CROATIAN NATIONAL BANK

Semi-annual Report

for the 1st half of 2008

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SEMI-ANNUAL REPORT FOR THE 1ST HALF OF 2008

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Zagreb, December 2008

1 Summary

The first half of 2008 was marked by an economic downturn, which was coupled by an increase in consumer price inflation, driven by strong imported inflationary pressures and in a small measure by domestic inflationary pressures. GDP grew annually by 3.8% in the first half of the year, a significantly lower rate compared with 5.6% in the whole of 2007. The economic slowdown was predominantly due to a drop in household consumption caused by the deceleration of household disposable income and related decline in consumer optimism. Additionally, negative trends in trade in goods further worsened external imbalances, which had a negative effect on real GDP growth. Moderate government consumption growth in the first half of the year was partly caused by its deceleration in the first quarter, when it was restricted under provisional budget financing then in effect. The opposite effect was produced only by strong investment activity, spurred primarily by private investments in non-residential building construction, which made gross fixed capital formation the main economic growth in generator in the first half of 2008.

The growth of gross value added, which measures the dynamics within the production side of the economy, also slowed in the first six months of this year, primarily due a drop in domestic demand for services. Gross value added in service activities, trade and hotels and restaurants for example, slowed noticeably, and a slowdown was also recorded in industrial production in the second quarter. GVA grew at an accelerated rate only in construction and, to a smaller extent, in agriculture and public administration.

The first half of 2008 was marked by positive labour market trends, the most important being the continued downturn in unemployment and upturn in employment, despite the deceleration towards the middle of the year, due to the slowdown in the real sector of the economy. Having accelerated in the first quarter, nominal wages (both gross and net) also grew at slower annual rates in the second quarter and, coupled by inflation growth, led to a drop in real net wages in the second part of the first half of 2008. The Act on Amendments to the Income Tax Act, adopted in June 2008, provided for an increase in personal allowance, starting from July, from HRK 1,600 to HRK 1,800 per month, whereas the Minimum Wage Act stipulated that the minimum wage be raised from HRK 2,441.25 to HRK 2,747.00.

Mounting imported and domestic inflationary pressures in the first six months of 2008 pushed up CPI inflation. The annual inflation rate stood at 7.6% in June 2008, increasing by 1.8 percentage points relative to 5.8% in December 2007. This increase was to a large extent due to direct and indirect impacts of the increase in world prices of crude oil, food raw materials and metal. In addition to imported inflationary pressures, domestic cost-push inflationary pressures also increased, as shown by the acceleration in the annual growth rate of unit labour costs for the total economy. The inflation increase was also attributable to strong domestic demand, which had a time-lag effect on price trends in the first half of 2008. As regards the overall CPI components, the bulk of the inflation increase in the first half of 2008 came from the price rise in energy (especially in refined petroleum products) and food products, with the latter surging since the second half of 2007. In contrast, the annual rate of change in the prices of industrial non-food products excluding energy slowed down slightly, indicating that there was no spillover effect from the increase in energy costs to these prices. Core inflation remained below total consumer price inflation, but its annual rate of change went up from 5.0% in December 2007 to 6.5% in June 2008. The increase in core inflation in the observed period was primarily due to the price growth of food products (meat, bread and cereal products).

The appreciation of the kuna/euro exchange rate helped ease inflationary pressures in the domestic economy. The exchange rate of the kuna appreciated by 1.1% versus the euro in the first six months of 2008. The kuna exchange rate appreciated more strongly in the second half of January due to a drop in the financial system liquidity, so that the CNB, in an effort to offset its nominal strengthening, intervened in the foreign exchange market purchasing foreign exchange from banks. Mild appreciation pressures continued after January, primarily boosted by seasonal factors, including a growth in demand for the kuna during the Easter holidays and a rise in foreign exchange inflows from tourism, and to some extent by foreign exchange inflows generated by corporate foreign borrowing. Nevertheless, the central bank held no foreign exchange auctions after January, allowing the kuna to appreciate slightly against the euro so as to stabilise inflationary expectations and alleviate the growth of euro-denominated import prices.

In view of described macroeconomic conditions, the Croatian National Bank implemented a more restrictive monetary policy in the first half of 2008, which was mainly reflected in the tightened liquidity, increased price of banks' refinancing with the CNB and continued application of the limits imposed on the growth of bank placements. The main instrument for the creation of kuna liquidity in the observed period were regular reverse repo operations, at which the central bank created liquidity in restricted amounts, taking heed of increased inflationary pressures. In addition to the reduced trading volumes, on average almost three times lower in the first six months of this year than in the same period in 2007, repo auctions were also marked by an increase in interest rates charged on funds placed by the CNB. The tightening of liquidity by the central bank resulted in the deceleration of almost all monetary aggregates.

Banks' lending continued to be regulated by the Decision on the purchase of compulsory CNB bills in the first half of 2008, which enabled the central bank to curb the growth of possible demand-pull inflationary pressures while offsetting negative trends in international economic relations. It should also be noted that the increase in bank placements was somewhat below the imposed limits in the first six months of this year, which is a sign that demand for loans also underwent changes due to the negative impact of the general economic slowdown, increase in lending interest rates and a change in expectations regarding interest rates and inflation trends.

The central bank complemented the said monetary measures with several important decisions governing bank supervision. By an amendment to the Decision on the capital adequacy of banks, implemented in early 2008, the CNB imposed additional capital requirements on fast-growing banks, mindful of the risk that a fast increase in placements might deteriorate the quality of the banks' assets. The banks whose placement growth exceeds the prescribed limit are therefore obliged to maintain a higher than prescribed capital adequacy ratio, which also depends on the structure of funds' sources. Furthermore, also increased were the weights used for the calculation of risk-weighted assets, applied to foreign currency indexed placements or placements to debtors with unmatched foreign exchange positions. These CNB measures prompted banks to further increase their capital levels, with the result that the capital adequacy ratio of the banking system stood at a high 15.2% at the end of June, considerably exceeding the prescribed 10%.

The first half of 2008 was marked by positive developments in the structure of banks' liabilities. The external debt of banks decreased further in this period, partially due to the continued implementation of the marginal reserve requirement. In addition, household savings and time deposits surged in the first six months of this year, which might be attributed to this sector's growing reliance on saving with banks, which is perceived as a safer form of investing.

By prompting banks to reduce their external debt and increase capital levels, and by stipulating high levels for foreign exchange reserve requirements, the CNB has managed to enhance the safety and stability of the Croatian banking system, which is an important accomplishment given the exposure to risks deriving from the current global financial crisis.

In contrast, the domestic capital market was in the first half of 2008 strongly influenced by negative developments in global and regional financial markets. The semi-annual turnover in shares decreased in the observed period compared with the second half of 2007 and the price of most shares listed on the Zagreb Stock Exchange plummeted, causing the CROBEX to drop sharply. In addition to the equity securities market, the Croatian debt securities market was also marked by downward trends in the first six months of 2008. The ballooning capital market prices, reflected at mid-2007 in extremely high price-earnings ratios for the shares included in the CROBEX, were deflated due to the change in risk perception by domestic and foreign investors, strengthening of inflationary pressures in Croatia and a majority of other countries, deepening of the crisis in world financial markets, caused by the problems with subprime mortgages in the US, and impending recession in the leading world economies.

In the first half of 2008, banks' interest rates on short-term loans grew further on the back of the accelerated growth of the EURIBOR, which hit a seven-year peak in that period, and monetary tightening. Interest rates on long-term household loans increased at especially sharp rates, while interest rates on some short-term loans drifted down, retaining their high volatility. Interest rates on household time deposits edged up, whereas interest rates on corporate time deposits decreased sharply compared with the high levels recorded towards the end of 2007.

The imbalances in international economic relations worsened further in the first half of 2008. Driven mainly by adverse foreign trade developments, the current account deficit widened by one fourth relative to the same period in 2007. The increase in the goods deficit was predominantly due to deterioration in the balance of trade in oil and refined petroleum products, caused by the oil price hike in the first half of 2008. Trends in trade in other export equipment were also negative, primarily due to a sharp increase in ships imports and in a smaller degree to extraordinary imports of helicopters and airplanes. The balances in the factor income and current transfers accounts also worsened, while the balance of international trade in goods improved thanks to an increase in income from tourism.

According to BOP data, total goods exports rose at an annual rate of 8% in the first half of 2008, slightly less than in the same period last year (9.3%). The slowdown in total exports was mainly caused by weaker exports of cork and wood, and cork and wood manufactures. In addition, exports of fish and fish products decreased, in large a measure due to new regulations on tuna fishing, farming and trade, and a drop was also recorded in exports of cereals and cereal products because of export duties levied on these products. However, exports of ships, electrical machinery, apparatus and equipment, oil and refined petroleum products accelerated.

In contrast with exports, total goods imports accelerated from 10.5% annually in the first half of 2007 to 14.7% in the first half of 2008 (according to BOP data). These trends are primarily attributable to the mentioned imports of other transport equipment (primarily of ships and in a smaller degree of aircrafts), which more than doubled. Oil and refined petroleum products imports also increased, exclusively due to the price rise of crude oil on the world market. Imports of road vehicles and capital goods also continued to surge, whereas aggregate imports of other goods slightly decelerated.

The capital and financial account recorded a larger net inflow in the first half of 2008 than in the same period in 2007, primarily arising from banks' currency and deposit withdrawals from abroad. In contrast, foreign direct investments declined from the first half of 2007, due largely to smaller capital infusions to foreign-owned banks in Croatia. The growing insecurity in global financial markets prompted investment funds to withdraw investments in foreign securities so that the portfolio investment account also recorded a net inflow. International reserves continued to grow in the first half of 2008, mainly on account of the increase in banks' allocations (foreign currency reserve requirements, including marginal reserve requirements), standing at EUR 9.9bn at the end of June.

External debt increased by 6.2% in the first half of 2008 relative to the end of 2007, with the increase generated by companies' borrowing with foreign banks and affiliated foreign companies. Banks' debt continued to decrease, due to central bank measures to curb lending, as well as to capital infusions and foreign exchange inflows from tourism. Government sector debt also went down slightly, mainly on account of the central government's repayment of a Samurai bond falling due in June.

The mentioned increase in inflation and goods imports, coupled by positive labour market developments, led to a surge in consolidated general government revenues in the first half of 2008. Government expenditures increased at a slower rate, the main reason being the lower increase in the first quarter when provisional budget financing was in effect. Furthermore, government investments, the lion's share of which was accounted for by traffic infrastructure investments, held steady at the last year's level, which resulted in a consolidated general government surplus in the first half of 2008 (GFS 1986). New borrowings were therefore primarily used for the refinancing of liabilities falling due in that period or for bridging short-term liquidity gaps. General government debt thus declined slightly in the observed period, with the decrease aided by the appreciation of the kuna exchange rate versus the currencies in which most of the debt is denominated.

2 International Environment

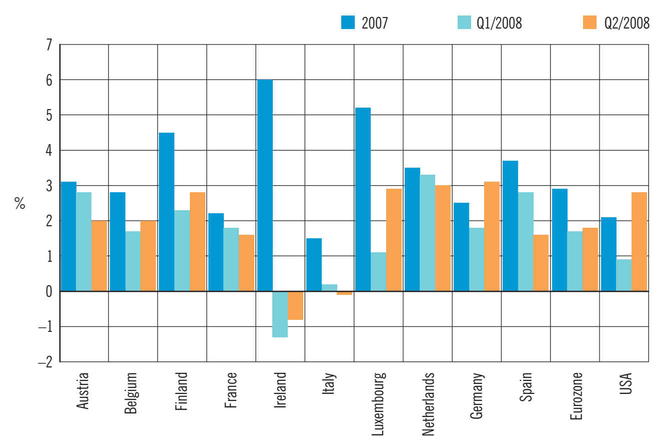
Global economic trends were in the first half of 2008 marked by the economic slowdown in the US and other developed countries, resulting from the spread of the US subprime mortgage market crisis to other financial markets and, to a certain extent, to the real sector. Global inflationary pressures continued to increase in the first six months of 2008, driven by the price surge in energy products, especially crude oil, and the increase in prices of other raw materials and food products on the world market.

The turmoil in the US financial market had an adverse effect on the growth of the world's largest economy: the US GDP annual growth rate dropped from 2.1% in 2007 to only 0.9% in the first quarter of 2008. Having broken out in the summer of 2007, the subprime mortgage market crisis, coupled by a sharp correction in real estate prices, resulted in the tightening of lending conditions and triggered a wave of investment distrust. The effects of the crisis spread rapidly to other segments of the financial market and caused large losses for the banks and funds that were, either directly or through securitisation of claims, exposed to mortgage market risks. In an effort to halt the negative trends, the US government implemented a package of fiscal and monetary measures designed to alleviate the effects of the crisis and boost domestic demand. Thanks to this and to good export performance brought about by the weakening of the US dollar, the economy rebounded somewhat in the second quarter, with the GDP annual growth rate rising to 2.8%. Despite the temporary recovery, the Fed, in view of the risks that the crisis could deepen and lead to a recession, cut the US Federal Funds Target Rate by as many as four times in the first half of the year, reducing it by a total of 2.25 percentage points and bringing it down to 2.00% at the end of this period, a record low in the last three years.

The US dollar/euro exchange rate continued to depreciate on the world foreign exchange market, rising by 7.3% in the first six months of 2008, from USD 1.47/EUR at the end of 2007 to USD 1.58/EUR at the end of June 2008. Downward pressures on the US dollar were mostly attributed to adverse economic indicators related to a decrease in personal consumption in the US, the subprime mortgage market crisis and the difference between the Fed's and the ECB's key interest rates.

The eurozone economy was also influenced by adverse developments in world financial markets and strong global price pressures. The eurozone's real GDP growth slowed to an annual rate of 1.8% in the first half of 2008, down from 2.9% and 2.4% in the first and second half of 2007 respectively. Economic activity contracted in almost all EU Member States, especially in the countries like Ireland, for example, that have strong ties with the US economy and financial system. These developments

Figure 1 Real GDP Growth in the USA and Selected Eurozone Countries

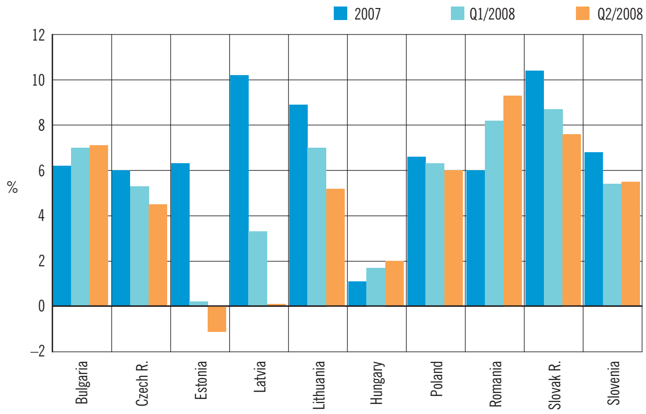


Sources: Eurostat and ECB.

resulted from the investment slowdown brought about by financing constraints and from the deceleration of personal consumption growth caused by a reduction in real disposable income. In addition, eurozone exports also slowed due to a decrease in demand from its major trading partners, the US and Great Britain. Eurozone inflation continued to rise at a rapid pace due to the increase in world prices of energy products and food, reaching 4.0% in June and considerably exceeding the ECB target rate of 2%. Despite the mounting inflationary pressures, the ECB held its key rate steady at 4.00% in the first six months of 2008 in view of downside risks to the outlook for the eruozone economic growth.

Affected by the world price increase and slowdown in foreign demand, the growth of CEE economies also slowed down in the first half of 2008, but remained relatively high. The effects of the global financial crisis were felt the most in the Baltic countries, especially in Estonia and Latvia, due to their strong dependence on foreign financing. The severe contraction in their economies, primarily due to tightened finances and significant real estate price corrections, caused a slump in personal consumption and investments and sent prices skyrocketing.[1] Despite a slowdown, other economies in the region continued to report good economic results, with annual GDP growth rates mostly exceeding 5%, primarily driven by strong domestic demand. The only exception is Hungary, suffering a much sharper economic slowdown for quite a long period of time.

Figure 2 Real GDP Growth in Selected Central and Eastern European Countries



Source: Eurostat.

Japan's economic slowdown also continued in the first part of the year. The annual GDP growth rate was down to 1.0% in the first half of 2008, from 2.5% in the first half and 1.7% in the second half of 2007. These developments were primarily due to a weakening of domestic demand and slowdown in exports. In addition, after a long period of deflation or zero inflation, consumer price inflation went up to 2.0% in June 2008, mostly as a result of external shocks (the price increase in oil and food).

In contrast with developed countries, developing countries and emerging markets' economic growth remained, despite a slight slowdown, at a high annual level of about 7%. The main growth drivers were the exporters of energy products and raw materials thanks to extremely high prices of their main goods exports. China's economic activity slackened slightly as a result of a small downturn in exports and investments. However, its annual GDP growth continued above 10%, mainly boosted by robust domestic demand.

World crude oil prices surged in the first six months of 2008, increasing by a staggering 75.4% in the observed period relative to the first half of 2007 and standing at an average of USD 108.2 per barrel.[2] The oil price increase was primarily caused by escalating geopolitical tensions and resulting market concerns over the depletion of the US crude oil and refined petroleum products' reserves, as well as by intensified funds' investments in commodity markets and a marked demand growth in developing countries, mainly reflecting strong demand for refined petroleum products in China. In the first half of the year, upward pressures on inflation were stemming from price increases in other raw materials on the world market, especially in cereals, iron ore and coal. Global inflation accelerated to over 6% at the end of June due to increased price pressures, especially intense in the emerging markets and developing countries because of their dependence on foreign resources, faster economic growth and insufficiently developed inflation curbing solutions.

[1] In June 2008, consumer prices increased annually by 11.5% in Estonia, 12.5% in Lithuania and by as much as 17.5% in Latvia.

[2] The average price of Brent, WTI and Dubai Fateh crude.

3 Economic Activity

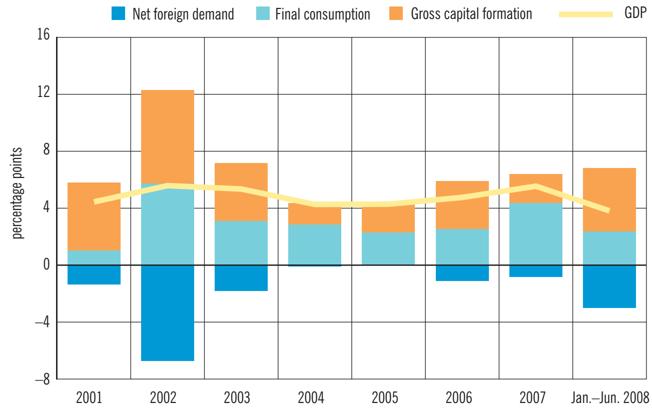
3.1 Demand

After a relatively strong growth of 5.6% in 2007, the rate of change in GDP dropped considerably to 3.8%[3] in the first half of 2008. These trends were predominantly due to a drop in personal consumption, caused by adverse changes in its main regular and irregular financing sources, coupled by the continued decline in consumer optimism. Household consumption rose annually by 3.2% in the first half of 2008, half the rate in 2007, contributing 2.0 percentage points to real GDP growth. Government consumption slowed early in the year as a result of provisional budget financing, which also partly accounted for its decelerated growth throughout the first half of the year. In consequence of the surge in goods and services imports, which failed to be offset by an equally high increase in total imports, external imbalances worsened in the period from January to June 2008. This was primarily due to developments in trade in goods, that is, to a considerably faster annual increase in goods imports than in goods exports. Net foreign demand thus contributed a negative 3.0 percentage points to real GDP growth in the observed period. The opposite effect was produced by strong private sector investments, mainly channelled into constructions, which led to a high annual growth of gross fixed capital formation (11.2%). This aggregate demand component was hence the major driver of real growth in the first half of 2008, with a contribution of 3.6 percentage points.

The first half of 2008 was marked by a considerable slowdown in the real annual growth of household consumption. Notwithstanding a contraction in real household consumption in the second quarter, its annual rate of change remained positive due to the base effect. Personal consumption increased annually by 4.3% in the first quarter and by only 2.2% in the second quarter. These trends primarily resulted from a slowdown in the main personal consumption financing source – the real wage bill. With a relatively stable growth in employment figures from the CPIA,[4] the dynamics of the net wage bill was in the observed period almost completely determined by the drop in the average real net wage. Bank placements to households decelerated further in the first half of the year, which is partly attributable to tightened lending conditions and partly to demand-side changes. Household

Figure 3 Contributions of Domestic and Foreign Demand to GDP Growth

constant prices



Source: CBS.

[3] The data for the period from the first quarter of 2005 to the second quarter of 2008 are preliminary and based on the CBS's quarterly GDP estimate.

[4] The number of insured registered with the CPIA is a more reliable short-term employment indicator than preliminary CBS's data on employment by activity. The final data will be released in April 2009.

consumption in the observed period was also given an unfavourable impact by real pension growth of only 0.55% in March and by the considerably reduced transfers to the household sector related to the repayment of debt to pensioners. As a result, consumer optimism constantly kept falling in the first half of the year, further slowing the growth of this aggregate demand component with the largest share in GDP.

Government consumption increased by 1.8% in real terms in the first quarter of 2008 relative to the same period in 2007. Its rate of change was 0.5% in the first quarter, under the provisional budget financing then in effect, and 3.2% in the second quarter. This acceleration in government consumption in the April to June period was almost wholly accounted for by a real annual increase of 6.0% in the expenditures for the use of goods and services. As there were no major changes in the employment dynamics in the broadly defined public administration, the dynamics of the current government consumption deflator was primarily accelerated by an 8.6% nominal annual increase in expenditures for employee compensation in the first half of 2008. It should also be mentioned that severance payments paid out in public administration in the first half of this year decreased annually and that their dynamics had no inflationary effect.

The main driver of economic growth in the first six months of 2008 was gross fixed capital formation, which was up by 11.2% relative to the same period in 2007. This was due to strong private sector investments, mainly channelled to non-residential buildings. It should be mentioned that such a high increase in net capital investments occurred despite the decline in government investments. Specifically, as shown by MoF data on consolidated general government revenues and expenditures in the first six months of 2008, the net acquisitions of fixed non-financial assets was 2.8% lower in nominal terms than in the same period in 2007.

International trade was in the first half of 2008 characterised by a relatively high increase in goods and services imports (7.6%), which considerably exceeded the increase in total exports (4.3%). This increase primarily came from a rise in imports of goods, especially ships. The imports growth in the second quarter was also partly fuelled by the settlement of the clearing debt owed by Russia and by Croatia Airlines' investments in the fleet renewal. Services imports also increased annually in the first six months of this year, partly boosted by an increase in the number of residents' trips abroad (the European Football Championship). In contrast, exports growth fell behind that of goods and services imports in the first half of this year mainly due to adverse changes in goods exports, to a great extent resulting from a sharp downturn in foreign demand for domestic goods.

3.2 Output

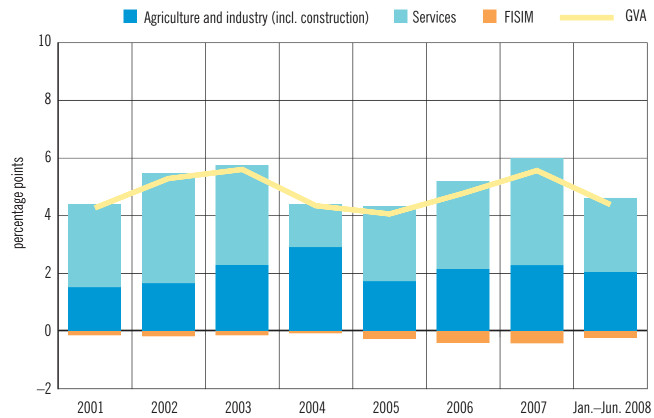
According to GDP by production approach, GVA in the economy increased in real terms by 4.4% compared with the same period in the previous year. Broken down by quarters, GVA decreased from 4.6% in the first quarter to 4.2% in the second quarter. GVA also increased at a lower rate in the first six months of 2008 than in the whole previous year (5.6%), to a great extent due to a moderation in domestic demand for services. The service sector contributed 2.6 percentage points to real GVA growth in the observed period, whereas the activities outside this sector (agriculture, industry and construction) contributed 2.1 percentage points.

Broken down by individual activities, GVA in construction recorded the highest real increase (9.1%) in the first quarter of 2008 relative to the same period in 2007. In addition to agriculture and public administration, construction was the only economic activity with GVA growth in the analysed period exceeding the average GVA growth for 2007. Other activities, especially trade and hotels and restaurants, recorded a more moderate GVA growth. GVA in industry also decelerated, especially in the second quarter, when domestic and foreign demand for industrial goods weakened.

Industry and Construction

GVA in industry increased by 4.1% in the first six months of 2008 relative to the same period in 2007, with its rate of change down by 2.4 percentage points from the 2007 average growth rate. A quarterly breakdown shows that GVA in industry, having grown at an annual rate of 4.5% early in the year, decelerated to 3.8% annually in the April to

Figure 4 Contributions of Industry and Services to GVA Growth
constant prices



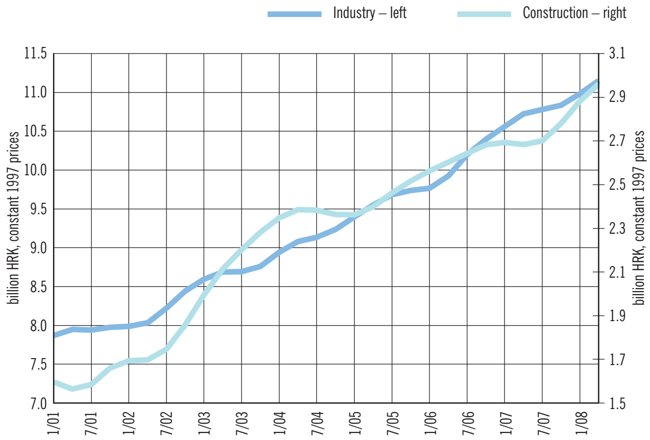
Source: CBS.

June period. The relatively moderate dynamics notwithstanding, industry was the main contributor to overall GVA growth in the first half of 2008.

Seasonally and calendar adjusted data[5] on total industrial production trends in the first six months of 2008 point to a marked increase in industrial production relative to the last quarter in the previous year. These trends were driven by the growth of domestic and foreign demand for almost all industrial groupings' products, and for investment goods in particular. This increase, however, proved insufficient to trigger a decline in producers' stocks of industrial finished products. The overall demand gradually weakened towards mid-year, with the result that industrial production dropped and stocks accumulated. Despite adverse trends in the April to June period, manufacturing, accounting for the bulk of industrial production, grew by 4.0% in the first half of 2008 compared to the same period in 2007. An interesting fact is that the increase in the total industrial production volume was throughout that period strongly supported by a marked rise in printing. Energy supply recorded high annual growth rates in the first half of the year, but this was primarily due to the base effect. On the other hand, mining and quarrying recorded divergent trends: other mining and quarrying grew, boosted by buoyant construction activity, whereas extraction of crude oil and natural gas had a negative annual rate of change. The mining and quarrying annual rate of change was negative in the observed period due to the production drop in some activities and the base effect.

Figure 5 Gross Value Added in Industry and Construction

trend-cycle



Source: CBS.

Construction activity surged in the first half of 2008, with its GVA growing at an annual rate of 7.7% in the first and accelerating to 10.4% in the second quarter. The seasonally adjusted total volume of construction works, measured by total working hours done on buildings, increased by 12.5% in the observed period relative to the same period in the previous year. Building construction, especially construction of sports and tourism facilities, had a very strong growth. In contrast, demand for housing real estate weakened, as evident from a slowdown in loans granted and a decrease in real estate investments planned by households. Civil engineering works increased more moderately than building construction in the first half of the year due to reduced government investments in transport infrastructure.

Non-Financial Services

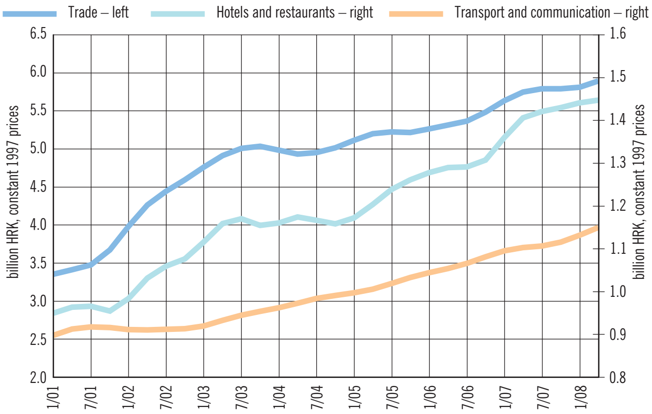
As household consumption declined, real GVA in trade continued to decelerate in the first half of the year. This was especially evident in the second quarter when real private consumption dropped in absolute terms. The annual GVA growth rate slowed from 4.8% in the last quarter of 2007 to 4.1% early in 2008, falling to a low of 1.8% in the April to June period. According to CBS data on distributive trade, both wholesale and retail trade turnover decelerated. Total retail trade turnover increased annually by 2.0% in the first six months, with the largest contribution to the increase coming from the turnover in motor fuels and lubricants and in motor vehicles.

GVA in hotels and restaurants rose at an annual rate of 7.1% in the first quarter and decelerated to only 1.6% in the second quarter, mainly due to the base effect. Specifically, the Easter holidays, usually triggering an increase in tourist demand, were in March this year, and not in April as in 2007. Consequently, volume indicators on demand for tourist services increased sharply in the first quarter and stagnated in the second quarter. The said developments can also be partly related to the European Football Championship. Tourist nights and arrivals thus increased by 1.9% and 1.6% respectively relative to the same period in 2007. It must be mentioned that this activity's GVA comprises only a part of the direct effects of tourism on the domestic economy, while no precise assessment can be made of its direct effects on other activities and indirect effects on the overall economy. Accordingly, the 0.1 percentage point contribution of hotels and restaurants to total GVA in the first half of the year does not give a true estimate of the effects of tourism on real economic developments.

5 The seasonally adjusted data exclude the short-term effects produced by common intra-annual economic and non-economic factors on the observed time series (e.g. holiday spending). The calendar adjustment refers to the elimination of differences in the number of working days which can to some extent account for the differences in output levels due to the lower number of hours worked.

Figure 6 Gross Value Added in Trade, Hotels and Restaurants, and Transport and Communication

trend-cycle



Source: CBS.

GVA in transport, storage and communications was 6.5% higher in the period from January to June 2008 than in the same period in the previous year. A quarterly breakdown shows that it increased at a faster rate in the April to June period. GVA in this activity was in the first half of 2008 in a great measure boosted by a rise in passenger traffic, on the increase in the second quarter to some extent probably due to the European Football Championship. However, goods transport trends are hard to assess precisely as comparability with historical data was made impossible due to a revision of the statistical survey on the road transport of goods inclusive of transport for hire or reward and for own account.[6] Nevertheless, the annual increase in standardised (manipulated) tonnes of goods recorded in the observed period in the transhipment of goods points to a growth of goods transport. As regards telecommunication services, the CBS has since 2008 been receiving data from the Croatian Telecommunication Agency and the historical data series on the number of minutes spent in the fixed and mobile networks has been revised since 2006. However, these data have not been included in regular CBS releases so that trends in demand for these services cannot be consistently monitored, although it is safe to assume that spending on mobile telephony continues to trend positively.

[6] The revision was conducted in January 2008. The most important methodological change relates to the changed sampling stratification so vehicles are distributed into new classes by loading capacity.

4 Labour Market

Indicated by administrative data at the beginning of the year, positive labour market trends were confirmed by the latest Labour Force Survey results and continued throughout the second quarter of 2008. Specifically, according to CES and CBS administrative data, unemployment continued to drop and employment to increase in the second quarter, although at slower rates than at the beginning of the year, which is attributable to the slowdown in economic activity in that period.

The slowdown in the annual growth of nominal gross and net wages paid out in the second quarter of this year, coupled by an increase in the CPI, resulted in the slowdown in real gross and net wages. Under the Act on Amendments to the Income Tax Act, adopted in June 2008, the basic personal allowance was as of July increased from HRK 1,600 to HRK 1,800 per month and the minimum wage was under the Minimum Wage Act raised from HRK 2,441.25 to HRK 2,747.00.

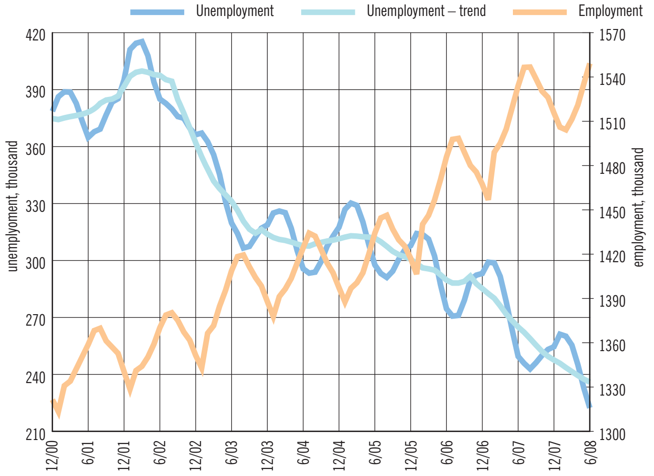
4.1 Employment and Unemployment

According to CES data, the registered unemployment in the first half of 2008 continued on the downward trend started already in early 2005. The drop in unemployment was more marked at the beginning of the year and slowed towards the middle. In the first six months of this year, unemployment was dropping at double-digit annual rates, with the result that registered unemployment stood at 222,290 at the end of June, a decrease of 27,300 (10.9%) from the end of June in the previous year.

Registered unemployment trends were in the first half of 2008 influenced by a reduced inflow into the CES register, which was very low in March and the lowest ever in May. Unemployment registered with the CES stood at 84,600 in the first six months of this year, a decrease of 6,300 (6.9%) from the same period in the previous year. In addition to the decrease in inflow, also registered was a decrease in outflow, both regarding employment from the register and removal from the register for reasons other than employment. Notwithstanding the annual decrease in the number of employed persons and persons removed from the register, the outflow level which remained high in the first half of the year was insufficient to change or make a significant impact on the downward trend in registered unemployment in that period. Total employment from the CES register stood at 75,800 in the first half of 2008, dropping by 9,600 (11.3%) from the first half of last year. The number of persons deleted from the register for the reasons other than employment, e.g. due to failure to report regularly, failure to meet legal requirements, registration cancellation, change of status, etc., also dropped in the said period and remained low.

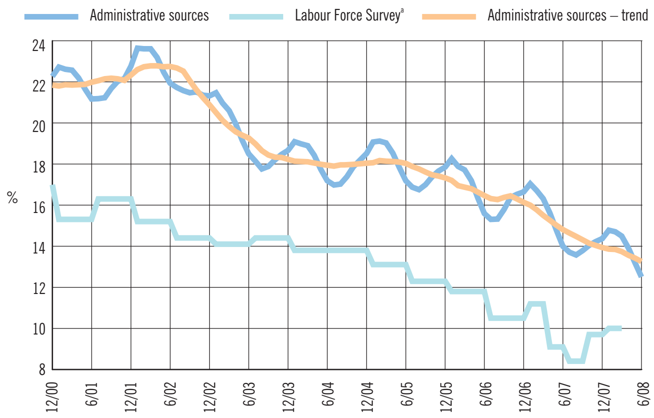
While data on employment from the register point to a drop in employment intermediated by the CES, preliminary CBS data and data on the number of insured with the CPIA suggest an annual increase in total employment. According to preliminary CBS data, average employment was 1,521,200 in the first half of 2008, while total employment increased annually by 1.4% in that period. However, the annual growth rate was calculated based on the revised data on employment for the period until January 2008 and on the preliminary data for the subsequent period and it is likely to increase following the revision of preliminary employment data for 2008 that is expected in April 2009. The number of insured with the CPIA, a reliable short-term employment indicator, shows that employment grew at an annual rate of 2.6% in the observed period.

Figure 7 Employment and Unemployment



Sources: CBS and CES.

Figure 8 Administrative and Labour Force Survey Unemployment Rates



[a] The Labour Force Survey is published quarterly since the beginning of 2007.

Source: CBS.

As shown by CBS data, the increase in employment in legal entities made the largest contribution to total employment growth in the first six months of this year. Employment in crafts and trades and free lances also made a positive contribution to total employment growth. However, this contribution was offset by the negative contribution of private farmers insured with the CPIA, whose numbers continued to decline in the observed period. The total employment structure by the NCEA shows that the contribution of individual activities remained largely the same as last year. The largest increase in employment was recorded in real estate, renting and business activities, financial intermediation and wholesale and retail trade. Employment in total public administration, inclusive of the narrowly defined public administration, education and health care and social welfare, increased annually, spurred by positive developments in all the three sectors. In contrast, mining and quarrying and manufacturing recorded the steepest annual drop in employment, which was in line with the weakening of domestic and foreign demand for industrial goods, confirmed by the reduced contribution of these activities to real GVA in the first half of 2008 relative to the same period in 2007.

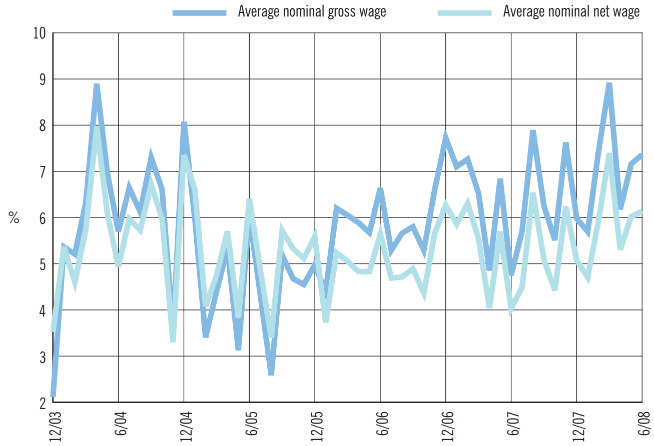
As of the beginning of 2007, the Labour Force Survey results have been released quarterly so that the latest results available at the time of writing this report relate only to the first quarter of this year, whereas the results for the second quarter are planned to be released in November. The available Labour Force Survey results show positive annual trends, including a decrease in unemployment and an increase in employment. According to the Survey's figures for the January to March period, unemployment stood at 176,000, dropping by 21,000 (10.7%) from the same period last year, whereas employment averaged at 1,591,000, a decrease of 28,000 (1.8) relative to the same period last year. The Labour Force Survey figures for the first quarter corroborated the trends announced by administrative sources and the second quarter indicators are anticipated to follow suit. In line with described labour market trends, the registered unemployment rate continued to drift downwards, reaching 13.2% in the second quarter of 2008 (down 1.5 percentage points over the first quarter). According to the latest results, the Labour Force Survey unemployment rate stood at 10.0% in the first quarter of 2008, down by 1.2 percentage points from the first quarter last year.

