PROSPECTUS

REPUBLIC OF CROATIA

€750,000,000
5.875 per cent. Notes due 2018

Issue price: 98.60 per cent.

The issue price of the €750,000,000 5.875 per cent. Fixed Rate Notes due 2018 (the "**Notes**") issued by the Republic of Croatia (the "**Issuer**", the "**Republic**" or "**Croatia**"), will be 98.60 per cent. of their principal amount. The Notes will mature on 9 July 2018 at their principal amount.

The Notes will be in bearer form in denominations of €100,000 and integral multiples of €1,000 in excess thereof up to and including €199,000. No Notes in definitive form will be issued with a denomination above €199,000. Interest on the Notes will accrue at the rate of 5.875 per cent. per annum from and including 8 July 2011 and will be payable in Euro annually in arrear on 9 July in each year, commencing 9 July 2012. Payments on the Notes will be made without withholding or deduction for or on account of taxes imposed by the Issuer except to the extent described under "*Terms and Conditions of the Notes — Taxation*".

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) by Moody's Investors Service Limited ("**Moody's**"), BBB- (negative) by Standard & Poor's Ratings Services ("**S&P**"), a division of The McGraw-Hill Companies Inc., and BBB- (negative) by Fitch Ratings Ltd. ("**Fitch**"). 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. As at the date of this Prospectus, each of the rating agencies is established in the European Union and has applied for registration under Regulation (EC) No 1060/2009 (the "**CRA Regulation**"), although notification of the corresponding registration decision has not yet been provided by the relevant competent authority.

The Notes have not been and will not be registered under the United States Securities Act of 1933, as amended (the "**Securities Act**"), or any state securities law, and may not be offered or sold within the United States or to, or for the account or benefit of, any U.S. person except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act.

The Notes will initially be represented by a temporary global Note (the "**Temporary Global Note**"), without interest coupons, which will be deposited with a common depositary for Clearstream Banking, *société anonyme* (**Clearstream, Luxembourg**) and Euroclear Bank S.A./N.V. ("**Euroclear**"), on or about 8 July 2011 (the "**Closing Date**"). The Temporary Global Note will be exchangeable for interests in a permanent global Note (the "**Permanent Global Note**") on or after a date which is expected to be 17 August 2011 (the "**Exchange Date**") upon certification as to non-U.S. beneficial ownership. The Permanent Global Note will be exchangeable for definitive Notes only in certain limited circumstances as described herein. See "*Summary of Provisions relating to the Notes while in Global Form*".

An investment in the Notes involves certain risks. See "*Risk Factors*" for a discussion of certain factors that should be considered in connection with an investment in the Notes.

Joint Lead Managers

DEUTSCHE BANK **HSBC** **ZAGREBAČKA BANKA D.D.**

Co-Managers

ERSTE GROUP **RAIFFEISEN BANK INTERNATIONAL**

7 July 2011

THE REPUBLIC OF CROATIA

*This Prospectus comprises a prospectus for the purposes of Article 5.3 of Directive 2003/71/EC (the "**Prospectus Directive**") and for the purposes of the Luxembourg Act.*

The Issuer accepts responsibility for the information contained in this Prospectus. To the best of the knowledge of the Issuer (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 Issuer, having made all reasonable enquiries, confirms that this Prospectus contains all information with respect to the Issuer 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.

*No person has been authorised in connection with the offering of the Notes to give any information or make any representation regarding the Issuer or the Notes other than as contained in this Prospectus. Any such representation or information should not be relied upon as having been authorised by the Issuer or any agency thereof or the Managers (as defined under "**Subscription and Sale**"). Neither the delivery of this Prospectus nor any sales made in connection with the issue of the Notes shall, under any circumstances, constitute a representation that there has been no change in the affairs of the Issuer since the date hereof.*

The Managers make no representation or warranty, express or implied, as to the accuracy or completeness of the information in this Prospectus. Each person receiving this Prospectus acknowledges that such person has not relied on any Manager or any person affiliated with any Manager in connection with its investigation of the accuracy of such information or its investment decision. Each person contemplating making an investment in the Notes must make its own investigation and analysis of the creditworthiness of the Issuer and its own determination of the suitability of any such investment, with particular reference to its own investment objectives and experience, and any other factors which may be relevant to it in connection with such investment.

This Prospectus does not constitute an offer of, or an invitation by or on behalf of the Issuer or any agency thereof or any Manager to subscribe or purchase, any of the Notes. The distribution of this Prospectus and the offering of the Notes in certain jurisdictions may be restricted by law. Persons into whose possession this Prospectus comes are required by the Managers to inform themselves about and to observe any such restrictions. For a description of certain further restrictions on offers and sales of Notes and distribution of this Prospectus, see "Subscription and Sale".

*In this Prospectus, all references to "**HRK**" and "**Kuna**" are to the lawful currency for the time being of the Issuer, all references to "**€**", "**EUR**", "**euro**" and "**Euro**" are to the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty on the Functioning of the European Union, and all references to "**U.S. dollars**", "**US$**" and "**USD**" are to the lawful currency for the time being of the United States of America.*

Certain amounts which appear in this Prospectus have been subject to rounding adjustments; accordingly, figures shown as totals may not be an arithmetic aggregation of the figures which precede them.

IN CONNECTION WITH THE ISSUE OF THE NOTES, DEUTSCHE BANK AG, LONDON BRANCH AS STABILISING MANAGER (THE STABILISING MANAGER) (OR PERSONS 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 STABILISING MANAGER (OR PERSONS ACTING ON BEHALF OF THE STABILISING MANAGER) IN ACCORDANCE WITH ALL APPLICABLE LAWS AND RULES.

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RISK FACTORS

The Issuer believes that the following factors may affect its ability to 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.

In addition, factors which are material for the purpose of assessing the market risks associated with the Notes are described below.

The Issuer believes that the factors described below represent the principal risks inherent in investing in the Notes, but the inability of the Issuer to pay interest, principal or other amounts on or in connection with the Notes may occur for other reasons which may not be considered significant risks by the Issuer based on information currently available to it or which it may not currently be able to anticipate. Prospective investors should also read the detailed information set out elsewhere in this Prospectus and reach their own views prior to making any investment decision.

FACTORS THAT MAY AFFECT THE ISSUER'S ABILITY TO FULFIL ITS OBLIGATIONS UNDER 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

An investment in a country such as Croatia, which achieved independence in 1991 and whose economy is still 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 legal 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. Therefore, 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 recent global financial and economic crisis or the current political turmoil in countries in Northern Africa and the Middle East 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 declaring independence in 1991, 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 yet 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 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, including those stemming from the recent global financial and economic crisis or the current political turmoil in countries in Northern Africa and the Middle East. Although in recent years Croatia has made significant gains in stabilising its currency, increasing its GDP, decreasing inflation and increasing real wages, the recent global financial and economic crisis negatively affected the Croatian economy. During the 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 Croatian Bureau of Statistics ("**CBS**"), Croatia's real GDP contracted by 1.4 per cent. in 2010 (based on preliminary data) and by 5.8 per cent. in 2009, as compared to GDP growth of 2.4 per cent. in 2008 and 5.1 per cent. in 2007. Net FDI decreased by 63.3 per cent. in 2009 compared to 2008 and by 6.0 per cent. in 2008 compared to 2007. In the first nine months of 2010 net FDI remained flat compared to the same period in 2009. However, inward FDI decreased by 30.8 per cent. during 2010, with net FDI remaining stable due to an accompanying 63.5 per cent. fall in outward FDI. In the first nine months of 2010, net lending/borrowing of the consolidated general government was 3.0 per cent. of GDP.

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 2010 and may not be sustainable in the future, as indicated by serious external imbalances. One of the main drivers of economic expansion in Croatia between 2001 and 2008 was domestic demand, which grew at an average annual rate of 5.9 per cent. Private consumption was boosted by the expansion of credit and investment was heavily concentrated in private construction. Capital inflows dropped by 27.1 per cent. in 2009 and this negative trend continued during the first nine months of 2010 as a result of the global financial and economic crisis, and in particular due to increased risk aversion by international investors and declining international liquidity, while external debt continued to rise but at a much slower pace. The gross external debt in euro terms grew from EUR 13.6 billion (53.3 per cent. of GDP) in 2001 to EUR 43.1 billion (94.9 per cent. of GDP or 267.1 per cent. of exports of goods and services) in 2009. The gross external debt in euro terms slightly increased in the first nine months of 2010, and amounted to EUR 44.7 billion in comparison to EUR 44.6 billion as of 31 December 2009. As a reflection of these difficulties, in December 2010 S&P lowered the Republic's rating from BBB (Outlook Negative) to BBB- (Outlook Negative), citing concerns about Croatia's fiscal position and external financing.

There can be no assurance that Croatia will return to the growth pattern experienced during 2001 to 2008 given that it relied heavily on substantial inflows of foreign capital during this period. Even 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. These economic factors could have a material adverse effect on Croatia's capacity to repay principal and make payments of interest on the Notes and on Croatia's credit rating.

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, see "*Overview of the Republic of Croatia — International Relations — European Union Accession*". Croatia is scheduled to join the EU on 1 July 2013. However, a national referendum among the Croatian population on EU membership is a prerequisite to accession. There can also be no assurance that Croatia will join 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.

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

A significant portion of Croatia's public external debt and domestic debt is denominated in foreign currencies. Foreign-currency debt accounts for 70.7 per cent. of total public debt as at 30 September 2010. As of 1 March 2011, Croatia did not have any hedging arrangements in respect of its foreign-currency denominated public debt. In the event of foreign currency fluctuations, and a devaluation of the Kuna relative to the U.S. dollar or the euro, 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, as at 31 December 2010, over 85 per cent. of corporate debt and approximately 75 per cent. of household debt was denominated in, or linked to, foreign currency. Only a small fraction of this debt is hedged. In 2010, as in 2009, almost all new lending was linked to foreign currencies. Despite the fact that foreign currency deposits now account for approximately 80 per cent. of all deposits and that large foreign currency deposits by households reduce currency mismatches at the aggregate level, this 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.

The further proliferation of the euro in the Croatian economy may adversely affect the CNB'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 domestic monetary policy mostly impacts the Kuna and has limited impact on other currencies including the euro, the further proliferation of the euro in the Croatian economy and widespread use of euro by the Croatian population may undermine the ability of the CNB to implement its monetary policies. Similarly, the policies of the European Central Bank affecting the euro may indirectly impact the Croatian economy. Any limitations on the ability of the CNB 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.

The current account deficit may increase

Croatia's current account deficit tripled between 2004 and 2008, mainly due to the widening trade deficit, but has declined considerably since then. The current account deficit increased by 194.1 per cent. in euro terms from EUR 1.4 billion (4.3 per cent. of GDP) in 2004 to EUR 4.2 billion (8.8 per cent. of GDP) in 2008. The current account deficit decreased by 42.9 per cent. in euro terms in 2009 and amounted to EUR 2.4 billion (5.3 per cent. of GDP). The decrease was mainly attributable to a narrowing of the deficit in trade in goods. The decreased deficit resulted from the fact that the decline in imports was greater than the decline in exports which was, in turn, due to a decline in the negative trade balance in road vehicles and petroleum and petroleum products as well as a surplus in trade in other transport equipment. In 2010, the current account produced a deficit of EUR 0.6 billion, a 75.8 per cent. decrease compared to 2009. 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 62.8 per cent. from EUR 6.9 billion in 2004 to EUR 11.2 billion in 2008. However, due to the effects of the global financial and economic crisis on both domestic and foreign demand, the trade deficit subsequently decreased by 31.5 per cent. in 2009 compared to 2008 and amounted to EUR 7.7 billion. This trend continued in 2010, with the trade deficit decreasing further by 19.1 per cent. to EUR 6.2 billion from EUR 7.7 billion in 2009. The decrease in the trade deficit and corresponding decrease in the current account deficit in 2009 are largely attributable to imports falling at a more rapid pace than exports as a result of decreased private consumption due to slowing economic activity. Similarly, in 2010, the falling current account deficit was caused by a lower trade deficit, but this time due to rising exports while imports stagnated. Since economic activity is expected to pick up in the near future, 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 increased 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.

If government 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

According to the plan for 2011, general government revenue is expected to decrease from HRK 124 billion in 2010 to a projected HRK 123 billion in 2011. The decrease in revenue is due to the abolition of the temporary changes to the tax system during the crisis which bolstered revenues by approximately HRK 1.5 billion in 2010, as described under "*Public Finance — Taxation*", changes in the personal income tax regime and the fact that no significant revenue is expected from privatisation in 2011. The Republic also faces growing expenses relating to public wages, social benefits and interest payments, which in the aggregate represented on average 26 per cent. of Croatia's GDP between 2005 and 2009 and 28.8 in 2010. Costs relating to the healthcare system increased by 51.7 per cent., from HRK 13.7 billion in 2005 to HRK 20.7 billion in 2010. Expenses relating to pensions increased by 28.9 per cent. from HRK 26.7 billion in 2005 to HRK 35.1 billion in 2010. 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 1:0.257 in 2009, may continue to rise. Expenses related to general government subsidies decreased from HRK 6.2 billion to HRK 5.9 billion between 2005 and 2010 but still remain relatively high.

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, revenue raising measures could prove inadequate to cover the continued increases in public debt and interest payments. These revenue raising measures could also be more difficult to implement due to other large-scale government initiatives in 2011, including the 2011 Census and the next parliamentary elections expected to take place in November 2011. 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.

Taken as a whole, 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.

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

The long-term foreign and domestic currency debt of the Republic is currently rated BBB- (Outlook Negative) by S&P and Baa3 (Outlook Stable) by Moody's. Fitch has assigned a rating of BBB- (Outlook Negative) to long-term foreign currency debt and BBB (Outlook Negative) to domestic currency debt. 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. In December 2010, S&P lowered the Republic's rating from BBB (Outlook Negative) to BBB- (Outlook Negative), citing concerns about Croatia's fiscal position and external financing. There can be no guarantee that the Republic will not experience further credit downgrades. A deterioration in any of the factors, or the materialisation of any of the risks, discussed herein may contribute to further credit rating downgrades which could result in a sub-investment grade rating of the Notes. In turn, any adverse changes in an applicable credit rating could adversely affect the trading price for 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 in Croatia grew rapidly in recent years as corporate and household sectors accumulated a heavy debt burden. Household debt in Croatia as a share of GDP is one of the highest among Central and Eastern European countries. Non-publicly guaranteed private sector external debt relates almost entirely to foreign borrowing by the corporate sector and banks. Non-publicly guaranteed private sector external debt grew strongly in recent years and amounted to EUR 32.1 billion (70.0 per cent. GDP) at the end of 2010, as compared to EUR 32.4 billion (71.0 per cent. of 2009 GDP), EUR 29.7 billion (62.1 per cent. of 2008 GDP), EUR 23.6 billion (54.4 per cent. of 2007 GDP), EUR 20.8 billion (52.5 per cent. of 2006 GDP) and EUR 17.0 billion (47.1 per cent. of 2005 GDP) at 31 December 2009, 2008, 2007, 2006 and 2005, respectively. These figures do not include the effects of round-tripping transactions, i.e., transactions which involve Croatian equity investment abroad to companies which then lend back to the investing company in Croatia. See "*Foreign Trade and International Balance of Payments — Capital and Financial Account*". 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 31 December 2010, foreign banks owned approximately 90.3 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 the 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.

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 2010 Transparency International Corruption Perceptions Index, Croatia was ranked 62 out of 180 countries under review (indicating that there were 61 countries with lower perceived levels of corruption). 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, the "**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 Croatia declared independence in 1991, 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 may impact 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 Notes are governed by English law and the Issuer 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 Issuer and a Croatian natural or legal person (which proceedings also include a non-Croatian natural or legal person); or (ii) the Issuer 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 judgment, Croatian courts may refuse to recognise such judgments 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. 51/1991). Once recognised, the foreign judgment is equal to the judgment of a Croatian court and is fit for enforcement.

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 interference 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 and the courts are generally not bound by earlier court decisions taken under the same or similar circumstances. This may result in an 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 31 December 2010, Croatia's general government debt excluding government guarantees was HRK 138.0 billion (41.3 per cent. of GDP), of which HRK 89.8 billion (65.1 per cent.) was internal debt and HRK 48.2 billion (34.9 per cent.) was external debt. As of 31 December 2010, the average maturity of the public external outstanding debt was 5.9 years whereas the average maturity of the public internal outstanding debt was 4.9 years. Any deterioration in financing conditions as a result of market, economic or political factors, which may be outside the Republic's control, may jeopardise 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 10 million tourists visit Croatia annually. Tourism contributes substantially to Croatia's GDP. Revenue generated by the tourism industry depends on various factors including consumer spending power, which may be adversely affected by 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 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 or natural gas to Croatia were to be restricted or if the price of oil were to significantly increase, the Republic's economy could be adversely affected. In addition, an increase in the price of oil or 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 Croatian National Bank ("**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 full 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 International Monetary Fund (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.

FACTORS WHICH ARE MATERIAL FOR THE PURPOSE OF ASSESSING THE MARKET RISKS ASSOCIATED WITH 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:

(i) 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;

(ii) 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;

(iii) 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;

(iv) understand thoroughly the terms of the Notes and be familiar with the behaviour of any relevant financial markets; and

(v) 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.

Risks related to the Notes generally

Set out below is a brief description of certain risks relating to the Notes generally:

Modification

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.

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, 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).

The European Commission has proposed certain amendments to the Directive which may, if implemented, 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 Issuer 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 Issuer is required to maintain an Agent in a Member State that is not obliged to withhold or deduct tax pursuant to the Directive.

Change of law

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.

Denominations involve integral multiples: definitive Notes

The Notes have denominations consisting of a minimum of €100,000 plus integral multiples of €1,000 in excess thereof up to and including €199,000. It is possible that the Notes may be traded in amounts that are not integral multiples of €100,000. In such a case a holder who, as a result of trading such amounts, holds an amount which is less than €100,000 in his account with the relevant clearing system at the relevant time may not receive a definitive Note in respect of such holding (should definitive Notes be printed) and would need to purchase a principal amount of Notes such that its holding amounts to at least €100,000.

If definitive Notes are issued, holders should be aware that definitive Notes which have a denomination that is not an integral multiple of €100,000 or its equivalent may be illiquid and difficult to trade.

Croatian Investors

The Notes and Coupons (each as defined herein) are governed by English law and the Issuer 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 or Coupon (see "*Terms and Conditions of the Notes — 15. Governing Law and Jurisdiction*" below). In respect of any proceedings between the Issuer and a Croatian natural or legal person to which a non-Croatian natural or legal person is not also a party, a Croatian court may refuse to recognise and give effect to the choice of English law as the law governing the Notes and Coupons and may also refuse to recognise and enforce an English court judgment awarded in connection therewith in the Republic of Croatia.

Risks related to the market generally

Set out below is a brief description of the principal market risks, including liquidity risk, exchange rate risk, interest rate risk and credit risk:

The secondary market generally

The Notes may have no established trading market when issued, and one may never develop. If a market does develop, it may not be very liquid. Therefore, 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.

Exchange rate risks and exchange controls

The Issuer will pay principal and interest on the Notes in euro. 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 euro. These include the risk that exchange rates may significantly change (including changes due to devaluation of the euro 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 euro would decrease (a) the Investor's Currency-equivalent yield on the Notes, (b) the Investor's Currency equivalent value of the principal payable on the Notes and (c) 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.

Interest rate risks

Investment in the Notes involves the risk that subsequent changes in market interest rates may adversely affect the value of them.

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 advisors to determine whether and to what extent (a) the Notes are legal investments for it, (b) the Notes can be used as collateral for various types of borrowing and (c) 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 will assign 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.

In general, European regulated investors are restricted from using a rating for regulatory purposes if such rating is not issued by a credit rating agency established in the European Union and registered under the CRA Regulation unless the rating is provided by a credit rating agency operating in the European Union before 7 June 2010 which has submitted an application for registration in accordance with the CRA Regulation and such registration is not refused.

TERMS AND CONDITIONS OF THE NOTES

The following is the text of terms and conditions of the Notes which, subject to completion and amendment, will be attached and (subject to the provisions thereof) will apply to each Note in definitive form:

The €750,000,000 5.875 per cent. Notes due 2018 (the "**Notes**", which expression includes, unless the context otherwise requires, any further Notes issued pursuant to Condition 12 and forming a single series with the Notes) of the Republic of Croatia (the "**Republic**"), as represented by the Minister of Finance, were authorised pursuant to the resolution of the Government of the Republic of Croatia dated 7 July 2011, passed in accordance with the Law on Execution of the Budget of the Republic of Croatia for the year 2011 (Official Gazette No. 140/10). A fiscal agency agreement dated 8 July 2011 (the "**Fiscal Agency Agreement**") has been entered into in relation to the Notes between the Republic, Deutsche Bank AG, London Branch as fiscal and principal paying agent (the "**Fiscal Agent**" and, together with any other paying agent appointed under Condition 6(f), the "**Paying Agents**"). In these Conditions, "**Fiscal Agent**" and "**Paying Agent**" shall include any successors appointed from time to time in accordance with the provisions of the Fiscal Agency Agreement, and any reference to an "**Agent**" or "**Agents**" shall mean any or all (as applicable) of such persons. The statements in these Conditions include summaries of, and are subject to, the detailed provisions of the Fiscal Agency Agreement. The Fiscal Agency Agreement includes the form of the Notes and the coupons relating to them (the "**Coupons**"). Copies of the Fiscal Agency Agreement are available for inspection by the holders of the Notes (the "**Noteholders**") and the holders of the Coupons (whether or not attached to them) (the "**Couponholders**") during usual business hours at the principal office of the Fiscal Agent at Winchester House, 1 Great Winchester Street, London EC2N 2DB and at the specified offices of each of the other Agents. The Noteholders and the Couponholders are bound by, and are deemed to have notice of, the provisions of the Fiscal Agency Agreement.

1. Form, Denomination and Title

(a) Form and Denomination

The Notes are serially numbered and in bearer form, in denominations of €100,000 and integral multiples of €1,000 in excess thereof up to and including €199,000, each with Coupons attached on issue. No Notes will be issued with a denomination above €199,000. Notes of one denomination may not be exchanged for Notes of any other denomination.

(b) Title

Title to the Notes will pass by delivery. The holder of any Note or Coupon 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 therein, any writing thereon or any notice of any previous theft or loss thereof) and no person will be liable for so treating the holder.

2. Status

The Notes and Coupons constitute direct, unconditional, (subject to the provisions of Condition 3) unsecured and unsubordinated and general obligations of the Republic. The Notes and Coupons 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.

3. Negative Pledge and Other Covenants

(a) Negative Pledge

So long as any of the Notes or Coupons remains outstanding (as defined in the Fiscal 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 the 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 and Coupons are secured equally and rateably therewith.

(b) Certain Definitions

In these Conditions:

"**Permitted Security Interest**" means:

(i) 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);

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

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

(iv) 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

(v) the renewal or extension of any Security Interest described in subparagraphs (i) and (ii) 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".

4. Interest

Each Note bears interest from and including 8 July 2011 at the rate of 5.875 per cent. per annum, payable annually in arrear on 9 July in each year (from and including 9 July 2012) until maturity (each an "**Interest Payment Date**"). The first such payment, for the period from and including 8 July 2011 to but excluding 9 July 2012 (and amounting to €58.91 per €1,000 principal amount of the Notes), will be made on 9 July 2012. Interest will be paid subject to, and in accordance with, the provisions of Condition 6.

The period beginning on and including 8 July 2011 and ending on but excluding the first Interest Payment Date and each successive period beginning on and including an Interest Payment Date and ending on but excluding the next successive Interest Payment Date is called an "**Interest Period**".

Each Note will cease to bear interest from and including the due date for redemption unless, after surrender of such Note, payment of principal is improperly withheld or refused or unless default is otherwise made in respect of payment, in which case it will continue to bear interest at the rate specified above (as well after as before judgment) until whichever is the earlier of (a) the day on which all sums due in respect of such Note up to that day are received by or on behalf of the relevant Noteholder and (b) the day on which notice has been given to the Noteholders that the Fiscal Agent has received all sums due in respect of the Notes up to such day (except, in the case of payment to the Fiscal Agent, to the extent that there is any subsequent default in payment in accordance with these Conditions).

Where interest is to be calculated in respect of a period which is equal to or shorter than an Interest Period, it will be calculated on the basis of the number of days in the relevant period, from and including the date from which interest begins to accrue to but excluding the date on which it falls due, divided by the number of days in the Interest Period in which the relevant period falls (including the first such day but excluding the last).

5. Redemption, Purchase and Cancellation

(a) Final Redemption

Unless previously redeemed, or purchased and cancelled, the Notes will, subject to Condition 6 below, be redeemed at their principal amount on 9 July 2018.

(b) Purchase and Cancellation

The Republic may at any time purchase Notes at any price in the open market or otherwise. The Notes so purchased, while held by or 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 11. Any Notes so purchased may, but need not, be cancelled at the election of the Republic. Any Notes so cancelled will not be reissued or resold.

6. Payments

(a) Method of Payment

Payments of principal and interest will be made against presentation and surrender (or, in the case of a partial payment, endorsement) of Notes or the appropriate Coupons (as the case may be) at the specified office of any Paying Agent in Euro by credit or transfer to a Euro account (or any other account to which Euro may be credited or transferred) specified by the payee in a city in which banks have access to the Trans-European Automated Real-time Gross Settlement Express Transfer (TARGET2) System (the "**TARGET2 System**") or by cheque. Payment of interest due in respect of any Note other than on presentation and surrender of matured Coupons shall be made only against presentation and either surrender or endorsement (as appropriate) of the relevant Note.

(b) Payments Subject to Fiscal Laws

All payments are subject in all cases to any applicable fiscal or other laws and regulations, but without prejudice to the provisions of Condition 7.

(c) Commissions

No commissions or expenses shall be charged to the Noteholders or Couponholders by any Agent in respect of any payments.

(d) Surrender of Unmatured Coupons

Each Note should be presented for redemption together with all unmatured Coupons relating to it, failing which the amount of any such missing unmatured Coupon (or, in the case of payment not being made in full, that proportion of the amount of such missing unmatured Coupon which the sum of principal so paid bears to the total principal amount due) will be deducted from the sum due for payment. Each amount of principal so deducted will be paid in the manner mentioned against surrender of the relevant missing Coupon not later than ten years after the Relevant Date (as defined in Condition 7) for the relevant payment of principal.

(e) Payments on Business Days

A Note or Coupon may only be presented for payment on a day which is a business day. No further interest or other payment will be made as a consequence of the day on which the relevant Note or Coupon may be presented for payment under this paragraph falling after the due date. In this Condition "**business day**" means a day on which commercial banks and foreign exchange markets are open for general business in the place of presentation and which is a day on which the TARGET2 System is open.

(f) Paying Agents

The initial Paying Agent and its specified office is listed below. The Republic reserves the right at any time to vary or terminate the appointment of any Paying Agent and to appoint additional or other Paying Agents, **provided that** it will maintain (a) a Fiscal Agent, (b) a Paying Agent having a specified office in at least one major European city and (c) a Paying Agent with a specified office in a European Union Member State 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. Notice of any change in the Paying Agents or their specified offices will promptly be given to the Noteholders in accordance with Condition 13.

7. Taxation

All payments of principal and interest in respect of the Notes and the Coupons by the Republic shall be made without withholding or deduction for, or on account of, any present or future taxes, duties, assessment or governmental charges of whatever nature imposed, levied, collected, withheld or assessed by the Republic or any political subdivision or any authority thereof or therein having power to tax (together "**Taxes**"), unless such withholding or deduction is required by law. If any such withholding or deduction is required by law, the

Republic shall pay such additional amounts as will result in the receipt by the Noteholders and the Couponholders of such amounts as would have been received by them had no such withholding or deduction been required, except that no such additional amounts shall be payable in respect of any Note or Coupon:

(i) 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 or Coupon by reason of having some connection with the Republic other than the mere holding of such Note or Coupon; or

(ii) if such Note or Coupon is surrendered for payment more than 30 days after the Relevant Date, except to the extent that the holder would have been entitled to such additional amounts on surrender of such Note or Coupon for payment on the last day of such period of 30 days; or

(iii) 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

(iv) 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 such Note or Coupon to another Paying Agent in a Member State of the European Union.

In these Conditions, "**Relevant Date**" means the date on which such payment first becomes due or, if the full amount payable has not been received by the Fiscal Agent on or prior to such due date, the date on which the full amount plus any accrued interest having been so received, notice to that effect has been given to the Noteholders in accordance with Condition 13.

Any reference in these Conditions to payments of principal or interest in respect of the Notes and Coupons shall be deemed to include any additional amounts which may be payable under this Condition 7.

8. Events of Default

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

  (i) 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

  (ii) 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

  (iii) the Republic ceases to be a member of the International Monetary Fund (the "**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

  (iv) (i) the acceleration of the maturity (other than by optional or mandatory redemption or other prepayment) of any Public External Indebtedness of the Republic, (ii) 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 (iii) 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

  (v) 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.

(b) 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.

9. Prescription

Claims against the Republic in respect of principal and interest shall become void unless made within a period of ten years, in the case of principal, and five years, in the case of interest, from the appropriate Relevant Date as defined in Condition 7.

10. Replacement of Notes and Coupons

If any Note or Coupon is lost, stolen, mutilated, defaced or destroyed it may be replaced at the specified office of the Paying Agent in Luxembourg, subject to all applicable laws and stock exchange requirements, upon payment by the claimant of the expenses incurred in connection with such replacement and on such terms as to evidence, security, indemnity and otherwise as the Republic may reasonably require. Mutilated or defaced Notes or Coupons must be surrendered before replacements will be issued.

11. Meetings of Noteholders; Modification; and Noteholders' Representative Committee

(a) Convening Meetings of Noteholders

The Fiscal 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 Fiscal 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.

(b) Quorum

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

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

(ii) 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.

(c) Reserved Matters

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

(i) 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;

(ii) 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;

(iii) 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;

(iv) 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 Fiscal Agency Agreement;

(v) to change or waive the provisions of the Notes set out in Condition 2 (*Status*);

(vi) 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;

(vii) 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

(viii) in connection with any proposed exchange, substitution or conversion of the type referred to in paragraph (vii) 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 8 (*Events of Default*).

(d) 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 Fiscal Agency Agreement by a majority of at least:

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

(ii) in the case of a matter other than a Reserved Matter, $66^2/_3$ 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, and all Couponholders.

(e) Written resolutions

In addition, the Fiscal 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 $66^2/_3$ 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, and on all Couponholders.

(f) Manifest error, etc

The Notes, these Conditions and the provisions of the Fiscal Agency Agreement may be amended without the consent of the Noteholders or the Couponholders to correct a manifest error. In addition, the parties to the Fiscal 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.

(g) Notes controlled by the Republic

For the purposes of (a) 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, (b) this Condition 11 and Schedule 3 to the Fiscal Agency Agreement, and (c) Condition 8, 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:

(i) "**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

(ii) "**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.

(h) Noteholders' Representative Committee

(i) 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:

(A) an Event of Default;

(B) 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 8 become an Event of Default; or

(C) 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 (A) 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 (B) voted against such resolution at a meeting of Noteholders duly convened and held in accordance with the provisions of the Fiscal 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 13 as soon as practicable after the notice is delivered to the Republic.

(ii) 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 (ii) (*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.

12. Further Issues

The Republic shall be at liberty from time to time, without the consent of the Noteholders or Couponholders, to create and issue further bonds or notes ranking equally in all respects (or in all respects save for the date and amount of the first payment of interest thereon) and so that the same shall be consolidated and form a single series with the Notes.

13. Notices

All notices to the Noteholders required to be given by these Conditions or the Fiscal Agency Agreement shall be validly given if 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 the Luxembourg Stock Exchange so require, notices will be published in a leading newspaper having general circulation in Luxembourg (which is expected to be the *Luxemburger Wort*) and/or on the website of the Luxembourg Stock Exchange, www.bourse.lu. Any such notice shall be deemed to have been given on the date of such publication or, if published more than once or on different dates, on the first date on which publication is made. Couponholders will be deemed for all purposes to have notice of the contents of any notice given to the Noteholders in accordance with this Condition.

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.

14. Contracts (Rights of Third Parties) Act 1999

No person shall have any right to enforce any term or condition of the Notes under the Contracts (Rights of Third Parties) Act 1999.

15. Governing Law and Jurisdiction

(a) Governing Law

The Notes, Coupons and the Fiscal Agency Agreement, and any non-contractual obligations arising out of or in connection with the Notes, Coupons and the Fiscal Agency Agreement, 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 of the Republic.

(b) Jurisdiction

The Republic irrevocably agrees for the benefit of the Noteholders and the Couponholders that the courts of England are to have jurisdiction to settle any disputes which may arise out of or in connection with the Fiscal Agency Agreement or the Notes and Coupons (including any disputes relating to any non-contractual obligations arising out of or in connection with the Fiscal Agency Agreement or the Notes and Coupons) 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 W1T 6BN 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.

USE OF PROCEEDS

The net proceeds of the issue are estimated to amount to approximately €738,562,500 and will be used for general budgetary governmental purposes.

SUMMARY OF PROVISIONS RELATING TO THE NOTES WHILE IN GLOBAL FORM

The Temporary Global Note and the Permanent Global Note contain provisions which apply to the Notes while they are in global form, some of which modify the effect of the terms and conditions of the Notes set out in this document. The following is a summary of certain of those provisions:

1. Exchange

The Temporary Global Note is exchangeable in whole or in part for interests in the Permanent Global Note on or after a date which is expected to be 17 August 2011 upon certification as to non-U.S. beneficial ownership in the form set out in the Temporary Global Note. The Permanent Global Note will only be exchangeable in whole but not in part (free of charge to the holder) for Notes in definitive form as described below:

(i) if the Permanent Global Note is held on behalf of one or more clearing systems and all of such clearing systems are closed for business for a continuous period of 14 days (other than by reason of holidays, statutory or otherwise) or announce an intention permanently to cease business or do in fact do so; or

(ii) the Notes become due and repayable pursuant to Condition 8.

In any such event, the Issuer shall give notice to the Fiscal Agent and the Noteholders of its intention to exchange the Global Note for definitive Notes on the Exchange Date (as defined below) specified in the notice.

If principal in respect of any Notes is not paid when due and payable, the holder of the Permanent Global Note may by notice to the Fiscal Agent (which may but need not be the default notice referred to in "**Default**" below) require the exchange of a specified principal amount of the Permanent Global Note (which may be equal to or (**provided that**, if the Permanent Global Note is held by or on behalf of a clearing system, that clearing system agrees) less than the outstanding principal amount of Notes represented thereby) for definitive Notes on or after the Exchange Date (as defined below) specified in such notice.

In exchange for the Permanent Global Note, the Issuer will deliver, or procure the delivery of, an equal aggregate principal amount of duly executed and authenticated Notes in definitive form, security printed in accordance with any applicable legal and stock exchange requirements and in or substantially in the form set out in Schedule 1 to the Fiscal Agency Agreement. On exchange of the Global Note, the Issuer will, if the holder so requests, procure that it is cancelled and returned to the holder.

"**Exchange Date**" means a day falling not more than 40 days after that on which the notice requiring exchange is given and on which banks are open for business in the city in which the specified office of the Fiscal Agent is located and, except in the case of exchange pursuant to (i) above, in the cities in which the relevant clearing systems are located.

2. Payments

No payment will be made on the Temporary Global Note unless exchange for an interest in the Permanent Global Note is improperly withheld or refused.

Payments of principal and interest in respect of Notes represented by the Permanent Global Note will be made against presentation for endorsement and, if no further payment falls to be made in respect of the Notes, surrender of the Permanent Global Note to or to the order of the Fiscal Agent or such other Paying Agent as shall have been notified to the Noteholders for such purpose. A record of each payment so made will be endorsed in the appropriate schedule to the Permanent Global Note, which endorsement will be *prima facie* evidence that such payment has been made in respect of the Notes.

3. Notices

So long as the Notes are represented by the Permanent Global Note and the Permanent Global Note is held on behalf of one or more clearing systems, notices to Noteholders may be given by delivery of the relevant notice to the relevant clearing systems for communication by them to entitled accountholders in substitution for publication as required by the Conditions, except that so long as the Notes are listed on the Luxembourg Stock Exchange and the rules of that Stock Exchange so require, notices will also be published in one daily newspaper having general circulation in Luxembourg (which is expected to be the "**Luxemburger Wort**") and/or on the website of the Luxembourg Stock Exchange, www.bourse.lu.

4. Prescription

Claims against the Issuer in respect of principal and interest on the Notes while the Notes are represented by the Permanent Global Note will become void unless the Permanent Global Note is presented for payment within a period of ten years (in the case of principal) and five years (in the case of interest) from the appropriate Relevant Date (as defined in Condition 7).

5. Meetings

The holder of the Global Note will be treated at any meeting of Noteholders as having one vote in respect of each €1,000 in principal amount of Notes for which the Permanent Global Note may be exchanged.

6. Purchase and Cancellation

Cancellation of any Note required by the Conditions to be cancelled following its purchase will be effected by reduction in the principal amount of the Permanent Global Note.

