REPUBLIC OF CROATIA

U.S.$1,500,000,000 6.750 PER CENT. NOTES DUE 2019

Issue price: 98.16 per cent.

The U.S.$1,500,000,000 6.750 per cent. Notes due 2019 (the "**Notes**") are issued by the Republic of Croatia (the "**Republic**" or "**Croatia**").

The Notes mature on 5 November 2019.

Application has been made to the *Commission de Surveillance du Secteur Financier* (the "**CSSF**") in its capacity as competent authority under the Luxembourg Act dated 10 July 2005 (the "**Luxembourg Act**") on prospectuses for securities to approve this document as a prospectus and to the Luxembourg Stock Exchange for the listing of the Notes on the Official List of the Luxembourg Stock Exchange and admission to trading on the Luxembourg Stock Exchange's regulated market.

The Notes will be rated Baa3 (stable outlook) by Moody's Investors Service, Inc., BBB (negative outlook) by Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies Inc. and BBB− (negative outlook) by Fitch Ratings Ltd. A rating is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating organisation.

The Notes have not been and will not be registered under the United States Securities Act of 1933, as amended (the "Securities Act") or with any securities regulatory authority of any state or other jurisdiction of the United States and may not be offered, sold or delivered within the United States or to, or for the account or benefit of, U.S. persons except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act and applicable state securities laws. Accordingly, the Notes are being offered, sold or delivered: (a) in the United States only to qualified institutional buyers ("QIBs") (as defined in Rule 144A ("Rule 144A") under the Securities Act) in reliance on, and in compliance with, Rule 144A; and (b) to Persons (other than U.S. Persons) (each as defined in Regulation S) outside the United States in reliance on Regulation S ("Regulation S") under the Securities Act. Each purchaser of the Notes will be deemed to have made the representations described in "Subscription and Sale" and is hereby notified that the offer and sale of Notes to it is being made in reliance on the exemption from the registration requirements of the Securities Act provided by Rule 144A. In addition, until 40 days after the commencement of the offering, an offer or sale of any of the Notes within the United States by any dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act if the offer or sale is made otherwise than in accordance with Rule 144A.

The Notes will initially be represented by two global certificates in registered form (the "**Global Certificates**"), one of which will be issued in respect of the Notes offered and sold in reliance on Rule 144A (the "**Restricted Global Certificate**") and will be registered in the name of Cede & Co., as nominee for The Depository Trust Company ("**DTC**") and the other of which will be issued in respect of the Notes offered and sold in reliance on Regulation S (the "**Unrestricted Global Certificate**") and will be registered in the name of a nominee of a common depositary for Euroclear Bank S A/N V, as operator of the Euroclear System ("**Euroclear**") and Clearstream Banking, société anonyme ("**Clearstream, Luxembourg**"). It is expected that delivery of the Global Certificates will be made on 5 November 2009 or such later date as may be agreed (the "**Closing Date**") by the Republic and the Joint Lead Managers (as defined under "*Subscription and Sale*").

Prospective investors should be aware that none of the statistical information in this Prospectus has been independently verified.

An investment in Notes involves certain risks. Prospective investors should have regard to the factors described under the heading *"Risk Factors"* on page 6.

Joint Lead Managers

BARCLAYS CAPITAL　　　CITI　　　J.P. MORGAN

The date of this Prospectus is 4 November 2009.

THE REPUBLIC OF CROATIA

This Prospectus comprises a prospectus for the purposes of Article 5.4 of Directive 2003/71/EC (the "**Prospectus Directive**") and for the purposes of the Luxembourg Act.

The Republic accepts responsibility for the information contained in this Prospectus. To the best of the knowledge of the Republic (having taken all reasonable care to ensure that such is the case) the information contained in this Prospectus is in accordance with the facts and does not omit anything likely to affect the import of such information.

The Republic, having made all reasonable enquiries, confirms that this Prospectus contains all material information with respect to the Republic and the Notes which is material in the context of the issue and offering of the Notes, that the information contained in this Prospectus is true and accurate in every material respect and is not misleading, that the opinions and intentions expressed in this Prospectus are honestly held and that there are no other facts the omission of which makes misleading any statement herein, whether of fact or opinion.

The Joint Lead Managers (as described under "*Subscription and Sale*", below) have not independently verified the information contained herein. Accordingly, no representation, warranty or undertaking, express or implied, is made and no responsibility or liability is accepted by the Joint Lead Managers as to the accuracy or completeness of the information contained or incorporated in this Prospectus or any other information provided by the Republic in connection with the offering of the Notes. No Joint Lead Manager accepts any liability in relation to the information contained or incorporated by reference in this Prospectus or any other information provided by the Republic in connection with the offering of the Notes or their distribution.

No person is or has been authorised by the Republic to give any information or to make any representation not contained in or not consistent with this Prospectus or any other information supplied in connection with the offering of the Notes and, if given or made, such information or representation must not be relied upon as having been authorised by the Republic or any of the Joint Lead Managers.

Neither this Prospectus nor any other information supplied in connection with the offering of the Notes (a) is intended to provide the basis of any credit or other evaluation or (b) should be considered as a recommendation by the Republic or any of the Joint Lead Managers that any recipient of this Prospectus or any other information supplied in connection with the offering of the Notes should purchase the Notes. Each investor contemplating purchasing any Notes should make its own independent investigation of the financial condition and affairs, and its own appraisal of the creditworthiness, of the Republic. Neither this Prospectus nor any other information supplied in connection with the offering of the Notes constitutes an offer or invitation by or on behalf of the Republic or any of the Joint Lead Managers to any person to subscribe for or to purchase any Notes.

Neither the delivery of this Prospectus nor the offering, sale or delivery of the Notes shall in any circumstances imply that the information contained herein concerning the Republic is correct at any time subsequent to the date hereof or that any other information supplied in connection with the offering of the Notes is correct as of any time subsequent to the date indicated in the document containing the same. The Joint Lead Managers expressly do not undertake to review the financial condition or affairs of the Republic during the life of the Notes or to advise any investor in the Notes of any information coming to their attention.

This Prospectus does not constitute an offer to sell or the solicitation of an offer to buy the Notes in any jurisdiction to any person to whom it is unlawful to make the offer or solicitation in such jurisdiction. The distribution of this Prospectus and the offer or sale of Notes may be restricted by law in certain jurisdictions. The Republic and the Joint Lead Managers do not represent that this Prospectus may be lawfully distributed, or that the Notes may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the Republic or the Joint Lead Managers which is intended to permit a public offering of the Notes or the distribution of this Prospectus in any jurisdiction where action for that purpose is required. Accordingly, no Notes may be offered or sold, directly or indirectly, and neither this Prospectus nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations. Persons into whose possession this Prospectus or any Notes may come must inform themselves about, and observe, any such restrictions on the distribution of this Prospectus and the offering and sale of Notes. In particular, there are restrictions on the distribution of this Prospectus and the offer or sale of Notes in the United States, the European Economic Area (including the United Kingdom) and the Republic of Croatia, see "*Subscription and Sale*".

IN CONNECTION WITH THE ISSUE OF THE NOTES, CITIGROUP GLOBAL MARKETS LIMITED AS STABILISING MANAGER (THE "STABILISING MANAGER") (OR PERSON(S) ACTING ON BEHALF OF THE STABILISING MANAGER) MAY OVER-ALLOT NOTES OR EFFECT TRANSACTIONS WITH A VIEW TO SUPPORTING THE MARKET PRICE OF THE NOTES AT A LEVEL HIGHER THAN THAT WHICH MIGHT OTHERWISE PREVAIL. HOWEVER, THERE IS NO ASSURANCE THAT THE STABILISING MANAGER (OR PERSONS ACTING ON BEHALF OF THE

STABILISING MANAGER) WILL UNDERTAKE STABILISATION ACTION. ANY STABILISATION ACTION MAY BEGIN ON OR AFTER THE DATE ON WHICH ADEQUATE PUBLIC DISCLOSURE OF THE TERMS OF THE OFFER OF THE NOTES IS MADE AND, IF BEGUN, MAY BE ENDED AT ANY TIME, BUT IT MUST END NO LATER THAN THE EARLIER OF 30 DAYS AFTER THE ISSUE DATE OF THE NOTES AND 60 DAYS AFTER THE DATE OF THE ALLOTMENT OF THE NOTES. ANY STABILISATION ACTION OR OVER-ALLOTMENT MUST BE CONDUCTED BY THE RELEVANT STABILISING MANAGER(S) (OR PERSONS ACTING ON BEHALF OF ANY STABILISING MANAGER(S)) IN ACCORDANCE WITH ALL APPLICABLE LAWS AND RULES.

The Notes have not been approved or disapproved by the United States Securities and Exchange Commission or any other securities commission or other regulatory authority in the United States, nor have the foregoing authorities reviewed or passed upon the accuracy or adequacy of this Prospectus. Any representation to the contrary is a criminal offence.

This Prospectus is being submitted on a confidential basis in the United States to a limited number of QIBs for informational use solely in connection with the consideration of the purchase of the Notes. It may not be copied or reproduced in whole or in part nor may it be distributed or any of its contents disclosed to anyone other than the prospective investors to whom it is originally submitted.

Each purchaser or holder of interests in the Notes will be deemed, by its acceptance or purchase of any such Notes, to have made certain representations and agreements as set out in "*Subscription and Sale*".

NOTICE TO NEW HAMPSHIRE RESIDENTS

NEITHER THE FACT THAT A REGISTRATION STATEMENT OR AN APPLICATION FOR A LICENSE HAS BEEN FILED UNDER CHAPTER 421-B OF THE NEW HAMPSHIRE REVISED STATUTES WITH THE STATE OF NEW HAMPSHIRE NOR THE FACT THAT A SECURITY IS EFFECTIVELY REGISTERED OR A PERSON IS LICENSED IN THE STATE OF NEW HAMPSHIRE CONSTITUTES A FINDING BY THE SECRETARY OF STATE OF NEW HAMPSHIRE THAT ANY DOCUMENT FILED UNDER CHAPTER 421-B IS TRUE, COMPLETE AND NOT MISLEADING. NEITHER ANY SUCH FACT NOR THE FACT THAT AN EXEMPTION OR EXCEPTION IS AVAILABLE FOR A SECURITY OR A TRANSACTION MEANS THAT THE SECRETARY OF STATE HAS PASSED IN ANY WAY UPON THE MERITS OR QUALIFICATIONS OF, OR RECOMMENDED OR GIVEN APPROVAL TO, ANY PERSON, SECURITY OR TRANSACTION. IT IS UNLAWFUL TO MAKE, OR CAUSE TO BE MADE, TO ANY PROSPECTIVE PURCHASER, CUSTOMER OR CLIENT ANY REPRESENTATION INCONSISTENT WITH THE PROVISIONS OF THIS PARAGRAPH.

SERVICE OF PROCESS AND ENFORCEMENT OF CIVIL LIABILITIES

The Republic is a foreign sovereign nation, and a substantial portion of the assets of the Republic are located outside the United States and the United Kingdom. As a result, it may not be possible for investors to effect service of process within the United States or the United Kingdom upon the Republic, or to enforce judgements obtained in courts located in the United States or United Kingdom, including judgements predicated upon civil liability provisions of the securities laws of the United States or any state or territory within the United States.

A substantial part of the Republic's assets are located in the Republic of Croatia and the courts of the Republic of Croatia may refuse to recognise a judgement obtained in a foreign jurisdiction (including, but not limited to England and the United States) in certain cases according to the provisions of the Croatian Law on Resolving Conflicts of Law with Other Countries' Laws and Regulations in Certain Matters (Official Gazette No. 53/1991). Once recognised, a foreign judgement is equal to the judgment of a Croatian court and is fit for enforcement in the Republic of Croatia.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

Some of the statements contained in this Prospectus, as well as written and oral statements that Republic and its representatives make from time to time in reports, filings, news releases, conferences, teleconferences, web postings or otherwise, are or may be deemed to be forward-looking statements. Statements that are not historical facts, including, without limitation, statements about the Republic's beliefs and expectations, are forward-looking statements. These statements are based on current plans, objectives, assumptions, estimates and projections. When used in this Prospectus, the words "anticipates", "estimates", "expects", "believes", "intends", "plans", "aims", "seeks", "may", "will", "should" and any similar expressions generally identify forward-looking statements. Therefore, undue reliance should not be placed on them. The Republic has based these forward-looking statements on its current view with respect to future events and financial results. Forward-looking statements speak only as of the date on which they are made and the Republic undertakes no obligation to update publicly any of them in light of new information or future events. Forward-looking statements involve inherent risks and uncertainties. the Republic cautions that a number of important factors could cause actual results to differ materially from those contained in any forward-looking statement. Forward-looking statements include, but are not limited to: (i) plans with respect to the implementation of economic policy, including privatisations, and the pace of economic and legal reforms; (ii) expectations about the behaviour of the economy if certain economic policies are implemented; (iii) the outlook for gross domestic product, inflation, exchange rates, interest rates, foreign investment, trade and fiscal accounts; and (iv) estimates of external debt repayment and debt service.

In addition to the factors described in this Prospectus, including those discussed under the "*Risk Factors*", the following factors, among others, could cause future results to differ materially from those expressed in any forward-looking statements made herein:

- adverse external factors, such as global or regional economic slowdowns that may affect the Republic, higher international interest rates, reduced demand for the Republic's exports or increases in oil and gas prices, which could each adversely affect the Republic's economy and in particular could negatively affect the current account, balance of payments and international reserves and cause or contribute to recession or low growth in the Republic;
- adverse domestic factors, such as recession, declines in foreign direct investment ("**FDI**") and portfolio investment, high domestic inflation, high domestic interest rates, exchange rate volatility, a reduction in gas supplies, difficulties in borrowing in the domestic and foreign markets, trade and political disputes between the Republic and its trading partners, political uncertainty or lack of political consensus, which could each lead to lower growth in the Republic and lower international currency reserves;
- decisions of the Republic's official creditors regarding the provision of new debt or rescheduling of the existing debt and decisions of international organisations regarding the terms of their financial assistance to the Republic, and accordingly the net cash flow to or from the Republic over the life of the Notes;
- decisions of international financial institutions such as the International Monetary Fund (the "**IMF**"), the World Bank, the European Bank for Reconstruction and Development (the "**EBRD**") and the European Investment Bank (the "**EIB**") regarding the funding of new or existing projects over the life of the Notes; and
- political and economic factors in the Republic and abroad, which affect the timing and structure of economic reforms in the Republic, the success and timing of the Republic's accession to the European Union ("**EU**"), the climate for FDI and the pace, scale and timing of privatisations in the Republic.

DEFINED TERMS AND CONVENTIONS

The following terms are used to refer to economic concepts that are discussed in this Prospectus:

- Gross domestic product ("**GDP**") means the total value of goods and services produced inside a country during the relevant period. Unless otherwise stated references to GDP is to real, rather than nominal, GDP.
- Gross value added ("**GVA**") is the value of output less the value of intermediate consumption; it is a measure of the contribution to GDP made by an individual producer, industry or sector and is used to estimate GDP. GVA (measured by sector) plus taxes minus subsidies equals GDP.
- Imports comprise all goods and services imported from abroad intended either for consumption or for inward processing. Exports comprise all goods and services exported from Croatia, which originate from domestic production or internal trade.
- The registered unemployment rate is calculated as the ratio of the members of the active population who register with local employment agencies as being unemployed to the total active population. "**Active Population**" means people employed and people over the age of 15 registered as seeking employment.
- The inflation rate is measured by the year-on-year percentage change in the consumer price index ("**CPI**"), unless otherwise specified. The CPI index, measures inflation based on the price of a basket of approximately 740 goods and services weighted according to the Household Budget Survey and retail sales data. Croatia also measures inflation in terms of producer price index ("**PPI**"), which is the measure of wholesale prices at the producer level for goods and services. Unlike CPI, the measure does not include services. Year-on-year rates are calculated by comparing the average of the twelve monthly indices for the later period against the average of the twelve monthly indices for the prior period.
- The budget deficit is consolidated revenues minus consolidated expenditures of the general government. This is the principal measure of fiscal balance for countries participating in the European Economic and Monetary Union.
- The Standard International Trade Classification ("**SITC**") is a statistical classification of the commodities entering external trade. It is designed to provide the commodity aggregates required for the purposes of economic analysis and to facilitate the international comparison of trade-by-commodity data.
- Consolidated public debt ("**Consolidated Public Debt**") means total internal and external general government debt plus direct guarantee obligations (i.e. other than the guarantee obligations of HBOR) of Croatia.
- General government debt ("**general government debt**") consists of the sum of: (i) central government debt; (ii) extrabudgetary debt (of government funds and agencies); and (iii) local government debt.

Capitalised terms which are used but not defined in any particular section of this Prospectus will have the meaning attributed thereto in "*Conditions of the Notes*" or any other section of this Prospectus.

Certain figures and percentages included in this Prospectus have been subject to rounding adjustments; accordingly figures shown in the same category presented in different tables may vary slightly and figures shown as totals in certain tables may not be an arithmetic aggregation of the figures which precede them.

References to a "**billion**" are to a thousand million.

All references in this document to "**U.S. dollars**", "**dollars**", "**U.S.$**", "**USD**" and "**$**" refer to United States dollars, and to "**HRK**" and "**Kuna**" refer to the lawful currency for the time being of the Republic. In addition, references to "**euro**", "**EUR**" and "**€**" refer to the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty establishing the European Community, as amended. References to "**Old EU Member States**" refer to Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden and United Kingdom whereas references to "**New EU Member States**" are to all other Member States of the European Union.

INFORMATION SOURCES

The statistical information in this Prospectus has been derived from a number of different identified sources. All statistical information provided in this Prospectus may differ from that produced by other sources for a variety of reasons, including the use of different definitions and cut-off times.

The source for most of the financial and demographic statistics for Croatia included in this Prospectus is data prepared by the Republic's Central Bureau of Statistics ("**CBS**"), a Croatian independent entity established to provide comprehensive statistical information, and the Croatian National Bank ("**CNB**"). The CBS harmonises, to the extent possible, its programmes and methodologies with the statistics of the EU. Certain other financial and statistical information contained herein has been derived from official Croatian government sources including the Ministry of Finance.

EXCHANGE RATES

The following table sets forth, for the periods indicated, the period end, average, high and low official mid-point rates published by the Croatian National Bank, expressed in Kuna per U.S. Dollar.

	Central Bank Rate			
Year Ended 31 December	**Period End**	**Average(1)**	**High**	**Low**
2005	6.233626	5.949959	6.315817	5.556868
2006	5.578401	5.839170	6.233626	5.521655
2007	4.985456	5.365993	5.711720	4.933413
2008	5.155504	4.934417	5.801776	4.522752
2009 (through 22 October)	4.828023	5.367107	5.941123	4.828023
Month Ended				
30 April 2009	5.610218	5.624643	5.726845	5.509606
31 May 2009	5.204211	5.408127	5.593729	5.217300
30 June 2009	5.204507	5.208034	5.321901	5.157039
31 July 2009	5.209672	5.197322	5.289124	5.126397
31 August 2009	5.107545	5.140614	5.209210	5.099204
30 September 2009	4.999548	5.030900	5.172779	4.909580
October 2009 (through 22 October)	4.828023	4.908442	4.997316	4.828023

Source: Croatian National Bank

(1) Average of daily rates.

CONTENTS

SUMMARY

This Summary does not purport to be complete and must be read as an introduction to this Prospectus and any decision to invest in the Notes should be based on a consideration of this Prospectus as a whole.

Words and expressions defined in "*Conditions of the Notes*" shall have the same meanings in this Summary.

THE REPUBLIC OF CROATIA

Territory and Population

The Republic occupies a total area of 56,538 square kilometres. The capital city, Zagreb, is located in the north of the country. The Dinaric Alps, which rise to 1,831 metres above sea level, run the length of the country. Croatia borders Slovenia to the north and Montenegro to the east and shares a sea border with Italy to the west and south. The Danube forms the eastern border with Serbia while the other two large rivers, the Sava and Drava, form the southern and northern borders with Bosnia Herzegovina and Hungary, respectively. The area of land between the rivers is dissected by many smaller tributaries. The Adriatic coastline is the most prominent feature of Croatia, running the entire length of the western border, from the Istrian peninsula in the north to Dubrovnik in the South with approximately 1,185 islands along the coast.

Constitution and Government Structure

A new constitution was adopted on 22 December 1990 and was substantially amended in December 1997, November 2000 and March 2001 (the "**Constitution**"). It established a multi-party democracy, with an economy based on market principles and private ownership. Under the Constitution, the President of Croatia (the "**President**") is elected for five-year terms and may not serve more than two terms. The President appoints, with the consent of the President of the Parliament, a Prime Minister of the Government (the "**Prime Minister**") who, in turn, appoints Government Ministers. Dr. Ivo Sanader was appointed Prime Minister following elections in 2003 and was reappointed following elections in November 2007. In July 2009, Dr. Ivo Sanader voluntarily resigned and Ms. Jadranka Kosor, the Vice Prime Minister at the time, was appointed as the Prime Minister. The Constitution is based on the separation of powers between the legislature, executive and judiciary.

Judicial Reform

In 2008, the Government commenced a reform of the judiciary (the "**Judicial Reform**") in order to combat corruption and restore confidence in the judicial system. The Ministry of Justice is undertaking measures aimed at establishing a more efficient judicial system founded upon principles of independence and professionalism. The objectives of the Judicial Reform include strengthening the rule of law, improving the efficiency and effectiveness of the judicial system, shortening the period of time between the commencement and conclusion of training, and improving professionalism and ongoing training of the staff.

International Relations

After gaining independence, Croatia was admitted to the United Nations (the "**UN**") in May 1992. In the same year, Croatia became a participant country in the Organisation for Security and Co-operation in Europe ("**OSCE**") and became a member of the IMF. In 1996, Croatia became the 40th Member State of the Council of Europe. In October 2000, Croatia became a member of the World Trade Organisation ("**WTO**"), while in 2002 it acceded to the Central European Free Trade Area. Furthermore, Croatia was elected as a non-permanent member of the UN Security Council for the period 2008-2009, holding the Council's Presidency in December 2008. Croatia became a candidate country for EU accession in June 2004 and the negotiation process is expected to enter the final phase in 2010, as discussed below. In April 2009, Croatia acceded to the North Atlantic Treaty Organization ("**NATO**").

European Union Accession

In October 2005, the EU Council of Ministers opened the accession negotiations of Croatia with the EU. In total, 35 chapters of the *acquis communautaire* (as defined below) will be negotiated. The screening exercise for Croatia was successfully completed in October 2006. At the most recent Inter-Governmental Conference on the Croatian EU accession held on 2 October 2009, additional 11 chapters were unblocked and Croatia has provisionally closed five chapters (Freedom of Movement for Workers; Company Law; Customs Union; Statistics; and Trans-European Networks) and opened six chapters (Free Movement of Capital; Taxation; Agriculture and Rural Development; Food Safety, Veterinary and Phytosanitary Policy; Justice, Freedom and Security; and Regional Policy and Coordination of Structural Instruments) for negotiation. Currently, 28 chapters have been formally opened, of which 12 chapters are provisionally closed and 16 chapters remain open.

Economy

The framework and goals of the economic policy of Croatia are defined in a series of strategic documents of the Government, namely: the Strategic Development Framework for 2006-2013, the Economic and Fiscal Policy Guidelines for 2009-2011 and the Pre Accession Economic Program (the "**PEP**"). Those documents provide the basis for the implementation of the economic policy in the medium term period, and they are prepared through consultations between the Government administration bodies and employers' and unions' representatives.

For the period from 2009 until 2011, the main economic policy goal is to maintain macroeconomic stability and ensure sustainable economic growth, increase employment, and strengthen the competitiveness of the Croatian economy.

GDP

The effects of the global financial and economic crisis were first felt in Balkan region in the second half of 2008 and intensified towards the end of the year. The negative impact of the crisis intensified further in the first half of 2009, and the Croatian economy is still experiencing these effects. In particular, GDP growth declined from 5.5 per cent. in 2007 to 2.4 per cent. in 2008, while in the first half of 2009, GDP contracted by approximately 6.5 per cent.

Gross Value Added

GVA growth in real prices decreased by 2.7 per cent. from 5.5 per cent. in 2007 to 2.8 per cent. in 2008, principally due to decreases in GVA growth in the mining and quarrying, manufacturing, electricity, gas and water supply sector, wholesale and retail trade sector and the hotel and restaurant sector. Adverse changes in real GVA in these industries were partially offset by an increase in construction. Real GVA contracted by 4.0 per cent. in the first half of 2009 as compared to the same period in 2008, primarily due to decreases in the wholesale and retail trade sector and decreases in the growth of the mining and quarrying, manufacturing, electricity, gas and water supply sector in large part due to the global financial and economic crisis. These decreases were partially offset by increases in the financial intermediation and public administration sectors.

Inflation

Price stability has been a constant and primary goal of the Croatian National Bank's (the "**CNB**") monetary policy, which the CNB pursues primarily through the maintenance of the relatively stable HRK/EUR exchange rate. The average annual rate of inflation as measured by the consumer price index ("**CPI**") increased from 2.9 per cent. in 2007 to 6.1 per cent. in 2008. This was principally due to a relatively high carry-over effect from 2007, and to a sharp increase in prices of food and refined petroleum products in the first half of 2008. The surge in CPI peaked in July 2008 when their annual rate of change reached 8.4 per cent. The annual rate of change of CPI subsequently decreased to 2.9 per cent. in December 2008. The average annual rate of change of CPI decreased from 3.3 per cent. in the first half of 2009 to 2.8 per cent. as of 31 August 2009. This decrease was due largely to contracting domestic personal consumption and decreasing energy prices.

Summary of the Risk Factors Relating to the Republic and the Notes

- An investment in a developing country such as Croatia is subject to substantially greater risks than an investment in a more developed country.
- Croatia may not succeed in implementing its proposed economic, financial and other reforms and policies which may adversely affect the Croatian economy and the Republic's ability to repay principal and make payments of interest on the Notes.
- The Republic's economy remains vulnerable to external shocks, including the ongoing global financial and economic crisis, which could have an adverse effect on the Republic's economic growth and its ability to service its public debt.
- Croatia may not join the European Union by the target date or at all.
- Depreciation in the Kuna may adversely affect the Croatian economic and financial condition.
- Proliferation of the Euro in the Croatian economy may adversely affect the Government's ability to implement its monetary policies.
- Current account deficit may continue to rise.
- Private Croatian borrowers may not be able to repay or reschedule their debt which may have a material adverse effect on the Croatian economy.
- Foreign banks may diminish or discontinue their support of their subsidiaries operating in Croatia.
- If Government's revenue decreases, some or all of the Government's expenses continue to rise, and state-owned enterprises' dependence on public finances is not reduced, Croatia may not be able to service its public debt and, as a result, to repay principal and make payments of interest on the Notes.
- Corruption and money laundering issues may hinder the growth of the Croatian economy, delay or foreclose EU accession and otherwise have a material adverse effect on Croatia.
- Croatia's legal system is not fully developed and presents greater risks and uncertainties than a more developed legal system.
- The uncertainties relating to the Croatian judicial system could have a negative effect on the economy and thus on the ability of Croatia to repay principal and make payments of interest on the Notes.
- Croatia may not be able to refinance its debt on favourable terms or at all.
- Croatia depends on the tourism industry as a significant source of revenue and any deterioration in the tourism industry may adversely affect the Republic's economy and its ability to service its debt.
- Deterioration in Croatia's relations with its major energy suppliers may adversely affect the supply of energy resources and therefore have a negative effect on the Croatian economy.
- Official economic data may not be accurate.
- There can be no assurance that Croatia's credit rating will not change.
- The Notes may not be a suitable investment for all investors.
- The terms of the Notes may be modified, waived or substituted without the consent of all the Holders of the Notes.
- Event of default.
- EU Savings Directive.
- Law governing the terms of the Notes may change.
- Definitive Notes not denominated in an integral multiple of U.S.$100,000 or its equivalent may be illiquid and difficult to trade.
- Croatian court may not recognise the choice of English law as the law governing the Notes.
- There may be no active trading market for the Notes.
- A claimant may not be able to enforce a court judgment against certain assets of Croatia in certain jurisdictions.
- Fluctuations in exchange rates and interest rates may adversely affect the value of the Notes.
- Legal investment considerations may restrict certain investments.
- Credit ratings may not reflect all risks.

THE OFFERING

Issuer:	The Republic of Croatia
Description of Notes:	U.S.$1,500,000,000 6.750 per cent. Notes due 2019 (the Notes), to be issued by the Republic on 5 November 2009 (the **Issue Date**).
Joint Lead Managers:	Barclays Bank PLC Citigroup Global Markets Limited J.P. Morgan Securities Ltd.
Interest:	6.750 per cent. per annum payable semi-annually in arrear on 5 May and 5 November in each year.
Events of Default:	Events of Default under the Notes include the non-payment of any interest due in respect of the Notes or any of them for a period of 15 days from the due date for payment thereof, breach of other obligations under the Notes (which breach is not remedied within 45 days) and certain events related to the Republic. Notes may only be declared due and payable, upon an Event of Default, if the holders of at least 25 per cent. in aggregate principal amount of the outstanding Notes give notice in writing to the Republic. Furthermore if the Republic receives notice in writing from holders of at least 50 per cent. in aggregate principal amount of the outstanding Notes to the effect that the Event of Default giving rise to a declaration of acceleration is cured and that such holders wish the relevant declaration to be withdrawn, the relevant declaration shall be withdrawn and shall have no further effect.
Negative Pledge:	The terms of the Notes contain a negative pledge provision given by the Republic in respect of Public External Indebtedness as described in Condition 4.
Cross Default:	The terms of the Notes contain a cross default provision, applying to the Public External Indebtedness of the Republic, as described in Condition 10.
Status of the Notes:	The Notes will constitute direct, unconditional, (subject to the provisions of Condition 4) unsecured and unsubordinated and general obligations of the Republic and will rank *pari passu* among themselves and at least (save for certain obligations required to be preferred by law) equally with all other present and future unsecured obligations of the Republic.
Meetings of Noteholders:	The Conditions of the Notes contain provisions for calling meetings of Noteholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Noteholders including Noteholders who did not attend and vote at the relevant meeting and Noteholders who voted in a manner contrary to the majority. The Conditions also contain provisions for the appointment of a Noteholders' representative committee.
Modification:	The Conditions of the Notes contain a provision permitting the Notes and the Conditions of the Notes to be amended without the consent of the Noteholders to correct a manifest error.
Taxation:	All payments in respect of the Notes by or on behalf of the Republic shall be made without withholding or deduction for, or on account of any Taxes as provided in Condition 8.
Listing and admission to trading:	Application has been made to the CSSF to approve this document as a prospectus and to the Luxembourg Stock Exchange for the listing of the Notes on the Official List of the Luxembourg Stock Exchange and admission to trading on the Luxembourg Stock Exchange's regulated market.
Governing Law:	The Notes and any non-contractual obligations arising out of or in connection with the Notes are governed by and shall be construed in

	accordance with, English law, provided however, that the due authorisation and execution of the Notes by and on behalf of the Republic shall be governed by the laws of the Republic.
Form:	The Notes will be issued in registered form in denominations of U.S.$100,000 and integral multiples of U.S.$1,000 in excess thereof.
Credit Ratings:	The Notes are expected to be assigned on issue a rating of Baa3 (stable outlook) by Moody's Investors Service, Inc. ("**Moody's**"), BBB (negative outlook) by Standard & Poor's Rating Services, a division of The McGraw-Hill Companies Inc. ("**S&P**") and BBB- (negative outlook) by Fitch Ratings Ltd. ("**Fitch**"). A credit rating is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating organisation.
Selling Restrictions:	The Notes have not been and will not be registered under the Securities Act and are subject to certain restrictions on transfers. See "*Subscription and Sale*" below.
Use of Proceeds:	The net proceeds of the issue of the Notes will be applied by the Republic for general budgetary governmental purposes.

RISK FACTORS

Investment in the Notes involves a high degree of risk. Prospective investors should carefully consider the following risk factors, together with the other information set out in this Prospectus, before making a decision to invest in the Notes and should understand that the risks set forth below could, individually or in the aggregate, have a material adverse effect on Croatia's capacity to repay principal and make payments of interest on the Notes or otherwise fulfil its obligations under the Notes. Most of these factors are contingencies which may or may not occur and the Issuer is not in a position to express a view on the likelihood of any such contingency occurring. Additional risks and uncertainties not currently known to the Republic or that the Republic currently deems to be immaterial may also materially affect the Republic's economy and its ability to fulfil its obligations under the Notes. In any such case, investors may lose all or part of their investment in the Notes. Words and expressions defined in "*Terms and Conditions of the Notes*" or elsewhere in this Prospectus have the same meanings in this section.

Risk Factors Relating to Croatia

An investment in a developing country such as Croatia is subject to substantially greater risks than an investment in a more developed country

An investment in a country such as Croatia, which achieved independence just over 17 years ago and whose economy is in transition, is subject to substantially greater risks than an investment in a country with a more developed economy and more developed political and legal systems. Although progress has been made in reforming Croatia's economy and political and judicial systems, the development of Croatia's legal infrastructure and regulatory framework is still ongoing. As a consequence, an investment in Croatia carries risks that are not typically associated with investing in more mature markets. Accordingly, investors should exercise particular care in evaluating the risks involved and must decide for themselves whether, in light of those risks, such investment is appropriate. Generally, investments in developing countries, such as Croatia, are only suitable for sophisticated investors who can fully appreciate the significance of the risks involved.

In addition, international investors' reactions to the events occurring in one country sometimes appear to demonstrate a "contagion" effect, in which an entire region or class of investment is disfavoured by international investors. The Republic could be adversely affected by negative economic or financial developments in other countries. There can be no assurance that any crises similar to the ongoing global financial and economic crisis will not negatively affect investor confidence in developing markets, including the Republic.

Croatia may not succeed in implementing its proposed economic, financial and other reforms and policies which may adversely affect the Croatian economy and the Republic's ability to repay principal and make payments of interest on the Notes

Since 1993, Croatia has undergone substantial political transformation from a constituent republic in a federal socialist state to an independent sovereign democracy. In parallel with this transformation, Croatia has been pursuing a programme of economic structural reform with the objective of establishing a market-based economy through privatisation of state enterprises and deregulation of the economy. However, this process is not complete. Croatia has made progress in the transition to a functioning market-based economy, but the rebuilding of Croatia's economic and institutional infrastructure to a Western European standard requires further investment and may take years to complete.

There can be no assurance that the economic and financial initiatives and the reforms described in this Prospectus will continue, will not be reversed or will achieve their intended aims. Failure of the Government of Croatia (the "**Government**") to implement its proposed economic, financial and other reforms and policies may negatively affect the Croatian economy and, as a result, have a material adverse effect on Croatia's capacity to repay principal and make payments of interest on the Notes.

The Republic's economy remains vulnerable to external shocks, including the ongoing global financial and economic crisis, which could have an adverse effect on the Republic's economic growth and its ability to service its public debt

The Republic's economy remains vulnerable to external shocks such as the ongoing global financial and economic crisis. Although in recent years Croatia has made significant gains in stabilising its currency, increasing its GDP, decreasing inflation and increasing real wages, the ongoing global financial and economic crisis negatively affected the Croatian economy. During the current crisis, Croatia has experienced a decline in GDP and FDI, and an increase in net lending/borrowing of the consolidated general government. According to the CBS, estimates Croatia's real GDP contracted by 6.5 per cent. in the first half of 2009, while GDP growth was 2.4 per cent. in 2008, compared to 5.5 per cent. and 4.7 per cent. in 2007 and 2006, respectively. The Government forecasts a GDP contraction of 5.0 per cent. in 2009. Net FDI decreased by 7.8 per cent. in 2008 compared to 2007, while in the first half of 2009 net FDI decreased by 56.9 per cent. compared to the same period in 2008. In the first six months of 2009, net lending/

borrowing of the consolidated general government was 2.3 per cent. of GDP as compared to 0.85% in the same period in 2008.

Despite the fact that Croatia's GDP growth averaged 4.3 per cent. in real terms between 1994 and 2008, this growth pattern has not been sustained in 2009 and may not be sustainable in the future, as indicated by serious external imbalances. One of the main drivers of economic expansion in Croatia in the period 2001-2008 was domestic demand, which grew at an average rate of 5.9 per cent. per year. Private consumption was boosted by the expansion of credit and investment was heavily concentrated in private construction. Such inflows dropped by more than half in the first six months of 2009 as a result of the global financial and economic crisis, due to increased risk aversion by international investors and declining international liquidity. In addition, the gross external debt in Euro terms grew from 53.3 per cent. in 2001 to 82.6 per cent. of GDP (or 197.2 per cent. of exports of goods and services) in 2008. The gross external debt in Euro terms grew from 155.1 per cent. of GDP in the first half of 2008 to 185.3 per cent. in the same period of 2009. There is no assurance that Croatia will return to the growth pattern experienced in 2001-2008 given that it relied heavily on substantial inflows of foreign capital during this period. As the global economy recovers in the future, the positive economic trends of recent years in Croatia may not continue over the longer term and may reverse.

Croatia may not join the European Union by the target date or at all

Croatia commenced negotiations regarding its accession to the EU in October 2005. The Republic's accession depends on many political and economic factors, including the successful conclusion of ongoing negotiations with the relevant EU bodies relating to the level of Croatia's harmonisation with EU law. In addition, in connection with the trial of the former General of the Armed Forces of Croatia, Mr. Ante Gotovina, the International Criminal Tribunal for the former Yugoslavia (the "**ICTY**") has requested that Croatia produce the so-called "artillery logs" which are the artillery journals relating to the Operation Storm. While the efforts to retrieve the artillery logs are ongoing, the ICTY's request to produce them remains outstanding and until such request is fulfilled or withdrawn, the ICTY may insist that Croatia is not in full compliance with the ICTY which, in turn, may result in a suspension of the EU accession negotiations. For the purposes of negotiating Croatia's accession to the EU the total body of EU law with which Croatia is to be harmonised has been divided into 35 chapters (the "***acquis communautaire***"). Although the shared objective of the negotiations is accession to the EU, these negotiations are an open-ended process, the outcome and timing of which cannot be guaranteed.

Currently, out of 35 chapters in total, 28 chapters are formally opened (of which, 12 chapters are provisionally closed) and 7 chapters are yet to be opened. See "*Overview of the Republic of Croatia —International Relations — European Union Accession*". Croatia expects to close all chapters of the *acquis communautaire* by the summer of 2010, and hopes to join the EU by 2012. However, there may not be a uniform desire among the Croatian population to join the EU and there can be no assurance that a national referendum in Croatia would vote to join the EU. There can be no assurance that Croatia will succeed in joining the EU by the target date or at all. In addition, delays or other adverse developments in Croatia's accession to the EU may have a negative effect on the Republic's economic performance and credit ratings.

Depreciation in the Kuna may adversely affect the Croatian economic and financial condition

A substantial share of public external debt (24.7 per cent. as at 31 May 2009) is denominated in foreign currencies, predominantly Euro, therefore Croatia remains vulnerable to currency risk. In the event of a significant devaluation of the Kuna, the negative impact on the service obligations in respect of the debt denominated in foreign currencies will not be completely offset by the positive impact on the service obligations in respect of debt denominated in Kuna. Any significant devaluation of the Kuna may have an adverse effect on the Republic's ability to repay its debt denominated in foreign currencies, including the amounts due under the Notes.

In addition, approximately 75 per cent. of corporate debt and 90 per cent. of household debt are denominated in, or linked to, foreign currency. Only a small fraction of this debt is hedged. In 2009, almost all new lending was linked to foreign currencies. Despite the fact that foreign currency deposits now account for over 60 per cent. of all deposits and that large foreign currency deposits by households reduce currency mismatches at the aggregate level, it does not eliminate macro-level mismatches and there are likely to be mismatches at the individual level between borrowers and depositors as well. The devaluation of the Kuna against foreign currencies may negatively affect the capacity of corporate and household borrowers to repay their debt and as a result adversely affect the financial and economic condition of Croatia.

Proliferation of the Euro in the Croatian economy may adversely affect the Government's ability to implement its monetary policies

In recent years, the role of the Euro in the Croatian economy and circulation of the Euro in Croatia substantially increased as a result of sizeable Euro capital inflows from abroad, including from persons working abroad who send money to their families in Croatia; the tourism industry, in particular the population's willingness to accept Euro from tourists; and the fact that a majority of corporate and household loans are Euro-denominated or Euro-indexed. As the Government's monetary policy mostly impacts Kuna and has limited impact on other currencies including the Euro, significant proliferation of the Euro in the Croatian economy and widespread use of Euro by the Croatian population may undermine the ability of the Government to implement its monetary policies. Similarly, the policies of the European Central Bank affecting the Euro may indirectly impact the Croatian economy. The inability of the Government to implement its monetary policies may have an adverse effect on the Croatian economy and thus on the ability of Croatia to repay principal and make payments of interest on the Notes.

Current account deficit may continue to rise

Croatia's current account deficit almost doubled between 2004 and 30 June 2009 mainly due to the widening trade deficit. Unlike in neighbouring countries, Croatia's exports as percentage of GDP remained flat over the past decade while imports have grown steadily as a result of rising consumption. As a result, the trade deficit increased by 93 per cent. from U.S.$ 8.6 billion in 2004 to U.S.$16.6 billion in 2008. In the first six months of 2009, the trade deficit decreased by 42.8 per cent. to U.S.$5.2 billion from U.S.$9.1 billion in the same period in 2008. The current account deficit increased by 205.9 per cent. in Euro terms and by 111.4 per cent. as a percentage of GDP from EUR 1.4 billion in 2004 (4.4 per cent. of GDP) to EUR 4.4 billion (9.3 per cent. of GDP) in 2008. The current account produced a deficit of EUR 2.7 billion 12.4 per cent. of GDP) in the first six months of 2009. The decrease in the trade deficit and a corresponding decrease in the current account deficit in the first six months of 2009 are largely attributable to imports falling at a more rapid pace than exports as a result of falling energy prices and lower private consumption due to slowing economic activity. Since the economic activity is increasing and energy prices continue to rise, the decreases in the current account and trade deficits may not be sustainable and may reverse. In addition, the export sector has benefited little from the strong capital inflows (including foreign direct investment) experienced in recent years as most capital inflows were used in consumption and non-tradable sectors such as construction, real estate and wholesale and retail trade, resulting in higher imports and a widening current account deficit. The existing current account deficit and any future increases therein may have an adverse effect on the Croatian economy and thus on the ability of Croatia to repay principal and make payments of interest on the Notes.

Private Croatian borrowers may not be able to repay or reschedule their debt which may have a material adverse effect on the Croatian economy

Private debt grew rapidly in recent years as corporate and household sectors accumulated a heavy debt burden. Household debt as a share of GDP is one of the highest among Central and Eastern European countries. Non-publicly guaranteed private sector debt was EUR 30.1 billion at 30 June 2009, as compared to EUR 28.8 billion (60.1 per cent. of GDP), EUR 23.5 billion (54.9 per cent. of GDP), EUR 20.8 billion (53.2 per cent. of GDP) and EUR 17.0 billion (47.5 per cent. of GDP) at 31 December 2008, 2007, 2006 and 2005, respectively. The year-on-year increases in non-publicly guaranteed private sector debt were mainly a consequence of strong foreign corporate borrowing. However, this slowed down noticeably in the last quarter of 2008 as a result of the broader economic slowdown. As of 30 June 2009, principal repayments on non-publicly guaranteed private sector debt in the last quarter of 2009 and 2010 amounted to EUR 2.3 billion and EUR 6.4 billion, respectively. Failure of private borrowers to repay or reschedule their debt may have a material adverse effect on the Croatian economy. In turn, this may affect Croatia's ability to repay principal and make payments of interest on the Notes.

Foreign banks may diminish or discontinue their support of their subsidiaries operating in Croatia

As of 30 June 2009, foreign banks owned approximately 90 per cent. of banks' assets in Croatia. Foreign banks may rebalance their global loan portfolio in a manner adversely affecting Croatia as a result of events related or unrelated to Croatia. In addition, foreign banks may decrease funding to their subsidiaries operating in Croatia due to actual or perceived deterioration in asset quality, particularly in the event of a weaker than expected economic performance. As a result of these or other factors, or other potential shocks, foreign banks may revise their business strategies in, or relating to, Croatia and in particular their decision to fund their subsidiaries in Croatia. This may lead to, among other things, a loss of confidence in the Kuna which, in turn, may result in significant devaluation of Kuna. Resulting balance sheet mismatches may negatively affect the Croatian economy and, as a result, have an adverse effect on Croatia's capacity to repay principal and make payments of interest on the Notes.

If Government's revenue decreases, some or all of the Government's expenses continue to rise, and state-owned enterprises' dependence on public finances is not reduced, Croatia may not be able to service its public debt and, as a result, to repay principal and make payments of interest on the Notes

Government's revenue is expected to decrease from HRK 134.7 billion in 2008 to a projected HRK 128.3 billion in 2009 in large part due to the global financial and economic crisis and may continue to decline. Expenses relating to public wages, social benefits and interest payments in the aggregate represented on average 25.6 per cent. of

Croatia's GDP between 2005 and 2008. In the same period, costs relating to the healthcare system decreased by 11.1 per cent. from HRK 14.4 billion in 2005 to HRK 12.8 billion in 2008, while expenses relating to pensions increased by 22.8 per cent. from HRK 26.7 billion in 2005 to HRK 32.8 billion in 2008. In the absence of adequate reform, the risk of increases in expenses relating to pensions and healthcare over the long-term is compounded by the fact that the old-age dependency ratio (the proportion of people aged 65 or older compared to the working population (people aged 15 to 64)), which increased from 1:0.252 in 2005 to 1:0.256 in 2007, may continue to rise. Expenses related to Government subsidies increased from HRK 5.2 billion to HRK 6.9 billion in the same period. If Government's revenues were to decline and increases in Government's expenses were to continue, the Government's gross operating balance (which is expected to decrease from HRK 4.5 billion in 2008 to a projected HRK -3.7 billion in 2009) may continue to deteriorate. Without sufficient structural reforms aimed at reducing the dependence of state-owned enterprises on public finances and at fostering greater economic efficiency through broader private sector participation, recent revenue raising measures could prove inadequate to cover the continued increases in public debt and interest payments. As a result, the primary deficit could become greater and debt servicing in turn more demanding. Government payment capacity may become further affected by economic cyclical trends and the risk of a delayed recovery of key economic sectors. Reduced revenues, coupled with increasing expenses related to public wages, social benefits, interest payments, healthcare system, pensions and subsidies, may adversely affect Croatia's ability to repay principal and make payments of interest on the Notes.

Corruption and money laundering issues may hinder the growth of the Croatian economy, delay or foreclose EU accession and otherwise have a material adverse effect on Croatia

Independent analysts have identified corruption and money laundering as problems in Croatia. In the 2008 Transparency International Corruption Perceptions Index, Croatia was ranked 62 out of 180 countries under review. In 2008, the Republic commenced a reform of the judicial system in order to combat corruption and restore confidence in the judicial system. See "*Overview of the Republic of Croatia — Constitution and Government Structure — The Judicial System*". The Act on Prevention of Money Laundering and Financing of Terrorism (Official Gazette of Republic of Croatia No. 87/08 — "Act") came into force on 1 January 2009 and is aimed at harmonising Croatian law on prevention of money laundering and financing of terrorism with the provisions of the Third EU Money Laundering Directive (Directive 2005/60/EC). However, there is no certainty as to the success of these measures. Any future allegations or evidence of corruption or money laundering in Croatia may have an adverse effect on the Croatian economy, in particular on Croatia's ability to attract foreign investment, and thus could negatively affect Croatia's ability to repay principal and make payments of interest on the Notes.

Croatia's legal system is not fully developed and presents greater risks and uncertainties than a more developed legal system

Since gaining independence in 1992, the Croatian legal system has been developing to support the transition to a market-based economy. New laws have been introduced and revisions have been made with respect to, amongst others, company, property, competition, securities, labour and taxation laws in order to harmonise them with EU laws. However, the Republic's legal system remains in transition and is therefore subject to greater risks and uncertainties than a more mature legal system. In particular, risks associated with the Croatian legal system include: (i) potential inconsistencies between and among the Constitution and various laws, presidential decrees, governmental, ministerial and local orders, decisions, resolutions and other acts; (ii) provisions in the laws and regulations that are ambiguously worded or lack specificity and thereby raise difficulties when implemented or interpreted; (iii) difficulty in predicting the outcome of judicial application of Croatian legislation; and (iv) the fact that not all Croatian resolutions, orders and decrees and other similar acts are readily available to the public or available in an understandable, organised form.

These and other factors that have an impact on Croatia's legal system make an investment in the Notes subject to greater risks and uncertainties than an investment in a country with a more mature legal system.

The uncertainties relating to the Croatian judicial system could have a negative effect on the economy and thus on the ability of Croatia to repay principal and make payments of interest on the Notes

The independence of the judicial system and its immunity from economic and political influences in Croatia remain questionable. The application and interpretation of the Constitution remain complicated and, accordingly, it is difficult to ensure smooth and effective resolution of discrepancies between the Constitution and applicable Croatian legislation on the one hand and among various laws of Croatia on the other hand.

The court system is underfunded compared to more mature jurisdictions. As Croatia is a civil law jurisdiction, judicial decisions under Croatian law generally have no precedential effect. For the same reason, courts are generally not bound by earlier court decisions taken under the same or similar circumstances, which can result in the inconsistent application of Croatian legislation to resolve the same or similar disputes. Furthermore, to date only a small number of judicial decisions have been publicly available and, therefore, the role of judicial decisions as guidelines in interpreting applicable Croatian legislation to the public at large is generally limited.

In 2008, the Republic commenced a reform of the judicial system. See "*Overview of the Republic of Croatia — Constitution and Government Structure — The Judicial System*". Despite these efforts, judicial decisions in Croatia remain difficult to predict. In addition, court orders are not always enforced or followed by law enforcement institutions. The uncertainties of the Croatian judicial system could have a negative effect on the economy and thus on the ability of Croatia to repay principal and make payments of interest on the Notes.

Croatia may not be able to refinance its debt on favourable terms or at all

The Republic has substantial amounts of internal and external public debt. As at 30 June 2009, Croatia's general government debt excluding Government guarantees was HRK 108.4 billion (31.7 per cent. of 2008 GDP), of which HRK 78.2 billion (72.2 per cent.) was internal debt and HRK 30.2 billion (27.8 per cent.) was external debt. As of October 2009, the average maturity of the public external outstanding debt was 3.86 years whereas the average maturity of the public internal outstanding debt was 3.6 years. Particularly given the relatively short maturity structure of the Republic's borrowing, any deterioration in financing conditions as a result of market, economic or political factors, which may be outside the Republic's control, may jeopardize the debt repayment ability of the Republic and adversely affect the Republic's ability to implement its economic strategy and reforms.

Croatia depends on the tourism industry as a significant source of revenue and any deterioration in the tourism industry may adversely affect the Republic's economy and its ability to service its debt

It is estimated that approximately 8 million tourists visit Croatia annually. Tourism contributes substantially to Croatia GDP. Revenue generated by the tourism industry depends on various factors including consumer spending power as a result of economic downturns and public perception of the attractiveness and safety of a potential tourist destination.

Negative developments affecting these and other factors may adversely affect the tourism industry and have negative effects on the Croatian economy and thus on the ability of Croatia to repay principal and make payments of interest on the Notes.

Deterioration in Croatia's relations with its major energy suppliers may adversely affect the supply of energy resources and therefore have a negative effect on the Croatian economy

Croatia's economy depends on its trade flows with certain other countries largely because Croatia imports a large percentage of its energy requirements. If bilateral trade relations with Croatia's major energy suppliers were to deteriorate or if supplies of oil and/or natural gas to Croatia were to be restricted, the Republic's economy could be adversely affected. In addition, an increase in the price for natural gas could adversely affect the pace of economic growth of Croatia. Furthermore, although higher gas prices have increased pressure for reforms in the energy sector, for modernisation of major energy-consuming industries of Croatia through the implementation of energy-efficient technologies and for the modernisation of production facilities, there can be no assurance that these reforms and modernisations will be implemented or will succeed. Any major changes in relations with major energy suppliers to Croatia, in particular any such changes adversely affecting supplies of energy resources to Croatia, may have adverse effects on the Croatian economy.

Official economic data may not be accurate

Although a range of government ministries including the Ministry of Finance, along with the CNB and the CBS, produce statistics on Croatia and its economy, there can be no assurance that these statistics are as accurate or as reliable as those compiled in more developed countries. Prospective investors in the Notes should be aware that figures relating to Croatia's GDP and many other aggregate figures cited in this Prospectus may be subject to some degree of uncertainty and may not be prepared in accordance with international standards. Furthermore, standards of accuracy of statistical data may vary from ministry to ministry or from period to period due to the application of different methodologies. In this Prospectus, data are presented as provided by the relevant ministry to which the data is attributed, and no attempt has been made to reconcile such data to the data compiled by other ministries or by other organisations, such as the IMF or World Bank. Since 2005 Croatia has produced data in accordance with the IMF's Special Data Dissemination Standard. There can be no assurance, however, that this IMF standard has been fully implemented or correctly applied. The existence of a sizeable unofficial or unobserved economy may also affect the accuracy and reliability of statistical information. Prospective investors should be aware that none of the statistical information in this Prospectus has been independently verified.

There can be no assurance that Croatia's credit rating will not change

Long-term debt of the Republic is currently rated BBB (Negative Outlook) by S&P, Baa3 (Stable Outlook) by Moody's and BBB- (Negative Outlook) by Fitch. A security rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency. Any adverse change in an applicable credit rating could adversely affect the trading price for the Notes.

Risk Factors Relating to an Investment in the Notes

The Notes may not be a suitable investment for all investors

Each potential investor in the Notes must determine the suitability of that investment in light of its own circumstances. In particular, each potential investor should:

- have sufficient knowledge and experience to make a meaningful evaluation of the Notes, the merits and risks of investing in the Notes and the information contained in this Prospectus or any applicable supplement;
- have access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Notes and the impact the Notes will have on its overall investment portfolio;
- have sufficient financial resources and liquidity to bear all of the risks of an investment in the Notes, including where the currency for principal or interest payments is different from the potential investor's currency;
- understand thoroughly the terms of the Notes and be familiar with the behaviour of any relevant financial markets; and
- be able to evaluate (either alone or with the help of a financial adviser) possible scenarios for economic, interest rate and other factors that may affect its investment and its ability to bear the applicable risks.

The terms of the Notes may be modified, waived or substituted without the consent of all the Holders of the Notes

The conditions of the Notes contain provisions for calling meetings of Noteholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Noteholders including Noteholders who did not attend and vote at the relevant meeting and Noteholders who voted in a manner contrary to the majority. Any such change in the terms of the Notes may adversely affect the trading price of the Notes.

