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on the Financial Condition, the Degree of Price Stability Achieved and the Implementation of Monetary Policy

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Contents

1 Summary

After a downturn in 2013, economic activity in Croatia held steady in the first half of 2014. Exports alone recorded noticeable positive trends, notwithstanding the dwindling growth in Croatia's main trading partners. Against the background of the ongoing contraction in investment and the commenced cuts in government consumption, the rise in exports was insufficient to spur economic revival. As a result, no major improvements were seen in the labour market, while the drop in import prices in the segment of food raw materials and weak domestic demand led to negative year-on-year inflation rates. In such conditions, the Croatian National Bank continued to pursue an expansionary monetary policy by maintaining a high level of liquidity in the banking system and stimulating loans to enterprises by the redemption of compulsory CNB bills from banks. At the same time, the stability of the domestic currency against the euro was maintained, which is, in view of the high euroisation, a key prerequisite for financial stability in the country. As further fiscal consolidation efforts are needed to stabilise public finances, the speed of economic recovery is hampered by the low competitiveness of the economy. No improvement in this regard is to be expected without structural reforms aimed at enhancing the business and investment climate.

Real GDP, which recorded slight quarterly growth in the first three months of 2014 (0.2%), again shrank in the second quarter (by 0.3%, according to the seasonally adjusted data). On an annual basis, the real decline in GDP was much larger (–0.6% and –0.8% in the first and second quarters, respectively) as economic activity slumped in the second half of the previous year. Among aggregate demand components, the sharpest drop was seen in investment and government consumption. By contrast, the robust growth in exports that started in mid-2013 continued into the first half of 2014. It should, however, be noted that some of this rise was due to changes in the recording of imports and exports transactions in the goods segment following Croatia's accession to the EU.

The end of the economic downturn in the first half of 2014 was accompanied by less negative developments in the labour market. The number of employed persons held steady at a low level, after having plummeted in the second half of 2013, while unemployment remained mostly unchanged from the end of 2013. As a result, the unemployment rate kept at a high 16.6% in the second quarter of 2014. Despite the absence of growth, nominal and real gross and net wages edged up in the first half of 2014.

The annual inflation rate remained slightly negative from February 2014. The drop in inflation in the first half of the year was the outcome of the fall in food prices, which was, in turn, the result of better yields thanks to the milder winter weather, and lower import prices of food raw materials. The slight decrease in the overall level of prices was also due to the fall in oil prices in the world market, subdued domestic demand and increased competition following Croatia's accession to the EU.

The surplus in Croatia's current account, observed since the beginning of 2013, shrank in the first half of 2014 (average for the last four quarters). This was largely attributable to government payments to the EU budget, which exceeded the amount of EU funds used. The balance in the current account was also affected adversely by larger expenditures based on direct equity investment, stemming from increased profits of foreign-owned banks and enterprises. By contrast, the robust growth in goods exports helped reduce the deficit of foreign trade in goods and services. With regard to the use of EU funds, it should be noted that the overall balance in transactions with the EU was positive as only advances from European funds that the Ministry of Finance disburses to final users are recorded in the current account, while the unallocated portion of the advances received is recorded in the financial account.

Very modest net foreign capital inflows of EUR 0.5bn in the first six months of 2014 were largely due to equity investment, while the net external debt position of domestic sectors improved. Leading the way in this regard were the banks; they increased their foreign assets substantially and reduced their foreign debt in the first half of the current year.

The central bank continued to implement its expansionary monetary policy while maintaining the stable exchange rate of the kuna against the euro. As the expansionary monetary policy sustained a high level of liquidity in the domestic banking system, the average liquidity surplus in credit institutions' accounts was HRK 7.7bn in the first six months of 2014, up HRK 2.7bn over the average for 2013.

The ongoing expansionary monetary policy, which has since the end of 2013 been supported by the purchase of compulsory CNB bills on the basis of growth in corporate placements, brought a further slight improvement in financing conditions for domestic enterprises in the still favourable international financial environment prevailing in the first half of 2014. Interest rates on long-term corporate loans continued to fall gradually, while interest rates on short-term loans held at favourable levels from the end of 2013. However, lending could not accelerate at a faster pace because of the weak corporate demand for loans, low business optimism and the strong risk aversion of banks. In such conditions, private enterprises recorded a slight increase in loans in the first six months of 2014, while total corporate placements decreased due to the deleveraging of public enterprises. Household deleveraging continued for the sixth consecutive year in response to the grim economic outlook and labour market conditions, as well as slightly elevated interest rates on some types of consumer and general-purpose loans.

Weak inflows of foreign capital and the reduced surplus in the current account were reflected in developments of gross international reserves, which dropped by EUR 0.6bn in the first six months of 2014. The fall in reserves was largely due to withdrawals from the government foreign currency deposit account with the CNB. At the end of June, gross international reserves stood at EUR 12.3bn and were sufficient to cover 7.9 months of goods and services imports. In contrast to gross reserves, net usable reserves (which exclude foreign currency reserve requirements, special drawing rights with the IMF, funds of the European Commission and funds of the Ministry of Finance) held almost steady in the first half of the year, and were EUR 10.5bn at the end of June. Gross and net international reserves remained considerably higher than the narrowest monetary aggregates – reserve money (M0) and money (M1).

The CNB invests international reserve funds predominantly in American and German government bonds, as well as in the securities of other developed countries that are considered safe, and is governed primarily by the principles of liquidity and safety. The net euro portfolio of the CNB generated a total income of EUR 54.8m, while the dollar-denominated portfolio generated USD 3.6m in the first half of 2014. An improvement in returns from the same period of 2013 was achieved, thanks to the lower yields and higher prices of German and American bonds, as well as the rise in prices of other eurobonds in which reserves are invested. The lower yields were the outcome of mounting geopolitical risks and larger investor demand for safer investments, such as American and German government debt, the slowdown in global growth, which fostered expectations that central banks worldwide would not hasten to increase their benchmark rates, as well as of incentive measures of the European Central Bank, which cut its key interest rates in the first half of 2014.

In conditions of uninterrupted years-long negative economic developments, banking system operations in the first half of 2014 were characterised by a reduction in bank balance sheets and even greater difficulties in loan collection. The ratio of non-performing loans (categories B and C) went up from 15.7% at end-2013 to 16.6% at end-June 2014. The fall in the quality of total loans was largely due to the performance of corporate loans, where the share of B and C category loans reached 29.6%. Under the influence of persistent risk aversion, the lack of credit recovery and problems relating to the collection of receivables, the banks continued to deleverage vis-à-vis domestic and foreign financial institutions, in particular majority foreign owners, while growth in domestic deposits (including household savings) was absent in the period under review.

According to preliminary unaudited data, banks' profit stood at HRK 1.6bn in the first half of 2014, a quarter more than in the same period of 2013. The higher profit was due to reduced funding costs, in particular lower interest rates on household deposits. The return on average assets (ROAA) and average equity (ROAE) indicators both improved noticeably from 2013, when expenses on loss provisions put a heavy burden on profit because of the new rules on placement classification and the asset quality review of European banks, conducted by the European Banking Authority (EBA).

Notwithstanding the deterioration in the loan portfolio quality, risks to bank operations remained adequately covered. Provisioning costs for risky loans grew in the first half of 2014 on account of the ageing of the non-performing portfolio and the exposure migration to riskier categories, as well as the application of stricter rules on the classification of placements and the making of value adjustments. Maturity match between assets and liabilities also improved, while liquidity surpluses remained noticeably larger than the prescribed minimum. The rise in profits and capital injections provided a boost to capitalisation of the domestic banking system. This was achieved thanks to the conservative approach followed in the previous years, which ensured a high level and quality of capital items, and to this year's adoption of measures on capital buffers. At the end of June 2014, all capital ratios were much above the prescribed minimum (the total capital ratio stood at 21.1%).

In the fiscal sphere, the first half of 2014 was marked by changes in the tax and pension system aimed at increasing budget revenues. This primarily refers to the partial transfer of assets from the second to the first pension pillar and an increase in the rate of compulsory health insurance contributions from 13% to 15%. However, the positive fiscal effects of these measures were weakened by VAT revenues noticeably lower than those seen at the same time last year. In the same period, expenditures were slightly lower than a year before, largely because the disbursement of the funds budgeted for payment of the health system's debt was postponed for the second half of the current year. As a result of these developments, net borrowing of consolidated general government (GFS 2001, on a cash basis) was HRK 4.4bn less in the first six months of 2014 than in the same period of 2013, standing at HRK 7.4bn. However, according to Eurostat data, which are presented in line with the new ESA 2010 methodology, net borrowing of general government stood at HRK 12.8bn in the first half of the current year. The larger deficit than evident from the MoF data is mostly due to the fact that, according to the ESA 2010 methodology, the transfer of assets from the second to the first pension pillar was not recorded as revenue to the state budget at the moment of transfer, but under financial accounts of the general government.

The government raised the lacking funds for budget financing by borrowing in the country and abroad. Conditions for government borrowing were relatively favourable in the first half of 2014 owing to low interest rates in international financial markets, as well as abundant liquidity in the domestic market, which was supported by the expansive monetary policy of the CNB. The government made use of favourable conditions by issuing two domestic bonds, worth EUR 650m and EUR 500m, respectively, and an additional EUR 1.25bn worth of eurobonds in May. This, however, sustained the trend of strong growth in public debt (ESA 2010), which stood at HRK 252.8m or 77.0% of GDP at the end of June 2014.

2 Global developments

Global economic growth was uneven in the first half of 2014, with favourable developments being observed in the US, developing and emerging market economies. The eurozone economy stagnated, while a considerable slowdown in real growth was recorded in Russia. China and India reported high economic growth rates, but the slowdown trend was still noticeable. The US dollar slightly strengthened against the euro from the end of the previous year. A growth in food prices was recorded, while the average oil price remained at the last year's level.

2.1 Movements of gross domestic product of selected economies

After performing poorly in real terms in the first quarter, owing to the exceptionally cold winter, weaker healthcare spending than expected and a decline in inventories, the USA recorded a strong growth in the second quarter thanks to the rise in personal consumption, exports, investments and inventories. Despite a temporary fall in economic activity in the first quarter, imports remained relatively stable in the first half of the year. The growth was spurred by Fed's policy of low interest rates and the concurrent maintenance of inflation on the target level. Labour market indicators improved significantly, as a result of a decline in the unemployment rate and a rise in the number of employed persons.

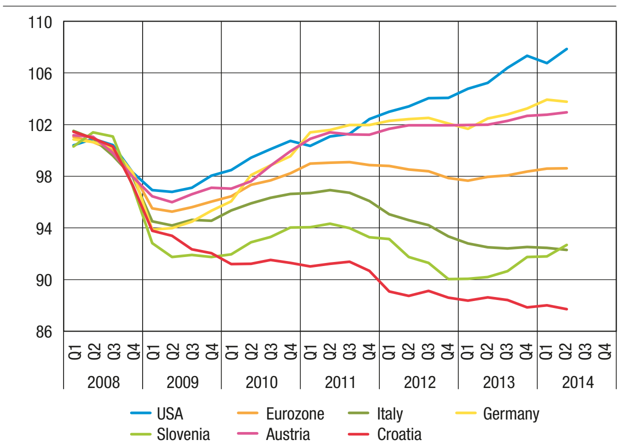
Following a slight growth in the first quarter, economic activity in the eurozone stagnated in the second quarter due to the fall in investments and inventories, which could not be offset by a mild growth in personal consumption. Observed by countries, a negative contribution to the growth in the second quarter came from the fall in GDP in real terms in Germany and Italy, while a positive contribution came from the economies of the Netherlands, Spain and Portugal. Yields on government bonds of peripheral member states continually decreased in the first half of 2014, due to the increased capital inflows from emerging market countries. However, a decrease in the risk premium in most of these countries did not result in any increase in placements to the private sector. Such developments resulted from the continued strong process of bank balance sheet restructuring, low level of confidence in the financial system and the still high level of credit risk in the economy. On the back of the ECB's extremely expansive monetary policy orientation, domestic demand was still limited by high unemployment and private sector debt.

Emerging market economies continued to record high economic growth rates, but with a noticeable downward trend. Developments in the Chinese economy in the first and second quarter were favourable: although they suggest planned growth could be realised on the annual level, it would still be lower than growth rates in recent Chinese economic history. Economic growth in India accelerated in the first half of the year, but following the parliamentary elections in April, the country was faced with the issue of high inflation. In order to bring inflation within the target range and reduce the volatility of food prices, the Indian government limited the export of certain categories of food products.

The economic growth in Russia decelerated considerably in the first half of 2014. The exacerbation of the conflict in Ukraine resulted in sanctions imposed by the USA and EU on Russia, which had a negative impact on investors' confidence and capital flows. According to preliminary data of the Russian central bank, net capital outflow in the financial and capital account of the balance of payments stood at USD 75bn in the first half of 2014, which had a negative effect on the exchange rate of the Russian rouble. An increase in the inflation rate, driven by the rise in food prices, has been noticeable since the beginning of the year.

Following the good results in the first quarter of 2014, the Japanese economy recorded a fall in real terms in the second quarter, due to the increase in VAT in April 2014. In line with this, the inflation rate increased considerably in May.

Figure 1 Gross domestic product of selected economies
seasonally adjusted data, constant prices, 2008 = 100



Sources: Eurostat and CNB.

2.2 Croatia's main trading partners

Among Croatia's main trading partners in the eurozone, Slovenia, Germany and Austria recorded economic growth in the first half of 2014, while Serbia, Bosnia and Herzegovina and Italy saw a decline in their economic activities. A slowdown in economic growth was more pronounced in the second quarter, with a special emphasis on the unexpected downturn in economic activity in Germany. Such developments were partly due to unfavourable weather conditions, particularly pronounced in Serbia and Bosnia and Herzegovina. Negative movements in trading partners also affected the real developments in Croatia in the second quarter.

German economy was marked by positive results in the first half of 2014, although the growth in the first quarter was partly offset by the decline in economic activity in the second from the previous quarter. The fall in economic activity in real terms was caused by a drop in net exports and investments, while a positive contribution to the change in GDP came from personal and government consumption. Reduced investment activity in the second quarter can be attributed to one-off effects of a mild winter and more pronounced investment activity in the first three months. A slowdown in growth in the main trading partners and geopolitical risks related to the conflicts in Ukraine also had a negative impact on the fall in economic activity of Germany.

The Austrian economy recorded a minimal growth in real economic activity in the first half of 2014, the largest positive contribution coming from government and personal consumption, while investments were reduced. Stable labour market indicators and an unemployment rate that is among the lowest in the eurozone contributed to the growth in personal consumption. The contribution of net exports to the growth in the second quarter was neutral, while there was an increase in exports and imports of goods and services.

The stagnation of the Italian economy in the first quarter was exacerbated by a decline in investment activity, due to a fall in the production of energy and the weakness of the construction sector. Negative developments marked by the fall in investments for the second consecutive quarter continued in the second quarter of 2014, while domestic demand was still subdued and under the influence of negative trends in the labour market. Bank credit activity shows signs of a recovery, but it was insufficient to produce any stronger growth in domestic demand. Despite the further relatively unfavourable macroeconomic trends, yields on government bonds continued to decline during the first six months of 2014.

Following solid growth in 2013, the Slovenian economy continued to grow in the first half of 2014. Although stagnation in economic activity was recorded in the first quarter, the second quarter saw growth. Broken down by aggregate demand components, exports made the greatest contribution to economic growth in the first half of 2014, while positive shifts can also be seen in domestic consumption, which has been growing for the third consecutive quarter. The recovery of domestic consumption was enabled by slightly more favourable labour market conditions, accompanied by growing employment and wages. Investments in the local infrastructure remained at a relatively high level, although their effect is probably only temporary. On the other hand, investments in machinery and equipment were reduced. The fall in prices of raw materials on the global market also affected the inflation rate, which remained in the first six months at the level of the eurozone average.

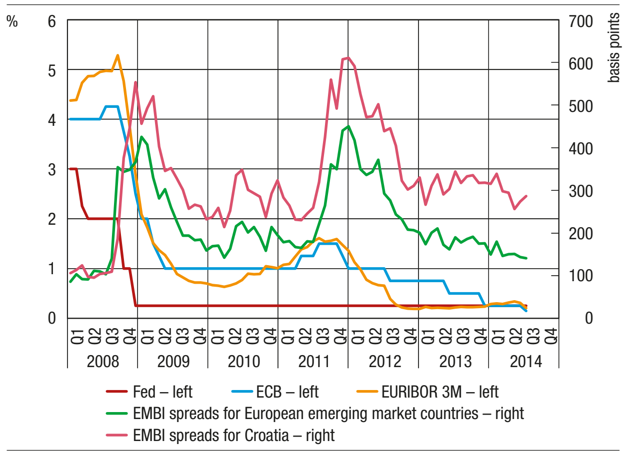
According to the first estimates, Serbia recorded a decline in real economic activity in the second quarter, after the stagnation in the first quarter. The fall in economic activity in the first half of 2014 was intensified by the effects of severe floods in May, which hit industrial production and the agriculture sector the most. Looking at the expenditure side, final consumption and private investments were reduced and a larger fall in economic activity was offset by the positive contribution of government investments and net exports. Weak inflow from foreign direct investments and increased domestic corporate demand for foreign exchange brought about the nominal weakening of EUR/RSD exchange rate, while low inflationary pressures resulted from the fall in food prices and weak domestic demand.

Bosnia and Herzegovina recorded a fall in real economic activity in the first half of 2014 from the end of 2013. The economy stagnated in the first quarter, the highest growth rates relative to the previous quarter being recorded in service and construction activities. Like Serbia, the country was exposed to severe floods in May, which resulted in a sharp fall in industrial production in that month. Consequently, real economic activity declined in the second quarter. Broken down by activities, the greatest decrease in economic activity was recorded in ore and stone quarrying activities. After the end-June revision of the Stand-by Arrangement, the IMF mission concluded that the programme was being implemented in a satisfactory manner, although there was room for additional fiscal relaxation in order to neutralise income losses and any further fall in economic activity. Deflationary trends were observed in the product market in the first six months, mostly due to the decrease in food product prices.

2.3 Benchmark interest rate trends

Thanks to the continued implementation of expansionary monetary policy and the improved conditions in financial markets, euro benchmark interest rates remained low in early 2014. Under such conditions, the three-month EURIBOR stood at around 0.3% in the first six months of 2014 and fell to the 2013 level in late June. In response to a significant inflation slowdown, the ECB, at a meeting in early June, decided to cut the interest rate on main refinancing operations by 10 basis points, bringing it down from 0.25% to 0.15%, and to reduce by the same amount the deposit interest rate, which became negative as a result, for the first time in the Eurosystem's history (–0.10%). Additional measures of monetary easing were also announced, aimed at improving the functioning of the monetary policy transmission mechanism, such as targeted long-term refinancing operations and preparations for the programme of direct purchase of asset-backed securities. The USA continued to pursue the policy of low interest rates in the first six months, inflation standing around 2% and unemployment falling below 6.5% in April, defined by the Fed as the target rate to start considering the increase of short-term interest rates. Despite favourable developments in the labour market, the Fed's range of key interest rates remained unchanged. In line with the announcements, the Fed continued the monthly programme of purchases of agency mortgage bonds and long-term government bonds in a reduced amount.

Figure 2 Benchmark interest rates and the average yield spread on bonds of European emerging market countries
end of period



Note: Data for period up to 30 June 2014.
Source: Blomberg.

Financing conditions for European emerging market economies mostly improved in the first half of 2014, in line with a further decrease in global risk aversion. This had a positive effect on the cost of borrowing for Croatia so that the spread on government bonds narrowed by more than 50 basis points in the first six months. The yield spread rose rapidly in late June, but remained at lower levels than early in the year. According to this indicator, Croatia still considerably lags behind all other Central and Eastern European countries.

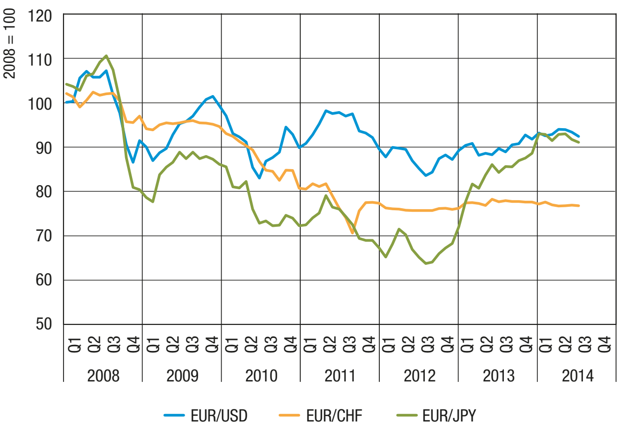
2.4 Exchange rates and price movements

The US dollar exchange rate weakened against the euro in the period from early January to end-April 2014, which can be attributed to signs of further recovery in the economy of the eurozone and announcements of relatively unfavourable economic indicators in the US early in the year. The Fed signalled its intention to continue pursuing a low interest rate policy in the following few quarters, which also contributed to the dollar's depreciation. However, the US dollar appreciated versus the euro in May, amid strong signals that the ECB would adopt another set of monetary expansion measures in June as a response to mounting deflation pressures in the eurozone. Further strengthening of the dollar against the euro was continued in line with the announcements of the recovery of American economy in the second quarter and the ECB's monetary easing in early June. The nominal EUR/CHF exchange rate was relatively stable in the first half of 2014, moving within a narrow range around an average value of EUR/CHF 1.22, very close to the administratively set floor of EUR/CHF 1.20. The substantial strengthening of the Swiss franc stemmed from mounting foreign exchange inflows, generated as a result of turmoil in some emerging market countries and the consequent outflows of capital from these countries to safe havens.

Inflation rapidly decelerated in all eurozone countries, with the harmonised annual inflation rate standing at only 0.5% in June 2014. A negative annual inflation rate in the mentioned month was recorded in Bulgaria, Greece, Portugal, Slovakia and Hungary. The inflation rate drop was driven by a decrease in raw material prices in the world market, but also by domestic factors, primarily subdued cost-push pressures resulting from still high unemployment.

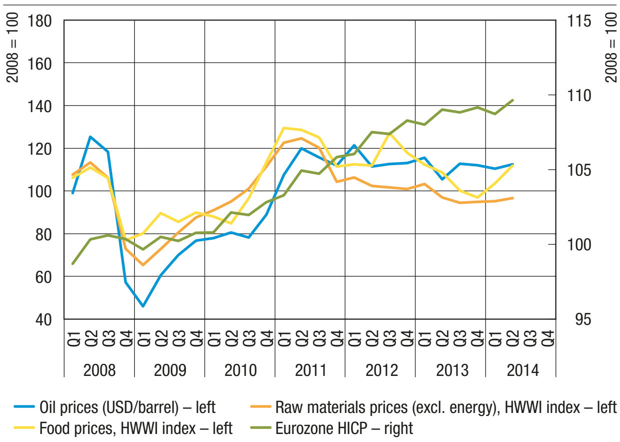
The average Brent crude oil price was relatively stable and stood at USD 109.8 in the second quarter of 2014 relative to USD 107.9 in the first quarter. Due to rising insecurity in Iraq, the price of crude oil briefly reached USD 115 per barrel in June, stabilising towards the end of the month, due to the easing of the geopolitical situation in the north of the country. The factors contributing to oil price stability include plentiful oil reserves in the USA that make its economy less sensitive to fluctuations in the supply of this energy product in the world market.

Figure 3 Exchange rates of individual currencies



Note: A growth in the index denotes a depreciation of a currency against the euro.
Source: Eurostat.

Figure 4 Prices



Sources: Eurostat, Bloomberg and HWWI.

The HWWI index of raw material prices (excluding energy, in US dollars) increased in the first four months in 2014, due to a rise in food product prices. Food product prices were reduced in the following months, primarily due to the fall in cereal prices, the HWWI index of raw material prices (excluding energy, in US dollars) thus returning in June to the level from the beginning of the year. It was largely due to favourable weather conditions and an exceptionally good harvest. The decrease in iron ore and coal prices was related to market expectations that the global demand for this raw material would weaken as a result of China's economic slowdown.

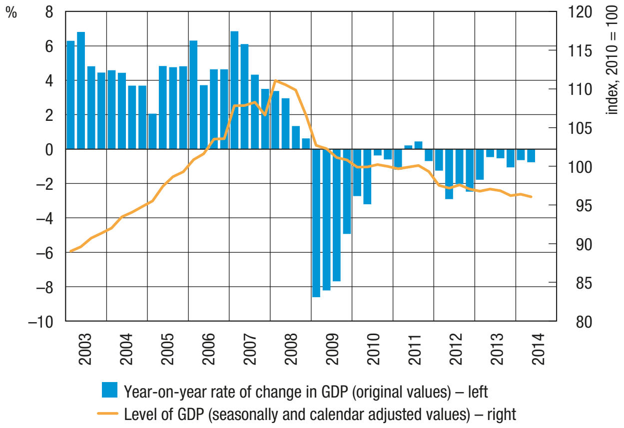
3 Aggregate demand and supply

After a fall in 2013, in the first two quarters of 2014 real economic activity remained at the level of the end of 2013. In the first quarter of 2014, real GDP, seasonally adjusted, slightly increased from the previous quarter (0.2%), spurred by the growth in goods exports and personal consumption.[1] The second quarter saw a decrease in real economic activity (–0.3%), due to a decline in all components of domestic and foreign demand. The fall in real exports of goods and services reflected the slowdown of growth in Croatia's main trading partners. The economic downturn was sharper at the annual level, with a fall of 0.6% in the first and 0.8% in the second quarter, in real terms.

3.1 Aggregate demand

Exports of goods and services in the first quarter grew by 1.4% from the previous quarter due to a surge in real exports of goods, while real exports of services declined. In current prices, the value of all categories of exports increased, except for capital goods and energy, whose exports decreased. Real exports of goods and services slightly declined in the second quarter from the first quarter of the current year (–0.4%), while a strong increase in real exports was recorded at the annual level. Balance of payments data show a mild growth in nominal exports of services from the same period in the previous year, which is in line with favourable developments in the number of nights stayed by foreign tourists in the second quarter. According to data on trade in goods, nominal exports of goods increased, with a strong growth in exports of oil and refined petroleum products. Positive annual trends in the trade in goods should be interpreted with caution, as data for 2013 and 2014 were considerably revised in June 2014, due inter alia to the increased number of incorrectly recorded transactions after Croatia's accession to the EU.

