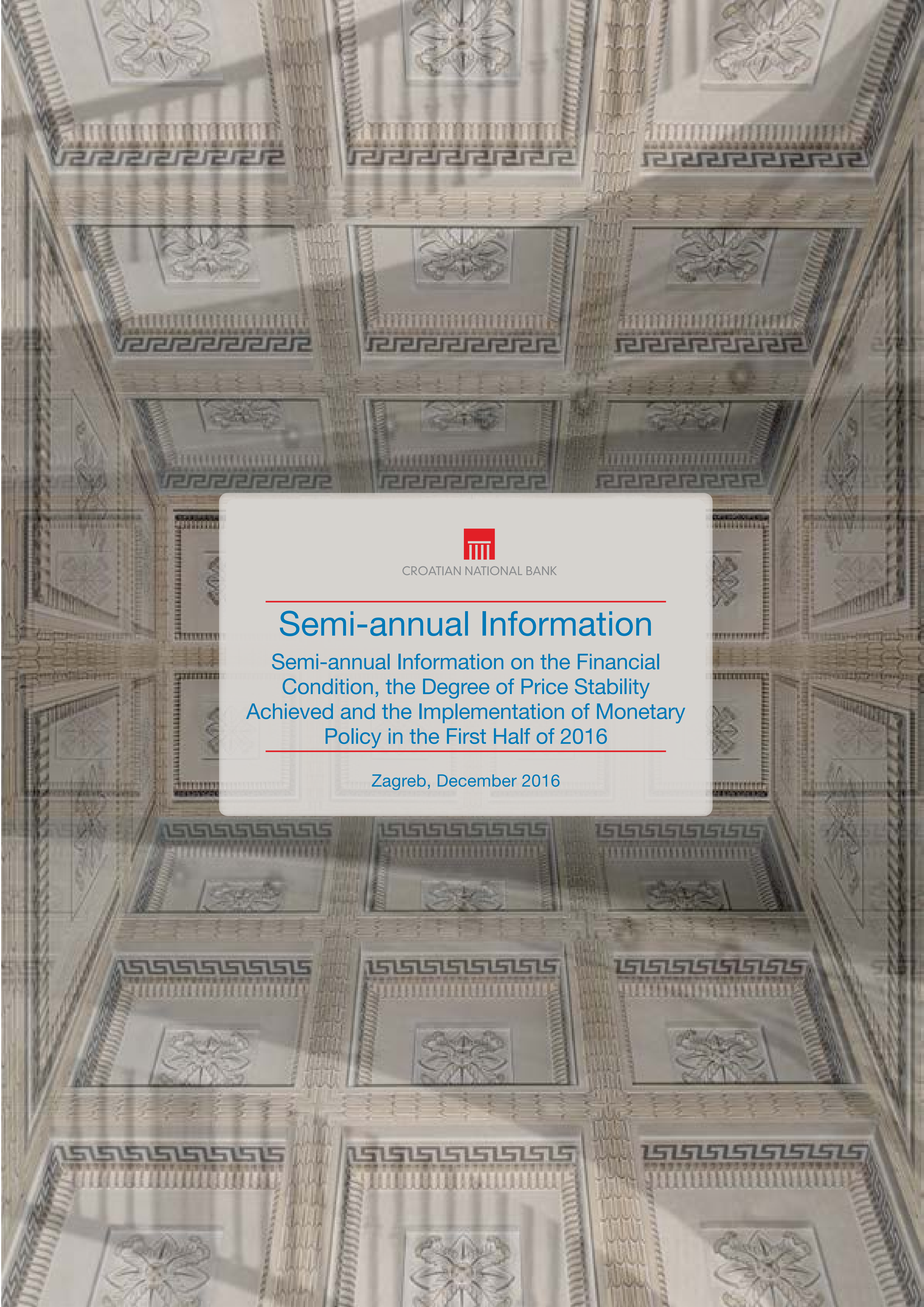


CROATIAN NATIONAL BANK

Semi-annual Information

Semi-annual Information on the Financial Condition, the Degree of Price Stability Achieved and the Implementation of Monetary Policy in the First Half of 2016

Zagreb, December 2016

HNB

SEMI-ANNUAL INFORMATION 2016

PUBLISHER

CROATIAN NATIONAL BANK
Publishing Department
Trg hrvatskih velikana 3
10002 Zagreb
Phone: +385 1 45 64 555
Contact phone: +385 1 45 65 006
Fax: +385 1 45 64 687

www.hnb.hr

ISSN 1849-3483 (online)

HNB

CROATIAN NATIONAL BANK

SEMI-ANNUAL INFORMATION

Semi-annual Information on the Financial Condition, the Degree of Price Stability Achieved and the Implementation of Monetary Policy in the First Half of 2016

2016

HNB

Contents

HNB

1 Summary

Economic growth in the first half of 2016 continued at a pace similar to that in the previous year. The further recovery of the Croatian economy was due to the increase in all components of domestic demand and exports, with a particularly noticeable growth in private sector investments. Positive trends in the labour market, involving an increase in employment and a decrease in unemployment, picked up momentum. The fall in the general price level accelerated slightly in the first half of 2016, largely due to the spillover of lower prices of oil and other raw materials in the global markets onto domestic prices. The continued expansionary orientation of the CNB's monetary policy, which is based on maintaining the stability of the exchange rate of the kuna against the euro, was further boosted by the introduction of structural repo operations in early 2016. In the conditions of high liquidity of the monetary system, the ongoing improvement in lending terms, and greater demand for credit, domestic lending activity, which had contracted for several years in a row, began to grow at the beginning of 2016. General government deficit and debt decreased sharply in the first half of the year.

Real GDP increased by an average of 0.6% per quarter in the first and second quarters of 2016 and was 2.7% higher in the first half of 2016 than in the same period of the preceding year. The steady recovery of the Croatian economy was spurred by the increase in all components of domestic demand, with significantly intensified investment activity of the private sector leading to a large annual contribution of gross fixed capital formation to real GDP growth. Exports of goods and services also expanded from the end of 2015, but at a noticeably slower annual growth rate. At the same time, as a result of the relatively strong increase in domestic demand, imports grew faster than exports, so that net foreign demand contributed negatively to GDP growth in the first half of the year.

The first six months of 2016 were marked by more intense positive trends in the labour market. Total employment according to CPIA data on the number of insured persons grew by 1.8% from the same period in 2015. While all activities contributed positively to total employment growth, the strongest contribution came from trade and other private sector service activities. Unemployment continued to decrease in the first half of 2016, due to both outflows from the register in consequence of employment and other business activities, and clearings from the records for other reasons, while net outflows related to employment predominated throughout 2015. The ILO unemployment rate went down from 16.3% in 2015 to 14.4% and 13.6% in the first and second quarters of the current year, respectively. The fall in unemployment was also reflected in the lower administrative unemployment rate, which averaged 16.1% in the first six months of 2016 (vs 18% in the first half of 2015). Although unit labour costs increased throughout the first half of 2016, they were lower, on average, than in the same period of 2015. Nominal gross wages grew by 1% on an annual level, while real wages rose somewhat more, thanks to the parallel decrease in consumer prices.

The fall in the general price level accelerated slightly in the first half of 2016. This was largely due to the spillover of lower prices of oil and other raw materials in the global markets onto domestic prices, as well as weak domestic inflationary pressures and low inflation in Croatia's major trading partners. The annual rate of change in consumer prices fell from –0.6% in December 2015 to –1.6% in June 2016, with the contribution of prices of industrial products, energy and processed food products dropping the most. Energy is the component that again made the largest negative contribution to the annual rate of change in consumer prices, which went from –0.9 percentage points in December 2015 to –1.2 percentage points in June 2016, mostly due to the cut in administrative prices of natural gas. Core inflation re-entered the negative zone, falling from 0% in December 2015 to –0.9% in June 2016.

The deficit in the current and capital account was larger in the first half of 2016 than in the same period of 2015 as a result of the escalating deficit in the trade in goods and primary income accounts. By contrast, the surplus in the secondary income and capital transfers accounts increased owing to reduced payments to the EU budget and larger capital transfers from EU funds. In addition, net exports of services expanded thanks to favourable tourism results. If cumulative values over the past year are taken into account, the current account surplus shrank to 5.4% of GDP in the second quarter of 2016, from 5.7% at the end of 2015.

The domestic costs of financing of the government and other domestic sectors steadily decreased in the first half of 2016 in the conditions of high liquidity supported by the expansionary monetary policy of the CNB. With positive trends in interest rates, credit standards of domestic credit institutions continued to ease while demand for corporate and household loans increased steadily. The total debt of non-financial corporations levelled off in the first quarter and increased in the second quarter of 2016. There were changes in the structure of corporate financing in comparison with the previous few years in that there was an increase in financing from domestic sources. The total debt of households (transaction-based) also expanded.

Foreign capital flows in the first half of 2016 were marked by a marginal net capital outflow in the financial account of the balance of payments (excluding change in international reserves reduced by foreign liabilities of the CNB). On the one hand, the net debt position of domestic sectors improved perceptibly, particularly noteworthy being the reduction in foreign liabilities of the government and credit institutions. On the other hand, net equity liabilities grew by almost the same amount, mainly due to the noticeable increase in reinvested earnings of foreign-owned banks. As a result, relative indicators of gross and net external debt improved from the end of December 2015.

The monetary policy of the Croatian National Bank remained expansionary in the first half of 2016 and was further boosted by the introduction of long-term kuna structural repo operations. The surplus kuna liquidity went up from the average of HRK 6.7bn in 2015 to HRK 9.2bn in the first half of 2016, while overnight interbank interest rates in the money market remained very low. The CNB held two structural repo auctions, placing HRK 711.5m for a four year term at a fixed interest rate of 1.8%. In this way, the CNB ensured the banks access to longer term sources of kuna liquidity, which supported the trend of increased kuna lending to domestic sectors and the lowering of the yield curve for long-term government borrowing. As regards regular weekly reverse repo operations, their average daily balance stood at HRK 117.5m in the first half of 2016. In its foreign exchange transactions, the CNB withdrew HRK 142.5m without affecting the abundant liquidity of the monetary system.

In addition to supporting the high liquidity of the monetary system, the Croatian National Bank continued to maintain the stability of the exchange rate of the kuna against the euro. The average exchange rate of the kuna against the euro was 0.9% lower in the first half of 2016 than the average recorded in the same period of the previous year. Appreciation pressures on the kuna were mostly driven by favourable tourism results, larger inflows from EU funds and expectations associated with the announced issuance of government bonds in the foreign market (subsequently postponed). In late May, the CNB intervened in the foreign exchange market by purchasing EUR 83.5m, after which the appreciation trend of the kuna came to an end.

In such financial conditions, the dynamics of credit institutions placements was more favourable than in the previous several years. After falling for two years in a row, corporate placements grew by 3.1% (transaction-based) in the first half of 2016. Household placements, which decreased for seven consecutive years, also increased in the first six months of 2016, by 0.7% (transaction-based), with a particularly pronounced growth in kuna loans. On the other hand, the nominal balance of household loans shrank noticeably due to the partial write-off of loans linked to the Swiss franc in the conversion process, which began to gain speed in December 2015 and was almost complete by the end of June.

Gross international reserves stood at EUR 12.9bn at end-June 2016, down by EUR 0.8bn (5.6%) from the end of 2015. The fall in gross reserves was mostly the result of the decision to suspend the foreign currency reserve requirement allocation to an account at the CNB, amounting to EUR 0.5bn. This decision made it possible for the banks to take a more flexible approach to foreign exchange liquidity management from early 2016, allowing them to meet the total foreign exchange component of reserve requirements by average daily balances of foreign currency assets. Also, the fall in gross reserves was partly due to withdrawals from the government foreign currency deposit account with the CNB. As these factors had no effect on developments in net usable reserves, which edged up from the end of 2015 (by 1.0%), reaching EUR 11.3bn at the end of June.

The CNB invests international reserve funds with financial institutions and in countries with a high investment grade and the assessment of creditworthiness is based on indicators issued by internationally recognised rating agencies (Moody's, Standard & Poor's and FitchRatings) and on an internally-developed creditworthiness assessment model. At the end of the first half of 2016, approximately 59% of total CNB international reserves were invested in countries, banks and institutions within the two highest credit rating categories or the BIS and the IMF, and in foreign cash in the CNB vault.

Net international reserves of the CNB comprise the euro- and dollar-denominated held-for-trading portfolios, the euro- and dollar-denominated investment portfolios, funds entrusted to an external asset manager, and foreign cash in the CNB vault. The held-for-trading portfolios are valued at fair market prices, have short average maturities and are used as a source of liquidity. Investment portfolios have a longer average maturity and serve as a source of more stable long-term income. The annual rates of return on the CNB held-for-trading euro and dollar portfolios stood at 0.04% and 1.27% respectively in the first half of 2016. In the same period, the rates of return of the euro- and dollar-denominated investment portfolios were 1.04% and 1.75%, respectively, on an annual basis. In the first half of 2016, the rate of return on the funds entrusted to an international financial institution was 1.58% on an annual basis.

Bank assets amounted to HRK 382.2bn at the end of the first half of 2016, a decrease of 2.9% from the end of 2015. Developments in assets were strongly influenced by the conversion of Swiss franc loans to euro loans,[1] exchange rate changes and larger sales of claims. In the first half of 2016, bank profit (from continuing operations, before taxes) was HRK 3.5bn. Compared with the first half of 2015, profit surged (HRK 2.1bn or 152.6%) in most banks, mainly due to lower expenses on value adjustments and provisions and one-off gains from the sale of Visa Europe Ltd. shares.

The upward trend in the quality of loans continued, even when the effects of the sale of claims are excluded. The share of partly recoverable and fully irrecoverable loans (B and C risk categories) decreased from 16.7% at the end of 2015 to 15.0% at the end of the first half of 2016. In the sector of non-financial corporations, this share dropped from 34.7% to 30.0%, strongly influenced by the sale of claims. However, excluding the effects of that sale, data point to improved loan collection rates, in particular for loans to clients in pre-bankruptcy settlement and foreclosure proceedings. In addition to collections, a strong impact was made by the reclassification of claims to a better risk category, i.e. to the group of fully recoverable loans (risk category A).

The capital adequacy of banks continued to improve as the total capital ratio went up to 21.7%. As in previous years, this ratio's increase was driven by the fall in risk exposure and the parallel increase in own funds. Total risk exposure was reduced by HRK 7.0bn (2.9%). The key contributor to this was the write-off of some assets made during the conversion of loans linked to the Swiss franc, which lowered exposure to credit and currency risks.

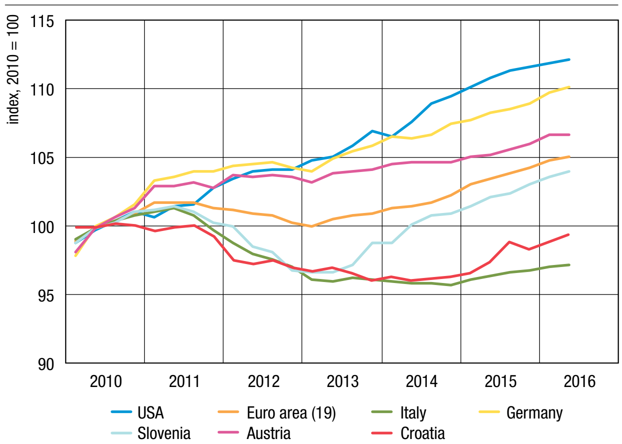
As a result of the sharp growth in revenues and slower growth in expenditures, fiscal policy in the first half of 2016 was marked by the continued sharp reduction in general government deficit (ESA 2010) compared with the same period of 2015 (HRK 1.9bn vs HRK 8.5bn). On the revenue side, a strong increase was seen in tax revenues, largely thanks to the recovery in economic activity, as well as capital revenues, which is associated with higher use of EU funds. On the expenditure side, social benefits (mostly pensions and health care expenditure) increased the most, followed by expenses for employees, while expenditures for intermediary consumption and interest expenditures were reduced. As the general government deficit was partly financed by deposit funds while the kuna was appreciating against the euro, general government debt stood at HRK 285.7bn at end-June 2016, or HRK 3.9bn less than at the end of 2015.

1 The conversion of Swiss franc loans (and kuna loans indexed to the Swiss franc) to euro loans (and euro-indexed kuna loans) is regulated by the Act on Amendments to the Consumer Credit Act and the Act on Amendments to the Credit Institutions Act (OG 102/2015).

2 Global developments

Global developments in the first half of 2016 were marked by continued moderate economic growth, accompanied by a slight decline in the volume of global trade and heightened uncertainty and volatility in the financial markets. The dynamics of global growth weakened gradually towards the middle of the year, mostly because of the slowdown in the growth in individual developed countries. This was particularly notable in the US, whose economy in the second quarter of 2016 recorded the lowest growth in the past two years (1.2% relative to the same period of the previous year), i.e. mostly due to a considerable weakening in private sector investment and the decline in exports. The growth in the euro area also slowed down moderately from the previous year, and the outcome of the UK referendum on the exit from the EU at the end of June raised uncertainties among investors and exporters. In developing and emerging market countries the expected dynamics of growth was maintained during the first half of 2016. A continued slowdown in the Chinese economy was offset by the mitigation of crises in Russia and Brazil. Inflation remained subdued at a global level, but the trend in the movement of the prices of oil and other raw materials changed from falling to rising.

Figure 2.1 Gross domestic product of selected economies
seasonally adjusted data, constant prices



Sources: Eurostat, BEA and CNB.

In the first half of 2016, the economy of the euro area continued to grow slightly, on the back of stable domestic demand assisted by the low prices of energy and a stimulative monetary policy. However, the growth decelerated slightly from the past year (1.7% relative to 1.9% in 2015) because of weakening dynamics in individual large markets, such as Italy and France, especially in the second quarter. This was the consequence of long-standing structural issues and large debts of domestic sectors, which make investment difficult and discourage consumption. Also, after a brief period of growth, at the end of 2015 the Greek economy again started to record negative rates of change that continued in 2016. Conversely, economic growth in Germany accelerated from 1.5% in 2015 to 1.8% in the first half of 2016. In addition to stable personal consumption, exports made the largest contribution to the growth of the German economy, i.e. mostly to other euro area members, which partially offset the relatively weak demand from the global market. Spain also stood out for its positive movements, with economic growth exceeding 3% for the second consecutive year, mostly owing to good results in tourism.

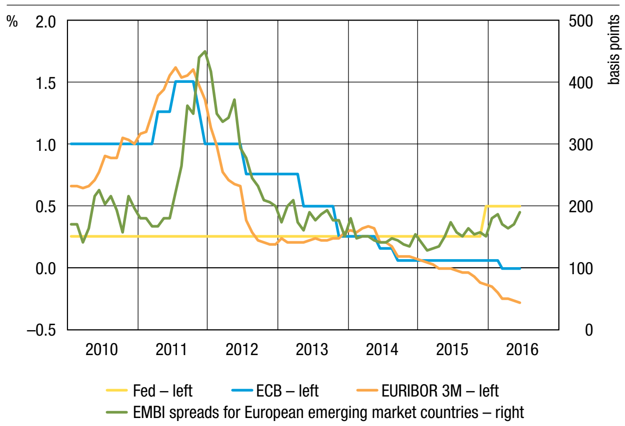
Economic trends in Croatia's major trading partner countries were relatively favourable in the first half of 2016, led by Germany. Although in the case of Italy and Austria growth faltered in the second quarter, economic developments were nevertheless more favourable than in 2015. In Slovenia, however, economic growth dynamics remained above the average of the euro area, i.e. mostly on the back of exports, while domestic demand weakened slightly. Trading partners in the region mostly recorded positive changes. The economy of Bosnia and Herzegovina grew in the first half of 2016 at the rate of 2.0%, mostly owing to improvement in the foreign trade balance. In the same period, economic growth in Serbia strengthened to 3.0%, after the 0.7% recorded in 2015.

2.1 Interest rate trends

The monetary policies of the US and the euro area exhibited divergent trends in the first half of 2016. The tightening of monetary policy in the US began in December 2015. Although further increase was expected, during the first half of 2016 the Fed did not increase its benchmark interest rate, because of relatively weak economic indicators and high global risks. In March 2016, the ECB additionally eased its monetary policy by cutting the benchmark interest rate to zero (in addition to reducing the marginal interest rate and the interest rate on bank deposits by 5 and 10 basis points respectively) and increasing the monthly amount of its bond purchase programme in the secondary market from EUR 60bn to EUR 80bn and expanding the list of eligible assets to include corporate bonds.

Financing conditions for European emerging market countries deteriorated in the first half of 2016 from the end of the

Figure 2.2 Benchmark interest rates and the average yield spread on bonds of European emerging market countries
end of period



Source: Blomberg.

previous year, although they were still relatively favourable. Thus the EMBI yield spread for European emerging market countries on average stood at about 175 basis points in the first six months of 2016, while at the end of 2015 it stood at 150 basis points. After the initial increase early in the year, the spread of yields decreased in the subsequent few months, and increased again by about 20 basis points after the referendum in the UK. Financing conditions in the interbank market continued to improve, which was also reflected by the further decline in the EURIBOR.

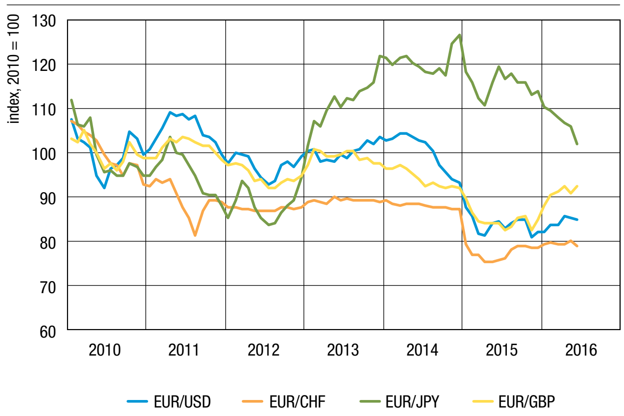
2.2 Exchange rates and price movements

The euro appreciated against the majority of the world's most important currencies in the first half of 2016. The weakening of the US dollar against the euro was mostly the result of expectations of market participants that the Fed could delay the rise in the key interest rate due to weaker than expected US economic indicators and higher global risks. The US dollar thus depreciated against the euro from EUR/USD 1.09 at the end of December 2015 to EUR/USD 1.11 at the end of June 2016. At the same time, increased uncertainty after the UK referendum on membership in the EU at the end of June had an impact on the sharp fall in the value of the pound sterling against the euro by almost 13% relative to the value recorded at the end of 2015. On the other hand, the rise in risk aversion resulted in the further strengthening of the Japanese currency against the euro in the global foreign exchange market.

The price of crude oil recovered notably by the end of the first half of 2016, after its lowest value in the past 13 years was recorded in mid-January. The Brent crude oil price stood at USD 48 per barrel at the end of June 2016 or up by 83% relative to the price of USD 26 recorded in mid-January (i.e. up by 35% from the end of December 2015). Factors on both supply and demand side contributed to the rise in the prices of oil. On one hand, the decrease in US production from the use of new technology continued, and there was a drop in production in some of the OPEC countries and Canada. On the other hand, a rather unexpected slight increase in demand for refined petroleum products in China, India and Russia contributed to the growth of crude oil prices.

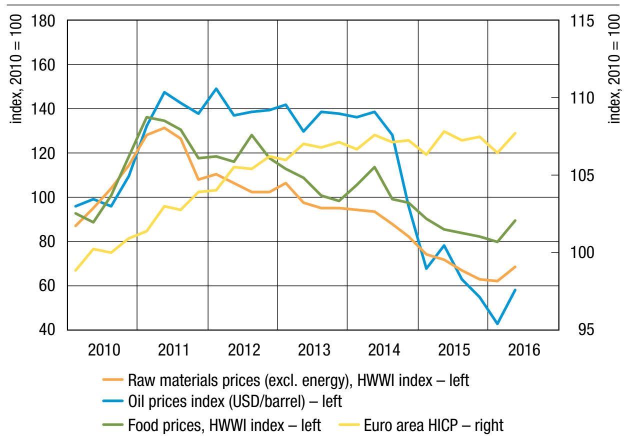
The decline in the prices of raw materials, excluding energy, which was recorded during the most part of 2015, stalled in the beginning of 2016. The prices of raw materials rose during the subsequent five months, so that the HWWI index (excluding energy in US dollars) was up by almost 14% in June 2016 from the value recorded in December 2015. Such developments were mostly attributable to the increase in the prices of food products, in particular of soya, corn and rice because of more adverse weather conditions in the production regions in South America and Asia. In addition, metal prices grew strongly, in particular of iron ore (by one third) and zinc because of the decline in production in the mines in China.

