Semi-annual Information

Semi-annual Information on the Financial Condition, the Degree of Price Stability Achieved and the Implementation of Monetary Policy in the Second Half of 2020

Zagreb, August 2021

HRVATSKA NARODNA BANKA • CROATIAN NATIONAL BANK

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SEMI-ANNUAL INFORMATION 2020

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in the Second Half of 2020

CROATIAN NATIONAL BANK

PUBLISHER

Croatian National Bank
Trg hrvatskih velikana 3
10000 Zagreb

www.hnb.hr

Those using data from this publication are requested to cite the source.

ISSN 1849-3483 (online)

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1 Summary

Aggregate supply and demand

Real GDP was 8.8% lower in the second half of 2020 than in the same period of the previous year as a consequence of the adverse impact of the COVID-19 pandemic on domestic economic activity and that of Croatia's major trading partners. If analysed by quarters, economic activity in the third quarter of 2020 declined by 10% on an annual level, and it fell by 7% in the fourth quarter. The largest individual contribution to the contraction of economic activity in the second half of 2020 was made by the decrease in total exports, mainly the exports of services. At the same time, the imports of goods and services also decreased, but less than total exports. Furthermore, the sharp decline in personal consumption reflected the adverse effect of the pandemic on the household potential as well as on the propensity to spend. In contrast, general government capital investments and consumption went up in the second half of 2020 from the same period of 2019.

Labour market

Employment, which started to grow in June 2020, also continued to increase in the second half of the year due to the recovery in economic activity and the later than usual beginning of the season, when the number of employed persons almost reached the pre-crisis values. The number of employed persons was thus 0.6% lower at the end of December 2020 than in the same period of 2019. The implementation of job preservation measures, introduced in March 2020, continued until the end of the year, albeit within a considerably smaller scope. The increase in the number of employed persons in the second half of 2020 was also reflected in the decrease in unemployment. The registered unemployment rate thus stood at 9% of the labour force at the end of 2020 (10% in the second quarter), or up by 1.8 percentage points from the same period of the previous year. The average nominal gross wage was 3.1% higher in December 2020 than in December 2019.

Inflation

Consumer price inflation was mostly negative in the second half of 2020, largely as a result of lower energy prices when compared with the same period in the previous year. The increase in the annual fall in overall consumer price inflation from –0.2% in June to –0.7% in December was attributed to the fall in the contribution of the prices of food products due to several important factors, such as the fall in the prices of certain food raw materials (particularly meat) in the EU market, the normalisation of the supply chain and the negative base effect as a result of the steep growth of the prices of meat in December 2019. The negative contribution of energy prices to overall inflation fell moderately (to –1.0 percentage point in December from –1.2 percentage points in June) as a result of the increase in the prices of refined petroleum products, spurred by the increase in the price of crude oil on the global market in the second half of the year. Core inflation declined from 1.1% in June to –0.1% in December, while the main deceleration had occurred by the end of the year, largely driven by the mentioned decrease in the annual rate of change in the prices of certain food products.

Current and capital account and foreign capital flows

The surplus in the current and capital account was much lower in the second half of 2020 than in the same period of the previous year. The pandemic and the accompanying epidemiological measures resulted in a sharp drop in revenues from tourism and a decrease in the net exports of services. Unfavourable developments were partly offset by a fall in the deficit of the foreign trade in goods as a result of a stronger decline in imports than exports. In addition, the contraction of economic activity was also reflected in the lower profitability of domestic banks and enterprises in foreign ownership, as a result of which the balance in the primary income account improved noticeably. The surplus in the secondary income account and in the account of capital transactions also grew as a result of a more intensive use of EU funds. At the same time, the net capital outflow in the financial account of the balance of payments reflects a further decrease in net debt liabilities of domestic sectors. Despite the improvement in the absolute amount, relative indicators of gross external debt and the net international investment position deteriorated due to the fall in nominal GDP, while the relative indicator of net external debt improved.

Monetary policy and private sector financing

In the second half of 2020, the CNB maintained a highly expansionary monetary policy ensuring favourable domestic financing conditions and maintaining the stability of the exchange rate of the kuna against the euro. Banks’ free reserves thus reached a record high in 2020, which contributed to keeping most interest rates at historical lows, similar to those before the pandemic outbreak. In the course of the second half of the year, banks relaxed credit standards for household loans after the strong tightening in the first half of the year while continuing to tighten credit standards for corporate loans. The annual growth of household placements continued to decelerate, mostly due to the decrease in general-purpose cash loans. By contrast, the annual growth of placements to corporations accelerated, mostly due to the strong increase in the first quarter. However, from April to December, credit activity oriented towards corporations was mainly subdued, mostly driven by the decrease in loans for working capital, which had recorded a sharp increase in March as a result of the demand of corporations for liquid assets. Although Croatia has been in the ERM II regime since 10 July 2020, the CNB's monetary and foreign exchange policy has not changed.

Public finance

The worsening of the government finance situation continued in the second half of 2020, although less pronouncedly than in the first half of the year. This deterioration reflects the continuation of the negative impact of the crisis on economic activity and tax revenues, as well as the impact of the implemented government measures necessary for alleviating the negative consequences of the crisis, most of all of the continued payment of job preservation grants. Thus, in the second half of 2020, according to the ESA methodology, a negative general government budget balance of HRK 12.2bn was recorded, which together with HRK 15.3bn in the first half of the year resulted in a total deficit at the 2020 level of HRK 27.5bn or –7.4% of GDP. Debt growth decelerated perceptibly in the second half of 2020, so that consolidated general government debt stood at HRK 329.7bn or 88.7% of GDP at the end of 2020, up by HRK 0.4bn from the balance at the end of June of the same year.

International reserves management

The CNB's international reserves were 2.1% higher at the end of 2020 than at the end of 2019, and net reserves increased by 1.9% in the same period. The growth of international reserves in 2020 was mostly driven by foreign currency inflows to the Ministry of Finance account due to the intensified foreign borrowing by the government and inflows from EU funds. Although about 75% of government securities of euro area member states had negative yields, the rate of return on the entire euro portfolio was 0.22% in 2020, while the rate of return on the dollar portfolio totalled 1.45%. In 2020, international reserves investments generated a total income of EUR 74.1m. Despite a particularly demanding and challenging environment, the primary objectives of the management of international reserves, liquidity and safety, were successfully achieved.

Business operations of credit institutions

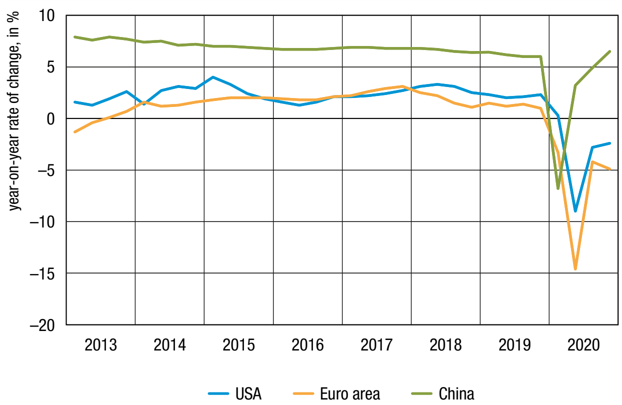
Business operations of credit institutions in 2020 were strongly influenced by the exceptional circumstances of having to operate in the midst of the COVID-19 pandemic. However, that operations were both safe and stable in such unfavourable and uncertain conditions must primarily be set down to the high liquidity and capitalisation of the banking system, and the preconditions for an additional reinforcement of the values of these positions in the newly-created circumstances were ensured by emergency regulatory adjustments. The largest negative impact of the new circumstances is observed in the drop in profitability of credit institutions, ROA and ROE, which more than halved to 0.6% and 4.4%, respectively. The major factor here was the growth of expenses on impairments, due to the perception of increased credit risks on both performing and non-performing exposures. An additional effect on the fall in profits came from the reduced operating income, despite cost cutting. The quality of exposure to credit risk, measured in terms of the share of non-performing loans in total loans improved slightly, so that the share of non-performing loans totalled 5.4%. In line with supervisory expectations regarding the pandemic, credit institutions retained their profits generated in 2019 and thus strengthened their capital further. Total risk exposure grew marginally, so that the total capital ratio increased additionally to a high 24.9%.

2 Global developments

In the second half of 2020, the rate of economic recovery was uneven across countries. China reached the pre-crisis annual GDP growth rates by the end of 2020, while the USA and the euro area, including all of Croatia's major trading partners, recorded a decline in economic activity from the previous year. The prices of raw materials increased in the second half of the year. Central banks continued to pursue an exceptionally expansionary monetary policy. Financing conditions for European emerging market countries, including Croatia, improved perceptibly. A strong trend of US dollar weakening against the basket of world currencies continued in the second half of the year.

Following a strong contraction caused by the COVID-19 pandemic in the first half of 2020, a recovery of the global economy was recorded in the remainder of the year. However, recovery dynamics was not consistent among countries due to different epidemiological situations and restrictive measures of various levels of stringency, the differences in the scope and level of fiscal measures aimed at assisting the economy and noticeably different economic structures, as well as the possibility of adjustment to operations amid crisis conditions. Thus, China had reached pre-crisis annual GDP growth rates by the end of 2020, while the USA and the euro area recorded a decline in economic activity in the second half of the year from the same period of the previous year (Figure 2.1). At the same time, an expansionary monetary policy, which was created as a response to the crisis caused by the pandemic, was continued, allowing financing conditions to remain relatively favourable.

Figure 2.1 Economic growth in selected markets



Sources: Eurostat, BEA and NBS.

The recovery of the US economy, the world's largest, was much stronger in the second half of 2020 than had been expected, primarily owing to a noticeable recovery of personal consumption and investments. The recovery was accompanied by very favourable labour market developments. Although previous forecasts indicated that the unemployment rate, which reached a record 14.8% in April 2020, would remain at two-digit levels until the end of the year, it was only 6.7% in December. The strongest recovery was recorded in the third quarter, while in the last three months it slowed down perceptibly due to the resurgence of the infection accompanied by the growing uncertainty surrounding the results of the presidential election and the elections for both

Houses of the Congress. Despite the recovery, economic activity was still below the pre-crisis level in the second half of the year, down by 2.8% and 2.4% in the third and the fourth quarter respectively, relative to the same period of the previous year.

As regards the euro area, the epidemiological situation was relatively favourable during the summer months, which contributed to the recovery in the third quarter. The monetary union's economy remained at 4.2% below the level from the same period of the previous year. In early autumn, the epidemiological situation started worsening again, which eventually resulted in a new pandemic wave and a series of very stringent restrictive measures in most member states. However, the fall in economic activity in the last three months of 2020 was much smaller than previously expected, in particular when compared with the first wave in spring. This was partly a result of the high degree of adjustment of the economy to operate amid pandemic conditions, in particular in member states with a high share of manufacturing industry (Germany). If viewed on an annual level, economic activity in the euro area fell by 4.9% in the last three months of 2020.

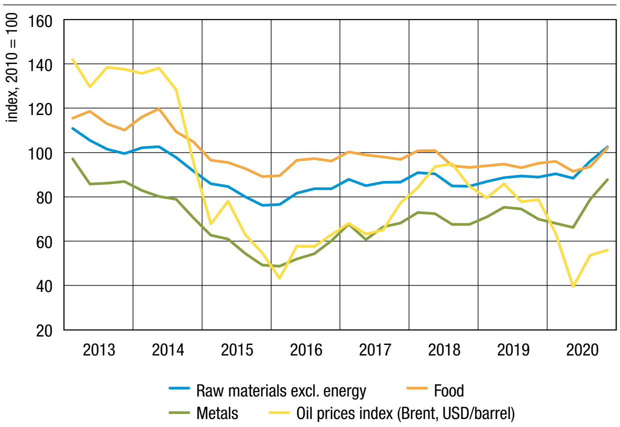
2.1 Croatia's main trading partners

All of Croatia's major trading partners saw a noticeable decline in economic activity in the second half of 2020 from the same period of the previous year. Nevertheless, the decline in economic activity was the most pronounced in euro area trading partners, in particular in Italy and Austria, and slightly less in Germany and Slovenia. With regard to Croatia's trading partners in Southeastern Europe, economic developments were uneven so that the level of economic activity in Serbia was only slightly lower than in the same period of the previous year, while the contraction in Bosnia and Herzegovina was similar to that recorded in euro area member states.

2.2 Prices, exchange rates and financing conditions

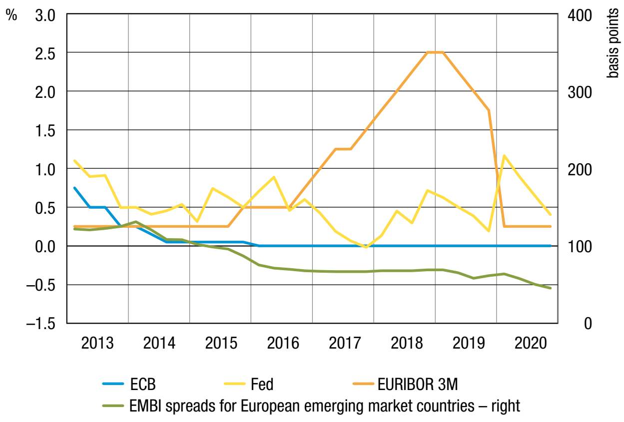
After a sharp fall in the first half of the year, raw material prices increased in the second half of 2020 (Figure 2.2). In the period from July to the end of October, the price of a barrel of Brent crude oil ranged between USD 37 to USD 46 and then rose to USD 51 by the end of the year, or 25% higher than the price at the end of June. The recovery in oil prices was due to the agreement among OPEC countries and other oil producers to reduce production in response to the decline in demand, a fall in crude oil reserves in the USA, the relaxation of the measures after the first wave of the economic lockdown, the news of the development of a vaccine against COVID-19 and the increase in the quotas for the imports of oil into China in 2021.

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



Sources: IMF and Bloomberg.

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



Source: Blomberg.

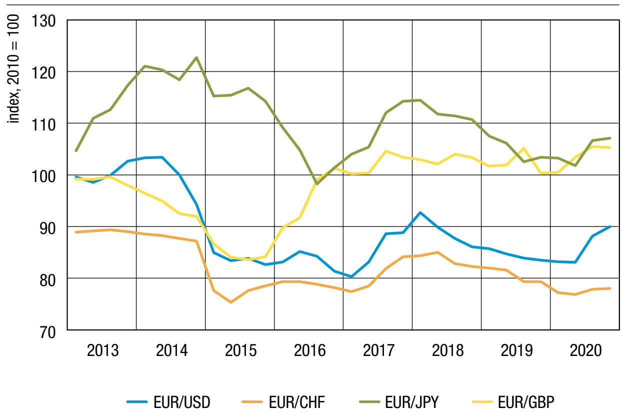
The prices of raw materials excluding energy also increased in the second half of 2020, reaching their highest levels since 2014. The increase in the prices of raw materials was the result of the easing of the initially introduced measures to curb the spread of the pandemic. The growth in the prices of metals spurred by the activation of industrial production worldwide was the most pronounced, while the prices of food products increased in all segments except the prices of meat. The drop in the prices of meat, of pork in particular, was the consequence of the decline in demand due to the limited imports of meat from Europe into China.

As regards monetary policy, in the second half of 2020, the exceptionally expansionary monetary policy of central banks in the world's largest economies, created as a response to the crisis caused by the pandemic, was continued, with individual instruments being additionally adapted to the newly-created circumstances, in particular in the euro area. Thus, the ECB, among other things, additionally increased (by EUR 500bn) the volume of its pandemic emergency purchase programme and extended it until March 2022. At the same time, the Fed extended the duration of all of its emergency instruments adopted in spring 2020 as well as foreign currency swap agreements with central banks worldwide.

After a strong deterioration due to the epidemic outbreak (Figure 2.3), the financing conditions for European emerging markets, including Croatia, improved noticeably and almost returned to the pre-crisis levels towards the end of the year.

At the peak of uncertainty in March 2020, the USD/EUR exchange rate dropped to the lowest level in the past several years and, in the subsequent months, started a strong trend of US dollar weakening against the basket of world currencies, which continued in the second half of the year. At the end of December 2020, the exchange rate of the US dollar against the euro was EUR/USD 1.19, which is an increase of 8.3% from the end of June 2020. The weakening of the US dollar against the euro (Figure 2.4) was mostly linked to structural factors, such as twin deficits, or the simultaneous growth of the federal budget deficit and the US trade

Figure 2.4 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.

deficit, and to optimism regarding the recovery of the European economy following the agreement on the multi-year budget and recovery facility reached among EU member states in the summer of 2020. The exchange rate of the Swiss franc against the euro stood at EUR/CHF 1.08, up by 1.6% at the end of December from the end of June.

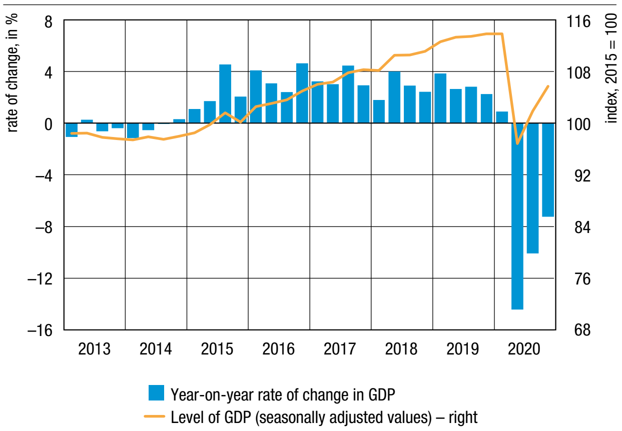
3 Aggregate supply and demand

The fall in total exports made the largest contribution to the total annual decrease in economic activity. The exports of services fell sharply due to the adverse impact of the pandemic on tourist activity. Personal consumption also declined, but more moderately than in the first half of the year. Investment activity recovered, primarily based on the growth of general government investments. General government consumption grew. Gross value added was the lowest in service activities in the second half of 2020.

