CROATIAN NATIONAL BANK

Semi-annual Report

for the 1st half of 2009

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SEMI-ANNUAL REPORT FOR THE 1ST HALF OF 2009

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Zagreb, December 2009

1 Summary

The first half of 2009 was largely characterised by the spillover effects of the global financial crisis onto the real sector. Eurozone GDP fell by 4.8% relative to the same period in the previous year, while US and Japanese GDP went down by 3.6% and 7.4% respectively. In response to this severe economic contraction, governments and central banks in industrial countries and some rapidly growing emerging markets put in place additional incentivising monetary and fiscal policy measures to restore confidence in financial markets and end the recession. These measures proved effective and the first indications that the worst of the recession was over appeared in the global economy late in the first half of the year. In Croatia, as in almost all Central and Eastern European countries, adverse global developments and plummeting global trade strongly affected output, so that real GDP contracted by 6.5% year-on-year in the first six months of 2009. This was primarily due to a sharp fall in export volume observed in the entire region, coupled with a decline in household consumption and gross capital formation. While the fall in exports resulted from negative trends in global trade, the fall in the two most important components of domestic demand was prompted by a collapse in business and consumer optimism and heightened uncertainty in the economy. On the other hand, government consumption recorded a positive annual rate of change in the first six months, which kept the economy from contracting even further. The negative impact of lower demand on GDP was mitigated by changes in the structure of final consumption and investments as demand for cars and similar imported products as well as equipment recorded a fall. This led to a large reduction in imports. However, as imports fell more than exports, overall net exports had a positive impact on GDP dynamics in statistical terms. GDP by the production approach shows that gross value added (GVA) decreased somewhat less than GDP in the first six months of 2009, by 4.0%, because the category of net indirect tax saw a strong real contraction, primarily due to a large decline in VAT revenues. GVA in trade decreased strongly due to weakened domestic and foreign demand, while GVA in agriculture, financial intermediation and public sector services edged up.

This led to a sharp drop in the current account deficit, by more than one third relative to the first half of 2008, with the decrease in the foreign trade deficit exceeding the drop in the services trade surplus by a large margin. In addition, the deficit in the factor income account, which grew rapidly in previous years, narrowed, partly due to changes in the statistical monitoring of reinvested earnings. The positive balance in the account of current transfers rose mildly, mostly due to intergovernmental subsidies-based growth of central government revenues.

As the impact of deteriorating economic conditions on labour market indicators occurs with a certain time lag, it became increasingly evident and strong towards the end of the first half of 2009. More precisely, according to the seasonally adjusted data, employment has trended down while unemployment has trended up ever since the end of last year. The negative real sector trends affected wages as well but somewhat later than they did employment and unemployment indicators. The high annual growth in wages recorded at the beginning of the year lost much of its momentum only in the second quarter. With the slowdown in nominal wages being much stronger than that in inflation, real wages also decelerated.

The annual consumer price inflation rate was 2.1% in June 2009, down from 2.9% in December 2008. Core inflation remained higher than the overall consumer price inflation but its annual rate of change also dropped, from 4.2% in December 2008 to 3.4% in June 2009. The slowdown in inflation was primarily due to a fall in domestic demand as well as a favourable base effect, i.e. robust growth in prices of crude oil and other raw materials in the world's market in the same period last year. Although these prices resumed their upward path in late first quarter of 2009, they remained lower than in the same period of 2008 and the appreciation of the kuna against the US dollar softened the upward pressures coming from this source. On the other hand, inflationary pressures in the first six months of 2009 mainly stemmed from administrative prices (prices of household gas, tobacco products and health care services). Late 2008 and early 2009 were marked by the year-on-year growth in unit labour costs in industry, which was a consequence of the rise in compensation per employee and a parallel drop in labour productivity. The annual growth in unit labour costs slowed towards the end of the first half of the year (from 7.7% in the last quarter of 2008 to 5.0% in the second quarter of 2009), exclusively as a result of slower growth in compensation per employee in industry. Although these trends indicate the presence of cost pressures on inflation, it should be said that in an environment of weaker economic activity, i.e. domestic demand contraction, labour costs are less likely to spill over onto prices.

In the first half of 2009, the monetary environment was affected by developments in global financial markets. Large demand for foreign exchange, particularly on the part of the government sector, and lower foreign currency inflows from abroad spurred downward pressures on the domestic currency in the first quarter. In response, the CNB intervened twice and sold a total of EUR 513m to banks. In addition, the CNB provided substantial additional foreign currency liquidity by an intensive use of and changes in monetary policy instruments. At the same time, the central bank managed kuna liquidity restrictively, taking account of the main objective – the maintenance of price stability. The monetary environment was much more stable in the second quarter. As depreciation pressures on the kuna began to abate, upward pressures emerged in the second quarter. Coupled with the seasonal effects, these pressures were strongly affected by the issue of government bonds in the international market, which generated a large foreign currency inflow from abroad. Since conditions in the money and foreign exchange markets were more stable than in late 2008 and early 2009, no further changes in monetary policy instruments were needed. Instead, the central bank maintained the system's stability and liquidity through its regular operations.

In line with adverse economic developments, almost all monetary and credit aggregates recorded a decline in the first half of 2009. The fall was most pronounced in net foreign assets of banks as these assets were used to meet large funding needs of the government. In addition to intensive lending to the government, the first quarter was characterised by a decline in bank placements to the private sector. The loan contraction, which was particularly evident in the household sector, was definitely affected by negative trends on both the demand and the supply side (in particular, tightened lending terms). Still, interest rates on corporate loans, which experience says are more risky, grew faster and were more volatile than interest rates on household loans.

With regard to domestic sector savings held with banks, it is noteworthy that the growth in savings and time deposits in the first six months of 2009 was twice as low as in the same period last year. The slower growth in savings was primarily due to a fall in deposits of enterprises, which depleted their financial assets in conditions of impeded access to liquidity. In contrast to corporate deposits, household deposits continued to grow in the first six months of the year but at a more moderate pace than in the previous year. In addition to moderate growth in total deposits, the substitution of foreign currency savings for kuna savings continued, increasing the level of euroisation of the domestic banking system.

Banks experienced difficulties in the collection of due but unpaid receivables as well as the rise in non-performing loans in the first six months of 2009. In consequence, profits were much lower and the number of banks that operated with losses was higher than in the same period of 2008. The ratio of non-performing loans to total loans grew from 4.9% at end-2008 to 6.0% at end-June 2009, while the number of banks that operated with losses grew from 7 to 10. Nevertheless, the capital adequacy ratio of banks rose to 15.9% due to capital increases based on retained earnings (and, to a small extent, capital injections) and asset restructuring, with the strong growth in government loans increasing the share of risk-free assets in total bank assets. In addition, the first half of 2009 saw the adoption of 22 new pieces of subordinate legislation and amendments to the Credit Institutions Act, due to come into effect on 31 March 2010, which completed the transposition of the acquis in the field of banking.

Movements in the domestic capital market closely followed global developments in the first half of 2009. The gradual recovery of global financial markets in the second quarter brought positive developments in the domestic capital market. Consequently, the domestic equity index, the CROBEX, grew between end-2008 and end-June 2009 despite the drop in the half-year turnover in shares. At the same time, weak activity in the domestic debt securities market pushed down the value of the bond index, the CROBIS.

Notwithstanding the global financial market turmoil, Croatia's external debt increased by EUR 1.5bn in the first half of the year, i.e. by much less than in the same period in 2008. Total growth was mainly generated by additional corporate borrowing from foreign banks and affiliated enterprises abroad. Commercial banks also increased their external debt, while the central government slightly reduced its foreign liabilities.

In the first half of 2009, the capital and financial account recorded a positive, but somewhat smaller net inflow compared with that registered in the first half of 2008. The fall in net capital inflows resulted from a decline in both direct investment in Croatia and foreign borrowing. With regard to foreign assets, it is noteworthy that inflows of funds were larger than in the same period last year, mostly due to the withdrawal of bank currency and deposits from abroad that took place after the cut in the minimum rate of foreign currency liquidity in early 2009. According to the balance of payments data, international reserves fell by EUR 78m in the first six months of 2009, standing at EUR 9.1bn at end-June.

International reserves management in the first half of 2009 was influenced by international activities to restore confidence in financial markets and find ways out of the recession. As a result, the yield curve fell to low levels both in the US and the EU, which was certainly detrimental to investors in fixed income instruments as low interest rates gave no opportunity to attain higher rates of return. In such conditions, the yield on the CNB euro portfolio was 2.16% and the yield on its US dollar portfolio was 0.07%, which generated a total income of HRK 0.5bn.

After growing vigorously in 2008, yields on Croatian eurobonds gradually stabilised in the first quarter of 2009. Early in the second quarter, growth of optimism on the world's stock exchanges boosted investor appetite for riskier assets. The yield spread between emerging market sovereign bonds and government bonds of developed countries thus narrowed despite the widening of the range of emerging markets debt securities. Thus, the spreads between required yields on the Croatian eurobonds due in 2011 and 2014 and the benchmark German bonds stood at 363 and 371 basis points respectively at the end of the first half of 2009, which was a decrease of 213 and 73 basis points respectively on the end of December 2008.

Due to adverse economic trends, consolidated general government revenues were 7.7% lower in the first six months of 2009 than in the same period in 2008. Tax revenues dropped even more (14.6%), particularly revenues from indirect taxes, which were most affected by the fall in aggregate demand. On the other hand, as almost all expenditure items recorded growth, budget expenditures grew by 8.3% relative to the same period in the preceding year. Since government investment activity almost held steady at the previous year's level, the consolidated general government deficit (GFS 2001) was a high HRK 7.3bn in the January-June period of 2009, in contrast to a surplus of HRK 3.0bn generated in the same period in 2008. As the government raised the funds needed through borrowing, its debt increased noticeably, to HRK 108.4bn at end-June. Due to impeded access to foreign capital markets early in the year, the government relied mostly on domestic banks to meet its funding needs, while it raised substantial funds in the second quarter by issuing bonds in foreign markets. The Ministry of Finance decided not to issue bonds on the domestic market this year and started issuing euro T-bills regularly in March, which generated considerable investor interest.

2 International Environment

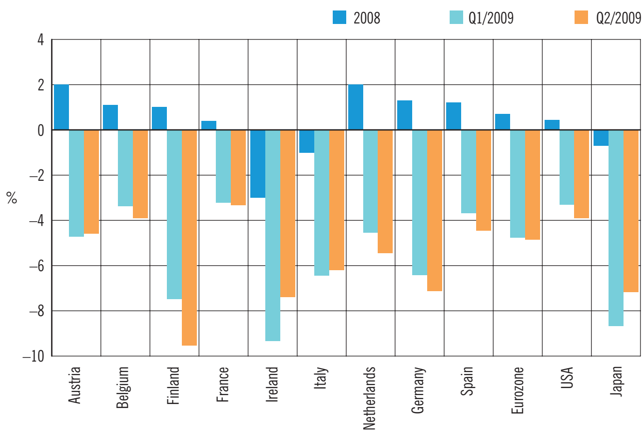
In the first half of 2009, the world's economy went through the most difficult phase of the economic crisis, showing the first signs of stabilisation late in the period. This was a result of comprehensive fiscal and monetary policy incentives as well as of the gradual normalisation of the financial market. At the same time, unfavourable real developments and an unfavourable base effect due to last year's high raw material prices, especially oil, resulted in global deflation pressures.

The US economy, the world's largest, contracted by 3.6% in the first half of 2009, the unemployment rate exceeding 9%, last seen in early 1980s. Financial markets did not fully recover, so lending conditions continued deteriorating during the period under review. Investments continued decreasing but strong industrial contraction did slow down. Shrinking world demand resulted in the narrowing of US exports but the negative effects on GDP were compensated for by the double decrease in imports. On the other hand, fully comprehensive fiscal policy measures paired with an expansive monetary policy contributed to the gradual stabilisation in the financial and real estate markets where the crisis had started back in 2007. The annual inflation rate, totalling 0% in January, entered negative territory for the first time in March, continuing the trend throughout the rest of the period under review. The Fed's key interest rate stood at the lowest end of the 0% to 0.25% band, first attained in December 2008, narrowing the room for further expansionary measures so the Fed turned to unconventional monetary policy measures.

Following strong appreciation pressures early in 2009, the US dollar started weakening against the euro in mid-March. The contracting demand for the dollar was induced, among other things, by better-than-expected indicators in the European market (including positive news on GDP movements in some eurozone countries), by the calming down of the situation in the financial markets and the corresponding boost in optimism and investor risk appetite, as well as by concerns regarding the growing US deficit. As a result, the exchange rate of the US dollar to the euro returned at end-June to its beginning-of-the-year level of USD 1.40/EUR.

GDP movements in the eurozone during the first half of the year were much like those in the US: real GDP went down by 4.8% but negative trends slowed down slightly at the end of the period. The decline in investments and consumption, which was negatively affected by rising unemployment, contributed to the economic contraction together with narrowing trading volumes in the region that were especially prominent in countries with large export sectors, like Germany. The steep decline of previously high real estate prices that had grown uninterruptedly over the previous years also had a negative influence on economic activity in some countries,

Figure 1 GDP in Selected Countries
real year-on-year growth rate



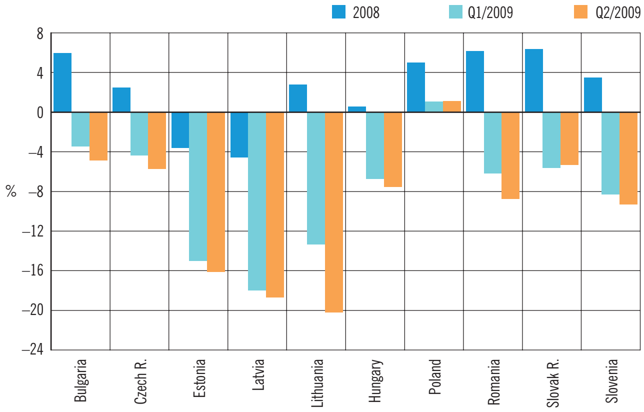
Sources: Eurostat and IMF.

especially Ireland and Spain. Due to negative pressures the annual inflation in the eurozone fell uninterruptedly in the first half of the year, entering negative territory at the end of the period. Accordingly, the ECB lowered its key interest rate in the first six months of the year, from 2.5% early in 2009 to only 1.0%, its all-time low.

The crisis was especially hard on CEE economies. The causes of the decline in real economic activity in this group of countries may, among other things, be found in the stoppage in the inflow of foreign capital, which in many countries led to the need for fiscal consolidation, which in turn made an additional negative contribution to economic activity. Owing to tightened lending conditions, investments and consumption declined and all CEE countries reported a noticeable rise in unemployment rates, which in some areas reached double digit levels (Baltic countries and Slovakia). Viewed individually, GDP contracted the most in Baltic countries, while Latvia, Hungary and Romania requested IMF assistance in the form of a stand-by arrangement to help them overcome their balance of payments crises. The only CEE country that saw its economy grow in the first half of the year, if only slightly, was Poland.

Real GDP also went down in Japan during the period in question, by 7.9% on an annual level, which is primarily a consequence of the decline in exports, investments, especially in real estate, and consumption. However, as in the case of the eurozone, negative trends slowed down in the second quarter, thanks to the slight recovery of exports and the growth of government investments within the framework of fiscal measures to spur the economy. Unfavourable real developments were also reflected in price movements so June saw a deflation of 1.8% on annual level.

Figure 2 GDP in Selected CEE Countries
real year-on-year growth rate



Source: Eurostat.

Despite the substantial slowdown, developing and emerging market countries registered positive rates of economic growth in the first half of the year in contrast to developed countries. Interrupted capital inflows, the decline in demand for exports from these countries and the fall in the prices of some of the raw materials that make up a significant portion of exports in many of the countries from this group were the key factors in the said slowdown. Nevertheless, the largest economies in this group, China and India, continued growing at relatively high rates, largely thanks to dynamic domestic demand but also fiscal stimuli.

In the six months under review, inflationary pressures weakened substantially on a global level in contrast to the first half of 2008 when they were very prominent. The main causes for the decrease may be found in the marked decline of economic activity and the decline in prices of raw materials, which, however, were also very low in the same period in 2008. Thus, after peaking in August last year, crude oil prices strongly declined during the remainder of 2008. Signs of stabilisation and possible start of economic recovery, the rise in investor optimism and the weakening of the US dollar spurred their renewed growth that started in March this year. In the period from the beginning of January to the end of June, the price of a barrel of crude oil went up from USD 45.3 to USD 70.1.[1] At the end of 2008, prices of other raw materials also went down substantially, but in the first half of 2009 they gradually stabilised.

[1] The average price of UK Brent, West Texas Intermediate and Dubai Fateh.

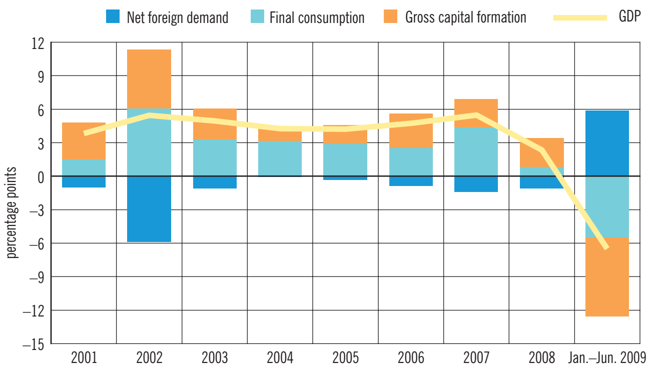
3 Economic Activity

3.1 Demand

Strong contraction in aggregate demand in the first half of 2009 led to a 6.5%[2] fall in real GDP on an annual level. Seasonally adjusted data[3] point to a significant decline in current economic activity in the first quarter of the year compared to the end of the previous year, and to its slight acceleration in the April to June period. Such dynamics was mainly influenced by a fall in exports seen throughout the region, a fall in household consumption and in gross fixed capital formation. While the exports fall can be attributed to negative trends in global trade, the fall in two major components of domestic demand can be attributed to falling consumer and business optimism and increased uncertainty in the economy. By contrast, the first six months of this year saw a positive annual rate of change in government consumption, indicating that this type of consumption prevented economic activity from an even sharper fall. The negative influence of fallen demand on GDP was mitigated by a change in the structure of final consumption and investment due to a fall in demand for cars and similar imported products and equipment. This led to an extremely large fall in imports, greater than the fall in exports and thus, statistically, net exports in general had a positive impact on GDP dynamics.

Household consumption fell by 9.7% on an annual basis in the first half of the year. The dynamics of personal consumption during that period was largely determined by growing consumer pessimism, despite relatively favourable developments in disposable income. As shown by available data, the effects of the economic crisis on disposable income only started to be felt more in the April to June period. Following an annual increase in the total number of employees in the first quarter of 2009, the rest of the first half of the year saw an annual fall in the number of employees, according to CPIA data.[4] However, given a positive change in the average real net wage in the economy throughout the first and second quarters, the real net wage bill, the main source of personal consumption financing,

Figure 3 Contributions of Domestic and Foreign Demand to Real GDP Growth



Note: Due to the method used for the calculation of real rates of change of GDP and its components, the sum of component contributions in one quarter diverges from the GDP dynamics.
Source: CBS.

[2] GDP data from the first quarter of 2006 to the second quarter of 2009 are preliminary data.

[3] Seasonal adjustment of data exclude short-term effects of events of an economic or a non-economic character that commonly take place during the year on the observed time series (e.g. holiday consumption). Calendar adjustment has to be made in respect of individual series, which implies elimination of the differences in the number of business days which can to an extent explain differences in the level of production arising from a fall in the number of hours worked.

[4] The number of persons insured with the CPIA is a more reliable short-term indicator of employment because recent CBS employment data by activities are preliminary data only (final data will be released in April 2010).

rose compared to the first half of the previous year. Developments in income from transfers, involving mainly pensions, child allowances, unemployment benefits and social assistance benefits also had a positive effect on total disposable income in the first half of the year. As the sharp fall in household consumption took place despite annual growth in disposable income, it is evident that households reduced their average propensity to consume based on current income. In addition to consumer pessimism (particularly as regards future economic situation and developments in the labour market), factors that also played a part were the smaller availability of new loans, increased burden of existing loans repayment and a fall in the real and financial assets of households. As a result, households rationalised their consumption, particularly as regards bigger purchases which are financed on the basis of new borrowing, as confirmed by data on real retail trade turnover, particularly in car sales which dropped significantly.

As the only component of aggregate demand with a positive annual rate of change (2.5%) from January to June 2009, government consumption at least partly mitigated the fall in economic activity. It should be mentioned that the first quarter of the year saw its highest annual growth in the past two years, mainly as a result of a sharp annual increase in expenditures for the use of goods and services, partly due to a favourable base effect (in the same period of 2008, government consumption was restricted by temporary financing). In the April to June period, the revised state budget and amendments to financial plans of extrabudgetary users notwithstanding, government sector consumption held steady at its beginning of year level. However, the absence of a favourable base effect, such as that seen in the first three months of 2009, led to a significant slowdown in the real growth rate of this component of aggregate demand in the second quarter.

Following exceptionally strong investment activity in 2008, this category of aggregate demand recorded a two-digit fall on an annual level (–12.6%) in the first half of 2009, with a somewhat bigger annual contraction taking place in the second quarter. Negative developments were seen in all components of investment consumption. Falling aggregate demand and growing insecurity as regards future economic developments led to a significant fall in corporate investment in machinery and equipment, as shown by data on imports and manufacture of capital goods and the number of newly registered vehicles of legal persons. At the same time, there was a fall in investments in construction, which account for around one half of total gross fixed capital formation, the fall being more prominent in the construction of residential and non-residential buildings than in civil engineering works. This points in particular to a decline in capital investments of the private sector and probable stagnation in government investments in real terms. It should be stressed that the fall in total investment activity was definitely also caused by growing illiquidity of the domestic economy and restricted access to financial resources needed for investment projects financing.

In the first half of 2009, international trade was marked by developments different from those that took place in the previous years, i.e. by a marked decline in goods and services exports (–17.4%) and an even stronger contraction of total imports (–22.9%). The first signs of these trends were already discernible in the last quarter of 2008, and after a considerable annual fall in imports and exports of goods and services in the first quarter of 2009, negative trends gained even more momentum in the second quarter. The effects of the contraction of economic activity, which hit all major export markets of the domestic economy, were seen in goods and services exports, while the fall in total imports was due to the declining domestic demand for foreign products intended for final consumption and investment. As domestic production largely relies on foreign products, the fall in goods imports can be explained by a falling demand for domestic goods and services.

3.2 Output

GDP by the production approach showed that GVA[5] decreased 4.0% in the first half of 2009. A slowdown in GVA formation, a consequence of the sizeable weakening of domestic and foreign demand, spread broadly across economic sectors. The rate of change in GVA was negative in all activities except agriculture and financial intermediation and public sector services, while an especially strong fall in GVA was observed in trade. Total economy value added declined in relative terms in the first half of the year by approximately one third less than GDP due to a strong real contraction of the category of net indirect taxes during that period, largely attributable to a big annual fall in value added tax revenues.

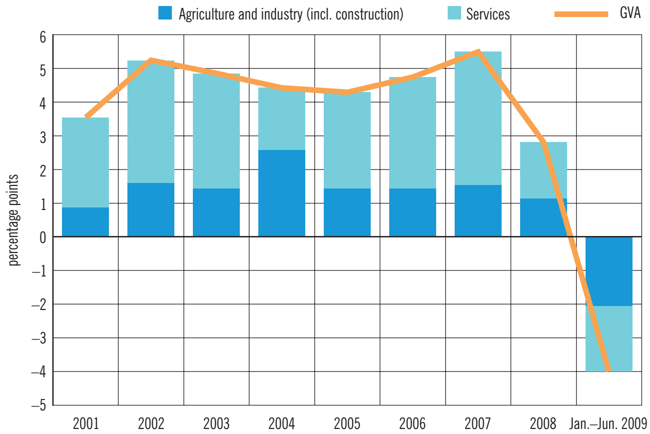
[5] In the national accounts, gross value added (GVA) in the economy is expressed in so-called basic prices, whereas gross domestic product (GDP) is expressed in market prices. The difference between these two values is the total amount of tax on products reduced by subsidies (net indirect taxes). As the 'net indirect taxes' category is not included in the CBS calculation of GDP in previous-year prices, this value can be calculated as a GDP and GVA residual in previous-year prices (with year 2000 as the benchmark year).

Industry and Construction

Gross value added in industry went down by 9.4% in the first half of 2009 from same period the previous year, with a somewhat lower negative annual rate of change in the second quarter of the year compared with the beginning of the year. Given that GVA in industry accounts for around one fifth of total GVA, these developments, paired with the contracting GVA in trade, were the main cause of the slowdown in total value added in the first half of the year.

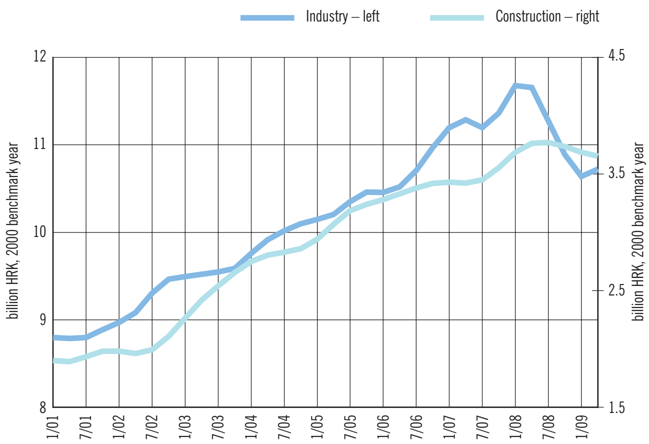
Seasonal and calendar adjusted data on the total volume of industrial production show that early 2009 was marked by exceptionally strong contraction of industrial production compared to the last quarter of the previous year, although there was a slight recovery in the second quarter. This recovery was almost entirely due to a sharp increase in current output in April; however, output continued to trend downwards in May and June. CBS data on foreign trade in goods suggest that the described developments in industrial production were the result of weakening of both domestic and foreign demand, while a slight acceleration of industrial production in the second quarter, mainly due to increased consumer goods production, can partly be attributed to a very small short-term increase in the foreign demand for such products. It is possible that changes in consumer preferences in favour of domestic production may have also contributed to this. Also, given that producers' inventories of finished goods declined throughout the first half of the year, it seems that the fall in current output was partly influenced by decisions of companies to reduce the level of inventories, which was very high at the end of 2008. It should be noted that unfavourable developments in industrial production led to a noticeable adjustment in the demand for labour in this economic sector, as seen in an evident fall in employment and a smaller number of registered job vacancies during the observed period.

Figure 4 Contributions of Industry and Services to Real GVA Growth



Source: CBS.

Figure 5 Gross Value Added in Industry and Construction
trend-cycle

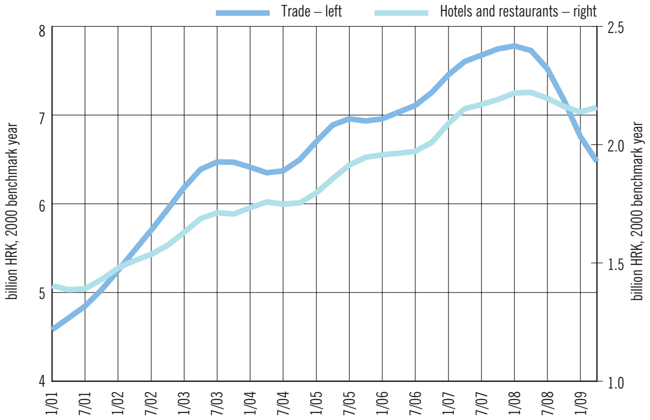


Source: CBS.

GVA formation in construction during the first two quarters of 2009 slackened compared to the same period in the previous year (–2.5% according to original data), primarily due to the decline in private sector investments in residential and non-residential buildings. By contrast, it seems that real investment activity of the government was almost equal to that which took place in the same period in the previous year, which can to an extent probably be explained by the political cycle associated with May elections for local government and self-government bodies. Seasonal and calendar adjusted data show that construction activity, after initial acceleration in the first two months of this year, started slowing down strongly in the months that followed. It seems that the reduction in investment demand by households, and probably by enterprises as well, contributed to the declining number of construction starts and a slowdown in the intensity of construction works already started, which resulted in a somewhat more pronounced negative annual rate of change in the second quarter compared to the beginning of the year. As the share of value added in this economic activity accounts for less than a tenth of the total GVA, its negative contribution to the total fall in GVA in the first half of 2009 was relatively small.

Figure 6 Gross Value Added in Trade and Hotels and Restaurants

trend-cycle



Source: CBS.

Non-Financial Services

Gross value added in trade had a negative annual rate of change of 15.8% in the first half of 2009, influenced by a sharp fall in household consumption. Broken down by quarters, there was a somewhat sharper decline in GVA in the second quarter relative to the first quarter. Accordingly, trade made an extremely negative contribution to total real GVA formation in the period from January to June 2009. As mentioned previously, such a fall in consumption took place in conditions of annual increase in disposable household income, so the reasons for this fall should be sought in other factors which affect individual purchasing decisions (consumer pessimism, unavailability of new loans, increased burden of repayment of existing loans, the effect of wealth, etc.).

Developments in hotels and restaurants point to a fall in demand for services. In the first half of 2009, GVA in hotels and restaurants decreased by 3.0% in real terms relative to the same period of 2008. However, the annual rate of decline in the second quarter was lower than that in the first quarter. Such developments can partly be explained by a fall in the number of registered overnight stays and tourist arrivals and a considerably smaller real consumption of foreign visitors due to the economic crisis, which has hit all the major tourist-generating markets. The fall in GVA in this area was probably influenced by cuts in entertainment expenses of companies and reduced household consumption of hotel and restaurant services. As this category accounts for a small share of the total gross value added of the economy, changes in it do not have a significant influence on total GVA formation, although it should be mentioned that the contribution of hotels and restaurants somewhat underestimates the total, direct and indirect, effects of tourist consumption on economic activity.

4 Labour Market

The slowdown and the fall in economic activity, accompanied by growing employer pessimism, affected the labour market indicators. As the impact of the unfavourable developments in the real sector on the labour market arises with a certain time lag, it became increasingly evident and strong towards the middle of the year. More precisely, according to the seasonally adjusted data, employment has trended down while unemployment has trended up ever since the end of last year. In contrast to employment and unemployment indicators, wages adjusted later to the developments in the real sector. Hence, high annual growth in wages, which was recorded at the beginning of the year, lost much of its momentum only in the second quarter. With the slowdown in nominal wages being much stronger than that in inflation, real wages also decelerated. The available data show that the private sector adjusted faster than the public sector to the current economic conditions and that employers made adjustments primarily on the employment side.

4.1 Employment and Unemployment

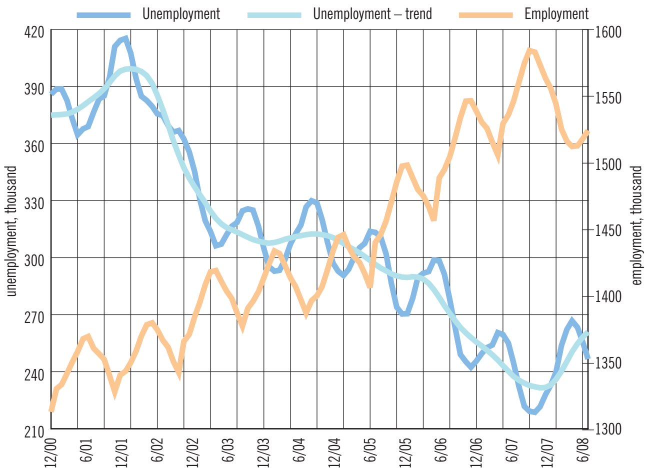
The slowdown in employment growth in 2008 and its decrease in the first half of 2009 reversed the total employment trend. As shown by the seasonally adjusted data, the number of employed trended downward continuously and more vividly from the end of 2008. The key contributors to this were persons employed in legal entities, which is mainly ascribed to their share, while the contributions of crafts and trades and freelance occupations and individual farmers actively insured with the CPIA also bore a negative sign. Although the CBS data for 2009 are still preliminary, the negative trends are also suggested by the number of persons insured with the CPIA, which is considered a reliable short-term indicator of employment.

As the content and the structure of the National Classification of Economic Activities have been adjusted to the EU classification NACE Rev. 2, early in the year the CBS started to publish its data in accordance with NCEA 2007 which replaced the previous NCEA 2002. The structure of total employment by activity shows that industry experienced the largest fall in the number of employed. If we take into account that one-fifth of all employed persons work in this sector, it also had the strongest negative contribution in the first half of the year. By the size of their negative contributions, the next to follow were trade, construction, accommodation providers and the food preparation industry and food services. Apart from the available monthly indicators of the real sector, which warned of unfavourable developments in these activities that were in the end confirmed by the reduction of their contributions to the formation of the real GVA, the decline in employment in the above activities was unquestionably influenced by growing pessimism and some administrative regulations such as the ban on Sunday trading.

The decrease in employment, apart from the CBS and the CPIA data, is also evident from the CES data. Owing to the reduction in demand for goods and services, employers made the required adjustments by decreasing production and, consequently, new hirings. This is corroborated by the number of those who found work with the help of the CES, which in the first half of 2009 fell by as much as 16% on annual level. The CES register in the reference period was marked by a substantial increase in the number of unemployed persons seeking for a job (up 35.5% over the first six months in 2008), the majority of whom came directly from employment, i.e. had been dismissed by their employers.

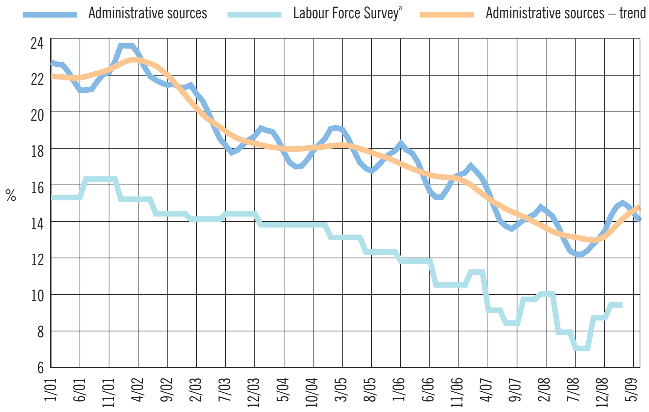
With the number of unemployed registered persons increasing and the number of employed registered persons decreasing, registered unemployment continued to grow, a trend observed as early as at the end of 2008. The labour

Figure 7 Employment and Unemployment



Sources: CBS and CES.

Figure 8 Administrative and Labour Force Survey Unemployment Rates

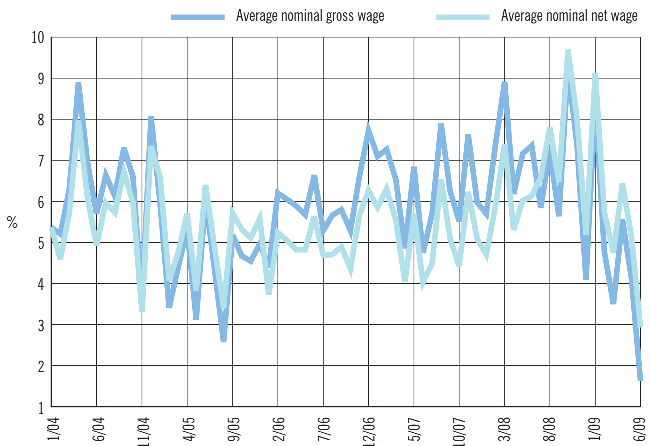


[a] The Labour Force Survey is published quarterly since the beginning of 2007.

Source: CBS.

Figure 9 Average Nominal Wages

year-on-year rate of change



Source: CBS.

market trends improved somewhat in the second quarter of 2009 in which the number of unemployed declined on account of the seasonal effect. This is also confirmed by the seasonally adjusted data showing stronger growth in unemployment towards the middle of the year. The registered unemployment reached 247,147 at end-June, up 11.2% over end-June 2008.

In line with these trends, the registered unemployment rate moved in line with unemployment dynamics, totalling 14.5% on average in the first half of 2009 or 0.7 percentage points more than in the same period in 2008. According to the latest Labour Force Survey, the unemployment rate dropped from 9.4% in the first quarter to 8.9% in the second quarter. However, this rate was, on average, higher in the first six months of 2009 than in the same period in 2008.

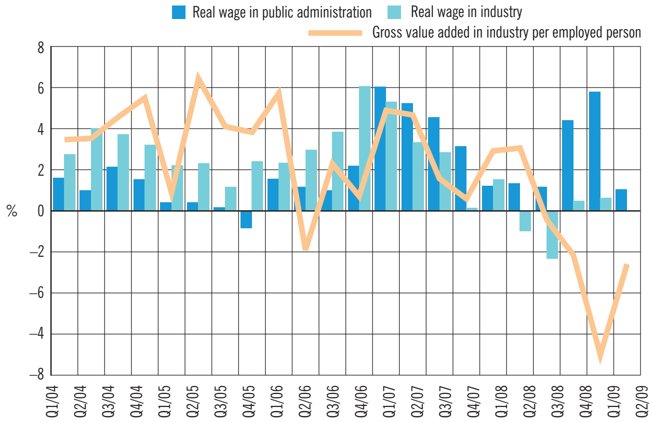
4.2 Wages and Labour Costs

The negative real sector trends affected wages as well but somewhat later than employment and unemployment indicators. Specifically, the wages paid out in the first half of the year grew on an annual level, which was above all the consequence of their high growth in the first months of 2009. Public sector wages were high at the beginning of 2009 on account of the rise in the wage calculation basis, while private sector wages slowed down significantly from the end of 2008. The growth in wages was also affected by the base effect stemming from the rise in the minimum wage in July 2008. The second quarter saw continued low growth in private sector wages and the deceleration in public sector wages. This was due to the legislative changes involving the reduction of the wage calculation basis in the public sector. Although causing the growth of total wages to slow down, this was not sufficient to result in negative rates of change. The above-stated leads us to the conclusion that private sector activities have, as far as employment and wages are concerned, adjusted faster to new conditions than public sector activities.