Figure 2.3 Exchange rates of individual currencies



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

Figure 2.4 Prices

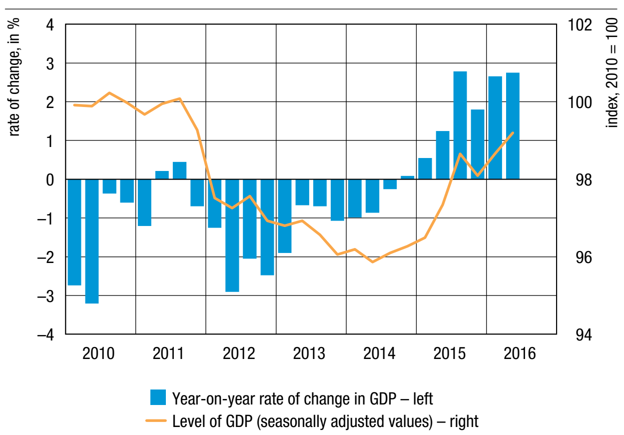


Sources: Eurostat, Bloomberg and HWWI.

3 Aggregate demand and supply

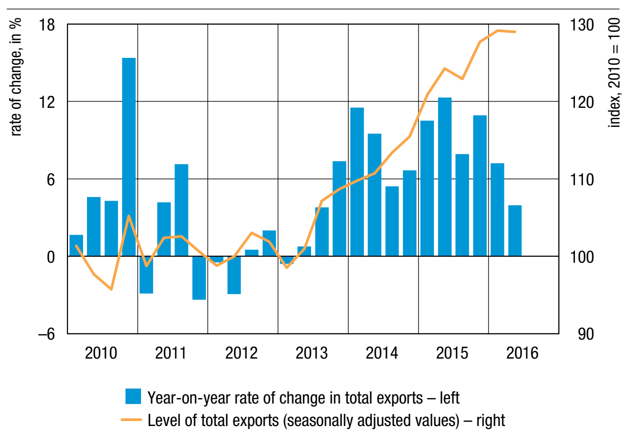
In the first six months of 2016, GDP was up by 2.7% from the same period in 2015. The current dynamics of GDP was also favourable. On a quarterly basis, real GDP growth was similar in the first and the second quarter (0.6% and 0.5%), while in the last eight quarters, a decline was reported only in the last quarter of 2015, i.e. as a result of the high basis from the previous quarter. The continuation of recovery of the Croatian economy is the result of the increase in all components of domestic demand. Investment activity of the private sector gained significant momentum, which resulted in a high annual contribution of gross fixed capital formation to real GDP growth. The exports of goods and services also increased from the end of the previous year, but their annual growth rate slowed down considerably. At the same time, a relatively strong increase in domestic demand resulted in imports growing faster than exports, so that net foreign demand contributed negatively to GDP growth in the first half of the year. On the supply side, gross value added grew by 2.6% at an annual level, primarily because of a continuation of favourable developments in manufacturing and trade, transportation and tourism.

Figure 3.1 Gross domestic product
real values



Source: CBS data seasonally adjusted by the CNB.

Figure 3.2 Exports of goods and services
real values



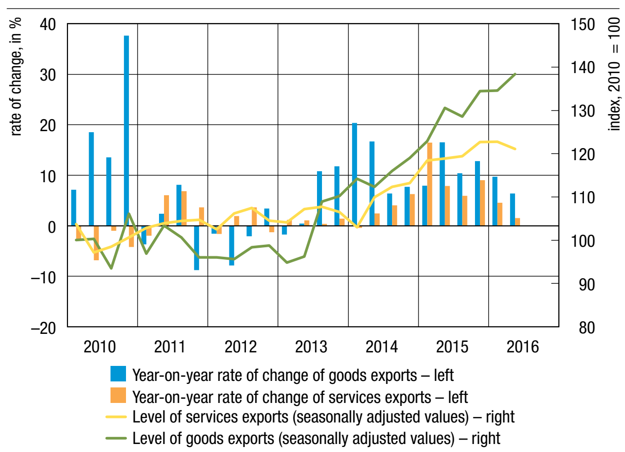
Source: CBS data seasonally adjusted by the CNB.

3.1 Aggregate demand

The annual growth of the exports of goods and services continued in the first half of 2016, but with an evident slowdown relative to the average of the previous year. The annual growth in the exports of goods and services fell in the first half of the year to 5.4% (7.2% in the first and 4.0% in the second quarter) after the 10.0% growth in 2015, the slowdown being observed both in the growth in the exports of goods and the growth in the exports of services. Nominal data on trade in goods by the main industrial groupings show that there was an across-the-board annual growth in the exports of goods. In the first six months of 2016, all industrial groupings recorded an increase in exports relative to the same period of the previous year, except energy, the decrease of which mainly reflected the decline in the price of oil in the global markets. The slowdown in the growth of the exports of durable consumer goods and capital goods was noticeable, while on the other hand the exports of non-durable consumer goods continued to grow sharply, with the growth in the exports of pharmaceutical and food products being particularly pronounced. With regard to the exports of services, data from the balance of payments suggest the continuation of positive developments in tourism, while on the other hand unfavourable performance was recorded in financial services, construction services and research and development services.

Personal consumption, individually the largest component of aggregate demand, in addition to exports, contributed the most to the growth of real GDP. In the first half of 2016, the current dynamics of this GDP component was similar to what

Figure 3.3 Real exports of goods and services

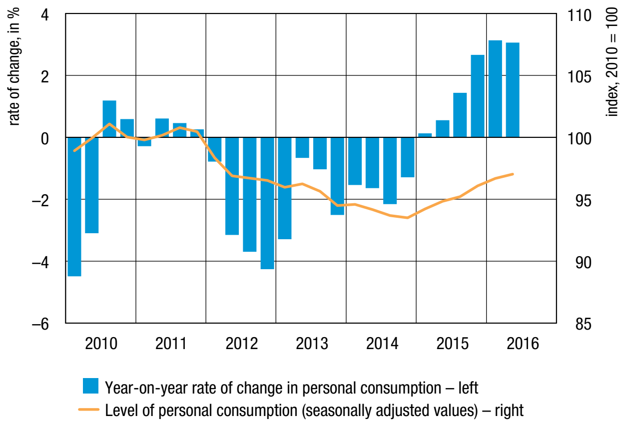


Source: CBS data seasonally adjusted by the CNB.

it was in 2015. However, the annual growth rate was high, which can mainly be correlated to the relatively strong growth of real disposable household income driven by favourable developments in the labour market and the decline in the prices of energy and food. Consumer confidence was also at a relatively high level. In addition, household deleveraging slowed down, which was particularly attributed to the growth of non-home loans.

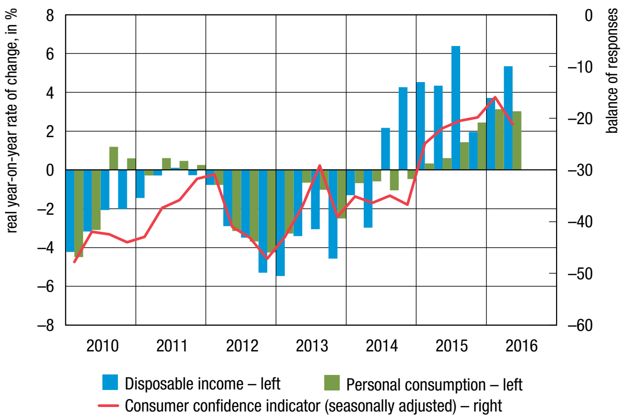
Investment activity intensified significantly, although the level of investments was still much lower than in the pre-crisis period. The annual growth rate of gross fixed capital formation stood at 5.4% in the first six months, and in the whole of 2015 it was 1.6%. In the structure of investments, private sector investments grew the most, while general government investments also increased. This component of aggregate demand grew on the back of higher gross profits of corporates in 2015 and an improvement in business confidence, stronger absorption of EU funds and more favourable conditions of financing in the form of lower interest rates and more relaxed standards for granting loans to enterprises, which resulted in

Figure 3.4 Personal consumption
real values



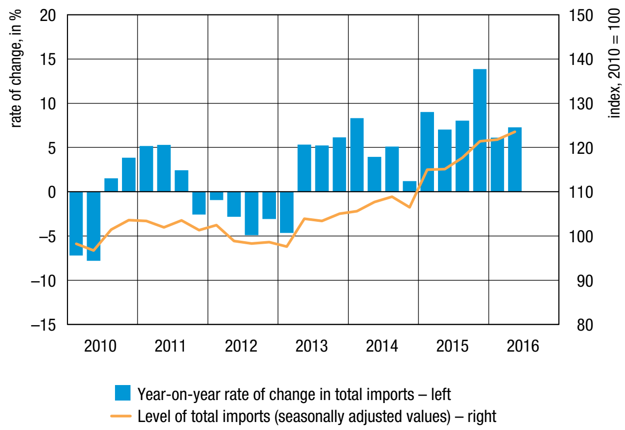
Source: CBS data seasonally adjusted by the CNB.

Figure 3.5 Determinants of personal consumption
real values



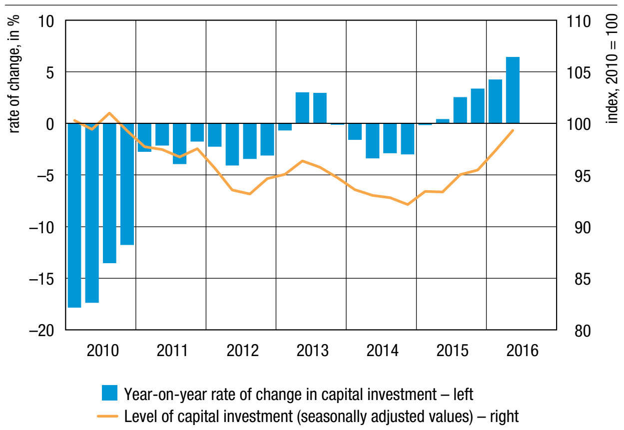
Note: The values of the consumer confidence indicator are calculated as averages of monthly data.
Sources: CBS, Ipsos and CNB.

Figure 3.7 Imports of goods and services
real values



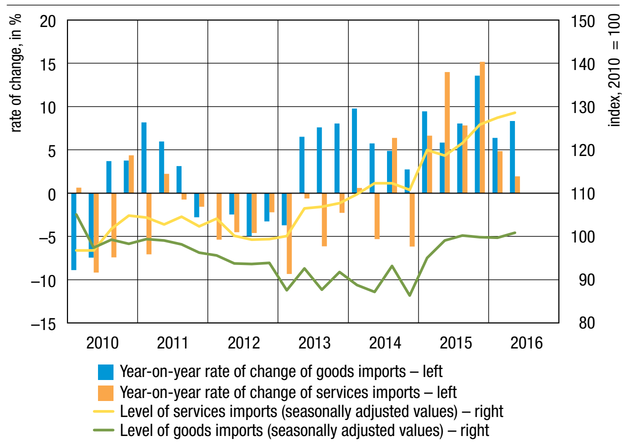
Source: CBS data seasonally adjusted by the CNB.

Figure 3.6 Gross fixed capital formation
real values



Source: CBS data seasonally adjusted by the CNB.

Figure 3.8 Real imports of goods and services



Source: CBS data seasonally adjusted by the CNB.

the recovery of loans to corporates (transaction-based). With regard to general government investments, data on capital transfers to general government from the EU budget suggest that their increase was mainly determined by the increased absorption of EU funds. The growth of investments resulted in the increase in the volume of construction works and a sharp rise in the imports of machinery and equipment.

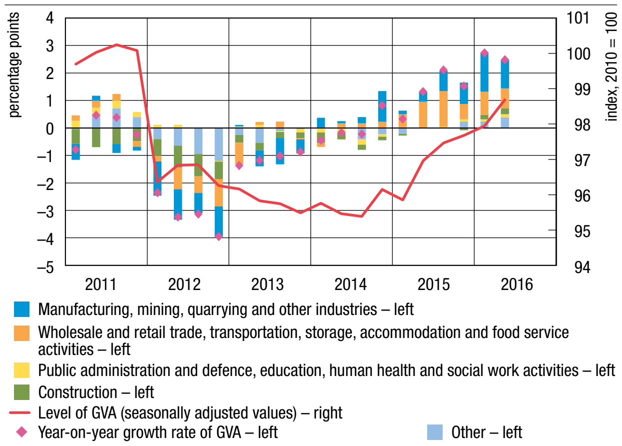
In the first six months of 2016, government consumption increased by 1.6% at an annual level, while in the previous year its growth stood at 1.0%. Such movements were mainly the consequence of the growth in the number of civil servants and government employees and higher social benefits in kind (according to the CPIA data on the number of employed persons and fiscal data according to the ESA 2010 methodology).

The growth in the imports of goods and services was faster than in exports because of the acceleration of domestic demand, amounting in the first half of 2016 to 6.4% (in the whole of 2015 it stood at 6.7%). A steep increase in imports primarily reflected the movements in the imports of goods, while the growth in the imports of services was weak. Nominal data on trade in goods show that, excluding energy, the imports of all of the main industrial groupings, in particular of capital goods, increased in the first half of the year.

3.2 Aggregate supply

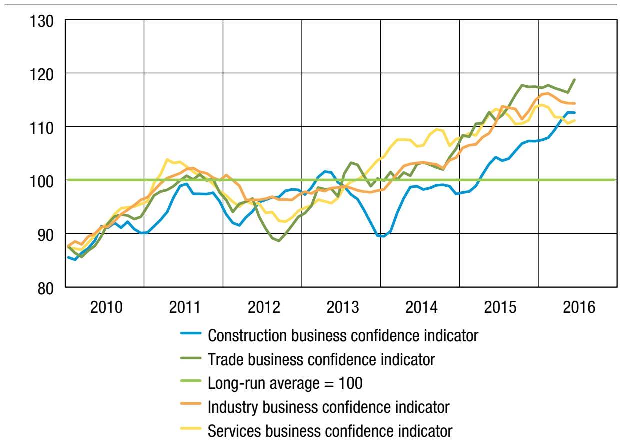
Gross value added (GVA) was up by 2.6% in the first half of the year from the same period in 2015. Observed individually, all activities increased in the first half of the year relative to the same period of the previous year, with the strongest real growth of GVA recorded in manufacturing, which made the largest contribution to the real growth of total value added. Also, gross value added grew noticeably in trade, transportation, accommodation and food service activities. In addition, after seven years of continued decline, growth in GVA was also observed in construction.

Figure 3.9 Change in GVA
contribution by components



Source: CBS data seasonally adjusted by the CNB.

Figure 3.10 Business confidence indicators
standardised seasonally adjusted values, three-member moving averages

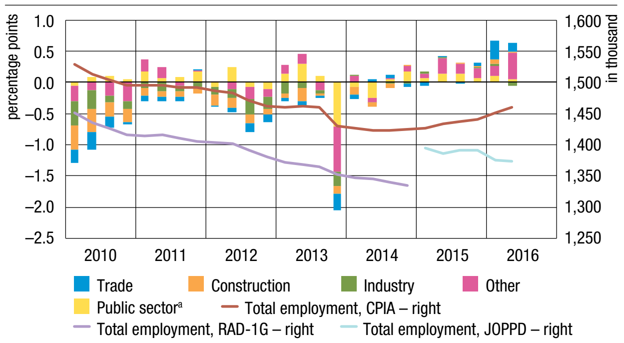


Sources: Ipsos and CNB data seasonally adjusted by the CNB.

4 Labour market

Favourable labour market trends at the end of 2015 intensified additionally in the first half of 2016. Total employment grew by 1.8% in the first half of 2016 from the same period of 2015, following the growth of 0.7% in the whole of 2015.[2] The number of employed persons grew in all sectors; however, this was mainly attributed to trade and other private sector service activities. Government incentives impacted the employment dynamics to a large extent.[3]

Figure 4.1 Total employment and contribution to the quarterly change in employment by sector
seasonally adjusted data



[a] Public administration and defence, compulsory social security, education and human health and social work activities.
Note: Around 20,000 insured persons were removed from the CPIA register due to administrative reasons in October 2013. The JOPPD form is now the source of data on employed persons and wages due to changes in the CBS methodology for collection and processing of data on employed persons and wages in effect as of January 2015. Structural columns show contributions by sector in accordance with CPIA data.
Sources: CBS and CPIA data seasonally adjusted by the CNB.

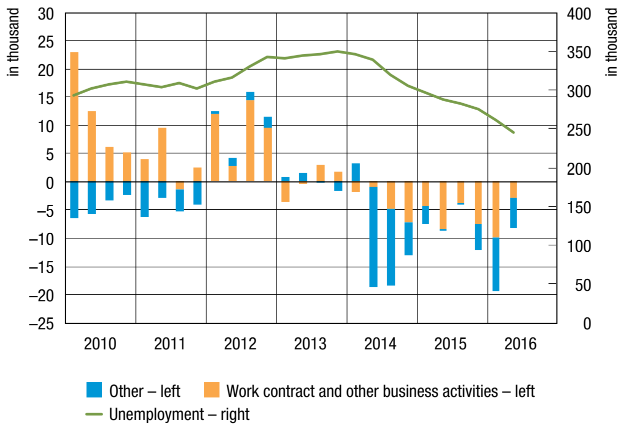
The decrease in unemployment accelerated in the first six months of 2016, and in June the number of unemployed persons was 10.8% lower than in December 2015. Unemployment decreased because of the intensified removal from the register for other reasons (non-compliance with legal provisions, outflow from the labour force, registration cancellation and failure to report regularly), but also for new employment.

The continued decrease in the number of unemployed persons in the first half of 2016 was also reflected in the decline in the registered unemployment rate, which in June dropped to 14.9%, its lowest level since July 2009 (Figure 4.3). The registered and ILO unemployment rates decreased significantly relative to the same period in 2015. Thus the registered unemployment rate on average stood at 16.1% (from 18.0% recorded in the first half of 2015), while the ILO rate decreased

2 The CNB uses CPIA data to assess employment trends. Administrative CBS data on the number of employed persons collected on the basis of the JOPPD form point to negative employment trends in the first half of 2016.

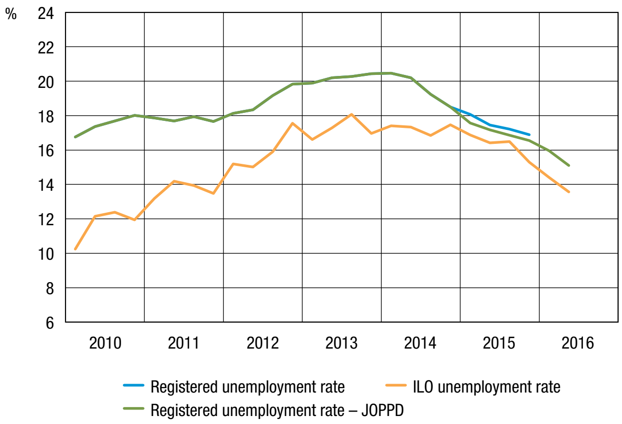
3 The largest positive contribution to the annual growth in total employment in the first half of 2016 was recorded in the category of employment of young people (persons under the age of 30) on open-ended contracts according to the Contributions Act (OG 143/2014), under which employers are exempted from payment of wage contributions for the period of five years, and on-the-job training without a work contract (Labour Act, OG 93/2014 and the Act on Employment Mediation and Unemployment Rights, OG 153/2013), with costs borne by the government.

Figure 4.2 Total unemployment and net inflows from unemployment
seasonally adjusted data



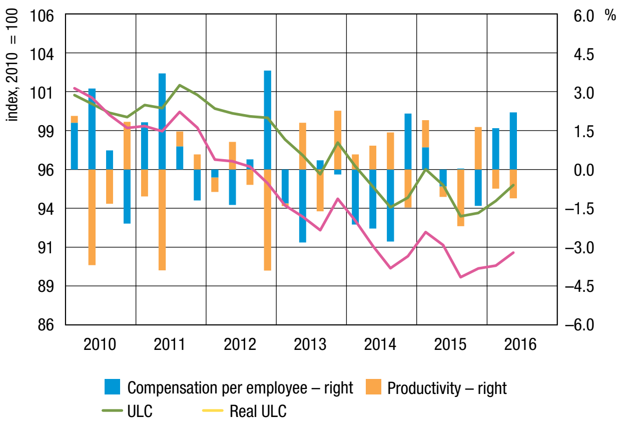
Source: CES data seasonally adjusted by the CNB.

Figure 4.3 Unemployment rate
seasonally adjusted data



Source: CBS data seasonally adjusted by the CNB.

Figure 4.4 Compensation per employee, productivity and unit labour costs
seasonally adjusted data, levels and quarterly rates of change



Note: Productivity growth carries a negative sign.
Sources: CBS and Eurostat data seasonally adjusted by the CNB.

to the average 14.1% (from 16.8%).

Although unit labour costs grew during the whole of the first half of 2016, on average they were at a lower level than in the same period of 2015 (Figure 4.4). Nominal gross wages in the first half of 2016 were 1.0% higher than in the previous year, which was positively contributed to by all sectors, except construction. The strongest rise in wages was recorded in the public sector. In addition, the annual growth of real wages was more prominent because of the decline in consumer prices, by which their purchasing power continued to grow.

5 Inflation

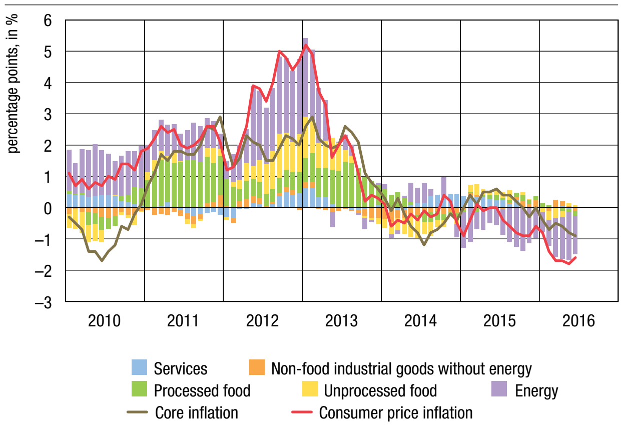
The decrease in the general price level in Croatia accelerated slightly in the first half of 2016. The average annual rate of change in consumer prices dropped to –1.5%, after reaching –0.5% in 2015. This was largely a result of the spillover of lower prices of oil and other raw materials in the global market onto domestic prices, followed by weak domestic inflationary pressures and low inflation in the euro area. In such circumstances, there were increased downward pressures on the prices included in the core CPI calculation, which, among other things, does not include energy and agricultural product prices. The average annual rate of change of this indicator declined from 0.2% in 2015 to –0.7% in the first half of 2016.

On the other hand, although the indicator of current developments in total inflation grew moderately during the first six months of 2016, it remained in slightly negative territory. This indicates a moderate weakening of short-term deflationary pressures. Furthermore, the inflation diffusion index shows that the share of the number of products the prices of which increased in a given month grew slightly in the total number of products. This share stood at 56.9% in June, which means that the prices of a majority of products in the HICP basket grew, while the negative rate of change refers to a relatively smaller share of products.

The annual rate of change in consumer prices fell from –0.6% in December 2015 to –1.6% in June 2016, with the contribution of the prices of industrial products, energy and processed food products dropping the most. Energy is the component that made the largest negative contribution to the annual rate of change in consumer prices, which went from –0.9 percentage points in December 2015 to –1.2 percentage points in June; this was mostly the result of the decline in the administrative price of natural gas. Core inflation moved into negative territory again, decreasing from 0% in December 2015 to –0.9% in June, i.e. mostly because of the fall in the prices of clothing, communication services, tobacco and milk and meat. Industrial producer prices in the domestic market (excluding energy) also accelerated the annual decline in prices, from –0.5% in December 2015 to –1.5% in June 2016, i.e. predominantly because of the decline in the prices of intermediate and non-durable consumer goods.

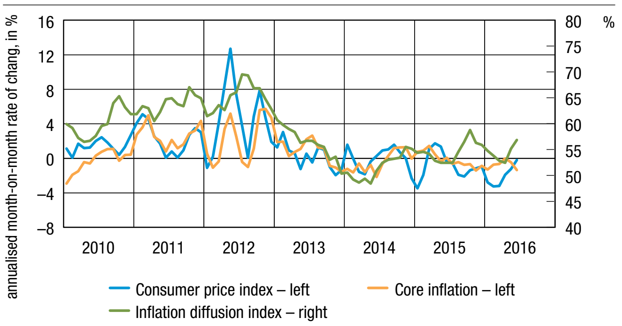
The movement of the deflator of imports of goods and services, whose annual decline accelerated in the first half of 2016, also indicated the strengthening of deflationary pressures resulting from the decrease in the prices of raw materials and finished products in the external environment. Since at the same time the annual fall in the deflator of exports of goods and services was relatively less pronounced, the trend of improvement in international trade conditions continued, which was present for the third consecutive year. This had a positive impact on the purchasing power of the household sector and the profitability of enterprises. In addition, the GDP deflator remained stable, and its annual rate of change remained in slightly negative territory.

