30 YEARS OF THE CROATIAN NATIONAL BANK

Semi-annual Information

Semi-annual Information on the Financial Condition, the Degree of Price Stability Achieved and the Implementation of Monetary Policy in the First Half of 2021

Zagreb, January 2022

HRVATSKA NARODNA BANKA • CROATIAN NATIONAL BANK

HNB

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Semi-annual Information on the Financial Condition, the Degree of Price Stability Achieved and the Implementation of Monetary Policy

in the First Half of 2021

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1 Summary

In the first half of 2021, GDP continued to recover after the strong contraction in 2020 caused by the coronavirus pandemic. Real economic activity increased by 7.8% in the first half of the current year relative to the same period in 2020. The annual increase in real GDP in the first six months of 2021 was primarily driven by a rise in total exports. Growing personal consumption also contributed to the increase in economic activity, and other components of domestic demand recorded upward trends as well. Observed on a quarterly basis, the first three months of the current year saw an increase in economic activity relative to the end of 2020 (5.0%); however, the level of economic activity was lower (by 0.6%) than in the same period of the preceding year, as the effect of the pandemic was not yet strong in the first quarter of 2020. In the period from April to June, real GDP increased slightly in quarterly terms (0.4%); however, observed annually, a high growth rate of 16.5% was recorded due to the base effect.

In January and February 2021, the number of employed persons stood above the level recorded in the same period in 2019 and near the level recorded prior to the onset of the pandemic in Croatia. However, due to slower and delayed hiring in the service sector, primarily in tourism-related activities, the number of employed persons ended May at a level slightly below that recorded in the same period in 2019. In June 2021, total employment again exceeded 2019 levels owing to stronger seasonal employment. Job preservation measures introduced in March 2020 continued to be implemented, covering an average of 8.8% of employed persons in the period from January to June 2021. Although the number of unemployed persons decreased steadily over the first half of 2021, at the end of June, unemployment was still higher than in the same period in 2019. The average nominal gross wage was 3.7% higher in the first half of 2021 than in the same period of the preceding year as wages picked up from 2.3% in the first quarter to 5% in the second quarter, partly due to the base effect. At the same time, the nominal net wage increased by 5.2% due to tax changes that reduced income tax rates from January 2021.

Consumer price inflation picked up considerably in the first half of 2021, remaining, nevertheless, at a relatively low level. The increase in inflation from −0.7% in December 2020 to 2.0% in June 2021 was primarily a result of the accelerated annual growth in the prices of energy (particularly refined petroleum products) attributable to the increase in the price of crude oil on the global market and to the positive base effect, i.e. the price decrease seen in the first half of 2020. The contribution of energy prices to overall inflation rose from –1.0 percentage point in December 2020 to 1.3 percentage points in June 2021. To a lesser extent, the pick-up in inflation in the first half of 2021 also stems from the increase in the annual rate of change in the prices of food (including alcoholic beverages and tobacco) and industrial products (excluding food and energy). Still, the annual growth in these two components remained low and the spillover of the increase in the prices of raw materials, higher freight rates and shortages of certain intermediate goods on the global market to domestic consumer prices in the first half of 2021 is estimated to have been mild. Against such a backdrop, core inflation gained pace as well (from −0.1 in December 2020 to 0.8% in June 2021); however, the pick-up was less pronounced than that seen in overall inflation. Low and stable inflation was supported by the contained domestic cost pressures arising from an increase in labour productivity stronger than the growth in wages, which resulted in lower unit labour costs.

In the first half of 2021, the deficit in the current and capital account increased relative to the same period in 2020, mainly as a result of the widening of the foreign trade deficit. Expenditures on direct equity investment increased as well, although to a considerably smaller extent; the increase was due to the improved performance of foreign-owned banks and enterprises. On the other hand, unfavourable developments were offset by an increase in the net exports of services, particularly travel services, as in the same period in 2020, there were virtually no arrivals of foreign tourists and tourist activity was rendered almost completely impossible due to the onset of the pandemic. The overall surplus in the secondary income account and in the capital account increased too, although to a smaller extent than the net exports of services; the trend was a result of a stronger uptake of EU funds and growing net revenues from personal transfers. As for foreign capital flows, the domestic sectors' external debt liabilities led to a deterioration of the relative indicator of gross external debt. At the same time, net external debt and net international investment position deteriorated to a significantly smaller extent in absolute terms (owing to an increase in foreign assets and the favourable effects of price, exchange-rate and other adjustments), so that, due to the increase in nominal GDP, their relative indicators improved.

In the first half of 2021, the CNB continued to pursue a highly expansionary monetary policy, maintaining the stability of the kuna to euro exchange rate and ensuring favourable domestic financing conditions. Banks' free reserves thus reached a record high in June, which contributed to reducing financing costs and keeping most interest rates at historically low levels, similar to those before the pandemic outbreak. The tightening of credit standards for corporate loans, in response to uncertainty following the outbreak of the pandemic, started in early 2020 and came to a halt as late as in the second quarter of 2021, when credit standards were also eased for household loans, especially housing loans. Corporate placements of credit institutions edged up in the first half of 2021, mainly owing to investment loans. Non-financial corporations borrowed abroad and from other domestic institutions, such as the CBRD and HAMAG BICRO, and the total corporate financing rose sharply in the first half of 2021. Household placements increased in the first six months, with the bulk of the increase accounted for by housing loans. The annual growth of household placements saw a slight recovery in the first half of the year, which could primarily be attributed to the continued several-year acceleration of the growth of housing loans and to some extent to a decelerated decline in general-purpose cash loans.

The consolidated general government deficit stood at HRK 9.3bn in the first half of 2021, mirroring the adverse effect of the pandemic. However, owing to a more favourable epidemiological situation than during the critical periods in 2020, the resulting relaxation of restrictive containment measures and the reduced need for fiscal stimuli, this was de facto a considerable improvement from the same period in 2020 (when the deficit stood at HRK 15.2bn). The consolidated general government debt stood at HRK 340.8bn at end-June 2021, up by HRK 10.6bn from the end of 2020. Public debt to GDP ratio edged down to 87.0%, from 87.3% at the end of 2020.

The CNB's international reserves grew by 13.7% from the end of 2020 to the end of the first half of 2021, and net reserves increased by 10.0% in the same period. The rise in international reserves in the first six months of 2021 was mainly driven by foreign currency inflows to the MoF account, which was largely purchased by the CNB. Although around 58% of government securities of euro area member states continued to have negative yields, the annual rate of return on the entire euro portfolio was 0.62% in the first half of 2021, while the annual rate of return on the entire US dollar portfolio totalled 1.05%. In the observed period, international reserves investments generated a total income of EUR 50.3m. Despite a particularly demanding and challenging environment, the primary objective of international reserves management, to ensure liquidity and safety, was successfully achieved.

The safety and stability of the banking system were preserved, even though credit institutions' operations were exposed to continued uncertainty in the second year of the COVID-19 pandemic. Their smooth operation in the observed period was the result of the effects of regulatory adjustments and measures taken by the CNB at the onset of the pandemic, further reinforcing the high levels of liquidity and capitalisation. Total capital ratio of 25.4% was much above the prescribed minimum, being among the highest in EU member states. The high liquidity in the system was also driven by strong channelling of assets to cash. Partly influenced by the described developments, the years-long trend of improvement in the quality of exposure continued, as evident from the decrease in the non-performing loans ratio to 5.1%. The drop in the value of this indicator was also due to the improved quality of loans to non-financial corporations, whereas household loans witnessed slight deterioration, as a result of reduced debt servicing capacity on general-purpose cash loans. In the first half of 2021, credit institutions generated a profit of HRK 2.6bn, up by 51.3% from the same period last year. This was due to considerably lower expenses on impairment for credit loss and the slight increase in net operating income. With the increase in profits, return on assets (ROA) and return on equity (ROE) also rose to 1.1% and 8.1% respectively.

2 Global developments

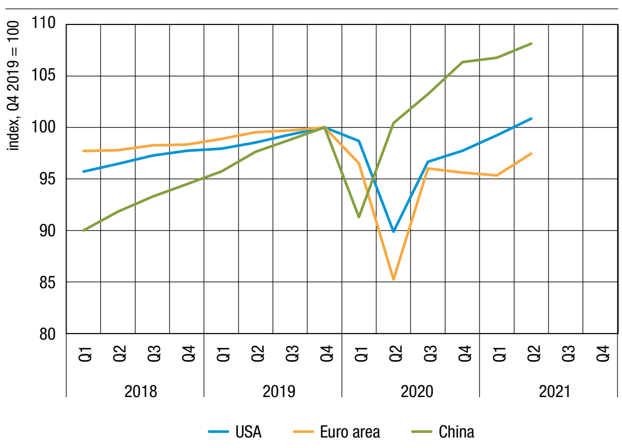
In the first half of 2021, the global economy was rebounding from the crisis caused by the coronavirus pandemic, but the recovery was uneven. In some countries, it was hampered by resurgent infections, disruptions in global supply chains coupled with growing expenses and raw material prices, and in developed economies, by growing inflation as well.

Monetary policy remained highly accommodative in most countries, continuing to ensure highly favourable financing conditions. However, some central banks began signalizing a possible shift towards an earlier normalisation of monetary policy.

In the first half of 2021, the global economy continued to recover from the crisis caused by the coronavirus pandemic, although at an uneven pace (Figure 2.1). Resurgent infections seen in developed economies in early 2021 delayed the relaxation of epidemiological measures until spring, when vaccination against COVID-19 started to pick up. At the same time, economic activity in China continued to return to normal amid stringent epidemiological measures. In other emerging markets, in particular developing markets, low vaccine availability greatly limited the reopening of their economies. In addition, global recovery was slowed down by the increasingly common disruptions in global supply chains and the lower availability of certain raw materials and goods needed in production. Higher expenses caused by such disruptions and the rising prices of raw materials significantly contributed to growing inflation in the second quarter, particularly in developed countries. Monetary policy remained highly accommodative in most countries, continuing to ensure very favourable financing conditions; however, some central banks started announcing the possibility of an earlier monetary policy normalisation.

In the first half of 2021, the US economy continued to recover relatively strongly owing to high vaccination rollout, which in turn enabled a faster relaxation of epidemiological measures and a gradual normalisation of economic activity, particularly in the service sector. Thanks to ample fiscal support that stimulated personal consumption, GDP increased by about 3% in the first half of the year, exceeding the pre-crisis level by 1%. Conditions in the labour market also continued to improve as the unemployment rate sank to below 5% of the workforce by the end of June. A somewhat smaller positive contribution to

Figure 2.1 Economic growth in selected markets



Sources: Eurostat, BEA and NBS.

economic growth came from government consumption, while the contribution of gross investments and net exports was slightly negative due to persisting uncertainty.

As for the euro area, following a slight economic contraction at the beginning of the year (–0.3% on a quarterly basis), the second quarter saw stronger-than-expected economic growth (2.2%). Still, by the end of June 2021, the level of economic activity went down by 2.5% from the first half of 2020. It was only when vaccination began to pick up in the second quarter that the reopening of the economy and the recovery of the service sector became possible. At the same time, the recovery of manufacturing industry slowed down, particularly in some industries such as the automotive industry, as a result of difficulties in the supply of certain important intermediate goods. Alongside Germany, which remained the main driver of economic activity in the euro area, the recovery in the second quarter was also significantly supported by countries with a large service sector share, such as Italy, France and Portugal.

2.1 Croatia's main trading partners

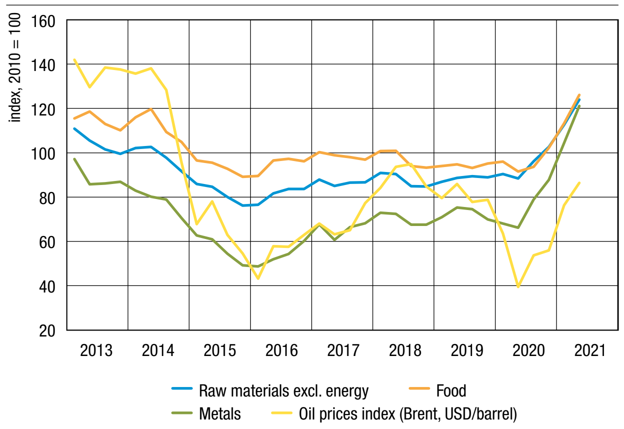
The economic activity in all of Croatia's major trading partners continued to increase in the first half of 2021. The economic recovery of some euro area countries, such as Italy, Austria and Germany, intensified in the second quarter, while in Slovenia, the growth was relatively strong from the beginning of the year. As for the trading partners in Southeastern Europe, economic developments were even more favourable since epidemiological measures were significantly less restrictive during the period. Still, only Serbia managed to exceed the pre-crisis levels of economic activity by mid-2021, while in other countries, particularly those dependent on tourism, economic activity remained significantly below pre-crisis levels.

2.2 Prices, exchange rates and financing conditions

In the first half of 2021, the substantial rise in the prices of raw materials, which began in mid-2020, continued (Figure 2.2). The price of a barrel of Brent crude oil jumped by 47% in the first six months, reaching USD 75. Growing demand, the decision of OPEC+ countries on further output cuts and the drop in US crude oil reserves all contributed to the price hike in early 2021. The increase in prices came to a brief halt in March and April as market sentiment changed in consequence of a rise in the yields on US government bonds, resulting in the strengthening of the US dollar in which oil prices are usually denominated. Nevertheless, prices began to climb again shortly thereafter, although at a somewhat slower pace, driven by further increases in demand and an improved global economic outlook owing to intensified vaccine use, as well as by the fact that OPEC+ countries failed to agree on a gradual decrease in oil supply restrictions.

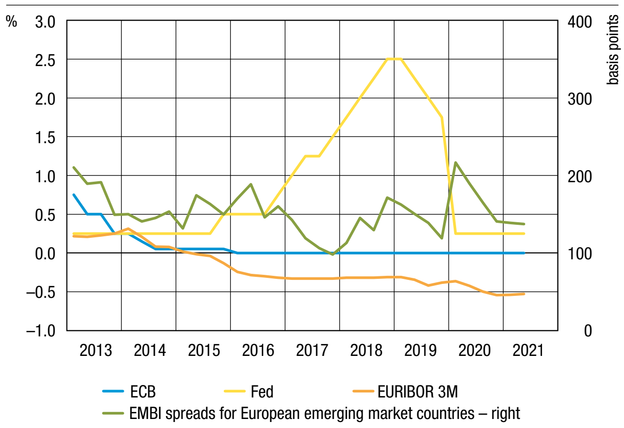
Raw material prices excluding energy also increased substantially in the first half of 2021. Prices of metals saw the most significant rise, exceeding pre-crisis levels by over 50% by the end of June. In addition to the continued strong demand from China, the increase in metal prices was also driven by announcements of large infrastructural projects in the US and the intensified decarbonisation seen in developed economies

Figure 2.2 Raw material prices in the world market in US dollars



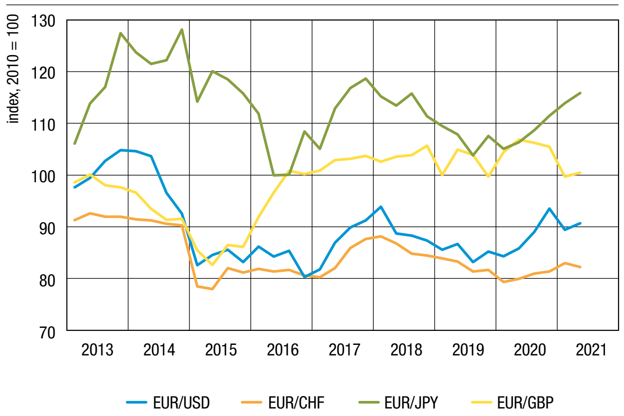
Sources: IMF and Bloomberg.

Figure 2.3 Benchmark interest rates and the average yield spread on bonds of European emerging market countries
end of quarter



Source: Blomberg.

Figure 2.4 Exchange rate movements of individual currencies against the euro



Notes: End-of-period exchange rates. A growth in the index indicates a depreciation of a currency against the euro.
Source: Eurostat.

aiming to meet the goals established by the Paris Agreement. The prices of food raw materials continued to increase sharply as well, triggered by growing demand and shocks on the supply side (occasional disruptions in supply and adverse weather conditions in the US and South America, which resulted in poorer yields of some crops, most notably soybean, corn and wheat). Meat prices also continued to grow as a result of stronger demand from countries in Eastern Asia, in particular China. Furthermore, the increase in energy prices spilled over to the rise in the prices of food raw materials by way of increased production and transportation costs.

The monetary policies of the central banks of the world's largest economies remained highly accommodative throughout the first half of 2021. The Fed extended the duration of all of its emergency measures adopted at the beginning of the pandemic as well as foreign currency swap agreements with central banks worldwide. Still, amid growing inflation in the US, which in June exceeded 5% on an annual basis, the Fed indicated that it might shift toward an earlier monetary policy normalisation. The ECB also continued to implement the measures introduced during the pandemic, having further increased their scope at the end of 2020.

Financing conditions for European emerging market countries, including Croatia, remained highly favourable in the first half of 2021 (Figure 2.3). This is a result of the prolonged highly accommodative monetary policies of large central banks and of the reduced risk aversion when it comes to investments in this group of countries.

Following a period of depreciation that extended over several months, the exchange rate of the US dollar against the euro recovered slightly in the first half of 2021 (Figure 2.4). At the end of June, it stood at EUR/USD 1.19, down by 3% on the end of 2020. The strengthening of the US dollar against the euro was most notable in the first quarter, when a strong fiscal stimulus was announced and the outlook for the US economy improved. However, in the spring months, the US dollar again weakened slightly against the euro as optimism regarding euro area recovery grew. The exchange rate of the Swiss franc against the euro weakened by 1% in the first half of the year, ending June at EUR/CHF 1.1. This was brought about by reduced risk aversion which has, since the onset of the pandemic, contributed to investments in safer currencies such as the Swiss franc.

3 Aggregate supply and demand

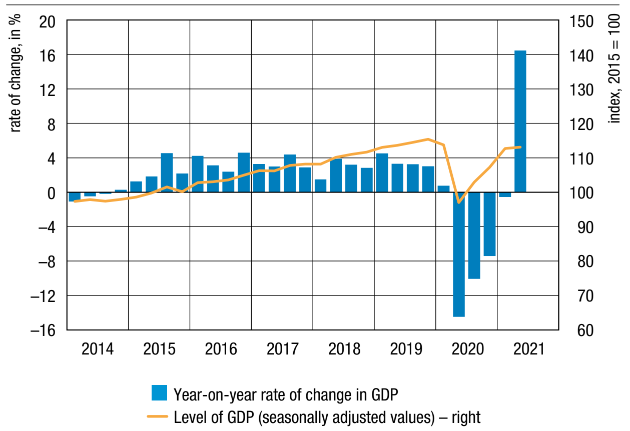
Following the unprecedented economic downturn of 2020, the first half of 2021 was marked by economic recovery. The most significant contribution to economic growth came from total exports, but the increase in personal consumption also provided a strong stimulus.

