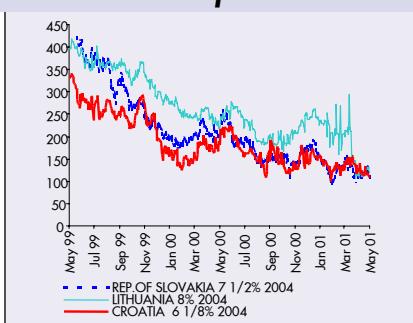


Strategy Croatia

2nd quarter 2001

Eurobond Comparison



Source: RZB-Group Research

Recommendations (Horizon: End of 3rd quarter 2001)

Bond market

Buy
T-bills 91 day maturity

Stock market

Hold
CROBEX

Buy
Pliva
Viktor Lenac

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Highlights

■ Following a decrease of Croatia's gross domestic product in 1999, GDP growth reached 3.7% in 2000, supported by strong growth in personal expenditure (4.1%) and an exceptionally good tourist season. However, as Croatia lacks greenfield investments, and as no such projects have been announced for the near future, we do not expect real GDP growth to exceed 3.4% in 2001. Thus, for the scenario featuring economic growth rising over 4% annually this year to materialise, there will have to be fiscal success in improving the state of the economy, and higher foreign direct investments are required as well.

■ Last year saw the highest growth rate in the price level in the past six years. Retail prices rose by 6.2%, and industrial product prices expanded by 9.7% on average. Inflation pressure from last year continued into this year due to the oil price increase in the international market and the stronger dollar. The budget deficit for 2001 - which was established within the context of the agreement with the IMF - is expected to be -5.3% at the end of this year.

■ The last municipal elections were held on 20 May and brought a polarisation between the left and the right. The centre almost disappeared, and the Croatian Democratic Union saw a comeback to the political scene. The Prime Minister's first statements indicate that there will be no major reshuffle of the government after these elections, but small changes are nevertheless possible.

Key figures

	1995	1996	1997	1998	1999	2000	2001e	2002f
Nominal GDP (USD bn)	18.8	19.9	20.1	21.6	20.1	19.0	21.4	25.8
Real GDP (% yoy)	6.8	6.0	6.5	2.5	-0.3	3.7	3.4	3.8
Gross industrial production (% yoy)	0.3	3.1	6.8	3.7	-1.4	1.7	2.8	3.3
Unemployment rate (%, avg)	14.5	15.8	16.8	17.2	19.1	21.2	22.0	20.0
Gross industrial Wages (avg, % yoy)	31.7	12.5	10.5	11.2	4.5	5.0	5.5	4.7
Producer prices (avg, % yoy)	0.7	1.4	2.3	-1.2	2.6	9.7	5.5	4.0
Consumer prices (avg, % yoy)	2.0	3.5	3.6	5.7	4.2	6.2	5.3	4.0
Consumer prices (eop, % yoy)	3.7	3.4	3.8	5.4	4.4	7.4	4.5	4.0
General budget balance (% of GDP)	-5.5	-7.0	-7.1	-6.4	-6.5	-6.7	-5.3	-4.3
Exports (USD bn)	4.6	4.5	4.2	4.6	4.4	4.6	4.6	5.0
Imports (USD bn)	7.9	8.2	9.4	8.8	7.7	7.8	8.0	8.3
Current account balance (USD bn)	-1.5	-1.1	-2.3	-1.5	-1.5	-0.5	-0.8	-0.9
Current account balance (% of GDP)	-7.7	-5.8	-11.6	-7.1	-7.6	-2.8	-3.9	-3.4
Official FX-reserves (USD bn)	1.9	2.3	2.5	2.8	3.0	3.5	3.8	3.9
HRK/USD avg	5.23	5.43	6.16	6.36	7.11	8.28	8.01	7.18
HRK/USD eop	5.32	5.54	6.30	6.25	7.65	8.16	7.63	6.98
HRK/EUR avg	6.76	6.81	6.96	7.14	7.58	7.64	7.35	7.34
HRK/EUR eop	6.81	6.86	6.95	7.33	7.68	7.60	7.25	7.40

Note: General budget balance from 2000 on excluding privatisation revenues

Source: RZB-Group Research

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Croatia

Summary

Politics

The last municipal elections were held on 20 May, and it was expected that the Social Democrats and the Social Liberals will reaffirm their strong positions, but an interesting polarisation to the left and the right occurred instead. The centre almost disappeared. Most of the votes in the capital Zagreb went to the Social Democrats, the Croatian People's Party and the Croatian Block which mainly consists of the Croatian Democratic Union, the majority party in Parliament until last year. This marks a comeback of the Croatian Democratic Union to the political scene, which is evidently a result of the present government's inability to fulfil the citizens' expectations. The Croatian People's Party achieved the greatest breakthrough at the municipal elections. It is the second-strongest single party as measured by the number of votes. The Prime Minister's first statements indicate that there will be no major reshuffle of the government after these elections, but small changes are nevertheless possible.

Economy

Following a decrease of Croatia's gross domestic product in 1999, GDP growth reached 3.7% last year. Unfortunately, last year's positive economic growth is not convincing because it was due to strong growth in personal expenditure (4.1%) and an exceptionally good tourist season, which made exports of goods and services in gross domestic product grow at a rate of 8.7%.

Last year saw the strongest increase in the price level in the past six years. Retail prices rose 6.2% on average, which was mostly due to the imposition of duties on tobacco and beverages as well as increases in the prices of oil products and energy. Last year's inflation pressure has continued this year due to the oil price increase on the international market and as a result of the stronger dollar.

The balance of payment's current account deficit significantly decreased in 2000 to -2.7% of GDP, compared to -7.3% in the previous year. This decrease was due to a good tourist season which ensured record revenues from providing tourist services.

The second quarter of this year witnessed the beginning of intensive nominal appreciation of the kuna against the euro. In April, Croatia experienced a significant foreign currency inflow through transfers and from tourists visiting Croatia during their holidays. Along with that, kuna appreciation is a consequence

of increased demand for kunas in the interbank market. During April and May the kuna appreciated by 6% against the euro.

Bond Market

Since the first Eurobond issue in February 1997, the Croatian government has almost exclusively used international markets for medium and long-term financing, leaving the domestic bond market largely undeveloped. The domestic debt market is dominated by short-term securities issued by the Ministry of Finance (Treasury Bills) and by the Croatian National Bank (CNB Bills). In 2000, three bonds were issued in the domestic market, namely by the Croatian Health Fund (HZZO) and the Croatian Agency for Deposit Insurance and Bank Rehabilitation (DAB 3 and DAB 5).

Yields on all three domestic bonds declined sharply in the first quarter of the year, in line with Croatian Eurobonds traded on the international markets. However, with a spread of 120-140 bps over Eurobonds with a similar maturity, domestic bonds still offer a very decent yield advantage, especially for domestic investors. Foreign investors are still reluctant to take advantage of this opportunity, mainly due to the currency risk and FX costs which they face when selling the bonds or at maturity, since all payments are effected in HRK at the prevailing CNB mid-rate.

Stock market

Unicredito Italiano and Allianz have joined forces in a bid for the control of Zagrebacka Banka. In the bid for the acquisition of a controlling interest of 75 percent plus one share in Zagrebacka Banka, Unicredito will take the lead role, acquiring approximately 60 percent of the voting shares against 15 percent of the partner Allianz. The bid represents an amount of USD 252 per share minus a dividend of USD 13.5 per share for 2000, or HRK 2,115.3 less dividend. The bid will be launched this summer if the bidders get the green light from the Croatian National Bank. It will be open for three weeks, with settlement in August or September. The Croatian National Bank is likely to take a decision about the bid in June.