Figure 5 Gross domestic product
real values

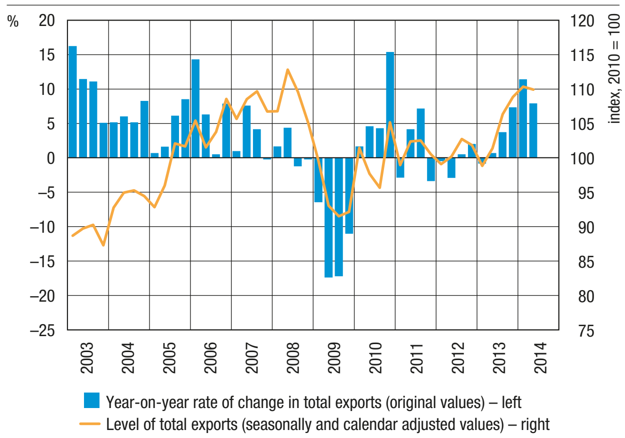


Source: CBS data seasonally adjusted by the CNB.

In the first six months, personal consumption remained at the level of the end of 2013. In the first three months of 2014, personal consumption went up (by 0.7% from the previous quarter), while in the second quarter it fell slightly (–0.2%). Further decline in household purchasing power, caused by the decrease in real disposable income, and further household deleveraging had a negative impact on personal consumption. The consumer confidence index still stagnated in the first half of 2014, at the level slightly below the long-term average.

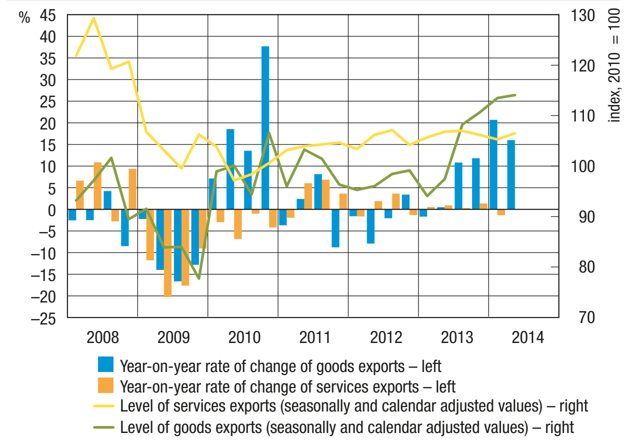
Investment activity decreased by 0.8% in the first quarter, with a fall in general government investments and a growth in private sector investments. The contraction in general government investment activity in the first quarter is indicated by government investment expenditures and a drop in

Figure 6 Exports of goods and services
real values



Source: CBS data seasonally adjusted by the CNB.

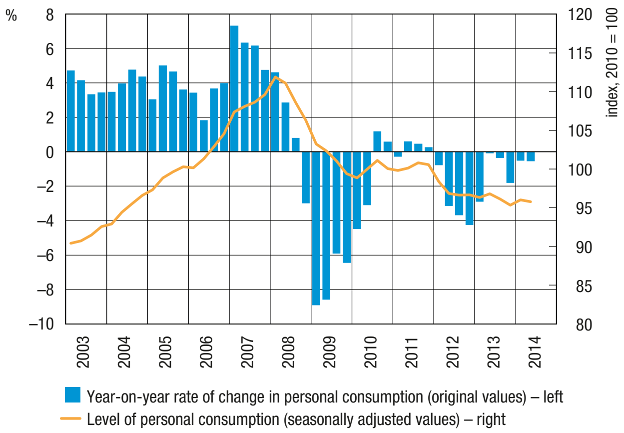
Figure 7 Real exports of goods and services



Source: CBS data seasonally adjusted by the CNB.

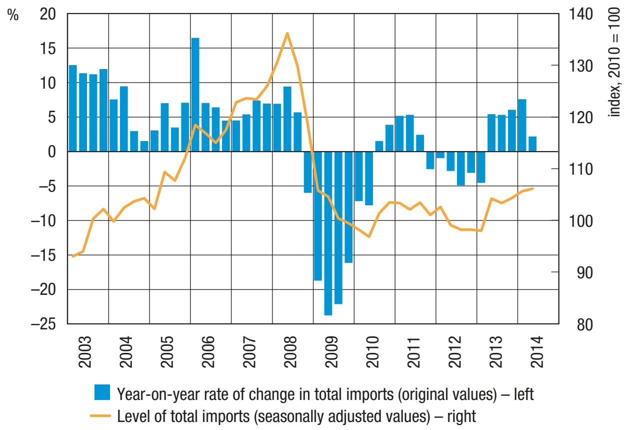
1 Seasonally adjusted data on quarterly growth rates are based on the new ESA 2010 methodology for GDP calculation.

Figure 8 Personal consumption
real values



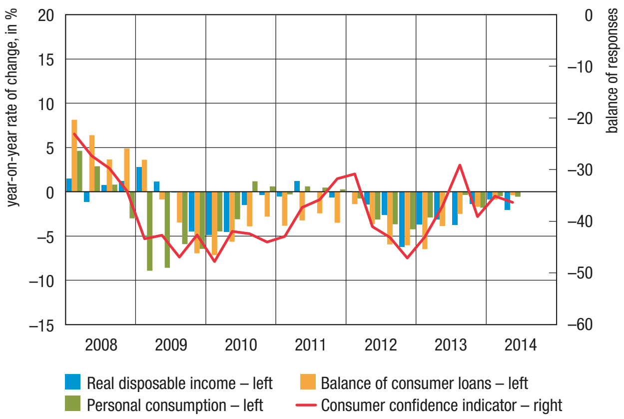
Source: CBS data seasonally adjusted by the CNB.

Figure 11 Imports of goods and services
real values



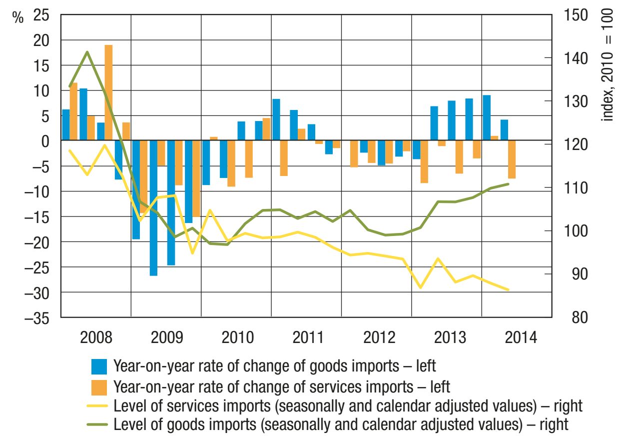
Source: CBS data seasonally adjusted by the CNB.

Figure 9 Determinants of personal consumption



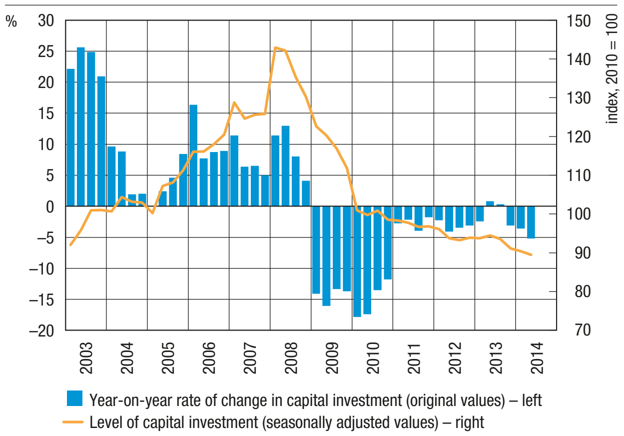
Note: The values of the consumer confidence indicator in a month are calculated as averages of monthly data.
Sources: CBS, Ipsos Puls and CNB.

Figure 12 Real exports of goods and services



Source: CBS data seasonally adjusted by the CNB.

Figure 10 Gross fixed capital formation
real values



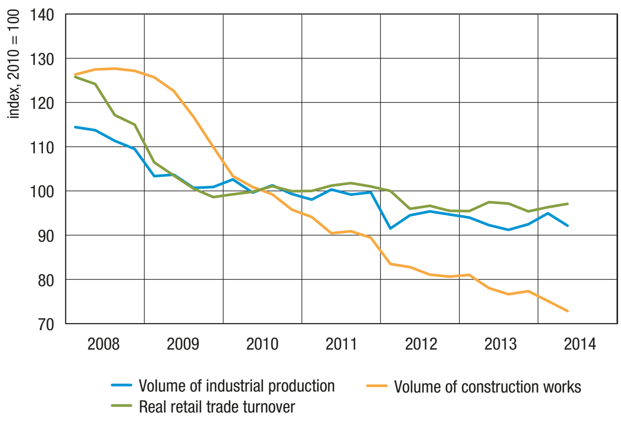
Source: CBS data seasonally adjusted by the CNB.

civil engineering works. On the other hand, the increase in imports of capital goods and the growth in construction works on buildings suggest a strengthening of private sector investments. Fixed capital formation continued to decline (–1.0%) in the second quarter, which is the fourth consecutive quarter of a considerable decrease in this component of aggregate demand. The fall in capital investments is partly the result of a further decline in the volume of construction works (–3.0%). Corporations reduced their investments in machinery and equipment, as suggested by the decline in the volume of the production of capital goods and the fall in imports of capital goods.

Government consumption decreased by 1.4% in the first quarter of 2014 and continued to fall in the second quarter as well (0.9%). This was the result of a decrease in the use of goods and services by the government and a fall in the number of civil servants and government employees, as suggested by a noticeable decrease in the number of employed persons in public administration, education and health care activities.

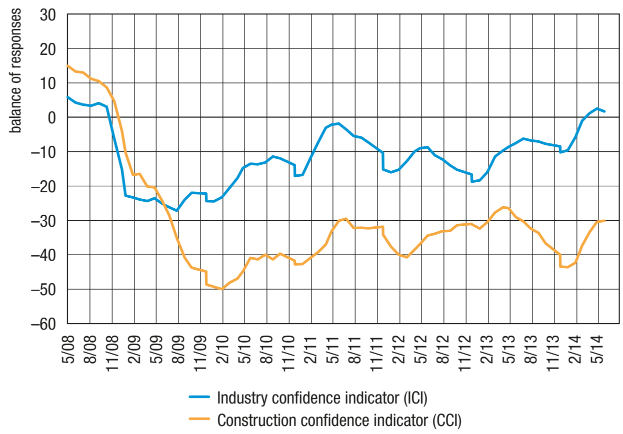
Real imports of goods and services went up by 1.3% in the first quarter of 2014 due to the growth in personal

Figure 13 Short-term economic indicators
seasonally and calendar adjusted



Note: Quarterly data are calculated as an average of monthly data.
Source: CBS data seasonally adjusted by the CNB.

Figure 14 Business confidence indicators
three-member moving averages of monthly data



Source: Ipsos Puls.

consumption and exports of goods. As shown by trade in goods data, imports of intermediate, capital and non-durable consumer goods increased sharply, whereas imports of energy declined significantly from the previous quarter. Despite the decrease in all components of domestic and foreign demand, a slight growth in imports of goods and services (0.5%) was recorded in the second quarter as compared to the previous quarter. Such movements are mostly due to the increase in imports of goods, whereas imports of services decreased. Broken down by main industrial groupings, a considerable growth in imports of energy and durable consumer goods was seen in the second quarter.

3.2 Aggregate supply

Real gross value added held steady in the first three months relative to the previous quarter. Economic downturn was recorded in construction, agriculture, forestry and fishing and information and communication activities. A growth in economic activity was recorded in other NCA activities, with the greatest positive contribution coming from manufacturing.

Real gross value added declined by 0.3% in the second quarter of 2014. Economic activity in construction continued to decrease and the fall was also prominent in agriculture, forestry and fishing and manufacturing. Only wholesale and retail trade recorded an increase in real gross value added. Business optimism indicators suggest slightly more favourable expectations of enterprises in industry and construction than at the end of the previous year. The annual fall in gross value added was considerably milder than the fall in GDP, whose adverse dynamics were additionally affected by a drop in indirect taxes.

4 Labour market

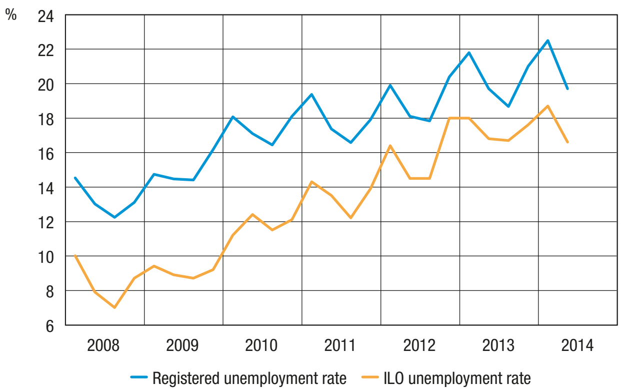
Labour market developments stabilised in the first six months of 2014 after having deteriorated significantly at the end of 2013. Nevertheless, as a result of negative contributions by all sectors, the year-on-year average number of employed persons was 2.5% lower than in the first half of 2013. Broken down by activities, the first half of 2014 saw an increase in the number of persons employed in service activities, particularly in accommodation and food service activities, while the number of persons employed in manufacturing and transportation and storage activities remained the same. The number of persons employed in other activities exhibited a significant drop.

Unemployment levels were 1.6% lower in the first six months of 2014 than in late 2013. In spite of the improvement, the number of unemployed persons remained high (around 345,000). The average registered unemployment rate stood at 20.4% in the first half of the year, dropping to 19.8% in June. Lower unemployment levels reflect lower inflows into the CES register and an increase in the number of persons removed from the CES register due to non-compliance with legal provisions. The internationally comparable unemployment rate according to the data from the Labour Force Survey dropped from 17.4% in the first quarter to 16.6% in the second quarter.

Nominal gross and net wages picked up in the first half of the year (both by 0.3%), with the rise being even more pronounced in real terms (by 0.3% and 0.8% respectively) owing to lower price levels.

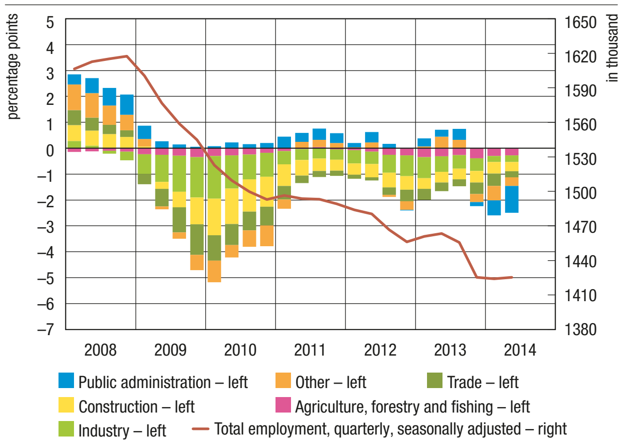
Nominal unit labour costs held steady in the first half of 2014, taking into account that the one-off increase in unit labour costs resulted in an increase in health insurance contributions from 13% to 15% as of April 2014. Real unit labour costs increased slightly, again as a result of lower price levels.

Figure 16 Unemployment and activity rates



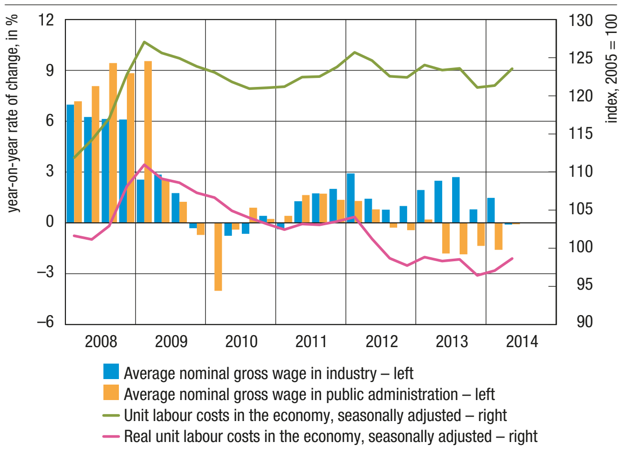
Note: Data for 2013 and the first and the second quarter of 2014 have been harmonised with the Census of Population, Households and Dwellings in the Republic of Croatia in 2011, while the previously released data were calculated based on the Census from 2001.
Sources: CBS and CES.

Figure 15 Total employment and contribution to the year-on-year change in employment by sector



Source: CPIA data seasonally adjusted by the CNB.

Figure 17 Gross wages and unit labour costs



Sources: CBS and CPIA data seasonally adjusted by the CNB.

5 Inflation

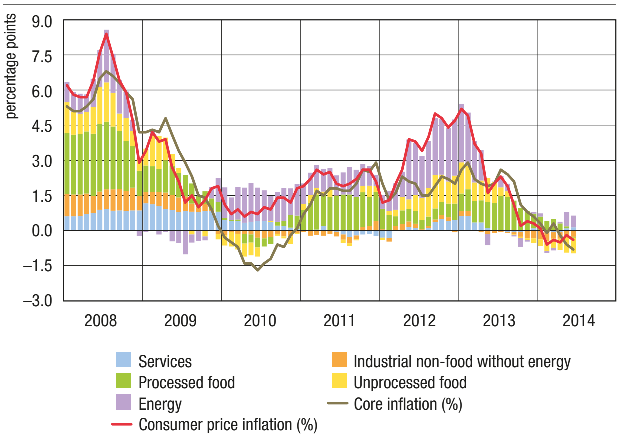
Croatia's annual consumer price inflation rate decreased considerably in 2013, moving into negative figures from February to June 2014 and standing at an average of –0.4%. Such trends primarily reflect imported deflationary pressures as well as reduced personal consumption and the absence of domestic cost pressures. Even though indicators of current inflation trends increased in May and June, they remained slightly negative.

Annual consumer price inflation fell from 0.3% in December 2013 to –0.4% in June 2014, with the contribution of food prices dropping the most (down by 1.1 percentage point). The drop was observed in three groups of products: vegetables (–0.4 percentage points), milk, cheese and eggs (–0.4 percentage points) and bread and cereals (–0.2 percentage points). Prices of vegetables dropped primarily because this year's winter was milder than the previous one, while the trends in processed food prices resulted from the decline in the prices of food raw materials on the global market, which began in July last year, and, to a somewhat smaller extent, from low domestic demand and stronger competition following Croatia's accession to the European Union.

On the other hand, administrative decisions, including an increase in the previously reduced VAT rate from 10% to 13% as well as increases in excises on tobacco and refined petroleum products, the water management and protection charge and the charge for the provision of communication services in mobile networks, contributed to a growth in prices in the first six months of 2014. The contribution of energy prices to the annual inflation was negligible in the first four months of 2014, but rose subsequently, reflecting the upward trend in the prices of refined petroleum products brought about by the rise in the prices of crude oil on the global market as well as by the aforementioned increase in excises and the unfavourable base effect. The contribution of industrial goods (without food and energy) to the annual inflation rose slightly in the first half of the year, mostly due to the sharper annual growth in the prices of water supply and footwear. The annual rate of change in the prices of services also saw a moderate increase, for the most part as a consequence of higher contributions of communications, hospital services and package holidays, the rise in the first two categories being the result of administrative decisions.

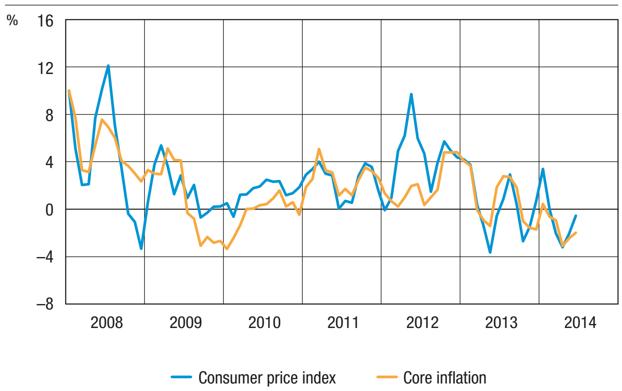
The annual rate of change in the deflator of imports of goods and services stagnated at the level of –1.0% in the last quarter of 2013 and the first half of 2014, confirming that the decline in the prices of raw materials and final products in the external environment has a significant effect on the decrease of prices. After almost four years, the deflator of exports of goods and services was negative again in the last three quarters, hovering around –1.1%. An equal decrease in the deflators of imports and exports on an annual basis indicates that trade conditions remained the same.

Figure 19 Year-on-year inflation rates and contribution of components to consumer price inflation



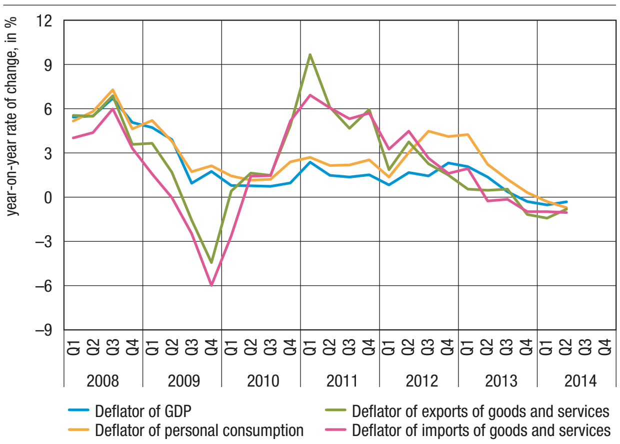
Sources: CBS and CNB calculations.

Figure 18 Consumer price index and core inflation[a]
annualised month-on-month rate of change



[a] Core inflation excludes agricultural product prices and administrative prices.
Note: The month-on-month rate of change is calculated from the quarterly moving average of seasonally adjusted price indices.
Sources: CBS and CNB calculations.

Figure 20 Deflator of GDP and its individual components



Source: CBS.

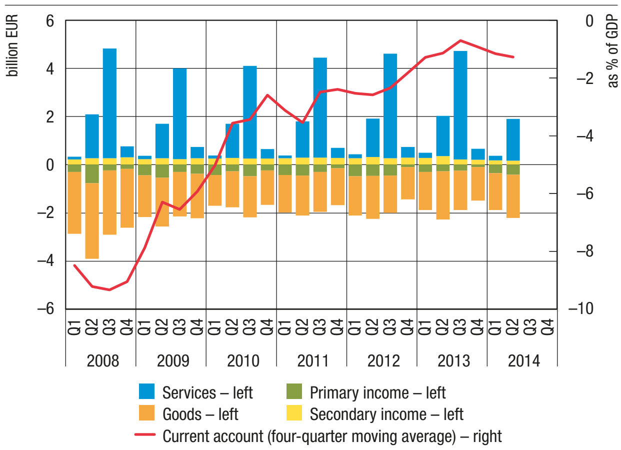
6 Foreign trade and competitiveness

In the first half of 2014, the current account balance deteriorated[2], displaying a deficit of EUR 1.8bn, up by 10.6% from the same period last year as a result of trends in the secondary and primary income accounts. The decrease in the surplus of the secondary income account primarily reflects government payments to the EU budget which were higher than the withdrawal from EU funds, while the increase in the deficit of the primary income account mainly originates from expenditures related to direct equity investment. On the other hand, negative impacts on the current account balance were mitigated by more favourable trends in international trade in goods resulting from the growth in exports. In addition, net exports of services saw a slight increase as well. Taking into account the cumulative value in the last four quarters, the current account surplus fell to 0.5% of GDP, which is slightly lower than the level recorded in the same period last year (0.6% of GDP).

The widening of the primary income account deficit in the first half of 2014 was primarily caused by expenditures from direct equity investment and more favourable year-on-year business performance of foreign-owned companies and banks. Better business performance was primarily observed in financial intermediation and construction. Higher interest expenses arising from foreign liabilities also added to the growth in the primary income account deficit, although to a smaller extent. Such trends are by and large a result of the higher costs of foreign financing for general government. In addition, net revenues from compensation to residents working abroad dropped.

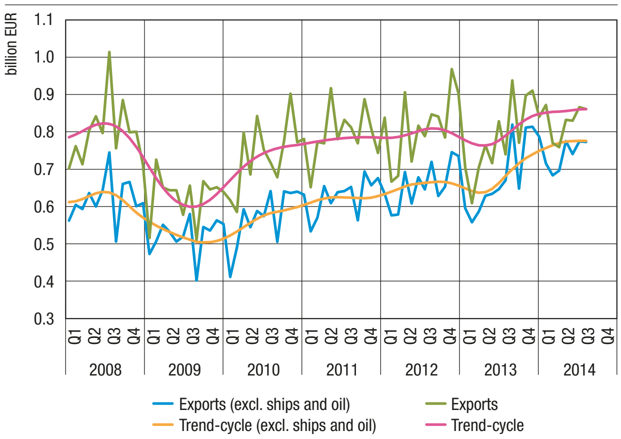
The surplus in the international trade in services was 2.9%

Figure 21 Current account balance and its structure



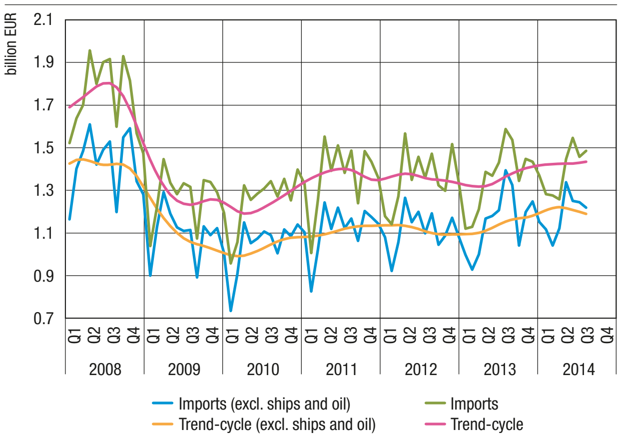
Source: CNB.

Figure 22 Goods exports (f.o.b.) and trend-cycle



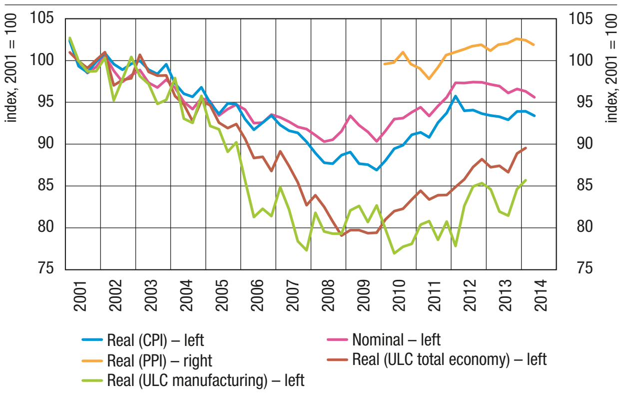
Source: CBS data seasonally adjusted by the CNB.

Figure 23 Goods imports (c.i.f.) and trend-cycle



Source: CBS data seasonally adjusted by the CNB.

Figure 24 Nominal and real effective exchange rates of the kuna



Note: The Croatian index of industrial producer prices on the non-domestic market, which is available from January 2010, is included in the calculation of the real effective exchange rate of the kuna deflated by producer prices. A fall in the index denotes an effective appreciation of the kuna.
Source: CNB.