The slowdown in nominal wages, accompanied by a less pronounced decline in consumer price inflation, decelerated the growth of real wages in the reference period. If in addition to this we also take into account the reduction in the number of employed persons, it can be estimated that the real wage bill, otherwise the main source of personal consumption financing, rose slightly in the first half of 2009 relative to the same period in 2008.

Figure 10 Average Real Gross Wage in Public Administration and Industry and Gross Value Added in Industry per Employed Person

year-on-year rate of change



Source: CBS.

The movement in real wages in the first half of the year was the result of the decelerated wage growth in the majority of activities, with some of them showing even negative annual rates of change. As for private sector activities, relative to the first half of 2008, wages decreased most in manufacturing and trade, making at the same time the largest negative contributions. In contrast, the noticeable wage growth in information and communication in the second quarter largely added to a significant positive contribution of these activities in the entire first half of 2009. As mentioned earlier, the annual growth in wages in the public sector, which was high early in 2009, decelerated significantly due to the reduction of the wage calculation base for civil servants and other government employees and government officials by 6% and 10% respectively.

Although manufacturing was one of the activities most hit by the crisis, wages in this sector of industry managed to make a slight positive contribution to the growth of total wages. Given the decline in production measured by real GVA that was sharper than that in employment, labour productivity in industry fell strongly in early 2009. Similar trends continued in the second quarter as indicated by the recent available data on the quarterly GDP calculation. Labour productivity continued to trend downward but at a slower pace than at the beginning of the year. However, it should be noted that the CBS employment data are only preliminary.

5 Prices

The reduction of inflationary pressures in Croatia in the first half of 2009 occurred under conditions of declining personal consumption, in a large measure caused by a significant drop in consumer optimism generated by negative expectations regarding the future of the economy and labour market developments. Although increasing since the end of the first quarter, world prices of crude oil and other raw materials remained at a considerably lower level than in the same period in the previous year; moreover, the appreciation of the kuna/US dollar exchange rate eased the pressures on inflation imposed by this source. In addition, a stable kuna/euro exchange rate makes a positive impact on domestic inflationary trends by stabilising inflation expectations and the prices of goods imported from the eurozone. By contrast, administrative price increases (household gas, tobacco products, and health services) exerted upward pressures on consumer price inflation in the first six months of this year. The high annual growth of unit labour cost from the end of 2008 and the beginning of 2009 slowed somewhat in the second quarter (from 7.7% in the last quarter of 2008 to 5.0% in the second quarter of 2009) due to a considerable slowdown in the annual growth rate of compensation per employee in industry. The annual rate of decrease in labour productivity accelerated in the same period. It should be noted that the weakening economic activity and domestic demand reduce the possibility of costs spilling over into prices.

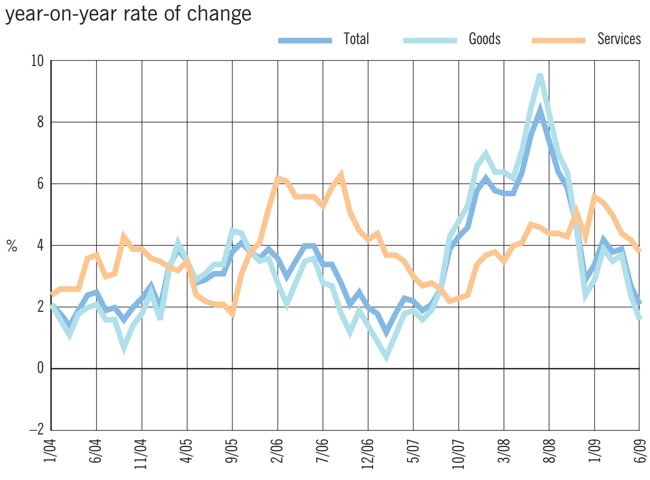
Consumer Prices

The annual inflation rate decelerated from 2.9% in December 2008 to 2.1% in June 2009. The annual rates of change in prices of most of the five main CPI components reduced in the first half of the year. A decrease in prices of non-processed food products and energy contributed the most to the slowdown in the overall annual inflation rate. These trends were due, in addition to a sharp slum in domestic demand, to a favourable base effect from the same period in 2008, when prices of most components surged on the back of sharp price increases in crude oil and other raw materials in the world market.

Core inflation remained higher than overall inflation, but its annual rate of change also fell, from 4.2% in December 2008 to 3.4% in June 2009. The slowdown in core inflation was for the most part due to a slowdown in the annual growth rate of food prices, especially bread and other bakery products and meat. These developments were caused by the stabilisation of these products' prices in the domestic market, and by a favourable base effect, derived from their sharp increases in the same period in 2008.

Figure 11 Consumer Price Index

year-on-year rate of change

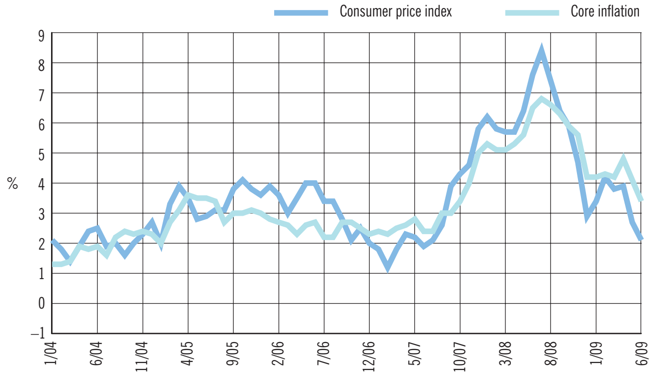


Source: CBS.

Administrative prices were a component to exert upward pressures on overall consumer price inflation in the observed period. Specifically, household gas prices rose by 15.2% in January from the previous month, tobacco products prices went up by 6.9% due to a rise in excises, and health care charges grew by 14.4% due to the introduction of participation fees for medical and hospital services.

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.

An analysis of the components of the food price index shows that the annual rate of change in prices of non-processed food products dropped significantly from 3.7% in December 2008 to 1.4% in June 2009, with the main cause being a decrease in the annual rate of change in fruit and meat prices. Inflationary pressures on the prices of processed food products also abated, although in a lesser degree. The annual rate of change in the prices of processed food products decelerated from 4.7% in December to 4.5% in June, predominantly due to a drop in the annual rate of change in the prices of bread and other bakery products and of milk and dairy products. The price growth of tobacco products (caused by the increase in excises) included into this group under the ECB classification had an opposite effect. These developments in food product prices point to an alleviation of inflationary pressures on the prices of products that had in 2008 been affected by the strong growth of world raw materials prices. The strong fall in demand was a domestic factor that contributed the most to the reduction in domestic food prices, while also spurring competition on the domestic market and leading to a decrease in trading margins.

Energy was a CPI component that contributed the most to the abatement of inflationary pressures in the period after July 2008, which saw these pressures peak and crude oil prices exceed USD 145 per barrel. Due to crude oil prices dropping to USD 41.3 in December 2008, the annual rate of change in energy prices fell from 16.5% in July 2008 to –1.7% in December 2008. World crude oil prices increased in the first six months of 2009, although at a much slower pace than in the same period in 2008, with the result that the annual rate of change in energy prices dropped further to –4.1% in June 2009. This drop was offset by a household gas price increase at the beginning of the year.

Table 1 Consumer Price Index, the five main categories of products

year-on-year rate of change

	Weight 2009	12/2008	3/2009	4/2009	5/2009	6/2009
Total	**100.0**	**2.9**	**3.8**	**3.9**	**2.7**	**2.1**
Energy	13.0	–1.7	–1.3	–0.4	–3.5	–4.1
Unprocessed food	14.7	3.7	9.5	6.7	3.5	1.4
Processed food (incl. alcoholic drinks and tobacco)	23.2	4.7	4.2	5.9	5.3	4.5
Industrial non-food without energy	28.3	2.2	2.2	2.5	2.3	2.2
Services	20.7	4.2	5.0	4.4	4.2	3.8

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.

Trends in industrial non-food products (excluding energy) were also affected by the marked drop in aggregate demand and reduced cost pressures on prices. Standing at 2.2% in June, the annual growth rate of this product group's prices was below its 2008 average of 3.0%.

The annual rate of change in services prices dropped to 3.8% in June (compared with 4.2% in December 2008). This was a consequence of the stabilisation of domestic services prices, notably those of services in road passenger transport and hotel and restaurant services, but also of a favourable base effect, i.e. the 2008 price increase of these services, indirectly brought about by the price hike in raw materials in the world market. This, in turn, shows that the alleviation of inflationary pressures on food products prices had a stabilising effect on hotel and restaurant services prices, and primarily on the prices of restaurant food and beverages. In general, services prices still record higher annual rates of increase than goods prices, which is mostly due to the growth of administrative prices (health and hospital services) early in the year.

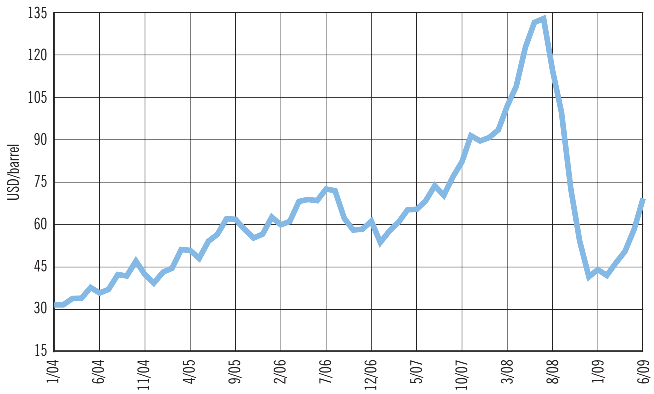
Import Prices

Having slumped in the second half of 2008, world crude oil prices stabilised in the first quarter in 2009 and from then on grew at a faster rate. Amounting to USD 69.1, the average price of crude oil per barrel was 67.3% higher in June than in December 2008. The increase in crude oil prices in the observed period is mostly attributed to signs of a global economic recovery, an increase in investor optimism and a drop in the value of the US dollar. Although expectations of growth in demand for crude oil have an impact on the crude oil price increase, the still relatively large reserves and weak demand imposed constraints.

Other world raw materials prices also increased. The HWWI index, which reflects price trends in raw materials (excluding energy, in US dollar terms) in the world market, increased by 12.0% in June from December 2008. The sharpest increase, largely spurred by strengthening demand from China, was in metal prices, and the prices of food products, especially oil seeds, also rose. However, raw materials prices remained considerably below the peak levels they reached in mid-2008, plunging after that period under the impact of the global recession and falling demand. In contrast, imported inflationary pressures eased on account of eurozone producer price trends. The annual rate of change in eurozone producer prices fell from 1.2% in December 2008 to –6.5% in June, primarily because of a drop in the annual rate of change in energy and intermediate goods prices. Producer prices of final consumption goods in the eurozone also decreased annually in June, signalling a possible decline in import pressures on domestic inflation.

As shown by data on industrial producer price trends, inflationary pressures continue to subside due to an annual decrease in world raw materials prices and a drop in domestic and foreign demand. The annual growth of industrial producer prices started slowing down in August 2008 and from March 2009 on recorded negative rates of change. The annual rate of change in producer prices stood at –1.0% in June 2009, compared with 4.3% in December 2008. Intermediate goods prices dropped at an annual rate of 5.1% in June, predominantly due to the decrease in metal prices, and to some extent also to a favourable base period, resulting from the strong price increases of these products in the first six months of the previous year. Spurred by the increase in world crude oil prices, producer prices of refined petroleum produces recorded continuous monthly growth from the beginning of the second quarter. However, as this growth was much stronger in the same period in 2008, the annual rate of

Figure 13 Average Crude Oil Prices[a] on the World Market

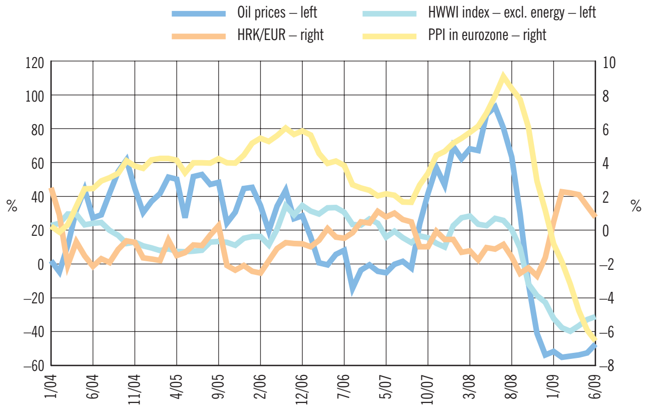


[a] Calculated as an average of the following oil prices (prompt delivery): Dubai Fateh, UK Brent and West Texas Intermediate.

Source: Bloomberg.

Figure 14 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 o 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.

change remained negative. Nevertheless, total energy prices at the group level drifted higher at an annual rate of 0.9%, with the highest price increase recorded in crude oil and natural gas extraction.

Durable consumer goods increased at the highest annual rate (4.8%) in June, largely boosted by a price increase in furniture production. Non-durable consumer goods prices moved up at a low annual rate of 0.8% in June, indicating weak inflationary pressures on the consumer prices of these products. It should be noted that the decrease in the producer prices of food products was offset by a price increase in tobacco products and beverages. Capital goods prices grew at an annual rate of 3.1% in June, with a very sharp price increase in the production of other transport equipment.

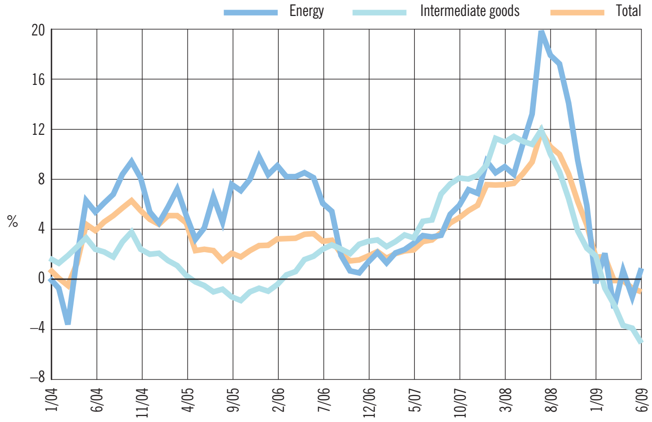
International Comparison of Consumer Prices

The annual rate of change in eurozone consumer prices was negative (–0.1%) in June 2009. Downward pressures on eurozone consumer prices were the strongest in the case of energy prices, which was a consequence of a significant base effect, resulting from the steep increase in world crude oil prices in mid-2008. The difference between the Croatian and the eurozone annual rate of change in consumer prices increased in the first half of 2009, mostly as a result of the growth of administratively regulated prices (the household gas price increase, increase in tobacco products prices brought about by the excise rise, and increase in health services charges). The annual rate of change in consumer prices in Croatia was 2.9% in December 2008, compared with 1.6% in the eurozone, while the respective rates were, as mentioned, 2.1% and – 0.1% in June 2009. According to a breakdown by components, the overall CPI for Croatia and that for the eurozone show a difference between trends in energy prices and processed food products prices. Croatia's energy prices decrease at a slower annual rate than eurozone prices, which can partly be attributed to the mentioned gas price increase. On the other hand, the growth rate of Croatia's processed food products prices is faster than the eurozone rate, among other things due to the price increase in tobacco products.

In comparison with the new CEE members of the EU, Croatia's annual consumer price inflation rate was in June 2009 higher than that in Estonia (–0.5%), Slovenia (0.2%),

Figure 15 Producer Prices of Industrial Products by Main Industrial Groupings

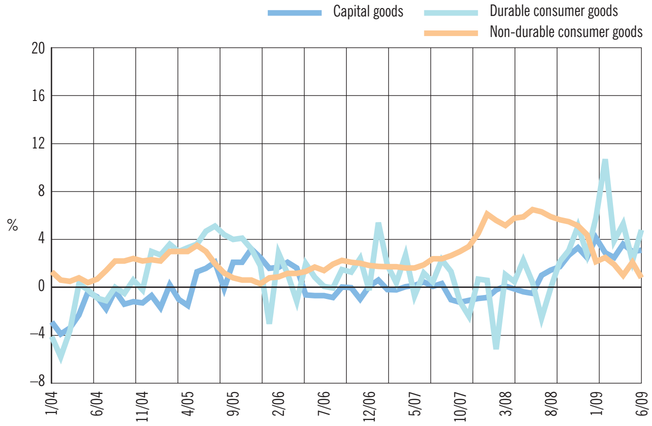
year-on-year rate of change



Source: CBS.

Figure 16 Producer Prices of Industrial Products by Main Industrial Groupings

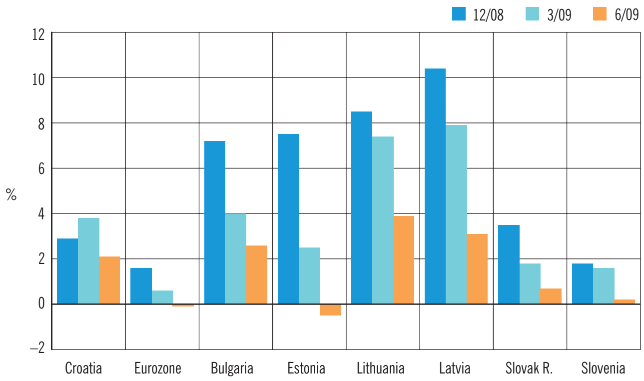
year-on-year rate of change



Source: CBS.

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

year-on-year rate of change



Sources: CBS and Eurostat.

Slovakia (0.7%) and the Czech Republic (0.8%) and was below the same rate in Romania (5.9%), Poland (4.2%), Lithuania (3.9%), Hungary (3.7%), Latvia (3.1%) and Bulgaria (2.6%).

Real Estate Prices

The annual real estate price growth slowed down considerably in 2008 as demand for residential real estate slumped due to a slower real growth in disposable household income, an increase in (nominal) interest rates on home loans, tightened lending conditions and a drop in consumer optimism. Expecting a further slowdown in domestic real estate prices, prospective buyers postponed their purchases. The downturn in demand for residential real estate thus continued in the first half of 2009 and, in the conditions of an ample supply of residential real estate, pushed down real estate prices by 5.3% from the same period in the previous year. The prices of residential real estate in Zagreb reduced at an annual rate of 3.1%, while the prices of residential real estate on the Adriatic Coast fell at an even sharper rate of 9.6%.

Table 2 Croatian Residential Real Estate Price Index

year-on-year rate of change

	Weight	2002	2003	2004	2005	2006	2007	2008	2007		2008		2009
									1st half	2nd half	1st half	2nd half	1st half
Croatia	100.0	1.8	0.6	13.0	8.8	16.5	13.0	5.8	17.5	8.7	5.8	5.8	–5.3
Zagreb	65.3	6.5	0.6	11.5	10.0	17.0	11.7	2.2	14.4	9.2	1.8	2.6	–3.1
Adriatic Coast	22.0	5.5	8.7	9.2	17.1	15.8	16.2	10.7	23.0	10.1	13.7	7.7	–9.6

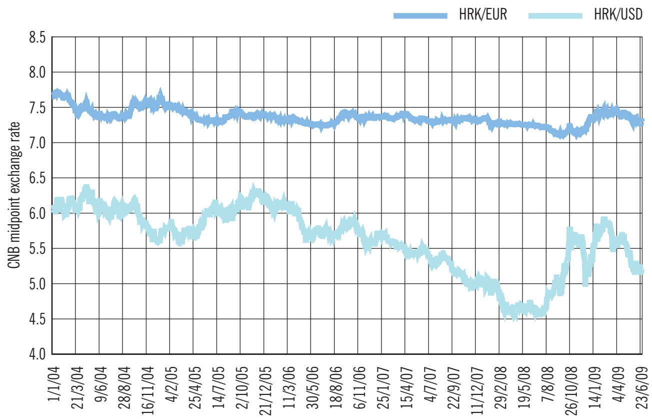
Note: The methodology used for compiling the hedonic real estate price index in Croatia is such that each calculation of the new value of the index (at the end of a semi-annual period) involves a reassessment of all the parameters of real estate prices achieved by the given equations, which, in turn, 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

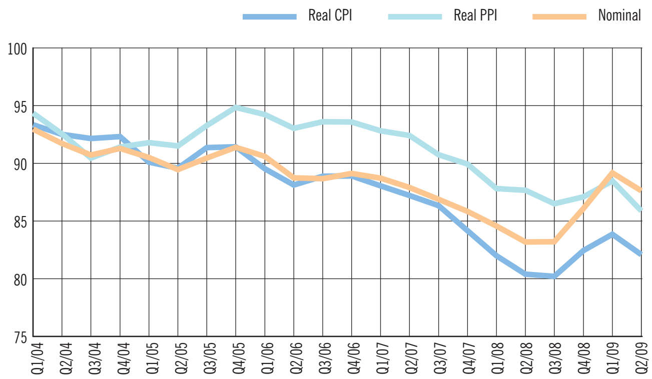
In the first six months of 2009, the kuna strengthened slightly against the euro (0.4%), with the exchange rate falling from HRK 7.32 for one euro on 31 December 2008 to HRK 7.29 for one euro on 30 June 2009. The strengthening of the kuna was a consequence of exchange rate developments in the second quarter, while the first quarter was marked by more prominent depreciation pressures on the domestic currency, mostly affected by stronger demand for foreign exchange from the government and enterprises due to maturing payments of their foreign liabilities and reduced capital inflow. In an effort to alleviate depreciation pressures, the CNB, through foreign exchange interventions on 23 January and 18 February, sold the banks a total of EUR 513.0m. In addition, through a change in its monetary policy instruments, the CNB released significant banks' foreign currency reserves. As appreciation pressures strengthened following the ensuing decrease in kuna liquidity, the CNB again intervened in the foreign exchange market on 27 February, purchasing EUR 331.2m from the banks. Depreciation pressures softened in the second quarter, as a result of the budget revision that created room for the government to borrow in the foreign market by issuing eurobonds as well as of indicators showing that enterprises would have no problems in refinancing their foreign liabilities. In addition, the narrowing of the trade deficit led to a decrease in financing requirements. As a result, the kuna was more exposed to appreciation pressures, which can be explained, among other things, by activities of market participants relating to the issue of government eurobonds and the usual seasonal

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



Source: CNB.

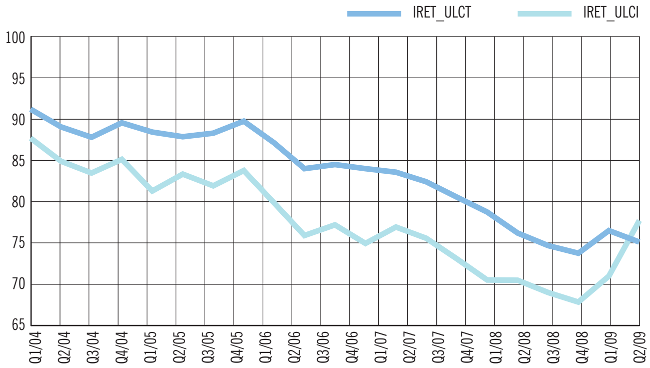
Figure 19 Indices[a] of the Nominal and Real Effective Kuna Exchange Rate with Consumer and Producer Prices and Unit Labour Cost
2001 = 100



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

Sources: CBS, ECB, OECD, national sources and CNB calculations.

Figure 20 Indices[a] of the Nominal and Real Effective Kuna Exchange Rate with Consumer and Producer Prices and Unit Labour Cost
2001 = 100



[a] The fall in the index denotes an appreciation of the kuna.
Sources: CBS, ECB, OECD, national sources and CNB calculations.

factors (the beginning of the tourist season). No central bank foreign exchange interventions were required. In foreign exchange transactions with the Ministry of Finance, the CNB repurchased EUR 411.10m net in the period from January to June 2009, relating primarily to the repurchase of the major portion of EUR 750m that the government generated by issuing eurobonds.

In the first six months of 2009, the kuna gained strength against the euro and against the Swiss franc (2.8%). However, it weakened against the US dollar (1.0%) and the pound sterling (14.8%). As a result, the index of the daily nominal effective kuna exchange rate depreciated by 0.1% against the currency basket (30 June 2009 relative to 31 December 2008).

Available data on the real effective exchange rate of the kuna in the first half of 2009 point to a slight improvement in the export price competitiveness relative to the previous six-month period. In the period under review, the index of the real effective exchange rate of the kuna deflated by producer prices and consumer prices depreciated by 2.0% and 0.4% respectively. Nevertheless, the realised weakening of the kuna in real terms was lower than its weakening in nominal terms (4.4%) because consumer prices in Croatia went up, while abroad they went down. Industrial prices in Croatia decreased less than abroad. As for the cost competitiveness of Croatian exports, available data on the movements of the index of the real effective exchange rate deflated by the unit labour cost for the first quarter of 2009 show that at the level of the economy as a whole appreciation totalled 1.8% relative to the previous quarter. This was a consequence of the growth in the unit cost of labour, which was faster in Croatia than elsewhere. In contrast, the index of the real effective kuna exchange rate with unit cost of labour in industry depreciated substantially (9.5%), which was, in addition to the realised nominal effective depreciation of the kuna, influenced by the decline of the unit cost of labour in industry which went up in other countries.

7 Monetary Policy and Monetary Developments

The negative impact of the global financial and economic crisis on domestic financial trends that occurred in late 2008 continued into 2009. In early 2009, the monetary environment was characterised by downward pressures on the kuna, which were also generated by the seasonal BOP deficit and substantial foreign currency liabilities of the government. The CNB managed to ease these pressures by an intensive use of and changes in monetary policy instruments, which released a substantial amount of foreign currency liquidity. At the same time, the central bank managed kuna liquidity restrictively, taking account of the main objective – maintenance of price stability, i.e. stability of the nominal exchange rate of the kuna against the euro as the main nominal anchor. Large funding needs of the central government strongly affected monetary policy in that period.

The monetary environment was much more stable in the rest of the first half of the year. As depreciation pressures on the kuna began to abate, upward pressures emerged in the second quarter. Coupled with the seasonal effects, these pressures were strongly affected by the issue of government bonds in the international market, which generated a substantial foreign currency inflow from abroad. However, since conditions in the money and foreign exchange markets were more stable than in late 2008 and early 2009, no further changes in monetary policy instruments were needed. Instead, the central bank maintained the system's stability and liquidity through its regular operations.

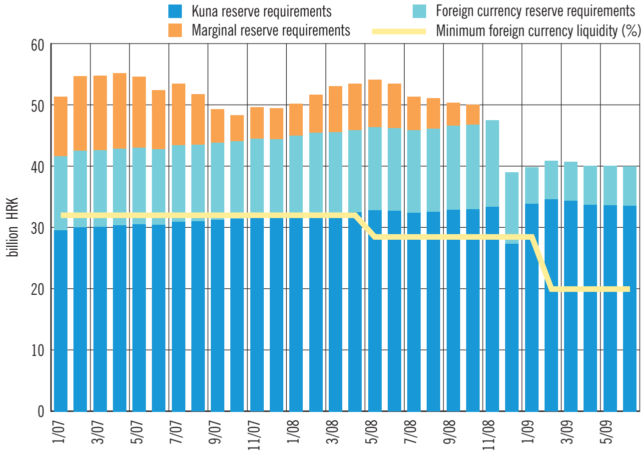
In line with adverse economic developments, almost all monetary and credit aggregates recorded a decline in the first half of 2009. The fall was most pronounced in net foreign assets of banks and money, although bank placements to the private sector, and households in particular, also decreased. Bank placements to the central government grew the most.

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

Commercial banks entered 2009 with large kuna liquidity surpluses, while depreciation pressures, observed since late 2008, increased further. Following the cut in the reserve requirement rate from 17% to 14% in December 2008 (which released HRK 5.9bn and EUR 346m), the CNB raised the percentage of the foreign currency reserve requirement that is set aside in kuna from 50% to 75% in January 2009 (thus withdrawing HRK 5.9bn from the system and releasing EUR 810m).

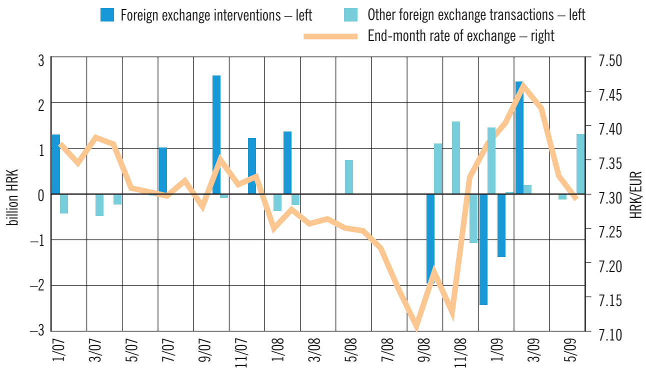
Early in February, the central bank further boosted the foreign currency liquidity of the banks by reducing the rate of the minimum required foreign currency claims from 28.5% to 25.0%. This relaxation of the foreign currency liquidity requirement, which released EUR 840m to banks, was coordinated with the planned government borrowing from domestic banks. However, domestic demand for foreign exchange was still strong, while adverse developments in the international environment continued. Consequently, in February the CNB again cut the rate of the minimum required foreign currency claims, to 20%, thereby freeing EUR 1.25bn. Furthermore, the maximum permitted open foreign exchange position was increased from 20% to 30% of the regulatory capital in late February, which facilitated the management of the foreign currency funds released.

Figure 21 Calculated Reserve Requirements and Minimum Foreign Currency Liquidity of Banks



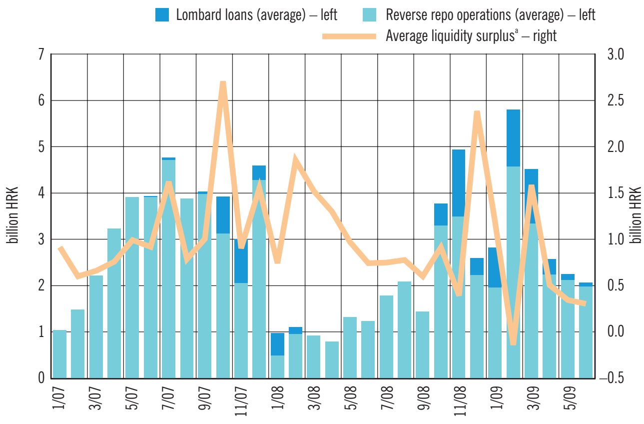
Source: CNB.

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. Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and foreign currency swaps with banks.
Source: CNB.

Figure 23 Kuna Liquidity, Reverse Repo Operations and Lombard Loans



[a] Overnight deposits with the CNB included.
Source: CNB.

By changing the reserve requirement and minimum foreign currency liquidity instruments, the CNB released a cumulative amount of EUR 2.9bn in the first quarter of 2009, and substantially helped to balance the demand and supply in the foreign exchange market and eventually to halt the weakening of the kuna. In the first two months of 2009, the CNB intervened twice in the foreign exchange market, placing EUR 0.5bn and withdrawing HRK 3.8bn. In contrast, the central bank purchased EUR 0.3bn in early March (creating HRK 2.5bn), thereby compensating for a part of international reserves that had been used in previous months. In the rest of the first half of 2009, there were no foreign currency auctions with commercial banks.

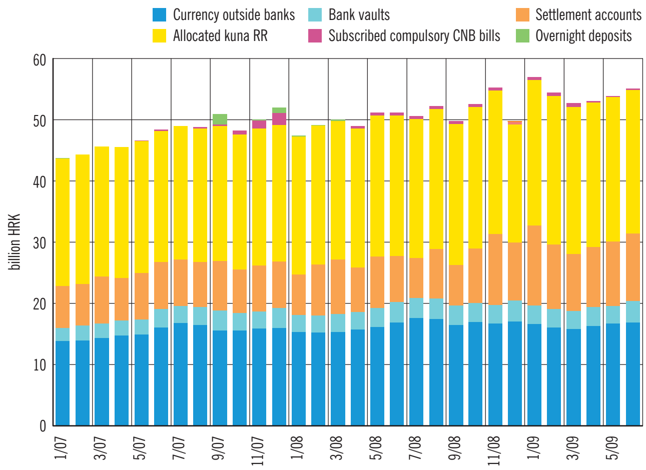
Apart from direct foreign exchange purchase and sale transactions with banks in the first half of 2009, the CNB also concluded a foreign currency swap contract with banks. Under this contract, on the basis of EUR 261.3m of foreign currency pledged as collateral, banks obtained HRK 1.9bn to lend to the central government. This amount was slightly increased afterward and the contract was extended to June when the government, based on the bond issue in the international market, raised funds to terminate some credit lines with Croatian banks.

In the first half of the year, foreign exchange transactions with the MoF, in addition to current foreign exchange purchase and sale transactions of small amounts, included the usual sale of the foreign currency funds needed to repay due liabilities to the Paris and London Clubs (EUR 59m), while EUR 473m generated by the government's international bond issue was purchased in June. The net monetary effect of all these CNB transactions with commercial banks and the central government was HRK 1.6bn generated in the first six months of 2009.

Kuna liquidity management by means of open market operations supported foreign currency operations and also aimed at preventing excessive exchange rate fluctuations. They were used restrictively, i.e. some 40% of the bids received from banks were accepted at a fixed rate of 6.0%. The turnover at reverse repo auctions, which was somewhat larger in the first quarter of the year, decreased gradually in the following months after a substantial amount of kuna liquidity was created by the March purchase of foreign exchange from the banks. In the periods of higher demand for foreign exchange banks occasionally relied on Lombard loans to maintain reserve requirements.

Reserve money (M0) increased by 10.8% in the first half of 2009, standing at HRK 55.1bn at end-June. This growth largely reflects the effects of monetary policy measures, which, particularly in the first quarter, aimed at withdrawing kuna liquidity in view of depreciation pressures. Within the structure of M0, the strongest growth was recorded by kuna reserve requirements set aside and balances in banks' settlement accounts in which banks maintain a part of calculated kuna reserve requirements. In contrast, currency outside banks declined, while compulsory CNB bills, which banks purchased in 2008 on account of excessive credit growth, came due.

Figure 24 Structure and Developments in Reserve Money

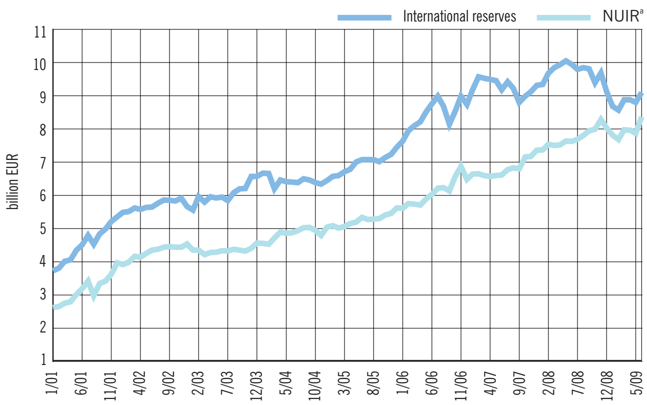


Source: CNB.

Gross international reserves of the CNB, which decreased early in 2009, returned to the level of December 2008 in late June. The fall in reserves began in October 2008 and was entirely due to monetary policy measures aimed at improving the banking system's foreign currency liquidity. At the time when capital flows and access to foreign funding were impeded, while foreign liabilities of the private sector and the government were large, the depletion of reserves provided the necessary foreign currency liquidity and supported the exchange rate of the kuna.

Figure 25 International Reserves of the CNB

at current rate of exchange



[a] NUIR = international reserves – foreign liabilities – CNB bills in f/c – reserve requirements in f/c – government foreign currency deposits.

Source: CNB.

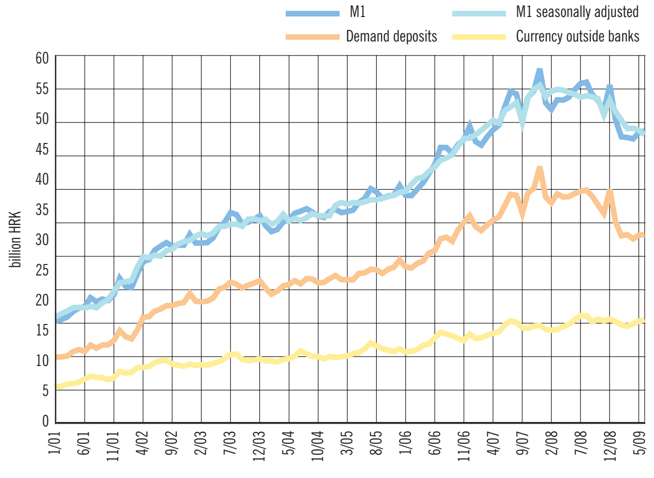
In the first two months of 2009, gross international reserves declined due both to the increase in the percentage of foreign currency reserve requirements set aside in kuna from 50% to 75% and the sale of foreign currency to banks. However, due to the purchase of foreign exchange from banks, reserves started recovering in March. Due to a stable exchange rate and favourable liquidity in the following period, no further changes in monetary policy instruments were needed to improve the banking system's foreign currency liquidity and no foreign exchange interventions were required, so the international reserves held mostly steady through to the end of June. Finally, at the end of June, the CNB purchased from the government the bulk of the foreign currency proceeds from the international bond issue, which fuelled the rise in reserves. At end-June, reserves stood at EUR 9.1bn, only –0.3% less than at the end of 2008, while their annual rate of change was –8.6%.

Notwithstanding a slight decline due to two foreign exchange interventions in January and February, net usable reserves continued to grow in the observed period. They increased due to the said purchases of foreign exchange from banks in March and the government in June, standing at EUR 8.4bn at end-June and growing annually by 9.7%.