The conditions of the Notes contain a provision permitting the Notes and the conditions of the Notes to be amended without the consent of the Noteholders to correct a manifest error.

Event of Default

The conditions of the Notes contain a provision which, if an Event of Default occurs, allows the holders of at least 25 per cent. in aggregate principal amount of the outstanding Notes to declare all the Notes to be immediately due and payable by providing notice in writing to the Republic, whereupon the Notes shall become immediately due and payable, at their principal amount with accrued interest, without further action or formality.

The conditions of the Notes also contain a provision permitting the holders of at least 50 per cent. in aggregate principal amount of the outstanding Notes to notify the Republic to the effect that the Event of Default or Events of Default giving rise to any above mentioned declaration is or are cured following any such declaration and that such holders wish the relevant declaration to be withdrawn. The Republic shall give notice thereof to the Noteholders, whereupon the relevant declaration shall be withdrawn and shall have no further effect.

EU Savings Directive

Under EC Council Directive 2003/48/EC on the taxation of savings income, Member States are required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State. However, for a transitional period, Belgium, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate withholding system in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries). A number of non-EU countries and territories including Switzerland have adopted similar measures (a withholding system in the case of Switzerland).

On 15 September 2008 the European Commission ("**EC**") issued a report to the Council of the European Union on the operation of the Directive, which included the Commission's advice on the need for changes to the Directive. On 13 November 2008 the EC published a more detailed proposal for amendments to the Directive, which included a number of suggested changes. If any of those proposed changes are made in relation to the Directive, they may amend or broaden the scope of the requirements described above.

If a payment were to be made or collected through a Member State which has opted for a withholding system and an amount of, or in respect of, tax were to be withheld from that payment, neither the Republic nor any Agent nor any other person would be obliged to pay additional amounts with respect to any Note as a result of the imposition of such withholding tax. The Republic is required to maintain an Agent in a Member State that is not obliged to withhold or deduct tax pursuant to the Directive.

Law governing the terms of the Notes may change

The conditions of the Notes are based on English law in effect as at the date of this Prospectus. No assurance can be given as to the impact of any possible judicial decision or change to English law or administrative practice after the date of this Prospectus.

Definitive Notes not denominated in an integral multiple of U.S.$100,000 or its equivalent may be illiquid and difficult to trade

The Notes have denominations consisting of a minimum of U.S.$100,000 plus integral multiples of U.S.$1,000 in excess thereof. It is possible that the Notes may be traded in amounts that are not integral multiples of U.S.$100,000. In each such a case a holder who, as a result of trading such amounts, holds an amount which is less than U.S.$100,000 in his account with the relevant clearing system at the relevant time may not receive a Certificate in respect of such holding (should Certificates be printed) and would need to purchase a principal amount of Notes such that its holding amounts to U.S.$100,000.

If Certificates are issued, holders should be aware that Certificates which have a denomination that is not an integral multiple of U.S.$100,000 or its equivalent may be illiquid and more difficult to trade than Notes denominated in an integral multiple of U.S.$100,000 plus integral multiples of U.S.$1,000 in excess thereof.

Croatian court may not recognise the choice of English law as the law governing the Notes

The Notes are governed by English law and the Republic has submitted to the non-exclusive jurisdiction of the courts of England to settle any disputes that may arise out of or in connection with any Note. In respect of any proceedings between (i) the Republic and a Croatian natural or legal person (which proceedings also includes a non-Croatian natural or legal person) or (ii) the Republic and a non-Croatian natural or legal person, a Croatian court will recognise and give effect to the choice of English law as the law governing the Notes if the merits of the dispute in question have an international element. In respect of recognition and/or enforcement of an English/foreign court judgement, Croatian courts may refuse to recognise such judgements only in certain cases according to the provisions of the Croatian Law on Resolving Conflicts of Law with Other Countries' Laws and Regulations in Certain Matters (Official Gazette No. 53/1991). Once recognised, the foreign judgement is equal to the judgment of a Croatian court and is fit for enforcement in the Republic of Croatia.

There may be no active trading market for the Notes

Although an application has been made to list on the Official List and trade the Notes on the Regulated Market "Bourse de Luxembourg" of the Luxembourg Stock Exchange, there is no assurance that such application will be accepted or that an active trading market for the Notes will develop or, if one does develop, that it will be liquid or maintained. If an active trading market in the Notes does not develop or is not maintained, the market price and liquidity of the Notes may be adversely affected.

The market for securities issued by Croatia is influenced by economic and market conditions in Croatia and, to a varying degree, economic conditions in other Eastern European markets as well as global, emerging and developed markets generally. There can be no assurance that events which would cause volatility of the sort that occurred in worldwide financial markets in 1998 and 2008 will not occur again, or that any such volatility will not adversely affect the price or liquidity of the Notes.

In addition, if the Notes are traded after their initial issuance, they may trade at a discount to their initial offering price, depending upon prevailing interest rates, the market for similar securities, general economic conditions and the financial condition of the Republic. As a result of the above factors, investors may not be able to sell their Notes easily or at prices that will provide them with a yield comparable to similar investments that have a developed secondary market.

A claimant may not be able to enforce a court judgment against certain assets of Croatia in certain jurisdictions

Croatia is a sovereign state. There is a risk that, notwithstanding the waiver of sovereign immunity by Croatia, a claimant will not be able to enforce a court judgment against certain assets of Croatia in certain jurisdictions (including the imposition of any arrest order or attachment or seizure of such assets and their subsequent sale) without Croatia having specifically consented to such enforcement at the time when the enforcement is sought.

The foreign exchange reserves of Croatia are controlled and administered by the CNB, which is an independent central bank legally distinct from the Government. Accordingly, such reserves would not be available to satisfy any claim or judgment in respect of the Notes.

Fluctuations in exchange rates and interest rates may adversely affect the value of the Notes

The Issuer will pay principal and interest on the Notes in U.S.$. This presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit (the "**Investor's Currency**") other than U.S.$. These include the risk that exchange rates may significantly change (including changes due to devaluation of the U.S.$ or revaluation of the Investor's Currency) and the risk that authorities with jurisdiction over the Investor's Currency may impose or modify exchange controls. An appreciation in the value of the Investor's Currency relative to U.S.$ would decrease (1) the Investor's Currency-equivalent yield on the Notes, (2) the Investor's Currency equivalent value of the principal payable on the Notes and (3) the Investor's Currency equivalent market value of the Notes.

Government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate. As a result, investors may receive less interest or principal than expected, or no interest or principal. In addition, investment in the Notes involves the risk that subsequent changes in market interest rates may adversely affect the value of the Notes.

Legal investment considerations may restrict certain investments

The investment activities of certain investors are subject to legal investment laws and regulations, or review or regulation by certain authorities. Each potential investor should consult its legal advisers to determine whether and to what extent (1) the Notes are legal investments for it, (2) the Notes can be used as collateral for various types of borrowing and (3) other restrictions apply to its purchase or pledge of the Notes. Financial institutions should consult their legal advisors or the appropriate regulators to determine the appropriate treatment of the Notes under any applicable risk-based capital or similar rules.

Credit ratings may not reflect all risks

Moody's, S&P and Fitch have assigned credit ratings to the Notes. The ratings may not reflect the potential impact of all risks related to structure, market, additional factors discussed above, and other factors that may affect the value of the Notes. A credit rating is not a recommendation to buy, sell or hold securities and may be revised or withdrawn by the rating agency at any time.

CONDITIONS OF THE NOTES

The following is the text of the Conditions of the Notes which (subject to modification and except for the paragraphs in italics) will be endorsed on the Certificates issued in respect of the Notes:

The U.S.$1,500,000,000 6.750 per cent. Notes due 2019 (the "**Notes**", which expression shall in these Conditions, unless the context otherwise requires, include any further notes issued pursuant to Condition 14 (*Further Issues*) and forming a single series with the Notes of the Republic of Croatia (the "**Republic**") are issued subject to and with the benefit of an Agency Agreement dated 5 November 2009 (such agreement as amended and/or supplemented and/or restated from time to time, the "**Agency Agreement**") made between the Republic, Citigroup Global Markets Deutschland AG & Co. as registrar (the "**Registrar**"), Citibank, N.A., London Branch as fiscal agent and transfer agent (the "**Fiscal Agent**" and "**Transfer Agent**") and the other initial paying agents named in the Agency Agreement (together with the Fiscal Agent, the "**Paying Agents**") and the other agents named in it (together with the Fiscal Agent, the Registrar and the other Paying Agents, the "**Agents**"). The holders of the Notes (the "**Noteholders**") are entitled to the benefit of a Deed of Covenant (the "**Deed of Covenant**") dated 5 November 2009 and made by the Republic. The original of the Deed of Covenant is held by the Fiscal Agent on behalf of the Noteholders at its specified office.

The statements in these Conditions include summaries of, and are subject to, the detailed provisions of and definitions in the Agency Agreement. Copies of the Agency Agreement are available for inspection during normal business hours by the holders of the Notes (the "**Noteholders**") appertaining to the Notes at the specified office of each of the Paying Agents. The Noteholders are entitled to the benefit of, are bound by, and are deemed to have notice of, all the provisions of the Agency Agreement and the Deed of Covenant applicable to them. References in these Conditions to the Fiscal Agent, the Registrar, the Paying Agents and the Agents shall include any successor appointed under the Agency Agreement.

*The owners shown in the records of Euroclear Bank S.A./N.V., as operator of the Euroclear System ("**Euroclear**"), Clearstream Banking, société anonyme ("**Clearstream, Luxembourg**") and the Depository Trust Company ("**DTC**") of book-entry interests in Notes are entitled to the benefit of, are bound by, and are deemed to have notice of, all the provisions of the Agency Agreement applicable to them.*

1. FORM, DENOMINATION AND TITLE

1.1 Form and Denomination

The Notes are issued in registered form in amounts of U.S.$100,000 and integral multiples of U.S.$1,000 in excess thereof (referred to as the "**principal amount**" of a Note). A note certificate (each a "**Certificate**") will be issued to each Noteholder in respect of its registered holding of Notes. Each Certificate will be numbered serially with an identifying number which will be recorded on the relevant Certificate and in the Register (as defined below) which the Republic will procure to be kept by the Registrar.

The Notes are not issuable in bearer form.

1.2 Title

The Registrar will maintain a register (the "**Register**") in respect of the Notes in accordance with the provisions of the Agency Agreement. Title to the Notes passes only by registration in the Register. The holder of any Note will (except as otherwise required by law) be treated as its absolute owner for all purposes (whether or not it is overdue and regardless of any notice of ownership, trust or any interest or any writing on, or the theft or loss of, the Certificate issued in respect of it) and no person will be liable for so treating the holder. In these Conditions "**Noteholder**" and (in relation to a Note) "**holder**" means the person in whose name a Note is registered in the Register.

For a description of the procedures for transferring title to book-entry interests in the Notes, see the Agency Agreement and Condition 2 (Transfers of Notes and Issue of Certificates).

2. TRANSFERS OF NOTES AND ISSUE OF CERTIFICATES

2.1 Transfers

A Note may be transferred by depositing the Certificate issued in respect of that Note, with the form of transfer on the back duly completed and signed, at the specified office of the Registrar or any of the Agents.

For a description of certain restrictions on transfers of interests in the Notes, see "Transfer Restrictions" and the Agency Agreement.

2.2 Delivery of new Certificates

Each new Certificate to be issued upon transfer of Notes will, within five business days of receipt by the Registrar or the relevant Agent of the duly completed form of transfer endorsed on the relevant Certificate, be mailed by uninsured mail at the risk of the holder entitled to the Note to the address specified in the form of transfer. For the purposes of this Condition, **business day** shall mean a day on which commercial banks and foreign exchange markets are open for business in the city in which the specified office of the Agent with whom a Certificate is deposited in connection with a transfer is located.

Except in the limited circumstances described herein (see "The Global Certificates — Registration of Title" and "The Global Certificates — Exchange For Certificates"), owners of interests in the Notes will not be entitled to receive physical delivery of Certificates. Issues of Certificates upon transfer of Notes are subject to compliance by the transferor and transferee with the certification procedures described above and in the Agency Agreement and, in the case of Restricted Certificates, compliance with the Securities Act Legend.

Where some but not all of the Notes in respect of which a Certificate is issued are to be transferred a new Certificate in respect of the Notes not so transferred will, within five business days of receipt by the Registrar or the relevant Agent of the original Certificate, be mailed by uninsured mail at the risk of the holder of the Notes not so transferred to the address of such holder appearing on the Register or as specified in the form of transfer.

2.3 Formalities free of charge

Registration of transfer of Notes will be effected without charge by or on behalf of the Republic or any Agent but upon payment (or the giving of such indemnity as the Republic or any Agent may reasonably require) in respect of any tax or other governmental charges which may be imposed in relation to such transfer.

2.4 Closed Periods

No Noteholder may require the transfer of a Note to be registered during the period of 15 days ending on the due date for any payment of principal, premium or interest on that Note.

2.5 Regulations

All transfers of Notes and entries on the Register will be made subject to the detailed regulations concerning transfer of Notes scheduled to the Agency Agreement. The regulations may be changed by the Republic with the prior written approval of the Registrar. A copy of the current regulations will be mailed (free of charge) by the Registrar to any Noteholder who requests one.

3. STATUS

The Notes constitute direct, unconditional, (subject to the provisions of Condition 4 (*Negative Pledge*) unsecured and unsubordinated and general obligations of the Republic. The Notes rank *pari passu,* without any preference among themselves, and at least *pari passu* in right of payment with all other present and future unsecured obligations of the Republic, save only for such obligations as may be preferred by mandatory provisions of applicable law.

4. NEGATIVE PLEDGE AND OTHER COVENANTS

4.1 Negative Pledge

So long as any of the Notes remains outstanding (as defined in the Agency Agreement), the Republic will not grant or permit to be outstanding any mortgage, charge, lien, pledge or other security interest (each a "**Security Interest**"), other than a Permitted Security Interest, over any of its present or future assets or revenues or any part thereof, to secure any Public External Indebtedness of the Republic or any other person or any guarantee of the Republic in respect of Public External Indebtedness, unless the Republic shall, in the case of granting of the security, before or at the same time, and in any other case, promptly, procure that the Republic's obligations under the Notes are secured equally and rateably therewith.

Certain Definitions:

In these Conditions:

Permitted Security Interest means:

(a) any Security Interest upon property (or any revenues therefrom) to secure Public External Indebtedness incurred for the purpose of financing the acquisition or construction of such property (or property which forms part of a class of assets of a similar nature where the Security Interest is by reference to the constituents of such class from time to time);

(b) any Security Interest existing on property (or any revenues therefrom) at the time of its acquisition;

(c) any Security Interest arising by operation of law which has not been foreclosed or otherwise enforced against the assets to which it applies;

(d) any Security Interest securing or providing for the payment of Public External Indebtedness incurred in connection with any Project Financing provided that such Security Interest only applies to (i) properties which are the subject of such Project Financing or (ii) revenues or claims which arise from the operation, failure to meet specifications, exploitation, sale or loss of, or failure to complete, or damage to, such properties; or

(e) the renewal or extension of any Security Interest described in sub paragraphs (a) and (b) above, provided that the principal amount of the original financing secured thereby is not increased.

Project Financing means any arrangement for the provision of funds which are to be used principally to finance a project for the acquisition, construction, development or exploitation of any property pursuant to which the persons providing such funds agree that the principal source of repayment of such funds will be the project and the revenues (including insurance proceeds) generated by such project.

Public External Indebtedness means any obligation for borrowed money which is (a) in the form of or represented by notes, bonds or other similar securities and which is listed or capable of being listed on any stock exchange and (b) denominated or payable, or at the option of the holder thereof payable, in a currency other than the lawful currency of the Republic provided that, if at any time the lawful currency of the Republic is the euro, then any indebtedness as described in (a) denominated or payable, or at the option of the holder thereof payable, in euro, shall be included in "Public External Indebtedness".

5. INTEREST

5.1 Interest Rate and Interest Payment Dates

The Notes bear interest on their outstanding principal amount from and including 5 November 2009 at the rate of 6.750 per cent. per annum, payable semi-annually in arrear on 5 May and 5 November in each year (each an "**Interest Payment Date**"). The first payment (representing a half-year's interest) for the period from and including 5 November 2009 to but excluding 5 May 2010 and amounting to U.S.$3,375 per U.S.$100,000 principal amount of Notes shall be made on 5 May 2010.

5.2 Interest Accrual

Each Note will cease to bear interest from and including its due date for redemption unless, upon due presentation, payment of the principal in respect of the Note is improperly withheld or refused or unless default is otherwise made in respect of payment. In such event, interest will continue to accrue until whichever is the earlier of:

(a) the date on which all amounts due in respect of such Note have been paid; and

(b) the day on which notice has been given to the Noteholders that the Fiscal Agent or the Registrar has received all sums due in respect of the Notes up to such day (except, in the case of payment to the Fiscal Agent or the Registrar to the extent that there is any subsequent default in payment in accordance with these Conditions).

5.3 Calculation of Broken Interest

When interest is required to be calculated in respect of a period of less than a half-year, it shall be calculated on the basis of a 360-day year consisting of 12 months of 30 days each and, in the case of an incomplete month, the number of days elapsed on the basis of a month of 30 days.

6. PAYMENTS

6.1 Payments in respect of Notes

Payment of principal and interest will be made by transfer to the registered account of the Noteholder or by U.S.$ cheque drawn on a bank that processes payments in U.S.$ mailed to the registered address of the Noteholder if it does not have a registered account. Payments of principal and payments of interest due otherwise than on an Interest Payment Date will only be made against surrender of the relevant Certificate at the specified office of any of the Agents. Interest on Notes due on an Interest Payment Date will be paid to the holder shown on the Register at the close of business on the date (the "**record date**") being the fifteenth day before the due date for the payment of interest.

For the purposes of this Condition, a Noteholder's registered account means the U.S.$ account maintained by or on behalf of it with a bank that processes payments in U.S.$, details of which appear on the Register at the close of business, in the case of principal, on the second business day (as defined below) before the due date for payment and, in the case of interest, on the relevant record date, and a Noteholder's registered address means its address appearing on the Register at that time.

6.2 Payments subject to Applicable Laws

Payments in respect of principal and interest on Notes are subject in all cases to any fiscal or other laws and regulations applicable in the place of payment, but without prejudice to the provisions of Condition 8 (*Taxation*).

6.3 No commissions

No commissions or expenses shall be charged to the Noteholders in respect of any payments made in accordance with this Condition.

6.4 Payment on Business Days

Where payment is to be made by transfer to a registered account, payment instructions (for value the due date or, if that is not a Business Day (as defined below), for value the first following day which is a Business Day) will be initiated and, where payment is to be made by cheque, the cheque will be mailed, on the Business Day preceding the due date for payment or, in the case of a payment of principal or a payment of interest due otherwise than on an Interest Payment Date, if later, on the Business Day on which the relevant Certificate is surrendered at the specified office of an Agent.

Noteholders will not be entitled to any interest or other payment for any delay after the due date in receiving the amount due if the due date is not a Business Day, if the Noteholder is late in surrendering its Certificate (if required to do so) or if a cheque mailed in accordance with this Condition arrives after the due date for payment.

In this Condition **"Business Day"** means a day (other than a Saturday or Sunday) on which commercial banks are open for business in London, New York City and, in the case of presentation of a Note Certificate, in the place in which the Note Certificate is presented.

6.5 Partial Payments

If the amount of principal or interest which is due on the Notes is not paid in full, the Registrar will annotate the Register with a record of the amount of principal, premium (if any) or interest in fact paid.

6.6 Agents

The names of the initial Agents and their initial specified offices are set out at the end of these Conditions. The Republic reserves the right at any time to vary or terminate the appointment of any Agent and to appoint additional or other Agents provided that:

(a) there will at all times be a Fiscal Agent;

(b) there will at all times be an Agent (which may be the Fiscal Agent) having a specified office in a major European city;

(c) the Republic undertakes that it will ensure that it maintains a Paying Agent in a Member State of the European Union that is not obliged to withhold or deduct tax pursuant to European Council Directive 2003/48/EC or any law implementing or complying with, or introduced in order to conform to, such Directive; and

(d) a Registrar.

Notice of any termination or appointment and of any changes in specified offices given to the Noteholders promptly by the Republic in accordance with Condition 12 (*Notices*).

7. REDEMPTION AND PURCHASE

7.1 Redemption at Maturity

Unless previously redeemed or purchased and cancelled as provided below, the Republic will redeem the Notes at their principal amount on 5 November 2019.

7.2 Purchases

The Republic may at any time purchase Notes at any price in the open market or otherwise. The Notes so purchased, while held on behalf of the Republic, shall not entitle the holder to vote at any meetings of the Noteholders and shall not be deemed to be outstanding for the purposes of calculating the quorum of meetings of Noteholders or for the purpose of Condition 13 (*Meetings of Noteholders; Modification; and Noteholders' Representative Committee*).

7.3 Cancellations

All Notes which are (a) redeemed or (b) purchased by or on behalf of the Republic may, but need not, be cancelled at the election of the Republic. Any Notes so cancelled will not be reissued or resold.

8. TAXATION

8.1 Payment without Withholding

All payments in respect of the Notes by or on behalf of the Republic shall be made without withholding or deduction for, or on account of, any present or future taxes, duties, assessments or governmental charges of whatever nature imposed, levied collected, withheld or assessed by or on behalf of the Republic or any political subdivision or any authority thereof or therein having power to tax (together "**Taxes**"), unless the withholding or deduction of the Taxes is required by law. In that event, the Republic will pay such additional amounts as may be necessary in order that the net amounts received by the Noteholders after the withholding or deduction shall equal the respective amounts which would have been receivable in respect of the Notes in the absence of the withholding or deduction; except that no additional amounts shall be payable in relation to any payment in respect of any Note:

(a) to a holder, or to a third party on behalf of a holder, if such holder is liable to such Taxes in respect of such Note by reason of his having some connection with the Republic other than the mere holding of the Note; or

(b) if such Note is surrendered for payment more than 30 days after the Relevant Date (as defined below), except to the extent that the holder would have been entitled to such additional amounts on surrender of such Note for payment on the last day of such period of 30 days assuming that day to have been a Business Day (as defined in Condition 6 (*Payments*)); or

(c) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to European Council Directive 2003/48/EC or any law implementing or complying with, or introduced in order to conform to, such Directive; or

(d) to a holder, or to a third party on behalf of a holder who would have been able to avoid such withholding or deduction by presenting the relevant Note to another Paying Agent in a Member State of the European Union.

8.2 Interpretation

In these Conditions **Relevant Date** means the date on which the payment first becomes due but, if the full amount of the money payable has not been received by the Fiscal Agent on or before the due date, it means the date on which, the full amount of the money plus any accrued interest having been so received, notice to that effect has been duly given to the Noteholders by the Republic in accordance with Condition 12 (*Notices*).

8.3 Additional Amounts

Any reference in these Conditions to any amounts in respect of the Notes shall be deemed also to refer to any additional amounts which may be payable under this Condition.

9. PRESCRIPTION

Claims in respect of principal and interest will become prescribed unless made within 10 years (in the case of principal) and five years (in the case of interest) from the Relevant Date, as defined in Condition 8 (*Taxation*).

10. EVENTS OF DEFAULT

10.1 If any of the following events (each an "**Event of Default**") occurs and is continuing:

(a) if default is made in the payment of any interest due in respect of the Notes or any of them and the default continues for a period of 15 days from the due date for payment thereof; or

(b) if the Republic fails duly to perform or observe any of its other obligations under these Conditions and such failure continues unremedied for 45 days after written notice thereof has been delivered by any Noteholder to the Fiscal Agent; or

(c) the Republic ceases to be a member of the International Monetary Fund ("**IMF**") or to be eligible to use the general resources of the IMF, and such situation continues unremedied for 45 days after written notice thereof has been delivered by any Noteholder to the Fiscal Agent; or

(d) (a) the acceleration of the maturity (other than by optional or mandatory redemption or other prepayment) of any Public External Indebtedness of the Republic, (b) the Republic defaults in the payment of any principal of or interest on any of its Public External Indebtedness when and as the same shall become due and payable, and such default continues for more than the period of grace, if any, originally applicable thereto or (in the case of interest where such grace period does not exist or is less than 30 days) 30 days, or (c) the Republic defaults in the payment when due and called upon (after the expiry of the period of grace, if any, originally applicable thereto or (in the case of payment where such grace period does not exist or is less than 30 days) 30 days) of any guarantee or indemnity of the Republic in respect of any Public External Indebtedness, provided that the aggregate amount of the relevant Public External Indebtedness in respect of which one or more of the events mentioned in this paragraph (iv) have occurred equals or exceeds US$70,000,000 or its equivalent; or

(e) if the Republic shall declare a general moratorium on the payment of principal of, or interest on the Public External Indebtedness of the Republic,

then the holders of at least 25 per cent. in aggregate principal amount of the outstanding Notes may, by notice in writing to the Republic (with a copy to the Fiscal Agent), declare all the Notes to be immediately due and payable, whereupon they shall become immediately due and payable at their principal amount together with accrued interest without further action or formality. Notice of any such declaration shall promptly be given to all other Noteholders by the Republic.

10.2 If the Republic receives notice in writing from holders of at least 50 per cent. in aggregate principal amount of the outstanding Notes to the effect that the Event of Default or Events of Default giving rise to any above mentioned declaration of acceleration is or are cured following any such declaration and that such holders wish the relevant declaration to be withdrawn, the Republic shall give notice thereof to the Noteholders (with a copy to the Fiscal Agent), whereupon the relevant declaration shall be withdrawn and shall have no further effect but without prejudice to any rights or obligations which may have arisen before the Republic gives such notice (whether pursuant to these Conditions or otherwise). No such withdrawal shall affect any other or any subsequent Event of Default or any right of any Noteholder in relation thereto.

11. REPLACEMENT OF CERTIFICATES

If any Certificate is lost, stolen, mutilated, defaced or destroyed it may be replaced at the specified office of the Registrar or the Fiscal Agent upon payment by the claimant of the expenses incurred in connection with the replacement and on such terms as to evidence and indemnity as the Republic may reasonably require. Mutilated or defaced Certificates must be surrendered before replacements will be issued.

12. NOTICES

12.1 Notices to the Noteholders

All notices to the Noteholders will be valid if mailed to them at their respective addresses in the Register maintained by the Registrar and published in a leading English language newspaper of general circulation in Europe (which is expected to be the *Financial Times*) and so long as the Notes are listed on the Luxembourg Stock Exchange and the rules of that Exchange so require, published in a daily newspaper in Luxembourg (which is expected to be the *Luxembourger Wort*) and/or the website of the Luxembourg Stock Exchange, *www.bourse.lu*. The Republic shall also ensure that notices are duly given or published in a manner which complies with the rules and regulations of any stock exchange or other relevant authority on which the Notes are for the time being listed. Any notice shall be deemed to have been given on the second day after being so mailed or on the date of publication or, if so published more than once or on different dates, on the date of the first publication.

All notices to the Republic will be valid if sent to the Republic at the Ministry of Finance of the Republic of Croatia, Zagreb or such other address as may be notified by the Republic to the Noteholders in accordance with the above paragraph of this Condition.

13. MEETINGS OF NOTEHOLDERS; MODIFICATION; AND NOTEHOLDERS' REPRESENTATIVE COMMITTEE

13.1 Convening Meetings of Noteholders

The Agency Agreement contains provisions for convening meetings of Noteholders to consider matters relating to the Notes, including the modification of any provision of these Conditions or the provisions of the Agency Agreement. Such a meeting may be convened by the Republic or the Fiscal Agent and shall be convened by the Republic or the Fiscal Agent at any time upon the request in writing of holders of at least 10 per cent. of the aggregate principal amount of the outstanding Notes.

13.2 Quorum

The quorum at any meeting of Noteholders convened to vote on an Extraordinary Resolution will be:

(a) one or more persons present and holding or representing at least 50 per cent. of the aggregate principal amount of the outstanding Notes; or

(b) where a meeting is adjourned and rescheduled owing to a lack of quorum, at any rescheduled meeting of Noteholders, one or more persons present and holding or representing at least 25 per cent. of the aggregate principal amount of the outstanding Notes;

provided, however, that any proposals relating to a Reserved Matter may only be approved by an Extraordinary Resolution passed at a meeting of Noteholders at which one or more persons present and holding or representing at least 75 per cent. of the aggregate principal amount of the outstanding Notes form a quorum.

13.3 Reserved Matters

In these Conditions, "Reserved Matter" means any proposal:

(a) to change the date, or the method of determining the date, for payment of principal, interest or any other amount in respect of the Notes, to reduce or cancel the amount of principal, interest or any other amount payable on any date in respect of the Notes or to change the method of calculating the amount of principal, interest or any other amount payable in respect of the Notes on any date;

(b) to change the currency in which any amount due in respect of the Notes is payable or the place in which any payment is to be made;

(c) to change the quorum required at any meeting of Noteholders or the majority required to pass an Extraordinary Resolution, Written Resolution or any other resolution of Noteholders or the number or percentage of votes required to be cast, or the number or percentage of Notes required to be held, in connection with the taking of any decision or action by or on behalf of the Noteholders or any of them;

(d) to change this definition, the definition of "Extraordinary Resolution", the definition of "outstanding" or the definition of "Written Resolution" in these Conditions or in the Agency Agreement;

(e) to change or waive the provisions of the Notes set out in Condition 3 (*Status*);

(f) to change the law governing the Notes, the courts to the jurisdiction of which the Republic has submitted in the Notes, the Republic's obligation to maintain an agent for service of process in England or the Republic's waiver of immunity, in respect of actions or proceedings brought by any Noteholder, set out in Condition 15 (*Governing Law and Submission to Jurisdiction*);

(g) to approve any exchange or substitution of the Notes for, or the conversion of the Notes into, any other obligations or securities of the Republic or any other person; or

(h) in connection with any proposed exchange, substitution or conversion of the type referred to in paragraph (g) to amend any of the provisions of the Notes describing circumstances in which Notes may be redeemed or declared due and payable prior to their scheduled maturity date as set out in Condition 10 (*Events of Default*).

13.4 Modifications

Any modification of any provision of these Conditions may be made if approved by an Extraordinary Resolution or a Written Resolution. In these Conditions, "Extraordinary Resolution" means a resolution passed at a meeting of Noteholders duly convened and held in accordance with the Agency Agreement by a majority of at least:

(a) in the case of a Reserved Matter, 75 per cent. of the aggregate principal amount of the outstanding Notes; or

(b) in the case of a matter other than a Reserved Matter, 66⅔ per cent. of the aggregate principal amount of the outstanding Notes which are represented at that meeting.

Any Extraordinary Resolution duly passed at any such meeting shall be binding on all the Noteholders, whether present or not and whether they voted in favour or not.

13.5 Written resolutions

In addition, the Agency Agreement contains provisions relating to Written Resolutions. A "Written Resolution" is a resolution in writing signed by or on behalf of the holders of at least 75 per cent. of the aggregate principal amount of the outstanding Notes, in the case of a Reserved Matter, or 66⅔ per cent. of the aggregate principal amount of the outstanding Notes, in the case of a matter other than a Reserved Matter. Any Written Resolution may be contained in one document or several documents in the same form, each signed by or on behalf of one or more Noteholders. Any Written Resolution shall be binding on all of the Noteholders, whether or not signed by them.

13.6 Manifest error, etc.

The Notes, these Conditions and the provisions of the Agency Agreement may be amended without the consent of the Noteholders to correct a manifest error. In addition, the parties to the Agency Agreement may agree to modify any provision thereof, but the Republic shall not agree, without the consent of the Noteholders, to any such modification unless it is of a formal, minor or technical nature or it is not materially prejudicial to the interests of the Noteholders.

13.7 Notes controlled by the Republic

For the purposes of (i) ascertaining the right to attend and vote at any meeting of Noteholders or the right to sign, or authorise the signature of, any Written Resolution, (ii) this Condition 13 and Schedule 5 to the Agency Agreement, and (iii) Condition 10 (*Events of Default*), those Notes (if any) which are held in circumstances where the Republic has the power to direct the casting of votes in respect of such Notes, whether directly or indirectly, shall (unless and until ceasing to be so held) be disregarded and be deemed not to remain outstanding. Without prejudice to the generality of the previous sentence, the Republic shall be deemed to have the power to direct the casting of votes in respect of a Note if the Note is held by or on behalf of the Republic or by or on behalf of any person which is owned or controlled directly or indirectly by the Republic or by any public sector instrumentality of the Republic, where:

(a) **public sector instrumentality** means the Republic of Croatia, any department, ministry or agency of the government of the Republic of Croatia or any corporation, trust, financial institution or other entity owned or controlled by the government of the Republic of Croatia; and

(b) **control** means the power, directly or indirectly, through the ownership of voting securities or other ownership interests or otherwise, to direct the management of or elect or appoint a majority of the board of directors or other persons performing similar functions in lieu of, or in addition to, the board of directors of a corporation, trust, financial institution or other entity.

In advance of any meeting of Noteholders or Written Resolution the Republic shall provide to the Fiscal Agent a certificate of the Republic setting out the total number of Notes which are held in circumstances where the Republic has at the date of such certificate the power to direct the casting of votes in respect of such Notes. The Fiscal Agent shall make any such certificate available for inspection during normal business hours at its specified office and, upon reasonable request, will allow copies of such certificate to be taken.

13.8 Noteholders' Representative Committee

(a) Appointment

The Noteholders may, by a resolution passed at a meeting of Noteholders duly convened and held in accordance with the Fiscal Agency Agreement by a majority of not less than 50 per cent. in principal amount of the Notes then outstanding, or by notice in writing to the Republic (with a copy to the Fiscal Agent) signed by or on behalf of the holders of not less than 50 per cent. in principal amount of the Notes then outstanding, appoint any person or persons as a committee to represent the interests of the Noteholders if any of the following events has occurred:

(i) an Event of Default;

(ii) any event or circumstance which could, with the giving of notice, lapse of time, the issuing of a certificate and/or fulfilment of any other requirement provided for in Condition 10 (*Events of Default*) become an Event of Default; or

(iii) any official public announcement by the Republic to the effect that the Republic is seeking or intends to seek a restructuring of the Notes (whether by amendment, exchange offer or otherwise),

provided, however, that no such appointment shall be effective if the holders of more than 25 per cent. of the principal amount of the Notes then outstanding have either (I) objected to such appointment by notice in writing to the Republic (with a copy to the Fiscal Agent) during a specified period following notice of the appointment being given (if such notice of appointment is made by notice in writing to the Republic) where such specified period shall be either 30 days or such other longer or shorter period as the committee may, acting in good faith, determine to be appropriate in the circumstances, or (II) voted against such resolution at a meeting of Noteholders duly convened and held in accordance with the provisions of the Agency Agreement. Such committee shall, if appointed by notice in writing to the Republic give notice of its appointment to all Noteholders in accordance with Condition 12 (*Notices*) as soon as practicable after the notice is delivered to the Republic.

(b) Powers

Such committee in its discretion may, among other things, (I) engage legal advisers and financial advisers to assist it in representing the interests of the Noteholders, (II) adopt such rules as it considers appropriate regarding its proceedings, (III) enter into discussions with the Republic and/or other creditors of the Republic, (IV) designate one or more members of the committee to act as the main point(s) of contact with the Republic and provide all relevant contact details to the Republic, (V) determine whether or not there is an actual or potential conflict of interest between the interests of the holders of the Notes then outstanding and the interests of the holders of debt securities of any one or more other series issued by the Republic and (VI) upon making a determination of the absence of any actual or potential conflict of interest between the interests of the holders of the Notes then outstanding and the interests of the holders of debt securities of any one or more other series issued by the Republic, agree to transact business at a combined meeting of the committee and such other person or persons as may have been duly appointed as representatives of the holders of securities of each such other series. Except to the extent provided in this paragraph (b) (*Powers*), such committee shall not have the ability to exercise any powers or discretions which the Noteholders could themselves exercise. The Republic shall pay any fees and expenses which are reasonably incurred by any such committee (including, without limitation, the costs of giving notices to Noteholders and the reasonable fees and expenses of the committee's legal advisers and financial advisers, if any) within 30 days of the delivery to the Republic of a reasonably detailed invoice and supporting documentation.

14. FURTHER ISSUES

The Republic may from time to time without the consent of the Noteholders create and issue further notes, having terms and conditions the same as those of the Notes, or the same except for the amount of the first payment of interest, which may be consolidated and form a single series with the outstanding Notes even if such further Notes may have more than *de minimis* original issue discount for U.S. Federal income tax purposes and even if doing so impacts the value of the Notes.

15. GOVERNING LAW AND SUBMISSION TO JURISDICTION

15.1 Governing Law

The Notes, the Agency Agreement and the Deed of Covenant, and any non-contractual obligations arising out of or in connection with the Notes, the Agency Agreement and the Deed of Covenant, are governed by, and will be construed in accordance with, English law, provided, however, that the due authorisation and execution of the Notes by and on behalf of the Republic shall be governed by the laws by the Republic.

15.2 Jurisdiction

The Republic irrevocably agrees for the benefit of the Noteholders that the courts of England are to have jurisdiction to settle any disputes which may arise out of or in connection with the Agency Agreement or the Notes (including any disputes relating to any non-contractual obligations arising out of or in connection with the Agency Agreement or the Notes) and that accordingly any suit, action or proceedings arising out of or in connection therewith (together referred to as "**Proceedings**") may be brought in the courts of England.

The Republic irrevocably and unconditionally waives and agrees not to raise any objection which it may have now or subsequently to the laying of the venue of any Proceedings in the courts of England and any claim that any Proceedings have been brought in an inconvenient forum and further irrevocably and unconditionally agrees that a final non-appealable judgment in any Proceedings brought in the courts of England shall be conclusive and binding upon the Republic and may be enforced in the courts of any other jurisdiction to which the Republic is or may be subject. Nothing in this Condition shall limit any right to take Proceedings against the Republic in any other court of competent jurisdiction, nor shall the taking of Proceedings in one or more jurisdictions preclude the taking of Proceedings in any other jurisdiction, whether concurrently or not.

The Republic irrevocably appoints the Ambassador of the Republic of Croatia in the United Kingdom, currently residing at the Embassy of the Republic of Croatia, 21 Conway Street, London W1P 5HL or, in his absence, his designate as its authorised agent for service of process in England. If for any reason such agent shall cease to be such agent for service of process, the Republic shall appoint a new agent for service of process in England and deliver to the Fiscal Agent a copy of the new agent's acceptance of that appointment within 30 days.

To the extent that the Republic is lawfully entitled to do so, the Republic waives any right to claim sovereign or other immunity from jurisdiction or execution in respect of any proceedings arising solely out of or in connection with the Notes with the exception of execution, attachment or other legal or judicial process or remedy against property which is used solely or mainly for official purposes (including but not limited to ambassadorial and consular real estate, buildings and the contents thereof in the Republic or elsewhere, or any bank accounts of embassies or consulates, in each case necessary for the proper, official, ambassadorial or consular functioning of the Republic and the assets necessary for the proper functioning of the Republic as a sovereign power). The waiver of immunities in this Condition 15 constitutes a limited and specific waiver for the purpose of the Notes and under no circumstances shall it be interpreted as a general waiver by the Republic.

16. RIGHTS OF THIRD PARTIES

No rights are conferred on any person under the Contracts (Rights of Third Parties) Act 1999 to enforce any term of this Note, but this does not affect any right or remedy of any person which exists or is available apart from that Act.

THE GLOBAL CERTIFICATES

The Global Certificates contain the following provisions which apply to the Notes in respect of which they are issued whilst they are represented by the Global Certificates, some of which modify the effect of the Conditions. Terms defined in the Conditions have the same meaning in paragraphs 1 to 7 below.

1. FORM OF THE NOTES

The Notes sold in reliance on Regulation S ("**Regulation S**") under the United States Securities Act of 1933 (the "**Securities Act**") (the "**Unrestricted Global Certificate**") will be represented on issue by an Unrestricted Global Certificate, which will be deposited with, and registered in the name of a nominee for the common depositary for, Euroclear and Clearstream, Luxembourg. Beneficial interests in an Unrestricted Global Certificate may be held only through Euroclear or Clearstream, Luxembourg or their participants at any time. By acquisition of a beneficial interest in the Unrestricted Global Certificate, the purchaser thereof will be deemed to represent, among other things, that it acquired such beneficial interest in accordance with Regulation S and that it will only offer, sell, pledge or otherwise transfer such beneficial interest in an offshore transaction in accordance with Rule 903 or Rule 904 of Regulation S. See "*Subscription and Sale*" and "*Transfer Restrictions*".

The Notes sold in reliance on Rule 144A under the Securities Act ("**Rule 144A**") (the "**Restricted Global Certificate**") will be represented on issue by a Restricted Global Certificate, which will be deposited with a custodian for, and registered in the name of a nominee of, DTC. Beneficial interests in a Restricted Global Certificate may only be held through DTC or its participants at any time. Beneficial interests in a Restricted Global Certificate may only be held by persons who are QIBs, holding their interests for their own account or for the account of one or more QIBs. By acquisition of a beneficial interest in a Restricted Global Certificate, the purchaser thereof will be deemed to represent, among other things, that it is a QIB and that, if in the future it determines to transfer such beneficial interest, it will transfer such interest in accordance with the procedures and restrictions contained in the Restricted Global Certificate. See "*Subscription and Sale*".

The Unrestricted Global Certificate and the Restricted Global Certificate are referred to herein as the "**Global Certificates**". Beneficial interests in Global Certificates will be subject to certain restrictions on transfer set out therein and under "*Transfer Restrictions*" and in the Agency Agreement and such Global Certificates will bear a legend as set out under "*Subscription and Sale*". On or prior to the 40th day after the later of the commencement of the offering and 5 November 2009 (the "**Closing Date**"), ownership of interests in an Unrestricted Global Certificate will be limited to persons who have accounts with Euroclear or Clearstream, Luxembourg, or persons who hold interests through Euroclear or Clearstream, Luxembourg, and any sale or transfer of such interests to U.S. persons shall not be permitted during such period unless such resale or transfer is made pursuant to Rule 144A as provided below.

No beneficial interest in an Unrestricted Global Certificate may be transferred to a person who takes delivery in the form of a beneficial interest in a Restricted Global Certificate unless (i) the transfer is to a person that is a QIB, (ii) such transfer is made in reliance on Rule 144A, and (iii) the transferor provides the Registrar with a written certification substantially in the form set out in the Agency Agreement to the effect that the transferor reasonably believes that the transferee is a QIB, that the transfer is being made in a transaction meeting the requirements of Rule 144A and that such transaction is in accordance with any applicable securities laws of any state of the United States or any other jurisdiction. No beneficial interest in the Restricted Global Certificate may be transferred to a person who takes delivery in the form of a beneficial interest in an Unrestricted Global Certificate unless the transfer is to a non-U.S. person in an offshore transaction in reliance on Regulation S and the transferor provides the Registrar with a written certification substantially in the form set out in the Agency Agreement to the effect that the transfer is being made to a person who is a non-U.S. person in accordance with Regulation S.

Any beneficial interest in an Unrestricted Global Certificate that is transferred to a person who takes delivery in the form of an interest in a Restricted Global Certificate will, upon transfer, cease to be an interest in such Unrestricted Global Certificate and become an interest in the Restricted Global Certificate, and, accordingly, will thereafter be subject to all transfer restrictions and other procedures applicable to beneficial interests in a Restricted Global Certificate for as long as it remains such an interest. Any beneficial interest in a Restricted Global Certificate that is transferred to a person who takes delivery in the form of an interest in an Unrestricted Global Certificate will, upon transfer, cease to be an interest in each Restricted Global Certificate and become an interest in the Unrestricted Global Certificate and, accordingly, will thereafter be subject to all transfer restrictions and other procedures applicable to beneficial interests in an Unrestricted Global Certificate for so long as it remains such an interest. No service charge will be made for any registration of transfer or exchange of Notes, but the Republic may require payment of a sum sufficient to cover any tax or other governmental charge payable in connection therewith.

Except in the limited circumstances described below, owners of beneficial interests in the Global Certificates will not be entitled to receive physical delivery of Notes.

2. ACCOUNTHOLDERS

For so long as any of the Notes are represented by the Global Certificates, each person (other than another clearing system) who is for the time being shown in the records of DTC or Euroclear or Clearstream, Luxembourg (as the case may be) as the holder of a particular aggregate principal amount of such Notes (each an "**Accountholder**") (in which regard any certificate or other document issued by DTC or Euroclear or Clearstream, Luxembourg (as the case may be) as to the aggregate principal amount of such Notes standing to the account of any person shall be conclusive and binding for all purposes) shall be treated as the holder of such aggregate principal amount of such Notes (and the expression "Noteholders" and references to "holding of Notes" and to "holder of Notes" shall be construed accordingly) for all purposes other than with respect to payments on such Notes, the right to which shall be vested, as against the Republic, solely in the nominee for the relevant clearing system (the "**Relevant Nominee**") in accordance with and subject to the terms of the Global Certificates. Each Accountholder must look solely to DTC or Euroclear or Clearstream, Luxembourg, as the case may be, for its share of each payment made to the Relevant Nominee.

3. CANCELLATION

Cancellation of any Note following its redemption or purchase by the Republic will be effected by reduction in the aggregate principal amount of the Notes in the Register and by the annotation of the appropriate schedule to the relevant Global Certificate.

4. PAYMENTS

Payments of principal and interest in respect of Notes represented by a Global Certificate will be made upon presentation or, if no further payment falls to be made in respect of the Notes, against presentation and surrender of such Global Certificate to or to the order of the Fiscal Agent or such other Agent as shall have been notified to the holders of the Global Certificates for such purpose.

Distributions of amounts with respect to book-entry interests in the Unrestricted Global Certificates held through Euroclear or Clearstream, Luxembourg will be credited, to the extent received by the Fiscal Agent, to the cash accounts of Euroclear or Clearstream, Luxembourg participants in accordance with the relevant system's rules and procedures.

Holders of book-entry interests in the Restricted Global Certificates holding through DTC will receive, to the extent received by the Fiscal Agent, all distribution of amounts with respect to book-entry interests in such Notes from the Fiscal Agent through DTC. Distributions in the United States will be subject to relevant U.S. tax laws and regulations.

A record of each payment made will be endorsed on the appropriate schedule to the relevant Global Certificate by or on behalf of the Fiscal Agent and shall be *prima facie* evidence that payment has been made.

5. NOTICES

So long as the Notes are represented by a Global Certificate and such Global Certificate is held on behalf of a clearing system, notices to Noteholders may be given by delivery of the relevant notice to that clearing system for communication by it to entitled Accountholders in substitution for notification as required by Condition 12 (*Notices*) except that, so long as the Notes are listed on the Luxembourg Stock Exchange and the rules of that Exchange so require, notices shall also be published in a daily newspaper having general circulation in Luxembourg (which is expected to be the *Luxembourger Wort*. Any such notice shall be deemed to have been given to the Noteholders on the second day after the day on which such notice is delivered to Euroclear and/or Clearstream, Luxembourg (as the case may be) as aforesaid.

Whilst any of the Notes held by a Noteholder are represented by a Global Certificate, notices to be given by such Noteholder may be given by such Noteholder (where applicable) through Euroclear and/or Clearstream, Luxembourg and otherwise in such manner as the Fiscal Agent and Euroclear and Clearstream, Luxembourg may approve for this purpose.

6. REGISTRATION OF TITLE

The Registrar will not register title to the Notes in a name other than that of the Relevant Nominee for a period of 15 calendar days preceding the due date for any payment of principal, or interest in respect of the Notes.

7. EXCHANGE FOR CERTIFICATES

Exchange

Each Restricted Global Certificate will be exchangeable, free of charge to the holder, in whole but not in part, for Restricted Certificates and each Unrestricted Global Certificate will be exchangeable, free of charge to the holder, in whole but not in part, for Unrestricted Certificates (together with the Restricted Certificates, the "**Certificates**") upon the occurrence of an Exchange Event.

For these purposes an **Exchange Event** means that:

(a) circumstances described in Condition 10 (*Events of Default*) have occurred;

(b) in the case of an Unrestricted Global Certificate only, if Euroclear and/or Clearstream, Luxembourg is closed for business for a continuous period of 14 days (other than by reason of holiday, statutory or otherwise) or announces that it is permanently to cease business or does in fact do so and no successor or alternative clearing system is available; or

(c) in the case of a Restricted Global Certificate only, if DTC notifies the Issuer that it is no longer willing or able to discharge properly its responsibilities as depositary with respect to the relevant Global Certificate or DTC ceases to be a "clearing agency" registered under the U.S. Securities Exchange Act of 1934, as amended (the "**Exchange Act**") or is at any time no longer eligible to act as such and no qualified successor clearing system has been identified within 90 days of receipt of such notice from DTC,

provided that, in the case of any exchange pursuant to (b) or (c) above, the holder has given the Registrar not less than 30 days' notice at its specified office of such holder's intention to effect such exchange.

In exchange for the relevant Global Certificate, as provided in the Agency Agreement, the Registrar will deliver or procure the delivery of an equal aggregate principal amount of duly executed Certificates in or substantially in the from set out in the Agency Agreement.

Delivery

In such circumstances, the relevant Global Certificate shall be exchanged in full for Certificates and the Republic will, at the cost of the Republic (but against such indemnity as the Registrar or Transfer Agent may require in respect of any tax or other duty of whatever nature which may be levied or imposed in connection with such exchange), cause sufficient Certificates to be executed and delivered to the Registrar for completion and dispatch to the relevant Noteholders. A person having an interest in a Global Certificate must provide the Registrar with (a) a written order containing instructions and such other information as the Republic and the Registrar may require to complete, execute and deliver such Certificates and (b) in the case of the Restricted Global Certificate only, a fully completed, signed certification substantially to the effect that the exchanging holder is not transferring its interest at the time of such exchange or, in the case of simultaneous sale pursuant to Rule 144A, a certification that the transfer is being made in compliance with the provisions of Rule 144A to a purchaser that the transferor reasonably believes to be a QIB. Certificates issued in exchange for a beneficial interest in the Restricted Global Certificate shall bear the legend applicable to transfers pursuant to Rule 144A, as set out under *"Subscription and Sale"*.

Legends and transfers

The holder of a Certificate may transfer the Notes represented thereby in whole or in part in the applicable denomination by surrendering it at the specified office of any Transfer Agent, together with the completed form of transfer thereon. Upon the transfer, exchange or replacement of a Certificate bearing the legend referred to under "*Subscription and Sale*", or upon specific request for removal of the legend on a Certificate, the Republic will deliver only Certificates that bear such legend, or will refuse to remove such legend, as the case may be, unless there is delivered to the Republic and the Registrar such satisfactory evidence, which may include an opinion of counsel, as may reasonably be required by the Republic that neither the legend nor the restrictions on transfer set out therein are required to ensure compliance with the provisions of the Securities Act. Restricted Certificates will bear the same legend as the legend for the Restricted Global Certificates set out under "*Subscription and Sale*". The Restricted Certificates may not at any time be held by or on behalf of U.S. persons that are not QIBs. Before any Unrestricted Certificate may be offered, resold, pledged or otherwise transferred to a person who takes delivery in the form of a Restricted Certificate, the transferor and/or transferee, as applicable, will be required to provide the Registrar with a written certification substantially in the form set out in the Agency Agreement to the effect that the transferor reasonably believes that the transfer is (i) to a person that is a QIB and (ii) such transfer is made in reliance on Rule 144A. Unrestricted Certificates will bear the same legend as the legend for the Unrestricted Global Certificates set out under *"Subscription and Sale"*. Before any Restricted Certificates may be offered, resold, pledged or otherwise transferred to a person who takes delivery in the form of an Unrestricted Certificate, the transferor and/or transferee, as applicable, will be required to provide the relevant Registrar with a written certification substantially in the form set out in the Agency Agreement to the effect that the transfer is being made to a person who is a non-U.S. person in accordance with Regulation S.

USE OF PROCEEDS

The net proceeds of the issue of the Notes, amounting to approximately U.S.$1,468,650,000, will be applied by the Republic for general budgetary governmental purposes.

OVERVIEW OF THE REPUBLIC OF CROATIA

Territory and Population

The Republic occupies a total area of 56,538 square kilometres. The capital city, Zagreb, is located in the north of the country. The Dinaric Alps, which rise to 1,831 metres above sea level, run the length of the country. Croatia borders Slovenia to the north, Montenegro to the east and shares a sea border with Italy to the west and south. The Danube forms the eastern border with Serbia while the other two large rivers, the Sava and Drava, form the southern and northern borders with Bosnia Herzegovina and Hungary, respectively. The area of land between the rivers is dissected by many smaller tributaries. The Adriatic coastline is the most prominent feature of Croatia, running the entire length of the western border, from the Istrian peninsula in the north to Dubrovnik in the South with approximately 1,185 islands along the coast.

According to the CBS census, as at 31 March 2001, the total population of the five largest Croatian towns was as follows: Zagreb is the largest city in the country, with a population of 779,145, and is considered a leading industrial, cultural and scientific centre in Croatia. Other cities of significant size are Split (population 188,694), Rijeka (population 144,043), Osijek (population 114,616) and Zadar (population 72,718). According to the 2001 census, the total population of the country was 4,437,460.

The telephone number of the Ministry of Finance of Croatia is +385 1 45 91 333.

The following table sets forth the age distribution of Croatia's population at the end of the periods indicated:

	Year ended 31 December					
	2005		2006		2007	
Age	People	Per cent. of total	People	Per cent. of total	People	Per cent. of total
	(thousands)		*(thousands)*		*(thousands)*	
Youth (0-14)	703.1	15.8	692.9	15.6	687.0	15.5
Working age (15-64)	2,986.2	67.2	2,989.7	67.3	2,984.5	67.3
Pensioners (65 and over)	752.8	16.9	758.6	17.0	764.9	17.2
Total	**4,442.8**	**100.0**	**4,441.2**	**100.0**	**4,436.4**	**100.0**

Source: Croatian Central Bureau of Statistics

The table above shows a trend towards a higher proportion of pensioners within the overall population relative to those of working age and youth.

The following table sets out a breakdown of population by religion in 2001:

	Population	Per cent. of total
	(thousands)	
Roman Catholics(1)	3,903,854	88.0
Orthodox Christians(2)	236,793	5.3
Muslims(3)	56,777	1.3
Other	240,036	5.4
Total	**4,437,460**	**100.0**

Source: Croatian Central Bureau of Statistics

(1) Includes members of the Roman Catholic Church, the Greek Catholic Church and the Old Catholic Church.

(2) Aggregated members of Orthodox Christian Churches.

(3) Includes members of all other religions and non believers

As of 31 December 2007, Croatia was divided among 21 countries including the City of Zagreb which is a separate county, 127 towns/cities and 429 municipalities in Croatia.