7. Default

The Permanent Global Note provides that the holder may cause the Permanent Global Note or a portion of it to become due and payable in the circumstances described in Condition 8 by stating in the notice to the Fiscal Agent the principal amount of Notes which is being declared due and payable. If principal in respect of any Note is not paid when due and payable, the holder of the Permanent Global Note may elect that the Permanent Global Note becomes void as to a specified portion and that the persons entitled to such portion as accountholders with a clearing system acquire direct enforcement rights against the Issuer under further provisions of the Permanent Global Note executed by the Issuer as a deed poll.

OVERVIEW OF THE REPUBLIC OF CROATIA

Territory and Population

The Republic occupies a total area of 87,661 square kilometres, of which 56,594 square kilometres is land and 31,067 square kilometres is sea. 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.

The most recent CBS census was held in April 2011, data on which will be published later in 2011. According to the previous census held in 2001, as at 31 March 2001, the total population of the five largest Croatian towns is as follows: Zagreb is the largest city in the country, with a population of 779,145, and is considered the 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					
	2007		2008		2009	
Age	People	Per cent. of total	People	Per cent. of total	People	Per cent. of total
	(thousands)		*(thousands)*		*(thousands)*	
Youth (0-14)	687.0	15.5	681.4	15.4	712.5	16.1
Working age (15-64)	2,984.5	67.3	2986.2	67.3	2985.2	67.5
Pensioners (65 and over)	764.9	17.2	767.4	17.3	764.0	17.2
Total	**4,436.4**	**100.0**	**4435.0**	**100.0**	**4425.7**	**100.0**

Source: Croatian Central Bureau of Statistics

The following table sets out a breakdown of population by religious group 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

Croatia is divided among 21 counties including the City of Zagreb as a separate county, 127 towns/cities and 429 municipalities.

History

In October 1918, following the defeat of the Austro-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 Austro-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 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 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 programmes and reforms between 1995 and 2000. Since 2000, following the reform programme 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, 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 European Bank for Reconstruction and Development (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 in 2010 the negotiation process entered the final phase, as discussed below. In April 2009, Croatia acceded to North Atlantic Treaty Organisation ("**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 so that it can draw sums up to a specified amount, usually over a period of 12 to 18 months, to help with short-term balance of payments difficulties. 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. Since 2007, the IMF has conducted routine annual missions to Croatia, as part of the ongoing process of cooperation. Within this framework, the IMF issued its last Staff Report on Croatia in June 2010.

Together with the IMF, the International Bank for Reconstruction and Development (the "**IBRD**" or "**World Bank**") 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's 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) continue 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 January 2010, the Government adopted the 2010-2012 PEP and in January 2011, the Government adopted the 2011-2013 PEP.

In October 2005, the EU Council of Ministers opened the accession negotiations of Croatia with the EU. All chapters of the *acquis communitaire* have now been provisionally closed. Croatia expects to sign the Accession Treaty in the second half of 2011 and to be a member of the EU on 1 July 2013. Prior to becoming a member of the EU, and in accordance with the Constitution, Croatia must receive the backing of the Croatian population by a national referendum. The EU will monitor Croatia's continuing compliance with the *acquis* and the Parliament of each EU member country must ratify Croatia's accession.

Constitution and Government Structure

The Constitution was adopted on 22 December 1990 and was substantially amended in December 1997, November 2000, April 2001 and June 2010. 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. Ivo Sanader was appointed Prime Minister following elections in 2003 and was reappointed following elections in November 2007. In July 2009, 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, the President 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 constitutional duties, the President has the power, at the proposal, and with the countersignature, of the Prime Minister, 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 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	Deputy Prime Minister and Minister of Regional Development, Forestry and Water Management
Đuro Popijač	Minister of Economy, Labour and Entrepreneurship
Domagoj Ivan Milošević	Deputy Prime Minister for Foreign Investment
Slobodan Uzelac	Deputy Prime Minister for Social Issues and Human Rights
Božidar Kalmeta	Minister of the Sea, Transport and Infrastructure
Jasen Mesić	Minister of Culture
Davor Božinović	Minister of Defence
Damir Bajs	Minister of Tourism
Darko Milinović	Deputy Prime Minister and Minister of Health and Social Welfare
Davorin Mlakar	Minister of Public Administration
Gordan Jandroković	Deputy Prime Minister and Minister of Foreign Affairs and European Integration
Dražen Bošnjaković	Minister of Justice
Martina Dalić	Minister of Finance
Branko Bačić	Minister of Environmental Protection, Physical Planning and Construction
Petar Čobanković	Deputy Prime Minister for the Economy and 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**"), comprising of 11 members, 7 of which are selected from amongst judges, 2 from amongst university law professors and 2 from amongst members of the Parliament (among whom one has to be a member of the opposition), for a four-year term and may not serve more than two consecutive terms. Judicial office is permanent. The Council, according to the Constitution and law, decides independently on the appointment, promotion, transfer, dismissal and disciplinary responsibilities of the judges and court presidents, with the exception of the president of the Supreme Court.

The Constitutional Court of Croatia consists of 13 judges who are elected for a term of eight years by the Parliament (by two-thirds majority vote of all representatives) from among notable jurists, especially judges, public prosecutors, lawyers and university professors of law, in a way and within a procedure prescribed by the constitutional act. It has the authority to annul unconstitutional laws or regulations and to decide on jurisdictional questions among the legislature, executive and judiciary, and on whether or not a President should be impeached. 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 added 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. In December 2009, further amendments to the Courts Act were adopted, dealing with, *inter alia,* additional criteria for evaluation of the judges and conditions for appointment of judges. In October 2010, the Courts Act was further amended to conform with recent amendments to the Croatian Constitution. As part of these amendments, the conditions for appointment and dissolution of the judges, as well as of the courts' presidents were removed from the Courts Act and are now covered by the High Judiciary Council Act. The latest amendments to the Courts Act came into force in March 2011 and aim to harmonise the Courts Act with the provisions of the new General Administrative Procedure Act, in particular in relation to parts of the Courts Act dealing with the content of the decision evaluating judges and deadlines for submitting appeals and the appellate procedure.

The Judicial Trainees and Bar Examination Act, passed in July 2008 (and amended in July 2009), 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 Judicial Academy Act was promulgated on 17 December 2009, entered into force on 1 January 2010 and was subsequently amended in November 2010. It 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, and improving the overall efficiency of the judicial system, is another important objective of the judicial reform. According to the European Commission's Interim Report on Reforms in Croatia in the Field of Judiciary and Fundamental Rights released in March 2011 (the "**EU Report**"), from December 2009 to December 2010, Croatia reduced the overall case backlog before the courts by 1.3 per cent., from 795,722 to 785,561 cases. In the same period, the backlog of old criminal cases was reduced by 10.6 per cent. The EU Report pointed out that measures are being put in place to prevent undue delay in court cases, including the gradual introduction of new methods of enforcement, the recruitment of additional judges, court advisors and court clerks in the most overburdened courts, and incentives to judges to ensure the speedy handling of older cases. In addition, the EU Report noted that a track record of implementation of the new criminal procedure has been established and Croatia has continued to implement the rationalisation of municipal and misdemeanour courts, ensuring efficient operation of the merged courts and adopting a plan for rationalisation of county and commercial courts.

One indicator of the success of the judicial reform efforts is the expedited resolution of cases that are more than three years old. According to the EU Report, between December 2009 and December 2010, the backlog of old civil cases pending for three years or more has increased by 3.8 per cent. The EU Report further noted that a convincing track record of implementing the civil procedure code has not yet been established, that the backlog of old enforcement decisions has also increased, and that a number of important courts, including Zagreb and Split, continue to suffer from high case backlogs. Overall, however, the EU Report noted that Croatia improved the efficiency of its judiciary between December 2009 and December 2010.

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 as of late 2009, despite the fact that approximately 1.7 million new cases are filed annually, approximately 890,000 cases in total were pending at all court levels.

In addition, a new enforcement system is intended to improve the judgment enforcement process by making the process more efficient and professional, to be accomplished in part by empowering enforcement officers. The new 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; however, the majority of its provisions will come into effect on 1 January 2012. The new 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 (the majority its provisions will come into effect on 1 January 2012).

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. According to the EU Report, Croatia has established a track record of substantial results based on efficient, effective and unbiased investigation, prosecution and court rulings in organised crime and corruption cases at all levels including high level corruption, and in vulnerable sectors such as public procurement. Also according to the EU Report, the operational capacity of USKOK has been reinforced, and the police have become more effective and a number of high-level corruption cases investigations are underway or indictments have been issued. The EU Report also points out that most high level corruption and public procurement cases have not yet reached the stage of court rulings and that the capacity of the courts to handle cases adequately remains to be fully tested in part due to staffing difficulties. For example, out of 436 posts available at the PNUSKOK, some 20 per cent. remained to be filled as of 31 December 2010.

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.

In June 2010, the anti-corruption office USKOK indicted the former Deputy Prime Minister Damir Polancec for abuse of office and powers. Under the indictment filed with the Zagreb County Court, Polancec was accused of abusing the office and powers between July and October 2008 to help others obtain an illegal gain amounting to approximately HRK 500,000. In October 2010, a Croatian court sentenced Polancec to 15 months in prison for abuse of office and state funds.

In December 2010, former Prime Minister Ivo Sanader was detained by police in Austria at the request of the Croatian authorities as part of an USKOK investigation of alleged fraud and corruption. Sanader remains in custody in Austria pending an extradition hearing. Sanader served as Prime Minister from 2003 to 2009.

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. In November 2009, the Government adopted a Regulation on Office for Central Public Procurement (OG 138/09). 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 harmonisation of the Croatian anti-money laundering and terrorist financing legislation with 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, 74/09 and 153/09), 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 and 153/09), 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), the Regulation on Amendments to the Foreign Exchange Act (OG 153/09), the Act on Amendments to the Foreign Exchange Act (OG 145/10), the Act on Execution over Financial Assets (OG 91/10) and the new Payment System Act (OG 133/09; which came into force on 1 January 2011, with exception of certain provisions that shall enter into force on the day of accession of Croatia to the European Union).

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 27 December 2009, a first round of presidential elections was held and President Ivo Josipović, of the SDP, won 32.42 per cent. of votes, which was not sufficient to win the elections outright. A second round of presidential elections was held on 10 January 2010 between first-round winner President Ivo Josipović and first-round runner-up Milan Bandić, and Mr. Josipović confirmed his leadership with a victory of 60.26 per cent. of votes, becoming the first elected president nominated by the SDP. 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 2015.

Parliamentary Elections

The most recent elections of deputies for the Parliament were held on 25 November 2007. The next parliamentary elections must be held on or before 11 March 2012; the current government has indicated that elections are likely to be held 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. The next elections for the local and regional self-governments are expected to take place in 2013.

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.

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 annual GDP. 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 the Croatian economy;
- introducing a competitive environment and appropriate ownership structure with a reduced role for the Government in the economy;
- protecting 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 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 minimising 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 2.4 per cent. in 2009 on the basis of CPI (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 a 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 Croatian Privatisation Fund (*Hrvatski fond za privatizaciju*) ("**CPF**"). Through the privatisation programme, former and current employees, pensioners and management of the privatised entities acquired part ownership of these entities.

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 "**Privatisation 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 the World Bank. The CPF was created by merging two former agencies: the Agency for Reconstruction and Development and the Croatian Development Fund. The CPF was repealed in March 2011 and replaced with a new Government Agency for State Assets Management ("**AUDI**").

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 sought to dispose 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**"). 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;
- support of 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, as of March 2011, comprised 662 companies with a total equity of HRK 52.4 billion, of which HRK 14.2 billion represented majority State-owned companies. The CPF was a minority owner of 90 per cent. of these companies (601 companies), holding up to 25 per cent. of the shares in 561 companies and from 25 per cent. to 50 per cent. in 40 companies. The CPF held more than 50 per cent. of the shares in 61 companies.

As of March 2011, the portfolio of State majority-owned companies that have not yet been privatised can be broken down by sectors as follows: 20 companies in the industry sector, 14 in the tourism sector, 8 in the agriculture sector and 19 companies in 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 30 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, and in May 2010, in the second round of privatisation, the CPF received a total of four bids for three Croatian shipyards which are being privatised.

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.

Neither the CPF nor the Government anticipates any significant revenues from privatisation efforts to be recognised in the Government's 2011 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 reserved for 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 telephone market.

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 offered to the current and former employees of Croatia Telecom and Croatian Post, out of which 5.9 per cent. were sold, further reducing the ownership of Croatia to 3.6 per cent. In November 2010, the Government transferred its remaining 3.6 per cent. stake to the Pensioners Fund.

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 the prior consent of the Parliament. Some of the remaining shares would be transferred 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. Through a limited public bid in November 2010, MOL further increased its shareholding to approximately 47.3 per cent.

Economic Policy

One of the main objectives of Croatia's economic policy is to continue the process of narrowing the gap between its GDP per capita and the EU average. According to Eurostat estimates, as at 31 December 2009, Croatia's per capita income was approximately 65 per cent. of the GDP per capita of the EU27 countries in purchasing power standards.

The framework and objectives of the economic policy of the Republic of Croatia are defined in a series of strategic documents of the Government of the Republic of Croatia, namely: the Strategic Development Framework for 2006-2013, the Government Programmes Strategy 2010-2012, the Economic and Fiscal Policy Guidelines and the Pre-accession Economic Programme (PEP).

The main objective of Croatia's economic policy in the current macroeconomic environment is to preserve macroeconomic stability and create conditions for recovery and stable economic growth. This year's PEP reflects the set economic policy objective and describes in detail the macroeconomic developments and projections, further direction of the fiscal policy, as well as the key structural reforms in the 2010-2012 period.

In the circumstances of financial restrictions and a declining economic activity the emphasis is put on fiscal policy, which will, within the set framework, aim to achieve the set economic objectives. In this sense, the fiscal policy will be focused on fulfilling the twelve general objectives laid down in the Government Programmes Strategy:

- Macroeconomic and economic stability;
- Optimum environment for the development of a competitive economy;
- Strengthening of the state of law and the rule of law;
- Promoting knowledge, excellence and culture;

- Uniform regional development;
- Strengthening social equality;
- Positioning Croatia as one of the leading European tourist destinations;
- Improving competitiveness in agriculture, the food industry and fisheries;
- Further strengthening the international status of the Republic of Croatia;
- Improving the police and armed forces as the citizens' services;
- Health care, maintaining and improving health; and
- Environmental protection.

Supporting macroeconomic and fiscal policy, the implementation of key structural reforms will be continued in the medium-term in accordance with the priorities of the Government of the Republic of Croatia. With this view, further measures will be taken, aiming at improving the entrepreneurial climate, further improving the financial sector, completing reforms of the public administration, the judiciary reform and combating corruption, and at restructuring and privatisation of dependent sectors. In addition, further measures will be taken aimed at ensuring social fairness and the financial sustainability of the health and social security systems, environment protection, incentives to employment and further development of a knowledge-based society.

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 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 programme focuses 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 programmes and the improvement of emergency medical services. At the request of the Government, the World Bank has agreed to provide a credit line of EUR100 million for exporters through 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. As of 31 December 2010, the World Bank was financing 16 projects in Croatia in a wide range of sectors with loans remaining to be disbursed amounting to approximately US$550 million. The International Finance Corporation's portfolio of investment in Croatia amounts to approximately US$233 million and the Multilateral Investment Guarantee Agency's guarantees relating to projects within Croatia amounted to US$650 million as of 31 December 2010. This represents a decrease in the amount of financing and the number of projects financed compared with prior periods indicating Croatia's reduced need for financing relative to other countries.

Recent Economic Developments and Trends

The effects of the global financial and economic crisis were first felt in Croatia in the second half of 2008 and intensified towards the end of the year. The negative impact of the crisis intensified further in 2009 with the largest GDP decline in the second quarter of 2009. In particular, real GDP growth slowed down from 5.1 per cent. in 2007 to 2.2 per cent. in 2008. The negative impact of the crisis intensified further in 2009 and annual GDP contracted by 6.0 per cent. in 2009. This trend continued in 2010, with annual GDP for 2010 contracting by 1.4 per cent. The third quarter of 2010 exhibited a 0.3 per cent. growth in GDP but this trend was reversed in the fourth quarter. The CBS flash estimate for the first quarter of 2011 indicates a year on year GDP decline of 0.9 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; the reduction in banks' reserve requirement from 17 per cent. to 14 per cent. in December 2008 and further to 13 per cent. in February 2010; the reduction of the minimum required ratio of banks' foreign currency claims to foreign currency liabilities from 28.5 per cent. to 20 per cent.; and the raising of the limit on banks' open foreign exchange position from 20 to 30 per cent. in February 2009, 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 authorised 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 30 June 2010, no Croatian banks have accessed emergency liquidity assistance.
- In the last quarter of 2008 and beginning of 2009, the CNB abolished the marginal reserve requirement, reduced banks' reserve requirements and the prescribed minimum foreign currency liquidity ratio, and increased permitted open foreign currency positions for banks. These measures were further supplemented by the CNB's selling of foreign currency through foreign exchange interventions and by more restrictive management of domestic currency liquidity through regular repo auctions. For additional discussion of measures taken by the CNB in response to the adverse effects of the global financial and economic crisis, see "*Monetary Developments and International Reserves — Monetary Policy and Instruments*".
- 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.
- In January 2010, the Government adopted measures to stimulate economic recovery and development. In particular, the Government adopted two measures ("**Model A**" and "**Model B**") to increase lending in the economy with the active participation of the Government, the CNB, HBOR and commercial banks. Under "Model A", commercial banks are invited to issue loans, part of which are funded by HBOR. Under "Model B", commercial banks are invited to issue loans, part of which are guaranteed by the Government. Approximately HRK 9.0 billion (up to HRK 5.0 billion in "Model A" and up to HRK 4.0 billion in "Model B") of new loans could be extended to the private sector in 2010 through these models. In line with this, in February 2010, the CNB reduced the reserve requirement rate from 14 to 13 per cent. releasing approximately HRK 2.9 billion (of which the majority (HRK 2 billion) was then allocated to HBOR) and was aimed at lending, jointly with commercial banks, to enterprises according to criteria established by the Government ("**Model A**"). By the end of 2010 HRK 2.1 billion of loans had been approved. To stimulate demand for the remaining funds, in January 2011 the Government amended Model A in order to reduce interest rates on loans and relax eligibility conditions.

These measures, together with intermittent intervention by the CNB that 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 depreciation pressures on the Kuna during the beginning of 2009 were followed by the appreciation of the Kuna in the second and fourth quarters of 2009. Overall, the HRK/EUR exchange rate appreciated slightly in 2009, strengthening from HRK 7.32/EUR at the end of 2008 to HRK 7.31/EUR at the end of 2009, but depreciated to HRK 7.39/EUR at the end of 2010.

On 8 March 2011, the CNB announced that approximately EUR 850 million will become available within the Croatian banking system for financing economic projects, based on a reduction in the minimum required ratio of banks' foreign currency claims to foreign currency liabilities from 20 per cent. to 17 per cent. The purpose of this decision, which entered into force on 11 March 2011, is to stimulate investment in new projects that could contribute to improved exports and balance of payments and job creation over the short term. It is expected that manufacturing and tourism will be the main areas where new investment projects will be focused.

Exports of goods and services, based on balance of payments data expressed in EUR, increased by 7.8 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 the 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, excluding other transport equipment and gas exports, as well as oil and refined petroleum products, the rise in exports was negligible. In 2009, exports of goods and services decreased to EUR 16.1 billion, which represented a decrease of 18.9 per cent. as compared to 2008, primarily due to negative developments relating to trade in goods. In general, negative trade developments in 2009 were in line with the observed contraction in world trade as a result of the global economic crisis. More specifically, in 2009 the trade in goods deficit decreased by 31.6 per cent. compared to 2008 as a result of the decrease in imports outpacing the decrease in exports. This is mainly attributable to a decline in the negative trade balance in road vehicles and petroleum and petroleum products (in the case of the latter partially due to price effects) as well as from a surplus in trade in other transport equipment. In 2010, exports of goods and services increased to EUR 17.6 billion (8.9 per cent.), while imports registered a slight decline.

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 primarily due to 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 2009, imports of goods and services decreased by 24.7 per cent. compared to 2008 and amounted to EUR 17.9 billion, primarily as a result of the contraction in domestic demand for imports as a consequence of the global financial and economic crisis. The decrease was principally attributable to the decline in imports of goods, which experienced decreases broadly distributed across all categories, in particular with respect to road vehicles, petroleum and petroleum products. In 2010 total imports declined by 0.6 per cent. in comparison with 2009, mainly as a result of a decrease in the imports of general industry machinery and road vehicles.

The current account deficit widened from EUR 3.2 billion in 2007 to EUR 4.3 billion in 2008, which represented a decrease of 34.0 per cent. The current account deficit reached 9.2 per cent. of GDP in 2008, increasing by 1.6 per cent. of GDP compared to 2007. This increase was principally due to growing imbalances in foreign trade in goods, while strong performance in the services sector, primarily in tourism, helped to offset some of those negative effects. The current transfers account remained unchanged in 2008, while the negative balance in the factor income account further increased. In 2009, the current account deficit decreased by 43.6 per cent. to EUR 2.5 billion (5.5 per cent. of GDP), primarily due to developments relating to trade in goods. In particular, the trade in goods deficit decreased by EUR 3.4 billion, or 31.5 per cent. as compared to 2008, as a result of a decline in imports larger than in exports. The positive effect of the trade in goods deficit contraction on the current account balance was partially offset by decreased net exports of services, which declined by 18.4 per cent. in 2009 compared to 2008, mainly due to decreased tourism revenues. In 2010, the current account deficit narrowed to EUR 0.6 billion as opposed to the deficit of EUR 2.4 billion in 2009, mainly as a result of developments relating to trade in goods.

In 2009, as a result of the global financial and economic crisis, all of the main Croatian high frequency macroeconomic indicators displayed negative trends. The available data from the CBS for 2010 points to a continuation of unfavourable trends but at a slower pace.

In 2009, industrial production declined by 9.2 per cent., as compared to growth of 1.2 per cent. in 2008 and growth of 4.9 per cent. in 2007, according to CBS data. In 2010, industrial production contracted by 1.4 per cent. compared to 2009. In 2009, real turnover in retail trade declined by 15.3 per cent. as compared to a decrease of 0.5 per cent. in 2008 and an increase of 5.3 per cent. in 2007. Real turnover in retail trade contracted by 1.8 per cent. in 2010 compared to 2009. Construction work volume decreased by 6.5 per cent. in 2009, as compared to 2008, whereas in 2010 it recorded an annual decline of 16.4 per cent.

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 2009, total tourist arrivals declined by 2.9 per cent., while the recorded decrease in nights spent was 1.4 per cent. In early 2009, a Tourism Action Plan was initiated by the Government in order to 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. In 2010, tourist arrivals into Croatia increased by 3.2 per cent. from 10.3 million to 10.6 million and the number of nights spent in Croatia increased by 2.6 per cent. from

55.0 million to 56.4 million, in each case compared to the same period in 2009. The data on tourist arrivals and number of nights spent does not include those tourists in ports of nautical tourism. The growth rate in the first eleven months of 2010 has been calculated based on comparable data for 2009, in both cases excluding nautical tourism.

In 2009, the average inflation rate stood at 2.4 per cent. Downward pressures on inflation came from weakened domestic demand, alleviated imported inflation pressures and slower growth of unit labour costs. These downward pressures were to some extent offset by the growth of prices of the products with regulated pricing, such as gas, tobacco products, and medical and hospital services (prices of tobacco products went up due to a rise in excise taxes, while health care prices grew due to the introduction of participation fees for medical and hospital services). These inflation trends continued in 2010, bringing the average annual inflation rate down further to 1.1 per cent. It is expected that inflationary pressures will increase in 2011, in part due to the uptick in internal economic activity and in part due to external factors, including the rise in worldwide commodity and food prices.

The capital and financial account recorded larger net capital inflows in the last quarter of 2008 than in the same period in 2007 primarily due to increased direct investments, especially round-tripping transactions. Additional contribution to total capital inflows came from a decrease in international reserves, which resulted from a change in monetary policy (abolishing the marginal reserve requirement) aimed at improving commercial banks' foreign currency liquidity. Strong foreign borrowing by banks also contributed to the inflow of capital. In 2008, the capital and financial account had 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 amounted to EUR 0.8 billion and was related to the acquisition of 22 per cent. of INA shares by MOL. (This does not take into account two round-tripping transactions, see "*Foreign Trade and International Balance of Payments — Capital and Financial Account*".) 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.

Net inflows of capital on the capital and financial account in 2009 were significantly lower than in 2008 (by 27.1 per cent.) and, excluding the change in international reserves, which amounted to EUR 4.1 billion, almost one third less than in 2008. Specifically, both debt and equity related capital inflows decreased considerably (debt liabilities decreased by 30.1 per cent. and equity liabilities by 59.1 per cent.). Lower debt inflows mostly reflect a decrease in foreign borrowing by domestic companies due to declining economic activity and lower availability of foreign sources of funding during 2009. A significant decrease in direct equity investment reflected the overall uncertainty and risk aversion present in the global financial markets. In addition, the growth in foreign assets also weakened in 2009 as compared to 2008, primarily due to the decreased level of banks' foreign assets as a result of a reduction in the minimum required amount of foreign currency claims. After a decline in 2008, gross international reserves increased by EUR 0.9 billion in 2009.

Capital inflows in 2010 were limited and amounted to EUR 0.04 billion, excluding the change in international reserves. During this period, domestic sectors increased the level of their foreign assets by EUR 0.2 billion and their liabilities by EUR 1.6 billion. Net FDI in 2010 totalled EUR 0.6 billion, approximately one half to that in 2009. Inward FDI decreased by 79 per cent. during 2010, accompanied with 83 per cent. fall in outward FDI. The entire amount of inward FDI related to direct equity investment and retained earnings related to other business activities, financial intermediation, except insurance and pension funds, real estate and retail trade.

Increasing by EUR 5.9 billion in 2008, Croatia's gross external debt exceeded EUR 40.6 billion at the end of December 2008 (85 per cent. of GDP). The increase of debt levels from 2007 was mainly a consequence of strong corporate foreign borrowing, however, this slowed noticeably in the last quarter of 2008. In 2009, external debt continued to rise, but at a slower pace compared to 2008, increasing by EUR 4.6 billion. In 2009, the composition of government debt shifted when, after several years of declining external indebtedness, the Government significantly increased its foreign liabilities, while banks and enterprises recorded much slower debt growth. In 2010, gross external debt increased by EUR 1.2 billion to EUR 46.4 (101 per cent. of GDP).

After deleveraging 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 decrease in February 2009 prompted by the CNB's reduction of the minimum required amount of foreign currency claims, increased in the next three months and then, as is typical in the summer months, started to decrease which continued until December when an increase of EUR 0.8 billion was recorded. Banks' external debt at the end of 2009 amounted to EUR 10.7 billion and was EUR 0.6 billion higher than at the end of 2008. As at 31 December 2010, banks' external debt stood at EUR 10.8 billion, EUR 0.1 billion higher than at the end of December 2009.

The general government external debt attributable to the reclassification of Croatian Motorways in the external debt statistics from the government sector to the other sectors as of January 2008, which led to a one-off decrease in the debt of this sector (EUR 1.2 billion) in January 2008. In contrast to prior years, in 2009 the general government external debt increased significantly (by EUR 1.0 billion) and amounted to EUR 5.7 billion, mostly as a result of two bond issues on the international markets, which was partially offset by the repayment of two maturing Eurobonds. In 2010 the general government external debt increased by EUR 0.9 billion and amounted to EUR 6.6 billion.

External debt of other sectors (mostly enterprises) was the main driver of the mounting external debt in recent years. At the end of 2008, in the midst of the global financial crisis, availability of foreign sources of finance significantly declined, resulting in an external debt stagnation during the last two months of 2008. In 2008, enterprises increased their external debt by EUR 3.9 billion (inclusive of direct debt investment in enterprises), while the reclassification of Croatian Motorways increased the level of other sectors debt by an additional EUR 1.2 billion. Weak economic activity and insecurity regarding any potential recovery of the economy continued to affect corporate demand for foreign funding during 2009. As a result, the growth of corporate foreign borrowing slowed, and the increase in corporate debt amounted to EUR 1.5 billion in 2009 (inclusive of direct debt investment in enterprises). In 2010, enterprises increased their liabilities abroad, both to foreign banks and to parent companies, by EUR 0.3 billion.

Croatia also experienced floods in September 2010 as a result of unusually heavy rainfall, which caused rivers to burst their banks, forced people to leave their homes and damaged public infrastructure, private homes, agriculture and businesses. The Government estimates the total direct damage caused by flooding at approximately EUR 47 million. After applying for assistance from the EU Solidarity Fund, in February 2011 Croatia received EUR 1.17 million to support relief operations by the national, regional and local governments.

Gross Domestic Product

In the beginning of 2009, GDP data for the period from 1995 to the third quarter of 2008 was revised, under the recommendation of the CBS and CNB, in order to bring GDP calculations and estimates more in line with the European System of Accounts (ESA 1995) standard. The GDP calculation by production approach has been improved by including the non-observed economy, the new estimate of rent values for apartments rented and available for rent and the new estimate 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 line with the production side of the GDP revision. The largest revisions were to household consumption, with an average increase of 22.7 per cent. compared to the old calculations, due to revisions to the estimate of rent values for apartments rented and available for rent, allocation of FISIM and the non observed economy. The second largest correction was to the export of tourist services, which now takes into account non observed economy and the allocation of FISIM.

There was an additional data revision published by the CBS in December 2010 due to new and improved data sources and calculation methods used. The revision consists of the following methodological improvements: 1) the inclusion of consumption of fixed capital of government non-market producers; 2) the inclusion of the results of the Economic Accounts for Agriculture into national accounts as a replacement for previously used simple calculations; 3) the valuation of the insurance output in line with ESA 95; 4) the valuation of the output of non-market producers, who satisfy the 50 per cent. rule of ESA 95; 5) the inclusion of the production of software for own account; 6) the verification of the size of cross-border flows of compensation of employees using the number of employees and provision of a correct valuation including taxes and social contributions; and 7) the reviewing of all taxes on production and comparison of VAT assessed with time-adjusted VAT payments. Previous data series have been revised although the revisions for the period after 2007 are still preliminary.

The effect of this statistical revision at the GDP level in nominal terms was an average increase of 0.4 per cent. throughout the whole period from 1995 to 2007. Since better quality and more exhaustive data sources were available for the period from 2000 to 2007, the GDP in nominal terms was corrected upwards by 0.8 per cent. in that period. The greatest positive revision, 1.6 per cent., was recorded in 2006 and the greatest negative revision, 0.5 per cent., in 1998. The largest impact to corrections of GDP had a part that refers to the improvement of the calculation of taxes and new calculation of consumption of fixed capital. On the other hand, the greatest impact to the decrease of GDP was due to a decrease in agricultural production according to the new calculation. The effect of this statistical revision at GDP in real terms ranged between an increase of 0.72 per cent. in 2000 and a decrease of -0.56 per cent. in 2002.

At the end of March 2011, the revised data on the quarterly gross domestic product (GDP) on the basis of minor methodological revision according to new and improved data sources and calculation methods used was released.

The release contains the revised data for the period from the first quarter of 2000 to the fourth quarter of 2010. Data series have been revised according to the annual GDP calculation for the period from 2000 to 2007. Data for the period 2008 to 2010 are preliminary. The main purpose of this revision is the adjustment of GDP estimates with the European System of Accounts (ESA 1995). Therefore, this revision improves the coverage and quality of estimates published to date due to the new data sources and calculation methods used.

The following table sets forth real and nominal GDP amounts, as well as HRK/EUR and HRK/U.S.$ exchange rates, for the periods indicated.

	Year ended 31 December			Three months ended 31 March	
	2008	2009	2010	2010	2011[1]
Nominal GDP (HRK millions)	345,015	335,189	334,564	77,565	—
Real GDP (HRK millions)[2]	249,550	234,599	231,804	54,504	—
Nominal GDP (EUR millions)	47,765	45,669	45,917	10,647	—
Nominal GDP per capita (EUR)	10,771	10,311	10,367	2,404	—
Real GDP growth (per cent.)	2.2	(6.0)	(1.4)	(0.9)	—
HRK/EUR exchange rate (average for the period)	7.22	7.34	7.29	7.29	7.40
HRK/U.S.$ exchange rate (average for the period)	4.93	5.28	5.50	5.26	5.42

Source: Central Bureau of Statistics and Croatian National Bank

(1) Constant previous year prices, reference year 2000.

(2) Flash estimate of real GDP growth.

The following table sets forth GDP real growth rates of various sectors of the economy for the periods indicated.

	Year ended 31 December			Three months ended 31 March	
	2008	2009	2010	2010	2011[1]
			(per cent.)		
Households	0.8	(8.5)	(0.9)	(4.0)	—
Government	1.9	0.2	(0.8)	(1.1)	—
Gross fixed capital formation	8.2	(11.8)	(11.3)	(13.9)	—
Exports of goods and services	2.2	(17.3	6.0	2.8	—
Imports of goods and services	3.3	(20.4)	(1.3)	(4.8)	—
Change in overall GDP for the period	**2.2**	**(6.0)**	**(1.4)**	**(2.3)**	**(0.9)**

Source: Central Bureau of Statistics

(1) Flash estimate of real GDP growth.

The following table sets forth the annual and quarterly GDP by expenditure:

	Final Consumption Expenditure		Gross Fixed capital formation	Exports of goods and services	Imports of goods and services	Gross domestic product (market price)
	Households	Government				
			(per cent.)			
2000	3.4	(1.8)	(3.9)	11.9	3.6	3.8
2001	4.7	(5.3)	7.0	8.8	10.7	3.7
2002	8.2	4.5	14.1	1.1	13.6	4.9
2003	3.9	2.1	24.6	11.6	12.1	5.4
2004	4.2	3.4	5.1	5.4	4.9	4.1
2005	4.1	2.1	4.9	3.5	4.2	4.3
2006	3.2	4.5	11.1	5.8	8.3	4.9
2007	6.3	5.6	7.1	3.7	6.2	5.1
2008	0.8	1.9	8.2	2.2	3.3	2.2
2009	(8.5)	0.2	(11.8)	(17.3)	(20.4)	(6.0)
2010	(0.9)	(0.8)	(11.3)	6.0	(1.3)	(1.4)
2000						
First quarter	5.7	1.2	(5.9)	6.9	1.3	4.3
Second quarter	5.7	(2.4)	(3.3)	14.0	3.3	4.8
Third quarter	0.2	(2.6)	(1.0)	17.4	6.0	4.3
Fourth quarter	2.2	(3.2)	(5.6)	5.6	3.7	1.6

	Final Consumption Expenditure: Households	Final Consumption Expenditure: Government	Gross Fixed capital formation	Exports of goods and services	Imports of goods and services	Gross domestic product (market price)
			(per cent.)			
2001						
First quarter	5.6	(3.8)	9.8	4.7	12.9	3.0
Second quarter	7.1	(5.3)	5.2	2.7	17.0	4.8
Third quarter	1.4	(8.2)	1.0	14.4	7.3	4.1
Fourth quarter	4.6	(4.1)	13.3	9.2	6.4	2.6
2002						
First quarter	8.0	2.1	11.7	(0.9)	12.7	4.2
Second quarter	7.5	3.7	11.7	7.6	9.8	3.3
Third quarter	8.8	6.8	20.4	(1.2)	16.8	6.3
Fourth quarter	8.7	5.8	12.5	0.2	15.2	5.6
2003						
First quarter	4.7	3.7	23.2	15.4	11.0	6.0
Second quarter	4.1	3.1	26.9	9.6	10.4	6.6
Third quarter	3.3	0.8	26.1	9.9	12.4	4.7
Fourth quarter	3.4	0.7	21.8	13.7	14.4	4.3
2004						
First quarter	3.5	2.1	9.4	6.3	7.9	4.6
Second quarter	4.0	4.4	8.5	3.8	8.4	4.4
Third quarter	4.8	3.9	1.4	5.8	3.6	3.7
Fourth quarter	4.4	3.1	1.8	5.7	0.6	3.8
2005						
First quarter	3.1	0.9	0.4	0.0	2.7	2.0
Second quarter	5.0	2.1	3.3	5.7	7.1	4.9
Third quarter	1.6	2.3	5.9	3.8	1.8	4.9
Fourth quarter	3.6	3.1	10.0	3.7	4.8	5.1
2006						
First quarter	3.4	3.0	18.2	13.0	17.4	6.5
Second quarter	1.8	4.1	8.6	4.2	5.8	4.0
Third quarter	3.7	4.0	9.6	1.0	5.6	4.8
Fourth quarter	4.0	6.8	9.6	10.1	5.9	4.6
2007						
First quarter	7.5	5.3	11.19	1.0	4.0	6.8
Second quarter	6.6	5.0	6.4	6.9	6.3	5.9
Third quarter	6.4	6.6	6.3	5.3	7.9	4.2
Fourth quarter	4.9	5.4	4.5	0.1	6.5	3.5
2008						
First quarter	4.4	0.0	9.9	3.2	7.1	4.1
Second quarter	2.4	3.2	12.6	4.4	7.8	3.3
Third quarter	0.3	1.4	6.6	2.5	6.2	1.4
Fourth quarter	-3.4	3.1	3.4	(1.5)	(7.5)	0.0
2009						
First quarter	(9.9)	3.9	(12.4)	(13.9)	(20.7)	(6.7)
Second quarter	(9.5)	1.1	(12.7)	(21.0)	(24.1)	(6.9)
Third quarter	(6.9)	(0.6)	(10.5)	(19.7)	(23.4)	(5.7)
Fourth quarter	(7.4)	(3.3)	(11.3)	(11.8)	(12.2)	(4.6)
2010						
First quarter	(4.0)	(1.1)	(13.9)	2.8	(4.8)	(2.3)
Second quarter	(2.5)	(1.8)	(13.4)	6.9	(4.9)	(2.3)
Third quarter	1.9	(0.9)	(9.5)	4.1	3.4	0.3
Fourth quarter	1.2	0.6	(8.0)	10.8	1.1	(0.6)

In 2008, mainly due to the global financial and economic crisis, GDP growth amounted to 2.2 per cent., decelerating by 2.9 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 of 3.3 per cent. in 2008, the lowest since 1999. Exports of goods and services rose by 2.2 per cent. primarily because of the downward trend in foreign demand in the second half of 2008 and the decrease in revenue from exports. The main driver of the 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 contributing to this were decreasing consumer confidence, a decrease in real net wage growth and a 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 weakening domestic demand.