The impact of the COVID-19 pandemic on domestic economic activity, as well as on the economic activity of most of Croatia's major trading partners, was extremely adverse. Real GDP was 8.8% lower in the second half of 2020 than in the same period of 2019, when there was an annual growth rate of 2.5%. The fall in total exports made the largest contribution to the total annual decrease in economic activity. As a consequence of the adverse impact of the pandemic on tourist activity, the exports of services fell sharply, while the exports of goods increased. In addition to total exports, personal consumption also fell sharply. In the second half of 2020, the imports of goods and services also declined, although less than total exports, so that the contribution of net foreign demand to the total change in economic activity was very negative.

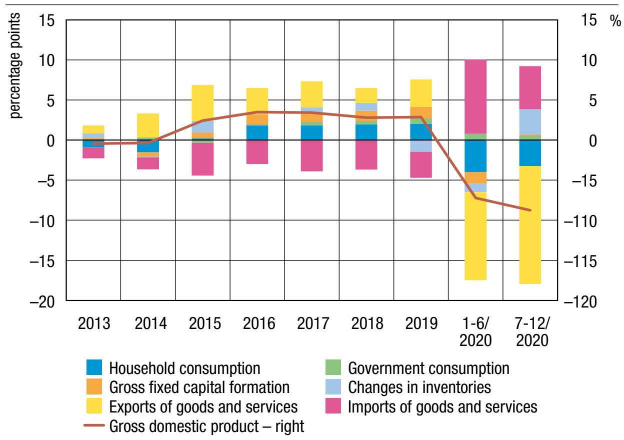
If analysed on a quarterly basis, economic activity partly recovered in the second half of 2020. After a sharp fall in the second quarter relative to the beginning of the year (–14.9%), in the period from July to September, economic growth stood at 5.2%, and in the period from October to December it was 3.8%. Despite the recovery, average real GDP in the second half of 2020 was 1.5% lower than in the first half of the year. According to the production approach, gross value added (GVA) was 6.7% lower in the second half of the year than in the same period of 2019. The sharpest fall in activity was recorded in service activities that involve close contacts in operations, such as wholesale and retail trade, transportation and storage, accommodation and food service activities.

Figure 3.1 Gross domestic product
real values



Source: CBS (seasonally adjusted by the CNB).

Figure 3.2 GDP rate of change
contributions by components



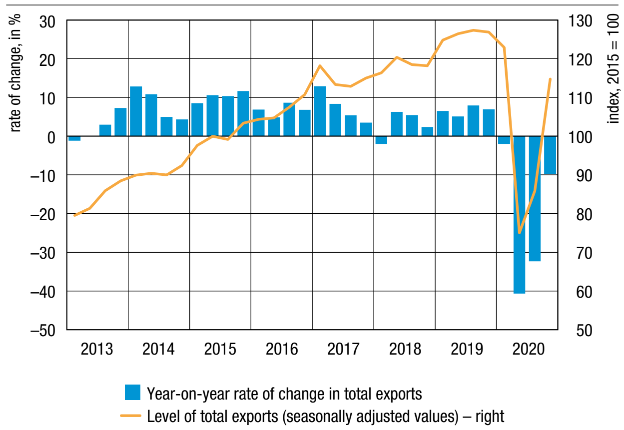
Source: CBS.

3.1 Aggregate demand

The real exports of goods and services were 24.8% lower in the second half of 2020 than in the same period of the previous year. The decrease was mostly driven by the extremely poor performance in the exports of services, which shrank by 42.9%, primarily as a consequence of the lower demand for tourist services during the pandemic. There was no significant decline in total exports due to the slightly more favourable developments in goods exports, which were 2.7% higher in the second half of 2020 than in the same period of 2019. The annual increase was the result of the growth of goods exports on a quarterly basis (16.7% and 5.9% in the third and the fourth quarter respectively). Nominal data on the trade in goods broken down by main industrial groupings show that the exports of intermediate goods and durable consumer goods increased in the last six months of 2020 on an annual level, while the exports of energy, capital goods and non-durable consumer goods decreased.

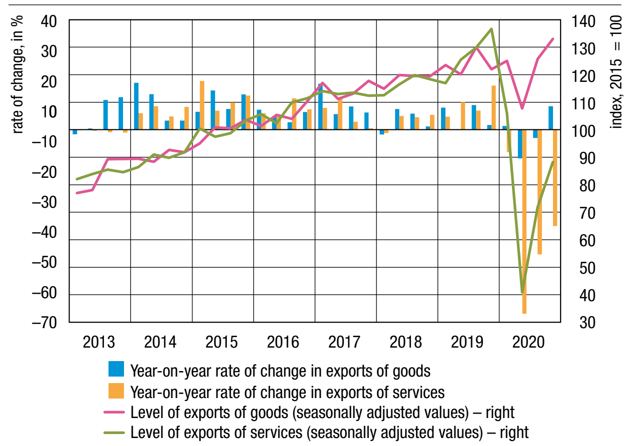
Personal consumption fell by 5.9% in the second half of 2020 from the same period in 2019 (in the first half of the year, the decrease was 6.8%). Thus, if viewed at the level of the whole year, personal consumption was 6.4% down from the performance in 2019, although at the same time employee compensations increased throughout the year. The sharp decrease in household consumption reflects the adverse impact of the COVID-19 pandemic on the household potential as well as propensity to spend. In addition to imposed social distancing measures having directly limited the provision of certain services, household consumption also decreased because of the avoidance of the risk of contagion and the rise in uncertainty following the worsening of the economic situation. Thus, Consumer Confidence Survey data show that in the second half of the year household optimism recovered only partially from the sharp decline in the second quarter. The rise in uncertainty also led to a decline in the propensity to spend and to reduced household borrowing. If analysed on a quarterly basis, household consumption started recovering in the third quarter (growth stood at 8.8% from the previous three months when it fell by 12.4%). Growth continued in the last quarter, albeit at a much slower pace (1.6%).

Figure 3.3 Exports of goods and services
real values



Source: CBS.

Figure 3.4 Real exports of goods and services

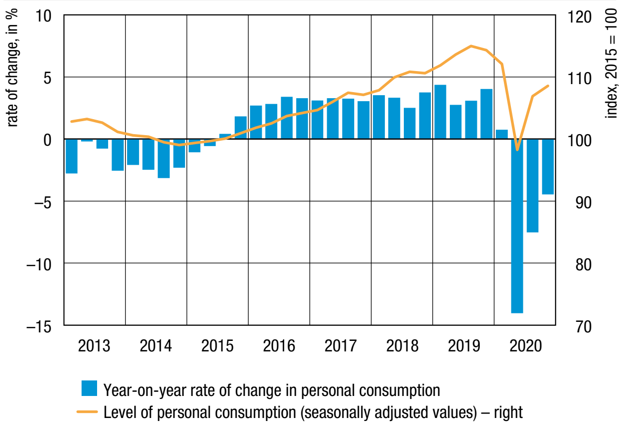


Source: CBS.

Investment activity recovered strongly in the second half of 2020 and, according to seasonally adjusted data, it was 7.5% higher than in the first six months, when it was down by 6.4%. If analysed on an annual basis, capital investment was up by 0.5% in the second half of 2020 from the same period of the previous year (in the first half of the year the decline was 6.3%). Quarterly data show that, after a sharp fall in the second quarter (by 16.3%), capital investment increased by 14.1% from July to September, thus coming close to the level from the end of 2019. The growth of investment was slightly slower (6.8%) in the fourth quarter. The available fiscal data suggest that the recovery of investment activity is primarily the result of the growth of general government investments. At the entire 2020 level, investment activity was 2.9% lower than in 2019.

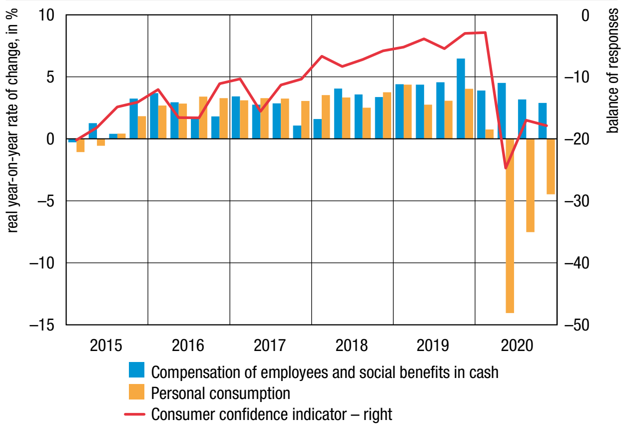
General government consumption was up by 3.1% in the second half of 2020 from the same period of 2019 (in the first half of the year, growth stood at 3.8%). Nominal data show that the annual growth was driven by the increase in consumption

Figure 3.5 Personal consumption
real values



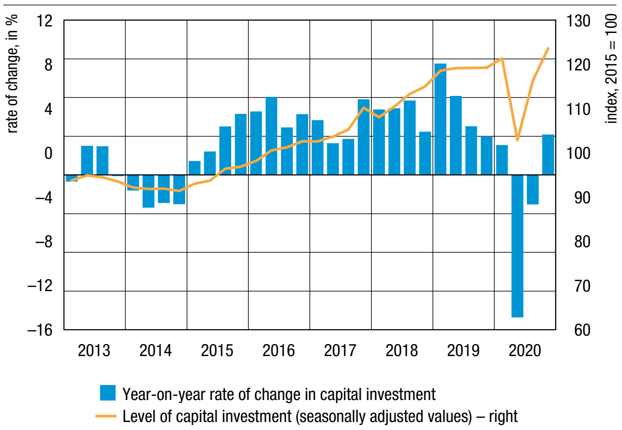
Source: CBS (seasonally adjusted by the CNB).

Figure 3.6 Determinants of personal consumption
real values and index



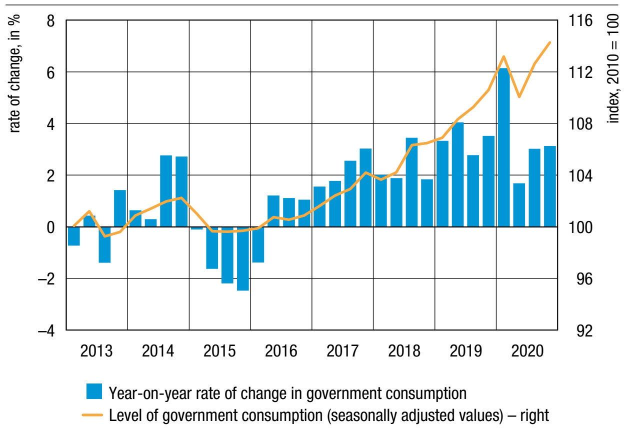
Note: Real values of compensation of employees and social benefits in cash were calculated by deflating nominal values using the personal consumption deflator.
Sources: CBS, Ipsos and CNB.

Figure 3.7 Gross fixed capital formation
real values



Source: CBS (seasonally adjusted by the CNB).

Figure 3.8 Government consumption
real values



Source: CBS (seasonally adjusted by the CNB).

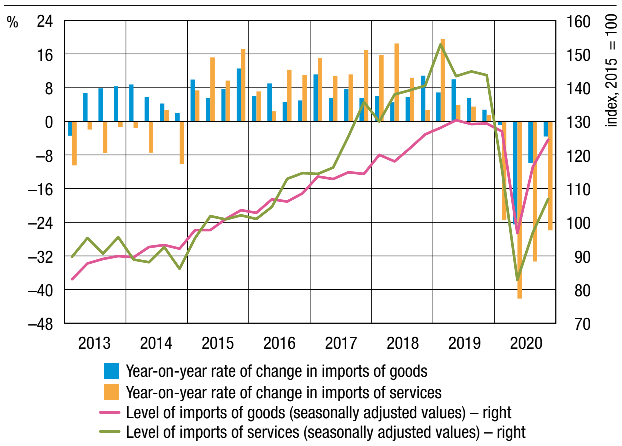
for employee compensations, which might reflect an increase in the number of working hours in the health care sector. If viewed at the level of the whole of 2020, the government consumption growth rate stood at 3.4%, and it was thus the only component of domestic demand that made a positive contribution to the overall change in real GDP.

The imports of goods and services declined by 10.9% in the period from July to December 2020 from the same period of the previous year, which was a much smaller decline than in the first six months of 2020 (16.6%). After a sharp fall in total imports in the second quarter (23.5% on a quarterly basis, 27.5% on an annual basis), imports grew in the third quarter (17.7% from the previous three months) and continued growing in the fourth quarter, albeit at a slightly slower rate (7.1% on a quarterly basis). Despite this recovery, the level of total imports in the second half of the year remained lower on an annual basis. Nominal data on the trade in goods broken down by main industrial groupings show that the annual fall in goods imports in the second half of 2020 was driven by the smaller imports of energy, while imports increased in other MIG components. At the level of 2020, total imports were down 13.8% from the previous year. The decline in total imports, although strong, was smaller than the decline in total exports, which resulted in a negative contribution of net foreign demand to the change in real economic activity in 2020.

3.2 Aggregate supply

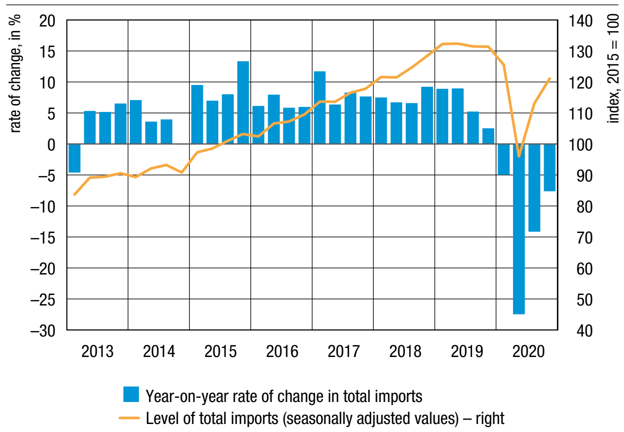
Gross value added (GVA) was down 6.7% in the second half of 2020 from the same period of the previous year (the decline in the first six months stood at 5.8%). GVA decreased in almost all

Figure 3.10 Real imports of goods and services



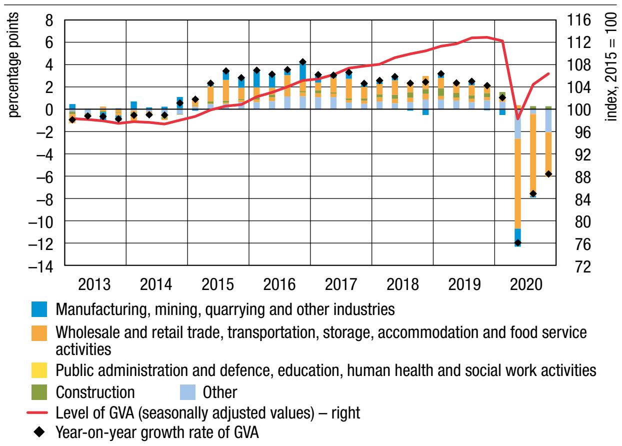
Source: CBS (seasonally adjusted by the CNB).

Figure 3.9 Imports of goods and services
real values



Source: CBS (seasonally adjusted by the CNB).

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



Source: CBS (seasonally adjusted by the CNB).

activities on an annual level, except in agriculture, forestry and fishing, construction and information and communications. As in the previous six months, the sharpest decrease in GVA was seen in wholesale and retail trade, transportation and storage, accommodation and food service activities and in other service activities. At the level of the whole of 2020, GVA decreased by 6.3%, so that the fall in GVA was less pronounced than the fall in total GDP, due to the considerable payments of fiscal support to enterprises.

4 Labour market

The number of employed persons increased in the second half of 2020. Thus, the number of unemployed persons decreased from the first half of the year, although in December 2020 there were about 25,000 more unemployed persons than in the same period of the previous year. Wages grew moderately in the second half of the year. The unit labour cost decreased markedly due to a more pronounced labour productivity growth (real GDP growth was stronger than growth in employment).

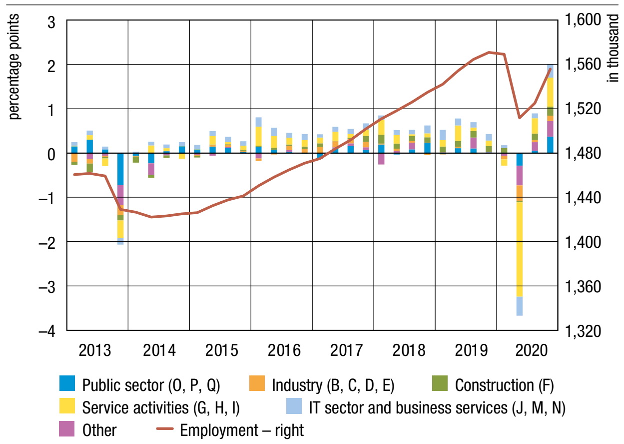
4.1 Employment and unemployment

Employment growth, which started in June 2020, continued at a similar intensity in the subsequent months, reflecting the recovery in economic activity as a result of the improved epidemiological situation and the easing of restrictive measures, as well as the later than usual beginning of the season. Despite the worsening of the epidemiological situation, employment growth intensified in October and November 2020, indicating the growing number of enterprises that managed to adapt operations to the specific circumstances between the two epidemic waves.

At the end of December 2020, the number of employed persons almost reached pre-crisis values, so that total employment was about 0.6% lower than in the same period of 2019. It is worth noting that the job preservation measures introduced in March 2020 continued in the second half of the year, but their scope was considerably smaller. Thus, in the second half of 2020, on average 6.5% of the total number of employed persons were covered by the mentioned measures (in comparison to 27.7% in the period from March to June).

