HNB

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 2020

Zagreb, November 2020

HRVATSKA NARODNA BANKA • CROATIAN NATIONAL BANK

SEMI-ANNUAL INFORMATION 2020

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in the First Half of 2020

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1 Summary

In the first half of 2020, the global economy and the euro area were hit by the coronavirus pandemic, so that the Croatian economy also faced unprecedented challenges. The long-term economic impacts of the pandemic are only beginning to take shape while inflation has been additionally sluggish globally due to the decline in demand and the great uncertainty. The responses by fiscal and monetary policies to the crisis were more decisive than ever and financing conditions, after the initial shock, remained relatively favourable.

Central banks provided the key support to the economies using all available measures. The CNB has, among other things, intervened in the foreign exchange market, purchased government bonds in the secondary market, carried out structural and regular operations. The CNB ensured exchange rate stability additionally by concluding a swap agreement with the European Central Bank enabling the exchange of the kuna for the euro in the amount of up to EUR 2bn. All the measures individually, and in some measures in interaction, have preserved the stability of the exchange rate and liquidity payments, the government's access to domestic and international financial markets, ensured the smooth functioning of the banking system and maintained the confidence of citizens in the banking, foreign exchange and payment systems.

The whole of the first half of the year was marked by the activities of finalising the process of joining the Exchange Rate Mechanism (ERM II), which was accomplished on 10 July, a key milestone in the process of the adoption of the euro in the Republic of Croatia.

Global developments

A strong contraction of the global economy was recorded in the first half of 2020 as a result of the fast spreading of the coronavirus and the epidemiological measures introduced. In developed countries, the fall in real GDP was the most pronounced during the peak of the pandemic in spring. In the USA, for example, economic activity fell by as much as 9% in the second quarter (from the same period of 2019). In China, the source of the pandemic, the strongest contraction was recorded in the first quarter, while a noticeable recovery in economic activity occurred in the subsequent three months.

Aggregate supply and demand

As a consequence of the pandemic and the measures introduced to suppress it, Croatian real GDP was 7.8% lower in the first half of 2020 than in the same period of 2019, mostly due to the decline in personal consumption, investments and total exports, in particular the exports of services (tourism), while government consumption grew moderately. Personal consumption fell by 6.8% on an annual level. The decline reflected the fall in disposable income due to the negative developments in the labour market, the decline in the consumption of services the provision of which was limited by epidemiological measures as well as the smaller propensity for spending among citizens because of the social distancing measure and the avoidance of risk of contagion and considerable worsening in consumer optimism. Such developments were also reflected in reduced household borrowing.

Labour market

In the beginning of 2020, employment continued to grow, but the trend was stopped in March with the escalation of the pandemic and the introduction of restrictive measures to suppress it. The number of employed persons was 3.3% lower in June 2020 than the year before, primarily because of the smaller number of employed persons in the activity of accommodation and food services. The several-year favourable downward trend in unemployment was also halted. The unemployment rate measured as the share of registered unemployed persons in the total working age population was 10.2 % in June 2020 and 7% at the end of 2019. Fiscal measures, such as subsidies to enterprises, mitigated the decrease in employment and growth in unemployment. Wages increases also decelerated markedly. The average nominal gross wage was slightly higher in June 2020 than in June 2019. This growth was mostly the result of the payment of government subsidies to enterprises.

Inflation

The annual consumer price inflation rate decelerated from 1.4% in December 2019 to –0.2% in June 2020, under the effect of the decrease in the prices of refined petroleum products resulting from the decline in global demand. The spread of the pandemic had an impact on the decrease in inflationary pressures in general, in particular in tourism-related services because of the significant drop in the number of travellers and in durable consumer goods because of the fall in investments. Core inflation slowed down moderately from 1.2% in December 2019 to 1.1% in June 2020, largely driven by the decrease in the annual rate of change in the prices of certain food products (bread, meat and milk) and in hotel and restaurant and accommodation services.

Current and capital account

The decline in economic activity associated with the pandemic resulted in the much sharper fall in goods imports than exports, so that the current and capital account deficit was lower in the first half of 2020 than in the same period of the previous year. In contrast, the considerable decrease in the net exports of services, particularly in tourism, had an unfavourable effect on the current and capital account balance.

Private sector financing

The conditions of household, corporate and government financing remained favourable, thanks to strong monetary policy measures implemented with the aim of supporting liquidity. This means that banks' short-term interest rates remained unchanged or even decreased slightly from the period before the pandemic. The same applies to the interest rates on long-term household borrowing and to the costs of short-term corporate financing. However, interest rates on long-term corporate loans still increased slightly, with interest rates on renegotiated loans increasing, while interest rates on pure new loans decreased. Credit institutions also tightened their credit standards.

Foreign capital flows

The financial account of the balance of payments recorded a net capital inflow of EUR 0.8bn in the first half of 2020, which was primarily the result of the decrease in international reserves. Amid great uncertainty and strong depreciation pressures, the CNB intervened several times in the foreign exchange market in the first half of the year, by selling record amounts of foreign currency, which was in contrast to the same period last year when it mostly intervened through foreign currency purchases. If the change in gross international reserves and liabilities of the CNB is excluded, the first six months of 2020 saw a net capital inflow of EUR 0.3bn, having fallen by EUR 2.0bn from the same period of the previous year. Gross international reserves of the Republic of Croatia decreased by EUR 1.2bn (6.7%) in the first six months of 2020, ending June at EUR 17.3bn. Relative indicators of external debt and international investment position deteriorated.

Monetary policy

The CNB promptly adjusted its monetary policy using all measures available, some for the first time, in order to maintain the stability of the kuna/euro exchange rate and favourable conditions of financing for citizens, enterprises and government. The CNB sold EUR 2.7bn to banks, after which the exchange rate of the kuna was stable, and the kuna liquidity withdrawn through the sale of foreign currency was more than offset by other monetary policy measures of the CNB, including structural and regular operations, a cut in the reserve requirement rate and the secondary market purchase of government bonds. As a result, kuna liquidity was at its record high, enabling the government and the private sector to continue borrowing from domestic banks on almost the same terms as before the crisis. However, credit standards were tightened because of weakening economic activity and a decline in demand for loans, contributing to a slowdown in household lending.

Public finance

The budget deficit of HRK 13.2bn in the first half of 2020 reflects the adverse effect of the crisis caused by the pandemic on economic activity, including the budget revenues. The provisional measures to mitigate the adverse effects of the crisis also contributed to the decrease in revenues on account of a write-off of taxes and the growth in expenditure for job preservation grants. This mainly refers to the second quarter, in which the deficit stood at almost HRK 10bn. The budget deficit was mainly financed in the domestic market.

International reserves management

Although almost 60% of government securities of euro area member states had negative yields, the annual rate of return on the entire euro portfolio was 0.36% in the first half of 2020, while the annual rate of return on the dollar portfolio totalled 2.17%. In the first half of 2020, international reserves investments generated an income of EUR 54.1m. In a particularly demanding and challenging environment, the primary objective of international reserves management, namely to ensure liquidity and safety, was successfully achieved.

Business operations of credit institutions

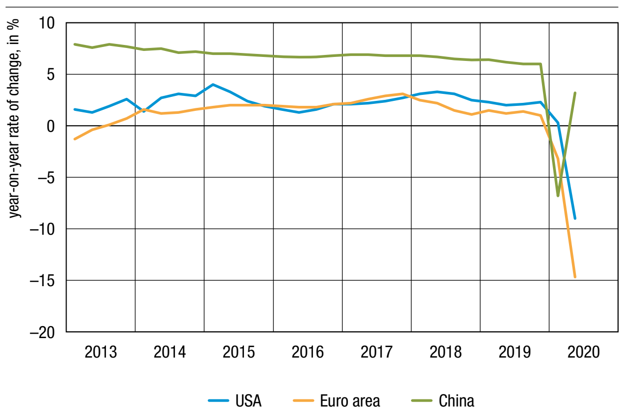
Business operations of banks in the first half of 2020 were strongly influenced by the Covid-19 pandemic, their profits and indicators of return being half as much as in the same period of 2019. Profits were lower due to the decrease in almost all operating income items and the increase in operating expenses caused by higher credit risk. However, the strong capital and liquidity position of banks, CNB measures to alleviate the consequences of the pandemic, coupled with targeted amendments to the prudential regulatory framework and a more flexible approach to its implementation absorbed the shock and ensured a continuation of safe and stable bank operations.

The quality of exposure to credit risk, measured in terms of the share of non-performing loans in total loans, remained at last year's level, so the non-performing loans ratio totalled 5.5%. In line with supervisory expectations of the CNB from credit institutions regarding the pandemic, banks retained their profits generated in 2019 and thus further strengthened their capital.

2 Global developments

A strong contraction of the global economy was recorded in the first half of 2020 as a result of measures against the escalation and spread of the coronavirus pandemic as well as of changes in the behaviour of consumers and enterprises due to heightened uncertainty. In developed countries, real GDP fell sharply in the second quarter during the peak of the pandemic wave in spring, while in China, the source of the pandemic, the strongest contraction was recorded in the first quarter, with a noticeable recovery in economic activity in the subsequent three months (Figure 2.1). Central banks from all over the world responded to the economic shock caused by the pandemic with a strong monetary expansion, which resulted in a perceptible increase in central banks' balance sheets. This has enabled financing conditions, after the initial shock, to remain relatively favourable and governments to respond to the crisis with large fiscal packages to assist all sectors of the economy.

Figure 2.1 Economic growth in selected markets



Sources: Eurostat, BEA and NBS.

The coronavirus pandemic had a negative effect on the largest world economy as early as in the first quarter, a sluggish economic growth of 0.3% on an annual level being recorded in the USA in the first three months of 2020. However, with the sudden worsening of the epidemiological situation at the end of March and the resulting introduction of restrictive measures in a number of federal states, in the second quarter, economic activity fell by 9.0%, which was noticeably stronger than the contraction caused by the global financial crisis. All GDP components recorded a decline, with the exception of government consumption, while at the same time price pressures eased noticeably, as a result of which inflation remained below the Fed's target.

As regards the euro area, economic activity declined by 3.2% in the first quarter, but contraction deepened strongly during the spring months when the pandemic wave reached its peak and resulted in the suspension of economic activities due to the prescribed epidemiological measures. There was a decline of 14.7% on an annual level. The intensity of the contraction was uneven, the decrease in economic activity being the most pronounced in members that were among the countries most severely hit by the pandemic and/or with a large share of services, in particular tourist activity, in the structure of the national economy, such as Spain, France, Italy or Greece, while the decline was noticeably smaller in the Scandinavian countries. In the course of June, with the arrival of warmer weather and the normalisation of the epidemiological situation, as well as the gradual lifting of restrictive measures, economic activity picked up again in most of the member states.

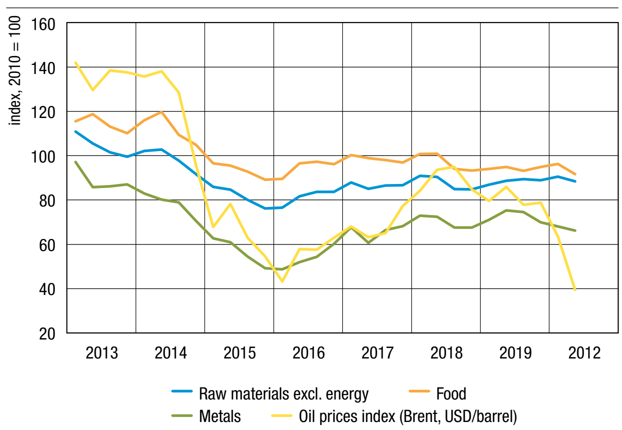
2.1 Croatia’s main trading partners

All of Croatia’s major trading partners saw a noticeable decline in economic activity. This decline was the most pronounced in euro area countries, in particular in Italy, where the epidemiological situation during spring was very difficult and where extremely restrictive epidemiological measures were introduced as early as in February. At the same time, the decline in economic activity was less pronounced in Germany, Austria and Slovenia. With regard to Croatia’s trading partners in Southeastern Europe, in the first quarter, Serbia and Bosnia and Herzegovina recorded economic growth on an annual level. However, the worsening of the epidemiological situation and the introduction of rigorous measures in the subsequent three months resulted in a strong contraction.

2.2 Prices, exchange rates and financing conditions

Raw material prices fell considerably in the first half of 2020. The average price of a barrel of Brent crude oil was USD 40 in June, down by 40% from the end of 2019. The fall in the prices in the first four months can be explained by reduced global demand as a result of the decline in economic activity, as well as the failed attempt to reach an agreement between Saudi Arabia and Russia on the reduction of oil production and growing inventories of major global crude oil producers. The downward slope of crude oil prices came to a halt in early May after which the price continued to grow until the end of June. The increase in prices was mostly due to the agreement among OPEC countries and other oil producers to reduce production in response to the decline in demand. The price increase was also spurred by the earlier-than-expected easing of the restrictions imposed in response to the pandemic, which fuelled a rise in demand for oil. The prices of raw materials excluding energy also decreased in the first six months of 2020. This was mostly due to the fall in the prices of metals and food raw materials caused by the pandemic. Metal prices fell sharply in the first four months of 2020, but partly recovered later on, thanks to the resumption of industrial production in China resulting in larger demand. The majority of food products recorded a drop in prices.

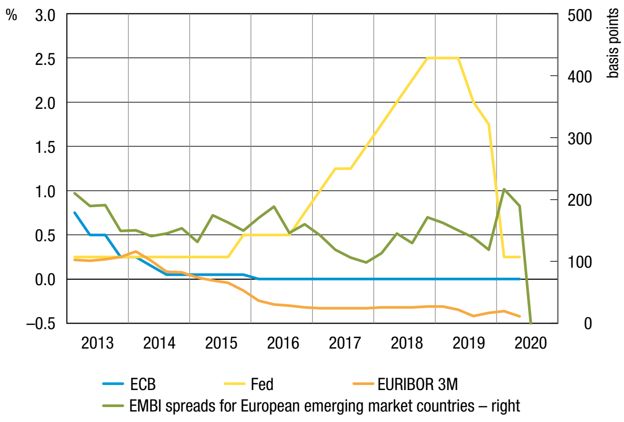
Figure 2.2 Raw material prices in the world market in US dollars



Sources: IMF and Bloomberg.

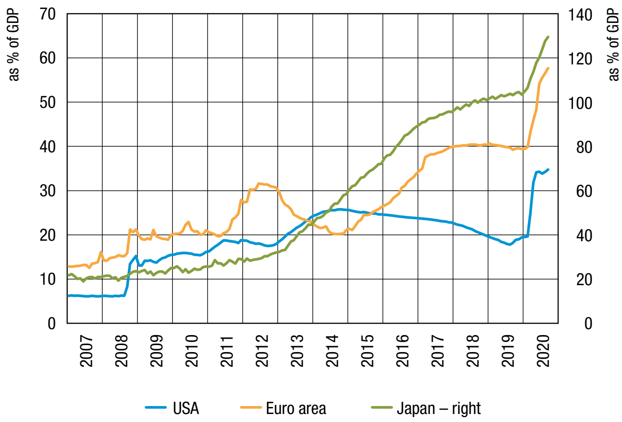
The central banks of the countries with developed financial markets promptly adopted strong unconventional measures to respond to the strong contraction of economic activity. Following a three-year period in which it gradually raised its benchmark interest rate, the Fed

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



Source: Blomberg.

Figure 2.4 Central banks' assets to GDP



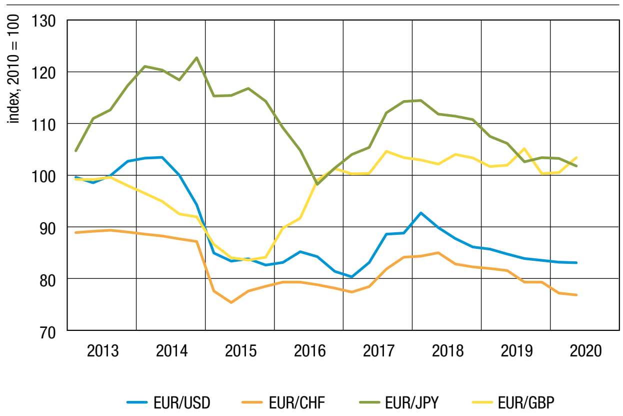
Sources: AMECO and FRED.

responded to the first signs of the deterioration in the global epidemiological situation and reduced its benchmark interest rate back to the historical minimum at several extraordinary meetings (Figure 2.3). At the same time, the Fed introduced several funding programmes that sharply increased the Fed's balance sheet (Figure 2.4). In addition, in order to secure sufficient dollar liquidity for the global economy, the Fed concluded bilateral currency swap agreements with a number of central banks, under which central banks can temporarily swap their domestic currency for US dollars. Following the pandemic outbreak, the ECB also responded decisively through a range of unconventional monetary policy measures to maintain financial stability and favourable financing conditions for all sectors of the economy. Although in a noticeably smaller volume than the Fed, the ECB also concluded currency swap agreements with some non-euro area central banks (e.g. Bulgaria, Denmark and Croatia) to ensure sufficient euro liquidity.

After a strong deterioration due to the epidemic outbreak, the financing conditions for European emerging markets, including Croatia, improved towards the end of the second quarter, but the EMBI index for European emerging markets increased by 70 basis points at the end of June 2020 from the end of 2019.

The tendency of the euro to weaken against the US dollar in the world foreign exchange market, present constantly since the beginning of 2018, continued in the first half of 2020, albeit at a slower rate than in the previous year. The first half of the year was marked by the volatility of the exchange rate due to the outbreak of

Figure 2.5 Exchange rate movements of individual currencies against the euro



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

the pandemic and the heightened risk aversion of investors. However, after the reaction of central banks and the stabilisation of the situation in financial markets, the pre-crisis trends in the foreign exchange market continued. At the end of June 2020, the US dollar/euro exchange rate was EUR/USD 1.10, which is a decrease of 0.5% from the end of 2019. The recovery of the exchange rate of the euro at the end of June was also attributed to the increased outlook concerning the reaching of an agreement at the EU level with regard to the recovery instruments as well as the early economic activity indicators that pointed to a strong recovery after the lifting of epidemiological measures. The exchange rate of the Swiss franc against the euro stood at EUR/CHF 1.06, down by around 3.2% from the end of the year.

3 Aggregate supply and demand[1]

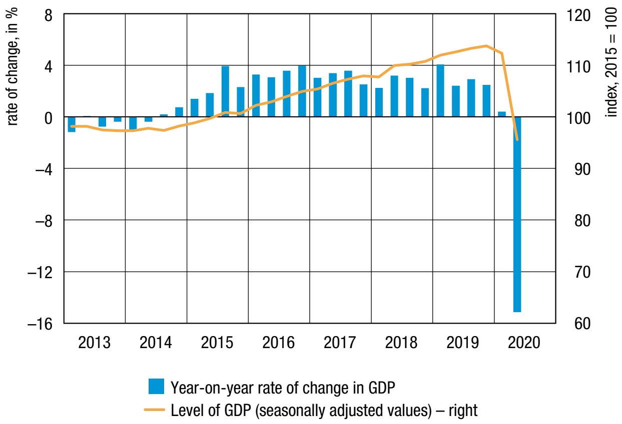
Real GDP was 7.8% lower in the first half of 2020 than in the same period of the previous year as a consequence of the adverse impact of the coronavirus pandemic on global and domestic economic activity. If analysed by quarters, economic activity in the first three months of 2020 grew by 0.4% on an annual level, and it fell by 15.1% in the second quarter. The largest individual contribution to the contraction of economic activity in the first six months of the current year was made by personal and investment consumption, while government consumption grew moderately. Total exports fell sharply, in particular the exports of services, due to the decline in foreign tourist demand because of the avoidance of travel and exposure to the risk of contagion and due to foreign and domestic epidemiological measures that mostly restricted the provision of tourism-related services. However, since at the same time the imports of goods and services decreased significantly, the negative contribution of net foreign demand to economic growth declined on an annual level.

In the first half of 2020, economic activity fell sharply as a consequence of the extremely adverse impact of the coronavirus pandemic on global and domestic economic activity, mainly in the second quarter. The effects of the pandemic were shown in the smaller propensity for spending and the growing general economic uncertainty, as well as in the negative impact that the measures to curb the pandemic had on the provision of certain services. The key measures, varying in intensity, that were implemented in Croatia from the beginning of March to the beginning of June, included: the closure of schools, universities and kindergartens and organising online schooling; the closure of restaurants, bars, night clubs, cinemas, theatres, museums, public libraries and sports centres; the prohibition of public gatherings and intercounty travel and the implementation of a mandatory 14 day quarantine when entering Croatia and reducing the operation of public transport and the working hours of shops. Similar measures were implemented in almost all European countries.