In 2009, mainly as a result of the continuation of the global financial crisis that commenced in the second half of 2008, GDP contracted by 6.0 per cent. in real terms, which represented a decrease of 8.2 per cent. in GDP compared to 2008, when GDP grew by 2.2 per cent. When observing the breakdown of GDP by expenditure in 2009, all categories except for government consumption recorded year-on-year real declines. Imports of goods and services recorded the largest decrease in 2009 (20.4 per cent.) as a result of severe contraction in domestic demand. Due to a sharp decline in foreign demand for domestic goods and services, exports of goods and services declined by 17.3 per cent. in 2009. Shrinking domestic and foreign demand, a general deterioration of business climate, decreased capital availability and high financing costs were some of the key factors leading to the decrease of 11.8 per cent. in gross fixed capital formation in 2009. Personal consumption, which was the main driver of economic growth in most of the years preceding the global financial and economic crisis, recorded a decline of 8.5 per cent. in 2009. This decline was largely driven by a sharp fall in consumer confidence which was already noticeable in the second half of 2008 and was reflected mainly through postponement of purchases of more expensive durable consumer goods. A decreasing propensity to consume also closely correlated with unfavourable developments in the capital markets which led to a decrease in the value of households' financial assets. The other significant factors contributing to the decline in personal consumption in 2009 were the decreases in real net wage and in the real amount of granted consumer loans. In addition, increasing payment obligations on existing loans to households due to rising interest rates had a negative impact on household consumption. The effect on weakening domestic demand of government consumption, the only component with a positive growth in 2009 (0.2 per cent.), was negligible.

In 2010, real GDP fell by 1.4 per cent. year-on-year, as a result of the continuing global financial crisis and spillover effects on domestic demand. On the expenditure side, gross fixed capital formation was the category which fell the most in 2010, posting a decline of 11.3 per cent. in real terms. Goods and services imports which fell by 0.8 per cent. in real terms, personal consumption fell by 0.9 per cent. in real terms and government consumption fell by 1.3 per cent. in real terms. With a 6.0 per cent. year-on-year growth in real terms, goods and services exports were the only category which grew year-on-year in real terms in 2010.

Gross Value Added

GVA in real terms declined by 4.1 per cent. in 2009, decelerating by 6.9 percentage points as compared to 2008 when it grew by 2.8 per cent. This decline was largely attributable to the real GVA decrease in the wholesale and retail trade sector and the mining, quarrying, manufacturing, electricity, gas and water supply sectors. The GVA dynamics and trends in 2009 are primarily due to the negative effects of the global financial and economic crisis.

Negative GVA trends continued in 2010 and real GVA declined by 1.7 per cent. Nominal GVA decreased from HRK 335,189 million in 2009 to HRK 334,564 million in 2010.

The nominal GVA decrease in 2010 was due to nominal year-on-year GVA decreases in: construction by 16.4 per cent.; transport, storage and communication by 2.4 per cent.; in wholesale and retail trade; repair of motor vehicles motorcycles and personal and household goods by 1.2 per cent.; and in public administration and defence, compulsory social security, education, health and social work, other community, social and personal services and activities of households by 1.0 per cent. The activities which recorded a year-on-year increase of nominal GVA by 0.1 per cent. are financial intermediation, real estate, renting and business activities.

The following table sets forth nominal GVA in current prices of various sectors[1] for the periods indicated:

	Year ended 31 December					
	2007	2008	2009		2010	
	(HRK millions)	*(HRK millions)*	*(HRK millions)*	*(per cent. of total)*	*(HRK millions)*	*(per cent. of total)*
Agriculture, hunting, forestry and fishing	13,217	15,333	15,745	5.4	15,902	5.5
Mining and quarrying, manufacturing, electricity, gas and water supply	53,572	57,855	53,337	18.4	54,791	19.0
Construction	20,955	24,716	23,241	8.0	19,268	6.7
Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods	34,897	36,626	32,136	11.1	31,939	11.1
Hotel and restaurants	11,590	12,562	12,619	4.3	12,868	4.5
Transport, storage and communications	21,813	22,639	21,484	7.4	21,034	7.3
Financial intermediation, real estate, renting and business activities	68,094	74,682	77,980	26.8	78,720	27.3
Other[3]	46,996	51,673	54,107	18.6	53,834	18.7
Total GVA	**271,134**	**296,086**	**290,647**	**100.0**	**288,356**	**100.0**

Source: Central Bureau of Statistics

(1) The data on GVA for groupings of activities (sectors) have been obtained by summing up the figures of corresponding individual activities.

(2) The annual data on GDP and GVA calculation for the year 2007 have been revised while the annual data for the years 2008, 2009 and 2010 have not yet been revised.

(3) 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 real GVA[1] in constant previous year prices, reference year 2000, for the periods indicated:

	Year ended 31 December					
	2007[2]	2008	2009		2010	
	(HRK millions)	*(HRK millions)*	*(HRK millions)*	*(per cent. of total)*	*(HRK millions)*	*(per cent. of total)*
Agriculture, hunting, forestry and fishing	10,834	11,192	11,438	5.7	11,420	5.8
Mining and quarrying, manufacturing, electricity, gas and water supply	45,300	45,889	41,638	20.8	40,976	20.8
Construction	14,080	15,278	14,340	7.2	11,989	6.1
Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods	31,038	30,953	26,525	13.2	26,197	13.3
Hotel and restaurants	8,773	8,969	8,707	4.3	8,703	4.4
Transport, storage and communications	20,347	21,348	19,963	10.0	19,483	9.9
Financial intermediation, real estate, renting and business activities	38,678	40,007	40,511	20.2	40,816	20.7
Other[3]	33,677	34,408	34,767	17.3	34,724	17.6
Total GVA	**203,394**	**209,030**	**200,462**	**100.0**	**196,958**	**100.0**
Taxes minus subsidies on products	**47,174**	**48,928**	**44,542**	**—**	**46,207**	**—**
GDP	**250,568**	**257,958**	**245,004**	**—**	**243,165**	**—**

Source: Central Bureau of Statistics

(1) The data on GVA for groupings of activities (sectors) have been obtained by summing up the figures of corresponding individual activities.

(2) The annual data on GDP and GVA calculation for the year 2007 have been revised while the annual data for the years 2008, 2009 and 2010 have not yet been revised.

(3) 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[1] for the periods indicated:

	Year ended 31 December			
	2007[2]	2008	2009	2010
	(per cent.)			
Agriculture, hunting, forestry and fishing	(3.6)	3.3	2.0	(0.2)
Mining and quarrying, manufacturing, electricity, gas and water supply	5.5	1.3	(9.3)	(1.6)
Construction	3.8	8.5	(6.1)	(16.4)
Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods	6.0	(0.3)	(14.3)	(1.2)
Hotel and restaurants	10.8	2.2	(2.9)	(0.1)
Transport, storage and communications	6.3	4.9	(6.5)	(2.4)
Financial intermediation, real estate, renting and business activities	7.0	3.4	1.3	0.8
Other[3]	1.6	2.2	1.0	(0.1)
Total GVA growth	**4.9**	**2.8**	**(4.1)**	**(1.7)**

Source: Central Bureau of Statistics

(1) The data on GVA for groupings of activities (sectors) have been obtained by summing up the figures of corresponding individual activities.

(2) The annual data on GDP and GVA calculation for the year 2007 have been revised while the annual data for the years 2008, 2009 and 2010 have not yet been revised.

(3) 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

As a result of the uncertain economic climate, the growth rate of GVA in agriculture, hunting, forestry and fishing sector declined from 2.2 per cent. in 2009 to -0.2 per cent. in 2010 representing 5.8 per cent. of total GVA measured in constant prices.

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

As a result of increased resource demands due to an increase in exports, the rate of negative growth in GVA in the mining and quarrying, manufacturing, electricity, gas and water supply sector decelerated, from -9.3 per cent. in 2009 to -1.6 per cent. in 2010, representing 19.0 per cent. of total GVA, measured in current prices, which is an increase by 0.6 percentage points when compared to 2009.

In 2009, GVA in the mining and quarrying, manufacturing, electricity, gas and water supply sector measured in current prices, increased by 2.7 per cent, from HRK 53.3 billion in 2009 to HRK 54.8 billion in 2010.

Real GVA in the mining and quarrying, manufacturing, electricity, gas and water supply sector declined by 1.6 per cent. in 2010 as compared to 2009. The reason for the decrease was the decline in demand as a result of the global economic crisis.

Construction

In 2010 GVA in the construction sector experienced negative growth at an annual rate of -16.4 per cent., compared with a negative growth of -6.1 per cent. in 2009. This negative development was due, in part, to the fact that the construction sector tends to be a lagging sector; it therefore manifested the impact of the global economic crisis later than other sectors in the Croatian economy; it also reflects the slowdown in construction that resulted from a decrease in construction investment and the suspension of construction projects as a result of the global financial crisis.

In 2010 the share of GVA in the construction sector in total GVA, measured in current prices, stood at 6.7 per cent., which is a decrease of 1.3 percentage points compared to 2009 (when it stood at 8.0 per cent.).

GVA in the construction sector measured in current prices decreased by 17.1 per cent. year-on-year in 2010 (from HRK 23.2 billion in 2009 to HRK 19.3 billion in 2010). Unfavourable financial and economic conditions were the main contributing factors to these developments, as the sharp decrease in demand for both residential and commercial real estate as well as the excess supply in the real estate market, resulted in a decrease in private sector investment in construction activity. In addition, deteriorating conditions in domestic and foreign financial markets limited the availability of financing for capital projects. The decline in construction activity of the public sector, in particular, largely reflects decreasing activity relating to the construction of road infrastructure.

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

The rate of negative growth of GVA in the wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods sector decreased in 2010 to -1.2 per cent., compared to-14.3 per cent. in 2009. The negative growth in both periods was driven by the declining employment rate, disposable income and loan availability; however, these trends were less pronounced in 2010, contributing to a lower rate of negative growth.

GVA in wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods sector measured in current prices, decreased by 0.6 per cent. from HRK 32.1 billion in 2009 to HRK 31.9 billion in 2010, representing 11.1 per cent. share of total GVA.

Hotel and restaurants

As a result of an increase in foreign demand for tourist services, the negative GVA rate in the hotel and restaurants sector decelerated, from -2.9 per cent. in 2009, to -0.1 per cent. in 2010, representing a 4.5 per cent. share of total GVA measured in current prices, which is an increase of 0.2 percentage points compared to 2009 (when it stood at 4.3 per cent.).

Transport, storage and communications

As a result of the relative improvements in the outlook for the overall economy, the negative growth rate in the GVA in the transport, storage and communications sector was lower decelerated in 2010 to -2.4 per cent., compared with -6.5 per cent. in 2009, representing 7.3 per cent. share of total GVA measured in current prices.

GVA in the transport, storage and communications sector, measured in current prices, recorded a decline of 2.1 per cent. from HRK 21.5 billion in 2009 to HRK 21.0 billion in 2010.

Financial intermediation, real estate, renting and business activities

In 2010 GVA in the financial intermediation, real estate, renting and business activities sector experienced growth at an annual rate of 0.8 per cent., compared with a growth rate of 1.3 per cent. in 2009. The deceleration in the growth rate was due, in part, to the fact that components of this sector, such as real estate and renting, are lagging indicators and experienced some of the impacts of the global economic crisis later than other sectors in the Croatian economy.

The financial intermediation, real estate, renting and business activities sector represented 27.3 per cent. of total 2010 GVA measured in current prices, which is an increase of 0.5 percentage points compared to 2009.

Other Sectors

In 2010 GVA in the other sectors, a category which contains public administration and defence, compulsory social security, education, health and social work, other community, social and personal services and activities of households, experienced negative growth of -0.1 per cent., representing 18.7 per cent. of total GVA measured in current prices.

GVA in current prices in the remaining sectors, which include public administration and defence, compulsory social security, education, health and social work, other community, social and personal services and activities of households, decreased by 0.5 per cent. from HRK 54.1 billion in 2009 to HRK 53.8 billion in 2010.

Inflation and Trends in Prices

Inflation in Croatia is measured by a CPI and a PPI. The CPI is based on the price of a basket of approximately 740 goods and services weighted according to the Household Budget Survey and retail sales data. The PPI is based on a basket of approximately 400 industrial products. Unlike the CPI, the PPI does not take into account services. Standards for calculating CPI and PPI in Croatia are materially in line with the standards used for calculating the CPI and the PPI in the EU.

Price stability has consistently been the primary objective of the CNB's monetary policy. The CNB's main strategy for achieving price stability has been to attempt to maintain a relatively stable HRK/EUR exchange rate.

The following table sets forth the average annual rate of inflation, as measured by the CPI and the PPI, for the periods indicated.

	Year ended 31 December				
	2006	**2007**	**2008**	**2009**	**2010**
			(per cent.)		
CPI	3.2	2.9	6.1	2.4	1.1
PPI	2.9	3.4	8.3	(0.4)	4.3

Source: Central Bureau of Statistics

The average annual rate of inflation as measured by the 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 in the CPI that would result if the level of the CPI reached in the last month of a given year (for example 2007) remained constant throughout the following year (2008). This is equivalent to the percentage difference between the level of the 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 the given year (that is, 2007) only. When the level of the CPI in the last month of the given year is above its average level for that year, the carry-over effect on annual average growth in the following year (in the example, 2008) is positive. Conversely, the carry-over effect is negative when the level of the CPI at the end of the given year 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 the following year on the basis of developments in the given year. The actual annual average growth rate observed in the following year will then be the combination of the carry-over effect and growth developments in the course of that year.

The surge in the CPI peaked in July 2008 when its annual rate of change reached 8.4 per cent. The annual rate of change of the 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 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 pressures. 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 commodity prices recorded a large increase in 2008 compared to 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 higher 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 compared to 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.

Declines in inflation, which commenced in the second half of 2008, continued throughout 2009. The average annual inflation rate decreased from 6.1 per cent. in 2008 to 2.4 per cent. in 2009. Several factors contributed to downward pressures on prices, including weakened domestic demand for goods and services, reduced inflation pressures stemming from prices of imports and slower growth of unit labour costs. These downward pressures were to some extent offset by the growth in prices of subsidised products, such as gas, tobacco products, and medical and hospital services. The carry-over effect on annual inflation growth in 2009 was only 0.2 percentage points due to a decrease in consumer prices in the second half of 2008 following their strong growth in the first half of the year, spurred by a sharp increase in the prices of crude oil and other raw materials in the world market. In contrast, the carry-over effect on annual inflation growth in 2008 was much higher, standing at 3.3 percentage points. Industrial producer prices followed a trend similar to general inflation, decreasing at an even faster pace as their average annual rate of change decreased from 8.3 per cent. in 2008 to 0.4 per cent. in 2009.

Inflation in Croatia in 2010 was low and stable, the average annual CPI inflation rate dropped to 1.1 per cent. from 2.4 per cent. in 2009, due to the decrease in the rate of change in food prices and prices of industrial products, excluding food and energy. Such trends occurred in conditions of weak domestic demand and unit labour costs, as employment decreased more than production, while compensation per employee dropped on an annual basis. Furthermore, the implicit deflator of imports of goods and services was negative in the first half of 2010, despite the rise in raw material prices, which had a positive impact on domestic inflation. In 2010, consumer price inflation trends were also influenced by the base-period effect as the impact of the substantial increase in administratively regulated prices (gas, tobacco products, health care and hospital services) in the same period of 2009 disappeared. Nevertheless, low annual rates of change in producer prices of durable and non-durable consumer goods confirm that producers refrained from transferring the price increases in energy and other raw materials to consumers. Instead, they adjusted to higher import costs by reducing other costs and/or their profit margins.

The increase in world prices of raw materials affected developments in particular components of the CPI. Prices of energy (in particular, refined petroleum products and gas) provided the largest contribution to the overall annual inflation rate in 2010. The annual rates of change in prices of food products also began to grow in mid-year, mostly due to the rise in world prices of food raw materials (in particular, cereals, oilseeds and sugar) and energy products.

Consumer price inflation in Croatia increased during the first four months of 2011. This was mainly due to external pressures, including increases in prices of food raw materials, energy products and other raw materials on the global market. Inflationary trends were mitigated by poor domestic demand and unfavourable trends on the domestic labour market. The overall annual CPI inflation rate increased from 1.8 per cent. in December 2010 to 2.4 per cent. in April 2011. The largest contribution to this rise came from an increase in the annual rate of change in the prices of processed food products whose annual growth rate in April reached 5.9 per cent., which is 6.0 percentage points higher than last year's average. In addition, a growth in tobacco product prices was also recorded during the observed period as a result of the delayed effect of increasing excise taxes on cigarettes in 2010 and increases in the producer prices of tobacco. Although energy prices rose during the first four months of 2011 as a result of increases in the prices of petroleum products resulting from a noticeable rise in world crude oil prices, their annual growth slowed to 6.6 per cent., which is 2.9 percentage points lower than the average recorded in 2010.

After being relatively stable and moving around 3 per cent. during 2006 and 2007, industrial producer prices increased considerably during 2008. Their annual rate of change went up from 5.9 per cent. in December 2007 to 11.8 per cent. in July 2008 and dropped to 4.3 per cent. in December 2008. The highest growth among industrial producer prices in the first seven months of 2008 was recorded by energy and intermediate goods prices. These developments resulted from the growth in the prices of crude oil and other raw materials in the world market. However, imported inflationary pressures started to ease at mid-July, which was a result of a break in the upward trend of world raw material prices.

Developments in industrial producer prices during 2009 were influenced by the economic slowdown and reduced cost pressures. The annual rate of change in these prices fell from 4.3 per cent. in December 2008 to 1.6 per cent. in December 2009, decreasing mainly between January and October 2009. The annual rate of change in producer prices increased in the last quarter of 2009, primarily on account of a sharp increase in energy prices due to an unfavourable base effect related to world crude oil prices plummeting in the last quarter of 2008. Producer prices continued to rise during the first several months of 2010 due to an energy price increase. In the middle of the second quarter, the rising trend in producer prices stopped and their annual growth rate dropped from 5.0 per cent. in March to 3.3 per cent. in August. The rest of 2010 was marked by a sharp increase in world commodity prices, resulting in an increase in the annual rate of change in producer prices to 5.7 per cent. in December 2010. In April 2011 this rate increased to 7.5 per cent. primarily on account of a sharp increase in the annual growth in non-durable consumer goods prices and intermediate goods prices reflecting a further increase in food and other raw material prices on the world market.

Looking at historical trends it can be concluded that producer price inflation is more volatile than consumer price inflation and that its trends reflect world market developments more closely. This is also evident in the data for the past few months, which show increases in the annual producer price inflation that can be linked to pressures stemming from an increase in world commodity prices. The industrial producer price index is an important short-term indicator of the business cycle that shows price changes in the industrial sector. It may also indicate inflationary changes before they reach consumers. Nevertheless, from the viewpoint of monetary policy, relatively greater importance is given to CPI which measures changes in prices of goods and services acquired, used or paid over time by reference to population (private households) for consumption purposes.

Government Subsidies

The Government maintains a direct subsidy programme for certain large industries such as agriculture the Croatian railways in particular. The following table sets out Government subsidies in real prices for the periods indicated:

Industry	Year ended 31 December 2007	2008	2009	2010
	(HRK thousands)			
Croatian railways	1,655,700	1,727,348	1,411,774	1,524,580
Agriculture	3,063,343	3,228,520	3,513,902	3,542,820
Shipyards and shipbuilding	390,920	394,928	311,442	32,008
HBOR	300,000	146,000	215,000	250,000
Other industries[(1)]	1,082,047	1,362,717	637,347	639,261
Total subsidies	**6,492,010**	**6,859,512**	**6,089,465**	**5,988,669**

Source: Ministry of Finance

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

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

Industry	Year ended 31 December			
	2007	2008	2009	2010(1)
	(per cent.)			
Croatian railways	0.52	0.50	0.42	0.46
Agriculture	0.96	0.94	1.05	1.06
Shipyards and shipbuilding	0.12	0.11	0.09	0.01
HBOR	0.09	0.04	0.06	0.07
Other industries(2)	0.34	0.39	0.19	0.19
Total subsidies	**2.04**	**1.99**	**1.82**	**1.79**

Source: Ministry of Finance

(1) Based on preliminary CBS data.

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

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 2004. 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 the Republic of Croatia, the Environment and Energy Efficiency Fund, Vodovod i kanalizacija d.o.o., Split (a 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 EBRD, the IBRD, the CEB and the European Investment Bank ("**EIB**").

Infrastructure Development Projects

In the period between 2006 and 2009, the average share of capital investments on a consolidated government level accounted for approximately 5.0 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 2011 Budget anticipates that capital investment projects will account for 3.9 per cent. of GDP, which represents an increase from 2010, when capital investment projects accounted for approximately 3.7 per cent. of GDP (based on preliminary data).

Between June and December 2008, approximately 41.5 kilometres of new motorways were opened, including the A1 Zagreb-Split-Ploce, Sestanovac-Zagvozd, Zagvozd-Ravca, A4 Zagreb-Gorican and A6 Zagreb-Rijeka sections of the motorway. In addition, the Government completed approximately 36.9 km of widening of existing roads. In June 2010, approximately 28 kilometres of the full profile of section Kanfanar-Pula of Istrian Epsilon was opened. With additional works completed in June 2011, a full profile of section Pula-Umag of Istrian Epsilon is now open for traffic. Future infrastructure priorities for the Government, which may be developed and financed in partnership with the private sector, include the modernisation of the Zagreb airport and construction of a hydroelectric power plant in the Dubrovnik area.

Employment

Unemployment in Croatia consistently decreased during the years 2005 through and including 2008. The average registered unemployment rate reached 13.2 per cent. of the population of working age citizens in 2008, as the adverse effects of the global financial and economic crisis spilled over to the labour market. The average number of registered unemployed persons on the Croatian Employment Service ("**CES**") register in 2009 increased by 26,433 persons, or 11.2 per cent., as compared with 2008, as the number of persons registering with the CES increased and the number of persons coming off the register decreased. The average registered unemployment rate (the proportion of registered unemployed in the labour force) in 2009 amounted to 14.9 per cent., up from 13.2 per cent. in 2008.

The year-on-year increase in the number of registered unemployed persons (in relative terms), which commenced in February 2009 and accelerated throughout 2009, reached its peak in January 2010, when the year-on-year growth in the number of registered unemployed persons stood at 21.7 per cent., and has been decreasing since. In December 2010, the average number of registered unemployed persons amounted to 319,845 which is an increase of 28,300 or 9.7 per cent. compared to December 2009. In 2010, the average number of registered unemployed persons stood at 302,425 which represents a year-on-year increase of 39,251 persons or 14.9 per cent. (compared with the average figure for 2009 of 263,174). The average unemployment rate increased from 14.9 per cent. in 2009 to 17.6 per cent. in 2010.

The following table sets forth the unemployment rate calculated under International Labour Organisation ("**ILO**") methodology for the periods indicated.

	Year ended 31 December			
	2007	**2008**	**2009**	**2010**
ILO unemployment rate	9.6	8.4	9.1	11.8

The following table sets forth the unemployment rate calculated under the registered unemployment methodology for the periods indicated.

	Year ended 31 December		
	2008	**2009**	**2010**
	(average for the period, in per cent.)		
Registered unemployment rate	13.2	14.9	17.6

The key difference between the ILO unemployment methodology and the "registered unemployment" methodology is that while the latter uses official data on persons who have registered as unemployed with CES, the ILO methodology uses labour force surveys and does not count as unemployed persons who are actually employed (for example, in seasonal or shadow-economy jobs) but have registered as unemployed.

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

	Year ended 31 December			
	2007	2008	2009	2010
	(average for the period)			
Total employed persons	1,516,909	1,554,805	1,498,784	1,418,779
Total unemployed	264,446	236,741	263,174	302,425
Rate of unemployment (per cent.)(1)	14.8	13.2	14.9	17.6
GDP per employee (HRK)(2)	209,840	221,902	223,641	235,811
GDP per employee (EUR)(2)	28,604	30,721	30,471	32,364

Source: Central Bureau of Statistics and Croatian Employment Service

(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) The annual data on GDP calculation for the year 2007 have been revised while the annual data for the years 2008, 2009 and 2010 have not yet been revised.

The data presented in this section does not reflect ESA95.

In 2009, the average number of employed persons was 1,498,784, a decrease of 56,021 or 3.6 per cent. when compared to 2008. Towards the end of 2009, the year-on-year decline in employment became more pronounced. Consequently, at the end of 2009, the number of employed persons was 1,450,039, which represents a decrease of 93,839 as compared to the end of 2008. In 2010 the average number of employed persons decreased to 1,418,779.

In 2009, due to the effects of the global financial and economic crisis, employment declined on a year-on-year basis in almost all activities (according to the National Classification of Economic Activities, ("**NCEA 2007**"). The largest contributions to the average annual decrease in total employment in 2009 resulted from the following sectors: wholesale and retail trade, repair of motor vehicles and motorcycles (a decrease of 18,659 jobs or 8.4 per cent. on average), manufacturing (a decrease of 16,103 jobs or 6.5 per cent. on average), accommodation and food service activities (a decrease of 3,827 jobs or 7.6 per cent. on average) and construction (a decrease of 3,282 jobs or 3.0 per cent. on average). Due to the fact that negative developments in the real estate sector spilled over to the construction activity sector with a delay, unlike industry and trade, the increase in layoffs in the construction activity sector was more pronounced in the second half of 2009. On the other hand, employment in the public administration sector (including public administration and defence; compulsory social security, education, human health and social work activities) rose (43,111 jobs or 1.3 per cent.), partly offsetting the negative contribution of the private sector.

In 2010, employment had declined, as compared with 2009, in all activities except: administration and support services; education; and human health and social work. The largest contributions to the average decrease in total employment from November 2009 to November 2010 were from the following sectors: construction (a decrease of approximately 14,500 jobs, or 14.3 per cent.), wholesale and retail trade, mining and quarrying (a decrease of approximately 10,800 jobs, or 4.8 per cent.), and repair of motor vehicles and motorcycles (a decrease of approximately 10,000 jobs or 5.1 per cent.). Increases in employment were seen in: education (an increase of approximately 600 jobs, or 0.6 per cent.); administration and support services (an increase of approximately 300 jobs, or 0.9 per cent.); and human health and social work (an increase of approximately 200 jobs, or 0.2 per cent.).

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

	Year ended 31 December			
	2007	2008	2009	2010
	(average for the period)			
Public administration and defence, compulsory social security(1)	104,803	106,542	105,797	105,260
Education	97,013	100,394	103,275	104,356
Human health and social work activities	76,431	79,139	80,595	80,509
Total	**278,247**	**286,075**	**289,667**	**290,124**

Source: Central Bureau of Statistics

(1) Includes military and police.

In 2010, an average of 290,124 people (approximately 20.4 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. On 4 December 2009, the Parliament adopted the new Labour Act ("**ZOR**") that provides, among other things, that, unless the collective bargaining agreement states otherwise, upon the expiration of a collective bargaining agreement, the provisions thereof that govern the labour relations that are subject to the agreement shall continue to apply until the execution of a new collective bargaining agreement. Collective bargaining agreements are normally entered between, and govern the rights and obligations of, employers, on the one hand, and trade or labour unions acting on behalf of their members, on the other hand, and typically contain provisions governing labour relations and related matters.

ZOR became effective on 1 January 2010; however, at the session held on 31 May 2010, the Government adopted a proposal to amend ZOR ("**ZOR Amendment Proposal**") that envisages that (i) a newly executed collective bargaining agreement may provide for the extended application of the provisions thereof after the expiration of the agreement and until the execution of a new collective bargaining agreement, however, such an extended application period may not exceed six months, (ii) after the ZOR Amendment comes into force, in cases when an existing collective bargaining agreement provides for the application of its provisions upon its expiration, such an extended application period may not exceed six months, and (iii) in the absence of a provision extending the application of the collective bargaining agreement after its termination, on the day the ZOR Amendment becomes effective, the provisions of the existing collective bargaining agreements shall cease to apply after the expiration of such agreements. The unions opposed the proposal and the Government subsequently withdrew it. The most recent changes and amendments to ZOR, dealing with, inter alia, annual leave, working hours and redistribution of working time were published in the Official Gazette No. 61/11.

Wages and labour costs

The beginning of 2009 was marked by a high annual growth of wages, in line with favourable developments in previous years. However, annual growth of wages moderately slowed in the second quarter of 2009 in most private sector activities as well as in the public sector as the decision reducing wages of civil servants and other government employees by 6 per cent. and reducing wages of government officials by 10 per cent. became effective. In addition to the negative effect on net wages of the unfavourable macroeconomic environment due to the global financial and economic crisis, the Act on the Special Tax on Salaries, Pensions and Other Income (which entered into force on 1 August 2009 and was abolished on 1 November 2010) imposed a special tax rate of 2 per cent. on monthly income between HRK 3,000.00 and HRK 6,000.00 and a special tax rate of 4 per cent. on monthly income exceeding HRK 6,000.00.

The deceleration in wages growth became more pronounced towards the end of 2009, and the year-on-year decline in nominal wages was recorded in November 2009. When considering the annual average, nominal gross wages grew by 2.2 per cent. in 2009 compared to 2008, which represents a 4.9 per cent. decrease in growth compared to 2008. Nominal net wages increased by 2.6 per cent. in 2009 compared to 2008, which represents a 4.4 per cent. decline in growth compared to 2008. However, taking into account the effect of the special tax on average monthly net wages, net wages started falling in July 2009. Nevertheless, as a result of the strong growth of wages in the first half of 2009, nominal net wages (after the effect of the special tax) rose by 1.1 per cent. in 2009 compared to 2008.

Taking into account the average annual inflation as measured by the growth of the CPI, real net wages increased by 0.2 per cent., while real gross wages declined by 0.2 per cent. in 2009. However, when accounting for the effect of the special tax on average monthly nominal net wage, real net wages in 2009 declined by approximately 1.2 per cent. compared to 2008.

Despite the aforementioned reduction, public sector wages increased at a higher rate in 2009 than wages in the private sector, due to their high levels at the beginning of the year. According to NCEA 2007, the highest year-on-year average real gross wages growth in 2009 was recorded in the following sectors: electricity, gas, steam and air conditioning supply (5.8 per cent.); public administration and defence and compulsory social security (1.9 per cent.). The largest decreases were recorded by administrative and support service activities (-2.8 per cent.); mining and quarrying (-2.8 per cent.); and agriculture, forestry and fishing (-2.4 per cent.). The average real gross wages in manufacturing and wholesale and retail trade; and repair of motor vehicles and motorcycles, which are the sectors that have the highest percentages of total employment, also recorded annual declines of 1.6 per cent. and 2.3 per cent., respectively.

During 2010, average net monthly earnings of those in paid employment decreased compared to the average figure for 2009. The average net monthly earnings for 2010 of those in paid employment was HRK 5,343, representing a 0.6 per cent. increase in nominal terms, or a 0.5 per cent. decrease in real terms, from the average in 2009. The average gross monthly earnings of those in paid employment in October 2010 was HRK 7,650, representing a 0.8 per cent. decrease in nominal terms, or a 2.0 per cent. decrease in real terms, from the average in 2009.

In 2009, labour productivity in industry increased by 0.1 per cent. as compared to 2008. This negligible increase reflected strong declines in both the industrial production volume and the number of employed persons in industry. In the first eleven months of 2010, labour productivity in industry decreased by 1.6 per cent. as a result of the decrease in industrial production volume outpacing the decrease in the number of employed persons.

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

	Year ended 31 December			
	2007	2008	2009	2010
Average monthly gross wages and salaries in HRK	7,047	7,544	7,711	7,679
Average monthly net wages and salaries in HRK(1)	4,841	5,178	5,311	5,343
Net wages and salaries in EUR (average exchange rate)(1)	660	717	724	733

Source: Central Bureau of Statistics and Ministry of Finance

(1) Does not reflect the effect of the special tax.

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 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 2009, 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 2011 Budget, 0.5 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 2009, the Mandatory Health Insurance Act came into force and has provided all employed mothers with a right to maternity leave, with full salary compensation until their child is six months old, in the amount of their average salary paid before the maternity leave. Under the amended legislation, the minimum financial compensation from sixth month until one year of child's age ranges from HRK 1,663 to HRK 2,500, and depends on the salary compensation the mother has received until the child is six months old. Also, one-off financial aid to cover the expenses relating to childbirth total HRK 2,328. The Act on Child Support (Official Gazette 94/01, 138/06, 107/07 and 61/11) establishes a minimum amount of monthly child support payments at HRK 199.56. Moreover, the Act on Child Support establishes an additional allowance for parents with up to four children.

In the period from 2008 to 2010, the average level of maternity allowances and child support allowances was 1.1 per cent. of GDP. According to the most recent budget, it is expected that these allowances will continue to account for 1.2 per cent. of GDP in 2011.

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 1.3 to 1. 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 fifteen 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 pension[1]		Average monthly pension amount after tax and surtax		Number of people receiving child allowance[2]		Unemployment benefit recipients	
	Number of recipients	Year-on-year per cent. change	HRK	Year-on-year per cent. change	Number of recipients	Year-on-year per cent. change	Number of recipients	Year-on-year per cent. change
2008	1,145,438	2.3	2,343	6.9	227,111	(0.7)	64,712	8.3
2009	1,172,500	2.4	2,387	1.9	210,242	(7.1)	81,588	26.1
2010	1,197,130	2.1	2,362	(1.0)	211,625	6.6	83,121	1.9

Source: Croatian Pension Insurance Institute, Croatian Employment Service

(1) Since January 2008, the total number of people receiving pension includes pensioners 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.

The following table sets forth the value of the net assets 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		
	2008	**2009**	**2010**
		(HRK thousands)	
Mandatory fund[1]	22,590,933	29,264,636	36,328,054
Open voluntary funds[2]	799,665	1,144,809	1,472,212
Closed voluntary funds[3]	148,378	218,343	287,794
Total	**23,538,977**	**30,627,788**	**38,088,060**

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, AZ Zagreb, Cestarski MF, HAC MF and Sindikat hrvatskih željeznicara.

The Government 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. 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 35.13 billion for 2011, while pension insurance contributions by beneficiaries are anticipated to reach HRK 19.36 billion for 2011, therefore 55.1 per cent. of pension expenditures will be funded by pension insurance contributions.

On 1 November 2010 the new Act on Amendments to the Pension Insurance Act (OG 121/2010) came into force. The most important changes relate to equalisation of the conditions for exercising pension rights for men and women. The age limit for women will be gradually increased (by 3 months every year from 2011) to match that for men, which is currently 65. The transition period should last until 2030. As part of Croatia's efforts to control its budget deficit, the Government has also introduced reforms to temporarily freeze special pensions and to remove automatic indexation of pension amounts. The most recent changes and amendments to the Pension Insurance Act were published in the Official Gazette No. 61/11.

FOREIGN TRADE AND INTERNATIONAL BALANCE OF PAYMENTS

Current Account Balance

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

	Year ended 31 December					
	2005	2006	2007	2008	2009	2010
Current account balance in EUR (millions)	(1,895.5)	(2,635.7)	(3,118.8)	(4,216.5)	(2,407.7)	(582.1)
Current account (as a percentage of nominal GDP)	(5.3)	(6.6)	(7.2)	(8.8)	(5.3)	(1.3)

Source: Croatian National Bank

In 2008, Croatia's current account deficit reached EUR 4,216.5 million, or 8.8 per cent. of GDP, representing an increase of 35 per cent. in EUR terms, or 23 per cent. in GDP percentage terms, compared to 2007. The increase was principally due to the increase in the trade in goods 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 2009, the current account deficit decreased by 43 per cent. in EUR terms, or 3.6 percentage points in GDP percentage terms, compared to 2008, primarily due to the decrease in the trade in goods deficit as a result of the decline in imports outpacing the decline in exports. The decline in imports was mainly attributable to a decrease in domestic demand and in oil and energy prices. In 2010, the current account deficit recorded another decrease (-76 per cent.), falling to EUR 0.6 billion, principally as a result of developments relating to trade in goods. 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 trade in goods deficits may start to increase again. See *"Risk Factors — The current account deficit may continue to rise*".