Exports of services grew at an annual rate of 21.3%, in contrast to the decline of almost 44% (in the same period) in 2020. Growing household consumption is attributable to the base effect, an increase in disposable income due to more favourable labour market developments and the restored availability of certain services. Investments recovered too as investment activity exceeded the pre-crisis levels recorded (in the same period) in 2019.

Following the unprecedented economic downturn of 2020, brought about by the negative effects of the coronavirus pandemic on both the global and the Croatian economy, the first half of 2021 saw a recovery of real economic activity. Observed by quarters, in the period from January to March this year, the level of real economic activity was 5.0% higher than at the end of 2020, but remained, despite the strong growth, below the level recorded in the same period in 2020 (by 0.6%) due to the fact that at the beginning of 2020 the pandemic still did not have a significant effect on the Croatian economy. In the period from April to June, real GDP growth slowed down to 0.4% on a quarterly basis, but a high growth rate of 16.5% was recorded on an annual basis due to the base effect. In the first quarter of 2021, real GDP was 7.8% higher than in the same period in 2020, when a drop of 7.3% was recorded.

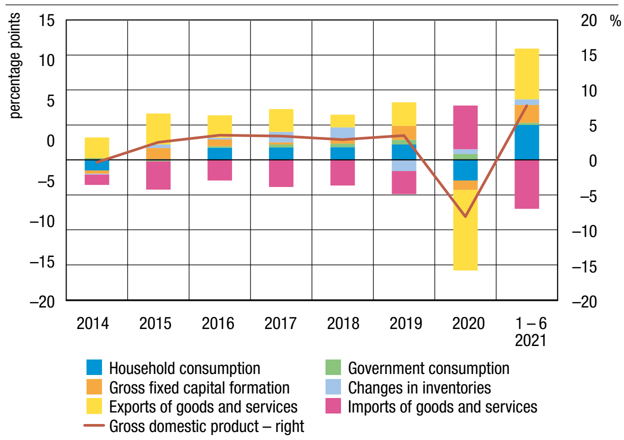
The largest positive contribution to annual economic growth in the period from January to June this year came from total exports, with increased personal consumption also contributing to the increase in GDP. In addition, other components of domestic

Figure 3.1 Gross domestic product
real values



Source: CBS (seasonally adjusted by the CNB).

Figure 3.2 GDP rate of change
contributions by components



Source: CBS (seasonally adjusted by the CNB).

demand also increased on an annual basis. Since exports of goods and services grew faster than total imports, the contribution of net foreign demand to GDP growth was positive in the observed period.

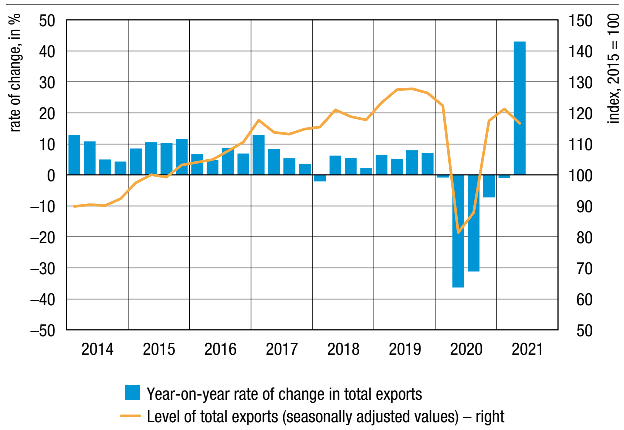
If analysed by the production approach, in the first half of 2021, the annual increase in gross value added (GVA) was 6.2%. An increase in economic activity was recorded across all activities except real estate activities, with the most significant growth seen in service activities such as wholesale and retail trade, transportation and storage and accommodation and food service activities, i.e. in activities that had been most adversely affected by the pandemic.

3.1 Aggregate demand

In the first quarter of 2021, real exports of goods and services fell on an annual basis (–1.0%), while in the second quarter, they soared (43.0%). The exceptionally high growth rate in the second quarter was primarily a result of an extremely low base, and was brought about by only a partial recovery of the service sector, so that the level of total exports remained below the level recorded in the equivalent period in 2019, before the onset of the coronavirus pandemic. Observed at the level of the entire first half of the year, total exports were up by 20.5% on the same period in the preceding year, when total exports fell by 22.0%.

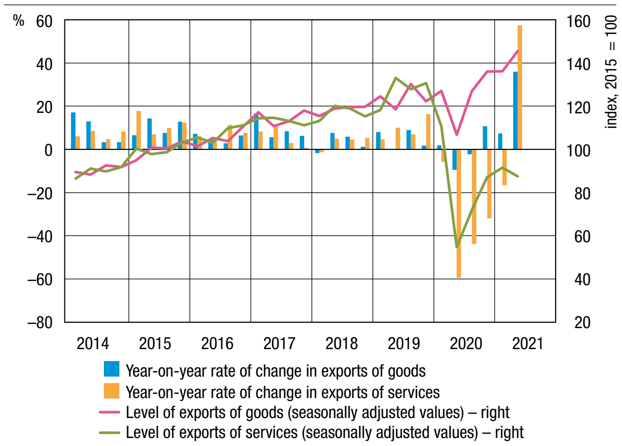
Real exports of goods increased by 7.4% in the first quarter of 2021 from the same period in 2020, and in the second quarter the increase was as high as 36.0%. In the goods trade, the developments were favourable throughout the entire observed period, as indicated by the acceleration in the exports of goods at quarterly levels (0.1% in the first quarter and 6.9% in the second quarter). Real exports of goods increased by 21.1% in the first half of 2021 from the same period in 2020 (when they dropped by 3.9%) and thus exceeded pre-crisis levels. The nominal data on the trade in goods according to main industrial groupings show that in the first half of 2021, the exports of all groups of products grew on an annual basis, most notably the export of energy, which was, among other things, a result of a rise in the prices of energy products that affected real flows

Figure 3.3 Exports of goods and services
real values



Source: CBS (seasonally adjusted by the CNB).

Figure 3.4 Real exports of goods and services



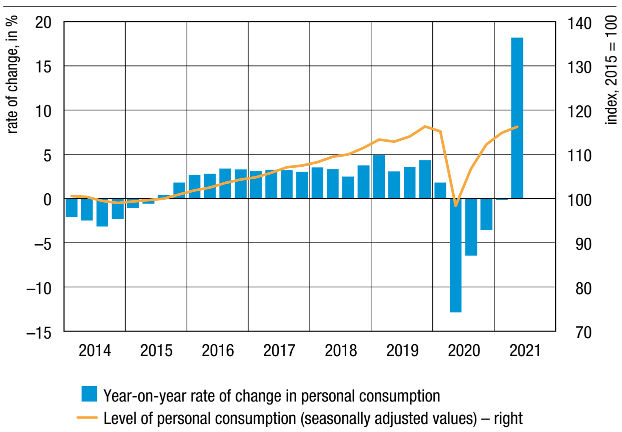
Source: CBS (seasonally adjusted by the CNB).

of goods trade in the context of national accounts. As for the exports of services, the annual growth rate stood at 21.3% in the first half of 2021, while in the same period in the preceding year, it was 43.9% lower. In the first quarter of 2021 exports of services dropped (by 16.6%), but in the second quarter, they saw a sharp rise on an annual basis (57.4%). Although the recovery of service activities was strong in the first half of the year, it was not complete, so the exports of services remained below the level recorded in the same period in 2019.

Following a stagnation on an annual basis in the first quarter of 2021, household consumption went up by 18.2% in the second quarter. The substantial rise was primarily due to the base effect, but was also driven by an increase in disposable income brought about by more favourable labour market developments and higher availability of certain services that had previously been restricted due to the measures to fight the pandemic. Personal consumption was thus 8.5% higher in the period from January to June 2021 than in the same period in 2020, when a decrease of 5.7% was recorded. The data on household expectations also point to an increased propensity for spending, with the confidence index continuously increasing throughout the first half of the year.

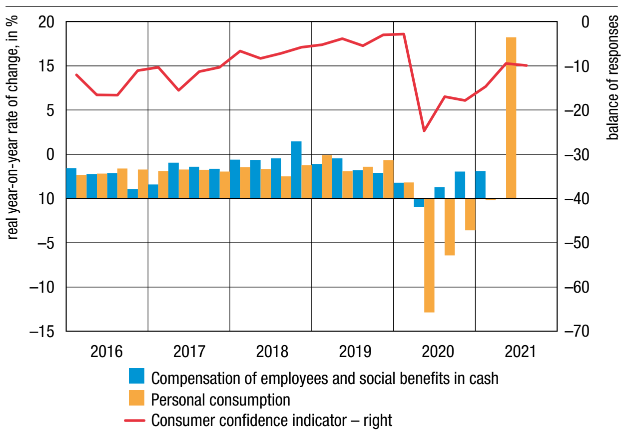
The surge in investment activity that started in the second half of 2020 continued into the first quarter of 2021. Gross fixed capital formation went up by 4.3% from the end of 2020, when a quarterly growth of 2.2% was recorded. Observed on an annual basis, capital investments increased by 5.0% in the first three months of 2021 from the same period in 2020, so investment activity exceeded the pre-crisis level recorded in the same period in 2019. The growth in investments came to a halt in the second quarter of 2021, which saw a quarterly decline (0.7%); nevertheless, investments grew strongly on an annual basis (18.1%), and their level remained above the level seen in the same period in 2019. If analysed at the level of the entire first half of the year, annual gross fixed capital formation grew by 11.3% in the first six months of 2021. Data on construction indicate that the two-digit rate of growth in overall investment activity is attributable not only to the base effect, but also to the growth in the volume of construction works on buildings and civil engineering works. In addition, imports of capital goods also increased substantially.

Figure 3.5 Personal consumption
real values



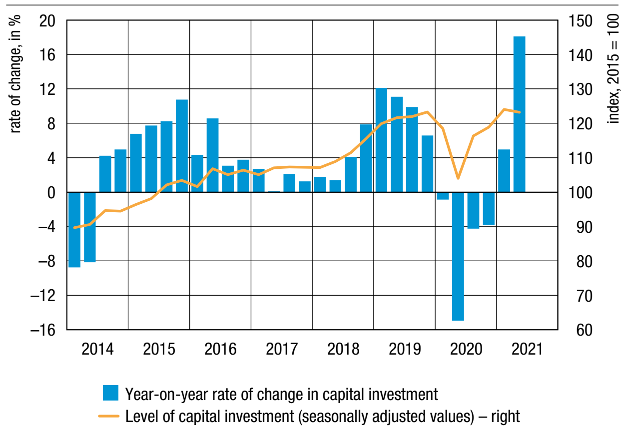
Source: CBS (seasonally adjusted by the CNB).

Figure 3.6 Determinants of personal consumption
real values and index



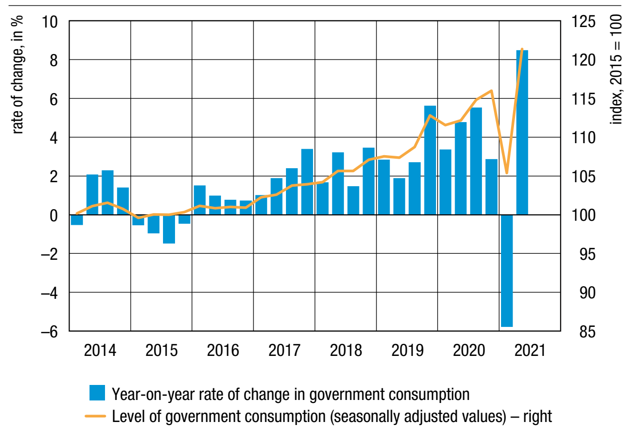
Note: Real values of compensation of employees and social benefits in cash were calculated by deflating nominal values using the personal consumption deflator.
Sources: CBS, Ipsos and CNB.

Figure 3.7 Gross fixed capital formation
real values



Source: CBS (seasonally adjusted by the CNB).

Figure 3.8 Government consumption
real values

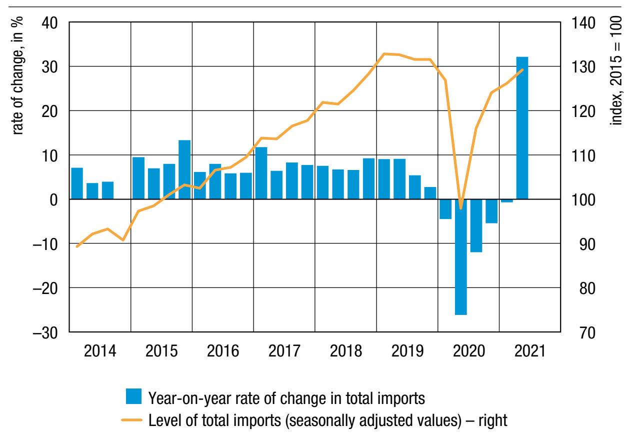


Source: CBS (seasonally adjusted by the CNB).

In the first half of 2021, government consumption increased by 1.3% from the same period in the previous year. In the first quarter, an annual decline of 5.8% was recorded, while the second quarter saw an annual growth of 8.5%. The real developments mentioned above are a result of the government consumption deflator trends, while nominal data indicate that government consumption increased in both quarters. Specifically, a nominal increase was seen in government expenditures on the use of goods and services, employee compensations and social transfers in kind.

In the first quarter of 2021, imports of goods and services decreased slightly relative to the same period in 2020 (–0.7%), while in the second quarter they increased sharply (32.2%) on account of the base effect, i.e. the steep fall (22.8%) seen in the second quarter of 2020. Total imports thus increased by 14.2% in the first six months of 2021 from the same period of the previous year (when a decline of 15.7% was recorded), reflecting the increase in personal consumption, investment activity and total exports. Imports of goods grew by 16.0% annually, and the nominal data on the trade in goods show that imports increased on an annual basis across all of the main industrial groupings. At the same time, imports of services rose by 3.9% from the same period in the previous year, indicating that the tourist consumption of residents abroad in the first half of 2021 still did not reach the pre-crisis levels seen in 2019. Although strong, the annual increase in imports in the first two quarters of 2021 was slower than the increase in exports, resulting in a positive contribution of net foreign demand to the total change in GDP.

Figure 3.9 Imports of goods and services
real values

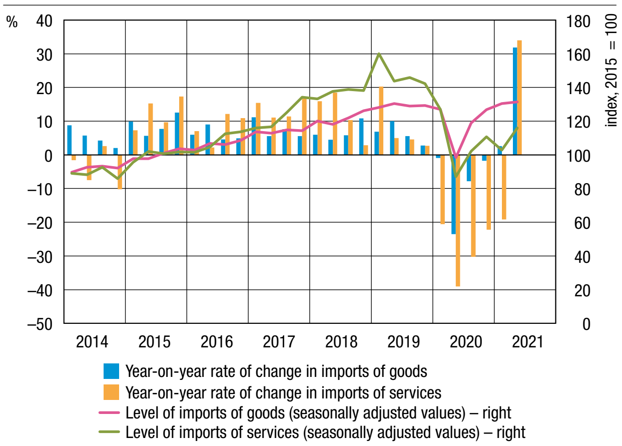


Source: CBS (seasonally adjusted by the CNB).

3.2 Aggregate supply

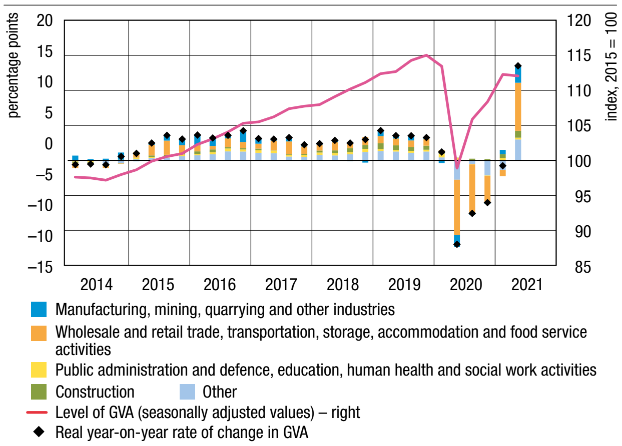
In the period from January to June 2021, gross value added (GVA) was 6.2% higher than in the same period in 2020, when it fell by 5.7% on an annual level. GVA grew across all activities except real estate activities in the first half of the current year. Strongest GVA growth was seen in wholesale and retail trade, transportation and storage and accommodation and food service activities, i.e. in the activities which had been impacted the most by the effect of the pandemic on the economy. In addition, construction also picked up. Observed by quarters, in the first quarter, GVA was lower (by 0.8%), while in the second quarter it was considerably higher (13.4%) than in the same period in 2020 due to the base effect. At the quarterly level, GVA increased by 3.6% in the first quarter, mainly owing to the increase in wholesale and retail trade, transportation and storage and accommodation and food service activities, while in the second quarter, it fell by 0.2%.

Figure 3.10 Real imports of goods and services



Source: CBS (seasonally adjusted by the CNB).

Figure 3.11 GVA rate of change
contributions to the annual change by components



Source: CBS (seasonally adjusted by the CNB).

4 Labour market

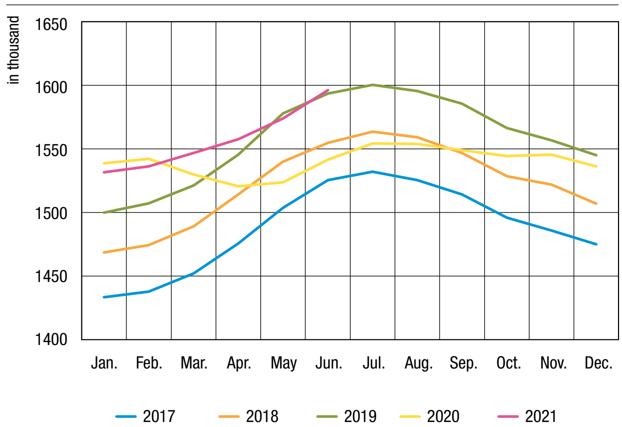
Following a recovery in employment in the second half of 2020, in January and February 2021, the number of employed persons came near the levels recorded at the beginning of 2020, thus exceeding the levels seen in the same period in 2019. Still, slower employment in tourism-related service activities resulted in slower employment growth. On the other hand, employment grew the most in construction and the IT sector.

Job preservation subsidies covered an average of 8.8% of employed persons in the period from January to June 2021. The ILO unemployment rate was 9% in the first half of the current year, the employment rate was 47.3% and the participation rate stood at a relatively low 51.9%. Wages went slightly up in the first half of 2021, by 5.8% and 2.7% in the public sector and the rest of the economy respectively, or 3.7% on average in the entire economy.