Figure 5.2 Year-on-year inflation rates and contribution of components to consumer price inflation



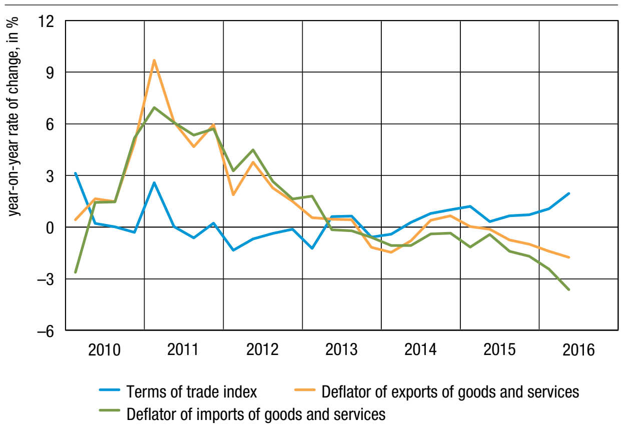
Sources: CBS and CNB calculations.

Figure 5.1 Indicators of current developments in inflation



Note: The month-on-month rate of change is calculated from the quarterly moving average of seasonally adjusted consumer price indices. The inflation diffusion index is measured by a 6-month moving average. Core inflation does not include agricultural product prices and administrative prices. The inflation diffusion index shows the share of the number of products whose prices increased in a given month in the total number of products and is based on the monthly rates of change derived from the seasonally adjusted components of the HICP.
Sources: CBS, Eurostat and CNB calculations.

Figure 5.3 Deflators of exports and imports of goods and services and the terms of trade index



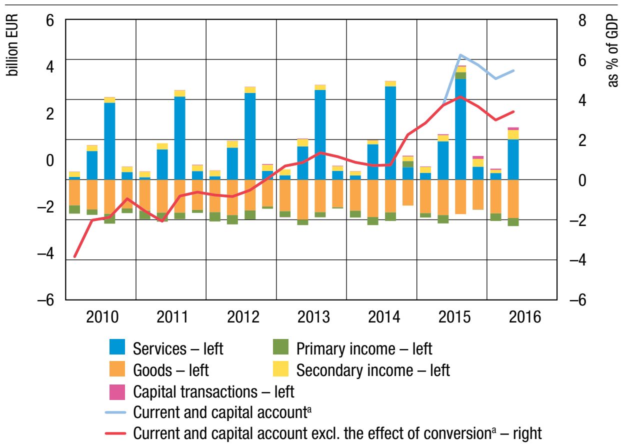
Source: CBS.

6 Current and capital account

The balance in the current and capital account deteriorated in the first half of 2016 from the same period of the previous year, fuelled by an increased deficit in the foreign trade in goods due to a faster growth in imports than in exports and an increased deficit in the primary income account, associated with revenues from direct investments. Increased use of EU funds and increased revenues from tourism had an opposite effect. If cumulative values over the past year are observed, the surplus in the current and capital account shrank to 5.4% of GDP in the second quarter of 2016, from 5.7% at the end of 2015.[4]

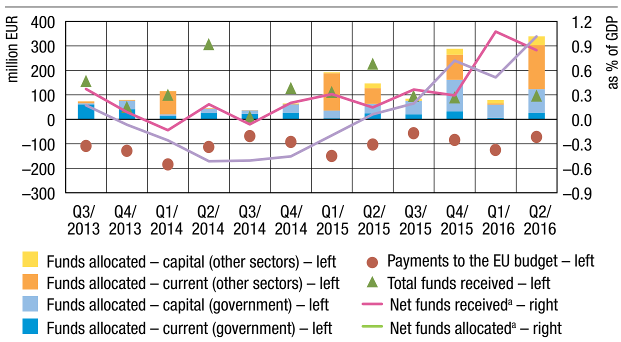
Net services exports rose in the first half of 2016 by 3.5% on an annual level, mostly as a result of favourable results in tourism. Revenues from travel services rose by 6.7%, witnessing a visible improvement in volume and financial indicators. Thus the number of foreign tourist arrivals rose by 2.4% and the number of nights by 5.1%, mostly attributable to tourists from the United Kingdom, Poland, Austria and Sweden. By contrast, the number of arrivals and nights of tourists from Germany, Japan and Italy fell. The increase in the surplus in the services account was also due to larger net exports of transport services, in contrast with the opposite effect made by deterioration in the balance of other services, particularly technical, trade-related and construction services.

Figure 6.1 Current and capital account balance and its structure



[a] Sum of the last four quarters.
Source: CNB.

Figure 6.2 Transactions with the EU budget



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

Net revenues in the secondary income account rose in the first half of 2016, largely as a result of lower payments into the EU budget, while the value of current transfers from EU funds was somewhat smaller than in the same period of the previous year. A surplus was also generated in the capital transactions account due to more intensive use of capital transfers from EU funds, particularly to the government. The average annual amount of surplus of the EU funds used over payments into the EU budget has been rising steadily and, according to June 2016 data, it reached 1.0% of GDP, still, however, a much poorer result than in peer Central and Eastern European countries.

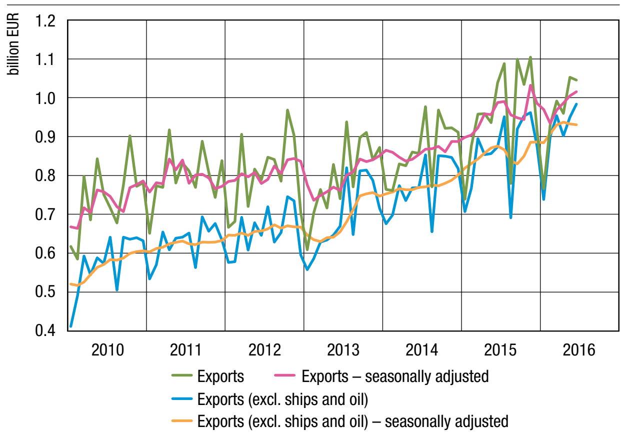
The deficit in the primary income account rose by a high one quarter in the first half of 2016 from the same period of the previous year, mostly driven by an increase in expenditures on direct equity investments. This is the result of better business results of foreign-owned enterprises, particularly those in financial intermediation activity, with bank profits almost doubling from the same period of the previous year. Another factor contributing to a higher primary account deficit was a decline in revenues from direct equity investments due to poorer business results of domestically-owned foreign enterprises. By contrast, higher revenues from compensations to residents working abroad and smaller interest expenditures for foreign liabilities, particularly of enterprises and banks, contributed to a reduction in the primary income account deficit.

The trade deficit rose in the first half of 2016 by 4.5% on an annual level, particularly due to the increased deficit in the trade in capital equipment and road vehicles. These developments were mitigated by a reduction in the deficit in the trade in refined petroleum products, spurred by a favourable impact of the fall in prices, and an improved balance in several fast-growing export sectors (Croatian goods exports witnessed a significant growth in the past three years. For more details, see Box 1 Changes in the dynamics and structure of Croatian goods exports since entry into the EU).

In the first half of 2016, goods exports accelerated from the previous half of the year, though at a much slower pace than in the same period of the previous year. Total goods exports thus rose by 2.6% from the previous half of the year, mainly driven by exports of the narrow aggregate (excluding ships and oil) which rose by 8.5%. Particularly strong were exports of capital equipment (electrical machinery, apparatus and appliances) and medical and pharmaceutical and food products (mostly sugar, fish and preparations) and leather and textile products. By contrast, exports of ships, which had been rising steadily

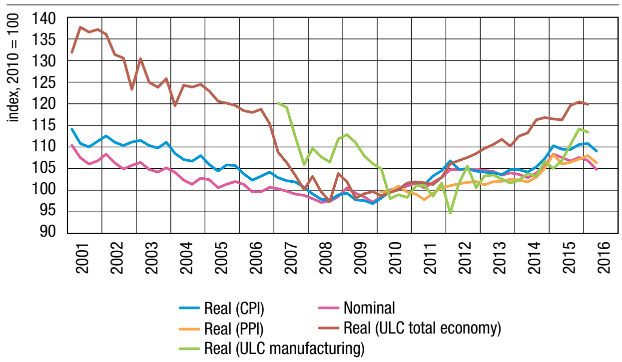
4 The effect of the cost of banks associated with the expected conversion of loans in Swiss francs, estimated at approximately 2% of GDP has been factored in.

Figure 6.3 Goods exports (f.o.b.)



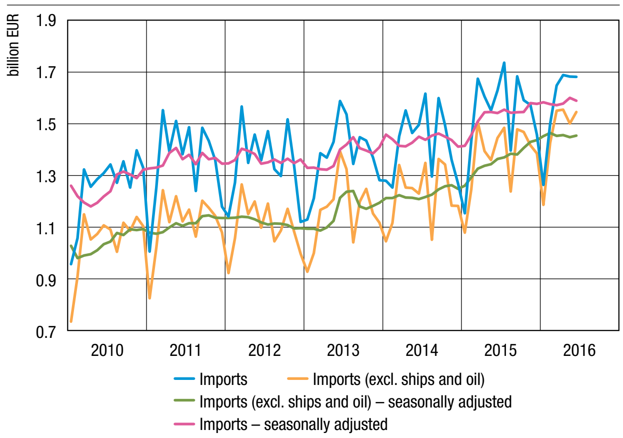
Note: Seasonally adjusted values are shown as three-member moving averages of monthly data.
Source: CBS data seasonally adjusted by the CNB.

Figure 6.5 Nominal and real effective exchange rates of the kuna



Note: Real effective exchange rate of the kuna deflated by producer prices includes the Croatian index of industrial producer prices on the non-domestic market, which is available from January 2010. The unit labour cost is calculated as the ratio between compensation per employee and labour productivity (defined as GDP per person employed). A fall in the index indicates an effective appreciation of the kuna.
Source: CNB.

Figure 6.4 Goods imports (c.i.f.)



Note: Seasonally adjusted values are shown as three-member moving averages of monthly data.
Source: CBS data seasonally adjusted by the CNB.

since the second half of 2014, fell considerably in the first six months of 2016. Exports of oil and refined petroleum products also continued to decline. Unfavourable developments were also seen in exports of other mineral fuels and lubricants and wearing apparel.

In the first half of 2016, goods imports rose by 1.3% from the previous half of the year. If ships and oil are excluded, imports grew even faster (3.1%), largely attributable to stronger imports of capital equipment (particularly general industrial machinery and machinery specialised for particular industries), road vehicles, metal industry products, and medical and pharmaceutical products. By contrast, imports of oil and refined petroleum products continued to fall and so did the imports of ships previously exported for finishing purposes. Imports of electricity and leather and textile products also fell.

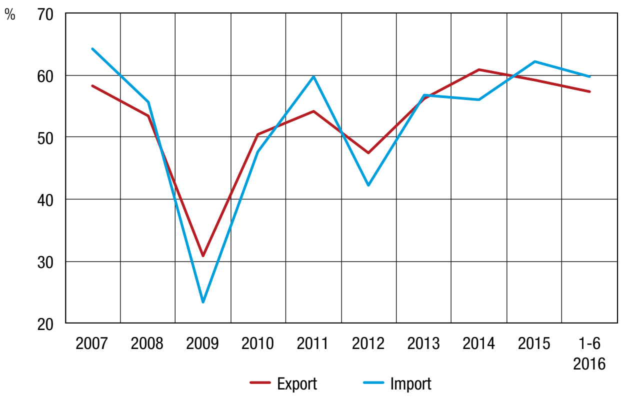
In the first half of 2016, the price competitiveness of Croatian exports remained almost unchanged from the previous year's average. In the first six months of 2016, the real effective exchange rates deflated by consumer and producer prices held steady at average 2015 levels, mostly owing to the fact that the low rate of change in domestic consumer and producer prices as compared to that in the main trading partners offset the effects of the nominal effective appreciation of the kuna. Data on the real effective kuna exchange rates deflated by unit labour costs available only for the first quarter of 2016 indicate a small fall in price competitiveness from the previous quarter.

Box 1 Changes in the dynamics and structure of Croatian goods exports since entry into the EU

Croatia's goods exports since accession to the EU have been very dynamic, widely diffused across a large number of products and mostly focussed on the European Union market. The importance of medium-sized and small enterprises in total export results is growing. There are also changes in the production structure of goods exports, with a growing, though still small, share in higher value-added products which also witness a pronounced growth in intra-industry trade.

The Croatian economy has undergone positive changes in the past three years, as seen in an ever increasing orientation of domestic producers to foreign markets. This is also confirmed by data on the sale of industrial products on the domestic and foreign markets showing that the growth in industrial production, present since end-2013, was determined primarily by foreign sales as well as by data on the average increase in goods exports of approximately 10% in the past two years. The diffusion index of exports growth also shows an increase in the number of products or sectors with rising exports. Namely, the share of products in the total number of approximately 3,000 production categories at 5-digit level of the Standard International Trade Classification (SITC 5) which has been rising steadily since the accession to the EU stood at almost 60% in 2015, a slight increase from the year prior to the crisis. Imports also saw a widely diffused growth.

Figure 6.6 Developments in the diffusion index of the Croatian goods exports/imports growth



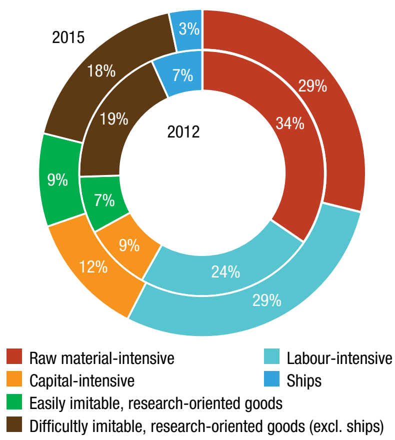
Note: Diffusion in exports (imports) growth is defined as the ratio between the number of products with a positive annual rate of change in exports (imports) and the total number of export (import) products (on 5-digit SITC level of aggregation).
Sources: CBS and CNB calculations.

The recovery in exports was driven by a considerable acceleration in demand growth for imports in some of the major Croatian trading partners, such as Italy, Slovenia or Austria, but even more by changes in trading terms with EU countries following Croatia's accession to the European Union, which facilitated trading procedures with other member states for Croatia, and in turn helped and accelerated exports. For example, the average number of days to expedite exports[5] fell to 16 days in 2014, from 20 days needed in 2012 and as many as 26 days in 2005. However, this is still below the EU average of 12 days, with poorer performance than that in Croatia being observed only in Hungary, the Czech Republic, Bulgaria and Italy. EU membership also meant the application of the common EU customs tariff policy, which led to the termination of all the existing free trade agreements that Croatia was a party to, the most significant being the Central European Free Trade Agreement (CEFTA). As a result, in contrast with the fast growth in trade with EU member states, the loss of a preferential status in trade with CEFTA countries had an unfavourable impact on exports to these countries, and a shift in trade directions was also witnessed in trade with third countries.

The analysis of changes in the market share of Croatian goods exports in the two years following Croatian accession to the EU, conducted by the European Commission,[6] shows that exports growth was widely diffused across smaller and more dynamic sectors, spurred by exports of a larger number of newer products, particularly to EU member states. This also led to changes in the structure of goods exports, with a rising share of easily imitable research-oriented goods (particularly medical and pharmaceutical products, plastics in non-primary forms and telecommunication apparatus) and capital-intensive goods (most notably electricity and road vehicles). By contrast, the share of difficultly imitable, research-oriented goods fell considerably, driven particularly by a fall in the exports of ships. In its analysis, the European Commission concluded that it was "positive that a rising share of goods exports involves less price-sensitive production and probably higher added value, although the share of raw material-intensive and labour-intensive goods remains considerable". The share of labour-intensive goods in the structure of exports increased partly due to growing repairs and processing activities.

There are also visible changes in the structure of export enterprises, with medium-sized and small enterprises growing in importance. Namely, in most countries, and particularly in small and open economies, exports are concentrated in a small number of enterprises. This is confirmed by the results of the CompNet research network of the ECB, according to which the average share of the 10 largest exporters in total Croatian goods exports between 2002 and 2014 stood at 30% on average and did not differ greatly from that of Central and Eastern European countries.[7] However, the last years of the observed period saw a fall in the share of the largest exporters and a small growth in the importance of medium-sized and small enterprises in total export

Figure 6.7 Goods exports by production categories
as % of total exports



Raw material-intensive goods: food products, raw materials, mineral fuels, animal and vegetable oils, etc.

Labour-intensive goods: textile, clothing and footwear, furniture, cork and wood, fabricated metal and non-metal products, etc.

Capital-intensive goods: electricity, road vehicles, iron and steel, beverages and tobacco, etc.

Easily imitable, research-oriented goods: medical and pharmaceutical products, organic and chemical products, plastics in non-primary forms, office machinery, telecommunication apparatus, etc.

Dificultly imitable, research-oriented goods: ships, electrical appliances, office machinery, scientific instruments, plastics in primary forms, etc.

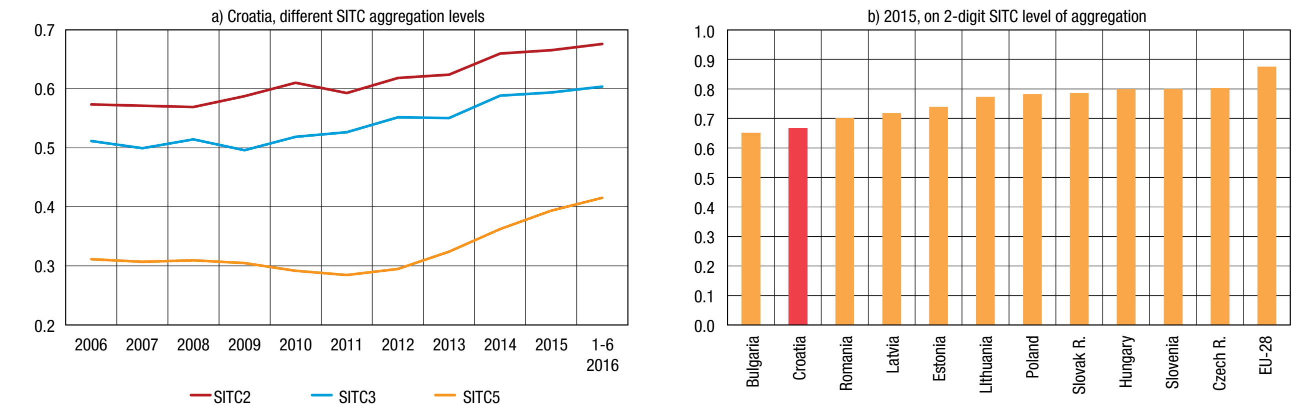
Sources: CBS and CNB calculations.

5 Source: World Bank, http://data. worldbank.org/indicator/IC. EXP. DURS.
6 Source: European Commission, Country Report Croatia 2016.
7 The results of the CompNet research network (ECB) are available at: https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1788.en.pdf.

Figure 6.8 Exports and labour productivity by size of enterprise

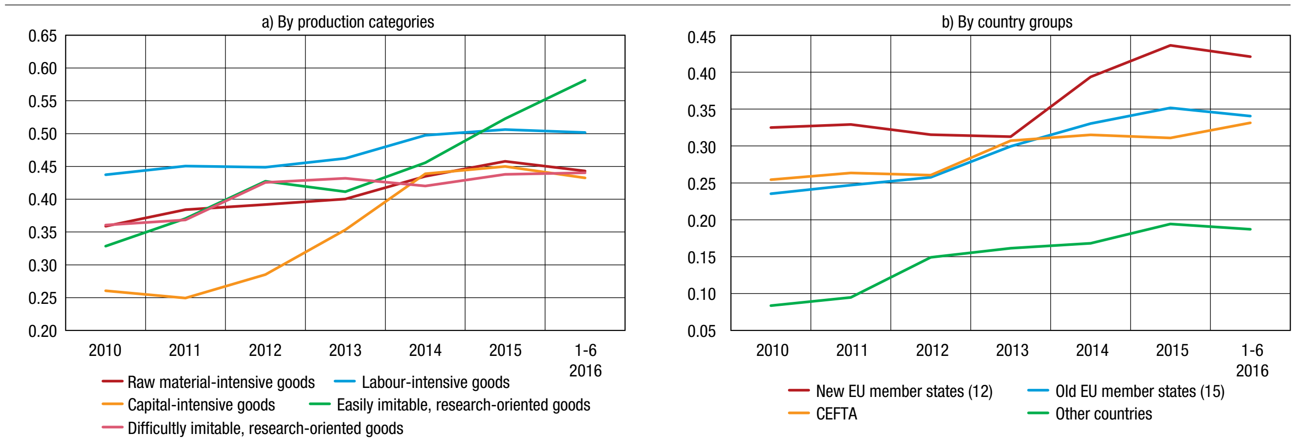
Note: Labour productivity is based on value added per employee. On average, small enterprises have up to 50 employees, medium-sized between 50 and 250 and large enterprises over 250 employees.
Sources: CompNet, ECB and CNB.

Figure 6.9 Intra-industry trade Gruber-Lloyd index



Sources: CBS and CNB calculations.

Figure 6.10 Disaggregated intra-industry trade Gruber-Lloyd index



Note: Gruber-Lloyd indices have been calculated for individual production categories/country groups, disaggregated on 5-digit SITC level of aggregation.
Sources: CBS and CNB calculations.

results. It was exactly these enterprises that witnessed a faster and stronger recovery in exports than large enterprises. In addition, these enterprises, particularly medium-sized enterprises, had a more powerful impact on the developments in total labour productivity in Croatia, in the wake of its entry into the EU.

Following Croatia's entry into the EU, the links between changes in exports and imports grew stronger. Among goods that contributed the most to growth in exports those that also contributed the most to growth in imports are often found, such as trade in electricity, clothing, road vehicles and miscellaneous manufactured articles. The usual positive correlation between developments in imports and exports may be explained by various factors such as dependence of exports on imports, transit trade (transit of goods through Croatia or import of goods for future re-export, generating profit on price differences) and processing activities; the increase in this correlation in the past few years was fuelled by liberalisation in the electricity trade, in addition to faster dynamics of the existing factors.

Stronger links between developments in exports and imports may point to a rising intra-industry trade,[8] i.e. the trade in goods from the same industry, which is as a rule more significant in the trade in more sophisticated goods and more to be found in the foreign trade of more open and developed countries. The Grubel-Lloyd index,[9] the most frequently used measure of intra-industry trade, shows that the degree of intra-industry trade in Croatia started growing strongly following the country's accession to the EU. However, it is still not as significant as in peer countries and is among the lowest of all EU member states, similar to that in Bulgaria and Romania.

Although intra-industry trade is usually the strongest in the trade in more sophisticated goods, in Croatia it is relatively high in the trade of labour-intensive goods (clothing, fabricated metal products, furniture and miscellaneous manufactured articles). However, the share of intra-industry trade in easily imitable, research-oriented goods (medical and pharmaceutical products, plastics in non-primary forms and telecommunication apparatus) and capital-intensive goods (electricity, road vehicles and essential oils and perfumes and toilet preparations) has been rising sharply since 2013. Observed by partner countries, the strongest intra-industry trade during the observed period was seen in the trade with EU member states, particularly new member states and it has strengthened additionally since Croatia's entry into the EU, while that with non-EU member states and the countries of the region was the slowest. A detailed analysis shows that intra-industry trade with new EU member states was mostly influenced by trade with Slovenia, which rose considerably, particularly trade in electricity and electrical machinery, apparatus and appliances, in the past years.

8 Intra-industry trade may be vertical, i.e. exports and imports of goods at different stages of production (for instance, export of quality clothing and import of poorer quality clothing) and horizontal which comprises trade in the same goods of different characteristics (e.g. different car types).