Viktor Lenac announced 2000 results. The group's net profit amounts to HRK 18.1 mn, which corresponds to an 80% increase over the previous year. We maintain our "strong buy" recommendation on Viktor Lenac.

Focus on...**the Eve of a New Foreign Currency Law**

In April this year, the Croatian parliament adopted amendments to the Foreign Exchange Operations Act which have partly liberalised FX flows for the domestic corporate sector. Significant liberalisation efforts of FX regulations are necessary to get closer to the European Monetary Union in order to achieve an intensification and expansion of the Croatian financial market, to strengthen confidence in the financial system and to accelerate the country's economic rehabilitation. The government expressed an opinion stating that a longer period will be necessary for a complete change of the legislation. It therefore suggested that only amendments to the existing Act be adopted.

According to the government's opinion, liberalisation of the foreign currency payments system should be conducted in three phases:

- (1) the first phase is included in the current changes of the Act and relates to the liberalisation of FX credit financing within the country for making external payments and the liberalisation of FX revenues in the corporate sector;
- (2) the second phase covers further liberalisation in respect of external capital transactions;
- (3) the third phase regards the introduction of the euro.

The second phase should be implemented at the beginning of next year, following the first version of the new Foreign Currency Act which is to be finalised by the end of this year. This shows that the Central Bank is pressing ahead with this act so as to attain a higher liberalisation level and to draw closer to the euro because Croatia is highly eurised. This can best be seen from FX deposit data which constituted 72% of total savings in Croatian banks at the end of March this year. Therefore, commercial banks' balance sheets had considerable amounts of assets in foreign currency which could be loaned only to companies making external payments prior to the recent changes of the FX Act. The restriction on making capital transfers abroad is still in force for domestic persons, whereas foreign persons are free to make external transfers from their FX accounts.

Banks mostly approve kuna loans, so in the periods of high demand for loans as has been the case in 1H 2001, there is pressure on kuna appreciation. The kuna has appreciated 6% against the euro in only

two months. The extent of the appreciation looked dangerous, especially for exports and tourism, so the Croatian National Bank decided to introduce new measures in order to check kuna appreciation.

The Croatian National Bank tried to stop kuna appreciation through three interventions in May, buying around EUR 150 million, but it did not succeed in its efforts. As appreciation proceeded extremely fast, and the kuna appreciated by almost 6% in the subsequent two months, the Croatian National Bank decided to take more resolute steps than FX interventions. In the middle of May, the CNB Council adopted two important decisions. Firstly it lowered the rate of legal reserves from 23.5 to 22 percent, which has left a higher amount of kunas at the banks' disposal. The second decision extended the basis for the calculation of legal reserves also to external FX loans received. Extending the calculation basis has microeconomic effects. First of all, it constitutes an implicit introduction of a tax on commercial banks whose disposable assets decline, and asset sources are becoming more expensive, which will stop the decrease in interest rates that started together with the appreciation of the kuna. As a result, corporate loans will decrease (they grew by as much as 7.8% in the first quarter of this year, which is by far more than in the whole last year when growth of a mere 0.9% was recorded).

The unification of kuna and FX legal reserves was a positive decision by the CNB, as domestic and foreign currency was given equal importance, which can ultimately serve as a good basis for the introduction of the euro.

Against this background, the question is whether it is advisable to use an exchange rate regime in which the continuous switching from the domestic currency into foreign currency and vice versa only increases expenses to business subjects. In order to moderate the consequences of high eurisation, it is necessary to continue the liberalisation of external FX transactions, which is suggested in the second phase of liberalisation of the foreign currency payment system.

This means that the liberalisation of external FX transactions will influence the increased competitiveness of Croatian entrepreneurs who are struggling with competitive pressure in international markets, due to the existing FX regulations. The problem is that the capital account is still restricted to domestic legal persons, so that they can dispose of FX freely only to make

payment for legal business with foreign persons through banks authorised to make external payments, and they cannot transfer their money anytime they want. On the other hand, foreign physical persons can make all external payments from their FX accounts and make external transfers and withdraw FX from FX accounts and FX savings accounts up to the deposited amount, without any restrictions.

In the future, increased liberalisation of the capital account will enable Croatia to integrate into the European Union and introduce the euro more easily. In Croatia the euro is an extremely important currency, not only as regards savings, but regarding all transactions. That is to say, all transactions are indexed to the euro, regardless of the fact that the kuna has been stable for seven years already and even more profitable than the euro. Only during the last two months did kuna holdings earn 6% more than euro assets. Nevertheless, the euro, i.e. the German mark, is an irreplaceable part of everyday life in Croatia. Finally, the kuna is used only as a means of payment without any solid basis to function as a means of retaining value in Croatia.

In this context it is extremely important for Croatia to approach the euro area as soon as possible - be it through fixing the exchange rate or through the bilateral introduction of the euro. That is to say, costs of daily conversion from euro to kuna and vice versa are very high for the Croatian economy. Therefore, introducing the euro as soon as possible would be of great importance for the Croatian economy. In that case, Croatia ought to sign a special euro-monetary agreement with the European Central Bank through which Croatia would borrow the euro as its own currency, at the same time keeping its central bank. By abandoning the kuna, monetary sovereignty would not be lost, but it would certainly be limited, as it is already now due to the high level of foreign currency in circulation. The Croatian National Bank could thus forget about the exchange rate and concentrate on interest rates and prices.

The CNB's current assets today mostly comprise FX reserves amounting to around USD 3.5 bn, which is twice as much as the kuna share of the passive balance with the CNB. The passive balance includes kuna cash of about USD 700 million, the remaining share of primary money supply (money in accounts and banks' treasury, legal kuna reserves) about USD 600 million, CNB kuna Treasury Bills and money in state accounts of roughly USD 400 million, and the

remainder is denominated in FX: liabilities towards the IMF, FX Treasury Bills, legal FX reserves. The Croatian National Bank could buy euro cash for USD 700 million, and hence buy the same amount which is now circulating in kuna. The other part of CNB's passive balance consists of deposits. The result of this operation would be a decrease in reserves from USD 3.5 to 2.8 billion and the disappearance of the consideration of USD 700 million in kuna cash. A possible use for the reserves would then be as a basis for monetary expansion without fears about the exchange rate which would no longer exist by that time, because the euro would have become the official currency. Money supply could increase and decrease only through purchases and sales of state and personal securities in the open market. High capital inflows would no longer present a problem because nobody would have to convert FX into another currency. FX inflows would have the immediate effect of monetary expansion, and FX outflows would be a direct monetary restriction. This means that the central bank should react only upon estimated oscillations that could influence prices in an undesired way. The desired inflation would include a low premium above European inflation.

It is hard to expect that the European Central Bank will approve such a special euromonetary agreement. The question remains if the European Central Bank will give the licence for producing the Euro to an institution which has only just started to build its reputation, and how will customers and users of Euro look upon such an agreement. Unilateral introduction of the Euro is utopian, politically incorrect and an unacceptable move. Still there are no objective reasons for the European Central Bank weakening the administrative path towards the Euro.

It is reasonable for Croatia to look for a path towards the euro, since the country is a small and open economy recording eight to ten million border crossings and import accounting for around 40% of GDP.