4.1 Employment and unemployment

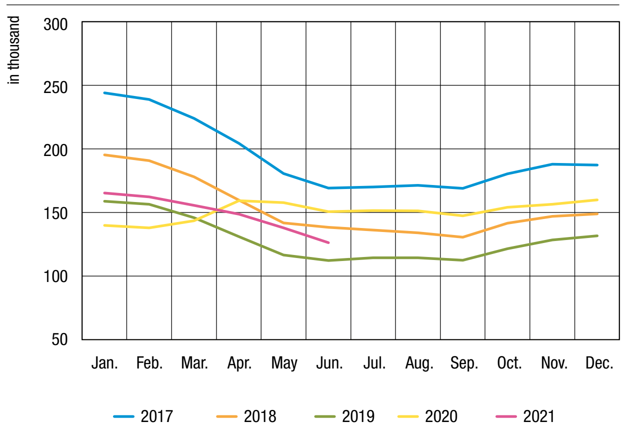
Following a recovery in employment in the second half of 2020, in January and February 2021, the number of employed persons came near to the figures recorded in early 2020, thus exceeding the levels seen in the same period in 2019. However, since slower employment in tourism-related service activities resulted in slower employment growth, at the end of May, the number of employed persons stood below the levels recorded in the same period in 2019 (Figure 4.1). In June 2021, thanks to the stronger seasonal effect on employment numbers, overall employment exceeded 2019 levels. However, despite stronger seasonal employment, the number of employed persons in accommodation and food service activities remained below pre-crisis levels. On the other hand, employment grew strongly in construction and the IT sector.

Figure 4.1 Employment
levels



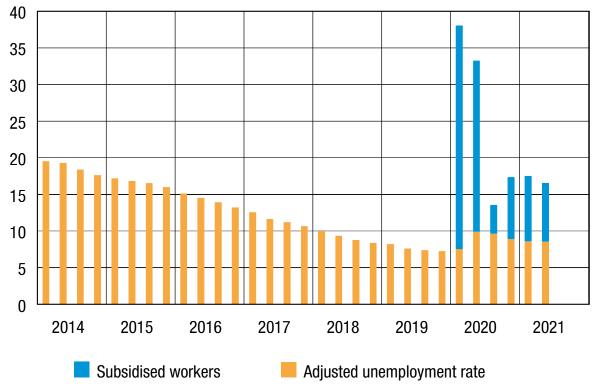
Source: CPII.

Figure 4.2 Total unemployment
levels



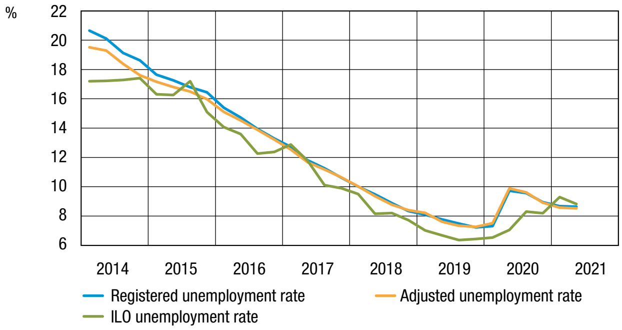
Source: CES.

Figure 4.3 Unemployment rate (seasonally adjusted data) and subsidised workers
as % of labour force



Notes: The data on subsidised workers for the first quarter of 2020 refer to March. The unemployment rate is the adjusted unemployment rate.
Sources: CPII and CES (calculated and seasonally adjusted by the CNB).

Figure 4.3a Unemployment rates
seasonally adjusted data



Notes: The ILO unemployment rate data for the first quarter of 2021 and onwards are not comparable to the data previously released due to changes in the methodology of the Labour Force Survey. The adjusted unemployment rate is the CNB estimate and is calculated as the share of the number of registered unemployed persons in the working age population, estimated as the sum of unemployed persons and persons insured with the CPII. Since January 2015, the calculation of the registered unemployment rate published by the CBS has used the data on employed persons from the JOPPD form.
Sources: CBS and CES (calculated and seasonally adjusted by the CNB).

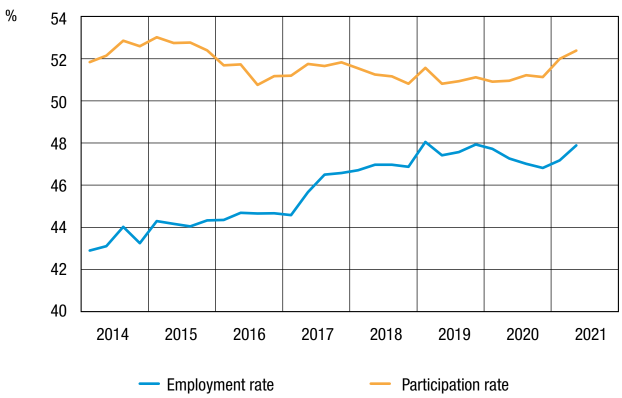
At the beginning of 2021, the number of unemployed persons was slightly above levels recorded in 2019, but the difference widened in the months that followed, due to relatively slow seasonal employment. As seasonal employment gained pace in June 2021, unemployment numbers came near 2019 levels again, but still remained slightly higher. At the end of June 2021, the number of unemployed persons was 25,000 lower than on the same date in the preceding year (Figure 4.2).

Job preservation subsidies covered an average of 8.8% of all employed persons from January to June 2021, or 8% of the labour force (Figure 4.3). In January and February the number of subsidised workers remained at the levels seen in late 2020, after which it started to decline, with the exception of a temporary increase in April. Still, despite the steady decrease, the number of subsidised workers was 20,000 higher in June 2021 than in the same period in 2020.

Since the number of unemployed persons decreased, the registered unemployment rate went down as well. According to seasonally adjusted data, the share of unemployed persons in the labour force dropped from 8.8% in December 2020 to 8.4% at the end of June 2021 (Figure 4.3a).

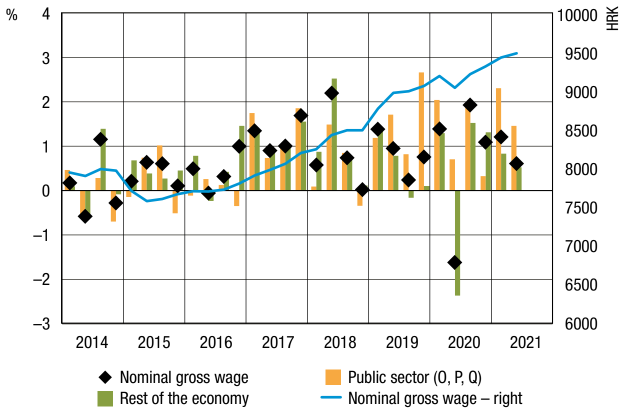
The ILO unemployment rate was 9% in the first half of 2021 (Figure 4.3a). In the same period, the employment rate was 47.3%, and the participation rate was 51.9% (Figure 4.4). Due to changes in the methodology of the Labour Force Survey, the data for the first quarter of 2021 and onwards are not comparable to the previously released data.

Figure 4.4 Labour Force Survey
seasonally adjusted series



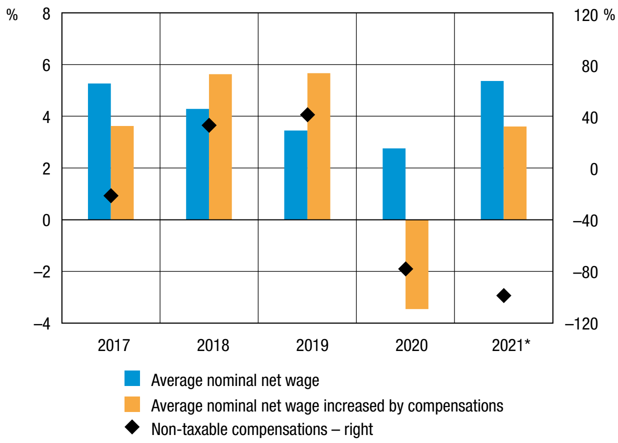
Note: Due to changes in the methodology of the Labour Force Survey, the data for the first quarter of 2021 and onwards are not comparable to previously released data.
Source: CBS (seasonally adjusted by the CNB).

Figure 4.5 Average nominal gross wage
seasonally adjusted data, quarterly rate of change and levels



Note: Data on the average nominal gross wage by activity refer to data from the RAD-1 form, and from January 2016 to data from the JOPPD form.
Source: CBS (calculated and seasonally adjusted by the CNB).

Figure 4.5a Average nominal net wage and non-taxable compensations
year-on-year rate of change

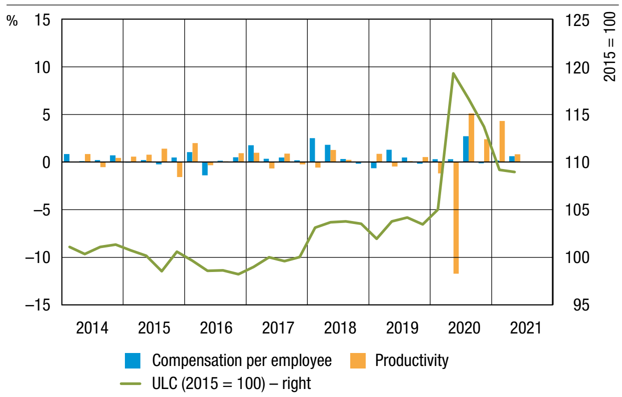


*Data refer to the first half of 2021.
Source: CBS.

4.2 Wages and unit labour costs

Wage growth slowed down in the first half of 2021, remaining contained in relation to the intensity of recovery (Figure 4.5). Average wages in the public sector and the rest of the economy grew by 5.8% and 2.7% respectively in the first half of 2021; due to the base effect of the decrease in wages in the second quarter of 2020, the average nominal gross wage in the entire economy grew by 3.7% from the same period in 2020.

Figure 4.6 Compensation per employee, productivity and unit labour costs
seasonally adjusted data, quarterly rate of change and levels (2015 = 100)



Note: In the calculation of unit labour costs, paid compensation of employees and real GDP were taken from the national accounts, while data on the number of employees (persons employed in legal persons and natural persons who received compensation) and total employment were taken from the CPII.
Sources: CPII and Eurostat (seasonally adjusted by the CNB).

The tax changes implemented in January 2021 reduced income tax rates (from 24% and 36% to 20% and 30%) and thus had a favourable impact on the rise in nominal net wages in 2021. Hence, the average nominal net wage grew by 5.2% in the first half of 2021 relative to the same period in 2020. It is important to note that the wage statistics do not include non-taxable compensations, which had had a significant impact on the disposable income of employed persons before the onset of the pandemic, but have been almost completely absent since May 2020. Nominal net wages increased by non-taxable compensations thus increased at a slower rate in the period from January to June 2021, by 3.6% (Figure 4.5a).

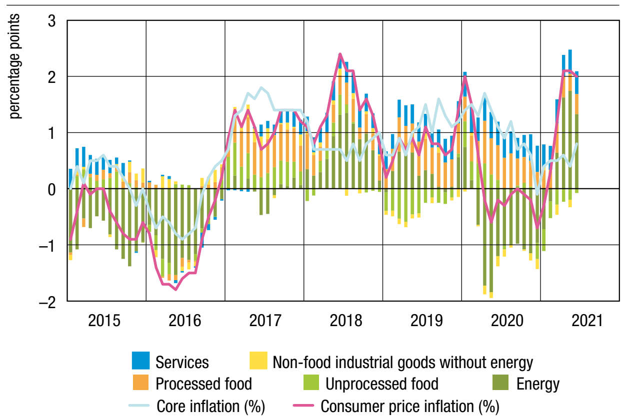
In the first quarter of 2021, nominal unit labour costs continued to decline considerably, but in the second quarter, the decrease slowed down. This reflects a slowdown in the increase of labour productivity and a slightly more dynamic increase in compensations per employee, although the increase was still slower than the increase in labour productivity (Figure 4.6).

5 Inflation

Consumer price inflation picked up from –0.7% at the end of 2020 to 2.0% in the first half of 2021. Factors contributing to such an increase, such as the hike in the prices of energy and crude oil on the global market and the positive base effect, are estimated to be temporary. Core inflation (excluding agricultural product prices, energy prices and administered prices) stood at 0.8% in June. The annual inflation rate in the euro area increased as well, from –0.3% in December 2020 to 1.9% in June 2021.

In the first half of 2021, consumer price inflation picked up considerably, but remained at a relatively low level (Figure 5.1). The factors affecting such price trends are estimated to be mostly temporary. The increase in inflation seen in the first six months (from –0.7% in in December 2020 to 2.0% in June 2021) was mainly caused by the accelerated annual growth in energy prices (particularly refined petroleum products) resulting from the increase in the prices of crude oil on the global market and by the positive base effect.[1] To a lesser extent, energy prices also picked up as a result of an increase in the prices of gas and solid fuels. The contribution of energy prices to overall inflation rose from –1.0 percentage point in December 2020 to 1.3 percentage points in June 2021.

Figure 5.1 Year-on-year inflation rate and contributions of components to consumer price inflation

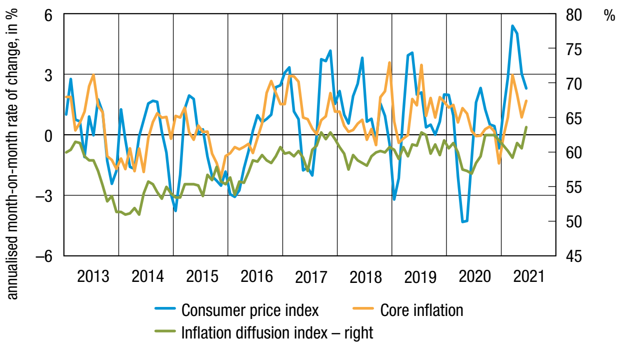


Notes: Core inflation excludes agricultural product prices, energy prices and administered prices. Processed food products include alcoholic beverages and tobacco.
Sources: CBS and CNB calculations.

The pick-up in inflation seen in the first half of 2021 was also, in small part, a result of an increase in the annual rate of growth in the prices of food and industrial products (excluding food and energy). The annual rate of change in food prices (including beverages and tobacco) grew from 0% in December 2020 to 0.9% in June 2021. The increase in the annual rate of growth in the prices of unprocessed food products may be attributed largely to adverse weather conditions which caused lower yields (vegetables) and to the developments in the global market (meat). Furthermore, the acceleration of the annual rate of change in the prices of processed food products (bread, milk, cheese, eggs, oil and fats) is mostly a result of a spillover of imported cost pressures, most notably increases in the prices of food raw materials on the global market and of energy products. In addition, the annual increase in the prices of tobacco also gained pace in the first half of the year.[2]

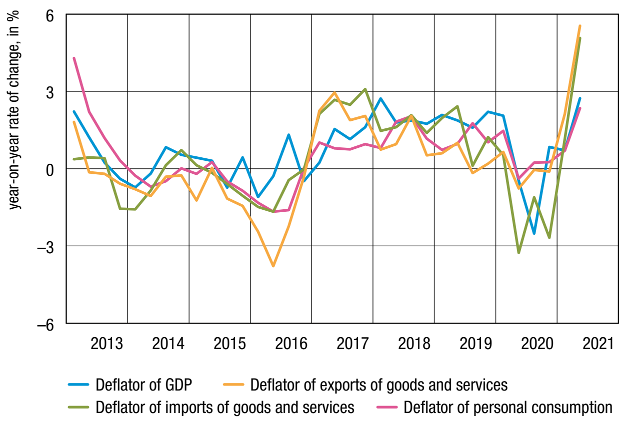
1 The waning of the effect of a considerable drop in the prices of refined petroleum products at the onset of the pandemic on the decrease in the annual rate of change in the prices of energy.

Figure 5.2 Indicators of current inflation trends



Notes: The month-on-month rate of change is calculated from the quarterly moving average of seasonally adjusted consumer price indices. The inflation diffusion index shows the share of the number of products whose prices increased in a given month in the total number of products, measured by a 6-month moving average, and is based on the monthly rates of change derived from the seasonally adjusted components of the HICP.
Sources: CBS, Eurostat and CNB calculations.

Figure 5.3 Deflator of GDP and its individual components



Source: CBS.

Against the backdrop of demand recovery and supply-side shocks, the annual rate of change in the prices of industrial products (excluding food and energy) picked up as well (from –0.7% in December 2020 to 0.0% in June 2021). Still, the inflation of the aforementioned prices remained low, so that the spillover of the increase in the prices of industrial raw materials, higher freight rates and shortages of certain intermediate goods (e.g. semiconductors) on the global market to domestic consumer prices has been relatively limited. Nevertheless, indicators of price developments in earlier stages of production and distribution point to a somewhat stronger spillover of supply-side shocks to the producer prices on the domestic market, which primarily concerns intermediate

Table 5.1 Price indicators

year-on-year rate of change

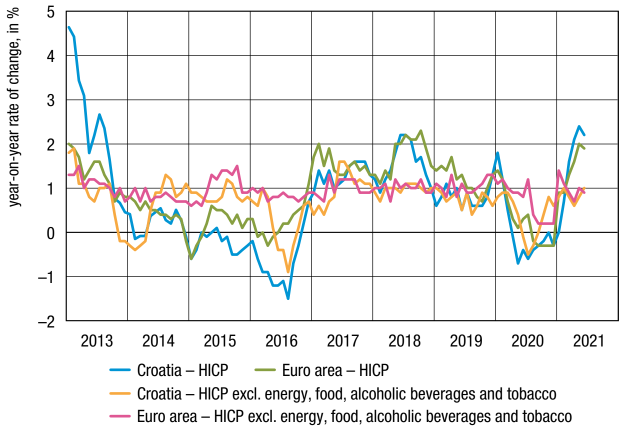
	6/20	9/20	12/20	3/21	6/21
Consumer price index and its components					
Total index	–0.2	0.0	–0.7	1.2	2.0
Energy	–7.1	–5.8	–5.7	3.9	8.1
Unprocessed food	1.9	0.7	–3.5	–3.3	–0.9
Processed food	2.7	2.1	1.3	2.2	1.5
Non-food industrial goods without energy	–0.7	0.0	–0.7	–0.7	0.0
Services	1.6	1.4	1.8	1.7	1.6
Other price indicators					
Core inflation	1.1	0.7	–0.1	0.5	0.8
Index of industrial producer prices on the domestic market	–3.1	–3.2	–1.2	3.2	7.8
Index of industrial producer prices on the domestic market (excl. energy)	0.4	–0.4	0.1	0.7	1.4
Harmonised index of consumer prices	–0.4	–0.3	–0.3	1.6	2.2
Harmonised index of consumer prices at constant tax rates	–0.3	–0.2	–0.1	1.1	2.0

Sources: CBS and Eurostat.

2 Due to an increase in the producer prices of tobacco products. In March 2021, excises on tobacco were raised, but in April 2021, the effect of the increase in excises on the annual rate of growth in the prices of tobacco waned as in April 2020, the prices of tobacco products also went up due to an increase in excises.

goods, whose annual rate of price change increased to 3.4% in the first half of 2021 (from 0.6% in December 2020). The concurrent acceleration of the annual increase in the producer prices of durable consumer goods was less pronounced (from 0.0% in December to 2.0% in June 2021). The stable annual rate of change in the prices of services, which slowed down only slightly (from 1.8% in December 2020 to 1.6% in June 2021) also contributed to low and stable inflation.