History

In October 1918, following the defeat of the Austrio-Hungarian Empire in World War I, a Croatian National Council took power in Zagreb and called for union with the other South Slavic parts of the Austrio-Hungarian Empire. Dalmatia, a separate Habsburg crown land since 1815, also recognised the authority of the Croatian National Council. In December 1918, the Kingdom of the Serbs, Croats and Slovenes was proclaimed in Belgrade and in 1929, the name of the country was changed to the Kingdom of Yugoslavia.

Following World War II, Communist-led forces proclaimed a new Yugoslavia. A federal state of six republics was set up, substantially restoring the old borders of Bosnia and Croatia, but splitting Macedonia off from Serbia and setting up two autonomous regions within Serbia. All power was given to the non-ethnic Communist party led by General Tito. In 1948, the former Yugoslavia broke off relations with the former Soviet Union ("**USSR**") and initiated a certain amount of economic liberalisation.

The late 1980s brought dramatic changes in international politics. Reforms in Eastern Europe, which culminated in the disintegration of the USSR and the Warsaw Pact, and the end of the cold war, caused a transformation of the Eastern Bloc. This also had a profound effect on the former Yugoslavia where reformers began to reject the existing federal concepts and embrace democratic ideas.

The first free elections in Croatia since World War II took place in April and May 1990 and resulted in a clear victory for the Croatian Democratic Union Party which gained 205 of the 350 seats in Hrvatski Sabor, the Croatian Parliament (the "**Parliament**"). However the growing nationalism in Serbia at this time caused concern amongst ethnic Serbs living in Croatia.

The disintegrating Yugoslav federal government made it clear that changes would have to be made to Yugoslavia's constitution. In May 1991, 83.56 per cent. of the Croatian electorate turned out for a referendum on independence. Over 94 per cent. of the votes were in favour of independence, and Croatia's declaration of independence on 25 June 1991 coincided with Slovenia's decision to do the same.

However, in May 1991, fighting between rebel Croatian Serb forces and Croatian police units broke out in the area bordering Bosnia-Herzegovina (around Knin), in Baranja (north of Osijek) and Slavonia (the region west of the Danube River). The Yugoslav National Army (the "**YNA**") intervened in support of the rebel Croatian Serbs. During the summer and early autumn of 1991 (the "**1991 War**"), rebel Croatian Serb forces and the YNA took control of more than one quarter of Croatia's territory.

Rebel Croatian Serbs proclaimed the independence of the occupied territories on 19 December 1991, although they never gained international recognition. Despite this, Croatia declared itself an independent sovereign state but was not immediately recognised by other countries. After the introduction of a law on Human Rights and Minorities by the Parliament, Croatia was recognised by the EU on 15 January 1992, followed by the United States on 7 April 1992.

In May 1995, Croatian forces re-established control over the entire region of Western Slavonia. On 4 August 1995, the Croatian army sought to re-establish control over the rebel Croatian Serb held areas bordering Bosnia Herzegovina and the majority of the Serb population left the area for the Former Republic of Yugoslavia ("**FRY**") and Bosnia-Herzegovina, although some have now returned.

In November 1995, an agreement was reached to return the area of Eastern Slavonia to Croatian rule by peaceful reintegration overseen by the international community, which was completed by 1998.

International Relations

After gaining independence, Croatia was admitted to the UN in May 1992. In the same year, Croatia became a participant country in the Organisation for Security and Co-operation in Europe ("**OSCE**") and became a member of the IMF. In 1996, Croatia became the 40th Member State of the Council of Europe. See "*The Economy*" for a discussion of the economic programs and reforms between 1995 and 2000. Since 2000, following the reform programmes of subsequent governments, various integration processes with international organisations became a higher priority. In October 2000, Croatia became a member of the World Trade Organisation ("**WTO**"), while in 2002 it acceded to the Central European Free Trade Area. Croatia is also a member of the International Development Association, the International Finance Corporation, the EBRD, the International Labour Organisation, the Bank for International Settlements and the Inter-American Development Bank. Croatia has been active in regional cooperation in Central and South East Europe through its membership in the Central European Initiative, the South-East European Cooperation Process and the Regional Cooperation Council. Furthermore, Croatia was elected as a non-permanent member of the UN Security Council for the period 2008-2009, holding the Council's Presidency in December 2008. Croatia became a candidate country for EU accession in June 2004 and the negotiation process is expected to enter the final phase in 2010, as discussed below. In April 2009, Croatia acceded to NATO.

The IMF has taken the lead in assisting Croatia in maintaining macroeconomic stability since 1994. See "*The Economy — Stabilisation of the Economy*". On 29 March 2006, the Executive Board of the IMF completed its second review under the Stand By Arrangement for Croatia, which was approved by the IMF on 4 August 2004. A Stand By Arrangement is an IMF credit facility providing assurance to a member country that it can draw up sums up to a specified amount, usually over a period of 12 to 18 months, to help with short-term balance of payments. In completing the review, the Executive Board also granted an extension of the arrangement until 15 November 2006 as well as an augmentation of access to an amount equivalent to 99 million Special Drawing Rights ("**SDR**") (approximately U.S.$146.3 million). In November 2006, the Executive Board of the IMF successfully completed its third review under the Stand By Arrangement for Croatia. The expiry of the mentioned Stand By Arrangement and the decision not to conclude another Stand By Arrangement opened a new phase of relations between Croatia and the IMF wherein Croatia has the opportunity to demonstrate its ability to implement the adopted economic policy, particularly concerning fiscal discipline and the remaining structural reforms.

Together with the IMF, the International Bank for Reconstruction and Development (the "**IBRD**") also maintains a close collaborative relationship with Croatia in supporting its reforms. The IBRD has taken the lead in policy dialogue on structural and institutional reforms in a number of sectors. This reform agenda includes measures to: (i) reduce the level of public expenditure and the size of the Government administration; (ii) restructure the pension and health sectors; (iii) enhance labour market flexibility; (iv) strengthen market institutions and the competitiveness of the economy; (v) mitigate the social cost of reforms and poverty through restructuring of social welfare programs; and (vi) begin the process of judicial reform.

European Union Accession

In October 2001, after having accepted the EU guidelines for negotiating and concluding the Stabilisation and Association Agreement ("**SAA**") between Croatia and the EU Member States, Croatia started accession negotiations with the EU. The SAA was initialled on 14 May 2001 and signed at the Meeting of the Council of Ministers in Luxembourg on 29 October 2001. On the basis of the SAA, Croatia became a candidate for accession to the EU. The SAA was ratified in the Croatian Parliament on 5 December 2001, in the European Parliament on 12 December 2001 and in the EU member countries at the end of October 2004. The SAA came into force on 1 February 2005.

On 21 February 2003, Croatia submitted its application for EU membership. On 10 July 2003, the EC submitted to Croatia the EU accession application questionnaire regarding the political, economic and administrative situation in Croatia and Croatia sent its answers on 9 October 2003. Croatia signed an additional Protocol 7 of the SAA with the EC, regulating the trade with the EU that was temporarily in effect from 1 May 2004, and came into force on 1 February 2005. The EC gave a positive opinion (*avis*) on the application of Croatia for full membership to the EU on 20 April 2004.

On 18 June 2004, the European Council decided to promote Croatia as an official candidate for EU membership. In accordance with the candidate status for EU membership, Croatia had to prepare the Pre-Accession Economic Programme (the "**PEP**") for the period 2005-2007, which was adopted by the Government on 30 November 2004. This was the first economic document on the basis of which the EC assessed the implementation of reforms in Croatia. The PEP is a strategic document for EU membership candidate countries regulating the economic policy and structural reforms that are necessary for their successful accession to the EU. The PEP is prepared and submitted to the EC on an annual basis during the period prior to accession to the EU.

The Government adopted the 2006-2008 PEP on 8 December 2005 in accordance with the proclaimed goal of EU accession, representing the framework for all activities related to negotiations with the EU member countries. In January 2009, the Government adopted the PEP for the period 2009-2011. The 2009-2011 PEP reflects economic policy aimed at stimulating long-term sustainable growth and supporting macroeconomic stability, with a focus on raising Croatia's competitiveness and increasing living standards in Croatia. The dialogue with the EC on the issues covered by the PEP continues after PEP submission in the form of technical expert meetings and high-level discussions that enable assessment of the programme. In 2009, given the changed macroeconomic conditions, revised macroeconomic and fiscal projections for the 2009-2011 period were presented to the EC.

In October 2005, the EU Council of Ministers opened the accession negotiations of Croatia with the EU. In total, 35 chapters of the *acquis communautaire* will be negotiated. Once a chapter has been screened and if no significant problems have been identified, a candidate may open such a chapter for negotiations. In certain cases, a candidate initiates certain reforms aimed at preparing a chapter for negotiations. The screening exercise for Croatia was successfully completed in October 2006. Slovenia imposed a veto on Croatia's EU accession negotiations in December 2008 due to a bilateral border issue between Croatia and Slovenia, however, in September 2009, Slovenia lifted its veto and the two countries have agreed to settle the border dispute before the international judicial body on the basis of international law. Due in part to the delay in negotiations as a result of the Slovenian veto, it is currently expected that Croatia will conclude the accession negotiations by the summer of 2010. In accordance with Article 141 of the Croatian Constitution (the "**Constitution**"), a national referendum on the EU accession must be held in Croatia. In addition, the Constitution will be amended in connection with the EU accession. The bill relating to the amendment to the constitution is expected to undergo Parliamentary review by the end of 2009 and be passed in the first quarter of 2010. The key amendments include (1) the elimination of quorum requirement in Article 86 of the Constitution which currently provides that at a referendum, the decision is made by the majority of the voters who have voted, provided that the majority of electors have taken part in the referendum, and (2) the addition of provisions relating to the election of representatives from Croatia to the European Parliament.

At the most recent Inter-Governmental Conference on the Croatian EU accession held on 2 October 2009, an additional 11 chapters were unblocked, five chapters were provisionally closed (Freedom of Movement for Workers; Company Law; Customs Union; Statistics; and Trans-European Networks) and six chapters were opened (Free Movement of Capital; Taxation; Agriculture and Rural Development; Food Safety, Veterinary and Phytosanitary Policy; Justice, Freedom and Security; and Regional Policy and Coordination of Structural Instruments) for negotiation. Currently, 28 chapters have been formally opened, of which 12 chapters are provisionally closed and 16 chapters remain open. The following table summarises the current status of the chapters of the *acquis communautaire*.

Chapter	Status
Company Law	Provisionally Closed
Customs Union	Provisionally Closed
Economic and Monetary Policy	Provisionally Closed
Education and Culture	Provisionally Closed
Enterprise and Industrial Policy	Provisionally Closed
External Relations	Provisionally Closed
Freedom of Movement for Workers	Provisionally Closed
Information Society and Media	Provisionally Closed
Intellectual Property Law	Provisionally Closed
Science and Research	Provisionally Closed
Statistics	Provisionally Closed
Trans-European Networks	Provisionally Closed
Agriculture and Rural Development	Opened
Consumer and Health Protection	Opened
Energy	Opened
Financial and Budgetary Provisions	Opened
Financial Control	Opened
Financial Services	Opened
Food Safety, Veterinary and Phytosanitary Policy	Opened
Free Movement of Capital	Opened
Free Movement of Goods	Opened
Justice, Freedom and Security	Opened
Public Procurement	Opened
Regional Policy and Coordination of Structural Instruments	Opened
Right of Establishment & Freedom to Provide Services	Opened
Social Policy and Employment	Opened
Taxation	Opened
Transport Policy	Opened
Competition Policy	Not opened
Environment	Not opened
Fisheries	Not opened
Foreign, Security and Defence Policy	Not opened
Judiciary and Fundamental Rights	Not opened
Institutions	Not opened
Other Issues(1)	Not opened

Source: Ministry of Finance

(1) The chapter on “Other Issues” includes miscellaneous issues which arise during the negotiations but which are not covered under any other negotiating chapter. No such issues have been identified as yet. The chapter on “Other Issues” is addressed at the end of the negotiation process.

Key Challenges to EU Accession

1. Judiciary and Fundamental Rights

A number of changes, some of which are ongoing, are needed in respect of the Judiciary and Fundamental Rights chapter. For a discussion of the ongoing judicial reform, see “*— Constitution and Government Structure — The Judicial System*” below.

2. Competition Policy

Another potentially challenging item is Croatia’s comparative economic competitiveness. A long period of nominal exchange rate stability coupled with the recent strong depreciation of several competitor country currencies as well as large trade deficits raise concerns about the adequacy of Croatia’s competitiveness compared to neighbouring countries. In addition, the export sector has benefited little from the strong capital inflows (including FDI) experienced in recent years and has been affected by relatively high unit labour costs. Unlike in neighbouring countries, the share of Croatia's export sector in GDP remained constant over the past decade. Croatia's share in world and EU imports has also stagnated. As a result, growing imports responding to a household consumption and foreign direct investment boom gave rise to large trade and current account deficits. In order to improve Croatia's economic competitiveness, the key challenge ahead is to improve tradable sector performance, in particular by increasing exports.

In addition, certain reforms, primarily relating to the Government's subsidies, in particular subsidies to the shipbuilding industry, are needed in connection with the Competition Policy chapter. The subsidies of the shipbuilding industry have been largely decreasing since 2006. See "*The Economy — Government's Subsidies*". The Government subsidises the shipbuilding industry by making payments to shipyards equal to approximately 6 per cent. of the value of each contract entered into by shipyards. In 2008 and the first six months of 2009, subsidies in real prices to the shipbuilding industry amounted to HRK 394.9 million and 170.3 million, respectively. In addition, all Government financial guarantees relating to the shipbuilding industry are treated as subsidies, the values of which are measured as the achieved savings in the borrowing costs. If a guarantee covers not more than 80 per cent. of the underlying borrowing, the provision of such guarantee is not treated as non-competitive behaviour according to the applicable EU standards. For a description of the ongoing efforts to privatise the shipbuilding industry, see "*The Economy — Privatisation Programme*" below.

Constitution and Government Structure

The Constitution was adopted on 22 December 1990 and was substantially amended in December 1997, November 2000 and April 2001. It established a multi-party democracy, with an economy based on market principles and private ownership. Under the Constitution, the President is elected for five-year terms and may not serve more than two terms. The President appoints, with the consent of the President of the Parliament, a Prime Minister who, in turn, appoints Government Ministers. Dr. Ivo Sanader was appointed Prime Minister following elections in 2003 and was reappointed following elections in November 2007. In July 2009, Dr. Ivo Sanader voluntarily resigned and Ms. Jadranka Kosor, the Vice Prime Minister at the time, was appointed as the Prime Minister. The Constitution is based on the separation of powers between the legislature, executive and judiciary.

Legislature

Croatia has a single chamber Parliament, which consists of 153 elected members who are elected by national general elections for a four-year term. The Parliament has the power to pass laws, amend the Constitution, adopt the State budget, declare war or peace, pass resolutions, adopt national security and defence strategy, realise civil control over the armed forces and the security services, decide on alterations of the Croatian borders, call referenda, carry out elections, as well as exercise certain supervisory powers over the Government. Laws are passed by majority vote provided that a majority of members are present, except that laws which deal with certain constitutional rights can only be passed by (in certain cases) a two thirds majority of all members or (in other cases) a majority of all members. The President promulgates laws validly enacted by the Parliament. If, in the President's view, the law does not conform to the Constitution, he may initiate proceedings to review the constitutionality of the law before the Constitutional Court.

The State Budget is passed by the Parliament by which State revenues and receipts are estimated and State expenditures and expenses for one year are established in accordance with law.

During a state of war, the President may issue decrees on the grounds and within the authority received from the Parliament. If the Parliament is not in session, the President may issue decrees required in connection with the war, which must be submitted for approval to the Parliament as soon as the Parliament is in a position to convene. In case of an immediate threat to the independence, unity and existence of the Republic, or if the governmental bodies are prevented from performing their institutional duties, the President has the power, at the proposal of the Prime Minister and with her counter signature, to issue such decrees. If the President does not submit a decree to the Parliament for approval or if the Parliament does not approve it, the decree ceases to be in force.

International agreements ratified in accordance with the Constitution and published in the National Gazette are part of the internal legal order of the Republic and are subordinate only to the provisions of the Constitution. Their provisions may be changed or repealed only as specified in such agreements, or in accordance with the general principles of international law.

Pursuant to the Constitution, the Parliament may call a referendum on a proposal for the amendment of the Constitution, on a law, or any other issue within its competence. The President of the Republic may, at the proposal of the Government and with the counter-signature of the Prime Minister, call a referendum on a proposal for the amendment of the Constitution or any other issue which he considers to be important for the independence, unity and existence of the Republic. The Parliament shall call a referendum upon the issues mentioned above when so demanded by ten per cent. of all voters in the Republic. At such a referendum, the decision shall be made by the majority of the voters who have voted, provided that the majority of the total number of electors have taken part in the referendum. Decisions made at referenda are binding and a law thereon shall be passed.

The Executive

The President is elected by the popular vote of Croatian citizens. The President gives the mandate to the Prime Minister to appoint the Government based on the number of seats in Parliament held by each political party and consultation with each relevant political party, and provided that the Prime Minister has the confidence of the majority of all members of the Parliament. The President is the Commander in Chief of the armed forces. The President may dissolve Parliament if: (a) the President receives a proposal from the Government (countersigned by the Prime Minister) and, after consultation with the leaders of each of the political parties which comprise the Parliament, the Parliament adopts a vote of no confidence; or (b) Parliament does not adopt the State budget within 120 days from the date when the State budget was presented as a bill. Elections for members of the Parliament must be held not later than 60 days after the expiry of the mandate or dissolution of the Parliament.

The following table sets forth the current members of the Government.

Name	Title
Jadranka Kosor	Prime Minister
Božidar Pankretić	Vice Prime Minister and Minister of Regional Development, Forestry and Water Management
Damir Polančec	Vice Prime Minister and Minister of Economy, Labour and Entrepreneurship
Đurđa Adlešič	Vice Prime Minister
Slobodan Uzelac	Vice Prime Minister
Bianca Matković	Minister without Portfolio
Božidar Kalmeta	Minister of the Sea, Transport and Infrastructure
Božo Biškupić	Minister of Culture
Branko Vukelić	Minister of Defence
Damir Bajs	Minister of Tourism
Darko Milinović	Minister of Health and Social Welfare
Davorin Mlakar	Minister of Public Administration
Gordan Jandroković	Minister of Foreign Affairs and European Integration
Ivan Šimonović	Minister of Justice
Ivan Šuker	Minister of Finance
Marina Matulović Dropulić	Minister of Environmental Protection, Physical Planning and Construction
Petar Čobanković	Minister of Agriculture, Fisheries and Rural Development
Radovan Fuchs	Minister of Science, Education and Sports
Tomislav Ivić	Minister of the Family, Veterans' Affairs and Intergenerational Solidarity
Tomislav Karamarko	Minister of Interior
Jagoda Premužić	Secretary of the Government

The Judicial System

Croatia's three-tier judicial system is independent. On the first level are the municipal courts, followed by the county courts, and finally by the Croatian Supreme Court (the "**Supreme Court**") which is the highest court in Croatia. The Supreme Court hears appeals of decisions of first instance county courts, the High Commercial Court of Croatia, the Administrative Court of Croatia, and any other court when prescribed by the law. The Supreme Court has the authority to decide on the conflict of jurisdiction between the courts in Croatia. Other specialised courts exist to deal with commercial and administrative law matters. Judges are appointed by the High Judiciary Council of Croatia (the "**Council**"), the members of which are selected from amongst judges, attorneys at law and university law professors, and are elected for a four-year term by the Parliament and may not serve more than two subsequent terms. Following an initial five-year term for newly appointed judges, judges whose appointments are renewed for a second term are appointed for life and may not be removed except by the Council under limited circumstances.

The Constitutional Court of Croatia consists of 13 judges who are elected for eight years by the Parliament, and it has the authority to annul unconstitutional laws or regulations and to decide on jurisdictional questions among the legislature, executive and judiciary, and on the impeachability of the President. It has jurisdiction to protect the constitutional freedom and rights of citizens.

The screening of the Judiciary and Fundamental Rights Chapter of the *acquis communautaire* was held during September 2006 and October 2006. During this first phase of screening, the EC representatives held presentations on the *acquis communautaire* in the area of the judiciary, with special emphasis on the independence, efficiency and reform of the judiciary, as well as presentations in the field of human rights. The bilateral phase of screening was held on 17 and 18 October 2006 when Croatian representatives presented to the EC the legislation and level of alignment accomplished in this chapter. The Committee welcomed certain progress in implementation of the judiciary and public administration reforms, and on the Government's anti-corruption programme, however, it also noted that there is considerable scope for further improvement on these issues.

Judicial Reform

In 2008, the Government commenced the Judicial Reform in order to combat corruption and restore confidence in the judicial system. The Ministry of Justice is undertaking measures aimed at establishing a more efficient judicial system founded upon principles of independence and professionalism. The objectives of the Judicial Reform include strengthening the rule of law, improving the efficiency and effectiveness of the judicial system, shortening the period of time between the commencement and conclusion of training, and improving professionalism and ongoing training of the staff.

To facilitate the implementation of the Judicial Reform, the Government adopted on 25 June 2008 a revised Action Plan (the "**Action Plan**") which is an integral part of the Judicial Reform strategy. The Action Plan comprises more than 170 specific measures describing the efforts to be made in order to lay the foundation for an independent, impartial, professional and efficient judicial system.

Within the Judicial Reform, particular attention is paid to the independence of the judicial system. The Act on the Amendments to the Courts Act adopted in September 2008 adds several new features to the process of appointing judges in order to ensure objective, transparent and uniform work of judicial councils. On 21 May 2009 the Judicial Council Standing Orders (the "**Standing Orders**") were passed, which provide for the manner in which judicial councils operate, convene meetings, evaluate judges' performance, make opinions on candidates for judges, propose candidates for court presidents, and assess and determine complaints of infringement of the Code of Judges' Ethics. The Standing Orders are designed to establish objective and transparent criteria for decision-making in connection with evaluating judges' performance.

The Judicial Trainees and Bar Examination Act, passed in July 2008, prescribes terms and conditions for traineeships to courts, State Attorney's offices and professional programmes, and professional practice for attorney and notary public trainees and lawyers.

The draft Judicial Academy Act, which is currently under Parliamentary review, is designed to introduce uniform, objective and transparent criteria for admission to a judicial or State attorney's position via the selection of students at the National School for the Judiciary. The goal of the National School is to provide the candidates with knowledge and skills required for autonomous, accountable, independent and impartial performance of the chairperson's role.

Reduction of the backlog of court cases is another important objective of the Judicial Reform. Current efforts focus on more expedited resolution of cases that are more than three years old. The Supreme Court monitors the progress of resolution of such cases by the municipal and county courts. The Supreme Court also prepared an action plan aimed at resolving such cases. At the beginning of the Justice Reform 1.8 million cases remained unresolved, whereas presently, despite the fact that approximately 1.7 million new cases are filed annually, approximately 890,000 cases in total are pending at all court levels.

In addition, a new enforcement system is intended to improve the judgment enforcement process by making the process more simplified and professional, to be accomplished in part by empowering enforcement officers. The draft Enforcement Act is intended to reduce the reasons for launching legal remedies in order to obtain enforcement, the circumstances under which enforcement can be postponed or challenged by third parties, narrow the pool of movable assets excluded from enforcement and provide rules governing the disclosure by competent institutions of information on assets of persons subject to enforcement. The draft Public Enforcement Officers Act is intended to establish a Public Enforcement Officers' Chamber, which will contain a Public Enforcement Officers Register and regulate the remuneration of public enforcement officers.

Anti-Corruption and Organised Crime

For the purpose of combating corruption and organised crime, three enforcement bodies have been established (together the "**USKOK System**"):

- The Office for the Suppression of Corruption and Organised Crime — USKOK ("**USKOK**")
- The National Police of the Corruption and Organised Crime Suppression Office — PN USKOK ("**PN USKOK**")
- Corruption and Organised Crime Cases Court Departments — the "USKOK Courts" (the "**USKOK Courts**")

USKOK Courts were established in Zagreb, Split, Rijeka and Osijek county and municipal courts in October 2008. Decisions of the USKOK Courts can be appealed to the Supreme Court. On 1 March 2009 the USKOK System began operation and the judges were appointed. From inception until 1 September 2009, 864 persons were reported to USKOK for corruption related offences. Investigations were initiated against 364 persons during that period. A total of 231 persons were indicted, 53 of which for abusing a position of authority, 47 for receiving bribes, 84 for giving bribes, 43 for illegal intermediation, two for receiving bribery in business operations and two for giving bribes in business operations. The courts reached verdicts in 108 of these cases, of which 94 were convictions, 11 were acquittals and 3 cases were postponed or rejected for lack of evidence.

Past and ongoing corruption cases include investigations against the former Minister of the Interior, officials and private individuals involved in the privatisation process, and cases relating to the shipbuilding industry and university administration fraud.

New legislation regulating public procurement was passed in 2007 and entered into force on 1 January 2008 (with the exception of certain provisions which will enter into force once Croatia joins the EU). Amendments to the Public Procurement Act, which entered into force on 1 January 2009, aligned the Act fully with the chapters of the EU *acquis communautaire*. The so-called "anti-corruption clause" was incorporated into the Act which seeks to prevent conflicts of interest in the area of public procurement. The Concessions Act and the Public Private Partnership Act were adopted as well. The Public Procurement System Directorate of the Ministry of Economy, Labour and Entrepreneurship and the State Commission for Control of Public Procurement Procedures supervise the public procurement procedure to ensure that it is transparent and implemented consistently.

Recently Enacted Legislation

The Parliament passed the Anti-Money Laundering and Terrorist Financing Law (the "**AML/TFL**") on 15 July 2008. AML/TFL entered into force on 1 January 2009. AML/TFL is based on Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purposes of money laundering and terrorist financing and other relevant international standards. The AML/TFL contributed to the harmonization of the Croatian anti-money laundering and terrorist financing legislation with the international Anti-Money Laundering and Combating the Financing of Terrorism ("**AML/CFT**") standards. Currently, Croatia's AML/CFT measures are equivalent, in all material respects, to those in EU Member States.

In the financial sector, recently enacted legislation includes the Credit Institutions Act (OG 117/08 and 74/09), the Act on Financial Collateral (OG 76/07), the Act on the Takeover of Joint Stock Companies (OG 109/07 and 36/09), the Act on the Croatian National Bank (OG 75/08), the Act on Amendments to the Insurance Act (OG 82/09), the Capital Market Act (OG 88/08, 146/08 and 74/09), the Act on Criminal Offences Against the Capital Market (OG 152/08), the Act on Electronic Money Institutions (OG 117/08 and 74/09), the Act on Settlement Finality in Payment and Financial Instruments Settlement Systems (OG 117/08), the Act on Amendments to the Deposit Insurance Act (OG 119/08), the Financial Conglomerates Act (OG 147/08), the Act on Amendments to the Act on Compulsory Insurance within the Transport Sector (OG 75/09), the Act on Amendments to the Credit Unions Act (OG 25/09), the Consumer Credit Act (OG 75/09), the Accounting Act (OG 109/07), the Act on Amendments to the Audit Act (OG 139/08) and the Regulation on Amendments to the Foreign Exchange Act (OG 92/09).

The Political Parties

The major political parties that participated in parliamentary elections on 25 November 2007 were the Croatian Democratic Union ("**HDZ**"), Social Democratic Party ("**SDP**"), Croatian People's Party ("**HNS**") and Croatian Peasant Party ("**HSS**"). HDZ won the highest number of seats in the Parliament and Dr. Ivo Sanader was reappointed as Croatia's Prime Minister. In July 2009, Dr. Ivo Sanader voluntarily resigned and Ms. Jadranka Kosor, the Vice Prime Minister at the time, was appointed as the Prime Minister. The HDZ has adopted a strategy in favour of a pro-European, mainstream conservative orientation that is committed to democracy, the rule of law, human rights and minority rights. The Government has initiated a number of key reforms, including of the defence system, which is being reorganised in order to prepare the country for its future obligations as a member of the NATO alliance.

Presidential Elections

On 2 January 2005, a first round of presidential elections was held and President Stjepan Mesic, of the HNS, won 48.92 per cent. of votes, which was not sufficient to win the elections outright. A second round of presidential elections was held on 16 January 2005 and Mr. Stjepan Mesic confirmed his leadership with a victory of 65.93 per cent. of votes. According to the Constitution, presidential elections should be held not less than 30 and not more than 60 days before the expiry of the term of office of the incumbent President. It is therefore expected that the next presidential elections will be held in November or December 2009, or in January 2010.

Parliamentary Elections

The most recent elections of deputies for the Parliament were held on 25 November 2007. The next elections are scheduled to take place in November 2011. The following table sets out the current composition of the Parliament:

Party	Seats	Percentage
Croatian Democratic Union (HDZ)	66	43.13
Social Democratic Party of Croatia (SDP)	56	36.60
Croatian Peasant Party (HSS)(1)	6	3.92
Croatian People's Party (HNS)	5	3.27
Istrian Democratic Council (IDS)	3	1.96
Croatian Democratic Alliance of Slavonia and Baranja (HDSSB)	3	1.96
Independent Democratic Serbian Party (SDSS)	3	1.96
Croatian Social Liberal Party (HSLS)(1)	2	1.30
Croatian Party of Rights (HSP)	1	0.66
Croatian Party of Pensioners (HSU)	1	0.66
Croatian Democratic Action Party (SDA HR)	1	0.66
Independent Deputies	6	3.92
Total	**153**	**100.00**

Source: Internet Editorial Staff of the Croatian Parliament, 28 September 2009

(1) HSS and HSLS formed an 8-seat coalition.

In the November 2007 elections, HDZ secured additional support from the HSS-HSLS coalition, the HSU and representatives from the ethnic and national minority parties and representatives including SDSS and SDA HR.

The most recent elections for the local and regional self-governments took place on 17 May 2009. These were the first local elections where municipality, city and county mayors have been elected directly.

Croatia is divided into 21 counties containing 127 towns/cities and 429 municipalities. The Croatian Constitution reserves certain functions, including police services, education and other local services, for the county and local governments.

Co-Operation with the ICTY

The ICTY requested the warrant for the arrest and extradition of the former General of the Armed Forces of Croatia, Mr. Ante Gotovina. Contact by the responsible Croatian bodies and the State Chief Attorney of Croatia, who was in charge of the co-ordination of all activities, with the representatives of the ICTY Prosecution contributed to the locating and arrest of Mr. Gotovina on 7 December 2005 in the Canary Islands. On 10 December 2005, Mr. Gotovina was transferred to the ICTY, and he appeared before the ICTY panel of judges and gave his plea. The trial of Mr. Gotovina commenced in March 2008. Prosecution completed presenting its case in March 2009. The Defence commenced presenting its case in May 2009 and is expected to finish by the end of 2009. The decision on the trial of Mr. Gotovina is anticipated in 2010.

Domestic War Crime Trials

The process of making the Croatian judiciary capable of conducting war crime trials and taking over the cases from the ICTY includes the passing of amendments to existing legislation (Criminal Code), the passing of new acts (the Witness Protection Act, the Rome Statute Application Act), and the special training of Croatian judges and State attorneys. In April 2005 after monitoring such trials, a favourable report on the ability of the Croatian judiciary to prosecute war crimes was submitted by the OSCE. The decision of the ICTY dated 14 September 2005 to transfer the case against the retired Generals Ademi and Norac to the Croatian judiciary was in line with the above OSCE report. At the end of 2006, the Zagreb State Attorney filed an indictment with the Zagreb County Court against Messrs. Ademi and Norac. The submission of the indictment follows the September 2005 decision by the ICTY Referral Bench to transfer the ICTY indictment against Messrs. Ademi and Norac to Croatia.

In May 2008, Mr. Ademi was acquitted of all charges and Mr. Norac (who had been sentenced in 2003 to a 12-year prison sentence for war crimes committed against civilians in the Gospić area in 1991) was convicted on two counts of war crimes against civilians in Medački džep in 1993 and was sentenced to seven years in prison.

THE ECONOMY

Unless otherwise specifically noted, the statistical information presented in this section has been extracted, without material change, from reports published by, or information obtained from, the Central Bureau of Statistics, Croatian National Bank and the Ministry of Finance of Croatia.

Overview of Post Independence Developments

Following Croatia's declaration of independence on 25 June 1991, the Socialist Federal Republic of Yugoslavia expelled Croatia from the Yugoslav monetary system on 27 June 1991. The central bank of the former Yugoslavia retained all foreign exchange reserves, leaving Croatia with no hard currency reserves. The 1991 War also prevented Croatia from accessing external sources of financing. The 1991 War left approximately one third of the country's territory outside of Government control and significantly disrupted lines of communication, both within the country and with many of Croatia's international trading partners.

The hostilities also caused significant damage to the country's infrastructure, housing and industrial plants. The 1991 War displaced hundreds of thousands of people and substantially reduced tourism, which had previously accounted for a substantial part of Croatia's economy. It is expected that ongoing expenditures relating to the 1991 War, including reconstruction, veteran's pensions and costs associated with providing refuge to the significant number of refugees and displaced persons from the Balkan region will continue to range from 2.0 to 2.5 per cent. of GDP for the year. The Government expects these expenditures to decrease as a share of GDP in the long-term, as reconstruction of war damage reaches completion.

Croatia's industrial base was further disrupted by the loss of previous markets in the former Yugoslavia and the loss of trade routes to the South and the East through the former Yugoslavia. Between 1989 and 1993, Croatia's real economic output shrank significantly and disposable incomes fell sharply. The drop in economic activity, alongside growing expenses linked to the refugee crisis and other mounting pressures on public expenditure, led to an increased public deficit and resulted in high levels of inflation.

Stabilisation of the Economy

Background to the Stabilisation Programme

At the time of the breakout of the 1991 War, Croatia was still using the currency of the former Yugoslavia. External borrowing was virtually impossible as the country was not recognised internationally and war risks meant that commercial lenders were unwilling to extend credit. The deficit could only be financed by money creation, aggravating an already high inflation rate. Croatia introduced a new, temporary currency, the Croatian Dinar ("**HRD**"), in December 1991 and initially maintained a fixed exchange rate against the Deutsche Mark ("**DEM**"). At first, this helped to reduce inflation, but lack of public confidence in the HRD led to foreign currency substitution and inflation soon reignited. In addition, the CNB policy of increasing its foreign exchange reserves in the domestic market resulted in increased issuance of the domestic currency, further aggravating inflationary pressures. In 1994, the HRD was replaced by a new, permanent currency, the Croatian Kuna ("**HRK**").

The 1993 Stabilisation Programme

In October 1993, the Government adopted a stabilisation programme (the "**Stabilisation Programme**") with the short-term objective of eradicating hyperinflation and, in the longer term, transitioning into an effective market economy. The Stabilisation Programme had four general targets:

- stabilising and strengthening of the Croatian economy;
- introducing a competitive environment and appropriate ownership structure with a reduced role for the Government in the economy;
- protecting of low income population groups from the inflationary redistribution of income; and
- establishing preconditions for sustainable economic development and growth.

The implementation of the Stabilisation Programme by the Government, the CNB and the Ministries of Finance and of Economy, Labour and Entrepreneurship, among others, broke the inflationary cycle. The Stabilisation Programme continues to serve as the basis for economic policy in Croatia and, as of October 2009, has been adhered to by each subsequent Government since its original adoption in 1993. The economic goals and policies of the Government are designed to align with a monetary policy that will meet the conditions for long-term low inflation by minimizing fiscal imbalances. In the longer term, the aim of these policies is to establish the full external convertibility of the Kuna, to achieve long-term price stability, to reduce unemployment and to establish an appropriate internal and external balance in terms of sustained and sustainable growth.

The implementation of the Stabilisation Programme resulted in a reduction in inflation from over 1,000 per cent. in 1992 and 1993 to 8.4 per cent. in 2008 on the basis of PPI (as defined below) based on CBS statistics. Once the initial monetary stabilisation had been achieved, the Government embarked on the second stage of the stabilisation programme which included the rehabilitation of the banking system and acceleration of privatisation of businesses previously owned and operated by the State. On 14 October 1995 the Government entered into the Stand By Arrangement with the IMF which provided access to additional funding. This agreement also opened the door to additional financing from the World Bank and the EBRD. Since the 1995 Stand By Arrangement expired, there have been two further Stand By Arrangements, one approved in 2001 and the other in 2004. The last Stand By Arrangement expired in November 2006.

The Privatisation Programme

Overview

Croatia commenced its privatisation programme in 1991. The aim of the programme was to privatise approximately 3,000 State-owned enterprises. The methods of privatisation were, to a certain extent, dictated by the system of State ownership and socialist self-management in the former Yugoslavia. The Government decided that such enterprises would be provided with a degree of autonomy in shaping their privatisation: each enterprise would propose features of its privatisation, such as equity or debt structures, or debt/equity swaps. These would then either be accepted or rejected, but not modified, by the CPF. Through the privatisation programme, former and current employees, pensioners and management of the privatised entities acquired ownership.

Privatisation has been implemented in two phases: the first under the 1991 Law on the Transformation of Socially Owned Enterprises (the "**Law on Transformation**") and the second under the Privatisation Law (the "**Privatization Law**") enacted in mid-1993 which came into force on 22 March 1996. The Croatian Privatisation Fund (*Hrvatski fond za privatizaciju*) ("**CPF**") is the governmental agency responsible for privatisation. It was established by the Croatian Privatization Fund Act, at the request of the IMF and World Bank. The CPF was created by merging two former agencies: the Agency for Reconstruction and Development and the Croatian Development Fund.

The Government awards concessions according to the procedures outlined in the Concessions Act (Official Gazette no. 125/08) (the "**Concessions Act**"). The Concessions Act regulates the process by which non-Government entities acquire the right to use Croatia's natural resources and resources of interest, the right to engage in activities of national interest to Croatia and the construction and utilisation of facilities and plants necessary to carry out those activities.

Privatisation Process

Under the Law on Transformation, shares in the relevant enterprise, which would be valued on the basis of the estimated net book value of the enterprise, had to be offered to the enterprise's former and current employees, then to State employees and employees at public enterprises, and finally to other citizens of Croatia. All such subscribers were entitled to purchase shares at a basic discount of 20 per cent., plus a further discount of 1 per cent. for each year of employment in Croatia (up to a maximum discount of 60 per cent. on acquisition with a value up to and including DEM 20,000).

The Privatisation Law introduced a further limit in that no more than 50 per cent. of the value of any company could be purchased by subscribers entitled to such discounts. Those individuals acquiring shares were allowed to pay in instalments over a five-year period (subsequently increased to 20 years). To the extent that shares above the DEM 20,000 threshold were purchased, no discount was available but the instalment payment option was available; such shares as well as the discounted shares could be purchased with Frozen Foreign Exchange Deposits, ("**FFEDs**"). In January 1994, the Government changed its policy to allow a partial distribution of shares in companies to be privatised. Private subscribers were entitled to obtain outright that part of their full entitlement of shares that represented their discount, merely by paying either the first annual instalment or 5 per cent. of the price of the non-discounted portion. Subscribers who obtained their "discounted shares" in this way were under no liability, in practice, to pay the remaining instalments under the contract to purchase the remaining "non-discounted shares". The sequence and progress of individual privatisation stages are determined by decisions of the Government and approved by the Parliament.

The remaining shares, namely those which were not acquired by employees, former employees, State employees and employees of public enterprises or other citizens of Croatia, were transferred to the CPF and the State Pension Funds.

The CPF disposes of the shares in its portfolio by way of public auction, tender or private sale. However, since such cash generating methods did not prove effective, the remaining shares were divested by way of a mass voucher privatisation scheme, specially designed for the war-affected population.

The mass voucher privatisation involved a distribution of the shares not sold in the first phase of privatisation. The vouchers were given to individuals affected by the hostilities, such as injured servicemen, war widows and their families, families of interned or missing soldiers or civilians, former political prisoners and displaced persons and refugees (around 5 per cent. of the total population). Under Croatian law, vouchers are not securities and are not tradable. Individual voucher holders could bid for single company shares or invest in a voucher fund. More than 90 per cent. of the voucher holders chose to invest in voucher funds, which in turn placed the majority of the bids for shares.

The cash proceeds from the privatisation of enterprises have accrued to the Government. Up to and including 1995, cash proceeds were transferred to the general budget. Since 1996, all proceeds realised by the CPF have been transferred to the Croatian Bank for Reconstruction and Development ("**HBOR**"). The Government initially saw the privatisation programme as a significant source of revenue for the general budget, however, receipts from privatisation have not been as large as expected due partly to the option granted to investors to pay for their shares with FFEDs.

To aid in the privatisation programme, legislation was passed to establish several individual privatisation investment funds (each a "**Privatisation Investment Fund**") were established. The Privatisation Investment Funds were listed on the Zagreb Stock Exchange ("**ZSE**") in 1999 and had five years to restructure their portfolio and transform themselves into regular closed-end investment funds. The strategy of most Private Investment Funds is to sell their holdings in privatised companies and invest the proceeds in other listed securities.

In accordance with the Government's policy for promoting economic prosperity within Croatia (the "**Strategic Development Framework 2006-2013**"), the main goals in the field of privatisation are:

- completion of the privatisation process of State-owned companies managed by the CPF and their rehabilitation, including in particular, completion of the privatisation process of the shipbuilding industry by 2010;
- support of the employees through labour market institutions and welfare policy; and
- transformation of the CPF into an institution that will manage State property efficiently and actively.

Out of approximately 3,000 companies that started their transition process at the beginning of the 1990s, the portfolio of the CPF, in October 2009, contained 785 companies with the total equity of HRK 60.9 billion, of which HRK 16.5 billion were State-owned. In accordance with the ownership structure, CPF was a minority owner of 80 per cent. of these companies (629 companies), holding up to 25 per cent. of their shares. The CPF's shareholding in 72 of the companies ranges from 25 per cent. to 50 per cent., and in 84 of the companies its shareholding exceeds 50 per cent.

As of October 2009, the portfolio of State majority-owned companies that have not yet been privatised can be broken down by sectors as follows: 27 companies in the industry sector, 17 in the tourism sector, 12 in the agriculture sector and 28 companies in the other sectors.

In the industry sector, the shipbuilding industry is the most significant part of the portfolio owned by CPF. Currently, this industry is being prepared for privatisation in accordance with the Decision on the Intention to Privatise and the Principles of Privatisation of Five Shipyards Majority-Owned by the Government that was adopted by in May 2008. On 31 September 2009, CPF announced that only two valid bids were received for the privatisation of five of Croatia's shipyards. The CPF subsequently revised the terms of the privatisation, but has not established a date for the submission of new bids.

After the privatisation of the ferrous metallurgy sector (comprised mainly of the sale of the Split Iron Plant, the Sisak Pipe Rolling Mill and the TLM Šibenik Aluminium Factory), activities were launched to resolve the issue of the long-term sustainability of the shipbuilding industry. This industry is considered to be the most complex and demanding industry in privatisation terms and still remains in the portfolio of the CPF.

The CPF is currently conducting the bidding process for ZRC Lipik (a tourism and hospitality business) and concluded the bidding for Vukovarski Poljoprivredno Industrijski Kombinat (a producer, processor and trader of agricultural products and other foodstuffs) on 22 October 2009. Neither the CPF nor the Government anticipates any significant revenues from either of these two privatisation efforts to be recognized in the Government's 2009 Budget.

Privatisation of Utilities (including Oil and Gas)

HT-hrvatske telekomunikacije d.d. ("**Croatia Telecom**") has been partly privatised, with Deutsche Telekom purchasing 35 per cent. of the shares in Croatian Telecom in 1999 for US$850 million and an additional 16 per cent. in 2001 for EUR 500 million. An additional 7 per cent. of Croatian Telecom shares were sold to its employees in 2005 and 7 per cent. of shares in Croatian Telecom were transferred to the Fund for Croatian Homeland War Veterans and their Family Members ("**FOND HB**"). Croatia currently has three fixed telephony operators and a high level of competition in the mobile markets.

On 5 October 2007, Croatia sold 32.5 per cent. of Croatian Telecom's existing ordinary shares by Initial Public Offering ("**IPO**"), thus reducing its shareholding from 42 per cent. to 9.5 per cent., of which 2.5 per cent. was reserved for bonus shares under the IPO retail preferential offering. Since 5 October 2007, Croatia Telecom ordinary shares have been listed on the ZSE, while Global Depositary Receipts ("**GDRs**") have been listed on the London Stock Exchange ("**LSE**"). In June 2008, 7 per cent. of shares were sold to the current and former employees of Croatia Telecom and Croatian Post, further reducing the ownership of Croatia to 3.6 per cent.

The privatisation of the Croatian Oil and Gas Company INA-INDUSTRIJA NAFTE d.d., ("**INA**"), is based on the Law on the Privatisation of INA (Official Gazette 32/02) passed by the Parliament on 19 March 2002. This provides for the privatisation of INA to be carried out in phases. Of these phases, four have already taken place, starting with the sale of 25 per cent. plus one share to the strategic investor MOL, a Hungarian Oil and Gas Public Limited Company ("**MOL**"), in 2003 and then the transfer, without compensation, of 7 per cent. of INA shares to Fond HB in 2005. The next phase was the sale of at least 15 per cent. of INA shares by way of a public offering to Croatian citizens, Croatian legal entities and foreign investors, which took place in November 2006. The ordinary shares of INA (16.2 per cent. of total number of shares) were listed and began trading on the official market of the ZSE and as GDRs on the LSE. The following privatisation phase, of selling a maximum of 7 per cent. of INA shares to present and former INA employees, was completed in November 2007 (6.28 per cent. of total shares).

The final phase of the INA privatisation envisages the sale or a swap of the remaining INA shares depending on market conditions. This would either be to a strategic investor or on the capital markets, pursuant to the Government's decision and subject to prior consent of the Parliament. The last phase would be the transfer of some of the remaining shares to former owners under the Law on Compensation for Property Expropriated during the Yugoslav Communist regime. None of these phases have been commenced or scheduled yet.

Croatia will retain direct ownership of 25 per cent. plus one share of INA, a stake which will be privatised once Croatia becomes a member of the EU.

MOL's voluntary takeover offer to all shareholders of INA, which was announced on 5 September 2008 and completed in October 2008, had a major effect on the shareholder structure. After the takeover offer MOL became INA's largest shareholder with a 47.16 per cent. share followed by the Government with a 44.84 per cent. share.

Economic Policy

According to the World Bank country brief on Croatia from April 2009, Croatia's objective is to reach 75 per cent. of the EU's average per capita income by 2013. Currently Croatia's per capita income stands at approximately US$15,600, approximately 63 per cent. of the GDP per capita of the EU27 countries in purchasing power standards.

The framework and goals of the economic policy of Croatia are defined in a series of strategic documents of the Government, namely: the Strategic Development Framework for 2006-2013, the Economic and Fiscal Policy Guidelines for 2009-2011 and the PEP. Those documents provide the basis for the implementation of the economic policy in the medium term period, and they are prepared through consultations between the Government administration bodies and employers' and unions' representatives. The Strategic Development Framework for 2006-2013 is the main strategic document which defines the priority areas of action and the economic policy goals until 2013. The Economic and Fiscal Policy Guidelines for 2009-2011 provide a three-year fiscal framework for the implementation of the goals and measures laid out in the Strategic Development Framework for 2006-2013. The PEP for 2009-2011 builds on these two documents and defines the macroeconomic and fiscal framework for the forthcoming three-year period, the priority areas of the policy of the Government, the order of those priorities, as well as the specific measures necessary for successful implementation of the structural economic reforms.

For the period from 2009 until 2011, the main economic policy goal is to maintain macroeconomic stability and ensure sustainable economic growth, increase employment, and strengthen the competitiveness of the Croatian economy.

Achieving the main economic policy goal requires:

- positive rates of economic growth;
- further fiscal consolidation, reduction of public debt and stabilisation of external debt;
- promoting business and entrepreneurship;
- restructuring, including modernisation and privatisation of the economic sectors dependent on Government aid;
- continuing the reform of the public administration and judicial system, accompanied by the active implementation of anti-corruption measures; and
- further regional development supported by continued investments in infrastructure, transportation and water and gas supply.

In September 2008, the World Bank's Board endorsed the Country Partnership Strategy ("**CPS**") for Croatia for 2009-2012. The goal of the CPS is to support the completion of Croatia's EU accession and the convergence of its income level with that of other EU member states in a fiscally, socially and environmentally sustainable fashion. In pursuing this goal, the CPS aims to:

- sustain macroeconomic stability;
- strengthen private sector-led growth and accelerate convergence with the EU;
- improve the quality and efficiency in the social sectors; and
- increase the sustainability of long-term development.

In the selection and structuring of projects to be supported, primary consideration is given to the potential contribution of the proposed projects to the Croatia's EU accession agenda. Projects that enhance Croatia's capacity to absorb EU funds, especially following the accession, have high priority. The CPS envisages an indicative aggregate base-case lending amount of approximately US$1.0 to 1.4 billion for investment operations over the four-year period. The CPS lending program will mainly focus on the areas of public expenditure reform, governance, investment climate and climate change.

In 2009, the World Bank's Board approved three loans exceeding US$240 million to fund the continuation of the Rijeka gateway, coastal city pollution control programs and the improvement of emergency medical services. At the request of the Government, the World Bank has agreed to provide a credit line of approximately EUR100 million for exporters through the HBOR and commercial banks to help mitigate the impact of the global financial and economic crisis and to provide funding for the private sector. Other projects being developed cover such areas as judicial reforms, disaster risk management and mitigation, port development, irrigation and education. The CPS may be adjusted, if necessary, to help address the consequences of the global financial and economic crisis. Currently, the World Bank finances 18 projects in Croatia in a wide range of sectors with a combined loan amount of almost US$1.1 billion. The International Finance Corporation's portfolio of investment in Croatia amounts to approximately US$340 million and the Multilateral Investment Guarantee Agency's guarantees relating to projects within Croatia slightly exceeded US$40 million as of June 2009.

Recent Economic Developments and Trends

The effects of the global financial and economic crisis were first felt in the Balkan region in the second half of 2008 and intensified towards the end of the year. The negative impact of the crisis intensified further in the first half of 2009, and the Croatian economy is still experiencing these effects. In particular, GDP growth declined from 5.5 per cent. in 2007 to 2.4 per cent. in 2008, while in the first half of 2009 GDP contracted by approximately 6.5 per cent.

Domestic banks responded to these economic pressures by increasing their foreign financing and, commencing in January 2009, many domestic banks began drawing down their foreign assets, facilitated by regulatory changes such as the abolishment of the marginal reserve requirement in October 2008 and the reduction in banks reserve requirement from 17 per cent. to 14 per cent. in December 2008, as further described under "*Monetary Developments and International Reserves*" below.

In response to the global financial and economic crisis, the CNB tailored monetary policy to support macroeconomic and financial stability and maintain liquidity in the system. The CNB addressed emerging liquidity shortages through active use of regulatory requirements and repo auctions, while it maintained policy rates (the repo auction rate) that were generally stable at 6.0 per cent. In addition to monetary policy mechanisms, the CNB and the Government took the following actions:

- In October 2008, the Government increased the guarantee per account on bank deposits from HRK 100,000 (EUR 14,000) to HRK 400,000 (EUR 56,000), after banks experienced a large volume of household deposit withdrawals. In addition, Parliament authorized the Government to increase the guarantee limit further if necessary. Together with adequate support from the CNB and parent banks, this measure helped stop deposit withdrawals and encourage future deposits.

- In November 2008, the CNB simplified the rules for banks to access emergency liquidity assistance. As of October 2009, no Croatian banks have accessed emergency liquidity assistance.

- The Government obtained funds for HBOR from international institutions such as the World Bank and the European Investment Bank to support exporters and small-to-medium enterprises.

- The Government took steps to curtail public spending, for example by cutting public sector wages by 6.0 per cent. and freezing any public sector wage increases until GDP shows positive growth. As of the date hereof, this freeze was still in place. For additional discussion on actions taken by the CNB to counteract the negative effects of the global financial and economic crisis, see "*Monetary Developments and International Reserves*".

These measures, together with intermittent intervention by the CNB resulted in a total reserve loss between September 2008 and March 2009, as well as other factors, contributed to stabilising the Croatian market, strengthening consumer confidence and limiting the depreciation of the Kuna against the Euro. The EUR/HRK exchange rate appreciated from 7.46 as at 31 March 2009 to 7.29 as at 30 June 2009, and then remained constant at 7.29 as at 30 September 2009.

As a result of the global financial and economic crisis, Croatia is experiencing a contraction in real economic growth, depreciation pressures on the HRK/EUR exchange rate, a decrease in, and uncertainty regarding, foreign capital inflows and increasing financing needs in most domestic sectors. GDP according to expenditure shows a slowdown in the annual dynamics of most aggregate demand components in 2008 and 2009. Household and government consumption continued to decelerate in 2008, as compared to 2007, primarily due to a sharp increase in consumer prices. During the same period, both exports and imports in goods and services, as measured by volume, slowed considerably. These decreases resulted in a negative contribution of exports and imports by volume to overall economic growth.

Exports of goods and services, based on balance of payments data expressed in EUR, increased by 7.6 per cent. from EUR 17.0 billion in 2006 to EUR 18.3 billion in 2007. Exports of goods and services in 2008 increased by 8.7 per cent. to EUR 19.9 billion as compared to 2007. This increase in exports was largely due to an increase in exports of services, especially in the tourism sector. Exports of goods rose principally as a result of an increase in other transport equipment and natural and manufactured gas exports. However, if these two divisions as well as oil and refined petroleum products are excluded, the rise in exports is negligible. For the first half of 2009, exports of goods and services decreased by 17.7 per cent., as compared to the same period in 2008, to EUR 6.7 billion from EUR 8.1 billion.

Imports of goods and services, based on balance of payments data expressed in EUR, increased from EUR 21.5 billion in 2007 to EUR 23.7 billion in 2008. This increase was predominantly caused by a rise in the imports of goods, especially energy products (oil and gas) and other transport equipment, whereas imports of other goods increased at a slower rate due to a large extent to a decline in imports of road vehicles in the fourth quarter of 2008. In the first half of 2009, imports of goods and services fell by 25.2 per cent. to EUR 8.9 billion from EUR 11.9 billion in the first half of 2008.

The current account deficit widened from EUR 3.2 billion in 2007 to EUR 4.4 billion in 2008, a deterioration of 35.4 per cent. The current account deficit reached 9.3 per cent. of GDP in 2008, increasing by 1.7 per cent. of GDP compared to 2007. This widening was principally due to growing imbalances in foreign trade in goods, while the strong performance in the services sector, primarily in tourism, helped to alleviate those negative effects. The current transfers account remained unchanged, while the negative balance in the factor income account further increased. According to the Economic Intelligence Unit, Croatia currently has a current account deficit which is among the lowest in the Central and Eastern European region.

