 20.5 | 20.8 | 21.0 | 21.2 | 21.2 | 21.3 | 21.4 | 21.5 | 21.6 | 21.8 |
| Fixed capital formation, real growth % y-o-y | 3.7 | 1.6 | 5.3 | 4.0 | 3.4 | 3.2 | 2.4 | 2.3 | 2.3 | 2.3 | 2.3 | 3.3 |

*e/f = BMI estimate/forecast. Source: National Sources, BMI* ment, greying population) we believe this is sub-optimal. At best, an extended period of low inflation will continue to boost real incomes over the short term, driving a modest uptick in consumer spending.

**Modest Growth Ahead For Croatia**

Real GDP Growth, % chg y-o-y




*e/f = BMI estimate/forecast. Source: Eurostat, BMI*

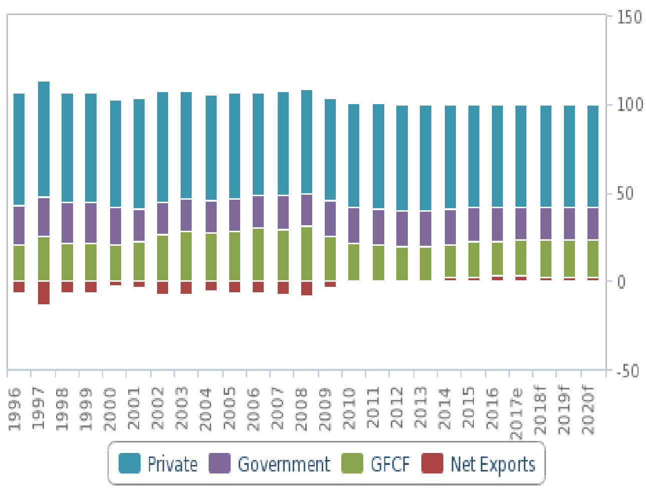
Improvements to household wealth are unlikely to be significant over the longer term, however. In the absence of control over its currency (the kuna is loosely pegged to the euro) the country has pursued a internal devaluation to tackle competitiveness issues. Wages are still high relative to most regional peers, suggesting the internal devaluation has further to run. We expect successive administrations to restrict public sector pay packages and attempt to reduce the influence of the country's strong labour unions.

**Government Consumption:** Government spending will account for 18.5% of GDP over the next five years. Croatia's debt dynamics are unsustainable, with the budget deficit and public debt load among the highest in the region. Though we expect both of these figures to gradually improve – thereby reducing the need for harsh austerity measures – we do not believe the government will have much room to stimulate growth via fiscal policy in the coming years.

**Gross Fixed Capital Formation:** Though business activity will pick up, fixed capital formation will not recover its severe post-crash decline of around 45% over the coming decade. We forecast fixed investment to comprise just over 20% of GDP by 2020, having been as high as 30% of GDP in 2007. This reflects weakness in Croatia's housing sector and business climate. Entrenched housing oversupply and a declining population suggests there is limited scope for a recovery in house prices and residential construction following the sector's crash. A low capacity utilisation ratio implies there will be a limited need for businesses to invest in new productive capacity anytime soon, while the country's labour productivity is among the lowest in the EU. The government's relatively weak fiscal accounts and the perception among voters that past administrations spent unwisely in the pre-crisis years, means government spending on infrastructure projects will remain subdued in the foreseeable future, with the exception of EU-funded projects and ventures in the high-value tourism sector.

**Private Consumption The Main Driver Of The Economy**

Real GDP By Expenditure Breakdown, % GDP




*e/f= BMI estimate/forecast. Source: National sources, BMI*

**Net Exports:** We expect net exports to comprise around 2.2% of GDP on average over the next five years. This is a big improvement compared to the past, with net exports accounting for -7.3% of GDP in 2007. Imports collapsed during the financial crisis, due to a severe reduction in domestic demand, in a

**TABLE: NET EXPORTS FORECASTS**

| | 2016 | 2017e | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f | 2026f | 2027f |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Net exports of goods and services, HRKbn | 10.5 | 11.3 | 9.8 | 9.3 | 8.7 | 8.0 | 8.3 | 8.5 | 8.7 | 9.0 | 9.3 | 9.6 |
| Net exports of goods and services, % of GDP | 3.0 | 3.1 | 2.6 | 2.4 | 2.1 | 1.9 | 1.8 | 1.8 | 1.8 | 1.7 | 1.7 | 1.7 |
| Net exports of goods and services, real growth % y-o-y | 3.1 | 9.6 | -20.7 | -9.9 | -12.7 | -16.5 | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 | 4.0 |

*e/f = BMI estimate/forecast. Source: Eurostat, BMI*

sub-optimal rebalancing of the country's external accounts. A rebound in consumption and investment will drive up import growth, offsetting much the income from Croatia's booming tourism industry and minimising the overall contribution of net exports to headline growth.

# External Trade And Investment Outlook

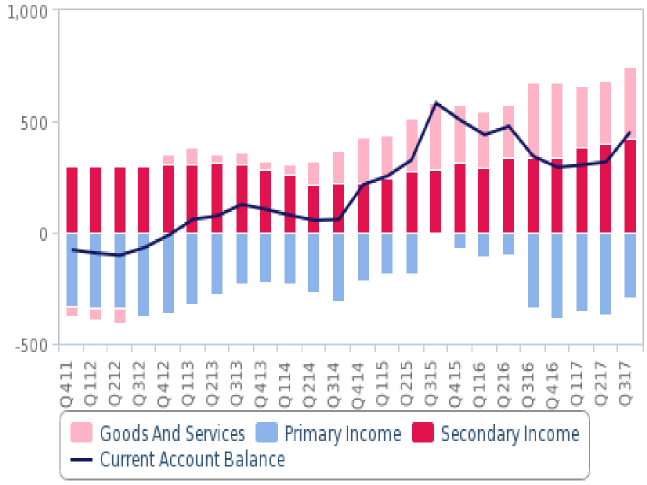
## Narrowing Current Account Surplus No Threat To External Stability

**BMI VIEW**

*Strong imports, cooling externa demand and moderating tourism growth will see Croatia's current account surplus narrow over the coming years. That said, the country's net international investment position is set to further improve, reducing Croatia's vulnerability to external shocks.*

**Current Account To Remain In Robust Surplus**

Current Account Balances, EURmn, 4qma




*Source: HNB, BMI*

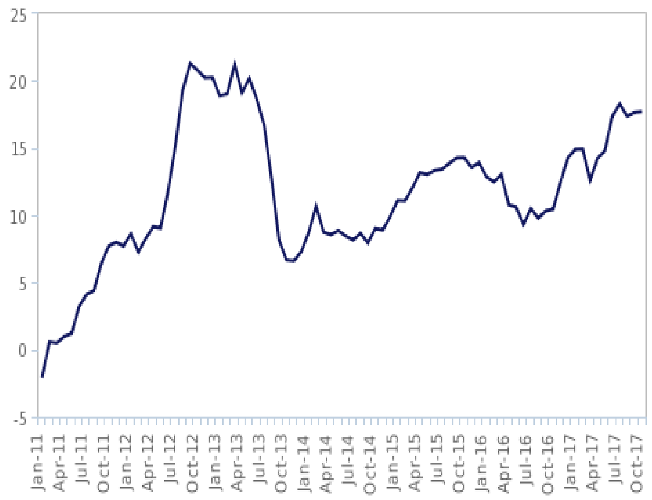
Following an estimated current account surplus of 3.0% of GDP in 2017, we forecast it to narrow over the coming years to 1.9% by 2019. This will be due to strong import demand, cooling external demand, and weaker tourism growth. That said, the continued current account surpluses over the coming years will continue to narrow Croatia's net international investment deficit and thus further reduce the country's vulnerability to external shocks.

### Cooling External Demand And Tourism Growth To Weigh On Current Account

The main factor that will drive a narrowing of Croatia's current account surplus over the next two years relates to a widening of the country's trade deficit. From January to October 2017 the trade deficit widened to EUR6.5bn, compared to EUR5.8bn over the same time period of the previous year. This was due to import growth of 12.0% y-o-y, and we believe that Croatian demand for imported goods will remain elevated over the coming quarters as the outlook for the Croatian consumer remains strong (*see 'Growth To Cool As External Demand Softens', December 13*).

**Tourism Boom To Cool**

Foreign Tourist Arrivals, % chg y-o-y, 12mma




*Source: Eurostat, BMI*

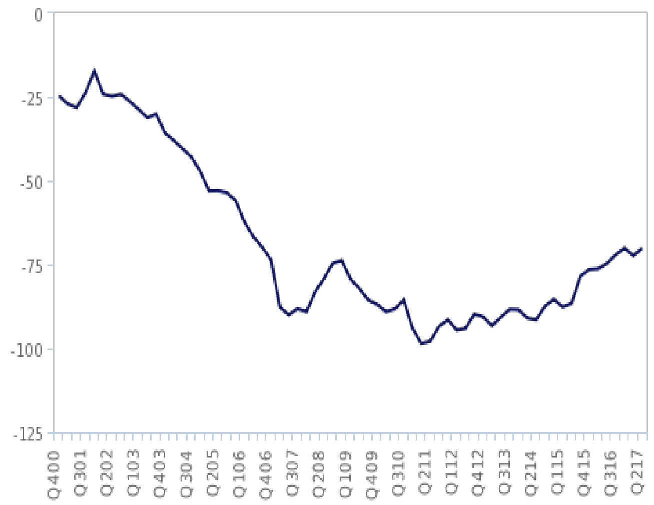
Notwithstanding strong domestic demand, a healthy outlook for Croatia's exporting industries will prevent a more severe widening of the trade deficit. Over the first nine months of 2017, goods and services exports rose by 10.3% y-o-y (compared to 5.6% in the same period of the previous year) and we anticipate that growth in both categories will remain on a healthy trajectory, despite cooling somewhat in the quarters ahead. We forecast real GDP growth in the eurozone – the country's largest trading partner – to peak in 2017, whilst a recovering Turkish tourism industry will moderate the pace of foreign tourist arrivals. Taken together, these factors underpin our forecasts for the Croatian goods deficit to widen from 15.8% of GDP in 2017 to 16.5% in 2019, while the services surplus will narrow from 18.8% to 18.2%.

### Improving Investment Position To Reduce External Vulnerabilities

Given our forecasts of persistent current account surpluses, we anticipate that Croatia's net international investment position (NIIP) will continue to improve over the coming years, thus reducing the country's vulnerability to external shocks. The deficit has already substantially improved from a high of 98.6% of GDP in Q111 to 70.1% in Q317, which means that the country is gradually approaching the threshold below which the European Commission no longer regards the NIIP as a macroeconomic balance (anything above 60.0%). Additionally, the breakdown of the NIIP is relatively stable, since the share of foreign direct investment (FDI) liabilities to total liabilities in Q317 stood at 44.9% (compared to 'hot money' liabilities standing at 55.0%), which suggests that in times of global and domestic risk aversion the country is not overly exposed to capital flight.

**C/A Surpluses To Narrow NIIP Deficit**

Net International Investment Position, % of GDP




*Source: Eurostat, BMI*

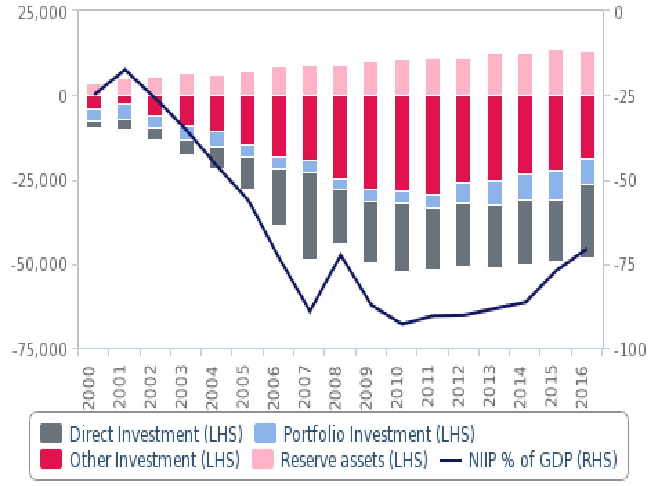
While Croatia is not reliant on external financing due to its current account surplus, we note that the country will need to boost foreign direct investment inflows to boost its longer-term growth potential. Net FDI inflows as a percentage of GDP are still some 49.0% below their pre-financial crisis level (7.6% in 2007 compared to 3.7 in 2016). In order to boost FDI inflows the government will have to take greater efforts to implement structural reforms in order to improve its business environment. Indeed, the IMF, in its concluding article four statement, reiterated that it is critical for Croatia to reduce the administrative burden on doing business, which is furthermore underscored by the country's relatively poor 51 out of 190 rank on the World Banks 2017 Ease of Doing Business Index.

# Outlook On External Position

**International Investment Position Poses Significant Risk:** Croatia's improved current account position masks risks associated with high levels of net external debt. Croatia has one of the largest net international investment position (NIIP) deficits in the region. The NIIP has been driven wider in recent years, in both nominal terms and more substantially as a proportion of GDP (due to almost six years of negative economic growth post-2008). Large NIIP deficits can typically pose problems if financial conditions deteriorate, with sustained capital flight then turning into a more salient risk to financial stability.

**High But Improving**

Net International Investment Position, EURmn




*Source: Eurostat, BMI*

For Croatia, the composition of the NIIP has also deteriorated in recent years. While net foreign direct investment (FDI) stands at around -45% of GDP, it fell as global liquidity conditions deteriorated during the economic downturn and has been slow to recover. Stable, long-term, FDI liabilities are generally hard to withdraw if financial conditions deteriorate, and thus pose a lower threat to financial stability.

On top of this, the remaining net liability position has become increasingly weighted towards short-term capital, exposing Croatia to potential capital flight. Croatia's rapidly growing

**TABLE: CAPITAL & FINANCIAL ACCOUNT BALANCE**

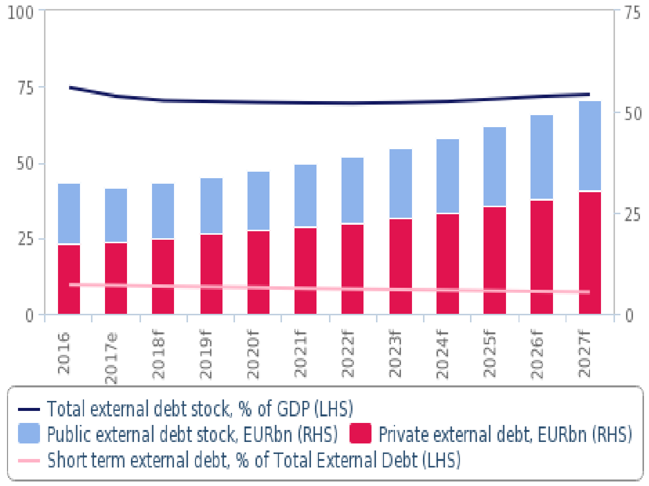
| | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|
| Capital account, EURbn | 0.0 | 0.1 | 0.1 | 0.3 | 0.5 |
| Financial account, EURbn | -0.4 | 1.4 | -0.1 | 2.6 | 1.0 |
| Capital and financial account, % of GDP | -0.7 | 3.2 | -0.1 | 6.6 | 3.2 |
| Net FDI inflows per capita, EUR | 287.9 | 198.2 | 162.5 | 58.3 | 465.0 |
| Net portfolio investment, EURbn | 1.7 | 1.9 | -0.7 | 0.1 | -1.3 |
| Net other Investment, EURbn | 2.5 | 0.4 | 0.9 | 1.5 | 2.2 |

*Source: HNB, BMI*

public debt load has been partially funded by foreign purchases of government debt. As a result, net portfolio liabilities have more than doubled in size since 2007.

**Debt Burden A Source Of Concern**

Total External Debt




*e/f = BMI estimate/forecast. Source: World Bank QEDS, BMI*

**External Debt:** In our view, Croatia's debt load is unsustainable. There is an outlying risk that the country's deteriorating sovereign risk profile eventually prompts investors to pull out of Croatian government debt markets, forcing the government to seek external (ie IMF) assistance to plug budget funding gaps. The remainder of the net liability position is comprised of 'other investments', which are also typically easier to withdraw if financial conditions deteriorate.

On a more positive front, a large international reserve pile acts as an important buffer against any capital flight turning into a systemic risk to financial stability, at least over the short term. Import cover is currently around six months, and running current account surpluses in the years ahead should also result in healthy FX reserve accumulation going forward. On top of this, the central bank's commitment to loosely pegging the kuna against the euro mitigates against any FX risks to the country's external debts, of which a significant proportion is EUR denominated.

**Trade Composition:** Most of Croatia's trade of goods involves machinery and manufactured goods, with the shipbuilding

**TABLE: CURRENT ACCOUNT BALANCE FORECASTS**

| | 2017e | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f | 2026f | 2027f |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Balance of trade in goods, EURbn | -7.7 | -8.2 | -8.6 | -8.8 | -9.3 | -9.8 | -10.5 | -11.2 | -12.0 | -12.5 | -12.9 |
| Balance of trade in goods, % of GDP | -15.8 | -16.0 | -16.1 | -15.8 | -16.1 | -16.0 | -16.3 | -16.6 | -16.9 | -16.8 | -16.4 |
| Balance of trade in services, EURbn | 16.6 | 17.3 | 17.9 | 18.8 | 20.0 | 21.2 | 22.5 | 23.9 | 25.3 | 26.9 | 28.5 |
| Balance of trade in services, % of GDP | 33.9 | 33.9 | 33.7 | 33.8 | 34.3 | 34.8 | 35.0 | 35.3 | 35.7 | 36.0 | 36.4 |
| Primary income balance, EURbn | -1.5 | -1.7 | -2.0 | -2.3 | -2.5 | -2.8 | -3.1 | -3.4 | -3.7 | -4.1 | -4.5 |
| Primary income balance, % of GDP | -3.1 | -3.4 | -3.7 | -4.1 | -4.3 | -4.5 | -4.8 | -5.0 | -5.2 | -5.5 | -5.7 |
| Secondary income balance, EURbn | 1.4 | 1.6 | 1.9 | 2.0 | 2.1 | 2.3 | 2.5 | 2.6 | 2.8 | 3.0 | 3.2 |
| Secondary income balance, % of GDP | 2.9 | 3.2 | 3.5 | 3.6 | 3.7 | 3.8 | 3.8 | 3.9 | 4.0 | 4.0 | 4.1 |
| Current account balance, EURbn | 1.4 | 1.2 | 1.0 | 1.1 | 1.0 | 1.1 | 1.0 | 0.8 | 0.6 | 0.7 | 0.9 |
| Current account balance, % of GDP | 3.0 | 2.4 | 1.9 | 1.9 | 1.8 | 1.8 | 1.5 | 1.2 | 0.8 | 0.9 | 1.2 |

*e/f = BMI estimate/forecast. Source: CNB, BMI*

**TABLE: TOP 5 GOODS EXPORTS IN 2016**

| By Country | % of total exports | By Category | % of total exports |
|---|---|---|---|
| Italy | 13.7 | Mineral fuels, mineral oils and products of their distillation | 23.5 |
| Slovenia | 12.5 | Misc. manufactured articles | 16.9 |
| Germany | 11.8 | Manufactured goods | 15.7 |
| Bosnia & Herzegovina | 9.2 | Chemical products | 13.2 |
| Austria | 6.4 | Food & live animals | 11.2 |

*Source: Trademap, BMI.*

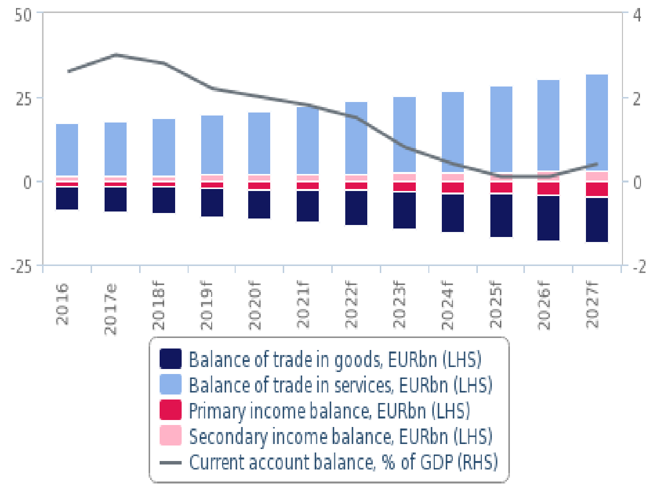
**TABLE: TOP 5 GOODS IMPORTS IN 2016**

| By Country | % of total imports | By Category | % of total imports |
|---|---|---|---|
| Germany | 16.1 | Machinery & transport equipment | 25.7 |
| Italy | 12.6 | Manufactured goods | 17.8 |
| Slovenia | 10.9 | Chemical products | 15.3 |
| Austria | 8.0 | Misc. manufactured articles | 14.4 |
| Hungary | 7.1 | Mineral fuels and lubricants | 12.3 |

*Source: Trademap, BMI.*

industry a key player. The country remains heavily dependent on trade with a select group of countries in the eurozone (especially Italy and Germany) and the Western Balkans (Serbia and Bosnia & Herzegovina), although demand in the latter region was crushed by the global financial crisis. This concentration of trade had been a drag on activity in Croatia in recent years, but now it is more encouraging as the regional recovery should help drive export growth.