If analysed by quarters, economic activity in the first quarter increased by 0.4% on an annual level, and in the second quarter it fell by 15.1% from the same period of the previous year. Consequently, real GDP was 7.8% lower in the first six months of 2020 than in the same period of 2019 (for comparison, at the rate of growth was then 3.2%). Personal consumption stands out as making the largest individual contribution to the decline in economic activity. Capital investment also decreased sharply, while government consumption grew moderately. With regard to foreign demand, total exports fell sharply, in particular the exports of services, as a result of travel restrictions due to the measures to stop the spread of the virus in the population and the general lower demand for tourist services because of the high risk of contagion. At the same time, the imports of goods

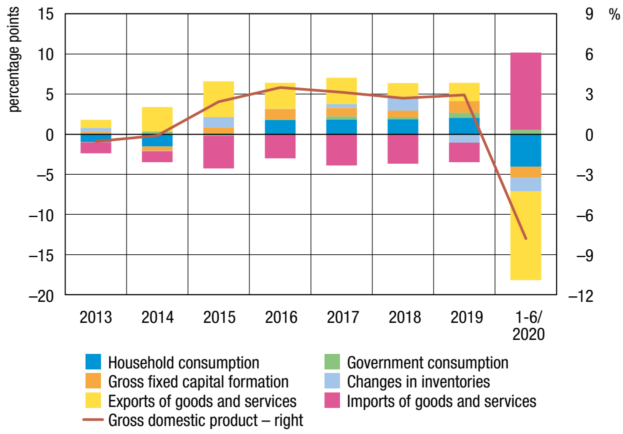
1 On 19 October 2020, the CBS presented a revised time series of data on gross domestic product (GDP) for the period 1995 – 2019. The official CBS quarterly GDP data, available up to 16 October 2020, were used in the Semi-annual Information.

Figure 3.1 Gross domestic product
real values



Source: CBS.

Figure 3.2 GDP rate of change
contributions by components



Source: CBS.

and services also dropped considerably so that the negative contribution of net foreign demand to economic growth was reduced on an annual level.

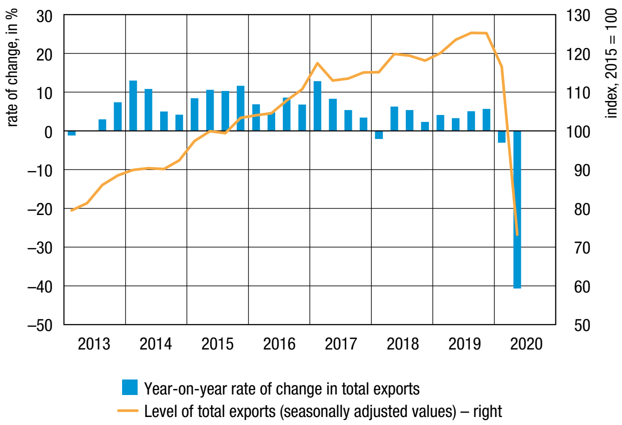
If analysed by the production approach, in the first half of the year the annual decline in gross value added (GVA) was 5.8%. Economic activity declined in almost all activities, with the largest drop recorded in service activities such as wholesale and retail trade, transportation and storage, accommodation and food service activities.

3.1 Aggregate demand

The real exports of goods and services fell sharply in the first half of 2020, and it was lower by 25.6% than in the same period of the previous year when the annual rate of growth of total exports stood at 3.6%. Total exports in the first quarter of 2020 fell by 3.0% on an annual level and recorded an annual decline of 40.6% in the second quarter.

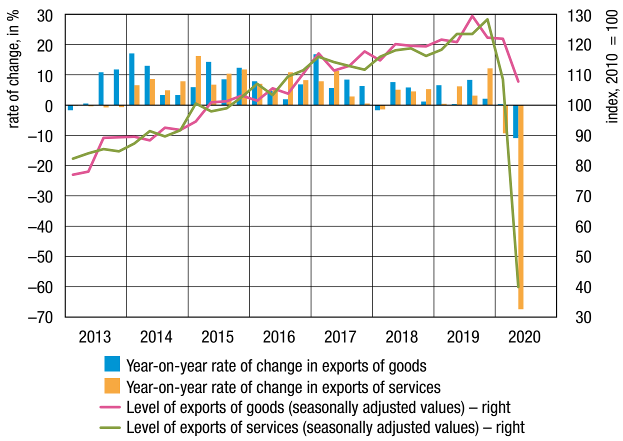
Goods exports decreased by 5.4% in the first half of 2020 from the same period of the previous year, when they grew by 3.3%. The exports of goods in the first quarter

Figure 3.3 Exports of goods and services
real values



Source: CBS.

Figure 3.4 Real exports of goods and services

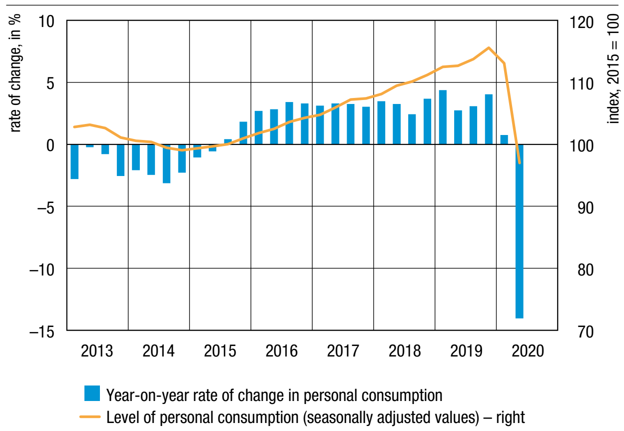


Source: CBS.

of 2020 held steady relative to the same period of 2019 and then dropped sharply in the second quarter (10.9% on an annual level). Nominal data on the trade in goods broken down by main industrial groupings show that the exports of all groups of products, in particular the exports of capital goods, decreased in the first half of 2020 on an annual level. The exports of services had declined by 9.4% already in the first quarter of 2020 from the same period of the previous year and the decline accelerated significantly in the second quarter and reached 67.4%.

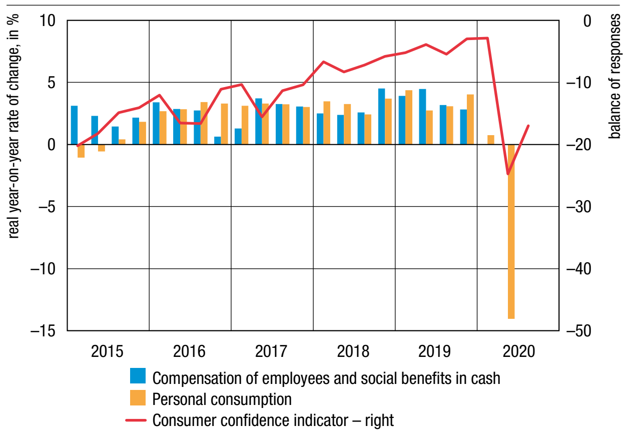
Personal consumption fell by 6.8% from the same period of the previous year (when it rose by 3.5%). The decline reflected the adverse effect of the pandemic on the economy and on the propensity of people to spend. Apart from the provision of a large number of services having been directly limited due to the measures implemented, household consumption also decreased because of their efforts to avoid social contacts to the largest possible extent in order to reduce the risk of contagion. The strong

Figure 3.5 Personal consumption
real values



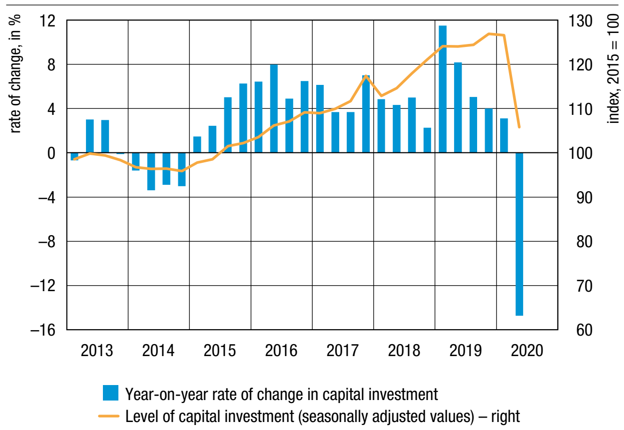
Source: CBS.

Figure 3.6 Determinants of personal consumption
real values and index



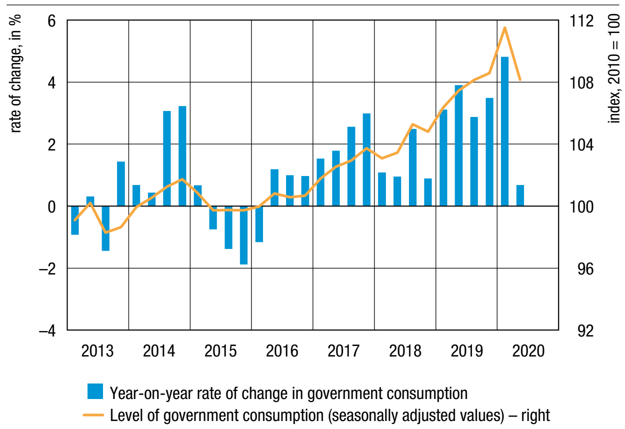
Note: Real values of compensation of employees and social benefits in cash were calculated by deflating nominal values using the personal consumption deflator.
Sources: CBS, Ipsos and CNB.

Figure 3.7 Gross fixed capital formation
real values



Source: CBS.

Figure 3.8 Government consumption
real values



Source: CBS.

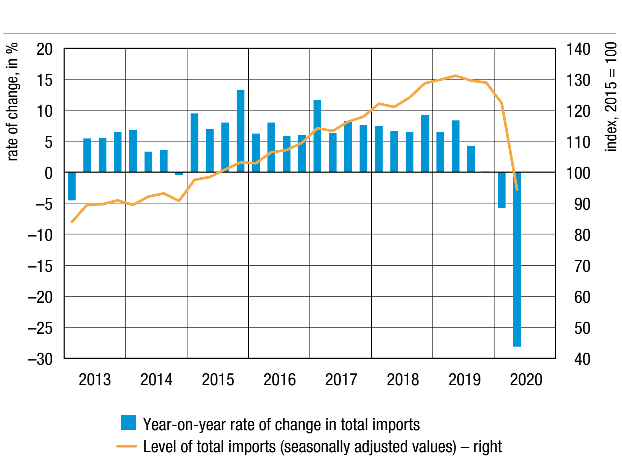
deterioration in consumer optimism and the rise in uncertainty also led to the decline in the propensity to spend and to reduced household borrowing. In addition, negative developments in the labour market resulted in the fall in disposable income. Quarterly data show that household consumption in the first quarter was 2.1% lower than in the last three months of 2019, after which the decline accelerated strongly in the second quarter and stood at 14.2% on a quarterly level (or 14.0% on an annual level).

The impact of the pandemic on the rise of economic uncertainty was also reflected in investment activity. Gross fixed capital formation was down by 6.3% in the first six months of 2020 from the same period of 2019 (when it grew 9.7%). If analysed on a quarterly level, investment activity in the first three months of 2020 remained at the level from the end of 2019 (–0.3%) and then dropped sharply in the period from April to June (16.4% on a quarterly level). The data on the decline in the volume of construction works on buildings point to the decrease in private investment. In contrast, in the first half of 2020, the volume of other civil engineering works increased, reflecting the trends in public investment, which, according to fiscal data, was 16.1% higher in the first half of the year than in the same period of the previous year.

Government consumption was the only component of domestic demand that made a positive contribution to the overall change in real GDP and its annual growth in the first half of 2019 stood at 2.7%. However, the annual government consumption growth decelerated relative to the same period of 2018, when the annual real growth rate stood at 3.5%. Nominal data show that, on an annual level, consumption for the use of goods and services declined, while consumption for employee compensations increased, in accordance with the previously agreed increases in wages in the health sector as well as the increase in the base for the calculation of wages in the public sector by 2%.

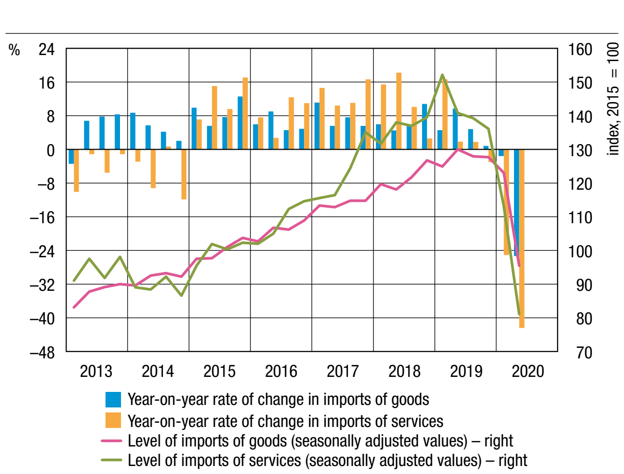
The imports of goods and services declined by 17.5% in the first six months of 2020 from the same period of the previous year (when the annual growth stood at 7.5%), thus reflecting the decline in personal consumption, investment activity and total exports. Nominal data on the trade in goods show that, on an annual level, imports decreased in all of the main industrial groupings, mostly the imports of energy, noticeably as a

Figure 3.9 Imports of goods and services
real values



Source: CBS.

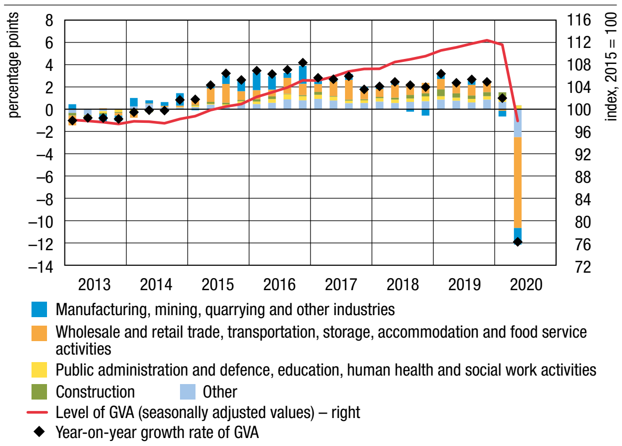
Figure 3.10 Real imports of goods and services



Source: CBS.

result of the drop in crude oil prices. The fall in the imports of services by 33.8% on an annual level may be linked to the smaller tourist consumption of residents abroad. The decrease in imports in the first two quarters of 2020, although sharp, was less pronounced than the decline in exports. This has resulted in a negative contribution of net foreign demand to the total rate of change in GDP (of 1.4 percentage points), smaller, however, than in the same period of 2019 (when it was 2.4 percentage points).

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



Source: CBS (seasonally adjusted by the CNB).

3.2 Aggregate supply

In the period from January to June 2020, gross value added (GVA) was 5.8% lower than in the same period of 2019, when it had grown by 2.8% on an annual level. GVA decreased in almost all activities, except in construction, information and communications and public administration and defence, education, human health and social work activities. The sharpest decrease in GVA was seen in wholesale and retail trade, transportation and storage, accommodation and food service activities. These activities, which are closely related to tourism, made the largest contribution to the total decrease in GVA. In addition, a decrease was also recorded in other service activities the functioning of which was restricted by the epidemiological measures of social distancing. The decline reflected the direct effects of the measures introduced as well as the changes in the habits of consumers.

4 Labour market

In the beginning of 2020, employment continued to grow, but the situation worsened in March with the escalation of the pandemic and the introduction of restrictive measures to suppress it, thus reversing the several-year favourable trend. The number of employed persons was 3.3% lower in June 2020 than in the year before and declined to the level from June 2018. The sharpest decline in the number of employed persons was recorded in the activity of accommodation and food services, which were hit the hardest by the restrictive measures. The several-year downward trend in unemployment was also halted in March. Growth in unemployment had an impact on the registered unemployment rate, which stood at 10.2% of the labour force in June 2020 (from 7% at the end of 2019). In June 2020, the average nominal gross wage was slightly higher than in June 2019. The relatively less pronounced response of the labour market to the sharp decline in economic activity in the second quarter of 2020 primarily reflected the measures of the Government of the Republic of Croatia aimed at job preservation.

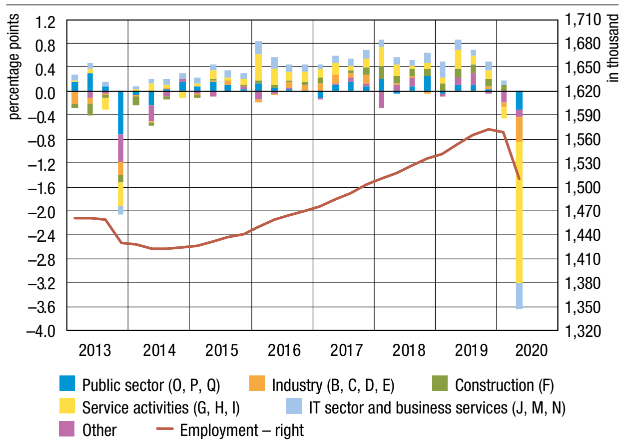
4.1 Employment and unemployment

The coronavirus pandemic had a very unfavourable effect on labour market developments. The employers' response to the decline in economic activity was very swift, but substantial fiscal grants for the preservation of jobs offset the intensity of the decrease in employment.[2]

In the beginning of 2020, employment remained at the level from the end of 2019, and in March, when restrictive measures to curb the coronavirus pandemic were introduced, the several-year growth trend was stopped. The number of employed persons fell sharply in April and continued its downward trajectory at a slower rate in May, too. Accommodation and food service activities, which were the most affected by restrictive measures, recorded the sharpest decrease in the number of employed persons. The improvement in the epidemiological situation and the lifting of restrictive measures led to set the pace for a slight increase in employment in June 2020 from the previous month.

In all, at the end of June 2020, the number of employed persons was down by 3.3% from June of the previous year, thus

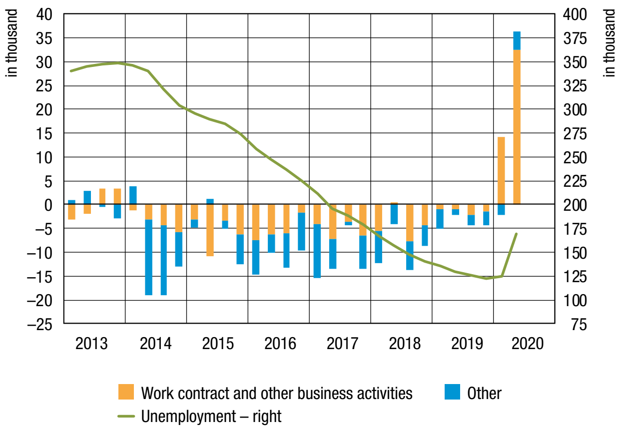
Figure 4.1 Employment by NCA activities
seasonally adjusted data, contributions to the quarterly rate of change



Source: CPII (seasonally adjusted by the CNB).

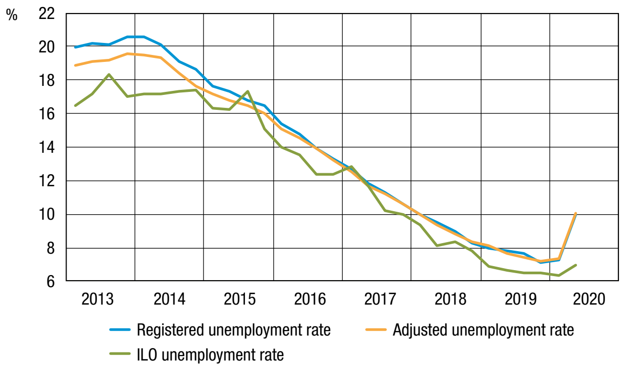
2 In the period from March to May, as many as one third of the total number of employed persons received job preservation grants, and in June, their coverage decreased noticeably.

Figure 4.2 Total unemployment and net unemployment inflows
seasonally adjusted data



Source: CES (seasonally adjusted by the CNB).

Figure 4.3 Unemployment rates
seasonally adjusted data



Notes: The adjusted unemployment rate is the CNB estimate and is calculated as the share of the number of registered unemployed persons in the working age population estimated as the sum of unemployed persons and persons insured with the CPII. Since January 2015, the calculation of the registered unemployment rate published by the CBS has been made using the data on employed persons from the JOPPD form.
Sources: CBS and CES (seasonally adjusted by the CNB).

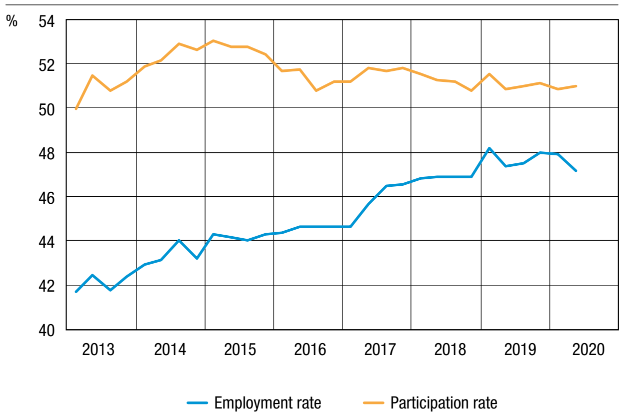
falling to the level from June 2018 and the average number of employed persons in the first half of 2020 was 0.5% lower than in the same period of the previous year.

Unemployment continued to fall in early 2020, but the several-year downward trend was stopped in March 2020 when unemployment grew due to the increasingly stronger inflows of newly unemployed persons in the CES register. The inflow of newly unemployed persons intensified additionally in April, and, consequently, the increase in unemployment accelerated. In May 2020, the growth of unemployment slowed down and in June unemployment decreased as a result of new employment. At the end of June 2020, the number of unemployed persons was higher by almost 40 thousand than the year before.