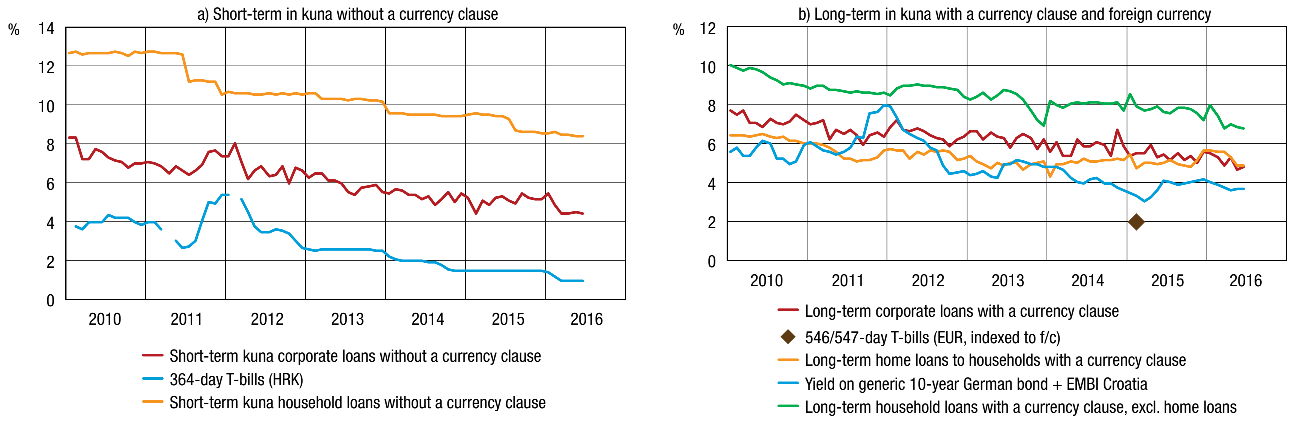
9 The value of the Grubel-Lloyd index ranges between 0 (inter-industry trade exclusively) and 1 (intra-industry trade exclusively) and is calculated as: $GL_i = \sum_i \left(1 - \frac{|Ex_i - Im_i|}{Ex_i + Im_i}\right) \times \frac{f_i}{F}$, where Ex_i is exports, Im_i imports, and f_i volume of trade in goods (exports + imports) in an individual sector i, and F volume (exports + imports) of the total trade in goods, or its subaggregate for which the index is being calculated. The level of data disaggregation has a big impact on the final value of the index, given that a smaller share of trade is classified as intra-trade with industry narrowing on higher levels of disaggregation (e.g. SITC 5).

7 Financing conditions and capital flows

The developments in the costs of domestic sectors' financing in the first half of 2016 were mostly favourable. The interest rate on one-year kuna T-bills fell from 1.48% at end-2015 to 0.94% in June 2016, the lowest level ever. The average short-term interest rates on kuna bank loans in the first six months of 2016 were lower for all the sectors compared to the previous year average and end-2015. Long-term costs of bank financing with a currency clause were also more favourable than at the end of the previous year. The fall in interest rates was also spurred by a fall in the cost of sources of bank financing, as reflected in the fall in the NRR[10] and EURIBOR. The only interest rate that rose was that on home loans which saw a temporary hike from December 2015 to April 2016, but this was due to the conversion of loans with a currency clause in the Swiss franc into loans with a currency clause in the euro. The interest rates on converted loans, determined by a special law and recorded in interest rate statistics as newly negotiated euro loans, were mostly higher than market interest rates applicable at the time.

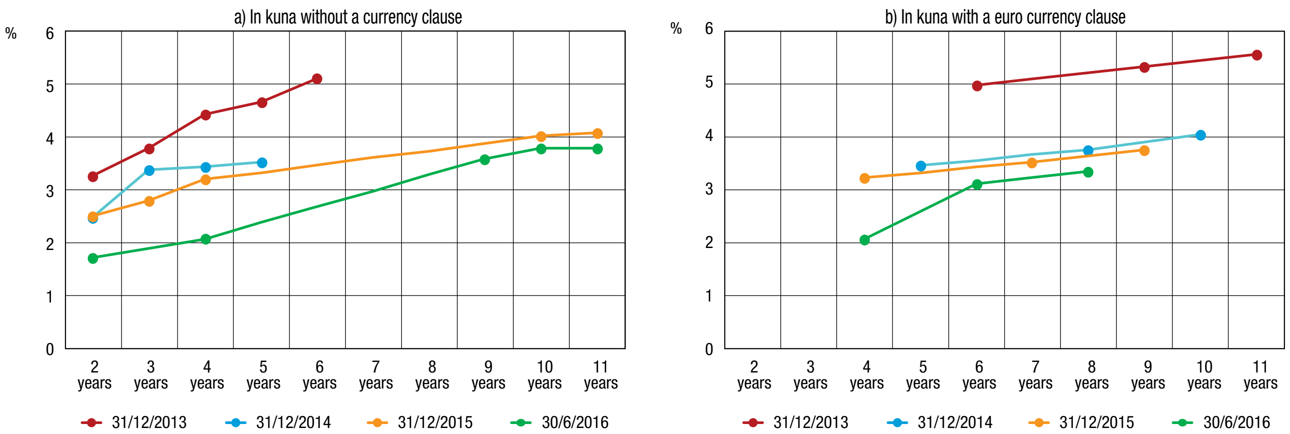
The cost of government borrowing abroad, estimated by the sum of yields on the German government bond and EMBI indicator for Croatia, fell in the first half of 2016, primarily as a result of the fall in yields on long-term German borrowing. Nevertheless, the issue of foreign government bonds, planned

Figure 7.1 Costs of financing of domestic sectors



Note: EMBI (Emerging Market Bond Index) is the spread between yields on government securities of emerging markets, including Croatia, and risk-free securities of developed countries.
Sources: MoF, Bloomberg and CNB.

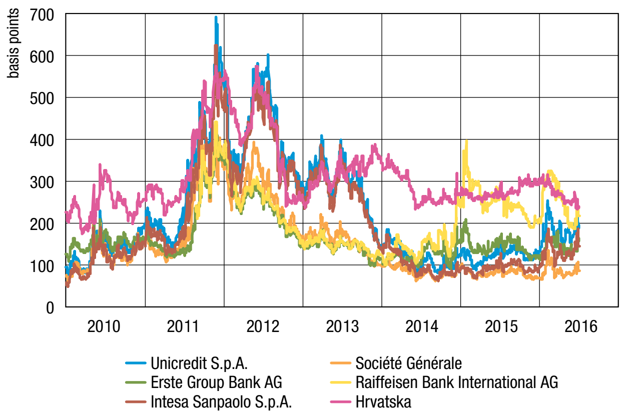
Figure 7.2 Yield-to-maturity on RC bonds



Note: Dots show achieved yields; other values are interpolated.
Source: CNB.

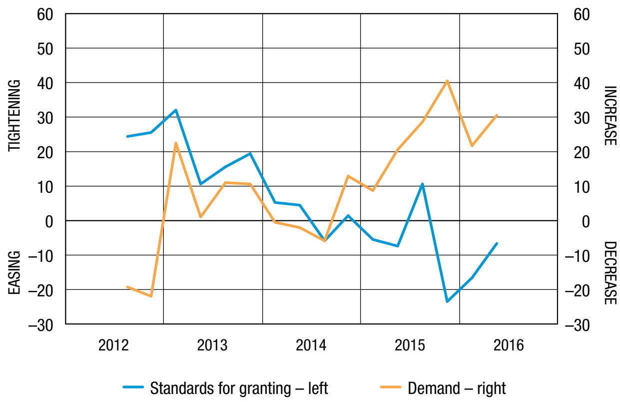
10 The national reference rate (NRR) is the average interest rate paid on deposits by the banking sector which is used as one of the benchmark interest rates for determining the level of the variable component of the variable interest rate on loans, in accordance with Article 11a of the Credit Consumer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

Figure 7.3 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: S&P Capital IQ.

Figure 7.4 Standards for granting loans and corporate demand for loans



Note: Data represent the net percentage of banks weighted by the share in total loans to corporations.
Source: CNB.

for May, was postponed due to political uncertainties in the country at the time. The yields on Croatian government bonds rose slightly towards the end of June owing to financial market instabilities following the referendum decision of the United Kingdom to exit the European Union. At the same time, the yields on German government bonds fell further, also spurred by referendum results, pushing upwards the yield spread between Croatian and German government bonds.

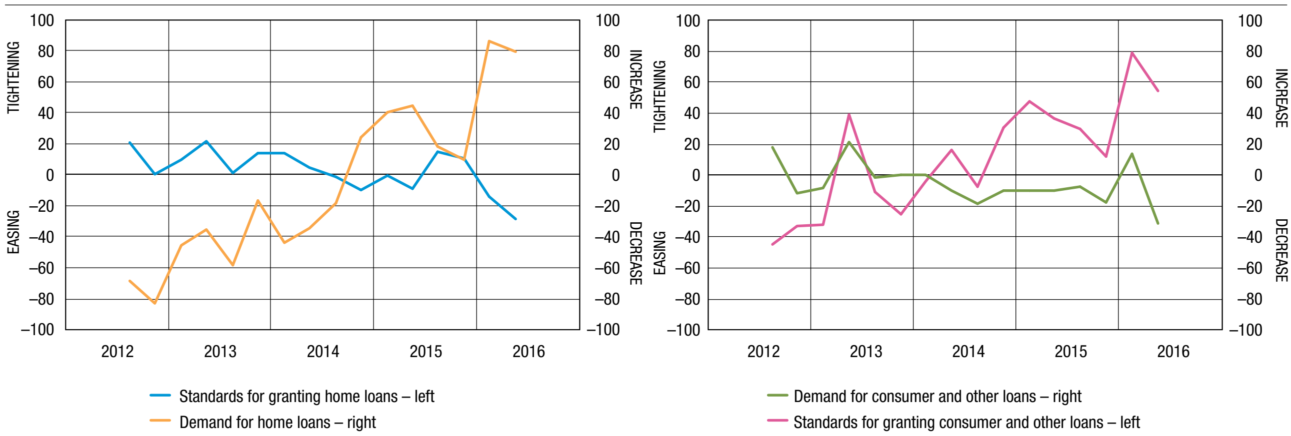
The yield on the four-year kuna bond without a currency clause at the end of June 2016 was 1.1 percentage point lower than at the end of the previous year, while at the same time the yield on the six-year kuna bond with a currency clause in euro fell by approximately 0.3 percentage points. The yield curve on Croatian government bonds of all maturities has been falling visibly since end-2013. It was largely influenced by the effect of expansionary monetary policies on the financial markets.

In the first quarter of 2016, CDSs for parent banks of the largest Croatian banks reached the highest levels in the past two years due to rising concerns of the financial markets regarding future profitability of banks. This was followed by a short period of stabilisation. However, in the wake of the UK referendum decision to exit the EU, parent banks' CDSs rose again and at the end of June were higher than at the end of 2015. By contrast, at mid-year, the CDS for Croatia was lower than at the end of 2015, though holding at a much higher level than those in peer countries.

With favourable developments in domestic interest rates, standards for granting loans and corporate demand for loans continued to improve steadily throughout the first half of 2016. According to the results of the Bank Lending Survey, the easing of granting standards for enterprises was mostly due to competition among banks, their liquidity and positive expectations regarding general economic developments while the surge in demand was largely driven by the need for inventories and working capital financing and debt restructuring.

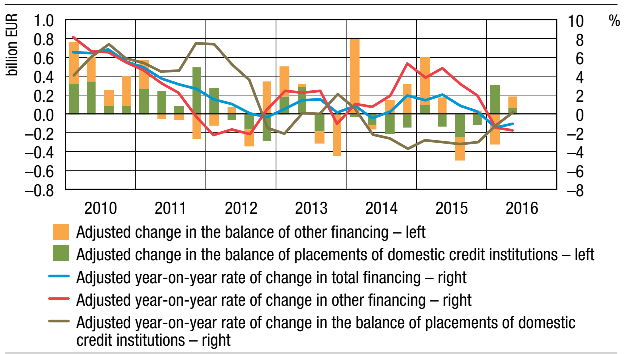
As regards the household sector loan demand and supply, banks' responses to the Bank Lending Survey in the first half of 2016 point to the most favourable developments in demand for consumer and home loans since the Survey was first introduced, i.e. from end 2012. The increased demand for home loans was mostly due to consumer confidence and the

Figure 7.5 Standards for granting loans and household demand for loans



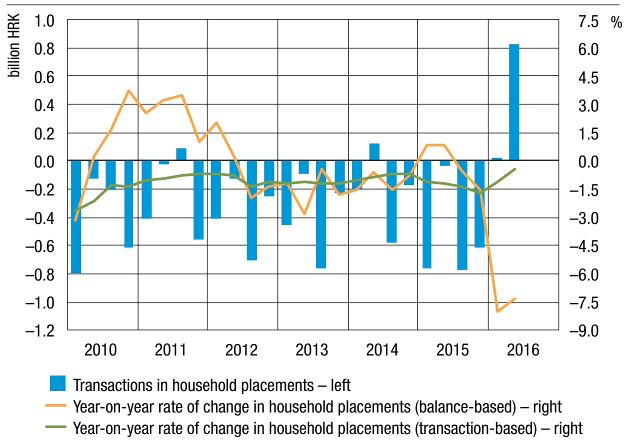
Note: Data represent the net percentage of banks weighted by the share in total loans to households.
Source: CNB.

Figure 7.6 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 are calculated on the basis of data on transactions in placements of domestic credit institutions and data on the developments in external debt which do not include the effect of the assumption of loans to the shipyards by the Ministry of Finance in 2012 and the effect of the transformation of debt into equity.
Sources: HANFA, CNB and CNB calculations.

Figure 7.7 Placements to households



Source: CNB.

increased demand for consumer and other loans was due to spending on durable consumer goods. As regards loan granting standards, in the first half of 2016, those applied to home loans were relaxed the most since the Survey was first conducted, mostly owing to competition among banks and lower costs of bank sources of financing. As regards consumer and other household loans, the trend towards a steady easing of the standards for granting these loans that started in early 2014 continued into the second quarter of 2016, after a temporary tightening in the first quarter of the year.

The total debt of non-financial corporations held steady in the first quarter of 2016 but rose in the second quarter of the year. However, the annual rate of change in total corporate debt at the end of June was negative and stood at –1.0%, but this was largely the result of corporate deleveraging in the second half of 2015. The first half of the year saw a change in the structure of corporate financing from the previous several years. On an annual level, corporate financing from domestic credit institutions rose for the first time after having fallen for two years. Domestic financing from other sources also rose. By contrast, the public and the private corporate sectors continued to deleverage abroad on an annual level in the second quarter of 2016. Public enterprises witnessed a more pronounced fall in deleveraging.

The developments in household placements in the first half of 2016 were more favourable than in the same period of the previous years. Placements to households thus rose by 0.7% (transaction-based) in the first six months of 2016, with a particularly sharp increase in kuna lending. The annual growth rate in kuna placements to households, transaction-based, stood at 23.2% in mid-2016, while foreign currency placements to households fell by 10.1%. This helped slow down the trend of deleveraging on an annual level, with the annual fall in household placements at the end of June standing at –0.4%, compared to –1.7% at the end of 2015. In mid-2016, general-purpose cash loans made the biggest contribution to growth in household placements. By contrast, home loans made the biggest contribution to household deleveraging, due to a fall in foreign currency home loans, in contrast with home loans in kuna which grew considerably, their stock in the first half of 2016 rising by 46.9%. The nominal stock of total loans to households declined significantly in the first half of 2016, largely driven by the process of conversion and partial write-offs of loans in Swiss francs launched in more substantial amounts in December last year. From end-November 2015 to end-June 2016, household loans linked to the Swiss franc fell from HRK 21.7bn to HRK 2.1bn, with HRK 11.2bn having been converted into the euro and HRK 5.9bn having been written off. In addition to the process of conversion, the fall in the stock of claims from households was also driven by the sale of non-performing loans, which amounted to HRK 0.6bn in the first half of 2016.

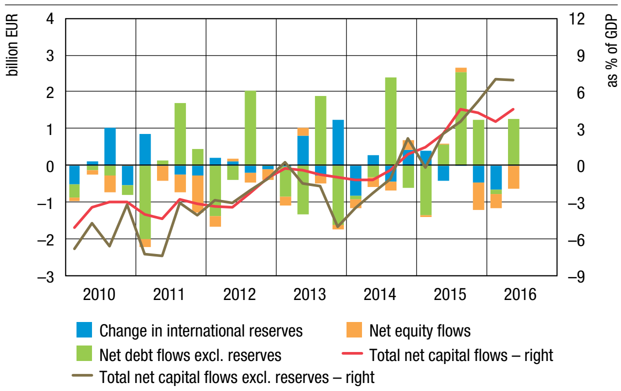
7.1 Capital flows between Croatia and foreign countries

In the first half of 2016, the financial account of the balance of payments, excluding the change in international reserves and CNB liabilities,[11] saw only a slight net outflow of equity abroad (EUR 0.1bn). This was due to a considerable improvement in the net debt position of domestic sectors, particularly in the pronounced decline in foreign liabilities of the government and credit institutions, which was accompanied by almost the same increase in net equity liabilities. As a result, the relative indicators of gross and net external debt (expressed as a share in GDP) improved from the end of December 2015.

The considerable net inflow from equity investments in the first half of 2016 was largely influenced by a sharp increase in reinvested earnings on the liabilities side. This was mostly associated with the financial intermediation activity, with banks' reinvested earnings rising significantly from the same period of the previous year, driven by high profits earned in the current period. Dividend payments leading to a reduction in reinvested earnings and a fall in equity investments were also extremely low following last year's losses associated with the cost of the expected conversion of loans in Swiss francs. In addition, direct equity investment in Croatia rose, mainly due

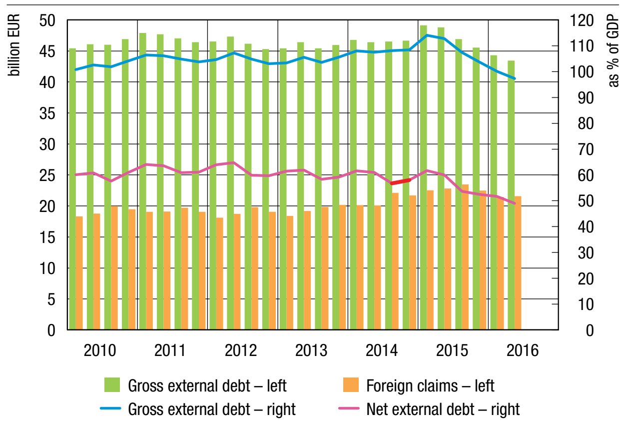
11 The investment of a share of international reserves in repo agreements resulted in an increase in gross international reserves and an increase in the external debt of the CNB in the same amount.

Figure 7.8 Financial account flows



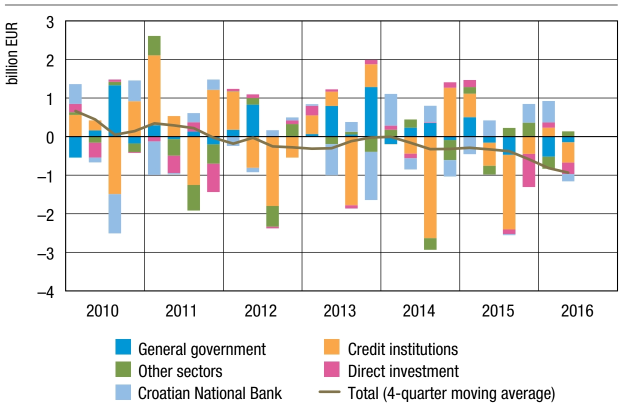
Note: A positive value indicates net outflow of equity abroad. Net flows represent the difference between the change in assets and the change in liabilities. Total net capital flow series are shown as the sum of the last four quarters. Interantioanl reserves show the change in gross international reserves net of the liabilities of the CNB.
Source: CNB.

Figure 7.10 Gross and net external debt



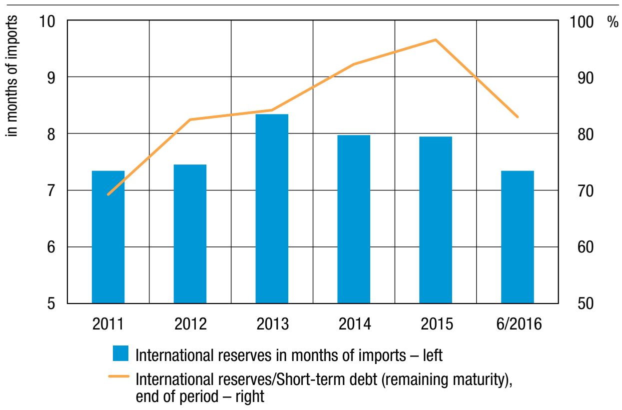
Note: Net external debt is calculated as gross external debt stock net of foreign debt claims.
Source: CNB.

Figure 7.9 Net external debt transactions by sectors



Note: Transactions refer to the change in debt excl. cross-currency changes and other adjustments. Net external debt is calculated as gross external debt stock net of foreign debt claims.
Source: CNB.

Figure 7.11 International reserves adequacy indicators



Note: The calculation for 2016 includes data on the stock of reserves and external debt as at end-June 2016 and the average monthly value of imports of goods and services in the previous one-year period.
Source: CNB.

to debt-to-equity swaps, while new investments remained very modest and mostly took place in retail trade and real estate activities and other business activities. Net inflows from equity investments were influenced by their decline on the assets side.

The net capital outflow based on debt investment of EUR 1.1bn in the first half of 2016 was the result of a sharp decline in foreign liabilities, in contrast with a smaller fall in foreign assets. The general government witnessed the biggest improvement in its net debt position to foreign creditors, as a result of a fall in long-term liabilities based on debt securities and loans. It was followed by credit institutions which witnessed a fall in foreign liabilities and a twice as small decline in foreign assets. The deleveraging of other domestic sectors in relation to affiliated foreign creditors can fully be attributed to a transaction in one business group (the reduction in the liabilities of an enterprise was financed by a sale of foreign equity assets) and debt-to-equity transactions. By contrast, net liabilities of other domestic sectors towards non-affiliated creditors rose, exclusively owing to an increase in trade credits.

The total gross external debt of the Republic of Croatia, based on stock at end-June 2016 fell by EUR 2.0bn in the first half of 2016 (if the effects of cross-currency changes and other adjustments are excluded). The deleveraging was of almost the same intensity as in the previous year, and if observed by individual sectors, credit institutions and the government were particularly active in this regard. At the same time, cross-currency changes and other adjustments of EUR 0.1bn had an additional impact on the fall in in the stock of gross external debt which fell to EUR 43.4bn or 97.3% of GDP at the end of June, from 103.7% of GDP at the end of the previous year. Given a fall in the foreign assets of the domestic sectors, the fall in net external debt in the first half of 2016 was two times smaller than that of gross external debt (if the effects of cross currency changes and other adjustments are excluded). At end-June, the net external debt fell to EUR 21.9bn, accounting for 49.0% of GDP (52.5% at the end of 2015).

Gross international reserves fell by a total of EUR 0.8bn in the first half of the year, mostly as a result of a CNB decision to suspend the foreign currency reserve requirement allocation to an account with the central bank and, to a lesser extent, withdrawals from the government foreign currency deposit account with the CNB. At the end of June, gross international reserves stood at EUR 12.9bn, sufficient for the coverage of 7.3 months of goods and services imports compared to 7.9 months of imports at the end of the previous year. In addition, due to a somewhat more pronounced increase in short-term debt by remaining maturity,[12] its coverage by international reserves fell from 96.5% at end-2015 to 82.9% at end-June 2016.

12 The growth in short-term debt on a remaining maturity basis from end-2015 is largely the result of the maturity of a long-term debt falling due in the second quarter of 2017 consisting of USD 1.5bn worth government bond issued in 2012 on the American market, with a currency risk hedge, and of EUR 250m worth bond issued by the CBRD in 2007.

8 Monetary policy

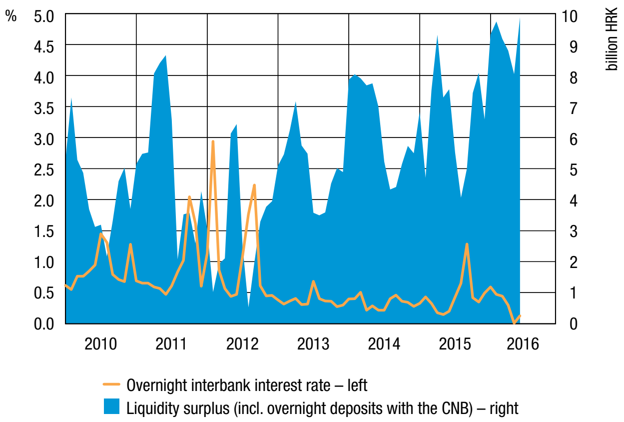
In the first half of 2016, the CNB continued to pursue an expansionary monetary policy and to maintain the stability of the exchange rate of the kuna against the euro. Surplus kuna liquidity rose from the average HRK 6.7bn in 2015 to HRK 9.2bn in the first half of 2016. In such conditions, the overnight interest rate on the interbank money market, which witnessed a noticeable fall in the volume of trading, fell to 0.13% in June, from 0.49% in December of the previous year. The yields on MoF kuna T-bills and the kuna yield curve on government bonds also fell.

