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REPUBLIC OF CROATIA

U.S.$1,500,000,000 6.250 PER CENT. NOTES DUE 2017

Issue price: 99.472 per cent.

The U.S.$1,500,000,000 6.250 per cent. Notes due 2017 (the "**Notes**") are issued by the Republic of Croatia (the **"Issuer"** or **"Republic**" or "**Croatia**").

The Notes mature on 27 April 2017.

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. The CSSF assumes no responsibility as to the economic and financial soundness of the transaction or the quality or solvency of the Issuer in accordance with Article 7(7) of the Prospectus Act 2005. Application has also been made 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 Issuer is, and the Notes are expected to be, rated Baa3 (stable outlook) by Moody's Investors Service, Ltd., BBB- (negative outlook) by Standard & Poor's Credit Market Services Europe Ltd., and BBB- (negative outlook) by Fitch Ratings Ltd. A rating is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating organisation. As at the date of this Prospectus, each of the rating agencies is established in the European Union and is registered under Regulation (EU) No 1060/2009 (as amended) (the "**CRA Regulation**"). As such, each of the rating agencies is included in the list of credit rating agencies published by the European Securities and Markets Authority ("**ESMA**") on its website in accordance with such Regulation. In general, European regulated investors are restricted under the CRA Regulation from using credit ratings for regulatory purposes, unless such ratings are issued by a credit rating agency established in the EU and registered under the CRA Regulation (and such registration has not been withdrawn or suspended), subject to transitional provisions that apply in certain circumstances whilst the registration application is pending. Such general restriction will also apply in the case of credit ratings issued by non-EU credit rating agencies, unless the relevant credit ratings are endorsed by an EU-registered credit rating agency or the relevant non-EU rating agency is certified in accordance with the CRA Regulation (and such endorsement action or certification, as the case may be, has not been withdrawn or suspended). The list of registered and certified rating agencies published by ESMA on its website in accordance with the CRA Regulation is not conclusive evidence of the status of the relevant rating agency included in such list, as there may be delays between certain supervisory measures being taken against a relevant rating agency and the publication of the updated ESMA list. Certain information with respect to the credit rating agencies and ratings is set out in the sections entitled "*Credit Ratings*", "*There can be no assurance that Croatia's credit rating will not change*" and "*Credit Ratings may not reflect all risks*" of this Prospectus.

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

The Notes will initially be represented by two global certificates in registered form (the "**Global Certificates**"), one of which will be issued in respect of the Notes offered and sold in reliance on Rule 144A (the "**Restricted Global Certificate**") and will be registered in the name of Cede & Co., as nominee for The Depository Trust Company ("**DTC**") and the other of which will be issued in respect of the Notes offered and sold in reliance on Regulation S (the "**Unrestricted Global Certificate**") and will be registered in the name of a nominee of a common depositary for Euroclear Bank S.A./N.V. ("**Euroclear**") and Clearstream Banking, société anonyme ("**Clearstream, Luxembourg**"). It is expected that delivery of the Global Certificates will be made on 27 April 2012 or such later date as may be agreed (the "**Closing Date**") by the Republic and the Joint Lead Managers (as defined under "*Subscription and Sale*").

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

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

Joint Lead Managers

CITIGROUP **DEUTSCHE BANK** **J.P. MORGAN**

The date of this Prospectus is 26 April 2012.

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

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

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

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

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

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

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

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

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

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

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

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

NOTICE TO NEW HAMPSHIRE RESIDENTS

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

SERVICE OF PROCESS AND ENFORCEMENT OF CIVIL LIABILITIES

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

A substantial part of the Republic's assets are located in the Republic of Croatia and the courts of the Republic of Croatia may refuse to recognise a judgement obtained in a foreign jurisdiction (including, but not limited to England and the United States) in certain cases according to the provisions of the Croatian Law on Resolving Conflicts of Law with Other Countries' Laws and Regulations in Certain Matters (OG 53/1991). Once recognised, a foreign judgement is equal to the judgment of a Croatian court and is fit for enforcement in the Republic of Croatia.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

DEFINED TERMS AND CONVENTIONS

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

- Gross domestic product ("**GDP**") means the total value of goods and services produced inside a country during the relevant period. Unless otherwise stated references to GDP is to real, rather than nominal, GDP.

- Gross value added ("**GVA**") is the value of output less the value of intermediate consumption; it is a measure of the contribution to GDP made by an individual producer, industry or sector and is used to estimate GDP. GVA (measured by sector) plus taxes minus subsidies equals GDP.

- Imports comprise all goods and services imported from abroad intended either for consumption or for inward processing. Exports comprise all goods and services exported from Croatia, which originate from domestic production or internal trade.

- The registered unemployment rate is calculated as the ratio of the members of the active population who register with local employment agencies as being unemployed to the total active population. "**Active Population**" means people employed and people over the age of 15 registered as seeking employment.

- The inflation rate is measured by the year-on-year percentage change in the consumer price index ("**CPI**"), unless otherwise specified. The CPI index, measures inflation based on the price of a basket of approximately 740 goods and services weighted according to the Household Budget Survey and retail sales data. Croatia also measures inflation in terms of producer price index ("**PPI**"), which is the measure of wholesale prices at the producer level calculated based on a basket of approximately 400 industrial products. Unlike CPI, PPI does not take into account services. Year-on-year rates are calculated by comparing the average of the twelve monthly indices for the later period against the average of the twelve monthly indices for the prior period.

- The budget deficit is consolidated revenues minus consolidated expenditures of the general government. This is the principal measure of fiscal balance for countries participating in the European Economic and Monetary Union.

- The Standard International Trade Classification ("**SITC**") is a statistical classification of the commodities entering external trade. It is designed to provide the commodity aggregates required for the purposes of economic analysis and to facilitate the international comparison of trade-by-commodity data.

- General government debt ("**general government debt**") consists of the sum of: (i) central government debt; (ii) extra budgetary debt (of government funds and agencies); and (iii) local government debt.

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

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

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

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

References to "**OG**" and "**Official Gazette**" are to "*Narodne novine*", the official newspaper of the Republic of Croatia for the publication of acts, laws and other rules and regulations of the Croatian Parliament, the Croatian Government, the Ministries and other regulatory bodies and of the President of the Republic of Croatia. Legislation generally becomes effective eight days following publication in the Official Gazette.

Certain official data related to the year ended 31 December 2011 as well as all data relating to the period from 1 January 2012 to the present is preliminary and subject to change.

INFORMATION SOURCES

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

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

EXCHANGE RATES

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

	Period End	Average[1]	High	Low
2005	6.233626	5.949959	6.315817	5.556868
2006	5.578401	5.839170	6.233626	5.521655
2007	4.985456	5.365993	5.711720	4.933413
2008	5.155504	4.934417	5.801776	4.522752
2009	5.089300	5.280370	5.941123	4.803825
2010	5.568252	5.500015	6.088922	5.009663
2011	5.819940	5.343508	5.825236	4.947426
January 2012	5.764975	5.846617	5.956276	5.751606
February 2012	5.633652	5.733239	5.830141	5.633652
March 2012	5.623580	5.709035	5.771751	5.623580
April 2012 (through to 10 April)	5.723806	5.660529	5.724063	5.615424

Source: Croatian National Bank

(1) Average of daily rates.

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OVERVIEW

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

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

THE REPUBLIC OF CROATIA

Territory and Population

Croatia 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 and Montenegro to the east and shares a sea border with Italy to the west and south. The Danube forms the eastern border with Serbia while the other two large rivers, the Sava and Drava, form the southern and northern borders with Bosnia Herzegovina and Hungary, respectively. The area of land between the rivers is dissected by many smaller tributaries. The Adriatic coastline is the most prominent feature of Croatia, running the entire length of the western border, from the Istrian peninsula in the north to Dubrovnik in the South with approximately 1,185 islands along the coast.

Constitution and Government Structure

Croatia's constitution was adopted on 22 December 1990 and was substantially amended in December 1997, November 2000, April 2001 and June 2010 (the "**Constitution**"). It established a multi-party democracy, with an economy based on market principles and private ownership. Under the Constitution, the President of Croatia (the "**President**") is elected for five-year terms and may not serve more than two terms. The current President, Ivo Josipović, was elected in February 2010. The President appoints, with the consent of the President of the Parliament, a Prime Minister of the Government (the "**Prime Minister**") who, in turn, appoints Government Ministers. The current Prime Minister is Zoran Milanović, appointed in December 2011. The Constitution is based on the separation of powers between the legislature, executive and judiciary. The most recent parliamentary elections were held on 4 December 2011.

Judicial Reform

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

International Relations

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

European Union Accession

In October 2005, the EU Council of Ministers formally opened Croatia's accession negotiations with the EU. Following the adoption of the EU *acquis communitaire* into national law and the completion of negotiations, Croatia signed the EU Accession Treaty (the "**Accession Treaty**") on 9 December 2011. Full EU membership is expected on 1 July 2013. On 22 January 2012, EU accession was approved in a national referendum, with 66.27 per cent. of those participating voting in favour and 33.13 per cent. voting against. Prior to accession, the EU will continue to monitor Croatia's compliance with the *acquis communitaire*. In addition, the parliament of each EU member state must ratify the Accession Treaty before it can come into effect. As of the date hereof, six EU member states have ratified the Accession Treaty.

Economy

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 2010 (the latest year for which data is available), Croatia's per capita income was approximately 61 per cent. of the GDP per capita of the 27 EU member states in purchasing power terms.

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

The main objective of the economic policy in the current macroeconomic environment is to preserve macroeconomic stability and create conditions for recovery and stable economic growth.

GDP

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 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. According to preliminary estimates, in 2011 GDP recorded a growth rate of 0.0 per cent. in real terms, year-on-year.

Gross Value Added

GVA in real terms declined by 4.1 per cent. in 2009 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 and 2010 were primarily due to the negative effects of the global financial and economic crisis. In 2010, GVA declined by 1.7 per cent. compared to a decline of 4.1 for 2009. This decrease was mainly due to real GVA decreases in the construction (16.4 per cent.) and transport, storage and communication (2.4 per cent.) sectors. 2011 saw a real stagnation in GVA i.e. a real growth rate of 0.0 per cent., year-on-year. Nominal GVA increased from HRK 288,356 million in 2010 to HRK 295,165 million in 2011. The real stagnation was mainly the result of a real increase in GVA in hotels and restaurants (4.4 per cent.), and a real decrease of GVA recorded in construction (9.3 per cent.).

Inflation

Price stability has consistently been the primary goal of the Croatian National Bank's (the "**CNB**") monetary policy, which the CNB pursues primarily through the maintenance of the relatively stable HRK/EUR exchange rate. The average annual rate of inflation as measured by the consumer price index ("**CPI**") increased from 2.9 per cent. in 2007 to 6.1 per cent. in 2008. Declines in inflation, which commenced in the second half of 2008, continued throughout 2009. The average annual inflation rate for the years ended 2009, 2010 and 2011 was 2.4 per cent., 1.1 per cent. and 2.3 per cent., respectively. 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 as well as increases in food and commodities prices and energy prices (gas and refined petroleum product prices).

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

- An investment in a developing country such as Croatia is subject to substantially greater risks than an investment in a more developed country.
- Croatia may not succeed in implementing its proposed economic, financial and other reforms and policies which may adversely affect the Croatian economy and Croatia's ability to repay principal and make payments of interest on the Notes.
- Croatia's economy remains vulnerable to external shocks which could have an adverse effect on Croatia's economic growth and its ability to service its public debt.
- Croatia may not join the EU by the target date or at all and EU membership may have adverse effects on certain sectors of the economy.
- Depreciation in the Kuna may adversely affect the Croatian economic and financial condition.
- The further proliferation of the euro in the Croatian economy may adversely affect the CNB's ability to implement its monetary policies.
- The current account deficit may increase.
- If government revenue decreases, some or all of the Government's expenditure reduction plans prove insufficient, 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.
- There can be no assurance that Croatia's credit rating will not change.
- Private Croatian borrowers may not be able to repay or reschedule their debt which may have a material adverse effect on the Croatian banking system and the Croatian economy.
- The high level of foreign ownership in the Croatian banking system makes it vulnerable to disruption as a result of internal or external factors.
- Corruption and money laundering issues may hinder the growth of the Croatian economy, delay or foreclose EU accession and otherwise have a material adverse effect on Croatia.
- Croatia's legal system is not fully developed and presents greater risks and uncertainties than a more developed legal system.
- The uncertainties relating to the Croatian judicial system could have a negative effect on the economy and thus on the ability of Croatia to repay principal and make payments of interest on the Notes.
- Croatia may not be able to refinance its debt on favourable terms or at all.
- Croatia depends on the tourism industry as a significant source of revenue and any deterioration in the tourism industry may adversely affect the Republic's economy and its ability to service its debt.
- Deterioration in Croatia's relations with its major energy suppliers may adversely affect the supply of energy resources and therefore have a negative effect on the Croatian economy.
- Official economic data may not be accurate.
- The Notes may not be a suitable investment for all investors.
- The terms of the Notes may be modified, waived or substituted without the consent of all the Holders of the Notes.
- Event of Default.
- EU Savings Directive.
- Law governing the terms of the Notes may change.
- Definitive Notes not denominated in an integral multiple of U.S.$200,000 or its equivalent may be illiquid and difficult to trade.
- A Croatian court may not recognise the choice of English law as the law governing the Notes.
- There may be no active trading market for the Notes.
- A claimant may not be able to enforce a court judgment against certain assets of Croatia in certain jurisdictions.
- Fluctuations in exchange rates and interest rates may adversely affect the value of the Notes.
- Legal investment considerations may restrict certain investments.
- Credit ratings may not reflect all risks.

THE OFFERING

Issuer:	The Republic of Croatia
Description of Notes:	U.S.$1,500,000,000 6.250 per cent. Notes due 2017 (the "**Notes**"), to be issued by the Republic on 27 April 2012 (the "**Closing Date**").
Joint Lead Managers:	Citigroup Global Markets Limited, Deutsche Bank AG, London Branch, J.P. Morgan Securities Ltd.
Interest:	6.250 per cent. per annum payable semi-annually in arrear on 27 April and 27 October in each year.
Events of Default:	Events of Default under the Notes include the non-payment of any interest due in respect of the Notes or any of them for a period of 15 days from the due date for payment thereof, breach of other obligations under the Notes (which breach is not remedied within 45 days) and certain events related to the Republic. Notes may only be declared due and payable, upon an Event of Default, if the holders of at least 25 per cent. in aggregate principal amount of the outstanding Notes give notice in writing to the Republic. Furthermore if the Republic receives notice in writing from holders of at least 50 per cent. in aggregate principal amount of the outstanding Notes to the effect that the Event of Default giving rise to a declaration of acceleration is cured and that such holders wish the relevant declaration to be withdrawn, the relevant declaration shall be withdrawn and shall have no further effect.
Negative Pledge:	The terms of the Notes contain a negative pledge provision given by the Republic in respect of Public External Indebtedness as described in Condition 4.
Cross Default:	The terms of the Notes contain a cross default provision, applying to the Public External Indebtedness of the Republic, as described in Condition 10.
Status of the Notes:	The Notes will constitute direct, unconditional, (subject to the provisions of Condition 4) unsecured and unsubordinated and general obligations of the Republic and will rank *pari passu* among themselves and at least (save for certain obligations required to be preferred by law) equally with all other present and future unsecured obligations of the Republic.
Meetings of Noteholders:	The Conditions of the Notes contain provisions for calling meetings of Noteholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Noteholders including Noteholders who did not attend and vote at the relevant meeting and Noteholders who voted in a manner contrary to the majority. The Conditions also contain provisions for the appointment of a Noteholders' representative committee.
Modification:	The Conditions of the Notes contain a provision permitting the Notes and the Conditions of the Notes to be amended without the consent of the Noteholders to correct a manifest error.
Taxation:	All payments in respect of the Notes by or on behalf of the Republic shall be made without withholding or deduction for, or on account of any Taxes as provided in Condition 8.
Listing and admission to trading:	Application has been made to the CSSF to approve this document as a prospectus and to the Luxembourg Stock Exchange for the listing of the Notes on the Official List of the Luxembourg Stock Exchange and admission to trading on the Luxembourg Stock Exchange's regulated market.
Governing Law:	The Notes and any non-contractual obligations arising out of or in connection with the Notes are governed by and shall be construed in accordance with, English law, provided however, that the due

authorisation and execution of the Notes by and on behalf of the Republic shall be governed by the laws of the Republic.

Form:	The Notes will be issued in registered form in denominations of U.S.$200,000 and integral multiples of U.S.$1,000 in excess thereof.
Credit Ratings:	The Issuer is, and the Notes are expected to be, rated Baa3 (stable outlook) by Moody's Investors Service Ltd. ("**Moody's**"), BBB- (negative outlook) by Standard & Poor's Credit Market Services Europe Ltd. ("**S&P**"), and BBB- (negative outlook) by Fitch Ratings Ltd. ("**Fitch**"). A credit rating is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating organisation. As at the date of this Prospectus, each of Moody's, S&P and Fitch is established in the European Union and is registered under the CRA Regulation. As such, each of Moody's, S&P and Fitch is included in the list of credit rating agencies published by ESMA on its website in accordance with such Regulation.
	In general, European regulated investors are restricted under the CRA Regulation from using credit ratings for regulatory purposes, unless such ratings are issued by a credit rating agency established in the EU and registered under the CRA Regulation (and such registration has not been withdrawn or suspended), subject to transitional provisions that apply in certain circumstances whilst the registration application is pending. Such general restriction will also apply in the case of credit ratings issued by non-EU credit rating agencies, unless the relevant credit ratings are endorsed by an EU-registered credit rating agency or the relevant non-EU rating agency is certified in accordance with the CRA Regulation (and such endorsement action or certification, as the case may be, has not been withdrawn or suspended). The list of registered and certified rating agencies published by ESMA on its website in accordance with the CRA Regulation is not conclusive evidence of the status of the relevant rating agency included in such list, as there may be delays between certain supervisory measures being taken against a relevant rating agency and the publication of the updated ESMA list.
Selling Restrictions:	The Notes have not been and will not be registered under the Securities Act and are subject to certain restrictions on transfers. See "*Subscription and Sale*" below.
Use of Proceeds:	The net proceeds of the issuance of the Notes will be applied by the Republic for general budgetary governmental purposes.

RISK FACTORS

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

Risk Factors Relating to Croatia

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

An investment in a country such as Croatia, which achieved independence 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, investment in Croatia's sovereign securities could be adversely affected by negative economic or financial developments in other countries. Furthermore, if one or more of the countries that comprise Croatia's major trading partners (many of whom are in the EU) were to experience further negative consequences as a result of the global financial and economic crisis, or the sovereign debt crisis, this could adversely affect the Croatian economy. There can be no assurance that conditions resulting from any crises similar to the global financial and economic crisis that started in 2008, the ongoing sovereign debt crisis or the recent political turmoil in countries in Northern Africa and the Middle East will not negatively affect the economic performance of, or investor confidence in, developing markets, including Croatia.

Croatia may not succeed in implementing its proposed economic, financial and other reforms and policies which may adversely affect the Croatian economy and Croatia'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 may be unable to complete planned privatisations or may experience difficulties implementing budget reforms. 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 in a timely manner or at all. 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.

Croatia's economy remains vulnerable to external shocks which could have an adverse effect on Croatia's economic growth and its ability to service its public debt

Croatia's economy remains vulnerable to external shocks, including those stemming from the global financial and economic crisis that started in 2008, the ongoing sovereign debt crisis or the recent political turmoil in certain emerging markets. Although in recent years Croatia has made significant gains in stabilising its currency, increasing

its GDP, decreasing inflation and increasing real wages, the global financial and economic crisis negatively affected the Croatian economy. In recent years, Croatia has experienced negative trends in GDP, a mixed trend in FDI and an increase in the net lending/borrowing of the consolidated general government. According to the Croatian Bureau of Statistics ("**CBS**"), Croatia's real GDP remained flat in 2011 after contracting 1.4 per cent. in 2010 and by 6.0 per cent. in 2009, as compared to GDP growth of 2.4 per cent. in 2008 and 5.1 per cent. in 2007. After experiencing a significant decline in 2010, net FDI recovered in 2011 and amounted to EUR 1.0 billion (mostly associated with debt-equity swaps and retained earnings). However, net FDI still remains low compared to pre-crisis levels. Net FDI in 2011 amounted to only 29.7 per cent. of net FDI in 2007 and 31.5 per cent. of net FDI in 2008. Based on preliminary data, in 2011 net lending/borrowing of the consolidated general government was 5.6 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 pattern has not been sustained since 2009 and Croatia may not return to a similar growth pattern 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 decreased by 20.4 per cent. in 2009 and this negative trend continued during 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. In 2011, Croatia recorded an improvement to capital inflows, which grew by 27.5 per cent. to EUR 1.7 billion (excluding international reserve charges). The gross external debt (including both public and private debt) in euro terms grew from EUR 13.6 billion (52.9 per cent. of GDP) in 2001 to EUR 45.2 billion (99.1) per cent. of GDP) in 2009. The gross external debt in euro terms continued to increase in 2010 and 2011 and amounted to EUR 46.5 billion (101.2 per cent. of GDP) as at 31 December 2010 and EUR 45.7 billion (99.6 per cent. of GDP) as at 31 December 2011. (See "*Public Finance — External Debt*".)

There can be no assurance that Croatia will return to the growth pattern experienced in the period from 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 EU by the target date or at all and EU membership may have adverse effects on certain sectors of the economy

Croatia commenced formal negotiations on EU accession in October 2005. As a prerequisite to EU accession, Croatia had to harmonise its national law with the body of EU law (the "*acquis communautaire*"). Following completion of negotiations, Croatia signed the accession treaty with the EU on 9 December 2011 (the "**Accession Treaty**"). On 22 January 2012, EU accession was approved in a national referendum and on 9 March 2011, the Croatian Parliament ratified the Accession Treaty. Full EU membership is expected on 1 July 2013. Prior to accession, the parliament of each EU member state must ratify the Accession Treaty before it can come into effect. As of the date hereof, six out of the 27 EU member states have ratified the Accession Treaty.

There can be no assurance that the remaining 21 EU member states will ratify the Accession Treaty prior to 1 July 2013 and it is possible that domestic political developments in certain member states could lead to delays. In addition, Croatia is subject to ongoing monitoring by the EU of the country's compliance with the *acquis communautaire* and the Pre-Accession Economic Programme (See "*Overview — International Relations — European Union Accession*" and "*The Economy — Economic Policy*"). As a result of these factors, there can be no assurance that Croatia will join the EU by the target date or at all. Delays or other adverse developments in Croatia's accession to the EU may have a negative effect on Croatia's economic performance.

If Croatia joins the EU in 2013, its economy will become part of the EU internal market and would be exposed to increased competition which could have adverse effects on sectors of the economy that are unable to compete. In addition, Croatia would be required to significantly reduce the level of domestic subsidies to the agriculture sector which amounted to 1.01 per cent. of GDP for the year ended 31 December 2011 (see "*The Economy — Government Subsidies*"). As a result of EU membership, Croatia expects to receive financial assistance from EU structural funds pursuant to the EU Cohesion Policy. However, there is no guarantee that Croatia will meet the criteria to receive disbursements under these funds or that such funds would be available (see *"The Economy — Economic Policy — EU Structural Funds"*).

If Croatia joins the EU in 2013, it will seek to enter the Exchange Rate Mechanism ("**ERM II**"). Under ERM II, the exchange rate of a non-euro area Member State is fixed against the euro and is only allowed to fluctuate within set limits. Entry into ERM II is based on an agreement between the ministers and central bank governors of the non-euro area Member State and the euro-area Member States, and the European Central Bank. Entry into ERM II will be a step towards the full adoption of the euro in Croatia, in line with Croatia's commitment pursuant to the

Accession Treaty. Croatia's date of entry into ERM II and, subsequently, into the eurozone, would primarily depend on Croatia's macroeconomic indicators, i.e. the ability to fulfil a set of membership criteria which are more stringent than those applied to previous candidates. The policy measures required to meet such criteria, Croatia's entry into ERM II and adoption of the euro could each result in adverse macroeconomic effects on Croatia's economy and lead to lower rates of economic growth.

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 or linked to foreign currencies. Foreign-currency and foreign currency-linked debt accounts for 73.9 per cent. of general government debt as at 31 December 2011. In addition, substantially all government guarantees are denominated in or linked to foreign currency. 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 30 September 2011, approximately 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 2011, as in 2010 and 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. Over the last twelve months the Croation National Bank has intervened in the foreign currency market five times in an effort to stabilise the euro/Kuna exchange rate. 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. See "*Monetary Developments and International Reserves — Monetary Policy and Instruments*".

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.

Croatia is committed to entering the ERM II and adopting the euro following EU accession, subject to certain criteria being met. The policy measures required to meet such criteria, Croatia's entry into ERM II and adoption of the euro could each result in adverse macroeconomic effects on Croatia's economy and lead to lower rates of economic growth.

The current account deficit may increase

Croatia's current account deficit tripled between 2004 and 2008, mainly due to the widening trade deficit, and even though it has declined since 2008, it is expected to increase again in the future. The current account deficit increased by 212.9 per cent. in euro terms from EUR 1.4 billion (4.1 per cent. of GDP) in 2004 to EUR 4.3 billion (8.9 per cent. of GDP) in 2008. The current account deficit decreased by 46.2 per cent. in euro terms in 2009 and amounted to EUR 2.3 billion (5.0 per cent. of GDP). The decrease was mainly attributable to a narrowing of the deficit in trade in goods. In 2010, the current account produced a deficit of EUR 0.5 billion (1.0 per cent. of GDP), a 79.4 per cent. decrease compared to 2009. In 2011, based on preliminary data, the current account deficit further declined by 5.5 per cent. to EUR 0.5 billion (1.0 per cent. of GDP).

Croatia's exports as a 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 61.3 per cent. from EUR 6.7 billion in 2004 to EUR 10.9 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 31.7 per cent. in 2009 compared to 2008 and amounted to EUR 7.4 billion. This trend continued in 2010, with the trade deficit decreasing further by 19.2 per

cent. to EUR 6.0 billion from EUR 7.4 billion in 2009. The trend was reversed in 2011, based on preliminary data, and the trade deficit increased by 6.1 per cent. in 2011, reaching EUR 6.4 billion. The decrease in the trade deficit and corresponding decrease in the current account deficit in 2009 were 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, due to rising exports while imports stagnated. The trade deficit increased in 2011, primarily due to an increase in imports and a growth in the prices of oil and energy commodities. 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 expenditure reduction plans prove insufficient, 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 consolidated general government budget for 2012, general government revenue is expected to be HRK 125.1 billion, an increase of 1.7 per cent. over planned general government revenue for 2011. The level of general government revenue is continued to be impacted by the difficult macroeconomic environment. The general government budget expects to raise HRK 2.0 billion from the privatisation of two state-owned enterprises, Croatia Osiguranje (an insurance company) and Hrvatska Postanska Banka (a bank). However, there is no guarantee that these privatisations will be successful or that the Government will be able to raise the full expected amount. Despite reduction efforts, Croatia also faces substantial expenses relating to public wages, social benefits (including healthcare and pensions) and interest payments, which represented 26.5 per cent. of Croatia's GDP in 2011. 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 the working age population (people aged 15 to 64) to people aged 65 or older) remains high (1:0.254 in 2011). Further pressure on the budget is added by expenses related to general government subsidies. Even though such expenses decreased from HRK 6.5 billion to HRK 6.2 billion between 2007 and 2011, they still remain relatively high. In addition, the level of compensation to government employees remains high, amounting to HRK 37.1 billion or 9.3 per cent. of GDP according to the budget for 2011. The 2012 budget has introduced measures to reduce the level of compensation (by reducing special supplements to salaries relating to part-time work, overtime work and special working conditions), with the aim of saving 0.6 per cent. of GDP. However, there can be no guarantee that the Government would be able to implement such measures successfully or that they would achieve the projected amount of savings and thus make it difficult for Croatia to achieve the targets set under the Fiscal Responsibility Law.

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. 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. Actual economic growth in 2012 may be lower than Government projections and assumptions used for the 2012 budget. Lower than expected growth would have a negative impact on budget revenue and negative implications for adhering to the Fiscal Responsibility Law. Lower than expected growth would increase the share of expenditure to GDP (with an unchanged level of expenditure) thereby making it more likely that the Government will fail to meet the targets set in the Fiscal Responsibility Law to reduce the expenditure-to-GDP ratio by 1 per cent. per year. In a lower growth environment, additional expenditure reduction measures may be required to adhere to the Fiscal Responsibility Law. This would add pressure to the existing fiscal consolidation plan.

Taken as a whole, reduced revenues, coupled with high 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. There can be no guarantee that the Republic will not experience credit downgrades. A deterioration in key economic indicators or the materialisation of any of the risks discussed herein may contribute to 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. In addition, a sub-investment grade rating could adversely affect Croatia's ability to refinance existing indebtedness, finance the deficit and could affect payment of principal and interest under the Notes.

As at the date of this Prospectus, each of Moody's, S&P and Fitch is included in the list of credit rating agencies published by ESMA on its website in accordance with Regulation (EU) No. 1060/2009 (as amended). 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.

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

Private debt in Croatia has grown rapidly since the mid-2000s 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 has remained flat in recent years and amounted to EUR 31.7 billion (70.0 per cent. of 2011 GDP) as at 31 December 2011, EUR 32.1 billion (70.0 per cent. of 2010 GDP) and EUR 32.4 billion (71.0 per cent. of 2009 GDP). (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*"). Non-performing loans have been increasing continuously during the economic crisis, from 4.9 per cent. in 2008 to 12.4 per cent. in 2011 and may continue to rise. Non-performing loans to enterprises have experienced the greatest increase, from 7.2 per cent. in 2008 to 20.1 per cent. in 2011. See "*Monetary Developments and International Reserves — Banking System — Loan Exposure*").

Failure of private borrowers to repay or reschedule their debt may have a material adverse effect on the Croatian banking system and the Croatian economy. In turn, this may affect Croatia's ability to repay principal and make payments of interest on the Notes.

The high level of foreign ownership in the Croatian banking system makes it vulnerable to disruption as a result of internal or external factors

As at 31 December 2011, foreign banks owned approximately 90.6 per cent. of banks' assets in Croatia. The Croatian banking system is exposed to the banking systems of other European countries, including Italy and Austria. Foreign banks may rebalance their global loan portfolio in a manner adversely affecting Croatia as a result of events related or unrelated to Croatia, including as a result of the ongoing economic turbulence in the eurozone and sovereign debt markets. 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 and a continued rise in non-performing loans. 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 2011 Transparency International Corruption Perceptions Index, Croatia fell four spots to be ranked 66 out of 182 countries under review (indicating that there were 65 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 (OG 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 evolving to support the country's transition to a market-based economy. New laws have been introduced and revisions have been made with respect to, amongst others, company, property, competition, public procurement, 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, 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 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. Because legislation in a number of areas was adopted following independence and is still fairly recent, relevant judicial decisions may not be publicly available and, therefore, the role of judicial decisions as guidelines in interpreting applicable Croatian legislation to the public at large may be 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

Croatia has substantial amounts of internal and external public debt. As at 31 December 2011, general government debt stood at HRK 160.0 billion (45.7 per cent. of GDP) and government guarantees stood at HRK 59.8 billion (17.5 per cent. of GDP), for a total amount of HRK 215.8 billion or 63.2 per cent. of GDP. See *"Public Finance"*. As of 31 December 2011, the average maturity of external public debt outstanding was 7.2 years whereas the average maturity of the domestic public debt outstanding was 4.6 years. Any deterioration in financing conditions as a result of market, economic or political factors, which may be outside Croatia's control, may jeopardise Croatia's ability to repay and/or refinance existing debt and thereby adversely affect Croatia'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. See "*The Economy — Gross Value Added — Hotels and Restaurants*".

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.

Risk Factors Relating to an Investment in the Notes

The Notes may not be a suitable investment for all investors

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

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

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

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

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

Event of Default

The conditions of the Notes contain a provision which, if an Event of Default occurs, allows the holders of at least 25 per cent. in aggregate principal amount of the outstanding Notes to declare all the Notes to be immediately due

and payable by providing notice in writing to the Republic, whereupon the Notes shall become immediately due and payable, at their principal amount with accrued interest, without further action or formality.

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

EU Savings Directive

Under EC Council Directive 2003/48/EC on the taxation of savings income (the "**Directive**"), 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 or to certain limited types of entities established 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 Republic nor any Agent nor any other person would be obliged to pay additional amounts with respect to any Note as a result of the imposition of such withholding tax. The Republic is required to maintain an Agent in a Member State that is not obliged to withhold or deduct tax pursuant to the Directive.

