Raiffeisen RESEARCH

Wide Angle Shot: €@Croatia — 360-degree view economics, banks & capital markets

May 30, 2023 9:40 CEST

Out of a difficult macro-financial decade (the 2010s) Croatia emerged stronger, as proven in recent crises. Croatia stayed the minimum time inside ERM II and adopted the EUR 1 Jan 2023. Euroization has been traditionally high, and HRK abandonment is easy to bear. Pros of the common currency, including cheaper (re-)financing costs (public & private sector), outweigh cons. Now the door to European capital markets opens up. We expect local banks and non-financials to make greater use of Eurobond markets. Slovakia can serve as a blueprint here. On top, "country risk" appetite re-emerges, also regarding Croatian exposures at Western banks. The latter is crucial as a lot of investments will be needed for real convergence. Finally, we see no evidence that the euro introduction excessively fueled inflation.

European integration completed: euro adoption was quick, but no self runner

Nearly half a year has passed since Croatia became the **20th member of the euro area** (EA), and thus, with its entry into Schengen, this nicely rounded off the **tenth anniversary** of its **EU membership (2013).** From the very beginning and like Slovenia (that entered EU in 2004, euro area entry 2007), Croatia was determined to introduce the euro as soon as possible, due to the historically inherited high level of euroization of the entire economy, in particular, due to the high dependence on tourism, and trade/financial exposure to countries with which it shares the European single currency today. However, due to a complex mix of local and external factors Croatia did not manage to introduce the euro as swiftly as neighboring Slovenia.

It is worth noting that the strategic goal of euro adoption went hand in hand with Croatia's entry into the EU, which is almost ten years ago. As the examples of the Central European EU members Czechia, Hungary, and Poland demonstrate, this **obligation** alone — Demark is the only EU member with an opt-out clause — is not a guarantor of swift euro adoption: **CE-3** is still **far from entering the currency bloc,** while each of them has been an EU member for almost a decade longer than Croatia. In no CE-3 country, we currently see euro entry ambitions (not to speak about a shared political vision or a granular planning). Against this backdrop, it is all the more impressive that **Croatia spent only 2.5 years in the euro area "waiting room" ERM II**. Moreover, especially in light of the multiple crises of the last three years, it is not an exaggeration to state that the final stage of euro introduction in Croatia was quick and smooth (only Greece spent less time in ERM II). However, the path toward the euro was everything but easy.

Zrinka ZIVKOVIC-MATIJEVIC
Analyst
+385 1 6174-338
zrinka.zivkovic-matijevic@rba.hr

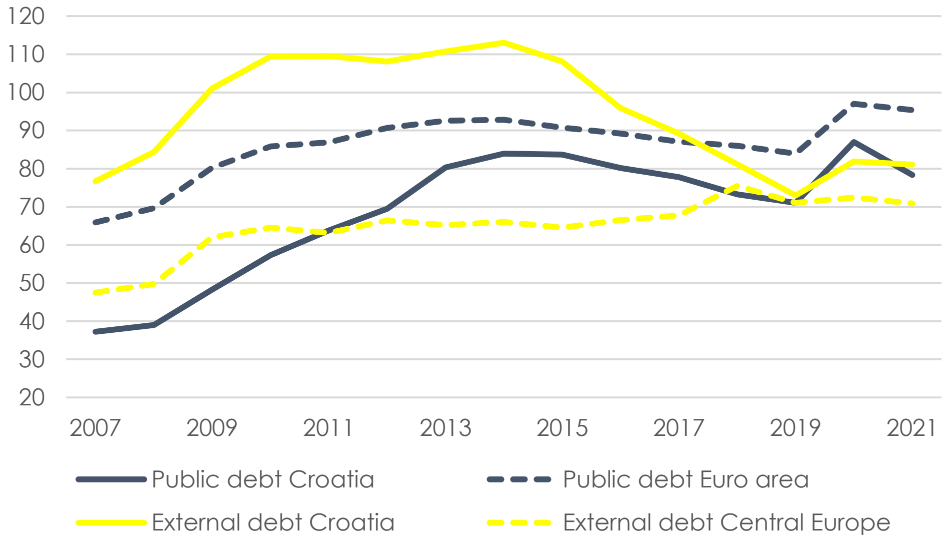
Gunter DEUBER
Analyst Editor
+43 1 71707-5707
gunter.deuber@rbinternational.com

	ERM II entry	Euro adoption	Years in ERM 2
Greece	01.01.1999.	01.01.2001	2.0
Slovenia	28.06.2004.	01.01.2007	2.5
Cyprus	02.05.2005.	01.01.2008	2.7
Malta	02.05.2005.	01.01.2008	2.7
Slovakia	28.11.2004.	01.01.2009	3.1
Estonia	28.06.2004.	01.01.2011	6.5
Latvia	02.05.2005.	01.01.2014	8.7
Lithuania	28.06.2004.	01.01.2015	10.5
Croatia	**10.07.2020.**	**01.01.2023**	**2.5**
Bulgaria	10.07.2020.		

Source: ECB, RBI/Raiffeisen Research

More than a decade before EU accession, with a **market share** of **foreign banks** at **90%** (mostly major euro area credit institutions), Croatia had already **deep financial linkages** to the euro area. However, EU negotiations, which started already in Oct-2005, were a bumpy road as Croatia struggled with legacies from the Yugoslavia break-up, an underdeveloped institutional framework, and poor public finances for many years. This took its revenge brutally at times of the Great Financial Crisis (GFC) which triggered an **unprecedented deep** and **long-lasting recession in Croatia** from 2009 onwards. Unlike other CE/SEE economies, Croatia was stuck for almost six years in a recessionary environment, predominantly due to **excessive debt accumulation** in nearly all sectors of its small-open economy. By the mid-2010s, Croatia's external debt was well above comparable figures in Central Europe (and almost at the level of the euro area), while at that time Croatia ran the risk of reaching a public debt ratio of at least at the euro area level (before the GFC, Croatia's debt ratio was still 30 percentage points below that of the euro area). This debt accumulation was facilitated by the deep integration into the overoptimistic global and European leverage cycle before the GFC. The inflow of foreign capital (debt) essentially fed rapid economic growth years before the GFC but, at the same time, concealed the accumulated structural weaknesses within the economy. The much-needed process of deleveraging and reducing external vulnerabilities took years but obviously, Croatia greeted the following crises more prepared.