Basic information and main features

Structural information

■ Land Area	56,538 sq km
■ Population	4.7 (estimate 2000)
■ Capital city	Zagreb
■ Fiscal Year	Jan 1st - Dec 31st
■ Currency	Kuna (HRK)

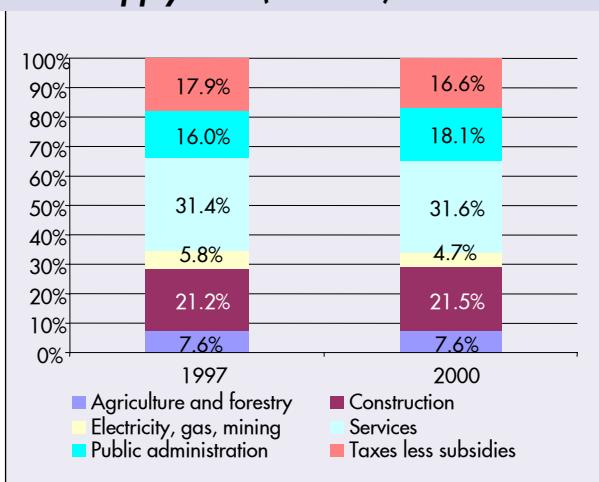
Source: Croatian National Bank, Croatian Bureau of Statistics, MoF

Foreign currency rating

	Long-term	Short-term
■ Standard & Poor's	BBB-	A3
■ Moodys	Baa3	P-3
■ Fitch IBCA	BB+	A3

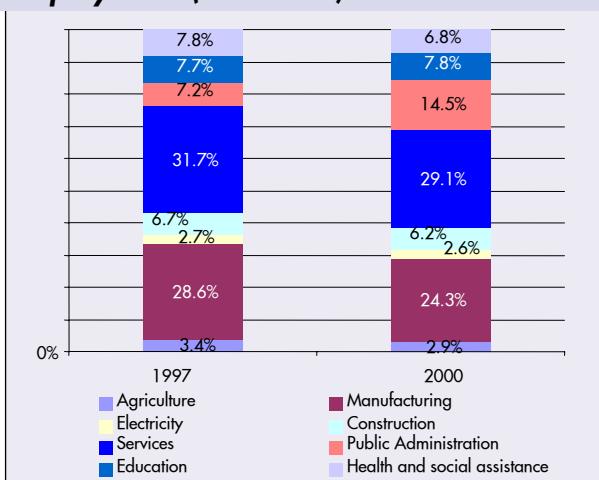
Note: On 9th February 2001 Standard & Poor's revised its outlook from "negative" to "stable".

GDP: supply side (% share)



Source: Croatian Bureau of Statistics, RZB-Group Research

Employment (% of total)



Source: Croatian Bureau of Statistics, RZB-Group Research

Major cities (population 1991)

Zagreb	1,100,000
Split	264,802
Rijeka	205,842
Osijek	164,589
Cakovec	118,707
Sl. Brod	113,547
Varazdin	94,044
Pula	84,583
Karlovac	80,844
Dubrovnik	70,676

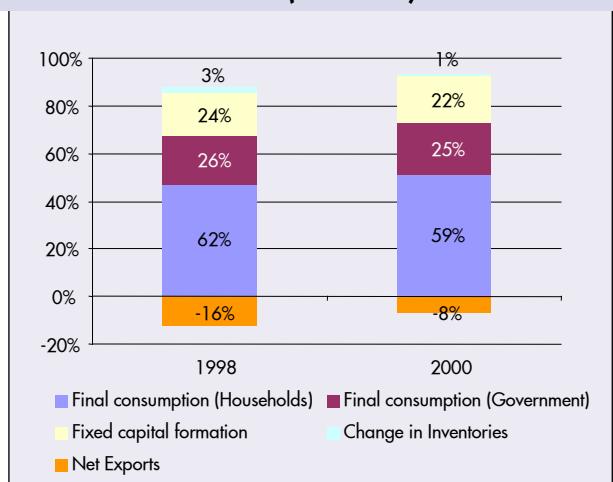
Source: Croatian Bureau of Statistics

GDP 2000

■ USD mil, current prices	19,030
■ USD, per capita	4,050
■ PPP USD, per capita	7,600
■ real growth rate	3.7%

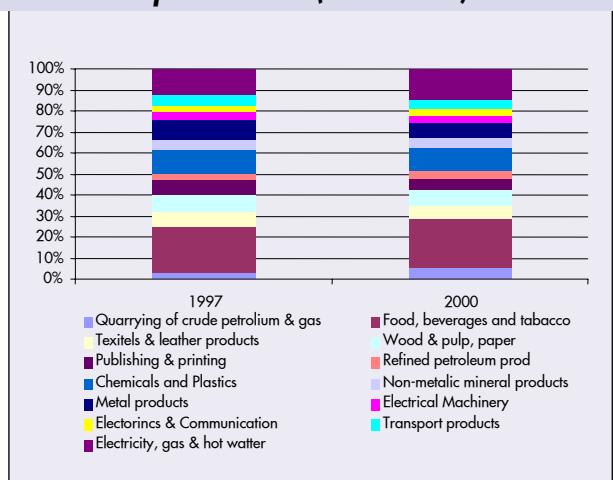
Source: Croatian Bureau of Statistics, RZB-Group Research, WIIW

GDP: demand side (% share)



Source: Croatian Bureau of Statistics, RZB-Group Research

Industrial production (% of total)



Source: Croatian Bureau of Statistics, RZB-Group Research

Local Elections confirmed

Dominance of Left-Wing and Right-Wing

At the last parliamentary elections (January 2000), the six-party coalition won the majority of seats in Parliament. In the past 18 months, the ruling coalition changed the Constitution twice. The goal of the first amendment was to curtail the authority of the President and hence ensure that Croatia will become a country with a parliamentary political system. The second time the Constitution was changed in order to abolish the Chamber of Counties which had no real political power.

Revoking all authority of the President, except over armed forces and in international relations has left the main political power in the hands of the government which was formed as a six-party coalition after the elections.

The last **municipal elections** were held on 20 May, and it was expected that Social Democrats and Social Liberals will reaffirm their strength, but an interesting polarisation occurred to the left and the right, the centre almost disappearing. Most of the votes in the capital Zagreb went to the Social Democrats, the Croatian People's Party and the Croatian Block which mostly consists of the Croatian Democratic Union, the majority party in Parliament until last year. This marks a **comeback of the Croatian Democratic Union** to the political scene, which is evidently a result of the present government's inability to fulfil the citizens' expectations.

The Social Democrats won most of the votes and are still the strongest political party in Croatia. That is, in most towns and counties in which it has been a ruling party within various coalitions the Social Democratic Party has succeeded in retaining the leading position. The Croatian Social Liberal Party, which formed a coalition with the Social Democrats after the last elections, suffered the steepest loss. They did not win a single seat in the City Assembly. The Croatian People's Party achieved the greatest breakthrough at the municipal elections. It is the second-strongest single party according to the number of votes. The Prime Minister's first statements indicate that there will be no major reshuffle of the government after these elections, but small changes are nevertheless possible.

