

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

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.

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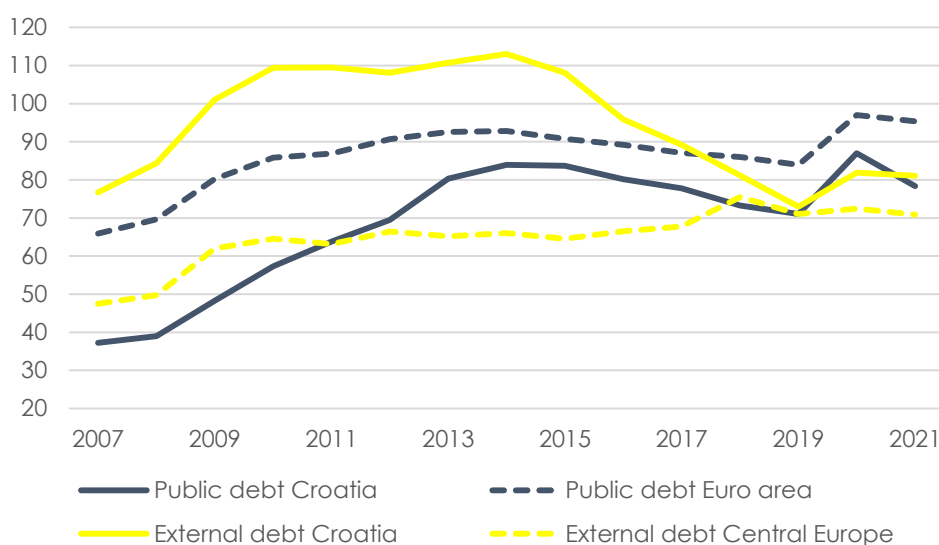
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	ERM II entry	Euro adoption	Years in ERM 2
Greece	01.01.1999.	01.01.2001	2.0
Slovenia	28.06.2004.	01.01.2007	2.5
Cyprus	02.05.2005.	01.01.2008	2.7
Malta	02.05.2005.	01.01.2008	2.7
Slovakia	28.11.2004.	01.01.2009	3.1
Estonia	28.06.2004.	01.01.2011	6.5
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