Law governing the terms of the Notes may change

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

Definitive Notes not denominated in an integral multiple of U.S.$200,000 or its equivalent may be illiquid and difficult to trade

The Notes have denominations consisting of a minimum of U.S.$200,000 plus integral multiples of U.S.$1,000 in excess thereof. It is possible that the Notes may be traded in amounts that are not integral multiples of U.S.$200,000. In each such a case a holder who, as a result of trading such amounts, holds an amount which is less than U.S.$200,000 in his account with the relevant clearing system at the relevant time may not receive a Certificate in respect of such holding (should Certificates be printed) and would need to purchase a principal amount of Notes such that its holding amounts to U.S.$200,000.

If Certificates are issued, holders should be aware that Certificates which have a denomination that is not an integral multiple of U.S.$200,000 may be illiquid and more difficult to trade than Notes denominated in an integral multiple of U.S.$200,000.

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

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

There may be no active trading market for the Notes

Although an application has been made to list on the Official List and trade the Notes on the regulated market "*Bourse de Luxembourg*" of the Luxembourg Stock Exchange, there is no assurance that such application will be accepted or that an active trading market for the Notes will develop or, if one does develop, that it will be liquid or

maintained. If an active trading market in the Notes does not develop or is not maintained, the market price and liquidity of the Notes may be adversely affected.

The market for securities issued by Croatia is influenced by economic and market conditions in Croatia and, to a varying degree, economic conditions in other Eastern European markets as well as global, emerging and developed markets generally. There can be no assurance that events which would cause volatility of the sort that occurred in worldwide financial markets in 1998 and 2008-2009 will not occur again, or that any such volatility will not adversely affect the price or liquidity of the Notes.

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

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

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

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

Croatian law on execution currently in force prescribes certain assets that are not available for enforcement. It is expected that as of 1 July 2012 the relevant provisions prescribing those restrictions will be amended and certain additional assets owned by Croatia, in particular the means, equipment and objects intended for the purpose of state administration and judicial authorities would also become unavailable to satisfy any claim or judgment in respect of the Notes.

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

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

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

Legal investment considerations may restrict certain investments

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

Credit ratings may not reflect all risks

Moody's, S&P and Fitch are expected to 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 relevant rating agency at any time.

CONDITIONS OF THE NOTES

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

The U.S.$1,500,000,000 6.250 per cent. Notes due 2017 (the "**Notes**", which expression shall in these Conditions, unless the context otherwise requires, include any further notes issued pursuant to Condition 14 (*Further Issues*) and forming a single series with the Notes) of the Republic of Croatia (the "**Republic**") are issued subject to and with the benefit of an Agency Agreement dated 27 April 2012 (such agreement as amended and/or supplemented and/or restated from time to time, the "**Agency Agreement**") made between the Republic, Deutsche Bank Trust Company Americas and Deutsche Bank Luxembourg S.A. as registrars (the "**Registrars**"), Deutsche Bank AG, London Branch as fiscal agent and transfer agent (the "**Fiscal Agent**" and together with Deutsche Bank Trust Company Americas and Deutsche Bank Luxembourg S.A. the "**Transfer Agents**") and the other initial paying agents named in the Agency Agreement (together with the Fiscal Agent, the "**Paying Agents**") and the other agents named in it (together with the Fiscal Agent, the Registrars, the Transfer Agents and the other Paying Agents, the "**Agents**"). The holders of the Notes (the "**Noteholders**") are entitled to the benefit of a Deed of Covenant dated 27 April 2012 (the "**Deed of Covenant**") and made by the Republic. The original of the Deed of Covenant is held by the Fiscal Agent on behalf of the Noteholders at its specified office.

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

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

1. FORM, DENOMINATION AND TITLE

1.1 Form and Denomination

The Notes are issued in registered form in amounts of U.S.$200,000 and integral multiples of U.S.$1,000 in excess thereof (referred to as the "**principal amount**" of a Note). A note certificate (each a "**Certificate**") will be issued to each Noteholder in respect of its registered holding of Notes. Each Certificate will be numbered serially with an identifying number which will be recorded on the relevant Certificate and in the relevant Register (as defined below) which the Republic will procure to be kept by the relevant Registrar.

The Notes are not issuable in bearer form.

1.2 Title

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

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

2. TRANSFERS OF NOTES AND ISSUE OF CERTIFICATES

2.1 Transfers

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

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

2.2 Delivery of new Certificates

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

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

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

2.3 Formalities free of charge

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

2.4 Closed Periods

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

2.5 Regulations

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

3. STATUS

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

4. NEGATIVE PLEDGE AND OTHER COVENANTS

4.1 Negative Pledge

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

Certain Definitions:

In these Conditions:

Permitted Security Interest means:

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

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

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

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

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

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

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

5. INTEREST

5.1 Interest Rate and Interest Payment Dates

The Notes bear interest on their outstanding principal amount from and including 27 April 2012 at the rate of 6.250 per cent. per annum, payable semi-annually in arrear on 27 April and 27 October in each year (each an "**Interest Payment Date**"). The first payment (representing a half year's interest) for the period from and including 27 April 2012 to but excluding 27 October 2012 and amounting to U.S.$31.25 per U.S.$1,000 principal amount of Notes shall be made on 27 October 2012.

5.2 Interest Accrual

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

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

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

5.3 Calculation of Broken Interest

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

6. PAYMENTS

6.1 Payments in respect of Notes

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

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

6.2 Payments subject to Applicable Laws

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

6.3 No commissions

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

6.4 Payment on Business Days

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

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

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

6.5 Partial Payments

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

6.6 Agents

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

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

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

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

(d) there will at all times be a Registrar (or Registrars).

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

7. REDEMPTION AND PURCHASE

7.1 Redemption at Maturity

Unless previously redeemed or purchased and cancelled as provided below, the Republic will redeem the Notes at their principal amount on 27 April 2017.

7.2 Purchases

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

7.3 Cancellations

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

8. TAXATION

8.1 Payment without Withholding

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

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

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

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

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

8.2 Interpretation

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

8.3 Additional Amounts

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

9. PRESCRIPTION

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

10. EVENTS OF DEFAULT

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

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

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

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

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

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

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

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

11. REPLACEMENT OF CERTIFICATES

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

12. NOTICES

12.1 Notices to the Noteholders

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

12.2 Notices to the Republic

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

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

13.1 Convening Meetings of Noteholders

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

13.2 Quorum

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

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

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

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

13.3 Reserved Matters

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

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

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

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

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

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

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

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

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

13.4 Modifications

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

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

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

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

13.5 Written resolutions

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

13.6 Manifest error, etc.

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

13.7 Notes controlled by the Republic

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

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

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

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

13.8 Noteholders' Representative Committee

(a) Appointment

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

(i) an Event of Default;

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

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

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

(b) Powers

Such committee in its discretion may, among other things, (I) engage legal advisers and financial advisers to assist it in representing the interests of the Noteholders, (II) adopt such rules as it considers appropriate regarding its proceedings, (III) enter into discussions with the Republic and/or other creditors of the Republic, (IV) designate one or more members of the committee to act as the main point(s) of contact with the Republic and provide all relevant contact details to the Republic, (V) determine whether or not there is an actual or potential conflict of interest between the interests of the holders of the Notes then outstanding and the interests of the holders of debt securities of any one or more other series issued by the Republic and (VI) upon making a determination of the absence of any actual or potential conflict of interest between the interests of the holders of the Notes then outstanding and the interests of the holders of debt securities of any one or more other series issued by the Republic, agree to transact business at a combined meeting of the committee and such other person or persons as may have been duly appointed

as representatives of the holders of securities of each such other series. Except to the extent provided in this paragraph (b) (*Powers*), such committee shall not have the ability to exercise any powers or discretions which the Noteholders could themselves exercise. The Republic shall pay any fees and expenses which are reasonably incurred by any such committee (including, without limitation, the costs of giving notices to Noteholders and the reasonable fees and expenses of the committee's legal advisers and financial advisers, if any) within 30 days of the delivery to the Republic of a reasonably detailed invoice and supporting documentation.

14. FURTHER ISSUES

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

15. GOVERNING LAW AND SUBMISSION TO JURISDICTION

15.1 Governing Law

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

15.2 Jurisdiction

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

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

The Republic irrevocably appoints the Ambassador of the Republic of Croatia in the United Kingdom, currently residing at the Embassy of the Republic of Croatia, 21 Conway Street, London 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.

16. RIGHTS OF THIRD PARTIES

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

THE GLOBAL CERTIFICATES

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

1. FORM OF THE NOTES

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

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

The Unrestricted Global Certificate and the Restricted Global Certificate are referred to herein as the "**Global Certificates**". Beneficial interests in Global Certificates will be subject to certain restrictions on transfer set out therein and under *"Transfer Restrictions"* and in the Agency Agreement and such Global Certificates will bear a legend as set out under *"Subscription and Sale"*.

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

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

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

2. ACCOUNTHOLDERS

For so long as any of the Notes are represented by the Global Certificates, each person (other than another clearing system) who is for the time being shown in the records of DTC or Euroclear or Clearstream, Luxembourg (as the case may be) as the holder of a particular aggregate principal amount of such Notes (each an "**Accountholder**") (in which

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

3. CANCELLATION

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

4. PAYMENTS

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

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

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

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

All payments in respect of Notes represented by a Global Certificate will be made to, or to the order of, the person whose name is entered on the relevant Register at the close of business on the Clearing System Business Day immediately prior to the date for payment, where Clearing System Business Day means Monday to Friday inclusive except 25 December and 1 January.

5. NOTICES

So long as the Notes are represented by a Global Certificate and such Global Certificate is held on behalf of a clearing system, notices to Noteholders may be given by delivery of the relevant notice to that clearing system for communication by it to entitled Accountholders in substitution for notification as required by Condition 12 (*Notices*) except that, so long as the Notes are listed on any stock exchange, notices shall also be published in accordance with the rules of such exchange. Any such notice shall be deemed to have been given to the Noteholders on the day after the day on which such notice is delivered to DTC, Euroclear and/or Clearstream, Luxembourg (as the case may be) as aforesaid.

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

6. REGISTRATION OF TITLE

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

7. EXCHANGE FOR CERTIFICATES

Exchange

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

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

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

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

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

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

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

Delivery

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

Legends and transfers

The holder of a Certificate may transfer the Notes represented thereby in whole or in part in the applicable denomination by surrendering it at the specified office of any Transfer Agent, together with the completed form of transfer thereon. Upon the transfer, exchange or replacement of a Certificate bearing the legend referred to under *"Subscription and Sale*", or upon specific request for removal of the legend on a Certificate, the Republic will deliver only Certificates that bear such legend, or will refuse to remove such legend, as the case may be, unless there is delivered to the Republic and the relevant Registrar such satisfactory evidence, which may include an opinion of counsel, as may reasonably be required by the Republic that neither the legend nor the restrictions on transfer set out therein are required to ensure compliance with the provisions of the Securities Act. Restricted Certificates will bear the same legend as the legend for the Restricted Global Certificates set out under *"Subscription and Sale*".

The Restricted Certificates may not at any time be held by or on behalf of persons in the United States that are not QIBs. Before any Unrestricted Certificate may be offered, resold, pledged or otherwise transferred to a person who takes delivery in the form of a Restricted Certificate, the transferor and/or transferee, as applicable, will be required to provide the relevant Registrar with a written certification substantially in the form set out in the Agency Agreement to the effect that the transferor reasonably believes that the transfer is (i) to a person that is a QIB and (ii) such transfer is made in reliance on Rule 144A. Unrestricted Certificates will bear the same legend as the legend for the Unrestricted Global Certificates set out under *"Subscription and Sale*". Before any Restricted Certificates may be offered, resold, pledged or otherwise transferred to a person who takes delivery in the form of an Unrestricted Certificate, the transferor and/or transferee, as applicable, will be required to provide the relevant Registrar with a written certification substantially in the form set out in the Agency Agreement to the effect that the transfer is being made in accordance with Regulation S.

USE OF PROCEEDS

The net proceeds of the issue of the Notes, amounting to approximately U.S.$1,490,205,000, will be applied by the Republic for general budgetary governmental purposes.

OVERVIEW OF THE REPUBLIC OF CROATIA

Territory and Population

Croatia 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 and 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. The census process was conducted in accordance with international standards that define the joint rules for the collection of data on population and housing and prescribe harmonised definitions aimed at ensuring the international comparability of data. The first set of results on population, households and dwellings were published on 30 June 2011. According to the preliminary 2011 census results: Zagreb is the largest city in the country, with a population of 792,875, and is considered the leading industrial, cultural and scientific centre in Croatia. Other cities of significant size include Split (population 178,192), Rijeka (population 128,735), Osijek (population 107,784) and Zadar (population 75,082). According to the 2011 census, the total population of the country was 4,290,612.

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

	Year ended 31 December					
	2009		2010		2011(*)	
Age	People	Per cent. of total	People	Per cent. of total	People	Per cent. of total
	(thousands)		*(thousands)*		*(thousands)*	
Youth (0-14)	678.2	15.3	671.2	15.2	660.9	15.0
Working age (15-64)	2,984.4	67.4	2,984.4	67.6	2,984.4	67.8
Pensioners (65 and over)	766.5	17.3	762.3	17.3	756.6	17.2
Total	**4,435.0**	**100.0**	**4,417.8**	**100.0**	**4,401.9**	**100.0**

Source: Croatian Central Bureau of Statistics
(*) Based on preliminary data

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 (based on latest available data)
(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 into 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 and 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 and Herzegovina and the majority of the Serb population left the area for the Former Republic of Yugoslavia ("**FRY**") and Bosnia and 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.

In October 2001, Croatia began negotiations for accession into the EU which concluded in December 2011 with the signing of an Accession Treaty. Accession into the EU was approved in a general referendum in January 2012, with EU membership expected on 1 July 2013. (See *"—International Relations — European Union Accession*")

International Relations

After gaining independence, Croatia was admitted to the UN in May 1992. In the same year, Croatia became a participant country in OSCE and became a member of the IMF. In 1996, Croatia became the 40th Member State of the Council of Europe. For a discussion of the economic programmes and reforms between 1995 and 2000 see "*The Economy*". 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 WTO, while in 2002 it acceded to the Central European Free Trade Area. Croatia is also a member of the International Development Association, the International Finance Corporation, the 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 the accession process is in its final phase, as discussed below. In April 2009, Croatia acceded to NATO.

The IMF has assisted 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 July 2011.

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 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 European Commission (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 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.

The annual PEPs reflect economic policies 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 latest PEP covering the period 2012-2014 was adopted by the government in February 2012 (see "*The Economy — Economic Policy*").

In October 2005, the EU Council of Ministers formally opened Croatia's accession negotiations with the EU. Following the adoption of the EU *acquis communitaire* into national law and the completion of negotiations, Croatia signed the EU Accession Treaty on 9 December 2011. Full EU membership is expected on 1 July 2013. On 22 January 2012, EU accession was approved in a national referendum, with 66.27 per cent. of those participating voting in favour and 33.13 per cent. voting against. Prior to accession, the EU will continue to monitor Croatia's compliance with the *acquis communitaire*. In addition, the parliament of each EU member state must ratify the Accession Treaty before it can come into effect. As of the date hereof, six EU member states have ratified the Accession Treaty, namely Slovakia, Hungary, Bulgaria, Italy, Malta and Latvia. EU membership is expected to open new economic opportunities and promote Croatia's stability and prosperity (see "*The Economy — Economic Policy — EU Structural Funds*").

Constitution and Government Structure

Croatia's 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.. The Constitution is based on the separation of powers between the legislature, executive and judiciary. The current President is Ivo Josipović (elected in February 2010) and the current Prime Minister is Zoran Milanović (appointed in December 2011).

Legislature

Croatia has a single chamber Parliament, which consists of 151 elected members who are elected by national general elections for a four-year term. The Parliament has the power to pass laws, pass and 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, certain appointments and dismissals, exercise certain supervisory powers over the Government, as well as gives amnesty for criminal acts. Laws are passed by majority vote provided that a majority of members are present, except that laws which deal with rights of national minorities and, in certain cases, constitutional rights can only be passed by 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 Official 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 at least 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 and the Government collaborate to formulate and execute the foreign policy. 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 cabinet which entered into office on 23 December 2011.

Name	Title
Zoran Milanović	Prime Minister
Radimir Čačić	First Deputy Prime Minister and Minister of the Economy
Milanka Opačić	Deputy Prime Minister and Minister of Social Welfare Policy and Youth
Neven Mimica	Deputy Prime Minister for Home, Foreign and European Affairs
Branko Grčić	Deputy Prime Minister and Minister of Regional Development and EU Funds
Slavko Linić	Minister of Finance
Ante Kotromanović	Minister of Defence
Vesna Pusić	Minister of Foreign and European Affairs
Ranko Ostojić	Minister of Interior
Orsat Miljenić	Minister of Justice
Arsen Bauk	Minister of Administration
Gordan Maras	Minister for Entrepreneurship and Trade
Mirando Mrsić	Minister of Labour and Pension System
Siniša Hajdaš Dončić	Minister for Maritime Affairs, Transport and Infrastructure
Tihomir Jakovina	Minister of Agriculture
Veljko Ostojić	Minister of Tourism
Mirela Holy	Minister for Environment and Nature Protection
Ivan Vrdoljak	Minister of Construction and Physical Planning
Predrag Matić	Minister of War Veterans
Rajko Ostojić	Minister of Health
Željko Jovanović	Minister of Science, Education and Sports
Andrea Violić	Minister of Culture

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, inter alia, decides on ordinary legal remedies (appeals), when so prescribed, under special laws and decides on extraordinary legal remedies against final court judgements, in accordance with special laws. The Supreme Court has the authority to decide on the conflict of jurisdiction between the courts of different types in Croatia. Specialised courts exist to deal with commercial, administrative and misdemeanour law matters. Judges are appointed by the State Judiciary Council of Croatia (the "**Council**"), comprising 11 members, seven of whom are selected from amongst judges, two from amongst university law professors and two 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 one consecutive term. Judicial office is permanent. The Council, according to the Constitution and law, decides independently on the appointment, promotion, transfer, dismissal, immunity 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 on Constitutional Court of the Republic of Croatia. 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 a judicial reform programme 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 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 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 programme, 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 (the "**Courts Act**") and are now covered by the State Judiciary Council Act. In March and November 2011 the Courts Act was amended in order to be harmonised with the provisions of the new Administrative Disputes Act (OG 20/10) and to deal with content of the decisions evaluating judges and deadlines for submitting appeals and the appellate procedure regarding such decisions.

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 a subsequent amendment came into force on 3 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 programme. According to the European Commission's most recent 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 and the Supreme Court has also prepared an action plan aimed at resolving such cases.

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 expected to come into force on 1 July 2012, after its initial postponement of entry into force originally envisaged for 1 January 2012. The law 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, additional amendments thereto may be expected before its entry into force. The new Public Enforcement Officers Act (OG 139/10, as amended) establishes a Public Enforcement Officers' Chamber, contains provisions dealing with a Public Enforcement Officers Register and regulates, *inter alia*, the operations and remunerations of public enforcement officers. However, entry into force of the majority of the Act's provisions has been postponed until 1 July 2012 and additional amendments thereto may be expected before its entry into force.

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 new Police Act was adopted in March 2011 aimed at making the police a more professional service and introducing some depoliticising measures. The EU Report also points out that most high level corruption and public procurement cases have not yet reached the stage of court rulings. Further efforts are needed in improving the track system of USKOK and Courts to reduce the average duration of cases.

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 Polančec for abuse of office and powers. Under the indictment filed with the Zagreb County Court, Polančec 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 Polančec to 15 months in prison for abuse of office and state funds.

In December 2010, former Prime Minister Ivo Sanader who served from 2003 to 2009 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 was extradited from Austria to Croatia in July 2011 and the trial against him commenced in November 2011.

New Public Procurement Act (OG 90/11) was passed in 2011 and entered into force on 1 January 2012 (with the exception of certain provisions which will enter into force once Croatia joins the EU). Amendments to the Public Procurement Act are fully aligned 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 March 2012, the Government adopted a Regulation on Internal Organization of the 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.

Certain 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). In addition, further amendments to the Insurance Act, the Investment Fund Act, the Credit Institutions Act, Financial Collateral Act, the Act on Settlement Finality in Payment and Financial Instruments Settlement Systems and some other act dealing with the financial sector, are expected to be adopted in the course of 2012 in order for such laws to be further harmonised with the relevant EU Directives.

The Political System

Political Parties

The major political parties that participated in parliamentary elections on 4 December 2011 were the Croatian Democratic Union ("**HDZ**"), Social Democratic Party ("**SDP**"), Croatian Democratic Alliance of Slavonia and Baranja ("**HDSSB**") and Croatian Labourists-Labour Party ("**CLLP**"). The "Kukuriku" coalition led by the SDP won 80 out of 151 seats in the Sabor. Apart from the SDP, the coalition includes the Croatian People's Party ("**HNS**"), the Istrian Democratic Assembly ("**IDS**") and the Croatian Party of Pensioners ("**HSU**"). The leader of the SDP, Zoran Milanović, was appointed as Croatia's Prime Minister on 23 December 2011.

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 won 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

Currently, the Croatian Parliament has 151 members. Elections for these members were held on 4 December 2011 and the new members of Parliament took office on 22 December 2011. The following table sets out the current composition of the Parliament:

	Seats	Percentage
Social Democratic Party of Croatia (SDP)	60	39.7
Croatian Democratic Union (HDZ)	45	29.8
Croatian People's Party (HNS)	14	9.3
Croatian Democratic Alliance of Slavonia and Baranja (HDSSB)	6	4.0
Croatian Labourists — Labour Party	6	4.0
Croatian Party of Pensioners (HSU)	3	2.0
Christian Democratic Council (IDS)	3	2.0
Independent Democratic Serbian Party (SDSS)	3	2.0
Croatian Civic Party (HGS)	2	1.3
Bosnian Democratic Party of Croatia (BDSH)	1	6
Croatian Peasant Party (HSS)	1	0.7
Croatian Party of Rights dr. Ante Starčević (HSP dr. Ante Starčević)	1	0.7
Independent Deputies[(1)]	6	4.0
Total	**151**	**100.00**

Source: Internet Editorial Staff of the Croatian Parliament, 30 January 2012

(1) Out of the six independent Members of the Croatian Parliament, two are affiliated with the parliamentary group of political parties, one with the HNS and one with the SDP.

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.

Cooperation with the ICTY and Domestic War Crime Trials

Croatia has cooperated with the International Criminal Tribunal for the Former Yugoslavia (the "**ICTY**") in connection with the prosecution of crimes committed during the 1991 War which resulted in the sentencing in 2011 of two former generals of the armed forces of Croatia to 18 and 24 years in prison, respectively. Croatia's domestic courts have been in the process of hearing war crimes cases brought by the State Prosecutor's Office and related to the 1991 War.

General Information

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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**") was 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 ("**GAMA**"). As of 1 January 2011, the state property (including but not limited to the shares in companies) is managed pursuant to the Act on Managing the State Property, the State Property Management Strategy, the State Management Property Plan and other regulations adopted by the Government and GAMA. See *"Public Finance — Fiscal developments in 2011"*.

The Government awards concessions according to the procedures outlined in the Concessions Act (OG 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, as at 15 January 2012, the portfolio of GAMA comprised 682 companies with the total nominal initial capital value of HRK 91.2 billion, while the total nominal value of the state portfolio stood at HRK 40.5 billion. The bulk of the portfolio comprises companies in difficulties which as such are not interesting to potential investors and require comprehensive restructuring and consolidation prior to their sale or in the course of their sale. Between its establishment on 1 April 2010 and 15 January 2012, GAMA announced/accepted the sale of holdings in 59 companies, ten of which were successfully completed, generating some HRK 68.9 million in income. Underway as at 15 January 2012 was the sale of shares/holdings of 19 companies (nine of which were companies in the minority ownership that were being sold through the model of public auction, four of which were companies in the majority ownership that were being sold through the model of public tenders while six companies were being sold through the model of sale on a regulated market). In 2011, bankruptcy or liquidation proceedings were initiated in 25 companies.

In the context of state property management, with the establishment of GAMA, a significant emphasis is placed on the management of real estate property in state ownership. In this context, GAMA performs a number of activities as determined by law. In addition to its regular tasks relating to, for instance, current and investment maintenance, preparation of proposals for spatial development solutions and ensuring that the real estate property meets all the requirements as regards the documentation required by law, in the management of state property in the form of real estate property, GAMA places emphasis on the mobilisation of real estate property for the purpose of stimulating economic activity, attracting new investment and in general, spurring economic growth and development.

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 Sibenik 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 GAMA.

Privatisation Efforts in 2012 and the Medium Term

According to the 2012 budget, the Government anticipates HRK 2 billion in revenues from the privatisation of Croatia Osiguranje (an insurance company) and Hrvatska Postanska Banka (a bank). In the medium term, the Government will seek to continue the privatisation of shipyards, initiate disposals of government property holdings and commence privatisation efforts in the railway and transport sector, energy production sector and the petrochemicals sector.

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 U.S.$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 (OG 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 2010 (the latest year for which data is available), Croatia's per capita income was approximately 61 per cent. of the GDP per capita of the EU27 countries in purchasing power terms.

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 2011-2013, 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. The 2012 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 2012-2014 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.

EU Structural Funds

Following EU accession, Croatia expects to be able to apply for and receive EU structural funds pursuant to the EU Cohesion Policy. The Cohesion Policy aims to achieve a balanced development within the European Union and strengthen the global competitiveness of the European economy. Funds pursuant to the Cohesion Policy are made available to Member States that need additional investment in order to achieve balanced and sustainable economic and social development. Those funds include the European Social Fund (engaged in programmes relating to employment and labour market participation), the European Regional Development Fund (supporting job creation, competitiveness, economic growth, improved quality of life and sustainable development) and the Cohesion Fund (available to EU member states with GDP of less than 90 per cent. of the EU average and aiming to boost economic development). In order to receive disbursements pursuant to these EU programmes, Croatia must propose suitable projects, meet certain initial criteria and comply with ongoing monitoring obligations relating to transparency and the proper use of funds.

Plans for Adoption of the Euro

Following EU accession, Croatia will seek to enter the Exchange Rate Mechanism ("**ERM II**"). Under ERM II, the exchange rate of a non-euro area Member State is fixed against the euro and is only allowed to fluctuate within set limits. Entry into ERM II is based on an agreement between the ministers and central bank governors of the non-euro area Member State and the euro-area Member States, and the European Central Bank. Entry into ERM II will be a step towards the full adoption of the euro in Croatia, in line with Croatia's commitment pursuant to the Accession Treaty. Croatia is a highly euroised economy (both on the asset and liabilities side) and the benefits of adopting the euro are believed to outweigh the possible disadvantages of eurozone membership. Croatia's date of entry into ERM II and, subsequently, into the eurozone, would primarily depend on Croatia's macroeconomic indicators, i.e. the ability to fulfil a set of membership criteria which are more stringent than those applied to previous candidates.

World Bank Country Partnership Strategy

In September 2008, the World Bank's Board endorsed the Country Partnership Strategy ("**CPS**") for Croatia for 2009-2012. The strategy has been extended until 2013 and will be revised upon Croatia's accession into the EU. 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 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 U.S.$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 U.S.$240 million to fund the continuation of the Rijeka gateway, coastal city pollution control programmes and the improvement of emergency medical services. At the request of the Government, the World Bank has agreed to provide a credit line of EUR100 million for exporters through HBOR and commercial banks to help mitigate the impact of the global financial and economic crisis and to provide funding for the private sector. Other projects being developed cover such areas as judicial reforms, disaster risk management and mitigation, port development, irrigation and education. The CPS may be adjusted, if necessary, to help address the consequences of the global financial and economic crisis. As of 31 December 2011, the World Bank was financing 51 loans and projects in Croatia amounting to approximately 3.15 billion U.S.$ in a wide range of sectors, out of which 13 loans remaining to be fully disbursed amounting to approximately U.S.$508 million. The International Finance Corporation's portfolio of investments in Croatia amounted to approximately U.S.$650 million and the Multilateral Investment Guarantee Agency's guarantees relating to projects within Croatia amounted to U.S.$660 million as of 31 December 2011.

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 that year. Real GDP growth slowed from 5.1 per cent. in 2007 to 2.2 per cent. in 2008. The negative impact of the crisis intensified further in 2009 with annual GDP for 2010 contracting by 6.0 per cent in real terms. The negative trends continued in 2010 with annual GDP contracting 1.2 per cent. According to the estimations of gross domestic product, the year 2011 saw a stagnation of economic activity as GDP recorded a growth rate of 0.0 per cent. in real terms, year-on-year.

With regards to high frequency indicators in 2011, industrial production declined by 1.2 per cent. year-on-year, real turnover in retail trade increased by 1.0 per cent., number of tourist nights went up by 7.0 per cent. and the construction work index decreased by 9.1 per cent., year-on-year. Exports of goods recorded year-on-year growth of 9.9 per cent., while the imports of goods increased by 9.7 per cent. in 2011.

The high frequency indicators for January 2012 largely point to negative trends in economic activity. Industrial production declined by 3.4 per cent. year-on-year, real turnover in retail trade increased 1.9 per cent., number of tourist nights went up by 12.8 per cent., while the imports of goods recorded stronger growth (11.7 per cent.) than exports of goods (3.7 per cent.).

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 to increase lending in the economy with the active participation of the Government, the CNB, HBOR and commercial banks, but only one of these measures ("**Model A**") was implemented. Under Model A, commercial banks are invited to issue loans, part of which are funded by HBOR. 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. 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. By March 2012 almost all funds provided for Model A were disbursed to the corporate sector, i.e. HRK 3.0 billion from commercial banks and HRK 2.0 billion from HBOR.

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 euro/Kuna 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. In the first half of 2011 the euro/Kuna exchange rate was stable but it started to depreciate in the third quarter as residents reduced foreign borrowing while short-term foreign capital somewhat withdrew from government securities. In an effort to dampen the depreciation pressures, the central bank intervened twice in the foreign exchange market and raised the reserve requirement rate from 13% to 14%. At the end of December 2011, the euro/Kuna exchange rate stood at 7.53, having depreciated by 2.0 per cent. from 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.

In 2010, exports of goods and services increased to EUR 17.6 billion (8.9 per cent.), while 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.

Also, in 2010, the current account deficit recorded another decrease (-79 per cent.), falling to EUR 0.5 billion, principally as a result of developments relating to trade in goods. In 2011 the current account deficit saw a further decline by 5.5 per cent., down to EUR 0.4 billion (-1.0 per cent. of GDP). The improvement of the total balance was primarily attributable to a growth in net exports of services. However, these favourable trends were partially offset by increased deficit in trade of 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*".

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. Despite healthy tourism results in 2011, total exports of goods and services decelerated relative to the previous year with an annual growth rate of 6.1 per cent., reaching EUR 18.8 billion.

Imports of goods and services, based on balance of payments data expressed in EUR, increased from EUR 21.5 billion in 2007 to EUR 23.7 billion in 2008. This increase was 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. After a slight decrease in 2010, total imports of goods and services recovered in 2011 by 5.8 per cent. reaching EUR 18.8 billion.

In 2008, Croatia's current account deficit reached EUR 4,258.1 million, or 8.9 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 46 per cent. in EUR terms, or 3.9 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 (-79 per cent.), falling to EUR 0.5 billion, principally as a result of developments relating to trade in goods. In 2011 the current account deficit saw a further decline by 5.5 per cent., down to EUR 0.4 billion (-1.0 per cent. of GDP). The improvement of the total balance was primarily attributable to a growth in net exports of services. However, these favorable trends were partially offset by increased deficit in trade of 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*".

In 2009, the average inflation rate stood at 2.4 per cent. Downward pressures on inflation 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 trends continued in 2010, bringing the average annual inflation rate down further to 1.1 per cent. Consumer price inflation in Croatia accelerated in 2011, but remained relatively low. The average annual inflation rate increased to 2.3% in 2011. The increase was mainly due to a rise in food product prices, stemming from an increase in the world prices of food raw materials and other raw materials, and from the price growth of tobacco products. An opposite effect, especially evident in a decrease in services prices, was produced by weak domestic demand and adverse trends in the domestic labour market.

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.