The expansionary orientation of the monetary policy received a further boost with the introduction of long-term kuna structural repo operations. In the first half of 2016, two out of the total of four planned structural repo auctions were held. At these auctions, the CNB granted to the banks a total of HRK 711.5m for a four year term at a fixed interest rate of 1.8% (of which HRK 565.0m were placed at the auction in February and HRK 146.5m at the auction in May). These operations provided the banks with access to longer term sources of kuna liquidity which should in turn help maintain the trend of increased bank lending in the domestic currency, which accelerated further in the first half of 2016. The CNB continued to hold regular weekly reverse repo operations at a fixed interest rate of 0.5%. However, in the conditions of ample surplus kuna liquidity, the average balance of funds placed at these auctions in the first six months of this year stood at only HRK 117.5m.

Foreign exchange transactions of the CNB had a negative net effect on kuna liquidity in the first half of 2016. The central bank sold net EUR 17.5m worth of foreign exchange, withdrawing HRK 142.5m, without undermining the high monetary system liquidity. The increase in kuna liquidity was spurred by a foreign exchange intervention made towards the end of May, at which the central bank purchased a total of EUR 83.5m, thus creating HRK 625.6m. In addition, in the foreign exchange transactions with the MoF in the first half of the year, the CNB purchased EUR 109.7m worth of foreign exchange. The sale of EUR 210.7m worth of foreign exchange to the European Commission had the opposite effect.

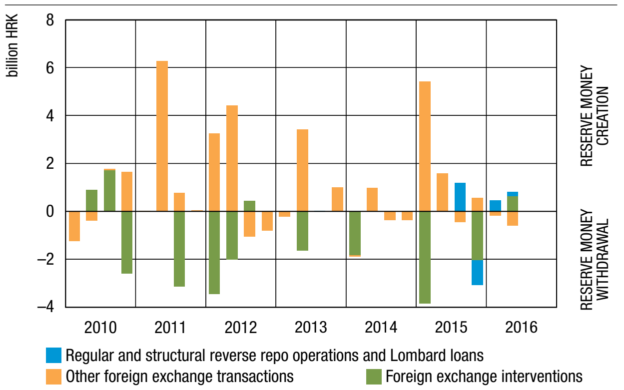
The nominal exchange rate of the kuna against the euro in the first six months of 2016 strengthened, having fallen from EUR/HRK 7.64 at the end of 2015 to EUR/HRK 7.51 at the end of June. Rising appreciation pressures on the kuna since March were in part also associated with good results in tourism, increased inflow of EU funds and expectations regarding the announced issuance of government bonds in the foreign market (postponed afterwards). To alleviate these pressures, the CNB intervened in the foreign exchange market on 31 May, purchasing EUR 83.5m and halting the strengthening of the kuna. As regards the average exchange rate, in the first half of 2016 it fell by 0.9% from the same period of the previous year. The exchange rate of the kuna against the American dollar and the Swiss franc also appreciated in the first half of 2016, mostly due to the strengthening of the euro on global

Figure 8.1 Bank liquidity and overnight interbank interest rate



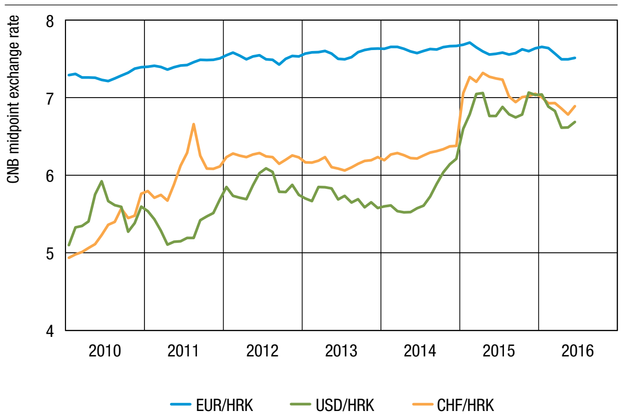
Source: CNB.

Figure 8.2 Flows of reserve money (M0) creation



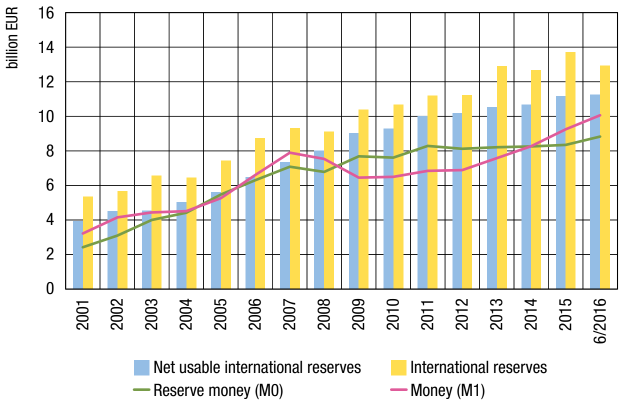
Note: Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and the EC as well as foreign currency swaps with banks, where the positive values refer to the purchase of foreign exchange by the CNB.
Source: CNB.

Figure 8.3 Nominal exchange rates of the kuna against selected currencies



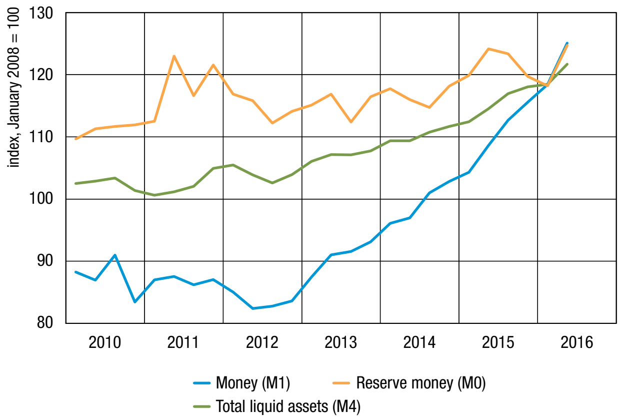
Source: CNB.

Figure 8.4 International reserves of the CNB and monetary aggregates



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

Figure 8.5 Monetary aggregates
index of developments in seasonally adjusted values, deflated by the consumer price index



Source: CNB.

foreign exchange markets.

At the end of June 2016, gross international reserves stood at EUR 12.9bn, a decrease of EUR 0.8bn (5.6%) from the same period of the previous year. The fall in gross reserves was largely (EUR 0.5bn) the result of decision to suspend the foreign currency reserve requirement allocation to the account with the CNB. This decision made it possible for the banks to take a more flexible approach to foreign exchange liquidity management, allowing them to meet the total foreign exchange component of reserve requirements by average daily balances of foreign currency assets The fall in gross reserves was also due to the use of the government foreign currency deposit with the CNB, which stood at EUR 411.8m at the end of 2015 and fell to EUR 241.0m by the end of June. Since these factors do not have an effect on the development in net usable reserves, these reserves rose slightly from end-2015 (1.0%) and at the end of June stood at EUR 11.3bn. Gross and net international reserves again considerably exceeded the balance of the narrowest monetary aggregates, M0 and M1.

The real seasonally adjusted values of money (M1) and total liquid assets (M4) continued to grow steadily in the first half of 2016. With subdued inflation continuing, the real growth in monetary aggregates was certainly boosted by growth in private sector lending and, in general, recovery in the domestic economy. Particularly noticeable was the growth in money (M1) as a result of a further fall in interest rates on savings and time deposits and the recovery in economic activity. The real value of reserve money (M0) also rose in the second half of 2016.

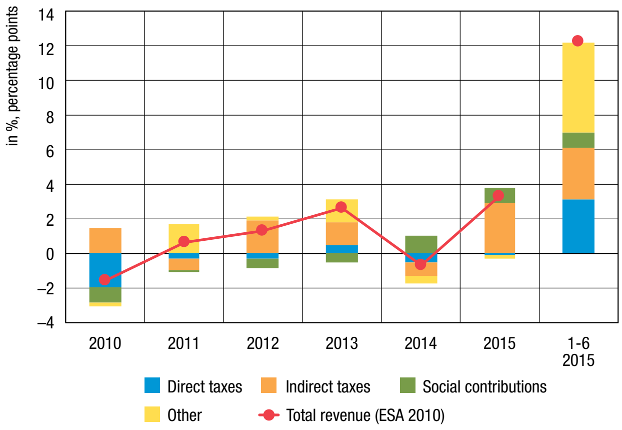
9 Public finance

Data on the execution of the consolidated general government budget in the first half of 2016 point to a sharp reduction in the deficit from the same period of the previous year. Such developments can be attributed to favourable results on the revenue side of the budget, mainly reflecting the recovery in economic activity, and stifled growth on the expenditure side of the budget partly also due to interim financing in the first quarter of the year.

The first half of 2016 was marked by favourable developments in all major items on the revenue side of the general government budget (measured by ESA 2010 methodology). Total revenues thus rose by 12.2% from the same period of 2015, with tax revenues, particularly those from direct taxes making the biggest contribution to this growth. Particularly evident was the growth in revenues from profit tax as a result of a considerable growth in entrepreneurs' profit in 2015 and the introduction of more restrictive terms for the use of tax reliefs based on reinvested earnings.[13] Indirect taxes also made a large contribution to total revenue growth in the first half of the year, as a result of a cyclical recovery in personal consumption and greater revenues from excises on refined petroleum products and tobacco products.[14] Revenues from social contributions also rose, reflecting favourable developments in the labour market. Positive developments were also seen in other revenues, particularly capital revenues, largely attributable to greater use of EU funds.

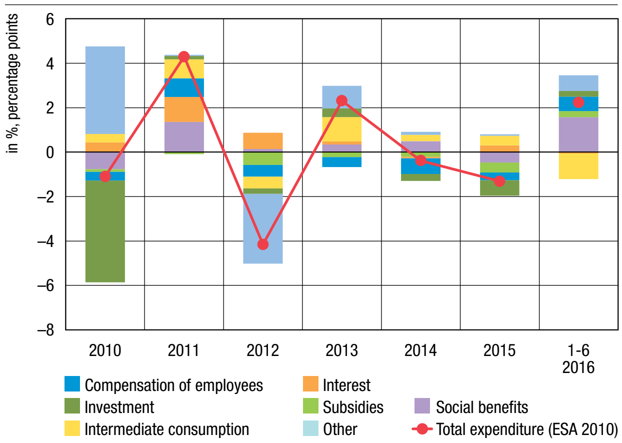
The expenditure side of the consolidated general government budget (ESA 2010 methodology) saw an increase of 2.2% in the first half of 2016, from the same period of the previous year. The increase was particularly evident in the second quarter following the beginning of the regular execution of the state budget and financial plans of extrabudgetary users. Expenditures for social benefits made the biggest contribution to expenditure growth, related to an increase in expenditures in the health sector, a small growth in expenditures for pensions due to an increase in the number of pensioners and pension indexation and an increase in expenditures for social welfare. According to CPIA and CBS data, the rise in employee compensations is due to a simultaneous rise in the number of civil servants and government employees and an increase in the average gross wage. Capital expenditures also rose sharply, as a result of improved withdrawal of EU funds. By contrast, expenditures for interest fell from the first half of 2015, as a

Figure 9.1 Consolidated general government revenue (ESA 2010)
year-on-year rate of change and contributions



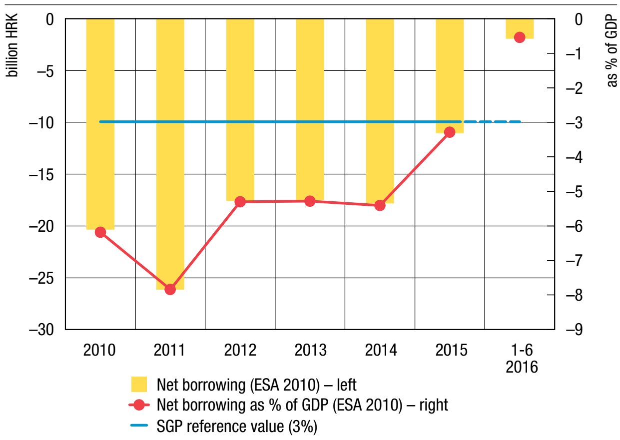
Sources: Eurostat and CNB calculations.

Figure 9.2 Consolidated general government expenditure (ESA 2010)
year-on-year rate of change and contributions



Sources: Eurostat and CNB calculations.

Figure 9.3 Consolidated general government balance (ESA 2010)

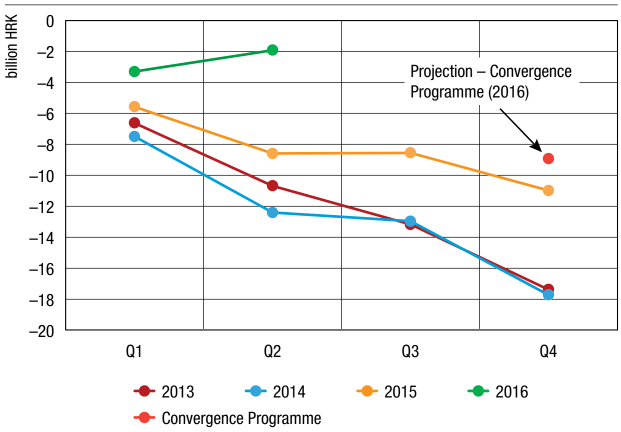


Note: SGP – Stability and Growth Pact. GDP for the first half of 2016 is calculated as the sum of the last four available quarterly data.
Sources: Eurostat and CNB calculations.

13 Faster growth in the first half of the year can also be attributed to the fact that the last day of April fell on a weekend, so end-of-year calculation cash payments were partly transferred to May. To record revenues from profit tax according to ESA 2010 methodology, the four month lag rule is applied.

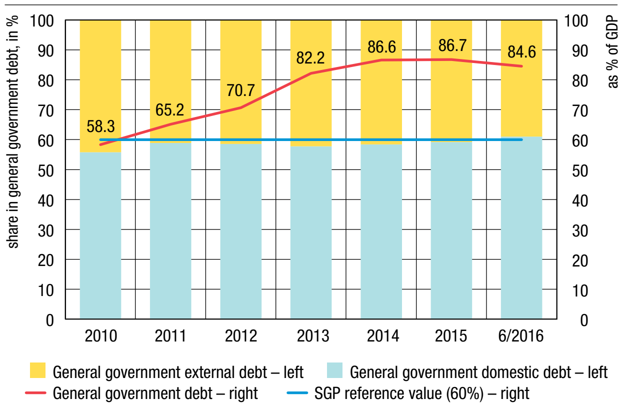
14 In the first quarter of 2015 lower excises applied to these groups of products.

Figure 9.4 General government cumulative balance by quarters (ESA 2010)



Sources: Eurostat and CNB calculations.

Figure 9.5 General government debt



Note: Nominal GDP calculated as the sum of GDP for the second quarter of 2016 and the last three available quarterly data was used for the calculation of the relative indicator at the end of June 2016.
Source: CNB.

result of the favourable influence of the fall in government borrowing costs.

The mentioned increase in revenues and the limited rise in expenditures in the first half of 2016 resulted in further fiscal adjustment. The general government deficit under the ESA 2010 methodology fell by HRK 6.6bn to HRK 1.9bn from the same period of the previous year. The general government deficit to GDP ratio (GDP calculated as the sum of the last four quarters) stood at 0.6% of GDP in the first half of the year.

Towards the end of June, the consolidated general government debt stood at HRK 285.7bn, a decrease of HRK 3.9bn from the end of 2015. The same period saw a rise in GDP, so the debt shown in terms of GDP fell to 84.6%. The reduction in debt amount was due to the appreciation of the kuna against the euro and financing of a part of the deficit by funds deposited in the previous periods. In addition to T-bills, in the first half of the year, the government issued HRK 4.0bn worth of 10-year bonds.

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 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.

10.1.1 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 liquidity level 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 and by imposing limits on maximum exposure for each investment category. Interest rate risk, or the risk of a fall in the value of the international reserves portfolio due to a possible 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 in 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.

10.1.2 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 obligations assumed, depending on the way in which international reserves are formed.

The component of international reserves acquired through outright purchases of foreign currency from banks and the MoF, 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 deposits of the Ministry of Finance, repo agreements with banks, foreign currency swaps in the domestic market, IMF membership and other assets owned by other legal persons, is managed by the CNB in accordance with obligations assumed, the aim being to ensure protection against currency and interest rate risks.

The CNB manages the funds based on allocated foreign currency reserve requirements in accordance with the currency structure of the obligations assumed while the maturity of investments may be different from the maturity of the obligations.

The component of international reserves managed by the CNB in line with its own guidelines can be kept in held-for-trading and investment portfolios or may be entrusted to foreign asset management companies. Held-for-trading portfolios, comprising held-for-trading financial instruments, are important for maintaining the daily liquidity of international reserves. The minimum daily liquidity and held-for-trading instruments used for daily liquidity maintenance are prescribed by a Governor's decision. Held-for-trading portfolios are carried at market (fair) value through profit and loss. Investment portfolios may be formed as held-to-maturity portfolios or available-for-sale portfolios.

The terminology of reporting on CNB international reserves includes the terms of gross and net reserves. The term gross reserves implies total international reserves. "Net reserves" refers to that component of the reserves managed by the CNB in line with its own guidelines.

10.2 International reserves in the first half of 2016

In the first six months of 2016 financial markets were marked by a strong decline in yields of government securities of developed countries due to expansionary monetary policies of the world's leading central banks and increased demand of investors for safer investments. A contribution to this came from expectations that the European Central Bank (ECB) would lower its benchmark rates and expand its quantitative easing programme, as well as expectations that the Federal Reserve would slow down the pace and the frequency of raising its key interest rate. In addition, uncertainty in the market mounted due to the slowdown in global economic growth and the decline in the prices of oil, commodities and equity prices. In accordance with expectations, the ECB additionally

Table 10.1 Monthly changes in total and net CNB international reserves

end of period, in million EUR

Month	Total reserves	Net reserves
December 2015	13,706.3	11,152.4
January 2016	13,556.9	11,266.7
February 2016	12,985.6	11,177.4
March 2016	13,198.4	11,073.6
April 2016	13,218.5	11,022.4
May 2016	12,828.1	11,065.6
June 2016	12,936.2	11,263.7
Change Jun. 2016 – Dec. 2015	–770.2	111.2

Source: CNB.

loosened its monetary policy in March, aiming to spur inflationary pressures and economic growth in the euro area. At the end of the six-month period, demand for safer investments additionally grew due to the unexpected outcome of the British referendum at which the majority voted for the UK's exit from the European Union and the consequent uncertainty as regards the future relationship between the UK and the EU. The yield on the ten-year German bond went into the negative territory of –0.17% for the first time after the Brexit referendum and kept at this level until the end of June. The yield on the ten-year US bond went down to 1.40%, the lowest level since July 2012. The Fed kept postponing the raising of its benchmark interest rate due to weak macroeconomic indicators but also due to the potential consequences of disturbances in the financial market on the US economy.

The total international reserves of the CNB as at 30 June 2016 stood at EUR 12,936.19m, down by EUR –770.16m or –5.6% from their balance on the last day of 2015 when they stood at EUR 13,706.35m.

The fall in international reserves was affected by the decision to abolish the allocation of the foreign currency component of reserve requirements, by a decrease in the balance at the MoF's foreign exchange account with the CNB, a lower level of repo transactions, the sale of foreign currency to the European Commission and the fall in the exchange rate of the American dollar against the euro. On the other hand, the increase in total international reserves in the first half of 2016 was a result of the purchase of foreign currency from the Ministry of Finance, the purchase of foreign currency from banks through interventions and the earnings from reserves management, which altogether contributed to the growth in net international reserves.

Net international reserves, excluding the foreign currency component of reserve requirements, special drawing rights with the IMF, the funds of the European Commission, the funds of the Ministry of Finance and investments in repo operations, increased by EUR 111.23m or 1.0% in the first six months of 2016, from EUR 11,152.45m to EUR 11,263.68m.

10.2.1 Total CNB turnover in the foreign exchange market in the first half of 2016

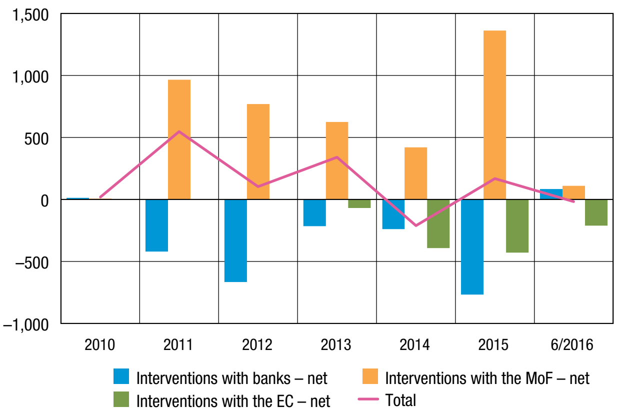
In the first six months of 2016, the Croatian National Bank purchased foreign currency in the domestic foreign exchange market from banks and the MoF and sold foreign currency to the European Commission. The CNB purchased a total of EUR 193.24m and sold a total of EUR 210.74m, resulting in a net sale of EUR 17.50m. Consequently, the sum of HRK 142.55m was withdrawn from circulation.

A total of EUR 83.50m was purchased from banks within the framework of a single intervention in the foreign exchange market that was held in May, while there were no foreign currency sales. The amount sold to the European Commission was EUR 210.74m.

In the first half of 2016, the CNB purchased EUR 109.74m from the MoF.

Figure 10.1 Foreign exchange interventions of the CNB with the banks, the EC and the MoF

in net amounts, from 2010 to the first half of 2016, in million EUR



Year	Banks	MoF	EC	Total
2010	13.6	5.9		19.5
2011	–419.4	966.5	0.0	547.1
2012	–666.3	770.2	0.0	103.9
2013	–214.9	625.7	–69.4	341.3
2014	–240.2	420.6	–392.2	–211.8
2015	–767.2	1,364.0	–428.9	167.9
6/2016	83.5	109.7	–210.7	–17.5

Source: CNB.

Table 10.2 Total CNB turnover in the foreign exchange market, 1 January – 30 June 2016

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	83.5	625.6	0.0	0.0	83.5	625.6
European Commission	0.0	0.0	210.7	1,603.0	–210.7	–1,603.0
Ministry of Finance	109.7	834.8	0.0	0.0	109.7	834.8
Total	193.2	1,460.5	210.7	1,603.0	–17.5	–142.5

Source: CNB.

Table 10.3 Structure of international reserves investment as at 30 June 2016

in %

Investment	30 June 2016		31 December 2015	
	Net reserves	Total reserves	Net reserves	Total reserves
1 Countries				
Government bonds	76.5	66.6	68.8	56.0
Reverse repo agreements	6.9	14.1	10.1	21.3
Central banks	5.1	6.3	6.7	6.0
Covered bonds	0.5	0.5	0.9	0.7
2 International financial institutions				
Deposits	0.2	3.1	0.8	5.7
Securities	5.0	4.3	5.2	4.2
Reverse repo agreements	2.4	2.1	4.5	3.6
External manager	1.6	1.4	1.6	1.3
3 Banks				
Deposits	0.0	0.0	0.4	0.3
Securities[a]	1.8	1.6	1.1	0.9
Total	100.00	100.00	100.00	100.00

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

Source: CNB.

10.3 Structure of international reserves investment

The CNB invests funds with financial institutions and in countries with an investment grade rating; the assessment of creditworthiness is based on ratings issued by internationally recognised rating agencies (Moody's, Standard & Poor's and 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 government securities of selected countries, securities of government agencies, collateralised deposits and instruments issued by international financial institutions and central banks.

Compared with end-December 2015, there was an increase in the share of investments in government securities and securities issued by government agencies. By contrast, there was a decrease in the share of investments in reverse repo agreements collateralised by government bonds and securities of international financial institutions, as well as in the share of investments in deposits of international financial institutions.

On the last day of the first half of 2016, approximately 59% of total CNB international reserves were invested in countries, banks and institutions within the two highest credit rating categories or invested in the BIS and the IMF or in foreign cash in the CNB vault.