Public & external debt (% of GDP): Croatia vs peers

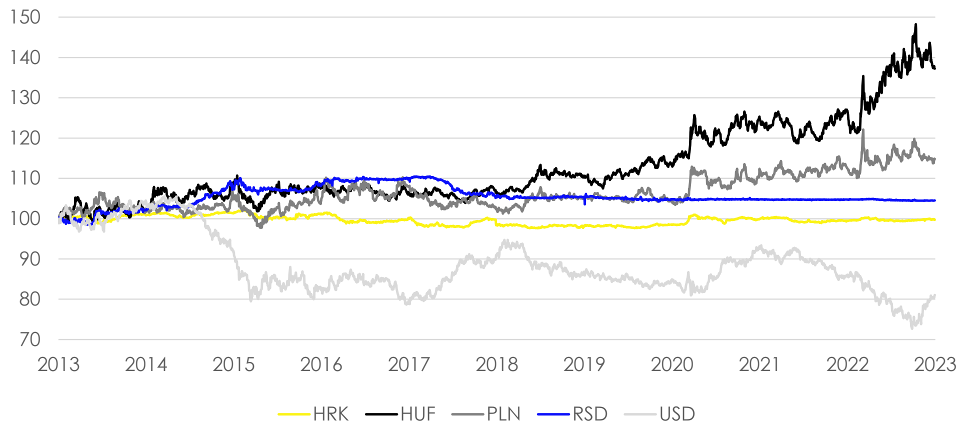


Source: Eurostat, national sources, RBI/Raiffeisen Research

Benefits of euro adoption: (Implicit) FX risk reduction

Over the years, a very particular country risk dimension has been the **above-average exposure** of **all domestic sectors — except banks — to** the (foreign currency) **euro** which were mostly unmatched/open currency positions from an asset-liability perspective. In public finances, the share of EUR-denominated general government debt continuously exceeded 70%. For more than 25 years, the Croatian National Bank (HNB) kept a very watchful eye on FX stability using **EUR/HRK** as the **main anchor** of **monetary policy** to comply with its main mandate — price stability (and confidence in the institutional setup). Nevertheless, despite the almost fixed (managed float) and predictable EUR/HRK movements (unlike elsewhere in CE/SEE), **FX exposure** was **considered** a **huge risk**, especially from the perspective of foreign investors and rating agencies. Several times the (potential) currency risk in Croatia became an issue of **back-door discussions** and/or **investor concerns** over the past decade. For instance, a potential IMF support package (that was mulled for some time in the 2010ies) might have required a nominal and real exchange rate alignment back then (something that would have gone against the sketched domestic overriding monetary policy goal). Some concerns about the FX rate stability/liquidity re-emerged at the beginning of the COVID-19 crisis. Back then it was key that ECB clearly demonstrated its responsibility beyond the euro area, e.g. offering FX liquidity support also to Croatia. Possibly the signaling effect was more important here than the actual liquidity provision. That said it was a positive signaling effect that Croatia was given the green light to enter the ERM II in the midst of the COVID-19 crisis in Europe.

Croatian managed float regime a success story*

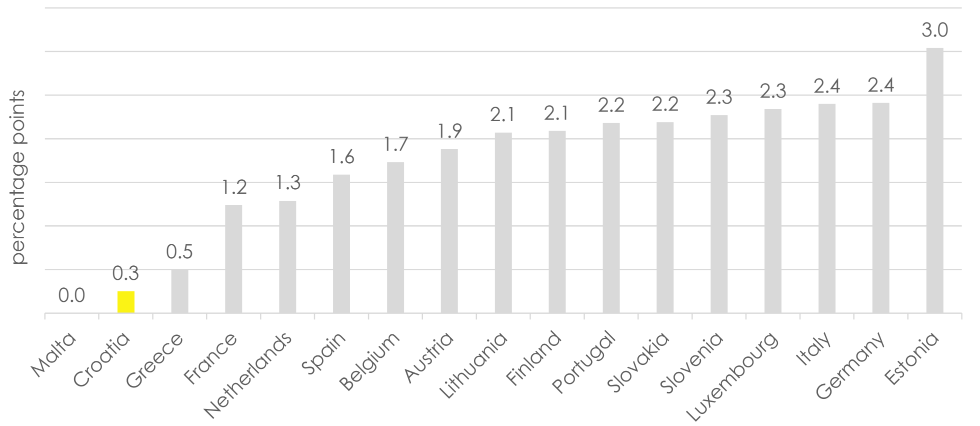


** all FX versus EUR. Indexed: 1 Jan 2013 = 100; values > 100 -> depreciation*

Source: Bloomberg Finance L.P., RBI/Raiffeisen Research

Once it became clear, in July 2022, that Croatia would become the 20th member of the euro area, even the usual HRK-seasonality vis-à-vis the euro disappeared. Moreover, Croatia more or less immediately received out-of-schedule sovereign rating upgrades from all major agencies (see chart further below) following the final formal confirmation of Croatia's euro adoption by the European Council in July last year. Risk premiums fell further as the market had obviously not priced in this outcome entirely. All in all, **HRK went down** in **history** as **one of the most stable currencies** of "New Europe". The **elimination** of **(implicit) currency risk**, the **drop** in **risk premiums**, and the abundance of liquidity that flooded the domestic market due to the reduction of the regulatory cost of domestic banks were the factors that **delayed** and **significantly mitigated** the **generally inevitable rise** of **private sector interest rates** on the **domestic market** in the recent period (see chart below).

Increase of average interest rates on new housing loans*



** maturities of more than 10y; percentage point change between November 2021 and February 2023*
Source: ECB, RBI/Raiffeisen Research

Croatia-specific factors plus EU politics supported euro adoption

Support for the euro usually increases after a country joins the euro area. In the case of Croatia, there are also local specifics. For **decades**, the **German mark** and, after it, the **euro**, has been a **symbol** of security, stability, and the **developed, orderly world** to which **Croatia wants to belong**. Trust in the European institutions in Croatia has been continuously higher than trust in the local institutions, political parties, and national authorities.

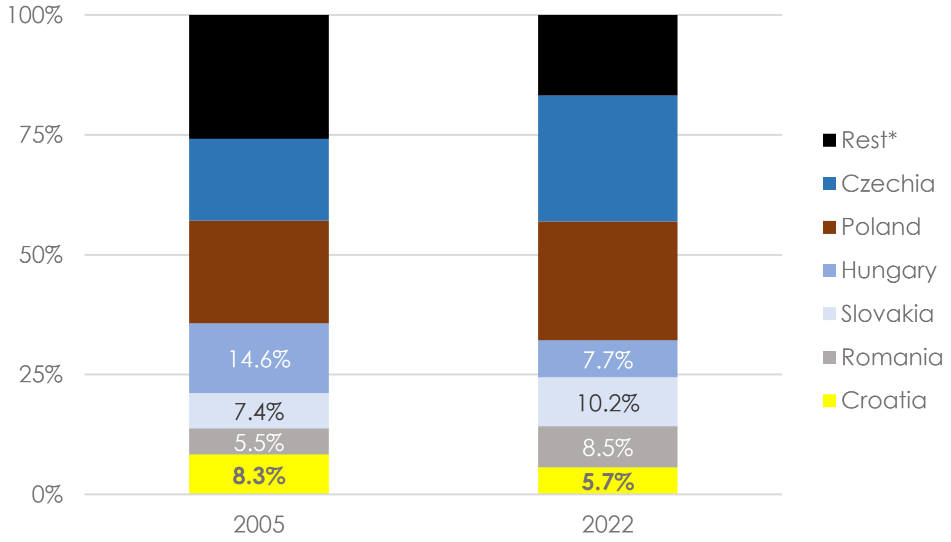
The national currency, HRK, never fulfilled all core functions of money because savings and borrowing were euro or EUR-denominated, the HNB has never pursued a classic monetary policy through usual (interest rate) monetary transmission channels. Therefore, abandoning HRK and losing monetary sovereignty did not cause negative emotions, but rather an opportunity for Croatia to achieve real convergence (which may be an important difference compared to Central European countries). All the above will continue and, according to our expectations, the **support** for the **euro** in **Croatia will grow**.