During 2011 substantial improvement was recorded on the capital and financial account although the amount of capital inflows is still considerably lower than before the crisis. Excluding changes in international reserves, net capital inflows grew by 27.5 per cent. reaching EUR 1.7 billion. Although most capital inflows took a form of direct equity investments, a huge portion (EUR 1.5 billion) came from debt-equity swaps made by a few companies which significantly reduced private companies' debt liabilities and increased the level of FDI. Excluding these transactions, direct equity investment amounted to EUR 0.7 billion (out of which EUR 0.3 billion refers to reinvested earnings). The structure by sectors reveals that besides the chemical and metal industry (35.6 per cent.) where most debt-equity swaps were conducted, most direct investments were related to real estate (16.0 per cent.), commission trade (15.8 per cent.) and telecommunication sector (15.3 per cent.).

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 billion (101 per cent. of GDP) and in 2011, it decreased by EUR 0.7 million to EUR 45.7 billion (99.6 per cent. of GDP). 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 increased by EUR 0.9 billion and amounted to EUR 6.6 billion; and enterprises increased their liabilities abroad, both to foreign banks and to parent companies, by EUR 0.3 billion. At the end of 2011 the stock of external debt was EUR 0.7 billion lower than at the end of the previous year and stood at EUR 45.7 billion (99.6 per cent of GDP). The decrease was almost entirely a result of debt-equity swaps made by a few companies. Excluding these transactions, new borrowing of domestic sectors exceeded total repayments by EUR 0.7 billion reflecting mostly new borrowings by banks and the Government. Private companies increased their liabilities, although less than in the previous year. Public companies along with non-bank financial institutions deleveraged.

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. In 2011 domestic banks increased their foreign liabilities by EUR 0.9 billion mostly as a result of their purchases of euro-denominated debt issued by the Croatian government in July 2011.

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. In 2011 the Government issued two new bonds, one in March (USD 1.5 billion) and one in July (EUR 0.8 billion). In March, a EUR 0.8 billion bond issued in 2001 was repaid. As a result of net transactions, the level of Government's external debt increased by EUR 0.4 billion relative to the end of 2010.

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. Although other sectors decreased their foreign liabilities in 2011 by EUR 2.1 billion, most of it reflects debt-equity swaps seen in the case of a few private companies. Specifically, if these transactions are excluded, private enterprises increased their liabilities in 2011, albeit to a lesser degree than in the previous year (EUR 0.7 billion in 2010 relative to EUR 0.9 billion in 2011). Public companies deleveraged by EUR 0.6 billion during 2011, after a long period of intensive borrowing. Non-banking financial institutions (excluding HBOR) continued deleveraging as well, although at a slower pace (EUR 0.8 billion compared to EUR 1.3 billion in 2010).

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.

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

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 periods 2008 to 2010 is preliminary. The main purpose of this revision is the synchronisation 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			
	2008	**2009**	**2010**	**2011**
Nominal GDP (HRK millions)	345,015	335,189	334,564	341,206
Real GDP (HRK millions)[2]	249,550	234,599	231,804	231,713
Nominal GDP (EUR millions)	47,765	45,669	45,917	45,897
Nominal GDP per capita (EUR)	10,771	10,311	10,367	10,427
Real GDP growth (per cent.)	2.2	(6.0)	(1.4)	0.0
HRK/EUR exchange rate (average for the period)	7.22	7.34	7.29	7.43
HRK/U.S.$ exchange rate (average for the period)	4.93	5.28	5.50	5.34

Source: Central Bureau of Statistics and Croatian National Bank

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

(2) For 2011, flash estimate of real GDP.

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

	Year ended 31 December			
	2008	**2009**	**2010**	**2011[1]**
	(per cent.)			
Households	0.8	(8.5)	(0.9)	0.2
Government	1.9	0.2	(0.8)	(0.2)
Gross fixed capital formation	8.2	(11.8)	(11.3)	(7.2)
Exports of goods and services	2.2	(17.3)	6.0	2.2
Imports of goods and services	3.3	(20.4)	(1.3)	1.0
Change in overall GDP for the period	**2.2**	**(6.0)**	**(1.4)**	**0.0**

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.)			
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)
2011	0.2	(0.2)	(7.2)	2.2	1.0	0.0
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)
2011						
First quarter	(0.1)	(0.9)	(6.7)	(3.7)	3.7	(1.0)
Second quarter	0.6	1.7	(7.3)	5.1	3.5	0.4
Third quarter	0.1	(0.4)	(8.4)	7.1	0.1	0.7
Fourth quarter	0.1	(1.3)	(6.1)	(3.5)	(3.0)	(0.4)

Source: Central Bureau of Statistics

In 2008, mainly due to the onset of 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 spill over 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.

With respect to economic activity in 2011, GDP stagnated in real terms compared to 2010, recording a real year-on-year growth of 0.0 per cent., which is a result of a year-on-year decrease of 1.0 per cent. and 0.4 per cent. in the first and fourth quarters of 2011, respectively, and an increase of 0.4 per cent. and 0.7 per cent. in the second and third quarters of 2011, respectively. Real GDP stagnation in 2011 was the result of a positive contribution of stockbuilding and net foreign demand, while domestic demand continued to result in a negative contribution to GDP change. Observing the components on the expenditure side of the GDP calculation, household consumption increased by 0.2 per cent. in real terms in 2011, as a consequence of a 0.1 per cent. fall in the first quarter and a 0.6 per cent., 0.1 per cent. and 0.1 per cent. rise in the second, third and fourth quarter, respectively. Government consumption recorded a real year-on-year decrease of 0.2 per cent. in 2011, as a result of a decline of 0.9 per cent. in the first quarter, growth of 1.7 per cent. in the second quarter, fall of 0.4 per cent. in the third quarter and a fall of 1.3 per cent. in the fourth quarter. In 2011 gross fixed capital formation remained the component which recorded the greatest fall with a real decline of 7.2 per cent. compared to 2010, owing to a decline in all four quarters, of 6.7 per cent., 7.3 per cent., 8.4 per cent. and 6.1 per cent., respectively. A real year-on-year growth in exports of goods and services amounted to 2.2 per cent. in 2011, which is a result of a 3.7 per cent. fall in the first quarter, a 5.1 per cent. and 7.1 per cent. rise in the second and third quarter, respectively, and a decrease of 3.5 per cent. again in the fourth quarter. Imports of goods and services were on a rise in first three quarters on a year-on-year basis (of 3.7 per cent., 3.5 per cent. and 0.1 per cent., respectively), while they recorded a fall of 3.0 per cent. in the fourth quarter, so that their real year-on-year increase amounted to 1.0 per cent. in 2011.

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.

2011 saw a real stagnation in GVA, recording a real growth rate of 0.0 per cent., year-on-year. Nominal GVA increased from HRK 288,356 million in 2010 to HRK 295,165 million in 2011. The real stagnation was the result of a real increase in GVA in hotels and restaurants (4.4 per cent.), financial intermediation, real estate, renting and business activities (2.3 per cent.), wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods (0.9 per cent.) and public administration and defence, compulsory social security, education, health and social work, other community, social and personal services and activities of households (0.5 per cent.), and a real decrease of GVA recorded in construction (9.3 per cent.), agriculture, hunting, forestry and fishing (2.8 per cent.), transport, storage and communication (1.7 per cent.) and mining, quarrying, manufacturing, electricity, gas and water supply (0.9 per cent.).

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

	Year ended 31 December					
	2008	2009	2010		2011[2]	
	(HRK millions)	(HRK millions)	(HRK millions)	(per cent. of total)	(HRK millions)	(per cent. of total)
Agriculture, hunting, forestry and fishing	15,333	15,745	15,902	5.5	15,876	5.4
Mining and quarrying, manufacturing, electricity, gas and water supply	57,855	53,337	54,791	19.0	57,710	19.6
Construction	24,716	23,241	19,268	6.7	17,567	6.0
Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods	36,626	32,136	31,939	11.1	32,965	11.2
Hotel and restaurants	12,562	12,619	12,868	4.5	13,589	4.6
Transport, storage and communications	22,639	21,484	21,034	7.3	20,741	7.0
Financial intermediation, real estate, renting and business activities	74,682	77,980	78,720	27.3	82,144	27.8
Other[3]	51,673	54,107	53,834	18.7	53,834	18.5
Total GVA	**296,086**	**290,647**	**288,356**	**100.0**	**295,165**	**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) Preliminary data subject to revision.

(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][2] in constant previous year prices, reference year 2000, for the periods indicated:

	Year ended 31 December					
	2008	2009	2010		2011[3]	
	(HRK millions)	(HRK millions)	(HRK millions)	(per cent. of total)	(HRK millions)	(per cent. of total)
Agriculture, hunting, forestry and fishing	11,192	11,438	11,420	5.8	11,102	5.6
Mining and quarrying, manufacturing, electricity, gas and water supply	45,889	41,638	40,976	20.8	40,603	20.6
Construction	15,278	14,340	11,989	6.1	10,871	5.5
Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods	30,953	26,525	26,197	13.3	26,444	13.4
Hotel and restaurants	8,969	8,707	8,703	4.4	9,089	4.6
Transport, storage and communications	21,348	19,963	19,483	9.9	19,154	9.7
Financial intermediation, real estate, renting and business activities	40,007	40,511	40,816	20.7	41,762	21.2
Other[3]	34,408	34,767	34,724	17.6	34,902	17.7
Total GVA	**209,030**	**200,462**	**196,958**	**100.0**	**196,874**	**100.0**
Taxes minus subsidies on products	**48,928**	**44,542**	**46,207**	—	**46,041**	—
GDP	**257,958**	**245,004**	**243,165**	—	**231,713**	—

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

(3) Preliminary data subject to revision.

(4) In current prices.

The following table sets forth annual real growth rates of GVA by sector[(1)] for the periods indicated:

	Year ended 31 December			
	2008	2009	2010	2011[(2)]
	(per cent.)			
Agriculture, hunting, forestry and fishing	3.3	2.2	(0.2)	(2.8)
Mining and quarrying, manufacturing, electricity, gas and water supply	1.3	(9.3)	(1.6)	(0.9)
Construction	8.5	(6.1)	(16.4)	(9.3)
Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods	(0.3)	(14.3)	(1.2)	0.9
Hotel and restaurants	2.2	(2.9)	(0.1)	4.4
Transport, storage and communications	4.9	(6.5)	(2.4)	(1.7)
Financial intermediation, real estate, renting and business activities	3.4	1.3	0.8	2.3
Other[(3)]	2.2	1.0	(0.1)	0.5
Total GVA growth	**2.8**	**(4.1)**	**(1.7)**	**0.0**

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) Preliminary data subject to revision.

(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 continuing uncertainty in the economy, the real growth rate of GVA in agriculture, hunting, forestry and fishing sector decelerated from 2.2 per cent. in 2009 to -0.2 per cent. in 2010 and then further to -2.8 per cent. in 2011. In 2011, GVA in the agriculture, hunting, forestry and fishing sector measured in current prices remained at the level of around HRK 15.9 billion recorded in 2010, representing 5.4 per cent. of total GVA.

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

As a result of an increase in exports and a slowing of negative trends in domestic demand, the rate of negative real 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 2011, influenced by a continuation of slowing of the negative domestic demand trends and positive movements regarding firms' stockbuilding process, the trend of deceleration in the negative growth rate of GVA in this sector continued with the decline from -1.6 per cent. in 2010 to -0.9 per cent.

In 2011, GVA in the mining and quarrying, manufacturing, electricity, gas and water supply sector measured in current prices increased from HRK 54.8 billion in 2010 to HRK 57.7 billion in 2011, representing 19.6 per cent. of total GVA.

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 2011, the GVA in the construction sector again recorded a significant real decrease of 9.3 per cent. compared to 2010. Unfavourable financial and economic conditions were the main contributing factors to these developments, as the low 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. GVA in the construction sector measured in current prices decreased from HRK 19.3 billion in 2010 to HRK 17.6 billion in 2011, representing 6.0 per cent. of total GVA.

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. In 2011, the real growth rate of GVA in the wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods sector was positive, amounting to 0.9 per cent. Both the improving personal consumption dynamics and the successful tourist season contributed to this result. GVA in the wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods sector measured in current prices increased from HRK 31.9 billion in 2010 to HRK 33.0 billion in 2011, representing 11.2 per cent. of total GVA.

Hotel and restaurants

As a result of increasing foreign demand for tourist services, the GVA real growth rate in the hotel and restaurants sector declined, from -2.9 per cent. in 2009, to -0.1 per cent. in 2010, and then recorded a positive 4.4 per cent. growth in 2011. GVA in the hotel and restaurants sector measured in current prices increased from HRK 12.9 billion in 2010 to HRK 13.6 billion in 2011, representing 4.6 per cent. of total GVA.

Transport, storage and communications

As a result of the unfavourable overall economic conditions, the growth rate in the GVA in the transport, storage and communications sector was, although slowing, negative for the third year in a row. After -6.5 per cent. in 2009, -2.4 per cent. in 2010, it amounted to -1.7 per cent. in 2011. GVA in the transport, storage and communications sector measured in current prices decreased from HRK 21.0 billion in 2010 to HRK 20.7 billion in 2011, representing 7.0 per cent. of total GVA.

Financial intermediation, real estate, renting and business activities

Despite adverse macroeconomic conditions, GVA in the financial intermediation, real estate, renting and business activities sector has continued to grow throughout the crisis period. In 2011 it experienced growth at an annual rate of 2.3 per cent. compared with a growth rate of 1.3 per cent. in 2009 and 0.8 per cent. in 2010. GVA in the financial intermediation, real estate, renting and business activities sector measured in current prices increased from HRK 78.7 billion in 2010 to HRK 82.1 billion in 2011, representing 27.8 per cent. of total GVA.

Other Sectors

In 2011 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 a real growth rate of 0.5 per cent., after a rise of 1.0 per cent. in 2009 and a negative growth rate of -0.1 per cent. in 2010. GVA in the other sectors measured in current prices increased from HRK 53.8 billion in 2010 to HRK 54.6 billion in 2011, representing 18.5 per cent. of total GVA.

Inflation and Trends in Prices

Inflation in Croatia is measured by CPI and PPI. 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. PPI is based on a basket of approximately 400 industrial products. Unlike CPI, 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 CPI and 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.

Overview of Inflation 2008-2011

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

	Year ended 31 December			
	2008	**2009**	**2010**	**2011**
		(per cent.)		
CPI	6.1	2.4	1.1	2.3
PPI	8.3	(0.4)	4.3	6.4

Source: Central Bureau of Statistics

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 accelerated in 2011, but remained relatively low. The average annual inflation rate increased from 1.1% in 2010 to 2.3% in 2011. The increase was mainly due to a rise in food product prices, stemming from an increase in the world prices of food raw materials and other raw materials, and from the price growth of tobacco products. An opposite effect, especially evident in a decrease in services prices, was produced by weak domestic demand and adverse trends in the domestic labour market. Consumer price inflation in Croatia decreased during the first two months of 2012. The overall annual CPI inflation rate decreased from 2.1 per cent in December 2011 to 1.3 per cent in February 2012. The largest contribution to this came from an decrease in the annual rate of change in the prices of processed food products and prices of industrial product (excluding food and energy).

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 and 2011 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 and 5.8 per cent in December 2010 and December 2011, respectively. In February 2012 this rate increased to 6.3 per cent primarily on account of a sharp increase in the annual growth in durable consumer goods prices and energy prices (notably the prices in the

extraction of crude oil, and a small acceleration was seen in the annual growth in the producer prices of refined petroleum products caused by the increase in the prices of crude oil on the global 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.

Inflation Outlook for 2012

Certain Government policies are expected to contribute to inflation in 2012. Tax changes and increases in administratively regulated prices are expected to be a source of inflationary pressures. The effect of the general VAT increase from 23% to 25% (effective 1 March 2012) will be only partially offset by the decrease in the VAT rate from 23% to 10% on certain products. This positive contribution on inflation will be partially offset by a 2 percentage points fall in health care contribution Croatian employers will face effective from 1 May 2012. Further inflationary pressures are expected from increases in the price of water (36.4%) and public transport (40%) in the City of Zagreb and rise of electricity, natural gas and housing heating prices.

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			
	2008	2009	2010	2011[2]
	(HRK thousands)			
Croatian railways	1,727,348	1,411,774	1,524,580	1,860,973
Agriculture	3,228,520	3,513,902	3,542,820	3,450,617
Shipyards and shipbuilding	394,928	311,442	32,008	17,884
HBOR	146,000	215,000	250,000	237,400
Other industries[1]	1,362,717	637,347	639,261	601,490
Total subsidies	**6,859,512**	**6,089,465**	**5,988,669**	**6,168,364**

Source: Ministry of Finance

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

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

Industry	Year ended 31 December			
	2008	2009	2010	2011[1]
	(per cent.)			
Croatian railways	0.50	0.42	0.46	0.55
Agriculture	0.94	1.05	1.06	1.01
Shipyards and shipbuilding	0.11	0.09	0.01	0.01
HBOR	0.04	0.06	0.07	0.07
Other industries[2]	0.39	0.19	0.19	0.18
Total subsidies	**1.99**	**1.82**	**1.79**	**1.81**

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.

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 anticipated that capital investment projects would 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 labour force in 2008. 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.. as the adverse effects of the global financial and economic crisis spilled over to the labour market.

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 decelerating towards the end of the year. In December 2010, the 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 17.4 per cent. in 2010. In 2011 there were 305,333 of registered unemployed on average, increasing by 2,908 or 1.0 per cent. compared to 2010, while the average unemployment rate increased to 17.9 per cent.

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

	Year ended 31 December			
	2008	**2009**	**2010**	**2011**
ILO unemployment rate	8.4	9.1	11.8	13.5

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**	**2011** (*)
	(average for the period, in per cent.)			
Registered unemployment rate	13.2	14.9	17.4	17.9

(*) Data for 2011 is preliminary.

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			
	2008	**2009**	**2010**	**2011**
	(average for the period)			
Total employed persons	1,554,805	1,498,784	1,432,454	1,396,260
Total unemployed	236,741	263,174	302,425	305,333
Rate of unemployment (per cent.)(1)	13.2	14.9	17.4	17.9
GDP per employee (HRK)(2)	221,902	223,641	233,560	244,371
GDP per employee (EUR)(2)	**30,721**	**30,471**	**32,055**	**32,451**

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 for the years 2008, 2009 and 2010 are subject to revision.

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 1,432,454, while in 2011, according to preliminary data, the average number of employed was 1,396,260, decreasing by 36,194 or 2.5 per cent. compared to 2010.

In 2009, due to the effects of the global financial and economic crisis, employment declined on a year-on-year basis in the largest part of 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 (3,592 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 most activities. The largest contributions to the average decrease in total employment in 2010 were from the following sectors: wholesale and retail trade, repair of motor vehicles and motorcycles (a decrease of 14,253 jobs, or 7.0 per cent.), construction (a decrease of 13,926 jobs, or 13.3 per cent.) and manufacturing (a decrease of 12,775 jobs, or 5.5 per cent.). The biggest increases in employment were seen in education (an increase of 1,706 jobs, or 1.7 per cent.) and administrative and support services (an increase of 1,639 jobs, or 5.0 per cent.).

In 2011, according to preliminary data, employment declined on a year-on-year basis in almost all activities. The largest contributions to the average annual decrease in total employment in 2011 resulted from construction (a decrease of 7,445 jobs, or 8.2 per cent. on average), manufacturing (a decrease of 5,866 jobs, or 2.7 per cent. on average) and wholesale and retail trade, repair of motor vehicles and motorcycles (a decrease of 4,983 jobs or 2.6 per cent. on average). The year-on-year increase in employment in 2011 was recorded in the public administration sector (an increase of 1.796 jobs, or 0.6 per cent.) and water supply; sewerage, waste management and remediation activities (an increase of 212 jobs, or 1.0 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			
	2008	**2009**	**2010**	**2011[2]**
	(average for the period)			
Public administration and defence, compulsory social security[1]	106,542	105,797	106,673	106,983
Education	100,394	103,275	104,981	105,684
Human health and social work activities	79,139	80,595	81,395	82,179
Total	**286,075**	**289,667**	**293,049**	294,846

Source: Central Bureau of Statistics

(1) Includes military and police.

(2) Data for 2011 is preliminary.

In 2011, an average of 294,846 people (approximately 21.1 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 (OG 149/09, as amended) ("**Labour Act**") 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. The Labour Act became effective on 1 January 2010. Later in 2010, the Government sought to adopt proposals to amend provisions of the Labour Act dealing with collective bargaining but those were unsuccessful. The most recent changes and amendments to Labour Act, dealt with, *inter alia*, annual leave, working hours and redistribution of working time and were published in the Official Gazette 61/11.

The Government is currently considering two new labour laws; one dealing with the representation of trade unions in negotiations, while the other one refers to the collective agreements. The first law aims to decrease the number of persons from trade unions who participate in negotiations in order to make it easier to reach an agreement. The second law seeks to address the issue of the expiration of the collective agreements by encouraging the negotiating parties to reach timely agreements. Under the current Labour Act, when a collective agreement expires before a new agreement has been entered into, the old agreement is extended indefinitely. The new law would provide that following the expiration of the collective agreement, its provisions will be valid for three months, after which the old collective agreement will terminate. The new labour laws are expected to be introduced into Parliament in late April 2012.

Wages and labour costs

During 2011, average net monthly earnings of those in paid employment increased compared to the average figure for 2010. The average net monthly earnings for 2011 of those in paid employment was HRK 5,441, representing a 1.8 per cent. increase in nominal terms, or a 0.4 per cent. decrease in real terms, from the average in 2010. It should be noted here that the above year-on-year growth rates of net wages are not corrected for the special tax on salaries, pensions and other receipts which entered into force on 1 August 2009 and was abolished on 1 November 2010. The average gross monthly earnings of those in paid employment also increased compared to the average figure for 2010. The average gross monthly earnings for 2011 of those in paid employment was HRK 7,796, representing a 1.5 per cent. increase in nominal terms, or a 0.8 per cent. decrease in real terms, from the average in 2010. Stronger nominal growth of net against gross wages was also affected by changes in income tax in July 2010.

According to NCEA 2007, year-on-year average real gross wages growth in 2011 was recorded in the following sectors: real estate activities (2.8 per cent.); financial and insurance activities (1.4 per cent.); agriculture, forestry and fishing (1.0 per cent.) and information and communication (0.2 per cent.). The largest decreases were recorded by administrative and support service activities (-4.1 per cent.); professional, scientific and technical activities (-3.9 per cent.); mining and quarrying (-2.5 per cent.); human health and social work activities (-1.8 per cent.); and water supply; sewerage, waste management and remediation activities (-1.7 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 decline of 1.0 per cent.

In 2011, labour productivity in industry increased by 2.9 per cent. as compared to 2010. This increase reflected stronger decline in the number of employed persons in industry than in the decline in industrial production volume.

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

	Year ended 31 December			
	2008	2009	2010	2011
Average monthly gross wages and salaries in HRK	7,544	7,711	7,679	7,796
Average monthly net wages and salaries in HRK[1]	5,178	5,311	5,343	5,441
Net wages and salaries in EUR (average exchange rate)[1]	717	724	733	732

Source: Central Bureau of Statistics and Ministry of Finance

(1) Does not reflect the effect of the special tax on salaries, pensions and other receipts which entered into force on 1 August 2009 and was abolished on 1 November 2010.

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 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 adopted the Act on Subsidies for Maintaining Employment (OG 94/09, as amended) which was in force from 1 August 2009 until 31 December 2010, and which permitted 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. Furthermore, in July 2009 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.

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 (OG 94/01, as amended) establishes a minimum amount of monthly child support payments. Moreover, the Act on Child Support establishes an additional allowance for the third and fourth child.

In the period from 2008 to 2011, 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 1.1 per cent. of GDP in 2012.

Pension System

The Pension Insurance Act, 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 are intended to 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 (OG 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	229,016	(4.8)	64,712	8.3
2009	1,172,500	2.4	2,387	1.9	212,616	(7.1)	81,588	26.1
2010	1,197,130	2.1	2,362	(1.0)	211,625	(0.5)	83,121	1.9
2011	1,212,261	1.3	2,347	(0.6)	214,680	1.4	75,222	(9.5)

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	2011
	(HRK thousands)			
Mandatory funds[1]	22,590,933	29,264,636	36,328,054	41,067,099
Open voluntary funds[2]	799,665	1,144,809	1,472,212	1,642,130
Closed voluntary funds[3]	148,378	218,343	287,794	326,598
Total	**23,538,977**	**30,627,788**	**38,088,060**	**43,035,827**

Source: Croatian Financial Services Supervisory Agency

(1) Mandatory Funds: Raiffeisen, PBZ-Co, AZ and Erste Plavi.

(2) Open Voluntary Funds: AZ Benefit, AZ Profit, Croatia Osiguranje, Raiffeisen, Erste Plavi Expert and Erste Plavi Protect.

(3) Closed Voluntary Funds: 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, 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 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, 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 35.24 billion for 2012, while pension insurance contributions by beneficiaries are anticipated to reach HRK 18.93 billion for 2012, therefore 53.7 per cent. of pension expenditures will be funded by pension insurance contributions.

Amendments to the Pension Insurance Act entered into force on 1 November 2010. Starting from 1 January 2011, they provide for a gradual increase in the age limit for entitlement to old-age and early retirement pensions for women of three months per year, during a 20-year transitional period. This seeks to ensure equal conditions for acquiring rights to pension for both men and women from the year 2030. The same Act provides for tighter conditions for the calculation of early retirement pensions and increased pensions for persons wishing to continue working after having met the conditions for old-age pension. Over the medium and long-term, these measures are

expected to result in a slowdown in the inflow of new pension beneficiaries and a slowdown in the growth in pension and pension-related expenditures.

Pursuant to Adjustments to the Act on the Supplement to a Pension Earned under the Pension Insurance Act, from 1 January 2012 the pension supplement (in the average amount of HRK 351) was integrated in the overall amount of their pensions for some 300,000 beneficiaries.

In addition, on 25 January 2012 Parliament adopted the Amendments to the Act on the Rights and Obligations of Representatives in the Croatian Parliament, under which, MPs, Constitutional Court Judges and the Auditor General will, in the future, earn their pensions pursuant to the Pension Insurance Act.

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			
	2008	**2009**	**2010**	**2011***
	(EUR millions)			
Current account balance in EUR (millions)	(4,258.1)	(2,292.5)	(472.1)	(446.3)
Current account (as a percentage of nominal GDP)	(8.9)	(5.0)	(1.0)	(1.0)

Source: Croatian National Bank

* Based on Preliminary data

In 2008, Croatia's current account deficit reached EUR 4,258.1 million, or 8.9 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 46 per cent. in EUR terms, or 3.9 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 (-79 per cent.), falling to EUR 0.5 billion, principally as a result of developments relating to trade in goods. In 2011, based on preliminary data, the current account deficit saw a further decline by 5.5 per cent., down to EUR 0.4 billion (-1.0 per cent. of GDP). The improvement of the total balance was primarily attributable to a growth in net exports of services. However, these favourable trends were partially offset by increased deficit in trade of 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 data for the years 2009 through 2010, as well as historical data since 1999, was revised at the beginning of 2011 to reflect changes in methodology and data collection. These include changes in the following items:

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 resulting 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.

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.

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, government external debt 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 9.8 billion, EUR 11.2 billion and EUR 7.7 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 31.5 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 19.0 per cent. compared to 2009 as a result of a recovery in exports, which increased significantly, while imports registered only a negligible decline. After a two -year long contraction, the merchandise trade deficit increased in 2011 by 6.1 per cent. relative to the previous year, reaching EUR 6.4 billion. Even though both exports and imports recovered noticeably in 2011, an increase of imports outpaced that of exports, primarily due to a substantial oil and energy commodities price growth.

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, organization 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			
	2008	**2009**	**2010**	**2011**
	(EUR millions)			
Food and live animals	727.4	740.6	760.3	851.9
Beverages and tobacco	167.9	163.6	189.0	172.6
Crude materials, except fuels	582.8	459.8	601.5	746.4
Mineral fuels and lubricants	1,222.1	977.5	1,113.1	1,162.3
Animal and vegetable oils and fats	24.3	18.0	20.5	20.9
Chemical products	944.8	726.4	1,013.5	1,097.0
Manufactured goods classified chiefly by material	1,466.7	1,133.3	1,260.8	1,433.2
Machinery and transport equipment	3,212.3	2,233.8	2,819.5	2,846.0
Miscellaneous manufactured articles	1,309.6	1,235.1	1,073.3	1,211.0
Commodities and transactions, n.e	1.7	3.0	6.9	48.4
Total	**9,585.1**	**7,529.4**	**8,905.2**	**9,589.7**

Source: Central Bureau of Statistics

According to the data from the CBS, total exports of goods amounted to EUR 9.6 billion (20.1 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, as well as furniture and furniture components, decreased substantially, partially offset by the increase in exports of electrical machinery 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 18.3 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.

In 2011, merchandise exports recorded an annual growth rate of 7.7 per cent., reaching EUR 9.6 billion. Most of mentioned increase came from exports of oil and refined petroleum products, machinery specialized for particular industries, metalliferous ores and metal scrap, manufactured fertilizers and medical and pharmaceutical products. Though export of other transport equipment recorded a mild decrease, realized amount exceeded its average historical level by one third. Negative trends were seen in exports of electrical and power generating machinery, plastics in primary forms as well as natural and manufactured gas.

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			
	2008	**2009**	**2010**	**2011**
	(EUR millions)			
Food and live animals	1,478.2	1,341.9	1,360.0	1,539.0
Beverages and tobacco	132.6	130.1	138.2	148.7
Crude materials, except fuels	427.7	245.0	255.5	268.3
Mineral fuels and lubricants	3,659.3	2,566.0	2,843.5	3,547.6
Animal and vegetable oils and fats	79.8	58.5	56.5	81.4
Chemical products	2,203.4	1,885.2	2,137.2	2,247.0
Manufactured goods classified chiefly by material	3,871.4	2,761.5	2,725.0	2,931.0
Machinery and transport equipment	6,738.8	4,337.2	3,880.4	3,623.2
Miscellaneous manufactured articles	2,218.9	1,878.2	1,736.1	1,889.5
Commodities and transactions, n.e	7.1	16.7	4.5	0.3
Total	**20,817.1**	**15,220.1**	**15,137.0**	**16,275.9**

Source: Central Bureau of Statistics

According to CBS data, total imports of goods stood at EUR 20.8 billion (43.6 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 6.8 per cent., which is less than half of the rate recorded in 2007 (9.6 per cent.). Among the SITC divisions which decreased most noticeably were imports of miscellaneous manufactured articles, non-ferrous metals, organic chemical products and road vehicles recorded in the last quarter of 2008. In contrast, imports of crude fertilisers, iron and steel as well as electrical current increased in 2008.

In 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, notably oil prices. 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 0.5 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 19.0 per cent. compared to 2009.

The two -year imports decline was followed by a 7.5 per cent. growth in 2011, with total imports reaching EUR 16.3 billion. The strongest growth came from imports of oil and refined petroleum products, electric current and natural and manufactured gas which were fuelled by high prices. In addition, the recovery was also significant in case of imports of food, chemical and pharmaceuticals products, as well as road vehicles where the growth followed a three-year long negative trend. Negative rates of change were seen among only a few SITC divisions, the biggest being other transport equipment and certain capital goods such as telecommunications and power generating machinery.

Geographical Distribution of Croatia's Trade in Goods

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

	2008	2009	2010	2011
		(per cent.)		
Developed Countries	69.3	68.3	71.0	69.5
EU 27	60.9	60.6	61.1	59.8
Slovenia	7.8	7.4	7.8	8.3
Hungary	2.4	1.8	2.2	2.5
EU 15	44.2	43.9	44.6	42.7
Austria	5.8	5.4	5.3	5.7
Italy	19.2	19.0	18.6	15.8
Germany	10.7	11.0	10.4	10.1
EFTA[1]	1.2	1.7	1.1	2.4
Developing Countries	30.7	31.7	28.4	29.9
Bosnia and Herzegovina	15.3	12.8	11.6	12.2
Serbia, Montenegro	6.8	6.9	4.8	4.8
Russia	1.3	1.5	2.0	2.4
China	0.3	0.4	0.3	0.4

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.