**Surplus To Narrow**
Current Account Balance




*e/f = BMI estimate/forecast. Source: HNB, BMI*

# Monetary Policy

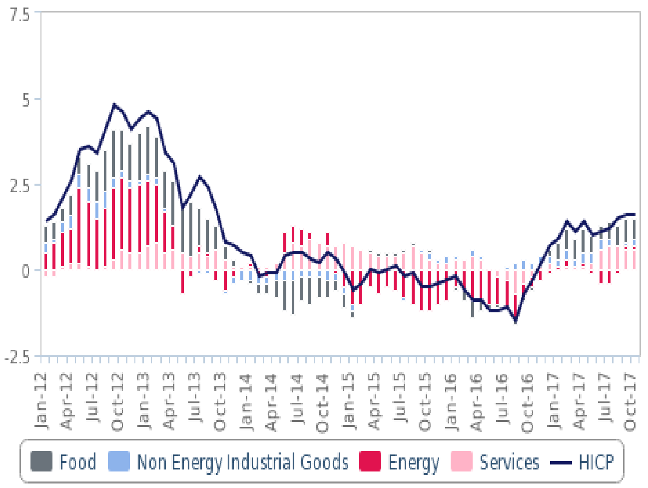
## Weak Supply Side Pressures To Keep Inflation Subdued

**BMI VIEW**

*While a strong outlook for the Croatian consumer will exert upward pressure on core inflation, the headline rate will remain well anchored as regional and commodity price pressures remain subdued. Meanwhile, the government's plan of joining the eurozone in the next seven-to-eight years seems feasible in our view.*

A relatively strong outlook for the Croatian consumer, aided by robust wage and rebounding consumer credit growth, will help to spur a slight uptick in Croatian inflation over the next two years. That said, a firmer uptick in the headline rate will be prevented by subdued imported inflation from the eurozone and only a weak uptick in commodity prices. As such, we forecast inflation to average 1.7% in 2018 and 1.9% in 2019, from an estimated 1.4% at end-2017. Meanwhile, the government's October announcement that it plans to join the eurozone within the next seven or eight years seems feasible in our view, although accession will largely depend on EU discretion, as Croatia is unlikely to fully comply with the public debt criterion of eurozone accession.

**Inflation Outlook Remains Moderate**
Harmonised Index Of Consumer Prices, % chg y-o-y And Component Contribution, pp




*Source: Eurostat, BMI*

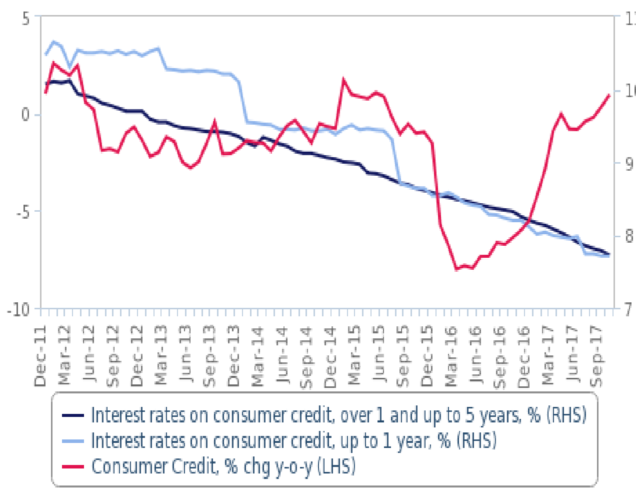
## Regional, Commodity Price Pressures To Weigh On Headline Inflation

Accelerating wage and rebounding consumer credit growth will be driving Croatian consumer price growth over the next two years. Although core inflation, after rising from -0.1% y-o-y in November 2016 to 1.7% in April 2017, has recently decelerated (to 1.5% in September), a strong outlook for the Croatian consumer suggests that core prices (ie excluding food and energy) will continue to build over the coming quarters. This will reflect a tightening labour market (the unemployment rate stood at 11.6% in October, compared to 14.0% a year earlier) and strong wage growth, which rose to 5.3% y-o-y on average over the first nine months of 2017.

Additionally, after two years of contraction, Croatian consumer loan growth rebounded in September 2017, and we believe that household credit growth will continue to pick up pace over the next two years. Indeed, given the Croatian National Bank's (HNB) quasi-peg of the Croatian kuna to the euro, we anticipate that the bank will maintain its accommodative monetary policy stance, and as such interest rates on consumer credit will remain at a multi-year low, supporting household demand for credit over the next two years.

Although rising demand-side pressures will exert upward pressures on consumer prices, weak supply-side pressures will keep headline inflation well anchored. This relates to two factors: weak regional inflation and moderate commodity price growth. To begin with, regional inflation, particularly in the eurozone, will remain subdued (we forecast 1.4% in 2018 and 1.6% in 2019) and as such imported inflation from the country's biggest trading partner (accounting for over 60.0% of total imports in 2016) will remain weak over the next two years. Additionally, our Oil and Gas team forecasts oil prices to rise by just 6.5% y-o-y on average in 2018, compared to 18.5% in 2017, and as such oil price inflation will remain subdued in the quarters ahead.

**Rebounding Loan Growth To Fuel Inflationary Pressure**
Consumer Credit Interest Rates And Consumer Credit Growth




*Source: ECB, BMI*

## Government's Seven-To-Eight-Year Euro Adoption Plan Feasible

Meanwhile, we believe that Prime Minister Andrej Plenkovic's plan to join the eurozone in the next seven to eight years is a feasible target. Currently, despite not yet being a member of the European Exchange Rate Mechanism II (in order to adopt the euro a country must have been in the ERM for two years), the country fulfils all but one of the remaining convergence criteria, as the kuna exchange rate remains stable, long-term interest and inflation rates remain within the bandwidth of eurozone averages, and the budget deficit does not exceed 3.0% of GDP. The only criterion that still remains out of reach, is that of public debt, which at an estimated 80.8% of GDP in 2017 significantly outstrips the targeted 60.0%.

Looking ahead, although we do not believe that the ratio will fall to 60.0% over the next seven to eight years (we forecast 72.3% by 2025), eurozone treaty provisions do provide that an applicant may join the currency union if the ratio is 'diminishing and approaching the reference value at a satisfactory pace'. While 'sufficiently diminishing' and a 'satisfactory pace' are not specifically specified, an 8.5 percentage point debt reduction over eight years is a noteworthy achievement. As such, given the wider institutional push for deeper EU integration, we believe that such a reduction could be favourably considered, which makes Croatian eurozone accession in the next seven-to-eight years a feasible target in our view.

# Monetary Policy Framework

While the National Bank of Croatia (HNB) does not have an explicit inflation target, price growth has been relatively manageable during the last 10 years. Even discounting a period of deflation in recent years (mirrored in many other CEE economies), CPI growth has remained in positive territory, averaging 2.6% over the past decade. This relatively low level of price growth reflects well against a number of regional peers. We expect inflation in Croatia to move back towards its long-term average over the forecast period.

**Inflation Credibility:** The HNB is generally viewed as one of

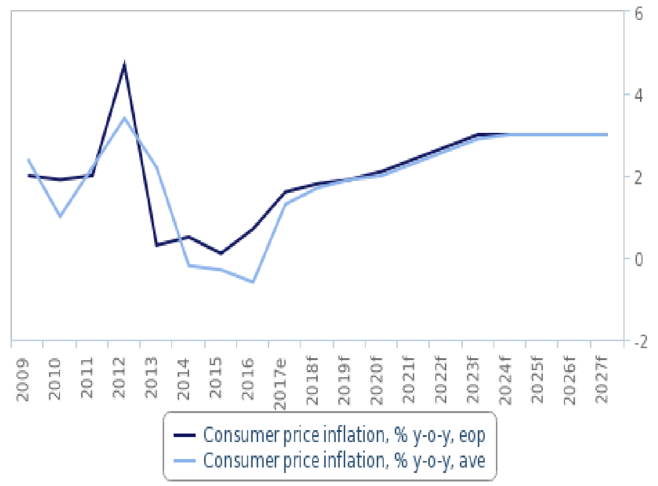
**TABLE: FULFILMENT OF NOMINAL EUROZONE CONVERGENCE CRITERIA**

| | HICP | Budget Deficit To GDP | Debt-To-GDP | Exchange Rate Stability | Long-Term Interest Rate |
|---|---|---|---|---|---|
| Accession Target | Not more than 1.5 percentage points above the rate of the three best performing member states | Not above 3.0% of GDP | Not above 60.0% of GDP | ERM II member for at least two years without severe tensions | Not more than 2 percentage points above the rate of the three best performing member states in terms of price stability |
| 2017 Status | Fulfilled | Fulfilled | Not Fulfilled | Partially fulfilled, no ERM II member but operating a stable quasi-peg to the euro | Fulfilled |

*Source: BMI*

the country's more credible institutions, particularly in light of a general mistrust of politicians and declining support for the country's traditional political parties. The HNB has a strong record of contributing to years of steady growth and low inflation in the years leading up to the financial crisis. In our view, the HNB enjoys a reasonable degree of independence and is generally perceived to be less corrupt than the government or judiciary. The HNB does not publish minutes of monetary policy meetings, but produces regular press releases following committee meetings, as well as a range of monetary policy and macroeconomic policy documents online.

**Returning To Conventional Territory**
Consumer Price Inflation

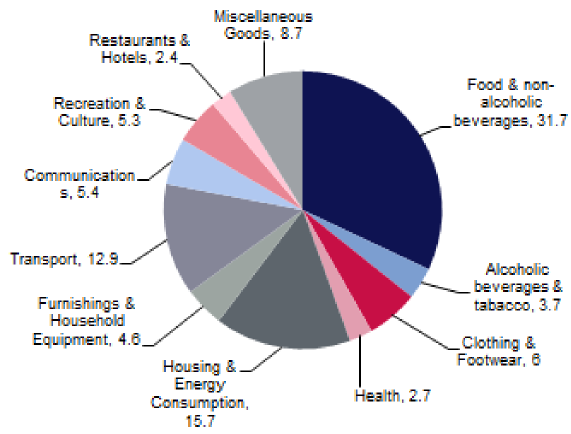



*f = BMI forecast. Source: Eurostat, BMI*

**Monetary Policy Regime:** The HNB pursues a relatively unorthodox monetary policy regime. The bank targets exchange rate stability of the kuna against the euro, and has done so relatively successfully over the past decade. It does not have a formal inflation target, choosing to loosely focus on 'maintaining price stability'.

The HNB's decision to target FX stability partially reflects a weak transmission system in Croatia. Almost 70% of household loans are taken out in FX, meaning altering the policy rate has only a limited impact on domestic demand and lending. While FX devaluation would help tackle Croatia's chronic long-term competitiveness issues, allowing the currency to devalue would impair loan repayments for the huge numbers of those with loans in FX. As a result, we see limited chance of the HNB abandoning its loose kuna peg against the euro anytime soon, which will continue to limit the scope of the HNB's monetary policy remit.

**CPI Breakdown**
Breakdown of CPI Basket, %




*Source: CSB, BMI.*

Croatia's consumer price index (CPI) basket is weighted heavily towards food and energy prices. Food prices comprise about a one-quarter weighting in the CPI basket. This means the trajectory of inflation is heavily determined by global agricultural commodity prices. As a net importer of agricultural products, particularly from other EU countries or neighbouring CEE countries, the quality of harvests in these economies can have a significant impact on price trends in Croatia.

Taken together, 'housing and utilities' and 'transport' comprise about a 28% weighting in the CPI basket, which are both in turn heavily determined by global energy prices. For 'transport', changes in the price of global crude oil (which have almost halved since 2014) are crucial. The liberalisation of energy prices demanded as conditions for Croatia to join the EU means the 'housing and utilities' subcomponent now has an increased ability to fluctuate and impact overall inflationary trends.

**TABLE: MONETARY POLICY FORECASTS**

| | 2017e | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f | 2026f | 2027f |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Consumer price inflation, % y-o-y, eop | 1.6 | 1.8 | 1.9 | 2.1 | 2.4 | 2.7 | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Central bank policy rate, % eop | 3.00 | 3.00 | 3.50 | 4.00 | 4.50 | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 |

*e/f = BMI estimate/forecast. Source: Eurostat, BMI*

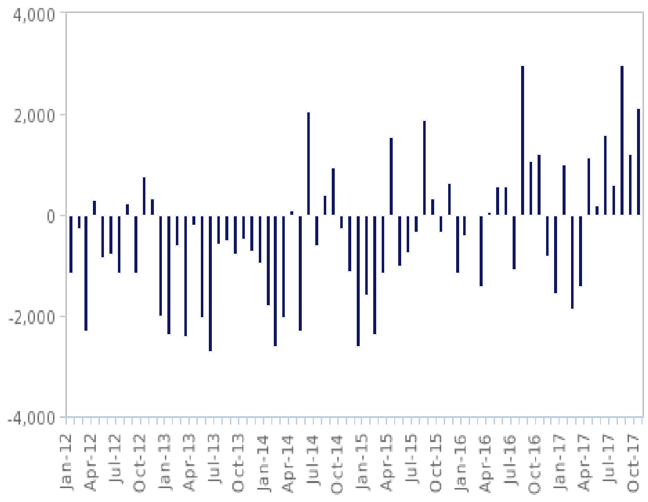
# Fiscal Policy And Public Debt Outlook

## Narrowing Budget Deficit Facilitating Debt Reduction

**BMI VIEW**

*We expect Croatia's budget deficit to narrow over the next two years, as a prudent fiscal policy and a healthy outlook for the economy will facilitate further deficit reduction. Given our small fiscal deficit forecasts, coupled with subdued borrowing costs and robust real GDP growth, we anticipate that the country's public debt ratio will continue to fall in the quarters ahead, serving the government's ultimate goal of joining the eurozone in the next seven to eight years.*

**Ten Month Performance Hinting At Record Low Deficit In 2017**
Budget Balance, HRKmn

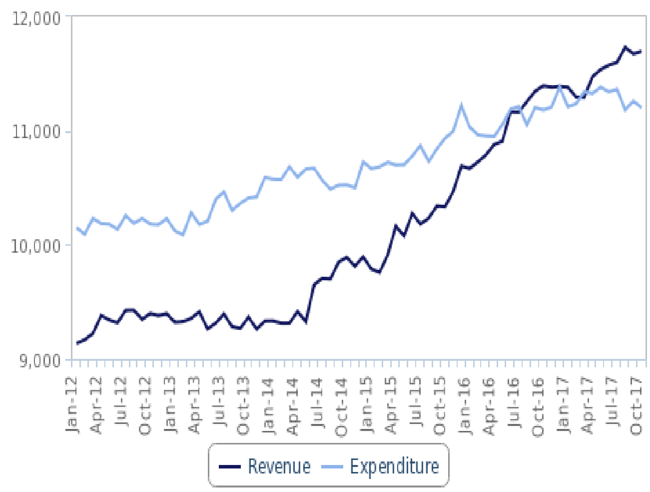



*Source: Croatian Ministry of Finance, BMI*

Although full-year data for 2017 is not available yet, we expect Croatia's budget deficit in 2017 to come in at a record low 0.6% of GDP. Over the first 10 months of the year the budget posted a surplus of HRK7.6bn, more than double the HRK3.6bn recorded over the same time period of the previous year. That said, the ten month budget surplus is no indication of a full year surplus, as the majority of government outlay is historically booked in the final two months of the year. Looking ahead, we expect a further narrowing to 0.5% of GDP in 2018, as a robust outlook for the Croatian economy and expenditure restraint will permit further fiscal consolidation in the quarters ahead. This combination of fiscal prudence and robust real GDP growth will facilitate a gradual reduction of the country's large public debt load, which will prove essential given the government's goal of joining the eurozone in the next seven to eight years.

Croatian budget deficit reduction over the coming quarters will be primarily driven by strong revenue growth and a relatively prudent expenditure policy. In January to October 2017 government revenues rose by 3.7% y-o-y and we believe that fiscal receipts will continue to grow at a healthy clip. Principally, this relates to the robust growth outlook of Croatia's economy (*see 'Growth To Cool As External Demand Softens', December 13*), bolstering value added tax (VAT) and social contribution tax receipts, which rose by 6.5% y-o-y and 4.0% over the first eight months of the year. Additionally, after rising by 17.1% y-o-y in January to August, we also believe that corporate tax intake will remain robust, as strong business confidence readings imply that Croatian businesses hold a positive view on their growth prospects, which will help sustain tax revenue growth in the corporate sector.

**Fiscal Prudence To Drive Deficit Reduction**
Central Government Revenue And Expenditure, HRKmn, 12mma

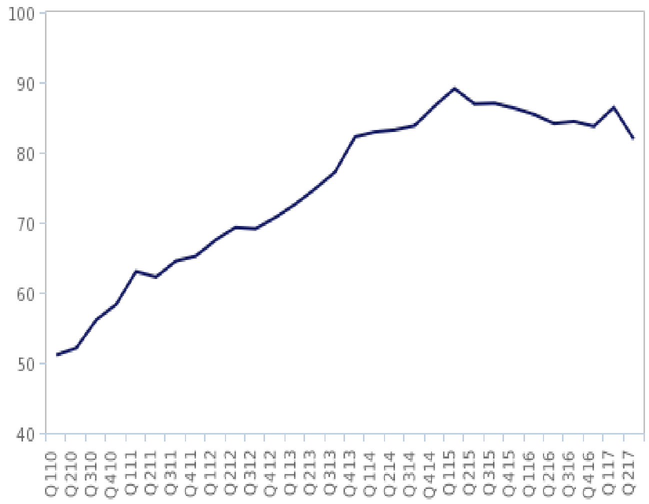



*Source: Croatian Ministry Of Finance, BMI*

Meanwhile, on the expenditure side, government spending over the first ten months of 2017 contracted by 3.0% y-o-y and we believe that public outlay will remain relatively subdued in the quarters ahead. Indeed, the 2018 budget drafted on November 2 does not foresee any major expenditure increases. Spending is projected to rise by just HRK5bn to HRK133.5bn. The most notable increases are earmarked for government employee salaries (up by HRK1.4bn) dating back to a collective agreement concluded in 2016 and pension payments (up by HRK1.6bn).