7.2 Developments in Monetary and Credit Aggregates

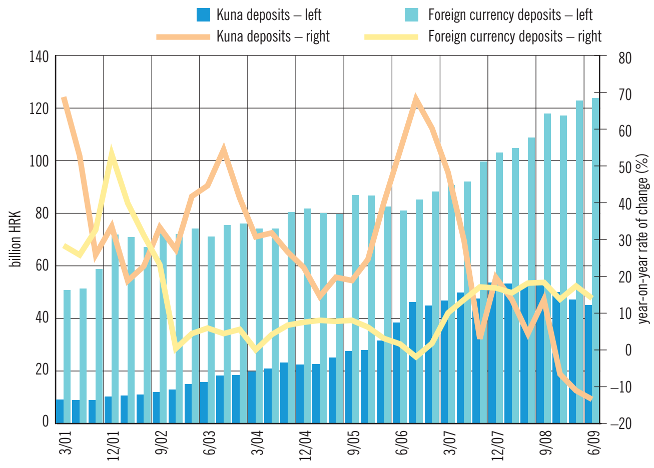
Monetary developments in the first half of 2009 were marked by a decline in almost all monetary and credit aggregates. The sharpest fall was recorded by banks' net foreign assets; thanks to changes in CNB regulations, banks used the bulk of funds from abroad to meet the huge funding needs of the government. In contrast, bank placements to the private sector declined in the observed period, which led to slower growth in net domestic assets of the banking system. As a result of the sharp fall in net foreign assets and moderate growth in net domestic assets, total liquid assets (M4) dropped sharply in the first half of 2009.

Figure 26 Money (M1)



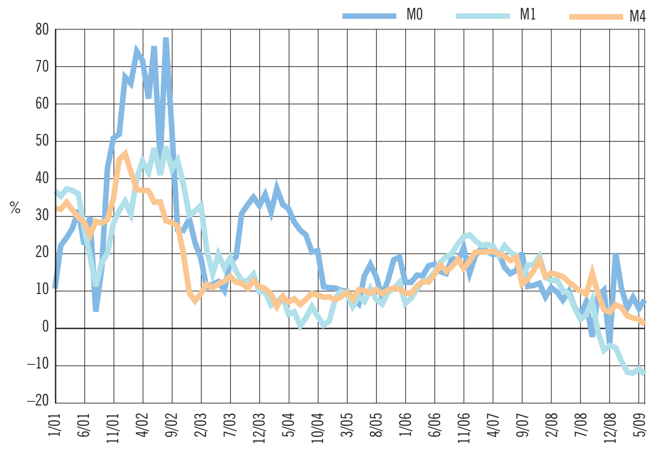
Source: CNB.

Figure 27 Kuna and Foreign Currency Deposits



Source: CNB.

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



Source: CNB.

Money (M1) contracted by HRK 7.5bn in the first half of the year due to adverse economic developments and the slump in bank lending. The annual rate of change of this monetary aggregate thus continued to fall, standing at –12.3% at the end of June.

The increase in savings and time deposits in the first six months of 2009 was HRK 1.6bn, which is half as much as in the same period in 2008. This slower growth in bank savings was primarily due to a fall in deposits of enterprises, which depleted their financial assets in conditions of impeded access to liquidity. In addition to moderate growth, the structure of total deposits indicates that the substitution of foreign currency savings for kuna savings continued. In the first half of 2009, kuna deposits decreased by HRK 5.1bn, while foreign currency savings held with banks grew by HRK 6.7bn. The increase in the level of euroisation of the domestic banking system began with the spillover of the global financial crisis to Croatia and continued under the influence of negative expectations about domestic economic trends.

The sectoral structure of deposits suggests that deposits of other banking and non-banking financial institutions grew the most, while the pace of growth in household deposits was more moderate than in the previous year. In contrast, corporate deposits declined sharply in the first six months of 2009 due to a major economic downturn and limited access to other funding sources.

As moderate growth in total savings and time deposits only partly offset the sharp decrease in money, total liquid assets fell by HRK 6.6bn in the first half of 2009. M4 grew by only 1.1% in the period between end-June 2008 and end-June 2009.

The contraction in bank lending to the private sector characterised the first half of 2009. Bank credit to the non-banking sector dropped by HRK 2.2bn or 1.0% in that period. This was due to diminished loan supply (banks focused more on government financing) as well as unfavourable trends in loan demand, which stemmed from tighter lending conditions, economic slowdown and low business and consumer optimism.

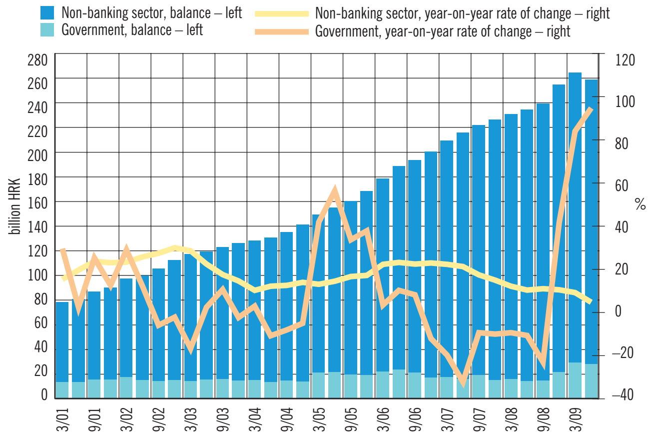
In terms of sectoral structure, it is evident that the slowdown in bank lending was most severe in household loans. They decreased by 2.2% from the beginning of the year, the decline being recorded in almost all loan categories. Car loans and other any-purpose loans dropped the most, which can be attributed to the weakening of personal consumption and the fall in retail trade turnover.

Loans to the corporate sector also exhibited negative trends in the first half of the year. However, as the slowdown in lending to this sector was less pronounced than the slowdown in lending to households, corporate loans increased by 0.5% in the first six months. This can be explained by higher corporate demand for domestic bank loans due to tightened access to other funding sources.

Placements to the government grew sharply in late 2008 and the central government continued to raise substantial funds in the domestic banking market in the first half of 2009. Banks' net claims on the central government, which increased by HRK 6.5bn in the first six months, stood at HRK 28.1bn at end-June 2009, almost twice as high as at end-June 2008. These claims decreased in late June 2009 due to the inflow of assets from the eurobond issue; the assets were partly used to repay credit liabilities and were partly deposited in government accounts with commercial banks and the CNB.

As already stated, banks financed the bulk of loans to the government and the fall in domestic funding sources by withdrawing their foreign currency assets held abroad, which decreased their foreign assets by HRK 8.6bn in the first half of 2009. As banks' foreign liabilities increased by HRK 2.5bn in the same period, their net foreign assets fell by a total of HRK 11.1bn in the first six months and were 35.6% less at end-June 2009 than at end-June 2008.

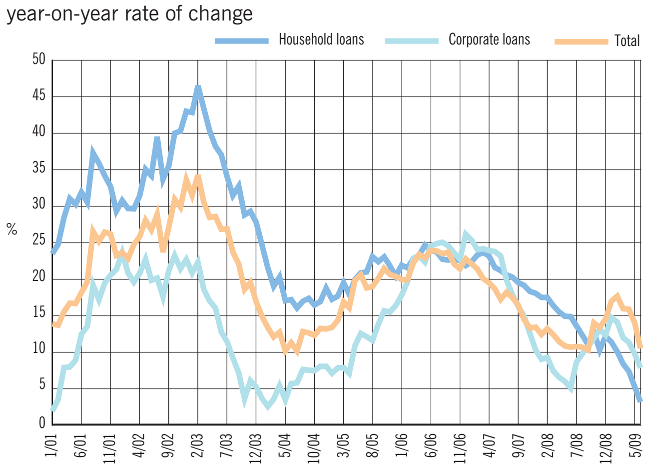
Figure 29 Bank Placements to the Non-Banking Sector and Net Claims on the Government



Source: CNB.

Figure 30 Bank Loans

year-on-year rate of change



Source: CNB.

8 Money Market

The end of the previous year and the beginning of 2009 were marked by tensions on the money market. Depreciation pressures on the exchange rate of the kuna prompted the central bank to release some of the previously immobilised foreign assets of the monetary system and to take a more restrictive approach to kuna liquidity creation for the purpose of exchange rate stabilisation. While successful in keeping the exchange rate under control, these measures increased tensions on the money market. Higher money market turnover during that period was accompanied by a sharp increase and a record interest rate volatility. The remaining part of the first half of the year was marked by easing of depreciation pressures and general stabilisation, as seen in the fall in interest rates and money market turnover compared to the first quarter of the year.

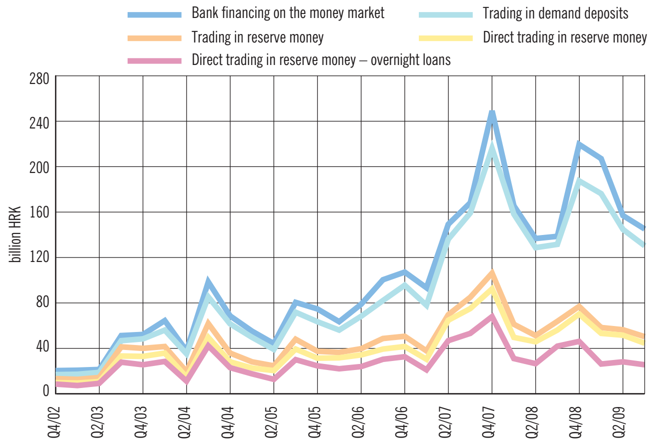
At the beginning of the year, the government relied for its financing mainly on loans from domestic banks, so the amounts of planned and subscribed (kuna) MoF T-bills fell by approximately 25.0% per auction in the January to March period. Poorer investor interest during that period boosted growth in interest rates on T-bills which largely moved in line with interest rates on the money market. Strong investor interest in euro T-bills, which the MoF started issuing regularly in March this year, facilitated the settling of the increased budget deficit financing needs of the government in the second quarter of the year. After nine T-bill auctions in the first quarter of the year at which a total of HRK 2.8bn was raised, eight auctions were held in the second quarter at which HRK 4.83bn were raised. At the end of June, the stock of subscribed T-bills stood at approximately HRK 18.5bn which is an increase of HRK 1.0bn compared to the end of 2008.

More expensive sources of bank financing, accompanied by bank credit portfolio quality worsening led to a steady growth in lending interest rates of banks in the first half of 2009. Interest rates on corporate loans, usually more risky placements, rose faster and were more volatile than interest rates on household loans. Their growth slowed down in the second quarter of the year under the influence of central bank measures which reduced banks' regulatory costs and ensured a satisfactory level of banking system liquidity and a significant fall in interest rates on the European monetary market. This also influenced deposit interest rates which remained relatively stable, with the exception of interest rates on kuna time deposits whose increase early in the year reflected banks' efforts towards improved kuna liquidity. With faster growth of lending interest rates compared to deposit interest rates in the second quarter, banks can be expected to generate a further increase in their net interest income in the conditions of slower credit growth.

8.1 Money Market Interest Rates

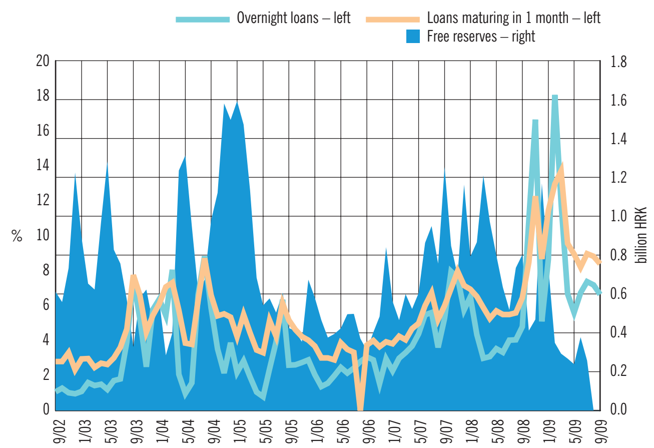
Depreciation pressures which prompted the central bank to release some of its foreign assets and to take a more restrictive approach to kuna liquidity creation led to a sharp increase in turnover and interest rates growth on the money market early in the year, although such trends subsided gradually in the second quarter of the year. As a result, at the end of last year the CNB stopped conducting repo operations with auctions in which prices are freely determined. Improved banking system liquidity in the second quarter led to money market stabilisation. Large turnover at the beginning of the year notwithstanding, the banks met their primary liquidity needs throughout the first half of the year on the money market in the average daily amount of approximately HRK 3.0bn (total HRK 364bn in the first half of the year), which is an increase of only HRK 160.0m compared with the same period in the previous year.

Figure 31 Money Market Turnover
quarterly data



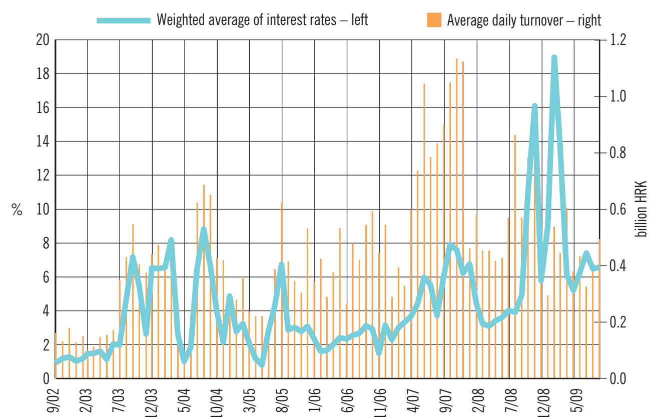
Source: CNB.

Figure 32 Interest Rates in Direct Interbank Trading and Free Reserves



Source: CNB.

Figure 33 Direct Interbank Trading in Overnight Loans
monthly average on the basis of daily data



Source: CNB.

Loans in demand deposit trading accounted for the largest share of bank financing on the money market (HRK 321.1bn) while HRK 42.7bn and HRK 0.1bn, respectively, were raised through repo agreements purchase and securities sale transactions. During the observed period, demand deposit trading witnessed further changes in terms of substitution of the sources of funding: the share of thus far the most important category, interbank trading, fell in the first half of the year to its record low of 33.4%, while the category of trading with non-banking financial institutions took the lead with 45.3%. The remaining fifth of the necessary funding needs were met through bank trading with other legal persons.

Interbank trading in reserve money in the first half of 2009 was as usual dominated by direct interbank trading, despite a fall in turnover. Direct interbank trading accounted for over 90% of this segment of trading in reserve money due to a very large concentration of trade in a small number of banks involved, while trading with Zagreb Money Market intermediation accounted for the rest of interbank trading.

The most liquid instrument in direct interbank trading in reserve money in the first half of the year was again overnight loans. After falling by almost one half in the first quarter of this year compared to the end of the previous year, the average daily turnover of these loans started recovering slightly in the second quarter. These developments boosted the growth and instability of interest rates on overnight loans early in the year when they reached their record high since the end of the 1990s. However, visible easing of the pressures on the money market in the second quarter led to interest rate on overnight loans stabilisation during that period.

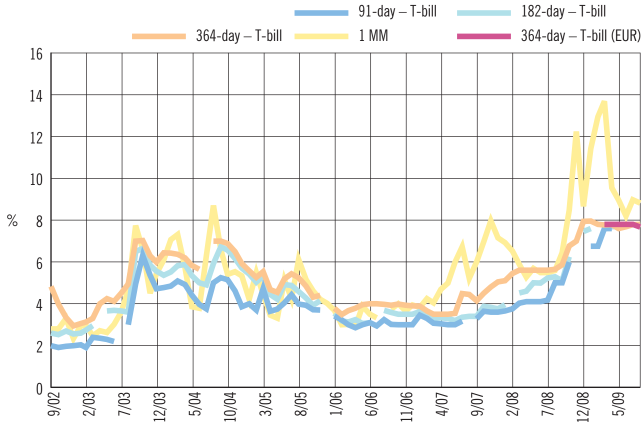
8.2 Interest Rates in the Short-Term Securities Market

Following a sharp increase in the short-term debt arising from issued T-bills towards the end of the previous year, at the beginning of the year the MoF turned increasingly towards domestic bank borrowing. Poorer investor interest in T-bills led to a fall in the volume of issues at T-bill auctions accompanied by a steady upward pressure on interest rates on T-bills (mainly shorter-term maturity bills) whose range in general was in line with interest rates on the money market. Regular issues of euro T-bills from March this year re-kindled investor interest. Nine T-bill auctions in the first quarter, which raised a total of HRK 2.8bn, were followed by eight auctions in the second quarter, which raised an additional HRK 4.83bn, HRK 2.7bn of which was raised on the basis of one-year euro T-bills.

Interest rates at shorter maturity kuna T-bill auctions continued to grow, reaching their highest levels since 2001. The weighted interest rate on 91-day T-bills rose sharply from 6.75% in January to 7.60% in March, April and June. The weighted interest rate on 182-day T-bills rose steadily throughout the first two quarters, though somewhat slower compared to the shortest maturity bills: from 7.60% in January to 7.70% in June. During the same period, interest rates on one-year kuna T-bills fell slightly (from 7.95% in December 2008 to 7.69% in June 2009). Government borrowing on the basis of euro T-bill issues was somewhat more expensive, although interest rates at their this year's first T-bill auction in March fell slightly compared to December previous year and remained unchanged until June (7.80%).

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

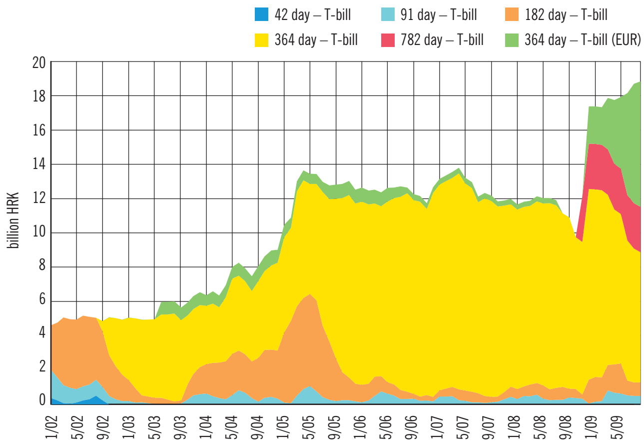
maturity structure



Sources: MoF and CNB.

Figure 35 T-Bill Stock

maturity structure, end of period



Sources: MoF and CNB.

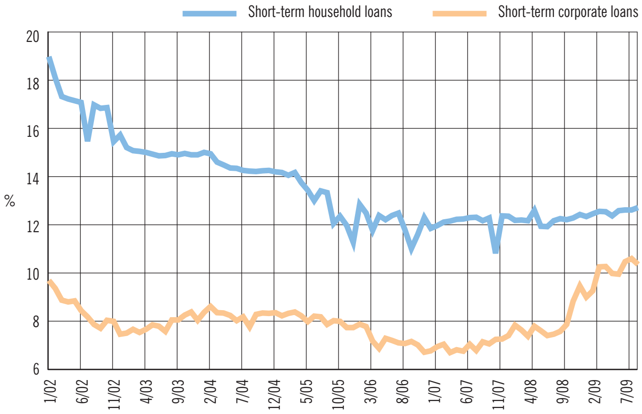
The government compensated this year's decline in the stock of total subscribed kuna T-bills, somewhat more pronounced during the second quarter, with an issue of euro T-bills. As a result, the stock of kuna T-bills as at December 2008 fell from HRK 15.2bn to HRK 12.5bn or by HRK 2.8bn in June this year, while the stock of euro T-bills during that period rose by over HRK 3.8bn (from HRK 2.2bn to HRK 6.0bn). At the end of June, the stock of total subscribed T-bills stood at approximately HRK 18.5bn, which is an increase of HRK 1.0bn compared to the end of 2008. Soon after their regular issue commenced, the share of euro T-bills in total bills rose, reaching approximately 33.0% in June, while the share of one-year kuna T-bills fell from 64% in December 2008 to only 45.0% in June this year. The longest maturity T-bills (728 days) accounted for approximately 15% of all T-bills (there was only one issue of these bills and that took place at the end of last year), while the shortest maturity, 91-day T-bills accounted for less than 5.0% of total T-bill subscriptions. 182-day T-bills accounted for a similar share of total T-bill subscriptions in June, following a significant decline in the first half of 2009.

8.3 Bank Interest Rates

More expensive sources of bank financing accompanied by bank credit portfolio quality worsening in the conditions of a falling volume in real economic activity boosted the growth of lending interest rates in the first half of 2009. However, a decline in interest rates on the European monetary market, together with reduced regulatory costs of banks under the influence of CNB measures, slowed down their growth. The same factors also slowed down the growth in deposit interest rates during the observed period.

Weighted interest rates on corporate loans which are usually riskier placements, rose faster and were more volatile than interest rates on household loans in the first half of the year. This relates in particular to short-term corporate and household loans. Following a temporary decline in April and May this year, interest rates on short-term kuna corporate loans without a currency clause again reached two-digit values in June. The weighted interest rate on short-term

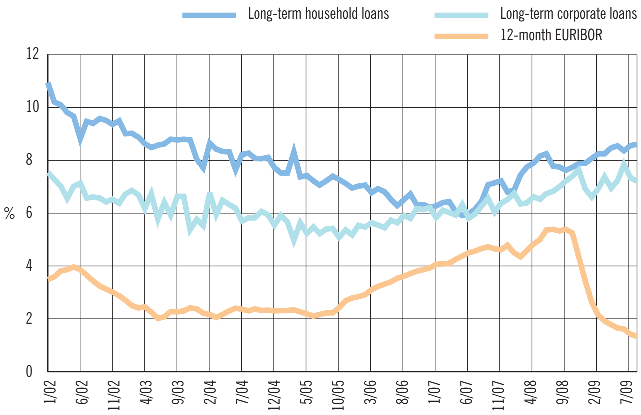
Figure 36 Bank Average Interest Rates[a] on Short-Term Loans without a Currency Clause



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

Source: CNB.

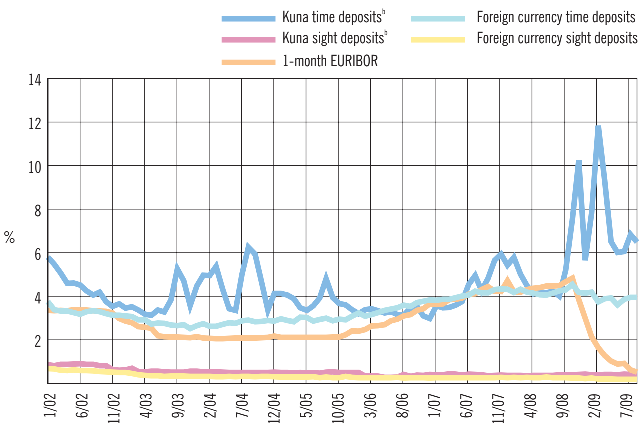
Figure 37 Bank Average Interest Rates[a] on Long-Term Loans with a Currency Clause



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

Source: CNB.

Figure 38 Average Bank Deposit Interest Rates[a]



[a] The average weighted interest rate on newly received deposits in the reporting month.
[b] Without a currency clause.

Source: CNB.

corporate loans without a currency clause thus rose from 8.98% in December 2008 to 10.25% in March and 10.46% in June 2009. The weighted interest rate on short-term household loans (tradesmen included) without a currency clause exhibited its usual volatility, growing from 12.33% in December 2008 to 12.53% in March 2009, and by additional 0.1 percentage point to 12.61% in June.

The weighted interest rate on long-term corporate loans with a currency clause moved in a similar direction, rising from 6.92% in December 2008 to 7.37% and 7.85% in March 2009 and April 2009, respectively. During the second quarter this rate followed the general trend of increase in lending interest rates which reached their several-year peak during that period. The weighted interest rate on long-term household loans continued to grow steadily, reaching 8.36% in June, compared to 8.25% in March and 7.89% at the end of the previous year.

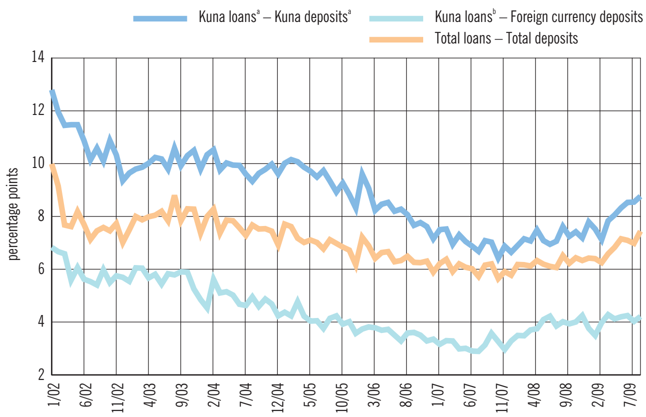
Deposit interest rates remained relatively stable during the first half of the year. The weighted interest rates on kuna time deposits without a currency clause were the only deposit interest rates which rose significantly in the first quarter, reflecting banks' efforts towards kuna liquidity strengthening. After having reached high levels and after having fluctuated noticeably at the end of last year and at the beginning of this year, the weighted interest rates on kuna time deposits without a currency clause stabilised in the second quarter of the year. Interest rates on kuna sight deposits, which are usually lower and more stable, remained relatively stable. Interest rates on corporate foreign currency time deposits and corporate foreign currency sight deposits fell slightly in the first half of this year, in contrast with interest rates on the same category of household foreign currency deposits which held steady during that period.

The widening of the spread between interest rates on comparable loans and deposits in the first seven months of this year reflects better awareness of the riskiness of placements and of potential losses associated with such placements. Interest rate spread on the so called "pure" kuna loans and deposits (without a currency clause), which demonstrated a strong growth tendency from April 2009, reached its highest level in the first half of the year in June (8.53%). By contrast, following an increase in the first quarter of the year, interest rate spread on foreign currency-indexed loans and foreign currency deposits remained relatively stable during the second quarter so that indices of net interest income continued to diverge. Total interest rate spread thus continued to widen steadily, reaching 7.10 percentage points in June, compared to 6.43 percentage points at the end of the previous year, which points to a further increase in net interest income of banks in conditions of slower credit growth.

Despite an increase in nominal interest rates on long-term corporate loans in Croatia, the real interest rate on these loans fell slightly at the beginning of this year due to a rise in the inflation rate relative to the previous quarter. Inflation slowdown in the second quarter boosted the growth of these rates in Croatia, the eurozone and in some comparable economies in the past year. The increase in real interest rates on corporate loans recorded in the first half of this year was similar to their growth rate ranges in comparable countries.

The dynamics of real interest rates on household time deposits in Croatia differed from the dynamics of nominal interest rates due to relatively larger inflation fluctuations. Real interest rates on short-term household deposits in Croatia rose considerably during the second quarter of this year compared to the previous quarter and the end of 2008. To a certain extent, such developments were also visible in the eurozone and other comparable countries during the observed period. The June increase in real interest rates in the eurozone was mainly the result of deflation, which this single currency area is faced with for the first time. Despite a fall in these rates, in the second quarter of this year Slovakia witnessed a recovery in real interest rates, which reached positive values for the first time since end-2007.

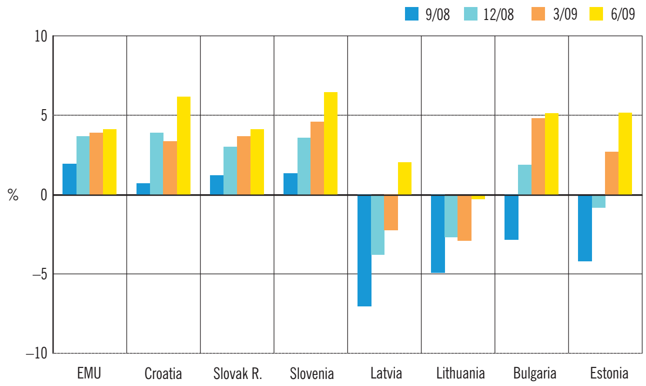
Figure 39 Spread between Average Bank Interest Rates on Loans and Deposits



[a] Without a currency clause. [b] With a currency clause.

Source: CNB.

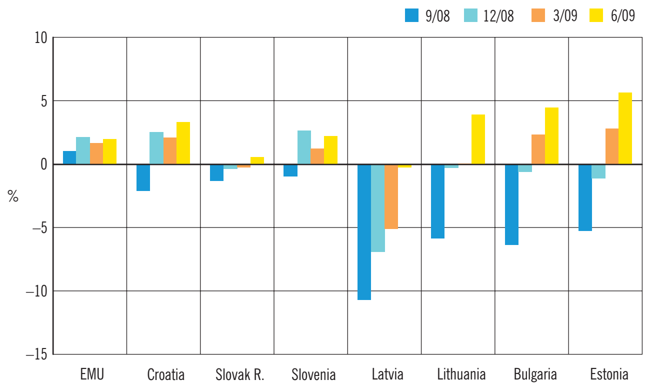
Figure 40 Real Interest Rates on Long-Term Corporate Loans in Selected Countries



Note: Due to the differences in statistical coverage from country to country, interest rates cannot be directly compared, but their development can be analysed.

Sources: Central banks' bulletins and CNB.

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



Note: Due to the differences in statistical coverage from country to country, interest rates cannot be directly compared, but their development can be analysed.

Sources: Central banks' bulletins and CNB.

9 Capital Market

Movements in the domestic capital market in the first quarter 2009 closely followed global developments. The beginning of 2009 was marked by the strengthening of recession pressures arising from the spillover of the effects of the global financial crisis onto the real economy during the previous year, as well as increasing investor concerns as regards potential new losses in the financial sector. However, the beginning of the second quarter of 2009 brought about an increase in optimism and a gradual recovery of financial markets, spurred by announcements of the world's major governments and central banks of their plans for financial system recovery and the provision of fiscal stimuli. Positive trends spilled over from the world's stock exchanges to developments in the domestic capital market. Consequently, the domestic equity index, the CROBEX, went up relative to the end of the previous year despite the fall in the semi-annual share turnover. Activity in the domestic debt securities market was weak, resulting in exceptionally low semi-annual bond turnover in the first six months of 2009, followed by the decline in the value of the CROBIS, the bond index, relative to the end of December 2008.

In the first half of 2009, almost all CEE capital markets recorded a decrease in the semi-annual share turnover paired with a sizeable decrease in the semi-annual bond turnover. The average daily share turnover fell in the first half of 2009 relative to the second half of 2008 on all stock exchanges under review, as did the average daily bond turnover. The ZSE share turnover to GDP ratio remained very weak, only the Bratislava Stock Exchange having a lower turnover, while other stock exchanges realised much higher turnovers. At the same time, the bond turnover to GDP ratio was higher on the Bratislava and Prague Stock Exchanges.

The rise in the value of all reference stock exchange indices upped the share market capitalisation at the end of June relative to the end of the previous year on all reference stock exchanges, except Slovakia. The bond market capitalisation decreased slightly in the period on the Budapest and Zagreb Stock Exchanges, and increased on the Bratislava and Ljubljana Stock Exchanges. At the end of the first half of 2009, the ZSE's share market capitalisation to GDP ratio continued to outperform all other reference stock exchanges in the region except for the Warsaw Stock Exchange, while the bond market capitalisation to GDP ratio continued lagging behind those of reference CEE countries.

Table 3 Comparison of Capital Market Indicators

1st half 2009	Bratislava	Budapest	Ljubljana	Prague	Warsaw	Zagreb
Average daily turnover, shares (in million EUR)	0.08	64.96	1.74	67.87	363.88	4.60
Average daily turnover, bonds (in million EUR)	47.19	2.51	0.80	88.51	3.86	2.24
Share turnover/GDP[a], annual level (%)	0.03	16.85	1.21	12.05	27.71	0.34
Bond turnover/GDP[a], annual level (%)	18.28	0.65	0.56	15.72	0.29	1.21
Turnover velocity[b]	0.55	106.54	4.75	41.66	....	5.91
Market capitalisation of shares (in million EUR), end of the first half	3,729.49	15,364.51	9,215.75	41,058.31	172,449.53	19,580.45
Market capitalisation of bonds (in million EUR), end of the first half	17,617.87	33,596.30	9,236.77	....	....	4,529.67
Market capitalisation of shares/GDP[a], end of the first half (%)	5.73	15.81	25.58	28.93	52.11	42.08
Market capitalisation of bonds/GDP[a], end of the first half (%)	27.08	34.58	25.64	....	....	9.74
Share index movement from the beginning of the year (%)	–7.37	25.15	15.36	4.66	11.72	10.11
Share index movement from the beginning of June (%)	–3.84	2.57	5.03	3.89	3.74	–11.56

[a] The sum of the GDP realised in the last two quarters of 2008 and the first two quarters of 2009.
[b] Annualised monthly share turnover x 100/ market capitalisation of shares.

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

Continued implementation of an unconventional expansive monetary policy of quantitative relaxation paired with the rise in the supply of government debt securities of developed countries due to fiscal stimuli, as well as greater investor appetite for riskier financial instruments, resulted in the reduction of yield spreads on bonds of emerging markets and developed countries in the first half of the year. As a result, the spread between the yield on Croatian eurobonds and yields on benchmark German bonds narrowed.

9.1 Equity Securities Market

In the first half of 2009, share turnover in the Croatian capital market decreased, totalling HRK 4.1bn, which was HRK 2.8bn or 41.0% less than in the second half 2008. The decline in demand for equity securities was a consequence of insecurity relating to the dynamics and intensity of the spillover of the world's financial crisis onto the Croatian real sector and the rising risk aversion of domestic investors, especially in the first three months of 2009, which resulted in the exceptionally low liquidity that marked the domestic capital market during the period in question.

Table 4 Initial Public Offering of Shares[a]

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
2008	2	24.2
Jan.-Jun. 2009	1	30.0

[a] The number of successful share issues through initial public offering includes only those that have HANFA approval.
Note: Public offerings are recorded according to the date of HANFA's decision.

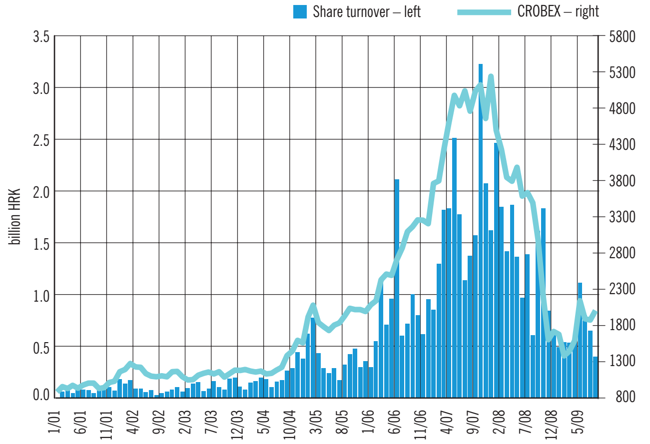
Source: HANFA.

The ZSE equity index, the CROBEX,[6] continued falling until the beginning of March, when it reached its lowest level for four and a half years, totalling 1262.6 points. The share prices of most shares on the ZSE started recovering in the second half of March, which continued until the end of the first half of 2009, pushing the CROBEX up to 1896.4 points by the end of June, up 10.1% on the end of the pervious year.

The reversal in the downward trend in the prices of most shares listed on the ZSE pushed up their market capitalisation[7] until the end of the first half of the year, which remained almost unchanged relative to the end of the previous year, totalling HRK 142.4bn or 42.1% of the realised GDP.8 At the end of June 2009, T-HT shares had the largest market capitalisation (HRK 17.9bn or 12.6% of the total market capitalisation), followed by INA shares (HRK 13.6bn or 9.6% of the total market capitalisation).

In the first half of 2009, shares were traded on three ZSE markets: the Official Market, the Regular Market and the Parallel Securities Market.[9] In addition to the already listed common shares of INA, Ingra d.d., Istraturist d.d., Magma d.d., Medika d.d., OT-Optima Telekom d.d., Pliva d.d., Podravka d.d., Viro tvornica šećera d.d., T-HT, Varteks d.d., Vaterina d.d. and the common and preferential shares of Croatia osiguranje d.d., also listed in the Official Market during the first half of the year were the common shares of Atlantic grupa d.d. and Institut IGH d.d. During the period in question, the most traded shares were T-HT shares, accounting for 22.7% of the total semi-annual turnover, followed by Atlantska plovidba d.d. (16.2%) and Institut IGH d.d. (7.8%). At the end of June 2009, 378 shares were listed on the ZSE, one more than the total number of shares listed in the domestic capital market at the end of 2008.

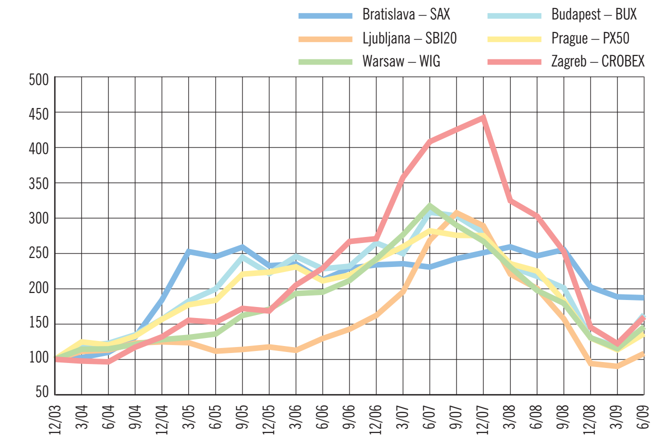
Figure 42 ZSE Monthly Share Turnover and End-Month CROBEX



Source: ZSE.

Figure 43 Selected Stock Exchange Indices

end of period, December 2003 = 100



Source: Bloomberg.

After the fall in the first quarter of 2009, all major CEE capital markets and the world's stock exchanges started recovering in the following three months. The greatest rise in the six months of 2009 was registered by the Budapest Stock Exchange index, which went up 25.1% relative to end-December 2008, followed by the Ljubljana (15.4%), Warsaw (11.7%), Zagreb (10.1%) and Prague (4.7%) stock exchange indices. Only the Bratislava stock exchange index went down (–7.4%) relative to the end of the previous year.

[6] Following its regular revision in March 2009, CROBEX constituents counted 24 shares. The shares of the following joint stock companies were excluded from the CROBEX relative to September 2008: Dom holding, Dioki, Konzum, Tehnika and Hidroelektra niskogradnja, and the shares of Kraš were included.

[7] The ZSE market capitalisation is calculated by multiplying the last price of each share by its issue number. However, the calculation also includes the share's liquidity so that the market capitalisation of a share not traded in the previous month is halved. For the shares not traded in the previous three months, the calculation includes only one fourth of its market capitalisation.

[8] The sum of the GDP realised in the last two quarters of 2008 and the first two quarters of 2009.