In the first half of 2009 the current account deficit improved significantly, decreasing by 38.6 per cent., or EUR 1.7 billion, as compared to the first half of 2008 (from EUR 4.4 billion down to EUR 2.7 billion). This decrease was due largely to decreased domestic consumption, and therefore decreased imports, in response to the global financial and economic crisis. The merchandise trade deficit narrowed by EUR 1.9 billion as compared to the first half of 2008, which was largely due to a larger drop in imports than in exports. At the same time, the positive balance on the services account decreased annually by EUR 406 million, the income account deficit declined by EUR 101.6 million and the current transfers account recorded a slight improvement of its positive balance, in the amount of EUR 5.9 million.

Economic indicators from the CBS for the first half of 2009 show negative trends in all major non-financial activities. Economic activity in sectors such as manufacturing and retail trade showed slower growth in 2008 than in earlier years. In 2008, industrial production grew by 1.2 per cent., as compared to growth of 4.9 per cent. in 2007 and growth of 4.1 per cent. in 2006, according to CBS data. Industrial production contracted by 10.2 per cent. in the first half of 2009 compared to the same period in 2008 due to decreases in domestic and foreign demand, yet improved as of 31 August 2009 to a cumulative contraction of 9.8 per cent. for the first eight months of 2009.

In 2008, real turnover in the retail trade declined by 1.2 per cent. as compared to an increase of 3.5 per cent. in 2007. Real turnover in retail trade contracted by 16.6 per cent. in the first half of 2009 compared to the same period in 2008 as a result of a decrease in household consumption, which improved slightly in July and August resulting in a cumulative annual contraction of 16.0 per cent. in the first eight months of 2009. In the first half of 2009, construction volume recorded an annual decline of 2.7 per cent. while the number of tourist overnights fell by 4.7 per cent, both as compared to the same period in 2008.

Year-on-year growth of tourist arrivals in 2008 as compared to 2007 amounted to 0.9 per cent., while the number of nights spent in Croatia increased by 2.0 per cent., as compared to an increase of 5.6 per cent. in 2007. In the first half of 2009, tourist arrivals decreased by 7.0 per cent. as compared to the first half of 2008. The number of nights spent in Croatia contracted by 4.7 per cent in the first half of 2009, which improved slightly as of 31 August 2009 to a contraction of 1.4 per cent. Early in 2009 a Tourism Action Plan was initiated by the Government in order to help attract more tourists to Croatia. Among the measures implemented was the temporary lifting of visa requirements for Russian and Ukrainian citizens visiting Croatia during the summer of 2009.

National accounts data reported by the CBS show that in the first half of 2009, GDP contracted by 6.5 per cent. The sectors with the strongest contraction were private consumption and fixed investment with contraction of 9.7 per cent. and 12.6 per cent., respectively. The volume of international trade was also significantly reduced with imports falling by 22.9 per cent. and exports by 17.4 per cent.

In the first half of 2009, the average inflation rate stood at 3.3 per cent., and is projected to remain low in 2009 and the coming years (approximately 3 per cent.), primarily due to downward pressures on prices from domestic demand.

The capital and financial account recorded larger net capital inflows in the last quarter of 2008 than in the same period in 2007 due primarily to the fall in international reserves, as a result of changes in monetary policy aimed at improving commercial banks' foreign currency liquidity marginal reserve requirement being revoked. Strong foreign borrowing by banks also contributed to the inflow of capital. In 2008, the capital and financial account had slightly larger net capital inflows than in 2007 with the largest inflow of funds attributable to direct investments (the largest single inflow of foreign direct investment was related to the acquisition of 22 per cent. of INA shares by MOL) In addition, significant capital inflow was recorded through the debt instruments on the other investment account, while portfolio investment experienced outflows of funds through repayment of Government bonds and, at the end of 2008, through withdrawal of funds from Croatia and increased investments abroad.

In the first half of 2009, net inflows (excluding the change in international reserves) on the capital and financial account amounted to EUR 2.6 billion, a decrease of 41.5 per cent. compared to the same period in 2008. The lower net inflow of capital was recorded primarily with direct investments, which were less than half of those in the same period in 2008. Unlike in the first half of 2008, the portfolio investments account experienced a net outflow of funds, as Government repayments exceeded the amount of new borrowing abroad. The net inflow of funds on the other investments account decreased by 24.9 per cent. compared to the first half of 2008, with liabilities decreasing by a half and foreign assets exceeding the levels recorded in the same period in 2008. Gross international reserves at the end of June 2009 stood at a level that was approximately equal to that in December 2008.

Increasing by EUR 5.9 billion in 2008, Croatia's gross external debt exceeded EUR 39.1 billion at the end of December (82.6 per cent. of GDP). The acceleration of debt from the previous year was mainly a consequence of strong corporate foreign borrowing, however, this slowed down noticeably in the last quarter of 2008. In the first seven months of 2009 external debt increased further by EUR 1.2 billion, which represents only half of the increase recorded in the same period of 2008. Debt growth was also mostly due to the strong borrowing of the corporate sector.

After decreasing their debt in the first nine months of 2008, banks increased their foreign liabilities in the fourth quarter of 2008 by EUR 2.1 billion, leading to a total debt growth of EUR 1.2 billion in 2008. In 2009, banks' external debt, after a drop in February prompted by the CNB's lowering of the minimum required amount of foreign currency claims, increased in the following months and (as is usual in the summer months) started to decrease after

May, reaching EUR 10.2 billion at the end of July. The general government external debt fell by EUR 0.1 billion in 2008. Unlike enterprises and banks, in the first seven months of 2009 the general government external debt decreased slightly, mostly reflecting repayment of the eurobond in February and samurai bond in June that was larger than the new eurobond issue in June of EUR 750 million.

Gross Domestic Product

In the beginning of 2009, GDP data for 1995 to the third quarter 2008 was revised according to new and improved data sources and calculation methods. The main purpose of this revision was the alignment of GDP estimates with the European System of Accounts (ESA 1995). The "calculation by production" approach has been improved by including the non-observed economy, the estimate of apartments available for rent and being rented and estimates and allocation of Financial Intermediation Services Indirectly Measured ("**FISIM**"). Entrepreneurs comprise the largest part of the non-observed economy by generally under-reporting revenues and over-reporting costs in order to minimise tax obligations. This inaccuracy of reporting is believed to be most prevalent in the construction, retail trade and hotel and restaurant sectors. The expenditure side GDP components were revised in order to align with EU standards. The largest revisions were to household consumption, with an average increase of 22.7 per cent. compared to old calculations, due to revisions to the estimate of apartments available for rent and being rented, allocation of FISIM and the non-observed economy. The second largest correction was to the export of tourist services, which now contains the non-observed economy and the allocation of FISIM.

The following table sets forth GDP real growth rates of various sectors of the economy as compared to the prior period:

	Year ended 31 December			Six months ended 30 June	Six months ended 30 June
	2006	**2007**	**2008**	**2008**	**2009**
			(per cent.)		
Households	3.5	6.2	0.8	3.2	(9.7)
Government	2.2	3.4	1.9	1.8	2.5
Gross fixed capital formation	10.9	6.5	8.2	11.3	(12.6)
Exports of goods and services	6.5	4.3	1.7	4.1	(17.4)
Imports of goods and services	7.4	6.5	3.6	7.7	(22.9)
Change in GDP for the period	4.7	5.5	2.4	3.8	(6.5)

Source: Central Bureau of Statistics and Croatian National Bank

In 2008, mainly as a consequence of the spillover of the global financial and economic crisis towards the end of the year, the GDP growth amounted to 2.4 per cent., decelerating by 3.1 percentage points compared to 2007. When observing the breakdown of GDP by expenditure categories, the highest GDP growth in 2008 was recorded by gross fixed capital formation, amounting to 8.2 per cent., primarily due to strong construction activity which, despite the crisis, had not slowed down significantly towards the end of 2008. Imports of goods and services recorded a real GDP growth rate of 3.6 per cent. in 2008, the lowest since 1999. The exports of goods and services rose by only 1.7 per cent. primarily because of the downward trend in foreign demand in the second half of the year and the decrease in revenue from exports. The main driver of economic slowdown in the second half of 2008 was the significant decrease in personal consumption, which recorded the lowest growth rate since 1999, amounting to only 0.8 per cent. The most important factors behind this trend in 2008 were decreasing consumer confidence, the decrease in real net wage bill growth and the slowdown in consumer credit growth. Government consumption, which recorded a real annual growth of 1.9 per cent., provided only a negligible contribution to the weakened domestic demand.

In the first half of 2009, GDP contracted by 6.5 per cent. compared to the same period in 2008. This contraction was caused by several factors, including a decline in exports of goods and services and in gross fixed capital formation. The only component from the expenditure side with a positive real growth rate in the first half of 2009 was Government consumption which recorded an annual rise of 2.5 per cent. This growth was largely due to increased Government spending in terms of both investments in infrastructure and expenditure on social services programs.

The components with the greatest real contraction in the first half of 2009 as compared to 2008 were imports and exports of goods and services as measured by volume, which declined by 22.9 per cent. and 17.4 per cent., respectively.

The following table contains real and nominal GDP figures in the period from 2005 to the first half of 2009:

	Year ended 31 December				Six months ended 30 June	
	2005	2006	2007	2008	2008	2009
Nominal GDP (HRK millions)	264,367	286,341	314,223	342,159	165,943	162,494
Nominal GDP (EUR millions)	35,725	39,102	42,833	47,370	22,825	22,018
Real GDP growth *(per cent.)*(EUR)	4.2	4.7	5.5	2.4	3.8	(6.5)
HRK/EUR exchange rate (average for the period)	7.40	7.32	7.34	7.22	7.27	7.38
HRK/USD exchange rate (average for the period)	5.95	5.84	5.36	4.94	4.76	5.55

Source: Croatian National Bank

Real GDP per capita was EUR 8,043, EUR 8,807, EUR 9,656 and EUR 10,682 in 2005, 2006, 2007 and 2008, respectively.

Gross Value Added

Growth of GVA in real prices decreased by 2.7 per cent. from a growth of 5.5 per cent. in 2007 to a growth of 2.8 per cent. in 2008. This decrease was principally due to decreases in the growth of GVA in the hotel and restaurant sector, wholesale and retail trade and the mining, quarrying, manufacturing, electricity, gas and water supply sector reflecting decreased consumption and a deceleration of tourism in large part to the global financial and economic crisis. These decreases were in part setoff by increases in the construction sector as a result of private investment in non-residential buildings. Real GVA contracted by 4.0 per cent. in the first half of 2009 as compared to the same period in 2008. This decrease was principally due to decreases in wholesale and retail trade and decreases in the growth of the mining, quarrying, manufacturing, electricity, gas and water supply sector and in large part due to the global financial and economic crisis. These decreases were in part offset by increases in value added from financial intermediation and public administration sectors.

The following table sets forth nominal GVA in current prices of various sectors for the periods indicated:

	Year ended 31 December					Six months ended 30 June		
	2005	2006	2007	2008		2008	2009	
	(HRK millions)				*(per cent. of total)*	*(HRK millions)*		*(per cent. of total)*
Agriculture, hunting, forestry and fishing	14,725	15,578	16,400	19,011	6.4	9,319	9,672	6.7
Mining and quarrying, manufacturing, electricity, gas and water supply	47,293	50,683	55,271	59,753	20.2	29,928	28,063	19.6
Construction	16,736	19,044	20,907	24,659	8.3	12,441	12,509	8.7
Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods	29,254	31,156	34,431	36,122	12.2	18,113	15,778	11.0
Hotel and restaurants	9,712	10,510	11,802	12,791	4.3	5,029	5,072	3.5
Transport, storage and communication	20,561	22,466	24,479	25,480	8.6	11,434	11,089	7.7
Financial intermediation, real estate, renting and business activities	48,630	54,881	61,795	67,743	22.9	33,423	35,135	24.5
Other(1)	39,273	41,738	45,351	49,870	16.9	24,195	26,099	18.2
Total GVA	**226,184**	**246,056**	**270,436**	**295,430**	**100.0**	**143,883**	**143,417**	**100.0**

Source: Central Bureau of Statistics and Croatian National Bank

(1) Includes public administration and defence, compulsory social security, education, health and social work, other community, social and personal services and activities of households.

The following table sets forth GVA in real prices for the periods indicated:

	Year ended 31 December					Six months ended 30 June		
	2005	2006	2007	2008		2008		2009
		(HRK millions)			(per cent. of total)	(HRK millions)		(per cent. of total)
Agriculture, hunting, forestry and fishing	13,448	13,706	13,897	14,338	6.9	7,072	7,195	7.2
Mining and quarrying, manufacturing, electricity, gas and water supply	41,100	42,552	45,001	45,621	21.8	23,378	21,184	21.3
Construction	12,430	13,389	13,847	15,026	7.2	7,695	7,505	7.5
Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods	27,514	28,324	30,344	30,255	14.5	14,887	12,538	12.6
Hotel and restaurants	7,556	7,911	8,624	8,816	4.2	3,605	3,497	3.5
Transport, storage and communication	17,964	19,504	20,956	22,044	10.5	10,801	10,187	10.2
Financial intermediation, real estate, renting and business activities	31,683	34,267	36,891	38,143	18.3	18,823	19,102	19.2
Other[(1)]	31,932	32,276	32,811	33,530	16.0	16,715	16,969	17.1
Total GVA	**183,960**	**192,676**	**203,264**	**208,966**	**100.0**	**103,536**	**99,439**	**100.0**
Taxes minus subsidies on products	**36,618**	**38,356**	**40,409**	**40,456**	**—**	**19,923**	**16,005**	**—**
GDP	**220,578**	**231,032**	**243,673**	**249,422**	**—**	**123,458**	**115,444**	**—**

Source: Central Bureau of Statistics and Croatian National Bank

(1) Includes public administration and defence, compulsory social security, education, health and social work, other community, social and personal services and activities of households.

The following table sets forth annual real growth rates of GVA by sector for the periods indicated:

	Year ended 31 December				Six months ended 30 June	
	2005	2006	2007	2008	2008	2009
			(per cent.)			
Agriculture, hunting, forestry and fishing	(0.3)	1.9	1.4	3.2	2.0	1.8
Mining and quarrying, manufacturing, electricity, gas and water supply	3.2	3.5	5.8	1.4	4.1	(9.4)
Construction	10.6	7.7	3.4	8.5	9.1	(2.5)
Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods	7.4	2.9	7.1	(0.3)	2.8	(15.8)
Hotel and restaurants	8.1	4.7	9.0	2.2	3.4	(3.0)
Transport, storage and communication	5.2	8.6	7.4	5.2	6.6	(5.7)
Financial intermediation, real estate, renting and business activities	4.2	8.2	7.7	3.4	4.8	1.5
Other[(1)]	1.4	1.1	1.7	2.2	2.6	1.5
Total GVA growth	4.3	4.7	5.5	2.8	4.4	(4.0)

Source: Central Bureau of Statistics and Croatian National Bank

(1) Includes public administration and defence, compulsory social security, education, health and social work, other community, social and personal services and activities of households.

Agriculture, hunting, forestry and fishing

In 2008, the GVA of the agriculture, hunting, forestry and fishing sectors, measured in current prices, increased by 15.9 per cent. to HRK 19.0 billion from HRK 16.4 billion in 2007. The increase was principally due to a rise in prices, as measured by the implicit deflator

The real GVA of the agriculture, hunting, forestry and fishing sectors increased by 3.2 per cent. in 2008 compared to 2007, mainly as a result of favourable weather conditions in 2008 that led to an increase in the volume of production of certain agricultural products. The economic activity in the sectors of agriculture, hunting, forestry and fishing was more pronounced in the second rather than the first half of 2008, mainly because the annual rate of change of GVA was higher during the period from July to December. In addition, in the first half of 2009, real GVA of these sectors increased by 1.8 per cent. compared to the same period in 2008. Therefore, the share of GVA in agriculture, hunting, forestry and fishing sectors in the total GVA of the economy in the first half of 2009 grew slightly compared to the same period in 2008 and reached 6.7 per cent.

Mining and quarrying, manufacturing, electricity, gas and water supply

The GVA in current prices for the mining and quarrying, manufacturing, electricity, gas and water supply sectors increased by 8.1 per cent. from HRK 55.3 billion in 2007 to HRK 59.8 billion in 2008. To a large extent this was a result of the rise in prices, as measured by implicit deflator

The real GVA of the mining and quarrying, manufacturing, electricity, gas and water supply increased by only 1.4 per cent. in 2008, as compared to 2008. Following a slight recovery of the real GVA dynamics early in the year, the second half of 2008 saw negative annual rates of change in these economic sectors, as a result of a noticeable weakening of both domestic and foreign demand. Real GVA of these sectors decreased by 9.4 per cent. in the first half of 2009, compared to the same period in 2008. Consequently, the share of GVA in mining and quarrying, manufacturing, electricity, gas and water supply in the overall GVA fell from 20.8 per cent. in the first half year of 2008 to 19.6 per cent. in the same period of 2009.

Construction

GVA in current prices in construction increased by 17.9 per cent. from HRK 20.9 billion in 2007 to HRK 24.7 billion in 2008, principally due to the rise in prices and in volumes.

Real GVA growth in construction accelerated strongly in 2008 compared to 2007 and reached 8.5 per cent. The increase in the construction activity was primarily attributable to the increase in construction activity in the private sector, as the public sector's construction activity, mainly related to the construction of road infrastructure, weakened slightly over the year. The private sector's activity in non-housing construction, such as the construction of tourist, sport and trading facilities, surged in 2008. Construction works on residential buildings also remained strong, but their contribution to the growth of the private sector construction activity was significantly smaller. In the first half of 2009, the real GVA in construction decreased by 2.5 per cent. compared to the same period 2008 as a result of lower activity in respect of housing and non-housing buildings in the private sector. Global financial and economic crisis played a crucial role in this development causing a sharp decrease in consumer confidence and demand for new housing. In addition, financing conditions on domestic and foreign credit markets deteriorated and, as a result, certain construction projects had to be cancelled or postponed. The share of GVA in construction in the overall GVA in the first half of 2009 increased very slightly compared to the same period in 2008.

Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods

Nominal data on wholesale and retail trade shows that this sector's GVA measured in current prices increased by 4.9 per cent. from HRK 34.4 billion in 2007 to HRK 36.1 billion in 2008.

A noticeable slowdown in personal consumption growth and stagnation in average foreign tourist consumption in real prices during the peak tourist season reflected negatively on the value added formation in both wholesale and retail trade in 2008. Real GVA in this division declined by 0.3 per cent. in 2008 compared to 2007, with the negative trend intensifying gradually towards the end of the year. The difference between the real and nominal growth values reflects the rise in prices. In the first half of 2009, negative developments in this sector intensified further. Real GVA in wholesale and retail trade decreased by 15.8 per cent. in the first half of 2009 compared with the same period of 2008, principally due to a sharp drop in personal consumption caused largely by low levels of consumer confidence. The share of GVA for wholesale and retail trade in the overall GVA decreased from 12.6 per cent. in the first half of 2008 to 11.0 per cent. in the first half of 2009.

Hotel and restaurants

In 2008, the GVA in current prices in hotels and restaurants sector rose only slightly to HRK 12.8 billion from HRK 11.8 billion in 2007. This increase was in line with the volume indicators of demand for tourist services, namely, a slight increase in tourist arrivals and a slightly stronger growth in tourist nights stayed in commercial accommodation facilities.

Real GVA in hotels and restaurants in 2008 rose 2.2 per cent. compared to 2007. Following the economic slowdown of growth in 2008, in the first half of 2009 the dynamics of the real GVA for the hotels and restaurants sector deteriorated further. In the first six months of 2009, real GVA in this sector fell by 3.0 per cent. compared to the same period in 2008, principally due to a decline in tourist arrivals and nights spent as well as to lower real consumption of foreign tourists as a result of the global financial and economic crisis. However, as many other sectors also recorded real decline in the first half of 2009, the share of GVA in hotels and restaurants in the overall GVA stayed at the same level as in the same period of 2007.

Transport, storage and communication

GVA in current prices for the transport, storage and communications sectors increased from HRK 24.5 billion in 2007 to HRK 25.5 billion in 2008, mainly as a result of the increase in volume as the prices in these sectors, as measured by implicit deflator, fell by 1.0 per cent. in 2008 compared to 2007.

Real growth of GVA in transport, storage and communications sectors in 2008 reached 5.2 per cent., which represents a slowdown in growth compared to 2007. This was mostly due to a slowdown in goods transport but also due to a deceleration in passenger transport (measured by the number of passengers carried and passenger-kilometres). With respect to the telecommunications sector, the downward trend in minutes spent in the fixed network ceased, whereas minutes spent in the mobile network continued to grow albeit at a somewhat slower pace than in 2007. In the first half of 2009, real GVA in the transport, storage and communications sectors fell by 5.7 per cent. compared to the same period in 2008 due to negative developments in industry and trade as well as in tourism. The share of GVA in the transport, storage and communications sectors in the overall GVA in the first half of 2009 decreased slightly compared to the first half of 2008.

Financial intermediation, real estate, renting and business activities

GVA in current prices for the financial intermediation, real estate, renting and business activities sectors increased by 9.6 per cent. from HRK 61.8 billion in 2007 to HRK 67.7 billion in 2008, reflecting an increase in prices and volume.

In the first half of 2009, real growth in these sectors slowed down significantly compared to the same period in 2008 (1.5 per cent. compared to 4.8 per cent.). Despite adverse financial and economic developments in the first half of 2009 as a result of the global financial and economic crisis, the share of GVA in financial intermediation, real estate, renting and business activities sectors in the overall GVA slightly increased compared to the first half of 2008.

Other

GVA in current prices for the other sectors increased by 10.0 per cent. from HRK 45.4 billion in 2007 to HRK 49.9 billion in 2008, mainly due to the increase in prices, as measured by implicit deflator

The real GVA grew by an annual rate of only 2.2 per cent. in 2008. In the first half of 2009, real GVA in these sectors grew by 1.5 per cent. as compared to the same period in 2008 reflecting a modest growth in public sector employment.

According to GDP data for 2008, the economic growth was 2.4 per cent., which is substantially lower than in 2007 (5.5 per cent.). This was due to adverse changes in private consumption and international trade, which also resulted in a marked slowdown of GVA growth in some activities, especially in trade and industry.

Inflation and Trends in Prices

Inflation in Croatia is measured by CPI and the producer price index ("**PPI**"). CPI is based on the price of a basket of approximately 740 goods and services weighted according to the Household Budget Survey and the retail sales data. PPI is based on a basket of roughly 400 industrial products. Standards for Calculating CPI and PPI in Croatia are materially in line with the standards used for calculating CPI and PPI in the EU.

Price stability has been a constant and primary goal of the CNB's monetary policy, which the CNB pursues primarily through the maintenance of the relatively stable HRK/EUR exchange rate.

The following table shows the average annual rate of inflation (in per cent.) as measured in CPI and PPI, from 2003 to 2008 and for the first half of 2009:

	Year ended 31 December						Six months ended 30 June	
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2008**	**2009**
				(per cent.)				
CPI	1.8	2.1	3.3	3.2	2.9	6.1	6.2	3.3
PPI	1.9	3.5	3.0	2.9	3.4	8.3	8.0	0.3

Source: Central Bureau of Statistics

The average annual rate of inflation as measured by CPI increased from 2.9 per cent. in 2007 to 6.1 per cent. in 2008. This was principally due to a relatively high carry-over effect from 2007, and to a sharp increase in prices of food and refined petroleum products in the first half of 2008. The carry-over effect on annual average inflation in 2008 was 3.3 per cent. Carry-over effects denote the annual average rate of growth that would result if the level of CPI reached in the last month of a given year (2007) remained constant throughout the following year (2008). This is equivalent to the percentage difference between the level of CPI in the last month of 2007 and the average level for that year. The calculation of carry-over effects is therefore based on CPI developments in 2007 only. When the level of CPI in the last month of 2007 is above its average level for that year, the carry-over effect on annual average growth in 2008 is positive. Conversely, the carry-over effect is negative when the level of CPI at the end of 2007 is below its average level for that year. Given that CPI growth in Croatia is most often positive, carry-over effects may be interpreted as the minimum annual average growth rate which will be observed in 2008 on the basis of developments in 2007. The actual annual average growth rate observed in 2008 will then be the combination of the carry-over effect and growth developments in the course of 2008.

The surge in CPI peaked in July 2008 when their annual rate of change reached 8.4 per cent. The annual rate of change of CPI subsequently decreased to 2.9 per cent. in December 2008. The annual increase in the inflation of consumer prices in 2008 was due to imported and domestic demand-side factors. One of the most significant domestic factors spurring inflation in the first seven months of 2008 was a strong acceleration of real aggregate demand in 2007. The real annual growth of personal consumption accelerated considerably in 2007 and the postponed impact of this was also observed in the first seven months of 2008. In addition, domestic inflationary pressures also arose from the growth of unit labour costs, caused by a slowdown in labour productivity and a continuing growth of the average nominal gross wage. The sizeable slowdown in inflation after July 2008 was primarily due to decreased personal consumption due in part to the global financial and economic crisis as well as declining imported inflationary pressure. Imported inflationary pressures in the first seven months of 2008 mainly stemmed from a large increase in world prices of raw materials, especially those of crude oil and food raw materials. Primary commodities prices recorded a large increase of 27.5 per cent. in 2008 compared with 2007. Having risen by an average of 10.6 per cent. (in U.S.$) in 2007, the global price of crude oil continued to grow at a much sharper rate averaging 36.4 per cent. in 2008 (from U.S.$71.1 per barrel in 2007 to U.S.$97.0 per barrel in 2008). This growth amounted to 24.1 per cent. in HRK terms in the same period, due to the nominal appreciation of the HRK exchange rate against the U.S. dollar. Food prices also rose sharply in 2008, with a growth rate of 23.3 per cent. compared with 2007.

Domestic inflationary pressures in 2008 were further eased by a slight appreciation of the HRK against the Euro from an average of HRK/EUR 7.34 in 2007 to an average of HRK/EUR 7.22 in 2008. Such exchange rate developments tend to produce a positive effect on domestic inflation as they stabilise both inflationary expectations and the prices of goods imported from the eurozone.

The average annual rate of change of CPI decreased from 3.3 per cent. in the first half of 2009 to 2.8 per cent. as of 31 August 2009. This decrease was due largely to contracting domestic personal consumption and decreasing energy prices due to the favourable base effects caused by the past energy price increases. Industrial producer prices also decreased and the average annual rate of change in the PPI decreased from 8.0 per cent. in the first half of 2008 to 0.3 per cent. in the first half of 2009.

Inflationary pressures in the first half of 2009 mainly stemmed from an increase in regulated prices, such as those of household gas, tobacco products and health care prices. CPI for the 12 month period ending 31 August 2009 increased 3.5 per cent as compared to the same period in 2008.

Domestic inflationary pressures continue to ease in the first eight months of 2009, helped by an appreciation of the HRK against the Euro to an average HRK/EUR of 7.37.

Government Subsidies

The Government maintains a subsidy programme for some large industries such as agriculture, Croatia's shipyards and the Croatian railways. The following table sets out Government subsidies in real prices for the periods indicated:

Industry	Year ended 31 December 2006	2007	2008	Plan 2009[(2)]	Six months ended 30 June 2008	2009
			(HRK thousands)			
Croatian railways	1,603,373	1,655,700	1,727,348	1,631,900	800,412	825,697
Agriculture	2,436,383	3,063,343	3,228,520	3,558,832	2,089,751	2,141,135
Shipyards and shipbuilding	479,159	390,920	394,928	311,700	178,715	170,292
HBOR	300,000	300,000	146,000	260,000	59,000	101,000
Other industries[(1)]	851,873	1,082,047	1,362,717	1,223,052	439,415	417,612
Total subsidies	**5,670,789**	**6,492,010**	**6,859,512**	**6,985,483**	**3,567,292**	**3,655,735**

Source: Ministry of Finance

(1) "Other industries" includes subsidies to air transport, water transport, road transport and tourism.

(2) Based on 31 July 2009 Budget.

The following table sets out Government subsidies as a percentage of nominal GDP for the periods indicated:

Industry	Year ended 31 December 2006	2007	2008	Plan 2009[(2)]	Six months ended 30 June 2008	2009
				(per cent.)		
Croatian railways	0.6	0.5	0.5	0.5	0.2	0.2
Agriculture	0.9	1.0	0.9	1.1	0.6	0.6
Shipyards and shipbuilding	0.2	0.1	0.1	0.1	0.1	0.1
HBOR	0.1	0.1	0.04	0.1	0.02	0.03
Other industries[(1)]	0.3	0.3	0.4	0.4	0.1	0.1
Total subsidies	**2.1**	**2.0**	**1.9**	**2.1**	**1.0**	**1.0**

Source: Ministry of Finance

(1) "Other industries" includes subsidies to air transport, water transport, road transport and tourism.

(2) Based on 31 July 2009 Budget.

The subsidies to the Croatian railways comprise the amounts provided for the maintenance of the railways system and for the expansion of the railways network. The subsidies to the shipbuilding industry have been decreasing since 2006. The Government intends to reduce the amount of the shipbuilding industry subsidies in the long-term.

Croatian Bank for Reconstruction and Development

HBOR was originally established on 12 June 1992 by the Act on the Croatian Credit Bank for Reconstruction and is entirely owned by the State. HBOR provides support to small and medium size enterprises ("**SMEs**"), large economic entities and State-owned companies and enables them, through its loan programmes, export credit insurance, guarantees and advisory services, to be competitive in domestic and foreign markets. HBOR is a development and export bank which supports Croatian business entities pursuant to the guidelines for the strategic development of the Republic of Croatia.

The strategic goal of HBOR is to promote systematic, sustainable and economic and social development in accordance with the strategic objectives of the Republic of Croatia. Within the framework of its activities, aside from lending, HBOR performs foreign currency payment transactions, undertakes mandated activities for and on behalf of the Government. HBOR also manages certain funds on behalf, and for the account, of a number of Ministries, the Fund for Development and Employment, the Fund for Regional Development of Republic Croatia, the Environment and Energy Efficiency Fund, Vodovod i kanalizacija d.o.o., Split (utility company) and the Croatian Agency for Small Business ("**HAMAG**"). These assets are kept separate from HBOR's assets and HBOR does not have any other liabilities in respect of them.

While a high percentage of HBOR's loans are made to intermediary banks, HBOR also extends loans directly to both private and public sector customers. Loans may be granted in Kuna or in foreign currencies. HBOR may also carry out other banking operations if they correlate with the above-listed functions. In addition, the Government may, from time to time, authorise HBOR to perform other financial transactions if, in its opinion, such transactions are in the best interests of Croatia. HBOR does not, however, carry out any banking, credit or other financial operations or other operations which would distort competition between HBOR and other ordinary or specialised credit and financial or other institutions. HBOR has substantial influence on the development of the State. Its primary aim is not to maximise profit but to maintain the value of its capital. It aims to secure a return on loans made by it and to preserve the value of funds lent by it, to set interest rates so as to cover its operating expenses, to create reserves by increasing capital and providing for risk exposure and to pass on foreign exchange risk to counterparties through loan agreements.

In addition to its own capital and reserves, HBOR raises funds on the international capital and banking markets and also through borrowings from "special financial institutions" such as KfW, the European Bank for Reconstruction and Development ("**EBRD**"), the International Bank for Reconstruction and Development ("**IBRD**"), the CEB and the European Investment Bank ("**EIB**").

Infrastructure Development Projects

In the period between 2006 and 2008, the average share of capital investments on a consolidated government level accounted for approximately 5.4 per cent. of GDP. The Government's principal capital investment projects include: the construction and reconstruction of roads and motorways, the reconstruction of war damaged housing units and water supply systems, the modernisation and restructuring of the national railways, as well as construction and modernisation of ports, education and science systems, healthcare and the judiciary. The Government's 2009 Budget anticipates that capital investment projects will account for 3.9 per cent. of GDP.

The following new roadways were opened to traffic in 2008: Between June and December 2008, approximately 41.5 kilometres of new motorways were opened, including the A1 Zagreb-Split-Ploče, Šestanovac-Zagvozd, Zagvozd-Ravča, A4 Zagreb-Goričan and A6 Zagreb-Rijeka sections of the motorway. In addition, the Government completed approximately 36.9 km of widening of existing roads.

Employment

Unemployment in Croatia consistently decreased during the years 2005 through and including 2008. The data presented in this section does not reflect ESA95. The average registered unemployment rate reached 13.2 per cent. of the population of working age citizens in 2008, down from 14.8 per cent. in 2007. The average number of registered unemployed persons on the Croatian Employment Service ("**CES**") register in 2008 decreased by 27,705 or 10.5 per cent. compared with 2007. This decline was primarily attributable to a decrease in new unemployed persons, which resulted in a sharp fall in the number of unemployed persons during the first half of 2008. The number of unemployed persons registered with CES was 219,334 in 31 August 2008, a record low for the preceding 17 years.

In the first half of 2009, however, the decreasing trend in unemployment reversed. While the number of unemployed persons decreased by 33,969 or 12.1 per cent. on an annual basis in the first six months of 2008, in the same period of 2009 unemployment increased by 12,431, or 5.0 per cent., and, as a result, the average unemployment rate increased from 13.8 per cent. in the first half of 2008 to 14.5 per cent. in the first half of 2009. Behind this increase in unemployment was an increase in the number of persons registering with the CES and a decrease in the number of persons coming off the register as a result of the global financial and economic crisis. As of 31 August 2009, the number of unemployed persons reached 251,005.

The table below shows the state of the labour market in Croatia for the periods indicated:

	Year ended 31 December			Six months ended 30 June	
	2006	2007	2008	2008	2009
	(average for the period)				
Total employed persons	1,467,876	1,516,909	1,554,805	1,542,228	1,524,360
Total unemployed	291,616	264,448	236,741	246,162	258,593
Rate of unemployment (per cent.)(1)	16.6	14.8	13.2	13.8	14.6
GDP per employee (HRK)(2)	195,072	207,147	220,066	107,600	107,027
GDP per employee (EUR)(2)	26,639	28,237	30,467	14,799	14,498

Source: Central Bureau of Statistics

(1) The registered unemployment rate is calculated as a ratio of unemployed persons to total active population (meaning the labour force which consists of persons whose activity status in the reference week is either employed or unemployed).

(2) Preliminary data for the period since February 2009.

In 2008, the total number of employed persons was 1,554,805, an increase of 2.5 per cent. when compared to 2007. According to the National Classification of Economic Activities ("**NCEA 2007**"), the largest contributions to the increase in total employment in 2008 came from the following sectors: real estate and business activities (8,164 jobs or 6.8 per cent.), construction (7,500 jobs or 7.4 per cent.) and wholesale and retail trade (7,695 jobs or 3.6 per cent.). Negative annual rates of change in employment in 2008 were reported only by electricity, gas, steam and air conditioning supply services. On the other hand, manufacturing and public administration (including education, health care and social welfare) recorded positive annual employment increases of 0.4 per cent. and 2.8 per cent., respectively.

At the end of the first half of 2009, the number of employed persons was 1,524,360, which represents a decrease of 30,445 positions as compared to the number of employed people at the end of 2008. As of 31 August 2009, the number of employed persons decreased to 1,517,783.

The table below shows the average number of people employed in the public sector for the periods indicated:

	Year ended 31 December			Six months ended 30 June	
	2006	2007	2008	2008	2009
	(average for the period)				
Public administration and defence, compulsory social security[(1)]	105,067	104,803	106,542	106,353	105,373
Education	94,169	97,013	100,394	100,277	102,406
Human health and social work activities	74,026	76,431	79,139	78,558	80,577
Total	**273,262**	**278,247**	**286,075**	**285,189**	**288,256**

Source: Central Bureau of Statistics

(1) Includes military and police.

During last year and the first half of 2009, approximately 290,000 people (nearly 20 per cent. of all employed persons) were employed in the public sector. This number is high in comparison with other countries in the region and efforts are being made to make the public sector more efficient.

Trade and labour unions are active in Croatia but there is no evidence to suggest any major strikes or confrontation between the Government and the unions in the near future. At the end of 2008 a new Labour Act had been proposed, but at the beginning of 2009 it was withdrawn from parliamentary procedure.

Wages and labour costs

The nominal growth of gross and net wages accelerated during 2008, and the annual rate of average nominal gross wage reached 7.1 per cent., an increase of 0.9 per cent. compared to 2007, whereas the average nominal net wage growth increased from 5.2 per cent. in 2007 to 7.0 per cent. in 2008.

In the first six months of 2009, net wages increased by 4.8 per cent. as compared to the same period in 2008 while gross wages in the same time increased by 4.0 per cent. These increases were primarily due to a 6.0 per cent. increase in public sector wages (before public sector wages were decreased by 6.0 per cent. in May in order to reduce government spending). In the first half of 2009, real gross wages increased by 0.7 per cent. as compared to the same period in 2008, and real net wages increased by 1.4 per cent. when compared to the first half of 2008. These increases were largely due to an increase of 6 per cent. in public sector wages.

Despite the acceleration of growth of nominal wages, the strong acceleration of the CPI throughout most of the year resulted in a lower real wage growth in 2008 than in 2007. The annual growth rate of average real gross wage paid in 2008 stood at 0.9 per cent., decelerating by 2.3 percentage points compared with 2007. Due to the effects of tax progression, average real net wage rose at a somewhat lower annual rate of 0.8 per cent. in 2008 as compared to an annual rate of 2.2 per cent. in 2007. In 2008 changes in the taxation of income took place, including an increase in personal allowance from HRK 1,600 to HRK 1,800 per month and the adoption of the Act on Minimum Wage, setting the minimum wage at HRK 2,747 per month. These changes resulted in a faster nominal growth of net wage compared to gross wage in the second half of the year.

In the first half of 2009, real gross wages increased by 0.7 per cent. as compared to the same period in 2008, and real net wages increased by 1.4 per cent. when compared to the first half of 2008. These increases were largely due to high nominal wages annual growth which was stronger than the increase in consumer price index.

According to NCEA 2007, average real gross wage growth in public administrations (including defence and compulsory social security) grew at an annual rate of 3.8 per cent. in 2008. In manufacturing and wholesale and retail trade (the activities account for large percentages of total employment) between 2007 and 2008, real gross wage paid decreased by 0.7 per cent. and increased by 1.5 per cent., respectively. Notable annual rates of real gross wage growth were also reported in the following sectors: mining and quarrying (11.6 per cent.), electricity, gas, steam and air conditioning supply (2.8 per cent.) and agriculture, forestry and fishing (0.4 per cent.). According to NCEA 2007, in the first half of 2009, year on year real gross wage growth/contraction was as follows: public administration (5.6 per cent. growth), manufacturing (1.7 per cent. contraction), wholesale and retail trade (2.2 per cent. contraction), mining and quarrying (2.1 per cent. contraction), electricity, gas, steam and air conditioning supply (8.0 per cent. growth) and agriculture, forestry and fishing (5.2 per cent. contraction).

Labour productivity in industry increased by 5.2 per cent. in 2007 as compared to 2006. In 2008, labour productivity in industry increased by 3.6 per cent. as compared to 2007. This increase was largely due to stagnation of industrial production and a reduced number of employed individuals in industry. In the first half of 2009, labour productivity decreased by 2.0 per cent. This decrease was largely due to a stronger decrease in industrial production than in total employment in that sector.

The following table shows average nominal wages in Croatia for the periods indicated:

	Year ended 31 December			Six months ended 30 June	
	2006	**2007**	**2008**	**2008**	**2009**
Average monthly gross wages and salaries in HRK	6,634	7,047	7,544	7,435	7,730
Average monthly net wages and salaries in HRK	4,603	4,841	5,178	5,073	5,316
Net wages and salaries in EUR (average exchange rate)	629	660	717	698	720

Source: Central Bureau of Statistics and Ministry of Finance

Social Security System

Unemployment

The social security system in Croatia consists of the Health Care Fund, the Pension and Disability Fund and the Employment Fund. These funds collect their revenues through payroll contributions and from Government transfers. Although the funds are responsible for their own budgets, the Ministry of Finance is required to supervise their budget preparation and the performance of the funds and to provide reports on the funds to Parliament.

Historically, unemployed persons in Croatia may apply for unemployment benefits, but in order to be eligible they must actively look for work.

In 2008, the total expenditure on unemployment benefits was HRK 1.2 billion, according to the Croatian Employment Services 2008 Yearbook. Of this total, HRK 814.7 million (70.2 per cent. of total expenditure on unemployment benefits) was disbursed for the financial support and legal protection of unemployed persons. The majority of the funds spent on financial support and legal protection, HRK 813.6 million, was spent to fund unemployment benefits. The Government spent HRK 109.3 million on pension insurance contributions for unemployed persons, and HRK 1.0 million to cover reimbursement for expenses incurred in the course of training and compensation for relocation expenses. Approximately HRK 137.1 million, HRK 132.8 million and HRK 4.3 million was spent on active labour market policy measures established in the 2008 Annual Employment Incentive Plans, the National Employment Action Plan 2005-2008, and the Action Plan for the Decade of Roma Inclusion 2005-2015, respectively.

In 2008, the Government undertook a restructuring of the previous unemployment regime, with the aim of protecting the unemployed from poverty in the first year of unemployment by providing higher compensation and a increased educational incentives. The Act on Employment Mediation and Unemployment Rights, which came into force on 1 January 2009, (the "**Employment Act**") among other things provides a financial incentive to persons enrolled in unemployment benefits if they participate in job training or re-training aimed at increasing their competitiveness in the labour market by enhancing their competencies, employability and mobility. In 2008, a total of 1,365 people participated in 97 job-specific training programmes and various other education and training programmes, such as computer education and foreign languages, in a variety of industries (e.g., tourism, trade and business administration, construction, textile and leather, mechanical engineering, professional services and agriculture). The financial incentive provided by the Employment Act is in the form of an education scholarship. The obligations and responsibilities of the unemployed under the Employment Act have increased as well.

In response to the global financial and economic crisis and in order to preserve the fiscal sustainability of the unemployment regime, the Government amended the unemployment benefits scheme in July 2009 in order to align benefits with the minimum wage. According to the Government's 2009 Budget, 0.32 per cent. of GDP will be allocated for the payment of unemployment benefits and investment in adult education designed to assist in retraining and obtaining employment. Furthermore, in July 2009 the Government adopted the Act on Subsidies for

Maintaining Employment, which permits employers to make agreements with unions to shorten the work week to 32 hours in order to save jobs, with the Government providing subsidies to cover workers' reduced net wages.

Healthcare

Healthcare reform is aimed at finding new sources of revenue while reducing unnecessary costs. One new source of revenue is the premium paid by holders of automobile insurance, which, as part of the healthcare reform effort, is being used to cover some of the expenses of the national health care system. In order to reduce costs, healthcare reform has targeted primary physicians, incentivising providers of basic care to perform diagnostic and therapeutic treatments for which, prior to healthcare reform, they would often have referred patients to a specialist.

Motherhood Protection

On 1 January 2008, Parliament amended the Mandatory Health Insurance Act to provide all employed mothers exercising their right to compulsory maternity leave, with full salary compensation until their child is six months old. Under the amended legislation, the minimum financial compensation during maternity leave totals HRK 1,663, while one-off financial aid to cover the expenses relating to childbirth total HRK 2,328. The According to the Act on Child Support (Official Gazette 94/01 138/06 107/07) establishes a minimum amount of monthly child support payments at HRK 199. Moreover, the Act on Child Support establishes an additional allowance for parents with up to four children.

In the period from 2006 to 2008, the average level of maternity allowances and child support allowances was 0.5 per cent. of GDP. In the first half of 2009 these allowances accounted for 0.3 percent of GDP.

Pension System

The Pension Law, which is primarily focused on redesigning the primary level of pension cover for Croatian citizens (the so-called "first pillar" of the present day three pillar system), was adopted by Parliament in July 1998 and such pension system operated until the end of 2001. The funds held by the pension fund were not sufficient to meet the future pension obligations of current employees due to the ageing of the population, an extraordinary increase in the number of beneficiaries caused by the 1991 War and declining economic activity between 1991 and 1993.

As part of these changes, the retirement age was raised to 65 years for males and 60 years for females and many of the existing provisions were curtailed as a first step to reforming the overall system. Despite that, the ratio of work force to pensioners in Croatia is 1 to 1.4. The first pillar will continue to pay full benefits to those above the relevant cut-off age (which is set at 40 years of age), but with substantially lower benefits paid to those below the relevant cut-off age.

Since a new pension insurance system was introduced in 2002, the participants are, during their active life, allocating their funds into two additional pillars.

For every employee in Croatia, employers allocate 20 per cent. of gross salary to the pension fund. 15 per cent. of gross salary of any reform participant is allocated to the obligatory pension fund, or to the first pillar of a pension, and 5 per cent. to the mandatory pension fund at the choice of the insured person, or the so-called "second pillar". The second pillar is a fully funded system based on mandatory contributions from wages paid to individual accounts of employees below 40 years of age (people between the ages of 40 and 50 have the opportunity to elect whether they will be part of the first or second pillar).

The third pillar is a voluntary private system, fully funded by voluntary employee or employer contributions. Currently, there are six open and thirteen closed voluntary pension funds and four mandatory pension funds in Croatia.

The three pillars combined should provide higher social security and higher overall level of pensions. The insurance risks are divided in several levels and according to insurance providers. This, in accordance with the goals of the reform, should be more favourable for beneficiaries of pensions and for overall economic movements than the provision of pension insurance based on inter-generational solidarity only. The investments of pension funds will increase total investments, thus promoting the development of capital markets, economic growth and the rise in living standards in Croatia. Following the Act on the Croatian Agency for Supervision of Financial Services published on 28 November 2005 (Official Gazette No. 140/05) the former pension bodies and regulator, the Insurance Companies Supervisory Authority, the Croatian Securities Commission and the Agency for Supervision of Pension Funds and Insurance have all ceased as of 1 January 2006. As of the same date, the Croatian Agency for Supervision of Financial Services ("**CASFS**") commenced its work as their legal successor.

The table below shows the number of people receiving pension, unemployment and child allowances for the periods indicated:

	Total number of people receiving pensions[(1)]		Average monthly pensions without tax and surtax[(2)]		Number of people receiving child allowance[(3)]		Unemployment benefit recipients	
	Number of users	**Per cent. change**	**HRK**	**Year on Year per cent.**	**Number of users**	**Year on Year per cent.**	**Number of users**	**Year on Year per cent.**
2006	1,100,086	1.8	1.876	2.5	216,828	(6.4)	64,902	(10.3)
2007	1,121,540	2.0	1.934	3.1	226,997	(4.7)	59,752	(7.9)
2008	1,148,290	2.4	2.060	6.5	228,177	(0.5)	64,712	(8.3)
First half of 2009	1,159,881	2.0	2.147	6.3	212,414	(6.7)	63,743	(22.4)

Source: Croatian Pension Insurance Institute, Croatian Employment Service

(1) Since January 2008, the total number of people receiving pension includes pension users as defined by the contract between the Republic and Bosnia and Herzegovina on the cooperation in the area of war-affected peoples' rights that were members of Croatian Defence Council and members of their families.

(2) Period average, pension users as defined by Retirement Insurance Act.

(3) Period average.

Certain privatised, or soon-to-be privatised, companies are required to make compulsory contributions to the veterans pension fund. For example, the Law on Privatization of Hrvatski Telekom (OG 65/99 and 68/01), the Law on Privatization of the HEP (Croatian Electricity Company) and the Law on Privatization of INA (Croatian Oil Company) (both OG 32/02) stipulate that in the process of privatization of these companies 7 per cent. of shares are to be transferred to war veterans and members of their families.

The following table sets forth the value of the net assets of the of the mandatory pension funds, open voluntary pension funds and closed voluntary pension funds at the end of the periods indicated:

	Year ended 31 December		Nine months ended 30 September
	2007	**2008**	**2009**
		(HRK thousands)	
Mandatory fund[(1)]	21,001,886	22,590,933	27,518,243
Open voluntary funds[(2)]	692,810	799,665	1,040,794
Closed voluntary funds[(3)]	119,082	148,378	198,564
Total	**21,813,778**	**23,538,977**	**28,757,601**

Source: Croatian Financial Services Supervisory Agency

(1) Includes Raiffeisen, PBZ-Co, A-Z and Erste PLAVI.

(2) Includes AZ Benefit, AZ Profit, Croatia Osiguranje, Raiffeisen, Erste Plavi Expert and Erste Plavi Protect.

(3) Includes NOVINAR, T-Mobile, AZ VIP, Croatia Osiguranje, Hrvatski Lijecnicki Sindikat, Sindikat Pomoraca Hrvatske, AZ Dalekovod, Ericsson Nikola Tesla, AZ HKZP, HEP Grupa, THT Grupa and Sindikat hrvatskih eljeznicara.

The Government recently introduced several reforms to the government pension scheme, aimed at improving the material status of pension beneficiaries and raising the level of average pension share in the average salary. On 1 January 2008 Parliament enacted the Act on Amendments to the Pension Insurance Act (OG 79/2007), which permitted the Government to raise early retirement pensions through a change in the baseline factor for determining early retirement pensions.

On 28 March 2008, the Government enacted the Act on Amendments to the Pension Insurance Act (OG 35/2008) which provided equal rights to pension insurance for beneficiaries working part-time to obtained. Similarly, the Allowance on Pensions Earned Act of 2007, in connection with the Pension Insurance Act (OG 79/2007), provides for improvements to the material status of "new pensioners" by harmonising the amount of pension obtained for the same number of accumulated years for beneficiaries who have obtained pensions based on regulations in force prior to pension reforms.

The Government funds pensions principally from pension contributions. However, because pension contributions do not cover all pension expenditure requirements, the Government uses other general budgetary revenue sources to meet funding requirements. The Government anticipates that pension expenses will reach HRK 34.1 billion, while pension insurance contributions by beneficiaries is anticipated to reach HRK 20.2 billion, meaning that 59.1 per cent. of pension expenditures are funded by pension insurance contributions.

FOREIGN TRADE AND INTERNATIONAL BALANCE OF PAYMENTS

Current Account Deficit

The following table sets forth the current account balance of Croatia for the periods indicated:

	Year ended 31 December					Six months ended 30 June
	2004	2005	2006	2007	2008	2009[(1)]
Current account in EUR (millions)	(1,433.7)	(1,975.6)	(2,715.2)	(3,236.7)	(4,385.1)	(2,738.6)
Current account (as a percentage of nominal GDP)	(4.4)	(5.5)	(6.9)	(7.6)	(9.3)	—

Source: Croatian National Bank

(1) Preliminary figures

In 2008, Croatia's current account deficit reached EUR 4,385.1 million, or 9.3 per cent. of GDP, representing an increase of 35.5 per cent. in EUR terms, or 22.3 per cent. in GDP percentage terms, compared to 2007. The increase was principally due to the increase in the merchandise trade deficit largely caused by the rise in oil prices and the deterioration in the factor income account, which was only partially offset by the services surplus. In the first half of 2009, the current account deficit decreased by 37.6 per cent. in EUR terms compared to the same period in 2008, primarily due to the decrease in the merchandise trade deficit as a result of the decline in imports outpacing the decline in exports. A significant decline in imports was attributable to a decrease in domestic demand and in oil and energy prices. As domestic demand is increasing and oil and energy prices continue to rise, the growth of imports may outpace that of exports and, as a result, the current account and merchandise trade deficits may start to increase again. See "*Risk Factors — Current account deficit may continue to rise*".

Goods Account and Recent Merchandise Trade Developments

Merchandise Trade Deficit

As in previous years, the foreign trade deficit made the biggest contribution to the widening of the current account deficit in 2008. Croatia has carried a foreign trade deficit since its independence in 1991. The trade deficit was EUR 8.3 billion, EUR 9.4 billion, EUR 10.8 billion and EUR 3.7 billion in 2006, 2007, 2008 and the first six months of 2009, respectively. According to balance of payments data calculated in Euros, the merchandise trade deficit increased by 14.4 per cent. in 2008, compared to an increase of 13.1 per cent. and 11.0 per cent. in 2007 and 2006, respectively. The increase in the merchandise trade deficit in 2008 was principally due to the significant deterioration in the trade in oil and refined petroleum products as a result of the surge in global crude oil prices in the first half of 2008. In addition, the positive trade balance in other transport equipment declined substantially in 2008 compared to 2007, primarily due to the reporting methodology of ship finishing works on a gross basis. During ship construction process, vessels exported abroad for finishing operations and imported back after such operations are completed, are reported in the foreign trade statistics on a gross basis. As a result, these movements distort the total value of exports and imports of other transport equipment.

In the first six months of 2009, according to balance of payments data, the merchandise trade deficit decreased by 34.4 per cent. compared to the same period in 2008, as a result of the decrease in imports outpacing the decrease in exports, mainly due to a decline in the negative trade balance in road vehicles and petroleum and petroleum products as well as from a surplus in trade in other transport equipment.

In May 2009, the Ministry of Economy, Labour and Entrepreneurship initiated a programme designed to incentivise and ultimately increase Croatian exports through six incentive measures. The measures aimed at individual entrepreneurs are designed to encourage participation of Croatian companies in foreign trade fairs, investments related to the development and introduction of new products on international markets and international business activities. The measures aimed at joint entrepreneurs are designed to stimulate joint participation of companies in foreign trade fairs, organisation of targeted economic missions on international markets and establishment and support of foreign sales offices in the target foreign markets. Public tenders for these incentives were announced in June 2009 and are still open.

Exports

The following table sets forth Croatia's exports of goods by sector for the periods indicated prepared in accordance with SITC methodology.

	Year ended 31 December			Eight months ended 31 August	
	2006	**2007**	**2008**	**2008**	**2009**
			(HRK millions)		
Food and live animals	5,549	5,437	5,250	2,949	3,532
Beverages and tobacco	1,133	1,195	1,212	807	813
Crude materials, except fuels	3,549	4,219	4,199	3,073	2,056
Mineral fuels and lubricants	9,146	8,547	8,788	6,360	4,543
Animal and vegetable oils and fats	109	116	175	98	88
Chemical products	5,548	6,229	6,822	4,637	3,414
Manufactured goods classified chiefly by material	8,993	10,185	10,589	7,048	5,497
Machinery and transport equipment	17,397	20,482	23,174	15,433	11,208
Miscellaneous manufactured articles	9,004	9,608	8,921	5,940	5,102
Commodities and transactions, n. e	9	25	12	8	13
Total	**60,437**	**66,043**	**69,142**	**46,352**	**36,267**

Source: Croatian National Bank

According to the data from the CBS, total exports of goods amounted to HRK 69.1 billion (20.2 per cent. of nominal GDP) in 2008 which represents an increase of 4.7 per cent. from 2007, as compared to an increase of 9.3 per cent. from 2006 to 2007. The strongest impact on export growth came from the exports of machinery and transport equipment, which contributed to more than half of the increase in total exports. If this SITC division is excluded from total exports, their annual growth rate is halved and amounts to 2.5 per cent.