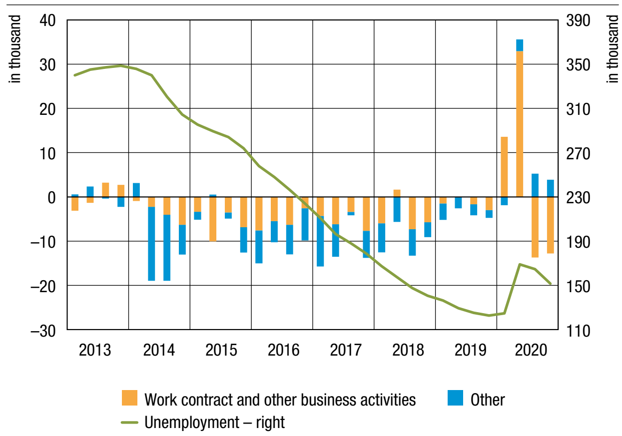
The increase in the number of employed persons in the second half of 2020 was also reflected in the decline in the number of unemployed persons. Unemployment thus declined in the third quarter as a result of an increased outflow from the CES

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



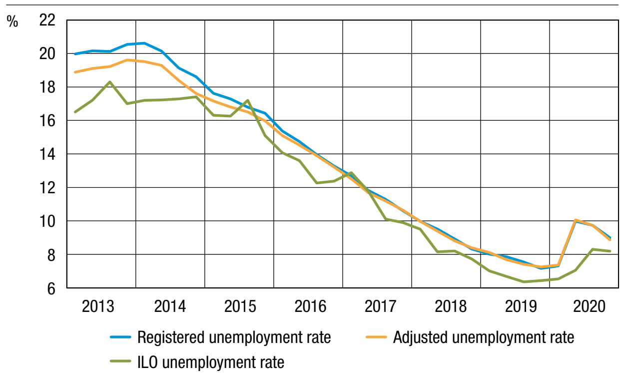
Source: CPII (seasonally adjusted by the CNB).

Figure 4.2 Total unemployment and net unemployment inflows
seasonally adjusted data



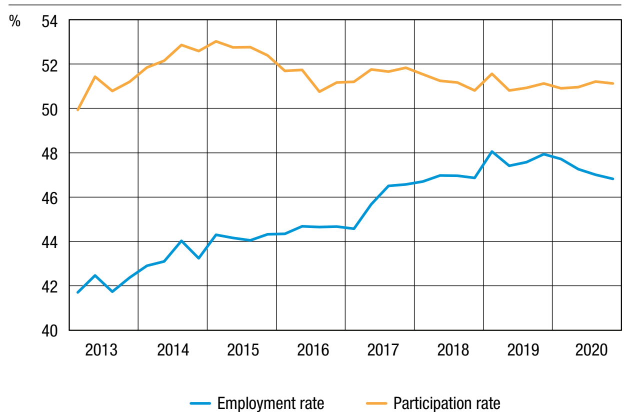
Source: CES (seasonally adjusted by the CNB).

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).

Figure 4.4 Labour Force Survey
seasonally adjusted series



Source: CBS (seasonally adjusted by the CNB).

register due to new employment, which also impacted the continuation of the fall in unemployment in the fourth quarter. Nevertheless, in December 2020, there were about 25,000 more unemployed persons than in the same period of 2019.

In line with the described developments, the registered unemployment rate (seasonally adjusted data) fell from 10% of the labour force in the second quarter of 2020 to 9.7% in the third quarter, and additionally to 9% in the fourth quarter, which was also 1.8 percentage points higher than in the same period of 2019.

The ILO unemployment rate increased in the third quarter of 2020 to 8.3% (from 7% in the second quarter), which points to a delayed reaction of the ILO unemployment figures to the decline in economic activity, possibly due to the difficult conditions and the manner in which the Labour Force Survey was conducted. In the fourth quarter, the ILO unemployment rate remained almost unchanged (8.2%).

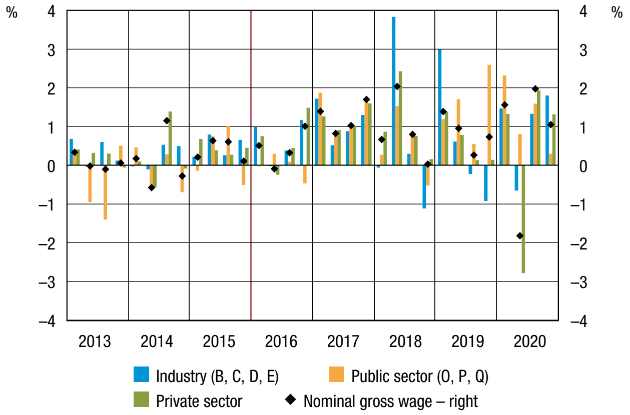
The ILO employment rate decreased in the second half of 2020, while the participation rate increased slightly (46.9% and 51.2% respectively), and similar trends were also present on an annual level.

4.2 Wages and unit labour costs

The average nominal gross wage was 2% higher in the third quarter of 2020 than in the previous three months, with a slightly more marked increase in wages in the private sector. At the end of the year, wage growth decelerated due to the slower growth in wages in the private sector, while wages in the public sector remained virtually unchanged. At the end of December 2020, the average nominal gross wage was 3.1% higher than in December 2019, with wages in the public sector rising by 5.3% and those in the private sector by 2%.

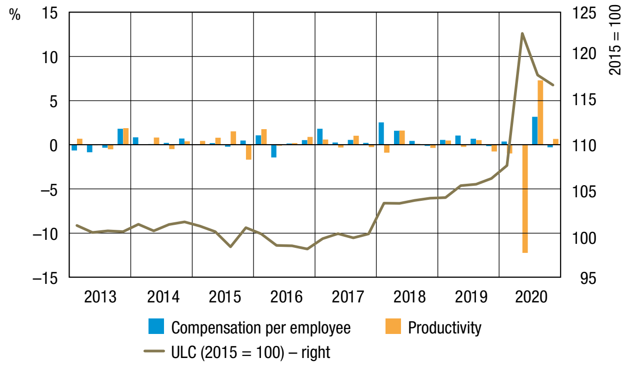
The growth of the purchasing power of wages in the second half of 2020 was only slightly smaller relative to the growth rate of the nominal net wage. If compared with the same period of 2019, the average real net wage in December 2020 was up by 4%.

Figure 4.5 Average nominal gross wage by NCA activities
seasonally adjusted data, contributions to the quarterly rate 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).

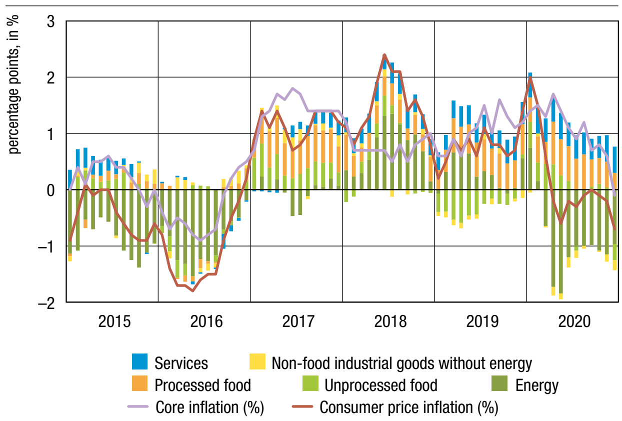
National accounts data for the third quarter of 2020 indicate a pronounced growth of productivity (stronger real GDP growth than employment growth), which, in addition to a smaller growth of paid compensation per employee, led to a decrease in unit labour costs. When interpreting the movements in unit labour costs, it is necessary to take into account that their growth in the second quarter would probably be less pronounced had there not been the payments of job preservation grants, which were included in the compensation of employees. The payments of job preservation grants were reduced strongly in the third quarter, but this was not reflected in the movement of employee compensations, so that unit labour costs, thanks to the recovery of productivity, continued to decrease. The same indicator decreased in the fourth quarter, reflecting growth in productivity and a decrease in employee compensations.

5 Inflation

Inflation mostly remained negative in the second half of 2020, largely as a result of lower energy prices than in the same period in the previous year. The increase in the annual drop in the consumer price inflation was attributed to the reduced contribution of the prices of unprocessed and processed food products. Core inflation decelerated in the second half of the year amid weaker demand. The annual rate of change in the prices of industrial products also decreased.

The average annual consumer price inflation decelerated from 0.8% in 2019 to 0.1% in 2020, mostly because of the prices of energy, that is, of the decrease in the prices of refined petroleum products.[1] This mirrors a sharp fall in the prices of crude oil on the global market, mainly as a result of the decline in demand due to the worsened global economic growth outlook. The weakening of demand due to the COVID-19 pandemic was a factor that had an effect on the easing of inflationary pressures, particularly in the segment of tourism-related services and durable consumer goods. Low inflation was also attributed to subdued inflationary pressures from the external environment, having in mind the low inflation in Croatia's major trading partners. In contrast, upward pressures on price growth came from interruptions in supply chains and the increase in unit labour costs and the costs associated with the implementation of epidemiological measures.

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



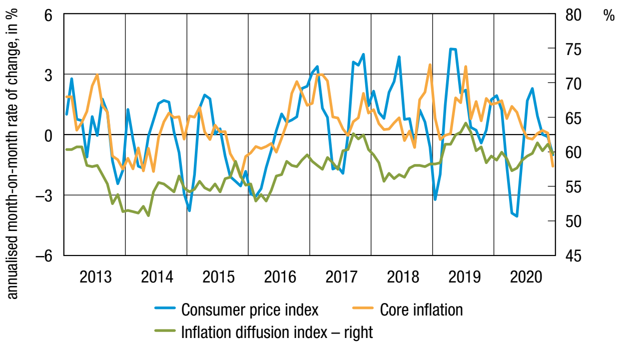
Notes: Core inflation excludes agricultural product prices, energy prices and administered prices. Processed food products include alcoholic beverages and tobacco.
Sources: CBS and CNB calculations.

After having entered negative territory in the first half of the year, inflation mostly remained negative in the second half of 2020, which was largely the effect of lower energy prices, as compared with the same period of the previous year (Figure 5.1). However, the negative contribution of energy to overall inflation decreased moderately (to –1.0 percentage point in December from –1.2 percentage points in June), which was the result of the increase in the prices of refined petroleum products, spurred by the increase in the price of crude oil on the global market in the second half of the year.

The increase in the annual fall in the consumer price inflation from –0.2% in June to –0.7% in December was attributed to the decrease in the contribution of the prices of

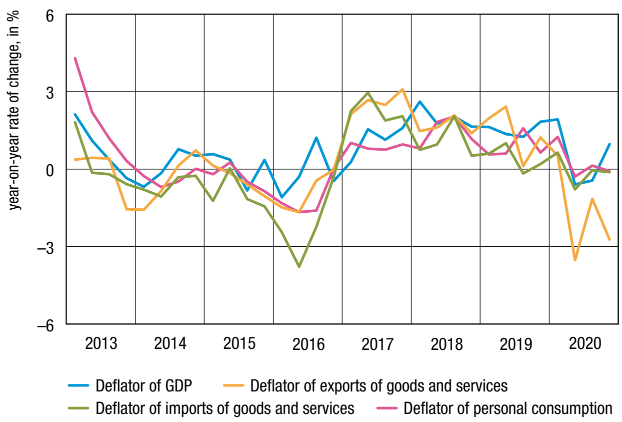
1 Due to the pandemic and the implementation of epidemiological measures that occasionally included the closure of shops, bars and restaurant, etc., in 2020, from time to time no field price collections could be made, thus hindering the statistical monitoring and analysis of consumer price movements because of the larger need for the assessment of the missing (imputed) prices. The measurement of the inflation rate was also hindered by a significant change in the structure of personal consumption.

Figure 5.2 Indicators of current inflation trends



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

Figure 5.3 Deflator of GDP and its individual components



Source: CBS.

unprocessed and processed food products. This was the result of the impact of several important factors, such as the decrease in the prices of certain food raw materials (particularly meat) on the EU market, the normalisation of the supply chain and the negative base effect as a result of the steep growth of the prices of meat in December 2019. The contribution of services to overall inflation was slightly higher from June to December, while the contribution of industrial products remained unchanged.

Core inflation, which excludes the prices of agricultural products, energy prices and administered prices, decreased from 1.1% in June to –0.1% in December. The main deceleration occurred towards the end of the year, mostly driven by the mentioned decrease in the annual rate of change in the prices of individual food products (particularly meat).

The implicit deflator of GDP increased from –0.6% in the second quarter of 2020

Table 5.1 Price indicators
year-on-year rate of change

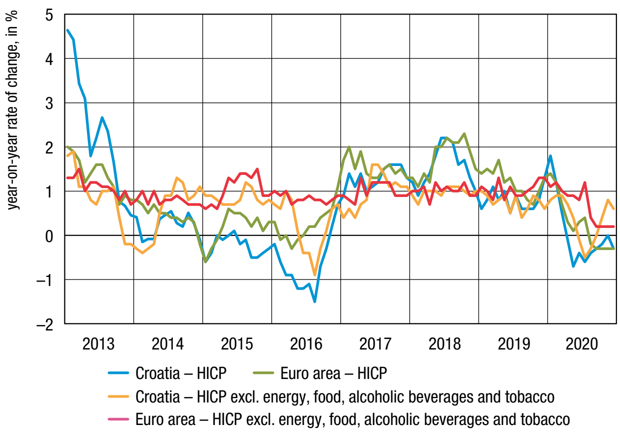
	12/19	3/20	6/20	9/20	12/20
Consumer price index and its components					
Total index	1.4	0.6	–0.2	0.0	–0.7
Energy	3.4	–3.8	–7.1	–5.8	–5.7
Unprocessed food	0.7	5.6	1.9	0.7	–3.5
Processed food	2.3	1.7	2.7	2.1	1.3
Non-food industrial goods without energy	–0.6	–0.1	–0.7	0.0	–0.7
Services	1.5	1.6	1.6	1.4	1.8
Other price indicators					
Core inflation	1.2	1.3	1.1	0.7	–0.1
Index of industrial producer prices on the domestic market	1.4	–1.2	–3.1	–3.2	–1.2
Index of industrial producer prices on the domestic market (excl. energy)	0.5	0.5	0.4	–0.4	0.1
Harmonised index of consumer prices	1.3	0.5	–0.4	–0.3	–0.3
Harmonised index of consumer prices at constant tax rates	2.1	1.0	–0.3	–0.2	–0.1

Sources: CBS and Eurostat.

to 0.9% in the fourth quarter. Trade conditions did not change significantly in the second half of the year, since the slowdown in the annual decrease in the deflator for the exports of goods and services and the deflator for the imports of goods and services were almost of the same intensity (Figure 5.3).

The annual rate of inflation in the euro area measured by the harmonised index of consumer prices was –0.3% in December 2020, or 0.6 percentage points lower than in June 2020 (Figure 5.4). In addition to the decrease in the annual growth of food prices, the slowdown in inflation was also due in part to the decrease in indirect taxes in some countries (particularly the temporary decrease in the VAT rate in Germany in the second half of 2020) and the appreciation of the euro against the basket of currencies. The largest negative contribution to overall inflation in the euro area in December came from energy (–0.7 percentage points). In the conditions of weakened demand in the second half of the year, core inflation (excluding the prices of energy, food, alcoholic beverages and tobacco) also slowed down in the euro area, standing at 0.2% in December, or 1 percentage point lower than in July. This was mostly the result of the deceleration in the annual growth of the prices of tourism-related services (international air transport and package holidays) and communication services. In addition, the annual rate of change in the prices of industrial products (excluding energy) also decreased.

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



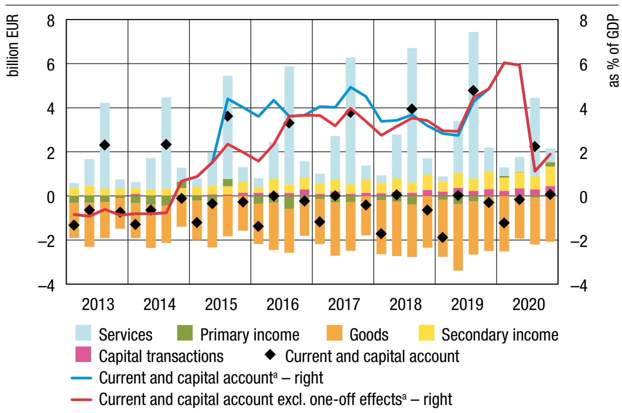
Source: Eurostat.

The decline in Croatia's annual inflation rate measured by the HICP decreased from –0.4% in June to –0.3% in December 2020. The increase in the contribution of the prices of energy and services to overall inflation was almost completely offset by the decrease in the contribution of food products to inflation movements. In December, Croatia's overall inflation was thus equal to that in the euro area. Croatia's core inflation rate measured by the HICP (excluding the prices of energy, food, alcoholic beverages and tobacco) accelerated from 0.7 percentage points to 0.6% in December, exceeding the euro area inflation rate by 0.4 percentage points.

6 Current and capital account

The surplus in the current and capital account was much lower in the second half of 2020, mainly due to the decrease in tourism revenues. Unfavourable trends were partly offset by the fall in the foreign trade deficit in goods due to the more moderate decline in exports than in imports, the improvement in the balance in the primary income account caused by a lower profitability of banks and enterprises in foreign ownership and the increase in the total surplus in the secondary income and capital transactions accounts because of the stronger absorption of EU funds. The indicators of price and cost competitiveness of Croatian exports worsened in the second half of 2020. Throughout 2020, the surplus of utilised EU funds over the payments to the EU stood at 4.2% of GDP, a noticeable improvement from 2.6% of GDP in 2019.

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.