[9] Listed in the Official Market are only those joint stock companies that choose to be listed in the Official Market and meet the set criteria for listing, such as the minimum amount of equity capital of the issuer or the expected market capitalisation, of HRK 100m, and the obligation to regularly present annual, semi-annual and quarterly reports. Only securities of those issuers that can present financial reports for the past two years and whose equity capital totals at least HRK 20m, or less, if the expected market capitalisation exceeds HRK 10m, may be listed in the Regular Market. The Parallel Securities Market is the lowest stock market segment in which companies are not required to submit data.

9.2 Debt Securities Market

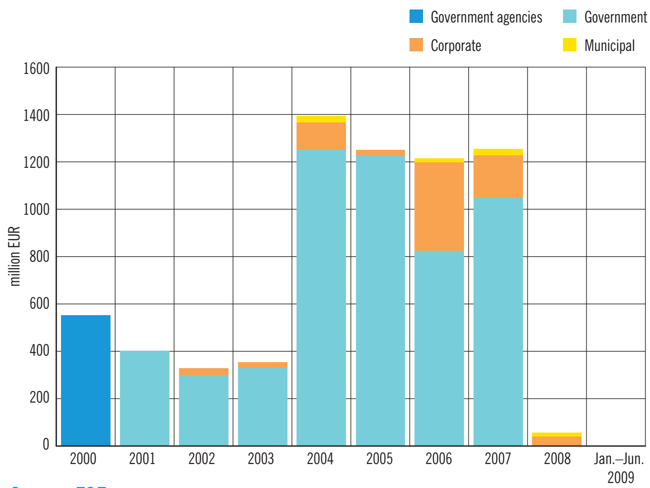
At the end of the first half of 2009, 34 bonds[10] were listed on the domestic capital market, eight of which were government bonds, eight were municipal bonds, one was a CBRD bond and seventeen were corporate bonds. This was one corporate bond fewer than at the end of the previous year. On the last day of June 2009, there were 11 commercial bills at the ZSE, issued by 10 issuers, or ten commercial bill and seven issuers fewer than at the end of December 2008. Their total nominal value was HRK 587.7m.

There were no new bond issues in the domestic debt securities market in the first half of 2009. In the first six months of this year, the Republic of Croatia met its financing needs in the domestic financial market, where, in addition to increased borrowing through bank loans, it focused on short-term borrowing through T-bill issuing. As a result, there were no new government bond issues in the domestic market during the period under review. In addition, there were no new long-term corporate or municipal bond issues. The Belišće d.d. bond, nominally valued at EUR 8.0m, fell due in mid-January 2009.

Bond turnover[11] in the first half of 2009 stood at only HRK 2.0bn, down HRK 3.2bn or 62.% on the second half of 2008. This was the lowest recorded semi-annual bond turnover since the first half of 2002. The substantial decrease of activity in the domestic debt securities market was a consequence of the lack of new debt issues during the period under review. The most liquid kuna bond in the observed period was the foreign currency indexed kuna bond of the Republic of Croatia, due in 2012, which accounted for 21.5% of the total semi-annual turnover (HRK 426.5m). Large turnover was also registered in trading in the foreign currency indexed kuna government bond due in 2019 (17.9% or HRK 355.4m) and the foreign currency indexed kuna government bond due in 2014 (17.2% or HRK 342.1m). Government bonds accounted for 73.6% and corporate bonds for 26.1% of the total semi-annual bond turnover on the ZSE. However, due to the slack investor interest in debt securities in the first half of 2009 bond turnovers were very weak.

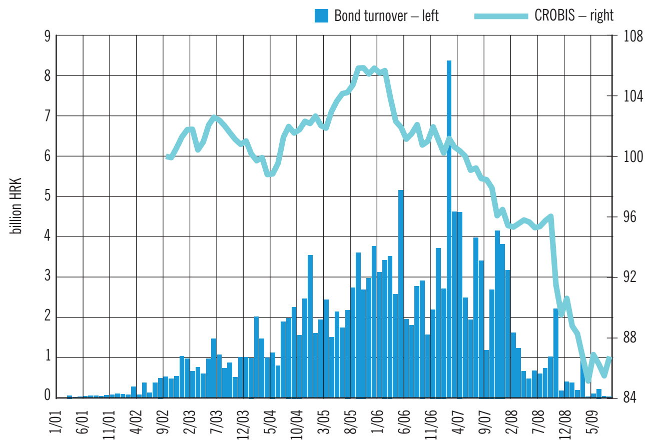
The value of the ZSE bond index, the CROBIS,[12] mostly declined during the first half of 2009, dropping to 86.9 points by the end of June, which was 4.4 points less than at the end of December 2008. The declining prices of one share of RC bonds that were regularly traded on the ZSE during the period in question reflected itself in the substantial increase in the yields to maturity of kuna government bonds in the first half of 2009 relative to their yields at the end of the previous year.

Figure 44 Bond Issues in the Domestic Market



Source: ZSE.

Figure 45 ZSE Monthly Bond Turnover and End-Month CROBIS



Source: ZSE.

10 This figure and the market capitalisation calculations exclude the bonds of the Fund for Compensation of Expropriated Property.

11 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 emphasizing that the bond turnover on the VSE was negligible, standing below 0.4% of the total turnover on both stock exchanges in all the observed years.

12 At the end of June 2009, the CROBIS included seven Republic of Croatia bonds.

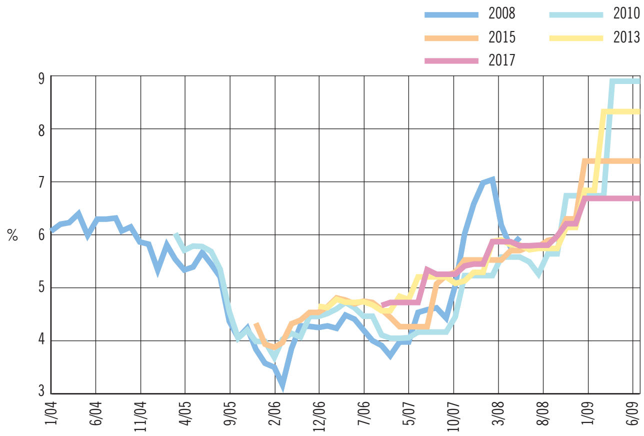
Table 5 Bond Issues in the Domestic Market, stock as at 30 June 2009

Series	Issuer	Issue date	Maturity	Currency	Issue nominal value	Nominal interest rate	Last price[a]	Current yield 30/6/2009
RHMF-O-125A	Republic of Croatia	23/5/2002	23/5/2012	EUR	500,000,000	6.875%	100.70	6.827%
RHMF-O-142A	Republic of Croatia	10/2/2004	10/2/2014	EUR	650,000,000	5.500%	94.50	5.820%
RHMF-O-19BA	Republic of Croatia	29/11/2004	29/11/2019	EUR	500,000,000	5.375%	89.10	6.033%
RHMF-O-103A	Republic of Croatia	8/3/2005	8/3/2010	HRK	3,000,000,000	6.750%	98.00	6.888%
RHMF-O-157A	Republic of Croatia	14/7/2005	14/7/2015	EUR	350,000,000	4.250%	87.10	4.879%
RHMF-O-15CA	Republic of Croatia	15/12/2005	15/12/2015	HRK	5,500,000,000	5.250%	88.50	5.932%
RHMF-O-137A	Republic of Croatia	11/7/2006	11/7/2013	HRK	4,000,000,000	4.500%	86.50	5.202%
RHMF-O-172A	Republic of Croatia	8/2/2007	8/2/2017	HRK	5,500,000,000	4.750%	88.00	5.398%
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%	98.10	5.607%
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%	–	–
GDST-O-177A	City of Split	8/7/2008	8/7/2017	EUR	8,200,000	6.000%	–	–
HBOR-O-112A	CBRD	11/2/2004	11/2/2011	EUR	300,000,000	4.875%	–	–
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%	86.50	5.925%
NEXE-O-116A	Nexe grupa d.d.	14/6/2006	14/6/2011	HRK	750,000,000	5.500%	90.60	6.071%
MTEL-O-097A	Metronet telekomunikacije d.d.	28/7/2006	28/7/2009	HRK	120,000,000	8.500%	99.63	8.532%
HEP-O-13BA	Hrvatska elektroprivreda d.d.	29/11/2006	29/11/2013	HRK	500,000,000	5.000%	91.70	5.453%
HOTR-O-941A	Hospitalija trgovina d.o.o.	5/10/2006	5/10/2009	HRK	75,000,000	8.250%	100.00	8.250%
ATGR-O-11CA	Atlantic grupa d.d.	6/12/2006	6/12/2011	HRK	115,000,000	5.750%	89.00	6.461%
INGR-O-11CA	Ingra d.d.	6/12/2006	6/12/2011	HRK	200,000,000	6.125%	80.00	7.656%
OPTE-O-142A	Optima telekom d.o.o.	01/2/2007	1/2/2014	HRK	250,000,000	9.125%	66.00	13.826%
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%	84.00	8.631%
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%	–	–
SEM-O-101A	Linijska nacionalna plovidba d.d.	12/1/2007	12/1/2010	HRK	15,000,000	7.000%	93.60	7.479%

[a] Regularly traded.

Source: ZSE, monthly report, June 2009.

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



Source: ZSE.

The market capitalisation of all bonds[13] on the domestic capital market was HRK 32.9bn (EUR 4.5bn) at the end of the first half of 2009, accounting for 9.7% of the realised GDP.[14] The market capitalisation of government bonds, municipal bonds and the CBRD bond was HRK 29.1bn (EUR 4.0bn), or 8.6% of GDP, whereas the market capitalisation of corporate bonds amounted to HRK 3.8bn (EUR 523.7m), i.e. 1.1% of the realised GDP.

For the first time in five years, at the end of May the Republic of Croatia issued a new euro-denominated bond in foreign markets, nominally valued at EUR 750m at the fixed interest rate of 6.5% a year. This was the largest RC international bond issue thus far. The euro-denominated international government bond, nominally valued at EUR 500m, fell due in 2009. In addition, the Samurai bond, nominally valued at JPY 25bn also fell due in June 2009. It was repurchased by a share of funds raised through the issue of the new international bond. Thus, five Croatian bonds were listed on foreign markets at the end of the first half of 2009, four of which were euro-denominated bonds and one bond was denominated in US dollars. The total nominal value of all five issues of Croatian bonds on foreign markets was HRK 22.7bn (EUR 3.1bn) at the end of June 2009, which was an increase of HRK 361.4m (EUR 63.1m) on the end of the previous year.

Table 6 Republic of Croatia International Bond Issues, stock as at 30 June 2009

Bond	Issue date	Currency	Amount	Nominal interest rate	Yield on issue day	Spread on issue day	Spread[a] 30/9/2008	Spread[a] 31/12/2008	Spread[a] 31/3/2009	Spread[a] 30/6/2009
London Club Series A, 2010	31/7/1996	USD	857,796,000	6-month LIBOR + 81.25 b.p.			286	827	712	283
Eurobonds, 2011	14/3/2001	EUR	750,000,000	6.75%	6.90%	215	195	576	571	363
Eurobonds, 2010	14/2/2003	EUR	500,000,000	4.625%	4.65%	102	173	606	546	306
Eurobonds, 2014	15/4/2004	EUR	500,000,000	5.000%	5.11%	101	186	445	513	371
Eurobonds, 2015	27/5/2009	EUR	750,000,000	6.500%	6.57%					470

[a] In relation to benchmark bond.

Source: Bloomberg.

After growing intensively in 2008, required yields on Croatian eurobonds levelled off in the first quarter of 2009. At the beginning of the second quarter 2009, rising optimism in the world's stock exchanges spurred investor interest in riskier investments. This, paired with the concurrent growth in the supply of government debt securities of individual countries arising from fiscal stimuli, resulted in the narrowing of yield spreads on bonds of emerging markets and developed countries. At the end of the first half of 2009, the spreads between required yields on Croatian eurobonds maturing in 2011 and 2014 and yields on benchmark German bonds widened to 363 and 371 basis points respectively, which was much less than at the end of December 2008, when these spreads stood at high 576 and 445 basis points respectively. Required yields on the new Croatian eurobond maturing in 2015 were higher than the required yields on the other two Croatian eurobonds during the period concerned so the yield spread between that international bond and the benchmark German eurobond totalled 470 basis points at the end of June 2009.

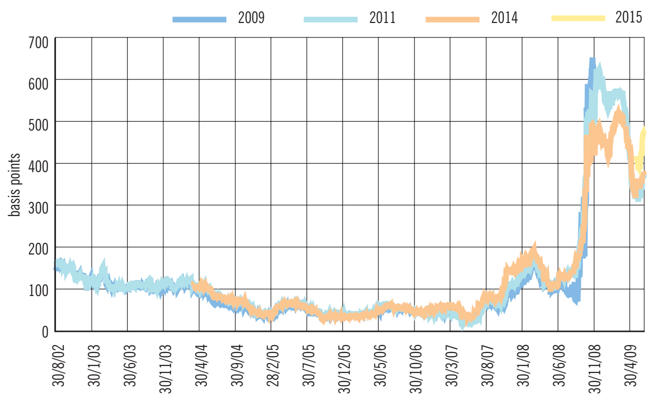
In the first half of 2009, the required yields on Croatian eurobonds continued mimicking the movements of yields on most eurobonds of new EU member states. Required yields on eurobonds of the majority of new EU member states declined in the first six months of 2009. Required yields on the Romanian, Hungarian and Croatian eurobond went down the most, by 5.9, 3.6 and 3.4 percentage points respectively, while the decrease of the required yield in other countries under review moved around some 1.3 percentage points. The required yield on the German benchmark

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

[14] See footnote 8.

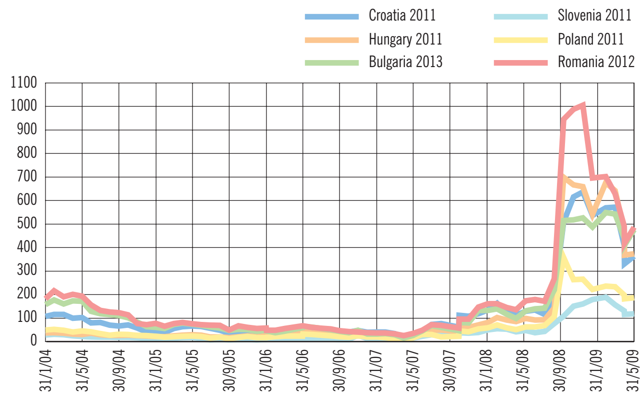
government bond also fell during the period less, however, than required yields on bonds of new EU member states, so the spread between their yields narrowed as well.

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



Source: Bloomberg.

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 contracted strongly in the first half of 2009. Relative to the same period in 2008, it fell by 37.6%, with revenues and expenditures trending down by 17.7% and 24.0% respectively. The largest contraction was seen in the foreign trade in goods. The foreign trade deficit decreased by one third on account of the fall in imports being stronger than that in exports. The deficit trended downward in most SITC divisions and most strongly in the trade in road vehicles and oil and refined petroleum products, halving over the same period in 2008. The volume of international trade in services also decreased noticeably, this deceleration being among other things also observed in tourism, which adversely impacted the positive balance in the account of services. After trending up strongly in previous years, the factor income deficit declined somewhat only in the second quarter of the year. The account of current transfers saw a slight growth in net revenues, due notably to the increase in central government revenues from intergovernmental subsidies.

The external debt rose by EUR 1.5bn in the first half of 2009, due mostly to corporate foreign borrowing from foreign banks and affiliated enterprises abroad. The external debt of banks trended up and the foreign liabilities of the central government declined modestly in the reference period. The recent economic crisis and unfavourable financing conditions in the foreign markets caused the external debt growth dynamics to decelerate significantly over the previous year. In addition to debt financing, a significant reduction was also seen in FDI inflows. The reduction in capital inflows notwithstanding, domestic sectors, observed aggregately, smoothly met their foreign liabilities.

10.1 Current Account

The current account deficit stood at EUR 2.7bn in the first half of 2009, down EUR 1.7bn (37.6%) from the same period in 2008. The strong fall in total deficit is attributable to the deceased in expenditures, notably imports of goods, which exceeded the revenue shortfall. The goods deficit fell by 34.4%, a reduction being observed in most SITC divisions, most markedly in the divisions of road vehicles, energy, raw materials and capital goods for industrial production, which decelerated considerably in the first half of 2009. The trade in other transport equipment (mostly ships) improved in the reference period mostly on the account of the methodological effects contributing to an exceptionally high growth of imports in this division in the first half of 2008.

In the first half of 2009 net service revenues went down by 21.4% from same period the previous year. The fall in total net revenues was mostly the consequence of the 16.1% fall in tourism revenues, which account for two thirds of the total. Resident tourist consumption expenditures abroad also decelerated in the reference period, by a third. Transportation services brought in almost two times less in net revenues, with the major shortfalls being observed in revenues from sea cargo transport services and air passenger transport services. The negative balance in the international trade in other services decreased, reflecting the drop in domestic demand. The bulk of that fall was accounted for by the decline in expenditures on architectural services, research and development services, royalties and license fees. In contrast, a modest increase was observed in revenues, mostly on account of services provided to the construction sector.

Table 7 Current Account
in million EUR

	1st half 2008	2008	1st half 2009[a]	Indices			
				1st half 2008/ 1st half 2007	1st half 2009[a]/ 1st half 2008	Q1/2009/ Q1/2008	Q2/2009[a]/ Q2/2008
CURRENT ACCOUNT	–4,389	–4,385	–2,739	130.0	62.4	72.1	49.0
1. Goods	–5,671	–10,794	–3,721	121.0	65.6	67.5	64.1
1.1. Credit (f.o.b.)	4,719	9,814	3,825	108.3	81.1	86.6	76.1
1.2. Debit (f.o.b.)	–10,390	–20,608	–7,546	114.9	72.6	76.4	69.4
2. Services	1,894	6,958	1,488	116.7	78.6	134.5	75.5
2.1. Credit	3,387	10,091	2,844	113.7	84.0	91.2	81.6
2.2. Debit	–1,493	–3,133	–1,357	110.2	90.9	85.4	96.3
3. Income	–1,109	–1,584	–1,008	133.5	90.8	146.7	69.7
3.1. Credit	695	1,352	417	107.8	60.1	64.9	55.7
3.2. Debit	–1,804	–2,936	–1,425	122.2	79.0	104.1	65.4
4. Current transfers	497	1,035	503	96.0	101.2	93.8	107.1
4.1. Credit	762	1,684	781	100.1	102.5	100.1	104.5
4.2. Debit	–266	–649	–279	108.8	104.9	110.9	99.3

[a] Preliminary data.
Source: CNB.

Tourism revenues decreased by 16.1% year-on-year in the first half of 2009, with their strongest decrease being observed mostly in the second quarter. Tourism revenues were only slightly lower in the first quarter of 2009 than the in the previous year, thanks in part to the World Handball Championship in January which saw an increase in the number of tourist arrivals and nights stayed. The sizeable fall in tourism revenues in the first half of 2009 was for the most part the consequence of the weaker average consumption per traveller, especially by tourists in commercial accommodation facilities. Moreover, the number of foreign tourist arrivals and nights decelerated in commercial accommodation facilities by 5.8% and 3.9% respectively. The structure of foreign tourists by country of residence shows that the number of nights stayed in commercial accommodation facilities by tourists from the Czech Republic, Russia and France fell the most in the reference period. In contrast, the number of nights stayed by tourists from the majority of old EU member states, notably Germany and Austria, increased, especially during Easter holidays.

The factor income deficit fell by 9.2% in the first half of 2009 from the same period in 2008. The bulk of this decrease was accounted for by the decline in expenditures from direct equity investment, notably reinvested earnings of foreign owners of domestic enterprises and banks. However, the observed decrease was only in a part the result of the fall in the profit of domestic enterprises, with a much stronger contribution coming from the change in the statistical monitoring of reinvested earnings.[15] In contrast, expenditures on interest on foreign debt continued to trend upward but at a slower pace than in the previous period, which was marked by a vigorous growth in such expenditures, while expenditures on interest on new foreign debt of the central government even trended downward. The revenues in the income account also declined (39.9%), which was mostly due to the methodologically-induced fall in revenues from reinvested earnings of domestic owners of foreign enterprises and the fall in revenues which the central bank and commercial banks realise from the investment of foreign assets (international reserves included).

The positive balance in the account of current transfers increased thanks mainly to the growth in revenues being slightly higher than the rise in expenditures. The growth in revenues was above all caused by intergovernmental subsidies-based inflows that exceeded reduced inflows from worker remittances from abroad. The central government was the key contributor to the growth of total expenditures, with other domestic sectors playing only a minor role.

10.2 Trade in Goods

As suggested by the CBS data, total exports of goods fell by 18.7% year-on-year in euro terms in the first half of 2009. The export growth began to slow down as early as at the end of 2008 and further deteriorated in the period until the end of the first half of 2009. Exports fell in most SITC divisions and most strongly in the division of other transport equipment (mostly ships), decelerating by almost a third. Almost the same reduction was observed in exports of oil and refined petroleum products, largely aided by a sizeable fall in their prices relative to the first half of 2008. Ships and oil

[15] See Box 1 in Bulletin No. 149.

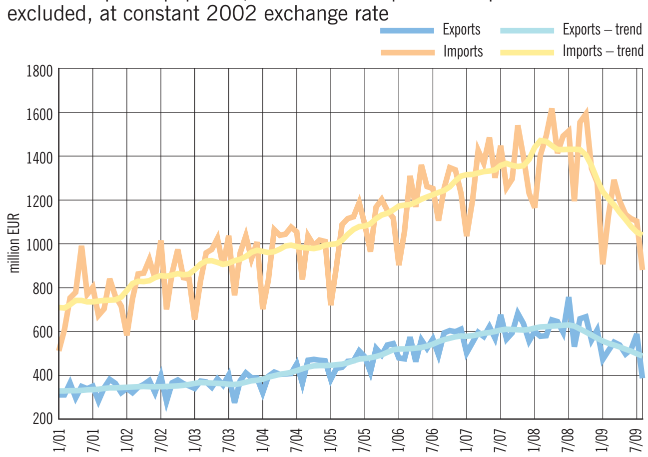
and refined petroleum products excluded, the decline in total exports is only mildly weaker (–15.4%). This narrow aggregate of exports shows that the largest fall of exports was recorded in metalliferous ores and metal scrap, plastics in primary forms, machinery specialised for particular industries and manufactures of minerals (n.e.c.).

In the few divisions marked by the growth of exports relative to the first half of 2008 were various agricultural and food products such as fish and preparations, cereals and cereal preparations and miscellaneous edible products and preparations. Improved exports in the division of fish and preparations were for the most part the result of the increased tuna exports to Japan, a key contributor to this being the completion of their two-year farming cycle. The increase in exports of cereals and cereal preparations should be attributed to low base-period effects, i.e. the fact that export taxes on corn and wheat were in force in the first half of 2008. In addition to agricultural products, export results somewhat better in the first half of 2009 than in the same period in 2008 were observed in the divisions of pharmaceutical products, electricity and power generating machinery and equipment.

According to the CBS data, total imports of goods decreased by 27.2% in euro terms in the first six months of 2009. As in the case of exports, SITC divisions marked by the largest decreases in imports were oil and refined petroleum products, due largely to the above-mentioned price factors, and other transport equipment, due largely to the base effect, i.e. the methodology in the treatment of imports of ships that were previously exported and finished in foreign shipyards. In addition, imports of road vehicles almost halved in the first half of 2009 and imports of various capital goods and raw materials for industrial production decelerated noticeably.

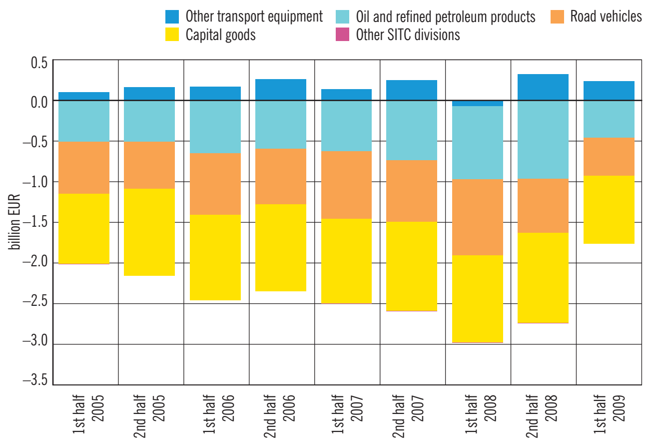
Figure 49 Goods Exports (f.o.b.) and Goods Imports (c.i.f.)

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.

In the few divisions marked by a slight growth of imports in the first half of 2009 were natural and manufactured gas, medical and pharmaceutical products and power generating machinery and equipment. Somewhat stronger growth in imports of gas in the first half of 2009 than in the same period of the previous year is attributed to the price factors observed at the beginning of the year when gas prices reached their climax due the Russia–Ukraine dispute about gas transit and supply.

Modest changes marked the geographic structure of the trade in goods in the first half of 2009 relative to the same period in 2008. Exports to the countries in the region (Bosnia and Herzegovina, Serbia and Montenegro) decelerated due mostly to a reduction in the export value of oil and refined petroleum products which are mainly exported to these markets. Exports to developed countries were marked by the fall of the share of exports to Slovenia (due notably to the fall in exports of metalliferous ores and metal scrap, leather, leather manufactures and dressed fur skins and power generating machinery and equipment) and the share of exports to Hungary (oil and refined petroleum products and manufactures of minerals (n.e.c.)). The countries marked by an increase in the share of exports in total exports were mostly those in which this result was generated by the trade in ships (Liberia, Cyprus and Malta). The share of exports to Japan also grew due to the above-mentioned rise in exports of tuna fish. Moreover, exports to Russia also grew noticeably on account of the further growth in exports of medicines to the Russian market that has been observed for some time now.

Table 8 Imports and Exports by Economic Classification of Countries
in %

Exports				Economic classification of countries	Imports			
2007	2008	1st half 2008	1st half 2009[a]		2007	2008	1st half 2008	1st half 2009[a]
70.5	69.4	69.7	69.2	Developed countries	73.2	72.6	73.1	73.0
60.3	61.0	61.8	61.4	EU-25	64.8	64.1	64.3	63.0
8.3	7.8	8.2	7.4	Slovenia	5.9	5.6	5.5	5.7
2.2	2.4	2.4	1.7	Hungary	2.9	3.2	3.3	3.1
43.7	44.2	44.8	44.7	EU-15	48.8	48.5	49.1	47.8
6.1	5.8	6.0	5.3	Austria	5.3	4.9	4.9	5.1
19.2	19.2	18.4	19.1	Italy	16.1	17.1	16.9	15.0
10.0	10.7	11.6	11.7	Germany	14.4	13.4	13.6	14.0
1.2	1.2	1.3	1.8	EFTA	1.9	1.7	1.6	2.8
29.5	30.6	30.3	30.8	Developing countries	26.8	27.4	26.9	27.0
14.4	15.3	15.0	12.6	Bosnia and Herzegovina	2.8	2.7	2.6	2.5
6.6	6.8	6.8	5.9	Serbia, Montenegro	1.3	1.4	1.3	1.3
1.3	1.3	1.2	1.6	Russia	10.1	10.4	10.5	9.8
0.2	0.3	0.2	0.4	China	6.2	6.2	5.9	6.9

[a] Preliminary data.
Sources: CBS and CNB.

Imports of goods were marked by the decrease in the share of imports from EU countries, which is mostly attributable to a significant fall in imports from Italy and Greece, including primarily ships and oil and refined petroleum products. The share of imports from EFTA countries was the only one to show a more significant growth in the group of developed countries which was for the most part the result of increased imports of electricity from Switzerland. As for developing countries, the share of imports from Russia decelerated on account of oil and refined petroleum products, which predominate in the structure of imports from this country. Notwithstanding its annual fall in the first half of 2009, the share of imports of goods from China continued to trend upward in the structure of total Croatian imports. The key contributor to this was slower fall in imports from China than in imports from other countries.

10.3 Capital and Financial Account

The capital and financial account (excluding changes in international reserves) recorded a net inflow of EUR 2.6bn in the first half of 2009, down 41.5% from the same period in 2008 (EUR 4.5bn). The decrease in net capital inflows is mostly to be attributed to the twice as low growth in domestic sector liabilities including both new FDIs in Croatia and new borrowings. As for direct investment, a strong fall, in addition in the above-mentioned reinvested earnings, was also observed in direct equity investment and borrowings from affiliated enterprises abroad. The foreign assets were marked by higher inflows in the reference period than in the same period last year, which was chiefly the result of the withdrawal of bank currency and deposits that took place after the cut in the rate of the minimum required foreign currency claims in the first quarter. International reserves decreased by EUR 78m in the first half of 2009. This was primarily due to lower allocations by banks and the effects of net foreign exchange interventions of the central bank.

In the first half of 2009, FDIs in Croatia stood at EUR 0.9bn, more than twice as low as in the same period the year before (EUR 2.0bn). Specifically, direct equity investment stood at only EUR 0.3bn, and a significant fall was also observed in reinvested earnings. The largest share of total equity investment was accounted for by the investment in extraction of crude oil and natural gas and service activities incidental to oil and gas extraction, excluding surveying (ENI Croatia, Tifon d.o.o. and Inagip d.o.o.) and investment in real estate activities and retail trade. Inflows from debt equity investment in Croatia also decelerated, which was in line with the deceleration of total external debt. Broken down by country of residence, investors from the Netherlands, Denmark, Hungary and Austria predominated in the reference period.

In the first half of 2009, the account of portfolio investment saw a modest net outflow of EUR 0.1bn, mainly including the reduction of domestic sector liabilities, especially the central government. Specifically, the repayment of due central government liabilities (eurobonds worth EUR 500m, Samurai bonds worth JPY 25bn and obligations to the London Club) exceeded the value of new issues (eurobonds worth EUR 750m that were mainly subscribed by foreign investors). The assets side showed no significant changes, with reduced bank investment being offset by increased investment of investment funds in debt and equity securities in the foreign market.

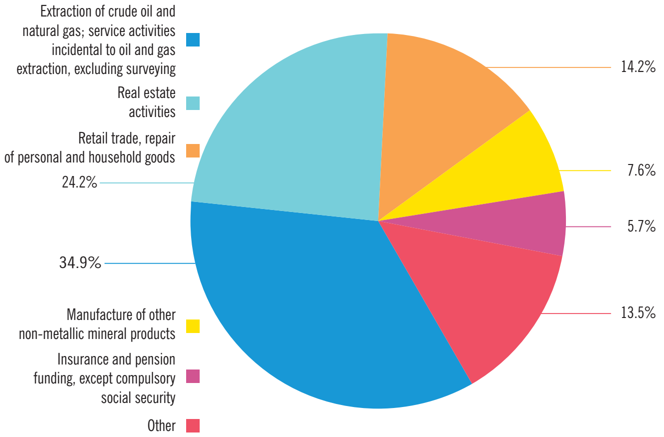
Table 9 Capital and Financial Account
in million EUR

	1st half 2008	2008	1st half 2009[a]	Indices			
				1st half 2008/ 1st half 2007	1st half 2009[a]/ 1st half 2008	Q1/2009/ Q1/2008	Q2/2009[a]/ Q2/2008
CAPITAL AND FINANCIAL ACCOUNT	3,727	5,962	2,723	134.7	73.0	104.9	34.6
1. Capital account	15	29	13	95.9	81.3	95.4	74.8
2. Financial account, excl. reserves	4,504	5,603	2,632	139.8	58.4	63.1	51.2
2.1. Direct investment	1,975	3,219	851	88.6	43.1	36.6	51.8
2.1.1. Abroad	–23	–134	–62	16.4	270.5	–	25.2
2.1.2. In Croatia	1,997	3,353	913	84.4	45.7	43.6	47.8
2.2. Portfolio investment	90	–627	–52	–	–	–	–
2.2.1. Assets	317	–273	5	–	1.6	46.1	–
2.2.2. Liabilities	–227	–354	–57	–	25.0	447.0	–
2.3. Financial derivatives	0	0	0	–	–	–	–
2.4. Other investment	2,439	3,011	1,832	181.2	75.1	120.6	7.8
2.4.1. Assets	460	–1,618	960	–	208.8	544.3	–
2.4.2. Liabilities	1,980	4,629	873	148.2	44.1	–	109.3
3. Reserve assets (CNB)	–792	330	78	167.6	–	–	347.1

[a] Preliminary data.
Source: CNB.

Net inflows to the account of other investment (including foreign assets and liabilities of domestic sectors arising from loans, trade credits and currency and deposits) totalled EUR 1.8bn in the first half of 2009. Somewhat more than one half of these inflows was generated by the fall in foreign assets, with the remaining inflows being account for by the increase in foreign liabilities. The decrease in assets was for the most part the consequence of the withdrawal of bank currency and deposits after the reduction in the rate of the minimum required foreign currency claims in the first quarter. In order to create additional reserves of foreign liquidity, banks increased their foreign assets again in the second quarter. Other investment liabilities grew less strongly in the first half of 2009 than in the same period in 2008 and were chiefly generated by enterprises.

Figure 51 Structure of Direct Equity Investment and Reinvested Earnings in the Republic of Croatia in the First Half of 2009



Source: CNB.

According to the balance of payments data (cross-currency changes excluded), international reserves dropped by only EUR 78m in the first six months of 2009. In the first quarter of the year they decelerated by EUR 0.4bn on account of lower bank allocations and foreign exchange transactions with the central government. Also negative was the contribution of central bank interventions in the foreign exchange market in January and February. However, in the second quarter of the year, reserves increased by EUR 0.3bn, for the most part due to the purchase of foreign exchange generated through the issue of central government eurobonds in June. According to the monetary statistics data (cross-currency changes included), international reserves declined by only EUR 31m in the first six months of 2009, ending June at EUR 9.1bn.

10.4 External Debt

Croatia's gross external debt rose by EUR 1.5bn (3.7%) in the first half of 2009, ending June at EUR 40.8bn. This increase is to the largest part (EUR 1.1bn) attributable to corporate foreign borrowing from foreign banks and affiliated enterprises abroad. Banks also increased their external debt (by EUR 0.5bn; hybrid and subordinated instruments included), while the central government debt slightly reduced (by EUR 69m).

Table 10 Gross External Debt by Domestic Sectors

end of period, in million EUR and %

	End-period stock			Structure		Absolute growth[a]		
	2007	2008	Jun. 2009	2008	Jun. 2009	2007	2008[b]	Jun. 2009[c]
1. Government[d]	5,372	4,197	4,087	10.7	10.0	–298	–1,241	–69
2. Croatian National Bank	2	2	1	0.0	0.0	0	0	–1
3. Banks	8,879	10,079	10,378	25.8	25.4	–1,344	1,161	313
4. Other sectors	14,743	19,836	20,726	50.7	50.8	4,243	4,899	696
5. Direct investment	3,933	5,010	5,616	12.8	13.8	1,054	1,052	515
o/w: Hybrid and subordinated instruments	56	217	364	0.6	0.9	–113	161	147
Total (1+2+3+4+5)	**32,929**	**39,125**	**40,808**	**100.0**	**100.0**	**3,655**	**5,871**	**1,453**

[a] The increase in debt is calculated in relation to the debt balance reported at the end of the previous year. [b] Comparable data have been used to calculate the debt growth (the application of the new system of reporting would increase the external debt balance as at end-2007 by EUR 325m or to EUR 33.3bn). [c] Comparable data have been used to calculate the debt growth (the switch to the advanced system of data processing would increase the external debt balance as at end-2008 by EUR 230m or to EUR 39.4bn). [d] Government does not include the CBRD. From early 2008 on, it also excludes CM whose debt at that point stood at EUR 1.2bn. Both CBRD and CM have been reclassified to other sectors.

Source: CNB.

In the first half of 2009, the external debt of other sectors (mostly enterprises) went up by EUR 0.7bn, which was several times less than in the same period in 2008 (EUR 3.1bn). The debt decelerated considerably in all types of enterprises and most strongly in public and mixed-ownership enterprises where it grew EUR 0.2bn in the first half of 2009 (EUR 1.5bn in the first half of 2008). The debt of enterprises in majority private ownership grew more sturdily than the debt of public enterprises but remained two times lower than in the same period in 2008 (EUR 0.5bn relative to EUR 1.0bn in the first half of 2008). The debt of non-banking financial institutions trended up by a modest EUR 27m, entirely as a result of the EUR 0.1bn increase in the external debt balance of the CBRD in the first half of the year. In contrast, other banking financial institutions, predominantly leasing companies, decreased their external debt by about the same amount. The corporate liabilities to affiliated enterprises were to an extent in line with the growth dynamics of corporate liabilities to foreign banks. Specifically, the slowdown in this debt category was less pronounced (the debt growth in the first half of 2009 stood at EUR 0.5bn, while in the same period of the previous year it amounted to EUR 0.7bn). This leads us to the conclusion that at the time of impeded access to financing in the world market, domestic enterprises increasingly turn to the safer and more accessible sources of funding offered by affiliated enterprises abroad.

Bank increased their foreign liabilities by EUR 0.3bn in the first six months of 2009 or by EUR 0.5bn if hybrid and subordinated instruments (i.e. the constituents of the direct investment-related debt) are included. Specifically, their debt declined slightly in the first quarter of 2009 thanks to the relaxation of monetary policy measures (the cut in the rate of the minimum required foreign currency claims) and the resultant release of a significant portion of foreign currency funds to banks required, among other things, for the repayment of foreign liabilities. Banks intensified their foreign borrowing in the second quarter of 2009, increasing their external debt balance by EUR 0.3bn, mostly on account of short-term loans and currency and deposits of non-residents.

The external debt of the government sector (including the central government, central government funds and local government) went down by EUR 69m in the first six months of 2009. The central government decreased its debt in the first quarter (by EUR 500m) primarily thanks to the repayment of the EUR 500m worth of eurobonds issued in 2002. After that, it again increased its debt in the second quarter by issuing new eurobonds worth EUR 750m that were mainly subscribed by foreign investors. A share of the raised funds was used for the repayment of Samurai bonds, valued at JPY 25bn (EUR 185m) Hence, its external debt balance rose by EUR 0.4bn in the second quarter of 2009. The external debt of the public sector rose by EUR 0.2bn in the first half of 2009, due to the above-mentioned rise in the debt of public and mixed-ownership enterprises and the CBRD which are, together with the government sector, included in its coverage. The contingent debt of the public sector (i.e. the publicly guaranteed private sector debt) continued falling, reaching EUR 38m at the end of the first half of 2009).