4.2 Wages and Labour Costs

Having accelerated in the first quarter, nominal wages slowed annually in the second quarter; gross wages were down from 7.3% in the first to 6.9% in the second quarter, whereas net wages declined from 6.0% to 5.8% in the same period. Under the Act on Amendments to the Income Tax Act [7] from June 2008, the basic personal allowance, i.e. the non-taxable portion of income of taxpayers in employment, was raised from HRK 1,600 to HRK 1,800, and that of pensioners from HRK 3,000 to HRK 3,200 per month. These amendments were complemented by an increase in personal allowance for dependent members of immediate family and children, disability of taxpayers and immediate family members, and in the limitations on dependent family members' receipts. The amendment to the Income Tax Act, applying to all payments made after 1 July 2008, made an impact on the wages for June paid out in July, confirming acceleration in the annual growth of net wages and deceleration in gross wages. Net wages thus increased at a higher rate than gross wages for the first time since the Income Tax Act came into effect in 2005.[8] June also saw the enactment of the Minimum Wage Act[9], which increased the minimum wage by HRK 306, from HRK 2,441.25 to HRK 2,747.00.

Figure 9 Average Nominal Wage

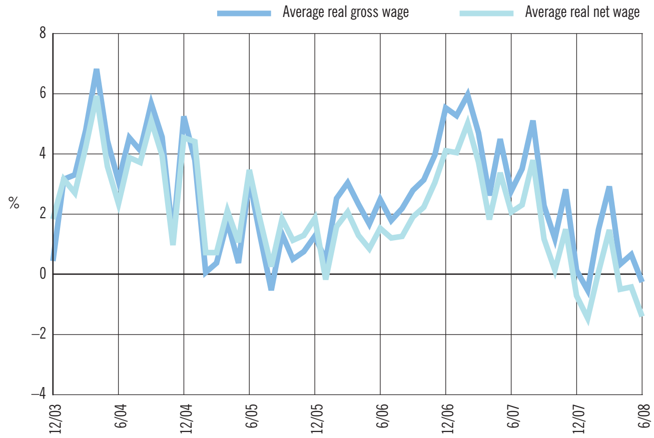
year-on-year rate of change



Source: CBS.

Figure 10 Average Real Wage

year-on-year rate of change



Source: CBS.

Real wages slowed annual growth from 1.3% in gross terms in the first quarter to 0.2% in the second quarter. Real net wages mainly recorded negative annual rates of change in the first six months and also decelerated, with a negative annual rate of change of 0.8% in the second quarter. The annual slowdown in real wages in the second quarter from the beginning of the year resulted from the annual slowdown in nominal wages and the accelerated growth of the CPI in the stated period.

These real wage trends in the second quarter were due to the wage slowdown in almost all activities, with some wages recording negative annual rates of change. These trends were primarily due to private sector activities, e.g. hotels and restaurants, real estate, renting and business activities, construction and manufacturing. However, in contrast with private sector wages, real gross wages in total public administration (including education, health care and social welfare) accelerated annually. Nevertheless, wage growth slowed considerably in the first half of 2008 relative to the first half of 2007, although, due to their high levels early in the year, only hotels and restaurants and financial intermediation had negative rates of change. The annual growth rate of the average real gross wage in industry slowed down from 1.9% in the first quarter to –0.2% in the second quarter, predominantly due to the decrease in mining and quarrying.

[7] OG 73/2008.

[8] OG 177/2004.

[9] OG 67/2008.

5 Prices

CPI inflation increased in the first six months of 2008, which was to a large extent due to the price rise of crude oil, food raw materials and metal on the world market. In addition to imported inflationary pressures, domestic cost-push inflationary pressures also grew, as indicated by the acceleration in the annual growth rate of unit labour costs for the total economy.[10] The inflation increase was also attributable to a rise in domestic demand in 2007, which had a time-lagged effect on price trends in the first half of 2008. The appreciation of the kuna/euro exchange rate had an impact on easing inflationary pressures in the domestic economy since it stabilised inflationary expectations and alleviated the pressures arising from the price increase in consumer goods and raw materials imported from the eurozone.

Consumer Prices

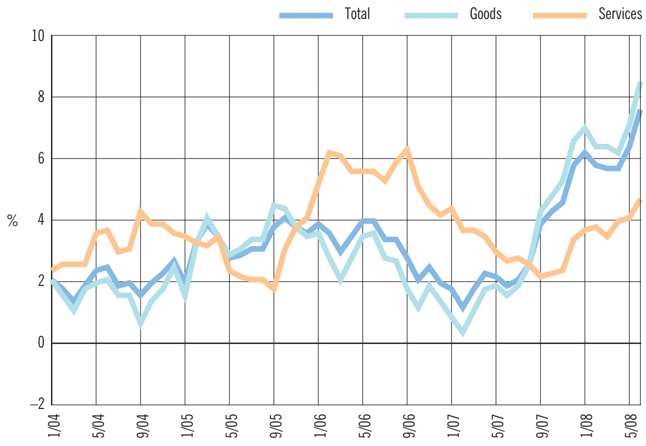
Annual inflation was 7.6% in June 2008, up by 1.8 percentage points from 5.8% in December 2007. Core inflation remained lower than overall CPI inflation, but its annual rate of change went up from 5.0% in December 2007 to 6.5% in June 2008. The increase in core inflation in the observed period was primarily due to the price growth of food products (meat, bread and cereal products).

The increase in the CPI inflation rate in the first half of 2008 was mainly caused by the rise in energy and food products' prices. The annual rate of change in energy prices grew from 5.2% in December to 11.6% in June 2008, due in the first place to the price increase in refined petroleum products, brought about by the surge in crude oil prices on the world market. The appreciation of the kuna/US dollar exchange rate alleviated some of the upward pressures on domestic refined petroleum products prices.

Having risen sharply in the second half of 2007, food prices continued to grow, although at a somewhat subdued pace, in the first six months of 2008. The annual rate of change in processed food prices thus increased from 10.5% in December 2007 to 12.6% in June 2008, primarily due to the price growth of bread and cereal products and to a small extent to the price increase in oil and milk and dairy products. The annual rate of change in fresh food prices grew from 9.3% in December 2007 to 10.8% in June

Figure 11 Consumer Price Index

year-on-year rate of change



Source: CBS.

[10] The annual growth rate of the average nominal compensation per employee accelerated in the first half of 2008 relative to the one in the same period in the previous year and exceeded the labour productivity growth rate.

2008, with the largest contribution to the growth coming from the price increase in meat, brought about by the prices rise of animal feed (e.g. corn). In contrast, the annual growth rate of vegetable prices slowed down in the first six months of this year.

Table 1 Consumer Price Index, classification of personal consumption by purpose

year-on-year rate of change

	Weight 2008	12/2007	1/2008	2/2008	3/2008	4/2008	5/2008	6/2008
Total	**100.0**	**5.8**	**6.2**	**5.8**	**5.7**	**5.7**	**6.4**	**7.6**
Food and non-alcoholic beverages	31.8	10.7	11.2	9.9	9.6	9.6	10.9	13.1
Alcoholic drinks and tobacco	5.5	6.4	6.5	6.4	6.6	7.1	5.4	5.3
Clothing and footwear	8.4	5.1	3.9	3.8	3.8	3.2	3.1	2.8
Housing, water, energy, gas and other fuels	14.2	3.9	4.9	4.8	4.7	4.6	5.3	5.9
Furniture, equipment and maintenance	5.3	3.0	3.4	3.8	4.0	4.5	4.8	5.3
Health	2.8	1.3	4.2	3.8	3.9	5.5	5.7	5.5
Transport	11.4	4.7	5.7	5.5	5.7	5.0	7.0	10.0
Communication	4.2	–0.3	–1.3	–1.3	–1.3	–1.3	–1.3	–1.3
Recreation and culture	6.1	1.8	1.9	1.2	0.3	0.2	0.3	1.9
Education	1.0	2.3	2.3	2.8	2.8	2.8	2.8	2.6
Catering services	3.5	2.4	3.0	3.8	5.0	5.2	6.2	6.6
Miscellaneous goods and services	5.8	4.4	3.7	3.9	4.0	4.4	4.1	4.3
Goods	**76.9**	**6.6**	**7.0**	**6.4**	**6.4**	**6.2**	**7.1**	**8.5**
Services	**23.1**	**3.4**	**3.7**	**3.8**	**3.5**	**4.0**	**4.1**	**4.7**

Source: CBS.

Table 2 Consumer Price Index, the five main categories of products

year-on-year rate of change

	Weight 2008	12/2007	1/2008	2/2008	3/2008	4/2008	5/2008	6/2008
Total	**100.0**	**5.8**	**6.2**	**5.8**	**5.7**	**5.7**	**6.4**	**7.6**
Energy	13.6	5.2	6.4	6.2	6.3	5.6	9.0	11.6
Fresh food	14.6	9.3	9.1	6.7	5.9	5.7	7.7	10.8
Processed food	22.8	10.5	11.4	11.2	11.4	11.6	11.7	12.6
Industrial non-food without energy	28.5	2.8	3.3	3.3	3.2	3.1	2.6	2.7
Services	20.5	2.8	3.0	3.0	3.1	3.5	3.6	4.4

Note: In order to analyse the consumer price inflation trends, the ECB uses the classification which divides the product basket into five main categories. In this classification, the basic product groups differ to some extent from those in the Classification of Individual Consumption by Purpose (COICOP). Hence, for example, the price of water is excluded from the index of services prices, calculated in accordance with the product basket divided into five main categories, and included in the index of goods prices.

Source: CBS.

Services prices increased more in the first six months of this year than in the same period in 2007 and their annual rate of change went up from 2.8% in December to 4.4% in June 2008. The overall services price index, broken down into components, points to a spillover effect from the price increase in food products to the prices of services in whose production they play an important role. Services prices were thus mainly boosted by the price increase in catering services and primarily in meals and drinks provided by restaurants. The indirect effects from the price increase in refined petroleum products were, with the time lag, reflected on price developments in transport services. For example, transport services prices rose markedly in the first half of 2008, mainly on account of the price growth of passenger transport by road. In addition, the acceleration in the annual growth rate of services prices was in a small degree due to the increase in the annual rate of change in the prices of public utility services (local rates and garbage and waste disposal prices) and health services. The opposite effect on services price trends was produced by the fall in the annual rate of change in communication services prices.

The annual rate of change in the prices of industrial non-food products excluding energy, which account for a considerable share (28.5%) in the CPI basket, drifted down from 2.8% in December 2007 to 2.7% in June 2008. The upward pressure on the prices of this product group, mainly arising from the price increase in household maintenance products and drugs, was offset by the price drop of clothing and footwear and cars.

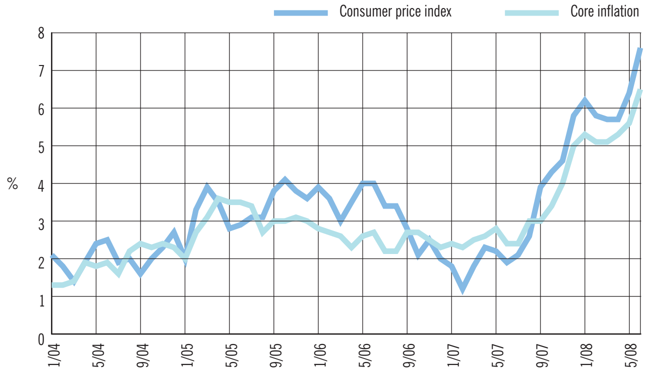
Import Prices

The surge in world crude oil prices continued from 2007 into the first six months of this year. The average price of crude oil increased by 46.9% in that period, from USD 89.5 per barrel in December 2007 to USD 131.5 per barrel in June 2008, with the daily price of Brent crude reaching USD 139.9 in late June. The increase was lower in kuna terms (36.5%) due to the nominal appreciation of the kuna/US dollar exchange rate. The crude oil price increase in the observed period is primarily attributable to escalating geopolitical tensions, market concerns over the drop in the US crude oil and refined petroleum products reserves and an increase in funds' commodity market investments.

Imported inflationary pressures on domestic consumer prices also came from the price growth of other raw materials on the world market, especially of food products (cereals and oilseeds), coal and iron ore. The annual rate of change in the HWWI index, which measures raw materials price trends in the world market (excluding energy, in US dollar terms), increased from 10.0% in December 2007 to 27.0% in June 2008. Furthermore, eurozone producer price inflation accelerated significantly. The annual rate of change in eurozone producer prices went up from 4.4% in December 2007 to 8.1% in June 2008, predominantly due to the price increase in energy and intermediate goods.

Figure 12 Consumer Price Index and Core Inflation[a]

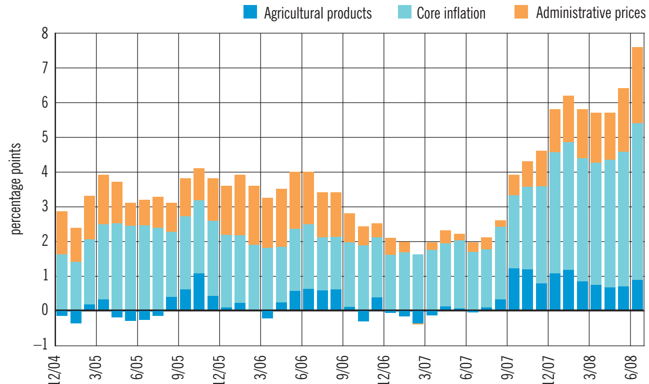
year-on-year rate of change



[a] Core inflation is calculated by excluding agricultural product prices and administrative prices (which include, among others, electricity and refined petroleum product prices) from the CPI basket of goods and services.

Source: CBS.

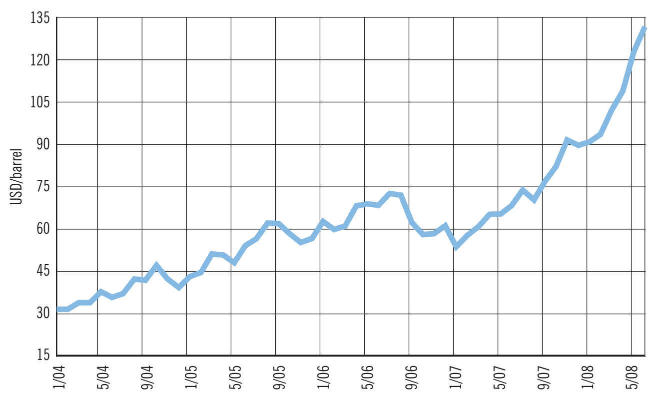
Figure 13 Contribution[a] of CPI Components to Year-on-Year Inflation Rate



[a] The contribution is defined as the relative importance of a CPI component for total inflation. The sum of contributions of all components expressed in percentage points in a relevant month is the amount of the annual consumer price inflation rate.

Sources: CBS and CNB calculations.

Figure 14 Average Crude Oil Prices[a] on the World Market



[a] Calculated as an average of the following oil prices (prompt delivery): Dubai Fateh, UK Brent and West Texas Intermediate.

Source: Bloomberg.

Industrial Producer Prices

Continuing on an upward trend from June 2007, domestic industrial producer price inflation accelerated in the first six months of this year and its annual rate of change grew from 5.8% in December 2007 to 9.6% in June 2008. The largest increase was recorded in energy and intermediate goods prices because of the surge in world prices of crude oil and other raw materials. The price rise of intermediate goods in the observed period was considerably boosted by the price growth of metal, attributable to the global price increase in these raw materials in the previous period. Durable and non-durable consumer goods prices also rose markedly, suggesting a spillover effect from the price increase in energy and intermediate products to final consumption goods in that period.

International Comparison of Consumer Prices

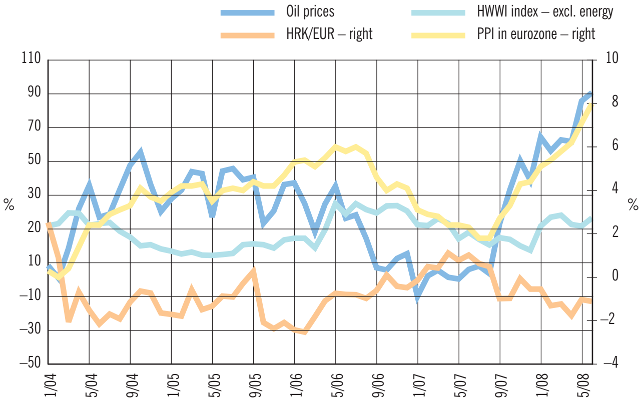
Standing at 7.6% in June 2008, Croatia's annual consumer price inflation rate exceeded the rates in the eurozone (4.0%), Slovakia (4.3%), Poland (4.3%), the Czech Republic (6.6%), Hungary (6.6%) and Slovenia (6.8%) and was lower than the rates recorded in Latvia (17.5%), Bulgaria (14.7%), Lithuania (12.7%), Estonia (11.5%) and Romania (8.7%), when considering all Member States.

The main reason why Croatia's consumer price inflation rate exceeded the eurozone rate by a significant 3.6 percentage points can be found in the difference between the contribution of food prices to the overall annual inflation rate in Croatia and that in the eurozone. Specifically, the June price increase in processed and fresh food was much higher in Croatia than in the eurozone,[11] and it was also higher in most of the CEE member states. ECB analysts have attributed the higher food price increase in the said countries to their weaker competition in retail trade and larger use of energy products in agriculture relative to the eurozone.

It also has to be mentioned that the relative share of food products and energy prices in total household expenses in Croatia is higher than that in EU Member States. In specific terms, food and energy prices account for 14.4% and 9.8% respectively in the CPI basket for the eurozone, while in Croatia this share is much higher, 20.1% and 13.6% respectively.

Figure 15 Imported Inflation: Oil Prices, the HWWI Index[a], the Average Kuna/Euro Exchange Rate and Producer Prices in the Eurozone

year-on-year rate of change

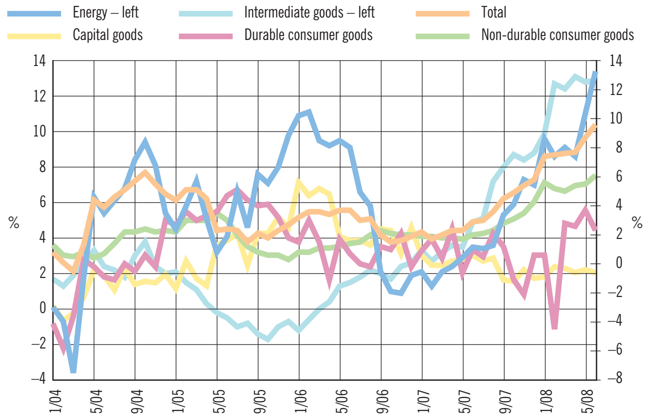


[a] The Hamburg Institute of International Economics (HWWI) constructed the aggregate index of raw materials prices in the world market, the so-called HWWI index. The HWWI index is the indicator of movements in costs for imported raw materials (it includes a total of 29 raw materials or 27 excluding energy) and it is used in analysing the influence of changes in the prices of raw materials in the world market on the changes in prices in industrial countries The index is calculated on the basis of raw materials prices expressed in US dollars.

Sources: Bloomberg, HWWI, Eurostat and CNB.

Figure 16 Producer Price Index by Main Industrial Groupings

year-on-year rate of change



Source: CBS.

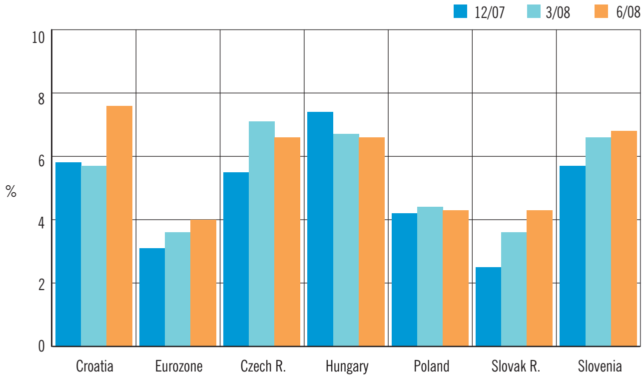
[11] In June 2008, Croatia's annual growth rate of fresh food prices stood at 10.8%, compared with 4.0% in the eurozone, whereas the annual growth rate of processed food stood at 12.6% in Croatia and at 7.0% in the eurozone. In contrast, Croatia's annual growth rate of energy prices of 11.6% in June was exceeded by the eurozone rate of 16.1%.

Real Estate Prices

In the first half of 2008, the domestic real estate market was marked by the continued slowdown in the annual growth rate of residential real estate prices, which dropped to 5.8% from 9.0% in the previous half of the year. These trends were due to a marked fall in the annual growth rate of residential real estate in Zagreb, from 9.4% in the second half of 2007 to only 1.8% in the first half of 2008. In contrast, residential real estate prices on the Adriatic grew at an accelerated rate, up from 10.9% in the second half of 2007 to 13.5% in the first half of 2008.

Figure 17 HICP in the Eurozone and Selected EU Countries and CPI in Croatia

year-on-year rate of change



Sources: CBS and Eurostat.

The real annual rate of change in newly granted home loans in Croatia reduced from 9.2% in the second half of 2007 to –3.2% in the first half of 2008, which can be taken as an indication of a decrease in demand for real estate. The upward trend in interest rates on home loans granted to households is an important factor influencing the slowdown in demand for these loans. The nominal interest rate on home loans increased by 1.0 percentage point during the last year, from 4.9% in June 2007 to 5.9% in June 2008.

Table 3 Croatia's Residential Real Estate Price Index

year-on-year rate of change

	Weight	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2006		2007		2008
												1st half	2nd half	1st half	2nd half	1st half
Croatia	100.0	6.4	0.8	–1.9	6.9	1.8	0.4	12.9	8.8	16.3	13.2	15.1	17.5	17.7	9.0	5.8
Zagreb	65.3	6.2	1.9	–1.4	–5.1	6.5	0.7	11.5	10.0	17.0	11.8	16.1	17.8	14.4	9.4	1.8
Adriatic Coast	22.0	6.0	–2.5	–6.8	26.7	5.6	8.6	9.1	16.6	15.2	17.0	14.4	16.0	23.8	10.9	13.5

Note: The methodology used for compiling the hedonic index of real estate prices in Croatia is such that each calculation of the new value of the index (at the end of a semi-annual period) involves a reassessment of all the parameters of real estate prices achieved by the given equations, which, in turn, results in a revision of the real estate price index for the previous semi-annual and annual periods. Therefore, the indices from the previous years are altered with each update, but are also more precisely measured, being calculated by a larger number of data.

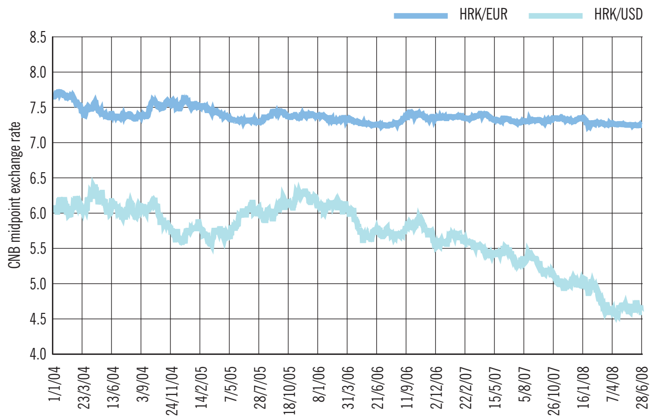
Sources: *Burza nekretnina* and CNB calculations.

6 Exchange Rate

The nominal exchange rate of the kuna appreciated by 1.1% versus the euro in the first six months of 2008, rising from HRK 7.33/EUR on 31 December 2007 to HRK 7.25/EUR on 30 June 2008. The exchange rate of the kuna appreciated more significantly in the second half of January because of a drop in the kuna liquidity of the financial system, prompting the CNB to offset the nominal appreciation of the domestic currency by purchasing EUR 189.1m from banks on 31 January and creating HRK 1.4bn. The nominal kuna/euro exchange rate was relatively stable during the following five months, fluctuating within a range of between HRK 7.23/EUR and HRK 7.29/EUR. Mild appreciation pressures in the period after the end of January were primarily generated by seasonal factors (an increase in demand for the kuna around the Easter holidays and strong foreign currency inflows from tourism). These appreciation pressures were to some extent counterbalanced by an increase in corporate demand for foreign exchange. The central bank carried out no foreign exchange auctions for five months after the auction in late January so banks obtained required foreign exchange at reverse repo auctions. As part of the foreign exchange transactions conducted with the government in the first half of 2008, the CNB sold EUR 20.2m net to the MoF and withdrew HRK 139.2m.

In the first six months of 2008, besides appreciating nominally by 1.1% against the euro, the kuna exchange rate appreciated by a considerable 7.8% against the US dollar and by 8.4% against the pound sterling, depreciating by 2.2% against the Swiss franc. Due to these kuna exchange rate trends, the index of the

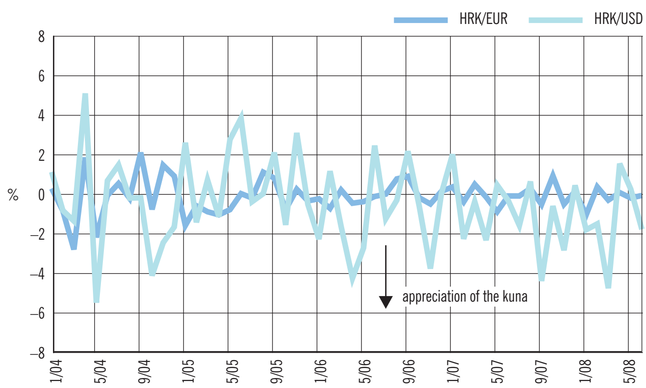
Figure 18 Daily Nominal Exchange Rate – HRK vs. EUR and USD



Source: CNB.

Figure 19 Rates of Change of the Nominal Exchange Rate – HRK vs. EUR and USD

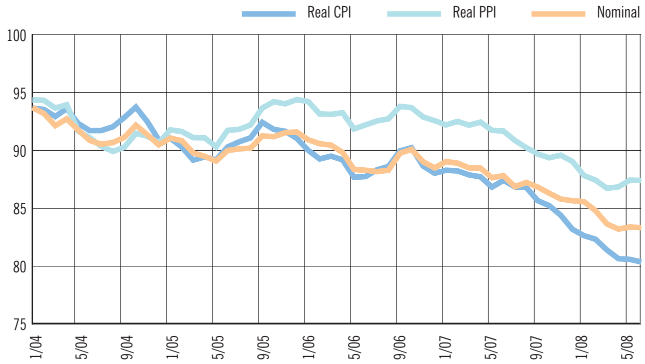
month-on-month, CNB midpoint exchange rate



Source: CNB.

Figure 20 Indices[a] of the Nominal and Real Effective Exchange Rate of the Kuna with Consumer and Producer Prices

2001 = 100



[a] The fall in in the index denotes an appreciation of the kuna.

Source: CNB.

daily nominal effective exchange rate of the kuna appreciated by 3.0% against the basket of currencies in the period from 31 December 2007 to 30 June 2008.

The data on the trends in the real effective exchange rate of the kuna in the first half of 2008 point to a slight deterioration in the price competitiveness of exports. The index of the real effective exchange rate of the kuna deflated by consumer prices appreciated by 3.4% in the observed period, which was higher than the appreciation of the average monthly index of the nominal effective exchange rate of the kuna (2.7%) due to a faster growth of domestic consumer prices relative to foreign consumer prices (in the eurozone, Switzerland and Great Britain) in that period. The nominal appreciation of the effective exchange rate of the kuna primarily resulted from the strong appreciation of the kuna exchange rate versus the US dollar. In contrast, the index of the real effective exchange rate of the kuna deflated by producer prices appreciated at a lower rate (1.8%) due to a slower growth of domestic producer prices than foreign producer prices (in the US and Great Britain).

7 Monetary Policy and Monetary Developments

In 2008, the Croatian National Bank continued to use the same instruments of monetary policy as in 2007. Banks' credit activities remained regulated by the Decision on the purchase of compulsory CNB bills. As in 2007, growth exceeding 12% was considered excessive credit growth. At the same time, banks' foreign borrowing was penalised by the marginal reserve requirement. Banks were thus encouraged to substitute their foreign liabilities for domestic deposits and capital.

The central bank continued to pursue the policy of stable exchange rate of the domestic currency, which, following a somewhat more pronounced appreciation early in the year, moved within a range of HRK 7.23/EUR and HRK 7.35/EUR in the first six months of 2008. In the conditions of mounting inflationary pressures, the stability of the exchange rate of the kuna, together with more restricted money supply and credit activity, was the main element of CNB's anti-inflationary monetary policy activities.

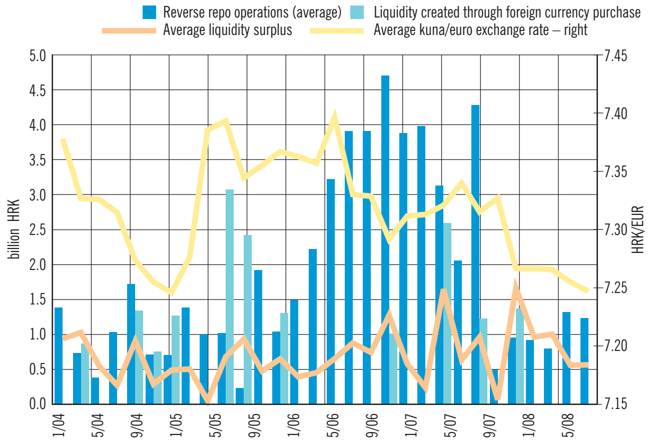
In addition to these monetary measures, the central bank adopted several important bank supervision measures. The Decision on the capital adequacy of banks imposes additional capital requirements on fast-growing banks as rapid credit growth entails the risk of deterioration in the quality of bank assets. Under the new decision, banks with growth rates exceeding the maximum permissible growth rate must have the capital adequacy ratio of over 12%; a 1 percentage point excess growth entails a 1.5 percentage point increase in the capital adequacy ratio. In addition, the Decision increases the risk weights used in the calculation of risk-weighted assets that are applicable to foreign currency denominated or indexed loans granted to debtors exposed to currency risk.

Following temporary orientation of banks towards foreign borrowing earlier this year, as a result of banks' adjustment to the new prudential measures and smooth operations in an environment characterised by limited liquidity, the first half of 2008 was marked by favourable changes in the structure of banks' liabilities. This refers most notably to a sharp increase in household savings and time deposits and further bank recapitalisation efforts leading to improved financial stability of the Croatian banking sector. On the other hand, credit activities of banks were within the limits prescribed by the central bank in the first half of the year.

7.1 Monetary Policy Instruments and Flows of Creating and Withdrawing Reserve Money

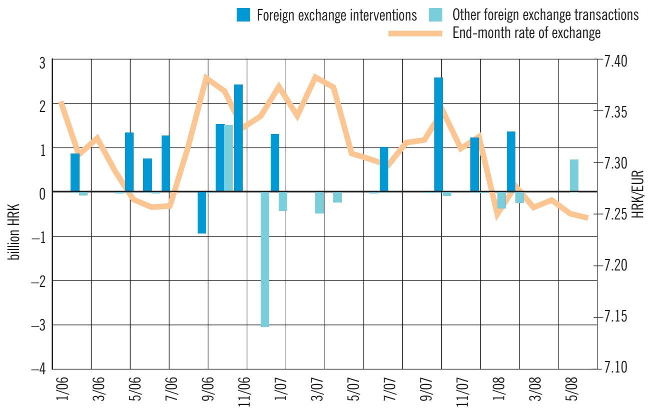
Regular reverse repo operations were the main instrument of kuna liquidity creation in the first half of 2008. However, it should be noted that their volume was smaller than last year as reserve money creation by the central bank was more restrictive given the growing inflationary pressures. Auction interest rates increased since auction turnover was lower, averaging HRK 1.0bn in the first six months or almost three times lower than in the same period in 2007. The marginal repo rate went up from 4.1% early in the year to 4.8% at the end of the first half of

Figure 21 Kuna Liquidity Creation through Reverse Repo Operations and Foreign Currency Purchase from Banks



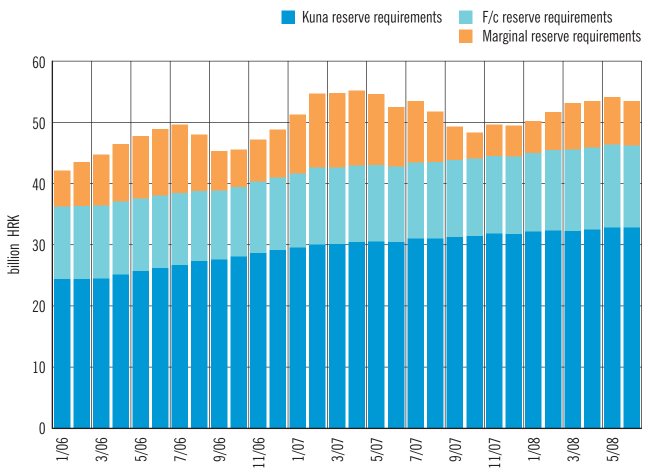
Source: CNB.

Figure 22 Foreign Exchange Transactions of the Croatian National Bank and Midpoint HRK/EUR Rate of Exchange



Note: The positive value of foreign exchange interventions and foreign exchange transactions relates to the repurchase of foreign exchange by the CNB.
Source: CNB.

Figure 23 Calculated Reserve Requirements



Source: CNB.

2008. Reverse repo operations were still the main instrument of managing short-term liquidity, contributing to stabilisation of imbalances in the money and foreign exchange markets.

Following strong appreciation pressures at the beginning of the year, there was no need for central bank interventions in the foreign exchange market since the exchange rate of the kuna against the euro was stable in the rest of the first half of 2008. The CNB intervened only once when it purchased from banks EUR 189.1m net at end-January to create HRK 1.4bn and forestall further appreciation pressures on the kuna. In its foreign exchange transactions with the Ministry of Finance, the CNB purchased EUR 20m net in the first six months of the year. However, this had little impact on kuna liquidity as it resulted in the creation of only HRK 140m net.

On several occasions early in the year, banks satisfied their liquidity needs by the Lombard facility. As part of its anti-inflationary actions, the central bank raised the interest rate on Lombard loans from 7.5% to 9.0%. Banks' liquidity was good in the first half of the year, with banks' free reserves in their transaction accounts averaging HRK 0.8bn, which is the usual level of surplus kuna liquidity.

Reserve requirements of banks increased in the first half of 2008 mostly due to rapid growth in household deposits, which increased the reserve requirement calculation base. The reserve requirement rate remained unchanged at 17%. Kuna reserve requirements grew by HRK 1.0bn in the first six months, to HRK 32.8bn, whereas foreign currency reserve requirements grew by HRK 0.8bn, reaching HRK 13.4bn in June. The growth in reserves that banks allocated to their accounts with the CNB in the period of low interest rates abroad and the related capital inflows that financed domestic credit expansion proved to be justified since in the period of uncertainty and risks associated with the global financial turmoil it serves as a buffer against difficulties in kuna and foreign exchange liquidity management of banks.

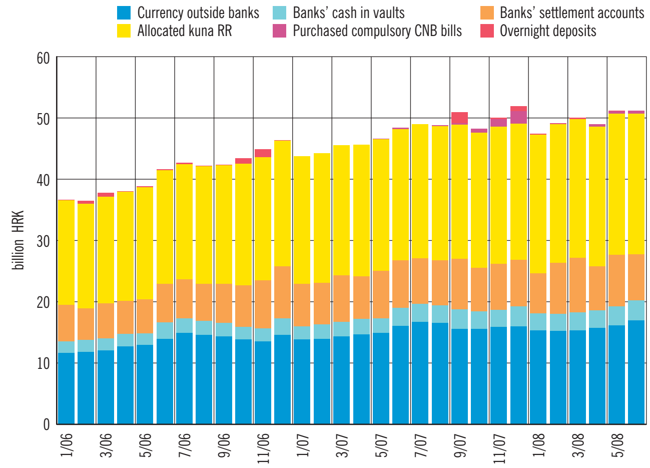
Foreign borrowing of banks in the first two months of 2008 led to the increase in marginal reserve requirements. These reserves held steady afterward and began their seasonal decline at the end of the first half of the year. Such developments are common for the beginning of the year when banks usually increase their foreign liabilities, while they use abundant inflows of domestic deposits in the rest of the year, particularly during the summer months, to reduce their foreign liabilities. On an annual level, the allocated marginal reserve requirements, which stood at HRK 7.2bn at end-June 2008, were one-fourth lower than in the same month last year. Such developments are a result of the overall effects of monetary policy instruments that, in addition to limited credit growth and increased recapitalisation efforts, encouraged banks to use free reserves to reduce external debt.

A more restrictive creation of kuna liquidity in the first six months of 2008 decelerated the increase in the narrowest monetary aggregate – reserve money M0. Its year-on-year rate of growth thus fell from 16.3% at the end of the first half of 2007 to 5.7% in June 2008. Reserve money growth was mostly fuelled by allocated kuna reserve requirements, which account for almost half of M0, and currency outside banks, which accounts for a third of reserve money. At end-June, reserve money M0 stood at HRK 51.2bn.

