OFFERING CIRCULAR

REPUBLIC OF CROATIA

€1,500,000,000
3.00 per cent. Notes due 2025
Issue price: 97.845 per cent.

The issue price of the €1,500,000,000 3.00 per cent. Fixed Rate Notes due 2025 (the "**Notes**") issued by the Republic of Croatia (the "**Issuer**", the "**Republic**" or "**Croatia**"), will be 97.845 per cent. of their principal amount. The Notes will mature on 11 March 2025 at their principal amount.

The Notes will be in registered form in denominations of €100,000 and integral multiples of €1,000 in excess thereof. Interest on the Notes will accrue at the rate of 3.00 per cent. per annum from and including 11 March 2015 and will be payable in Euro annually in arrear on 11 March in each year, commencing on 11 March 2016. Payments on the Notes will be made without withholding or deduction for or on account of taxes imposed by the Issuer except to the extent described under *"Terms and Conditions of the Notes — Taxation".*

This Offering Circular neither constitutes a prospectus pursuant to Part II of the Luxembourg law on prospectuses for securities (*loi relative aux prospectus pour valeurs mobiliéres*) dated 10 July 2005 (the "**Luxembourg Act**") which implements Directive 2003/71/EC as amended (which includes the amendments made by Directive 2010/73/EU to the extent that such amendments have been implemented in a relevant Member State of the European Economic Area) (the "**Prospectus Directive**") nor a simplified prospectus pursuant to Part III of the Luxembourg Act. Accordingly, this Offering Circular does not purport to meet the format and the disclosure requirements of the Prospectus Directive and Commission Regulation (EC) No. 809/2004 implementing the Prospectus Directive, and it has not been, and will not be, submitted for approval to any competent authority within the meaning of the Prospectus Directive and in particular the Supervisory Commission of the Financial Sector (*Commission de Surveillance du Secteur Financier*), in its capacity as competent authority under the Luxembourg Act.

The Issuer is rated Ba1 by Moody's Investors Service, Inc. ("**Moody's**"), BB by Standard & Poor's Credit Market Services Europe Ltd. ("**S&P**"), and the Issuer has a long term foreign currency issuer default rating of BB by Fitch Ratings Ltd. ("**Fitch**"). The Notes will be rated Ba1 by Moody's, BB by S&P, and BB by Fitch. A rating is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating organisation. As at the date of this Offering Circular, S&P and Fitch are established in the European Union and is registered under Regulation (EU) No 1060/2009 (as amended) (the "**CRA Regulation**"). Moody's is not established in the EEA but the rating it has given to the Notes is endorsed by Moody's Investors Service, Ltd, which is established in the EEA and registered under 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 "*There can be no assurance that Croatia's credit ratings will not change*" and "*Credit Ratings may not reflect all risks*" of this Offering Circular.

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

The Notes will initially be represented by a global certificate (the "**Global Certificate**"), in registered form, without interest coupons attached and will be registered in the name of a nominee of a common depositary for Clearstream Banking, *société anonyme* ("**Clearstream, Luxembourg**") and Euroclear Bank S.A./N.V. ("**Euroclear**"), on or about 11 March 2015 (the "**Closing Date**").

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

Joint Lead Managers

BARCLAYS **ERSTE GROUP** **J.P. MORGAN** **ZAGREBAČKA BANKA**

9 March 2015

THE REPUBLIC OF CROATIA

The Issuer accepts responsibility for the information contained in this Offering Circular. To the best of the knowledge of the Issuer (having taken all reasonable care to ensure that such is the case) the information contained in this Offering Circular is in accordance with the facts and does not omit anything likely to affect the import of such information. The Issuer, having made all reasonable enquiries, confirms that this Offering Circular contains all information with respect to the Issuer and the Notes which is material in the context of the issue and offering of the Notes, that the information contained in this Offering Circular is true and accurate in every material respect and is not misleading, that the opinions and intentions expressed in this Offering Circular are honestly held and that there are no other facts the omission of which makes misleading any statement herein, whether of fact or opinion.

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

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

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

*In this Offering Circular, all references to "**HRK**" and "**kuna**" are to the lawful currency for the time being of the Issuer, all references to "**€**", "**EUR**", "**euro**" and "**Euro**" are to the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty on the Functioning of the European Union, all references to "**U.S. dollars**", "**US$**" and "**U.S.$**" are to the lawful currency for the time being of the United States of America and all references to "**CHF**" or "**Swiss franc**" are to Swiss Francs. Certain amounts which appear in this Offering Circular have been subject to rounding adjustments; accordingly, figures shown as totals may not be an arithmetic aggregation of the figures which precede them.*

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

EXCHANGE RATES

The following table sets forth, for the periods indicated, the average monthly rates published by the Hrvatska narodna banka, expressed as kuna per Euro.

	2010	2011	2012	2013	2014	2015
January	7,290819	7,396420	7,546707	7,567746	7,629820	7,679826
February	7,304744	7,410873	7,579384	7,582399	7,654972	-
March	7,260644	7,393749	7,539590	7,585782	7,654440	-
April	7,258114	7,362212	7,494357	7,602485	7,627459	-
May	7,257505	7,391226	7,528940	7,568123	7,593665	-
June	7,229388	7,412196	7,546585	7,500346	7,573554	-
July	7,211539	7,419738	7,494496	7,494112	7,599809	-
August	7,246101	7,454965	7,486777	7,521353	7,626000	-
September	7,282934	7,486844	7,426569	7,587204	7,618519	-
October	7,320596	7,483324	7,500421	7,614419	7,650459	-
November	7,373159	7,487735	7,536449	7,627680	7,663895	-
December	7,392766	7,507179	7,529460	7,633202	7,667075	-

Source: Croatian National Bank and Hrvatska narodna banka

The following table sets forth, for the periods indicated, the period end, average, high and low official mid-point rates published by the Hrvatska narodna banka, expressed as kuna per U.S. dollar.

	Period End	Average[(1)]	High	Low
2008	5,1555040	4,9344170	5,8017760	4,5227520
2009	5,0893000	5,2803700	5,9411230	4,8038250
2010	5,5682520	5,5000150	6,0889220	5,0096630
2011	5,8199400	5,3435080	5,8252360	4,9474260
2012	5,7267940	5,8508610	6,1949390	5,6154240
2013	5,5490000	5,7058830	5,9436420	5,5133750
2014	6,3021070	5,7493220	6,3021070	5,4404300
January 2013	5,5942940	5,7014440	5,8090950	5,5942940
February 2013	5,7958900	5,6648250	5,7958900	5,5546880
March 2013	5,9188070	5,8467740	5,9315970	5,7833890
April 2013	5,8118050	5,8450170	5,9436420	5,7799920
May 2013	5,8611770	5,8284590	5,8816300	5,7565700
June 2013	5,7063440	5,6871730	5,8228840	5,5787300
July 2013	5,6452150	5,7336950	5,8693050	5,6377910
August 2013	5,7079420	5,6475670	5,7079420	5,6019000
September 2013	5,6423970	5,6909630	5,7765290	5,6122070
October 2013	5,5380910	5,5857140	5,6396820	5,5133750
November 2013	5,6080070	5,6515230	5,6877480	5,5735280
December 2013	5,5490000	5,5754080	5,6361720	5,5292710
January 2014	5,6191960	5,5970050	5,6377830	5,5418590
February 2014	5,6092200	5,6093370	5,6656560	5,5701950
March 2014	5,5758240	5,5382850	5,5759920	5,4872050
April 2014	5,4852430	5,5221420	5,5764590	5,4852430
May 2014	5,5747700	5,5241600	5,5870030	5,4404300
June 2014	5,5622770	5,5747600	5,6026880	5,5557200
July 2014	5,6980330	5,6072840	5,6980330	5,5292760
August 2014	5,7868990	5,7242640	5,7868990	5,6854980
September 2014	6,0153550	5,8895560	6,0153550	5,7868990
October 2014	6,0882110	6,0374620	6,0882110	5,9787360
November 2014	6,1636500	6,1413720	6,1790990	6,0880500
December 2014	6,3021070	6,2123580	6,3021070	6,1391830
January 2015	6,7777170	6,5954280	6,8599180	6,2995290

Source: Hrvatska narodna banka

(1) Average of daily rates.

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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 Offering Circular, 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 "*Terms and Conditions of the Notes*" or elsewhere in this Offering Circular have the same meanings in this section.

Risk Factors Relating to Croatia

Having recently acceded to the EU on the back of a raft of legal, economic, financial and other reforms and policies, Croatia is undergoing a period of transition which may adversely affect the Croatian economy and Croatia's ability to repay principal and make payments of interest on the Notes

On 1 July 2013, Croatia joined the EU and became its 28th member state. To facilitate this, it was necessary for the Government of Croatia (the "**Government**") to introduce a number of structural measures in 2012 and 2013 with the aim of strengthening the quality of public finances and bringing political, economic and judicial structures in line with EU requirements. In light of these large-scale sweeping measures, Croatia is in a transitional period and may experience difficulty during this period as its structures integrate into the EU.

Croatia has also undergone and continues to undergo changes in legislation due to its EU accession. As a result of these changes, there is a lack of an established practice under many securities, tax and other regulatory regimes in Croatia and new regulations may be subject to contradictory, ambiguous or changing interpretations by the Croatian regulatory authorities. Consequently, companies operating in this region may face tax, securities and other regulatory compliance-related risks that may be less predictable than in countries with more stable regulatory systems. As a result of EU membership, Croatia may be eligible 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 or the timing of any such disbursements (see "*The Economy — Economic Policy — EU Structural Funds*"). Access to EU structural funds will require co-financing by Croatia, which may be challenging in light of Croatia's fiscal and budgetary situation, and the Excessive Deficit Procedure imposed (see below). Furthermore, as an EU Member State, Croatia incurs additional costs related to its EU membership, including its contribution to the EU budget, which amounts to EUR 462 million for the 2015 fiscal year, which may place further strains on Croatia's fiscal condition.

Further, the Government has encountered resistance in the implementation of these reforms from trade unions. During 2013, hospital workers in Croatia went on strike in September, and staff of the state-owned Croatia Airlines d.d. engaged in an eight-day strike in May, in protest over cuts to salary, benefits and layoffs. Most recently, in 2014, school workers went on strike in February and April and staff of the state-owned HŽ Cargo d.o.o. engaged in a three-day strike during April. In addition, Croatia's implementation of the Excessive Deficit Procedure (as defined below) as a result of its budget deficit exceeding the reference value of 3 per cent. of GDP, could result in additional resistance, labour disruptions or social unrest. There can be no assurance that implementation of these or additional reforms will not result in further prolonged labour unrest or disruptions, which could have an adverse effect on Croatia's economy and ability to repay its obligations on the Notes.

Following accession to the EU, Croatia's trade policy is now in accordance with the rules of the EU Treaty. The EU has a common trade policy in relation to non-EU countries which involves, among other things, a common external tariff and common trade agreements with non-EU Member States. As part of the EU internal market, Croatia's economy is exposed to increased competition with other Member States. In addition, as part of its EU accession, Croatia also exited from the Central European Free Trade Agreement ("**CEFTA**") - a trade agreement between the non-EU countries in Southeast Europe which includes Serbia, Macedonia, Montenegro, Bosnia and Herzegovina, Kosovo, Albania, and Moldova. Prior to Croatia's exit from CEFTA, CEFTA countries accounted for a significant portion of Croatia's exports, particularly in the agriculture and food industries. Croatia's trade with its non-EU trade partners will now rely solely on each country's respective Stabilization and Association Agreement ("**SSA**"), which is each such country's bilateral trade agreement with the EU. Although the European Commission has conducted negotiations with the CEFTA countries on changing their SSAs to account for Croatia's EU accession, many Croatian exports may still face new or higher import tariffs and quotas in the CEFTA countries, which could have adverse effects on sectors of the economy that are unable to compete. Further, following accession to the EU, Croatia's trade with CEFTA countries declined, specifically in agro-food exports. In addition, as a result of EU accession Croatia is also required to significantly reduce the level of domestic subsidies to the agriculture sector. (see "*The Economy — Government Subsidies*").

As a member state of the EU, Croatia will be eligible to adopt the euro once it fulfils the necessary conditions, and will seek to enter the Exchange Rate Mechanism ("**ERM II**"), although the timing for this process remains uncertain and is unlikely to be in the short to medium term. 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, will primarily depend on Croatia's macroeconomic indicators, i.e. its 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, or negative, economic growth.

Croatia is subject to the Excessive Deficit Procedure and implementation of deficit reduction measures may adversely affect Croatia's economy

Under the Treaty on European Union of February 1992 (the "**Maastricht Treaty**"), implementing regulations and the Stability and Growth Pact (the "**Pact**") among EU Member States, Member States are required to pursue a medium-term objective of ensuring the long-term sustainability of public finances and minimising the risk of their budget deficit exceeding the reference value of 3 per cent. of GDP. A Member State whose general budget deficit exceeds the reference value of 3 per cent. of its GDP, or whose ratio of Government debt to GDP exceeds the reference value of 60 per cent., becomes subject to the excessive deficit procedure (the "**Excessive Deficit Procedure**"). The Excessive Deficit Procedure provides that the Economic and Finance Affairs Council, a Council composed of Economics and Finance Ministers of the Member States (the "**Ecofin Council**"), decides whether an excessive deficit has been incurred. If it concludes that there is an excessive deficit, the Ecofin Council, based on recommendations by the European Commission, suggests corrective measures aimed at a deficit reduction and then reviews the corrective measures taken by the Member State. If it determines that such corrective measures are not adequately implemented, the Maastricht Treaty and the Pact provide for a wide range of remedies, including the imposition of annual financial penalties. On 28 January 2014, the Council of the European Union opened an excessive deficit procedure for Croatia, adopting a decision on the existence of an excessive Government deficit as well as recommendations setting out measures to be taken to correct the deficit by 2016. Croatia's budget deficit is currently above 3 per cent. of GDP and Croatia believes that it may correct such deficit by 2017. The debt to GDP ratio is currently 80.5 per cent. and is expected to increase and stabilise only in 2017, although there can be no assurance at what level it will peak at and by when. Efforts to reduce taxation in order to stimulate growth and encourage entrepreneurs may hinder efforts to reduce the deficit. Separately, privitisations and/or a reduction in public spending/wages may prove unpopular and be difficult to implement. As such, this may result in the budget deficit exceeding 3 per cent. of GDP for longer than expected and implementation of the agreed deficit reduction measures may have an adverse effect on Croatia's economy (for further information see "*Public Finance*" and "*The Economy — Excessive Deficit Procedure*").

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 and the recent political turmoil in certain emerging markets as well as the continuing uncertainty regarding the EU Member States, including renewed uncertainty regarding Greece. The global financial and economic crisis negatively affected the Croatian economy.

After Croatian EU accession, on July 1, 2013, Croatia was obliged to leave CEFTA, but obtained access to concessions negotiated in the EU's preferential trade agreements with third countries. Croatia's economy remains vulnerable to any trade disruptions with its main EU trading partners, namely Austria, Germany and Italy.

A significant decline in the economic growth of any of Croatia's major trading partners, such as the EU countries, could, *inter alia*, have a material adverse impact on Croatia's balance of trade and adversely affect Croatia's economic growth.

In addition, the recent hostilities between Russia and Ukraine have been strongly opposed by the EU and the United States. The hostilities have prompted the EU and the United States to impose trade restrictions and sanctions on certain persons and entities affiliated with Russia as well as on certain key sectors of the Russian economy. The restriction on EU exports of agricultural and food products to Russia have to date had a limited effect on Croatia. Nonetheless, the potential repercussions surrounding the situation are unknown. The emergence of new or escalated tensions in the region, or the imposition of further economic or other sanctions in response to such tensions, which may include targeted sanctions against certain industries, could negatively affect other economies in the region and the Eurozone in general. Although Ukraine is not a material trading partner for Croatia, any contingent and ongoing escalation of the current tension in Ukraine may in turn have serious economic and geopolitical consequences for Europe as a whole and indirectly impact Croatia through its trading partners Austria and Germany and impact the Croatian economy.

Croatia continues to face a number of economic challenges including low worker participation, deleveraging of the private sector, a decline in personal consumption and a lack of growth. 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 if the global economy recovers in the future, the recovery may not be sustained and may reverse. This 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.

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 accounted for 75.9 per cent. of general Government debt as at 31 December 2012 and 76.7 per cent. as at 31 December 2013. 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 31 December 2013, 86.9 per cent. of total Central Government loans are denominated in or linked to foreign currency. Only a small fraction of this debt is hedged. From 2012 onwards, the share of the kuna component in Croatia's bank loan portfolio has been increasing. Despite the fact that foreign currency deposits now account for approximately 67.5 per cent. of all deposits (82.7 per cent. of time and saving 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. Since 1 January 2013 the Hrvatska narodna banka ("**HNB**") has intervened in the foreign currency market five times as part of its policy of pursuing a stable 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, International Reserves and Financial System — Monetary Policy and Instruments*".

The appreciation of the Swiss franc and the measures implemented by Croatian authorities to deal with this may have a negative impact on the Banking sector

A significant portion of the housing loans advanced by the Croatian banking sector (which according to supervisory data are around 36.5 per cent. of the total housing loans and around 7.4 per cent. of all loans advanced by the Croatian banking sector at 30 September 2014) are indexed to the Swiss franc. As at 30 September 2014, Swiss franc linked housing loans aggregated to approximately HRK 20.5 billion. These were historically adversely affected by the appreciation of the Swiss franc against the kuna by 17.2 per. cent in 2010, 4.3 per cent. in 2011 and 0.8 per cent. in 2012. With the Swiss National Bank's decision on 15 January 2015 to abolish the Swiss franc-euro peg, the Swiss franc appreciated against the kuna by around 20 per cent. on a single day. As the franc is now unpegged, the risk faced by such loans is heightened. Any further appreciation of the Swiss franc against the kuna may have an adverse impact on the economy.

As a result, the Croatian parliament and HNB have taken and are considering steps to address the impact of this appreciation on the Croatian banking sector, see "*Monetary Developments, International Reserves and Financial System — Loan Exposure*". As the purpose of these steps is to pass the risk of the Swiss franc appreciation to the banking sector, Croatian banks' profitability and asset quality is likely to be adversely affected.

The further proliferation of the euro in the Croatian economy may adversely affect the HNB'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 HNB 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 HNB 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 became a member state of the EU on 1 July 2013 and is committed to entering the ERM II and adopting the euro, 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 balance may deteriorate

Croatia's current account deficit has declined gradually since 2008 and recorded small surpluses in each of 2012, 2013 and 2014. Croatia's current account balance is significantly affected by its trade balance and any future negative changes in the trade balance and the current account balance could 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

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 2015 may be lower than Government projections and assumptions used for the 2015 budget. Lower than expected growth would have a negative impact on budget revenue and negative implications for adhering to the Excessive

Deficit Procedure. Lower than expected growth would increase the Government deficit (with an unchanged level of expenditure) thereby making it more likely that the Government will fail to meet the targets set in the Excessive Deficit Procedure. In a lower growth environment, additional expenditure reduction measures may be required to adhere to the Excessive Deficit Procedure.

Taken as a whole, reduced revenue, 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 ratings will not change

The long term foreign and domestic currency debt of the Republic is currently rated BB by S&P and Ba1 by Moody's. In August 2014, Fitch downgraded its foreign currency long term issuer default rating of the Republic to BB from BB+ previously, and downgraded its local currency long term issuer default rating to BB+ from BBB- previously. In January 2014, S&P downgraded its ratings from BB+ to BB and in March 2014 Moody's revised its outlook from stable to negative. There can be no guarantee that the Republic will not experience further credit downgrades or negative revisions to the outlook. Deterioration in key economic indicators or the materialisation of any of the risks discussed herein may contribute to further credit rating downgrades. In turn, any adverse changes in an applicable credit rating or credit rating outlook could adversely affect the trading price for the Notes. In addition, negative ratings action could adversely affect Croatia's ability to refinance existing indebtedness or finance its deficit and could affect payment of principal and interest under the Notes.

As at the date of this Offering Circular, S&P and Fitch are established in the European Union and are registered under Regulation (EU) No 1060/2009 (as amended) (the "**CRA Regulation**"). Moody's is not established in the EEA but the rating it has given to the Notes is endorsed by Moody's Investors Service, Ltd, which is established in the EEA and registered under the CRA Regulation. 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 relatively flat in recent years and amounted to EUR 29.3 billion as at 31 January 2014 and to EUR 28.5 billion as at 31 October 2014. Non-performing loans have been increasing continuously since the economic crisis, from 4.9 per cent. in 2008 to 17.2 per cent. as at 30 September 2014 and may continue to rise. Non-performing loans to enterprises have experienced the greatest increase, from 7.2 per cent. in 2008 to 30.6 per cent. as at 30 September 2014. See "*Monetary Developments, International Reserves and Financial 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 2014, foreign banks owned approximately 89.8 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 adverse economic developments in the eurozone and negative factors impacting the 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 further increases 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 and otherwise have a material adverse effect on Croatia

Independent analysts have identified corruption and money laundering as problems in Croatia. In the 2014 Transparency International Corruption Perceptions Index, Croatia ranked 61 out of 175 countries under review (indicating that there were at least 60 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 and 25/12) 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 a material 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. Although, further to Croatia's accession to the EU, the EU Directives have become an integral part of Croatia's legal system, and a significant part of the EU regulations has already been implemented in Croatian law, the Republic's legal system still 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 its 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 remains 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 2014, general Government debt stood at HRK 264.5 billion (80.5 per cent. of GDP) and Government guarantees stood at HRK 22.9 billion (7.0 per cent. of GDP), for a total amount of HRK 287.4 billion or 87.5 per cent. of GDP. See "*Public Debt*". As of 30 October 2014, the average remaining maturity of external central Government debt was 6.7 years whereas the average maturity of the domestic public debt outstanding as for 31 December 2014 was 3.8 years. In recent years Croatia has been able to refinance its existing debt on favourable terms due to the historic low interest rate environment since the financial crisis. However, any increase in global or emerging market rates may impact Croatia's ability to refinance its debt on favourable terms. Furthermore, contingent liabilities could crystallise and further increase Croatia's public debt (including as a result of state guarantees given to the shipyard industry and motorway companies as part of the restructuring and privatisation process being called). 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 its existing debt and thereby adversely affect Croatia's ability to implement its economic strategy and reforms and to make payment in respect of the Notes.

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 generally is adversely affected by economic downturns, and public perception of the attractiveness and safety of a potential tourist destination. Any changes in Croatia's visa issuing system may result in more difficulties for Russia and other non EU tourists visiting Croatia.

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, including Russia, 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 or natural gas were to significantly increase, the Republic's economy could be adversely affected. 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 adversely affect the Croatian economy.

Croatia's economy remains vulnerable to external adverse economic and financial conditions including the impact of general "contagion" effects. These could have a material adverse effect on Croatia's economic growth

International investors' reactions to the events occurring in one market sometimes appear to demonstrate a "contagion" effect, in which an entire region or class of investment is disfavoured by international investors, Croatia could be adversely affected by negative economic or financial developments in neighbouring countries, EU countries or countries with similar credit ratings. While in recent years Croatia has reduced its external vulnerability and implemented sound macroeconomic policies, which, until recently, had been reflected in the positive evolution of its ratings and spreads, Croatia has been adversely affected by such contagion effects on a number of occasions, including following the 1998 Russian financial crisis and the recent global economic crisis. Similar developments can be expected to affect the Croatian economy in the future.

There can be no assurance that the factors such as those described above or similar events will not negatively affect investor confidence in markets such as Croatia. In addition, there can be no assurance that these events will not adversely affect Croatia's economy and its ability to raise capital in the external debt markets in the future.

Official economic data may not be accurate and could be revised

A range of Government ministries, including the Ministry of Finance, along with the HNB and the Croatian Bureau of Statistics ("**CBS**"), produce statistics on Croatia and its economy. There can, however, be no assurance that these statistics are comparable with those compiled by other bodies, or in other countries, which use different methodologies. Prospective investors in the Notes should be aware that figures relating to Croatia's GDP and many other aggregate figures cited in this Offering Circular may differ from figures prepared by international bodies, such as the IMF, which may use different methodologies. The statistical information presented herein is based on the latest official information currently available from the stated source. The development of statistical information relating to Croatia is, however, an ongoing process and revised figures and estimates are produced on a regular basis. Figures presented may be subject to rounding and GDP figures are initially provisional. In addition, the existence of an unofficial or unobserved economy may affect the accuracy and reliability of statistical information. Prospective investors should be aware that none of the statistical information in this Offering Circular has been independently verified.

Additionally, Government debt statistics have been harmonised with ESA2010 and the Eurostat Manual on Government Deficit and Debt.

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:

(i) have sufficient knowledge and experience to make a meaningful evaluation of the Notes, the merits and risks of investing in the Notes and the information contained in this Offering Circular or any applicable supplement;

(ii) have access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Notes and the impact the Notes will have on its overall investment portfolio;

(iii) have sufficient financial resources and liquidity to bear all of the risks of an investment in the Notes, including where the currency for principal or interest payments is different from the potential investor's currency;

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

(v) be able to evaluate (either alone or with the help of a financial adviser) possible scenarios for economic, interest rate and other factors that may affect its investment and its ability to bear the applicable risks.

The terms of the Notes may be modified or waived 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 and for the passing of written resolutions of Noteholders without the need for a meeting. Such provisions are commonly referred to as "collective action clauses". These provisions permit defined majorities to bind all Noteholders including Noteholders who did not attend and vote at the relevant meeting or sign the relevant written resolution and Noteholders who voted in a manner contrary to the majority.

In the future, the Issuer may issue debt securities which contain collective action clauses in the same form as the collective action clauses in the conditions of the Notes. If this occurs, the Notes could be capable of aggregation with any such future debt securities, meaning that a defined majority of the holders of such debt securities (when taken in the aggregate) would be able to bind all holders of all the relevant aggregated series of debt securities, including the Notes.

Any modification or actions relating to any Reserved Matter (as defined in the conditions of the Notes), including in respect of payments and other important terms, may be made (a) to the Notes with the consent of the holders of 75 per cent. of the aggregate principal amount of the outstanding Notes, and (b) to multiple series of debt securities which may be issued by the Issuer (including the Notes) with the consent of both (i) the holders of at least two thirds of the aggregate principle amount of all outstanding debt securities being aggregated and (ii) the holders of at least 50 per cent. in aggregate principal amount of the outstanding debt securities of each series being aggregated. In addition, under certain circumstances, including the satisfaction of the Uniformly Applicable condition (as more particularly described in the conditions of the Notes), any such modification or action relating to any Reserved Matter may be made to multiple series of the Issuer's debt securities (including the Notes) with the consent of 75 per cent. of the aggregate principal amount of the outstanding debt securities of all affected series, without requiring a particular percentage of the holders of any individual affected debt securities to vote in favour of or approve any proposed modification or action. Any modification or action proposed by the Issuer may, as the option of the Issuer, be made in respect of certain series of the Issuer's debt securities only and, for the avoidance of doubt, the collective action provisions may be used for different groups of two or more debt securities simultaneously. At the time of any proposed modification or action, the Issuer will be obliged, *inter alia*, to specify which method or methods of aggregation will be used by the Issuer.

There is therefore a risk that the conditions of the Notes may be amended, modified or waived in circumstances whereby the holders of debt securities voting in favour of or signing a written resolution in respect of an amendment, modification or waiver may be holders of different series of debt securities and, as such, the majority of Noteholders would not necessarily have voted in favour of or signed a written resolution in respect of such amendment, modification or waiver. In addition, there is a risk that the provisions allowing for aggregation across multiple series of debt securities may make the Notes less attractive to purchasers in the secondary market on the occurrence of an Event of Default or in a distress situation.

The conditions of the Notes also 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, or where the modification is of a formal, minor or technical nature or is not materially prejudicial to the interests of the Noteholders.

Any such amendment, modification or waiver in relation to the Notes may adversely affect their trading price.

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 European Council Directive 2003/48/EC on the taxation of savings income, Member States are required to provide to the tax authorities of other Member States details of certain payments of interest or similar income paid or secured by a person established in a Member State to or for the benefit of an individual resident in another Member State or certain limited types of entities established in another Member State.

On 24 March 2014, the Council of the European Union adopted a Council Directive amending and broadening the scope of the requirements described above. Member States are required to apply these new requirements from 1 January 2017. The changes will expand the range of payments covered by the Directive, in particular to include additional types of income payable on securities. The Directive will also expand the circumstances in which payments that indirectly benefit an individual resident in a Member State must be reported. This approach will apply to payments made to, or secured for, persons, entities or legal arrangements (including trusts) where certain conditions are satisfied, and may in some cases apply where the person, entity or arrangement is established or effectively managed outside of the European Union.

For a transitional period, Austria is required (unless during that period it elects otherwise) to operate a withholding system in relation to such payments. The changes referred to above will broaden the types of payments subject to withholding in those Member States which still operate a withholding system when they are implemented.

The end of the transitional period is 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).

If a payment were to be made or collected through a Member State which has opted for a withholding system and an amount of, or in respect of, tax were to be withheld from that payment, neither the Issuer nor any Agent (as defined in the conditions of the Notes) nor any other person would be obliged to pay additional amounts with respect to any Note as a result of the imposition of such withholding tax. The Issuer is required to maintain a Paying 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 Offering Circular. 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 Offering Circular.

Certificates not denominated in an integral multiple of €100,000 or its equivalent may be illiquid and difficult to trade

The Notes have denominations consisting of a minimum of €100,000 plus integral multiples of €1,000 in excess thereof. It is possible that the Notes may be traded in amounts that are not integral multiples of €100,000. In each such a case a holder who, as a result of trading such amounts, holds an amount which is less than €100,000 in his account with the relevant clearing system at the relevant time may not receive a 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 at least €100,000.

If Certificates are issued, holders should be aware that Certificates which have a denomination that is not an integral multiple of €100,000 may be illiquid and more difficult to trade than Notes denominated in an integral multiple of €100,000.

Croatian courts may not recognise or may not enforce an English or non-EU court judgment

In respect of recognition and/or enforcement of a judgment obtained in an EU jurisdiction other than Croatia (including, but not limited to, England), Croatian courts may refuse to recognise such a judgment if there are grounds for refusal of recognition as provided in the provisions of the Council Regulation (EC) No 1215/2012 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters. In respect of recognition and/or enforcement of a non-EU court judgment, Croatian courts may refuse to recognise such judgments if there are grounds for non-recognition as provided in the Croatian Law on Resolving Conflicts of Law with Other Countries' Laws and Regulations in Certain Matters (OG 53/1991 and 88/2001). Once recognised (to the extent applicable), the judgment of a non-Croatian court is equal to the judgment of a Croatian court and is fit for enforcement in the Republic of Croatia (for enforcement of English court judgments, the conditions prescribed by the Council Regulation (EC) No. 1215/20121 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters or, as the case may be, the Regulation (EC) No 805/2004 of the European Parliament and of the Council of 21 April 2004 creating a European Enforcement Order of uncontested claims must be met).

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 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. In addition, liquidity may be limited if the Issuer makes large allocations to a limited number of investors.

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, 2008 and 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 Hrvatska narodna banka, 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.

On 15 October 2012 the new Execution Law (OG 112/12, 25/13 and 93/2014) came into force prescribing, similar to the old law on execution, certain assets that are not available for enforcement (such as, *inter alia*, assets out of trade and other assets regulated as such by a special law, as well as claims on the basis of taxes and other charges). In addition to those restrictions, the new law introduced certain additional assets owned by Croatia, *inter alia*, the equipment and facilities intended for the purposes of the functioning of local and regional self-government units and judicial authorities, which are 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 euro. This presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit (the "**Investor's Currency**") other than euro. These include the risk that exchange rates may significantly change (including changes due to devaluation of the euro or revaluation of the Investor's Currency) and the risk that authorities with jurisdiction over the Investor's Currency may impose or modify exchange controls. An appreciation in the value of the Investor's Currency relative to euro would decrease (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 or the ability of the Republic to make payment in respect of the Notes. 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 will assign credit ratings to the Notes. The ratings may not reflect the potential impact of all risks related to structure, market, additional factors discussed above, and other factors that may affect the value of the Notes. A credit rating is not a recommendation to buy, sell or hold securities and may be revised, suspended or withdrawn by the relevant rating agency at any time.

TERMS AND CONDITIONS OF THE NOTES

The following is the text of the terms and 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 €1,500,000,000 3.00 per cent. Notes due 2025 (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 11 March 2015 (such agreement as amended and/or supplemented and/or restated from time to time, the "**Agency Agreement**") made between the Republic and Deutsche Bank Luxembourg S.A. as registrar (the "**Registrar**"), Deutsche Bank AG, London Branch as fiscal agent and transfer agent (the "**Fiscal Agent**" and together with 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 Registrar, 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 11 March 2015 (the "**Deed of Covenant**") and made by the Republic. The original of the Deed of Covenant is held by the common depositary for Euroclear (as defined below) and Clearstream, Luxembourg (as defined below).

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 and the Deed of Covenant are available for inspection during normal business hours by the Noteholders appertaining to the Notes at the specified office of each of the Paying Agents. The Noteholders are entitled to the benefit of, are bound by, and are deemed to have notice of, all the provisions of the Agency Agreement and the Deed of Covenant applicable to them. References in these Conditions to the Fiscal Agent, the Registrar, the 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**") and Clearstream Banking, société anonyme ("**Clearstream, Luxembourg**") 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 €100,000 and integral multiples of €1,000 in excess thereof (referred to as the "principal amount" of a Note). A note certificate (each a "**Certificate**") will be issued to each Noteholder in respect of its registered holding of Notes. Each Certificate will be numbered serially with an identifying number which will be recorded on the relevant Certificate and in the Register (as defined below) which the Republic will procure to be kept by the Registrar.

The Notes are not issuable in bearer form.

1.2 Title

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

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

2. Transfers of Notes and Issue of Certificates

2.1 Transfers

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

2.2 Delivery of new Certificates

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

Except in the limited circumstances described herein (see "The Global Certificate — Registration of Title" and "The Global Certificate — 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.

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

2.3 Formalities free of charge

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

2.4 Closed Periods

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

2.5 Regulations

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

3. Status

The Notes constitute direct, unconditional, (subject to the provisions of Condition 4 (*Negative Pledge*)) unsecured and general obligations of the Republic. The Notes rank *pari passu,* without any preference among themselves, 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, from time to time outstanding, **provided, however, that** the Republic shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other obligations and, in particular, shall have no obligations to pay other such obligations at the same time or as a condition of paying sums due on the Notes and vice versa.

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 (i) 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, or (ii) any obligation for the payment of money in respect of a derivative transaction (which for the avoidance of doubt shall include any swap transaction), such derivative transaction being entered into in connection with hedging the interest rate or foreign exchange exposure in respect of an obligation that qualifies under (i) above, **provided that**, in each case, if at any time the lawful currency of the Republic is the euro, then any indebtedness 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 11 March 2015 at the rate of 3.00 per cent. per annum, payable annually in arrear on 11 March in each year (from and including 11 March 2016) until maturity (each an "**Interest Payment Date**"). The first payment for the period from and including 11 March 2015 to but excluding 11 March 2016 and amounting to €30 per €1,000 principal amount of Notes shall be made on 11 March 2016.

The period beginning on and including 11 March 2015 and ending on but excluding the first Interest Payment Date and each successive period beginning on and including an Interest Payment Date and ending on but excluding the next successive Interest Payment Date is called an "**Interest Period**".

5.2 Interest Accrual

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

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

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

5.3 Calculation of Broken Interest

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

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

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

6.2 Payments subject to Applicable Laws

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

6.3 **No commissions**

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

6.4 **Payment on Business Days**

Where payment is to be made by transfer to a registered account, payment instructions (for value the due date or, if that is not a Business Day (as defined below), for value the first following day which is a Business Day) will be initiated and, where payment is to be made by cheque, the cheque will be mailed, on the Business Day 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 on which the Trans-European Automated Real-time Gross Settlement Express Transfer (TARGET2) System is open and a day on which commercial banks and foreign exchange markets settle payments and are open for general business in London and, in the case of presentation of a Note Certificate, in the place in which the Note Certificate is presented.

6.5 **Partial Payments**

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

6.6 **Agents**

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

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

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

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

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

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

7. **Redemption and Purchase**

7.1 **Redemption at Maturity**

Unless previously redeemed or purchased and cancelled as provided below, the Republic will redeem the Notes at their principal amount on 11 March 2025.

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 any meetings of Noteholders or for the purpose of Condition 13 (*Meetings of Noteholders; Written Resolutions*).

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, or any amount under, 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 (d) 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 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 Register maintained by the Registrar and published in a leading English language newspaper of general circulation in Europe (which is expected to be the *Financial Times*) and so long as the Notes are listed on the Luxembourg Stock Exchange and the rules of that Exchange so require, published in a daily newspaper in Luxembourg (which is expected to be the *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; Written Resolutions

13.1 Convening Meetings of Noteholders; Conduct of Meetings of Noteholders; Written Resolutions

(a) The Republic may convene a meeting of the Noteholders at any time in respect of the Notes in accordance with the Agency Agreement. The Republic will determine the time and place of the meeting. The Republic will notify the Noteholders of the time, place and purpose of the meeting not less than 21 and not more than 45 days before the meeting.

(b) The Republic will convene a meeting of Noteholders if the holders of at least 10 per cent. in principal amount of the outstanding Notes (as defined in the Agency Agreement and described in Condition 13.9 (*Notes controlled by the Republic*) below) have delivered a written request to the Republic or the Fiscal Agent (with a copy to the Republic) setting out the purpose of the meeting. The Fiscal Agent will agree the time and place of the meeting with the Republic promptly. The Republic will notify the Noteholders within 10 days of receipt of such written request of the time and place of the meeting, which shall take place not less than 21 and not more than 45 days after the date on which such notification is given.

(c) The Republic (with the agreement of the Fiscal Agent) will set the procedures governing the conduct of any meeting in accordance with the Agency Agreement. If the Agency Agreement does not include such procedures, or additional procedures are required, the Republic and the Fiscal Agent will agree such procedures as are customary in the market and in such a manner as to facilitate any multiple series aggregation, if in relation to a Reserved Matter the Republic proposes any modification to the terms and conditions of, or action with respect to, two or more series of debt securities issued by it.

(d) The notice convening any meeting will specify, *inter alia*;

(i) the date, time and location of the meeting;

(ii) the agenda and the text of any Extraordinary Resolution to be proposed for adoption at the meeting;

(iii) the record date for the meeting, which shall be no more than five business days before the date of the meeting;

(iv) the documentation required to be produced by a Noteholder in order to be entitled to participate at the meeting or to appoint a proxy to act on the Noteholder's behalf at the meeting;

(v) any time deadline and procedures required by any relevant international and/or domestic clearing systems or similar through which the Notes are traded and/or held by Noteholders;

(vi) whether Condition 13.2 (*Modification of this Series of Notes only*), or Condition 13.3 (*Multiple Series Aggregation – Single limb voting*), or Condition 13.4 (*Multiple Series Aggregation – Two limb voting*) shall apply and, if relevant, in relation to which other series of debt securities it applies;

(vii) if the proposed modification or action relates to two or more series of debt securities issued by the Republic and contemplates such series of debt securities being aggregated in more than one group of debt securities, a description of the proposed treatment of each such group of debt securities;

(viii) such information that is required to be provided by the Republic in accordance with Condition 13.6 (*Information*);

(ix) the identity of the Aggregation Agent and the Calculation Agent, if any, for any proposed modification or action to be voted on at the meeting, and the details of any applicable methodology referred to in Condition 13.7 (*Claims Valuation*); and

(x) any additional procedures which may be necessary and, if applicable, the conditions under which a multiple series aggregation will be deemed to have been satisfied if it is approved as to some but not all of the affected series of debt securities.

(e) In addition, the Agency Agreement contains provisions relating to Written Resolutions. All information to be provided pursuant to Condition 13.1(d) (*Convening Meetings of Noteholders; Conduct of Meetings of Noteholders; Written Resolutions*) shall also be provided, *mutatis mutandis*, in respect of Written Resolutions.

(f) A "**record date**" in relation to any proposed modification or action means the date fixed by the Republic for determining the Noteholders and, in the case of a multiple series aggregation, the holders of debt securities of each other affected series that are entitled to vote on a Multiple Series Single Limb Extraordinary Resolution or a Multiple Series Two Limb Extraordinary Resolution, or to sign a Multiple Series Single Limb Written Resolution or a Multiple Series Two Limb Written Resolution.

(g) An "**Extraordinary Resolution**" means any of a Single Series Extraordinary Resolution, a Multiple Series Single Limb Extraordinary Resolution and/or a Multiple Series Two Limb Extraordinary Resolution, as the case may be.

(h) A "**Written Resolution**" means any of a Single Series Written Resolution, a Multiple Series Single Limb Written Resolution and/or a Multiple Series Two Limb Written Resolution, as the case may be.

(i) Any reference to "**debt securities**" means any notes (including the Notes), bonds, debentures or other debt securities issued by the Republic in one or more series with an original stated maturity of more than one year.

(j) "**Debt Securities Capable of Aggregation**" means those debt securities which include or incorporate by reference this Condition 13 (*Meetings of Noteholders; Written Resolutions*) and Condition 14 (*Aggregation Agent; Aggregation Procedures*) or provisions substantially in these terms which provide for the debt securities which include such provisions to be capable of being aggregated for voting purposes with other series of debt securities.

13.2 **Modification of this Series of Notes only**

(a) Any modification of any provision of, or any action in respect of, the Notes, the Agency Agreement and/or the Deed of Covenant may be made or taken if approved by a Single Series Extraordinary Resolution or a Single Series Written Resolution as set out below.

(b) A "**Single Series Extraordinary Resolution**" means a resolution passed at a meeting of Noteholders duly convened and held in accordance with the procedures prescribed by the Republic and the Fiscal Agent pursuant to Condition 13.1 (*Convening Meetings of Noteholders; Conduct of Meetings of Noteholders; Written Resolutions*) by a majority of:

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

(ii) in the case of a matter other than a Reserved Matter, more than 50 per cent. of the aggregate principal amount of the outstanding Notes.

(c) A "**Single Series Written Resolution**" means a resolution in writing signed or confirmed in writing by or on behalf of the holders of:

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

(ii) in the case of a matter other than a Reserved Matter more than 50 per cent. of the aggregate principal amount of the outstanding Notes.

Any Single Series Written Resolution may be contained in one document or several documents in the same form, each signed or confirmed in writing by or on behalf of one or more Noteholders.

(d) Any Single Series Extraordinary Resolution duly passed or Single Series Written Resolution approved shall be binding on all Noteholders, whether or not they attended any meeting, whether or not they voted in favour thereof and whether or not they signed or confirmed in writing any such Single Series Written Resolution, as the case may be.

13.3 **Multiple Series Aggregation – Single limb voting**

(a) In relation to a proposal that includes a Reserved Matter, any modification to the terms and conditions of, or any action with respect to, two or more series of Debt Securities Capable of Aggregation may be made or taken if approved by a Multiple Series Single Limb Extraordinary Resolution or by a Multiple Series Single Limb Written Resolution as set out below, provided that the Uniformly Applicable condition is satisfied.

(b) A "**Multiple Series Single Limb Extraordinary Resolution**" means a resolution considered at separate meetings of the holders of each affected series of Debt Securities Capable of Aggregation, duly convened and held in accordance with the procedures prescribed by the Republic and the Fiscal Agent pursuant to Condition 13.1 (*Convening Meetings of Noteholders; Conduct of Meetings of Noteholders; Written Resolutions*), as supplemented if necessary, which is passed by a majority of at least 75 per cent. of the aggregate principal amount of the outstanding debt securities of all affected series of Debt Securities Capable of Aggregation (taken in aggregate).