That said, a significant downside risk to the country's budget and wider sovereign profile remains in the uncertainty surrounding the country's agricultural and retail giant **Agrokor** (*see 'Political Crisis Averted, But Risks Remain Elevated', June 30*). The company, which amassed an unsustainable EUR6.0bn in debt (15.0% of Croatia's GDP) averted bankruptcy in early 2017 after the government took over managerial control of the corporation. For now, a roll-up financing agreement of up to EUR1.06bn with the company's main creditors should keep the concern financially afloat. Should the government's restructuring process however fail and thus necessitate a state bailout, public finances would significantly deteriorate and substantially widen the country's budget.

**Narrowing Budget Deficit To Ease Debt Burden**
Government Debt, % of GDP




*Source: Eurostat, BMI*

Leaving the Agrokor uncertainty aside, relatively small budget deficits, robust real GDP growth and subdued borrowing costs over the coming years will help facilitate a gradual reduction of the country's large public debt load. Specifically, we expect government debt as a percentage of GDP to fall from an estimated 80.8% in 2017 to 78.4% by 2019. That said, as we have highlighted in the country's economic growth outlook (*see 'Growth To Cool As External Demand Softens', December 13*), the government needs to ramp up structural reform implementation in order to boost real GDP, which would accelerate public debt reduction serving the government's seven-to-eight year goal of joining the eurozone. Currently, at 81.9% of GDP in Q217, government debt is still substantially above the 60.0% threshold for eurozone accession, and at the current rate of growth we do not expect the ratio to sufficiently fall in the next seven to eight years. Adopting the euro would substantially reduce fiscal stability risks, as eurozone accession would eliminate the exchange rate risk of the country's heavily euroised public debt burden (68.0% of public debt was denominated in euros in 2016). In the meantime, albeit, the large euro denominated public debt load, the Croatian National Banks commitment to its quasi-euro peg will mitigate exchange rate risks until eurozone accession.

## Structural Fiscal Position

**Government Debt:** The government debt load, at an estimated 80.8% of GDP in 2017, is significant for a country at Croatia's nascent level of economic development. Croatia will continue running fiscal deficits in the years ahead, which suggests the debt load will remain high (at around 76.6% of GDP in 2020 according to our forecasts). Croatia's declining population means that the burden of a growing debt load will be placed upon an ever shrinking number of workers. Debt repayment – including interest payments – will also remain a burden on government finances over the medium term.

Debt sustainability is reliant on favourable borrowing costs, which will not last forever. Despite these favourable conditions, the proportion of government expenditure going to 'interest' repayments' has risen in recent years in nominal terms and as a proportion of GDP, reflecting the ballooning size of the country's debt load and sluggish nominal growth. A recovery in economic activity will provide some relief, but our forecasts do not anticipate sufficient growth to make a significant dent in the debt pile without additional reforms from the government.

**Debt Structure:** Although the kuna's loose peg against the euro

**TABLE: FISCAL AND PUBLIC DEBT FORECASTS**

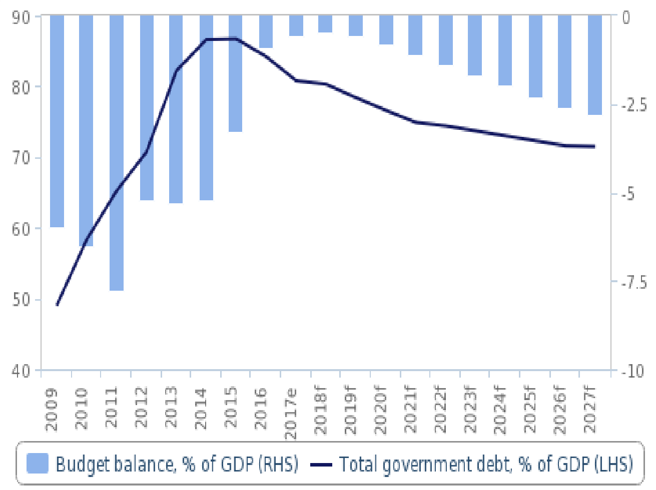
| | 2017e | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f | 2026f | 2027f |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Total revenue, HRKbn | 167.9 | 173.3 | 178.5 | 183.9 | 189.0 | 193.7 | 198.6 | 203.5 | 208.6 | 213.8 | 219.2 |
| Total revenue, HRK, % y-o-y | 4.0 | 3.2 | 3.0 | 3.0 | 2.8 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Total expenditure, HRKbn | 170.1 | 175.2 | 180.9 | 187.3 | 193.8 | 200.2 | 206.8 | 213.7 | 220.7 | 228.0 | 235.5 |
| Total expenditure, HRK, % y-o-y | 3.3 | 3.0 | 3.3 | 3.5 | 3.5 | 3.3 | 3.3 | 3.3 | 3.3 | 3.3 | 3.3 |
| Budget balance, HRKbn | -2.1 | -1.9 | -2.4 | -3.4 | -4.8 | -6.5 | -8.3 | -10.1 | -12.1 | -14.1 | -16.3 |
| Budget balance, % of GDP | -0.6 | -0.5 | -0.6 | -0.8 | -1.1 | -1.4 | -1.7 | -2.0 | -2.3 | -2.6 | -2.8 |
| Total government debt, EURbn | 40.0 | 40.8 | 41.8 | 42.6 | 43.6 | 45.4 | 47.5 | 49.4 | 51.3 | 53.4 | 56.1 |
| Total government debt, % of GDP | 80.8 | 80.3 | 78.4 | 76.6 | 74.9 | 74.4 | 73.7 | 73.0 | 72.3 | 71.6 | 71.5 |

*e/f = BMI estimate/forecast. Source: Eurostat, BMI*

mitigates Croatia's FX exposure, the debt structure remains relatively unfavourable. Attempts to refinance these debts at lower interest rates and with longer maturities (thus lowering the short-term debt burden), will prove more difficult as global credit conditions deteriorate.

**Debt Load Declining Gradually**

Gross Debt And Fiscal Balance (2009-2027)




*f = BMI forecast. Source: Eurostat, BMI*

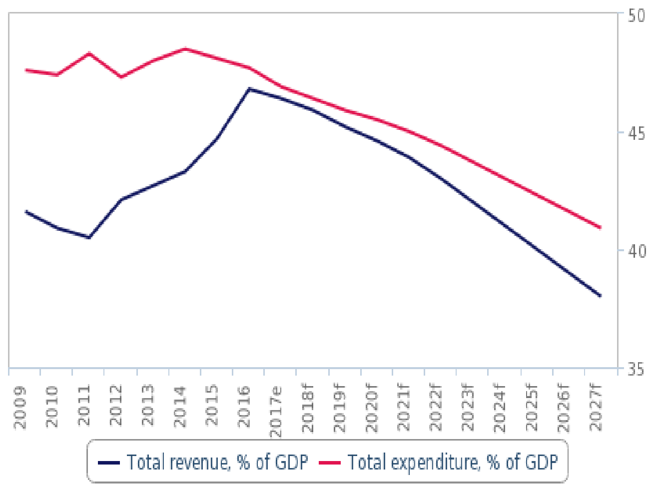
Furthermore, around 70% of Croatia's debts are denominated in euros, meaning that a large FX devaluation would inflate the country's nominal debt load. So long as the central bank continues targeting a loose currency peg for the HRK against EUR (as we expect) then FX exposure should remain limited.

**Fiscal Deficit:** Croatia's six-year economic slump after the financial crisis has had a devastating impact on the budget balance, which swung from a surplus equal to 0.4% of GDP in 2008 to a deficit of over 5% in 2014. With an economic recovery gaining traction in 2016, revenue growth should regain some lost ground in terms of GDP and help to bring down the deficit.

Croatia does not have any domestic debt policy anchors in place. The EU's Excessive Deficit Procedure (EDP), imposed on countries with public debt loads over 60% of GDP and budget deficits over 3.0%, is the biggest external policy anchor. But aside from notional punishments for missing loosely enforced budget targets, its ability to impact domestic fiscal policy is limited. The majority of the countries in the EU are still under EDP, despite many targeting an exit from the programme as early as 2013.

**Levelling Out**

Government Spending And Revenue




*f = BMI forecast. Source: Croatian Ministry of Finance, BMI*

However, the government will also be very limited in its ability to increase spending in the years ahead due to the risk that this will hit confidence in its ability or willingness to pay back debt and lead to a spike in borrowing costs.

**Government Share of GDP:** As the economy shrank, expenditure rose as a share of GDP as government's struggled to contain spending in the downturn. Under the guidance of the European Commission and its deficit reduction programme spending should come down as a proportion of GDP over the forecast period, though remain above the equivalent level of revenues.

**Revenue Sources:** Government revenue is overly reliant on consumption-based taxes, which can fall easily during economic downturns. This has happened since 2008, and our view that the country's economic recovery will remain extremely sluggish suggests limited scope for a significant pickup in government revenue going forward. Income tax revenue still remains far too low, and will continue being restricted by the country's large grey economy and rampant tax evasion.

**TABLE: MAIN REVENUE AND EXPENDITURE CATEGORIES**

| Main sources of revenue | % of total | Main areas of expenditure | % of total |
|---|---|---|---|
| VAT | 28.7 | Social security benefits | 27.8 |
| Social Security Contributions | 27.5 | Wages & salaries | 20.6 |
| Income & Corporation tax | 13.6 | Use of goods & services | 14.5 |
| Other Revenues | 13.1 | Interest | 8.3 |
| Excises | 8.5 | Subsidies | 6.1 |

*Source: Ministry of Finance, BMI.*

*Chapter 2:*

# 10-Year Forecast

## The Croatian Economy To 2027

### No Meaningful Convergence Without Structural Reforms

**BMI VIEW**

*The Croatian economy has the potential for robust long-term growth underpinned by convergence within the EU, but regional headwinds and structural economic inefficiencies make this unlikely unless the government enacts crucial reforms.*

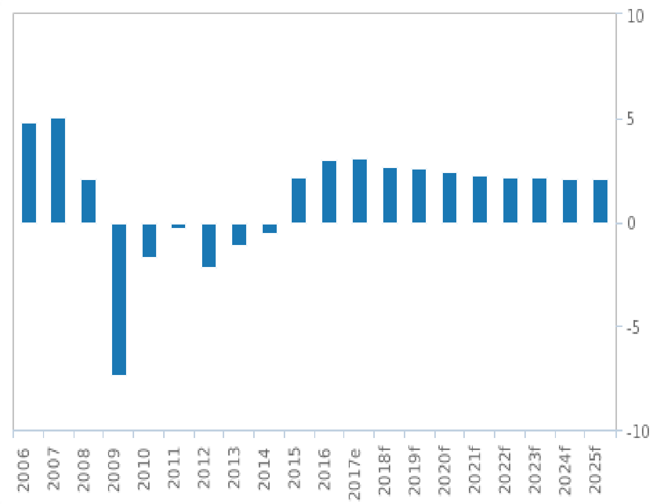
Though the Croatian economy contracted in six consecutive years from 2008-2014, we nonetheless hold a slightly better view of the economy over the long term. Having recorded a comfortable average annual growth rate of 4.5% over 2001-2007, we expect the negative outturn of subsequent years to be followed by below-trend growth from 2017-2026. Though this lies above the rate we expect for the eurozone it will not be enough to achieve significant convergence with more developed EU states. As a result of Croatia's growth dynamics and continued economic development, we project a rise in incomes.

### A Platform For Expansion

The country's long-term growth prospects are supported by a relatively high degree of institutional development and structural economic stability. In particular, the economy is sufficiently diversified away from the primary sector (which constitutes around 8% of GDP), indicating limited exposure to boom-bust commodity cycles that can wreak havoc with the growth cycles of commodity export-led economies. Croatia's export markets are fairly well diversified, with the top three export destinations accounting for around 37% of total exports. This limits the transmission of growth dynamics from any one individual export destination country to Croatia's own economic cycle, though with the vast majority of trade conducted with Eurozone states, the country's outlook will remain closely tied to that of the monetary bloc.

**Steady But Unspectacular Medium-Term Growth**

Real GDP, % chg y-o-y




*f = BMI forecast. Source: Eurostat, BMI*

### Public Finances To Weigh On Growth Outlook

Our long-term growth projections suggest that improvements to Croatia's economy will be gradual rather than spectacular over the next decade. Though the immediate risks have subsided as growth recovers, the rapid build up of fiscal debt during the crisis years will condition government spending plans for years to come, while also leaving the country exposed to market

**TABLE: LONG-TERM MACROECONOMIC FORECASTS**

| | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f | 2026f | 2027f |
|---|---|---|---|---|---|---|---|---|---|---|
| Nominal GDP, USDbn | 56.2 | 61.2 | 65.1 | 68.1 | 71.4 | 75.1 | 79.1 | 83.1 | 87.3 | 91.8 |
| Real GDP growth, % y-o-y | 2.7 | 2.6 | 2.4 | 2.3 | 2.2 | 2.2 | 2.1 | 2.1 | 2.1 | 2.2 |
| GDP per capita, USD | 13,485 | 14,777 | 15,818 | 16,641 | 17,534 | 18,562 | 19,655 | 20,757 | 21,921 | 23,176 |
| Population, mn | 4.16 | 4.14 | 4.12 | 4.09 | 4.07 | 4.05 | 4.02 | 4.00 | 3.98 | 3.96 |
| Consumer price inflation, % y-o-y, ave | 1.7 | 1.9 | 2.0 | 2.3 | 2.6 | 2.9 | 3.0 | 3.0 | 3.0 | 3.0 |
| Exchange rate HRK/USD, ave | 6.73 | 6.45 | 6.32 | 6.32 | 6.32 | 6.30 | 6.28 | 6.28 | 6.28 | 6.28 |
| Current account balance, % of GDP | 2.8 | 2.2 | 2.0 | 1.8 | 1.5 | 0.8 | 0.4 | 0.1 | 0.1 | 0.4 |

*f = BMI forecast. Source: National Sources, BMI* shocks. More fundamentally, we do not expect Croatia to fulfil its economic potential unless the government can implement significant structural reforms aimed at making the country competitive again. Without such reforms (and even possibly with them), Croatia looks set to begin converging with historically less-developed European counterparts over the next few years.

## Euro Adoption

Looking ahead, we do not expect Croatia to adopt the euro in the next seven to eight years, a goal of the government. The country currently falls short of meeting ECB targets for government debt and completing two years in the European Exchange Rate Mechanism (ERM II). While euro adoption will remain the overriding goal of the government, we expect efforts to hasten Eurozone membership will be hampered by the difficulties we anticipate in bringing down government debt below the Maastricht ceiling of 60% of GDP. As such, a best-case scenario would see entry into the Eurozone only towards the end of the 10-year forecast period.

**BMI**'s long-term macroeconomic forecasts are based on a variety of quantitative and qualitative factors. Our 10-year forecasts assume in most cases that growth eventually converges to a long-term trend, with economic potential being determined by factors such as capital investment, demographics and productivity growth. Because quantitative frameworks often fail to capture key dynamics behind long-term growth determinants, our forecasts also reflect analysts' in-depth knowledge of subjective factors such as institutional strength and political stability. We assess trends in the composition of the economy on a GDP by expenditure basis in order to determine the degree to which private and government consumption, fixed investment and the export sector will drive growth in the future. Taken together, these factors feed into our projections for exchange rates, external account balances and interest rates.

# Chapter 3:

# Political Outlook

## SWOT Analysis

### Strengths

- Croatia's membership of the EU should prevent standards in the areas of the judiciary and public administration dropping significantly over the medium term.
- Security risks remain low despite disputes in the Balkan area over the status of Kosovo. Croatia joined NATO in April 2009, which is likely to help regional stability.

### Weaknesses

- While progress continues to be made, Croatia remains institutionally weak, with judicial reform a necessity.
- Although some progress has been made combating corruption in the years leading up to Croatia's EU accession, we believe the quality of political processes in Croatia will remain poor for some time to come.
- The main parties are increasingly dependent on third-party interests to form a majority.

### Opportunities

- While Croatia's EU membership is unlikely to bring an end to ongoing regional disputes, such as the political deadlock with Bosnia-Herzegovina, we believe Croatia's membership could help to deter any significant escalation in regional tensions.

### Threats

- Croatia's attempts to block Serbia's EU accession negotiations and ongoing border disputes with Slovenia and Montenegro could cause an increase in tensions with neighbours.
- Further political instability surrounding the Agrokor crisis.
- Escalating tensions with Slovenia concerning the Bay of Piran border dispute.