10.4 Currency structure of international reserves

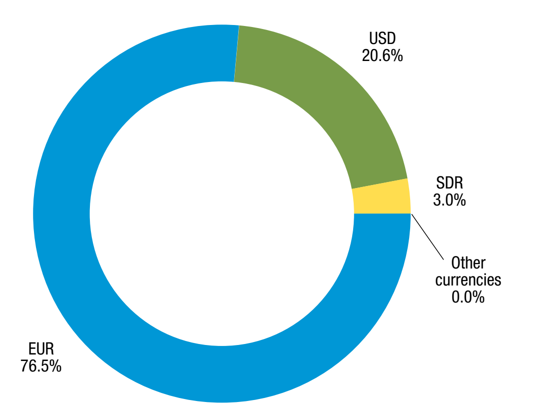
As at 30 June 2016, the euro accounted for 76.45% of the total international reserves, increasing from 73.06% at the end of 2015. The share of the American dollar in total international reserves, 24.11% at the end of 2015, had fallen to 20.56% by the end of June 2016.

The share of SDRs also increased, from 2.83% to 2.99% of the total international reserves, due to a decrease in the level of total reserves.

10.5 Foreign exchange gains and losses on CNB foreign currency portfolios in the first half of 2016

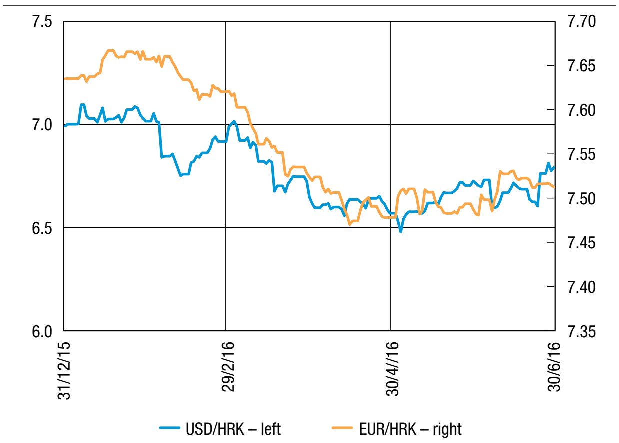
The financial performance of all central banks, including the CNB, depends on the volume and structure of their assets and liabilities. The CNB belongs among banks with a large share of international reserves in their assets. As at 30 June 2016, the share of total international reserves in CNB assets was as high as 97.26%, with the bulk of liabilities denominated in kuna. One of the consequences of this currency structure of assets and liabilities is the CNB's exposure to a significant

Figure 10.2 Currency structure of total international reserves as at 30 June 2016



Source: CNB.

Figure 10.3 Daily changes in USD/HRK and EUR/HRK exchange rates in the first half of 2016



Source: CNB.

currency risk, i.e. the risk of a change in the currency price of investments in relation to the reporting currency – the kuna. Foreign exchange gains and losses arising from fluctuations in EUR/HRK and USD/HRK exchange rates have a direct impact on the income and expense calculation reported in kuna in the CNB Income Statement.

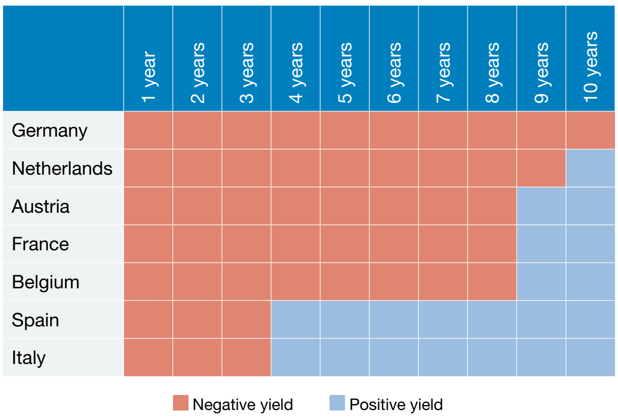
In the first half of 2016, the EUR/HRK exchange rate fell from 7.635 to 7.513 (–1.60%), with the result that unrealised foreign exchange losses on the CNB euro portfolio totalled HRK –1,084m. The US dollar weakened in relation to the kuna from 6.992 to 6.791 (–2.87%) in the same period. As a result, unrealised foreign exchange losses on the US dollar portfolio totalled HRK –523m in the first half of 2016. Realised foreign exchange gains arising from interventions of the CNB were HRK +7m in the reporting period.

As a result of fluctuations in the EUR/HRK and USD/HRK exchange rates and realised foreign exchange gains resulting from the CNB interventions, foreign exchange losses totalled HRK –1.600m in the reference period.

10.6 Results and analysis of CNB foreign currency portfolio management in the first half of 2016

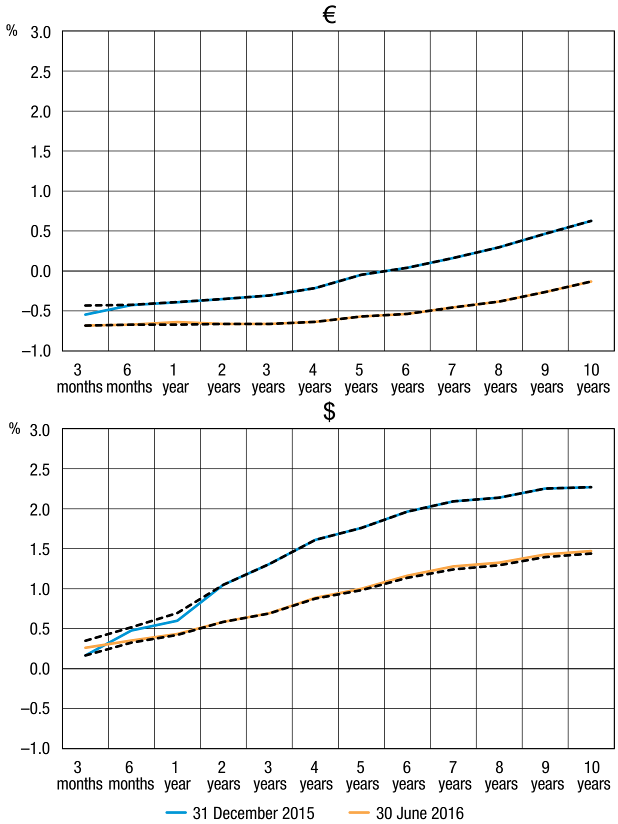
At its meeting held on 10 March 2016, the European Central Bank decided to further ease monetary policy in the euro area:

Figure 10.4 Yields on euro government bonds of selected countries by years to maturity
as at 30 June 2016



Source: Bloomberg.

Figure 10.5 German and American yield curves as at 31 December 2015 and 30 June 2016 and their spread in the first half of 2016



Source: Bloomberg.

- it lowered the repo rate by 5 basis points, to 0.00%, the rate on banks' deposits with the ECB by 10 basis points, to –0.40%, and the rate on overnight lending by 5 basis points, to 0.25%;
- it increased monthly purchases of securities from EUR 60bn to EUR 80bn;
- it expanded the list of eligible securities within the framework of the quantitative easing programme to include investment-grade bonds issued by non-bank corporations; and
- it launched a new series of four targeted longer-term refinancing operations (TLTRO II) with maturities of four years.

Table 10.4 Realised income and rates of return on the CNB foreign currency portfolios
in the first half, on annual basis, in million EUR and USD and %

Portfolio	Realised income	Annual rate of return						
	1st half 2016	1st half 2010	1st half 2011	1st half 2012	1st half 2013	1st half 2014	1st half 2015	1st half 2016
Held-for-trading euro portfolio	0.92	1.79%	0.35%	0.34%	–0.08%	0.59%	–0.01%	0.04%
Held-for-trading dollar portfolio	9.79	0.96%	0.62%	0.38%	0.08%	0.27%	0.31%	1.27%
Euro investment portfolio	27.86		2.31%	2.31%	2.29%	2.22%	1.59%	1.04%
Dollar investment portfolio	7.78							1.75%
External manager (USD)	1.57						0.19%	1.58%

Source: CNB.

The expansionary monetary policy in the euro area, increased demand of investors for safer investment opportunities due to heightened concerns regarding the slowdown in the global economic growth, as well as the British referendum regarding the UK's exit from the European Union resulted in a strong fall of yields in the market for government securities. At the end of June 2016, the yield curves of German bonds for all maturities up to 15 years, of Dutch bonds for all maturities up to 9 years, and of French, Austrian and Belgian bonds for all maturities up to 8 years were in negative territory. The Italian and the Spanish yield curves were in negative territory for all bonds with maturities up to 3 years.

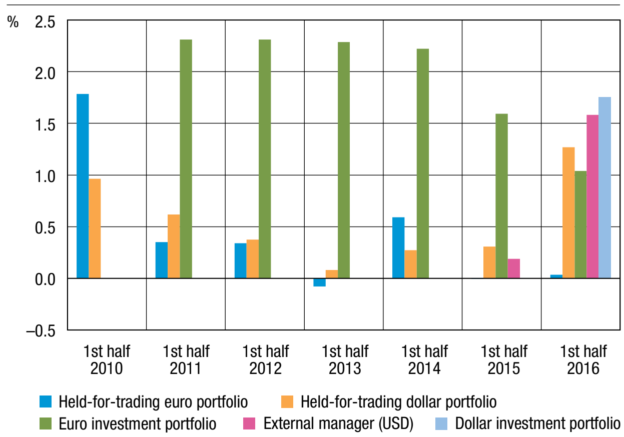
The intensive market reaction to increased volatility and weaker-than-expected macroeconomic indicators in the US contributed to the fall in the US yield curve, which was even steeper than the fall of the German yield curve. American yields are also strongly affected by the strong demand of global investors for positive yields amid conditions in which the amount of government bonds of developed countries with negative yields reached record highs. According to FitchRatings, as much as USD 11,700bn-worth of global government securities had negative yields at the end of June 2016.

Net international reserves of the CNB comprise the euro- and dollar-denominated held-for-trading portfolios, the euro- and dollar-denominated investment portfolios, the funds entrusted to an external manager and foreign cash in the vault.

The annual rates of return on the CNB held-for-trading euro and dollar portfolios stood at 0.04% and 1.27% respectively in the first half of 2016. The held-for-trading portfolios are valued at fair market prices, have short average maturities and are used as a source of liquidity.

The euro-denominated investment portfolio yielded a return of 1.04% in the first half of 2016, while the dollar-denominated investment portfolio yielded 1.75%, on an annual basis. Investment portfolios have a longer average maturity and serve as a source of more stable long-term income.

Figure 10.6 Annual rates of return on the CNB foreign currency portfolios from the first half of 2010 to the first half of 2016



Source: CNB.

The dollar funds entrusted for management to an international financial institutions yielded 1.58% in the first half of 2016, on an annual basis. The funds entrusted to an external manager enabled additional diversification and knowledge-exchange in the field of investment management.

Investments in net international reserves generated a total income of EUR 45.96m in the first half of 2016.

11 Business operations of credit institutions[15]

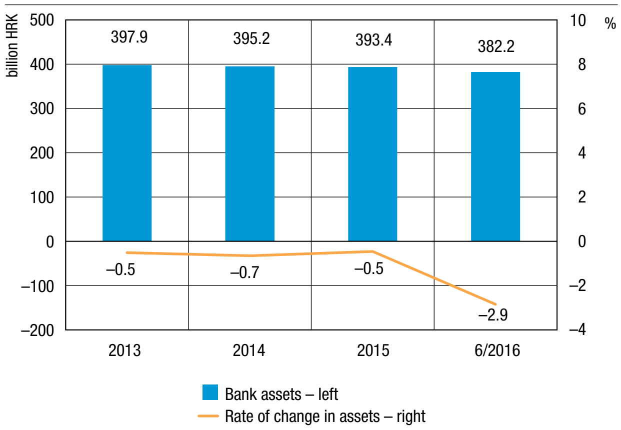
There were 33 credit institutions or 28 banks, one savings bank and five housing savings banks operating in the Republic of Croatia at the end of the first half of 2016. There were no changes in the total number of credit institutions from the end of 2015. However, very soon thereafter, at the beginning of July 2016, bankruptcy proceedings were opened against one bank.[16] There were no branches of foreign banks but more than a hundred credit institutions from the EU (and the EEA) used the benefits provided by the application of the single passport and set the preconditions for the direct provision of services in the Republic of Croatia.[17]

11.1 Banks

Banks in foreign ownership continued dominating the scene. The 16 banks that accounted for 89.9% of total bank assets continued to be in the majority ownership of foreign shareholders, while the remaining 12 banks were domestically owned. The majority of foreign-owned banks, 12 of them, were owned by shareholders from the European Union. The share of their assets in total bank assets totalled 88.9% at the end of the first half of 2016.

The downward trend in bank assets entered its fifth year. Bank assets amounted to HRK 382.2bn at the end of the first half of 2016, a decrease of 2.9% since the end of 2015. The conversion of loans in Swiss francs into loans in euros,[18] exchange rate fluctuations and the intensification of the sale of claims had a noticeable influence on bank assets. There has been a continuation of developments that started in 2015, reflected in poor lending and sustained bank deleveraging, especially to majority foreign owners.

Figure 11.1 Bank assets



Source: CNB.

Loans granted (gross) decreased by HRK 10.9bn (3.9%), with the bulk of the decrease resulting from two influences, the write-off of the principal in the loan conversion procedure and the sale of claims. The non-financial corporations sector, if the effects of the sale of claims are excluded, boasted a slight credit growth (some segments of manufacturing, tourism, agriculture, transportation and storage), predominantly in the form of kuna loans, especially loans for working capital. Currency restructuring in the household sector continued. Kuna home loans grew steeply, with the bulk of this growth being accounted for by the refinancing of converted loans. In addition, there has been a noticeable growth of kuna general-purpose cash loans, so they were, as in the previous two years, one of the rare types of household loans that increased. Overall, home financing went down, even if the effect of the write-off of the principal of converted loans is excluded.

The balance of provisions for loan conversion narrowed from the initial HRK 6.9bn at the end of September 2015 to HRK 183.9m at the end of June 2016, indicating that most of the conversions have been completed. Converted loans[19] totalled HRK 10.9bn (9.6% of total loans to households), with converted home loans accounting for the bulk of this figure (HRK 10.6bn or 21.7% of total home loans). In the first half of 2016, banks wrote off HRK 4.9bn worth of the principals of converted loans.

Sales of claims intensified significantly, having a slight positive influence on bank earnings. In the first half of 2016, some HRK 4.0bn of balance sheet claims in risk categories B and C were sold (and the additional HRK 0.9bn of the associated off-balance sheet claims), while in 2015 the sale of claims totalled HRK 2.8bn. The sale of claims on non-financial corporations played the key role and were purchased mainly by enterprises specialised in collecting claims. The claims sold were well covered by value adjustments (71.8%).

The fall in total bank assets resulted not only from loan conversion and sale of claims but also from the decline in the majority of the remaining items. The reduction in total bank deposits with the CNB was a consequence of the reduction of the allocated reserve requirement, partly due to the repeal of

15 This chapter shows breakdowns and data that are based on the same methodology applied in the compilation of the Banks Bulletin. Therefore, Notes on methodology from the Banks Bulletin, No. 29, (http://www.hnb.hr/en/analyses-and-publications/regular-publications/banks-bulletin) may be used to interpret data. The only exception are data relating to sectors that have been compiled in accordance with the ESA 2010 methodology (the Banks Bulletin, No. 29, draws on the ESA 1995 methodology).

16 Bankruptcy proceedings were opened against Banka splitsko-dalmatinska d.d., Split, on 1 July 2016.

17 The single passport system enables credit and financial institutions from the European Union and contracting parties to the Agreement on the European Economic Area to provide mutually recognised services in other member states without additional authorisation requirements.

18 The conversion of Swiss franc loans (and kuna loans indexed to the Swiss franc) to euro loans (and euro-indexed kuna loans) is regulated by the Act on Amendments to the Consumer Credit Act and the Act on Amendments to the Credit Institutions Act (OG 102/2015).

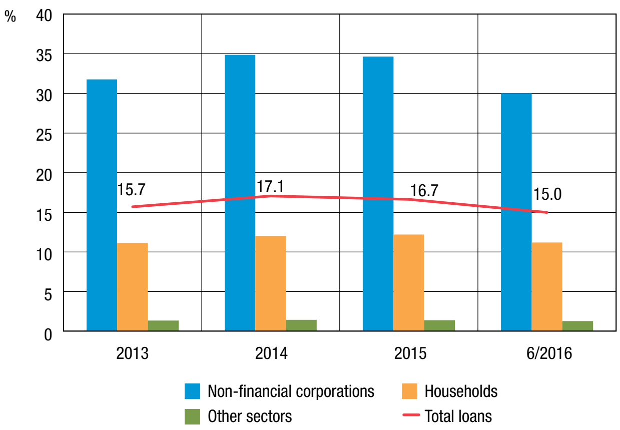
19 This excludes loans refinanced after the conversion.

the requirement to allocate the foreign exchange component of the reserve requirement,[20] and partly due to the reduction in the sources of bank financing, i.e. the basis for the calculation of the reserve requirement. Bank investments in securities decreased by HRK 1.3bn (2.5%) due to the decrease in investments in debt and equity securities of foreign issuers and despite the increase in investments in bonds of domestic government. Unusually strong developments were registered in connection with equity investments due to the sale of the shares of Visa Europe Ltd.[21] The earnings banks generated in the process, estimated at approximately HRK 650m, had a substantial effect on their current year profits.

Sources of bank financing fell by HRK 8.7bn (2.7%). The continuation of the years-long deleveraging trend vis-à-vis majority foreign owners had a decisive influence on these developments, lowering their share to 5.1% of total sources of finance. Domestic sources of financing decreased slightly primarily due to the decrease in sources of finance from households (1.6%), the decrease in time deposits having the key influence. The decline in time deposits was visible in other domestic sectors as well. Almost all also registered a significantly smaller increase in deposits in transaction accounts, contributing to the continuation of the trend observed in 2015. Liquidity coefficients within the maturity band of up to one month remained very high: 1.6 for the kuna and 1.9 for convertible currencies. The kuna coefficient remained stable, while the coefficient for convertible currencies continued trending slightly upwards. The strengthening of the kuna components of bank assets and liabilities continued, while the open foreign exchange position fell to its usual level thanks to the completion of the bulk of conversions. However, foreign currency assets and liabilities (including the kuna component with a currency clause) continued to dominate the total assets and liabilities of banks, boasting shares of 60.6% and 64.8% respectively.

Loan quality continued improving, even if the effects of the sale of claims are excluded. The share of partly recoverable and fully irrecoverable loans (B and C risk category loans) decreased from 16.7% at the end of 2015 to 15.0% at the end of the first half of 2016. In the non-financial corporates sector this share went down from 34.7% to 30.0% under the strong influence of the sale of claims. However, if this effect is excluded, data indicate improvements in loan recovery, especially from clients in pre-bankruptcy settlement proceedings and those involved in foreclosure proceedings. In addition to recovery, a noticeable contribution came from the reclassification of claims into a better risk category, that is, to the category of fully recoverable loans (loans categorised into risk category A). Developments in the household sector were mainly affected by the improvement in the quality of home loans, in which the share of B and C category loans decreased from 9.8% to 8.8%. These developments were substantially aided by changes in internal risk management rules within one bank, whereby it remained in compliance with the regulatory framework. In addition, these developments were also affected by the loan conversion, due to the possible improvement in debtor creditworthiness arising from partial debt write-offs and existing overpayments, but also from loan refinancing with other banks.

Figure 11.2 Share of bank partly recoverable and fully irrecoverable loans



Source: CNB.

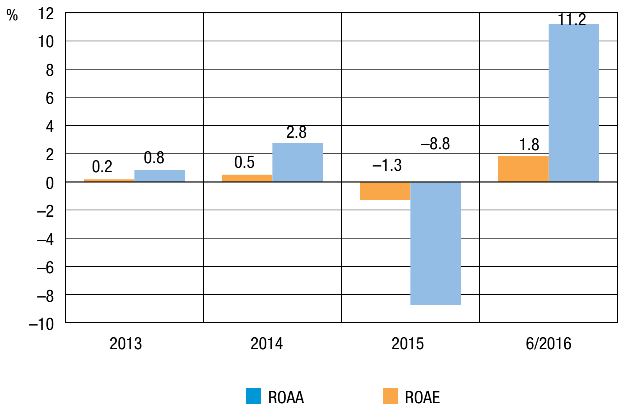
In the first half of 2016 value adjustments of total B and C category loans decreased by 9.2% under the key influence of the sale of claims. The decrease in loans of these categories was much more dynamic so their coverage continued to grow, from 56.9% at the end of 2015 to 59.7% at the end of the first half of 2016. This was a result of the portfolio ageing which was especially visible in the growth of the category C loans, especially loans to non-financial corporations from the construction and real estate sector and home loans to households. The coverage of home loans increased by over five percentage points, to 57.6%, despite the decrease in value adjustments. Developments as regards the value adjustments of home loans were influenced by the conversion because the decrease in principal as a result of the write-off, in conjunction with the maintenance of the same level of coverage, decreases the amount of value adjustments necessary. An additional influence may have been exerted by the reclassification of converted but also of other home loans. All this resulted in the income generated from the cancelling of expenses on value adjustments of home loans of HRK 293.9bn in the first half of 2016. In the same period of 2015, an expense of HRK 281.1m was realised under this item. The effects of alleviating the position of debtors in Swiss francs were visible also in the movements of other expenses, the expenses of fixing the exchange rate of the Swiss franc for loan repayments[22] and the expenses of court disputes arising from loans in this currency that banks had in the first half of 2015 and that were absent in the same period in 2016. One should also mention here the positive effects on interest income, given

20 The foreign exchange component of the CNB's reserve requirement was substituted by the requirement to maintain liquid and low-risk foreign currency assets (Decision on reserve requirements, OG 136/2015).

21 Visa Inc. (US) merged the European segment of its operations by taking over its daughter company Visa Europe Ltd. (United Kingdom), the global value of the transaction being estimated at EUR 18.4bn. The transaction includes the payment of a cash consideration to the shareholders of Visa Europe Ltd., of a consideration in the form of preferred shares of Visa Inc. and a deferred cash consideration three years after the date on which the purchase was completed. Source: http://investor.visa.com/sec-filings/sec-filings-details/default.aspx?FilingId=11372984.

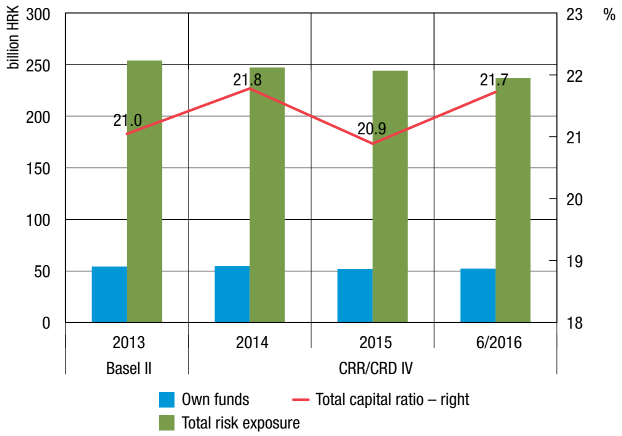
22 In January 2015, the Government decided to fix the exchange rate to HRK 6.39 for one Swiss franc for instalments/annuities in that currency (including those indexed to that currency) maturing within one year period.

Figure 11.3 Bank return on average assets (ROAA) and return on average equity (ROAE)



Source: CNB.

Figure 11.4 Bank total capital ratio



Source: CNB.

that interest rates on home loans indexed to the Swiss franc are limited to 3.23%.[23]

In the first half of 2016 banks realised HRK 3.5bn profits from continuing operations (before tax). Profits shot up vis-à-vis the first half of 2015 (HRK 2.1bn or 152.6%) in most banks under the key influence of lower expenses on value adjustments and provisions and one-off receipts arising from the sale of shares of Visa Europe Ltd. Five banks operated with losses, while in the same period last year there were seven. Four of them were operationally non-profitable at the same time, that is, their operating income was not sufficient to cover their general operating expenses.

Total expenses on value adjustments and provisions fell by HRK 1.4bn or 73.1%. In addition to changes in value adjustment costs in the household loans portfolio there was a noticeable effect from the lower costs of value adjustments of loans to non-financial corporations, as a result of measures aimed at the resolution of non-performing loans and improving the creditworthiness of individual clients. Net operating income registered an increase even without the effect of the sale of shares of Visa Europe Ltd., primarily under the influence of lower interest expenses. The expenses on household deposits were a quarter lower than in the same period last year as a result of a continued downward trend in deposit interest rates and the strengthening of the share of cheaper types of deposits, such as deposits with transaction accounts. The fall in interest income continued in all categories, the most in the category of interest income from loans (HRK 455.0m or 6.1%) due to the fall in all domestic sectors. The return on average assets (ROAA) and the return on average equity (ROAE) went up to 1.8% and 11.2% respectively. Similar values in the first half of the year were last recorded in June 2008. The indicators would go up even if the one-off effect of the sale of the shares of Visa Europe Ltd. were excluded (totalling 1.5% or 8.6%), due to the return of the risk costs to pre-crisis levels.