The balance of payments for 2010, as well as historical data since 1999, were revised at the beginning of 2011 to reflect changes in methodology and data collection. These include changes in the following items:

a) *Road transport*: The road transport expenditure item in the services account was estimated based on foreign payments data (ITRS) and periodic cif/fob parity surveys. By applying the cif/fob factor to merchandise imports (cif), the cost of shipping borne by non-residents was obtained i.e., total transport expenditure. The data obtained through these two methods was previously combined; however, this resulted in partial double-counting, and was discontinued with this revision, which includes only cif/fob survey data. This change resulted in a decrease in expenditures, and therefore the current account deficit, by EUR 50 million to 100 million per year.

b) *Domestic sectors' income on deposits abroad:* An estimate of other domestic sectors' deposits abroad, based on data provided by the Bank for International Settlements, is included in the financial account of the balance of payments; however, interest income on those deposits was not included in the current account until recently. Since the data on deposits doesn't include information on the type of deposit, the estimation of interest income is based on average interest rates on deposits of non-financial entities in the domestic currency of each given country, weighted by country structure of deposits as at the end of 2006. As a result, other sectors' interest income (credit) on the factor income account increased by EUR 10 million to 30 million, also decreasing the current account deficit.

c) *Debt securities issued by domestic sectors purchased by non-residents:* Data on debt securities issued by domestic sectors on the domestic market but traded by non-residents had not previously been included in the balance of payments statistics, and the information itself has only been collected since 2006. Its inclusion into the balance of payments affected the financial account (portfolio investment liabilities, debt securities and other sectors), with interest on these securities being added to the current account (factor income, portfolio investment income and debit), negatively affecting the current account deficit. In addition, the inclusion of these liabilities in balance of payment statistics also meant that the gross external debt position has increased by up to EUR 0.8 billion annually since 2005. In addition, since 2010, GED statistics have also been expanded to include newly available data on investments of residents into bonds issued by domestic sectors on international markets.

Goods Account and Recent Trade in Goods Developments

Trade in Goods 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 7.4 billion in 2006, 2007, 2008 and

2009, respectively. According to balance of payments data calculated in Euros, the trade in goods 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 trade in goods 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 the 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 2009, according to balance of payments data, the trade in goods deficit decreased by 31.6 per cent. compared to 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 2010, the trade in goods deficit contracted by 19.5 per cent. compared to 2009 as a result of a recovery in exports, which increased significantly, while imports registered only a negligible decline.

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				Three months ended 31 March
	2007	**2008**	**2009**	**2010**	**2011**
	(EUR millions)				
Food and live animals	741.3	727.4	740.6	760.2	187.8
Beverages and tobacco	163.0	167.9	163.6	189.0	26.7
Crude materials, except fuels	575.0	582.8	459.8	598.1	161.4
Mineral fuels and lubricants	1,165.0	1,222.1	977.5	1,110.5	175.6
Animal and vegetable oils and fats	15.9	24.3	18.0	20.5	4.9
Chemical products	849.2	944.8	726.4	1,016.6	230.4
Manufactured goods classified chiefly by material	1,388.4	1,466.7	1,133.3	1,260.9	299.0
Machinery and transport equipment	2,793.3	3,212.3	2,233.8	2,819.5	562.3
Miscellaneous manufactured articles	1,309.6	1,235.1	1,073.3	1,120.1	268.0
Commodities and transactions	3.4	1.7	3.0	6.9	2.7
Total	**9,004.1**	**9,585.1**	**7,529.4**	**8,902.4**	**1,918.9**

Source: Central Bureau of Statistics

According to the data from the CBS, total exports of goods amounted to EUR 9.6 billion (20.2 per cent. of nominal GDP) in 2008, which represented an increase of 6.5 per cent. from 2007, as compared to an increase of 9.1 per cent. from 2006 to 2007. The strongest impact on export growth came from the exports of other transport equipment, which contributed to more than half of the increase in total exports.

The decrease in the growth rate of exports in 2008 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.

The decrease in total exports of goods in 2009 as compared to 2008, expressed in EUR terms, amounted to 21.4 per cent., and was primarily due to the decrease in exports of other transport equipment as well as oil and refined petroleum products, the latter mainly a result of a substantial decline in these products' prices. In addition, a significant decrease was recorded in exports of metal manufactures, fertilizers, machinery specialised for particular industries, metalliferous ores and metal scrap and plastics in primary forms. Export growth was recorded in a small number of SITC divisions among which the most significant were cereals and cereal preparations as well as medical and pharmaceutical products.

In 2010, total exports increased by 18.2 per cent. compared to 2009, primarily due to growth in exports of other transport equipment as well as, to a lesser degree, exports of petroleum and petroleum products, metalliferous ores and metal scrap and medical and pharmaceutical products. The first quarter of 2011 saw a fall in total exports of 1.9 per cent. compared to the corresponding quarter of 2010. However, this negative rate of change is almost entirely attributable to base effects in the exports of ships, as extremely high values were recorded in the first quarter of 2010.

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				Three months ended 31 March
	2007	2008	2009	2010	2011
			(EUR millions)		
Food and live animals	1,306.9	1,478.2	1,341.9	1,359.7	285.0
Beverages and tobacco	126.7	132.6	130.1	138.2	20.2
Crude materials, except fuels	325.4	427.7	245.0	255.0	62.9
Mineral fuels and lubricants	2,862.3	3,659.3	2,566.0	2,835.5	729.0
Animal and vegetable oils and fats	45.8	79.8	58.5	56.5	12.0
Chemical products	2,068.2	2,203.4	1,885.2	2,137.3	496.4
Manufactured goods classified chiefly by material	3,723.0	3,871.4	2,761.5	2,724.9	613.7
Machinery and transport equipment	6,128.7	6,738.8	4,337.2	3,879.8	769.1
Miscellaneous manufactured articles	2,233.2	2,218.9	1,878.2	1,735.9	389.1
Commodities and transactions, n. e	12.8	7.1	16.7	4.5	5
Total	**18,833.0**	**20,817.1**	**15,220.1**	**15,127.2**	**3,377.4**

Source: Central Bureau of Statistics

According to CBS data, total imports of goods stood at EUR 20.8 billion (43.9 per cent. of nominal GDP) in 2008 and the annual growth in total imports of goods increased very slightly from 10.1 per cent. in 2007 to 10.5 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 slower in 2008 compared to 2007, standing at 4.1 per cent., which is less than half of the rate recorded in 2007 (11.5 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 2009, total imports of goods expressed in EUR terms declined by 26.9 per cent. principally due to a decrease in domestic demand and generally lower energy prices, including for oil. The decrease in imports resulted from a decline in the majority of SITC divisions, with the most significant decreases recorded in the imports of oil and refined petroleum products and road vehicles, the latter decreasing by approximately a half in comparison with 2008, as well as in the imports of other transport equipment.

According to CBS data, the trade deficit contracted by 31.5 per cent. in 2009 compared to 2008 and amounted to EUR 7.7 billion (EUR 11.2 billion in 2008) principally due to a more pronounced decline 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 contributed almost a half of the overall decrease in the total trade deficit.

In 2010, total imports declined by 0.6 per cent. in comparison with 2009, mainly as a result of a significant decrease in the imports of general industrial machinery and equipment, machinery specialised for particular industries and road vehicles. The merchandise trade deficit in the same period contracted by 19.1 per cent. compared to 2009. In the first quarter of 2011, imports recorded a small positive annual rate of change.

Geographical Distribution of Croatia's Trade in Goods

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

	Year ended 31 December		
	2008	**2009**	**2010**
		(per cent.)	
Developed Countries	69.3	68.3	71.0
EU 27	60.9	60.6	61.1
Slovenia	7.8	7.4	7.8
Hungary	2.4	1.8	2.2
EU 15	44.2	43.9	44.6
Austria	5.8	5.4	5.3
Italy	19.2	19.0	18.7
Germany	10.7	11.0	10.4
EFTA(1)	1.2	1.7	1.1
Developing Countries	30.7	31.7	29.0
Bosnia and Herzegovina	15.3	12.8	11.6
Serbia, Montenegro	6.8	6.9	4.8
Russia	1.3	1.5	2.0
China	0.3	0.4	0.3

Source: Central Bureau of Statistics

(1) European Free Trade Association

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

	Year ended 31 December		
	2008	**2009**	**2010**
		(per cent.)	
Developed Countries	72.2	72.2	70.3
EU 27	64.1	62.7	60.2
Slovenia	5.6	5.7	5.9
Hungary	3.2	3.2	2.8
EU 15	48.5	47.0	45.1
Austria	4.9	5.0	4.8
Italy	17.1	15.4	15.2
Germany	13.4	13.5	12.5
EFTA(1)	1.7	2.6	2.0
Developing Countries	27.8	27.8	29.7
Bosnia and Herzegovina	2.7	2.7	3.1
Serbia, Montenegro	1.4	1.6	1.5
Russia	10.3	9.5	9.0
China	6.2	6.8	7.2

Source: Central Bureau of Statistics

(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 the 15 countries that were EU Member States prior to 1 May 2004 (the "**EU I5**") increased in 2008 after falling slightly in 2007, with the biggest increase recorded for exports 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) and Serbia and Montenegro (non-metallic mineral manufactures and electrical machinery, apparatus and appliances), despite a noticeable deceleration in growth compared to 2007. In 2009, the share of developed countries decreased slightly as a result of a more pronounced decrease in exports to this country group than to developing countries, with the largest decreases recorded in exports to Italy, Germany and Slovenia. The decrease in exports to developing countries can be almost entirely attributed to the decline in exports to Bosnia and Herzegovina, mostly due to a decrease in the value of oil and petroleum product exported there. In a reversal of previous trends, 2010 saw an increase in the share of developed countries in Croatian exports, as exports to this country group grew faster than to developing countries. Growth of exports to developing countries was primarily driven by exports to the EU 15, in particular Italy.

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 increased imports of ships and oil. Imports from developing countries were largely determined by increased imports from Russia, which comprised almost entirely of energy products. In 2009, the shares of developed and developing countries in Croatian imports remained unchanged, thanks to similar rates of decline of imports to both country groups. Among developed countries, the largest drop was recorded for imports from Italy, while in the case of developing countries the decline was driven by Russia, as the value of imported oil and petroleum products decreased compared to 2008, in line with the world market prices. Imports from developed countries declined in 2010, while those from developing countries recorded a positive growth rate, resulting in an increase in the share of the latter in total Croatian imports. This principally reflects growth of imports from China and Bosnia and Herzegovina.

The following table sets forth major countries of destination of Croatian exports of goods as a percentage of total exports of goods in 2010 and the changes in exports to these countries in 2010 as compared to 2009.

	Share	Change
	(per cent.)	
Italy	18.7	15.9
Bosnia and Herzegovina	11.6	7.0
Germany	10.4	11.5
Slovenia	7.8	25.1
Austria	5.3	16.3

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 2010 and the changes in imports of goods from these countries in 2010 as compared to 2009.

	Share	Change
	(per cent.)	
Italy	15.2	(1.6)
Germany	12.5	(8.1)
Russia	9.0	(6.1)
China	7.2	4.6
Slovenia	5.9	1.7
Austria	4.8	(5.7)

Source: Central Bureau of Statistics

Services Account

The positive balance recorded on the services account improved in 2008 relative to 2007 by 11.1 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 covers only 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 the EU 15 showed no significant change compared to 2007. With respect to trade in other services, a modest worsening was recorded in the trade balance of transportation services, notably freight transport. However, the negative trade balance in other services fell by 21.1 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 in operational leasing services and agricultural services.

Net revenues from international trade in services in 2009 decreased by 18.4 per cent. compared to 2008 mainly due to decreased revenues from tourism, which declined by 14.5 per cent. or EUR 1.1 billion. The decrease in tourism revenues can primarily be attributed to lower average consumption, as the number of foreign tourist arrivals increased insignificantly and nights spent by foreign tourists decreased insignificantly (0.3 per cent. and 0.1 per cent., respectively). According to a break-down of tourist nights spent by country of residence, the number of nights spent by guests from new EU Member States, especially Hungary and Slovenia, decreased relative to 2008, while the number of nights spent by guests visiting from the EU 15 recorded a relatively milder decline. In relative terms, more negative results than in tourism were seen in transportation services. The positive trade balance in these services decreased by approximately a half compared to 2008, with the largest decrease recorded in sea fright and air passenger transport. In contrast, the negative balance in trade of other services improved slightly, as expenditures declined more than revenues. On the revenues side of these services, the largest decline was seen in miscellaneous business services (especially those related to architecture and legal services) and telecommunication services. On the other hand, revenues from agricultural and mining, as well as computer and construction services, increased. The drop on the expenditures side mostly came from miscellaneous business services as well as royalties and license fees.

In 2010, the positive balance on the services account increased slightly, mainly as a result of the deficit in the trade in other services falling by a half, as well as rising net revenues from transportation, while net revenues from tourism recorded a slight fall. Increased net revenues from transportation services mostly were due to higher volumes of international trade in goods as well as the higher number of tourists travelling. These improvements were seen primarily in sea and road freight transport. Regarding other services, the improvement of the balance mostly related to miscellaneous business services. Revenues from tourism declined by 2.2 per cent. in 2010 compared to 2009, which is mainly attributable to lower average spending by tourists. According to the CBS data, which covers only commercial accommodation facilities, arrivals of foreign tourists increased by 4.8 per cent., while the number of nights spent rose by 3.6 per cent., as compared to 2009.

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 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. dollars 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 forth the balance of payments for the periods indicated:

	Year ended 31 December					
	2005	2006	2007	2008	2009	2010
	(EUR million)[1]					
CURRENT ACCOUNT	(1,895.5)	(2,635.7)	(3,118.8)	(4,216.5)	(2,407.7)	(582.1)
Goods, services, and income	(3,079.3)	(3,743.1)	(4,161.8)	(5,287.0)	(3,444.0)	(1,661.4)
Credit	16,006.3	17,917.5	19,658.1	21,303.8	16,964.9	18,509.5
Debit	(19,085.6)	(21,660.6)	(23,819.8)	(26,590.8)	(20,408.9)	(20,170.9)
Goods and services	(2,136.1)	(2,568.0)	(3,067.4)	(3,719.2)	(1,617.0)	(51.9)
Credit	15,272.9	16,990.4	18,307.2	19,904.6	16,157.1	17,595.8
Debit	(17,409.1)	(19,558.4)	(21,374.6)	(23,623.8)	(17,774.1)	(17,647.7)
Goods	(7,518.0)	(8,344.2)	(9,434.0)	(10,793.8)	(7,386.9)	(5,945.3)
Credit	7,220.3	8,463.6	9,192.5	9,814.0	7,703.2	9,099.5
Debit	(14,738.3)	(16,807.8)	(18,626.5)	(20,607.8)	(15,090.1)	(15,044.8)
Services	5,381.8	5,776.2	6,366.6	7,074.6	5,769.9	5,893.4
Credit	8,052.6	8,526.8	9,114.7	10,090.6	8,453.9	8,496.3
Debit	(2,670.8)	(2,750.6)	(2,748.1)	(3,016.0)	(2,684.1)	(2,602.9)
Transportation	440.2	547.8	641.3	625.3	349.2	399.7
Credit	880.3	1,037.5	1,165.4	1,209.4	752.0	813.3
Debit	(440.1)	(489.7)	(524.0)	(584.1)	(402.8)	(413.6)
Travel	5,394.9	5,708.7	6,035.2	6,694.0	5,655.8	5,607.6
Credit	5,998.9	6,293.3	6,752.6	7,459.4	6,379.7	6,236.8
Debit	(604.1)	(584.6)	(717.3)	(765.5)	(724.0)	(629.2)
Other services	(453.3)	(480.3)	(310.0)	(244.6)	(235.1)	(113.9)
Credit	1,173.4	1,196.0	1,196.8	1,421.8	1,322.2	1,446.3
Debit	(1,626.6)	(1,676.3)	(1,506.7)	(1,666.4)	(1,557.3)	(1,560.1)
Income	(943.1)	(1,175.1)	(1,094.4)	(1,567.9)	(1,826.9)	(1,609.5)
Credit	733.4	927.1	1,350.9	1,399.1	807.9	913.7
Debit	(1,676.5)	(2,102.2)	(2,445.3)	(2,967.0)	(2,634.8)	(2,523.1)
Current transfers	1,183.8	1,107.4	1,043.0	1,070.5	1,036.3	1,079.3
Credit	1,628.4	1,639.5	1,576.1	1,684.4	1,607.8	1,674.8
Debit	(444.6)	(532.1)	(533.1)	(613.9)	(571.5)	(595.5)
CAPITAL AND FINANCIAL ACCOUNT	3,008.7	4,031.4	4,525.4	5,800.9	3,513.8	1,467.9
Capital account	53.8	(134.9)	28.5	14.9	42.7	36.0
Financial account, excl. reserves	3,776.8	5,578.5	5,218.6	5,455.6	4,367.6	1,515.7
Direct investment	1,276.1	2,561.5	3,467.8	3,245.8	1,206.9	593.3
Abroad	(191.8)	(206.8)	(211.2)	(972.6)	(888.8)	153.4
In Croatia	1,467.9	2,768.3	3,679.0	4,218.4	2,095.6	439.9
Portfolio investment	(1,187.9)	(197.3)	391.1	(782.1)	398.3	399.3
Assets	(581.3)	(459.8)	(404.7)	(277.9)	(584.3)	(351.5)
Liabilities	(606.6)	262.5	795.8	(504.3)	982.6	750.8
Financial derivatives	(88.4)	0.0	0.0	0.0	0.0	(252.7)
Other investment	3,777.0	3,214.3	1,359.7	2,991.9	2,762.4	775.8
Assets	982.2	(692.3)	(1,653.3)	(1,620.9)	759.9	639.6
Liabilities	2,794.7	3,906.6	3,012.9	4,612.8	2,002.6	136.2
Reserve assets	(821.8)	(1,412.2)	(721.6)	330.4	(896.4)	(83.8)
NET ERRORS AND OMISSIONS[2]	(1,113.3)	(1,395.7)	(1,406.6)	(1,584.3)	(1,106.1)	(885.8)

Source: Croatian National Bank

(1) Exchange rate: as at the end of the relevant period.

(2) 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.

Factor Income Account

The factor income account balance deteriorated in 2008 by 43.3 per cent. compared to 2007, principally due to a significant increase in expenditures (21.3 per cent.), accompanied by weak revenue growth (3.6 per cent.). On the revenue side, compensation to employees recorded a positive rate 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 increased by 16.5 per cent. in 2009 compared to 2008 primarily due to the decrease in revenues outpacing the decrease in expenditures. A decrease in total revenues on the factor income account in 2009 amounted to 42.3 per cent. compared to 2008, primarily due to the decline in revenues related to resident investments abroad as a result of weak business performance of domestically owned companies abroad. In addition, the CNB's and commercial banks' revenues from the investment of foreign assets also declined considerably in 2009 compared to 2008, with the exception of revenues attributable to compensation to employees, which grew by 4.1 per cent. On the expenditure side, the largest decline was observed in expenditures related to direct investment (dividends and reinvested earnings of foreign owned companies and banks).

Additionally, interest payments on external debt also decreased as a result of relatively low interest rates on the international markets during 2009.

Reversing the previous two years' developments, the factor income account balance improved in 2010 by 11.9 per cent. This is in equal measure a result of developments in both revenue and expenditure. The latter recorded a decrease as interest expenditure declined in line with lower interest rates on international markets. Revenues, in turn, increased due to higher direct equity investment income, as resident owners of companies abroad recorded profits, rather than losses as in 2009. Revenues relating to compensation of employees also increased while, on the other hand, domestic sectors recorded somewhat lower interest revenues from investments abroad.

Current Transfers

A minor positive change was recorded in the current transfers account balance in 2008 as compared to 2007, with increases in revenues outweighing expenditure growth. 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 increase also came from the government sector, specifically as a result of expenditures on pensions, taxes and a one-time payment resulting from the settlement of a legal dispute.

The change in the current transfers account balance in 2009 was also insignificant, but unlike in 2008 the positive balance declined, with decreases in both expenditures and revenues declined. The decrease in expenditures was slightly more pronounced in the government sector, which resulted in an improvement in the overall balance of the current transfers account. On the other hand, as revenues declined more than expenditures, especially those related to workers' remittances from abroad, the balance of other sectors deteriorated slightly.

Net revenues in the current transfers account in 2010 increased by 4.2 per cent. relative to the same period of 2009, entirely as a consequence of a positive change in revenues, while expenditures also increased slightly from the level recorded in the previous year. The growth in revenues can be attributed primarily to increased revenues earned by the private sector, mostly comprising gifts, donations and pensions from abroad, while the government sector experienced a decrease in revenues as compared to the previous year.

Capital and Financial Account

In 2008, the capital and financial account had larger net capital inflows than in 2007 and, excluding the change in reserves, stood at EUR 5.5 billion. The largest inflow of funds was attributable to direct investments, principally through an increase in equity capital. In addition, significant capital inflow was recorded on the other investment account where liabilities saw a high growth rate (53.1 per cent.) while the growth rate of assets decreased slightly (by 2.0 per cent.). The account of portfolio investment experienced outflows of funds through repayment of government bonds. 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 inflows 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 (53.1 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 85.0 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.

Net inflows of capital in the capital and financial account in 2009 were significantly lower than in 2008 (excluding the change in international reserves, net inflows stood at EUR 4.4 billion, a decline of one fifth compared to 2008). Both debt and equity related capital inflows dropped considerably. In addition, the growth in foreign assets weakened compared to 2008. After a decline in 2008, gross international reserves increased by

EUR 0.9 billion in 2009 (excluding SDR allocation). The much lower current account deficit (-42.9 per cent.) in 2009 resulted in significantly lower financing needs, so that despite the drop in inflows of capital (-19.4 per cent.), international reserves increased in the same period.

The increase in foreign liabilities of domestic sectors in 2009 (by EUR 5.1 billion) mostly reflects the growth of debt liabilities (by EUR 4.1 billion), particularly those of private companies. Nevertheless, compared with 2008, the intensity of foreign borrowing of domestic companies weakened considerably due to declining economic activity and reduced availability of foreign sources of finance during 2009. Banks also recorded lower debt growth than in 2009, while the Government stepped up external borrowing and increased its foreign liabilities by EUR 1 billion. Consequently, total foreign debt increased in 2009 by EUR 4.7 billion, which is approximately 40 per cent. less than the increase in 2008. Despite slower growth, the ratio of debt to GDP deteriorated due to a decrease in nominal GDP. The external debt to GDP ratio reached 99.1 per cent. at the end of 2009. The growth in foreign assets in 2009 mostly reflects resident direct investments abroad, which amounted to EUR 0.9 billion in 2009, most of which relates to round trip investment. Additionally, investment funds, after withdrawing from international capital markets during 2008, started investing again in 2009, mostly in debt securities. With respect to foreign assets of commercial banks, the decreased level can mostly be attributed to the reduction in the minimum required amount of foreign currency claims.

Two round-tripping transactions were recorded in Croatia, one in the last quarter of 2008 (EUR 0.8 billion) and one in the third quarter of 2009 (EUR 0.7 billion). These transactions involve Croatian equity investment abroad to companies which then lend back to the investing company in Croatia. Although these round-tripping transactions had no effect on the amount of net FDI inflows in Croatia, and thus no effect on the total financial account of the balance of payments, they had the effect of overstating the amount of direct investment in Croatia (through debt instruments) and Croatia's direct equity investment abroad during the period in which these transactions were performed. Also, this contributed to a significant increase in gross external debt (by a total of EUR 1.5 billion, as compared to the balance that excludes these transactions). In 2010, due to a liquidation of some of the companies within the group involved in this transaction, both inward and outward FDI decreased by the same amount (EUR 0.4 billion).

In 2010, excluding the change in foreign reserves, recorded net capital inflows amounted to only a third of that in 2009. During 2010, domestic sectors increased their foreign assets by EUR 0.2 billion and their liabilities by EUR 1.6 billion. Regarding foreign assets, the much lower change compared to previous years is largely attributable to developments in the FDI account as a result of the above changes in the ownership structure of the group of companies related to round trip transactions. Excluding these changes, investments abroad were higher than in the previous year, owing primarily to one large transaction (the purchase of Droga Kolinska by Atlantic Group) as well as improved business results of foreign companies under ownership of residents. The increase on the liabilities side almost entirely reflects new direct equity investments and reinvested earnings, given that domestic debt liabilities increased by only EUR 0.3 billion. However, due to unfavourable cross-currency changes, the level of external debt increased by EUR 1.2 billion compared to 2009. Government debt was the main reason for this growth, increasing by EUR 0.8 billion, principally as a result of a USD 1.25 billion Eurobond in July. Banks saw almost no change in their debt level, while companies mainly continued to refinance their liabilities, leading to a moderate increase in their stock of debt.

Foreign Direct Investment (FDI)

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

	Year ended 31 December					
	2005	**2006**	**2007**	**2008**	**2009**	**2010**
			(EUR millions)			
FDI into Croatia	1,467.92	2,768.31	3,679.03	4,218.37	2,095.64	439.89
FDI from Croatia abroad	(191.83)	(206.77)	(211.20)	(972.57)	(888.78)	153.43
FDI (net)	**1,276.08**	**2,561.54**	**3,467.83**	**3,245.80**	**1,206.86**	**593.33**

Source: Croatian National Bank, Foreign Direct Investments Statistics (as of May 2011)

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 0.2 billion or 6.4 per cent. compared to 2007, mainly due to lower inward investments (excluding round-tripping transactions). FDI into Croatia in 2008 totalled EUR 4.2 billion, increasing by EUR 0.5 billion or 14.7 per cent. compared to 2007, primarily due to round-tripping related investments, which totalled EUR 0.8 billion. Excluding round-tripping, inward investments totalled EUR 3.4 billion and were EUR 0.3 billion or 7.8 per cent. lower than in 2007. Equity investment dominated the structure of inward investments in Croatia, making up 64.8 per cent. of total inward FDI (excluding round-tripping transactions) in 2008 (as compared to 59.5 per cent. in 2007). Debt investment (i.e. domestic sectors' liabilities to their affiliated companies abroad), which accounted for 20.2 per cent. of total inward FDI (excluding round-tripping transactions) in 2008, decelerated 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 (excluding round-tripping) break-down by sector was as follows: 34 per cent. — financial intermediation (except insurance and pension funds), 27 per cent. — the manufacture of coke and refined petroleum products, 9 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, 6 per cent. — wholesale trade and commission trade. When reviewing 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.

Net FDI in 2009 amounted to EUR 1.2 billion, which represented a 62.8 per cent. decrease compared to 2008, primarily due to significantly decreased inward FDI, while resident investments abroad decreased only slightly. FDI into Croatia in 2009 totalled EUR 2.1 billion, decreasing by approximately a half compared to 2008. The structure of FDI into Croatia reveals the dominance of direct debt investment (i.e. domestic sectors' liabilities to their affiliated companies abroad) amounting to EUR 1.1 billion, more than half of which relates to round-tripping investments. Direct equity investments totalled EUR 0.7 billion, one third of the amount recorded in 2008. A significant decrease in direct equity investment reflected the reluctance of foreign investors to invest in developing countries and emerging markets and the overall uncertainty and risk aversion dominating the global financial markets. The amount of reinvested earnings was lower by a third compared to 2008, as foreign owned companies and banks made less profits in 2009 than in 2008. The breakdown of inward FDI (excluding round-tripping) by sector in 2009 was as follows: 46 per cent. — financial intermediation (except insurance and pension funds), 21 per cent. — other business activities, 8 per cent. — retail trade and commission trade, 8 per cent. — manufacture of coke and refined petroleum products, 8 per cent —real estate investments.

2010 saw a further decrease in the amount of net FDI, which halved compared to 2009. Inward FDI (excluding round trip transactions) fell by 39.7 per cent., reflecting primarily an outflow of debt-related investment, as the level of liabilities of domestic sectors to affiliated companies abroad decreased for the first time after a long period of growth. This was mainly the result of significant repayment of debt liabilities by non-bank financial institutions to foreign parent companies. On the other hand, new direct equity investment slightly exceeded levels seen in the previous year (EUR 0.8 billion compared to EUR 0.7 billion in 2009), while retained earnings recorded a more significant increase (57.5 per cent. growth over the level recorded in 2009). Regarding the sectoral structure of direct investments they mostly related to other business activities, financial intermediation, except insurance and pension funds (primarily reflecting banks' high retained earnings), real estate and retail trade. Looking at cumulative foreign direct investments in Croatia since 1993 by activity, the biggest share is related to financial intermediation, except insurance and pension funds, (35 per cent.), retail and wholesale trade (16 per cent.), manufacture of coke, refined petroleum products (7 per cent.), real estate activities (6 per cent.) as well as post and telecommunications (5 per cent.). In terms of a geographical break-down, European Union investors comprise the largest share of total FDI.

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 the training of employees,
- government contribution towards development of technological and innovation centres,
- government contribution of strategic business support activities, and
- government contribution in an 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 the 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.

In addition, in November 2010, the Croatian Government announced the establishment of an institutional task force aimed at encouraging FDI. In March 2011, Deputy Prime Minister Domagoj Ivan Milošević assumed additional responsibilities relating to overseeing Croatia's efforts to encourage inward FDI.

Exchange Rates

Croatia has a managed floating exchange rate regime, 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 and 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 price stability 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 significantly 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.

In 2008, there was a 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 during that 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 intensification of appreciation pressures caused by the decline in Kuna liquidity, 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 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.

The HRK/EUR exchange rate appreciated by 0.2 per cent. from the end of 2008 to the end of 2009, strengthening from HRK 7.32/EUR to HRK 7.31/EUR. As outlined below, the appreciation was primarily due to the developments in the last quarter of 2009, whereas the beginning of 2009 was marked by depreciation pressures stemming from the reduction in foreign capital inflows combined with strong government and corporate demand for foreign exchange required for the payment of maturing foreign liabilities. Depreciation pressures declined in the second quarter of 2009, among other things due to a government Eurobond issue and the expectations of significant capital inflows following announced borrowings by certain public companies. The usual seasonal appreciation pressures were not present in the summer months of 2009, partly due to a decrease in foreign exchange inflows from tourism compared to previous years, resulting in a stable Kuna/euro exchange rate. Exchange rate developments in the last quarter of 2009 were marked by the appreciation of the Kuna against the euro primarily due to an increase in the supply of foreign exchange in the domestic market as a result of borrowing abroad by some public enterprises and other companies as well as a Government bond issue in the US market. In addition, the Kuna also strengthened due to the continued narrowing of the trade deficit.

The CNB intervened seven times in the foreign exchange market in 2009. Two interventions (one in late January and one in mid-February) involved selling foreign exchange in response to mounting depreciation pressures, while the other five interventions were aimed at moderating the pace of the appreciation of the Kuna through foreign exchange purchases. At the auctions, the CNB purchased foreign exchange in the net amount of EUR 324.8 million. The volume of foreign exchange transactions between the Ministry of Finance and the CNB was also high in 2009. The CNB purchased EUR 570.4 million net from the Government, which represented a significant increase from EUR 185.9 million in 2008. The CNB's purchase from the Government in 2009 was attributable to a large extent to the purchase of foreign exchange raised by the Government through a Eurobond issue in May 2009, and to a smaller extent to the purchase of foreign exchange from a Government bond issue on the US market in November 2009.

The HRK/EUR exchange rate remained fairly stable in the first five months of 2010 in an environment of a balanced supply of, and demand for, foreign exchange and high Kuna liquidity in the system. In June appreciation pressures on the Kuna strengthened. These pressures stemmed from market participants' activities related to an expected new government bond issue in the domestic market, anticipations of additional capital inflows from public enterprise borrowing and increased investor interest in purchasing treasury bills with a currency clause. The Kuna also strengthened due to a drop in corporate demand for foreign exchange, caused by a reduced volume of foreign trade, and the beginning of the tourist season. In the remainder of 2010, depreciation pressures were more pronounced, particularly in the fourth quarter, due to an increase in foreign exchange demand of the banking sector (repayments of foreign liabilities and profit allocations to foreign owners) and the corporate sector (imports payments). At the end of 2010, the exchange rate stood at 7.39 HRK/EUR, depreciating by 1.1 per cent. from the end of 2009.

There were five interventions by the central bank in the foreign exchange market in 2010. The first three interventions (two in late June and one in early July) were held in order to curb the appreciation of the domestic currency. The CNB purchased a total of EUR 363.7 million from banks through these foreign exchange interventions, successfully putting an end to the appreciation trend of the Kuna. The central bank intervened again, selling a total of EUR 350.1 million in two foreign exchange interventions in the second half of November, thus easing depreciation pressures. In 2010 the CNB purchased a net of EUR 5.9 million from the Government.

In the first two months of 2011, the HRK/EUR exchange rate was relatively stable in a situation of balanced supply of and demand for foreign exchange. In March 2011, appreciation pressures on Kuna started to strengthen and this continued in April. Some of the factors contributing to this appreciation were foreign exchange liquidity in the system, foreign exchange inflows related to foreign tourists arrivals for Easter holidays, as well as expectations about additional foreign exchange inflows due to announced borrowing of the Government on the foreign market. In May 2011, depreciation pressures on Kuna prevailed, due to increased demand for foreign exchange. At the end of May 2011, the HRK/EUR exchange rate stood at 7.43, having depreciated by 0.6 per cent. from the end of 2010. In the first five months of 2011 there was no need for the central bank to intervene in the foreign exchange market. In the foreign exchange transactions with the Ministry of Finance, mainly in April 2011, the central bank purchased a net of EUR 857.4 million, which mainly relates to the purchase of foreign exchange from a Government bond issue.

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 2009, the HRK/U.S.$ exchange rate, affected by the developments on the global foreign exchange markets, appreciated by 1.3 per cent., from HRK 5.16/U.S.$ at 31 December 2008 to HRK 5.09/U.S.$ at 31 December 2009. In 2010, the HRK/U.S.$ exchange rate depreciated significantly (9.4 per cent.) from HRK 5.09/U.S.$ at 31 December 2009 to HRK 5.57/U.S.$ at 31 December 2010, mainly due to the strengthening of the U.S.$/EUR rate on the global foreign exchange markets as a result of euro weakness following developments relating to the fiscal stability of Greece and certain other Member States. At 6 June 2011, the exchange rate stood at 5.15 HRK/U.S.$.

Export price competitiveness deteriorated in 2008 compared to 2007. The index of the real effective Kuna exchange rate deflated by consumer prices appreciated in 2008 by 4.0 per cent., while the same index deflated by producer prices appreciated by 3.5 per cent., due to faster growth in consumer and producer prices in Croatia than in foreign countries in 2008 and due to appreciation of the nominal effective exchange rate of the Kuna. In 2008, the average monthly index of the nominal effective Kuna exchange rate appreciated by 1.9 per cent. compared to 2007.

Appreciation of the real effective exchange rate of the Kuna continued in 2009. The average real effective Kuna exchange rate deflated by consumer prices appreciated by 0.5 per cent. and the same rate deflated by producer prices appreciated by 2.8 per cent., as the result of price developments in Croatia relative to its main trading partners. Domestic consumer prices grew faster than foreign prices and domestic producer prices decreased at a slower rate than foreign prices, which led to a deterioration in export price competitiveness in 2009.

In 2010 the average real effective Kuna exchange rate deflated by consumer prices depreciated by 1.4 per cent. year-on-year, due to slower growth of domestic prices than foreign and due to nominal depreciation of the Kuna against the basket of currencies. On the other hand, domestic producer prices grew stronger than abroad, which led to a 0.2 appreciation of the real effective Kuna exchange rate deflated by producer prices. In the first quarter of 2011 the Kuna real effective exchange rates deflated by consumer and producer prices remained at levels similar to those in the last quarter of 2010. Although in this period Kuna nominally depreciated against the basket of currencies of Croatia's main trading partners, domestic prices grew faster than those abroad.

In the years prior to the crisis, Kuna real effective exchange rate indices deflated by unit labour costs in the whole economy and in industry were signalling deterioration of cost competitiveness, due to nominal effective appreciation of the Kuna as well as due to faster growth of unit labour costs in Croatia than in its main trading partners. These negative trends reversed in 2009, when Kuna real effective exchange rate indices deflated by unit labour costs depreciated. Latest available data for the first three quarters of 2010 indicate that real effective exchange rate indices deflated by unit labour costs continued to depreciate compared to the same period in the previous year (4.9 per cent. in the whole economy and 0.3 per cent. in the industry). In the first case this reflects nominal depreciation of the Kuna against the basket of currencies and stronger fall of unit labour costs in Croatia than in its main trading partners. On the other hand, the fall of domestic unit labour costs in the industry was less pronounced than abroad, which caused a smaller effective depreciation of the Kuna in real as compared to that in nominal terms. Decreasing unit labour costs in Croatia are the result of a stronger decrease in employment as compared to GDP and decreasing compensation per employee.