## BMI Political Risk Index

After a turbulent 2017, that culminated in the formation of yet a second government in only six months, Croatia has returned to broad political stability. We do however caution, that the ideological differences between the coalition partners could prove a headwind for future the current government and as such political risks remain weighted to the downside. Looking ahead, as the economic climate improves, the government will now have the opportunity to press ahead with structural reform implementation.

| | S-T Political | Trend | Regional Rank | Global Rank |
|---|---|---|---|---|
| Lithuania | 73.1 | = | 1 | 51 |
| Turkmenistan | 73.1 | = | 1 | 51 |
| Latvia | 72.1 | = | 3 | 57 |
| Hungary | 71.0 | = | 4 | 62 |
| Poland | 69.6 | - | 5 | 67 |
| Kazakhstan | 66.7 | = | 6 | 83 |
| Russia | 66.5 | = | 7 | 84 |
| Bulgaria | 65.2 | = | 8 | 90 |
| **Croatia** | **65.0** | **=** | **9** | **91** |
| Uzbekistan | 64.2 | + | 10 | 94 |
| Romania | 63.1 | - | 11 | 97 |
| Azerbaijan | 62.9 | = | 12 | 100 |
| Belarus | 62.5 | = | 13 | 102 |
| Montenegro | 60.4 | = | 14 | 110 |
| Albania | 59.8 | = | 15 | 115 |
| Kyrgyzstan | 58.8 | + | 16 | 119 |
| Serbia | 58.8 | = | 16 | 119 |
| Turkey | 57.1 | = | 18 | 126 |
| Georgia | 56.5 | = | 19 | 133 |
| Macedonia | 53.3 | + | 20 | 138 |
| Armenia | 52.7 | = | 21 | 142 |
| Moldova | 47.9 | = | 22 | 156 |
| Tajikistan | 47.3 | = | 23 | 159 |
| Ukraine | 41.5 | = | 24 | 170 |
| Bosnia-Herzegovina | 40.6 | = | 25 | 172 |
| Kosovo | 39.4 | = | 26 | 174 |

***Regional ave 59.6 / Global ave 63.3 / Emerging Markets ave 59.5***

| | L-T Political | Trend | Regional Rank | Global Rank |
|---|---|---|---|---|
| Poland | 81.6 | = | 1 | 25 |
| Lithuania | 78.4 | = | 2 | 32 |
| Latvia | 77.3 | = | 3 | 36 |
| Bulgaria | 72.0 | = | 4 | 50 |
| **Croatia** | **71.4** | **=** | **5** | **53** |
| Hungary | 71.4 | = | 5 | 53 |
| Albania | 71.3 | = | 7 | 55 |
| Romania | 70.6 | = | 8 | 61 |
| Montenegro | 70.3 | = | 9 | 63 |
| Kazakhstan | 66.0 | = | 10 | 79 |
| Serbia | 64.9 | = | 11 | 83 |
| Russia | 61.7 | = | 12 | 97 |
| Armenia | 61.5 | = | 13 | 99 |
| Moldova | 58.2 | = | 14 | 111 |
| Macedonia | 57.3 | = | 15 | 117 |
| Turkey | 57.3 | = | 15 | 117 |
| Belarus | 56.2 | = | 17 | 120 |
| Bosnia-Herzegovina | 55.8 | = | 18 | 121 |
| Uzbekistan | 55.8 | = | 18 | 121 |
| Georgia | 54.9 | = | 20 | 125 |
| Kosovo | 53.5 | = | 21 | 132 |
| Turkmenistan | 53.2 | = | 22 | 135 |
| Azerbaijan | 49.8 | = | 23 | 144 |
| Kyrgyzstan | 43.8 | = | 24 | 161 |
| Ukraine | 42.6 | = | 25 | 165 |
| Tajikistan | 36.2 | = | 26 | 176 |

***Regional ave 61.3 / Global ave 62.1 / Emerging Markets ave 57.2***

# Domestic Politics

## Political Stability To Support Structural Reform Implementation

**BMI VIEW**

*After two snap elections and a government reshuffle in the past two years we anticipate that Croatian politics will revert to relative calm over the coming quarters. A more stable political backdrop will thus open a window of opportunity for structural reforms, although implementation will face an uphill battle. The biggest political risks pertain to ongoing uncertainty surrounding the Agrokor restructuring and the Slovenian border dispute.*

Following a turbulent two years for Croatian politics amid two snap elections in 2016 and a government reshuffle in mid-2017, we expect political conditions in 2018 to remain relatively calm by Croatian standards. Although the Croatian Democratic Union (HDZ) and Croatian Peoples Party (HNS) coalition government (61 out of 151 seats) depends on the support of a variety of smaller parties and independents, public support for Prime Minister Andrej Plenkovic's HDZ party remains strong, making an early election in 2018 unlikely in our view.

Relative political stability in turn opens up the window of opportunity for structural reform implementation, which amidst the frequent changes in government has fallen off the agenda over the past two years. In response to this reform inertia, the IMF, in its concluding statement following the 2017 article four mission, emphasised that it is of utmost importance for Croatia to reduce the administrative burden of doing business (the Croatia's rank on the World Banks Ease of Doing Business Index has fallen from 43rd in 2016 to 51st out of 100 in 2017), increase the flexibility of the labour market, improve efficiency in the public sector, and enhance property rights and the judiciary.

That said, we do note that structural reform implementation will face an uphill battle, as the HDZ and HNS have never governed together before, which is furthermore complicated by the parties' divergent political ideologies as HDZ belongs to the right and HNS to the left of the political spectrum. These disparate political ideologies will prove a challenge when coming to terms on socially contentious and fiscally necessary pension reform (the pension fund ran a EUR2.3bn deficit in 2017 which amounts to 6.0% of GDP). As such, we anticipate structural reform implementation to remain slow, which means that real GDP growth will remain below potential, straining competitiveness and the government's plan of adopting the euro in the next seven to eight years.

**TABLE: POLITICAL OVERVIEW**

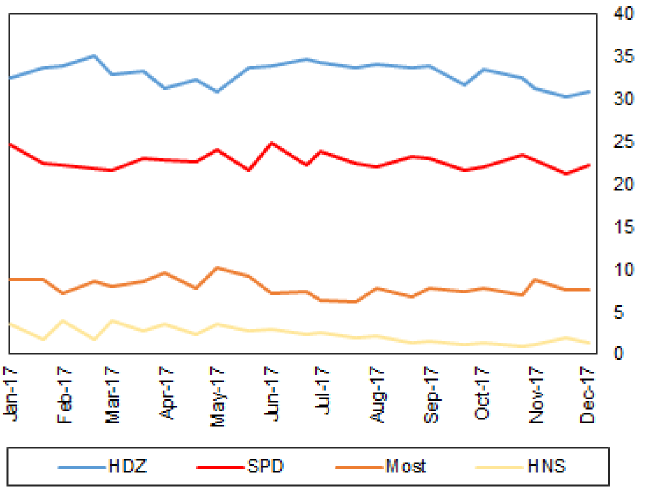
| | |
|---|---|
| System of Government | Parliamentary Democracy, Universal Suffrage: 151-Seat Sabor (Four Year Term). Executive power rests with PM. |
| Head of State | President Kolinda Grabar-Kitarovic, Five-year terms, limited to two |
| Head of Government | Prime Minister Andrej Plenkovic |
| Last Election | Parliamentary – September 11, 2016 |
| | Presidential – December 28 2014 / January 11 2015 |
| Composition Of Current Government | Coalition made up of Croatian Democratic Union (HDZ, 56 seats) and the Croatian People's Party (5 seats) |
| Key Figures | Deputy Prime Ministers: Marija Pejcinovic Buric (Minister of Foreign and European Affairs), Martina Dalic (Minister of Economy, Small and Medium Entrepreneurship and Crafts), Damir Krsticevic (Minister of Regional Defence), Predrag Stromar (Minister of Construction and Physical Planning) Darko Nekic (Minister of Public Administration). Minister of Finance – Zdravko Maric, Governor of the Croatian National Bank – Boris Vujcic. |
| Main Political Parties (number of seats in parliament) | Croatian Democratic Union (56 seats): Right-wing, Christian democratic party. Membership in the EU is a prime policy objective. Led by Andrej Penkovic. |
| | Bridge Of Independent Lists – Most (14) New, centrist party led by Bozo Petrov. |
| | Social Democratic Party (36): Centre-left social democratic party led by Davor Bernardic. |
| | Croatian People's Party – Liberal Democrats (5): Centre to Centre-left, advocating social liberalism and pro-Europeanism, led by Ivan Vrdoljak. |
| | Other parties represented in parliament: Independent Democratic Serb Party (3), Istrian Democratic Assembly (3), Human Shield (3), Ethnic Minority Represenatives (8) |
| Extra-Parliamentary Opposition? | None |
| Next Election | Parliamentary – By September 2020 |
| | Presidential – 2020 |
| Ongoing Disputes | Minor border disputes with Bosnia-Herzegovina and Slovenia. |
| Key Relations/ Treaties | WTO, CEFTA. NATO, EU. |
| BMI Short-Term Political Risk Index | 65.0 |
| BMI Long-Term Political Risk Index | 71.4 |

*Source: BMI, CIA Factbook.*

### Agrokor Uncertainty Remains Biggest Risk

Notwithstanding our view for relative political stability, a downside risk remains in the ongoing uncertainty surrounding the restructuring of the country's agricultural and retail giant Agrokor. The company, which amassed an unsustainable EUR6.0bn (15.0% of GDP) in debt, averted bankruptcy and has since then been placed under government control in order to restructure its debt load. For now, a roll-up financing agreement of up to EUR1.06bn with its creditors is keeping the company financially afloat, but should the restructuring efforts fail and require a state bailout, the country would plunge into a deep economic crisis, jeopardising the persistence of the current government. The debt is what caused the government reshuffle in June 2017(*see 'Political Crisis Averted, Bit Risks Remain Elevated', June 30*), and thus a failure of the company under the governments watch would almost certainly necessitate an early election.

**HDZ-HNS Coalition To Remain In Government**
Opinion Polls, %




*Source: National Polling Agencies, BMI*

### Slovenia Border Dispute To Shape Foreign Policy Agenda

On the foreign policy side of Croatian politics, the most contentious issue remains in the country's ongoing border dispute with Slovenia. The dispute, which concerns the sovereignty of the Bay of Piran and Slovenia's access to the high seas, dates back to the splitting of Yugoslavia in 1991 and was formally settled by an international arbitration ruling of June 29 2017. Croatia, however, rejects the ruling on the grounds of Ljubljana's alleged contact with the judges, and has since then failed to implement the decision according to the December 29 2017 deadline. While both Zagreb and Ljubljana have pledged to refrain from tension-raising actions, we nonetheless believe that Croatia's reluctance to comply will hinder the country's accession to the Schengen zone and the OECD, as the Slovenian government already announced it will block Croatian efforts to joining the two frameworks.

# Long-Term Political Outlook

## EU Anchor Supportive, But Risks Loom

**BMI VIEW**

*While we expect Croatia's long- term political risk profile to continue improving, we caution that further progress on reforms are needed for the country to realise its full economic potential. The major risks over the coming decade include corruption, poor demographics, still-powerful nationalist currents in the Balkans, and a potential weakening of the post-Brexit EU, which would be less able to champion political and economic reforms amongst newer EU members.*

Croatia made significant strides to bring its institutions and policy frameworks in line with EU standards as part of the EU accession process. This progress was rewarded when the country became the EU's 28th member on July 1 2013. At that point, enlargement fatigue was intensifying in the bloc on the back of the eurozone debt crisis. We continue to expect that Croatian membership of the EU – and its long-term goal to adopt the euro – will remain a key policy anchor over the next decade, encouraging further reform efforts and potentially improving the macroeconomic outlook for the country.

We do, however, highlight a number of major risks that could threaten Croatia's long-term political outlook. A further risk over the next few years is a possible weakening of the EU's ability to champion political and economic reforms in its newer members as it faces internal weakness following the UK's Brexit vote and the rise of Eurosceptic parties in key states.

### Challenges And Threats To Stability

**Corruption:** We expect corruption to remain a significant issue over the next decade and believe that if not significantly reduced, it could seriously undermine political, economic and social stability. Corruption remains endemic across most levels of government and society. While the push for reforms demanded by the EU accession process has helped to bring down corruption somewhat, public perceptions that this issue remains a tangible problem have remained high. According to

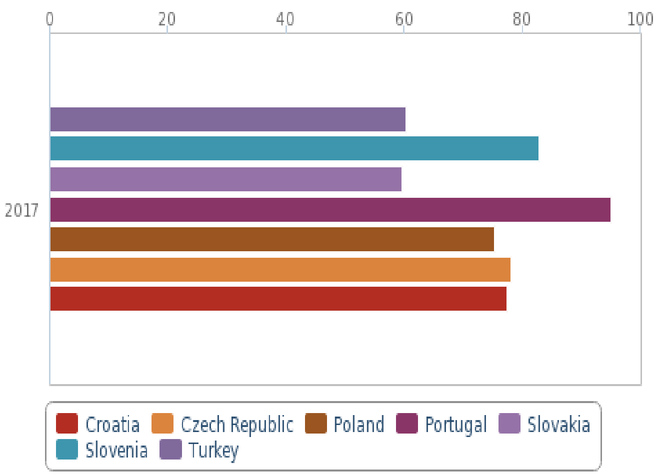
Transparency International's 2016 Corruption Perceptions Index, Croatia ranked 49th out of 160 countries, which ranks poorly compared to European Union peers.

The Transparency International report found that the Croatian public believes political parties are the most corrupt institution in the country. In addition, an Ernst & Young poll found that over 90% of people think corruption is still a significant issue. This was one of the reasons why neither of the two main political parties – both of which are tainted with corruption – secured a majority in either the 2015 or 2016 parliamentary elections.

This led to the removal of long-time leaders of both parties, a positive step for change, but Croatia will need to reduce actual corruption and public perceptions of the issue to ensure social and political stability over the next decade.

**Croatia Scores Relatively Poorly**

Business Cost Of Crime Index




*Source: BMI.*

**Nationalism:** Ethnic nationalism remains a latent issue in Croatia, threatening stability across all levels of society and increasing regional tensions. Croatia has yet to shed the vestiges of the Yugoslav wars (1991-1995) and while not immediately apparent, this issue tends to reappear in response to any number of events. Football matches often degenerate into violent inter-ethnic brawls. A giant swastika appeared on the pitch during a football match against Italy in 2015, with vandals spraying the symbol with a chemical that became visible only when the floodlights were turned on.

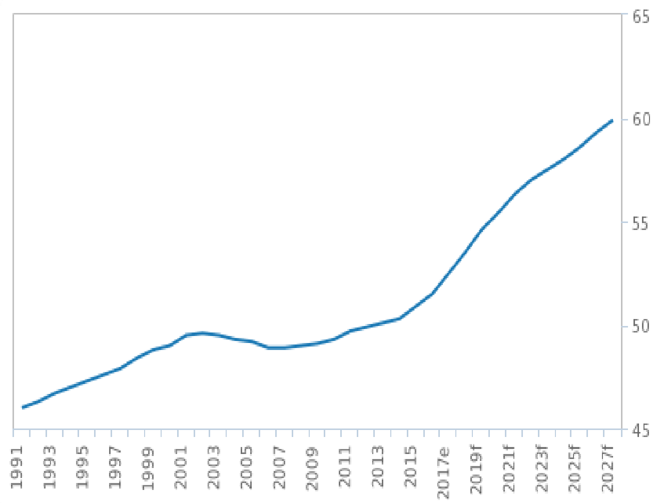
Later that same year, an annual mass to commemorate Croatia's controversial World War II leader Ante Pavelic sparked rival protests and claims of violent attacks.

The criminal proceedings at the International Criminal Tribunal for the former Yugoslavia (ICTY), with which cooperation has been a key exigency of the European Commission, has sparked national uproar against what many in Croatia see as a government betrayal in handing over 'national heroes' to be tried for war crimes. In our view, although necessary for improving investor sentiment towards the country and thereby bettering the country's economic prospects, Croatia will have a difficult time divesting itself from its ethno-nationalist past.

This is especially the case against the backdrop of rising popular disillusion with both national and international bodies of authority. According to a survey conducted by polling agency Gallup Balkan Monitor, of those asked 'as of today is there a political party or politician that represents your political views?', 62% responded that there was not. This cynicism combined with diminished economic prospects is indirectly promoting ethnic nationalism, especially among youths who do not have a vivid recollection of the Yugoslav wars. The ongoing migrant crisis adds another component to a volatile mix.

**Set To Surge**

Dependency Ratio, %




*e/f = BMI estimate/forecast. Source: UN, BMI*

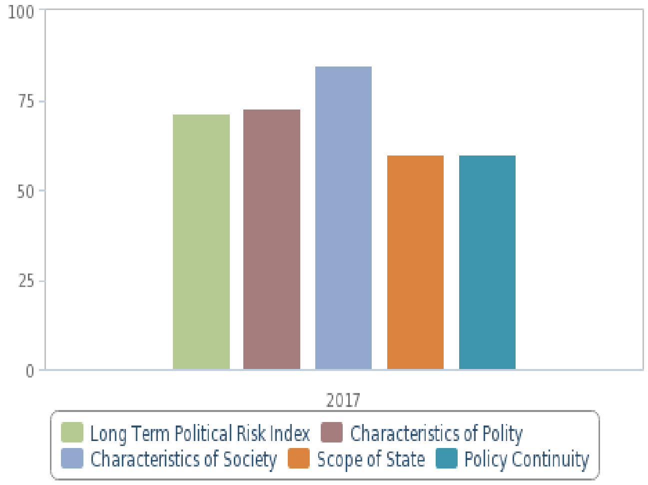
**Ageing Demographics:** We expect Croatia to suffer from unfavourable demographics over the coming decade. By our forecasts, the total dependency ratio will rise to over 55% by 2020, from 50% in 2013, putting increasing pressure on the declining productive segment of the Croatian labour market. This is even more striking when considered that Croatia has one of the lowest labour force participation rates in Europe, coming in at just above 50%. The rising dependency ratio and low participation rate will likely have an adverse impact on Croatia's long-term economic outlook and the future position of the government's fiscal accounts.

## Long-Term Political Risk Index: EU Anchor Pays Dividends

Our Long-Term Political Risk score for Croatia is 71.4 out of 100, well above the Western Balkan average. This reflects the benefits of Zagreb's reform drive begun in 2003 with the country's application to become a candidate for EU membership. Croatia performs well on most fronts, in particular in the 'characteristics of polity' and 'characteristics of society' sub-components. Given our expectation for Croatia's EU membership to prevent any sharp and significant deterioration in the country's political environment, we see potential for the country's Long-Term Political Risk score to continue to improve gradually.

**A Long Way To Go**

Long-Term Political Risk Indices (Out Of 100)




*Source: BMI*

## Scenarios For The Coming Decade

**Continued Convergence With EU Norms:** This is our core and best-case scenario, whereby Croatia continues its reform agenda having already secured EU membership. While we do not expect economic growth to return to pre-crisis levels and instead expect below-trend expansion over the next decade, EU membership should help to boost much needed foreign direct investment, with Croatia's increased access to the common market and EU funds underpinning investor confidence in the country.

**Croatia Loses Reform Momentum:** Having made the significant changes required to earn EU member status, the impetus behind making further improvements could diminish in Croatia, especially given the difficult economic climate which will increase resistance to some reforms. The absence of a unifying cause leads to a more fractured political landscape in which consensus is harder to find. In this scenario, 'transformation fatigue' and increased public ambivalence towards the EU contributes to the government's failure to address some of the key structural problems undermining the country's political and business environments. Here, the scale of the problems facing Croatia dampens hopes that accession will deliver significant benefits amongst the public, and ultimately delays the country's eventual adoption of the euro currency to even further beyond our 10-year forecast period.

This scenario would also become more likely if the EU itself weakens substantially or even fragments in the aftermath of 'Brexit'. A weakening of the EU may well result in less pressure on its newer members to carry out political and economic reforms.

**Regional Conflict:** While we view this possibility as highly unlikely, it cannot be completely discounted, given ongoing regional disputes and the political deadlock in neighbouring Bosnia-Herzegovina. The trigger for renewed conflict would likely occur in Bosnia-Herzegovina, most probably if the Serbian entity Republika Srpska were to attempt secession. Secessionist sentiment is running high among the Bosnian Serbs. Although not as large a community as ethnic Serbs, ethnic Croats make up about 14% of Bosnians (according to data from the CIA World Factbook), leaving open the possibility that Croatia could get dragged into a regional conflict. This would seriously weigh on the country's economic, political, and social future.