Tourist activity suffered a severe blow from the COVID-19 pandemic, the related concern about infection and the accompanying epidemiological measures imposed to curb the spreading of the contagion. Despite the relatively favourable epidemiological situation during the summer months, tourism revenues halved in the second half of 2020 from the same period of the previous year, thus contributing to a marked decrease in the current and capital account surplus. Unfavourable developments were partly alleviated by the fall in the foreign trade deficit in goods due to the more moderate fall in exports than in imports, the improvement in the balance in the primary income account caused by the lower profitability of banks and enterprises in foreign ownership and the increase in total surplus in the secondary income and capital transactions accounts as a result of a more intensive use of EU funds. On the 2020 level, the surplus in the current and capital account was 1.9% of GDP, as against 4.9% of GDP in the whole of 2019 (Figure 6.1).

6.1 Foreign trade and competitiveness

According to the balance of payments data, after goods exports shrank by 8.0%, goods imports by 14.0% and goods trade deficit by 20.7% in the first half of 2020 from the same period of the previous year, the contraction of foreign goods trade was mitigated in the second half of the year on an annual basis. Thus, goods exports declined by 3.0% and goods imports by 7.4%, while the deficit fell by 13.4% in the second half of

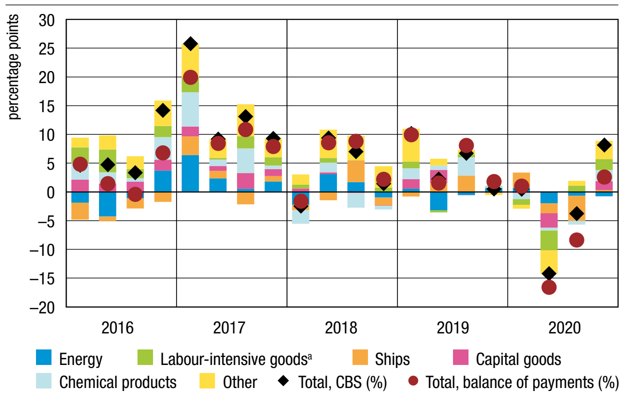
2020. If viewed at the level of the whole year, the goods trade deficit stood at 17.5% of GDP, which was an improvement of 1.7 percentage points from 2019.

In contrast to the balance of payments data, CBS data[2] show that goods exports grew slightly (by 1.7%) in the second half of 2020, mostly due to the exports of food products, in particular of cereals and other cereal products to Italy, medical and pharmaceutical products to the USA, France and Belgium, as well as the exports of certain capital goods, primarily electrical machinery, apparatus and appliances to Germany and Sweden (Figure 6.2). The exports of various finished goods also increased. By contrast, the exports of other transport equipment (mostly ships) to Malta and the Marshall Islands decreased, followed by the exports of road vehicles to Germany, France and Belgium, as well as energy products, more specifically of oil and refined petroleum products, to Bosnia and Herzegovina, Italy and Greece.

The fall in total goods imports (which, according to CBS data, was 5.5% from the same period of the previous year) was mostly due to the smaller imports of energy products (Figure 6.3), particularly oil and refined petroleum products from Azerbaijan, Iraq and Italy, and, to a lesser extent, electricity from Hungary. A decrease was also observed in the imports of road vehicles from Germany and Slovenia and food products, mostly meat and meat preparations, from Spain and Poland. In contrast, the imports of medical and pharmaceutical products from Belgium increased, followed by other transport equipment and some sorts of capital goods, mostly power generating machinery and equipment and electrical machinery, apparatus and appliances from China.

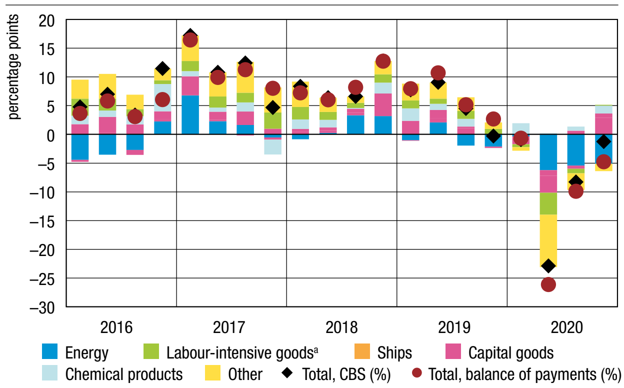
Despite a relatively favourable epidemiological situation in July and most of August net exports of services (in particular travel services) dropped sharply in the second half of 2020. Revenues from foreign tourist consumption were thus 50.1% smaller than in the

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



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

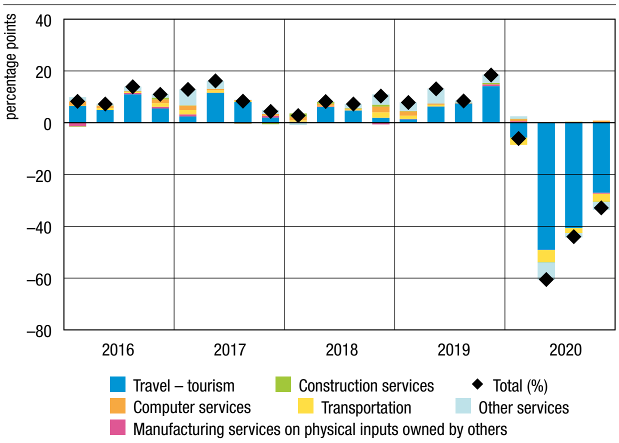
Figure 6.3 Goods imports (c.i.f.)
year-on-year rate of change and contributions



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

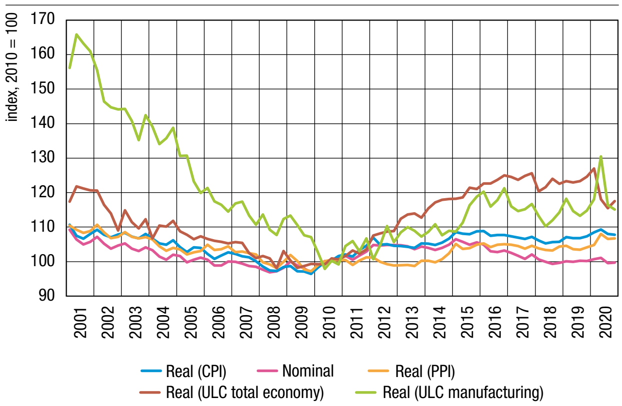
2 For more information on the differences in the scope of the trade in goods according to the balance of payments and CBS data, see Box 3 Foreign trade developments according to the balance of payments data, Macroeconomic Developments and Outlook No. 2, July 2017.

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



Source: CNB.

Figure 6.5 Nominal and real effective exchange rates of the kuna



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

same period of the previous year (Figure 6.4). The described fall in revenues reflects a decline in volume indicators, or the number of arrivals and nights stayed by foreign guests, with arrivals down by 61.7% and nights stayed by 50.9% according to the CBS data. If the cumulative values are observed, the surplus in the international trade in services decreased from 19.0% of GDP in 2019 to 10.6% in 2020.

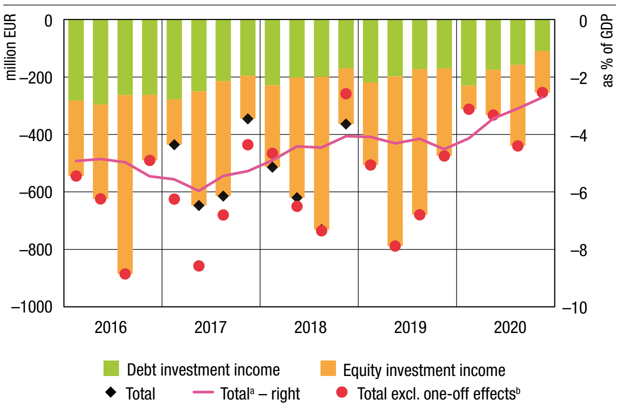
The indicators of the price and cost competitiveness of Croatian exports deteriorated in the second half of 2020, offsetting the partial improvement from the first half of the year (Figure 6.5). The appreciation of the real effective exchange rates deflated by consumer and producer prices and unit labour costs in the total economy was the consequence of the strengthening of the nominal effective exchange rate of the kuna. By contrast, the real effective exchange rate deflated by unit labour costs in manufacturing appreciated, to a smaller extent as a result of the strengthening of the nominal effective exchange rate of the kuna and to a larger extent of the rapid growth of unit labour costs in manufacturing in Croatia in comparison with the countries in the basket for the calculation of the effective exchange rate of the kuna.

6.2 Income and transactions with the EU

In the second half of 2020, the balance in the primary income account improved noticeably relative to the same period of the previous year. This was mostly due to much smaller expenditures on direct equity investment (Figure 6.6) as a result of lower profitability of banks and enterprises (in particular from accommodation and real estate activities) in foreign ownership. The improvement in the balance, to a much smaller extent, was also driven by the continued tendency of declining interest expenditures on foreign debt liabilities of domestic sectors.

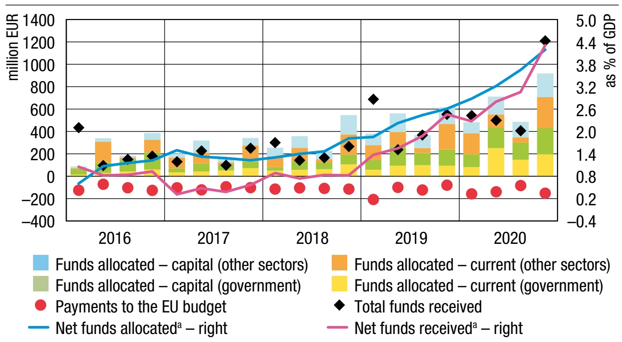
Net income from transactions with the EU budget rose noticeably in the second half of 2020 from the same period of the previous year (Figure 6.7). As regards the structure of the increase in the use of EU funds, an equal share related to capital and current purposes, while more funds were allocated to the government than to other domestic

Figure 6.6 Investment income



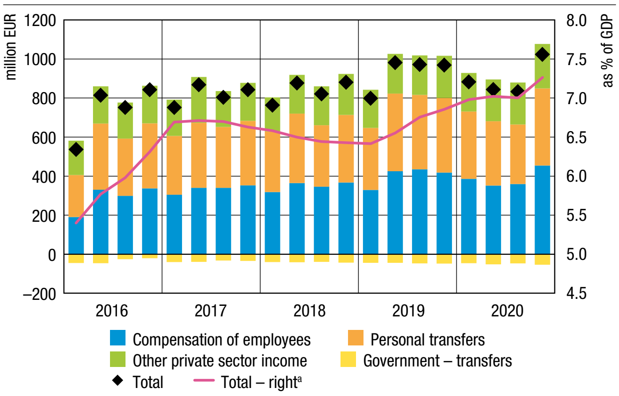
[a] Sum of the last four quarters, excluding one-off effects. [b] One-off effects include bank provisions for loans to the Agrokor Group in 2017 and 2018.
Source: CNB.

Figure 6.7 Transactions with the EU budget



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

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



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

sectors. Throughout 2020, the surplus of EU funds utilised over the payments to the EU budget stood at 4.2% of GDP, representing a noticeable improvement from 2.6% of GDP in 2019. After the fall in the first half of the year, the net inflow from other income, which includes compensation of persons temporarily employed abroad, personal transfers and transfers of the government and other private sector income, was also slightly smaller in the second half of 2020 than in the same period of the preceding year (Figure 6.8).

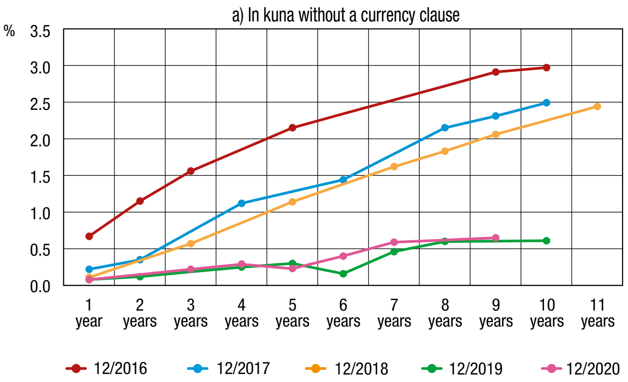
7 Private sector financing

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 maintenance of the favourable financing conditions of the private sector. In the second half of the year, banks relaxed the previously tightened credit standards for household consumer loans and other loans and, to a lesser extent, for housing loans. At the same time, credit standards for corporate loans were tightened in the second half of the year, in consequence of unfavourable outlook and expectations as well as collateral risk.

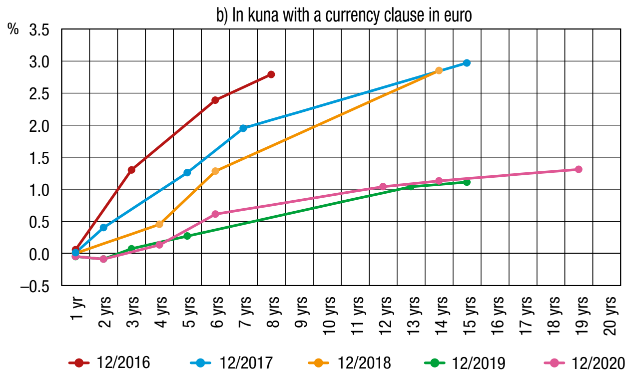
The growth of private sector borrowing slowed down in the second half of 2020. In that period, bank interest rates on pure new loans to domestic sectors mostly remained at historical lows, similar to those before the pandemic outbreak. Interest rates on renegotiated corporate loans were slightly higher than before the outbreak of the pandemic due to moratoria. These loans were granted at higher interest rates than those on pure new loans. In the course of the second half of the year, banks relaxed credit standards for household loans after the strong tightening in the first half of the year, while continuing to tighten credit standards for corporate loans.

Having increased slightly in the first half of 2020, government borrowing costs, one of the determinants of the costs of borrowing of other domestic sectors, went down to or were even somewhat below the level seen at the end of 2019. The interest rate on one-year kuna T-bills in the domestic market remained at 0.06% in December 2020 (Figure 7.2), holding steady from October 2019, while the interest rate on euro T-bills of the same maturity issued in the domestic market in October 2020 went down to –0.05%. The costs of long-term government financing were also more favourable in December than in the first half of the year (Figure 7.1). The government issued several long-term

Figure 7.1 Yield-to-maturity on RC bonds



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



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

bonds in the first half of the year in order to refinance liabilities and finance measures aimed at assisting the economy following the outbreak of the pandemic. Financing costs remained favourable, with a yield at issue ranging between 0.37% for the five-year kuna bond and 1.28% for the kuna bond with a currency clause in euro and 20 year maturity, the longest maturity for a bond issue so far. The government did not issue any bonds in the second half of 2020.

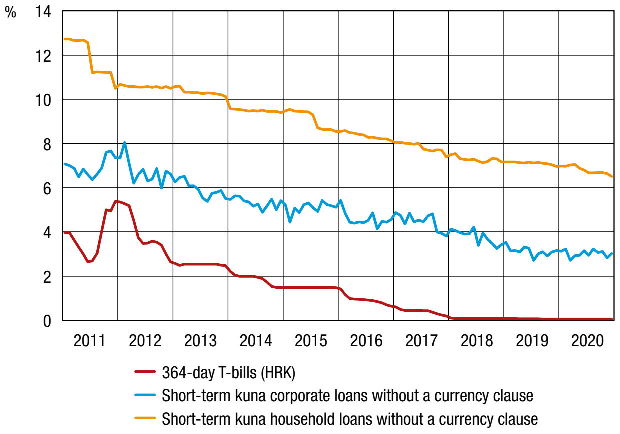
The decrease in financing costs following the initial shock triggered by the pandemic also reflected the cost of government borrowing on the foreign market, estimated by the sum of the EMBI index for Croatia and the yield on the German government bond. After reaching 2.1% at the end of March, financing costs declined steadily due mainly to the downward trend in the EMBI index for Croatia, and stood at 0.5% in December (Figure 7.3). Croatia's credit default swap (CDS) went up to 91 basis points in March, stabilised at 71 basis points in the period up to the end of September and then grew slightly to 75 basis points at the end of December. Credit rating agencies, Standard & Poor's and Fitch, maintained Croatia's BBB– investment rating with a stable outlook, while Moody's upgraded its rating from Ba2 with a positive outlook to Ba1 with a stable outlook in mid-November, one notch below investment grade.

As regards the corporate sector, the average interest rate on short-term corporate borrowing from banks in kuna without a currency clause did not change substantially in the second half of 2020 from the last quarter of 2019 (Figure 7.2). However, the average interest rate on long-term loans with a currency clause was 0.3 percentage points higher in the reference period (Figure 7.3). Such developments were mainly the result of the larger amount of renegotiated loans granted at interest rates higher than those on pure new loans. This effect was the strongest in the second quarter when the moratoria were mainly granted; however, the share of renegotiated loans in total loans remained relatively high in the following months as well. By contrast, interest rates on long-term pure new loans granted to corporates with a currency clause decreased slightly in that period. The analysis of the average costs of financing and the amount of loans shows that the average interest rate on loans above HRK 7.5m grew by 0.2 percentage points in the July-December period relative to the fourth quarter of 2019, while the interest rate on loans of up to HRK 7.5m remained almost unchanged (Figure 7.4).

The average interest rate on short-term kuna household loans without a currency clause continued to trend downward and was 0.4 percentage points lower in the second half of 2020 than in the last quarter of 2019 (Figure 7.2). The average interest rate on long-term housing loans with a currency clause was 0.1 percentage point higher in the reference period, partly as a result of the lower level of interest rates in the last quarter of 2019 due to the implementation of the housing loans subsidy programme. Concurrently, the interest rate on long-term household loans with a currency clause, excluding housing loans, remained almost unchanged (Figure 7.3).