The following table sets forth the end-of-month HRK/EUR exchange rate from January 2006 to May 2011:

	2006	2007	2008	2009	2010	2011
January	7.359333	7.373400	7.249864	7.373294	7.313102	7.407203
February	7.307577	7.345292	7.277476	7.403887	7.270536	7.414820
March	7.323554	7.382466	7.256652	7.457249	7.259334	7.382807
April	7.291280	7.372840	7.263753	7.425124	7.246875	7.354349
May	7.264151	7.308634	7.250440	7.326488	7.263120	7.431895
June	7.256979	7.303218	7.246264	7.292035	7.193455	7.373946
July	7.258119	7.297330	7.221125	7.333135	7.248517	
August	7.314609	7.319403	7.161648	7.326773	7.274976	
September	7.381777	7.281634	7.107741	7.288341	7.292743	
October	7.369343	7.350060	7.185881	7.225837	7.339273	
November	7.333542	7.313666	7.128034	7.317610	7.420325	
December	7.345081	7.325131	7.324425	7.306199	7.385173	

Source: Croatian National Bank

MONETARY DEVELOPMENTS AND INTERNATIONAL RESERVES

Monetary Policy and Instruments

Throughout 2008, 2009 and 2010 the CNB successfully maintained the stability of the HRK/EUR exchange rate, a key aspect of achieving domestic price stability as well as the stability of the financial sector as a whole.

During the fourth quarter of 2008 and the first quarter 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 decreased foreign capital net inflows, the CNB, in addition to maintaining domestic currency stability, focused on ensuring sufficient foreign currency liquidity. After reducing domestic currency liquidity creation in the first half of 2008 in order to alleviate inflationary pressures, in the second half of 2008 and in early 2009 the CNB tightly managed domestic currency liquidity to prevent exchange rate depreciation. In order to preserve exchange rate stability, during this period, the CNB took a number of steps. In October 2008, the CNB abolished marginal reserve requirements (as a result EUR 532 million was released in the system). In 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 was in Kuna and HRK 2.5 billion, or around EUR 345 million was in foreign exchange). In January 2009, the CNB increased the calculated foreign exchange component of the reserve requirement that is allocated in Kuna from 50 to 75 per cent. (the result was an increase of the Kuna reserve component, i.e. a decrease in the foreign exchange component by HRK 5.9 billion or around EUR 810 million), In 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 (which resulted in the freeing of EUR 2.1 billion that was previously set aside as part of banks' liquid foreign assets). At the same time, the CNB increased the limit on banks' open foreign exchange positions 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 by six domestic banks to the Government.

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

In line with a policy of more restrictive management of the money supply and due to a major increase in government borrowing from banks at the end of 2008, the CNB tightened regulations concerning the amount of collateral which automatically puts additional Kuna liquidity at banks' disposal. 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.

After the end of the first quarter of 2009, the monetary environment improved markedly. As a result, the remaining part of 2009 and 2010 were characterised by substantially more stable conditions. Appreciation pressures on the Kuna re-emerged in June 2009, which were to a large extent generated by foreign capital inflows related to the issuance of government bonds on the international financial markets and by foreign currency inflows related to tourism. The central bank prevented the excessive strengthening of the Kuna by intervening in the foreign exchange market, as well as by converting significant amounts of the foreign exchange receipts of the Government. Owing to the impact of these monetary policy actions, the Kuna/euro exchange rate remained stable, standing at 7.31 Kuna per euro at year-end 2009, which was almost the same level as at year-end 2008.

As in previous years, appreciation pressures on the Kuna/euro exchange rate were also recorded during the summer months of 2010 stemming from government foreign currency borrowing and foreign exchange inflows due to the tourist season. The CNB successfully halted the upward trend of the Kuna by purchasing a total of EUR 363.7 million from banks through three foreign exchange interventions (EUR 125.6 million on 24 June 2010, EUR 118.7 million on 26 June 2010, and EUR 119.4 million on 9 July 2010). In contrast, in the fourth quarter of 2010 depreciation pressures emerged due to an increase in foreign exchange demand in the banking sector (due to repayments of foreign liabilities and profit allocations to foreign owners) and the corporate sector (due to payments for imports and foreign acquisitions). In order to ease these pressures, the central bank intervened again by selling a total of EUR 350.1 million in two foreign exchange interventions (EUR 116.4 million and 233.7 million on 19 November 2010 and 30 November 2010, respectively). As a result of these CNB interventions, the Kuna/euro exchange rate again remained relatively stable, reaching 7.39 Kuna per euro at 31 December 2010, a depreciation of only 1.1 per cent. compared to the end of 2009. The exchange rate has been broadly stable also in the first five months of 2011, recording a depreciation of only 0.6 per cent, therefore there was no need for CNB intervention in the foreign exchange market.

Despite the gradual improvement of financial conditions, monetary developments in 2009 and 2010 were mainly influenced by the negative effects of the downturn in real economic activity, suppressed domestic demand, pressures on the credit market coming from large funding needs of the central government as well as stagnation of lending to the private sector. In such circumstances, the CNB has been primarily focused on providing sufficient primary liquidity to the banking system with the aim to foster the recovery of lending to the private sector while also maintaining the stability of the nominal Kuna/euro exchange rate.

With the aim of spurring corporate lending through the government programme for economic recovery, in February 2010 the central bank reduced the reserve requirement from 14 to 13 per cent. The majority of the released funds was allocated to HBOR (HRK 2 billion) and was aimed for use in corporate lending transactions. As HBOR directly participates in these loans by providing 40 per cent. of funds (private banks provide the remaining 60 per cent.), the total lending potential of the programme was HRK 5 billion. By the end of 2010 nearly one half of the planned loans (HRK 2.1 billion) was approved to the final clients (by way of comparison, total bank lending to the corporate sector in 2010, excluding the programme loans, grew by HRK 8.2 billion). In order to stimulate demand for the remaining funds of the program, in January 2011 the Government revised certain features of the program. The most important changes included reducing the lending rate, alleviating eligibility conditions, extending the repayment possibilities and expanding the allowed purposes of the loans.

In the first five months of 2011, the CNB continued to support favourable liquidity conditions. Thus, in early March 2011 the central bank additionally improved foreign exchange liquidity in the banking system by reducing the rate of minimum required foreign currency assets of banks relative to their foreign currency liabilities by three percentage points (from 20 to 17 per cent.). As a result of this change, the central bank released approximately EUR 850 million (HRK 6.3 billion) which may be used by banks to finance domestic lending activity. Moreover, as a result of this measure, the CNB reduced regulatory costs for banks, which may lead to an improvement of domestic financing conditions.

In an environment of high levels of Kuna liquidity, the need for creating reserve money by means of regular reverse repo operations was significantly reduced. Thus, the turnover at the regular repo auctions (held at a fixed rate of 6.0 per cent. since December 2008) gradually decreased throughout 2009 and since mid-October 2009 no auctions have been held. Favourable Kuna liquidity was also reflected in low levels of money market interest rates in late 2009 and throughout 2010, and the first five months of 2011, as well as in banks' increased use of overnight deposits with the CNB. The banks used the overnight deposit facility on a daily basis, even at the very beginning of the reserve maintenance period, which was previously uncommon. The average daily balance of overnight deposits with the CNB in 2010 was HRK 3.9 billion, and in the first five months of 2011 was HRK 6.3 billion, compared to only HRK 0.6 billion in 2009. The highest amount of overnight deposits (HRK 12.7 billion) was registered in mid-April 2011, i.e., close to the end of the reserve maintenance period.

Pursuant to the Law on the Croatian National Bank and the Decision on Reserve Requirements (Official Gazette Nos. 203/2003, 145/2004, 34/2005, 64/2005, 136/2005, 146/2005, 112/2008, 137/2008, 139/2008, 3/2009 and 18/2010) (the "**Reserve Requirement Decision**"), credit institutions are required to maintain with the CNB certain reserves in the settlement account, or in a separate account with the CNB. Reserve requirements apply to banks founded in Croatia and branches of foreign banks in Croatia and do 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 and 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 in risk categories depending on the likelihood of collection, i.e. on the expected future cash flows. 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 a credit institution's receivables.

Monetary Developments

The ratio of nominal GDP to total liquid assets ("**M4**") has shown a slightly downward trend over the last six years, whilst being broadly stable as shown by the table below.

	Year ended 31 December						Four months ended 30 April	
	2005	2006	2007	2008	2009	2010	2010	2011
Ratio of Nominal GDP/M4	1.7	1.6	1.5	1.5	1.5	1.4	1.5	1.5

Sources: Croatian Bureau of Statistics and Croatian National Bank

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

	Year ended 31 December				Four months ended 30 April	
	2007	2008	2009	2010	2010	2011
	(HRK millions)					
Reserve money (M0)[1]	51,923.9	49,743.0	56,141.9	56,249.1	54,076.0	59,632.7
Money (Ml)[2]	57,878.3	55,222.3	47,181.7	49,151.7	48,982.2	50,362.2
Broad money (M4)[3]	215,822.1	225,018.5	223,094.6	232,869.6	222,055.0	228,898.1
Net domestic assets[4]	166,375.5	183,279.1	178,083.2	188,845.0	184,328.8	195,543.3
Domestic credit[5]	210,828.4	232,982.1	231,661.9	247,580.8	234,764.5	250,233.1

Source: Croatian National Bank

(1) Reserve money (M0) consists of currency outside banks, cash in banks' vaults, banks' deposits with the CNB, other banking institutions' deposits and other domestic sectors' deposits with the CNB.

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

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

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

(5) Domestic credit comprises banks' claims on other non-government non-financial domestic sectors, other banking institutions and other financial institutions.

Monetary and credit developments in 2008 were mainly characterised by the spillover of the financial crisis and slowdown of economic growth in the last quarter of the year. 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 was moderate and, on the aggregate level, did not exceed the CNB recommended rate (12 per cent. annually). In addition, domestic banks' lending to the central government 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 a successful tourist season.

However, since 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 resulting from the financial crisis. The prompt reaction of commercial banks including the support of the parent banks, the CNB and the Government halted the deposit outflow. 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 addition, to increase foreign exchange liquidity, the CNB decreased the reserve requirement rate and abolished the marginal reserve requirement, thus freeing foreign exchange funds allocated over a long period of time.

In the last quarter of 2008 lending activities of banks to the private sector also lost momentum. Bank loans decelerated markedly as a result of a sharp fall in demand for loans caused by more stringent financing terms as well as the preference on the part of banks to preserve their liquidity in view of the crisis in the global and domestic financial markets. Bank activities in the last quarter of 2008 mostly focused on ensuring sufficient funds from abroad and on funding increased central government financing needs.

The developments described above affected the annual changes of monetary and credit aggregates in 2008. The nominal growth of bank placements to the non-banking sector was 10.5 per cent. 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 narrow money ("**M1**") growth became negative at the year-end. M1 thus fell by 4.6 per cent. in 2008.

The decelerating trend in lending to the private sector continued throughout 2009. Bank loans to the private sector fell by 0.6 per cent., with household loans falling by 2.9 per cent. (mostly due to contraction of consumer loans including loans for car purchase) and corporate loans growing by only 2.1 per cent. This was influenced by negative trends on both the supply side (rise in interest rates, increased risk aversion of the banks) and the demand side (fall in economic activity and personal consumption accompanied by a negative economic outlook). The year-on-year growth rate of net claims on the central government at end-2009 was relatively low (1.3 per cent.) because at the very end of the year the Government used part of the funds received from the issuance of a dollar bond to repay domestic short-term loans. The CNB supported the financing needs of domestic sectors, and especially of the Government, by decreasing the minimum required foreign currency coverage from 28.5 to 25 per cent. on 4 February 2009 and further to 20 per cent. on 20 February 2009 and thus releasing EUR 2.1 billion. In addition, in November 2009 the CNB abolished the Decision on the purchase of compulsory CNB bills, which had limited the excessive growth of bank loans in the past three years. However, based on a considerable slowdown of credit growth and the fact that banks were exercising greater caution as regards credit and associated risks, it was decided that formal restrictions of credit growth were no longer necessary.

The stagnation of bank lending and the worsening liquidity conditions in the real sector of the economy strongly influenced developments of M1, which recorded the most pronounced fall among all monetary aggregates during 2009 (14.6 per cent.). This was largely a result of the fall in demand deposits with banks, especially deposits of the corporate sector. The decline of the broadest money aggregate — M4 — was less pronounced (-0.9 per cent.), owing to a robust growth of foreign currency deposits (15.5 per cent.). In contrast, banks' foreign liabilities continued to grow throughout 2009 (by 6.7 per cent. year-on-year), except during the tourist season, when banks usually use seasonal deposit inflows generated by the tourism industry to decrease their foreign currency denominated debt. As the majority of non-resident deposits and loans came from foreign owners, parent bank funding proved to be a stable and significant source of financing of the domestic banking sector, especially given the adverse conditions in international markets and the slowdown of inflows from domestic financing sources.

In 2010, most monetary aggregates grew despite the decline in overall economic activity. M1 recovered most, growing by 4.2 per cent. Against the background of adverse economic conditions and a slight fall in deposit rates, the growth in total savings and time deposits was similar to the growth in 2009 (4.5 per cent.). This was exclusively associated with foreign currency deposits, as Kuna deposits continued to fall, thus further increasing the degree of euroisation of the domestic banking system. At the end of 2010, the share of foreign currency deposits in total time and savings deposits was 81 per cent. As a result of the growth in M1 and in savings and time deposits, total liquid assets (M4) increased by 4.4 per cent. in 2010.

Bank placements to the non-banking sector grew by 6.9 per cent. in 2010. It should be noted that almost half of this increase was due to exchange rate changes, particularly the weakening of the Kuna against the Swiss franc of 20.8 per cent. in 2010, which increased the amount of Swiss franc placements expressed in Kuna terms. At the end of 2010, loans indexed to CHF accounted for almost one fourth of total credit to households, while within corporate loans the share of these loans is much smaller (3.4 per cent.). Excluding the exchange rate effects, the rise in total placements to the non-banking sector was 3.6 per cent.

The positive trends in placements were favoured by a slight decrease in lending rates and the comfortable liquidity position of the banking system. However, due to weak loan demand, no significant recovery in bank lending has been recorded yet, especially for the household sector. The growth in bank loans was almost exclusively related to the corporate sector. Corporate placements grew by 8.8 per cent. in 2010 (7.0 per cent. excluding the exchange rate effect), mostly in the form of loans to private enterprises. The breakdown of corporate loans by maturity shows that the share of long-term loans increased. In contrast to corporate placements, household lending continued to decline. Excluding the exchange rate effect, household loans dropped by 1.4 per cent. Within the structure of household loans, the sharpest fall was recorded in car purchase loans and credit card loans.

In 2010, the central government continued to finance its needs on the domestic banking market, resulting in the growth of bank lending to that sector by 13.7 per cent.

In the first four months of 2011, moderate growth of bank placements to the non-banking sector was again mainly due to lending to enterprises. By April 2011, the exchange rate-adjusted annual growth rate of banks' placements to the corporate sector increased to 8.3 per cent from 7.0 per cent. at the end of 2010. In addition, the CNB's decision to stimulate banks' lending activity by reducing the minimum foreign exchange liquidity requirement from 20 per cent. to 17 per cent. is expected to additionally encourage lending to the corporate sector. In relation to lending to the household sector, in the first four months of 2011, no recovery in bank lending has been recorded. In the same period lending to the government continued to be strong. In the first four months of 2011 net bank placements to central government increased by 18.7 per cent.

M4 declined in the first four months of 2011 by 0.9 per cent (excluding the exchange rate effect). This decline can mainly be attributed to seasonal factors and the decline in the term and amount of saving deposits of enterprises. In the same period, M1 increased by 2.5 per cent., primarily as a result of growth in corporate demand deposits.

Reserve money ("**M0**") increased in 2009 (12.9 per cent. year-on-year) standing at HRK 56.1 billion at year-end. The rise in demand for reserve money was due to the increase in Kuna reserve requirement for banks. Namely, 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 reserve requirement for foreign currency-denominated deposits that is covered by Kuna-denominated assets from 50 per cent. to 75 per cent. Although the balance of M0 at the end of 2010 was almost the same as at the end of 2009, M0 fluctuated from HRK 54.1 billion to HRK 57.8 billion over the year. The volatility of M0 was largely due to inflows and outflows of government Kuna deposits with the CNB. In the first five months of 2011, M0 increased strongly (by 10.3 per cent compared to M0 as at 31 December 2010), reaching HRK 59.6 billion at 31 May 2011. This growth was mainly a result of the central bank's purchase of EUR 850 million from the Government, through which the CNB created HRK 6.2 billion of Kuna liquidity.

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				
	2006	2007	2008	2009	2010
	(HRK millions)				
ASSETS					
Foreign assets	64,088.2	68,177.8	66,805.5	75,807.8	78,728.2
Gold	—	—	—	—	—
Holdings of SDRs	5.3	5.6	5.3	2,423.7	2,634.5
Reserve position in the IMF	1.3	1.3	1.3	1.3	1.4
Currency and demand deposits with foreign banks	7.2	7.2	1,472.7	1,763.8	1,483.0
Time deposits with foreign banks	33,243.0	33,204.4	13,189.3	17,534.5	22,702.9
Securities in foreign currency	30,831.2	34,959.3	52,136.9	54,084.5	51,906.5
Non-convertible foreign exchange	0.0	0.0	0.0	0.0	0.0
Claims on central government and funds	0.9	1.0(1)	2.2	2.9	0.3
Claims in Kuna	0.9	1.0(1)	2.2	2.9	0.3
Bridging loans	—	—	—	—	—
Loans under separate decrees	—	—	—	—	—
Overdue claims	0.9	1.0	2.2	2.9	0.3
Claims in foreign currency	—	—	—	—	—
Claims on other domestic sectors	64.0	67.9	64.2	4.2	3.8
Claims on banks	3,911.5	4,178.3	13.9	13.5	12.9
Credits to banks	3,911.5	4,178.3	13.9	13.5	12.9
Refinancing of banks	—	—	—	—	—
Short-term credits against securities portfolio	—	—	—	—	—
Lombard credits	—	1,349.1	—	—	—
Short-term liquidity credits	—	—	—	—	—
Other credits	14.5	14.7	13.9	13.5	12.9
Reverse repo transactions	3,897.0	2,814.5	—	—	—
Overdue claims	—	—	—	—	—
Claims on other banking institutions	—	—	—	—	—
Total	**68,064.6**	**72,425.1**	**66,885.8**	**75,828.3**	**78,745.2**
LIABILITIES					
Reserve money	46,331.2	51,923.9	49,743.0	56,141.9	56,249.1
Currency outside banks	14,609.3	16,007.5	17,051.0	15,282.1	15,262.7
Banks' cash in vaults	2,698.0	3,305.8	3,428.3	3,659.6	4,048.7
Banks' deposits	29,023.9	32,610.6	29,263.7	37,200.1	36,937.6
Settlement accounts	8,535.7	7,553.9	9,520.3	12,024.6	10,246.1
Statutory reserves	20,478.2	22,275.6	19,222.7	23,600.6	22,705.1
CNB bills on obligatory basis	—	1,991.1	460.6	—	—
Overnight deposits	10.0	790.0	60.0	1,575.0	3,986.4
Deposits of other banking institutions	—	—	—	—	—
Deposits of other domestic sectors	—	—	—	—	0.0
Restricted and blocked deposits	16,633.5	14,286.0	8,064.1	5,091.6	4,833.9
Statutory reserve in foreign currency	16,576.7	14,257.5	8,008.3	5,041.7	4,773.2
Restricted deposits	56.9	28.6	55.8	49.9	60.7
Escrow deposits	—	—	—	—	—
Foreign liabilities	18.9	17.2	16.6	8.1	8.7
Use of IMF credit	—	—	—	—	—
Liabilities to international organisations	18.9	17.2	16.6	8.1	8.7
Liabilities to foreign banks	—	—	—	—	—
Central government and funds deposits	188.0	199.1	206.9	4,171.4	5,356.3
Demand deposits	174.5	125.8	171.1	1,839.2	2,629.9
Central government demand deposits	138.6	100.3	43.0	1,772.9	1,379.8
Central government funds demand deposits	35.9	25.4	128.2	66.2	1,250.1
Central government foreign currency deposits	13.5	73.3	35.8	2,332.2	2,726.4
CNB bills	—	—	—	—	—
CNB bills	—	—	—	—	—
Capital accounts	5,408.8	6,664.5	9,562.4	11,151.3	13,090.1
Other items (net)	(515.8)	(665.6)	(707.1)	(735.9)	(792.9)
Total	**68,064.6**	**72,425.1**	**66,885.8**	**75,828.3**	**78,745.2**

Source: Croatian National Bank

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), the 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). After a decrease in January and February 2009, gross international reserves started to increase and reached EUR 10.4 billion at year-end 2009, up by 13.76 per cent. compared with year-end 2008. Net international reserves of the CNB, which comprise an active portfolio managed by the CNB and foreign cash, rose by EUR 1,012.27 million in 2009 (12.6 per cent.) compared with 2008. At the end of 2009, net international reserves of the CNB stood at EUR 9,033.53 million.

The main factors leading to changes in the level of gross international reserves in 2009 on the inflow side were: EUR 1,125.75 million in foreign exchange interventions involving purchases of foreign currency from the banks; EUR 118.9 million in income from international reserves investment; EUR 669.8 million in foreign currency purchases from the Ministry of Finance and EUR 11.1 million in cross-currency changes.

The main factors leading to changes in the level of total international reserves in 2009 on the outflow side were: a fall of EUR 402.9 million in foreign currency reserve requirements; EUR 99.3 million in foreign currency sales to the Ministry of Finance and EUR 801.0 million in foreign exchange interventions involving sales of foreign currency to the banks.

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

In 2010, total international reserves of the CNB increased by 2.7 per cent., reaching EUR 10,660.30 million at the end of 2010, compared to EUR 10,375.55 million at year-end 2009. As of 31 December 2010, net international reserves of the CNB were EUR 9,287.93 million, which represents an increase of 2.8 per cent. as compared to EUR 9,034.53 million as of 31 December 2009.

The main factors leading to changes in the level of total international reserves in 2010 on the inflow side were: foreign currency inflows to the Ministry of Finance's account with CNB which amounted to EUR 1,551.14 million (including EUR 239.94 million in foreign currency the CNB purchased from the Ministry of Finance); EUR 363.70 million in foreign exchange interventions involving purchases of foreign currency from the banks; EUR 166.95 million in cross-currency changes; and EUR 91.69 million in income from international reserves investment.

The main factors leading to changes in the level of total international reserves in 2010 on the outflow side were: foreign currency outflows from the Ministry of Finance's account with CNB amounting to EUR 1,461.45 million (including EUR 234.03 million in foreign currency the CNB sold to the Ministry of Finance); EUR 350.10 million in foreign exchange interventions involving sales of foreign currency to the banks and a fall of EUR 79.39 million in foreign currency reserve requirements. The SDR 303.2 million allocation received in 2009 remained the same in 2010.

In the first five months of 2011, gross international reserves increased substantially (by 6.9 per cent relative to gross international reserves as at 31 December 2010), and reached EUR 11.4 billion at the end of May 2011. This growth was almost exclusively a result of Government foreign currency inflow related to an international bond issuance by the Government of USD 1.5 billion in March 2011. The CNB converted the majority of these foreign currency funds into Kuna, which led to an increase in both gross and net international reserves of the CNB. As a result, net international reserves of the CNB increased by 8.0 per cent compared to net international reserves of the CNB at 31 December 2010 and subsequently increased to EUR 10.0 billion at 31 May 2011.

As investors sought 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-collateralised 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. By way of response to the eurozone sovereign debt crisis in 2010 and the consequent fall in U.S. and German bond yields, the CNB shortened its investment portfolio duration. Furthermore, credit risk limits were further tightened and investments in countries with lower credit ratings were eliminated.

According to the degree of credit risk exposure, net 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 net international reserves, the share of investments in government bonds grew from 80.9 per cent. at

31 December 2008 to 85.6 per cent. at 31 December 2009. The share of net international reserves invested in non-collateralised instruments with the banks slightly increased from 1.3 per cent. at the end of 2008 to 1.6 per cent. at the end of 2009. During the same period, investments in international financial institutions and central banks also decreased, accounting for 10.5 per cent. of net international reserves. As of 31 December 2010, the share of net international reserve investments in government bonds increased to 88.1 per cent. from 85.6 per cent. at 31 December 2009; the share of investments with central banks and international financial institutions slightly increased to 10.6 per cent. from 10.5 per cent. at 31 December 2009; and the share of net international reserves invested in non-collateralised instruments decreased to 1.3 per cent., from 1.6 per cent. at the end of 2009.

Set out below is the composition of total international reserves for the periods indicated:

	Year ended 31 December					Three months ended 31 March
	2006	2007	2008	2009	2010	2011
	(EUR millions)					
Total international reserves	**8,697.89**	**9,247.32**	**9,120.74**	**10,375.55**	**10,660.31**	**11,393.85**
Statutory reserve in foreign currency	2,256.01	1,945.32	1,093.60	690.16	646.33	666.82
Central government foreign currency deposits	1.83	10.01	4.88	319.21	369.18	355.50
Holdings of SDRs	—	—	—	331.65	356.73	341.10
Net international reserves[(1)]	**6,440.04**	**7,291.99**	**8,022.26**	**9,034.53**	**9,288.08**	**10,030.43**

Source: Croatian National Bank

(1) Net international reserves = Total international reserves — Statutory reserve in foreign currency — Central government foreign currency deposits — SDR holdings. (Note: SDR holdings were included in net international reserves until 2009).

The following table sets out the composition of net international reserves for the periods indicated:

	Year ended 31 December		
	2008	2009	2010
	(per cent.)		
Government bonds	80.9	85.6	88.1
Financial instruments of central banks and international financial institutions	17.8	10.5	10.6
Non-collateralised instruments	1.3	1.6	1.3
Bank/covered bonds	0.0	2.3	0.0
Total	**100.0**	**100.0**	**100.0**

Source: Croatian National Bank

In terms of credit rating, 74.7 per cent. of the total reserves in 2009 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 10.5 per cent. of international reserves investment, banks rated Aa3 4.4 per cent., while the remaining share (10.4 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 remained mostly the same in 2010 with 70.22 per cent. invested in securities of countries and banks with an Aaa rating, 19.5 per cent. of total reserves was invested in banks with Aa1, Aa2 or Aa3 rating, and the remaining 10.3 per cent. of total international reserves invested in the International Monetary Fund and Bank for International Settlements.

As at 31 December 2009, the share of reserves in euro in net international reserves was 81.2 per cent. and the share of reserves in U.S.$ was 18.8 per cent. This ratio has generally not changed in 2010 — the share of reserves in euro in net reserves was 80.9 per cent. and the share of reserves in U.S.$ was 19.1 per cent. at the end of 2010.

The average size of the CNB euro portfolio that was actively managed by the CNB in 2009 was EUR 6.7 billion and the average size of the U.S.$ portfolio was U.S.$1.5 billion. In 2009, the net yield on the CNB euro portfolio was 1.73 per cent. (according to the Global Investment Performance Standards methodology) and the net yield on the CNB U.S.$ portfolio during the same period was 0.50 per cent. In 2010, the average size of the CNB euro portfolio and of the U.S.$ portfolio that were actively managed by the CNB increased to EUR 7.34 billion and U.S.$ 2.26 billion, respectively. In 2010, the net yield on the CNB euro portfolio was 1.09 per cent. and the net yield on the CNB U.S.$ portfolio was 0.67 per cent. The yields have been somewhat lower for the CNB euro portfolio during 2010 due to interest rate movements in the global markets, along with the above mentioned tightening of the investment guidelines.

Income realised from the investment of reserves in 2009 was EUR 111.0 million and U.S.$11.5 million. In 2010, the income realised from the investment of reserves was EUR 79.7 million and U.S.$16.01 million.

Capital adequacy, CNB measures to incentivise local currency lending and the impact of Basel II implementation

The regulations relating to capital adequacy calculations 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 was 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 was 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.

As of the beginning of 2008 the capital adequacy calculation regulations were strengthened further: instead of risk weightings 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 of 100 per cent. and 150 per cent., respectively, were applied.

The new Decision on the capital adequacy of credit institutions, which is harmonised with Basel II and EU regulations for calculating capital adequacy, entered into force on 31 March 2010. As a result, the minimum capital adequacy ratio was raised from 10 per cent. to 12 per cent. as of 31 March 2010. In addition as a result of the new methodology prescribed in the CNB harmonising legislation, at 31 March 2010, the capital adequacy ratio of the banking system increased by 2.52 percentage points over the end of 2009 and amounted to 18.97 per cent. This ratio remained stable at the end of March 2011 when it amounted to 19.13 per cent. The new methodology prescribes more detailed rules for applying risk weights. Although the prescribed risk weights are generally lower for all types of loans (including Kuna loans), due to the large share of currency-induced credit risk positions in total risk weighted assets, the capital adequacy increase was mostly triggered by lower risk weights on these positions.

Measures to control the increase of the unhedged euro-denominated asset base

In the years prior to the financial crisis, the CNB initiated several measures to indirectly stimulate the growth of banks' capital and domestic currency deposits, as opposed to foreign currency sources. These measures 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 addition, amendments to the minimum liquidity requirement of foreign exchange liabilities 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. Although these measures resulted in a decrease in the share of foreign currency and indexed items in banking assets (from 65.0 per cent. in 2006 to 57.5 per cent. in 2007) after the escalation of the financial crisis this share began to increase again (to 60.8 per cent. in 2008 and approximately 65.0 per cent. in both 2009 and 2010).

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 include the issuance and withdrawal of authorisations 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, specialised 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. The off-site supervision department makes assessments of banks' risk profiles 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, which, *inter alia,* implements Basel II and aligns Croatian legislation in that area with the relevant EU directives, 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 administrator, 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 administrator 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 a prohibition on profit distribution, ordering a reduction of expenses, limiting asset increases, a prohibition on the acquisition of shares or holdings in other legal persons, a prohibition on 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 any of the 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.

Under the Basel III regulatory framework, the Basel Committee on Banking and Supervision has proposed a number of fundamental reforms to the regulatory capital framework for internationally active banks, the principal elements of which are set out in its papers released on 16 December 2010. In addition, on 13 January 2011 the Basel Committee published the minimum requirements for regulatory capital to ensure loss absorbency at the point of non-viability. This release states that instruments issued after 1 January 2013 must meet these requirements in order to be recognised as Tier 1 or Tier 2 instruments for regulatory capital purposes. In addition, on 6 January 2011 the European Commission's services issued for consultation a technical working document on a possible framework for bank recovery and resolution, which includes proposals for a common set of tools for resolution of banks to improve the effectiveness of the arrangements for dealing with bank failures in the European Union. In particular, the working document includes a discussion of possible proposals to give the authorities resolution powers to write down debt of a failing bank (or to convert such debt into equity) to strengthen its financial position and allow it to continue as a going concern subject to appropriate restructuring. The CNB is actively monitoring these developments and plans to implement Basel III reforms in accordance with its international obligations, including its obligations as a candidate for EU accession.

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 March 2011 the Croatian banking system comprised 33 banks (1 of which being savings bank), 5 housing savings banks and HBOR. During the first half of 2009 one large and one middle sized bank merged and in the second half of 2010 one savings bank (with a market share of less than 0.05 per cent.) left the market following the loss of its banking licence. Six foreign banks have offices in Croatia. The decrease in the number of banks after 1998 has resulted from consolidation/mergers, takeovers 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						Three months ended 31 March
	2005	2006	2007	2008	2009	2010	2011
State ownership[(1)]	3.4	4.2	4.9	4.5	4.2	4.3	4.3
Private domestic ownership	5.3	5.0	4.7	4.9	4.9	5.3	5.4
Foreign bank ownership	91.3	90.8	90.4	90.6	90.9	90.4	90.3
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Croatian National Bank

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

The banking system in Croatia is highly concentrated with the two largest banks holding 42 per cent. of the market as at 31 March 2011. The majority of the commercial banks' assets are controlled by foreign shareholders. As at 31 March 2011, 15 entities were majority owned by foreign shareholders, 15 by private domestic shareholders and 2 by the State.

The table below provides a breakdown of the ownership of banks in Croatia as at 31 March 2011.

	Voting shares				
	In private (domestic) ownership	In government (domestic) ownership	Foreign (private) ownership	Share of market	Share in shareholders equity
			(per cent.)		
Zagrebacka banka d.d	2.7	0.6	96.7	25.4	26.4
Privredna banka Zagreb d.d	1.7	0.2	98.1	16.9	19.1
Erste&Steiermärkische Bank d.d. Rijeka	0.0	0.0	100.0	13.2	11.2
Hypo Alpe-Adria-Bank d.d	0.0	0.0	100.0	10.0	11.6
Raiffeisenbank Austria d.d	0.0	0.0	100.0	9.8	10.4
Société Générale-Splitska banka d.d	0.0	0.0	100.0	6.7	6.1
HPB d.d	0.4	99.5	0.1	3.9	2.2
OTP banka d.d	0.0	0.0	100.0	3.2	2.7
Volksbank d.d	0.0	0.0	100.0	2.0	2.9
Medimurska banka d.d	0.0	0.0	100.0	0.8	0.6
Podravska banka d.d	11.0	1.6	87.4	0.7	0.7
Jadranska banka d.d	70.8	12.1	15.3	0.7	0.7
Banco Popolare Croatia d.d	1.1	0.0	99.0	0.6	0.5
Istarska kreditna banka Umag d.d	70.2	3.7	26.1	0.6	0.4
Kreditna banka Zagreb d.d	87.7	0.4	11.9	0.6	0.5
Karlovacka banka d.d	94.5	5.1	0.4	0.6	0.2
Croatia banka d.d	0.0	100.0	0.0	0.5	0.2
Credo banka d.d	90.1	3.2	6.7	0.4	0.3
Imex banka d.d	100.0	0.0	0.0	0.4	0.2
Centar banka d.d	82.3	0.0	17.6	0.4	0.4
Vaba d.d. banka Varaždin	63.0	9.4	27.6	0.4	0.3
Partner banka d.d	100.0	0.0	0.0	0.3	0.3
Slatinska banka d.d	84.9	8.8	6.3	0.3	0.3
Banka Kovanica d.d	0.7	0.0	99.3	0.3	0.1
Stedbanka d.d	100.0	0.0	0.0	0.3	0.6
Veneto banka d.d	0.0	0.0	100.0	0.3	0.3
BKS Bank d.d	0.0	0.0	100.0	0.2	0.2
Banka Brod d.d	99.9	0.1	0.0	0.1	0.1
Samoborska banka d.d	98.6	1.4	0.0	0.1	0.2
Banka splitsko-dalmatinska d.d	84.4	0.0	15.6	0.1	0.1
Nava banka d.d	70.2	0.0	29.8	0.1	0.0
Primorska banka d.d	10.2	0.0	89.8	0.0	0.1
Aggregate weighted average by market share	5.7	4.7	89.6		
Aggregate weighted average by share in shareholders equity	5.0	2.8	92.2		

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 medium-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 31 March 2011. 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 31 March 2011:

	Money assets and deposits with the CNB	Deposits	Securities	Loans	Other
			(per cent.)		
Large banks	12.5	5.3	8.1	71.4	3.4
Medium-sized banks	13.7	5.9	11.8	65.0	4.3
Small banks	11.6	11.1	12.2	60.5	5.4
Total banks	**12.5**	**5.9**	**8.8**	**69.9**	**3.7**

Source: Croatian National Bank

The following table sets forth the structure of bank peer group liabilities as at 31 March 2011:

	Capital	Deposits	Securities	Loans	Other
			(per cent.)		
Large banks	14.7	68.0	0.9	13.2	3.2
Medium-sized banks	12.4	73.3	1.9	6.4	6.1
Small banks	11.7	74.1	1.2	9.9	3.1
Total banks	**14.2**	**69.0**	**1.0**	**12.3**	**3.5**

Source: Croatian National Bank

Asset growth of the banking sector was relatively slow in 2009 and 2010 reflecting scarce and expensive funding as well as risk averse behaviour of banks. In 2010, bank assets recorded an increase of 3.4 per cent., following growth of 2.2 per cent. in 2009. Relaxation of monetary and prudential measures allowed banks to use liquidity reserves to expand loans at a slightly faster pace in 2009 (2.4 per cent.) than the growth rate of overall assets. Easier access to funding did not result in a significant increase of loans in 2010 (5.9 per cent. in nominal terms (2.4 per cent. when exchange rate effects are excluded)). During the first three months of 2011 total assets stagnated and the share of loans in total assets increased further due to the increase of loans extended to the Government and the decrease of foreign liquid assets.

After its growth stopped and reversed in 2008, the Kuna component of banks' assets and liabilities continued to decline in 2009 but increased slightly in 2010 and the first three months of 2011. At 31 March 2011, the currency structure of bank assets remained stable compared with the end of 2009 and consisted of 35.2 per cent. Kuna assets, 40.9 per cent. foreign currency indexed assets and 23.8 per cent. foreign currency assets. At the same date, the currency structure of liabilities and capital was 41.0 per cent. Kuna, 55.1 per cent. foreign currency and 3.9 per cent. indexed to foreign currency.