# Operational Risk

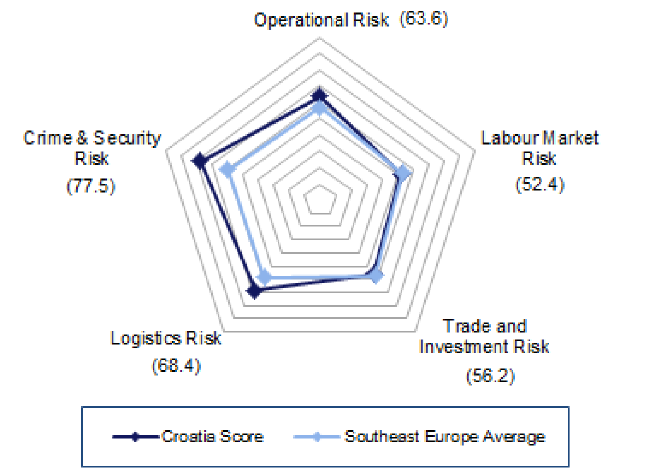
***BMI's** Operational Risk report series provides a comprehensive overview of potential risks facing investors operating in a country, as well as a cross-country regional evaluation of threats and advantages. The Operational Risk service evaluates Logistics Risk, Trade and Investment Risk, Labour Market Risk and Crime and Security Risk. Below are sections from these reports.*

Croatia offers a relatively safe operating environment and is one of the most appealing destinations for investment in the South East Europe region. Foreign and local businesses alike are exposed to limited crime and security risks, and the country benefits from having a strong police force and membership of various regional security initiatives. That said, despite good transport links and utility availability, the country's score is dragged down by the size of its small population and economy, as well as its overregulated and inflexible labour market. Nevertheless, Croatia is placed second out of 12 South East Europe states on **BMI**'s Operational Risk Index, with a relatively strong score of 63.6 out of 100, which ranks the country in 41st position out of 201 states globally.

**Labour Market (52.4/100):** Although the provision of free and compulsory education at primary and secondary school levels has resulted in a large portion of the population having obtained a formal education, Croatia's labour environment presents significant risks in terms of availability and costs. The country's failure to fully transition from a socialist system to a free market economy means that the labour market is over-regulated and inflexible. This has resulted in a high unemployment rate, a large shadow economy and increasing emigration levels, causing a shortage of labour availability. Businesses will consequently face difficulties recruiting for highly skilled positions and may be required to bear the additional costs of importing foreign workers.

**Low Crime And Security Risks Boost Operating Environment**

Operational Risk Scores




*Source: BMI Operational Risk Index. 100 = lowest risk; 0 = highest risk*

**Trade And Investment (56.2/100):** The Croatian economy is beginning to show signs of resilience as GDP growth outperforms expectations. The government has enacted a number of pro-investment reforms to its regulatory framework to attract greater volumes of foreign direct investment (FDI), and aims to treat foreign and domestic investors equally. While the country has a high level of openness to FDI, there is a lack of capital

**TABLE: OPERATIONAL RISK**

| | Operational Risk | Labour Market Risk | Trade And Investment Risk | Logistics Risk | Crime And Security Risk |
|---|---|---|---|---|---|
| Croatia score | 63.6 | 52.4 | 56.2 | 68.4 | 77.5 |
| Southeast Europe average | 57.2 | 53.2 | 57.4 | 58.3 | 60.1 |
| Southeast Europe position (out of 12) | 2 | 8 | 8 | 2 | 2 |
| Emerging Europe average | 56.9 | 55.3 | 58.2 | 57.4 | 56.7 |
| Emerging Europe position (out of 31) | 7 | 23 | 20 | 6 | 4 |
| Global average | 49.8 | 50.2 | 50.0 | 49.3 | 49.9 |
| Global position (out of 201) | 41 | 85 | 74 | 38 | 29 |

*Source: BMI Operational Risk Index. 100 = Lowest risk; 0 = highest risk.*

market liquidity, which may result in businesses struggling to raise investment funds or access credit. Nevertheless, Croatia's domestic financial market is more developed than that of other regional states, and businesses have recourse to international markets, creating an alternative market place for trading securities.

**Logistics (68.4/100):** Croatia scores highly in terms of logistics risk. As the situation stands, business operations are not hampered to a notable degree by shortages of any utilities, and the transport network offers sufficient internal and international connections for supply chains to reach their destinations with relative efficiency. EU membership and large levels of trade with fellow EU peers also mean that overall time and cost burdens for trade procedures remain very low. Nevertheless, road-based supply chains do face risks from congestion in key commercial areas, which causes some time delays and extra costs. In addition, the high cost of fuel in Croatia in relation to its regional peers somewhat erodes profits.

**Crime And Security (77.5/100):** Croatia presents investors with limited risks from a crime and security perspective and is not a specific target of any international terrorist groups. The country is generally considered one of the safest in the region, with low violent crime rates, and benefits from a highly capable and reliable police force. Financial crime is a potential risk area, particularly in conjunction with the high levels of corruption in government, which create the need for additional due diligence when competing for public contracts.

# Conflict Risk

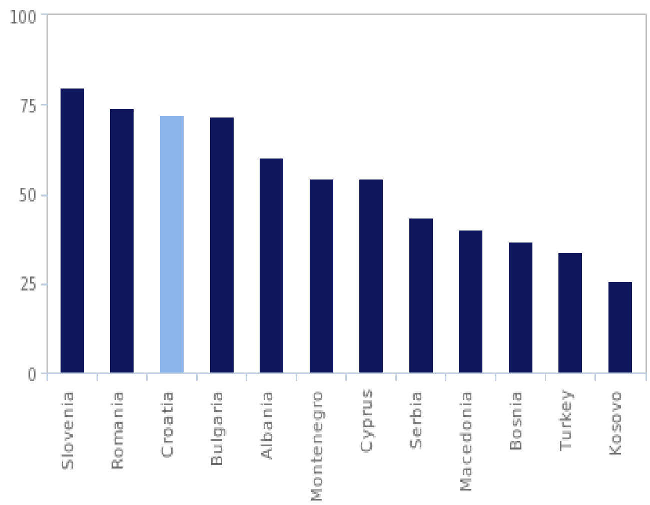
Investors in Croatia do not face particularly high risks in terms of either terrorism or interstate conflict. There are no recognised domestic terrorist groups and while there is a regional threat from Islamist extremist groups, Croatia is not considered to be a high-profile target. The country has greatly improved relations with neighbouring states in recent years, benefiting from membership to the EU, with little risk of cross-border conflict – although tensions with Serbia remain a cause for (albeit limited) concern. While relations with neighbouring Slovenia remain contentious due to an ongoing border dispute and disagreements relating to the flow of migrants between the two countries, both are engaged in diplomatic talks, and membership of the EU and NATO (for both countries) helps to ensure minimal risk of conflict. As a result, Croatia earns a strong score of 72.4 out of 100 for Conflict Risk, which places the country third out of 12 South East Europe states.

**Latest Conflict Risk Analysis:**

- Following Croatia's rejection of an international arbitration ruling regarding a decades-old border dispute with Slovenia, Croatia may face being blocked of its admission to international treaties and organisations in which Slovenia is already a party to. In early September 2017, Slovenia announced that it would block Croatia's admission to the OECD. Looking ahead, Croatia's membership in the organisation of the 35 most developed countries in the world will remain elusive as long as the border dispute is not fully resolved. That said, we believe the country's OECD exclusion would have few economic consequences and its non-membership of the OECD presents more of a reputational issue.

**Strong Strategic Partnerships, Low Terrorism Risk Foster Safe Environment**

South East Europe – Conflict Risk




*Source: BMI Crime and Security Risk Index. 100 = Lowest risk; 0 = highest risk.*

- In addition to the aforementioned foreign policy risk, the domestic political backdrop in Croatia will remain fragile. This follows from the collapse of the then six-month old Croatian Democratic Union (HDZ)-Bridge of Independent Lists (Most) coalition in April 2017, which resulted from the near bankruptcy of the country's agricultural and retail giant **Agrokor**. The subsequent coalition of HDZ (56 seats out of 151 in parliament) and the Croatian Peoples Party of Liberal Democrats (HNS, 5 seats) is, however, built on a weak foundation, as its parliamentary majority depends on the support of several independent and minority parties. Additionally, given the parties diverging political ideologies, with HDZ belonging to the right and HNS belonging to the left of the political spectrum, we believe that structural reform implementation will face an uphill battle. As such, there is a significant risk that the government will struggle to pass far-reaching reforms in areas such as health care and the pension system, both of which are needed to improve the country's sovereign risk profile.

## Terrorism And Political Violence

Croatia is one of the least exposed countries to terrorist threats in South East Europe; however, the threat of domestic political instability and social unrest has been rising due to the collapse of the six-month old Croatian Democratic Union (HDZ)-Bridge

**TABLE: MAIN ACTIVE TERRORIST GROUPS**

| Terrorist Group | Targets | Region/Sector Exposed | Threat Level |
|---|---|---|---|
| Regional Islamic extremist groups | Targets would most likely include military sites, the police, commercial buildings, Western interests, religious sites, government buildings and areas frequented by international tourists. | Attacks are largely unpredictable. Targets would likely include areas in the capital city Zagreb with large civilian populations. The sectors most exposed would be transport, tourism and retail. | • Low – Croatia's geographic location in the western Balkans makes it susceptible to international Islamist terrorist groups that operate trans-nationally from bases in Bosnia-Herzegovina, Serbia, Albania, Kosovo and Montenegro.<br>• The main organisations known to be active in the Balkans are al-Qaeda and the Muslim Brotherhood.<br>• The strategic objectives of al-Qaeda in the region are to recruit jihadist foreign fighters for global battlegrounds, such as Syria, and to use the region as a base to plan operations and traffic weapons into Europe.<br>• Croatia risks becoming the main transit route for these groups in the future, and radicalised individuals in Croatia are known to have joined extremist groups in Bosnia-Herzegovina and, from there, travelled on to international conflict zones. |
| Islamic State (IS) | Targets include civilians, politicians, strategic infrastructure, EU citizens, Western interests such as embassies, areas of public gathering and tourists. | Attacks are largely unpredictable. Targets would likely include border regions that coincide with migrant routes and areas in the capital city Zagreb with large civilian populations. The sectors that would be most exposed are tourism and retail. | • Low – Croatia is theoretically a target for international terrorist groups due to its membership of the EU and NATO, and its deployment of a limited number of troops to Iraq and Afghanistan, which could aggrieve Islamist extremist groups.<br>• However, other states in Central and Eastern Europe have been more active in their support of US foreign policy, such as Poland, which makes Croatia a less likely target for an international terrorist attack.<br>• Croatia has few, if any domestic terrorist cells, and is a relatively unattractive target for international terrorist groups – which are more likely to strike Western European states that are more involved in international affairs.<br>• There is a lingering regional terrorist threat, though this has so far not resulted in any attacks on Croatian soil.<br>• Attacks in previous years have largely been focused on political institutions – businesses are not likely to be targeted.<br>• However, some risk of property damage still exists as attacks are indiscriminate, and the EU migrant crisis continues to present border security risks. |
| Far Right Extremist Groups | Minority groups such as asylum seekers from Africa and Asia, Serbians and Roma people living within Croatia. | Tourism and retail sectors. | • Moderate – Since 2015 support for far-Right Nationalist movements has become far more pronounced across Europe, and Croatia is no different.<br>• The migrant crisis and various terrorist attacks across Europe have added to the problem of rising nationalist sentiment.<br>• Most likely to occur at events commemorating Croatia's independence and major sporting events. |

*Source: BMI*

of Independent Lists (Most) coalition in April 2017, which came as a blow to political stability and policy continuity. A new coalition was subsequently formed between the HDZ and the Croatian Peoples Party of Liberal Democrats (HNS), even though the two parties represent divergent political ideologies. In addition to likely instability within the governing parties, political stability will continue to be tested by the country's tense relationship with its Balkan neighbours. Nevertheless, Croatia is characterised by regular elections and a strong human rights record and, because of this, incidences of civil unrest are rare. As such, Croatia has a strong score of 72.8 out of 100 for Terrorism and Political Violence, which ranks the country in third place regionally.

**Terrorist Threat:** Croatia faces minimal risks of a terrorist attack from international groups and does not harbour any domestic terrorist groups. That said, Croatian businesses and investors need to remain vigilant as the country's membership to the EU and NATO leave it partially exposed to terror groups that are prone to attack Western interests. The country is also disproportionately exposed to the refugee crisis in the EU, and this ongoing migrant crisis has the potential to incite unrest and terrorist aggression, raising the risk of terrorist groups entering and exiting the country with anonymity. In light of this, Croatia's counterterrorism and intelligence-gathering apparatus is reliable, effective, professional and works well with international and local partners to combat global and regional terrorist threats.

**Political Violence Risk:** Political risks in Croatia will remain elevated over the next two years as the country continues to face both domestic and foreign policy issues. Domestically, we anticipate that the sustainability of the new coalition government will remain fragile, whilst the country's reluctance to recognise the arbitration ruling of its border dispute with Slovenia is likely to increase international pressures. Nevertheless, it is expected that Croatia's long-term political risk profile will improve, but we caution that further progress on reforms are needed for the country to realise its full economic potential. The major risks over the coming decade include corruption, poor demographics, still-powerful nationalist currents in the Balkans, and a potential weakening of the post-Brexit EU, which would be less able to champion political and economic reforms amongst newer EU members.

**Counterterrorism Capability:** Croatia has a strong domestic

**TABLE: POLITICAL VIOLENCE RISK**

| Main Causes | Key Flashpoints | Risk level and Impact on Business Environment |
|---|---|---|
| Corruption | We expect corruption to remain a significant issue over the next decade and believe that, if not significantly reduced, it could seriously undermine political, economic and social stability. Corruption remains endemic across most levels of government and society. | • Moderate – While the push for reforms demanded by the EU accession process has helped to bring down corruption somewhat, public perceptions that this issue remains a tangible problem have remained high.<br>• According to Transparency International's 2015 Corruption Perceptions Index, Croatia ranked 50th out of 160 countries – an improvement of 11 places on the previous year, but still leaving the country behind Georgia, Saudi Arabia, and Bahrain. |
| Nationalism | Ethnic nationalism remains a latent issue in Croatia, threatening stability across all levels of society and increasing regional tensions. Croatia has yet to shed the vestiges of the Yugoslav wars (1991-1995) and while not immediately apparent, this issue tends to reappear in response to any number of events. | • Low – The criminal proceedings at the International Criminal Tribunal for the former Yugoslavia (ICTY), with which cooperation has been a key exigency of the European Commission, has sparked national uproar against what many in Croatia see as a government betrayal in handing over 'national heroes' to be tried for war crimes.<br>• In our view, although necessary for improving investor sentiment towards the country, and thereby bettering the country's economic prospects, Croatia will have a difficult time divesting itself from its ethno-nationalist past. |
| Ageing Demographics | We expect Croatia to suffer from unfavourable demographics over the coming decade. By our forecasts, the total dependency ratio will rise to over 55% by 2020, from 50% in 2013, putting increasing pressure on the declining productive segment of the Croatian labour market. | • Moderate – This is even more striking when considered that Croatia has one of the lowest labour force participation rates in Europe, coming in at just above 50%.<br>• The rising dependency ratio and low participation rate will likely have an adverse impact on Croatia's long-term economic outlook and the future position of the government's fiscal accounts. |

*Source: BMI*

**TABLE: MAJOR CONFLICT FLASHPOINTS**

| Protagonist | Likely Cause Of Conflict | Form Such A Conflict Would Take | Likelihood Of Conflict |
|---|---|---|---|
| Slovenia | Territorial claims and maritime disputes surrounding the Bay of Piran, which is located north of the Adriatic Sea. | Conflict could take the form of a low- scale military confrontation, with a breakdown in diplomatic relations. | • Low – Croatia has a long-standing maritime and territorial dispute with Slovenia over the Bay of Piran, located south of the Gulf of Trieste.<br>• Following the dissolution of Yugoslavia, the median line of delimitation of the Gulf of Trieste was disputed by both countries.<br>• Slovenia asserts that the Bay cannot be delimited with Croatia as it is a 'historical bay' and therefore governed by the regime of Slovene internal waters, whereas Croatia disputes this assertion.<br>• Diplomatic relations have remained strained over this issue for over a decade.<br>• In 2010, both sides agreed to enter arbitration at the Permanent Court of Arbitration in the Hague. A resolution was expected in mid-2015; however, in late July 2015, Croatia announced it would withdraw from the arbitration process following allegations of corruption on the part of the Slovenian representatives.<br>• Both countries are fully committed to a diplomatic resolution process and there is a low probability of physical confrontation.<br>• Businesses face a low risk of disruption of supply chains or damage of assets due to conflict. |
| Slovenia | Disputes surrounding fishing rights in the Adriatic Sea. | If tensions escalate, there would likely be a blockade of Slovenian fishing vessels and commercial ships, and possibly confiscation by Croatia. | • Low – A separate area of dispute is Slovenia's opposition to the controversial proclamation of the Croatian Ecological and Fisheries Protection Zone ('ZERP') in the Adriatic Sea.<br>• Slovenia disputes this Exclusive Economic Zone and claims direct access to the international waters.<br>• This is a contentious issue since almost half of all the catchment of Slovenian fishermen originates from the zone.<br>• The EU and Slovenia condemned Croatia's move, as it restricts non-Croatian fishing.<br>• Nevertheless, Slovenian fishing continues in ZERP with no physical reprisal.<br>• The matter will likely be resolved diplomatically over time. |
| Bosnia-Herzegovina | Border disputes | If tension escalate, businesses can expect the imposition of trade embargoes, as well as possible border skirmishes. | • Low – Border disputes are common in the Balkans due to the nature of post-conflict resolution following the various civil wars and wars for independence in the region in the 1990s.<br>• Relations with Bosnia-Herzegovina are on a stronger footing than with Serbia, and border disputes between the two countries (concerning the town of Neum, Bosnia-Herzegovina's only access point to the Adriatic Sea and a slice of land that divides a section of Croatia, including Dubrovnik, from the remainder of the country) have largely been resolved, mitigating the risks of disruption in business operations, though tensions have the potential to flare up given a continued strain on resources.<br>• Low – Border disputes are common in the Balkans due to the nature of post-conflict resolution following the various civil wars and wars for independence in the region in the 1990s.<br>• Relations with Bosnia-Herzegovina are on a stronger footing than with Serbia, and border disputes between the two countries (concerning the town of Neum, Bosnia-Herzegovina's only access point to the Adriatic Sea and a slice of land that divides a section of Croatia, including Dubrovnik, from the remainder of the country) have largely been resolved, mitigating the risks of disruption in business operations, though tensions have the potential to flare up given a continued strain on resources. |
| Serbia | Border disputes and ongoing historical conflict resolution | Suspension of trade and diplomatic ties, public protests followed by border skirmishes | • Low – Regional rival Serbia, with whom Croatia fought a brutal war during the break-up of the former Yugoslavia in the 1990s, is still the subject of disputes around war-time issues, such as borders and reciprocal lawsuits for war crimes or genocide.<br>• Internally, further risks in Croatia emanate from the eastern region of Vukovar, which borders Serbia and has a considerable Serb minority. |

*Source: BMI*

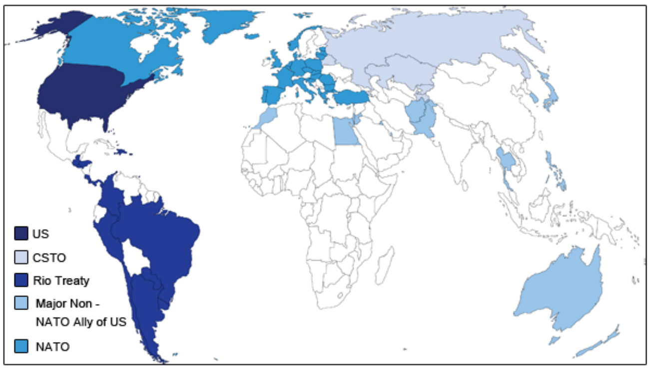
security force that benefits from close cooperation with its European neighbours and with organisations such as NATO. Though the country's security forces have not been truly tested in a crisis in recent history, Croatia has effective intelligence agencies, a capable police force and a developed counterterrorism legislation framework.