Croatia also benefited from developments on the **"broader playground"** of **EU policymaking**. Croatia's feasible rapid entry into the euro came at a time when it was quite **opportune** to demonstrate enlargement successes at the EU level from a "Brussels" perspective. At the same time, **institutional developments** in Croatia were clearly **more favourable** than in the other applicant country, Bulgaria. Moreover, the focus of **EU policy** on **sound macro-financial policies** well in line with the EU economic governance plus **rule of law issues** (also in relation to the allocation of EU funds) has increased. And in these areas, Croatia in recent years can be considered a paragon in the regional context. And in the light of a sound macro-financial position as a result of the structural adjustments of the last decade, Croatia is no longer considered the "next" ESM and/or TPI candidate; in other words, the country does not need to seek shelter in the euro area out of macro-financial weakness. In this respect, there was a win-win constellation here towards the introduction of the euro from a local and EU perspective. (Zrinka Zivkovic-Matijevic, Gunter Deuber)

Foreign exposures of Western banks - the Croatia re-emergence

The **Croatian banking market** is a **perfect reflection** of the outlined **realignments** of **macroeconomic nature**, as well as the **associated** deteriorating and improving **risk perception** among foreign banks and investors. Among the six major banking markets in the region of Central and South-Eastern Europe (PL, CZ, HU, SK, RO, HR), **Croatia** was the **number 4 market** in terms of importance at the **beginning** of the **2000s** (ahead of Slovakia and Romania). The lackluster economic growth performance and deleveraging of the 2010s combined with the macroeconomic uncertainties of that period then led to a relative loss of importance, and **Croatia slipped** to the **number 6 position** (share in exposures of Western banks to CE/SEE markets). Back in June 2020 exposures of Western banks towards Croatia were more or less at a level of 2005 or 2006 (in nominal terms). Since the absolute low point in 2019 and 2020 (share of 4.9% in CEE exposures of Western banks compared to 8%+ in the early 2000ies), Croatia's share in regional exposures of Western banks has been recovering and is currently back at just over 5 per cent (5.6% year-end 2022). We credit the **positive development** to the **clear euro entry perspective**. Especially since the **risk/return ratio** in **CE/SEE banking business** is currently shifting back **in favor** of **"Euro markets"** such as Slovakia and Croatia due to the much-needed drastic turnaround in the ECB's monetary policy.

Share in CEE-exposures Western banks (% of total)

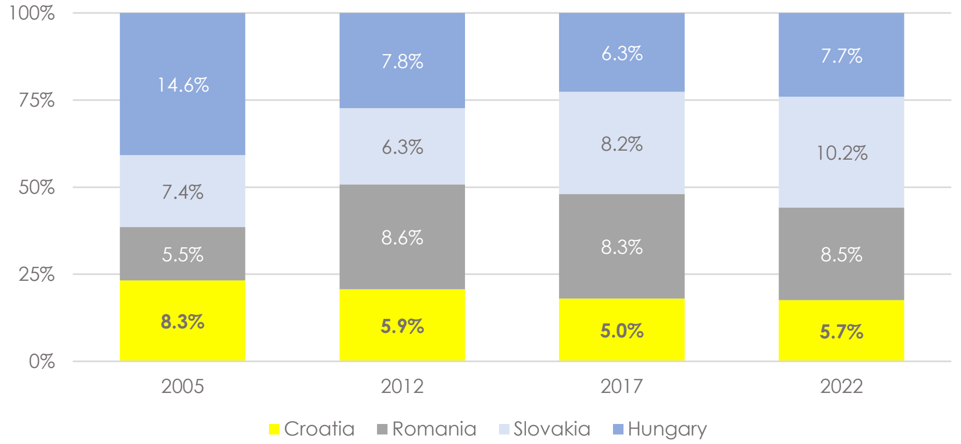


** Rest includes Russia, Ukraine, Belarus, Bulgaria, Serbia, Albania, Kosovo*

Source: BIS, company data, RBI/Raiffeisen Research

The **other major CE/SEE euro banking market Slovakia** is rather out of striking distance (share of 10% in regional exposures of Western banks), but at least Croatia has caught up again with Romania and Hungary (with a share of 8.5% and 7.7% respectively in the regional exposures of Western banks). That said, the relative loss of importance of Hungary since the early 2000ies is even more striking than the Croatian demise up until 2019/2020, i.e. before the latest turn-around. In the medium term, the **Croatian banking market** partly faces **similar challenges** and **opportunities** as Slovakia, where euro entry has first weakened the relative earnings profile compared to some neighboring countries. However, banks in Slovakia have also succeeded in tapping new earnings potential through structural measures and an increase in commission income outside the exchange rate business. Not to underestimate that the Slovak banking market enjoyed nice growth opportunities inside the euro area. Moreover, we see increasing capital markets business opportunities in the country, while we see Western banking groups active in the country well positioned to tap these income streams (see also the following chapters). (Gunter Deuber)

Shares in CEE exposures Western banks (% of total)*

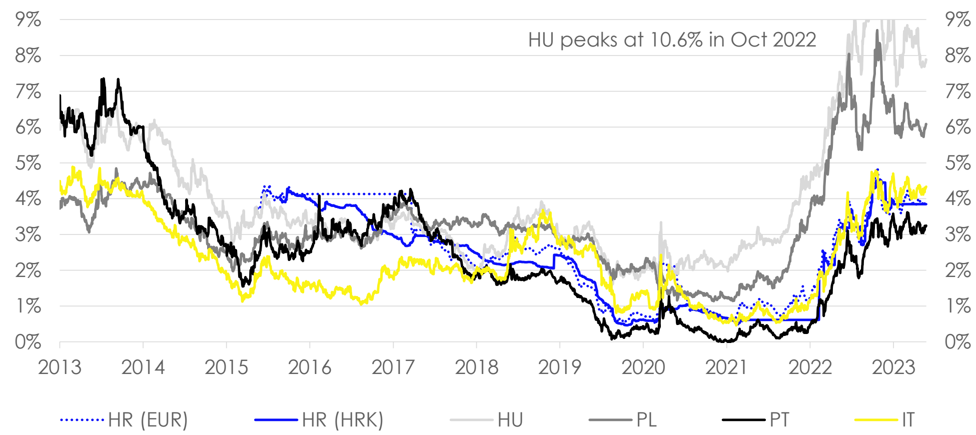


** Numbers shown in graph equal % of total, graphical illustration shows relative share in combined exposures to Croatia, Slovakia, Romania and Hungary (i.e. regarding this ratio Croatia went down from arond 25% in 2005 to around 20% in 2022; Romania is up from around 15% to 30%)*

Government bond yield convergence also a success story

Croatia's **government bond yields have shown an impressive convergence**. Already around 2017/2018, after finally being back on a stronger economic footing, the decoupling of e.g. Hungary and Poland started (see chart below). At that time, however, it was not clear when Croatia would qualify for ERM II. Nonetheless, Croatian bond yields managed to keep up with the peripheral euro area countries, eventually moving below Italy's yield level in 2018. At times, they even managed to match the yield levels of Portugal. **Currently, Croatia is trading close to Italy** again in terms of yields, although the latter is fundamentally in a better position than two years ago. During the existential COVID-19 crisis as well as the following next sweeping shift (Ukraine war, cost of living crisis) Croatian yields remained well-anchored vs. regional peers. Croatia's yield convergence story can be seen as a success story not only because it was priced very early on in the market and thus saved the state some financing costs, but also because the convergence between yields on the local government bond market (local currency bonds denominated in HRK) and yields on the international government bond market (foreign currency bonds denominated in EUR) was also completed early on (see blue lines in the chart below). Market participants may have been a little starved after the long ebb in terms of euro area expansion (since Lithuania's accession in 2015), but the above-mentioned exchange rate concerns did not stop them from their **convergence play**. And they were right.