The decrease in the growth rate of exports can principally be attributed to a substantial fall in exports of miscellaneous manufactured articles and cereals and cereal preparations. In addition, exports of apparel, sugar, sugar preparation and honey, as well as furniture and furniture components decreased substantially, partially offset by the increase in exports of electrical machinery, apparatus and equipment as well as power generating machinery and equipment.

In the first eight months of 2009, total exports of goods expressed in HRK terms declined by 21.8 per cent. compared to the same period in 2008, primarily due to the decrease in exports of other transport equipment as well as oil and refined petroleum products, with the latter mainly a result of a substantial decline in the prices of these products. In addition, a significant decrease was recorded in exports of metalliferous ores and metal scrap; fertilizers; machinery specialized for particular industries; plastics in primary forms and metal manufactures. Export growth was recorded in a small number of SITC divisions, among which the most significant were cereals and cereal preparations as well as fish and fish preparations.

Imports

The following table sets forth Croatia's imports of goods by sector for the periods indicated prepared in accordance with SITC methodology.

	Year ended 31 December			Eight months ended 31 August	
	2006	2007	2008	2008	2009
			(HRK millions)		
Food and live animals	9,032	9,585	10,672	6,989	6,555
Beverages and tobacco	804	929	957	648	667
Crude materials, except fuels	2,234	2,387	3,087	2,060	1,224
Mineral fuels and lubricants	19,941	20,993	26,427	17,849	12,282
Animal and vegetable oils and fats	326	336	575	359	262
Chemical products	13,581	15,174	15,916	10,841	9,265
Manufactured goods classified chiefly by material	24,405	27,314	27,960	18,886	13,526
Machinery and transport equipment	40,343	44,963	48,695	33,690	21,163
Miscellaneous manufactured articles	14,524	16,384	16,021	10,479	9,093
Commodities and transactions, n. e.	59	94	51	24	49
Total	**125,249**	**138,159**	**150,362**	**101,825**	**74,086**

Source: Croatian National Bank

According to CBS data, total imports of goods stood at HRK 150.4 billion (43.9 per cent. of nominal GDP) in 2008 and the annual growth in total imports of goods decreased slightly from 10.3 per cent. in 2007 to 8.8 per cent. in 2008, principally due to fast-growing imports of energy products (oil, refined petroleum products, as well as natural and manufactured gas) and transport equipment. Gas imports were affected by the low base figure for 2007 as a result of the completion of gas pipes that connect rigs in the northern Adriatic sea with the Croatian coast. The increase in oil imports was principally due to the considerable growth in energy prices in the first half of 2008. Imports of transport equipment increased substantially as a result of increased imports of ships previously exported for finishing purposes abroad and the increase in imports of air transportation and similar equipment.

Excluding other transport equipment, natural and manufactured gas, and oil and refined petroleum products, the growth of total imports was somewhat slower in 2008 compared to 2007, standing at 5.8 per cent., almost a third less than in 2007, when the growth rate was 8.6 per cent. Among the SITC divisions which decreased most noticeably were imports of miscellaneous manufactured articles, non-ferrous metals, organic chemical products and road vehicles recorded in the last quarter of 2008. In contrast, imports of crude fertilisers, iron and steel as well as electrical current increased in 2008.

In the first eight months of 2009, total imports of goods expressed in HRK, declined by 27.2 per cent., principally due to a decrease in domestic demand and energy prices, including oil. In particular, the decrease in imports resulted principally from a decrease in the majority of SITC divisions, with the most significant decline recorded in the imports of oil and refined petroleum products and road vehicles, which decreased by a half in comparison with the same period in 2008, as well as in the imports of other transport equipment.

According to CBS data, the trade deficit contracted by 31.8 per cent. in the first eight months of 2009 in comparison with the same period in 2008, amounting to HRK 37.8 billion (HRK 55.5 billion in the first eight months of 2008). This is the result of a more pronounced fall in imports than in exports, and is largely attributable to an improvement in the balance of trade in oil and road vehicles. These two sectors alone contributed to almost a half of the overall decrease in the total trade deficit.

Geographical Distribution of Croatia's Merchandise Trade

The following table sets forth a geographical distribution of Croatia's exports, calculated from HRK values.

	Year ended 31 December			Eight months ended 31 August	
	2006	2007	2008	2008	2009
			(per cent.)		
Developed Countries	72.7	70.5	69.4	68.5	68.7
EU 27	64.3	60.3	61.0	60.1	61.4
Slovenia	8.2	8.3	7.8	8.0	7.3
Hungary	1.6	2.2	2.4	2.3	1.7
EU 15	48.9	43.7	44.2	43.2	45.0
Austria	6.0	6.1	5.8	5.7	5.3
Italy	23.1	19.2	19.2	18.2	19.7
Germany	10.3	10.0	10.7	11.0	11.4
EFTA[(1)]	1.5	1.2	1.2	1.2	1.7
Developing Countries	27.3	29.5	30.6	31.5	31.3
Bosnia and Herzegovina	12.6	14.4	15.3	16.1	13.1
Serbia, Montenegro	5.4	6.6	6.8	6.8	6.0
Russia	1.2	1.3	1.3	1.3	1.4
China	0.2	0.2	0.3	0.2	0.4

Source: Croatian National Bank

(1) European Free Trade Association

The following table sets forth a geographical distribution of Croatia's imports, calculated from HRK values.

	Year ended 31 December			Eight months ended 31 August	
	2006	2007	2008	2008	2009
			(per cent.)		
Developed Countries					
EU 27	74.7	73.2	72.6	72.3	72.5
Slovenia	67.2	64.8	64.1	63.8	63.1
Hungary	6.3	5.9	5.6	5.5	5.8
EU 15	3.0	2.9	3.2	3.2	3.2
Austria	50.1	48.8	48.5	48.4	47.5
Italy	5.4	5.3	4.9	4.8	5.1
Germany	16.7	16.1	17.1	17.0	14.8
EFTA[(1)]	14.5	14.4	13.4	13.3	13.9
Developing Countries	1.7	1.9	1.7	1.6	2.7
Bosnia and Herzegovina	25.3	26.8	27.4	27.7	27.5
Serbia, Montenegro	2.8	2.8	2.7	2.6	2.6
Russia	1.1	1.3	1.4	1.4	1.3
China	10.1	10.1	10.4	11.2	10.3
Developed Countries	5.3	6.2	6.2	5.8	6.7

Source: Croatian National Bank

(1) European Free Trade Association

Within the geographic break-down of Croatia's exports of goods, the share of more developed countries decreased slightly in 2008 compared to 2007, as exports to these countries grew more slowly than those to developing countries. With respect to exports to developed countries, exports to Old EU Member States grew more than twice as fast in 2008 as in 2007, most notably to Italy (primarily ships) and Germany (principally ships and vehicles on trails), while the growth rate of exports to new EU Member States in 2008 decreased to a third of that recorded in 2007. As for trade with developing countries, major contributors to export growth were exports to neighbouring countries, particularly Bosnia and Herzegovina (oil, refined petroleum products and electricity), Serbia and Montenegro (non-metallic mineral manufactures and electrical machinery, apparatus and appliances), despite a noticeable deceleration in growth compared to 2007.

The structure of Croatia's imports of goods was also marked by a slight decrease in the share of imports from developed countries, driven by the same factors affecting exports. Although still dominant, imports from developed countries grew at a slightly lower rate in 2008 than in 2007, mostly due to slower growth of imports from Germany (mostly iron and steel, and road vehicles). However, imports from certain other developed countries, particularly from Italy, accelerated significantly. The increase of imports from Italy was primarily a result of higher imports of ships and oil. Imports from developing countries were largely determined by higher imports from Russia, which comprised almost entirely of energy products.

The following table sets forth major countries of destination of Croatian exports of goods as a percentage of total exports of goods in the first eight months of 2009 and the changes in exports to these countries in the first eight months of 2009 as compared to the first eight months of 2008.

	Share	Change
	(per cent.)	
Austria	5.3	(15.3)
Bosnia and Herzegovina	13.1	(36.5)
Germany	11.4	(19.1)
Italy	19.7	(28.0)
Slovenia	7.3	(28.6)

Source: Central Bureau of Statistics

The following table sets forth major countries of origin of imports of goods in Croatia as a percentage of total imports of goods in the first eight months of 2009 and the changes in imports of goods from these countries in the first eight months of 2009 as compared to the first eight months of 2008.

	Share	Change
	(per cent.)	
Austria	5.1	(23.7)
China	6.7	(15.6)
Russia	10.3	(33.0)
Germany	13.9	(24.3)
Italy	14.8	(36.4)
Slovenia	5.8	(23.3)

Source: Central Bureau of Statistics

Details of the International Balance of Payments

The balance of payments of Croatia represents a systematic overview of the value of economic transactions performed by Croatian residents with foreign countries within a particular period. It is compiled in accordance with the recommendations of the IMF Data sources, which include reports of the government institutions (CBS and Croatian Institute for Health Insurance), special reports of the CNB (International Transaction Reporting System, external debt relations, monetary statistics and reserve assets), and estimates and statistical research carried out by the CNB.

The balance of payments tabulates the credit and debit transactions of a country with foreign countries and international institutions for a specific period. Transactions are divided into three broad groups: current account, capital account and financial account. The current account is made up of: (1) trade in goods and (2) trade in services, income from profits and interest earned on overseas assets, net of those paid abroad, and net capital transfers to international institutions. The capital account primarily comprises net capital transfers from international institutions. The financial account is made up of items such as the inward and outward flow of money for direct investment, investment in debt and equity portfolios, international grants and loans and changes in the official reserves.

Balance of payments of Croatia data are reported in three currencies: in Euro, U.S. dollar and HRK. In all cases, the same data sources are used and the same principles regarding the scope of transactions and the procedures for compiling particular items are applied.

The last positive balance on the current account of international balance of payments was recorded in 1994.

The following table sets out the current account balance for the periods indicated:

	Year ended 31 December					Six months ended 30 June	
	2004	2005	2006	2007	2008	2008	2009[(1)]
				(EUR million)[(2)]			
CURRENT ACCOUNT	(1,433.7)	(1,975.6)	(2,715.2)	(3,239.2)	(4,385.1)	(4,389.5)	(2,738.6)
Goods, services, and income	(2,625.5)	(3,159.5)	(3,822.6)	(4,282.2)	(5,419.9)	(4,886.4)	(3,241.4)
Credit	14,952.8	15,990.2	17,884.8	19,610.4	21,256.5	8,800.5	7,086.8
Debit	(17,578.4)	(19,149.7)	(21,707.3)	(23,892.5)	(26,676.4)	(13,687.0)	(10,328.2)
Goods and services	(1,955.3)	(2,200.2)	(2,639.6)	(3,168.1)	(3,835.9)	(3,777.2)	(2,233.8)
Credit	14,243.5	15,272.9	16,992.1	18,317.3	19,904.6	8,105.4	6,669.3
Debit	(16,198.8)	(17,473.2)	(19,631.7)	(21,485.4)	(23,740.5)	(11,882.7)	(8,903.1)
Goods	(6,724.2)	(7,518.0)	(8,344.2)	(9,434.0)	(10,793.8)	(5,671.0)	(3,721.5)
Credit	6,606.8	7,220.3	8,463.6	9,192.5	9,814.0	4,718.8	3,824.9
Debit	(13,330.9)	(14,738.3)	(16,807.8)	(18,626.5)	(20,607.8)	(10,389.7)	(7,546.4)
Services	4,768.9	5,317.7	5,704.6	6,265.9	6,957.9	1,893.7	1,487.7
Credit	7,636.7	8,052.6	8,528.5	9,124.8	10,090.6	3,386.6	2,844.4
Debit	(2,867.8)	(2,734.9)	(2,823.9)	(2,858.9)	(3,132.7)	(1,492.9)	(1,356.7)
Transportation	299.3	376.1	443.5	487.6	508.5	231.6	124.0
Credit	791.3	880.3	1,006.7	1,122.4	1,209.4	567.2	371
Debit	(492.0)	(504.2)	(563.2)	(634.8)	(700.9)	(335.6)	(247)
Travel	4,822.3	5,394.9	5,708.7	6,035.2	6,694.0	1,842.0	1521.3
Credit	5,505.6	5,998.9	6,293.3	6,752.6	7,459.4	2,194.4	1840.3
Debit	(683.3)	(604.1)	(584.6)	(717.3)	(765.5)	(352.5)	(319.0)
Other services	(352.7)	(453.3)	(447.6)	(256.9)	(244.6)	(179.8)	(157.6)
Credit	1,339.8	1,173.4	1,228.5	1,249.8	1,421.8	625.1	633.1
Debit	(1,692.5)	(1,626.6)	(1,676.0)	(1,506.7)	(1,666.4)	(804.9)	790.7
Income	(670.2)	(959.2)	(1,182.9)	(1,114.1)	(1,584.0)	(1,109.2)	(1,007.6)
Credit	709.4	717.3	892.7	1,293.0	1,351.9	695.1	417.5
Debit	(1,379.6)	(1,676.5)	(2,075.6)	(2,407.1)	(2,935.9)	(1,804.3)	(1,425.1)
Current transfers	1,191.8	1,183.8	1,107.4	1,043.0	1,034.8	496.9	502.8
Credit	1,584.6	1,628.4	1,639.5	1,576.1	1,683.7	762.4	781.4
Debit	(392.8)	(444.6)	(532.1)	(533.1)	(649.0)	(265.5)	(278.6)
CAPITAL AND FINANCIAL ACCOUNT	2,561.0	3,014.3	3,670.4	4,146.7	5,962.4	3,727.4	2,722.7
Capital account	31.4	53.8	(133.8)	34.5	29.2	15.5	12.6
Financial account, excl. reserves	2,572.6	3,782.3	5,216.4	4,833.8	5,602.8	4,503.7	2,631.8
Direct investment	670.8	1,276.1	2,556.6	3,490.0	3,219.1	1,974.6	851.1
Abroad	(278.8)	(191.8)	(208.2)	(180.2)	(134.0)	(22.9)	(61.9)
In Croatia	949.6	1,467.9	2,764.8	3,670.2	3,353.1	1,997.5	913.0
Portfolio investment	287.1	(1,177.9)	(542.3)	(2.9)	(627.2)	89.9	(51.7)
Assets	(736.1)	(571.2)	(472.5)	(413.7)	(273.3)	317.4	5.2
Liabilities	1,023.2	(606.6)	(69.8)	410.8	(353.9)	(227.4)	(56.9)
Financial derivatives	0.0	(88.4)	0.0	0.0	0.0	0.0	0.0
Other investment	1,614.7	3,772.5	3,202.1	1,346.7	3,010.9	2,439.2	1,832.4
Assets	(498.4)	982.2	(692.3)	(1,653.4)	(1,617.9)	459.6	959.6
Liabilities	2,113.0	2,790.3	3,894.4	3,000.1	4,628.8	1,979.5	872.8
Reserve assets	(43.0)	(821.8)	(1,412.2)	(721.6)	330.4	(791.7)	78.3
NET ERRORS AND OMISSIONS[(3)]	(1,127.3)	(1,038.6)	(955.2)	(907.5)	(1,577.3)	662.0	15.9

Source: Croatian National Bank

(1) Preliminary data.

(2) Exchange rate: as at 31 December of the relevant year.

(3) The item "net errors and omissions" also comprises the counter entry of a portion of revenues from travel services which relates to such revenues not stated in the banks' records.

Services Account

The positive balance recorded on the services account improved in 2008 relative to 2007 by 11.0 per cent., principally due to tourism revenues rising by 10.5 per cent. in 2008 compared to 2007. The growth in tourism revenues resulted mostly from an increase in average consumption, as foreign tourist arrivals and nights spent (according to the CBS data, which refer only to commercial accommodation facilities) rose only slightly (1.2 per cent. and 2.1 per cent., respectively). The break-down of tourist nights by country of residence shows an increase in number of nights spent by guests from new EU Member States, especially Poland and Slovenia, while the number of nights spent by guests from Old EU Member States showed no significant change compared to 2007. With respect to trade in other services, a modest improvement was recorded in the trade balance of transportation services, notably freight transport. In addition, the negative trade balance in other services fell by 4.8 per cent. year-on-year, with the largest improvement seen in the trade of miscellaneous business services such as architecture, research and development and construction services. On the other hand, a deterioration was seen in the balance of trade of telecommunication services.

Net revenue from international trade in services in the first half of 2009 decreased by 21.4 per cent. compared with the first half of 2008, largely due to less favourable results in the account of travel and transportation services. Tourism net revenues declined by 17.4 per cent. reflecting a decrease in foreign tourist arrivals and nights spent (5.8 per cent. and 3.9 per cent., respectively) as well as lower average consumption. According to a break-down of tourist nights by country of residence, the number of nights spent by guests from new EU Member States, especially Czech Republic, Hungary and Slovenia, decreased by 8.2 per cent., while the number of nights spent by guests visiting from Old EU Member States remained at the same level as in 2008. The positive trade balance in transportation services decreased almost by a half as compared to the first half of 2008, with the largest deterioration seen in sea freight transport. Lower surplus from tourism and transport services was partially offset by an improvement in other services balance, where the negative balance decreased by 12.4 per cent. compared to the first half of 2008, due to higher revenues and lower expenditures. With respect to individual types of services, the biggest improvement was seen in research and development, royalties and licence fee and construction services.

Factor Income Account

The factor income account balance deteriorated in 2008 by 42.2 per cent. compared to 2007, principally due to a significant increase in expenditures (22.0 per cent.), accompanied by weak revenue growth (4.5 per cent.). On the revenue side, compensation to employees recorded low rates of growth, while revenues related to resident investments abroad decreased slightly compared to 2007. The significant increase in expenditures was primarily due to interest paid on foreign borrowing, as well as to expenditures related to direct investments.

The deficit in the factor income account decreased by 9.2 per cent. in the first half of 2009, compared to the first half of 2008, primarily due to a more significant decrease of expenditures than of revenues. The decline in expenditures was principally due to lower expenditures related to direct investment, especially reinvested earnings of foreign investors in Croatia, as a result of the adoption of a new system for statistical monitoring of reinvested earnings. The decline in expenditures was partially offset by increased interest payments on foreign borrowing. The decline in revenues on the factor income account was primarily due to a decrease in other investment income, principally as a result of lower central bank and commercial bank revenues from the investment of foreign assets, and due to smaller reinvested earnings of resident investments abroad, also reflecting the new system of statistical monitoring.

Current Transfers

No significant change was recorded in the current transfers account balance in 2008, with strong revenue growth compensating for a similar increase in expenditures. The growth of total revenues was mostly related to general government revenues from intergovernmental grants, including EU pre-accession funds. Revenues earned by other domestic sectors also grew to some extent. On the expenditures side, the biggest increase also came from the government sector, specifically as a result of expenditures on pensions, taxes and one time payment resulting from the settlement of a legal dispute.

In the first half of 2009, the positive balance in the current transfers account improved only slightly compared to the same period in 2008, reflecting a slight increase both in revenues and expenditures. The increase in total revenues is mainly due to general government revenues from intergovernmental grants including EU pre-accession funds, while other sectors experienced lower inflows of funds, especially those related to workers' remittances from abroad. On the expenditure side, the highest growth was recorded by the Government, principally due to the increase in pension payments to non-residents as well as intergovernmental grants.

Capital and Financial Account

In 2008, the capital and financial account had slightly larger net capital inflows than in 2007 and, excluding the change in reserves, stood at EUR 5.6 billion. The largest inflow of funds was attributable to direct investments, principally through the increase in equity capital. In addition, significant capital inflow was recorded on the account of other investment where liabilities saw a high growth rate (54.3 per cent.) while assets decreased slightly (-2.1 per cent.). The account of portfolio investment experienced outflows of funds through repayment of Government bonds and, at the end of 2008, through withdrawal of funds invested by non-residents in Croatian assets including in bonds and equity holdings and increased investment in foreign debt instruments by domestic banks and other sectors. After continuous growth during the last several years, gross international reserves in 2008 declined by EUR 0.3 billion mainly due to the change in monetary policy instruments.

Net inflow of capital through other investment such as trade credits, loans, currency and deposits more than doubled in 2008 compared to 2007 due to very high growth of foreign liabilities (123.6 per cent.), principally those of other domestic sectors and banks, which increased by EUR 3.5 billion and EUR 1.0 billion, respectively. This contributed to a further increase in the stock of external debt that at the end of 2008 reached 82.6 per cent. of GDP. However, strong inflow of capital was offset by significant outflows as a result of a rise in foreign assets (EUR 1.6 billion), mainly as a consequence of rumours in October about possible financial problems of foreign parent banks. As a result, households withdrew a significant amount of deposits from local banks, which in turn led to an increase in households' foreign currency holdings.

In the first half of 2009, net inflows (excluding the change in international reserves) on the capital and financial account amounted to EUR 2.6 billion, a decrease of 41.5 per cent. compared to the same period in 2008. The lower net inflow of capital was recorded for all sources of foreign investments but primarily for direct investments, which were less than half of those in the same period in 2008. Unlike in the first half of 2008, the portfolio investments account experienced a net outflow of funds, as Government repayments exceeded the amount of new borrowing abroad.

The net inflow of funds on the other investments account in the first half of 2009 amounted to EUR 1.8 billion, a decrease of 24.9 per cent. compared to the first half of 2008. The amount of liabilities decreased by a half while foreign assets exceeded the levels recorded in the same period in 2008, which in combination resulted in a smaller net inflow of funds. Lower liabilities are a result of declining economic activity and the lower availability of foreign sources of finance during that period. Consequently, total foreign debt growth decelerated in the first six months of 2009 and external debt increased by 3.7 per cent., compared to an increase of 6.5 per cent. in the first half of 2008. On the asset side, a significant withdrawal of bank foreign assets occurred in the first quarter of 2009 after the CNB lowered the rate of minimum required foreign currency claims, thus freeing a considerable amount of domestic banks' foreign currency funds. Gross international reserves at the end of June 2009 stood at level almost equal to that in December 2008, with different movements during that period. A significant decrease occurred during the first few months of the year, principally due to lower allocation of foreign currency reserve requirements and net interventions of the CNB, while foreign exchange transactions with the central government during that period mitigated the fall in international reserves. This decrease was reversed during the second quarter, bringing total reserves again to EUR 9.1 billion.

Foreign Direct Investment (FDI)

The following table sets out FDI in Croatia for the periods indicated.

	Year ended 31 December					Six months ended 30 June
	2004	2005	2006	2007	2008	2009[1]
			(EUR millions)			
FDI into Croatia	949.6	1,467.9	2,764.8	3,670.2	3,353.1	913.0
FDI from Croatia abroad	(278.8)	(191.8)	(208.2)	(180.2)	(134.0)	(61.9)
FDI (net)	**670.8**	**1,276.1**	**2,556.6**	**3,490.0**	**3,219.1**	**851.1**

Source: Croatian National Bank, Foreign Direct Investments Statistics (as of 7 October 2009)

(1) Preliminary figures.

FDI includes equity capital, reinvested earnings and debt relations between ownership-related residents and non-residents.

Net FDI in 2008 totalled EUR 3.2 billion, decreasing by EUR 0.3 billion or 7.8 per cent. compared to 2007, mainly due to lower inward investments. FDI into Croatia in 2008 totalled EUR 3.4 billion, decreasing by EUR 0.3 billion or 8.6 per cent. compared to 2007. Higher inward investments in 2007 were primarily due to substantial recapitalisations of foreign-owned banks prompted by the implementation of monetary policy measures in Croatia and several large equity investments (the sale of Tifon to MOL, the sale of Diners Club Adriatic to Erste Bank der oesterreichischen Sparkassen and the sale of Osiguranje Zagreb to Swiss Baloise-Holding). Equity investment dominates the structure of inward investments in Croatia, making up 65 per cent. of total inward FDI in 2008 (up from 60 per cent. in 2007). Debt investment (i.e. domestic sectors' liabilities to their affiliated companies abroad), which accounted for 20 per cent. of total inward FDI in 2008, decreased by nearly one third in 2008 after growing strongly in 2007. However, foreign owners of domestic banks and enterprises saw only a minor increase in their retained earnings compared to 2007.

In 2008, inward FDI break-down by sector was as follows: 34 per cent. — financial intermediation (except insurance and pension funds), 28 per cent. — the manufacture of coke and refined petroleum products, 8 per cent. — manufacture of other non-metallic mineral products, 6 per cent. — retail trade (except motor vehicles), 4 per cent. — the extraction of crude petroleum and natural gas, 4 per cent. — hotels and restaurants, 3 per cent. — wholesale trade and commission trade. When it comes to the FDI in monetary intermediation, recapitalisation of domestic banks by their foreign owners amounted to EUR 0.4 billion, which is significantly less than in 2007 (EUR 1.2 billion). Nevertheless, including substantial retained earnings, total FDI in this sector reached EUR 1.1 billion. In addition, significant inflows of equity investments were recorded in the manufacture of coke and refined petroleum products, which relates to the acquisition of 22 per cent. of INA shares by MOL, which was the largest individual inflow in 2008. In terms of a geographical break-down, Austrian investors (mostly bank owners) comprise the largest share of total FDI, followed by Hungarian investors (INA).

In the first half of 2009, net FDI amounted to EUR 851.1 million, representing a 56.9 per cent. decrease compared to the same period in 2008, primarily due to a decrease in inward FDI, while resident investments abroad increased slightly. FDI in Croatia amounted to EUR 913.0 million, representing a 54.3 per cent. decrease compared to the same period in 2008, primarily due to a fall in equity capital and retained earnings. Direct equity investment amounted to EUR 0.3 billion in the first six months of 2009, as compared to EUR 0.8 billion in the first half of 2008, which reflected the reluctance of foreign investors to invest in developing countries and emerging markets and the overall uncertainty and risk aversion present in global financial markets. More than two thirds of equity investments were realised in the following three sectors: the extraction of crude petroleum and natural gas, real estate activities and retail trade. The amount of reinvested earnings also significantly decreased, which was partly caused by the previously mentioned changes in their statistical monitoring. Debt investment saw the smallest decline, falling to EUR 0.6 billion, from EUR 0.8 billion in the first half of 2008. Total inward FDI break-down by sector in the first half of 2009 was as follows: 63 per cent. — financial intermediation (except insurance and pension funds), 12 per cent. — supporting and auxiliary transport activities, 11 per cent. — the extraction of crude petroleum and natural gas, 7 per cent. — retail trade and commission trade, 7 per cent. — other business activities.

In order to encourage private and foreign investment, the Investment Incentive Act provides for various incentives for investors, including:

- tax benefits,
- customs benefits (available until the day of Croatia's accession to the EU): when importing equipment which is an integral part of the investment, customs duties are not charged for certain categories of goods,
- Government contribution when new workplaces are created,
- Government contribution towards expenses arising in connection with training of employees,
- Government contribution towards development of technological and innovation centres,
- Government contribution of strategic business support activities, and
- Government contribution in the amount equalling 5 per cent. of construction costs of a new factory (up to a maximum of EUR 1.0 million), costs relating to purchases of new machines (up to a maximum of EUR 1.0 million) and infrastructure construction costs (up to a maximum of EUR 0.5 million) for large investment projects where the investment amount is at least EUR 15 million and it is intended that the project will create at least 100 new jobs.

These incentives are available to both foreign and domestic investors investing at least EUR 300 thousand. Croatia has signed agreements on mutual incentives and protection of investments with 53 countries. The most represented foreign investments in Croatia are investment in financial mediation sector, telecommunications, pharmaceuticals, extracting crude oil and gas and related services, trade, hotels and restaurants. The Investment Incentive Act is in compliance with the *acquis communautaire* in the area of State grants.

Exchange Rates

Croatia adheres to the exchange rate regime of managed floating, where the exchange rate of the Kuna is not fixed against another foreign currency or a basket of currencies but is rather freely determined by the foreign exchange market. The exchange rate therefore floats depending on the foreign exchange supply and demand on the foreign exchange market. The CNB does not predetermine the floor or the ceiling level of the exchange rate that it attempts to maintain or at which it will necessarily intervene. However, the CNB attempts to prevent excessive exchange rate volatility by occasional market interventions or by other monetary policy instruments that influence foreign exchange market or money market conditions such as open market operations reserve requirements, among others. The CNB aims to maintain the stability of the HRK/EUR exchange rate in order to meet its primary objective of maintaining stability of prices in Croatia. In particular, in economies where the role and circulation of the Euro are substantial and that have significant capital inflows such as Croatia's, prices are very sensitive to exchange rate fluctuations. As a result, exchange rate movements materially impact household inflationary expectations. The effect of this is augmented by the population's sensitivity to inflation as a result of experiencing hyperinflation in the early 1990's.

2008 was marked by a very slight nominal appreciation of the Kuna against the Euro, with the Euro declining from HRK 7.325 at the end of 2007 to HRK 7.324 at the end of 2008. Notwithstanding slightly more pronounced appreciation pressures at the beginning of 2008, the HRK/EUR exchange rate was relatively stable in the first seven months of 2008. Mild appreciation pressures in the reference period were to a large extent the result of the inflow of foreign currency tourism receipts and to a lesser degree an outcome of corporate foreign borrowing. The appreciation pressures on the HRK/EUR exchange rate were also stimulated by the inflow of foreign exchange necessary for the purchase of INA shares. The Kuna appreciated slightly in July and August 2008 principally due to increased demand at the peak of the tourism season. In the last quarter of 2008, the HRK/EUR exchange rate was mainly exposed to depreciation pressures brought on by the increase in demand for foreign exchange.

In 2008, the CNB intervened twice in the foreign exchange market. The CNB held the first auction on 31 January, after the decline in Kuna liquidity caused by the intensification of appreciation pressures, and bought EUR 189.1 million creating an additional Kuna liquidity of HRK 1.4 billion. The second auction was held on 27 October 2008, when the increase in demand for foreign exchange led to stronger depreciation pressures, and the CNB sold EUR 270.6 million, withdrawing HRK 2.0 billion from the system. Both interventions were spot transactions. In addition to these two interventions, in 2008 the CNB conducted one outright purchase of EUR 70 million with one bank in November and arranged foreign exchange swap transactions in the aggregate amount of EUR 150 million, with a two-week duration each from the end of November to December. Through all foreign transactions with the banks in 2008 the CNB has sold EUR 11.5 million net, withdrawing HRK 90.6 million from the system. In respect of transactions with the Government, the amount of foreign exchange was higher and these transactions had a stronger net effect on the Kuna liquidity in the monetary system. In foreign exchange transactions with the Ministry of Finance in 2008, the CNB purchased a net aggregate of EUR 185.9 million, releasing HRK 1.3 billion in the system.

In the first three months of 2009, movements in the HRK/EUR exchange rate were dominated by depreciation pressures caused by the increase in demand for foreign exchange needed for the servicing of the public external debt and the payment of corporate foreign liabilities in an environment of reduced capital inflows. In an effort to counteract the nominal weakening of the Kuna, the CNB intervened twice in the foreign exchange market in the first three months of 2009, selling to banks a total of EUR 513 million (EUR 328.3 million on 23 January and EUR 184.7 million on 18 February). The reduction of the minimum required amount of foreign currency claims (foreign currency liquidity ratio), first from 28.5 per cent. to 25.0 per cent. as decided on 29 January 2009 with implementation as of 6 February 2009 and then further to 20.0 per cent. as decided on 18 February 2009 with implementation as of 20 February 2009, was an additional measure by the CNB aimed at easing of depreciation pressures. In addition, the maximum open foreign exchange position of banks was increased from 20 per cent. to 30 per cent. of regulatory capital. The reduction of the minimum required rate of foreign currency liquidity enabled the banks to dispose more freely with foreign currency funds. The end of February 2009 witnessed appreciation pressures on the exchange rate due to the increase in demand for Kuna in the domestic market. In order to provide the necessary level of Kuna liquidity and to alleviate appreciation pressures, the CNB intervened in the foreign exchange market by purchasing a total of EUR 331.2 million from banks at the auction held on 27 February and putting into circulation HRK 2.5 billion. Overall, the nominal HRK/EUR exchange rate depreciated by 1.8 per cent. in the first three months of 2009, with the HRK/EUR exchange rate increasing from 7.324 on 31 December 2008 to 7.457 on 31 March 2009.

In the second quarter of 2009, the HRK/EUR exchange rate mainly experienced appreciation pressures principally as a result of the Government's Eurobond issue of EUR 750 million in June 2009, the expectations of significant capital inflows following announced borrowings by the HBOR, public companies and Croatian Motorways, and the beginning of the tourist season. In this period, the CNB did not hold foreign exchange auctions but conducted significant foreign exchange transactions with the Government. The CNB bought EUR 473 million from the Ministry of Finance which received EUR 750 million from the Eurobond issued in May. The nominal HRK/EUR exchange rate was 7.292 at the end of June 2009, representing an appreciation of 2.2 per cent. from the end of March 2009.

After appreciating in the second quarter of 2009, the HRK/EUR exchange rate depreciated slightly at the beginning of the third quarter. In particular, the first half of July witnessed the weakening of the Kuna due to increased foreign exchange demand, particularly by the corporate sector. Depreciation pressures on the Kuna eased somewhat in the second part of July, mainly as a result of stronger foreign currency inflows during the peak of the tourist season, which continued in August. Following its August appreciation, the exchange rate of the Kuna against the Euro continued to strengthen slightly during September. Standing at 7.315 on 30 September, the HRK/EUR exchange rate was almost unchanged since the end of 2008.

In line with the movements in the HRK/EUR exchange rate and the U.S.$/EUR exchange rate, the HRK/U.S.$ exchange rate depreciated by 3.4 per cent. in 2008, from HRK 4.99/U.S.$ at the end of 2007 to HRK 5.16/U.S.$ at the end of 2008. In the first nine months of 2009, the US dollar depreciated by 2.6 per cent. against the Euro on the global foreign exchange market. The HRK/U.S.$ exchange rate, affected by developments on global foreign exchange markets, appreciated by 3.0 per cent. in the same period, from HRK 5.16/U.S.$ at 31 December 2008 to HRK 5.00/U.S.$ at 30 September 2009.

Export price competitiveness deteriorated in 2008 compared to 2007. The index of the real effective Kuna exchange rate deflated by producer prices appreciated in the reference period by 4.6 per cent., while the same index deflated by consumer prices appreciated by 6.0 per cent., principally due to faster growth in consumer and producer prices in Croatia than in foreign countries in the reference period and due to appreciation of the nominal effective exchange rate of the Kuna. In the same period, the average monthly index of the nominal effective Kuna exchange rate appreciated by 3.5 per cent. principally due to the nominal depreciation of the HRK/U.S.$ exchange rate.

Although in July 2009 compared to December 2008 the Kuna depreciated slightly against the basket of foreign currencies in nominal terms, this was offset by faster growth in consumer prices in Croatia than abroad. Therefore, the index of the real effective Kuna exchange rate, deflated by consumer prices, appreciated during this period by 1.1 per cent. At the same time, the index of the real effective Kuna exchange rate, deflated by producer prices, appreciated even more (3.2 per cent.) because foreign producer prices fell while domestic producer prices rose.

The following table sets forth the end-of-month HRK/EUR exchange rate from January 2003 to September 2009:

	Year ended 31 December						
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
January	7.555767	7.670249	7.551070	7.359333	7.373400	7.249864	7.373294
February	7.620482	7.607293	7.507513	7.307577	7.345292	7.277476	7.403887
March	7.692318	7.395440	7.441756	7.323554	7.382466	7.256652	7.457249
April	7.567308	7.533576	7.364438	7.291280	7.372840	7.263753	7.425124
May	7.546434	7.369765	7.307220	7.264151	7.308634	7.250440	7.326488
June	7.508844	7.365831	7.310503	7.256979	7.303218	7.246264	7.292035
July	7.541513	7.406563	7.296747	7.258119	7.297330	7.221125	7.333135
August	7.457896	7.391677	7.378355	7.314609	7.319403	7.161648	7.326773
September	7.571370	7.547840	7.438696	7.381777	7.281634	7.107741	7.288341
October	7.593986	7.490452	7.381207	7.369343	7.350060	7.185881	—
November	7.655148	7.600835	7.400190	7.333542	7.313666	7.128034	—
December	7.646909	7.671234	7.375626	7.345081	7.325131	7.324425	—

Source: Croatian National Bank

MONETARY DEVELOPMENTS AND INTERNATIONAL RESERVES

Monetary Policy and Instruments

In 2008 and 2009 the CNB has continued to defend the stability of the HRK/EUR exchange rate which is the main nominal anchor for achieving domestic price stability. More restrictions on the money supply and limits on bank credit placements were the predominant anti-inflationary monetary actions. As a result of these actions, during 2008 and 2009 to date the volume of repo auctions decreased and interest rates significantly increased. Apart from strong appreciation pressures early in 2008, which the CNB mitigated by purchasing foreign currency from the banks, the stable HRK/EUR exchange rate in the remainder of the year did not call for CNB interventions until the fourth quarter of 2008 when depreciation pressures began to mount.

In the fourth quarter of 2008 and at the beginning of 2009 monetary policy was executed in an environment that was characterised by the strong spill-over effects of the global financial and economic crisis on domestic real activity. Given the slower economic growth and lower foreign capital net inflows, the CNB, in addition to maintaining domestic currency stability, focused on ensuring sufficient liquidity. Following the first half of 2008, when liquidity creation was reduced to alleviate inflationary pressures, the CNB has tightly managed HRK liquidity through weekly reverse repo transactions and helped to maintain exchange rate stability and thus overall financial stability in the country by taking the following steps:

- *October 2008:* the CNB abolished marginal reserve requirement (as a result EUR 532 million were released in the system);
- *December 2008:* the banks reserve requirement rate was reduced from 17 per cent. to 14 per cent. (HRK 8.4 billion released, of which HRK 5.9 billion in Kuna component and HRK 2.5 billion or around EUR 345m in foreign exchange component);
- *January 2009:* the CNB increased the calculated foreign exchange component of reserve requirement that is allocated in Kuna from 50 to 75 per cent. (result was an increase of Kuna reserve component, i.e. a decrease in foreign exchange component by HRK 5.9 billion or around EUR 810 million);
- *February 2009:* the minimum required amount of foreign currency assets was reduced from 28.5 to 20.0 per cent. of banks total foreign liabilities (resulted in freeing of EUR 2.1 billion that were previously set aside as part of banks liquid foreign assets).
- *February 2009:* the CNB increased the limit on banks' open foreign exchange position from 20 per cent. to 30 per cent. The expected resulting increase in bank liquidity was intended to stabilise the foreign exchange market, to improve domestic credit conditions and to facilitate a EUR 750 million syndicated loan of six domestic banks to the Government.

The above mentioned changes of monetary policy instruments substantially improved the foreign currency liquidity of the banking system. Besides these changes, the CNB has also intervened in the foreign exchange market at the beginning of 2009 by selling EUR 328.3 million on 23 January and EUR 184.7 million on 18 February, while on 27 February the CNB purchased EUR 331.2 million from banks.

In line with more restrictive management of the money supply, and due to a major increase in Government borrowing from banks, the CNB has tightened regulations concerning the amount of collateral which automatically puts additional Kuna liquidity at banks' disposal. Also, the nominal value of intraday and Lombard loans was reduced from 90 per cent. of collateral (T-bills) down to only 50 per cent. In addition, the scope of securities eligible as collateral was reduced to include only those with an original maturity of up to one year.

While the first two months of 2009 were marked by restrictive Kuna liquidity creation, in line with containing the depreciation pressures on domestic currency, in the second quarter of 2009 appreciation pressures began to develop as a result of the issue of Government bonds in the international market in May 2009 and the seasonal effects of the tourism industry on the Kuna. Due to the easing of tensions in the money and foreign exchange markets, sharply lower interest rates in most countries and stable inflation rate in Croatia, after February 2009 there was no need for additional changes in monetary policies. During the tourist season, which lasted from approximately the beginning of April to the end of August, demand for Kuna was pronounced, however, the exchange rate appreciated only moderately and as a result, additional foreign exchange interventions with the banks were not necessary. The only CNB action on the foreign exchange market in this period was the conversion in June 2009 from the Euro into the Kuna of a part of Government foreign exchange funds raised in the May 2009 international bond issue. Meanwhile, the CNB maintained markets' stability and liquidity through its ordinary course activities including holding repo auctions solely through the allotment at a fixed rate of 6.0 per cent. (unchanged since December 2008) in which the CNB was accepting on average 40 per cent. of bids received from banks. In autumn of 2009, as appreciation pressures on Kuna continued (supported by capital inflows due to foreign borrowing by several state-owned companies), the CNB intervened on the foreign exchange market by purchasing from banks EUR 1.3 million in September 2009 and EUR 154 million in October 2009.

Pursuant to the Law on the Croatian National Bank and the Decision on Reserve Requirements (Official Gazette Narodne novine, Nos. 203/2003, 145/2004, 34/2005, 64/2005, 136/2005, 146/2005, 112/2008, 137/2008, 139/2008 and 3/2009) (the "**Reserve Requirement Decision**"), credit institutions are required to maintain with the CNB certain reserves in the settlement account and in the vault, or in a separate account with the CNB. Reserve requirements apply to banks founded in Croatia and branches of foreign banks in Croatia and does not apply to special purpose banks when regulated by a special law and to HBOR. The reserve requirement comprises two parts, Kuna and foreign exchange. The Kuna base for calculating reserve requirements consists of the Kuna sources of funds which include received Kuna deposits and loans, issued Kuna-denominated debt securities, Kuna-denominated hybrid and subordinated instruments and other Kuna-denominated financial liabilities. The Kuna sources of funds excluded from the reserve requirement calculation include funds received from the CNB or HBOR, funds received from financial institutions which calculate reserve requirements pursuant to the Reserve Requirement Decision and relief funds received in connection with natural disasters including emergency funds for recovery of war damage. The foreign exchange base for calculating reserve requirements consists of the foreign exchange sources of funds, including received foreign exchange deposits and loans, obligations arising from the issued securities in foreign currency (excluding banks' equity securities), hybrid and subordinated instruments in foreign currency and other financial liabilities in foreign currency. The foreign exchange sources of funds excluded from the reserve requirement calculation include foreign exchange funds received from financial institutions which calculate reserve requirements pursuant to the Reserve Requirement Decision, blocked household foreign exchange savings converted into public debt of Croatia, foreign exchange loans refinanced by Croatia, foreign exchange funds received from HBOR and relief funds received in connection with natural disasters including emergency funds for recovery of war damage. A bank's reserve requirements are deemed satisfied if, during each one-month maintenance period, the average amount of the daily balances of the reserve accounts is not lower than the reserve requirement.

The level of reserve capital in the banking sector is set according to the risk sensitivity of a bank's balance sheet. Reserves are formed for provisions and impairment on banks' assets (especially loans) in a manner prescribed by the Credit Institutions Act. In addition, the CNB has the authority to prescribe in detail how such reserves are formed pursuant to a 'Decision on the Classification of Placement and Off — Balance Sheet Liabilities of Credit Institutions' (a "**Classification Decision**"). Generally, according to a Classification Decision, assets are classified according to the degree of risk (Risk categories) depending on a possibility of collection, i.e. on the expected future cash flows, all the placements are classified into three broad categories (regardless of whether exposures are individually significant or they belong to a portfolio of small loans), as follows:

- placements for which no evidence of impairment is identified on an individual basis (risk category A);
- placements for which evidence of partial impairment is identified, i.e. partly recoverable placements (risk categories B-1/B-2/B-3); or
- placements for which evidence of impairment is identified, equal to their carrying amount, i.e. fully irrecoverable placements (risk category C).

Additionally placements in risk categories according to the general classification criteria stated in a Classification Decision shall, in the entire period of contractual relationship, assess placement quality and shall classify placements into the appropriate risk categories on the basis of the following criteria: debtors' creditworthiness; debtors' timeliness in meeting their obligations towards a credit institution and other creditors; and quality of instruments of collateral for credit institution's receivables.

Monetary Developments

Monetary developments in 2008 were characterised by an increase in net domestic assets and a moderate decline in net foreign assets which led to slower growth in total liquid assets ("**M4**"). These trends were largely the result of changes in the last quarter. The ratio of nominal GDP to M4 has shown a slightly downward trend over the last 5 years, whilst being broadly stable as shown by the table below. By contrast in 2000 the ratio was approximately 2.4, the current trend would therefore suggest that the remonetisation process is complete.

	Year ended 31 December				
	2004	2005	2006	2007	2008
Ratio of Nominal GDP/M4	1.8	1.7	1.6	1.5	1.5

Sources: Croatian Bureau of Statistics and Croatian National Bank

The following table sets forth the Croatia's money supply at the end of the periods indicated:

	Year ended 31 December			Eight months ended 31 August	
	2006	2007	2008	2008	2009
			(HRK millions)		
Reserve money	46,331.2	51,923.9	49,743.0	52,228.3	55,346.9
Money (Ml)(1)	48,521.0	57,878.3	55,222.3	55,639.9	47,815.0
Broad money (M4)(2)	182,458.6	215,822.1	225,018.5	222,317.2	224,444.3
Net domestic assets(3)	154,844.1	166,375.5	183,279.1	171,507.8	186,660.7
Domestic credit(4)	183,379.5	210,828.4	232,982.1	222,854.4	230,228.9

Source: Croatian National Bank

(1) Money (Ml) comprises currency outside banks, deposits with the CNB by other banking institutions and other domestic sectors and banks' demand deposits.

(2) Broad money (M4) comprises money (M1), savings and time deposits and foreign currency deposits, as well as bonds and money market instruments.

(3) Net domestic assets are defined as a difference between total liquid assets and foreign assets (net).

(4) Domestic credit comprises banks' claims on other domestic sectors, other banking institutions and other financial institutions.

Until late in the third quarter of 2008 net domestic assets grew moderately due to more stringent financing terms by commercial banks, the overall economic slowdown and CNB measures to curb credit growth. The growth of bank placements to the non-banking sector on the system level did not exceed the CNB recommended rate. In the first nine months of 2008, placements rose by only 6.5 per cent., or 2.5 percentage points below the CNB ceiling. In addition to the moderate growth of placements to the private sector, central government borrowing from domestic banks was negligible, which together led to slower growth in net domestic assets. At the same time, banks' net foreign assets increased as banks used domestic deposit inflows to decrease their foreign liabilities. Deposit inflows were particularly strong due to adverse capital market developments and the successful tourist season.

However, with the effects of the global financial and economic crisis spilling over on Croatia at the beginning of the fourth quarter of 2008 monetary developments took a different path. At the beginning of October 2008 banks were faced with a major outflow of household deposits triggered by the lack of confidence amidst the financial crises. The prompt reaction of commercial banks including the support of the parent banks, the CNB and the Government halted the deposit outflow.

To increase foreign exchange liquidity, monetary policy was adjusted in response to the new conditions in the domestic and global financial markets. The CNB abolished the marginal reserve requirement thus freeing foreign exchange funds allocated over a long period of time. The Government increased the guaranteed amount of savings deposits from HRK 100,000 to HRK 400,000, which strengthened public confidence in the banking system.

In the last quarter of 2008 lending activities of banks to the private sector lost momentum. During this period bank loans grew, excluding exchange rate effect, less than 1.0 per cent. in total. These developments were the outcome of a sharp fall in demand for loans caused by more stringent financing terms, as well as the banks' preference to preserve their own liquidity and lend to the private sector more moderately in view of the uncertainty and crisis in the global and domestic financial markets. Bank activities in the last three months of 2008 thus mostly focused on ensuring sufficient funds from abroad and on central government financing. Bank claims on the central government grew more than 45 per cent. in that period, mostly on account of the increase in loans granted and T-bills subscribed.

The annual movements of monetary and credit aggregates in 2008 were largely affected by the financial crises and slowdown of economic growth. The growth of bank placements to the non-banking sector was 10.5 per cent. Excluding the exchange rate effect, the annual growth rate of placements was approximately 8.5 per cent., almost 8 percentage points less than the growth rate in 2007. The slowdown in bank lending was particularly pronounced in household loans. Their annual growth rate decreased from 18.0 per cent. in 2007 to 12.1 per cent. in 2008. In contrast to slower household loan growth, the annual growth rate of corporate loans increased to 11.4 per cent. in 2008. This suggests that, in an environment of weaker household demand for loans, banks focused more on corporate financing. Furthermore, as the global financial and economic crisis impeded their access to foreign capital, domestic enterprises increasingly turned to domestic banks for loans. Banks' net claims on the central government increased by 41.6 per cent. in 2008 and were mostly determined by the change in the last quarter. The annual growth rate of M4 fell to 4.3 per cent. in 2008 and money ("**M1**") growth became negative at the year-end. M1 thus fell by 4.6 per cent. in 2008.

The decelerating trend in credits to the private sector, together with strong lending to the Government, continued during the first eight months of 2009. Between January and August 2009, bank loans to the private sector fell by

1.2 per cent., while net claims on the central government grew by 40.5 per cent. The CNB supported financing needs of the domestic sectors, especially the Government, by further decreasing the minimal required foreign currency coverage from 28.5 to 25 per cent. on 6 February 2009 and further to 20 per cent. on 20 February 2009 and thus releasing EUR 2.1 billion. As in the last quarter of 2008, banks continued to borrow abroad until the beginning of the tourist season (in early June), when banks commenced using seasonal deposit inflows generated by the tourism industry to decrease their foreign currency denominated debt. Based on the figures representing the inflows of foreign currency funds into domestic banks, domestic banks still have access to foreign capital, which mostly comprise foreign currency denominated deposits and loans from parent banks.

Reserve money increased in the first eight months of 2009 (6.0 per cent. year on year) standing at HRK 55.3 billion at the end of August. The rise in demand for reserve money was due to the increase in Kuna reserve requirements for banks and reflected the impact of monetary measures aiming to tighten Kuna liquidity. The reduction in the reserve requirement from 17 to 14 per cent. in December 2008 was offset in January 2009 with an increase in the percentage of the foreign currency reserve requirement that is set aside in Kuna. Money (M1) decreased by 13.4 per cent. in the first eight months of 2009 as a result of the fall in demand deposits with banks, particularly deposits by the corporate sector. The broadest monetary aggregate, total liquid assets (M4) continued its downward trend in 2009, while its annual rate of change declined in 2009.

International Reserves Management

In managing the international reserves of Croatia, the CNB is governed by the principles of liquidity and safety of investment. In that context, it aims to maintain high liquidity of reserves and adequate risk exposure and, attempts to achieve favourable rates of return on its investments while adhering to these principles. Similar principles are normally used by other central banks in their international reserves management.

The CNB manages international reserves in two ways: (1) reserves formed through the outright purchase of foreign currency from the banks and the Ministry of Finance are actively managed in accordance with the pre-defined benchmark portfolios, and (2) reserves accumulated pursuant to the foreign currency reserve requirements and deposits of the Ministry of Finance are passively managed according to the foreign currency liabilities assumed (investments in this part of the portfolio are made in such a way that CNB is protected against currency or interest rate risk, i.e. they are made in the same currency and with the same maturity as the assumed liabilities).

Set out below is the balance sheet of the CNB at the end of the periods indicated.

	Year ended 31 December					**Eight months ended 31 August**	
	2004	**2005**	**2006**	**2007**	**2008**	**2008**	**2009**
				(HRK millions)			
ASSETS							
Foreign assets	49,373.4	54,862.5	64,088.2	68,177.8	66,805.5	70,469.3	68,081.9
Gold	—	—	—	—	—	—	—
Holdings of SDRs	4.8	6.3	5.3	5.6	5.3	4.7	2,169.4
Reserve position in the IMF	1.4	1.4	1.3	1.3	1.3	1.2	1.3
Currency and demand deposits with foreign banks	5.7	7.7	7.2	7.2	1,472.7	9.1	1,766.7
Time deposits with foreign banks	24,337.7	28,274.1	33,243.0	33,204.4	13,189.3	24,138.5	12,268.6
Securities in f/c	25,023.7	26,573.0	30,831.2	34,959.3	52,136.9	46,315.8	51,876.0
Non-convertible foreign exchange	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on central government and funds	3.3	1.4	0.9	1.0(1)	2.2	0.9	2.1
Claims in Kuna	3.3	1.4	0.9	1.0(1)	2.2	0.9	2.1
Bridging loans	—	—	—	—	—	—	—
Loans under separate decrees	—	—	—	—	—	—	—
Overdue claims	3.3	1.4	0.9	1.0	2.2	0.9	2.1
Claims in f/c	—	—	—	—	—	—	—
Claims on other domestic sectors	82.9	73.4	64.0	67.9	64.2	65.2	4.3
Claims on banks	408.9	4,215.6	3,911.5	4,178.3	13.9	2,570.2	2,668.0
Credits to banks	408.9	4,215.6	3,911.5	4,178.3	13.9	2,556.4	2,668.0
Refinancing of banks	—	—	—	—	—	—	—
Short-term credits against securities portfolio	—	—	—	—	—	—	—
Lombard credits	—	—	—	1,349.1	—	—	—
Short-term liquidity credits	—	—	—	—	—	—	—
Other credits	15.0	14.5	14.5	14.7	13.9	13.8	13.6
Reverse repo transactions	394.0	4,201.1	3,897.0	2,814.5	—	2,542.6	2,654.3
Overdue claims	—	—	—	—	—	13.8	—
Claims on other banking institutions	—	—	—	—	—	—	—
Total	**49,868.5**	**59,153.0**	**68,064.6**	**72,425.1**	**66,885.8**	**73,105.7**	**70,756.2**

	Year ended 31 December					Eight months ended 31 August	
	2004	2005	2006	2007	2008	2008	2009
	(HRK millions)						
LIABILITIES							
Reserve money	33,924.4	40,390.8	46,331.2	51,923.9	49,743.0	52,228.3	55,346.9
Currency outside banks	10,955.6	12,163.8	14,609.3	16,007.5	17,051.0	17,567.4	16,967.7
Banks' cash in vaults	1,871.0	2,210.7	2,698.0	3,305.8	3,428.3	3,323.8	3,579.5
Banks' deposits	21,082.6	26,016.3	29,023.9	32,610.6	29,263.7	31,337.0	34,799.8
Settlement accounts	6,408.2	8,411.1	8,535.7	7,553.9	9,520.3	7,996.5	11,130.5
Statutory reserves	14,674.4	17,605.2	20,478.2	22,275.6	19,222.7	22,894.7	23,537.7
CNB bills on obligatory basis	—	—	—	1,991.1	460.6	445.8	131.6
Overnight deposits	—	—	10.0	790.0	60.0	—	—
Deposits of other banking institutions	—	—	—	—	—	—	—
Deposits of other domestic sectors	15.1	—	—	—	—	—	0.0
Restricted and blocked deposits	10,777.1	13,551.8	16,633.5	14,286.0	8,064.1	14,652.0	4,768.9
Statutory reserve in f/c	10,764.7	13,495.9	16,576.7	14,257.5	8,008.3	14,597.3	4,715.2
Restricted deposits	12.4	55.9	56.9	28.6	55.8	54.7	53.7
Escrow deposits	—	—	—	—	—	—	—
Foreign liabilities	18.1	18.9	18.9	17.2	16.6	14.1	8.1
Use of IMF credit	—	—	—	—	—	—	−8.1
Liabilities to international organisations	18.1	18.9	18.9	17.2	16.6	14.1	0.0
Liabilities to foreign banks	—	—	—	—	—	—	—
Central government and funds deposits	263.2	332.2	188.0	199.1	206.9	513.0	395.6
Demand deposits	228.0	319.0	174.5	125.8	171.1	500.2	327.6
Central government demand deposits	123.0	246.3	138.6	100.3	43.0	94.4	279.9
Central government funds demand deposits	105.0	72.7	35.9	25.4	128.2	405.8	47.7
Central government f/c deposits	35.2	13.2	13.5	73.3	35.8	12.8	67.9
CNB bills	—	—	—	—	—	—	—
CNB bills	—	—	—	—	—	—	—
CNB bills in Kuna	—	—	—	—	—	—	—
CNB bills in f/c	—	—	—	—	—	—	—
Capital accounts	5,096.5	5,357.4	5,408.8	6,664.5	9,562.4	6,388.9	10,970.6
Other items (net)	(210.8)	(498.2)	(515.8)	(665.6)	(707.1)	(690.5)	(733.9)
Total	**49,868.5**	**59,153.0**	**68,064.6**	**72,425.1**	**66,885.8**	**73,105.7**	**70,756.2**

Source: Croatian National Bank

Net reserves comprise an active portfolio managed by the CNB plus SDR and foreign cash held by the treasury. Net international reserves of the CNB rose by EUR 672 million in 2008 or by 9.1 per cent. compared with 2007. At the end of 2008, net international reserves of the CNB stood at EUR 8.0 billion.