Intelligence is gathered and analysed by a single agency to align and coordinate the work better and increase the effectiveness of counterterrorism in Croatia. The Security and Intelligence Agency was established in 2006 by merging the Counterintelligence Agency and the Intelligence Agency. In addition there is the Military Security Agency, which is part of the Ministry of Defence and which supports its defence duties.

Despite a low national terrorist threat, Croatia's counterterrorism and intelligence-gathering apparatus is reliable, effective and professional and works well with international and local partners to combat global and regional terrorism threats. Croatia's international cooperation on counter-terrorism at the state and local level – with Interpol, Europol and NATO – is extensive, which suggests that it is up to global standards. As part of international efforts to counter violent extremists, Croatia participated in the International Security Assistance Force (ISAF) in Afghanistan, contributing approximately 300 troops.

In addition, Croatia cooperates closely with the Organization for Security and Co-operation in Europe's Action against Terrorism Unit and the US State Department's Export Control and Border Security Program to check illegal immigration along its 6,000 miles of coastline. Croatia also uses biometric passports and has signed a number of border crossing agreements with neighbours, making illegal border crossings by suspected criminal or terrorist elements much more difficult, and mitigating the risk of trans-national terrorist activity pertaining to Croatia's 750-mile border with Serbia, Montenegro and Bosnia-Herzegovina.

**Global Defence Agreements**




*Note: The US is a member of the Rio Treaty and NATO; Kuwait and Bahrain are also Major Non-NATO Allies of the US. Source: d-maps.com, BMI*

Croatia firmly supports the values and objectives of the UN Global Counter-Terrorism Strategy, especially the position that all counterterrorism measures must comply with the undertaken obligations under international law, including the Charter of the United Nations and relevant international conventions and protocols, and in particular with human rights law, refugee law and international humanitarian law. Croatia strives to act in accordance with those values and in line with provisions set by the United Nations, in particular those set by Committees established pursuant to relevant Security Council Resolutions.

**TABLE: MAJOR CONFLICT FLASHPOINTS (CONTINUED)**

| Protagonist | Likely Cause Of Conflict | Form Such A Conflict Would Take | Likelihood Of Conflict |
|---|---|---|---|
| | | | • Internally, further risks in Croatia emanate from the eastern region of Vukovar, which borders Serbia and has a considerable Serb minority.<br>• There are some cases of escalating animosities between Croats and Serbs in the region, with large protests and demonstrations in both July and August 2015, but nothing severe enough to threaten Croatia's territorial integrity.<br>• However, Croatia has made efforts to pacify the situation internally.<br>• The international community encourages good regional relations in the Western Balkans through concerted UN, NATO and EU efforts.<br>• Croatia joined the EU as the 28th member state in 2013 and Serbia has entered the EU accession process as well.<br>• Croatia is backing Serbia's integration into the EU and offered advice with regards to military cooperation with the EU.<br>• These strengthening diplomatic ties help to lessen the potential for aggressive engagement between the two countries and conflict is therefore highly unlikely. |

*Source: BMI*

Since Croatia joined NATO in 2009, it has drafted its own national strategy for the prevention and suppression of terrorism, implemented Anti-Money Laundering and Terrorist Financing Law standards, contributed to ISAF force in Afghanistan, chaired the UN Security Council's Counter-Terrorism Committee in 2009, and hosted the Council of Europe's Committee on Counterterrorism Experts as well as the NATO Parliamentary Assembly on security issues in Dubrovnik in 2013. This increased participation in global policy building and internal development of anti-terrorism legislation minimises the risks faced by foreign investors and multinationals that operate in Croatia, as they are protected against implication in terrorist financing and other illicit financial flows, not only within Croatia but in the EU as a whole.

## Interstate Conflict Risk

Croatia's membership to both the EU and NATO fosters co-operation and interdependence among its close regional neighbours and beyond, which significantly reduces the risk of conflict between EU states. The main interstate security risks to Croatia stem from disputes about the flow of migrants and demarcation of maritime and land borders with Slovenia and border disputes with Serbia; although it is unlikely that these tensions will escalate significantly in either case. Overall Croatia has a high score of 72.0 out of 100 for Interstate Conflict Risk, which places the country third out of 12 South East Europe states.

## Likelihood Of Conflict

**Military Capability:** Croatia operates a small, yet well-developed military, with additional support in the form of its membership to NATO. In addition, membership to the EU further boosts Croatia's military capability via joint training exercises and knowledge-sharing mechanisms. Although the country's military and defence expenditure are smaller than many of its regional neighbours, Croatia is considered able to defend itself on a limited scale and, in conjunction with NATO and EU partners, on a much larger scale.

**Size:** There are currently 16,550 active military personnel in the Croatian Armed Forces, where ground forces constitute over two-thirds of the military; the Navy and Air Force have 1,600 and 1,850 personnel respectively. In addition there are 102,700 reservists, available in case of a state of emergency. Total manpower available for military service amounted to an estimated 1.6mn, one of the smaller totals in the Emerging Europe region, between Georgia and Lithuania. It should be noted that Croatia's Armed Forces are about one-fifth of their size in the year 2000. The steady decline can be attributed to a process of demilitarisation of the country after the civil war in the 1990s and the abolition of compulsory military service in 2008.

Croatia's military budget shrunk from USD969.1mn in 2011 to USD852mn in 2012 and is now estimated at USD800.7mn. This military budget is lower than that of Slovakia but higher than Belarus, Bulgaria, Serbia and Slovenia. Croatia's expenditure is still about four times higher than that of direct neighbour Bosnia-Herzegovina and about a third higher than that of Slovenia. Defence remains important to the government and, in September 2014, the government agreed to keep military spending at 1.2% of GDP over the next decade.

The ongoing migrant crisis in Europe has exposed the numerical vulnerability of Croatia's armed forces, since the government has had to deploy police to assist in crowd control and border security. The security forces are overwhelmed to the point where, in August 2015, the EU provided USD43.5mn worth of financial assistance to the Croatian government to address the administration of migrants as, in light of bigger terrorist threats in countries such as France, more security was needed in order to guard the region against non-state actors. In October 2015, the country received a high of approximately 10,000 migrants per day, and we forecast the influx of migrants to continue to grow until the war in Syria ends and the threat of Islamic State is neutralised in the Middle East and North Africa. Businesses should anticipate additional security costs to supplement national security efforts amid this crisis in the medium term; however, these costs will be (on average) less than those experienced in other European states, such as Hungary, where tensions are high.

**Weaponry:** The economic recession throughout much of the EU and in Croatia from 2009 caused the revision of Croatia's plans to modernise its armed forces. However, the country does have modern and effective materiel, such as 72 tanks, 574 armoured fighting vehicles and a naval strength of 28 vessels. Croatia is, however, selling off surplus equipment as part of the country's plans to downsize its military. Despite this downsizing, the capability of Croatia's military forces remains very strong, meaning it can still function as a deterrent from aggression.

Croatia has also instituted a number of initiatives designed to boost its local industrial defence capabilities, including collaborations with NATO members and neighbouring states. Due to Croatia's responsibility towards NATO, some schedules had to be fulfilled, such as the procurement of modern armoured personnel carriers and the modernisation of infantry units, from training to equipment. Although there were quite a few setbacks in Croatia's army modernisation plans, this program is almost at completion and should be fully implemented by the beginning of 2016. Furthermore, large donations by the US military and other NATO allies should ensure that the Croatian Army of 2020 can fully integrate and interoperate with NATO in terms of equipment, logistics and weapon systems.

Croatia also has a significant military industry sector, which exported around USD120mn worth of military equipment and armament in 2010. Croatian-made weapons and vehicles used by the Croatian Armed Forces (CAF) include the standard sidearm HS2000 manufactured by **HS Produkt** and the M-84D battle tank designed by the **Đuro Đaković** factory. Uniforms and helmets worn by CAF soldiers are also locally produced and successfully marketed to other countries.

**Dispute Management (Bilateral):** Croatia maintains good relations with its neighbouring states, which reduces the likelihood of international conflict. Moreover, one of the pertinent disputes in which the country is engaged, with Slovenia, is being resolved at the Permanent Court of Arbitration, which offers further evidence of how the country wishes to diplomatically engage with potential adversaries. Furthermore, as a member of the EU and NATO, Croatia enjoys the protection of the mutual defence pact.

With both Croatia and Montenegro offering tenders for the exploration of oil and gas finds in disputed areas of the Adriatic Sea in November 2014, Croatian Prime Minister Zoran Milanovic emphasised the need to resolve the conflict, as tensions flared up. The Montenegrin government had claimed some areas that Croatia asserted as its own, and claimed that this was ratified by international law. Croatia was further concerned that the dispute could scare away potential investors. 'If we understand this as the beginning of some kind of arbitration between Croatia and Montenegro, it will be good,' Milanovic said, as reported by Balkan Insight. The Montenegrin government stated that it was only seeking to protect its interests in the maritime area, and was prepared to start a dialogue on the permanent demarcation of the maritime border, which was solved diplomatically in May 2015.

The 2002 Protocol on the Interim Regime along the Southern borders was also signed to resolve a dispute over a small peninsula called Prevlaka on the borders of Montenegro and Croatia. The peninsula was a point of dispute between Croatia and the Federal Republic of Yugoslavia. The UN was monitoring the region to prevent the problem dragging the countries into a conflict. The Kingdom of Enclava was established between the Slovenian town Metlica and Croatian capital city Zagreb, on land which was neither claimed by the Croats or the Slovenians. Slovenia and Croatia also faced border problems after their separation from Yugoslavia in 1991.

Croatia's application to NATO has been affected by border disputes, and in 2008 Slovenia prevented Croatia's accession into the EU due to the disputes. In 2009, the EU president and prime ministers from both countries came together and signed an arbitration agreement over the borders. Croatia has a long-standing maritime and territorial dispute with Slovenia stemming from the 1975 Treaty of Osimo, which determined the boundary of the Gulf of Trieste and was signed between Italy and Yugoslavia. Following the dissolution of Yugoslavia, Slovenia and Croatia inherited these international commitments. However, the median line of delimitation of the Gulf of Trieste is unfavourable to Slovenia because of its limited access to the high seas; businesses in both countries will face elevated costs of logistics and potential supply chain disruption if tensions escalate.

A particular area of concern in this matter is Piran Bay, which is located in the northern part of the Adriatic Sea and is the southernmost tip of the Gulf of Trieste. Slovenia asserts that the Bay cannot be delimited with Croatia as it is governed by the regime of Slovene internal waters. Croatia disputes this assertion, and with no meaningful progress on the matter, diplomatic relations were strained up until 2010. In one instance, both countries backed out of a bilateral agreement at the last minute in 2001 and later Slovenia repeatedly blocked Croatian bids to join the EU in 2008. In 2010, both sides agreed to enter arbitration at the Permanent Court of Arbitration in The Hague. A resolution was expected in mid-2015; however, in late July 2015, Croatia announced it would withdraw from the arbitration process following allegations of corruption on the part of the Slovenian representatives. Both countries have reiterated a commitment to a political resolution of the disagreement and there is a low probability of physical confrontation.

Regional rival Serbia, with whom Croatia fought a brutal war during the break-up of the former Yugoslavia in the 1990s, is still the subject of disputes revolving around war-time issues, such as borders and reciprocal lawsuits for war crimes or genocide. Internally, further risks in Croatia emanate from the eastern region of Vukovar, which borders Serbia and has a considerable Serb minority. There are some cases of escalating animosities between Croats and Serbs in the region, with large protests and demonstrations in both July and August 2015, but nothing severe enough to threaten Croatia's territorial integrity. Croatia has made efforts to pacify the situation internally. In 2015, Serbia criticised Croatia 'for increasingly frequent incidents targeting the Republic of Serbia and Serbs in Croatia.' Croatia, in turn, increased efforts to collaborate with Serbia on the protection of the Serbian minority residing in Croatia. State-level policy in Croatia seeks to enforce the human rights of Serbs, though, on the micro-level, vandalism against Serbian property, economic exclusion, unemployment and under-representation in the public sector have worsened in recent years due to simmering tensions between Serbs and Croats, especially in regions like Vukovar, where the wartime hostilities between the two ethnicities were the worst. A resurgence of right-wing nationalism in Croatia is also a potential source of risk, as anti-Serb political rhetoric has increased. The international community encourage good neighbourhood relations in the western Balkans through concerted UN, NATO and EU efforts. Croatia joined the EU as the 28th member state in 2013 and Serbia has entered the EU accession process as well. Croatia is backing Serbia's integration into the EU and offered advice with regards to military cooperation with the EU. These strengthening diplomatic ties help to lessen the potential for aggressive engagement between the two countries and conflict is therefore highly unlikely.

**Dispute Management (Multilateral):** A separate area of dispute with Croatia is Slovenian and Italian opposition to the proclamation of the Croatian Ecological and Fisheries Protection Zone ('ZERP') in the Adriatic Sea. Slovenia disputes this Exclusive Economic Zone and claims direct access to the international waters. This is a contentious issue since approximately 40% of all the catchment of Slovenian fishermen originates from the zone. The EU and Slovenia condemned Croatia's move, as it restricts non-Croatian fishing. Nevertheless, Slovenian boats still fish in the area, which increases the risk of tensions escalating, however platforms for conflict resolution mitigate the risk of armed conflict.

**Defence Agreements:** Despite ethnic tensions, the threat of inter- or intra-state war is very low as demonstrated by the recently signed military cooperation agreement between Croatia and Serbia and the military technical co-operation agreement signed between Croatia and the Former Yugoslav Republic Of Macedonia (FYROM).

Moreover, Croatia has been a member of NATO since 2009 and is, thus, covered by the collective security provision set out in Article 5 of the North Atlantic Treaty, which effectively protects it from outside aggression (eg from Serbia, which is not a NATO member) as an attack on Croatia would be regarded as attack on the whole alliance and trigger a multilateral military response. Croatia's armed forces have participated in various NATO missions, including deployments in Afghanistan and Kosovo that have given troops much need experience and improved training. Furthermore, NATO's secretary-general recently thanked Croatia for its contributions to operations in Afghanistan and Kosovo, and reiterated NATO's commitment to defending its member-states. As a NATO member, Croatia's military benefits from training by NATO states, as well as funding under the capability target package for Croatia. Croatia is also a party to the European Security and Defence Policy as part of the EU Common Foreign and Security Policy.

**Business Response:** Neither hardship pay nor a danger allowance is payable by the US Department of State. Most Western firms are unlikely to provide extra pay, which means businesses

**TABLE: BUSINESS RESPONSE TO CONFLICT RISK**

| Risk Level | Business Response |
|---|---|
| Low | • Businesses that rely on their goods being transported through Croatia's land borders should implement contingency plans, explore alternative routes and hedge against risk of supply chain disruption in light of stricter border controls, higher likelihood of protests and increased pressure on transport routes that coincide with migrant routes.<br>• Additional insurance cover may be warranted.<br>• Investment in counterterrorism and security training for workers will be necessary in light of the 2015 Paris attacks.<br>• All countries in the EU are vulnerable to infrastructural damage and disruption of business activities due to increased regional terrorism risk.<br>• Multinationals are particularly exposed.<br>• All multinational entities must adopt latest surveillance technology to ensure on-site safety of workers, assets and clients until government efforts to ramp up security in this regard are sufficient.<br>• Car allowance costs and additional cost of transportation for workers should be anticipated in light of the strain on public transport systems that comes with the influx of migrants and potential for social unrest, in light of the 2015 Paris attacks.<br>• Back up plans must be in place for the absence of the work force in the event of turmoil, especially in border regions and near densely populated migrant camps located near the borders.<br>• Foreign workers must avoid travelling alone in remote areas or areas densely populated by refugees. |

*Source: BMI*

do not face significantly higher labour costs. This helps to make Croatia an attractive and competitive investment destination in the South East Europe region.

## Transport Network

Businesses with supply chains which traverse Croatia face lower logistics risks in relation to regional peers due to the large extent of the country's road network and the fact that its ports act as a major conduit for international trade. However, risks still exist through poor competitiveness of the country's inland waterway transport network and the small extent and low density of the rail network. We highlight that the latter risk is expected to ease somewhat over the medium term due to Croatia's strong rail project pipeline, which should increase the rail network's competitiveness in the Croatian freight transport mode mix, once these projects begin to come online. Consequently, Croatia ranks in third place out of 12 South East Europe states, with a high score of 70.0 out of 100.

**Latest Transport Network Analysis:**

- The European Commission (EC) approved EUR80.8mn (USD95.07mn) for the modernisation and electrification of

**TABLE: ROAD RISKS**

| | |
|---|---|
| **Internal Coverage** | |
| Total Road Network: 26,958km | • Croatia's road network is one of the larger networks when compared regionally; the country's roads connect into the major cities, industrial areas and to the country's borders.<br>• Therefore adequate inland connections via road are present, which benefits key export and import sectors needing to travel across the country. |
| International Connections | |
| Strong, connected to all neighbouring and some regional peers via highways and two Pan-European Corridors. | • Main trans-border road routes are the EU Corridor 5 via Hungary-Zagreb-Rijeka and recently re-opened EU Corridor 10 from Zagreb through Bosnia-Herzegovina to Belgrade. Main internationals roadways connect Slovenia, Hungary, Bosnia and Serbia; thus, overland links to regional trade partners are good and risks for investors low. |
| Infrastructure Quality | |
| 15.1% of roads unpaved | • Key sectors such as refined fuel, wood, electronic parts and autos parts, which have road-based supply chains, benefit from extensive investment and the high quality of Croatia's main roads. This reduces risks to safety of cargo or of incurring extra time and monetary cost burdens as a result of delays.<br>• This is demonstrated by the fact that the vast majority of the Croatian road network is paved, which allows for easier, faster and safer overland haulage and significantly reduces the risk of delays or damage to goods or personnel for foreign businesses.<br>• Croatia has invested heavily in its road network, averaging 2.5% of GDP for 2002-2006, after the 1991-1995 Balkans war, with the help of EBRD and World Bank loans. |
| Usage | |
| Accounts for 80.21% of internal freight tonnage | • As a result of heavy investment in roads from the early 2000's, and the vast majority of Croatia's main trading partners being fellow EU peers, road is the most dominant form of overland freight haulage in the country. Congestion remains a large problem at key areas for road-based supply chains as a result of the heavy pressure on the country's road network. It is expected to remain an issue for supply chains over the medium-term, and will continue causing delays and adding extra costs.<br>• We expect road freight tonnage to have an average annual growth rate of around 5.5% from 2017 – 2021, as consumer demand rebounds and various road projects come online. |
| Disruption | |
| 9.2 road deaths per 100,000 people | • Croatian roads become hazardous in winter months, especially in mountainous areas where snow tyres are necessary. This can result in accidents causing supply chain delays, extra costs and compromising the safety of cargo.<br>• The road accident rate is relatively high in Croatia, at 9.2 per 100,000 of the population, when compared to its neighbours, which proves this point. However, the country's emergency response is competent and quick, which does provide relief for supply chains if they are involved in an accident. |
| Planned Projects | |
| | • Three bidders are competing for a contract to build the 2.4km cable-stayed Pelješac Bridge in Croatia. The bidders are Strabag, China Road and Bridge Corporation consortium and a joint venture between Astaldi and IC Ictas. The bids, varying between USD410mn and USD510mn, are higher than the original construction cost estimate of USD290mn by Croatian roads agency Hrvatske Ceste for the 55m high bridge and its access roads. The four-lane bridge will pass through Mali Ston Bay and will allow drivers to travel from Split to Dubrovnik without entering Bosnia. The overall project is expected to cost USD625mn, of which USD435mn will be provided by the EU from its Cohesion Fund. The project covers tunnels and viaducts, modernising roads and an 8km bypass near the town of Ston. Work is slated to be completed in 2022, according to Global Construction Review. |

*Source: BMI, World Bank, WHO*

the Zaprešić-Zabok railway line in northwest Croatia, as reported by RailwayPro. The upgrade of the 24km railway section will allow trains to run at a maximum speed of 120km per hour, reducing the travelling time. Work also includes building bridges and underpasses, and rebuilding the railway station and standpoint. Construction will start after state-run railway firm **HŽ Infrastruktura** selects a contractor through a tender. The project is slated to be completed by 2020.