Table 11 Current and Contingent External Debt of the Public Sector and Private Sector Debt
end of period, in million EUR and %

	End-period stock			Structure		Absolute growth[a]		
	2007	2008	Jun. 2009	2008	Jun. 2009	2007	2008[b]	Jun. 2009[c]
1. Public sector debt	9,259	10,248	10,623	26.2	26.0	1,003	848	235
2. Publicly guaranteed private sector debt	140	80	38	0.2	0.1	–64	–58	–27
3. Non-publicly guaranteed private sector debt	23,530	28,797	30,147	73.6	73.9	2,717	5,081	1,245
Total (1+2+3)	**32,929**	**39,125**	**40,808**	**100.0**	**100.0**	**3,655**	**5,871**	**1,453**

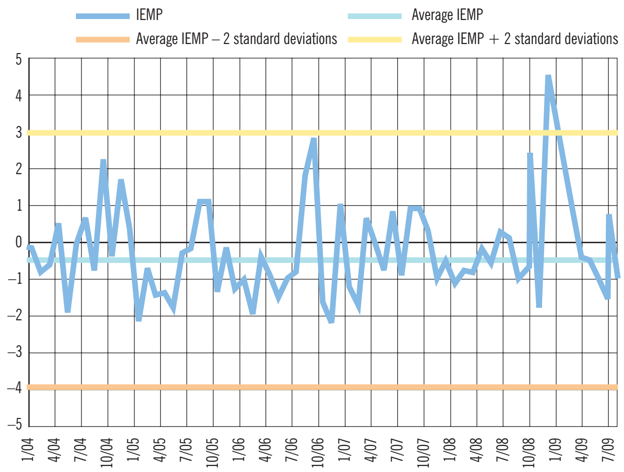
[a] The increase in debt is calculated in relation to the debt balance reported at the end of the previous year. [b] Comparable data have been used to calculate the debt growth (the application of the new system of reporting would increase the external debt balance as at end-2007 by EUR 325m or to EUR 33.3bn). [c] Comparable data have been used to calculate the debt growth (the switch to the advanced system of data processing would increase the external debt balance as at end-2008 by EUR 230m or to EUR 39.4bn).

Source: CNB.

10.5 International Liquidity

Following strong oscillations late in 2008 and early in 2009 caused by the depreciation of the kuna exchange rate and the fall in international reserves brought about by the changes in monetary policy instruments (i.e. the abolition of the marginal reserve requirement and the decrease in bank foreign currency reserve requirements) the index of exchange market pressure (IEMP[16]) was fairly stable in the subsequent months. The index mostly moved around its long-term average value at the end of the first and in the second quarter of 2009, showing that domestic sectors, observed aggregately, smoothly met their foreign liabilities. Favourable movements of the index in the period are chiefly to be attributed to the slight appreciation of the kuna and to the international reserves which, after the decrease in January and February, mainly trended upward until the end of the first half of 2009.

Figure 52 Index of Exchange Market Pressure



Source: CNB.

[16] IEMP 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

As a result of the sharp economic contraction that marked the first half of 2009, consolidated general government revenues fell substantially short both of the target and the amount generated in the same period of 2008 (a relative decline of 7.7%). Tax revenues dropped even more (14.6%), particularly revenues from indirect taxes, which were most affected by the fall in aggregate demand. On the other hand, budget expenditures grew by 8.3% relative to the same period last year; all expenditure items recorded growth except outlays for the acquisition of non-financial assets, which decreased slightly. Therefore, the consolidated general government deficit (GFS 2001), which stood at HRK 7.3bn in the January-June period of 2009, was large, particularly if one remembers the surplus of HRK 3.0bn generated in the same period last year. As the government raised the funds needed through borrowing, its debt increased to HRK 108.4bn at end-June. Due to impeded access to foreign capital markets early in the year, the government relied mostly on domestic banks to meet its funding needs, while it raised substantial funds in the second quarter by issuing bonds in foreign markets. The CNB also facilitated government borrowing in the domestic market by reducing the rate of the minimum required foreign currency claims and concluding a foreign currency swap contract with banks.

As early in the year it became obvious that the original 2009 budget was untenable, the first 2009 budget revision was passed in April. It projected lower revenues and a reduction in expenditures, particularly for the use of goods and services and employee compensations. The cut in the latter expenditures was due to the rollback of the basis for wage calculation to the previous year's level. However, as revenues planned in the first budget revision were reduced more than expenditures and outlays for the acquisition of non-financial assets, the MoF increased the consolidated general government deficit target from 0.8% to 1.6% of projected nominal GDP in 2009.

11.1 Consolidated General Government Revenues

Preliminary MoF data on budget execution show that consolidated general government revenues stood at HRK 61.2bn in the January-June period of 2009, down 7.7% on 2008. A sharp downturn in tax revenues changed the structure of total revenues relative to the same period in the previous year, i.e. the share of revenues from social contributions and other revenues increased.

In the first six months of 2009, tax revenues were down 14.6% compared with the same period in 2008. This decrease mostly reflected the fall (by almost one fifth) in VAT and excise revenues due to a sharp decline in personal consumption and foreign trade. It should be noted that the substantial downturn in excise revenues was due to unfavourable trends in almost all items of this revenue type. A major drop in imports of road vehicles thus led to a decline in revenues from excises on cars. Particularly noteworthy is that revenues from excises on tobacco products also decreased despite the increase in the special tax on tobacco products, which was made in line with EU practice (in effect as of January 2009). As these products have a low price elasticity of demand, the drop in excise revenues was in part due to the fact that some demand was met from stocks generated in late 2008, while it is also likely that the grey market trade in these products increased. Furthermore, although the real retail trade turnover in motor fuels and lubricants almost held steady at the previous year's level, revenues from these special taxes made the most significant negative contribution to growth due to arrears on excise duties on refined petroleum products and road fees. Reduced consumption of alcoholic and non-alcoholic beverages and beer lowered revenues from the related excises. It should be said that, in addition to weaker domestic demand, these trends were affected by a sharp decrease in foreign tourist spending relative to the comparable period last year.

Profit tax revenues also decreased noticeably in the first six months of 2009. This seems to be largely the result of the steadily mounting illiquidity in the economy, which creates difficulties for some enterprises in the payment of tax liabilities. In addition, as advance tax on current year profit is paid based on the tax return for the previous period (previous year), weaker business performance of profit tax payers in 2008 compared with 2007 led to a decrease in these revenues. Notwithstanding the increase in the nominal gross wage bill, income tax revenues also decreased mildly year-on-year due to last year's legal changes. Under the Act on Amendments to the Income Tax Act,[17] applied as of July 2008, the basic personal income tax exemption was raised from HRK 1,600 to HRK 1,800 a month, which reduced income tax revenues.

The growth in the nominal gross wage bill led to a slight annual increase in revenues from social contributions. In addition, growth was recorded by other revenues, accounting for slightly more than one-tenth of total revenues. This was primarily due to the good previous year's business performance of the CNB, which paid to the state budget a share of its profit (HRK 1.3bn) in March 2009. In contrast, administrative fees, accounting for the largest share of other revenues, made the largest negative contribution to growth in this revenue item.

11.2 Consolidated General Government Expenditures

Consolidated general government expenditures stood at HRK 65.9bn in the first half of 2009, half of the total expenditures projected for the entire year. Expenditures grew by 8.3% relative to the same period in 2008, which primarily reflects the dynamics of expenditures on social benefits, employee compensations and expenditures for the use of goods and services.

Social benefits, which account for more than two-fifths of total expenditures, rose faster than in the same period last year. Expenditures on social security benefits increased the most, due in part to the rise in pension expenditures triggered by the increase in the actual value of pensions and the number of pension beneficiaries, which was 1.2 million at end-June 2009. In addition to pension expenditures, it seems that health care expenditures also grew sharply in the observed period. The original 2009 budget envisaged a noticeable increase in health care expenditures, while the first budget revision adjusted these expenditures downward to some extent. At the same time, the growth of social assistance benefits, comprising, among other things, child allowances, disability pensions, Croatian war veterans' permanent rights and pension supplements was more than twice as slow as the growth in total social benefits in the first six months.

Expenditures for employees grew at almost the same rate in the first half of 2009 as in the same period in 2008, i.e. 8.6%. The substantial increase in this type of expenditure was to a large degree a result of an agreement between the government and the trade unions of civil servants and government employees on raising the wage calculation basis in the 2007-2009 period and to a small degree of the rise in employment. However, as government budget revenues fell short of the target due to the intensified contraction of economic activity, the agreed 6% wage growth became fiscally untenable. Therefore, the first 2009 budget revision rolled back the wage calculation basis for civil servants and employees to its December 2008 level, which slowed down wage growth in the second quarter.

Expenditures for the use of goods and services stood at HRK 7.5bn in the period under review, increasing by 11.6% year-on-year. The growth was primarily due to developments in the first quarter of 2009. Since spending on the use of goods and services was reduced the most in late 2008 relative to the original 2008 budget due to revenue underperformance, it is likely that a part of last year's liabilities was paid this year.

At the same time, due to stronger borrowing of the consolidated general government and unfavourable global economic trends that raised funding costs, interest expense was much higher than in the previous year. As a reflection of structural changes in consolidated general government debt, interest payments to residents grew sharply, while interest payments to non-residents grew moderately. On the other hand, subsidies grew at a much slower pace than in the previous year. Expenditures on subsidies thus grew only slightly in the observed period, with the growth in subsidies to public corporations considerably outpacing the rise in other subsidies.

It should be noted that the only expenditure category that registered a decrease was "other expenditures". This was largely a result of smaller transfers of road fees to Croatian Motorways (CM) for the purpose of financing road infrastructure construction and maintenance.

[17] OG 73/2008.

11.3 Operating Balance of the Consolidated General Government and Transactions in Non-Financial Assets and Financial Assets and Liabilities

A HRK 4.7bn negative net operating balance of the consolidated general government was generated in the first six months of 2009 owing to a substantial shortfall in revenues and to expenditure growth. In the same period, non-financial assets continued to grow, mostly due to new capital investments. Outlays for the acquisition of non-financial assets were slightly lower than in the first half of 2008. The bulk of these funds went on the acquisition of buildings and structures, which in accordance with GFS 2001 methodology comprise, among other things, roads, residential and commercial buildings, tunnels, bridges, etc. The said movements resulted in consolidated general government net borrowing (GFS 2001) of HRK 7.3bn, which the government had to raise by borrowing and/or decreasing its financial assets.

Table 12 Operating Balance and Transactions in Non-Financial Assets and Financial Assets and Liabilities, GFS 2001

in million HRK and %

	Consolidated general government		
	Jan.-Jun. 2008	Jan.-Jun. 2009	Jan.-Jun. 2009/ Jan.-Jun. 2008
1. Change in net worth (net operating balance)	5,426	–4,703	–
1.1. Revenue	66,306	61,207	92
1.2. Expense	60,880	65,911	108
2. Change in net non-financial assets	2,396	2,553	107
2.1. Acquisition of non-financial assets	3,091	2,927	95
2.2. Disposal of non-financial assets	695	374	54
3. Net lending (+) / borrowing (–) (1 – 2)	3,030	–7,256	–
3. Financing (5 – 4) Transactions in financial assets and liabilities	–3,030	7,256	–
4. Change in financial assets	3,031	2,152	71
4.1. Domestic	3,024	2,151	71
4.2. Foreign	7	1	13
5. Change in liabilities	2	9,408	–
5.1. Domestic	1,036	8,942	863
5.2. Foreign	–1,034	466	–

Note: On a cash basis.

Sources: MoF and CNB calculations.

Financial assets of the consolidated general government rose by HRK 2.2bn in the first six months. MoF data show that the bulk of the increase was due to the rise in financial assets in the form of deposits in government accounts with commercial banks and the CNB. It should be said that the CNB monetary statistics cannot confirm these trends. In addition to currency and deposits, growth was also recorded by financial assets in the form of (net) loans granted, which were several times higher than in the same period a year earlier. This can be largely attributed to the increase in due liabilities arising from government financial guarantees to shipyards. Although these guarantees constitute claims against these enterprises, it is unlikely that they will have to be paid.

As the consolidated general government generated a substantial deficit while its financial assets grew noticeably in the observed period, the government raised the funds needed through borrowing. In contrast with the first half of 2008 when consolidated general government liabilities held steady, they grew by HRK 9.4bn in the January-June period of 2009. Most of the funds needed were raised in the domestic market through new loans and T-bill issuance. A large amount was also raised through bond issuance in the foreign market. However, as almost the same amount was needed for external debt service payments, foreign liabilities recorded only a slight increase.

11.4 Balance of the Consolidated General Government on a Cash Basis (GFS 1986)

The consolidated general government deficit (GFS 1986) on a cash basis stood at HRK 8.6bn in the period from January to June 2009, in contrast with the surplus generated in the same period in the previous year. Broken down by the level of the consolidated general government, some 90% of the deficit was generated at the state budget level, while the rest was almost equally accounted for by extrabudgetary funds and local and regional self-government units. A part of the deficit that was generated by extrabudgetary funds was mostly the result of the operations of Croatian Roads (CR), the deficit of which increased relative to the same period in 2008. However, it should be noted that the higher CR deficit was not due to larger expenditures but to a sharp fall in revenues from the road fees incorporated in fuel prices.

Table 13 Consolidated General Government Balance, GFS 1986
in million HRK

	Jan.-Jun. 2008	Jan.-Jun. 2009
1. Net lending (+) / borrowing (–) GFS 2001	3,030	–7,256
2. Disposal of non-financial assets	695	374
3. Net acquisition of financial assets – loans	118	817
4. Acquisition of shares and other equity	212	159
5. Balance without capital revenues (1-2-3-4)	2,005	–8,607

Note: On a cash basis.
Source: MoF.

11.5 Government Debt

According to CNB data, general government debt stood at HRK 108.4bn at end-June 2009, up HRK 8.8bn over the end of 2008. The growth was entirely due to government borrowing in the domestic financial market as access to foreign markets was considerably impeded. The share of the domestic component in the total general government debt thus continued to trend upward in the observed period. It should be noted that the bulk of borrowing in the domestic market is short-term, which means that the growth in liabilities will have to be refinanced in late 2009 and in 2010. In the same period, contingent government debt arising from guarantees for domestic and foreign liabilities also increased sharply (HRK 2.0bn), standing at HRK 46.6bn at the end of the period under review.

Table 14 Consolidated General Government Debt
end of period, in million HRK

	Stock		Change
	Dec. 2008	Jun. 2009	Jan.-Jun. 2009
A. General government debt (1 + 2)	99,636	108,414	8,778.5
1. Domestic general government debt	69,158	78,198	9,039.5
1.1. Domestic debt of the Republic of Croatia	64,395	72,811	8,416.0
1.2. Domestic debt of central government funds	3,004	3,830	825.1
1.3. Domestic debt of local government	1,758	1,557	–201.6
2. External general government debt	30,478	30,217	–261.0
2.1. External debt of the Republic of Croatia	28,414	28,175	–239.6
2.2. External debt of central government funds	1,800	1,774	–26.3
2.3. External debt of local government	263	268	5.0
Supplement:			
B. Total guarantees issued by the Republic of Croatia	44,619	46,630	2,011.6
1. Domestic	13,197	13,764	567.1
2. Foreign	31,422	32,866	1,444.4

Note: CM and CBRD debts are not included in the data on the domestic and external debt of general government.
Source: CNB.

Domestic debt of consolidated general government stood at HRK 78.2bn at the end of the observed period, increasing by HRK 9.0bn over end-2008. The structure of domestic debt shows that the said increase was mostly due to the rise in loans received. A loan of EUR 750m, which a domestic bank syndicate granted to the government in February 2009 and which falls due on 30 September 2010, was largely used for the repayment of EUR 500m worth of foreign bonds that also fell due in February. The rest of the increase in loan-related debt was largely accounted for by short-term loans used to bridge the short-term illiquidity. Liabilities arising from T-bills also increased substantially, particularly those denominated in the euro, while the debt arising from bonds slightly decreased. The domestic debt of central government funds stood at HRK 3.8bn at end-June 2009, up HRK 0.8bn over the end of 2008. The debt increase reflected additional CR borrowing in the form of bank loans that were probably used to finance road construction investments. In contrast, domestic debt of local government units edged down.

Refinancing of the bulk of maturing foreign liabilities in the domestic market, as well as the meeting of most new funding needs in that market, slightly reduced the external debt of consolidated general government. The government issued EUR 750m worth of bonds in the foreign market in May. The funds thus raised were used for the repayment of the short-term loan raised in January, JPY 25bn worth of Samurai bonds that fell due in June, obligations to the London and Paris Clubs and for budget deficit financing.

12 Banking Sector

The effects of the global financial crisis began to spill over more strongly onto the domestic banking sector in the first half of 2009. The unfavourable developments in the real sector impaired the collection of banks' due receivables and increased bad placements, resulting in poorer banking sector financial performance. Given these circumstances, banks showed increased reluctance to incur additional risks. Hence, bank credit activity was mostly oriented towards the government in the first quarter and stagnated in the second quarter of 2009. Total sources of funds from majority foreign owners (received loans and deposits), which rose strongly after the lifting of the marginal reserve requirement in the last quarter of 2008, grew modestly in the first quarter of 2009 and accelerated in the second quarter. In contrast, these sources were stagnant in individual large banks, due probably to the efforts to maintain the capital adequacy ratio at the parent bank level. The retention of the major portion of the profit from 2008, the profit generated in the current year and the recapitalisation of individual banks additionally improved the capital position of banks and resulted in the high share of capital in bank balance sheet total. Concurrently, the slowdown of banks' business activities resulted in the decrease of capital requirements and in the growth of the already high capital adequacy ratio of banks. This strengthened the guarantee function of capital, i.e. increased its availability for the coverage of potentially higher risks, which is especially important in conditions of weakening operating results in the sector.

12.1 Business Operations of Banks

At the end of the first half of 2009, there were 32 banks, 2 savings banks and 5 housing savings banks operating in the Republic of Croatia. Relative to the end of 2008, the number of banks decreased by one due to the merger between Slavonska banka d.d., Osijek, and Hypo Alpe-Adria-Bank d.d., Zagreb. The entry of A štedna banka malog poduzetništva d.d., Zagreb into the banking sector increased the number of savings banks by one.

At the end of the first half of 2009, there were 6 large banks operating in the Republic of Croatia, unchanged from the end of 2008.[18] The number of medium-sized banks fell from four at the end of 2008 to three at the end of the first half of 2009 due to the merger between Slavonska banka d.d., Osijek and Hypo Alpe-Adria-Bank d.d., Zagreb in the first quarter of 2009. The entry of the newly established A štedna banka malog poduzetništva d.d., Zagreb into the banking sector in April 2009 increased the number of small banks to 25.

The above-mentioned transition of a medium-sized bank into the group of large banks significantly decreased total assets of the medium-size bank group and increased the total assets of large banks. Hence, relative to the end of 2008, the share of assets of medium-sized banks in total bank assets went down by 2.8 percentage points, to 9.6%, while the share of total assets of large banks increased to 82.3%. The increase in the number of small banks notwithstanding, total assets of this peer group decreased. However, owing to the concurrent decrease in total assets of all banks, the share of assets of small banks remained the same as at the end of 2008, totalling 8.1%.

[18] Depending on the size of the share of bank assets in the total assets of all banks at the end of the reporting period, banks (including savings 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. Housing savings banks make up a separate group.

Table 15 Number of Banking Institutions

end of period

Banks	2007	2008	Jan.-Jun. 2009
Number of banks at the beginning of the period	33	33	33
Banks that merged with other banks	–	–	1
Number of banks at the end of the period	33	33	32
Savings banks			
Number of savings banks at the beginning of the period	–	0	2
Savings banks that were granted license	–	2	0
Number of savings banks at the end of the period	–	1[a]	2
Housing savings banks			
Number of housing savings banks at the beginning of the period	5	5	5
Housing savings banks that were granted license	–	–	–
Number of housing savings banks at the end of the period	5	5	5

[a] As at 31 December 2008, A štedna banka malog poduzetništva d.d., Zagreb was not entered in the register of companies.

Source: CNB.

Table 16 Bank Peer Groups and Their Share in Total Bank Assets

end of period

	Number of banks			Share		
	2007	2008	Jun. 2009	2007	2008	Jun. 2009
Large banks	6	6	6	79.0	79.4	82.3
Medium-sized banks	4	4	3	12.9	12.5	9.6
Small banks	23	24[a]	25[b]	8.1	8.1	8.1
Total	**33**	**34**	**9**	**100.0**	**100.0**	**100.0**

[a] Obrtnička štedna banka d.d., Zagreb is included in the group of small banks. [b] A štedna banka malog poduzetništva d.d., Zagreb is included in the group of small banks.

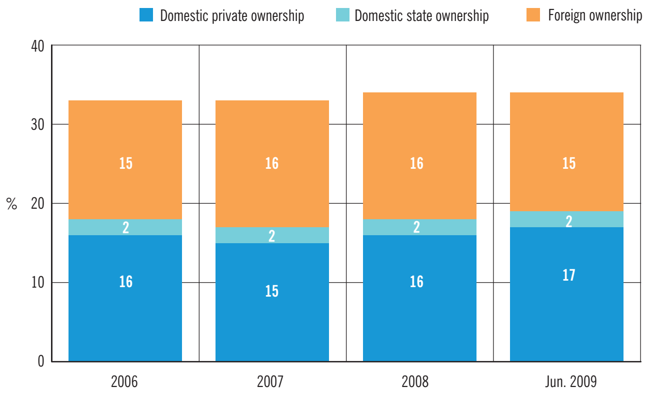
Source: CNB.

As before, the majority of banks (19) were in majority domestic ownership. With the entry of another savings bank into the banking sector, the number of banks in domestic private ownership rose by one relative to the end of 2008 and the number of banks in state ownership remained unchanged. Owing to the merger of Slavonska banka d.d., Osijek and Hypo Alpe-Adria-Bank d.d., Zagreb, the number of banks in majority foreign ownership fell by one.

The change in the number of banks did not affect the ownership structure of total bank assets. Despite the increase in the number of banks in domestic ownership and the 0.6% increase in their total assets relative to the end of 2008, the share of assets of domestic banks in total bank assets remained at 9.4%. Total assets of banks in foreign ownership decreased by 0.3% and their share in total bank assets did not change and stood at 90.6%.

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

end of period



Source: CNB.

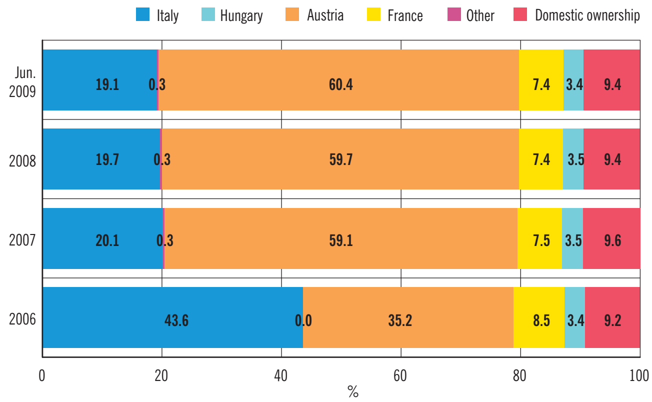
Table 17 Bank Assets by Ownership Residence and Form of Ownership
in %

Banks by ownership residence and form of ownership	Share of bank peer group assets in total bank assets		
	2007	2008	Jun. 2009
Banks in majority ownership of domestic shareholders	4.9	4.9	4.9
Banks in majority state ownership	4.7	4.5	4.5
Banks in majority ownership of foreign shareholders	90.4	90.6	90.6
Total	**100.0**	**100.0**	**100.0**

Source: CNB.

The assets of six banks in the majority ownership of Austrian shareholders (60.4%) accounted for the largest share in the assets of banks in foreign ownership. This group of banks reported an increase in assets of 0.9% in the reference half-year period, increasing its share in total bank assets relative to the end of 2008. Next are five banks owned by Italian shareholders with a share of 19.1%. Due to the decrease in their assets by 3.2%, their share in total bank assets also decelerated. As at the end of 2008, one bank was owned by shareholders from France, Hungary, San Marino and Luxemburg.

Figure 54 Bank Assets by Shareholder Domicile
end of period



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

12.1.1 Bank Balance Sheet

Structure of Bank Assets

Total bank assets amounted to HRK 369.4bn at the end of the second quarter of 2009, a decrease of 0.2% since the end of 2008. The decline in the assets of 3 large and 14 small banks resulted in the fall of assets in these two peer groups, while the assets of medium-sized banks rose owing to the growth in the assets of two banks from this peer group.[19]

Bank assets have been growing at slower pace since 2007, when the measure on the subscription of compulsory CNB bills was first applied to banks whose assets grew at a rate higher than permissible.[20] In 2008, bank assets went up by 7.2% (as compared with 13.3% in 2007 and 17.0% in 2006) and were additionally affected by disturbances observed in October 2008 – the withdrawal of deposits from some banks. The CNB took measures aimed at preserving the liquidity and stability of the system[21] and, in 2009, an additional amount of earlier immobilised assets was made available to banks. In the first quarter of 2009, the foreign currency liquidity measure was changed twice, i.e. the minimum required coverage between foreign currency liabilities and foreign currency claims was first decreased from 28.5% to 25% and then to 20%.[22] As this facilitated the withdrawal of deposits held with foreign banks, total deposits with banking institutions went down by more than HRK 6bn (17.2%) relative to the end of 2008, and their share in total assets dropped to 8.0%. Owing to this change and reduced investments in held-for-trading and available-for-sale securities, the share of liquid items in the structure of bank assets decelerated, and the share of loans granted rose, mainly due to the growth in loans granted to the government. As for liquid assets items,[23] the increase was only observed in the settlement account balance with the CNB. However, almost one half of the said increase was generated by one large bank.

[19] Excluding the effect of the merger between Slavonska banka d.d., Osijek and Hypo-Alpe-Adria-Bank d.d., Zagreb.

[20] Introduced in early 2007, the measure on the subscription of compulsory CNB bills is applied to banks whose placement growth in one calculation period exceeds the permissible growth rate. From 2007 on, the calculation basis and the permitted growth rate have been changed on several occasions. In line with the provisions currently in force, the permitted growth in placements and contingent liabilities is set at 18% for the period between 1 January 2008 and 30 June 2009. As none of the banks exceeded the permitted growth rate, there was no obligation to subscribe to the compulsory CNB bills in the respective calculation period. The placement growth in six small banks in the period in question exceeded 17%, whereas it amounted to 9.7% for all banks, i.e. it was two times smaller than the permitted growth.

[21] The marginal reserve requirement measure, originally aimed at limiting the foreign borrowing of banks, was repealed in October, and the reserve requirement rate was decreased from 17% to 14% in December 2008.

[22] Decision on amendments to the Decision on the minimum required amount of foreign currency claims (OG 17/2009 and 23/2009).

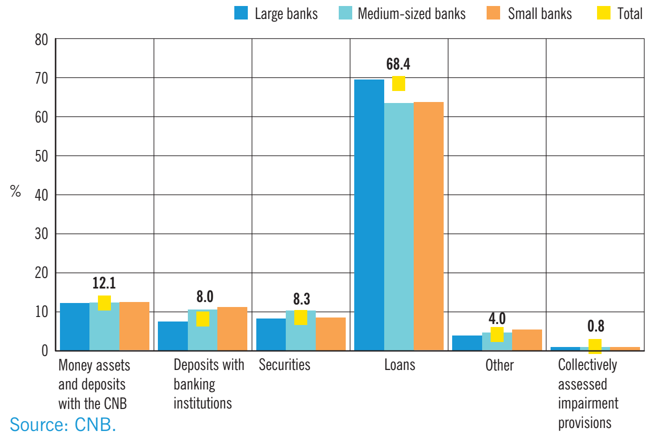
[23] Money assets and deposits with the CNB, deposits with banking institutions and securities in held-for-trading and available-for-sale portfolios.

Banks' investment in securities went down in the first half of 2009 (by HRK 4.2bn or 11.9%), a continuation of a persistent downward trend temporarily halted at the end of 2008 when, due to the changes in monetary regulations, investment in T-bills of the Ministry of Finance and foreign bonds trended up. The noticeable decrease in held-for-trading and available-for-sale securities in the first half of 2009, totalling HRK 3.8bn or 14.6%, was for the most part the consequence of the amendments to the accounting rules. Specifically, the amendments to the International Accounting Standards (2008) provide for the reclassification of securities held in these portfolios into the portfolio of loans and receivables. A significant portion of securities (HRK 2.3bn) was reclassified into the portfolio of loans and receivables in the second quarter of 2009. This basically means that no significant fall in available securities was observed in all banks and that the actual growth in bank loans granted in the first half of 2009 was smaller than reported. Apart from the accounting changes, the fall in securities investments should also be ascribed to unfavourable movement in market prices and to the sale of securities. The fall was observed in all securities portfolios, with reclassification effects contributing the most to the decrease in the held-for-trading portfolio (29.0%). The majority of securities were held in the available-for-sale portfolio (54.0%). The value of investments held in this portfolio is adjusted to market prices, and realised gains/losses are not directly recognised in the profit and loss account but carried as unrealised gains/losses in the account of capital. At the end of the second half of 2009, banks holding securities in this portfolio reported unrealised losses of HRK 165.5m, an increase of 46.2% relative to losses reported at the end of 2008. Shown by instruments, the structure of securities continued to be dominated by bonds (50.3%), with T-bills of the Ministry of Finance accounting for 31.1%. More than a half of all bonds (53.0%) were accounted for by non-resident bonds, primarily by bonds of foreign countries.

Total loans granted (in net terms) were HRK 6.3bn or 2.5% higher at the end of the second quarter than at the end of 2008. The strongest growth was observed in loans granted to the government (HRK 10.5bn), with only a modest growth being observed in loans to enterprises. The share of loans in assets went up by 4.0 percentage points in 2008 and 1.8 percentage points in the first half of 2009. At the end of the second quarter of 2009, this share was relatively high (accounting for 68.4% of assets), pointing to the important role of lending activities in the domestic banking system. The structure of bank loan portfolios (in net terms) saw an increase only in the share of loans granted to government units, to 12.7% of total loans granted (14.1% in large banks). In the first half of 2009, loans to government units rose by 48.9% and thus continued the trend observed in 2008 in which loans to this sector grew by 50.1%. Owing to the low rate of growth (0.3%), the share of loans granted to enterprises fell to its lowest level so far – 37.3% of loans granted. The fall in cash general purpose loans, utilised lines of credit and other loans, and car purchase loans made the strongest contribution to the decrease in total loans granted to households (2.7%). Their share decreased by a substantial 2.5 percentage points and accounted for 47.2% of total loans.

The share of loans in assets remained the highest in large banks (69.5%). The indicator for medium-sized banks, whose value was until recently somewhat lower than that for large banks, fell noticeably and was lower than the indicator for small banks at the end of the first half of 2009 (63.5% compared to 63.7%). With large banks playing the key role in the lending to the government in the first quarter of 2009, loans granted grew the most in this very group of banks, while total bank loans (net) rose by 3.8%. In the second quarter of 2009, growth of total loans granted was seen only in the group of small banks (with the majority of these loans being directed to enterprises), resulting in a fall in total bank loans granted (net) of 1.2%. Small banks were the only bank group where the share of loans to enterprises had the major share in the sector distribution of loans (54.1%). The shares of loans to enterprises were considerably lower in medium-sized and large banks, standing at 41.6% and 35.6% respectively, while their loans to households accounted for larger shares of 47.8% and 50.7% respectively.

Figure 55 Structure of Bank Peer Group Assets
as at 30 June 2009



Source: CNB.

Apart from the change in the sector distribution of loans, the result of the placement of funds to less risky clients (the government) and the need to maintain business relationships with important clients (enterprises), more significant changes were observed in the maturity structure of loans granted in the first half of 2009. The share of loans with an original maturity shorter than one year rose from 20.6% to 21.3%, a significant rise in loans with the remaining maturity up to one year (10.4%) being observed in the maturity structure of loans with remaining maturity. The amount of loans with remaining maturity over one year fell by 1.5%.

Table18 Structure of Bank Assets
end of period, in million HRK and %

	2007		2008			Jun. 2009		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	51,415.9	14.9	42,671.2	11.5	–17.0	44,848.9	12.1	5.1
1.1. Money assets	4,551.7	1.3	5,394.3	1.5	18.5	5,444.7	1.5	0.9
1.2. Deposits with the CNB	46,864.2	13.6	37,276.9	10.1	–20.5	39,404.2	10.7	5.7
2. Deposits with banking institutions	35,118.0	10.2	35,592.9	9.6	1.4	29,469.7	8.0	–17.2
3. MoF treasury bills and CNB bills	8,748.7	2.5	10,062.5	2.7	15.0	9,530.6	2.6	–5.3
4. Securities and other financial instruments held for trading	8,515.5	2.5	6,840.0	1.8	–19.7	4,532.0	1.2	–33.7
5. Securities and other financial instruments available for sale	11,326.4	3.3	12,480.3	3.4	10.2	11,271.8	3.1	–9.7
6. Securities and other financial instruments held to maturity	3,536.7	1.0	4,798.8	1.3	35.7	4,407.3	1.2	–8.2
7. Securities and other financial instruments not traded in active markets but carried at fair value	700.0	0.2	669.0	0.2	–4.4	945.2	0.3	41.3
8. Derivative financial assets	276.0	0.1	121.9	0.0	–55.8	515.8	0.1	323.0
9. Loans to financial institutions	6,949.8	2.0	5,796.7	1.6	–16.6	4,686.5	1.3	–19.2
10. Loans to other clients	209,319.6	60.7	240,808.0	65.1	15.0	248,181.4	67.2	3.1
11. Investments in subsidiaries, associates and joint ventures	1,703.9	0.5	1,774.1	0.5	4.1	1,934.9	0.5	9.1
12. Foreclosed and repossessed assets	355.7	0.1	391.7	0.1	10.1	493.5	0.1	26.0
13. Tangible assets (net of depreciation)	4,510.4	1.3	4,503.8	1.2	–0.1	4,462.4	1.2	–0.9
14. Interest, fees and other assets	5,471.0	1.6	6,624.6	1.8	21.1	7,206.8	2.0	8.8
15. Net of: Collectively assessed impairment provisions	2,866.2	0.8	3,042.4	0.8	6.1	3,052.9	0.8	0.3
Total assets	**345,081.4**	**100.0**	**370,093.0**	**100.0**	**7.2**	**369,434.0**	**100.0**	**–0.2**

Source: CNB.

Kuna loans, the strong growth in which marked 2007, decelerated in 2008 and trended downward in the last quarter. Similar trends were also observed in 2009. Kuna loans fell by 9.2% in the first half of 2009, due mainly to the decrease in kuna loans to enterprises, and accounted for 30.7% of total loans. Kuna loans with a currency clause rose by 4.7%, and the growth in foreign currency loans to the government units raised total foreign currency loans by 27.7%. The share of kuna loans with a currency clause stood at 54.8%, the remaining 14.5% being accounted for by foreign currency loans. The currency structure of total bank assets experienced changes similar to those seen in bank loans. This was not observed in foreign currency assets where the fall in foreign currency deposits with foreign banks and the CNB[24] offset the strong growth in foreign currency loans. Hence, total foreign currency assets decreased, accounting for 22.8%. Together with kuna assets with a currency clause, foreign currency assets accounted for 62.3% of total bank assets, the largest share of assets being denominated in or indexed to the euro (79.0%). The balance of loans denominated in or indexed to the Swiss franc decreased by 10.3%, and the share of these loans in total foreign currency loans and kuna loans with a currency clause decreased to 20.2%.

Structure of Bank Liabilities

In the first half of 2009, deposits received rose by a modest 0.1% and loans received decelerated by 4.1% (Table 1.5). Corporate deposits decelerated for the third consecutive quarter. After the strong fall of 14.7% in the first quarter and the additional fall of 1.5% in the second quarter, their total fall in the first half of 2009 reached 16.0%. In addition, a fall in deposits was also seen in the government sector (7.8%). Concurrently, deposits of foreign owners and financial institutions grew at the high rates of 16.8% and 18.8% respectively, being the key contributor to the reported growth of total deposits. In contrast, household deposits rose by a modest 0.4%. As they mostly included time deposits, this type of deposit was marked by a significant growth (5.1%), increasing its share in the maturity distribution of deposits (to 76.6% of all deposits). In contrast, deposits in giro and current accounts fell considerably (19.1%), primarily due

[24] The fall in foreign currency and the growth in kuna deposits with the CNB was for the most part the result of the increase in the foreign currency component of required reserves that is set aside in kuna, from 50% to 75% in the first half of 2009.

to their fall in all sectors, with their share in deposits decreasing to 13.5%. Savings deposits fell by 4.3% and made up the remaining 9.9% of deposits.

The fall in total loans received was the consequence of the decrease in loans received from foreign financial institutions (majority foreign owners excluded), caused by the repayment of the foreign loan in one large bank. In this bank, the fall in this source of funds was compensated for by the growth in loans and deposits received from majority foreign owners and as this item decreased in the remaining large banks, the fall in total loans received from majority foreign owners stood at 5.4%. Due to this and due to stronger needs for kuna liquidity, banks turned to domestic borrowing, increasingly using repo auctions of the CNB and then the sources of the CBRD. The share of non-residents in total loans received decreased from 62.8% to 58.9%, while as regards domestic creditors increased shares were reported by the CNB and the CBRD (4.9% and 27.3% respectively of total loans received).

Due to the significant growth in deposits received from majority foreign owners, above all in three banks from the group of large banks, total sources of funds from majority foreign owners rose in the reference half-year period by HRK 3.7bn or 7.1% and thus concurrently increased their share in total received deposits and loans to 18.7%. Of the six large banks, a rise in loans and deposits received from majority foreign owners was observed in three, with small banks in foreign ownership increasingly using this source of financing. Notwithstanding the increase of 31.7%, the share of funds provided by majority foreign owners remained low in small banks (1.7%) because only 7 out of 25 small banks are in foreign ownership. In medium-sized and large banks this indicator stood at 8.3% and 21.6% respectively.