Figure 5.4 Indicators of price developments in Croatia and the euro area



Source: Eurostat.

Core inflation (excluding agricultural product prices, energy prices and administered prices) gained pace from –0.1% in December to 0.8% in June, primarily as a result of a pick-up in the annual increase in the prices of processed food products (including beverages and tobacco) and fresh meat, industrial products (clothing and footwear, motor vehicles) and catering services. Low and stable core inflation was supported by the contained domestic cost pressures arising from an increase in labour productivity stronger than the growth in wages, which resulted in lower unit labour costs.

The implicit deflator of GDP increased from 0.8% in the fourth quarter of 2020 to 2.7% in the second quarter of 2021. Trading conditions improved in the first half of the year as the increase in the deflator of goods and services exports was stronger than the increase in the deflator of goods and services imports (Figure 5.3).

The annual rate of inflation in the euro area measured by the harmonised index of consumer prices picked up from –0.3% in December 2020 to 1.9% in June 2021 (Figure 5.4). The increase in inflation in the euro area in the first half of 2021 is estimated to be a result of several temporary factors, such as the pick-up in the annual increase in energy prices (due to the positive base effect and the price increase in the current year), the increase in the prices of raw materials resulting from disruptions in supply chains and the positive base effect related to the temporary VAT rate decrease effected in Germany in mid-2020. Therefore, the contributions of energy and industrial products to overall inflation increased considerably in the first half of 2021 (by 1.9 and 0.5 percentage points respectively).

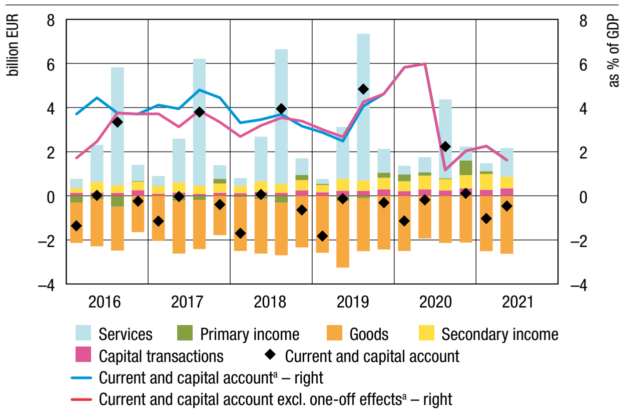
The annual rate of inflation in Croatia measured by the harmonised index of consumer prices (HICP) stood at 2.2% in June 2021, exceeding the annual HICP inflation rate in the euro area by 0.3%. Core inflation in Croatia (measured by the HICP excluding energy, food, alcoholic beverages and tobacco) was very low in June and only slightly higher than that in the euro area (1.0% versus 0.9%).

6 Current and capital account

The recovery of domestic demand resulted in an increase in the foreign trade deficit. Unfavourable developments were offset by an increase in the net exports of services, particularly travel services, as in the same period in 2020, there were almost no arrivals of foreign tourists and tourist activity was virtually non-existent.

The price and cost competitiveness of Croatian exports improved in the first half of 2021, as suggested by the depreciation of real effective exchange rates of the kuna deflated by consumer and producer prices and unit labour costs. In the transactions with the EU budget, the surplus of EU funds utilised over payments stood at 3.9% of GDP at the end of June, with a larger share related to current purposes and more funds allocated to the government than to other domestic sectors.

Figure 6.1 Current and capital account balance and its structure



[a] Sum of the last four quarters.
Note: One-off effects include the conversion of CHF-linked loans in 2015 and bank provisions for loans to the Agrokor Group in 2017 and 2018.
Source: CNB.

In the first half of 2021, the deficit in the current and capital account increased relative to the same period in 2020, which was mainly a result of the widening of the foreign trade deficit against the backdrop of recovering domestic demand. In addition, expenditures on direct equity investment increased as a result of improved performance of foreign-owned banks and enterprises, although to a considerably smaller extent. Unfavourable developments were offset by an increase in the net exports of services, particularly travel services, after the arrivals of foreign tourists and tourist activity became possible again. The overall surplus in the secondary income account and in the capital account increased too, although to a smaller extent than the net exports of services; the trend was brought about by the stronger uptake of EU funds and growing net revenues from personal transfers. If the last four quarters are observed, the surplus in the current and capital account in the period up to the end of June 2021 totalled 1.6% of GDP, having gone down by 0.4 percentage points from the level recorded in the whole of 2020 (Table 6.1).

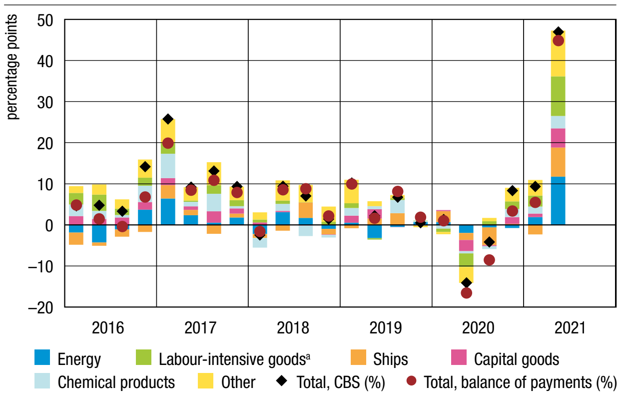
6.1 Foreign trade and competitiveness

In the first half of 2021, according to the balance of payments data, exports of goods increased by 23.7%, imports grew by 20.0%, and the deficit widened by 15.4% from the same period in the preceding year due to the faster increase of imports in absolute terms. The noticeable pick-up in the imports and exports of goods was a result of recovered trade flows, growing domestic and foreign demand and the partial restoration of supply chains that had been disrupted after the outbreak of the crisis. In addition, the manufacturing industry recovered faster than the service sector and was accompanied by a rise in raw material prices on the global market. Accordingly, total goods exports increased by 13.8% in the first half of 2021 relative to the equivalent period in 2019, while imports grew by 3.2% and the trade deficit shrank by 8.5%. Observing the past year, the goods trade deficit in the period up to the end of June 2021 totalled 17.9% of GDP, down by 0.6 percentage points from the whole of 2020.

CBS data[3] show that the increase in the exports of goods in the first half of 2021 was broadly based (Figure 6.2), and that the annual increase was mainly driven by higher exports of energy products, mainly oil and refined petroleum products to Hungary, as well as by certain categories of capital goods, most notably electrical machinery, apparatus and appliances to Germany and metal industry products to Italy and Slovenia. Furthermore, the exports of medical and pharmaceutical products to the US and the exports of other chemical products to Italy, Germany and the Netherlands also rose noticeably. Increased exports of other transport equipment (mostly ships) and food products (in particular cereals and other cereal products, fish and fish preparations and fruit and vegetables) also contributed to the favourable export performance.

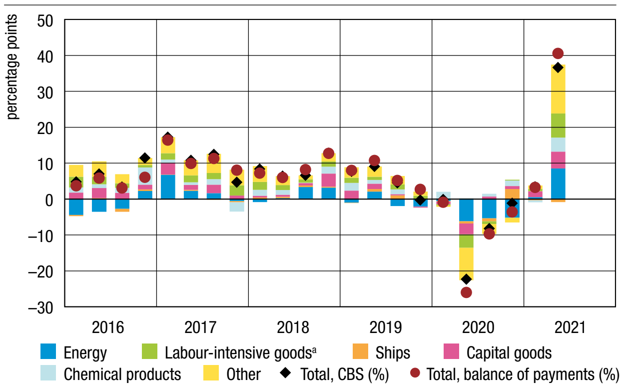
The increase in total goods imports was broadly based as well (Figure 6.3). Particularly worth noting was the increase in the import of energy products (most notably gas from the US and oil and refined petroleum products from Azerbaijan), followed by imports of capital goods (most notably electrical machinery, apparatus and appliances

Figure 6.2 Goods exports (f.o.b.)
year-on-year rate of change and contributions



[a] Labour-intensive goods (according to the SITC) include: textile, wearing apparel, footwear, leather, paper, cork and wood, furniture, manufactures of metals and non-metallic mineral manufactures, prefabricated buildings and manufactured articles n.e.c.
Sources: CBS and CNB.

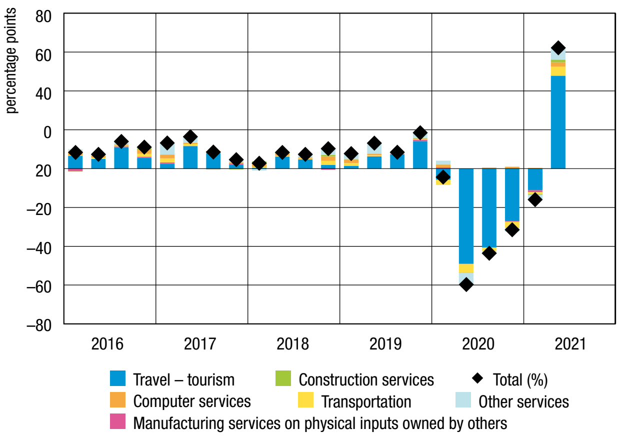
Figure 6.3 Goods imports (c.i.f.)
year-on-year rate of change and contributions



[a] Labour-intensive goods (according to the SITC) include: textile, wearing apparel, footwear, leather, paper, cork and wood, furniture, manufactures of metals and non-metallic mineral manufactures, prefabricated buildings and manufactured articles n.e.c.
Sources: CBS and CNB.

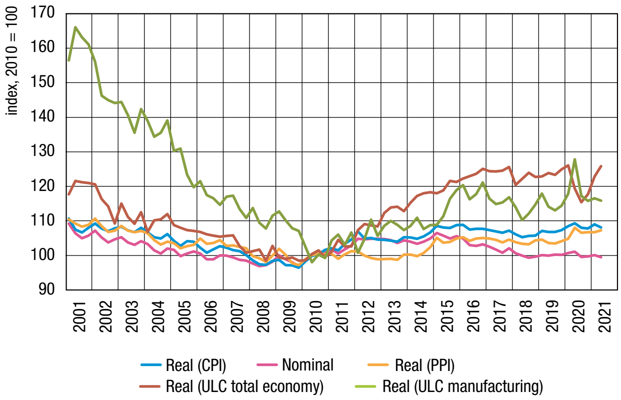
3 For more information on the differences in the scope of the trade in goods according to the balance of payments and CBS data, see Box 3 Foreign trade developments according to the balance of payments data, Macroeconomic Developments and Outlook No. 2, July 2017.

Figure 6.4 Services exports
year-on-year rate of change and contributions



Source: CNB.

Figure 6.5 Nominal and real effective exchange rates of the kuna



Notes: The unit labour cost is calculated as the ratio between compensation per employee and labour productivity (defined as GDP per person employed). A fall in the index indicates an effective appreciation of the kuna.
Source: CNB.

from China, Germany and Slovenia) and metal industry products from Italy. In addition, the imports of road vehicles from Germany, France and the Czech Republic also increased significantly, as did the imports of other chemical products (excluding medical and pharmaceutical products) from Germany, Italy and Slovenia.

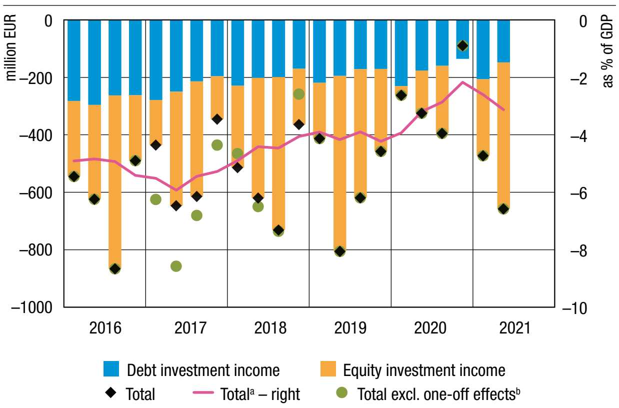
In contrast to the foreign trade in goods, international trade in services saw a noticeable improvement in balance. In the first half of 2021, net exports of services increased significantly owing to increased tourism revenues (by 55.9%), i.e. thanks to the more vigorous tourist consumption by foreign tourists following last year's plunge (Figure 6.4). Nevertheless, travel revenues reached but a half (53%) of the revenue level seen in the same period in the record-setting year of 2019. The cumulative values recorded over the past year reveal that the surplus in the international trade in services increased from 10.5% of GDP in 2020 to 11.2% at end-June 2021.

The price and cost competitiveness of Croatian exports improved in the first half of 2021. This is suggested by the depreciation of the real effective kuna exchange rates deflated by consumer and producer prices, as well as by the depreciation of the real effective kuna exchange rates deflated by unit labour costs in the overall economy and in the manufacturing industry relative to the end of the preceding year (Figure 6.5). Such developments stem from the more favourable price and cost developments in Croatia than those seen in major trading partners, while at the same time, the nominal effective exchange rate of the kuna appreciated slightly, mainly as a result of the appreciation of the kuna against the euro.

6.2 Income and transactions with the EU

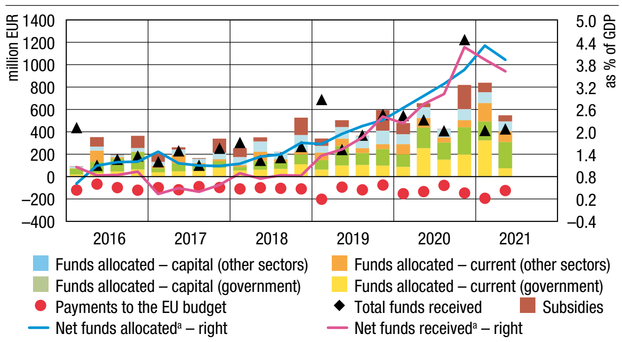
The negative investment income balance deteriorated slightly in the first six months of 2021 relative to the same period in 2020 due to higher net expenditures on equity investments (Figure 6.6) resulting from the better performance of foreign-owned banks and enterprises (particularly in the oil industry and trade and construction). At the same time, net interest expenditures on foreign debt liabilities of domestic sectors decreased

Figure 6.6 Investment income



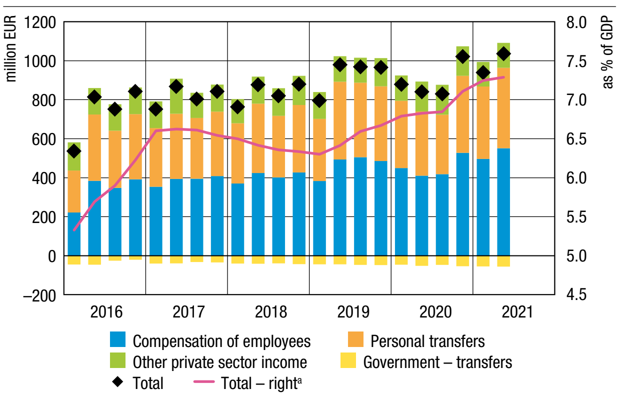
ª Sum of the last four quarters, excluding one-off effects. [b] One-off effects include bank provisions for loans to the Agrokor Group in 2017 and 2018.
Source: CNB.

Figure 6.7 Transactions with the EU budget



ª Sum of the last four available quarters.
Notes: As regards total funds received from EU funds, only funds allocated and paid out to end beneficiaries are recorded in the current and capital account of the balance of payments, while funds received but not allocated are recorded in the financial account. Payments to the EU budget carry a negative sign in the figure. The positive value of net received and net allocated funds is the surplus over the payments to the EU budget.
Sources: CNB and MoF.

Figure 6.8 Other income, excluding investment income and transactions with the EU



ª Sum of the last four available quarters.
Note: Compensation of employees is recorded in the primary income account, while other series (personal transfers, other private sector income and government transfers) are recorded in the secondary income account.
Source: CNB.

slightly, particularly government expenses on issued securities.

Net revenues arising from transactions with the EU budget increased in the first half of 2021 (by EUR 0.2bn) relative to the same period in 2020. As regards the structure of the increase in the use of EU funds, a larger share was related to current purposes and more funds were allocated to the government than to other domestic sectors. The surplus of EU funds utilised over the payments to the EU budget, reported as the sum of the last four quarters, thus increased from 3.7% of GDP at the end of 2020 to 3.9% of GDP at the end of June 2021 (Figure 6.7).

Net inflow from other income, which excludes income from equity and debt investments and transactions with the EU budget, also increased in the first half of 2021 relative to the equivalent period in 2020 due to a rise in net revenues from compensations of persons temporarily employed abroad and from personal transfers (Figure 6.8).

7 Private sector financing

The costs of financing of the government and other domestic sectors mostly decreased in the first half of 2021, remaining close to record lows. The already very low interest rates on short-term government borrowing dropped further, while the interest rate on one-year euro T-bills decreased from 0.06% to –0.05%.

The private sector continued to benefit from the very favourable financing conditions, driven by the further decrease in the funding costs of the Croatian banking system and the exceptionally expansionary monetary policy, with liquidity surplus standing at record high levels. Interest rates on household loans also generally trended down in the first half of 2021 compared with the last quarter of 2020.

The country's credit rating also remained unchanged in the first half of 2021. Standard & Poor's and Fitch maintained Croatia's BBB– investment rating with a stable outlook, while Moody's maintained its Ba1 rating with a stable outlook, one notch below investment grade.

Domestic sectors' financing costs mostly decreased in the first half of 2021, remaining close to record lows. In the same period, banks slightly eased the credit standards for household and corporate loans. Total corporate financing increased on an annual level as a result of the rise in foreign borrowing, and to a smaller extent also due to the growth in domestic debt. After a significant slowdown in 2020, the annual growth of household placements started to recover mildly, while the rise in housing loans continued to gain momentum.

Government borrowing costs, one of the determinants of borrowing costs for other domestic sectors, mostly went down in the first half of the year, particularly yields on kuna debt without a currency clause. The already very low interest rates on short-term borrowing dropped further. The interest rate on one-year kuna T-bills in the domestic market edged down from 0.06% in late 2020 to 0.02% in June 2021 (Figure 7.2), while the interest rate on euro T-bills of the same maturity issued in the domestic market remained at –0.05% in May, the same as in the previous issue in October 2020. In early May, the government refinanced a large issue of one-year euro T-bills, raising the amount to EUR 1.2bn from EUR 1.0bn a year ago, while the interest rate decreased from 0.06% to –0.05%. Long-term yields on government bonds were in June close to pre-pandemic levels (Figure 7.1), while costs of long-term financing in kuna without a currency clause were even more favourable. In late February, the government issued two tranches of eurobonds in the international capital market worth EUR 1.0bn each, with a 1.26% yield on 12-year bonds and a 1.79% yield on 20-year bonds. The maturity period for issued eurobonds was, for the first time, extended to 20 years, by which Croatia acquired funds for the longest term in its history of borrowing in the international capital market.