The capital adequacy of banks continued improving with the total capital ratio increasing to 21.7%. The increase in the ratio, as in the previous years, was spurred by the decline in exposures to risk and the parallel growth of own funds. Total risk exposure fell by HRK 7.0bn (2.9%). The key influence came from the implementation of loan conversions, reducing exposure to credit and currency risks. Own funds of banks increased slightly (1.0%) under the greatest influence of recapitalisation and inclusion of current year profit, followed by the retention of a portion of the profit made in 2015. A small number of banks operated at a profit in 2015 so the amount of dividends (paid or required to be paid) was relatively small (HRK 356.8m) and included a small amount of payments from retained earnings from the previous years.

11.2 Housing savings banks

Assets of housing savings banks declined by 1.5% to HRK 7.7bn under the influence of developments regarding their key components, that is, the decline in deposits of housing savings

Table 11.1 Ownership structure of banks and their share in total bank assets

end of period

Banks	Dec. 2014		Dec. 2015		Jun. 2016	
	Number of banks	Share	Number of banks	Share	Number of banks	Share
Domestic ownership	12	9.9	12	9.7	12	10.1
Domestic private ownership	10	4.7	10	4.4	10	4.5
Domestic state ownership	2	5.2	2	5.3	2	5.6
Foreign ownership	16	90.1	16	90.3	16	89.9
Total	28	100.0	28	100.0	28	100.0

Source: CNB.

23 At the beginning of 2014, interest rates on home loans indexed to the Swiss francs were limited to 3.23%. The restriction will remain in force until the exchange rate of the Swiss franc depreciates to a level below the appreciation of 20% which triggered the limitation of the interest rate level.

Table 11.2 Structure of bank assets

end of period, in million HRK and %

	Dec. 2014		Dec. 2015			Jun. 2016		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Money assets and deposits with the CNB	50,252.6	12.7	49,425.3	12.6	–1.6	48,450.2	12.7	–2.0
Money assets	6,462.7	1.6	7,289.7	1.9	12.8	8,050.8	2.1	10.4
Deposits with the CNB	43,789.9	11.1	42,135.6	10.7	–3.8	40,399.4	10.6	–4.1
Deposits with financial institutions	26,369.0	6.7	27,727.6	7.0	5.2	27,153.9	7.1	–2.1
MoF treasury bills and CNB bills	15,353.5	3.9	12,258.7	3.1	–20.2	9,618.5	2.5	–21.5
Securities	34,236.2	8.7	37,901.3	9.6	10.7	39,235.9	10.3	3.5
Derivative financial assets	1,357.0	0.3	2,431.1	0.6	79.2	2,474.4	0.6	1.8
Loans	253,132.3	64.0	246,949.2	62.8	–2.4	238,486.0	62.4	–3.4
Loans to financial institutions	5,735.2	1.5	5,002.3	1.3	–12.8	5,195.8	1.4	3.9
Loans to other clients	247,397.1	62.6	241,946.9	61.5	–2.2	233,290.2	61.0	–3.6
Investments in subsidiaries, associates and joint ventures	2,722.1	0.7	4,185.3	1.1	53.8	4,225.5	1.1	1.0
Foreclosed and repossessed assets	1,544.8	0.4	1,550.0	0.4	0.3	1,473.9	0.4	–4.9
Tangible assets (net of depreciation)	4,243.0	1.1	4,456.1	1.1	5.0	4,280.1	1.1	–3.9
Interest, fees and other assets	6,027.2	1.5	6,509.5	1.7	8.0	6,778.0	1.8	4.1
Total assets	395,237.7	100.0	393,394.3	100.0	–0.5	382,176.4	100.0	–2.9

Source: CNB.

Table 11.3 Structure of bank liabilities and capital

end of period, in million HRK and %

	Dec. 2014		Dec. 2015			Jun. 2016		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans from financial institutions	641.6	0.2	622.4	0.2	–3.0	971.5	0.3	56.1
Short-term loans	602.5	0.2	611.2	0.2	1.4	249.5	0.1	–59.2
Long-term loans	39.1	0.0	11.2	0.0	–71.3	722.0	0.2	6,336.0
Deposits	286,075.4	72.4	294,214.6	74.8	2.8	288,561.4	75.5	–1.9
Transaction account deposits	67,556.2	17.1	76,631.9	19.5	13.4	82,864.1	21.7	8.1
Savings deposits	18,045.1	4.6	21,052.5	5.4	16.7	21,851.6	5.7	3.8
Time deposits	200,474.1	50.7	196,530.2	50.0	–2.0	183,845.7	48.1	–6.5
Other loans	35,919.8	9.1	23,658.6	6.0	–34.1	20,301.6	5.3	–14.2
Short-term loans	5,632.7	1.4	2,109.5	0.5	–62.5	2,180.3	0.6	3.4
Long-term loans	30,287.2	7.7	21,549.2	5.5	–28.9	18,121.3	4.7	–15.9
Derivative financial liabilities and other financial liabilities held for trading	1,180.5	0.3	2,339.2	0.6	98.2	2,208.9	0.6	–5.6
Debt securities issued	299.9	0.1	300.8	0.1	0.3	300.0	0.1	–0.3
Short-term debt securities issued	0.0	0.0	0.8	0.0	–	0.0	0.0	–100.0
Long-term debt securities issued	299.9	0.1	300.0	0.1	0.0	300.0	0.1	0.0
Subordinated instruments issued	2,050.0	0.5	2,724.0	0.7	32.9	2,682.0	0.7	–1.5
Hybrid instruments issued	2,319.4	0.6	2,198.4	0.6	–5.2	2,200.4	0.6	0.1
Interest, fees and other liabilities	11,231.2	2.8	17,361.6	4.4	54.6	12,837.6	3.4	–26.1
Total liabilities	339,717.8	86.0	343,419.6	87.3	1.1	330,063.4	86.4	–3.9
Share capital	33,757.2	8.5	34,275.4	8.7	1.5	33,990.5	8.9	–0.8
Current year profit (loss)	1,534.6	0.4	–4,615.8	–1.2	–	2,862.4	0.7	–
Retained earnings (loss)	15,943.0	4.0	15,579.3	4.0	–2.3	11,228.9	2.9	–27.9
Legal reserves	1,046.0	0.3	1,035.2	0.3	–1.0	1,047.1	0.3	1.2
Reserves provided for by the articles of association and other capital reserves	2,600.4	0.7	2,892.5	0.7	11.2	2,981.0	0.8	3.1
Revaluation reserves	727.9	0.2	1,115.1	0.3	53.2	644.3	0.2	–42.2
Previous year profit (loss)	–89.1	0.0	–307.0	–0.1	244.4	–641.3	–0.2	108.9
Total capital	55,519.9	14.0	49,974.7	12.7	–10.0	52,113.0	13.6	4.3
Total liabilities and capital	395,237.7	100.0	393,394.3	100.0	–0.5	382,176.4	100.0	–2.9

Source: CNB.

banks savers and the decline in home loans. This continued the trend observed in 2015. As regards home loans, there was a noticeable increase in kuna items, although much less intensive than in the banks, while the quality of all home loans remained very good, risk categories B and C accounting for 1.6%. Lower interest income, especially from investments in the bonds of the Republic of Croatia, contributed to profit (from continuing operations, before tax) declining by 14.3%, to HRK 29.8m. Profitability measured by ROAA and ROAE declined to 0.8% and 6.5% respectively. All housing savings banks operated with a profit. The total capital ratio continued growing to 26.7%, equally as a result of the increase in own funds and the decrease in risk exposure.

Table 11.4 Bank income statement

in reference periods, in million HRK and %

	Amount		Change
	Jan. – Jun. 2015	Jan. – Jun. 2016	
Continuing operations			
Interest income	9,287.0	8,488.0	–8.6
Interest expenses	3,982.5	3,041.2	–23.6
Net interest income	5,304.5	5,446.8	2.7
Income from fees and commissions	2,108.7	2,097.4	–0.5
Expenses on fees and commissions	612.3	554.7	–9.4
Net income from fees and commissions	1,496.4	1,542.6	3.1
Income from equity investments	187.5	201.2	7.3
Gains (losses)	202.3	903.2	346.5
Other operating income	265.2	250.2	–5.7
Other operating expenses	514.9	685.5	33.1
Net other non-interest income	140.1	669.1	377.5
Total operating income	6,941.0	7,658.5	10.3
General administrative expenses and depreciation	3,642.9	3,603.4	–1.1
Net operating income before loss provisions	3,298.0	4,055.0	23.0
Expenses on value adjustments and provisions	1,893.1	508.6	–73.1
Other gains (losses)	–1.2	0.0	–100.0
Profit (loss) from continuing operations, before taxes	**1,403.8**	**3,546.4**	**152.6**
Income tax on continuing operations	180.1	685.7	280.7
Profit (loss) from continuing operations, after taxes	1,223.7	2,860.7	133.8
Discontinued operations			
Profit (loss) from discontinued operations, after taxes	0.6	1.6	185.6
Current year profit (loss)	**1,224.3**	**2,862.4**	**133.8**
Memo item:			
Number of banks operating with losses, before taxes	7	5	–28.6

Source: CNB.

Tablica 11.5 Classification of bank placements and assumed off-balance sheet liabilities by risk categories

end of period, in million HRK and %

Risk (sub) category	Dec. 2014			Dec. 2015			Jun. 2016		
	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	365,613.1	3,363.4	0.9	362,550.9	3,348.0	0.9	357,499.9	3,327.0	0.9
B-1	15,728.9	2,364.5	15.0	12,528.5	1,836.8	14.7	10,508.6	1,452.0	13.8
B-2	19,774.4	9,768.0	49.4	18,363.9	9,484.3	51.6	14,423.6	7,517.0	52.1
B-3	5,559.4	4,615.6	83.0	8,008.0	6,578.8	82.2	7,434.1	6,153.2	82.8
C	10,022.5	10,020.4	100.0	10,453.1	10,453.9	100.0	10,681.0	10,681.4	100.0
Total	416,698.2	30,131.8	7.2	411,904.4	31,701.9	7.7	400,547.1	29,130.6	7.3

Source: CNB.

Tablica 11.6 Bank loans

end of period, in million HRK and %

	Dec. 2014		Dec. 2015			Jun. 2016		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans								
General government	56,339.5	20.1	57,544.8	20.9	2.1	54,811.0	20.7	–4.8
Non-financial corporations	92,019.5	32.9	87,269.5	31.7	–5.2	86,887.3	32.8	–0.4
Working capital loans	37,359.7	13.3	35,295.5	12.8	–5.5	36,559.2	13.8	3.6
Investment loans	26,624.1	9.5	25,502.6	9.3	–4.2	24,823.2	9.4	–2.7
Shares in syndicated loans	3,049.9	1.1	3,054.1	1.1	0.1	3,119.1	1.2	2.1
Construction loans	4,177.0	1.5	3,488.2	1.3	–16.5	3,145.6	1.2	–9.8
Other loans to non-financial corporations	20,808.7	7.4	19,929.1	7.2	–4.2	19,240.1	7.3	–3.5
Households	122,346.4	43.7	120,426.7	43.7	–1.6	114,272.8	43.2	–5.1
Home loans	56,127.3	20.1	54,998.8	20.0	–2.0	48,588.7	18.4	–11.7
Mortgage loans	2,843.3	1.0	2,599.4	0.9	–8.6	2,388.7	0.9	–8.1
Car loans	1,439.3	0.5	1,057.3	0.4	–26.5	1,070.4	0.4	1.2
Credit card loans	3,831.0	1.4	3,716.2	1.3	–3.0	3,684.8	1.4	–0.8
Overdraft facilities	8,157.5	2.9	7,856.8	2.9	–3.7	7,833.4	3.0	–0.3
General-purpose cash loans	39,123.4	14.0	39,808.8	14.5	1.8	40,422.8	15.3	1.5
Other household loans	10,824.7	3.9	10,389.4	3.8	–4.0	10,283.9	3.9	–1.0
Other sectors	9,224.3	3.3	10,180.4	3.7	10.4	8,582.9	3.2	–15.7
Total	**279,929.8**	**100.0**	**275,421.4**	**100.0**	**–1.6**	**264,554.0**	**100.0**	**–3.9**
Partly recoverable and fully irrecoverable loans								
General government	47.4	0.1	14.7	0.0	–69.1	11.8	0.0	–19.8
Non-financial corporations	32,086.4	67.2	30,256.6	66.0	–5.7	26,072.7	65.7	–13.8
Working capital loans	13,228.6	27.7	12,475.0	27.2	–5.7	10,960.3	27.6	–12.1
Investment loans	7,937.2	16.6	7,861.7	17.1	–1.0	6,686.5	16.9	–14.9
Shares in syndicated loans	328.0	0.7	174.4	0.4	–46.8	78.8	0.2	–54.8
Construction loans	3,236.0	6.8	2,794.1	6.1	–13.7	2,479.9	6.3	–11.2
Other loans to non-financial corporations	7,356.6	15.4	6,951.4	15.2	–5.5	5,867.2	14.8	–15.6
Households	14,718.9	30.8	14,673.8	32.0	–0.3	12,774.3	32.2	–12.9
Home loans	4,934.7	10.3	5,374.5	11.7	8.9	4,252.6	10.7	–20.9
Mortgage loans	929.1	1.9	871.6	1.9	–6.2	779.9	2.0	–10.5
Car loans	92.7	0.2	76.4	0.2	–17.6	67.3	0.2	–11.9
Credit card loans	157.7	0.3	140.1	0.3	–11.2	128.5	0.3	–8.3
Overdraft facilities	1,052.0	2.2	960.7	2.1	–8.7	916.1	2.3	–4.6
General-purpose cash loans	3,807.8	8.0	3,674.7	8.0	–3.5	3,387.0	8.5	–7.8
Other household loans	3,745.0	7.8	3,575.8	7.8	–4.5	3,242.9	8.2	–9.3
Other sectors	902.4	1.9	917.4	2.0	1.7	802.6	2.0	–12.5
Total	**47,755.1**	**100.0**	**45,862.5**	**100.0**	**–4.0**	**39,661.4**	**100.0**	**–13.5**
Value adjustments of partly recoverable and fully irrecoverable loans								
General government	11.7	0.0	4.2	0.0	–63.7	3.3	0.0	–21.8
Non-financial corporations	15,654.0	63.9	16,739.5	64.2	6.9	15,165.2	64.0	–9.4
Working capital loans	6,574.3	26.9	7,543.0	28.9	14.7	0.0	0.0	–100.0
Investment loans	3,529.6	14.4	4,297.0	16.5	21.7	3,855.5	16.3	–10.3
Shares in syndicated loans	52.6	0.2	86.4	0.3	64.4	88.3	0.4	2.2
Construction loans	1,703.2	7.0	1,670.7	6.4	–1.9	1,622.0	6.8	–2.9
Other loans to non-financial corporations	3,794.3	15.5	3,142.3	12.0	–17.2	9,599.4	40.5	205.5
Households	8,273.8	33.8	8,745.2	33.5	5.7	8,009.0	33.8	–8.4
Home loans	2,161.0	8.8	2,812.8	10.8	30.2	2,448.7	10.3	–12.9
Mortgage loans	439.1	1.8	459.7	1.8	4.7	444.8	1.9	–3.2
Car loans	76.3	0.3	60.9	0.2	–20.2	54.3	0.2	–10.8
Credit card loans	147.1	0.6	130.0	0.5	–11.6	119.5	0.5	–8.1
Overdraft facilities	1,001.4	4.1	915.4	3.5	–8.6	869.0	3.7	–5.1
General-purpose cash loans	2,660.7	10.9	2,586.7	9.9	–2.8	2,404.2	10.2	–7.1
Other household loans	1,788.2	7.3	1,779.7	6.8	–0.5	1,668.5	7.0	–6.3
Other sectors	540.3	2.2	589.9	2.3	9.2	507.0	2.1	–14.0
Total	**24,479.8**	**100.0**	**26,078.8**	**100.0**	**6.5**	**23,684.5**	**100.0**	**–9.2**

Note: The distribution by institutional sectors is conducted in accordance with the European System of Accounts 1995 (ESA 1995). Households include households and non-profit institutions serving households. Data on financial institutions and non-residents are included in item Other sectors.

Source: CNB.

Table 11.7 Own funds, risk exposure and capital ratios of banks

end of period, in million HRK and %

	Dec. 2014		Dec. 2015			Jun. 2016		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Own funds	**53,780.0**	**100.0**	**50,917.1**	**100.0**	**–5.3**	**51,435.7**	**100.0**	**1.0**
Tier 1 capital	50,931.0	94.7	46,586.3	91.5	–8.5	47,331.4	92.0	1.6
Common equity tier 1 capital	50,931.0	94.7	46,586.3	91.5	–8.5	47,331.4	92.0	1.6
Capital instruments eligible as common equity tier 1 capital	33,482.2	62.3	33,717.6	66.2	0.7	34,112.8	66.3	1.2
Retained earnings	16,707.9	31.1	11,820.6	23.2	–29.3	12,340.8	24.0	4.4
Other items	740.9	1.4	1,048.1	2.1	41.5	877.8	1.7	–16.2
Additional tier 1 capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tier 2 capital	2,849.0	5.3	4,330.9	8.5	52.0	4,104.3	8.0	–5.2
Total risk exposure amount	**246,959.3**	**100.0**	**243,830.0**	**100.0**	**–1.3**	**236,839.2**	**100.0**	**–2.9**
Risk weighted exposure amounts for credit, counterparty credit and dilution risks and free deliveries	218,615.5	88.5	211,793.3	86.9	–3.1	208,702.5	88.1	–1.5
Standardised approach	185,416.7	75.1	182,231.5	74.7	–1.7	180,720.0	76.3	–0.8
Central governments or central banks	2,843.2	1.2	3,736.4	1.5	31.4	3,588.2	1.5	–4.0
Corporates	63,408.8	25.7	62,041.5	25.4	–2.2	65,690.8	27.7	5.9
Retail	61,537.1	24.9	60,349.7	24.8	–1.9	58,058.7	24.5	–3.8
Exposures in default	26,710.5	10.8	21,427.2	8.8	–19.8	19,230.9	8.1	–10.3
Other items	30,917.2	12.5	34,676.6	14.2	12.2	34,151.4	14.4	–1.5
Internal ratings based approach (IRB)	33,198.8	13.4	29,561.8	12.1	–11.0	27,982.5	11.8	–5.3
Settlement/delivery risks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Position, foreign exchange and commodities risks	4,193.1	1.7	8,550.8	3.5	103.9	5,045.1	2.1	–41.0
Operational risk	23,796.0	9.6	22,871.3	9.4	–3.9	22,501.2	9.5	–1.6
Credit valuation adjustment	354.7	0.1	614.7	0.3	73.3	590.3	0.2	–4.0
Common equity tier 1 capital ratio	**20.6**	**–**	**19.1**	**–**	**–7.4**	**20.0**	**–**	**4.6**
Tier 1 capital ratio	**20.6**	**–**	**19.1**	**–**	**–7.4**	**20.0**	**–**	**4.6**
Total capital ratio	**21.8**	**–**	**20.9**	**–**	**–4.1**	**21.7**	**–**	**4.0**

Source: CNB.

Table 11.8 Structure of housing savings bank assets

end of period, in million HRK and %

	Dec. 2014		Dec. 2015			Jun. 2016		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Money assets and deposits with the CNB	0.0	0.0	0.0	0.0	42.9	0.0	0.0	–10.0
Money assets	0.0	0.0	0.0	0.0	42.9	0.0	0.0	–10.0
Deposits with the CNB	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposits with financial institutions	434.1	5.6	563.9	7.3	29.9	583.8	7.6	3.5
MoF treasury bills and CNB bills	350.8	4.5	162.4	2.1	–53.7	59.9	0.8	–63.1
Securities	2,481.2	31.9	2,706.7	34.8	9.1	2,800.8	36.6	3.5
Derivative financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	4,381.4	56.4	4,226.0	54.4	–3.5	4,085.4	53.4	–3.3
Loans to financial institutions	141.6	1.8	52.0	0.7	–63.3	44.6	0.6	–14.3
Loans to other clients	4,239.7	54.5	4,174.0	53.7	–1.5	4,040.8	52.8	–3.2
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	1.4	0.0	783.8	1.4	0.0	1.3
Tangible assets (net of depreciation)	3.0	0.0	2.2	0.0	–28.7	2.1	0.0	–2.6
Interest, fees and other assets	124.4	1.6	109.6	1.4	–11.9	123.7	1.6	12.8
Total assets	7,774.9	100.0	7,772.2	100.0	0.0	7,657.0	100.0	–1.5

Source: CNB.

Table 11.9 Structure of housing savings bank liabilities and capital

end of period, in million HRK and %

	Dec. 2014		Dec. 2015			Jun. 2016		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans from financial institutions	60.5	0.8	42.0	0.5	–30.6	28.5	0.4	–32.1
Short-term loans	60.5	0.8	42.0	0.5	–30.6	28.5	0.4	–32.1
Long-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposits	6,694.3	86.1	6,645.0	85.5	–0.7	6,445.8	84.2	–3.0
Transaction account deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings deposits	4.7	0.1	0.0	0.0	–99.4	0.0	0.0	–3.7
Time deposits	6,689.6	86.0	6,645.0	85.5	–0.7	6,445.8	84.2	–3.0
Other loans	95.8	1.2	95.4	1.2	–0.3	93.9	1.2	–1.6
Short-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term loans	95.8	1.2	95.4	1.2	–0.3	93.9	1.2	–1.6
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	83.4	1.1	83.2	1.1	–0.2	82.5	1.1	–0.9
Interest, fees and other liabilities	124.9	1.6	129.7	1.7	3.9	206.1	2.7	58.9
Total liabilities	7,058.8	90.8	6,995.4	90.0	–0.9	6,856.9	89.5	–2.0
Share capital	487.9	6.3	487.9	6.3	0.0	487.9	6.4	0.0
Current year profit (loss)	58.9	0.8	47.5	0.6	–19.3	25.7	0.3	–45.9
Retained earnings (loss)	120.1	1.5	177.6	2.3	47.8	200.5	2.6	12.9
Legal reserves	9.0	0.1	10.5	0.1	16.3	11.6	0.2	10.1
Reserves provided for by the articles of association and other capital reserves	–8.0	–0.1	–10.7	–0.1	33.7	–15.7	–0.2	46.8
Revaluation reserves	48.1	0.6	64.0	0.8	32.9	90.1	1.2	40.9
Previous year profit (loss)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total capital	716.1	9.2	776.8	10.0	8.5	800.2	10.5	3.0
Total liabilities and capital	7,774.9	100.0	7,772.2	100.0	0.0	7,657.0	100.0	–1.5

Source: CNB.

Table 11.10 Housing savings bank income statement
in reference periods, in million HRK and %

	Amount		Change
	Jan. – Jun. 2015	Jan. – Jun. 2016	
Continuing operations			
Interest income	180.1	165.7	–8.0
Interest expenses	105.2	101.2	–3.8
Net interest income	74.8	64.5	–13.8
Income from fees and commissions	26.6	26.3	–1.1
Expenses on fees and commissions	3.2	2.8	–10.1
Net income from fees and commissions	23.5	23.5	0.1
Income from equity investments	0.0	0.0	0.0
Gains (losses)	2.3	4.9	113.7
Other operating income	1.8	1.8	–3.2
Other operating expenses	10.6	11.7	10.3
Net other non-interest income	–6.5	–5.1	–22.2
Total operating income	91.7	82.9	–9.6
General administrative expenses and depreciation	57.6	51.8	–10.1
Net operating income before loss provisions	34.1	31.1	–8.9
Expenses on value adjustments and provisions	–0.7	1.3	–
Other gains (losses)	0.0	0.0	0.0
Profit (loss) from continuing operations, before taxes	**34.8**	**29.8**	**–14.3**
Income tax on continuing operations	5.2	4.1	–22.1
Profit (loss) from continuing operations, after taxes	29.6	25.7	–13.0
Discontinued operations			
Profit (loss) from discontinued operations, after taxes	0.0	0.0	0.0
Current year profit (loss)	**29.6**	**25.7**	**–13.0**

Source: CNB.

Table 11.11 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. 2014		Dec. 2015			Jun. 2016		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
A	5,907.3	98.8	5,539.7	98.8	–6.2	5,415.8	98.8	–2.2
B	67.1	1.1	58.3	1.0	–13.1	57.4	1.0	–1.5
C	5.4	0.1	9.9	0.2	81.9	8.8	0.2	–11.2
Total	5,979.7	100.0	5,607.8	100.0	–6.2	5,482.0	100.0	–2.2

Source: CNB.