	2008	2009	2010	2011
		(per cent.)		
Developed Countries	72.2	72.2	70.3	69.8
EU 27	64.1	62.7	60.2	61.8
Slovenia	5.6	5.7	5.9	6.2
Hungary	3.2	3.2	2.8	3.0
EU 15	48.5	47.0	45.1	45.8
Austria	4.9	5.0	4.8	4.5
Italy	17.1	15.4	15.2	16.3
Germany	13.4	13.5	12.5	12.6
EFTA[1]	1.7	2.6	2.0	2.0
Developing Countries	27.8	27.8	29.9	30.3
Bosnia and Herzegovina	2.7	2.7	3.1	3.3
Serbia, Montenegro	1.4	1.6	1.5	1.8
Russia	10.3	9.5	9.0	7.3
China	6.2	6.8	7.2	7.1

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), 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. In 2011, the share of Croatian exports to developed countries decreased, mainly due to a poor performance of exports to EU Member States, particularly Italy. At the same time, EFTA share growth was primarily driven by substantial amount of ships exported to Norway. The growing trade with developing countries largely came from increased exports of oil and refined petroleum products to Bosnia and Herzegovina.

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. Though Croatia's imports from developed countries slightly decelerated during 2011, recovery of EU Member states share was notable due to increased imports of oil and refined petroleum products from Italy. Mild imports growth from developing countries is mainly attributed to growth of imports from Bosnia and Herzegovina.

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, 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 16.8 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 2.3 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.

2011 saw a 7.0 per cent. increase in the positive balance on the services account, attributable mainly to a 5.9 per cent. increase in tourism revenues. According to CBS data, arrivals of foreign tourists and number of nights spent grew on an annual basis by 9.0 and 7.4 per cent., respectively. In addition to tourism, positive contribution came also from a decrease in net imports of miscellaneous business services, especially architectural, engineering and other technical services. Net revenues from transportation services were boosted by a successful tourist season and increased air passenger transportation, while revenues from sea freight transportation were subdued.

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[1]				
	2007	2008	2009	2010	2011[3]
		(EUR millions)			
CURRENT ACCOUNT	**(3,150.6)**	**(4,258.1)**	**(2,292.5)**	**(472.1)**	**(446.3)**
Goods, services and income	(4,193.6)	(5,328.5)	(3,328.8)	(1,560.1)	(1,563.5)
Credit	19,614.5	21,237.2	17,114.1	18,618.5	19,751.4
Debit	(23,808.0)	(26,565.7)	(20,442.9)	(20,178.5)	(21,314.9)
Goods and services	(3,103.3)	(3,780.6)	(1,529.9)	(4.0)	50.2
Credit	18,271.3	19,843.3	16,314.7	17,713.0	18,800.8
Debit	(21,374.6)	(23,623.8)	(17,844.6)	(17,717.0)	(18,750.6)
Goods	(9,469.9)	(10,855.2)	(7,415.5)	(5,990.7)	(6,358.5)
Credit	9,156.6	9,752.7	7,674.5	9,063.6	9,784.2
Debit	(18,626.5)	(20,607.8)	(15,090.1)	(15,054.3)	(16,142.8)
Services	6,366.6	7,074.6	5,885.7	5,986.7	6,408.7
Credit	9,114.7	10,090.6	8,640.2	8,649.4	9,016.5
Debit	(2,748.1)	(3,016.0)	(2,754.5)	(2,662.7)	(2,607.8)
Transportation	641.3	625.3	482.9	512.3	481.0
Credit	1,165.4	1,209.4	938.2	973.0	962.4
Debit	(524.0)	(584.1)	(455.3)	(460.7)	(481.5)
Travel	6,035.2	6,694.0	5,655.8	5,600.8	5,970.2
Credit	6,752.6	7,459.4	6,379.7	6,230.0	6,598.6
Debit	(717.3)	(754.5)	(724.0)	(629.2)	(628.4)
Other services	(310.0)	(244.6)	(253.0)	(126.4)	(42.5)
Credit	1,196.8	1,421.8	1,322.2	1,446.4	1,455.5
Debit	(1,506.7)	(1,666.4)	(1,575.2)	(1,572.8)	(1,498.0)
Income	(1,090.2)	(1,548.0)	(1,798.9)	(1,556.1)	(1,613.7)
Credit	1,343.2	1,393.9	799.4	905.5	950.7
Debit	(2,433.5)	(2,941.9)	(2,598.3)	(2,461.5)	(2,564.3)
Current transfers	1,043.0	1,070.5	1,036.3	1,088.0	1,117.1
Credit	1,576.1	1,684.4	1,607.8	1,684.6	1,679.6
Debit	(533.1)	(613.9)	(571.5)	(596.6)	(562.4)
CAPITAL AND FINANCIAL ACCOUNT	**4,437.6**	**5,774.9**	**3,466.0**	**1,319.4**	**1,335.8**
Capital account	28.5	14.9	43.1	34.5	(8.3)
Financial account, excl. reserves	5,130.8	5,429.6	4,319.3	1,368.7	1,744.7
Direct investment	3,435.2	3,248.4	1,526.6	408.2	1,022.6
Abroad	(216.1)	(970.2)	(888.2)	112.9	(25.8)
In Croatia	3,651.3	4,218.6	2,414.8	295.3	1,048.4
Portfolio investment	335.9	(810.1)	420.9	477.0	645.7
Assets	(421.6)	(380.8)	(558.1)	(368.3)	508.6
Liabilities	757.5	(429.2)	979.1	845.4	137.1
Financial derivatives	0.0	0.0	0.0	(252.7)	(59.7)
Other investment	1,359.7	2991.2	2371.7	736.2	136.1
Assets	(1,653.3)	(1,621.6)	748.0	657.7	296.9
Liabilities	3,012.9	4612.8	1623.8	78.5	(160.8)
Reserve Assets	(721.6)	330.4	(896.4)	(83.8)	(400.6)
NET ERRORS AND OMISSIONS[2]	**(1,287.0)**	**(1,516.8)**	**(1,173.4)**	**(847.3)**	**(889.4)**

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.

[3] Based on preliminary data.

Factor Income Account

The factor income account balance deteriorated in 2008 by 42.0 per cent. compared to 2007, principally due to a significant increase in expenditures (20.9 per cent.), accompanied by weak revenue growth (3.8 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 16.2 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 42.7 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 4.0 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 13.5 per cent. This is a result of relatively equal 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.

In 2011 the balance on the factor income account deteriorated by 3.7 per cent. relative to 2010, owing to a pronounced growth of expenditures, primarily interest payments. At the same time, expenditures related to foreign equity investments decreased considerably, reflecting lower profitability of foreign owned domestic companies. Similarly, domestic owners of companies abroad also recorded lower revenues, as their businesses continued to struggle with the global economic crisis. On the other hand, revenues related to investments of international reserves recovered significantly relative to 2010. Also, revenues related to compensation of employees continued growing at a stable pace.

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 5.0 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.

In 2011, positive developments marked current transfers' account, whereas net revenues increased by 2.7 per cent. The government balance for distribution by sector worsened mainly due to a drop in revenues. However, the private sector's balance improved as considerable revenue growth was recorded based on workers' remittances, gifts and donations.

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 5.4 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 1.9 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 (-46.2 per cent.) in 2009 resulted in significantly lower financing needs, so that despite the drop in inflows of capital (-19.9 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 0,3 billion and their liabilities by EUR 1.1 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 0.30.4 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 0.9 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.

During 2011 substantial improvement was recorded to the capital and financial account although the amount of capital inflows is still considerably lower than before the global economic crisis. Excluding changes in international reserves, net capital inflows grew by 27.5 per cent. reaching EUR 1.7 billion. Although most capital inflows took the form of equity investments, a huge portion (EUR 1.5 billion) came from debt-equity swaps made by a few companies which significantly reduced private companies' debt liabilities. This was also the main reason for the decrease in the stock of external debt. At the end-2011 the stock of external debt was EUR 0.7 billion lower relative to the previous year and stood at EUR 45.7 billion (99.6 per cent of GDP). Omitting debt-equity swap transactions, new borrowings exceeded total repayments by EUR 0.7 billion reflecting new borrowings by banks and the government. In March 2011, the Government issued a USD 1.5 billion bond and at the same time repaid a EUR 0.8 billion bond issued in 2001. Another EUR 0.8 billion bond was issued in July out of which two thirds was subscribed by foreign investors with the remaining part taken up by resident banks and investment funds. Along with new borrowing mostly from parent banks, domestic banks also used some of their own foreign assets in the amount of EUR 1.3 billion. Public companies and non-banking financial institutions notably reduced liabilities to foreign creditors in 2011, while private enterprises managed to refinance most of their due liabilities and raise some additional funds to maintain their business activities.

Foreign Direct Investment (FDI)

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

	Year ended 31 December				
	2007	**2008**	**2009**	**2010**	**2011***
		(EUR millions)			
FDI into Croatia	3,651.3	4,218.6	2,414.8	295.3	1,048.4
FDI from Croatia abroad	216.1	970.2	888.2	112.9	25.8
FDI (net)	3,435.2	3,248.4	1,526.6	408.2	1,022.6

Source: Croatian National Bank, Foreign Direct Investments Statistics
* Based on Preliminary data

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 5.4 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 0.6 billion or 15.5 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 0.2 billion or 6.4 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 1.5 billion, which represented a 53.0 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 2.4 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 1.5 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 a third lower 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 was considerably lower than 2009 (down -73 per cent.). Inward FDI (excluding round trip transactions) 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 was significantly below levels seen in the previous year (EUR 0.4 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). The sectoral structure of direct investments 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 2011, based on preliminary data, net FDI more than doubled compared to the previous year and amounted to EUR 1.0 billion. The level of domestic residents' direct investments abroad increased, after a slump in 2010. As the high level of inward FDI was mostly associated with already mentioned debt-equity swaps, excluding these transactions direct equity investment amounted to EUR 0.7 billion. Direct investments only figured EUR 0.4 billion, while the remaining amount was retained earnings, reflecting reluctance of foreign investors to invest in Croatia. When it comes to the sectoral structure, a significant amount of equity investment was recorded in chemical and metal industry (35.6 per cent.), real estate (16.0 per cent.), commission trade (15.8 per cent.) and telecommunication sector (15.3 per cent.). Geographically, investors from European Union continued to comprise the largest share of 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 activities,
- 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, subject to other terms and conditions set out in the law. 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.

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 EUR/HRK 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 hyperinflation episodes in former Yugoslavia and in the early 1990's.

In 2008, there was a slight nominal appreciation of the Kuna against the euro, with the euro declining from EUR/HRK 7.325 at the end of 2007 to EUR/HRK 7.324 at the end of 2008. Notwithstanding slightly more pronounced appreciation pressures at the beginning of 2008, the EUR/HRK 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 EUR/HRK 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 EUR/HRK 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 EUR/HRK exchange rate appreciated by 0.2 per cent. from the end of 2008 to the end of 2009, strengthening from EUR/HRK 7.32 to EUR/HRK 7.31. 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 EUR/HRK 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 EUR/HRK 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 EUR/HRK, 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 half of 2011 the EUR/HRK exchange rate was stable, with the nominal daily exchange rate standing at EUR/HRK 7.37 at the end of June . Demand and supply in the foreign exchange market were relatively balanced, prompting no CNB interventions in the market. The EUR/HRK exchange rate started to depreciate in the third quarter of 2011 as residents reduced foreign borrowing and investors repositioned their holdings in government issued securities. The latter reflected the increasing risk premium of Croatia in international capital markets and a decline in the supply of euro-indexed treasury bills. In an effort to reduce the depreciation pressures, the central bank intervened twice in the foreign exchange market (with the sale of a total of EUR 419.4 million to commercial banks at the foreign currency auctions held on 25 July and 19 September) and raised the reserve requirement rate from 13 per cent. to 14 per cent. in October 2011. The deprecation trend stopped while the CNB demonstrated its intention to continue implementing the policy of a stable exchange rate against the euro, despite more complex environment in the foreign exchange market. At the end of December 2011, the EUR/HRK exchange rate stood at 7.53, having depreciated by 2.0 per cent. from the end of 2010. In the foreign exchange transactions with the Ministry of Finance the central bank purchased a net of EUR 968.2 million, which mainly relates to the purchase of EUR 850 million in April, thus converting most of the funds from the government's international bond issue.

In early 2012, the EUR/HRK exchange rate came under strong depreciation pressures, stemming from an increase in corporate demand for foreign currency, required for the payment of maturing foreign liabilities and the deleveraging of private and public enterprises. In an effort to curb the nominal weakening of the domestic currency, the central bank intervened twice in the foreign exchange market in January and once in February, selling to banks a total of EUR 458.0 million (EUR 197.0 million on 4 January, EUR 130.0 million on 17 January and EUR 131.0 million on 23 February 2012). The central bank also contributed to the stabilization of the exchange rate by raising the bank reserve requirement rate from 14 per cent. to 15 per cent. in February. The exchange rate at the end of February stood at EUR/HRK 7.58, a slight depreciation of 0.6 per cent. since the end of 2011.

In line with the movements in the EUR/HRK exchange rate and the U.S.$/EUR exchange rate, the U.S.$/HRK exchange rate depreciated by 3.4 per cent. in 2008, from U.S.$/HRK 4.99 at the end of 2007 to U.S.$/HRK 5.16 at the end of 2008. In 2009, the U.S.$/HRK exchange rate, affected by the developments on the global foreign exchange markets, appreciated by 1.3 per cent., from U.S.$/HRK 5.16 at 31 December 2008 to U.S.$/HRK 5.09 at 31 December 2009. In 2010, the U.S.$/HRK exchange rate depreciated significantly (9.4 per cent.) from U.S.$/HRK 5.09 at 31 December 2009 to U.S.$/HRK 5.57 at 31 December 2010, mainly due to the strengthening of the U.S.$/EUR rate on the global foreign exchange markets as a result of euro weakness following developments relating to the fiscal stability of Greece and some other EU Member States. The Kuna depreciated against the US dollar in 2011, mainly reflecting movements in the global foreign exchange markets during the last two months of the year, characterized by the strengthening of the US dollar against the euro. At 31 December 2011, the exchange rate stood at U.S.$/HRK 5.82. The end-February exchange rate stood at U.S.$/HRK 5.63.

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 per cent appreciation of the real effective Kuna exchange rate deflated by producer prices. The development in the real effective Kuna exchange rate deflated by consumer and producer prices in 2011 suggests improvement in the price competitiveness of the Croatian economy. Such developments were primarily determined by the weakening of the Kuna against the basket of currencies of the major trading partners and, to some extent, more favourable movements in domestic consumer prices. In 2011 the average real effective Kuna exchange rate deflated by consumer and producer prices depreciated by 2.5 per cent and 1.5 per cent, respectively.

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 and 2010, when Kuna real effective exchange rate indices deflated by unit labour costs depreciated. Latest available data for the first three quarters of 2011 indicate that real effective exchange rate indices deflated by unit labour costs continued to depreciate compared to the same period in the previous year. This reflects nominal depreciation of the Kuna against the basket of currencies and relatively more favourable movements in domestic unit labour costs than in its main trading partners.

The following table sets forth the end-of-month EUR/HRK exchange rate from January 2007 to March 2012:

	2007	2008	2009	2010	2011	2012
January	7.373400	7.249864	7.373294	7.313102	7.407203	7.564800
February	7.345292	7.277476	7.403887	7.270536	7.414820	7.576699
March	7.382466	7.256652	7.457249	7.259334	7.382807	7.506917
April	7.372840	7.263753	7.425124	7.246875	7.354349	—
May	7.308634	7.250440	7.326488	7.263120	7.431895	—
June	7.303218	7.246264	7.292035	7.193455	7.373946	—
July	7.297330	7.221125	7.333135	7.248517	7.452071	—
August	7.319403	7.161648	7.326773	7.274976	7.470854	—
September	7.281634	7.107741	7.288341	7.292743	7.492023	—
October	7.350060	7.185881	7.225837	7.339273	7.485529	—
November	7.313666	7.128034	7.317610	7.420325	7.498586	—
December	7.325131	7.324425	7.306199	7.385173	7.530420	—

MONETARY DEVELOPMENTS AND INTERNATIONAL RESERVES

Monetary Policy and Instruments

Despite the negative effects of the global financial and economic crisis on the domestic economy since 2008, the CNB has successfully maintained the stability of the euro/Kuna exchange rate, a key aspect of achieving domestic price stability as well as the stability of the financial sector as a whole. The CNB seeks to maintain the stability of the euro/Kuna exchange rate through a variety of instruments, including foreign exchange interventions and altering reserve requirements to tighten or expand banking sector liquidity. For an overview of recent interventions, see "*—Policy Developments in 2011*" and "*—Policy Developments in 2012*".

Monetary developments from 2009-2011 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 these 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 euro/Kuna exchange rate.

Policy Developments prior to 31 March 2009

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.

Policy Developments between 1 April 2009 and 31 December 2010

After the end of the first quarter of 2009, the monetary environment improved markedly. As a result, the remaining part of 2009 was 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 euro/Kuna 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 euro/Kuna 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 euro/Kuna 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.

Policy Developments in 2011

The exchange rate was broadly stable in the first two quarters of 2011, so there was no need for CNB intervention in the foreign exchange market. However, the monetary environment during the summer months was marked by the weakening of the euro/Kuna exchange rate. Therefore, the CNB conducted two foreign exchange interventions in the second and third quarter of 2011 respectively, selling a total of EUR 419.4 million (EUR 238.9 million on 25 June and EUR 180.5 on 19 September) and raised the reserve requirements rate in October (from 13 per cent. to 14 per cent.), thus withdrawing a total of HRK 5.7 billion from the market. As a result, further depreciation pressures on the domestic currency were prevented. In line with measures taken, the liquidity of the domestic banking system declined in the second half of 2011 compared to the first six months of the year. Nevertheless, the average surplus Kuna liquidity, including overnight deposits with the central bank, was still favourable, standing at HRK 4.3 billion in December 2011. Interest rates on the interbank money market rose only temporarily, with overnight trading rates rising from exceptionally low and stable levels of below 1 per cent. in the first half of the year to the average 1.4 per cent. in the last quarter of 2011.

Policy Developments in 2012

At the beginning of 2012, the monetary environment was again marked by depreciation pressures on the Kuna arising primarily from the seasonal pattern of Croatia's current account. In an effort to counteract the weakening of the domestic currency, the central bank intervened three times in the foreign exchange market, selling a total of EUR 458 million to commercial banks (EUR 197 million on 4 January, EUR 130 million on 17 January and EUR 131 million on 23 February). However, pressures on the exchange rate remained. The CNB therefore decided to raise the reserve requirement ratio further by one percentage point (from 14 per cent. to 15 per cent.) at the end of January which helped to stabilize the exchange rate. Despite the significant withdrawal of domestic liquidity from the domestic market a substantial amount of liquidity returned to bank accounts from government Kuna deposits with the CNB and the average surplus Kuna liquidity in the system still remained favourable.

Reserve Requirements

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 were allocated to HBOR (HRK 2 billion) and were 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) were 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. By the end of 2011 nearly all of the loans provided (HRK 4.6 billion) were approved and made available to the final clients. Overall, this programme proved to be relatively successful because the terms of the loans were considerably more favourable in comparison with those provided in accordance with market conditions.

Foreign Currency Liquidity and Reverse Repo Operations

At the beginning of 2011 the CNB improved foreign currency liquidity conditions in the banking system. In early March 2011 the central bank reduced 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 early 2012 the CNB again changed its decision on the minimum amount required for foreign currency claims, in order to facilitate government financing. By way of exception, in the period from 16 February 2012 to 15 August 2013, the nominal amount of treasury bills of the Ministry of Finance of the Republic of Croatia issued in euro at an auction held on 14 February 2012 and paid in on 16 February 2012 (EUR 763.9 million) are included in foreign currency claims.

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, 2010 and 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 the 2011 was HRK 4.9 billion and in 2010 was HRK 3.9 billion, compared to only HRK 0.6 billion in 2009. The highest amount of overnight deposits (HRK 14.0 billion) was registered in mid- July 2011, i.e., close to the end of the reserve maintenance period.

Legal Framework

Pursuant to the Law on the Croatian National Bank (OG 75/08) and the Decision on Reserve Requirements (OG 133/10, as amended) (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 seven years, whilst being broadly stable as shown by the table below.

	Year ended 31 December							Two months ended 28/29 February	
	2005	2006	2007	2008	2009	2010	2011	2011	2012
Ratio of Nominal GDP/M4	1.7	1.6	1.5	1.5	1.5	1.4	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			Two months ended 28/29 February	
	2009	2010	2011	2011	2012
			(HRK millions)		
Reserve money (M0)[(1)]	56,141.9	56,249.1	62,379.5	57,627.2	59,111.2
Money (M1)[(2)]	47,181.7	49,151.7	52,850.9	49,436.2	48,414.0
Broad money (M4)[(3)]	223,094.6	232,869.6	241,056.9	231,562.5	236,222.8
Net domestic assets[(4)]	178,083.2	188,845.0	207,581.7	192,815.1	209,022.5
Domestic credit[(5)]	231,661.9	247,520.2	261,048.8	247,554.2	261,788.7

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. 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 (3.9 per cent). Excluding the exchange rate effects, the rise in total placements to the non-banking sector was 3.5 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 (6.9 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, household lending continued to decline. Excluding the exchange rate effect, household loans dropped by 1.3 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.

Monetary developments in 2011 have been marked by an accelerated trend in bank lending to the government. Banks' placements to the government registered a strong annual increase of 15.5 per cent. Together with the annual decline in government deposits with banks and the CNB, the overall net claims on the central government increased by 51.9 per cent in 2011.

The growth of bank placements to the non-banking sector in 2011 (3.8 per cent) barely surpassed that of 2010 (3.5 per cent). A positive contribution to the increase in placements came from the corporate sector. The exchange-rate adjusted annual growth rate of banks' placements to the corporate sector increased to 9.1 per cent from 6.9 per cent at the end of 2010. Thus, bank corporate financing in 2011 was slightly stronger than the year before, primarily due to demand for short-term working capital and gradual foreign deleveraging. Investment loans accounted for only a smaller portion of corporate loan growth, so credit growth failed to yield the expected effects of stronger economic recovery and increasing employment. Under such conditions, the subdued demand from households for new loans observed in 2010 failed to recover in 2011 and, as a result, household loans continued to fall by an additional 1.1 per cent in 2011 (excluding exchange rate effects).

M4 increased by 2.1 per cent in 2011 (after excluding the exchange rate effects) indicating a slowdown in the growth of this monetary aggregate (3.2 per cent in 2010). In the M4 structure, the growth of M1 was more prominent in 2011 than over the previous year (7.5 per cent relative to 4.2 per cent), primarily due to the recovery in currency outside banks but also due to the rising trend in demand deposits of the domestic private sector. In contrast to money, total savings and time deposits increased but at slower pace than in the year before. The slowdown of total deposits can be attributed to decline in foreign currency deposits, especially in corporate sector. The stagnation of the overall economic activity together with the repayment of foreign liabilities led to increased spending of corporate foreign currency deposits, resulting in a strong fall totalling 25.4 per cent at the end of 2011.

In the first two months of 2012 foreign currency deposits of the domestic private sector were still decreasing but at a slower pace compared to the end of previous year, which led to the slight improvement in total savings and time deposits in observed period. At the same time, demand deposits of enterprises dropped sharply and influenced development of M1. M1 thus fell by 2.0 per cent on annual basis and M4 decelerated from 2.1 per cent in 2011 to 0.5 per cent at the end of February 2012 (exchange rate effects excluded).

Moderate growth of bank placements to the non-banking sector continued during January and February 2012, exclusively due to lending to enterprises. By February 2012, banks' placements to the enterprises grew by 8.3 per cent annually (exchange rate effects excluded), while there was still no recovery in bank lending to the household sector. In the same period, lending to the government continued to be strong (25.8 per cent annually), which together with the rise in deposits led to a slight slowdown in net banks' placements to the central government.

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 2011 M0 registered strong annual growth of 10.9 per cent reaching HRK 62.4 billion at year-end. This growth was mainly a result of the CNB's net foreign currency transactions (higher foreign currency purchases from government than foreign currency sales to banks), which led to the creation of base money. Decrease of government Kuna deposits from the account at the central bank has also increased the level of monetary reserves. In the first two months of 2012, M0 fell compared to the end of 2011. At the end of February M0 amounted to HRK 59.1 billion, growing annually by 2.6 per cent.

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				
	2007	**2008**	**2009**	**2010**	**2011**
	(HRK millions)				
ASSETS					
1. Foreign assets	68,177.8	66,805.5	75,807.8	78,728.2	84,302.0
1.1. Gold	—	—	—	—	—
1.2. Holdings of SDRs	5.6	5.3	2,423.7	2,634.5	2,716.3
1.3. Reserve position in the IMF	1.3	1.3	1.3	1.4	1.4
1.4. Currency and demand deposits with foreign banks	7.2	1,472.7	1,763.8	1,483.0	1,887.2
1.5. Time deposits with foreign banks	33,204.4	13,189.3	17,534.5	22,702.9	18,676.4
1.6. Securities in f/c	34,959.3	52,136.9	54,084.5	51,906.5	61,020.7
1.7. Non-convertible foreign exchange	0.0	0.0	0.0	0.0	0.0
2. Claims on central government and funds	1.0	2.2	2.9	0.3	251.8
2.1. Claims in Kuna	1.0	2.2	2.9	0.3	251.8
Bridging loans	—	—	—	—	—
Loans under separate decrees	—	—	—	—	—
Overdue claims	1.0	2.2	2.9	0.3	0.8
2.2. Claims in f/c	—	—	—	—	—
3. Claims on other domestic sectors	67.9	64.2	4.2	3.8	3.5
4. Claims on banks	4,178.3	13.9	13.5	12.9	139.2
4.1. Credits to banks	4,178.3	13.9	13.5	12.9	139.2
Refinancing of banks	—	—	—	—	—
Short-term credits against securities portfolio	—	—	—	—	—
Lombard credits	1,349.1	—	—	—	—
Short-term liquidity credits	—	—	—	—	126.8
Other credits	14.7	13.9	13.5	12.9	12.4
Reverse repo transactions	2,814.5	—	—	—	—
4.2. Overdue claims	—	—	—	—	—
5. Claims on other banking institutions	—	—	—	—	—
Total (1+2+3+4+5)	**72,425.1**	**66,885.8**	**75,828.3**	**78,745.2**	**84,696.5**

	Year ended 31 December				
	2007	2008	2009	2010	2011
	(HRK millions)				
LIABILITIES					
1. Reserve money	51,923.9	49,743.0	56,141.9	56,249.1	62,379.5
1.1. Currency outside banks	16,007.5	17,051.0	15,282.1	15,262.7	16,689.1
1.2. Banks' cash in vaults	3,305.8	3,428.3	3,659.6	4,048.7	4,253.9
1.3. Banks' deposits	32,610.6	29,263.7	37,200.1	36,937.6	41,436.0
Settlement accounts	7,553.9	9,520.3	12,024.6	10,246.1	12,705.0
Statutory reserves	22,275.6	19,222.7	23,600.6	22,705.1	25,755.0
CNB bills on obligatory basis	1,991.1	460.6	—	—	—
Overnight deposits	790.0	60.0	1,575.0	3,986.4	2,976.0
1.4. Deposits of other banking institutions	—	—	—	—	—
1.5. Deposits of other domestic sectors	—	—	—	0.0	0.6
2. Restricted and blocked deposits	14,286.0	8,064.1	5,091.6	4,833.9	5,600.2
2.1. Statutory reserve in f/c	14,257.5	8,008.3	5,041.7	4,773.2	5,538.3
2.2. Restricted deposits	28.6	55.8	49.9	60.7	61.9
2.3. Escrow deposits	—	—	—	—	—
3. Foreign liabilities	17.2	16.6	8.1	8.7	0.4
3.1. Use of IMF credit	—	—	—	—	—
3.2. Liabilities to international organizations	17.2	16.6	8.1	8.7	0.4
3.2. Liabilities to foreign banks	—	—	—	—	0.0
4. Central government and funds deposits	199.1	206.9	4,171.4	5,356.3	1,773.1
4.1. Demand deposits	125.8	171.1	1,839.2	2,629.9	1,183.6
Central government demand deposits	100.3	43.0	1,772.9	1,379.8	849.7
Central government funds demand deposits	25.4	128.2	66.2	1,250.1	333.9
4.2. Central government f/c deposits	73.3	35.8	2,332.2	2,726.4	589.5
4.3. CNB bills	—	—	—	—	—
5. CNB bills	—	—	—	—	—
5.1. CNB bills in Kuna	—	—	—	—	—
5.2. CNB bills in f/c	—	—	—	—	—
6. Capital accounts	6,664.5	9,562.4	11,151.3	13,090.1	15,787.9
7. Other items (net)	(665.6)	(707.1)	(735.9)	(792.9)	(844.6)
Total (1+2+3+4+5+6+7)	**72,425.1**	**66,885.8**	**75,828.3**	**78,745.2**	**84,696.5**

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 2011, gross international reserves increased by 5.0 per cent. relative to gross international reserves at 31 December 2010, and reached EUR 11.2 billion. 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. Net purchase of foreign currency from the government in 2011 amounted EUR 968.23 million, while two sales of foreign exchange to the banks, totalling EUR 419.40 million, had opposite effect on the level of international reserves. The net effect of other factors on gross international reserves, such as outflows of government foreign currency deposits from the CNB, increase in foreign currency reserve requirements, income from reserves management and foreign currency cross-changes, was neutral in 2011. Net international reserves also recorded growth, increasing by 7.9 per cent compared to net international reserves of the CNB at 31 December 2010, reaching the EUR 10.0 billion at end 2011. The SDR 303.2 million allocation received in 2009 remained the same in 2011.

At the beginning of 2012, gross international reserves increased further, reaching EUR 11.4 billion by the end of February. The growth of international reserves in the first two months of 2012, which amounted to EUR 215.90 million or 1.9 per cent, was recorded mainly due to increase in government foreign currency deposits held at the central bank. This inflow was a consequence of the Ministry of Finance's EUR Treasury bill issuance in February 2012. Contrary to the trend for gross international reserves, in the first two months of 2012 net reserves have slightly decreased. As of 29 February 2012 net international reserves stood at EUR 9.9 billion, or 0.8 per cent (EUR 82 million) lower compared to end 2011. This change was result of slightly higher foreign currency sales with banks through three interventions (EUR 458.00 million) comparing to the net purchases of foreign currency with Ministry of Finance (EUR 428.58 million). 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, international financial institutions, central banks and covered bonds. In terms of the structure of net international reserves, the share of investments in government bonds declined to 74.7 per cent. at 31 December 2011 from 88.1 per cent. at 31 December 2010, while the share of investments with central banks and international financial institutions increased to 22.0 per cent. at 31 December 2011 from 10.6 per cent. at 31 December 2010. The share of net international reserves invested in non-collateralised instruments with the banks slightly decreased to 1.2 per cent. at the end of 2011 from 1.3 per cent. at the end of 2010.

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

	Year ended 31 December		
	2009	2010	2011
		(EUR millions)	
Total international reserves	**10,375.82**	**10,660.31**	**11,194.86**
Statutory reserves in foreign currency	690.06	646.33	735.45
Central government foreign currency deposits	319.21	369.18	78.28
Holdings of SDRs	331.73	356.73	360.71
Net international reserves[(1)]	9,034.81	9,288.08	10,020.42

Source: Croatian National Bank

(1) Net international reserves = Total international reserves — Statutory reserve in foreign currency — Central government foreign currency deposits — SDR holdings.

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

	Year ended 31 December		
	2009	2010	2011
		(per cent.)	
Government bonds	85.6	88.1	74.7
Financial instruments of central banks and international financial institutions	10.5	10.6	22.0
Non-collateralised instruments	1.6	1.3	1.2
Bank/covered bonds	2.3	0.0	2.1
Total	**100.0**	**100.0**	**100.0**

Source: Croatian National Bank

In terms of credit rating, the share of the total reserves invested in securities of countries and banks with the highest Aaa rating according to Moody's increased in 2011 to 84.2 per cent. from 70.2 per cent. in 2010. Investments rated Aa1, Aa2 and Aa3 accounted for 8.1 per cent. of total international reserves at 31 December 2011 decreasing from 19.5 per cent. at 31 December 2010. The remaining 7.7 per cent. of total international reserves in 2011 was invested in the International Monetary Fund and the Bank for International Settlements, a decrease from 10.3 per cent. in 2010.

As of 31 December 2011, the share of reserves in euro in net international reserves was 80.8 per cent. and the share of reserves in U.S.$ was 19.2 per cent. This ratio has not changed significantly from 2010 when 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.