By applying the new CNB decision regulating bank placement growth in 2008, early in the year the CNB repurchased from banks compulsory CNB bills subscribed in 2007 on account of excessive credit growth, thus making immediately available a total of HRK 2.0bn. However, the central bank withdrew the thus-created liquidity in open market operations, which led to a temporary fall in reserve money. In the remainder of the first half of the year placement growth recorded by most banks was within the limits prescribed, with larger amounts of CNB bills subscribed only in April and May. The stock of subscribed CNB bills was HRK 435m at the end of the first half of 2008.

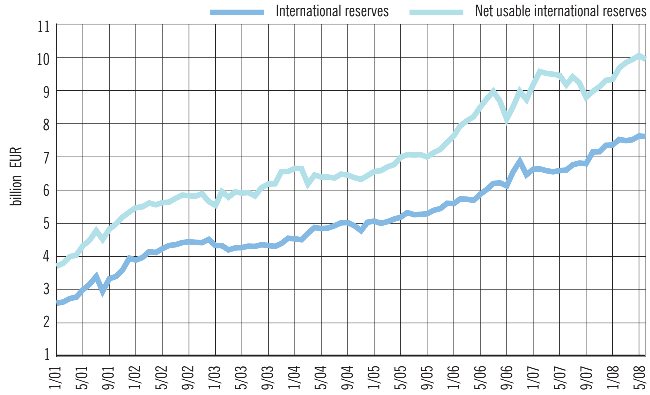
Gross international reserves of the CNB continued to grow steadily in the first six months of 2008. The increase was mainly due to foreign currency inflows arising from allocated foreign currency and marginal reserve requirements and, to a lesser extent, foreign currency repurchased from commercial banks and the central government. At end-June 2008, gross international reserves stood at EUR 9.9bn, which is an increase of EUR 634m or 6.8% compared with the end of 2007. In the same period, net international reserves which, among others, include banks' foreign currency funds deposited with the CNB, grew less rapidly, by 3.8% or EUR 265m, amounting to EUR 7.9bn at the end of the first half of 2008.

Figure 24 Structure and Developments in Reserve Money



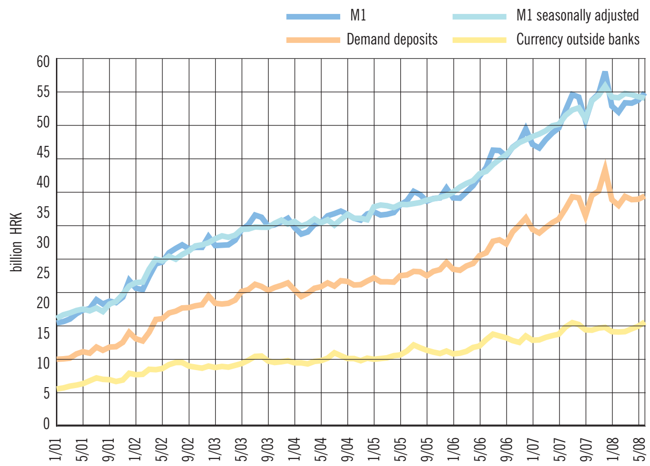
Source: CNB.

Figure 25 International Reserves of the CNB
at current rate of exchange



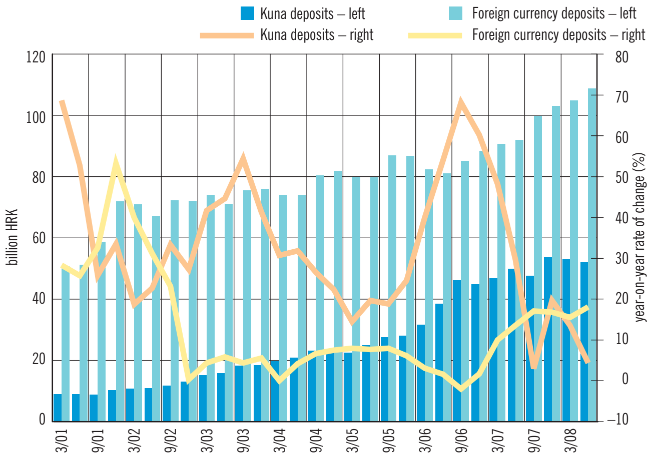
NUIR = international reserves – foreign liabilities – CNB bills in f/c – reserve requirements in f/c – government foreign currency deposits.
Source: CNB.

Figure 26 Money (M1)



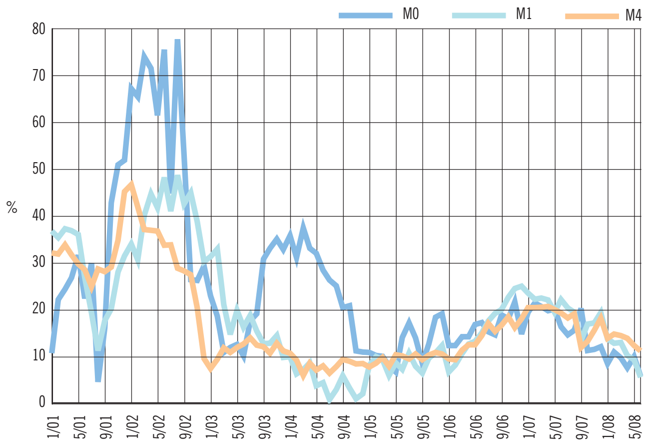
Source: CNB.

Figure 27 Kuna and Foreign Currency Deposits



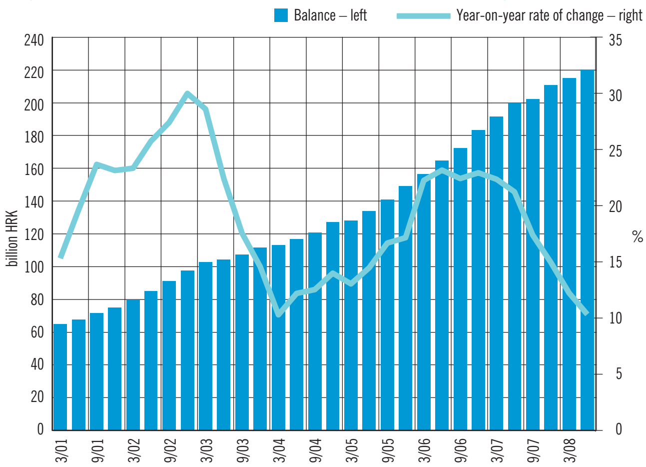
Source: CNB.

Figure 28 Monetary Aggregates
year-on-year rate of change



Source: CNB.

Figure 29 Banks' Placements to the Non-Banking Sector



Source: CNB.

7.2 Developments in Monetary and Credit Aggregates

Monetary developments in the first half of 2008 were marked by stagnation in total liquid assets (monetary aggregate M4) and a fall in money (monetary aggregate M1). Developments in net foreign assets of banks adversely affected growth in M4, while domestic bank placements boosted its growth. Growth in bank placements to the domestic non-banking sector was moderate, partly due to central bank measures aimed at limiting credit growth and partly due to weaker loan demand. In addition, central bank measures prompted banks to reduce their external debt. As a result of adverse developments in the capital market, the first half of 2008 also witnessed exceptionally robust growth in household savings and time deposits.

Money, a monetary aggregate that comprises demand deposits and currency outside banks, fell by nearly HRK 3.5bn in the first half of 2008. Its annual growth rate slowed from 19.3% at end-2007 to only 5.5% at end-June 2008.

Total savings and time deposits of all domestic sectors held with commercial banks continued to grow in the first half of 2008. Observed by sector, this increase was entirely the result of a strong increase in household deposits. They grew by almost HRK 9.0bn since the beginning of the year, much more than loans granted to this sector. As usual, foreign currency deposits accounted for the major portion (more than two-thirds) of the increase in household deposits. Total foreign currency deposits thus continued to grow strongly in the first half of the year, recording a high annual growth rate of 18.1% at end-June.

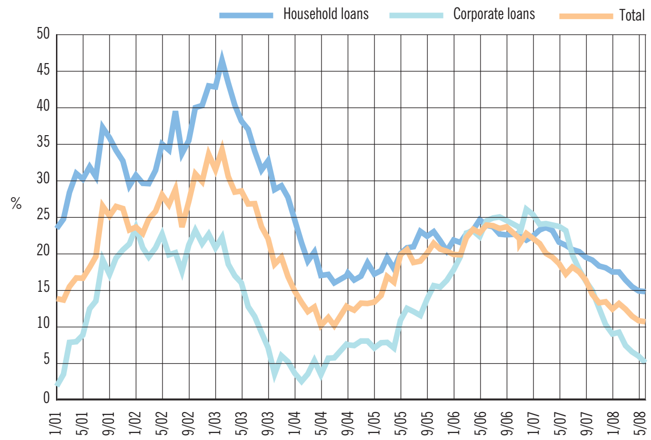
Corporate savings and time deposits fell by HRK 4.6bn in the first half of the year. This reduction was almost entirely due to a fall in kuna deposits, which was mainly caused by the T-HT dividend payment in May 2008. On an annual level, total kuna non-monetary deposits were 4.4% higher at end-June 2008 than at the end of the same month last year.

Since money decreased and savings and time deposits increased by almost the same amount, total liquid assets (M4) stagnated in the first half of 2008. This affected the annual growth rate of this broadest monetary aggregate; it steadily declined since the beginning of the year and stood at 11.1% at the end of June.

Following the successful implementation of central bank measures to curb bank lending in 2007, credit growth continued to decelerate in the first half of 2008. This may be attributed to changes on the loan demand side. The rise in bank lending rates, the overall economic slowdown, accelerating inflation, and changed expectations concerning future interest rate and inflation developments negatively affect the overall demand for loans. Bank placements thus grew by 4.5% in the first six months of 2008, while their permissible growth rate (that does not entail the purchase of compulsory CNB bills) for that period was 6%. The annual growth rate of total placements also fell further to 10.3% at end-June 2008.

Figure 30 Banks' Loans

year-on-year rate of change



Source: CNB.

The structure of placements by sector shows that bank lending to both households and enterprises slowed down in the first half of the year. Within household loans, home loans recorded the sharpest slowdown. Their growth averaged some HRK 0.4bn a month in the first six months of 2008, and was nearly halved compared with its monthly average in 2007. Among other types of loans, slower growth was recorded by other non-purpose loans and car purchase loans, while a slight acceleration was recorded only by credit card loans.

In the first half of 2008, the central government continued to raise the funds needed in the domestic market. Total government liabilities to banks thus grew by HRK 1.7bn in the first half of the year, the bulk of which related to bank loans. To facilitate central government funding in the domestic market (a syndicated foreign currency loan of EUR 760m), the central bank amended the Decision on the minimum required amount of foreign currency claims at end-May, thus freeing a part of foreign currency funds for the banks. Central government deposits with banks grew by HRK 2.5bn in the first six months of 2008 so that banks' net claims on the central government fell by HRK 0.8bn in that period.

Although banks temporarily resorted to foreign financing in the first several months of 2008 in response to tighter liquidity conditions, their foreign liabilities declined in the following months. Banks' foreign liabilities fell by HRK 0.9bn in the first six months. Such developments confirm that central bank measures were effective and led to a reduction in the external debt of banks. Due to the cut in the minimum required rate of foreign currency claims from 32% to 28.5%, banks' foreign assets decreased by HRK 8.9bn in the first half of the year. On an annual level, banks' net foreign assets were 24.0% higher at end-June 2008 than at the end of the same month last year.

8 Money Market

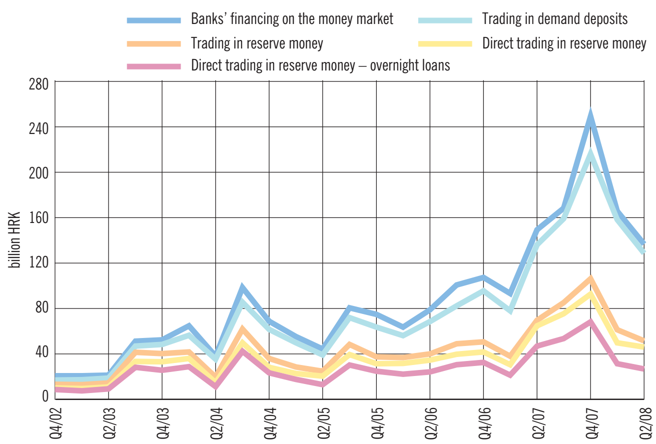
A larger part of the first half of 2008 saw favourable banking system liquidity, accompanied by reduced level and volatility of interest rates in overnight money trading, relative to their high levels recorded at end-2007. In contrast to the money market interest rate movements, interest rates at MoF T-bill auctions continued to grow in the first six months of 2008 due to a somewhat poorer investors' interest, reaching their record high since mid-2005. The stock of subscribed T-bills in the first half of the year moved around the 2007 year-end level of HRK 11.7bn, which is also the stock amount in June 2008.

As a result of an accelerated EURIBOR growth, hitting its record high in the last seven years, and monetary policy tightening in the first half of 2008 the upward trend of the banks' lending interest rates on long-term loans continued. Such a trend was most evident in interest rates on long-term household loans. In contrast, interest rates on individual short-term loans were slightly reduced, retaining their commonly high volatility. Interest rates on household time deposits rose slightly, while those on corporate time deposits fell considerably, from their high levels recorded at end-2007.

8.1 Money Market Interest Rates

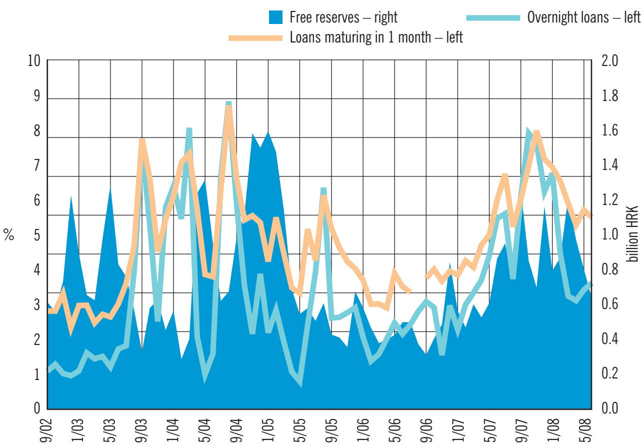
Favourable banking system liquidity in the first half of 2008 contributed to a reduction of turnover in the money market, where banks financed their primary liquidity in the average daily amount of HRK 2.4bn (a total of HRK 302.5bn in the entire semi-annual period), which is HRK 0.9bn less than the record turnover recorded in the second half of 2007. Accordingly, banks were financed on the money market by a total of HRK 115.0bn less than in the previous six-month period, which can mostly be accounted for, on an individual basis, by a considerable fall in a category of trading that is traditionally most important, i.e. interbank trading in reserve money, of HRK 78.6bn, although a fall was also recorded in majority of other money market trading categories. The only exception to such general movements is trading in demand deposit with other legal persons, which continued its steady growth. Out of a total of HRK 302.5bn kuna loans received by banks on the money market, the largest portion referred to loans in demand deposit trading (HRK 287.1bn), as usual, whereas funds in the amount of HRK 12.0bn and HRK 3.4bn were collected by the purchase of repo agreements and sale of securities, respectively. As

Figure 31 Money Market Turnover
quarterly data



Source: CNB.

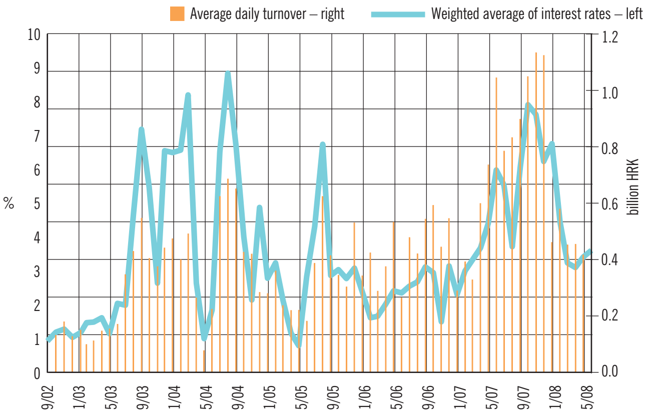
Figure 32 Interest Rates in Direct Interbank Trading and Banks' Free Reserves



Source: CNB.

Figure 33 Direct Interbank Trading in Overnight Loans

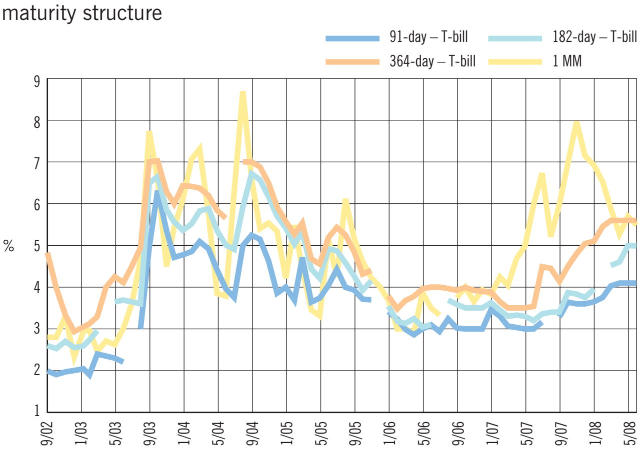
monthly averages on the basis of daily data



Source: CNB.

Figure 34 Interest Rates on T-Bills and in Direct Interbank Trading

maturity structure



Sources: MoF and CNB.

a result of the said movements, the share of loans received from banks in demand deposit trading was reduced to its historical low of 39.3%. In contrast, a record high 30.8% was accounted for by loans received from other legal persons, whereas 29.9% was accounted for by loans received from non-banking financial institutions.

As usual, direct trading among banks predominated in the interbank trading in reserve money, amounting to HRK 95.7bn, while interbank trading intermediated by the ZMM generated a total of HRK 17.1bn. Overnight loans continued to be the most liquid instrument in direct interbank trading in reserve money, accounting for HRK 58.0bn. The average daily turnover of these loans more than halved, from HRK 1.1bn in December 2007 to HRK 425.5m in June 2008. A smaller volume of bank money market financing was accompanied by the interest rate reduction in direct interbank trading, as a result of which the monthly weighted interest rate on overnight loans fell from 6.23% in December 2007 to 3.60% in June 2008, its daily volatility being on the decrease. Although banks' free reserves were slightly reduced relative to end-2007, they still remained at a relatively high level.

The average daily turnover of overnight loans intermediated by the ZMM was also considerably reduced, from HRK 175.3m in December 2007 to HRK 63.3m in June 2008. The monthly weighted interest rate on these loans fell from 5.33% in December 2007 to 3.20% in June 2008.

8.2 Interest Rates on the Short-Term Securities Market

In the first half of 2008, the Ministry of Finance held 18 T-bill auctions, where reduced investors' interest was recorded despite favourable liquidity of the financial system. Accordingly, the average amount of the received bids per auction was HRK 400.6m, HRK 90.8m less than in the previous six-month period. A relatively high percentage of these bids was accepted at the auctions (83.7% on average), as a result of which T-bills worth HRK 6.0bn were subscribed, i.e. HRK 1.3bn less than in the second half of 2007, which is still a HRK 187.0m increase compared to the planned issue amount.

In the first quarter of 2008, interest rates on T-bill auctions moved in the opposite direction to the money market interest rates, rising continuously during the observed period and reaching their record high since mid-2005. The weighted interest rate on 182-day T-bills recorded the largest increase, from 3.75% in December 2007 to 4.99% in June 2008. The weighted interest rates on 91-day and 364-day T-bills rose more moderately, from 3.60% and 5.05%, respectively, in December 2007 to 4.10% and 5.60%, respectively, in June 2008.

The stock of the subscribed T-bills in the first half of the year moved around the 2007 year-end level of HRK 11.7m, which is also the stock amount in June 2008. One-year T-bills still predominated in the structure of total subscribed T-bills, with their share additionally rising from 91.1% at the end of the second half of 2007 to 92.6% at the end of the first half of 2008. They were followed by 182-day T-bills, with the share of 5.3%, whereas the share of the shortest-term T-bills was 2.1%.

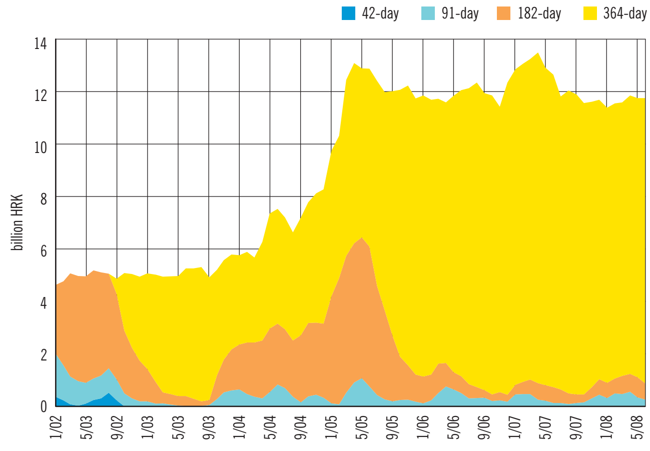
8.3 Banks' Interest Rates

In the first half of the year, growth of banks' lending interest rates on long-term loans additionally intensified. In contrast, interest rates on individual short-term loans were slightly reduced, retaining their usually high volatility. Accordingly, the weighted interest rate on short-term corporate loans not indexed to foreign currency was down by only one basis point in June 2008 against December 2007, standing at 7.38%. The weighted interest rate on short-term household loans not indexed to foreign currency fell from 12.34% in December 2007 to 11.91% in June 2008.

In accordance with an accelerated EURIBOR growth, hitting its record high in the last seven years, and monetary policy tightening, interest rates on long-term loans continued to rise in the first half of 2008. The weighted interest rate on long-term corporate kuna loans indexed to foreign currency thus increased from 6.51% in December 2007 to 6.74% in June 2008. Growth acceleration, which started in mid-2007, was recorded in interest rates on long-term household loans. This growth was especially pronounced in weighted interest rates on long-term kuna household loans indexed to foreign currency, which went up from 6.80% in December 2007 to 8.25% in June 2008, representing

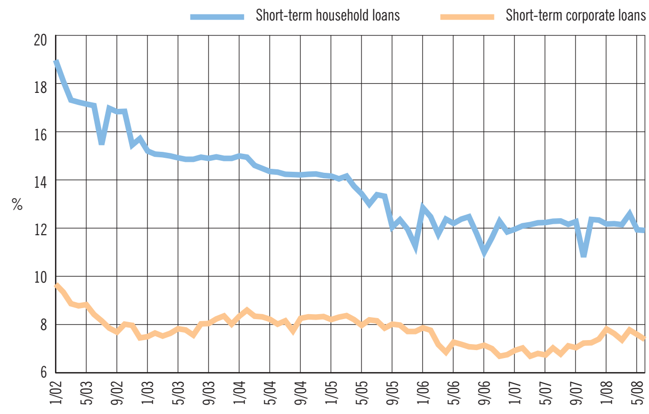
Figure 35 T-Bills Stock

maturity structure, end of period



Sources: MoF and CNB.

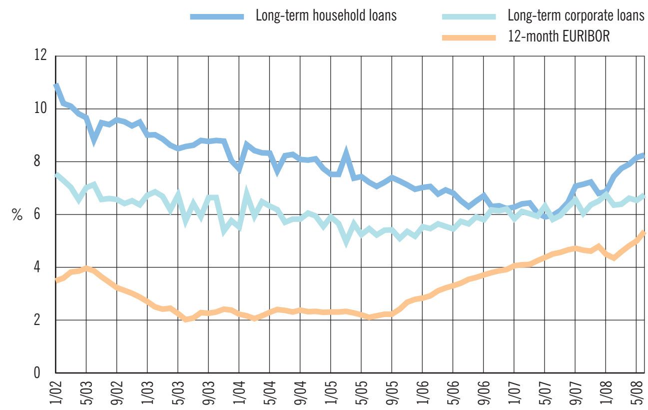
Figure 36 Banks' Average Interest Rates[a] on Short-Term Loans Not Indexed to Foreign Currency



[a] The average weighted interest rate on newly granted loans in the reporting month.

Source: CNB.

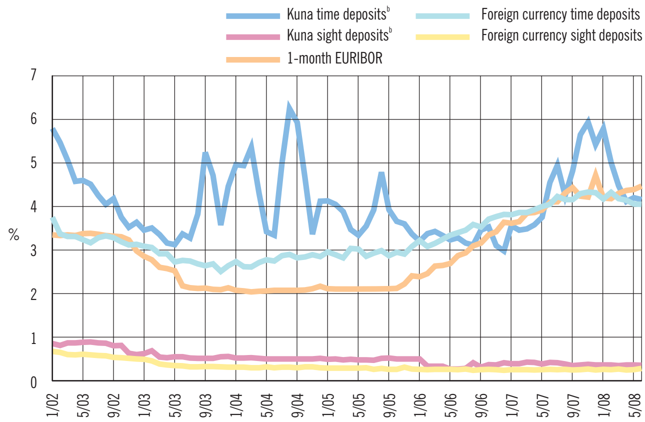
Figure 37 Banks' Average Interest Rates[a] on Long-Term Loans Indexed to Foreign Currency



[a] The average weighted interest rate on newly granted loans in the reporting month.

Source: CNB.

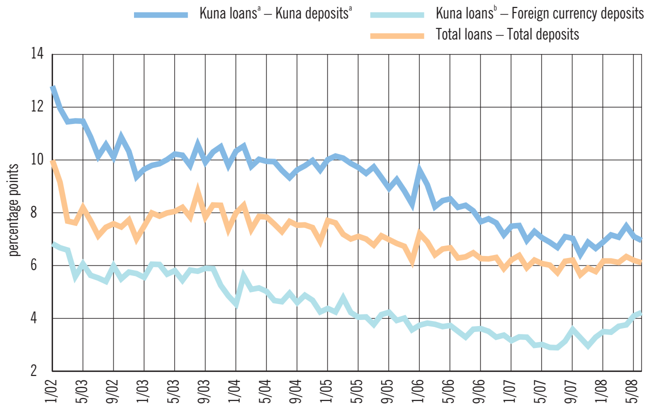
Figure 38 Banks' Average Deposit Interest Rates[a]



[a] The average weighted interest rate on newly received deposits in the reporting month.
[b] Non-indexed to f/c.

Source: CNB.

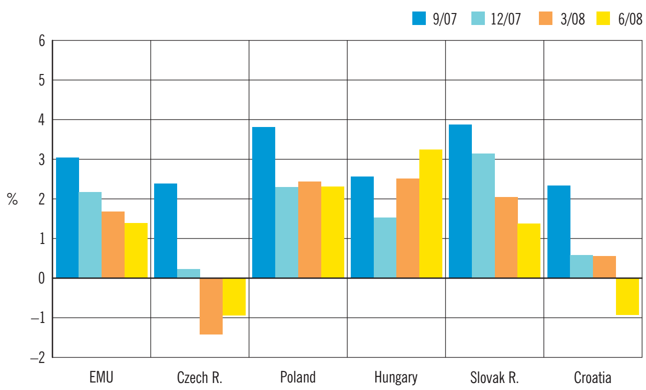
Figure 39 Spread between Banks' Average Interest Rates on Loans and Deposits



[a] Non-indexed to f/c. [b] Indexed to f/c.

Source: CNB.

Figure 40 Real Interest Rates on Long-Term Corporate Loans in Selected Countries



Note: Due to the difference between individual countries' statistical coverage interest rates cannot be directlycompared, but their movements can be analysed.

Sources: Central banks' bulletins and CNB.

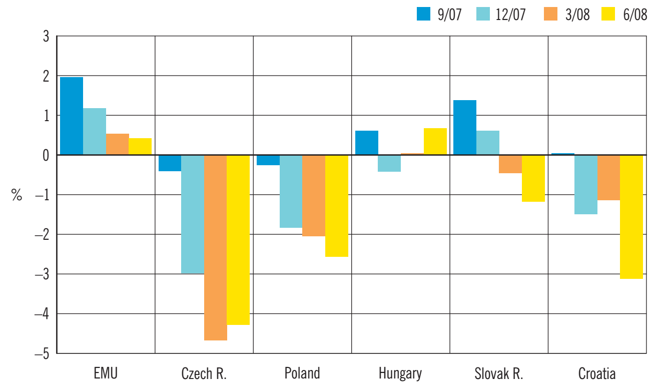
its record high since early 2005. A change in the structure of newly granted long-term household loans by purpose and currency contributed considerably to an intense growth of this weighted interest rate. Accordingly, the share of more expensive other long-term loans increased at the expense of the cheapest home loans and car loans, whereas, at the same time, the share of most favourable loans indexed to the Swiss franc was reduced in total newly granted long-term household loans indexed to foreign currency.

Interest rates on household time deposits rose slightly in the first half of 2008 relative to the end of 2007, while at the same time, the rates on corporate time deposits fell considerably, which also contributed to a reduction of the weighted interest rates on time deposits. Analysing the money market interest rates movements, it can be observed that the weighted interest rate on kuna time deposits not indexed to foreign currency was reduced most, from high 5.42% in December 2007 to 4.16% in June 2008. At the same time, the weighted interest rate on foreign currency time deposits was reduced more moderately from 4.32% in December 2007 to 4.05% in June 2008. Interest rates on sight deposits were traditionally stable, so that the weighted interest rate on kuna sight deposits not indexed to foreign currency was thus one basis point lower in June 2008 than in December 2007, amounting to 0.35%, whereas the weighted interest on foreign currency sight deposits rose from 0.25% in December 2007 to 0.28% in June 2008.

Following a reversal of a multi-annual downward trend of the spread between interest rates on comparable loans and deposits at end-2007, in the first half of 2008 its rise additionally intensified. The spread between the weighted interest rate on total loans and the weighted interest rate on total deposits thus increased from 5.78 percentage points in December 2007 to 6.11 percentage points in June. The spread between the weighted interest rate on kuna loans not indexed to foreign currency and the weighted interest rate on kuna deposits not indexed to foreign currency also increased considerably, from 6.65 percentage points in December 2007 to 6.95 percentage points in June 2008. The spread between the weighted interest rate on foreign currency indexed kuna loans and the weighted interest rate on foreign currency deposits widened from 3.29 percentage points in December 2007 to 4.22 percentage points in June 2008, returning thus to its mid-2005 level.

As a result of a high inflation rate, recorded at the end of the first six-month period of 2008, the real interest rate on long-term corporate kuna loans became negative. Fall of a real interest rate on long-term corporate loans, due to inflation rate increase relative to end-2007, was also recorded in the majority of the selected Central and East European countries, as well as in the eurozone member states, whereas an increase in the observed rate was recorded only in Poland and Hungary.

Figure 41 Real Interest Rates on Short-Term Household Deposits in Selected Countries



Note: Due to the difference between individual countries' statistical coverage interest rates cannot be directlycompared, but their movements can be analysed.

Sources: Central banks' bulletins and CNB.

Inflation acceleration at the end of the first half of 2008 relative to end-2007 also represented the main reason for a drop in the real interest rate on three-month kuna household deposits in Croatia, as a result of which this interest rate recorded negative values, as it was the case at end-2007. Real interest rates on short-term household deposits were, at the same time, reduced in most of the observed countries, while their rise was recorded only in Hungary.

9 Capital Market

In the first half of 2008, the domestic capital market was under the strong influence of adverse global and regional financial market trends, as well as of some domestic factors. The period under review saw a decline in turnover of shares compared with the second half of 2007, accompanied by a marked downfall in the prices of most shares listed on the ZSE, which was reflected in a sharp decrease in the CROBEX. In the first six months of 2008, the debt securities market was marked by a downward trend, much like the equity securities market. A negative shift in the risk perception by domestic, but also global investors, paired with further strengthening of inflationary pressures in Croatia and most other countries, deepening crisis in the world's financial markets caused by the problems with subprime mortgages in the US and increased risk of recession in the world's leading economies contributed to deflation of the price bubble on the domestic capital market that was characterised by the exceptionally high price earnings ratio for shares included in the CROBEX in the middle of last year.

In the first half of 2008, the share turnover on capital markets of all CEE countries went down and so did the bond turnover. All reference stock exchanges had a lower average daily share turnover in June 2008 relative to December 2007, as well as lower average daily bond turnover, which in the period concerned went up only at the Bratislava Stock Exchange. The ZSE share turnover remained low, measured against the GDP, with only the Ljubljana and the Bratislava Stock Exchange registering lower share turnovers, while share turnovers at other stock exchanges were much higher. In contrast, the bond turnover to GDP ratio was higher only at the Bratislava and Prague Stock Exchange.

The decline in value of all reference stock exchange indices decreased the market capitalisation of shares at the end of June 2008 relative to the end of the previous year at all reference stock exchanges, except in the Czech Republic and Slovakia. The market capitalisation of bonds declined in the observed period only at the Zagreb Stock Exchange. The ZSE's share market capitalisation to GDP ratio continued to exceed the ratios of all reference stock exchanges in the first half of 2008, while its ratio of bond market capitalisation to GDP continued to lag behind the ratios of reference CEE stock exchanges.

Table 4 Comparison of Capital Market Indicators

June 2008	Bratislava	Budapest	Ljubljana	Prague	Warsaw	Zagreb
Average daily turnover, shares (million EUR)	0.02	56.57	2.23	145.97	314.33	6.70
Average daily turnover, bonds (million EUR)	82.97	9.17	0.69	73.67	3.10	4.75
Share turnover/GDP[a], annual level (%)	0.01	13.71	1.59	26.19	23.33	4.27
Bond turnover/GDP[a], annual level (%)	34.92	2.22	0.49	13.22	0.23	3.02
Turnover velocity[b]	0.09	54.07	3.87	46.84	…	4.96
Market capitalisation of shares (million EUR), end of month	4,917.39	26,362.72	14,537.42	78,533.40	…	34,072.79
Market capitalisation of bonds (million EUR), end of month	14,077.89	41,207.23	6,271.66	…	…	5,173.21
Market capitalisation of shares/GDP[a], end of month (%)	8.21	25.35	41.19	55.91	…	85.56
Market capitalisation of bonds/GDP[a], end of month (%)	23.51	39.62	17.77	…	…	12.99
Share index movement from the beginning of the year (%)	–1.77	–22.29	–30.71	–18.27	–26.06	–31.52
Share index movement from the beginning of the month (%)	–2.57	–9.71	–6.38	–11.96	–11.75	–10.04

[a] Gross domestic product is calculated as the sum of the GDP realised in the last two quarters of 2007 and the first two quarters of 2008.
[b] Annualised monthly share turnover x 100/ market capitalisation of shares.

Sources: Bloomberg, BSSE, BSE, PSE, LJSE, WSE and ZSE.

Under the influence of the deepening financial crisis caused by the US subprime mortgage market crisis and the consequent rising risk aversion of global investors, required yields on Croatian eurobonds rose uninterruptedly in the first half of 2008. As a result, the spreads between required yields on Croatian eurobonds with shorter maturities and yields on benchmark German bonds widened, while the spread of the Croatian bond of shorter maturity even narrowed.

9.1 Equity Securities Market

Share turnover on the Croatian capital market reduced in the first half of 2008, to HRK 9.9bn at the end of June, which was HRK 1.1bn or 9.8% down on the second half of 2007. This decline in demand for equity securities was a consequence of the bleak outlook caused by unfavourable trends on global financial markets and substantial losses sustained by some of the world's largest financial institutions, paired with strengthening inflationary pressures in most countries and visible slowdown in the world's leading economies, not to mention a large number of inexperienced small investors who were attracted to numerous IPOs last year. Negative developments on the domestic equity securities market were partly influenced by the sale of shares pledged as collateral for margin loans and investment instruments, such as various certificates and derivative financial instruments based on shares listed on the ZSE, sold to their clients by foreign banks.

Table 5 Initial Public Offering of Shares
in million HRK

Year	Number of successful issues	Total value of issues
1997	17	839.4
1998	6	247.1
1999	3	29.0
2000	1	20.0
2001	1	13.0
2002	1	11.8
2003	1	1.2
2004	2	11.0
2005	4	231.0
2006	0	0.0
2007	4	46.9
Jan.-Jun. 2008	0	0.0

Note: Public offerings are recorded according to the date of HANFA's decision.
Source: HANFA.

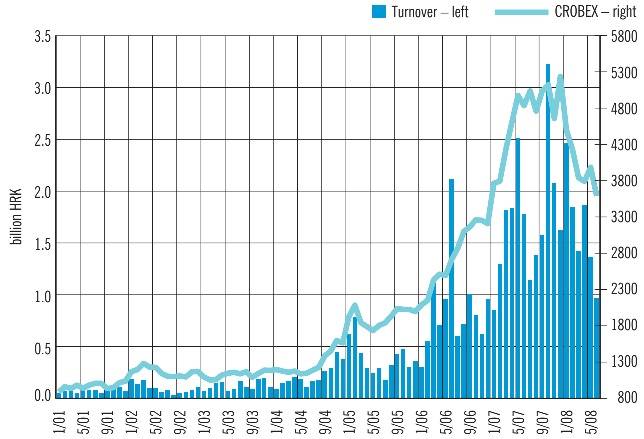
The ZSE share index, the CROBEX,[12] continued to fall until mid-April, reaching the lowest level in over a year. In addition to all these factors, the decline in the prices of majority of shares in mid-April was affected by the end of the tree-year period during which war veterans were prohibited from selling their shares in the War Veterans Fund (WVF), which increased the uncertainty owing to concerns that a large-scale sale of WVF shares might have a negative impact on the price of its portfolio shares, as well as on the market value of other shares on the ZSE. After recovering in May, until the end of June the value of the CROBEX again declined to 3588 points, down by 31.5% on the end of 2007.

Due to the drop in prices of most shares listed on the ZSE, until the end of the first half of 2008 market capitalisation of shares[13] decreased by 29.9% compared with the end of 2007, standing at HRK 246.9bn or 85.6% of the realised GDP.[14] The largest market capitalisation at the end of June 2008 was realised by shares of Ina (HRK 25.7bn or 10.4% of total market capitalisation) and shares of Zagrebačka banka d.d. (HRK 25.0bn or 10.1 of total market capitalisation).