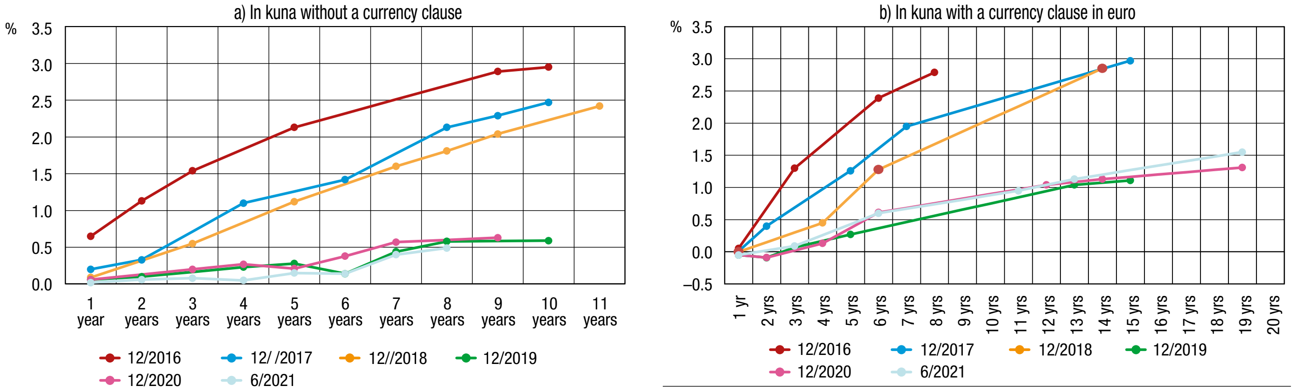
The government's foreign borrowing costs, estimated by the sum of the EMBI for Croatia and the yield on the ten-year German government bond, increased from 0.5% at the end of the previous year to 1.0% in June (Figure 7.3), mostly due to the rise in the yield on the German government bond. Croatia's credit default swap (CDS) mostly held steady in the first half of 2021, standing at 78 basis points in late June, only 3 basis points more than at end-2020. The country's credit rating also remained unchanged in the first half of 2021. The credit rating agencies Standard & Poor's and Fitch maintained Croatia's BBB– investment rating with a stable outlook, while Moody's maintained its Ba1 rating with a stable outlook, one notch below investment grade.

Corporate financing costs decreased slightly in the first half of 2021 relative to the last quarter of 2020. The average interest rate on short-term corporate borrowing from banks in kuna without a currency clause dropped by 0.1 percentage point (Figure 7.2), while the average interest rate on long-term loans with a currency clause fell by 0.2 percentage points (Figure 7.3). Broken down by the size of loans, the average interest rate on large loans above HRK 7.5m and on smaller-value loans fell by 0.3 percentage points (Figure 7.4). Loans ranked in terms of amounts include loans in foreign currency.

Interest rates on household loans generally trended down in the first half of 2021 compared with the last quarter of 2020. The average interest rate on short-term kuna household loans without a currency clause dropped by 0.2 percentage points (Figure 7.2), while the average interest rate on long-term household loans with a currency clause, excluding housing loans, fell by 0.4 percentage points (Figure 7.3). The average interest rate on long-term housing loans with a currency clause increased only slightly, which is mostly attributable to the very low level of these interest rates in the last quarter of 2020 due to the large amounts of housing loans granted under the APN's subsidy programme.

A further decrease in the funding costs of the Croatian banking system in the conditions of the exceptionally expansionary monetary policy and historically high

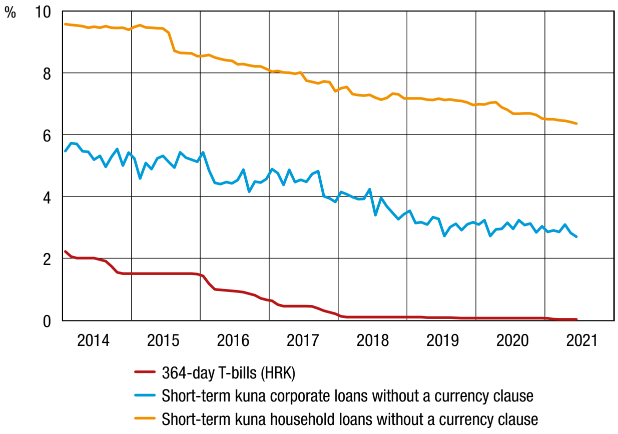
Figure 7.1 Yield-to-maturity on RC bonds



Notes: The dots show the achieved yields, while other values have been interpolated. Data for a one-year yield refer to the achieved interest rate on one-year kuna T-bills without a currency clause
Source: CNB.

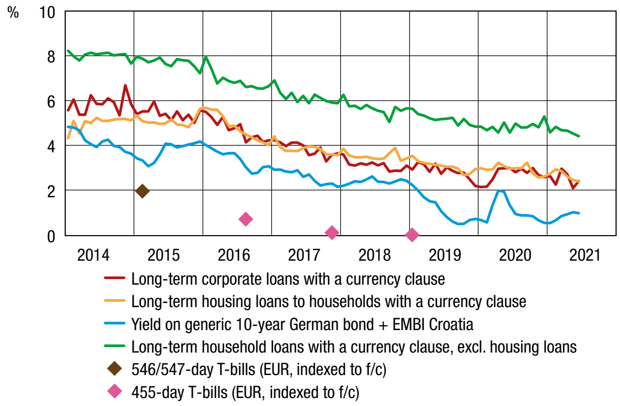
Notes: The dots show the achieved yields, while other values have been interpolated. Data for a one-year yield refer to the achieved interest rate on one-year T-bills with a currency clause in euro. Data for the end of 2016 refer to November, for the end of 2017, 2019 and 2020 refer to October, and for June 2021 refer to May 2021.
Source: CNB.

Figure 7.2 Short-term financing costs
in kuna without a currency clause



Sources: MoF and CNB.

Figure 7.3 Long-term financing costs
in kuna with a currency clause and in foreign currency

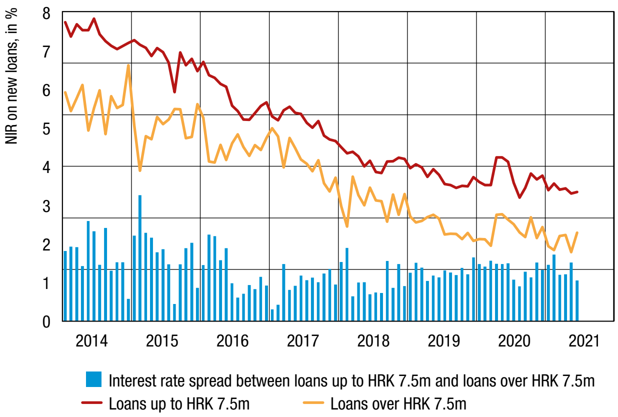


Note: EMBI, or the Emerging Market Bond Index, shows the spread between yields on government securities of emerging market economies, Croatia included, and risk-free securities issued by developed countries.
Sources: MoF, Bloomberg and CNB.

surplus liquidity contributed to the maintenance of favourable financing conditions for the private sector. The first half of 2021 witnessed a further decrease in the national reference rate[4] (Figure 7.5) and in EURIBOR, which fell to its record low (Figure 2.6).

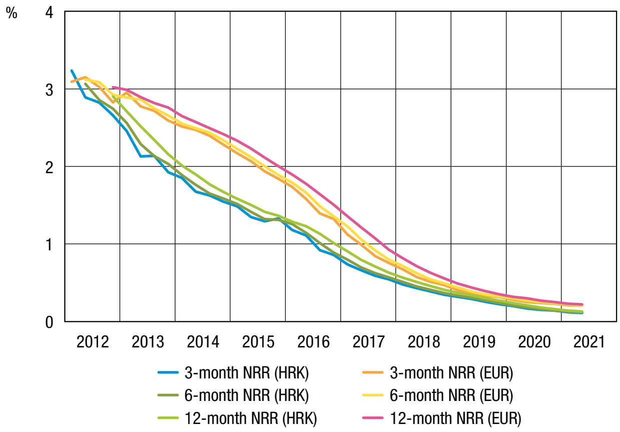
According to the bank lending survey, the tightening of credit standards for corporate loans in response to uncertainty following the outbreak of the pandemic started in early 2020 and came to a halt as late as in the second quarter of 2021 (Figure 7.6). The easing of standards in the second quarter was influenced by high liquidity, competition from other banks and favourable industry or firm-specific outlooks. Demand for loans decreased abruptly in the second quarter of 2020 and the unfavourable trends persisted until the first quarter of 2021, when there was a mild

Figure 7.4 Bank interest rates on loans to non-financial corporations by volume



Source: CNB.

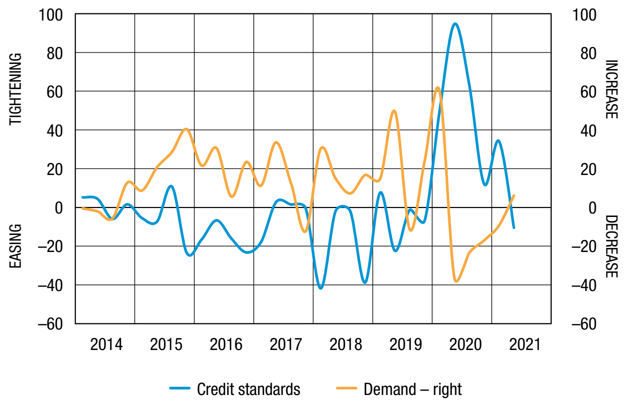
Figure 7.5 National reference rate (NRR)



Note: The rates shown are the rates for all natural and legal persons.
Sources: CNB and HUB.

4 The national reference rate (NRR) is the average interest rate paid on deposits by the banking sector. It is used as one of the benchmark interest rates for determining the level of the variable component of variable interest rate on loans, in accordance with Article 11a of the Consumer Credit Act (pursuant to the Act on Amendments to the Consumer Credit Act, OG 143/2013).

Figure 7.6 Credit standards and corporate demand for loans



Note: Data show the net percentage of banks weighted by the share in total corporate loans.
Source: CNB.

increase in total demand. Demand by small and medium-sized enterprises and demand for short-term loans increased, while demand by large enterprises and demand for long-term loans decreased. According to bank responses, the need of enterprises for financing of working capital and debt restructuring led to the growth in total demand in the second quarter of 2021, which was, however, offset by the reduced corporate needs for financing of investments.

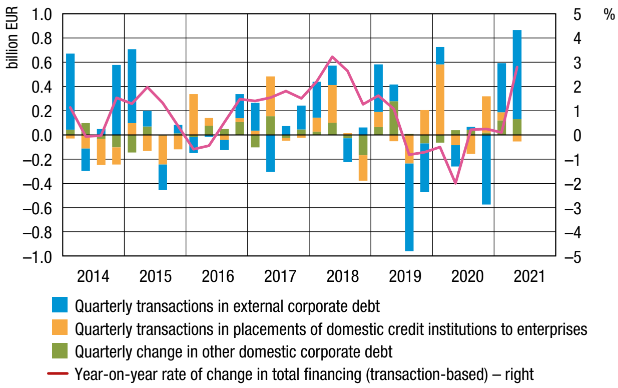
With regard to households, the credit standards for housing loans were relaxed in the first half of 2021, after holding steady in the last quarter of 2020, while the easing of standards for consumer and other loans almost came to a halt (Figure 7.7). The easing of standards for both types of loans in the first half of 2021 was mostly influenced by competition from other banks and, in case of housing loans, by positive expectations related to overall economic trends, as well as by improved prospects in the real estate market. The easing of standards for consumer and other loans was limited by concerns about the creditworthiness of clients. Demand for both types of loans grew during the first and the second quarter, particularly for consumer and other loans. Demand for housing loans was fuelled by the favourable outlook for the real estate market, whereas stronger consumption of durable consumer goods and consumer confidence provided a boost to demand for consumer loans.

The corporate demand for loans was spurred by economic recovery, but the growth in corporate lending remained subdued in the first half of 2021. Corporate foreign borrowing increased, while growth was also recorded in borrowing from the CBRD and

Figure 7.7 Credit standards and household demand for loans

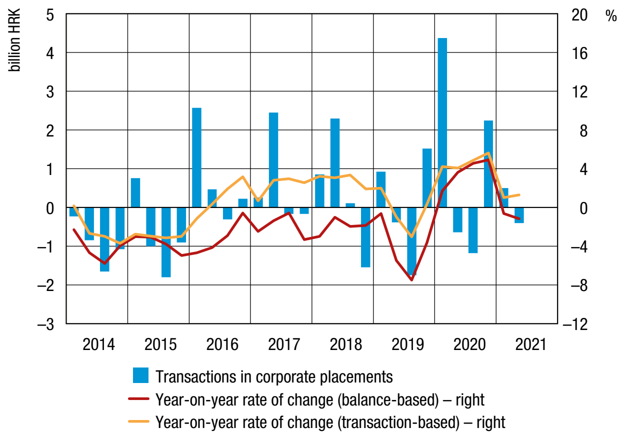
Note: Data show the net percentage of banks weighted by the share in total household loans.
Source: CNB.

Figure 7.8 Corporate financing



Notes: Other domestic financing includes borrowing from domestic leasing companies, CBRD and HAMAG. External debt excludes the effect of debt-equity swaps. All changes were calculated according to transactions (except for leasing companies).
Sources: HAMAG BICRO, HANFA, CNB and CNB calculations.

Figure 7.9 Corporate domestic placements of credit institutions

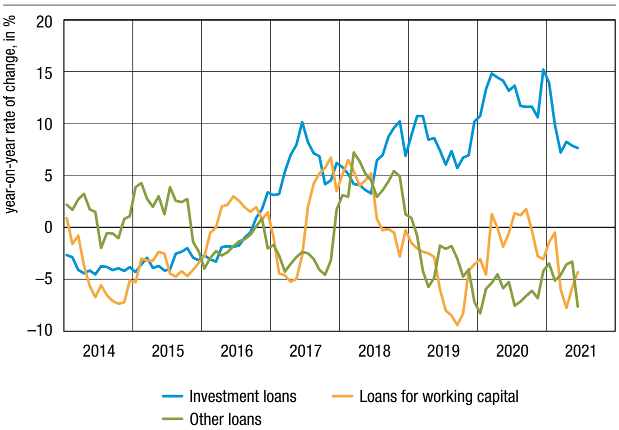


Source: CNB.

HAMAG BICRO due to the use of loans for maintaining liquidity during the pandemic (Figure 7.8). If viewed on an annual level, total corporate debt increased by 2.8% (transaction-based) at end-June, driven by the rise in external debt, and to a smaller extent by the increase in other domestic financing, mostly as a result of corporate financing through the CBRD and HAMAG BICRO.

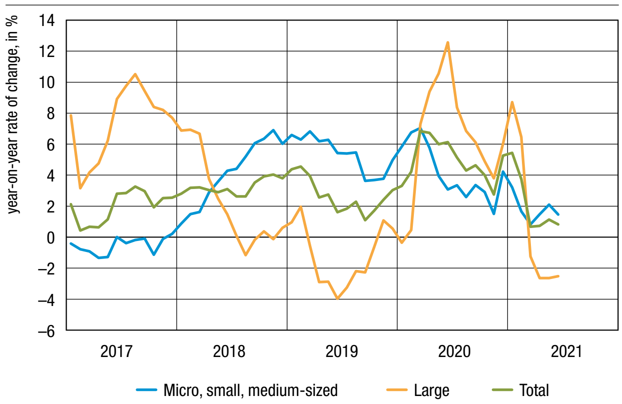
After having played an important role in corporate financing in 2020, corporate placements of credit institutions grew by a mere HRK 0.1bn or 0.1% in the first six months of 2021, with their annual growth rate standing at 1.3% at end-June (transaction-based, Figure 7.9). This growth was again determined by demand for investment loans, which were 7.6% higher in late June on an annual basis (Figure 7.10), which was, however, considerably lower than in the previous year. Other loans dropped on an annual basis, particularly working capital loans, which fell by 4.3%. Loans to micro, small and medium-sized enterprises increased steadily, growing by 1.5% in June, which was less than a year ago. Large enterprises started to deleverage

Figure 7.10 Growth in corporate loans by purpose
transaction-based



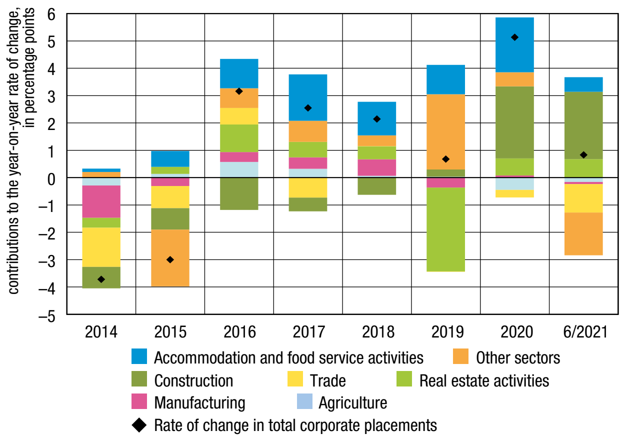
Source: CNB.

Figure 7.11 Growth in corporate placements by size
transaction-based



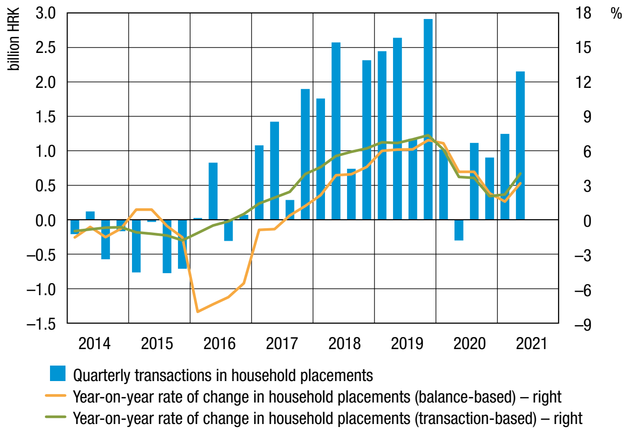
Note: The data were adjusted for the assessment of the effect of activated government guarantees for loans to particular shipyards and the decrease in the claims on the Agrokor Group linked to the operational implementation of the settlement.
Source: CNB.

Figure 7.12 Growth in corporate placements by activity
transaction-based



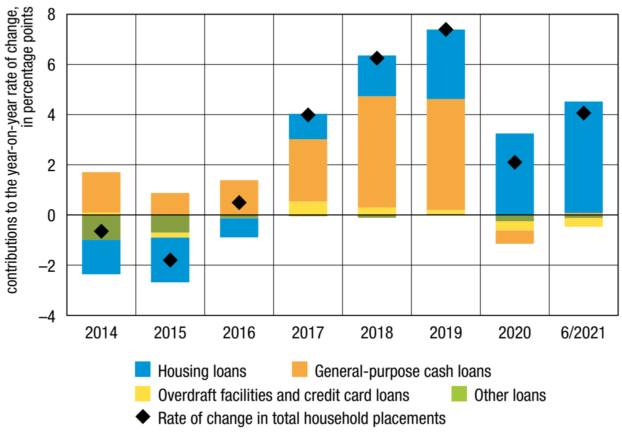
Source: CNB.