The average size of the CNB euro portfolio that was actively managed by the CNB in 2010 was EUR 7.34 billion and the average size of the U.S.$ portfolio was U.S.$2.26 billion. In 2010, the net yield on the CNB euro portfolio was 1.09 per cent. (according to the Global Investment Performance Standards methodology) and the net yield on the CNB U.S.$ portfolio during the same period was 0.67 per cent. In 2011, the average size of the CNB euro portfolio and of the U.S.$ portfolio that were actively managed by the CNB amounted to EUR 3.84 billion and U.S.$2.51 billion, respectively, while the size of the CNB euro held-to-maturity portfolio was EUR 3.98 billion. In 2011, the net yield on actively managed CNB euro portfolio was 1.36 per cent. and the net yield on actively managed CNB U.S.$ portfolio was 0.56 per cent, whereas the yield on the CNB euro held-to-maturity portfolio was 2.31 per cent.

Income realized from the investment of reserves in 2010 was EUR 79.7 million and U.S.$16.01 million. In 2011, the income realized from the investment of reserves was EUR 114.14 million and U.S.$14.86 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 by the end of December 2011 when it amounted to 19.15 per cent according to un-audited data. 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 2009, where it remained through 2011).

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 trustee, 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 administration if:

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

However, the CNB has the discretion to postpone the application of the above provisions where the CNB is of the view that facts exist indicating a high probability of improvement of the credit institution's position. If the credit institution has a capital adequacy ratio of between 9 and 12 per cent., the CNB may impose, in addition to the above measures, other restrictions such as 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 December 2011 the Croatian banking system comprised 32 banks (one of which being a savings bank), five housing savings banks and HBOR. During the first half of 2009 one large and one middle sized bank (owned by the same foreign financial institution) merged. Afterwards, two small banks (both with market share below 0.5 per cent.) left the market following the loss of banking license: one savings bank (in the second half of 2010) and one commercial bank (in the second half of 2011). Four foreign banks have representative 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		
	2009	2010	2011
		(per cent.)	
State ownership[1]	4.2	4.3	4.5
Private domestic ownership	5.0	5.4	4.9
Foreign bank ownership	90.9	90.3	90.6
Total	**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 December 2011. The majority of the commercial banks' assets are controlled by foreign shareholders. As at 31 December 2011, 16 entities were majority owned by foreign shareholders, 13 by private domestic shareholders and 2 by the State. By virtue of the high level of foreign ownership, the Croatian banking system is exposed to the Austrian and Italian banking systems, among others.

The table below provides a breakdown of the ownership of commercial banks in Croatia as at 31 December 2011:

	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	25.6	27.8
Privredna banka Zagreb d.d.	1.8	0.2	98.0	16.7	20.0
Erste&Steiermarkische Bank d.d. Rijeka	0.0	0.0	100.0	14.0	11.5
Hypo Alpe-Adria-Bank d.d.	0.0	0.0	100.0	10.1	9.8
Raiffeisenbank Austria d.d.	0.0	0.0	100.0	9.5	10.2
Societe Generale-Splitska banka d.d.	0.0	0.0	100.0	6.6	6.2
HPB d.d.	0.2	99.4	0.3	4.0	2.2
OTP banka d.d.	0.0	0.0	100.0	3.2	2.5
Volksbank d.d.	0.0	0.0	100.0	1.8	2.8
Podravska banka d.d.	10.8	1.5	87.7	0.7	0.7
Jadranska banka d.d.	72.5	12.1	15.4	0.7	0.6
Medimurska banka d.d.	0.0	0.0	100.0	0.7	0.7
Kreditna banka Zagreb d.d.	99.5	0.4	0.1	0.7	0.5
Banco Popolare Croatia d.d.	1.0	0.0	99.0	0.7	0.6
Istarska kreditna banka Umag d.d.	71.2	3.7	25.2	0.6	0.4
Imex banka d.d.	100.0	0.0	0.0	0.5	0.3
Karlovacka banka d.d.	93.0	5.0	2.0	0.5	0.2
Croatia banka d.d.	0.0	100.0	0.0	0.5	0.2
Centar banka d.d.	85.4	0.0	14.6	0.4	0.3
Slatinska banka d.d.	84.5	8.8	6.7	0.3	0.3
Partner banka d.d.	100.0	0.0	0.0	0.3	0.3
Stedbanka d.d.	100.0	0.0	0.0	0.3	0.6
Vaba d.d. banka Varazdin.	68.6	9.4	22.0	0.3	0.2
Veneto banka d.d.	0.0	0.0	100.0	0.3	0.3
Banka Kovanica d.d.	0.5	0.0	99.5	0.3	0.2
BKS Bank d.d.	0.0	0.0	100.0	0.3	0.2
Banka Brod d.d.	0.3	0.0	99.8	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	0.1
Primorska banka d.d.	10.2	0.0	89.8	0.0	0.1
Aggregate weighted by market share	5.3	4.9	89.8		
Aggregate weighted by share in shareholders equity	4.7	2.8	92.5		

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 December 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 December 2011:

	Money assets and deposits with the CNB	Deposits	Securities	Loans	Other
		(per cent.)			
Large banks	13.2	6.0	7.6	69.9	4.1
Medium-sized banks	12.5	8.5	10.4	65.0	4.3
Small banks	12.2	10.2	13.3	59.7	5.4
Total banks	13.0	6.6	8.3	68.6	4.2

Source: Croatian National Bank

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

	Capital	Deposits	Securities	Loans	Other
			(per cent.)		
Large banks	14.2	68.2	1.1	12.8	3.7
Medium-sized banks	11.5	72.9	1.7	7.1	6.9
Small banks	11.5	73.9	1.9	9.9	2.9
Total banks	13.7	69.1	1.2	12.1	3.9

Source: Croatian National Bank

Asset growth of the banking sector was relatively slow after 2008 reflecting scarce and expensive funding, lower demand for credit as well as risk averse behaviour of banks. In 2011, bank assets recorded an increase of 4.2 per cent., following growth of 3.4 per cent. in 2010 and 2.2 per cent. in 2009. Relaxation of monetary and prudential measures after the start of financial crisis allowed banks to use liquidity reserves to expand loans at a slightly faster pace than the growth rate of overall assets which resulted in the increase of the bank loans to bank assets ratio. However, easier access to funding did not result in a significant increase of loans in 2010 or 2011. In nominal terms credit growth amounted to 5.3 per cent. in 2010 and 6.1 per cent. in 2011 but only 3.5 per cent. in 2010 and 4.3 per cent. in 2011 when exchange rate effects are excluded.

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 remained broadly stable in 2011. At 31 December 2011, the currency structure of bank assets remained stable compared with the end of 2010 and consisted of 35.1 per cent. Kuna assets, 40.8 per cent. foreign currency indexed assets and 24.1 per cent. foreign currency assets. At the same date, the currency structure of liabilities and capital was 41.6 per cent. Kuna, 54.5 per cent. foreign currency and 3.9 per cent. indexed to foreign currency.

Capitalisation

At the end of 2011, the total capital of Croatian banks was HRK 55.9 billion, an increase of 2.7 per cent. from the end of 2010 and of 6.3 per cent. from the end of 2009. The major contributors to this were share capital and retained earnings which increased 17.5 per cent. and 29.0 per cent., respectively, from 2009 to 2011. Since mid 2008 banks' capital to assets ratio remained stable at around 14 per cent. and amounted to 13.7 per cent. as at December 2011. Despite high value adjustments costs, according to un-audited data, banks' current year pre-tax profit increased by 8.4 per cent. in 2011 mainly as a result of strong net interest income and increased cost efficiency.

The growth of assets of financial intermediaries in Croatia was 4.1 per cent. in 2009, 3.5 per cent in 2010 and 3.8 per cent. in 2011, representing a compounded annual growth rate of 3.8 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' and 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 2011 the regulatory capital of Croatian banks totalled HRK 53.6 billion, an decrease of 1.4 per cent. compared with the end of 2010 and an increase of 1.9 per cent. compared with the end of 2009. Since banks in Croatia have a conservative capital structure, regulatory capital is predominantly made up of Tier 1 capital (around 96 per cent. as of 31 December 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 a change 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 3.4 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 18.8 per cent. in 2010 and increased slightly to 19.2 per cent. in 2011 as a result of the mentioned regulatory change as well as a higher share of low risk placements (governments and central banks) which lead to the decrease of risk weighted assets.

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) and again to 17.0 per cent. in March 2011. 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 as well as low demand for credit led to the stagnation of asset growth in 2010 (0.6 per cent. effectively and 3.4 per cent. nominally). In 2011, banks asset growth somewhat accelerated based on increased funding from foreign owners. However, this growth (4.2 per cent. nominally 2.6 per cent. effectively) is still significantly lower compared with pre-crisis period. Total bank assets as at 31 December 2011 amounted to HRK 407.4 billion, an increase of HRK 16.3 billion as compared with the end of 2010.

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 2007 to 2011:

	Year ended 31 December		
	2009	2010	2011
	(HRK millions)		
Total assets	378,371	391,071	407,407
Total placements and contingent liabilities	426,886	419,318	438,157

Source: Croatian National Bank

According to audited data, in 2010 commercial banks in Croatia realised HRK 4.4 billion profit before tax, an increase of 3.3 per cent. in comparison with 2009. Five commercial banks realised losses in 2010 and their assets represent 1.5 per cent. of the total assets of all banks in Croatia. The total loss amounted to HRK 193.9 million, or 0.05 per cent. of all bank assets in Croatia. In 2011, according to un-audited data banks' pre-tax profits totalled HRK 4.7 billion, representing a increase of 8.4 per cent. compared with 2010. Seven commercial banks representing 1.6 per cent. of banking system assets reported losses in 2011 totalling HRK 99.3 million or 0.02 per cent. of all bank assets in Croatia. The increase in total bank profits in 2011 was primarily due to an increase in operating profits of 4.0 per cent. and somewhat lower value adjustment costs compared with the 2010).

Loan Exposure

Total (net) loans of banks as at 31 December 2011 amounted to HRK 279.3 billion, which represents an increase of 4.6 per cent. as compared to 31 December 2010. Of those loans 43.5 per cent. were retail loans, while 39.2 per cent. were corporate loans. Compared with 2010, (net) loans to the corporate sector increased by 7.3 per cent. in 2011 while (net) loans to households stagnated. Far stronger growth was recorded in loans to government entities (14.1 per. cent) which increased their share in total loans to 14.1 per cent. in 2011 compared to 2010. Loans to non-residents decreased by 5.3 per cent. in 2011 which decreased their share of total loans to 0.7 per cent.

During 2011, the share of non-performing loans continued to increase albeit at slower pace compared with 2010 as it rose from 11.2 per cent. to 12.4 per cent.

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

	As at 31 December						
	2002	2004	2006	2008	2009	2010	2011
	(per cent.)						
Non-performing loans	10.2	7.4	5.2	4.9	7.8	11.2	12.4
Non-performing loans to households	5.8	4.7	4.1	3.9	5.8	7.8	8.6
Non-performing loans to enterprises	15.6	11.9	7.7	7.2	12.8	18.1	20.1

Source: Croatian National Bank

While non-performing loans increased across all sectors in 2011, including in the household sector which historically has demonstrated lower levels of non-performing loans. However, the increase in non-performing loans from 2008 onwards was the greatest in the corporate sector due to continued economic difficulties following the global financial and economic crisis.

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 through the end of 2011, 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 3.8 per cent. in 2009 compared to the peak in real estate prices reached in 2008. In 2010 this decline accelerated to 6.3 per cent. in 2010 but slowed down to 3.1 per cent. in 2011. 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 (5.2 per cent. as at 31 December 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 4.3 per cent. in 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, 8.6 per cent. in 2010 and 7.8 per cent. in 2011).

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

	As at 31 December							
	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	63.1
CHF	3.1	9.6	15.0	16.5	16.0	13.4	12.9	10.8
Other currencies	3.7	3.7	3.0	1.4	1.4	1.2	1.1	1.2
Kuna	19.7	18.6	28.5	38.6	34.6	27.3	26.4	24.9

Source: Croatian National Bank

According to unaudited data, total expenses on loss provisions declined slightly from HRK 3,714 million at the end of 2010 (which represented a 5.7 per cent. increase compared with 2009) to HRK 3,664 million at the end of 2011 due to a decline in collectively assessed impairment provisions.

Loans (net) to households reached HRK 122.4 billion at the end of 2011, an increase of HRK 0.2 billion (0.2 per cent.) compared to the end of 2010. However, since Kuna depreciated against Swiss franc and Euro during 2011 (by 4.5 per cent. and 2.0 per cent.) these loans effectively declined. The share of housing loans and other loans to households in total net loans to households increased during 2011. The share of credit card loans and vehicle purchase loans decreased in 2011. The share of mortgage loans remained relatively flat in 2011.

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 after 2008 reflecting turbulence in the macroeconomic environment and weaker demand. During 2010 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 with similar dynamics continuing in 2011 as housing loans and

general purpose loans effectively stagnated while all other loans to households effectively declined. Consequently, the share of housing loans in total net loans to households increased to 48.2 per cent. as at 31 December 2011. Apart from relatively faster growth of these loans compared with other loans to households and Kuna depreciation against the 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 annual growth of 4.9 per cent. in 2010, in 2011 bank deposits grew by 4.5 per cent. With deposits by the corporate sector, government and domestic financial companies decreasing in 2011 (by 3.0, 2.5 and 7.4 per cent.) and the growth rate of deposits by households slowing down to 4.6 per cent., banks relied on non-resident funding (mostly from their owners) which increased by 16.3 per cent. The share of deposits to total bank liabilities has remained relatively stable since 2007 and stood at 69.1 per cent. as at 31 December 2011.

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

	As at 31 December					
	2009	**2010**	**2011**	**2009**	**2010**	**2011**
	(HRK millions.)			*(per cent. change over end of previous year)*		
Loans	**252,308**	**267,101**	**279,324**	**2.4**	**5.9**	**4.6**
Households	118,449	122,183	122,398	(3.9)	3.2	0.2
Enterprises	94,673	102,027	109,502	0.6	7.8	7.3
Government	31,542	34,577	39,439	46.7	9.6	14.1
Financial institutions	6,048	6,386	6,158	4.5	5.6	(3.6)
Non-residents	1,596	1,929	1,827	(16.8)	20.8	(5.3)
Deposits	**256,680**	**269,178**	**281,385**	**3.6**	**4.9**	**4.5**
Households	144,052	155,803	162,910	3.6	8.2	4.6
Enterprises	45,072	45,798	44,406	(8.8)	1.6	(3.0)
Government	4,214	5,212	5,080	(29.9)	23.7	(2.5)
Financial institutions	17,458	15,000	13,883	9.5	(14.1)	(7.4)
Non-residents	45,883	47,365	55,105	22.9	3.2	16.3

Source: Croatian National Bank

As of 31 December 2011, total deposits amounted to HRK 281.4 billion. In 2011, non-resident and household deposits increased by HRK 7.7 billion (16.3 per cent.) and HRK 7.1 billion (4.6 per cent.) which compensated for the decline of deposits from the corporate sector (HRK 1.4 billion or 3.0 per cent.), domestic financial institutions (HRK 1.1 billion or 7.4 per cent.) and government (HRK 0.1 billion or 2.5 per cent. Since households and non-residents foreign exchange deposits were the main driver of the increase of deposits in 2009 and 2010, the currency structure of deposits changed and the non Kuna component increased to 69.1 per cent. as of December 2010. However, in 2011 the non Kuna component decreased to 67.3 per cent. amid the recovery of household and corporate sector Kuna deposits accompanied with a decline of corporate sector non-Kuna deposits.

As of 31 December 2011, 65.8 per cent. of total deposits were denominated in a foreign currency, 31.3 per cent. in Kuna, and only 1.4 per cent. were deposits indexed to foreign currency. Total deposits consisted of 56.6 per cent. household deposits, 15.8 per cent. corporate deposits, with 19.6 per cent. belonging to non-residents and 6.7 per cent. to State and financial institutions.

The total placements of banks to the central government amounted to HRK 41.3 billion at 31 December 2011, which is an increase of 13.1 per cent. compared to the end of 2010 and of 20.7 per cent. compared to the end of 2009. This amount consists of HRK 22.3 billion in central Governmental loans and HRK 19.0 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 2.31 billion by December 2011.

The Croatian Registry of Loan Obligations (Hrvatski registar obveza po kreditima d.o.o., "**HROK**") 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, as well as certain credit card companies and leasing companies.

Impact of the economic and financial 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 deposit 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 achieved an increase of 4.4 per cent. in their operating profits in 2010. This allowed banking sector capital levels to slightly increase making the banking sector as a whole slightly more resilient to potential future shocks. According to un-audited data, in 2011 banks managed to increase their operating income by a further 3.9 per cent. amid reduced value adjustments costs and increased operating efficiency. However, seven banks reported negative pre-tax earnings at year-end 2011 which is an increase compared with five at the end of 2010.

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 2010 financing from foreign owners was reduced by 1.5 per cent. to HRK 58.9 billion. However, in 2011 financing from foreign owners increased by 16.6 per cent. to HRK 68.7 billion which allowed somewhat 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. 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 and to 53.6 per cent. at the end 2009. This ratio declined further in 2010 to 49.6 per cent. and in 2011 to 40.6 per cent. In the same period 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, to 62.4 at the end of 2010, only to increase to 66.7 per cent. by December 2011 amid the increased deposits placed in foreign banks. The decrease of liquidity ratios 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 rise in liabilities 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 31 December 2010 this ratio stayed as at the year end 2009 level only to decrease further in 2011 to 10.6 per cent. The decrease of this ratio in the last three 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 31 December 2010 the ratio decreased to 15.8 per cent. and further to 14.8 per cent. as of December 2011.

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. and to 17.0 per cent. of total foreign liabilities, which took place in February 2009 and March 2011, resulted in additional foreign exchange liquidity for Croatian banks. (See also "*Monetary Policy and Instruments*" above for details of further liquidity measures).

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. A credit institution may be established as a bank, savings bank or a housing savings bank. 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) shall be higher than or equal 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 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 (until Croatia becomes an EU Member State, defined as all banks established outside Croatia) 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 (min. 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 0.08 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; however, the Government expects to privatise Croatian Postal Bank during 2012.

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 rates 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. Extremely good liquidity in the domestic financial system continued during the entire 2011. Therefore banks' needs for money market financing remained low during this period. Weighted average interest rate on overnight loans in direct interbank trading continued to stagnate below 1.0 per cent. level except for a short period at the beginning of fourth quarter of 2011 when interest rates slightly increased due to decreased liquidity caused by the rise of government deposits at the CNB after new bond issue on the domestic market and increased reserve requirement rate. Very good financial system liquidly continued into January and February 2012, with overnight money market interest rates remaining at a relatively low level, despite three foreign exchange market interventions and an increase in the reserve requirement rate (withdrawing a total of HRK 6.6bn). However, the weighted interest rates on overnight loans in direct interbank trading went up a bit from 0.61 per cent. in December 2011 to 2.94 per cent. in February 2012.

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 during the whole 2011 (standing at 0.61 per cent. in December 2011). Interest rates on the overnight loans in direct interbank trading slightly increased at the beginning of 2012.

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 slightly increased during 2011 to HRK 1.4 billion with total turnover amounting to HRK 352.9 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 to 32.2 per cent. However, during 2011, especially the second year-half, the share of interbank trading somewhat increased to 35.4 per cent. 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 30.0 per cent. in 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 34.6 per cent. in 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 2011 direct interbank trading accounted for more than 90 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 49.1 billion in 2011. The average daily turnover in overnight loans was HRK 0.2 billion in 2010 and it remained at that level in 2011, while the average daily turnover in loans intermediated by the ZMM was only HRK 21 million in 2011.

During 2011 the Government raised HRK 18.8 billion in Kuna denominated T-bills and HRK 5.7 billion in EUR-linked T-bills at 32 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 2.62 per cent in June 2011. The weighted interest rates on 91-day T-bills and 182-day T-bills denominated in Kuna in June 2011 were 1.39 per cent. and 2.15 per cent., respectively. However, the strong rise of the global risk premium due to the debt crisis in the peripheral countries of the euro zone, deterioration f the global financing conditions, issuance of two domestic government bonds and exchange rate interventions stimulated in the second half of 2011 increase of the weighted interest rates on Kuna T-bills regardless of their maturity. From September 2011 EUR-linked 91-day T-bills were regularly issued besides the EUR-linked T-bill with one-year maturity. Weighted interest rate on these one-year 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. However, by the end of 2011 it rose again to 4.98 per cent. Weighted interest rate on 91-day EUR-linked T-bills was only slightly lower in December 2011 (4.50 per cent.).

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 December 2011, the total stock of subscribed T-bills rose again to HRK 15.4 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 0.71 billion at the end of December 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 remained almost unchanged during 2011 since the Government mainly refinanced maturing T-bills (amounting to HRK 20.7 billion at the end of December).

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. This trend continued in 2011 due to very good domestic financial sector liquidity in the stable monetary environment and relatively low money market interest rates. However, the pace of interest rate declines was somewhat slower and uneven compared to previous years. 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 half of 2011. However, in the second half of 2011 this trend was reversed so by the end of December 2011 interest rates reached 7.48 per cent. 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 declined further to 6.37 per cent. by the end of December 2011. In the same period, 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 11.18 per cent. at the end of December 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 7.53 per cent. at the end of December 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 rose again slightly in 2011, standing at 2.46 per cent. as of December 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. Although this downward trend continued in the first quarter of 2011, it was reversed in the following months so interest rates reached 2.76 per cent. at 31 December 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 rising again to 0.55 per cent. by the end of December 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. This trend continued during 2011 as it declined to 6.22 per cent. by the end December 2011. 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 to 7.48 per cent. at 31 December 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. However it fell to 4.25 per cent. at December 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 two market specialists and 27 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 2010	Second half of 2010	First half of 2011	Second half of 2011	Variation of second half of 2011 from first half of 2011	Variation of second half of 2011 from second half of 2010
Regular volume	80,311,377	59,906,167	55,639,537	44,242,012	(20.5)	(26.1)
of which Stocks	11,821,932	12,314,231	26,527,746	15,456,511	(41.7)	25.5
of which Bonds	68,489,445	47,591,936	26,211,791	28,785,501	9.8	(39.5)
of which Rights	0	0	0	0	—	—
of which Commercial Paper	0	0	2,900,000	0	(100)	—
Block volume[1]	0	0	0	519,454	—	—
Reported volume[2]	361,145,139	329,675,500	115,351,000	52,413,000	(54.6)	(84.1)
Institutional volume[3]	1,961,864,250	1,215,065,693	5,352,851,852	4,096,576,398	(23.5)	237.1
Total number of trades	154,035	132,840	205,737	145,761	(29.2)	9.7
Number of securities traded	221	218	224	—	—	—
Number of trading days	122	128	125	127	1.6	(0.8)
Daily average volume	19,699,351	12,465,938	44,190,739	33,021,664	(25.3)	163.4

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. By the end of 2010 total number of commercial paper issues listed at the ZSE decreased to 24, issued by 13 issuers. The number of commercial paper issues listed at the ZSE further fell to 15 by the end of December 2011 and they were issued by 9 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. However, uncertainty about the global recovery erased all gains by the end of 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 six months of 2011 by an additional 5.7 per cent. as it reached 2,231 at the end of June 2011.

However, in the second half of 2011 it decreased again, finishing the year 17.6 per cent. lower compared to 2010. 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 December 2011 total market capitalisation of shares listed on the ZSE was HRK 130.6 billion (39.0 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. Although during the first six months of 2011 CROBIS increased by 2.6 per cent., it finished 2011 4.5 per cent. lower than 2010. 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. However, in 2011 total bond turnover fell again by 92.2 per cent. to HRK 553.1 million. 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 December 2011. 12 of these bonds were government bonds, six 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. In 2011 the Government issued two new ten-year bonds, a HRK 1.5 billion 5.75 per cent. bond and a EUR 600 million 6.50 per cent. bond. Two new corporate bonds were issued in the same period.

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 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 so by the end of 2011 it increased again to 610 basis points.

Six Croatian bonds were listed on foreign markets as at 31 December 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 (U.S.$ 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, a U.S.$ 1.5 billion 6.375 per cent. Eurobond was issued, followed by an issuance of EUR 750 million 5.785 per cent. Eurobond on June 2011. In total six Croatian bonds were listed on foreign markets as at the end of December 2011 with outstanding nominal value of approximately EUR 5.2 billion.

Regulation of the Non-Banking Sector

The Croatian Financial Supervisory Authority Act (OG 140/2005, as amended) 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, investment companies, investment and other funds and their management companies, pension fund insurance companies, the Central Depository & Clearing Company, insurance and reinsurance companies, insurance agents and brokers, legal persons dealing with factoring (unless such activities are conducted by banks in the framework of their registered activity, leasing companies and other entities being otherwise subject to supervision under applicable laws dealing with capital markets, investment and other funds, taking-over, pension insurance, insurances and financial services.

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 Markets Act (OG 88/08, as amended) on 18 July 2008 which entered into force on 1 January 2009. The new Act incorporates all relevant regulations of the *acquis communautaire*.

Some articles of the Capital Market Act came into force on 1 January 2010. In addition, some provisions of the Act will come into force or, as the case may be, will cease to be in effect after the accession of Croatia to the EU.

Pursuant to the Capital Markets Act, for the purpose of protection of investors the Investor Protection Fund has been established and it is being operated by the Central Depository & Clearing Company. The membership of the Fund is obligatory for, *inter alia*, investment companies authorised to hold a client's funds and/or financial instruments and credit institutions providing investment services and/or carrying out investment activities on the basis of an authorization under the Credit Institutions Act, when providing investment services and certain ancillary services under the Capital Markets Act.

PUBLIC FINANCE

Overview of the 2012 Budget

The budget for 2012 (the "**2012 Budget**") and projections for 2013 and 2014 were adopted in February 2012 (a delay compared to the usual cycle due to the parliamentary elections held in December 2011). According to the 2012 Budget, total revenues of the consolidated general government are planned at 35.7 per cent. of GDP and total expenditures are planned at 37.4 per cent. of GDP, which will result in net lending/borrowing of -3.3 per cent. of GDP (according to the GFS 2001 methodology).

The goal of the revenue-side policies in the 2012 Budget is to encourage the competitiveness of the domestic economy by decreasing the labour costs of enterprises. The 2012 Budget seeks to achieve this by reforming the system of social security and pension contributions on salary, thereby decreasing the non-tax burden on enterprises. Additional measures seek to rebalance the tax burden primarily through changes in the income tax system and by lowering the value added tax rate for certain groups of goods and services. Finally, in 2012 Croatia intends to partially fund its operating deficit through the privatisation of Croatia Osiguranje (an insurance company) and Hrvatska Postanska Banka (a bank). See "*The Economy — The Privatisation Programme — Privatisation Efforts in 2012 the Medium Term*". Measures on the budget expenditure side reflect the need for faster resolution of fiscal imbalances, streamlining costs and ensuring the sustainability of public finances in light of the ongoing unfavourable financial and economic conditions. These measures on the budget revenue and expenditure side seek to contribute to the decrease in the budget deficit and the general government deficit over the medium-term period and reversing the negative trend in the ratio of public debt to GDP. See " *— Fiscal Policy and Performance in 2012*".

Fiscal developments in 2011

In December 2010 the Parliament adopted the budget for 2011 and projections for 2012-2013. Total consolidated general government budget revenues in 2011 were planned to decrease by 0.9 percentage points of GDP relative to 2010, according to the GFS 2001 methodology. The main reason behind this trend was a base effect coming from the absence of certain revenues, some of which were one-off, in 2011 compared to 2010. Specifically, during 2010, the state budget recorded on the revenue side a considerable amount of receipts based on tax obligations from the previous periods as well as a special tax on salaries, pensions and other receivables, which was no longer in force in 2011. In addition, in 2011, the whole-year effect of changes in the income tax system from mid-2010 was present, which resulted in a lower level of income compared to 2010. On the other hand, the expense side of the budget for 2011 was determined by the Croatian Parliament, as part of the revision of the 2010 budget, relating to the expenditure ceilings for the 2011 and 2012 budgets. As a result of these trends in revenue and expense, net lending/borrowing of the consolidated general government was increased by 0.6 percentage points i.e. from -4.4% of GDP in 2010 to -5.0% of GDP in 2011 (based on preliminary data). According to the ESA 95 methodology net lending/borrowing of the consolidated general government for 2011 was planned at -5.6 per cent. of GDP.

The Fiscal Responsibility Law ("**Fiscal Responsibility Law**") was adopted by the Croatian Parliament in November 2010. The Fiscal Responsibility Law lays down fiscal rules aimed at the implementation of fiscal consolidation in the forthcoming period and or strengthens fiscal responsibility, by introducing, among other measures, individual provisions for the achievement of a higher level of fiscal responsibility. According to the Fiscal Responsibility Law, total general budget expense expressed as a percentage of the estimated gross domestic product must decrease annually by at least 1 percentage point (ESA 95 methodology), and this will continue until the primary fiscal balance equates to zero or a positive figure. Subsequently, the goal is to achieve a cyclically adjusted primary fiscal balance of the general budget at zero or a positive level during the cycle in order to achieve stabilization and a reduction of public debt as a percentage of gross domestic product. On 25 March 2011 the Government established the Fiscal Policy Committee, tasked with efficient management of public finances and improvement in the implementation of fiscal policy. Members of the Fiscal Policy Committee were appointed by the Government upon the recommendations from independent institutions, including the Institute of Economics, Zagreb, the Institute of Public Finance, Croatian National Bank, the State Audit Office, the Faculty of Economics and Business, Zagreb, the Faculty of Economics and Business, Split and the Faculty of Law, Zagreb). The Fiscal Policy Committee, as a professional and independent body, will contribute to the enhancement of the system of public finances and to the monitoring of the application of the fiscal rules enacted in the Fiscal Responsibility Law. Complying with the transparency principles, the committee is obliged to inform the public about its activities, by publishing them on the internet.

The financing models from 2010, which were used with a view to boost credit activity in the country, were upgraded in 2011. Certain determinants of the models were redefined with an aim to provide assistance to entrepreneurs in overcoming the economic crisis and also to promote investment projects. The revised model "A" (i.e. the model "A+") introduced new measures, such as more lenient criteria for lending to entrepreneurs, allowing loans to both

finance working capital and settle liabilities to suppliers, financial institutions, the state and other creditors. In addition, the share of a loan that can be used for the refinancing of existing liabilities in banks was raised from 20% to 40%, which allowed entrepreneurs to substitute older, more expensive sources of financing with cheaper ones. Other new options included a one-off repayment of a half of the amount of loan, as well as bridge loans, allowing loans to be granted to entrepreneurs immediately after the allocation of the quota at the auction, instead of waiting for completion of the procedure between the CBRD and the bank. In addition, model "A+" offered lower interest rates on CBRD's funds. In 2011, 5 auctions were held under this model. In addition, with an aim of providing entrepreneurs with high-quality financing for their high-quality new or already launched investment projects, the Law on the Guarantee Fund for Promoting Economic Development (OG 34/11) was adopted, as a supplement to model "B". This removed, to a large extent, the obstacles to the launching of projects that could not be previously realised on account of problems with instruments of collateral or entrepreneur's own participation in the project.

In the area of public administration reform, the implementation of the State Administration Reform Strategy 2008-2011 moved forward as the framework for the modernisation and rationalisation of state administration. The Act on Amendments to the Civil Service Act, which entered into force in May 2011, as well as the implementing regulations, improved the evaluation system, increased the mobility of civil servants, strengthened their responsibility and introduced the possibility of expert training with state authorities. The new Political Activity and Electoral Campaign Financing Act was adopted in 2011. It envisages a 10% cut in the funds set aside by the state budget for regular annual financing of political parties relative to the funds currently allocated. The Act also reduced the maximum amount of donations that natural and legal persons may make to political parties annually and laid down maximum cost limits for election campaigns. The Act on the Register of Public Sector Employees was adopted with a view to establishing a high quality and efficient system of centralised wage calculation and human resources management. Consequently, the Register was established and as of 30 December 2011 it included 227,127 employees of the approximately 230,000 employees in 2,227 institutions. Within the framework of electronic administration development, activities envisaged by the e-Administration Development Strategy 2009-2012 were continued in 2011, including a focus on the establishment of the Croatian interoperability framework.

State property management focused on mobilising state property and its use as a tool for economic growth and stimulation of investment, maximum rationalisation of the state property usage and creation of a sustainable state property management system in accordance with the law. In contrast with the Privatisation Act which provided for only two methods for the sale of shares and holdings, the Act on Managing the State Property provides for seven methods to sell shares and holdings as a way of managing state property. The Act provides for public offer (initial public offering), public bidding (public auction), public tenders, sale on a regulated capital market, sale through the acceptance of a takeover bid and sale through the acceptance of minority holders squeeze-out bids as well as capital injections. These methods are more dynamic and better suited to modern capital markets and economic developments.