In the first half of 2008 shares were traded on four ZSE markets: the Official Market, Closed-End Investment Fund Shares Market, Public Joint-Stock Company Shares Market and Parallel Securities Market. In the first six months of 2008, in addition to the common shares of Ina, Ingra d.d., Istraturist d.d., Magma d.d., Medika d.d., Pliva d.d., Podravka d.d., Šećerana Viro d.d., T-HT, Varteks d.d., Veterina d.d. and the common and preferential shares of Croatia osiguranje d.d., also listed on the Official Market were common shares of Optima Telekom d.d. In the period in question, the most traded shares were T-HT shares, which made up 12.4% of the total semi-annual share turnover, followed by Atlanska plovidba d.d. with a share of 7.7% and Ina with a share of 7.2%. At the end of June 2008, a total of 375 shares were listed on the ZSE, reducing the number of shares listed on the domestic capital market by eight shares compared to the end of 2007.

In the first half of 2008, most of the major world stock exchange indices declined, and similar trends marked the markets in CEE countries. Of all reference CEE stock exchange indices, the ZSE went down the most at the end of June 2008 compared to the end of December 2007, by 31.5%, followed by the LJSE (30.7%), WSE (26.1%), BSE (22.3%) and PSE (18.3%) indices. The Bratislava Stock Exchange Index fell the least, by 1.8%.

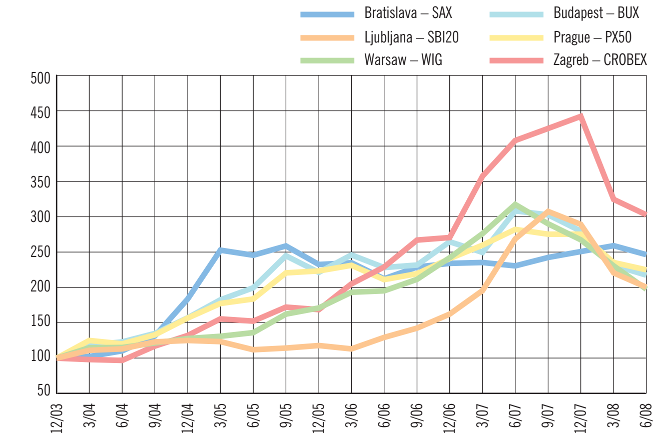
Figure 42 ZSE Monthly Share Turnover and End-Month CROBEX



Source: ZSE.

Figure 43 Selected Stock Exchange Indices

end of period, December 2003 = 100



Sources: Bloomberg and reports from BSSE, BSE, PSE, LJSE, WSE and ZSE.

[12] After its regular revision in March 2008, the CROBEX was comprised of 28 shares. The shares of the following joint stock companies were excluded from the CROBEX since September 2007: Arenaturist, AD Plastika, Badel 1862 and Rivijera Poreč, while the shares of Ledo and Luka Ploče were included.

[13] The ZSE market capitalisation is calculated by multiplying the last price and the number of issued shares for each share. The liquidity of a share is also taken into account, so only half of the market capitalisation of shares not traded in the previous month and a quarter of the market capitalisation of shares not traded in the previous three months are taken into account.

[14] Gross domestic product is calculated as the sum of the GDP realised in the last two quarters of 2007 and the first two quarters of 2008.

9.2 Debt Securities Market

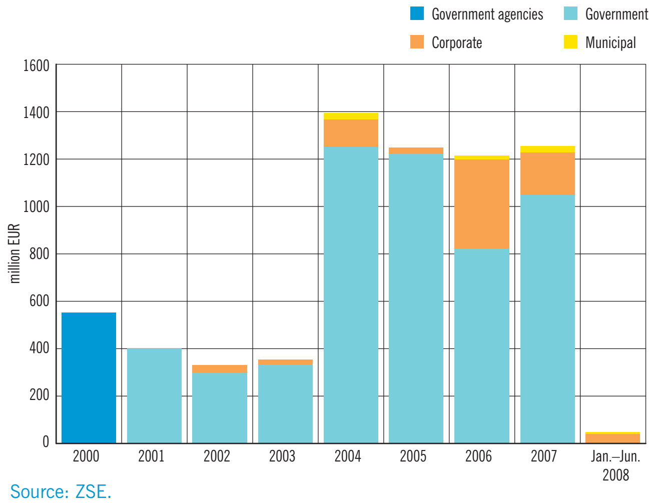
At the end of the first half of 2008, a total of 35 bond issues were quoted on the domestic debt securities market,[15] of which nine were government bonds, seven were municipal bonds and one CBRD bond, as well as eighteen corporate bonds, which was on government bond less than at the end of December 2007. On the last day of June 2008, there were eighteen commercial paper issues listed at the ZSE by 14 issuers, which were seven commercial paper issues or four issuers fewer than at the end of December 2007, with a total nominal value of HRK 858.6m.

In the first half of 2008, two corporate bonds and a new tranche of a municipal bond were issued in the domestic debt securities market. In the observed period, the Republic of Croatia satisfied its financing needs by taking out a syndicated loan from domestic banks, which resulted in no new government bond issues in the domestic market. The five-year kuna bond of the RC, with a nominal value of HRK 1.0bn, became due in May 2008. One more corporate bond became due until the end of the first half of the year, while the listing of a corporate issue on the ZSE was removed due to its early redemption.

In late January 2008, Rijeka promet d.d. issued a ten-year kuna bond, nominally valued at HRK 192m and having a yield to maturity at issue of 6.85%, while Plodine d.d. issued a five-year kuna bond, nominally worth HRK 100m and with a yield to maturity at issue of 9.08%. In addition to these corporate issues, the city of Rijeka issued the third tranche of a ten-year euro bond, nominally valued at EUR 8.2m, raising the total value of this issue to EUR 24.6m.

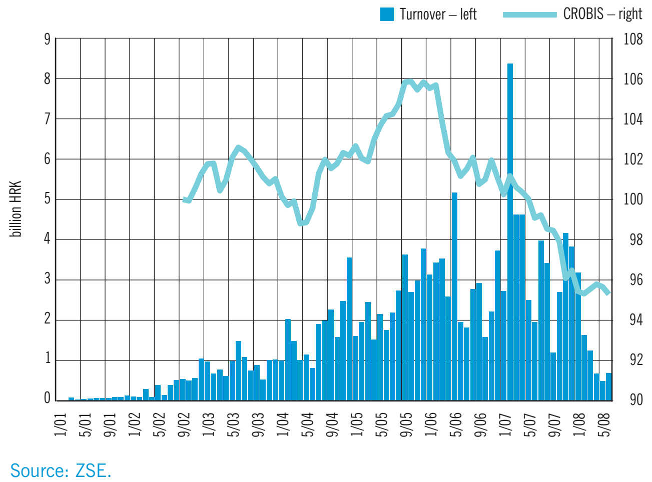
The bond turnover[16] in the first half of 2008 totalled HRK 7.9bn, down HRK 11.4bn or 59.0% on the second half of 2007. This was the lowest semi-annual bond turnover registered since the first half of 2004. The substantial narrowing of bond turnover in the domestic debt securities market was partly a consequence of the lack of new government issues in the period under review. In the first six months of 2008, the most liquid bonds were the Republic of Croatia kuna bonds indexed to foreign currency and maturing in 2019 and 2014, of which each accounted for 17%, or HRK 1.3bn, of the total semi-annual turnover. The kuna government bond due in 2017 and a foreign currency indexed kuna government bond due in 2015 also accounted for large shares in the total turnover of 16%, or HRK 1.3bn, and 10%, or HRK 0.8bn, respectively. Government bonds made up 92.4% of the total semi-annual bond turnover, while the liquidity of corporate bonds mildly increased, accounting for 7.6% of the total semi-annual bond turnover on the ZSE.

Figure 44 Bond Issues in the Domestic Market



Source: ZSE.

Figure 45 ZSE Monthly Bond Turnover and End-Month CROBIS



Source: ZSE.

[15] This figure and the calculation of market capitalisation do not include the bonds of the Fund for the Compensation of Expropriated Property.

[16] The data on the total bond turnover from January 2004 to February 2007 are the sum of the respective bond turnovers on the VSE and ZSE, with the unified ZSE data used since the VSE and ZSE merger in March 2007. It needs emphasising that the bond turnover on the VSE had been negligible, standing below 0.4% of the total turnover on both stock exchanges in all the observed years.

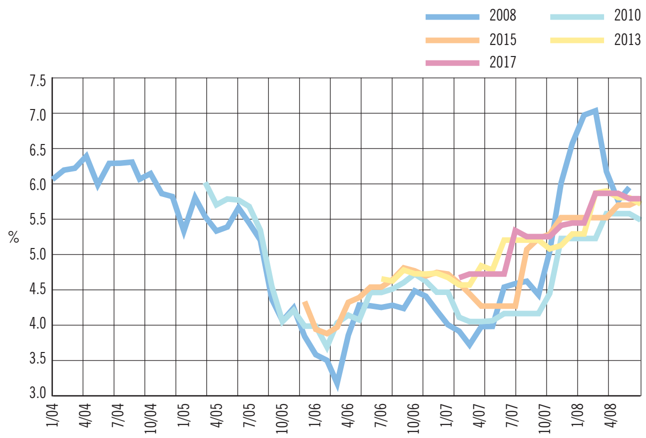
Table 6 Bond Issues in the Domestic Market, stock as at 30 June 2008

Series	Issuer	Issue date	Maturity	Currency	Issue nominal value	Nominal interest rate	Last price[a]	Current yield 30/6/2008
RHMF-O-08CA	Republic of Croatia	14/12/2001	14/12/2008	EUR	200,000,000	6.875%	100.65	6.831%
RHMF-O-125A	Republic of Croatia	23/5/2002	23/5/2012	EUR	500,000,000	6.875%	103.50	6.643%
RHMF-O-142A	Republic of Croatia	10/2/2004	10/2/2014	EUR	650,000,000	5.500%	98.90	5.561%
RHMF-O-19BA	Republic of Croatia	29/11/2004	29/11/2019	EUR	500,000,000	5.375%	98.55	5.454%
RHMF-O-103A	Republic of Croatia	8/3/2005	8/3/2010	HRK	3,000,000,000	6.750%	102.00	6.618%
RHMF-O-157A	Republic of Croatia	14/7/2005	14/7/2015	EUR	350,000,000	4.250%	98.90	4.297%
RHMF-O-15CA	Republic of Croatia	15/12/2005	15/12/2015	HRK	5,500,000,000	5.250%	96.80	5.424%
RHMF-O-137A	Republic of Croatia	11/7/2006	11/7/2013	HRK	4,000,000,000	4.500%	94.70	4.752%
RHMF-O-172A	Republic of Croatia	8/2/2007	8/2/2017	HRK	5,500,000,000	4.750%	92.90	5.113%
GDKC-O-116A	City of Koprivnica	29/6/2004	29/6/2011	HRK	60,000,000	6.500%	101.30	6.417%
GDZD-O-119A	City of Zadar	1/9/2004	1/9/2011	EUR	18,500,000	5.500%	98.00	5.612%
GDRI-O-167A	City of Rijeka	18/7/2006	18/7/2016	EUR	24,574,513	4.125%	–	–
GDST-O-137A	City of Split	24/7/2006	24/7/2013	EUR	8,000,000	4.563%	100.30	4.549%
GRVI-O-17AA	City of Vinkovci	23/10/2007	23/10/2017	HRK	42,000,000	5.500%	–	–
GROS-O-17AA	City of Osijek	30/10/2007	30/10/2017	HRK	25,000,000	5.500%	–	–
GDST-O-15BA	City of Split	27/11/2007	27/11/2015	EUR	8,100,000	4.750%	–	–
HBOR-O-112A	CBRD	11/2/2004	11/2/2011	EUR	300,000,000	4.875%	–	–
BLSC-O-091A	Belišće d.d.	14/1/2005	14/1/2009	EUR	8,000,000	5.500%	101.60	5.413%
MDKA-O-087A	Medika d.d.	11/7/2005	11/7/2008	EUR	16,500,000	4.500%	99.10	4.541%
RBA-O-112A	Raiffeisenbank Austria d.d.	10/2/2006	10/2/2011	HRK	600,000,000	4.125%	97.50	4.231%
PODR-O-115A	Podravka d.d.	17/5/2006	17/5/2011	HRK	375,000,000	5.125%	94.40	5.429%
NEXE-O-116A	Nexe grupa d.d.	14/6/2006	14/6/2011	HRK	750,000,000	5.500%	94.60	5.814%
MTEL-O-097A	Metronet telekomunikacije d.d.	28/7/2006	28/7/2009	HRK	120,000,000	8.500%	101.90	8.342%
HOTR-O-941A	Hospitalija trgovina d.o.o.	5/10/2006	5/10/2009	HRK	75,000,000	8.250%	100.10	8.242%
HEP-O-13BA	Hrvatska elektroprivreda d.d.	29/11/2006	29/11/2013	HRK	500,000,000	5.000%	92.50	5.405%
ATGR-O-11CA	Atlantic grupa d.d.	6/12/2006	6/12/2011	HRK	115,000,000	5.750%	98.35	5.846%
INGR-O-11CA	Ingra d.d.	6/12/2006	6/12/2011	HRK	200,000,000	6.125%	98.00	6.250%
OPTE-O-142A	Optima telekom d.o.o.	1/2/2007	1/2/2014	HRK	250,000,000	9.125%	96.98	9.409%
JDGL-O-126A	Jadran Galenski laboratorij d.d.	11/6/2007	11/6/2012	HRK	125,000,000	5.650%	–	–
JDRA-O-129A	Jadranka d.d.	13/9/2007	13/9/2012	HRK	75,000,000	6.475%	–	–
JRLN-O-12AA	Jadrolinija d.d.	25/10/2007	25/10/2012	HRK	70,000,000	6.500%	99.50	6.533%
OIV-O-14BA	Odašiljači i veze d.o.o.	20/11/2007	20/11/2014	HRK	100,000,000	7.250%	–	–
HEP-O-17CA	Hrvatska elektroprivreda d.d.	7/12/2007	7/12/2017	HRK	700,000,000	6.500%	–	–
RPRO-O-181A	Rijeka promet d.d.	25/1/2008	25/1/2018	HRK	192,000,000	6.813%	–	–
PLOR-O-133A	Plodine d.d.	4/3/2008	4/3/2013	HRK	100,000,000	9.000%	–	–

[a] Regularly traded.

Source: ZSE, monthly report, June 2008.

Figure 46 Trends in Yields to Maturity of Government Bonds on the Domestic Market



Source: ZSE.

At the end of the first half of 2008, the market capitalisation of all bonds[17] on the domestic market totalled HRK 37.5bn (EUR 5.2bn), or 13.0% of the realised GDP.[18] The market capitalisation of government bonds, municipal bonds and the CBRD bond totalled HRK 33.3bn (EUR 4.6bn), or 11.5% of the realised GDP, whereas market capitalisation of corporate bonds totalled HRK 4.2bn (EUR 0.6bn), which made up 1.4% of the realised GDP.

Despite a slight increase in March and April 2008, the ZSE bond index, the CROBIS,[19] decreased until the end of June 2008 to 95.3 points, which was a drop of 1.2 points compared to the end of December 2007. A decline in the prices of RC bonds regularly traded on the ZSE contributed to a mild increase in yields to maturity of almost all kuna government bonds in the first half of 2008, compared to yields at the end of last year.

In line with the strategy of substituting foreign with domestic borrowing, the Republic of Croatia issued no new bonds in foreign markets in the first six months of 2008. Since a Samurai bond issued in 2002, worth JPY 25bn or some HRK 1.1bn, fell due late in June, there were six Croatian bond issues on foreign capital markets at the end of the first half of 2008. Four were euro-denominated, one in Japanese yens and one was denominated in US dollars. The total nominal value of all six issues of Croatian bonds in foreign markets was HRK 21.4bn (EUR 3.0bn) at the end of June 2008, which was a drop of HRK 1.6bn (EUR 0.1bn) relative to the end of December 2007.

Table 7 Republic of Croatia International Bond Issues, stock as at 30 June 2008

Bond	Issue date	Currency	Amount	Nominal interest rate	Yield on issue day	Spread on issue day	Spread[a] 30/9/2007	Spread[a] 31/12/2007	Spread[a] 31/3/2008	Spread[a] 30/6/2008
London Club Series A, 2010	31/7/1996	USD	857,796,000	6-month LIBOR + 81.25 b.p.			134	142	176	200
Eurobonds, 2011	14/3/2001	EUR	750,000,000	6.75%	6.90%	215	74	112	157	115
Eurobonds, 2009	11/2/2002	EUR	500,000,000	6.25%	6.45%	158	64	94	154	106
Eurobonds, 2010	14/2/2003	EUR	500,000,000	4.625%	4.65%	102	64	95	128	84
Eurobonds, 2014	15/4/2004	EUR	500,000,000	5.00%	5.11%	101	79	147	179	110
Samurai bonds, 2008	26/6/2002	JPY	25,000,000,000	2.15%	2.15%	144	65	67	101	....
Samurai bonds, 2009	26/6/2003	JPY	25,000,000,000	1.23%	1.23%	99	63	66	96	99

[a] In relation to benchmark bond.

Source: Bloomberg.

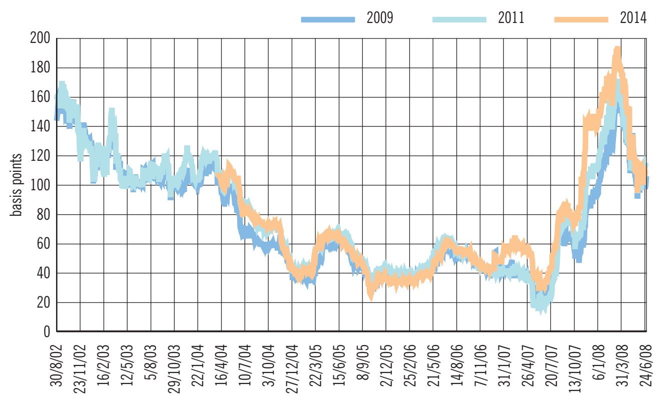
[17] Excluding the bonds of the Fund for the Compensation of Expropriated Property.

[18] See footnote 14.

[19] At the end of June, the CROBIS included eight Republic of Croatia bonds.

Negative trends on almost all financial markets of the world that started late in 2007 further intensified in the first half of 2008. Unfavourable developments on financial markets were accompanied by strong growth of energy prices, especially oil, which contributed to the strengthening of inflationary pressures in most countries. However, to support the weakened US economy and reduce the danger of recession, the Fed continued lowering its key interest rate, which late in April declined to its lowest level, of 2.00%, ever since November 2004. In contrast, the ECB, due to persisting strong inflationary pressures in the eurozone, left its key interest rate at the level of 4.00%. A shift in the risk perception by global investors on all the world's capital markets, especially on the markets of developing countries, prompted an increase in investor interest for safer investments and a rise in demand for government bonds of most developed countries. This led to a fall of required yields on low-risk bonds in the first six months of 2008. At the same time, the required yields on Croatian eurobonds increased, which resulted in the widening of spreads between their yields and required yields on benchmark German bonds. However, by the end of June 2008, the required yields on benchmark German bonds increased due to the forecasted rise in ECB's key interest rate prompted by strong inflationary pressures. Since required yields on Croatian eurobonds grew at a milder rate than the required yield on benchmark German bonds, their yield spreads narrowed. Thus, until the end of the first half of 2008, the spreads between required yields on Croatian eurobonds due in 2009 and 2011 and required yields on benchmark German bonds expanded to 106 and 115 basis points respectively, a mild increase compared with 94 and 112 basis points late in December 2007. On the other hand, the spread between the required yield on the Croatian eurobond due in 2014 and the required yield on the benchmark German bond reduced from 147 basis points late in 2007 to 110 basis points at the end of June due to a strong increase of yields on the benchmark German bond in the second quarter of 2008.

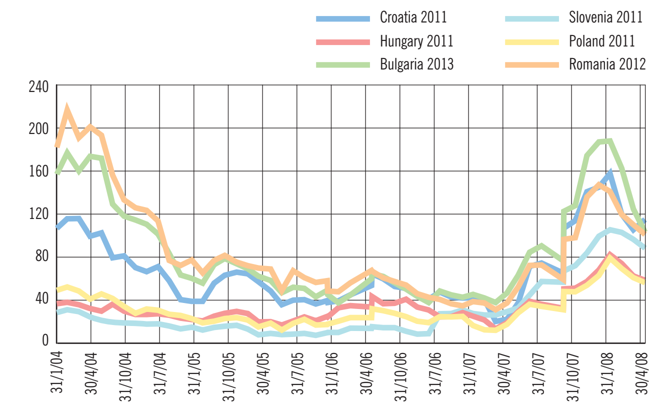
Figure 47 Croatian Eurobond Spread 2009, 2011 and 2014, Compared with Benchmark German Bonds



Source: Bloomberg.

In the first half of 2008, yields on Croatian eurobonds continued to move in the same direction as the yields on eurobonds of new EU Member States. Since required yields on eurobonds of new EU Member States decreased at a milder rate than the required yield on the benchmark German bond in the first two months of 2008, i.e. their March growth was more intensive than that of the German bond, their spreads widened considerably until the end of the first quarter 2008 relative to the end of the previous year. However, by the end of June the increase in the required yields on eurobonds of new EU Member States was much milder than the increase of the required yield on the benchmark German bond, with the result that their yield spread narrowed sharply, although still higher than at the end of 2007. At the end of the first half of 2008, only the yield spread of the Bulgarian bond decreased compared with end of the previous year.

Figure 48 Croatian Eurobond Spread and the Spread of Similar Euro-Denominated Bonds of Selected Transition Countries Compared with the Benchmark German Bond



Source: Bloomberg.

10 International Transactions

The current account deficit grew by one fourth in the first half of 2008 relative to the same period last year, due mainly to further deterioration in international trade in goods. Rapid growth in the goods trade deficit is mainly attributed to external shocks, including above all the hike in oil prices. In addition, the trade in ships contributed negatively to the trade in goods. This was largely due to the methodology applied in the reporting of finishing operations. Specifically, it leads to sharp oscillations of values traded in the division of other transport equipment. The negative developments also marked the factor income account and the account of current transfers, while only international trade in services showed better results in the first half of 2008 than in the same period last year.

In the first half of 2008, the external debt grew by EUR 2.1bn or 6.2%. The main generators of its growth were corporate borrowings from foreign banks and affiliated enterprises. The government sector decreased its external debt in the reference period, due, among other things, to the repayment of Samurai bonds that fell due in June. Banks also decreased their external debt liabilities in the first half of 2008, thanks mainly to the inflow of recapitalisation funds and the stronger inflow of foreign currency tourism receipts.

10.1 Current Account

The current account deficit stood at EUR 4.3bn in the first half of 2008, up 27.7% year-on-year over the same period last year. The main contributor to this was the growing imbalance in international trade in goods, marked by the strong growth of goods imports (14.7% in the first half of 2008 compared with 10.5% in the first half of 2007) and the slowdown in goods exports (8.0% in the first half of 2008 compared with 9.3% in the first half of 2007). As a result, the goods deficit rose by 21% year-on-year. One third of this increase was accounted for by the deterioration in the following two SITC divisions: oil and refined petroleum products and other transport equipment (notably ships).

The trade deficit in oil and refined petroleum products grew by as much as 66.1% (in constant US dollars) in the first half of 2008 due to the surge in crude oil prices that also affected Croatian import and export prices. The effects of this increase were somewhat offset by the decrease in net value of oil imports. The adverse performance in other transport equipment trade is attributed to high imports of ships, imports of helicopters from Russia (the settlement of the clearing debt) and imports of passenger aircrafts from Canada by the domestic airline company (the fleet renewal). As for the trade in ships, net imports stood at USD 109m in the reference period. The average value of exports in this segment of trade in one six-month period is usually higher than USD 200m. Inter alia, the lower performance figure is attributed to the methodology applied in the reporting of finishing operations on a gross basis, and in particular to the fact that a significant portion of imports was accounted for by the imports of fishing boats and tankers that were finished in domestic or foreign shipyards. Oil, refined petroleum products and other transport equipment excluded, the negative balance in the trade in goods was significantly lower and yet somewhat higher than in the first half of 2007 (16% in constant US dollars vs. 13.1%). The accelerated growth of net imports of road vehicles and capital goods continued to contribute the most to the relatively high growth of goods imports.

Table 8 Current Account
in million EUR

	1st half 2007	2007	1st half 2008[a]	Indices			
				1st half 2007/ 1st halft 2006	1st half 2008[a]/ 1st half 2007	Q1 2008/ Q1 2007	Q2 2008[a]/ Q2 2007
CURRENT ACCOUNT	–3,393	–3,230	–4,332	103.8	127.7	125.0	131.6
1. Goods	–4,687	–9,434	–5,673	111.6	121.0	118.8	122.9
1.1. Credit (f.o.b.)	4,355	9,193	4,703	109.3	108.0	108.8	107.3
1.2. Debit (f.o.b.)	–9,042	–18,626	–10,376	110.5	114.7	113.9	115.5
2. Services	1,623	6,296	1,905	129.5	117.4	98.9	118.6
2.1. Credit	2,978	9,155	3,398	111.0	114.1	109.7	115.6
2.2. Debit	–1,355	–2,859	–1,492	94.9	110.1	111.3	108.9
3. Income	–846	–1,135	–1,070	93.0	126.5	134.7	123.8
3.1. Credit	646	1,296	697	174.5	107.9	106.3	109.3
3.2. Debit	–1,492	–2,431	–1,767	116.6	118.4	117.6	118.8
4. Current transfers	517	1,043	506	87.9	97.8	89.4	105.5
4.1. Credit	761	1,576	767	90.3	100.8	97.6	103.6
4.2. Debit	–244	–533	–261	95.7	107.2	116.0	99.8

[a] Preliminary data.
Source: CNB.

The positive balance in the account of services grew by 17.4%. This improvement is mainly attributed to tourism revenues which, after growing by 16.0% year-on-year in the first half of 2008, stood at EUR 2.2bn. The high growth in tourism revenues is only to some extent contributed to the increase in the number of foreign tourist nights and arrivals (according to the CBS data, the foreign tourist nights and arrivals in commercial accommodation facilities grew by 2.1% and 2.8% respectively). Much stronger contributions came from the average spending of foreign tourists which is, inter alia, explained by the increase in prices of food and fuel and their large share in overall tourist spending. The improvement in trade balance was also observed in transportation services, notably sea cargo transport services. In contrast, the trade balance in other services deteriorated, in particular in telecommunication services and in some business services such as legal and accounting services.

The factor income deficit went up by one fourth in the first half of 2008 relative to the same period last year. Above all, this attributed to the growth in dividends paid out to the foreign owners of domestic enterprises and banks. Retained earnings of foreign owners, largely generated in the segment of monetary intermediation, went up slightly. Interest expenses on foreign borrowings also went up, with corporate interest expenses growing by about 60% in the first half of 2008 relative to the same period last year. However, this was somewhat offset by a slowdown in bank interest expenses, while interest expenses on government foreign borrowings were stagnant. Total revenues of domestic sectors, shown in the account of factor income, rose by 7.9% in the first half of 2008 relative to the same period last year. This in particular included the stable growth in compensation to employees working abroad and interest earned on banks' assets held abroad.

The positive balance in the account of current transfers went down by 2.2% year-on-year in the first half of 2008, due mainly to the growth in government expenses on non-resident pensions. In contrast, the contributions of domestic enterprises for non-resident pensions went down significantly in the reference period. Total revenues of domestic sectors stagnated at the level observed in the first half of 2007, while the fall in government revenues was offset by the growth in other sectors' revenues, notably donations and worker's remittances.

10.2 Trade in Goods

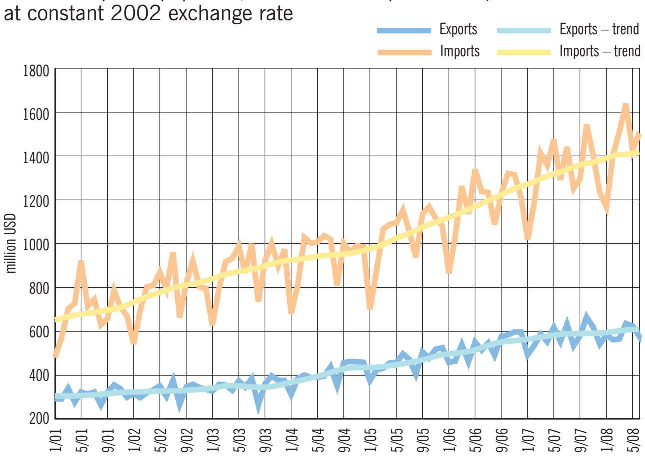
According to the CBS data, total exports of goods (in constant US dollars) grew by 11.9% in the first half of 2008. Although exports grew at a rate largely similar to that observed in the first half of 2007, the structure of contributions of individual SITC divisions to the overall growth of exports changed significantly. Specifically, the first half of 2008 saw a significant increase in the contribution of other transport equipment (notably ships) and the increase in the contribution of natural and manufactured gas, caused mainly by the base-period effects. In addition, exports of electrical machinery, apparatus and equipment and exports of oil and refined petroleum products accelerated in the reference period. Speaking of oil, the strong export growth of this energy product, which was somewhat offset by the fall in the volume of its exports, is attributed to the increase in oil prices.

In contrast, exports of cork and wood, and cork and wood manufactures slowed down and exports of fish and preparations, and cereals and cereal preparations decelerated significantly in the first six months of 2008. The fall in exports of cereals is attributed to the effect of the base period. Specifically, domestic producers, prompted by high prices of cereals in the world market in the first half of 2007, increased their exports in that period, which in turn resulted in the introduction of export taxes on these products and the decrease in exports. The fall in exports of fish and preparations is attributed to the negative effects of the amendments to the Ordinance on tuna fishing, farming and trade adopted in 2007, which set forth the minimum catch weight.

Total imports of goods grew at much faster rate in the first six months of 2008 than in the same period last year (20.4%, in constant US dollars, compared with 12.1%). This trend is primarily attributable to the accelerated imports of other transport equipment (primarily of ships and in a smaller degree of aircrafts), which more than doubled. Another strong contribution came from the growth in the value of imports of oil and refined petroleum products that was solely caused by the increase in crude oil prices in the world market and accompanied by the decrease in the volume of imports of this energy product. Imports of other goods slowed down slightly in the reference period (11.8% vs. 12.5%), mainly due to slower growth of imports of iron and steel, organic chemicals and non-ferrous metals. Although their growth rate slowed down, imports remained fairly robust, due largely to high growth of imports of road vehicles and capital goods.

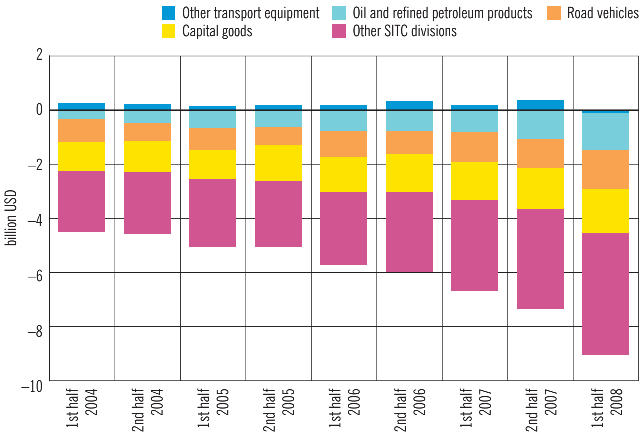
Figure 49 Goods Exports (f.o.b.) and Goods Imports (c.i.f.)

other transport equipment, oil and refined petroleum products excluded at constant 2002 exchange rate



Sources: CBS and CNB.

Figure 50 Contributions of Selected SITC Divisions to Trade in Goods



Source: CBS.

According to the geographic structure of Croatia's exports of goods, the share of exports to developed countries slowed down in the first half of 2008 relative to the same period last year. However, the share of exports to this group of countries remained the largest and stood at 68.6%. Although the growth of exports to developed countries was relatively fast, notably to Germany and Great Britain, it was largely outpaced by the growth of exports to developing countries. The reason for this lies in the fact that exports to developing countries, especially to the neighbouring countries in the region (Bosnia and Herzegovina, Serbia and Montenegro), are largely accounted for by energy products whose value was predominantly determined by the rise in prices in the first half of 2008.

Similar developments were observed in the geographic structure of Croatia's imports of goods. Specifically, the share of imports from developed countries fell slightly in the reference period, while overall imports from this group of countries accelerated. This in particular refers to the imports from old EU Member States – Italy (oil and refined petroleum products) and Germany (road vehicles). The strong growth of imports from developing countries is mostly attributed to higher imports from Russia, largely generated by the increase in the value of imports of oil and refined petroleum products. Imports from China, predominantly accounted for by consumption goods (telecommunication apparatus, wearing apparel and miscellaneous manufactured articles), continued to grow at high rates.

Table 9 Imports and Exports by Economic Classification of Countries
in %

Exports				Economic classification of countries	Imports			
2006	2007	1st half 2007	1st half 2008[a]		2006	2007	1st half 2007	1st half 2008[a]
71.7	69.3	71.6	68.6	Developed countries	72.6	71.8	73.1	72.3
63.2	59.1	60.2	60.7	EU-25	65.0	63.3	64.5	63.6
8.2	8.3	8.3	8.3	Slovenia	6.3	5.9	6.1	5.5
1.7	2.2	1.8	2.4	Hungary	3.0	2.9	2.6	3.3
48.8	43.7	46.0	44.9	EU-15	50.1	48.7	50.4	49.2
6.0	6.1	6.3	6.1	Austria	5.4	5.3	5.4	4.9
23.1	19.1	21.1	18.5	Italy	16.7	16.0	16.8	17.0
10.3	10.0	10.4	11.7	Germany	14.5	14.4	14.5	13.6
1.5	1.2	1.3	1.4	EFTA	1.7	1.9	1.9	1.6
28.3	30.7	28.4	31.4	Developing countries	27.4	28.2	26.9	27.7
12.6	14.4	13.5	15.1	Bosnia and Herzegovina	2.8	2.8	2.9	2.6
5.4	6.6	6.1	6.9	Serbia, Montenegro	1.1	1.3	1.2	1.3
1.2	1.3	1.0	1.2	Russia	10.1	10.1	9.4	10.3
0.2	0.2	0.1	0.2	China	5.3	6.2	5.7	5.9

[a] Preliminary data.
Source: CBS.

10.3 Capital and Financial Account

The capital and financial account recorded a larger net inflow in the first half of 2008 (EUR 3.9bn) than in the same period in 2007 (EUR 2.7bn), primarily arising from banks' currency and deposit withdrawals from abroad. Although lower than in the first half of 2007, a net inflow was also observed in the account of direct investment. The growing insecurity in global financial markets prompted investment funds to withdraw investments in foreign securities so that the portfolio investment account also recorded a net inflow. International reserves grew by EUR 0.8bn in the first half of 2008, mainly on account of the increase in banks' allocations (foreign currency reserve requirements, including marginal reserve requirements).

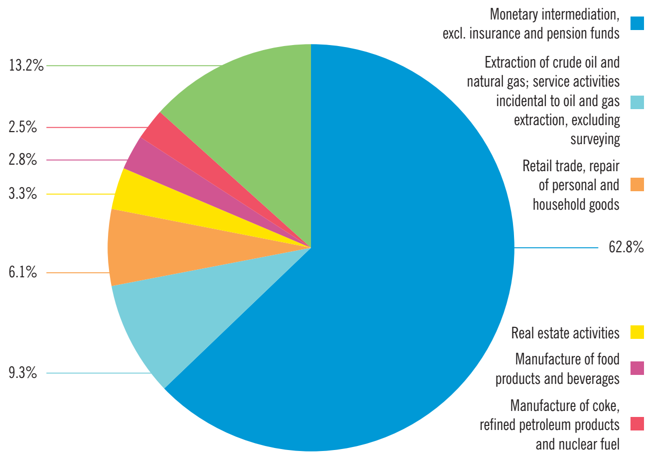
Table 10 Capital and Financial Account
in million EUR

	1st half 2007	2007	1st half 2008[a]	Indices			
				1st half 2007/ 1st half 2006	1st half 2008[a]/ 1st half 2007	Q1 2008/ Q1 2007	Q2 2008[a]/ Q2 2007
CAPITAL AND FINANCIAL ACCOUNT	2,746	4,095	3,854	92.6	140.4	160.6	120.9
1. Capital account	16	35	17	–	104.7	69.0	132.2
2. Financial account, excl. reserves	3,202	4,782	4,629	71.3	144.6	132.9	168.4
2.1. Direct investment	2,216	3,439	1,839	172.8	83.0	82.9	83.1
2.1.1. Abroad	–141	–180	11	172.8	–	–	344.0
2.1.2. In Croatia	2,357	3,619	1,828	172.8	77.6	65.4	94.4
2.2. Portfolio investment	–351	–3	99	65.3	–	–	–150.8
2.2.1. Assets	–644	–413	323	613.3	–	–	–
2.2.2. Liabilities	293	410	–224	–	–	162.2	–
2.3. Financial derivatives	0	0	0	–	–	–	–
2.4. Other investment	1,338	1,346	2,691	35.7	201.2	130.2	–
2.4.1. Assets	10	–1,653	794	0.8	8.306.3	143.9	–
2.4.2. Liabilities	1,328	3,000	1,897	50.7	142.8	124.7	181.6
3. Reserve assets (CNB)	–472	–722	–792	34.5	167.6	86.1	–28.5

[a] Preliminary data.
Source: CNB.

FDIs in Croatia were lower in the first half of 2008 than in the same period last year (EUR 1.8bn compared with EUR 2.4bn). The greatest decrease was observed in equity investment. Among these, the most prominent were lower recapitalisations of domestic banks by their foreign owners (EUR 0.4bn compared with EUR 0.7bn). In addition, the foreign owner of Pliva d.d. withdrew its retained earnings of EUR 0.2bn in the first quarter of 2008, which directly contributed to the decrease in equity investment. The observed decrease was however offset in the second quarter of 2008 when the foreign owner recapitalised Pliva d.d. with about EUR 0.2bn. In addition to banking and chemical industry, significant investments were also made in the extraction of crude oil and natural gas, the various forms of trade and the manufacture of food products and beverages. The analysis of investment by countries shows that the major investors in the reference period were Austria (banking), Germany (trade), Hungary (oil industry) and the Netherlands (recapitalisation of Pliva d.d. through a Dutch branch of Barr Pharmaceuticals Inc.).