Figure 7.13 Household placements



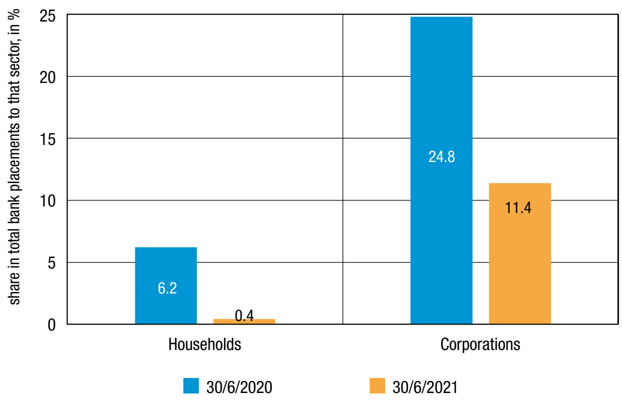
Source: CNB.

Figure 7.14 Growth in household placements by loan type
transaction-based



Source: CNB.

Figure 7.15 Loans under payment deferral or restructuring measures



Note: Since June 2021, data on approved loan payment deferral or restructuring applications have been collected according to a new methodology, but this has not led to significant deviations from the data collected by applying the old methodology.
Source: CNB.

on an annual level in March (Figure 7.11), after having accounted for most of the growth since last March.

The bulk of the annual growth in placements in late June 2021 was seen in construction (result of a large transaction in December), the real estate activity and the activities of accommodation and food service, which were at the forefront of growth in most previous years[5] (Figure 7.12). On the other hand, placements to other activities decreased, particularly to trade and professional, scientific and technical activities.

After much slower growth in 2020, mostly due to lower demand for general-purpose cash loans, the rise in household placements started to accelerate slightly in the first half of 2021, so that their annual growth rate went up from 2.1% in late 2020 to 4.0% in June

5 In October 2019, a large corporation switched from Section L (Real estate activities) to Section E (Water supply, sewerage, waste management and remediation activities). This is why in 2019 a sharp decrease in placements was recorded in Real estate activities, and a substantial rise was seen in Other sectors, which include Water supply activity.

2021 (transaction-based, Figure 7.13). The several-year upward trend in housing loans continued to gain momentum, spurred also by the implementation of the government subsidy programme. The annual growth in housing loans reached 10.1% in late June 2021, up from 7.5% in the year before. After falling for several consecutive months, the annual growth in general-purpose cash loans accelerated moderately, from –1.3% in 2020 to 0.2% in June (Figure 7.14).

At the end of June 2021, 11.4% of total bank placements to corporates were covered by payment deferral or restructuring measures, substantially less than in June 2020 (Figure 7.15). However, in the household sector this share decreased sharply in the same period, standing at only 0.4% at the end of June.

8 Foreign capital flows

A strong net capital inflow of EUR 2.5bn was recorded in the first six months of 2021, mostly due to the rise in net debt liabilities of domestic sectors, especially the government, with a growth in net equity liabilities that was twice as weak.

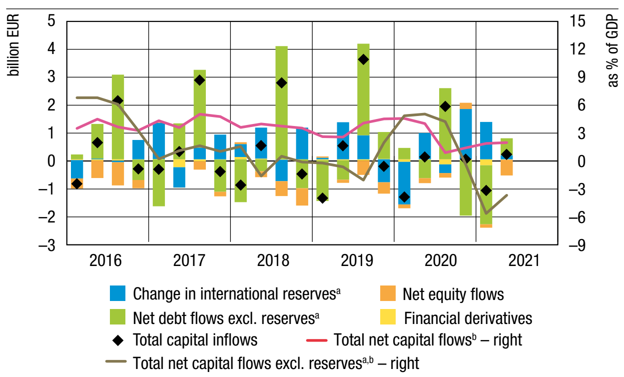
The government issued two eurobond tranches in the international market, and also borrowed, among other things, under the European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) and a loan from the International Bank for Reconstruction and Development (IBRD). The net debt position of banks and other domestic sectors deteriorated to a significantly lesser extent (including net liabilities to affiliated enterprises).

International reserves surged, and the total net capital inflow was ultimately much smaller, standing at EUR 1.0bn.

The stock of gross external debt at the end of June 2021 was equivalent to 84.2% of GDP, up by 4.4 percentage points from late 2020, while net external debt came to 14.5% of GDP.

The financial account of the balance of payments, changes in gross international reserves and liabilities of the CNB excluded, saw a strong net capital inflow of EUR 2.5bn in the first six months of 2021, significantly more than EUR 0.7bn in the same period of last year. The bulk of net capital inflows was related to the rise in net debt liabilities of domestic sectors, especially of the government, with a growth in net equity liabilities that was twice as weak. International reserves surged, and thus the total net capital inflow was ultimately much smaller, standing at EUR 1.0bn (Figure 8.1).

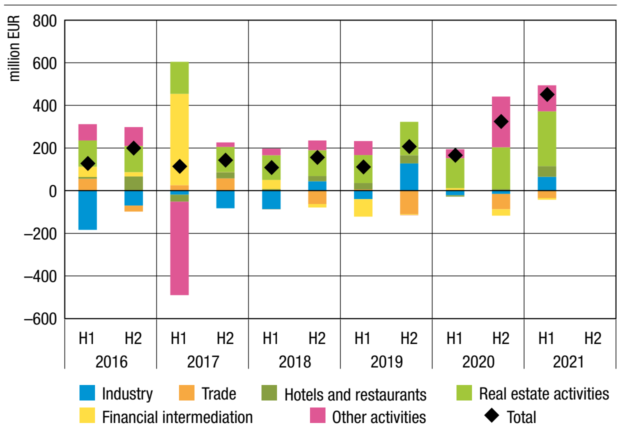
Figure 8.1 Flows in the financial account of the balance of payments



[a] Changes in gross international reserves net of CNB foreign liabilities.
[b] Sum of the previous four quarters.
Notes: Net flows are the difference between changes in assets and liabilities. Equity flows comprise changes in foreign direct equity investments, reinvested earnings and portfolio equity investment. Positive value means net capital outflow abroad.
Source: CNB.

The net inflow from equity investments of EUR 0.7bn in the first half of 2021 was the result of a significantly faster growth in the liabilities than in the assets of domestic sectors. The increase in foreign liabilities was especially driven by reinvested earnings of domestic enterprises and banks owned by non-residents, which was much bigger than in the same period of the previous year, owing to the rise in profitability. In addition, reinvested earnings in the current year largely exceeded the results from pre-crisis 2019, owing to increased profit followed by significantly reduced dividend payouts. The bulk of reinvested earnings in the first six months of 2021 stems from the banking sector, pharmaceutical industry and trade. Moreover, new direct equity investments in Croatia grew considerably more than in the last few years, mainly owing to investments in real estate, computer programming activities and the automobile industry (Figure 8.2). By contrast, asset growth was mostly triggered by investments of domestic institutional investors in foreign shares and equity holdings.

Figure 8.2 Foreign direct equity investment in Croatia by activities

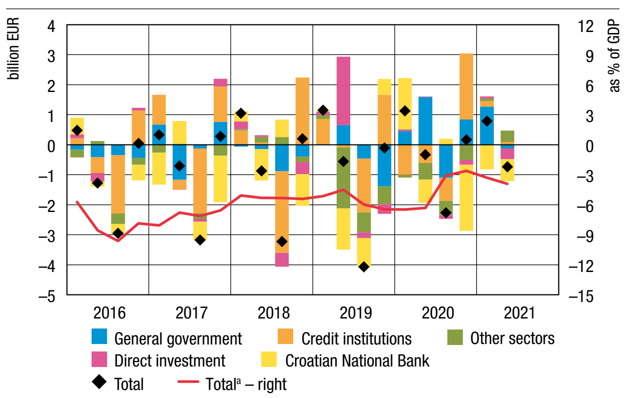


Note: Equity investment net of debt-to-equity transactions and round-tripping investments.
Source: CNB.

The increase in the net debt liabilities of domestic sectors in the first half of 2021 (by EUR 1.5bn, excluding the change in international reserves and liabilities of the CNB) is the result of the rise in liabilities of all domestic sectors, especially the government, which issued two eurobond tranches worth EUR 2.0bn in the international capital market in March, using over one half of the inflow to repay the due ten-year US dollar bond. The long-term credit liabilities of the government also increased, arising from, among other things, borrowing under the European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) and a loan from the International Bank for Reconstruction and Development (IBRD). The net debt position of banks and other domestic sectors deteriorated to a significantly lesser extent (including net liabilities to affiliated enterprises).

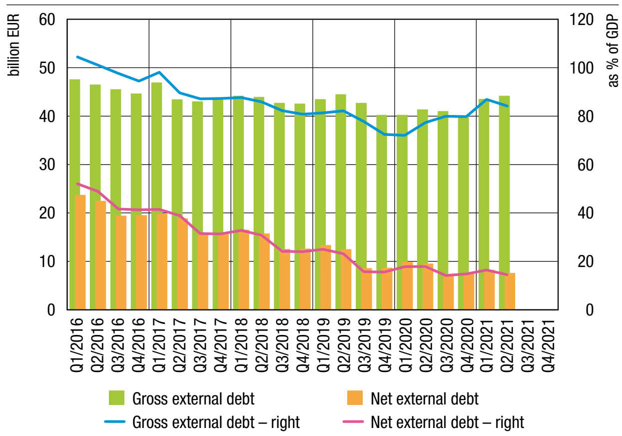
The mentioned rise in net debt liabilities has been almost fully offset by the increase in international reserves (gross reserves net of CNB's liabilities) by EUR 1.5bn, since a considerable portion of the funds obtained by foreign borrowing, as well as inflows

Figure 8.3 Net external debt transactions by sectors



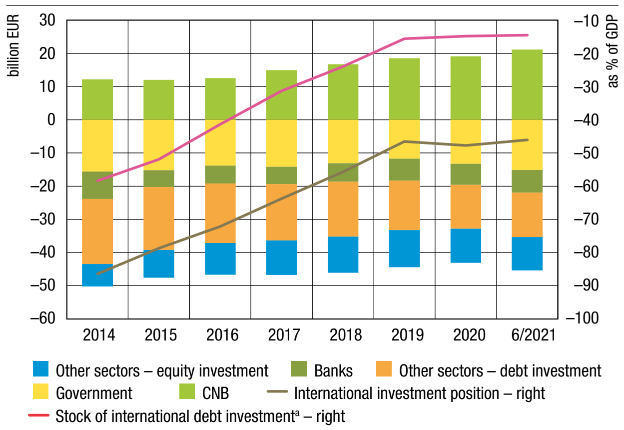
[a] Sum of the previous four quarters.
Notes: Transactions refer to the change in debt excluding cross-currency changes and other adjustments. Net external debt is calculated as the gross external debt stock net of foreign debt claims.
Source: CNB.

Figure 8.4 Stock of gross and net external debt



Note: Net external debt is calculated as the gross external debt stock net of foreign debt claims.
Source: CNB.

Figure 8.5 International investment position (net) by sectors



[a] Stock of international debt investments (net) equals the negative value of the net external debt.
Source: CNB.

from transfers from EU funds was sold by the government to the CNB. Consequently, there has been only a modest net inflow of debt capital in the first half of 2021, since the strong increase in liabilities has been accompanied by an equally strong rise in assets.

The sharp rise in debt liabilities of domestic sectors, of government in particular, led to a deterioration in the relative indicator of gross external debt, which was only partly offset by the growth in nominal GDP. At the end of June 2021, the gross external debt stock stood at EUR 44.2bn or 84.2% of GDP, an increase of 4.4 percentage points from the end of 2020 (Figure 8.4). On the other hand, despite a modest rise in the absolute amount, the relative indicator of net external debt improved. Net external debt stood at EUR 7.6bn (14.5% of GDP) at the end of June 2021, down by 0.3 percentage points from the end of 2020.

Higher financial liabilities of domestic sectors (transaction-based) have been considerably compensated for by the favourable effect of price, exchange rate and other adjustments, which led to an only mild deterioration of the net international investment position in absolute terms. However, due to the rise in nominal GDP, the relative indicator of the international investment position improved and stood at –46.1% of GDP in late June 2021, from –47.8% of GDP at the end of 2020 (Figure 8.5).

9 Monetary policy

The CNB continued to pursue a highly expansionary monetary policy, amid favourable and stable conditions in the domestic financial markets.

The CNB purchased EUR 1.8bn from the government and the banks in foreign exchange transactions, creating HRK 13.3bn in reserve money. No interest was shown in other operations, due to a very high kuna liquidity surplus. Still available to the CNB, should a need arise, is a swap line agreed in April 2020 with the European Central Bank, enabling the exchange of kuna for euro up to EUR 2bn.

The first half of 2021 was marked by a further highly expansionary monetary policy, amid stable conditions in the domestic financial markets.

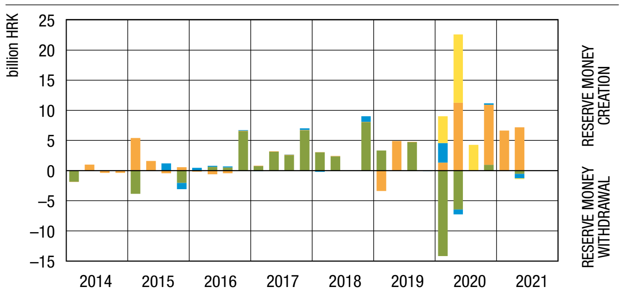
The first half of this year did not see any significant pressures in the foreign exchange market, which resulted in the CNB participating in this market only rarely. In early April, the CNB sold EUR 190m to the banks, and in mid-June it purchased EUR 120m. In addition, on several occasions the CNB purchased large amounts of foreign exchange inflows from the Ministry of Finance of the Republic of Croatia, mostly stemming from the EU funds. If total foreign exchange transactions are observed, from the beginning of the year to end-June, the CNB purchased net EUR 1.8bn, creating HRK 13.3bn in reserve money (Figure 9.1).

As for other monetary policy instruments, in the first half of this year they were used to withdraw HRK 750m. Even though the CNB continued to conduct regular weekly operations at a fixed rate of 0.05%, due to the small interest shown by banks, the CNB has not used this instrument to place funds since the beginning of the year. No structural operations were offered by the CNB in the same period, and their stock fell by HRK 750m due to early repayments.

Monetary policy measures boosted banks' free reserves to record highs. Thus the average daily liquidity surplus of the domestic banking system reached HRK 72.0bn in June, up from HRK 54.7bn at the end of 2020 (Figure 9.2). The increase in surplus liquidity was driven not only by the purchase of foreign exchange from the government but also by a fall in government kuna deposits with the CNB.

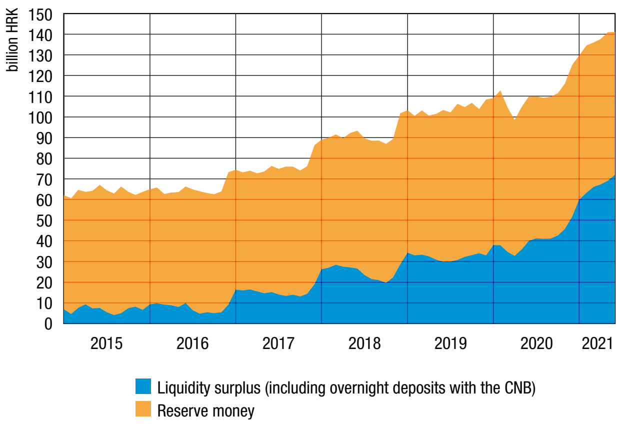
The purchase of foreign exchange from the government and a higher level of repo agreements led to an increase in international reserves in the first half of 2021. They rose by EUR 2.6bn (13.7%) in gross terms from the end of the previous

Figure 9.1 Flows of reserve money (M0) creation



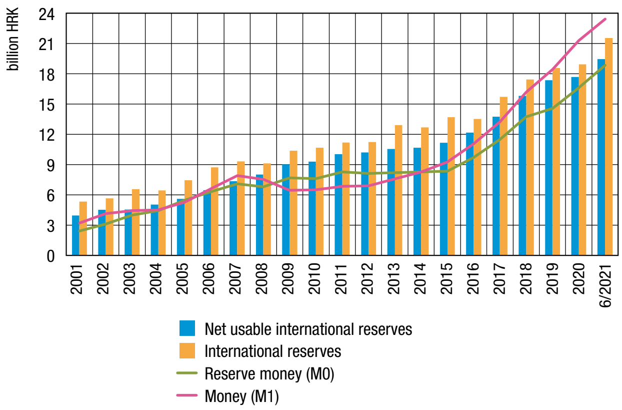
Notes: The Lombard facility cancelled on 28 September 2017 was replaced by the overnight facility. Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and the EC and foreign currency swaps with banks. The positive values refer to the purchase of foreign exchange.
Source: CNB.

Figure 9.2 Bank liquidity and reserve money



Source: CNB.

Figure 9.3 International reserves of the CNB and monetary aggregates

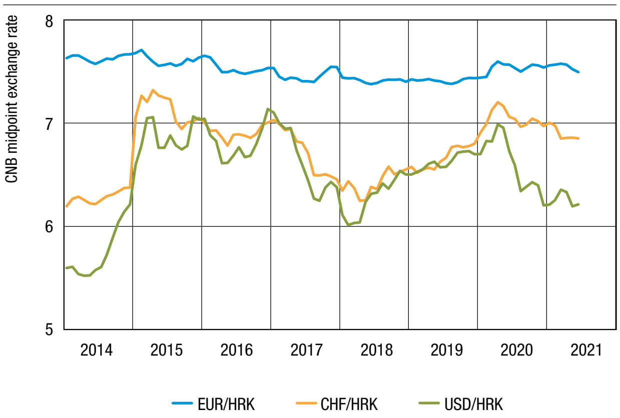


Note: Net usable international reserves are defined as international reserves net of CNB foreign liabilities, reserve requirements in f/c, government foreign currency deposits and off-balance sheet liabilities (swaps).
Source: CNB.

year, standing at HRK 21.5bn at the end of June (Figure 9.3). Net usable reserves rose by EUR 1.8bn (10.0%) from the end of the previous year, reaching EUR 19.5bn at the end of June. Still available to the CNB, should a need arise, is a swap line agreed in April 2020 with the European Central Bank, enabling the exchange of kuna for euro up to EUR 2bn.