The registered unemployment rate (seasonally adjusted data) remained unchanged in January and February 2020, relative to December 2019 (7% of the labour force). However, it increased in the subsequent months and reached 10.4% in May. The rate decreased slightly to 10.2% in June, which was an increase by 2.4 percentage points from the same month in 2019.

According to data from the Labour Force Survey, the unemployment rate in the first half of 2020 stood at 6.7%, a slightly lower level than in the same period of the previous year (6.8%). It is worth noting that the latest performances for the second quarter of 2020 point to a strong increase in the gap between the registered and ILO unemployment rates, which might reflect the decline in the quality of such data taking into consideration the specific conditions in which the Labour Force Survey was conducted.

Figure 4.4 Labour Force Survey
seasonally adjusted series



Source: CBS (seasonally adjusted by the CNB).

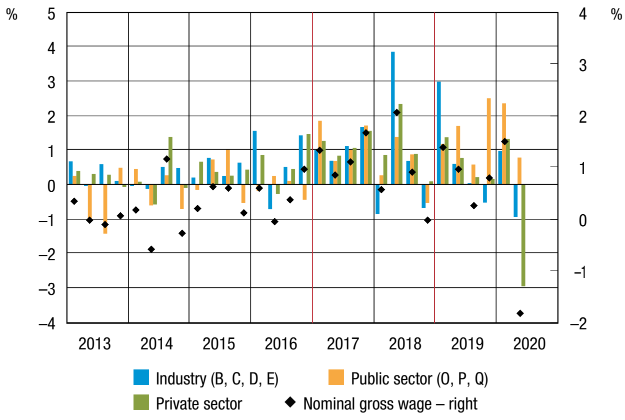
The employment rate decreased in the first half of 2020, while the participation rate remained almost unchanged (47.5% and 50.9% respectively) from the levels at the end of 2019. Both the employment rate and the participation rate decreased on an annual level.

4.2 Wages and unit labour costs

In the first quarter of 2020, the increase in wages accelerated from the end of 2019, with the wage increase being broadly based. However, the coronavirus pandemic also impacted the trends in wages. Thus the average nominal gross wage (seasonally adjusted data) paid out in April was 2.3% lower than in March 2020. Private sector wages fell more markedly, while public sector wages declined only moderately. The decline in wages also continued in May 2020, though at a much slower rate. The average nominal gross wage rose in June 2020 from the previous month, and it was slightly higher than in June 2019. Taking into account the large number of workers that received government grants, the above leads to the conclusion that employers paid out the difference between the grant and the contracted workers' wages to the largest extent.

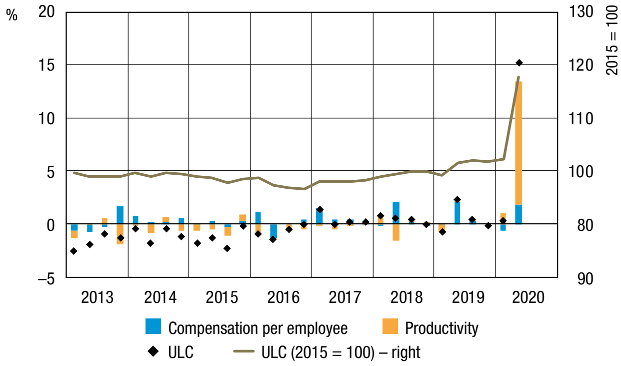
Unit labour costs rose by 9.5% in the first half of 2020 from the same period of the previous year, as it primarily reflected the sharp decline in labour productivity. An equally sharp decline in labour productivity is also recorded when productivity is calculated as the ratio between production and the number of working hours (instead of production and the number of employed persons). According to the official CBS data, no significant decline in the number of working hours of the kind that was registered in most other EU member states was recorded in the second quarter of 2020.

Figure 4.5 Average nominal gross wage by NCA activities
seasonally adjusted data, quarterly rates of change



Note: As of January 2016, data refer to the JOPPD form, while earlier data refer to the RAD-1 form.
Sources: CBS and CNB calculations (seasonally adjusted by the CNB).

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



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

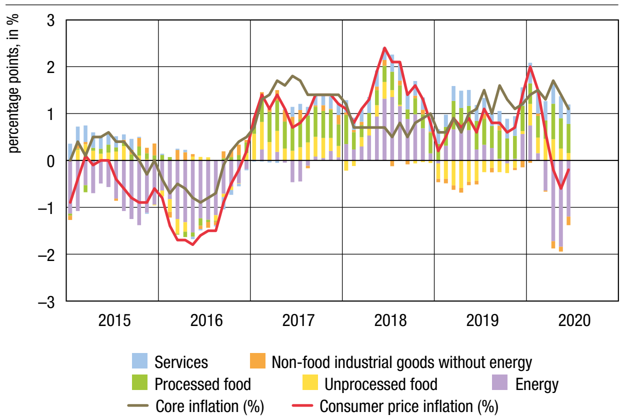
5 Inflation

The annual consumer price inflation rate decelerated from 1.4% in December 2019 to –0.2% in June 2020, under the effect of the decrease in the prices of energy, in particular of refined petroleum products. This reflected the sharp drop in crude oil prices on the global market that was largely the result of the decrease in demand due to the worsened outlook for global economic growth caused by the coronavirus pandemic. The spread of the pandemic had an impact on the easing of inflationary pressures as a result of the decrease in demand, particularly pronounced in the segment of tourism-related services and durable consumer goods. By contrast, inflationary pressures in the first half of 2020 stemmed from the increase in unit labour costs (taking into account the significant decline in labour productivity), the shocks on the supply side, mostly related to the disruptions in supply chains due to the pandemic outbreak and the rise in excise duties. Core inflation slowed down moderately from 1.2% in December 2019 to 1.1% in June 2020, mostly driven by the decrease in the annual rate of change in the prices of certain food products (bread, meat and milk) and in hotel and restaurant and accommodation services.

The annual consumer price inflation decelerated considerably in the first half of 2020 as a result of the decrease in energy prices, primarily of refined petroleum products. The sharp fall in the prices of crude oil on the global market was the result of the decline in demand due to the worsened global economic growth outlook because of the coronavirus pandemic and the failure by the OPEC+ countries to reach an agreement to reduce output. The average price of a barrel of Brent crude oil dropped to USD 23 in April, having fallen by 67% from December 2019. The spread of the pandemic had an impact on the decrease in inflationary pressures due to the decline in demand, which was particularly pronounced in the segment of tourism-related services (accommodation and restaurants and bars) and durable consumer goods (cars). In contrast, inflationary pressures in the first half of 2020 were fuelled by the increase in unit labour costs (with regard to the considerable fall in labour productivity), shocks on the supply side primarily associated with interruptions in supply chains triggered by the pandemic outbreak and administrative decisions (the rise in the prices of cigarettes, and sugary and alcoholic beverages driven by the April increase in excise duties).

The annual consumer price inflation rate decelerated from 1.4% in December 2019 to –0.2% in June 2020. The

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



Notes: Core inflation does not include agricultural product prices, energy prices and administered prices. Processed food products include alcoholic beverages and tobacco.
Sources: CBS and CNB calculations.

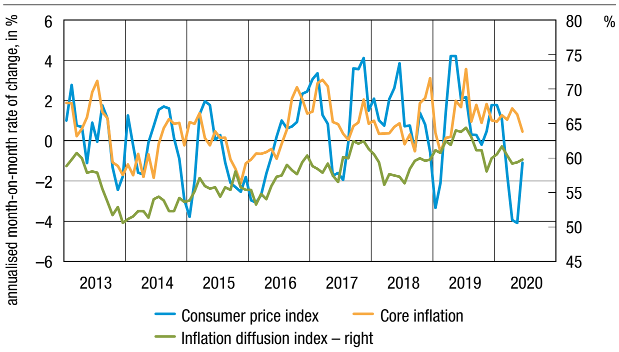
contribution of energy prices to the annual consumer price inflation thus fell from 0.6 percentage points in December to –1.2 percentage points in June (Figure 5.1). In addition to refined petroleum products the price of which went down 13% in June from the same period of the previous year, the mentioned fall in the contribution of energy prices was influenced to a smaller extent by a fall in the prices of solid fuels and natural gas (which are administered prices and which decreased in April). As at the end of 2019, the contribution of the prices of industrial products (food and energy excluded) to inflation was slightly negative in June 2020, at –0.2 percentage points.

By contrast, the contribution of the prices of food products to overall inflation rose slightly in the first half of 2020. The annual growth rate of the prices of unprocessed food products accelerated strongly at the beginning of the year (from 0.7% in December 2019 to 5.6% in January 2020). This was to a considerable extent due to the base period effect (the fall in the prices of these products in January 2019 that followed the reduction in the VAT rate). In March and April, the annual growth rate of the prices of unprocessed food products held steady at a high level from the beginning of the year and then slowed down to 1.9% in June, mostly due to the slowdown in the annual growth rate of the price of meat (as a result of the steep growth of the prices of meat in the second half of 2019). In addition, the significant acceleration in the annual growth rate of the prices of processed food products (including alcohol and tobacco) from 1.7% in March to 3.3% in April 2020, was mostly due to increased excises on tobacco and sugary and alcoholic beverages, after which the annual growth in these prices slowed down. The impact of the increase in excise duties on the annual consumer price inflation rate at the end of June stood at 0.3 percentage points.

The annual growth rate of services prices was 1.6% in June 2020, so that the contribution of the services prices to inflation was almost equal to that at the end of 2019 (0.4 percentage points). The increased contribution of the prices of telephone services and insurance connected with transport to overall inflation was largely offset by the smaller contribution of the prices of hotel and restaurant services. It should be noted that no field price collections were made in April 2020 and that a large number of commercial and catering facilities were closed so to calculate the consumer price index, it was necessary to construct the missing prices (imputed prices). Price collections in March and May of 2020 were hindered to a smaller extent. Services prevail in the list of indices having low reliability and over 50% of imputed prices. For this reason, the analysis of data on the movement of services prices should be approached with greater caution.

The annual core inflation rate (the calculation of which excludes the prices

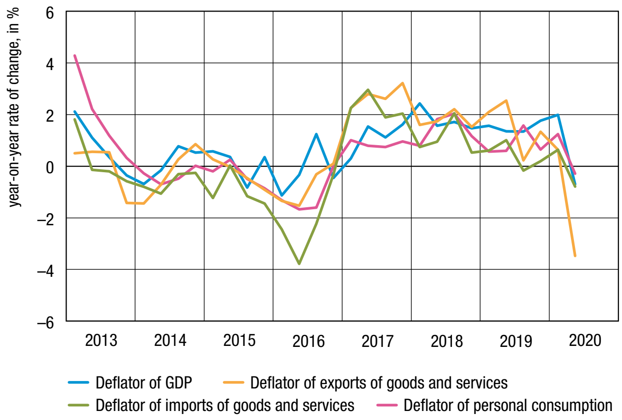
Figure 5.2 Indicators of current inflation trends



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

of agricultural products, energy prices and administered prices) decelerated from 1.2% in December to 1.1% in June 2020. Core inflation accelerated to 1.7% in the first four months. This was mostly driven by acceleration in the annual growth rate of prices of individual food products (particularly meat, milk, cheese and eggs), tobacco, clothing, pharmaceutical products and telephone services. Core inflation slowed down to 1.1% in the subsequent two months, mostly driven by a fall in the annual growth rate of the prices of processed food products, meat, clothing and accommodation services.

Figure 5.3 Deflator of GDP and its individual components



Source: CBS.

The implicit deflator of GDP decreased from 1.8% in the fourth quarter of 2019 to –0.7% in the second quarter of 2020 (Figure 5.3). In the first half of 2020, the deflator for goods and services exports decelerated significantly and in the second quarter entered negative territory. Trade conditions deteriorated as the annual decrease in the deflator for goods and services imports was relatively less pronounced.

The annual rate of inflation in the euro area measured by the harmonised index of consumer prices slowed down from 1.3% in December 2019 to 0.3% in June 2020 (Figure 5.4), mostly as a result of a fall in the annual rate of change in energy prices from 0.2% in December to –9.3% in June. Also, the annual growth of services and industrial products prices (excluding food and energy) slowed down to a lesser extent in the euro area in the first half of 2020. The slowdown in overall inflation was partly

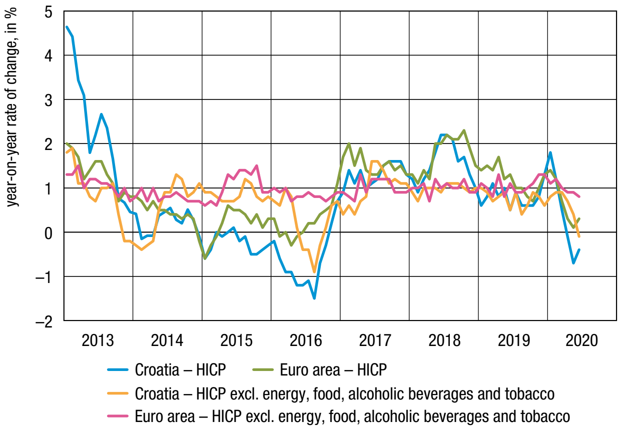
Table 5.1 Price indicators

year-on-year rate of change

	6/19	9/19	12/19	3/20	6/20
Consumer price index and its components					
Total index	0.6	0.8	1.4	0.6	–0.2
Energy	1.4	0.2	3.4	–3.8	–7.1
Unprocessed food	–4.7	–2.7	0.7	5.6	1.9
Processed food	2.6	2.6	2.3	1.7	2.7
Non-food industrial goods without energy	–0.3	0.4	–0.6	–0.1	–0.7
Services	1.3	1.2	1.5	1.6	1.6
Other price indicators					
Core inflation	1.1	1.6	1.2	1.3	1.1
Index of industrial producer prices on the domestic market	0.4	–0.3	1.4	–1.2	–3.1
Index of industrial producer prices on the domestic market (excl. energy)	1.0	0.8	0.5	0.5	0.4
Harmonised index of consumer prices	0.5	0.6	1.3	0.5	–0.4
Harmonised index of consumer prices at constant tax rates	1.1	1.1	2.1	1.0	–0.3

Sources: CBS and Eurostat.

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



Source: Eurostat.

mitigated by an increased contribution of the prices of unprocessed and processed food products to overall inflation. Core inflation, which excludes the prices of energy, food, alcoholic beverages and tobacco, fell from 1.3% in December to 0.8% in June in the euro area, spurred by the mentioned slowdown in the annual growth of services and industrial products prices.

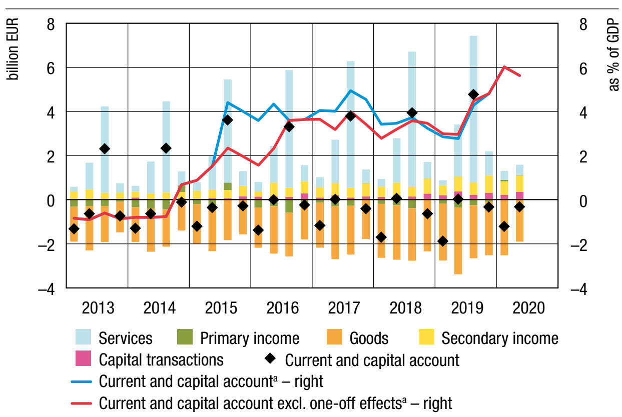
Croatia's annual inflation rate measured by the HICP declined from 1.3% in December 2019 to –0.4% in June 2020, and core inflation measured by the HICP declined from 0.6% in December 2019 to –0.1% in June 2020. The annual inflation in Croatia in June 2020 was 0.7 percentage points lower (and core inflation was 0.9 percentage points lower) than that in the euro area, which was mostly the result of a less pronounced annual growth of the prices of services in Croatia than in the euro area.

6 Current and capital account

The current and capital account deficit fell in the first half of 2020 from the same period of the previous year. The coronavirus pandemic and the accompanying epidemiological measures as well as the strong contraction of economic activity in the country and abroad resulted in a noticeable decrease in the goods trade deficit due to a considerably sharper decline in the imports than in the exports of goods. In addition, due to the sharp fall in the profitability of domestic enterprises and banks in foreign ownership, the balance in the primary income account improved, and the surplus in the secondary income account and in the account of capital transactions grew as a result of a more intensive use of EU funds. In contrast, the considerable decrease in the net exports of services, mainly the sharp drop in revenues from tourism, had an unfavourable effect on the current and capital account balance.

The current and capital account deficit fell in the first half of 2020 from the same period of the previous year. Favourable developments were recorded in the first quarter, while the balance worsened significantly in the second quarter under pandemic conditions. If the whole of the first half of the year is analysed, the improvement in the current and capital balance was mostly attributed to the fall in the foreign trade deficit. The contraction of economic activity in the country and abroad under the coronavirus pandemic conditions and the accompanying epidemiological measures resulted in a considerably stronger contraction of goods imports than of exports. In addition, the fall in the current and capital account deficit was caused by the lower profitability of banks and enterprises in foreign ownership, as well as a more intensive use of EU funds. In contrast, the very unfavourable impact on the current and capital account balance was particularly due to the sharp decline in revenues from the tourist consumption of non-residents. If the last four quarters are analysed, the surplus in the current and capital account in the period until the end of June 2020 was 5.6% of GDP, or 0.8 percentage points higher than in the whole of 2019, as a result of the very favourable performance in the first and the fall in nominal GDP in the second quarter.

Figure 6.1 Current and capital account balance and its structure

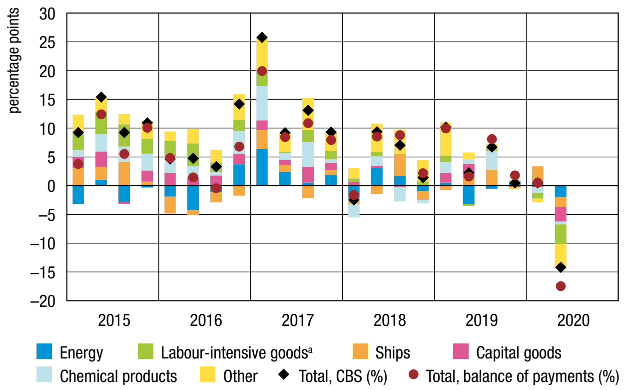


[a] Sum of the last four quarters.
Note: One-off effects include conversion of CHF-linked loans in 2015 and bank provisions for loans to the Agrokor Group in 2017 and 2018.
Source: CNB.

6.1 Foreign trade and competitiveness

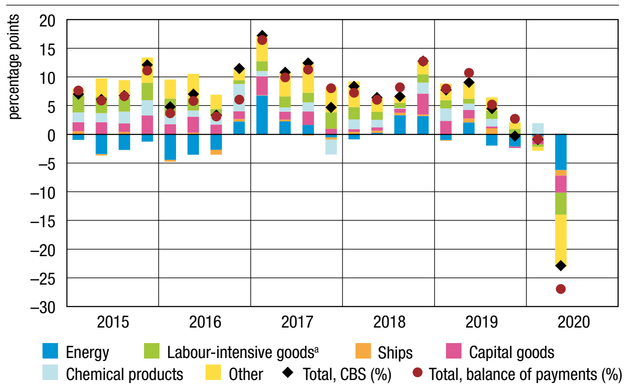
With regard to foreign trade, due to the sharp fall in foreign demand, total goods exports in the first six months of 2020, according to the balance of payments data, were 8.7% lower than in the same period of the previous year.

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



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

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



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

At the same time, in the conditions of the contraction of domestic economic activity, the fall in goods imports was even sharper and stood at 14.5%. As a result, the goods trade deficit decreased by 21.0%. Observing the cumulative values of performances over the past year, the goods trade deficit in the period up to the end of June 2020 stood at 17.9% of GDP, up by 1.5 percentage points from the whole of 2019.

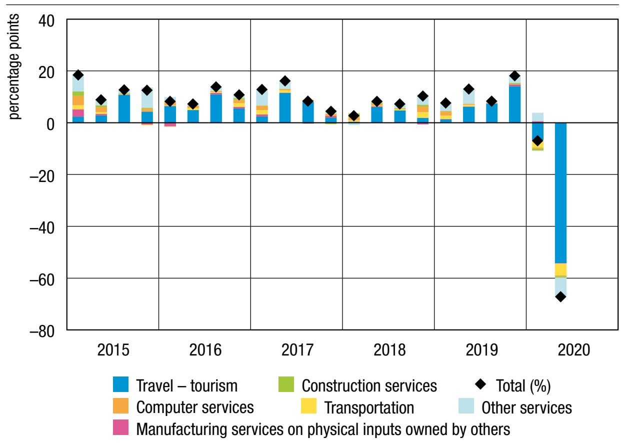
The CBS data[3] show that the annual fall in goods exports in the first half of 2020 was mostly due to smaller exports of road vehicles (to Germany, Slovenia and China), textile industry products (to Italy, Spain and Germany), metal industry products (to Germany, Slovenia and Italy) and capital goods (mostly machinery specialised for particular industries to Germany). In addition, the exports of energy products fell sharply as a result of the fall in the exports of electricity to Bosnia and Herzegovina. By contrast, the exports of other transport equipment (mostly of ships to Luxembourg) and food products (in particular of cereals and other cereal products to Italy) increased.