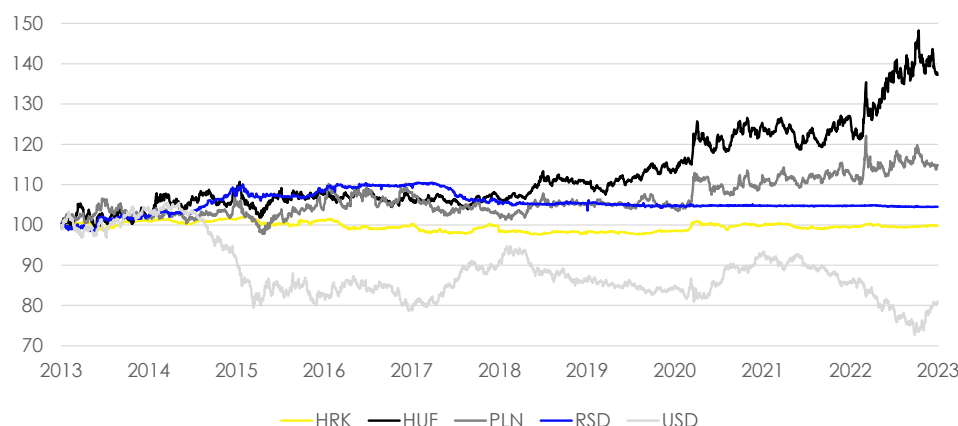


Source: Eurostat, national sources, RBI/Raiffeisen Research

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*

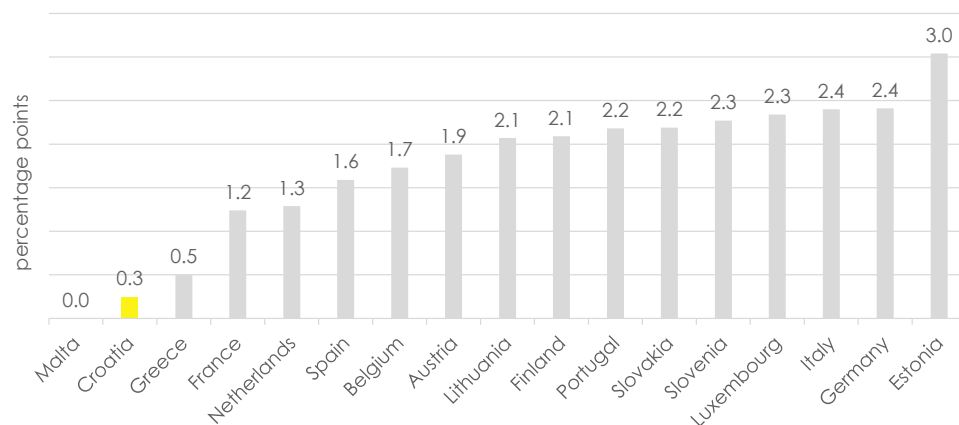


* all FX versus EUR. Indexed: 1 Jan 2013 = 100; values > 100 -> depreciation

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**.

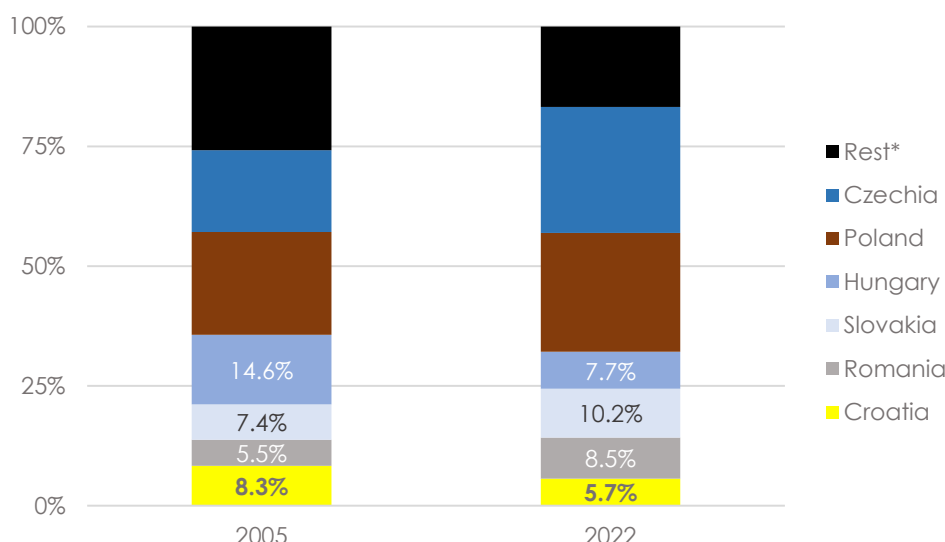
Croatia also benefited from developments on the **"broader playground"** of **EU policymaking**. Croatia's feasible rapid entry into the euro came at a time when it was quite **opportune** to demonstrate enlargement successes at the EU level from a "Brussels" perspective. At the same time, **institutional 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)