The main factors leading to changes in the level of total international reserves in 2008 on the inflow side were: EUR 409 million in foreign exchange interventions involving purchases of foreign currency from the banks; EUR 457 million in income from international reserves investment; EUR 271 million in foreign currency purchases from the Ministry of Finance; and EUR 47 million in cross-currency changes arising from the strengthening of the US dollar against the euro at the end of 2008 compared to the end of 2007.

The main factors leading to changes in the level of total international reserves in 2008 and 2009 on the outflow side were: a fall of EUR 852 million in foreign currency reserve requirements (with the marginal reserve requirement falling by EUR 686 million and the reserve requirements falling by a further EUR 167 million); EUR 85 million in foreign currency sales to the Ministry of Finance; and EUR 421 million in foreign exchange interventions involving sales of foreign currency to the banks.

After 3 years of continuous growth (from EUR 6.4 billion at the end of 2004 to EUR 9.3 billion at the end of 2007), CNB's gross international reserves declined in the third quarter of 2008 and the first two months of 2009 by 12.8 per cent. as a result of changes in the monetary policy instruments to improve foreign currency liquidity of the banking system and alleviate the adverse shocks created by the international financial markets (the marginal reserve requirement was abolished in October 2008 and foreign currency reserve requirement was reduced in December 2008). Although the gross international reserves continued to decrease in January and February 2009, they started to increase thereafter. In September 2009, gross international reserves stood at EUR 9.3 billion while the annual rate of change recovered to −5.0 per cent.

At the end of September 2009, net international reserves of the CNB stood at EUR 8.7 billion, which represents an increase of 8.0 per cent. as compared to 31 December 2008. The impact of changes in the monetary instruments in the last quarter of 2008 and the first quarter of 2009 mostly affected gross reserves only, while the net usable reserves continued to grow, reaching the annual growth rate of 9.1 per cent. at the end of September 2009.

In August 2009, the Ministry of Finance accepted SDR 270.7 million of general SDR allocation. An additional SDR 32.5 million of special one-time allocation was received in early September, totalling approximately U.S.$470 million which will further strengthen the international reserves.

As investors fled into safer assets during the global financial and economic crisis, prices of the U.S.$ and Euro denominated Government bonds grew strongly, which reflected positively on the return on the CNB's foreign currency portfolios. In response to the global financial and economic crisis, credit risk management guidelines tightened in 2008 and as a result the CNB's investment portfolio was restructured. Investments in non-collateralized bank deposits were almost completely withdrawn and re-invested in safer assets such as Government bonds, Bank for International Settlement deposits and deposits with the central banks.

According to the degree of credit risk exposure, total international reserves have been divided into funds invested in Government bonds, covered bonds, banks, international financial institutions and central banks. In terms of the structure of total international reserves, the share of investments in Government bonds grew from 55.2 per cent. at 31 December 2007 to 83.1 per cent. at 31 December 2008, and have remained at this level in 2009. These investments are less exposed to credit risk as they comprise investments in bonds of countries with the highest credit rating. By contrast, the share of total international reserves invested in non-collateralised instruments with the banks was decreased from 42.6 per cent. at the end of 2007 to 1.2 per cent. at the end of 2008, and has been kept at this level in 2009. The investments in the international financial institutions and central banks also increased and accounted for 15.7 per cent. of the total international reserves.

In terms of credit rating, 85.6 per cent. of the total reserves in 2008 were invested in securities of countries and banks with the highest Aaa rating according to Moody's. Banks rated Aa1 and Aa2 accounted for more than 7.9 per cent. of international reserves investment while the remaining share (6.4 per cent.) of total international reserves was invested in the International Monetary Fund and the Bank for International Settlements. This allocation of the total reserves has mostly remained the same in 2009.

As at 31 December 2008, the share of reserves in Euro in net international reserves was 81.7 per cent. and the share of reserves in U.S.$ was 18.3 per cent. This ratio has generally not changed in 2009. In 2008, the yield on net CNB Euro portfolio was 5.7 per cent. (according to the Global Investment Performance Standards methodology) and the yield on net CNB U.S.$ portfolio during the same period was 4.6 per cent. The yields were somewhat lower in 2009 due to interest rate movements in the global markets, along with the above mentioned tightening of the investment guidelines. The average size of the CNB Euro portfolio that was actively managed by the CNB in 2008 was EUR 6.3 billion and the average size of the U.S.$ portfolio was U.S.$2.0 billion. Income realised from reserves investment in 2008 was EUR 351 million and U.S.$88 million. In the first half of 2009, such income was EUR 67.0 million and U.S.$0.8 million.

CNB measures to incentivise local currency lending

The regulations for capital adequacy calculation were changed in 2006 to take into account currency-induced credit risk: new risk weightings of 75 per cent. and 125 per cent. were introduced into the calculation of credit risk-weighted assets (in addition to the existing risk weightings of 0, 20, 50 and 100 per cent.). A 75 per cent. risk weighting is assigned to foreign currency loans and loans with a currency clause which are completely insured by mortgages, specifically loans approved to debtors who do not have adjusted foreign exchange positions. A 125 per cent. risk weighting is assigned to foreign currency claims and claims with a currency clause which are not covered by the bank's deposits or mortgaged property, specifically claims from debtors who do not have adjusted foreign exchange positions.

In addition, as of the beginning of 2008 this regulation was further strengthened: instead of risk weights of 75 per cent. for collateralised and 125 per cent. for uncollateralised foreign currency and foreign currency indexed claims on clients with an unmatched currency position, new weights are applied, of 100 per cent. and 150 per cent. respectively.

The capital adequacy ratio is, for now, still being calculated according to the described regulations, i.e. by applying risk weightings for the calculation of credit risk-weighted assets. The new Decision on the capital adequacy of credit institutions, which is harmonized with the EU regulations for calculating capital adequacy, has been approved and will enter into force as of 31 March 2010. In addition, the minimum capital adequacy ratio will be raised from 10 per cent. to 12 per cent. as of 31 March 2010.

Measures to control the increase of the un-hedged Euro-denominated asset base

In the last couple of years, the CNB has initiated several measures to indirectly stimulate the growth of banks' capital and domestic currency deposits, as opposed to foreign currency sources. These measures have focussed on amendments to the marginal reserve requirement in order to discourage banks from foreign borrowing, and to encourage the banks to start to finance their lending activities by increasing their capital. In additional, amendments to the minimum liquidity requirement of foreign exchange liabilities has stimulated the banks to attract domestic currency deposits instead of foreign exchange deposits or deposits indexed to a foreign currency. Thus, in order to match the currency structure of their assets with the currency structure of their sources of funding, commercial banks have been motivated to lend more in domestic currency and to offer more attractive interest rates on Kuna loans.

Banking System

The CNB is responsible for the supervision of banks, savings banks, housing savings banks and credit unions. The supervisory tasks of the CNB also comprise the issuance and withdrawal of authorizations for these institutions and other authorizations and approvals in accordance with the relevant acts, the adoption of relevant subordinate legislation and the supervision of operations of these institutions. Legal compliance and safety and soundness of bank operations and risk management are assessed through on-site supervision, specialized on-site supervision and off-site supervision. On-site supervision is performed according to the CNB's methodology and in line with the annual supervisory plan adopted at the end of each calendar year for the following year. On-site examinations are performed at the banks' premises using original documentation and internal reports. In large banks, targeted on-site examinations are performed, while in medium-sized and small banks full-scope examinations are performed in tandem with targeted examinations. In the off-site department, assessments of banks' risk profiles are based on information provided in compulsory, extensive reports that banks submit to the CNB. If violations or irregularities are established, the on-site and off-site departments work together and issue regulatory orders that require banks to implement remedial measures.

Pursuant to the Credit Institutions Act, where a credit institution is either in breach of a law or regulation or its financial position makes its continued operation uncertain, the CNB may withdraw authorisation to provide particular financial services, appoint a special administration, withdraw the credit institution's authorisation, initiate the compulsory winding-up of the credit institution or submit a request to initiate bankruptcy proceedings. The CNB shall appoint a special administration if:

- a credit institution was ordered to and has failed to implement supervisory measures, owing to which its liquidity or solvency could be jeopardised;
- a credit institution fails to meet the minimum capital adequacy ratio of 12 per cent. despite the supervisory measures imposed;
- a credit institution has a capital adequacy ratio of equal to or less than 6 per cent.; or
- a credit institution's continued operation would, or could, jeopardise its solvency or liquidity and it is necessary to protect the interests of the credit institution's creditors.

However, the CNB has the discretion to postpone the application of the above provisions where the CNB is of the view that facts exist indicating a high probability of improvement of the credit institution's position. If the credit institution has a capital adequacy ratio of between 9 and 12 per cent., the CNB may impose, in addition to the above measures, other restrictions such as prohibition on profit distribution, ordering a reduction of expenses, limiting asset increases, prohibition of acquisition of shares or holdings in other legal persons, prohibition of increasing exposures to a single person, or ordering the management board to propose a recapitalisation of the credit institution. If the credit institution has a capital adequacy ratio of between 6 and 9 per cent., the CNB may also impose following measures: requiring that the credit institution stops or alters the performance of certain more risky activities, requiring the suspension of certain persons with special rights and responsibilities, requiring that interest rates on received deposits do not exceed comparable market interest rates, the restriction of salaries and other income for persons with special rights and responsibilities, ordering shareholders to sell their shares in the credit institution, or ordering the credit institution to sell the shares it holds in another legal person or to wind-up such entity.

Structure of the Banking Industry

Croatia has a two-tier banking system in which the CNB acts as a central bank but does not engage in commercial banking.

At the end of June 2009 the Croatian banking system comprised 34 banks (2 of which being savings banks), 5 housing savings banks and HBOR. During the first half of 2009, one savings bank entered the market and one large and one middle-sized bank merged. Six foreign banks have offices in Croatia. The decrease in the number of banks after 1998 has resulted from consolidation/mergers, take-overs and the bankruptcy of some banks.

The proportion of the assets of banks within Croatia held in foreign ownership rose sharply between 1996 and 2002 as shown by the table below:

	1996	1999	2002
		(per cent.)	
State owned	78.4	45.6	4.0
Domestically owned	20.7	14.5	5.8
Foreign owned	1.0	39.9	90.2

Source: Croatian National Bank

The following table sets out the share ownership of the total assets of banks in Croatia (as a percentage) at the end of the periods indicated:

	Year ended 31 December					Six months ended 30 June	
	2004	2005	2006	2007	2008	2008	2009
				(per cent.)			
State ownership(1)	3.1	3.4	4.2	4.9	4.5	4.9	4.5
Private domestic ownership	5.6	5.3	5.0	4.7	4.9	4.6	4.9
Foreign bank ownership	91.3	91.3	90.8	90.4	90.6	90.5	90.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

(1) State owned and private with a significant public stake of at least 50 per cent. owned by the State.

Source: Croatian National Bank

The banking system in Croatia is highly concentrated with the two largest banks holding 41.7 per cent. of the market as at 30 June 2009. The majority of the banks' assets are controlled by foreign shareholders. As at 30 June 2009 15 entities were majority owned by foreign shareholders, 17 by private domestic shareholders and 2 by the State.

Please see below the breakdown of ownership of banks in Croatia as at 30 June 2009.

	Voting shares				
	In private domestic ownership	**In government (domestic) ownership**	**Foreign (private) ownership**	**Share of market**	**Share in shareholders equity**
			(per cent.)		
Zagrebačka banka d.d.	3.1	0.5	96.4	24.8	16.1
Privredna banka Zagreb d.d.	0.7	1.3	98.0	16.9	11.8
Erste&Steiermärkische Bank d.d. Rijeka	3.7	0.2	96.2	12.9	12.2
Raiffeisenbank Austria d.d.	2.1	0.0	97.9	10.3	12.9
HYPO Alpa-Adria-Bank d.d.	0.0	0.0	100.0	10.1	20.9
Société Générale-Splitska banka d.d.	0.0	0.0	100.0	7.4	3.2
HPB d.d.	1.1	98.9	0.0	4.1	2.4
OTP banka d.d.	0.0	0.0	100.0	3.4	3.4
Volksbank d.d.	0.0	0.0	100.0	2.1	5.3
Medimurska banka d.d.	2.5	0.0	97.5	0.8	0.4
Podravska banka d.d.	11.2	1.8	87.0	0.7	0.9
Istarska kreditna banka Umag d.d.	76.6	3.5	19.9	0.6	0.6
Jadranska banka d.d.	84.6	12.2	3.2	0.6	0.8
Karlovačka banka d.d.	86.1	7.5	6.5	0.6	0.6
Banco Popolare Croatia d.d.	1.1	0.0	98.9	0.5	0.9
Croatia banka d.d.	0.0	100.0	0.0	0.5	0.7
Credo banka d.d.	100.0	0.0	0.0	0.4	0.4
Kreditna banka Zagreb d.d.	99.5	0.4	0.0	0.4	0.8
Banka Kovanica d.d.	6.9	0.0	93.1	0.3	0.7
Imex banka d.d.	100.0	0.0	0.0	0.3	0.2
Partner banka d.d.	100.0	0.0	0.0	0.3	0.3
Slatinska banka d.d.	88.5	8.8	2.7	0.3	0.3
Štedbanka d.d.	100.0	0.0	0.0	0.3	0.9
Vaba d.d. banka Varaždin	80.8	2.3	16.9	0.3	0.7
BKS Bank d.d.	0.2	0.0	99.8	0.2	0.2
Veneto banka d.d.	0.0	0.0	100.0	0.2	1.0
Banka Brod d.d.	100.0	0.0	0.0	0.1	0.2
Banka splitsko-dalmatinska d.d.	79.6	0.0	20.4	0.1	0.2
Nava banka d.d.	100.0	0.0	0.0	0.1	0.1
Samoborska banka d.d.	99.6	0.4	0.0	0.1	0.2
Primorska banka d.d.	14.3	0.0	85.7	0.0	0.2
Aggregate weighted by market share	6.1	5.1	88.8		
Aggregate weighted by share in shareholders equity	7.7	3.6	88.8		

Source: Croatian National Bank

Large banks are categorised as having a market share (in the total banking sector according to assets) of more than 5 per cent. and middle-sized banks are categorised as having a market share of between 1 per cent. and 5 per cent. According to these criteria there were 9 large or medium-sized banks in Croatia as at 30 June 2009. Only one of these banks, HPB, is majority owned by the government (or government agencies).

The following table sets forth the structure of bank peer group assets as at 30 June 2009:

	Money assets and deposits with the CNB	**Deposits**	**Securities**	**Loans**	**Other**
		(per cent.)			
Large banks	12.1	7.4	8.1	69.5	2.9
Medium-sized banks	12.3	10.4	10.2	63.4	3.7
Small banks	12.3	11.1	8.4	63.7	4.4
Total banks	12.1	8.0	8.3	68.4	3.1

Source: Croatian National Bank

The following table sets forth the structure of bank peer group liabilities as at 30 June 2009.

	Capital	Deposits	Securities	Loans	Other
			(per cent.)		
Large banks	14.2	66.5	1.9	14.1	3.4
Medium-sized banks	14.2	68.4	1.3	12.3	5.8
Small banks	14.2	72.2	0.6	9.6	3.4
Total banks	14.0	67.1	1.7	13.5	3.6

Source: Croatian National Bank

Changes in banks' balance sheets in 2008 were influenced by the monetary and prudential measures of the CNB, while the effects of the implementation of those measures were seen at the end of 2008 in slower assets growth, substitution of a part of foreign sources of financing with additional capital and currency restructuring of the entire balance sheet. Continued implementation of the same monetary and prudential measures, combined with a spillover of the effects of the global financial and economic crisis into domestic markets, led to slower growth in banks' assets. This slowdown continued during the first half of 2009, as investors remained risk averse.

Balance sheet currency restructuring, involving growth of the Kuna component of banks' assets and liabilities, which started at the end of 2006, continued throughout 2007, but slowed down in 2008. At the end of 2008, bank assets consisted of 39.3 per cent. Kuna assets, 37.2 per cent. foreign currency indexed assets and 23.5 per cent. foreign currency assets. On the liabilities and capital side, the Kuna component accounted for 47.0 per cent., foreign currency indexed component accounted for 4.4 per cent. and foreign currency accounted for 48.6 per cent. of the total. During 2008 and first half of 2009, despite of growth in interest rates on Kuna deposits, Kuna liabilities continued to stagnate. At the end of June 2009 liabilities and capital were comprised of 44.6 per cent. Kuna liabilities and capital, 51.1 per cent. foreign currency and 4.3 per cent. were indexed to foreign currency. On the assets side, significant decreases in Kuna loans (especially to corporates) attributed to the reduction of the Kuna component to 37.7 per cent. of total assets, the share of foreign currency assets decreased to 22.8 per cent. of total assets, while the share of foreign currency indexed assets rose to 39.6 per cent. at the end of June 2009 due to growth in foreign currency indexed loans.

Capitalisation

At the end of 2008 the total capital of Croatian banks was HRK 49.9 billion, an increase of 15.6 per cent. from the end of 2007 and 59.9 per cent. from the end of 2006. The major contributor to this was the increase in share capital, which increased HRK 11.7 billion or 70.6 per cent. from 2006 to 2008. As a result, the percentage of share capital in total capital of banks increased from 53.1 per cent. at the end of 2006 to 56.7 per cent. at the end of 2008. In addition, banks retained in capital almost 80 per cent. of the profit earned in 2007. During the first half of 2009, banks' capital increased by 3.5 per cent., reaching 14.0 per cent. of total assets. Banks reported an increase in their current year pre-tax profit of 13.4 per cent.

The growth in financial assets in Croatia was 17.03 per cent. in 2006, 13.29 per cent. in 2007 and 7.43 per cent. in 2008, this represented a compounded annual growth rate of 12.59 per cent. for the three years 2006 to 2008.

Risk-Based Capital Requirements and Solvency Ratios

The capital adequacy ratio is regulated by Title V of the Credit Institutions Act. In addition, capital adequacy is regulated by the *'Decision On The Capital Adequacy Of Credit Institutions'*, the *'Decision On Own Funds Of Credit Institutions'*, the *'Decision On Reports On Own Funds and Capital Requirements Of Credit Institutions'*, and the *'Decision On The Classification Of Placements and Off Balance Sheet Liabilities Of Credit Institutions'*.

Regulatory capital (own funds) refers to the sum of capital requirements to cover the following items of risk as defined in Art. 131 of the Credit Institutions Act: 1) credit risk ; 2) counterparty risk; 3) position risk and settlement risk; 4) exceeding permitted exposure limits; 5) foreign-exchange risk and commodities risk; and 6) operational risk. In comparison, minimum statutory capital (referred to as 'initial capital'), is defined in Art.29 of the Credit Institutions Act and is currently HRK 40m for banks, HRK 8m for savings banks, and HRK 20m for housing savings banks.

At the end of 2008 the regulatory capital of Croatian banks totalled HRK 48.9 billion, an increase of 15.9 per cent. compared with the end of 2007 and 51.9 per cent. compared with the end of 2006. During the first half of 2009, banks' regulatory capital increased by 3.5 per cent.

After showing a downward trend for several years, declining from 14.6 per cent. in 2005 to 14.0 per cent. in 2006, the CNB capital adequacy ratio rose to 16.36 per cent. in 2007 and declined to 15.16 per cent in 2008. As over the previous years, the reason for this decline is to be found in faster growth of risk-weighted assets over regulatory capital which is partly a result of changes in prudential measures aimed at increasing capital requirement for currency induced credit risk. As a result, at the end of 2008, the growth rate of risk weighted assets was 28.4 per cent., while the growth rate of total bank exposures to credit and market risks was 25.1 per cent. At the end of June 2009 risk-weighted assets had declined by 0.3 per cent. compared with the end of 2008, reflecting a slowdown in banks' activities and the increased share of loans to government which have a 0 per cent. risk-weight. Exposure to market risk also decreased (by 29.3 per cent.) resulting in a decrease of the total capital requirement by 1.5 per cent. Consequently, the capital adequacy ratio increased to 15.93 per cent. at the end of June 2009.

Total assets of banks as at 31 December 2008 amounted to HRK 370.1 billion, an increase of HRK 25.0 billion, (7.2 per cent.) as compared with the end of 2007. The annual growth rate of banks' assets was lower in 2008 than in 2007 (13.3 per cent.) and at the end of 2006 (17.0 per cent.). The observed slowdown may to a large extent be attributed to the measure on the compulsory purchase of CNB bills aiming to slow down the credit growth, which was introduced in 2006. Specifically, in the first six months of 2008, the banks' assets grew at a rate of less than 1.0 per cent., while the credit growth was 5.5 per cent. due to asset restructuring. However, in the second half of 2008 the CNB measures were redesigned in the context of the global financial scene. In the second half of the 2008 total banks' assets increased by 6.5 per cent., while the credit growth was 8.1 per cent. At the end of June 2009 compared with the end of 2008 banks' asset growth rate was negative (-0.2 per cent.), while credit growth slowdown to 2.5 per cent.

The following table sets out an overview of the assets of the Croatian banks as at 31 December for the years 2005 to 2008 (in million HRK):

	Year ended 31 December				Six months ended 30 June
	2005	2006	2007	2008	2009
			(HRK millions)		
Total assets	260,277	304,605	345,081	348,209	369,434
Total placements and contingent liabilities	272,447	349,630	396,421	402,419	417,230

Source: Croatian National Bank

According to audited data, in 2008 commercial banks in Croatia made HRK 5.7 billion profit before tax, an increase by 12.4 per cent. in comparison with 2007. Seven banks made losses in 2008 and their assets represent 1.2 per cent. of total assets of all banks in Croatia. The total loss amounted to HRK 154.1 million. At the end of June 2009 banks' pre-tax profits totalled HRK 2.9 billion, representing a decrease of 14.3 per cent. compared to the first half of 2008. Ten banks reported losses totalling HRK 73.3 million. The reduction in total bank profit compared to the first half of 2008 was primarily due to an increase in provisioning costs and a decrease in net interest income.

Loan Exposure

Total loans of banks in 2008 amounted to HRK 246.6 billion (an increase of 14.0 per cent. as compared to 2007) and 49.8 per cent. of the loans were retail loans, while 38.2 per cent. were corporate loans. At the end of June 2009 the total (net) amount of loans was HRK 252.9 billion, representing an increase of 2.5 per cent. compared with the end of 2008. Loans to enterprises increased by only 0.3 per cent., and the proportion of total loans represented by loans to enterprises reduced to 37.3 per cent. The total amount of loans to households reduced by 2.7 per cent. compared to the position as at the end of 2008, and the proportion of total loans represented by loans to households reduced to 47.2 per cent. The largest change in bank loan portfolio at the end of the first six months of 2009 relative to the end of 2008 was the increase of loans to government units, which increased by 48.9 per cent., thereby continuing the upward trend which began in 2008 following the participation of the banks in external and domestic public debt refinancing.

During 2008 the percentage of non-performing loans started to increase for the first time since late 1990's, with the average overall percentage of non-performing loans increasing from below 5 per cent. during 2008 to its current level of approximately 6 per cent.

The table below shows the percentage of loans that were non-performing for the periods indicated:

	Year ended 31 December						Six months ended 30 June
	1998	2000	2002	2004	2006	2008	2009
				(per cent.)			
Non-performing loans	9.3	9.5	5.9	4.6	3.2	3.2	6.0

Source: Croatian National Bank

This trend was spread through all sectors, however, the contribution of the corporate sector was greatest. Historically the household sector has demonstrated lower levels of non-performing loans.

Real estate prices started to decline in 2008 and the trend has continued in 2009, as a result of an increase in the interest rates on real estate loans; a sharp decline in the volume of newly approved loans; and a decline in real household income. This decline was still modest in 2009, reaching about 5 per cent. in the first half of 2009 compared to the peak reached in 2008. As banks have been conservative in their lending policies, resulting in relatively low loan to value ratios, this decline is not expected to have a significant impact on the quality of their collateral. In addition, housing loans were predominantly granted to persons purchasing property for use as their domestic residence rather than as a speculative investment. As a result, a small, and relatively stable, portion of housing loans (currently approximately 2.5 per cent.) are currently non-performing.

Total expenses on loss provisions rose from HRK 241 million at the end of June 2008 to HRK 1,158 million at the end of June 2009 due to a rise in expenses on value adjustments and provisions for identified losses on an individual basis, which was linked to the decline in quality of total placements and contingent liabilities (so called bad loans).

Loans to households reached HRK 122.7 billion at the end of 2008, an increase of HRK 13.2 billion (12.0 per cent.) compared to the end of 2007. Accounting for less than half of that increase, home loans grew by 15.8 per cent. while their share in total net loans extended to households and total net loans of banks stood at 42.3 per cent. and 21.1 per cent. respectively. All other loans extended to households grew by 9.5 per cent. Net loans to households reached HRK 119.4 billion at the end of June 2009, a decrease of HRK 3.3 billion (2.7 per cent.) compared to the end of 2008. In contrast to previous years during which bank credit activity was oriented towards the household sector, the growth of loans to households slowed down significantly in 2008 and 2009 reflecting turbulence in the macroeconomic environment and weaker demand. At the end of June 2009 all types of loans to households had reduced relative to the end of 2008. Home loans decreased by 0.7 per cent., while their share of the total net loans to households and the total net loans slightly declined to 43.2 per cent. and 20.4 per cent. respectively. Almost half of the reduction in loans to households was a result of the decline in general purpose loans (by 2.9 per cent.), however, the proportion of general purpose loans within loans to households loans remained the same (43.0 per cent.).

In comparison with a growth rate of 6.3 per cent. in 2008 and 14.9 per cent. in 2007, at the end of June 2009 deposits with banks grew by only 0.1 per cent. relative to the end of 2008. This reduction in the rate of growth of deposits was mainly the result of a 16.0 per cent. decrease in the amount of deposits by enterprises. The share of deposits in total bank liabilities remained stable from 2006 to 2008 reaching a total of 67.1 per cent. as at the end of June 2009.

At the end of June 2009, total deposits amounted to HRK 248.0 billion, with significant decrease in giro account and current account deposits of HRK 7.9 billion (19.1 per cent.) compared with the end of 2008. Time deposits increased by HRK 9.2 billion (5.1 per cent.) in the same period. Non-resident deposits increased by HRK 5.2 billion (14.1 per cent.), as a result of increase in foreign shareholders' deposits (16.8 per cent.) and financial institutions' deposits (18.8 per cent.) in the same period. Households deposits grew by 0.4 per cent. compared to the end of 2008. Kuna deposits decreased by HRK 10.4 billion (10.4 per cent.), mainly as a result of decrease in giro account and current account Kuna deposits. Foreign exchange deposits increased by HRK 11.9 billion (8.4 per cent.) while currency linked deposits decreased by HRK 1.2 billion (17.7 per cent.).

At the end of June 2009, 61.6 per cent. of total deposits were denominated in a foreign currency, 36.1 per cent. in Kuna, and only 2.3 per cent. were currency linked deposits. Total deposits consisted of 55.0 per cent. household deposits, 16.7 per cent. corporate deposits, with 17.2 per cent. belonging to non-residents and 11.1 per cent. to State, financial and non-profit institutions.

The 2.5 per cent. increase in total banks' loans in the first half of 2009 was mostly due to an increase in loans to government, which rose by approximately HRK 10.5 billion.

The receivables of banks from the central government amount to HRK 47.5 billion, and after the first quarter of 2009, which is an increase of 21.7 per cent. compared to the end of 2008. This amount consists of HRK 32.0 billion credits and HRK 15.5 billion Ministry of Finance treasury bills and Government securities. The deposits of central government with commercial banks slightly decreased from HRK 6.0 billion at the end of 2008, to HRK 5.6 billion at the end of June 2009.

HBOR funds are not subject to the mentioned decision, and are not taken into account when calculating the permitted increase in placements, thus raising the demand of commercial banks for HBOR loans.

The Croatian Registry of Loan Obligations (Hrvatski registar obveza po kreditima d.o.o., "**HROK**"), a company for business services that are customary in countries with developed financial markets, started its operations at the beginning of May 2007. HROK was formed to maintain a complete registry of loans made in Croatia. It was established by 20 banks in Croatia representing over 97 per cent. of the credit market in Croatia, and the accession of other banks is also expected.

The complete registry of loans is a system for collection, processing and exchange of information on all loan obligations of customers and due fulfilment of these obligations.

The exclusive users of HROK's services are banks and savings banks. There is also a plan to include credit card companies and leasing companies into HROK, since they can give a more complete insight into the debt of consumers.

Impact of recent events in the financial markets

Under the impact of limitations placed on lending, increases in marginal reserve requirements on foreign liabilities and higher weights on currency-induced credit risk, Croatian banks have started to replace foreign borrowing with raising new capital and attracting more domestic Kuna deposits. In addition to capital strengthening and restructuring of liabilities, most Croatian banks have remained profitable which makes the banking sector more resilient to shocks.

Although Croatian banks are not directly exposed to the ongoing global financial and economic crisis, they are partially dependent on funding from foreign parent banks that are themselves exposed to risks arising from the current turmoil. The global economic turmoil did not cause a deceleration in the inflow of capital from parent banks to the domestic banking system. In the last quarter of 2008 and the beginning of 2009, foreign parent banks provided substantial funds to their Croatian subsidiaries (approximately EUR 2.2 billion in total), which contributed to the stability of the domestic banking system. Furthermore, in the subsequent period domestic banks' liabilities towards their foreign owners stabilized at those levels reached at the beginning of the year and so far they have not declined.

Foreign Currency Liquidity

In an economy such as Croatia which has a high volume of euros in circulation, the issue of foreign currency liquidity of both banks and the entire economy is particularly sensitive. The foreign currency liquidity management of banks is regulated by determining the minimum amount of foreign currency assets required to be held. Banks meet this requirement by using transactions with non-residents, which implies that slower or interrupted capital inflows from abroad would cause difficulties in the maintenance of foreign currency liquidity of Croatian banks. Foreign currency liquidity indicators have deteriorated from the previously very high levels as a consequence of the turbulences in financial markets in the last quarter of 2008. The ratio of foreign liquid assets to foreign short-term liabilities fell from 81.3 per cent. at the end of 2007 to 64.4 per cent. at the end of 2008 and to 52.7 per cent. at the end of June of 2009, while the ratio of foreign liquid assets to total foreign assets declined from 73.7 per cent. at the end of 2007 to 69.6 per cent. at the end of 2008 and to 68.4 per cent. at the end of June 2009. This was partly the result of a change in regulation which allowed banks to decrease their net foreign assets (see further "*Monetary Policy and Instruments*" above), as well as due to a sharp rise in liabilities (more precisely in non-resident deposits and loans during the last quarter of 2008 and beginning of 2009) primarily directed from parent banks to their Croatian subsidiaries in order to maintain their liquidity (which was under pressure due to some deposit withdrawals in early October 2008).

Banking sector liquidity, measured as the ratio of total liquid assets to total assets, was stable from 2006 to 2008, standing at 11.7 per cent. at the end of 2008. However the ratio decreased to 9.6 per cent. by the end of July 2009 due to a change in regulation that allowed banks to sell foreign assets. The ratio of total liquid assets to total short-term liabilities increased slightly to 51.9 per cent. from 49.3 per cent. at the end of 2007. At the end of June 2009 the ratio was 48.2 per cent.

Considering its major implications for the entire economy, the CNB policy of maintaining adequate international reserves, with international reserves currently running at a satisfactory level also ensures external liquidity of the economy. Also, the substitution of foreign borrowing by new equity, which has been triggered by macroprudential measures of the CNB, has enhanced banking sector resilience to foreign currency liquidity risk.

Due to current market conditions and the global financial and economic crisis, the restrictions on the marginal reserve requirement were removed as of 10 October 2008 (by a decision of the Council of the CNB). By this measure, the CNB released to commercial banks for their disposal approximately EUR 355 million and USD129 million in order to help provide additional foreign exchange liquidity and increase banks' ability to fulfil their obligations towards all clients. (See also "*Monetary Policy and Instruments' above for details of further liquidity measures*")

Bank Regulation and Prudential Standards

The Credit Institutions Act entered into force on 1 January 2009. It introduces the term credit institution, which is defined as a legal person whose core activity is to receive deposits and other repayable funds from the public and to grant credits for its own account or to issue means of payment in the form of electronic money. A credit institution may be established as a bank, savings bank, housing savings bank or an electronic money institution. A bank must follow the principles of liquidity and solvency, and as of 1 July 2009 the minimum rate of capital adequacy must be at least 12 per cent. Regulatory capital (own funds) refers to the sum of capital requirements to cover the following items of risk as defined in Art. 131 of the Credit Institutions Act: 1) credit risk; 2) counterparty risk; 3) position risk and settlement risk; 4) exceeding permitted exposure limits; 5) foreign-exchange risk and commodities risk; and 6) operational risk.

According to Croatian law both direct and indirect acquisition of a bank's shares must be approved by the CNB beforehand, if 10 per cent. or more (a qualifying holding), 20 per cent. or more, 30 per cent. or more, 50 per cent. or more shares are acquired.

A foreign bank can offer banking and other financial services in the territory of Croatia only through a branch established on the basis of a licence from the CNB. As a condition to the granting of a licence, the CNB may also require that the foreign bank deposits a certain amount of money in Croatia or provide some other corresponding security for the settlement of liabilities arising from business operations in Croatia.

The Credit Institutions Act contains certain provisions that will become effective as of the date when Croatia becomes a member of the EU and which are linked to the single passport regulations within the provision and supervision of financial services in the EU.

Deposit Insurance

The State Agency for Deposit Insurance and Bank Rehabilitation has been established as a specialised financial institution for deposit insurance of banks and saving banks and for implementation of bank rehabilitation procedures in insolvency. The Government founded the Agency, which guarantees the commitments and liabilities of the Agency. The assets for the operation of the Agency comprise insurance premiums paid to the Agency by banks and saving banks for the purpose of savings deposit insurance and revenues earned by the Agency through its operation. Deposits (in HRK or foreign currency) are insured up to HRK 400,000. Prior to obtaining authorization to provide services, credit institutions must join the deposit insurance scheme run by the State Agency for Deposit Insurance and Bank Rehabilitation. Banks are required to pay a levy of 0.3 per cent. of their initial capital at the start, and are required to pay quarterly premiums of 0.125 per cent. of their insured deposit base at the end of each financial quarter in which they conduct business.

Rehabilitation Programme and Privatisation of Banks

The legislative structure for the rehabilitation programme was previously set out in the Act on Bank Rehabilitation and Restructuring which came into force on 11 June 1994 and was revoked in 2000 after the Government privatised most of the restructured banks. The rehabilitation of insolvent banks was implemented by the transfer of bad bank credits to a special agency, recapitalisation, replacing shareholders and replacing bank management.

In order to revitalise the banking sector and to support economic growth, the Government has rehabilitated six banks: Slavonska banka, Privredna banka Zagreb Riječka banka, Dubrovačka banka, Splitska Banka and Croatia banka.

The State still maintains a significant share in HPB — Hrvatska poštanska banka (Croatian Postal Bank) and Croatia banka (i.e, these two banks remain state-owned).

Money Market

The last quarter of 2008 and first quarter of 2009 were characterised by instability in the money and foreign exchange markets. A decrease in foreign capital inflows in the last quarter of 2008 resulted in strong depreciation pressures on the domestic currency. In addition, withdrawal of deposits from banks in the first half of October 2008 prompted banks to convert assets into more liquid forms which boosted demand for foreign exchange. To address the increased demand for liquidity, the CNB abolished the marginal reserve requirement which previously was 55 per cent., thus releasing approximately EUR 355 million and USD129 million into the banking system. Continuing downward pressures on the Kuna in late October prompted the CNB to undertake a foreign exchange intervention in which HRK 2.0 billion was purchased from the banks. However, Kuna liquidity was created cautiously by way of reverse repo auctions. Although the largest ever amounts of the funds demanded and funds placed by repo auctions and Lombard loans were recorded in 2008. This policy helped maintain a stable exchange rate but resulted in increased tension on the money market. Reduction of the reserve requirement rate in early December from 17 per cent. to 14 per cent. temporarily eased the pressures on the money market and sharply reduced money market interest rates. The weighted average interest rates for overnight loans in direct interbank trading fell from 16.10 per cent. in November to 5.77 per cent. in December of 2008.

Depreciation pressures on the Kuna resumed in January 2009, prompting the CNB to increase the calculated foreign currency component of reserve requirements that is set aside in Kuna from 50 per cent. to 75 per cent. and intervene in the foreign exchange market on two occasions (23 January and 18 February) in order to stabilise the exchange rate withdrawing a total of HRK 3.8 billion. This also contributed to a rapid rise in money market interest rates and an increase in their volatility from mid-January 2009. In addition to these measures, during February 2009 the CNB also conducted a two-step decrease of the minimum required amount of foreign currency claims of a bank's total foreign liabilities from 28.5 per cent. to 25.0 per cent. and then further to 20.0 per cent. which released EUR 2.1 billion that were previously set aside as part of banks' liquid foreign assets. The policy actions conducted from October 2008 improved foreign currency liquidity of the banking system, releasing funds worth EUR 3.8 billion.

As depreciation pressures on the Kuna started to subside in February, in subsequent intervention on 27 February 2009, the CNB purchased Euros, creating HRK 2.46 billion and easing money market pressures. As a result, money market rates decreased considerably and liquidity of the system remained sufficient. The increase in the level and volatility of money market interest rates that began in the last quarter of 2008 decelerated in March 2009. The weighted interest rate on overnight loans in direct interbank trading in reserve money decreased from a record high of 18.97 per cent. in February to an average of 13.67 per cent. in March. On quarterly level interest rates decreased from an average of 13.86 per cent. in the first quarter of 2009 to 5.87 per cent. in the second quarter. As the tourist season intensified and the share of domestic currency held outside banks increased, interest rates rose to 7.41 per cent. in July. As the CNB created additional Kuna liquidity by increasing placements though repo auction and Lombard loans, money market rates decreased to 6.47 per cent. in August.

Money market turnover increased between January and August 2009 compared to the same period in 2008 as a result of restrictive money creation, especially in the first quarter. Banks met their primary liquidity needs on the money market in the average daily amount of HRK 2.8 billion, compared to HRK 2.6 billion in the same period in 2008. In the first eight months of 2009, total turnover amounted to HRK 460.3 billion, compared to HRK 394.9 billion in the same period of 2008.

In the first eight months of 2009, the largest share of total loans placed on the money market was, as in the past, attributable to loans in demand deposit trading (HRK 409.1 billion or 77.98 per cent.), and banks additionally raised HRK 51.2 billion by purchasing repo agreements. The remaining HRK 64.3 billion was raised through the sale of securities. Within the structure of demand deposit trading, the share of interbank trading, traditionally the largest category, declined to 35.5 per cent. in the first eight months of 2009 from 41.8 per cent in the same period in 2008. Share of demand deposit trading with other legal persons declined to 22.8 per cent. from 26.4 per cent. in the same respective periods. Conversely, the share of demand deposit trading with non-banking financial institutions increased to 41.7 per cent. from 29.4 per cent.

Within interbank trading in demand deposits, direct interbank trading remained dominant, totalling HRK 131.5 billion in the first eight months of 2009, while bank trading with Zagreb Money Market ("**ZMM**") intermediation was HRK 13.6 billion. Overnight loans continued to be the most liquid instrument in direct interbank trading in reserve money, accounting for HRK 69.7 billion in the first eight months of 2009. The average daily turnover in overnight loans was HRK 796.9 million in the same period. The average daily turnover in loans intermediated by the ZMM was HRK 82.2 million in the first eight months of 2009.

The Government raised substantial short-term domestic funding in order to cover the consolidated government deficit and to refinance maturing T-bills. In the first eight months of 2009, the Ministry of Finance raised a total of HRK 9.6 billion at 23 T-bill auctions, of which HRK 5.2 billion were EUR-linked and HRK 4.4 billion Kuna denominated T-bills. EUR-linked T-bills are denominated in EUR but settled in Kuna at the official CNB rate. Interest rates at auctions of T-bills were close to the record levels seen at the end of 2008 and remained flat during the first eight months of 2009. The weighted interest rate on one-year Kuna T-bills hit a record high of 7.95 per cent. in December 2008 and has slightly decreased since then to 7.8 per cent. in August 2009. The 91-day T-bills and 182-day T-bills denominated in Kuna have not been issued since June 2009, when their interest rates were 7.6 and 7.7 per cent., respectively. EUR-linked T-bills were issued only with one-year maturity and weighted interest rates on these bills fell from 7.95 per cent. in December 2008 to 7.67 per cent. in August 2009.

Total stock of subscribed T-bills grew in the first eight months of 2009 but at a much slower pace than in 2008, increasing from HRK 17.4 billion at the end of 2008 to HRK 18.8 billion at the end of August 2009. The share of Euro denominated T-bills increased from 12.5 per cent. to 38.8 per cent. in the same period.

Slowing economic activity, expected to result in further increase in non-performing loans and adversely affect banking sector's profitability, as well as rising funding costs, prompted banks to raise interest rates. In the first seven months of 2009, interest rates on loans, in particular on corporate and household loans, continued their upward trend observed in 2008. Interest rates on both short-term Kuna denominated and long-term loans with currency clause increased. Between December 2008 and July 2009, weighted interest rates on Kuna denominated short-term corporate loans increased from 8.98 per cent. to 10.58 per cent., while weighted interest rates on long term corporate loans with currency clause rose from 6.92 per cent. to 7.34 per cent. In the same period, weighted interest rates on short-term Kuna denominated household loans rose from 12.33 per cent. to 12.60 per cent. and weighted interest rates on long-term household loans with currency clause increased from 7.89 per cent. to 8.56 per cent. Except for interest rates on short-term Kuna denominated corporate loans that were more volatile than in 2008, movements of other interest rates remained within their usual short-term volatility bands.

The end of 2008 and beginning of 2009 were characterised by high levels and significant volatility of weighted interest rates on Kuna time deposits. Subsequently, their volatility declined and interest rates stabilised, although at a higher level than in most of 2008. The increase in, and volatility of, the weighted interest rates on time deposits were principally due to short-term corporate time deposits reflecting the developments on interbank money market. Weighted interest rates on time deposits rose from 5.65 per cent. in December 2008 to 6.83 per cent. in July 2009. Weighted interest rates on foreign currency time deposits declined from 4.14 per cent. to 3.95 per cent. during the same period. Within the structure of interest rates on these deposits, the decline in corporate rates outpaced the decline in household rates. Interest rates on sight deposits were relatively stable, increasing only marginally from 3.97 per cent. in December 2008 to 4.03 per cent. in July 2009.

Spreads between lending and deposit rates widened, compared to the beginning of 2009. Between December 2008 and July 2009, the spread between the weighted interest rate on total loans and the weighted interest rate on total deposits rose from 6.42 per cent. to 6.98 per cent., while the spread between the weighted interest rate on Kuna loans without a currency clause and the weighted interest rate on Kuna deposits without a currency clause increased from 7.79 per cent. to 8.54 per cent. in the same period. The spread between the weighted interest rate on Kuna loans with a currency clause and the weighted interest rate on foreign currency deposits increased from 3.76 per cent. to 4.03 per cent. in the same period.

Capital Markets

In 2007 the Varaždin Stock Exchange merged with the Zagreb Stock Exchange ("**ZSE**"), and the ZSE is currently the only stock exchange in Croatia. There are two types of participants envisaged in the ZSE system: brokers and specialists. The system for specialists has not yet been implemented although some preparations have started. Once implemented the role of specialists will be to maintain market liquidity of specific shares within boundaries set by the ZSE defining the maximum spread and minimum quoted volume. There are currently 44 brokerages with 211 licensed brokers whose role is to execute client orders.

The following table sets forth the break-down of total trading volume for the periods indicated:

				Variation of First half of 2009	
	First half of 2008	Second half of 2008	First half of 2009	from Second half of 2008	from First half of 2008
Regular volume	116,994,886	273,111,381	69,239,406	(74.6)	(40.8)
of which Stocks	16,317,483	18,045,468	17,821,350	(1.2)	9.2
of which Bonds	84,093,954	237,764,460	28,734,342	(87.9)	(65.8)
of which Rights	16,583,449	193,453	16,829,994	8599.8	1.5
of which Commercial Paper	NA	17,108,000	5,853,720	(65.8)	N/A
Block volume(1)	849,437	845,306	0	(100.0)	(100.0)
Reported volume(2)	257,127,500	197,512,800	79,000,000	(60.0)	(69.3)
Institutional volume(3)	3,852,275,488	2,203,313,523	891,667,071	(59.5)	(76.9)
Total number of trades	383,845	374,319	278,677	(25.6)	(27.4)
Number of securities traded	336	295	289	(2.0)	(14.0)
Number of trading days	123	126	120	(4.8)	(2.4)
Daily average volume	34,367,864	21,228,437	8,665,887	(59.2)	(74.8)

Source: Zagreb Stock Exchange

(1) Block trades are negotiated deals that are done outside regular order book and daily price limits.

(2) Reported trades are trades with bonds in amount greater that HRK 3.0 million.

(3) Institutional trades are trades reported by institutional investors.

There was only one stock issue in 2009, which was a recapitalization of an already listed company and there were no new corporate or bond listings on ZSE. At the end of 2008 there were 21 commercial paper issues by 17 issuers, at the end of August 2009, there were six commercial paper issues listed at the ZSE by six issuers.

Regulation of Non-Banking Sector

The Croatian Financial Supervisory Authority Act (Official Gazette No. 140/2005) envisaged the establishment of a single body responsible for the supervision of the non-banking financial sector. The Act combined the existing supervisory authorities in the non-banking financial sector into a single supervisory authority responsible for the non-banking financial sector, the Croatian Agency for Supervision of Financial Services ("**CASFS**"). CASFS became operative as of 1 January 2006 and its responsibilities include supervision of:

- stock exchanges and regulated public markets, authorised companies and securities issuers;
- investment, privatisation investment and pension fund management companies, investment funds, privatisation investment funds, pension funds, the Fund of the Croatian Homeland War Veterans and Their Family Members and the Pensioners' Fund;
- brokerage companies, brokers and investment consultants;
- institutional investors;
- the Central Depository and Clearing Company;
- the Central Registry of Insured Persons;
- insurance companies, pension insurance companies, insurance agents and brokers; and
- legal persons dealing with leasing and factoring, unless such activities are conducted by banks in the framework of their registered activity, in to the Act on CASFS and other relevant legislation.

The establishment of a single authority for the supervision of financial institutions in the non-banking financial sector has contributed, within the framework of its regulatory and supervisory responsibilities, to stability of the financial system. With the establishment of an institution for consolidated supervision of the non-banking financial sector, the preconditions for the adoption of a single financial services act were met.

The Croatian Parliament promulgated the new Capital Market Act (Official Gazette No. 88/08, 146/08 and 74/09) on 18 July 2008 which entered into force on 1 January 2009. The new Act incorporates all relevant regulations of the *acquis communautaire*.

After the Capital Market Act comes into force, the Securities Market Act (Official Gazette Nos. 84/02 and 138/06) shall cease to have effect and the Agency ("**HANFA**") will adopt regulations pursuant to the Capital Market Act in the three month period after the Act comes into force. Until the adoption of the regulations in accordance with the Capital Market Act, regulations adopted pursuant to the Securities Market Act shall continue to apply accordingly insofar as they are not contrary to the Capital Market Act. Some articles of the Capital Market Act will not come into force until 1 January 2010. In addition, some provisions of the Act will come into force or, as the case may be, will cease to be in effect after the accession of Croatia to the EU.

In the first five months of 2009, developments on domestic capital markets closely followed those in more mature capital markets worldwide, namely, continuation of the declines witnessed in 2008 in January and February 2009, followed by a recovery in March. The initial CROBEX recovery was less pronounced than in more mature markets, however, in May the year-to-date growth significantly outpaced that in more mature markets which was followed by a relatively strong decline that lasted until early July and was more pronounced than in other European emerging markets due to a relatively small market and as a result of investor over reaction to good news with respect to the world economy in May 2009. At the end of August 2009, CROBEX recorded an increase of 13.4 per cent. compared to the beginning of the year. However, as a result of declining prices of less traded shares and their diminished liquidity (less liquid shares have lower weight in calculating market capitalisation in Croatia), total market capitalisation of shares listed on ZSE decreased from HRK 142.1 billion at the end of 2008 to HRK 138.4 billion at the end of August 2009. At the end of August 2009, total market capitalisation of shares listed on the ZSE was 40.6 per cent. of GDP, compared to 41.5 per cent. at the end of 2008. Equity trading on the ZSE is organised into three market segments: prime market, official market and regular market. The ZSE also operates a multilateral trade platform.

Increased risk aversion by domestic and international investors, concerns about the state of economy and low liquidity of the market are some of the challenges facing the domestic bond market. In the first eight months of 2009, the ZSE bond index, CROBIS, fell by 4.2 per cent. Total bond turnover on the ZSE in the first half of 2009 was

HRK 2.0 billion, a 74.9 per cent. decrease from the first half of 2008. Total market capitalisation of bonds listed on ZSE decreased from HRK 33.4 billion at the end of 2008 to HRK 35.0 billion at the end of August 2009 and represented 9.8 per cent. of GDP, compared to 10.2 per cent. at the end of 2008, as a result of declining bond prices and a lack of new issues.

Thirty five bonds were listed on the domestic capital market as at the end of 2008. In the first eight months of 2009, one corporate bond matured and three bonds were delisted subsequent to ZSE reorganisation. Therefore, at the end of August 2009, a total of 31 bonds were listed on the domestic capital market comprised of eight Government bonds, one State agency (HBOR) bond, eight municipal bonds and 14 corporate bonds. As at the end of August, there were no new Government or corporate bond issues on domestic market in 2009 yet. At the end of August 2009, there were six commercial paper issues listed on the ZSE with a total nominal value of HRK 244.5 million issued by six issuers, as compared to 21 issues with a total nominal value of 1,196.45 million issued by 17 issuers as at the end of 2008.

Yield spread between Croatian Eurobonds and benchmark bonds as measured by JPMorgan EMBI Index decreased from 501 basis points at the end of December 2008 to 301 basis points at the end of August 2009. The trend of the fluctuations of the spread on Croatian Eurobonds broadly followed other European emerging markets Eurobonds reflecting an increased risk aversion by investors. More stable market environment allowed the issue of a EUR 750 million Eurobond in June 2009 that matures January 2015 and has a coupon rate of 6.5 per cent.

Five Croatian bonds were listed on foreign markets as at the end of August 2009, four of which were Euro denominated and one bond was denominated in US dollars. In the first eight months of 2009, two bonds listed on foreign markets matured, one denominated in Euro and one in Yen. Total outstanding nominal value of Croatian bonds listed on foreign markets was approximately EUR 2.4 billion at the end of August 2009.

In October 2008, HANFA decided to establish an intervention fund (the "**Fund**") that will compensate investors in the event that individual investment funds are unable to sell their financial assets and repay their investors. The duration of the Fund is five years. Initial investors in the Fund are four companies involved in the management of four mandatory pension funds (AZ mirovinsko društvo, ROMF, PBZ-CO mirovinsko društvo and Erste Plavi) and four companies involved the management of four open investment funds (ZB Invest, PBZ Invest, RBA Invest and Erste Invest). The Fund may be approached on a voluntary basis by fund management companies experiencing difficulties with the sale of a part or all of their assets and confronted with repayment requests from their stakeholders. A precondition for the purchase of assets by the Fund is that the company managing the requesting fund initiates liquidation proceedings, namely, the process of closing the fund, within a reasonable time. An initial payment of HRK 50 million was contributed by the initial investors after the establishment of the Fund, which will be increased if needed.

PUBLIC FINANCE

Consolidated General Government Results for 2008

Revenue

In 2008, the total revenue of the consolidated general government amounted to HRK 134.7 billion, which was HRK 2.1 billion (1.5 per cent.) less than the revenue budgeted for 2008, and HRK 8 billion more than the revenue for 2007.

In respect of revenue of the consolidated general government in 2008: the largest portion of revenue related to budgetary central government representing 85.9 per cent.; then extra-budgetary users represented 3.1 per cent.; and local government represented 10.9 per cent. Since January 2007, all transactions of the social security funds (the Croatian Institute for Pension Insurance, the Croatian Health Insurance Institute and the Croatian Employment Service) have been included within budgetary central government. Following the supplementary budget in 2008, the sector classification of institutional units was brought into line with the ESA 95 methodology, as a result of the Croatian Motorways Ltd. is classified into the sub-sector of public non-financial corporations rather than general government sector.

Tax revenues represented the most important revenue-generating category comprising 59.1 per cent. of the consolidated general government revenue in 2008. Compared with 2007, tax revenues increased by 8.6 per cent. in 2008 but remained HRK 1.4 billion or 1.7 per cent. below the budgeted amount for 2008.

The largest part of tax revenue is generated through value added tax ("**VAT**"). In 2008, revenues from VAT, collected in their entirety by budgetary central government, amounted to HRK 41.3 billion, representing an increase of 9.4 per cent. compared with 2007 but 3.4 per cent. below the budgeted amount for 2008.