Table 19 Structure of Bank Liabilities

end of period, in million HRK and %

	2007		2008			Jun. 2009		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	20,573.0	6.0	19,270.0	5.2	–6.3	20,436.8	5.5	6.1
1.1. Short-term loans	11,325.6	3.3	8,314.0	2.2	–26.6	9,603.0	2.6	15.5
1.2. Long-term loans	9,247.4	2.7	10,956.1	3.0	18.5	10,833.8	2.9	–1.1
2. Deposits	233,108.0	67.6	247,813.9	67.0	6.3	248,042.5	67.1	0.1
2.1. Giro account and current account deposits	45,284.0	13.1	41,313.1	11.2	–8.8	33,440.7	9.1	–19.1
2.2. Savings deposits	26,859.4	7.8	25,640.1	6.9	–4.5	24,536.6	6.6	–4.3
2.3. Time deposits	160,964.5	46.6	180,860.7	48.9	12.4	190,065.2	51.4	5.1
3. Other loans	31,738.8	9.2	32,862.6	8.9	3.5	29,535.7	8.0	–10.1
3.1. Short-term loans	5,528.8	1.6	7,955.1	2.1	43.9	6,437.1	1.7	–19.1
3.2. Long-term loans	26,210.1	7.6	24,907.5	6.7	–5.0	23,098.5	6.3	–7.3
4. Derivative financial liabilities and other financial liabilities held for trading	367.5	0.1	1,578.3	0.4	329.4	329.7	0.1	–79.1
5. Debt securities issued	3,476.7	1.0	3,392.3	0.9	–2.4	3,220.3	0.9	–5.1
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	3,476.7	1.0	3,392.3	0.9	–2.4	3,220.3	0.9	–5.1
6. Subordinated instruments issued	225.7	0.1	53.3	0.0	–76.4	387.1	0.1	625.7
7. Hybrid instruments issued	636.6	0.2	2,055.7	0.6	222.9	2,790.2	0.8	35.7
8. Interest, fees and other liabilities	11,781.4	3.4	13,139.7	3.6	11.5	13,018.9	3.5	–0.9
Total liabilities	**301,907.8**	**87.5**	**320,165.9**	**86.5**	**6.0**	**317,761.2**	**86.0**	**–0.8**
Total capital	**43,173.6**	**12.5**	**49,927.1**	**13.5**	**15.6**	**51,672.7**	**14.0**	**3.5**
Total liabilities and capital	**345,081.4**	**100.0**	**370,093.0**	**100.0**	**7.2**	**369,434.0**	**100.0**	**–0.2**

Source: CNB.

The issuance of hybrid and subordinated instruments by two large banks made the key contribution to the growth of this source of funds in liabilities, which continued however to account for a small share. As only two large banks issued bonds, the share of debt securities remained low.

Until the end of June 2009, banks redistributed the major portion of the profit generated in 2008 (HRK 4.6bn) – HRK 1.3bn were used for the augmentation of reserves, HRK 2.2bn were channelled into retained earnings and HRK 1.1bn were divided among shareholders. The current year profit and the recapitalisation of five banks made positive contributions to the capital. Hence, its share in assets was high and amounted to as much as 14.0%.

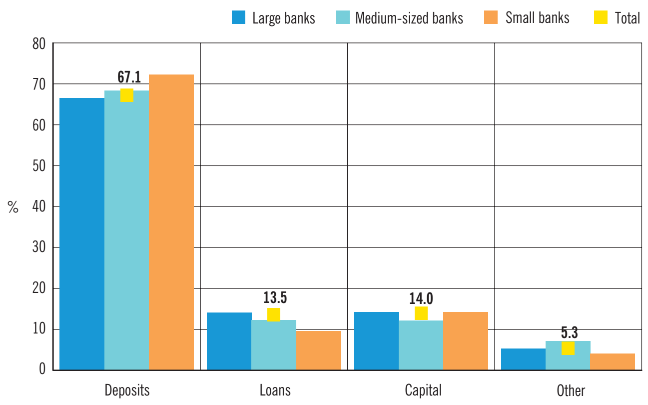
Despite the increase in interest rates on kuna deposits, the kuna component of liabilities continued to stagnate in the first half of 2009, a trend present throughout the whole of 2008. Kuna deposits decreased by HRK 10.4bn (10.4%), due primarily to the fall in deposits in giro and current accounts. Concurrently, foreign currency time deposits went up by a significant 10.6%, the increase in total foreign currency deposits totalling HRK 11.9bn or 8.4%. The share of the kuna component on the liabilities and capital side stood at 44.6%, while the foreign currency component and the kuna component with a currency clause accounted for 51.1% and 4.3% respectively. Considering that bank capital is entirely denominated in kuna, the kuna component in total liabilities (exclusive of capital) was lower and stood at 35.6.%

12.1.2 Bank Capital

In the first half of 2009, total bank capital rose by HRK 1.8bn or 3.5%, showing a trend of deceleration relative to the growth rates observed in previous periods. Specifically, a rise in capital was observed in large and small bank groups, amounting to 8.2% and 3.6% respectively, while total capital in the group of medium-sized banks fell by 28.0%, due primarily to the merger between one medium-sized bank and one large bank in the first quarter of 2009.[25]

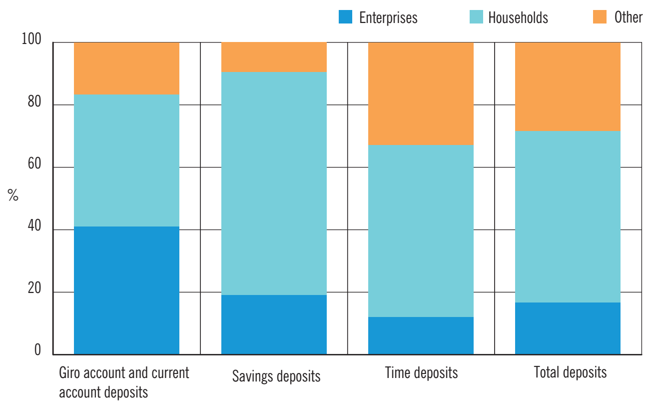
The distribution of the 2008 profit increased retained earnings by HRK 2.2bn or 38.5% and reserves stipulated by the articles of association and other capital reserves by HRK 1.2bn. The share capital rose by a modest by HRK 0.5bn or 1.8% and together with profit generated in the first six months of 2009 positively contributed to total capital and its share in balance sheet total (increasing it from 13.5% to 14.0%). The share capital of large and small banks rose by 0.6 percentage points in each group and accounted for almost the same shares (14.2%), while it decelerated by somewhat less than 1 percentage point in the group of medium-sized banks, remaining the lowest among all bank groups.

Figure 56 Structure of Bank Peer Group Liabilities
as at 30 June 2009



Source: CNB.

Figure 57 Structure of Bank Deposits by Types and Sectors
as at 30 June 2009



Source: CNB.

In the first half of 2009, the regulatory capital rose by the same percentage as total bank capital, i.e. 3.5%. To a small extent, this increase was the result of the rise in its key constituent, core capital, which rose by 1.6% or HRK 0.8bn. Supplementary capital I, which went up by HRK 1.1bn or by as much as 50.9%, contributed much more to the rise of regulatory capital. None of the banks utilised supplementary capital II.

Banks from the group of large banks increased the amount of their regulatory capital.[26] The same trend, although significantly weaker than in the group of large banks, was reported by the group of small banks.[27] Medium-sized banks reported a decrease in their regulatory capital level. The core capital, being the predominant component of regulatory capital, grew both in large and small banks (by 5.9% and 2.8% respectively), while supplementary capital I rose strongly in the group of large banks and fell in the group of small banks (by 10.1%). Both components of regulatory capital decreased in the group of medium-sized banks – core capital went down by 28.1% and supplementary capital I by 60.7%.

[25] Excluding the effect of the merger, the rise in total capital of large banks and medium-sized banks would amount to 3.3% and 5.0% respectively in the reference period.

[26] Excluding the effect of the merger, the rise in regulatory capital of large banks would amount to 3.4%.

[27] Excluding the effect of the merger, the rise in regulatory capital of medium-sized banks would amount to 5.5%.

Table 20 Structure of Bank Total Capital
end of period, in million HRK and %

	2007		2008			Jun. 2009		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Share capital	25,179.3	58.3	28,287.6	56.7	70.6	28,785.3	55.7	1.8
2. Current year profit/loss	4,067.4	9.4	4,612.5	9.2	35.9	2,357.8	4.6	–48.9
3. Retained earnings/loss	4,212.0	9.8	5,694.1	11.4	53.2	7,883.5	15.3	38.5
4. Legal reserves	1,054.3	2.4	969.4	1.9	9.9	1,082.4	2.1	11.7
5. Total reserves provided for by the articles of association and other capital reserves	8,644.2	20.0	10,511.3	21.1	57.8	11,749.0	22.7	11.8
6. Unrealised gains/losses on value adjustments of financial assets available for sale	30.7	0.1	–112.5	–0.2	–868.9	–164.5	–0.3	46.2
7. Reserves arising from hedging transactions	–0.8	0.0	0.0	0.0	–100.0	0.0	0.0	0.0
8. Previous year profit/loss	–13.6	0.0	–35.3	–0.1	1,189.6	–20.9	0.0	–40.8
Total capital	**43,173.6**	**100.0**	**49,927.1**	**100.0**	**59.7**	**51,672.7**	**100.0**	**3.5**

Source: CNB.

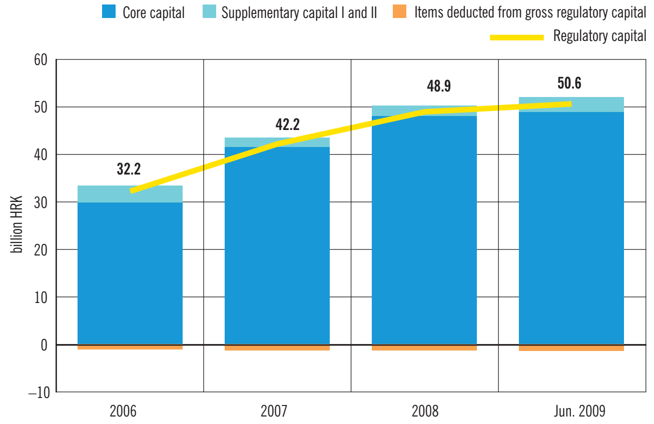
Notwithstanding a modest increase in the net value of risk-weighted assets at the end of the first half of 2009 relative to the end of 2008, the weighted amount of balance sheet assets decreased by 0.3%. Specifically, although the amount of net claims weighted by the highest risk weight of 150% – uncollateralised foreign currency (and indexed) claims on clients with unmatched foreign exchange positions – rose by 6.2% or HRK 6.0bn and thus increased the weighted amount of such claims by HRK 9.0bn, claims weighted by risk weights of 20% and 100% decreased significantly, by 22.9% and 6.4% respectively, contributing to the decrease in the weighted amount of such claims by HRK 1.8bn and HRK 7.9bn respectively.

Following modest changes in the amounts of total and risk-weighted bank assets in the first half of 2009, their ratio remained almost unchanged from the end of 2008 (75.3%).

As well as in the weighted amount of balance sheet assets, a decrease was also observed in the weighted amount of standard off-balance sheet items (guarantees, commitments, etc.) and other off-balance sheet items (interest rate agreements, currency agreements, etc.), total exposure to credit risk, included in the calculation of the capital adequacy ratio, decreased in the first half of 2009 by 1.0%. In light of the fact that the exposure to market risks reduced by almost a third (29.3%), the total capital requirement for all risks went down by 1.5%. With the 3.5% increase in regulatory capital, the capital adequacy ratio rose from 15.16% to 15.93%. The capital adequacy ratio trended up only in large banks and all banks achieved capital adequacy ratios above the legally prescribed minimum of 10%.

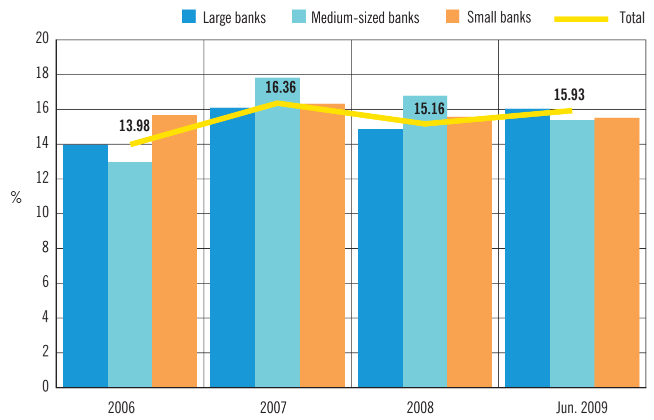
All banks calculated the capital requirement for credit and currency risks. They went down by 1.0% and 9.6% respectively, accounting

Figure 58 Structure of Bank Regulatory Capital
end of period



Source: CNB.

Figure 59 Bank Capital Adequacy Ratio
end of period

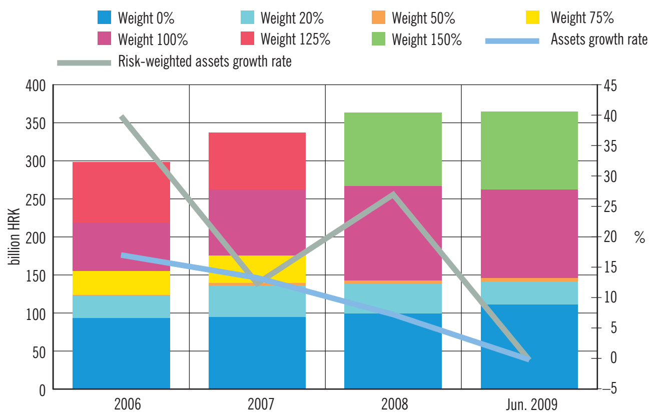


Source: CNB.

for 98.7% and 0.5% of the total capital requirement. The capital requirement for position risks was reported by eight banks (six large and two medium-sized banks) whose trading book activities exceeded the minimum stipulated volume of trading book activities; it went down by 39.4% and accounted for 0.7% of the total capital requirement at the end of the first half of 2009. The highest decrease was observed in the capital requirement for options (73.9%).

Figure 60 Bank Assets Included in Total Risk-Weighted Assets

end of period



Source: CNB.

12.1.3 Quality of Bank Assets

Total bank placements and contingent liabilities exposed to credit risk and subject to classification into different risk categories[28] totalled HRK 417.2bn at the end of the first half of 2009, which was a decrease of 1.2% relative to the end of the previous year.

Total bank placements and contingent liabilities decreased relative to end-2008 on account of the fall in off-balance sheet items, which exceeded the growth in balance sheet placements. Specifically, the assumed liabilities to bank clients were HRK 7.6bn (or almost 11.0%) lower at end-June 2009 than at end-2008, mostly on account of the decrease in credit lines and commitments. Concurrently, owing to stronger lending to government units, balance sheet placements rose by HRK 2.4bn or 0.7%.

Notwithstanding the decrease or very small growth in loans granted to the majority of institutional sectors and owing to a greater volume of lending to government units, the share of gross loans continued growing in the distribution of placements and contingent liabilities by instrument, reaching 62.3% (up 2.5 percentage points) of total placements and contingent liabilities. Due to the fall in bank deposits held with other financial institutions (HRK 3.9bn or 5.4%), which was in part the consequence of the decrease in the prescribed minimum coverage ratio between foreign currency liabilities and foreign currency claims from 28.5% to 25% and then to 20% in the first quarter, the share of deposits at end-June 2009 fell to 16.4% of placements and contingent liabilities. Debt securities and other available-for-sale assets fell by HRK 1.5bn (8.1%) relative to the end of 2008, the main cause for this being the reclassification of several types of securities into the portfolio of loans and receivables in the second quarter of 2009. This also resulted in a negligible fall in the share of that portfolio of securities in total placements and contingent liabilities (to 4.0%). The shares of other balance sheet items in the distribution of placements and contingent liabilities changed only slightly so that balance sheet placements accounted for 92.9% of total placements and contingent liabilities at end-June 2009. The remaining 7.1% were accounted for by contingent liabilities whose share in the distribution of total placements and contingent liabilities fell by 1.6 percentage points relative to the end of 2008. Looking at placements by activities, the concentration remained the largest in the household sector to which banks granted 34.9% of total placements and contingent liabilities at the end of the first half of 2009.

The lower amount of deposits, debt securities and other held-to-maturity and available-for-sale assets, and off-balance sheet contingent liabilities, i.e. placements usually estimated by banks as those of highest quality, contributed to the decrease in fully recoverable placements and contingent liabilities (category A placements) of HRK 8.6bn (2.1%) relative to end-2008. Concurrently, following the changes in the portfolio of loans, bad placements (partly recoverable and irrecoverable placements distributed into B and C risk categories) grew by a sizeable HRK 3.3bn or 23.5%. The bulk of the increase in bad placements and contingent liabilities, totalling HRK 2.9bn, was associated with risk category B. Hence, the share of placements distributed into that risk category trended up from 2.3% at end-2008 to 3.1% of gross placements and contingent liabilities at end-June 2009. The share of placements and contingent liabilities from risk category A declined from 96.7% to 95.8%, whereas, due to the increase of 10.0%, the share of placements and contingent liabilities from risk category C in gross placements and contingent liabilities went up from 1.0% to 1.1%.

[28] Pursuant to the Decision on the classification of placements and contingent liabilities of banks (OG 17/2003, 149/2005 and 74/2006) and in accordance with IAS 39, bank placements and contingent liabilities are classified into risk categories: A – fully recoverable placements and contingent liabilities, B – partly recoverable placements and contingent liabilities and C – irrecoverable placements and contingent liabilities.

Table 21 Classification of Bank Placements and Contingent Liabilities by Risk Categories
end of period, in million HRK and %

	2007		2008		Jun. 2009	
	Amount	Share	Amount	Share	Amount	Share
Fully recoverable placements and contingent liabilities (category A)	384,204.3	96.9	408,397.9	96.7	399,841.3	95.8
Partly recoverable placements and contingent liabilities (category B)	7,946.5	2.0	9,865.7	2.3	12,754.4	3.1
Irrecoverable placements and contingent liabilities (category C)	4,270.3	1.1	4,214.6	1.0	4,634.3	1.1
Total	**396,421.2**	**100.0**	**422,478.1**	**100.0**	**417,230.0**	**100.0**

Source: CNB.

The share of bad placements and contingent liabilities in total placements and contingent liabilities grew at the highest rate in large banks, from 2.9% at end-2008 to 4.0% at end-June 2009, which was a consequence of the 27.2% growth in bad placements and contingent liabilities in this group of banks. The share of bad placements and contingent liabilities in total placements and contingent liabilities stood at 4.0% in medium-sized banks, with the growth rate in bad placements and contingent liabilities in this group amounting to 20.9%. In small banks, bad placements and contingent liabilities grew by 5.4%, increasing their share in total placements and contingent liabilities from 6.3% to 6.7%.

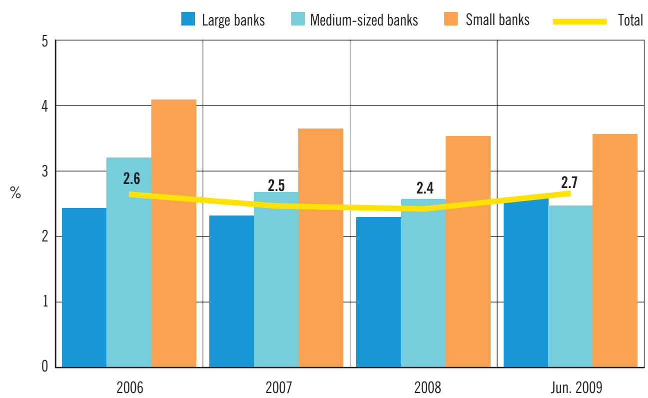
Table 22 Ratio of Total Bank Value Adjustments and Provisions to Total Placements and Contingent Liabilities
end of period, in million HRK and %

	2007	2008	Jun. 2009
1. Total value adjustments against placements and provisions for contingent liabilities	9,774.6	10,230.1	11,096.3
1.1. Value adjustments against placements and provisions for contingent liabilities	6,290.3	6,555.2	7,479.2
1.2. Collectively assessed impairment provisions	3,484.3	3,674.9	3,617.1
2. Total placements and contingent liabilities	396,421.2	422,478.1	417,230.0
3. Relative ratio: total value adjustments and provisions/total placements and contingent liabilities	2.5	2.4	2.7

Source: CNB.

Banks classified almost one half of all bad placements and contingent liabilities into risk category B-1, expecting to recover more than 70% of contracted claims. The rise of almost HRK 2.0bn (31.5%) in placements classified into this risk category contributed the most to total growth in bank bad placements in the reference period. Somewhat faster was the growth in placements classified into risk category B-2 (32.9% or HRK 0.9bn); this mostly includes claims for which the collection period is extended to two years and the recoverable amount estimated between 30% and 70% of the contractual amount. Placements classified into risk category B-3 fell by a negligible 0.1%. The possible further deterioration in the recovery of claims is also indicated by the 13.3% rise in placements being overdue for more than 90 days for which banks, on the basis of other criteria, above all collateral, expect that they will be repaid in full and classified into risk category A.

Figure 61 Ratio of Total Bank Peer Group Value Adjustments and Provisions to Total Placements and Contingent Liabilities
end of period



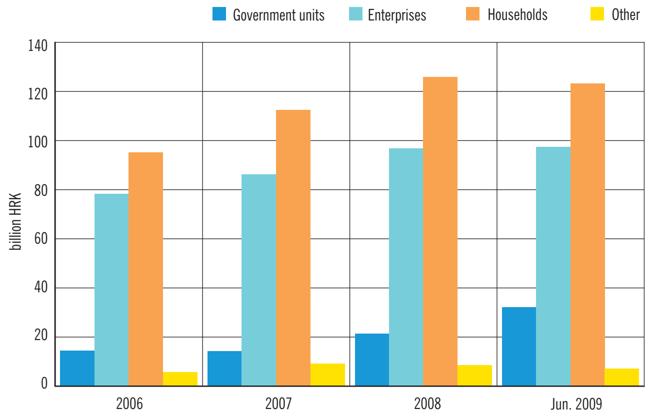
Source: CNB.

Bad placements and contingent liabilities are subject to value impairment by the amount of individually identified loss due to the impossibility of full recovery (categories B and C), while placements and contingent liabilities classified into risk category A are subject to collectively assessed impairment provisions. The total amount of such value adjustments and provisions rose by 8.5% (to HRK 11.1bn) relative to end-2008 on account of the 14.1% rise in the amount of value adjustments and provisions for bad placements. At the same time, collectively assessed impairment provisions went down by 1.6% due to the narrowing of the base, i.e. placements and contingent liabilities from risk category A. The increase in total value adjustments and provisions and the concurrent decrease in total placements and contingent liabilities increased their relative ratio to 2.7%. This ratio grew from 2.3% to 2.6% in large banks, decelerated from 2.6% to 2.5% in medium-sized banks and remained at 3.6% in small banks, the value it also had at end-2008.

Bank loans granted (gross) went up by HRK 7.1bn in the first half of 2009, totalling HRK 259.8bn and growing at the rate of 2.8%. The slowdown in loan growth is attributed to the decline in bank lending activities in the second quarter of 2009, i.e. the negative quarterly growth rate of gross loans (1.0%), observed for the first time in the past ten years.

Bank lending activities in the first half of 2009 were mainly directed to the financing of government needs. Hence, relative to end-2008, the growth in loans was almost entirely accounted for by the rise in loans to government units (HRK 10.5bn or 48.9%). Loans to enterprises (HRK 0.6bn or 0.7%) and non-profit institutions (HRK 10.6m or 1.8%) grew at a much lower rate, while the volume of lending to other sectors decreased. Loans to households were almost HRK 2.8bn (2.2%) lower, while loans to financial institutions and non-residents decreased by HRK 1.1bn (19.2%) and HRK 174.7m (8.7%) respectively.

Figure 62 Bank Loans by Type of User
end of period



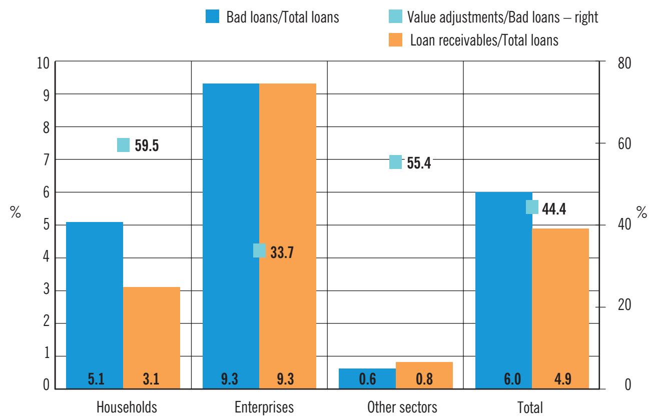
Source: CNB.

Hence, the slowdown in loans granted coincided with the deterioration in the quality of the loan portfolio generated by the jump in bad loans. Relative to end-2008, banks estimated HRK 3.1bn or 24.9% more loans as partly recoverable or irrecoverable, with bad loans totalling HRK 15.6bn at end-June and accounting for 6.0% of gross bank loans. The largest increase in bad loans was reported in the second quarter of 2009, and their quarterly growth rate of 15.4% was the highest in the past ten years. As a result, the share of bad loans in total loans grew from 4.9% at end-2008 to 5.1% at the end of the first quarter and then to the above-mentioned 6.0% at end-June 2009.

The bulk of the increase in bad loans included loans classified into risk categories B-1 (HRK 1.8bn or 35.7%) and B-2 (HRK 0.9bn or 33.5%), which is an indication of a significant deterioration in a debtor's timeliness or increased delinquency in settling liabilities to banks. The possible further deterioration in the quality of loans is also suggested by the rise in loans (HRK 0.6bn or 13.3%) that, notwithstanding a delinquency in the payment of principal longer than 90 days, banks have estimated as fully recoverable and classified into risk category A due to the high-quality collateral.

The key contributors to the change in the quality of bank loans were the developments in the portfolio of loans granted to households and enterprises, accounting for a total of 84.4% of gross bank loans. Relative to the end of 2008, bad loans in these two sectors grew at almost the same rates: 25.5% (HRK 1.8bn) in enterprises and 25.3% (HRK 1.3bn) in households, and considerably accelerated in the second quarter of 2009. The share of bad loans in total loans to the enterprise sector rose by 1.8 percentage points, to 9.3%, in the reference half-year period. In the household sector, this share rose by 1.1 percentage points, totalling 5.1%.

Figure 63 Loan Quality
as at 30 June 2009



Source: CNB.

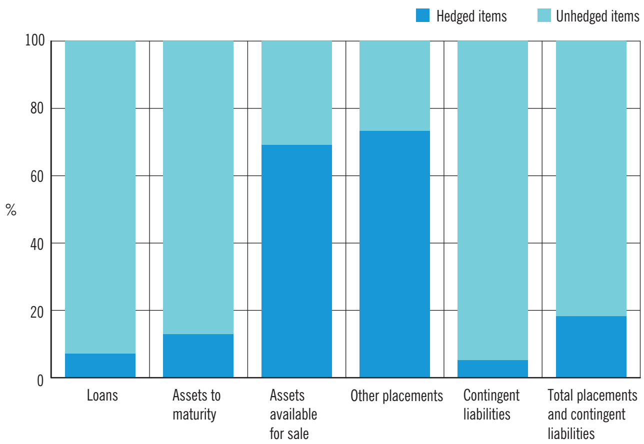
Total household loans estimated fully recoverable by banks and classified into risk category A were HRK 4.0bn (3.3%) lower at end-June 2009 than at end-2008. In addition to regular repayments, the decline in these loans was also affected by the deterioration in the quality of loans granted to households, i.e. banks' estimates that a portion of loans granted to households no longer meets the conditions for the classification into risk category A. Among household loans, the highest value of the share of partly recoverable and irrecoverable loans was in mortgage loans (11.8%) and cash loans, credit lines and other loans (7.7%), and the smallest in home loans (2.5%).

Total due but unpaid loan receivables[29] rose by HRK 3.3bn (35.3%), reaching HRK 12.7bn or 4.9% of gross loans. Of the total amount of due but unpaid loan receivables, HRK 7.6bn were accounted for by B and C loans, and the remaining HRK 5.1bn by A loans. The rise in total but unpaid loan receivables was mostly brought about by the growth in receivables due from enterprises, which, after the increase of 43.7%, accounted for 8.8% of loans granted to enterprises. Due but unpaid household loan receivables rose by 19.6%, the majority of this increase being accounted for by due but unpaid receivables from cash loans, credit lines and other loans (up 21.7%), while the largest increase in relative terms was observed in credit card loans (37.7%). After a modest increase, the share of due but unpaid household loans stood at 3.1%;the highest value of this share was seen in cash loans, credit lines and other loans (5.5%).

At end-June 2009, banks set aside HRK 6.9bn for the value adjustment of loans, an increase of HRK 0.8bn (13.9%) relative to end-2008. The growth in value adjustments was lower than the growth in bad loans, with the coverage ratio between bad loans and value adjustments decreasing from 48.7% at end-2008 to 44.4% at end-June 2009. This contributed to the continuation of its year-long downward trend. The coverage ratio between bad loans and value adjustments decreased the most for loans to enterprises (from 38.1% to 33.7%) and loans to households (from 63.8% to 59.5%). As for household loans, the best coverage ratio between bad loans and value adjustments was seen in loans that are usually not covered by quality insurance instruments: credit card loans (80.0%) and cash loans, credit lines and other loans (68.2%).

Total placements and contingent liabilities exposed to currency-induced credit risk (CICR),[30] i.e. all placements and contingent liabilities in foreign currency and indexed to foreign currency, amounted to HRK 241.6bn[31] or 59.0% of total net placements and contingent liabilities at end-June 2009. Relative to end-2008, placements and contingent liabilities exposed to CICR went up by HRK 3.4bn or 1.4%, pushing up their share in total net placements and contingent liabilities by 1.7 percentage points. The growth in foreign currency and indexed loans to government units and enterprises caused a rise in those placements and contingent liabilities not hedged against the effects of the CICR of almost HRK 9.5bn or 5.1% relative to the balance at end-2008. Concurrently, owing to the decrease in loans to other sectors (except for financial institutions) and contingent liabilities and other types of placements, the hedged amount of total net placements and contingent liabilities fell by HRK 6.1bn or 3.3%. As a result, the share of net placements and contingent liabilities unhedged against CICR rose from 78.9% at end-2008 to 81.7% at end-June, i.e. the share of net placements and contingent liabilities hedged against CICR decreased from 21.1% to 18.3%. The analysis of individual types of placements shows that contingent liabilities were for the most part unhedged against the effects of CICR (94.7%) and they were followed by loans whose unhedged share stood at 92.8%. Of total net placements and contingent liabilities to households, the largest sector, 95.6% was not hedged against the effects of CICR.

Figure 64 Structure of Net Placements Exposed to CICR
as at 30 June 2009



Source: CNB.

At end-June 2009, 61.3% of net placements and contingent liabilities of large banks was exposed to CICR – 82.4% of them were unhedged, i.e. granted to debtors with unmatched foreign currency positions. In contrast, medium-sized and small banks had a smaller share of net placements and contingent liabilities exposed to CICR, 46.2% and 48.1% respectively. There was no hedging in the 78.6% of net placements and contingent liabilities of medium-sized banks exposed to the effects of CICR, whereas in small banks this share stood at 75.4%.

Of the total amount of bank placements (excluding contingent liabilities), 46.0% were covered by quality insurance instruments, which was an insignificant increase relative to the end of 2008. The most important

[29] For loans that did not fall due in their entire amount, only the portion that fell due was included.

[30] The risk that, in the case of a weakening of domestic currency, clients that do not have stable foreign currency income will not be able to repay their foreign currency or foreign currency indexed liabilities.

[31] Net book value, i.e. the amount reduced by value adjustments.

instrument of collateral for bank placements[32] was residential real estate – the share of placements collateralised by residential real estate property in total collateralised placements stood at 37.0%. Then came other instruments (as laid down by the internal bylaws of banks) with a share of 23.3% of net placements, followed by commercial real estate (21.4%), guarantees or securities of domestic government units and the CNB (12.1%) and deposits (6.2%). The value of collateral covered 88.5% of the value of collateralised placements, a modest decrease relative to the end of 2008.

Large banks had the best collateralised to total placements ratio of 48.7%, followed by small banks (39.2%) and medium-sized banks (28.2%). In large banks, residential real estate was the predominant instrument of collateral, while in other bank groups this role was taken by commercial real estate.

12.1.4. Quality of Bank Earnings

At the end of June 2009, bank pre-tax profit totalled HRK 2.9bn, a decrease of HRK 476.7m or 14.3% relative to the end of the first half of 2008.[33] Since bank operating profit was somewhat lower than HRK 4.0bn and 10.8% higher than in the same period in the previous year, weaker operating results were above all the consequence of the rise in expenses on loss provisions. The decrease in bank profit in the reference period was also the result of the decline in net interest income by 3.1% caused by a growth in interest expenses (24.9%) stronger than in interest income (11.9%).

Relative to June 2008, all bank groups reported a decrease in total profit and the profitability of their operations. However, the smallest fall in pre-tax profit was reported by large banks, by about 10.0%. Large banks thus continued to generate the bulk of total bank pre-tax profit, 93.0%. The profit of medium-sized banks went down by 58.0% and the profit of small banks by 27.1% relative to the end of the first half of 2008. These changes additionally reduced the share of profit of medium-sized and small banks in total bank profit, from 7.6% at end-June 2008 to 3.7% at end-June 2009 in medium-sized banks and from 3.8% to 3.3% in small banks. The shares of these bank groups in total bank profit were much lower than the shares of their assets in total bank assets. The operating results of medium-sized banks in the reference period, relative to the same period last year, were partly affected by the merger between one bank from this group and one large bank and partly by the rise in general administrative expenses and expenses on loss provisions. The rise in these expenses brought about a decrease in the profit of small banks as well.

Of 34 banks, 24 banks achieved total pre-tax profits of HRK 2,937.8m, while ten banks reported losses totalling HRK 73.3m. The share of assets of banks that operated with losses made up almost 6.0% in total bank assets at the end of June 2009.

Table 23 Bank Income Statement
in million HRK and %

	Jan.-Jun. 2008	Jan.-Jun. 2009	
	Amount	Amount	Change
Total interest income	10,330.7	11,557.3	11.9
Total interest expenses	5,511.9	6,886.4	24.9
Net interest income	4,818.7	4,670.9	–3.1
Total income from fees and commissions	2,116.2	2,083.4	–1.6
Total expenses on fees and commissions	655.4	618.6	–5.6
Net income from fees and commissions	1,460.8	1,464.7	0.3
Other non-interest income	1,234.4	1,825.9	47.9
Other non-interest expenses	340.8	247.4	–27.4
Net other non-interest income	893.6	1,578.4	76.6
Net non-interest income	2,354.4	3,043.2	29.3
General administrative expenses and depreciation	3,594.9	3,749.2	4.3
Net operating income before loss provisions	3,578.3	3,964.9	10.8
Expenses on value adjustments and provisions for identified losses	240.5	1,158.2	381.6
Expenses on collectively assessed impairment provisions	–3.5	–57.8	1,569.2
Total expenses on loss provisions	237.0	1,100.4	364.2
Income/loss before taxes	3,341.2	2,864.6	–14.3
Income tax	590.3	506.7	–14.2
Current year profit/loss	2,750.9	2,357.8	–14.3

Source: CNB.

[32] Pursuant to the Decision on supervisory reports of banks (OG 115/2003, 29/2006, 46/2006 and 74/2006) high quality instruments of collateral are residential and commercial real estate property, deposits, guarantees or securities of domestic government units and the CNB, government units and central banks of OECD member states, domestic banks and banks of OECD member states but also all other instruments specified as high quality collateral instruments in internal bank bylaws.

[33] A more substantial decrease in profit was last reported at the end of 2001 when relative to the end of 2000 the pre-tax profit fell by 14.03%. The bulk of this decrease was due to the losses in Riječka banka.

Net income of banks (the sum of net interest and net non-interest income) rose by 7.5% or HRK 541.0m relative to the end of the first half of 2008, totalling HRK 7.7bn. Above all, this was the result of the rise in other non-interest income, i.e. the rise in profit from derivatives trading and profit from foreign exchange trading. The observed growth in other non-interest income, additionally spurred by the decrease in other non-interest expenses, contributed to the change in the structure of net bank income (increasing the share of net other non-interest income from 12.5% to 20.5%). In contrast, the shares of the two major components of net bank income decreased: net interest income went down from 67.2% to 60.6% (due to the fall of 3.1%) and net income from fees and commissions went down to 19.0% (due to a fall that was somewhat higher than 1 percentage point).

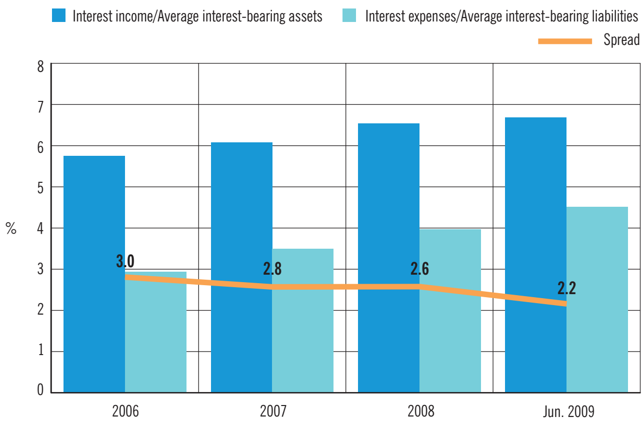
Total interest income stood at HRK 11.6bn at the end of June 2009, up HRK 1.2bn or 11.9% relative to the end of June 2008. Specifically, interest income grew half as much as interest expenses due to the fall in the volume of placements, especially loans. The decrease in the base resulted in lower interest income from this source, with income from deposits granted decreasing by almost 60% relative to the end of June 2008. Banks offset this decrease by increasing all other components of interest income, especially the income from loans granted (by 15.7%) which accounted for the major item (86.6%) of total interest income.