Yield convergence started well ahead of ERM-II entrance*



** all yields are 10y generic local currency long-term yields except for HR (EUR), which is generic 10y EUR denominated Eurobond yield*

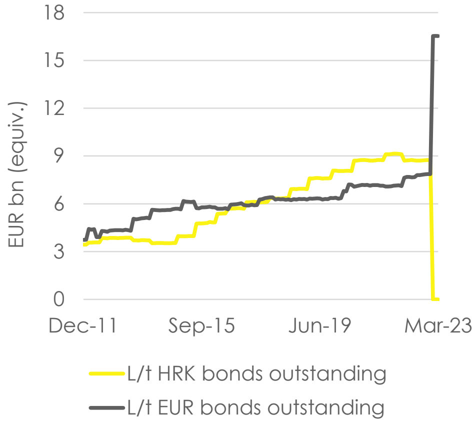
Source: Bloomberg Finance L.P., RBI/Raiffeisen Research

Government bond issuance was always "euroised" and also international

Croatia's euroization is unequivocally reflected in the central government bond issuance history. Even before becoming EU member in 2013, the central government used the European single currency as an issuance currency also on the domestic capital markets (charts below). Right before the introduction of the euro, the outstanding domestic bonds were denominated in **roughly equal parts in EUR and HRK**, with the kuna portion being converted in its entirety after the introduction of the euro as of 1 Jan 2023 (for the sake of completeness: short-term domestic bonds outstanding amounted to almost EUR 2500 mn as of Mar-23).

An even more pronounced preference for EUR-denominated bond issuance can be observed in Croatia's international debt market operations. The share of sovereign Eurobonds issued in other than EUR FX (mainly USD) started to decline firmly from 2016 onwards with only one USD sovereign Eurobond currently outstanding.

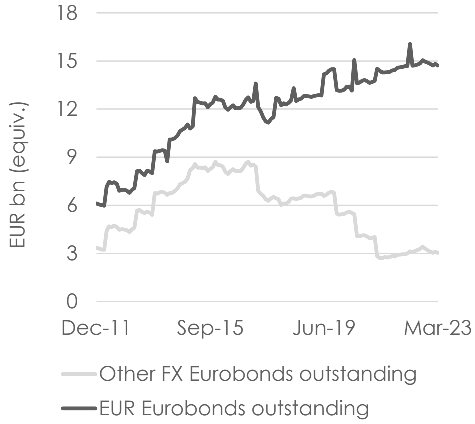
Central govt domestic bonds*



** long-term central governmentt local bond outstanding amounts (domestic capital markets); last data point: March 2023*

Source: HNB, RBI/Raiffeisen Research

Central govt international bonds*

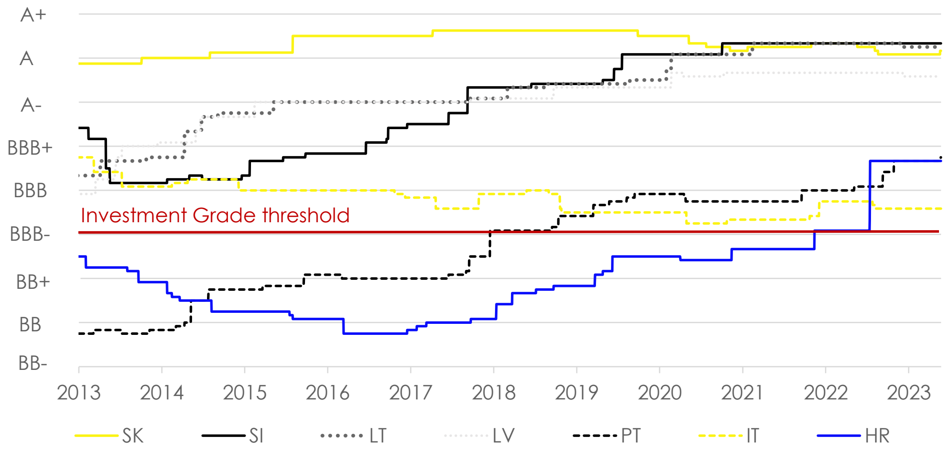


** long-term (s/t not existent) central government Eurobonds outstanding (international markets); last data point: March 2023*

Source: HNB, RBI/Raiffeisen Research

Since the introduction of the euro, Croatia abstained from the international debt capital markets. The latter is also due to the very **successful issuance of Croatia's first-ever retail bond** (in EUR). This transaction made lots of headlines as this was the Treasury's debut on the retail bond market and as it was a hybrid one being open to institutional investors as well. EUR 1.85 bn were sold of the 2y bond carrying a 3.65% coupon, well above the EUR 1 bn issuance target. Retail investors bought EUR 1.34 bn of the 8-March-2025 government paper, while institutional investors took EUR 515 mn. Total bids reached EUR 2.31 bn. According to official statements, the proceeds were used to repay maturing debt. Apart from HRKGB (local currency government bonds) redemption, there was also an foreign currency government bond (Eurobond), i.e. **USD 1.5 bn CROATI maturing recently** (4 April 2023; in the chart above this bond is still shown as data are until March-2023 only). The **last USD CROATI sovereign Eurobond will have to be repaid on 26 Jan 2024** (USD 1.75). Croatia tapped **international debt capital markets in April 2022** for the last time issuing a 10y EUR CROATI (EUR 1.25 bn). In the three years before (2019-2021) Croatia was a regular guest on international debt primary markets, continuously developing its EUR sovereign Eurobond curve. Our best guess is that the Croatian MinFin will reappear on international debt markets this year.

Croatia sovereign rating history versus peers*



** CE/SEE euro area members: Slovenia (SI) introduced euro in 2007, Slovakia (SK) in 2009, Estonia (not in chart) in 2011, Lithuania (LT) in 2014, Latvia (LV) in 2015, and Croatia in 2023; currently, out of CE/SEE only Bulgaria is waiting to join ERM II (likely 2025)*

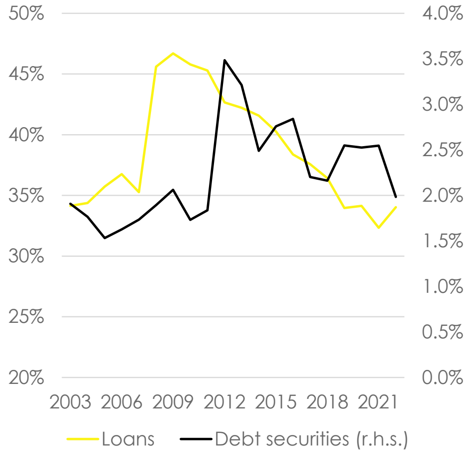
Source: Trading Economics, Refinitiv, RBI/Raiffeisen Research

What concerns the rating outlook, finally, **Croatia's sovereign rating is expected to remain unchanged** in the foreseeable future with the recent rating statements of all three big agencies pointing to mainly structural issues (which take time) as potential rating triggers. (**Stephan Imre**)

Private sector access to euro area investor/capital pools

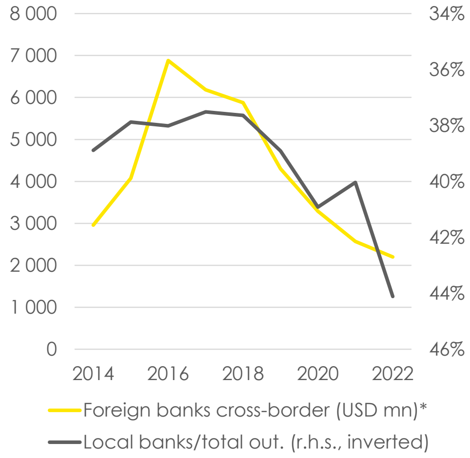
Same as in manifold other aspects, we believe the adoption of the euro bodes well for the Croatian private sector which can improve its visibility in front of the eurozone debt investors. Speaking of the corporate sector, Croatian companies have historically been rare guests on the international bond market leaning more on bank loans for funding. As we read from the country's sector accounts (consolidated basis), local non-financial corporations (NFC) rely on debt securities only for about 2% of their total financial liabilities, while loan obligations account for 35%. Moreover, we note the **recently increased role** of the **domestic banking sector** for **NFC financing**, whereas cross-border lending to Croatian corporates from foreign banks has considerably decreased in the last years (according to BIS LBS data). For comparison, in the euro area in aggregate NFCs finance about 5-6% of their liabilities on the wholesale debt market. The lifting of investors' concerns over FX risks should be positive for the image of Croatian issuers, however, it may take effort to make international creditors forget their bad memories of the Agrokor saga. Alternative to Eurobonds, Croatian companies may also take a less beaten path and consider other corners of the European debt capital market, for instance, **private placements** or **Schuldscheindarlehen (SSD)**, where CEE borrowers could not build a proper track record so far (mainly limited to sporadic deals from Czechia and Hungary). The SSD sector can be especially attractive by its **less extensive regulation** and flexibility in size and borrowing terms for medium-sized enterprises, though it also has its specifics in terms of governance (German law), regional focus (DACH countries) and a rather conservative investor base. Still, we believe the latter might be potentially receptive to new issuers coming from an IG-rated eurozone country.