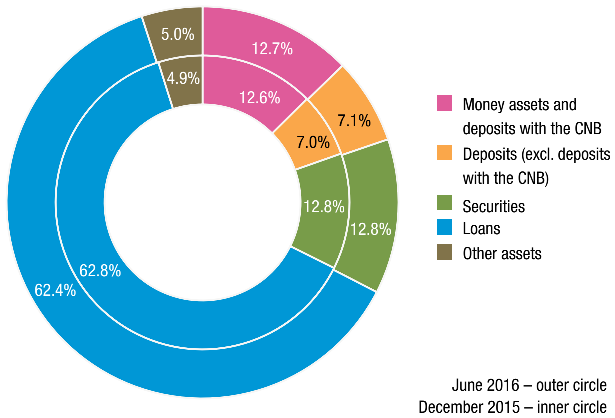
Table 11.12 Coverage of housing savings bank total placements and assumed off-balance sheet liabilities by total value adjustments and provisions

end of period, in million HRK and %

	Dec. 2014	Dec. 2015	Jun. 2016
Total value adjustments against placements and provisions for assumed off-balance sheet liabilities	69.1	68.3	69.4
Value adjustments and provisions	17.5	20.0	22.3
Collectively assessed value adjustments and provisions	51.5	48.4	47.2
Total placements and assumed off-balance sheet liabilities	5,979.7	5,607.8	5,482.0
Coverage	1.2	1.2	1.3

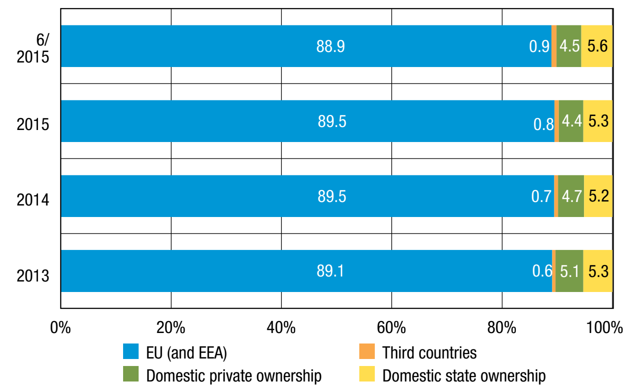
Source: CNB.

Figure 11.7 Structure of bank assets



Source: CNB.

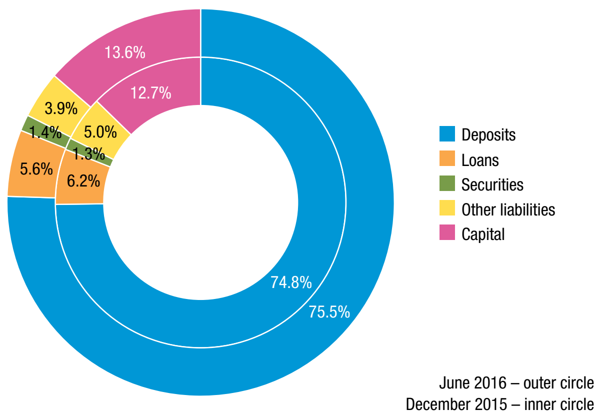
Figure 11.5 Bank assets by shareholder domicile



Note: For the purpose of this overview, a shareholder's domicile means the head office of a legal person or the residence of a natural person. Third country is a foreign country which is not a member state of the EU or a party to the Agreement on the European Economic Area.

Source: CNB.

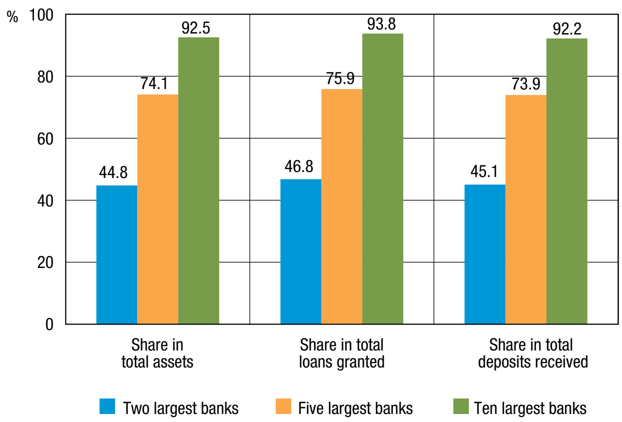
Figure 11.8 Structure of bank liabilities and capital



Source: CNB.

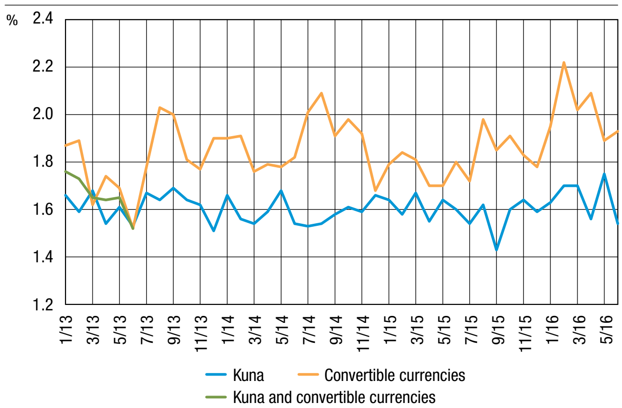
Figure 11.6 Shares of assets, loans and deposits of the largest banks in total assets, loans and deposits

as at 30 June 2016



Source: CNB.

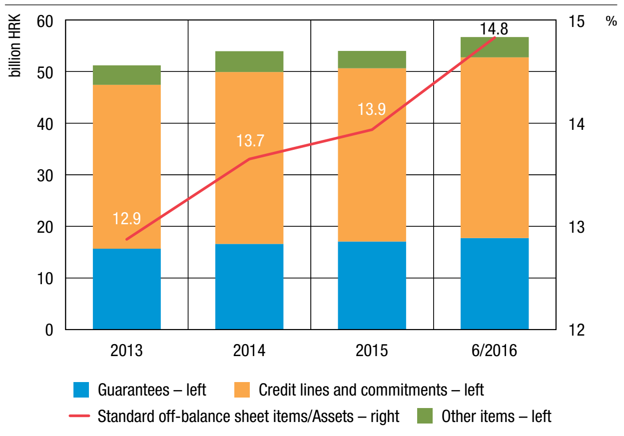
Figure 11.9 Minimum liquidity coefficient for period up to one month



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.

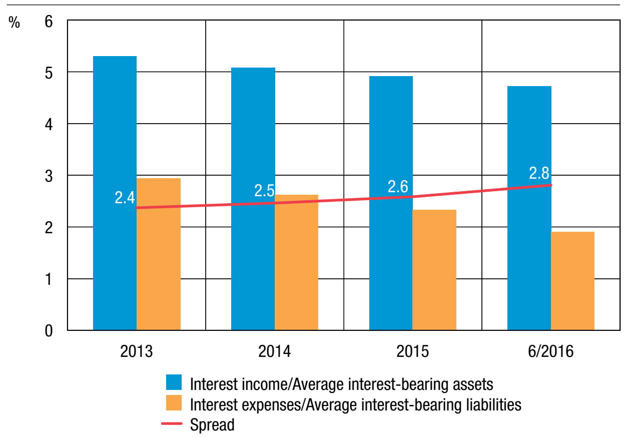
Source: CNB.

Figure 11.10 Bank standard off-balance sheet items



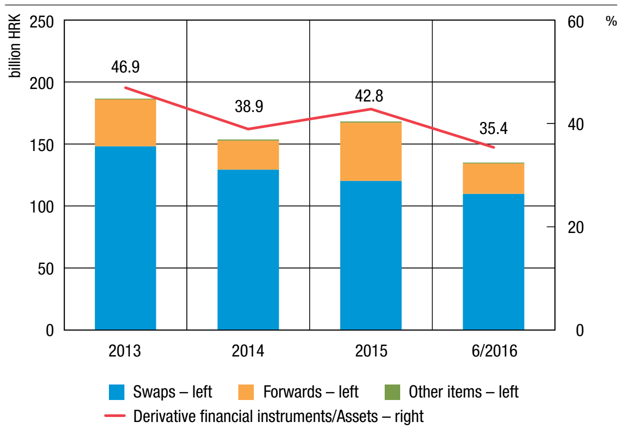
Source: CNB.

Figure 11.13 Income from interest-bearing assets and expenses on interest-bearing liabilities



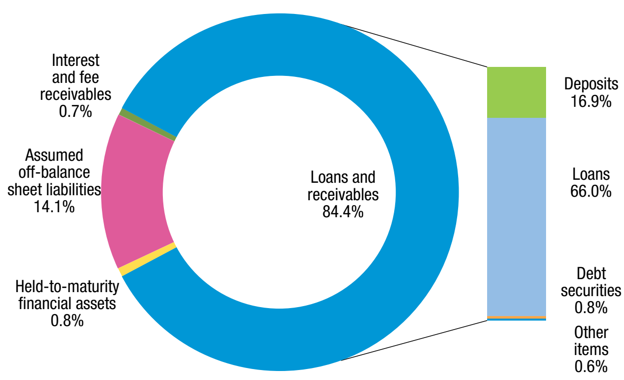
Source: CNB.

Figure 11.11 Bank derivative financial instruments (notional amount)



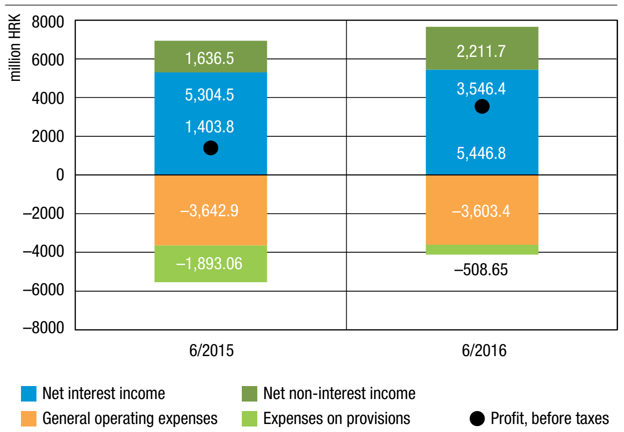
Source: CNB.

Figure 11.14 Structure of bank placements and assumed off-balance sheet liabilities
as at 30 June 2016



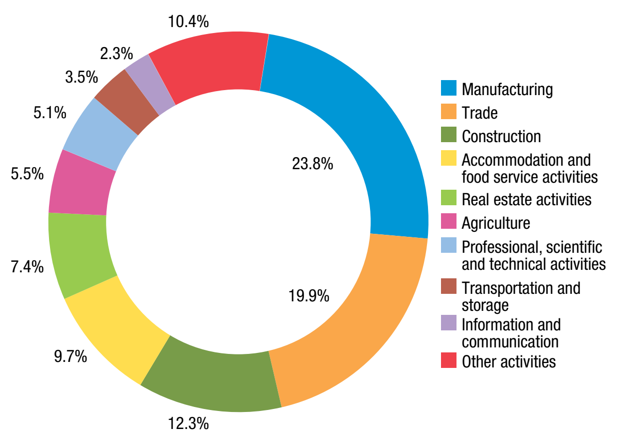
Source: CNB.

Figure 11.12 Bank profit from continuing operations
before taxes



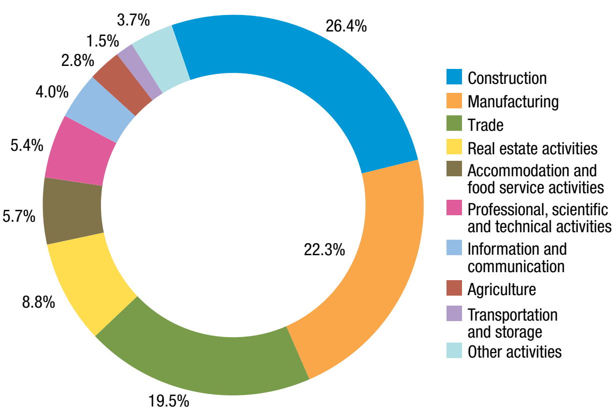
Source: CNB.

Figure 11.15 Structure of bank loans to non-financial corporations by activities
as at 30 June 2016



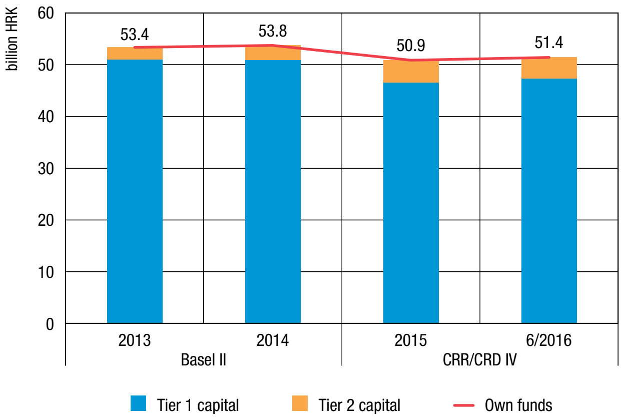
Source: CNB.

Figure 11.16 Structure of bank partly recoverable and fully irrecoverable loans to non-financial corporations by activities
as at 30 June 2016



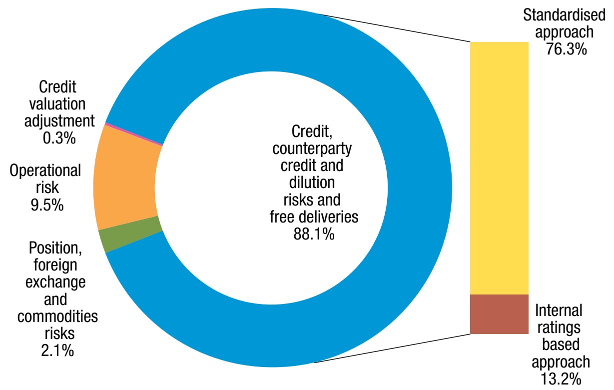
Source: CNB.

Figure 11.18 Bank own funds



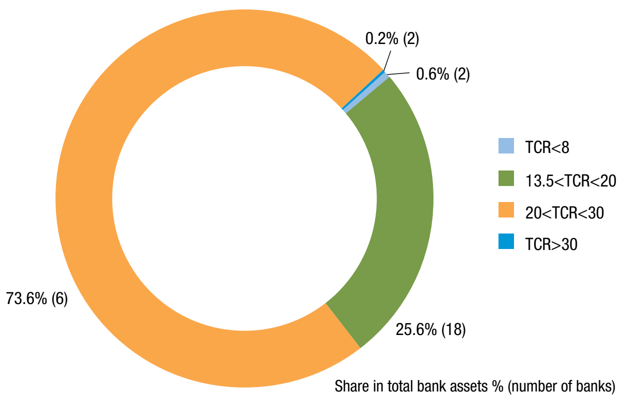
Source: CNB.

Figure 11.17 Structure of bank total risk exposure
as at 30 June 2016



Source: CNB.

Figure 11.19 Distribution of the bank total capital ratio (TCR)
as at 30 June 2016



Source: CNB.

Box 2 Provision of services by EU credit institutions

EU credit institutions may provide services in the Croatian financial market either directly or through a branch. EU credit institutions may freely establish branches in the Republic of Croatia. However, the CNB may, where it deems that financial stability is jeopardised, prevent the merger of a systemically important credit institution from the Republic of Croatia with an EU credit institution. The supervisor of the home member state carries out the prudential supervision of a credit institution that has established a branch in another member state, while the competent authority of the host member state (CNB) monitors the activities of the branch as regards the influence on financial stability, protects the general good and notifies the supervisor of the home member state. The CNB may carry out on-site examination in exceptional circumstances only, in specified cases and for specified purposes. The first branch to which operations of a domestic bank that had merged with an Austrian parent bank (BKS) were transferred was established in Croatia this year. It is noteworthy that banks operating in Croatia and similar cross-border groups are predominantly organised as subsidiary banks, while there are only a few branches. As a result, without substantial changes in their operating model it may be assumed that banks in Croatia will continue their operations through subsidiary banks.

Croatia's joining the EU opened its banking and financial market to the provision of services by EU credit and financial institutions. EU credit institutions may provide banking services in the Croatian market directly or through a branch established in the RC. When providing services directly, if it is not necessary to establish a legal entity in the RC; the supervisory authority of the home member state of the credit institution intending to provide services notifies the Croatian National Bank of the authorisation to provide services in the RC. In the process, the CNB cannot question the authorisation. However, after the credit institution starts providing services in the territory of the Republic of Croatia the CNB monitors its compliance with Croatian regulations.[24]

In addition to the direct provision of services, credit institutions of other member states may provide services for which they have obtained authorisation in their home member state through a branch established in the RC. Potentially smaller costs, more efficient allocation of capital, a higher level of protection against political risk and the potentially lower prudential requirements applied to the branches of credit institutions from other states may provide incentives to establish branches. Apart from one bank (BKS), all other foreign banks operate in the Croatian market through subsidiary banks that are separate legal entities and comply fully with the Credit Institutions Act.

Establishing a branch of an EU credit institution

Within the framework of the right of establishment as laid down in the Treaty on the Functioning of the European Union, companies established pursuant to the law of an EU member state, which have their head offices in the EU, are entitled to establish a branch in other member states. A credit institution that intends to establish a branch in the territory of the RC submits an application to enter the branch in the register of companies. The CNB may notify the credit institution from another member state on the requirements it needs to comply with for the purpose of protecting the general good while providing services through a branch in the RC.

According to supervisory practices, when reaching their decision on the application for the establishment of a branch within the territory of another member state, the supervisory authorities of the state where the credit institution has its principal place of business shall assess:

(i) whether the credit institution has the appropriate organisational, technical and personnel structure or adequate financial position to provide the planned scale of services through a branch;

(ii) whether the credit institution is in this way attempting to evade the stricter rules and regulations in force in its home member state; or

(iii) whether this could jeopardise the safety and stability of the credit institution's operation.

According to the information available, the impact on the financial stability of another member state is rarely assessed, or not at all. The issue of financial stability is left to the sole care of the supervisor of the host county, in this case, the CNB, which, according to EU rules has no influence in the decision-making process.

Significant branch

The establishment of a new branch in Croatia is not a threat to financial stability in the short term but the merger of an existing large credit institution with a parent bank and the transfer of operations to a newly established branch, which would then become a significant branch, would open the door for new risks and/or for the shifting of and changes to existing risks to financial stability. Particular reasons for considering a branch to be significant are the following:

(i) the market share of the branch in terms of deposits as defined in the law governing deposit insurance exceeds 2% in the RC;

(ii) the likely impact of a temporary or permanent cessation of the provision of services on systemic market liquidity and the payment, clearing and settlement systems in the RC; and

(iii) the size and the importance of the branch in terms of number of clients within the context of the banking or financial system of the RC.

Mergers of credit institutions

The transfer of operations of a domestic credit institution to a newly established branch is carried out in two formal steps: firstly, the domestic bank merges with the foreign parent, which requires the CNB approval, and then the foreign parent (i.e. bank) establishes a branch in the RC. The CNB may deny the authorisation for a merger of a domestic credit institution with a bank from another EU member states if in the process of approval it establishes that there are legal grounds to do so, i.e. that the "disruption of the safety and soundness of any single credit institution or of the stability of the financial system in the Republic of Croatia as a whole" might occur (Article 64 of the Credit Institutions Act).

The establishment of a branch of an EU bank does not change a client's status from the aspect of consumer protection because a branch is obligated to adhere to all Croatian

24 The list of institution exercising the right of establishment and freedom to provide services: http://www.hnb.hr/en/core-functions/supervision/passport-notifications.

regulations relating to consumer protection. Clients of a branch of an EU bank have the same rights as clients of a bank that has its head office in the Republic of Croatia. According to EU regulations, the regulations of the member state in which services are provided apply to the branch of an EU bank.

Deposit insurance

Deposit insurance is regulated by EU directives and is harmonised at EU level. Clients of a branch of an EU bank have deposit insurance coverage within the framework of a deposit insurance system to which the bank in whose branch they have placed their deposit belongs. Accordingly, if an Austrian bank establishes a branch in the Republic of Croatia, all savers that have deposits in its branch, regardless of the EU member state they come from, will be insured in Austria. In the event of an insurance event occurring, the insurance system of the EU member state where the branch comes from is obligated to compensate all depositors equally, up to the insured amount, regardless of the country of their residence.

Branch supervision

The prudential supervision of the branch is carried out by the regulator of the founding credit institution within the framework of the comprehensive supervision of the credit institution. Exceptionally, in certain cases and for clearly specified purposes, oversight may be carried out by the CNB. For instance, the CNB monitors the activities of the branch as regards the influence on financial stability, protects the general good and notifies the supervisor of the home member state if it establishes violations of the regulations governing the operation of credit institutions, in certain cases and for clearly specified purposes.

The current market situation indicates that there is little likelihood of the existing significant subsidiaries of credit institutions from the EU with head offices in the RC turning into branches in the medium term. The eight largest banks in foreign ownership, measured by the size of their assets, account for a larger share of claims on households than claims from non-financial corporations, which, according to research,[25] indicates that the transformation to branches is less likely.

Payment system and statistics

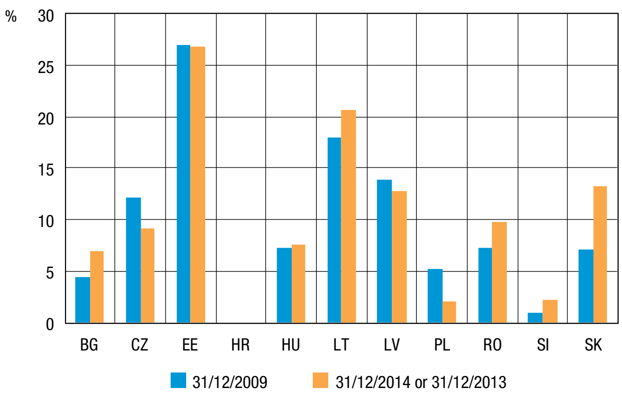
The branches of foreign banks are obligated to adhere to all monetary requirements and to open a kuna and a foreign currency account with the CNB. This makes them subject to the reporting requirement, which ensures the comprehensive monitoring of statistical data connected with payment services conducted in the RC. Thanks to this information the CNB monitors whether the branch does implement monetary measures.

A branch of an institution that has its head office in another EU member state is part of a population of monetary financial institutions that are included in the list of monetary financial institutions for statistical purposes in the country in which the branch operates. Accordingly, the branch is obligated to report statistical data to the CNB, as are all other banks that operate in Croatia.

Branches in the CEE EU member states

EU member states from Central and Eastern Europe are characterised by a large share of foreign ownership in their banking systems. Although in recent years in most of the member states from Central and Eastern Europe a growth in the market share of branches can be seen, the share of branch assets in total banking system assets by country (Figure 11.20) still does not indicate that all branches put together are of systemic importance. With the exception of the Baltic member states and Slovakia, which in the period under review recorded the sharpest increase and a higher level of the ratio referred to, in other countries this ratio was below 10% at the end of 2014.

Figure 11.20 Ratio of assets of branches to total banking system assets, by country



Note: In the calculation of the ratio used were the latest available data of a member state's supervisory disclosure (31 December 2013 for the Czech Republic, Hungary, Poland and Slovenia and 31 December 2014 for the others).
Sources: EBA and competent authorities of the member states.

25 Fáykiss, P., G. Grosz, and G. Szigel (2013): *Transforming subsidiaries into branches – Should we be worrying about it?*, Magyar Nemzeti Bank Occasional Papers 106.
Cerutti, E., G. Dell'Ariccia, and M. S. M. Pería (2007): *How banks go abroad: Branches or subsidiaries?*, Journal of Banking&Finance, Vol. 31, pp. 1669-1692.

Abbreviations and symbols

Abbreviations

bn	– billion
b.p.	– basis points
BEA	– U. S. Bureau of Economic Analysis
BOP	– balance of payments
c.i.f.	– cost, insurance and freight
CBRD	– Croatian Bank for Reconstruction and Development
CBS	– Central Bureau of Statistics
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
RAMP	– Reserves and Advisory Management Program
ROAA	– return on average assets
ROAE	– return on average equity
o/w	– of which
PPI	– producer price index
Q	– quarter
RR	– reserve requirement
SDR	– special drawing rights
SGP	– Stability and Growth Pact
SITC	– Standard International Trade Classification
USD	– US dollar
VAT	– value added tax
ZSE	– Zagreb Stock Exchange
ZMM	– Zagreb Money Market

Symbols

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

ISSN 1849-3483 (online)