The annual fall in goods imports in the first half of 2020 was driven by the smaller imports of energy products, particularly oil and refined petroleum products (due to the price decrease) from Italy and electricity from Hungary. In addition, a sharp fall was recorded in the imports of road vehicles (from Germany, Slovenia and Hungary), capital goods (mostly general industrial goods from Italy and Germany) and metal industry products (from Italy and Germany). In contrast, growth was recorded in the imports of chemical and pharmaceutical products, particularly of medical and pharmaceutical products from Belgium.

Net services exports fell sharply in the first half of 2020 (by 66.1% from the same period of the previous year), as a consequence of the contraction of tourism revenues

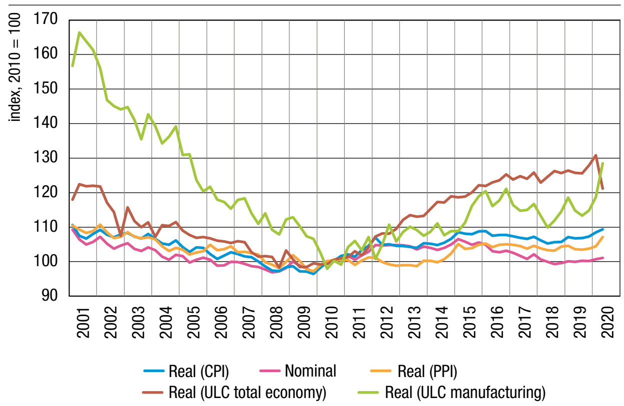
3 For more information on the differences in the scope of the trade in goods according to the balance of payments and CBS data, see Box 3 Foreign trade developments according to the balance of payments data, Macroprudential Developments and Outlook No. 2, July 2017.

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



Source: CNB.

Figure 6.5 Nominal and real effective exchange rates of the kuna



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

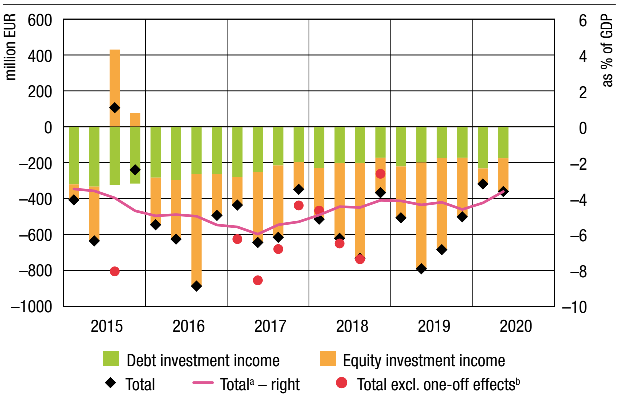
because the spring lockdown following the coronavirus pandemic outbreak almost fully stopped any kind of activity in tourism or arrival of foreign guests. Consequently, revenues from tourist non-resident consumption decreased by 73.0% from the same period of the previous year, reflecting a decline in volume indicators in tourism as well as the decline in average consumption. The CBS data show that the arrivals of foreign guests fell by 81.5% and the number of nights stayed by 79.8%. The decline was particularly observed in the arrivals of guests from Germany, Austria, the UK and Poland. At the same time tourist consumption of residents abroad fell by 60.1%. The cumulative values recorded over the past year reveal that the surplus in the international trade in services decreased from 19.2% of GDP in 2019 as a whole to 16.7% in the period until end-June 2020.

The depreciation of the real effective exchange rates deflated by consumer and producer prices and unit labour costs in manufacturing during the observed period reflects to a smaller extent the weakening of the kuna against the basket of currencies and to a larger extent a more favourable trend in domestic prices and costs in comparison with developments in the main trading partners. By contrast, the real effective exchange rate deflated by unit labour costs in the total economy appreciated as a result of faster growth in unit labour costs in the total economy in Croatia than in the countries in the basket for the calculation of the effective exchange rate of the kuna.

6.2 Income and transactions with the EU

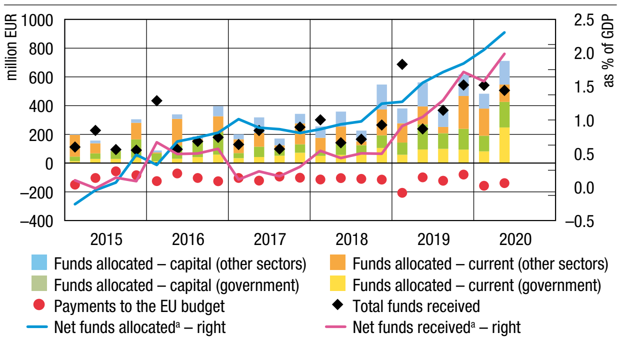
The negative investment income balance decreased considerably in the first half of 2020 from the same period of the previous year. This was due to the decrease in net expenditures on direct equity investment primarily as a result of lower profitability of banks and enterprises (in particular from the oil and pharmaceutical industries, trade and tourism) in foreign ownership. The share of dividends in the structure of expenditures on direct equity investments decreased sharply, mostly as a result of the ban on dividend pay-outs by domestic banks, while total reinvested earnings increased.

Figure 6.6 Investment income



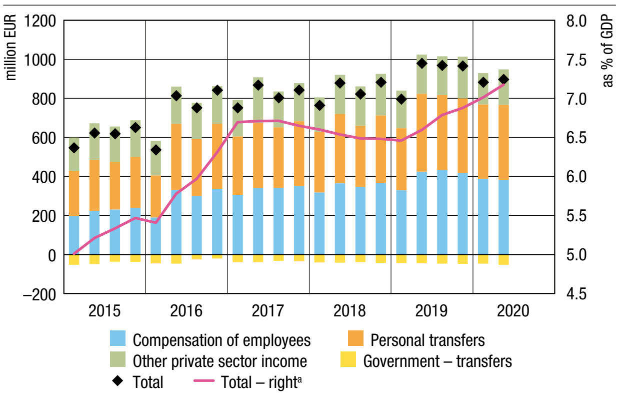
[a] Sum of the last four quarters, excluding one-off effects. [b] One-off effects include the conversion of CHF-linked loans in 2015 and bank provisions for loans to the Agrokor Group in 2017 and 2018.
Source: CNB.

Figure 6.7 Transactions with the EU budget



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

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



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

Although to a much smaller extent, foreign enterprises owned by residents reported better business results. Net interest expenditures on foreign debt liabilities of domestic sectors decreased slightly.

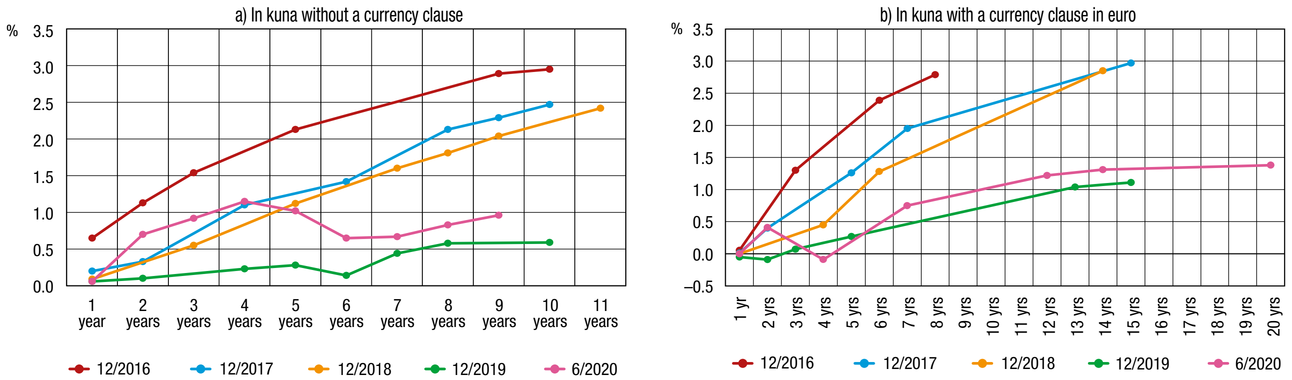
Net income from transactions with the EU budget rose noticeably in the first half of 2020 from the same period of the previous year as a result of more intensive use of EU funds. As regards the structure of the increase in the use of funds, the largest share related to current revenues of the government sector. The surplus of EU funds utilised over the payments to the EU budget, reported as the sum of the last four quarters, amounted to 3.2% of GDP at the end of June 2020 from 2.6% of GDP in 2019. The net inflow from other income, excluding investment income and transactions with the EU budget, stagnated in the first half of 2020 from the same period of the previous year as its growth in the first quarter was offset by the decline in the second quarter.

7 Private sector financing

Domestic sectors' financing conditions mostly held steady at favourable levels in the first half of 2020 thanks to strong monetary policy measures. Credit institutions' interest rates on short-term borrowing remained virtually the same, or decreased slightly from the period before the coronavirus pandemic, while interest rates on long-term household borrowing remained almost unchanged. However, interest rates on long-term loans to non-financial corporations, which include pure new loans and renegotiated loans, increased by about 80 basis points from their minimum level, to which they fell at the end of 2019. The increase relates to interest rates on renegotiated loans, while interest rates on pure new loans decreased. In the second quarter of 2020, the share of renegotiated loans increased considerably due to the granting of the deferral of payment, when interest rates were at a slightly higher level than those on pure new loans. Credit institutions also tightened credit standards.

Government borrowing costs, one of the determinants of the costs of borrowing of other domestic sectors, had a similar dynamics as the interest rates of credit institutions. Thus, the interest rate on one-year kuna T-bills in the domestic market held steady from October 2019 and stood at 0.06% in June 2020 (Figure 7.2), while the interest rate on euro T-bills of the same maturity in May stood at 0.00%. In addition, at the end of April, the government conducted an auction to refinance EUR 1.0bn in matured treasury bills from January 2019 with a 455-day maturity by a new issue in the same amount with a 364-day maturity and the interest rate of 0.06%. As regards the costs of long-term government financing, yield-to-maturity on government bonds increased moderately (Figures 7.1a and b). Growth in yields was subdued by the CNB when it started purchasing government bonds in the secondary market at the end of the first quarter and thus ensured the government securities market stability. At the end of February, the MoF issued three bond tranches in the domestic market

Figure 7.1 Yield-to-maturity on RC bonds



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

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

worth a total of almost HRK 15bn at the most favourable borrowing conditions and the longest maturity period to date[4]. When the pandemic broke out, government needs to finance measures aimed at assisting the economy increased, so that a seven-year bond worth EUR 1.45bn indexed to foreign currency was issued in May and additional bonds worth a total of HRK 5.1bn were issued at the end of June[5].

The cost of government borrowing on the foreign market, estimated by the sum of the EMBI index for Croatia and the yield on the German government bond, increased from 0.7% at the end of December to 2.1% at the end of March (Figure 7.3). However, the EMBI for Croatia fell by the end of June, so that the estimated government borrowing cost decreased to 1.2%. A temporary increase was also observed in the credit default swap (CDS) due to the pandemic. Thus the CDS almost doubled and reached 91 basis points in the first 20 or so days of March, and then dropped to 75 basis points by the end of June, the average in the last quarter of 2019. Credit rating agencies, Standard & Poor's and Fitch, maintained Croatia's BBB–investment rating, with Fitch changing the country's outlook from positive to stable in the beginning of April and S&P confirming the outlook as stable at the end of May. Since 2016, the Moody's rating for Croatia has been unchanged at Ba2, two notches below investment grade with positive outlook. In mid-June 2020, the government issued a eurobond worth EUR 2.0bn, with maturity in 2031 and a 1.64% yield. The achieved yield was slightly higher than that of the previous year's issue of the ten-year eurobond (1.32%), but at the same time it was 45 basis points lower than the initially announced price. In addition to assisting the economy, the funds raised through the June issue were also used for refinancing the eurobond maturing in July 2020.

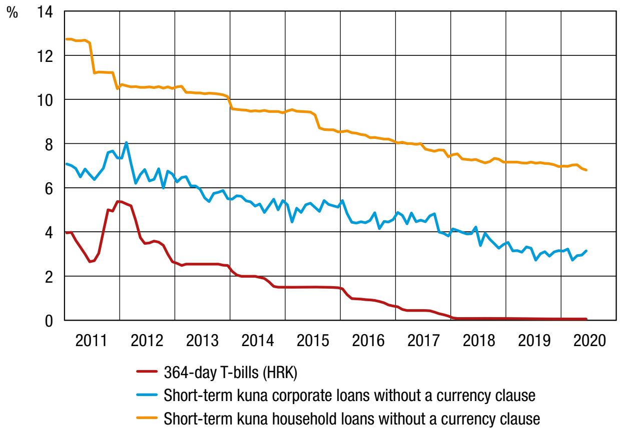
Short-term corporate financing costs remained stable, while interest rates on long-term financing increased. Thus, the interest rate on short-term corporate borrowing from banks in kuna without a currency clause did not change significantly in the first half of 2020 from the end of the previous year (Figure 7.2). By contrast, the interest rate on long-term loans with a currency clause had increased by 0.8 percentage points by the end of June from its minimum level at the end of 2019, with the increase in interest rates on renegotiated loans, while interest rates on pure new loans fell in that period (Figure 7.3). In the second quarter of 2020, the share of renegotiated loans increased considerably due to the granting of the deferral of payment, when interest rates were at a slightly higher level than those on pure new loans. The costs of financing according to the loan amount (Figure 7.4) increased by about 0.5 percentage points in April and had decreased only slightly by the end of June.

The interest rate on short-term kuna household loans without a currency clause was 0.2 percentage points lower than at the end of 2019 (Figure 7.2), while the interest rate on long-term household loans with a currency clause, excluding housing loans, dropped

4 These included a 5-year HRK 5bn bond with a yield at issue of 0.37%, the second tranche of a HRK 4bn bond indexed under trends in the kuna to euro exchange rate that matures in 2034, with a yield of 1.12% and a EUR 800m worth bond indexed to foreign currency, with a yield of 1.28% and 20 year maturity, the longest maturity for a bond issue so far. On the whole, the collected funds were mostly used for the refinancing of the two bonds maturing in early March.

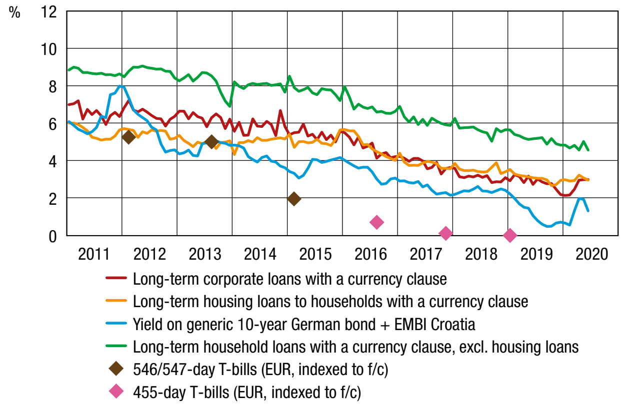
5 The third tranche of kuna bonds worth HRK 2.46bn that mature in 2026, with a yield of 0.85% and the second tranche of kuna bonds worth HRK 2.59bn that mature in 2028, with a yield of 0.94% were issued in the domestic market.

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



Sources: MoF and CNB.

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

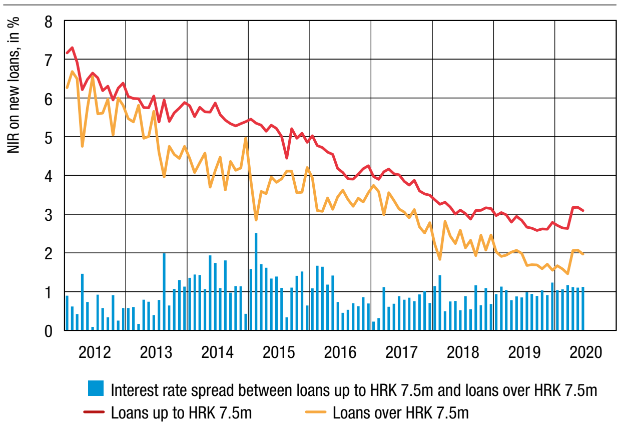


Note: EMBI, or the Emerging Market Bond Index, shows the spread between yields on government securities of emerging market economies, Croatia included, and risk-free securities issued by developed countries.
Sources: MoF, Bloomberg and CNB.

by 0.3 percentage points. By contrast, the interest rate on long-term housing loans at the end of June remained almost unchanged from the level at the end of 2019, also as a result of the housing loans subsidy programme (Figure 7.3).

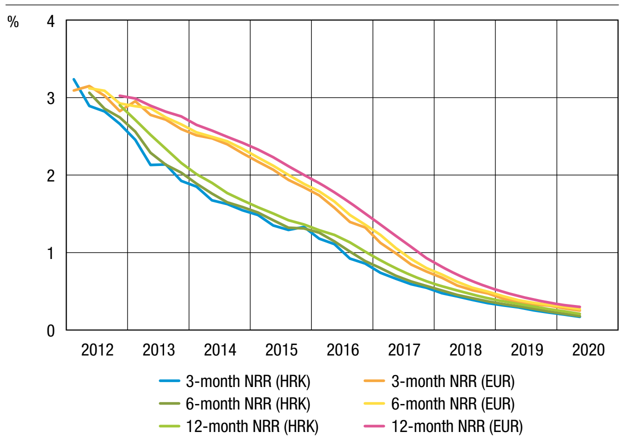
Further decrease in the funding costs of the Croatian banking system in conditions of the exceptionally expansionary monetary policy and historically high surplus liquidity contributed to the favourable financing conditions of the private sector. Despite the slight increase in the first half of 2020, EURIBOR remained in negative territory (Figure 2.3), while the national reference rate (NRR)[6] continued to decline moderately (Figure 7.5).

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



Source: CNB.

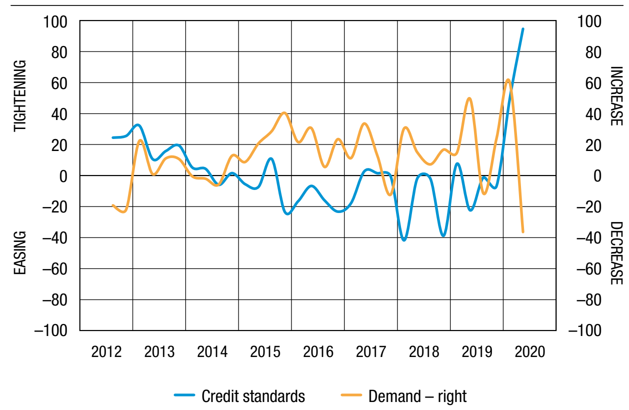
Figure 7.5 National reference rate (NRR)



Note: The rates shown refer to rates applicable to all natural and legal persons.
Sources: HUB and CNB.

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

Figure 7.6 Credit standards and corporate demand for loans

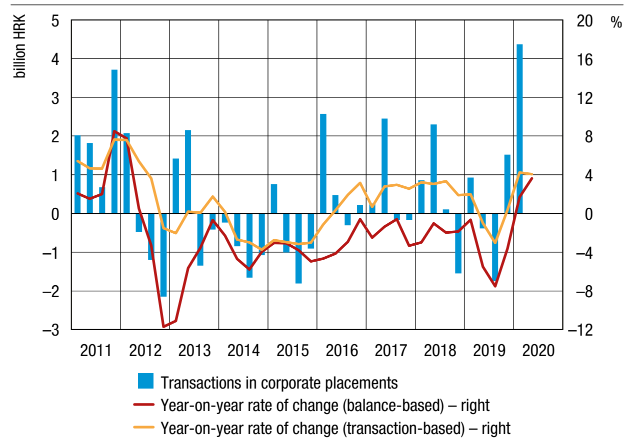


Note: Data show the net percentage of banks weighted by the share in total corporate loans.
Source: CNB.

According to the bank lending survey, in the first quarter of 2020, corporate demand for loans recorded the sharpest increase followed by the strongest decrease in demand in the second quarter accompanied by the most pronounced tightening of credit standards for corporate loans since the survey was first introduced (Figure 7.6). The tightening in standards was mainly affected by the worsened outlook of industry or the individual corporation, as well as by negative expectations related to overall economic trends.