HR: NFC financing (% liabilities)*



NFC - Non-Financial Corporations
** Based on consolidated sector accounts*
Source: Eurostat, RBI/Raiffeisen Research

HR: NFC loans (outstanding)



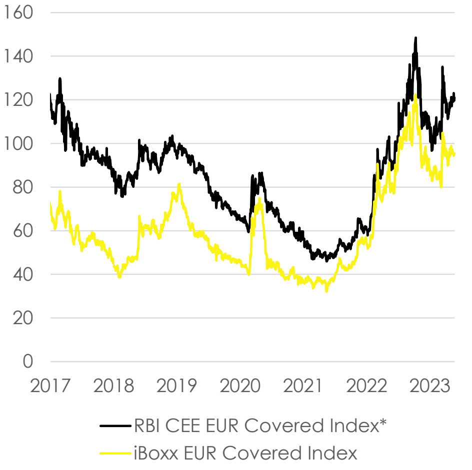
NFC - Non-Financial Corporations
** Foreign banks' cross-border claims based on BIS locational banking statistics (LBS)*
Source: BIS, ECB, RBI/Raiffeisen Research

More opportunities for Croatian banks on the Eurobond market

Unlike the corporate sector, **Croatian banks** have been **more actively present** on the **Eurobond market** lately, nudged by the regulator to build up MREL buffers. On a fair note, public benchmark-size issues of eligible instruments have been supplied mainly by local subsidiaries of foreign MPE groups (RBI, Erste) with pure local players still lagging; meanwhile, subsidiaries of foreign SPE groups (UniCredit, Intesa) source MREL funding intra-group. In contrast to that, there is another European marketplace that can be **relevant** for **all Croatian banks equally — covered bonds**. Here, we believe that all necessary prerequisites are fulfilled to follow in the footsteps of CEE peers that have already established this asset class on an international scale (Polish, Slovak and Czech banks).

Essentially, Croatia should benefit from a relatively delayed introduction of the national covered bond legislation (the law was approved in April 2022), as it is coming into force right on the heels of the European Covered Bond Directive, hence setting the basic concepts aligned from the start. In particular, the law stipulates compliance with the CRR Article 129 for cover pool assets, which renders the **"European Covered Bond (Premium)" label** the **base case** for **Croatian issuers**. Otherwise, **Croatia's covered framework** features rather standard requirements, including, inter alia, over-collateralization (5%, nominal basis), the inclusion of hedging derivatives in the cover pool, liquidity coverage (six months), independent cover pool monitor, soft bullet maturity option, and obligatory quarterly reporting for investors. We see the banks' outstanding housing loan portfolios as well-structured for prospective cover pools: apart from the resolved FX risk, they feature a significant share of contracts with long-term initial rate fixation (2021-2022: 30% of all new housing loans issued had a >10y fixation) and healthy NPL levels (2022: 2.2% for sector total, partly dampened by active loan origination).

Yield spread to German Bunds (bp)

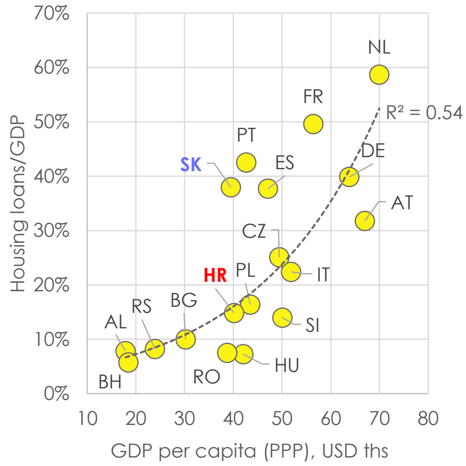


** The custom index contains CEE EUR-denominated fixed-coupon covered bonds ≥EUR 250 mn size and ≥1Y remaining maturity, weighted by market value adjusted for duration*

Data per 23/05/2023, all values indicative

Source: Refinitiv, RBI/Raiffeisen Research

Housing loan market penetration



As of 2022

Source: ECB, IMF, National banks, RBI/Raiffeisen Research

From the regional context, we think the example of **Slovakia** gives a **good flavour** of the **long-term potential** the EU and euro area membership can unlock for the housing market via improvements of the institutional and legal frameworks (including the covered bond legislation). Effectively, Slovak banks have seen the penetration of the residential mortgage market on a steady rise going up from ~10% (loans/GDP) in 2004 to above 30% currently, which places them in the league of wealthier Western economies. In this regard, the bet on convergence for the Croatian banking sector may be further underpinned by dedicated government subsidies in the segment and indirect support from NGEU funds part of which is allocated to post-earthquake reconstruction (residential and non-residential buildings) with a focus on energy efficiency and decarbonisation. Importantly, **international covered bond investors** prove **less critical** to the **CEE risk** (as compared to MREL instruments, for example), which ensures reasonable borrowing costs. Even though **Croatian banks stay well-covered with deposit funding** for now (sector's loan-to-deposit ratio ~70%), we expect the relative economics of covered bond issuance to improve with the inevitable upward adjustment in deposit prices. (Ruslan Gadeev, Jürgen Walter)

Price level index 2022 estimate, EU=100

	HFCE	Food and non-alch. beverage	Restaurants and hotels	Energy
Austria	110.2	106.3	117.1	107.1
Germany	107.3	105.2	104.1	118.1
Euro area	105.1	103.5	101.6	108.5
EU	100.0	100.0	100.0	100.0
Slovakia	92.1	101.2	94.9	69.4
Slovenia	88.1	100.7	88.4	80.8
Czechia	83.2	93.8	75.2	85.8
Croatia	**72.4**	**100.9**	**85.6**	**53.5**
Hungary	72.1	97.5	67.2	41.7
Poland	62.2	74.3	83.9	66.8
Romania	56.3	72.4	53.9	56.8

** HFCE = Household final consumption expenditure*

Source: Eurostat, ECB, RBI/Raiffeisen RESEARCH

Price convergence still in progress, recent shocks reveal structural issues

When comparing the newcomer in the EA with regional peers, obviously there is a high and above-average correlation between the business and inflation cycles with the EA. Still, the inflation criterion set in the necessary preconditions for entry proved to be tricky. Namely, when there is a shock on the supply side, as it happened right before the assessment of **Croatia's readiness to enter the euro area**, structural factors come to the fore. Apart from a stronger economic recovery and lower competition in the local market, the **higher inflation in Croatia in comparison to the EA average** (especially in core countries) could be explained by the **differences in the consumer basket structure** arising from the larger share of food and accommodation services. The first one reflects the lower degree of Croatia's economic development and the second one the high reliance of the whole economy on tourism.