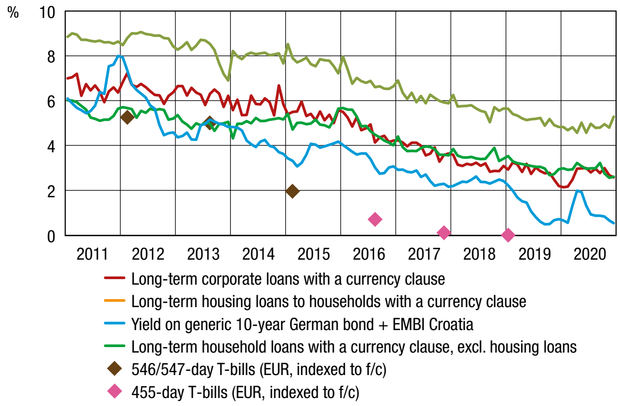
Further decrease in the funding costs of the Croatian banking system in conditions of the exceptionally expansionary monetary policy and historically high surplus liquidity contributed to the maintenance of the favourable financing conditions of the private sector. Despite the increase in the first half of 2020, EURIBOR fell and reached

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

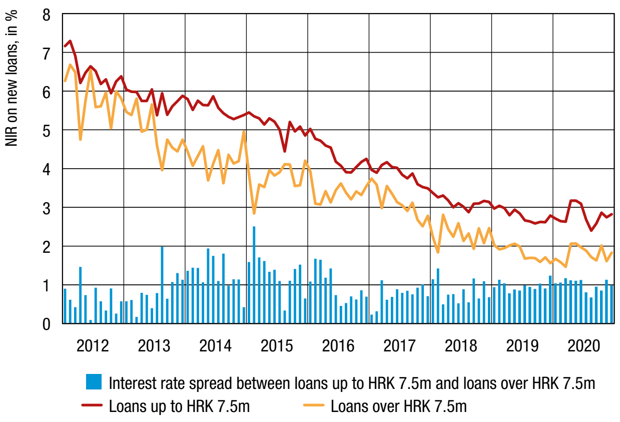


Note: EMBI, or the Emerging Market Bond Index, shows the spread between yields on government securities of emerging market economies, Croatia included, and risk-free securities issued by developed countries.
Sources: MoF, Bloomberg and CNB.

its historical low in December (Figure 2.6), while the national reference rate (NRR)[3] continued to decline moderately also in the fourth quarter (Figure 7.5).

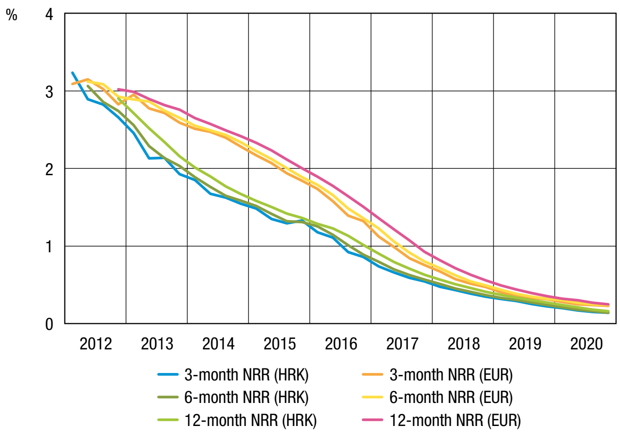
According to the bank lending survey, credit standards for corporate loans continued to tighten in the fourth quarter (Figure 7.6), although slightly less pronouncedly than in the previous part of the year. The tightening in standards in the second half of the year was mainly affected by the worsened outlook of industry or individual corporations, negative expectations related to overall economic trends and collateral risk. The decline in demand for loans also continued for the third consecutive quarter, mostly as a result of the fall in investments, but it was mitigated by the need of

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



Source: CNB.

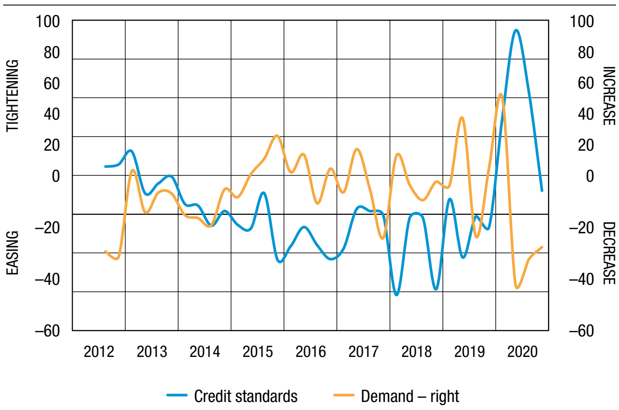
Figure 7.5 National reference rate (NRR)



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

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

Figure 7.6 Credit standards and corporate demand for loans



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

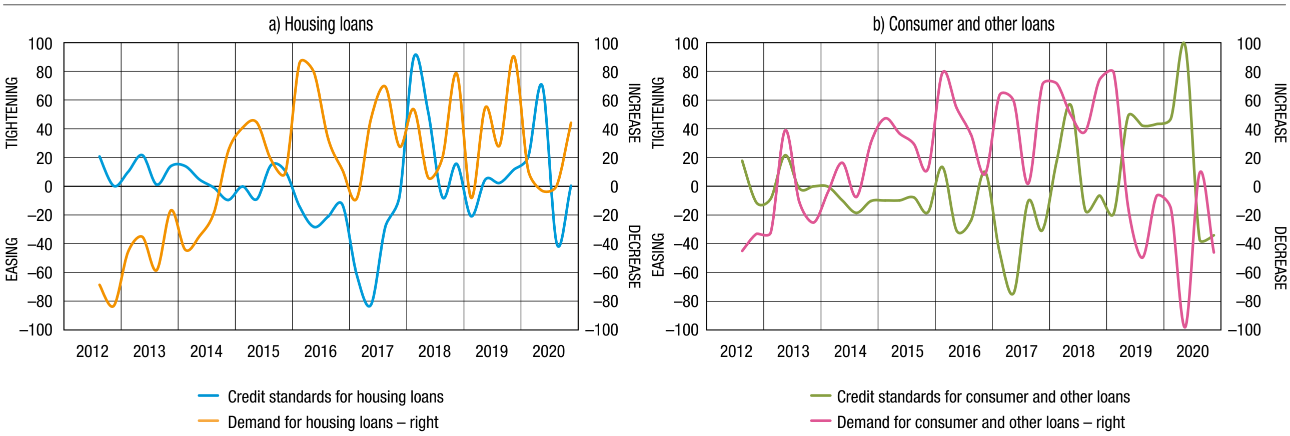
corporations for debt restructuring and financing of working capital. Against this background, an increase was registered in demand for short-term loans.

Following a substantial tightening in the first half of 2020, in the second half of the year, banks eased credit standards for consumer and other household loans, and to a smaller extent for housing loans (Figure 7.7). Such developments were due in housing loans to better real estate market prospects and in consumer and other loans to competition among banks. After a slight increase in the third quarter, the demand for consumer and other loans declined in the last quarter under the effect of the worsening in consumer confidence. In contrast, the demand for housing loans increased.

Total corporate debt increased in 2020. This was mostly due to the developments in the first quarter when domestic lending accompanied by external borrowing increased noticeably. In the subsequent quarters, total corporate debt declined, largely on account of external deleveraging; however, it did not manage to offset the increase in the first three months (Figure 7.8). Thus, total corporate debt was up by 0.8% (transaction-based) in 2020 from the preceding year.

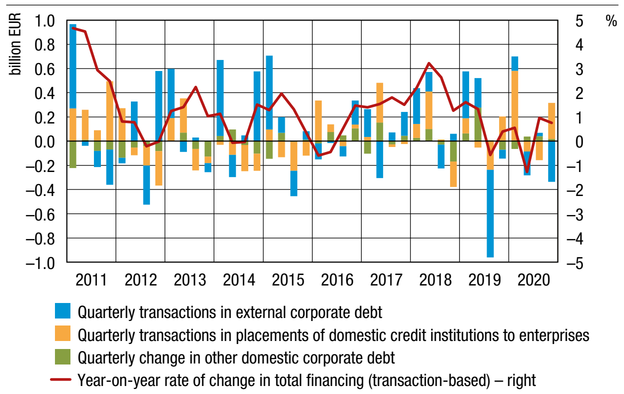
As regards bank financing of non-financial corporations after March, corporate domestic placements of credit institutions fell in the remaining part of the year, not counting a strong increase in December, which was the result of just a single transaction. The mentioned transaction, accounting for almost a half of total corporate placement transactions in the whole of 2020, was reflected in the annual growth rate, which at the end of December 2020 reached 5.6% (transaction-based) (Figure 7.9). The

Figure 7.7 Standards for granting loans and household demand for loans



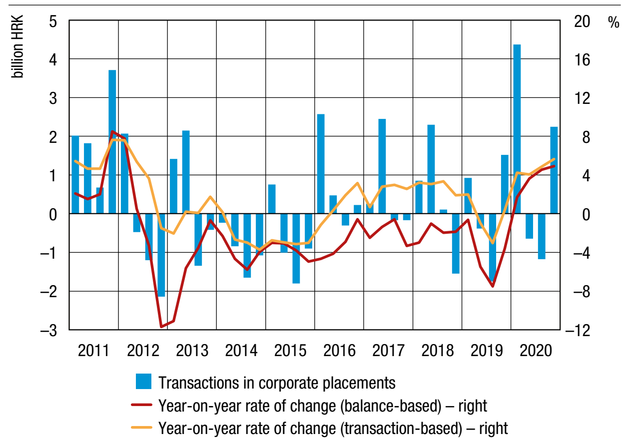
Note: Data show the net percentage of banks weighted by the share in total household loans.
Source: CNB.

Figure 7.8 Corporate financing



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

Figure 7.9 Corporate domestic placements of credit institutions

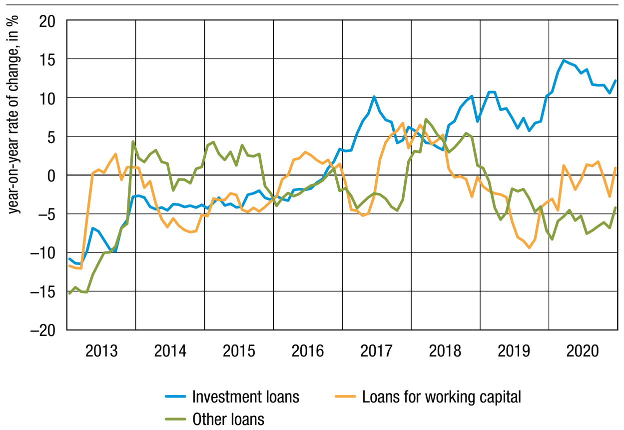


Source: CNB.

disappearance of the negative effect of the decrease in claims on the Agrokor Group and the activation of government guarantees to shipyards, which had lowered the growth rates of placements in 2018 and 2019, also contributed to the increase in the annual growth rate of corporate placements. Investment loans were up by 12.2% in December from the same month of the previous year (Figure 7.10), and loans for working capital grew modestly (0.9%), while other loans dropped on an annual basis. Observing the growth of placements by the size of enterprises, after strong growth in the first half of 2020, large enterprises, mostly deleveraging since July, contributed to a substantial slowdown in the annual growth rate of their placements, which was 6.0% in December (Figure 7.11). The annual growth of placements to micro, small and medium-sized enterprises also slowed down, hovering around 3% in July to December period.

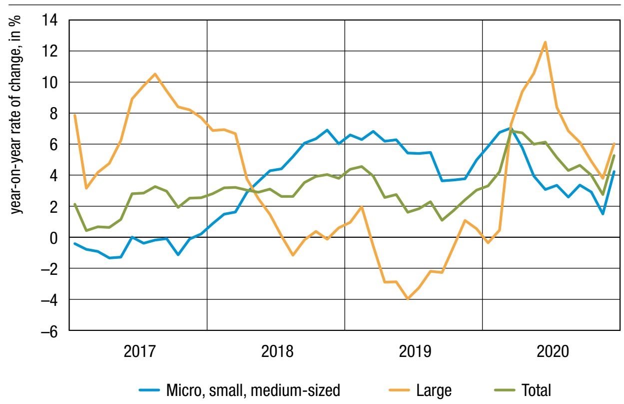
The analysis of corporate loans by activities shows that construction activity (which was the consequence of the large transaction in December) and the activities of accommodation and food service accounted for the bulk of the growth in placements

Figure 7.10 Growth in corporate loans by purpose
transaction-based



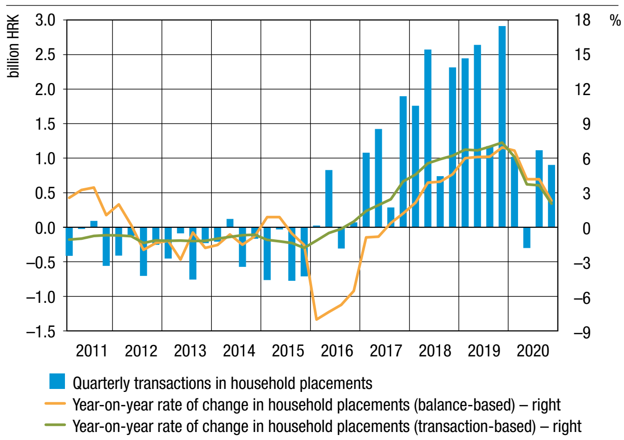
Source: CNB.

Figure 7.11 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 7.13 Household placements



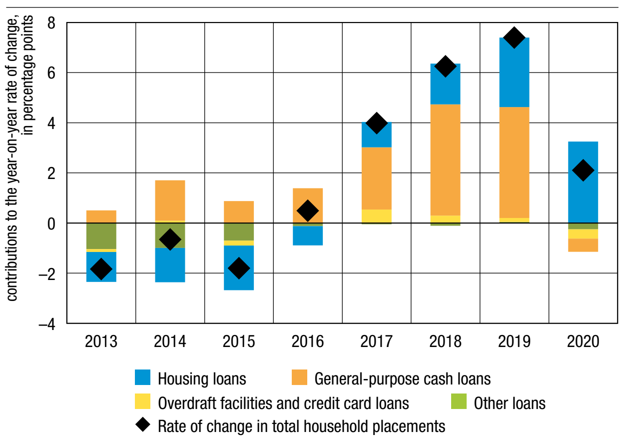
Source: CNB.

in 2020, the trend observed in the latter activities in most previous years[4] (Figure 7.12). In contrast, a mild decrease was recorded in agriculture and trade.

In contrast to the fall reported in the second quarter, during the July to December period there was a rise of HRK 2.0bn in placements to households. However, the annual growth of placements continued to decelerate moderately and at the end of the year stood at 2.1% (transaction-based), not even a third of the increase in 2019 (Figure 7.13). The smaller growth resulted from the 1.3% decline in general-purpose cash loans at the yearly level, as against the 11.5% rise at the end of the previous year. In contrast, the annual growth of housing loans accelerated from 6.4% in 2019 to 7.5% in 2020, spurred also by the implementation of the housing loans subsidy programme. In line with this, housing loans were the main source of growth in household placements in 2020 (Figure 7.14), while general-purpose cash loans, after a substantial positive contribution in the previous years, went down in 2020.

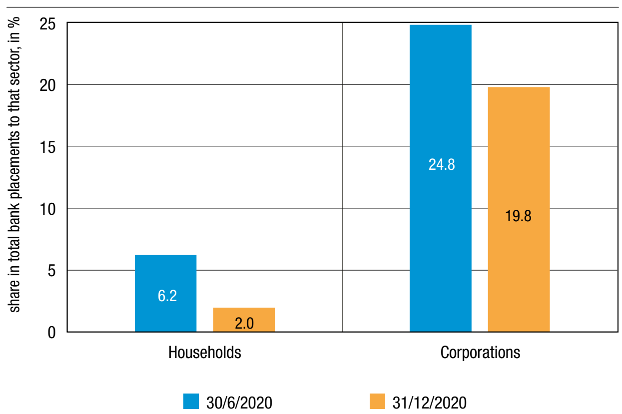
With respect to the measures for the deferral of payments and the restructuring of existing credit liabilities directed at households and corporations affected by the crisis, the amount of placements covered by measures was substantially higher in the corporate

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



Source: CNB.

Figure 7.15 Loans under payment deferral or restructuring measures



Source: CNB.

4 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 in 2019.

sector than in the sector of households. At the end of 2020, out of total bank placements to corporations, 19.8% was encompassed by the measures, slightly less than in June (Figure 7.15). However, in the household sector this share decreased by one third in the same period, reaching 2.0% at the end of the year.

8 Foreign capital flows

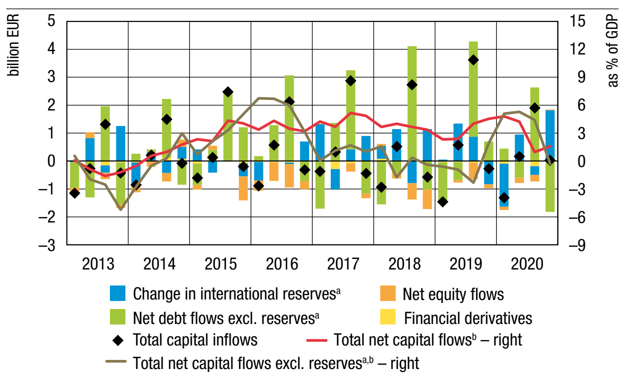
A net capital outflow and a modest net inflow of equity investments were recorded in the second half of 2020. Government net liabilities decreased and the net debt position of banks deteriorated perceptibly. Reserves increased and gross external debt decreased in absolute terms, although the relative indicator of gross external debt worsened. The relative indicator of net external debt improved despite the unfavourable impact of the decline in nominal GDP. The net international investment position also improved in absolute terms.