Many activities aimed at promoting entrepreneurship were also continued in 2011 such as the "hitro.hr" service devised as one-stop-shop to conduct all the activities necessary for company establishment in one place in a single day. The services are available in all counties. An electronic service for crafts and trades registration was also developed (e-crafts and trades). Based on the programme of incentives to small and medium-size enterprises, four operational plans were conducted with incentive programmes aimed at strengthening competitiveness, innovation and the use of new technologies, fast-growing activities, clusters, female entrepreneurship, start-up and disabled persons entrepreneurship, cooperative entrepreneurship, crafts development, education in entrepreneurship and vocational training, in accordance with the needs of the economy.

The modernisation of the network of courts and state attorney's offices continued both through additional amendments to the legislative framework and the implementation of the physical unification of judicial authorities. One of the measures to increase the efficiency of the judicial system is the establishment of a unified system of monitoring cases at the courts and in the network of state attorneys, and consequently the Court Case Management System (ICMS) was upgraded in 2011. Improvement began in July 2011 for the case management system in the network of state attorney's offices. In the past period, legislative amendments were introduced in the segment of the enforcement procedure, contributing to the successful and efficient enforcement system and in the segment of administrative disputes, to the increase protection of parties in the proceedings.

As a means of tackling unemployment, during 2011 the Croatian Employment Service spent HRK 281 million to implement active employment policy measures, an increase of 55.3% compared to the previous year. The number of persons participating in these measures also increased, from 13,088 in 2010 to 33,972 in 2011 (increase of 160%). 13,788 persons participated in training for the unemployed and 10,780 persons participated in public works, which is an increase of 202% and 114%, respectively, compared to 2010. Training and public works were the measures

intended primarily for persons unemployed for an extended period of time with very difficult access to the labour market. The number of persons included in workplace training without concluding employment contracts, intended for young persons with no previous work experience, rose from only 448 in 2010 to 4,760 in 2011. This sharp increase was due to the fact that lack of experience was identified as one of the main obstacles to young persons' employment. Active measures for the unemployment compensation expenditure ratio stood at 20% in 2011.

The decision to suspend pension adjustment in 2010 remained in force throughout 2011. In 2010 and 2011 these measures reduced the state budget expenditures by a total of HRK 260 million. The monitoring of the implementation of the Act on the Supplement to a Pension Earned under the Pension Insurance Act led to the inclusion of the pension supplement into the amount of the pension for certain categories of beneficiaries. The pension supplement was part of a different taxation regime, providing the beneficiaries of the supplement with a more favourable position compared with other pensioners. Aiming to cut administrative costs under the 2nd pillar of pension insurance, relevant legal changes transferred a share of costs incurred by the uniform record-keeping of personal accounts of mandatory pension fund members from the state budget to mandatory pension companies. In addition, at the end of 2011 the annual management fee for mandatory pension companies was cut to 0.45% of the total assets of a given pension fund from 0.65% at the beginning of 2011.

The Social Welfare Act, adopted in May 2011, introduced a uniform definition of households and a clearer income and property census with regards to the eligibility for social assistance, benefits, support and services. The new act introduced a basis that is linked to the relative poverty threshold, published yearly by the CBS. The basis is 22.5% of the monthly amount of the relative at-risk-of-poverty threshold for single-person households. In an effort to enable further deinstitutionalisation and expansion of the service network, the new Foster Care Act was adopted in July 2011. It regulates new forms of foster care (kinship foster care, non-kinship foster care and professional foster care, as a completely new type of foster care), placing emphasis on training and education of foster care providers, as a contribution to the deinstitutionalisation of the social welfare system.

In 2011, the healthcare sector recorded a successful reduction in the previously high rates of sick leave as well as a reduction in the long waiting lists for specialist exams and surgical procedures. The process of renewing old medical equipment and the construction of new health care facilities was started, while the building of health care facilities already under construction was completed. Special attention is being given to capacity strengthening in the segment of one-day treatments and day hospitals, reducing health care costs and increasing the satisfaction of patients with the health care system. Through the introduction of a payment model for health care services requiring acute hospital treatments, according to diagnostic therapeutic groups (DTS), the average number of hospital stays was reduced and the quality of treatment was improved. The system of payment collection for the treatment of traffic accident casualties, which generated large losses in the past, was also revised. A new model of financing the activities of general/family medicine, medical care of pre-school children, medical care of women and dental medical care, includes a mixed paying model for medical care — with amounts based on the number of insured persons, payment of executed diagnostic therapeutic treatments and amounts for the participation in the work of general/dental health care centres and execution of the preventive programme. The process of decentralisation of the primary health care system was carried out and a system of concessions was introduced. The improvement in the control of expenditures was also achieved through better control of granted sick leaves.

Further unfavourable economic developments over the year had an impact on revenues and expense trends, but to a somewhat smaller extent than in 2010, such that there was no need during the year for adoption of the amendments to the budget. It should also be mentioned that the 2011-2013 Public Debt Management Strategy was adopted by the Government in February 2011.

Consolidated general government results for first three quarters of 2011

According to the GFS 2001 methodology, the total revenue of the consolidated general government amounted to HRK 91.5 billion in the January — September 2011 period. Tax revenues, as the most significant revenue category, amounted to HRK 52.7 billion. Among tax revenues, revenue generated through VAT amounted to HRK 28.2 billion; income tax revenue amounted to HRK 6.8 billion and corporate tax revenue amounted to HRK 5.7 billion. Revenue generated from excise duties was HRK 8.5 billion. The revenue from social contributions, which is the second highest revenue category, amounted to HRK 28.7 billion.

The total expense of the consolidated general government amounted to HRK 98.0 billion in the January — September 2011 period. The largest share of the total expense of the consolidated general government related to social benefits which recorded HRK 42.2 billion. Compensation of employees amounted to HRK 26.4 billion, use of goods and services to HRK 10.7 billion, subsidies to HRK 5.9 billion, interest to HRK 6.3 billion, other expense to HRK 5.5 billion, and grants to HRK 1.0 billion.

In the January — September 2011 period net acquisition of non-financial assets amounted to HRK 3.1 billion (comprising total acquisitions of HRK 3.6 billion and total disposals of HRK 478.3 million).

The level of net lending/borrowing of the consolidated general government, in first nine months of 2011, stood at -2.8 per cent. of GDP, according to the GFS 2001 methodology. At the same time the level of net lending/borrowing of the consolidated general government according to the ESA 95 methodology was recorded at -3.0 per cent. of GDP.

According to available preliminary consolidated central government data, both revenues and expenses were realized above 99 per cent relative to the plan. This resulted in the net lending/borrowing of -4.5 per cent. of GDP (of which Budgetary Central Government Expense realised net lending/borrowing of -4.1 per cent. of GDP and the Extra-budgetary Users of -0.4 per cent. of GDP) according to the GFS 2001 methodology. According to the ESA 95 methodology net lending/borrowing of the consolidated central government was realized at the level of -5.2 per cent. of GDP.

Fiscal policy and performance in 2012

In the first three months of 2012, temporary financing was initially in effect due to the parliamentary elections held at the end of 2011. Immediately after the new Government was formed, the budget preparation process started. In February 2012 the Parliament adopted the budget for 2012 and projections for the 2013-2014 periods.

Total consolidated general government budget revenues in 2012 are planned to increase by HRK 2.0 billion relative to 2011 plan. Total consolidated general government budget expense in 2012 are planned to decrease by HRK 2.9 billion relative to 2011 plan. Based on described revenues and expense plans, net lending/borrowing is to decrease by 1.7 percentage points, from -5.0 per cent. of GDP in 2011 to -3.3 per cent. of GDP in 2012 according to the GFS 2001 methodology. According to the ESA 95 methodology, net lending/borrowing in 2012 is expected to be at the level of -3.8 per cent. of GDP.

Revenues

The consolidated general government revenue plan for 2012 and projections for the 2013 — 2014 periods are based on macroeconomic assumptions for the aforementioned period, changes in the tax legislation, further harmonisation of Croatian legislation with the EU *acquis communautaire* and a full EU membership of the Republic of Croatia as of 1 July 2013. Tax legislation changes are made to ensure greater fairness in taxation and in order to achieve better competitiveness of the Croatian economy. See "*— Budgetary Central Government Expense— Medium-term fiscal policy and fiscal developments in the 2012 Budget*".

In 2012, total revenues of the consolidated general government are planned in the amount of HRK 125.1 billion. 86.9 per cent. of total revenues are expected from the Budgetary Central Government, 10.4 per cent. from the Local Government and the remaining 2.7 per cent. from Extra-budgetary Users. Among Extra-budgetary Users, the highest level of revenues is planned to be recorded from Croatian Waters (HRK 1.6 billion) and the Fund for Environmental Protection and Energy Efficiency (HRK 1.1 billion).

With a share of 58.8%, planned tax revenues of HRK 73.6 billion are expected to serve as the most important category of total revenues. The largest tax revenues are to be generated through VAT, amounting to HRK 40.5 billion. Revenues from excise taxes are expected in the amount of HRK 11.5 billion, personal income tax in the amount of HRK 9.2 billion, and profit tax in the amount of HRK 7.7 billion. Social contributions are the second most important revenue category with a share of 29.6 per cent., or an amount of HRK 37.0 billion.

Expense

Reduction on the expense side of the budget represents the key goal in terms of achievement of fiscal sustainability during the current unfavourable economic conditions. Taking into account widening of fiscal imbalances in the past several years and a need for complying with the Fiscal Responsibility Law, it was important to identify significant savings that could be made on the expense side of the budget in order to return public finances to a sustainable footing.

For 2012, the most important part of the general government budget (i.e., the state budget) records a nominal decrease in expense in almost all categories, whereas expense arising from interests and pensions is the most significant expense which records a year-on-year growth. Aggregate expense budgeted for 2012 amounts to HRK 131.0 billion with HRK 113.8 billion allocated to the Budgetary Central Government, HRK 13.1 billion to the Local Government and HRK 4.1 billion to Extra-budgetary Users.

The largest category of expense is allocated to social benefits, in the amount of HRK 56.2 billion. Social benefits are related, for the most part, to expenses incurred in connection with pensions, the healthcare system, social welfare, maternity leave allowances, child allowance and unemployment.

The budget allows for compensation of employees in amount HRK 34.4 billion, out of which wages and salaries amount to HRK 29.6 billion and social contributions to HRK 4.8 billion.

The budgeted amounts allocated for other expense categories include: HRK 15.4 billion for use of goods and services, HRK 8.1 billion for other expenses, HRK 8.1 billion for interest payments, HRK 6.7 billion for subsidies, and HRK 2.1 billion for grants.

Transaction in Non-Financial Assets

In 2012, net acquisition of non-financial assets of the Consolidated General Government is planned in amount HRK 5.7 billion with the acquisition of nonfinancial assets (HRK 6.6 billion) surpassing the disposal of nonfinancial assets (HRK 867.1 million). The principal non-financial assets are fixed assets, mainly buildings and structures.

Net Lending/Borrowing

The consolidated general government net lending/borrowing planned for 2012 is at the level of -3.3 per cent. of GDP according to the GFS 2001 methodology. According to the ESA 95 methodology, net lending/borrowing in 2012 is expected to be at the level of -3.8 per cent. of GDP.

Liabilities related to pensions

One of financially the most significant issues referring to the difference between ESA 95 and GFS 2001 calculating of fiscal balance lies in the treatment of the so-called pensioners' debt. 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 2011 HRK 9.3 billion had been paid out. The remaining amount of HRK 938 million will be paid by the end of 2013. The yearly amount of the payment to be made in 2012, accounts for approximately 0.2 per cent. of GDP, while the payment for 2013 is significantly lower. These compensation payments are made through a special private fund (the Pensioners Fund), which is not part of the general government sector.

The following table sets out the Consolidated General Government budget for 2008 to 2012

Consolidated General Government According to Government Level

	Year ended 31 December			Plan	Nine months ended 30 September	Nine months ended 30 September	Plan
	2008	**2009**	**2010**	**2011**	**I-IX 2010**	**I-IX 2011**	**2012**
				HRK million			
1. REVENUE (A+B+C)	**134,737.8**	**128,087.1**	**123,709.2**	**123,050.8**	**91,905.2**	**91,506.9**	**125,102.0**
A) Budgetary central government	**115,766.5**	**110,251.2**	**107,457.6**	**107,049.4**	**79,955.4**	**79,831.6**	**108,648.3**
B) Extrabudgetary users	4,223.8	**3,804.2**	**3,351.6**	**3,403.5**	**2,447.6**	**2,356.4**	**3,404.2**
1. Croatian Pension Insurance Administration	—	—	—	—	—	—	—
2. Croatian Institute for Health Insurance	—	—	—	—	—	—	—
3. Croatian Employment Service	—	—	—	—	—	—	—
4. Croatian Waters	2,058.6	1,922.8	1,668.3	1,715.8	1,216.9	1,131.0	1,584.4
5. Fund for Environmental Protection and Energy Efficiency	1,221.2	1,168.6	1,040.7	1,064.1	761.4	748.5	1,145.5
6. Croatian Motorways Ltd.	—	—	—	—	—	—	—
7. Croatian Roads Ltd.	81.0	112.8	86.2	52.0	66.7	45.3	47.1
8. State Agency for Deposit Insurance and Bank Rehabilitation	808.3	566.5	529.6	519.4	381.2	404.5	565.0
9. Croatian Privatisation Fund	54.7	33.5	26.7	1.9	21.3	1.9	—
10. Agency for management of the public property	—	—	—	50.4	—	25.2	62.3
C) Local government	**14,747.5**	**14,031.7**	**12,900.0**	**12,597.9**	**9,502.2**	**9,318.9**	**13,049.6**
2. EXPENSE (A+B+C)	**130,258.6**	**132,450.2**	**133,486.1**	**133,851.6**	**97,884.5**	**97,994.5**	**130,991.9**
A) Budgetary central government	**111,299.7**	**114,305.0**	**116,237.0**	**116,806.6**	**85,946.2**	**86,476.8**	**113,815.5**
B) Extrabudgetary users	**5,308.1**	**4,217.6**	**4,205.2**	**4,094.3**	**2,667.2**	**2,381.7**	**4,063.2**
1. Croatian Pension Insurance Administration	—	—	—	—	—	—	—
2. Croatian Institute for Health Insurance	—	—	—	—	—	—	—

	Year ended 31 December			Plan	Nine months ended 30 September	Nine months ended 30 September	Plan
	2008	2009	2010	2011	I-IX 2010	I-IX 2011	2012
				HRK million			
3. Croatian Employment Service	—	—	—	—	—	—	—
4. Croatian Waters	2,313.7	1,709.5	1,754.0	1,722.9	912.1	882.4	1,546.3
5. Fund for Environmental Protection and Energy Efficiency	1,063.9	1,111.1	954.3	948.5	628.7	578.0	1,011.6
6. Croatian Motorways Ltd.	—	—	—	—	—	—	—
7. Croatian Roads Ltd.	1,588.7	1,048.0	1,405.9	1,301.7	1,058.4	851.7	1,322.9
8. State Agency for Deposit Insurance and Bank Rehabilitation	254.7	267.2	17.0	21.4	12.9	10.9	82.5
9. Croatian Privatisation Fund	87.0	81.8	74.0	16.2	55.1	16.2	—
10. Agency for management of the public property	—	—	—	83.5	—	42.5	99.7
C) Local government	**13,650.7**	**13,927.5**	**13,043.9**	**12,950.7**	**9,271.2**	**9,136.0**	**13,113.1**
NET/GROSS OPERATING BALANCE (1-2)	**4,479.2)**	**(4,363.1)**	**(9,776.9)**	**(10,800.8)**	**(5,979.3)**	**(6,487.5)**	**(5,889.8)**
3. CHANGE IN NET WORTH: TRANSACTIONS (3.1.+3.2.-3.3.)	**4,479.2)**	**(4,363.1)**	**(9,776.9)**	**(10,800.8)**	**(5,979.3)**	**(6,487.5)**	**(5,889.8)**
3.1. CHANGE IN NET ACQUISITION OF NON-FINANCIAL ASSETS	**7,344.1**	**6,357.3**	**4,847.8**	**6,412.5**	**3,076.4**	**3,130.8**	**5,680.5**
Acquisition	**8,876.6**	**7,132.4**	**5,626.8**	**7,223.6**	**3,591.3**	**3,609.1**	**6,547.5**
A) Budgetary central government	3,291.5	2,267.4	1,550.7	1,965.3	845.3	884.6	1,721.5
B) Extrabudgetary users	1,421.7	1,659.4	1,455.1	2,447.9	938.4	1,424.9	2,092.2
C) Local government	4,163.4	3,205.5	2,621.0	2,810.4	1,807.5	1,299.6	2,733.9
Disposals	**1,532.5**	**7751**	**778.9**	**811.1**	**514.9**	**478.3**	**867.1**
A) Budgetary central government	303.4	304.0	318.3	351.3	222.9	221.2	301.6
B) Extrabudgetary users	181.6	21.7	8.2	44.6	7.3	19.0	155.2
C) Local government	1,047.5	449.4	452.5	415.2	284.6	238.1	410.3
NET LENDING/BORROWING (1-2-3.1)	**(2,865.0)**	**(10,720.3)**	**(14,624.8)**	**(17,213.2)**	**(9,055.7)**	**(9,618.4)**	**(11,570.3)**
ESA 95 NET LENDING/NET BORROWING*	(3,603.8)	(12,836.7)	(15,582.4)	(18,213.2)	(9,515.0)	(10,330.9)	(12,570.3)
Payments for compensation of pensioners	1,067.1	816.3	820.0	816.3			820.0
ESA 95 NET LENDING/NET BORROWING (with compensation of pensioners)	(4,670.9)	(13,653.0)	(16,402.4)	(19,029.5)	(9,515.0)	(10,330.9)	(13,390.3)
ESA 95 NET LENDING/NET BORROWING (with compensation of pensioners), % OF GDP	(1.4)	(4.1)	(4.9)	(5.6)	(2.8)	(3.0)	(3.8)
TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING) (3.3-3.2)	**2,865.0**	**10,720.3**	**14,624.8**	**17,213.2**	**9,055.7**	**9,618.4**	**11,570.3**
3.2. CHANGE IN NET ACQUISITION OF FINANCIAL ASSETS	**2,918.0**	**6,729.3**	**2,590.5**	**(1,055.7)**	**6,951.5**	**4,187.0**	**(390.9)**
3.2.1. Domestic	**2,905.6**	**6,727.0**	**2,590.1**	**(1,062.4)**	**6,950.3**	**4,187.0**	**(405.3)**
A) Budgetary central government	1,690.5	6,823.2	1,942.8	(1,615.9)	5,633.1	3,078.1	(552.4
B) Extrabudgetary users	1,073.6	538.3	873.5	578.3	1,104.4	630.8	334.5
C) Local government	141.4	(634.6)	(226.1)	(24.9)	212.7	478.1	(187.3)
3.2.2. Foreign	**12.4**	**2.3**	**0.4**	**6.7**	**1.2**	**0.0**	**14.4**
A) Budgetary central government	12.4	2.3	0.4	6.7	1.2	—	14.4
B) Extrabudgetary users	—	—	—	—	—	—	—
C) Local government	—	—	—	—	—	—	—
3.2.3. Monetary gold and SDRs	**—**	**—**	**—**	**—**	**—**	**—**	**—**
3.3. CHANGE IN NET INCURRENCE OF LIABILITIES	**5,783.0**	**17,449.7**	**17,215.3**	**16,157.5**	**16,007.2**	**13,805.3**	**11,179.4**
3.3.1. Domestic	**6,949.5**	**10,169.7**	**12,871.8**	**6,882.3**	**11,577.0**	**5,048.7**	**928.8**
A) Budgetary central government	5,656.6	9,576.6	11,835.1	4,339.3	10,883.4	4,432.5	(523.2)
B) Extrabudgetary users	1,139.1	553.6	1,057.4	1,631.2	814.7	809.5	760.2
C) Local government	153.8	39.5	(20.6)	911.9	(121.1)	(193.3)	691.8
3.3.2. Foreign	**(1,166.5)**	**7,279.9**	**4,343.5**	**9,275.2**	**4,430.2**	**8,756.7**	**10,250.7**
A) Budgetary central government	(1,445.8)	6,878.4	4,277.0	9,105.4	4,488.0	8,818.3	10,124.3
B) Extrabudgetary users	304.1	423.4	79.0	179.8	(50.5)	(56.2)	141.4
C) Local government	(24.9)	(21.8)	(12.4)	(10.0)	(7.4)	(5.3)	(15.0)

Source: Ministry of Finance

Note: On a cash basis.

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

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

Budgetary Central Government Revenue

	Year ended 31 December		
	2009	2010	2011 (Preliminary)
		(HRK thousands)	
REVENUE	**110,257,947**	**107,466,351**	**107,069,670**
Taxes	**63,678,926**	**62,856,582**	**61,422,186**
Taxes of income and profits and capital gains	**10,839,269**	**7,608,630**	**8,595,516**
Payable by individuals	1,399,411	1,201,546	1,307,486
Payable by corporations and other enterprises	9,439,858	6,407,084	7,288,030
Taxes on property	**532,297**	**443,983**	**448,489**
Taxes on goods and services	**49,238,277**	**50,980,460**	**50,244,065**
General taxes on goods and services	37,173,833	37,812,425	37,847,826
Value-added taxes	37,050,354	37,688,520	37,718,154
Sales taxes	123,479	123,905	129,672
Excises	10,998,910	11,972,326	11,215,054
— on cars, other motor vehicles, boats and planes	696,791	589,983	663,585
— on petroleum products	6,045,624	6,932,709	5,978,413
— on alcohol	189,895	207,445	172,083
— on beer	680,567	655,266	653,951
— on nonalcoholic beverages	125,817	121,615	123,347
— on tobacco products	3,073,671	3,292,993	3,473,375
— on coffee	156,910	149,682	126,424
— on luxury goods	29,635	22,633	23,875
Taxes on international trade and transactions	**1,721,164**	**1,644,448**	**1,766,356**
Other taxes	**1,347,920**	**2,179,061**	**367,761**
Social contributions	**39,994,739**	**38,712,382**	**38,605,067**
Social security contributions	39,994,739	38,712,382	38,605,067
Employee contributions	17,925,299	17,290,552	17,302,315
Employer contributions	21,373,979	20,783,571	20,686,181
Self-employed or unemployed contributions	695,462	638,260	616,570
Unallocable contributions	0	0	0
Grants	**616,307**	**637,087**	**868,988**
Other revenue	**5,967,975**	**5,260,300**	**6,173,430**
Property income	**2,367,214**	**1,298,345**	**1,869,510**
Interest	123,488	125,088	115,034
Dividends	106,625	111,303	286,579
Withdrawals from income of quasi-corporations	1,342,502	318,939	637,969
Rent	794,600	743,015	829,928
Sales of goods and services	**1,682,037**	**1,856,422**	**1,381,724**
Sales of market establishments	0	0	0
Administrative fees	981,712	1,190,921	1,152,971
Incidental sales by nonmarket establishments	700,325	665,501	228,752
Fines, penalties, and forfeits	**515,461**	**524,795**	**534,434**
Voluntary transfers other than grants	**15,865**	**15,940**	**29,068**
Miscellaneous and unidentified revenue	**1,387,397**	**1,564,799**	**2,358,694**

Source: Ministry of Finance

Budgetary Central Government Expense

	Year ended 31 December		
	2009	2010	2011 (Preliminary)
		(HRK thousands)	
EXPENSE	**117,923,992**	**120,323,332**	**119,939,511**
Compensation of employees	**31,289,325**	**31,096,464**	**31,737,350**
Wages and salaries	26,555,399	26,391,104	26,932,391
Social contributions	4,733,926	4,705,360	4,804,959
Use of goods and services	**7,364,017**	**7,655,745**	**7,943,604**
Interest	**5,225,174**	**6,236,482**	**7,097,592**
To nonresidents	1,391,408	1,723,831	2,491,668
To residents other than general government	3,833,767	4,512,651	4,605,924
Subsidies	**6,710,033**	**6,582,192**	**6,555,277**
To public corporations	3,134,258	3,186,622	3,063,739

	Year ended 31 December		
	2009	2010	2011 (Preliminary)
		(HRK thousands)	
To private enterprises	3,575,775	3,395,569	3,491,538
Grants	**5,559,586**	**5,778,575**	**5,083,665**
To foreign governments	78,184	58,594	39,806
Current	68,150	49,412	34,346
Capital	10,034	9,181	5,459
To international organisations	134,031	175,808	212,234
Current	133,061	175,808	212,234
Capital	970	0	0
To other general government units	5,347,372	5,544,174	4,831,625
Current	2,598,678	2,663,291	2,468,917
Capital	2,748,694	2,880,883	2,362,708
Social benefits	**56,148,295**	**56,906,555**	**56,482,968**
Social security benefits	40,605,352	43,008,291	42,752,824
Social assistance benefits	15,258,234	13,728,987	13,602,326
Employer social benefits	284,709	169,277	127,817
Other expense	**5,627,561**	**6,067,319**	**5,039,054**
Property expense other than interest	7,730	88	12
Miscellaneous other expense	5,619,832	6,067,231	5,039,042
Current	2,174,864	2,280,627	2,018,297
Capital	3,444,968	3,786,604	3,020,745

Source: Ministry of Finance

Budget Process

The legal framework regulating the area of public finance is set on four levels: the Constitution; the Budget Law 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 Law.

On 1 January 2009 the new Budget Law 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 (by mid-April).

2. The Strategy of the Government Programmes is adopted by the Government on the proposal of the Ministry of Finance (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.

In the first three months of 2012, temporary financing was initially in effect due to the parliamentary elections held at the end of 2011. Immediately after the new Government was formed, the budget preparation process started. In February 2012 the Parliament adopted the budget for 2012 and projections for the 2013 — 2014 periods.

Medium-term fiscal policy and fiscal developments in the 2012 Budget

In the context of greater economic uncertainty and risk at the global and domestic level, in the forthcoming mid-term period the key challenge of economic policy is preservation of macroeconomic stability and creation of conditions for recovery and stable economic growth. Fiscal policy in the forthcoming mid-term period will be based on three principles: 1) creation of preconditions for reviving the economy, primarily through the investment cycle and the improvement of business conditions, 2) sustainability of public finances in accordance with the Fiscal Responsibility Law, 3) protection of most vulnerable social groups of society.

The aforementioned three principles of fiscal policy are being implemented on both the revenue and expenditure side of the budget. Accordingly, several measures were introduced at the revenue side. For the purpose of further strengthening fairness in taxation of income from labour, from 1 March 2012 the level of basic personal allowance was raised and tax brackets adjusted, while the tax rates themselves remain the same. The contribution rate for compulsory health insurance paid by employers on gross salary of their employees will be reduced by two percentage points from 1 May 2012, which will improve cost competitiveness of the economy and stimulate employment. From 1 March the new general VAT rate of 25% was introduced and a lower rate applied to certain groups of goods and services that represented a heavier burden, in relative terms, for citizens with lower income. In the forthcoming period, the revenue side of the budget will be marked by further rationalisation of non-tax levies burdening entrepreneurs and revenues that are under the influence of further harmonisation of the Republic of Croatia with the European Union.

The measures on the expenditure side of the budget are primarily directed at improving fiscal imbalances and ensuring a sustainable level of financing in the presently still unfavourable financial and economic conditions. In adjusting expenditures to a realistic framework, apart from savings, additional expense should be accounted for in certain categories of expenditure in the forthcoming years. This primarily includes interest expenditure, expenditure arising from pensions and contributions that the Republic of Croatia will have to make to the EU budget. Accordingly, observing the provisions of the Fiscal Responsibility Law, as well as the need for closing the fiscal gaps, savings must be made in other groups of expenditure, where it is crucial to implement structural measures and reforms.

Consequently, the Government expects to quickly close the fiscal gaps that have been present in the past several years as a direct consequence of adverse economic developments. Apart from deficit reduction, one of the most important objectives is to halt the growth, and then reverse the trend, of the public debt as a share of GDP. For the described fiscal policy plan to be successful, it is extremely important to successfully implement the Fiscal Responsibility Law.

All the above mentioned goals and envisaged trends of fiscal policy are underpinned and dependant on the implementation of key structural reforms in the upcoming period.

Addressing economic activity in general, it is crucial to start the investment cycle. The Government will provide incentives by starting its own investment cycle and by supporting private investments through increased liquidity, tax and non-tax incentives for entrepreneurs and investors and by ensuring financial stability. The new investment cycle should be based on the public-private partnership, public sector resources, EU funds and development of financial institutions. Key short to medium term investment priorities include investment in energy (electricity, gas, oil derivatives) and various kinds of transport (rail, air, roads and highway). Improvement of the rule of law, protection of creditors and adherence to concluded contacts are some of the measures to be implemented in order to secure a positive investment climate and thus strengthen the competitiveness of the Croatian economy for foreign investment.

Supporting the judiciary in the efficient implementation of the bankruptcy law, establishing labour courts, reducing the duration of court proceedings, especially in the segment of collection of outstanding debts, and motivating parties in commercial disputes to opt for alternative methods of dispute solving will contribute to the achievement of the said goal, together with efficient anti-corruption measures at all levels of the society.

Further rationalisation and improvements in efficiency are planned in the realm of public administration reform, as well as in the sector of public property management.

There will also be a continuation of labour market measures aimed at tackling unemployment, especially among vulnerable categories (long-term, youth, women).

From 1 January 2012, pension adjustment will be reinstated, through the application of the so-called Swiss formula for pension indexation (i.e., adjustment in accordance with an index resulting from a 50% increase in gross salaries and 50% consumer price increase). Moreover, recent legal changes provide the persons who voluntarily joined the 2nd pillar of the pension insurance scheme (insured persons who on 1 January 2002 were aged 40 or more, but below the age of 50, and who by their own choice joined the so-called 2nd pillar — some 95,000) with the possibility of opting out from the scheme when they retire. It is estimated that it will prove more favourable for a significant number of insured persons who might decide to retire in the following years to return to the 1st pillar and that the transfer of assets from their personal accounts to mandatory pension funds, despite incurring expected higher costs arising from the payment of their pension from the 1st pillar, will benefit the state budget through increased income. As for the system of generation solidarity, the system of the minimum pension is under revision, in particular the system of financing the minimum pension, re-examining the possibilities of being granted minimum pension pursuant to the income or property qualifications, as well as re-examining the possibility of widening the scope of pension beneficiaries allowed to work under contracts of employment in addition to receiving their pension.

Plans in the social welfare are aimed at the improvement of the position of the socially vulnerable groups through introduction of uniform criteria for determining disability and functional incapacity, as well as the establishment of a common assessment body, the new organisation of social welfare centres under the model of "one-stop-shops" and further deinstitutionalisation of the social welfare system.

Finally, within the realm of healthcare, the system of electronic appointments and electronic medical records as well as the establishment of palliative care will be set up in the course of 2012, and efforts will continue to improve the criteria for the inclusion of the medicines on the basic medicine list.

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; 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 (OG 177/2004, entry into force on 1 January 2005, OG 73/2008, entry into force on 1 July 2008, OG 80/2010, entry into force on 1 July 2010, OG 114/2011, entry into force on 15 October 2011, and OG 22/2012, entry into force on 1 March 2012.).

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. By the amendments to the Income Tax Act (OG. 22/2012) income from capital also includes dividends and shares in profit on the basis of equity participation above HRK 12,000 on an annual basis. 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; and others do not count as income.

By the amendments to the Income Tax Act, which entered into force on 1 March 2012, the level of basic personal allowance is raised from HRK 1,800 to HRK 2,200, the level of personal allowance for pensioners is raised from HRK 3,200 to HRK 3,400, tax brackets are changed, but the rates at which this tax is paid remain unchanged. More specifically, under the new legislative amendments, income tax is levied at a rate of 12% on the amount from the taxable income to the amount of the basic personal allowance, at a rate of 25% on the taxable income difference from the amount of the basic personal allowance to the quadruple basic personal allowance and at a rate of 40% on the taxable income above the quadruple amount of the basic personal allowance. Accordingly, an increase in net wages for lower income groups is provided, and a reduction in net wages for higher income groups, which also contributes to progressiveness of taxation.

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 2,200	— Up to HRK 26,400	0 per cent. (personal allowance)
— Up to HRK 2,200	— Up to HRK 26,400	12 per cent.
— Over HRK 2,200 up to HRK 8,800 (*the next HRK 6,600,00*)	— Over HRK 26,400 up to HRK 105,600 (*the next HRK 79,200,00*)	25 per cent.
— Over HRK 8,800	— Over HRK 105,600	40 per cent.