Revenues from excise taxes amounted to HRK 11.9 billion in 2008, which represented a decrease of 2.4 per cent. compared with 2007 and 4.3 per cent. below the budgeted amount for 2008.

The highest annual growth rates in 2008 were recorded by the excise duty on luxury products (8.9 per cent.), tobacco products (4.8 per cent.) and coffee (3.1 per cent.).

Revenues from excise duty on oil derivates have the largest share (51.1 per cent. in 2008) within the total revenues of excise duty and amounted to HRK 6.1 billion for the twelve months ended 31 December 2008. The figure for 2008 represented a decrease of 6.5 per cent. compared with 2007 and is approximately 7.1 per cent. below the budget for 2008. Revenues from excise duty on tobacco and tobacco products represented the second largest share in total revenues of excise duty being HRK 3.08 billion (26.0 per cent.) in 2008 (1.8 per cent. above the budget).

Income tax revenues payable by individuals amounted to HRK 10.8 billion in 2008, which is an increase of 8.3 per cent. compared to 2007 and is 0.1 per cent. higher than budgeted for 2008. As of January 2007, income tax revenue payable by individuals became entirely the revenue of the local government while profit tax (corporate income tax) became entirely the revenue of the budgetary central government. The change in these formerly shared taxes were enacted through the amendments to the Act on the Financing of Units of Local and Regional Self-Government where a part of income tax revenue is still being collected within the budgetary central government for the purpose of equalization and then transferred to local government units. Amendments to the Act on the Financing of Units of Local and Regional Self-Government provide a more even and equitable distribution of tax revenues in all areas of Croatia (especially areas of special State concern) and also for a higher liquidity of the overall system of the financing of local government. The proportion of income tax revenue relating to local government was 84.3 per cent. in 2008 with the remaining 15.7 per cent. relating to budgetary central government.

Revenues from profit tax were HRK 10.6 billion for 2008, representing an increase of 19.7 per cent. in comparison with 2007 and 5.4 per cent. higher than budgeted for in 2008. This can be explained by the rise of industrial production and by business results generally in 2008. With amendments to the Act on the Financing of Units of Local and Regional Self-Government, the revenues from profit tax became entirely for the account of budgetary central government.

The revenue from taxes on property amounted to HRK 1.2 billion, representing an increase of 6.6 per cent. compared with 2007 but 4.8 per cent. below the 2008 budget. Approximately half of the total revenues from taxes on property were realised at the budgetary central government level and the other half at the local government level.

Revenue from taxes on international trade and transactions are all collected at the budgetary central government level. They amounted to HRK 1.9 billion in 2008, representing an annual increase of 15.8 per cent. compared to 2007 and exceeding the budget for 2008 by 4.5 per cent.

Other tax revenue amounted to HRK 316.2 million in 2008, which represented a decrease of 7.5 per cent. compared with 2007 figures.

The revenue from social contributions, which are the second most important revenue category of consolidated general government, amounted to 30.2 per cent. of 2008 revenue, and amounted to HRK 40.7 billion which represents an increase of 9.4 per cent. compared with 2007. Within the structure of social contributions, the largest part (HRK 21.8 billion) refers to employer contributions (which have increased by 9.6 per cent. compared with 2007). HRK 18.1 billion refers to employee contributions (which has increased by 9.5 per cent. compared with 2007), and the remaining HRK 845.0 million refers to contributions made by the self employed and unemployed.

Grants received during 2008 amounted to HRK 498.5 million, 91.3 per cent. of which were grants from international organisations and 6.8 per cent. were grants from foreign governments.

Other revenue was realised in the amount of HRK 13.9 billion in 2008. The largest part consisted of sales of goods and services (54.7 per cent.), followed by property income (22.2 per cent.), miscellaneous and unidentified revenues (18.4 per cent.) and the remainder of the amount related to fines, penalties and forfeits and voluntary transfers other than grants. The sales of goods and services amounted to HRK 7.6 billion, 97.2 per cent. of which related to administrative fees. Out of the total revenues from administrative fees, 42.4 per cent. related to extra-budgetary users, 40.3 per cent. related to local government and 17.3 per cent. to budgetary central government. Property income amounted to HRK 3.1 billion, which consists mainly of rents (HRK 1.6 billion), and to withdrawals from income of quasi-corporations (HRK 910.6 million). Miscellaneous and unidentified revenues amounted to HRK 2.5 billion, fines, penalties and forfeits amounted to HRK 499.3 million, while voluntary transfers other than grants amounted to HRK 145.9 million.

Expense

In 2008, the total expenses of consolidated general government amounted to HRK 130.3 billion, which was HRK 1.2 billion (0.9 per cent.) below the budgeted amount but HRK 11.5 billion (9.7 per cent.) higher than in 2007. Out of the total expenditure of consolidated general government, HRK 111.3 billion related to budgetary central government, HRK 5.3 billion related to extra-budgetary users and HRK 13.7 billion related to local government. The largest share of the total expenses of consolidated general government in 2008 (40.9 per cent.) referred to social benefits, followed by compensation of employees (25.8 per cent.), use of goods and services (12.7 per cent.), other expenditure (8.7 per cent.), subsidies (6.2 per cent.), interest (3.9 per cent.) and grants made (1.8 per cent.).

Social benefits amounted to HRK 53.3 billion in 2008 (an increase of 9.3 per cent. compared to 2007). Within the structure of social benefits, 70.6 per cent. related to social security benefits, 28.9 per cent. related to social assistance benefits, while the remaining 0.5 per cent. related to employer social benefits. In 2008 the expense for social benefits mostly related to the following categories: pensions, health care, maternity leave allowances, child allowance and unemployment. Expense for pensions was HRK 32.8 billion (an increase of 9.7 per cent. compared to 2007), out of which HRK 14.3 billion related to expense for old age pensions, HRK 4.9 billion to pensions for disabled persons, HRK 4.8 billion to veterans' pensions and HRK 3.7 billion related to family pensions. Expense for the healthcare system amounted to HRK 12.8 billion, child allowance totalled HRK 1.9 billion, additional maternity leave totalled HRK 899.5 million and unemployment benefits HRK 814.7 million.

Compensation of government employees totalled HRK 33.6 billion in 2008, approximately as budgeted, of which wages and salaries amounted to HRK 28.6 billion and social contributions to HRK 5.0 billion.

Government expenses for the use of goods and services in 2008 amounted to HRK 16.5 billion and was 4.4 per cent. below the budget but recorded an increase of 8.9 per cent. compared to 2007.

Expenses for subsidies totalled HRK 8.1 billion in 2008, (6.6 per cent. below budget). Subsidies to public corporations comprise half of the total subsidies and their largest part refers to subsidies to Croatian Railways in the amount of HRK 1.7 billion, while subsidies to private enterprises made up the other half of total subsidies.

Expense for interest payments amounted to HRK 5.0 billion, of which HRK 3.4 billion related to interest payments to residents, and HRK 1.6 billion to interest to non-residents.

Expense for grants amounted to HRK 2.3 billion, 67.0 per cent. (HRK 1.5 billion) of which related to capital grants to other general government units, 25.0 per cent. (HRK 575.4 million) referred to current grants to other general government units, 3.9 per cent. to grants to foreign governments and the remaining 4.2 per cent. referred to grants to international organisations.

Other expenses amounted to HRK 11.3 billion, corresponding to 98.8 per cent. of the budgeted amount for 2008.

Net acquisition of non-financial assets

In 2008 total net acquisition of non-financial assets amounted to HRK 7.3 billion (comprising total acquisitions of HRK 8.8 billion and total disposals of HRK 1.5 billion), which was HRK 1.9 billion less than budgeted for in 2008.

Net lending/borrowing in 2008

The planned net lending / borrowing for 2008 stood at -1.2 per cent. for the consolidated general government while the final data for 2008 shows net lending / borrowing outturn at the level of -1.1 per cent. of GDP according to the ESA 95 methodology.

Adjustments to the 2008 Budget

The original budget of 2008 was adjusted in a supplementary budget in June 2008 pursuant to which revenue and expenditure plans were increased by approximately 0.8 per cent. of GDP in comparison with the original budget for 2008. However, the second half of 2008 was characterised by a slowdown in the growth of economic activity (GDP growth declined from 4.3 per cent. in the first quarter to 3.4 per cent. in the second quarter, 1.6 per cent. in the third quarter and 0.2 per cent. in the fourth quarter of 2008). As a result the amount of revenue collected in the second half of 2008 was not as high as envisaged under the June supplementary budget. Expenditure during the second half of 2008 was therefore carefully monitored so that adjustments could be made in line with the actual revenue collected during that period. Actual 2008 revenue decreased by approximately 0.7 per cent. of GDP and, as a result of the ongoing adjustments to expenditure, savings in expenditure also amounted to approximately 0.7 per cent. of GDP. The planned deficit target was therefore unaffected.

Liabilities related to pensions

According to the Constitutional Court Decision from 1998, the Government is obliged to pay compensation to pensioners for the partial indexation in the period 1993-1998. Compensation payments started in 2006 and by the end of 2008 HRK 6.8 billion had been paid out. The remaining amount of HRK 3.4 billion will be paid by the end of 2013. On average, the yearly amount of these payments accounts for 0.2 per cent. of GDP. These compensation payments are made through a special private fund (Pensioners Fund), which is not part of the general government sector.

The following table set out the consolidated general government budget for the periods indicated:

	Year ended 31 December					Six months ended 30 June
	2006	**2007**	**Plan 2008**	**2008**	**Plan 2009**	**2009**
	(HRK millions)					
REVENUE	**112,293.8**	**126,716.0**	**136,844.9**	**134,737.8**	**128,329.2**	**61,207.4**
Budgetary central government	95,234.1	108,297.0	118,051.1	115,766.5	110,871.5	52,618.1
Extrabudgetary users	5,158.5	5,040.0	4,254.8	4,223.8	3,597.0	1,703.3
Croatian Pension Insurance Administration	293.5	—	—	—	—	0.0
Croatian Institute for Health Insurance	848.7	—	—	—	—	0.0
Croatian Employment Service	18.4	—	—	—	—	0.0
Croatian Waters	1,526.9	1,992.0	1,906.3	2,058.6	1,773.1	833.9
Fund for Environmental Protection and Energy Efficiency	659.8	1,102.9	1,367.5	1,221.2	1,129.7	534.0
Croatian Motorways Ltd.	1,271.1	1,375.3	—	—	—	0.0
Croatian Roads Ltd.	64.7	119.9	167.3	81.0	77.7	39.7
State Agency for Deposit Insurance and Bank Rehabilitation	409.6	391.4	777.9	808.3	566.8	278.4
Croatian Privatisation Fund	65.9	58.3	35.8	54.7	49.5	17.3
Local government	11,901.2	13,379.0	14,539.0	14,747.5	13,860.7	6,886.1
EXPENSE	**107,721.7**	**118,770.5**	**131,485.1**	**130,258.6**	**131,998.1**	**65,910.8**
Budgetary central government	90,525.3	100,936.3	113,086.0	111,299.7	114,495.6	56,900.7
Extrabudgetary users	6,726.8	6,015.1	5,286.7	5,308.1	4,568.4	2,049.7
Croatian Pension Insurance Administration	565.9	—	—	—	—	0.0
Croatian Institute for Health Insurance	931.6	—	—	—	—	0.0
Croatian Employment Service	155.0	—	—	—	—	0.0
Croatian Waters	1,774.0	2,086.6	2,191.9	2,313.7	1,782.7	788.6
Fund for Environmental Protection and Energy Efficiency	694.9	1,047.3	1,200.5	1,063.9	898.7	428.1
Croatian Motorways Ltd.	1,272.7	1,509.4	—	—	—	0.0
Croatian Roads Ltd.	1,226.9	1,235.8	1,559.5	1,588.7	1,537.7	653.0
State Agency for Deposit Insurance and Bank Rehabilitation	27.4	47.8	226.5	254.7	253.3	139.0
Croatian Privatisation Fund	78.4	88.2	108.4	87.0	95.9	40.9
Local government	10,469.6	11,819.0	13,112.4	13,650.7	12,934.1	6,960.5
NET/GROSS OPERATING BALANCE	**4,572.1**	**7,945.5**	**5,359.8**	**4,479.2**	**(3,668.8)**	**(4,703.4)**
CHANGE IN NET WORTH: TRANSACTIONS	4,572.1	**7,945.5**	**5,359.8**	**4,479.2**	**(3,668.8)**	**(4,703.4)**
CHANGE IN NET ACQUISITION OF NON-FINANCIAL ASSETS	9,082.9	11,015.0	9,198.8	7,344.1	6,070.2	2,552.9
Acquisition	10,350.3	12,319.4	10,368.5	8,876.6	6,944.6	2,926.8
Budgetary central government	1,908.5	3,043.9	3,887.9	3,291.5	2,496.1	917.9
Extrabudgetary users	4,927.9	5,334.7	1,962.0	1,421.7	1,180.4	469.2
Local government	3,513.9	3,940.8	4,518.6	4,163.4	3,268.2	1,539.7
Disposals	1,267.3	1,304.5	1,169.7	1,532.5	874.5	373.9
Budgetary central government	352.7	498.7	357.4	303.4	338.5	143.1
Extrabudgetary users	375.1	69.0	81.3	181.6	75.9	18.4
Local government	539.6	736.8	731.0	1,047.5	460.0	212.4
NET LENDING/BORROWING	(4,510.8)	(3,069.4)	(3,839.0)	(2,865.0)	(9,739.0)	(7,256.3)
ESA 95 NET LENDING/NET BORROWING(1)	(6,079.4)	(4,357.5)	(4,025.4)	(3,603.8)	(10,336.0)	(7,853.9)
ESA 95 NET LENDING/NET BORROWING, PERCENTAGE OF GDP	*(2.1)*	*(1.4)*	*(1.2)*	*(1.1)*	*(3.1)*	*(2.3)*
TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING)	4,510.8	3,069.4	3,839.0	2,865.0	9,739.0	7,256.3
CHANGE IN NET ACQUISITION OF FINANCIAL ASSETS	(2,629.9)	(2,403.1)	637.4	2,918.0	1,504.5	2,151.9
Domestic	(2,646.6)	(2,421.1)	624.9	2,905.6	1,502.8	2,151.0
Budgetary central government	(3,063.9)	(3,752.8)	102.1	1,690.5	906.4	2,216.3
Extrabudgetary users	470.5	795.6	487.3	1,073.6	507.6	404.6
Local government	(53.1)	536.1	35.6	141.4	88.7	(469.9)
Foreign	16.7	18.0	12.5	12.4	1.8	0.9
Budgetary central government	16.7	18.0	12.5	12.4	1.8	0.9
Extrabudgetary users	—	—	—	—	—	0.0
Local government	—	—	—	—	—	0.0
Monetary gold and SDRs	—	—	—	—	—	0.0
CHANGE IN NET INCURRENCE OF LIABILITIES	1,881.0	666.4	4,476.4	5,783.0	11,243.6	9,408.3
Domestic	5,363.6	2,147.5	5,401.0	6,949.5	6,620.3	8,941.8
Budgetary central government	3,166.3	1,477.6	4,206.6	5,656.6	5,972.0	8,467.0
Extrabudgetary users	2,116.5	539.5	962.8	1,139.1	514.8	490.6
Local government	80.8	130.4	231.6	153.8	133.6	(15.7)
Foreign	(3,482.6)	(1,481.2)	(924.6)	(1,166.5)	4,623.3	466.4
Budgetary central government	(3,943.2)	(2,980.2)	(1,286.1)	(1,445.8)	4,263.3	233.3
Extrabudgetary users	551.2	1,523.7	406.6	304.1	404.9	243.6
Local government	(90.6)	(24.7)	(45.0)	(24.9)	(45.0)	(10.5)

Source: Ministry of Finance

Note: On a cash basis unless otherwise stated.

(1) On accrual basis (including annual arrear change, Croatian Roads and Croatian Motorways transactions on accrual basis)

The following tables set out the detailed budget for the budgetary central government.

Budgetary Central Government Revenue

	Year ended 31 December			First seven months	
	2006	2007	2008	2008	2009
			(HRK thousands)		
REVENUE	95,235,557	108,320,595	115,772,655	68,923,200	62,223,728
Taxes	58,469,091	64,234,530	69,572,699	42,322,862	34,617,255
Taxes of income and profits and capital gains	8,515,615	10,589,083	12,252,205	7,810,962	6,706,894
Payable by individuals	3,459,649	1,772,708	1,687,502	842,155	658,111
Payable by corporations and other enterprises	5,055,966	8,816,375	10,564,703	6,968,807	6,048,783
Taxes on property	482,331	578,621	635,930	356,169	327,516
Taxes on goods and services	47,546,223	51,099,930	54,482,172	32,826,470	26,410,709
General taxes on goods and services	35,091,381	37,91,6,509	41,474,566	25,374,360	20,600,846
Value-added taxes	34,931,750	37,747,987	41,308,036	25,271,827	20,526,925
Sales taxes	159,631	168,522	166,531	102,533	73,921
Excises	11,564,709	12,168,666	11,875,126	6,847,680	5,207,518
— on cars, other motor vehicles, boats and planes	1,270,422	1,433,427	1,452,827	972,105	459,242
— on petroleum products	6,316,440	6,484,816	6,065,140	3,508,221	2,570,380
— on alcohol	230,178	231,342	218,786	135,638	73,988
— on beer	716,167	743,000	717,401	380,001	361,553
— on nonalcoholic beverages	140,404	142,462	139,160	74,097	66,759
— on tobacco products	2,710,348	2,943,649	3,084,293	1,659,414	1,566,926
— on coffee	156,666	161,936	166,979	100,640	89,799
— on luxury goods	24,084	28,033	30,540	17,564	18,872
Taxes on international trade and transactions	1,588,456	1,641,478	1,900,865	1,147,668	999,608
Other taxes	336,466	325,418	301,527	181,593	172,528
Social contributions	33,877,148	37,203,486	40,703,484	23,293,099	23,430,063
Social security contributions	33,877,148	37,203,486	40,703,484	23,293,099	23,430,063
Employee contributions	15,084,349	16,531,305	18,100,364	10,393,614	10,511,905
Employer contributions	18,051,382	19,845,488	21,758,077	12,427,538	12,510,573
Self-employed or unemployed contributions	741,418	826,692	845,043	471,946	407,585
Unallocable contributions	0	0	0		
Grants	195,984	428,038	468,634	259,309	354,327
Other revenue	2,693,335	6,454,541	5,027,838	3,047,931	3,822,084
Property income	832,400	3,526,540	1,612,229	1,086,956	1,976,173
Interest	108,232	164,558	147,911	91,063	99,866
Dividends	17,835	1,194,582	212,387	194,670	89,943
Withdrawals from income of quasi-corporations	288,113	117,730	504,074	495,034	1,342,532
Rent	418,220	2,049,670	747,856	306,189	443,832
Sales of goods and services	1,209,296	1,526,646	1,450,683	954,748	616,209
Sales of market establishments	0	0	0	0	0
Administrative fees	821,741	1,318,050	1,274,882	856,217	480,663
Incidental sales by nonmarket establishments	387,555	208,596	175,800	98,531	135,547
Fines, penalties, and forfeits	391,616	429,034	490,600	267,858	292,501
Voluntary transfers other than grants	6,737	11,241	9,384	5,577	6,292
Miscellaneous and unidentified revenue	253,286	961,080	1,464,942	732,791	930,909

Source: Ministry of Finance

Budgetary Central Government Expense

	Year ended 31 December			First seven months 2008	First seven months 2009
	2006	2007	2008		
			(HRK thousands)		
EXPENSE	95,949,951	108,007,605	115,292,426	64,476,389	68,262,165
Compensation of employees	24,313,867	27,545,141	29,948,535	17,174,563	18,491,416
Wages and salaries	20,663,890	23,237,088	25,453,436	14,570,613	15,677,202
Social contributions	3,649,977	4,308,053	4,495,099	2,603,950	2,814,214
Use of goods and services	6,069,116	7,162,402	8,113,694	4,013,216	4,427,481
Interest	4,713,615	4,535,008	4,683,219	3,037,218	3,188,959
To nonresidents	1,863,999	1,672,563	1,542,146	1,317,778	1,257,241
To residents other than general government	2,849,616	2,862,444	3,141,074	1,719,440	1,931,718
Subsidies	5,670,789	6,492,010	6,859,512	4,103,005	4,166,234
To public corporations	2,692,785	3,007,099	3,199,114	1,872,378	1,937,525
To private enterprises	2,978,004	3,484,912	3,660,398	2,230,627	2,228,710
Grants	6,652,994	8,363,202	5,783,063	2,776,149	2,902,730
To foreign governments	64,795	103,410	89,446	13,759	44,662
Current	37,760	75,261	60,246	8,165	35,688
Capital	27,035	28,149	29,200	5,595	8,973
To international organisations	89,619	73,941	96,503	64,938	85,455
Current	89,619	73,941	96,503	64,938	84,486
Capital	0	0	0	0	0
To other general government units	6,498,581	8,185,852	5,597,115	2,697,451	2,772,614
Current	2,663,156	2,305,125	2,291,490	1,168,925	1,605,077
Capital	3,835,425	5,880,726	3,305,625	1,528,526	1,167,536
Social benefits	43,444,589	48,175,989	52,593,214	29,534,953	32,107,886
Social security benefits	30,535,396	34,167,894	37,600,722	21,067,419	23,219,034
Social assistance benefits	12,786,632	1,3,815,777	14,745,264	8,364,953	8,744,164
Employer social benefits	122,561	192,318	247,228	102,581	144,688
Other expense	5,084,980	5,733,853	7,311,189	3,837,287	2,977,459
Property expense other than interest	7,600	1,132	16,015	3,567	4,107
Miscellaneous other expense	5,077,381	5,732,721	7,295,174	3,833,720	2,973,351
Current	2,304,214	2,837,557	2,626,644	1,555,422	1,396,604
Capital	2,773,167	2,895,164	4,668,530	2,278,298	1,576,747

Source: Ministry of Finance

Fiscal developments in 2009

The decline in global economic activity, especially the drop in economic activity in neighbouring countries, has resulted in a negative impact on economic activity in Croatia, and consequently lower levels of revenues than expected in relation to the originally budgeted plan for 2009.

In response to the above the first supplementary budget was adopted in April 2009 pursuant to which the total revenue of the consolidated general government (together with the revenue from disposal of non-financial assets) was reduced by HRK 8.8 billion in comparison to the initial budget plan, while the total expense (together with the expense from acquisition of non-financial assets) was reduced by HRK 6.2 billion (HRK 5.4 billion in reductions and savings were made at the budgetary central government level). Major reductions and savings were made in: the expense for compensation of employees (due to a 6 per cent. reduction of the base salary in state and public services); the expense for use of goods and services (where the savings referred mainly to military equipment, energy and materials used for current and capital maintenance); the expense for subsidies (mostly in agriculture); and the expense for social benefits (primarily due to savings made in health sector).

In response to the continuation of unfavourable macroeconomic conditions caused by the spill-over of the global financial and economic crisis leading to a further decline in economic activity in Croatia, on 17 July 2009 Parliament adopted the second supplementary budget. In comparison to the previous plan, the expected consolidated general government revenues decreased by a further HRK 8.0 billion while expenditures decreased by a further HRK 2.0 billion (HRK 780.6 million in reductions and savings were made at the budgetary central government level). Savings have been realised primarily regarding the following items: material expenses, subsidies and capital investments. Furthermore, the basis for calculation of salaries of the Government officials has been reduced as well as the pensions of representatives in the Parliament.

On 31 July 2009 the third supplementary budget was adopted. The new plan of the consolidated general government revenues for 2009 is based on projected macroeconomic trends, the realization of the revenues in 2009 to date and the projected realisation of additional revenue. Under the new plan, the total revenue together with revenue from sales (disposals) of non-financial assets for 2009 amounts to HRK 129.2 billion, which represents an increase of HRK 1.4 billion in comparison to the previous plan.

Tax revenues are the most important revenues and with the new plan they are planned in the amount of HRK 73.0 billion, representing an increase of HRK 1.3 billion in comparison with the previous plan.

Under the new plan for 2009 the VAT revenue is estimated in the amount of HRK 36.8 billion, which is HRK 502 million more than previously planned. The rationale for this increase is expected effects of the change in the VAT rate, i.e. an increase of the VAT rate from 22.0 per cent. to 23.0 per cent.

Excise revenues have been increased by HRK 30.5 billion in relation to the previous plan and are currently set to be HRK 10.7 billion. This is primarily as a result of the amendments to the Act on Excise Duties on Passenger Cars, Other Motor Vehicles, Vessels and Aircraft under which amendments the provisions relating to the taxation of vessels and aircraft are brought into line with the provisions relating to taxation of passenger cars and motorcycles. In this regard the increase in taxation has been focussed on the economically stronger tax payers.

The remaining taxes are set at a total level of HRK 937.3 million reaching thus an increase of HRK 755.0 million due to the Special Tax pursuant to the adoption of the Act on Special Tax on Salaries, Pensions and Other Receivables (the "**Special Tax Act**") exceeding HRK 3,000.00. Under the Special Tax net pay-outs of between HRK 3,000.00 and HRK 6,000.00 are taxed at 2 per cent. and those higher than HRK 6,000.00 are taxed at 4 per cent. The Special Tax came into effect in August 2009 and pursuant to the Special Tax Act is scheduled to be in force until 31 December 2010. However, the implementation of the Special Tax Act exceeding HRK 3,000 is currently being considered by the Constitutional Court following civil actions against it, the results of which are expected before the end of the year.

Administrative fees (which are recorded under 'other revenue') have been increased under the new budget plan. Planned revenue from administrative fees has been increased by HRK 142.2 million due to the Act on Fee on Services in Mobile Electronic Communication Networks which introduces a fee on services on mobile electronic communication networks at a rate of 6 per cent. of the revenue realised through providing those services.

Within the third supplementary budget, the total expense of the consolidated general government together with the total acquisition of non-financial assets in 2009 amounts to HRK 138.9 billion, which is a decrease of HRK 250.6 million in relation to the previous plan. Thus representing a further saving. In comparison to the previous plan, expenses for employee compensation is reduced by HRK 56.0 million and the expense for social benefits is reduced by HRK 242.9 million primarily due to savings in the health sector. Under the amendments to the Employment Mediation Act and Unemployment Rights the amount of unemployment benefit has been anchored to the minimal wage. However, the expense for subsidies has increased by HRK 518.2 million due to the increase of subsidies to agriculture and subsidies for employment following the Employment Protection Act introduced as a measure of employment protection in conditions of economic activity slowdown.

Other savings have been realised through the reduction of other expenses which cumulatively amount to HRK 233.7 million, as well as the acquisition of non-financial assets which has been reduced by HRK 291.7 million compared to the previous plan.

Based on the new total revenue and total expenditure plan for 2009, net lending/borrowing of the consolidated general government is set at HRK -10.3 billion (3.1 per cent. of GDP according to the ESA 95 methodology).

Consolidated general government results in the first half of 2009

In the first six months of 2009 the total revenue of the consolidated general government amounted to HRK 61.2 billion. Tax revenues, as the most significant revenue category, amounted to HRK 33.8 billion. Among tax revenues, revenue generated through VAT amounted to HRK 17.1 billion; income tax revenue amounted to HRK 5.1 billion while corporate tax revenue amounted to HRK 5.3 billion; and revenue generated from excise duties recorded the level of HRK 4.1 billion. The revenue from contributions, which is the second most important revenue category, amounted to HRK 19.9 billion.

The total expense of the consolidated general government, on the other hand, amounted to HRK 65.9 billion in the first half of 2009. The largest share of the total expense of the consolidated general government related to social benefits which recorded HRK 27.8 billion. Compensation of employees amounted to HRK 17.6 billion, use of goods and services to HRK 7.5 billion, other expense to HRK 4.4 billion, subsidies to HRK 4.3 billion, interest to HRK 3.2 billion and grants to HRK 1.1 billion.

In the first six months of 2009 net acquisition of the non-financial assets amounted to HRK 2.6 billion (comprising total acquisitions of HRK 2.9 billion and total disposals of HRK 373.9 million).

Described developments resulted in the level of net lending/borrowing of the consolidated general government of 2.3 percent of GDP in the first six months of 2009 according to the ESA 95 methodology.

Unfavourable macroeconomic conditions left an impact on the development of revenue in the first half of 2009. However, due to new sources of revenue introduced through the third supplementary budget adopted at the end of July, as well as favourable results of tourist season, the realisation of revenue indicated improvement in August and September of 2009. Additionally, the realisation of expenditure indicated a slowdown in the same period.

Budget Process

The legal framework regulating the area of public finance is set on four levels: the Constitution; the Budget Act and its implementing regulations; the annual budget of Croatia; and various ordinances and instructions. The principal legal act regulating the budgetary processes, regulating relations between institutions within the system and establishing prerequisites for ensuring fiscal discipline and the quality of public finance management is the Budget Act.

On 1 January 2009 the new Budget Act entered into force, which incorporates the new best practices for efficient budget management. It specifies the instruments for public expenditure management and regulates the process of planning, preparation, adoption and execution of the budget, asset management and debt management, public debt management, borrowing and issuance of guarantees by the central government and the units of local and regional self-government, budgetary relations in the public sector, accounting, as well as budgetary supervision.

The Strategy for Improvement and Modernisation of the Processes within the State Treasury for 2007-2011 sets out the basic development for the area of budget management. The State Treasury carries out, amongst other activities, budget preparation and consolidation, budget execution, state accounting, public debt management and manages the affairs of financial management of EU aid funds. The legal obligation of assessing the fiscal impact of the proposed laws and bylaws, for which a standard methodology was created, has been extended to also cover planning acts (including strategies, programmes, plans and policies). Internal auditing units have been established in all ministries and a number of other budget users and efforts are currently focused on further development of the methodology and capacity building, thus resulting in the improvement of the internal control process.

In order to additionally improve the budget execution process, the Ministry of Finance is implementing a project aimed at developing an IT solution to facilitate the efficient and accurate exchange of data between the financial management information systems of the budget users and the financial management information system of the State Treasury.

Budget preparation has been improved and consists of five steps:

1. The Strategic Plans for a three-year period are prepared by the budgetary users based on the instructions of the Ministry of Finance and Central Office for Development Strategy and Co-ordination of the EU funds (the CODEF) (by mid-April).

2. The Strategy of the Government Programmes is adopted by the Government on the proposal of the Ministry of Finance and the CODEF on the basis of such Strategic Plans for the three-year period (by the end of April).

3. Economic and Fiscal Policy Guidelines for a three-year period are adopted by the Government covering strategic goals of economic and fiscal policy, key macroeconomic indicators, key indicators of fiscal policy, revenue and expenditure estimates of all budgetary levels, limits of financial plans for a three-year period for ministries, central government offices and agencies as well as projections of the public debt trends and sensitivity tests based on changes in macroeconomic and fiscal conditions and presumptions (by mid-June).

4. Instructions for the preparation of the State budget proposal are prepared and delivered to the budgetary and extra-budgetary users by the Ministry of Finance based on the Economic and Fiscal Policy Guidelines. Responsible ministries submit coordinated proposals of financial plans to the Ministry of Finance, which is followed by the negotiation and co-ordination stage (by the end of June).

5. Finally, the Ministry of Finance prepares the draft State budget and projections for the next two-year period and delivers it to the Government (by 15 October).

After adoption of the budget by the Government (by 15 November) and by the Parliament (by the end of the year), the budget planning and preparation process ends. Thereafter, the budget execution process starts with the State Treasury taking a central role in the budget execution, liquidity management and budget funds spending supervision and control.

Fiscal developments in the medium-term period

In September 2009, the Government adopted the Strategy of the Government Programmes. Following this, Economic and Fiscal Policy Guidelines were drawn up and adopted by the Government. The Guidelines define the Government's fiscal policy direction in the forthcoming three-year period, providing the fundamental fiscal and economic assumptions for the preparation of future budgets.

In response to the current unstable macroeconomic environment, the key goal of the Government is to preserve macroeconomic stability and create the conditions for recovery and stable economic growth. In this context, fiscal policy is directed to fulfilling the twelve general goals defined in the Strategy of the Government Programmes as follows:

1. To help foster macroeconomic stability, the Government proposes to manage the public finances more efficiently and to enhance the quality of macroeconomic statistics. Furthermore, the Government aims to collect fiscal revenues in a fair and effective manner and to make better use of EU funding.

2. To achieve a business environment which encourages the development of a competitive economy, the Government will stimulate investment, change the structure of exporters, and step up efforts at economic diplomacy. The Government will also bring forward measures to transform the domestic economy by protecting intellectual property rights, harmonising legislation, promoting a more flexible labour market and enhancing national infrastructure.

3. To strengthen the judicial system and the rule of law, the judiciary and judicial authorities will be reformed, the costs of judicial proceedings rationalised and the problem of corruption and organised crime reduced.

4. To strengthen knowledge, excellence and culture, the Government will promote the creation of a more efficient, advanced and standardised education system and the creation of an information society.

5. To achieve more uniform regional development, national and regional Government co-ordination will be improved alongside the fostering of enterprise.

6. To strengthen social justice, the quality of life of families and vulnerable social groups will be improved, the social security system will be improved and a sustainable pension insurance system will be developed.

7. To position Croatia as the leading European tourist destination, the Government will promote the sustainable exploitation of natural, cultural and historical resources, the preservation and development of such resources and the creation of an environment that is attractive to investors.

8. To achieve a more competitive agricultural, alimentary and fishing sector, agricultural planning and rural development will continue, the market mechanisms for selling agricultural and food produce will be improved, the health of humans, animals and plants will be protected and consumers' interests safe-guarded.
9. To further strengthen the international position of Croatia, bilateral and multilateral international cooperation will be strengthened and entry to the operating bodies of various multilateral organisations will be sought. Furthermore, the Government will carry out its international nuclear safety obligations.
10. To enhance the protection of citizens, the civil police force will be reformed, corruption and organised crime combated and road traffic safety increased. On an international level the security on the state border will be strengthened and the work of missions to the NATO Alliance and European Union Members intensified.
11. To improve public health, the provision of healthcare will be improved, modernised and standardised, while the government will also seek to promote healthy lifestyles.
12. To strengthen environmental protection and physical planning, the system of planning administration will be reformed and new protective measures introduced. The Government will protect the diversity of natural resources, the quality of urban and natural environments, and Croatia's rich architectural heritage.

According to the Guidelines, the revenue programme is based on the assumption of the economic recovery and legislative measures introduced through the third supplementary budget in July 2009, namely as follows:

1. the expected yearly effect of the increase of the VAT rate to 23 per cent. is HRK 1.5 billion (0.45 per cent. of GDP);
2. the expected effect of the Special Tax (see further "*Fiscal Developments in 2009*" above) is around HRK 2.1 billion in 2010 (0.63 per cent. of GDP);
3. the expected yearly effect of Amendments to the Act on Excise Duties on Passenger Cars, Other Motor Vehicles, Vessels and Aircraft is HRK 150 million (0.04 per cent. of GDP); and
4. the expected yearly effect of the Act on the Fee on Services in Mobile Electronic Communication Networks is HRK 430 million (0.13 per cent. of GDP).

In line with the aforementioned, the total revenue of the consolidated general government is expected to rise at the rate of 1.6 per cent. in 2010, 2.4 per cent. in 2011, and 4.9 per cent. in 2012.

The total expense of the consolidated general government is based on the objectives and programmes defined by the Strategy of Government Programmes and is planned to increase by 0.6 per cent. in 2010. Within that expenditure, the budgetary central government expense for 2010 is planned at the level realised in 2009, namely HRK151.7 million below the level budgeted for 2009. Furthermore, total expenditure is projected to rise by 2.4 per cent. in 2011 and by 2.8 per cent. in 2012.

Expected developments of revenue and expenditure trends are expected to result in a decrease of the consolidated general government deficit from 2.9 per cent. of GDP in 2009, 2.3 per cent. in 2010, 2.2 per cent. in 2011 and 1.4 per cent. in 2012.

Taxation System

The Constitution stipulates that everyone in Croatia must contribute to the payment of public expenses in accordance with their economic capabilities and that the tax system should be based on principles of equality and equity as well as on economic efficiency. Croatia's tax year is the calendar year. The country's tax structure includes both direct taxation through income taxes and corporation taxes, and indirect taxation through value added tax. In addition, there are excise duties, taxes on property and custom duties. Income taxes are assessed on individuals. About 2.2 million individuals and businesses pay income and profit and corporation tax in Croatia.

In the medium term changes to the tax system will be aimed at simplifying the tax system, while the process of aligning the tax system with the EU legislation will continue.

The Tax Administration is the administrative organisation within the Ministry of Finance whose basic duty is to implement tax regulations and regulations concerning the payment of obligatory contributions.

The Croatian tax system comprises:

- National taxes:
- Value Added Tax;

- Profit tax (i.e., corporate income tax);
- Special taxes (excise) on passenger cars, other motor vehicles, vessels and aircraft; mineral oils; alcohol; beer; non-alcoholic beverages; tobacco products; coffee; luxury products and tax on liability; and comprehensive road vehicle insurance premiums;
- County taxes: inheritance and gifts tax; tax on road motor vehicles; tax on vessels; and a levy on coin-operated machines for amusement;
- City or municipal taxes: surtax on income tax; consumption tax; tax on holiday homes; tax on trade name; and tax on the use of public land;
- Joint taxes (the income from which is distributed among the State, the municipality, the city and the county): income tax and real estate transfer tax;
- Levies on the organisation of games of chance, including: one-time organisation of lotteries; games of chance in casinos; games of chance — in bookmakers; and games of chance in coin-operated machines. There is also a levy on the organisers of prize games for the benefit of the Croatian Red Cross.

With the amendments of the Act on the Financing of Units of Local and Regional Self-Government, profit tax has entirely become a source of State budget revenues, whereas income tax revenues have been allocated to local and regional governments.

Income tax is regulated by the Income Tax Act (Official Gazette No. 177/2004, entry into force on 1 January 2005 and Official Gazette No. 73/2008, entry into force on 1 July 2008).

Income tax is assessed on individuals and paid for the tax period (a calendar year). Taxable income includes: employment income; self employment income; income from property and property rights; income from capital; income from insurance; and other income. According to the Income Tax Act, income from capital includes: interest income, withdrawals of assets and the use of services at the expense of the profit realised in the current tax period, as well as the shares in profits realised through the allocation of own shares or purchased call options of own shares, which were acquired during a tax period. Receipts from interest on HRK and foreign currency savings or on deposits; receipts from interest on securities issued pursuant to a special act; direct payments of insurance premiums for the purchase of supplementary part of lifetime pension benefits; pensions of residents acquired abroad; and others do not count as income.

Income tax is levied at a rate of 15 per cent. on a sum equivalent to up to twice the amount of the basic personal allowance; at a rate of 25 per cent. on the difference between the previous threshold and five times the amount of the basic personal allowance; at a rate of 35 per cent. on a difference between the previous threshold and 14 times the amount of the basic personal allowance; and at a rate of 45 per cent. on the tax base exceeding 14 times the amount of the basic personal allowance referred to in Article 36, Paragraph 1 of the Income Tax Act. No taxation is applicable to amounts below the base personal allowance.

The income tax referred to in Paragraph 1 of Article 36 may be increased by a surtax on income tax imposed by units of local self-government pursuant to special legislation.

The monthly tax base	**The annual tax base**	**Tax rates**
— Up to HRK 1,800	— up to HRK 21,600	0 per cent. (personal allowance)
— Up to HRK 3,600	— Up to HRK 43,200	15 per cent.
— Over HRK 3,600 up to HRK 9,000 *(the next HRK 5,400,00)*	— Over HRK 43,200 up to HRK 108,000 *(the next HRK 64,800,00)*	25 per cent.
— Over HRK 9,000 up to HRK 25,200 *(the next HRK 16,200)*	— Over HRK 108,000 up to HRK 302,400 *(the next HRK 194,400)*	35 per cent.
— Over HRK 25,200	— Over HRK 302,400	45 per cent.

The amendments to the Income Tax Act (Official Gazette No. 73/2008), increased the base personal allowance from HRK 1,600 to HRK 1,800. In order to mitigate the consequences this measure has on the revenues of local and regional government, the Act on the Financing of Units of Local and Regional Self-Government was also amended (Official Gazette No. 73/2008, into force as of 1 July 2008) to enforce additional distribution of income tax to the local units so as to enable them to execute their functions. The former distribution of income tax has been amended whereby the share of income tax has been increased by 3 percentage points for towns and municipalities and by 0.5 percentage points for counties. These amendments are targeted at achieving more balanced and even distribution of taxes in all areas of Croatia, particularly relating to the areas of special state concern, and to improve the liquidity of the financial system at the local level.

Profit tax (Corporate Income Tax) is regulated by the Profit Tax Act (Official Gazette No. 177/2004, 90/2005, 57/2006 and 146/08). The profit tax is paid at the rate of 20 per cent. of the assessed tax base.

The following are subject to profit tax:

- a company or another legal or natural person resident in Croatia, who is permanently and independently engaged in an economic activity for the purpose of deriving a profit, an income or revenue or other assessable economic benefits;
- a resident permanent establishment of a non resident entrepreneur;
- a person who derives income pursuant to the income tax regulations, if he/she declares that he/she intends to pay profit tax instead of income tax; and
- an entrepreneur, namely a natural person who derives income from small business or the activities equalised therewith, if:
  1. his/her total revenue in the preceding tax period exceeded HRK 2,000,000;
  2. his/her total income in the preceding tax period exceeded HRK 400,000;
  3. the value of his/her long term assets exceeds HRK 2,000,000; or
  4. his/her employed more than 15 employees on average during the preceding tax period.

In addition, a withholding tax of 15 per cent. was introduced in 2005. Withholding tax is tax levied on profits generated by a non-resident in Croatia and is charged on interest and copyright as well as other intellectual property rights, market research services, tax and auditing services, and business counselling services paid to foreign entities.

In Croatia, double taxation avoidance treaties are applied, which have been ratified by Croatia and other countries. According to these treaties the double taxation of certain income is avoided, with the intention that profits and assets defined by the treaty are subject to tax in only one state or at a rate which is less than the one prescribed by domestic tax regulations.

In Croatia, value added tax was introduced on 1 January 1998, replacing retail sales tax, and is regulated by the Value Added Tax Act (Official Gazette Nos. 47/1995, 106/1996, 164/1998, 105/1999, 54/2000, 73/2000, 48/2004, 82/2004, 90/2005, 76/2007 and 94/09). From 1 January 2006 the VAT rates have been 0 per cent., 10 per cent. and 22 per cent., both goods and services are assessed at the same rate. Since 1 August 2007, a differentiated 10 per cent. VAT rate has been in effect, and it applies to daily and periodical newspapers and magazines, with the exception of those that mainly or only contain advertisements and serve advertising purposes. Since August 2009, amendments to the Value Added Tax Act (Official Gazette No. 94/09) have been in effect whereby the VAT rate has been increased by 1 per cent., i.e. from 22 per cent. to 23 per cent. Furthermore, the Special Tax Act has been introduced (Official Gazette No. 94/09), as well as the Act on Special Tax on Income from Independent Personal Activities and Other Incomes (Official Gazette No. 119/09) and amendments have been made to the Act on Excise Duties on Passenger Cars, Other Motor Vehicles, Vessels and Aircraft (Official Gazette No. 94/09) (for further information on each of these, see "*Fiscal Developments in 2009*" above).

PUBLIC DEBT

The total general government debt (which includes both the internal and external debt of the central government, extra-budgetary funds and local government) plus direct guarantee obligations (i.e. other than the guarantee obligations of HBOR) ("**Consolidated Public Debt**") of Croatia stood at HRK 122.0 and HRK 133.4 billion as at the end of 2007 and 2008 respectively. This comprised total general government debt of HRK 104.6 and HRK 99.6 billion, and direct guarantees by the Republic of HRK 17.4 and HRK 33.8 billion as at 2007 and 2008 respectively. As at 30 June 2009 the Consolidated Public Debt of the Republic stood at HRK 143.3 billion, comprising total general government debt of HRK 108.4 billion and direct guarantees by the Republic of HRK 34.9 billion.

Total general government debt was comprised 69.4 per cent. (HRK 69.2 billion) by internal debt as at the end of 2008 (compared with 61.9 per cent., HRK 64.8 billion at the end of 2007) and 30.6 per cent. (HRK 30.5 billion) by external debt at the end of 2008 (compared with 38.1 per cent., HRK 39.8 billion at the end of 2007). As at 30 June 2009 the general government debt consisted of 72.1 per cent. (HRK 78.2 billion) of internal debt and 27.9 per cent. (HRK 30.2 billion) of external debt.

The Consolidated Public Debt as at the end of 2008 represented 39.0 per cent. of nominal GDP, which was an increase of 0.2 percentage points from 38.8 per cent. at the end of 2007. As at 30 June 2009, a proportional amount of the Consolidated Public Debt for the first six months of 2009 represented 44.1 per cent. of the nominal GDP for that period, reflecting an increase of 5.1 per cent. points compared with the full year figures for 2008. General government internal debt as a proportion of nominal GDP, represented 21 per cent. of nominal GDP at the end of 2005, 21 per cent. at the end of 2006, 21 per cent. at the end of 2007, 20 per cent. at the end of 2008, and has risen in 2009 to 23 per cent. of nominal GDP as at 30 June 2009. General government external debt as a proportion of nominal GDP has decreased since 2005, representing 17 per cent. of nominal GDP at the end of 2005, 15 per cent. at the end of 2006, 13 per cent. at the end of 2007, 9 per cent. a the end of 2008, and 9 per cent. of nominal GDP as at 30 June 2006.

The Republic intends to repay its short-term debt through syndicated lending with domestic banks. The Republic intends to borrow approximately EUR 1.4 billion in the international capital markets during 2010 to repay external debt and to finance the deficit. The Government aims for 65 to 75 per cent. of its debt obligations to be fixed rate obligations.

Total general government debt amounted to 74.7 per cent. of Consolidated Public Debt in 2008 and 85.8 per cent. in 2007, with guarantees amounting to 25.3 per cent. of Consolidated Public Debt in 2008 and 14.2 per cent. in 2007. As at 30 June 2009 total general government debt amounted to 75.6 per cent. of Consolidated Public Debt, and guarantees amounted to 24.4 per cent. As at 30 June 2009 guarantees issued by Croatia amounted to HRK 46 billion comprising HRK 13.8 billion in domestic guarantees (of which HRK 0.6 billion related to guarantees made by HBOR), and HRK 32.9 billion in external guarantees (HRK 11.1 billion of which related to guarantees made by HBOR).

Total general government debt decreased by HRK 5 billion from 2007 to 2008, which was accompanied by a decrease in the proportion of nominal GDP comprised by total general government debt from 33.3 per cent. in 2007 to 29.1 per cent. in 2008. The external component of general government debt stood at 8.9 per cent. of nominal GDP at the end of 2008, which is an annual decrease of 3.8 percentage points in comparison with 2007 when it was 12.7 per cent. of nominal GDP.

The internal component of the total general government debt recorded an increase of HRK 4.4 billion, and its share of nominal GDP decreased from 20.6 per cent. in 2007 to 20.2 per cent. in 2008. As at 30 June 2009, total general government debt had increased by HRK 8.8 billion in comparison to the end of 2008, with the internal component increasing by HRK 9.0 billion and the external component decreasing by HRK 0.3 billion. Based on a proportional amount of the general government debt for the first six months of 2009, total general government debt represented 33.3 per cent. of nominal GDP, with the internal component representing 24.1 per cent. of nominal GDP and the external component representing 9.3 per cent.

The largest share of general government debt relates to central government, which was HRK 85.9 billion in 2007, HRK 92.8 billion in 2008, and HRK 101.0 billion as at 30 June 2009. This represented 82.1 per cent., 93.1 per cent. and 93.1 per cent. of total general government debt respectively.

The total amount of debt relating to extra-budgetary users was HRK 16.5 billion in 2007, HRK 4.8 billion in 2008, and HRK 5.6 billion as at 30 June 2009. This represented 15.8 per cent., 4.8 per cent. and 5.2 per cent. of total general government debt respectively.

The total amount of debt relating to local government was HRK 2.2 billion in 2007, 2.0 billion in 2008, and HRK 1.8 billion as at 30 June 2009. This represented 2.1 per cent., 2.0 per cent. and 1.7 per cent. of total general government debt respectively.

Extra-budgetary funds are established through an act of law that are financed from special purpose taxes, i.e., contributions and/or non-tax revenues, and that are managed predominantly by the Government or local/regional governments (State Budget Act, Official Gazette No. 87/2008).

Total guarantees issued by Croatia, excluding those issued by HBOR, increased from HRK 17.4 billion at the end of 2007 (5.5 per cent. of nominal GDP), to HRK 33.8 billion at the end of 2008 (9.8 per cent. of nominal GDP) and to HRK 34.9 billion as at 30 June 2009. Based on a proportional amount of the guarantees for the first six months of 2009, the total amount of guarantees, excluding those issued by HBOR, represented 10.7 per cent. of nominal GDP as at 30 June 2009. The proportion of guarantees which were external has increased from 54.8 per cent. at the end of 2007, to 63.3 per cent. at the end of 2008 before decreasing to 62.4 per cent. as at 30 June 2009.

According to Art. 74 of the Budget Law (National Gazette No. 87/2008) the maximum permitted level of government debt is 60 per cent. of nominal GDP. Pursuant to Art.75 of the Budget Law (National Gazette No. 87/2008) provides for more restrictive limits to be established annually under the Budget Execution Law for the relevant year. Under Art. 29 of the Budget Execution Law for 2009 (National Gazette No. 149/2008, 44/2009, 86/2009 and 95/2009) the current limitation on state debt is set at 48 per cent. of GDP.

Croatia currently has a flexible credit line with the IMF. The general allocation of special drawing rights ("**SDRs**") has been done in a way that each member was allocated 74.13 per cent. of their quota by the IMF. As a result, on 28 August 2009, the IMF allocated to Croatia's SDR account the amount of SDR 270.6 million (equivalent to USD$421 million), this amount is managed at the CNB. In addition, a special one-off allocation of SDR has also been made in the amount of SDR 21.4 billion (based on the amendments to the IMF Statute on special allocation of SDR). The objective of the special one-off allocation is to equalize the member states with respect to the ratio of the allocation it has received and its quota (a significant number of IMF members have never received their SDR allocation, the last SDR allocation being approved by the IMF between 1979 and 1981). Based on this special allocation, the Republic of Croatia received additional SDR 32.4 million (equivalent to USD 50.5 million) on 9 September 2009 and these funds will also add to international reserves of the Republic of Croatia. The Republic of Croatia has not yet used these allocations.

The following table shows the Central Domestic Debt Stock of Croatia for the periods indicated:

Debt item	Year ended 31 December			Six months ended 30 June		
	2006	2007	2008	2009	Maturity	Interest rate
	(HRK thousands)				(year)	(per cent.)
Big Bonds Series I	1,895,424	1,964,084	2,179,752	2,094,742	2011	5
Big Bonds Series II	370,209	304,995	236,586	199,623	2011	7.20
Big Bonds Series III	379,277	319,974	257,403	223,445	2012	7.20
G Bonds — Series 02 D-08	1,469,016	1,465,026	0	0	2008	6.875
G Bonds — Series 03 D-12	3,672,541	3,662,566	3,662,213	3,646,018	2012	6.875
G Bonds — Series 04 D-08	1,000,000	1,000,000	0	0	2008	6.125
G Bonds — Series 05 D-14	4,774,303	4,761,335	4,760,876	4,739,823	2014	5.500
G Bonds — Series 06 D-07	2,938,032	0	0	0	2007	3.875
G Bonds — Series 07 D-19	1,469,016	3,662,566	3,662,213	3,646,018	2019	5.375
G Bonds — Series 08 D-10	3,000,000	3,000,000	3,000,000	3,000,000	2010	6.750
G Bonds — Series 09 D-15	2,570,778	2,563,796	2,563,549	2,552,212	2015	4.250
G Bonds — Series 10 D-15	5,500,000	5,500,000	5,500,000	5,500,000	2015	5.250
G Bonds — Series 11 D-13	4,000,000	4,000,000	4,000,000	4,000,000	2013	4.500
G Bonds — Series 12 D-17	0	5,500,000	5,500,000	5,500,000	2017	4.750
BRA Bonds I	148,602	0	0	0	2007	6.00
BRA Bonds II	147,598	123,299	98,200	84,807	2012	5
BRA Bonds III	393,280	331,787	266,906	231,694	2012	7.20
BRA Bonds III	202,039	168,777	134,421	116,088	2012	5
BRA Bonds Va	4,117	0	0	0	2007	6
BRA Bonds Vb	408,870	212,561	0	0	2008	7
Syndicated Loan I	3,672,541	3,662,566	3,662,213	3,646,018	2010	5.45
Syndicated Loan II	0	0	5,566,563	5,541,947	2013	4.71
Syndicated Loan III	0	0	0	5,469,026	2010	6.90
Medium and long term debt	**38,015,643**	**42,203,332**	**45,050,895**	**50,191,460**		
Treasury Bills	12,662,170	11,975,258	14,605,000	12,462,000		
Other short term debt	1,612,521	476,268	300,000	2,312,250		
Treasury Bills FX	0	0	2,170,169	5,731,868		
Short term debt	14,274,691	12,451,526	17,075,169	20,506,118		
Total debt	**52,290,334**	**54,654,858**	**62,126,064**	**70,697,578**		

Source: Croatian National Bank

Internal Debt Instruments

There are no limitations on the aggregate amount of internal debt, or on its component parts.

Big Bonds represent the bonds issued as part of the restructuring of the economy during 1991 and 1992, and which replaced the Croatian banks' bad loans to the state owned companies. HRK 5.86 billion of Big Bonds were issued, carrying coupons of 5 per cent. and 7.5 per cent.

BRA Bonds represent the bonds, issued to the Bank Rehabilitation Agency, to serve as a capital injection for a few banks as part of their rehabilitation process. A total of HRK 5.52 billion in principal amount of these bonds were issued during 1996 to 1999 with maturities of 10 and 15 years, carrying coupons of 5 per cent., 6 per cent. and 7.2 per cent.

G-Bonds are bullet bonds issued through a syndicate of domestic banks and listed on the ZSE.

Syndicated Loans are loans arranged through a syndicate of domestic banks.

Treasury Bills are announced through publicly announced auctions and are issued under the Ministry of Finance's Treasury Bills Issuance Programme, which was created in July 1996. Please see below the average weighted treasury bill yield for the period indicated:

	Year ended 31 December			Six months ended 30 June
	2006	2007	2008	2009
	(HRK millions)			
364 days HRK	3.91	4.13	6.27	7.83
364 days EUR	—	—	7.95	7.80

Source: Office of Public Debt

Croatia has strengthened its internal and external debt systems and market infrastructure with support from a loan from the World Bank and grants under the EU CARDS programme. The development focussed on education of operating personnel, installation and development of information technology systems for debt management and debt recordings, establishment of electronic auction facilities for internal debt, as well as development of central depositary and agency functions. This process was started in 2005 and completed in 2007.