The financial account of the balance of payments recorded a net capital outflow of EUR 1.9bn in the second half of 2020, which was primarily the result of the increase in international reserves (Figure 8.1). If the change in gross international reserves and liabilities of the CNB is excluded, the second six months of 2020 saw a net capital outflow of EUR 0.4bn, having fallen by EUR 2.9bn from the same period of the previous year. The net capital outflow was the result of a fall in net debt liabilities of other domestic sectors and the government, while net equity liabilities rose slightly.

The second half of 2020 saw a modest net inflow from equity investments of EUR 0.2bn, considerably less than that in the same period of the previous year, resulting from reinvested earnings on the liabilities side being more than twice as small, which was largely due to less favourable results in banking, accommodation activity, the oil industry and real estate activities. At the same time, new direct equity investments increased moderately from the same period of the previous year, and mostly took place in the real estate and computer programming sectors (Figure 8.2). By contrast, asset growth was mostly triggered by investments of domestic institutional investors in foreign shares and equity holdings.

If the change in international reserves and liabilities of the CNB is excluded, there was a net outflow of debt capital of EUR 0.8bn in the second half of 2020. This was mostly due to the improvement in the net debt position of other domestic sectors (including their net liabilities to affiliated creditors). In addition, government net liabilities decreased. In July, the government repaid USD 1.25bn worth of bonds issued in 2010, by which its net debt position improved noticeably despite the long-term borrowing within the framework of the European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) in the last quarter of 2020. In order to repay a maturing bond, in the first

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



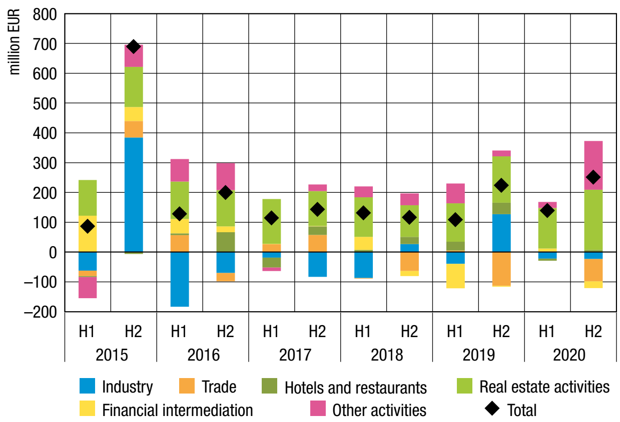
[a] Changes in gross international reserves net of CNB foreign liabilities.
[b] Sum of the previous four quarters.
Notes: Net flows mean the difference between changes in assets and liabilities. Equity flows comprise changes in foreign direct equity investments, reinvested earnings and portfolio equity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

half of the year (in June), the government issued new bonds worth EUR 2.0bn in the international market, which in addition to covering the July repayment of the maturing bond were also earmarked to finance the anti-crisis measures aimed at mitigating the negative impacts of the pandemic. In contrast, the net debt position of banks worsened noticeably (Figure 8.3), reflecting a strong decline in their foreign assets in the last quarter of 2020.

The CNB was forced to intervene in the foreign exchange market amid great uncertainty after the outbreak of the pandemic in the first half of the year by selling record amounts of foreign currency; however, a strong increase in reserves in the second half of the year more than offset the decrease in the first six months and their level was higher at the end of 2020 than at the end of 2019. The increase in reserves in the second half of the year was mostly the result of the purchase of foreign exchange from the government due to the larger inflow of EU funds and long-term government borrowing within the SURE programme.

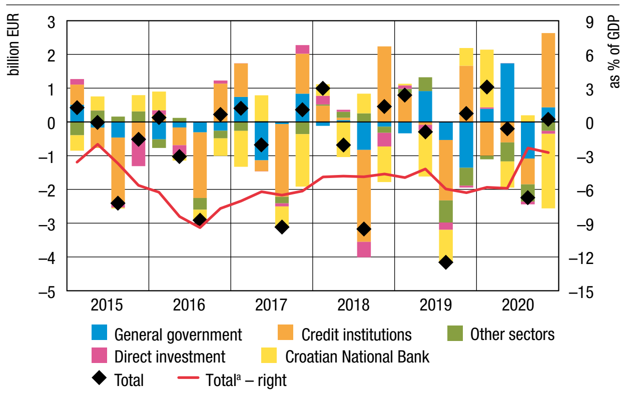
The deleveraging of domestic sectors coupled with favourable effects of cross-currency changes and other statistical adjustments in the second half of 2020 contributed to the fall in gross external debt in absolute amount. However, as a result of the sharp economic contraction and the consequent smaller nominal GDP, the relative indicator of gross external debt deteriorated, standing at 82.4% of GDP at the end of 2020, an increase of 2.7 percentage points from the end of June (Figure 8.4). As foreign assets grew perceptibly in the same period, the relative indicator of net external debt improved notwithstanding the unfavourable impact of the fall in nominal GDP. Net external debt

Figure 8.2 Foreign direct equity investment in Croatia by activities



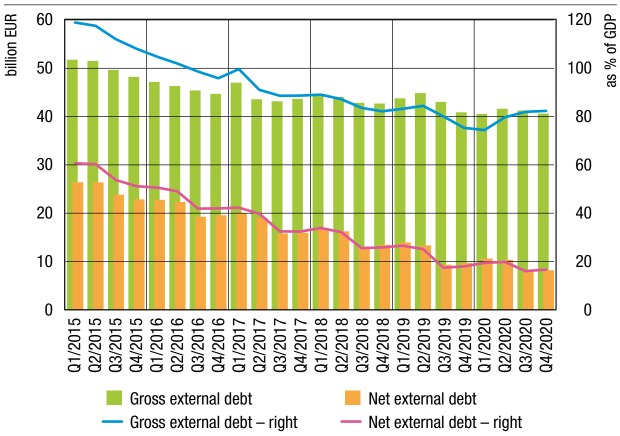
Note: Equity investment net of debt-to-equity transactions and round-tripping investments.
Source: CNB.

Figure 8.3 Net external debt transactions by sectors



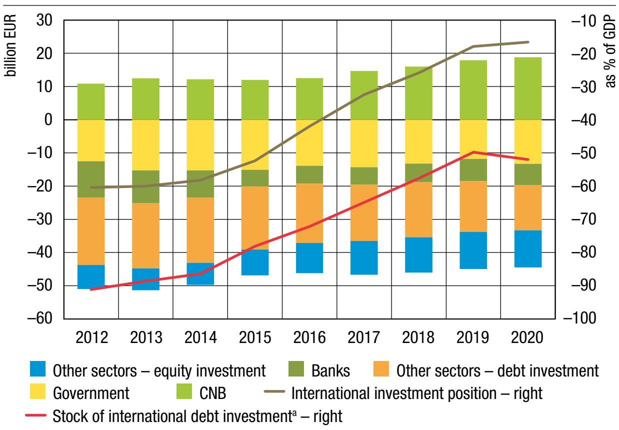
[a] Sum of the previous four quarters.
Notes: Transactions refer to the change in debt excl. cross-currency changes and other adjustments. Net external debt is calculated as the gross external debt stock net of foreign debt claims.
Source: CNB.

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.

stood at EUR 8.2bn or 16.6% of GDP at the end of 2020, down by 3.2 percentage points from the end of June.

The net international investment position also improved in absolute terms (Figure 8.5) since the effect of the decrease in domestic sectors' net liabilities was bigger than the increase in net liabilities from equity investments. However, due to the fall in nominal GDP, the relative indicator of the international investment position deteriorated at the end of 2020 and was –52.0% of GDP from –50.8% of GDP at the end of June (Figure 8.5).

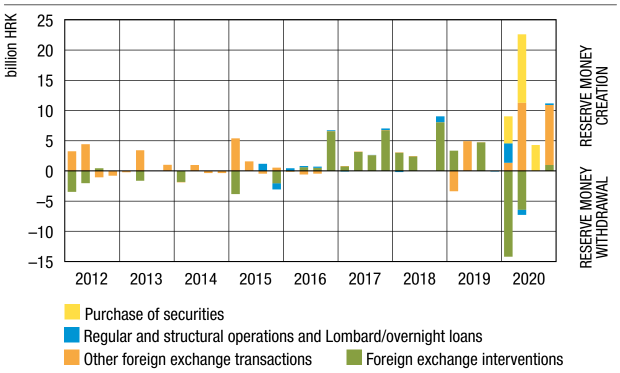
9 Monetary policy

The CNB promptly stabilised the conditions on domestic financial markets in early 2020, so that in the second half of the year no additional monetary policy measures were required, apart from the purchase of foreign currency from the banks by which slightly stronger appreciation pressures were mitigated. There was no need for additional purchases of government bonds. A moderate increase in international reserves and the growth of monetary aggregates continued.

In the second half of 2020, the CNB continued to pursue its highly expansionary monetary policy. In response to the unfavourable economic and financial circumstances caused by the outbreak of the pandemic, in the first half of the year the CNB adopted a series of monetary policy measures to maintain the stability of the kuna/euro exchange rate, ensure sufficient kuna and foreign exchange liquidity and support the stability of the government securities market. Once the financial conditions on domestic financial markets had stabilised, no further monetary policy measures were needed in the second half of the year, apart from the purchase of foreign exchange from banks and the government by which the CNB mitigated slightly stronger appreciation pressures at the end of the year. The liquidity surplus continued to grow, due also to autonomous factors.

To preserve exchange rate stability amid growing uncertainty regarding the effects of the pandemic, the CNB intervened strongly on the foreign exchange market, selling to banks a total of EUR 2.7bn. 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 and there were no foreign currency purchases from or sales to banks on the market until end-November. In response to appreciation pressures on the exchange rate by the end of the year, the central bank intervened in December by purchasing EUR 130m from banks. On an annual level, the CNB sold to the banks in all a net of EUR 2.6bn. In addition to the foreign exchange interventions of the CNB, the foreign exchange market was also calmed by the agreement between the CNB and the ECB on establishing a currency swap line, allowing for the exchange of the kuna for the euro in the amount of EUR 2bn. As regards other foreign exchange transactions, in the course of 2020, the CNB purchased a net of EUR 3.0bn from the Ministry of Finance, creating HRK 22.6bn. Most of this amount was recorded in June and December, when the CNB purchased EUR 1.5bn and EUR 1.3bn respectively. When total foreign exchange transactions in 2020 are observed, the CNB purchased a

Figure 9.1 Flows of reserve money (M0) creation



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

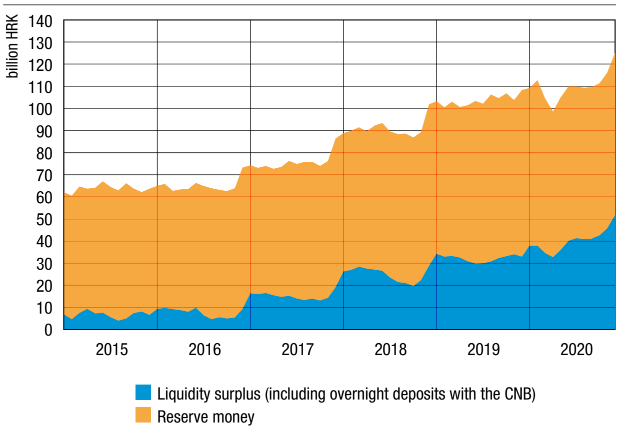
net of EUR 0.4bn, creating HRK 2.9bn in reserve money (Figure 9.1).

Reserve money creation in 2020 was also supported by the CNB's securities purchases, the first of which took place in March and was aimed at creating additional liquidity to normalise the functioning of that segment of the financial market and the maintenance of favourable financing conditions for all sectors. At five auctions held from March to June, the CNB purchased bonds with a total market value of HRK 20.3bn (Figure 9.1). There was no need for further purchases of government bonds in the second half of the year.

As for other monetary policy measures, in 2020 the CNB placed long-term kuna funds to banks via structural operations. The first auction, worth HRK 3.8bn, was conducted in March and the second auction, worth HRK 0.5bn, was held in November, both for a five-year term at an interest rate of 0.25%. A portion of the funds was used by banks for the partial early repayment of existing structural loans, so that their balances were HRK 2.6bn larger at the end than at the beginning of the year. In addition to long-term funds, the CNB also placed to banks short-term kuna funds via regular weekly operations at a fixed interest rate that was cut from 0.3% to 0.05%. The banks' demand peaked in April, when the average amount of funds placed reached HRK 1.1bn. However, amid very high levels of kuna liquidity surplus, banks have shown no interest in funds available through this monetary policy instrument since mid-May 2020. In addition, the reserve requirement rate was kept at 9% throughout the second half of 2020, after the CNB reduced it from 12% to 9% in March, releasing to banks HRK 6.34bn of the funds previously allocated to a special statutory reserve account held with the CNB.

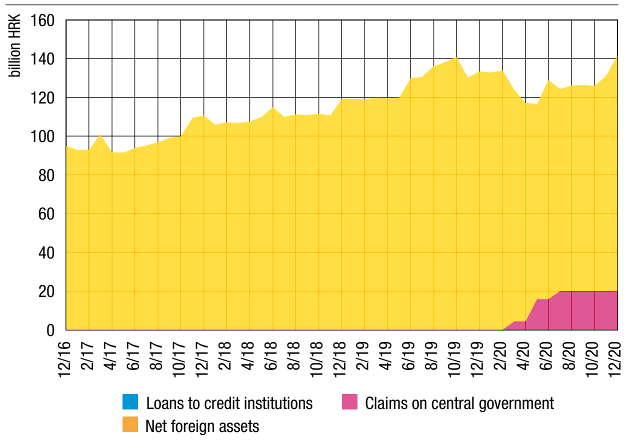
By purchasing government bonds, holding structural and regular open market operations and cutting the reserve requirement rate, the CNB supplied banks with a total of HRK 29.3bn in kuna liquidity from March to the end of 2020, almost all of which was released in the period from March to early July. As a result, the banks' free reserves started to reach historical highs. The average daily surplus liquidity of the domestic banking market grew from HRK 32.2bn in 2019 to HRK 41.2bn in July 2020

Figure 9.2 Bank liquidity and reserve money



Source: CNB.

Figure 9.3 CNB balance sheet structure

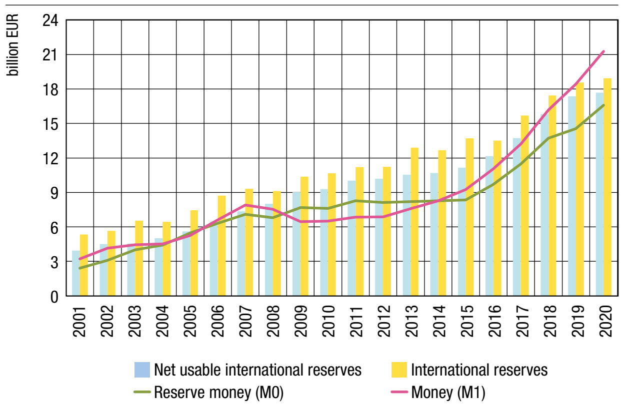


Source: CNB.

and further to HRK 51.7bn in December (Figure 9.2). The larger liquidity surplus in the second half of the year was also due to a fall in government kuna deposits with the CNB.

The central bank's balance sheet structure changed significantly over the first half of the year as a result of the increase in claims on domestic banks and government bond purchase. The share of foreign assets, i.e. international reserves, decreased temporarily due to the sale of foreign currency to banks at the onset of the pandemic, but it started to grow steadily from June (Figure 9.3).

Figure 9.4 International reserves of the CNB and monetary aggregates



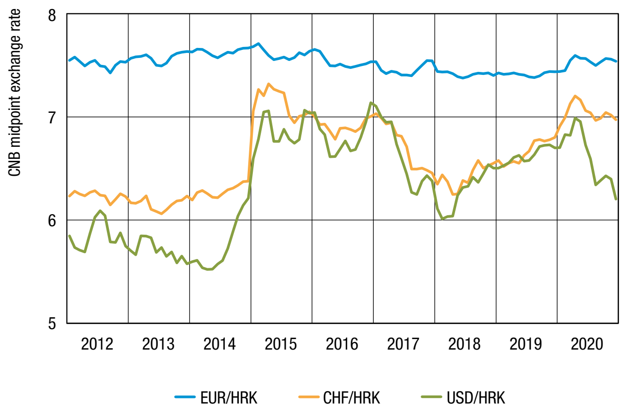
Note: Net usable international reserves are defined as international reserves net of CNB foreign liabilities, reserve requirements in f/c, government foreign currency deposits and off-balance sheet liabilities (swaps).
Source: CNB.

International reserves, which had dropped sharply in March and April as a result of large foreign exchange sales, began to recover from June, mostly due to the purchases of foreign exchange from the government. International reserves continued to grow at a steady and modest pace in the second half of the year, reaching EUR 18.9bn at the end of 2020, which was an increase of EUR 0.4bn from the end of 2019 (Figure 9.4). Net usable reserves went up by EUR 0.3bn (1.9%) from the end of the previous year, reaching EUR 17.7bn at the end of December. Both gross and net reserves are still higher than reserve money (M0).