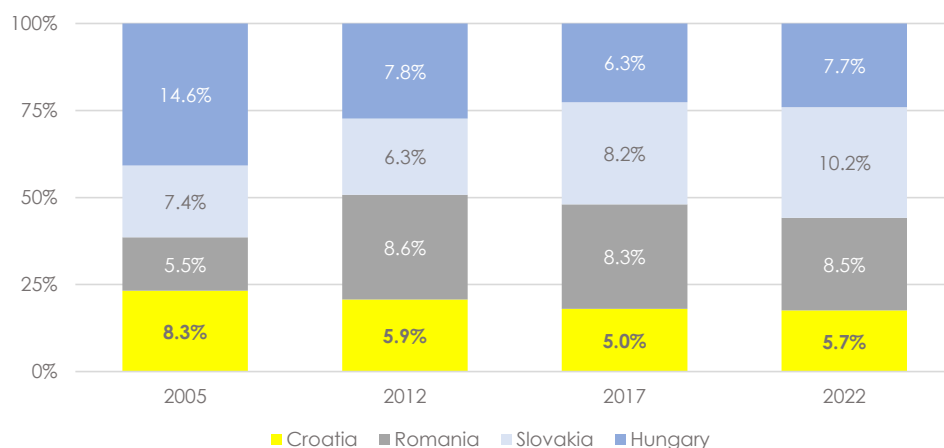


* Rest includes Russia, Ukraine, Belarus, Bulgaria, Serbia, Albania, Kosovo

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)*

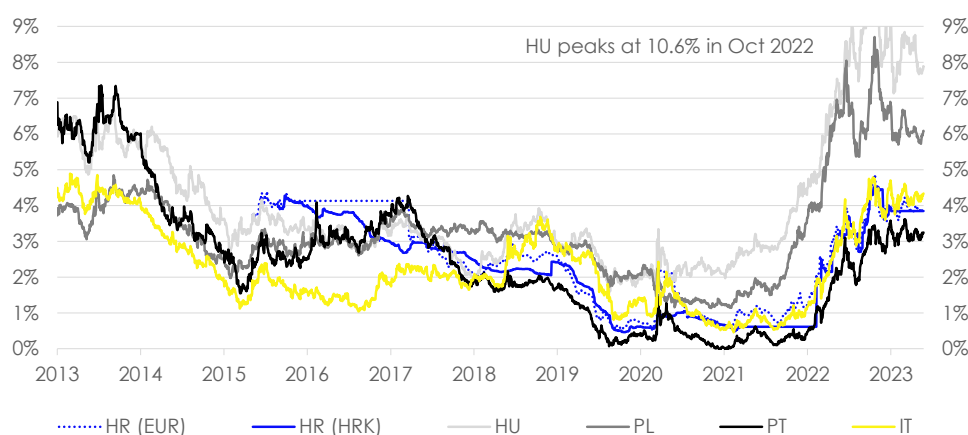


* Numbers shown in graph equal % of total, graphical illustration shows relative share in combined exposures to Croatia, Slovakia, Romania and Hungary (i.e. regarding this ratio Croatia went down from around 25% in 2005 to around 20% in 2022; Romania is up from around 15% to 30%)

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

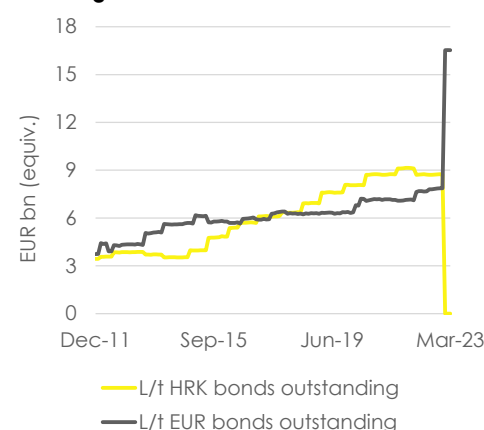
Source: Bloomberg Finance L.P., RBI/Raiffeisen Research

Government bond issuance was always "euroised" and also international

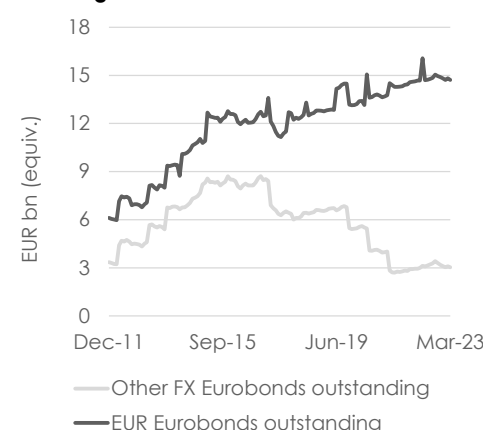
Croatia's euroization is unequivocally reflected in the central government bond issuance history. Even before becoming EU member in 2013, the central government used the European single currency as an issuance currency also on the domestic capital markets (charts below). Right before the introduction 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*