- Three bidders are competing for a contract to build the 2.4km cable-stayed Pelješac Bridge in Croatia. The bidders

**TABLE: RAIL RISKS**

| | |
|---|---|
| **Internal Coverage** | |
| Total Railway Network: 2,722km | • Croatia ranks in the top half of the region for the extent of its rail network, with rail connections providing adequate linkages between ports, the capital Zagreb and regional peers. This benefits key export and import sectors such as oil and refined fuels, autos parts and wood. |
| | • Croatia has good internal connections, but it scores lower in its railway intensity scores than regional peers Slovenia and Bulgaria. |
| International Connections | |
| Extensive, connected to most immediate neighbours and further regional peers via rail network and two Pan-European Corridors. | • Croatia benefits from having rail links between its ports, capital and regional peers such as Slovenia, Hungary and Serbia. |
| | • The most important lines are the Pan-European Corridors X and Vb, which run from Slovenia via Zagreb to Serbia, and from Hungary to Zagreb to the port of Rijeka, respectively. |
| | • This benefits key export and import sectors, as Croatia's main trading partners are all within the eurozone and Emerging Europe region. This reduces travel times and costs for these supply chains. |
| Infrastructure Quality | |
| | • Investors in Croatia who will be utilising the country's railway network to meet their logistics needs must be aware, however, that the quality of the railway system is of a relatively low standard, and the quality of the wagons that operate on it differ significantly. |
| | • Croatia's rail network still suffers to some extent from years of under-investment and lack of maintenance under Communism, as well as from the damage during the 1991-1995 Balkans war. The railway network needs to be modernised, as much of the network still operates on a single-track gauge and two thirds of the network are not electrified, which impedes high-speed railway connections. |
| | • The Croatian government is making great efforts to improve the quality of the railway system, with 39% of all transport investment in 2017 going into the railway industry in order to boost railway connectivity and alleviate the burden of freight traffic volume on the road network. There is a strong railway project pipeline and the quality is expected to increase moderately over the medium term. This is further aided by the privatisation process which Croatia's rail system has been undergoing since 2012. |
| Usage | |
| Accounts for 13.1% of internal freight haulage | • Due to low intensity of the railway system, rail accounts for a small portion of Croatia's freight transport mix. |
| | • While freight haulage volumes are expected to pick up over the medium-to-long term on the back of consumer demand and heavy industries' performances rebounding, time delays or extra costs will not be caused by supply chains as a result of additional traffic. |
| | • Any additional traffic will be accommodated through the coming online of various rail projects, such as the USD225mn project on the 38.2km Dugo Selo-Krizevci rail section. This will accommodate rail freight haulage growth in the medium-term and attract operators to use rail as a freight mode in Croatia. |
| Disruption | |
| | • There is a medium to high chance of rail worker strikes impacting on supply chain activity from a time and cost perspective, as the last strike occurred in 2015. |
| Planned Projects | |
| | • The European Commission (EC) approved EUR80.8mn (USD95.07mn) for the modernisation and electrification of Zaprešić-Zabok railway line in northwest Croatia, reports RailwayPro. The upgrade of the 24km railway section will allow trains to run at a maximum speed of 120km per hour, reducing the travelling time. Work also includes building bridges and underpasses, and rebuilding the railway station and standpoint. Construction will start after state-run railway firm HŽ Infrastruktura selects a contractor through a tender. The project is slated to be completed by 2020. |
| | • The European Commission (EC) has granted approval for 32 transport projects worth HRK3.2bn (EUR509.24mn) to Croatia, reports Railway Pro, citing Minister of Maritime Affairs, Transport and Infrastructure Oleg Butković. The financing, to be provided under the EU's Connecting Europe Facility, will be used in preparing necessary documents and undertaking works such as construction, reconstruction and the modernisation of transport infrastructure, noted Butković. Railway transport will receive the maximum share of the funds. The schemes, to be carried out by Croatian Railways, include the reconstruction of Rijeka-Brajdica rail station, construction of an intermodal container terminal in Brajdica and refurbishment of the Križevci-Koprivnica railway. |

*Source: BMI, World Bank*

are **Strabag**, **China Road and Bridge Corporation** consortium and a joint venture between **Astaldi** and **IC Ictas**. The bids, varying between USD410mn and USD510mn, are higher than the original construction cost estimate of USD290mn by Croatian roads agency Hrvatske Ceste for the 55m high bridge and its access roads. The four-lane bridge will pass through Mali Ston Bay and will allow drivers to travel from Split to Dubrovnik without entering Bosnia. The overall project is expected to cost USD625mn, of which USD435mn will be provided by the EU from its Cohesion Fund. The project covers tunnels and viaducts, modernising roads and an 8km bypass near the town of Ston. Work is slated to be completed in 2022, according to Global Construction Review.

- The European Commission (EC) has granted ap-

**TABLE: PORTS AND INLAND WATERWAY RISKS**

| | |
|---|---|
| **Internal Coverage** | |
| Strong; Croatia has four major seaports located at Ploče, Rijeka, Šibenik and Split. Total length of navigable inland waterways: Total length of navigable inland waterways: 785 km | • Croatia's has several well-developed commercial ports on the Adriatic Sea, with the biggest ports being located in Ploče, Rijeka, Šibenik and Split. |
| | • Croatia's Port Rijeka is significantly closer to Budapest, Vienna, Belgrade and Munich than the German and Benelux ports, which offers opportunities for international logistics businesses to markedly reduce the time and costs of shipping goods to Central Europe by diverting cargo flows to Croatian ports. |
| | • Furthermore, inland waterway transport is available as a supply chain alternative, albeit in a limited capacity. In total, Croatia possesses 785 km of inland waterways at the rivers of Sava (of which only a small part classifies as international class of waterway), Drava and Duna. These can be utilised to stem the expected increase in traffic demand when cargo flows shift to South-East Europe. |
| International Connections | |
| Liner Connectivity: 32.51 (highest score 167.5) | • Croatia's ports have the third highest levels of connectivity in the South East Europe region, just behind Slovenia. |
| | • Croatia's ports feature on major international shipping lines (especially the Croatian ports of Rijeka and Split) and have strong inland connections to Croatia's capital and regional peers via road and rail. |
| | • This reduces transit times and costs for intermodal transport supply chains, such as sectors using Croatia as a transit corridor for land access to the central EU. |
| Infrastructure Quality | |
| | • Exporters from and importers to Croatia, as well as supply chains using the country's ports as a conduit for access to central European markets, benefit from the high quality of Croatia's seaports, which allows for time and cost efficient supply chain delivery. |
| | • While the country's ports are the major conduit for international trade, a lack of investment in waterways has led its role in supply chains to decrease. |
| | • The river ports at Sisak, Slavonski Brod, Osijek and Vukovar have to be upgraded to meet modern technological standards in order for inland waterway transport to be a more competitive supply chain option with road and rail. |
| Usage | |
| Port of Rijeka throughput: 214,348 TEUs (BMI 2016 estimate). Inland waterways account for 6.6% of internal freight tonnage. | • We expect positive growth in container throughput for the Port of Rijeka (Croatia's main trading hub), with an average annual growth rate for container throughput of 3.8% for the 2017-2021 period. |
| | • This is largely due to the highly positive impact on port operations which the running of them by International Container Services is having. |
| | • This expected uptick in growth will be accommodated by the completion of a new container terminal at the Port of Rijeka (which is slated to come online by the end of 2018), and its efficient handling by International Container Services Inc. Therefore, port congestions will not be a problem for supply chains. |
| | • Inland waterways freight volumes will remain fairly stable as they're used primarily for commodity products, for which demand in the slowly recovering economy is not increasing dramatically. |
| Disruption | |
| | • There is limited risk for supply chains incurring time or financial losses as a result of port worker strikes disrupting port operations. In 2017 a ferry worker strike resulted in a peaceful protest at Split Port. |
| Planned Projects | |
| | • Investments include port reconstruction and modernisation at Rijeka, Šibenik and Zadar, upgrading of the ferry terminal at Split, and construction of a bulk cargo and container terminal at the port of Ploče, for which China-based CNBM International Engineering won a contract valued at EUR100mn (USD128mn) as part of a public-private partnership deal with Ploče Port and Ploče Port Authority. The Rijeka Gateway will cost EUR190mn, and the government is to invest EUR32mn in the project, which will result in the creation of 2,000-3,000 new jobs. |

*Source: BMI, World Bank, UNCTAD*

proval for 32 transport projects worth HRK3.2billion (EUR509.24mn) to Croatia, reports Railway Pro, citing Minister of Maritime Affairs, Transport and Infrastructure Oleg Butković. The financing, to be provided under the EU's Connecting Europe Facility, will be used in preparing necessary documents and undertaking works such as construction, reconstruction and the modernisation of transport infrastructure, noted Butković. Railway transport will receive the maximum share of the funds. The schemes, to be carried out by **Croatian Railways**, include the reconstruction of Rijeka-Brajdica rail station, construction of an inter-modal container terminal in Brajdica and refurbishment of the Križevci-Koprivnica railway.

## Extent And Quality Of Transport Network

Croatia scores rather well for the extent of its transport network, largely on the back of its expansive road and rail networks in comparison to other South East European states. The expansion of Croatia's tourism sector has encouraged a virtuous circle of increased investment in capacity and infrastructure, improved transport links, and rising tourist arrivals; all welcome news for the development of the road freight sector in the country, which is the largest freight mode in the Croatian freight mix. Furthermore, international connections via all freight transport modes remain adequate. Overall, Croatia scores a high 70.2 out of 100 for the Extent of its Transport Network, ranking in third place regionally.

**TABLE: AIR TRANSPORT RISKS**

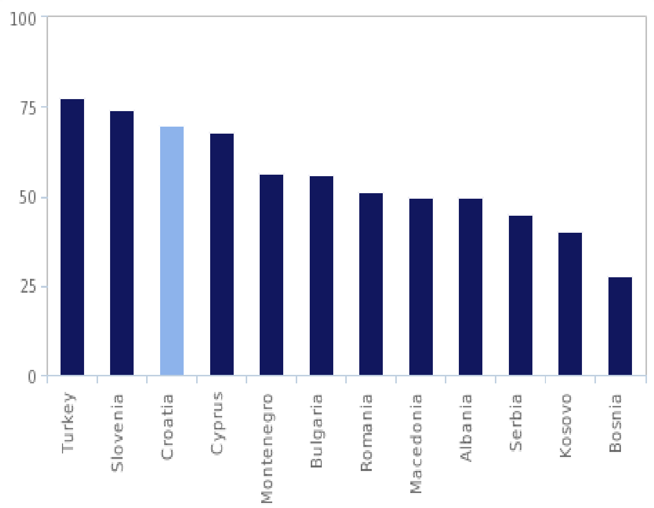
| | |
|---|---|
| **Internal Coverage** | |
| Croatia has 24 airports with paved runways, an estimated nine of which are international. | • There are 24 airports with paved runways in Croatia, with nine airports of international significance: the most important are Zagreb, Dubrovnik, Split, Pula, Zadar, and Rijeka. |
| International Connections | |
| 0.41 air passengers per capita | • Croatia is a tourist hub, and therefore Croatian airports have high levels of international connectivity in terms of flight connections.<br>• Zagreb International Airport is Croatia's biggest and busiest airport, which has extensive international connections to a variety of European destinations, as well as others more further afield, such as Lebanon, Turkey, Canada, South Korea, Qatar and Dubai. Well known international carriers such as Air France, British Airways, flydubai, Iberia, KLM and Qatar Airways also operate out of Zagreb International Airport. A variety of these airlines offer belly-hold cargo carriage options, which increases international connectivity for freight carriage to or from Croatia.<br>• Zagreb International Airport also has five dedicated cargo carriers which offer flights to Turkey, Qatar, Slovenia and Germany. This benefits sectors such as consumer goods and packaged medicaments which originate from or are destined for international markets which are not European. |
| Infrastructure Quality | |
| | • Croatia's airports receive very low freight traffic at present (especially when compared regionally), and are of sufficient capacity and quality to handle the freight traffic volumes they receive.<br>• Therefore congestion or safety concerns as a result of poor quality are not risks for businesses with air-based supply chains travelling to or from Croatia.<br>• The ongoing expansions and upgrades of Dubrovnik Airport will further enhance the quality of air transport available in Croatia. |
| Usage | |
| Air freight volumes: 0.7 tonnes-km in 2016. | • As Croatia mostly engages in regional trade via road or rail, the use of airfreight options is limited. Indeed, Croatia's airfreight volumes are well below the regional average of 353.1 tonnes-km. We estimate that in 2016, airfreight accounted for a very small 0.01% of the total overland freight mix in Croatia.<br>• However, as consumer spending levels slowly rebound over the medium-term, and the expansion of Dubrovnik Airport comes underway, we expect airfreight tonnage volumes to grow at a rate of about 2.4% in the 2017-2021 period.<br>• That said, congestion will not become an issue for supply chains, as the coming online of Dubrovnik Airport (slated for Q4 2019), should accommodate additional traffic flows. |
| Disruption | |
| | • There is a high risk of airport or airline worker strikers impacting on airport operations, causing delays for supply chains and adding extra costs. In 2017, there was partial traffic disruption as a result of national carrier Croatia Airline s worker strikes. |
| Planned Projects | |
| | • Strabag signed a EUR122mn (USD147mn) contract to renovate and expand Dubrovnik Airport in Croatia. Strabag will deliver the project through a joint venture, in which it holds a 53.92% stake. The scheme involves modernising and expanding airport runways, the lighting system and building a rescue and fire station and other service and office buildings. The scheme is slated to be completed by Q419 (SeeNews). |

*Source: BMI, CIA World Factbook, World Bank*

As a result of significant investment, Croatia's road and maritime transport systems are of high quality, resulting in the safe passage of cargo, meaning that the country has become a conduit for international trade flows through to central European states. There are significant rail and air transport projects scheduled to come online over the short-to-medium term, which will boost the quality of these transport modes for freight travel. Consequently, Croatia scores 69.7 out of 100 for the Quality of its Transport Network, ranking in third place regionally.

**Extensive Reach Of Road Network Boosts Score**

South East Europe – Transport Network




*BMI Logistics Risk Index. Note: 100 = lowest risk; 0 = highest risk*

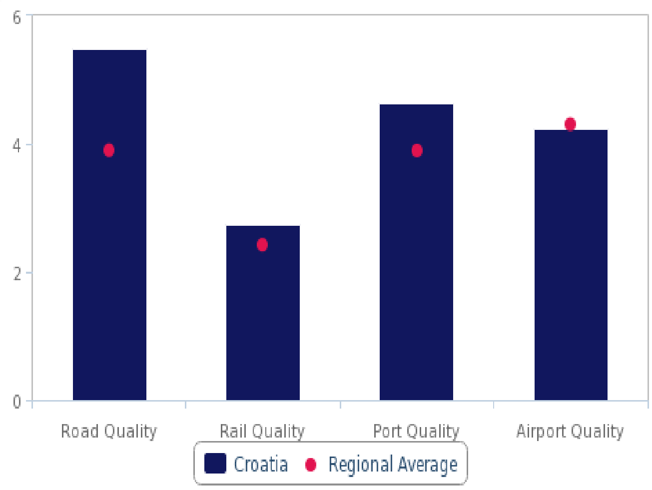
**Roads:** As a result of significant investment since the 2000s, and the fact that the vast majority of Croatia's trading partners are located in the EU, road is the dominant form of freight transport in the country. Key export areas such as refined fuel, wood, and autos and electronic parts benefit from the high quality of the country's roads and strong inter-regional links. However, as a result of the extensive use of the road network, congestion remains a significant issue in important commercial areas such as the capital city and along coastal roads. Despite numerous projects coming online which will extend road network and improve quality even further, congestion is expected to remain an issue for supply chains going forward.

**Railways:** Rail plays a small part in Croatia's overland freight haulage mix, largely as a result of the low density of the railway network and its poor quality. This is expected to improve over the medium to long term as various rail projects come online, which are expanding and upgrading the rail network, as well as the privatisation process of Croatia's rail operator.

**Ports And Inland Waterways:** Inland waterways offer another freight option for supply chains in Croatia. However, while the country's ports are the major conduit for international trade, a lack of investment in waterways has led its role in supply chains to decrease. This is the opposite to the situation at the country's ports, where foreign investors have developed facilities and ensured better connections for Croatia to major trade routes, which has led to a fall in transport times and costs.

**Rail Quality Poses Most Significant Logistics Risk**

Croatia and Regional Average-Infrastructure Quality

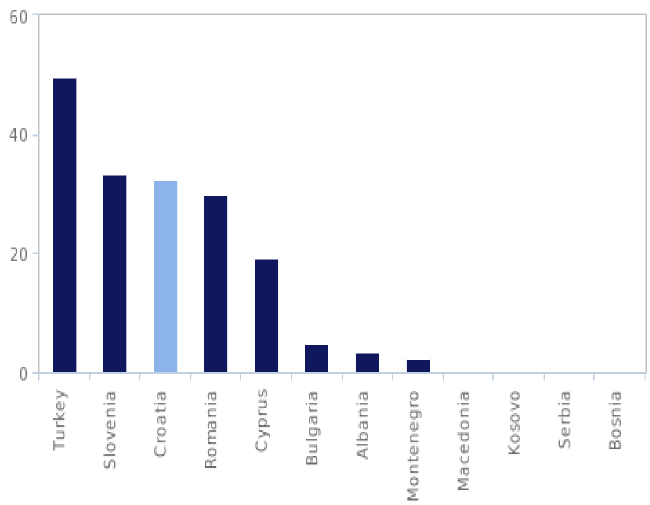



*Note: 7 = highest score; 1 = lowest score. Source: World Economic Forum's Global Competitiveness Index, 2015-16*

**Airports:** Croatia's air freight volumes are relatively low by regional standards, with the country's aviation supply chains losing out due to under-developed airports. Connectivity levels are curtailed further by freighter flights focused on Western Europe, rather than connecting Croatia with the wider aviation market, thereby decreasing the level of supply chain options that are available. However, Croatia's airports are geared more towards tourism than freight, so they function effectively at their intended sub-section of air transport.

**Strong Shipping Connections Increase Competitiveness Of Ports**

South East Europe – Liner Connectivity




*Note: 167.48 = highest score; 0 = lowest score. Source: UNCTAD*

## Chapter 5:
# BMI Global Macro Outlook

## EM Growth To Accelerate In 2018 While DMs Plateau

- The acceleration in global growth in 2018 will be marked by improving emerging markets and slowing DMs (ex-US).
- Divergence will increase among emerging markets in 2018, as China's economy decelerates for the seventh year out of the past eight, while EMs ex-China continue accelerating.
- The US will outperform among DMs, though tax reform is unlikely to provide a big boost.
- Against this improving growth backdrop, tightening monetary policy will be a key theme for 2018.