2 According to the Balance of Payments and International Investment Position Manual, Sixth Edition (BPM6).

larger in the first half of 2014 than in the first half of 2013, mostly owing to the rise in revenues from tourism (2.1%). The trend was notably due to the increase in the number of arrivals and overnight stays of tourists from Germany, Austria, Italy and the UK. At the same time, the number of overnight stays of tourists from Russia and the Netherlands continued to decline. In addition, net imports of other services saw an increase as a consequence of unfavourable trends in the international trade in personal, cultural and recreational services as well as in construction and other business services.

According to CBS data, total exports of goods exhibited only a slight increase of 0.4% in the first half of 2014 from the previous half-year. Exports of ships decreased considerably, and downward trends were observed in the exports of oil and refined petroleum products as well. By contrast, exports of other goods excluding ships and oil grew by 4.8% from the second half of 2013. Among individual SITC divisions, the growth was mostly a result of an increase in exports of food (notably sugar and sugar preparations and vegetables and fruit) and wearing apparel. Exports of cork and wood and telecommunications and sound recording apparatus increased as well. Performance was poor in certain segments, as evidenced by the continued decline in the exports of medical and pharmaceutical goods and metalliferous ores and metal scrap.

Imports of goods rose by 2.4% from the second half of 2013 to the first half of 2014 owing to the upsurge in the imports of ships previously exported for finishing purposes, while the imports of oil and refined petroleum products remained stagnant. If ships and oil are excluded, the growth in imports is even more pronounced (3.7%), which is mainly attributable to the increase in the imports of road vehicles and capital goods, particularly in the first quarter of 2014. Imports of footwear and wearing apparel, electric current and beverages and tobacco also exhibited a substantial increase, while imports of natural and manufactured gas fell.

Indicators of price competitiveness of Croatian exports were relatively stable in the first half of 2014, remaining in line with the values recorded in the previous two years. Nevertheless, there is evidence of a slight improvement of price competitiveness at an annual level, i.e. of a depreciation of real effective exchange rates of the kuna deflated by consumer and producer prices due to the fact that domestic prices were more favourable than those of the majority of Croatia's main trading partners. Data on the real effective kuna exchange rates deflated by unit labour costs available for the first quarter of 2014 indicate their continued depreciation, although at a slower pace than in the previous quarter. A contribution was made here by the developments in domestic unit labour costs, which were more favourable than those in most of Croatia's main trading partners.

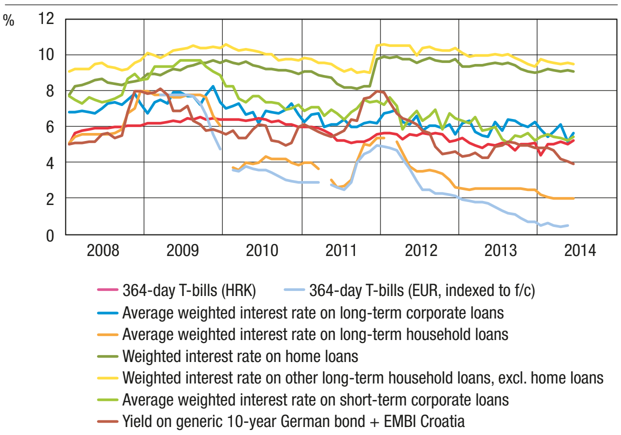
7 Financing conditions and capital flows

Financing conditions for domestic sectors were on average slightly more favourable in the first six months of 2014 than in the previous year. High liquidity in international financial markets led to lower costs of government financing abroad, while the expansionary monetary policy of the CNB enabled the government to borrow in the domestic market on highly favourable terms. Although corporate and household borrowing costs were on average slightly lower than last year, the placements of credit institutions to domestic sectors shrank in the first half of 2014.

Improved government financing conditions in the foreign market, estimated in terms of the yield on the German government bond and the EMBI yield spread for Croatia, continued into the first half of 2014 spurred by exceptionally high liquidity and low interest rates in international financial markets. Against such a background, the government issued a bond in the European market at end-May 2014 on significantly more favourable terms than it had previously done. Eight-year government bonds in the amount of EUR 1.25bn were issued with a required yield of 4.02%, compared with a ten-year bond issue in November 2013 with a yield of 6.2%. Government financing costs in the domestic market remained very low as well, primarily owing to the continued high liquidity policy of the CNB. The interest rate on one-year kuna T-bills dropped to 2.0% by mid-year, while the interest rate on T-bills with a euro currency clause fell to 0.5%.

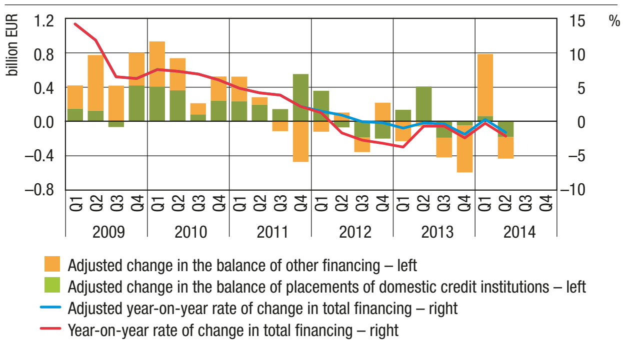
The credit default swap (CDS) on bonds issued by parent banks of the largest domestic banks narrowed somewhat in the first six months of 2014. For the first time after a several-year period, the level of CDS for Italian banks fell below that of Austrian banks. The credit default swap for Croatia also tightened in the first six months of 2014, remaining, however,

Figure 25 Costs of domestic and foreign financing



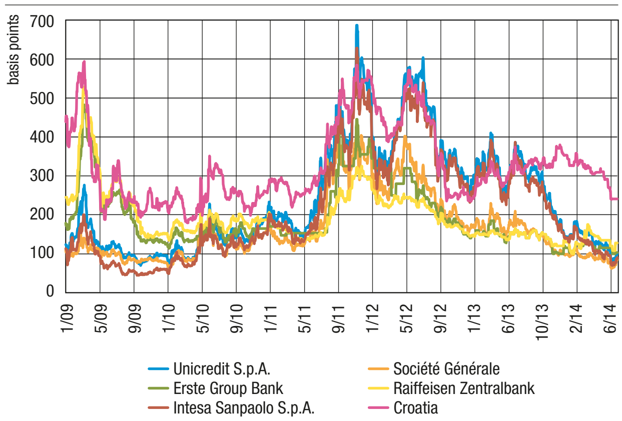
Sources: Bloomberg, MoF and CNB.

Figure 27 Corporate financing by sources



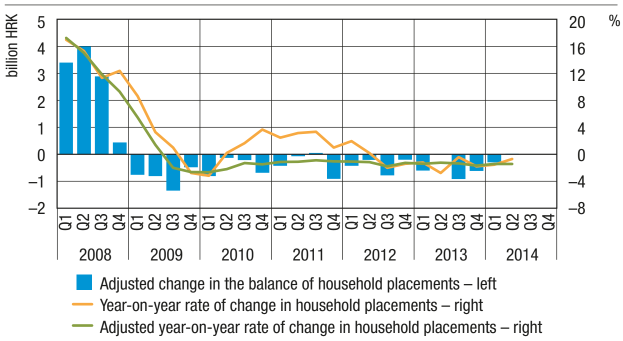
Note: Other financing includes corporate borrowing from domestic leasing companies and direct borrowing from the CBRD, as well as borrowing from foreign banks and affiliated enterprises abroad. The adjusted changes do not include the effects of the assumption of loans to the shipyards by the Ministry of Finance, the sale of partly recoverable and fully irrecoverable placements by one bank, the bankruptcy of Centar banka d.d., the methodological changes in the recording of fees and the exchange rate changes.
Sources: HANFA (CNB calculations) and CNB.

Figure 26 CDS spreads for Croatia and selected parent banks of domestic banks



Note: Credit default swaps (CDS) spread is an annual premium that a CDS buyer pays for protection against credit risk associated with an issuer of an instrument.
Source: Bloomberg.

Figure 28 Placements to households



Note: The adjusted changes are calculated on the basis of data which do not include the effect of transactions of one bank which, in an effort to reduce the amount of partly recoverable and fully irrecoverable placements, transferred a portion of its claims to a company indirectly owned by a parent bank (which in turn contributed to the decrease in its external debt), the bankruptcy of Centar banka d.d., the methodological changes in the recording of fees and the effect of the exchange rate changes.
Source: CNB.

relatively high, particularly when compared with other Central and Eastern European countries.

As regards corporate financing, interest rates on long-term loans continued their gradual decline in the first half of 2014, although with marked volatility. At the same time, interest rates on short-term corporate loans remained at the favourable levels recorded in the second half of 2013. In spite of that, the deleveraging of public enterprises in the first half of 2014 reduced the total corporate debt to domestic banks. Similar developments were also noticeable in corporate foreign borrowing, where public enterprises continued to deleverage, while borrowing by private enterprises grew slightly. The quarterly dynamics of foreign borrowing were greatly affected by a large company that arranged a loan in March and then significantly reduced its debt in April.

Observed on an annual basis, total corporate debt at end-June 2014 was 1.6%[3] lower than in the same period last year. These trends indicate that, in spite of favourable interest rates, corporate lending continues to be dominated by the subdued demand for loans arising from unfavourable expectations regarding economic developments and weak investment activity.

In the household sector, the trend of deleveraging continued for the sixth consecutive year, although with a slight increase in household loans in the second quarter of 2014. Lending activities aimed at this sector were further dampened by the reduced demand for loans resulting from unfavourable economic outlooks and labour market developments as well as by the still relatively high interest rates, particularly on consumer and general-purpose household loans. In addition, interest rates on home loans also rose gradually from the beginning of 2014.

7.1 Capital flows between Croatia and foreign countries

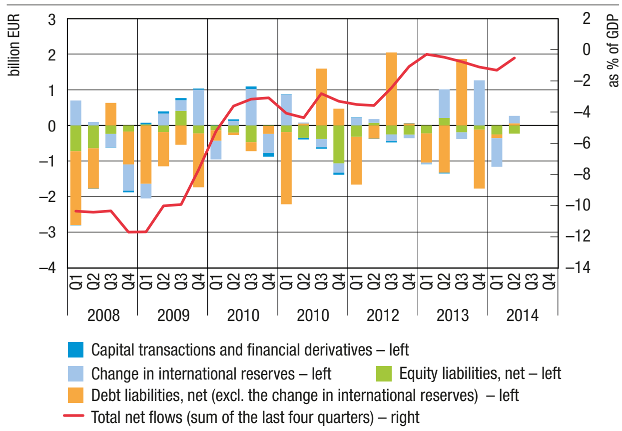
In the first half of 2014, the balance of payments capital and financial account[4], excluding changes in international reserves, recorded an increase in net liabilities, i.e. a net capital inflow of EUR 0.5bn. This is primarily related to the increase in net liabilities arising from equity investments, while the net external debt position of domestic sectors improved. Net capital inflow was significantly lower than in the same period last year (EUR 2.2bn), when net external debt liabilities, in particular those of credit institutions and general government, increased considerably. In the first six months of 2014, international reserves decreased.

Foreign direct investment in the first half of 2014 was marked by a round-tripping direct investment that contributed to an increase in assets and liabilities by the same amount (EUR 1.5bn). Accordingly, the most substantial growth in liabilities was observed in other business activities. In addition, liabilities arising from direct investment rose in retail trade, construction and the real estate sector. Better business performance of foreign-owned corporations and banks had a positive effect on reinvested earnings.

3 Excluding the effects of the assumption of the shipyard debt which became government debt, the transfer of a bank's non-performing placements to a company indirectly owned by the parent bank, the bankruptcy of Centar banka d.d., the change in the book-entry system of fees and exchange rate changes.

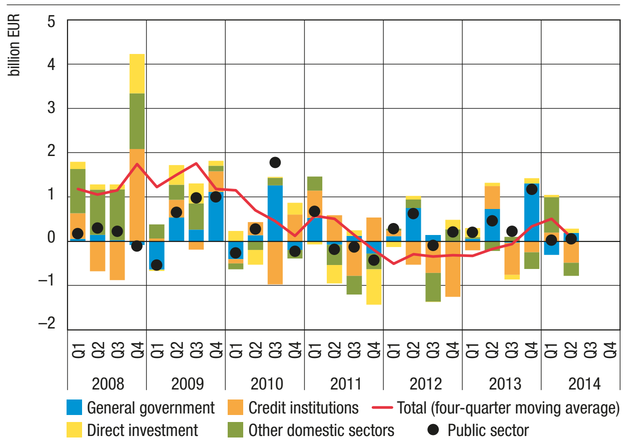
4 According to Balance of Payments and International Investment Position Manual, Sixth Edition (BPM6).

Figure 29 Capital and financial account flows



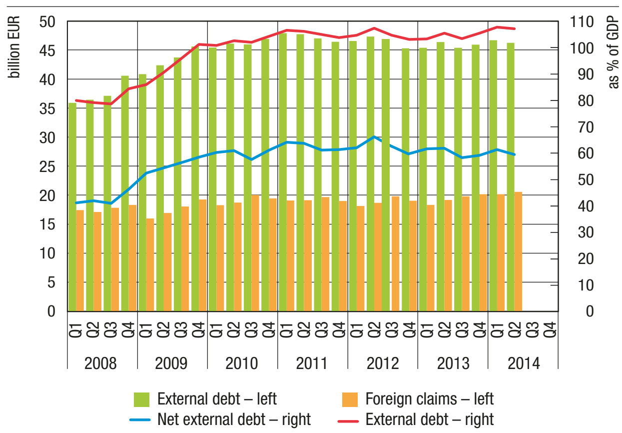
Note: A change in net equity and debt liabilities represents the difference between assets and liabilities. A positive change in international reserves denotes their growth.
Source: CNB.

Figure 30 Gross external debt transactions by sectors



Source: CNB.

Figure 31 Gross and net external debt



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

The decrease in net debt liabilities of domestic sectors in the first half of 2014 is primarily attributable to credit institutions, which increased their foreign assets and, at the same time, reduced their liabilities. A decrease in general government liabilities was also observed, in part resulting from the repayment of a short-term loan arranged in late 2013, transactions in the secondary government bond market and the repayment of EUR 500m worth of ten-year old foreign bonds that fell due in April. On the other hand, EUR 1.25bn worth of bonds issued in May had an opposite effect on government liabilities. In contrast to the banks and the government, other domestic sectors increased their net external debt liabilities in the first six months.

The improvement of the net external debt position of domestic sectors was accompanied by a drop of EUR 0.6bn in international reserves in the first six months of 2014. The drop was brought about by the CNB's sale of foreign currency to commercial banks and the decrease in central government foreign currency deposits with the CNB. International reserves stood at EUR 12.3bn at end-June and were sufficient to cover 7.9 months of goods and services imports.

Gross external debt increased by EUR 0.2bn in the first half of 2014, if the effects of cross-currency and other changes are excluded. The increase was significantly smaller than in the same period last year (EUR 1.2bn) owing to the decrease in the foreign liabilities of the general government and credit institutions, as opposed to last year's growth. The rise in total liabilities to foreign creditors in the first half of 2014 was brought about by the borrowing of other domestic sectors, notably private non-financial corporations. CBRD external debt increased as well, as did the liabilities to affiliated enterprises. At end-June 2014, gross external debt stood at EUR 46.3bn, accounting for 107.0% of GDP. At the same time, net external debt stood at EUR 26.2bn, accounting for 60.6% of GDP.

8 Monetary policy

The CNB continued to pursue an expansionary monetary policy in the first half of 2014. The central bank maintained high primary liquidity in the monetary system created in the previous years, keeping the exchange rate of the domestic currency against the euro stable. In addition, the redemption of compulsory CNB bills from banks continued to encourage the growth of corporate placements. Although the first six months saw slightly more favourable trends in monetary and credit aggregates than in the year before, delayed economic recovery hampered a more significant acceleration of their growth.

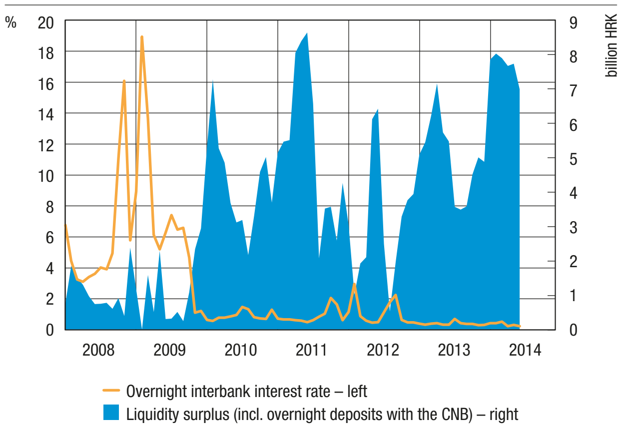
CNB's foreign exchange transactions conducted in the first half of the year resulted in a net sale of foreign currency in the amount of EUR 115.5m and, in turn, the withdrawal of HRK 0.9bn in reserve money. At end-January, EUR 240.2m were sold to banks in a foreign exchange intervention by the CNB, while the foreign exchange transactions with the European Commission resulted in a foreign exchange sale of EUR 292.7m. This reflects a conversion of kuna funds allocated monthly to the EC's account with the central bank by the government as payments to the EU budget. Foreign exchange purchase was only conducted in transactions with the government, in which EUR 417.4m worth of foreign currency was purchased from the Ministry of Finance in the first six months.

The favourable level of kuna liquidity in the monetary system remained unaffected by CNB foreign exchange operations and rose further in the first six months of 2014. Surplus liquidity in credit institutions' settlement accounts averaged HRK 7.7bn, up by HRK 2.7bn from the average recorded in 2013. The bulk of the increase was accounted for by the decrease in the average balance of the government kuna deposit with the CNB (HRK 0.8bn) and the CBRD's loan repayment to banks early in the year (HRK 1.6bn). Liquidity was further boosted by the repurchase of compulsory CNB bills from banks in a net amount of HRK 0.5bn, by which the central bank encouraged corporate placement growth. Due to high liquidity levels, overnight interbank interest rates and interest rates at MoF T-bill auctions were very low.

The nominal kuna/euro exchange rate was relatively stable in the first six months of 2014, exhibiting only slight sporadic fluctuations. The average exchange rate stood at EUR/HRK 7.62 in that period, unchanged from the last quarter of the previous year and only 0.6% above the 2013 average. As regards the exchange rate of the kuna against other major currencies, in the first half of the year it weakened slightly against the Swiss franc and strengthened moderately against the US dollar. These developments reflected changes in the Swiss franc and US dollar exchange rates versus the euro in the global financial market.

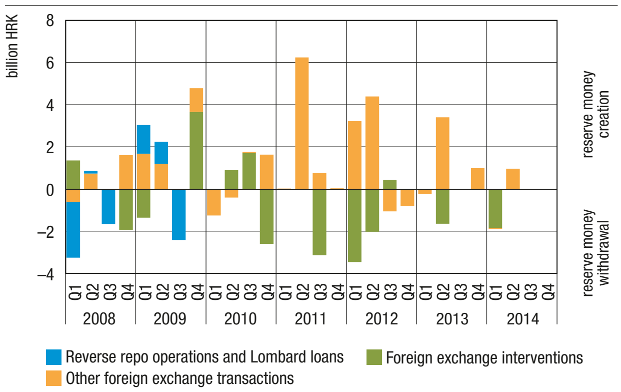
CNB's international reserves stood at EUR 12.3bn at the end of June 2014, down by 4.4% or EUR 0.6bn from the end of 2013. The decrease in gross reserves in the first half of the year was a result of the net sale of foreign currency by the CNB and an outflow from the government's foreign currency deposit

Figure 33 Bank liquidity and overnight interbank interest rate



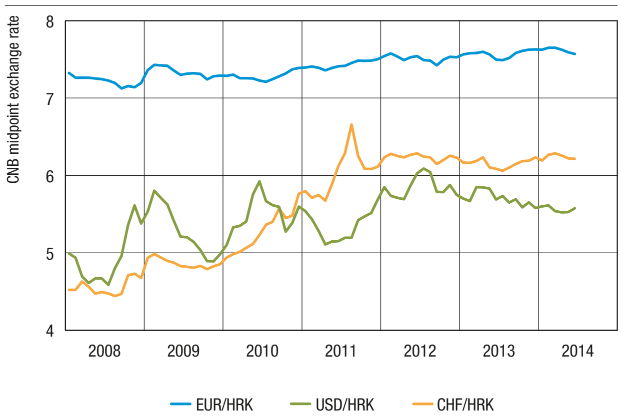
Source: CNB.

Figure 32 Flows of reserve money (M0) creation



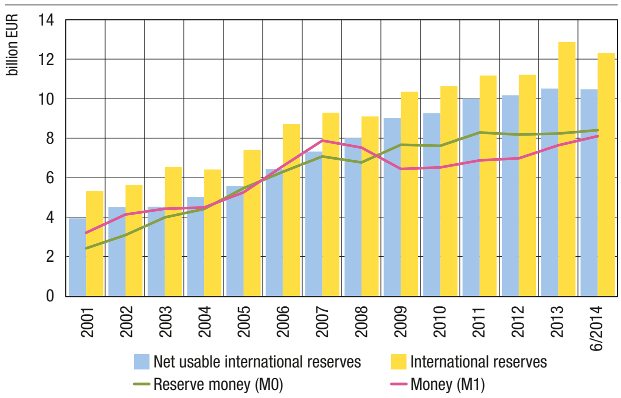
Note: Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and the EC as well as foreign currency swaps with banks, where the positive values refer to the purchase of foreign exchange by the CNB.
Source: CNB.

Figure 34 Nominal exchange rates of the kuna against selected currencies



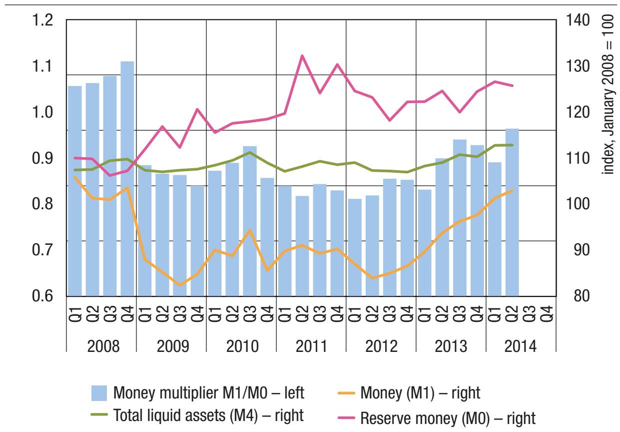
Source: CNB.

Figure 35 International reserves of the CNB and monetary aggregates



Note: Net usable international reserves are defined as international reserves net of CNB foreign liabilities in f/c, reserve requirements in f/c, general and special SDR allocations in 2009, government foreign currency deposits and off-balance sheet liabilities (swaps).
Source: CNB.

Figure 36 Monetary aggregates and money multiplier
index of developments in seasonally adjusted values, deflated by the consumer price index



Source: CNB.

with the central bank. The government retained a portion of foreign currency deposited with the central bank at end-November 2013 for the purposes of financing in 2014. The largest portion of the deposited foreign currency (around EUR 0.4bn) was purchased from the government, i.e. converted into the kuna, by the CNB. In contrast to gross reserves, net usable reserves exhibited only a slight decrease in the first six months of 2014 (by EUR 39m or 0.4%), standing at EUR 10.5bn at end-June. Gross and net international reserves remained considerably higher than the narrowest monetary aggregates.

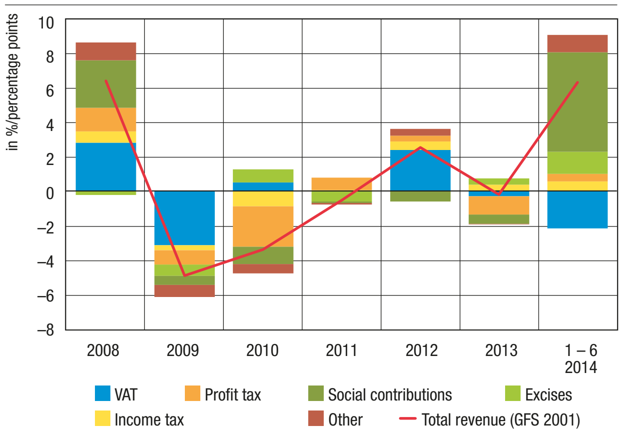
Real values of money (M1) and total liquid assets (M4) trended up in the first half of the year. Following the growth in the first quarter, M4 held steady in the second quarter, while M1 continued to grow. Reserve money also increased in the first six months, despite a slight decrease in the second quarter.

9 Public finance

Despite adverse economic developments, changes in tax legislation and the pension system prompted a noticeable annual increase in consolidated general government revenues (GFS 2001, cash basis) in the first half of 2014 (6.3%) from the same period last year. The upward trend was primarily a result of an increase in revenues from social contributions in the second quarter due to a partial transfer of assets of employees covered by an accelerated pension plan from the second to the first pension pillar and an increase in the rate of compulsory health insurance contributions from 13% to 15% as of April this year. The revenue increase was further enhanced by the revenues from grants (inflows from EU funds) and income and profit taxes. Income tax revenues increased partly due to the changed dynamics of tax refunds based on tax returns, while the increase in profit tax revenues may be associated with the less frequent use of tax reliefs based on reinvested profit than in the same period last year. On the other hand, VAT revenues shrank considerably in spite of the increase of the reduced VAT rate from 10% to 13% as of January this year and the whole-year effect of fiscal cash register system implementation. Such developments are partially attributable to the unfavourable dynamics of relevant macroeconomic fundamentals, VAT refunds to entrepreneurs from the EU for expenses incurred in Croatia, to which they have been entitled since Croatia joined the EU, as well as the base effect of the one-off strong growth in VAT revenues at the end of the first half of 2013 owing to the increase in the imports of goods.