Figure 51 Structure of Direct Equity Investment and Retained Earnings in the Republic of Croatia in the First Half of 2008



Source: CNB.

The account of portfolio investment saw a net inflow of EUR 0.1bn in the first half of 2008, due mainly to the withdrawal of funds invested by domestic investment funds in foreign equity and debt securities. This inflow was largely offset by the outflow of funds intended for the repayment of Samurai bonds worth JPY 25bn (about EUR 160m) in June.

The net inflow to the account of other investment (including foreign assets and liabilities of domestic sectors arising from loans, trade credits, and currency and deposits) stood at EUR 2.7bn in the first half of 2008. It was to a large extent the result of the withdrawal of banks' currency and deposits from abroad and the additional foreign borrowings of domestic sectors which were more pronounced in the first half of 2008 than in the same period last year (CBRD and enterprises in majority private ownership).

According to the balance sheet data, international reserves (cross-currency changes excluded) rose by EUR 0.8bn in the first six months of 2008. This annual growth in reserves was above all the result of the increase in allocations of foreign currency reserves requirements (marginal reserve requirements included) in the first quarter of 2008 when banks registered the increase in their foreign liabilities. In addition, the growth in reserves was also accounted for by the central bank's intervention in the foreign exchange market at the end of January. According to the monetary statistics data (cross-currency changes included), international reserves rose by 6.8% in the first six months of 2008, ending June at EUR 9.9bn.

10.4 External Debt

Total external debt, shown in accordance with the new system of reporting,[20] rose by 6.2% in the first half of 2008. The main contributors to this were corporate borrowings from foreign banks and affiliated enterprises. In contrast, banks and the government sector decreased their debt liabilities in the reference period.

The external debt of other sectors (largely enterprises) grew by 12.4% in the first half of 2008, which is a decrease compared with the same period last year (15.8%). The main reason behind this was a slight fall in the debt of mixed-ownership enterprises and the slowdown in the debt of non-banking financial institutions (mainly leasing companies). In contrast, enterprises in majority private ownership continued to report relatively high debt growth rates (in the first six months of 2008, their debt rose by 14.2%). The growth of corporate debt liabilities towards foreign banks was paired with the slower growth of their liabilities towards affiliated enterprises (direct investment debt went up by 16% in the first half of 2008, while in the same period last year it grew by 20.3%).

In the first six months of 2008, banks decreased their debt liabilities by EUR 0.2bn (2.2%). Specifically, after reporting a temporary increase in their foreign liabilities in the first two months of 2008, banks decreased their external debt liabilities in the following months, aided by the inflow of recapitalisation funds and the strong inflow of foreign currency deposits into the banking system. In line with these developments, the share of banks' external debt in total external debt declined further at the end of June 2008, reaching 24.6%.

[20] In accordance with the obligations assumed during the pre-accession negotiations with the European Commission, the new legislative provisions governing the monitoring of foreign borrowing entered into force early in 2008. The new system of reporting, applied to all non-banking financial institutions, public and mixed enterprises, and the selected sample of other non-financial enterprises, led to an upward adjustment in the external debt balance at the end of 2007, increasing it by EUR 295m or to EUR 33.2bn.

Table 11 Gross External Debt by Domestic Sectors

end of period, in million EUR and %

	2006	2007[a]	2007[b]	Jun. 2008	Structure		Indices	
					2007[b]	Jun. 2008	2007[a]/2006	Jun. 2008/2007[b]
1. Government	6,668	6,663	6,729	6,673	20.3	18.9	99.9	99.2
2. Croatian National Bank	3	2	2	2	0.0	0.0	91.4	86.1
3. Banks	10,223	8,879	8,888	8,695	26.8	24.6	86.9	97.8
4. Other sectors	9,503	13,452	13,711	15,411	41.3	43.7	141.6	112.4
5. Direct investment	2,878	3,933	3,893	4,517	11.7	12.8	136.6	116.0
o/w: Subordinated and hybrid instruments	167	56	56	217	0.2	0.6	33.5	387.0
Total (1+2+3+4+5)	**29,274**	**32,929**	**33,224**	**35,297**	**100.0**	**100.0**	**112.5**	**106.2**

[a] Old reporting system. [b] New reporting system.

Source: CNB.

The external debt of the government sector decreased by EUR 0.1bn in the first six months of 2008, ending June at EUR 6.7bn (18.9% of total external debt). The major factors contributing to this decrease were the regular payments to the London and Paris Clubs and the repayment of Samurai bonds worth JPY 25bn (or about EUR 160m) that fell due in June. As for new withdrawals, they included a syndicated loan granted to the CBRD in May (EUR 230m) and the first tranche of PAL 2 granted to the central government by the World Bank (EUR 100m). The external debt of the public sector, which in addition to the government sector comprises public and mixed-ownership enterprises, grew by EUR 0.1bn in the first half of 2008 due to the acceleration in debt of public enterprises. In contrast, the contingent debt of the public sector (i.e. the publicly guaranteed private sector debt) continued to decline.

Table 12 Current and Contingent External Debt of the Public Sector and the Private Sector Debt

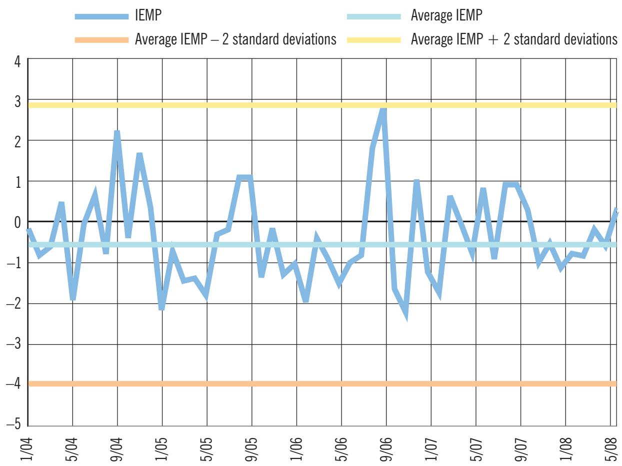
end of period, in million EUR and %

	2006	2007[a]	2007[b]	Jun. 2008	Structure		Indices	
					2007[b]	Jun. 2008	2007[a]/2006	Jun. 2008/2007[b]
1. Public sector debt	8,257	9,259	9,408	9,533	28.3	27.0	112.1	101.3
2. Publicly guaranteed private sector debt	204	140	138	106	0.4	0.3	68.5	77.1
3. Non-publicly guaranteed private sector debt	20,813	23,530	23,678	25,658	71.3	72.7	113.1	108.4
Total (1+2+3)	**29,274**	**32,929**	**33,224**	**35,297**	**100.0**	**100.0**	**112.5**	**106.2**

[a] Old reporting system. [b] New reporting system.

Source: CNB.

Figure 52 Index of Exchange Market Pressure



Source: CNB.

10.5 International Liquidity

In the first half of 2008, the index of exchange market pressure (IEMP)[21] indicated no difficulties in the settlement of international payments. The index was slightly below its long-term average value due to the appreciation of the kuna exchange rate and the increase in international reserves. The reserves grew strongly in the first quarter on account of larger marginal reserve requirements allocations and the central bank's repurchase of foreign currency from banks.

[21] It is calculated as a weighted average of the monthly growth rate of the kuna/euro exchange rate (at end-period) and the monthly growth rate of gross international reserves (in euro terms), using standard deviations as weights.

11 Government Finance

11.1 Fiscal Policy Features in the First Half of 2008

In the first half of 2008, fiscal developments were marked by strong growth in general government revenues that resulted from a noticeable increase in prices of goods and services, favourable labour market trends and the good business performance of Croatian companies in 2007. By contrast, the growth of government expenditures was more moderate, mainly as a result of low first-quarter growth and provisional financing applicable at the time which restricted government consumption. As government investment activity, which mostly relates to traffic infrastructure investments, held steady at last year's level, the first six months of 2008 recorded a consolidated general government surplus (GFS 1986). Most of the new borrowing was used for the purpose of refinancing the liabilities that fell due during that period or bridging the usual short-term illiquidity. General government debt fell slightly in the observed period, which was also due to appreciation of the exchange rate of the kuna against the currencies in which the bulk of the debt is denominated.

11.2 Consolidated General Government Revenues

According to MoF data, consolidated general government revenues rose by 11.5% and reached HRK 66.8bn in the first six months of 2008. Their annual growth, which was somewhat slower than that in the same period last year, was mainly fuelled by increased revenues from value added tax, social contributions and profit tax.

In absolute terms, tax revenues rose by HRK 4bn annually in the first half of 2008. Of this amount, two thirds can be attributed to an increase in indirect taxes. VAT collection in the first six months of the year generated HRK 20.4bn, which accounts for almost one third of total general government revenues. Compared with the same period of the previous year, the growth of this type of revenues accelerated from 11.2% to 13.4%. Such developments were largely due to accelerated inflation measured by the consumer price index and a slight acceleration in imports, given that the growth of personal consumption was significantly slower than in the first half of 2007. Revenues from excises that do not depend directly on price developments (except excises on cars) seem to confirm this view. They fell by 2.1% on an annual level during the observed period. Developments in this type of revenues were largely the result of a fall in revenues from excises on refined petroleum products that was mostly due to the base period effect. More specifically, Government regulation, under which excises on all types of unleaded petrol were reduced by 25 lipa per litre, has been in force since May 2007. [22]

Despite slower economic growth in the first half of 2008 compared with the same period last year, the labour market continued to witness positive trends, such as those seen in increased employment and gross wages growth and a resultant noticeable growth in revenues from income tax and social contributions. Income tax collected generated HRK 5.1bn or 13.3% more than in the same period 2007. A noticeable increase was seen in revenues from social contributions which reached HRK 19.8bn, an increase of 9.7% compared with the first six months of 2007. The largest share

[22] Regulation on the change of excises on refined petroleum products (OG 44/2007).

of these strictly earmarked funds can be attributed to contributions for pension insurance, contributions for health insurance and, much less, to employment contributions.

Profit tax revenues generated HRK 6.2bn in the January to June period of this year, which is an increase of 17.2% compared with the previous year. This was a continuation of the high growth of this type of revenues which started in 2005, as a result of steady growth of pre-tax profit reported by Croatian entrepreneurs.

11.3 Consolidated General Government Expenditures

Expenditures of the consolidated general government reached HRK 60.9bn in the first half of 2008, which is an increase of 10.2% compared with the same period in 2007. Their growth was particularly strong during the second quarter, which can be explained by restricted government spending under the provisional financing scheme applied until the adoption of the 2008 budget in March. The largest contribution to annual expenditures growth was provided by expenditures on social benefits and employee compensations, which jointly account for almost 70% of the budget on this level of government.

Expenditures on social benefits were HRK 25.1bn during the observed period, which is an increase of 8.1% compared with the same period last year. Over two thirds of these expenditures can be attributed to social security benefits that comprise, among others, the bulk of pensions and health care expenditures. They grew by 8.0% annually, also as a result of payments of previous period arrears of the health care system, and an increase in the number of pension beneficiaries and the average pension paid. Expenditures on social assistance benefits, which include disability pensions, child's allowance, Croatian war veterans' permanent rights and compensatory supplement to the pension also rose significantly in the January to June period of 2008 and reached HRK 7.5bn.

Expenditures on employee compensations were HRK 16.4bn in 2008, which is an increase of 8.6% compared with the same period last year. Wages and salaries of civil servants and employees accounted for the major share of this amount, while social contributions paid by central government units accounted for its smaller share. The increase in this type of expenditures is the result of an increase in the number of employees in the narrowly defined public administration and defence, education, health care and social welfare. Also, based on an agreement reached between the Government of the Republic of Croatia and the public services union to increase the base for the calculation of wages in the 2007-2009 period, the observed period saw an increase in gross wages in all the mentioned activities.

Expenditures on the use of goods and services (including the use of telephone, postal services, transport and energy and intellectual and personal services) were HRK 6.9bn in the first half of 2008. Compared with the same period of the previous year, the growth of this category of expenditures slowed down significantly, from 11.5% to 7.0%.

Expenditures on subsidies were HRK 4.2bn in the first six months of 2008, an increase of as much as 22.8% compared with the same period in 2007. This acceleration is the result of further relatively large subsidies to public corporations and private enterprises. Subsidies to public corporations, with subsidies to Croatian Railways accounting for their large share, stood at HRK 2.1bn, while subsidies to private enterprises reached HRK 2.0bn.

Interest expense stood at HRK 3.3bn in the first half of 2008, their growth accelerating significantly compared with the previous year. The dynamics of this category of general government expenditures was influenced by increased interest rates on domestic and foreign financial markets, and changes in the structure of general government debt, i.e. greater reliance on longer-maturity instruments. A reduction in general government external debt notwithstanding, the amount of foreign interest paid held steady at its last year's level, while interest paid to domestic creditors rose sharply.

11.4 Operating Balance and Transactions in Non-Financial and Financial Assets and Liabilities

Revenues growth, which outstripped expenditures growth in the first six months of 2008, led to a further increase in the positive net operating balance compared with the previous year (HRK 5.9bn compared with HRK 4.6bn in the January to June period of 2007). At the same time, investment activities of consolidated general government units rose only slightly, with their non-financial assets rising by HRK 4bn in the first half of the year. With the net operating balance greatly exceeding public investment, net borrowing amounted to HRK 1.9bn during the observed period. A part of the surplus was used to finance due liabilities while the rest was deposited to government accounts with the banks and the CNB.

The acquisition of non-financial assets, which is largely indicative of developments in capital investments of the general government sector, amounted to HRK 4.7bn in the first half of 2008, which is an increase of only 3.2% compared with the same period last year. As infrastructure investments account for the major share of government investments, the largest share of funds was used for the acquisition of buildings and structures, a category that according to the

GFS 2001 methodology includes residential buildings, office buildings, schools, hospitals, motorways, roads, bridges, tunnels, railways, etc. HRK 2.1bn were spent for the construction and renewal of road infrastructure by CM and CR, while HRK 1.7bn were spent by the local government.

Table 13 Operating Balance and Transactions in Non-Financial Assets and Financial Assets and Liabilities, GFS 2001
in million HRK

	Consolidated general government		
	Jan.-Jun. 2007	Jan.-Jun. 2008	Jan.-Jun. 2008 / Jan.-Jun. 2007
1. Change in net worth (net operating balance)	4,617.3	5,883.9	127
1.1. Revenue	59,914	66,825	112
1.2. Expense	55,297	60,942	110
2. Change in net non-financial assets	3,878.4	3,955.3	102
2.1. Acquisition of non-financial assets	4,504	4,650	103
2.2. Disposal of non-financial assets	626	695	111
3. Net lending (+) / borrowing (–) (1 – 2)	738.9	1,928.6	261
3. Financing (5 – 4) Transactions in financial assets and liabilities	–738.9	–1,928.6	261
4. Change in financial assets	1,386.2	2,604.9	188
4.1. Domestic	1,378	2,598	188
4.2. Foreign	8	7	89
5. Change in liabilities	647.3	676.2	104
5.1. Domestic	1,088	1,036	95
5.2. Foreign	–441	–360	82

Note: On a cash basis.

Source: MoF.

Financial assets of the consolidated general government rose by HRK 2.6bn in the January to June period of 2008, almost entirely as a result of domestic assets growth. Government deposits rose by HRK 3bn, while assets in the form of loans granted rose slightly. The sale of shares in state ownership had the opposite effect. According to available data, 4.2% of T-HT shares and 12.5% of shares of Petrokemija d.d. were sold to employees of these companies in June.

Government liabilities rose by HRK 0.7bn in the first half of 2008, fully due to an increase in domestic liabilities, in contrast with foreign liabilities which continued to fall.

11.5 Balance of the Consolidated General Government on a Cash Basis

The consolidated general government surplus, exclusive of capital revenues (on a cash basis, GFS 1986) stood at HRK 0.9bn in the January to June period of 2008, in contrast with its last year's deficit of HRK 0.3bn. Such developments can be fully attributed to a threefold increase in the government budget surplus associated with a sharp increase in revenues. By contrast, the deficit of extrabudgetary users and units of local and regional self-government rose sharply due to a much slower growth of revenues compared with expenditures and acquisitions of non-financial assets.

Table 14 Consolidated General Government Balance, GFS 1986
in million HRK

		Jan.-Jun. 2007	Jan.-Jun. 2008
1.	Net lending (+) / borrowing (–) GFS 2001	739	1,929
2.	Disposal of non-financial assets	626	695
3.	Net acquisition of financial assets – loans	312	118
4.	Acquisition of shares and other equity	134	212
5.	Acquisition of securities other than shares	0	0
6.	Acquisition of other accounts receivable	1	0
7.	Balance without capital revenues (1 – 2 – 3 – 4 – 5 – 6)	–334	904

Note: On a cash basis.

Source: MoF.

11.6 Government Debt

As shown by CNB data, general government debt, exclusive of CBRD debt, stood at HRK 104.5bn at the end of June 2008. Compared with the end of 2007, general government debt fell by HRK 0.1bn, mainly due to a fall in the external debt at the level of the Republic of Croatia. Appreciation of the exchange rate of the kuna against the currencies in which the bulk of the debt is denominated (euro, American dollar and yen) recorded during the observed period contributed to its fall in statistical terms. Contingent debt based on issued government guarantees for domestic and foreign liabilities rose by a moderate HRK 0.1bn, reaching HRK 17.5bn at the end of the observed period.

In light of the consolidated general government surplus generated in the first six months of 2008 and the funds raised through disposals of non-financial assets, the government had to borrow mainly for the purpose of refinancing the liabilities that fell due during that period or bridging the usual short-term illiquidity. The share of the domestic component of the general government debt steadily increased during that period.

Table 15 General Government Debt and CBRD Debt

end of period, in million HRK

	Stock				Change	
	Dec. 2006	Jun. 2007	Dec. 2007	Jun. 2008	Jan.-Jun. 2007	Jan.-Jun. 2008
A. General government debt (1+2)	102,725	104,536	104,630	104,483	1,811	–147
1. Domestic general government debt	61,078	63,870	64,794	66,123	2,792	1,329
1.1. Domestic debt of the Republic of Croatia	54,217	56,616	56,506	57,573	2,399	1,067
1.2. Domestic debt of central government funds	5,168	5,541	6,333	6,752	372	419
1.3. Domestic debt of local government	1,693	1,713	1,955	1,798	20	–157
2. External general government debt	41,647	40,666	39,835	38,360	–981	–1,475
2.1. External debt of the Republic of Croatia	32,557	31,219	29,409	27,498	–1,337	–1,911
2.2. External debt of central government funds	8,938	9,275	10,202	10,656	336	454
2.3. External debt of local government	152	172	224	205	20	–19
B. CBRD debt (1+2)	7,686	9,134	9,662	10,574	1,448	912
1. CBRD domestic debt	348	281	191	568	–67	378
2. CBRD external debt	7,339	8,853	9,472	10,006	1,515	534
Supplement:						
C. Total guarantees issued by the Republic of Croatia	14,188	14,992	17,418	17,519	804	100
1. Domestic	7,252	8,051	7,868	7,604	799	–264
2. Foreign	6,936	6,941	9,551	9,915	5	364

Source: CNB.

In addition to debt restructuring aiming at increasing the share of domestic debt and reducing the share of external debt, the MoF is also attempting to increase the share of longer-term instruments in the structure of debt, most specifically bonds maturing in five and/or ten years, and to ensure equal dynamics of liabilities' maturities. However, due to uncertainties in international capital markets, the MoF has given up its issue of eurobonds planned under the budget and has instead agreed a syndicated foreign currency loan worth EUR 760m nominally with domestic banks. The loan falls due in 2010, with an option to extend principal repayments to 2013. To ensure sufficient liquidity of the banking system and avoid squeezing out of the private sector from the loan market, i.e. prevent further foreign borrowing of banks, the CNB lowered the rate of the minimum required foreign currency claims from 32% to 28.5%. The funds made available to the MoF under this loan will be withdrawn in tranches, and have been or will be used largely to refinance the liabilities due (JPY 25bn worth of Samurai bonds that fell due in June, EUR 200m worth of bonds issued in the domestic market that fall due in December and EUR 200m worth of the short-term foreign currency loan that a domestic bank syndicate granted to the government in early March this year), but also to close the planned deficit in the second half of the year. In addition to Samurai bonds, the obligations falling due in the first six months of the year include a five-year HRK 1bn bond issued in the domestic market and this year's first payment obligations towards the London and Paris Clubs.

In the January to June period, central government funds borrowed exclusively on the basis of bank loans. Their total debt at end-June reached HRK 17.4bn, of which almost two thirds can be attributed to external debt. Compared with the end of the previous year, their debt rose by HRK 0.9bn, as a result of new foreign borrowing of CM and domestic borrowing of CR and CPF.

CBRD debt rose by HRK 0.9bn in the first six months of 2008, reaching HRK 10.6bn at end-June. In the last several years, the CBRD ensured the bulk of the funds needed to finance its credit programmes through foreign bond issues.

However, due to unfavourable developments in international capital markets, there were no new issues during the observed period so that the recorded increase in its debt stock can be fully ascribed to growing loan liabilities. In June, the CBRD and a syndicate of twenty foreign banks concluded an agreement on a syndicated loan of EUR 230m, and the same month recorded a significant increase in CBRD debt associated with domestic banks' loans.

12 Banking Sector

12.1 Banks' Business Operations

At the end of June 2008, the banking sector comprised 33 banks and 5 housing savings banks, with no changes in the number of banking institutions operating in the Republic of Croatia being reported in the first half of the year. The share of assets of banks and housing savings banks in total banking sector assets also remained unchanged, standing at 98.1% and 1.9%, respectively.

Table 16 Number of Banking Institutions

end of period

Banks	2006	2007	Jan.-Jun. 2008
Number of banks at the beginning of the period	34	33	33
Banks that merged with other banks	–1	–	–
Banks undergoing winding-up proceedings	–	–	–
Banks whose license was revoked	–	–	–
Number of banks at the end of the period	33	33	33
Housing savings banks			
Number of housing savings banks at the beginning of the period	4	5	5
Housing savings banks that were granted license	1	–	–
Number of housing savings banks (and savings banks) at the end of the period	5	5	5

Source: CNB.

At the end of the first half of 2008, similarly as at the end of 2007, there were six large, four medium-sized and 23 small banks operating in the Republic of Croatia.[23] The share of these three groups of banks in the total assets of all banks changed only slightly. The group of small banks increased its share by one per mille, or 0.1%, to the expense of an equal fall in the share of medium-sized banks, thus continuing its steady growth from end-2006.

Note: Data on the operation of banks and housing savings banks in the first half of 2008 are based on unconsolidated unaudited financial statements submitted by banks and housing savings banks to the Croatian National Bank.

[23] Depending on the size of the relative share of the bank's assets in the total assets of all banks at the end of the reporting period, banks have been divided into three peer groups: large, medium-sized and small banks. Large banks are banks whose assets exceed 5% of the total assets of all banks, medium-sized banks are banks whose assets are greater than 1% and less than 5% of the total assets of all banks, and small banks are banks whose assets are less than 1% of the total assets of all banks.

Table 17 Bank Peer Groups and Their Share in Total Bank Assets

end of period

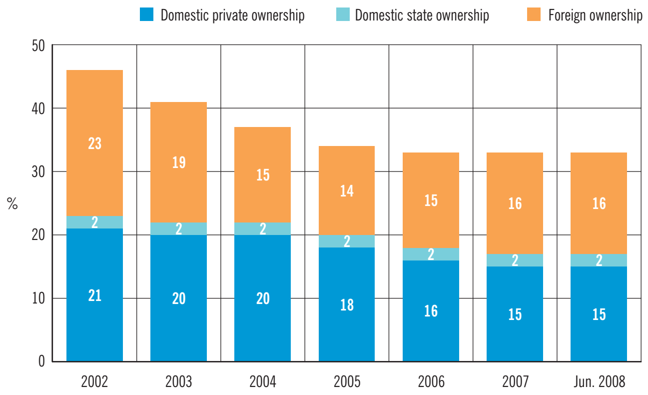
	Number of banks			Share		
	2006	2007	Jun. 2008	2006	2007	Jun. 2008
Large banks	6.0	6.0	6.0	80.2	79.0	79.0
Medium-sized banks	4.0	4.0	4.0	12.0	12.9	12.8
Small banks	23.0	23.0	23.0	7.8	8.1	8.2
Total	**33.0**	**33.0**	**33.0**	**100.0**	**100.0**	**100.0**

Source: CNB.

Compared to the end of 2007, the share of assets of the two largest banks in the assets of all banks stood at 41.2%, increasing by 0.3 percentage points, and reaching its highest level since end-2006. The share of the five largest banks rose 0.4 percentage points to 71.9% of the total assets of banks, also their highest level in the past two years. The assets of the ten largest banks accounted for 91.8% of the total balance sheet of all banks.

Figure 53 Number of Banks by Ownership Residence and Form of Ownership

end of period



Source: CNB.

In the first half of 2008, there were no changes in the number of banks in domestic (private or state) and foreign ownership, compared to the end of 2007.

There were also no significant changes in the structure of banks' assets in terms of the type of ownership compared to the end of 2007. The share of banks' assets in majority state ownership fell by 0.1 percentage point at the end of the first half of 2008 as a result of a 2.4% fall in the total assets of banks in domestic state ownership during the observed half-year period. At the same time, the share of banks' assets in majority foreign ownership rose by 0.1 percentage points as a result of a 1.1% increase in assets growth. The share of banks' assets in majority domestic ownership in the total assets of all banks remained unchanged, while these banks reported a 1.5% assets growth compared to the end of 2007.

Table 18 Banks' Assets by Ownership Residence and Form of Ownership

in %

Banks by ownership residence and form of ownership	Bank peer groups' share of assets in total bank assets		
	2006	2007	Jun. 2008
Banks in majority ownership of domestic shareholders	5.0	4.9	4.9
Banks in majority state ownership	4.2	4.7	4.6
Banks in majority ownership of foreign shareholders	90.8	90.4	90.5
Total	**100.0**	**100.0**	**100.0**

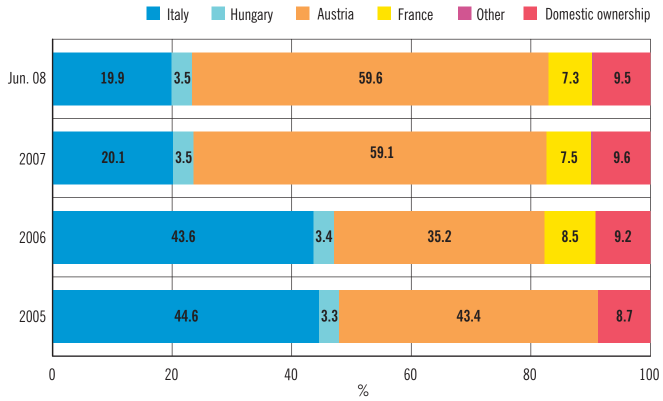
Source: CNB.

At the end of the first half of 2008, the largest number of banks was in domestic private ownership (15), while two banks remained in state ownership. Of the banks in majority ownership of foreign shareholders, the largest number (7) were in the ownership of Austrian shareholders, 5 of them were in majority ownership of Italian shareholders, and 1 bank was in majority ownership of shareholders from France, Hungary, San Marino and Luxembourg, respectively. The total assets of banks in majority ownership of Austrian shareholders accounted for 59.6%, or the largest share of total banks' assets at the end of the first half of 2008. Compared to their end-2007 balance, the share of this group rose slightly as a result of higher growth rate of assets of these banks (1.8%) compared to total banks' assets growth (0.9%).

The number of banking groups, obligated pursuant to the Decision on consolidated financial reports of a banking group[24] to report through a superordinate bank to the Croatian National Bank on its operations rose in the first half of 2008 from nine to ten. The superordinate banks of those banking groups were Erste & Steiermärkische bank d.d., Hrvatska poštanska banka d.d., Hypo Alpe-Adria-Bank d.d., Karlovačka banka d.d., OTP banka Hrvatska d.d., Privredna banka Zagreb d.d., Raiffeisenbank Austria d.d., Slatinska banka d.d., Société Générale-Splitska banka d.d., and Zagrebačka banka d.d.

Figure 54 Banks' Assets by Shareholders' Domicile

end of period



Note: For the purpose of this overview the shareholder's domicile means the head office of a company or residence of the owner (a natural person).

Source: CNB.

12.1.1 Banks' Balance Sheet

Structure of Banks' Assets

Further use of monetary and prudential measures of the CNB in the first half of 2008 led to a steady slowdown in assets' growth, while credit activities of banks continued to be intense. In the conditions of reduced sources of financing, the growth of net loans was financed mainly through asset restructuring and reduction of almost all other forms of placements and to a lesser extent through capital increase.

Table 19 Structure of Banks' Assets

end of period, in million HRK and %

	2006			2007			Jun. 2008		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	49,615.2	16.3	15.7	51,415.9	14.9	3.6	52,674.6	15.1	2.4
1.1. Money assets	3,931.0	1.3	17.4	4,551.7	1.3	15.8	4,913.9	1.4	8.0
1.2. Deposits with the CNB	45,684.2	15.0	15.5	46,864.2	13.6	2.6	47,760.7	13.7	1.9
2. Deposits with banking institutions	26,005.6	8.5	12.3	35,118.0	10.2	35.0	28,198.4	8.1	–19.7
3. MoF treasury bills and CNB bills	8,077.2	2.7	15.3	8,748.7	2.5	8.3	7,729.3	2.2	–11.7
4. Securities and other financial instruments held for trading	7,730.4	2.5	–6.7	8,515.5	2.5	10.2	6,541.0	1.9	–23.2
5. Securities and other financial instruments available for sale	12,678.2	4.2	7.3	11,326.4	3.3	–10.7	10,306.1	3.0	–9.0
6. Securities and other financial instruments held to maturity	3,311.9	1.1	–35.1	3,536.7	1.0	6.8	3,544.5	1.0	0.2
7. Securities and other financial instruments not traded in active markets but carried at fair value	460.1	0.2	–58.2	700.0	0.2	52.1	590.5	0.2	–15.6
8. Derivative financial assets	280.9	0.1	90.7	276.0	0.1	–1.8	426.6	0.1	54.6
9. Loans to financial institutions	4,035.4	1.3	4.3	6,949.8	2.0	72.2	4,797.1	1.4	–31.0
10. Loans to other clients	183,740.0	60.3	24.1	209,319.6	60.7	13.9	223,430.9	64.2	6.7
11. Investments in subsidiaries, associates and joint ventures	1,675.5	0.6	4.6	1,703.9	0.5	1.7	1,778.1	0.5	4.4
12. Foreclosed and repossessed assets	445.6	0.1	25.1	355.7	0.1	–20.2	359.2	0.1	1.0
13. Tangible assets (net of depreciation)	4,434.1	1.5	5.6	4,510.4	1.3	1.7	4,539.6	1.3	0.6
14. Interest, fees and other assets	4,787.8	1.6	–2.3	5,471.0	1.6	14.3	6,178.8	1.8	12.9
15. Net of: Collectively assessed impairment provisions	2,672.6	0.9	18.1	2,866.2	0.8	7.2	2,885.4	0.8	0.7
Total assets	**304,605.3**	**100.0**	**17.0**	**345,081.4**	**100.0**	**13.3**	**348,209.2**	**100.0**	**0.9**

Note: The value of assets is expressed in gross amounts in the chapter on monetary and credit aggregates and in net amounts (i.e. net of impaired assets) in the above balance sheet.

Source: CNB.

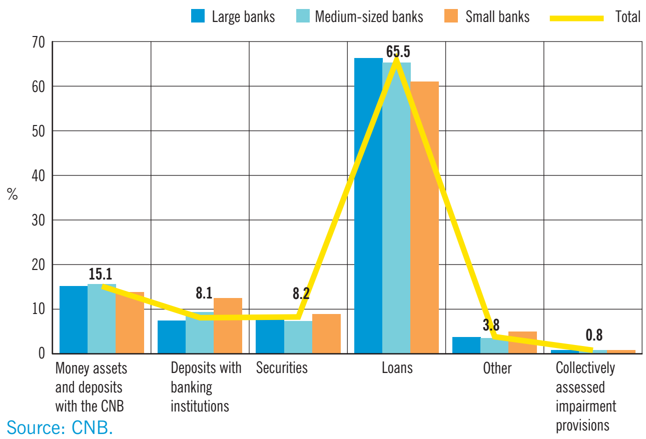
[24] OG 17/2003 and 149/2005.

The total assets of all banks at the end of the first half of 2008 stood at HRK 348.2bn, increasing by HRK 3.1bn, or 0.9% compared to their end-2007 balance. While 21 banks reported assets growth, the remaining 12 banks reported a fall in assets during the observed period. Driven by a trend of growth in several small banks in the past several years, this group of banks reported the largest asset growth rate (1.2%). Assets of large banks rose by 0.9% and those of medium-sized banks rose by 0.5%.

Banks' assets growth rate in the first half of the year, the slowest in the past five years is the result of monetary and prudential measures, mostly placements' growth restriction associated with the implementation of the measure on the subscription of compulsory CNB bills. Thus, in the first six months of the year, the banks reported a slower growth rate (4.5%) than that permitted (6%) of the part of assets considered placements in terms of the Decision on the purchase of compulsory CNB bills.[25] At the same time, off-balance sheet items of banks which are considered placements shrank by 2.5%.

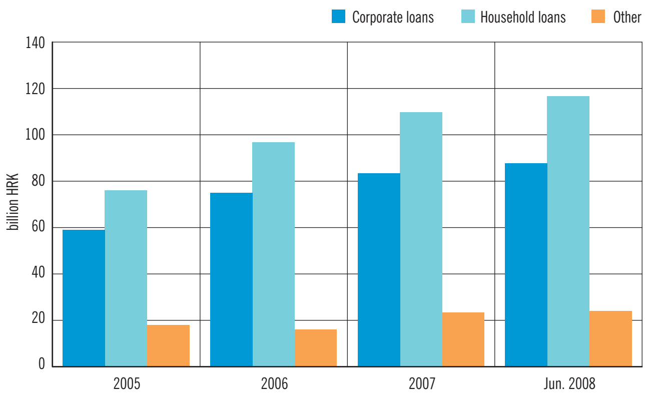
Much faster growth of these placements, i.e. loan granted, compared to total assets growth, was mainly due to structural changes in banks' assets. The total amount of net loans granted rose by HRK 12.0bn, an almost four-fold increase compared to assets growth, in contrast with investments in deposits and securities which fell by a total of HRK 11.0bn. Despite a visible slowdown in net loans growth during the observed period (5.5% compared to 9.9% in the same period previous year), a concurrent fall in other types of placements led to a further increase in the share of loans in banks' assets.

Figure 55 Structure of Bank Peer Groups' Assets
as at 30 June 2008



Source: CNB.

Figure 56 Net Loans by Type of User
end of period



Source: CNB.

Compared to the end of 2007, the share of loans in banks' assets rose by almost three percentage points, with net loans accounting for 65.5% of banks' assets at the end of the first half of 2008. Given a fall in loans granted to financial institutions compared to end-2007, the entire increase in net loans, and increase in their assets share, was due to loans granted to non-financial sectors. In the observed half-year period, medium-sized banks reported the largest increase in the amount of loans granted (7.2%) and their share in assets (up from 61% at end-2007 to 65% at the end of the first half of 2008). The amount of loans granted rose the least in the group of small banks (0.9%), in which loans accounted for 60.8% of assets. In the group of large banks, loans rose by 5.7%, and again accounted for the largest share of assets (66.1%).

Similarly as in 2007, credit activities of banks focused mainly on households which accounted for over one half of the total increase in net loans in the first half of 2008. Loans to households thus rose by HRK 7.0bn or 6.4% and reached HRK 116.5bn or 51.0% of total net loans of banks. As regards the structure of loans granted to households, it can be seen that home loans and other loans grew equally. A larger share of the total increase in home loans of HRK 3.0bn was denominated in kuna with a currency clause (HRK 1.9bn), while kuna loans rose by HRK 1.1bn. Due to a relatively faster growth of kuna home loans (31.6%) than loans with a currency clause (4.6%), the share of kuna loans in the total amount of home loans granted rose from

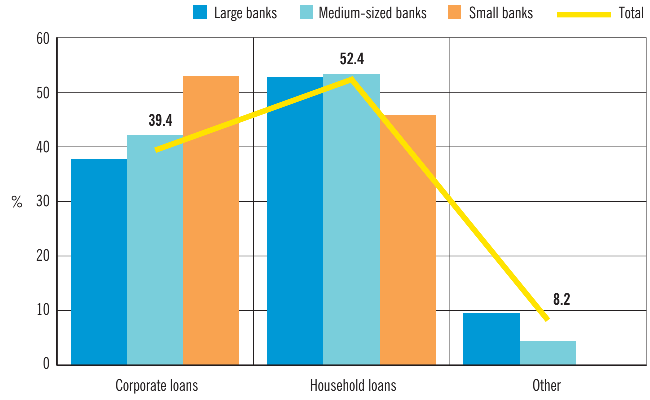
[25] OG 132/2007 and 29/2008.

8.0% at end-2007 to 9.9% at the end of the first half of 2008.

Corporate loans rose by HRK 4.3bn (5.2%), with the largest share of the increase being denominated in kuna with a currency clause. Compared to the end of 2007, in relative terms loans to the government rose the most (19.5% or HRK 2.8bn), with the whole amount of the increase going to foreign currency loans, which ultimately influenced total net loans in foreign currency which in relative terms rose the most (14.2%). The other two components of total net loans – kuna and kuna with a currency clause rose by 4.4% and 4.9%, respectively compared to the end of 2007, but their share in total net loans did not change significantly. Similarly as at the end of 2007, the largest share of total net loans (52.2%) was denominated in kuna with a currency clause, 38.2% of net loans were kuna loans, while the remaining 9.6% were accounted for by loans in foreign currency.

Figure 57 Structure of Net Loans by Bank Peer Groups

as at 30 June 2008



Source: CNB.