(c) A "**Multiple Series Single Limb Written Resolution**" means each resolution in writing (with a separate resolution in writing or multiple separate resolutions in writing distributed to the holders of each affected series of Debt Securities Capable of Aggregation, in accordance with the applicable bond documentation) which, when taken together, has been signed or confirmed in writing by or on behalf of the holders of at least 75 per cent. of the aggregate principal amount of the outstanding debt securities of all affected series of Debt Securities Capable of Aggregation (taken in aggregate). Any Multiple Series Single Limb Written Resolution may be contained in one document or several documents in substantially the same form, each signed or confirmed in writing by or on behalf of one or more Noteholders or one or more holders of each affected series of debt securities.

(d) Any Multiple Series Single Limb Extraordinary Resolution duly passed or Multiple Series Single Limb Written Resolution approved shall be binding on all Noteholders and holders of each other affected series of Debt Securities Capable of Aggregation, whether or not they attended any meeting, whether or not they voted in favour thereof, whether or not any other holder or holders of the same series voted in favour thereof and whether or not they signed or confirmed in writing any such Multiple Series Single Limb Written Resolution, as the case may be, and on all couponholders (where applicable) of each other affected series of Debt Securities Capable of Aggregation.

(e) The "**Uniformly Applicable**" condition will be satisfied if:

(i) the holders of all affected series of Debt Securities Capable of Aggregation are invited to exchange, convert, or substitute their debt securities, on the same terms*, for (i) the same new instrument or other consideration or (ii) a new instrument, new instruments or other consideration from an identical menu of instruments or other consideration; or

(ii) the amendments proposed to the terms and conditions of each affected series of Debt Securities Capable of Aggregation would, following implementation of such amendments, result in the amended instruments having identical provisions (other than provisions which are necessarily different, having regard to different currency of issuance).

(f) Any modification or action proposed under Condition 13.3(a) may be made in respect of some series only of the Debt Securities Capable of Aggregation and, for the avoidance of doubt, the provisions described in this Condition 13.3 may be used for different groups of two or more series of Debt Securities Capable of Aggregation simultaneously.

13.4 **Multiple Series Aggregation – Two limb voting**

(a) In relation to a proposal that includes a Reserved Matter, any modification to the terms and conditions of, or any action with respect to, two or more series of Debt Securities Capable of Aggregation may be made or taken if approved by a Multiple Series Two Limb Extraordinary Resolution or by a Multiple Series Two Limb Written Resolution as set out below.

(b) A "**Multiple Series Two Limb Extraordinary Resolution**" means a resolution considered at separate meetings of the holders of each affected series of Debt Securities Capable of Aggregation, duly convened and held in accordance with the procedures prescribed by the Republic and the Fiscal Agent pursuant to Condition 13.1 (*Convening Meetings of Noteholders; Conduct of Meetings of Noteholders; Written Resolutions*), as supplemented if necessary, which is passed by a majority of:

(i) at least two thirds of the aggregate principal amount of the outstanding debt securities of all affected series of Debt Securities Capable of Aggregation (taken in aggregate); and

(ii) more than 50 per cent. of the aggregate principal amount of the outstanding debt securities in each affected series of Debt Securities Capable of Aggregation (taken individually).

(c) A "**Multiple Series Two Limb Written Resolution**" means each resolution in writing (with a separate resolution in writing or multiple separate resolutions in writing distributed to the holders of each affected series of Debt Securities Capable of

* Meaning the same offer on principal, the same offer on all interest accrued but unpaid prior to an exchange or event of default and the same offer on past due interest (or other relevant financial features of the bonds), but any such offer may contain differences as between different series of affected Debt Securities Capable of Aggregation which are necessary having regard to the currency of denomination.

Aggregation, in accordance with the applicable bond documentation) which, when taken together, has been signed or confirmed in writing by or on behalf of the holders of:

(i) at least two thirds of the aggregate principal amount of the outstanding debt securities of all the affected series of Debt Securities Capable of Aggregation (taken in aggregate); and

(ii) more than 50 per cent. of the aggregate principal amount of the outstanding debt securities in each affected series of Debt Securities Capable of Aggregation (taken individually).

Any Multiple Series Two Limb Written Resolution may be contained in one document or several documents in substantially the same form, each signed or confirmed in writing by or on behalf of one or more Noteholders or one or more holders of each affected series of Debt Securities Capable of Aggregation.

(d) Any Multiple Series Two Limb Extraordinary Resolution duly passed or Multiple Series Two Limb Written Resolution approved shall be binding on all Noteholders and holders of each other affected series of Debt Securities Capable of Aggregation, whether or not they attended any meeting, whether or not they voted in favour thereof, whether or not any other holder or holders of the same series voted in favour thereof and whether or not they signed or confirmed in writing any such Multiple Series Two Limb Written Resolution, as the case may be, and on all couponholders (where applicable) of each other affected series of Debt Securities Capable of Aggregation.

(e) Any modification or action proposed under Condition 13.4(a) may be made in respect of some series only of the Debt Securities Capable of Aggregation and, for the avoidance of doubt, the provisions described in this Condition 13.4 may be used for different groups of two or more series of Debt Securities Capable of Aggregation simultaneously.

13.5 **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 majority required to pass an Extraordinary Resolution, a 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, or the definition of "Extraordinary Resolution", "Single Series Extraordinary Resolution", "Multiple Series Single Limb Extraordinary Resolution", "Multiple Series Two Limb Extraordinary Resolution", "Written Resolution", "Single Series Written Resolution", "Multiple Series Single Limb Written Resolution" or "Multiple Series Two Limb Written Resolution";

(e) to change the definition of "debt securities" or "Debt Securities Capable of Aggregation";

(f) to change the definition of "Uniformly Applicable";

(g) to change the definition of "outstanding" or to modify the provisions of Condition 13.9 (*Notes controlled by the Republic*);

(h) to change the legal ranking of the Notes;

(i) to change any provision of the Notes describing circumstances in which Notes may be declared due and payable prior to their scheduled maturity date, set out in Condition 10.1 (*Events of Default*);

(j) to change the law governing the Notes, the courts to the jurisdiction of which the Republic has submitted in the Notes, any of the arrangements specified in the Notes to enable proceedings to be taken or the Republic's waiver of immunity, in respect of actions or proceedings brought by any Noteholder, set out in Condition 17 (*Governing Law and Submission to Jurisdiction*);

(k) to impose any condition on or otherwise change the Republic's obligation to make payments of principal, interest or any other amount in respect of the Notes, including by way of the addition of a call option;

(l) except as permitted by any related guarantee or security agreement, to release any agreement guaranteeing or securing payments under the Notes or to change the terms of any such guarantee or security; or

(m) to exchange or substitute all the Notes for, or convert all the Notes into, other obligations or securities of the Republic or any other person, or to modify any provision of these Conditions in connection with 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, which would result in the Conditions as so modified being less favourable to the Noteholders which are subject to the Conditions as so modified than:

  (i) the provisions of the other obligations or debt securities of the Republic or any other person resulting from the relevant exchange or substitution or conversion; or

  (ii) if more than one series of other obligations or debt securities results from the relevant exchange or substitution or conversion, the provisions of the resulting series of debt securities having the largest aggregate principal amount.

13.6 **Information**

Prior to or on the date that the Republic proposes any Extraordinary Resolution or Written Resolution pursuant to Condition 13.2 (*Modification of this Series of Notes only*), Condition 13.3 (*Multiple Series Aggregation – Single limb voting*) or Condition 13.4 (*Multiple Series Aggregation – Two limb voting*), the Republic shall publish in accordance with Condition 14 (*Aggregation Agent; Aggregation Procedures*), and provide the Fiscal Agent with the following information:

(a) a description of the Republic's economic and financial circumstances which are, in the Republic's opinion, relevant to the request for any potential modification or action, a description of the Republic's existing debts and a description of its broad policy reform programme and provisional macroecomic outlook;

(b) if the Republic shall at the time have entered into an arrangement for financial assistance with multilateral and/or other major creditors or creditor groups and/or an agreement with any such creditors regarding debt relief, a description of any such arrangement or agreement. Where permitted under the information disclosure policies of the multilateral or such other creditors, as applicable, copies of the arrangement or agreement shall be provided;

(c) a description of the Republic's proposed treatment of external debt securities that fall outside the scope of any multiple series aggregation and its intentions with respect to any other debt securities and its other major creditor groups; and

(d) if any proposed modification or action contemplates debt securities being aggregated in more than one group of debt securities, a description of the proposed treatment of each such group, as required for a notice convening a meeting of the Noteholders in Condition 13.1(d)(vii) (*Convening Meetings of Noteholders; Conduct of Meetings of Noteholders; Written Resolutions*).

13.7 **Claims Valuation**

For the purpose of calculating the par value of the Notes and any affected series of debt securities which are to be aggregated with the Notes in accordance with Condition 13.3 (*Multiple Series Aggregation – Single limb voting*) and Condition 13.4 (*Multiple Series Aggregation – Two limb voting*), the Republic may appoint a Calculation Agent. The Republic shall, with the approval of the Aggregation Agent and any appointed Calculation Agent, promulgate the methodology in accordance with which the Calculation Agent will calculate the par value of the Notes and such affected series of debt securities. In any such case where a Calculation Agent is appointed, the same person will be appointed as the Calculation Agent for the Notes and each other affected series of debt securities for these purposes, and the same methodology will be promulgated for each affected series of debt securities.

13.8 **Manifest error, etc.**

The Notes, these Conditions and the provisions of the Agency Agreement may be amended by the Republic 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.

13.9 **Notes controlled by the Republic**

For the purposes of (a) determining the right to attend and vote at any meeting of Noteholders, or the right to sign or confirm in writing, or authorise the signature of, any Written Resolution, (b) this Condition 13 (*Meetings of Noteholders; Written Resolutions*) and (c) Condition 10 (*Events of Default*), any Notes which are for the time being 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 shall be disregarded and be deemed not to remain outstanding, where:

(i) "**public sector instrumentality**" means the Croatian National Bank (*Hrvatska Narodna Banka*), the Croatian Ministry of Finance (*Ministarstvo Financija*), any other 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 or any of the foregoing; and

(ii) "**control**" means the power, directly or indirectly, through the ownership of voting securities or other ownership interests or through contractual control 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.

A Note will also be deemed to be not outstanding if the Note has previously been cancelled or delivered for cancellation or held for reissuance but not reissued, or, where relevant, the Note has previously been called for redemption in accordance with its terms or previously become due and payable at maturity or otherwise and the Republic has previously satisfied its obligations to make all payments due in respect of the Note in accordance with its terms.

In advance of any meeting of Noteholders, or in connection with any Written Resolution, the Republic shall provide to the Fiscal Agent a copy of the certificate prepared pursuant to Condition 14.4 (*Aggregation Agent; Aggregation Procedures – Certificate*), which includes information on the total number of Notes which are for the time being 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 and, as such, such Notes shall be disregarded and deemed not to remain outstanding for the purposes of 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 in respect of any such meeting. 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.

13.10 **Publication**

The Republic shall publish all Extraordinary Resolutions and Written Resolutions which have been determined by the Aggregation Agent to have been duly passed in accordance with Condition 14.7 (*Aggregation Agent; Aggregation Procedures – Manner of Publication*).

13.11 **Exchange and Conversion**

Any Extraordinary Resolutions or Written Resolutions which have been duly passed and which modify any provision of, or action in respect of, the Conditions may be implemented at the Republic's option by way of a mandatory exchange or conversion of the Notes and each other affected series of debt securities, as the case may be, into new debt securities containing the modified terms and conditions if the proposed mandatory exchange or conversion of the Notes is notified to Noteholders at the time notification is given to the Noteholders as to the proposed modification or action. Any such exchange or conversion shall be binding on all Noteholders.

14. **Aggregation Agent; Aggregation Procedures**

14.1 **Appointment**

The Republic will appoint an Aggregation Agent to calculate whether a proposed modification or action has been approved by the required principal amount outstanding of Notes, and, in the case of a multiple series aggregation, by the required principal amount of outstanding debt securities of each affected series of debt securities. In the case of a multiple series aggregation, the same person will be appointed as the Aggregation Agent for the proposed modification of any provision of, or any action in respect of, these Conditions or the Agency Agreement in respect of the Notes and in respect of the terms and conditions or bond documentation in respect of each other affected series of debt securities. The Aggregation Agent shall be independent of the Republic.

14.2 **Extraordinary Resolutions**

If an Extraordinary Resolution has been proposed at a duly convened meeting of Noteholders to modify any provision of, or action in respect of, these Conditions and other affected series of debt securities, as the case may be, the Aggregation Agent will, as soon as practicable after the time the vote is cast, calculate whether holders of a sufficient portion of the aggregate principal amount of the outstanding Notes and, where relevant, each other affected series of debt securities, have voted in favour of the Extraordinary Resolution such that the Extraordinary Resolution is passed. If so, the Aggregation Agent will determine that the Extraordinary Resolution has been duly passed.

14.3 **Written Resolutions**

If a Written Resolution has been proposed under the terms of these Conditions to modify any provision of, or action in respect of, these Conditions and the terms and conditions of other affected series of debt securities, as the case may be, the Aggregation Agent will, as soon as reasonably practicable after the relevant Written Resolution has been signed or confirmed in writing, calculate whether holders of a sufficient portion of the aggregate principal amount of the outstanding Notes and, where relevant, each other affected series of debt securities, have signed or confirmed in writing in favour of the Written Resolution such that the Written Resolution is passed. If so, the Aggregation Agent will determine that the Written Resolution has been duly passed.

14.4 **Certificate**

For the purposes of Condition 14.2 (– *Extraordinary Resolutions*) and Condition 14.3 (– *Written Resolutions*), the Republic will provide a certificate to the Aggregation Agent up to three days prior to, and in any case no later than, with respect to an Extraordinary Resolution, the date of the meeting referred to in Condition 13.2 (*Meetings of Noteholders; Written Resolutions – Modification of this Series of Notes only*), Condition 13.3 (*Meetings of Noteholders; Written Resolutions – Multiple Series Aggregation – Single limb voting*) or Condition 13.4 (*Meetings of Noteholders; Written Resolutions – Multiple Series Aggregation – Two limb voting*), as applicable, and, with respect to a Written Resolution, the date arranged for the signing of the Written Resolution.

The certificate shall:

(a) list the total principal amount of Notes and, in the case of a multiple series aggregation, the total principal amount of each other affected series of debt securities outstanding on the record date; and

(b) clearly indicate the Notes and, in the case of a multiple series aggregation, debt securities of each other affected series of debt securities which shall be disregarded and deemed not to remain outstanding as a consequence of Condition 13.9 (*Meetings of Noteholders; Written Resolutions – Notes controlled by the Republic*) on the record date identifying the holders of the Notes and, in the case of a multiple series aggregation, debt securities of each other affected series of debt securities.

The Aggregation Agent may rely upon the terms of any certificate, notice, communication or other document believed by it to be genuine.

14.5 **Notification**

The Aggregation Agent will cause each determination made by it for the purposes of this Condition 14 (*Aggregation Agent; Aggregation Procedures*) to be notified to the Fiscal Agent and the Republic as soon as practicable after such determination. Notice thereof shall also promptly be given to the Noteholders.

14.6 **Binding nature of determinations; no liability**

All notifications, opinions, determinations, certificates, calculations, quotations and decisions given, expressed, made or obtained for the purposes of this Condition 14 (*Aggregation Agent; Aggregation Procedures*) by the Aggregation Agent and any appointed Calculation Agent will (in the absence of manifest error) be binding on the Republic, the Fiscal Agent and the Noteholders and (subject as aforesaid) no liability to any such person will attach to the Aggregation Agent or the Calculation Agent in connection with the exercise or non-exercise by it of its powers, duties and discretions for such purposes.

14.7 **Manner of publication**

The Republic will publish all notices and other matters required to be published pursuant to the Agency Agreement including any matters required to be published pursuant to Condition 10 (*Events of Default*), Condition 13 (*Meetings of Noteholders; Written Resolutions*), this Condition 14 (*Aggregation Agent; Aggregation Procedures*) and Condition 15 (*Noteholders' Committee*):

(a) on the website of the Croatian Ministry of Finance (*Ministarstvo Financija*);

(b) through the systems of Clearstream Banking, *société anonyme* and Euroclear Bank S.A./N.V. and/or any other international or domestic clearing system(s) through which the Notes are for the time being cleared;

(c) in such other places and in such other manner as may be required by applicable law or regulation; and

(d) in such other places and in such other manner as may be customary.

15. **Noteholders' Committee**

15.1 **Appointment**

(a) Holders of at least 25 per cent. of the aggregate principal amount of the outstanding debt securities of all series of affected debt securities (taken in aggregate) may, by notice in writing to the Republic (with a copy to the Fiscal Agent), appoint any person or persons as a committee to represent the interests of such holders (as well as the interests of any holders of outstanding debt securities who wish to be represented by such a committee) if any of the following events has occurred:

(i) an Event of Default under Condition 10 (*Events 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;

(iii) any public announcement by the Republic, to the effect that the Republic is seeking or intends to seek a rescheduling or restructuring of the Notes or any other affected series of debt securities (whether by amendment, exchange offer or otherwise); or

(iv) with the agreement of the Republic, at a time when the Republic has reasonably reached the conclusion that its debt may no longer be sustainable whilst the Notes or any other affected series of debt securities are outstanding.

(b) Upon receipt of a written notice that a committee has been appointed in accordance with Condition 15.1(a) (– *Appointment*), and a certificate delivered pursuant to Condition 15.4 (– *Certification*), the Republic shall give notice of the appointment of such a committee to:

(i) all Noteholders in accordance with Condition 12 (*Notices*); and

(ii) the holders of each affected series of debt securities in accordance with the terms and conditions of such affected series of debt securities,

as soon as practicable after such written notice and such certificate are delivered to the Republic.

15.2 **Powers**

Such committee in its discretion may, among other things:

(a) engage legal advisers and financial advisers to assist it in representing the interests of the Noteholders;

(b) adopt such rules as it considers appropriate regarding its proceedings;

(c) enter into discussions with the Republic and/or other creditors of the Republic; and

(d) 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.

Except to the extent provided in this Condition 15.2 (– *Powers*), such committee shall not have the ability to exercise any powers or discretions which the Noteholders could themselves exercise.

15.3 **Engagement with the committee and provision of information**

(a) The Republic shall:

(i) subject to Condition 15.3(b), engage with the committee in good faith;

(ii) provide the committee with information equivalent to that required under Condition 13.6 (*Meetings of Noteholders; Written Resolutions – Information*) and related proposals, if any, in each case as the same become available, subject to any applicable information disclosure policies, rules and regulations; and

(iii) pay any reasonable fees and expenses of any such committee (including without limitation, the reasonable and documented fees and expenses of the committee's legal and financial advisers, if any) following receipt of reasonably detailed invoices and supporting documentation.

(b) If more than one committee has been appointed by holders of affected series of debt securities in accordance with the provisions of this Condition 15 (*Noteholders' Committee*) and/or equivalent provisions set out in the terms and conditions of any affected series of debt securities, the Republic shall not be obliged to engage with such committees separately. Such committees may appoint a single steering group (to be comprised of representatives from such committees), whereupon the Republic shall engage with such steering group.

15.4 **Certification**

Upon the appointment of a committee, the person or persons constituting such a committee (the "**Members**") will provide a certificate to the Republic and to the Fiscal Agent signed by the authorised representatives of the Members, and the Republic and the Fiscal Agent may rely upon the terms of such certificate.

The certificate shall certify:

(a) that the committee has been appointed;

(b) the identity of the Members; and

(c) that such appointment complies with the terms and conditions of the relevant bond documentation.

Promptly after any change in the identity of the Members, a new certificate which each of the Republic and the Fiscal Agent may rely on conclusively, will be delivered to the Republic and the Fiscal Agent identifying the new Members. Each of the Republic and the Fiscal Agent will assume that the membership of the committee has not changed unless and until it has received a new certificate.

The provisions of this Condition 15.4 (– *Certification*) shall apply, *mutatis mutandis*, to any steering group appointed in accordance with Condition 15.3(b) (– *Engagement with the committee and provision of information*).

In appointing a person or persons as a committee to represent the interests of the Noteholders, the Noteholders may instruct a representative or representatives of the committee to form a separate committee or to join a steering group with any person or persons appointed for similar purposes by other affected series of debt securities.

16. **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.

17. **Governing Law and Submission to Jurisdiction**

17.1 **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.

17.2 **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. To the extent allowed by law, 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 17 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.

18. **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.

USE OF PROCEEDS

The net proceeds of the issue are estimated to amount to approximately €1,466,475,000 and will be used for general budgetary governmental purposes**.**

SUMMARY OF PROVISIONS RELATING TO THE NOTES WHILE IN GLOBAL FORM

The Global Certificate contains the following provisions which apply to the Notes in respect of which it is issued whilst they are represented by the Global Certificate, 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 will be represented on issue by a Global Certificate in registered form without interest coupons (the "**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 the Global Certificate may be held only through Euroclear or Clearstream, Luxembourg or their participants at any time.

Except in the limited circumstances described below, owners of beneficial interests in the Global Certificate 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 Certificate, each person (other than another clearing system) who is for the time being shown in the records of 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 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 Euroclear and Clearstream Luxembourg (the "**Relevant Nominee**") in accordance with and subject to the terms of the Global Certificate. Each Accountholder must look solely to Euroclear or Clearstream, Luxembourg, as the case may be, for its share of each payment made to the Relevant Nominee.

3. **Cancellation**

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

4. **Payments**

Payments of principal and interest in respect of Notes represented by the 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 the 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 Certificate for such purpose.

Distributions of amounts with respect to book-entry interests in the Global Certificate 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.

A record of each payment made will be endorsed on the appropriate schedule to the 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 the Global Certificate will be made to, or to the order of, the person whose name is entered on the 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 the Global Certificate and the 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 Euroclear and/or Clearstream, Luxembourg (as the case may be) as aforesaid.

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

6. **Registration of Title**

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

7. **Exchange for Certificates**

Exchange

The Global Certificate will be exchangeable, free of charge to the holder, in whole but not in part, for 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; or

(b) 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,

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

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

Delivery

In such circumstances, the 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 Registrar or Transfer Agent may require in respect of any tax or other duty of whatever nature which may be levied or imposed in connection with such exchange), cause sufficient Certificates to be executed and delivered to the Registrar for completion and dispatch to the relevant Noteholders. A person having an interest in the Global Certificate must provide the Registrar with a written order containing instructions and such other information as the Republic and the Registrar may require to complete, execute and deliver such Certificates.

Transfers

Transfers of book-entry interests in the Global Certificates will be effected through the records of Euroclear and/or Clearstream, Luxembourg and their respective participants in accordance with the rules and procedures of Euroclear and/or Clearstream, Luxembourg and their respective direct and indirect participants.

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.

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. According to the 2011 census results; Zagreb is the largest city in the country, with a population of 790,017. Zagreb is considered the leading industrial, cultural and scientific centre in Croatia. Other cities of significant size include Split (population 178,102), Rijeka (population 128,624), Osijek (population 108,048) and Zadar (population 75,062). According to the 2011 census, the total population of the country was 4,284,889.

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 the 2011 census, which is the latest available data)

The following table sets out a breakdown of population by religious group in 2011:

	Population	**Per cent. of total**
	(thousands)	
Roman Catholics[(1)]	3,697,143	86.3
Orthodox Christians[(2)]	190,143	4.4
Muslims	62,977	1.5
Other[(3)]	334,626	7.8
Total	**4,284,889**	**100.0**

Source: Croatian Central Bureau of Statistics (based on the 2011 census, which is the 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 the year 626, the Croatian people submitted the Roman provinces of Dalmatia, Pannonia and Illyricum and established two independent principalities that were united into the Croatian Kingdom by its first King Tomislav who was crowned in 925. Along with the Frankish Kingdom, Adriatic Croatia was the first permanent and organised state in Central Europe.

After the extinction of the native Trpimirović dynasty, the Parliament (Sabor) was electing rulers of other states as Kings of Croatia, thereby creating a personal union – first between Croatia and Hungary (1102 – 1300 and 1307 – 1526), and then between Croatia and Austria (1527 – 1918). Between the 15th and 18th centuries, the Croatian Kingdom acted as a bulwark for Christian Europe and was crucial in halting the further advance of the Ottoman Empire towards the West, while on the other side the Venetian Republic occupied most of the Croatian coast.

Owing to its special position within the Habsburg Monarchy, the Croatian Kingdom preserved its sovereignty until the collapse of the Monarchy in 1918. After discontinuing constitutional links with Austria and Hungary in 1918, Croatia was included in the newly created Kingdom of Serbs, Croats and Slovenes (later the Kingdom of Yugoslavia) without the consent of the Parliament. As a result, Croatia was for the first time placed within a Balkan political context, and by coercion, ceased to exist as a state.

The autonomous Banovina of Croatia, established in 1939 by the agreement between the Croatian opposition and the Yugoslav Government, lasted until the Axis powers broke up Yugoslavia in 1941. Despite the plebiscitary support of the population for the pro-Western peasant-democratic coalition, the Second World War in Croatia was led between two radical movements – the Ustasha under the auspices of the Axis and the Communists (Partisans) on the side of the Allies, which both declared their own Croatian state.

From 1945, Croatia was one of the six federal states of Marshal Tito's communist Yugoslavia. The democratic people's movement known as the Croatian Spring which sought political rights for Croatia within Yugoslavia and which opposed the forced merging of the Croatian language with Serbian into Serbo-Croatian in 1967, was repressed by the Yugoslav regime in 1971.

Following democratic elections in 1990, the Republic of Croatia declared independence in 1991, as the majority of member states of Yugoslavia did. Using the former federal army and local rebels, Serbia and Montenegro attacked Croatia and Bosnia and Herzegovina in 1991 with the aim of retaining the territories conquered in the rump Yugoslavia. The war ended in 1995 with a victory for Croatia and the liberation of occupied areas, while the simultaneous successes of the Croatian-Bosniak alliance led to the peace process in Bosnia and Herzegovina.

Croatia became a member of NATO in 2009, and joined the EU in 2013 as its 28th member state.

International Relations

After gaining independence, Croatia was admitted to the UN in May 1992. In the same year, Croatia became a participant country in the Organization for Security and Co-operation in Europe and became a member of the IMF. In 1996, Croatia became the 40th Member State of the Council of Europe. 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 World Trade Organization, 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. In April 2009, Croatia acceded to NATO. On 1 July 2013, Croatia became a member state of the EU.

The IMF has assisted Croatia in maintaining macroeconomic stability since 1994. See "*The Economy — Stabilisation of the Economy*". The IMF conducts routine annual missions to Croatia and issued its last Staff Report on Croatia in May 2014.

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 programmes; and (vi) continue the process of judicial reform.

Constitution and Government Structure

Croatia's Constitution was adopted on 22 December 1990 and was substantially amended in December 1997, November 2000, April 2001, June 2010 and December 2013 (the latest amendment to the Constitution is related to the definition of marriage). 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 Kolinda Grabar-Kitarović (elected in January 2015) and the current Prime Minister is Zoran Milanovic (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 and give 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 can only be passed by a two thirds majority of all members and, in certain cases, laws on constitutional rights can only be passed by 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 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 mandates 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 Government cabinet members.

Name	Title
Zoran Milanović	Prime Minister
Vesna Pusić	First Deputy Prime Minister and Minister of Foreign and European Affairs
Milanka Opačić	Deputy Prime Minister and Minister of Social Welfare Policy and Youth
Ranko Ostojić	Deputy Prime Minister and Minister of Interior
Branko Grčić	Deputy Prime Minister and Minister of Regional Development and EU Funds
Boris Lalovac	Minister of Finance
Ante Kotromanović	Minister of Defence
Ivan Vrdoljak	Minister of Economy
Orsat Miljenić	Minister of Justice
Arsen Bauk	Minister of Public Administration
Gordan Maras	Minister of Entrepreneurship and Trade
Mirando Mrsić	Minister of Labour and Pension System
Siniša Hajdaš Dončić	Minister of Maritime Affairs, Transport and Infrastructure
Tihomir Jakovina	Minister of Agriculture
Darko Lorencin	Minister of Tourism
Mihael Zmajlović	Minister of Environmental and Nature Protection
Anka Mrak — Taritaš	Minister of Construction and Physical Planning
Predrag Matić	Minister of War Veterans
Siniša Varga	Minister of Health
Vedran Mornar	Minister of Science, Education and Sports
Andrea Zlatar 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 judgments, 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 two terms. 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.

Judicial Reform

Prior to EU accession, the Government focused its judicial reform efforts on strengthening the rule of law, improving the efficiency and effectiveness of judicial system, shortening the period of time between the commencement and conclusion of legal training, and improving professionalism and ongoing training of the staff. Since accession, the Government is focusing on aligning its judiciary with that of the EU along with integration into the EU judicial process.

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.

Past and ongoing corruption cases include investigations against a former Deputy Prime Minister, a former Prime Minister, a 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.

A new Public Procurement Act (OG 90/1 and 83/13, 143/13 and 13/2014) was passed in 2011 and entered into force on 1 January 2012 (certain provisions entered into force on 1 July 2013, upon Croatia's accession to the EU). Amendments to the Public Procurement Act are fully aligned with the chapters of the EU acquis communautaire. An "**anti-corruption clause**" was incorporated into the Act which seeks to prevent conflicts of interest in the area of public procurement. In June 2013, the Government adopted an Ordinance on Internal Organisation of the State Commission for Control of Public Procurement Procedures (OG 84/13 and 145/2014). The Concessions Act and the Public Private Partnership Act were adopted as well. The Public Procurement System Directorate of the Ministry of Economy and the State Commission for Control of Public Procurement Procedures supervise the public procurement procedure to ensure that it is transparent and implemented consistently. In January 2015, the Government adopted a new Ordinance on Internal Organisation of the State Office for Central Public Procurement (OG 3/2015).

Certain Recently Enacted Legislation

The Parliament passed the Anti-Money Laundering and Terrorist Financing Law (the "**AML/TFL**") on 15 July 2008. The 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.

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 Milanovic, was appointed as Croatia's Prime Minister on 23 December 2011.

Presidential Elections

On 28 December 2014, a first round of presidential elections was held and Mr. Ivo Josipović, the acting President since 2010,, won 38.46 per cent. of votes, which was not sufficient to win the elections outright. A second round of presidential elections was held on 11 January 2015 between first-round winner Mr. Ivo Josipović and first-round runner-up Ms. Kolinda Grabar-Kitarović, nominated by the HDZ, and Ms. Grabar-Kitarović won 50.74 per cent. of votes, becoming newly elected president for a 5 year term starting in February 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:

	Seat	Percentage
Social Democratic Party of Croatia (SDP)	58	39.7
Croatian Democratic Union (HDZ)	42	29.8
Croatian People's Party (HNS)	13	9.3
Croatian Democratic Alliance of Slavonia and Baranja (HDSSB)	7	4.0
Croatian Labourists — Labour Party	6	4.0
Croatian Party of Pensioners (HSU)	4	2.0
Istrian Democratic Party (IDS)	2	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
Democratic Centre		
Croatian Sustainable Development		
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 May 2013. The next elections for the local and regional self-governments are expected to take place in 2017.

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 continue to hear war crimes cases brought by the State Prosecutor's Office related to the 1991 War.

General Information

The address of the Ministry of Finance of Croatia is Katančićeva 5, HR-10000 Zagreb, Croatia and the telephone number is +385 1 45 91 333.

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, the 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 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 HNB 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 HNB 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*) (the "**CPF**"). Through the privatisation programme, former and current employees, pensioners and management of the privatised entities acquired part ownership of these entities.

Out of approximately 3,000 companies that started their transition process at the beginning of the 1990s, more than two-thirds have now been privatised.

Privatisation Efforts in the Medium Term

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.

In November 2012, Croatian Railways was divided into three connected companies: CR Infrastructure, CR Passenger Transport and CR Cargo. By the end of 2012, 1,400 employees had left these companies during or as a result of the restructuring process. CR Cargo is in the process of privatisation, and a tender for expressions of interest was published. The process involves the restructuring of CR Cargo and the possibility of acquiring equity interests in the business. The privatisation of Croatia osiguranje was finalised in 2014.

A project to privatise the motorway network has been the subject of a challenge by way of referendum and there is currently no indication of timing for progress in respect of this project.

A number of companies in which the state has a minority stake are also expected to be privatised, subject to market conditions. The total estimated Government proceeds of these privatisations amounted to HRK 1 billion in January 2015.

Four of the planned five phases of the privatisation of the Croatian Oil and Gas Company INA-INDUSTRIJA NAFTE d.d., ("**INA**") have been executed, with the Hungarian Oil and Gas Public Limited Company ("**MOL**") currently owning 47.3 per cent. of INA. The Government currently has 44.84 per cent. share and the remaining shares are publicly owned.

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.

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 2013 Croatia's per capita income was approximately 61 per cent. of the GDP per capita of the EU28 countries in purchasing power terms. Prior to accession to the EU, the framework and goals of the economic policy of Croatia were defined in a series of strategic documents of the Government, namely: the Strategic Development Framework for 2006-2013, the Government Programmes Strategy 2013-2015, the Economic and Fiscal Policy Guidelines and the Pre-accession Economic Programme (the "**PEP**"). The 2013 Economic Programme of Croatia represents a transition between the PEP and the reporting requirements under the European Semester, in order to improve coordination of Croatia's economic policies and help strengthen budgetary discipline, macroeconomic stability, and growth. These documents provide the basis for the implementation of the economic policy in the medium term period, and they are prepared through consultations between Government administration bodies and employers' and unions' representatives.

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.

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 12 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 are expected to 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 are expected to 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.

Public Administration Reform

In 2012, the Fiscal Cash Register Act (OG 133/12) (the "**Fiscal Cash Register Act**") was adopted. The purpose of this legislation was to create conditions for supervision of cash transactions (issuance of invoices, sale of goods and services for cash) and decrease tax evasion. The Fiscal Cash Register Act regulates the manner in which cash transactions are performed, defines subjects and models of fiscal cash register procedures, prescribes mandatory income elements intended to aid effective tax auditing and sets out a plan for the phased introduction of fiscal cash registry procedures and other provisions relevant to its implementation. The Fiscal Cash Register Act entered into force on 1 January 2013.

The Act on Financial Business Activity and Pre-Bankruptcy Settlement (OG 108/12, 144/12, 81/13 and 112/13) (the "**Act on Financial Business Activity and Pre-Bankruptcy Settlement**") entered into force on 1 October 2012. The Act on Financial Business Activity and Pre-Bankruptcy Settlement regulates financing of enterprises and sets deadlines for monetary liability settlement and regulations for the operation of enterprises in case of insolvency and illiquidity, i.e. the procedure of pre-bankruptcy settlement. It is expected that the Act on Financial Business Activity and Pre-Bankruptcy Settlement will help to ameliorate the issue of tight cash flow and insolvency that affects many Croatian enterprises. Under the Act on Financial Business Activity and Pre-Bankruptcy Settlement, a business owner who cannot pay his creditors within 60 days must seek to settle with them within another 60 days. If the business owner is unable to settle with his creditors, the pre-bankruptcy settlement procedure is launched. The procedure is conducted by the Financial Agency ("**FINA**") and may last up to 120 days. Once the pre-bankruptcy settlement procedure is launched, creditors will no longer have the right to block the debtor's account. The settlement will succeed if it is agreed to by the debtor and the creditors who have more than 50 per cent. of the claims, and it must be upheld by a commercial court. If the parties are unable to reach a settlement, a bankruptcy procedure is launched. The Act on Financial Business Activity and Pre-Bankruptcy Settlement envisages sanctions against members of management or supervisory boards who fail to launch a settlement procedure or act against the law.

In the area of public administration reform, the plan to implement a central salary system for the ministries was enacted in February 2013, for the public sector (comprising approximately 230,000 employees including schools and health institutions). The Ministry of Public Administration (the "**MOPA**") is also in the final stage of equalising wages for equal positions in the state administration and public sector. It is also working on the Civil Service Salaries Act of which the final draft will be based on the data collected from the central salary system. It is also expected that state administration wages will be reduced through a 3 per cent. cut in wages. The MOPA is also currently drafting the Strategy for the Modernisation of the Public Administration 2013-2018.

The Act on the Restoration of Public Institutions (the "**Act on the Restoration of Public Institutions**") came into force in January 2013 and was subsequently amended by entry into force of the Government's Ordinance in December 2014. This process is being implemented as a result of public institutions' accumulation of debts and arrears that negatively affect the economy. It is designed to enable public institutions to observe the 30- and 60-day limit for contract payments by restructuring financial obligations of the institutions unable to settle their accrued liabilities. As debts and arrears are significant in the health sector, the Act on the Restoration of Public Institutions requires that local units, which cannot address the liabilities of health institutions owned by them, request the central Government to begin the restoration programme. The restoration programme has been implemented since November 2013.

EU Structural Funds

Having joined the EU on 1 July 2013, Croatia is now 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 to 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. In addition, receipt of funds under these EU programmes is subject to a co-financing requirement by Croatia.

Excessive Deficit Procedure

On 28 January 2014, the European Commission opened an Excessive Deficit Procedure ("**EDP**") against Croatia to reduce the excessive Government deficit by 2016. The EDP recommendations required Croatia to reach a headline deficit target of 4.6 per cent. of GDP in 2014, 3.5 per cent. of GDP in 2015 and 2.7 per cent. of GDP in 2016. This is consistent with an improvement in the structural balance of 0.5 per cent. of GDP in 2014, 0.9 per cent. of GDP in 2015 and 0.7 per cent. of GDP in 2016. These headline deficit targets are also consistent with the adoption of consolidation measures amounting to 2.3 per cent. of GDP in 2014 and 1.0 per cent. of GDP in 2015 and 2016, in order to reach the required adjustment of the structural balance.

The first assessment of effective action took place in June 2014, wherein the European Commission concluded that Croatia had delivered the consolidation strategy that was intended to achieve the recommended targets, and considered that the EDP for Croatia was temporarily suspended.

According to the most recent report by the European Commission regarding the EDP for Croatia published in November 2014, the 'bottom-up' approach showed that Croatia had taken the measures deemed necessary to reach the structural targets under EDP for 2014.

The next assessment by the European Commission of effective action taken by Croatia will take place in May 2015 once Croatia has submitted the Convergence Programme and National Reform Programme for 2015.

Plans for Adoption of the Euro

As a member state of the EU, Croatia is committed to adopt the euro once it fulfils the necessary conditions, and 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 (though not expected in the short term) are dependent on Croatia's ability to fulfil the relevant membership criteria. *See "Risk Factors – The further proliferation of the euro in the Croatian economy may adversely effect the HNB's ability to implement its monetary policies"*.

World Bank Country Partnership Strategy

In June 2013, the World Bank's Board endorsed the Country Partnership Strategy ("**CPS**") for Croatia for 2014-2017, replacing the previous CPS for 2009-2012, whose goal was to support the completion of Croatia's EU accession. The primary goal of the 2014-2017 CPS is to speed up Croatia's convergence with the EU, prioritising aspects of the Europe 2020 "smart, sustainable, and inclusive growth" strategy and the Government's current reform agenda. The CPS focuses on the following three themes:

- fiscal adjustment through reforms at the sector level;
- innovation and trade competitiveness for growth and shared prosperity; and
- helping maximise the economic benefits of becoming an EU member state.

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 post-EU accession agenda. Projects that improve fiscal consolidation for macroeconomic stability, promote private sector-led growth and maximise the economic benefits of EU membership by enhancing Croatia's capacity to absorb EU funds, have high priority. The

CPS envisages an indicative aggregate base-case lending amount of approximately U.S.$800 million for investment operations over the four-year period. The CPS lending programme focuses on the areas of public finance, competitiveness and EU membership.

The World Bank's current total active lending portfolio with respect to Croatia consists of 11 projects with total commitments of approximately U.S.$775 million in a wide range of sectors. In addition, the International Finance Corporation's portfolio of investments in Croatia amounts to approximately U.S.$192 million and the Multilateral Investment Guarantee Agency's guarantees relating to projects within Croatia amounts to approximately U.S.$900 million.

Economic Incentives Reform

The Agency for Investment and Competitiveness was established by the Government in April 2012. It will provide assistance in removing administrative barriers and will conduct post-investment supervision as well as advisory services in relation to investment and promotion of Croatia as a desired investment destination. In order to help stimulate new investment, the Ministry of Economy has prepared the Catalogue of Investments (the "**Catalogue**") comprising all investment projects related to energy, tourism and infrastructure. The Catalogue will be regularly updated by the Agency for Investment and Competitiveness.

In addition, the Government adopted several new acts aimed at improving competitiveness and growth. The Act on Investment Incentives and Improvement of Business Environment (the "**Act on Investment Incentives and Improvement of Business Environment**") came into force in October 2012. The Act on Investment Incentives and Improvement of Business Environment regulates incentives for investment projects in production and manufacturing activities, development and innovation activities, business support activities, high added value service activities and activities in tourism. Investors in production and manufacturing activities, technological development and innovation activities, or strategic activities related to business support have various tax benefits. Several types of non-refundable financial support for job creation and professional improvement of employees are also available to investors. Furthermore, the Republic of Croatia offers additional non-refundable financial support for investments in development and innovation of products via high technology.

The Act on Strategic Investment Projects (the "**Act on Strategic Investment Projects**") is envisaged as a measure to support investment. Its purpose is to speed up the implementation of large projects of strategic interest for the Government (i.e. legal ownership issues, granting of licences). The Act on Strategic Investment Projects applies to capital projects with a value of a minimum HRK 150 million or capital projects fulfilling certain criteria such as employment of a considerable number of persons, contribution to development of tourism, economy, exports, implementation of projects in undeveloped parts of the country and development of the infrastructure network. Strategic projects are selected by Government committee. All of the procedures connected with these projects are to be given high priority and all the relevant documents necessary for the start-up of these projects should, in principle, be granted by the relevant institutions in 15 working days.

HBOR is also engaged in activities to stimulate the Croatian economy. These include reduced interest rates for loans, loans without foreign exchange clauses, risk sharing and support to exporters. Interest rates were reduced by 1 percentage point for loans to support investments in agriculture, fisheries, tourism, energy efficiency and renewable energy resources. All loans approved prior to the end of 2012 were allowed to be executed without foreign exchange clauses except those approved with interest rates linked to EURIBOR. HBOR also developed new models of risk sharing. For instance, HBOR shares risks with commercial banks in the financing of new projects for small and medium-size enterprises. Projects valued at greater than HRK 9 million can also be financed via a new model of risk sharing where commercial banks and HBOR share the risk equally.

Gross Domestic Product

The following table sets forth real and nominal GDP amounts for the periods indicated.

	Year ended 31 December			
	2011	2012	2013	2014*
Nominal GDP (HRK millions)	332,587	330,456	330,135	328,155
Real GDP (HRK millions)[(1)]	327,118	319,962	316,957	314,633
Nominal GDP (EUR millions)	44,737	43,959	43,591	43,009
Nominal GDP per capita (EUR)	10,446	10,297	10,250	10,134
Real GDP growth (per cent.)	(0.3)	(2.2)	(0.9)	(0.7)

Source: Central Bureau of Statistics and Hrvatska narodna banka

(1) Constant previous year prices, reference year 2010.