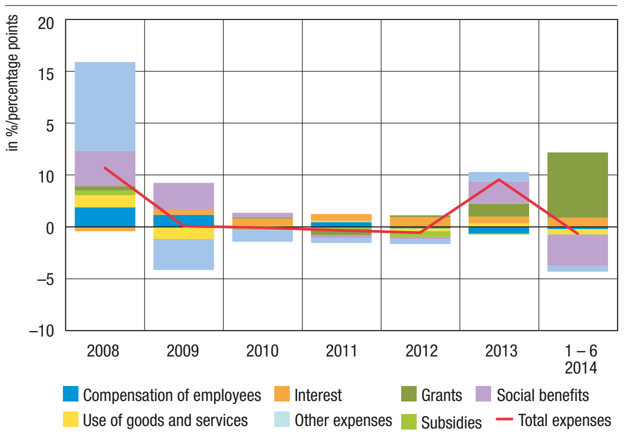
Consolidated general government expenditures, including the acquisition of non-financial assets, were 0.7% lower in the first half of 2014 than in the same period last year. Expenditures on social benefits contributed the most to the reduction of expenditures thanks to the lower amount of funds

Figure 37 Consolidated general government revenue
year-on-year rate of change and contributions



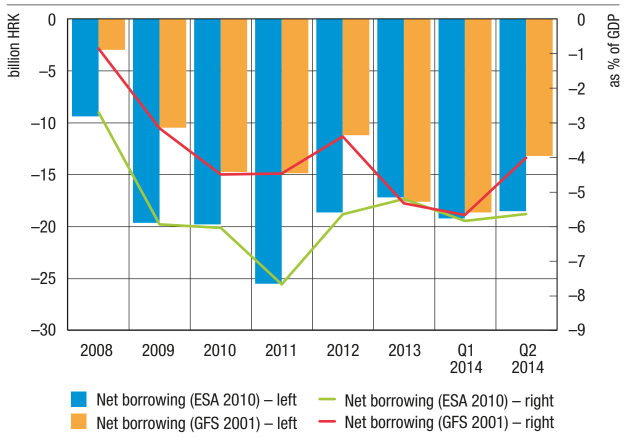
Note: GFS 2001, on cash basis.
Sources: MoF (CNB calculations).

Figure 38 Consolidated general government expense
year-on-year rate of change and contributions



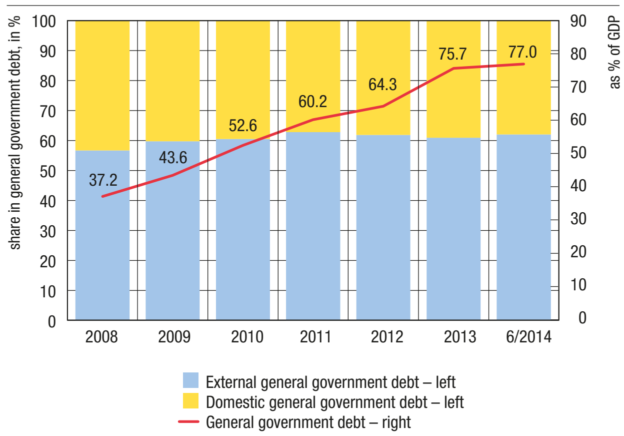
Note: GFS 2001, on cash basis.
Sources: MoF (CNB calculations).

Figure 39 Consolidated general government balance



Note: Data for 2014 show four-quarter moving averages.
Sources: MoF (CNB calculations).

Figure 40 General government debt
end-period stock



Source: CNB.

allocated to the rehabilitation of the finances of the health system. However, the government budget envisages an additional HRK 2.2bn intended for health institution financial rehabilitation by the end of 2014. Expenditures for the use of goods and services, employee compensation and other expenditures were reduced as well, most likely as a result of the implementation of savings announced within the excessive deficit procedure. Expenditures for grants due to payments to the EU budget and interest expenses exhibited an opposite trend. Expenditures for the acquisition of non-financial assets were considerably lower in the observed period, primarily as a result of reduced investment activity of Croatian Waters and Croatian Roads, while the aforementioned expenditures increased at the government budget level.

Consolidated general government net borrowing (GFS 2001, cash basis) in the first half of the year amounted to HRK 7.4bn, which is HRK 4.4bn less than in the observed period last year. The major part of the deficit was generated in the first quarter of the current year. The entire amount of the deficit was generated at the consolidated central government level, while the local government generated a surplus.

According to Eurostat data, the general government deficit under ESA 2010 stood at HRK 12.8bn in the first half of 2014, up by HRK 1.3bn from the same period last year. The difference relative to the aforementioned deficit according to the GFS 2001 methodology is largely attributable to the fact that, under ESA 2010, funds transferred from the second to the first pension pillar are not recorded as revenue to the state budget at the moment of transfer, but are included in the financial accounts instead. According to the published data, total revenues dropped by 1.5% on an annual basis in the first half of the year, primarily due to the decrease in VAT revenues. On the other hand, total expenditures rose slightly from the same period last year, mainly on account of payments to the EU budget and the growth of interest expenses.

The government financed the deficit by borrowing and by deposit funds raised by borrowing at the end of 2013. In the first half of the year, the government issued two domestic bonds with a currency clause worth EUR 650m and EUR 500m respectively, used partly for refinancing maturing bonds. In May this year, the government issued a eurobond worth EUR 1.25bn on the international capital market under relatively favourable conditions. As a result, at end-June the public debt (ESA 2010) exceeded the amount recorded at the end of last year by HRK 3.0bn, reaching HRK 252.8bn, or 77.0% of GDP.

10 International reserves management

The Croatian National Bank manages the international reserves of the Republic of Croatia; under the Act on the Croatian National Bank, these reserves constitute a part of the central bank balance sheet. The manner in which the international reserves are managed is consistent with the established monetary and foreign exchange policies; in managing the international reserves, the CNB is governed primarily by the principles of liquidity and safety. The international reserves of the Republic of Croatia comprise all claims and all banknotes in a convertible foreign currency as well as special drawing rights.

10.1 Institutional and organisational framework, management principles, risks and manner of international reserves management

10.1.1 Institutional and organisational framework of international reserves management

The Council of the CNB formulates the strategy and policy of international reserves management and approves the risk management strategic framework. The International Reserves Commission is the body responsible for the development of international reserves investment strategies in accordance with the objectives and criteria set by the Council of the CNB and for the adoption of tactical decisions on international reserves management, while taking into account market conditions. The International Reserves and Foreign Exchange Liquidity Department is responsible for investment and maintaining the liquidity of international reserves on a daily basis, for risk management and the preparation of reports for the Commission and the Council.

10.1.2 Principles of and risks in international reserves management

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

Risks present in international reserves management are primarily financial risks such as credit, interest rate and currency risks, though other risks, such as liquidity and operational risks, also play a role. The CNB limits exposure to credit risk by investing in highly rated government bonds, collateralised deposits and non-collateralised deposits with financial institutions with the highest credit rating. Interest rate risk, i.e. the risk of a fall in the value of the international reserves portfolio due to a potential increase in interest rates, can be controlled by means of benchmark portfolios and by investing a part of international reserves in the held-to-maturity portfolio. Currency risk arises from currency fluctuations between the kuna and the euro and between the kuna and the US dollar. Liquidity risk is controlled by investing reserves into readily marketable bonds and partly in deposit instruments with short maturities. Operational risk can be controlled by strict separation of functions and responsibilities, precisely defined methodologies and procedures, and regular internal and external audits.

10.1.3 Manner of international reserves management

As provided by the Decision on international reserves management, the Croatian National Bank manages international reserves in two ways: in line with its own guidelines and in accordance with the assumed foreign currency liabilities, depending on the way in which international reserves are formed.

The component of international reserves acquired through definitive 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 other component of the reserves, formed on the basis of the allocated foreign currency component of reserve requirements, MoF deposits, 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 according to the foreign currency liabilities assumed, the aim being to ensure protection against currency and interest rate risks.

The component of international reserves managed by the CNB in line with its own guidelines can be kept in held-for-trading and held-to-maturity portfolios. Held-for-trading portfolios, comprising held-for-trading financial instruments, are important for maintaining the daily liquidity of international reserves. Held-for-trading portfolios are carried at market (fair) value through profit and loss. Held-to-maturity portfolios comprise fixed income and fixed maturity securities that the CNB holds until maturity, carried at amortised cost.

The terminology of reporting on CNB international reserves includes the terms of gross and net reserves. Gross reserves imply total international reserves. Net reserves imply that component of the reserves managed by the CNB in line with its own guidelines.

10.2 International reserves in the first half of 2014

Total international reserves of the CNB as at 30 June 2014 stood at EUR 12,334.55m, down by EUR 572.78m or 4.4%

Table 1 Monthly changes in CNB international reserves

end of period, in million EUR

Month	Total reserves	Net reserves
December 2013	12,907.34	10,537.89
January 2014	12,892.87	10,588.61
February 2014	12,569.59	10,330.01
March 2014	12,099.86	10,321.10
April 2014	11,680.23	10,312.95
May 2014	13,016.35	10,359.42
June 2014	12,334.55	10,498.47
Change		
Jun. 2014 – Dec. 2013	–572.78	–39.41

Source: CNB.

Table 2 Total CNB turnover in the foreign exchange market, 1 January – 30 June 2014
at the exchange rate applicable on the value date, in million

	Purchase (1)		Sale (2)		Net (1 – 2)	
	EUR	HRK	EUR	HRK	EUR	HRK
Domestic banks	0.00	0.00	240.20	1,836.27	–240.20	–1,836.27
European Commission	0.00	0.00	292.68	2,235.00	–292.68	–2,235.00
Ministry of Finance	417.36	3,158.76	0.00	0.00	417.36	3,158.76
Total	417.36	3,158.76	532.88	4,071.27	–115.52	–912.51

Source: CNB.

from the balance on the last day of 2013 (EUR 12,907.34m). The main drivers of changes in total international reserves during the first half of 2014 were transactions across the accounts of the Ministry of Finance and the European Commission and foreign currency sales to banks through interventions.

Net international reserves, excluding the foreign currency component of reserve requirements, special drawing rights (SDRs) with the IMF and the funds of the European Commission and the Ministry of Finance, decreased by EUR 39.41m (0.4%) in the first six months of 2014, from EUR 10,537.89m to EUR 10,498.47m.

10.2.1 Total CNB turnover in the foreign exchange market in the first half of 2014

In the first six months of the current year, the Croatian National Bank purchased foreign currency from the MoF and sold foreign currency to the banks in the Republic of Croatia and the European Commission. The CNB purchased a total of EUR 417.36m and sold a total of EUR 532.88m, resulting in a net sale of EUR 115.52m. Consequently, the sum of HRK 912.51m was withdrawn from circulation.

EUR 240.20m worth of foreign currency was sold to banks in an auction in February, with no foreign currency purchased from banks, while EUR 292.68m were sold to the European Commission. In the first half of 2014, the CNB purchased EUR 417.36m from the MoF, while there were no foreign currency sales to the MoF.

10.2.2 Structure of international reserves investment

The CNB invests funds with financial institutions and in countries with the highest credit rating. The assessment of creditworthiness is based on ratings issued by internationally recognised rating agencies (Moody's, Standard & Poor's and FitchRatings) and on an internally-developed creditworthiness assessment model. There are restrictions on investments in individual financial institutions and countries, which serves to diversify credit risk.

The lion's share of CNB foreign currency portfolios is invested in instruments such as government securities of selected countries, instruments issued by international financial institutions and reverse repo agreements. The share of investments in government bonds, deposits with banks and deposits with international financial institutions (IFIs) grew from the end of December 2013. On the other hand, the share of investments in reverse repo agreements collateralised by government bonds decreased, as did the share of investments in central banks.

The change in the investment structure was affected by the easing of the crisis in the European market and the decline in the ECB benchmark interest rate. Lower ECB rates led to a drop in interest rates on deposits with certain central banks as

Table 3 Structure of international reserves investment as at 30 June 2014
in %

Investment	30 June 2014		31 December 2013	
	Net reserves	Total reserves	Net reserves	Total reserves
1 Countries				
Government bonds	76.07	64.75	66.66	54.42
Reverse repo agreements	4.23	5.92	3.82	14.42
Central banks	4.12	4.09	5.48	7.96
Covered bonds	1.21	1.03	1.95	1.60
2 International financial institutions				
Deposits	0.28	5.73	0.28	3.02
Securities	7.56	6.44	9.30	7.59
Reverse repo agreements	3.29	5.07	4.74	4.65
3 Banks				
Deposits	1.35	5.38	1.71	1.40
Securities[a]	1.87	1.59	6.06	4.95
Total	100.00	100.00	100.00	100.00

[a] Refers to securities guaranteed by German federal states.
Source: CNB.

well as to a drop in the rates on reverse repo agreements to a level near zero or even lower.

On the last day of the first half of 2014, 65% of total CNB international reserves were invested in instruments within the two highest credit rating categories or in the BIS and the IMF.

Currency structure of international reserves

On 30 June 2014, the share of the euro in the total international reserves was 80.23%, down from 81.34% at the end of 2013, largely due to the lower euro amount in the account of the Ministry of Finance with the CNB.

The share of the American dollar in the total international reserves increased in the same period, from 16.02% at the end of 2013 to 16.95% on the last day of the first half of 2014. The share of SDRs also went up from 2.64% to 2.81% of the total international reserves, primarily due to the rise in the value of SDRs against the euro.

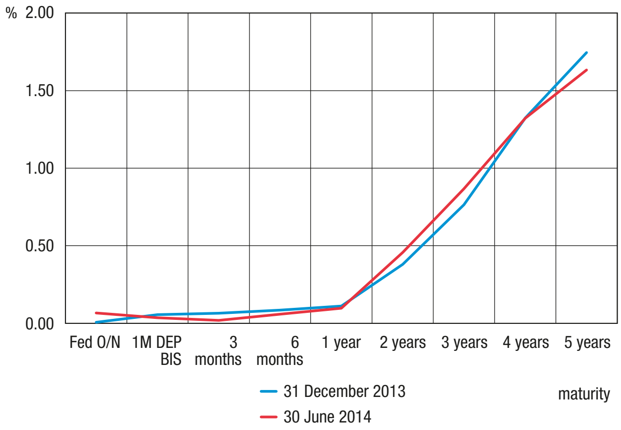
Results and analysis of CNB foreign currency portfolio management in the first half of 2014

The Fed's key interest rate remained unchanged in the first half of 2014, ranging between 0.00% and 0.25%, the level at which it has stood since the end of 2008. In December 2013, the Federal Open Market Committee (FOMC) began curtailing its programme of government and mortgage bond purchase from USD 85bn to USD 75bn. The gradual tightening of the American monetary policy continued for four FOMC meetings in 2014, reducing the purchase programme to USD 35bn a month at the end of the first half of the current year.

Early in June, the ECB cut the key one-week repo rate from 0.25% to 0.15%, lowered the interest rate on banks' deposits with the ECB into negative territory, from 0.00% to –0.10%, and reduced the rate on overnight lending from 0.75% to 0.40%. The announced set of ECB measures to increase liquidity, boost credit activity in the eurozone and enhance the functioning of the monetary policy transmission mechanism included the introduction of targeted longer-term refinancing operations (TLTRO).

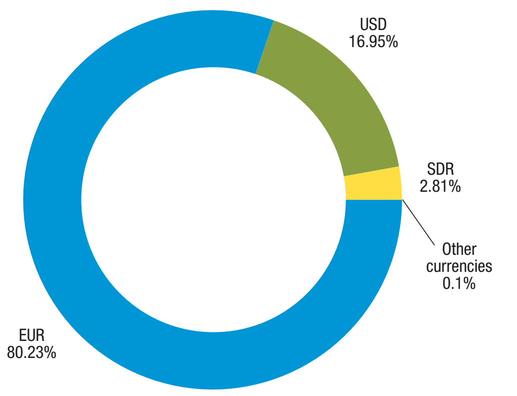
In the first six months of the current year, the US ten-year government bond yield fell by 50 basis points, reaching 2.53%, while the German ten-year government bond yield dropped by 68 basis points, falling to 1.25%. Lower yields are a result of the heightening of geopolitical risks, the slowdown in global growth and the ECB's incentive measures.

Figure 43 Yield curve of American government bonds and other selected instruments



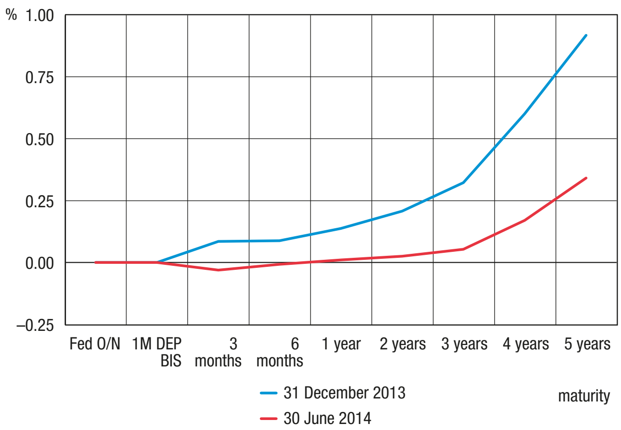
Source: CNB.

Figure 41 Currency structure of total international reserves
as at 30 June 2014



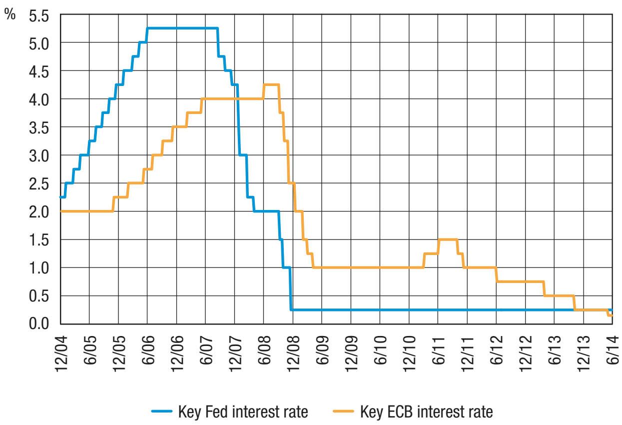
Source: CNB.

Figure 44 Yield curve of German government bonds and other selected instruments



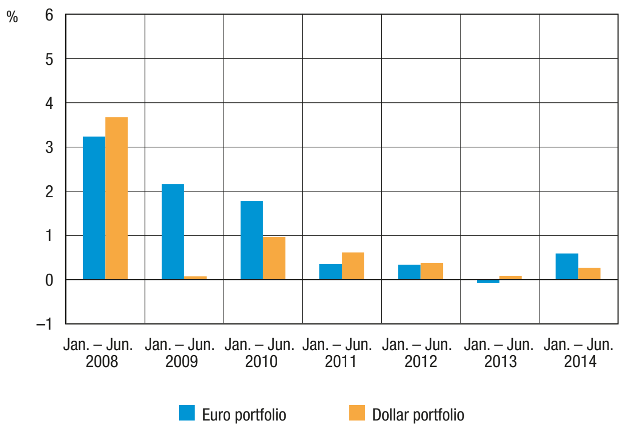
Source: CNB.

Figure 42 Changes in key Fed and ECB interest rates



Source: Bloomberg.

Figure 45 Annual rates of return on the CNB held-for-trading euro and dollar portfolios
in the first half, on annual basis



Source: CNB.

Table 4 Realised income and rates of return on the CNB foreign currency portfolios
in million EUR and USD and %

Portfolio	Realised income (in million EUR and USD)	Annual rate of return (in the first half, %)						
	Jan. – Jun. 2014	Jan. – Jun. 2008	Jan. – Jun. 2009	Jan. – Jun. 2010	Jan. – Jun. 2011	Jan. – Jun. 2012	Jan. – Jun. 2013	Jan. – Jun. 2014
Held-for-trading euro portfolio	12.42	3.23	2.16	1.79	0.35	0.34	–0.08	0.59
Held-for-trading dollar portfolio	3.56	3.67	0.07	0.96	0.62	0.38	0.08	0.27
Held-to-maturity euro portfolio	42.42	–	–	–	2.31[a]	2.31	2.29	2.22

[a] Effect in the period from 23 May 2011 to 30 June 2011.
Source: CNB.

The CNB's international reserves are principally invested in American and German securities as well as securities of other developed countries considered low-risk, primarily eurozone members. Net international reserves of the CNB comprise the euro and dollar-denominated held-for-trading portfolios and the euro-denominated held-to-maturity portfolio.

The rate of return on the CNB dollar-denominated held-for-trading portfolio stood at 0.27% on an annualised basis in the first six months of 2014, while the annualised rate of return on the CNB euro held-for-trading portfolio stood at 0.59% in the same period. The improvement of the held-for-trading portfolio performance from the same period last year is a consequence of the lower yields and higher prices of German and US bonds as well as the higher prices of other euro-denominated bonds in which international reserves are invested. The euro-denominated held-to-maturity portfolio had a rate of return of 2.22% in the first half of 2014.

In the first half of 2014, CNB's net euro portfolios generated a total income of EUR 54.84m, while the dollar-denominated portfolio generated USD 3.56m in the same period.

11 Business operations of credit institutions

The continuation of several-years-long unfavourable economic developments in the first half of 2014 was reflected in a decrease in bank balance sheet and further increase in difficulties in the collection of loans. Bank lending activity to all sectors decreased, and accelerated ageing of the portfolio contributed significantly to the growth in the share of non-performing loans (B and C category), which rose from 15.7% at the end of 2013 to 16.6% at the end of the first half of 2014. The greatest impact on the fall in the quality of total loans came from corporate loans, whose share in B and C category loans stood at 29.6%. The highest growth rates of B and C category loans were recorded in trade and real estate activity. The coverage of B and C category loans by value adjustments continued to grow, which was driven by the ageing of the non-performing portfolio and migration to riskier categories, but also the application of the new rules on the classification of placements. They require a gradual increase in value adjustments, depending on the time elapsed since a debtor's delinquency in repayment.

Banks continued to deleverage to domestic and foreign financial institutions, particularly to majority foreign owners, while growth in domestic sources (including household savings) also failed to materialise in the observed period. However, maturity mismatch of assets and liabilities improved due to the refinancing of certain banks from their parent banks, and surplus liquidity demonstrated by banks under stress scenarios was still considerably above the minimum prescribed. Higher expected inflows based on derivative financial instruments led to an increase in liquidity coefficient for convertible currencies, while banks engaged in foreign exchange arbitrage in an attempt to find additional sources of income against the background of the fall in lending activity.

According to preliminary unaudited data, bank profits rose by one quarter, mostly under the influence of lower expenses on sources of financing. It particularly involved the fall in interest rates and the related lower interest expenses on household deposits. The return on average assets (0.8%) and the return on average equity (4.6%) were considerably higher than in the same period last year and much higher than at the end of 2013, when expenses on loss provisions heavily burdened the profit, under the influence of the new rules on the classification of placements and EBA's exercise of the asset quality review of European banks. However, the main source of bank income, i.e. interest income, continued to decrease. In addition to the growth in non-performing claims and weak lending activity, new rules on consumer credit, which have been in effect since the beginning of 2014, also had a strong effect in the observed period. It was particularly evident in home loans indexed to the Swiss franc. The fall in income from these loans stood at around 40%, due to the limiting of interest rates.

The growth in profit and recapitalisations strengthened the capital positions, despite the payment of HRK 1.3bn of dividends (mostly from retained earnings). The transfer to the new capital regime (CRR/CRD IV) brought no surprises. Business risks were still adequately covered, despite their expanded definition. This was accomplished thanks to the conservative approach of previous years, which provided a high level and quality of capital items, and this year's adoption of measures on capital buffers. At the end of June 2014, all capital ratios were considerably higher than the prescribed minimum (the total capital ratio stood at 21.1%) and only two banks had difficulties in the maintenance of certain rates.

11.1 Banks

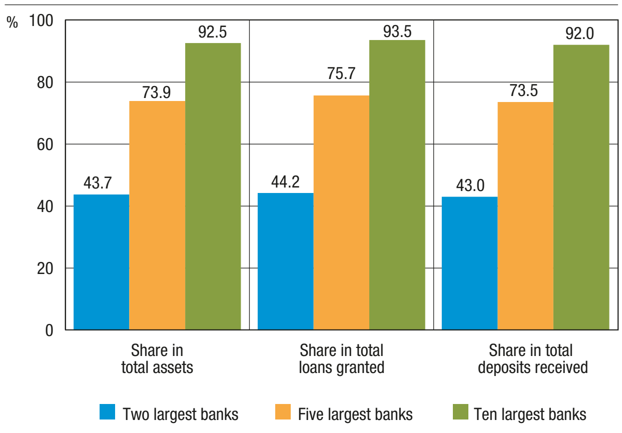
11.1.1 Structural features

At the end of June 2014, there were 35 credit institutions or 29 banks, one savings bank and five housing savings banks operating in the country, which was the same as at the end of 2013. Their assets stood at HRK 400.2bn, down 1.3% from the end of 2013. The fall was the result of a decrease in the assets of banks (1.3%)[5] and housing savings banks (0.9%), but these slight developments had no impact on the structure of system assets. A dominant share of 98.1% of assets of credit institutions was accounted for by bank assets and the remaining 1.9% by housing savings bank assets.

A decline in the assets of leading banks from the end of 2013 resulted in a mild decrease in the system concentration. The value of the Herfindahl-Hirschman index (HHI) for assets stood at 1429 at the end of June 2014, down 0.8% from the end of 2013. HHI for deposits decreased by almost the same amount (to 1403), and a somewhat sharper decrease was seen in HHI for loans granted (net), by 2.3%, to 1482. A significant concentration in the banking system is also evident in the shares of leading banks in total assets, loans and deposits of all banks, which only slightly decreased from the end of 2013. The only increase was seen in the share of assets of two largest banks in total assets.

In the first half of 2014, the number of banks majority

Figure 46 Shares of assets, loans and deposits of the largest banks in total assets, loans and deposits
as at 30 June 2014



Source: CNB.

5 The savings bank included.

Table 5 Ownership structure of banks and their share in total bank assets
end of period

	Dec. 2012		Dec. 2013		Jun. 2014	
	Number of banks	Share	Number of banks	Share	Number of banks	Share
Domestic ownership	15	9.9	14	10.3	13	10.4
Domestic private ownership	13	5.2	12	5.1	11	4.8
Domestic state ownership	2	4.8	2	5.3	2	5.6
Foreign ownership	16	90.1	16	89.7	17	89.6
Total	31	100.0	30	100.0	30	100.0

Source: CNB.

owned by foreign shareholders rose by one, to 17 (Table 5)[6]. Nevertheless, the share of these banks' assets in total assets of all banks decreased only slightly from the end of 2013. Mild changes in the structure of assets observed by the ownership structure were caused by the fall in assets of banks in domestic and foreign private ownership and the concurrent growth in assets of banks in domestic state ownership, due to which only total market share of two state-owned banks increased. The largest number of banks in foreign ownership (6) belonged to Austrian shareholders, and the assets of these banks accounted for 59.4% of the total assets of all banks. Three banks in the ownership of Italian shareholders came next, with a total market share of 18.5% and two banks in the ownership of Hungarian shareholders, with a total market share of 4.1%. A bank owned by French shareholders also had a bigger share (6.7%), while a bank in the ownership of Czech shareholders accounted for 0.3% of bank assets. The remaining 0.6% of the total assets was accounted for by four banks in majority ownership of shareholders from third countries (outside the EU).