We forecast global real GDP growth to remain broadly steady in 2018 at 3.1%, versus 3.2% in 2017. The key theme for world economic activity in 2018 will be an acceleration in emerging market (EM) growth, carrying on a recovery following several years of weakness, compared with a modest slowdown in developed market (DM) growth, after a year in which activity surprised to the upside.

Real GDP growth in EMs will rise by 0.1 percentage points (pp) to 4.8% in 2018, whereas it will drop by 0.2pp in developed markets to 2.0%.

Even this belies a much larger divergence in favour of EMs, as this group (excluding China) will accelerate on aggregate by nearly 0.4pp to 3.7% in 2018. China will decelerate for the seventh year out of the past eight, to 6.5% in 2018, following

**TABLE: GLOBAL MACROECONOMIC FORECASTS**

| | | 2016 | 2017f | 2018f | 2019f | 2020f | 2021f |
|---|---|---|---|---|---|---|---|
| **Real GDP Growth, % y-o-y** | | | | | | | |
| | **US** | 1.5 | 2.2 | 2.2 | 2.0 | 1.9 | 1.9 |
| | **Eurozone** | 1.8 | 2.2 | 1.8 | 1.6 | 1.5 | 1.5 |
| | **Japan** | 1.0 | 1.8 | 1.5 | 0.5 | 0.4 | 0.4 |
| | **China** | 6.7 | 6.8 | 6.5 | 6.2 | 5.8 | 5.4 |
| | **World** | 2.6 | 3.2 | 3.1 | 3.0 | 3.0 | 2.9 |
| **Consumer Inflation, % (ave)** | | | | | | | |
| | **US** | 1.8 | 2.0 | 2.0 | 2.1 | 2.1 | 2.1 |
| | **Eurozone** | 0.4 | 1.5 | 1.8 | 1.8 | 1.8 | 1.9 |
| | **Japan** | -0.1 | 0.7 | 2.0 | 2.8 | 2.9 | 3.0 |
| | **China** | 1.8 | 1.6 | 1.8 | 2.2 | 2.3 | 2.4 |
| | **World** | 2.5 | 2.7 | 2.8 | 2.9 | 2.8 | 2.9 |
| **Interest Rates, % (eop)** | | | | | | | |
| | **Fed Funds Rate** | 0.50 | 1.25 | 1.75 | 2.25 | 2.25 | 2.25 |
| | **ECB Refinancing Rate** | 0.00 | 0.00 | 0.00 | 0.00 | 0.25 | 0.75 |
| | **Japan Overnight Call Rate** | -0.10 | -0.10 | -0.10 | 0.00 | 0.25 | 0.50 |
| **Exchange Rates (ave)** | | | | | | | |
| | **USD/EUR** | 1.11 | 1.13 | 1.10 | 1.15 | 1.17 | 1.17 |
| | **JPY/USD** | 108.81 | 112.00 | 117.00 | 121.00 | 122.00 | 123.00 |
| | **CNY/USD** | 6.65 | 6.78 | 6.60 | 6.59 | 6.59 | 6.57 |
| **Oil Prices, USD/bbl (ave)** | | | | | | | |
| | **OPEC Basket** | 40.76 | 50.50 | 54.00 | 60.00 | 67.00 | 69.00 |
| | **Brent Crude** | 45.13 | 53.50 | 57.00 | 63.00 | 70.00 | 72.00 |

*f = forecast. Source: BMI*

a once-off acceleration to 6.8% in 2017 from 6.7% in 2016.

In H217, most high-frequency growth indicators were indicating an acceleration in activity and, in general, momentum looks as though it will be preserved throughout H118. Trade volumes grew by around 5.0% y-o-y in Q317, and our leading indicator – which was beginning to dip lower from very high levels in Q317 on the back of input variables such as a weaker dollar and a downturn in China's purchasing managers index (PMI) – has stabilised, suggesting a continuation of this momentum into Q118. Industrial production is at around six-year highs, and though the slowdown in commodity price rises suggests a moderation going into 2018, production should remain robust.

Apart from EMs, the US will play a key role in the upturn. US manufacturing orders are typically a good leading indicator for global growth, and they are signalling that world real GDP excluding the US will continue to expand at the current rate. Our 2.2% US real GDP growth forecast for 2018 would mark another year of above-potential expansion, and while it denotes flat growth versus an estimated 2.2% in 2017, the composition of activity is arguably more robust, as we expect stronger trade and private investment. Furthermore, the risks to US growth are to the upside. While passage of the USD1.5trn tax bill in consideration by congress is largely incorporated into our forecasts already, the earlier timing (we had expected it only by early-to-mid 2018) may result in a modest upward bump in our 2018 and 2019 real GDP.

The net economic impact from this stimulus looks as though it will be modest, but it may give the US Federal Reserve (Fed) slightly more ammunition to push for rate hikes in 2018 – presenting upside risks to our end-year Fed funds rate forecast of

**TABLE: DEVELOPED STATES – REAL GDP GROWTH, % y-o-y**

| | 2016 | 2017f | 2018f | 2019f |
|---|---|---|---|---|
| **Developed States Aggregate Growth** | 1.7 | 2.2 | 2.0 | 1.8 |
| G7 | 1.4 | 2.1 | 1.9 | 1.7 |
| Eurozone | 1.8 | 2.2 | 1.8 | 1.6 |
| EU-28 | 1.9 | 2.3 | 1.9 | 1.7 |
| | | | | |
| **Select Developed States** | | | | |
| Australia | 2.5 | 2.1 | 1.8 | 2.2 |
| Austria | 1.5 | 2.6 | 2.0 | 1.8 |
| Belgium | 1.2 | 1.6 | 1.5 | 1.5 |
| Canada | 1.5 | 3.1 | 2.0 | 2.0 |
| Czech Republic | 2.4 | 4.3 | 3.3 | 2.3 |
| Denmark | 1.7 | 2.2 | 2.1 | 1.9 |
| Finland | 1.9 | 3.0 | 2.0 | 1.6 |
| France | 1.2 | 1.7 | 1.8 | 1.7 |
| Germany | 1.9 | 2.3 | 1.8 | 1.6 |
| Hong Kong | 2.0 | 3.7 | 3.0 | 2.5 |
| Ireland | 5.2 | 4.2 | 3.6 | 3.1 |
| Italy | 0.9 | 1.5 | 1.1 | 0.8 |
| Japan | 1.0 | 1.8 | 1.5 | 0.5 |
| Netherlands | 2.2 | 3.0 | 1.8 | 1.7 |
| Norway | 1.1 | 1.7 | 2.0 | 1.7 |
| Portugal | 1.4 | 2.5 | 1.9 | 1.3 |
| Singapore | 2.0 | 3.2 | 3.0 | 2.8 |
| South Korea | 2.8 | 3.2 | 3.0 | 3.2 |
| Spain | 3.2 | 2.9 | 2.2 | 2.2 |
| Sweden | 3.3 | 3.1 | 2.5 | 2.3 |
| Switzerland | 1.4 | 0.8 | 2.0 | 1.8 |
| Taiwan | 1.5 | 2.7 | 2.5 | 2.8 |
| United Kingdom | 1.8 | 1.5 | 1.2 | 1.5 |
| United States of America | 1.5 | 2.2 | 2.2 | 2.0 |

*f = forecast. Source: BMI*

1.75%. And indeed, against this backdrop of improving global growth, tightening monetary policy will be among our key themes for 2018. Despite our expectation for waning commodity price gains, headline inflation will pick up to a five-year high of 2.8% in 2018, from 2.7% in 2017. Importantly, 2017 is likely to have marked a key inflexion point, in which the tail risks flipped from being tilted towards deflation and instead towards upside inflation risks.

## Developed States

Developed states aggregate real GDP growth will decelerate from an 'as good as it gets' performance in 2017 of 2.2%, to 2.0% in 2018, with the US largely outperforming. Broadly speaking, we expect that following a period of above-trend growth leading to catch-up with very negative output gaps, driven mainly by employment gains, real GDP growth performances will relent in the next few years.

The ongoing strength of eurozone economic data in Q417 suggests that momentum will remain robust in the early stages of 2018. However, our core view is that we are nearing a cyclical peak and that growth rates will plateau, and begin to ease, as we progress through 2018. Headwinds will mount, including from weaker employment growth and tighter financial conditions, while key structural challenges remain largely unaddressed. Consensus forecasts for 2018 continue to rise, setting the stage for disappointment. Our 2018 real GDP forecast of 1.8% is now below consensus.

We have revised up our Italian real GDP growth forecast for 2017 from 1.4% to 1.5%, reflecting the ongoing strength of the domestic and wider eurozone recovery in H217. However, with structural reform momentum stalled and 2018 general elections unlikely to produce a reform-minded government, longer-term growth potential will remain subdued. While we have also re-

**TABLE: EMERGING MARKETS – REAL GDP GROWTH, % y-o-y**

| | 2016 | 2017f | 2018f | 2019f |
|---|---|---|---|---|
| **Emerging Markets Aggregate Growth** | **4.2** | **4.7** | **4.8** | **4.7** |
| | | | | |
| **Latin America** | -0.5 | 1.5 | 2.3 | 2.5 |
| Argentina | -2.3 | 2.9 | 3.3 | 3.5 |
| Brazil | -3.6 | 0.4 | 1.7 | 1.9 |
| Mexico | 2.3 | 2.0 | 2.1 | 2.2 |
| | | | | |
| **Middle East and North Africa** | 2.8 | 1.8 | 2.4 | 2.7 |
| Saudi Arabia | 1.7 | -0.5 | 1.3 | 2.0 |
| UAE | 3.0 | 1.8 | 2.8 | 3.3 |
| Egypt | 4.2 | 4.1 | 4.9 | 4.6 |
| | | | | |
| **Sub-Saharan Africa** | 1.7 | 2.4 | 3.7 | 3.9 |
| South Africa | 0.3 | 0.8 | 1.3 | 1.8 |
| Nigeria | -1.5 | 0.9 | 3.0 | 3.5 |
| | | | | |
| **Emerging Asia** | 6.4 | 6.5 | 6.3 | 6.1 |
| China | 6.7 | 6.8 | 6.5 | 6.2 |
| India* | 7.1 | 6.4 | 6.7 | 6.6 |
| Indonesia | 5.0 | 5.1 | 5.3 | 5.4 |
| Malaysia | 4.2 | 5.9 | 5.5 | 5.0 |
| Philippines | 6.8 | 6.7 | 6.3 | 6.2 |
| Thailand | 3.2 | 3.6 | 3.4 | 3.6 |
| | | | | |
| **Emerging Europe** | 1.7 | 3.4 | 2.9 | 2.7 |
| Russia | -0.2 | 1.6 | 1.7 | 1.7 |
| Turkey | 2.9 | 5.4 | 3.8 | 3.3 |
| Hungary | 2.0 | 3.6 | 3.3 | 2.6 |
| Romania | 4.8 | 7.1 | 3.8 | 3.6 |
| Poland | 2.8 | 4.1 | 3.6 | 3.2 |

*f = forecast; *Fiscal years ending March 31 (2017 = 2017/18). Source: BMI* vised up our 2018 real GDP forecast from 1.0% to 1.1%, this nonetheless implies a slowdown and weaker growth than the eurozone aggregate.

## Emerging Markets

EMs remain broadly in an upswing in terms of real GDP growth, with high-frequency indicators such as industrial production and retail sales generally showing an uptick across the board. Growth is being supported by relatively firm demand from DMs, and gradually rising commodity prices, stable exchange rates (compared with recent years) and largely positive investor sentiment towards EMs.

We expect that these factors will continue to support EM growth throughout the coming year. Indeed, we forecast that aggregate real GDP growth will accelerate to 4.8% in 2018 from 4.7% in 2017, even as China's economy slows down. In keeping with this positive outlook, the main changes to our real GDP growth forecasts over the past month have been upward revisions. We have raised our projections for Malaysia, Turkey and Romania, although we caution that the latter two economies are showing signs of overheating, and current growth rates are unsustainable.

In Malaysia's case, we have revised upward our forecasts for real GDP growth to 5.9% in 2017, 5.5% in 2018 and 5.0% in 2019, from 5.3%, 5.0% and 4.6% respectively. The latest data show that growth is broad-based, with the manufacturing sector being an outperformer. Leading indicators suggest that economic momentum remains strong and we expect the government's plans to reduce bureaucracy to be positive for the business environment. We anticipate that the authorities will drive continued investment in the infrastructure sector, improving the country's connectivity.

For Turkey, we have raised our projections for real GDP growth, as government stimulus measures and strong external demand have led to a robust performance of the economy. Our forecasts have been increased to 5.4% in 2017, 3.8% in 2018 and 3.3% in 2019, from 4.3%, 3.3% and 2.9% respectively. However, fiscal stimulus has heightened economic overheating risks. Other signs of overheating include high inflation, rising interest rates and rapid currency depreciation – all of which will likely see economic activity slow significantly in 2018.

Overheating risks are even more acute in Romania. The economy is experiencing strong wage growth on the back of tight labour markets and fiscal stimulus, and this will continue to fuel household consumption over the coming months. We have revised upward our forecast for real GDP growth in 2017 to 7.1% from 5.4% previously. However, we have left our projections for 2018 and 2019 unchanged at 3.8% and 3.6% respectively, indicating that we expect growth to slow markedly. Surging inflation will prompt the central bank to tighten monetary policy aggressively in 2018, and we view the current pro-cyclical expansion as unsustainable in light of a rising public debt load and widening budget deficit.

**TABLE: CROATIA – MACROECONOMIC DATA & FORECASTS**

| | 2017e | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f | 2026f | 2027f |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Nominal GDP, USDbn | 55.2 | 58.7 | 61.2 | 65.1 | 68.1 | 71.4 | 75.1 | 79.1 | 83.1 | 87.3 | 91.8 |
| Nominal GDP, EURbn | 48.8 | 51.1 | 53.2 | 55.6 | 58.2 | 61.0 | 64.2 | 67.6 | 71.0 | 74.6 | 78.4 |
| Real GDP growth, % y-o-y | 3.1 | 2.7 | 2.6 | 2.4 | 2.3 | 2.2 | 2.2 | 2.1 | 2.1 | 2.1 | 2.2 |
| GDP per capita, USD | 13,168 | 14,098 | 14,777 | 15,818 | 16,641 | 17,534 | 18,562 | 19,655 | 20,757 | 21,921 | 23,176 |
| GDP per capita, EUR | 11,653 | 12,259 | 12,850 | 13,520 | 14,223 | 14,986 | 15,865 | 16,799 | 17,741 | 18,736 | 19,809 |
| Population, mn | 4.19 | 4.16 | 4.14 | 4.12 | 4.09 | 4.07 | 4.05 | 4.02 | 4.00 | 3.98 | 3.96 |
| Unemployment, % of labour force, eop | 10.8 | 16.6 | 16.3 | 16.0 | 15.5 | 15.0 | 14.5 | 14.0 | 13.5 | 13.0 | 12.5 |
| Consumer price inflation, % y-o-y, ave | 1.3 | 1.7 | 1.9 | 2.0 | 2.3 | 2.6 | 2.9 | 3.0 | 3.0 | 3.0 | 3.0 |
| Lending rate, %, ave | 7.0 | 7.0 | 7.5 | 7.5 | 7.5 | 7.5 | 7.5 | 7.5 | 7.5 | 7.5 | 7.5 |
| Central bank policy rate, % eop | 3.00 | 3.00 | 3.50 | 4.00 | 4.50 | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 |
| Private final consumption, % of GDP | 58.0 | 58.2 | 58.3 | 58.4 | 58.5 | 58.5 | 58.5 | 58.5 | 58.4 | 58.4 | 58.0 |
| Private final consumption, real growth % y-o-y | 3.8 | 3.0 | 2.8 | 2.6 | 2.5 | 2.2 | 2.2 | 2.0 | 2.0 | 2.0 | 1.5 |
| Government final consumption, % of GDP | 18.9 | 18.7 | 18.6 | 18.5 | 18.4 | 18.4 | 18.4 | 18.4 | 18.4 | 18.4 | 18.5 |
| Government final consumption, real growth % y-o-y | 2.2 | 1.5 | 1.5 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 3.0 |
| Fixed capital formation, % of GDP | 20.0 | 20.5 | 20.8 | 21.0 | 21.2 | 21.2 | 21.3 | 21.4 | 21.5 | 21.6 | 21.8 |
| Fixed capital formation, real growth % y-o-y | 1.6 | 5.3 | 4.0 | 3.4 | 3.2 | 2.4 | 2.3 | 2.3 | 2.3 | 2.3 | 3.3 |
| Exchange rate HRK/USD, ave | 6.57 | 6.43 | 6.45 | 6.32 | 6.32 | 6.32 | 6.30 | 6.28 | 6.28 | 6.28 | 6.28 |
| Exchange rate HRK/EUR, ave | 7.42 | 7.40 | 7.42 | 7.40 | 7.40 | 7.39 | 7.37 | 7.35 | 7.35 | 7.35 | 7.35 |
| Budget balance, HRKbn | -2.1 | -1.9 | -2.4 | -3.4 | -4.8 | -6.5 | -8.3 | -10.1 | -12.1 | -14.1 | -16.3 |
| Budget balance, % of GDP | -0.6 | -0.5 | -0.6 | -0.8 | -1.1 | -1.4 | -1.7 | -2.0 | -2.3 | -2.6 | -2.8 |
| Goods and services exports, EURbn | 24.0 | 25.0 | 25.9 | 27.2 | 28.9 | 30.7 | 32.7 | 34.8 | 37.1 | 39.5 | 42.2 |
| Goods and services imports, EURbn | 22.5 | 23.6 | 24.7 | 25.9 | 27.5 | 29.1 | 31.1 | 33.3 | 35.6 | 37.8 | 40.1 |
| Balance of trade in goods and services, EURbn | 1.5 | 1.3 | 1.1 | 1.3 | 1.4 | 1.6 | 1.6 | 1.5 | 1.5 | 1.7 | 2.2 |
| Balance of trade in goods and services, % of GDP | 3.1 | 2.6 | 2.1 | 2.4 | 2.4 | 2.6 | 2.4 | 2.3 | 2.1 | 2.3 | 2.8 |
| Current account balance, EURbn | 1.4 | 1.2 | 1.0 | 1.1 | 1.0 | 1.1 | 1.0 | 0.8 | 0.6 | 0.7 | 0.9 |
| Current account balance, % of GDP | 3.0 | 2.4 | 1.9 | 1.9 | 1.8 | 1.8 | 1.5 | 1.2 | 0.8 | 0.9 | 1.2 |
| Foreign reserves ex gold, EURbn | 13.3 | 14.3 | 14.8 | 16.2 | 17.9 | 18.8 | 20.9 | 21.4 | 21.4 | 21.4 | 21.4 |
| Import cover, months | 7.1 | 7.3 | 7.2 | 7.5 | 7.8 | 7.7 | 8.1 | 7.7 | 7.2 | 6.8 | 6.4 |

*e/f = BMI estimate/forecast. Source: National Sources, BMI*

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**Copy Deadline:** 5 January 2018

**ISSN: 2057-9632**