* Preliminary data

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

	Year ended 31 December			
	2011	2012	2013	2014*
	(per cent.)			
Households	0.3	(3.0)	(1.2)	(0.6)
NPISH	3.8	(4.3)	4.9	0.0
Government	(0.3)	(1.0)	0.5	(1.7)
Gross fixed capital formation	(2.7)	(3.3)	(1.0)	(3.8)
Exports of goods and services	2.2	(0.1)	3.0	5.6
Imports of goods and services	2.5	(3.0)	3.2	3.7
Change in overall GDP for the period	**(0.3)**	**(2.2)**	**(0.9)**	**(0.7)**

Source: Central Bureau of Statistics

* Preliminary data

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

	Final consumption expenditure						
	Households	NPISH	Government	Gross fixed capital formation	Exports of goods and services	Imports of goods and services	Gross domestic product (market price)
				(per cent.)			
2009							
First quarter	(8.9)	3.3	5.4	(14.1)	(6.4)	(18.7)	(8.6)
Second quarter	(8.6)	(3.0)	3.1	(16.1)	(17.4)	(23.8)	(8.2)
Third quarter	(5.9)	(1.8)	(2.0)	(13.3)	(17.2)	(22.1)	(7.7)
Fourth quarter	(6.5)	(3.0)	(1.6)	(13.7)	(11.0)	(16.1)	(4.9)
2010							
First quarter	(4.5)	(3.5)	(1.2)	(17.8)	1.7	(7.2)	(2.7)
Second quarter	(3.1)	(1.0)	(2.8)	(17.4)	4.6	(7.8)	(3.2)
Third quarter	1.2	(0.6)	(1.6)	(13.5)	4.3	1.5	(0.4)
Fourth quarter	0.6	(4.4)	(0.9)	(11.8)	15.4	3.9	(0.6)
2011							
First quarter	(0.3)	3.0	(2.2)	(2.8)	(2.9)	5.2	(1.2)
Second quarter	0.6	3.4	0.8	(2.2)	4.2	5.3	0.2
Third quarter	0.5	4.0	1.1	(3.9)	7.1	2.4	0.4
Fourth quarter	0.3	4.8	(0.9)	(1.8)	(3.4)	(2.6)	(0.7)
2012							
First quarter	(0.8)	(5.0)	(0.8)	(2.3)	(0.5)	(0.9)	(1.3)
Second quarter	(3.2)	(4.7)	0.2	(4.1)	(2.9)	(2.8)	(2.9)
Third quarter	(3.7)	(3.3)	(0.8)	(3.4)	0.5	(4.9)	(2.0)
Fourth quarter	(4.3)	(4.0)	(2.6)	(3.1)	2.0	(3.1)	(2.5)
2013							
First quarter	(2.9)	3.5	0.2	(2.4)	(0.8)	(4.5)	(1.8)
Second quarter	(0.1)	4.7	1.3	0.8	0.7	5.4	(0.5)
Third quarter	(0.4)	5.6	(0.8)	0.3	3.7	5.3	(0.5)
Fourth quarter	(1.8)	5.5	1.4	(3.1)	7.4	6.0	(1.1)
2014							
First quarter	(0.5)	(0.1)	(2.1)	(3.6)	11.4	7.6	(0.6)
Second quarter	(0.5)	1.3	(3.4)	(5.2)	7.9	2.2	(0.8)
Third quarter	(1.1)	(1.2)	(1.4)	(3.6)	4.1	3.2	(0.5)

Source: Central Bureau of Statistics
Note: Data for 2014 is provisional.

In 2010, real GDP fell by 1.7 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 15.2 per cent. in real terms. In 2010, goods and services imports fell by 2.5 per cent. in real terms, household consumption fell by 1.5 per cent., and Government consumption fell by 1.6 per cent. in real terms. With a 6.2 per cent. year-on-year growth in real terms, goods and services exports were the most significant category which grew year-on-year in real terms in 2010.

With respect to economic activity in 2011, GDP remained virtually unchanged in real terms compared to 2010, recording a real year-on-year decrease of 0.3 per cent. Observing the components on the expenditure side of the GDP calculation, household consumption increased in real terms by 0.3 per cent., consumption of NPISH increased by 3.8 per cent., while Government consumption recorded a real year-on-year decrease of 0.3 per cent. In 2011, gross fixed capital formation remained the component which recorded the greatest fall with a real decline of 2.7 per cent. compared to 2010, owing to a decline in all four quarters. A real year-on-year growth in exports of goods and services amounted to 2.2 per cent. in 2011, while the real growth of imports of goods and services amounted to 2.5 per cent. in 2011.

In 2012, GDP recorded a real decrease of 2.2 per cent. compared to the same period of 2011. This constituted a real year-on-year decrease of GDP of 1.3 per cent. in the first quarter of 2012, 2.9 per cent. in the second quarter, 2.0 per cent. in the third quarter of 2012 and 2.5 per cent. in the fourth quarter of 2012. The main contributor to GDP decline in 2012 came from gross fixed capital formation, which decreased by 3.3 per cent in real terms, year-on-year, imports of goods and services, and households, which both decreased by 3.0 per cent. Government consumption decreased by 1.8 per cent. in 2012.

In 2013 GDP recorded a decrease in real terms of 0.9 per cent. in comparison to 2012, which represents a cumulative drop of 12.5 per cent. in comparison to 2008. The most significant contribution to the real fall of GDP from the expenditure side in 2013 came from a 1.2 per cent. decline in household consumption. Government consumption saw a slight growth of 0.5 per cent., accompanied by the increase of both exports and imports of goods and services by 3.0 and 3.1 per cent. respectively. The drop in household consumption in 2013 was the consequence of negative trends on the labour market and continued deleveraging of the household sector. After four consecutive years of strong decline, the further 1.0 per cent. reduction of gross fixed capital formation is the result of reduced private sector investment, though this was somewhat weaker than in the preceding year, and also of unimplemented investment projects of public enterprises, particularly at the end of the year.

According to preliminary data of the Croatian Bureau of Statistics, GDP fell by 0.7 per cent. in 2014. Gross fixed capital formation contributed the most to the decline, falling by 3.8 per cent., followed by Government consumption, which fell by 1.7 per cent. Growth in exports of goods and services amounted to 5.6 per cent., while the real growth of imports of goods and services amounted to 3.7 per cent..

Gross Value Added ("GVA")

In 2011 real GVA stayed unchanged in comparison with 2010. Construction and agriculture, forestry and fishing recorded the biggest declines in 2011, while information and communication, real estate and other activities increased. In 2012, real GVA decreased by 3.2 per cent. This decrease was primarily a result of real GVA decreases in: construction and agriculture, forestry and fishing. In 2013, the GVA further decreased by 0.7 per cent. due to decreases in: agriculture, forestry and fishing; manufacturing, mining and quarrying and other industries; and construction. In the first three quarters of 2014 real GVA decreased by 0.5 per cent. mainly due to the decline in construction and agriculture, forestry and fishing.

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

	Year ended 31 December							
	2011		2012		2013		2014*	
	(HRK millions)	*(per cent. of total)*	*(HRK millions)*	*(per cent. of total)*	*(HRK millions)*	*(per cent. of total)*	*(HRK millions)*	*(per cent. of total)*
Agriculture, forestry and fishing	13,338	4.7	12.538	4.5	11,885	4.3	10,795	4.8
Manufacturing, mining and quarrying and other industries	59,626	20.9	60,396	21.5	59,033	21.1	43,594	19.5
Construction	17,578	6.2	15,492	5.5	14,934	5.3	18,681	8.3
Wholesale and retail trade, transportation, storage, accommodation and food service activities	57,684	20.2	56,797	20.3	58,535	20.9	50,167	22.4
Information and communication	13,240	4.6	12,920	4.6	12,936	4.6	10,804	4.8
Financial and insurance activities	20,568	7.2	19,166	6.8	19,060	6.8	13,980	6.2
Real estate activities	28,649	10.0	28,645	10.2	28,655	10.2	20,179	9.0
Other[2]	75,024	26.3	74,350	26.5	74,588	26.7	55,796	24.9
Total GVA	**285,707**	**100.0**	**280,305**	**100.0**	**279,625**	**100.0**	**223,996**	**100.0**

* 2014 as of 30 September

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 professional, scientific, technical, administrative and support service activities; public administration and defence, education, human health and social work activities and other service activities.

The following table sets forth real GVA[1] in constant prices, reference year 2010, for the periods indicated:

	Year ended 31 December							
	2011		2012		2013		2014*	
	(HRK millions)	*(per cent. of total)*	*(HRK millions)*	*(per cent. of total)*	*(HRK millions)*	*(per cent. of total)*	*(HRK millions)*	*(per cent. of total)*
Agriculture, forestry and fishing	13,135	4.7	11,383	4.1	12,340	4.4	7,990	3.8
Manufacturing, mining and quarrying and other industries	56,350	20.1	56,631	20.5	59,266	21.3	44,214	21.1
Construction	17,331	6.2	15,525	5.6	14,837	5.3	10,371	4.9
Wholesale and retail trade, transportation, storage, accommodation and food service activities	57,137	20.4	55,820	20.2	56,651	20.4	45,681	21.8
Information and communication	13,676	4.9	13,115	4.7	13,008	4.7	9,476	4.5
Financial and insurance activities	19,702	7.0	20,080	7.3	18,998	6.8	14,295	6.8
Real estate activities	27,509	9.8	28,717	10.4	28,532	10.2	21,419	10.2
Other[2]	75,330	26.9	75,337	27.2	74,741	26.8	56,104	26.8
Total GVA	**280,390**	**100.0**	**276,608**	**100.0**	**278,374**	**100.0**	**209,550**	**100.0**

* 2014 as of 30 September

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 professional, scientific, technical, administrative and support service activities; public administration and defence, education, human health and social work activities and other service activities.

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

	Year ended 31 December			
	2011	2012	2013	2014*
	(per cent.)			
Agriculture, forestry and fishing	(3.8)	(14.7)	(1.6)	(4.2)
Manufacturing, mining and quarrying and other industries	(1.1)	(5.0)	(1.9)	0.1
Construction	(8.5)	(11.7)	(4.2)	(7.3)
Wholesale and retail trade, transportation, storage, accommodation and food service activities	0.6	(3.2)	(0.3)	0.2
Information and communication	(0.5)	(0.9)	0.7	(1.5)
Financial and insurance activities	3.3	(2.4)	(0.9)	(0.2)
Real estate activities	1.3	0.2	0.4	(0.4)
Other[(2)]	3.0	0.6	1.1	(0.7)
Total GVA growth	**0.0**	**(3.2)**	**(0.7)**	**(0.5)**

* 2014 as of 30 September

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 professional, scientific, technical, administrative and support service activities as well as public administration and defence, education, human health and social work activities and other service activities.

Agriculture, forestry and fishing

As a result of the continuing uncertainty in the economy, the GVA in the agriculture, forestry and fishing sector recorded a real decline of 6.6 per cent. in 2010 and 3.8 per cent. in 2011. In 2012, the real GVA decrease in this sector was 14.7 per cent. and, in 2013, 1.6 per cent, year on year. In the first three quarters of 2014, GVA in the agriculture, forestry and fishing sector declined by 4.2 per cent..

Manufacturing, mining, quarrying, and other industries

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 manufacturing, mining, quarrying and other industries decelerated, from 10.1 per cent. in 2009 to 2.3 per cent. in 2010. GVA declined further by 1.1, 5.0 and 1.9 per cent in 2011, 2012 and 2013 respectively. In the first three quarters of 2014 the GVA in this sector grew by 0.1 per cent..

Construction

In 2010, GVA in the construction sector experienced negative growth at an annual rate of -15.7 per cent. 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, GVA in the construction sector recorded a real decrease of 8.5 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. In 2012, real GVA in this sector decreased by 11.7 per cent., year-on-year, and in 2013, decreased 4.2 per cent For the first three quarters of 2014, the GVA in this sector declined by 7.3 per cent..

Wholesale and retail trade, transportation, storage, accommodation and food service activities

The rate of negative growth of GVA in the wholesale and retail trade, transportation, storage, accommodation and food service activities decelerated in 2010 to -2.8 per cent., compared to -11.4 per cent. in 2009. The negative growth in both periods was driven by the declining employment rate, disposable income and loan availability. These trends, however, 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, transportation, storage, accommodation and food service activities was positive, amounting to 0.6 per cent. Both the improving personal consumption dynamics and the successful tourist season contributed to this result. In 2012, real GVA in this sector decreased by 3.2 per cent. and, in 2013, it decreased by 0.3 per cent, year-on-year. In the first three quarters of 2014, the GVA in the wholesale and retail trade, transportation, storage, accommodation and food service grew by 0.2 per cent..

Information and communication

The information and communication sector has recorded negative real growth rates since the beginning of the crisis period. In 2010, 2011 and 2012 the GVA growth rates in this sector amounted to -1.39 per cent., -0.5 per cent. and -0.9 per cent. respectively. In 2013, GVA in this sector increased by 0.7 per cent., year-on-year. During the first three quarters of 2014, the GVA in this sector declined by 1.5 per cent..

Financial and insurance activities

Despite adverse macroeconomic conditions, GVA in the financial and insurance activities grew by 4.0 per cent. in 2010 and 3.3 per cent. in 2011. However, in 2012, GVA in this sector decreased by 2.4 per cent. and, in 2013, it decreased by 0.9 per cent. in real terms, year-on-year. In the first three quarters of 2014, the GVA in this sector decreased by 0.2 per cent..

Real estate activities

GVA in the real estate activities sector recorded an increase of 2.7 per cent. in real terms in 2010 and an increase of 1.3 per cent. in 2011. In 2012, GVA in this sector increased by 0.2 per cent. and, in 2013, it increased by 0.4 per cent., year-on-year During the first three quarters of 2014, the GVA in this sector declined by 0.4 per cent..

Other Sectors

In 2011, GVA in the other sectors, a category which contains professional, scientific, technical, administrative and support service activities as well as public administration and defence, education, human health and social work activities and other service activities, experienced a real growth rate of 3.0 per cent., after a negative growth rate of 0.6 per cent. in 2010. Growth continued in 2012 (0.6 per cent.) and 2013 (1.1 per cent.), year-on-year. In the first three quarters of 2014, the GVA in this sector decreased by 0.7 per cent..

Inflation and Trends in Prices

Inflation in Croatia is measured according to a consumer price index ("**CPI**") and a producer price index ("**PPI**"). The CPI is based on the price of a basket of approximately 869 goods and services weighted according to the Household Budget Survey and retail sales data. The PPI on the domestic market is based on a basket of approximately 1,539 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 Hrvatska narodna banka (central bank of the Republic of Croatia, HNB) monetary policy. The HNB's main strategy for achieving price stability has been to attempt to maintain a relatively stable HRK/EUR exchange rate.

Overview of Inflation (2010 - 2014)

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

	Year ended 31 December				
	2010	**2011**	**2012**	**2013**	**2014**
			(per cent.)		
CPI	1.1	2.3	3.4	2.2	-0.2
PPI	4.3	6.3	7.0	0.5	-2.7

Source: Central Bureau of Statistics

Inflation in Croatia in 2010 was low and stable, the average annual CPI inflation rate dropped to 1.1 per cent. 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 per cent. in 2010 to 2.3 per cent. 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 continued to increase in 2012, with the average annual inflation rate increasing to 3.4 per cent. The most significant contributors to upward pressures on inflation were Government decisions to increase the VAT rate in March 2012 and the prices of electricity and gas in May 2012. Food prices, especially the prices of agricultural products, increased due to the bad weather conditions and a rise in agricultural commodities prices on the world market. The overall annual CPI inflation rate increased from 2.1 per cent. in December 2011 to 4.7 per cent. in December 2012. The largest contribution came from an increase in the annual rate of change in the prices of energy, unprocessed food products and prices of services.

The end of period consumer price inflation rate decreased by 4.4 percentage points in 2013; from 4.7 per cent. in 2012 to only 0.3 per cent. The average annual inflation rate slowed down from 3.4 per cent. in 2012 to 2.2 per cent. in 2013. The largest contribution to the fall in inflation came from energy and food prices. The slowdown in inflation mirrors the fall in raw materials prices on the world market and the absence of domestic inflationary pressures from the perspective of both demand and cost. Administered decisions added around 0.6 percentage points to the average annual inflation rate in 2013. The bulk of the increase was the result of an increase in the water management and protection charge, repeal of the zero VAT rate and an increase in excise duty on tobacco. Weak domestic demand and decline in unit labor costs continued to contribute to the low core inflation rate.

The annual CPI inflation rate declined from 0.3 per cent. in December 2013 to -0.5 per cent. in December 2014. Such developments primarily reflect the spill-over of the drop in global raw material prices on domestic consumer prices. The decline in the prices of food raw materials, which was 21 per cent. lower in December 2014 than in mid 2013, was particularly prominent. Therefore, prices of food products, which account for a significant share of 26.7 per cent. in the CPI basket, put the greatest pressure on the decrease in the overall annual inflation. The last five months also saw a slowdown in the annual rise in energy prices, particularly in the prices of fuel and lubricants for personal transport equipment driven by a slump in the prices of crude oil on the global market which began in July 2014. Weak foreign and domestic economic activity and low core inflation in the euro area also contributed to the year-on-year decline in the CPI index, although to a lesser extent.

Producer prices rose 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. Producer prices continued to increase in 2012 with the annual rate of change increasing to 6.9 per cent. in December 2012, primarily due to a sharp increase in the annual growth of energy prices (notably the prices of electricity and gas and water collection, treatment and supply prices). The annual rate of change in producer prices, excluding energy, stood at 2.2 per cent. in December 2012, down from 2.9 per cent. in December 2011. Producer prices decreased in 2013 with the annual rate of change decreasing to -2.6 per cent. in December 2013, primarily due to a sharp decrease in energy prices. In 2014 producer prices continued to decrease.

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. 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 2015

Against the backdrop of low imported inflation, lack of inflationary pressures from the demand side and the stable exchange rate of the kuna against the euro, the average annual consumer price inflation rate is likely to hover around 0.2 per cent. in 2015. The rise in the average annual rate of change in the CPI, excluding food and energy, may put mild upward pressure on inflation, in line with the expected slow recovery of personal consumption. In addition, the annual rise in producer prices in eurozone countries is expected to pick up, suggesting that 2015 may see moderate growth in the import prices of miscellaneous manufactured articles. Furthermore, the drop in the average annual rate of change in food prices reflecting the expected slowdown in the annual decline in food raw material prices on the global market is projected to be less marked in 2015 than it was in 2014 due to the likely depreciation of the kuna against the US dollar. Nevertheless, energy prices are expected to decrease under the assumption that average global prices of Brent crude oil will slide on an annual basis and that regulated energy prices (electricity, gas and household heating) will remain the same. In relation to oil prices, current market expectations incorporated in spot contracts indicate that oil prices will stagnate at the level of the last quarter of 2014 in the following year. This implies that the price of Brent crude oil would be somewhat lower than in the HNB's last official inflation projection.

Government Subsidies

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

	Year ended 31 December			
Industry	**2010**	**2011**	**2012**	**2013[(2)]**
	(HRK thousands)			
Croatian railways	1,598,729	1,491,300	1,206,600	396,232
Agriculture	3,542,820	3,687,313	2,804,612	2,492,232
Shipyards and shipbuilding	11,002	127,084	407,488	622,260
HBOR	250,000	237,400	100,000	`109,899
Other industries[(1)]	1,179,641	1,012,180	1,243,620	562,877
Total subsidies	**6,582,192**	**6,555,277**	**5,762,321**	**4,183,500**

Source: Ministry of Finance

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

(2) Data presented in the Annual Report on State Aid for 2013.

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

	Year ended 31 December			
Industry	**2010**	**2011**	**2012**	**2013**
	(per cent.)			
Croatian railways	0.5	0.5	0.4	0.1
Agriculture	1.1	1.1	0.8	0.8
Shipyards and shipbuilding	0.00	0.04	0.12	0.2
HBOR	0.08	0.07	0.03	0.03
Other industries[1]	0.4	0.3	0.4	0.2
Total subsidies	**2.0**	**2.0**	**1.7**	**1.3**

Source: Ministry of Finance

(1) "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.

It should be noted that after the Croatian accession to the European Union on 1 July 2013, approval, monitoring and recovery of state aid is under the jurisdiction of the European Commission. Data presented for 2013 can be found in the Annual Report on State Aid for 2013. The Croatian Government submitted the Annual Report to the Croatian Parliament for approval and it will be published on the website of the Ministry of Finance.

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 and 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 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 Council of Europe Development Bank (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.

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

In 2011, there were on average 305,333 registered unemployed persons, an increase of 2,908 or 1.0 per cent. compared to 2010, while the average unemployment rate increased to 17.8 per cent. Unfavorable trends in the labour market continued in 2012, as the average number of registered unemployed persons amounted to 324,324 as at 31 December 2012, an increase of 18,991 or 6.2 per cent. compared to 31 December 2011. The average registered unemployment rate amounted to 18.9 per cent. as at 31 December 2012, an increase of 1.1 percentage points compared to 31 December 2011. In 2013, the average number of registered unemployed persons amounted to 345,112 an increase of 6.4 per cent. compared to 2012 and the average registered unemployment rate amounted to 20.2 per cent., an increase of 1.3 percentage points compared to 2012.

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

	Year ended 31 December				**As of 30 September**
	2010	**2011**	**2012**	**2013**	**2014**
	(average for the period, in per cent.)				
ILO unemployment rate	11.8	13.5	15.8	17.1	15.7

Source: Central Bureau of Statistics

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

	Year ended 31 December				
	2010	**2011**	**2012**	**2013**	**2014***
	(average for the period, in per cent.)				
Registered unemployment rate	17.4	17.8	18.9	20.2	19.6

Source: Central Bureau of Statistics

**Preliminary data*

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 (according to administrative data) in Croatia for the periods indicated:

	Year ended 31 December				
	2010	2011	2012	2013	2014[2]
	(average for the period)				
Total employed persons	1,432,454	1,411,238	1,395,116	1,364,298	1,303,399
Total unemployed	302,425	305,333	324,324	345,112	328,187
Rate of unemployment (per cent.)[1]	17.4	17.8	18.9	20.2	19.6
GDP per employee (HRK)	228,266	236,640	—	—	
GDP per employee (EUR)	31,328	31,831	—	—	

Source: Central Bureau of Statistics

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

(2) *Preliminary data*

The data presented in this section does not reflect ESA95.

In 2010, the average number of employed persons decreased to 1,432,454, while in 2011, the average number of employed persons was 1,411,238, decreasing by 21,216 or 1.5 per cent., compared to 2010. In 2012, the number of employed persons declined to the average level of 1,395,116, which represents a decrease of 16,122 or 1.1 per cent. lower compared to 2011. In 2013, the number of employed persons declined to an average of 1,364,298 which represents a decrease of 30,818 or 2.2 per cent. lower compared to 2012. In 2014, the number of employed persons declined to an average of 1,303,399 (according to preliminary data) which represents a decrease of 60,899 or 4.5 per cent. lower compared to 2013.

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

	Year ended 31 December				
	2010	2011	2012[1]	2013	2014*
	(average for the period)				
Public administration and defence, compulsory social security	106,673	106,699	104,696	105,472	103,854
Education	104,981	106,804	108,500	109,937	111,400
Human health and social work activities	81,395	83,045	84,911	84,911	84,492
Total	293,049	296,547	297,195	300,320	299746

Source: Central Bureau of Statistics

**Preliminary data*

In 2012, an average of 297,195 people (approximately 21.6 per cent. of all employed persons) were employed in the public sector. In 2013, an average of 300,320 people were employed in the public sector, representing 22.7 per cent. of all employed persons. In 2014, an average of 299,746 people (according to preliminary data) were employed in the public sector, representing 22.99 per cent. of all employed persons. 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. 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. Croatia's labour laws are aligned with relevant EU legislation.

Labour market

The Law on Criteria for Participation in Tripartite Bodies and Representativeness for Collective Bargaining, which entered into force on 28 July 2012, had enabled the start of collective negotiations among private and public companies and public institutions where they were previously avoided. This Law was subsequently replaced by the Law on Representativeness of Employer's Associations and Unions, which came into force on 7 August 2014.

The Collective Agreement for Civil Service containing new transport regulations was signed on 4 August 2012. The Annex of the Collective Agreement was also signed and contained further decreases of the wage bill. Change included cancellation of Christmas bonuses in 2012 and 2013, cancellation of the holiday bonus in 2013, reduction of per diems from HRK 170.00 to HRK 150.00 and reduction of jubilee bonuses by 75 per cent. (50 per cent. reduction in the actual amount and 50 per cent. reduction in the number of beneficiaries). As civil servants, police and army employees that have signed the collective agreement represent one third of total public sector employees. Further reductions were to be found in amendment to the Basic Collective Agreement for Public Service Employees dated 12 December 2012.

The New Basic Collective Agreement for public services was signed on 12 December 2012. Four trade unions, which had previously refused to sign the agreed changes, have the same rights regulated in their branch collective agreements (for education and healthcare). Therefore, in order to ensure just application of legal provisions for all public sector employees and to maintain budget stability, the Government passed The Act on Denial of Payment of a Part of Material Rights for Public Services Employees, that entered into force on 20 December 2012.

Amendments to the Employment Incentive Act (the "**Amendments to the Employment Incentive Act**") were adopted in September 2012. The purpose of the legislation is to mitigate the consequences of the economic crisis. The Amendments to the Employment Incentive Act (i) apply to unemployed persons regardless of their previous working experience unless they had less than a year of working experience in the vocation they were trained for; (ii) enable the Croatian Employment Service (the "**CES**") to pay health contributions for workers with previous working experience during the first 12 months of their occupational training; and (iii) seek to provide incentives for the employment of seasonal workers in agriculture up to 90 days within a calendar year. Through the end of 2012, there were 62,626 seasonal workers in agriculture that were employed according to the regulation. From 18 June 2012 until the end of the 2012 there were 353,746 vouchers sold to 3,363 employers in order to employ seasonal workers in agriculture.

The implementation of active labour market policy measures is targeted towards the inclusion of youth in the labour market, self-employment, enhancing employability and improving the participation rate of persons in an unfavourable position in the labour market, as well as support for employers facing labour market difficulties and employment in tourism sector. In 2012, there was a 27 per cent. increase in national funds spent for active labour market policy measures ("**ALMM**") and in 2013 the financing of ALMM will be increased by 24 per cent. as compared to 2012, with the aim of providing more opportunities to unemployed persons.

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 monthly net earnings for 2011 of those in paid employment in legal entities 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 monthly gross earnings of those in paid employment in legal entities also increased compared to the average figure for 2010. The average monthly gross 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.

During 2012, there was a nominal increase but a real decrease in wages. In 2012, the average monthly net earnings per person in paid employment in legal entities was HRK 5,487, which is a 0.8 per cent. increase in nominal terms and a 2.6 per cent. decrease in real terms, compared to 2011. Average monthly gross earnings per person in paid employment in legal entities was HRK 7,875 in 2012, representing a 1.0 per cent. increase in nominal terms and a 2.4 per cent. decrease in real terms compared with 2011.

During 2013, there was a continued trend of a nominal increase but a real decrease in wages. In 2013, the average monthly net earnings per person in paid employment in legal entities was HRK 5,515, which is a 0.5 per cent. increase in nominal terms and a 1.7 per cent. decrease in real terms, compared to 2012. Average monthly gross earnings per person in paid employment in legal entities was HRK 7,939 in 2013, representing a 0.8 per cent. increase in nominal terms, or a 1.4 per cent. decrease in real terms, year-on-year.

The following table shows average nominal monthly wages in Croatia per person in paid employment in legal entities for the periods indicated:

	Year ended 31 December				
	2010	2011	2012	2013	2014[(2)]
Average monthly gross wages and salaries in HRK	7,679	7,796	7,875	7,939	7,934
Average monthly net wages and salaries in HRK[(1)]	5,342	5,441	5,487	5,515	5,505
Net wages and salaries in EUR (average exchange rate)[(1)]	733	732	729	728	722

Source: Central Bureau of Statistics

(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.

(2) *Preliminary data for January-October 2014.*

Social Security System

Unemployment

The social security system in Croatia consists of the Croatian Health Insurance Fund (the "**HZZO**"), 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 addition, Croatian legislation 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.

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.

In September 2012, the Parliament of the Republic of Croatia adopted the National Strategy of the Development of the Croatian Health Care System 2012 – 2020. The document presents an in-depth quantitative and qualitative analysis of the current status and future trends in health care, and sets out principal priorities for its development until 2020. As hospitals are required to account for their budgets through use of DRG-based invoices (acute impatient care) and fee for service invoices (outpatient care), prices of inpatient and outpatient services have been lowered in order to increase hospital productivity within the reduced budget. In order to implement economies of scale, in May 2012 the Minister of Health issued a decree to all Government-owned hospitals to unify procurement of necessary medical products and consumables. The reform is implemented so that each hospital procures a certain good for all hospitals. A number of county-owned hospitals have also joined the initiative (resulting in an average procurement of seven per item). The first 22 tenders were published in December 2012. In 2012, the Croatian Institute for Health Insurance reduced rights to compensation for patients' travel costs. Furthermore, the Ministry of Health has continued with the development of the Croatian eHealth ICT system. Its ePrescriptions and eReferrals (from GPs to primary care laboratories) components were successfully piloted and implemented nationwide in 2011. In 2012, the Ministry of Health successfully finalised its eReferrals (from primary care to hospitals), eWaiting lists (hospital procedures), eFormulary (reimbursed medicines and medical products), and Health Insurance Business Intelligence system components. This did not have any direct or indirect fiscal effects in 2012, but it is expected to be of measurable use in improving health system management and efficiency of providers through easier monitoring and evaluation.

In 2013, the Croatian Health Insurance Fund planned to decrease its expenditure on sick leave compensations by 10 per cent., through measures of stricter controls and through modifications of relevant regulation.

The Ministry of Health (the "**Ministry of Health**") also is seeking to design a feasible plan to outsource non-clinical hospital services (NCS) from public hospitals. The Ministry of Health published an international tender for consulting services to develop an implementation plan for rationalisation and outsourcing/spin off of nonclinical hospital services from public hospitals. The consultancy was finalised by the end of July 2013, and pilot projects in selected hospitals was contracted and initiated by end of 2013. Dissemination is planned for 2015.

The underdevelopment of the private supplementary health insurance market presents an issue for health financing, as it both limits the growth of the private sector (which would then relieve some burden of the public sector — at least for the wealthier part of the population) and the Government's ability to raise out of pocket payments and limiting levels of publicly provided care for relatively wealthier citizens. The share of the private supplementary health insurance amounts to approximately 1 per cent. of the total health insurance market. The fiscal impact of planned changes to legislation cannot yet be precisely determined due to the complexity of effects and due to reform measures still being defined. The Ministry of Health will also continue to invest in eHealth, which is expected to improve health system management and the efficiency of providers through easier monitoring and evaluation.

Motherhood Protection

Croatian legislation provides 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. In addition, the minimum financial compensation in the second six months of a child's life 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. In addition, the legislation establishes a minimum amount of monthly child support payments for up to four children.

In the period from 2009 to 2013, the average level of maternity allowances and child support allowances was 1.1 per cent. of GDP.

Pension System

Croatia has a three pillar pension system. 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, the first pillar of a pension, and 5 per cent. to the mandatory pension fund at the choice of the insured person, or the 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.

Since January 2011, the age limit for entitlement to old age and early retirement pensions for women has increased by three months per year, and this will continue during a 20 year transitional period. The purpose is to ensure equal conditions for acquiring rights to a pension for both men and women from the year 2030. At the same time, conditions for the calculation of early retirement pensions and increased pensions for persons wishing to continue working after having met the conditions for an old age pension were tightened. 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.

Currently, there are six open and sixteen closed voluntary pension funds and four mandatory pension funds in Croatia. These are regulated by the Croatian Agency for Supervision of Financial Services ("**CASFS**").

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 *(end of the period)*	Year-on-year per cent. change	Number of recipients	Year-on-year percent. Change	Number of recipients	Year-on-year percent. change
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)	214,68	1,4	75,222	(9.5)
2012	1,217,203	0.4	2,383	1,5	211,703	(1.4)	85,194	13,3
2013	1,182,464	(2,9)	2,486	4.3	208,836	(1.4)	74,597	(12,4)
2014	1,223,160	3.4	2,417	(2.8)	201,655	(3,4)	60,735	(18.6)

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				
	2010	2011	2012	2013	2014[(4)]
	(end of the period, HRK thousands)				
Mandatory funds[(1)]	36,328,054	41,067,099	51,133,725	58,237,703	62.192,602
Open voluntary funds[(2)]	1,472,212	1,642,130	1,987,416	2,208,116	2,451,691
Closed voluntary funds[(3)]	287,794	326,598	441,855	494,615	549,602
Total	**38,088,060**	**43,035,827**	**53,562,996**	**60,940,434**	**65.193.895**

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, AZ VIP, Croatia Osiguranje, Hrvatski Lijecnicki Sindikat, AZ Dalekovod, Ericsson Nikola Tesla, AZ HKZP, HEP Grupa, THT Grupa, AZ Zagreb, Cestarski MF, HAC MF and Sindikat hrvatskih zeljeznicara, Raiffeisen, Auto Hrvatska, AZ Zaba, Autocesta Rijeka - Zagreb.

(4) *Preliminary data for July 2014.*

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. In 2012, pension expenditure amounted to HRK 35.1 billion. HRK 19.3 billion was covered by pension contributions while the remainder (HRK 15.8 billion) was covered by tax revenues. In 2013, pension expenditure amounted to HRK 35.6 billion, of which HRK 19.7 billion referred to pension contributions and the remainder (HRK 15.9 billion) was covered by tax revenues. Figures relating to 2014 are in the process of being finalised.

Pensions and Social Welfare Policies

Various pension system reforms have also been undertaken. Regarding the first pillar, several amendments enabled reductions of pension costs for the state budget. In February 2012, the Act on Rights and Duties of the Croatian Parliament Members was amended. As a result, Parliament members, members of the Government, judges of the Constitutional Court and the chief state auditor are no longer eligible for pensions with more favourable benefits, in accordance with the Pension Insurance Act. The Croatian Parliament has also adopted the Amendment to the Act on Special Rights of the President of the Republic of Croatia. As a result, after the end of the term of office, the President of the Republic of Croatia will no longer be eligible for a pension with more favourable benefits, in accordance with the Pension Insurance Act. Amendments to the Act on Pension Insurance Entitlements for Active Military Officers, Police Officers and Authorised Officials have resulted in the revocation of certain privileges for this category of insured persons.

Amendments to the Act on Compulsory and Voluntary Pension Funds enabled insured persons who voluntarily entered the second pillar (approximately 95,000 insured persons between the age of 40 and 50 at the time when pension reform had started) to opt out from the second pillar at the time when they fulfil conditions for old-age or early retirement pension in accordance with the Pension Insurance Act. In order to reduce the administrative cost in the second pillar of the pension insurance system, the Amendments to the Act on Data Gathering on Insured Persons with regard to Compulsory Insurance Contributions were adopted. This resulted in the partial transfer of the cost for the maintenance of personal accounts of compulsory pension funds from the state budget to compulsory pension insurance companies. In 2014, the Act on Compulsory and Voluntary Pension Funds was replaced by entry into force of the Act on Compulsory Pension Funds and the Act on Voluntary Pension Funds.

In order to adapt labour legislation to the economic crisis, the Ministry of Labour and Pension System have begun labour legislation reform which have been implemented. During the first phase, in response to requirements of harmonisation with EU legislation, the Government reached an agreement with social partners on the proposed Labour Act changes with respect to collective redundancies, fixed-term work, a trial period and temporary employment agency. These changes were designed to accelerate collective redundancy procedures, increase flexibility in fixed-term employment by allowing a longer duration of the first employment contract for a definite period, improve security of fixed-term employees by restricting objective reasons for successive contracts, and improve the work of temporary agencies. The second phase is aimed at solving strategic issues such as simplifying hiring procedures, dismissal procedures, liberalisation of working time provisions, revision of the severance pay system, promotion of part time work and balancing temporary employment. The changes to the labour legislation are aimed at accelerating the restructuring procedures of employers, reducing segmentation in the labour market, and improving the adaptability and flexibility of the workforce. Both phases were implemented and the changes were enacted in June 2013.

As was planned, the new Pension Insurance Act was adopted in 2013 (and subsequently amended in 2014) with respect to the envisaged measures in the first pension pillar. Its goal is to reform the invalidity system in order to reduce the number of its beneficiaries and to increase the possibility of occupational rehabilitation for a significant number of invalidity pension beneficiaries. The Government plan was to introduce changes in the pension indexation formula and to reduce the number of working places and occupations where the retirement qualifying periods are calculated with extended duration. Finally, there are ongoing discussions with respect to lengthening the retirement age from 65 to 67 and equalising the retirement age for men and women in the mid term period.

Social Welfare Reform

The Ministry of Social Policy and Youth took significant measures to reduce social spending in 2012. Procurements of products for all social welfare institutions were unified, including the procurement of certain food, office supplies and other equipment necessary for the care of beneficiaries and the functioning of institutions. Furthermore, the Ministry began drafting a unified methodology for determining prices of social services, contracting and paying for such services as well as rationalising the number of professional and technical staff prescribed by minimum standards. It is expected that the staff reduction measures will cut employee costs by approximately 4 per cent. The process of transformation and deinstitutionalisation of social welfare homes has been accelerated. Two centres and one home for adults with mental illnesses were selected as models in the pilot project that will initiate the transformation and deinstitutionalisation.

The Ministry of Social Policy and Youth has also accelerated activities related to the introduction of a transparent and functional IT system and the establishment of a unified registry of beneficiaries, with a goal of rationalising public expenditure for social welfare. This is the precondition for the networking of databases within the state administration, particularly the Tax Administration. The introduction of this IT system is intended to improve financial and administrative controls and provide a basis for the better control of expenses for social benefits, as well as to establish the connection with the accounting system, which is intended to perform the calculation and verification of social benefit payments. The automatic data verification is intended to reduce the possibility of multiple payments of social benefits and other errors.

The reform of the social welfare system continues to focus on the better distribution of social benefits to the most vulnerable beneficiaries as well as system transparency, fairness in exercising the rights to benefits, prevention of rights abuse and achieving equal social protection. A new Social Welfare Act (OG 157/2013) was adopted in December 2013 and entered into force on 1 January 2014. The new Social Welfare Act is designed to unify social benefits from various systems with the common purpose of protecting the most vulnerable population. The Social Welfare Act introduces a unified means test with the purpose of identifying the most vulnerable groups of citizens. As a result, the entire system of social cash benefits will be rationalised and its effectiveness is expected to increase.

In order to achieve adequate support of, and to simplify the procedure for exercising the rights of persons with disabilities, the Social Welfare Act unified disabled persons' rights exercised through various systems prior to adoption thereof and ensured the necessary support for disabled persons and children with difficulties. The amount of personal disability compensation is intended to provide equal opportunities for persons with disabilities in social inclusion. The Social Welfare Act was further amended in December 2014 (the changes and amendments thereto were published in the Official Gazette 152/2014).

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				Twelve months ended 30 September
	2010	**2011**	**2012**	**2013**	**2014***
Current account balance in EUR (millions)	(502.6)	(360.3)	(61.0)	341.2	62.8
Current account (as a percentage of nominal GDP)	(1.1)	(0.8)	(0.1)	0.8	0.1

Source: Hrvatska narodna banka and Central Bureau of Statistics

* Based on preliminary data.

In 2008 the current account deficit was 8.8 per cent. of GDP and started declining in 2009. In 2010, the current account deficit recorded another decrease (-78.2 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 28.3 per cent., down to EUR 0.4 billion (-0.8 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 an increased deficit in the trade of goods. The current account balance further improved in 2012, with a minor deficit of EUR 0.06 billion (-0.1 per cent. of GDP). The improvement of the total balance was primarily attributable to the growth of net revenues of services (due to a fall in imports of other services and a growth in tourism revenues). In 2013, a surplus on the current account was recorded in the amount of EUR 0.3 billion (0.8 per cent. of GDP), due to a lower deficit on the primary income account and growth in net exports of services. During the twelve month period up to September 2014, a minor surplus of EUR 0.06 billion or 0.1 per cent. of GDP was recorded. In that period favourable trends in foreign trade, resulting from faster growth in exports than in imports of goods and services, were accompanied by more adverse developments in the primary and secondary income accounts.

Balance of Payments (BPM6): At the end of October 2014 methodology prescribed by the BPM6 (Balance of Payments and International Investment Position Manual, 6th ed.) and ESA 2010 standard were introduced, including revised historical data starting from 2000. Changes resulting from the introduction of the BPM6 did not affect the current, capital and financial (including foreign exchange reserves) account balance. Changes in these positions from previously published data are a result of data revision for the purpose of quality and coverage control. In relation to presentation, the use of arithmetic signs changed such that negative signs are no longer used on the debit side of the current account and each increase/decrease in the financial account is represented by a positive/negative figure.

Current account changes according to BPM6: One of the most important changes in the current account is the change in the treatment of processing, which is recorded under services (manufacturing services on physical inputs owned by others) instead of goods, and on a net instead of on a gross basis. Merchanting transactions are reclassified from trade in services to trade in goods, along with the change of transaction valuation from a net basis to a gross basis. Furthermore, repairs on goods are no longer recorded on the goods, but on the services account. Non-monetary gold is shown separately from other goods because of its special role in the financial market. Moreover, financial intermediation services indirectly measured ("**FISIM**") are reclassified from the income account (now referred to as primary income) to the financial services, worker remittances are no longer a standard component but a supplementary item included in personal transfers, and current transfers are now referred to as secondary income. Statistics in trade in services is collected and presented in more detail and there have been changes in the names and scopes of individual services.

Financial account changes according to BPM6: In the financial account, direct investments are no longer classified on a directional principle (investment abroad and in Croatia) but on an assets/liabilities principle, and further divided into regular investment, reverse investment and investment between fellow enterprises. Furthermore, permanent debt (direct investment with the economic features of long-term debt) is no longer included in the direct investment account but in the other investment account. Interest and principal arrears are no longer recorded separately as transactions, all related changes are recorded under the original instrument. New allocation of special drawing rights are included among transactions, resulting in an increase of foreign exchange reserves and long-term debt liabilities.

Additionally, regarding merchandise trade, after Croatia joined the European Union on 1 July 2013 merchandise trade data is based on two different sources: the Intrastat form for trade between EU countries (the "**Intrastat**") and the Single Administrative Document for trade with non-EU countries (the "**Extrastat**"). Data on exports by countries is shown according to the country of destination. Since joining the European Union a new methodological criterion applies to data on imports. Under Extrastat, data on imports is shown according to the country of origin of goods, while under Intrastat, data on the arrival of goods is presented by the country of dispatch.

Goods Account and Recent Trade in Goods Developments

Trade in Goods Deficit

According to balance of payments data, in 2010, the trade in goods deficit contracted by 20.6 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 7.8 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. For the year ended 31 December 2012, the merchandise trade deficit decreased by 1.3 per cent., compared to the year ended 31 December 2011, as a result of a bigger decrease in imports than in exports. In 2013 the imports of goods increased more than exports resulting in higher goods trade deficit, that increased by 4.6 per cent. compared to 2012. As the goods exports increased significantly in the first three quarters of 2014, outpacing the increase in imports, the goods trade deficit decreased by 3.2 per cent. compared to the same period previous year.

As a result of BPM6 implementation, differences between the goods account in the balance of payments and merchandise trade account according to foreign trade statistics of the Central Bureau of Statistics increased (reasons are explained in methodological notes). The following two sections on Exports and Imports describe detailed merchandise trade developments according to CBS data.