11.1.2 Bank balance sheet and off-balance sheet items

Assets

In the first half of 2014 bank assets declined by HRK 5.1bn or 1.3% (Table 6). The observed rate of decrease in assets was largely due to the changes in the exchange rate of the kuna against the three most widely represented currencies in the bank foreign currency sub-balance sheets. If this effect were excluded, the decline would be milder and amount to 0.8%. The entire decrease in assets was accounted for by foreign currency items (HRK 7.3bn or 3.0%), while kuna assets increased (HRK 2.2bn or 1.5%), which brought about very mild changes in the currency structure of assets.

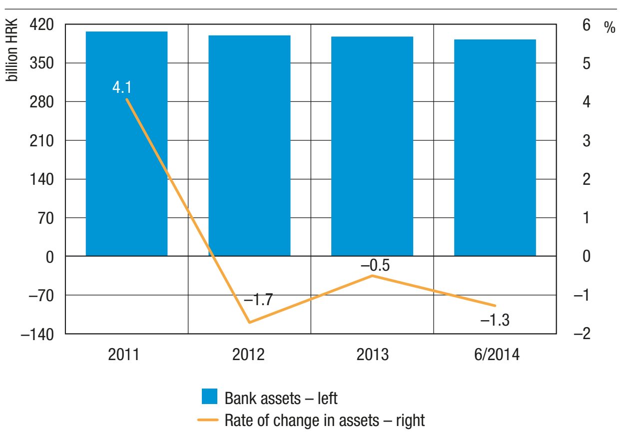
The fall in bank balance sheets reflects the continued unfavourable developments in the domestic economy, which negatively affect the demand for loans and creditworthiness of banks' clients and reduce the propensity to save. On the back of a persistent risk aversion and difficulties in the collection of claims, banks continued to reduce lending activity and deleverage on the domestic and foreign financial market. A decrease in the assets of the majority of leading banks in the system had a key impact on the course of changes in total assets, although the assets of half of the total number of banks increased.

Developments in total bank assets were mostly determined by changes in net loans, which are structurally dominant with a share of 65.0%. At the end of the first half of 2014, net loans were HRK 8.5bn or 3.2% lower (2.7% effectively) than at the end of 2013, reflecting the deleveraging of all institutional sectors. In the structure of the loan portfolio observed by types of loans, a considerable increase was seen only in loans that can be used for servicing due liabilities, such as loans for payments made on the basis of guarantees and other commitments, and cash and other general-purpose loans. The quality of the loan portfolio continued to deteriorate due to the increase in partly recoverable and fully irrecoverable loans, while a consequent growth in value adjustments had an additional impact on the fall in net loans and bank balance sheets. The greatest contribution to the fall in net loans thus came from corporate deleveraging and deterioration in the quality of loans to that sector, followed by a drop in lending to government units and financial institutions. Further household deleveraging was also observed in the first half of 2014, mostly in a decrease in home loans.

Foreign currency loans and kuna loans indexed to a foreign currency accounted for the bulk of the decrease in net loans, which resulted in the slight currency restructuring of bank assets. Foreign currency loans declined by HRK 8.1bn (4.1%), mostly due to the fall in kuna loans indexed to a foreign currency granted to households and corporates.

Deposits with the CNB decreased significantly from the end of 2013 (HRK 2.0bn or 4.5%) and the greatest impact

Figure 47 Bank assets



Source: CNB.

6 In the first half of 2014, Czech J&T Banka received the approval from the CNB Council to acquire a qualifying holding which accounts for more than 50% of the share capital of Vaba banka d.d., Varaždin.

Table 6 Structure of bank assets
end of period, in million HRK and %

	Dec. 2012		Dec. 2013			Jun. 2014		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Money assets and deposits with the CNB	51,169.4	12.8	51,284.0	12.9	0.2	50,293.0	12.8	–1.9
Money assets	6,438.9	1.6	6,369.7	1.6	–1.1	7,387.1	1.9	16.0
Deposits with the CNB	44,730.5	11.2	44,914.3	11.3	0.4	42,905.9	10.9	–4.5
Deposits with banking institutions	23,847.3	6.0	21,464.2	5.4	–10.0	22,652.4	5.8	5.5
MoF treasury bills and CNB bills	10,701.6	2.7	13,634.0	3.4	27.4	14,801.3	3.8	8.6
Securities	32,095.1	8.0	30,033.7	7.5	–6.4	30,837.3	7.9	2.7
Derivative financial assets	910.6	0.2	1,583.6	0.4	73.9	1,893.5	0.5	19.6
Loans[a]	267,965.1	67.0	263,822.4	66.3	–1.5	255,287.2	65.0	–3.2
Loans to financial institutions	10,130.1	2.5	8,912.2	2.2	–12.0	7,049.9	1.8	–20.9
Loans to other clients	257,835.1	64.5	254,910.2	64.1	–1.1	248,237.3	63.2	–2.6
Investments in subsidiaries, associates and joint ventures	3,120.0	0.8	3,185.7	0.8	2.1	3,381.0	0.9	6.1
Foreclosed and repossessed assets	1,268.5	0.3	1,541.2	0.4	21.5	1,688.1	0.4	9.5
Tangible assets (net of depreciation)	4,320.1	1.1	4,253.5	1.1	–1.5	4,291.7	1.1	0.9
Interest, fees and other assets	7,411.0	1.9	7,061.5	1.8	–4.7	7,624.3	1.9	8.0
Net of: Collectively assessed impairment provisions[b]	2,888.9	0.7	–	–	–	–	–	–
Total assets	399,919.8	100.0	397,863.7	100.0	–0.5	392,749.8	100.0	–1.3

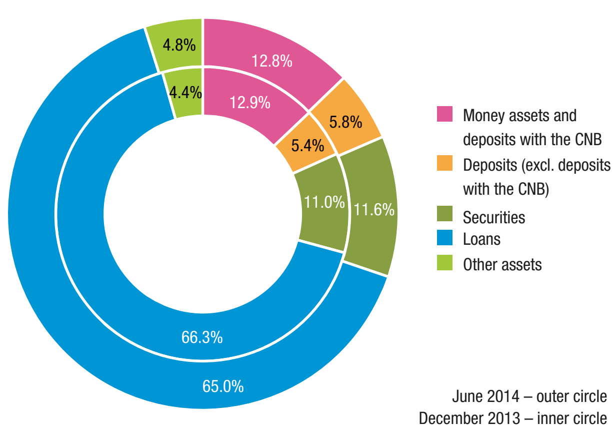
[a] As of October 2013, loan amount is reduced by the amount of collected fees (formerly recorded as deferred income in liabilities).
[b] As of October 2013, the amounts of financial instruments are reduced by the amount of the corresponding collectively assessed impairment provisions (for category A).
Source: CNB.

on the total change came from lower balance in banks' settlement accounts (HRK 1.6bn or 11.0%). A slight decrease in the remaining items in the structure of deposits with the CNB can be noticed at the end of the first half of 2014; the amount of allocated reserve requirements decreased by 0.7%, while compulsory CNB bills fell by 5.0%. The opposite movements were observed in deposits with financial institutions, which rose by a total of HRK 1.2bn (5.5%). Mostly involved in this was the growth in deposits with foreign parent banks while the increase in deposits with domestic credit institutions also made a minor contribution to the total change.

The only significant form of assets that recorded a steady growth was securities investments, which increased by almost HRK 2.0bn (4.5%) from the end of 2013. Thanks to this and due to the effect of the fall in most of the other items in the structure of assets, the upward trend in the share of securities in bank assets continued, reaching 11.6% at the end of the first half of 2014. This growth was entirely accounted for by debt securities issued by domestic issuers, with securities of government units, notably MoF T-bills, up by HRK 1.2bn (8.6%), and bonds of the Republic of Croatia, up by HRK 1.1bn (9.2%), being the main contributors to the change. The significance of securities of domestic government units in the structure of debt securities thus additionally increased to 61.4%. Also noteworthy for their share were investments in securities of foreign governments (14.2%) and foreign financial institutions (10.2%) and domestic corporates (12.0%). Banks again distributed the bulk of securities in the portfolio of financial assets available for sale (64.7%) and the increase in unrealised gains on these instruments in the first half of 2014 had a positive impact on banks' capital. The amount of equity securities investments remained almost unchanged, so the significance of these investments (1.2%) in total securities investments was still negligible.

Among the other, less significant, items in the structure of assets, relatively high growth rates were recorded in derivative financial assets, which rose by 19.6% in the first half of 2014, mostly on account of the positive fair value of contracts with foreign financial institutions. Claims with the exchange rate as the underlying variable increased the most. Foreclosed and repossessed assets in exchange for items past due also continued to grow, but at a slower pace than in 2013, when they rose by 21.5%. In the first half of 2014 these assets went up by HRK 147.0m (9.5%) and stood at HRK 1.7bn. Despite their growth from 2008 onwards, foreclosed and repossessed assets

Figure 48 Structure of bank assets



Source: CNB.

still have a low share in total bank assets of only 0.4%. In the first half of 2014, the increase in these assets mostly related to foreclosed and repossessed construction objects and residential buildings and flats, which together with land account for almost 60% of total foreclosed and repossessed assets. Difficulties in the collection of claims were evident in the ageing of the foreclosed and repossessed assets, i.e. the further rise in assets acquired more than two years ago.

Liabilities and capital

A decline of HRK 5.5bn or 1.6% in bank liabilities in the first half of 2014 reflects further deleveraging of banks in domestic and foreign financial market and a decrease in deposits of almost all institutional sectors. A fall in received deposits and loan liabilities, accompanied by a fall in issued hybrid instruments in the first six months of 2014, resulted in a decrease in total sources of bank financing by HRK 6.1bn or 1.9%.

The greatest nominal impact on developments in the sources of financing came from a decline in liabilities to foreign owners, based on received loans, deposits and issued hybrid instruments, by a total of HRK 4.5bn or 8.7%. The significance of this source of financing has been falling since 2011, when it reached the peak of the growth that started after the outbreak of the crisis in 2008. At the end of the first half of 2014, owners' funds had a share of 14.6% in total sources of financing. In the last two years banks substituted foreign sources of financing by domestic sources, but in the first half of this year domestic sources declined, by HRK 3.6bn or 1.4%. This was mainly due to a decrease in the main source of financing, i.e. deposits, the bulk of the decrease being accounted for by corporate and financial institutions' deposits, and a hiatus in the usual growth of household deposits had an additional impact on total developments in deposits. The only significant increase in the sources of financing related to funds of foreign financial institutions other than parent banks (11.0%), due to which the significance of non-residents in the sources of bank financing decreased only slightly (to 20.6%).

Most of the banks in foreign ownership (12 of them) used parent banks' sources, but in a lower amount than at the end of 2013. Only two banks increased the share of parent banks' sources in total sources of financing.

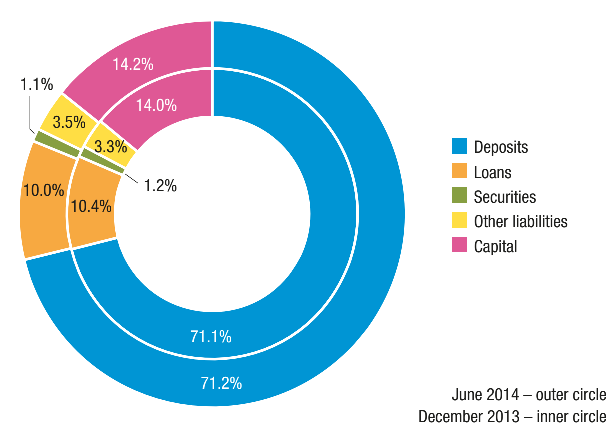
A slow growth in deposits has been present since the outbreak of the crisis in 2008 and it was mostly associated with the deleveraging of banks to majority foreign owners and a

Table 7 Structure of bank liabilities and capital
end of period, in million HRK and %

	Dec. 2012		Dec. 2013			Jun. 2014		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans from financial institutions	16,802.9	4.2	15,146.0	3.8	–9.9	14,917.7	3.8	–1.5
Short-term loans	3,273.9	0.8	2,124.8	0.5	–35.1	2,102.1	0.5	–1.1
Long-term loans	13,529.0	3.4	13,021.2	3.3	–3.8	12,815.6	3.3	–1.6
Deposits	275,844.0	69.0	282,805.6	71.1	2.5	279,567.8	71.2	–1.1
Transaction account deposits	47,466.3	11.9	54,245.1	13.6	14.3	56,132.4	14.3	3.5
Savings deposits	21,229.8	5.3	21,785.7	5.5	2.6	21,578.4	5.5	–1.0
Time deposits	207,147.9	51.8	206,774.8	52.0	–0.2	201,857.0	51.4	–2.4
Other loans	30,599.2	7.7	26,337.2	6.6	–13.9	24,220.9	6.2	–8.0
Short-term loans	4,669.1	1.2	4,531.3	1.1	–3.0	3,338.9	0.9	–26.3
Long-term loans	25,930.1	6.5	21,805.9	5.5	–15.9	20,882.0	5.3	–4.2
Derivative financial liabilities and other financial liabilities held for trading	1,752.3	0.4	1,878.1	0.5	7.2	2,046.0	0.5	8.9
Debt securities issued	300.0	0.1	299.9	0.1	0.0	299.9	0.1	0.0
Short-term debt securities issued	0.0	0.0	0.0	0.0	–	0.0	0.0	–
Long-term debt securities issued	300.0	0.1	299.9	0.1	0.0	299.9	0.1	0.0
Subordinated instruments issued	1,391.0	0.3	1,453.5	0.4	4.5	1,463.3	0.4	0.7
Hybrid instruments issued	3,243.0	0.8	3,005.9	0.8	–7.3	2,456.6	0.6	–18.3
Interest, fees and other liabilities[a]	12,611.7	3.2	11,445.8	2.9	–9.2	11,888.1	3.0	3.9
TOTAL LIABILITIES	342,544.1	85.7	342,371.9	86.1	–0.1	336,860.4	85.8	–1.6
Share capital	34,231.0	8.6	33,964.7	8.5	–0.8	34,623.6	8.8	1.9
Current year profit (loss)	2,687.6	0.7	477.6	0.1	–82.2	1,268.1	0.3	165.5
Retained earnings (loss)	15,706.9	3.9	16,315.3	4.1	3.9	15,884.3	4.0	–2.6
Legal reserves	1,081.1	0.3	1,108.6	0.3	2.5	1,111.8	0.3	0.3
Reserves provided for by the articles of association and other capital reserves	3,292.4	0.8	3,035.4	0.8	–7.8	2,600.5	0.7	–14.3
Revaluation reserves	427.0	0.1	610.4	0.2	42.9	739.6	0.2	21.2
Previous year profit (loss)	–50.1	0.0	–20.2	0.0	–59.8	–338.5	–0.1	1,579.2
TOTAL CAPITAL	57,375.7	14.3	55,491.8	13.9	–3.3	55,889.4	14.2	0.7
TOTAL LIABILITIES AND CAPITAL	399,919.8	100.0	397,863.7	100.0	–0.5	392,749.8	100.0	–1.3

[a] As of October 2013, the amount of granted loans in assets is reduced by the amount of fees collected on loans (formerly recorded as deferred income in liabilities).
Source: CNB.

Figure 49 Structure of bank liabilities and capital



Source: CNB.

slow growth in household deposits. These trends in 2013 resulted in the weakest growth in total deposits in the last 16 years (2.0% effectively), and were continued into the first six months of 2014 with a decrease in deposits of HRK 3.2bn or 1.1% (0.7% excluding the exchange rate effect). In addition to further deleveraging to parent banks, a fall in deposits in the first half of 2014 was largely due to a fall in corporate deposits (HRK 1.7bn or 3.9%) and financial institution deposits (HRK 1.2bn or 7.1%), accompanied by a decline in household savings (HRK 646.7m or 0.4%). The mentioned negative developments were partly offset by the increased deposits of government units and non-profit institutions, which rose by 3.9% and 7.1% in the first half of 2014. Household deposits decreased due to a fall in time and savings deposits. Nevertheless, they were still the major source of bank financing, with the share of 53.4% in sources and 61.7% in total bank deposits. Foreign currency deposits still accounted for the largest share of 76.1% in the structure of household savings deposits and their amount decreased by 1.3% in the first half of 2014. Foreign currency corporate deposits also declined and the total impact of these changes is evident from the decrease in foreign currency liabilities, by HRK 4.8bn or 2.1%.

Bank liabilities based on received loans went down by HRK 2.3bn (5.7%) from the end of 2013. This was the continuation of the downward trend from the previous three years, due to which the significance of received loans in bank assets declined and the loans received to assets ratio fell to less than 10.0% at the end of the first half of 2014. The bulk of this decrease related to foreign creditors, mostly parent banks, while the bulk of the decrease in loans received on the domestic market related to creditors from the sector of other financial intermediaries.

A decline in the amount of hybrid instruments (HRK 549.3m or 18.3%) was the greatest change among other bank liabilities in the first half of 2014. The significance of these instruments thus additionally decreased and together with subordinated instruments and debt securities issued, they accounted for only 1.3% of total sources of financing. Only one bank used debt securities issued as a source of financing, with a very small impact on total bank assets.

The negative effect of developments in sources of financing on bank balance sheets was partially offset by an increase in capital of HRK 397.6m or 0.7%, which was produced by two main factors. The major one was the current year's profit, which was much higher than the whole profit in 2013. The second one was the effect of the recapitalisation carried out in the first half of 2014 in seven banks, which led to an increase in the share capital of all banks by HRK 659.0m (1.9%). However, only a minor part of this increase was generated by new funds paid in, while a larger part related to the use of capital reserves and instruments with the characteristics of capital in order to strengthen the share capital and cover a part of losses brought forward in certain banks. The increase in the share capital thus resulted in structural changes among capital items rather than in the growth in total capital. In addition to the growth in share capital and current year's profit, the growth in capital was also due to larger unrealised gains on value adjustments of financial assets available for sale (40.5%), included in the capital item relating to revaluation reserves. As a result of these changes, the share of capital in bank liabilities and capital increased further at the end of the first half of 2014 (Figure 49).

By the end of the first half of the current year, banks distributed the greatest part of the profit from 2013. Most of the banks distributed the profit made into capital reserves, while only few of them paid out a dividend from the profit of 2013 and retained earnings from previous years, totalling HRK 1.3bn. Nevertheless, retained earnings of all banks were still high and stood at HRK 15.9bn, and together with all capital reserves stood at HRK 20.0bn, which accounted for more than 35% of the total bank capital at the end of the first half of 2014. The distribution of these capital reserves within the system was quite uneven and was mostly concentrated in a smaller number of banks. The capital of several banks was burdened by the retained losses from previous years and poor business performances at the end of 2013 additionally increased these losses, to more than HRK 1.8bn.

Liquidity indicators

Following the increase in 2013, the maturity mismatch of short-term assets and short-term liabilities (up to one year) decreased in the first half of 2014. The short-term assets to short-term liabilities ratio went up by almost five basis points, to 76.7%.

The short-term cumulative gap up to one year[7] was negative and stood at HRK 58.7bn at the end of June 2014, which was a decrease of HRK 15.1bn or 20.5% from the end of 2013. A considerable decline in the mismatch was primarily under the influence of a decline in short-term liabilities, the bulk of which related to the extension of the remaining maturities of time deposits. Short-term liabilities thus decreased by a total of HRK 12.4bn (4.7%), with the greatest impact coming from the fall in time deposits in the category of the remaining maturity of 6 to 12 months. Time deposits with the remaining maturity of more than one year increased concurrently (HRK 8.7bn or 19.4%), and both developments were influenced by the changes in the maturity structure of household and non-resident deposits, due to the refinancing of certain banks from parent banks. Changes in assets were in the opposite direction

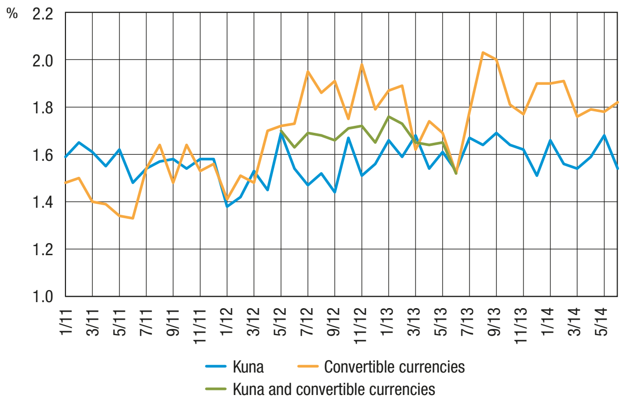
7 Short-term cumulative maturity mismatch of assets and liabilities (cumulative gap) is calculated as the difference between assets (net) and liabilities with the same remaining maturity bracket and includes all categories of the remaining maturity bracket up to one year. A positive gap means that the amount of assets is greater than the amount of liabilities, while the opposite situation is termed a negative gap.

to and of lower intensity than in liabilities, i.e. a minor growth in short-term assets was recorded (1.4%) and a somewhat bigger fall in long-term assets (3.8%). The increase in short-term assets was related to greater investments into securities, while the decrease in assets with the remaining maturity of more than one year mostly related to net loans. Almost all gaps in a maturity shorter than one year were negative, i.e. the amount of liabilities exceeded the amount of claims expected by the bank in that period. The greatest negative gap was recorded in the maturity category of three to six months (HRK 22.4bn).

The banks generally still have significant surplus liquidity and the amount of that surplus increased slightly from end-year. Readily marketable assets (RMA)[8] thus rose by 1.3%, to the amount of HRK 62.2bn. With respect to the decline in bank assets on a semi-annual level, the share of RMA in the total bank assets increased slightly, to 15.8%. The greatest individual growth in RMA was accounted for by deposits with credit institutions in foreign currency. Due to a concurrent decrease in these assets in kuna, driven by the fall in deposits with the CNB, the mentioned changes had no impact on the currency structure of readily marketable assets. The mentioned items almost equally changed their shares in RMA, so following the increase of 2.7 basis points at the end of the first half of 2014, deposits with credit institutions became the leading form of these assets, with a share of 26.1% in readily marketable assets. At the end of 2013, deposits with the CNB accounted for the largest share in readily marketable assets, falling to 22.6% after their decrease in the first half of 2014. MoF T-bills (20.9%) and securities available for sale (15.2%) also had a significant share.

The estimated money inflows continued more than sufficiently to cover the estimated outflows under stress conditions, so the minimum liquidity coefficients (MLC)[9] remained significantly above the prescribed minimum (Figure 50). At the end of the first half of 2014, MLC in kuna for the period of up to one week was 2.1 and for the period of up to one month 1.5, while MLC in convertible currencies was 2.7 (up to one week) and 1.8 (up to one month).

Figure 50 Minimum liquidity coefficient for period up to one month



Note: By way of exception, in the period from 1 May 2012 to 30 June 2013, credit institutions had to meet the minimum liquidity coefficient on a collective basis, i.e. for both kuna and all convertible currencies combined.
Source: CNB.

Currency adjustment of bank assets and liabilities

In the first half of 2014 bank assets declined due a fall in foreign currency items of HRK 7.3bn or 3.0%, while kuna items went up by HRK 2.2bn or 1.5%. Bank liabilities (excluding capital) decreased concurrently due to a decline in foreign currency items of HRK 4.8bn or 2.1%, and to a lesser extent due to a fall in kuna items of HRK 0.7bn or 0.7% The effective changes in assets and liabilities were somewhat milder than the nominal, due to more intensive changes in foreign currency items and developments in the exchange rate of the kuna against the most significant currencies in bank balance sheets (euro, Swiss franc and American dollar). These changes resulted in an effective decline in total assets by 0.8%, while total bank liabilities effectively stagnated. Exchange rates of the mentioned currencies changed from the end of 2013 by less than 1%, the greatest change being the fall in the value of the kuna-euro exchange rate (0.9%), which had the greatest impact on the difference between the effective and nominal rate of change in bank assets and liabilities. The value of the exchange rate of the kuna against the Swiss franc fell by 0.1% and went up by 0.2% against the American dollar.

The share of kuna items in the currency structure of bank assets slightly increased, to 38.4% of bank assets. The share of foreign currency assets was 61.6%, which was 1.1 percentage points less than at the end of 2013. This decline was the result of the fall in kuna assets indexed to a foreign currency and a decrease in its share in total bank assets, to 37.0%, whereas a mild growth in foreign currency assets led to an increase in their share in total assets, to 24.6%.

The fall in foreign currency net loans (HRK 8.1bn or 4.1%) was stronger than the decline in total foreign currency assets of banks, and it was almost equally accounted for by the fall in foreign currency net loans (4.4%) and kuna loans indexed to a foreign currency (by 4.0%). The effects of the mentioned change in the foreign currency assets of banks were partly offset by the rise in deposits in foreign currencies with financial institutions (HRK 1.1bn). The growth in MoF T-bills by HRK 2.7bn (23.7%) made the biggest contribution to the mild growth in the kuna assets of banks, while the greatest decline in kuna items in the observed period was accounted for by banks' funds on settlement accounts with the CNB (HRK 1.6bn).

Having fallen by HRK 4.1bn or 2.6%, foreign currency time deposits contributed the most to the decline in the foreign currency liabilities of banks. Received loans in foreign currency and hybrid instruments also declined (by 3.8% and 38.3%) due to a decrease in long-term loans. Kuna liabilities went down by HRK 0.7bn (0.7%) in the observed period, due to a decline in short-term received loans and savings and time deposits.

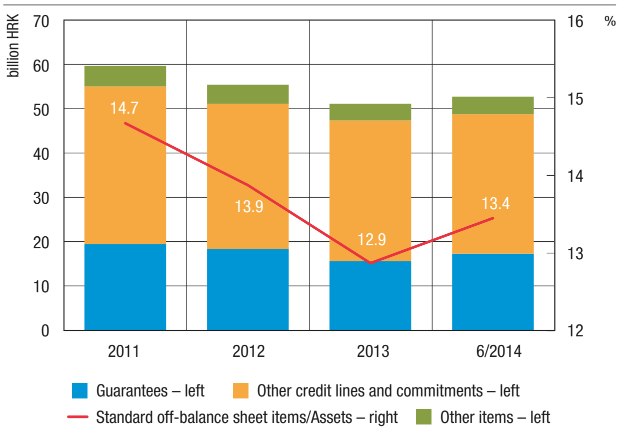
Changes in the currency structure of bank liabilities were very mild and ranged around 0.3 percentage point, which was how much the foreign currency component of total liabilities decreased and the kuna component increased. Foreign currency liabilities accounted for 66.9% of total liabilities and the bulk of it related to foreign currencies (63.3%), while only 3.6% related to liabilities in kuna indexed to a foreign currency.

8 Readily marketable assets (RMA) mean assets which may be quickly (within four working days) and easily (without substantial losses) turned into cash.