Under the circumstances of the slower growth of placements and contingent liabilities, interest income from loans granted to all sectors, except government units and financial institutions, went up at a slower rate than in the first half of 2008. The greater volume of lending to the government at the end of 2008 and in the first half of 2009 was reflected in the 64.2% increase of interest income from loans to government units, while in the sector of financial institutions the rise of interest income from loans was 74.9%. Since the growth of loans to households and enterprises slowed down in 2008 and the first half of 2009 (loans to enterprises rose by 0.7% and loans to households decreased by 2.2% in the reference period), the increase in interest income from this basis may be attributed to the higher price of loans and especially the increase in interest rates on long-term loans. Looking at the structure of interest income from loans by institutional sector, households accounted for the largest portion of income (51.4%). However, relative to the end of the first half of 2008, this share went down by 3.1 percentage points. By size of share in interest income from loans, the next to follow was income from loans to enterprises (36.2%), which decreased by 0.3 percentage points. Only income from loans granted to government units and financial institutions (up from 6.6% to 9.3% and from 1.5% to 2.3% respectively) increased its share in total income from loans.

The increase in the average interest expenses was higher than the rise in the average interest income and thus contributed to the continuation of the persistent downward trend in the spread.[34] The average interest income by the unit of interest-bearing assets attained its highest level (6.7%) in the last five years, indicating a level of average income by the same unit of assets being higher than in all previous periods. Specifically, the reason for the continued narrowing of the spread lies in the substantially slower growth dynamics of the average interest income by the unit of interest-bearing asset as compared with the growth dynamics of the average interest expenses by the unit of interest-bearing liabilities at the end of the first half (4.5%).

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

end of period



Source: CNB.

Net income from fees and commission grew at the rate of 0.3%, which was much lower than at the end of June 2008 (13.3%). This was a consequence of the parallel fall in income from (by HRK 32.8m or 1.6%) and expenses on (by HRK 36.8m or 5.6%) fees and commission. The decrease in income from fees and commissions was entirely the result of the fall in income from fees for payment services provided to enterprises, which went down by HRK 55.1m or 9.4%. Although at slower rates than in previous reporting periods, all other components of income from fees and commissions, except for net exchange rate fluctuations (which were insignificant), continued to trend upward.

The crucial contribution to the rise in net bank income in the first six months of 2009 came from the growth in other non-interest

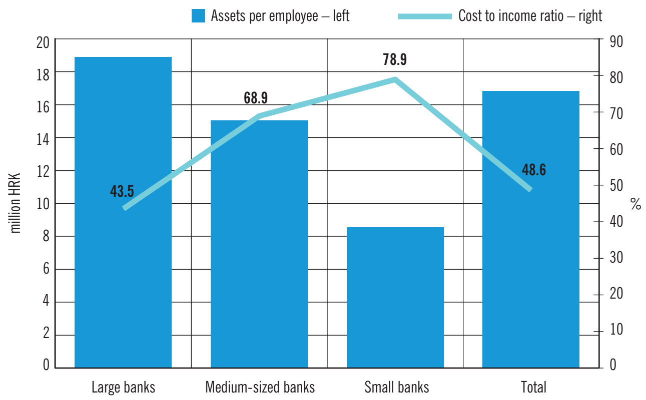
[34] The spread was calculated as the difference between interest income earned on average interest-bearing assets and interest expense incurred on average interest-bearing liabilities.

income which, together with the decrease in other non-interest expenses, resulted in HRK 688.7m (29.3%) higher net non-interest income. The bulk of this income was derived from the realised profit from trading activities amounting to almost HRK 2.0bn and partly offset by the loss from exchange rate fluctuations (HRK 684.6m[35]). The decrease in other income categories resulted in other non-interest income being HRK 591.4m (47.9%) higher in the first half of 2009 than in the same period of the previous year. Total increase in other non-interest income of banks was for the most part (92.2%) the result of their rise in large banks (by 48.8%) and partly in small banks (by 115.3%). In contrast, other non-interest income decreased by 8.1% in medium-sized banks. At end-June 2009, all bank groups reported profit from trading activities. Derivatives trading continued to predominate in the trading activities of large banks, accounting for HRK 1.4bn of their profit. The second largest was trading in kuna money assets, accounting for HRK 970m of large banks' profits. Foreign exchange trading predominated in medium-sized and small banks, making up 80.4% and 98.4% respectively of total trading profit in these banks. Profits of medium-sized and small banks from this basis were almost equal (HRK 76.5m and HRK 75.5m respectively). However, relative to end-June 2008, this caused the foreign exchange trading profit of medium-sized banks to increase by 17.0% and that of small banks to decrease by 76.5%.

Costs (including general administrative expenses and depreciation) were 4.3% higher at end-June 2009 than at end-June 2008 due primarily to the growth in other administrative expenses (9.3%) and depreciation expenses (6.0%). Net bank income halved (7.5%) in the first half of 2008 relative to previous years. As a result, banks strove to slow down the growth of their costs by the same amount, which increased their cost effectiveness and decreased their cost to income ratio from 50.1% to 48.6%. In a review of the value of this indicator in the peer groups of banks it is evident that only large banks raised their cost effectiveness. The value of this indicator reduced only in this bank group, totalling 43.5%. In contrast, this indicator deteriorated in the other two bank groups, remaining the largest in small banks (78.9%) and standing at 68.9% in medium-sized banks.

Figure 66 Cost Effectiveness by Bank Peer Groups

as at 30 June 2009



Source: CNB.

In the first half of 2009, the number of bank employees went down by 105, ending June at 21,960. Owing to the concurrent fall in assets, the decline in the number of bank employees did not affect the asset-to-employee ratio of banks which remained the same as at the end of 2008 (HRK 16.8m). Only large banks maintained the assets to employee ratio above its average value (HRK 18.8m). In medium-sized and small banks, this ratio stood at HRK 15.0m and HRK 8.6m respectively.

Figure 67 Return on Average Assets by Bank Peer Groups

end of period

Source: CNB.

Total expenses on loss provisions were more than three times higher in the reference period than in the same period in the previous year, prompting banks to allocate HRK 863.3m from their net operating income. This was due to the rise in expenses on value adjustments and provisions for identified losses on an individual basis of HRK 917.7m, while expenses

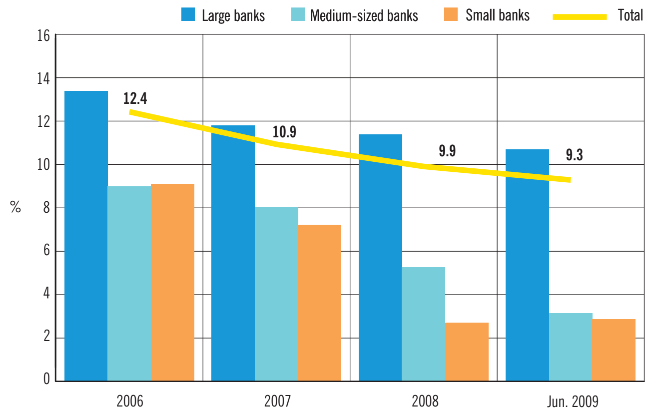
[35] Banks mostly use derivatives as a hedge against currency risk (due to the complexity of the hedge accounting rules, they are reported as held-for-trading derivatives). Hence, profit from derivatives trading should be viewed in the context of exchange rate differentials.

on collectively assessed impairment provisions fell by HRK 54.3m. The increase in expenses on value adjustments and provisions for identified losses on an individual basis may be linked to the decline in the quality of total placements and contingent liabilities, i.e. the increase in bad placements and contingent liabilities, primarily bad loans (risk categories B and C). Concurrently, the 2.1% fall in placements and contingent liabilities from category A in the first six months of 2009 (they rose by 1.4% in the same period of 2008) was the key contributor to the decrease in expenses on collectively assessed impairment provisions.

The return on average assets (ROAA[36]) decreased by 0.4 percentage points at the end of the first half of 2009 relative to the end of the first half of 2008 due to the fall in bank profit by 14.3%. The decrease in profit was mainly caused by the rise in expenses on provisions for identified losses at a rate higher than that observed in net bank income. The ROAA was higher than one only in large banks (1.8%), while at the end of the first half of 2008 it had stood at 2.2%. The ROAA in medium-sized banks fell from 1.1% in June 2008 to 0.5% at the end of June 2009. Small banks decreased their annual ROAA by 0.3 percentage points or to 0.6%.

Figure 68 Return on Average Equity by Bank Peer Groups

end of period



Source: CNB.

The years-long downward trend of the return on average equity (ROAE) continued in the reference period. At the end of the first half of 2009, the ROAE amounted to 9.3%. Relative to June 2008, this indicator fell by 2.8 percentage points due to the fall in current year profit and the rise in capital generated by the retention of major shares of profit earned in 2008 and the recapitalisations. This indicator reduced in all bank groups – in large banks from 13.5% to 10.7%, in medium-sized banks from 7.7% to 3.1% and in small banks from 4.8% to 2.9%.

12.1.5 Bank Liquidity

After halving in 2008 relative to the previous year, the growth in total received deposits stood at 0.1% nominally in the first half of 2009. Although the deposits balance remained almost unchanged relative to end of 2008, significant changes were observed in the sectoral, maturity and currency structures of deposits.

The household sector continued to be the largest source of deposits, accounting for 55.0% of total received deposits. Relative to the end of 2008, household deposits went up by only HRK 484.5m or 0.4%. Corporate deposits declined by HRK 7.9bn or 16.0% in the same period, which contributed to a further fall in the share of these deposits in total deposits from 19.9% to 16.7%. Banks used the increase in deposits of domestic and foreign financial institutions (by a total of HRK 8.3bn) to offset the fall in corporate deposits, which contributed to the increase in the share of non-resident deposits by another 2.1 percentage points or to 17.2%. Owing to these changes, non-resident deposits became the second largest source of deposits in banks. Deposits of government units and non-profit institutions also declined, by 7.8% and 3.7% respectively, which made no significant impact on the amount of their shares.

Relative to the end of 2008, all sectors reported smaller or larger decreases in the balance of sight deposits, i.e. in giro and current account balances and savings account balances. The decrease in sight deposits was offset by the increase in time deposits in all sectors, except in the sector of enterprises. Hence, the first half of 2009 saw the continuation of the upward trend in the share of time deposits in total deposits, by 3.6 percentage points or to 76.6%, while the share of giro and current account deposits decreased from 16.7% to 13.5% and the share of savings deposits fell from 10.4% to 9.9%. The rise in time deposits to the detriment of sight deposits generally contributes to the stability of sources of financing. However, it should be noted that the decrease in sight deposits in the last year was part of an overall decrease in deposits in all sectors (except for the government sector), and especially in the sector of enterprises, which saw a decrease in all types of deposits.

The change in the currency structure of deposits in the first half of 2009 manifested itself in the continuation of the restructuring process, which favoured the increase in foreign currency deposits, by HRK 11.9bn or 8.4%. As a result,

[36] ROAA is calculated from pre-tax profit, and ROAE from after-tax profit.

their share in total deposits rose by another 4.7 percentage points or to 61.6%. In contrast, kuna deposits and deposits in kuna tied to the currency clause fell by HRK 10.4bn and HRK 1.2bn, causing their shares to shrink. The share of kuna deposits decreased from 40.3% to 36.1%, and the share of deposits in kuna tied to the currency clause fell by 0.5 percentage points, accounting for 2.3% of all deposits. The major portion of the increase in foreign currency deposits or deposits tied to the currency clause was accounted for by deposits in euros (HRK 10.7bn), which, after the said increase, accounted for about 55.9% of all deposits, while kuna deposits accounted for 36.1%.

At end-June 2009, the ratio of loans granted to deposits received exceeded 100% for the first time in the past ten years. The key contributors to this were large banks, in which this ratio remained the largest, totalling 104.5%. Medium-sized banks (92.7%) and small banks (88.2%) continued to account for a larger share of received deposits than loans granted. With loans received decreasing at a rate higher than that observed in assets, the share of received loans in assets went down by 0.6 percentage points, a trend present since 2005. Net interbank position (the difference between the funds placed with financial institutions and the funds received from them relative to total assets) reduced additionally, due above all to the fall in deposits with banking institutions and then the decrease in loans received from non-residents.

Table 24 Bank Liquidity Ratios

end of period, in %

	2007	2008	Jun. 2009
Loans granted/Deposits received	92.8	99.5	101.9
Loans received/Total assets	15.2	14.1	13.5
Net interbank position	5.2	–5.2	–8.1

Source: CNB.

In the first half of 2009, received bank loans went down by HRK 2.2bn (4.1%) owing to a HRK 3.2bn decrease in loans received from foreign financial institutions. The major portion of this decrease (HRK 2.0bn) included the repayment of loans to other foreign financial institutions, i.e. those not owned by majority foreign owners, while loans from majority foreign owners, after an increase in hybrid and subordinated instruments by HRK 1.1bn, declined by a total of HRK 1.2bn (5.4%). Banks generated some of the needed funds by increasing their borrowings in the domestic financial market (CNB repo loans and CBRD loans), thus increasing their liabilities to domestic financial institutions by HRK 1.2bn or 6.1%, which contributed to the rise in the share of domestic financial institutions.

Table 25 Structure of Received Loans

end of period, in million HRK and %

	2007		2008			Jun. 2009		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans from government units	183.3	0.4	125.7	0.2	–31.4	95.3	0.2	–24.3
Loans from financial institutions	20,573.0	39.3	19,270.0	37.0	–6.3	20,436.8	40.9	6.1
Loans from enterprises	189.4	0.4	3.5	0.0	–98.1	4.1	0.0	15.4
Loans from foreign financial institutions	31,117.8	59.5	32,603.9	62.5	4.8	29,364.3	58.8	–9.9
Loans from other non-residents	248.3	0.5	129.3	0.2	–47.9	72.0	0.1	–44.3
Total loans received	52,311.8	100.0	52,132.6	100.0	–0.3	49,972.4	100.0	–4.1
Loans from majority foreign owner	17,600.8	33.6	22,735.6	43.6	29.2	21,503.9	43.0	–5.4

Source: CNB.

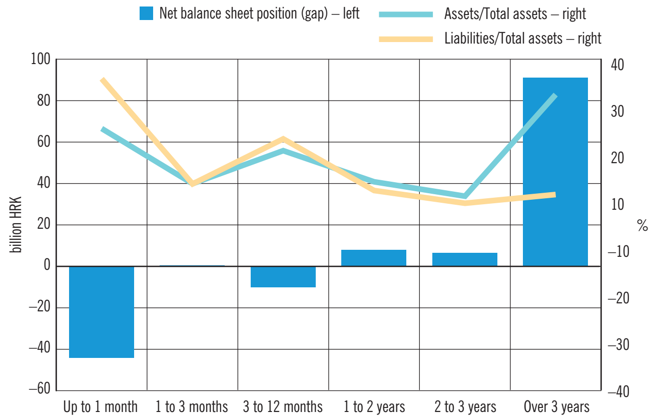
At end-June 2009, the maturity structure mismatch or the negative cumulative gap[37] in the short-term maturity (up to one year) continued to mark banks' balance sheets. However, relative to end-2008, the mismatch narrowed in two categories of the remaining short-term maturity, while the maturity category of one to three months showed a positive gap.

The negative short-term cumulative gap decreased by a total of HRK 11.4bn (17.5%), or to HRK 53.7bn, which was above all the result of the decrease in short-term liabilities by HRK 9.1bn or 3.6% and the rise in short-term assets by HRK 2.3bn or 1.2%. The decrease in short-term liabilities is attributed to the above-mentioned decrease in sight deposits and time deposits with the shortest maturity (up to one month) and received loans and issued debt securities with the remaining maturity of three months to up to one year. The increase in short-term assets was mainly the

[37] This represents the difference between assets (net) and liabilities with the same period until maturity.

consequence of the rise in short-term loans which managed to offset the decrease in the shortest maturity deposits with banking institutions and the decrease in the portfolio of securities. Owing to these changes, the share of short-term assets in total bank assets increased by a modest 0.7 percentage points, or from 50.5% to 51.2%, while the share of short-term liabilities in total assets went down from 68.3% to 66.0%. The mismatch was the largest and decreased by HRK 7.9bn for the shortest maturity (up to one month), and by HRK 2.1bn for maturities between three months and up to one year. However, the mismatch for maturities between one and three months went from red to black, changing from minus HRK 918.1m to plus HRK 524.5m.

Figure 69 Asset and Liability Maturity Match or Mismatch
as at 30 June 2009



Source: CNB.

12.2 Business Operations of Housing Savings Banks

As at end-2008, there were five housing savings banks operating in the Republic of Croatia at end-June 2009. Their total assets decreased, the trend also observed in bank assets, but at much higher rate, of 5.3%. As a result, the share of assets of housing savings banks in total banking sector assets, on a downward trend since the end of 2005, decreased from 1.9% to 1.8%.

Four housing savings banks, whose assets accounted for 98.0% of total housing savings bank assets, remained in majority, direct or indirect, ownership of foreign shareholders. The only housing savings bank in majority domestic state ownership increased its share in total housing savings bank assets from 1.6% to 2.0% owing to the 17.2% rise in its assets in the first six months of 2009.

The number of employees in housing savings banks decreased negligibly, from 416 to 408. Hence, their share in total number of employees in the banking sector went down from 1.9% to 1.8% (the same as the share in assets).

12.2.1 Housing Savings Bank Balance Sheet

The amount of assets decreased in three housing savings banks, and, in addition to the growth of 17.2% observed in the smallest and the youngest housing savings bank, a modest increase in assets (of only 0.1%) was reported by one housing savings bank.

Owing to the strong growth of 22.9% (HRK 0.9bn), the share of loans in total assets of housing savings banks rose from 58.2% to 75.5%. On the other hand, investments in securities dropped by HRK 1.2bn or 48.6%. The reported decrease in securities and the concurrent rise in loans granted were above all the result of the changes in the accounting rules, or, to be precise, the amendments to the International Accounting Standards (2008) which, pending certain conditions having been met, provide for the reclassification of investments held in the portfolio of securities into the portfolio of loans and receivables. In the second quarter of 2009, one large bank and members of its group, inclusive of one housing savings bank, reclassified a significant amount of securities (in case of the mentioned housing savings bank they exclusively included the bonds of the Republic of Croatia) into the portfolio of loans and receivables.

The share of investments in securities in total assets continued to trend downward and, after accounting for more than two thirds of total assets at end-2006 (66.8%, with loans granted by housing savings banks accounting for somewhat more than one fourth of assets or 28.0%), stood at 19.2% at end-June 2009. In one housing savings bank only, securities accounted for more than a half in total assets.

Following the above-stated increase, net loans of housing savings banks stood at HRK 5.0bn at end-June 2009. With reference to this, it should be noted that the rise in loans granted to households (home loans) stood at only 2.8%, and that the growth in loans granted to government units doubled in the reference period – they grew by as much as 104.5% thanks to the reclassification. Before the reclassification, securities were held in the available-for-sale portfolio, meaning that after a substantial decrease in this portfolio the majority of securities of housing savings banks were classified into the portfolio of securities held until maturity (72.9%).

Table 26 Structure of Housing Savings Bank Assets

end of period, in million HRK and %

	2007		2008			Jun. 2009		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	0.0	0.0	0.0	0.0	13.3	0.0	0.0	58.8
1.1. Money assets	0.0	0.0	0.0	0.0	13.3	0.0	0.0	58.8
1.2. Deposits with the CNB	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2. Deposits with banking institutions	47.1	0.7	259.7	3.7	451.7	112.3	1.7	–56.7
3. MoF treasury bills and CNB bills	255.5	3.9	327.7	4.7	28.2	274.6	4.2	–16.2
4. Securities and other financial instruments held for trading	156.8	2.4	76.5	1.1	–51.2	1.9	0.0	–97.6
5. Securities and other financial instruments available for sale	1,246.4	19.0	1,121.1	16.1	–10.1	59.1	0.9	–94.7
6. Securities and other financial instruments held to maturity	871.2	13.3	692.7	9.9	–20.5	795.0	12.0	14.8
7. Securities and other financial instruments not traded in active markets but carried at fair value	528.4	8.1	241.4	3.5	–54.3	134.2	2.0	–44.4
8. Derivative financial assets	6.7	0.1	0.0	0.0	–100.0	0.0	0.0	0.0
9. Loans to financial institutions	106.5	1.6	273.9	3.9	157.2	145.3	2.2	–47.0
10. Loans to other clients	3,172.3	48.5	3,780.7	54.3	19.2	4,837.0	73.3	27.9
11. Investments in subsidiaries, associates and joint ventures	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
13. Tangible assets (net of depreciation)	8.1	0.1	8.8	0.1	8.7	8.5	0.1	–2.5
14. Interest, fees and other assets	196.0	3.0	240.9	3.5	22.9	287.6	4.4	19.4
15. Net of: Collectively assessed impairment provisions	50.1	0.8	58.0	0.8	15.7	55.9	0.8	–3.7
Total assets	**6,544.8**	**100.0**	**6,965.5**	**100.0**	**6.4**	**6,599.8**	**100.0**	**–5.3**

Source: CNB.

In the first six months of 2009, there was a noticeable fall in received deposits of housing savings banks. Deposits decreased by more than HRK 0.5bn or 9.0%, totalling HRK 5.7bn, a fall being observed in four housing savings banks. Hence, a high increase was observed not only in loans granted but also in the ratio of granted loans to deposits, from 64.4% at end-2008 to 86.9% at the end of June 2009.

Table 27 Structure of Housing Savings Bank Liabilities

end of period, in million HRK and %

	2007		2008			Jun. 2009		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	0.2	0.0	0.1	0.0	–18.2	60.4	0.9	40,679.7
1.1. Short-term loans	0.0	0.0	0.0	0.0	0.0	60.2	0.9	–
1.2. Long-term loans	0.2	0.0	0.1	0.0	–18.2	0.1	0.0	–12.2
2. Deposits	6,038.4	92.3	6,298.1	90.4	4.3	5,733.5	86.9	–9.0
2.1. Giro account and current account deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2.2. Savings deposits	0.0	0.0	0.0	0.0	2.6	0.0	0.0	–67.5
2.3. Time deposits	6,038.3	92.3	6,298.1	90.4	4.3	5,733.5	86.9	–9.0
3. Other loans	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
3.2. Long-term loans	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	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
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	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
7. Hybrid instruments issued	39.9	0.6	91.3	1.3	128.6	96.0	1.5	5.2
8. Interest, fees and other liabilities	223.9	3.4	263.4	3.8	17.6	330.5	5.0	25.5
Total liabilities	**6,302.3**	**96.3**	**6,652.9**	**95.5**	**5.6**	**6,220.3**	**94.3**	**–6.5**
Total capital	**242.5**	**3.7**	**312.5**	**4.5**	**28.9**	**379.4**	**5.7**	**21.4**
Total liabilities and capital	**6,544.8**	**100.0**	**6,965.5**	**100.0**	**6.4**	**6,599.8**	**100.0**	**–5.3**

Source: CNB.

12.2.2 Housing Savings Bank Capital

The total capital of housing savings banks rose in the first half of 2009 by 21.4% or HRK 66.9m. Hence, its share in assets grew from 4.5% to 5.7%. Most of this increase was accounted for by the rise in share capital of 8.2% (by HRK 370m), with the positive impact on the capital position being produced by improved financial operating results.

Table 28 Structure of Housing Savings Bank Total Capital
end of period, in million HRK and %

	2007		2008			Jun. 2009		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Share capital	357.1	147.3	450.9	144.3	26.3	487.9	128.6	8.2
2. Current year profit/loss	–44.7	–18.4	12.9	4.1	–128.9	21.6	5.7	67.0
3. Retained earnings/loss	–15.9	–6.6	–61.6	–19.7	286.5	–50.0	–13.2	–18.8
4. Legal reserves	2.5	1.0	3.4	1.1	37.0	4.8	1.3	39.6
5. Total reserves provided for by the articles of association and other capital reserves	0.0	0.0	0.6	0.2	–	1.0	0.3	69.3
6. Unrealised gains/losses on value adjustments of financial assets available for sale	–56.5	–23.3	–93.7	–30.0	65.9	–85.8	–22.6	–8.4
7. Reserves arising from hedging transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
8. Previous year profit/loss	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total capital	**242.5**	**100.0**	**312.5**	**100.0**	**28.9**	**379.4**	**100.0**	**21.4**

Source: CNB.

The regulatory capital of housing savings banks grew at lower rate than total capital, by 14.7% or HRK 58.2m. This increase was almost entirely accounted for by the rise in core capital of HRK 54.4m, brought about by a significant increase in core capital of two housing savings banks of 54.2% and 48.9% respectively, while, at the same time, supplementary capital I went up by HRK 4.7m (owing to the increase of 15.8% in one housing savings bank). None of the housing savings banks used supplementary capital II in the calculation of total regulatory capital.

The rise in regulatory capital exceeded a modest increase in total risk-weighted assets (0.6%), pushing up the capital adequacy ratio of housing savings banks by almost 2.0 percentage points. This ratio stood at 15.00% at end-June 2009 and 13.15% at end-2008.

The capital requirement for credit risk increased by a modest 0.7% and the capital requirement for market risks went down by 4.7% (accompanied by the increase in the capital requirement for currency risk of 51.0%); their shares in the structure of total capital requirement experienced no significant changes, amounting to 98.5% and 1.5% respectively, or the same as at end-2008.

12.2.3 Quality of Housing Savings Bank Assets

Total placements and contingent liabilities of housing savings banks fell in the first six months of 2009, totalling HRK 6.4bn. Fully recoverable placements (A placements) declined by the same amount as total placements, while partly recoverable placements (B placements) fell by a smaller amount of 3.7%. In contrast, irrecoverable placements (C placements) grew by a significant 26.4%, causing total bad placements (B and C placements) to rise by 2.6%. However, the share of bad placements in total placements and contingent liabilities of housing savings banks remained low (0.5%), and bad placements were reported by three housing savings banks, the same as at the end of 2008.

Table 29 Classification of Housing Savings Bank Placements and Contingent Liabilities by Risk Categories
end of period, in million HRK and %

	2007		2008		Jun. 2009	
	Amount	Share	Amount	Share	Amount	Share
Fully recoverable placements and contingent liabilities (category A)	5,670.3	99.7	6,598.5	99.5	6,321.3	99.5
Partly recoverable placements and contingent liabilities (category B)	14.9	0.3	24.6	0.4	23.7	0.4
Irrecoverable placements and contingent liabilities (category C)	2.9	0.1	6.5	0.1	8.2	0.1
Total	**5,688.1**	**100.0**	**6,629.5**	**100.0**	**6,353.2**	**100.0**

Source: CNB.

Although total placement value adjustments and provisions for contingent liabilities decreased by 4.5% (value adjustments went down by 5.2% and collectively assessed impairment provisions by 4.4%), i.e. more than total placement and contingent liabilities, the observed changes were insufficient to contribute to a more significant change in the ratio of value adjustments and provisions to total placements and contingent liabilities.

Table 30 Ratio of Total Housing Savings Bank Value Adjustments and Provisions to Total Placements and Contingent Liabilities
end of period, in million HRK and %

	2007	2008	Jun. 2009
1. Total value adjustments against placements and provisions for contingent liabilities	57.6	69.8	66.6
1.1. Value adjustments against placements and provisions for contingent liabilities	6.4	10.7	10.2
1.2. Collectively assessed impairment provisions	51.2	59.0	56.4
2. Total placements and contingent liabilities	5,688.1	6,629.5	6,353.2
3. Relative ratio: total value adjustments and provisions/total placements and contingent liabilities	1.0	1.1	1.0

Source: CNB.

Housing savings banks' placements exposed to CICR accounted for 88.1% of total net placements of housing savings banks at the end of the second quarter of 2009, which is a decrease from the 90.0% at the end of 2008. The share of unhedged placements rose from 90.0% to 92.1%, which is attributed to placements granted by housing savings banks to the household and government sectors that do not have a matched foreign currency position.

12.2.4 Quality of Housing Savings Bank Earnings

In contrast to the minimum profit in the first half of 2008 (HRK 0.03m), in the same period this year housing savings banks reported an after-tax profit of HRK 21.6m. All housing savings banks reported better financial results, with one housing savings bank continuing to operate at a loss (which was several times lower than the loss observed in the same period last year). The operating results improved mostly on the account of the increase in net interest income.

The total net income of housing savings banks went up by 29.5%, totalling HRK 86.9m. This was due to the substantial rise in net interest income of 14.8%, which came to HRK 73.4m, and a modest increase in net income from fees and commissions of 1.3% or HRK 30.1m. The rise in net income was also aided by the decrease in negative net other non-interest income of 37.6%.

The rise in net interest income is attributed to the increase in interest income by 5.2%, which was the expected consequence of the increase in loans granted, and the concurrent fall of 0.8% in interest expenses.

Considering a modest increase (2.0%) in general administrative expenses and depreciation (HRK 62.1m), net operating income before loss provisions was almost four times higher compared with the end of the second quarter in 2008 and stood at HRK 24.9m. Owing to the decrease in expenses on loss provisions, the pre-tax profit reached HRK 27.3m and the after-tax profit HRK 21.6m.

Interest income was 5.2% or HRK 8.6m higher compared with the same period in 2008 and mostly comprised income from loans granted (61.8%) which grew by 14.8%. With income from debt securities decreasing by 11.7%, their share in total interest income decelerated by something more than one third (35.7%). Three fourths of interest income from loans granted (74.3%) were accounted for by income from home loans granted to households, which grew by 25.1%. Concurrently, income from loans granted to government units decreased from almost one third (30.1%) to one fifth (20.3%) of income from loans granted.

Despite the growth in expenses on time deposits received from households (by 0.6%) and the twofold increase in interest expenses on debt securities (hybrid instruments), interest expenses were lower owing to the 19.6% fall in insurance premiums for savings deposits.

Table 31 Housing Savings Bank Income Statement
in million HRK and %

	Jan.-Jun. 2008	Jan.-Jun. 2009	
	Amount	Amount	Change
Total interest income	165.6	174.2	5.2
Total interest expenses	101.6	100.8	–0.8
Net interest income	63.9	73.4	14.8
Total income from fees and commissions	33.9	34.5	1.7
Total expenses on fees and commissions	4.2	4.3	3.8
Net income from fees and commissions	29.7	30.1	1.3
Other non-interest income	–13.6	–5.4	–60.2
Other non-interest expenses	13.0	11.2	–13.8
Net other non-interest income	–26.5	–16.6	–37.6
Net non-interest income	3.2	13.6	323.7
General administrative expenses and depreciation	60.9	62.1	2.0
Net operating income before loss provisions	6.3	24.9	296.8
Expenses on value adjustments and provisions for identified losses	4.1	0.1	–97.7
Expenses on collectively assessed impairment provisions	2.0	–2.6	–228.3
Total expenses on loss provisions	6.1	–2.5	–140.3
Income/loss before taxes	0.1	27.3	21,937.1
Income tax	0.1	5.8	5,785.7
Current year profit/loss	0.0	21.6	82,811.5

Source: CNB.

12.3 Report on Prudential Regulation and Supervision

The Croatian National Bank exercises supervision of credit institutions in order to maintain the stability and safety of their operations and ensure confidence in the banking system, particularly on the part of savers and depositors. The supervisory tasks of the CNB comprise the issuance and withdrawal of: authorisations of the stated institutions, approvals to perform the function of the chairperson or a member of a credit institution's management board, and other authorisations and approvals prescribed by the Credit Institutions Act.[38] The key tasks of the CNB also include the adoption of subordinate regulations that prescribe in more detail the rules on the management of the risks to which credit institutions are exposed in their operations and public disclosure of data and information on credit institutions' operations with a view to enhancing their transparency. The CNB has in place a reporting system as well as procedures and measures it can take against credit institutions to ensure compliance with regulations and improve risk management methods, procedures and techniques. The lawfulness and regularity of operation of credit institutions and credit unions and risk management are assessed through on-site supervision, specialised on-site supervision and analysis of the prescribed financial statements and other reports submitted by credit institutions to the CNB upon request.

12.3.1 New Regulations on Business Operations and Supervision of Credit Institutions and Credit Unions

The Credit Institutions Act came into effect in early 2009. However, the implementation of all subordinate legislation that the CNB adopted under this Act, as well as the Act's provisions on the application of rules under Basel II international standards and the Capital Requirements Directive – CRD (as well as other EU directives relevant for the operation of credit institutions) was postponed until 31 March 2010. As this is a completely new regulatory framework, credit institutions had to be given an appropriate time limit for adjusting and organising their operations in accordance with new regulations and recommendations, which involve large changes in the organisation, as well as management methods and techniques, in particular risk management. To gain an insight into the size of reforms brought by the Credit Institutions Act and subordinate legislation adopted under it, one should note that all current regulations (Banking Act and all subordinate legislation adopted under it) will expire on 31 March 2010, while 22 pieces of new subordinate legislation[39] adopted under the Credit Institutions Act will enter into force. The enactment

[38] Official Gazette 117/2008 and 74/2009.

[39] Subordinate legislation was published in the Official Gazette 1/2009 and 41/2009.

of this legislation completed the transposition of the *acquis* in the area of banking;[40] this is much more complex than former regulations.

The segment of capital adequacy and requirements, which is one of the most complex parts of the new framework, is regulated by three subordinate legislations: the Decision on own funds of credit institutions, the Decision on the capital adequacy of credit institutions and the Decision on reports on own funds and capital requirements of credit institutions.

The areas of risk management and internal control systems in credit institutions are also prescribed in more detail in new subordinate legislation: the Decision on risk management, the Decision on liquidity risk management, the Decision on the management of interest rate risk in the non-trading book, the Decision on internal control systems, the Decision on limits on credit institutions' holdings in non-financial institutions and holdings of tangible assets, the Decision on the obligation to make provisions for litigation conducted against a credit institution, the Decision on outsourcing and the Decision on the internal capital adequacy assessment process for credit institutions.

Due to its importance, credit risk is prescribed in more detail in the Decision on the classification of placements and off-balance sheet liabilities of credit institutions, the Decision on submitting reports about borrowers whose debt to a credit institution exceeds a specified amount and the Decision on large exposures of credit institutions.

Years-long experience in supervision indicated a need to improve decisions which thus far regulated supervision, consolidated supervision and external audit. As a result the following were adopted: the new Decision on the method of exercising supervision of credit institutions and imposing supervisory measures, the new Decision on the supervision of a group of credit institutions on a consolidated basis, the Decision on the criteria and procedure for granting prior approval of the Croatian National Bank for the appointment of the chairperson or a member of the management board of a credit institution, the Decision on detailed conditions for the establishment, operation and dissolution of branches of third-country credit institutions in the Republic of Croatia, the Decision on representative offices of credit institutions with registered offices outside the Republic of Croatia and the Decision on the contents of audits of credit institutions.

The application of Basel II standards in the supervision of credit institutions provided the public an important role, supplementing that of the competent authority in the risk management of credit institutions and the supervision exercised over them. As a result, the Decision on public disclosure of compliance with prudential requirements by credit institutions was adopted, providing for transparency of credit institution operations and enhancing market discipline.

The entire new body of regulations was publicly discussed prior to final adoption. A three-day workshop for credit institutions was held in November 2008 during which the most important decisions were presented, while a two-day workshop related to reports on capital requirements, liquidity management and interest rate risk in the non-trading book[41] was organised in April 2009.

To create a better legislative framework for the functioning of the single market for the provision of financial services by credit institutions, and in response to the need to amend supervisory rules on credit institutions' operations arising from the turmoil in the financial market that began in 2007 and culminated in late 2008 and early 2009, the European Commission put forward an initiative to amend the Capital Requirements Directive. In addition, Directive 2009/14/EC amending Directive 94/19/EC on deposit-guarantee schemes, which was adopted in March 2009, also requires changes to the provisions of the Credit Institutions Act.

Proposed CRD amendments drastically redesign the supervisory rules for monitoring risk management in credit institutions, above all regarding the calculation of capital adequacy and large exposures of credit institutions as well as supervisory methods for dealing with crises and cooperation between supervisors. Hence, the CNB and the MoF have taken appropriate actions to speed up the harmonisation of domestic regulations governing the operation and supervision of credit institutions with relevant amendments to the *acquis*.

The need to amend all regulations in the Republic of Croatia governing the supervision and operation of credit institutions in line with the CRD amendments also implies changes to the Credit Institutions Act and relevant subordinate legislation that the CNB adopted in January 2009. For that purpose, the CNB and the MoF agreed to align these regulations with the amended EU directives expeditiously in order to amend the Act and relevant subordinate legislation by the end of 2009 and thus enable credit institutions to implement these amendments by the time of full application of the new regulations on 31 March 2010.

[40] Capital requirements directive – CRD (Directive 2006/48/EC and Directive 2006/49/EC), Directive 2001/24/EC 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.

[41] Amendments to the decisions were published in the Official Gazette No. 41 of 3 April 2009.

To improve transparency in the application of the provisions of the Credit Institutions Act and subordinate legislation as well as the Act on Electronic Money Institutions, in February 2009 the CNB began publishing on its website answers to and opinions about questions from credit institutions, financial institutions, consumers and other interested parties in efforts to ensure a simple and consistent implementation of these regulations.

12.3.2 Supervision of Credit Institutions

Supervision of credit institutions consists of several coordinated activities; it begins with the adoption of supervisory regulations and rules and ends with the imposition of measures on credit institutions.

On-Site Examination of Credit Institutions

The Croatian National Bank carries out on-site examinations in accordance with the adopted methodology for supervision and the on-site examination plan adopted at the end of each year for the following year. In the first half of 2009, on-site examinations covered 11 banks and one housing savings bank whose assets accounted for 41.19% of banking assets in Croatia according to the data as at 30 June 2009. In the same period, on-site examinations were also carried out in 10 credit unions accounting for 47.99% of total assets of credit unions according to the data as at 31 March 2009.

A total of 18 on-site examinations of banks, one on-site examination of a housing savings bank and 10 on-site examinations of credit unions were carried out in the course of the first half of 2009. On-site examinations of credit institutions were performed by 37 CNB examiners, while 10 examiners participated in on-site examinations of credit unions. In the course of examinations of credit unions, HRK 22.82m of assets per employee was examined on-site.