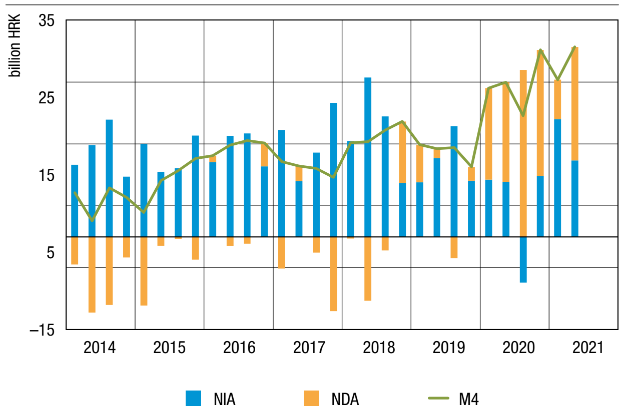
The exchange rate of the kuna against the euro depreciated slightly in the first three months of 2021, but started appreciating afterwards. The appreciation of the exchange rate intensified in May and June, driven by the increased supply of foreign exchange from the Ministry of Finance and the banks, which resorted to shorting their foreign exchange positions. The exchange rate of the kuna against the euro was EUR/HRK 7.49 at the end of June, down by 0.9% from the end of the same month of the previous year, while the average exchange rate from the beginning of the year stood at EUR/HRK 7.55, up 0.3% from the average exchange rate in the same period of the previous year (Figure 9.4). If developments in the exchange rate of the kuna against the euro from

Figure 9.4 Nominal exchange rates of the kuna against selected currencies



Source: CNB.

Figure 9.5 Net foreign assets, net domestic assets and total liquid assets (M4)
absolute changes in the last 12 months



Note: Absolute changes exclude the exchange rate effect.
Source: CNB.

joining the European Exchange Rate Mechanism to the end of the first half of 2021 are observed, compared to the central rate[6], the average exchange rate moved within a very narrow range of –1.0% to +0.7%. At the end of June 2021, the exchange rate of the kuna against the US dollar had fallen from the end of the same month in 2020, reflecting the weakening of the US dollar against the euro. The exchange rate of the kuna against the Swiss franc also recorded a lower level during the same period, mirroring the effect of kuna strengthening against the euro and euro strengthening against the Swiss franc.

The strong upward trend in monetary aggregates continued in the first half of 2021. Total liquid assets (M4) slowed down on an annual level, from 9.1% at the end of 2020 to 8.7% at the end of June 2021 (transaction-based) (Figure 9.5), reflecting a slower growth in net domestic assets (NDA). Slower NDA growth reflects a slowdown in the growth of net claims on the central government. At the same time, the growth in net foreign assets (NFA) accelerated, driven by an inflow of foreign exchange to the MoF then purchased by the CNB.

6 Croatia entered the Exchange Rate Mechanism II (ERM II) in July 2020, with the central rate of the kuna being set at 1 euro = 7.5345 and the standard fluctuation band at ±15% around this rate.

10 Public finance

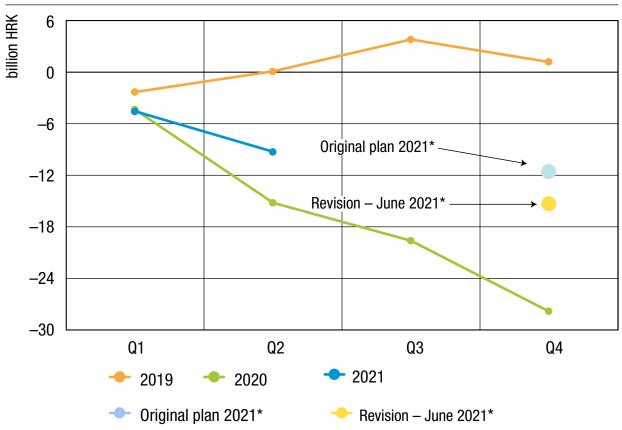
The consolidated general government deficit was HRK 9.3bn, which was a marked improvement from last year's deficit of HRK 15.2bn, brought about by a more favourable epidemiological situation, the relaxation of containment measures and the reduced need for fiscal stimuli. The public debt to GDP ratio edged down to 87.0%, from 87.3% at the end of 2020.

The consolidated general government deficit stood at HRK 9.3bn in the first half of 2021. However, with a more favourable epidemiological situation than during the critical periods in 2020, the resulting relaxation of restrictive containment measures and a reduced need for fiscal stimuli, the deficit was considerably lower than in the same period last year (when it stood at HRK 15.2bn). This improvement in terms of deficit was especially pronounced in the second quarter of 2021, when it stood at HRK 4.7bn, which was a sharp decrease from the HRK 10.8bn of the same period in the previous year.

In the first half of 2021, total revenues (ESA 2010) witnessed a sharp growth (13.7%) relative to the same period of the preceding year. The growth in total revenues was mostly spurred by the surge in indirect taxes due to a recovery in personal consumption and in the tourist activity and, to a lesser extent, by the increase in excise duties on tobacco and tobacco products. Revenues from social contributions also picked up, as a result of a labour market recovery, i.e. the growth in employment and the average nominal gross wage. Other revenues also recorded a robust growth, to a large extent reflecting the increased withdrawal of EU funds. By contrast, revenues from direct taxes declined as a result of tax disburdening. More precisely, on 1 January 2021 the profit tax rate for all entrepreneurs with a turnover of up to HRK 7.5m was reduced from 12% to 10%, while the income tax rates were reduced from 36% and 24% to 30% and 20% respectively.

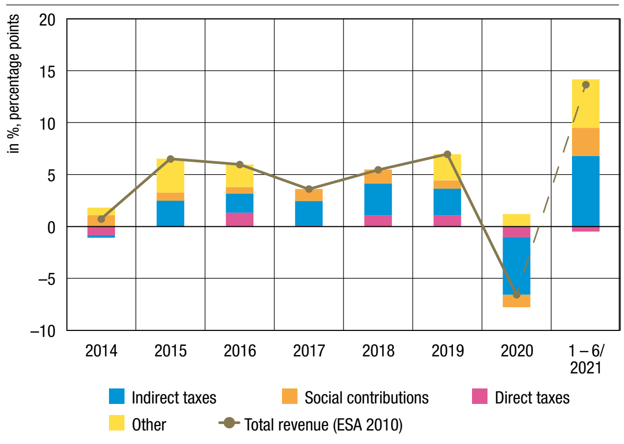
The expenditure side of the consolidated general government budget (ESA 2010) continued to increase in the first half of 2021 (by 5.5%), albeit slower than in the same period last year. The slowdown in the growth of total expenditures mainly reflects a decrease in support to the economy related to the COVID-19 pandemic, while interest expenditures also decreased due to the still very favourable financing conditions, despite the sharp increase in public debt. On the other hand, intermediate consumption expenditures rose sharply,

Figure 10.1 General government cumulative balance by quarters (ESA 2010)



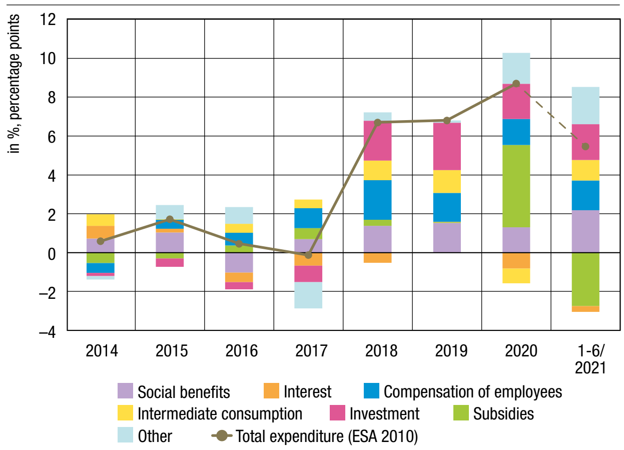
Sources: Eurostat and MoF (CNB calculations).

Figure 10.2 Consolidated general government revenue (ESA 2010)
year-on-year rate of change and contributions



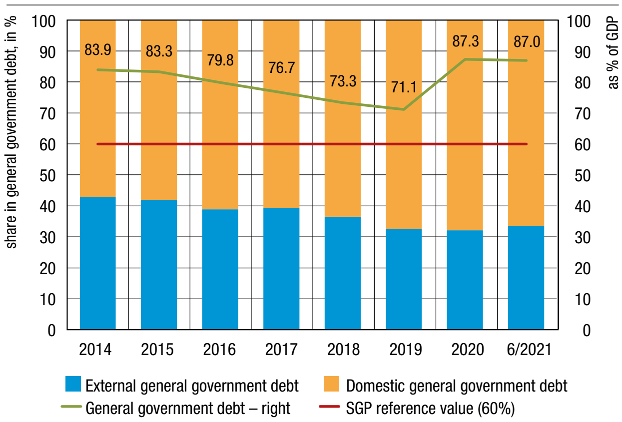
Source: Eurostat (CNB calculations).

Figure 10.3 Consolidated general government expenditure (ESA 2010)
year-on-year rate of change and contributions



Source: Eurostat (CNB calculations).

Figure 10.4 General government debt
stock, end of period



Note: Nominal GDP for the last four available quarters was used to calculate the relative indicator as at the end of June 2021.
Source: CNB.

probably due to the increased material expenses related to the pandemic. Expenditures for social benefits, which in addition to cash benefits also include goods and services provided to citizens by the government, rose as well, due to larger expenditures in the health sector and increased social support, including the COVID-19 allowance for pensioners. Expenditures for employee compensations continued their last year's dynamic growth, at a rate of around 6%, mostly owing to the increase in the wage calculation base for civil servants and government employees, while general government investments continued to grow due to the intensified use of EU funds.

Consolidated general government debt stood at HRK 340.8bn at end-June 2021, up by HRK 10.6bn from the end of 2020. The public debt to GDP ratio edged down to 87.0%, from 87.3% at the end of 2020. In late February, the RC Government issued bonds in the international market worth EUR 2bn (two euro issues worth EUR 1bn each). Despite a deterioration in fiscal indicators relative to the pre-crisis period, borrowing conditions were favourable, which resulted in significant savings in terms of interest expenditures. Thus, the first bond will mature in 2033, with an annual coupon rate of 1.125% and a yield of 1.257%, while the second bond will mature in 2041, with an annual coupon rate of 1.750% and a yield of 1.788%. The collected funds were used for financing of the deficit and refinancing of the due eurobond of USD 1.5bn, with a coupon rate of 6.375%.

11 International reserves management

International reserves of the CNB stood at EUR 21.5bn as at 30 June 2021, up by 13.7% from the end of 2020. In the environment of a prolonged period of negative euro yields and historically low US dollar yields, net international reserves investments generated an income of EUR 50.33m or HRK 379.96m in the first six months of 2021.

The annual rate of return on the entire euro portfolio of net reserves was 0.62%, while the annual rate of return on the entire US dollar portfolio totalled 1.05% in the first half of 2021.

International reserves management was marked in early 2021 by the successful implementation of the ECB's accounting guidelines and the resulting adjustment of all the business operations. In the unfavourable environment of a prolonged period of negative euro yields and historically low US dollar yields, a satisfactory level of earnings was generated, with the primary objective of international reserves management, namely to ensure liquidity and safety, successfully accomplished.

The CNB manages international reserves in two ways: in line with its own guidelines or in accordance with the assumed obligations, depending on the way in which international reserves are formed. The component of international reserves acquired through purchases of foreign currency from banks and the MoF, through IMF membership and through the income derived from the investment of international reserves and other CNB assets, is managed by the CNB in line with its own guidelines (the term 'net reserves' is used for this part of the reserves).

The other component of the reserves, which is formed on the basis of deposits of the MoF, repo agreements with banks, foreign currency swaps in the domestic market, IMF membership and other assets owned by other legal persons, is managed by the CNB in accordance with obligations assumed.

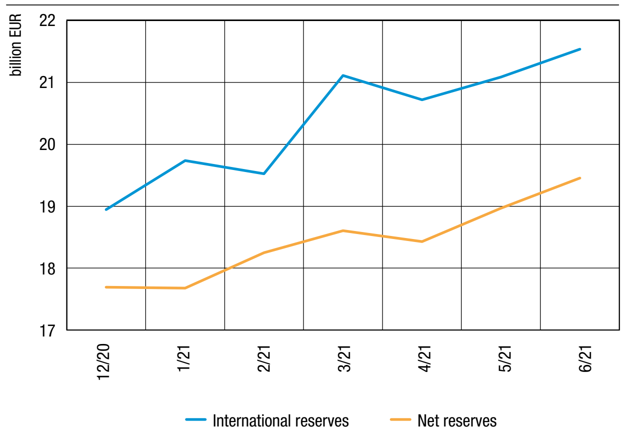
11.1 Structure of and developments in international reserves

International reserves of the CNB stood at EUR 21,539.7m as at 30 June 2021, up by EUR 2,595.3m or 13.7% from the end of 2020, when they stood at EUR 18,944.4m. Over the same period, net reserves increased by EUR 1,762.7m (10.0%), from EUR 17,692.0m to EUR 19,454.7m.

The strong growth in international reserves in the first half of 2021 was mostly brought about by foreign currency inflows to the MoF account, which was largely purchased by the CNB, as well as by the higher level of agreed repo transactions at the end of the first half of the year.

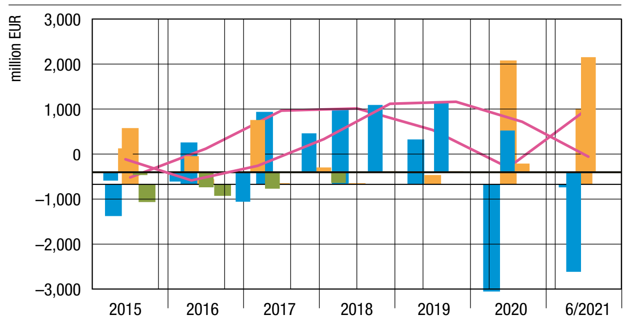
Securities of governments and government institutions, reverse repo agreements and foreign cash accounted for the largest share in the structure of international reserves investment at the end of June 2021. At the end of the first half of 2021, a part of

Figure 11.1 Monthly changes in total and net CNB international reserves in the first half of 2021



Source: CNB.

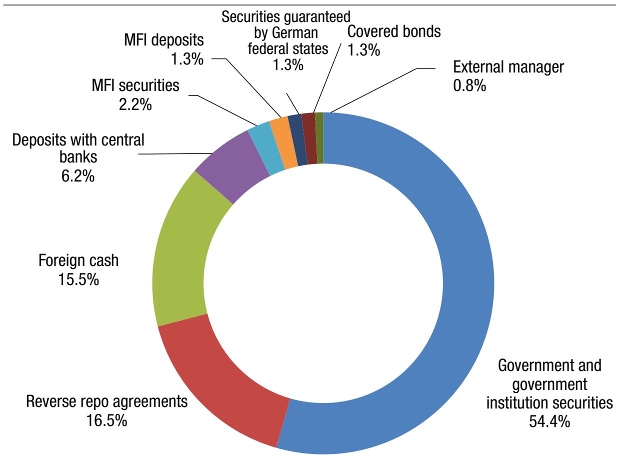
Figure 11.2 Foreign exchange interventions of the CNB with the banks, the MoF and the EC
in net amounts



	2015	2016	2017	2018	2019	2020	6/2021
Banks	−767.2	1,018.8	1,757.0	1,808.9	1,088.9	−2,595.6	−70.0
MoF	1,364.0	125.6	30.6	30.4	228.1	3,004.0	1,838.9
EC	−428.9	−277.8	–	–	–	–	–
Total	167.9	866.6	1,787.6	1,839.3	1,316.9	408.4	1,768.9

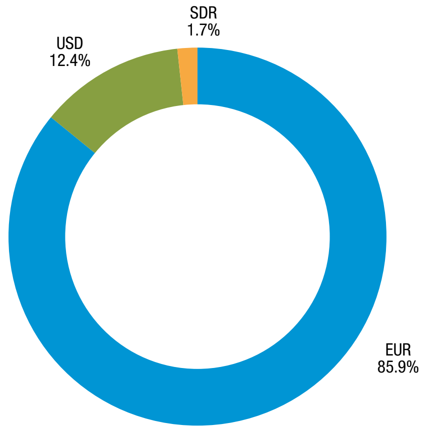
Note: Positive values refer to the purchase and negative to the sale of foreign exchange by the CNB.
Source: CNB.

Figure 11.3 Structure of international reserves investment
as at 30 June 2021



Source: CNB.

Figure 11.4 Currency structure of total international reserves
as at 30 June 2021



Source: CNB.

international reserves was also accounted for by ESG investments (1.0%).

The CNB invests funds with financial institutions and in countries with an investment grade rating; the assessment of creditworthiness is based on ratings issued by internationally recognised rating agencies (Moody's, Standard & Poor's and Fitch Ratings) and on an internally-developed creditworthiness assessment model.

At the end of the first half of 2021, approximately 60% of the CNB international reserves was invested in countries, banks and institutions within the two highest credit rating categories or invested in the BIS and the IMF or in foreign cash in the CNB vault.

In the first six months of 2021, the currency structure of international reserves changed slightly in favour of the euro. The share of the euro in international reserves increased from 85.0% at the end of 2020 to 85.9% in the first half of 2021, while the share of the US dollar decreased from 13.0% to 12.4%. The share of SDRs in international reserves dropped slightly from 1.9% to 1.7%.

11.2 Financial markets and international reserves management results in the first half of 2021

Global economic and financial trends in the first half of 2021 were still dominantly influenced by the developments related to the COVID-19 pandemic. Measures to limit economic activity were in force in early 2021, while the epidemiological situation improved considerably in the following months of the first half of 2021 with the pick-up in vaccination. This contributed to more favourable current economic trends and spurred optimism about final recovery, while the inflation rate accelerated. Against this background, financial markets witnessed a growth in yields on government bonds, especially for long-term maturities, while positive trends continued in equity markets. The end of the first half of 2021 saw a waning of positive sentiment due to the spreading of the new Delta variant, and the trend of growing yields came to a halt. Unprecedented monetary and fiscal measures remained in force, without any indication of their tightening due to the faster recovery and the rise in the inflation rate. The leading central banks were of the view that the increase in prices was temporary and transitory and that accommodative measures were still necessary to ensure favourable financing conditions.

Yields on issued European government securities increased in the first six months of 2021, and the share of securities having negative yields decreased to 58% from the elevated 75% reached at the end of 2020. The German yield curve for all maturities up to ten years remained in negative territory.

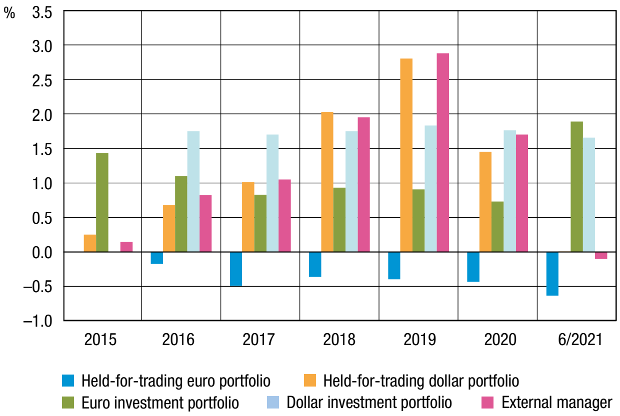
The US yield curve for maturities up to ten years grew by an average of 35 basis points in the first six months of 2021, with the largest increase in the part of the curve for maturities from four to ten years.