The exchange rate of the kuna against the euro stabilised, after having depreciated in March and the first half of April. However, over the summer months, the expectations regarding the strengthening of the kuna as a result of better than expected tourist indicators led to its appreciation. As early as in the second half of August, the exchange rate started depreciating slightly due to epidemiological measures tightening in outbound markets and the worsening of the situation with regard to the spreading of the infection in Croatia. The trend of a mild depreciation continued over the following two months due to growing uncertainty regarding the pandemic. Nevertheless, the kuna/euro exchange rate started to appreciate mildly in early November and by the end of December returned to the level seen at the end of September. This was due, among other things, to weaker demand of legal persons for foreign exchange on the domestic foreign exchange market. The exchange rate of the kuna against the euro was EUR/HRK 7.54 at the end of 2020, up by 1.3% since the end of 2019, while the average exchange rate in 2020 was EUR/HRK 7.53, an increase of 1.6% from the average exchange rate in the same period in 2019 (Figure 9.5).[5] The exchange rate of the kuna against the US dollar was lower at the end of 2020 than at the end of 2019 as a result of the weakening of the US dollar versus the euro. By contrast, the kuna/Swiss franc exchange rate went higher

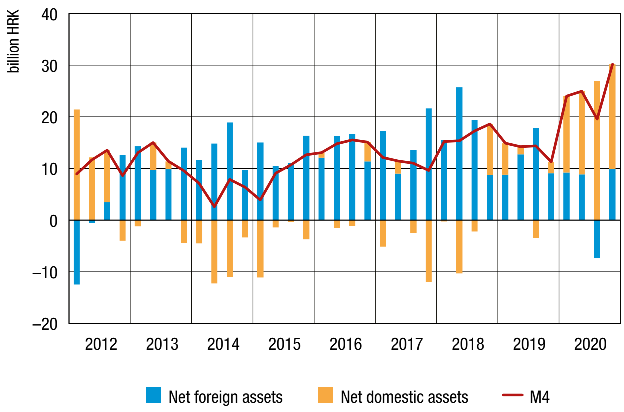
5 Croatia entered the Exchange Rate Mechanism (ERM II) in July 2020, with the central rate of the kuna being set at 1 euro = 7.5345 and the standard fluctuation band at ±15% around this rate (Box 4 Croatia's entry into the Exchange Rate Mechanism II (ERM II), Macroeconomic Developments and Outlook No. 9, December 2020).

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 exclude the exchange rate effect.
Source: CNB.

in the period under review, reflecting the combined effect of the weakening of the kuna against the euro and the weakening of the euro against the Swiss franc.

The upward trend in monetary aggregates continued in the second half of 2020. The annual rate of growth in total liquid assets (M4) was 9.1% (transaction-based) in December 2020, an acceleration relative to the growth of 7.7% in June and twice as high as at end-2019 (Figure 9.6). The growth in M4 was again largely driven by the strong increase in net domestic assets (NDA), mostly due to the intensified borrowing of the government from banks and the CNB’s purchase of government bonds on the secondary market. Among M4 components, foreign exchange deposits grew by 5% in 2020, while money (M1), that is, kuna funds in transaction accounts, recorded an annual growth of 17%.

10 Public finance

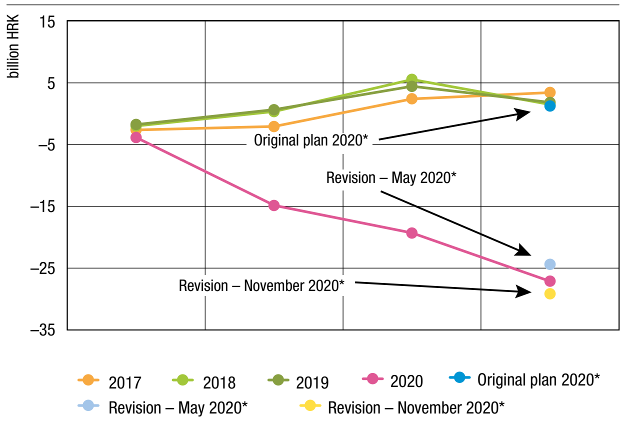
As a consequence of the crisis on economic activity and thereby on tax revenues, as well as government measures, mostly due to the continuation of payment of job preservation grants, the general government budget balance was negative in the second half of 2020, which resulted in the total deficit of 7.4% of GDP at the level of 2020. Consolidated general government debt continued to grow in the second half of the year, although more moderately than in the first half, and stood at 88.7% of GDP at the end of 2020.

The deterioration in government finances continued in the second half of 2020, although it was slightly less pronounced than in the first half of the year. This was a consequence of the continued negative impact of the crisis on economic activity and thereby on tax revenues, as well as of the implemented government measures necessary for alleviating the negative consequences of the crisis, most of all of the continued payment of job preservation grants. According to the ESA methodology, a negative general government budget balance of HRK 12.2bn was recorded in the second half of 2020, which together with HRK 15.3bn in the first half of the year resulted in the total deficit of HRK 27.5bn or 7.4% of GDP at the level of 2020. Such an annual budget performance is significantly less favourable than the general government budget balance from 2019, when a surplus of HRK 1.2bn, or 0.3% of GDP, was recorded. The comparison between the performance and the deficit planned in the amendments to the 2020 state budget from May 2020 shows an approximately HRK 2.7bn less favourable performance , while in comparison with the planned deficit from November 2020 the actual performance was about HRK 1.9bn more favourable.

The decomposition of the change in the nominal general government balance shows that the change in the nominal balance in 2020 as a whole was exclusively under the favourable effect of the decrease in interest expenditures due to the still present favourable financing conditions on the capital market. In contrast, the cyclical component determined by the impact of the unfavourable economic situation and one-off measures had an unfavourable effect on the change in the nominal balance.

As regards the revenue side of the budget (ESA 2010), total revenues were slightly lower (–4.0%) in the second half of 2020 than in the first half of the year (–9.3%). The drop in budget revenues was mostly related to indirect taxes due to unfavourable pandemic-driven economic

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

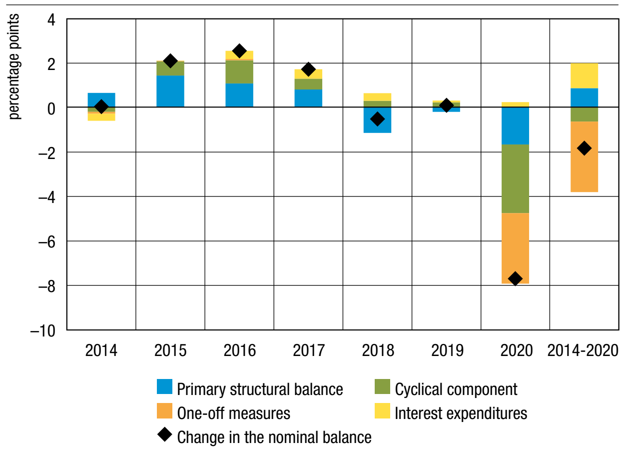


Sources: Eurostat and MoF (CNB calculations).

trends, which were also reflected in a slump in personal consumption. However, in the second half of the year, revenues from indirect taxes were somewhat supported by the partial recovery of demand after the improvement of the epidemiological situation, which also led to a partial recovery in tourism-related activities. Apart from the above, revenues from indirect taxes were also influenced by tax amendments in the VAT system in the second half of the year, i.e. the reduced VAT rate to 13% for food and desserts preparation and serving in and outside catering establishments. Revenues from direct taxes and social contributions made a much smaller negative contribution to the decline in total revenues, reflecting the success of the measures for the mitigation of the negative effects of the crisis on economic developments as well as the gradual recovery of economic activity after the relaxation of the stringent restrictive measures implemented in the first half of 2020. The developments in the revenues from direct taxes were also affected by the previously implemented tax cuts. The fourth round of the tax reform of 1 January 2020 resulted in an increase in the personal tax exemption in the income tax system and the number of profit taxpayers subject to a lower rate. In contrast to the mentioned developments of tax revenues, other revenues grew perceptibly in the second half of the year, thus offsetting the decline in total revenues. The growth in other revenues reflects an uptake in the absorption of EU funds, the financial assistance of the Solidarity Fund for earthquake-affected areas and the payments of one-off exceptional aid from the EU, while the European Commission allowed member states to use the remaining funds from the previous multiannual financial framework (2014 – 2020) to finance measures aimed at curbing the crisis caused by the pandemic.

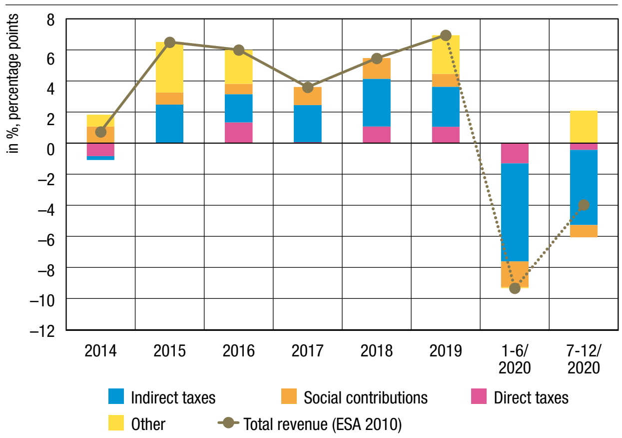
On the expenditure side of the consolidated general government budget (ESA 2010), total expenditures increased by 9.5% in the second half of 2020 relative to the growth of 7.6% in the first half of the year. Almost all expenditure categories grew, with the growth of total expenditures mostly having been fuelled by a significant increase in expenditures on subsidies, reflecting the continuation of job preservation grants paid out to employers. General government investments and other expenditures also led to the growth of the expenditure side of the budget, with the growth in investment most

Figure 10.2 Decomposition of the change in the nominal general government balance



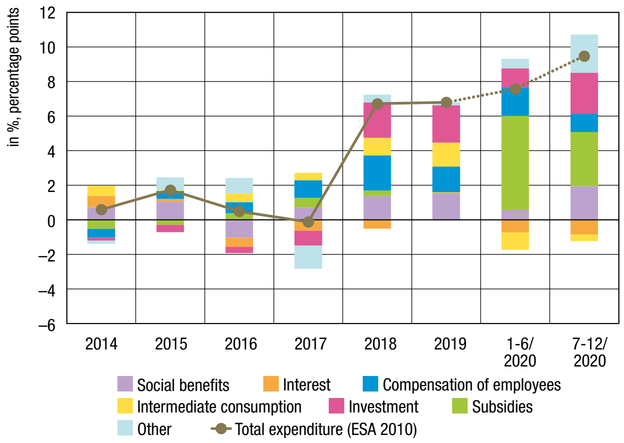
Source: CNB.

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



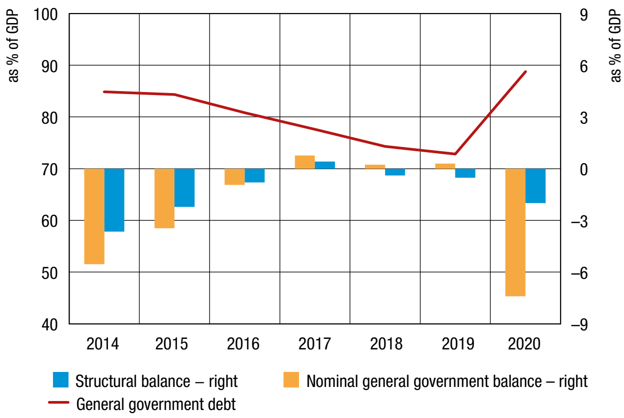
Source: Eurostat (CNB calculations).

Figure 10.4 Consolidated general government expenditure (ESA 2010)
year-on-year rate of change and contributions



Source: Eurostat (CNB calculations).

Figure 10.5 General government debt
stock, end of period



Source: CNB.

likely reflecting the intensified implementation of infrastructure projects financed by EU funds, the start of the reconstruction of material damage caused by earthquakes and the purchase of additional medical equipment in healthcare institutions in state ownership due to the pandemic. The same effect was produced by expenditures for social benefits due to the growth of payments to unemployed persons, pension indexation and the previous increase in funds for the parent-caregiver status and the status of a caregiver of a person with disability. Compensations of employees also grew, reflecting a 2% increase in the wage calculation base in the public sector from 1 January 2020. By contrast, the negative contributions of interest and intermediary consumption expenditures only slightly mitigated the strong growth of expenditures in the second half of the year from the same period in 2019. The decrease in interest expenditures reflects favourable conditions for the refinancing of liabilities falling due, which were maintained even during the pandemic crisis. The decrease in expenditures for intermediary consumption also mirrors the reallocation of some expenditures of this kind under the budget revision from November 2020 to other expenditure items, the largest share of the funds being reallocated to job preservation grants.

Consolidated general government debt stood at HRK 329.7bn or 88.7% of GDP at the end of 2020, up by HRK 0.4bn relative to the end of June of the same year. The debt increase slowed down noticeably in the second half of 2020, after a steep increase in debt in the first half of the year. The government met the increased need to finance the budget deficit caused by the unfavourable effects of the crisis on economic developments and the cost of one-off measures to offset these effects mostly in the course of the first half of the year and largely on the domestic market. A foreign bond worth USD 1.25bn that matured in mid-July, was partly refinanced by the issue of additional tranches of two domestic bonds in late June, i.e. the third tranche of bonds in the nominal amount of HRK 2.46bn maturing in 2026, with a yield-to-maturity of 0.85% and the second tranche of bonds in a nominal amount of HRK 2.59bn maturing in 2028, with a yield-to-maturity of 0.94%.

11 International reserves management

The growth of international reserves in 2020 was mostly driven by foreign currency inflows to the Ministry of Finance account due to the intensified foreign borrowing by the government and inflows from EU funds. The decrease in reserves was mostly caused by the sale of foreign exchange to banks through foreign exchange interventions and a lower level of agreed repo transactions at the end of the year. In the prolonged period of negative euro yields and historically low US dollar yields, the continuous adoption of strategic decisions on international reserves management over the previous ten years ensured an appropriate level of earnings of EUR 74.1m or HRK 556.3m.

The international reserves of the Croatian National Bank in the year marked by the pandemic were the cornerstone of the maintenance of the stability of the exchange rate of the domestic currency, and their upward trend continued. Reserves management in 2020 was particularly challenging and operationally demanding amid severe market fluctuations, disrupted liquidity and heightened uncertainty, coupled with record large outflows based on foreign exchange interventions in March and April followed by a noticeable growth in reserves in the remainder of the year. In such an environment, the primary objective of international reserves management, liquidity and safety, was successfully achieved.

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

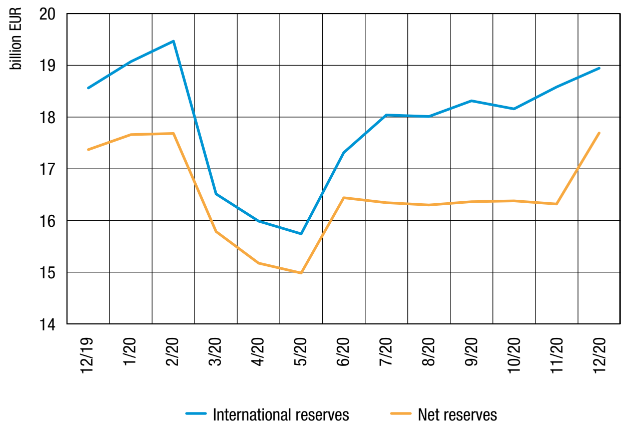
The other component of the reserves, which is formed on the basis of deposits of the MoF, repo agreements with banks, foreign currency swaps in the domestic market, IMF membership and other assets owned by other legal persons, is managed by the CNB in accordance with obligations assumed.

11.1 Structure of and developments in international reserves

International reserves of the CNB stood at EUR 18,944.4m as at 31 December 2020, up by EUR 382.1m or 2.1% from the end of 2019, when they stood at EUR 18,562.4m. Over the same period, net reserves increased by EUR 322.3m, or 1.9%, from EUR 17,369.7m to EUR 17,692.0m.

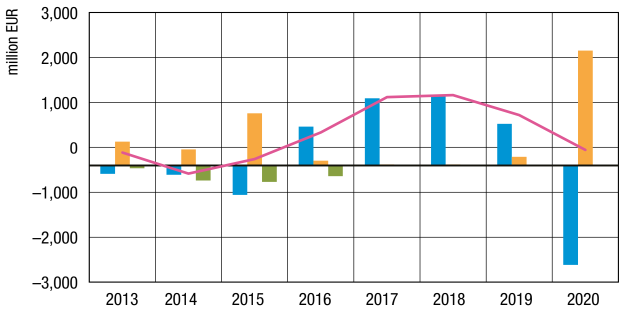
The increase in international reserves in 2020 was mostly brought about by foreign currency inflows to the MoF account due to intensified government borrowing in the foreign market and inflows from EU funds, while the decrease in reserves was largely driven by the sale of foreign exchange to banks through foreign exchange interventions and a lower level of agreed repo transactions at the end of the year.

Figure 11.1 Monthly changes in total and net CNB international reserves in 2020



Source: CNB.

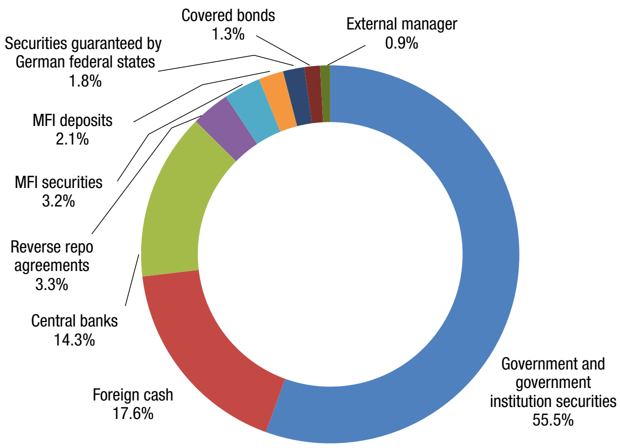
Figure 11.2 Foreign exchange interventions of the CNB with the banks, the MoF and the EC
in net amounts



	2013	2014	2015	2016	2017	2018	2019	2020
Banks	−214.9	−240.2	−767.2	1,018.8	1,757.0	1,808.9	1,088.9	−2,595.6
MoF	625.7	420.6	1,364.0	125.6	30.6	30.4	228.1	3,004.0
EC	−69.4	−392.2	−428.9	−277.8	–	–	–	–
Total	341.3	−211.8	167.9	866.6	1,787.6	1,839.3	1,316.9	408.4

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 31 December 2020



Source: CNB.

Figure 11.4 Currency structure of total international reserves
as at 31 December 2020

Source: CNB.