In complying with the compulsory CNB bills subscription requirement, towards the end of 2007, the banks placed a part of their capital increase into deposits with other banks. In the first half of this year, the banks reduced these deposits by a total of HRK 6.9bn (19.7%), fully as a result of decreased deposits with foreign banks, in contrast with deposits with domestic banks which rose by HRK 0.6bn (42.8%). Time deposits with foreign banks fell by HRK 7.4bn (23.1%), partly as a result of a reduction in mandatory minimum coverage of foreign currency liabilities by foreign currency claims from 32% to 28.5%[26] which liberated funds for banks' participation in a refinancing loan arrangement for foreign and domestic public debt repayment. The share of deposits in banks' assets fell by over two percentage points (from 10.2% at end-2007 to 8.1% at the end of the first half of 2008).

Large banks reduced their securities investments by a significant 15.5% or HRK 4.2bn, medium-sized banks reduced them by 1.1% while small banks increased this type of investments by 4.9%. As a result, compared to the end of 2007, the rate of decline in securities investments (T-bills of the MoF included) of all banks stood at 12.5% (HRK 4.1bn). Looking at debt securities instruments, it is evident that bonds, most notably bonds of foreign financial institutions, accounted for almost one half of the total decline in securities investments (almost HRK 2.0bn or 11.4%). In terms of the amount of decline, banks' investments in T-bills of the MoF which fell by HRK 1.0bn or 11.7% ranked next. Banks also reduced their equity investments by 12.3% as a result of a one-third fall in corporate equity. Similar changes in the amount of investments in debt and equity securities did not cause any changes in their share in total securities, so that, in the same way as at the end of 2007, 96.3% of investments were debt related and 3.7% were equity related investments. With a 53.3% share, bonds continued to be the most frequent securities instrument in banks. The share of total securities in banks' assets fell by 1.3 percentage points compared to the end of 2007 and stood at 8.2% at the end of the first half of 2008.

Structure of Banks' Liabilities

Compared to their end-2007 balance, the liabilities of banks based on loans received fell by HRK 3.3bn (6.2%). Received deposits were also much smaller compared to the end of 2007 (0.3%) and so were issued securities and subordinated instruments. A slight compensation for the fall in these sources of financing was provided by a HRK 1.2bn increase in hybrid instruments, with the total liabilities of banks falling by HRK 1.8bn (0.6%) compared to the end of 2007.

[26] Decision on the minimum required amount of foreign currency claims (OG 29/2008).

Table 20 Structure of Banks' Liabilities

end of period, in million HRK and %

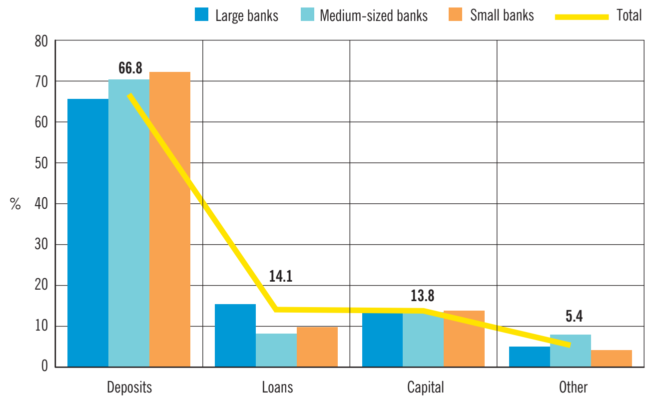
	2006			2007			Jun. 2008		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	15,102.5	5.0	9.1	20,573.0	6.0	36.2	17,861.6	5.1	–13.2
1.1. Short-term loans	7,286.7	2.4	–0.8	11,325.6	3.3	55.4	7,726.4	2.2	–31.8
1.2. Long-term loans	7,815.8	2.6	20.3	9,247.4	2.7	18.3	10,135.2	2.9	9.6
2. Deposits	202,950.5	66.6	18.2	233,108.0	67.6	14.9	232,431.2	66.8	–0.3
2.1. Giro account and current account deposits	37,696.5	12.4	29.2	45,284.0	13.1	20.1	40,736.0	11.7	–10.0
2.2. Savings deposits	26,601.4	8.7	1.8	26,859.4	7.8	1.0	26,756.4	7.7	–0.4
2.3. Time deposits	138,652.5	45.5	19.1	160,964.5	46.6	16.1	164,938.8	47.4	2.5
3. Other loans	39,762.9	13.1	9.9	31,738.8	9.2	–20.2	31,190.3	9.0	–1.7
3.1. Short-term loans	10,028.1	3.3	22.1	5,528.8	1.6	–44.9	6,766.3	1.9	22.4
3.2. Long-term loans	29,734.8	9.8	6.3	26,210.1	7.6	–11.9	24,423.9	7.0	–6.8
4. Derivative financial liabilities and other financial liabilities held for trading	221.6	0.1	–0.9	367.5	0.1	65.9	355.2	0.1	–3.3
5. Debt securities issued	3,583.4	1.2	5.5	3,476.7	1.0	–3.0	3,409.0	1.0	–1.9
5.1. Short-term debt securities issued	0.0	0.0	–	0.0	0.0	0.0	0.0	0.0	0.0
5.2. Long-term debt securities issued	3,583.4	1.2	5.5	3,476.7	1.0	–3.0	3,409.0	1.0	–1.9
6. Subordinated instruments issued	758.1	0.2	–1.6	225.7	0.1	–70.2	54.9	0.0	–75.7
7. Hybrid instruments issued	552.4	0.2	–37.7	636.6	0.2	15.2	1,815.8	0.5	185.2
8. Interest, fees and other liabilities	10,413.5	3.4	6.5	11,781.4	3.4	13.1	13,020.2	3.7	10.5
Total liabilities	**273,344.9**	**89.7**	**15.4**	**301,907.8**	**87.5**	**10.4**	**300,138.3**	**86.2**	**–0.6**
Total capital	**31,260.3**	**10.3**	**33.3**	**43,173.6**	**12.5**	**38.1**	**48,070.9**	**13.8**	**11.3**
Total liabilities and capital	**304,605.3**	**100.0**	**17.0**	**345,081.4**	**100.0**	**13.3**	**348,209.2**	**100.0**	**0.9**

Source: CNB.

At the end of the first half of 2008, over one half of the banks reported a fall in deposits. Total banks' deposits thus shrank by HRK 0.7bn compared to the end of 2007 and stood at HRK 232.4bn. Deposits fell in all three groups of banks, with the largest decline in both absolute and relative terms being reported by small banks (HRK 0.3bn or 1.4%). The fall in total deposits was mainly due to a HRK 8.2bn (3.5%) fall in corporate deposits, which reflected equally on sight and time deposits. Owing to household deposits growth, particularly time deposits which increased by 11.0% compared to the end of 2007, total time deposits rose by 2.5%, while total giro and current account deposits fell by 10.0% and savings deposits by 0.4%. Households deposited over two thirds of the increase in time deposits in banks in foreign currency which led to a 4.2% increase in total deposits in foreign currency. During the observed period and influenced by a fall in giro and current accounts and corporate time deposits, total deposits in kuna fell by 3.1% and deposits in kuna with a currency clause fell by 24.5%, due to these deposits' fall in all the institutional sectors.

Figure 58 Liability Structure by Bank Peer Groups

as at 30 June 2008

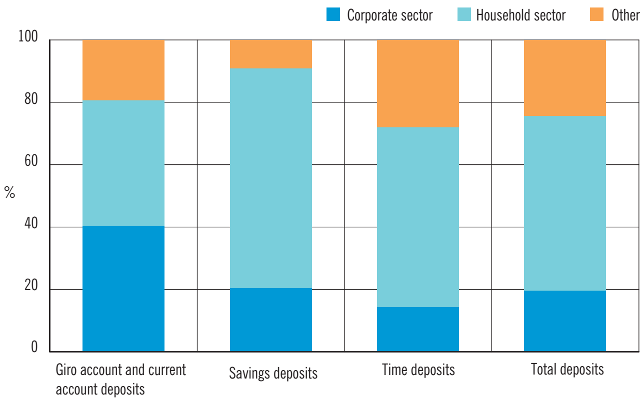


Source: CNB.

At the end of the first half of 2008, banks' liabilities based on loans received fell by HRK 3.3bn compared to the end of 2007, with the largest share of the fall being attributed to a

HRK 2.7bn (13.2%) fall in liabilities towards domestic financial institutions. Liabilities towards foreign financial institutions and majority foreign owners did not change much, so that due to the fall in loans from domestic creditors, the share of loans from majority foreign owners in the total amount of loans received rose from 33.6% at the end of 2007 to 35.9% at the end of the first half of 2008. Together with deposits, funds from foreign owners accounted for 13.6% of total received loans and deposits of banks. Above-average shares of the said sources were reported in large and medium-sized banks (14.4% and 14.9%, respectively), while they were much lower in small banks (4.2%), despite the fact that small banks more than doubled their liabilities to their foreign owners.

Figure 59 Structure of Deposits by Type and Sector
as at 30 June 2008



Source: CNB.

At the end of the first half of 2008, banks increased significantly their liabilities arising from issued hybrid instruments (HRK 1.2bn or 185.2%). This increase can be attributed mainly to two banks into which these funds have been paid by their majority foreign owners. Liabilities arising from issued subordinated instruments and long-term issued securities fell by a total of HRK 238.5m, so the share of all the three mentioned instruments rose slightly compared to the end of 2007 and accounted for 1.5% of the total liabilities of banks.

12.1.2 Banks' Capital

Following its exceptionally large increase in 2007 (38.1%), banks' capital continued to grow strongly throughout the first half of 2008 (11.8%), thus increasing its share to 13.8% of liabilities of all banks. Capital of large and small banks rose by 12.1% and that of medium-sized banks by 6.4% during the observed period. In all bank groups, the shares of capital in the liabilities structure increased and their value was almost the same, similarly as at end-2007. Significant increase in this indicator in large and medium-sized banks in 2007 was influenced by monetary and supervisory measures of the CNB. In the previous years, the value of this indicator was inversely proportionate to the amount of a bank's assets; i.e. it was the smallest in large banks and the largest in small banks, which is considered a common development in its value.[27]

Table 21 Structure of Banks' Total Capital
end of period, in million HRK and %

	2006			2007			Jun. 2008		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Share capital	16,584.2	53.1	43.9	25,179.3	58.3	51.8	28,124.4	58.5	11.7
2. Current year profit/loss	3,394.8	10.9	4.5	4,067.4	9.4	19.8	2,750.9	5.7	–32.4
3. Retained earnings/loss	3,716.8	11.9	48.7	4,212.0	9.8	13.3	5,714.4	11.9	35.7
4. Legal reserves	882.4	2.8	10.5	1,054.3	2.4	19.5	1,097.4	2.3	4.1
5. Total reserves provided for by the articles of association and other capital reserves	6,662.0	21.3	24.5	8,644.2	20.0	29.8	10,345.5	21.5	19.7
6. Unrealised gains/losses on value adjustments of financial assets available for sale	14.6	0.0	–37.8	30.7	0.1	109.9	46.6	0.1	51.7
7. Reserves arising from hedging transactions	8.3	0.0	–	–0.8	0.0	–109.4	0.0	0.0	–100.0
8. Previous year profit/loss	–2.7	0.0	–	–13.6	0.0	396.3	–8.1	0.0	–40.2
Total capital	**31,260.3**	**100.0**	**33.3**	**43,173.6**	**100.0**	**38.1**	**48,070.9**	**100.0**	**11.3**

Source: CNB.

[27] A larger share of capital on the balance sheets of smaller banks is usually interpreted to be a result of smaller availability of sources of funds, most notably received loans. For instance, at the end of 2004, the share of capital in liabilities amounted to 7.9% in large banks, 10.2% in medium-sized banks and 13.8% in small banks.

The increase in the share of capital in the structure of banks' liabilities is the result of substitution of foreign borrowing by capital investments of foreign owners of banks for the purpose of business optimisation in view of monetary[28] and supervisory[29] measures of the CNB.

In the first half of 2008, two large, one medium-sized and six small banks were recapitalised with nearly HRK 3.0bn. A little over one half of this amount went to recapitalisation of one large bank. As a result, the banks' share capital rose by 11.7% in the first half of 2008 and was the most significant booster of total banks' capital growth as well as its largest component (58.5%). Small banks had the highest growth rate of share capital (20.1%). They were followed by large banks (12.1%) and medium-sized banks (4.9%).

The increase in the total capital of banks was influenced by an increase in total reserves provided for by the articles of association and other capital reserves and bigger retained earnings. Until the end of the second quarter of this year, the banks had allocated the major share of HRK 4.1bn in profit earned in 2007. They used almost 80% of the profit to strengthen their capital positions, so legal, total reserves provided by the articles of association and other capital reserves rose by HRK 1.7bn (18.1%) and retained earnings by HRK 1.5bn (35.7%) with almost HRK 0.8bn being paid out to shareholders.

In 2007 and in the first half of 2008, total capital outstripped regulatory capital both in terms of its amount and growth rate. Given that legislation allows inclusion of other, lower quality forms of capital in terms of durability and availability (supplementary capital) for the purpose of calculating regulatory capital, such developments may seem illogical at first. However, due to small use of supplementary capital, the treatment of investment in capital of other banks and financial institutions as deduction items from regulatory capital and the fact that current year profit constitutes an integral part of the total capital, while it can be included in regulatory capital only subject to fulfilment of certain conditions,[30] the growth of total capital in recent periods has been more pronounced than that of regulatory capital.

Bank recapitalisations in the first half of 2008 had a favourable impact on developments in core capital and consequently on regulatory capital of banks which rose by 9.4% during the observed period and stood at HRK 46.2bn at the end of June. Core capital, as the highest quality component of regulatory capital, rose by 8.3%, though supplementary capital I which is included in regulatory capital rose by an even higher 31.3%. Thus the share of core capital in gross regulatory capital fell slightly; from 95.5% at end-2007 to 94.6% at the end of the first half of 2008. Regulatory capital rose the most in medium-sized banks (11.2%) and that primarily as a result of an increase in supplementary capital I (60.0%) through an issue of hybrid instruments. In large and medium-sized banks regulatory capital rose by 9.3% and 7.4%, respectively, mainly as a result of bank recapitalisation efforts.

In addition to medium-sized banks, large banks also increased significantly (34.4%) supplementary capital I which is included in regulatory capital, also through an issue of hybrid instruments. As a result, the share of supplementary capital I in gross regulatory capital of banks rose from 4.5% to 5.4%. The growth of supplementary capital I was toned down by further exclusion of collectively assessed impairment provisions from regulatory capital.[31] Low level of the share of supplementary capital I of all banks notwithstanding, some banks, most notably medium-sized banks, relied more on this form of capital. Supplementary capital II was reported by only two small banks, with its share in gross regulatory capital of all banks standing at only 0.01%.

The net value of banks' assets weighted by risk increased by HRK 3.7bn or 1.1% compared to end-2007, while its weighted amount rose by a high HRK 42.7bn or 19.7%. As a result, the risk-weighted assets to net assets ratio rose sharply from 62.9% at end-2007 to 74.6% at the end of the first half of 2008.

The reason behind this sharp increase in risk-weighted assets lies in tightening of the conditions for risk-weighting for claims subject to a currency-induced credit risk (CICR)[32] and the fastest growth of these net assets items. In the

[28] Decision on the marginal reserve requirement (OG 146/2005, 69/2006 and 130/2007) and Decision on the minimum required amount of foreign currency claims (OG 59/2008).

[29] Decision on the capital adequacy of banks (OG 17/2003, 120/2003, 130/2006, 130/2007 and 31/2008). Since mid-2006, the banks have been obligated to estimate and monitor currency-induced credit risk (CICR). These measures were further tightened in 2008 with an increased weight for foreign currency (and indexed) claims on the clients with an unmatched currency position. Additional requirements for minimum capital adequacy were also prescribed in 2008 for those banks whose quarterly placements' growth exceeds the maximum permitted rate of placements growth, which is calculated on the basis of the rate of use of secondary sources of funds and capital adequacy ratio.

[30] To include current year profit in regulatory capital, a bank needs to issue a decision on the allocation of current year profit in retained earnings or reserves and obtain an approval from the CNB.

[31] Under the Decision on amendments to the instruction for the uniform implementation of the decision on the capital adequacy of banks (OG 41/2006) of 31 December 2006, collectively assessed provisions are to be gradually excluded from regulatory capital, so that at 31 December 2007, the banks were obligated to exclude from regulatory capital any amount in excess of 0.50%, as at 30 June 2007 any amount in excess of 0.25% of the sum total of risk-weighted assets, standard and other off-balance sheet items. Until 31 December 2006, it was possible to include these provisions up to the amount of 1.25% of the sum of total of risk-weighted assets, standard and other off-balance sheet items.

[32] Since the beginning of 2008, risk weights of 75% for covered and 125% for uncovered (and indexed) claims on clients with unmatched currency positions, have been replaced by new risk weights of 100% and 150%.

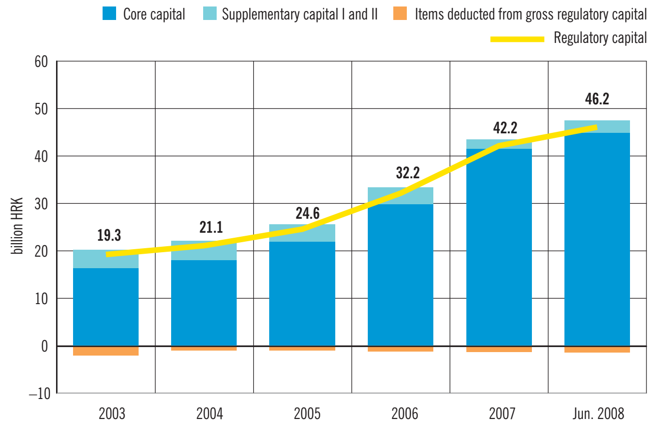
first half of 2008, uncovered foreign currency (and indexed) claims on the clients with unmatched currency positions (risk weight of 150%) rose by HRK 10.3bn (13.7%), while total risk-weighted net assets rose by HRK 3.7bn (1.1%). As a result, this item's share in net assets rose in the observed period from 22.2% to 24.9%, while its share in the risk-weighted value of assets rose from 43.0% to 49.0%. The share of covered foreign currency (and indexed) claims on the clients with unmatched currency positions in the net value of assets fell from 10.5% at the end of 2007 to 9.8% at the end of the second half of 2008 as a result of a HRK 2.1bn (5.9%) fall in these claims. However, the risk-weighted amount rose by 25.4% due to an increase in risk weights from 75% to 100% and accounted for 12.9% of the total risk-weighted assets. The growth of kuna home loans led to a HRK 1.1bn (35.8%) increase in net assets items weighted by a 50% risk weight, while net assets weighted by 20% risk weight fell by a high HRK 7.9bn (18.9%) due to relaxation of the measures on the minimum foreign currency coverage and associated smaller claims on the foreign banks.

The growth of credit risk exposure based on balance sheet positions was due not only to direct regulatory changes, but also particularly to a high increase in uncovered placements exposed to CICR granted to the household sector and the government.[33]

In addition to risk-weighted balance sheet assets, total credit risk exposure for the purpose of calculating capital adequacy ratio includes risk-weighted standard (guarantees, financing obligations, etc.) and other off-balance sheet items (interest rate agreements, currency agreements, etc.). The share of risk-weighted balance sheet assets rose during the observed period and remained dominant (87.4%), the share of risk-weighted standard off-balance sheet items was 12.4% and the share of risk-weighted other off-balance sheet items was 0.16%. Due to an increase in all the components, total risk-weighted balance sheet and off-balance sheet items (standard and others) rose by 19.6% in the first half of 2008. Given smaller market risk exposure (11.9%), total risk exposure rose by HRK 7.6bn or 18.1%. The significant increase in regulatory capital, boosted by recapitalisation and issues of hybrid instruments, could nevertheless not offset high risk exposure growth, so that capital adequacy ratio of all banks fell from 16.36% to 15.16%.

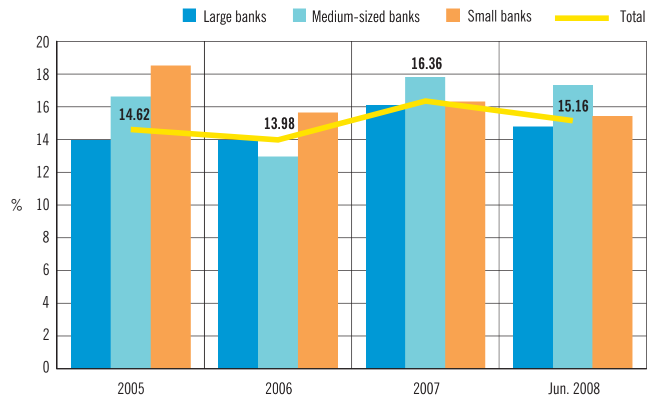
All the banks reported a capital adequacy ratio above the legally prescribed minimum of 10%. Nevertheless, all bank groups, and particularly large banks, reported a fall in their capital adequacy ratios (from 16.11% to 14.78%) due to a large increase in risk-weighted balance sheet and off-balance sheet (standard and others) items (20.3%). The smallest change was seen in medium-sized banks whose capital adequacy ratio, similarly as at end-2007, was the

Figure 60 Structure of Banks' Regulatory Capital
end of period



Source: CNB.

Figure 61 Capital Adequacy Ratio by Bank Peer Groups
end of period

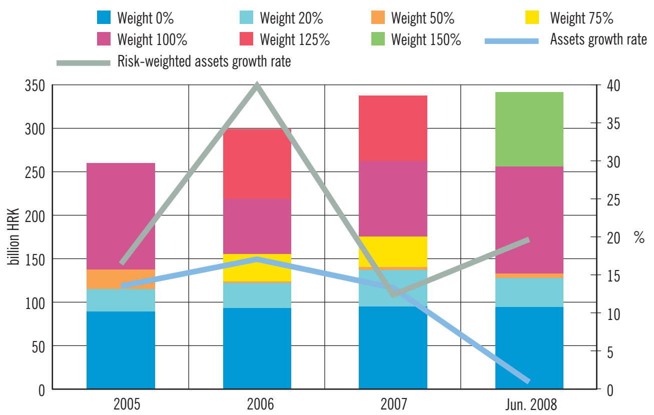


Source: CNB.

[33] In May 2008, the Government of the Republic of Croatia issued a Decision on the borrowing of the Republic of Croatia by means of a EUR 760m worth of foreign currency loan syndicated by domestic banks. Leading loan arrangers included Zagrebačka banka d.d., Privredna banka Zagreb d.d., Raiffeisenbank Austria d.d., Société Générale-Splitska banka d.d., Erste & Steiermärkische Bank d.d. and Hypo Alpe-Adria Bank d.d.

Figure 62 Banks' Assets Included in Total Risk-Weighted Assets

end of period



Source: CNB.

highest and stood at 17.34%, while in small banks it was 15.43%. Four banks which accounted for 5.6% of assets of all banks reported a capital adequacy ratio below 11%. All the banks met the additional capital adequacy ratio requirements introduced this year. In the second quarter of 2008 only one bank reported placements growth at the rate above the maximum permissible growth rate calculated on 31 March 2008 based on the rate of use of secondary sources of funds and the capital adequacy ratio. However, following recapitalisation in the second quarter, this bank's capital adequacy ratio as at 30 June 2008 was above the prescribed minimum.

Six large, two medium-sized and one small banks whose trading book transactions exceeded the minimum prescribed volume of trading book activities, reported capital requirements for position risks at the end of the first half of 2008. The remaining 24 banks were not subject to the comprehensive approach, but were obligated to calculate capital requirements for credit and currency risks only. The capital requirement for position risks was reduced as a result of a fall in all its components, except commodity risk, with the largest fall being seen in capital requirements for interest rate risk and equity risk. No bank reported a capital requirement for exceeding the permissible exposure limits and settlement risk. Due to a fall in the capital requirement for position risks, the capital requirement for market risks, despite an increase in the capital requirement for currency risk, fell by 11.9%, thus decreasing its share in capital requirements to 2.4%. Such developments may be associated with a lower volume of trading activities of banks due to unfavourable developments in the domestic and foreign financial markets, particularly capital markets.

The capital requirement for position risks fell in all groups of banks. Only small banks reported an increase in the capital requirement for market risks as a result of an increase in the capital requirement for currency risk.

12.1.3 Quality of Banks' Assets

Following a slight decline in the first quarter (0.2%), total credit risk exposure of banks, i.e. total placements and contingent liabilities of banks rose by HRK 6.7bn (1.7%) in the second quarter of this year, reaching on a half-year level a 1.5% growth rate and HRK 402.4bn. On an annual level, the growth of placements and contingent liabilities of banks continued to slow down steadily so that total placements and contingent liabilities rose by 7.9% compared to the first half of 2007.

Placements and contingent liabilities of large banks rose by 1.8% during the observed period, while those of medium-sized and small banks rose by a much lower 0.4% and 0.1%, respectively.

Banks' placements (balance sheet items) rose by HRK 4.9bn (1.5%) while contingent liabilities (standard off-balance sheet items) rose by HRK 1.1bn (1.6%). Similarly as at the end of 2007, placements accounted for 82.6% and contingent liabilities for 17.4% of placements and contingent liabilities. However, there were significant changes in individual types of placements – the share of loans rose from 56.0% to 58.1% of placements and contingent liabilities, while the share of deposits and securities fell to 18.8% and 4.5%, respectively. The shares of other items (claims arising from income, embedded derivatives and other claims) remained almost unchanged. Previously mentioned government borrowing and the associated relaxation of the measure on minimum foreign currency coverage led to a growth in loans to government units and a fall in deposits in foreign banks. Loan growth was also financed by a further decline in securities investments and fresh capital.

Loans granted (gross) rose by HRK 11.9bn (5.4%) with household loans which rose by 6.3% accounting for the major share of this growth. Of the total loans granted to households, cash loans, overdraft facilities and other household loans grew the most in nominal terms (HRK 3.3bn or 6.7%), while home loans, with an increase of HRK 3.0bn, had an equal growth rate (6.7%). The largest contribution to total bad loans growth (5.0%), as the most significant component of bad placements and contingent liabilities (86.9%),[34] was provided by a 6.2% growth in bad loans to households.

[34] Bad placements and contingent liabilities/loans are placements and contingent liabilities/loans classified into risk categories B and C.

Bad loans rose the most in medium-sized banks (11.6%). The same group of banks also reported the highest growth rate of total loans (6.6%). Large banks increased their loans granted by 5.6% and small banks by 0.9%.

Bad to total loans ratio was 4.8% while bad to total placements and contingent liabilities ratio was much lower and stood at 3.2% as a result of a well-rated quality of given deposits and contingent liabilities. A mild increase in the share of bad placements and contingent liabilities was influenced by a 5.8% increase in bad placements and contingent liabilities, while total placements and contingent liabilities rose by 1.5%. The largest nominal growth was seen in bad loans and bad contingent liabilities which grew by 14.6% on a semi-annual basis.

The largest share of bad placements and contingent liabilities was reported in small banks (6.0%), then in medium-sized banks and large banks (3.6% and 2.9%, respectively).

Table 22 Classification of Banks' Placements and Contingent Liabilities by Risk Categories

end of period, in million HRK and %

Placements	2006		2007		Jun. 2008	
	Amount	Share	Amount	Share	Amount	Share
Fully recoverable placements (category A)	338,310.4	96.8	384,204.3	96.9	389,498.6	96.8
Partly recoverable placements (category B)	7,147.3	2.0	7,946.5	2.0	8,733.4	2.2
Irrecoverable placements (category C)	4,173.1	1.2	4,270.3	1.1	4,187.8	1.0
Total	**349,630.8**	**100.0**	**396,421.2**	**100.0**	**402,419.8**	**100.0**

Source: CNB.

Total value adjustments and provisions for placements and contingent liabilities under which banks are exposed to credit risk stood at HRK 9.7bn, a decline of 0.8% compared to the end of 2007. The provisions thus set aside covered 2.4% of the total placements and contingent liabilities of banks, a 0.1 percentage point fall compared to the end of 2007. Value adjustments against placements and provisions fell by 1.2% while collectively assessed impairment provisions fell by 0.1%. Average provisions for placements and contingent liabilities classified into risk category B stood at 23.2% and average provisions for total bad placements stood at 48.1%. Therefore, despite an increase in the total amount of placements and contingent liabilities which are expected to generate losses, the banks expect to achieve greater recoverability of bad placements and contingent liabilities.

Table 23 Banks' Value Adjustments and Provisions

end of period, in million HRK and %

	2006	2007	Jun. 2008
Total value adjustments against placements and provisions for contingent liabilities	9,252.2	9,774.6	9,696.2
– Value adjustments against placements and provisions for contingent liabilities	6,201.3	6,290.3	6,215.3
– Collectively assessed impairment provisions	3,050.9	3,484.3	3,480.8
Total placements and contingent liabilities	349,630.8	396,421.2	402,419.8
Relative ratio: total value adjustments and provisions/total placements and contingent liabilities	2.6	2.5	2.4

Source: CNB.

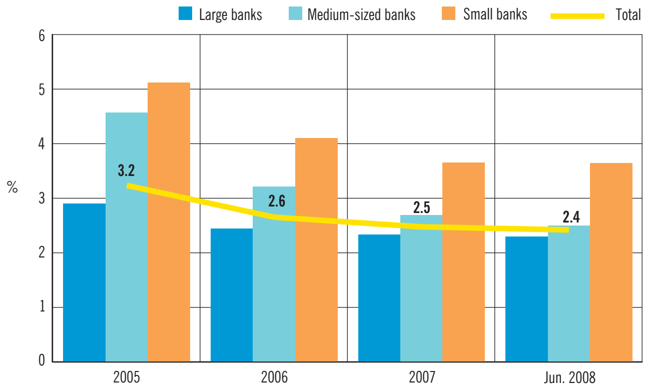
The coverage of total placements and contingent liabilities by total value adjustments and provisions changed slightly in the first six months of this year compared to the end of the previous year (from 2.5% to 2.4%) due to a fall in the coverage in the medium-sized group of banks (from 2.7% to 2.5%). The group of small banks (3.6%) and the group of large banks (2.4%), which have the largest impact on the system as a whole, did not report changes in this indicator.

Total placements and contingent liabilities exposed to a currency-induced credit risk (CICR), i.e. all placements and contingent liabilities in foreign currency and indexed to a foreign currency[35] were HRK 216.7bn, or 54.7% of total placements and contingent liabilities (net) at the end of the first half of 2008. During the observed half-year period, placements and contingent liabilities exposed to CICR rose by HRK 4.7bn or 2.2%. The share of placements and contingent liabilities exposed at the end of the first half of 2007 was 56.3% while at the end of the first half of 2006 when CICR monitoring was introduced, this indicator stood at 64.6%.

Loans exposed to CICR rose by HRK 7.9bn (5.7%) and contingent liabilities exposed to CICR rose by HRK 0.5bn (1.9%). Looking by sectors, the largest increase in placements and contingent liabilities exposed to CICR was reported in government units (HRK 5.3bn or 38.1%). Given that the share of government units in total CICR exposure rose by over two percentage points (to 8.9%) and that placements in that sector, in addition to non-profit institu-

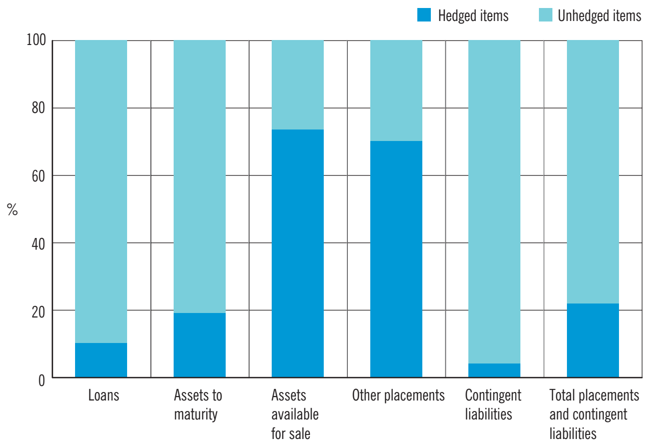
[35] In net carrying amount, i.e. reduced by value adjustments.

Figure 63 Ratio of Placements and Contingent Liabilities to Value Adjustment and Provisions by Bank Peer Groups
end of period



Source: CNB.

Figure 64 Structure of Net Placements Exposed to CICR
as at 30 June 2008



Source: CNB.

tions and the household sector, are the most exposed to CICR (as these sectors as a rule do not generate foreign currency inflow and have an unmatched currency position), the aggregate indicator of hedged placements and contingent liabilities fell from 24.5% to 22.1%. In other words, of the total amount of placements and contingent liabilities which are subject to CICR, 77.9% did not have adequate hedge against CICR impact.

Small banks reported the smallest share of exposed placements and contingent liabilities in total placements and contingent liabilities (43.2%) and the highest level of hedge for the exposed portfolio (30.4%). The reason for this lies in a smaller share of foreign currency and indexed placements in the structure of credit exposure and probably a greater share of smaller-amount short-term placements which are, in accordance with the regulations, reported as hedged.

The share of placements (contingent liabilities excluded) covered by quality insurance instruments rose from 40.2% at the end of 2007 to 42.7% of total placements at the end of the first half of 2008. Insurance instruments provided coverage for 89.1% of the value of placements covered by insurance. Quality insurance instruments comprise residential and business property, deposits, guarantees or securities issued by domestic government units and the CNB, government units and central banks of OECD countries, domestic banks, banks of OECD countries and all other instruments determined by banks in their bylaws as quality insurance instruments. The most important insurance instruments were residential and business property which accounted for 37.9% and 23.2%, respectively, of the covered amount of claims.

Large banks accounted for the largest share of covered placements in total placements (45.2%), probably attributable to significant home loans which are characterised by good payment insurance. In this group of banks, 39.0% of insured placements have residential property as the instrument of insurance. Medium-sized banks had a low percentage of covered placements (29.7%) due to a very low share of covered placements in one bank in this group. Small banks had 38.1% of placements covered, with business property as the dominant type of insurance instrument (39.4%).

12.1.4 Quality of Banks' Earnings

Banks reported a significant increase in profit in the first half of 2008, largely attributable to interest income growth and reduced expenses on loss provisions. At the end of the first half of 2008, banks reported HRK 3,341.2m in income before taxes, an increase of 34.4% over the same period previous year. Income before tax was reported by 28 banks while the remaining five banks reported a loss of HRK 50.9m. All the five mentioned banks belong to a group of small banks, and two of them have been operating with a loss for the second consecutive year.

Medium-sized banks reported the largest relative increase in income before tax (67.3%) compared to the first half of 2007. Large banks increased their income before tax by 36.1% while small banks, as a result of losses in five small banks, saw a 20.2% fall in income before tax. At the end of the first half of 2008, large banks accounted for 88.6% of total income before tax of all banks, which is an increase of almost ten percentage points compared to the share of their assets in total assets of banks.

Table 24 Banks' Income Statement

in million HRK and %

	Jan.-Jun. 2007	Jan.-Jun. 2008	
	Amount	Amount	Change
Total interest income	8,525.7	10,330.7	21.2
Total interest expenses	4,412.1	5,511.9	24.9
Net interest income	4,113.7	4,818.7	17.1
Total income from fees and commissions	1,938.1	2,116.2	9.2
Total expenses on fees and commissions	649.1	655.4	1.0
Net income from fees and commissions	1,289.0	1,460.8	13.3
Other non-interest income	1,039.8	1,234.4	18.7
Other non-interest expenses	322.3	340.8	5.7
Net other non-interest income	717.5	893.6	24.5
Net non-interest income	2,006.5	2,354.4	17.3
General administrative expenses and depreciation	3,173.2	3,594.9	13.3
Net operating income before loss provisions	2,946.9	3,578.3	21.4
Expenses on value adjustments and provisions for identified losses	469.6	237.0	–49.5
Expenses on collectively assessed impairment provisions	305.3	240.5	–21.2
Total expenses on loss provisions	164.2	-3.5	–102.1
Income/loss before taxes	2,477.4	3,341.2	34.9
Income tax	434.5	590.3	35.9
Current year profit/loss	2,042.9	2,750.9	34.7

Source: CNB.

Net income of banks rose by 17.2% compared to the end of the first half of 2007. Its components, net interest income and net non-interest income grew by 17.1% and 17.3%, respectively. As a result of their almost equal growth dynamics, there were no significant changes in the structure of net income, so that net interest income, similarly as at the end of the first half of 2007, accounted for 67.2% of net income. A slight change was observed in the distribution of non-interest income as a result of a larger increase in net other non-interest income (24.6%) compared to the increase in net income from fees and commissions (13.3%), so that net income from fees and commissions accounted for 20.4% of net income and other non-interest income accounted for 12.5% of net income of banks.

Influenced by asset restructuring, faster credit activities and increased prices of loans, interest income rose the most during the observed period (HRK 1.8bn or 21.2%). Such a change added to the importance of this source of income for banks as the share of interest income in total income rose from 74.1% to 75.5% at the end of the first half of 2008 compared to the same period previous year.

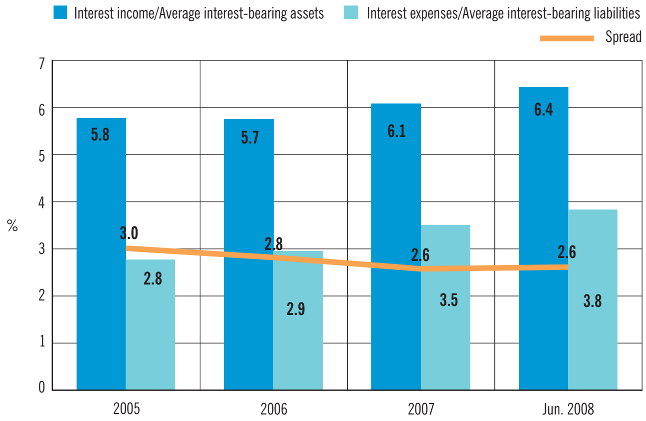
Interest income from loans granted rose by 21.0%, fuelled by an increase in this type of income in all institutional sectors. A somewhat slower than average growth of interest income from loans was seen in two major sectors, the household sector (20.3%) and enterprises (20.2%). As a result, the share of income from loans granted to the said sectors in total interest income from loans fell only slightly, with loans to households remaining the main source of interest income from loans (54.6%) while in terms share size, interest income from loans to enterprises came next (36.5%).