9 The minimum liquidity coefficient (MLC) is calculated as a ratio between expected inflows (including readily marketable assets) and the expected outflows in stressed conditions in two given periods (up to one week and up to one month), and it needs to be equal to or greater than one. MLC is calculated for kuna, all convertible currencies combined and for each non-convertible currency individually (if it is significant).

A stronger fall in foreign currency assets than in foreign currency items in the first half of 2014 resulted in a decrease in their positive difference. Foreign currency assets of banks were thus HRK 16.4bn higher than foreign currency liabilities at the end of the observed period, while at the end of 2013, that difference was HRK 18.9bn. The average open foreign exchange position of all banks was long in the first quarter of 2014 and stood at 3.1%, while in the second quarter it was short and stood at 1.4% of average own funds.[10] The shift from the usually long position to the short one has been a common trend for the second quarter in the last few years.

Figure 51 Bank standard off-balance sheet items



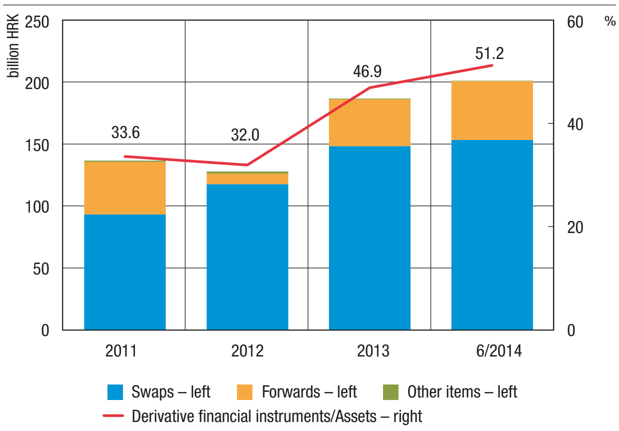
Source: CNB.

Standard off-balance sheet items

The downward trend in the amount of standard off-balance sheet items has been present since the beginning of the crisis, except in 2011, when a very small increase was recorded. This trend came to a halt in the first half of 2014, when standard off-balance sheet items rose by HRK 1.6bn (3.1%). They thus reached the amount of HRK 52.8bn and their ratio to assets increased to 13.4% (Figure 51). This increase was generated mostly by issued guarantees, the amount of which went up by HRK 1.6bn or 10.5% in the first half of the current year. Almost the entire amount of the increase in guarantees was accounted for by the guarantees granted to corporates. In terms of the amount of change, revolving loans also stand out, with a decrease of HRK 604.0m or 7.1%, due primarily to the effect of the decline in these liabilities to corporates and central government.

Developments in other standard off-balance sheet items were not significant, so the structure of the total assumed liabilities has not changed much from the end of 2013. Almost half of the total off-balance sheet items was still accounted for by credit lines and commitments, whose share fell only slightly, to 44.82%. The share of guarantees increased to 32.8% and the share of revolving loans decreased to 14.9% of all standard off-balance sheet items. All other assumed liabilities accounted for 7.5% of the total standard off-balance sheet items of banks.

Figure 52 Bank derivative financial instruments (notional amount)



Source: CNB.

Derivative financial instruments

Growth in the notional value of derivative financial instruments in 2013 was strong, at the rate of 46.0%, but slowed down in the first half of 2014, to 7.8%. The total amount of the notional value of derivative financial instruments thus reached its peak of HRK 201.1bn, and due to a concurrent decline in total bank assets, their ratio increased from 46.9% at the end of 2013 to 51.2% at the end of the first half of 2014. This ratio was higher than the average for the system in only four banks. A large volume of operations with derivative financial instruments was common for banks that lead in terms of the amount of assets, while most of the banks still relatively rarely used derivative financial instruments in their operations or did not use them at all.

In the first half of 2014, the notional value of instruments that most affected the developments in the previous year continued to grow. The significant growth in these instruments is related partly to increased needs by clients and partly to the search for additional sources of bank income. The amount of forwards thus increased considerably, by HRK 9.7bn or 25.6%, while a somewhat slower increase was observed in the amount of swaps, by HRK 5.0bn or 3.4%. Changes in the amount of all other derivative instruments had a negligible effect on the total movements, due to their small share in the structure of total derivative instruments.

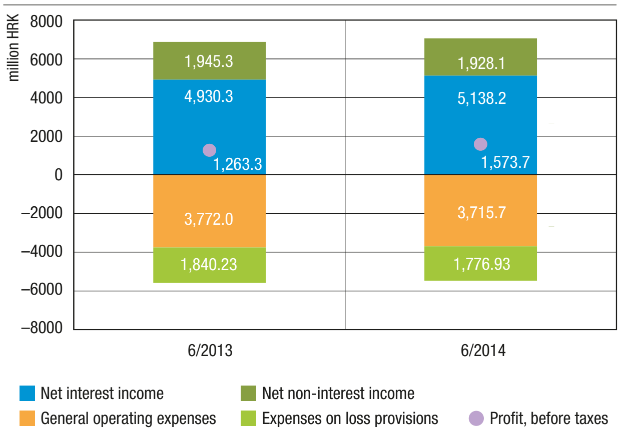
The bulk of the increase in derivative financial instruments was accounted for by the growth in notional amount of these instruments with foreign financial institutions, among which majority foreign owners and affiliated enterprises still had a considerable share. Banks often contracted derivatives serving to hedge their own positions with majority foreign owners, and they often closed positions contracted on the account of clients with foreign owners, which hedges them against market risk. The amount of instruments contracted with domestic banks and insurance companies and pension funds also increased significantly.

The rise in the notional amount of derivative instruments was entirely related to the instruments with the exchange rate

10 Due to harmonisation with EU regulations, as of 30 June 2014, the limitation of the level of net open foreign exchange position of banks to 30% of own funds has been abolished.

as the underlying variable. Their amount increased by HRK 17.6bn or 17.6% from the end of 2013, while the notional amount of instruments with other underlying variables decreased. In the structure of derivative financial instruments observed by type of underlying variable, the share of the largest group of instruments, that with the exchange rate as the underlying variable, increased further to 58.6% of the total notional amount. Although a significant amount of derivatives serves banks to hedge against economic risks, primarily against currency and interest rate risks, banks still distribute almost the entire amount of notional instruments in the held-for-trading portfolio. At the end of the first half of 2014, almost 98% of all instruments were distributed in this portfolio, while the remaining small share of total derivative financial instruments was reported by banks as hedging and embedded derivatives. This kind of treatment of derivative financial instruments resulted from complex hedge accounting rules and requirements for public disclosures which have to be applied for the portfolio of hedging instruments.

Figure 53 Bank profit from continuing operations, before taxes



Source: CNB.

11.1.3 Earnings

Income statement

Following a strong decrease in 2013, bank earnings picked up in the first half of 2014. The increase in profit from the first half of 2013 was largely due to lower expenses on sources of financing. This particularly involved the fall in interest rates and the related lower interest expenses on household deposits. Indicators of returns were considerably higher than in the same period last year and much higher than at the end of 2013, when expenses on loss provisions heavily burdened profits, under the influence of the new rules on the classification of placements and EBA's exercise of the asset quality review of European banks.

According to preliminary unaudited data, banks reported HRK 1.6bn of profit (from continuing operations, before taxes) in the first half of 2014, an increase of HRK 310.3m or 24.6% from the first half of 2013 (Table 8). The growth in profit would be somewhat milder (18.3%) if one bank that operated with losses and went bankrupt in late September 2013 were excluded from data for the first half of 2013.

A significant increase in the business performance of banks, by almost one quarter, actually reflects strong changes in the performance of a relatively small number of banks. The growth in profit was thus influenced by changes in three banks, where lower expenses on value adjustments and provisions had the greatest effect on the improvement of their performances. One of the mentioned banks operated with losses in the same period last year, but now turns a profit, while the profit of the remaining two banks increased sharply, by 45.8% and 203.6% respectively. In addition to the three mentioned, only four more banks operated with profits higher than in the same period last year. Ten banks operated with losses or one bank fewer than in the previous year. However, the total amount of losses was somewhat higher, standing at HRK 160.0m, and the share of assets of banks which operated with losses decreased. At the end of the first half of 2014 it stood at 2.9%, as compared to 11.3% of total bank assets from the end of the first half of 2013. Except for one bank, all banks operating with losses were operationally non-profitable, i.e. the level of net income in these banks was insufficient to cover the general operating expenses, and one operationally non-profitable bank reported profit due exclusively to reversed value adjustments and provisions.

Due to good liquidity reserves and higher risk aversion, banks were able to affect favourable developments in interest expenses and they also continued to actively manage other operating expenses. However, in an unfavourable environment, where non-performing loans still grew and there was no recovery of lending activity, interest income continued to fall. This was also largely affected by the new rules on consumer credit, which have been in effect since the beginning of 2014.

The greatest change in banks' income statement and the greatest impact on the increase in profit came from the item of interest expenses. They reduced by HRK 479.9m or 9.8% and in addition to this, savings were made in general operating expenses and expenses on value adjustments and provisions. While the cut in general operating expenses was actually the continuation of the trend of strict control of expenses, the fall in expenses on value adjustments and provisions was primarily the result of lower expenses on value adjustments and provisions for collectively assessed impairment provisions, due to a decline in placements and off-balance sheet liabilities classified into risk category A[11], and lower expenses on provisions for court proceedings. At the same time, expenses on value adjustments and provisions for B and C risk categories[12] increased, primarily as a result of the growth in loan losses.

The fall in interest expenses was most pronounced in deposits, particularly time deposits, followed by other sources of financing, such as received loans and hybrid and subordinated instruments. While in received loans and hybrid and subordinated instruments this fall was the result of deleveraging to domestic and foreign banks, in time deposits it was also due to

11 For placements and off-balance sheet liabilities classified into risk category A (fully recoverable placements and off-balance sheet liabilities), credit institutions have to perform the impairment/value adjustment in the amount of latent losses established by internal methodology, where the level of the impairment/value adjustment may not be lower than 0.8% of the total balance of A category placements and off-balance sheet liabilities. For credit institutions having no internal methodology this level is set at 1%.

12 Placements and off-balance sheet liabilities are classified into risk categories A, B and C. Fully recoverable placements and off-balance sheet liabilities are classified into risk category A, partly recoverable placements and off-balance sheet liabilities into risk category B and fully irrecoverable placements and off-balance sheet liabilities into risk category C.

the fall in interest rates. In deposits on transaction accounts and savings deposits, the key impact came from the fall in interest rates.

Interest expenses on time deposits were HRK 579.7m or 16.8% lower than in the first half of 2013. All sectors recorded a decrease, particularly the household sector (HRK 335.7m or 14.1%), despite the increase in time deposits of this sector. Due to a decline in the remaining sectors, the total amount of time deposits decreased from the end-June 2013, while sight deposits, especially deposits on transaction accounts, increased considerably. Despite that, their expenses were also reduced, at a sharper rate than in time deposits. Interest expenses on deposits on transaction accounts were HRK 20.8m or 22.0% lower, the decline being relatively equally distributed among the sector of corporates, government units and households. The second sharpest decline in interest expenses on time deposits was recorded in the non-resident sector (HRK 89.2m or 16.6%), foreign financial institutions accounting for the bulk of the decrease. This was largely due to the changes in one bank, probably generated against the background of developments in ZIBOR and favourable financing conditions in 2014.

Banks' interest income declined by HRK 272.0m or 2.8% from the first half of 2013, due mostly to the fall in interest income from assets held in the loans and receivables portfolio, particularly in interest income from loans. A growth in interest income was generated only by financial assets held for trading (HRK 120.2m or 15.9%) and financial assets held to maturity (HRK 16.8m or 9.8%). In the first case, this was the result of the growth in interest income from derivatives held for trading, notably interest income from swaps, which also brought on the growth in interest expenses to banks. The net result, created by netting of interest income from assets and expenses on interest liabilities in the trading portfolio, was positive, but considerably weaker than last year (by HRK 37.2m or 29.6%). The growth in interest income from assets held to maturity was the result of the increase in income from bills of exchange. A considerable growth in these investments, which mostly involve only a few clients, led to a relatively strong increase in banks' income (HRK 35.7m or 32.5%). At the same time, investments in MoF T-bills and bonds held to maturity resulted in considerably lower interest income to banks, as a result of the fall in yields.

Interest income from loans fell by HRK 345.8m or 4.2%, thus continuing the trend from the previous two years. This was mostly caused by the fall in interest income in the household sector in the first half of 2014, as opposed to the movements from previous years, when the greatest impact came from the fall in interest income from corporate loans. Interest income from household loans decreased by HRK 366.4m or 8.0%, the greatest fall being recorded in interest income from home loans, by HRK 246.6m or 15.2%, followed by interest

Table 8 Bank income statement
in reference periods, in million HRK and %

	Amount		Change
	Jan. – Jun. 2013	Jan. – Jun. 2014	
Continuing operations			
Interest income	9,805.1	9,533.0	–2.8
Interest expenses	4,874.8	4,394.8	–9.8
Net interest income	4,930.3	5,138.2	4.2
Income from fees and commissions	2,004.4	2,077.0	3.6
Expenses on fees and commissions	600.7	587.0	–2.3
Net income from fees and commissions	1,403.6	1,490.0	6.2
Income from equity investments	346.4	188.0	–45.7
Gains (losses)	314.9	434.8	38.1
Other operating income	205.1	206.7	0.8
Other operating expenses	324.7	379.7	16.9
Net other non-interest income	541.6	449.8	–17.0
Total operating income	6,875.6	7,078.0	2.9
General administrative expenses and depreciation	3,772.0	3,715.7	–1.5
Net operating income before loss provisions	3,103.6	3,362.4	8.3
Expenses on value adjustments and provisions	1,840.2	1,776.9	–3.4
Other gains (losses)	0.0	–11.7	–
Profit (loss) from continuing operations, before taxes	1,263.3	1,573.7	24.6
Income tax on continuing operations	281.2	309.1	9.9
Profit (loss) from continuing operations, after taxes	982.1	1,264.6	28.8
Discontinued operations			
Profit (loss) from discontinued operations, after taxes	4.2	3.5	–16.3
Current year profit (loss)	986.3	1,268.1	28.6
Memo item:			
Number of banks operating with losses, before taxes	11	10	–9.1

Source: CNB.

income from car loans and overdraft facilities. In general-purpose cash loans, the only type of household loans which has recorded growth lately, the rise in interest income from loans was barely noticeable (HRK 1.4m or 0.1%). Such developments were influenced by changes in the rules on consumer credit, which introduced limitations on interest rates. Changes were particularly evident in home loans in kuna with a currency clause in Swiss francs. The new rules set special limitations for instances of significant appreciations of currencies to which home loans are indexed. In practice, this means that interest rates on home loans indexed to the Swiss franc are limited to 3.23%.[13] Primarily under this influence, interest income from home loans indexed to the Swiss franc decreased from the first half of 2013 by HRK 222.5m or 40.1%. The decline in this income in 2013 amounted to 7.9%. Significantly smaller was the fall in interest income from home loans indexed to the euro. It stood at HRK 13.5m or 1.5%, with almost equal impacts coming from the regular repayment of loans and deterioration in the quality of loans. After the household, next in terms of size of decrease in interest income was the corporate sector, the fall being much milder than in 2013. It stood at HRK 104.6m or 4.2% and the bulk of decrease related to loans for working capital. The increase in interest income from corporate loans involved only a few types of loans, the shares in syndicated loans standing out with an increase of HRK 39.3m or 14.5%. In contrast to the remaining sectors, interest income from loans granted to government units and non-residents went up, as a result of somewhat stronger lending activity. The increase in interest income from loans to government units was more significant (HRK 124.5m or 13.1%), particularly from loans granted to MoF, while the increase in non-residents was stronger (as much as 46.4% or HRK 18.7m) and it mostly related to the growth in income from loans granted to foreign corporates. Slightly more than one half of the increase involved corporates from Slovenia.

Savings on interest expenses outweighed the effects of the fall in interest income, which led to the strengthening of the most important and most stable source of bank income – net interest income. It stood at HRK 5.1bn and it was HRK 207.9m or 4.2% higher than in the same period in 2013. Its share rose to 72.6% of banks' operating income. The amount and share of the remaining part of operating income, net non-interest income, decreased, with an increase in income from fees and commissions and a decrease in other net non-interest income, by a considerable 17.0%. It was largely affected by lower income from equity investments, due to last year's exceptional income of one bank, generated by the sale of an investment company. Net income from fees and commissions recorded a noticeable growth (6.2%), as a result of an increase in income and a decrease in expenses on that item. The growth in income was due to the rise in all items, except fees and commission for issued letters of credit and guarantees. The increase was the sharpest in income from credit cards, fees and commissions for asset management and fees and commissions on contracts for insurance companies. Fees and commission related to credit cards increased the most in the sub-sector of foreign financial institutions, which was probably the result of the increased turnover made at points of sale of domestic banks by credit cards issued by foreign banks. Lower expenses on fees and commissions resulted from lower expenses on payment operations.

Further savings were also made in general administrative expenses and depreciation. These expenses declined slightly, by HRK 56.4m or 1.5%, due mostly to lower expenses per employee, followed by lower depreciation expenses. The number of employed persons continued to fall. Relative to the same period last year, the number of employed persons decreased by 454 or 2.4% (a decrease of 109 employees involved a bank that went bankrupt), while in the first half of 2014, banks reduced the number of employees by only 34 or 0.2%.

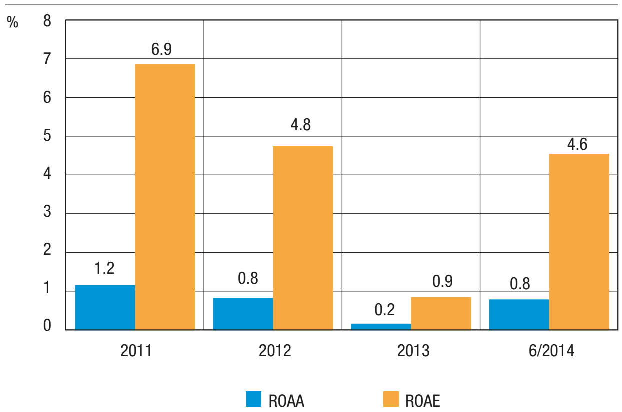
Lower expenses, particularly expenses of sources of financing, led to a significant increase in net operating income before loss provisions. It went up by HRK 258.8m or 8.3%, to HRK 3.3bn. Lower expenses on value adjustments and provisions additionally improved the performance from the same period last year, which eventually resulted in a growth in profit from continuing operations (before taxes) of almost one quarter.

Indicators of returns

Growth in bank operating profitability, as measured by the net operating income before loss provisions to average assets ratio, was the source of growth in indicators of return on banks' assets and equity. The ratio rose from 1.6% at the end of the first half of 2013 to 1.7% at the end of the first half of 2014, while the risk cost (maintained on the level of 0.9% of average assets) led to ROAA rising to 0.8%. ROAE also increased, to 4.6% (Figure 54). Although they had recovered from the end of 2013, indicators of returns were still relatively low. They were twice as low as at the end of 2008.

The still high risk aversion, evident from the growth in placements to less risky sectors (such as government units),

Figure 54 Bank return on average assets (ROAA) and bank return on average equity (ROAE)



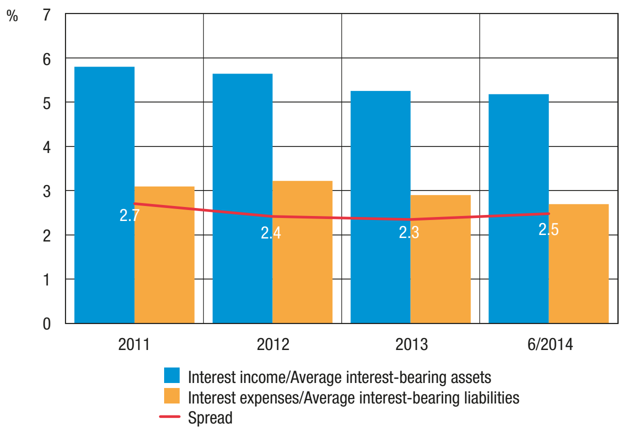
Source: CNB.

13 The new regulations prescribe that, when the exchange rate of the currency to which a loan is indexed appreciates more than 20% against the kuna, interest rate on home loans may not be higher than the average weighted interest rate at which these loans were granted, reduced by 30%. The CNB published in the Official Gazette 149/2013 that the average weighted interest rate at which Croatian credit institutions granted home loans in Swiss francs and kuna with a currency clause in Swiss francs was 4.62%. Reduced by 30%, it stands at 3.23% The bulk of home loans granted with a currency clause in Swiss francs is subject to the mentioned limitation, which lasts until the exchange rate of the Swiss franc depreciates to the level below the said appreciation of 20%, continuously in the period of 30 days.

accompanied by the fall in the quality of the existing portfolio and the new rules on consumer credit, reduced the average interest income (Figure 55). However, lower expenses on sources of financing enabled the expansion of the interest rate spread and the growth in operating profitability. An additional contribution came from managing the general operating expenses, which continued to fall. The cost-to-income ratio decreased from 59.3% to 52.8%. However, on the individual level, a large number of banks were heavily burdened by general operating expenses, especially smaller institutions.

Expenses on value adjustments and provisions took slightly more than one half of net operating income before loss provisions (52.5%), which was somewhat less than in the same period last year. Their total amount was reduced, largely due to the fall in lending activity and considerably lower value adjustments and provisions for latent losses in risk category A. Expenses on loss provisions for risk categories B and C increased concurrently, due to migration of claims to riskier categories, but also to new rules on the classification of placements, which require, among other things, a gradual increase in value adjustments, depending on the time that has passed since a debtor's delinquency in repayment.

Figure 55 Income from interest-bearing assets and expenses on interest-bearing liabilities



Source: CNB.

11.1.4 Credit risk

Placements and assumed off-balance sheet liabilities

Total placements and assumed off-balance sheet liabilities that are exposed to credit risk[14] and are subject to the classification into risk categories in accordance with the rules that govern classification, stood at HRK 411.2bn at the end of June 2014 (Table 9), a decline of HRK 6.7bn or 1.6% from the end of 2013. The effects of the exchange rate changes excluded, the decrease was somewhat milder and stood at 1.2%. Banks reduced the most their credit risk exposure arising from loans granted, which fell by HRK 7.0bn or 2.4% (effectively 1.9%). All other placement items helped to bring about this fall, while the only positive contribution came from off-balance sheet liabilities, which grew by HRK 1.6bn or 3.1%.

Banks reduced their lending activity to all sectors, the most, in nominal terms, to government units, with a decrease in loans to this sector by HRK 2.1bn or 4.8%. Loans to domestic financial institutions recorded the highest rate of decline in the half-year, by as much as one fifth or HRK 1.9bn, under the influence of the repayment of unused part of the syndicated CBRD loan under the Programme for the Development of the Economy. The second greatest decline was recorded in corporate loans (HRK 1.7bn or 1.6%). This was mostly the result of deleveraging of public enterprises (4.8%), while loans to other corporates recorded milder negative changes (0.8%). Pressured by the several-year-long recession, the household sector continued to deleverage (0.9%), while positive movements were observed only in loans which, mostly on a short-term basis, supplement the missing funds (general-purpose cash loans, other loans and overdraft facilities). Despite the decline in the amount and significance, granted loans still had a dominant share in total placements and off-balance sheet liabilities of banks (68.1%).

Relative to the end of 2013, banks reduced the amount of

Table 9 Classification of bank placements and assumed off-balance sheet liabilities by risk categories

end of period, in million HRK and %

Risk category/subcategory	Dec. 2012			Dec. 2013			Jun. 2014		
	Placements and assumed off-balance sheet liabilities	Value adjustments and provisions	Coverage	Placements and assumed off-balance sheet liabilities	Value adjustments and provisions	Coverage	Placements and assumed off-balance sheet liabilities	Value adjustments and provisions	Coverage
A	378,979.1	3,418.1	0.9	369,289.2	3,301.4	0.9	361,135.4	3,215.0	0.9
B-1	18,812.4	2,608.7	13.9	19,330.6	3,055.0	15.8	18,373.0	2,819.4	15.3
B-2	13,703.7	6,346.6	46.3	15,913.8	7,500.3	47.1	17,663.0	8,538.7	48.3
B-3	2,839.8	2,290.3	80.6	4,339.3	3,547.4	81.8	4,468.8	3,663.8	82.0
C	7,630.9	7,629.7	100.0	8,991.4	8,972.1	99.8	9,549.8	9,549.7	100.0
Total	421,965.9	22,293.4	5.3	417,864.4	26,401.2	6.3	411,190.1	27,786.6	6.8

Source: CNB.

14 Total bank exposure to credit risk comprises placements (balance sheet items) and assumed off-balance sheet liabilities. The placements are divided into a loan and receivables portfolio and a portfolio of held-to-maturity financial assets, with the receivables on interest and fees being shown under a separate item (receivables based on income). The portfolios of financial assets comprise various instruments such as loans, deposits, bonds and T-bills, and assumed off-balance sheet liabilities comprise guarantees, credit lines, etc.

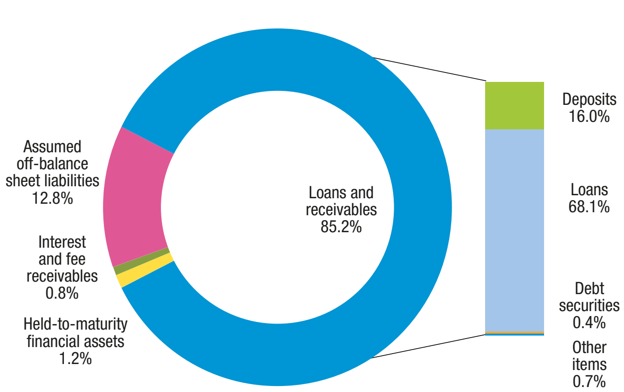
deposits made, by HRK 0.9bn or 1.3%. The decline was entirely accounted for by deposits with the CNB, although it was partly offset by the increased deposits with foreign financial institutions. Banks' debt securities exposed to credit risk decreased from the end of 2013 by a total of HRK 613.3m (8.4%). It was mostly due to a decline in bank investments in government securities distributed in the held-to-maturity portfolio, by HRK 594.9m (10.6%), while securities distributed in the loan and receivables portfolio decreased much less (1.1%). However, banks did not reduce total investments in the securities of the RC in the first half of 2014, but as the bulk of their securities investments, they distributed them in the portfolios that are not subject to classification into risk categories (mainly the available-for-sale portfolio).

Following the three consecutive years of decline, banks increased their off-balance sheet liabilities in the first half of 2014, by HRK 1.6bn or 3.1%. As a result, their share in the structure of items exposed to credit risk strengthened slightly, to 12.8% of total placements and off-balance sheet liabilities. The growth in assumed liabilities was generated by the increase in guarantees and revolving loans, mostly made to large domestic corporates.