Securities of governments and government institutions, foreign cash and deposits with central banks accounted for the largest share in the structure of international reserves investment at the end of 2020. A portion of international reserves was also invested in green bonds (0.4%) at the end 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 2020, approximately 64% of the CNB international reserves was invested in countries, banks and institutions within the two highest credit rating categories or invested in the BIS and the IMF or in foreign cash in the CNB vault.

In 2020, the currency structure of international reserves changed in favour of the euro. Thus, the share of the euro in international reserves increased from 82.0% at the end of 2019 to 85.0% in 2020, while the share of the US dollar decreased from 15.9% to 13.0%. The share of SDRs in international reserves dropped slightly from 2.0% to 1.9%.

11.2 Financial markets and international reserves management results in 2020

In 2020, the COVID-19 pandemic fuelled the most turbulent global economic and financial movements in modern history. Global financial markets saw extreme volatility, as evident in the rapid fall in stock exchange indices followed by their recovery, 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. Markets were more under the impact of positive sentiment only late in the year because of the start of the coronavirus vaccine rollout, the US presidential election outcome and the final UK-EU Brexit agreement.

In such circumstances, the ECB launched a new securities purchase programme in March, raised the amount of the existing programme and introduced new long-term refinancing operations. The Fed also introduced new securities purchase programmes, but also reduced the range for its benchmark interest rate to the minimum.

Yields on issued European government securities decreased in 2020, to the largest extent for long-term maturities, so that fully 75% of government securities of euro area member states had negative yields at the end of the year. The entire German yield curve was in negative territory at the end of 2020.

The US yield curve dipped sharply in 2020, and the average fall for all maturities of US government securities up to ten years totalled 132 basis points.

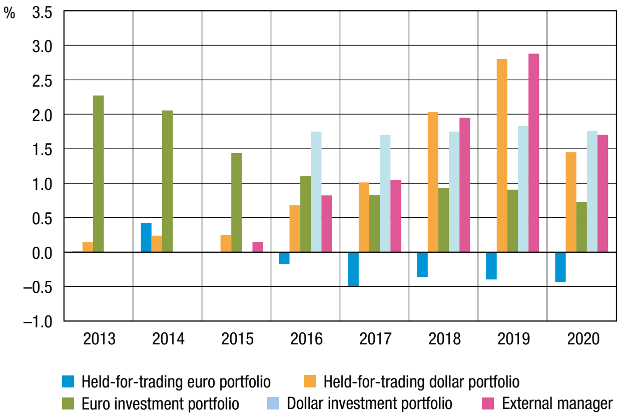
International reserves managed by the CNB in line with its own guidelines comprise the held-for-trading portfolios, the investment portfolios, the funds entrusted to an external manager and foreign cash in the vault.

In the environment of a prolonged period of negative euro yields and US dollar yields at historic lows, an appropriate level of earnings was ensured by the strategic decisions on international reserves management made consistently over the previous ten years. This refers primarily to the formation since 2011 of investment portfolios that served as a basis for the adoption of tactical decisions and the adjustments of investment guidelines. In 2020, net international reserves investments generated a total income of EUR 74.1m or HRK 556.3m.

The rate of return on the entire euro portfolio of net reserves was 0.22%, while the rate of return on the entire dollar portfolio totalled 1.54% in 2020. If held-for-trading and investment portfolios are observed separately, the euro held-for-trading portfolio generated a rate of return of –0.43%, while the dollar held-for-trading portfolio generated a rate of return of 1.45% in 2020. The euro-denominated investment portfolio yielded a return of 0.73%, while the dollar-denominated investment portfolio yielded a return of 1.76%.

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 47% of net reserves have a longer average

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



Source: CNB.

maturity and serve as a source of more stable long-term income.

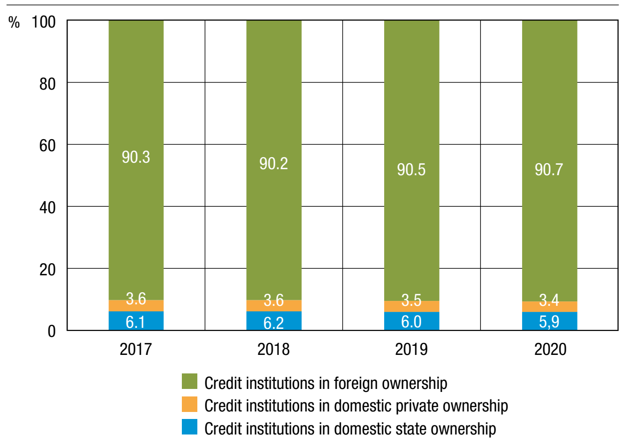
In 2020, the rate of return on the US dollar funds entrusted for management to an international financial institution was 1.70%. The entrusting of funds to an international financial institution enabled additional diversification and knowledge-exchange in the field of investment management.

12 Business operations of credit institutions

A more flexible approach to the application of the regulatory framework and the adjustment of certain supervisory activities ensured the reinforcement of the high liquidity and capitalisation of the banking system even amid the unfavourable pandemic conditions.

The security and stability of business operations of credit institutions in 2020, despite the unfavourable effects and uncertainty caused by the COVID-19 pandemic, were primarily the result of the high liquidity and capitalisation of the banking system, and the preconditions for an additional reinforcement of the values of these positions in the newly-created circumstances were ensured by emergency regulatory adjustments. The CNB undertook a series of measures to alleviate the negative economic consequences of the pandemic and the two devastating earthquakes, 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 Banking Authority (EBA). The focus of the 2020 SREP cycle was on the ability of credit institutions to respond to changes and challenges in the environment and on their most relevant vulnerabilities and risks in the context of the impact of the pandemic.

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

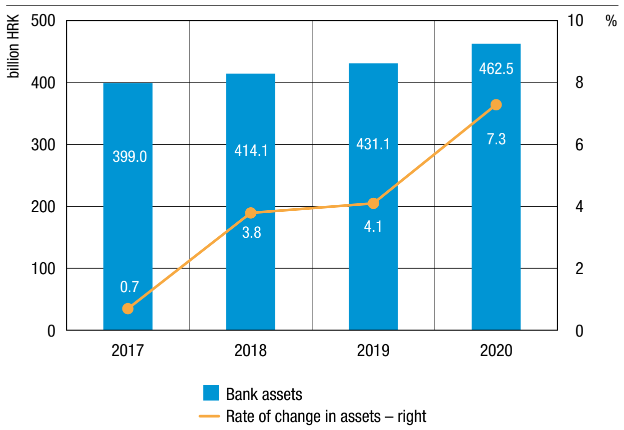


Source: CNB.

As at the end of 2019, 23 credit institutions, 20 banks and three housing savings banks, were operating in the RC in 2020. In addition, there was one branch of an EU credit institution operating in the country, while some 170 institutions from the EU and the European Economic Area had notified the CNB of their intentions regarding the direct provision of mutually recognised services in the territory of the Republic of Croatia.[6] The system continued to be dominated by other systemically important banks,

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

Figure 12.2 Assets of credit institutions



Source: CNB.

accounting for 90.6% of all assets held by credit institutions.[7] A slightly larger share (90.7%) was held by the 14 credit institutions in majority foreign ownership.

In 2020, the assets of credit institutions grew by 7.3% to a record high of HRK 462.5bn, primarily financed by the rise in deposits of domestic sectors. The largest increase in the assets came from highly liquid assets in settlement accounts with the CNB, cash and deposits, which was reflected in the high level of the liquidity coverage ratio (LCR) of 181.9%, much above the prescribed minimum of 100%. All credit institutions complied with the prescribed minimum liquidity requirements. Despite the reduction of the reserve requirement rate[8] the share of total deposits with the CNB increased additionally to 19.2% of total assets.

Total loans (net) went up 5.7%. Credit activity was mostly oriented towards financing the needs of government units, for which loans increased by 18.1%, while it was more restrained towards non-financial corporations and households. The increase in non-financial corporation loans (4.8%) primarily reflected their growth in the first quarter, and after the contraction in the middle of the year, a slight recovery was again recorded in the fourth quarter. Household loans went up 1.4%. The years-long upward trend in general-purpose cash loans came to an end and the only important form of household lending that continued to grow was housing loans, driven by the participation of credit institutions in the government programme for subsidised housing loans.

In 2020, all credit institutions actively supported debtors hit by the pandemic and earthquakes by moratorium measures to facilitate repayment. A part of the approved measures expired in the course of the year, so that at the end of 2020 the stock of unexpired moratoria aligned with the EBA[9] requirements stood at HRK 24.5bn, proportionate to a 6.3% of total loans and advance payments. The largest amount of these measures applied to non-financial corporation loans.

Deposits received by credit institutions increased by 8.5%. The growth in the deposits of domestic sectors, particularly those of non-financial corporations (16.9%)

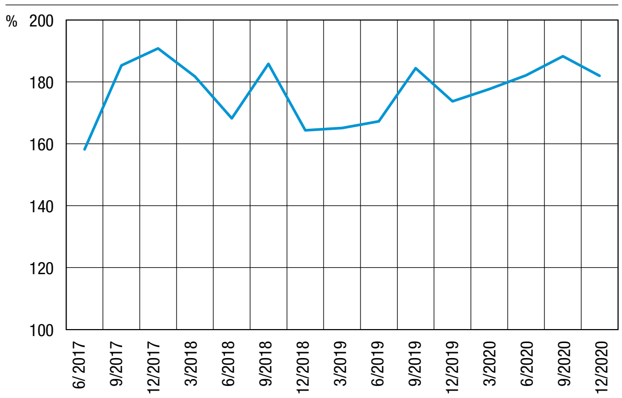
7 Other systemically important (O-SII) credit institutions are credit institution the failure or malfunction of which could lead to systemic risk in the Republic of Croatia. Information on the last review of other systemically important credit institutions may be found here.

8 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%.

9 On 2 April 2020, the EBA issued the Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis. Due to the further development of the pandemic and recognising the increased insolvency risk for debtors and the need for the proper maintenance of risk on capital positions of banks, the EBA published two amendments to the Guidelines, with the deadline for the application on moratoria concluded by 31 March 2021 (EBA/GL/2020/02, EBA/GL/2020/08 and EBA/GL/2020/15). The CNB expects the credit institutions that grant moratoria on loan repayment to fully apply the Guidelines.

and households (6.1%), and deposits and loans of financial institutions (36.3%), including the use of CNB loans from the package of measures to boost banking system liquidity in the midst of the crisis triggered by the pandemic were the key source of the rise in bank assets. The long-lasting trend of maturity transformation of total deposits continued with a further decrease in time deposits and in their share in total deposits to 31.2%. The share of deposits in transaction accounts increased to 63.4% of total deposits, and these trends were primarily the consequence of the changes in the structure of household deposits.

Figure 12.3 Liquidity coverage ratio (LCR)



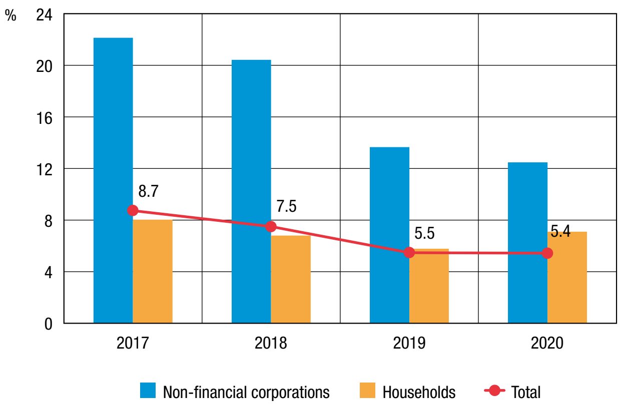
Source: CNB.

In 2020, credit institutions recognised a significant increase in credit risk, mostly reflected in the increase in the performing assets in value impairment stage 2 that had not yet defaulted.[10] By constantly growing throughout the year, the share of assets in stage 2 increased to 11.5% of total financial assets, or up by five percentage points. A significant share of the increase may be attributed to the circumstances relating to the pandemic, that is, the expected losses in a share of performing loans to which moratorium measures applied. The rise in non-performing loans was also noticeable, although, due to the impact of new credit activity, their share in total loans decreased slightly from last year's 5.5% to 5.4% (non-performing loans ratio). The increase in non-performing loans was mostly the result of reduced household debt servicing capacity on general-purpose cash loan, so that the share of non-performing loans in that sector increased from 5.8% in 2019 to 7.1% at the end of 2020. The increase in non-financial corporation loans and the sale of claims had an impact on the decrease in the share of non-performing loans in that sector from 13.7% to 12.5%. The share of NPLs was below 5% in only seven credit institutions,[11] while in eight credit institutions the share was above 10%, as a result of which the relative quality of total loans remains worse than the EU average. However, better than the EU average is the coverage of non-performing loans by impairment of 64.1%, by which credit institutions have already cut their earnings.

10 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, that is, in the case of default, the instrument is transferred to stage 3, where the loss that is actually incurred is determined.

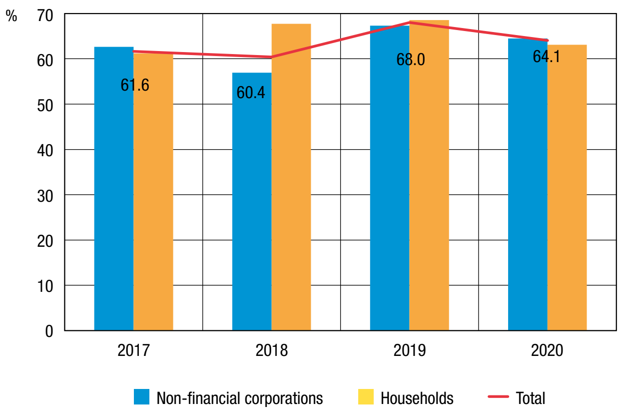
11 The threshold of 5% is a reference value by which EBA identifies a high NPLR, which triggers additional regulatory requirements related to a strategy to reduce NPLs and manage credit risk.

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



Source: CNB.

Figure 12.5 Coverage of non-performing loans by impairment



Source: CNB.

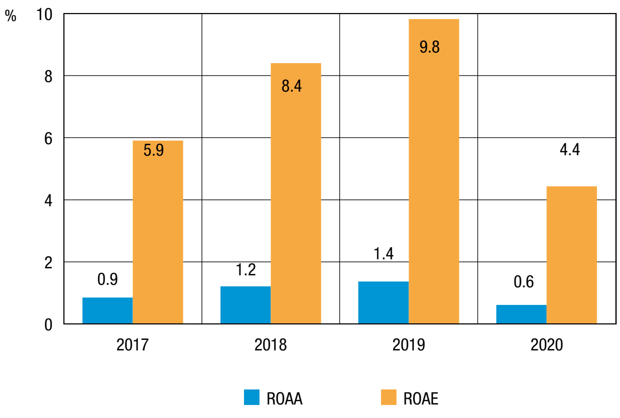
Impairment costs incurred by the mentioned recognition of the increased credit risk and smaller operating income reduced the profit to HRK 2.7bn, by more than a half relative to the previous year. With the decrease in profits, return on assets (ROA) and return on equity (ROE) also decreased to 0.6% and 4.4% respectively. Expected credit losses on loans in stage 2 and NPLs resulted in a three and a half times larger amount of expenses on impairments and provisions than in 2019. The decrease in all components of total net operating income by 9.9% was attributed to the fall in most income, despite cost cutting. The decrease was primarily driven by 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 profitability was partially mitigated by a further decrease in interest expenses, mostly maturity restructuring of household deposits, and a decrease in expenses on fees and commissions. The cost-to-income ratio (CIR) grew to 55.0%, but the deterioration was the outcome of methodological changes.[12]

Key indicators of bank capitalisation grew additionally, the total capital ratio of 24.9% being among the highest of EU member states. In line with supervisory expectations regarding the pandemic, credit institutions 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.[13] The result was a slight increase in total capital (1.0%). The low intensity of the increase in total risk exposure

12 Within this indicator, as of 30 June 2020, general expenses also include 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.

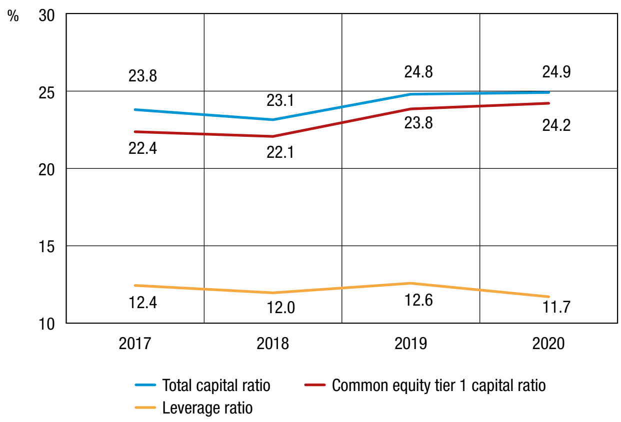
13 Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic (CRR Quick fix), has been applied since 27 June 2020.

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



Source: CNB.

Figure 12.7 Key indicators of credit institution capitalisation



Source: CNB.

(0.6%) may primarily be attributed to the introduction of transitional restrictions in the standardised approach to credit risk measurement for the treatment of exposures arising from public debt denominated in the currency of another member state.[14] This has enabled the reintroduction of a 0% risk weight to euro-denominated exposures to the Republic of Croatia. Coupled with the increased application of the risk weight of 35% to exposures based on housing loans, it resulted in the fall in the value of the average credit risk weight from 47.4% to 44.6%. The importance of the 0% risk weight is also reflected in the share of exposures to which this weight is assigned in total risk weighted exposures, which stood at a high 43.7% at the end of 2020. Total capital ratio of all credit institutions exceeded the 8%-minimum, while in eight credit institutions, accounting for a 65.8% share of total assets of all credit institutions, this ratio exceeded 20%.

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

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

HNB

ISSN 1848-7505