Municipal elections

	Major city (Zagreb)	County of Zagreb
SDP	27%	18%
HDZ	20%	24%
HNS	18%	8%
HSS		22%
DC		7%
Independent	8%	

Source: RZB-Group Research

Main Political parties in Parliament

Ruling Coalition	Party leader	Orientation
Social Democrats Party (SDP)	Ivica Racan	Center-left
Social Liberal Party (HSLS)	Drazen Budisa	Center
Croatian Peasant's Party (HSS)	Zlatko Tomicic	Center-left
Istrian Democratic Party (IDS)	Ivan Jakovcic	Center-right
Liberal Party (LS)	Zlatko Kramaric	Center
Croatian People's Party (HNS)	Vesna Pusic	Center
Opposition Parties		
Serbian People's Party (SNS)	Milin Dukic	Right
Croatian Party of Rights (HSP)	Ante Djapic	Right
Democratic Center (DC)	Mate Granic	Center
Croatian Democratic Union (HDZ)	Ivo Sanader	Center-right

Source: RZB-Group Research

Election Schedule*

Presidential election	January 2005
Parliamentary elections	January 2004
Municipal elections	May 2005

Source: RZB-Group Research

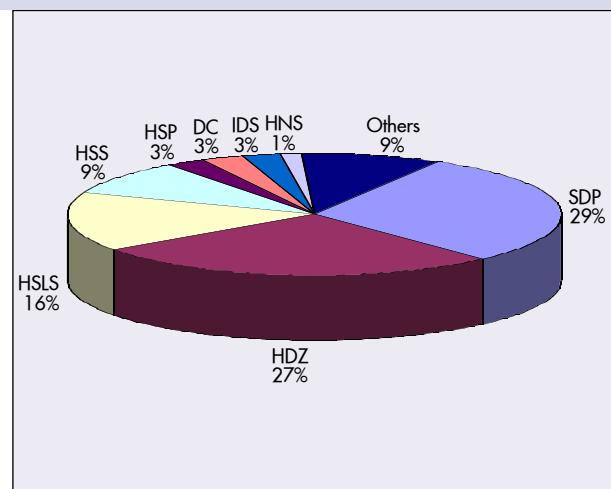
* elections for president are every 5 years, elections for parliament & municipal elections every 4 years

Ruling Persons

Function	Name	Party Affiliation
President	Stipe Mesic	no political affiliation
Prime Minister	Ivica Racan	Social Democrats
President of Parliament	Zlatko Tomicic	Croatian Peasants Party

Source: RZB-Group Research

Seats in Parliament



Source: RZB-Group Research

Economic indicators Croatia within CEE: Outlook

Real GDP (% yoy)

Countries	1999	2000	2001e	2002f
Poland	4,1	4,1	3,9	5,0
Hungary	4,5	5,2	4,6	5,0
Czech Rep.	-0,8	3,1	3,5	3,8
CEEC-3	3,0	4,1	3,9	4,7
Slovakia	1,9	2,2	3,8	4,5
Slovenia	4,9	4,8	4,0	4,5
Croatia	-0,3	3,7	3,4	3,8
Bulgaria	2,4	5,0	5,0	4,5
Romania	-3,2	1,6	3,0	4,5
Estonia	-1,1	6,8	5,0	5,5
Latvia	1,1	5,8	5,5	6,0
Lithuania	-4,1	2,5	3,5	4,5
CEEC-11	2,0	3,8	3,9	4,6
Russia	3,2	7,6	3,5	3,5
Ukraine	-0,4	5,3	1,0	1,0
EU-15	2,3	3,3	2,5	3,0
USA	4,1	5,0	2,2	3,5

Source: WIIW, RZB-Group Research

Consumer prices (avg, % yoy)

Countries	1999	2000	2001e	2002f
Poland	7,3	10,1	6,1	6,2
Hungary	10,0	9,8	9,2	7,0
Czech Rep.	2,1	3,9	4,0	3,5
CEEC-3	6,6	8,6	6,3	5,7
Slovakia	10,6	12,1	7,3	4,5
Slovenia	6,1	8,9	8,5	5,5
Croatia	4,2	6,2	5,3	4,0
Bulgaria	0,4	10,1	8,0	6,0
Romania	45,8	45,7	36,3	25,5
Estonia	3,3	3,9	4,7	2,9
Latvia	2,4	2,6	2,1	2,7
Lithuania	0,8	1,0	1,7	1,2
CEEC-11	10,3	12,3	9,4	7,5
Russia	85,6	20,8	22,0	16,3
Ukraine	22,7	28,2	27,8	26,9
EU-15	1,3	2,2	2,0	1,9
USA	2,2	3,4	3,0	2,7

Source: WIIW, RZB-Group Research

Current account (% of GDP)

Countries	1999	2000	2001e	2002f
Poland	-7,5	-6,1	-5,6	-5,0
Hungary	-4,3	-3,2	-4,4	-4,4
Czech Rep.	-3,0	-4,6	-5,3	-4,9
CEEC-3	-5,8	-5,1	-5,3	-4,9
Slovakia	-5,8	-3,1	-4,1	-4,0
Slovenia	-3,9	-3,3	-3,2	-2,9
Croatia	-7,5	-2,8	-4,0	-3,6
Bulgaria	-5,3	-5,8	-4,7	-3,5
Romania	-3,8	-3,9	-4,0	-4,1
Estonia	-5,7	-5,6	-5,7	-5,4
Latvia	-9,5	-7,2	-7,6	-7,9
Lithuania	-11,2	-8,1	-7,9	-8,5
CEEC-11	-5,7	-4,8	-5,0	-4,7
Russia	13,8	18,9	10,5	5,2
Ukraine	2,7	5,3	1,7	3,1
EU-15	0,6	-0,2	-0,2	0,3
USA	-3,5	-4,4	-4,5	-4,2

Source: WIIW, RZB-Group Research

Budget balance (% of GDP)

Countries	1999	2000	2001e	2002f
Poland	-3,5	-2,7	-3,0	-2,5
Hungary	-3,7	-3,4	-3,4	-3,3
Czech Rep.	-1,6	-7,7	-9,4	-8,6
Slovakia	-3,6	-4,0	-4,5	-4,0
Slovenia	-0,6	-1,0	-1,5	-1,3
Croatia	-6,5	-6,7	-5,3	-4,3
Bulgaria	-1,0	-1,0	-1,5	-1,5
Romania	-4,9	-3,7	-4,2	-3,8
Estonia	-4,7	-1,1	-0,5	-0,8
Latvia	-4,2	-3,3	-1,7	-2,0
Lithuania	-7,4	-3,6	-1,9	-1,6
Russia	-1,7	2,4	-1,0	-1,0
Ukraine	-2,2	-1,3	-3,2	-2,4
EU-15	-1,5	0,6	-0,3	0,0
USA	1,3	2,5	2,5	1,8

Source: WIIW, RZB-Group Research

Exchange Rate LCY/EUR

Countries	1999	2000	2001e	2002f
Poland	4,23	4,01	3,73	4,29
Hungary	252,8	260,1	260,1	261,8
Czech Rep.	36,9	35,6	34,3	34,4
Slovakia	44,1	42,6	43,3	43,0
Slovenia	193,6	205,0	216,5	222,5
Croatia	7,58	7,64	7,35	7,34
Bulgaria	1,9558	1,9558	1,9558	1,9558
Romania	16295	19956	27324	36822
Estonia	15,6	15,7	15,7	15,7
Latvia	0,63	0,56	0,55	0,59
Lithuania	4,28	3,72	3,69	3,85
Russia	26,5	26,2	26,9	32,5
Ukraine	4,4	5,1	5,9	8,4
USA	1,07	0,93	0,92	1,02

Source: WIIW, RZB-Group Research

Exchange Rate LCY/USD

Countries	1999	2000	2001e	2002f
Poland	3,95	4,31	4,07	4,19
Hungary	237,2	279,6	285,1	256,2
Czech Rep.	34,5	38,3	37,4	33,6
Slovakia	41,4	45,8	47,5	42,0
Slovenia	181,8	220,5	235,3	217,5
Croatia	7,11	8,21	8,01	7,18
Bulgaria	1,828	2,103	2,132	1,911
Romania	15333	21458	29700	36100
Estonia	14,7	16,8	17,0	15,3
Latvia	0,59	0,61	0,60	0,58
Lithuania	4,00	4,00	4,02	3,76
Russia	24,9	28,2	29,3	31,8
Ukraine	4,1	5,4	6,5	8,2
Euro-11	0,93	1,08	1,09	0,98

Source: WIIW, RZB-Group Research

Economic growth to slow down

Pessimism about the world economy is still spreading. Europe too seems increasingly vulnerable to the recession virus. The reason is that the leading indicators for ***Euroland*** have also continued to deteriorate. To date, the ***CEE economies*** have been little affected by fears of recession in the USA and Japan and worries about growth within the EU. The CEE economies are in the middle of the convergence processes that are needed for EU membership and are driving growth forward with the help of privatisations and investment.