Activities generating non-interest income for banks led to an 18.7% increase in other non-interest income and a 9.2% increase in income from fees and commissions. A decline in profit on all trading activities resulted in an 86.1% fall in income compared to the end of the same period 2007, while the banks reported a loss in securities trading and value adjustments of assets not actively traded. Larger profit was generated in the category of assets available for sale, assets held to maturity and equity investments and, unlike the comparable last year period when they reported loss on the calculated foreign exchange differences, at the end of the first half of 2008, the banks reported profit on this item.

In the first half of 2008, interest expenses again grew faster than interest income (24.9% compared to 21.2%), with their ratio increasing from 51.7% to 53.4%. Interest expenses based on deposits, which account for 73.6% of all interest expenses, rose the most (30.3%). Interest expenses based on household deposits rose by 25.0% and

Figure 65 Income from Interest-Bearing Assets and Expenses on Interest-Bearing Liabilities

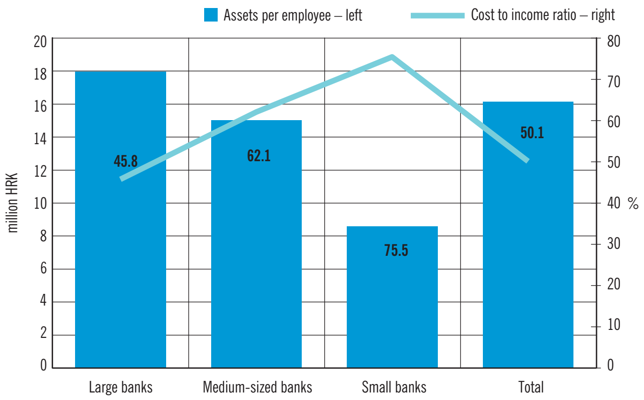
end of period



Source: CNB.

Figure 66 Operating Efficiency by Bank Peer Groups

as at 30 June 2008



Source: CNB.

those based on deposits of enterprises rose by 45.5%. Expenses based on received deposits of all other institutional sectors also rose, with the largest relative increase being recorded in expenses based on deposits received from financial institutions (74.4%). Smaller reliance of banks on received loans led to a relatively low growth of interest expenses based on received loans (10.1%), and interest expenses towards foreign financial institutions, which accounted for 69.5% of total interest expenses based on received loans rose by 7.3%, or less than the average increase in interest expenses based on received loans.

General administrative expenses and depreciation rose by HRK 421.6m, or 13.3%, compared to the same period 2007, with their largest increase being reported in large banks (14.1%). In medium-sized and small banks they rose by 13.0% and 9.2%, respectively.

Total expenses on loss provisions fell by HRK 225.3m or 48.7% at the end of the first half of 2008, compared to end-June 2007. A contribution to a fall in total loss provisions was provided by slower growth of category A placements in the first half of this year (1.4%), compared to the same period 2007 (6.7%), causing a fall in expenses on provisions for identified losses arising from category A placements by HRK 123.8m or 86.6%.

A fall in total expenses on loss provisions was also due to banks' assessment of higher placement recoverability as the share of bad placements and contingent liabilities in total liabilities fell from 3.3% at the end of the first half of last year to 3.2% at the end of the same period this year. Expenses on value adjustments and provisions for identified losses on an individual basis fell by HRK 57.5m (19.3%) compared to the same period previous year, mainly under the influence of a 22.6% fall in expenses on loan value adjustments. Total expenses on loss provisions fell in all three groups of banks, with the largest fall being reported by large banks (50.8%), then medium-sized (44.9%) and small banks (39.9%).

High profit growth of banks with a concurrent slow assets growth led to increased average asset profitability of banks measured by ROAA, whose value stood at 1.9% at the end of the first half of 2008. This indicator's developments in the past five years show that its value was the highest at the end of the observed period, mainly owing to increased ROAA of large banks. Large banks saw the largest increase in ROAA, from 1.7% at the end of 2007 to 2.2% at the end of the first half of 2008. ROAA of medium-sized banks did not change since end-2006 (1.1%), while ROAA of small banks, as a result of an increase in assets and a fall in profit, shrank by 0.3 percentage points and stood at 0.9%.

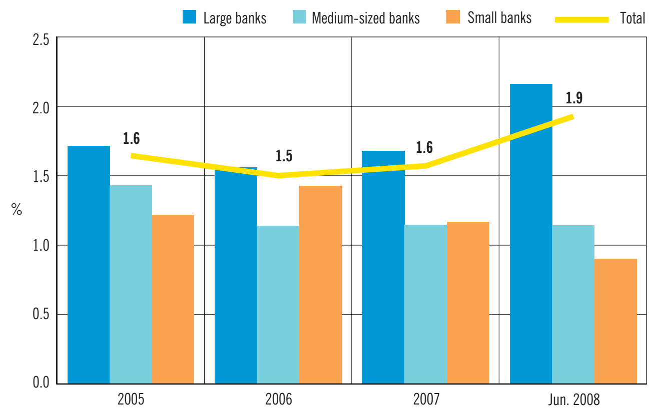
The inflow of fresh capital in banks in the past two years has led to a fall in average capital profitability as measured by ROAE, while the effects of recapitalisation became visible this year, as seen in the increased value of the indicator. The return on average equity was 12.1% at the end of the first half of 2008, which is an increase of 1.1 percentage points compared to end-2007.

Similarly as in the case of the ROAA indicator, the value of the ROAE indicator of all banks was under the influence of the group of large banks which had an above-average ROAE (13.5%). In the half-year period, only the group of large banks reported an increase in ROAE (1.7 percentage points) while medium-sized banks and small banks reported a fall from 8.0% at the end of 2007 to 7.7% and 7.2% to 4.8%, respectively.

Large banks accounted for the smallest share (65.8%) of net interest income in net income at the end of the first half of 2008. Medium-sized banks followed with 74.7%. The shares of net interest income in net income of these two groups of banks fell compared to the same period previous year, while that of small banks rose by a considerable 11.8 percentage points and stood at 81.4%. Such a change in the structure of net income of small banks was due to losses generated by securities investments, which almost halved the amount of net other non-interest income, while its share in net income fell from 13.4% at the end of the first half of 2007 to only 0.5% at the end of the first half of 2008. Loss on trading in securities, foreign currency and derivatives was the main reason behind a fall in net other non-interest income of medium-sized banks, as a result of which its share in net income of medium-sized banks fell by 4.0 percentage points and stood at only 0.9%. Medium-sized banks accounted for the largest share of net income from commissions and fees in net income (24.7%) while large and small banks accounted for 20.0% and 18.1%, respectively of net income from commissions and fees in net income.

Figure 67 Return on Average Assets by Bank Peer Groups

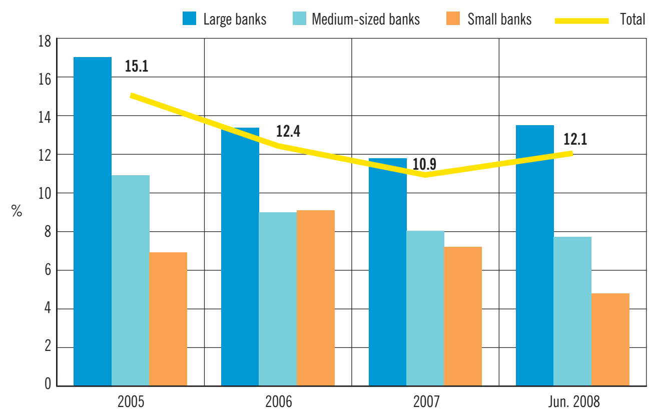
end of period



Source: CNB.

Figure 68 Return on Average Equity by Bank Peer Groups

end of period



Source: CNB.

The increase in average interest income of banks was influenced by a steady growth in interest rates on loans throughout the first half of 2008. Their fastest growth was seen in interest rates on loans with a currency clause while their somewhat more moderate growth was seen in loans without a currency clause. At the same time, deposit interest rates either held steady at their end-2007 level or fell slightly.

A slower growth of banks' assets in the first half of 2008 coupled with a simultaneous increase in the number of employees led to a fall in the amount of asset per employee to HRK 16.1m per employee. The number of employees in banks rose from 20,613 at the end of 2007 to 21,576, an increase of 4.7%. Medium-sized banks reported the largest increase in the number of employees (5.7%) while large banks and small banks reported an increase of 4.6% and 4.2%, respectively. A greater asset per employee than average of all banks was reported by large banks (HRK 18.0m) while medium-sized banks reported HRK 15.0m in asset per employee. The amount of asset per employee was the smallest in small banks (HRK 8.6m) and it is still evident that small banks employ a relatively large number of persons (15.3% of the total number of employees) which by far exceeds their share in total assets of all banks.

Cost efficiency, measured as costs to income ratio, continued to grow as a result of changes in large banks. Costs (general administrative expenses and depreciation) were up 13.3%, mainly as a result of growing employee expenses. However, larger growth of net income (17.2%) compared to costs led to an improvement in the cost to income ratio from 52.1% at end-2007 to 50.1% at the end of the first half of 2008. The values of this indicator differed among individual bank groups. Only large banks improved their cost efficiency compared to end-2007 by reducing the value of this indicator by 3.2 percentage points to 45.8%. Cost efficiency of medium-sized and small banks worsened, as seen in a 3.0 and 7.3 percentage points, respectively, increase in their indicators, rising to 62.1% and 75.5% in medium-sized and small banks, respectively.

12.1.5 Banks' Liquidity

Total sources of banks' financing (received deposits, received loans, issued debt securities and issued subordinated and hybrid instruments) stood at HRK 286.8bn at the end of the first half of 2008. Compared with the end of 2007, these sources fell by HRK 3.0bn or 1.0%. A fall in deposits, received loans and issued subordinated instruments was somewhat mitigated by a large HRK 1.2bn or 185.2% increase in the amount of issued hybrid instruments in four banks. These changes caused small changes in the structure of the sources of banks' financing compared to the end of 2007, with the share of deposits rising to 81.1% and the share of hybrid and subordinated instruments rising to 0.7% of the total sources while the share of loans received fell to 17.1% of total sources. The total sources of financing declined equally in all bank groups, with the largest decline taking place in medium-sized banks (1.3%), while the rate of decline in large and small banks equalled the average rate and stood at 1.0%.

At the end of the first half of 2008, deposits received by banks amounted to HRK 232.4bn, which is a fall of HRK 676.7m (0.3%) compared to their end-2007 balance. The largest nominal decline in received deposits compared to the end of 2007 was seen in the group of small banks (HRK 296.8m or 1.4%) as a result of a fall in deposits in 12 small banks. In addition, deposits fell in two large banks, causing a fall in total deposits of large banks of HRK 280.7m (0.2%) and in two medium-sized banks, causing the total deposits of medium-sized banks to fall by HRK 99.2m or 0.3%.

Loans received were HRK 49.1bn, which is a 6.2% fall compared to their end 2007 balance. Compared to end-2007, loans received rose only in the group of small banks (HRK 246.3m or 9.7%), as a result of increase in these liabilities in 13 small banks. Of the remaining banks, only one large bank and two medium-sized banks reported an increase in the amount of loans received, so that total loans of large banks fell by HRK 2.7bn (5.9%) while loans received by medium-sized banks fell by HRK 835.3m or 18.5%.

Despite significant changes in the sources of financing of small banks, deposits still accounted for 87.7%, or the major share of their sources of financing while the share of loans received rose to 11.9%. Securities and other instruments accounted for only 0.4% of the sources of financing of small banks. Large banks again reported the smallest share of deposits and the largest share of loans (79.4% and 18.7%, respectively) in the sources of financing, while in medium-sized banks, 86.9% of the sources were deposits and 10.2% were loans received.

Table 25 Banks' Liquidity Ratios

end of period, in %

	2006	2007	Jun. 2008
Loans extended/Deposits received	92.5	92.8	98.2
Loans received/Total assets	18.0	15.2	14.1
Net interbank position	–4.9	–1.4	–2.2

Source: CNB.

Deposits and loans received from the majority foreign owner fell by HRK 1.4bn (3.6%) compared to their end-2007 balance and stood at HRK 38.3bn at the end of the first half of 2008. Their share in the total sources of banks' financing fell from 13.7% in 2007 to 13.4% at the end of June 2008. Due to a larger amount of received deposits, small banks were the only group of banks whose share of deposits and loans from the majority foreign owner rose (from 2.0% at end-2007 to 4.2%). Medium-sized banks relied the most on deposits and loans from majority foreign owners which accounted for 14.4% of their total sources while this type of funds accounted for a somewhat smaller share in the sources of financing of large banks (14.1%).

Households again provided the main source of banks' financing. Their growing importance can be seen in the structure of sources of financing by institutional sectors.[36] Compared to the end of 2007, the share of households in total deposits and loans rose by 3.4 percentage points and stood at 46.4%, while the share of non-residents, the next sector in terms of share size, fell slightly and stood at 21.2%. Enterprises accounted for 16.2% of total deposits and

[36] Issued debt securities and subordinated and hybrid instruments (which participate in the total structure of financing sources with 1.9%) have not been classified by sector for analysis purposes.

loans of banks and compared to end-2007, this share fell by 2.7 percentage points. The structure of the sources of financing differed among groups of banks. While small banks relied the most on households (57.7%), this source of financing accounted for 44.5% and 45.5%, respectively of the sources of financing of medium-sized banks and large banks. In terms of share size, non-residents were the second source of financing (23.4%) in large banks while in medium-sized and small banks, financial institutions were the second most important source of financing (20.9% and 18.8%, respectively).

Table 26 Structure of Loans Received by Banks

end of period, in million HRK and %

	2006			2007			Jun. 2008		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
Loans from government units	272.9	0.5	–48.3	183.3	0.4	–32.8	141.1	0.3	–23.1
Loans from financial institutions	15,102.5	27.5	9.1	20,573.0	39.3	36.2	17,861.6	36.4	–13.2
Loans from enterprises	0.0	0.0	–99.9	189.4	0.4	0.0	0.0	0.0	–100.0
Loans from foreign financial institutions	39,129.4	71.3	11.3	31,117.8	59.5	–20.5	30,860.9	62.9	–0.8
Loans from other non-residents	360.5	0.7	–24.8	248.3	0.5	–31.1	188.3	0.4	–24.2
Total loans received by banks	54,865.4	100.0	9.7	52,311.8	100.0	–4.7	49,051.9	100.0	–6.2
Loans from majority foreign owners	22,925.5	41.8	29.5	17,600.8	33.6	–23.2	17,617.7	35.9	0.1

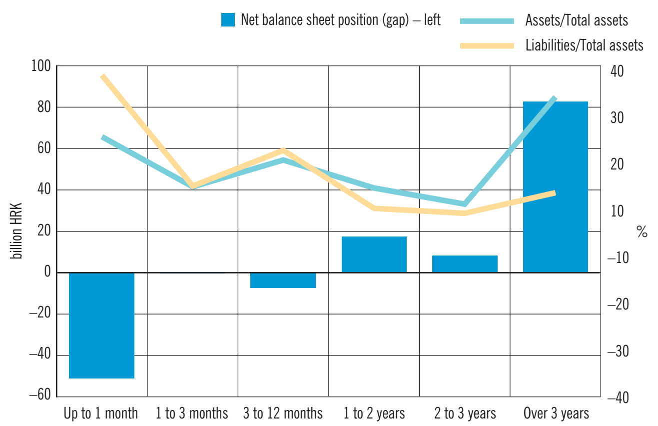
Source: CNB.

Compared to end-2007, the banks reduced their liabilities based on received loans towards all the institutional sectors. In nominal terms, they reduced their liabilities the most towards domestic financial institutions. Liabilities towards the CNB fell by HRK 2.5bn or 60.1%, their fall exceeding the total amount of decline in loans received from that sector. Foreign financial institutions, including majority foreign owners, continued to be the most important source of loans for domestic banks, accounting for 62.9% of the total loans received at the end of the first half of 2008.

The main factor which contributed to the fall in received deposits of banks in the first half of 2008 was a HRK 8.2bn (15.3%) fall in deposits of enterprises and to a lesser extent a fall in deposits of non-residents (HRK 1.7bn or 5.8%) and deposits of financial institutions (HRK 767.1bn or 3.9%). A simultaneous increase in household deposits (HRK 8.8bn or 7.3%), deposits of state institutions (HRK 1.1bn or 20.9%) and deposits of non-profit institutions (HRK 137.6m or 5.1%), somewhat mitigated total deposits' fall. These changes had an impact on total deposits' structure, with the largest change compared to end-2007 being seen in the increased share of household deposits which rose to 56.2% of total deposits (a 4.0 percentage point increase). The share of deposits of enterprises fell by 3.5 percentage points and stood at 19.6%, while the shares of all other sectors changed by less than 1 percentage point.

Figure 69 Banks' Assets/Liabilities by Remaining Maturity

as at 30 June 2008



Source: CNB.

Changes in the amount of deposits received by individual sectors compared to the end of 2007, caused changes in the maturity structure of deposits with increased share of time deposits and reduced share of sight deposits. Almost one half of the total fall in deposits of enterprises can be attributed to a HRK 3.8bn fall in giro and current account deposits. Due to a simultaneous fall in deposits of government units, total giro and current account deposits of banks fell by HRK 4.5bn or 10.0%. A significant fall in time deposits of enterprises (HRK 4.9bn or 17.2%), deposits of financial institutions (HRK 1.0bn or 6.1%) and non-residents (HRK 1.9bn or 6.8%) notwithstanding, time deposits did not fall, owing to their faster growth in other sectors. Time deposits of households rose by HRK 9.4bn (11.0%) while time deposits of government units almost doubled, rising by HRK 2.3bn,

At the end of the first half of 2008, time deposits accounted for 71.0% of total deposits, which is an increase of 1.9 percentage points compared to end-2007. The share of giro and current account deposits fell by the same percentage, accounting for 17.5% of total deposits. There were no changes in the share of savings deposits which again accounted for 11.5% of total deposits.

The trend of increase in the loans granted to deposits received ratio accelerated in the first half of 2008 as a result of further loan growth and simultaneous deposits' fall. This ratio was the highest in large banks and, following an increase of 5.9 percentage points compared to the end of 2007, stood at 100.8%. In medium-sized banks, the value of this ratio rose by 7.5 percentage points and stood at 92.4% while in small banks, despite its 2.4 percentage points increase, it was the lowest and stood at 84.3%.

Placements restructuring and a fall in the liabilities of banks caused smaller changes in the maturity structure of assets and liabilities of banks. Compared to end-2007, the banks reduced their negative cumulative gap[37] in the period up to one year by HRK 2.1bn (1.2%). This change was the result of a fall in investments in securities and deposits placed with other banks, so that short-term assets fell by HRK 4.6bn or 2.5%. Short-term liabilities of banks also fell by HRK 0.8bn or 0.3% as a result of a fall in short-term deposits. This change led to a fall in the share of short-term assets (with the remaining maturity up to 1 year) in total assets of banks from 52.5% to 50.7% and a fall in the share of short-term liabilities of banks in total assets from 69.0% to 68.1%. The largest contribution to the positive gap in the category of remaining maturity from one to two years was provided by a larger amount of loans granted and a fall in liabilities based on received loans in this maturity category. There was a fall in the positive gap in the category with the remaining maturity from two to three years, and in the long-term category (remaining maturity over three years) the positive gap increased due to a growth in loans granted and a fall in long-term time deposits.

12.2 Housing Savings Banks' Business Operations

At the end of the first half of 2008, there were five housing savings banks operating in the Republic of Croatia. A somewhat faster growth of housing savings banks' assets compared to the growth of banks' assets, halted a fall in the share of housing savings banks' assets in total banking sector assets which stood at 1.9% at the end of the first half of 2008.

Similarly as at the end of 2007, four housing savings banks were in a majority direct or indirect ownership of foreign shareholders with their assets accounting for 98.9% of total housing savings banks' assets. The remaining 1.1% of the total housing savings banks' assets went to one housing savings bank in a majority state ownership. At the end of the first half of 2008, housing savings banks employed 387 persons, or 1.8% of the total number of employees in the banking sector.

12.2.1 Housing Savings Banks' Balance Sheet

At the end of the first half of 2008, total housing savings banks' assets rose by HRK 120.1m (1.8%) and amounted to almost HRK 6.7bn. During the observed half-year period, only one housing savings bank reported a fall in its total assets, while all other housing savings banks reported total assets growth.

The growth of housing savings banks' assets was financed by share capital increase and issued hybrid instruments, while deposits of housing savings banks' savers, following a slight increase towards the end of 2007, fell again, particularly in the first half of this year. The trend of growth of loans granted was present again, while credit activities of housing savings banks, similarly as in 2007, were mainly due to asset restructuring through cuts in securities investments. This caused further change in the structure of housing savings banks assets, with an ever increasing fall in the share of securities investments and a rising share of net loans in assets. At the end of the first half of 2008, net loans accounted for 53.1% of housing savings banks assets, which is an increase of 15.0 percentage points compared with the same period 2007 and an increase of 5.9 percentage points compared to end-2007.

[37] It represents the difference between net assets and liabilities (not including capital) with the same period until maturity.

Table 27 Structure of Housing Savings Banks' Assets

end of period, in million HRK and %

	2006			2007			Jun. 2008		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	0.0	0.0	–75.0	0.0	0.0	200.0	0.0	0.0	80.0
1.1. Money assets	0.0	0.0	–75.0	0.0	0.0	200.0	0.0	0.0	80.0
1.2. Deposits with the CNB	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2. Deposits with banking institutions	111.5	1.8	–84.5	47.1	0.7	–57.8	119.7	1.8	154.3
3. MoF treasury bills and CNB bills	347.7	5.5	–55.5	255.5	3.9	–26.5	101.5	1.5	–60.3
4. Securities and other financial instruments held for trading	284.4	4.5	–27.2	156.8	2.4	–44.9	103.2	1.5	–34.2
5. Securities and other financial instruments available for sale	1,058.3	16.6	49.7	1,246.4	19.0	17.8	1,269.0	19.0	1.8
6. Securities and other financial instruments held to maturity	1,303.3	20.5	49.9	871.2	13.3	–33.2	883.7	13.3	1.4
7. Securities and other financial instruments not traded in active markets but carried at fair value	1,260.6	19.8	–8.8	528.4	8.1	–58.1	364.6	5.5	–31.0
8. Derivative financial assets	5.4	0.1	100.0	6.7	0.1	23.3	0.0	0.0	–100.0
9. Loans to financial institutions	69.9	1.1	–73.5	106.5	1.6	52.4	67.8	1.0	–36.4
10. Loans to other clients	1,713.0	26.9	135.4	3,172.3	48.5	85.2	3,471.6	52.1	9.4
11. Investments in subsidiaries, associates and joint ventures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
12. Foreclosed and repossessed assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13. Tangible assets (net of depreciation)	7.0	0.1	–14.4	8.1	0.1	15.1	9.5	0.1	18.4
14. Interest, fees and other assets	250.8	3.9	–22.5	196.0	3.0	–21.9	326.5	4.9	66.6
15. Net of: Collectively assessed impairment provisions	40.5	0.6	9.5	50.1	0.8	23.9	52.4	0.8	4.6
Total assets	**6,371.4**	**100.0**	**3.8**	**6,544.8**	**100.0**	**2.7**	**6,664.9**	**100.0**	**1.8**

Source: CNB.

At the end of the first half of 2008, net loans of housing savings banks rose by HRK 260.6m (8.0%) compared to end-2007. Home loans grew faster than total loans (HRK 321.4m or 14.5%) while loans granted to financial institutions and government units fell by 36.4% and 2.3%, respectively. At the end of the first half of 2008, housing savings banks accounted for 5.0% of the total home loans granted by the banking sector. The increase in the amount of home loans caused the ratio of loans to deposits received from housing savings banks' savers to increase from 36.6% at the end of 2007 to 42.9% at the end of the first half of 2008.

Total investments of housing savings banks in securities fell by HRK 336.2m or 11.0% at the end of the first half of 2008 compared to the end of 2007. Investments in both types of securities in housing savings banks' portfolios were reduced so that investments in bonds of the Government of the Republic of Croatia fell by HRK 182.2m (6.5%) and investments in T-bills of the Ministry of Finance fell by HRK 154.0m (60.3%). The portfolio of securities not traded in active markets and carried at fair value through profit and loss fell by almost one half (48.4%), the portfolio held for trading fell by 34.2%, while the remaining two portfolios rose slightly. The largest amount of securities (50%) were allocated to the portfolio of securities available for sale, while the portfolio of securities held to maturity accounted for 32.7% of the total amount of securities.

Deposits of housing savings banks' savers stood at HRK 5.9bn at the end of the first half of 2008, which is a decrease of 2.2% compared to end-2007. The increase in deposits in 2007 mainly took place towards the end of the year and can be associated with the exercise of the right of housing savings banks' savers to government incentives. Their slight increase in the second quarter of 2008 notwithstanding, the fall in deposits of housing savings banks' savers (2.5%) in the first quarter of the year led to a total fall in deposits in the first half of 2008. Three housing savings banks increased the amount of their issued hybrid instruments by a total of HRK 50.9m (127.4%).

Table 28 Structure of Housing Savings Banks' Liabilities
end of period, in million HRK and %

	2006			2007			Jun. 2008		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	0.0	0.0	0.0	0.2	0.0	0.0	0.2	0.0	–8.3
1.1. Short-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1.2. Long-term loans	0.0	0.0	0.0	0.2	0.0	0.0	0.2	0.0	–8.3
2. Deposits	5,803.6	91.1	5.2	6,038.4	92.3	4.0	5,906.0	88.6	–2.2
2.1. Giro account and current account deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2.2. Savings deposits	0.0	0.0	32.0	0.0	0.0	18.2	0.0	0.0	–74.4
2.3. Time deposits	5,803.6	91.1	5.2	6,038.3	92.3	4.0	5,906.0	88.6	–2.2
3. Other loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3.1. Short-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3.2. Long-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4. Derivative financial liabilities and other financial liabilities held for trading	0.0	0.0	–100.0	0.0	0.0	0.0	0.0	0.0	0.0
5. Debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5.1. Short-term debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5.2. Long-term debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Subordinated instruments issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
7. Hybrid instruments issued	61.7	1.0	497.5	39.9	0.6	–35.3	90.8	1.4	127.4
8. Interest, fees and other liabilities	312.5	4.9	–19.7	223.9	3.4	–28.4	382.8	5.7	71.0
Total liabilities	**6,177.8**	**97.0**	**4.4**	**6,302.3**	**96.3**	**2.0**	**6,379.8**	**95.7**	**1.2**
Total capital	**193.6**	**3.0**	**–12.1**	**242.5**	**3.7**	**25.3**	**285.1**	**4.3**	**17.6**
Total liabilities and capital	**6,371.4**	**100.0**	**3.8**	**6,544.8**	**100.0**	**2.7**	**6,664.9**	**100.0**	**1.8**

Source: CNB.

12.2.2 Housing Savings Banks' Capital

Total housing savings banks' capital rose by HRK 42.6m or 17.6%, compared to the end of 2007. Similarly as at the end of 2007, share capital of housing savings banks rose by significant HRK 53.8m, but the total capital increase was reduced by the amount of unrealised loss on value adjustments of financial assets available for sale which rose by HRK 11.2m in the first half of 2008. Similarly as at the end of 2007, three housing savings banks reduced their capital by the said unrealised loss, while one housing savings bank reported profit on this basis.

Table 29 Structure of Housing Savings Banks' Total Capital
end of period, in million HRK and %

	2006			2007			Jun. 2008		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Share capital	287.5	148.5	41.4	357.1	147.3	24.2	410.9	144.1	15.1
2. Current year profit/loss	–54.5	–28.2	0.0	–44.7	–18.4	–17.9	0.0	0.0	–100.1
3. Retained earnings/loss	–37.1	–19.2	–30.8	–15.9	–6.6	–57.1	–61.6	–21.6	286.5
4. Legal reserves	2.3	1.2	19.6	2.5	1.0	8.1	3.4	1.2	37.0
5. Total reserves provided for by the articles of association and other capital reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Unrealised gains/losses on value adjustments of financial assets available for sale	–13.1	–6.8	0.0	–56.5	–23.3	330.5	–67.7	–23.7	19.8
7. Reserves arising from hedging transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
8. Previous year profit/loss	8.5	4.4	0.0	0.0	0.0	–100.0	0.0	0.0	0.0
Total capital	**193.6**	**100.0**	**–12.1**	**242.5**	**100.0**	**25.3**	**285.1**	**100.0**	**17.6**

Source: CNB.

Regulatory capital of housing savings banks rose by 29.2% compared to the end of 2007 and stood at HRK 365.5m at the end of June. The increase in regulatory capital was the result of recapitalisation and the inclusion of hybrid instruments in supplementary capital I.

The increase in regulatory capital notwithstanding, capital adequacy ratio of housing savings banks steadily trended downwards, falling from 14.5% at the end of 2007 to 13.9% at the end of the first half of 2008. Decreased capital adequacy ratio was due to home loans growth and changes in CNB regulations which introduced higher risk weights for asset items exposed to currency-induced credit risk (CICR) as almost one third of risk-weighted assets of housing savings banks is granted to debtors with unmatched foreign currency positions and inadequate instruments of collateral. In the first half of 2008, the net value of assets weighted by risk rose by 1.9%, while their risk-weighted value rose by 42.5%. The main contributor to the growth in the risk-weighted amount of assets was the growth in net assets exposed to CICR weighted from early 2008 by a risk weight of 100% (58.6%) and 150% (26.2%).

Steady credit activities of housing savings banks based on asset restructuring led to an increase in the share of capital requirement for credit risk in the capital requirement structure, with this share increasing from 94.3% of the total capital requirement at the end of 2007 to 98.1% at the end of the first half of 2008

12.2.3 Quality of Housing Savings Banks' Assets

At the end of the first half of 2008, total placements and contingent liabilities of housing savings banks stood at HRK 6.1bn, which is an increase of 6.5% compared with the end of 2007. The main contribution to this growth came from fully recoverable placements (category A) which rose by 6.4%. At the same time, bad placements (categories B and C) rose by a high 29.5%, causing the trend of mild decline in the quality of placements to continue. Nevertheless, bad placements still stood at a relatively low HRK 23.0m, similarly as bad placements in total placements and contingent liabilities of housing savings banks (0.4%). Bad placements were again reported by only one housing savings bank.

Table 30 Classification of Housing Savings Banks' Placements and Contingent Liabilities by Risk Categories
end of period, in million HRK and %

Placements	2006		2007		Jun. 2008	
	Amount	Share	Amount	Share	Amount	Share
Fully recoverable placements (category A)	4,540.7	99.8	5,670.3	99.7	6,034.3	99.6
Partly recoverable placements (category B)	5.7	0.1	14.9	0.3	17.3	0.3
Irrecoverable placements (category C)	1.4	0.0	2.9	0.1	5.7	0.1
Total	**4,547.8**	**100.0**	**5,688.1**	**100.0**	**6,057.3**	**100.0**

Source: CNB.

The largest share of net placements of housing savings banks (92.6%) were exposed to CICR at the end of the first half of 2008 and 92.5% of the exposed placements were not covered against the impact of this risk. Compared to end-2007, the share of placements exposed to CICR in total placements did not change significantly as a result of regulatory restrictions still in force which provide that housing savings banks may place their funds to two sectors only, the households and government units, i.e. sectors which as a rule have an unmatched foreign currency position.

Total value adjustments against placements and provisions for contingent liabilities grew much faster than placements and contingent liabilities (56.8%) thus slightly increasing the ratio of value adjustments and provisions to total placements and contingent liabilities. With fully recoverable placements as the dominant category in the structure of total placements and contingent liabilities, the bulk of total value adjustments and provisions consisted again of collectively assessed impairment provisions.

Table 31 Housing Savings Banks' Value Adjustments and Provisions
end of period, in million HRK and %

	2006	2007	Jun. 2008
Total value adjustments against placements and provisions for contingent liabilities	44.8	57.6	63.2
– Value adjustments against placements and provisions for contingent liabilities	3.6	6.4	10.0
– Collectively assessed impairment provisions	41.2	51.2	53.2
Total placements and contingent liabilities	4,547.8	5,688.1	6,057.3
Relative ratio: total value adjustments and provisions/total placements and contingent liabilities	1.0	1.0	1.0

Source: CNB.

12.2.4 Quality of Housing Savings Banks' Earnings

At the end of the first half of 2008, housing savings banks generated minimum income before taxes (HRK 124 thousand), mainly owing to increased income from loans granted. Two housing savings banks reported a total profit of HRK 12.2m, while the remaining three housing savings banks reported an almost equal amount of loss. The total profit of housing savings banks fell in the first half of 2008 (at the end of the first quarter it stood at HRK 1.9m), as a result of increased second quarter losses in three housing savings banks.

Table 32 Housing Savings Banks' Income Statement
in million HRK and %

	Jan.-Jun. 2007	Jan.-Jun. 2008	
	Amount	Amount	Change
Total interest income	46.2	63.9	38.5
Total interest expenses	143.1	165.6	15.7
Net interest income	97.0	101.6	4.8
Total income from fees and commissions	29.8	29.7	–0.2
Total expenses on fees and commissions	34.1	33.9	–0.5
Net income from fees and commissions	4.3	4.2	–2.7
Other non-interest income	–28.0	–26.5	–5.4
Other non-interest expenses	–15.8	–13.6	–13.9
Net other non-interest income	12.3	13.0	5.6
Net non-interest income	1.7	3.2	84.0
General administrative expenses and depreciation	62.7	60.9	–2.8
Net operating income before loss provisions	–14.8	6.3	–142.4
Expenses on value adjustments and provisions for identified losses	6.6	6.1	–7.5
Expenses on collectively assessed impairment provisions	0.7	4.1	520.7
Total expenses on loss provisions	6.0	2.0	–66.4
Income/loss before taxes	–21.4	0.1	–100.6
Income tax	0.3	0.1	–65.2
Current year profit/loss	–21.7	0.0	–100.1

Source: CNB.

Net income of housing savings banks amounted to HRK 67.1m at the end of the first half of 2008, which is an increase of 40.2% compared to the same period previous year. The largest contribution to the increase in net income was provided by a 38.5% growth in net interest income. Owing to a fall in realised losses on securities, the loss on item net other non-interest income amounted to 5.4%, while net income from commissions and fees fell by a slight 0.2%.

Total expenses of housing savings banks rose by 1.6% over a one year period, mainly due to a 5.3% increase in interest expenses on deposits of savers. At the same time, housing savings banks reduced their general administrative expenses by 2.8% and expenses on loss provisions by 7.5%, boosting positive financial results at the end of the first half of 2008.

Loss on securities trading and loss on assets not traded in active markets and carried at fair value through profit and loss almost halved compared to the same period 2007 and stood at HRK 11.7m, while realised losses on assets available for sale rose by 95.6% and stood at HRK 2.7m.

Total realised losses on securities shown in the income statement fell by HRK 9.0m (38.6%) over a one year period and stood at HRK 14.7m. However, if HRK 64.4m in unrealised losses by which some of the housing savings banks directly reduced their capital pursuant to IAS 39 is added to this amount, it follows that total losses of housing savings banks on securities investments were HRK 78.8m. Until end-2007, securities investments of housing savings banks were the biggest source of interest income, having accounted, their downward trend notwithstanding, for 54.6% of total interest income at the end of 2007. Further asset restructuring and decreased securities investments led to a fall in interest income from these investments which fell by 21.2% over a one year period and stood at HRK 70.3m at the end of the first half of 2008, accounting for 42.5% of total interest income from placements. Looking at these data, it is evident that total losses on securities exceeded income generated on this basis.

Interest income from loans granted exceeded interest income from securities and stood at HRK 93.8m at the end of the first half of 2008. Compared to the same period 2007, interest income from loans rose by 77.0%, while their share in the structure of total interest income rose by 19.6 percentage points and stood at 56.7%. Interest income from home loans accounted for 38.6% of total interest income.

12.3 Supervision Report

12.3.1 On-Site Supervision

In the first half of 2008, on-site examination covered 14 banks, or 31.25% of banking system assets, and seven non-banking financial institutions. Non-banking institutions are savings and loan associations which were undergoing the process of transformation pursuant to amendments to the Banking Act and the Credit Unions Act.

A total of 22 on-site examinations of banks and 10 on-site examinations of savings and loan associations were conducted. Examinations of savings and loan associations were conducted in the framework of transformation of savings and loan associations (based on their requests) into savings banks. Housing savings banks were not subject of on-site examination during the observed period.

Table 33 Total Number of On-Site Examinations and the Amount of Examined Assets

On-site examinations	2007	30 June 2008
Full-scope on-site examinations	4	6
Targeted on-site examinations	27	16
Total number of on-site examinations	31	22
Assets examined on-site (thousand HRK)	192,555,478	110,882,084
Assets per employee examined on-site (thousand HRK)	4,813,887	3,465,065

Source: CNB.

Based on the completed on-site examinations in 2008 and associated reports, 10 decisions were issued imposing measures to improve the conditions in the banks, i.e. to eliminate violations and irregularities established in the course of on-site examinations

Five small banks and one medium-sized bank underwent a full-scope on-site examination of their operations. Three on-site targeted examinations were conducted in the area of liquidity and market risk in one large bank and verification of recapitalisation in one small bank.

There were 13 specialised on-site examinations in 2008 which covered 11 banks. The subject of eight specialised on-site examinations was implementation of the measures of monetary and exchange rate policies, of which one was conducted in a large bank and one in a medium-sized bank. The system of internal controls was the subject of four specialised on-site examinations in mainly small banks. Information technology was the subject of one specialised on-site examination in one bank.

12.3.2 Off-Site Analysis

The main task of off-site analysis is to monitor the risk profile of banks' business operations. The assessment is based mainly on the analysis of the prescribed financial statements submitted by banks to the CNB.