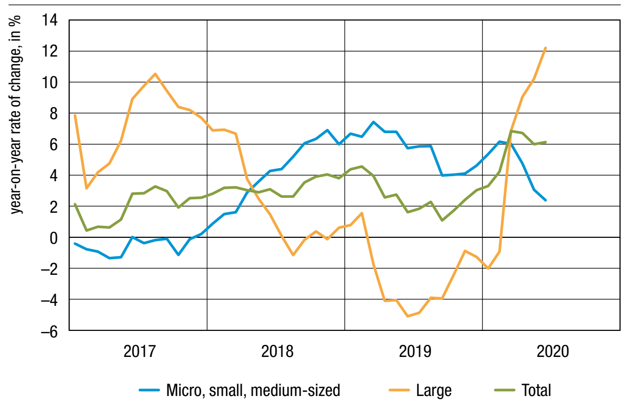
In such circumstances, credit institutions increased placements to non-financial corporations by HRK 3.7bn in the first half of 2020, with their annual growth rate at the end of June reaching 4.1% (transaction-based, Figure 7.7). The annual increase in corporate placements was still negatively affected by the decrease of claims on the Agrokor Group and, to a lesser extent, by the activation of government guarantees to shipyards, which was estimated at about 2 percentage points in June (Figure 7.8). Corporate lending (transaction-based, excluding the one-off effects of shipyards and Agrokor) grew steadily in the past three years by almost 3% on an annual basis, and accelerated to about 4% in February and 6% in the period from March to June. The accelerated annual growth of placements was driven by investment loans with the annual growth at the end of June reaching 13.1%, as well as by the sharp increase in loans for working capital in March (Figure 7.9). Lending to large corporations accelerated noticeably, while the annual growth of placements to micro, small and medium-sized enterprises slowed down. In addition to the financing of investments and working capital, the strong intensification of corporate demand

Figure 7.7 Corporate domestic placements of credit institutions



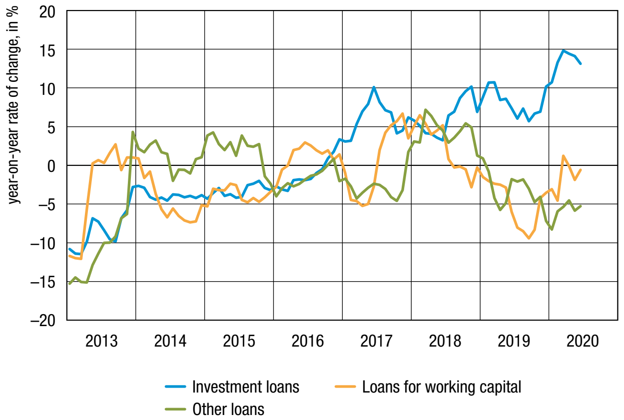
Source: CNB.

Figure 7.8 Growth of corporate placements by size
transaction-based



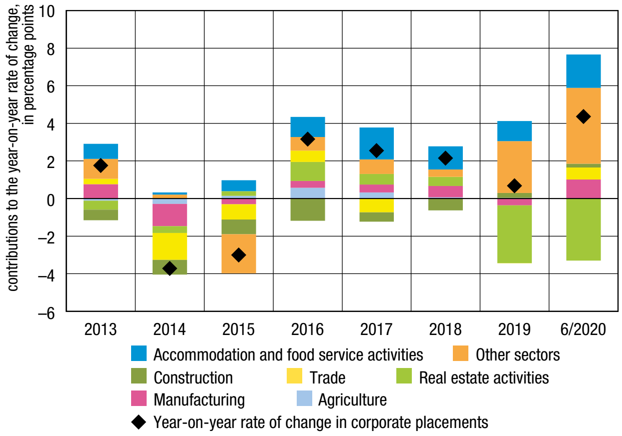
Note: The data were adjusted for the assessment of the effect of activated government guarantees for loans to particular shipyards and the decrease in the claims on the Agrokor Group linked to the operational implementation of the settlement.
Source: CNB.

Figure 7.9 Growth in corporate loans by purpose
transaction-based



Source: CNB.

Figure 7.10 Growth of corporate placements by activity
transaction-based

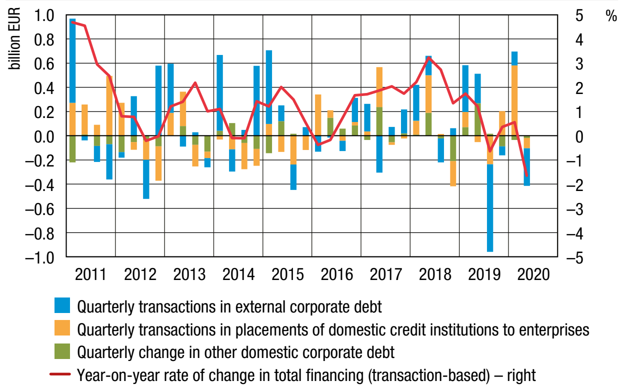


Source: CNB.

for loans (Figure 7.6) was attributed to the need of corporations for debt restructuring.

If corporate loans are broken down by activities (Figure 7.10), it is evident that placements grew in almost all activities. Accommodation and food service activities, manufacturing and trade stand out by their positive contribution. A negative contribution only came from real estate activities, although this was exclusively a result of a change in the activity of one large corporation.[7]

Figure 7.11 Corporate financing



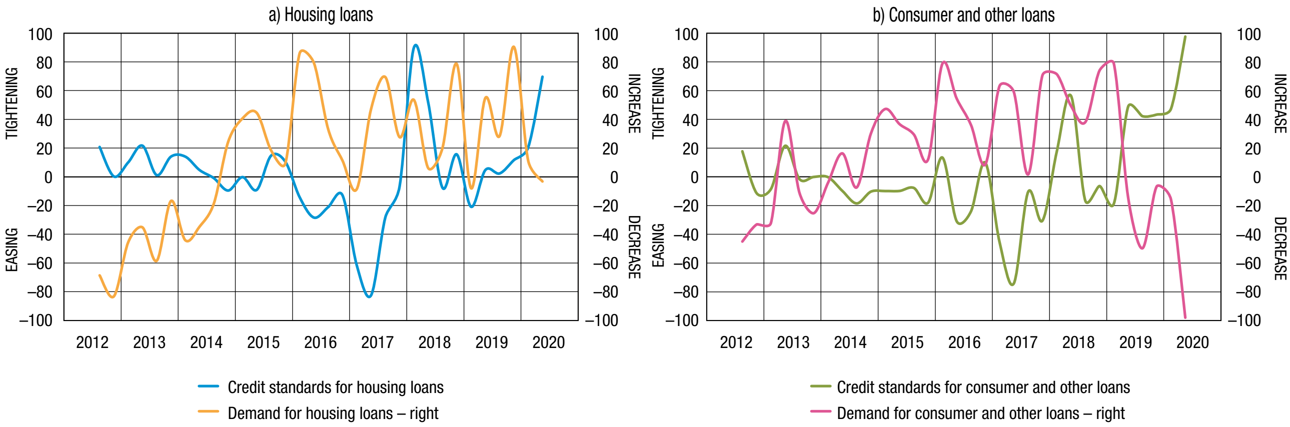
Notes: Other domestic financing includes borrowing from domestic leasing companies and the CBRD. External debt excludes the effect of debt-to-equity transactions. All changes were calculated according to transactions (except for other domestic debt).
Sources: HANFA, CNB and CNB calculations.

In contrast to growth in borrowing recorded in the first quarter, the deleveraging of corporations in the country and abroad was recorded in the second quarter of 2020. Due to the increase in the first three months that preceded the pandemic outbreak period, the total debt of non-financial corporations thus increased in the first half of 2020 (Figure 7.11). If viewed on an annual level, total corporate debt decreased by 1.6% (transaction-based) at the end of June.

Household demand for loans declined, while banks continued to tighten credit standards for household loans because of weakening economic activity, uncertainty regarding the consequences of the pandemic and negative expectations concerning overall economic developments. The sharpest decline in demand was recorded in the

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

Figure 7.12 Standards for granting loans and household demand for loans

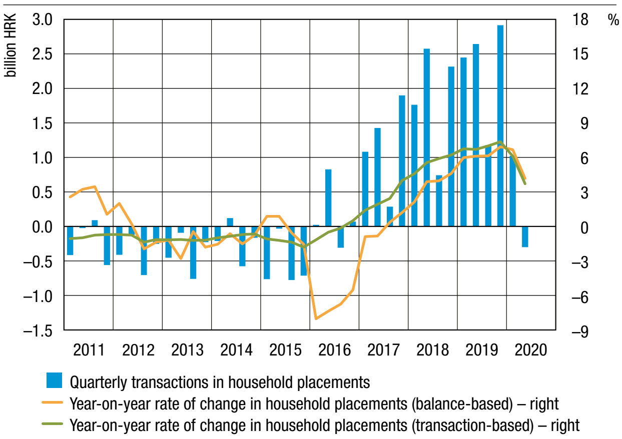


Note: Data show the net percentage of banks weighted by the share in total household loans.
Source: CNB.

second quarter of 2020, with the simultaneous strongest tightening of standards for granting consumer and other loans (7.12). The worsening of standards was additionally driven by customer creditworthiness in consumer and other loans and real estate market prospects in housing loans.

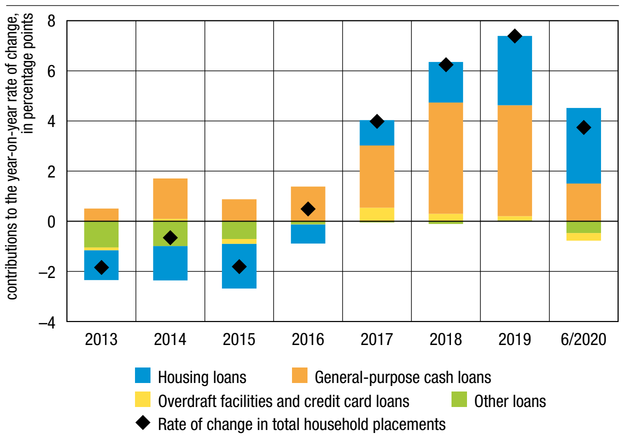
In the first half of the year, household placements increased by HRK 0.7bn. For the first time after almost three years, a monthly decline in placements was recorded in March, which also continued to a considerable extent in April. The annual growth in household placements decelerated strongly and at the end of June stood at 3.7% (transaction-based), only a half of the growth generated at the end of the previous year (Figure 7.13). The weaker lending to households was mostly the consequence of the decrease in the level of general-purpose cash loans in the second quarter, the annual growth of which declined continuously from 11.5% at the end of the previous year to 3.8% at the end of June (according to the bank lending survey, the decline in demand for these loans was the result of the drop in consumption of durable consumer goods and the worsening in consumer confidence). Thus, for the first time since the end of 2012, in June 2020, the contribution of this type of loan to the annual growth of total placements to households was lower than the contribution of housing loans (Figure 7.14). The annual growth rate of housing loans in June (7.1%) accelerated slightly from the end of 2019, also as a result of the housing loans subsidy programme. As indicated by the survey, the demand for housing loans continued to grow in the first quarter, albeit at a much smaller intensity than in the last quarter of 2019.

Figure 7.13 Household placements



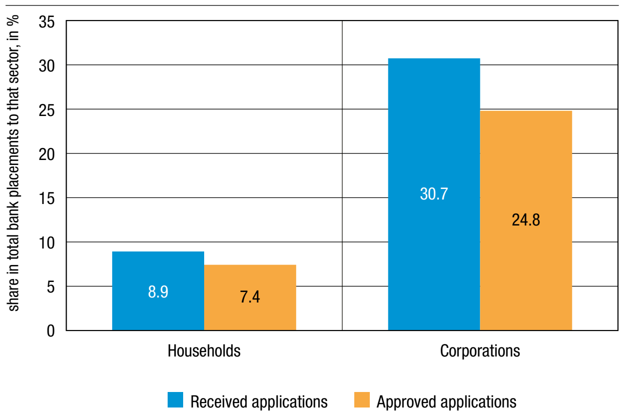
Source: CNB.

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



Source: CNB.

Figure 7.15 Received and approved loan payment deferral or restructuring applications



Source: CNB.

However, the demand fell in the second quarter, under the effect of the closure of the housing loans subsidy programme, less favourable expectations for the real estate market and the decline in consumer confidence (Figure 7.12).

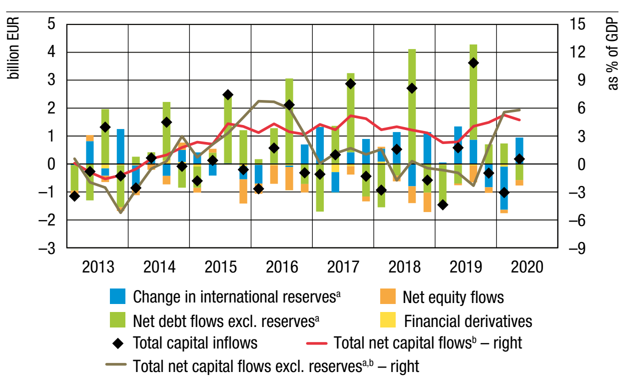
The measures directed at households and corporations affected by the crisis include programmes for the deferral of payment and the restructuring of existing credit liabilities. Thus, up until the end of June 2020, banks received a large number of applications from corporations and households for some form of the measures. The applications received from corporations accounted for slightly more than the one third of total bank placements to corporations, while approved applications accounted for 24.8% of total placements. In the case of households, the share was about three times smaller and the approved applications accounted for 7.4% of the total placements to this sector (Figure 7.15).

8 Foreign capital flows

The financial account of the balance of payments recorded a net capital inflow of EUR 0.8bn in the first half of 2020, almost the same as in the same period of the previous year (Figure 8.1). This is primarily the result of the decrease in international reserves. Amid great market uncertainty following the outbreak of the coronavirus pandemic, institutional investors and credit institutions were forced to adjust their foreign currency positions, which resulted in strong depreciation pressures. This prompted the CNB to intervene several times in the foreign exchange market in the first half of the year, by selling record amounts of foreign currency, which was in contrast to the same period last year when it mostly intervened through foreign currency purchases. The change in gross international reserves and liabilities of the CNB amounted to EUR –0.6bn in the first six months of 2020, down from EUR 1.4bn in the same period of 2019. If the change in gross international reserves and liabilities of the CNB is excluded, the first six months of the year saw a net capital inflow of EUR 0.3bn, having fallen by EUR 2.0bn from the same period of the previous year.

The net inflow from equity investments of EUR 0.3bn in the first six months of 2020 was the result of a faster growth in the foreign liabilities than in the assets of the domestic sectors. The rise in foreign liabilities mainly involved reinvested earnings of domestic enterprises owned by non-residents, which were notably larger than in the same period of the previous year. Specifically, while total profit of domestic enterprises in foreign ownership halved, reinvested earnings of the banking sector increased due to the central bank's decision to ban dividend payouts to foreign owners. In the same period, foreign direct investments in Croatia, which rose by a half from the same period of 2019, mostly took place in the real estate sector (Figure 8.2). New foreign direct investments were recorded only in the first three months of 2020, with no inflows seen in the second quarter. On the other hand, the mild increase in foreign assets was largely driven by reinvested earnings of foreign enterprises owned by residents, which outstripped the decrease in investments in foreign shares and equity holdings.

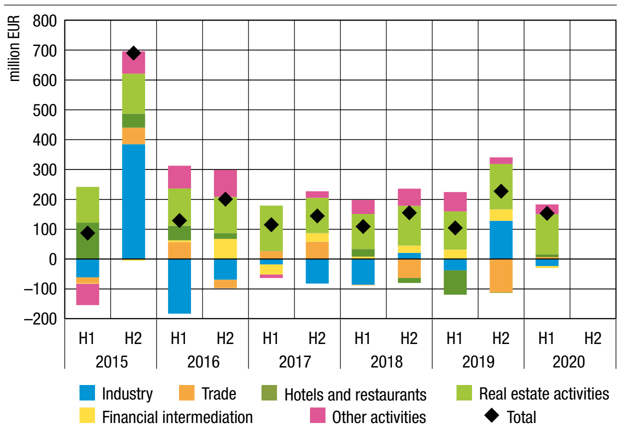
Figure 8.1 Flows in the financial account of the balance of payments



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

Net inflows of debt capital amounted to EUR 0.4bn in the first half of 2020. However, if the change in gross international reserves and CNB liabilities is excluded, there was a net outflow of debt capital of EUR 0.2bn. This was mostly due to the sharp increase in the foreign assets of banks which, during the spring interventions of the CNB, purchased substantial amounts of foreign currency in the foreign exchange market. The outbreak of the coronavirus pandemic

Figure 8.2 Foreign direct equity investment in Croatia by activities

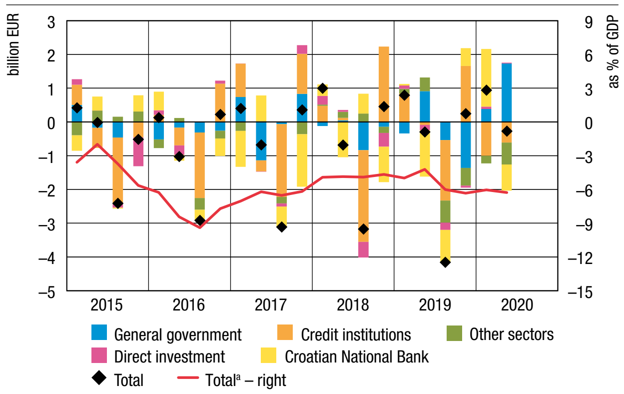


Note: Equity investment net of debt-to-equity transactions and round-tripping investments.
Source: CNB.

and changes in the expectations regarding economic conditions in the country, particularly as regards the main tourist season, led to increased euroisation of the domestic sectors' portfolio and resulted in depreciation pressures on the exchange rate of the kuna. To balance the asset side of the balance sheet with the rise in foreign currency liabilities, the banks purchased foreign currency and deposited it abroad. In parallel to the growth in banks' foreign assets, net debt liabilities of other domestic sectors decreased noticeably due to the deleveraging of private non-financial corporations and other financial institutions. By contrast, net debt liabilities of the government grew sharply. In June, the government issued new bonds worth EUR 2.0bn in the international market intended to cover the July repayment of the USD 1.25bn worth of bonds issued in 2010 and in part to finance the counter-crisis measures aimed at mitigating the negative impacts of the pandemic. The government sold the majority of funds raised to the central bank, which cushioned the fall in CNB's international reserves (EUR –1.3bn in the first half of 2020).

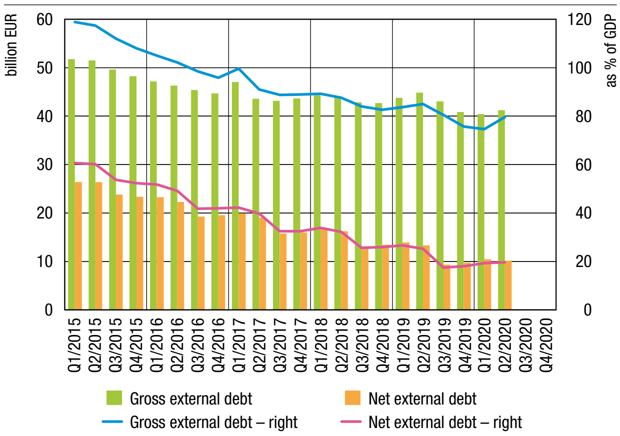
The rise in debt liabilities of domestic sectors, of government in particular, coupled with a plunge in nominal GDP, led to a deterioration in relative indicators of external debt, which was only partly offset by the favourable impact of cross-currency changes and other statistical adjustments. At the end of June 2020, the gross external debt stock stood at EUR 41.3bn or 79.7% of GDP, an increase of 3.9 percentage points from the end of 2019 (Figure 8.4). In view of the fact that foreign assets increased in the same period and that the unfavourable impact of the nominal GDP fall is smaller at lower levels of

Figure 8.3 Net external debt transactions by sectors



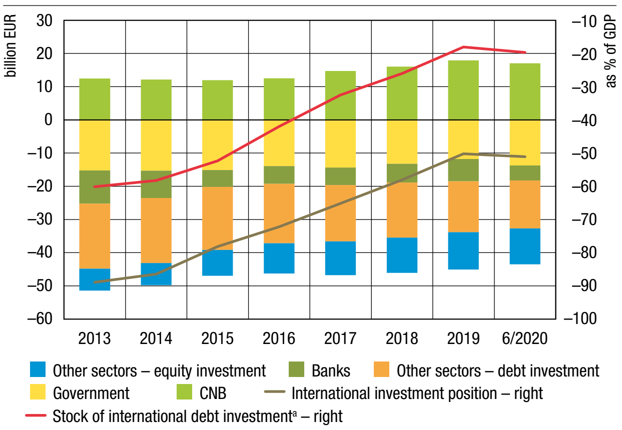
[a] Sum of the previous four quarters.
Notes: Transactions refer to the change in debt excl. cross-currency changes and other adjustments. Net external debt is calculated as the gross external debt stock net of foreign debt claims.
Source: CNB.

Figure 8.4 Stock of gross and net external debt



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

Figure 8.5 International investment position (net) by sectors



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

relative indicators, the deterioration of the relative indicator of net external debt was less pronounced. By the end of June 2020, net external debt came to EUR 10.2bn or 19.6% of GDP, an increase of 1.6 percentage points from the end of 2019.

Notwithstanding the increase in net debt and equity liabilities of domestic sectors (transaction-based), the favourable effect of price, exchange rate and other equity investment adjustments improved the net international investment position in absolute terms. However, due to the fall in nominal GDP, the relative indicator of the net international investment position worsened from –50.2% of GDP at end-2019 to –51.0% of GDP at the end of June 2020 (Figure 8.5).