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				Ten months ended 31 October
	2010	2011	2012	2013[(1)]	2014[*]
	(EUR millions)				
Food and live animals	760.3	851.7	958.9	904.0	827.5
Beverages and tobacco	189.0	172.4	182.4	169.8	141.7
Crude materials, except fuels	601.5	746.7	757.0	788.0	681.4
Mineral fuels and lubricants	1,113.1	1,154.7	1,320.1	1,341.7	1,226.3
Animal and vegetable oils and fats	20.5	20.9	20.3	18.7	22.1
Chemical products	1,013.5	1,097.0	1,050.1	1,062.2	897.0
Manufactured goods classified chiefly by material	1,260.8	1,432.2	1,372.9	1,507.3	1,417.8
Machinery and transport equipment	2,819.5	2,845.7	2,582.0	2,307.8	1,802.4
Miscellaneous manufactured articles	1,120.1	1,211.0	1,205.1	1,329.1	1,350.7
Commodities and transactions, n. e	6.9	49.8	179.7	106.6	92.6
Not classified	0.0	0.0	0.0	54.3	61.8
Total	**8,905.2**	**9,582.2**	**9,628.7**	**9,589.4**	**8,521.2**

* The data for 2014 is provisional.

(1) After joining EU merchandise trade statistics is based on Intrastat (for trade between EU Member States) and Extrastat (for trade with non-EU countries).

Source: Central Bureau of Statistics

According to CBS data, 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 7.6 per cent., reaching EUR 9.6 billion. Most of mentioned increase came from exports of oil and refined petroleum products, machinery specialised for particular industries, metalliferous ores and metal scrap, manufactured fertilizers and medical and pharmaceutical products. Although exports of other transport equipment recorded a mild decrease, realised 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.

Total exports of goods remained at EUR 9.6 billion in 2012, increasing slightly by 0.5 per cent. from the previous year. The strongest growth came from exports of non-monetary gold, petroleum and petroleum products, telecommunications and sound-recording equipment, cereals and cereal preparations and medical and pharmaceutical products. Positive trends in exports were partially offset by decrease in exports of other transport equipment, mostly ships (due to the high value of net exports in the previous year), plastics in primary forms, iron and steel.

In 2013, total exports of goods decreased by 0.4 per cent. compared to 2012 and amounted to EUR 9.6 billion. The largest negative effect on export performance came from lower exports of ships due to restructuring and privatization of shipyards. Furthermore, after three years of growth, exports of petroleum and petroleum products also dropped noticeably. In a number of other sectors exports also decreased, including sugar and sugar preparations, non-monetary gold, as well as metalliferous ores and metal scrap.. On the other hand, exports of electricity, cork and wood and miscellaneous manufactured articles increased significantly, as well as of iron and steel. Also, exports of some capital goods increased significantly, in particular exports of electrical machinery and apparatus, general industrial machinery and power-generating machinery.

In the first ten months of 2014 merchandise exports increased by 8.2 per cent. relative to the same period in the previous year. Export activity at the beginning of the year mainly increased, but slowed down considerably in the next four months. The narrow aggregate of exports, excluding ships and oil, had the most significant impact on the annual increase in the overall exports of goods, specifically wearing apparel and electricity. Exports of cork and wood, capital goods (particularly general industrial machinery) and food products (notably feeding stuff for animals and sugar and sugar preparations) also increased. Exports of oil and refined petroleum products stagnated, while the exports of other transport equipment (mostly ships) continued to decrease for the fourth consecutive year.

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				Ten months ended 31 October
	2010	**2011**	**2012**	**2013(1)**	**2014***
	(EUR millions)				
Food and live animals	1,360.0	1,539.0	1,618.3	1,742.3	1,605.0
Beverages and tobacco	138.2	148.7	156.8	166.2	166.1
Crude materials, except fuels	255.5	268.3	234.1	253.4	247.6
Mineral fuels and lubricants	2,843.5	3,553.2	3,767.3	3,583.0	2,763.3
Animal and vegetable oils and fats	56.5	81.4	121.5	108.6	80.2
Chemical products	2,137.2	2,246.9	2,195.9	2,231.4	1,919.4
Manufactured goods classified chiefly by material	2,725.0	2,930.7	2,696.9	2,879.5	2,572.9
Machinery and transport equipment	3,880.4	3,623.2	3,603.4	3,749.1	3,191.9
Miscellaneous manufactured articles	1,736.1	1,889.5	1,819.5	1,811.3	1,894.8
Commodities and transactions, n. e	4.5	0.3	0.7	0.7	22.9
Not classified	0.0	0.0	0.0	2.3	4.3
Total	**15,137.0**	**16,281.1**	**16,214.4**	**16,527.9**	**14,468.3**

* The data for 2014 is provisional.

(1) After joining the EU, merchandise trade statistics are based on Intrastat (for trade between EU Member States) and Extrastat (for trade with non-EU countries).

Source: Central Bureau of Statistics

According to CBS data, 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, due to strong exports growth.

Imports increased by 7.6 per cent. in 2011, with total imports reaching EUR 16.3 billion. The strongest growth came from imports of oil and refined petroleum products, electricity and natural and manufactured gas which were fuelled by high prices. In addition, imports of food, chemical and pharmaceuticals products, as well as road vehicles also increased significantly. 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.

In 2012, total imports of goods was EUR 16.2 billion, declining by 0.4 per cent. in comparison with 2011. The decrease in imports resulted from a decline in a number of SITC divisions, with the most significant decreases recorded in imports of petroleum and petroleum products, road vehicles, organic chemicals, and iron and steel. In contrast, imports of natural and manufactured gas, other transport equipment, electricity, telecommunications and sound-recording equipment as well as fixed vegetable fats and oils increased in 2012.

Total imports of goods increased by 1.9 per cent. in 2013 compared to 2012 and amounted to EUR 16.5 billion. This was mainly due to an increase in imports of capital goods (notably electrical machinery and apparatus), certain agricultural products (particularly dairy products and eggs, meat and meat preparations and vegetables and fruits), road vehicles and leather and leather goods. An increase in imports of certain electrical machinery and apparatus (mostly solar products impacted by a trade dispute between China and the European Union) and road vehicles was recorded in the second quarter, prior to Croatian accession to the European Union. At the same time, a significant decline was recorded in imports of ships, oil and petroleum products, fertilizers and electricity. The trade deficit increased in 2013 by 5.4 per cent. compared to 2012.

In the first ten months of 2014 imports of goods increased by 4.3 per cent. compared to the same period previous year. Strengthening of imports can mainly be attributed to the increase in imports of wearing apparel and footwear, road vehicles, food products (like meat and meat preparations and cereals and cereal preparations) and electricity. Imports of ships also increased. By contrast, imports of oil and petroleum products, natural and manufactured gas, as well as of capital goods (mostly electrical machinery and apparatus and power-generating machinery) declined in the same period. The trade deficit decreased, by 0.9 per cent. compared to the same period of the previous year.

Geographical Distribution of Croatia's Trade in Goods

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

	2010	2011	2012	2013[(3)]	Ten months ended 31 October 2014[*]
			(per cent.)		
EU 27	61.1	59.9	58.2	61.8	63.8
Slovenia	7.8	8.3	8.6	10.4	11.5
Hungary	2.2	2.5	2.5	2.4	3.5
EU 15	44.6	42.8	41.1	42.5	41.8
Austria	5.3	5.7	6.5	6.3	6.2
Italy	18.6	15.8	15.3	14.5	14.0
Germany	10.4	10.1	10.2	11.8	11.2
CEFTA	18.7	19.2	21.0	19.6	20.5
Bosnia and Herzegovina	11.6	12.2	12.8	12.2	12.1
Serbia	3.9	3.9	4.3	4.0	4.8
EFTA[(1)]	1.1	2.4	1.3	1.7	1.8
Other[(2)]	19.1	18.5	19.6	16.9	14.0
Russia	2.0	2.4	3.4	2.9	2.4
China	0.3	0.4	0.4	0.6	0.5

[*] The data for 2014 is provisional.
[(1)] European Free Trade Association.
[(2)] Excluding EU 27, CEFTA and EFTA.
[(3)] After joining the EU merchandise trade statistics are based on Intrastat (for trade between EU Member States) and Extrastat (for trade with non-EU countries).
Source: Central Bureau of Statistics

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

	2010	2011	2012	2013[(3)]	Ten months ended 31 October 2014[*]
			(per cent.)		
EU 27	60.2	61.8	72.6	73.9	75.3
Slovenia	5.9	6.2	9.5	11.5	10.7
Hungary	2.8	3.0	6.0	6.3	6.4
EU 15	45.1	45.8	50.0	48.5	50.1
Austria	4.8	4.5	9.8	9.0	8.4
Italy	15.2	16.4	14.0	13.1	14.0
Germany	12.5	12.6	13.3	14.0	15.0
CEFTA	5.4	5.9	6.4	5.9	5.3
Bosnia and Herzegovina	3.0	3.6	3.6	3.5	2.7
Serbia	1.5	1.9	1.9	1.8	2.1
EFTA[(1)]	2.0	2.2	2.7	1.5	1.2
Other[(2)]	32.4	30.1	18.4	18.6	18.2
Russia	8.9	7.8	7.0	4.5	5.4
China	7.1	7.6	2.5	3.5	2.6

[*] The data for 2014 is provisional.
[(1)] European Free Trade Association.
[(2)] Excluding EU 27, CEFTA and EFTA.
[(3)] After joining the EU merchandise trade statistics are based on Intrastat (for trade between EU Member States) and Extrastat (for trade with non-EU countries).
Source: Central Bureau of Statistics

Exports to EU Member States increased in 2010. The growth was primarily driven by exports to the EU 15 (15 countries that were EU Member States prior to 1 May 2004), in particular Italy and Luxembourg. However, in 2011, the share of Croatian exports to EU Member States slightly decreased, mainly due to a poor performance of exports to EU 15 Member states, particularly Italy. At the same time, EFTA share growth was primarily driven by the substantial amount of ships exported to Norway. The growing trade with CEFTA countries largely came from increased exports of oil and refined petroleum products to Bosnia and Herzegovina.

In 2012, the share of Croatian exports to EU Member States further decreased, mainly due to a decrease in exports of ships to France and Luxembourg and petroleum and petroleum products to Malta. At the same time, exports to Austria (non monetary gold) increased, as well as the share of Croatian exports to Russia (telecommunication equipment). The growth of exports to CEFTA countries also increased during 2012, and mainly comprised of electricity to Bosnia and Herzegovina and manufactured fertilizers and electric transformers to Serbia.

After two years of decrease, the share of Croatian exports to EU Member States countries increased in 2013 mostly as a result of an increased share of exports to new member states like Slovenia (notably oil, petroleum products and electricity) and Slovakia (notably furniture and parts). Exports to the EU 15 countries, which had been weak during the previous two years, increased in 2013, mostly with respect to exports of electrical machinery, apparatus and appliances to Germany and exports of power-generating machinery and equipment to the UK. The share of Croatian exports to EFTA countries also increased, mostly due to exports to Switzerland (power-generating machinery and equipment and electricity). At the same time, the share of CEFTA countries decreased due to the decline of exports to most member countries. Excluding the impact of exports of other transport equipment to CEFTA countries, weaker exports to Serbia (electrical appliances and machinery and manufactured fertilizers), as well as to Bosnia and Herzegovina (electricity, cereals and cereal preparations) recorded in 2013.

Intensification of exports of goods in the first ten months of 2014, compared to the same period of the previous year, was mainly driven by an increase in share of Croatian exports to the EU Member States, the increased exports of energy products to Slovenia and Hungary having the largest impact. The exports of clothing to Spain, but also iron, steel, cork and wood to Italy grew considerably. Exports to most of the CEFTA countries increased in the same period as well, mainly as a result of the increase of exports to Serbia (electricity and food products). Croatian exports to EFTA slightly increased as a result of increased exports of power-generating machinery and equipment to Switzerland. Exports to non-EU and non-regional markets continued to decrease.

Imports from EU Member States declined further in 2010, while those from CEFTA and third (excluding EU 27, CEFTA and EFTA) 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. During 2011, the share of EU Member States improved due to increased imports of oil and refined petroleum products from Italy. Furthermore, imports growth from CEFA countries is mainly attributed to growth of imports from Bosnia and Herzegovina. However, following Croatia's accession to the EU, trade with CEFTA countries saw a decline, specifically in agro-food exports.

Following three years of growth, in 2012 the share of Croatian imports from developing countries decreased, primarily due to a significant fall in imports of petroleum from Azerbaijan. In contrast, the share of Croatian imports from EU Member States increased, partly as a result of an increase in imports of electricity from Switzerland and telecommunication equipment from Sweden.

In 2013, after joining the EU there was a methodological change in the statistical recording of merchandise imports due to the implementation of the Intrastat system of recording merchandise trade with other EU Member States, Intrastat has been applied as of the EU accession, and it can affect all trade data. However, the breakdown of imports by countries is made according to countries of dispatch in Intrastat, and according to the country of origin in Extrastat, whilst prior to EU accession, all imports (for trade with both EU and non-EU countries) were shown according to the country of origin. As a result, data for 2012 and 2013 is not fully comparable. Looking at comparable data (available for 2012 and the first half of 2013 at the country but not at the product level), the share of EU Member States slightly increased, which can mainly be attributed to Slovenia, Denmark and the Czech Republic. At the same time, the share of imports from Italy and Austria significantly declined, as did imports from Russia and Turkey.

According to the latest CBS data for the first ten months of 2014, the share of imports from the EU Member States increased annually. This was mainly a result of the rise in the imports from the EU Member States, while the imports of apparel from Italy, road vehicles from Germany and electricity from Hungary grew considerably. At the same time, imports of oil and refined petroleum products from

Slovenia sharply decreased. Moreover, imports from CEFTA countries declined, mostly due to the reduced imports of electricity and non-ferrous metals from Bosnia and Herzegovina. The share of developing countries in Croatian imports slightly decreased, which was mainly attributed to the sharp decline of imports of electrical machinery, apparatus and appliances from China. Meanwhile, the imports of oil and refined petroleum products from Russia increased considerably.

Services Account

In 2010, the positive balance on the services account decreased slightly, as a result of the decline in net revenues from the manufacturing services on physical inputs owned by others and net revenues from tourism. These negative developments were mitigated by a decline of deficit in the trade in other services as well as a rise in net revenues from transportation. Increased net revenues from transportation services were mainly due to higher volumes of international trade in goods as well as a higher number of tourists travelling. These improvements were seen primarily in sea and road freight transport. Regarding other services, the improvement of the balance is mostly related to miscellaneous business services, in particular research and development, as well as business and management services. Revenues from tourism declined by 2.3 per cent. 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 7.4 per cent. increase in the positive balance on the services account, attributable mainly to a 6.2 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, a positive contribution, although to a much smaller extent, came from trade in other business services, especially architectural and engineering, as well as agricultural and mining services. Positive developments were also recorded in net revenues from the manufacturing services on physical inputs owned by others. By contrast, net revenues from transportation services declined, mainly due to lower net revenues from sea freight transport.

In 2012, net revenues from international trade in services increased by 5.3 per cent. in EUR terms, reaching EUR 6.5 billion. This improvement was primarily driven by developments in trade in other services and tourism. Lower negative balance in trade of other services is mostly related to financial services (notably financial intermediation services indirectly measured, FISIM) and other business service. Regarding tourism, there was a 3.7 per cent. growth in revenues, a 4.5 per cent. increase in arrivals of foreign tourists (consisting mainly of tourists from Germany and other EU countries) and a 5.1 per cent. increase in numbers of nights spent by foreign tourists

The positive balance on the services account increased further in 2013 by 4.2 per cent. compared to 2012. This increase is primarily attributable to higher exports of travel services 5.0 per cent., as the physical indicators of tourist activity improved significantly. The number of foreign tourist arrivals and duration of visits grew on an annual basis by 5.6 and 3.8 per cent., respectively, mainly due to tourists from Great Britain, Poland and Germany. A noticeable fall was recorded in the numbers of arrivals and nights spent by visitors from Italy, as well as from Russia, Ukraine and Turkey due to alignment of the visa regime with the EU that came into effect on 1 April 2013. Net imports of other services increased and net revenues from transportation continued to deteriorate, primarily as a result of fall in revenues from sea freight and air passenger transport.

Based on preliminary data, in the first three quarters of 2014, net exports of services increased relative to the same period of the previous year (3.9 per cent.), primarily as a result of the 2.5 per cent. rise in the revenues from travel services. The higher number of arrivals (5.5 per cent.) and overnight stays (2.6 per cent.) of tourists from Germany, Austria, Hungary and the UK contributed to the growth in revenues from tourism. Net exports of transportation services and manufacturing services on physical inputs owned by others increased as well. At the same time, net imports of other services declined on account of the fall in the net imports of financial services and the rise in the net exports of telecommunication, computer and information services.

Details of the International Balance of Payments

Croatia's balance of payments 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 Health Insurance Fund), special reports of the Hrvatska narodna banka

(International Transaction Reporting System, external debt relations, monetary statistics and reserve assets), and estimates and statistical research carried out by the HNB.

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, (2) trade in services, (3) primary income from profits and interest earned on overseas assets, net of those paid abroad, and (4) secondary income. 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.

Croatia's balance of payments data is reported in three currencies: in Euro, U.S. dollars and kuna. 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 following table sets forth the balance of payments for the periods indicated:

	Year ended 31 December				**Nine months ended 30 September**	
	2010	**2011**	**2012**	**2013**	**2013**	**2014***
CURRENT ACCOUNT	(502.6)	(360.3)	(61.0)	341.2	1,160.9	882.6
Goods, services, and primary income	(1,565.0)	(1,509.6)	(1,222.1)	(729.4)	291.4	305.4
Credit	17,898.0	19,053.6	19,278.0	19,610.2	15,912.0	16,719.7
Debit	19,463.0	20,563.2	20,500.1	20,339.6	15,620.6	16,414.3
Goods and services	(161.5)	(192.5)	218.8	203.7	1,134.1	1,546.0
Credit	16,985.8	18,100.6	18,309.0	18,747.4	15,038.4	15,937.4
Debit	17,147.3	18,293.1	18,090.2	18,543.6	13,904.3	14,391.3
Goods	(5,922.2)	(6,381.9)	(6,297.5)	(6,588.5)	(5,205.9)	(5,041.4)
Credit	8,058.1	8,742.4	8,672.8	8,923.1	6,488.1	7,174.5
Debit	13,980.3	15,124.4	14,970.3	15,511.7	11,694.1	12,215.9
Services	5,760.7	6,189.4	6,516.3	6,792.2	6,340.0	6,587.4
Credit	8,927.7	9,358.2	9,636.2	9,824.2	8,550.2	8,762.8
Debit	3,167.0	3,168.7	3,119.9	3,032.0	2,210.2	2,175.4
Manufacturing services on physical inputs owned by others	158.8	192.0	192.3	188.5	137.4	162.8
Credit	243.4	252.4	271.7	220.7	160.7	171.9
Debit	84.5	60.4	79.4	32.2	23.3	9.2
Transport	300.9	277.6	268.7	234.5	177.7	205.0
Credit	978.0	977.8	966.7	922.0	699.0	740.9
Debit	677.1	700.1	698.0	687.5	521.3	535.8
Travel	5,600.8	5,984.5	6,136.7	6,523.0	6,101.6	6,269.1
Credit	6,230.0	6,616.9	6,858.7	7,202.8	6,606.1	6,774.0
Debit	629.2	632.4	722.0	679.8	504.5	504.9
Other services	(299.9)	(264.7)	(81.3)	(153.7)	(76.7)	(49.5)
Credit	1,476.3	1,511.0	1,539.1	1,478.7	1,084.4	1,076.0
Debit	1,776.2	1,775.7	1,620.4	1,632.4	1,161.1	1,125.5
Primary income	(1,403.4)	(1,317.1)	(1,440.9)	(933.1)	(842.7)	(1,240.6)
Credit	912.2	953.0	969.0	862.9	873.7	782.3
Debit	2,315.7	2,270.0	2,409.9	1,796.0	1,716.3	2,022.9
Secondary income	1,062.4	1,149.2	1,161.1	1,070.5	869.5	577.2
Credit	1,629.7	1,670.3	1,719.6	1,817.5	1,361.6	1,332.9
Debit	567.3	521.1	558.5	746.9	492.1	755.7
CAPITAL ACCOUNT	59.6	37.6	47.8	51.0	29.4	28.9
FINANCIAL ACCOUNT	(1,346.0)	(1,433.4)	(390.2)	(437.3)	48.3	244.2
Direct investment	(943.3)	(1,204.7)	(1,196.8)	(858.4)	(589.3)	(757.0)
Assets	125.3	(168.8)	(63.0)	(117.7)	146.3	1,880.5
Liabilities	1,068.6	1,035.9	1,133.8	740.6	735.5	2,637.5
Portfolio investment	(401.6)	(582.3)	(1,743.8)	(1,890.6)	(464.7)	562.3
Assets	408.0	(491.9)	311.5	(92.7)	168.4	246.1
Liabilities	809.7	90.4	2,055.3	1,797.9	633.1	(316.1)
Financial derivatives	252.7	75.2	(54.7)	8.7	(15.4)	(15.1)
Other investment	(337.6)	(122.2)	2,559.4	458.5	537.2	1,454.3
Assets	(689.2)	(244.6)	(605.6)	(160.1)	226.9	1,704.6
Liabilities	(351.6)	(122.4)	(3,165.0)	(618.7)	(310.2)	250.2
Reserve Assets	83.8	400.6	45.8	1,844.4	580.5	(1,000.3)
NET ERRORS AND OMISSIONS[(1)]	(903.0)	(1,110.7)	(377.0)	(829.5)	(1,141.9)	(667.3)

* Based on preliminary data.

Source: Hrvatska narodna banka

(1) 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.

Primary Income Account

Reversing the previous two years' developments, the primary income account balance improved in 2010 by 14.9 per cent. This is a result of relatively equal developments in both revenue and expenditure. The latter recorded a decrease as interest expenditures, in particular banks and corporations, declined in line with lower interest rates on international markets. Revenues 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, revenues related to investments of international reserves declined.

In 2011 the balance on the primary income account slightly improved compared to 2010, due to the fall of expenditures accompanied by growth of revenues. Regarding expenditures, although interest payments on foreign debt, in particular of banks and government, increased, 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.

The deficit based on primary income widened in 2012 by 9.4 per cent. Compensations of employees grew significantly. Also, revenues related to investments of international reserves continued to increase. However, this was to a large extent off-set by negative developments related to revenues recorded by domestically-owned companies abroad. Expenditures on the factor income account increased considerably more than revenues, mainly due to higher interest payments, while expenditures related to foreign direct equity investments were lower compared to the previous year.

The balance on the primary income account improved substantially in 2013, by 35.2 per cent. compared to the previous year, as a result of significantly lower expenditures related to direct equity investments due to shrinking profits in the banking sector, the manufacture of refined petroleum products and telecommunications. Additionally, there were lower interest expenditures of firms and banks as a result of general deleveraging. One offsetting trend was higher Government financing costs as a result of increased borrowing abroad.

The primary income account balance deteriorated in the first nine months of 2014 by 47.2 per cent. compared to the same period of the previous year. The widening deficit was primarily a result of the improved business performance of foreign-owned companies and banks. This mainly refers to financial intermediation, construction and post and telecommunication activities. Increased costs of foreign financing, primarily of the general government, also added to the primary income account deficit. Furthermore, net revenues from compensations to residents working abroad dropped slightly.

Secondary Income Account

Net revenues in the secondary income account in 2010 increased by 5.8 per cent. relative to 2009, 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 from personal transfers (including workers' remittances) and social benefits while the Government sector experienced stagnation in revenues as compared to the previous year.

In 2011 net revenues in the secondary income account increased by 8.2 per cent. The general government balance worsened mainly due to a drop in revenues. However, the other sector's balance improved as considerable revenue growth was recorded based on miscellaneous current transfers, while expenditures slightly declined.

The secondary income account balance in 2012 remained almost unchanged, as growth in revenues was to a large extent offset by increase in expenditures. The growth of total revenues was caused by a positive change in the other sector revenues, while government revenues decreased. Similarly, total expenditures increased due to higher expenditures of the private sector, while expenditures of the Government stagnated.

In 2013 net revenues on the secondary income account decreased by 7.8 per cent. compared to the previous year, as a result of stronger growth of expenditures than revenues. Higher expenditures were mostly influenced by the government payments to the EU budget. On the other hand, revenues increased due to social benefits and, mainly, withdrawal of funds from the EU budget. Part of the inflow from EU funds was also recorded in the capital transfers.

The positive balance in the secondary income account declined in the first nine months of 2014. As in 2013, this primarily reflects the fact that the amount of utilised EU funds by Government and other sectors was lower than the payments to the EU budget.

Capital Account

In the 2010-2013 period on the capital account a positive balance was recorded, which on average amounted to EUR 0.05 billion. In the first three quarters of 2014 surplus on the capital account stagnated compared to the same period of the previous year and amounted to EUR 0.03 billion. Although part of the inflow from EU funds are recorded in the capital transfers, it is important to keep in mind that the current and capital account only show the funds paid out to end beneficiaries, while the funds received, but not yet allocated are only recorded on the financial account.

Financial Account

In 2010, excluding the change in foreign reserves, recorded net capital inflows, i.e. net incurrence of liabilities, amounted to EUR 1.4 billion, which is less than a third of that in 2009. This mainly reflects a significant drop in the inflow of debt related capital. Regarding equity related capital, the much lower change in foreign assets compared to the previous year is largely attributable to developments in the FDI account as a result of round trip transactions. However, the level of external debt increased by EUR 1.3 billion compared to 2009, including the effect of unfavourable cross-currency changes. Government debt was the main reason for this growth, increasing by EUR 0.8 billion, principally as a result of a USD 1.25 billion bond in July 2010. Banks saw a slight increase in their debt level, while other domestic sectors (including FDI debt) mainly continued to refinance their liabilities, leading to a moderate increase in their stock of debt.

During 2011 substantial improvement was recorded on the financial account although the amount of capital inflows was still considerably lower than before the global economic crisis. Excluding changes in international reserves, net capital inflows grew by 28.3 per cent. reaching EUR 1.8 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 of 2011 the stock of external debt was EUR 0.5 billion lower relative to the previous year and stood at EUR 46.4 billion (103.7 per cent. of GDP). Omitting debt-equity swap transactions, the stock of external debt increased by EUR 1.0 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 foreign borrowing mostly from parent banks, domestic banks also decreased their foreign assets by EUR 1.2 billion. Public non-financial corporations and non-banking financial institutions notably reduced liabilities to foreign creditors in 2011, while private non-financial corporations managed to refinance most of their due liabilities and raise some additional funds to maintain their business activities.

In 2012 net capital inflows were significantly lower than in 2011 and heavily subdued when compared with the pre-crisis amounts. Net capital inflows, excluding changes in international reserves, amounted to EUR 0.4 billion. Scarce capital inflows were primarily attributable to substantial deleveraging of banks. They decreased their foreign liabilities by EUR 2.3 billion as the credit activity was weak. Additionally, non-bank financial institutions continued deleveraging, if the effect of one bank's transfer of non-performing placements to a company indirectly owned by the parent bank is excluded, albeit at a lower level than in previous years. Public non-financial companies also decreased their foreign liabilities, in spite of a November foreign bond issuance of USD 0.5 billion by the Croatian electricity company, HEP. Concurrently, debt creating flows mostly originated from the Government foreign bond in the amount of USD 1.5 billion issued in April 2012. Private non-financial corporations increased their foreign debt liabilities, mainly due to Agrokor conducting foreign bond issuances of EUR 0.3 billion and EUR 0.6 billion in April 2012 and October 2012. Consequently, at the end of 2012, gross external debt stood at

EUR 45.3 billion, and was EUR 1.1 billion lower than in 2011. Relative external indebtedness improved by 0.7 percentage points and amounted to 103.0 per cent. of GDP.

Financial account (excluding the changes in international reserves) in 2013 recorded net capital inflow of EUR 2.3 billion, compared to EUR 0.4 billion in 2012. Due to a further drop in investors' confidence, inflows of foreign direct equity investments were lower than in 2012. However, as a result of intensive Government borrowing at the international financial markets debt liabilities of domestic sectors increased considerably. On the other hand, credit institutions continued with the deleveraging process, although at a slower pace compared to the previous year. Other domestic sectors, primarily public non-financial corporations, have also reduced their external liabilities to foreign creditors. Total gross external debt in 2013 increased by EUR 0.6 billion and stood at EUR 45.9 billion or 105.3 per cent. of GDP at the end of the year.

In the first nine months of 2014, the financial accounts, excluding changes in international reserves, recorded a noticeable net capital outflow, i.e. a sharp fall in net foreign liabilities of EUR 1.2 billion. This was primarily associated with the improvement of the credit institutions' net foreign position due to substantial increase in their foreign assets, followed by significant reduction of their foreign liabilities. By contrast, the government and other domestic sectors increased their net foreign liabilities. The government's liabilities grew in May, when a EUR 1.25 billion long-term bond was issued, and in September, when Croatian Motorways borrowed a total of EUR 550 million. The repayment of EUR 500 million worth of ten year old foreign bonds that matured in April had an opposite effect. Debt liabilities of other domestic sectors, mainly of private non-financial corporations, and, to a much lesser extent, of other public financial institutions (except monetary financial institutions), also grew. In the first ten months of 2014 the stock of total gross external debt increased by EUR 0.3 billion, as a result of negative cross-currency changes, reaching EUR 46.3 billion. Excluding the effect of cross-currency changes, total repayments of domestic sectors' foreign liabilities exceeded their new borrowing.

Foreign Direct Investment

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

	Year ended 31 December				Nine months ended 30 September
	2010	2011	2012	2013	2014*
			(EUR millions)		
Assets	125.3	(168.8)	(63.0)	(117.7)	1,880.5
Liabilities	1,068.6	1,035.9	1,133.8	740.6	2,637.5
Direct Investment	**(943.3)**	**(1,204.7)**	**(1,196.8)**	**(858.4)**	**(757.0)**
Direct Investment as a percentage of GDP	**2.1**	**2.7**	**2.7**	**2.0**	**1.7**

* Based on preliminary data.
Source: Hrvatska narodna banka, Foreign Direct Investments Statistics

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

2010 saw a further decrease in the amount of net FDI inflow (to EUR 0.9 billion), which was lower than 2009 (down -29.2 per cent.) Excluding the effects of round tripping transactions (which influenced net acquisition of financial assets and net incurrence of liabilities by the same amount: EUR 0.7 billion in 2009 and EUR -0.6 billion in 2010), this primarily reflects higher net incurrence of financial assets, while net incurrence of financial liabilities was only slightly higher than in previous year. The purchase of Droga Kolinska by Atlantic Group contributed to the growth of assets, as well as improved business results of foreign companies under ownership of residents. On the liabilities side, direct equity investment was significantly below the level seen in the previous year (EUR 0.4 billion compared to EUR 0.7 billion in 2009), caused by the effect of round tripping, while retained earnings recorded a significant increase (84.8 per cent. growth over the level recorded in 2009). The sectoral structure of equity investments is mostly related to wholesale, retail trade and real estate. In terms of a geographical break-down, European Union investors comprise the largest share of total FDI.

In 2011, net FDI inflow amounted to EUR 1.2 billion, which is 27.7 per cent. growth compared to the previous year. Debt-equity swaps had a significant impact on the structure of net incurrence of FDI liabilities. Excluding these transactions direct equity investment amounted to EUR 0.4 billion. When it comes to the sectoral structure, a significant amount of equity investment was recorded in the chemical and metal industries, real estate, wholesale trade and commission trade, as well as the telecommunication sector. Geographically, investors from the European Union continued to comprise the largest share of FDI. Retained earnings almost halved, reflecting lower profitability of foreign-owned domestic companies and banks.

In 2012, net inflow of foreign direct investments in Croatia amounted to EUR 1.2 billion, similar to the amount recorded in 2011. Looking on the liabilities side, when debt equity swaps are excluded, only EUR 0.4 billion of new equity investments were realised, which is marginally lower than in 2011, but significantly lower than in the pre-economic crisis years. Among the activities, most of the equity investments were related to real estate, recreational, cultural and sporting activities, retail and wholesale trade, as well as the manufacture of coke and refined petroleum products. When it comes to retained earnings, the largest amounts continue to be recorded in the sectors of financial intermediation, the production of chemical products and the manufacture of coke and refined petroleum products. When compared to the previous year, the total amount of retained earnings decreased in 2012 as the profitability of foreign owned banks and companies deteriorated. As regards to other capital, debt to affiliated companies slightly increased. The majority of total investments was made by investors from Austria, Czech Republic, Luxembourg and Turkey.

Net foreign direct investment inflow in Croatia declined further in 2013 (amounting to EUR 0.9 billion) with new equity investments (excluding debt-equity swaps), on the liabilities side, amounting to only EUR 0.4 billion, similar to the level recorded in 2012. Looking at sector distribution, the highest inflow of direct equity investments in 2013 was recorded in real estate activities, financial intermediation, retail trade and manufacture of metal products. Equity investments were negatively influenced by the transaction in the second quarter, when domestic company Crodux derivati d.o.o. acquired a subsidiary of an Austrian oil company, OMV Hrvatska d.o.o. Significantly lower profitability of domestic companies and banks in foreign ownership affected reinvested earnings, which were negative.

In the first nine months of 2014 net FDI inflow amounted to EUR 0.8 billion, compared to EUR 0.6 billion in the same period of the previous year. The increase in net foreign direct investments is mainly attributable to the rise in reinvested earnings, in particular in financial intermediation, construction and the manufacture of chemicals and chemical products, with substantial improvement observed in post and telecommunications activities as well. In the second quarter round tripping investment in the amount of EUR 1.5 billion was recorded. Excluding this, equity investments remained modest and, on the liabilities side, mainly referred to investments in other business activities, real estate, retail trade, hotels, restaurants, recreational, cultural and sporting activities.

Exchange Rates

The following table sets forth the end-of-month EUR/HRK exchange rate from January 2010 to January 2015:

	2010	2011	2012	2013	2014	2015
January	7,313102	7,407203	7,564800	7,581946	7,644916	7,694064
February	7,270536	7,414820	7,576699	7,585661	7,658268	-
March	7,259334	7,382807	7,506917	7,586727	7,658394	-
April	7,246875	7,354349	7,531440	7,600678	7,604192	-
May	7,263120	7,431895	7,559568	7,556230	7,588935	-
June	7,193455	7,373946	7,510100	7,451344	7,571371	-
July	7,248517	7,452071	7,518303	7,490071	7,636504	-
August	7,274976	7,470854	7,478883	7,553891	7,627133	-
September	7,292743	7,492023	7,449746	7,611593	7,626267	-
October	7,339273	7,485329	7,533132	7,619859	7,662622	-
November	7,420325	7,498586	7,550662	7,630815	7,673128	-
December	7,385173	7,530420	7,545624	7,637643	7,661471	-

Source: Croatian National Bank

Croatia has a managed floating exchange rate regime, where the exchange rate of the kuna (HRK) 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 HNB 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 HNB 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 HNB 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.

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 HNB 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 HNB 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 HNB 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 HNB 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 2012, EUR 130.0 million on 17 January 2012 and EUR 131.0 million on 23 February 2012). The central bank also contributed to the stabilisation of the exchange rate by raising the bank reserve requirement rate from 14 per cent. to 15 per cent. in February. During March 2012 and April 2012 the exchange rate appreciated mostly due to stronger investor demand for Ministry of Finance treasury bills and expectation of foreign exchange inflows from government foreign borrowing. In the second half of May the EUR/HRK exchange rate came under strong depreciation pressures and as a result the central bank intervened in the foreign exchange market with the sale of a total of EUR 266.4 million to commercial banks on 28 May 2012. The kuna slightly strengthened against the euro during the next four months. While domestic currency usually appreciates over the summer months in response to seasonal foreign currency inflows, appreciation pressures continued in September, partly driven by expectations of foreign borrowings by some public and private enterprises. The HNB intervened in the foreign exchange market on 19 September 2012 by purchasing EUR 58.1 million from banks. Domestic currency in the last quarter of 2012 returned to its level of the end of the June 2012 and remained stable, with no significant fluctuations. At the end of December 2012, the exchange rate stood at EUR/HRK 7.55, a slight depreciation of 0.2 per cent. since the end of 2011.

The exchange rate remained fairly stable in 2013. The nominal daily EUR/HRK exchange rate moved between –1.6 per cent. and 1.0 per cent. around an average annual exchange rate of EUR/HRK 7.57, depreciating by 0.7 per cent. from 2012. The kuna depreciated slightly against the euro during the first four months of 2013. Late in the first quarter and early in the second quarter, HRK/EUR exchange rate developments were influenced by a U.S.$ 1.5 billion government bond issue in the international market. Domestic investor interest in these bonds and a large amount of reserve money (EUR 450 million) created through HNB's foreign exchange transactions with the MoF led to depreciation pressures. In response to these pressures, the HNB intervened in the foreign exchange market on 12 April, selling EUR 214.9 million to banks. In the following two months EUR/HRK exchange rate appreciated, which may be linked to the usual seasonal developments and expected government bond issue in the domestic market. Domestic currency in the second half of the year returned to its level of the mid April and remained stable. At the end of December 2013, the exchange rate stood at 7.64 EUR/HRK, depreciating by 1.2 per cent. from the end of 2012.

In 2014 the EUR/HRK exchange rate was stable. The nominal daily exchange rate of the kuna against the euro moved within a narrow range between –0.6% and 0.9% around an average annual exchange rate of EUR/HRK 7.63, depreciating by 0.8% from 2013. The HNB intervened in the foreign exchange market just once in 2014, in late January, selling EUR 240.2 million worth of foreign currency to banks, thus channelling a portion of foreign exchange inflows from government foreign borrowing to the market and meeting an increased seasonal demand for foreign exchange. At the end of December 2014, the exchange rate stood at 7.66 EUR/HRK, depreciating by 0.3% from the end of 2013.

Total foreign exchange transactions of the HNB in 2014 resulted in a net foreign exchange sale in the amount of EUR 211.8 million and a withdrawal of HRK 1.6 billion. This net sale of foreign exchange resulted from transactions with banks and the European Commission, while the kuna liquidity was generated from net foreign exchange purchased from the central government.

In January 2015 the nominal daily HRK/EUR exchange rate depreciated by 0.4% from end 2014. In order to respond to demand, the HNB intervened in the foreign exchange market by selling EUR 326.2 million to banks on 22 January. The HNB further intervened on 20 February by selling a further EUR 172.7 million.

In line with the movements in the EUR/HRK exchange rate and the U.S.$/EUR exchange rate, in 2010 the U.S.$/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.$/EUR rate on the global foreign exchange markets as a result of euro weakness following developments relating to the fiscal stability of Greece and some other EU Member States. The kuna depreciated against the US dollar in 2011, mainly reflecting movements in the global foreign exchange markets during the last two months of the year, characterised by the strengthening of the US dollar against the euro. At 31 December 2011, the exchange rate stood at U.S.$/HRK 5.82. In 2012, the U.S.$/HRK exchange rate appreciated slightly by 1.6 per cent., due to the weakening of the U.S.$/EUR rate on the global foreign exchange markets. At 31 December 2012, the exchange rate stood at U.S.$/HRK 5.73. In 2013, the U.S.$/HRK exchange rate appreciated by 3.1 per cent., due to the weakening of the US dollar against the euro on the global foreign exchange markets. At 31 December 2013, the exchange rate stood at U.S.$/HRK 5.55. The kuna depreciated significantly against the US dollar in 2014, mainly reflecting movements in the global foreign exchange markets during the second half of the year, characterised by the strengthening of the US dollar against the euro. The U.S.$/HRK exchange rate depreciated by 13.6 per cent. in 2014, from U.S.$/HRK 5.55 at the end of 2013 to U.S.$/HRK 6.30 at the end of 2014.

Regarding export price competitiveness, in 2010 the average real effective kuna exchange rate deflated by consumer prices depreciated by 1.6 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 1.4 per cent., respectively. The indicators of Croatian export price competitiveness showed diverse trends in 2012. In 2012, the real effective kuna exchange rate deflated by consumer prices depreciated by 1.4 per cent., due to nominal depreciation of the kuna against the basket of currencies, while domestic consumer prices grew stronger than abroad. On the other hand, the real effective kuna exchange rate deflated by producer prices appreciated by 2.5 per cent., which was a result of domestic producer prices growing much stronger than abroad.

The indicators of Croatian export price competitiveness for 2013 showed a slow down or even an end to the trend of improving competitiveness that existed during the last few years. The average real effective kuna exchange rate, deflated by producer prices, continued to depreciate but at much slower pace compared to the previous year. On the other hand, the average real effective kuna exchange rate, deflated by consumer prices appreciated, due to nominal appreciation of the kuna against the basket of currencies and due to somewhat faster growth of domestic than foreign prices, partly resulting from pressures from the administrative measures, although these pressures was much stronger in 2012.

After somewhat unfavourable trends in 2013, the indicators of Croatian export price competitiveness improved again in 2014. The average real effective kuna exchange rate deflated by producer prices continued to depreciate at a broadly similar pace compared to the previous year. On the other hand, after appreciating during 2013, the average real effective kuna exchange rate deflated by consumer prices depreciated in 2014, mostly reflecting price developments in Croatia relative to its main trading partners, thus returning to its 2012 level.

In the years prior to the crisis, the 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, 2010, 2011 and 2012 when kuna real effective exchange rate indices deflated by unit labour costs depreciated. The real effective the kuna exchange rate deflated by unit labour costs in the whole economy continued to depreciate in 2013 and 2014 but at much slower pace compared to 2012.

MONETARY DEVELOPMENTS, INTERNATIONAL RESERVES AND FINANCIAL SYSTEM

Monetary Policy and Instruments

Despite the negative effects of the global financial and economic crisis on the domestic economy since 2008, Hrvatska narodna banka (HNB) 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 HNB 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 below "*Monetary Policy Developments April 2010-February 2015*".

Monetary Policy Developments April 2010-February 2015

During 2010, monetary policy principally comprised exchange rate management. See further "*Exchange Rates*".

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 an average of 1.4 per cent. in the last quarter of 2011.

In 2012, the HNB took measures to ensure adequate market liquidity and the stability of domestic currency. The HNB repurchased foreign exchange from the Government, obtained from foreign borrowing, and sold foreign currency in the market. The central bank thus continued its accommodative policy, reflected in surplus kuna and foreign currency liquidity and low money market interest rates. In 2012, foreign exchange purchases exceeded sales by EUR 104 million, thus yielding HRK 0.8 billion of domestic currency. The HNB purchased a total of EUR 770 million in foreign currency through transactions with the Government, while EUR 666 million was sold through foreign currency interventions. The policy of supporting a high liquidity environment was reflected in the historically low levels of overnight money market interest rates.

In 2013, the HNB continued its accommodative monetary policy, which is based on favourable domestic liquidity while keeping a stable exchange rate against the euro. The primary source of domestic liquidity was the HNB's purchase of foreign currency from the Ministry of Finance, which was related to inflows from Government foreign borrowing. Overall, during 2013, the HNB's net foreign currency transactions resulted in net purchases of EUR 341 million, and in base money creation of HRK 2.6 billion. Banks' liquidity continued to be very high and money market interest rates remained at historically low levels. Against a background of high liquidity, no open market operations were necessary.