The quality of placements and assumed off-balance sheet liabilities continued to deteriorate, although at a slower pace than in previous years, so the share of partly recoverable placements and assumed off-balance sheet liabilities (risk category B) and fully irrecoverable placements and assumed off-balance sheet liabilities (risk category C) in the total stood at 12.2% at end-June. Several simultaneous circumstances had led to such developments: the absence of new lending activity of banks, the fall in other less risky exposures (particularly deposits and securities), persistent unfavourable economic developments that kept the risk level high, and finally, the ageing of the portfolio.

Risk category A placements and off-balance sheet liabilities decreased in the first half of 2014 by HRK 8.2bn or 2.2%. Much stronger was the decrease in the part of placements with receivables that are more than 90 days past due (A90), which were one fifth lower. The level of A90 total placements and off-balance sheet liabilities in the total remained relatively low (0.3%), thus continuing the trend present from June 2013, since which time their level has not exceeded 1% of total placements and off-balance sheet liabilities of risk category A.

Figure 56 Structure of bank placements and assumed off-balance sheet liabilities
as at 30 June 2014



Source: CNB.

Accordingly, the total amount of placements with unpaid due receivables declined from the end of 2013, by a considerable HRK 6.1bn or 4.7%. This decrease almost entirely reflected the changes in the shortest maturity band of due receivables (up to 15 days), whose amount was HRK 7.1bn or 10.0% lower, mainly due to regular repayments. In contrast to this, the ageing structure of placements with the unpaid debt due more than one year continued to deteriorate, due to the growth in claims in almost all long maturity bands, particularly in three to five years and five to ten years. Of the total of HRK 33.6bn of banks' due but unpaid receivables on placements, as much as HRK 23.7bn or 70.5% were overdue for over one year, and more than one third of the total amount of due receivables was overdue for more than five years.

Total losses in portfolios exposed to credit risk continued to grow, from 6.3% to 6.8% of total placements and off-balance sheet liabilities (Table 9). Value adjustments for B and C risk categories went up by HRK 1.5bn or 6.5%, which is twice as high as the growth in their base (3.1%). Following the strong increase in the previous year, the growth in the coverage of these risk categories was somewhat milder in the first half of 2014, with the increase of 1.6 basis points or to 49.1%. Collectively assessed value adjustments and provisions fell only slightly, but owing to a concurrent fall in the base, the coverage of risk category A remained at the usual level of 0.9%.

Almost the entire decline in total placements and off-balance sheet liabilities in the first half of 2014 involved the component that had been made in foreign currencies or indexed to foreign currencies. The foreign exchange component declined by HRK 7.1bn or 2.8%, mostly on account of a decrease in placements and off-balance sheet liabilities in euros and Swiss francs. This then resulted in a decrease in the share of placements and off-balance sheet liabilities exposed to currency induced credit risk (CICR), to 60.6%, with a particular fall in the part that was not hedged against CICR. As usual, the greatest impact on these changes came from loans, and in the observed period the sharpest decline was recorded in the shares in syndicated loans and home loans to clients with an unmatched currency positions. The share of loans unhedged against this risk thus fell slightly, but it was still predominant (88.3% of loans exposed to CICR).

Loans

Total bank loans (from the loans and receivables portfolio, in gross amount) stood at HRK 279.9bn at the end of June 2014. The level of loans decreased from the end of 2013 by HRK 7.0bn or 2.4% (1.9% excluding the exchange rate effects). Such a strong nominal decline in loans on a semi-annual level was last time recorded in the second half of 2012, but most of these changes were driven by the sale of receivables.

The decrease in loans in the first half of 2014 reflects deleveraging of all institutional sectors, with the government units sector recording the greatest decline, of HRK 2.1bn or 4.8%. Almost this entire amount was created by deleveraging of the central government, particularly on the basis of syndicated loans and loans for working capital. The greatest relative change (of 20.8%) was recorded in the financial institutions sector, the key factor being a decline in loans to the CBRD by HRK 2.1bn, which exceeded the growth in loans granted to other domestic financial institutions (particularly credit institutions, pension funds and insurance companies). The fall in loans to the CBRD was the result of the repayment of an unused part of loan under the Programme for the Development of the Economy[15]. The bulk of funds from this Programme (62.8%) remained unused and was returned to the banks. Due to the low base, the second greatest relative change involved a decrease in loans to the non-resident sector (9.3%), mostly due to a decline in short-term loans granted to foreign financial institutions.

In the first half of 2014, a decrease in loans to the two most significant sectors was recorded, i.e. to corporates and households, which together account for more than 80% of the total portfolio of granted loans. A decrease in corporate loans by 1.6% reflected negative developments in both sub-sectors, with negative movements in loans to public enterprises being more intensive. Loans granted to this sub-sector fell by HRK 1.1bn or 4.8%, mainly due to the fall in loans for working capital, investment loans and other loans in several large public enterprises. The rate of decline in loans to other corporates, of 0.8% (HRK 660.0m), was mostly the result of the exchange rate effects, excluding which the fall in loans to this sub-sector would have been considerably weaker and come to 0.2%. The household sector continued to deleverage, but at a somewhat slower pace than in the previous years, so the fall in household loans in the first six months stood at HRK 1.0bn or 0.8% (0.3% excluding the exchange rate effect). Having fallen by HRK 1.3bn or 2.3%, home loans had the greatest individual negative impact in this sector for the second consecutive year. As in the previous years, the fastest decline was observed in car loans, at the rate of 19.1%. These negative developments were partly offset by the growth in general-purpose loans and other household loans.

A number of unfavourable developments, such as the fall in lending activity, persistent recession pressures and the ageing of the portfolio, contributed to the further deterioration of loan quality indicators. The share of B and C risk category loans rose from 15.7% at the end of 2013 to 16.6% at the end of June 2014. The growth in the share of non-performing loans was the result of a simultaneous decline in A risk category loans (by 3.5%) and an increase in B and C risk category loans (by 3.1%). A particularly strong nominal decrease in A risk category loans (by HRK 8.4bn), mostly related to the sectors which usually have a low share of non-performing loans, such as government units, financial institutions and public enterprises, and, due to deleveraging, a considerable fall in A risk category loans, was also present in the remaining sectors. The outflow of quality low-risk clients led to a decline in the base, or total claims on loans, which directly increased the impact of B and C risk category loans on the quality of the loan portfolio. An additional negative impact came from the migration of existing claims into riskier categories, evident in the growth of B-2 risk sub-category loans by 11.0% and C risk category loans by 8.2% and the related increase in losses in the loan portfolio.

Having increased by HRK 917.7m or 3.0%, corporate loans had the key impact on the growth in risk categories B and C. The share of B and C category loans in total corporate loans thus reached 29.6% (28.3% at the end of 2013). If public enterprises were excluded, in the sub-sector of other corporates, the share of B and C category loans in total loans would be 36.2%. As for the household sector, B and C category loans increased by slightly more than HRK 0.5bn (3.8%), their share rising from 11.1% to 11.6% of total loans. The quality of almost all types of loans deteriorated, and general-purpose cash loans and other loans had the greatest impact on the growth in B and C category loans in the first half of the year. Despite that, banks most often granted these loans in the observed period.

As in the previous years, the dynamics of increase in loans estimated by banks as partly or fully irrecoverable were exceeded by the growth rate in value adjustments (7.2%). In addition to the mentioned negative economic environment, this growth is also associated with the application of stricter rules on the classification of placements and the making of value adjustments[16]. It then had a positive impact on further growth in the level of coverage of total B and C category loans by value adjustments, by an additional 1.8 percentage points, i.e. to 48.0%. The increase in the coverage of B and C category loans to corporates from 41.2% at the end of 2013 to 43.6% at the end of the first half of 2014 contributed the most to the growth in the coverage of total loans, which is in line with the developments so far and the usually higher degree of risk involved in corporate lending. Household loans, which recorded a slight growth in the coverage, to 57.2%, also had a positive impact on the increase in the total level of coverage of B and C category loans by value adjustments.

Looking at corporate loans, it is evident that banks reduced almost all types of loans in the first half of 2014; reduced the most, in nominal terms, were syndicated loans, other loans and construction loans. Loans for payments made on the basis of guarantees and other commitments and reverse repo loans had the only noticeable impact on the growth in loans to that sector. Despite the decrease, the most widely represented form of lending to corporates was still loans for working capital, followed by loans for investments, accounting respectively for 37.0% and 25.5% of total corporate loans. The next to follow in terms of significance in this sector was the shares in syndicated loans and other unspecified loans, which accounted for 11.4% and 12.5% respectively of total loans.

Broken down by activities, the greatest nominal decline in corporate loans was recorded in the trade activity (HRK 820.1m or 4.1%), information and communication activities (HRK 340.2m or 13.4%) and agriculture (HRK 320.8m or 6.7%). The largest increase in loans was recorded in accommodation and food service activities (HRK 498.8m or 7.3%), which was partly due to seasonal factors and associated with preparation for the tourist season.

15 In order to spur lending activity, the CNB reduced the reserve requirement rate at the end of June 2014. Using the funds thus freed up, a total of 13 banks granted to the CBRD a syndicated loan of HRK 3.4bn. The objective of the Programme was to ensure favourable loans to domestic entrepreneurs, to be granted in proportional ratios by banks and the CBRD. At auctions, the banks bid for a loan quota amount relating to the share of the loan from the CBRD and contributed own funds equivalent to the amount of the quota granted and placed them to users. Loans under this Programme could be granted until 31 December 2013 at the latest, and paid out until 30 June 2014.

16 Changes in the rules on the classification of placements in mid-2013 were primarily aimed at identifying the increased risks for claims with long periods of collection and the adequate valuation of such claims in assets. Long legal procedures and low liquidity in the real estate market demotivate banks to take steps towards collection from collateral. The regulatory changes were made in order to stimulate banks to a more active assessment of collateral value (by introducing minimum impairment factors of the market price and collection period) and the gradual increase in value adjustments, depending on the time that elapsed since a debtor's delinquency in repayment.

Table 10 Bank loans

end of period, in million HRK and %

	Dec. 2012		Dec. 2013			Jun. 2014		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans								
Government units	37,720.1	13.3	43,460.8	15.2	15.2	41,359.5	14.8	–4.8
Corporates	107,997.5	38.0	107,989.4	37.6	0.0	106,269.2	38.0	–1.6
Working capital loans	39,728.8	14.0	39,619.8	13.8	–0.3	39,310.6	14.0	–0.8
Investment loans	28,497.7	10.0	27,206.5	9.5	–4.5	27,143.8	9.7	–0.2
Shares in syndicated loans	11,134.8	3.9	12,646.3	4.4	13.6	12,065.0	4.3	–4.6
Construction loans	5,326.9	1.9	4,722.7	1.6	–11.3	4,407.0	1.6	–6.7
Other corporate loans	23,309.2	8.2	23,794.1	8.3	2.1	23,342.8	8.3	–1.9
Households	126,198.0	44.5	123,595.3	43.1	–2.1	122,547.6	43.8	–0.8
Home loans	59,235.9	20.9	57,629.7	20.1	–2.7	56,307.3	20.1	–2.3
Mortgage loans	3,073.7	1.1	3,007.4	1.0	–2.2	2,889.4	1.0	–3.9
Car loans	3,174.9	1.1	2,162.6	0.8	–31.9	1,749.8	0.6	–19.1
Credit card loans	3,941.2	1.4	3,834.6	1.3	–2.7	3,801.7	1.4	–0.9
Overdraft facilities	8,611.7	3.0	8,353.5	2.9	–3.0	8,429.4	3.0	0.9
General-purpose cash loans	36,436.4	12.8	37,229.0	13.0	2.2	37,811.1	13.5	1.6
Other household loans	11,724.3	4.1	11,378.5	4.0	–3.0	11,558.9	4.1	1.6
Other sectors	11,990.1	4.2	11,822.1	4.1	–1.4	9,684.7	3.5	–18.1
Total	283,905.6	100.0	286,867.6	100.0	1.0	279,861.0	100.0	–2.4
Partly recoverable and fully irrecoverable loans								
Government units	68.2	0.2	47.4	0.1	–30.6	47.2	0.1	–0.3
Corporates	26,952.3	68.1	30,542.9	67.8	13.3	31,460.6	67.7	3.0
Working capital loans	10,327.7	26.1	12,284.4	27.3	18.9	12,702.0	27.4	3.4
Investment loans	6,914.9	17.5	7,762.4	17.2	12.3	7,918.4	17.1	2.0
Shares in syndicated loans	120.8	0.3	263.4	0.6	118.1	345.0	0.7	31.0
Construction loans	3,489.5	8.8	3,550.8	7.9	1.8	3,358.1	7.2	–5.4
Other corporate loans	6,099.4	15.4	6,681.9	14.8	9.5	7,137.1	15.4	6.8
Households	11,977.6	30.3	13,755.2	30.5	14.8	14,270.5	30.7	3.7
Home loans	3,654.2	9.2	4,690.6	10.4	28.4	4,813.1	10.4	2.6
Mortgage loans	732.7	1.9	894.1	2.0	22.0	912.7	2.0	2.1
Car loans	157.7	0.4	121.3	0.3	–23.1	104.9	0.2	–13.5
Credit card loans	174.8	0.4	174.3	0.4	–0.3	175.3	0.4	0.6
Overdraft facilities	1,280.5	3.2	1,241.9	2.8	–3.0	1,220.5	2.6	–1.7
General-purpose cash loans	3,297.5	8.3	3,522.3	7.8	6.8	3,708.9	8.0	5.3
Other household loans	2,680.2	6.8	3,110.8	6.9	16.1	3,335.1	7.2	7.2
Other sectors	552.3	1.4	681.9	1.5	23.5	662.0	1.4	–2.9
Total	39,550.4	100.0	45,027.3	100.0	13.8	46,440.3	100.0	3.1
Value adjustments of partly recoverable and fully irrecoverable loans								
Government units	25.4	0.2	10.1	0.0	–60.2	10.8	0.0	7.0
Corporates	9,812.1	58.3	12,596.9	60.6	28.4	13,729.9	61.6	9.0
Working capital loans	3,684.3	21.9	4,963.8	23.9	34.7	5,406.4	24.3	8.9
Investment loans	2,180.9	13.0	2,779.6	13.4	27.5	3,144.7	14.1	13.1
Shares in syndicated loans	51.7	0.3	84.2	0.4	62.9	55.7	0.2	–33.9
Construction loans	1,335.8	7.9	1,603.5	7.7	20.0	1,704.4	7.6	6.3
Other corporate loans	2,559.4	15.2	3,165.8	15.2	23.7	3,418.8	15.3	8.0
Households	6,690.5	39.7	7,790.8	37.5	16.4	8,165.2	36.6	4.8
Home loans	1,257.3	7.5	1,848.7	8.9	47.0	2,018.6	9.1	9.2
Mortgage loans	213.8	1.3	338.8	1.6	58.5	380.5	1.7	12.3
Car loans	124.9	0.7	99.2	0.5	–20.6	86.7	0.4	–12.6
Credit card loans	161.2	1.0	161.3	0.8	0.0	162.6	0.7	0.8
Overdraft facilities	1,205.3	7.2	1,181.9	5.7	–1.9	1,167.4	5.2	–1.2
General-purpose cash loans	2,455.3	14.6	2,641.2	12.7	7.6	2,700.6	12.1	2.2
Other household loans	1,272.7	7.6	1,519.7	7.3	19.4	1,648.8	7.4	8.5
Other sectors	305.2	1.8	390.4	1.9	27.9	375.3	1.7	–3.9
Total	16,833.1	100.0	20,788.2	100.0	23.5	22,281.2	100.0	7.2

Note: As of October 2013, loan amount is reduced by the amount of collected fees.
Source: CNB.

Construction loans (24.8%), loans to manufacturing (20.6%) and trade (18.2%) dominated in the structure of total loans to corporates observed by activities. In the first half of 2014, construction loans fell by HRK 311.9m or 1.2%, due mostly to the decrease in loans to corporates involved in construction and maintenance of buildings (planning, construction, installations, facade works etc.). Loans granted to manufacturing rose by only HRK 114.4m or 0.5%. The increase in this type of loans was mostly directed to the production of food products and beverages and the construction of ships and boats, while loans to most other activities included in the manufacturing decreased.

The greatest contribution to the increase in B and C category loans in the corporate sector came from loans to the trade activity, which rose by HRK 503.6m or 8.4%. In addition to the construction activity, which had a share of 24.8% in the distribution of total B and C category loans to corporates, the trade activity also had a high share (20.7%), while every third kuna of loans to trade generated no income to the banks. One third of the total amount of loans granted to the construction activity was also assessed as irrecoverable, and a decline in B and C category loans to this activity was recorded for the first time in the observed period (since 2010, since when a distribution by activities was made according to NCA 2007). Concurrently, in the activity closely related to construction, i.e. real estate activities, a strong growth in B and C risk category loans was recorded, of HRK 426.3m or 20.9%. The riskiest activity in the corporate sector, with the greatest share of partly recoverable and fully irrecoverable loans, was still the information and communication activity (50.8%). There was a considerable decline in B and C category loans (12.9%) and total loans (13.4%) in this activity in the first half of the year, the changes being primarily the result of concluded pre-bankruptcy settlements of certain debtors. The next to follow by the share of B and C category loans were professional, administrative and support service activities (41.6%) and real estate activities (37.7%). In all three mentioned activities, the coverage of B and C category loans by value adjustments was at the average level for corporate loans.

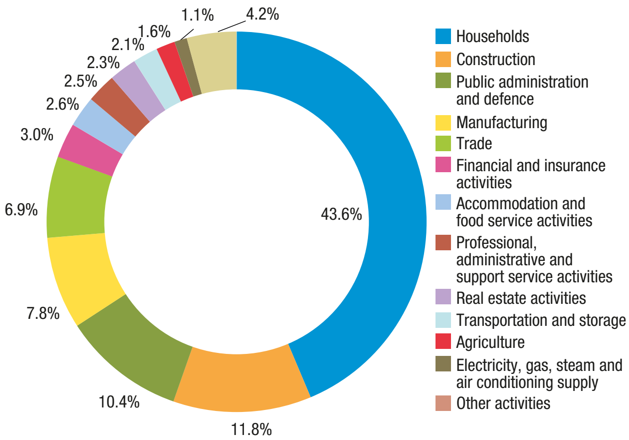
The household sector continued to deleverage for the sixth consecutive year, but at a slower pace than in previous periods. However, the key processes present for a longer time continued into the first half of 2014 and almost all significant types of household loans continued to fall, except general-purpose cash loans. Having declined by a further HRK 1.3bn or 2.3%, home loans had a key impact on the total fall in loans from 2013. Excluding the exchange rate effect, home loans decreased by 1.8%, while the only effective increase (of only 0.2%) was recorded in home loans indexed to the American dollar. Home loans indexed to the Swiss franc maintained the highest amount and rate of decline in the half-year, in effective terms, by HRK 780.3m or 3.6%.

Two types of loans dominated the structure of household loans, accounting for three quarters of total household loans at the end of the first half of 2014. With the share of 46.0%, home loans continued to account for the largest share in total household loans, and due to the increase in the amount of general-purpose cash loans, the significance of these loans in the structure of household loans rose to 30.9%. The next to follow by size of share, but much smaller, were overdraft facilities (6.9%) and other (unspecified) loans (3.5%).

In the first half of 2014, the quality of household loans continued to deteriorate, but at a much slower pace than in the previous year. The share of B and C risk categories in total household loans reached 11.6% (Figure 59). The growth in non-performing loans was particularly evident in general-purpose cash loans (by HRK 186.6m or 5.3%), other loans (by HRK 177.8m or 10.9%) and home loans (by HRK 122.6m or 2.6%). The share of B and C category loans in general-purpose cash loans and other loans thus rose to 9.8% and to 28.9% respectively.

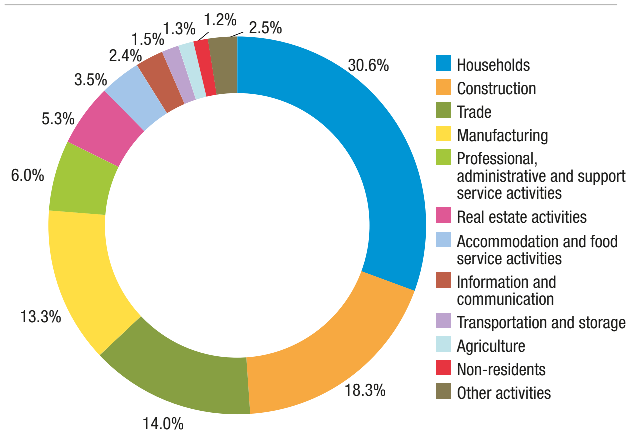
Home loans are the most significant type of household loans, and the quality of this part of the portfolio has been on a continuous decline, so the share of non-performing home loans in the total reached 8.6%. The relevant value adjustments somewhat offset these dynamics, so the coverage of home loans at end-June 2014 was higher than at the end of 2013 (41.9%, as compared to 39.4%). Having increased by 6.1%, B and C category home loans indexed to the euro had the greatest impact on this change, but they maintained above-average loan quality (5.2% was assessed as non-performing). The poorest quality was recorded in home loans indexed to the Swiss franc,

Figure 57 Structure of bank loans by activities
as at 30 June 2014



Source: CNB.

Figure 58 Structure of bank partly recoverable and fully irrecoverable loans by activities
as at 30 June 2014



Source: CNB.

with the share of partly recoverable and fully irrecoverable loans in the total of 12.8%. A better quality than home loans was recorded only in education loans (1.6%), credit card loans (4.3%), Lombard loans (4.5%) and car loans (4.6%). However, all of the four mentioned types of loans together had a share in total household loans of only 5.7% and had no major impact on the total quality of this sector's loan portfolio.

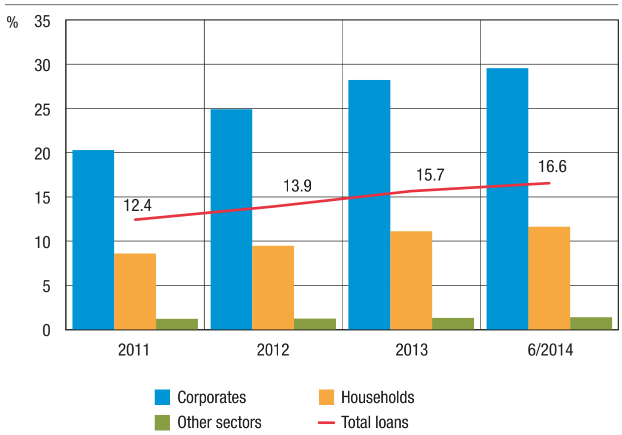
11.1.5 Capital adequacy

As of 1 January 2014, the Regulation (EU) No 575/2013 and Directive 2013/36/EU set out the framework for determining the capital and capital ratios of credit institutions. The new rules brought new, stricter definitions of capital and broader scope of risk (for example, the inclusion of the counterparty credit risk associated with over-the-counter (OTC) derivatives), but also a different regulation of capital ratios. The minimum prescribed capital adequacy ratio was thus set to 8% as of 1 January 2014 and it consists of the common equity tier 1 capital of 4.5%, additional tier 1 capital of 1.5% and tier 2 capital of 2%. The additional capital requirement is composed gradually of buffers: a) capital conservation buffer (with the aim of accumulating capital in a phase of positive financial and economic conditions, which will enable credit institutions to continue with their operations in a period of stress), b) countercyclical capital buffer (with the aim of accumulating capital in a phase of excessive credit growth in order for that capital to be able to absorb losses in phases of stress), c) structural systemic risk buffer (with the aim of providing protection against systemic risks that do not depend on cycles) and d) capital buffers for global and other systemically important institutions. As the minimum prescribed capital adequacy ratio at the beginning of 2014 was increased only by the capital buffer of 2.5%, the required capital adequacy ratio was 10.5%, a decrease from the end of 2013, when it stood at 12%. Bearing in mind the degree and development of structural systemic risks, at end-May 2014 the CNB introduced a buffer for structural systemic risk, which is 1.5% for all credit institutions, while an additional 1.5% must be maintained by institutions of relatively larger scope and complexity of operations. The required capital adequacy ratio thus rose to 12% for small and 13.5% for other credit institutions. It should be noted that these additional capital requirements do not apply to institutions which hold supervisory imposed buffers based on the joint decisions of the colleges of supervisors from the application of this Decision to the adoption of new supervisory decisions.

Business risks remained adequately covered in the new framework – all capital ratios on the level of all banks were considerably higher than the prescribed minimum. At the end of June 2014, the common equity tier 1 capital ratio of banks stood at 20.1%, as did the tier 1 capital ratio. The total capital (own funds) ratio stood at 21.1%, a slight increase from the end of 2013 when it stood at 21.0%. Both own funds and total risk exposure decreased in the first half of 2014, a decline in exposure being slightly more pronounced, which led to the growth in total capital ratio. The decrease in exposures was due to a relatively large fall in exposures related to debt instruments held for trading (by 41.8%), which can be associated with the changes in the provisions related to the general position risk (for zone 1, in the approach based on maturity, a weight of 0.0% is now applied instead of 0.1%)[17]. The introduction of the new risk, the credit valuation adjustment risk, had a small impact, while the exposure to credit risk, counterparty credit risk and dilution risks and free deliveries (hereinafter: credit risk) remained almost unchanged.

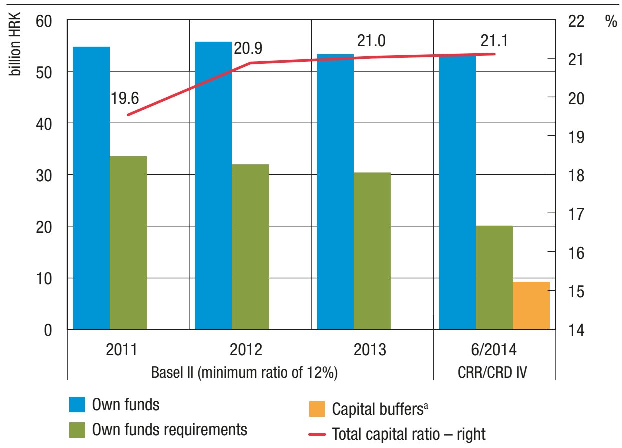
The maintenance of the weighted amount of bank exposure to credit risk at almost the same level was the result of a decline in the amount of weighted exposures and a growth in the average credit risk weight. The degree of the exposure declined by 2.6%, reflecting the fall in business activities of banks, notably in lending. There was a concurrent increase in the average credit risk weight, from 54.0% to 55.5%. The average weight under the standardised approach rose from 55.7% to 56.1%. This growth was due to the tightening of rules on weighting for categories of institutions and public sector entities, which led to the shift of exposures from the 50% weight to higher risk weights, and also to the introduction of the new category, i.e. exposures in default. As a result, there was a considerable

Figure 59 Share of bank partly recoverable and fully irrecoverable loans



Source: CNB.