International reserves managed by the CNB in line with its own guidelines comprise the held-for-trading portfolios, the investment portfolios, the funds entrusted to an external manager and foreign cash in the vault.

In the environment of a prolonged period of negative euro yields and US dollar yields at record lows, with a continued growth in international reserves, an appropriate level of earnings was ensured by the strategic decisions on international reserves management made consistently over the previous ten years. This refers primarily to the formation since 2011 of investment portfolios that served as a basis for the adoption of tactical decisions and the adjustments of investment guidelines. In the first six months of 2021, net international reserves investments generated an income of EUR 50.33m or HRK 379.96m.

The annual rate of return on the entire euro portfolio of net reserves was 0.62%, while the annual rate of return on the entire US dollar portfolio totalled 1.05% in the first half of 2021. If held-for-trading and investment portfolios are observed separately, the euro held-for-trading portfolio generated an annual rate of return of –0.63%, while the US dollar held-for-trading portfolio generated an annual rate of return of 0.01% in the first six months of 2021. The euro-denominated investment portfolio and the US dollar-denominated investment portfolio yielded annual rates of return of 1.89% and 1.66% respectively.

Figure 11.5 Annual rates of return of the CNB foreign currency portfolios from 2015 to the first half of 2021



Source: CNB.

The held-for-trading portfolios, which account for approximately 41% of net reserves, have short average maturities and are used to maintain foreign currency liquidity. Investment portfolios, which account for approximately 41% of net reserves, have a longer average maturity and serve as a source of more stable long-term income.

In the first half of 2021, the annual rate of return on the US dollar funds entrusted for management to an international financial institution was –0.10%. The entrusting of funds to an international financial institution enabled additional diversification and knowledge-exchange in the field of investment management.

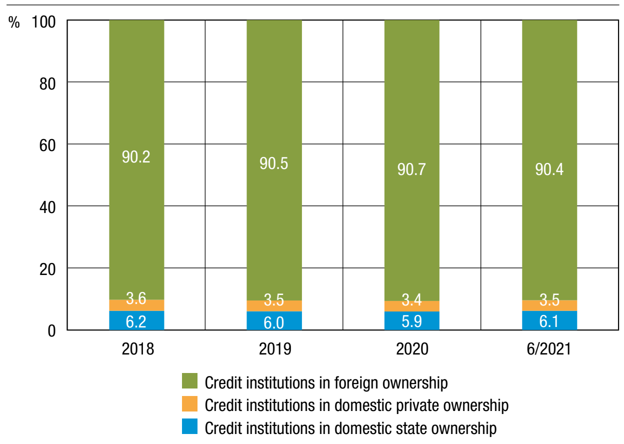
12 Business operations of credit institutions

Despite the ongoing uncertainty around the pandemic for the second year running, the banking system remained safe and stable, highly liquid and well-capitalised, which was also the result of the measures taken by the CNB to alleviate the negative consequences of the pandemic and the earthquakes.

The years-long trend of improvement in the quality of assets continued, with a drop in non-performing loans and the increase in the cash component of credit institutions' assets. However, this structure of bank assets, marked by the sharp rise in cash and weaker lending activity, cut interest income, which is the main source of bank earnings. Nevertheless, credit institutions' profits increased relative to the comparable period in 2020, mostly owing to the significantly less burdensome credit loss costs and the moderate growth in non-interest income.

The security and stability of business operations of credit institutions that characterise the banking system of the Republic of Croatia continued into the first half of 2021, despite the ongoing uncertainty around the COVID-19 pandemic for the second year running. This was primarily due to high liquidity and capitalisation, reinforced in 2020 by emergency regulatory adjustments and measures taken by the CNB to alleviate the negative economic consequences of the pandemic and the devastating earthquakes. The assets of credit institutions continued to increase, mostly due to the rise in household deposits, while the effect of the further channelling of assets to cash is mirrored in the trends of most of the key performance indicators. However, interest income, the main source of bank earnings, continues to be restrained by the sharp growth in cash with low lending activities and other investments. Nevertheless, credit institutions' profits increased relative to the comparable period in 2020, mostly owing to the significantly less burdensome credit loss costs and the moderate growth in non-interest income. The years-long upward trend in the quality of total exposure persisted, with the fall in non-performing loans to non-financial corporate sector playing an important role.

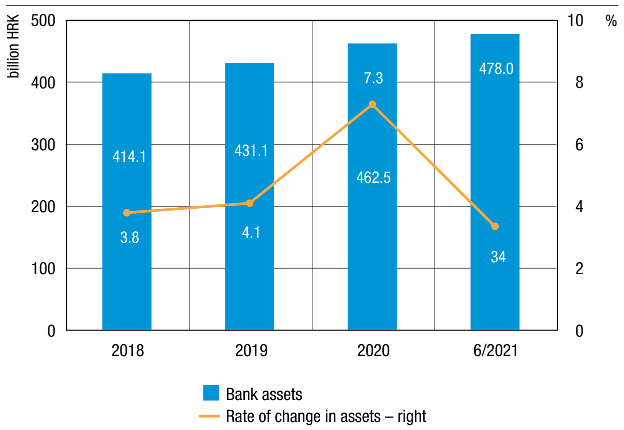
Figure 12.1 Ownership structure of credit institutions and their share in total assets of credit institutions



Source: CNB.

There have been no changes in the number of credit institutions since the end of 2019, so there were 20 banks and three housing savings banks operating in the Republic of Croatia in the first half of 2021. There was no change in the number of

Figure 12.2 Assets of credit institutions



Source: CNB.

credit institutions in majority foreign ownership (14), and they accounted for the bulk of the total assets of credit institutions (90.4%). Other systemically important banks continued to dominate, accounting for 90.8% of all assets held by credit institutions.[7] There was only one branch of an EU credit institution operating in the Republic of Croatia, while some 180 institutions from the EU and the European Economic Area had notified the CNB of their intentions regarding the direct provision of mutually recognised services.[8]

The assets of credit institutions rose by HRK 15.5bn (3.4%) in the first half of 2021, standing at a record high of HRK 478.0bn. The largest source of growth in assets was the increase in received deposits, especially in current accounts of households (HRK 12.9bn or 9.3%). By contrast, deposits with agreed maturities continued their long-year downward trend in most sectors, with further maturity restructuring of total deposits towards shorter maturities.

The rise in the assets of credit institutions was primarily evident in the sharp increase in cash (HRK 12.9bn or 14.7%), while the changes in other important asset items were nowhere near as pronounced. The increase in cash, especially in settlement accounts with the CNB, had a favourable impact on most key performance indicators of credit institutions, and was especially reflected in the high level of the liquidity coverage ratio (LCR). LCR stood at 186.0%, much above the prescribed minimum of 100%, with all credit institutions meeting the prescribed minimum liquidity requirements.

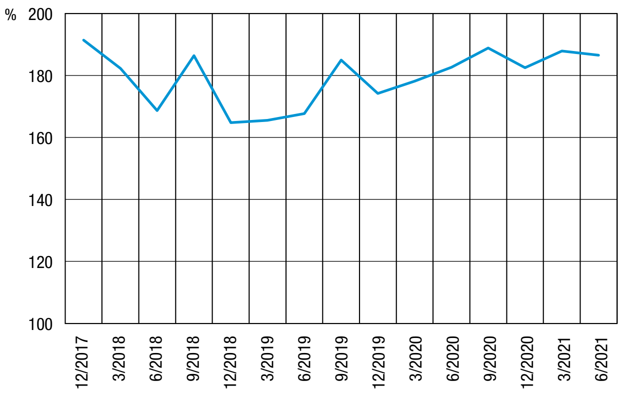
Loans and advances (net) rose by HRK 2.1bn (0.7%).[9] The strongest impact on the total change came from the rise in household loans (2.1%), due to the further increase in housing loans, reinforced by the government subsidy programme. The upward trend in general-purpose cash loans, which had increased at high rates in past years, almost came to a halt in the observed period. Loans to the general government and appropriated statutory reserve funds with the CNB increased by 2.3% and by 6.1% respectively, while loans and advances to other sectors trended downward. Claims on credit institutions witnessed the sharpest decrease (18.6%), mostly influenced by deposit withdrawals from foreign banks, while loans to non-financial corporations also edged down (by 0.5%). Investments in debt securities edged up (by 1.2%).

7 Other systemically important (O-SII) credit institutions are credit institutions the failure or malfunction of which could lead to systemic risk in the Republic of Croatia. Information on the last review of other systemically important credit institutions may be found here.

8 Updated information on credit institutions operating in the territory of the Republic of Croatia may be found here.

9 Loans and advances are debt instruments held by the credit institution that are not securities. They include loans, deposits and advances.

Figure 12.3 Liquidity coverage ratio (LCR)



Source: CNB.

The years-long trend of improvement in the quality of assets continued, owing to the fall in non-performing loans and the influence of the mentioned increase in cash. The non-performing loans ratio (NPL ratio) decreased from 5.4% at the end of 2020 to 5.1% at the end of the observed period. The developments in total NPLs was largely influenced by their decline in the non-financial corporate sector, in which the NPL ratio fell from 12.5% to 11.6%, the sale of claims having a considerable impact. In the first half of 2021, that is, credit institutions sold HRK 1.4bn worth of claims, mostly non-performing claims on non-financial corporations. The growth in NPLs in the household loans portfolio was offset by new lending activity. Thus, the share of NPLs in that sector held steady at 7.1%. The rise in non-performing household loans was largely the result of a reduced debt servicing capacity on general-purpose cash loans and increased failure among debtors to meet their obligations in a timely manner.

Despite the positive trend, the relative quality of total loans remained below the EU average. This is the result of the NPL ratio being below 5% in only eight credit institutions but above 10% in six credit institutions.[10] However, impairment for expected credit loss, i.e. the coverage of non-performing loans by impairment, stood at 62.6%, better than the EU average.

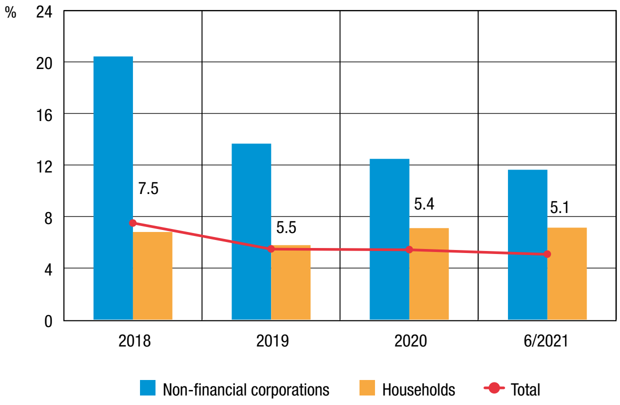
Uncertainty about the pandemic and exposures covered by moratoria in 2020 resulted in a significant rise in credit risk, reflected in the increase in performing loans in value impairment stage 2.[11] Despite the ongoing pandemic, the assessed level of the risk in the observed period fell, and so the share of stage 2 in total loans and advances dropped from 13.1% to 12.4%. This can partly be attributed to the decline in moratoria easing the repayment of credit liabilities for households, which resulted in the decrease in stage 2 loans in the sector concerned. However, credit risk and the share of stage 2 continued to increase in the case of loans to non-financial corporations, ultimately resulting in a rise in total loans and advances in stage 2 relative to the pre-crisis period. At the end of the first half of 2021, the stock of unexpired moratoria aligned with the EBA requirements[12] went down to HRK 10.6bn, proportionate to a 3.4% of total loans

10 The threshold of 5% is a reference value by which EBA identifies a high NPLR, which triggers additional regulatory requirements related to a strategy to reduce NPLs and manage credit risk.

11 Each instrument that is subject to the calculation of expected credit loss, which includes all debt instruments measured at amortised cost and at fair value through other comprehensive income, is classified in one of the three stages of value impairment. Instrument is classified in stage 2 if there is a significant increase in credit risk (although still not in default), where the expected loss is calculated for the entire lifetime of the instrument.

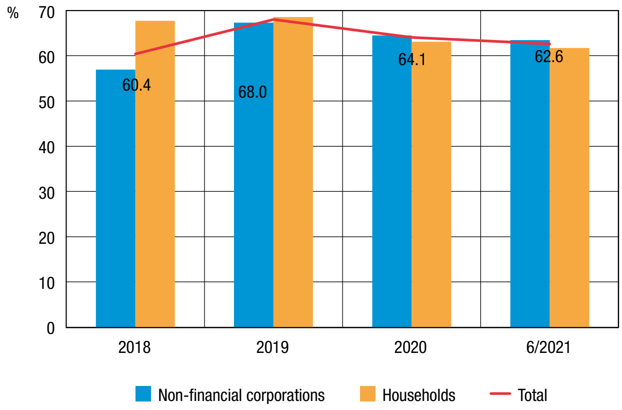
12 The CNB expects credit institutions to fully comply with EBA Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis.

Figure 12.4 Share of non-performing loans in total credit institution loans



Source: CNB.

Figure 12.5 Coverage of non-performing loans by impairment



Source: CNB.

and advances. The majority of the remaining moratoria should have expired by the end of September 2021.

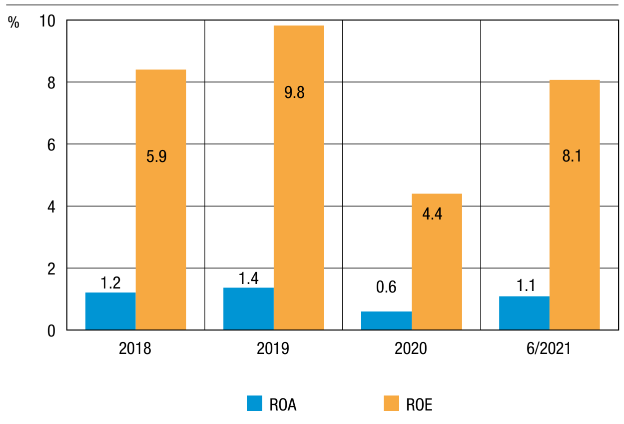
At the end of the first half of 2021, all credit institutions combined operated at a profit, totalling HRK 2.6bn. Profits rose by HRK 0.9bn (51.3%) from the same period last year, due to considerably lower expenses on impairment for credit loss and the mild increase in net operating income. With the increase in profits, return on assets (ROA) and return on equity (ROE) also rose to 1.1% and 8.1% respectively. High level of impairment expenses in the comparable period last year was due to uncertainty around the pandemic. Even though credit institutions continued recognising credit loss, their costs decreased by a significant 73.4% in the observed period. Total net income rose by 3.0%, mainly owing to the increase in income from dividends and income from fees and commissions. Interest income, as the main source of income, continued to decline, partly as a result of changes in the structure of assets, i.e. the weakening of lending activity and other investments generating interest income, and also due to the growth in NPLs, especially in household loans. Interest expenses, primarily expenses based on household deposits with agreed maturities, also continued their downward trend. The increase in total net income and the decrease in general operating expenses led to an improved cost efficiency. The cost-to-income ratio (CIR) decreased to 51.2%.

The effects of last year's retention of profit[13] and targeted pandemic-related regulatory adjustments[14] were further reflected in the very high key indicators of banking system capitalisation. The movements in own funds and in total risk exposures were very slight, resulting in total capital ratio falling only marginally and standing at 25.4%. The ratio is still among the highest in EU member states. Total capital ratio

13 Decision on a temporary restriction of distributions (OG 4/2021)

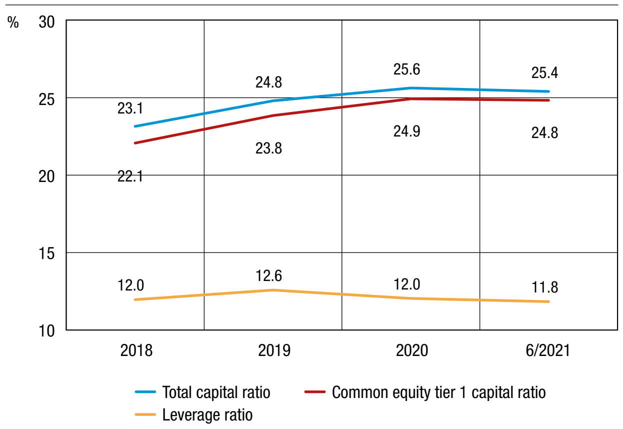
14 Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic (CRR Quick fix) has been applied since 27 June 2020

Figure 12.6 Bank return on assets (ROA) and return on equity (ROE)



Source: CNB.

Figure 12.7 Key indicators of credit institution capitalisation



Source: CNB.

of all credit institutions was above the minimum of 8%, while 11 credit institutions, accounting for 75.9% of all assets held by credit institutions, had their total capital ratio equalling or exceeding 20%.

The effect of last year's introduction of transitional provisions in the standardised approach to credit risk measurement for the treatment of exposures arising from public debt denominated in the currency of another member state, i.e. the reintroduction of a 0% risk weight to euro-denominated exposures to the Republic of Croatia15, along with the increased application of the risk weight of 35% to exposures based on housing loans, can be seen in the further fall in the value of the average credit risk weight from 44.6% to 42.9%. The importance of the 0% risk weight is also reflected in the share of exposures to which this weight is assigned in total risk-weighted exposures, which grew at the end of the first half of 2021 due to the increase in cash, standing at a high 45.6%.

15 Up to 31 December 2022 "quick fix" amendments to the CRR enable a 0% risk weight to be reintroduced for exposures to the central governments and central banks of member states, where those exposures are denominated and funded in the domestic currency of another member state.

Abbreviations and symbols

Abbreviations

APN – Agency for Transactions and Mediation in Immovable Properties
bn – billion
b.p. – basis points
BEA – U. S. Bureau of Economic Analysis
BOP – balance of payments
c.i.f. – cost, insurance and freight
CBRD – Croatian Bank for Reconstruction and Development
CBS – Central Bureau of Statistics
CDS – credit default swaps
CEE – Central and Eastern European
CEFTA – Central European Free Trade Agreement
CES – Croatian Employment Service
CHF – Swiss franc
CHIF – Croatian Health Insurance Fund
CHY – Yuan Renminbi
CICR – currency-induced credit risk
CPF – Croatian Privatisation Fund
CPI – consumer price index
CPII – Croatian Pension Insurance Institute
CM – Croatian Motorways
CNB – Croatian National Bank
CR – Croatian Roads
EBA – European Banking Authority
ECB – European Central Bank
EEA – European Economic Area
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
HUB	– Croatian Banking Association
incl.	– including
IMF	– International Monetary Fund
JPY	– Japanese yen
m	– million
MIGs	– main industrial groupings
MM	– monthly maturity
MoF	– Ministry of Finance
NBS	– National Bureau of Statistics of China
NCA	– National Classification of 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
RAMP	– Reserves and Advisory Management Program
ROAA	– return on average assets
ROAE	– return on average equity
o/w	– of which
PPI	– producer price index
Q	– quarter
RR	– reserve requirement
SDR	– special drawing rights
SE	– South-East
SGP	– Stability and Growth Pact
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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