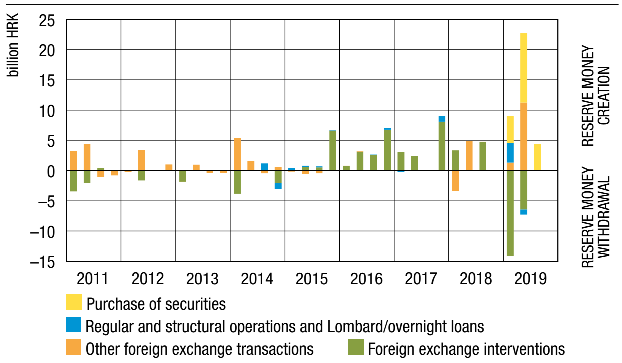
9 Monetary policy

In efforts to prevent the weakening of the kuna and secure sufficient foreign currency liquidity, the CNB sold EUR 2.7bn to banks, most of it in late March and early April, after which the exchange rate of the kuna was stable. The kuna liquidity withdrawn through the sale of foreign currency was more than offset by other monetary policy measures of the CNB, including structural and regular operations, a cut in the reserve requirement rate and the secondary market purchase of government bonds starting from March to stabilise the market for government securities. As a result, kuna liquidity remained at high levels, while yields on government bonds and borrowing costs at domestic banks did not grow much overall. Nevertheless, sluggish economic activity was reflected in the tightening of credit standards for corporate and household loans and a slowdown in household lending. On the other hand, corporate loans grew sharply in February and March due to an upward trend in investment activity before the pandemic as well as the increase in demand for liquid assets because of the growing uncertainty regarding the pandemic. Credit activity oriented towards corporations weakened during the subsequent months.

In the first half of 2020, the central bank responded to deteriorating economic and financial conditions caused by the coronavirus pandemic with a series of measures aimed at securing the foreign exchange and kuna liquidity and maintaining the stability of the financial system. In addition to recording foreign exchange interventions, the CNB started to buy Croatian government bonds.

Growing uncertainty regarding the effects of the pandemic gave rise to increased demand by domestic sectors for foreign exchange. The increased demand was partially the result of changes in short-term expectations about exchange rate movements as most investors in the domestic market realised that there would be no seasonal appreciation of the kuna this year in view of the projected fall in tourism revenues. In addition, investment funds were faced with strong deposit withdrawal at the outbreak of the pandemic. To pay off investors, investment funds vigorously sold their assets, which mainly included government bonds. In an environment of limited market liquidity, this in turn led to a fall in their prices and growing yields, threatening the stability of the financial market. Foreign exchange deposits in banks grew sharply in March, which shows that the deposits withdrawn from funds were transferred to

Figure 9.1 Flows of reserve money (M0) creation



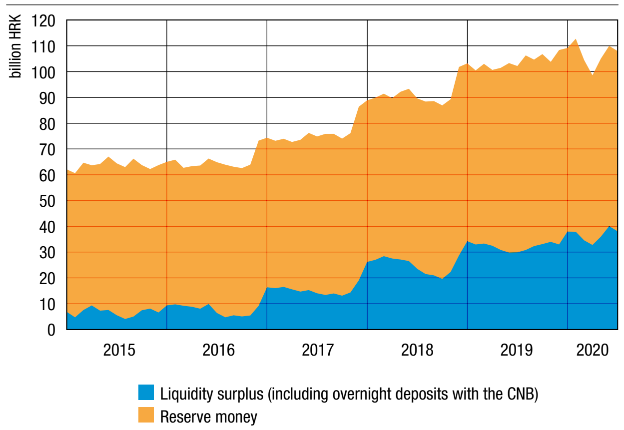
Notes: The possibility of using Lombard loans has been abolished, while the possibility of using overnight credits was introduced on 28 September 2017. Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and the EC and foreign currency swaps with banks, where the positive values refer to the purchase of foreign exchange by the CNB. Data for the third quarter of 2020 refer to 1 July.
Source: CNB.

banks. This worsened the foreign exchange position of banks and fuelled their demand for foreign currency. The exchange rate of the kuna weakened by 2.5% relative to the euro from late February to mid-April. To prevent further kuna weakening, the CNB intervened strongly on the foreign exchange market, selling a total of EUR 2.7bn to banks. The bulk of the foreign exchange was sold in the second half of March and at the beginning of April, after which the exchange rate stabilised from the middle of April onwards. The exchange rate of the kuna against the euro stood at EUR/HRK 7.56 at the end of June 2020, up by 2.2% relative to the end of the same month in 2019, while the average exchange rate in the first six months of 2020 stood at EUR/HRK 7.53, having increased by 1.5% on the same period in 2019 (Figure 9.5). As regards other foreign exchange transactions, from the beginning of the year to the end of June, the CNB purchased EUR 1.7bn from the Ministry of Finance, creating HRK 12.6bn. A net total of HRK 8.0bn in reserve money was thus withdrawn by foreign exchange transactions in the first six months of 2020 (Figure 9.1).

To maintain stability in the government bond market, in March, the CNB began purchasing the government bonds of the Republic of Croatia (Figure 9.3.). The scope of potential participants in securities purchase and sale operations was extended to pension companies, pension insurance companies, companies managing open-ended investment funds, insurance companies and housing savings banks. At two auctions held in March, one auction held in April and two auctions held in June, the CNB purchased bonds with a total market value of HRK 20.3bn, thus preventing the freezing of the bond market and supporting its liquidity as well as securing favourable financing conditions for all sectors.

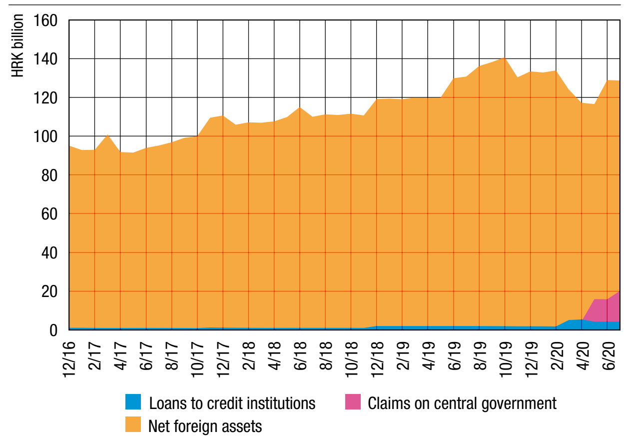
In order to maintain favourable financing conditions, in addition to the purchase of government bonds, the CNB also used other monetary policy measures. In March, the central bank conducted a structural open market operation placing HRK 3.8bn to banks for a five-year term at an interest rate of 0.25%, the highest amount supplied in structural operations thus far. A part of the funds was used by banks for the early repayment of existing structural loans, so that their balances went up by HRK 2.4bn at

Figure 9.2 Bank liquidity and reserve money



Note: Data up to 1 July 2020.
Source: CNB.

Figure 9.3 CNB balance sheet structure



Note: Data up to 1 July 2020.
Source: CNB.

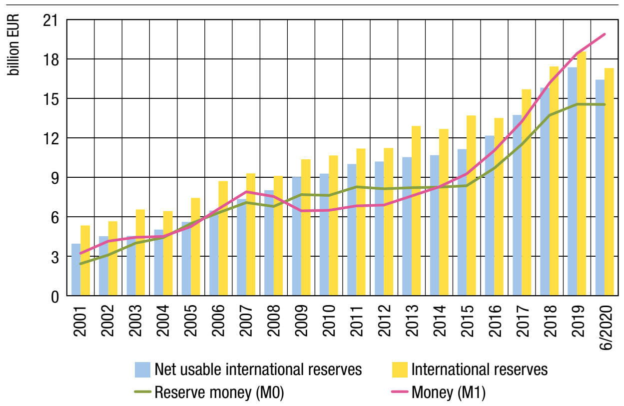
the end of June from the beginning of the year. Moreover, in March, the CNB initiated the placement of short-term kuna funds via regular weekly operations for the first time since 2017. The interest rate on such loans was cut from 0.3% at the first auction in March to 0.05% in all subsequent auctions. The banks' demand at weekly auctions peaked in April, when the average amount of funds placed reached HRK 1.1bn, after which the interest of the banks began to wane and disappeared completely by mid-May. Finally, in March, the CNB lowered the reserve requirement rate from 12% to 9%, releasing to banks HRK 6.34bn of the funds previously allocated to a special statutory reserve account held with the CNB.

Thanks to the measures described above, which supplied banks with a total of HRK 29.1bn of kuna liquidity, the liquidity surplus of the monetary system hit a record high of HRK 38.1bn at the beginning of July, up by 18.2% from the average liquidity surplus in 2019 (Figure 9.2). By maintaining ample liquidity surpluses, the CNB is supporting banking system stability in adverse conditions and striving to contribute to the preservation of favourable domestic financing conditions.

Measures taken since the outbreak of the pandemic resulted in significant changes in the central bank's balance sheet structure. The share of domestic assets grew on the assets side, reflecting the increase in claims on domestic banks (open-market operations) and government bond purchase. On the other hand, the sale of foreign exchange to banks resulted in a drop in the share of foreign assets, i.e. international reserves. Nevertheless, they still constitute the dominant part of CNB assets (Figure 9.3).

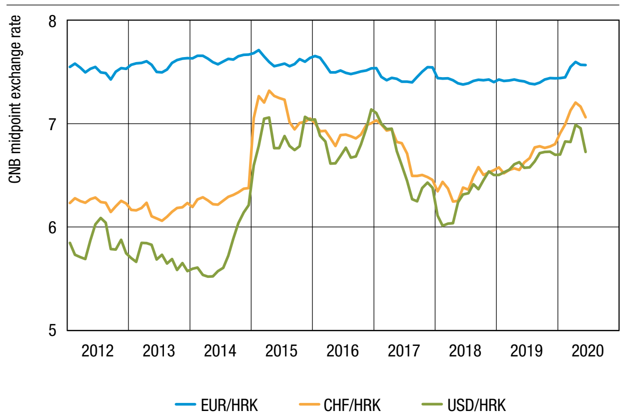
Gross international reserves of the Republic of Croatia decreased by EUR 1.2bn (6.7%) in the first six months of 2020, ending June at EUR 17.3bn (Figure 9.4). Net usable reserves dropped by EUR 0.9bn over the same period, totalling EUR 16.4bn at the end of June. In addition to the sale of foreign exchange to banks, the decline in gross reserves was also a result of a smaller amount of repo agreements concluded, while the purchase of foreign exchange from the government worked in the opposite direction. Despite that, both gross and net reserves are still higher than reserve money (M0). Also worth noting is the swap line between the CNB and the European Central Bank,

Figure 9.4 International reserves of the CNB and monetary aggregates



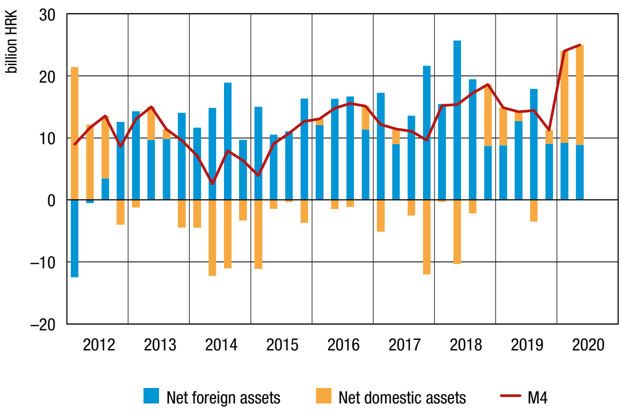
Note: Net usable international reserves are defined as international reserves net of the CNB foreign liabilities, reserve requirements in f/c, government foreign currency deposits and off-balance sheet liabilities (swaps).
Source: CNB.

Figure 9.5 Nominal exchange rates of the kuna against selected currencies



Source: CNB.

Figure 9.6 Net foreign assets, net domestic assets and total liquid assets (M4)
absolute change in the last 12 months



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

established in April, which enables the exchange of the kuna for the euro up to EUR 2bn. If necessary, this may be used to provide additional foreign exchange liquidity without the need for using international reserves.

Exchange rate movements of the kuna against the euro also affected the exchange rate of the kuna against other currencies. The higher exchange rate of the kuna against the US dollar and the Swiss franc at the end of June 2020 relative to the same month in 2019 reflects the combined effect of the weakening of the kuna against the euro and the weakening of the euro against both of these currencies (Figure 9.5).

CNB's monetary operations fuelled a much faster increase in total liquid assets (M4). The annual rate of growth in M4 went up from 3.5% at end-December 2019 to 7.7% (transaction-based) at end-June 2020 (Figure 9.6). On the other hand, net domestic assets (NDA) of the monetary system grew substantially in the same period due to increased borrowing of the government from banks and the CNB's purchase of government bonds on the secondary market. The growth in M4 was also driven by the rise in the net foreign assets (NFA) of the monetary system, with the NFA of the CNB going slightly down and the NFA of credit institutions going steeply up. Among M4 components, foreign exchange deposits grew the most. This was a result of the upsurge in foreign currency deposits in March and of the inflow from investment funds. This briefly interrupted the several-year long downward trend of the euroisation of the banking system; however, recent data suggest that the rise in deposit euroisation was only short-term.

Box 1 CNB monetary policy measures aimed at alleviating the negative consequences of the pandemic

The CNB adopted a series of monetary policy measures in response to the unfavourable economic and financial circumstances caused by the outbreak of the novel coronavirus pandemic. The measures secured the stability of the kuna/euro exchange rate, created additional liquidity to enable domestic banks to continue with their lending activity and stabilised the domestic government bond market. The measures contributed to the continuation of the accommodative monetary policy aimed at maintaining favourable financing conditions for the domestic sectors over the future period in which the consequences of the pandemic will have a negative effect on economic activity.

Growing uncertainty and increasing concern over an unfavourable outcome of the Covid-19 pandemic resulted in extremely high volatility on international financial markets, and in Croatia in stronger demand for foreign exchange and increasing yields and decreasing prices of government bonds. Since the beginning of March, then, the Croatian National Bank has adopted a series of monetary policy measures in order to stabilise the financial conditions on domestic financial markets. The measures comprise activities focused on three objectives:

(1) maintaining the stability of the kuna/euro exchange rate and securing sufficient foreign exchange liquidity to prevent the materialisation of exchange rate risks to the banking system and the economy as a whole;
(2) increasing the kuna liquidity of the banking system to help maintain low interest rates and enable banks to continue with their lending activity; and
(3) supporting the stability of the government securities market through the purchase of government bonds in the secondary market, thus creating the additional liquidity needed to normalise the functioning of that segment of the financial market and enabling the government, and, consequently, other economic sectors to continue to acquire funds under acceptable conditions.

From 9 March to the beginning of July, the CNB placed EUR 2.7bn of foreign exchange to banks via foreign exchange interventions and bilateral foreign exchange transactions, which amounts to 5.7% of GDP. Furthermore, over the same period, it injected HRK 29.1bn (8% of GDP) of kuna liquidity into the financial system using other measures. Since a part of kuna funds was withdrawn from banks through the sale of foreign exchange to banks, observed in its totality, monetary policy action resulted in a net increase of HRK 8.4bn in kuna liquidity, which amounts to 2.3% of GDP. An overview of all monetary policy measures taken since the beginning of March to the beginning of July and their financial effect is shown in Table 1.

Despite strong interventions during the crisis caused by the coronavirus pandemic, the Croatian National Bank still has at its disposal sufficient funds to respond to any future disruptions on the financial markets. According to end-of-June data, the CNB has EUR 17.3bn of gross reserves, or EUR 16.6bn of net usable

Table 1 CNB monetary policy measures aimed at alleviating the negative consequences of the pandemic

Objectives	Measures	Effect on foreign exchange liquidity (in EUR million)	Effect on kuna liquidity (in HRK million)	Effect on kuna liquidity (as % of GDP)
Stabilising the exchange rate and ensuring foreign exchange liquidity	Foreign exchange transactions			
	Sale of foreign exchange – interventions	2,244	–16,980	–4.7
	Sale of foreign exchange – bilateral transactions	482	–3,658	–1.0
	Foreign exchange transactions – total	**2,726**	**–20,638**	**–5.7**
Ensuring kuna liquidity	Other measures			
	Structural operations		3,800	1.0
	– return		–1,332	–0.4
	Regular operations		7,780	2.1
	– return		–7,780	–2.1
	Reserve requirement reduction		6,336	1.7
Supporting the stability of the government bond market	Government bond purchase		15,909	4.4
	Other measures – total		**24,713**	**6.8**
Net effect on kuna and foreign exchange liquidity		**2,726**	**4,075**	**1.1**

Notes: Data from 9 March to 1 July 2020. Negative values indicate liquidity withdrawal and positive values indicate liquidity creation. 'GDP' is the GDP forecast for 2020 according to the official projection of the CNB. 'Return' indicates early and regular repayments of structural and weekly loans.
Source: CNB.

reserves, which is an adequate level of reserves by any usual standard[8]. It is further necessary to note that the CNB entered a swap line agreement with the European Central Bank, which, should such a need arise, provides for the exchange of the kuna for the euro in the amount of EUR 2bn. Finally, according to data as at the end of May, credit institutions also have at their disposal over EUR 6bn of foreign assets which may be withdrawn from abroad if needed, while their free kuna reserves, i.e. kuna liquidity surpluses, stand at very high levels as well (HRK 38.1bn at the beginning of July). Considering all this, monetary policy still has room for manoeuvre and the instruments at its disposal to continue to meet its objectives of maintaining exchange rate stability and securing favourable financing conditions for domestic sectors.

8 For more details on the adequacy of international reserves, refer to the HNBlog post of Gorana Lukinić Čardić entitled ''Does Croatia have sufficient international reserves?'' (https://www.hnb.hr/en/-/ima-li-hrvatska-dovoljno-me-unarodnih-pricuva).

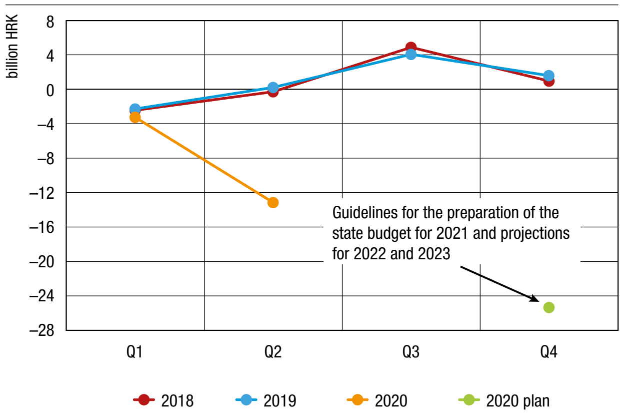
10 Public finance

The budget deficit of HRK 13.2bn in the first half of 2020 reflects the adverse effect of the crisis caused by the pandemic on economic activity, including tax revenues, as well as the impact of the provisional measures to mitigate the adverse effects of the crisis on the decrease in revenues on account of a write-off of taxes and growth in the expenditure for job preservation grants. If analysed by quarters, in the period from January to March 2020, the deficit stood at HRK 3.2bn, comparable with the same period of the previous year, which then deepened considerably and reached HRK 9.9bn in the second quarter. Consolidated general government debt stood at HRK 329.6bn at the end of June 2020, up by HRK 36.7bn from the balance at the end of 2019, reflecting the rising needs of the government to finance the realised and the expected budget deficit, needs that were mostly met in the domestic market.

A budget deficit of HRK 13.2bn, which was generated in the first half of 2020, was the outcome of the negative impact of the crisis caused by the coronavirus pandemic on economic activity and tax revenues, as well as of provisional measures aimed at alleviating the negative consequences of the crisis, evident both in the decline in revenues due to tax write-offs and the rise in expenditures driven by job preservation grants and tax write-offs. This is a severe deterioration from the results seen in the same period of 2019 (a surplus of HRK 0.2bn). Viewed by quarters, the deficit of HRK 3.2bn generated from January to March 2020 was comparable to that recorded in the first quarter of the previous year, but it widened considerably in the second quarter, to HRK 9.9bn.