Motivated by banks' subdued level of lending to the private sector and high liquidity, in April 2013 the HNB's Council adopted a decision to reduce the HNB interest rate on banks' overnight deposits from 0.25 per cent. to 0.00 per cent. as banks were using the standing facility of overnight deposits on a daily basis and in increasing amounts. From 1 January to 23 April 2013, the average daily balance of overnight deposits at the central bank reached HRK 5.6 billion, roughly equalling the average liquidity surplus in the monetary system. Following the HNB's decision to reduce interest rates, banks started to manage the whole liquidity surplus on their settlement accounts at the central bank and the deposit facility was no longer used. In August the HNB permitted the inclusion of one-and-a-half-year euro T-bills of the Ministry of Finance in the liquid foreign currency claims of banks. Through the issuance of those bills, the Government substantially refinanced the maturity of T-bills that were also incorporated in liquid foreign currency claims (EUR 0.7 billion) and, as a result, there was no effect on the minimum rate of foreign currency liquidity, which remained at 17 per cent.

In line with earlier efforts, at the end of 2013 the HNB adopted new measures aimed at stimulating bank lending to corporates and supporting economic recovery. They involved the lowering of the reserve requirement rate from 13.5 per cent. to 12 per cent. as of December 2013 and the requirement on banks to purchase three-year compulsory HNB bills for the total amount of the released kuna funds. These funds are being released gradually and conditionally on banks' credit growth to corporate sector (e.g. the released amount at the end of each calendar month equals half of the increase in bank's loans to corporate sector in the previous month). In addition to the reserve requirement reduction, and in line with the general trend of falling interest rates, the interest rate on Lombard loans was also cut in December 2013 from 6.25 per cent. to 5.00 per cent.

In 2014, the HNB continued to implement the expansionary monetary policy together with maintaining the stable nominal kuna/euro exchange rate. The expansionary monetary policy stance was conducted in an environment marked by the delayed recovery of lending activity, risk aversion of banks and economic entities, low level of business and consumer optimism and subdued inflationary pressures. An accommodative monetary policy was reflected in the maintenance of high levels of liquidity created in previous years. The average surplus kuna liquidity on credit institutions' accounts in 2014 increased to HRK 6.4 billion, compared to HRK 5.0 billion in 2013. The high liquidity level contributed to the lowering of overnight interest rates on the interbank market to exceptionally low levels (only 0.28 per cent in December 2014). Indirectly, ample liquidity also contributed to more favourable short-term government borrowing on T-bills market. For example, yields on 6-month T-bills in 2014 decreased by 60 basis points, reaching 0.60 per cent. by the end of December, while 1-year T-bills recorded a drop of 90 basis points, yielding 1.50 per cent. by the end of 2014.

Reserve money creation in 2014 was again mainly driven by the foreign currency transactions. Due to seasonal depreciation pressures the HNB intervened in the foreign exchange market on 31 January by selling EUR 240.2 million. There was no need for interventions in the remaining part of 2014. Meanwhile, HNB continued conducting foreign currency transactions with the Ministry of Finance and European Commission. In the period from January to December 2014 the HNB sold EUR 392.2 million to the European Commission. These transactions refer to the conversion of kuna funds allocated by the government to the EC's account with the central bank as payments to the EU budget. Transactions with the government resulted in the net purchase of EUR 420.6 million. Similarly to previous years, those purchases were generated from the Government foreign borrowing. Therefore, in the environment of subdued capital inflows, Government foreign borrowing remained the main source of foreign currency inflows.

As of November 2014, the HNB cut the foreign currency reserve requirement allocation rate on funds received from connected clients from 100 per cent. to 60 per cent. The share of the foreign currency reserve set aside to the account with the HNB was thus equalized for all foreign currency sources. As a result, the foreign currency reserve requirement set aside to the account with the HNB decreased by around EUR 80 million, and the part of reserve requirement maintained by banks in foreign assets increased by the same amount.

At the beginning of 2015, the monetary policy stance remained unchanged. HNB continued with an accommodative monetary policy while keeping the exchange rate stable. Due to depreciation pressures HNB conducted intervention on the foreign exchange market by selling EUR 326.2 million on 22 January and selling EUR 172.7 million on 20 February. Despite the intervention, excess liquidity remained high, as by the end of January 2015 credit institutions were still holding HRK 5.5 billion of excess funds at their accounts with the HNB.

Reserve Requirements and Credit Schemes

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 (HRK 2 billion) were allocated to Hrvatska banka za obnovu i razvitak (Croatia's development bank, HBOR) 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 programme, in January 2011 the Government revised certain features of the programme. 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.

A new credit scheme was launched in 2012 in order to encourage bank lending to the private sector and to stimulate domestic economic activity. In April 2012, the HNB decreased the reserve requirement rate from 15 per cent. to 13.5 per cent. releasing around HRK 4 billion into the banking system, of which HRK 3.4 billion was used for this new credit scheme. Along with these funds, the commercial banks secured an additional HRK 3.4 billion from other sources, which constituted their 50 per cent. share in the programme. This new credit scheme, entitled the Programme for the Development of the Economy (Programme), had a total credit potential of HRK 6.8 billion to be allocated to companies in 2012 and 2013.

The Programme targeted companies which are at least 25 per cent. privately owned and achieve a minimum 10 per cent. of revenue in the international market. The intention was to improve domestic terms of financing as Programme loans featured lower interest rates compared to market rates. The repayment period for the loans is up to three years, including a one year grace period. Furthermore, the HNB, in calculating the minimum required foreign currency claims, treated 50 per cent. of the banks' shares in the loans as foreign liquid assets. These measures also reduced regulatory cost for banks.

The implementation of the Programme began in mid-June 2012 and was completed at the end of 2013. In auctions organised by HBOR, credit quotas granted to commercial banks amounted to HRK 3.4 billion but the total amount of loans disbursed to the companies by 31 December 2013 reached HRK 1.6 billion. The weighted average interest rate for end users of these credits was 3.7 per cent., which was approximately 2 percentage points lower than the average market interest rates on long-term bank loans to enterprises. As the Programme allowed 50 per cent. of funds disbursed to end users to be used for refinancing needs, the implementation of the Programme did not result in robust credit growth.

At the end of 2013 the HNB adopted new measures to encourage bank lending to the corporate sector and boost economic recovery. In December 2013, the reserve requirement rate was reduced from 13.5 per cent. to 12 per cent. Following this reduction, banks were obliged to purchase compulsory HNB bills from the released funds of a total amount of HRK 3.9 billion. On a monthly basis, HNB redeems compulsory bills in the amount of half of the increase in a bank's placements to domestic non-financial corporations in the previous month. From 31 December 2013 to 31 December 2014, the central bank repurchased HRK 758 million of compulsory bills or 19 per cent. of the total amount of bills initially held by banks. By the end of January 2015 HNB repurchased additional HRK 206 million as a result of credit developments in December 2014. However, as a stronger revival in growth of corporate placements is constrained by the numerous factors beyond the scope of monetary policy, and particularly by still weak corporate demand, the programme did not reach its full potential.

Foreign Currency Liquidity and Reverse Repo Operations

At the beginning of 2011, the HNB 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) for further use by banks to finance domestic lending activity. As a result of this measure, the HNB reduced regulatory costs for banks. In early 2012, the HNB again changed 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 June 2012, the HNB issued a decision under which the calculation of minimum required foreign currency claims also includes 50 per cent. of the amount of bank loans granted to economic entities in the context of the Programme. This, together with the reduction of the reserve requirement rate from 15 per cent. to 13.5 per cent., and the exclusion of funds received from multilateral development banks from the calculation base, had a positive impact on banks' foreign currency liquidity during 2012.

In an environment of high levels of kuna liquidity, the need to create 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 through 2009 and since mid 2009 no auctions have been held.

Legal Framework

Pursuant to the Law on the Hrvatska narodna banka (OG 75/08 and 54/13) and the Decision on Reserve Requirements (OG 133/10, 30/2011, 109/2011, 136/2011, 12/2012, 43/2012, 142/2013 and 121/2014) (the Reserve Requirement Decision), credit institutions are required to maintain with the HNB certain reserves in the settlement account, or in a separate account with the HNB. Reserve requirements apply to banks founded in Croatia and branches of foreign banks in Croatia and do not apply to special purpose saving banks (housing saving banks), banks that are regulated by a special law or 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 HNB and HBOR, funds received from financial institutions which calculate reserve requirements pursuant to the Reserve Requirement Decision, relief funds received in connection with natural disasters including emergency funds for recovery of war damage and funds received from one of the following multilateral development banks: International Bank for Reconstruction and Development, International Financial Corporation, Council of Europe Development Bank, European Bank for Reconstruction and Development and European Investment Bank. The foreign exchange base for calculating reserve requirements consists of the foreign exchange sources of funds, including received foreign exchange deposits and loans, issued foreign exchange-denominated debt 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 the HNB and HBOR, foreign exchange funds received from financial institutions which calculate reserve requirements pursuant to the Reserve Requirement Decision, foreign exchange relief funds received in connection with natural disasters including emergency funds for recovery of war damage and foreign exchange funds received from one of the following multilateral development banks: International Bank for Reconstruction and Development, International Financial Corporation, Council of Europe Development Bank, European Bank for Reconstruction and Development and European Investment Bank. 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.

Monetary Developments

The ratio of nominal GDP to total liquid assets (M4) has been broadly stable since 2010 as shown by the table below.

	Year ended 31 December				30 Sept
	2010	2011	2012	2013	2014
Ratio of Nominal GDP/M4	1.3	1.3	1.2	1.2	1.1

Sources: Croatian Bureau of Statistics and Hrvatska narodna banka

The following table sets forth the Republic of Croatia's money supply (in kuna) at the dates indicated:

	As at 31 December				
	2010	2011	2012	2013	2014
Reserve money (M0)[(1)]	56,261.7	62,379.3	61,329.0	62,968.1	63,380.0
Money (M1)[(2)]	47,986.6	51,489.4	52,002.8	58,172.9	63,500.0
Broad money (M4)[(3)]	249,147.4	260,992.3	270,333.5	279,845.9	287,564.6
Net domestic assets[(4)]	207,278.7	229,821.0	222,882.5	217,522.2	212,442.9
Domestic credit[(5)]	247,659.5	259,394.1	247,385.5	244,264.8	237,910.1

Source: Hrvatska narodna banka

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

(2) Money (Ml) comprises currency outside credit institutions, deposits with the HNB by other banking institutions and other domestic sectors and credit institutions ' 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 and money market funds´ shares/units (the last is included in M4 as of December 2011)

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

(5) Domestic credit comprises credit institutions' claims on other non-Government non-financial domestic sectors, investment funds other than money market funds, other financial intermediaries, financial auxiliaries, insurance corporations and pension funds.

In 2010, most monetary aggregates grew despite the decline in overall economic activity. M1 recovered most, growing by 1.7 per cent after a decline of 14.5 per cent. in 2009. 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 (2.1 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 84.1 per cent. As a result of the growth in M1 and in savings and time deposits, total liquid assets (M4) increased by 2.0 per cent. in 2010.

Credit institution placements grew by 5.6 per cent. in 2010. Almost half of this increase was due to exchange rate changes, particularly the 20.8 per cent. weakening of the kuna against the Swiss franc in 2010, which increased the amount of Swiss franc placements expressed in kuna terms. At the end of 2010, loans indexed to Swiss francs accounted for almost one quarter of total credit to households, while within corporate loans the share of these loans is much smaller (less than 4 per cent.). Excluding the exchange rate effects and methodological breaks[1], the rise in total placements in 2010 was 3.1 per cent.

The positive trends in placements reflected 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 lending was recorded, especially for the household sector. The growth in credit institution loans almost exclusively related to the corporate sector. Corporate placements grew by 2.7 per cent. in 2010 (5.9 per cent. excluding the exchange rate effect and methodological breaks), 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 and methodological breaks, household loans dropped by 1.4 per cent. Within the structure of household loans, the sharpest fall was recorded in car purchase loans and credit card loans.

In 2010, the central Government continued to finance its needs on the domestic banking market, resulting in the growth of credit institution lending to that sector by 16.3 per cent.

Monetary developments in 2011 were marked by an accelerated trend in credit institution lending to the Government. Credit institutions' placements to the Government registered a strong annual increase of 20.3 per cent. Together with the annual decline in Government deposits with banks and the HNB, the overall net claims on the central Government increased by 31.9 per cent. in 2011.

The growth of credit institution placements in 2011 (3.0 per cent., excluding exchange rate effects) was substantially similar to that in 2010. A positive contribution to the increase in placements came from the corporate sector. The exchange-rate adjusted annual growth rate of placements to the corporate sector increased to 6.9 per cent. Thus, credit institution corporate financing in 2011 was stronger than the year before, primarily due to demand for short-term working capital and gradual foreign deleveraging. Investment loans accounted for 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 fell by 1.0 per cent. in 2011 (excluding exchange rate effects).

M4 increased by 4.8 per cent. in 2011 (3.4 per cent. after excluding exchange rate effects) indicating a slowdown in the growth of this monetary aggregate. However, more than half of the growth in 2011 can be attributed to the inclusion of the money market funds shares in the monetary aggregate M4 from December 2011 onwards in line with the ESA 2010 methodology. In the M4 structure, the growth of M1 was more prominent in 2011 than over the previous year (7.3 per cent. relative to 1.7 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 in 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 23.1 per cent. at the end of 2011.

[1] For detailed clarification on the methodological changes implemented on historical data from 1999 onwards, see Appendix in HNB Bulletin 190 issued in March 2013 – Alignment of the statistical reporting of the CNB with the reporting requirements of the EU.

In 2012, total savings and time deposits increased by 3.5 per cent. (relative to 1.0 per cent. in 2011). Growth in deposits was marked by strong foreign currency deposits inflow, particularly over the summer months when the seasonal increase in foreign currency deposits of the household sector was most pronounced. Foreign currency deposits grew by 4.9 per cent. in 2012, after falling by 3.8 per cent. the year before (exchange rate changes excluded). Unlike foreign currency deposits, kuna deposits decreased by 7.3 per cent. in 2012, partly as a result of the one-off conversion of kuna deposits into foreign currency deposits by a major enterprise. As a result of deposit developments and growth in money M1 of 1.0 per cent., the annual growth rate of total liquid assets increased to 6.0 per cent. (excluding the exchange rate effect), an increase from 3.4 per cent. in 2011.

In 2012, credit institution lending decreased by 4.6 per cent. or HRK 12.0 billion. This reduction was partially due to a series of transactions carried out by one bank in December 2012 which, aiming to strengthen its balance sheet, transferred a total of HRK 5.6 billion of partly recoverable and irrecoverable placements to an SPV company indirectly owned by its parent bank. Additionally, in 2012 the Ministry of Finance assumed HRK 9.2 billion of shipyard loan liabilities (of which HRK 6.7 billion were liabilities to domestic credit institutions), pursuant to a restructuring of the shipyard sector, which resulted in the reclassification of those corporate loans into claims on central Government. Excluding the December transaction, the Ministry of Finance's assumption of the shipyards' credit liabilities and the impact of exchange rate changes, the credit institution lending in 2012 was stagnant (its annual rate of change was -0.1 per cent.). On the other hand, credit institutions' placements to the Government in 2012 increased by HRK 1.7 billion or 2.5 per cent., excluding the assumed shipyards' credit liabilities. With respect to loan developments in the household sector, moderate deleveraging of this sector continued in 2012.

The scale of credit institutions' external deleveraging in 2012 was substantial. Against the background of growing domestic deposits and decreasing lending to the private sector, credit institutions reduced their foreign liabilities. The net external position of credit institutions thus improved by HRK 15.7 billion or 31.2 per cent. in 2012. Even excluding the effect of the decrease in the external debt by a commercial bank as a result of the funds received from the sale of its receivables, the annual improvement in credit institutions' net foreign position remained high, totalling HRK 11.8 billion or 23.4 per cent.

In 2013, monetary developments were characterised by the strong growth of deposit money, especially of enterprises, which contributed to the higher than expected growth of narrow money M1 which grew by 11.9 per cent. At the same time savings and time deposits increased by a moderate 2.2 per cent. kuna deposits rose by 6.2 per cent. while foreign currency deposits grew by 0.5 per cent. (excluding the exchange rate effect). Stronger growth of narrow money M1 compared to growth of deposits reflected the preference of the domestic sector towards more liquid assets in an environment of a moderate downward trend in banks' interest rates. As a result of these developments, the growth of the broadest monetary aggregate M4 remained moderate in 2013, amounting to 3.0 per cent. (after excluding the exchange rate effect).

Credit institutions' lending activity in 2013 generally remained low. Credit recovery was constrained by subdued demand, tightening in credit standards, the growth in non-performing loans (NPLs) and delayed economic recovery. In 2013, the adjusted annual change of total claims on the private sector amounted to ─0.4 per cent., compared to ─0.1 per cent. in 2012 (the 2013 adjusted annual growth rate of claims excludes the bankruptcy of Centar banka d.d., methodological changes relating to fee booking, the transfer by a commercial bank non-performing loans to a special purpose vehicle in preparation for the sale of the bank, and exchange rate effects). As regards domestic corporate financing, in 2013 the adjusted credit growth amounted to 1.3 per cent., after a fall of 2.1 per cent. in the previous year. On the other hand, the household sector continued to deleverage. Unchanged financing conditions coupled with suppressed demand held down by unfavourable developments in the labour market and negative expectations continued to limit lending to this sector, bringing the adjusted annual decrease in loans to households in 2013 to 1.7 per cent. Net credit institutions' placements to Government decreased by 3.1 per cent. in 2013. This was a consequence of significant Government deposit accumulation, after an international bond issuance in November that was intended to provide the majority of funds for the Government's financing needs in 2014. Gross placements to Government showed credit growth of 13.2 per cent. in 2013.

The trend of credit institutions' deleveraging slowed in 2013. The net external position of credit institutions, excluding the exchange rate effect, improved by HRK 1.9 billion or 5.4 per cent. in 2013, which represents only 11.6 per cent. of the amount by which credit institutions had reduced their net foreign liabilities in 2012. The improvement of the net external position in 2013 was a result of the reduction of credit institutions' foreign liabilities.

Monetary developments in 2014 were marked by the continued growth of domestic deposits amid still subdued credit activity. The annual growth rate of the broadest monetary aggregate, M4, at the end of 2014 stood at 2.0 per cent., excluding the exchange rate effect, thus decelerating only modestly compared to the year before (annual growth rate of M4 in 2013 was 3.0 per cent.). The growth in M4 continued to reflect the increase in deposit money, which increased by 9.2 per cent., as well as growth of savings and time deposits in domestic currency, which increased by 2.3 per cent whereas foreign currency deposits remained around the level reached at the end of 2013 (their annual growth rate, excluding the exchange rate effect, was 0.1 per cent.).

Notwithstanding the gradual improvement in financing conditions, including a decline in lending rates and easing of credit standards, domestic lending activity remained subdued in 2014. At the end of 2014, total claims on the private sector recorded an annual decrease of 3.0 per cent., excluding the exchange rate effect (with claims on enterprises and households decreasing by 4.3 per cent., and 1.3 per cent., respectively). However, the decline in domestic credit institutions' claims on enterprises was partly compensated by foreign borrowing of the corporate sector in 2014. The trend of substituting domestic with foreign debt was driven by privately owned companies, while state-owned enterprises reduced both their foreign and domestic loans in 2014.

Although the balance of reserve money (M0) at the end of 2010 was almost the same as at the beginning of the year, M0 fluctuated between 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 HNB. In 2011, M0 registered strong annual growth of 10.9 per cent. reaching HRK 62.4 billion at 31 December 2011. This growth was mainly a result of the HNB'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. A decrease of Government kuna deposits from the account at the central bank also increased the level of monetary reserves. At 31 December 2012, M0 amounted to HRK 61.3 billion and reflected a decrease of 1.7 per cent. from 31 December 2011. This was primarily attributable to the reduction of the reserve requirement rate in April 2012 from 15 per cent. to 13.5. per cent. The balance of M0 at 31 December 2013 stood at HRK 63.0 billion, a 2.7 per cent. increase compared to the 31 December 2012 balance. M0 growth in 2013 reflected an increase in funds in the settlement accounts of credit institutions held at the HNB, which indicates a higher level of liquidity in the banking system. At 31 December 2014, M0 amounted to HRK 63.4 billion. The 0.7 per cent. increase of M0 in 2014 was attributable to an increase of currency outside credit institutions.

International Reserves Management

In managing the international reserves of Croatia, the HNB is governed by the principles of liquidity and safety of investment. In that context, the HNB 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.

The HNB 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 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 the HNB 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 composition of total international reserves as at the dates indicated:

	As at 31 December				
	2010	2011	2012	2013	2014
			(EUR millions)		
Total international reserves	**10,660.31**	**11,194.96**	**11,235.79**	**12,907.53**	**12,687.44**
Statutory reserves in foreign currency	646.33	735.57	675.20	578.60	488.79
Central Government foreign currency deposits	369.18	78.28	10.40	1,450,27	1,117.52
Holdings of SDRs....................................	356.73	360.71	352.82	340.78	364.04
Net international reserves(1).....................	9,288.08	10,020.41	10,197.37	10,537.88	10,717.09
Imports of goods & services (months) ...	6.5	6.6	6.8	6.8	n/a(2)

Source: Hrvatska narodna banka

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

(2) Not available.

In 2010, the total international reserves of the HNB increased by 2.7 per cent., reaching EUR 10,660.30 million at 31 December 2010. As of 31 December 2010, the net international reserves of the HNB were EUR 9,287.93 million, which represents an increase of 2.8 per cent. compared to 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 HNB which amounted to EUR 1,551.14 million (including EUR 239.94 million in foreign currency the HNB 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 HNB amounting to EUR 1,461.45 million (including EUR 234.03 million in foreign currency the HNB 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, total international reserves increased by 5.0 per cent. relative to total international reserves at 31 December 2010, and reached EUR 11.19 billion. This growth was almost exclusively a result of Government foreign currency inflow related to an international bond issuance by the Government of U.S.$ 1.5 billion in March 2011. The HNB converted the majority of these foreign currency funds into kuna, which led to an increase in both total and net international reserves of the HNB. Net purchase of foreign currency from the Government in 2011 amounted to EUR 968.23 million and increased international reserves, while two sales of foreign exchange to the banks, totalling EUR 419.40 million, had an opposite effect on the level of international reserves. The net effect of other factors on total international reserves, such as outflows of Government foreign currency deposits from the HNB, 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 their level at 31 December 2010, reaching EUR 10.0 billion at 31 December 2011. The SDR 303.2 million allocation received in 2009 remained the same in 2011.

In 2012, total international reserves increased, reaching EUR 11.24 billion at 31 December 2012. The annual growth of international reserves in 2012 amounted to EUR 41 million or 0.4 per cent. (0.7 per cent. excluding the EUR/U.S.$ exchange rate effect). The growth was mainly the result of the net purchase of EUR 770 million from the Government and investment income realised of EUR 110 million, less net sales of EUR 666 million to banks. The remaining difference was the result of a decrease in Government foreign currency deposits as well as a decrease of reserve requirements in foreign currency.

Total international reserves increased in 2013, reaching EUR 12.9 billion at 31 December 2013. The main drivers of the change in the level of total international reserves in 2013 were net inflow of foreign currency to the Ministry of Finance's account with HNB (EUR 1,385 million), net purchases of foreign currency from the Ministry of Finance (EUR 626 million) and investment income (EUR 91 million), less foreign exchange interventions involving sales of foreign currency to the banks (EUR 215 million) and sales of foreign currency to European Commission (EUR 69 million).

Since the outbreak of the global financial crisis in 2008, the HNB has tightened its risk management guidelines. In order to minimise credit risks, the HNB stopped investments into uncollateralised deposits with banks and rerouted the proceeds to other central banks and international financial institutions. Furthermore, its list of eligible sovereign issuers was reduced and it ceased investing in issues with lower credit ratings. In response to the fall in yields on German and U.S. bonds, the HNB also reduced the duration of its actively managed portfolios and introduced a longer-term euro held-to-maturity portfolio to reduce its interest rate risks and to enhance the overall expected return.

Total international reserves decreased in 2014, reaching EUR 12.7 billion at 31 December 2014 due to a decrease in Ministry of Finance and European Commission foreign currency deposits as well as a decrease of reserve requirements in foreign currency. On the other hand, net international reserves increased by EUR 141 million to EUR 10.7 billion. The main drivers of the change in the level of total international reserves in 2014 were net purchases of foreign currency from the Ministry of Finance (EUR 420.6 million) and investment income (EUR 105.8 million) less foreign exchange interventions involving sales of foreign currency to the banks (EUR 240.2 million) and sales of foreign currency to European Commission (EUR 392.2 million).

In 2014 investment guidelines were to some extent/moderately relaxed as the European debt crisis eased and as a response to changes in the financial market following the ECB's decision to reduce the deposit facility rate to negative. Investments into uncollateralised deposits with banks were allowed again and the list of eligible sovereign issuers was expanded to include investment grade issuers.

In terms of credit rating, the share of the total reserves placed with or invested in securities issued by countries, banks or international financial institutions with the highest Aaa rating according to Moody's stood at 40.6 per cent. at 31 December 2014. Investments rated Aa1, Aa2 and Aa3 accounted for 18.0 per cent. of total international reserves, while investments rated A1, A2 and A3 were at 20.7 per cent. Investments rated Baa1 and Baa2 amounted to 14.1 per cent. The remaining 6.3 per cent. of total international reserves at 31 December 2014 were invested with the International Monetary Fund and the Bank for International Settlements and foreign currency cash at HNB.

The following table sets out the composition of net international reserves as at the dates indicated:

	As at 31 December			
	2011	**2012**	**2013**	**2014**
	(per cent.)			
Government bonds	74.7	68.9	70.5	73.4
Financial instruments of central banks and international financial institutions	22.0	24.7	19.8	11.9
Non-collateralised instruments	1.2	0.0	1.7	11.5
Bank/covered bonds	2.1	6.4	8.0	3.2
Total net international reserves	**100.0**	**100.0**	**100.0**	**100.0**

Source: Hrvatska narodna banka

Reflecting their relative credit risk exposure, net international reserves are categorised as: funds invested in Government bonds; international financial institutions; central banks; non-collateralised instruments with commercial banks; bonds issued by banks and covered bonds. In terms of the structure of net international reserves, the share of investments in Government bonds increased to 73.4 per cent. at 31 December 2014 from 70.5 per cent. at 31 December 2013. The share of investments with central banks and international financial institutions decreased from 19.8 per cent. at 31 December 2013 to 11.9 per cent. at 31 December 2014. Investments in non-collateralised instruments with commercial banks increased to 11.5 per cent. of net international reserves at 31 December 2014 compared to the end of 2013. when it amounted to 1.7 per cent. The remaining 3.2 per cent. of net international reserves were invested in bonds issued by banks or covered bonds.

As of 31 December 2014, the share of reserves in euro in net international reserves stood at 80.1 per cent. and was lower then compared to 31 December 2013 when it was 81.8 per cent. At the same time share of reserves in U.S.$ was 19.9 per cent., higher than the 18.1 per cent. held at 31 December 2013.

The average size of the HNB euro and U.S.$ portfolios that were actively managed in 2011 amounted to EUR 3.84 billion and U.S.$ 2.51 billion, respectively. The average size of the HNB euro held-to-maturity portfolio in 2011 stood at EUR 3.98 billion. In 2011, the net yield on the actively managed euro portfolio was 1.36 per cent, 0.56 per cent. on the U.S.$ portfolio, and 2.31 per cent. on the euro held-to-maturity portfolio. In 2012, the average size of the actively managed HNB euro portfolio, the U.S.$ portfolio and the euro held-to-maturity portfolio was EUR 4.02 billion, U.S.$ 2.45 billion and EUR 3.93 billion, respectively. The net yield on the actively managed euro portfolio, the U.S.$ portfolio and the euro held-to-maturity portfolio was 0.3 per cent., 0.35 per cent. and 2.31 per cent., respectively. In 2013, the average size of the actively managed HNB euro portfolio, the U.S.$ portfolio and the euro held-to-maturity portfolio were EUR 4.13 billion, U.S.$ 2.56 billion and EUR 3.90 billion, respectively. The net yield on the actively managed euro portfolio, the U.S.$ portfolio and the euro held-to-maturity portfolio was 0.01 per cent., 0.14 per cent. and 2.27 per cent., respectively.

In 2014, the average size of the actively managed HNB euro portfolio, the U.S.$ portfolio and the euro held-to-maturity portfolio were EUR 3.99 billion, U.S.$ 2.64 billion and EUR 4.10 billion, respectively. The net yield on the actively managed euro portfolio, the U.S.$ portfolio and the euro held-to-maturity portfolio was 0.42 per cent., 0.24 per cent. and 2.06 per cent., respectively.

The income realised 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. In 2012, the income realised from the investment of reserves was EUR 103.13 million, and U.S.$ 9.22 million. In 2013, the income realised from the investment of foreign reserves was EUR 87.81 million and U.S.$ 3.60 million. In 2014, the income realised from the investment of foreign reserves was EUR 100.48 million and U.S.$ 6.33 million.

Banking System

The HNB is responsible for the supervision of banks, savings banks, housing savings banks and credit unions. The supervisory tasks of the HNB also include the issuance and withdrawal of authorisations for these institutions, the adoption of relevant subordinate legislation and the supervision of operations of these institutions. Legal compliance, safety and soundness of bank operations and risk management are assessed through on-site and off-site supervision. On-site supervision is performed according to the HNB'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 supervision department makes assessments of banks' risk profiles based on information provided in compulsory reports that banks submit to the HNB, on-site supervision findings and other relevant information. If violations or irregularities are established, the HNB issues regulatory orders that require banks to implement remedial measures.

The Credit Institutions Act (OG 159/2013 and 19/2015) (the "**Credit Institutions Act**"), which, *inter alia*, implemented Basel II and Basel III, aligns Croatian legislation in that area with the relevant EU directives and regulations. Where a credit institution is either in breach of a law or other regulation or its financial position makes its continued operation uncertain, the HNB may abolish authorisation to provide particular financial services, appoint a special administrator, abolish the credit institution's authorisation, initiate the compulsory winding-up of the credit institution or submit a request to initiate bankruptcy proceedings. Furthermore, the HNB may appoint a trustee when it estimates a need for further evaluation and monitoring over the financial state and over the credit institutions management conditions.

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 HNB in advance. 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 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, the HNB monitors not only the legal position of a potential acquirer, but also the acquirer's financial health and other relevant factors.

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. The HNB is actively monitoring and developing credit institution legislation with respect to changes in EU legislation and in accordance with its international obligations, including its obligations as an EU member. Through the adoption of the new Credit Institutions Act, which entered into force in January 2014, Croatian banking legislation has been harmonised with the Capital Requirements Regulations and the Capital Requirements Directive. This has given the HNB a new set of instruments that are designed to address risks more efficiently.

The main change in the new legislation, which entered into force in January 2014, is in the area of capital adequacy. Minimum regulatory capital adequacy is now directly regulated by the Capital Requirements Regulation and it is ensured at three levels: Common Equity Tier 1 capital ratio of 4.5 per cent., Tier 1 capital ratio of 6 per cent. and Total Capital ratio of 8 per cent. Also, the additional capital requirement is composed of the following buffers: a capital conservation buffer that ensures the accumulation of capital in a phase of positive conditions which can absorb losses in a period of stress; a countercyclical capital buffer that will reduce the negative effect of overheating of credit growth; a structural systemic risk buffer for the purpose of protection against systemic risks that do not depend on cycles; capital buffers for global systemically important institutions; and capital buffers for other systemically important institutions. From May 2014 a credit institution whose share in the total assets of the Croatian banking system equals or exceeds 5% shall apply a structural systemic risk buffer rate of 3% of the total risk exposure amount. Other credit institutions shall apply a structural systemic risk buffer rate of 1.5% of the total risk exposure amount.

Alongside capital buffers, the new Regulation imposes the obligation to form and maintain adequate liquidity buffers of credit institutions for amortisation of potential liquidity shocks. The liquidity coverage ratio (LCR) designed to cover the possible imbalances between liquidity inflows and outflows in extremely stressed conditions during one month and the Net Stable Funding Ratio (NSFR) aimed at long-term structural improvement of credit institutions' liquidity will need to be complied with. As the implementation of these ratios will be gradual (from 2015 to 2018), the HNB will continue to use its existing national liquidity requirement (minimal liquidity coefficient) during the transitional period.

Implementation of EU legislation relating to recovery and resolution, such as the Bank Recovery and Resolution Directive (Directive 2014/59/EU - BRRD), which includes a common set of tools to enable authorities to improve the effectiveness of the arrangements for dealing with bank failures in the EU, is currently taking place in Croatia. The BRRD is mainly incorporated in the new Act on Recovery and Resolution of Credit Institutions and Investment Firms (OG 19/2015), which entered into force on 28 February 2015. Parts of this Directive relating to recovery plans, early intervention measures and group financial support arrangements are implemented in the Credit Institutions Act on the amendments to the Credit Institutions Act ("**Act on the amendments**") published in the Official Gazette no. 19/2015 (the majority of provisions of the Act on amendments entered into force on 28 February 2015). In addition, regarding the investment firms, parts of the BRRD relating to recovery plans, early intervention measures and group financial support arrangements are implemented in the Capital Market Act on the amendments thereto published in the Official Gazette no. 18/2015.

According to the Act on the amendments each credit institution, that is not part of a group subject to consolidated supervision, is obliged to draw up and maintain a recovery plan providing for measures to be taken by the credit institution to restore its financial position following a significant deterioration of its financial situation. The parent credit institution has to draw up a group recovery plan. The requirement to draw up a recovery plan has already been prescribed by the existing Credit Institutions Act but the Act on the amendments sets out a detailed procedure for the assessment of individual and group plans. The recovery plans prescribed by the existing Credit Institutions Act were due to be submitted to the HNB by 31 December 2014.

The Act on the amendments introduces early intervention measures which the HNB can impose on a credit institution in the case a credit institution infringes or is likely in the near future to infringe, the requirements of the Credit Institutions Act, Regulation (EU) 575/2013 and other regulations relating to banking operations, to the extent that the liquidity, solvency or viability of operations of a credit institution is jeopardised. During early intervention the HNB may, in addition to supervisory measures, impose the following measures on a credit institution:

- require implementation or update of a recovery plan;
- require changes to business strategy;

- require changes to the legal or operational structures;
- require a credit institution to convene or if the management body fails to comply with that requirement convene directly, a meeting of shareholders of the institution, and in both cases set the agenda;
- require one or more members of the management body or senior management to be removed or replaced if those persons are found unfit to perform their duties;
- require one or more members of the management body or senior management to be removed or replaced irrespective of the fact that they are found fit to perform their duties;
- require the removal of the management body of the credit institution, in its entirety or with regard to individuals and appoint a substitute management board member;
- appoint a temporary administer to the credit institution; or
- appoint a special administration to the credit institution.

Among other amendments to the Credit Institutions Act it is worth mentioning that a new requirement regarding protection of depositors is introduced. If a credit institution intends to reduce Common Equity Tier 1 items it has to repay deposits, including interest, to each depositor who requires so in the period of six months of the public disclosure of the intention to reduce Common Equity Tier 1 capital items. The credit institution is not obliged to execute such repayment of deposits if it decides to postpone the reduction of common equity tier 1 items to the period of two years from the publication of the intention of capital items reduction.

At the end of December 2013, the Croatian parliament adopted the Act on the Financial Stability Council (OG 159/2013), an inter-institutional body that will provide assistance in harmonising different policies, coordination of assessment, consideration and systemic risks mitigation activities and communication with the general public. Steps are also being taken to formalise cooperation in terms of crises situation resolution. This law clearly defines the following intermediate objectives of macro-prudential policy: a) mitigation and prevention of excessive credit growth and leverage; b) mitigation and prevention of excessive maturity mismatch and market illiquidity; c) limitation of direct and indirect exposure concentration; d) limitation of the systemic impact of procedures motivated by inappropriate incentives with a view to reducing the breach of business and professional rules of conduct; e) strengthening the resilience of financial infrastructure and f) other goals set out in on the recommendation of the European Systematic Risk Board.

Classification of Placements

A new classification scheme that affects loan loss provisions levels and dynamics was implemented in October 2013. The new classification scheme regulates loan classification and requires banks to value their collateral more actively. It is expected to result in increased non-performing loans coverage which is intended, in the long-term, to accelerate the process of non-performing loans resolution and create a solid base for future credit growth. However, in the short-term it is expected to increase loan loss provisions.

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) and off-balance sheet items in a manner prescribed by the Credit Institutions Act. In addition, the HNB has the authority to prescribe in detail how such reserves are formed pursuant to the classification decision entitled *'Decision on the Classification of Placement and Off-Balance Sheet Liabilities of Credit Institutions*' (OG 41A/2014). Generally, according to the Classification Decision, assets (for this purpose named "placements") are classified according to the degree of risk in risk categories on the basis of the following main criteria: (1) debtors' creditworthiness; (2) debtors' timeliness in meeting their obligations towards a credit institution and other creditors; and (3) quality of instruments of collateral for a credit institution's receivables. 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 objective evidence of impairment is identified on an individual basis (risk category A);

- placements for which objective evidence of partial impairment is identified, i.e. partly recoverable placements (risk categories B-1/B-2/B-3); or
- placements for which objective evidence of full impairment is identified, i.e. fully irrecoverable placements (risk category C).

The same approach is applied to the categorisation and provisioning for off-balance sheet items.

Structure of the Banking Industry

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

At the end of September 2014, the Croatian banking system comprised 30 banks (one of which is a savings bank), five housing savings banks and HBOR. The number of banks has fallen since 1998 as a result of consolidation/mergers, takeovers and the bankruptcy of some banks. During 2009 one large and one middle-sized bank (owned by the same foreign financial institution) merged. In 2012, one large and one small bank (already owned by the large bank) merged. Also, three small banks (each with a market share below 1.0 per cent.) left the market following the loss of its banking license: one savings bank (in the second half of 2010) and two commercial banks (in the second half of 2011 and in the second half of 2013). Four foreign banks have representative offices in Croatia. Two banks remain state-owned — Hrvatska postanska banka (Croatian Postal Bank) and Croatia banka; however, the Government is considering the privatisation of the Croatian Postal Bank at some point in the future.

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				**As at 30 September**
	2010	**2011**	**2012**	**2013**	**2014**
	(per cent.)				
State ownership[(1)]	4.3	4.5	4.8	5.2	5.3
Private domestic ownership	5.3	4.8	5.1	5.0	4.7
Foreign bank ownership	90.4	90.8	90.2	89.8	89.8
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Hrvatska narodna banka

(1) State owned and privately owned but where at least 50 per cent. of the private owner is owned by the State.

The banking system in Croatia is highly concentrated with the two largest banks holding over 43 per cent. of total assets as at 30 September 2014. The majority of the commercial banks' assets are controlled by foreign shareholders. As at 30 September 2014, 17 entities were majority owned by foreign shareholders, 10 by private domestic shareholders and two 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 with a market share of 1.0 per cent. or more as at 30 September 2014 (which together had a 92.6 per cent. market share at 30 September 2014):

	In private domestic ownership	In Government (domestic) ownership	Foreign (private) ownership	Share of market[(1)]	Share in shareholders' equity
			(per cent.)		
Zagrebacka banka d.d.	2.8	0.5	96.7	26.3	28.8
Privredna banka Zagreb d.d.	1.8	0.1	98.1	17.2	20.7
Erste&Steiermarkische Bank d.d. Rijeka	0.0	0.0	100.0	15.3	12.9
Raiffeisenbank Austria d.d.	0.0	0.0	100.0	8.0	8.7
Hypo Alpe-Adria-Bank d.d.	0.0	0.0	100.0	7.1	8.9
Societe Generale-Splitska banka d.d.	0.0	0.0	100.0	7.0	6.4
HPB d.d.	0.5	99.4	0.1	4.5	1.9
OTP banka d.d.	0.0	0.0	100.0	3.6	3.0
Sberbank d.d.	0.0	0.0	100.0	2.6	2.5
Kreditna banka Zagreb d.d.	99.8	0.2	0.0	1.0	0.6
Aggregate weighted by market share	5.42	5.54	89.04		
Aggregate weighted by share in shareholders' equity	4.35	2.53	93.12		

Source: Hrvatska narodna banka

(1) Measured by the Bank's assets as a proportion of total banking sector assets

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 10 large or medium-sized banks in Croatia as at 30 September 2014. 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 a percentage of their assets, as at 30 September 2014:

	Money assets and deposits with the HNB	Deposits	Securities	Loans	Other
			(per cent.)		
Large banks	12.2	8.8	11.5	63.3	4.2
Medium-sized banks	11.6	8.6	13.3	62.1	4.5
Small banks	13.2	9.4	16.2	55.4	5.8
Banking system	**12.2**	**8.9**	**12.0**	**62.6**	**4.3**

Source: Hrvatska narodna banka

The following table sets forth the structure of bank peer group liabilities, as a percentage of their liabilities, as at 30 September 2014:

	Capital	Deposits	Securities	Loans	Other
			(per cent.)		
Large banks	14.9	71.3	1.2	9.5	3.1
Medium-sized banks	9.5	74.8	0.8	8.8	6.1
Small banks	10.9	77.5	1.4	7.7	2.7
Banking system	**13.9**	**72.2**	**1.2**	**9.3**	**3.4**

Source: Hrvatska narodna banka

Asset growth in the banking sector was 3.4 per cent. in 2010 and 4.2 per cent. in 2011, followed by a 1.3 per cent. decrease in 2012 and a decrease of 0.5 per cent. in 2013. In the first nine months of 2014, asset growth was 0.5 per cent. However, accounting for the depreciation of the kuna during the first nine months of 2014, banking sector assets effectively increased by 0.3 per cent.. The reduction of bank assets in 2013 was the result of four factors: a) one small bank left the market; b) loan loss provisions increased due to the amended classification rules which subsequently decreased the net value of assets; c) a methodology change in reporting deferred income from fees; and d) a transaction carried out by one bank which, aiming to strengthen its balance sheet, transferred HRK 1.0 billion net of partly recoverable and irrecoverable placements to an SPV company owned by its parent. The reduction in 2012 was also primarily driven by transactions carried out by one bank which transferred HRK 3.7 billion net of partly recoverable and irrecoverable placements to an SPV company owned by its parent bank in order to clean its balance sheet. In 2011, bank assets recorded an increase of 4.2 per cent. 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. In 2012, the nominal credit decrease was 2.7 per cent. (and 2.9 per cent. when exchange rate effects are excluded). Excluding the asset transfer by one bank, nominal credit growth in 2012 would have been 0.8 per cent., (although it would have remained unchanged if exchange rate effects were excluded). In 2013, net loans decreased by 2.3 per cent. when exchange rate effects are excluded (1.5 per cent. nominally) and in the first nine months of 2014 net loans decreased by 5.3 per cent when exchange rate effects are excluded (decreased 5.2 per cent. nominally).

The kuna component of banks' assets and liabilities increased slightly in 2010 and remained broadly stable in 2011, 2012 and 2013. At 30 September 2014, the currency structure of bank assets remained stable compared with 31 December 2013 and consisted of 37.8 per cent. kuna assets, 36.0 per cent. foreign currency indexed assets and 26.2 per cent. foreign currency assets. At the same date, the currency structure of liabilities and capital was 33.4 per cent. kuna, 63.1 per cent. foreign currency and 3.5 per cent. indexed to foreign currency.