Capitalisation

At the end of 2010, the total capital of Croatian banks was HRK 54.4 billion, an increase of 3.5 per cent. from the end of 2009 and of 8.9 per cent. from the end of 2008. The major contributors to this were retained earnings, share capital and statutory and other reserves which increased 56.8 per cent., 4.2 per cent. and 8.3 per cent., respectively, from 2008 to 2010. During the first three months of 2011, banks' capital increased by 1.8 per cent. from December 2010, reaching 14.2 per cent. of total assets. Despite high value adjustments costs, banks' current year pre-tax profit increased by 3.3 per cent. in 2010 mainly as a result of strong net interest income and increased cost efficiency.

The growth of assets of financial intermediaries in Croatia was 2.6 per cent. in 2008, 3.9 per cent in 2009 and 3.8 per cent. in 2010, representing a compounded annual growth rate of 3.4 per cent. for the three years period.

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'.

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 40 million for banks, HRK 8 million for savings banks, and HRK 20 million for housing savings banks.

At the end of 2010 the regulatory capital of Croatian banks totalled HRK 54.4 billion, an increase of 3.6 per cent. compared with the end of 2009 and of 11.2 per cent. compared with the end of 2008. During the first three months of 2011, banks' regulatory capital increased further by 0.6 per cent. compared with the end of 2010. Since banks in Croatia have a conservative capital structure, regulatory capital is predominantly made up of Tier 1 capital (around 93 per cent. as of 31 March 2011).

After increasing from 14.0 per cent. in 2006 to 16.4 per cent. in 2007, the banking sector capital adequacy ratio declined to 15.2 per cent. in 2008 and rose again to 16.4 per cent. in 2009. The principal reason for the decline in the capital adequacy ratios recorded in 2008 was changes in prudential measures aimed at increasing the capital required for currency induced credit risk. During 2009, risk weighted assets, as well as total bank exposures to risks, declined by approximately 1 per cent. indicating a decreased risk appetite on the part of banks during the financial crisis (a slowdown in banks' activities and the increased share of loans to the Government which have a zero per cent. risk-weighting). In 2010, bank regulatory capital increased by 3.6 per cent. Importantly, however, the total risk exposures declined significantly because of the new methodology (in line with Basel II standards) used for its calculation. Consequently, the capital adequacy ratio increased to 18.4 per cent. in 2010 and increased slightly to 19.1 per cent. as of 31 March 2011.

The slowdown in the growth of bank assets started in 2008 and can to a large extent be attributed to the escalation of the global financial crisis and deterioration in market conditions, which stimulated risk averse behaviour by market participants, resulting in a significant decrease in credit growth. The commencement of the global financial crisis in 2008 prompted the CNB to redesign its measures: the Marginal Reserve Requirement was abolished in 2008 and the Minimum Required Amount of Foreign Currency Claims was reduced twice in February 2009 (from 28.5 per cent. to 25.0 per cent. and further from 25.0 per cent to 20.0 per cent). Also, the compulsory purchase of CNB bills, introduced in 2007 with the goal of slowing down credit growth and credit risk build-up, was cancelled in 2009. Subsequently, total bank assets increased by 7.2 per cent. in 2008 and by 2.2 per cent. in 2009. Risk averse behaviour by banks coupled with scarce and expensive funds as well as low demand for credit led to the stagnation of asset growth in 2010 (0.7 per cent. effectively and 3.4 per cent. nominally). Total bank assets as at 31 December 2010 amounted to HRK 391.1 billion, an increase of HRK 12.9 billion as compared with the end of 2009. Although the nominal annual growth rate of bank assets was higher in 2010 than in 2009 (when it was 2.2 per cent.) this was primarily a result of a Swiss franc appreciation against Kuna meaning that the growth of bank assets continued to decelerate for a fourth year. During the first three months of 2011 the effective stagnation of banking sector assets continued.

The following table sets out an overview of the assets, placements and contingent liabilities of the Croatian banks as at 31 December for the years 2006 to 2010 and for the three months ended 31 March 2011:

	Year ended 31 December				Three months ended 31 March
	2007	2008	2009	2010	2011
	(HRK millions)				
Total assets	345,081	369,955	378,216	391,088	389,805
Total placements and contingent liabilities	396,421	422,478	426,886	419,309	420,614

Source: Croatian National Bank

According to audited data, in 2010 commercial banks in Croatia realised HRK 4.4 billion profit before tax, a decrease of 3.3 per cent. in comparison with 2009. Eight banks realised losses in 2009 and their assets represent 1.5 per cent. of the total assets of all banks in Croatia. The total loss amounted to HRK 193.4 million, or 0.05 per cent. of all bank assets in Croatia. During the first three months of 2011, banks' pre-tax profits totalled HRK 1.3 billion, representing a decrease of 3.5 per cent. compared with the first three months of 2010. Seven banks reported losses in the first three months of 2011 totalling HRK 62.9 million. The reduction in total bank profits in the first three months of 2011 compared to the first three months of 2010 was primarily due to an increase in operating profits that exceeded value adjustment costs (which were slightly higher in the first three months of 2011 as compared with the first three months of 2010).

Loan Exposure

Total (net) loans of banks in 2010 amounted to HRK 267.1 billion, which is an increase of 5.9 per cent. as compared to 2009. Of those loans 45.5 per cent. were retail loans, while 38.2 per cent. were corporate loans. As of 31 March 2011 the total (net) amount of loans was HRK 272.4 billion, representing an increase of 2.0 per cent. compared with the end of 2010. Loans to the corporate sector increased by 1.1 per cent. and loans to households decreased by 1.6 per cent during the first three months of 2011 compared to the first three months of 2010. Loans to non-residents increased by 3.3 per cent. in first three months of 2011 compared to growth of 20.8 per cent. in the first three months of 2010, however, their share of total loans remained below 1 per cent. Strongest growth however was recorded with loans to government entities (17.4 per. cent) which resulted in the share of loans to enterprises in total loans falling to 37.9 per cent. and the share of loans to households in total loans falling to 43.9 per cent.

During 2010, the share of non-performing loans continued to increase as it rose from 7.8 per cent. in 2009 to 11.2 per cent. in 2010. The level of non-performing loans as of 31 March 2011 stood at approximately 11.5 per cent.

The table below shows the percentage of loans that were non-performing as at the dates indicated:

	As at 31 December						As at 31 March
	2002	2004	2006	2008	2009	2010	2011
				(per cent.)			
Non-performing loans	10.2	7.4	5.2	4.9	7.8	11.2	11.5
Non-performing loans to households	—	4.7	4.1	3.9	5.8	7.8	8.0
Non-performing loans to enterprises	—	11.9	7.7	7.2	12.8	18.0	18.7

Source: Croatian National Bank

While non-performing loans increased across all sectors in 2010, including in the household sector which historically has demonstrated lower levels of non-performing loans, the increase in non-performing loans in the corporate sector was the greatest.

Historically, the household sector has demonstrated lower levels of non-performing loans, due to the fact that household loans are generally collateralised and often guaranteed by third parties. By comparison, corporate loans do not benefit from such security and carry higher risk; hence, non-performing loans in the corporate sector have therefore increased as a result of the general decline in economic activity.

Real estate prices started to decline in 2008 and the trend continued in 2009 and 2010, 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 (measured in terms of average market price) was 4.8 per cent. in 2009 compared to the peak in real estate prices reached in 2008 and additional decline of 5.5 per cent. in 2010 compared to 2009. This decline is not expected to have a significant impact on the quality of banks' collateral as banks were conservative in granting the loans and 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 still small, but rising portion of housing loans (approximately 4.5 per cent. as at 31 March 2011) are currently non-performing. The performance of housing loans, in addition to job losses and unfavourable labour market developments, has been adversely affected by the appreciation of the Swiss franc against Kuna exchange rate (17.2 per. cent in 2010 and 3.3 per cent. in the first five months of 2011) with around 45 per cent. of housing loans being indexed to the Swiss franc. Elevated interest rates, which remain somewhat above their pre-crisis level, further undermined the performance of household loans (the average interest rate on long term foreign currency indexed loans to households amounted to 6.5 per cent. in 2007, 7.8 per cent. in 2008, 8.6 per cent. in 2009 and 8.6 per cent. in 2010). In the first three months of 2011 the average interest rate on long term foreign currency indexed loans to households declined to 8.2 per cent.

The table below shows a breakdown of total loans by currency as at the dates indicated:

	As at 31 December							As at 31 March
	2004	2005	2006	2007	2008	2009	2010	2011
					(per cent.)			
Currency breakdown of total loans								
Euro	73.6	68.1	53.6	43.5	48.0	58.2	59.6	61.3
CHF	3.1	9.6	15.0	16.5	16.0	13.4	12.9	11.5
Other currencies	3.7	3.7	3.0	1.4	1.4	1.2	1.1	1.0
Kuna	19.7	18.6	28.5	38.6	34.6	27.3	26.4	26.1

Source: Croatian National Bank

Total annualised expenses on loss provisions rose from HRK 3,514.6 million at the end of 2009 (which represented a 220.8 per cent. increase compared with 2008) to HRK 3,713.6 million at the end of 2010 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 (net) to households reached HRK 122.2 billion at the end of 2010, an increase of HRK 3.7 billion (3.2 per cent.) compared to the end of 2009. The 3.2 per cent. nominal growth of household loans in 2010 was, however, driven by Swiss franc appreciation against the Kuna. The share of household loans in total net loans to households increased during 2010 while credit card loans and vehicle purchase loans decreased and mortgage loans and other loans to households stagnated. Again, driven by the Swiss franc exchange rate (which depreciated against the Kuna by 4.2 per cent. in the first three months of 2011), net loans to households reached HRK 120.3 billion at 31 March 2011, a decrease of HRK 1.9 billion (1.5 per cent.) compared to the end of 2010.

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 2009 and 2010 reflecting turbulence in the macroeconomic environment and weaker demand. During 2010 and the first three months of 2011 housing loans, mortgage loans and general purpose loans (representing together more than 90 per cent. of total household loans) effectively stagnated while vehicle purchase loans and credit card loans decreased. The share of housing loans in total net loans to households increased to 46.9 per cent. as of 31 March 2011. Apart from relatively faster growth of these loans compared with other loans to households and Kuna depreciation against Swiss franc (currency mostly present in housing indexed loans), this is also a result of slower increase of non performing housing loans compared with other household loans.

After posting an annual growth of 3.6 per cent. in 2009, in 2010 bank deposits grew by 4.9 per cent. This slowdown in the rate of growth of deposits was mainly the result of an 8.2 per cent. increase in the amount of deposits by households while deposits by enterprises increased only slightly (by 1.6 per cent.). In the first three months of 2011, bank deposits stagnated. The share of deposits to total bank liabilities has remained relatively stable since 2007 and stood at 69.0 per cent. as at 31 March 2011.

The table below shows loans extended and deposits received by the banking sector as at the dates indicated:

	As at 31 December		As at 31 March		As at 31 December		As at 31 March	
	2009	2010	2010	2011	2009	2010	2010	2011
	(HRK millions.)				*(per cent. change over end of previous year)*			
Loans	**252,308**	**267,101**	**253,901**	**272,368**	**2.4**	**5.9**	**0.6**	**2.0**
Households	118,449	122,183	118,232	120,295	(2.9)	3.2	(0.2)	(1.5)
Enterprises	94,673	102,027	96,734	103,144	0.6	7.8	2.2	1.1
Government	31,542	34,577	32,161	40,605	46.7	9.6	2.0	17.4
Financial institutions	6,048	6,386	5,126	6,332	4.5	5.6	(15.2)	(0.8)
Non-residents	1,596	1,929	1,648	1,992	(16.8)	20.8	3.2	3.3
Deposits	**256,680**	**269,178**	**253,672**	**269,113**	**3.6**	**4.9**	**(1.2)**	**0.0**
Households	144,052	155,803	145,705	155,964	3.6	8.2	1.1	0.1
Enterprises	45,072	45,798	43,992	42,568	(8.8)	1.6	(2.4)	(7.1)
Government	4,214	5,212	4,538	5,128	(29.9)	23.7	7.7	(1.6)
Financial institutions	17,458	15,000	15,839	14,773	9.5	(14.1)	(9.3)	(1.5)
Non-residents	45,883	47,365	43,597	50,680	22.9	3.2	(5.0)	7.0

Source: Croatian National Bank

As of 31 December 2010, total deposits amounted to HRK 269.2 billion with household deposits being the main driver of their growth. Deposits from financial institutions were the only deposits to decline in 2010. As of 31 March 2011, total deposits amounted to HRK 269.1 billion, with an increase in non-resident (mostly foreign owners of Croatian resident financial institutions) deposits of HRK 3.3. billion (7.0 per cent.) compensated for by a HRK 3.2 billion (7.1 per cent.) decrease of enterprise deposits as at 31 March 2011 each as compared to 31 December 2010. All the other deposits stagnated. Since households and non-residents foreign exchange deposits were the main driver of the increase of deposits after 2009, the currency structure of deposits continued to change with the non Kuna component declining to 68.6 per cent. as of March 2011.

As of 31 March 2011, 66.9 per cent. of total deposits were denominated in a foreign currency, 31.4 per cent. in Kuna, and only 1.7 per cent. were deposits indexed to foreign currency. Total deposits consisted of 58.0 per cent. household deposits, 15.8 per cent. corporate deposits, with 18.8 per cent. belonging to non-residents and 7.3 per cent. to State and financial institutions.

The 2.0 per cent. increase in total bank loans in the first three months of 2011 was due to an increase in loans to the Government, which rose by approximately HRK 6.0 billion compared with the end of 2010. The total placements of banks to the central government amount to HRK 57.6 billion at 31 March 2011, which is an increase of 14.8 per cent. compared to the end of 2010 and of 24.6 per cent. compared to the end of 2009. This amount consists of HRK 40.6 billion in Governmental loans and HRK 17.0 billion Ministry of Finance treasury bills and government securities. The deposits of the central government with commercial banks increased during 2010 from HRK 1.38 billion at the end of 2009, to HRK 2.45 billion at the end of 2010 and decreased to HRK 2.35 billion by March 2011.

The Croatian Registry of Loan Obligations (Hrvatski registar obveza po kreditima d.o.o., "**HROK**"), a credit bureau, 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 the recent crisis on the financial markets

In 2009, a period characterised by the continuation of unfavourable macroeconomic conditions during which domestic deposits stagnated, banks were able to increase their foreign financing and foreign liquid assets. With domestic deposits growth stronger than credit growth in 2010, banks reduced their reliance on previously accumulated foreign liquid assets, which remained at a relatively high level. Banks earnings were affected to a large extent by rising value adjustment costs, which rose around 220 per cent. in 2009 and increased by a further 5.7 per cent. in 2010 exerting a significant pressure on banks profits. Banks still managed to support their operating profits however by keeping operational costs down, maintaining interest rates at relatively high levels and by increasing the share of (more expensive) short-term loans. Banks, therefore managed to offset relatively high interest costs and achieve an increase of 4.4 in their operating profits. This allowed banking sector capital levels to slightly increase making the banking sector as a whole slightly more resilient to potential future shocks. However, five banks reported negative pre-tax earnings at year-end 2010 and seven at the end of March 2011.

Although Croatian banks were not directly exposed to the global financial and economic crisis, they are partially dependent on funding from foreign parent banks that were themselves exposed to such risks. The global economic turmoil did not cause a deceleration in the inflow of capital from parent banks to the domestic banking system. Moreover, parent banks proved to be a stable source of financing through the crisis. In 2008 loans and deposits from parent banks increased by 30.9 per cent. to HRK 52.0 billion, with additional increase of 15.1 per cent. in 2009 to HRK 59.8 billion. In the first three quarters of 2010 financing from foreign owners was reduced by 4.5 per cent. to HRK 57.1 billion. The decrease in parent bank financing in the first three quarters of 2010 was driven by the reduced need for support from foreign parent banks. During 2010 financing from foreign owners was reduced by 1.5 per cent. to HRK 58.9 billion but increased again in the first three months of 2011 to allow for stronger credit growth.

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 maintaining the 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 which began in 2008 but experienced a sharp increase in the third quarter of 2010 as banks used deposit growth to support their liquidity position. The ratio of foreign liquid assets to foreign short-term liabilities fell from 81.3 per cent. at the end of 2007 to 64.6 per cent. at the end of 2008, to 53.6 per cent. at the end 2009, only to increase to 58.8 per cent. at the end of September of 2010, 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, to 64.3 per cent. at the end of 2009, only to increase to 66.0 at the end of September of 2010. The decrease of liquidity ratios from 2007 to 2009 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, decreased from 12.7 per cent. in 2007 to 11.7 per cent. in 2009. As of September 2010 this ratio stayed as at the year end 2009 level. The decrease of this ratio in the last two years was partly due to a change in regulation that allowed banks to sell a part of non-earnings bearing assets. The ratio of total liquid assets to total short-term liabilities decreased from its 2007 level of 17.6 and amounted 16.3 per cent. at the end of 2008 and 2009. As of 30 September 2010 the ratio decreased marginally and amounted to 16.2 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 in the economy. Also, macro-prudential measures of the CNB in the years of strong economic and credit growth (2006-07) enhanced the resilience of the banking sector to foreign currency liquidity risk. Marginal reserve requirements made foreign debt more expensive for banks and higher risk weights for foreign currency induced credit risk required recapitalisation of banks. Together, these measures triggered the substitution of foreign borrowing by new equity.

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 U.S.$129 million in order to help provide additional foreign exchange liquidity and increase banks' ability to fulfil their obligations towards all clients. Furthermore, decreasing the minimum required amount of foreign currency assets from 28.5 per cent. to 20.0 per cent. of total foreign liabilities, which took place in February 2010, resulted in additional foreign exchange liquidity for Croatian banks. (See also "*Monetary Policy and Instruments*" above for details of further liquidity measures).

As banks drew on their foreign currency liquidity accumulated in the pre-global financial and economic crisis period, foreign currency liquidity indicators have decreased. The ratio of foreign liquid assets to foreign short-term liabilities fell from 81.3 per cent. at the end of 2007 to 53.6 per cent. at the end of 2009, to 49.6 per cent. at the end of 2010 and to 35.5 per cent. at the end of March 2011. In the same time, the ratio of foreign liquid assets to total foreign assets declined from 73.7 per cent. at the end of 2007 to 64.3 per cent. at the end of 2009, to 62.4 at the end of 2010 and to 58.4 per cent at the end of March 2011. The decrease of liquidity ratios from 2007 to early 2011 was also influenced by 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 (particularly 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, decreased from 12.7 per cent. in 2007 to 11.7 per cent. in 2009 and to 11.5 per cent. in 2010. As of March 2011 this ratio was 10.5 per cent. In part, the decrease in this ratio reflected a change in regulation that allowed banks to sell a part of non-interest bearing assets. The ratio of total liquid assets to total short-term liabilities decreased from its 2007 level of 17.6 to 16.3 per cent. at the end of 2008 and 2009 and to 15.4 per cent. at the end of 2010. As of 31 March 2011, the ratio was 14.0 per cent.

Bank Regulation and Prudential Standards

The Credit Institutions Act, which is aligned with Basel II, 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 31 March 2010 a banks' 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: (i) credit risk; (ii) counterparty risk; (iii) position risk and settlement risk; (iv) exceeding permitted exposure limits; (v) foreign-exchange risk and commodities risk; and (vi) operational risk.

According to Croatian law both direct and indirect acquisition of a bank's shares or an increase in the holding of a bank's shares must be approved by the CNB beforehand. The thresholds set by law are: 10 per cent. or more (a qualifying holding), 20 per cent. or more, 30 per cent. or more and 50 per cent. or more shares acquired. These thresholds are based on: recommendations and practise from other countries and the historic experience of CNB and EU Directives. The motive for choosing a number of thresholds is to monitor more closely the ownership structure changes in a bank. That way, before giving the approval for crossing each threshold, CNB monitors not only the legal position of a potential acquirer, but also the acquirer's financial health and other relevant factors.

Foreign banks can offer banking and other financial services in the territory of Croatia only through branches established on the basis of a licence from the CNB. As a condition to granting a licence, the CNB also requires that the foreign bank deposits a certain amount of money in Croatia (HRK 40 million) that will be counted as regulatory capital after the establishment of the institution is complete.

The Credit Institutions Act also 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 and 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 (approximately EUR 55,000). Prior to obtaining authorization to provide services, credit institutions must join the deposit insurance scheme run by the Agency. 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.

Two banks remain state-owned — Hrvatska poštanska banka (Croatian Postal Bank) and Croatia banka.

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 U.S.$129 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 2008 to 5.77 per cent. in December of 2008. The year 2009 was generally marked by large fluctuations in interest rates on the money market, with monthly averages ranging between 19.0 per cent. in February and 1.0 per cent. in November 2009. The rate was 1.20 per cent. in December 2009. Liquidity in the financial system was high in 2010 so the total turnover in the money market was mostly at low levels, while interest rates remained around 1.0 per cent. Observed over the five-year period leading up to 2010, interest rates on money market deposits were at their highest average monthly level during the first quarter of 2009 and at their lowest average monthly level in the first quarter of 2010. Although for most of 2010, the weighted average interest rate for overnight loans in direct interbank trading was below the 1.0 per cent. level, in December 2010 it slightly increased to 1.28 per cent. and in May 2011 it stood at 0.57 per cent.

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 in the banking system, releasing funds worth EUR 3.8 billion.

Depreciation pressures on the Kuna started to subside in February and in a 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 in 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 a quarterly basis 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. The liquidity of the domestic banking system was exceptionally good throughout the last quarter of 2009, cutting interest rates on the money market to approximately 1.0 per cent. Owing to good banking system liquidity, towards the end of 2009, the average weighted interest rate on overnight loans in direct interbank trading fell to 1.20 per cent. in December 2009.

The year 2010 was marked by high liquidity in the domestic banking system and a stable EUR/HRK exchange rate. High liquidity was supported by decreasing the reserve requirement rate in February 2010 (from 14 per cent. to 13 per cent.) in order to release liquidity for government measures aimed at stimulating economic activity. Subsequently, in this period, interest rates on overnight loans in direct interbank trading reached their lowest level in the past five years, averaging below 1.0 per cent. A reduction in the rate of minimum required foreign currency assets of banks relative to their foreign currency liabilities from 20 per cent. to 17 per cent. in March 2011 further contributed to high liquidity in the domestic banking system, therefore interest rates on overnight loans in direct interbank trading remained low over the first five months of 2011 (standing at 0.57 per cent. in May 2011).

Money market turnover decreased in 2009 compared to 2008. Banks met their primary liquidity needs on the money market in the average daily amount of HRK 2.5 billion, compared to HRK 2.6 billion in 2008. In 2009, total turnover amounted to HRK 637.5 billion, compared to HRK 657.0 billion in 2008. In 2010, the average daily turnover was 1.3 billion and total turnover amounted to 319.9 billion. Average daily turnover further decreased during the first quarter of 2011 to HRK 1.2 billion with total turnover amounting to HRK 75.1 billion.

In 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 560.8 billion or 88.0 per cent.), and banks additionally raised HRK 76.7 billion by purchasing repo agreements. The remaining HRK 0.3 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 36.5 per cent. in 2009 from 41.8 per cent. in 2008, falling in 2010 and in the first quarter of 2011 to 32.2 per cent. and 17.5 per cent., respectively. Share of demand deposit trading with other legal persons increased to 40.6 per cent. in 2009 from 31.8 per cent. in 2008. During 2010 it increased to 41.0 per cent., falling to 35.0 per cent. in the first quarter of 2011. Conversely, the share of demand deposit trading with non-banking financial institutions decreased to 22.9 per cent. in 2009 from 26.4 per cent. in 2008, but subsequently increased again to 26.8 per cent. in 2010 and 47.5 per cent. in the first quarter of 2011.

Within interbank trading in demand deposits, direct interbank trading remained dominant, totalling HRK 77.7 billion in 2010, while bank trading with Zagreb Money Market ("**ZMM**") intermediation was HRK 11.3 billion. During the first quarter of 2011 direct interbank trading accounted for almost 80 per cent. of total interbank trading in demand deposits. Overnight loans continued to be the most liquid instrument in direct interbank trading in reserve money, accounting for HRK 53.3 billion in 2010 and HRK 5.7 billion in the first quarter of 2011. The average daily turnover in overnight loans was HRK 0.2 billion in 2010 and HRK 0.1 in the first quarter of 2011, while the average daily turnover in loans intermediated by the ZMM was HRK 0.1 billion in the first quarter of 2011.

The Government raised substantial short-term domestic funding in order to cover the consolidated government deficit and to refinance maturing T-bills. HRK 9.2 billion in Kuna denominated T-bills and HRK 0.8 billion in EUR-linked T-bills was raised during first five months of 2011 at 12 T-bill auctions. EUR-linked T-bills are denominated in EUR but settled in Kuna at the official CNB rate. The weighted interest rate on one-year Kuna T-bills hit a record high of 7.95 per cent. in December 2008. It was 6.06 per cent. in December 2009 and has decreased since then to 3.84 per cent. in December 2010 and 2.81 per cent in May 2011. The weighted interest rates on 91-day T-bills and 182-day T-bills denominated in Kuna in May 2011 were 1.60 per cent. and 2.32 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 4.72 per cent. in December 2009. and continued to fall during 2010 reaching 2.88 per cent. in December 2010 and 2.71 per cent in May 2011. This decrease in interest rates was a result of a stable monetary environment characterised by sufficient available liquidity.

The total stock of subscribed Kuna denominated T-bills fell in 2010, decreasing from HRK 12.1 billion at the end of 2009 to HRK 11.5 billion at the end of 2010. However, by the end of May 2011, the total stock of subscribed T-bills rose to HRK 14.1 billion. The stock of euro denominated T-bills decreased from EUR 1.36 billion at the end of 2009 to EUR 1.24 billion at the end of 2010 and EUR 1.08 billion at the end of May 2011. Consequently, the total stock of T-bills also fell from HRK 22.1 billion at the end of 2009 to HRK 20.7 billion at the end of 2010 and rose again to HRK 21.8 billion at the end of May 2011.

The main factors which boosted bank interest rate growth in the first half of 2009 were more expensive sources of bank financing, the worsening of the quality of credit portfolios of banks and large government demand for bank loans. At the same time, the growth in interest rates was mitigated by a reduction in the costs of regulatory compliance for banks (including reductions in required foreign liabilities coverage and general reserve requirements) and the improvements in system liquidity under the influence of CNB measures. Starting in the second half of 2009 and as a result of the easing of liquidity pressures and the first signs of recovery in neighbouring countries, investor risk aversion began to decline, leading to a decrease in Croatia’s sovereign risk premium. This in turn facilitated access to foreign sources of financing and led to a decline in interest rates on corporate loans. Bank interest rates on deposits remained relatively stable throughout the first half of 2009, owing to developments in interest rates on foreign currency deposits, while weighted interest rates on Kuna time deposits without a currency clause rose considerably. In the second half of 2009, deposit interest rates generally moved in line with developments in lending interest rates of banks, keeping interest rate spreads relatively stable.

In general, lending interest rates of banks, particularly on short-term corporate loans, fell in the fourth quarter of 2009 and continued to decrease in 2010. Such developments in interest rates were an indication of improved banking system liquidity. In 2010, interest rates on loans, in particular on corporate and household loans, trended down compared to 2009. Interest rates on both short-term Kuna-denominated loans and long-term loans with a currency clause generally decreased. Between December 2009 and December 2010, weighted interest rates on Kuna denominated short-term corporate loans decreased from 9.29 per cent. in December 2009 to 6.98 per cent. in December 2010 and continued to decrease in the first quarter of 2011 to 6.88 per cent. at 31 March 2009, while weighted interest rates on long-term corporate loans with a currency clause fell from 7.31 per cent. at the end of 2009 to 7.19 per cent. at the end of 2010 and remained at that level until the end of March 2011. In the same period(s), weighted interest rates on short-term Kuna denominated household loans fell slightly from 12.68 per cent. in December 2009 to 12.64 per cent. at 31 December 2010 and increased slightly to 12.66 per cent. at the end of March 2011. Weighted interest rates on long-term household loans with a currency clause decreased from 9.02 per cent. at the end of December 2009 to 8.16 per cent. at the end of December 2010 and rose slightly to 8.18 per cent. at the end of March 2011.

In the fourth quarter of 2009 and throughout 2010, interest rates on time deposits mirrored declining interest rates on loans, thus stabilising interest rate spreads. The increase in liquidity also affected interest rates on time deposits, reducing them to multi-year lows in late 2009 and in early 2010. Weighted interest rates on time deposits fell from 5.65 per cent. at 31 December 2008 to 2.52 per cent. at 31 December 2009 and 1.94 per cent. in December 2010 and stand at 1.66 per cent. as of March 2011. Weighted interest rates on foreign currency time deposits declined from 4.14 per cent. to 3.58 per cent. from 31 December 2008 to 31 December 2009, falling further to 2.69 per cent. at 31 December 2010. This downward trend continued in the first quarter of 2011 as such interest rates reached 2.36 per cent. at 31 March 2011. Interest rates on corporate giro-accounts denominated in Kuna were relatively stable, decreasing only marginally from 0.62 per cent. at 31 December 2008 to 0.60 per cent. at 31 December 2009, 0.51 per cent. at 31 December 2010 and 0.49 per cent. by the end of March 2011.

Between 31 December 2008 and 31 December 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 7.03 per cent., while at 31 December 2010 it declined to 6.64 per cent. However it rose again during first quarter of 2011 to 7.00 per cent. 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. at 31 December 2008 to 8.90 per cent. at 31 December 2009, but this trend reversed and at 31 December 2010 the spread was 8.29 per cent., decreasing again marginally to 8.27 per cent. as 31 March 2011. The spread between the weighted interest rate on Kuna loans with a currency clause and the weighted interest rate on foreign currency deposits increased steadily from 3.76 per cent. at 31 December 2008 to 4.30 per cent. at 31 December 2009 and 4.69 per cent. in December 2010, reaching 4.94 per cent. in March 2011.

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 which maintain market liquidity of specific shares within boundaries set by the ZSE defining the maximum spread and minimum quoted volume. There are currently 2 market specialists and 33 brokerages. Equity trading on the ZSE is organised into three market segments: the prime market, the official market and the regular market. The ZSE also operates a multilateral trade platform.

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

	First half of 2009	Second half of 2009	First half of 2010	Second half of 2010	Variation of second half of 2010 from first half of 2010	Variation of second half of 2010 from second half of 2009
Regular volume	69,239,406	103,969,337	80,311,377	59,906,167	(25.4)	(42.4)
of which Stocks	17,821,350	15,570,993	11,821,932	12,314,231	4.2	(20.9)
of which Bonds	28,734,342	85,227,764	68,489,445	47,591,936	(30.5)	(44.2)
of which Rights	16,829,994	1,473,100	0	0	—	—
of which Commercial Paper . .	5,853,720	1,697,480	0	0	—	—
Block volume(1)	0	0	0	0	—	—
Reported volume(2)	79,000,000	80,861,339	361,145,139	329,675,500	(8.7)	307.7
Institutional volume(3)	891,667,071	842,618,645	1,961,864,250	1,215,065,693	(38.1)	44.2
Total number of trades	278,677	208,575	154,035	132,840	(13.8)	(36.3)
Number of securities traded . . .	289	239	221	29	(86.9)	(87.9)
Number of trading days	120	128	122	128	4.9	0.0
Daily average volume	8,665,887	8,026,948	19,699,351	12,465,938	(118.6)	(55.3)

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 December 2009, there were 39 commercial paper issues listed at the ZSE by 20 issuers. At the end of December 2010, there were 24 commercial paper issues listed at the ZSE by 13 issuers.

Developments on the domestic capital markets in 2009 closely followed those in more mature capital markets worldwide. The beginning of the year was marked by the spillover effects of the world financial crisis on the real economy and high risk aversion of global investors. The first two months of 2009 saw a worsening of the declines witnessed in 2008, followed by the first signs of recovery in March. The initial recovery of the domestic stock price index, CROBEX, was less pronounced than in more mature markets. However, in May 2009 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. Positive trends from the world markets encouraged the recovery of the domestic capital market which continued till the last quarter of 2009, when investors' concern about the sustainability of the economic recovery of the largest economies and worsening domestic macroeconomic indicators negatively influenced the movements on the domestic capital market. The year 2010 started optimistically with developments on domestic capital markets broadly following European markets in the first weeks of January. This continued until mid-February, despite declines in stock prices on developed markets driven by worries about global recovery. The second quarter of 2010 was marked by rapidly growing investor risk aversion on the financial markets as the Greek crisis threatened to escalate and deepen. This situation was mostly reflected in the fall in the prices of shares on all major global capital markets with the Croatian equity markets following negative trends, albeit with somewhat less volatility. Thus, at the end of second quarter of 2010, the CROBEX was 7.4 per cent. lower compared to the beginning of the year. No major price changes were observed till December 2010, when Hungary's energy group MOL, which is the biggest shareholder in Croatia's oil and gas firm INA offered to buy out shares held by minor shareholders. After MOL announced its bid, trading by local pension funds resulted in a significant price increase of INA's shares and the failure of MOL's offer. These developments resulted in increased optimism and liquidity in the domestic market and led to the surge in prices of the shares of Croatian entities that continued into early 2011.

Market liquidity in 2009 was low, despite the fact that the CROBEX index of the Zagreb Stock Exchange rose 16.4 per cent. After a positive start of 2010, over the first five months of 2010 CROBEX slightly decreased (1.0 per cent.), which was the result primarily of negative domestic and international macroeconomic movements in the second quarter of 2010. However, CROBEX eventually finished 2010 5.3 per cent. higher than in 2009. CROBEX increased over the first five months of 2011 by an additional 8.0 per cent. as it reached 2,279 at the end of May 2011. The total market capitalization of shares listed on the ZSE decreased from HRK 142.1 billion

(41.5 per cent. of GDP) at the end of 2008 to HRK 135.4 billion (40.6 per cent. of GDP) at the end of 2009 and to HRK 140.9 billion at the end of December 2010. At the end of May 2011 total market capitalisation of shares listed on the ZSE was HRK 155.3 billion (46.4 per cent of GDP for 2010).

In 2009, the domestic bond market faced challenges related to increased risk aversion by domestic and international investors, low liquidity, and concerns about the state of the economy. In 2009, the ZSE bond index, CROBIS, increased by 5.8 per cent. In the first five months of 2010, CROBIS increased further by 1.5 per cent. but eventually finished 2010 0.2 per cent. lower than in 2009. During the first five months of 2011 CROBIS increased by 2.6 per cent. Total bond turnover on the ZSE in 2010 was HRK 7.1 billion, 112.4 per cent. higher compared to 2009, when the lowest turnover since the year 2001 was recorded. The total market capitalisation of bonds listed on the ZSE increased from HRK 33.4 billion at the end of 2008 to HRK 36.0 billion at the end of 2009 and represented 10.7 per cent. of GDP in 2009, compared to 10.2 per cent. of GDP at the end of 2008. At the end of 2010, the total market capitalisation of bonds listed on the ZSE was HRK 52.7 billion, equal to 15.8 per cent. of GDP.

33 bonds were listed on the domestic capital market at the end of 2009, 36 were listed at the end of 2010 and 34 were listed at the end of May 2011. Ten of these bonds were government bonds, eight were municipal bonds and 16 were corporate bonds. In the first half of 2010, there were two new government ten-year issues (a HRK 3.5. billion 6.75 per cent. bond and a EUR 350 billion foreign currency-indexed 6.50 per cent. bond) which were partially used to repay the domestic bond that matured in March 2010 (HRK 3.0 billion) and in the second half of 2010 there was one government seven-year issue (HRK 4.0 billion 6.25 per cent.). In the same period there was one corporate issue.

The average monthly yield spread between Croatian Eurobonds and benchmark bonds as measured by the JPMorgan EMBI Index decreased from 488 basis points at the end of 2008 to 246 basis points at the end of 2009, but increased again and reached 298 basis points at the end of 2010 due to unstable conditions in the global bond markets. However, over first five months of 2011 it declined again to 245 basis points. The trend of the fluctuations in the spread on Croatian Eurobonds broadly followed other European emerging markets Eurobonds, reflecting movements of global risk aversion. The stabilisation of the market environment allowed the issuance by the Government in June 2009 of a EUR 750 million 6.5 per cent. Eurobond due January 2015 and the issuance in November 2009 of U.S.$1.5 billion 6.75 per cent. notes due 2019.

Five Croatian Government bonds were listed on foreign markets as at the end of 2010, three of which were denominated in euro and two in U.S. dollars. In 2010 one bond listed on foreign markets matured (EUR 500 million) and one new bond was issued on 14 July 2010 (USD 1.25 billion). The total outstanding nominal value of Croatian Government bonds listed on foreign markets was approximately EUR 4.1 billion at the end of 2010. Six Croatian bonds were listed on foreign markets as at the end of 2009. In 2010 one bond listed on foreign markets matured (EUR 500 million) and one new bond due July 2020 was issued on 14 July 2010 (USD 1.25 billion). The last payment to the London club was due in late July 2010, therefore, five Croatian bonds were listed on foreign markets as at the end of 2010, three of which were denominated in euro and two in U.S. dollars. The total outstanding nominal value of Croatian bonds listed on foreign markets was approximately EUR 4.1 billion at the end of 2010. In March 2011 the EUR 750 million 6.5 per cent. Eurobond matured. On 24 March 2011 USD1.5 billion 6.375 per cent. Eurobond was issued, in total four Croatian bonds were listed on foreign markets as at the end of May 2011 whose outstanding nominal value was approximately EUR 3.2 billion.