Figure 60 Bank total capital ratio



[a] Capital conservation buffer and structural systemic risk buffer.
Source: CNB.

17 Based on the Results of quantitative impact study of the proposed Regulation and Capital Requirements Directive, September 2012, www.hnb.hr.

increase in the significance of items that are assigned a risk weight of 150%.

The amount of exposures weighted by a 50% weight (net, after the use of credit risk mitigation techniques) declined by almost HRK 6.5bn or 56.5%. At the end of 2013, the largest share of items with this weight involved the category of public sector entities, followed by the category of institutions. Under the new regime, weights for exposures distributed in these categories (in the event of the absence of credit assessment, with a maturity of exposures longer than three months) depend on credit quality step assigned to the central government. It can thus be assumed that most of these exposures are now weighted by a 100% weight. However, a decline in the amount of exposures weighted by this weight was recorded in the observed period, under the influence of several factors. Banks' business activities decreased, which also led to the fall in the amount of exposures, while value adjustments continued to grow. In addition, some of the exposures previously weighted by a 100% weight were transferred into the new category of exposures in default. This category was introduced instead of the category of past due items, but its scope is much wider.[18] Exposures distributed in the category of exposures in default, the value adjustments of which are less than 20% of the unsecured part of the exposure, are weighted by a 150% weight. At a 150% weight, banks reported HRK 10.4bn of exposures or 3.0% of the total weighted exposure, which is much more than HRK 6.4% or 1.8% at the end of 2013. The next to follow by the size of increase was the 35% weight, where the amount of exposures increased by HRK 3.7bn, to HRK 15.4bn or 4.5% of the total weighted exposure. It was strongly influenced by one bank, which used for the first time the preferential weight for exposures secured by residential real estate property. In addition to the growth in the share of exposures weighted by 150%, the impact of the newly-introduced weight of 250% also stands out, and it is applied to investments in financial sector entities, which are lower than or equal to 10% of common equity tier 1 capital of the institution. The 250% weight was used by banks to weight HRK 1.3bn of exposures, that is, 0.4% of the total weighted exposure.

Despite the decrease in the amount, items weighted by a 100% weight still accounted for the bulk of the total amount of exposure weighted by credit risk – 39.0%. Items weighted by a 0% and 75% weight were the next to follow, with the share of 33.5% and 11.4% respectively.

Due to a decline in total capital ratio to 8%, the capital requirement for own funds decreased considerably, from HRK 30.5bn to HRK 20.2bn. However, taking into account the capital buffers, unutilised capital remained at almost the same level. Since 1 January 2014, the capital conservation buffer has been applied in the Republic of Croatia, and since 19 May 2014, the structural systemic risk buffer has been applied. Both buffers are maintained by the common equity tier 1 capital (which may not be used to cover other risks). Credit institutions that do not comply with the provisions on capital buffers are subject to restrictions related to the distribution (such as the payment of dividends) and are obligated to make plans for the preservation of capital. The capital conservation buffer is calculated by multiplying the total risk exposure by 2.5%, while the requirement for structural systemic risk is set at 3% of the total risk exposure for large credit institutions (whose assets account for more than 5% of total assets of credit institutions), while for other institutions it is set at 1.5%. Exempt from the obligation to maintain the structural systemic risk buffer are institutions that were, by the joint decisions of the colleges of supervisors, prescribed the rate higher than 12% as of the date of this obligation entering into force. At the end of June 2014, banks were obligated to allocate HRK 6.4bn of the capital conservation buffer and HRK 2.9bn of the structural systemic risk buffer, which together amounts to HRK 9.2bn.

Nava banka and Karlovačka banka had difficulties in maintaining certain prescribed rates. At the end of June 2014, Nava banka did not meet any of the prescribed rates (the CNB requested the opening of bankruptcy proceedings against the bank in July), while Karlovačka banka did not meet the requirement for the tier 1 capital ratio of a minimum of 6%.

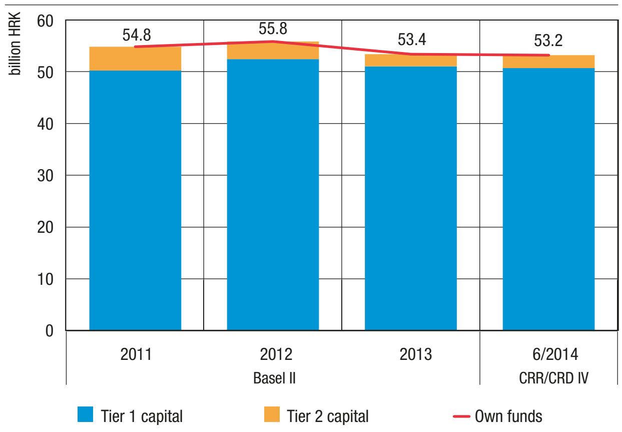
Table 11 Own funds, risk exposure and capital ratios of banks
as at 30 June 2014, in million HRK and %

	Amount	Share
Own funds	53,187.8	100.0
Tier 1 capital	50,674.2	95.3
Common equity tier 1 capital	50,674.2	95.3
Capital instruments eligible as common equity tier 1 capital	33,865.1	63.7
Retained earnings	16,384.2	30.8
Other items	424.9	0.8
Additional tier 1 capital	0.0	0.0
Tier 2 capital	2,513.6	4.7
Total risk exposure amount	252,121.2	100.0
Risk weighted exposure amounts for credit, counterparty credit and dilution risks and free deliveries	222,465.0	88.2
Standardised approach	192,435.3	76.3
Central governments or central banks	3,179.3	1.3
Corporates	63,078.4	25.0
Retail	66,680.1	26.4
Exposures in default	26,885.5	10.7
Other items	32,612.0	12.9
Internal ratings based approach (IRB)	30,029.7	11.9
Settlement/delivery risks	0.0	0.0
Position, foreign exchange and commodities risks	4,577.4	1.8
Operational risk	24,657.8	9.8
Credit valuation adjustment	421.0	0.2
Common equity tier 1 capital ratio	20.1	–
Tier 1 capital ratio	20.1	–
Total capital ratio	21.1	–

Source: CNB.

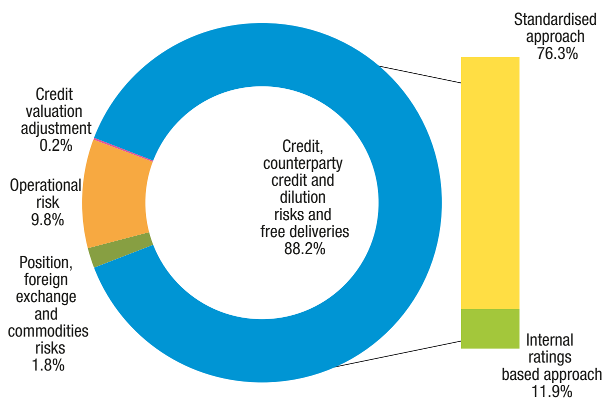
18 It involves all exposures to the client whose at least one receivable is unpaid and overdue for more than 90 days or it is considered likely that the debtor will not fully service its liabilities (not taking into account the possibility of the collection from collateral).

Figure 61 Bank own funds



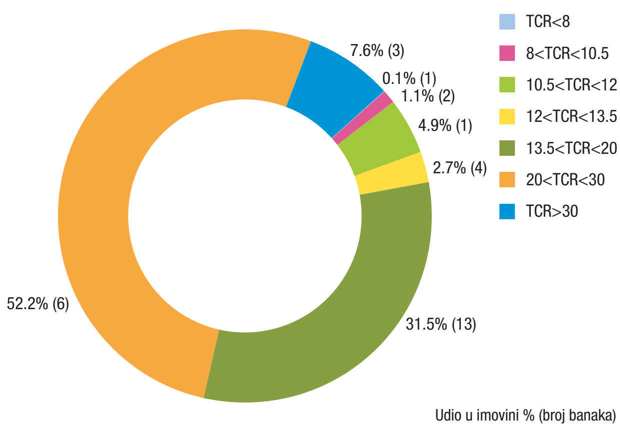
Source: CNB.

Figure 62 Structure of bank total risk exposure
as at 30 June 2014



Source: CNB.

Figure 63 Distribution of the bank total capital ratio (TCR)
as at 30 June 2014



Source: CNB.

11.2 Housing savings banks

The number of housing savings banks operating in the Republic of Croatia remained unchanged – there were five of them at the end of the first half of 2014. One housing savings bank was still in majority state ownership and the remaining four were in the direct or indirect majority ownership of foreign shareholders.

In the observed semi-annual period, housing savings banks' assets slightly declined by HRK 64.8m or 0.9% (0.1% if the exchange rate effect is excluded). Due to a higher rate of decline in banks' assets, the share of housing savings banks' assets in total assets of credit institutions increased slightly, from 1.8% to 1.9%.

The mentioned decrease in total assets of housing savings banks was the result of developments in three housing savings banks, which reported a fall in assets, ranging from 4.0% to 10.6%. Only one housing savings bank increased its assets (by 7.7%) in the previous period, while assets of the remaining housing savings bank remained unchanged. More than three quarters of total assets were accounted for by housing savings banks in direct or indirect majority ownership of Austrian shareholders and they increased their market share by more than one percentage point (to 76.6%). The share of assets of a housing savings bank in domestic ownership in total assets of housing savings banks continued to fall and stood at 3.7%. A slight fall was also recorded in the market share of assets of the housing savings bank in indirect majority ownership of Italian shareholders, to 19.8%.

11.2.1 Balance sheet

At the end of the first half of 2014, total assets of housing savings banks stood at HRK 7.5bn (Table 12). A slight decline in assets in the observed period and weak changes in assets in previous years point to the stagnation present since 2008.

A decrease in the balance sheet of housing savings banks from the end of 2013 was due to the fall in sources of financing, mostly of received loans (almost exclusively short-term loans), which declined by almost one half, to HRK 104.6m. Such movements in liabilities were mostly reflected on the asset side in a decline in investments in MoF T-bills, by almost one quarter, and in a decline in the item of other assets related to the regular calculation of state incentives, i.e. the closing of receivables from the MoF and the execution of the payment obligation to housing savings banks savers.[19]

Due to the fall in investments in MoF T-bills and, to a smaller extent to the fall in investments in RC bonds, total securities investments were 5.1% lower. Net loans went up by HRK 190.6m or 4.7%, their share in total assets of housing savings banks rising to 56.3%. The growth in loans granted was mostly the result of the increase in home loans, by HRK 145.3m or 3.8%. Loans to financial institutions increased by a smaller amount (HRK 64.8m), but much more in relative terms (311.2%), due to the effect of the increase in one housing savings bank. Three housing savings banks recorded an increase in loans granted, ranging from 12.0% to as much as 65.2%, while the remaining two savings banks recorded a decline.

19 In accordance with the provisions of the Act on Amendments to the Act on Housing Savings and State Incentive to Housing Savings (Official Gazette 139/2013), state incentives to housing savings accumulated in the period from 1 January to 31 December 2014 will not be paid out from the government budget of the Republic of Croatia.

Table 12 Structure of housing savings bank assets

end of period, in million HRK and %

	Dec. 2012		Dec. 2013			Jul. 2014		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Money assets and deposits with the CNB	0.0	0.0	0.0	0.0	92.9	0.0	0.0	–55.6
Money assets	0.0	0.0	0.0	0.0	92.9	0.0	0.0	–55.6
Deposits with the CNB	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposits with banking institutions	723.1	9.7	522.8	6.9	–27.7	526.6	7.0	0.7
MoF treasury bills and CNB bills	594.1	8.0	435.9	5.8	–26.6	331.8	4.4	–23.9
Securities	2,056.4	27.6	2,256.5	29.8	9.7	2,224.3	29.7	–1.4
Derivative financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans[a]	3,767.6	50.5	4,034.6	53.3	7.1	4,225.2	56.3	4.7
Loans to financial institutions	69.3	0.9	20.8	0.3	–70.0	85.6	1.1	311.2
Loans to other clients	3,698.3	49.6	4,013.8	53.1	8.5	4,139.7	55.2	3.1
Investments in subsidiaries, associates and joint ventures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreclosed and repossessed assets	0.2	0.0	0.2	0.0	0.0	0.2	0.0	0.0
Tangible assets (net of depreciation)	5.3	0.1	3.9	0.1	–27.1	3.3	0.0	–14.8
Interest, fees and other assets	363.5	4.9	310.8	4.1	–14.5	188.5	2.5	–39.3
Net of: Collectively assessed impairment provisions[b]	54.1	0.7	–	–	–	–	–	–
TOTAL ASSETS	7,456.1	100.0	7,564.7	100.0	1.5	7,499.9	100.0	–0.9

[a] As of October 2013, loan amount is reduced by the amount of collected fees (formerly recorded as deferred income in liabilities).
[b] As of October 2013, the amounts of financial instruments are reduced by the amount of the corresponding collectively assessed impairment provisions.
Source: CNB.

Table 13 Structure of housing savings bank liabilities and capital

end of period, in million HRK and %

	Dec. 2012		Dec. 2013			Jul. 2014		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans from financial institutions	0.0	0.0	139.6	1.8	100.0	10.0	0.1	–92.8
Short-term loans	0.0	0.0	139.6	1.8	100.0	10.0	0.1	–92.8
Long-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposits	6,344.9	85.1	6,359.0	84.1	0.2	6,359.0	84.8	0.0
Transaction account deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings deposits	160.7	2.2	223.8	3.0	39.3	142.1	1.9	–36.5
Time deposits	6,184.1	82.9	6,135.2	81.1	–0.8	6,216.8	82.9	1.3
Other loans	94.3	1.3	95.5	1.3	1.2	94.6	1.3	–0.9
Short-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term loans	94.3	1.3	95.5	1.3	1.2	94.6	1.3	–0.9
Derivative financial liabilities and other financial liabilities held for trading	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Subordinated instruments issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Hybrid instruments issued	97.8	1.3	88.4	1.2	–9.6	82.8	1.1	–6.3
Interest, fees and other liabilities[a]	345.5	4.6	278.9	3.7	–19.3	260.2	3.5	–6.7
Total liabilities	6,882.4	92.3	6,961.4	92.0	1.1	6,806.7	90.8	–2.2
Share capital	487.9	6.5	487.9	6.4	0.0	487.9	6.5	0.0
Current year profit (loss)	67.5	0.9	29.9	0.4	–55.7	42.9	0.6	43.6
Retained earnings (loss)	25.1	0.3	91.1	1.2	262.6	120.1	1.6	31.9
Legal reserves	6.7	0.1	8.2	0.1	22.8	9.0	0.1	10.0
Reserves provided for by the articles of association and other capital reserves	3.6	0.0	3.5	0.0	–1.2	–5.9	–0.1	–
Revaluation reserves	–17.1	–0.2	–17.2	–0.2	0.7	39.2	0.5	–
Previous year profit (loss)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total capital	573.7	7.7	603.4	8.0	5.2	693.2	9.2	14.9
Total liabilities and capital	7,456.1	100.0	7,564.7	100.0	1.5	7,499.9	100.0	–0.9

[a] As of October 2013, the amount of granted loans in assets is reduced by the amount of fees collected on loans (formerly recorded as deferred income in liabilities).
Source: CNB.

Having fallen by HRK 130.5m (55.5%), the significance of received loans halved and fell to only 1.6% of total sources of financing. The almost sole form of financing of housing savings banks was still deposits received from housing savings bank savers, with a share of 97.1% in total sources of financing. At the end of the observed period they stood at HRK 6.4bn, which was the same as the amount of these deposits at the end of 2013. Hybrid instruments had a negligible significance, with the share of 1.3% in total sources of financing.

Housing savings banks increased their capital in the first half of the year by a considerable 14.9% or HRK 89.9m. There were no recapitalisations in the observed period, so in addition to 2014 profit, the greatest contribution to the increase in capital came from the rise in revaluation reserves, by HRK 56.4m. This capital item includes unrealised gains (or losses) on value adjustments of financial assets available for sale and it also regularly and considerably affects the fluctuations in the amount of housing savings banks' capital. This item increased significantly in the observed period, due to a noticeable growth in investments in securities distributed in the available-for-sale portfolio and favourable movements in their fair value. As a result, the share of capital in housing savings banks' liabilities and capital increased by 1.3 percentage points, to 9.2%.

11.2.2 Earnings

At the end of the first half of 2014 housing savings banks generated HRK 48.6m in (pre-tax) profit from continuing operations, a considerable increase of HRK 28.5m or 142.1% from the same period in the previous year (Table 14). All housing savings banks operated with a profit.

Considerable growth in profit of housing savings banks was mostly the result of realised net other non-interest income, while savings banks reported losses in the same position in the same period last year. Changes in other items of income and expenses had no significant impact on developments in profit. Big changes in the income statement of housing savings banks are common and most often associated with the purpose of investing in RC securities, i.e. with developments in the fair value and the results of the purchase/sale of RC securities. Relative to the same period in 2013, the increase in gains in 2014 was influenced by the greater amount and market value of RC bonds in the portfolio of securities held for trading, which generated a profit of more than HRK 14.1m to housing savings banks. At the end of the first half of the previous year, this portfolio of securities generated losses of HRK 6.2m to housing savings banks.

Interest income increased by HRK 6.3m or 3.8%, largely due to the 10.8% growth in income from home loans. Accompanied by a mild growth in interest expenses (3.5%), it led to an increase in net interest income by 4.3%. A decline in net income from fees and commissions of 13.1% was mostly affected by lower income from housing savings banks' contracts (15.1%).

Movements in net income resulted in a considerable rise in operating income (25.1%), which, accompanied by savings in general operating expenses (6.3%) and a positive impact of reversed provisions and value adjustments (mostly on a collective basis), led to an increase in profit. Due to the mentioned developments, indicators of returns of housing savings banks recovered relative to the end of the first half of 2013, so ROAA increased from 0.6% to 1.3% and ROAE from 5.5% to 13.2% at the end of the first half of 2014. The cost-to-income ratio decreased from 74.7% to 55.8%, thus approaching the average cost-to-income ratio of banks.

Table 14 Housing savings bank income statement
in reference periods, in million HRK and %

	Amount		Change
	Jan.–Jun. 2013	Jan.–Jun. 2014	
Continuing operations			
Interest income	166.5	172.8	3.8
Interest expenses	96.8	100.2	3.5
Net interest income	69.7	72.7	4.3
Income from fees and commissions	32.8	29.0	–11.5
Expenses on fees and commissions	4.6	4.6	–2.0
Net income from fees and commissions	28.2	24.5	–13.1
Income from equity investments	0.0	0.0	–
Gains (losses)	–6.2	17.8	–
Other operating income	3.3	1.6	–52.1
Other operating expenses	11.8	12.1	3.0
Net other non-interest income	–14.7	7.3	–
Total operating income	83.1	104.4	25.6
General administrative expenses and depreciation	62.1	58.2	–6.3
Net operating income before loss provisions	21.0	46.2	119.9
Expenses on value adjustments and provisions	0.9	–2.4	–
Other gains (losses)	0.0	0.0	–
Profit (loss) from continuing operations, before taxes	20.1	48.6	142.1
Income tax on continuing operations	4.3	5.7	32.9
Profit (loss) from continuing operations, after taxes	15.8	42.9	172.0
Discontinued operations			
Profit (loss) from discontinued operations, after taxes	0.2	0.0	–100.0
Current year profit (loss)	16.0	42.9	168.6

Source: CNB.

The number of employees in housing savings banks continued to decrease, so they had 343 employees at the end of the first half of 2014, which is a decrease of 30 employees or 8.0% from the end of 2013. Although assets declined concurrently, but at a slower pace, due to the fall in the number of employees, the indicator of the amount of assets managed by one employee of the housing savings bank increased from HRK 20.3m at the end of 2013 to HRK 21.9m at the end of the first half of 2014. This indicator has been on an upward trend since the second half of 2012. Since the beginning of 2013, it has been regularly higher than the value of the same indicator for banks.

11.2.3 Credit risk

The amount of total placements and assumed off-balance sheet liabilities of housing savings banks declined by 6.5%, to HRK 5.9bn in the first half of 2014. The decrease in total amount of items exposed to credit risk was due to a considerable fall in debt securities distributed in the loan and receivables

Table 15 Classification of housing savings bank placements and assumed off-balance sheet liabilities by risk categories
end of period, in million HRK and %

Risk category	Dec. 2012		Dec. 2013			Jun. 2014		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
A	5,979.0	99.5	6,234.4	99.2	4.3	5,822.5	99.0	–6.6
B	29.7	0.5	48.3	0.8	62.7	53.4	0.9	10.6
C	2.7	0.0	3.8	0.1	42.7	4.3	0.1	12.8
Total	6,011.4	100.0	6,286.5	100.0	4.6	5,880.3	100.0	–6.5

Source: CNB.

Table 16 Coverage of housing savings bank total placements and assumed off-balance sheet liabilities by total value adjustments and provisions
end of period, in million HRK and %

	Dec. 2012	Dec. 2013	Jul. 2014
Total value adjustments against placements and provisions for assumed off-balance sheet liabilities	61.2	66.7	64.6
Value adjustments and provisions	6.7	12.1	14.2
Collectively assessed value adjustments and provisions	54.5	54.6	50.4
Total placements and assumed off-balance sheet liabilities	6,011.4	6,286.5	5,880.3
Coverage	1.0	1.1	1.1

Source: CNB.

portfolio (66.0%), which, despite the increase in loans granted, resulted in a decline in the entire loans and receivables portfolio of housing savings banks of 6.0%. An additional impact on the decrease in items exposed to credit risk came from a decline in assumed off-balance sheet liabilities (47.5%) and a decline in the amount of securities distributed in the portfolio of financial assets held to maturity (3.6%).

The highest-quality placements and assumed off-balance sheet liabilities classified into risk category A decreased by 6.6% in the observed period. The rate of this decline was slightly higher than the decline in total placements and assumed off-balance sheet liabilities, so the share of risk category A in total placements slightly decreased accordingly. Nevertheless, this share was still high and stood at 99.0% at the end of the first half of 2014. Due to the fall in the quality of granted loans, placements and assumed off-balance sheet liabilities that housing savings banks classified into risk categories B and C increased by 10.8% and accounted for the remaining 1.0% of total placements and assumed off-balance sheet liabilities. More than 90.0% of this share involved risk category B placements.

Loans granted were still the most significant type of placements of housing savings banks, with the share of 72.7% in total placements and assumed off-balance sheet liabilities. Gross amount of loans went up by 4.7% from the end of 2013, while loans classified into risk categories B and C increased even sharper (10.8%). Despite this growth, the quality of the housing savings banks' loan portfolio did not deteriorate and the share of partly recoverable and fully irrecoverable loans in the total remained at only 1.3%. An almost equal share of B and C risk category loans was recorded in the portfolio of kuna loans without a currency clause (1.2%) and kuna loans indexed to the euro (1.4%). Unpaid receivables more than 90 days overdue still constituted an almost negligible share in the structure of total placements of housing savings banks (less than 0.5%).

Total value adjustments and provisions were 3.1% lower at the end of the first half of 2014, which was due to a decrease in placements from risk category A, which has a dominant share in the structure of placements and assumed off-balance sheet liabilities of housing savings banks. As a result, value adjustments and collectively assessed impairment provisions decreased by 7.7%. A simultaneous fall in the quality of housing savings banks' placements and an increase of 17.4% in the relevant value adjustments and provisions for B and C risk categories had a smaller impact on developments in total value adjustments and provisions. The coverage of total placements and assumed off-balance sheet liabilities by value adjustments and provisions did not change and stood at 1.1%, while the coverage of B and C risk categories increased by 1.5 percentage points, to 24.6%.

11.2.4 Capital adequacy

The introduction of the new capital regime in housing savings banks led to a growth in the total capital (own funds) ratio. At the end of the first half of 2014, the ratio stood at 23.3%, a considerable increase from the end of 2013, when it stood at 20.5%. This resulted from a simultaneous growth in own funds and a decline in risk exposures. Own funds increased by 2.9%, while total risk exposure declined significantly, by 9.6%, primarily due to lower credit risk exposure (11.3%), while a decline in operational risk exposure (3.2%) had a much smaller impact. Only exposure to market risks increased, due to the 9.8% growth in exposures related to debt instruments held for trading.

The fall in the credit risk-weighted exposure amount was influenced by a decline in the amount of exposure that is being weighted, driven by a decrease in business activities, and a decline in the average weight for credit risk, from 36.2% to 33.3%. An increase in the share of items with 35% and 75% weights, on account of a decrease in the share of items with 50% and 100% weights, contributed to the decline in weight. Housing savings banks thus increased the use of a preferential weight for exposures secured by residential real estate property (35%), as well as the use of a 75% weight for the household category. The new framework eased the conditions for the distribution of exposures in that category – the maximum exposure amount was increased to EUR 1m and institutions now determine on their own whether there is a sufficient level of granularity in the portfolio.

Abbreviations and symbols

Abbreviations

bn	– billion
b.p.	– basis points
BOP	– balance of payments
c.i.f.	– cost, insurance and freight
CBRD	– Croatian Bank for Reconstruction and Development
CBS	– Central Bureau of Statistics
CEE	– Central and Eastern European
CEFTA	– Central European Free Trade Agreement
CES	– Croatian Employment Service
CHF	– Swiss franc
CHY	– Yuan Renminbi
CICR	– currency-induced credit risk
CIHI	– Croatian Institute for Health Insurance
CPF	– Croatian Privatisation Fund
CPI	– consumer price index
CPIA	– Croatian Pension Insurance Administration
CM	– Croatian Motorways
CNB	– Croatian National Bank
CR	– Croatian Roads
EBA	– European Banking Authority
ECB	– European Central Bank
EFTA	– European Free Trade Association
EMU	– Economic and Monetary Union
EU	– European Union
EUR	– euro
excl.	– excluding
f/c	– foreign currency
FDI	– foreign direct investment
Fed	– Federal Reserve System
FINA	– Financial Agency
f.o.b.	– free on board
GDP	– gross domestic product
GVA	– gross value added
HANFA	– Croatian Financial Services Supervisory Agency
HICP	– harmonised index of consumer prices
HRK	– kuna
incl.	– including
IMF	– International Monetary Fund
JPY	– Japanese yen
m	– million
MIGs	– main industrial groupings
MM	– monthly maturity
MoF	– Ministry of Finance
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
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
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
	– average
a, b, c,...	– indicates a note beneath the table and figure
*	– corrected data
()	– incomplete or insufficiently verified data

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