Capitalisation

Banks' capital to assets ratio in Croatia has remained stable at around 14 per cent. since 1 January 2010 and amounted to 13.9 per cent. as at 30 September 2014. At 30 September 2014, the total capital of Croatian banks was HRK 55.7 billion, an unchanged level compared with the end of 2013 but around 3 per. cent decrease compared with end 2012. The major contributor to the decrease in 2013 was current period earnings, which decreased by 73.3 per cent. The decrease of earnings in 2013 was primarily the result of increased value adjustment costs that followed the changed rates on placements classification in October 2013. In the first nine months of 2014, bank capital remained broadly unchanged, as somewhat better current earnings were annulled by an increased dividend pay-out. The classification rules have resulted in the increased non-performing loans coverage ratio accompanied by significantly higher loan provisions that recorded an increase of 56.9 per cent. in 2013.

The growth of assets of financial intermediaries in Croatia was 3.5 per cent. in 2010 and in 2011, followed by 0.5 per cent. growth in 2012 and 0.8 per. cent. growth in 2013, representing a compounded annual growth rate of 2.1 per cent. for the four year period. In the first nine months of 2014 assets of financial intermediaries increased another 2.2 per cent. compared to the end of 2013. The compounded annual growth rate from 2010 to September 2014 amounted to 2.1 per cent.

Risk-Based Capital Requirements and Solvency Ratios

At 30 September 2014, the regulatory capital of Croatian banks totalled HRK 53.1 billion, an increase of 0.15 per cent. compared with the end of 2013 and a decrease of 4.8 per cent. compared with the end of 2012. Since banks in Croatia have a conservative capital structure, regulatory capital is predominantly made up of Tier 1 capital (around 94 per cent. as of 30 September 2014).

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 of the banking sector increased to 19.6 per cent. in 2011 and increased to 20.9 per cent. in 2012 as a result of the regulatory change as well as a higher share of low risk placements (Governments and central banks) which led to a decrease in risk weighted assets. The rising share of low risk placements and an absolute decline in the loan portfolio resulted in an increase in the capital adequacy ratio to 20.9 per cent. as of 31 December 2012 and it was at 21.0 per cent. at 31 December 2013. As at 30 September, capital adequacy ratio increased to 21.3 per cent. The slowdown in the growth of bank assets is largely attributable to the escalation of the global financial crisis and deteriorating market conditions, which stimulated risk averse behaviour by market participants, resulting in a significant decrease in credit growth. In response of this trend the HNB reduced Minimum Required Amount of Foreign Currency Claims 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 and cancelled the compulsory purchase of HNB bills in 2009. Subsequently, total bank assets increased by 2.2 per cent. in 2009. Risk averse behaviour by banks as well as low demand for credit led to flat asset growth in 2010 (0.6 per cent. effectively and 3.4 per cent. nominally). In 2011, banks asset growth increased based on increased funding from foreign owners. However, this growth (4.2 per cent. nominally and 2.6 per cent. effectively) was low compared with pre-crisis period. Total bank assets as at 31 December 2011 amounted to HRK 407.0 billion, an increase of HRK 16.0 billion as compared with the end of 2010. Excluding the transfer of part of a loan portfolio to a related-party SPV, bank assets would have decreased by approximately 0.7 per cent. effectively in 2012 as a result of risk averse behaviour by banks as well as low demand for credit. In 2013 bank assets decreased further and amounted to HRK 397.9 billion, in part as a result of a further partial portfolio transfer to an SPV. During the first nine months of 2014 total banks assets increased by 1.8 per cent. amounting to HRK 399.7 billion.

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 2010 to 2013 and as at 30 September 2014:

	As at 31 December				**As at 30 September**
	2010	**2011**	**2012**	**2013**	**2014**
	(HRK millions)				
Total assets	391,071	406,938	399,916	398,118	399,723
Total placements and contingent liabilities	419,318	437,717	421,966	418,000	418,792

Source: Hrvatska narodna banka

According to audited data, in 2011 commercial banks in Croatia realised HRK 4.7 billion profit before tax, an increase of 7.4 per cent. in comparison with 2010. Eight commercial banks realised losses in 2011 and their assets represented 2.0 per cent. of the total assets of all banks in Croatia. The total loss amounted to HRK 132.8 million, or 0.03 per cent. of all bank assets in Croatia. In 2012, according to audited data banks' pre-tax profits totalled HRK 3.5 billion, representing a decrease of 26.1 per cent. compared with 2011. The decrease in total bank profits in 2012 was due to a decrease in operating profits of 12.0 per cent. and increased loan provisions. Bank profits decreased further in 2013. Compared with 2012, pre-tax profits declined 70.0 per cent. and amounted to HRK 1.0 billion. The decrease in profits was influenced primarily by value adjustment costs following amended loan classification rules that were aimed at increasing non-performing loans coverage and NPL aging process as well as foreign banks preparing for the Asset quality review process (AQR). Therefore, although net operating profit decreased by only 3.2 per cent. in 2013, bank profits decreased noticeably following increased value adjustment costs. In the first nine months of 2014, pre-tax profits decreased 6.4 per cent compared with the first nine months of 2013 and amounted to HRK 2.0 billion.

Loan Exposure[2]

The total (net) loans of Croatian banks as at 30 September 2014 amounted to HRK 252.4 billion, which represents a decrease of 5.1 per cent. as compared to 31 December 2013. Of those loans, 45.2 per cent. were retail loans, while 35.7 per cent. were corporate loans. Compared with 2013, (net) loans to the corporate sector decreased by 5.5 per cent. in the first nine months of 2014 while (net) loans to households decreased by 1.4 per cent. Loans to Government entities were the only loan segment that recorded an increase in 2013 (15.3 per cent. compared to 2012) which increased their share in total loans to 15.2 per cent. in 2013. In the first nine months of 2014, net loans to Government entities decreased by

[2] Break down of loans by institutional sectors is reported under the old ESA95 methodology in this section.

13.5 per. cent, however this was reversed in early October with new Government debentures with banks. Net loans to non-residents increased by 51.4 per cent. in the first nine months of 2014, resulting in an increase of their share of total net loans to 1.5 per cent.

During the first nine months of 2014, the share of non-performing loans continued to increase compared with December 2013 as it rose from 15.7 per cent. to 17.2 per cent.

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

	As at 31 December				As at 30 September
	2010	2011	2012	2013	2014
	(per cent.)				
Non-performing loans	11.2	12.4	13.9	15.7	17.2
Non-performing loans to households	7.8	8.6	9.5	11.1	12.0
Non-performing loans to enterprises	18.1	20.1	25.0	28.3	30.6

Source: Hrvatska narodna banka

Non-performing loans have increased across all sectors after 2010, 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. The quality of loans to the corporate section principally depends on economic activity and the quality of loans to households principally depends on the labour market. As a result NPL growth is expected to continue due to expected low economic activity and unfavourable labour market conditions.

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 generally do not benefit from such security and carry higher risk.

Real estate prices continued to decline through the end of 2013, as a result of low demand following a decline in real household income as well as risk aversion caused by unfavourable trends on labour market. The decline in real estate prices (measured in terms of average market price) was 8.1 per cent. in 2010 compared to 2009 and a further 3.7 per. cent in 2011 followed by increase of 1.0 per. cent in 2012.During 2013 real estate prices decreased by 16.5 per cent which was followed by further 2.8 per. cent decrease in the first nine months of 2014. This overall decline in real estate prices 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 (8.7 per cent. as at 30 September 2014) are currently non-performing. The performance of housing loans, in addition to job losses and unfavourable labour market developments, was adversely affected by the appreciation of the Swiss franc against the kuna (by 17.2 per. cent in 2010, 4.3 per cent. in 2011 and 0.8 per cent. in 2012). As at 30 September 2014: approximately 36.5 per cent. of housing loans, (being an aggregate of HRK 20.5 billion of a total of HRK 56.3 billion of housing loans); and approximately 7.4 per cent. of total gross loans (being an aggregate of HRK 20.5 billion of a total of HRK 275.9 billion of total loans), were housing loans indexed to the Swiss franc. In January 2015, the Swiss National Bank abolished the Swiss franc-euro peg and, as a result, the Swiss franc appreciated significantly against the kuna. To address this, at the end of January 2015, the Croatian parliament determined to fix, for a one year period, the kuna-Swiss franc exchange rate at 6.39 (versus 7.1420 as at 24 February 2015), the rate prevailing prior to the Swiss National Bank's abolition of the Swiss franc-euro peg. A working group comprising representatives from the Ministry of Finance, commercial banks, the consumer union Franak and the HNB has been formed and is currently considering various options for relief for debtors of Swiss franc loans. At the first meeting, the banks offered a model of debt relief and walk away model for debtors with Swiss franc housing loans based on social criteria. However, representatives of the consumer union Franak have demanded a conversion of Swiss franc loans into Kuna loans at the initial CHF interest rates and initial exchange rates. At present, it is not possible to discern the impact of these measures. However, if implemented, these measures are likely to negatively impact the profitability of Croatian banks. See "*Risk factors – The appreciation of the Swiss franc and the measures implemented by the Croatian authorities to deal with this may have a negative impact on the Banking sector*".

Elevated interest rates, which although declining still remain above their pre-crisis level, further undermined the performance of household loans (the average interest rate on the stock of household loans indexed to foreign currency was 7.2 per cent., 7.1 per. cent., 7.0 per cent and 6.4 per cent. at December of 2011, 2012, 2013 and September 2014, respectively.

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

	As at 31 December				As at 30 September
	2010	2011	2012	2013	2014
	(per cent.)				
Currency breakdown of total loans					
Euro	59.6	63.1	62.4	64,2	63.8
CHF	12.9	10.8	9.8	8.8	8.7
Other currencies	1.1	1.2	1.3	0.8	0.8
kuna	26.4	24.9	26.6	26.2	26.7

Source: Hrvatska narodna banka

According to audited data, total loan loss provisions amounted to HRK 3.7 billion at 31 December 2011 (which represented a 0.4 per cent. increase compared with the level at 31 December 2010) and increased further to HRK 3.8 billion at 31 December 2012. In 2013 these expenses increased by 56.9 per cent. and amounted to HRK 5.9 billion. In the first nine months of 2014 loan loss provisions amounted to HRK 3.4 billion.

Loans (net) to households reached HRK 114.2 billion at 30 September 2014, recording a decrease of HRK 1.6 billion (1.4 per cent.) compared to 31 December 2013. The share of housing loans, mortgage loans and vehicle purchase loans decreased in 2014 while the share of, credit card loans, overdrafts and other loans to households was flat whilst the share of general purpose loans increased. The decrease reflected both a loan decrease in absolute terms and increased loan loss provisions (especially for housing loans, mortgage loans and other loans to households).

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 remained unchanged while vehicle purchase loans and credit card loans decreased. In 2012, only general purpose loans to households remained unchanged while all other types of household loans decreased.

After posting annual growth of 4.9 per cent. in 2010 and 4.5 per cent. in 2011, deposits by banks decreased by 2.0 per cent. in 2012, followed by recovery of 2.5 per cent. in 2013. Deposits growth continued during first nine months of 2014 by posting an additional increase of 2.0 per cent. compared to the end of 2013. In 2014, Government deposits increased by 19.4 per cent. while deposits by the corporate sector increased by 8.0 per cent. In addition, funding in the form of deposits from domestic financial institutions increased by 6.6 per cent. after recording a decrease of 6.9 per cent. in 2013. Household deposits remained broadly on the same level as at end of 2013 increasing by 0.5 per cent. which represents slowed pace compared with 2012 and 2013 when household deposits increased by 4.2 and 3.8 per cent. respectively. The share of deposits to total bank liabilities has remained broadly stable since 2009 and increased marginally to 72.2 per cent. as at 30 September 2014.

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

	As at 31 December				As at 30 September	As at 31 December				As at 30 September
	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014
	(HRK millions.)					*(per cent. change over end of previous year)*				
Loans	**262,962**	**276,688**	**267,072**	**266,146**	**252,405**	**5.9**	**5.2**	**-3.5**	**-0.3**	**-5.2**
Households	121,869	121,999	119,508	115,806	114,210	3.2	0.1	-2.0	-3.1	-1.4
Enterprises	105,099	113,029	98,185	95,458	90,170	7.8	7.5	-13.1	-2.8	-5.5
Government	27,113	32,703	37,695	43,451	37,595	9.6	20.6	15.3	15.3	-13.5
Financial institutions	6,386	6,158	9,095	8,912	8,660	5.6	-3.6	47.7	-2.0	-2.8
Non-residents	2,494	2,799	2,590	2,520	2,732	20.9	12.2	-7.5	-2.7	-31.3
Deposits	**269,178**	**281,385**	**275,787**	**282,803**	**288,555**	**4.9**	**4.5**	**-2.0**	**2.5**	**2.0**
Households	155,803	162,910	169,742	176,184	176,985	8.2	4.6	4.2	3.8	0.5
Enterprises	45,798	44,413	41,874	42,954	46,397	1.6	-3.0	-5.7	2.6	8.0
Government	5,212	5,074	5,190	6,309	7,536	23.7	-2.7	2.3	21.6	19.4
Financial institutions	15,000	13,883	18,514	17,232	18,364	-14.1	-7.4	33.4	-6.9	6.6
Non-residents	47,365	55,105	40,466	40,125	35,881	3.2	16.3	-26.6	-0.8	-10.6

Source: Hrvatska narodna banka

As of 30 September 2014, total deposits amounted to HRK 288.555 billion. In the first nine months of 2014, domestic financial institutions, non-residents and Government deposits decreased by HRK 1.9 billion (3.0 per cent.). However, increased deposits from the domestic private sector more than compensated for this decrease as deposits from the corporate sector increased by HRK 3.4 billion (8.0 per cent.). At the same time, deposits from households increased by HRK 0.8 billion (0.5 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 31 December 2010. In 2011, however, the non-kuna component decreased to 67.3 per cent. at 31 December 2011 amid faster kuna deposits growth. In 2012 the currency structure of total deposits did not change materially. In 2013, all domestic sectors increased their kuna deposits faster than the non-kuna deposits and, as a result, the non-kuna component decreased to 66.9 per cent. That trend continued in the 2014 with the non-kuna component decreasing to 66.4 per cent. by the end of September 2014.

As of 30 September 2014, 65.7 per cent. of total deposits were denominated in a foreign currency, 33.0 per cent. in kuna, and only 0.6 per cent. were deposits indexed to a foreign currency. Total deposits consisted of 61.3 per cent. household deposits, 16.1 per cent. corporate deposits, with 12.4 per cent. belonging to non-residents and 9.0 per cent. to Government and financial institutions.

The total amounts lent by banks to the central Government amounted to HRK 65.7 billion at 30 September 2014, which is a decrease of 4.6 per cent. compared to the end of 2013. This amount consists of HRK 37.6 billion in central governmental loans and HRK 28.1 billion in Ministry of Finance treasury bills and Government securities. The deposits of the central Government with commercial banks decreased from HRK 2.11 billion at the end of 2011 to HRK 1.92 billion at the end of 2012, but increased to HRK 3.61 billion at 31 December 2013 and to HRK 4.2 billion at 30 September 2014.

Continuing 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 remained virtually unchanged, 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 loan loss provision, which rose around 220 per cent. in 2009 and increased by a further 5.7 per cent. in 2010 exerting 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.

In 2011, banks increased their operating income by 3.8 per cent. as result of increased net interest income and reduced loan loss provisions. However, eight banks reported negative pre-tax earnings in 2011 which is an increase from five banks at the end of 2010. In 2012, amid high interest costs from foreign financing and somewhat weaker non-interest income, banks' operating income decreased by 12.0 per cent. As loan loss provisions increased by 5.9 per cent., pre-tax profit decreased by 26.1 per cent. In 2013, banks' pre-tax profit decreased by 70.0 per cent. mostly driven by an increase in loan loss provisions of 69.9 per cent. In the first nine months of 2014, bank pre-tax profit decreased by 8.2 per cent. compared to the same period of last year.

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 throughout the crisis. In 2008 loans and deposits from parent banks increased by 30.9 per cent. to HRK 52.0 billion, with an 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, but increased by 16.6 per cent. to HRK 68.7 billion in 2011, which permitted somewhat stronger credit growth. However, an extended period of low credit demand and somewhat elevated interest costs on foreign funding resulted in substantial external deleveraging by banks in 2012, with the loans and deposits from foreign owners decreasing by 23.3 per cent. to HRK 52.7 billion in 2012. This deleveraging process slowed down but continued in 2013 as the loans and deposits from foreign owners decreased to HRK 48.6 billion at 31 December 2013. In the first nine months of 2014 financing from foreign owners was reduced further to HRK 40.6 billion which is a decrease of 16.5 per. cent compared with December 2013.

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. Central bank measures during the global financial and economic crisis were designed to soften the impact on banks' balance sheets and support their credit potential in the form of unlocking the reserves held in the form of foreign assets. Subsequently, after banks started unlocking their foreign liquidity reserve, foreign liquidity indicators started declining. Subsequently, 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), and also due to a rise in liabilities (prior to 2012) primarily directed from parent banks to their Croatian subsidiaries in order to maintain their liquidity (which was under pressure due to deposit withdrawals in early October 2008).

Banking sector liquidity, measured as the ratio of total liquid assets to total assets, was 10.6 per cent. in 2011 and 10.2 per cent. in 2012. In 2013, this ratio increased to 10.5 per cent. Similarly, the ratio of total liquid assets to total short-term liabilities, which was 15.8 per cent. at 31 December 2010, decreased to 14.8 per cent. at 31 December 2011 and to 14.3 per cent. at 31 December 2012. In 2013, this ratio also increased slightly and amounted to 14.5 per cent. at 31 December 2013. With banks unable to channel the inflow of domestic deposits into credit growth, they transferred their funds abroad in the form of liquid assets. Consequently, the ratio of total liquid assets to total assets increased to 19.5 per. cent

With the regulatory changes aimed mostly at easing banks' obligations to hold prescribed levels of foreign liquidity reserves, foreign liquidity indicators witnessed a more visible decreasing trend. The ratio of foreign liquid assets to foreign short-term liabilities which was 49.6 per cent. at 31 December 2010, decreased to 40.6 per cent. at 31 December 2011. This ratio increased to 44.6 per cent. at 31 December 2012 as foreign liabilities decreased faster than the foreign liquid assets. This ratio decreased to 40.3 per cent. at 31 December 2013 due to simultaneously increased short term foreign financing and decreased foreign liquid assets. However, banks investment in foreign liquid assets in mid-2014 sharply increased this ratio to 82.1 per. cent. as at 30 September 2014. The ratio of foreign liquid assets to total foreign assets, which was 62.4 per cent. at the end of 2010, increased to 66.7 per cent. at 31 December 2011 due to increased deposits placed in foreign banks. In 2012, the ratio decreased to 59.5 per cent. at 31 December 2012 with liquid foreign assets decreasing faster than total foreign assets. In 2013 this ratio increased marginally to 59.6 per cent. at 31 December 2013 amid the gradual decrease of foreign liquid assets compared with total foreign assets. By September 2014, this ratio increased to 67.6 per. cent influenced mostly by foreign component of liquid assets.

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 the 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 EUR 100,000. Prior to obtaining authorisation 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.

Money Market

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 2011. Therefore banks' needs for money market financing remained low during this period. The weighted average interest rate on overnight loans in direct interbank trading continued to remain below the 1.0 per cent. level except for a short period at the beginning of the fourth quarter of 2011 when interest rates slightly increased due to decreased liquidity caused by the rise of Government deposits at the HNB after new bond issue on the domestic market and an increase in the reserve requirement rate.

Good financial system liquidity continued in the throughout 2012, with overnight money market interest rates remaining at a relatively low level, despite four foreign exchange market interventions and an increase in the reserve requirement rate (withdrawing a total of HRK 8.6 billion). However, the weighted interest rates on overnight loans in direct interbank trading went up from 0.61 per cent. in December 2011 to 2.94 per cent. in February 2012, only to decline again to 0.47 per cent. in June 2012. Strong liquidity levels maintained in the domestic financial system in the first half of 2012 were reduced slightly in the third quarter due to the seasonally stronger demand for currency over the summer months and the rise in the average balance of central Government deposits with the HNB and the issuance of new tranches of two Government bonds in the domestic market. This resulted in the slight rise of money market interest rates to levels from earlier in the year. However, in the fourth quarter of 2012, liquidity in the financial system returned to a favourable level, as it was boosted by the HNB's intervention in the foreign exchange market at mid-September, which injected HRK 430.3 million into the system. As a result, the overnight interest rate in the interbank market decreased to below one per cent. by year end.

Good liquidity in the domestic financial system continued during 2013 so the total turnover in the money market was at low levels. This period was also marked by low volatility in overnight market interest rates. The weighted interest rates on overnight loans in direct interbank trading decreased from 0.46 per cent. in December 2012 to a record low of 0.30 per cent. in December 2013. Also, continuing downward pressures on the kuna in mid-April prompted the HNB to undertake a foreign exchange intervention in which HRK 1.6 billion was purchased from the banks. This had no effect on overnight interest rates levels.

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 2011 (standing at 0.61 per cent. in December 2011). Interest rates on overnight loans in direct interbank trading slightly increased at the beginning of 2012 but remained below one per cent. throughout most of 2012 (standing at 0.46 per cent. in December 2012). Good liquidity in the domestic financial system continued during 2013, so interest rates on overnight loans in direct interbank trading reached their lowest level, averaging below 0.5 per cent. This trend continued during the 2014, with weighted interest rates remaining at a low level (0.28 per cent. at the end of December 2014).

In 2010, the average daily money market turnover was 1.3 billion and total turnover amounted to HRK 321.8 billion. Average daily turnover slightly increased during 2011 to HRK 1.4 billion with total turnover amounting to HRK 352.9 billion. In 2012, the average daily turnover was HRK 1.3 billion and total turnover amounted to HRK 313.7 billion. In 2013, money market turnover continued to decrease as the average daily turnover was HRK 0.63 billion with total annual turnover amounting to HRK 158.3 billion. During 2014, average daily turnover slightly increased to HRK 0.9 billion and total turnover amounted to HRK 217.6 billion.

In 2009, the largest share of total loans placed on the money market was 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, which was 32.2 per cent. in 2010 fell to 24.4 per cent. in 2011. However, during the second half of 2012 the share of interbank trading increased to 32.0 per cent., but subsequently decreased again to 25.2 per cent. in 2013 and 21.5 per cent. in 2014.. During 2010, the share of demand deposit trading with non-banking financial institutions increased to 41.0 per cent., decreased to 30.5 per cent. in 2011 and decreased further to 24.1 per cent. in 2012. During 2013, the downward trend was reversed and this share accounted for 27.3 per cent. of demand deposit trading. During 2014, the share of demand deposit trading with non-banking financial institutions increased 40.7 per cent. by the end of December 2014. Conversely, the share of demand deposit trading with other legal persons was 26.8 per cent. in 2010 and 45.0 per cent. in 2011 only to decrease slightly to 43.8 per cent. in 2012. However, during 2013, the share of demand deposit trading with other legal persons increased again, to 47.5 per cent, but in 2014 fell again to 37.8 per cent..

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 and continued to increase during 2012 (to nearly 95 per cent.). Overnight loans continued to be the most liquid instrument in direct interbank trading in reserve money, accounting for HRK 53.3 billion in 2010, HRK 49.1 billion in 2011 and HRK 52.0 billion in 2012. The average daily turnover in overnight loans was HRK 0.2 billion in 2010 and it remained at that level in 2011 and 2012, while the average daily turnover in loans intermediated by the ZMM was only HRK 18 million in 2012. In 2013, direct interbank trading amounted to HRK 26.9 billion (87 per cent. of total interbank trading), while bank trading with ZMM intermediation was HRK 4.0 billion (13 per cent. of total interbank trading). Overnight loans remained the dominant form of direct and intermediated interbank trading accounting for HRK 18.8 billion. In this context, the average daily turnover in overnight loans was HRK 75.4 million, while the average daily turnover in loans intermediated by the ZMM was HRK 10.2 million. During 2014, direct interbank trading and bank trading with ZMM intermediation slightly increased to HRK 31.2 billion (82 per cent. of total interbank trading and HRK 6.8 billion (18 per cent. of total interbank trading), respectively. Overnight loans continued to be the most liquid instrument in direct interbank trading, accounting for HRK 25.1 billion in 2014. In the same period the average daily turnover in overnight loans was HRK 99.5 million, while the average daily turnover in loans intermediated by ZMM was HRK 21.1 million.

The Government issues both kuna denominated T-bills and EUR-linked T-bills at T-bill auctions. EUR-linked T-bills are denominated in EUR but settled in kuna at the official HNB rate. In February 2012, EUR denominated T-bills with one- and two-year maturity were issued for the first time.

The total stock of subscribed kuna denominated T-bills was HRK 11.5 billion at the end of 2010. By the end of December 2011, the total stock of subscribed T-bills had risen to HRK 15.4 billion, and was HRK 15.6 billion at the end of December 2012. During 2013 and 2014, the stock of subscribed kuna denominated T-bills continued to rise and was HRK 20.8 billion at the end of 2013 and HRK 24.0 billion at the end of 2014. The stock of euro denominated T-bills was EUR 1.24 billion at the end of 2010 and EUR 0.71 billion at the end of December 2011. However, by the end of December 2012 the stock of euro denominated T-bills increased to EUR 1.4 billion, but subsequently decreased again to EUR 1.1 billion at the end of 2013 and to EUR 0.8 billion at the end of 2014. Consequently, the total stock of T-bills increased from HRK 20.7 billion at the end of 2011 to HRK 25.9 billion at the end of 2012 and HRK 28.9

billion at the end of 2013. The total stock of T-bills continued to rise during 2014 and was HRK 30.2 billion at the end of December 2014.

The weighted interest rate on one-year kuna T-bills was 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, a strong rise of the global risk premium due to the debt crisis in the peripheral countries of the euro zone, deterioration of global financing conditions, issuance of two domestic Government bonds and exchange rate interventions in the second half of 2011 resulted in an increase of the weighted interest rates on kuna T-bills regardless of their maturity. However, during 2012 weighted interest rates on kuna denominated T-bills decreased. This downward trend continued in 2013 and in the first quarter of 2014, with weighted interest rates on kuna T-bills reaching their record low in December 2014 (between 0.3 per cent. and 1.5 per cent. depending on the maturity).

Weighted interest rates on one-year EUR-linked T-bills was 2.88 per cent. in December 2010. However, by the end of 2011 it had risen to 4.98 per cent. The weighted interest rate on the 91-day EUR-linked T-bills was only slightly lower in December 2011 (4.50 per cent.). Weighted interest rates on EUR-linked T-bills also decreased during 2012, reaching 1.10 per cent. for 91-day T-bills and 2.15 per cent. for 365-day T-bills in December 2012. This trend continued in 2013 as weighted interest rates reached 0.45 per cent. and 0.70 per cent. on 91-day and one-year T-bills, respectively, in December 2013. During 2014 weighted interest rates on these T-bills continued to fall and were 30 per cent, for 91 day T-bill and 0.48 per cent for 365-day T-bills in December 2014.

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, and was HRK 15.6 billion at the end of December 2012. During 2013 and the first three months of 2014, the stock of subscribed kuna denominated T-bills continued to rise and was HRK 20.8 billion at the end of 2013 and HRK 23.3 billion at the end of March 2014. 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. However, by the end of December 2012 the stock of euro denominated T-bills increased to EUR 1.4 billion, but subsequently decreased again to EUR 1.1 billion at the end of 2013 and to EUR 0.8 billion at the end of March 2014. Consequently, the total stock of T-bills increased from HRK 20.7 billion at the end of 2011 to HRK 25.9 billion at the end of 2012 and HRK 28.9 billion at the end of 2013. The total stock of T-bills continued to rise during the first three months of 2014 and was HRK 29.7 billion at the end of March 2014.

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 HNB 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, decreased in 2010. Such developments in interest rates were an indication of improved banking system liquidity. This trend continued in 2011 due to good domestic financial sector liquidity in a stable monetary environment and relatively low money market interest rates. However, the pace of interest rate declines was somewhat slower and uneven compared to the previous year. Against the background of strong financial system liquidity and a stable monetary environment in 2012 and 2013, bank lending interest rates generally were stable or continued a slow downturn trend. Interest rates on both short-term kuna-denominated loans and long-term loans with a currency clause generally decreased and this trend continued in 2014. 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. While growth continued during the first three months of 2012, the interest rate decreased to 7.15 per cent. by the end of 2012 and declined further to 6.12 per cent. by the end of 2013. During the first three months of 2014 the interest rate increased only slightly to 6.19 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 and 5.76 per cent. by the end of December 2012. However, in the first four months of 2013 this trend was reversed. Interest rates reached 6.23 per cent. in April 2013, but subsequently decreased again to 6.01 per cent. by the end of December 2013 and declined further to 5.50 per cent. by the end of March 2014. 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. By the end of December 2012, this interest rate increased only slightly to 11.20 per cent. and fell again slightly to 11.01 per cent. in December 2013. This downturn trend continued during the first quarter of 2014, resulting in weighted interest rates reaching 10.15 per cent. by the end of March 2014. 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. At the end of December 2012 this interest rate stood at 7.61 per cent., as slight growth was recorded during 2012. During 2013, this interest rate generally was stable and stood at 7.59 per cent. in December 2013. However, in the first three months of 2014 this interest rate subsequently decreased and reached 7.35 per cent. in March 2014.

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 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 were 1.94 per cent. in December 2010 and rose again slightly in 2011, standing at 3.24 per cent. as of December 2011. During 2012, the weighted interest rate on time deposits fell to 3.04 per cent. by the end of December. During the next two years, the downward trend continued and those interest rates were 2.42 per cent. in December 2013 and 2.17 at the end of 2014. Weighted interest rates on foreign currency time deposits were 3.58 per cent. t 31 December 2009 and fell to 2.69 per cent. at 31 December 2010 and 2.92 per cent. at 31 December 2011. Although the upward trend continued throughout most of 2012, this interest rate fell to 2.67 per cent. by the end of December 2012. By the end of 2013 this interest rate fell to 2.20 per cent. and declined further to 1.93 per cent by the end of 2014. Interest rates on corporate giro-accounts denominated in kuna were relatively stable, being 0.51 per cent. at 31 December 2010, 0.59 at 31 December 2011 and 0.56 at the end of 2012. During 2013 this interest rate decreased and reached 0.39 per cent. by the end of December 2013. At the end of 2014. This interest rate were 0.31.

The spread between the weighted interest rate on total loans and the weighted interest rate on total deposits was 6.64 per cent. at 31 December 2010, 6.54 per cent. at the end of December 2011 and 6.55 per cent. at the end of December 2012. At the end of 2013, the spread was 6.41 per cent. During 2014, this spread decreased only slightly to 6.11 per cent. The spread between the weighted interest rate on kuna loans without a currency clause and the weighted interest rate on kuna deposits without a currency clause was 8.29 per cent. at 31 December 2010 and 8.02 per cent. at 31 December 2011. During 2012, this interest rate spread decreased only marginally to 7.99 per cent. as at 31 December 2012By the end of 2013, this interest rate spread fell to 7.65 per cent. and declined further to 7.39 per cent. by the end of2014. The spread between the weighted interest rate on kuna loans with a currency clause and the weighted interest rate on foreign currency deposits was 4.69 per cent. at 31 December 2010. During 2011, this interest rate spread slightly increased to 4.78 per cent. at 31 December 2011. However, it fell to 4.52 per cent at the end of 2012. The decline accelerated during 2013 and the interest rate spread stood at 4.05 per cent. as at 31 December 2013. From the end of 2013, this interest rate spread increased to 4.56 per cent. at the end of December 2014.

Capital Markets

The Zagreb Stock Exchange ("**ZSE**") is the only stock exchange in Croatia. There are two types of participants 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 four market specialists and 19 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:

	2010	2011	2012
Regular volume	140,217,544	99,881,551	199,843,140
of which Stocks	24,136,163	41,984,257	43,212,507
of which Bonds	116,081,381	54,997,292	155,786,656
of which Rights	0	2	160
of which Commercial Paper	0	2,900,000	60,000
of which Structured Products(1)	0	0	783,817
Block volume(2)	0	519,454	5,382,102
Reported volume(3)	690,820,639	167,764,500	236,604,700
Institutional volume(4)	3,176,929,943	9,449,428,250	8,696,728,039
Total number of trades	285,951	351,498	280,990
Number of securities traded	253	344	367
Number of trading days	250	252	250
Daily average volume	3,324,153	1,064,149	1,767,320

Source: Zagreb Stock Exchange

(1) Since the trading of structured products began at the end of September 2012, annual change could not be presented.

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

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

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

There was only one stock issue in 2009, which was a recapitalisation of an already listed company and there were no new corpora of 2010, there were 24 commercial paper issues listed at the ZSE by 13 issuers. The number of commercial paper issues listed at 2011 and they were issued by nine issuers. At the end of 2012, there were eight commercial paper issues listed on the ZSE, and th of 2013, there were six commercial paper issues listed on the ZSE issued by three issuers and that number fell further at the end o paper issues listed on domestic capital market issued by two issuers.

Developments on the domestic capital market in 2010 broadly followed European markets, 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 a 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 the 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 until 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 minority 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 a surge in prices of the shares of Croatian entities that continued into early 2011. However, uncertainty about the global recovery had erased all gains by the end of 2011. The launch of structured products on the ZSE in 2012 represented an important step in the further development of the Croatian capital markets. As one of the steps towards providing more detailed information for investors, from February 2013, six new indices were introduced on the ZSE – CROBEXplus© and indices for five sectors – CROBEXnutris© (food production), CROBEXindustrija© (industrial production), CROBEXkonstrukt© (construction), CROBEXtransport© (transport) i CROBEXturist© (tourism). Equally, from February 2014, ZSE launched new equity index CROBEXtr© which is a market capitalization weighted total return index. The new index maintains the composition of the existing price index CROBEX® but it will include dividends. From July 2014 started the SEE Link, a platform aimed at increasing liquidity in Southern and Eastern Europe and set up for trading securities listed on the Bulgaria, Macedonia and Zagreb stock exchanges. In comparison with the stock indices from the region, CROBEX outperformed the Hungarian, Czech and Slovakian stock indices, while the Romanian, Polish, Slovenian and Bulgarian stock indices performed more strongly than CROBEX during that period. (

At 31 December 2010, the CROBEX was 5.3 per cent. higher than at the start of the year. The CROBEX increased over the first six months of 2011 by 5.7 per cent. as it reached 2,231 at the end of June 2011. However, in the second half of 2011 it decreased, finishing the year 17.6 per cent. lower compared to 2010. At the end of 2012, while the CROBEX remained at the same level as at the end of 2011, turnover was 44.3 per cent. lower compared to the previous year (HRK 2.9 billion). By the end of 2013, the CROBEX reached 1,794 and was 3.1 per cent. higher compared to the end of 2012, but the stock turnover was 6.8 per cent. lower compared to 2012 (HRK 2.7 billion). At the end of 2014, the stock market turnover was in line with the previous year, the CROBEX had decreased by 2.7 per cent. and reached 1,745.4. However, during the year the CROBEX was higher and by the end of September 2014 remained more than 1,900.0. The total market capitalisation of shares listed on the ZSE was HRK 140.9 billion at the end of December 2010. At the end of December 2011, the total market capitalisation of shares listed on the ZSE was HRK 130.6 billion, and this decreased to HRK 127.8 billion by the end of 2012. By the end of 2013 it had decreased to HRK 119.0 billion, but it increased to HRK 126.2 billion by the end of 2014. In the first five months of 2010, the ZSE bond index, CROBIS increased 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. By the end of 2012, CROBIS reached 103.8 and was 13.7 per cent. higher compared to the end of 2011. By the end of 2013, CROBIS reached 99.2 and was 4.4 per cent. lower compared to the end of 2012. By the end of 2014 it increased by 5.8 per cent. compared to the level at the end of 2013 and reached 105.0. Total bond turnover on the ZSE in 2010 was HRK 7.1 billion, 112.4 per cent. higher compared to 2009. However, in 2011 total bond turnover fell by 92.2 per cent. to HRK 553.1 million. In 2012, total bond turnover increased by 25.6 per cent. compared to 2011 and reached HRK 694.8 million. Total bond turnover in 2013 was 17.4 per cent. lower compared to the previous year and amounted to HRK 574.0 million. In 2014, total bond turnover amounted to HRK 715.8 million and it was 24.7 per cent. higher compared to 2013. The total market capitalisation of bonds listed on the ZSE was HRK 52.7 billion at the end of 2010 and represented 15.8 per cent. of GDP. 36 bonds were listed on the domestic capital market at the end of 2010 and 34 were listed at the end of December 2011. In July 2012, Croatia issued two new tranches of existing bonds, jointly worth approximately HRK 5.0 billion. At the end of 2012, there were 32 bonds listed on ZSE and the total market capitalisation of bonds amounted to HRK 62.0 billion. 33 bonds (12 Government, 5 municipal and 16 corporate bonds) were listed on the ZSE at the end of 2013 and the total market capitalisation of these bonds was HRK 64.3 billion. At the end of 2014, there were 29 bonds listed on the domestic capital market (with the total market capitalisation of HRK 75.3 billion), one Government and three corporate bonds fewer compared to the end of 2013. In 2014, the Republic of Croatia issued new tranches of three existing bonds. An additional tranche of EUR 650 million of the bond maturing in July 2024, a tranche of EUR 500 million tranche of bond maturing in November 2019 and finally, a HRK 3.25 billion tranche bond maturing in July 2018. Additionally, during the 2014, the Republic of Croatia issued one Eurobond in the amount of EUR 1.25 billion. At the end of year there were 9 bonds listed on the international capital markets (3 bonds denominated in EUR and 6 bonds denominated in USD).

The average monthly yield spread between Croatian Eurobonds and benchmark bonds as measured by the JPMorgan EMBI Index was 298 basis points at the end of 2010, reflecting unstable conditions in the global bond markets. Over the first five months of 2011 the spread 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 and, by the end of 2011, it had increased to 610 basis points. Following positive developments in global risk aversion, the EMBI spread for Croatia fell to 330 basis points by the end of December 2012. By the end of 2013, the Croatian EMBI spread decreased further to 315 basis points, while at 31 December 2014 it reached 310 basis points.

Regulation of the Non-Banking Sector

The Croatian Financial Services Supervisory Agency ("**CFESA**") is the body responsible for the supervision of the non-banking financial sector in Croatia. 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.

An Investor Protection Fund is 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 authorisation under the Credit Institutions Act, when providing investment services and certain ancillary services under the Capital Market Act.

PUBLIC FINANCE

Fiscal developments in 2014

In line with the EU Council recommendations that Croatia resolve its excessive budgetary deficit, amendments to the budget and financial plans of extrabudgetary users for 2014 were adopted in March 2014. The amendments propose a series of measures on both the revenue and expenditure sides of the budget, and their structural effect is assessed at the level of 1.9 per cent. of GDP. However, in order to achieve the level of necessary consolidation measures of 2.3 per cent. of GDP in line with the EU Council recommendations, the Government of Croatia prepared additional measures of 0.4 per cent. of GDP in 2014, which were contained in the Conclusion of the Government of Croatia, Decision on measures to temporarily cease the execution of the Croatian State Budget for 2014, and other relevant subordinate legislation. Additional structural measures were also adopted in the amount of 1 per cent. of GDP in 2015 and 2016.

In line with the above, Croatia needs to achieve the target nominal general Government budget deficit at the level of 4.6 per cent. of GDP in 2014, 3.5 per cent. of GDP in 2015 and 2.7 per cent. of GDP in 2016 according to the ESA 2010 methodology.

In November 2014 the Government of Croatia adopted Amendments to the State Budget and Financial Plans of extrabudgetary users for the second time. Following the intensification of negative macroeconomic trends in relation to those previously expected, it was estimated that gross domestic product in 2014 would decrease by 0.7 per cent. along with a change in nominal GDP of 1.6 percentage points in relation to the previously expected projection. In such conditions, the realisation of budget revenues was also significantly weaker than expected. The most significant reductions were registered in the revenues from value added taxes by 0.4 per cent. of GDP, corporate income tax by 0.08 per cent. of GDP and contributions by 0.07 per cent. of GDP. In addition, the significant reduction in the revenues from state aid was also expected by 0.4 per cent. of GDP, due to weaker withdrawal of EU funds than expected. On the other hand, special taxes and excise duties were expected to achieve better results than planned, by 0.23 per cent. of GDP.

Regarding the expenditures, the reductions were planned in the majority of budget categories, at the level of 0.5 per cent. of GDP in relation to the plan from March 2014. These amendments include the subsidies reducing measures in the expenditure, based on a Government Decision regarding the measures for temporary suspension of the state budget execution, from April 2014. Other savings refer to the interest saved due to more favourable borrowing in foreign and domestic markets, and to capital expenditures following the slow down in the dynamics of the capital projects realisation. On the other hand, it was necessary to provide additional funds for expenditure on employment (0.1 per cent. of GDP), pensions (0.1 per cent. of GDP), and the alleviation of damages caused by floods (0.09 per cent. of GDP).

In April 2014, the Government adopted a Convergence Programme of Croatia for 2014-2017, which included a series of structural measures on both the revenue and the expenditure side of the budget with the aim of implementing fiscal consolidation, in line with the EU Council Recommendations. In this regard, structural measures of 2.3 per cent. of GDP were foreseen in 2014, of 1 per cent. of GDP in 2015, and of 1 per cent. of GDP in 2016. The Convergence Programme also defines one-off measures for the reduction of the general government deficit by 0.8 per cent. in 2014 and 0.6 per cent. of GDP in 2015.

On June 2, 2014, after assessing the Convergence Programme, the European Commission concluded that Croatia had undertaken appropriate measures and, consequently, the excessive deficit procedure was held in abeyance. Due to the existence of negative risks, Croatia is obliged to ensure the implementation of appropriate measures, defined in the EU Council Recommendations. Consequently, Croatia will be reporting on the implementation of the appropriate fiscal consolidation measures every 6 months.

On October 31 2014, Croatia submitted to the European Commission the second progress report on the implementation of fiscal consolidation measures. At the end of November 2014, the Commission concluded that Croatia slightly exceeded the required fiscal effort of 2.3 per cent. of GDP in 2014. Moreover, according to the preliminary data on the 2014 budget execution, the foreseen savings exceeded the planned ones, resulting in the estimated fiscal effort of 2.6 per cent. of GDP.

The following paragraphs give an overview of structural measures on both the revenue and the expenditure side of the budget implemented in 2014 according to ESA 95 methodology.

Structural measures on the revenue side of the budget

Tax on gains from games of chance

The Government defined new tax brackets by prescribing higher tax rates for larger gains. Therefore, the following tax rates were established: 1) tax rate of 10 per cent. on gains ranging from HRK 750 to HRK 10,000, 2) tax rate of 15 per cent. on gains ranging from HRK 10,000 to 30,000, 3) tax rate of 20 per cent. on gains ranging from HRK 30,000 to 500,000, and 4) tax rate of 30 per cent. on gains above half a million kuna. The fiscal impact of these modifications in 2014 was planned to be in the amount of 0.09 per cent. of GDP. However, the analysis showed that revenues would not materialise according to the plan. Consequently the Government planned additional modifications in this respect for 2015. According to the preliminary data on budget execution for 2014, fiscal impact of this measure amounts to 0.03 per cent. of GDP.

Amendments to the system of contributions for pension insurance based on an accelerated retirement scheme

As of 1 April 2014, insurees whose rights are regulated by special regulations are enabled, if they desire, to transfer funds from their personal account from the second into the first pension pillar, considering that the pensions for the said categories of insurees are calculated and paid out as though they are not included in the second pension pillar. According to the preliminary data on budget execution for 2014, the fiscal impact of these measures is budgeted at 0.12 per cent. of GDP. One-time measures of transferring funds from the second to the first pillar should also be taken into consideration, with the fiscal impact of 0.9 per cent. of GDP.