Regulation of the 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 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*.

By entry into force of the Capital Market Act, the Securities Market Act (Official Gazette Nos. 84/02 and 138/06) has ceased to have effect and the CASFS obligation to adopt regulations pursuant to the Capital Market Act in the three month period after the Act comes into force has started. 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 came into force on the 1st 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 October 2008, CASFS 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 stake-holders. 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

Fiscal developments in 2010

In December 2009, the Croatian Parliament adopted the budget for 2010 which for the first time included the projections for the following two years (2011 and 2012). The general government budget for 2010 incorporated the same level of revenues as a share of GDP as those realised in 2009 and a 0.5 per cent. of savings on the expenditures side, as compared to 2009. As a result, the budgeted level of net lending/borrowing, according to GFS 2001 methodology, was reduced from 3.2 per cent. of GDP in 2009 to 2.7 per cent. of GDP in 2010.

While in 2009 the lack of financial liquidity within the system was a source of problems, this has been reversed since the beginning of 2010 and the level of financial liquidity is at satisfactory levels. However, the problems in passing financial resources from the banking system to businesses persist. The Government has undertaken measures to address these issues with the goal to establish a scheme to support credit activity benefitting existing businesses that have been affected by the crisis as well as to ensure a framework for providing resources aimed at fostering new investments.

In order to better address economic challenges, the Government has prepared new guidelines for economic policy activities which tie together planned measures and expected goals. The Government has formulated several financing and development models, aimed at achieving the goals of maintaining macroeconomic stability, fostering economic development and strengthening investment activities.

Model 'A': The scope of Model 'A' is the active participation of the state through HBOR in co-financing banks' credit placements for working capital financing. The HBOR is expected to participate at 40 per cent. and commercial banks at 60 per cent. The goal is to ensure sufficient liquidity for companies to overcome the current economic climate and mitigate the negative effects of the global economic and financial crisis. As a prerequisite for implementation of this model, the Council of the Croatian National Bank has lowered the Reserve Requirement Rate from 14 per cent. to 13 per cent. A portion of the released liquidity to banks in the amount of HRK 2 billion was directed to HBOR in the form of commercial banks' club credit. Through this set of measures, a potential credit amount of approximately HRK 5 billion has been created for entrepreneurs. Thus, a substantial credit potential that will be channelled to the economy has been with the aim of strengthening the competitiveness of businesses by improving liquidity and maintaining and expanding business activity. The criterion for selection of banks for participation in the programme is the interest rate which the bank is willing to offer for its 60-per cent. share in the credit. HBOR's interest rate on its 40 per cent. share in the credit is fixed at 3.8 per cent. The final interest rate is the weighted average of interest rate offered by the bank on the auction and HBOR interest rate.

Model 'B': The second model encompasses the establishment of a guarantee fund with the aim to assume part of the risk coverage for new banks' credit placements. The maximum amount of the guarantee which the Government will approve within the guarantee fund is HRK 2 billion. The fund scheme is organised with HBOR which conducts all activities under the scheme on behalf of the Government. The Government would guarantee at most 50 per cent. of any funding, with the remainder to be provided by banks in competitive auctions. Thus, at least HRK 4 billion could be channelled to entrepreneurs through this Model. This Model is primarily intended for investment projects to ensure new investment. However, it can also be used for refinancing existing debt entered into after 1 July 2008. The criteria for selecting banks for the purposes of assigning guarantees are based on the risk percentage which the bank is ready to assume and the effective interest rate.

Model 'C': The third model is defined by the Guidelines for aid to enterprises which are experiencing difficulties. The model complements the two other models by creating a foundation for rapid, efficient and final assistance to enterprises that are experiencing difficulties over extended periods of time. The only criterion for receiving the Government's assistance under Model C is to submit sustainable restructuring plans in cases where the only other viable option would be bankruptcy.

At the beginning of 2011, these models were subject to review with a view to preparing necessary changes in order to achieve more functionality and competitiveness.

In addition to these measures, the Government adopted an Economic Recovery Programme (the "**ERP**") in 2010. The main goal of the programme is to foster economic recovery and the creation of a competitive economy for achieving improved standards and a better quality of life.

In connection with the implementation of the ERP, the Government has adopted the Programme Activities Implementation Plan which sets out the key activities to be undertaken within specifically defined deadlines, aiming to achieve nearly 70 per cent. of the Programme measures during 2010. The Programme is based upon stability, sustainability and social responsibility, while encompassing a series of areas among which the fiscal policy, public administration operation, government asset management, justice reform, pension system reform, social policy, including education and environmental protection systems should be emphasised. The intention behind all the measures to be conducted within the Programme is to address various structural challenges in the Croatian economy. The fiscal policy measures include: a reduction in expenditure; improved efficiency and transparency; redirecting budgetary resources from cost ineffective spending towards targeted social transfers; and making economically justified capital investments. In addition, the ERP includes a series of measures towards reducing government interference in economic activity and igniting a new investment cycle with economically measurable long-term effects, coupled with maximum participation from the private sector.

As the majority of the envisaged measures were planned to be undertaken by the end of 2010, the intention was to prioritise those that can completed within the shortest timeframe.

In accordance with the provisions of the ERP, many measures were implemented or commenced while a number of important measures in the area of public finance were already implemented. The Government introduced changes intended to simplify income taxation by reducing the number of tax rates and repealing tax reliefs. Changes were also made to the tax brackets ranges of the taxable basis which are now subject to new income tax rates. The change in the taxable basis tax bracket together with the change in income tax rates applicable to the new tax brackets, has led to a reduction in the income tax burden which provides an additional boost to consumption. More specifically, the previous tax rate was decreased from 15 per cent. to 12 per cent., while the 35 per cent. and 45 per cent. tax rates were repealed and replaced by a new 40 per cent. tax rate. The decrease in the former tax rate to 12 per cent. is particularly important for lower income individuals as it raises their disposable income. These changes in the system of income taxation led to an increase in net income for approximately 1.5 million citizens. By repealing tax reliefs which amounted to HRK 12,000 annually, which were accessible to a lesser extent by the socially vulnerable groups of Croatian society, the Government achieved both a higher level of social sensitivity and a simplified, more efficient income taxation system.

In addition, the special tax on salaries, pensions and other receivables was abolished in two phases during 2010. The special tax was introduced in mid-2009 with a limited lifespan, to expire no later than by the end of 2010. In April 2010, the Croatian Parliament adopted an Act abolishing the first strand of the special tax on salaries, pensions and other receivables, which charged a rate of 2 per cent. tax on income ranging from HRK 3,000 to HRK 6,000, with effect from 1 July 2010. The Act abolished the second strand of the special tax, which charged at a rate of 4 per cent. on net payments exceeding HRK 6,000, with effect from 1 November 2010.

Also the ERP envisaged an adoption of the Fiscal Responsibility Act. This Act was adopted at the end of 2010 with the aim of strengthening budgetary responsibility and ensuring long-term fiscal sustainability where the application of fiscal rules plays an important role in increasing budgetary accountability and control. Fiscal rules are made in two stages. The first includes an annual decrease in the share of general government expenditure-to-GDP ratio by at least 1 percentage point until primary the balance of the general government is in balance or surplus and the second one that implies keeping the cyclically adjusted primary balance positive or in balance over the cycle once the goal of the first stage of fiscal rules is achieved. Moreover, the Fiscal Policy Committee was established and it will contribute to the independent and knowledge-based budget deliberations and oversight. The Debt Management Strategy 2011-2013 was also adopted with the view to secure budget funding at an acceptable risk level and at the lowest mid to long-term costs.

In the area of public administration reform, the reorganisation of state institutions and agencies continued through their rationalisation, adoption of uniform criteria for the establishment of agencies, institutions and other regulatory bodies as well as the adoption of principles guiding functional decentralisation and territorial reorganisation. Public service efficiency has been improved through implementation of the 2 for 1 model (for 2 employees who leave the service 1 new enters), the establishment of a register for public sector employees, and the preparation of a Salaries Act. Improvements in the public procurement sector have also been made following the introduction of a new centralised system designed to achieve savings.

State property management has also been enhanced through several measures. From 2011 the Croatian Privatisation Fund and the Central State Administrative Office for State Property Management were merged into a single institution — the State Property Management Agency. Furthermore, members of the relevant supervisory and management boards have been chosen based on public tenders, while board procedures and contracts of board members are subject to national standards and rules. Companies which are majority-owned by the state will have to comply with the Corporate Governance Code. Effective real estate management was also strengthened through legislation regulating leasing and selling of commercial property as well as the sale of flats owned by the Republic of Croatia.

Economic revival was boosted through a series of activities: average payment time regarding the obligations of public companies was decreased from 72 to 42 days in 2010. Over the same period, the average payment time regarding the claims of public companies was reduced from 106 to 69 days. Cheaper working-capital is also provided through Model A and A+ (a variation of Model A). In 2010, 583 loans to Croatian businesses were approved, totalling HRK 2.5 billion at favourable interest rates (ranging from 4.3 per cent. to -5.9 per cent.) through Model A. A Guarantee Fund is also geared to encourage economic development through more favourable guarantee mechanisms for investors. The real estate market has been encouraged through more favourable loan interest rates, discounts for young families that do not own a house and grants contributing towards monthly loan instalments. Tax payers can also restructure tax debt accrued by the end of 2010 for a period of 30 months at an interest rate of around 8.25 per cent., as part of their obligation to settle tax liabilities for 2011. Furthermore, the Government also adopted a catalogue of 30 investment projects in the public sector, worth about HRK 14 billion.

With the aim of promoting the Croatian economy, the Parliament passed the Law on the Procedure and Conditions concerning Construction Activities to Promote Investments, facilitating procedures and reducing the time taken to obtain necessary building permits. An inter-ministerial working group was established in order to identify and tackle barriers to direct investment in Croatia. The Government adopted the Action Plan for Removing Barriers to Investment in Croatia in October 2010.

Judicial reform was stepped up through the adoption of a revised Action Plan for the Judicial Reform Strategy. A more efficient bankruptcy mechanism was ensured through legally stipulated shortened procedures, decreased costs, strengthened cooperation of state administration bodies in the bankruptcy framework and an increased number of possible bankruptcy trustees. Further positive trends have also been recorded, such as rationalisation of the court network, reduction in case backlog and procedure duration, as well as delegation of cases. An Act on Mediation was also adopted to discourage parties from long-term trials and to promote the peaceful settlement of disputes. The institute of public bailiff was introduced and the implementation of forfeiture regarding cash assets was simplified.

Regarding the labour market, the Croatian Parliament adopted Amendments to the Act on the Grants for Job Preservation (in force from July — December 2010) expanding the possibility of aid allocation to employers who signed an agreement on instalment payments of wage arrears. The change in the amount of grants also enables allocation of aid to employers in the labour-intensive sectors who pay minimum wages to their workers. Amendments to the Act on Employment Mediation and Unemployment Rights were also adopted as well as the National Plan for Employment Incentives for the period 2011-2012.

With the aim of developing education and science as a prerequisite for economic development and growth, the Government stepped up reform efforts by adopting amendments to the Act on Education in Primary and Secondary Schools. An Act on Higher Education, an Act on Scientific Activity and an Act on Universities were prepared and debated. Moreover, the Government adopted a Learning Strategy for Entrepreneurship 2010-2014 and a programme of measures for simplification of small and medium-sized businesses also containing measures aimed at promotion of an entrepreneurial mindset among young people.

In the area of environment protection, measures to preserve the environment continue to be undertaken. The Government adopted amendments to the Waste Management Plan in the Republic of Croatia and conducted a series of activities related to the recovery of landfills. Furthermore, almost all subordinate legislation related to the Act on Water and the Act on Financing Water Management was adopted.

For the pension system, Amendments to the Pension Insurance Act from November 2010 increased the age limit for entitlement to old-age and early-retirement pension for women, which should result in equal pension-age criteria for both men and women after a 20-year transition period. Early retirement is also discouraged through introduced increases in the baseline factor for calculating the amount of early retirement pension. Privileged pensions earned under the special regulations were also reduced by 10 per cent. which should save HRK 800 million in the state budget in the course of 2010 and 2011. Furthermore, in the context of adjustments to the general pension system, amendments to the Act on the Rights and Duties of Members of the Croatian Parliament were adopted, by which pension conditions for female and male parliamentarians were aligned, so that, in the future, parliamentary representatives who reach 60 years and 25 years of service and achieve at least one full mandate in the Croatian Parliament will be able to retire. The new Act equalises the right to an old-age pension of female and male parliamentarians and a transitional period up to 2031 was introduced for women.

In the healthcare sector, several financing changes regarding financial stability of the health system were introduced: revenue from participation in the primary health care (charged participation in cash), revenue from supplementary health insurance, revenue from pension contributions from the pension above HRK 5,108, and revenue from the compulsory insurance of motor vehicle liability of the functional insurance premium paid. The rationalisation of healthcare institutions (hospital mergers), as well as introduction of E-prescription, E-referal, E-health service order, rationalization of institution network, greater control of sick leave and reduced operating costs of the Croatian Institute for Health Insurance lead to an increase in the rationality and a cost reduction in health care system.

In the area of social welfare reform, the existing network of social welfare centres is being rationalised. Consequently instead of 80 centres and 27 subsidiaries, there will be 21 Bureaus of Social Welfare at the county level. According to the established criteria they will have local centres for social welfare in the form of subsidiaries and offices in order to ensure better availability of service to the users. Social services are provided through a network of public institutions, but they can also be given in the concession to the eligible legal and natural persons. A New Social Welfare Act and the Strategy of Social Welfare System Development in the Republic of Croatia for the period 2011-2016 were also adopted in order to further improve efficiency of social assistance.

Macroeconomic developments and developments in budgeted revenues during 2010 suggested a reduced outturn than that originally anticipated. An amendment to the macroeconomic and fiscal projections was made towards the end of August 2010 within the framework of government budget revision and the revision of financial plans and projections of other levels of the general government. On a general government level, these changes involved an annual reduction in the revenue plan of 1.7 per cent. of GDP while the expenditure of the general government budget increased by 0.1 per cent. of GDP. The greatest changes in the plan for 2010 came at the budgetary central government level, which is the largest component of the general government budget. The revenue plan of the budgetary central government was reduced by HRK 4.5 billion or 1.4 per cent. of GDP, while total expenditure was increased by HRK 0.9 billion or 0.3 per cent. of GDP. The increase in budgetary central government expenditure in 2010 resulted from the need to procure additional funds on an annual basis for individual expenditure categories such as pensions, natural disasters and unemployment benefits. At the same time, further rationalisation of other expenditure categories was made to an extent that was designed to largely offset the increase in the above-mentioned expenditure categories.

In view of the changes in revenue and expenditure, the new level of net lending/borrowing of the consolidated general government stood at — 5.1 per cent. of GDP (according to ESA 95 methodology), while the final outturn shows a realization of the deficit at a level of -4.9 per cent. of GDP.

The changes in the 2010 budget were largely driven by macroeconomic developments affecting revenue and further rationalisation on expenditure. Changes in the 2010 budget also represent a basis for the 2011 budget. In particular, on the adoption of the 2010 budget revision, the Croatian Parliament issued a conclusion providing that the level of expenditures determined under the 2010 budget revision also represents the ceiling for expenditures in the following two years (i.e. 2011 and 2012). Subsequently, in November 2010, the Government of the Republic of Croatia proposed and the Croatian Parliament adopted the 2011 budget containing projections for 2012 and 2013 which are in line with the above-mentioned restrictions regarding the maximum level of expenditures.

In addition to the 2011 budget and projections for 2012 and 2013, the Croatian Parliament also adopted in the Fiscal Responsibility Act in November 2010. This Act lays down fiscal rules aimed at implementing fiscal consolidation in the forthcoming period and introduces specific provisions to achieve a higher level of fiscal responsibility. According to the above-mentioned fiscal rules, total general budgeted expenditure expressed as a percentage of the estimated gross domestic product will be decreasing annually by at least 1 percentage point, and this will continue until the primary fiscal balance equates to zero or a positive figure. Subsequent to this, the aim is to maintain a cyclically adjusted primary fiscal balance of the general budget at zero or positive level during the cycle in order to achieve stabilisation and reduction of public debt in gross domestic product.

Also, by the end of 2010, the strategy for public debt management was drafted in line with the provisions of the ERP, which was adopted by the Government in February 2011.

Consolidated general government results for 2010

In 2010, the total revenue of the consolidated general government amounted to HRK 123.7 billion. Tax revenues, as the most significant revenue category, amounted to HRK 71.7 billion. Among tax revenues, revenue generated through VAT amounted to HRK 37.7 billion; income tax revenue amounted to HRK 9.2 billion and corporate tax revenue amounted to HRK 6.4 billion. Revenue generated from excise duties was HRK 12.0 billion. The revenue from social contributions, which is the second most important revenue category, amounted to HRK 38.7 billion.

The total expense of the consolidated general government amounted to HRK 133.6 billion in 2010. The largest share of the total expense of the consolidated general government related to social benefits which recorded HRK 57.6 billion. Compensation of employees amounted to HRK 35.0 billion, use of goods and services to HRK 15.2 billion, subsidies to HRK 7.9 billion, other expense to HRK 9.0 billion, interest to HRK 6.7 billion and grants to HRK 2.4 billion.

In 2010 net acquisition of the non-financial assets amounted to HRK 4.8 billion (comprising total acquisitions of HRK 5.6 billion and total disposals of HRK 778.4 million).

The level of net lending/borrowing of the consolidated general government, in 2010, stood at 4.9 per cent. of GDP, according to the ESA 95 methodology.

In 2010, revenue was realised at 0.4 per cent. below the budgeted amount while total expense together with net acquisition of non-financial assets was 99 per cent. of the budgeted amount. As a result, the overall net lending/ borrowing of the 2010 general government was realised at 4.9 per cent. of GDP compared to the budgeted amount of 5.1 per cent.

Fiscal policy and performance in 2010

Macroeconomic developments in 2010, particularly in the first half, suggested that the originally projected level of economic activity would not be met for the whole year. These trends also affected the revenue side of the general government budget. In addition, certain measures taken in accordance with the ERP of the Government of the Republic of Croatia, including the abolition of the crisis tax which was introduced in 2009 and changes to the personal income tax system (including changes in rates and tax brackets to which rates apply on one side and the abolition of exemptions on the other side) also affected revenue collection in 2010. All of the developments described above caused general government revenue to be adjusted downwards by 1.7 per cent. of GDP compared to the original budget while keeping the expenditure side broadly stable with an increase of 0.1 per cent. compared to budget. In the light of the changes on the revenue and expenditure side, the new level of net lending/borrowing for 2010 stood at -5.1 per cent. of GDP.

According to the final outcome of 2010, overall revenues and expenditures were realised above 99 per cent. of the yearly budget. According to the ESA 95 methodology, the Consolidated General Government deficit, i.e. net lending/borrowing accounted for -4.9 per cent. of GDP in 2010 compared to -5.1 per cent. of GDP as was originally planned. Budgetary Central Government realised net lending/borrowing in line with the budget, while the Extrabudgetary users realised their net lending/borrowing at -0.1 per cent. of GDP, 0.1 per cent. of GDP lower than budgeted. The budget of the Local Government was balanced, whereas their planned level of net lending/borrowing stood at -0.2 per cent. of GDP.

In December 2010 the Parliament adopted the budget for 2011 and projections for the 2012-2013 periods. Total Consolidated General Government budget revenues in 2011 are planned to decrease by 1.3 percentage points of GDP relative to 2010. The main reason behind this trend is a base effect coming from absence of certain revenues, some of which are one off, in 2011 compared to 2010. On the other hand, the expenditure side of the budget for 2011 is determined by the Conclusion of the Croatian Parliament that provides that the level of expenditures determined under the 2010 budget revision should also represent the ceiling for expenditures in the following two years, i.e. the years 2011 and 2012. As a result of described trends in revenues and expenditures, net lending/borrowing is to increase by 0.6 percentage points i.e. from -4.9 per cent. of GDP in 2010 to -5.5 per cent. of GDP in 2011. The Croatian Parliament also adopted in November 2010 the Fiscal Responsibility Law.

Revenues

Total revenues of the Consolidated General Government amounted to HRK 123.7 billion in 2010 which makes realization of 99.6 per cent. of the budgeted amount. Observing the Consolidated General Government according to government level, it can be seen that 86.9 per cent. of total revenues refer to the Budgetary Central Government, 10.4 per cent. to the Local Government and the remaining 2.7 per cent. to Extra-budgetary Users. Among Extra-budgetary Users, the highest level of revenues was recorded by the Croatian Waters (HRK 1.7 billion) and the Environment Protection Fund (HRK 1.0 billion).

Within the structure of total revenues the most important category, with the share of 58.0 per cent., relates to tax revenues, collected in the amount of HRK 71.7 billion. Compared to 2009 they recorded an annual decrease of 2.5 per cent., and their realization corresponds to 0.1 per cent. above the amount planned for 2010. The largest amount is generated through value added tax amounting to HRK 37.7 billion.

Revenues from excises amounted to HRK 12.0 billion, a level of 0.4 per cent. below the budgeted.

Income tax revenues amounted to HRK 9.2 billion, which is 1.1 per cent. below the budgeted amount, and at the same time an annual decline of 11.0 per cent. This tax, in addition to economic trends, was also affected by a reduction of number of rates from four to three rates (12.0 per cent., 25.0 per cent. and 40.0 per cent.) and changes in the income range to which the rates apply. Revenues from profit tax amounted to HRK 6.4 billion, which is an annual decline of 32.1 per cent. and also 1.5 per cent. above the budgeted amount. This reflects reduced operating results and lower profit of enterprises in 2009, since the profit tax is paid in accordance with the results achieved in the previous year. Within other tax revenues, the special tax on salaries, pensions and other receivables was abolished in stages in 2010 but still amounted to HRK 1.9 billion in 2010.

Social contributions are the second most important revenue category with a share of 31.3 per cent. in total generated revenues. They amounted to HRK 38.7 billion which is in annual decline of 3.2 per cent. Such movements of these revenues are primarily determined by developments in the labour market.

Expense

Expense of the Consolidated General Government amounted to HRK 133.5 billion in 2010, which is 0.2 per cent. below the planned amount. According to government level, HRK 116.2 billion refer to the Budgetary Central Government, HRK 13.0 billion to the Local Government and HRK 4.2 billion to Extra-budgetary Users.

The largest share of expense refers to social benefits, which were realised in the amount of HRK 57.6 billion which is an annual increase of 1.1 per cent. Social benefits are mostly related to expenses for pensions, expenses for the healthcare system, social welfare, maternity leave allowances, child allowance and expenses for unemployment. Expenses for pensions amounted to HRK 34.8 billion, expenses for the healthcare system to HRK 12.9 billion, social welfare to HRK 2.2 billion, maternity leave allowances to HRK 2.2 billion, child allowance to HRK 1.7 billion and unemployment benefits to HRK 1.5 billion.

Compensation of employees amounted to HRK 35.0 billion, out of which wages and salaries amounted to HRK 29.8 billion and social contributions to HRK 5.2 billion. In comparison to the previous year these expenses declined by 0.7 per cent. Namely, in the first four months of 2009 the base salary for public services was 6.0 per cent. higher than base salary which was valid in the rest of 2009 and throughout the entire 2010.

Expense for use of goods and services amounted to HRK 15.3 billion, with other expenses amounting to HRK 9.0 billion, expense for subsidies amounting to HRK 7.9 billion, expense for interest payments amounting to HRK 6.7 billion, and grants amounting to HRK 2.1 billion.

Transaction In Non-Financial Assets

Net acquisition of non-financial assets of the Consolidated General Government amounted to HRK 4.8 billion with the acquisition of nonfinancial assets (HRK 5.6 billion) surpassing the disposal of nonfinancial assets (HRK 778.9 million). This amount accounts for 81.4 per cent. of the amount budgeted for 2010. The principal non-financial assets are fixed assets, mainly buildings and structures.

Net Lending/Borrowing

The budgeted net lending/borrowing for 2009 stood at -5.1 per cent. for the consolidated general government while the final data for 2009 shows net lending/borrowing outturn at the level of -4.9 per cent. of GDP according to ESA 95 methodology.

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 2010 HRK 8.4 billion had been paid out. The remaining amount of HRK 1.8 billion will be paid by the end of 2013. On average, the yearly amount of the payments to be made, accounts for approximately 0.2 per cent. of GDP. These compensation payments are made through a special private fund (the Pensioners Fund), which is not part of the general government sector.

Consolidated General Government Budget

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

	Year ended 3			
	2007	2008	Plan 2009	2009
				(HRK m
1. REVENUE (A+B+C)	**126,716.0**	**134,737.8**	**128,329.2**	**128,068.8**
A) Budgetary central government	108,297.0	115,766.5	110,871.5	110,251.2
B) Extra-budgetary users	5,040.0	4,223.8	3,597.0	3,785.9
1. Croatian Pension Insurance Administration	—	—	—	—
2. Croatian Institute for Health Insurance	—	—	—	—
3. Croatian Employment Service	—	—	—	—
4. Croatian Waters	1,992.0	2,058.6	1,773.1	1,921.9
5. Fund for Environmental Protection and Energy Efficiency	1,102.9	1,221.2	1,129.7	1,168.6
6. Croatian Motorways Ltd.	1,375.3	—	—	—
7. Croatian Roads Ltd.	119.9	81.0	77.7	96.8
8. State Agency for Deposit Insurance and Bank Rehabilitation	391.4	808.3	566.8	566.5
9. Croatian Privatisation Fund	58.3	54.7	49.5	32.2
C) Local government	13,379.0	14,747.5	13,860.7	14,031.7
2. EXPENSE (A+B+C)	**118,770.5**	**130,258.6**	**131,998.1**	**132,883.7**
A) Budgetary central government	100,936.3	111,299.7	114,495.6	114,304.6
B) Extra-budgetary users	6,015.1	5,308.1	4,568.4	4,651.6
1. Croatian Pension Insurance Administration	—	—	—	—
2. Croatian Institute for Health Insurance	—	—	—	—
3. Croatian Employment Service	—	—	—	—
4. Croatian Waters	2,086.6	2,313.7	1,782.7	1,708.9
5. Fund for Environmental Protection and Energy Efficiency	1,047.3	1,063.9	898.7	1,111.1
6. Croatian Motorways Ltd.	1,509.4	—	—	—
7. Croatian Roads Ltd.	1,235.8	1,588.7	1,537.7	1,483.0
8. State Agency for Deposit Insurance and Bank Rehabilitation	47.8	254.7	253.3	267.2
9. Croatian Privatisation Fund	88.2	87.0	95.9	81.4
C) Local government	11,819.0	13,650.7	12,934.1	13,927.5
NET/GROSS OPERATING BALANCE (1–2)	**7,945.5**	**4,479.2**	**(3,668.8)**	**(4,814.9)**
3. CHANGE IN NET WORTH: TRANSACTIONS (3.1.+3.2.-3.3.)	**7,945.5**	**4,479.2**	**(3,668.8)**	**(4,814.9)**

	Year ended 3			
	2007	2008	Plan 2009	2009
				(HRK n
3.1. CHANGE IN NET ACQUISITION OF NON-FINANCIAL ASSETS	11,015.0	7,344.1	6,070.2	5,923.5
Acquisition	12,319.4	8,876.6	6,944.6	6,698.2
A) Budgetary central government	3,043.9	3,291.5	2,496.1	2,267.4
B) Extra-budgetary users	5,334.7	1,421.7	1,180.4	1,225.3
C) Local government	3,940.8	4,163.4	3,268.2	3,205.5
Disposals	1,304.5	1,532.5	874.5	774.7
A) Budgetary central government	498.7	303.4	338.5	304.0
B) Extra-budgetary users	69.0	181.6	75.9	21.3
C) Local government	736.8	1,047.5	460.0	449.4
NET LENDING/BORROWING (1-2–3.1)	**(3,069.4)**	**(2,865.0)**	**(9,739.0)**	**(10,738.5)**
ESA 95 NET LENDING/NET BORROWING*	**(4,357.5)**	**(3,603.8)**	**(10,336.1)**	**(12,787.4)**
Payments for compensation of pensioners	**3,347.9**	**1,067.1**	**816.3**	**816.3**
ESA 95 NET LENDING/NET BORROWING (with compensation of pensioners)	**(7,705.4)**	**(4,670.9)**	**(11,152.3)**	**(13,603.7)**
ESA 95 NET LENDING/NET BORROWING (with compensation of pensioners), per cent. OF GDP	***(2.4)***	***(1.4)***	***(3.3)***	***(4.1)***
TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING) (3.3–3.2)	3,069.4	2,865.0	9,739.0	10,738.5
3.2. CHANGE IN NET ACQUISITION OF FINANCIAL ASSETS	(2,403.1)	2,918.0	1,504.5	6,729.4
3.2.1. Domestic	(2,421.1)	2,905.6	1,502.8	6,727.1
A) Budgetary central government	(3,752.8)	1,690.5	906.4	6,823.2
B) Extra-budgetary users	795.6	1,073.6	507.6	533.4
C) Local government	536.1	141.4	88.7	(629.6)
3.2.2. Foreign	18.0	12.4	1.8	2.3
A) Budgetary central government	18.0	12.4	1.8	2.3
B) Extra-budgetary users	—	—	—	—
C) Local government	—	—	—	—
3.2.3. Monetary gold and SDRs	—	—	—	—

	Year ended 3			
	2007	2008	Plan 2009	2009
				(HRK m
3.3. CHANGE IN NET INCURRENCE OF LIABILITIES	666.4	5,783.0	11,243.6	17,467.9
3.3.1. Domestic	2,147.5	6,949.5	6,620.3	10,185.5
A) Budgetary central government	1,477.6	5,656.6	5,972.0	9,576.6
B) Extra-budgetary users	539.5	1,139.1	514.8	564.4
C) Local government	130.4	153.8	133.6	44.5
3.3.2. Foreign	(1,481.2)	(1,166.5)	4,623.3	7,282.4
A) Budgetary central government	(2,980.2)	(1,445.8)	4,263.3	6,878.4
B) Extra-budgetary users	1,523.7	304.1	404.9	425.9
C) Local government	(24.7)	(24.9)	(45.0)	(21.8)

Note: On a cash basis.

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

Source: Ministry of Finance.

The following tables set out the detailed budget for the budgetary central government including the actual figures for 2010.

Budgetary Central Government Revenue

	Year ended 31 December			
	2007	2008	2009	2010
	(HRK thousands)			
REVENUE	**108,320,595**	**115,772,655**	**110,257,947**	**107,466,351**
Taxes	**64, 234, 530**	**69, 572, 699**	**63, 678, 926**	**62, 856, 582**
Taxes of income and profits and capital gains	10, 589, 083	12, 252, 205	10, 839, 269	7, 608, 630
Payable by individuals	1, 772, 708	1, 687, 502	1, 399, 411	1, 201, 546
Payable by corporations and other enterprises	8, 816, 375	10, 564, 703	9, 439, 858	6, 407, 084
Taxes on property	578, 621	635, 930	532, 297	443, 983
Taxes on goods and services	51, 099, 930	54, 482, 172	49, 238, 277	50, 980, 460
General taxes on goods and services	37, 916, 509	41, 474, 566	37, 173, 833	37, 812, 425
Value-added taxes	37, 747, 987	41, 308, 036	37, 050, 354	37, 688, 520
Sales taxes	168, 522	166, 531	123, 479	123, 905
Excises	12, 168, 666	11, 875, 126	10, 998, 910	11, 972, 326
— on cars, other motor vehicles, boats and planes	1, 433, 427	1, 452, 827	696, 791	589, 983
— on petroleum products	6, 484, 816	6, 065, 140	6, 045, 624	6, 932, 709
— on alcohol	231, 342	218, 786	189, 895	207, 445
— on beer	743, 000	717, 401	680, 567	655, 266
— on nonalcoholic beverages	142, 462	139, 160	125, 817	121, 615
— on tobacco products	2, 943, 649	3, 084, 293	3, 073, 671	3, 292, 993
— on coffee	161, 936	166, 979	156, 910	149, 682
— on luxury goods	28, 033	30, 540	29, 635	22, 633
Taxes on international trade and transactions	1, 641, 478	1, 900, 865	1, 721, 164	1, 644, 448
Other taxes	325, 418	301, 527	1, 347, 920	2, 179, 061
Social contributions	**37, 203, 486**	**40, 703, 484**	**39, 994, 739**	**38, 712, 382**
Social security contributions	37, 203, 486	40, 703, 484	39, 994, 739	38, 712, 382
Employee contributions	16, 531, 305	18, 100, 364	17, 925, 299	17, 290, 552
Employer contributions	19, 845, 488	21, 758, 077	21, 373, 979	20, 783, 571
Self-employed or unemployed contributions	826, 692	845, 043	695, 462	638, 260
Unallocable contributions	0	0	0	0
Grants	**428, 038**	**468, 634**	**616, 307**	**637, 087**
Other revenue	**6, 454, 541**	**5, 027, 838**	**5, 967, 975**	**5, 260, 300**
Property income	3, 526, 540	1, 612, 229	2, 367, 214	1, 298, 345
Interest	164, 558	147, 911	123, 488	125, 088
Dividends	1, 194, 582	212, 387	106, 625	111, 303
Withdrawals from income of quasi-corporations	117, 730	504, 074	1, 342, 502	318, 939
Rent	2, 049, 670	747, 856	794, 600	743, 015
Sales of goods and services	1, 526, 646	1, 450, 683	1, 682, 037	1, 856, 422
Sales of market establishments	0	0	0	0
Administrative fees	1, 318, 050	1, 274, 882	981, 712	1, 190, 921
Incidental sales by nonmarket establishments	208, 596	175, 800	700, 325	665, 501
Fines, penalties, and forfeits	429, 034	490, 600	515, 461	524, 795
Voluntary transfers other than grants	11, 241	9, 384	15, 865	15, 940
Miscellaneous and unidentified revenue	961, 080	1, 464, 942	1, 387, 397	1, 564, 799

Source: Ministry of Finance

Budgetary Central Government Expense

	Year ended 31 December			
	2007	2008	2009	2010
	(HRK thousands)			
EXPENSE	**108,007,605**	**115,292,426**	**117,923,992**	**120,323,332**
Compensation of employees	**27, 545, 141**	**29, 948, 535**	**31, 289, 325**	**31, 096, 464**
Wages and salaries	23, 237, 088	25, 453, 436	26, 555, 399	26, 391, 104
Social contributions	4, 308, 053	4, 495, 099	4, 733, 926	4, 705, 360
Use of goods and services	**7, 162, 402**	**8, 113, 694**	**7, 364, 017**	**7, 655, 745**
Interest	**4, 535, 008**	**4, 683, 219**	**5, 225, 174**	**6, 236, 482**
To nonresidents	1, 672, 563	1, 542, 146	1, 391, 408	1, 723, 831
To residents other than general government	2, 862, 444	3, 141, 074	3, 833, 767	4, 512, 651
Subsidies	**6, 492, 010**	**6, 859, 512**	**6, 710, 033**	**6, 582, 192**
To public corporations	3, 007, 099	3, 199, 114	3, 134, 258	3, 186, 622
To private enterprises	3, 484, 912	3, 660, 398	3, 575, 775	3, 395, 569
Grants	**8, 363, 202**	**5, 783, 063**	**5, 559, 586**	**5, 778, 575**
To foreign governments	103, 410	89, 446	78, 184	58, 594
Current	75, 261	60, 246	68, 150	49, 412
Capital	28, 149	29, 200	10, 034	9, 181
To international organisations	73, 941	96, 503	134, 031	175, 808
Current	73, 941	96, 503	133, 061	175, 808
Capital	0	0	970	0
To other general government units	8, 185, 852	5, 597, 115	5, 347, 372	5, 544, 174
Current	2, 305, 125	2, 291, 490	2, 598, 678	2, 663, 291
Capital	5, 880, 726	3, 305, 625	2, 748, 694	2, 880, 883
Social benefits	**48, 175, 989**	**52, 593, 214**	**56, 148, 295**	**56, 906, 555**
Social security benefits	34, 167, 894	37, 600, 722	40, 605, 352	43, 008, 291
Social assistance benefits	13, 815, 777	14, 745, 264	15, 258, 234	13, 728, 987
Employer social benefits	192, 318	247, 228	284, 709	169, 277
Other expense	**5, 733, 853**	**7, 311, 189**	**5, 627, 561**	**6, 067, 319**
Property expense other than interest	1, 132	16, 015	7, 730	88
Miscellaneous other expense	5, 732, 721	7, 295, 174	5, 619, 832	6, 067, 231
Current	2, 837, 557	2, 626, 644	2, 174, 864	2, 280, 627
Capital	2, 895, 164	4, 668, 530	3, 444, 968	3, 786, 604

Source: Ministry of Finance

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 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 the 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.

If, during the course of a given year, expenditures and/or expenses increase, or if revenues and/or receipts decrease in reference to the budget plan adopted at the beginning of the year, whether as a result of the occurrence of new liabilities for the state budget or economic developments, the Government may propose amendments to the state budget, which are subject to the same approval process as the original budget.