Central govt international bonds*



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

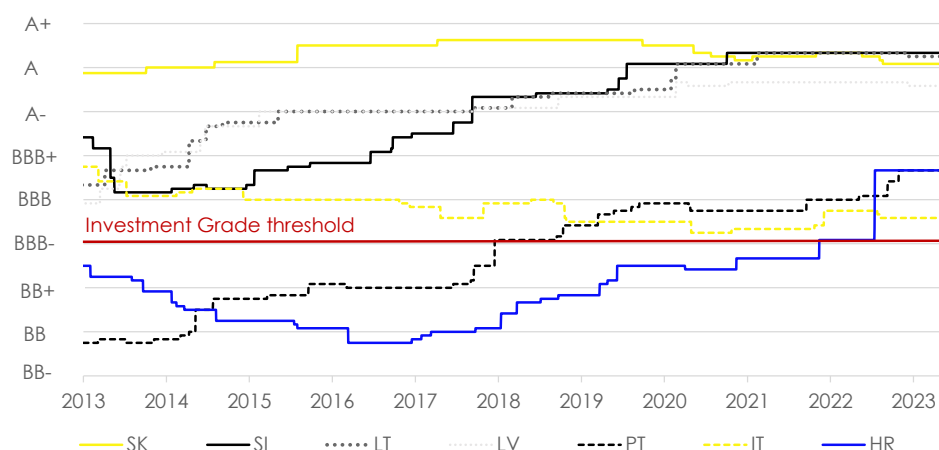
Source: HNB, RBI/Raiffeisen Research

* 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*



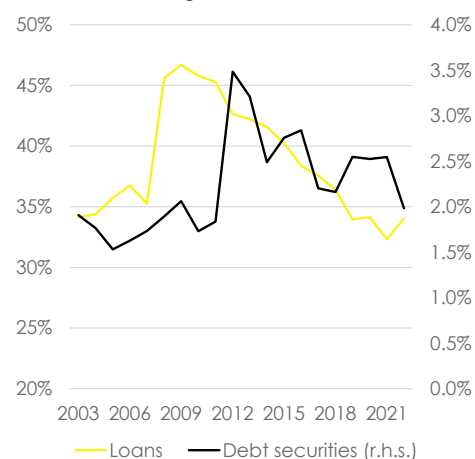
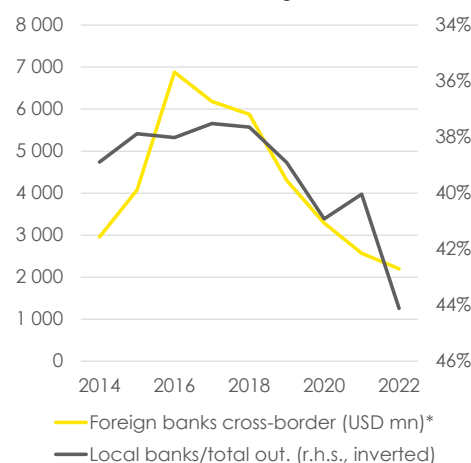
* CE/SEE euro area members: Slovenia (SI) introduced euro in 2007, Slovakia (SK) in 2009, Estonia (not in chart) in 2011, Lithuania (LT) in 2014, Latvia (LV) in 2015, and Croatia in 2023; currently, out of CE/SEE only Bulgaria is waiting to join ERM II (likely 2025)

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)*

HR: NFC loans (outstanding)


NFC - Non-Financial Corporations

* Based on consolidated sector accounts

Source: Eurostat, RBI/Raiffeisen Research

NFC - Non-Financial Corporations

* Foreign banks' cross-border claims based on BIS locational banking statistics (LBS)