As regards the revenue side of the budget (ESA 2010), total revenues were as much as 8.2% lower in the first half of 2020 than in the same period of the preceding year. The drop was mostly related to indirect taxes due to unfavourable pandemic-driven economic trends, which were also reflected in a slump in personal consumption and weaker dynamics of demand in tourism-related activities. Revenues from indirect taxes were also influenced by the reduced burden of the VAT system, that is, the widened coverage of the 13% VAT rate to include food and drink service activities. Income from the sales of goods and services also made a strong negative contribution to revenues, mostly due to restrictive epidemiological measures that limited the provision of most government services, such as public administration services. A smaller negative contribution came from direct taxes, which may be attributed to

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



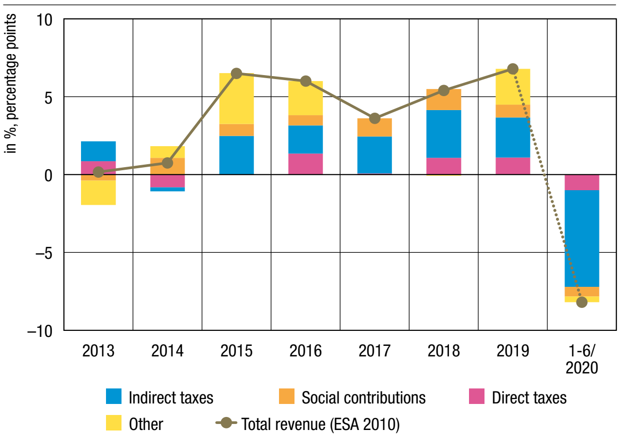
Sources: Eurostat and MoF (CNB calculations).

the successful alleviation of the negative consequences of epidemiological measures on employment figures, as well as the possibility to defer tax payments, where deferred payments should be recorded as revenues when the tax liability arises (under the ESA methodology). Revenues in this category were also smaller due to the reduction in the tax burden implemented in the fourth round of the comprehensive tax reform, that is, the increase in the number of profit taxpayers subject to a lower tax rate, as well as the increase in personal tax exemption and the lowering of taxes for income taxpayers under the age of 30. As with direct taxes, the negative impact of the crisis on revenues from social contributions was less severe, whereas the smallest decrease was seen in other revenues, which were largely supported by the continued relatively successful absorption of EU funds. This was also influenced by one-off exceptional aid from the EU under the European Commission decision to allow member states to use the remaining funds from the current financial period (2014 – 2020) to finance measures aimed at addressing the repercussions of the pandemic (such as job preservation grants and the procurement of medical equipment).

As regards the expenditure side of the consolidated general government budget (ESA 2010), total expenditures were much larger in the first half of 2020 (6.6%) than in the same period of the previous year. It should be noted that expenditure developments were also influenced by the payout of the aforementioned one-off exceptional aid supplied by the EU. Expenditure growth was mostly fuelled by the sharp increase in expenditures on subsidies, largely reflecting the job preservation grants paid out to employers. The growth was also driven by employee compensation, which reflected the impact of the previously agreed increase in wages to employees in the health and education system and the 2% increase in the wage calculation base for civil servants and government employees starting from 1 January 2020. Furthermore, general government investments also went up, which, in addition to the continued infrastructure projects financed by EU funds, may reflect the purchase of medical equipment necessary to contain the coronavirus pandemic. The increase in total expenditures was cushioned by the negative contributions of intermediary consumption, interest and other expenditures. The reduction in expenditures for intermediary consumption was due to the reallocation of some such expenditures under the budget revision to other expenditure items (mostly job preservation grants), while interest expenditures were smaller due to continued favourable refinancing conditions and a stable credit rating.

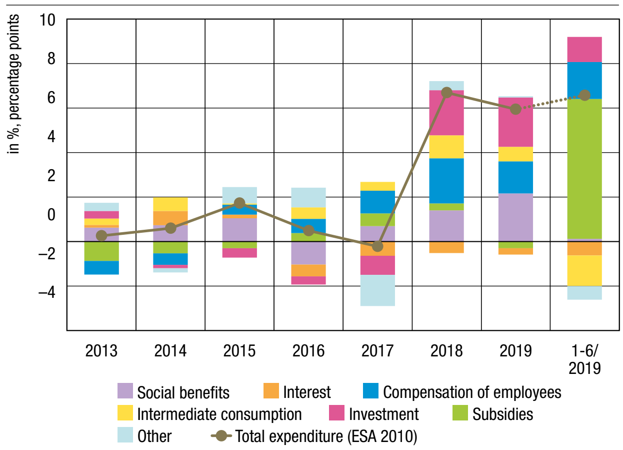
Consolidated general government debt stood at HRK 329.6bn at end-June 2020, growing by HRK 36.7bn from the end of 2019. The notable debt increase, mostly in

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



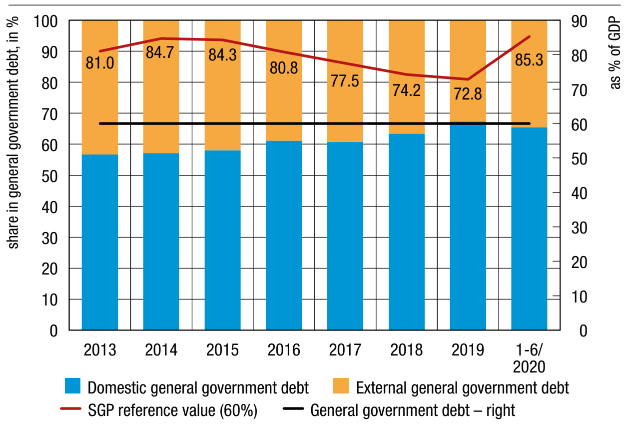
Source: Eurostat (CNB calculations).

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



Source: Eurostat (CNB calculations).

Figure 10.4 General government debt
stock, end of period



Note: Nominal GDP for the last four available quarters was used to calculate the relative indicator as at the end of June 2020.
Source: CNB.

the domestic market, largely reflects the growth in current and future government needs to finance the deficit caused by the negative impact of the pandemic and restrictive epidemiological measures on economic developments as well as by the cost of the measures taken to alleviate this unfavourable impact. In addition, data revision due to the reclassification of a series of units from the sector of non-financial corporations into central and local government raised the level of debt from January 2001 onwards (with a more considerable spike in the period from 2007 to 2014, a consequence of the reclassification of the company HŽ Putnički prijevoz). As regards bond issues in financial markets, in late February the government issued bonds in the domestic market worth a total of HRK 15bn (two kuna issues worth HRK 5bn and HRK 4bn, the latter of which was added to the November 2019 issue, and a EUR 800m worth bond indexed to foreign currency) used to refinance maturing bonds with a value of HRK 12.7bn. The government also issued new domestic bonds worth EUR 1.445bn in early May to finance much larger current needs and a eurobond worth EUR 2.0bn on the international market in June to repay foreign bonds maturing in July and to finance larger current needs. Notwithstanding the crisis, all these bonds were issued at favourable terms.

Box 2 Fiscal policy measures aimed at alleviating the negative consequences of the pandemic

In March and April, the Government of the Republic of Croatia adopted a package of fiscal policy measures worth 2.5% of GDP to address the negative consequences of the coronavirus pandemic. The package was upheld in the revised budget adopted by the Croatian Parliament in May. According to the estimates of the Croatian Ministry of Finance, published in the Convergence Programme of the Republic of Croatia for 2020 and 2021, the total cost of the measures related to job preservation grants in April, May and June will amount to some HRK 6.7bn (1.8% of the estimated GDP in 2020). Furthermore, the cost of write-off of taxes and contributions has been estimated to HRK 1.8bn (around 0.5% of GDP). Finally, the cost of the procurement of additional medical equipment amounts to some HRK 600m (around 0.2% of GDP). The effects of the aforementioned measures under the ESA methodology have been estimated to 2.5% of GDP, considering that revenues are recorded on an accrual basis, which excludes the effect of deferred tax payments.

Fiscal policy measures implemented in the first half of 2020 in Croatia with the aim of alleviating the negative consequences of the coronavirus pandemic have had a direct effect on the developments in government budget revenues and expenditures.

Before highlighting the implemented measures it is necessary to note that fiscal measures adopted in Croatia are, by their characteristics, scope and intensity, mostly comparable to the measures adopted by the governments of other European Union member states.[9] In most countries, in addition to the increase in expenditures for the procurement of necessary medical equipment, the governments responded to the crisis with some form of stimulus or subsidies to pay out wages to workers employed in companies suffering the most severe consequences of the restrictive measures implemented. The goal was to prevent mass layoffs of workers amid collapsing economic flows, but also to accelerate the recovery of the economy following the abolition of restrictions. This was supported by experiences of certain countries following the global financial crisis, primarily Germany, which have shown that preventing layoffs and re-employment of workers has a positive impact on the speed of recovery once economic circumstances improve. In addition to job preservation

9 Detailed overviews of fiscal and other measures implemented by individual countries may be found on the websites of the IMF and OECD, while the same information for European countries may be found on the websites of the European Commission, the Network of EU IFIs, some audit firms, think tanks, etc. By comparing the list of measures, one may notice that the information included is continuously changing, which is why there is no definitive list and source of all measures implemented by individual countries. Furthermore, different overviews contain varying information related to the overall effect of implemented measures, depending on whether the effect is estimated on a gross or net basis, whether financial guarantees are included in full or realised amount, etc. See, for example:
https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19;
https://www.oecd.org/coronavirus/en/policy-responses;
https://ec.europa.eu/info/sites/info/files/coronavirus_policy_measures_14_may.pdf;
https://www.euifis.eu/eng/fiscal/266/june-2020-update-of-the-european-fiscal-monitor-on-the-fiscal-measure;
https://www2.deloitte.com/ro/en/pages/business-continuity/articles/EU-countries-measures-on-COVID-19-under-magnifying-glass.html.

measures, numerous governments, the Government of the Republic of Croatia included, introduced deferrals and/or write-offs of certain tax liabilities to improve the financial position and liquidity of companies faced with sharply declining revenues due to the negative impact of restrictive measures on their output and/or demand for their products.

The Government of the Republic of Croatia reacted promptly and adopted the first package of measures addressing the crisis as early as on 17 March 2020, i.e. three weeks after the first patient infected with the virus had been registered in Croatia. Soon thereafter, on 2 April, the second package of measures was adopted, adjusting some of the measures included in the first package and introducing new ones.

Government grants for job preservation may be highlighted as the most significant measure adopted by the Government of the Republic of Croatia. The measure envisaged the subsidising of wage expenses in the amount of HRK 3,250 per employee in March (paid out in April) and HRK 4,000 for April and May. In addition, contributions for pension and health insurance were written off, with the exception of payments to the second pillar of pension insurance, which were made by the government budget. According to the CEI data and information from the Ministry of Finance, the cost of the aforementioned measure amounted to around HRK 6.7bn or around 1.8% of estimated GDP in 2020.

As for changes to tax regulations, the first package of measures allows business entities that experienced or estimated they would experience a decline in revenues greater than 20% to defer, free of interest, or pay in instalments their liabilities based on direct taxes and contributions. The measure was amended in the April package of economic measures so as to enable business entities with an annual turnover of up to HRK 7.5m (93% of all business entities) and a decline in revenues of over 50% to be fully exempt from paying public contributions (direct taxes and contributions) falling due in April, May and June 2020. Over the same period, business entities generating an annual turnover higher than HRK 7.5m and experiencing a fall in revenues of more than 50% will be partially exempt from paying the contributions referred to above in proportion to the decrease in their revenues. According to the CNB estimates, the cost of write-offs of taxes and contributions is estimated at HRK 1.8bn (around 0.5% of GDP), while tax deferrals will not be recorded, as revenues are presented on an accrual basis under the ESA 2010 methodology.[10]

Finally, the estimated cost of the procurement of medical and protective equipment to fight the coronavirus pandemic amounts to around HRK 600m or around 0.2% of GDP according to the Convergence Programme.

Although the revised government budget envisages the same amount of expenditures as originally planned, significant re-allocations were performed to secure the funds necessary to finance the measures and activities needed to fight the pandemic and its consequences; therefore, these changes have no effect on the

10 To ensure additional liquidity of economic entities, the government also introduced the option of VAT payment upon the settlement of issued invoices; however, it seems that the majority of tax payers do not plan to use the aforementioned option.

Table 1 Fiscal policy measures aimed at alleviating the negative consequences of the pandemic

The most significant measures		Fiscal effect, in HRK million	Fiscal effect, as % of GDP
Job preservation grants	Subsidies to enterprises	6,300.0	1.7
	Payments to the second pillar of pension insurance	400.0	0.1
1 Total grants		6,700.0	1.8
Write-off of direct taxes and contributions	Income tax	100.0	0.0
	Pension insurance contributions	800.0	0.2
	Health insurance contributions	800.0	0.2
	Profit tax	50.0	0.0
2 Total write-offs		1,750.0	0.5
3 Procurement of medical and protective equipment to fight COVID-19		600.0	0.2
Total		**9,050.0**	**2.5**

Notes: The effects of measures are CNB estimates. 'GDP' is the projected GDP for 2020 according to the CNB projection.
Sources: MoF and CNB.

budget balance.[11] The total amount of measures affecting the budget balance could come to around 2.5% of GDP.

By applying the fiscal measures referred to above, Croatia acted in line with the recommendations of the European Commission and the activation of the general escape clause of the Stability and Growth Pact.

Specifically, the Commission recommended EU member states to take whatever measures necessary to effectively respond to the pandemic, preserve the economy and support the ensuing recovery. At the same time, it is necessary to bear in mind that once economic conditions allow, member states will have to continue to implement fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability.

11 A reallocation of HRK 1.8bn was performed in early April, while the Amendments of the Government Budget of the Republic of Croatia for 2020 secure an additional HRK 4.9bn (HRK 1.6bn from EU funds). Furthermore, HRK 100m has been set aside for the urgent, stage-one repair of family houses, residential and commercial buildings and multi-apartment buildings damaged in the earthquake that struck the city of Zagreb and its surroundings. To finance the measures specified above, funds have been set aside from the savings of ministries and other government bodies, in particular the Ministry of Finance, Ministry of Science and Education, Ministry of Defence and Ministry of the Interior.

11 International reserves management

The CNB's total international reserves decreased by 6.7% from the end of 2019 to the end of the first half of 2020, and net reserves fell by 5.4% in the same period. The decrease in international reserves over the first six months of 2020 was a consequence of the sale of foreign exchange to banks aimed at countering depreciation pressures and a smaller amount of concluded repo agreements. Although almost 60% of government securities of euro area member states had negative yields, the annual rate of return on the entire euro portfolio was 0.36% in the first half of 2020, while the annual rate of return on the dollar portfolio totalled 2.17%. In the first half of 2020, international reserves investments generated an income of EUR 54.1m. In a particularly demanding and challenging environment, the primary objective of international reserves management, to ensure liquidity and safety, was successfully achieved.

The first half of 2020 was characterised by major turbulence in financial markets caused by the economic shutdown triggered by the confinement measures aimed at containing the coronavirus pandemic. Reserves management was particularly challenging in the early stages of the coronavirus crisis in March and April 2020 amid severe market fluctuations, lower liquidity and higher uncertainty, coupled with record large outflows based on foreign exchange interventions of the CNB. In such an environment, the primary objective of international reserves management, namely to ensure liquidity and safety, was successfully achieved.

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

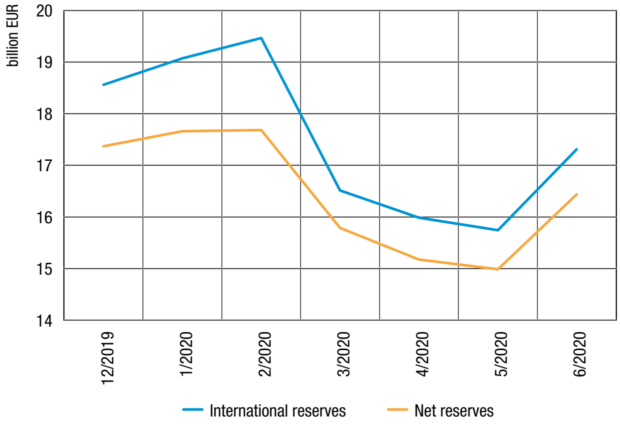
The other component of the reserves, formed on the basis of deposits of the MoF, repo agreements with banks, foreign currency swaps in the domestic market, IMF membership and other assets owned by other legal persons, is managed by the CNB in accordance with obligations assumed.

11.1 Structure of and developments in international reserves

International reserves of the CNB stood at EUR 17,312.3m as at 30 June 2020, down by EUR 1,250.1m or 6.7% from the end of 2019, when they stood at EUR 18,562.4m. Over the same period, net reserves decreased by EUR 931.3m, or 5.4%, from EUR 17,369.7m to EUR 16,438.4m.

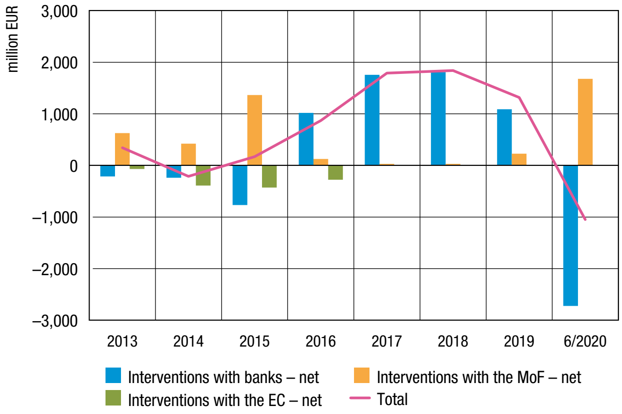
The decrease in international reserves in the first half of 2020 was a consequence of the sale of foreign exchange to banks aimed at countering depreciation pressures,

Figure 11.1 Monthly changes in total and net CNB international reserves in the first half of 2020



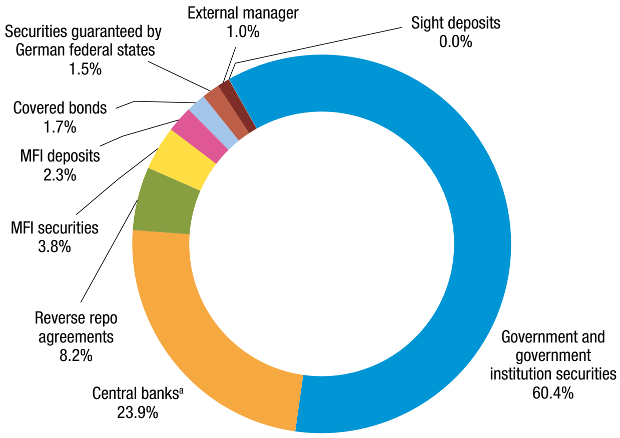
Source: CNB.

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



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

Figure 11.3 Structure of international reserves investment
as at 30 June 2020



[a] Includes foreign cash.
Source: CNB.

Figure 11.4 Currency structure of total international reserves
as at 30 June 2020

Source: CNB.

amounting to a total of EUR 2.7bn, and a smaller amount of concluded repo agreements. The drop in reserves was partially offset by the purchase of foreign exchange from the government (EUR 1.7bn).

Securities of governments and government institutions, deposits with central banks, including foreign cash, and reverse repo agreements accounted for the largest share in the structure of international reserves investment at the end of the first half of 2020.

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.

At the end of June 2020, around 60% of the 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.

The currency structure of international reserves remained the same from the end of 2019 to the end of the first half of 2020. The share of the euro edged down to 81.9% at end-June 2020, from 82.0% at end-2019. The share of the US dollar remained unchanged at 15.9%. The share of SDRs in international reserves grew marginally, from 2.0% to 2.1%.

11.2 Financial markets and international reserves management results in the first half of 2020

In the first half of 2020, the coronavirus pandemic fuelled the most turbulent global economic and financial movements in modern history. Major global economies recorded a sharp downturn due to the lockdown measures, while the prompt response by central banks aimed at avoiding an even deeper recession and government response through fiscal measures has been unprecedented. All this created extreme volatility in global financial markets, as evident in the rapid fall in stock exchange indices, the drop in yields on government securities, substantial volatility of the US dollar against the euro, as well as a noticeable increase in gold prices and a decrease in oil prices.

Within efforts to support the European economy amid the coronavirus crisis, the European Central Bank introduced a purchase programme of private and public sector securities (Pandemic Emergency Purchase Program, PEPP), expanded the current purchase programme and secured additional liquidity by introducing new longer-term refinancing operations.

The Fed responded to the coronavirus crisis by reducing the range for its benchmark interest rate on two occasions in March by a total of 150 basis points, to 0.00 – 0.25%, and by introducing a comprehensive package of measures.

Yields on almost all issued European government securities decreased in the first half of 2020, almost 60% of government securities of euro area member states having negative yields at end-June. The yield curve for German bonds for all maturities up to twenty five years was in negative territory at the end of June 2020.

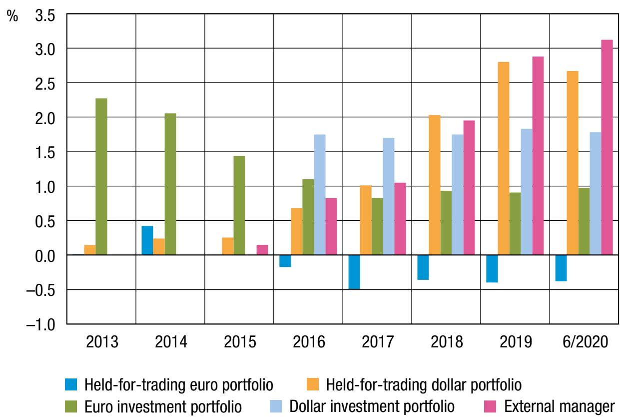
US yields dropped sharply across the entire curve in the first six months of 2020, the average fall for all maturities up to ten years totalling as much as 138 basis points.

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

In the first half of 2020, net international reserves investments generated an income of EUR 54.1m or HRK 405.3m.

Despite the negative rate of the euro yield curve, in the first half of 2020, the rate of return on the entire euro portfolio of net reserves was 0.36%, while the rate of return on the entire dollar portfolio totalled 2.17% on an annual basis. If held-for-trading and investment portfolios are observed separately, the euro held-for-trading portfolio generated an annual rate of return of –0.38%, while the dollar held-for-trading portfolio generated an annual rate of return of 2.67% in the first half of 2020. The euro-denominated investment portfolio yielded a return of 0.97%, while the dollar-denominated investment portfolio yielded a return of 1.78% on an annual basis.