Fiscal developments in the medium-term period

In September 2009, the Government for the first time adopted the Strategy of the Government Programmes. The Strategy is adopted for the three year period and therefore the objectives stated in the Strategy are not to be changed every year. In May 2010, the Government presented a comprehensive ERP that served as a ground for the Strategy of Government Programmes for the period 2011 — 2013. The Strategy is based on the Strategic plans that all Ministries and other State bodies compiled and it was adopted by the Government in September 2010.

In the forthcoming period from 2012 to 2014, the key objective of the Government of the Republic of Croatia will be the preservation of macroeconomic stability and the creation of conditions for recovery and stable economic growth. Fiscal policy will be directed towards consolidation of public finances, and the Fiscal Responsibility Act adopted by the Parliament on 23 November 2010 (Official Gazette 139/10) will play a crucial role in this context. The Act came into force on 1 January 2011.

In this context, fiscal policy will aim to fulfil the twelve general objectives laid down in the Strategy of Government Programmes for the 2011-2013 period:

- Macroeconomic and economic stability;
- Optimum environment for the development of a competitive economy;
- Strengthening of the state of law and the rule of law;
- Promoting knowledge, excellence and culture;
- Uniform regional development;
- Strengthening of social justice positioning of the Republic of Croatia as one of the leading European tourist destinations;

- More competitive agricultural, food industry and fisheries sector;
- Further strengthening the international status of the Republic of Croatia;
- Improving the police and armed forces in the service to citizens;
- Health protection, maintenance and improvement; and
- Environmental protection.

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 the process of aligning the tax system with the EU legislation will continue, although the tax system is aligned to a great extent and the chapter on taxation is provisionally closed.

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); and special taxes (excise) on passenger cars, other motor vehicles, vessels and aircraft; alcohol and alcoholic beverages, tobacco products, energy-generating products and electrical energy; non-alcoholic beverages; coffee; luxury products; 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; fees for providing services in mobile electronic communication networks; and Levies on the winnings and organisation of games of chance, including: lottery games (monthly fee for organisation of lottery games and tax on winnings); casino games; betting games (fees for organisation of betting games and tax on winnings); coin-operated machine games; and fees on one-time organisation of lotteries. There is also a levy on the organisers of prize games for the benefit of the Croatian Red Cross.

Income tax is regulated by the Income Tax Act (Official Gazette No. 177/2004, entry into force on 1 January 2005, Official Gazette No. 73/2008, entry into force on 1 July 2008 and Official Gazette No. 80/2010, entry into force on 1 July 2010).

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 (i) 12 per cent. on a sum equivalent to up to twice the amount of the basic personal allowance; (ii) 25 per cent. on the difference between that threshold and six times the amount of the basic personal allowance; and (iii) 40 per cent. on the tax base exceeding six times the amount of the basic personal allowance referred to in Article 36, Paragraph 1 of the Income Tax Act. No income tax is applicable to earnings that fall 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	12 per cent.
— Over HRK 3,600 up to HRK 10,800 (*the next HRK 7,200,00*)	— Over HRK 43,200 up to HRK 129,600 (*the next HRK 86,400,00*)	25 per cent.
— Over HRK 10,800	— Over HRK 129,600	40 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.

In line with the ERP, Parliament has adopted the Act on Amendments to the Income Tax Act (Official Gazette no. 80/10), whereby the number of tax rates has been reduced to three: 12, 25 and 40 per cent. and certain tax relief provisions have been abolished. It is estimated that the total net effect of these measures would result in the reduction in budget revenue by 0.3-0.4 per cent. of GDP.

The Special Tax Act introduced within the third supplementary budget for 2009 was gradually phased out. The 2 per cent. rate was abolished with effect from 1 July 2010, and the second rate of 4 per cent. was abolished with effect from 1 November 2010.

Profit tax (Corporate Income Tax) is regulated by the Profit Tax Act (Official Gazette No. 177/2004, 90/2005, 57/2006, 146/08 and 80/2010). The profit tax is paid at the rate of 20 per cent. of the assessed tax base. In December 2008, the Parliament also adopted the Act on supplements to the Profit Tax Act which shall enter into force on the day of Croatia's accession to the EU.

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, amendments have been made to the Act on Excise Duties on Passenger Cars, Other Motor Vehicles, Vessels and Aircraft (Official Gazette No. 94/09 and 21/10).

In addition to the changes in the Income Tax Act, changes in the Profit Tax Act were also proposed by the Government and subsequently adopted by the Croatian Parliament on 18 June 2010. These changes primarily aim to reduce tax evasion and to increase collection rates. The amended Profit Tax Act will aid in the implementation of the activities contained in the ERP by providing tax recognition of expenses on the basis of voluntary pension insurance premiums paid. It also requires that large corporate taxpayers (as defined in the accounting regulations) file their corporate profit tax declaration in an electronic format. The regulatory arrangement in cases of settling private costs at the expense of operating resources, as well as the use of business asses for private purposes (especially concerning yachts, speedboats, airplanes, apartments and holiday houses) will contribute to the reduction of tax evasion. Furthermore, the proposed legislation will reduce the possibility of tax avoidance by taking over those companies that generate tax losses solely to employ such a loss to reduce the tax base and pay less corporate profits tax. Additionally, limitations are placed on transferring profits between affiliated residents enjoying preferential status for the purpose of paying less corporate profits tax. The payment of the withholding profits tax for the services paid to legal persons with their seat or the place of actual management or supervision in the countries, save for the European Union member-states, in which the corporate profits tax rate stands at under 12.5 per cent., will also reduce tax evasion options. Finally, accurate application of the Profit Tax Act will contribute to increased tax revenue generation.

At the beginning of April, the Croatian Parliament adopted the Law on a special measure for the collection of tax debts resulting from the economic crisis. According to this law, taxpayers who owed taxes at the end of 2010, because of the economic crisis, but have been regularly paying taxes in 2011, will be able to settle the debt in instalments over 30 months at an interest rate of 8.3 per cent. The measure refers to taxpayers who have been regularly paying taxes in 2011 or will pay them at once when applying for the settlement of last year's debt in instalments, for which they can apply within three months of the bill's enactment. The measure supports the continuity and sustainability of budgetary revenues as well as entrepreneurs in overcoming the consequences of the economic crisis.

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) (the "**Consolidated Public Debt**") of Croatia stood at HRK 134.3 and HRK 156.5 billion as at the end of 2008 and 2009 respectively. This comprised total general government debt of HRK 100.4 and HRK 117.8 billion, and direct guarantees by the Republic of HRK 33.9 and HRK 38.7 billion as at 2008 and 2009 respectively. As at 31 December 2010 the Consolidated Public Debt of the Republic stood at HRK 183.0 billion, comprising total general government debt of HRK 138.0 billion and direct guarantees by the Republic of HRK 45.0 billion.

Total general government debt was composed of 64.8 per cent. (HRK 76.3 billion) in internal debt as at the end of 2009 (compared with 65.6 per cent., HRK 65.9 billion at the end of 2008) and 35.2 per cent. (HRK 41.5 billion) in external debt at the end of 2009 (compared with 34.4 per cent., HRK 34.5 billion at the end of 2008). As at 31 December 2010 the general government debt consisted of 65.1 per cent. (HRK 89.8 billion) in internal debt and 34.9 per cent. (HRK 48.2 billion) in external debt.

The Consolidated Public Debt as at the end of 2009 represented 46.7 per cent. of nominal GDP, which was an increase of 7.8 percentage points from 38.9 per cent. at the end of 2008. As at 31 December 2010, Consolidated Public Debt represented 54.7 per cent. of nominal GDP, and reflecting an increase of 8 per cent. compared with 2009. General government internal debt as a proportion of nominal GDP represented 19.9 per cent. of nominal GDP at the end of 2006, 17.4 per cent. at the end of 2007, 19.1 per cent. at the end of 2008, 22.8 per cent. at the end of 2009, and has risen to 26.8 per cent. of nominal GDP at the end of 2010. General government external debt as a proportion of nominal GDP has decreased since 2006, representing 15.4 per cent. of nominal GDP at the end of 2006, 11.3 per cent. at the end of 2007, 10.0 per cent. at the end of 2008, and has risen to 12.4 per cent. at the end of 2009, and 14.4 per cent. at the end of 2010.

The Republic intends to issue a total of approximately EUR 1.8 billion (approximately USD 2.5 billion) in the international capital markets during 2011 to repay external debt and to finance the deficit. In March 2011, the Republic issued USD 1.5 billion of 6.375 per cent. Notes due 2021 in the international capital markets. The Government aims for 65 to 75 per cent. of its debt obligations to be fixed rate obligations. No syndicated loans are scheduled to mature during 2011.

Total general government debt increased by HRK 20.2 billion from 2009 to 2010, which was accompanied by an increase in the proportion of general government debt as percentage of nominal GDP from 35.2 per cent. in 2009 to 41.3 per cent. in 2010. The external component of general government debt recorded an increase of HRK 6.7 billion and stood at 14.4 per cent. of nominal GDP at the end of 2010, which is an annual increase of 2.0 percentage points in comparison with 2009 when it was 12.4 per cent. of nominal GDP.

The internal component of the general government debt recorded an increase of HRK 13.5 billion, and its share of nominal GDP increased from 22.8 per cent. in 2009 to 26.8 per cent. in 2010

The largest share of general government debt relates to central government, which was HRK 93.6 billion in 2008, HRK 110.2 billion in 2009, and HRK 129.2 billion in 2010.

The total amount of debt relating to extra-budgetary users was HRK 4.8 billion in 2008, HRK 5.5 billion in 2009, and HRK 6.6 billion in 2010.

The total amount of debt relating to local government was HRK 1.9 billion in 2008, 2.1 billion in 2009, and HRK 2.2 billion in 2010.

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 increased from HRK 33.9 billion at the end of 2008 (9.8 per cent. of nominal GDP), to HRK 38.6 billion at the end of 2009 (11.5 per cent. of nominal GDP) and to HRK 45.0 billion in 2010 (13.4 per cent. of nominal GDP). The proportion of guarantees which were external has increased from 6.2 per cent. of nominal GDP in 2008, to 6.9 per cent. in 2009 and to 8.1 per cent. in 2010. It is expected that due to the finalisation of the restructuring of the shipbuilding sector, the Government will assume a portion of the guarantees issued to the shipyards and consequently increase its internal and external direct debt.

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. 30 of the Budget Execution Law for 2011 (National Gazette No. 140/2010,) 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 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 U.S.$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 equalise 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 U.S.$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 and no additional allocations have been made since September 2009.

Internal Debt and Internal Debt Instruments

The following table shows the Central Domestic Debt Stock of Croatia for the periods indicated.

Debt Item	Year ended 31 December 2007	2008	2009	2010	Maturity	Interest rate
		(HRK thousands)			*(year)*	*(per cent.)*
Big Bonds — Series I	1,964,084	2,179,752	2,140,826	2,209,572	2011	5
Big Bonds — Series II	304,995	236,586	162,803	85,202	2011	7.20
Big Bonds — Series III	319,974	257,403	189,809	119,226	2012	7.20
G Bonds — Series 02 D-08	1,465,026	0	0	0	2008	6.875
G Bonds — Series 03 D-12	3,662,566	3,662,213	3,653,100	3,692,587	2012	6.875
G Bonds — Series 04 D-08	1,000,000	0	0	0	2008	6.125
G Bonds — Series 05 D-14	4,761,335	4,760,876	4,749,029	4,800,362	2014	5.500
G Bonds — Series 06 D-07	0	0	0	0	2007	3.875
G Bonds — Series 07 D-19	3,662,566	3,662,213	3,653,100	3,692,587	2019	5.375
G Bonds — Series 08 D-10	3,000,000	3,000,000	3,000,000	0	2010	6.750
G Bonds — Series 09 D-15	2,563,796	2,563,549	2,557,170	2,584,811	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	5,500,000	5,500,000	5,500,000	5,500,000	2017	4.750
G Bonds — Series 13 D-20	0	0	0	5,000,000	2020	6.750
G Bonds — Series 14 D-20	0	0	0	7,385,173	2020	6.500
G Bonds – Series 15 D-17	0	0	0	4,000,000	2017	6.25
BRA Bonds I	0	0	0	0	2007	6.00
BRA Bonds II	123,299	98,200	71,665	44,521	2012	5
BRA Bonds III	331,787	266,906	196,817	123,627	2012	7.20
BRA Bonds IV	168,777	134,421	98,099	60,942	2012	5
BRA Bonds Va	0	0	0	0	2007	6
BRA Bonds Vb	212,561	0	0	0	2008	7
Syndicated Loan I	3,662,566	3,662,213	3,653,100	3,692,587	2014	5.15
Syndicated Loan II	0	5,566,563	5,552,711	5,612,731	2013	4.71
Syndicated Loan III	0	0	5,479,649	5,538,880	2014	5.45
Medium and Long Term Debt	**42,203,332**	**45,050,895**	**50,157,878**	**63,642,806**		
Treasury Bills	11,975,258	14,605,000	12,135,000	11,545,000		
Other short term debt	476,268	300,000	0	0		
Treasury Bills FX	0	2,170,169	9,968,278	9,173,589		
Total short term debt	12,451,526	17,075,169	22,103,278	20,718,589		
Total debt	**54,654,858**	**62,126,064**	**72,261,156**	**84,361,395**		

Source: Ministry of Finance

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. The average weighted treasury bill yields for the periods indicated are set forth below:

	Year ended 31 December			
	2007	**2008**	**2009**	**2010**
	(per cent.)			
364 days HRK	4.13	6.27	7.15	3.96
364 days EUR	—	7.95	6.98	3.33

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 forth Croatia's domestic debt which is, as of 31 December 2010, scheduled to be redeemed between 2011 and 2020.

Redemption of domestic debt	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
					(HRK million)					
Redemption of principle	**2,523. 05**	**6,618.99**	**11, 422.10**	**9, 416.10**	**8, 084.81**	**0.00**	**9, 500.00**	**0.00**	**3, 692.59**	**12, 385.17**
Big bonds I	2, 209.57	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds II	85.20	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds III	77.96	41.27	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series II	29.33	15.19	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series III	80.84	42.79	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series IV	40.15	20.79	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 03 D-12	0.00	3, 692.59	0.00	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	4, 800.36	0.00	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	3, 692.59	0.00
Bonds — Series 09 D-15	0.00	0.00	0.00	0.00	2, 584.81	0.00	0.00	0.00	0.00	0.00
Bonds — Series 10 D-15	0.00	0.00	0.00	0.00	5, 500.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 11 D-13	0.00	0.00	4, 000.00	0.00	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	5, 500.00	0.00	0.00	0.00
Bonds — Series 13 D-20	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	5, 000.00
Bonds — Series 14 D-20	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	7, 385.17
Bonds — Series 15 D-17	0.00	0.00	0.00	0.00	0.00	0.00	4, 000.00	0.00	0.00	0.00
FX Syndicated Loan I	0.00	0.00	1, 846.29	1, 846.29	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan II	0.00	2, 806.37	2, 806.37	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan III	0.00	0.00	2, 769.44	2, 769.44	0.00	0.00	0.00	0.00	0.00	0.00
Interest payments	**3,558.69**	**3,227.35**	**2, 900.30**	**2, 259.98**	**1, 925.87**	**1,527.26**	**1, 396.64**	**1,016.01**	**1,016.01**	408.77
Big bonds I	110.79	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds II	4.62	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds III	7.21	1.49	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series II	1.86	0.38	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series III	7.48	1.54	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series IV	2.55	0.52	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 03 D-12	253.87	126.93	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 05 D-14	264.02	264.02	264.02	132.01	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 07 D-19	198.48	198.48	198.48	198.48	198.48	198.48	198.48	198.48	198.48	0,00
Bonds — Series 09 D-15	109.85	109.85	109.85	109.85	109.85	0.00	0.00	0.00	0.00	0.00
Bonds — Series 10 D-15	288.75	288.75	288.75	288.75	288.75	0.00	0.00	0.00	0.00	0.00
Bonds — Series 11 D-13	180.00	180.00	180.00	0.00	0,00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 12 D-17	261.25	261.25	261.25	261.25	261.25	261.25	130.63	0,00	0.00	0.00
Bonds — Series 13 D-20	337.50	337.50	337.50	337.50	337.50	337.50	337.50	337.50	337.50	168.75
Bonds — Series 14 D-20	480.04	480.04	480.04	480.04	480.04	480.04	480.04	480.04	480.04	240.02
Bonds — Series 15 D-17	250.00	250.00	250.00	250.00	250.00	250.00	250.00	0,00	0.00	0,00
FX Syndicated Loan I	205.05	205.61	153.65	51.12	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan II	293.41	219.86	73.15	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan III	301.96	301.13	303.62	150.98	0.00	0.00	0.00	0.00	0.00	0.00
Total debt service	**6,081.74**	**9,846.34**	**14,322.40**	**11,676.08**	**10,010.68**	**1,527.26**	**10,896.64**	**1,016.01**	**4,708.60**	**12,793.94**

Source: Ministry of Finance

Note: Exchange rate is the mid rate exchange rate: Mid exchange rate of the CNB as of 31 December 2010

External Debt

The following table sets out Croatia's external debt ratios at the end of the periods indicated:

	As at 31 December					
	2005	2006	2007	2008	2009	2010
	(per cent.)					
Total outstanding external debt(*)/GDP	72.1	74.8	77.7	85.0	99.1	101.1
General government external debt/GDP	17.8	15.1	11.4	10.1	12.5	14.4
Governmental external guaranties/ GDP	5.2	5.0	8.8	9.2	10.6	11.6

Source: Croatian National Bank

* Total external debt excluding round-tripping transactions.

The following table sets out the ratio of total debt service to exports of goods and services at the end of the periods indicated:

	2005	2006	2007	2008	2009	2010
Ratio of total debt service to exports of goods & services	25.0	35.8	33.3	28.2	46.1	42.4

The average original maturity of all total outstanding external debt was 8.1 years as of 31 December 2010.

Foreign-currency debt accounted for 72.7 per cent. of the general government debt as at 31 December 2010. As of 31 March 2011, Croatia has hedging arrangements in place in respect of its latest U.S. dollar denominated bond issue (U.S.$1.5 billion issued in March 2011). The Republic is evaluating entering into further hedging arrangements in respect of debt denominated in U.S. dollars in particular.

As of the date hereof, Croatia has raised U.S.$1.5 billion of new external debt in 2011

Obligations relating to external debt of the former Yugoslavia

The international loans on which former Yugoslavia defaulted following its dissolution fell into two categories: loans to public creditors (Paris club) and loans to commercial banks (London club). Croatia has repaid its obligations in respect of both categories.

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. As of 31 December 2010, Croatia does not have any obligations towards members of the Paris Club or members of the London Club.

The following table sets out the outstanding bonds issued by Croatia in the international bond market as at 31 December 2010
2020:

Projections of Repayments of International Bonds of Croatia

		Original Principal Amount	2011	2012	2013	2014	2015	2016
							(EUR)*	
EUR 750,000,000	Principal	750,000,000	750,000,000					
6.75 per cent. Notes due 2011	Interest		50,625,000					
EUR 500,000,000	Principal	500,000,000	0	0	0	500,000,000		
5.0 per cent. Notes due 2014	Interest		25,000,000	25,000,000	25,000,000	25,000,000		
EUR 750,000,000	Principal	750,000,000	0	0	0	0	750,000,000	
6.5 per cent. Notes due 2015	Interest		48,750,000	48,750,000	48,750,000	48,750,000	48,750,000	
USD 1.500.000.000	Principal	1,130,965,788	0	0	0	0	0	0
6.75 per cent. Notes due 2019	Interest		76,340,191	76,340,191	76,340,191	76,340,191	76,340,191	76,340,191
USD 1,250,000,000	Principal	942,471,490	0	0	0	0	0	0
6.625 per cent. Notes due 2020	Interest		62,438,736	62,438,736	62,438,736	62,438,736	62,438,736	62,438,736
Principal repayment (EUR*)			**750,000,000**	**0**	**0**	**500,000,000**	**750,000,000**	**0**
Interest repayment (EUR*)			**263,153,927**	**212,528,927**	**212,528,927**	**212,528,927**	**187,528,927**	**138,778,927**
Total Servicing Costs (EUR*)			**1,013,153,927**	**212,528,927**	**212,528,927**	**712,528,927**	**937,528,927**	**138,778,927**
Total Principal Outstanding (at year end) (EUR*)			**3,323,437,278**	**3,323,437,278**	**3,323,437,278**	**2,823,437,278**	**2,073,437,278**	**2,073,437,278**

Source: Ministry of Finance

* Exchange rate: Mid exchange rate of the CNB as of 31 December 2010

The following table sets forth a breakdown of the total general government debt of Croatia as at the end of the periods indicated.

GENERAL GOVERNMENT DEBT	As at 31 December 2005	2006	2007	2008	2009	2010
			(HRK millions)			
1. GG Internal Debt	54,554	57,837	55,544	65,891	76,308	89,790
1.1 Central Government	49,274	51,475	51,914	60,993	70,447	82,991
Treasury Bills	12,211	11,503	11,421	14,260	17,558	16,887
Money Market Instruments	1	0	0	11	19	21
Bonds	29,652	33,144	34,624	35,519	36,587	48,901
CNB Loans	1	1	1	2	3	0
Bank Loans	7,409	6,827	5,868	11,201	16,280	17,182
1.2 Government Funds & Agencies	3,953	5,198	2,058	3,035	3,794	4,605
Money Market Instruments	0	0	0	0	0	0
Bonds	0	0	0	0	0	0
Bank Loans	3,953	5,198	2,058	3,035	3,794	4,605
1.3 Local Governments	1,327	1,164	1,572	1,863	2,067	2,194
Money Market Instruments	41	29	37	12	7	0
Bonds	185	294	472	583	575	545
Bank Loans	1,101	841	1,063	1,268	1,486	1,649
2. GG External Debt	46,930	44,676	35,893	34,472	41,536	48,235
2.1 Central Government	37,981	35,572	34,393	32,619	39,812	46,249
Money Market Instruments	67	910	320	180	1,244	3,459
Bonds	28,519	24,942	25,046	22,992	28,884	31,647
Loans	9,395	9,720	9,027	9,447	9,684	11,143
2.2 Government Funds & Agencies	8,750	8,938	1,452	1,826	1,715	1,984
Money Market Instruments	0	0	0	0	0	0
Bonds	0	0	0	0	0	0
Loans	8,750	8,938	1,452	1,826	1,715	1,984
2.3 Local Governments	199	166	48	27	9	2
Money Market Instruments	0	0	0	0	0	0
Bonds	0	0	0	0	0	0
Loans	199	166	48	27	9	2
3. Total (1+2)	**101,484**	**102,513**	**91,437**	**100,363**	**117,845**	**138,025**
4. Government Guarantees	19,734	21,964	39,280	44,671	50,968	58,905
1. Internal	5,880	7,660	11,521	13,299	15,693	20,060
o/w: HBOR	534	348	191	808	41	2,034
2. External	13,854	14,304	27,759	31,372	35,275	38,845
o/w: HBOR	6,605	7,339	9,472	10,005	12,306	11,911

Source: Ministry of Finance and Croatian National Bank

(1) As from CNB Bulletin No. 146 (March 2009) 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 2006-2010

The following table sets forth a breakdown of the total external debt of Croatia divided according to sector.

Gross External Debt of Domestic Sectors

	As at 31 December(1)					
	2005	**2006**	**2007**	**2008**	**2009**	**2010**
			(EUR millions)			
Government	6,369.8	6,087.1	6,064.8	4,762.0	5,739.4	6,565.1
Short-term	11.0	125.1	49.0	60.3	170.4	469.2
Money market instruments	9.0	123.9	43.7	24.6	170.3	468.3
Credits	0.0	0.0	0.0	31.7	0.0	0.0
Trade credits	0.0	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	2.0	1.3	5.3	4.0	0.1	0.9
Principal arrears	1.8	0.0	1.1	3.9	0.1	0.8
Interest arrears	0.2	1.2	4.2	0.1	0.0	0.1
Other	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	6,358.8	5,962.0	6,015.8	4,701.7	5,569.0	6,095.9
Bonds	3,871.4	3,402.3	3,406.2	3,162.1	3,976.4	4,307.4
Credits	2,484.8	2,557.8	2,608.4	1,538.9	1,592.6	1,788.5
Trade credits	2.6	1.9	1.2	0.7	0.0	0.0
Other debt liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Croatian National Bank	2.6	2.6	2.3	2.3	1.1	1.2
Short-term	2.6	2.6	2.3	2.3	1.1	1.2
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	2.6	2.6	2.3	2.3	1.1	1.2
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	8,979.8	10,237.1	8,892.6	10,088.9	10,688.7	10,768.8
Short-term	2,505.2	3,362.7	2,361.2	3,793.3	3,091.8	3,008.6
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0
Credits	1,064.8	1,150.4	710.8	1,121.1	806.8	935.1
Currency and deposits	1,438.6	2,211.1	1,648.8	2,670.3	2,283.9	2,073.0
Other debt liabilities	1.7	1.2	1.7	2.0	1.2	0.6
Principal arrears	0.0	0.0	0.1	0.0	0.0	0.0
Interest arrears	1.7	1.2	1.5	2.0	1.2	0.6
Other	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	6,474.7	6,874.4	6,531.4	6,295.6	7,596.9	7,760.2
Bonds	457.7	472.4	472.5	466.6	9.0	8.9
Credits	3,822.7	4,217.3	3,565.1	3,373.9	3,545.3	3,366.4
Currency and deposits	2,194.3	2,184.7	2,493.9	2,455.0	4,042.7	4,384.9
Other debt liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Other Sectors	8,187.1	10,519.8	14,828.3	19,901.0	21,374.8	21,663.8
Short-term	706.7	700.9	1,478.2	925.3	1,346.7	1,623.1
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0
Credits	133.0	155.0	681.0	652.9	677.7	546.2
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0
Trade Credits	27.8	35.9	31.1	39.5	28.2	26.6
Other debt liabilities	545.9	510.0	766.0	232.9	640.9	1,050.3
Principal arrears	502.1	460.6	683.4	170.4	523.6	883.2
Interest arrears	43.8	49.4	82.6	62.5	117.2	167.1
Other	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	7,480.4	9,818.9	13,350.1	18,975.7	20,028.1	20,040.7
Bonds	774.6	857.4	1,293.4	1,251.6	1,665.8	1,574.1
Credits	6,542.1	8,816.1	11,766.9	17,391.3	18,069.6	18,220.2
Currency and deposits	0.0	0.0	0.0	10.6	0.0	0.0
Trade Credits	163.7	145.4	289.8	322.2	292.6	246.4
Other debt liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Direct Investment	2,450.7	2,878.4	3,932.8	5,835.9	7,440.3	7,399.8
of which round-tripping transactions				825.6	1,499.00	1,190.90
Short-term	177.5	233.9	540.4	1415.7	446.8	914.3
Money market instruments	0.0	0.0	0.0	0.0	0.0	0.0
Credits	36.3	51.2	216.8	1314.0	343.2	741.8
Trade credits	0.0	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	141.2	182.7	323.6	101.6	103.6	172.5
Principal arrears	121.8	158.2	293.9	85.8	73.5	133.2
Interest arrears	19.4	24.5	29.7	15.8	30.1	39.2
Other	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	2273.2	2644.5	3392.5	4420.2	6993.4	6485.5
Bonds	0.0	0.0	0.0	0.0	0.0	0.0
Credits	2239.3	2618.1	3374.5	4414.7	6992.4	6482.5
Trade credits	33.9	26.4	18.0	5.5	1.0	3.0
Other debt liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Total	**25,990.0**	**29,725.0**	**33,720.8**	**40,590.0**	**45,244.3**	**46,398.7**
Total (excluding round-tripping transactions)	**25,990.0**	**29,725.0**	**33,720.8**	**39,764.4**	**43,745.3**	**45,207.8**

Source: Croatian National Bank

(1) Exchange rate as at 31 December in the relevant year.

At the end of 2010, bank liabilities amounted to EUR 10.8 billion. The table below sets out in percentage terms the structure of bank liabilities as at the dates indicated:

	As at 31 December 2010	
	(EUR millions)	*(per cent.)*
Structure of bank liabilities		
Short term loans	935.1	8.7
Short term currency and deposits	2,073.00	19.2
Other short term liabilities	0.6	0.0
Long term bonds	8.9	0.1
Long term credits	3,366.37	31.3
Long term currency and deposits	4,384.93	40.7

Source: Croatian National Bank

The projected servicing of short, medium and long term outstanding external debt as at 31 December 2010 is provided in the following table:

Gross External Debt by Domestic Sectors and Projected Principal Future Payments

	Gross External Debt as at 31 December 2010	Immediate	Projected future principal payments during 2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Other
						(EUR millions)							
Public sector	**14,247.5**	**70.5**	**1,851.6**	**1,668.0**	**1,264.1**	**1,246.6**	**1,454.2**	**472.7**	**1,005.9**	**279.5**	**1,509.9**	**1,112.7**	**2,311.9**
Short-term	651.3	69.3	542.6	39.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	13,431.3	0.0	1,155.1	1,620.3	1,264.1	1,246.6	1,454.2	472.7	1,005.9	279.5	1,509.9	1,112.7	2,310.3
Direct investment	165.0	1.2	153.8	8.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.6
Short-term	25.9	1.2	24.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	139.1	0.0	129.1	8.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.6
Publicly guaranteed private sector	**5.5**	**0.0**	**2.8**	**2.3**	**0.3**	**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	5.5	0.0	2.8	2.3	0.3	0.0	0.0	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	32,145.8	985.9	11,110.0	5,131.1	2,855.9	2,083.9	1,507.3	1,799.7	1,295.4	1,149.7	1,106.5	749.5	2,371.0
Short-term	4,450.8	814.6	3,210.4	425.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	20,460.1	0.0	4,744.8	3,745.0	2,483.2	1,699.2	1,264.4	1,590.9	1,114.4	1,049.2	859.3	534.7	1,374.8
Direct investment	7,234.9	171.3	3,154.7	960.2	372.7	384.6	242.9	208.8	181.0	100.5	247.2	214.7	996.2
Short-term	888.4	171.3	600.7	116.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	6,346.4	0.0	2,554.0	843.9	372.7	384.6	242.9	208.8	181.0	100.5	247.2	214.7	996.2
Total	**46,398.8**	**1,056.4**	**12,964.4**	**6,801.4**	**4,120.3**	**3,330.5**	**2,961.5**	**2,272.4**	**2,301.3**	**1,429.2**	**2,616.4**	**1,862.2**	**4,682.9**

Gross External Debt by Domestic Sectors and Projected Interest Future Payments

	Gross External Debt as at 31 December 2010	Immediate	Projected Future Interest Payments during 2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Other
						(EUR millions)							
Public sector	**14,247.5**	**0.0**	**466.2**	**526.8**	**475.7**	**441.1**	**383.8**	**315.0**	**299.5**	**258.4**	**328.0**	**171.1**	**176.6**
Short-term	651.3	0.0	22.3	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	13,431.3	0.0	441.3	524.5	475.7	441.1	383.8	315.0	299.5	258.4	328.0	171.1	176.6
Direct investment	165.0	0.0	2.6	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term	25.9	0.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	139.1	0.0	1.7	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Publicly guaranteed private sector	**5.5**	**0.0**	**0.1**	**0.1**	**1.7**	**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	5.5	0.0	0.1	0.1	1.7	0.0	0.0	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	32,145.8	0.0	744.9	539.1	459.4	364.0	307.4	265.9	178.2	126.4	629.9	267.6	819.1
Short-term	4,450.8	0.0	72.6	2.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	20,460.1	0.0	565.6	461.0	397.8	315.2	265.4	222.8	129.7	99.6	422.0	129.9	240.1
Direct investment	7,234.9	0.0	106.6	75.3	61.6	48.8	42.1	43.1	48.5	26.8	208.0	137.7	578.9
Short-term	888.4	0.0	16.7	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	6,346.4	0.0	90.0	74.8	61.6	48.8	42.1	43.1	48.5	26.8	208.0	137.7	578.9
Total	**46,398.8**	**0.0**	**1,211.2**	**1,066.0**	**936.7**	**805.1**	**691.2**	**580.9**	**477.7**	**384.9**	**958.0**	**438.7**	**995.7**

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.

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 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).

The European Commission has proposed certain amendments to the Directive, which may, if implemented, amend or broaden the scope of the requirements described above.

SUBSCRIPTION AND SALE

Deutsche Bank AG, London Branch, HSBC Bank plc and Zagrebačka banka d.d. (together the "**Joint Lead Managers**") and Erste Group Bank AG and Raiffeisen Bank International AG (together with the Joint Lead Managers, the "**Managers**") have, in a subscription agreement (the "**Subscription Agreement**") dated 7 July 2011, jointly and severally agreed to subscribe and pay for, or to procure subscriptions and payment for, the Notes at their issue price of 98.600 per cent. of their principal amount less a combined management and underwriting commission. In addition, the Issuer has agreed to reimburse the Managers for certain of their expenses in connection with the management of the issue of the Notes. The Managers are entitled in certain circumstances to be released and discharged from their obligations under the Subscription Agreement prior to the issue of the Notes. The Issuer has agreed to indemnify the Managers against certain liabilities in connection with the issue of the Notes.

United States

The Notes have not been and will not be registered under the Securities Act and the Notes are subject to U.S. tax law requirements. Subject to certain exceptions, the Notes may not be offered, sold or delivered within the United States or to, or for the account or benefit of, U.S. persons. Each Manager has agreed that it will not offer, sell or deliver any Notes within the United States or to U.S. persons, except as permitted by the Subscription Agreement.

In addition, until 40 days after the commencement of the offering of the Notes, an offer or sale of Notes within the United States by any dealer, whether or not it is participating in the offering of the Notes, may violate the registration requirements of the Securities Act.

United Kingdom

Each Manager has represented and agreed that it has complied and will comply with all applicable provisions of the Financial Services and Markets Act 2000 with respect to anything done by it in relation to the Notes in, from or otherwise involving the United Kingdom.

Republic of Croatia

Each 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 or will be taken in any jurisdiction by the Managers or the Republic of Croatia that would permit a public offering of the Notes, or possession or distribution of this Prospectus or any other offering or publicity material relating to the Notes, in any country or jurisdiction where action for that purpose is required. Each Manager has agreed that it will, to the best of its knowledge and belief, comply with all applicable securities laws and regulations in each jurisdiction in which it acquires, offers, sells or delivers Notes or has in its possession or distributes this Prospectus or any such other material, in all cases at its own expense. Each Manager has agreed that it will also ensure that, to the best of its knowledge and belief, no obligations are imposed on the Republic or any other Manager in any such jurisdiction as a result of any of the foregoing actions. The Republic and the other Managers have agreed that they will each have no responsibility for obtaining, and each Manager has agreed that it will obtain, any consent, approval or permission which is, to the best of its knowledge and belief, required by it for the acquisition, offer, sale or delivery by it of Notes under the laws and regulations in force in any jurisdiction to which such Manager is subject or in or from which it makes any acquisition, offer, sale or delivery. No Manager is authorised to make any representation or use any information in connection with the issue, subscription and sale of the Notes other than as contained in this Prospectus or any amendment or supplement to it.

GENERAL INFORMATION

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 €4,590.

Documents

Copies (and certified English translations where the documents in question are not in English) of the following documents may be inspected during usual business hours on any weekday (Saturdays, Sundays and public holidays excepted) at the offices of the Paying Agent in Luxembourg during the period of 12 months following the date of this Prospectus:

(a) the Fiscal Agency Agreement which includes the forms of the Temporary Global Note, the Permanent Global Note and the definitive Notes;

(b) the resolution of the Government of the Republic of Croatia dated 7 July 2011 authorising the issue of the Notes; and

(c) the budget of the Issuer for the current fiscal year.

In addition, copies of this Prospectus are available on the Luxembourg Stock Exchange's website at *www.bourse.lu*.

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 7 July 2011, passed in accordance with the Law on Execution of the Budget of the Republic of Croatia for the year 2011 (*Official Gazette* No. 140/10).

Litigation

The Issuer 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 Issuer 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 Issuer.

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 Issuer since 31 December 2010.

Clearing Systems

The Notes have been accepted for clearance through Euroclear and Clearstream, Luxembourg. The relevant identification numbers are set forth below:

Common code	064594028
ISIN	XS0645940288
WKN	A1GTC3

The address of Euroclear is Euroclear Bank SA/NV, 1 Boulevard du Roi Albert II, B-1210 Brussels and the address of Clearstream, Luxembourg is Clearstream Banking, 42 Avenue JF Kennedy, L 1855 Luxembourg.

Yield

On the basis of the issue price of the Notes of 98.600 per cent. of their principal amount, the yield on the Notes is 6.127 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.

Ratings

The Issuer is rated BBB- (negative outlook) by Standard & Poor's, a division of the McGraw Hill Companies, Inc, Baa3 (stable outlook) by Moody's Investors Service Limited, BBB- (negative outlook) by Fitch Ratings Ltd. and BBB (stable outlook) by Rating and Investment Information, Inc.

The Notes have been assigned a rating of Baa3 (stable) by Moody's Investors Service Limited, BBB- (negative) by Standard & Poor's, a division of the McGraw Hill Companies, Inc and BBB- (negative) by Fitch Ratings Ltd.

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