Profit tax (Corporate Income Tax) is regulated by the Profit Tax Act (OG 177/2004, as amended). 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 was introduced in 2005. Withholding tax is tax levied on profits generated by a non-resident in Croatia and is charged on interest, dividends, shares in profit and copyright as well as other intellectual property rights, market research services, tax and auditing services, and business counselling services paid to foreign entities. Withholding tax is payable at the rate of 15 per cent., except for the dividends and shares in profit, for which the rate of withholding tax is 12 per cent. In addition, a rate of withholding tax of 20 per cent., is payable on services rendered by service providers which have their registered seat (or factual seat) in countries in which the general or average nominal profit tax amount less than 12.5 per cent., such countries being published on a list adopted by the Minister of Finance provided, however, that the special rate of withholding tax does not apply to the EU Member States.

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.

Changes in the Profit Tax Act, adopted by the Croatian Parliament on 18 June 2010 primarily aim to reduce tax evasion and to increase collection rates. The amended Profit Tax Act aid in the implementation of the activities 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) contribute to the reduction of tax evasion. Furthermore, the proposed legislation reduces 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.

The amendments to the Profit Tax Act (OG 22/2012) introduce obligation to pay tax after deduction on dividends and shares in profit. Amendments refer to decreasing taxable base in proportion to the part of the profit achieved and put into the fixed capital of the company, in accordance with special provisions. Also, by the mentioned amendments the article 31 of the Profit Tax Act, about withholding tax, has been aligned with the Council Directives (90/435/EEC, 2003/123/EC and 2006/98/EC), taking into effect introduction of the obligation to pay tax after deduction on dividends and shares in profit.

In Croatia, VAT was introduced on 1 January 1998, replacing retail sales tax, and is regulated by the Value Added Tax Act (OG 47/1995, as amended). 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 August 2009, amendments to the Value Added Tax Act (OG 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. As of 1 March 2012, the new general value added tax rate of 25% entered into force, implying the increase of VAT general rate of two percentage points. Given the regressive nature of this tax form, there is intention to make some changes in the tax system in order to ease the effect of the changes for lower-income categories of population. In that respect, instead of 23%, the VAT rate of 10% is applied for individual products and services, such as edible oils and fats of vegetable and animal origin, children's food and processed food for children and infants on the basis of cereals, supply of water, except bottled or otherwise packaged drinking water, white sugar from sugar cane and sugar beet. According to these latest amendments of the Value Added Tax Act, starting on 1 January 2013, the VAT rate of 10% will also be applicable on the services of preparing food and providing services of catering and preparing and serving non-alcoholic drinks and beverages, wine and beer in catering facilities.

Furthermore, in order to achieve greater rationality of the VAT system, abolishment of input VAT deduction is stipulated for acquisition and renting of vessels for entertainment, airplanes, personal motor cars and other types of personal transport, including acquisition of all goods and services in relation to of the aforementioned goods. Furthermore, complete abolishment of input VAT deduction is stipulated for acquisition of goods and services for the purpose of representation. These provisions simplify the process of determining the tax obligation, decrease tax evasion and also ensure the inflow of funds in the state budget.

At the beginning of April 2011, 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 (certain categories excluded) who owed taxes and certain other levies related to entrepreneurship at the end of 2010 (subsequently changed to 31 January 2012) because of the economic crisis, but have been regularly paying taxes after 1 January 2011 (subsequently changed to 31 January 2012) are able to settle the debt in instalments over 30 months (subsequently changed to 36 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. On 24 February 2012 the Croatian Parliament adopted the Law on Amendments to the Law on special measures for the collection of tax debt caused by the economic crisis, which was published in OG 25/12 on 28 February 2012. In addition to settlement of the debt in instalments, the possibility of write-off of tax debt on the basis of interest is prescribed.

PUBLIC DEBT

Overview

The total general government debt (which includes both the internal and external debt of the central government, extra-budgetary funds and local government) stood at HRK 156.0 billion as at 31 December 2011, corresponding to 45.7 per cent. of GDP. The majority of general government debt as at 31 December 2011 was internal debt (HRK 103.3 billion, amounting to 66.2 per cent.), whereas external debt amounted to HRK 52.7 billion or 33.8 per cent of total general government debt. Total government guarantees (including internal and external guarantees and guarantees in respect of HBOR) stood at HRK 59.8 billion as at 31 December 2011, corresponding to 17.5 per cent. of GDP.

The table set forth below provides an overview of general government debt and government guarantees in absolute terms and as a percentage of GDP as at the end of the preceding five years (2007-2011).

	2007	2008	2009	2010	2011
General Government Debt (HRK million)	104,670.1	100,634.2	117,733.0	138,007.8	155,971.9
- as a percentage of GDP	*32.9%*	*29.2%*	*35.1%*	*41.3%*	*45.7%*
Government Guarantees (HRK million)	26,962.2	44,613.7	50,922.6	59,350.3	59,837.2
- as a percentage of GDP	*8.5%*	*12.9%*	*15.2%*	*17.7%*	*17.5%*
Total (General Government Debt + Government Guarantees) *(HRK million)*	**131,632.3**	**145,248.0**	**168,655.6**	**197,358.1**	**215,809.2**
- as a percentage of GDP	***41.4%***	***42.1%***	***50.3%***	***59.0%***	***63.2%***

Source: Ministry of Finance and Croatian National Bank

According to Art. 74 of the Budget Law the maximum permitted level of general government debt is 60 per cent. of nominal GDP. Art. 75 of the Budget Law provides for more restrictive limits to be established annually under the Budget Execution Law for the relevant year. Under Art. 28 of the Budget Execution Law for 2012 (OG 24/12) the current limitation on general government debt is set at 55 per cent. of GDP. The Government aims for 65 to 75 per cent. of its debt obligations to be fixed rate obligations.

General Government Debt and Government Guarantees

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

	2007	2008	2009	2010	2011
			(end of period in HRK million)		
General Government Debt					
1. Internal Debt	60,145.9	65,755.4	75,799.7	89,249.1	103,289.2
1.1 Central Government	51,924.0	61,006.1	70,447.0	82,952.1	95,720.7
Treasury Bills	11,420.6	14,260.3	17,558.3	16,886.5	18,990.4
Money Market Instruments	—	10.7	19.3	20.5	20.6
Bonds	34,634.4	35,531.3	36,586.8	48,862.5	56,191.2
CNB Loans	1.0	2.2	2.9	0.3	0.8
Bank Loans	5,867.9	11,201.5	16,279.8	17,182.3	20,517.7
1.2 Government Funds & Agencies	6,357.8	3,035.0	3,794.4	4,604.7	5,791.5
Money Market Instruments	—	—	—	—	—
Bonds	—	—	—	—	—
Bank Loans	6,357.8	3,035.0	3,794.4	4,604.7	5,791.5
1.3 Local Governments	1,864.1	1,714.3	1,558.3	1,692.3	1,777.0
Money Market Instruments	36.8	12.0	6.8	1.6	6.4
Bonds	365.5	414.0	406.4	387.0	260.9
Bank Loans	1,461.8	1,288.3	1,145.1	1,303.6	1,509.6
2. External Debt	44,524.2	34,878.8	41,933.3	48,758.7	52,682.7
2.1 Central Government	34,190.6	32,619.4	39,812.5	46,445.4	50,365.2
Money Market Instruments	320.0	180.3	1,244.3	3,458.6	1,189.2
Bonds	25,046.1	22,991.6	28,884.2	31,684.5	36,962.4
Loans	8,824.5	9,447.4	9,684.1	11,302.3	12,213.6

	2007	2008	2009	2010	2011
		(end of period in HRK million)			
2.2 Government Funds & Agencies	10,000.7	1,826.1	1,715.3	1,988.2	2,092.2
Money Market Instruments	—	—	—	—	—
Bonds	—	—	—	—	—
Bank Loans	10,000.7	1,826.1	1,715.3	1,988.2	2,092.2
2.3 Local Governments	333.0	433.4	405.5	325.1	225.4
Money Market Instruments	—	—	—	—	—
Bonds	106.8	168.7	168.2	168.7	135.9
Bank Loans	226.1	264.7	237.2	156.4	89.5
3. Total General Government Debt (1+2)	**104,670.1**	**100.634.2**	**117,733.0**	**138,007.8**	**155,971.9**
Government Guaranties:	**26,962.2**	**44,613.7**	**50,922.6**	**59,350.3**	**59,837.2**
1. Internal	8,058.5	13,255.1	15,652.8	20,017.1	22,116.5
o/w HBOR	190.7	807.9	41.4	2,576.6	2,269.1
2. External	18,903.7	31,358.6	35,269.8	39,333.2	37,720.8
o/w HBOR	9,372.5	9,970.3	12,305.6	11,945.7	11,030.4

Source: Ministry of Finance and Croatian National Bank

(1) As from CNB Bulletin No. 146 (March 2009) HBOR (Croatian Bank for Reconstruction and Development) is reclassified from the central government funds sub-sector to the non-banking financial institutions sub-sector. The reclassification covers the entire statistical series. As well, the HAC (Croatian Motorways) is reclassified from the central government funds sub-sector to the public enterprises sub-sector. This reclassification covers the statistical series from January 2008 onwards.

Note: Exchange rate as at 31 December 2006-2011

General Government Debt

General government debt was composed of 64.4 per cent. (HRK 75.8 billion) in internal debt as at the end of 2009 (compared with 65.3 per cent., HRK 65.8 billion at the end of 2008) and 35.6 per cent. (HRK 41.9 billion) in external debt at the end of 2009 (compared with 34.7 per cent., HRK 34.9 billion at the end of 2008). As at 31 December 2010 the general government debt consisted of 64.7 per cent. (HRK 89.2 billion) in internal debt and 35.3 per cent. (HRK 48.8 billion) in external debt. As at 31 December 2011 the general government debt consisted of 66.2 per cent. (HRK 103.3 billion) in internal debt and 33.8 per cent. (HRK 52.7 billion) in external debt.

General government internal debt as a proportion of nominal GDP represented 19.9 per cent. of nominal GDP at the end of 2006, 18.9 per cent. at the end of 2007, 19.1 per cent. at the end of 2008, 22.6 per cent. at the end of 2009, and has risen to 26.7 per cent. of nominal GDP at the end of 2010 and to 30.3 per cent. of nominal GDP at the end of 2011. 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, 14.0 per cent. at the end of 2007, 10.1 per cent. at the end of 2008, and has risen to 12.5 per cent. at the end of 2009, 14.6 per cent. at the end of 2010 and to 15.4 per cent. at the end of 2011.

General government debt increased by HRK 20.3 billion from 2009 to 2010, which was accompanied by an increase in the proportion of general government debt as percentage of nominal GDP from 35.1 per cent. in 2009 to 41.3 per cent. in 2010. In 2011 general government debt increased by HRK 18.0 billion in comparison to 2010 bringing the proportion of general government debt to 45.7 per cent. of nominal GDP. The external component of general government debt recorded an increase of HRK 3.9 billion and stood at 15.4 per cent. of nominal GDP at the end of 2011, which is an annual increase of 0.8 percentage points in comparison with 2010 when it was 14.6 per cent. of nominal GDP. The internal component of the general government debt recorded an increase of HRK 14.1 billion, and its share of nominal GDP increased from 26.7 per cent. in 2010 to 30.3 per cent. in 2011.

The largest share of general government debt relates to central government, which was HRK 93.6 billion in 2008, HRK 110.3 billion in 2009, HRK 129.4 billion in 2010 and 146.1 billion in 2011. The total amount of debt relating to Government Funds and Agencies was HRK 4.9 billion in 2008, HRK 5.5 billion in 2009, HRK 6.6 billion in 2010 and 7.9 billion in 2011. The total amount of debt relating to local governments was HRK 2.1 billion in 2008, 2.0 billion in 2009, 2.0 billion in 2010 and 2.0 billion in 2011.

Government Funds and Agencies (i.e., extra-budgetary funds) are established through an act of law and are financed from special purpose taxes, i.e., contributions and/or non-tax revenues, and are managed predominantly by the Government or local/regional governments (Budget Law, OG 87/2008).

Government Guarantees

Total guarantees issued by Croatia increased from HRK 33.8 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), HRK 44.8 billion in 2010 (13.4 per cent. of nominal GDP) and to HRK 46.5 in 2011 (13.6 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, 8.2 per cent. in 2010 and to 7.8 per cent. in 2011. It is expected that due to the finalisation of the restructuring of the shipbuilding sector, in 2012 the Government will assume the guarantees issued to the shipyards amounting to HRK 9.2 billion and consequently increase its internal and external direct debt.

Internal Central Government Debt and Internal Central Government Debt Instruments

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

Debt item

	Year ended 31 December					
	2007	**2008**	**2009**	**2010**	**2011**	**Maturity**
			(HRK thousands)			*(year)*
Big Bonds Series I	1,964,084	2,179,752	2,140,826	2,209,572	0	2011
Big Bonds Series II	304,995	236,586	162,803	85,202		2011
Big Bonds Series III	319,974	257,403	189,809	119,226	42,080	2012
G Bonds — Series 02 D-08	1,465,026	0	0	0	0	2008
G Bonds — Series 03 D-12	3,662,566	3,662,213	3,653,100	3,692,587	3,765,210	2012
G Bonds — Series 04 D-08	1,000,000	0	0	0	0	2008
G Bonds — Series 05 D-14	4,761,335	4,760,876	4,749,029	4,800,362	4,894,773	2014
G Bonds — Series 07 D-19	3,662,566	3,662,213	3,653,100	3,692,587	3,765,210	2019
G Bonds — Series 08 D-10	3,000,000	3,000,000	3,000,000	0	0	2010
G Bonds — Series 09 D-15	2,563,796	2,563,549	2,557,170	2,584,811	2,635,647	2015
G Bonds — Series 10 D-15	5,500,000	5,500,000	5,500,000	5,500,000	5,500,000	2015
G Bonds — Series 11 D-13	4,000,000	4,000,000	4,000,000	4,000,000	4,000,000	2013
G Bonds — Series 12 D-17	5,500,000	5,500,000	5,500,000	5,500,000	5,500,000	2017
G Bonds — Series 13 D-20	0	0	0	5,000,000	5,000,000	2020
G Bonds — Series 14 D- 20	0	0	0	7,385,173	7,530,420	2020
G Bonds — Series 15 D- 17	0	0	0	4,000,000	4,000,000	2017
G Bonds — Series 16 D- 16	0	0	0	0	1,500,000	2016
G Bonds — Series 17 D- 22	0	0	0	0	4,518,252	2022
BRA Bonds — Series I	0	0	0	0	0	2007
BRA Bonds — Series II	123,299	98,200	71,665	44,521	15,486	2012
BRA Bonds — Series III	331,787	266,906	196,817	123,627	43,634	2012
BRA Bonds — Series IV	168,777	134,421	98,099	60,942	21,198	2012
BRA Bonds — Series Vb	212,561	0	0	0	0	2008
Syndicated Loan I	3,662,566	3,662,213	3,653,100	3,692,587	3,765,210	2014
Syndicated Loan II	0	5,566,563	5,552,711	5,612,731	5,723,119	2013
Syndicated Loan III	0	0	5,479,649	5,538,880	5,647,815	2014
Syndicated Loan IV	0	0	0	0	1,957,909	2016
Medium and long term debt	**42,203,331**	**45,050,894**	**50,157,877**	**63,642,806**	**69,825,963**	
Treasury Bills	11,975,258	14,605,000	12,135,000	11,545,000	15,285,000	
Other short term debt	476,268	300,000	0	0	0	
Treasury Bills FX		2,170,169	9,968,278	9,173,589	5,228,837	
Short term debt	**12,451,526**	**17,075,169**	**22,103,278**	**20,718,589**	**20,513,837**	
Total debt	**54,654,857**	**62,126,062**	**72,261,156**	**84,361,395**	**90,339,800**	

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	2011
			(per cent.)		
364 days HRK	4.13	6.27	7.15	3.96	3.71
364 days EUR	—	7.95	6.98	3.33	3.84

Source: Office of Public Debts

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.

As of 31 December 2011, the average maturity of Croatia's domestic central government debt was 4.6 years.

Domestic banks syndicated loans amounting to EUR 380 million and domestic bonds amounting to EUR 500 million are scheduled to mature during 2012.

The following table sets forth Croatia's domestic central government debt stock which is, as of 31 December 2011, scheduled to be redeemed between 2012 and 2022.

Redemption of domestics debt	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					(HRK million)						
Redemption of principal	**7,140.75**	**11,959.65**	**9,992.87**	**8,527.23**	**1,891.58**	**9,500.00**	**0.00**	**3,765.21**	**12,530.42**	**0.00**	**4,518.25**
Big bonds I	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds II	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds III	42.08	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series II	15.49	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series III	43.63	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series IV	21.20	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 03 D-12	3,765.21	0.00	0.00	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	4,894.77	0.00	0.00	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	3,765.21	0.00	0.00	0.00
Bonds — Series 09 D-15	0.00	0.00	0.00	2,635.65	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 10 D-15	0.00	0.00	0.00	5,500.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 11 D-13	0.00	4,000.00	0.00	0.00	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	5,500.00	0.00	0.00	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	5,000.00	0.00	0.00
Bonds — Series 14 D-20	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	7,530.42	0.00	0.00
Bonds — Series 15 D-17	0.00	0.00	0.00	0.00	0.00	4.000.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 16 D-16	0.00	0.00	0.00	0.00	1.500.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 17 D-22	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	4,518.25
FX Syndicated Loan I	0.00	1,882.61	1,882.61	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan II	2.861.56	2.861.56	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan III	0.00	2.823.91	2.823.91	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan IV	391.58	391.58	391.58	391.58	391.58	0.00	0.00	0.00	0.00	0.00	0.00
Interest payments	**3,754.32**	**3,398.71**	**2,727.49**	**2,364.97**	**1,942.43**	**1,703.67**	**1,323.04**	**1,323.04**	**707.18**	**293.69**	**293.69**
Big bonds I	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds II	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Big bonds III	1.51	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series II	0.39	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series III	1.57	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
BRA bonds — Series IV	0.53	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 03 D-12	129.43	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 05 D-14	269.21	269.21	134.61	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 07 D-19	202.38	202.38	202.38	202.38	202.38	202.38	202.38	202.38	0.00	0.00	0.00
Bonds — Series 09 D-15	112.01	112.01	112.01	112.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 10 D-15	288.75	288.75	288.75	288.75	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 11 D-13	180.00	180.00	0.00	0.00	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	130.63	0.00	0.00	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	168.75	0.00	0.00
Bonds — Series 14 D-20	489.48	489.48	489.48	489.48	489.48	489.48	489.48	489.48	244.74	0.00	0.00
Bonds — Series 15 D-17	250.00	250.00	250.00	250.00	250.00	250.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 16 D-16	86.25	86.25	86.25	86.25	86.25	0.00	0.00	0.00	0.00	0.00	0.00
Bonds — Series 17 D-22	293.69	293.69	293.69	293.69	293.69	293.69	293.69	293.69	293.69	293.69	293.69
FX Syndicated Loan I	209.66	156.67	52.13	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan II	224.18	74.59	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan III	307.06	309.59	153.95	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
FX Syndicated Loan IV	109.48	87.34	65.50	43.66	21.88	0.00	0.00	0.00	0.00	0.00	0.00
Total debt service	**10,895.07**	**15,358.36**	**12,720.36**	**10,892.20**	**3,834.01**	**11,203.67**	**1,323.04**	**5,088.25**	**13,237.60**	**293.69**	**4,811.94**

Source: Ministry of Finance

Note: Exchange rate: Mid exchange rate of the CNB as of 31 December 2011

External Debt

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

	As at 31 December				
	2007	**2008**	**2009**	**2010**	**2011**
			(per cent.)		
General government external debt/GDP	14.0	10.1	12.5	14.6	15.4
Governmental external guaranties(incl. HBOR)/ GDP	5.9	9.1	10.5	11.8	11.1
Total external debt (private and government) (*)/GDP	77.7	85.0	99.1	101.2	99.6

Source: Croatian National Bank, Ministry of Finance

* Total external debt, including private external debt, general government external debt and general government external guarantees (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:

	As at 31 December				
	2007	**2008**	**2009**	**2010**	**2011**
	(per cent.)				
Ratio of total debt service to exports of goods & services	35.1	29.7	46.8	41.9	36.9

As of 31 December 2011, the average maturity of Croatia's external central government debt was 7.2 years.

Foreign currency and foreign currency linked debt accounted for 73.9 per cent. of the general government debt as at 31 December 2011. As of 31 December 2012, Croatia has hedging arrangements in place in respect of its last two U.S. dollar denominated bond issues (U.S.$1.25 billion issued in July 2010 and 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.

As of the date hereof, Croatia has raised no new external debt in 2012. The Republic expects to issue a total of approximately EUR 1.2 billion (approximately USD 1.6 billion) in the international capital markets during 2012 to repay maturing debt and to finance the deficit.

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.

Relations with the IMF

Croatia currently has an undrawn 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.

The following table sets out the outstanding bonds issued by Croatia in the international bond market as at 31 December 2011 and the debt service schedule for each year until 2020:

Projection of Repayments of International Bonds of the Republic of Croatia

		Amount in EUR	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
EUR 500,000,000	*Principal*	500,000,000	0	0	500,000,000							
5.0 per cent. Notes due 2014	*Interest*		25,000,000	25,000,000	25,000,000							
EUR 750,000,000	*Principal*	750,000,000	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						
EUR 750,000,000	*Principal*	750,000,000	0	0	0	0	0	0	750,000,000			
5.875 per cent. Notes due 2018	*Interest*		44,062,500	44,062,500	44,062,500	44,062,500	44,062,500	44,062,500	44,062,500			
US $1.500,000,000	*Principal*	1,159,285,936	0	0	0	0	0	0	0	1,159,285,936		
6.75 per cent. Notes due 2019	*Interest*		78,251,801	78,251,801	78,251,801	78,251,801	78,251,801	78,251,801	78,251,801	78,251,801		
US $1,250,000,000	*Principal*	966,071,614	0	0	0	0	0	0	0	0	966,071,614	
6.625 per cent. Notes due 2020	*Interest*		60,379,476	60,379,476	60,379,476	60,379,476	60,379,476	60,379,476	60,379,476	60,379,476	60,379,476	
US $1,500,000,000	*Principal*	1,159,285,936	0	0	0	0	0	0	0	0	0	1,159,285,936
6.375 per cent. Notes due 2021	*Interest*		73,904,478	73,904,478	73,904,478	73,904,478	73,904,478	73,904,478	73,904,478	73,904,478	73,904,478	73,904,478
Principal repayment (EUR*)			0	0	500,000,000	750,000,000	0	0	750,000,000	1,159,285,936	966,071,614	1,159,285,936
Interest repayment (EUR*)			330,348,255	330,348,255	330,348,255	305,348,255	256,598,255	256,598,255	256,598,255	212,535,755	134,283,954	73,904,478
Total Servicing Cost (EUR*)			330,348,255	330,348,255	830,348,255	1,055,348,255	256,598,255	256,598,255	1,006,598,255	1,371,821,691	1,100,355,568	1,233,190,415
Total Principal Outstanding (at year end EUR*)		**5,284,643,486**	**5,284,643,486**	**5,284,643,486**	**4,784,643,486**	**4,034,643,486**	**4,034,643,486**	**4,034,643,486**	**3,284,643,486**	**2,125,357,550**	**1,159,285,936**	**0**

Source: Ministry of Finance

Note Exchange rate: Mid exchange rate of the CNB as of 31 December 2011

Total External Debt (Public and Private)

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

	As at 31 December[1]				
	2007	2008	2009	2010	2011
	(EUR millions)				
Government	**6,064.8**	**4,762.0**	**5,739.4**	**6,602.2**	**6,996.0**
Short-term	49.0	60.3	170.4	469.2	157.9
Money market instruments	43.7	24.6	170.3	468.3	157.9
Credits	0.0	31.7	0.0	0.0	0.0
Trade credits	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	5.3	4.0	0.1	0.9	0.0
Principal arrears	1.1	3.9	0.1	0.8	0.0
Interest arrears	4.2	0.1	0.0	0.1	0.0
Other	0.0	0.0	0.0	0.0	0.0
Long-term	6,015.8	4,701.7	5,569.0	6,133.1	6,838.1
Bonds	3,406.2	3,162.1	3,976.4	4,313.1	4,926.5
Credits	2,608.4	1,538.9	1,592.6	1,819.9	1,911.6
Trade credits	1.2	0.7	0.0	0.0	0.0
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Croatian National Bank	**2.3**	**2.3**	**1.1**	**1.2**	**0.1**
Short-term	2.3	2.3	1.1	1.2	0.1
Money market instruments	0.0	0.0	0.0	0.0	0.0
Credits	(0.0)	(0.0)	0.0	0.0	0.0
Currency and deposits	2.3	2.3	1.1	1.2	0.1
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Long-term	0.0	0.0	0.0	0.0	0.0
Banks	**8,892.6**	**10,088.9**	**10,688.7**	**10,753.0**	**11,627.9**
Short-term	2,361.2	3,793.3	3,091.8	3,003.5	3,572.0
Money market instruments	0.0	0.0	0.0	0.0	0.0
Credits	710.8	1,121.1	806.8	930.1	511.1
Currency and deposits	1,648.8	2,670.3	2,283.9	2,073.0	3,060.6
Other debt liabilities	1.7	2.0	1.2	0.4	0.2
Principal arrears	0.1	0.0	0.0	0.0	0.0
Interest arrears	1.5	2.0	1.2	0.4	0.2
Other	0.0	0.0	0.0	0.0	0.0
Long-term	6,531.4	6,295.6	7,596.9	7,749.5	8,056.0
Bonds	472.5	466.6	9.0	8.9	1.9
Credits	3,565.1	3,373.9	3,545.3	3,355.7	3,739.7
Currency and deposits	2,493.9	2,455.0	4,042.7	4,384.9	4,314.4
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Other Sectors	**14,828.3**	**19,901.0**	**20,993.8**	**20,929.2**	**20,181.7**
Short-term	1,478.2	925.3	1,346.7	1,613.5	1,485.2
Money market instruments	0.0	0.0	0.0	0.0	0.1
Credits	681.0	652.9	677.7	519.1	415.7
Currency and deposits	0.0	0.0	0.0	0.0	0.0
Trade Credits	31.1	39.5	28.2	30.9	33.9
Other debt liabilities	766.0	232.9	640.9	1,063.5	1,035.5
Principal arrears	683.4	170.4	523.6	892.8	861.8
Interest arrears	82.6	62.5	117.2	170.7	173.7
Other	0.0	0.0	0.0	0.0	0.0
Long-term	13,350.1	18,975.7	19,647.1	19,315.7	18,696.5
Bonds	1,293.4	1,251.6	1,665.8	1,590.1	1,386.2
Credits	11,766.9	17,391.3	17,688.7	17,437.1	17,178.8
Currency and deposits	0.0	10.6	0.0	0.0	0.0
Trade Credits	289.8	322.2	292.6	288.4	131.4
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Direct Investment	**3,932.8**	**5,835.9**	**7,821.2**	**8,197.8**	**6,927.7**
of which round-tripping transactions			825.6	1,499.0	
Short-term	540.4	1,415.7	446.8	923.8	1,324.2
Money market instruments	0.0	0.0	0.0	0.0	0.0
Credits	216.8	1,314.0	343.2	765.2	1,068.3
Trade credits	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	323.6	101.6	103.6	158.6	255.9
Principal arrears	293.9	85.8	73.5	124.5	207.5
Interest arrears	29.7	15.8	30.1	34.2	48.4
Other	0.0	0.0	0.0	0.0	0.0

	As at 31 December[1]				
	2007	2008	2009	2010	2011
	(EUR millions)				
Long-term	3,392.5	4,420.2	7,374.4	7,274.0	5,603.6
Bonds	0.0	0.0	0.0	0.0	0.0
Credits	3,374.5	4,414.7	7,373.4	7,271.0	5,600.0
Trade credits	18.0	5.5	1.0	3.0	3.6
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Total	**33,720.8**	**40,590.0**	**45,244.3**	**46,483.4**	**45,733.4**
Total (excluding round-tripping transactions)	**33,720.8**	**40,590.0**	**44,418.7**	**44,984.4**	**45,733.4**

Source: Croatian National Bank

[1] Exchange rate as at 31 December in the relevant year.

Gross External Debt (Public and Private) Service and Maturity Calendar

The projected principal and interest service payments for all external debt outstanding as at 31 December 2011 is provided in the following tables.

Gross External Debt (Public and Private) by Domestic Sectors and Projected Principal Payments

	External Debt as at 31 December 2011	Immediate	Projected future principal payments during										
			2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Other
	(EUR millions)												
Public sector	**14,076.2**	**78.0**	**2,238.9**	**1,330.9**	**1,385.3**	**1,481.5**	**539.6**	**1,089.6**	**713.4**	**1,500.8**	**1,140.1**	**1,244.0**	**1,334.1**
Short-term	337.3	75.7	261.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	13,522.1	0.0	1,836.6	1,330.9	1,385.3	1,481.5	539.6	1,089.6	713.4	1,428.6	1,140.1	1,244.0	1,332.5
Direct investment	216.7	2.3	140.6	0.0	0.0	0.0	0.0	0.0	0.0	72.2	0.0	0.0	1.6
Short-term	132.6	2.3	130.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	84.1	0.0	10.3	0.0	0.0	0.0	0.0	0.0	0.0	72.2	0.0	0.0	1.6
Publicly guaranteed private sector	2.7	0.0	2.4	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	2.7	0.0	2.4	0.3	0.0	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	31,654.5	1,213.6	12,530.9	4,219.6	2,485.8	1,542.5	2,153.2	2,018.4	1,300.7	1,091.3	750.6	340.6	2,007.4
Short-term	4,877.8	960.0	3,917.8	0.0	(0.0)	(0.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	20,065.7	0.0	5,699.7	3,614.7	1,905.3	1,222.8	1,828.5	1,787.3	1,181.2	725.0	550.9	277.0	1,273.4
Direct investment	6,711.0	253.6	2,913.4	604.9	580.6	319.7	324.7	231.1	119.5	366.3	199.7	63.6	734.1
Short-term	1,191.6	253.6	938.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	5,519.4	0.0	1,975.4	604.9	580.6	319.7	324.7	231.1	119.5	366.3	199.7	63.6	734.1
Total	**45,733.4**	**1,291.6**	**14,772.1**	**5,550.8**	**3,871.2**	**3,023.9**	**2,692.8**	**3,108.1**	**2,014.1**	**2,592.1**	**1,890.6**	**1,584.6**	**3,341.5**

Source: Croatian National Bank

[1] Exchange rate as at 31 December in the relevant year.

Gross External Debt (Public and Private) by Domestic Sectors and Projected Interest Payments

	Gross External Debt as at 31 December 2011	Immediate	Projected future interest payments during										
			2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Other
						(EUR millions)							
Public sector	**14,076.2**	**0.0**	**403.6**	**539.6**	**499.3**	**436.8**	**366.6**	**348.1**	**303.1**	**274.3**	**183.4**	**80.5**	**163.2**
Short-term	337.3	0.0	3.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	13,522.1	0.0	397.8	539.6	499.3	436.8	366.6	348.1	303.1	269.7	183.4	80.5	163.2
Direct investment	216.7	0.0	2.4	0.0	0.0	0.0	0.0	0.0	0.0	4.6	0.0	0.0	0.0
Short-term	132.6	0.0	1.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	84.1	0.0	1.1	0.0	0.0	0.0	0.0	0.0	0.0	4.6	0.0	0.0	0.0
Publicly guaranteed private sector	2.7	0.0	0.0	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	2.7	0.0	0.0	1.7	0.0	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	31,654.5	0.0	747.2	600.4	454.4	374.9	339.9	239.8	184.3	284.7	241.6	76.3	604.6
Short-term	4,877.8	0.0	49.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	20,065.7	0.0	576.0	514.1	384.7	321.6	274.7	182.2	149.8	94.8	126.0	66.6	205.2
Direct investment	6,711.0	0.0	121.8	86.3	69.7	53.3	65.2	57.6	34.6	189.9	115.6	9.8	399.3
Short-term	1,191.6	0.0	19.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	5,519.4	0.0	102.2	86.3	69.7	53.3	65.2	57.6	34.6	189.9	115.6	9.8	399.3
Total	**45,733.4**	**0.0**	**1,150.9**	**1,141.6**	**953.7**	**811.7**	**706.6**	**587.9**	**487.4**	**559.0**	**425.0**	**156.8**	**767.8**

Source: Croatian National Bank

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

TAXATION

The comments below are of a general nature only and are based on the provisions currently in force. Prospective Noteholders should consult their tax advisers as to the tax laws and specific tax consequences of acquiring, holding and disposing of the Notes.