The central bank's excessively restrictive monetary policy will dent ***Poland's*** growth, especially during H1. High real interest rates have weakened domestic demand. Consequently, we have reduced our Polish growth forecast for 2001 to 3.9%. The slowdown of the EU economy is likely to make itself felt in ***Hungary's*** export performance. However, that should be partly offset by increases in public-sector and private consumption. For the ***Czech Republic*** and ***Slovakia*** we expect an acceleration of GDP growth due to a strengthening of domestic demand. Expectations of lower economic activity have become even more widespread. The slowdown of economic growth in the EU will burden trade balances in the CEE region and is unlikely to be offset by the lower oil prices. As a result, we expect most CEE economies (with the exceptions of Poland and Bulgaria) to develop slightly bigger C/A deficits. However, those deficits should be significantly smaller than those that necessitated corrections in the past. In addition, they will without exception be solidly financed.

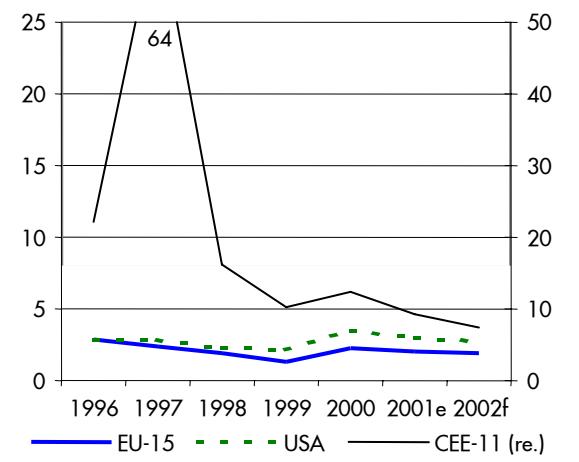
That will create investor confidence and will have clear consequences: among other things, those countries' currencies will remain strong in the short and medium term (including and above all versus the EUR). A strong currency also creates risks in a rallying economy, but that should not yet become an issue before mid-year. Instead, the principal source of support for exchange rates is likely to be FDI in an environment in which all the economic data show a strong performance - ranging from falling rates of inflation to sustained growth at its full.

Interest and yield forecasts

		current	Sep-01	Dec-01	Mar-02
Euro-12	3m MM rate	4.6	4.3	4.3	4.4
	5y Bond	4.7	5.6	5.7	6.0
	10y Bond	5.1	6.2	6.4	6.6
USA	3m MM rate	4.0	4.0	4.1	4.1
	5y Bond	4.9	4.8	5.0	5.3
	10y Bond	5.5	5.3	5.7	6.0

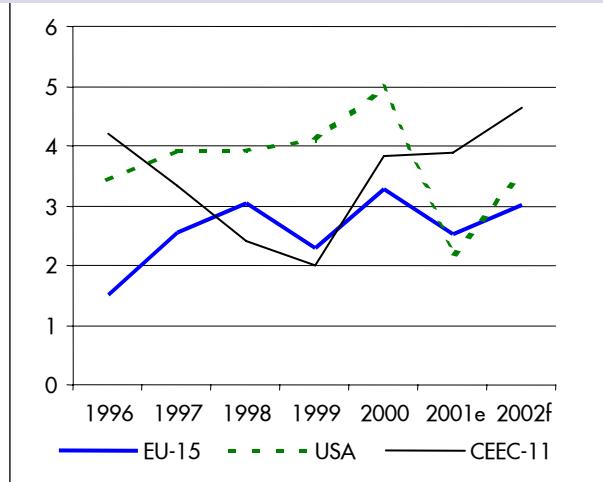
Source: Reuters, RZB-Group Research

Consumer prices (avg, % yoy)



Source: Thomson Financial Datastream, RZB-Group Research

Real GDP (% yoy)



Source: RZB-Group Research

FX-rate forecasts

currency	current	Sep-01	forecast
			Dec-01
			Mar-02
USD/EUR	0.88	0.89	0.95
% chg.		-0.8	-7.1
JPY/USD	123.7	120	115
% chg.		3.1	7.5
JPY/EUR	109.3	107	109
% chg.		2.3	0.0

Source: Reuters, RZB-Group Research

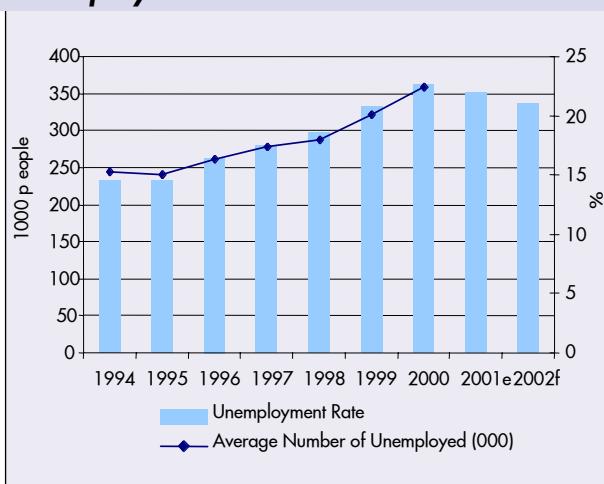
Out of depression... at a slow pace

Growth outlook



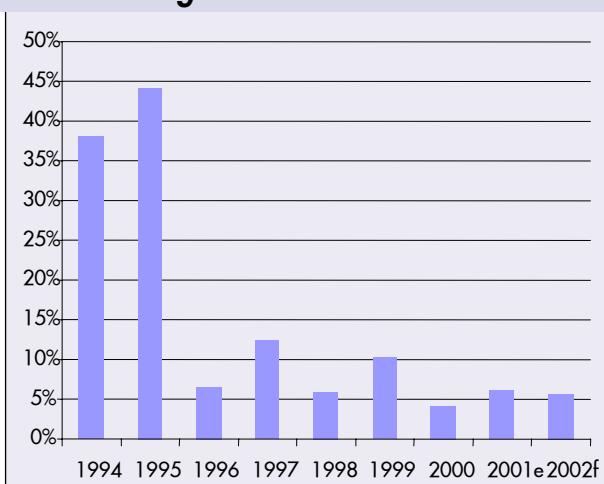
Source: Croatian Bureau of Statistics, RZB-Group Research

Unemployment



Source: Croatian Bureau of Statistics, RZB-Group Research

Real net wages



Source: Croatian Bureau of Statistics, RZB-Group Research

Following a decrease in gross domestic product in 1999, Croatia reached GDP growth of 3.7% last year. Unfortunately, last year's positive economic growth is not convincing because it relies on strong growth of personal expenditure (4.1%) and an exceptionally good tourist season, which made export of goods and services in gross domestic product grow at a rate of 8.7%. Industrial production rose by a mere 1.7% last year, which is not sufficient for attaining a notable rate of economic growth. Last year recorded the sharpest decrease in investment (-3.5%) in the past few years, and this year should see a decline by about 1%.