Table 32 The Number of On-Site Examinations of Credit Institutions and the Amount of Examined Assets

On-site examinations	Jan.-Jun. 2008	Jan.-Dec. 2008	Jan.-Jun. 2009
Full-scope on-site examinations	6	9	5
Targeted on-site examinations	16	25	14
Total number of on-site examinations	22	31	19
Assets examined on-site (in thousand HRK)	110,882,084	310,966,446	154,878,029
Assets per employee examined on-site (in thousand HRK)	3,465,065	7,774,161	4,185,893

Source: CNB.

In the first half of 2009, full-scope on-site examinations were carried out in four banks and one housing savings bank. Credit risk management was assessed in two large banks.

Table 33 On-Site Examinations Carried Out in the January-June period of 2009

Bank groups	Specialised on-site examinations			On-site examinations of risk management		Assets covered by on-site examinations (in thousand HRK, as at 30 June 2009)	The share of assets covered by on-site examinations in total bank group assets
	Internal control systems	IT systems	Implementation of monetary and foreign exchange policy	On-site examinations of entire operations (CAMELS)	Prevalidation		
Large banks	2		2	1	2	113,209,381	37.23
Medium-sized banks			2	2		35,447,353	100.00
Small banks	1	1	4	1		4,988,301	16.72
Total (all banks)	**3**	**1**	**8**	**4**	**2**	**153,645,035**	**41.60**
Housing savings banks				1		1,232,994	18.68
Total (all institutions)	**3**	**1**	**8**	**5**	**2**	**154,878,029**	**41.19**

Source: CNB.

Specialised on-site examinations in the first half of 2009 covered 9 banks and in 3 banks specialised on-site examination was carried out twice. Hence, a total of 12 specialised on-site examinations were carried out in the reference period. Three examinations included the oversight of internal control systems, one the oversight of IT systems, while eight examinations were focused on the implementation of monetary and foreign exchange policy measures.

Based on on-site examinations carried out in the first half of 2009 and violations and irregularities that were established in issued reports, the CNB imposed measures for the elimination of established violations and irregularities and the improvement of the situation. Three decisions on supervisory measures were issued and one memorandum of understanding was concluded. Based on on-site examinations of 10 credit unions, the CNB issued four decisions to impose measures to eliminate established violations and irregularities.

Off-Site Examination of Credit Institutions

The main task of supervision of credit institutions performed by analysing reports (hereinafter: off-site examination) is to monitor the risk profile of credit institutions. The assessment is based mainly on the analysis of the prescribed financial statements and other reports submitted by credit institutions to the CNB upon request.

Six components of credit institution operations are assessed in the methodology for preparing written analyses (capital, assets, earnings, liquidity, market risks and management). Each of the said analysed areas is assigned an appropriate component rating, and ultimately an overall composite rating for each specific credit institution. The quality of credit institution management, which combines the assessment of adequacy of management of all the risks, is the most important component in the assessment of the risk profile of the entire operations of a credit institution. In addition to off-site analysis of individual credit institutions, an analysis of consolidated financial statements of groups of credit institutions is made semi-annually. To provide adequate tools for systematic monitoring and analysis of risks to which credit institutions are exposed in their operations, a project to advance the methodology for assessing risks in credit institutions was launched in 2009.

Based on an analysis of financial statements in the first half of 2009, nine reports on established irregularities were drafted and delivered to credit institutions and six decisions issued requiring the implementation of remedial measures. The most frequent reason for drafting reports was excess exposures to one person or persons in a special relationship.

In response to persistent negative trends in global financial markets that began in 2008 and their potential spillover effects on the domestic banking system, the CNB continued with intensified liquidity risk monitoring at the system level. In order to ensure adequate monitoring and timely actions of the CNB in 2009, liquidity risk monitoring at the level of individual credit institutions has been carried out based on 10-day liquidity reports and monthly stress test results, which credit institutions delivered to the CNB. In addition, monitoring of the credit portfolio quality has been intensified by the introduction of monthly reports on due but unpaid receivables broken down by sector and maturity.

To improve communication and cooperation with credit institutions and ensure timely reporting to the CNB about the planned activities, regular annual meetings with credit institutions have been held since 2008. In addition to regular annual meetings, targeted meetings to solve specific operating problems of individual credit institutions were held in the first half of 2009.

During 2009, based on signed memoranda of understanding, cooperation with foreign supervisors of banking groups to which domestic credit institutions belong continued. Within the framework of intensifying activities in the segment of risk assessment on the consolidated basis of an EU parent bank, which is supported and required by the Committee of European Banking Supervisors, supervisory reports were drafted for submission to the relevant regulators in line with the requests received over the year.

Furthermore, cooperation with the Croatian Financial Services Supervisory Agency (HANFA) continued in 2009 by the holding of regular meetings of the Working Committee and the exchange of information on entities subject to common supervision.

As over the previous years, in early 2009 meetings were held with external auditors in order to ensure timely exchange of information on credit institutions' operations. During the meetings, external auditors presented the results of their pre-audits and were briefed on those areas of credit institutions' operations they were expected to control (audit) more closely in order to provide high quality opinions on the financial position of a respective institution.

Issuance of Authorisations and Approvals to Credit Institutions

In the first half of 2009, a total of 23 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 credit institution, for the acquisition of a qualifying holding in the share capital of a credit institution, internal audit outsourcing, for the acquisition of holdings in the share capital of an undertaking by a credit institution, for acquisitions of credit institutions and other undertakings, for changes in general operating conditions of housing savings banks and decision-taking on applications for issuing authorisations for the provision of financial services by credit institutions and authorisations for the operation of savings banks and credit unions. In the area of market competition, an analysis based on a survey of the housing loan market "Anti-competitive Behaviour of Banks in Housing Lending", was written and posted on the CNB website.

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 central bank. The way in which the international reserves are managed is consistent with the established monetary and foreign exchange policies; in managing the international reserves, the CNB is governed primarily by the principles of liquidity and safety. The international reserves of the Republic of Croatia comprise all claims and banknotes in a convertible foreign currency as well as special drawing rights.

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

Principles of and Risks in International Reserves Management

Managing the international reserves of the Republic of Croatia, the central bank is guided by the principles of security of investment and liquidity (Article 19 of the Act on the Croatian National Bank). In this context, it maintains high liquidity of reserves and appropriate risk exposure and, with the given restrictions, attempts to ensure favourable rates of return on its investments.

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 limits exposure to credit risk by investing in highly rated government bonds, collateralised deposits and non-collateralised deposits in banks with the highest credit rating. Interest rate risk, or the risk of a fall in the value of the international reserves portfolio due to unfavourable interest rate changes, can be controlled by means of benchmark portfolios. Currency risk arises from currency fluctuations between the kuna and the euro and the kuna and the US dollar. 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

Under the 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 foreign currency liabilities assumed.

The CNB actively manages that part of international reserves formed through outright purchase of foreign currency from the banks and the MoF 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, swap arrangements and special drawing rights (SDR), is managed passively by the CNB, depending on assumed foreign currency liabilities, 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 SDRs and foreign cash.

13.2 International Reserves in the First Half of 2009

The spillover of the effects of the financial crisis onto the real sector of the economy led to the intensification of incentivising monetary and fiscal policy measures. Combined with other factors, monetary expansion in the US and in the European Union caused the yield curve to plummet. While such a situation was favourable to security issuers, it was very unfavourable for investors with fixed yield instruments in their portfolios. The environment of low interest rates does not pave the way for significant return rates in this segment of the market and at the same time it exposes investors to increased risk of a fall in prices in the case of increased yield. It is a known fact, which has been theoretically and empirically proven, that interest rate risk increases when the yield curve is at lower levels.

Total international reserves of the CNB stood at EUR 9,089.89m on 30 June 2009, EUR 30.86m down from the EUR 9,120.74m on the last day of 2008. Net international reserves, which do not include foreign currency reserve requirements and MoF funds, rose by EUR 330.39m in the first six months of 2009, up from EUR 8,022.26m to EUR 8,352.65m.

Table 34 Monthly Changes in Total and Net CNB International Reserves

end of period, in million EUR

Month	Total reserves	Net reserves
December 2008	9,120.74	8,022.26
January 2009	8,674.49	7,806.95
February 2009	8,557.58	7,670.81
March 2009	8,869.37	7,965.82
April 2009	8,884.88	7,958.99
May 2009	8,788.35	7,862.52
June 2009	9,089.89	8,352.65
Change Jun. 2009 – Dec. 2008.	**–30.86**	**330.39**

Source: CNB.

The main factors leading to changes in the level of total international reserves in the first six months of 2009 on the inflow side were:

1) EUR 830.25m in total inflow for the account of MoF (of which the CNB purchased from the MoF EUR 484.32m);

2) EUR 619.15m in foreign currency purchases from the banks through interventions (of which EUR 287.95m went to swap arrangement);

3) EUR 68.33m in funds earned based on total CNB international reserves investments;

4) EUR 33.99m in positive cross-currency changes arising from a 1.4% increase in the dollar/euro exchange rate;

and on the outflow side:

1) EUR 800.97m in foreign currency sales to the banks through interventions (of which EUR 287.95m went to the swap arrangement);

2) EUR 452.72m fall in total allocated foreign currency reserve requirements; and

3) EUR 73.22m in MoF foreign currency sales and EUR 253.78m in MoF foreign currency liabilities payment.

Total CNB Turnover in the Foreign Exchange Market in the First Half of 2009

In the first six months of 2009, the Croatian National Bank intervened in the market through foreign currency purchase and sale transactions with domestic banks, the MoF and foreign banks. The Croatian National Bank purchased a total of EUR 1,103.47m on the foreign exchange market and sold a total of EUR 874.22m thus registering a total net purchase of EUR 229.25m and issuing a total of HRK 1,600.01m.

In the first half of 2009, the CNB intervened in the foreign exchange market in January and February, selling to domestic banks a total of EUR 513.02m. At the end of February (value date 3 March), the CNB purchased from the banks EUR 331.2m, thus selling net EUR 181.82m and withdrawing a net of HRK 1.39bn in the first six months of the year. On the basis of the swap arrangement (swap auction) in January 2009, the CNB initially withdrew EUR 261.25m so the banks obtained HRK 1.9bn. The contracted amount rose to EUR 287.95m under the March renewal and the whole transaction was completed in June by means of foreign currency sale and purchase of kuna from domestic banks.

The effect of purchase and sale transactions with the MoF in the first six months of 2009 was a net purchase of EUR 411.10m and an issue of HRK 2,992.82m.

Table 35 Total CNB Turnover in the Foreign Exchange Market, 1 January – 30 June 2009
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	619.15	4,554.26	800.97	5,946.81	–181.82	–1,392.55
Ministry of Finance	484.32	3,538.00	73.22	545.18	411.10	2,992.82
Foreign banks	0.00	0.00	0.03	0.25	–0.03	–0.25
Total	**1,103.47**	**8,092.26**	**874.22**	**6,492.24**	**229.25**	**1,600.01**

Source: CNB.

Table 36 CNB Foreign Exchange Interventions with Domestic Banks, 1 January – 30 June 2009
at the exchange rate applicable on the intervention date, in million

Month	Purchase (1)		Sale (2)		Net (1 – 2)	
	EUR	HRK	EUR	HRK	EUR	HRK
January	261.3	1,901.0	328.3	2,429.8	–67.1	–528.7
February	0.0	0.0	184.7	1,374.4	–184.7	–1,374.4
March	357.9	2,653.2	0.0	0.0	357.9	2,653.2
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	288.0	2,142.6	–288.0	–2,142.6
Total	**619.2**	**4,554.3**	**801.0**	**5,946.8**	**–181.8**	**–1,392.6**

Note: In March, a total of EUR 331.2m were purchased from banks and the amount of the swap arrangement increased by EUR 26.7m.
Source: CNB.

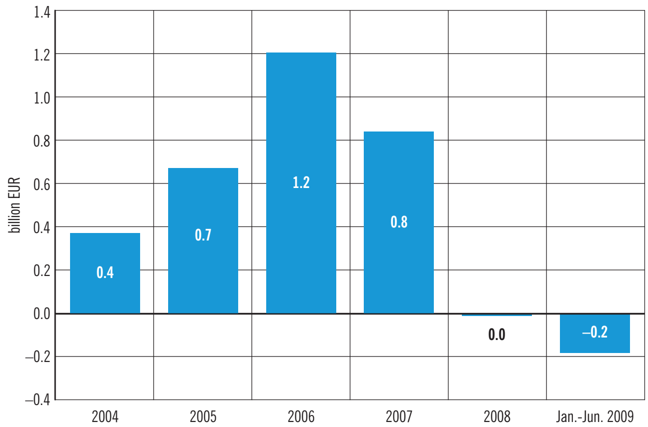
Risks in International Reserves Management and Structure of International Reserves Investment in the First Half of 2009

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 invests only in funds of financial institutions and countries with the highest credit rating. The evaluation of creditworthiness is based on ratings issued by large, internationally recognised rating agencies;

Figure 70 CNB Foreign Exchange Interventions with Domestic Banks
in net amounts



Source: CNB.

2) there are restrictions on investments in individual financial institutions and countries which serve to diversify credit risk;

3) a large share of investments in financial institutions is collateralised, i.e. covered by government bonds whose market value is equal to or higher than the value of the funds placed.

In 2008, the International Reserves Commission introduced more restrictive criteria for all the banks.

According to the degree of credit risk exposure, total international reserves are divided into funds invested in government bonds, covered bonds, bank bonds and instruments issued by international financial institutions, central banks and commercial banks.

Table 37 Structure of International Reserves Investment According to Credit Risk as at 30 June 2009

at market value, in million EUR

Investment	Net reserves	Reserve requirements	Marginal reserve requirements	Ministry of Finance	Total reserves	30 June 2009	
						As % of net reserves	As % of total reserves
Government bonds[a]	7,307.5	207.1	0.0	0.0	7,514.5	87.5	82.7
International financial institutions	525.3	0.0	0.0	0.0	525.3	6.3	5.8
Central banks[b]	378.8	433.3	0.0	0.2	812.2	4.5	8.9
Bank bonds	40.0	0.0	0.0	0.0	40.0	0.5	0.4
Covered bonds	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Banks	101.1	0.0	0.0	96.7	197.8	1.2	2.2
Total	**8,352.6**	**640.3**	**0.0**	**96.9**	**9,089.9**	**100.0**	**100.0**

[a] Also included are reverse repo agreements which are collateralised by government bonds. [b] Inclusive of foreign currency cash of EUR 200.31m held in the vault of the CNB.

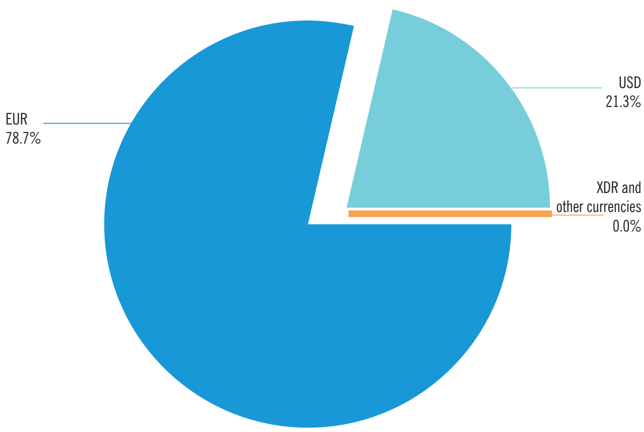
Source: CNB.

The structure of total international reserves of the CNB did not change significantly compared to 31 December 2008. The share of total international reserves invested in government bonds of high-rated states, as the safest form of assets, remained steadily at a high level and stood at 82.67% on 30 June 2009, a slight fall compared to 83.09% at the end of 2008. Only 2.18% of the total reserves was invested in banks towards end-June 2009. The remaining part of the reserves was invested in central banks (8.94%), international financial institutions (5.78%) and in bank bonds (0.44%). In the first half of 2009, the CNB also invested part of the funds in bank bonds.

The structure of net international reserves of the CNB also remained similar to that at end-2008. The only significant change was the increase in funds invested in government bonds and reverse repo agreements, up from 80.92% on 31 December 2008 to 87.49% on 30 June 2009, with a simultaneous fall in investment in central banks, international financial institutions and commercial banks. Investments in time deposits in central banks fell the most; from 10.13% at the end of 2008 to 4.54% of net international reserves at the end of June 2009.

Figure 71 Currency Structure of Total International Reserves

as at 30 June 2009



Source: CNB.

Currency Structure of International Reserves

On 30 June 2009, the euro accounted for 78.73% and the American dollar for 21.25% of the total international reserves.

Interest Rate Risk in International Reserves Management

Interest rate risk is the risk of a fall in the price of bonds or the value of foreign currency portfolios of international reserves due to unfavourable interest-rate changes in fixed income markets. 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, thus reflecting the long-term investment strategy of the reserves.

In present conditions of low interest rates, in international reserves management special attention is paid to interest rate risk.

Results and Analysis of CNB's Foreign Currency Portfolio Management from 1 January to 30 June 2009

In the first half of 2009, the rate of return on the CNB net euro portfolio stood at 2.16% on an annual level, while the rate of return on the CNB net dollar portfolio during the same period stood at 0.07%.

Table 38 Realised Income and Rates of Return[a] on the CNB Foreign Currency Portfolios
at market value, in million EUR and USD and %

Portfolio	Realised income	Annual rate of return					
	Jan.-Jun. 2009	Jan.-Jun. 2004	Jan.-Jun. 2005	Jan.-Jun. 2006	Jan.-Jun. 2007	Jan.-Jun. 2008	Jan.-Jun. 2009
EUR	66.98	2.36	3.11	1.77	3.02	3.23	2.16
USD	0.78	0.58	2.52	3.59	4.98	3.67	0.07

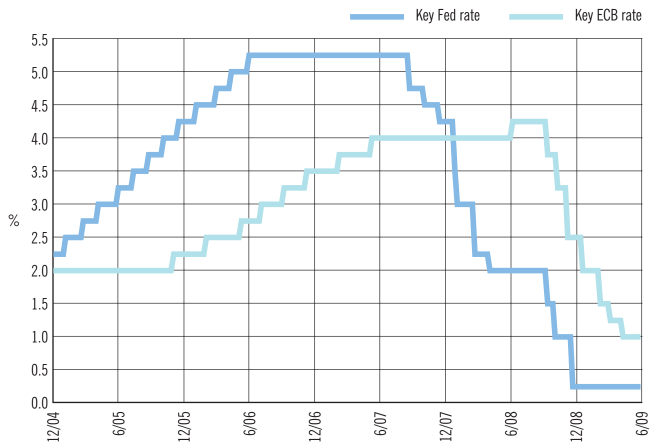
[a] Rates of return are shown on an annual basis and calculated in accordance with Global Investment Performance Standards (GIPS).
Source: CNB.

In the first half of 2009, the actively managed euro portfolio generated an income of EUR 66.98m, while the dollar portfolio generated an income of USD 0.78m or EUR 0.57m during that period.

The European Central bank (ECB) continued to pursue an expansive monetary policy in the first half of 2009. It cut its benchmark one-week repo rate on four occasions in the January to May period 2009, from 2.50% to 1.00%, where it remained until end-June. The Fed did not change its key overnight interest rate in the first half of the year so it ranged between 0% and 0.25%, the level at which it also stood, following seven consecutive cuts, at the end of 2008.

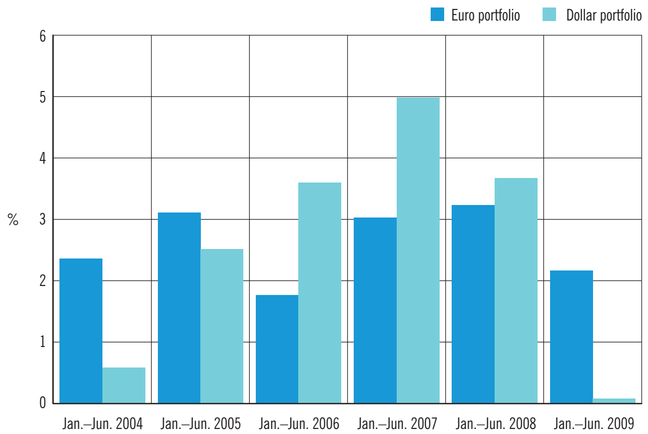
Relatively low rates of return on the CNB net euro and dollar portfolios in the first six months of 2009 were primarily the result of low euro and particularly low dollar yield curves caused by a large increase in bond prices in 2008. Such a large price increase in 2008 and the mentioned fall in the yield curve, leave almost no room for any significant increase in bond prices or improved outturn in the period to come. Low yield curve was the result of large demand for safer forms of investments, which was spurred by the global financial crisis that unfolded in 2008.

Figure 72 Changes in Key ECB and Fed Rates



Source: Bloomberg.

Figure 73 Rates of Return on CNB Euro and Dollar Portfolios



Source: CNB.

14 Conclusion

The first half of 2009, which was marked by the financial crisis, contraction of the global economy and international trade, and deteriorated financing conditions, was an extremely challenging period for the implementation of duties and tasks within the CNB's fields of competence. As in other countries in the region, adverse global trends led to a sharp fall in exports and an upsurge in the cost of foreign borrowing, which created substantial depreciation pressures on the domestic foreign exchange market in the first quarter of 2009. The private sector adjusted to new conditions by reducing demand (with the fall in import demand being larger than the fall in domestic demand due to a major drop in imports of cars and capital equipment) and restructuring assets portfolios, which further raised the level of euroisation. As a result of these economic trends, the budget deficit deepened. Due to unfavourable conditions in international financial markets and relatively high total external debt, the key government finance issue could not be how to act counter-cyclically but how to ensure timely payment of existing liabilities.

Despite extremely adverse conditions in the domestic economy, the CNB has implemented its main objectives and tasks. The growth rate of consumer prices stayed low and mostly in line with that in the eurozone and comparable Central European countries. The maintenance of low inflation was particularly attributable to a stable exchange rate of the kuna against the euro, which serves as the main anchor to inflationary expectations. Exchange rate stability was preserved despite numerous changes in monetary policy instruments, whereby the CNB released a substantial amount of foreign currency liquidity and created an appropriate amount of kuna liquidity. It should be noted that instead of falling, the international reserves of the CNB remained at their end-2008 level. In addition, while the global financial turmoil was marked by substantial government support to banks, Croatian banks did not record major losses and none of them had to be rehabilitated by the government. Thanks to CNB prudential measures that were already in force, banks entered the crisis with a substantial capital buffer and an adequate ratio of liquid financial assets, which enabled them to cope successfully with the financial turmoil. Finally, by releasing foreign currency liquidity, the CNB supported the overall economic policy of the Republic of Croatia, as well as government financing at the time when financial market pressures were strongest.

Although the CNB implemented the main objectives and tasks within its area of responsibility, external debt continued to grow and relative external debt indicators worsened in the first half of 2009. As Croatia is already viewed as a heavily indebted country, one cannot reasonably expect the continuation of uninterrupted substantial capital inflows that would return the economic growth rates to pre-crisis levels. Moreover, these flows could become scarcer and more expensive, which could prolong the period of weak economic growth. In that case, all problems would become even more serious.

Briefly, it is necessary to abandon as soon as possible the current unsustainable pattern of economic growth based on domestic consumption, which is financed by borrowing, and embark on structural measures capable of strengthening long-term growth potential. Although not within direct CNB control, such a move will certainly affect monetary policy implementation in future.

Condensed Financial Statements in Compliance with IAS 34 as at 30 June 2009

HNB
SAVJET
Trg hrvatskih velikana 3, 10002 Zagreb
tel.: 01 45 64 781, 45 64 555 / faks: 01 45 50 598, 46 10 551
teleks: 22 569 / www.hnb.hr

Pursuant to Article 42, paragraph 3, item 3 of the Act on the Croatian National Bank (Official Gazette 75/2008), the Council of the Croatian National Bank, at its session held on 9 September 2009, issued the

DECISION

on the condensed financial statements of the Croatian National Bank as at 30 June 2009

The condensed financial statements of the Croatian National Bank as at 30 June 2009 are hereby adopted in compliance with IAS 34:

a) CROATIAN NATIONAL BANK BALANCE SHEET

– assets	HRK 72,457,278,610.04
– liabilities	HRK 72,457,278,610.04
– off-balance sheet items on the asset and liability sides	HRK 7,069,968,644.99
– treasury inventory system items on the asset and liability sides	HRK 85,874,262,225.54

b) CROATIAN NATIONAL BANK STATEMENT OF INCOME

– income	HRK 10,196,135,684.77
– expenses	HRK 9,706,844,991.44
– operating surplus	HRK 489,290,693.33

c) STATEMENT OF CHANGES IN EQUITY

– equity balance as at 31 December 2008	HRK 8,111,453,060.71
– total changes	HRK 489,974,885.77
– equity balance as at 30 June 2009	HRK 8,601,427,946.48

HRVATSKA NARODNA BANKA

HNB

d) STATEMENT OF CASH FLOWS

– net cash flows from operating activities	HRK 1,689,240,097.63
– net cash flows from investing activities	HRK (34,947,977.67)
– net cash flows from financing activities	HRK (1,662,788,623.38)
– effect of exchange differences	HRK 979,558.09
– net cash flows	HRK (7,516,945.33)

Dec. No.: 1651/2009

Zagreb, 9 September 2009

CROATIAN NATIONAL BANK
COUNCIL CHAIRMAN

CROATIAN NATIONAL BANK
GOVERNOR

Željko Rohatinski, D.Sc.

HRVATSKA NARODNA BANKA

2

Statement of Income

1 January – 30 June 2009, all amounts are expressed in thousands of kunas

	1 January – 30 June 2009	1 January – 30 June 2008
Interest and similar income	466,712	1,159,332
Interest and similar expense	(107,435)	(305,409)
Net interest income	**359,277**	**853,923**
Fee and commission income	2,678	3,229
Fee and commission expense	(2,210)	(1,616)
Net fee and commission income	**468**	**1,613**
Net result from financial operations	171,601	164,774
Net foreign exchange differences	54,569	(1,261,165)
Other income	2,291	13,191
Operating income/(expenditure)	**588,206**	**(227,664)**
Operating expenses	(169,295)	(159,762)
Decrease in provisions	70,380	5,139
Operating surplus/(deficit)	**489,291**	**(382,287)**

Balance Sheet

as at 30 June 2009, all amounts are expressed in thousands of kunas

	30/6/2009	31/12/2008
Assets		
Cash and current accounts with other banks	1,466,832	1,473,516
Deposits with other banks	14,436,224	13,186,457
Trading securities	50,386,134	52,136,879
Loans	2,412,067	111
Balances with the International Monetary Fund	2,953,988	2,904,533
Equity investments	58,126	57,441
Accrued interest and other assets	155,322	174,046
Tangible and intangible assets	588,586	581,531
TOTAL ASSETS	**72,457,279**	**70,514,514**
Liabilities		
Banknotes and coins in circulation	20,369,192	20,479,274
Due to banks and other financial institutions	39,508,648	37,298,672
Due to the State and State institutions	914,929	249,323
Due to the International Monetary Fund	2,948,226	2,897,961
Accrued interest and other liabilities	114,856	1,477,831
Total liabilities	**63,855,851**	**62,403,061**
Equity		
Initial capital	2,500,000	2,500,000
Reserves	5,612,137	5,611,453
Operating surplus	489,291	–
Total equity	**8,601,428**	**8,111,453**
TOTAL EQUITY AND LIABILITIES	**72,457,279**	**70,514,514**

The Condensed Financial Statements on the pages 100 to 106 were approved on 30 July 2009 by

Accounting Department Director

Ivan Branimir Jurković

Governor

Željko Rohatinski, D.Sc

Statement of Changes in Equity

1 January – 30 June 2009, all amounts are expressed in thousands of kunas

	Initial capital	General reserves	Revaluation reserves	Unrealised gains/losses	Operating surplus/ (deficit)	Total equity
Balance as 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 as at 30 June 2008	**2,500,000**	**3,199,309**	**371,103**	**(5,644)**	**(382,287)**	**5,682,481**
Balance as at 1 January 2009	**2,500,000**	**5,250,086**	**364,851**	**(3,484)**	**0**	**8,111,453**
Exchange differences on available-for-sale financial assets				684		684
Operating surplus					489,291	489,291
Balance as at 30 June 2009	**2,500,000**	**5,250,086**	**364,851**	**(2,800)**	**489,291**	**8,601,428**

Statement of Cash Flows

1 January – 30 June 2009, all amounts are expressed in thousands of kunas

	1 January – 30 June 2009	1 January – 30 June 2008
Cash flows from operating activities		
Interest received	542,438	1,161,039
Interest paid	(110,981)	(314,895)
Fees and commissions received	2,724	3,271
Fees and commissions paid	(2,281)	(1,647)
Other receipts	4,838	7,975
Expenses paid	(138,646)	(130,504)
	298,092	**725,239**
Changes in operating assets and liabilities		
(Increase)/Decrease in deposits with other banks	(1,543,762)	6,872,140
(Increase)/Decrease in loans	(2,352,152)	2,511,204
Sale/(Purchases) of trading securities	2,323,129	(12,623,570)
Decrease/(Increase) in other assets	29,031	(23,765)
Increase/(Decrease) in other liabilities	1,296	(1,243)
(Decrease) in amounts due to the International Monetary Fund	(28)	(24)
(Decrease)/Increase of currency in circulation	(110,082)	935,955
Increase in amounts due to banks and other financial institutions	2,362,394	3,363,347
Increase in amounts due to the State	681,322	371,213
	1,391,148	**1,405,257**
Net cash from operating activities	**1,689,240**	**2,130,496**
Cash flows from investing activities		
Purchase of property and equipment	(34,948)	(34,906)
Net cash from investing activities	**(34,948)**	**(34,906)**
Cash flows from financing activities		
Net issuance of CNB bills	(320,227)	(1,556,433)
Payments to the State Budget	(1,342,562)	(484,860)
Net cash from financing activities	**(1,662,789)**	**(2,041,293)**
Effect of exchange differences	**980**	**(52,368)**
Net (decrease)/increase in cash	**(7,517)**	**1,929**
Cash at beginning of period	**1,478,843**	**13,788**
Cash at end of period	**1,471,326**	**15,717**

The notes on the pages 103 to 106 form an integral part of these Condensed Financial Statements.

Notes to the Financial Statements of the Croatian National Bank

BASIS FOR THE PREPARATION OF THE CONDENSED FINANCIAL STATEMENTS

The Condensed Financial Statements are prepared in accordance with the Act on the Croatian National Bank and the International Accounting Standard (IAS) 34 – Interim Financial Reporting.

The Condensed Financial Statements are prepared in accordance with the same accounting policies, balance sheet principles and evaluation methods for assets, liabilities, equity and reserves, income, expenditures and the financial result as those applied in the preparation of the latest Annual Financial Statements of the Croatian National Bank.

In this reporting period, the Croatian Financial Reporting Standards Committee adopted the Decision on the release of International Financial Reporting Standard 8 – Operating Segments (Official Gazette No. 150 of 6 March 2009). The release of this Standard led to no changes in Croatian National Bank accounting policies and made no impact on the statements either for this or for the previous periods.

The Croatian National Bank engaged neither in seasonal nor in cyclical operations in the reporting period. All the activities were carried out according to the subject and time of realization under the principle of continuity for indefinite time period.

REPORTING CURRENCY

The Financial Statements are presented in the national currency of the Republic of Croatia – the kuna. The Financial Statements are presented in thousands of kunas.

INTEREST AND SIMILAR INCOME

(All amounts are expressed in thousands of kunas)

	1 January – 30 June 2009	1 January – 30 June 2008
Deposits	75,241	805,941
Trading securities	285,788	323,923
International Monetary Fund	1	32
Loans to domestic banks	105,311	29,090
Other	371	346
	466,712	1,159,332

The decrease in interest income from the investment of international reserves in deposits and securities in the reporting period compared with the previous period resulted from a decrease in Fed and ECB benchmark interest rates, a drop in total international reserves and a fall in investments in deposits in favour of safer forms of investment less exposed to credit risk.

AN OVERVIEW OF DEVELOPMENT IN FED AND ECB BENCHMARK INTEREST RATES:

	USD	EUR
1 January – 30 June 2009	0.00% – 0.25%	2.5% – 1.00%
1 January – 30 June 2008	4.25% – 2.00%	4.00%

INTEREST AND SIMILAR EXPENSE

(All amounts are expressed in thousands of kunas)

	1 January – 30 June 2009	1 January – 30 June 2008
Kuna reserve requirements	87,252	84,658
Foreign currency reserve requirements	10,842	82,957
Compulsory CNB bills in kuna	326	46
Repurchase arrangements	7,866	136,844
Other	1,149	904
	107,435	305,409

OPERATING EXPENSES
(All amounts are expressed in thousands of kunas)

	1 January – 30 June 2009	1 January – 30 June 2008
Staff costs (Note on staff costs)	81,154	81,800
Materials, services and administrative expenses	42,212	38,963
Costs of production of banknotes and coins in Croatian kunas	26,298	23,701
Depreciation and amortisation	19,631	15,298
	169,295	**159,762**

STAFF COSTS
(All amounts are expressed in thousands of kunas)

	1 January – 30 June 2009	1 January – 30 June 2008
Net salaries	34,715	34,828
Contributions from and on salaries	20,188	20,498
Taxes and local taxes	9,541	10,657
Other staff costs	16,710	15,817
	81,154	**81,800**

The average number of employees in the 2009 reporting period was 615 (2008: 597).

DECREASE IN PROVISIONS
(All amounts are expressed in thousands of kunas)

	1 January – 30 June 2009	1 January – 30 June 2008
a) Loans		
Amounts collected	(59,804)	–
b) Accrued interest and receivables		
Amounts collected	(7,639)	–
c) Provisions for risks and charges		
Provisions released	(2,937)	(5,139)
	(70,380)	**(5,139)**

DEPOSITS WITH OTHER BANKS
(All amounts are expressed in thousands of kunas)

	30/6/2009	31/12/2008
Deposits with foreign central banks	4,460,648	4,475,949
Deposits with foreign commercial banks	9,962,360	8,696,933
Deposits with domestic commercial banks	13,216	13,575
	14,436,224	**13,186,457**

The Croatian National Bank manages the international reserves of the Republic of Croatia by investing them into the types of assets specified by the Act on the Croatian National Bank, applying the principles of liquidity and investment safety. The bulk of international reserves consist of debt securities payable in the convertible currency of the debtor, and the second largest category comprises Croatian National Bank deposit balances with foreign banks with high credit rating.

TRADING SECURITIES
(All amounts are expressed in thousands of kunas)

	30/6/2009	31/12/2008
Securities denominated in EUR	40,281,316	37,839,659
Securities denominated in USD	10,104,818	14,297,220
	50,386,134	**52,136,879**

The nominal value of the above-stated securities at 30 June 2009 was HRK 49,570,145 (31 December 2008: HRK 51,088,116).

LOANS
a) By type of loan

(All amounts are expressed in thousands of kunas)

	30/6/2009	31/12/2008
Loans to domestic banks		
– Repo loans	2,411,960	–
– Intervention loans	–	59,804
Other loans	788	792
Gross loans	**2,412,748**	**60,596**
Less: provisions for loan impairment	(681)	(60,485)
	2,412,067	**111**

BALANCES WITH THE INTERNATIONAL MONETARY FUND
(All amounts are expressed in thousands of kunas)

	30/6/2009	31/12/2008
Membership quota	2,949,494	2,899,206
Special Drawing Rights (XDR) and deposits	4,494	5,327
	2,953,988	**2,904,533**

BANKNOTES AND COINS IN CIRCULATION
(All amounts are expressed in thousands of kunas)

	30/6/2009	31/12/2008
Banknotes and coins in circulation	**20,369,192**	**20,479,274**

DUE TO BANKS AND OTHER FINANCIAL INSTITUTIONS
(All amounts are expressed in thousands of kunas)

	30/6/2009	31/12/2008
Kuna reserve requirements	23,493,433	19,222,748
Foreign currency reserve requirements	4,668,463	8,005,097
Other deposits of domestic banks	11,194,470	9,590,210
Foreign banks and other financial institutions	8,254	16,622
Court-mandated deposits	3,651	3,391
Compulsory CNB bills in kuna	140,377	460,604
	39,508,648	**37,298,672**

An amendment to the Decision on reserve requirements (of 2 January 2009) provides for the calculation and allocation of banks' reserve requirements by including 75% of the calculated foreign exchange component of reserve requirements into the calculated kuna component of reserve requirements and allocating it in kuna (instead of the previously allocated 50%).

DUE TO THE INTERNATIONAL MONETARY FUND
(All amounts are expressed in thousands of kunas)

	30/6/2009	31/12/2008
Bills of exchange denominated in HRK	2,940,835	2,890,695
Other IMF's accounts	7,391	7,266
	2,948,226	**2,897,961**

ACCRUED INTEREST AND OTHER LIABILITIES

The accrued interest and other liabilities as at 31 December 2008 included the liabilities related to the allocation of a part of the operating surplus for 2008 (HRK 1,342,495) to the State Budget, with the payment executed on 6 March 2009.

EQUITY

The equity funds of the Croatian National Bank consist of the initial capital and reserves, including the accumulated operating surplus comprised within the reserves.

RISK MANAGEMENT

The Croatian National Bank manages international reserves of the Republic of Croatia based on the principles of liquidity and safety. The Bank maintains high liquidity of international reserves and appropriate risk exposure and within defined limits aims to realize adequate returns for its investments.

Risks which exist within international reserves management are primarily financial risks such as credit risk, interest rate risk and foreign exchange risk. However, attention is given also to liquidity and operating risk.

CAPITAL COMMITMENTS AND OFF-BALANCE SHEET ITEMS

Capital Commitments: As at 30 June 2009, the Croatian National Bank had capital commitments in the amount of HRK 21,389 (31 December 2008: HRK 27,124).

OFF-BALANCE SHEET ITEMS

(All amounts are expressed in thousands of kunas)

	30/6/2009	31/12/2008
Non-issued banknotes and coins	82,748,579	85,606,614
Stamp duties and bills of exchange	309,659	406,879
	83,058,238	**86,013,493**

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
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
HRK	– kuna
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
OECD	– Organisation for Economic Co-Operation and Development
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

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