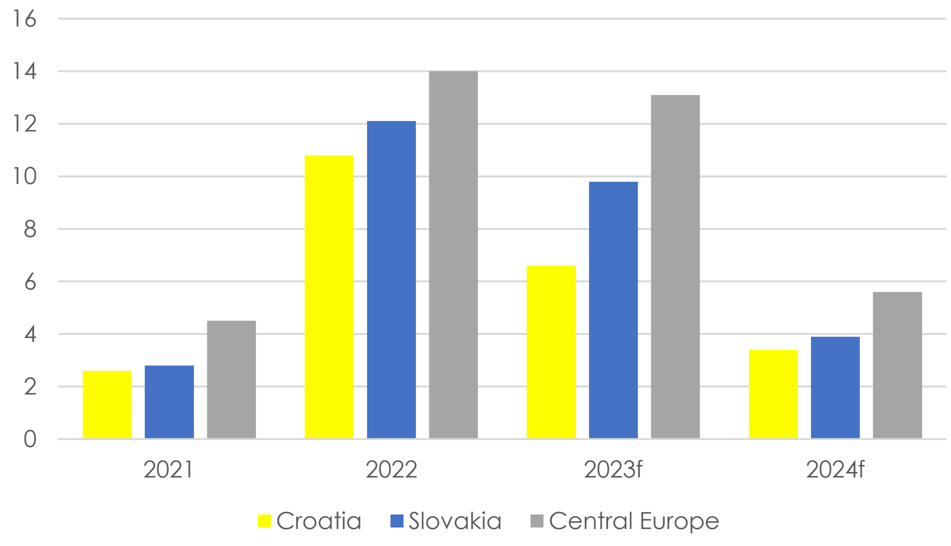
However, **price convergence** must inevitably happen over time, especially in a small and open economy like Croatia. Once a country becomes a member of the EA, we assume this process to accelerate. This should be driven by lower transaction costs, greater transparency and comparability of prices, which supports also exports and investment and eventually should promote **real convergence**, including higher incomes. In this case, the relative structure of the consumer basket will also change i.e. become more "mature" and thus more aligned with core EA countries.

Croatia introduced the euro in the middle of an unprecedented supply shock (supply bottlenecks, war in Ukraine, energy and food price increase) when inflation in both Croatia and the EA was at a historic peak. The fear that the **euro itself will cause higher prices proved to be irrational** (once again). Namely, it is difficult or almost impossible to determine whether inflationary pressures in H2-2022 are and to what extent the consequence of the announcement of the introduction of the euro (in mid-2022); or wether they can purely be attributed to the overall global trend of the supply shock inflation. The latest **research by the HNB and the ECB** showed that the impact of the pure euro changeover on consumer prices in Croatia has been relatively small so far and of the same order of magnitude as that observed in earlier changeovers, despite a more challenging inflationary environment. It amounted to 0.4 percentage points.

Moreover, it is also important to note the special period in which Croatia introduced the euro. Many **neighboring countries** suffered substantial **weakening of local currencies** in the context of the COVID-19 crisis and the Ukraine war, which partly acted as an **additional inflation driver**. In this respect, it is interesting that the region of Central Europe has even in recent years, currently and probably also until 2024, been characterised by higher inflation than Croatia. Even Slovakia, a euro area country, is more likely to have higher inflation than Croatia in 2021-2024. In this respect, we find it difficult to identify a clear additional influence of the introduction of the euro on inflation. (mindful of all currently existing distorting effects of government measures on inflation measurement, which complicates cross-country comparisons). Here, the **clear course towards euro membership**, including the associated exchange rate stability, has even proved to be an **inflation damper**.

Inflation convergence will continue but apart from the intensity of real convergence, it may also depend on other factors, such as the liberalization of the prices of goods and services that are currently partially or fully **administratively regulated** (gas, electricity, water, housing, etc.). The overall level of prices in Croatia stands at 69% of the EA average, the lowest being for energy (49%). Still, in the short run, the convergence of service prices seems to be the most realistic. Convergence of food prices seems already close to its end (98% in 2022), pushed not only by increasing cost, lower consumer influence, and (lower) competition but also by the profit margins of retailers.

Inflation snapshot: CPI (% yoy, average)



Source: Eurostat, RBI/Raiffeisen Research

Real convergence continues with structural reforms needed

With respect to real convergence, after a decade of small progress and almost stagnation (between 2003 and 2015), in recent years Croatia achieved a significant degree of real convergence towards the euro area. Its **GDP per capita**, which was around 55% of the EA average in 2012 (just before the EU accession), reached slightly over **70% in 2022**.

In our view, as the example of some EA countries clearly shows, growth and convergence have to be achieved on a sustainable basis, meaning that it must be achieved on a lasting basis and not just at a given point in time (growth quality). This means, real convergence based on increased productivity and competitiveness. In the case of Croatia, there is room for accelerating real convergence by implementing structural reforms, given that **Croatia is lagging, in particular when it comes to total factor productivity**. Therefore, it is crucial to continue implementing structural reforms. In addition, strengthening institutional capacity and the rule of law plays a pivotal role as well.

This is a great opportunity because Croatia is in a "prestigious society" that can also represent the interests of a small country which, by joining the euro area, nevertheless strengthened its geopolitical position. In addition, a number of the ECB instruments or the European stabilization mechanism, provide stability, security, and refuge, if there is a need, which we strongly believe that Croatia will not experience. (Zrinka Zivkovic-Matijevic, Gunter Deuber)

Disclosure

Croatia:

3. RBI or one of its affiliated legal entities is a market maker or specialist or a designated sponsor or stabilisation manager or liquidity provider in financial instruments of the issuer.

3. RBI or one of its affiliated legal entities is a market maker or specialist or a designated sponsor or stabilisation manager or liquidity provider in financial instruments of the issuer.

3. RBI or one of its affiliated legal entities is a market maker or specialist or a designated sponsor or stabilisation manager or liquidity provider in financial instruments of the issuer.

Croatia:

3. RBI or one of its affiliated legal entities is a market maker or specialist or a designated sponsor or stabilisation manager or liquidity provider in financial instruments of the issuer.

Croatia:

3. RBI or one of its affiliated legal entities is a market maker or specialist or a designated sponsor or stabilisation manager or liquidity provider in financial instruments of the issuer.

Croatia:

3. RBI or one of its affiliated legal entities is a market maker or specialist or a designated sponsor or stabilisation manager or liquidity provider in financial instruments of the issuer.

Risk notifications and explanations

Warnings

- Figures on performance of economic data presented in this publication refer to the past. Past performance of these data is not a reliable indicator for future results and the development. This is particularly true in cases when the data has been available short (e. g., for less than 12 months). In particular, this very short comparison period is not a reliable indicator for future results and the development of economic data.
- The performance of economic data can rise or fall due to exchange rate fluctuations.
- Forecasts of future performance are based purely on estimates and assumptions. Actual future performance may deviate from the forecast. Consequently, forecasts are not a reliable indicator for future results and the development of economic data.

The information in this publication which is contributed by analysts from RBI's subsidiary banks are disseminated unaltered under RBI's responsibility.

A description of the concepts and methods used in the preparation of macro economic analyses is available under: www.raiffeisenresearch.com/concept_and_methods.

Detailed information on sensitivity analyses (procedure for checking the stability of potential assumptions made in the context of macro economic analysis) is available under: www.raiffeisenresearch.com/sensitivity_analysis.

History of short term recommendations

Symbol	Date	Recommendation	Company
HR	27.04.2023	Under Revision	Croatia
HR	04.10.2022	Under Revision	Croatia

History of long term recommendations			
Symbol	Date	Recommendation	Company
HR	27.04.2023	Not rated	Croatia
HR	04.10.2022	Not rated	Croatia

The distribution of all recommendations relating to the 12 months prior to the publications date (column A), as well as the distribution of recommendations in the context of which services of investment firms set out in Sections A (investment services and activities) and B (ancillary services) of Annex I of Directive 2014/65/EU of the European Parliament and of the Council ("special services") have been provided in the past 12 months (column B).