Croatia

Under existing Croatian laws and regulations, payments of principal on the Notes to any individual or legal entity which is not resident or incorporated in Croatia will not be subject to taxation in Croatia, and no withholding of any Croatian tax will be required on any such payments. Pursuant to the Personal Income Tax Act payment of the interest on the Notes to foreign natural persons is not subject to personal income tax. Pursuant to the Profit Tax Act, interest on Notes held by foreign legal persons are exempted from payment of a withholding tax.

No Croatian tax will be payable in respect of any gain, whether realised or unrealised, made by a holder (which is not resident or incorporated in Croatia) in respect of any Notes. No stamp, registration or similar duties or taxes will be payable in Croatia by Noteholders in connection with the issue or transfer of the Notes. However, subject to any applicable double taxation treaty, a natural or legal person who inherits or receives gifts (including Notes) in the Republic is under an obligation to pay Croatian tax in respect of such inheritance or gift, in accordance with applicable laws.

United States

U.S. Federal Income Taxation

The discussion of U.S. tax matters in this Prospectus is not intended or written to be used, and cannot be used by any person, for the purpose of avoiding U.S. federal, state or local tax penalties, and was written to support the promotion or marketing of the offering of the Notes. Each taxpayer should seek advice based on such person's particular circumstances from an independent tax adviser.

The following summary of the material U.S. federal income tax considerations of the purchase, ownership and disposition of the Notes by a U.S. Holder (as defined below) is based upon the U.S. Internal Revenue Code of 1986, as amended (the "**Code**"), final, temporary and proposed Treasury regulations issued thereunder, and published judicial and administrative interpretations thereof, each as of the date hereof, and all of which are subject to change, possibly with retroactive effect.

This summary does not purport to be a complete analysis of all potential tax consequences. This discussion does not address all of the U.S. federal income tax consequences that may be relevant to an investor in light of such investor's particular circumstances or to investors subject to special treatment under U.S. federal income tax laws, such as certain financial institutions, certain U.S. expatriates, insurance companies, retirement plans, dealers in securities or foreign currencies, traders in securities that elect mark-to-market tax accounting, U.S. Holders whose functional currency is not the US dollar, partnerships, tax-exempt organisations, regulated investment companies, real estate investment trusts, persons subject to alternative minimum tax and persons holding the Notes as part of a "straddle," "hedge," "conversion transaction" or other integrated transaction. In addition, this discussion is limited to persons that purchase the Notes for cash at original issue and at their "issue price" (the first price at which a substantial part of the Notes are sold to the public for cash, excluding sales to bond houses, brokers or similar persons or organisations acting in the capacity of underwriters, placement agents or wholesalers) and that hold the Notes as capital assets for U.S. federal income tax purposes.

For purposes of this discussion, the term "U.S. Holder" means a beneficial owner of a Note that is, for U.S. federal income tax purposes, (i) an individual that is a citizen or resident of the United States, (ii) a corporation created or organised in, or under the laws of, the United States, any state therein or the District of Columbia, (iii) an estate the income of which is subject to U.S. federal income tax regardless of its source, or (iv) a trust primarily supervised by a U.S. court and controlled by U.S. persons.

If a partnership or an entity classified as a partnership for U.S. federal income tax purposes invests in Notes, the U.S. federal income tax treatment of a partner in such partnership will generally depend upon the status of such partner and the activities of the partnership. Prospective investors that are partnerships, and partners in such partnerships, should consult their own tax advisers to determine the U.S. federal income tax consequences to them of the purchase, ownership and disposition of the Notes.

The Republic does not currently intend to issue further notes forming a single Series with the Notes that have more than *de minimis* original issue discount for U.S. federal income tax purposes ("**OID**") unless such further notes are issued in a "qualified reopening" for U.S. federal income tax purposes. However, the determination regarding whether to proceed with any proposed further issue will be made at the time of such further issue and the Republic may decide to proceed even if a particular further issue would be issued with more than *de minimis* OID and not in a qualified reopening. The Republic is under no obligation to notify Noteholders of any such determination and no assurances can be given in respect of such determination.

Prospective purchasers of the Notes should consult their own tax advisers concerning the tax consequences of investing in Notes in light of their particular circumstances, including the application of the U.S. federal income tax considerations discussed below, as well as the application of other tax laws.

Payments of interest

Payments of interest on the Notes generally will be taxable to a U.S. Holder as ordinary income at the time that such payments are received or accrued, in accordance with such U.S. Holder's usual method of accounting for U.S. federal income tax purposes. Interest income on a Note generally will constitute foreign source income for U.S. federal income tax purposes and generally will be considered "passive" income, which is treated separately from other types of income in computing the foreign tax credit that may be allowable to U.S. Holders under U.S. federal income tax laws. U.S. Holders should consult their own tax advisers regarding the calculation and availability of foreign tax credits.

Sale, exchange and redemption of Notes

Generally, upon the sale, exchange or redemption of a Note, a U.S. Holder will recognise taxable gain or loss equal to the difference between the amount realised on the sale, exchange, or redemption (less any amount attributable to accrued but unpaid interest, which will be treated as a payment of interest in the manner described above) and such U.S. Holder's adjusted tax basis in the Note. A U.S. Holder's adjusted tax basis in a Note generally will equal the amount paid for the Note. Such gain or loss generally will be capital gain or loss and will be long term capital gain or loss if at the time of sale, exchange or redemption the Note has been held by such U.S. Holder for more than one year. The deductibility of capital losses by U.S. Holders is subject to limitations. Gain or loss realised by a U.S. Holder on the sale or retirement of a Note generally will be U.S. source.

Information reporting and backup withholding

Information returns may be filed with the U.S. Internal Revenue Service (the "**IRS**") (unless the U.S. Holder establishes, if requested to do so, that it is an exempt recipient) in connection with payments on the Notes, and the proceeds from the sale, exchange or other disposition of Notes. If information reports are required to be made, a U.S. Holder may be subject to U.S. backup withholding if it fails to provide its taxpayer identification number, or to establish that it is exempt from backup withholding. The amount of any backup withholding imposed on a payment will be allowed as a credit against any U.S. federal income tax liability of a U.S. Holder and may entitle the U.S. Holder to a refund, provided the required information is timely furnished to the IRS.

U.S. Holders should consult their own tax advisers regarding any reporting obligations they may have as a result of their acquisition, ownership or disposition of Notes. Failure to comply with certain reporting obligations could result in the imposition of substantial penalties.

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 or to certain limited types of entities established 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.

CLEARING AND SETTLEMENT ARRANGEMENTS

*The information set out below is subject to any change in or reinterpretation of the rules, regulations and procedures of DTC, Euroclear or Clearstream, Luxembourg (together, the **"Clearing Systems"**) currently in effect. The information in this section concerning the Clearing Systems has been obtained from sources that the Republic believes to be reliable, but neither the Republic or the Joint Lead Managers takes any responsibility for the accuracy of this section. Investors wishing to use the facilities of any of the Clearing Systems are advised to confirm the continued applicability of the rules, regulations and procedures of the relevant Clearing System. None of the Republic and any other party to the Agency Agreement will have any responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interests in the Notes held through the facilities of any Clearing System or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.*

Clearing Systems

Euroclear and Clearstream, Luxembourg

Euroclear and Clearstream, Luxembourg each hold securities for their customers and facilitate the clearance and settlement of securities transactions by electronic book-entry transfer between their respective account holders. Euroclear and Clearstream, Luxembourg provide various services including safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Euroclear and Clearstream, Luxembourg also deal with domestic securities markets in several countries through established depositary and custodial relationships. Euroclear and Clearstream, Luxembourg have established an electronic bridge between their two systems across which their respective participants may settle trades with each other.

Euroclear and Clearstream, Luxembourg customers are worldwide financial institutions, including underwriters, securities brokers and dealers, banks, trust companies and clearing corporations. Indirect access to Euroclear and Clearstream, Luxembourg is available to other institutions that clear through or maintain a custodial relationship with an account holder of either system.

DTC

DTC has advised the Republic that it is a limited purpose trust company organised under the New York Banking Law, a member of the Federal Reserve System, a "banking organisation" within the meaning of the New York Banking Law, a "clearing corporation" within the meaning of the New York Uniform Commercial Code and a "clearing agency" registered pursuant to Section 17A of the Exchange Act. DTC holds securities that its participants ("**Direct Participants**") deposit with DTC. DTC also facilitates the settlement among Direct Participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerised book-entry changes in Direct Participants' accounts, thereby eliminating the need for physical movement of securities certificates. Direct Participants include both U.S. and non U.S. securities brokers and dealers, banks, trust companies, clearing corporations and certain other organisations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("**DTCC**"). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non U.S. securities brokers and dealers, banks and trust companies that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("**Indirect Participants**" and, together with Direct Participants, "**Participants**"). More information about DTC can be found at www.dtcc.com and www.dtc.org.

Under the rules, regulations and procedures creating and affecting DTC and its operations (the "**DTC Rules**"), DTC makes book-entry transfers of Registered Notes among Direct Participants on whose behalf it acts with respect to Notes accepted into DTC's book-entry settlement system ("**DTC Notes**") as described below and receives and transmits distributions of principal and interest on DTC Notes. The DTC Rules are on file with the Securities and Exchange Commission. Direct Participants and Indirect Participants with which beneficial owners of DTC Notes ("**Owners**") have accounts with respect to the DTC Notes similarly are required to make book-entry transfers and receive and transmit such payments on behalf of their respective Owners. Accordingly, although Owners who hold DTC Notes through Direct Participants or Indirect Participants will not possess Registered Certificates, the DTC Rules, by virtue of the requirements described above, provide a mechanism by which Direct Participants will receive payments and will be able to transfer their interest in respect of the DTC Notes.

Purchases of DTC Notes under the DTC system must be made by or through Direct Participants, which will receive a credit for the DTC Notes on DTC's records. The ownership interest of each actual purchaser of each DTC Note

("**Beneficial Owner**") is in turn to be recorded on the Direct and Indirect Participant's records. Beneficial Owners will not receive written confirmation from DTC of their purchase, but Beneficial Owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the DTC Notes are to be accomplished by entries made on the books of Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in DTC Notes, except in the event that use of the book-entry system for the DTC Notes is discontinued.

To facilitate subsequent transfers, all DTC Notes deposited by Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorised representative of DTC. The deposit of DTC Notes with DTC and their registration in the name of Cede & Co. or such other DTC nominee effect no change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the DTC Notes; DTC's records reflect only the identity of the Direct Participants to whose accounts such DTC Notes are credited, which may or may not be the Beneficial Owners. The Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Redemption notices shall be sent to DTC. If less than all of the DTC Notes within an issue are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such issue to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to DTC Notes unless authorised by a Direct Participant in accordance with DTC's Money Market Instrument Procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Issuer as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the DTC Notes are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal and interest payments on the DTC Notes will be made to Cede & Co., or such other nominee as may be requested by an authorised representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Issuer or the relevant agent (or such other nominee as may be requested by an authorised representative of DTC), on the relevant payment date in accordance with their respective holdings shown in DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name", and will be the responsibility of such Participant and not of DTC, relevant agents or the Issuer, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal and interest to DTC is the responsibility of the Issuer, disbursement of such payments to Direct Participants is the responsibility of DTC, and disbursement of such payments to the Beneficial Owners is the responsibility of Direct and Indirect Participants.

Under certain circumstances, including if there is an Event of Default under the Notes, DTC will exchange the DTC Notes for definitive Registered Notes, which it will distribute to its Participants in accordance with their proportionate entitlements and which, if representing interests in a Rule 144A Global Note, will be legended as set forth under "*Subscription and Sale*" and "*Transfer Restrictions*".

A Beneficial Owner shall give notice to elect to have its DTC Notes purchased or tendered, through its Participant, to the relevant agent, and shall effect delivery of such DTC Notes by causing the Direct Participant to transfer the Participant's interest in the DTC Notes, on DTC's records, to the relevant agent. The requirement for physical delivery of DTC Notes in connection with an optional tender or a mandatory purchase will be deemed satisfied when the ownership rights in the DTC Notes are transferred by Direct Participants on DTC's records and followed by a book-entry credit of tendered DTC Notes to the relevant agent's DTC account.

DTC may discontinue providing its services as depository with respect to the DTC Notes at any time by giving reasonable notice to the Issuer or the relevant agent. Under such circumstances, in the event that a successor depository is not obtained, DTC Note certificates are required to be printed and delivered.

The Issuer may decide to discontinue use of the system of book-entry-only transfers through DTC (or a successor securities depository). In that event, DTC Note certificates will be printed and delivered to DTC.

Since DTC may only act on behalf of Direct Participants, who in turn act on behalf of Indirect Participants, any Owner desiring to pledge DTC Notes to persons or entities that do not participate in DTC, or otherwise take actions with respect to such DTC Notes, will be required to withdraw its Registered Certificates from DTC.

The information in this section concerning DTC and DTC's book-entry system has been obtained from sources that Issuer believes to be reliable, but Issuer takes no responsibility for the accuracy thereof.

Registration and Form

Book-entry interests in the Notes held through Euroclear and Clearstream, Luxembourg will be represented by the Unrestricted Global Certificate registered in the name of a nominee of, and held by, a common depositary for Euroclear and Clearstream, Luxembourg. Book-entry interests in the Notes held through DTC will be represented by the Restricted Global Certificate registered in the name of Cede & Co., as nominee for DTC, and held by a custodian for DTC. As necessary, the relevant Registrar will adjust the amounts of Notes on the relevant Register for the accounts of Euroclear, Clearstream, Luxembourg and DTC to reflect the amounts of Notes held through Euroclear, Clearstream, Luxembourg and DTC, respectively. Beneficial ownership of book-entry interests in Notes will be held through financial institutions as direct and indirect participants in Euroclear, Clearstream, Luxembourg and DTC.

The aggregate holdings of book-entry interests in the Notes in Euroclear, Clearstream, Luxembourg and DTC will be reflected in the book-entry accounts of each such institution. Euroclear, Clearstream, Luxembourg or DTC, as the case may be, and every other intermediate holder in the chain to the beneficial owner of book-entry interests in the Notes will be responsible for establishing and maintaining accounts for their participants and customers having interests in the book-entry interests in the Notes. The Registrar which maintains the Register of Notes held through Euroclear and Clearstream, Luxembourg will be responsible for maintaining a record of the aggregate holdings of Notes registered in the name of a common nominee for Euroclear and Clearstream, Luxembourg and the Registrar which maintains the Register of Notes held through DTC will be responsible for maintaining a record of the aggregate holdings of Notes registered in the name of a nominee for DTC, and/or, in each case if individual Certificates are issued in the limited circumstances described under "*The Global Certificates — Registration of Title*", holders of Notes represented by those individual Certificates. The Fiscal Agent will be responsible for ensuring that payments received by it from the Republic for holders of book-entry interests in the Notes holding through Euroclear and Clearstream, Luxembourg are credited to Euroclear or Clearstream, Luxembourg, as the case may be, and the Fiscal Agent will also be responsible for ensuring that payments received by the Fiscal Agent from the Republic for holders of book-entry interests in the Notes holding through DTC are credited to DTC.

The Republic will not impose any fees in respect of holding the Notes; however, holders of book-entry interests in the Notes may incur fees normally payable in respect of the maintenance and operation of accounts in Euroclear, Clearstream, Luxembourg or DTC.

Clearing and Settlement Procedures

Initial Settlement

Upon their original issue, the Notes will be in global form represented by the two Global Certificates. Interests in the Notes will be in uncertified book-entry form. Purchasers electing to hold book-entry interests in the Notes through Euroclear and Clearstream, Luxembourg accounts will follow the settlement procedures applicable to conventional Eurobonds. Book-entry interests in the Notes will be credited to Euroclear and Clearstream, Luxembourg participants' securities clearance accounts on the business day following the Closing Date against payment (value the Closing Date). DTC participants acting on behalf of purchasers electing to hold book-entry interests in the Notes through DTC will follow the delivery practices applicable to securities eligible for DTC's Same Day Funds Settlement system. DTC participants' securities accounts will be credited with book-entry interests in the Notes following confirmation of receipt of payment to the Republic on the Closing Date.

Secondary Market Trading

Secondary market trades in the Notes will be settled by transfer of title to book-entry interests in the Clearing Systems. Title to such book-entry interests will pass by registration of the transfer within the records of Euroclear, Clearstream, Luxembourg or DTC, as the case may be, in accordance with their respective procedures. Book-entry interests in the Notes may be transferred within Euroclear and within Clearstream, Luxembourg and between Euroclear and Clearstream, Luxembourg in accordance with procedures established for these purposes by Euroclear and Clearstream, Luxembourg. Book-entry interests in the Notes may be transferred within DTC in accordance with procedures established for this purpose by DTC. Transfer of book-entry interests in the Notes between Euroclear or

Clearstream, Luxembourg and DTC may be effected in accordance with procedures established for this purpose by Euroclear, Clearstream, Luxembourg and DTC.

General

None of Euroclear, Clearstream, Luxembourg or DTC is under any obligation to perform or continue to perform the procedures referred to above, and such procedures may be discontinued at any time.

None of the Republic or any of their agents will have any responsibility for the performance by Euroclear, Clearstream, Luxembourg or DTC or their respective participants of their respective obligations under the rules and procedures governing their operations or the arrangements referred to above.

SUBSCRIPTION AND SALE

Citigroup Global Markets Limited, Deutsche Bank AG, London Branch and J.P. Morgan Securities Ltd. (the "**Joint Lead Managers**") have, pursuant to a Subscription Agreement (the "**Subscription Agreement**") dated 26 April 2012, jointly and severally agreed to subscribe or procure subscribers for the Notes at the issue price of 99.472 per cent. of the principal amount of Notes less a combined selling concession and management and underwriting commission of 0.125 per cent. of the principal amount of the Notes, subject to the provisions of the Subscription Agreement. The Republic will also reimburse the Joint Lead Managers in respect of certain of their expenses, and has agreed to indemnify the Joint Lead Managers against certain liabilities (including liabilities under the Securities Act), incurred in connection with the issue of the Notes. The Subscription Agreement may be terminated in certain circumstances prior to payment of the issue price to the Republic.

United States

The Notes have not been and will not be registered under the Securities Act and, subject to certain exceptions, may not be offered or sold within the United States except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act. Accordingly, the Notes are being offered and sold only (a) outside the United States in offshore transactions in reliance on, and in compliance with, Regulation S and (b) in the United States to a limited number of QIBs as defined in the Securities Act in connection with resales by the Joint Lead Manager, in reliance on, and in compliance with, Rule 144A.

In addition, until 40 days after the commencement of the offering, an offer or sale of Notes within the United States by any dealer (whether or not participating in the offering of the Notes) may violate the registration requirements of the Securities Act if such offer or sale is made otherwise than in accordance with Rule 144A.

Each purchaser of a Note, by its acceptance thereof, will be deemed to have acknowledged, represented to and agreed with the Republic and the Joint Lead Managers as follows:

(a) It understands and acknowledges that the Notes have not been registered under the Securities Act or any other applicable securities law, and that the Notes are being offered for sale in transactions not requiring registration under the Securities Act or any other securities laws, including sales pursuant to Rule 144A and Regulation S and, unless so registered, may not be offered, sold or otherwise transferred except in compliance with the registration requirements of the Securities Act or any other applicable securities laws, pursuant to an exemption therefrom or pursuant to a transaction not subject thereto.

(b) It is either (i) a QIB and is aware that any sale of the Notes to it will be made in reliance on Rule 144A and it is acquiring the Notes for its own account or for the account of another QIB with respect to which it exercises full investment discretion, or (ii) it is purchasing the Notes in an offshore transaction (as defined in Regulation S) in accordance with Regulation S.

(c) It is purchasing the Notes for its own account or for the account of investors meeting the requirements of paragraph (b) above for which it is acting as a fiduciary or agent and with respect to which it has the authority to make these acknowledgements, representations and agreements, in each case not with a view to, or for offer or sale in connection with, any distribution thereof in violation of the Securities Act.

(d) If it is a QIB purchasing the Notes pursuant to Rule 144A, it will not offer, sell, pledge or otherwise transfer the Notes except (i) (A) to the Republic, (B) to a person whom the purchaser reasonably believes is a QIB in a transaction meeting the requirements of Rule 144A, (C) in an offshore transaction complying with Rule 903 or Rule 904 of Regulation S or (D) in a transaction that is otherwise exempt from the registration requirements of the Securities Act but only upon delivery to the Republic of an opinion of counsel in form and scope satisfactory to the Republic and (ii) in accordance with all applicable securities laws of the States of the United States.

(e) It acknowledges that certificates in respect of Notes purchased pursuant to Rule 144A, unless otherwise agreed by the Republic, will bear a legend to the following effect:

THE SECURITIES REPRESENTED HEREBY HAVE NOT BEEN AND WILL NOT BE REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE SECURITIES ACT). THE HOLDER HEREOF, BY PURCHASING THE NOTES IN RESPECT OF WHICH THIS CERTIFICATE IS ISSUED, AGREES, FOR THE BENEFIT OF THE REPUBLIC, THAT SUCH NOTES MAY BE OFFERED, SOLD, PLEDGED OR OTHERWISE TRANSFERRED ONLY (A)(1) TO THE REPUBLIC, (2) IN COMPLIANCE WITH RULE 144A UNDER THE SECURITIES ACT TO A PERSON THAT THE HOLDER REASONABLY BELIEVES IS A QUALIFIED INSTITUTIONAL BUYER WITHIN THE MEANING OF RULE 144A UNDER THE SECURITIES ACT PURCHASING FOR ITS OWN ACCOUNT OR FOR THE ACCOUNT OF A QUALIFIED INSTITUTIONAL BUYER WHOM THE HOLDER HAS

INFORMED, IN EACH CASE, THAT THE OFFER, SALE, PLEDGE OR OTHER TRANSFER IS BEING MADE IN RELIANCE ON RULE 144A, (3) IN AN OFFSHORE TRANSACTION COMPLYING WITH RULE 903 OR 904 OF REGULATION S UNDER THE SECURITIES ACT, OR (4) IN A TRANSACTION THAT IS OTHERWISE EXEMPT FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT BUT ONLY UPON DELIVERY TO THE REPUBLIC OF AN OPINION OF COUNSEL IN FORM AND SCOPE SATISFACTORY TO THE REPUBLIC; AND (B) IN COMPLIANCE WITH ALL APPLICABLE SECURITIES LAWS OF THE STATES OF THE UNITED STATES.

It acknowledges that certificates in respect of Notes purchased pursuant to Regulation S, unless otherwise agreed by the Republic, will bear a legend to the following effect:

THIS NOTE HAS NOT BEEN AND WILL NOT BE REGISTERED UNDER THE US SECURITIES ACT OF 1933, AS AMENDED (THE SECURITIES ACT), OR WITH ANY SECURITIES REGULATORY AUTHORITY OF ANY STATE OR OTHER JURISDICTION OF THE UNITED STATES AND MAY NOT BE OFFERED OR SOLD, PLEDGED OR OTHERWISE TRANSFERRED WITHIN THE UNITED STATES EXCEPT PURSUANT TO AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT

Each purchaser further acknowledges that the Joint Lead Managers and their affiliates and otherwise will rely upon the truth and accuracy of the foregoing acknowledgements, representations and agreements. If it is acquiring any Restricted Global Certificates for the account of one or more QIBs, the purchaser thereof represents that it has sole investment discretion with respect to each such account and that it has full power to make the foregoing acknowledgements, representations and agreements on behalf of each such account.

United Kingdom

Each Joint Lead Manager has represented and agreed that:

(a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the Financial Services and Markets Act 2000 (the "**FSMA**")) received by it in connection with the issue or sale of the Notes in circumstances in which Section 21(1) of the FSMA does not apply to the Republic; and

(b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Notes in, from or otherwise involving the United Kingdom.

Croatia

Each Joint Lead Manager has represented and agreed that it will not, as part of its initial distribution, offer or sell any Notes to residents of the Republic of Croatia or legal entities incorporated in the Republic of Croatia unless such residents or legal entities are authorised or licensed under Croatian law to acquire, hold, manage or dispose of the Notes on the date of their Offer.

General

No action has been taken by the Republic or any of the Joint Lead Managers that would, or is intended to, permit a public offer of the Notes in any country or jurisdiction where any such action for that purpose is required. Accordingly, each Joint Lead Manager has undertaken that it will not, directly or indirectly, offer or sell any Notes or distribute or publish any offering circular, prospectus, form of application, advertisement or other document or information in any country or jurisdiction except under circumstances that will, to the best of its knowledge and belief, result in compliance with any applicable laws and regulations and all offers and sales of Notes by it will be made on the same terms.

TRANSFER RESTRICTIONS

Due to the following significant transfer restrictions applicable to the Notes, investors are advised to consult legal counsel prior to making any reoffer, resale, pledge, transfer or disposal of the Notes.

The Notes have not been registered under the Securities Act, and may not be offered or sold in the United States except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act. Accordingly, the Notes are being offered and sold (1) in the United States only to persons reasonably believed to be "qualified institutional buyers," which are referred to as QIBs, as defined in Rule 144A under the Securities Act in compliance with Rule 144A and (2) to persons outside the United States ("**foreign purchasers**") in offshore transactions pursuant to Regulation S under the Securities Act.

By its purchase of Notes, each purchaser of Notes will be deemed to:

(a) represent that it is purchasing the Notes for its own account or an account with respect to which it exercises sole investment discretion and that it and any such account is (i) a QIB, and is aware that the sale to it is being made in reliance on Rule 144A or (ii) a foreign purchaser that is outside the United States;

(b) acknowledge that the Notes have not been registered under the Securities Act and may not be offered or sold within the United States except as set forth below;

(c) if it is a person other than a foreign purchaser outside the United States, agree that if it should resell or otherwise transfer the Notes within the time period referred to in Rule 144 under the Securities Act after the original issuance of the Notes, it will do so only (i) to the Issuer, (ii) to a QIB in compliance with Rule 144A, (iii) outside the United States in an offshore transaction in compliance with Rule 903 or 904 of Regulation S under the Securities Act, (iv) pursuant to the exemption from registration provided by Rule 144 under the Securities Act (if available) but only upon delivery to the Issuer of an opinion of counsel in form and scope satisfactory to the Issuer or (v) pursuant to an effective registration statement under the Securities Act. Subject to the procedures set forth in the Agency Agreement, prior to any proposed transfer of the Notes (other than pursuant to an effective registration statement) within the time period referred to in Rule 144 under the Securities Act after the original issuance of the Notes, the holder thereof must check the appropriate box set forth on the reverse of its Notes relating to the manner of such transfer and submit the Notes to the Fiscal Agent;

(d) agree that it will deliver to each person to whom it transfers Notes notice of any restriction on transfer of such Notes;

(e) understand and agree that Notes initially offered in the United States to QIBs will be represented by one or more Restricted Global Certificates and that Notes offered outside the United States in offshore transactions pursuant to Regulation S will be represented by one or more Unrestricted Global Certificates;

(f) understand that unless registered under the Securities Act, the Notes (other than those issued to foreign purchasers) will bear a legend substantially to the following effect, unless otherwise agreed by the Issuer and the holder thereof:

THE NOTES REPRESENTED HEREBY HAVE NOT BEEN AND WILL NOT BE REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE SECURITIES ACT), OR ANY SECURITIES LAW OF ANY STATE IN THE UNITED STATES OF AMERICA, AND MAY NOT BE REOFFERED, RESOLD, PLEDGED OR OTHERWISE TRANSFERRED EXCEPT AS PERMITTED BY THE FOLLOWING SENTENCES. THE HOLDER HEREOF, BY PURCHASING THE NOTES IN RESPECT OF WHICH THIS CERTIFICATE IS ISSUED, ACKNOWLEDGES AND AGREES, FOR THE BENEFIT OF THE ISSUER, THAT SUCH NOTES MAY BE OFFERED, SOLD, PLEDGED OR OTHERWISE TRANSFERRED ONLY (A)(l) TO THE ISSUER, (2) IN COMPLIANCE WITH RULE 144A UNDER THE SECURITIES ACT TO A PERSON THAT THE HOLDER REASONABLY BELIEVES IS A QUALIFIED INSTITUTIONAL BUYER WITHIN THE MEANING OF RULE 144A UNDER THE SECURITIES ACT PURCHASING FOR ITS OWN ACCOUNT OR FOR THE ACCOUNT OF A QUALIFIED INSTITUTIONAL BUYER WHOM THE HOLDER HAS INFORMED, IN EACH CASE, THAT THE OFFER, SALE, PLEDGE OR OTHER TRANSFER IS BEING MADE IN RELIANCE ON RULE 144A, (3) IN AN OFFSHORE TRANSACTION COMPLYING WITH RULE 903 OR 904 OF REGULATION S UNDER THE SECURITIES ACT, OR (4) IN A TRANSACTION THAT IS OTHERWISE EXEMPT FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT BUT ONLY IF AVAILABLE AND UPON DELIVERY TO THE ISSUER OF AN OPINION OF COUNSEL IN FORM AND SCOPE SATISFACTORY TO

THE ISSUER; AND (B) IN EACH CASE IN COMPLIANCE WITH ALL APPLICABLE SECURITIES LAWS OF THE STATES OF THE UNITED STATES;

(g) acknowledge that the Issuer and the Joint Lead Managers will rely upon the truth and accuracy of the foregoing acknowledgments, representations and agreements, and agree that if any of the acknowledgments, representations or warranties deemed to have been made by it by its purchase of Notes are no longer accurate, it shall promptly notify the Issuer and the Joint Lead Managers; and

(h) if it is acquiring Notes as a fiduciary or agent for one or more investor accounts, represent that it has sole investment discretion with respect to each such account and it has full power to make the foregoing acknowledgments, representations and agreements on behalf of each such account.

GENERAL INFORMATION

Authorisation

The Republic has obtained all necessary consents, approvals and authorisations in the Republic of Croatia in connection with the issue and performance of the Notes. The issue of the Notes was authorised pursuant to the resolution of the Government of the Republic of Croatia dated 25 April 2012, passed in accordance with the Law on Execution of the Budget of the Republic of Croatia for the year 2012 (*Narodne novine* No. 24/2012).

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 €5,750.

Clearing Systems

Application has been made for acceptance of the Restricted Global Certificates into DTC's book-entry settlement system. The Unrestricted and Restricted Global Certificates have been accepted for clearance through Euroclear and Clearstream, Luxembourg. The ISIN for the Unrestricted Global Certificates is XS0776179656 and for the Restricted Global Certificates is US226775AE40. The Common Code for the Unrestricted Global Certificates is 077617965 and for the Restricted Global Certificates is 077625704. The CUSIP number for the Restricted Global Certificates is 226775 AE4.

No significant change

There has been no significant change in the tax and budgetary systems, gross public debt, foreign trade and balance of payments, foreign exchange reserves, financial position and resources and income and expenditure figures of the Republic since 31 December 2011.

Litigation

The Republic is not, nor has it been involved in any governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Republic is aware) in the 12 months preceding the date of this document which may have or have in such period had a significant effect on the financial position of the Republic.

Documents

For the period of 12 months following the date of this Prospectus, copies (and certified English translations where the documents in question are not in English) of the following documents will be available for inspection during usual business hours on any weekday (Saturdays, Sundays and public holidays excepted) from the specified office of the Paying Agent for the time being in Luxembourg:

(a) the Agency Agreement which includes the forms of the Global Notes;

(b) the resolution of the Government of the Republic of Croatia dated 25 April 2012 authorising the issue of the Notes; and

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

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

Joint Lead Managers transacting with the Republic

Certain of the Joint Lead Managers and their affiliates have engaged, and may in the future engage, in investment banking and/or commercial banking transactions with, and may perform services to the Republic and its affiliates in the ordinary course of business.

Yield

On the basis of the issue price of the Notes of 99.472 per cent. of their principal amount, the yield on the Notes is 6.375 per cent. on an annual basis.

Third Party Information

The Issuer confirms that where information included in this Prospectus has been sourced from a third party, that information has been accurately reproduced and that as far as the Issuer is aware and is able to ascertain from information published by that third party, no facts have been omitted which would render the reproduced information inaccurate or misleading.

THE REPUBLIC

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