In March this year, Croatia signed an agreement with the International Monetary Fund on a stand-by arrangement, lasting 14 months and worth SDR 200 mn. The Croatian economy needs such an agreement in order to show potential investors that it is able to maintain macroeconomic stability achieved and to lower internal economic imbalances.

It is important to attract so-called greenfield investments, i.e. investments in technologically advanced branches of production which have the greatest positive effect in the sense of positive long term economic growth, employment and a levelled balance of payments. As Croatia lacks exactly this kind of investment and as no projects have been announced for the near future, we do not expect real GDP growth to exceed 3.4% in 2001. Thus, for the scenario featuring economic growth rising over 4% annually this year to materialise, there will have to be fiscal success in improving the state of the economy as well as higher foreign direct investments.

Investment



Source: Croatian Bureau of Statistics, RZB-Group Research

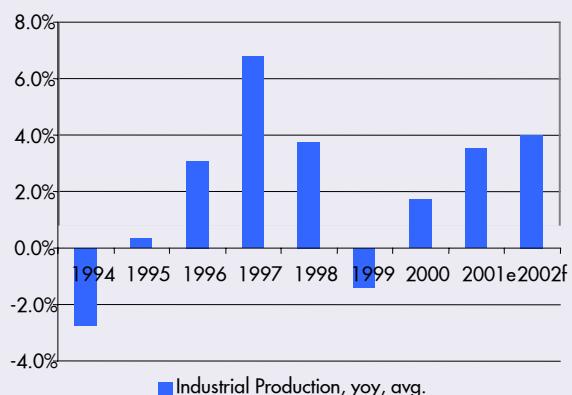
Industry is recovering, tourism is intensifying

Last year industrial production grew at the rate of only 1.7%, as a consequence of a decrease in production at the beginning of the year following the general elections. At the beginning of this year the situation is remarkably different, and one can notice a much stronger recovery in production than expected already in the first four months. January already indicated a take-off of industrial production due to the low base in January last year, at the time of the general elections. After a slight decrease in February, March recorded strong growth by 4.6% compared to March last year, and April saw an increase of as much as 9.8% in relation to April last year. Cumulative growth during the first four months of the year 2001 was 6.6% when compared to the same period last year. Current optimism regarding results in this year's industrial production might soon wane because slight a fall-off in economic growth is expected in the European Union countries, and thus also lower import demand. As 43.1% of Croatian merchandise exports is directed towards the EU countries, it is possible that also production directed at exports to the EU will slacken.

One can expect that this year's production will record significantly higher growth rates than in the last two years, but in any case Croatia needs considerable foreign direct investments, the so-called greenfield investments, to attain high growth rates in industrial production. This year does not show signs of big investments, but the government expects more smaller-scale investments which will not influence industrial production growth notably.

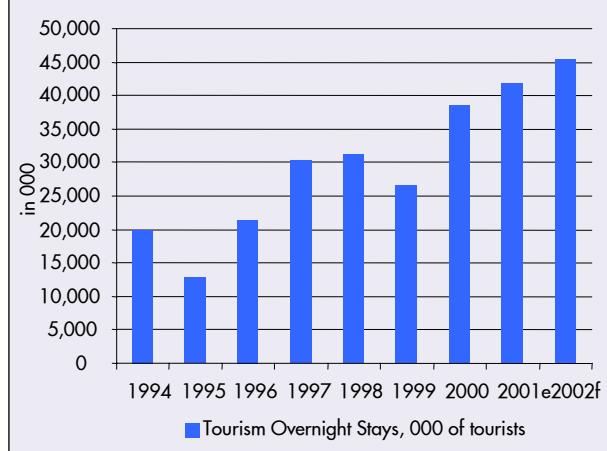
Tourism is Croatia's most important export sector and significantly improved last year, after weak growth in 1998 and a decrease in 1999. A 45% rise in the number of overnight stays is an outstanding result raising hopes that this year will also yield a good result. Last year's FX inflow from tourism amounted to EUR 3 billion. Results from the beginning of this year and estimates for March and April give reason for optimism. The importance of tourism is all the greater when the trade deficit is financed from the inflow of tourism revenues. Along with financing the trade deficit, tourism is an important sector which increases private consumption during the third quarter. This year is expected to see an increase in the number of foreign tourists coming mostly from Central Europe: Germany, Austria, Italy, Slovenia, Slovakia, the Czech Republic and Hungary. According to our forecasts, the number of overnight stays could register an increase by around 9% compared to last year.

Industrial Production Outlook



Source: Croatian Bureau of Statistics, RZB-Group Research

Tourism Overnight Stays Outlook



Source: Croatian Bureau of Statistics, RZB-Group Research

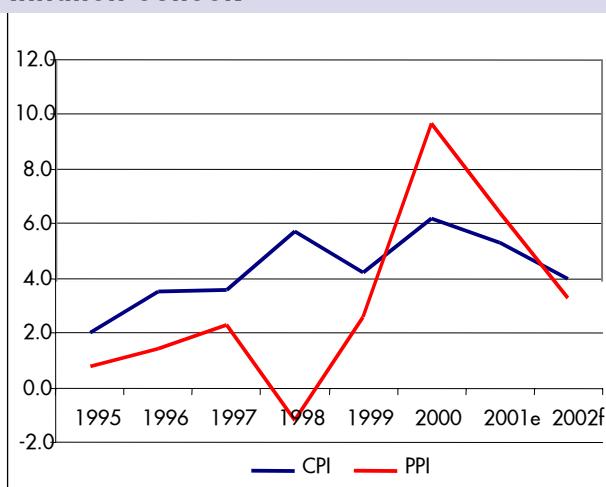
Tourism Overnight Stays Growth Outlook



Source: Croatian Bureau of Statistics, RZB-Group Research

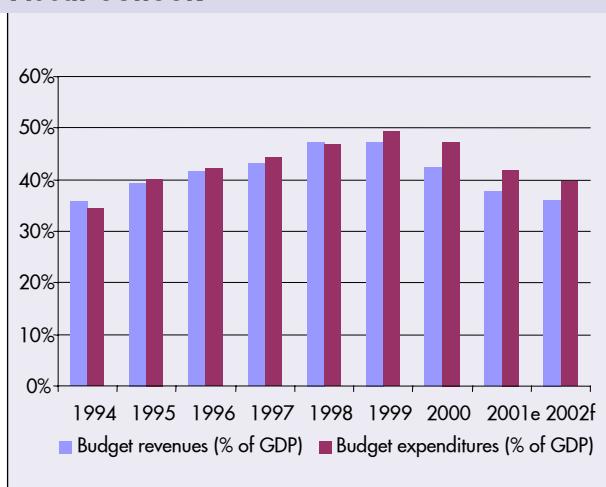
Need for lower price increase and budget expenditure

Inflation outlook



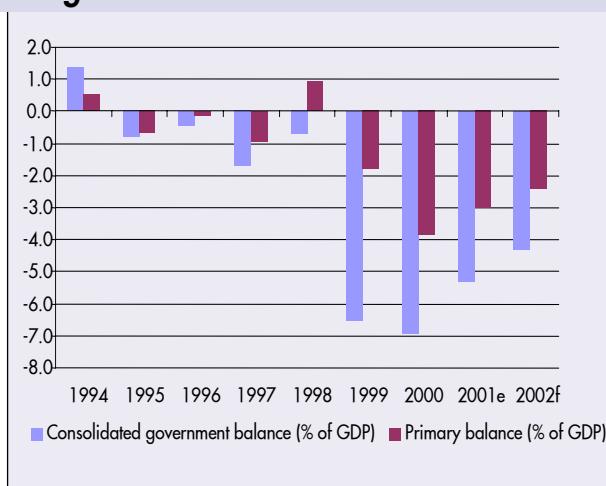
Source: Croatian Bureau of Statistics, RZB-Group Research