The existing methodology for preparing written analyses on a quarterly basis was expanded in the first half of 2008 to include in addition to current assessment of the four components of business operations of banks (capital, assets, earnings and liquidity) market risks and bank management as additional two components. Each of the said analysed areas is assigned an appropriate component rating, and ultimately an overall composite rating for each specific bank. The quality of bank management which combines the assessment of adequacy of management of all the risks in a bank, is the most important component in the assessment of the risk profile of the entire operations of a bank. In addition to off-site analysis of individual banks, continuous efforts are made to improve off-site analysis of consolidated financial statements of banking groups.

Based on an analysis of financial statements in the first half of 2008, eleven reports on established irregularities were drafted and submitted and ten decisions issued on the activities to improve the conditions in the banks. The most frequent reason for drafting the report were excess exposures towards one person or persons in a special relationship.

To improve communication and cooperation with the banks and ensure timely informing of the Croatian National Bank about the planned activities of banks, regular annual meetings with the banks have been held since the first half of 2008. In the first part of the year, 22 meetings were held with the banks and housing savings banks, while the remaining meetings with the banks will be held in the second part of the year. During 2008, based on signed memoranda of understanding, the CNB continued its cooperation with foreign supervisors of banking groups to which domestic banks belong.

In the first half of 2008, a number of meetings were held with the representatives of competent regulators for parent banks of the Croatian banks. Some of the meetings were held as previously arranged regular meetings at which information was exchanged regarding the business operations and the quality of the operations of the parents or their subsidiaries operating in Croatia. Plans regarding supervision were also exchanged, ranging from the planned regulatory amendments to specific plans related to on-site examination. Other meetings held related to enactment of new CNB regulations implementing the *acquis communautaire*. At these meetings, participants exchanged their experiences in the practical application of individual segments of these regulations. One of the examples of this cooperation is participation of the representatives of the CNB at meetings associated with advanced approaches to measuring credit and operational risk, i.e. prevalidation procedures in case of banking groups with members operating in Croatia.

A special form of cooperation in this area was technical assistance provided by CNB to representatives of the central bank of Montenegro in the area of supervision of market risk management.

12.3.3 Licensing and Market Competition

In the first six months of 2008, a total of 64 decisions were issued in the area of licensing and market competition, which relate to decision-taking on applications for issuing prior approval for the appointment of management board members of a bank, for the acquisition of a qualifying holding in the share capital of a bank, internal audit outsourcing, for the acquisition of holdings in the share capital of a bank and decision-taking on applications for issuing authorisations for the provision of financial services by banks and authorisations for the operation of savings banks and credit unions. In light of the obligation of savings and loan associations, pursuant to the Credit Unions Act, to submit to the Croatian National Bank until 31 December 2007 an application for a licence to operate as a credit union or until 1 March 2008 an application for a licence to operate as a savings bank, until 30 June 2008, 14 licences were issued for the operations of credit unions and two licences were issued for the operations of a savings bank (of which one emerged as a result of transformation from a savings and loan association and the other was a newly-established savings bank), while 11 applications for the operations of a savings bank were refused.

12.3.4 Drafting of New Legislation in the Area of Business Operations and Supervision of Banks

The first half of 2008 was marked by intensive efforts towards drafting a final proposal of the Credit Institutions Act and subordinate legislation that is to fully transpose the Capital Requirements Directive,[38] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and Council Directive 89/117/EEC on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents.

In the context of public consultation, the CNB has held a presentation of the draft Credit Institutions Act for management board members of banks, and a two-day seminar for senior and mid-level bank management officials. In early June 2008, the draft Credit Institutions Act was presented to the European Commission. The final proposal of the Credit Institutions Act was submitted to the Ministry of Finance on 25 June 2008.

In addition to the Credit Institutions Act, the Croatian National Bank also prepared a proposal of the Act on Electronic Money Institutions in the first half of 2008, transposing the Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions. The Act on Electronic Money Institutions regulates the area which has so far not been regulated by a special law and introduces for the first time a definition of electronic money that is to contribute to a uniform identification of electronic money institutions in the Republic

[38] Directives 2006/48/EC and 2006/49/EC.

of Croatia. The final proposal of the Act on Electronic Money Institutions was submitted to the Ministry of Finance on 25 June 2008.

The Credit Institutions Act and the Act on Electronic Money Institutions were enacted by the Croatian Parliament on 26 September 2008, and published in the Official Gazette 117/2008. The major part of the provisions of these two acts enter into force on 1 January 2009.

In addition to the Credit Institutions Act and the Act on Electronic Money Institutions, the authorities also began work on the drafting of the Act on Supplementary Supervision of Financial Conglomerates implementing the Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. For the purpose of the drafting of this Act, a mixed working group has been established consisting of representatives of the MoF, HANFA and the CNB. The adoption of this Act is expected until end-2008.

13 International Reserves Management

The Croatian National Bank manages the international reserves of the Republic of Croatia, which under the Act on the Croatian National Bank constitute a part of the balance sheet of the Croatian National Bank. The Croatian National Bank manages international reserves in accordance with the established monetary and foreign exchange policies and in doing so is governed primarily by the principles of liquidity and safety. International reserves of the Republic of Croatia comprise all claims and securities in a convertible foreign currency, banknotes and coins in a convertible foreign currency and special drawing rights (SDR).

13.1 Institutional and Organisational Framework, Principles of Management, Risks and Manner of International Reserves Management

Institutional and Organisational Framework of International Reserves Management

The Council of the CNB formulates the strategy and policy for international reserves management and approves the framework for risk management. The International Reserves Commission is the body responsible for the development of international reserves investment strategies in accordance with the objectives set by the Council of the CNB and for the adoption of tactical decisions in international reserves management, while taking into account market conditions.

Principles of International Reserves Management and Risks in International Reserves Management

In managing the international reserves of the Republic of Croatia, the central bank is governed by principles of liquidity and safety of investment (Article 17 of the Act on the Croatian National Bank). In that context, it maintains high liquidity of reserves and adequate risk exposure, and with the given restrictions, attempts to ensure favourable rates of return on its investments. Similar principles are observed by other central banks in their international reserves management.

Risks present in international reserves management are primarily financial risks such as credit, interest rate and currency risks though other risks such as liquidity and operational risks also play a role. The CNB can mitigate credit risk exposure by investing into government bonds with a high rating, collateralised deposits and non-collateralised deposits in banks with ultimate credibility. Interest rate risk, or the risk of a fall in the value of international reserves portfolio due to unwanted interest rate changes, can be controlled by means of the so called benchmark portfolios. Currency risk arises from cross-currency fluctuations between the kuna and the euro and the kuna and the American dollar. Currency structure of the international reserves of the CNB is determined in accordance with the currency structure of foreign liabilities of the Republic of Croatia and currency structure of goods and services imports. Liquidity risk can be controlled by investing reserves into easily marketable bonds and partly into short-term deposit instruments. Operational risk can be controlled by strict separation of functions and responsibilities, precisely defined methodologies and procedures and regular internal and external audits.

Manner of International Reserves Management

As provided by a Decision on international reserves management, the Croatian National Bank manages international reserves in two ways: 1) actively, in accordance with its own guidelines and 2) passively, in accordance with the assumed foreign exchange obligations.

The CNB actively manages that part of international reserves which is formed through outright purchase of foreign currency from the banks and the MoF at foreign exchange interventions of the CNB, in accordance with the set benchmark portfolios, thus achieving an adequate risk-return profile. The other part of the reserves, formed on the basis of allocated foreign currency reserve requirements of banks, deposits of the MoF, repo transactions and special drawing rights (SDR), is managed passively by the CNB, depending on the assumed foreign exchange obligations, and with the aim of ensuring protection against currency and interest rate risks.

The terminology of reporting on international reserves of the CNB includes the terms of gross and net reserves. Gross reserves imply total international reserves. Net reserves imply the share of reserves actively managed by the CNB and SDR and foreign cash.

13.2 International Reserves in the First Half of 2008

Total international reserves of the CNB on 30 June 2008 were EUR 9,941.03m which is an increase of EUR 633.82m, or 6.8% compared with their end-2007 level (EUR 9,307.21m).

The main factors leading to changes in the level of total international reserves in 2008 on the inflow side were:

1) an increase in total allocated foreign currency reserve requirements of EUR 441.7m (marginal reserve requirements rose by EUR 327.5m, while foreign currency reserve requirements rose by EUR 114.14m),
2) EUR 189.1m in foreign exchange interventions involving purchases of foreign currency from the banks,
3) EUR 148.2m in net income from total international reserves investment,
4) EUR 109.2m in foreign exchange purchase transactions with the Ministry of Finance,

and on the outflow side:

1) EUR 84.3m in foreign exchange sales transactions with the Ministry of Finance,
2) EUR 158.8m in cross-currency changes arising from a 6.8% fall in the value of the American dollar compared with the euro at the end of June 2008 compared with the end of 2007.

Total CNB Turnover in the Foreign Exchange Market in the First Half of 2008

The central bank intervened in the foreign exchange market in the first half of 2008 by purchasing and selling foreign currency from and to the banks, the MoF and foreign banks. These transactions led to a net increase in international reserves of the CNB of EUR 214.0m, and an issue of HRK 1.5bn in the first six months of 2008.

In its foreign exchange intervention with domestic banks on 31 January 2008 (value date 4 February), the CNB purchased EUR 189.1m, thus creating HRK 1.4bn in kuna liquidity. There were no sales of foreign currency to the banks in the first six months of 2008. In the first half of 2008, the CNB sold to the Ministry of Finance EUR 84.3m, thus withdrawing HRK 617.4m from the system, and purchased from the Ministry of Finance EUR 109.2m, thus creating HRK 790.1m.

Table 34 Monthly Changes in Total CNB International Reserves
end of period, in million EUR

Month	Total reserves
December 2007	9,307.21
January 2008	9,332.62
February 2008	9,676.72
March 2008	9,841.51
April 2008	9,928.35
May 2008	10,051.06
June 2008	9,941.03
Change Dec. 2008 – Dec. 2007	**633.82**

Source: CNB.

Table 35 Total CNB Turnover in the Foreign Exchange Market, 1 January – 30 June 2008

at the exchange rate applicable on the value date, in million

	Purchase (1)		Sale (2)		Net (1 – 2)	
	EUR	HRK	EUR	HRK	EUR	HRK
Domestic banks	189.10	1,370.19	0.00	0.00	189.10	1,370.19
Ministry of Finance	109.23	790.11	84.31	617.38	24.93	172.73
Foreign banks	0.00	0.00	0.01	0.07	–0.01	–0.07
Total	**298.33**	**2.160.30**	**84.32**	**617.44**	**214.02**	**1,542.85**

Source: CNB.

Table 36 CNB Foreign Exchange Interventions with Domestic Banks, 1 January – 30 June 2008

at the exchange rate applicable on the intervention date, in million

Month (number of interventions)	Purchase (1)		Sale (2)		Net (1 - 2)	
	EUR	HRK	EUR	HRK	EUR	HRK
January	0.0	0.0	0.0	0.0	0.0	0.0
February (1)	189.1	1,370.2	0.0	0.0	189.1	1,370.2
March	0.0	0.0	0.0	0.0	0.0	0.0
April	0.0	0.0	0.0	0.0	0.0	0.0
May	0.0	0.0	0.0	0.0	0.0	0.0
June	0.0	0.0	0.0	0.0	0.0	0.0
Total	**189.1**	**1,370.2**	**0.0**	**0.0**	**189.1**	**1,370.2**

Source: CNB.

Risks in International Reserves Management and Structure of International Reserves Investment in the First Half of 2008

Credit Risk in International Reserves Management

Credit risk is the risk that a counterparty will not settle an obligation in full, either when due or at any time thereafter. The CNB provides for three levels of protection against credit risk:

1) the CNB places funds only in financial institutions and countries with the highest credit rating; credit rating is based on ratings issued by major international rating agencies,

2) investments in individual financial institutions and countries are restricted which ensures credit risk diversification; and

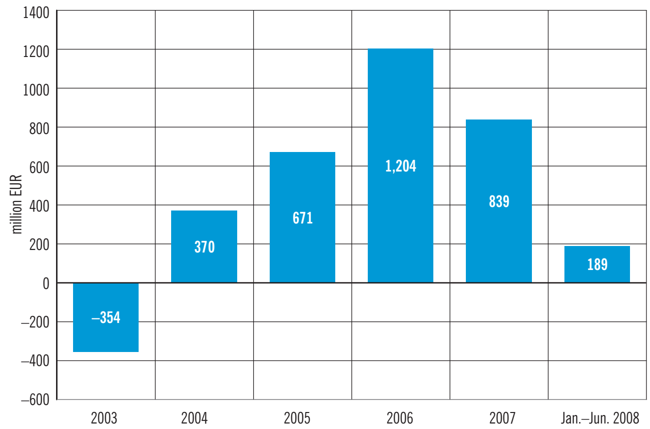
3) a large share of investment is collateralised, i.e. the CNB requires that security be provided in the form of government bonds of the same or greater market value than the value of the funds placed.

According to the degree of credit risk exposure, total international reserves have been divided into funds invested in government bonds, covered bonds, central banks, international financial institutions and banks.

The share of total international reserves invested in government bonds rose from 55.32% at the end of 2007, to a high 73.76%, or EUR 7,332.24m on 30 June 2008. By contrast, investments in banks fell, so that time deposits with banks stood at EUR 2,342.11m at the end of the first half of 2008, or at 23.56% compared with 42.41% at the end of 2007. The change in the structure of total international reserves investments was the result of a reduced credit risk exposure associated with the crisis on the global financial markets. While 2.42% of total international

Figure 70 CNB Foreign Exchange Interventions with Domestic Banks

in net amounts



Source: CNB.

reserves were invested in international financial institutions, 0.26% of total international reserves were invested in central banks.

Table 37 Structure of International Reserves Investment According to Credit Risk as at 30 June 2008
at cost, in million EUR

Investment	Net reserves	Reserve requirements	Marginal reserve requirements	Ministry of Finance	Total reserves	30 June 2008 As % of net reserves	30 June 2008 As % of total reserves
Government bonds[a]	5,100.2	1,247.9	984.2	0.0	7,332.2	67.0	73.8
Covered bonds	0.0	0.0	0.0	0.0	0.0	0.0	0.0
International financial institutions	148.5	88.1	4.2	0.0	240.8	1.9	2.4
Central banks	25.9	0.0	0.0	0.0	25.9	0.3	0.3
Banks	2,339.3	0.0	0.0	2.8	2,342.1	30.7	23.6
Total	**7,613.8**	**1,336.0**	**988.4**	**2.8**	**9,941.0**	**100.0**	**100.0**

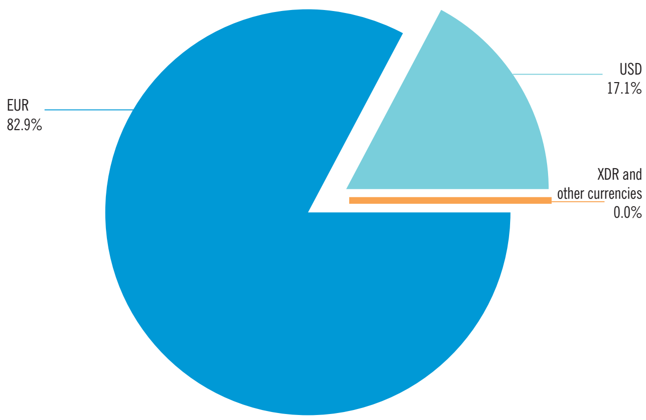
[a] Also included are reverse repo agreements which are collateralised by government bonds and bonds of German federal states.
Source: CNB.

In terms of credit rating, over 96% of all international reserves were invested in issuers with the highest credit rating in the first half of 2008.

Currency Structure of International Reserves

The CNB Council has defined precisely in its Decision on international reserves management the principles for the calculation of currency structure of net international reserves of the CNB as well as currency structure of the part of reserves passively managed by the CNB. The currency structure of net international reserves is adjusted twice a year with the currency structure of the projected amounts of external debt repayments (principal and interest) of the Republic of Croatia for the following year and with the currency structure of goods and services imports in the past year. International reserves currency risk management by the CNB thus has to be observed in a broader context as currency structure of international reserves of the CNB is actually used to reduce exposure to currency risk arising from foreign obligations of the Republic of Croatia.

Figure 71 Currency Structure of Net International Reserves
as at 30 June 2008



Source: CNB.

As at 30 June 2008, the share of reserves in euro in net international reserves was 82.90% and the share of reserves in American dollars was 17.09%. Part of the reserves generated by allocated foreign currency reserve requirements and marginal reserve requirements, funds of the MoF, repo transactions and funds in SDR are managed passively by the central bank, depending on the currency structure of assumed foreign exchange obligations.

Interest Rate Risk in International Reserves Management

Interest rate risk is the risk of a fall in the prices of bonds, or the value of foreign currency portfolios of international reserves of the CNB due to unwanted interest rate changes in fixed income instruments. Interest rate risk of international reserves of the CNB is controlled by means of precisely defined benchmark portfolios. Benchmark portfolios meet the required risk-return profile and reflect a long-term investment strategy of the reserves. The principles of benchmark portfolios ensure a positive annual yield on the net dollar and euro portfolios of the CNB over a one-year period and yield stability over a long term.

Results and Analysis of CNB Foreign Currency Portfolio Management in the First Half of 2008

The average yield on the net euro portfolio of the CNB in the first six months of 2008 stood at 3.17% annually, while the average yield on the net dollar portfolio of the CNB during that period stood at 3.53%. The average size of the net euro portfolio of the CNB actively managed in the first half of 2008 was EUR 6,144.8m, while the average size of the net dollar portfolio was USD 2,078.8m.

Table 38 Realised Income and Average Yields on Net CNB Foreign Currency Portfolios
at market value, in million EUR and USD and %

Portfolio	Realised income	Average amount invested	Annual yield rate					
	Jan.-Jun. 2008	Jan.-Jun. 2008	Jan.-Jun. 2003	Jan.-Jun. 2004	Jan.-Jun. 2005	Jan.-Jun. 2006	Jan.-Jun. 2007	Jan.-Jun. 2008
EUR	96.25	6,144.77	3.47	2.30	3.07	1.75	3.00	3.17
USD	36.16	2,078.83	2.00	0.58	2.50	3.53	4.91	3.53

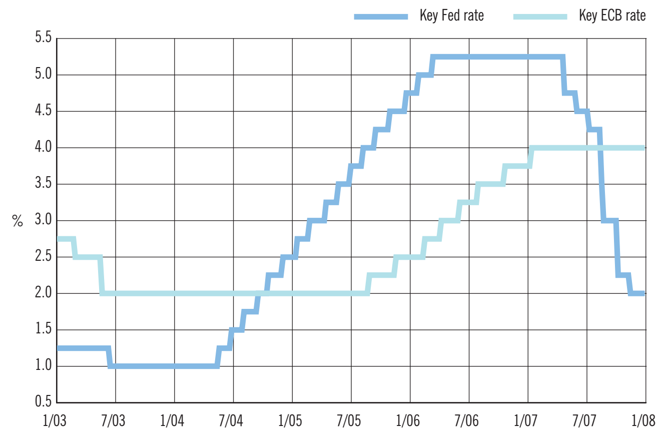
Source: CNB.

The European Central Bank (ECB) left its key interest rate unchanged at 4.00% in the first six months of 2008. The Fed reduced its key interest rate on four occasions in the first six months of 2008, which as a result fell from 4.25% at the end of 2007 to 2.00%. The yield on American T-bills fell by large 133 basis points during the observed period, while the yield on longer-term bonds fell by 40 basis points during the same period. As a result, American bond prices rose sharply in the first half of 2008.

The yield on the euro portfolio of the CNB in the first half of 2008 was the result of an increase in interest rates in the eurozone and an ensuing fall in bond prices, mainly due to inflationary expectations. The yield on euro-bonds rose between 50 and 60 basis points in the first half of 2008, causing a fall in euro-denominated government bond prices during the same period.

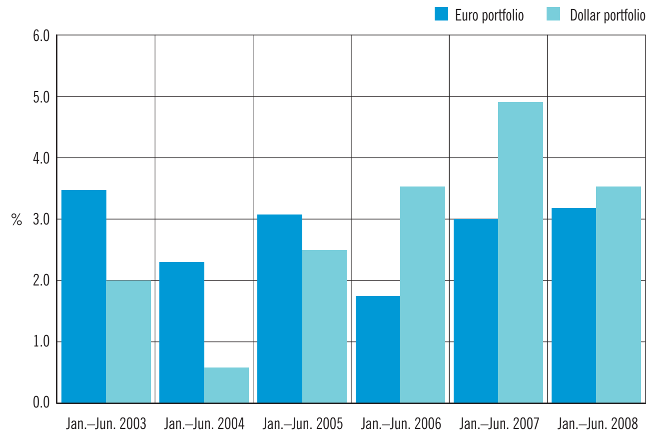
The yield on the dollar portfolio of the CNB was the result of increased volatility on the American market, particularly in the government bonds market where investors engaged in a massive sale of all risky forms of assets, replacing them with safer instruments thus leading to a fall in the yield on American bonds and their large price increase.

Figure 72 Changes in Key ECB and Fed Rates



Sources: ECB and Fed.

Figure 73 Yields on the CNB Euro and Dollar Portfolios



Source: CNB.

Financial Statements of the Croatian National Bank as at 30 June 2008

Statement of Income

1 January – 30 June 2008, in thousand HRK

	Notes	1 January – 30 June 2008	1 January – 30 June 2007
Interest and similar income	2	1,159,332	1,187,842
Interest and similar expense	3	(305,409)	(282,231)
Net interest income		**853,923**	**905,611**
Fee and commission income		3,229	3,201
Fee and commission expense		(1,616)	(1,545)
Net fee and commission income		**1,613**	**1,656**
Net result from financial operations	4	164,774	163,448
Net foreign exchange losses	5	(1,261,165)	(469,892)
Other income	6	13,191	3,247
Operating income/(expenditure)		**(227,664)**	**604,070**
Operating expenses	7	(159,762)	(146,610)
Decrease/(increase) in provisions	8	5,139	(1,054)
Operating surplus/(deficit)		**(382,287)**	**456,406**

Balance Sheet

as at 30 June 2008, in thousand HRK

	Notes	As at 30 June 2008	As at 30 June 2007
Assets			
Cash and current accounts with other banks	9	9,771	27,338
Deposits with other banks	10	25,360,115	35,709,099
Trading securities	11	46,598,648	31,169,792
Loans	12	1,652,515	5,655,788
Balances with the International Monetary Fund	13	2,746,544	3,007,746
Equity investments	14	53,523	54,664
Accrued interest and other assets	15	214,922	200,026
Tangible and intangible assets	16	564,754	403,295
TOTAL ASSETS		**77,200,792**	**76,227,748**
Liabilities			
Banknotes and coins in circulation	17	20,249,131	19,076,430
Due to banks and other financial institutions	18	47,833,374	48,097,400
Due to the State and State institutions	19	587,442	311,553
Due to the International Monetary Fund	20	2,739,421	3,000,527
Accrued interest and other liabilities	21	108,943	101,121
Total liabilities		**71,518,311**	**70,587,031**
Equity			
Initial capital	22	2,500,000	2,500,000
Reserves	22	3,182,481	3,140,717
Total equity		**5,682,481**	**5,640,717**
TOTAL EQUITY AND LIABILITIES		**77,200,792**	**76,227,748**

Statement of Changes in Equity

1 January – 30 June 2008, in thousand HRK

	Initial capital	General reserves	Revaluation reserves	Unrealised gains/losses	Operating surplus/deficit	Total equity
Balance at 1 January 2007	2,500,000	2,439,410	241,873	3,990	0	5,185,273
Exchange differences on available-for-sale financial assets				(962)		(962)
Operating surplus					456,406	456,406
Balance at 30 June 2007	**2,500,000**	**2,439,410**	**241,873**	**3,028**	**456,406**	**5,640,717**
Balance at 1 January 2008	**2,500,000**	**3,199,309**	**371,103**	**(3,795)**	**0**	**6,066,617**
Exchange differences on available-for-sale financial assets				(1,849)		(1,849)
Operating deficit					(382,287)	(382,287)
Balance at 30 June 2008	**2,500,000**	**3,199,309**	**371,103**	**(5,644)**	**(382,287)**	**5,682,481**

Statement of Cash Flows

1 January – 30 June 2008, in thousand HRK

	As at 30 June 2008	As at 30 June 2007
Cash flows from operating activities		
Interest received	1,161,039	1,144,709
Interest paid	(314,895)	(289,145)
Commissions received	3,271	3,156
Commissions paid	(1,647)	(1,813)
Other receipts	7,975	11,152
Expenses paid	(130,504)	(134,608)
	725,239	**733,451**
Changes in operating assets and liabilities		
Decrease/(increase) in deposits with other banks	6,872,140	(2,846,059)
Decrease/(increase) in loans	2,511,204	(1,758,661)
(Purchases) of trading securities	(12,623,570)	(447,975)
(Increase)/decrease in other assets	(23,765)	406,953
(Decrease)/increase in other liabilities	(1,243)	231
(Decrease) in amounts due to the IMF	(24)	(18)
Increase in currency in circulation	935,955	1,769,228
Increase in amounts due to banks and other financial institutions	3,363,347	2,476,298
Increase/(decrease) in amounts due to the State	371,213	(344,558)
	1,405,257	**(744,561)**
Net cash from operating activities (I)	**2,130,496**	**(11,110)**
Cash flows from investing activities		
Purchase of property and equipment	(34,906)	(21,222)
Net cash from investing activities (II)	**(34,906)**	**(21,222)**
Cash flows from financing activities		
Net issuance of CNB bills	(1,556,433)	167,410
Payments to the State Budget	(484,860)	(104,772)
Net cash from financing activities (III)	**(2,041,293)**	**62,638**
Effect of exchange differences (foreign exchange losses) (IV)	**(52,368)**	**(10,593)**
Net increase in cash (I + II + III + IV)	**1,929**	**19,713**
Cash at beginning of year	**13,788**	**13,552**
Cash at end of period (Note 24)	**15,717**	**33,265**

The accompanying notes form an integral part of these financial statements.

Notes to the Financial Statements of the Croatian National Bank

NOTE 1 – BASIS FOR THE PREPARATION OF FINANCIAL STATEMENTS

The Financial Statements of the Croatian National Bank as at 30 June 2008 are prepared in accordance with the Act on the Croatian National Bank (Official Gazette 36/2001 and 135/2006) and International Financial Reporting Standards.

The Financial Statements of the Croatian National Bank as at 30 June 2008 are prepared in accordance with the accounting policies, balance sheet principles and methods of evaluating assets, liabilities, equity, income, expenditures and the financial result prescribed by current laws and other regulations.

NOTE 2 – INTEREST AND SIMILAR INCOME

in thousand HRK

	1/1/2008 – 30/6/2008	1/1/2007 – 30/6/2007
Deposits	805,941	850,803
Trading securities	323,923	286,694
International Monetary Fund	32	35
Loans to domestic banks	29,090	44,518
Other	346	5,792
	1,159,332	**1,187,842**

The most important part of income of the Croatian National Bank is interest income on placing international reserves as deposits with foreign central and first-class banks, and in debt securities.

NOTE 3 – INTEREST AND SIMILAR EXPENSE

in thousand HRK

	1/1/2008 – 30/6/2008	1/1/2007 – 30/6/2007
Kuna reserve requirements	84,658	78,457
Foreign currency reserve requirements	82,957	85,814
Compulsory CNB bills in kuna	46	–
Repurchase arrangements	136,844	117,442
Other	904	518
	305,409	**282,231**

NOTE 4 – NET RESULT FROM FINANCIAL OPERATIONS

in thousand HRK

	1/1/2008 – 30/6/2008	1/1/2007 – 30/6/2007
Net result from sale and changes in fair value of trading securities	164,774	163,448
	164,774	**163,448**

NOTE 5 – NET FOREIGN EXCHANGE LOSSES

in thousand HRK

	1/1/2008 – 30/6/2008	1/1/2007 – 30/6/2007
Net foreign exchange losses	(1,261,165)	(469,892)

Since the international reserves of the Republic of Croatia account for over 90% of the balance sheet of the Croatian National Bank, any changes in foreign exchange rates imminently affect the balance sheet and the income statement. Under the Act on the Croatian National Bank and International Financial Reporting Standards, exchange rate differences are reported in the income statement of the Croatian National Bank.

NOTE 6 – OTHER INCOME

in thousand HRK

	1/1/2008 – 30/6/2008	1/1/2007 – 30/6/2007
Gains on sales of numismatics	660	1.483
Other income	12.531	1.764
	13.191	**3.247**

NOTE 7 – OPERATING EXPENSES

in thousand HRK

	1/1/2008 – 30/6/2008	1/1/2007 – 30/6/2007
Staff costs (Note 7.1)	81,800	76,327
Materials, services and administrative expenses	38,963	37,816
Costs of production of banknotes and coins	23,701	18,957
Depreciation and amortisation	15,298	13,510
	159,762	**146,610**

NOTE 7.1 – STAFF COSTS

in thousand HRK

	1/1/2008 – 30/6/2008	1/1/2007 – 30/6/2007
Net salaries	34,828	33,205
Contributions from and on salaries	20,498	19,636
Taxes and local taxes	10,657	10,086
Other staff costs	15,817	13,400
	81,800	**76,327**

The average number of employees as at 30 June 2008 was 596.50 (30 June 2007: 588.83).

NOTE 8 – INCREASE/DECREASE IN PROVISIONS

in thousand HRK

	1/1/2008 – 30/6/2008	1/1/2007 – 30/6/2007
a) Interest		
New value adjustment	–	5,712
b) Provisions for risks and charges		
Provisions released	(5,139)	(4,658)
	(5,139)	**1,054**

NOTE 9 – CASH AND CURRENT ACCOUNTS WITH OTHER BANKS

in thousand HRK

	30/6/2008	30/6/2007
Cash on hand	4,143	4,394
Current accounts with foreign banks	5,628	22,944
	9,771	**27,338**

NOTE 10 – DEPOSITS WITH OTHER BANKS

in thousand HRK

	30/6/2008	30/6/2007
Deposits with foreign central banks	183.799	324.816
Deposits with foreign commercial banks	25.162.599	35.369.992
Deposits with domestic commercial banks	13.717	14.291
	25.360.115	**35.709.099**

The Croatian National Bank manages international reserve funds by investing them into types of assets specified in the Act on the Croatian National Bank by applying the principles of safety and liquidity. Most of international reserve funds are invested in deposits with first-class foreign banks as well as debt securities payable in a convertible currency of the debtor (Note 11).

NOTE 11 – TRADING SECURITIES

in thousand HRK

	30/6/2008	30/6/2007
Securities denominated in EUR	30.661.870	25.323.493
Securities denominated in USD	15.936.778	5.846.299
	46.598.648	**31.169.792**

The nominal value of the securities amounted to HRK 46,512,819 thousand as at 30 June 2008 (30 June 2007: HRK 31,116,188 thousand).

NOTE 12 – LOANS

a) By type of loan

in thousand HRK

	30/6/2008	30/6/2007
Loans to domestic banks		
– Lombard loans	–	372,600
– Repo loans	1,652,400	5,283,065
– Intervention loans	60,759	63,228
Other loans	796	804
Gross loans	**1,713,955**	**5,719,697**
Less: provisions for loan impairment	(61,440)	(63,909)
	1,652,515	**5,655,788**

b) Movements in provisions for loan impairment

in thousand HRK

	30/6/2008	30/6/2007
Balance at 1 January	63,909	63,909
Amounts collected	(2,469)	–
Balance at 30 June	**61,440**	**63,909**

NOTE 13 – BALANCES WITH THE INTERNATIONAL MONETARY FUND

in thousand HRK

	30/6/2008	30/6/2007
Membership quota	2,740,598	3,001,817
Special Drawing Rights (XDR) and deposits	5,946	5,929
	2,746,544	**3,007,746**

NOTE 14 – EQUITY INVESTMENTS

in thousand HRK

	30/6/2008	30/6/2007
Membership in other international institutions	37,386	40,943
Investments in domestic trade companies	16,137	13,721
	53,523	**54,664**

The membership in other international institutions relates to the shares of the Bank for International Settlements, Basle, and the shares of SWIFT (Society for Worldwide Interbank Financial Telecommunication). Investments in domestic trade companies represent the share of the Croatian National Bank in the equity capital of the Croatian Monetary Institute (42.6%).

NOTE 15 – ACCRUED INTEREST AND OTHER ASSETS

in thousand HRK

	30/6/2008	30/6/2007
Accrued interest	90,619	107,407
Prepaid expenses	97,547	87,413
Numismatics	9,535	9,485
Gold and other precious metals	3,627	3,367
Other assets	80,349	75,954
	281,677	**283,626**
Impairment allowance	(66,755)	(83,600)
	214,922	**200,026**
Movements in provisions		
Balance at 1 January	(66,755)	(77,888)
New value adjustment	–	(5,712)
Balance at 30 June	**(66,755)**	**(83,600)**

The major portion of prepaid expenses in the amount of HRK 94,218 thousand (30 June 2007: HRK 84,239 thousand) relates to the prepaid costs of printing banknotes and minting coins.

NOTE 16 – TANGIBLE AND INTANGIBLE ASSETS

The tangible and intangible assets of the Croatian National Bank were HRK 564,754 thousand as at 30 June 2008 (30 June 2007: HRK 403,295 thousand). Depreciation in the first half of the year amounted to HRK 15,299 thousand.

The tangible fixed assets of the Bank are neither subject to a mortgage nor to a fiduciary relationship.

NOTE 17 – BANKNOTES AND COINS IN CIRCULATION

in thousand HRK

	30/6/2008	30/6/2007
Cash in circulation	20,249,131	19,076,430

NOTE 18 – DUE TO BANKS AND OTHER FINANCIAL INSTITUTIONS

in thousand HRK

	30/6/2008	30/6/2007
Kuna reserve requirements	22,981,083	21,433,710
Foreign currency reserve requirements	16,823,415	18,704,406
Other deposits of domestic banks	7,573,664	7,771,199
Foreign banks and other financial institutions	14,660	16,970
Court-mandated deposits	5,867	3,705
Compulsory CNB bills in kuna	434,685	167,410
	47,833,374	48,097,400

The major portion of the Bank's liabilities to banks relates to reserve requirements of banks allocated in the accounts with the Croatian National Bank.

NOTE 19 – DUE TO THE STATE AND STATE INSTITUTIONS

in thousand HRK

	30/6/2008	30/6/2007
Domestic currency account balances	567,030	285,714
Foreign currency account balances	20,412	25,839
	587,442	311,553

NOTE 20 – DUE TO THE INTERNATIONAL MONETARY FUND

in thousand HRK

	30/6/2008	30/6/2007
Bills of exchange denominated in HRK	2,732,553	2,993,005
Other IMF's accounts	6,868	7,522
	2,739,421	3,000,527

The bills of exchange denominated in the Croatian kuna relate to the membership of the Republic of Croatia in the International Monetary Fund.

NOTE 21 – ACCRUED INTEREST AND OTHER LIABILITIES

in thousand HRK

	30/6/2008	30/6/2007
Accrued interest	19,930	19,852
Due to employees	5,952	5,538
Taxes and contributions	5,345	5,046
Due to the Ministry of Finance	4,831	5,451
Amounts due to suppliers	2,232	2,382
Other liabilities	70,653	62,852
	108,943	101,121

NOTE 22 – EQUITY

The equity funds of the Croatian National Bank consist of the initial capital and reserves. The initial capital in the amount of HRK 2,500,000 thousand is non-transferable and cannot be encumbered by any guarantees.

The semi-annual interim report for 1 January – 30 June 2008 shows an operating deficit of HRK 382,287 thousand.

NOTE 23 – TREASURY INVENTORY

in thousand HRK

	30/6/2008	30/6/2007
Non-issued banknotes and coins	83,041,918	87,205,279
Stamp duties and bills of exchange	74,834	81,106
	83,116,752	**87,286,385**

NOTE 24 – CASH

in thousand HRK

	30/6/2008	30/6/2007
Cash on hand	4,143	4,394
Current account balances with foreign banks	5,628	22,943
Special Drawing Rights (XDR) and deposits with the IMF	5,946	5,928
	15,717	**33,265**

Abbreviations and Symbols

Abbreviations

bn	– billion
b.p.	– basis points
BOP	– balance of payments
c.i.f.	– cost, insurance and freight
CBRD	– Croatian Bank for Reconstruction and Development
CBS	– Central Bureau of Statistics
CEE	– Central and Eastern European
CES	– Croatian Employment Service
CICR	– currency-induced credit risk
CIHI	– Croatian Institute for Health Insurance
CPF	– Croatian Privatisation Fund
CPI	– consumer price index
CPIA	– Croatian Pension Insurance Administration
CM	– Croatian Motorways
CNB	– Croatian National Bank
CR	– Croatian Roads
ECB	– European Central Bank
EFTA	– European Free Trade Association
EMU	– Economic and Monetary Union
EU	– European Union
EUR	– euro
excl.	– excluding
f/c	– foreign currency
FDI	– foreign direct investment
Fed	– Federal Reserve System
FINA	– Financial Agency
FISIM	– financial intermediation services indirectly measured
f.o.b.	– free on board
GDP	– gross domestic product
GVA	– gross value added
HANFA	– Croatian Financial Services Supervisory Agency
HICP	– harmonised index of consumer prices
IEMP	– index of exchange market pressure
IMF	– International Monetary Fund
IPO	– initial public offering
m	– million
MIGs	– main industrial groupings
MM	– monthly maturity

MoF	– Ministry of Finance
NCEA	– National Classification of Economic Activities
n.e.c.	– not elsewhere classified
NUIR	– net usable international reserves
OG	– Official Gazette
R	– Republic
ROAA	– return on average assets
ROAE	– return on average equtiy
o/w	– of which
PPI	– producer price index
Q	– quarter
RR	– reserve requirement
SDR	– special drawing rights
SITC	– Standard International Trade Classification
USD	– US dollar
VAT	– value added tax
ZSE	– Zagreb Stock Exchange
ZMM	– Zagreb Money Market

Symbols

–	– no entry
....	– data not available
0	– value is less than 0.5 of the unit of measure being used
Ø	– average
a, b, c,...	– indicates a note beneath the table and figure
*	– corrected data
( )	– incomplete or insufficiently verified data