Figure 11.5 Annual rates of return of the CNB foreign currency portfolios from 2013 to the first half of 2020



Source: CNB.

The held-for-trading portfolios, which account for approximately 33% of net reserves, have short average maturities and are used as a source of liquidity. Investment portfolios, which account for approximately 52% of net reserves, have a longer average maturity and serve as a source of more stable long-term income.

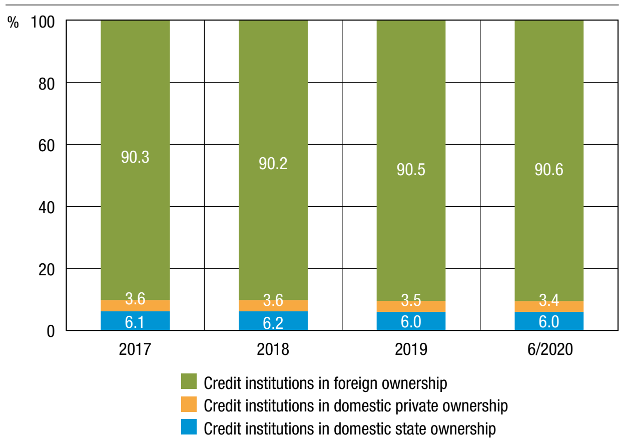
In the first half of 2020, the annual rate of return on the US dollar funds entrusted for management to an international financial institution was 3.12%. The entrusting of funds to an international financial institution enabled additional diversification as well as knowledge-exchange in the field of investment management.

12 Business operations of credit institutions

Business operations of banks in the first half of 2020 were strongly influenced by the exceptional circumstances of dealing with the Covid-19 pandemic. However, the strong capital and liquidity position of banks, CNB measures to alleviate the negative economic consequences of the pandemic, coupled with targeted amendments to the prudential regulatory framework and a more flexible approach to its implementation ensured a continuation of safe and stable bank operations. The strongest negative impact of new circumstances is evident in the drop in profits and indicators of return – ROAA and ROAE, which halved to 0.9% and 5.6%, respectively. The major factor here was the growth of expenses on impairments, due equally to the perception of increased credit risks on performing and on non-performing exposures. Profits were also lower due to the decrease in almost all operating income items. The quality of exposure to credit risk, measured in terms of the share of non-performing loans in total loans, remained at last year's level, so the non-performing loans ratio totalled 5.5%. In line with supervisory expectations regarding the pandemic, banks retained the profits generated in 2019 and thus further strengthened their capital Total risk exposure grew marginally, so the total capital ratio remained as high as 24.7%.

Structural features of the system of credit institutions did not change much from the end of 2019 to the end of the first half of 2020; there were 20 banks and three housing savings banks operating in the Republic of Croatia. In addition, there was one branch of an EU credit institution operating in the country, while some 200 institutions from the EU (and the EEA) had notified the CNB of the direct provision of mutually recognised services in the territory of the Republic of Croatia.[12] The system continued to be dominated by other systemically important banks, accounting for 90.6%[13] of all assets held by credit institutions. An equal share was held by the 14 credit institutions in majority foreign ownership.

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



Source: CNB.

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

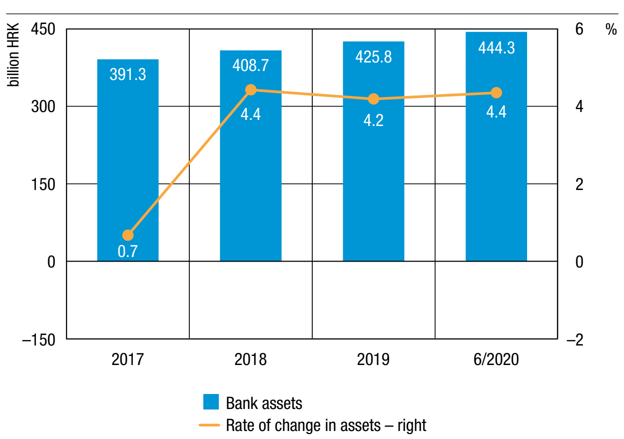
13 Other systemically important (O-SII) credit institutions are credit institutions the failure or malfunction of which could lead to systemic risk in the Republic of Croatia. Information on the last review of other systemically important credit institutions may be found here.

12.1 Banks

In the first half of 2020 business operations of banks were strongly influenced by the exceptional circumstances of dealing with the Covid-19 pandemic. The CNB undertook a series of measures to alleviate the negative economic consequences of the pandemic, including supervisory measures aimed at a more flexible approach to the application of the regulatory framework. Certain supervisory activities were adjusted, deadlines for the implementation of supervisory measures were extended, and credit institutions were notified of supervisory expectations related to the classification of exposures, the fulfilment of the liquidity coverage ratio (LCR), retention of profits generated in 2019 and appropriate adjustments of their variable remuneration payments. Within the supervisory review and evaluation process (SREP), the CNB adopted a pragmatic approach and kept additional capital requirements at levels set in the previous SREP cycle, which was in line with the guidelines of the European Supervisory Authority (EBA). The focus of the 2020 SREP was on the ability of credit institutions to respond to changes and challenges in the environment and on their most relevant risks and vulnerabilities in the context of the Covid-19 pandemic, whereas any deficiencies identified were to be primarily addressed with qualitative measures.

In the first half of 2020, bank assets increased by 4.4%, to HRK 444.3bn. Loans increased the most, particularly those to foreign credit institutions and government units. Loans to non-financial corporations grew in the first months of the observed period, but started on a downward path in April. The rise in household loans was mostly driven by the growth in housing loans attributable to the government continuing to subsidise housing loans. The steady years-long upward trend in general-purpose cash loans to households came to an end and these loans decreased. The reduction of the reserve requirement rate[14] triggered changes in the structure of highly liquid assets, which, among other things, pushed the LCR (short-term liquidity indicator) up to a high 181.4%. Almost a quarter of total bank assets were accounted for by highly liquid assets – cash and received deposits. The greatest contribution to this share again came from assets in settlement accounts with the CNB. All banks complied with the minimum liquidity requirements (100%-level).

Figure 12.2 Bank assets

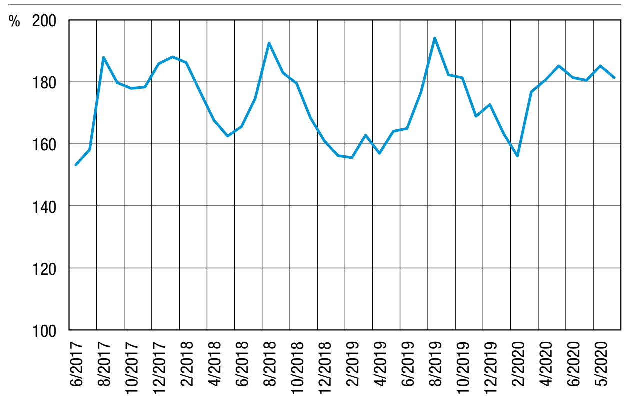


Source: CNB.

Total deposits went up 4.4%. The growth in the deposits of domestic sectors, particularly those of non-financial corporations (10.6%) and households (3.0%), and the use of CNB loans from the package of measures to boost banking system liquidity in the midst of the crisis triggered by the coronavirus pandemic were the key source of the rise in bank

14 In line with the Decision on amendments to the Decision on reserve requirements (OG 36/2020), the reserve requirement rate was reduced from 12% to 9%.

Figure 12.3 Liquidity coverage ratio (LCR)



Source: CNB.

assets. The steady decrease in time deposits and the increase in deposits in transaction accounts supported the long-lasting trend of maturity transformation in total deposits, mostly owing to the impact of developments in the structure of household deposits. The share of deposits in transaction accounts rose to 62.6% and the share of time deposits dropped to 31.7% of total deposits.

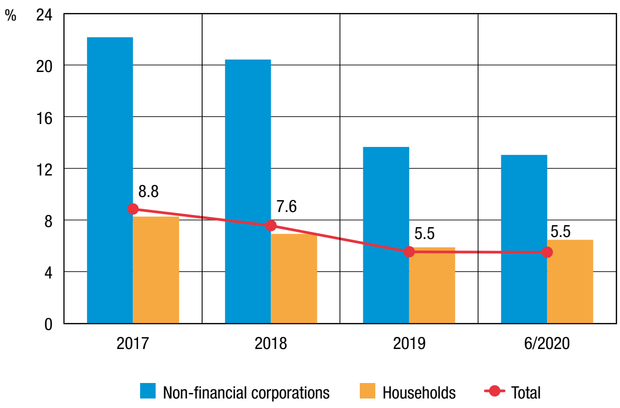
In the first half of 2020, banks perceived a substantial increase in credit risk, mostly associated with performing exposures still not at default (value impairment stage 2).[15] The total increase in exposures in this stage (48.1%) was mostly driven by the rise in the portfolio of loans to non-financial corporations. By comparison, non-performing loans (NPLs) grew relatively slightly (4.5%), which may be associated with the application of the rules on the classification of claims and moratoriums granted to debtors. This growth was outstripped by new credit activity in that period, so the non-performing loans ratio (NPLR) remained at last year's level of 5.5%. However, in only four banks was this indicator below the threshold of 5%, while at a half of them the NPLR continued to exceed 10%.[16] In comparative terms, this is still among the highest in EU member states and less favourable than the EU NPLR average. At the same time, the coverage of non-performing loans by impairment (67.8%) is among the highest and much above the average, which shows that banks have identified a higher level of expected losses and that these losses have already burdened their profits and capital.

The years-long trend of improvement in the portfolio of household loans came to a halt and their quality deteriorated. The NPLR for the household sector went up from 5.9% in 2019 to 6.5% at the end of the first half of 2020, largely due to the quality deterioration of general-purpose cash loans. More specifically, the first half of 2020 saw an end to the increase in general-purpose cash loans, which had lasted for several years and compensated for the deterioration in loan quality. The marginal improvement in the quality of loans to non-financial corporations, that is the decrease in the NPLR from 13.7% to 13.0%, may be attributed to new lending activity and the use of moratorium measures. By the end of June 2020, banks approved deferral and moratorium measures

15 The concept of value impairment stage 1, 2 and 3 has been developed and accepted both in literature and practice. From the aspect of loss expectation, each instrument that is subject to the calculation of expected credit loss, which includes all debt instruments measured at amortised cost and at fair value through other comprehensive income, is classified in one of the three stages of value impairment. If its credit risk is low, it is classified into stage 1, where the 12-month expected credit loss is calculated. If there is a significant increase in credit risk (although still not in default) it is transferred to stage 2, where the expected loss is calculated for the entire lifetime of the instrument. If loss is actually incurred, the instrument is transferred to stage 3, where the loss that is actually incurred is determined.

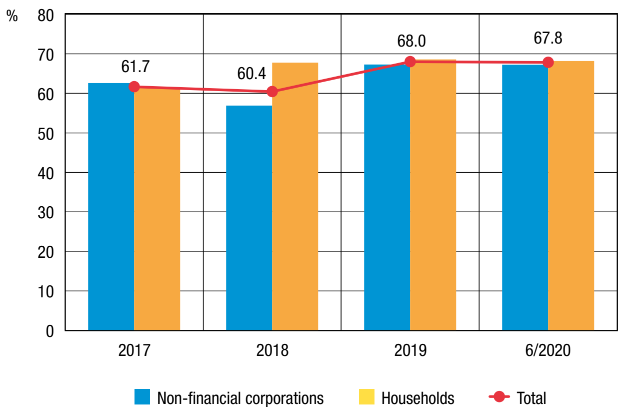
16 The threshold of 5% is a reference value by which EBA identifies a high NPLR, which triggers additional regulatory requirements related to a strategy to reduce NPLs and manage credit risk.

Figure 12.4 Share of non-performing loans in total bank loans



Source: CNB.

Figure 12.5 Coverage of non-performing loans by impairment



Source: CNB.

worth HRK 32.4bn, which is equal to 8.8% of total loans. While legal persons accounted for the larger share of the approved amount (68.5%), households accounted for the greater number of applications (82.6%).

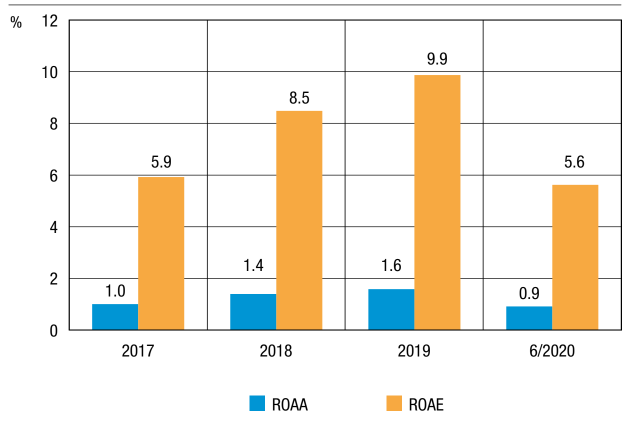
At the end of the first half of 2020 bank profits amounted to HRK 1.7bn, down 47.6% from the first half of 2019. With the decrease in profits, return on average assets (ROAA) and return on average equity (ROAE) also decreased, to 0.9% and 5.6%, respectively. Most of the decrease in profits was due to expected credit losses on non-performing loans and on performing loans with much higher credit risks, which more than quadrupled the amount of value impairments and provisions. Profits were also adversely affected by the decrease in all components of total net income, of 7.0%, primarily the fall in income from dividends, which was undoubtedly the consequence of the conservative approach of regulators and subsidiaries to dividends amid pandemic conditions. The 2019 recovery in interest income from loans, which followed a long-lasting downward trend, did not continue, while income from fees and commissions also decreased. The downward pressure of these income sources on bank profitability was partially mitigated by a further decrease in interest expenses, mostly restructuring of household deposits, and a decrease in expenses on fees and commissions. The cost-to-income ratio (CIR) grew to 54.5%, its deterioration being the outcome of methodological changes.[17]

Key indicators of bank capitalisation remained at high levels, the total capital ratio of 24.7% being among the highest of EU member states. In line with supervisory expectations regarding the pandemic, banks retained their profits generated in 2019 and thus further strengthened their capital. Additional capital stability has been provided by the adoption of Regulation (EU) 2020/873 (*CRR Quick fix*), with targeted amendments to the prudential regulatory framework. Within adopted measures, the most important

17 Within this indicator, as of 30 June 2020, general expenses include also contributions to the resolution fund and deposit insurance premiums, which were formerly reported within other (unspecified) operating expenses and directly deducted from total net income.

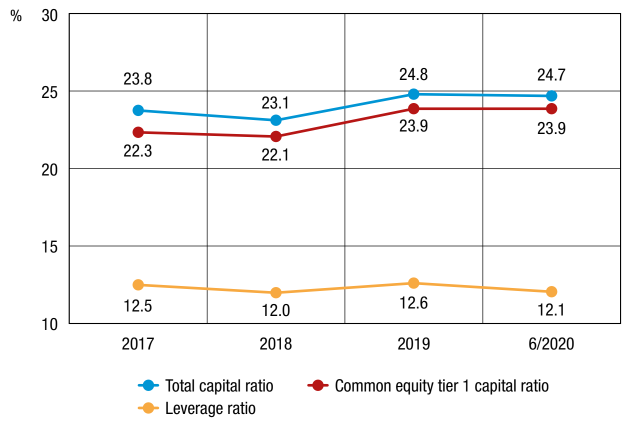
impact on the domestic banking system was made by the reintroduction of transitional arrangements for the treatment of exposures arising from public debt issued in the currency of another member state, that is, allowing the application of a 0% risk weight to euro-denominated exposures to the Republic of Croatia.[18] The application of these provisions helped in avoiding the volatility of tier 1 capital, so that the marginal reduction in own funds (0.1%) was the outcome of a reduction in tier 2 capital. While greater exposure to credit risk led to a slightly larger total risk exposure (0.4%), the average credit risk weight decreased, from 47.5% to 46.6%, due to the favourable impact of the reintroduced application of a 0% risk weight. The importance of this risk weight is reflected in the share of exposures to which this weight is assigned in total risk weighted exposures, which stood at a high 41.0% at the end of the first half of 2020. Total capital ratio of all banks exceeded the 8%-minimum, while in seven banks, accounting for a 70.3% share of total assets of all banks, this ratio exceeded 20%.

Figure 12.6 Bank return on average assets (ROAA) and return on average equity (ROAE)



Source: CNB.

Figure12.7 Key indicators of bank capitalisation



Source: CNB.

12.2 Housing savings banks

The assets of housing savings banks grew by only 0.1%, to HRK 5.3bn in the first half of 2020, while their share in total assets of credit institutions remained at 1.2%. The key source of funding, the deposits of housing savings bank depositors, decreased (0.7%), so that a mild increase in lending was financed through changes in the asset structure, the greatest of which had to do with the decrease in investments in RC bonds. Housing loans grew by 2.5%, and the share of housing savings banks in total housing loans of the system remained at 5.5%. The mentioned decline in deposits of housing savings bank depositors was undoubtedly impacted by another cut in state incentives for housing savings.[19]

18 Up to 31 December 2022 "quick fix" amendments to the CRR enable a 0% risk weight be reintroduced for exposures to the central governments and central banks of member states, where those exposures are denominated and funded in the domestic currency of another member state. The preferential risk weight for such exposures was last applied in late 2017. A risk weight of 25% was applied at end-2019, whereas a 50% risk weight was applied at the end of the first quarter of 2020.

The characteristically good quality of loans remained the same. The non-performing loan ratio stood at 0.9%, while the coverage of non-performing loans was 55.4%.

In the first half of 2020, housing savings banks generated HRK 10.1m in profits, down 2.6% from the same period of 2019. Indicators of return – ROAA and ROAE stood at 0.5% and 4.3%, respectively. Total net operating income fell sharply (29.7%), due to the decrease in all operating income items, as well as the impact of larger losses of trading with securities. This smaller total net income was insufficient to cover general operating expenses, as evident from the unsatisfactory value of the CIR indicator (115.0%). The fall in total net income was almost entirely compensated by income from the reversal of asset impairment, due to the reduced coverage of exposures classified into risk category A, from 0.8% in 2019 to 0.4% at the end of the first half of 2020.[20] The fall in income thus did not make a significant negative impact on profits.

Total capital ratio stood at 23.7%. Its fall of 0.3 percentage points from 2019 was driven by the increase in housing loans, which raised the overall exposure to risks.

19 Under the Decision on the amount of state incentives for housing savings in 2020, a limit is set on state incentives, at 0.7%, or a maximum of HRK 35 per saver (OG 7/2020). For the sake of comparison, when housing savings were first introduced in 1998 state incentives were set at 25%, or a maximum of HRK 1,250.

20 The provision of the Decision on the classification of exposures into risk categories and the method of determining credit losses (OG 114/2017 and 110/2018), under which the total impairment by exposures classified into risk sub-categories A-1 and A-2 until 31 December 2018 could not be below 0.8% of the gross carrying value of exposures in those risk sub-categories, except in the case of financial assets at fair value through other comprehensive income, ceased to have effect on 1 January 2020.

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
CDS – credit default swaps
CEE – Central and Eastern European
CEFTA – Central European Free Trade Agreement
CES – Croatian Employment Service
CHF – Swiss franc
CHIF – Croatian Health Insurance Fund
CHY – Yuan Renminbi
CICR – currency-induced credit risk
CPF – Croatian Privatisation Fund
CPI – consumer price index
CPII – Croatian Pension Insurance Institute
CM – Croatian Motorways
CNB – Croatian National Bank
CR – Croatian Roads
EBA – European Banking Authority
ECB – European Central Bank
EEA – European Economic Area
EFTA – European Free Trade Association
EMU – Economic and Monetary Union
EU – European Union
EUR – euro
excl. – excluding
f/c – foreign currency
FDI – foreign direct investment
Fed – Federal Reserve System
FINA – Financial Agency
f.o.b. – free on board
GDP – gross domestic product
GVA – gross value added
HANFA – Croatian Financial Services Supervisory Agency
HICP – harmonised index of consumer prices
HRK – kuna

HUB	– Croatian Banking Association
incl.	– including
IMF	– International Monetary Fund
JPY	– Japanese yen
m	– million
MIGs	– main industrial groupings
MM	– monthly maturity
MoF	– Ministry of Finance
NBS	– National Bureau of Statistics of China
NCA	– National Classification of Activities
n.e.c.	– not elsewhere classified
NUIR	– net usable international reserves
OECD	– Organisation for Economic Co-Operation and Development
OG	– Official Gazette
R	– Republic
RAMP	– Reserves and Advisory Management Program
ROAA	– return on average assets
ROAE	– return on average equity
o/w	– of which
PPI	– producer price index
Q	– quarter
RR	– reserve requirement
SDR	– special drawing rights
SE	– South-East
SGP	– Stability and Growth Pact
SITC	– Standard International Trade Classification
USD	– US dollar
VAT	– value added tax
ZSE	– Zagreb Stock Exchange
ZMM	– Zagreb Money Market

Symbols

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

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