Fiscal outlook



Source: MoF, RZB-Group Research

Budget balance



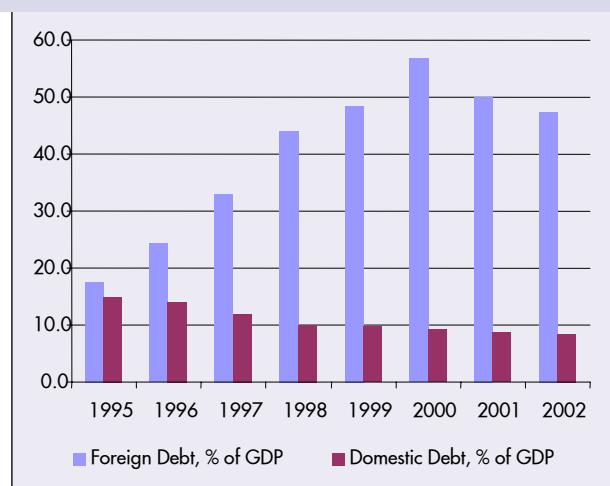
Source: MoF, RZB-Group Research

Last year recorded the highest growth rate in prices in the past six years. Retail prices rose 6.2% on average, which was mostly due to the implementation of duties on tobacco and beverages, as well as oil products and energy price increases. Year-on-year growth in the Industrial Product Price Index is 11.2%, and 9.7% on average.

Last year's inflation pressure continued also in this year due to oil price increases and a stronger dollar on the international markets. At the beginning of 2001 the government introduced a **new mode of calculating** the oil price every 15 days by applying a formula including the change in the oil price on world markets and the movement of the US dollar exchange rate against the euro. As this year saw oil price rises and dollar appreciation against the euro, all oil product prices on domestic market grew. Additionally, the government introduced a petroleum fee for **financing construction of roads** in March.

The budget for 2001 was established in the context of the agreement with the IMF which requested budget expenditure to be **reduced to a tenable framework**. The central budget is still heavily burdened by pension and health care funds which are mostly financed from the central budget. The long-expected pension fund reform was announced to take place in the beginning of 2001. Until the end of 2001, privatisation inflows of around USD 1 bn are expected. However, it is questionable whether the sale of 16% of Croatian Telecom to Deutsche Telekom will be realised. Should this privatisation not take place, the state will have to find an **alternative source of financing**. It is expected that the deficit of the consolidated central government will amount to -5.3% at the end of this year.

Public debt



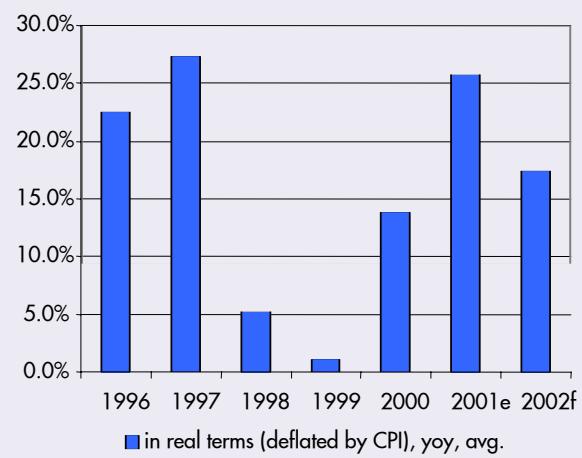
Source: Croatian National Bank, MoF, RZB-Group Research

Recovery in lending activity... to the corporate sector

Last year was marked by an increase of commercial banks' credit activity, especially towards the **household** sector. Loans from commercial banks increased by 10.2% last year. Loans to the households increased by 21.0%, and only 0.9% increase was recorded toward corporate sector. Looking at the whole banking system, the average interest rate on short-term kuna loans had amounted to 15.3% at the beginning of 2000, whereas it decreased to a mere 10.5% by the end of the year. A more **significant decrease in lending rates** compared to deposit rates shows that **interest margins have decreased**, which made banks strive to be more efficient and to adjust their businesses to new market circumstances. During the first quarter of this year, banks' credit activity to the corporate sector increased by 7.8% in comparison to the level at the end of last year.

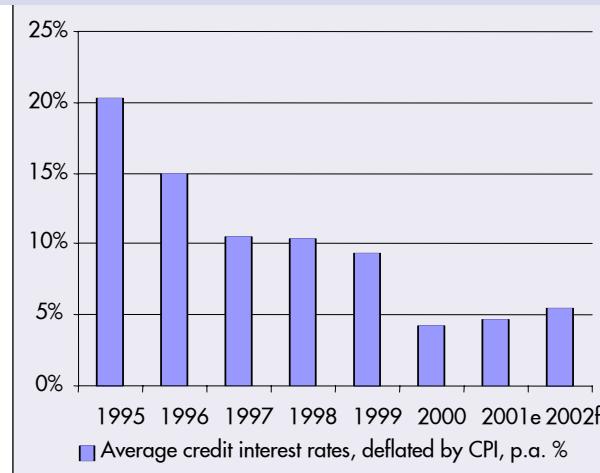
The current account deficit significantly decreased in 2000 to -2.7%, compared to -7.3% of GDP in the previous year. This decrease was realised thanks to a **good tourist season** which ensured record revenues from tourist services. As usual, the deficit occurred in merchandise trade. The trade deficit was HRK 29.3 bn. In 2000 foreign investments were lower than in the previous year, because the privatisation of Croatian Telecom was postponed until 2001. **Foreign investments covered** the current account deficit, so they remain a significant source of financing the current account. As regards the structure of foreign direct investments, purchases of existing companies are still absolutely predominant. Foreign exchange reserves reached a record level of USD 3.5 bn in 2000.

Money supply



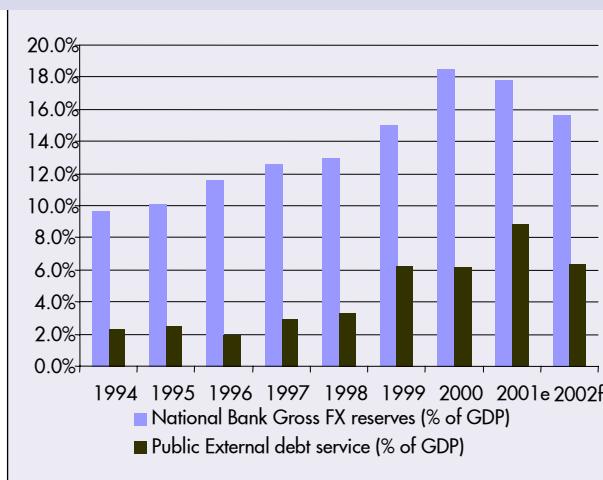
Source: Croatian National Bank, RZB-Group Research