	Column A	**Column B**
Investment recommendation	Basis: All recommendations for all financial instruments (last 12 months)	Basis: Recommendations for financial instruments of all issuers, for which special services were rendered in the last 12 months
Buy recommendations	61.3%	59.8%
Hold recommendations	22.9%	22.4%
Sell recommendations	15.8%	17.8%

The distribution of all recommendations relating to the 3 months prior to the publications date (column A), as well as the distribution of recommendations in the context of which services of investment firms set out in Sections A (investment services and activities) and B (ancillary services) of Annex I of Directive 2014/65/EU of the European Parliament and of the Council ("special services") have been provided in the past 3 months (column B).

	Column A	**Column B**
Investment recommendation	Basis: All recommendations for all financial instruments (last 3 months)	Basis: Recommendations for financial instruments of all issuers, for which special services were rendered in the last 3 months
Buy recommendations	40.0%	40.6%
Hold recommendations	42.5%	40.6%
Sell recommendations	17.5%	18.8%

Disclaimer

Responsible for this publication: Raiffeisen Bank International AG („RBI")

RBI is a credit institution according to §1 Banking Act (Bankwesengesetz) with the registered office Am Stadtpark 9, 1030 Vienna, Austria.

Raiffeisen RESEARCH is an organisational unit of RBI.

Supervisory authority: As a credit institution (acc. to § 1 Austrian Banking Act; Bankwesengesetz) Raiffeisen Bank International AG is subject to the supervision by the Austrian Financial Market Authority (FMA, Finanzmarktaufsicht) and the National Bank of Austria (OeNB, Oesterreichische Nationalbank). Additionally, RBI is subject to the supervision by the European Central Bank (ECB), which undertakes such supervision within the Single Supervisory Mechanism (SSM), which consists of the ECB and the national responsible authorities (Council Regulation (EU) No 1024/2013 - SSM Regulation). Unless set out herein explicitly otherwise, references to legal norms refer to norms enacted by the Republic of Austria.

This document is for information purposes and may not be reproduced or distributed to other persons without RBI's permission. This document is a macro economic analysis, which contains no recommendations on financial instruments, indices or issuers of financial instruments. This document constitutes neither a solicitation of an offer nor a prospectus in the sense of the Austrian Capital Market Act (Kapitalmarktgesetz) or the Austrian Stock Exchange Act (Börsegesetz) or any other comparable foreign law. An investment decision in respect of a financial instrument, a financial product or an investment (all hereinafter "product") must be made on the basis of an approved, published prospectus or the complete documentation for such a product in question, and not on the basis of this document.

This document does not constitute a personal recommendation to buy or sell financial instruments in the sense of the Austrian Securities Supervision Act (Wertpapieraufsichtsgesetz). Neither this document nor any of its components shall form the basis for any kind of contract or commitment whatsoever. This document is not a substitute for the necessary advice on the purchase or sale of a financial instrument, a financial product or advice on an investment. In respect of the sale or purchase of one of the above mentioned products, your banking advisor can provide individualised advice suitable for investments and financial products.

This analysis is fundamentally based on generally available information and not on confidential information which the party preparing the analysis has obtained exclusively on the basis of his/her client relationship to a person.

Unless otherwise expressly stated in this publication, RBI deems all of the information to be reliable, but does not make any assurances regarding its accuracy and completeness.

The information in this publication is current as per the latter's creation date. It may be outdated by future developments, without the publication being changed.

Unless otherwise expressly stated (www.raiffeisenresearch.com/special_compensation) the analysts employed by RBI are not compensated for specific investment banking transactions. Compensation of the author or authors of this report is based (amongst other things) on the overall profitability of RBI, which includes, inter alia, earnings from investment banking and other transactions of RBI. In general, RBI forbids its analysts and persons reporting to the analysts from acquiring securities or other financial instruments of any enterprise which is covered by the analysts, unless such acquisition is authorised in advance by RBI's Compliance Department.

SPECIAL REGULATIONS FOR THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND (UK): This document does not constitute either a public offer in the meaning of the Austrian Capital Market Act (Kapitalmarktgesetz; hereinafter „KMG") nor a prospectus in the meaning of the KMG or of the Austrian Stock Exchange Act (Börsegesetz). Furthermore, this document does not intend to recommend the purchase or the sale of securities or investments in the meaning of the Austrian Supervision of Securities Act (Wertpapieraufsichtsgesetz). This document shall not replace the necessary advice concerning the purchase or the sale of securities or investments. For any advice concerning the purchase or the sale of securities of investments kindly contact your RAIFFEISENBANK. This publication has been either approved or issued by RBI in order to promote its investment business. Raiffeisen Bank International AG ("RBI"), London Branch is authorised by the Austrian Financial Market Authority and subject to limited regulation by the Financial Conduct Authority ("FCA"). Details about the extent of its regulation by the FCA are available on request. This publication is not intended for investors who are Retail Customers within the meaning of the FCA rules and shall therefore not be distributed to them. Neither the information nor the opinions expressed herein constitute or are to be construed as an offer or solicitation of an offer to buy (or sell) investments. RBI may have affected an Own Account Transaction within the meaning of FCA rules in any investment mentioned herein or related investments and/or may have a position or holding in such investments as a result. RBI may have been, or might be, acting as a manager or co-manager of a public offering of any securities mentioned in this report or in any related security.

SPECIFIC RESTRICTIONS FOR THE UNITED STATES OF AMERICA AND CANADA: This document may not be transmitted to, or distributed within, the United States of America or Canada or their respective territories or possessions, nor may it be distributed to any U.S. person or any person resident in Canada, unless it is provided directly through RB International Markets (USA) LLC ("RBIM"), a U.S. registered broker-dealer, and subject to the terms set forth below.

SPECIFIC INFORMATION FOR THE UNITED STATES OF AMERICA AND CANADA: This research document is intended only for institutional investors and is not subject to all of the independence and disclosure standards that may be applicable to research documents prepared for retail investors. This report was provided to you by RB International Markets (USA) LLC (RBIM), a U.S. registered broker-dealer, but was prepared by our non-U.S. affiliate Raiffeisen Bank International AG (RBI). Any order for the purchase or sale of securities covered by this report must be placed with RBIM. You can reach RBIM at 1177, Avenue of the Americas, 5th Floor, New York, NY 10036, phone +1 212-600-2588. This document was prepared outside the United States by one or more analysts who may not have been subject to rules regarding the preparation of reports and the independence of research analysts comparable to those in effect in the United States. The analyst or analysts who prepared this research (i) are not registered or qualified as research analysts with the Financial Industry Regulatory Authority ("FINRA") in the United States, and (ii) are not allowed to be associated persons of RBIM and are therefore not subject to FINRA regulations, including regulations related to the conduct or independence of research analysts.

The opinions, estimates and projections contained in this report are those of RBI only as of the date of this report and are subject to change without notice. The information contained in this report has been compiled from sources believed to be reliable by RBI, but no representation or warranty, express or implied, is made by RBI or its affiliated companies or any other person as to the report's accuracy, completeness or correctness. Securities which are not registered in the United States may not be offered or sold, directly or indirectly, within the United States or to U.S. persons (within the meaning of Regulation S under the Securities Act of 1933 ["the Securities Act"]), except pursuant to an exemption under the Securities Act. This report does not constitute an offer with respect to the purchase or sale of any security within the meaning of Section 5 of the Securities Act and neither shall this report nor anything contained herein form the basis of, or be relied upon in connection with, any contract or commitment whatsoever. This report provides general information only. In Canada it may only be distributed to persons who are resident in Canada and who, by virtue of their exemption from the prospectus requirements of the applicable provincial or territorial securities laws, are entitled to conduct trades in the securities described herein.