The following table sets out the domestic debt which is, as of 30 June 2009, scheduled to be redeemed between 2009 and 2019:

Redemption of domestic debt	Second Half 2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
(HRK million)											
Redemption of principal	**137.89**	**12,404.28**	**2,489.29**	**6,535.63**	**6,770.97**	**4,739.82**	**8,052.21**	**0.00**	**5,500.00**	**0.00**	**3,646.02**
Big bonds I	0.00	0.00	2,179.75	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds II	37.19	77.88	84.19	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds III	33.98	71.71	76.95	40.79	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series II	13.27	27.56	28.95	15.04	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series III	35.22	74.38	79.85	42.25	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series IV	18.23	37.70	39.60	20.56	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 03 D-12	0.00	0.00	0.00	3,646.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 05 D-14	0.00	0.00	0.00	0.00	0.00	4,739.82	0.00	0.00	0.00	0.00	0.00
Bonds — Series 07 D-19	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	3,646.02
Bonds — Series 08 D-10	0.00	3,000.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 09 D-15	0.00	0.00	0.00	0.00	0.00	0.00	2,552.21	0.00	0.00	0.00	0.00
Bonds — Series 10 D-15	0.00	0.00	0.00	0.00	0.00	0.00	5,500.00	0.00	0.00	0.00	0.00
Bonds — Series 11 D-13	0.00	0.00	0.00	0.00	4,000.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 12 D-17	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	5,500.00	0.00	0.00
FX Syndicated Loan I	0.00	3,646.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan II	0.00	0.00	0.00	2,770.97	2,770.97	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan III	0.00	5,469.03	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Interest payments	**1,224.89**	**2,289.44**	**1,757.83**	**1,501.32**	**1,320.81**	**984.82**	**854.48**	**457.26**	**326.63**	**196.01**	**196.01**
Big bonds I	43.02	86.05	86.05	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds II	7.22	11.30	4.52	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds III	8.02	12.40	7.07	1.46	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series II	2.11	3.21	1.82	0.36	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series III	8.31	12.83	7.36	1.53	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series IV	2.92	4.45	2.55	0.51	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 03 D-12	125.35	250.70	250.70	125.35	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 05 D-14	130.38	260.69	260.69	260.69	260.69	130.35	0.00	0.00	0.00	0.00	0.00
Bonds — Series 07 D-19	98.00	196.01	196.01	196.01	196.01	196.01	196.01	196.01	196.01	196.01	196.01
Bonds — Series 08 D-10	101.25	101.25	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 09 D-15	54.25	108.47	108.47	108.47	108.47	108.47	108.47	0.00	0.00	0.00	0.00
Bonds — Series 10 D-15	144.38	288.75	288.75	288.75	288.75	288.75	288.75	0.00	0.00	0.00	0.00
Bonds — Series 11 D-13	90.00	180.00	180.00	180.00	180.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 12 D-17	130.63	261.25	261.25	261.25	261.25	261.25	261.25	261.25	130.63	0.00	0.00
FX Syndicated Loan I	39.07	32.14	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan II	51.29	102.58	102.58	76.94	25.65	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan III	188.68	377.36	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total debt service	**1,362.78**	**14,693.71**	**4,247.12**	**8,036.95**	**8,091.79**	**5,724.65**	**8,906.69**	**457.26**	**5,826.63**	**196.01**	**3,842.03**

Source: Ministry of Finance

Note: Exchange rate is midpoint exchange rate of the CNB as of 30 June 2009.

External Debt

The following table sets out external debt ratios of Croatia at the end of the periods indicated:

	Year ended 31 December					Six months ended 30 June
	2004	2005	2006	2007	2008	2009
			(per cent.)			
Total outstanding external debt/GDP	70.0	72.1	74.9	76.9	82.6	87.6
General government external debt/GDP	20.0	17.2	14.5	12.7	8.9	9.0
Governmental external guaranties/ GDP	3.2	2.7	2.4	3.0	6.3	6.5

Source: Croatian National Bank

The ratio of total debt service to exports of goods and services stood at 22.5 per cent., 25.0 per cent., 35.8 per cent., 33.3 per cent. and 28.3 per cent. in 2004, 2005, 2006, 2007 and 2008, respectively.

The average maturity of all total outstanding external debt is 3.86 years and of all outstanding internal debt is 3.6 years as of October 2009.

The international loans on which former Yugoslavia defaulted following its dissolution fall into two categories: loans to public creditors (Paris club) and loans to commercial banks (London club).

A total of EUR 1.04 billion of external debt has been raised in 2009 to date, and the issue of the Notes will be more than sufficient to complete the anticipated external financing needs for 2009.

Paris Club

On 16 December 2005, Croatia and the Republic of Italy entered into an agreement on the consolidation and rescheduling of Croatia's debt to the Republic of Italy. This agreement marked the completion of Croatia's involvement in the rescheduling of the former Yugoslavia's debts to the Paris Club members. In particular, this was the last of the 15 bilateral agreements signed with the public creditors of the Paris Club, comprising Austria, Belgium, Denmark, France, Italy, Japan, Kuwait, Netherlands, Norway, Germany, U.S.A, Spain, Sweden, Switzerland and Great Britain.

As at 30 June 2009, Croatia's outstanding debt to Paris Club members was EUR 84.1 million.

London Club

On 26 April 1996, Croatia reached an agreement with the International Coordinating Committee of the Bank Creditors of the former Yugoslavia. Pursuant to this agreement, Croatia assumed 29.5 per cent. of loans for the refinancing of the debt of the former Yugoslavia under the New Financing Agreements dated 20 September 1988, and 19.7 per cent. of loans under the Trade and Deposit Facility Agreement dated 20 September 1988. On 3 July 1996, this debt was exchanged for Croatian Series A securities in the amount of U.S.$857.8 million due 2010 and Series B securities in the amount of U.S.$604.4 million due 2006, each at an interest rate of 6-month U.S.$ LIBOR plus a margin of 81.25 bps .The Series B securities were repaid in full in 2006. As at 30 June 2009, the outstanding principal amount of the Series A U.S.$116.97 million.

As part of the agreement with each of the Paris Club and the London Club on the consolidation and rescheduling of its share of the former Yugoslavia's debt to the Clubs, Croatia assumed 28.49 per cent. of former Yugoslavia's debt to the Paris Club creditors and 29.5 per cent. of former Yugoslavia's debt to the London Club creditors. After signing the agreement with the London Club in July 1996, Croatia normalised relations with all its foreign creditors.

The following table sets out the outstanding bonds issued by Croatia in the international bond market as at 30 June 2009 and the debt service schedule for each year until 2014:

Projections of Repayments of International Bonds of Croatia

		Original Principal Amount	Repayment Schedule						
			Second Half 2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
London Club Series A :									
U.S.$857,796,000 Floating Rate Notes due 2010	*Principal:*	612,230,370	27,828,653	55,657,306	—				
	Interest[(2)]		936,869	803,031	—				
EUR 750,000,000 6.75 per cent. Notes due 2011	*Principal:*	750,000,000	—	—	750,000,000				
	Interest:		—	50,625,000	50,625,000				
EUR 500,000,000 4.625 per cent. Notes due 2010	*Principal:*	500,000,000	—	500,000,000					
	Interest:		—	23,125,000					
JPY 500,000,000 5.0 per cent. Notes due 2014	*Principal:*	500,000,000	—	—	—	—	—	500,000,000	
	Interest:		—	25,000,000	25,000,000	25,000,000	25,000,000	25,000,000	
EUR 750,000,000 6.5 per cent. Notes due 2015	*Principal:*	750,000,000	—	—	—	—	—	—	750,000,000
	Interest:		—	28,582,192	48,750,000	48,750,000	48,750,000	48,750,000	48,750,000
Principal Repayment (EUR[(1)]).			27,828,653	555,657,306	750,000,000	0	0	500,000,000	750,000,000
Interest Payment (EUR[(1)]).			936,869	128,135,223	124,375,000	73,750,000	73,750,000	73,750,000	48,750,000
Total Servicing Costs (EUR[(1)])			28,765,522	683,792,529	874,375,000	73,750,000	73,750,000	573,750,000	798,750,000
Total Principal Outstanding (at year end) (EUR[(1)]). . . .			2,555,657,306	2,000,000,000	1,250,000,000	1,250,000,000	1,250,000,000	750,000,000	0

Source: Ministry of Finance

(1) Exchange rate: Mid exchange rate of the CNB as of 30 June 2009.

(2) 6m U.S.$ LIBOR +13/16

The following table sets out a breakdown of the total general government debt of Croatia as at the end of the period indicated.

General Government Debt	Year ended 31 December				Six months ended 30 June
	2005	2006	2007	2008(1)	2009
			(HRK millions)		
General Government Internal Debt	56,046.5	61,078.1	64,794.3	69,158.1	78,197.5
Central Government	50,559.5	54,216.7	56,506.5	64,395.2	72,811.1
Treasury Bills	12,533.4	12,662.2	11,975.3	16,775.2	18,193.9
Money Market Instruments	0.9	—	—	10.7	7.0
Bonds	30,716.0	34,827.9	38,795.2	36,542.7	36,324.3
CNB Loans	1.4	0.9	1.0	2.2	1.2
Bank Loans	7,307.8	6,725.7	5,735.0	11,064.4	18,284.7
Government Funds and Agencies	3,935.0	5,168.2	6,332.6	3,004.4	3,829.5
Money Market Instruments	—	—	—	—	—
Bonds	—	—	—	—	—
Bank Loans	3,935.0	5,168.2	6,332.6	3,004.4	3,829.5
Local Governments	1,551.9	1,693.1	1,955.2	1,758.5	1,556.9
Money Market Instruments	40.7	29.3	36.8	12.0	10.7
Bonds	196.4	314.8	500.5	500.4	498.8
Bank Loans	1,314.7	1,349.0	1,418.0	1,246.1	1,047.4
General Government External Debt	45,380.3	41,647.2	39,834.6	30,477.9	30,216.9
Central Government	36,414.5	32,556.6	29,424.0	28,414.3	28,174.6
Money Market Instruments	—	—	—	—	—
Bonds	27,020.1	22,836.9	20,397.3	18,768.2	18,274.3
Loans	9,394.5	9,719.7	9,026.7	9,646.0	9,900.3
Government Funds and Agencies	8,749.8	8,938.2	10,186.7	1,800.3	1,774.0
Money Market Instruments	—	—	—	—	—
Bonds	—	—	—	—	—
Loans	8,749.8	8,938.2	10,186.7	1,800.3	1,774.0
Local Governments	216.0	152.5	223.9	263.3	268.3
Money Market Instruments	—	—	—	—	—
Bonds	—	—	—	—	—
Loans	216.0	152.5	223.9	263.3	268.3
Total	**101,426.8**	**102,725.3**	**104,628.9**	**99,636.0**	**108,414.4**
Government Guaranties:					
1. Internal	5,802.7	7,599.8	8,058.5	13,196.8	13,763.9
of which: HBOR	534.2	347.5	190.7	807.9	643.9
2. External	13,791.8	14,274.6	19,002.8	31,421.7	32,866.2
of which: HBOR	6,605.1	7,338.8	9,471.5	10,005.1	11,085.7

Source: Ministry of Finance and Croatian National Bank

(1) As from CNB Bulletin No. 146 (March 2009) the HBOR (Croatian Bank for restructuring and Development) is reclassified from the subsector central government funds to the subsector non-banking financial institutions. The reclassification covers the entire statistical series. As well, the HAC (Croatian Motorways) is reclassified from the subsector central government funds to the subsector public enterprises. This reclassification covers the statistical series from January 2008 onwards.

Note: Exchange rate as at 31 December 2005-2008 and 30 June 2009

The following table sets out a breakdown of the total external debt of Croatia divided according to sector.

Gross External Debt of Domestic Sectors

	Year ended 31 December[1]					Six months ended 30 June
	2004	**2005**	**2006**	**2007**	**2008**	**2009**
			(EUR millions)			
Government	6,546.5	6,152.7	5,670.1	5,371.6	4,161.1	4,143.8
Short-term	2.7	2.0	1.3	5.3	31.8	14.6
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0
Credits	0.0	0.0	0.0	0.0	31.7	14.5
Trade credits	0.0	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	2.7	2.0	1.3	5.3	0.1	0.1
Principal arrears	2.4	1.8	0.0	1.1	0.0	0.1
Interest arrears	0.3	0.2	1.2	4.2	0.1	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	6,543.9	6,150.7	5,668.8	5,366.5	4,129.3	4,129.2
Bonds	4,291.2	3,663.4	3,109.1	2,756.9	2,562.4	2,506.1
Credits	2,250.6	2,484.8	2,557.6	2,608.4	1,566.2	1,622.5
Trade credits	2.1	2.6	1.9	1.2	0.7	0.7
Other debt liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Croatian National Bank	2.4	2.6	2.6	2.3	2.3	1.1
Short-term	2.4	2.6	2.6	2.3	2.3	1.1
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0
Credits	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	2.4	2.6	2.6	2.3	2.3	1.1
Other debt liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	0.0	0.0	0.0	0.0	0.0	0.0
Banks	7,731.7	6,978.7	10.222.6	8,879.1	10,064.7	10,379.4
Short-term	1,969.2	2,505.2	3,362.7	2,361.2	3,793.1	3,257.2
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0
Credits	519.9	1,064,8	1,150.4	710.8	1,121.1	893.1
Currency and deposits	1,448.9	1,438.6	2,211.1	1,648.8	2,670.3	2,362.9
Other debt liabilities	0.9	1.7	1.2	1.7	1.7	1.1
Principal arrears	0.0	0.0	0.0	0.1	0.0	0.0
Interest arrears	0.9	1.7	1.2	1.5	1.7	1.1
Other	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	5,762.5	6,473.6	6,659.9	6,517.9	6,271.6	7,122.2
Bonds	453.2	456.6	457.9	459.0	440.8	446.6
Credits	3,517.4	3,822.7	4,217.3	3,565.1	3,375.9	3,160.7
Currency and deposits	1,791.9	2,194.3	2,184.7	2,493.9	2,455.0	3,515.0
Other debt liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Other Sectors	6,606.7	8,176.4	10,500.2	14,743.1	20,014.9	20,675.4
Short-term	535.6	706.7	700.9	1,478.2	996.4	1,173.9
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0
Credits	98.5	133.0	155.0	681.0	734.5	809.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0
Trade Credits	23.7	27.8	35.9	31.1	37.0	38.6
Other debt liabilities	413.5	545.9	510.0	766.0	224.9	326.3
Principal arrears	377.1	502.1	460.6	683.4	175.2	257.7
Interest arrears	36.3	43.8	49.4	82.6	49.7	68.6
Other	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	6.071.1	7,469.7	9.799.3	13,264.9	19,018.5	19,501.5
Bonds	749.0	763.9	837.6	1,208.3	1,195.1	1,194.6
Credits	5,192.3	6,542.1	8,816.1	11,766.9	17,473,7	18,002.9
Currency and deposits	0.0	0.0	0.0	0.0	10.6	1.8
Trade Credits	129.8	163.7	145.4	289.8	339.1	302.2
Other debt liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Direct Investment	2,046.1	2,450.7	2,878.4	3,932.8	5,103.2	5,606.3
Short-term	124.1	177.5	233.9	540.4	578.9	531.8
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0
Credits	33.0	36.3	51.2	216.8	499.0	448.1
Trade credits	0.0	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	91.2	141.2	182.7	323.8	79.9	83.7
Principal arrears	78.1	121.8	158.2	293.9	58.2	60.6
Interest arrears	13.1	19.4	24.5	29.7	21.7	23.1
Other	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	1,921.9	2,273.2	2,644.5	3,392.5	4,524.3	5,074.6
Bonds	0.0	0.0	0.0	0.0	0.0	0.0
Credits	1,892.2	2,239.3	2,618.1	3,374.5	4,522.7	5,069.1
Trade credits	29.8	33.9	26.4	18.0	1.5	5.5
Other debt liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Total	**22,933.4**	**25,761.1**	**29,273.9**	**32,929.2**	**39,346.1**	**40,806.1**

Source: Croatian National Bank

(1) Exchange rate as at 31 December in the relevant year.

In 2008, bank liabilities amounted to EUR 10.1 billion. Please see below a table setting out in percentage terms the structure of bank liabilities for the period of:

Structure of bank liabilities	Year ended 31 December 2008	
	(EUR millions)	*(per cent.)*
Short term loans	1,121,10	11.13
Short term currency and deposits	2,670,30	26.51
Other short term liabilities	2	0.02
Long term bonds	456,8	4.54
Long term credits	3366,3	33.42
Long term currency and deposits	2455	24.38

Source: Croatian National Bank

The projected servicing of short, medium and long term outstanding external debt as of 30 June 2009 is provided in the following table:

Gross External Debt by Domestic Sectors and Projected Principal Future Payments

	Gross External Debt as at 30 June 2009	Immediate	Projected future principal payments during										
			2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Other
			(EUR millions)										
Public sector	**10,712.7**	**38.3**	**775.6**	**1,489.9**	**1,864.5**	**564.4**	**1,166.7**	**916.7**	**1,252.5**	**367.6**	**922.3**	**216.2**	**1,138.2**
Short-term	239.9	38.3	76.4	125.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	10,471.2	0.0	699.2	1,364.7	1,864.5	564.4	1,166.7	916.7	1,252.5	367.6	922.3	216.2	1,136.5
Direct investment	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.7
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.7
Publicly guaranteed private sector	**37.6**	**0.0**	**27.5**	**3.3**	**2.8**	**2.3**	**0.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**1.3**
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	37.6	0.0	27.5	3.3	2.8	2.3	0.3	0.0	0.0	0.0	0.0	0.0	1.3
Direct investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-publicly guaranteed private sector	**30,055.8**	**373.0**	**6,939.2**	**6,429.3**	**5,404.8**	**2,616.9**	**1,571.1**	**1,405.8**	**731.0**	**784.6**	**603.5**	**375.8**	**2,820.9**
Short-term	4,206.9	289.3	2,793.4	1,124.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	20,244.2	0.0	3,037.9	4,197.1	4,281.3	2,058.7	1,285.6	1,178.7	583.1	592.9	487.1	332.4	2,209.5
Direct investment	5,604.6	83.7	1,107.9	1,108.0	1,123.5	558.2	285.5	227.1	147.9	191.7	116.3	43.4	611.4
Short-term	531.8	83.7	265.9	182.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	5,072.9	0.0	842.0	925.8	1,123.5	558.2	285.5	227.1	147.9	191.7	116.3	43.4	611.4
Total	**40,806.1**	**411.3**	**7,742.3**	**7,922.5**	**7,272.1**	**3,183.6**	**2,738.2**	**2,322.4**	**1,983.6**	**1,152.2**	**1,525.7**	**591.9**	**3,960.3**

Gross External Debt by Domestic Sectors and Projected Interest Future Payments

	Gross External Debt as at 30 June 2009	Immediate	Projected Future Interest Payments during										
			2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Other
			(EUR millions)										
Public sector	10,712.7	0.0	99.0	339.5	308.8	219.7	197.7	179.7	143.8	82.2	71.4	32.9	120.1
Short-term	239.9	0.0	3.8	2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	10,471.2	0.0	95.2	337.4	308.8	219.7	197.7	179.7	143.8	82.2	71.4	32.9	120.1
Direct investment	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Publicly guaranteed private sector	**37.6**	**0.0**	**0.7**	**0.2**	**0.1**	**0.1**	**1.7**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	37.6	0.0	0.7	0.2	0.1	0.1	1.7	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-publicly guaranteed private sector	**30,055.8**	**0.0**	**341.0**	**576.3**	**412.7**	**292.7**	**249.4**	**160.5**	**119.8**	**99.2**	**82.1**	**63.7**	**253.3**
Short-term	4,206.9	0.0	12.7	14.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	20,244.2	0.0	267.2	457.7	346.1	247.2	216.5	138.6	104.6	87.7	73.3	55.9	221.6
Direct investment	5,604.6	0.0	61.1	104.7	66.7	45.5	33.0	21.9	15.2	11.5	8.8	7.8	31.7
Short-term	531.8	0.0	11.3	10.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	5,072.9	0.0	49.7	94.2	66.7	45.5	33.0	21.9	15.2	11.5	8.8	7.8	31.7
Total	**40,806.1**	**0.0**	**440.7**	**916.1**	**721.6**	**512.5**	**448.7**	**340.2**	**263.6**	**181.4**	**153.5**	**96.6**	**373.4**

TAXATION

The comments below are of a general nature only and are based on the provisions currently in force. Prospective Noteholders should consult their tax advisers as to the tax laws and specific tax consequences of acquiring, holding and disposing of the Notes.

Croatia

Under existing Croatian laws and regulations, payments of principal on the Notes to any individual or legal entity which is not resident or incorporated in Croatia will not be subject to taxation in Croatia, and no withholding of any Croatian tax will be required on any such payments. Pursuant to the Personal Income Tax Act payment of the interest on the Notes to foreign natural persons is not subject to personal income tax. Pursuant to the Profit Tax Act, interest on Notes held by foreign legal persons are exempted from payment of a withholding tax.

No Croatian tax will be payable in respect of any gain, whether realised or unrealised, made by a holder (which is not resident or incorporated in Croatia) in respect of any Notes. No stamp, registration or similar duties or taxes will be payable in Croatia by Noteholders in connection with the issue or transfer of the Notes. However, subject to any applicable double taxation treaty, a natural or legal person who inherits or receives gifts (including Notes) in the Republic is under an obligation to pay Croatian tax in respect of such inheritance or gift, in accordance with applicable laws.

United States

U.S. Federal Income Taxation

The discussion of U.S. tax matters in this Prospectus is not intended or written to be used, and cannot be used by any person, for the purpose of avoiding U.S. federal, state or local tax penalties, and was written to support the promotion or marketing of the offering of the Notes. Each taxpayer should seek advice based on such person's particular circumstances from an independent tax adviser.

The following summary of the material U.S. federal income tax considerations of the purchase, ownership and disposition of the Notes by a U.S. Holder (as defined below) is based upon the U.S. Internal Revenue Code of 1986, as amended (the "**Code**"), final, temporary and proposed Treasury regulations issued thereunder, and published judicial and administrative interpretations thereof, each as of the date hereof, and all of which are subject to change, possibly with retroactive effect.

This summary does not purport to be a complete analysis of all potential tax consequences. This discussion does not address all of the U.S. federal income tax consequences that may be relevant to an investor in light of such investor's particular circumstances or to investors subject to special treatment under U.S. federal income tax laws, such as certain financial institutions, certain U.S. expatriates, insurance companies, retirement plans, dealers in securities or foreign currencies, traders in securities that elect mark-to-market tax accounting, U.S. Holders whose functional currency is not the US dollar, partnerships, tax-exempt organisations, regulated investment companies, real estate investment trusts, persons subject to alternative minimum tax and persons holding the Notes as part of a "straddle," "hedge," "conversion transaction" or other integrated transaction. In addition, this discussion is limited to persons that purchase the Notes for cash at original issue and at their "issue price" (the first price at which a substantial part of the Notes are sold to the public for cash, excluding sales to bond houses, brokers or similar persons or organisations acting in the capacity of underwriters, placement agents or wholesalers) and that hold the Notes as capital assets for U.S. federal income tax purposes.

For purposes of this discussion, the term "U.S. Holder" means a beneficial owner of a Note that is, for U.S. federal income tax purposes, (i) an individual that is a citizen or resident of the United States, (ii) a corporation created or organised in, or under the laws of, the United States, any state therein or the District of Columbia, (iii) an estate the income of which is subject to U.S. federal income tax regardless of its source, or (iv) a trust primarily supervised by a U.S. court and controlled by U.S. persons.

If a partnership or an entity classified as a partnership for U.S. federal income tax purposes invests in Notes, the U.S. federal income tax treatment of a partner in such partnership will generally depend upon the status of such partner and the activities of the partnership. Prospective investors that are partnerships, and partners in such partnerships, should consult their own tax advisers to determine the U.S. federal income tax consequences to them of the purchase, ownership and disposition of the Notes.

The Republic does not currently intend to issue further notes forming a single Series with the Notes that have more than *de minimis* original issue discount for U.S. federal income tax purposes ("**OID**") unless such further notes are issued in a "qualified reopening" for U.S. federal income tax purposes. However, the determination regarding whether to proceed with any proposed further issue will be made at the time of such further issue and the Republic may decide to proceed even if a particular further issue would be issued with more than *de minimis* OID and not in a qualified reopening. The Republic is under no obligation to notify Noteholders of any such determination and no assurances can be given in respect of such determination.

Prospective purchasers of the Notes should consult their own tax advisers concerning the tax consequences of investing in Notes in light of their particular circumstances, including the application of the U.S. federal income tax considerations discussed below, as well as the application of other tax laws.

U.S. Holders

Payments of interest

Payments of stated interest on the Notes generally will be taxable to a U.S. Holder as ordinary income at the time that such payments are received or accrued, in accordance with such U.S. Holder's usual method of accounting for U.S. federal income tax purposes. Interest income on a Note generally will constitute foreign source income for U.S. federal income tax purposes and generally will be considered "passive" income, which is treated separately from other types of income in computing the foreign tax credit that may be allowable to U.S. Holders under U.S. federal income tax laws. U.S. Holders should consult their own tax advisers regarding the calculation and availability of foreign tax credits.

Sale, exchange and redemption of Notes

Generally, upon the sale, exchange or redemption of a Note, a U.S. Holder will recognise taxable gain or loss equal to the difference between the amount realised on the sale, exchange, or redemption (less any amount attributable to accrued but unpaid interest, which will be treated as a payment of interest in the manner described above) and such U.S. Holder's adjusted tax basis in the Note. A U.S. Holder's adjusted tax basis in a Note generally will equal the cost of the Note to the U.S. Holder reduced by any principal payments previously received by the U.S. Holder. Such gain or loss generally will be capital gain or loss and will be long term capital gain or loss if at the time of sale, exchange or redemption the Note has been held by such U.S. Holder for more than one year. The deductibility of capital losses by U.S. Holders is subject to limitations. Gain or loss realised by a U.S. Holder on the sale or retirement of a Note generally will be U.S. source.

Information reporting and backup withholding

Information returns may be filed with the U.S. Internal Revenue Service (the "**IRS**") (unless the U.S. Holder establishes, if required to do so, that it is an exempt recipient such as a corporation) in connection with payments on the Notes and the proceeds from the sale, exchange or other disposition of Notes. If information reports are required to be made, a U.S. Holder may be subject to U.S. backup withholding if it fails to provide its taxpayer identification number, or to establish that it is exempt from backup withholding. The amount of any backup withholding imposed on a payment will be allowed as a credit against any U.S. federal income tax liability of a U.S. Holder and may entitle the U.S. Holder to a refund, provided the required information is timely furnished to the IRS.

EU Savings Directive

Under EC Council Directive 2003/48/EC on the taxation of savings income, Member States are required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State. However, for a transitional period, Belgium, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries). A number of non-EU countries and territories including Switzerland have adopted similar measures (a withholding system in the case of Switzerland).

On 15 September 2008 the European Commission issued a report to the Council of the European Union on the operation of the Directive, which included the Commission's advice on the need for changes to the Directive. On 13 November 2008 the European Commission published a more detailed proposal for amendments to the Directive, which included an number of suggested changes. If any of those proposed changes are made in relation to the Directive, they may amend or broaden the scope of the requirements described above.

CLEARING AND SETTLEMENT ARRANGEMENTS

*The information set out below is subject to any change in or reinterpretation of the rules, regulations and procedures of DTC, Euroclear or Clearstream, Luxembourg (together, the "**Clearing Systems**") currently in effect. The information in this section concerning the Clearing Systems has been obtained from sources that the Republic believes to be reliable, but neither the Republic or the Joint Lead Managers takes any responsibility for the accuracy of this section. Investors wishing to use the facilities of any of the Clearing Systems are advised to confirm the continued applicability of the rules, regulations and procedures of the relevant Clearing System. None of the Republic and any other party to the Agency Agreement will have any responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interests in the Notes held through the facilities of any Clearing System or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.*

Clearing Systems

Euroclear and Clearstream, Luxembourg

Euroclear and Clearstream, Luxembourg each hold securities for their customers and facilitate the clearance and settlement of securities transactions by electronic book-entry transfer between their respective account holders. Euroclear and Clearstream, Luxembourg provide various services including safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Euroclear and Clearstream, Luxembourg also deal with domestic securities markets in several countries through established depositary and custodial relationships. Euroclear and Clearstream, Luxembourg have established an electronic bridge between their two systems across which their respective participants may settle trades with each other.

Euroclear and Clearstream, Luxembourg customers are worldwide financial institutions, including underwriters, securities brokers and dealers, banks, trust companies and clearing corporations. Indirect access to Euroclear and Clearstream, Luxembourg is available to other institutions that clear through or maintain a custodial relationship with an account holder of either system.

DTC

DTC has advised the Republic that it is a limited purpose trust company organised under the New York Banking Law, a member of the Federal Reserve System, a "banking organisation" within the meaning of the New York Banking Law, a "clearing corporation" within the meaning of the New York Uniform Commercial Code and a "clearing agency" registered pursuant to Section 17A of the Exchange Act. DTC holds securities that its participants ("**Direct Participants**") deposit with DTC. DTC also facilitates the settlement among Direct Participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerised book-entry changes in Direct Participants' accounts, thereby eliminating the need for physical movement of securities certificates. Direct Participants include both U.S. and non U.S. securities brokers and dealers, banks, trust companies, clearing corporations and certain other organisations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("**DTCC**"). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non U.S. securities brokers and dealers, banks and trust companies that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("**Indirect Participants**" and, together with Direct Participants, "**Participants**"). More information about DTC can be found at www.dtcc.com and www.dtc.org.

Under the rules, regulations and procedures creating and affecting DTC and its operations (the "**DTC Rules**"), DTC makes book-entry transfers of Registered Notes among Direct Participants on whose behalf it acts with respect to Notes accepted into DTC's book-entry settlement system ("**DTC Notes**") as described below and receives and transmits distributions of principal and interest on DTC Notes. The DTC Rules are on file with the Securities and Exchange Commission. Direct Participants and Indirect Participants with which beneficial owners of DTC Notes ("**Owners**") have accounts with respect to the DTC Notes similarly are required to make book-entry transfers and receive and transmit such payments on behalf of their respective Owners. Accordingly, although Owners who hold DTC Notes through Direct Participants or Indirect Participants will not possess Registered Certificates, the DTC Rules, by virtue of the requirements described above, provide a mechanism by which Direct Participants will receive payments and will be able to transfer their interest in respect of the DTC Notes.

Purchases of DTC Notes under the DTC system must be made by or through Direct Participants, which will receive a credit for the DTC Notes on DTC's records. The ownership interest of each actual purchaser of each DTC Note ("**Beneficial Owner**") is in turn to be recorded on the Direct and Indirect Participant's records. Beneficial Owners will not receive written confirmation from DTC of their purchase, but Beneficial Owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the DTC Notes are to be accomplished by entries made on the books of Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in DTC Notes, except in the event that use of the book-entry system for the DTC Notes is discontinued.

To facilitate subsequent transfers, all DTC Notes deposited by Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorised representative of DTC. The deposit of DTC Notes with DTC and their registration in the name of Cede & Co. or such other DTC nominee effect no change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the DTC Notes; DTC's records reflect only the identity of the Direct Participants to whose accounts such DTC Notes are credited, which may or may not be the Beneficial Owners. The Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Redemption notices shall be sent to DTC. If less than all of the DTC Notes within an issue are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such issue to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to DTC Notes unless authorised by a Direct Participant in accordance with DTC's Money Market Instrument Procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Issuer as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the DTC Notes are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal and interest payments on the DTC Notes will be made to Cede & Co., or such other nominee as may be requested by an authorised representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Issuer or the relevant agent (or such other nominee as may be requested by an authorised representative of DTC), on the relevant payment date in accordance with their respective holdings shown in DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name", and will be the responsibility of such Participant and not of DTC, relevant agents or the Issuer, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal and interest to DTC is the responsibility of the Issuer, disbursement of such payments to Direct Participants is the responsibility of DTC, and disbursement of such payments to the Beneficial Owners is the responsibility of Direct and Indirect Participants.

Under certain circumstances, including if there is an Event of Default under the Notes, DTC will exchange the DTC Notes for definitive Registered Notes, which it will distribute to its Participants in accordance with their proportionate entitlements and which, if representing interests in a Rule 144A Global Note, will be legended as set forth under *"Subscription and Sale"* and *"Transfer Restrictions"*.

A Beneficial Owner shall give notice to elect to have its DTC Notes purchased or tendered, through its Participant, to the relevant agent, and shall effect delivery of such DTC Notes by causing the Direct Participant to transfer the Participant's interest in the DTC Notes, on DTC's records, to the relevant agent. The requirement for physical delivery of DTC Notes in connection with an optional tender or a mandatory purchase will be deemed satisfied when the ownership rights in the DTC Notes are transferred by Direct Participants on DTC's records and followed by a book-entry credit of tendered DTC Notes to the relevant agent's DTC account.

DTC may discontinue providing its services as depository with respect to the DTC Notes at any time by giving reasonable notice to the Issuer or the relevant agent. Under such circumstances, in the event that a successor depository is not obtained, DTC Note certificates are required to be printed and delivered.

The Issuer may decide to discontinue use of the system of book-entry-only transfers through DTC (or a successor securities depository). In that event, DTC Note certificates will be printed and delivered to DTC.

Since DTC may only act on behalf of Direct Participants, who in turn act on behalf of Indirect Participants, any Owner desiring to pledge DTC Notes to persons or entities that do not participate in DTC, or otherwise take actions with respect to such DTC Notes, will be required to withdraw its Registered Certificates from DTC.

The information in this section concerning DTC and DTC's book-entry system has been obtained from sources that Issuer believes to be reliable, but Issuer takes no responsibility for the accuracy thereof.

Registration and Form

Book-entry interests in the Notes held through Euroclear and Clearstream, Luxembourg will be represented by the Unrestricted Global Certificate registered in the name of a nominee of, and held by, a common depositary for Euroclear and Clearstream, Luxembourg. Book-entry interests in the Notes held through DTC will be represented by the Restricted Global Certificate registered in the name of Cede & Co., as nominee for DTC, and held by a custodian for DTC. As necessary, the Registrar will adjust the amounts of Notes on the Register for the accounts of Euroclear, Clearstream, Luxembourg and DTC to reflect the amounts of Notes held through Euroclear, Clearstream, Luxembourg and DTC, respectively. Beneficial ownership of book-entry interests in Notes will be held through financial institutions as direct and indirect participants in Euroclear, Clearstream, Luxembourg and DTC.

The aggregate holdings of book-entry interests in the Notes in Euroclear, Clearstream, Luxembourg and DTC will be reflected in the book-entry accounts of each such institution. Euroclear, Clearstream, Luxembourg or DTC, as the case may be, and every other intermediate holder in the chain to the beneficial owner of book-entry interests in the Notes will be responsible for establishing and maintaining accounts for their participants and customers having interests in the book-entry interests in the Notes. The Registrar will be responsible for maintaining a record of the aggregate holdings of Notes registered in the name of a common nominee for Euroclear and Clearstream, Luxembourg, a nominee for DTC and/or, if individual Certificates are issued in the limited circumstances described under "*The Global Certificates — Registration of Title*", holders of Notes represented by those individual Certificates. The Fiscal Agent will be responsible for ensuring that payments received by it from the Republic for holders of book-entry interests in the Notes holding through Euroclear and Clearstream, Luxembourg are credited to Euroclear or Clearstream, Luxembourg, as the case may be, and the Fiscal Agent will also be responsible for ensuring that payments received by the Fiscal Agent from the Republic for holders of book-entry interests in the Notes holding through DTC are credited to DTC.

The Republic will not impose any fees in respect of holding the Notes; however, holders of book-entry interests in the Notes may incur fees normally payable in respect of the maintenance and operation of accounts in Euroclear, Clearstream, Luxembourg or DTC.

Clearing and Settlement Procedures

Initial Settlement

Upon their original issue, the Notes will be in global form represented by the two Global Certificates. Interests in the Notes will be in uncertified book-entry form. Purchasers electing to hold book-entry interests in the Notes through Euroclear and Clearstream, Luxembourg accounts will follow the settlement procedures applicable to conventional Eurobonds. Book-entry interests in the Notes will be credited to Euroclear and Clearstream, Luxembourg participants' securities clearance accounts on the business day following the Closing Date against payment (value the Closing Date). DTC participants acting on behalf of purchasers electing to hold book-entry interests in the Notes through DTC will follow the delivery practices applicable to securities eligible for DTC's Same Day Funds Settlement system. DTC participants' securities accounts will be credited with book-entry interests in the Notes following confirmation of receipt of payment to the Republic on the Closing Date.

Secondary Market Trading

Secondary market trades in the Notes will be settled by transfer of title to book-entry interests in the Clearing Systems. Title to such book-entry interests will pass by registration of the transfer within the records of Euroclear, Clearstream, Luxembourg or DTC, as the case may be, in accordance with their respective procedures. Book-entry interests in the Notes may be transferred within Euroclear and within Clearstream, Luxembourg and between Euroclear and Clearstream, Luxembourg in accordance with procedures established for these purposes by Euroclear and Clearstream, Luxembourg. Book-entry interests in the Notes may be transferred within DTC in accordance with procedures established for this purpose by DTC. Transfer of book-entry interests in the Notes between Euroclear or Clearstream, Luxembourg and DTC may be effected in accordance with procedures established for this purpose by Euroclear, Clearstream, Luxembourg and DTC.

General

None of Euroclear, Clearstream, Luxembourg or DTC is under any obligation to perform or continue to perform the procedures referred to above, and such procedures may be discontinued at any time.

None of the Republic or any of their agents will have any responsibility for the performance by Euroclear, Clearstream, Luxembourg or DTC or their respective participants of their respective obligations under the rules and procedures governing their operations or the arrangements referred to above.

SUBSCRIPTION AND SALE

Barclays Bank PLC, Citigroup Global Markets Limited and J.P. Morgan Securities Ltd. (the "**Joint Lead Managers**") have, pursuant to a Subscription Agreement (the "**Subscription Agreement**") dated 4 November 2009, jointly and severally agreed to subscribe or procure subscribers for the Notes at the issue price of 98.16 per cent. of the principal amount of Notes, less a combined selling concession and management and underwriting commission of 0.25 per cent. of the principal amount of the Notes, subject to the provisions of the Subscription Agreement. The Republic will also reimburse the Joint Lead Managers in respect of certain of their expenses, and has agreed to indemnify the Joint Lead Managers against certain liabilities (including liabilities under the Securities Act), incurred in connection with the issue of the Notes. The Subscription Agreement may be terminated in certain circumstances prior to payment of the issue price to the Republic.

United States

The Notes have not been and will not be registered under the Securities Act and, subject to certain exceptions, may not be offered or sold within the United States or to or for the account or benefit of a U.S. person except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act. Accordingly, the Notes are being offered and sold only (a) outside the United States to persons other than U.S. persons as defined in Regulation S in offshore transactions in reliance on, and in compliance with, Regulation S and (b) in the United States to a limited number of QIBs as defined in the Securities Act in connection with resales by the Joint Lead Manager, in reliance on, and in compliance with, Rule 144A.

In addition, until 40 days after the commencement of the offering, an offer or sale of Notes within the United States by any dealer (whether or not participating in the offering of the Notes) may violate the registration requirements of the Securities Act if such offer or sale is made otherwise than in accordance with Rule 144A.

Each Joint Lead Manager has represented and agreed that it has offered and sold, and will offer and sell, the Notes (a) as part of its distribution at any time and (b) otherwise until 40 days after the later of the commencement of the offering and the Closing Date, only in accordance with Rule 903 of Regulation S or Rule 144A. Accordingly, neither such Joint Lead Manager nor its affiliates, nor any persons acting on its or their behalf, have engaged or will engage in any directed selling efforts (as defined in Regulation S) with respect to the Notes, and such Joint Lead Manager, its affiliates and all persons acting on its or their behalf have complied and will comply with the offering restrictions requirement of Regulation S. Each Joint Lead Manager has agreed that, at or prior to confirmation of sale of the Notes (other than a sale pursuant to Rule 144A), it will have sent to each distributor, dealer or person receiving a selling concession, fee or other remuneration that purchases the Notes from it during the restricted period a confirmation or notice to substantially the foregoing effect.

Each purchaser of a Note, by its acceptance thereof, will be deemed to have acknowledged, represented to and agreed with the Republic and the Joint Lead Managers as follows:

(a) It understands and acknowledges that the Notes have not been registered under the Securities Act or any other applicable securities law, and that the Notes are being offered for sale in transactions not requiring registration under the Securities Act or any other securities laws, including sales pursuant to Rule 144A and Regulation S and, unless so registered, may not be offered, sold or otherwise transferred except in compliance with the registration requirements of the Securities Act or any other applicable securities laws, pursuant to an exemption therefrom or pursuant to a transaction not subject thereto.

(b) It is either (i) a QIB and is aware that any sale of the Notes to it will be made in reliance on Rule 144A and it is acquiring the Notes for its own account or for the account of another QIB with respect to which it exercises full investment discretion, or (ii) it is not a U.S. person (as defined in Regulation S) or purchasing for the account or benefit of a U.S. person and is purchasing the Notes in an offshore transaction (as defined in Regulation S) in accordance with Regulation S.

(c) It is purchasing the Notes for its own account or for the account of investors meeting the requirements of paragraph (b) above for which it is acting as a fiduciary or agent and with respect to which it has the authority to make these acknowledgements, representations and agreements, in each case not with a view to, or for offer or sale in connection with, any distribution thereof in violation of the Securities Act.

(d) If it is a QIB purchasing the Notes pursuant to Rule 144A, it will not offer, sell, pledge or otherwise transfer the Notes except (i) (A) to the Republic, (B) to a person whom the purchaser reasonably believes is a QIB in a transaction meeting the requirements of Rule 144A, (C) in an offshore transaction complying with Rule 903 or Rule 904 of Regulation S or (D) in a transaction that is otherwise exempt from the registration requirements of the Securities Act but only upon delivery to the Republic of an opinion of counsel in form and scope satisfactory to the Republic and (ii) in accordance with all applicable securities laws of the States of the United States.

(e) It acknowledges that certificates in respect of Notes purchased pursuant to Rule 144A, unless otherwise agreed by the Republic, will bear a legend to the following effect:

THE SECURITIES REPRESENTED HEREBY HAVE NOT BEEN AND WILL NOT BE REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE SECURITIES ACT). THE HOLDER HEREOF, BY PURCHASING THE NOTES IN RESPECT OF WHICH THIS CERTIFICATE IS ISSUED, AGREES, FOR THE BENEFIT OF THE REPUBLIC, THAT SUCH NOTES MAY BE OFFERED, SOLD, PLEDGED OR OTHERWISE TRANSFERRED ONLY (A)(1) TO THE REPUBLIC, (2) IN COMPLIANCE WITH RULE 144A UNDER THE SECURITIES ACT TO A PERSON THAT THE HOLDER REASONABLY BELIEVES IS A QUALIFIED INSTITUTIONAL BUYER WITHIN THE MEANING OF RULE 144A UNDER THE SECURITIES ACT PURCHASING FOR ITS OWN ACCOUNT OR FOR THE ACCOUNT OF A QUALIFIED INSTITUTIONAL BUYER WHOM THE HOLDER HAS INFORMED, IN EACH CASE, THAT THE OFFER, SALE, PLEDGE OR OTHER TRANSFER IS BEING MADE IN RELIANCE ON RULE 144A, (3) IN AN OFFSHORE TRANSACTION COMPLYING WITH RULE 903 OR 904 OF REGULATION S UNDER THE SECURITIES ACT, OR (4) IN A TRANSACTION THAT IS OTHERWISE EXEMPT FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT BUT ONLY UPON DELIVERY TO THE REPUBLIC OF AN OPINION OF COUNSEL IN FORM AND SCOPE SATISFACTORY TO THE REPUBLIC; AND (B) IN COMPLIANCE WITH ALL APPLICABLE SECURITIES LAWS OF THE STATES OF THE UNITED STATES.

It acknowledges that certificates in respect of Notes purchased pursuant to Regulation S, unless otherwise agreed by the Republic, will bear a legend to the following effect:

THIS NOTE HAS NOT BEEN AND WILL NOT BE REGISTERED UNDER THE US SECURITIES ACT OF 1933, AS AMENDED (THE SECURITIES ACT), OR WITH ANY SECURITIES REGULATORY AUTHORITY OF ANY STATE OR OTHER JURISDICTION OF THE UNITED STATES AND MAY NOT BE OFFERED OR SOLD, PLEDGED OR OTHERWISE TRANSFERRED WITHIN THE UNITED STATES EXCEPT PURSUANT TO AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT

Each purchaser further acknowledges that the Joint Lead Managers and their affiliates and otherwise will rely upon the truth and accuracy of the foregoing acknowledgements, representations and agreements. If it is acquiring any Restricted Global Certificates for the account of one or more QIBs, the purchaser thereof represents that it has sole investment discretion with respect to each such account and that it has full power to make the foregoing acknowledgements, representations and agreements on behalf of each such account.

United Kingdom

Each Joint Lead Manager has represented and agreed that:

(a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of the Notes in circumstances in which Section 21(1) of the FSMA does not apply to the Republic; and

(b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Notes in, from or otherwise involving the United Kingdom.

Croatia

Each Joint Lead Manager has represented and agreed that it will not, as part of its initial distribution, offer or sell any Notes to residents of the Republic of Croatia or legal entities incorporated in the Republic of Croatia unless such residents or legal entities are authorised or licensed under Croatian law to acquire, hold, manage or dispose of the Notes on the date of their Offer.

General

No action has been taken by the Republic or any of the Joint Lead Managers that would, or is intended to, permit a public offer of the Notes in any country or jurisdiction where any such action for that purpose is required. Accordingly, each Joint Lead Manager has undertaken that it will not, directly or indirectly, offer or sell any Notes or distribute or publish any offering circular, prospectus, form of application, advertisement or other document or information in any country or jurisdiction except under circumstances that will, to the best of its knowledge and belief, result in compliance with any applicable laws and regulations and all offers and sales of Notes by it will be made on the same terms.

TRANSFER RESTRICTIONS

Due to the following significant transfer restrictions applicable to the notes, investors are advised to consult legal counsel prior to making any reoffer, resale, pledge, transfer or disposal of the Notes.

The Notes have not been registered under the Securities Act, and may not be offered or sold in the United States or to, or for the account or benefit of, U.S. persons (as defined in Regulation S under the Securities Act) except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act. Accordingly, the Notes are being offered and sold (1) in the United States only to persons reasonably believed to be "qualified institutional buyers," which are referred to as QIBs, as defined in Rule 144A under the Securities Act in compliance with Rule 144A and (2) to persons outside the United States ("**foreign purchasers**") in offshore transactions pursuant to Regulation S under the Securities Act.

By its purchase of Notes, each purchaser of Notes will be deemed to:

(a) represent that it is purchasing the Notes for its own account or an account with respect to which it exercises sole investment discretion and that it and any such account is (i) a QIB, and is aware that the sale to it is being made in reliance on Rule 144A or (ii) a foreign purchaser that is outside the United States;

(b) acknowledge that the Notes have not been registered under the Securities Act and may not be offered or sold within the United States except as set forth below;

(c) if it is a person other than a foreign purchaser outside the United States after the expiration of the distribution compliance period, agree that if it should resell or otherwise transfer the Notes within the time period referred to in Rule 144(k) under the Securities Act after the original issuance of the Notes, it will do so only (i) to the Issuer, (ii) to a QIB in compliance with Rule 144A, (iii) outside the United States in an offshore transaction in compliance with Rule 903 or 904 of Regulation S under the Securities Act, (iv) pursuant to the exemption from registration provided by Rule 144 under the Securities Act (if available) but only upon delivery to the Issuer of an opinion of counsel in form and scope satisfactory to the Issuer or (v) pursuant to an effective registration statement under the Securities Act. Subject to the procedures set forth in the Agency Agreement, prior to any proposed transfer of the Notes (other than pursuant to an effective registration statement) within the time period referred to in Rule 144(k) under the Securities Act after the original issuance of the Notes, the holder thereof must check the appropriate box set forth on the reverse of its Notes relating to the manner of such transfer and submit the Notes to the Fiscal Agent;

(d) agree that it will deliver to each person to whom it transfers Notes notice of any restriction on transfer of such Notes;

(e) understand and agree that Notes initially offered in the United States to QIBs will be represented by one or more Restricted Global Certificates and that Notes offered outside the United States in offshore transactions pursuant to Regulation S will be represented by one or more Unrestricted Global Certificates;

(f) understand that unless registered under the Securities Act, the Notes (other than those issued to foreign purchasers after expiration of the distribution compliance period) will bear a legend to the following effect, unless otherwise agreed by the Issuer and the holder thereof:

THE NOTES REPRESENTED HEREBY HAVE NOT BEEN AND WILL NOT BE REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE SECURITIES ACT), OR ANY SECURITIES LAW OF ANY STATE IN THE UNITED STATES OF AMERICA, AND MAY NOT BE REOFFERED, RESOLD, PLEDGED OR OTHERWISE TRANSFERRED EXCEPT AS PERMITTED BY THE FOLLOWING SENTENCES. THE HOLDER HEREOF, BY PURCHASING THE NOTES IN RESPECT OF WHICH THIS CERTIFICATE IS ISSUED, ACKNOWLEDGES AND AGREES, FOR THE BENEFIT OF THE ISSUER, THAT SUCH NOTES MAY BE OFFERED, SOLD, PLEDGED OR OTHERWISE TRANSFERRED ONLY (A)(l) TO THE ISSUER, (2) IN COMPLIANCE WITH RULE 144A UNDER THE SECURITIES ACT TO A PERSON THAT THE HOLDER REASONABLY BELIEVES IS A QUALIFIED INSTITUTIONAL BUYER WITHIN THE MEANING OF RULE 144A UNDER THE SECURITIES ACT PURCHASING FOR ITS OWN ACCOUNT OR FOR THE ACCOUNT OF A QUALIFIED INSTITUTIONAL BUYER WHOM THE HOLDER HAS INFORMED, IN EACH CASE, THAT THE OFFER, SALE, PLEDGE OR OTHER TRANSFER IS BEING MADE IN RELIANCE ON RULE 144A, (3) IN AN OFFSHORE TRANSACTION COMPLYING WITH RULE 903 OR 904 OF REGULATION S UNDER THE SECURITIES ACT, OR (4) IN A TRANSACTION THAT IS OTHERWISE EXEMPT FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT BUT ONLY IF AVAILABLE AND UPON DELIVERY TO THE ISSUER OF AN OPINION OF COUNSEL IN FORM AND SCOPE

SATISFACTORY TO THE ISSUER; AND (B) IN EACH CASE IN COMPLIANCE WITH ALL APPLICABLE SECURITIES LAWS OF THE STATES OF THE UNITED STATES;

(g) acknowledge that the Issuer and the Joint Lead Managers will rely upon the truth and accuracy of the foregoing acknowledgments, representations and agreements, and agree that if any of the acknowledgments, representations or warranties deemed to have been made by it by its purchase of Notes are no longer accurate, it shall promptly notify the Issuer and the Joint Lead Managers; and

(h) if it is acquiring Notes as a fiduciary or agent for one or more investor accounts, represent that it has sole investment discretion with respect to each such account and it has full power to make the foregoing acknowledgments, representations and agreements on behalf of each such account.

GENERAL INFORMATION

Authorisation

The Republic has obtained all necessary consents, approvals and authorisations in the Republic of Croatia in connection with the issue and performance of the Notes. The issue of the Notes was authorised pursuant to the resolution of the Government of the Republic of Croatia dated 4 November, 2009, passed in accordance with the Law on Execution of the Budget of the Republic of Croatia for the year 2009 (*Narodne novine* No. 149/08, 44/09, 86/09 and 95/09).

Listing and Admission to Trading

Application has been made to the CSSF to approve this document as a prospectus. Application has also been made to the Luxembourg Stock Exchange for the Notes to be admitted to trading on the Luxembourg Stock Exchange's regulated market and to be listed on the Official List of the Luxembourg Stock Exchange. The Luxembourg Stock Exchange's regulated market is a regulated market for the purposes of the Markets in Financial Instruments Directive (Directive 2004/39/EC).

The total expenses related to the admission to trading of the Notes are approximately €6,210.00.

Clearing Systems

Application has been made for acceptance of the Restricted Global Certificates into DTC's book-entry settlement system. The Unrestricted and Restricted Global Certificates have been accepted for clearance through Euroclear and Clearstream, Luxembourg. The ISIN for the Unrestricted Global Certificates is XS0464257152 and for the Restricted Global Certificates is US226775AB01. The Common Code for the Unrestricted Global Certificates is 046425715 and for the Restricted Global Certificates is 046442407. The CUSIP number for the Restricted Global Certificates is 226775AB0.

No significant change

There has been no significant change in the tax and budgetary systems, gross public debt, foreign trade and balance of payments, foreign exchange reserves, financial position and resources and income and expenditure figures of the Republic since 31 December 2008.

Litigation

The Republic is not, nor has it been involved in any governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Republic is aware) in the 12 months preceding the date of this document which may have or have in such period had a significant effect on the financial position of the Republic.

Documents

For the period of 12 months following the date of this Prospectus, copies (and certified English translations where the documents in question are not in English) of the following documents will be available for inspection during usual business hours on any weekday (Saturdays, Sundays and public holidays excepted) from the specified office of the Paying Agent for the time being in Luxembourg:

(a) the Subscription Agreement;

(b) the Agency Agreement which includes the forms of the Global Notes;

(c) the resolution of the Government of the Republic of Croatia dated 4 November 2009 authorising the issue of the Notes; and

(d) the budget of the Republic for the current fiscal year.

In addition, copies of this Prospectus are available on the Luxembourg Stock Exchange's website at *www.bourse.lu*.

Joint Lead Managers transacting with the Republic

Certain of the Joint Lead Managers and their affiliates have engaged, and may in the future engage, in investment banking and/or commercial banking transactions with, and may perform services to the Republic and its affiliates in the ordinary course of business.

Yield

On the basis of the issue price of the Notes of 98.16 per cent. of their principal amount, the yield on the Notes is 7.009 per cent. on an annual basis.

Third Party Information

The Issuer confirms that where information included in this Prospectus has been sourced from a third party, that information has been accurately reproduced and that as far as the Issuer is aware and is able to ascertain from information published by that third party, no facts have been omitted which would render the reproduced information inaccurate or misleading.

THE REPUBLIC

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Croatia

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REGISTRAR

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To the Republic as to Croatian law

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