Concession fees

The planned increase in concession coefficients was not possible to carry out, because it would lead to negative effects on business operations performed by concessionaires. The outcome of the collection of due debts varies on a case by case basis as certain concessionaires are undergoing a pre-bankruptcy settlement procedure. Overall, planned revenues in this respect were not realized in 2014.

Withdrawal of revenues from profits of companies in state ownership and agencies, institutes and other legal persons with public authority

The State Budget Execution Act for 2014 has introduced the obligation of paying a portion of the profits of companies of strategic and special interest for Croatia under majority or minority ownership of the state and the excess of the revenues over the expenditures of agencies, institutes and other legal persons with public authorities and founded by the state, which do not have the status of budgetary users. The decision on payment of funds is made by the Government as a measure to reduce the excessive deficit. The fiscal effect of these measures is budgeted at 0.15 per cent. of GDP in 2014. The payment of profits pertains exclusively to profits achieved in the previous calendar year, and is not subject to the statistical treatment of superdividend.

Contributions for health insurance

As of 1 April 2014, the contributions for health insurance are increased from 13 per cent. to 15 per cent. The fiscal effect of the changed rate in 2014 is budgeted at 0.49 per cent. of GDP.

Excise on fuel and electricity

With the proposed Regulation on amendments to the Regulation on the excise rates on motor petrol, gas oil and kerosene used as a propellant, the excise rates were increased by 20 lipa/litre for leaded gasoline, unleaded gasoline and gas oil used as a propellant. The fiscal effect of the increase in these excise duties is budgeted at 0.1 per cent. of GDP in 2014.

Fees for telecommunication services

An increase in the fees for the right to economic use of spectrum for public mobile networks has been announced. Following assessments based on available data, it is budgeted that this will account for an increase in revenues of approximately 0.5 per cent. of GDP by the end of the year.

Expenditure structural measures

Expenditure structural measures include: compensation of employees, use of goods and services, subsidies, social benefits, grants and other expenses and expense for the acquisition of non-financial assets.

Compensation of employees

As of 1 April 2014, the right to increased salaries on the basis of achieved years of service in the amount of 4 per cent., 8 per cent. and 10 per cent. for employees in the civil and public services was revoked. Also, salaries were decreased by 6 per cent., additions to salaries for military persons in the defence sector were decreased, as were additions for passive on-call duty in the justice system. The method of salary calculation was changed in the science sector. These measures are budgeted to have a structural fiscal impact in 2014 of 0.11 per cent. of GDP. However, the increased rate of contributions for health insurance from 13 to 15 per cent., with an effect of 0.08 per cent. of GDP, results in a net budgeted structural fiscal savings in compensation of employees of 0.03 per cent. of GDP.

Use of goods and services

The structural reduction of use of goods and services is budgeted at 0.2 per cent. of GDP, and pertains to savings that budgetary users will achieve in employee travel benefits (standardisation of rights for employee travel benefits in civil and public services, ensuing from the new Fundamental Collective Agreement), maintenance costs, intellectual and personal services (control of freelance contracts and the work of committees), overhead costs, information services and expenditures for materials, raw materials and services. During the year, procedures are expected to be implemented to unite the public procurement of all budgetary users in individual procurement categories, as defined by the Decision of the Government of the Republic of Croatia on procurement categories. The information system of the State Treasury will follow the dynamics of execution of these expenditures, which allows for commitment control in this cost category.

Subsidies

The structural savings on subsidies in 2014 totalled 0.37 per cent. of GDP. The greatest reduction pertains to the subsidies given to the Croatian Bank for Reconstruction and Development (HBOR) and for shipbuilding. The cost of subsidising interest rates by HBOR, as the difference between the interest rates approved by the commercial banks and the referential interest rate guaranteed by HBOR for exporters, was reduced, thus achieving savings of 0.09 per cent. of GDP. Thus, the scope of subsidised loans will be significantly reduced in the forthcoming period, while for early approved loans, which are still in the payment stage, the total amount of necessary subsidies was reserved in the previous period. Subsidies to shipbuilding were reduced by 0.09 per cent. of GDP, as shipyard owners were not able to fulfil their own contributions in the restructuring costs as defined by the restructuring plans, and therefore the amount of state contributions is smaller. At the end of the restructuring period, the ratio 60/40 must be retained in the total restructuring costs. The altered dynamics and amounts of state subsidies in restructuring will be the subject of additional contracts, in the form in which the contract was concluded. Furthermore, subsidies to farmers were reduced by 0.04 per cent. of GDP due to the smaller amount in subsidy applications in 2013, pursuant to which farmer subsidies are granted in 2014. As a result of the envisaged restructuring dynamics, subsidies to Croatian Railways were reduced in the amount of 0.04 per cent. of GDP. The reduction of subsidies to entrepreneurship recorded an effect of 0.03 per cent. of GDP as a consequence of the inability of many entrepreneurs to fulfil the prescribed legal obligation regarding the realisation of investment levels, i.e. the opening of a minimal number of jobs associated with investments. Other subsidies, which primarily pertain to stimulating production of biofuels, active labour market policy measures, manufacturing industry and reducing subsidies in science and education system, culture and tourism, were reduced by 0.04 per cent. of GDP.

Social benefits and social transfers

The Government's efforts in relation to social benefits and social transfers are mostly focused on the healthcare system and to a lesser extent on the active employment policy. Continuous activities are carried out in the healthcare system in order to achieve reduction in costs for the procurement of prescription medications, better control of sick leave and greater rationalisation of business operations carried out by hospitals.

Regarding the costs of the procurement for prescription medications, a public tender was carried out in order to determine new reference prices of medicines, which resulted in a new list of medications, effective from the beginning of February 2014. Changes in relation to the administration of the price of medication were also carried out on the basis of external referencing. Furthermore, a continuous reduction in the price of medication has been achieved by putting generic drugs with more favourable prices on the list. All of the above has resulted in a reduction in the total expenses for all medication financed by the Croatian Health Insurance Institute, even though the total consumption of medication has not decreased.

Greater usage of regular controls in relation to sick leave resulted in a decrease in the sick leave rate from 2.90 per cent. in the first nine months of 2013 to 2.69 per cent. in the same period of 2014. In addition, the number of employees on sick leave also decreased from 42,376 in the first nine months of 2013 to 38,964 in the same period of 2014 based on the daily average. This trend has also resulted in the reduction of the compensation for sick leave from HRK 1.1 billion during 2013 to HRK 943.5 million during 2014.

The rationalisation of business operations undertaken by hospital and healthcare institutions has been carried out through the financial rehabilitation programme, greater availability of information in relation to the healthcare system and a new model of primary healthcare contracting. The implementation of the financial rehabilitation programme includes modifications in the organisational structure of hospitals, a reduction in the number of duties, rationalisation of diagnostic procedures, an increase in the activities of daily hospitals, control of employment, rationalisation of specialisations and the development of new services based on the market principles. Such efforts have resulted in the rationalisation of the expenditure of healthcare institutions, especially institutions undergoing rehabilitation. However, due to the decrease in the budget of the Croatian Health Insurance Institute, the revenues of hospital institutions have been significantly reduced and therefore, rationalisation has not covered the losses completely but has resulted in their gradual decrease.

All the aforementioned measures in this category have resulted in structural savings of 0.3 per cent. of GDP in 2014.

Other current and capital transfers

Measures undertaken in current and capital transfers have resulted in total structural savings of 0.18 per cent. of GDP. These mostly include support in the food-processing industry, development of competitiveness of the wood sector, an active employment policy and integral development of local communities. The funds for financing the renovation and maintenance of the water drainage and irrigation system have been sourced from Croatian Waters instead of the state budget based on the Water Management Plan from February 2014. Help provided to local units in relation to regional planning and construction (as defined in the new Regional Planning Act) has been permanently reduced due to the termination of the obligation to co-finance the salaries of the employees taken over by county and city administrations. These activities, previously under the remit of the state, have been assumed by local units, and their total cost reduced due to the simplification of the procedure stipulated by the new Act. Permanent savings have also been achieved in the expenditure of the Guarantee Fund for industry and innovation and in the development of entrepreneurship infrastructure. Furthermore, large savings have also been recorded in the expenditure for the railway infrastructure, due to the revision in the preparation and implementation of EU projects. In the science sector, the participation of students in costs for food has increased, and a significant rationalisation of student food-subsidies had been carried out. In addition, significant savings have been recorded in subsidies for the accommodation of regular students. Other structural measures in relation to the expenditure for tourism promotion, housing care and assistance and projects in entrepreneurship have also undergone major cost-cutting measures.

Expenditure for gross investments in the capital

Structural savings in gross investments in the capital amounted to 0.2 per cent. of GDP in 2014. Expenses in relation to the construction of border crossings and projects in the healthcare, science and judiciary sectors, recorded larger savings than originally projected. The reduction in expenditure for projects in the healthcare sector was carried out through consolidated public procurement for more healthcare institutions and through the reduction in the costs of replacing old equipment. In addition, savings have also been made in the judiciary sector through reduced informatisation, an upgrade of prison capacities and restructuring of judiciary infrastructure. The same approach regarding the rationalisation of costs is present also in the science sector.

Extrabudgetary users

Structural reductions in the deficit of extrabudgetary users amounted to 0.4 per cent. of GDP instead of the projected 0.2 per cent. of GDP in 2014. These savings primarily stem from the fact that Croatian Roads have significantly decreased their investment activities, while Croatian Waters have slightly increased their deficit as a consequence of their participation in alleviating the damage caused by the floods in Eastern Slavonia.

Overview of the 2015 Budget

At the end of November 2014, the 2015 Draft Budget was adopted. It introduces significant statistical and methodological modifications, influencing the scope of institutions and the scope of funds within the framework of the state budget as well as the application of gross principle on certain revenue categories. These changes support transparency and comprehensiveness of the state budget and producing a more statistical budget statement of revenues and expenses.

The expected revenues were modified on several accounts and budgetary users found there to be an increase in the expected use of EU funds. In addition, revenues also include own and earmarked revenues of budgetary users that have not been previously planned for in the budget. From this year, the treatment of income tax returns for taxpayers with headquarters in areas of special state concern, have also been modified. As opposed to the net principle, according to which state budget revenues have been reduced by outturns, from this year the gross principle will be applied. According to this principle, the total amount of collected taxes is to be registered and then, through the transfer to local and regional self-government units, the funds for the return of this tax are to be provided from the state budget.

The expected expenditure is corrected for the described increase in revenues. Thus, expenditure increased on the basis of the planned own resources of budgetary users and of an increased use of EU funds.

The level of state budget revenues and expenditure has been significantly influenced by the Mandatory Health Insurance Act, stipulating the exit of the Croatian Health Insurance Fund (hereinafter referred to as HZZO) from the state treasury system from January 1, 2015. HZZO has become an extrabudgetary user of the state budget and therefore, its financial plan has to be approved by the Croatian Parliament. Revenues from health insurance contributions, revenues from participation in health care costs (co-payment) and from supplemental voluntary health insurance, and other revenues of HZZO by special regulations, are excluded from the state budget revenues. These revenues, as well as the expense settled from them, are an integral part of the financial plan of HZZO. There has been a transfer to HZZO, as indicated in the state budget, for the amount of HRK 2.4 billion in accordance with Article 72 of the Mandatory Health Insurance Act. As a result, state healthcare institutions (i.e. hospitals) have been included in the state budget for the first time.

Taking into consideration all of the abovementioned circumstances, 2015 state budget revenues and expenditures are not directly comparable to previous years.

In relation to planned structural efforts, compared to the 2014 Convergence Programme, there have been some changes in the contents of structural measures. Previously announced structural measures have not been abolished, although the implementation of some measures from the Convergence Programme is proceeding at a slower pace than planned, therefore, alternative measures have been defined in the 2015 budget for the purposes of addressing the excessive budget deficit. Consequently, the following paragraphs give an overview of structural measures on both the revenue and the expenditure side of the budget in 2015 according to ESA 95 methodology.

Structural measures on the revenue side of the budget

Tax on gains from games of chance

On January 1, 2015, the Amendments to the Act on Games of Chance entered into force, whereby all gains are to be taxed irrespectively of their amount. Thus, the tax is to be paid at the rate of 10 per cent. on gains up to HRK 10,000, at the rate of 15 per cent. on gains above HRK 10,000 up to HRK 30,000, at the rate of 20 per cent. on gains above HRK 30,000 up to HRK 500,000, and at the rate of 30 per cent. on gains above HRK 500,000. The expected fiscal impact of this measure is 0.06 per cent. of GDP in 2015.

Tax on savings interests

Since January 1, 2015, the Amendments to the Income Tax Act introduced a tax on interest derived from savings at a rate of 12 per cent.. The expected fiscal impact amounts to 0.09 per cent. of GDP in 2015.

The increase in contributions for health insurance

Since April 1, 2014, contributions for health insurance have been increased from 13 per cent. to 15 per cent. The additional fiscal impact of the increase in this rate amounts to 0.2 per cent. of GDP in 2015.

Excise duties on energy sources and electricity

The additional fiscal impact of 0.04 per cent. of GDP is to be realised in 2015 through the increase in excise duties on energy sources and electricity from 2014.

Structural measures on the expenditure side of the budget

Compensation of employees

Measures that commenced in 2014 shall continue in 2015 as well. The right of the increase in salary on the basis of accrued seniority years of 4 per cent., 8 per cent. and 10 per cent. for employees in civil and public services has been abolished. Furthermore, salaries for state officials have been reduced based on the decision on the basis level for the calculation of state officials' salaries. The benefits in the defence and judiciary systems have also been removed, and the way of calculating bonuses on the base salary in the science sector has been modified. In 2015, state officials' salary basis was further reduced, taking effect from December 2014 and reducing the salary basis by further a 8 per cent. By establishing a central salary management system for all public sector institutions, it enables the execution and supervision over the payments and salary calculation as well as the alignment of coefficients of job complexity. In addition, further savings in the civil and public service wage bill are expected depending on the results of the spending review currently in progress. The increase in the health insurance contribution rate from 13 per cent. to 15 per cent. will also have an impact in the first four months of 2015. One of the key modifications is also the exit of HZZO from the State Treasury, which will result in savings in this budget category. Taking into account all of the aforementioned, the planned net structural fiscal savings in the compensation of employees amount to 0.08 per cent. of GDP.

Intermediate consumption

Planned structural reduction in the intermediate consumption amounts to 0.02 per cent. of GDP, and it is primarily the result of the judiciary system reorganisation. This reduction includes territorial and organisational restructuring of the judiciary system, reorganisation and rationalisation of the judges and state-attorneys network. The aim is to achieve better organisation of court work and faster resolution of cases, shortening the duration of court proceedings and create more even workload levels for judicial bodies and officials. The result of this process will also reduce the number of municipal and misdemeanour courts and municipal state attorney's offices. It is also possible to mention the reduction in the costs for printing services regarding the production of printed-forms, linked with the slower pace of production of citizens' personal documents. The aforementioned slowdown can be explained by the fact that the majority of citizens' personal documents have already been produced in previous years.

Subsidies

Planned structural savings in subsidies in 2015 amount to 0.08 per cent. of GDP. The largest reduction refers to the subsidies provided for the Croatian Bank for Reconstruction and Development (HBOR) and agriculture sector. The cost of subsidising the interest by HBOR has been reduced and refers to the difference between the interest approved by commercial banks and reference interest rate guaranteed by HBOR for exporters. The volume of subsidised credits has been significantly reduced while for all earlier approved credits, still under repayment, the total amount of necessary subsidies was earmarked in the budget for previous period. Subsidies for farmers are characterised a reduction in the national component of direct payments in agriculture and their substitution with EU funds. Active employment policy during the observed period is also characterised by the efforts made in order to increase the absorption of EU funds intended for this purpose. Other subsidies, primarily in the sectors of science and education, culture and tourism, will also record minor savings.

Social benefits and social transfers

Social benefits will record savings linked with child allowance, subsidies and state guarantees for housing credits, one-off financial aids to war veterans' families as well as extra-institutional services for elderly persons. The aforementioned structural savings (not including the health sector) will amount to 0.05 per cent. of GDP, The savings in child allowances are expected to be achieved by linking the payments with the data on the potential user's means test, which should lead to improved targeting. Pursuant to the Act on Subsidizing and State Guarantee for Housing Credits, the National Real Estate Agency subsidizes a part of interests in the first four years of using a housing credit. Subsidies were approved in 2011 and 2012. In 2015, reduced payments of due liabilities will be executed, after which there are no more liabilities for approved subsidies. In addition, reduction in one-off financial aids to the perished war soldiers' families is also expected to be successful, due to amendments to the relevant Regulation and Ordinance from 2014. The amendments will make the conditions necessary to receive one-off financial aid considerably more stringent. The simplified procedure of allocating the funds designated for extra-institutional services for elderly persons has also contributed to the savings in this category of expenditure. The new procedure, as a result of legal changes, enables the allocation of financial means directly from the line ministry to final users.

Other current and capital transfers

This category will record a total structural reduction in the amount of 0.08 per cent. of GDP in 2015. Permanent savings will be realised in the expenditure of the Guarantee Fund for industry and innovations, which was abolished this year. In December 2014, the Act on Housing Savings and State Incentive Payments for Housing Savings was amended. These amendments change the formula for the calculation of state financial incentives for depositors saving for housing, which significantly reduces the annual payment of incentives from the state budget. In addition, savings are planned in the railway sector, linked with a reduction in expenditure for the modernisation of railway vehicles to HŽ Passenger Transport. Furthermore, savings on the costs for housing care and assistance are also foreseen on the basis of a more efficient implementation of the Regional Housing Care Programme. Savings are also expected in the project of entrepreneurship and support for innovations. The reduction in the expenditure is also planned in the tourism sector, in particular in the sector of tourism promotion, regarding revenues of the Croatian National Tourist Board from other designated sources (sojourn tax and membership in tourist boards).

Expenditure for gross investments in capital investments

Planned structural savings in capital investments amount to 0.04 per cent. of GDP. The reduction is underpinned by the reform efforts in the healthcare system through improved procedures of consolidated public procurement for more healthcare institutions, the savings on the renovation of healthcare infrastructure and the strategic redirection to the financing from EU funds. The reduction in expenditures in the science sector primarily stems from the reduction in the national financing of certain projects and redirection to financing from EU funds.

Extrabudgetary users

Structural reduction in the deficit of extrabudgetary users will amount to 0.13 per cent. of GDP in 2015. These savings primarily relate to an increase in the surplus of the State Agency for Deposit Insurance and Bank Rehabilitation and of the Environmental Protection and Energy Efficiency Fund.

Resulting fiscal trends in the consolidated general Government for the nine months ended 30 September 2014

According to the GFS 2001 methodology, the total revenue of the consolidated general Government amounted to HRK 98.7 billion in the nine months ended 30 September 2014. Tax revenues, as the most significant revenue category, amounted to HRK 55.9 billion. Among tax revenues, revenue generated through VAT amounted to HRK 30.6 billion; income tax revenue amounted to HRK 7.8 billion and corporate tax revenue amounted to HRK 4.2 billion. Revenue generated from excise duties was HRK 9.9 billion. Revenue from social contributions, which is the second highest revenue category, amounted to HRK 31.8 billion.

The total expense of the consolidated general Government amounted to HRK 102.7 billion in the nine months ended 30 September 2014. The largest share of the total expense of the consolidated general

Government related to social benefits and amounted to HRK 43.3 billion. Compensation of employees amounted to HRK 25.6 billion, use of goods and services to HRK 10.4 billion, interest to HRK 8.7 billion, subsidies to HRK 5.2 billion, other expenses to HRK 5.6 billion and grants to HRK 3.8 billion.

In the first three quarters of 2014, net acquisition of non-financial assets amounted to HRK 2.9 billion (comprising total acquisitions of HRK 3.5 billion and total disposals of HRK 596.4 million). The level of net lending/borrowing of the consolidated general Government in first nine months of 2014 stood at HRK -6.8 billion or -2.1 per cent of GDP, according to the GFS 2001 methodology.

According to the preliminary data in 2014, total revenues of the budgetary central government amounted to HRK 113.6 billion, which is HRK 341.8 million less than planned. Total expenses amounted to HRK 125.4 billion, which is HRK 2.6 billion less than planned. Savings were made on all expenditure categories, mainly capital expenses, use of goods and services and subsidies. Net acquisition of non-financial assets amounted to HRK -1.1 billion.

The aforementioned preliminary data for 2014 resulted in budgetary central Government net borrowing of HRK 13 billion or 3.9 per cent of GDP. In the same period, extrabudgetary users recorded net borrowing of HRK 254.6 million or 0.1% of GDP and consolidated central government of HRK 13.2 billion or 4% of GDP.

The following table sets out the Consolidated General Government budget from 2011 to 2014:

Consolidated General Government According to Government Level

	Year ended 31 December			Nine months ended 30 September		Plan
	2011	**2012**	**2013**	**I-IX 2013**	**I-IX 2014**	**2014***
			(*HRK million*)			
1. REVENUE (A+B+C)	**123.024,5**	**126.131,6**	**125.878,6**	**92.218,9**	**98.738,0**	**141.863,4**
A) Budgetary central government	107.067,2	109.558,4	108.581,8	79.735,6	85.601,5	116.733,4
B) Extrabudgetary users	3.307,1	3.312,3	3.462,6	2.469,5	2.873,3	4.210,6
1. Croatian Waters	1.584,7	1.574,9	1.714,9	1.212,9	1.406,1	2.010,0
2. Fund for Environmental Protection and Energy Efficiency	1.069,0	1.049,3	1.032,5	731,7	818,8	1.311,4
3. Croatian Roads Ltd.	57,5	55,4	51,5	32,1	40,2	57,5
4. State Agency for Deposit Insurance and Bank Rehabilitation	552,8	576,1	597,2	443,9	555,7	822,8
5. Croatian Privatisation Fund	1,9	-	-	-	-	-
6. Agency for management of the public property	41,1	56,7	49,2	48,8	-	-
7. Restructuring and sale center.			17,2	-	52,5	8,9
C) Local government	12.650,2	13.260,8	13.834,3	10.013,9	10.263,1	20.919,4
2. EXPENSE (A+B+C)	**132.944,6**	**132.413,4**	**138.217,2**	**102.768,5**	**102.672,2**	**148.830,7**
A) Budgetary central government	116.163,3	115.318,0	119.880,8	89.752,6	89.962,9	123.640,6
B) Extrabudgetary users	4.151,5	3.838,1	4.482,5	3.067,0	2.832,7	4.625,0
1. Croatian Waters	1.436,7	1.439,9	1.455,1	1.007,7	977,1	1.586,6
2. Fund for Environmental Protection and Energy Efficiency	884,3	934,0	835,0	571,0	709,8	1.097,6
3. Croatian Roads Ltd.	1.320,9	1.277,0	1.478,1	1.023,3	914,8	1.725,5
4. State Agency for Deposit Insurance and Bank Rehabilitation	408,9	89,5	538,3	327,6	172,6	63,1
5. Croatian Privatisation Fund	16,2	-	-	-	-	-
6. Agency for management of the public property	84,6	97,8	138,9	137,3	-	-
7. Restructuring and sale center			37,2	-	58,4	152,2
C) Local government	12.629,7	13.257,3	13.854,0	9.949,0	9.876,7	20.565,0
NET/GROSS OPERATING BALANCE (1–2)	**-9.920,0**	**-6.281,8**	**-12.338,6**	**-10.549,6**	**-3.934,2**	**-6.967,3**
3. CHANGE IN NET WORTH: TRANSACTIONS (3.1.+3.2.-3.3.)	**-9.920,0**	**-6.281,8**	**-12.338,6**	**-10.549,6**	**-3.934,2**	**-6.967,3**
3.1. CHANGE IN NET ACQUISITION OF NON-FINANCIAL ASSETS	5.043,9	4.573,7	5.264,1	3.520,9	2.903,9	8.159,6
Acquisition	5.876,1	5.175,9	6.040,6	3.999,0	3.500,3	9.233,2
A) Budgetary central government	1.486,0	1.108,0	1.564,0	758,7	996,8	2.565,7
B) Extrabudgetary users	2.265,9	2.334,3	2.377,9	1.820,4	1.269,7	2.895,8

	Year ended 31 December			Nine months ended 30 September		Plan
	2011	2012	2013	I-IX 2013	I-IX 2014	2014*
			(*HRK million*)			
C) Local government	2.124,2	1.733,7	2.098,7	1.419,9	1.233,8	3.771,7
Disposals	832,3	602,2	776,5	478,1	596,4	1.073,6
A) Budgetary central government	347,0	278,4	259,5	191,1	411,1	315,5
B) Extrabudgetary users	32,4	30,8	28,8	26,1	2,6	0,1
C) Local government	452,8	293,1	488,2	261,0	182,6	758,0
NET LENDING/BORROWING (1-2–3.1)	**-14.963,9**	**-10.855,4**	**-17.602,7**	**-14.070,4**	**-6.838,1**	**-15.126,9**
As a percentage of GDP	**-4.5**	**-3.3**	**-5.3**	**-**	**-**	**-4.6**
TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING) (3.3–3.2)	14.963,9	10.855,4	17.602,7	14.070,4	6.838,1	15.126,9
3.2. CHANGE IN NET ACQUISITION OF FINANCIAL ASSETS	87,2	58,5	14.305,7	4.383,3	-5.338,5	-2.691,2
3.2.1. Domestic	81,9	52,0	14.100,4	4.382,0	-5.339,4	-2.902,2
A) Budgetary central government	-817,7	-674,4	13.792,7	4.412,0	-6.897,9	-3.263,3
B) Extrabudgetary users	458,8	479,2	148,2	-213,8	1.057,2	442,1
C) Local government	440,8	247,2	159,5	183,8	501,3	-81,1
3.2.2. Foreign	5,3	6,5	205,2	1,3	0,9	211,0
A) Budgetary central government	5,3	6,5	205,2	1,3	0,9	211,0
B) Extrabudgetary users	-	-	-	-	-	-
C) Local government	-	-	-	-	-	-
3.2.3. Monetary gold and SDRs	-	-	-	-	-	-
3.3. CHANGE IN NET INCURRENCE OF LIABILITIES	15.051,2	10.913,9	31.908,4	18.453,7	1.499,7	12.435,7
3.3.1. Domestic	6.465,8	2.864,0	10.340,9	8.394,3	-3.081,1	6.328,6
A) Budgetary central government	4.793,1	1.414,0	8.904,9	7.979,3	-3.306,8	4.926,6
B) Extrabudgetary users	1.655,3	1.544,3	1.680,8	728,6	591,1	1.383,1
C) Local government	17,4	-94,3	-244,9	-313,6	-365,3	18,9
3.3.2. Foreign	8.585,3	8.049,8	21.567,5	10.059,4	4.580,7	6.107,0
A) Budgetary central government	8.597,2	8.125,2	21.534,8	10.071,4	4.580,3	6.025,1
B) Extrabudgetary users	-5,4	-69,2	38,2	-7,9	3,2	81,9
C) Local government	-6,5	-6,2	-5,5	-4,1	-2,8	-

Note: On a cash basis.

* The budget for 2014 includes budgets of 576 local units and their budgetary and extrabudgetary units, while for the previous years only 53 of the largest local units were included.

Source: Ministry of Finance

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

Budgetary Central Government Revenue

	Year ended 31 December		
	2012	**2013**	**2014 preliminary**
		(HRK thousands)	
REVENUE	**109.558.928**	**108.585.049**	**113.568.151**
Taxes	**64.693.898**	**63.044.946**	**63.349.864**
Taxes of income and profits and capital gains	8.966.867	7.738.141	7.059.707
Payable by individuals	1.269.525	1.372.698	1.401.942
Payable by corporations and other enterprises	7.697.342	6.365.443	5.657.765
Taxes on property	397.736	462.315	385.981
Taxes on goods and services	53.205.019	53.349.544	55.191.815
General taxes on goods and services	40.778.865	40.388.379	41.076.665
Value-added taxes	40.652.023	40.253.061	40.923.499
Sales taxes	126.841	135.319	153.166
Excises	11.206.489	11.682.936	12.846.449
— on cars, other motor vehicles, boats and planes	532.226	550.826	781.614
— on petroleum products	5.678.586	6.496.009	7.122.179
— on alcohol	190.874	172.331	233.094
— on beer	631.038	606.557	597.903
— on nonalcoholic beverages	119.379	114.747	117.635
— on tobacco products	3.915.174	3.616.934	3.875.598
— on coffee	116.045	122.012	118.245
— on luxury goods	23.168	3.520	181
Taxes on international trade and transactions	1.754.364	1.159.371	424.501
Other taxes	369.912	335.576	287.860
Social contributions	**37.845.871**	**37.149.263**	**41.695.456**
Social security contributions	37.845.871	37.149.263	41.695.456
Employee contributions	17.493.535	17.619.709	20.923.443
Employer contributions	19.771.608	18.924.562	20.384.790
Self-employed or unemployed contributions	580.727	604.992	387.223
Unallocable contributions	0	0	0
Grants	**968.378**	**1.737.825**	**2.064.549**
Other revenue	**6.050.782**	**6.653.016**	**6.458.282**
Property income	1.963.801	1.748.331	2.368.549
Interest	59.214	123.816	103.915
Dividends	681.776	577.348	1.107.328
Withdrawals from income of quasi-corporations	0	0	0
Rent	1.222.812	1.047.166	1.157.306
Sales of goods and services	1.662.470	1.786.642	1.577.570
Sales of market establishments	0	0	0
Administrative fees	990.828	1.017.183	776.693
Incidental sales by nonmarket establishments	671.643	769.459	800.877
Fines, penalties, and forfeits	525.955	580.941	621.703
Voluntary transfers other than grants	46.341	52.446	48.504
Miscellaneous and unidentified revenue	1.852.214	2.484.657	1.841.956

Source: Ministry of Finance

Budgetary Central Government Expense

	Year ended 31 December		
	2012	**2013**	**2014 preliminary**
		(HRK thousands)	
EXPENSE	**118.729.992**	**123.505.883**	**125.378.888**
Compensation of employees	**31.383.210**	**30.461.818**	**30.032.631**
Wages and salaries	26.910.038	26.286.011	25.633.257
Social contributions	4.473.172	4.175.807	4.399.374
Use of goods and services	**7.406.320**	**7.537.416**	**7.171.336**
Interest	**8.335.656**	**9.259.196**	**9.911.063**
To nonresidents	3.123.476	3.755.471	4.411.192
To residents other than general government	5.212.180	5.503.725	5.499.871
Subsidies	**5.762.321**	**5.537.845**	**5.174.466**
To public corporations	2.216.271	2.002.133	1.147.667
To private enterprises	3.546.050	3.535.712	4.026.799
Grants	**4.843.769**	**6.511.699**	**8.536.389**
To foreign governments	25.615	9.436	14.243
Current	21.078	4.111	6.622
Capital	4.537	5.326	7.621
To international organisations	247.448	2.056.525	3.658.111
Current	247.448	2.056.525	3.658.111
Capital	0	0	0
To other general government units	4.570.706	4.445.737	4.864.035
Current	2.440.511	2.362.235	2.445.496
Capital	2.130.195	2.083.502	2.418.539
Social benefits	**56.169.850**	**58.943.356**	**59.096.633**
Social security benefits	42.797.897	45.411.600	45.435.237
Social assistance benefits	13.240.668	13.392.974	13.488.711
Employer social benefits	131.285	138.782	172.685
Other expense	**4.828.865**	**5.254.553**	**5.456.370**
Property expense other than interest	66	340	233
Miscellaneous other expense	4.828.799	5.254.213	5.456.137
Current	2.068.407	2.316.424	2.760.629
Capital	2.760.392	2.937.789	2.695.508
Budgetary deficit	**-9,171,064**	**-14,920,834**	**-11,810,737**
As a percentage of GDP	**-2.8**	**-4.5**	**-3.6**

Source: Ministry of Finance

Fiscal rule and Fiscal Policy Committee

The amendments to the Fiscal Responsibility Act have altered the fiscal rule. The initial fiscal rule envisaged the reduction of expenditures of the general budget, expressed in the share in the gross domestic product by at least one percentage point per year, till achieving the primary balance at the level of zero or a positive amount (in nominal terms). In the conditions of a deep recession and negative output gap, such a rule due to its cyclic nature further threatened chances for growth. Alignment with the EU requirements tied to the new framework for managing the economic policy in the EU, and directed at strengthening the implementation of the Pact on Stability and Growth, was a further reason for changing the rule. The target value of the new fiscal rule becomes the mid-term budgetary objective, which will be achieved according to the adjustment plan, at the recommendations of the EU Council, in which the year-on-year reduction of the structural balance must be at least 0.5 per cent. GDP. The mid-tem budgetary objective is determined as the value of the structural balance, which ensures that the general budget deficit does not surpass 3 per cent. of GDP, and the public debt does not exceed 60 per cent. of GDP. In the sense of sustainable expenditure movements, a provision was introduced that the annual growth of general budget expenditures must not surpass the referential potential rate of growth of the gross domestic product as defined by the EC, increased by the expected price growth, in which exceptions are permitted for certain expenditure categories. Furthermore, the Act on Amendments to the Fiscal Responsibility Act defines the circumstances in which the fiscal rule will not be applied, under the condition that this does not threaten fiscal sustainability in the mid-term period. These circumstances are limited to catastrophic situations and larger economic disturbances, which have significant financial influence on the state of the general budget, which is in line with the provisions of the Pact on Stability and Growth. The existence of these circumstances is determined by the Fiscal Policy Committee.

Based on the recommendations of the European Commission, the above fiscal rule is to be further amended. Consequently, the Croatian administration is currently in the process of revising the current fiscal rule. Further specifications of the rule are now being discussed with the technical services of the European Commission.

With respect to the European Commission recommendations for a stronger increase in the independence of Fiscal Policy Committee, further changes are expected through the Fiscal Responsibility Act. These changes aim to considerably strengthen the status and the role of the Fiscal Policy Committee, which is currently established as a working body within the Parliament and is the only institution tasked by the law to control the budget. All appointed members of the Fiscal Policy Committee make their decisions independently and are members of the academic community.

The Decision on the establishment of Fiscal Policy Committee (adopted at the beginning of 2014) increased the powers and independence of the Fiscal Policy Committee and members already exercise these powers in the process of budget planning and execution and regarding the fulfilment of the fiscal rule. These powers will be further increased in the new Fiscal Responsibility Act currently discussed with the European Commission.

Transposing of Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States

Considering the entry into full EU membership in July 2013, the Republic of Croatia was obliged to transpose Council Directive 2011/85/EU into the national legislation by the end of the year as part of the six-pack, thereby achieving alignment with budgetary discipline according to the requirements of the Agreement on the Functioning of the EU. In one part, the provisions of the Directive were transposed by the Act on Amendments to the Fiscal Responsibility Act, which defines the standards of fiscal planning in documents pertaining to the drafting of the state budget, and projections made by the Republic of Croatia, or which the Government of the Republic of Croatia proposes for adoption to the Croatian Parliament. In this way, fiscal transparency is increased through the public availability of macroeconomic and budgetary projections, as well as the assumptions and relevant parameters upon which those projections are based.

These amendments to the Act also prescribe the obligation to publish information on the effect of tax expenditures on revenues, and information on potential obligations with a significant effect on the budget, such as state guarantees, which also ensues from Council Directive 2011/85/EU.

Fiscal responsibility

The Fiscal Responsibility Act introduced the Statement on Fiscal Responsibility by which the head of the budgetary and extrabudgetary user of the state budget and budgets of local and regional self-government units and heads of local and regional self-governments once per year confirm that in their work they ensure the legal, intentional and purposeful usage of resources, and the efficient functioning of the financial management system and controls within the framework of funds allocated in the budget or financial plan. Amendments to the Act on Fiscal Responsibility introduced the obligation to compile and submit the Statement on Fiscal Responsibility of companies and other legal entities under ownership of the Republic of Croatia, and for companies and other legal persons in the ownership of one or more local and regional self-government units. This amendment to the Act is very important in the context of Croatia's full membership in the EU, which opened numerous opportunities for using EU funds, and the above stated companies and other legal persons are the greatest potential users of these funds. Considering the obligations that must be met prior to and during the usage of EU funds, a transparent system of financial management and control is demanded of the potential users of those resources.

Apart from political responsibility, the misdemeanour responsibility of heads of all levels was also introduced in order to place an emphasis on the credibility of the issued Statements on Fiscal Responsibility and strengthening the system of responsibility.

Regulation on the compilation and submission of Statements of Fiscal Responsibility and reports on the application of the fiscal rule

The most recent amendments to the Fiscal Responsibility Act established a deadline of 90 days for the Government of the Republic of Croatia to align the Regulation on the compilation and submission of Statements of Fiscal Responsibility and reports on the application of the fiscal rule with the provisions of the Act. The Regulation will prescribe the form and content of reports on the application of the fiscal rule, and documentation pursuant to which the Statement of Fiscal Responsibility is based.

Budget Process

The State Treasury carries out, amongst other activities, budget preparation and consolidation, budget execution, state accounting and public debt management and also manages the financial management of EU funds.

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

On 1 January 2009, a new Budget Act entered into force, which incorporated 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.

In December 2012, the Act on the Amendments to the Budget Act was adopted. A primary reason for these changes was to facilitate EU programmes in light of Croatia's impending accession to the EU. For example, changes introduced by this Act include:

1. Increased flexibility being given concerning execution of the financial contributions of the Republic of Croatia to the EU Budget based on the system of EU-own resources. These contributions can be executed above the planned level in the same manner as the priority given to repayments of the principal of and interest on state debt and state guarantees; and

2. Budget users being allowed to make an advance payment without the consent of the Minister of Finance or the president of a local and regional executive body for liabilities assumed under contracts for projects co-financed by the EU funds.

In February 2015, the Act on the Amendments to the Budget Act was published in the Official Gazette no. 15/2015. Primary reasons for these changes were as follows:

- On 2 June 2014 the European Commission issued Country Specific Recommendations for Croatia based on the assessment of the Convergence Programme and National Reform Programme. The actions proposed by these recommendations should be taken in 2014 and 2015.

- One of the recommendations requires further improvements to be made to the budgetary planning process, to be achieved through the Act on the Amendments to the Budget Act

The Act on the Amendments to the Budget Act will introduce the following changes:

1. The budget process is being harmonised with EU requirements by including two key documents of the European Semester, the National Reform Programme and the Convergence Programme of the Republic of Croatia in the budget planning process;

2. Coverage of the general government sector defined by the Budget Act and the register of budget users and extra-budgetary users is harmonised in the part defining the extra-budgetary users with statistical coverage established by the European statistical methodology ESA2010;

3. The strengthening of medium-term budget framework through:

    - strengthening the role of projections adopted together with the budget by the Parliament or the representative body of local or regional self-government unit;

    - changes to setting ceilings for budget users as the basis for preparation of the financial plans (ceilings are necessary for the implementation of existing programmes or activities and will be given separately from the ceilings which are necessary for the introduction and implementation of new or changed programmes or activities);

4. The strengthening of the budget transparency principle by prescribing mandatory publication of yearly financial statements for budgets, budget users and extra-budgetary users on their websites;

5. The improvement of projections and control of future spending through monitoring and approving the creation of multi-annual liabilities regardless of the source of financing (both state and local or regional self-government units) or budget users' own or earmarked revenues that are currently not paid into the budget (EU projects are excluded);

6. Improved control of the use of budget funds as a result of the provision requiring budget users, extra-budgetary users and local or regional self-government units to conduct inspections of purposeful and lawful use of the funds paid from the budget pursuant to special legislation and by improving provisions relating to budget supervision;

7. Greater flexibility in the execution of EU projects will be introduced by facilitating the reallocation of up to 15 per cent. for national participation in project financing (an increase from 5 per cent.); and

8. Improved implementation of the objectives of public debt management as a result of the obligation to prepare public debt management strategy and to monitor its implementation.

Budget preparation consists of five steps:

1. The Strategic Plans for a three-year period are prepared by budgetary users in coordination with the ministry in charge of structural reforms and coordination of EU funds (by the end of March), and they are used as a basis for The National Reform Programme. The Ministry of Finance, on the other hand, prepares the Convergence Programme. The National Reform Programme and Convergence Programme are intended to be adopted by the Government (by the end of April);

2. 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);

3. 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 September); and

4. 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.

The Strategy for Improvement and Modernisation of the Processes within the State Treasury set 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 and public debt management and also 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.

Budget execution in Croatia is prescribed by means of the Budget Act and the Budget Execution Act that is adopted on a yearly basis, together with the State Budget. The Budget Execution Act regulates, among other things, the exemptions and special features arising from the adopted budget and facilitates the implementation and execution of the budget.

The budget execution process is supported by SAP Treasury system and Single Treasury Account. Key steps in budget execution process are: entry of reservation of funds, recording obligations in the general ledger of the state budget and payments according to the request for payments.

In order to further improve the budget execution process, the Ministry of Finance is implementing a project aimed at developing an IT system 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.

The above mentioned integration of information systems has enabled data to be recorded in one place in the central State Treasury, and to be accessible by all users. The key role of the IT system, as well as managing data, is to ensure that budget users enter only those procurement procedures for which there is coverage in the current budget, or approval by the Government to create a projection for the next two years. The new IT system can therefore also be used to manage liabilities.

Croatia Spending Review

On 28 January 2014, the Ecofin Council, adopted the decision on the existence of the excessive budget deficit for Croatia. Recommendations suggested fiscal adjustment for Croatia with the aim of reducing the state budget deficit to below 3 per cent. by 2016. In July 2014 the Government adopted the Plan of Implementation of Country-Specific Recommendations for the Republic of Croatia for 2014. One of the measures for achieving the sustainability of public finances is to carry out a spending review with an aim to reduce total public spending. The deadline for finalisation of the spending review is 15 March 2015.

The Government adopted the decision on the performance of the spending review and the decision on the appointment of the presidents and members of the relevant committees carrying out the spending review. The review covers the following categories:

- expenditure for employees paid from the state budget;
- subsidies;
- the healthcare system;
- the business operations of agencies, institutes, funds and other legal persons with public authority; and
- tax expenditures.

The objective of the spending review is to reduce expenditure by at least 10 per cent. annually in relation to the current plan for 2014 in the categories which are subject to the review.

By 1 March 2015, the Government intends to have adopted a conclusion on the selection of measures which should lead to the reduction of total public spending and which should be built into the medium-term budgetary documents, based on the reports of the appointed committees.

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.

In the medium term the process of aligning the tax system with 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 (excises) on motor vehicles; alcohol and alcoholic beverages, tobacco products, energy-generating products and electrical energy; coffee and non-alcoholic beverages; 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, OG 22/2012, entry into force on 1 March 2012, OG 144/2012, entry into force on 1 January 2013, OG 125/2013, entry into force on 1 January 2013, OG 148/2013, entry into force on 19 December 2013 and OG 143/2014, entry into force on 1 January 2015, with exception of Article 11 in part relating to taxation of capital gains, which shall enter into force on 1 January 2016) (the "**Income Tax Act**").