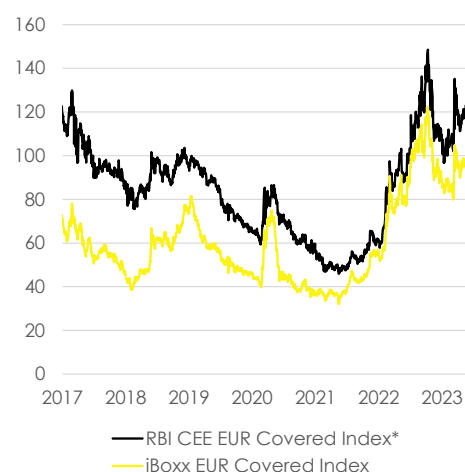
Source: BIS, ECB, RBI/Raiffeisen Research

More opportunities for Croatian banks on the Eurobond market

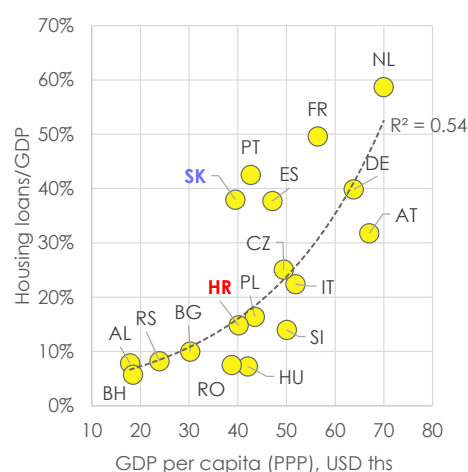
Unlike the corporate sector, **Croatian banks** have been **more actively present** on the **Eurobond market** lately, nudged by the regulator to build up MREL buffers. On a fair note, public benchmark-size issues of eligible instruments have been supplied mainly by local subsidiaries of foreign MPE 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)



Housing loan market penetration



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

Data per 23/05/2023, all values indicative

Source: Refinitiv, RBI/Raiffeisen Research

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.

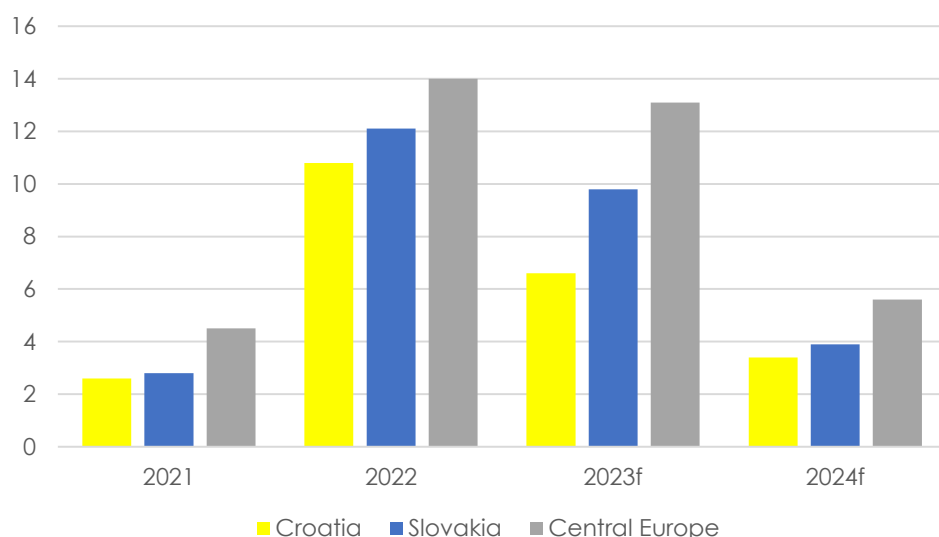
However, **price convergence** must inevitably happen over time, especially in a small and open economy like Croatia. Once a country becomes a member of the EA, we assume this process to accelerate. This should be driven by lower transaction costs, greater transparency and comparability of prices, which 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 whether 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)

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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

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Producer of this publication Raiffeisen Bank International AG Am 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)