If any term of this Disclaimer is found to be illegal, invalid or unenforceable under any applicable law, such term shall, insofar as it is severable from the remaining terms, be deemed omitted from this Disclaimer. It shall in no way affect the legality, validity or enforceability of the remaining terms.

Raiffeisen RESEARCH

JÖRG BAYER
Austria ,
joerg.bayer@rbinternational.com

FABIAN BLASCH
Austria ,
fabian.blasch@rbinternational.com

GUNTER DEUBER
Austria ,
gunter.deuber@rbinternational.com

CASPER ENGELEN
Austria ,
casper.engelen@rbinternational.com

ALEXANDER FRANK
Austria ,
alexander.frank@rbinternational.com

RUSLAN GADEEV
Austria ,
ruslan.gadeev@rbinternational.com

AMADEA HIESS
Austria ,
amadea.hiess@rbinternational.com

STEPHAN IMRE
Austria ,
stephan.imre@rbinternational.com

MARTIN KUTNY
Austria ,
martin.kutny@rbinternational.com

FABIAN LAMINGER
Austria ,
fabian.laminger@rbinternational.com

THOMAS LEIRER
Austria ,
thomas.leirer@rbinternational.com

OLIVER MARX
Austria ,
oliver.marx@rbinternational.com

MATTHIAS REITH
Austria ,
matthias.reith@rbinternational.com

WERNER SCHMITZER
Austria ,
werner.schmitzer@rbinternational.com

GOTTFRIED STEINDL
Austria ,
gottfried.steindl@rbinternational.com

MARKUS TSCHAPECK
Austria ,
markus.tschapeck@rbinternational.com

JÜRGEN WALTER
Austria ,
juergen.walter@rbinternational.com

GEORG ZACCARIA
Austria ,
georg.zaccaria@rbinternational.com

FRANZ ZOBL
Austria ,
franz.zobl@rbinternational.com

BRISIDA BUZI
Albania ,
Brisida.BUZI@raiffeisen.al

VALBONA GJEKA
Albania ,
valbona.gjeka@raiffeisen.al

FJORENT RRUSHI
Albania ,
Fjorent.Rrushi@raiffeisen.al

ARISTEA VLLAHU
Albania ,
Aristea.Vllahu@raiffeisen.al

OLGA ZHEGULO
Belarus ,
olga.zhegulo@priorbank.by

ASJA GRDJO
Bosnia Herzegovina ,
asja.grdjo@raiffeisengroup.ba

IVONA ZAMETICA
Bosnia Herzegovina ,
ivona.zametica@raiffeisengroup.ba

MIRZA ZORNIC
Bosnia Herzegovina ,
mirza.zornic@raiffeisengroup.ba

PETAR BEJUK
Croatia ,
petar.bejuk@rba.hr

ANA LESAR
Croatia ,
ana.lesar@rba.hr

ELIZABETA SABOLEK-RESANOVIC
Croatia ,
elizabeta.sabolek-resanovic@rba.hr

ANA TURUDIC
Croatia ,
ana.turudic@rba.hr

ZRINKA ZIVKOVIC-MATIJEVIC
Croatia ,
zrinka.zivkovic-matijevic@rba.hr

HELENA HORSKA
Czech Republic ,
Helena.Horska@rb.cz

DAVID VAGENKNECHT
Czech Republic ,
david.vagenknecht@rb.cz

LEVENTE BLAHÓ
Hungary ,
levente.blaho@raiffeisen.hu

GERGELY PÁLFFY
Hungary ,
gergely.palffy@raiffeisen.hu

ZOLTÁN TÖRÖK
Hungary ,
torok.zoltan@raiffeisen.hu

DOROTA STRAUCH
Poland ,
dorota.strauch@raiffeisen.pl

NICOLAE COVRIG
Romania ,
Nicolae.Covrig@raiffeisen.ro

ANDREEA-ELENA DRAGHIA
Romania ,
Andreea-Elena.DRAGHIA@raiffeisen.ro

IONUT DUMITRU
Romania ,
Ionut.Dumitru@raiffeisen.ro

ANASTASIA BAYKOVA
Russia ,
ABAIKOVA@raiffeisen.ru

GREGORY CHEPKOV
Russia ,
grigory.chepkov@raiffeisen.ru

STANISLAV MURASHOV
Russia ,
stanislav.murashov@raiffeisen.ru

LJILJANA GRUBIC
Serbia ,
ljiljana.grubic@raiffeisenbank.rs

TIBOR LORINCZ
Slovakia ,
tibor_lorincz@tatrabanka.sk

SERHII KOLODII
Ukraine ,
serhii.kolodii@raiffeisen.ua

OLEKSANDR PECHERYTSYN
Ukraine ,
oleksandr.pecherytsyn@raiffeisen.ua

Imprint

Information requirements pursuant to the Austrian E-Commerce Act

Raiffeisen Bank International AG Registered Office: Am Stadtpark 9, 1030 Vienna
Postal address: 1010 Vienna, Postfach 50Phone: +43-1-71707-1846Fax: + 43-1-71707-1848

Company Register Number: FN 122119m at the Commercial Court of ViennaVAT Identification Number: UID ATU 57531200Austrian Data Processing Register: Data processing register number (DVR): 4002771S.W.I.F.T.-Code: RZBA AT WW

Supervisory Authorities: As a credit institution (acc. to § 1 Austrian Banking Act; Bankwesengesetz) Raiffeisen Bank International AG is subject to the supervision by the Austrian Financial Market Authority (FMA, Finanzmarktaufsicht) and the National Bank of Austria (OeNB, Oesterreichische Nationalbank). Additionally, RBI is subject to the supervision by the European Central Bank (ECB), which undertakes such supervision within the Single Supervisory Mechanism (SSM), which consists of the ECB and the national responsible authorities (Council Regulation (EU) No 1024/2013 - SSM Regulation). Unless set out herein explicitly otherwise, references to legal norms refer to norms enacted by the Republic of Austria.

Membership: Austrian Federal Economic Chamber, Federal Bank and Insurance Sector, Raiffeisen Association.

Statement pursuant to the Austrian Media Act

Publisher and editorial office of this publication Raiffeisen Bank International AGAm Stadtpark 9, A-1030 Vienna**Media Owner of this publication**Raiffeisen RESEARCH – Verein zur Verbreitung von volkswirtschaftlichen Analysen und FinanzmarktanalysenAm Stadtpark 9, A-1030 Vienna**Executive Committee of Raiffeisen RESEARCH – Verein zur Verbreitung von volkswirtschaftlichen Analysen und Finanzmarktanalysen:**Mag. Gunter Deuber (Chairman), Mag. Helge Rechberger (Vice-Chairman)Raiffeisen RESEARCH – Verein zur Verbreitung von volkswirtschaftlichen Analysen und Finanzmarktanalysen is constituted as state-registered society. Purpose and activity are (inter alia), the distribution of analysis, data, forecasts and reports and similar publications related to the Austrian and international economy as well as financial markets.**Basic tendency of the content of this publication**

- Presentation of activities of Raiffeisen Bank International AG and its subsidiaries in the area of conducting analysis related to the Austrian and international economy as well as the financial markets.
- Publishing of analysis according to various methods of analyses covering economics, interest rates and currencies, government and corporate bonds, equities as well as commodities with a regional focus on the euro area and Central and Eastern Europe under consideration of the global markets.

Producer of this publication Raiffeisen Bank International AGAm Stadtpark 9, A-1030 Vienna

Creation time of this publication: 30/05/2023 15:19 P.M. (CEST) ;

First Dissemination of this publication: 30/05/2023 15:19 P.M. (CEST)