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, capital gains 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 most recent amendments to the Income Tax Act, which entered into force on 1 January 2015, the level of basic personal allowance was raised from HRK 2,200 to HRK 2,600, the maximum level of personal allowance for pensioners was raised from HRK 3,400 to HRK 3,800 and tax brackets were changed so that income tax is now levied at a rate of 12 per cent. on the taxable income of up to HRK 2,200, at a rate of 25 per cent. on the taxable income difference from the amount of HRK 2,200 to the amount of HRK 13,200 and at a rate of 40 per cent. on the taxable income above the amount of 13,200. The basic personal allowance was increased in the state assisted areas of the first division from HRK 3,200 to HRK 3,500 and of the second division from HRK 2,700 to HRK 3,000. These changes will increase net wages for lower income groups and increase disposable income for medium income groups, which should lead to increased consumption and a boost to economic trends.

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	12 per cent.
— Over HRK 2,200 up to HRK 13,200	— Over HRK 26,400 up to HRK 158,400	25 per cent.
— Over HRK 13,200	— Over HRK 158,400	40 per cent.

Amendments to the Income Tax Act also introduced a savings interest tax at the rate of 12 per cent. from 2015, while a tax on capital gains from financial assets will be introduced from 1 January 2016. Taxation on capital gains from financial assets will include taxation of income from*, inter alia*, sales of transferable securities issued after 1 January 2016. By way of exception, the capital gain will not be taxed if, for example, the sale of securities has been undertaken after three years as of the day such securities were acquired. In order to equalise taxation of various capital gains, tax relief for dividends and shares in profit up to HRK 12,000 will be abolished. Taking into consideration that the tax burden for labour income is considerably larger compared to capital income, these new changes in the capital taxation will improve tax fairness and increase the tax base. An increased tax base will provide a starting point for relieving the tax burden of labour income in the near future.

Profit tax (Corporate Income Tax) is regulated by the Profit Tax Act (OG 177/2004, 90/2005, 57/2006, 80/2010, 146/2008, 22/2012, 148/2013 and 143/2014). 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 became effective on the day of Croatia's accession to the EU.

The following are subject to profit tax:

- a company and another legal and 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 natural 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 craft or the activities equalised therewith, if:
  1. his/her total revenue in the preceding tax period exceeded HRK 3,000,000;
  2. or if he/she fulfils two of the following three conditions:
     - his/her total income in the preceding tax period exceeded HRK 400,000;
     - the value of his/her long term assets exceeds HRK 2,000,000;
     - he/she employed more than 15 employees on average during the preceding tax period.

In addition, withholding tax is 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 (subject to certain exemptions). 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 the place of actual management or supervision) in countries which are considered to be a tax heaven or financial centres. However, this special rate does not apply to EU Member States and countries with which Croatia has concluded and, therefore, applies double taxation avoidance treaties, such countries being published on a list adopted by the Minister of Finance and Tax Administration.

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 aids 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 assets 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 exceptions as defined above (the EU Member States and countries with which Croatia has concluded double taxation avoidance treaties) also reduced tax evasion options. Finally, accurate application of the Profit Tax Act contributed to increased tax revenue generation.

The amendments to the Profit Tax Act (OG 22/2012) introduced an 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 rates were 0 per cent., 10 per cent. and 23 per cent. prior to March 2012, with both goods and services are assessed at the same rate. As of 1 March 2012, a new general value added tax rate of 25 per cent. entered into force. 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 per cent., the VAT rate of 10 per cent. 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. Starting on 1 January 2013, the VAT rate of 10 per cent. is also 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. From 1 January 2013, amendments to the Value Added Tax Act (OG 136/2012) have been in effect whereby VAT for products which have been taxed with 0 per cent. rate now amounts to 5 per cent. In addition, from 1 January 2013, the fiscalisation process has started, with an objective of reducing tax evasion in cash transactions. In order to bring Croatia into full compliance with the EU VAT legislation, a new Value Added Tax Act was adopted on 14 June 2013, promulgated on 17 June 2013 and published in OG 73/13 on 18 June 2013. The majority of the provisions of this new Value Added Tax Act came into force upon Croatia's accession to the EU on 1 July 2013. As of 1 January 2014, the VAT rate of 10 per cent. increased to 13 per cent. The Value Added Tax Act was further amended at the end of 2014. A few provisions of this latest amendment came into force on 11 December 2014, however, the majority of the provisions thereof came into force on 1 January 2015.

At the beginning of April 2011, the Croatian Parliament adopted the Law on a Special Measure for the Collection of Tax Debt Resulting from the Economic Crisis (OG 45/2011). 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 the Special Measure for the Collection of Tax Debt Resulting from the Economic Crisis, which was published in OG 25/12. By this Amendment, another measure for collection of tax debt was introduced, the possibility of write-off of tax debt on the basis of interest, and the Law accordingly changed its name to the Law on Measures for the Collection of Tax Debt Resulting from the Economic Crisis. The Law was further amended in July 2012 (OG 78/2012).

The Act on Collection of the Tax Debt Caused by the Economic Crisis was adopted on 15 July 2013, promulgated on 18 July 2013 and published in OG 94/13 on 22 July 2013. It deals with the conditions, manner and procedure for collection of unpaid tax debt incurred until 31 January 2013. The Act on Collection of the Tax Debt of Physical Persons was adopted on 26 April 2013, promulgated on 2 May 2013 and published in OG 55/13 on 8 May 2013. It deals with the conditions, manner and procedure for collection of unpaid tax debt of physical persons.

The most significant changes in 2013 related to excise duties, due to their adjustment to EU legislation. The new Law on Special Tax on Motor Vehicles (OG 15/2013 and 108/2013) ("**Law on Special Tax on Motor Vehicles**") implemented a new model of excise taxation on vehicles by way of a combined system of taxation in which the special tax is determined in part as a value criteria (based on a percentage of the sales price), and partly as an ecological criteria (depending on CO2 emissions). Airplanes are exempt from the Law on Special Tax on Motor Vehicles. Excise tax on luxury products was abolished from 1 January 2013.

At the end of 2012, excise taxes on tobacco products were increased in order to achieve the minimum level of excise duties required by the EU. In 2013, as part of Croatia's obligation to ensure that the total excise tax on cigarettes is at least 57 per cent. of the weighted average retail selling price of cigarettes released for consumption and a minimum of €64 per 1,000 cigarettes, further adjustments of excise on tobacco was implemented in June 2013. In March 2014, further adjustments of excise on tobacco were implemented as part of Croatia's obligation to ensure that the minimum excise tax on tobacco products should be €77 per 1,000 cigarettes.

From 1 July 2013, the excise rates on energy products and electricity were increased in order to reach a minimum level of excise duties required by the EU. Also, in order to harmonise with EU legislation, from 1 July 2013 excise taxes on natural gas and electricity were introduced. The excise tax for fuel also increased from September 2013 and again from April 2014.

At the end of 2014 the Government of Croatia has defined new tax brackets for tax on gains from games of chance (entry into force on 1 January 2015), with the assignment of higher tax rates to higher achieved gains. The following was determined: 1) 10 per cent. tax rate on gains up to HRK 10,000; 2) 15 per cent. tax rate on gains from HRK 10,000 to 30,000; 3) 20 per cent. tax rate on gains from HRK 30,000 to 500,000; and 4) 30 per cent. tax rate on gains over HRK 500,000.

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 units) stood at HRK 264.5 billion as at 31 December 2014, corresponding to 80.5 per cent. of GDP. The majority of general Government debt as at 31 December 2014 was internal debt (HRK 163.8 billion, amounting to 61.9 per cent.), whereas external debt amounted to HRK 100.7 billion or 38.1 per cent. of total general Government debt. Total Government guarantees (including internal and external guarantees and guarantees in respect of HBOR) stood at HRK 22.9 billion as at 31 December 2014, corresponding to 7.0 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 four years (2010-2013):

	2011	2012	2013	2014*
General Government Debt (HRK million)	199,358.7	213,184.3	250,545.5	264,498.1
— as a percentage of GDP	*59.9*	*64.5*	*75.9*	*80.5*
Government Guarantees (HRK million)	21,664.9	24,924.8	23,874.2	22,899.9
— as a percentage of GDP	*6.5*	*7.5*	*7.2*	*7.0*
Total (General Government Debt + Government Guarantees) (HRK million)	**221,023.6**	**238,109.1**	**274,419.7**	**287,398.1**
— as a percentage of GDP	***66.5***	***72.1***	***83.1***	***87.5***

*estimate
Source: Ministry of Finance and Hrvatska narodna banka

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.

	Year ended 31 December				
	2010	2011	2012	2013	2014
General government debt	end of period, (HRK million)				
1 Domestic debt of general government	**104.371,4**	**125.756,8**	**131.530,9**	**152.532,0**	**163.813,0**
1.1 Domestic debt of central government	100.613,4	121.900,1	127.761,2	147.769,9	158.766,1
Short-term debt securities	17.198,1	19.308,5	18.259,6	22.838,9	24.224,8
Long-term debt securities	48.710,8	55.891,2	63.118,4	71.821,7	82.032,6
Loans	34.704,6	46.700,5	46.383,2	53.109,3	52.508,7
1.2 Domestic debt of social security funds	1,0	2,3	1,6	0,9	3,5
Short-term debt securities	0,0	0,0	0,0	0,0	0,0
Long-term debt securities	0,0	0,0	0,0	0,0	0,0
Loans	1,0	2,3	1,6	0,9	3,5
1.3 Domestic debt of local government	3.756,9	3.854,3	3.768,0	4.761,2	5.043,4
Short-term debt securities	0,0	0,0	0,0	0,0	0,0
Long-term debt securities	384,9	260,2	209,1	151,7	103,3
Loans	3.372,0	3.594,1	3.559,0	4.609,5	4.940,1
2 External debt of general government	**68.725,7**	**73.601,9**	**81.653,4**	**98.013,5**	**100.685,2**
2.1 External debt of central government	68.069,0	73.037,4	81.140,7	97.530,0	100.556,3
Short-term debt securities	3.520,5	1.205,3	895,1	539,8	645,1
Long-term debt securities	30.790,1	35.979,1	45.121,8	60.016,0	62.893,3
Loans	33.758,4	35.853,0	35.123,9	36.974,2	37.017,9
2.2 External debt of social security funds	0,0	0,0	0,0	0,0	0,0
Short-term debt securities	0,0	0,0	0,0	0,0	0,0
Long-term debt securities	0,0	0,0	0,0	0,0	0,0
Loans	0,0	0,0	0,0	0,0	0,0
2.3 External debt of local government	656,7	564,6	512,7	483,4	128,8
Short-term debt securities	0,0	0,0	0,0	0,0	0,0
Long-term debt securities	165,8	133,6	132,5	132,7	126,8
Loans	490,9	431,0	380,2	350,7	2,0
3 Total (1+2)	**173.097,1**	**199.358,7**	**213.184,3**	**250.545,5**	**264.498,1**
Supplement: Central government guarantees	29.432,0	21.664,9	24.924,8	23.874,2	22.899,9**
Domestic debt	10.586,4	5.490,2	9.542,6	7.933,9	5.791,1
o/w: Guarantees to CBRD	2.641,3	2.256,3	5.610,6	4.309,7	723,4
o/w: Guarantees for CBRD loans	1.177,3	802,0	823,6	825,1	1.945,4
External debt	18.845,7	16.174,7	15.382,2	15.940,3	17.108,8
o/w: Guarantees to CBRD	11.912,8	11.021,3	10.677,3	11.546,9	12.762,3

**estimate*
*** as of November 2014*
Source: HNB
Note: Exchange rate as at the end of period

Internal Central Government Debt and Internal Central Government Debt Instruments

Central Government Domestic Debt Stock of Croatia

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

Debt item	2011	2012	2013	2014	Maturity
Big Bonds Series I	0	0	0	0	2011
Big Bonds Series II	0	0	0	0	2011
Big Bonds Series III	42,08	0	0	0	2012
G Bonds - Series 02 D-08	0	0	0	0	2008
G Bonds - Series 03 D-12	3,765,210	0	0	0	2012
G Bonds - Series 04 D-08	0	0	0	0	2008
G Bonds - Series 05 D-14	4,894,773	4,904,656	4,964,468	0	2014
G Bonds - Series 07 D-19	3,765,210	3,772,812	3,818,822	7,661,471	2019
G Bonds - Series 08 D-10	0		0	0	2010
G Bonds - Series 09 D-15	2,635,647	2,640,968	2,673,175	2,681,515	2015
G Bonds - Series 10 D-15	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	0	0	2013
G Bonds - Series 12 D-17	5,500,000	5,500,000	5,500,000	5,500,000	2017
G Bonds - Series 13 D-20	5,000,000	5,000,000	5,000,000	5,000,000	2020
G Bonds - Series 14 D- 20	7,530,420	7,545,624	7,637,643	7,661,471	2020
G Bonds - Series 15 D- 17	4,000,000	4,000,000	4,000,000	4,000,000	2017
G Bonds - Series 16 D- 16	1,500,000	3,500,000	3,500,000	3,500,000	2016
G Bonds - Series 17 D- 22	4,518,252	7,545,624	7,637,643	7,661,471	2022
G Bonds - Series 18 D- 18	0	0	2,750,000	6,000,000	2018
G Bonds - Series 19 D- 24			5,728,232	10,726,059	2024
BRA Bonds - Series I	0	0	0	0	2007
BRA Bonds - Series II	15,486	0	0	0	2012
BRA Bonds - Series III	43,634	0	0	0	2012
BRA Bonds - Series IV	21,198	0	0	0	2012
BRA Bonds - Series Vb	0	0	0	0	2008
Syndicated Loan I	3,765,210	3,772,812	3,818,822	2,522,031	2016
Syndicated Loan II	5,723,119	2,867,337	2,219,422	1,484,231	2016
Syndicated Loan III	5,647,815	5,659,218	5,289,068	1,621,678	2016
Syndicated Loan IV	0	0	0	4,903,341	2019
Other FX loans	1,957,909	1,569,490	1,891,590	1,907,706	2018
Long term loan indexed to eur – HZZO	0	0	2,023,975	2,030,290	2016
Long term loan – HZZO	0	0	1,288,000	890,667	2018
Other		7,248,103	7,295,587	7,343,072	
Medium and long term debt	69,825,963	75,026,644	82,536,446	88,595,004	
Treasury Bills	15,285,000	15,625,000	20,810,000	23,957,000	
Treasury Bills indexed to eur	5,228,837	4,472,925	2,714,266	848,125	
Treasury Bills FX	0	5,764,253	5,346,350	5,363,030	
Other short term debt	0	2,365,281	2,268,551	1,550,381	
Short term debt	20,513,837	28,227,459	31,139,167	31,718,535	
Total debt	90,339,800	103,254,103	113,675,612	120,313,539	

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 economic restructuring of 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 5.0 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 the years 1996 to 1999 with maturities of 10 and 15 years, carrying coupons of 5.0 per cent., 6.0 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 sold 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			
	2011	**2012**	**2013**	**2014**
	(per cent.)			
364 days HRK	3.71	3.74	2.53	1.76
364 days EUR	3.84	3.51	1.75	0.52

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 focused 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 2014, the average maturity of Croatia's domestic central Government debt was 3.8 years.

Domestic bank syndicated loans amounting to HRK 4.8 billion and domestic bonds amounting to HRK 8.2 billion are scheduled to mature in 2015.

Redemption of domestic debt

The following table sets forth Croatia's domestic central Government debt stock which is, as of 31 December 2014, scheduled to be redeemed between 2015 and 2024.

	2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
					(HRK)					
Redemption of principle	13.048,77	11.404,99	12.662,75	7.899,04	4.695,55	12.705,43	43,96	7.705,43	43,96	5.790,06
Bonds – Series 07 D-19	0,00	0,00	0,00	0,00	3.830,74	0,00	0,00	0,00	0,00	0,00
Bonds – Series 09 D-15	2.681,51	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Bonds – Series 10 D-15	5.500,00	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	5.500,00	0,00	0,00	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	5.000,00	0,00	0,00	0,00	0,00
Bonds – Series 14 D-20	0,00	0,00	0,00	0,00	0,00	7.661,47	0,00	0,00	0,00	0,00
Bonds – Series 15 D-17	0,00	0,00	4.000,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Bonds – Series 16 D-16	0,00	3.500,00	0,00	0,00	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	7.661,47	0,00	0,00
Bonds – Series 18 D-18	0,00	0,00	0,00	6.000,00	0,00	0,00	0,00	0,00	0,00	0,00
Bonds – Series 19 D-24	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	5.746,10
FX Syndicated Loan I	638,45	638,45	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
FX Syndicated Loan II	739,80	739,80	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
FX Syndicated Loan III	810,84	810,84	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
FX Syndicated Loan IV	0,00	817,17	1.634,19	1.634,19	817,17	0,00	0,00	0,00	0,00	0,00
Other FX Loans	602,70	538,85	76,61	76,61	0,00	0,00	0,00	0,00	0,00	0,00
Long term Loans (HZZO)	397,33	2.421,30	64,00	32,00	0,00	0,00	0,00	0,00	0,00	0,00
Other	1.678,14	1.938,57	1.387,94	156,23	47,64	43,96	43,96	43,96	43,96	43,96
Interest payments	4.108,03	3.520,37	2.887,92	2.377,87	1.987,04	1.292,65	873,19	870,10	367,50	361,46
Bonds – Series 07 D-19	205,90	205,90	205,90	205,90	205,90	0,00	0,00	0,00	0,00	0,00
Bonds – Series 09 D-15	113,96	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Bonds – Series 10 D-15	288,75	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	130,63	0,00	0,00	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	168,75	0,00	0,00	0,00	0,00
Bonds – Series 14 D-20	498,00	498,00	498,00	498,00	498,00	249,00	0,00	0,00	0,00	0,00
Bonds – Series 15 D-17	250,00	250,00	250,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Bonds – Series 16 D-16	201,25	201,25	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Bonds – Series 17 D-22	498,00	498,00	498,00	498,00	498,00	498,00	498,00	498,00	0,00	0,00
Bonds – Series 18 D-18	315,00	315,00	315,00	315,00	0,00	0,00	0,00	0,00	0,00	0,00
Bonds – Series 19 D-24	330,40	330,40	330,40	330,40	330,40	330,40	330,40	330,40	330,40	330,40
FX Syndicated Loan I	51,89	22,29	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
FX Syndicated Loan II	49,03	16,36	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
FX Syndicated Loan III	77,06	38,53	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
FX Syndicated Loan IV	208,39	208,39	173,23	141,32	70,66	0,00	0,00	0,00	0,00	0,00
Other FX Loans	67,36	33,68	7,09	3,06	0,00	0,00	0,00	0,00	0,00	0,00
Long term Loans (HZZO)	103,21	63,37	4,16	0,83	0,00	0,00	0,00	0,00	0,00	0,00
Other	251,07	240,46	138,03	47,87	46,59	46,51	44,79	41,70	37,10	31,06
Total debt service	17.156,80	14.925,36	15.550,67	10.276,91	6.682,59	13.998,09	917,15	8.575,53	411,46	6.151,52

Source: Ministry of Finance
Note: Exchange rate: Mid exchange rate of the CNB as of 31.12.2014.

External Debt

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

	2011	2012	2013	October 2014
Total outstanding external debt/GDP	103.7	103.0	105.3	107.4
Governmental external guaranties (incl. HBOR)/GDP	—	—	—	—
General government external debt/GDP	21.5	24.9	29.2	31.6

Source: Hrvatska narodna banka, Ministry of Finance

* Total external debt, including private external debt, general government external debt and general government external guarantees).

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

	2011	2012	2013	2014*
		(per cent.)		
Ratio of debt service to exports of goods & services	39.5	42.7	40.1	44.6

Source: Hrvatska narodna banka

* Based on preliminary data.

(1) External debt service includes principal payments on bonds, long term trade credits and long term credits, as well as total interest payments net of interest payments on direct investments.

As of 31 October 2014, the average remaining maturity of Croatia's external central government debt was 6.7 years.

As of 31 December 2014, Croatia had hedging arrangements in place in respect of five of its six outstanding US dollar denominated bond issues (U.S.$ 1.25 billion issued in 2010, U.S.$ 1.5 billion issued in 2011, U.S.$ 1.5 billion issued in 2012, U.S.$ 1.5 billion issued in April 2013 and U.S.$ 1.75 billion issued in November 2013). These hedging arrangements have been executed with international and domestic banks under ISDA documentation. ISDA documentation contains a set-off provision, which one party may exercise if certain default or early termination events occur in respect of the other party. If exercised against Croatia, the set-off provision allows a hedging bank to offset any amount that would otherwise be payable by it under the ISDA against the nominal amount of a debt obligation of Croatia, including the Notes, regardless of the market value of that obligation. Croatia is evaluating the option of entering into further hedging arrangements in respect of debt denominated in U.S. dollars.

In 2012 the Croatian Government raised external debt in the international capital markets in the amount of U.S.$1.5 billion. In 2013 two U.S.$ bonds were issued totalling U.S.$3.25 billion. International bonds amounting to Euro 500 million maturing in 2014 were fully repaid at maturity in April 2014. In May 2014 bonds amounting to EUR 1.25 billion were issued and eurobonds amounting to Euro 750 million were fully repaid at maturity in January 2015.

Obligations relating to external debt of the former Yugoslavia

The international loans on which the 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 account the amount of SDR 270.6 million (equivalent to U.S.$421 million). This amount is managed at the HNB. In addition, a special one-off allocation of SDR has also been made. The objective of the special one-off allocation was 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, Croatia received an additional SDR 32.4 million (equivalent to U.S.$50.5 million) on 9 September 2009 and these funds will also be added to international reserves of the Republic of Croatia. 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 30 December 2014 a until 2024:

		Amount in (EUR*)	2014. (EUR*)	2015. (EUR*)	2016. (EUR*)	2017. (EUR*)	2018. (EUR*)	2019. (EUR*)	2020. (EUR*)	
EUR 500.000.000...........................	Principal	500,000,000	500,000,000							
5.0 %, Maturity: 2014	Interest		25,000,000							
EUR 750.000.000...........................	Principal	750,000,000	0	**750,000,000**						
6.5 %, Maturity: 2015	Interest		48,750,000	48,750,000						
U.S.$ 1.500.000.000	Principal	1,233,857,114	0	0	0	**1,233,857,114**				
6.25% Maturity: 2017	Interest		77,116,070	77,116,070	77,116,070	38,558,035				
EUR 750.000.000...........................	Principal	750,000,000	0	0	0	0	**750,000,000**			
5.875%, Maturity: 2018	Interest		44,062,500	44,062,500	44,062,500	44,062,500	44,062,500			
EUR 1.250.000.000........................	Principal	1,250,000,000	0	0	0	0	0	0	0	
3.875% Maturity 2022	Interest			46,875,000	46,875,000	46,875,000	46,875,000	46,875,000	46,875,000	
U.S.$ 1.500.000.000	Principal	1,233,857,114	0	0	0	0	0	**1,233,857,114**		
6.75 %, Maturity: 2019	Interest		83,285,355	83,285,355	83,285,355	83,285,355	83,285,355	83,285,335		
U.S.$ 1.250.000.000	Principal	1,028,214,262	0	0	0	0	0	0	**1,028,214,262**	
6.625 %, Maturity: 2020	Interest		68,119,195	68,119,195	68,119,195	68,119,195	68,119,195	68,119,195	68,119,195	
U.S.$ 1.500.000.000	Principal	1,233,857,114	0	0	0	0	0	0	0	**1**
6.375% Maturity: 2021	Interest		78,658,391	78,658,391	78,658,391	78,658,391	78,658,391	78,658,391	78,658,391	
U.S.$ 1.500.000.000	Principal	1,233,857,114	0	0	0	0	0	0	0	
5.500% Maturity: 2023	Interest		59,938,976	67,862,141	67,862,141	67,862,141	67,862,141	67,862,141	67,862,141	
U.S.$ 1.750.000.000	Principal	1,439,499,967								
6.000% Maturity: 2024	Interest		50,857,313	76,285,969	76,285,969	76,285,969	76,285,969	76,285,969	76,285,969	
Principal Repayment (EUR*)			500,000,000	750,000,000	0	1,233,857,114	750,000,000	1,233,857,114	1,028,214,262	1
Interest Payment (EUR*)...............			535,787,800	591,014,621	542,264,621	503,706,587	465,148,552	421,086,052	337,800,697	
Total Servicing Costs (EUR*)			1,035,787,800	1,341,014,621	542,264,621	1,737,563,701	1,215,148,552	1,654,943,166	1,366,014,959	1
Total Principal Outstanding (at year end) (EUR*)		**10,653,142,686**	**10,153,142,686**	**9,403,142,686**	**9,403,142,686**	**8,169,285,572**	**7,419,285,572**	**6,185,428,458**	**5,157,214,196**	**3**

* Exchange rate: Mid exchange rate of the HNB as of 31 December 2013
Source: Ministry of Finance

Total External Debt (Public and Private)

The following table sets out the total external debt of Croatia divided according to sector:

	2010	2011	2012	2013	10/2014
General government	**9,126.0**	**9,624.9**	**10,938.9**	**12,711.9**	**13,604.3**
Short-term	468.3	157.9	118.1	269.6	114.3
Currency and deposits	0.0	0.0	0.0	0.0	0.0
Debt securities	468.3	157.9	117.2	69.6	114.3
Loans	0.0	0.0	0.9	200.0	0.0
Trade credit and advances	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Long-term	8,657.7	9,467.0	10,820.8	12,442.3	13,490.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0
Debt securities	4,321.4	5,069.8	6,247.1	7,846.8	8,515.8
Loans	4,336.3	4,397.1	4,573.7	4,595.5	4,974.3
Trade credit and advances	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Central bank	**357.3**	**360.1**	**351.0**	**421.5**	**384.5**
Short-term	1.2	0.1	0.0	83.5	28.4
Currency and deposits	1.2	0.1	0.0	83.5	28.4
Debt securities	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.0	0.0	0.0
Trade credit and advances	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Long-term	356.1	360.0	351.0	338.0	356.1
Special drawing rights (allocations)	356.1	360.0	351.0	338.0	356.1
Currency and deposit s	0.0	0.0	0.0	0.0	0.0
Debt securities	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.0	0.0	0.0
Trade credit and advances	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Deposit taking corporations, except the central bank	**11,212.4**	**12,207.9**	**9,885.8**	**9,156.8**	**7,799.7**
Short –term	3,173.6	3,953.1	2,024.2	2,317.1	1,605.7
Currency and deposits	2,201.3	3,291.4	1,470.2	1,735.3	1,255.9
Debt securities	0.0	0.0	0.0	0.0	0.0
Loans	947.8	526.0	516.8	557.3	320.0
Trade credit and advances	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	24.5	135.8	37.2	24.5	29.8
Long-term	8,038.8	8,254.7	7,861.6	6,839.7	6,194.0
Currency and deposits	4,592.8	4,407.6	4,261.1	3,849.6	3,655.0
Debt securities	8.9	1.9	8.9	3.8	2.6
Loans	3,436.0	3,844.4	3,568.8	2,984.0	2,533.8
Trade credit and advances	0.0	0.0	0.0	0.0	0.0
Other debt liabilities	1.1	0.9	22.8	2.4	2.8
Other sectors	**20,076.3**	**19,186.9**	**18,714.2**	**17,931.7**	**18,391.2**
Short-term	912.5	915.8	1,130.3	626.4	794.6
Currency and deposits	0.0	0.0	0.0	0.0	0.0
Debt securities	0.0	0.1	0.1	0.0	0.0
Loans	881.7	881.4	952.0	511.1	698.6
Trade credit and advances	30.9	34.2	178.1	115.2	96.0
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Long-term	19,163.8	18,271.1	17,584.0	17,305.3	17,596.6
Currency and deposit s	1.6	1.6	1.6	1.6	1.6
Debt securities	1,607.5	1,411.6	2,316.6	2,282.0	1,844.1
Loans	17,261.7	16,721.9	15,152.8	14,880.4	15,571.2
Trade credit and advances	293.0	135.9	113.0	141.2	179.6
Other debt liabilities	0.0	0.0	0.0	0.0	0.0
Direct investment: intercompany lending	**6,136.5**	**5,017.4**	**5,386.2**	**5,698.5**	**6,069.2**
Debt liabilities of direct investment enterprises to direct investors	4,131.0	4,143.1	4,082.4	3,521.6	3,773.2
Debt liabilities of direct investors to direct investment enterprises	366.7	175.5	164.5	159.5	222.5
Debt liabilities to fellow enterprises	1,638.7	698.9	1,139.4	2,017.4	2,073.5
Gross external debt position	**46,908.4**	**46,397.2**	**45,276.1**	**45,920.4**	**46,248.9**

Source: Hrvatska narodna banka

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

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

The following table sets forth the projected principal payments for all external debt outstanding as at 31 October 2014.

	Gross External Debt as at 31 October 2014	Immediate /Arrears	2014*	2015	2016	2017	2018	2019	2020	2021	2022	2023	Other
	(EUR million)												
Public sector	**17,714.7**	**0.9**	**4,241.5**	**2,188.4**	**1,038.1**	**2,844.4**	**928.3**	**2,004.6**	**1,445.4**	**1,482.2**	**1,413.1**	**1,009.1**	**2,832.4**
Other investment	17,713.6	0.9	4,241.5	2,187.3	1,038.1	2,844.4	928.3	2,004.6	1,445.4	1,482.2	1,413.1	1,009.1	2,832.4
Short-term	193.9	0.0	923.4	111.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	17,519.7	0.9	3,318.1	2,075.6	1,038.1	2,844.4	928.3	2,004.6	1,445.4	1,482.2	1,413.1	1,009.1	2,832.4
Direct investment	1.1	0.0	0.0	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	1.1	0.0	0.0	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Publicly guaranteed private sector	**76.7**	**2.6**	**96.6**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Other investment	76.7	2.6	96.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	76.7	2.6	96.6	0.0	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	**28,457.5**	**1,993.5**	**10,690.5**	**6,368.2**	**3,661.5**	**3,546.2**	**1,739.5**	**1,872.2**	**1,948.3**	**527.2**	**619.1**	**825.7**	**1,500.7**
Other investment	22,389.4	1,607.1	8,968.4	5,024.9	2,967.9	2,819.7	1,421.0	1,595.0	1,696.9	465.2	506.5	381.8	1,169.0
Short-term	2,349.0	108.2	3,594.0	1,234.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	20,040.4	1,498.9	5,374.4	3,790.0	2,967.9	2,819.7	1,421.0	1,595.0	1,696.9	465.2	506.5	381.8	1,169.0
Direct investment	6,068.1	386.5	1,722.1	1,343.4	693.5	726.4	318.5	277.2	251.4	62.0	112.5	443.9	331.6
Short-term	251.0	29.3	231.1	88.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	5,817.1	357.1	1,491.0	1,255.0	693.5	726.4	318.5	277.2	251.4	62.0	112.5	443.9	331.6
Total	**46,248.9**	**1,997.1**	**15,028.6**	**8,556.6**	**4,699.6**	**6,390.6**	**2,667.8**	**3,876.8**	**3,393.7**	**2,009.4**	**2,032.1**	**1,834.8**	**4,333.0**

* Repayments made until October 2014 and projected repayments for the following months.

Source: Hrvatska narodna banka

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

The following table sets forth the projected interest service payments for all external debt outstanding as at 31 October 2014.

	Gross External Debt as at 31 October 2014	2014*	2015	2016	2017	2018	2019	2020	2021	2022	2023	Other
	(EUR millions)											
Public sector	**17,714.7**	**696.5**	**612.8**	**650.7**	**592.8**	**487.8**	**458.8**	**348.6**	**243.9**	**198.2**	**112.0**	**172.7**
Other investment	17,713.6	696.5	612.8	650.7	592.8	487.8	458.8	348.6	243.9	198.2	112.0	172.7
Short-term	193.9	4.9	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	17,519.7	691.6	612.0	650.7	592.8	487.8	458.8	348.6	243.9	198.2	112.0	172.7
Direct investment	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Publicly guaranteed private sector	**76.7**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Other investment	76.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	76.7	0.0	0.0	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
Non-publicly guaranteed private sector	**28,457.5**	**710.4**	**483.7**	**432.9**	**346.6**	**269.8**	**212.2**	**199.2**	**66.5**	**79.1**	**103.0**	**382.5**
Other investment	22,389.4	616.3	405.5	361.0	287.1	235.3	187.0	168.9	55.2	63.4	48.3	173.8
Short-term	2,349.0	43.8	12.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	20,040.4	572.5	392.8	361.0	287.1	235.3	187.0	168.9	55.2	63.4	48.3	173.8
Direct investment	6,068.1	94.1	78.2	71.9	59.5	34.5	25.1	30.3	11.3	15.6	54.8	208.7
Short-term	251.0	2.0	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	5,817.1	92.0	76.9	71.9	59.5	34.5	25.1	30.3	11.3	15.6	54.8	208.7
Total	**46,248.9**	**1,407.0**	**1,096.5**	**1,083.6**	**939.4**	**757.6**	**670.9**	**547.8**	**310.3**	**277.3**	**215.1**	**555.2**

* Repayments made until end-October 2014 and projected repayments for the following months.

Source: Hrvatska narodna banka

(1) *Exchange rate as at 31 December in the relevant year, and 31st October for 2014*

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 person 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 (OG 177/2004, 73/2008, 80/2010, 114/2011, 22/2012, 144/2012, 125/13, 148/2013 and 143/2014) payment of the interest on the Notes to foreign natural persons is not subject to personal income tax. Pursuant to the Profit Tax Act (OG 177/2004, 90/2005, 57/2006, 80/2010, 146/2008, 22/2012, 148/2013 and 143/2014) 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 being a legal person (which is not resident or incorporated in Croatia) in respect of any Notes. No Croatian tax will be payable in respect of any gain, whether realised or unrealised, made by a holder being a natural person (which is not resident in Croatia) in respect of any Notes, provided such Notes are not deposited with a Croatian depositary. No stamp, registration or similar duties or taxes will be payable in Croatia by Noteholders in connection with the issue or transfer of the Notes. However, subject to any applicable double taxation treaty, a natural or legal person who inherits or receives gifts (including Notes) in the Republic is under an obligation to pay Croatian tax in respect of such inheritance or gift, in accordance with applicable laws.

EU Savings Directive

Under European Council Directive 2003/48/EC on the taxation of savings income, Member States are required to provide to the tax authorities of other Member States details of certain payments of interest or similar income paid or secured by a person established in a Member State to or for the benefit of an individual resident in another Member State or certain limited types of entities established in another Member State.

On 24 March 2014, the Council of the European Union adopted a Council Directive amending and broadening the scope of the requirements described above. Member States are required to apply these new requirements from 1 January 2017. The changes will expand the range of payments covered by the Directive, in particular to include additional types of income payable on securities. The Directive will also expand the circumstances in which payments that indirectly benefit an individual resident in a Member State must be reported. This approach will apply to payments made to, or secured for, persons, entities or legal arrangements (including trusts) where certain conditions are satisfied, and may in some cases apply where the person, entity or arrangement is established or effectively managed outside of the European Union.

For a transitional period, Austria is required (unless during that period it elects otherwise) to operate a withholding system in relation to such payments. The changes referred to above will broaden the types of payments subject to withholding in those Member States which still operate a withholding system when they are implemented.

The end of the transitional period is 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 proposed financial transactions tax ("FTT")

On 14 February 2013, the European Commission published a proposal for a Directive for a common FTT in Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia (the "**participating Member States**").

The proposed FTT has very broad scope. If introduced in the form proposed on 14 February 2013, it could apply to certain dealings in the Notes (including secondary market transactions) in certain circumstances.

Under the 14 February 2013 proposal, FTT could apply in certain circumstances to persons both within and outside of the participating Member States. Generally, it would apply to certain dealings in the Notes where at least one party is a financial institution, and at least one party is established in a participating Member State. A financial institution may be, or be deemed to be, "established" in a participating Member State in a broad range of circumstances, including (a) by transacting with a person established in a participating Member State or (b) where the financial instrument which is subject to the dealings is issued in a participating Member State.

Joint statements issued by participating Member States indicate an intention to implement the FTT by 1 January 2016.

However, the FTT proposal remains subject to negotiation between the participating Member States and the scope of any such tax is uncertain. It may therefore be altered prior to any implementation. Additional EU Member States may decide to participate.

Prospective holders of the Notes are advised to seek their own professional advice in relation to the FTT.

SUBSCRIPTION AND SALE

Barclays Bank PLC, Erste Group Bank AG, J.P. Morgan Securities plc and Zagrebačka banka d.d. (together the "**Joint Lead Managers**") have, in a subscription agreement (the "**Subscription Agreement**") dated 9 March 2015, jointly and severally agreed to subscribe and pay for, or to procure subscriptions and payment for, the Notes at their issue price of 97.845 per cent. of their principal amount less a combined management and underwriting commission. In addition, the Issuer has agreed to reimburse the Joint Lead Managers for certain of their expenses in connection with the management of the issue of the Notes. The Joint Lead Managers are entitled in certain circumstances to be released and discharged from their obligations under the Subscription Agreement prior to the issue of the Notes. The Issuer has agreed to indemnify the Joint Lead Managers against certain liabilities in connection with the issue of the Notes.

United States

The Notes have not been and will not be registered under the Securities Act. Subject to certain exceptions, the Notes may not be offered, sold or delivered within the United States. Each Joint Lead Manager has agreed that it will not offer, sell or deliver any Notes within the United States, except as permitted by the Subscription Agreement.

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

United Kingdom

Each 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.

Republic of 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, to the best of the relevant Joint Lead Manager's knowledge and belief, authorised or licensed under Croatian law to acquire, hold, manage or dispose of the Notes on the date of their offer.

Professional investors (as defined pursuant to Article 61 of the Capital Market Act) that are generally authorised to acquire, hold, manage or dispose of the Notes, include, but are not limited to, credit institutions, investment companies, insurance companies, obligatory pension funds, certain voluntary pension funds and certain investment funds.

Any Joint Lead Manager not having arranged for a "passport" notification to the Hrvatska narodna banka in accordance with Article 87 of the Credit Institutions Act is authorised to sell the Notes to respective residents of the Republic of Croatia or legal entities incorporated in the Republic of Croatia, provided such sale is not made directly in the territory of the Republic of Croatia, but either at a distance (e.g. by post, fax, or electronic mail) on a reverse inquiry basis or outside of the territory of the Republic of Croatia.

Any Joint Lead Manager having arranged for the relevant "passport" notification to the Hrvatska narodna banka, as referred to in the previous paragraph, is authorised to directly render respective mutually recognised financial services in the territory of the Republic of Croatia on a temporary basis (i.e. such services should not be rendered on a regular, frequent or on an on-going basis).

Any Joint Lead Manager being duly authorised by Hrvatska narodna banka for providing relevant financial services is authorised to sell the Notes to respective residents of the Republic of Croatia or legal entities incorporated in the Republic of Croatia.

Republic of Italy

The offering of the Notes has not been registered pursuant to Italian securities legislation and, accordingly, no Notes may be offered, sold or delivered, nor may copies of the Offering Circular or of any other document relating to the Notes be distributed in the Republic of Italy, except:

(i) to qualified investors (*investitori qualificati*), as defined pursuant to Article 100 of Legislative Decree No. 58 of 24 February 1998, as amended (the "**Financial Services Act**") and Article 34-ter, first paragraph, letter (b) of CONSOB Regulation No. 11971 of 14 May 1999, as amended from time to time ("**Regulation No. 11971**"); or

(ii) in other circumstances which are exempted from the rules on public offerings pursuant to Article 100 of the Financial Services Act and Article 34-*ter* of Regulation No. 11971.

Any offer, sale or delivery of the Notes or distribution of copies of the Offering Circular or any other document relating to the Notes in the Republic of Italy under (i) or (ii) above must be:

(a) made by an investment firm, bank or financial intermediary permitted to conduct such activities in the Republic of Italy in accordance with the Financial Services Act, CONSOB Regulation No. 16190 of 29 October 2007 (as amended from time to time) and Legislative Decree No. 385 of 1 September 1993, as amended (the "**Banking Act**"); and

(b) in compliance with Article 129 of the Banking Act, as amended, and the implementing guidelines of the Bank of Italy, as amended from time to time, pursuant to which the Bank of Italy may request information on the issue or the offer of securities in the Republic of Italy; and

(c) in compliance with any other applicable laws and regulations or requirement imposed by CONSOB or other Italian authority.

General

No action has been or will be taken by the Joint Lead Managers or the Republic of Croatia that would, or is intended to, permit a public offering of the Notes or possession or distribution of this Offering Circular or any other offering or publicity material relating to the Notes in any country or jurisdiction where any such action for that purpose is required. Each Joint Lead Manager has undertaken to the Republic of Croatia that it will not, directly or indirectly, offer or sell any Notes or have in its possession, 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. The Republic and the Joint Lead Managers have agreed that each Joint Lead Manager will obtain any consent, approval or permission which is, to the best of the relevant Joint Lead Manager's knowledge and belief, required for the offer, purchase or sale by it of Notes under the laws and regulations in force in any jurisdiction to which such Joint Lead Manager is subject or in which it makes such offers, purchases or sales and it will, to the best of its knowledge and belief, comply with all such laws and regulations. No Joint Lead Manager is authorised to make any representation or use any information in connection with the issue, subscription and sale of the Notes other than as contained in this Offering Circular or any amendment or supplement to it.

GENERAL INFORMATION

Listing and Admission to Trading

Application has been made to the Luxembourg Stock Exchange for the Notes to be admitted to trading on the Luxembourg Stock Exchange's regulated market and to be listed on the Official List of the Luxembourg Stock Exchange. The Luxembourg Stock Exchange's regulated market is a regulated market for the purposes of the Markets in Financial Instruments Directive (Directive 2004/39/EC).

The total expenses related to the admission to trading of the Notes are approximately €6,300.

Documents

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

(a) the Fiscal Agency Agreement which includes the form of the Certificates;

(b) the resolution of the Minister of Finance dated 4 March 2015 authorising the issue of the Notes; and

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

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

Authorisation

The Republic has obtained all necessary consents, approvals and authorisations in the Republic of Croatia in connection with the issue and performance of the Notes. The issue of the Notes was authorised pursuant to the resolution of the Minister of Finance dated 4 March 2015 (Class: 450-08/15-01/11, Reg. No. 513-05-03-15-1), passed in accordance with the Law on Execution of the State Budget of the Republic of Croatia for the year 2015 (OG 148/2014) and the Budget Act (OG 87/2008, 136/2012 and 15/2015).

Litigation

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

No Significant Change

There has been no significant change in the tax and budgetary systems, gross public debt, foreign trade and balance of payments, foreign exchange reserves, financial position and resources and income and expenditure figures of the Issuer since 31 December 2014.

Clearing Systems

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

Common code	111729891
ISIN	XS1117298916

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

Yield

On the basis of the issue price of the Notes of 97.845 per cent. of their principal amount, the yield on the Notes is 3.256 per cent. on an annual basis.

Third Party Information

The Issuer confirms that where information included in this Offering Circular 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.

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. In addition, in the ordinary course of their business activities, the Joint Lead Managers and their affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers. Such investments and securities activities may involve securities and/or instruments of the Republic or the Republic's affiliates. Certain of the Joint Lead Managers or their affiliates that have a lending relationship with the Republic routinely hedge their credit exposure to the Republic consistent with their customary risk management policies. Typically, such Joint Lead Managers and their affiliates would hedge such exposure by entering into transactions which consist of either the purchase of credit default swaps or the creation of short positions in securities, including potentially the Notes offered hereby. Any such short positions could adversely affect future trading prices of Notes offered hereby. The Joint Lead Managers and their affiliates may also make investment recommendations and/or publish or express independent research views in respect of such securities or financial instruments and may hold, or recommend to clients that they acquire, long and/or short positions in such securities and instruments. For the purpose of this paragraph the term "**affiliates**" includes also parent companies and parent companies' affiliates.

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