Real Interest rates



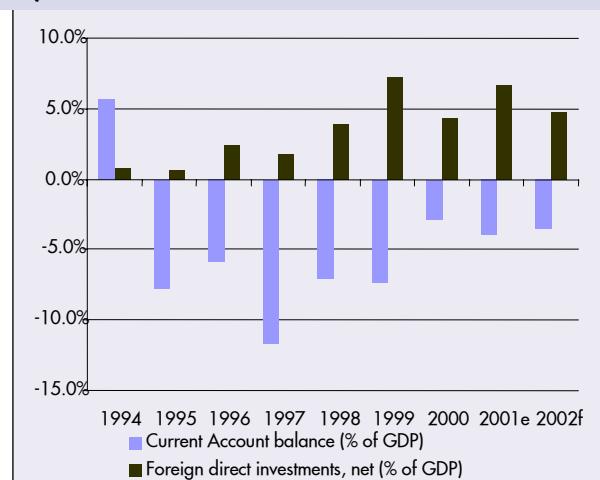
Source: Croatian National Bank, RZB-Group Research

FX-reserves



Source: Croatian National Bank, RZB-Group Research

C/A and FDI



Source: Croatian National Bank, RZB-Group Research

Sudden appreciation ... before tourist season

FX-outlook

	current	Jun 01	Sep 01	Dec 01
HRK/EUR	7.3320	7.2953	7.2224	7.2500
HRK/USD	8.3101	7.9297	8.1150	7.6320

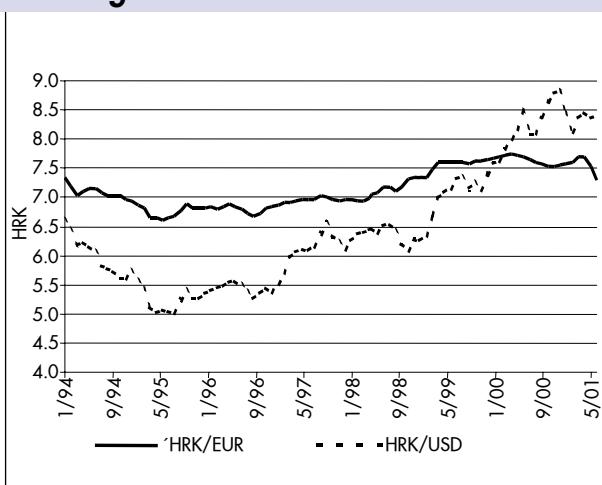
Source: Reuters, RZB-Group Research

Exchange rate arrangement

- Free float regime
- Totaly orientated towards Euro, with the perspective of fixed regime in future and introduction of Euro

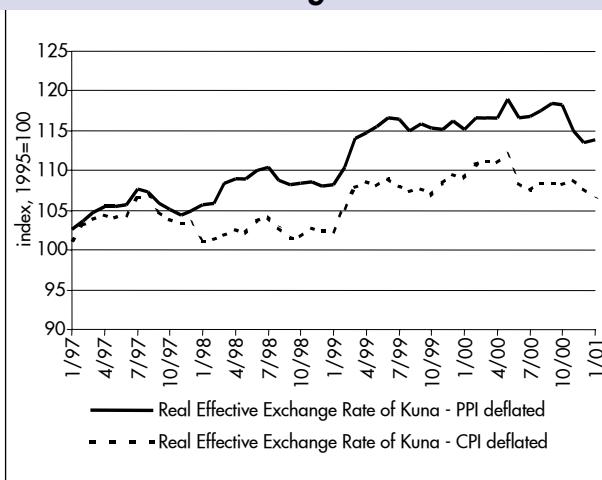
Source: RZB-Group Reserach

Exchange Rate



Source: Croatian National Bank

Real Effective Exchange Rate



Source: Croatian National Bank, RZB-Group Research

The kuna appreciated against the euro in 2000. By year-end, it had appreciated by 1.1% against the euro over the whole of 2000, i.e. it depreciated by 0.7% on an average annual exchange rate. This movement in the exchange rate mirrors the economic environment in the previous year, which was marked by a hefty FX inflow during the tourist season. The relation of the kuna against the US dollar was determined by the exchange rate of the euro vs. the dollar. The euro depreciated against the dollar significantly last year, so that the US dollar exchange rate jumped above the 9 kuna level. After the euro appreciated at the end of the year, the dollar exchange rate amounted to 8.15 kunas last year. Due to the high increase in the price level, last year recorded an appreciation of the real effective exchange rate deflated by PPI by 2.4%.

The second quarter of this year witnessed the beginning of intensive nominal appreciation of the kuna against the euro. In April, Croatia registered a **significant inflow of foreign currency** through transfers and from tourists visiting Croatia during their holidays. Along with that, kuna appreciation is a consequence of increased demand for kunas in the interbank market, which occurred due to ever greater demand for loans disbursed in kuna and higher foreign currency positions which are profuse on the banks' accounts. In this context, banks were forced to convert their foreign currencies into kunas in order to be able to disburse loans and to exit the long foreign currency positions in their balance sheets. By doing that, banks found themselves in an endless circle which resulted in kuna appreciation against the euro every day and which the Croatian National Bank tried to stop through three foreign currency interventions in which it purchased EUR 150 mn. It is evident that these interventions were insufficient, so the Croatian National Bank decided **to introduce a new legal reserve** on foreign currency loans from abroad in an attempt to decrease foreign currency supply on the domestic market. This will lower foreign currency supply administratively, but it will also decrease loan supply in kunas which has set off towards the corporate sector at long last. The decrease in interest rates will not continue. During April and May the kuna appreciated by 5% against the euro.

This year an even better tourist season is expected than last year and hence also higher foreign currency inflow during the tourist season. Therefore, further pressure on kuna appreciation will not cease until the end of August.

Banking

Croatian Banking Sector in 2000

Structural changes in the Croatian banking industry started with bankruptcies, mergers and acquisitions in 1998 and continued through 1999 and 2000 with **consolidation** which brought stability in the system. The **share of foreign banks** in the Croatian banking sector has grown to 56% (if the share of Zagrebacka banka is included, this share was 87%), which is the main characteristic of the market, along with the process of concentration in the banking sector. According to the latest information from the Croatian National Bank, there are 43 banks operating in Croatia, 20 savings banks and 4 building societies. Out of total number of banks, 21 are foreign-owned, and foreign investors have minor shareholdings in a few others. The appearance of foreign banks in the Croatian market improved overall performance of the banking system, forcing existing banks to develop new products and services.

High concentration is evident in the market share of the 2 biggest banks (Zagrebacka and Privredna banka) which was 52% based on total assets, while the market share of the 5 biggest banks was 71% at the end of 2000. Since banks finished the process of positioning themselves in the market in 2000, no major changes are expected in the course of 2001.

At the end of 2000, total assets of Croatian banks amounted to 112.7 bn kuna, which represents an increase by 20% compared to the end of 1999 (93.7 bn kuna). Loan activity has shown a **distinctive recovery** and is therefore expected to reach the level of 1998 (60 bn kuna). Loan diversification has changed, i.e. share of corporate loans decreased from 69.2% in 1998 to 60.4% at the end of 2000. At the same time, the share of loans approved to retail clients increased from 29.7% (1998) to 37.9% (2000). Besides growth in financing retail clients, a continuous increase was recorded in placements of T-bills of the Croatian National Bank. Placements of the CNB have grown from 1% in 1997 to 4.7% in 2000. This development shows a slow recovery of the corporate sector which forced banks to invest in less risky placements and to maintain a sufficient level of liquid assets. Improved confidence in the banking system is evident through the increase in savings, especially savings in foreign currencies which grew by DEM 2.5 bn in 2000. Moreover, **confidence** of retail customers was strengthened by a bond issue of the State Agency for Deposit Insurance and Bank

Rehabilitation by which the deposits from bankrupted banks were paid off.

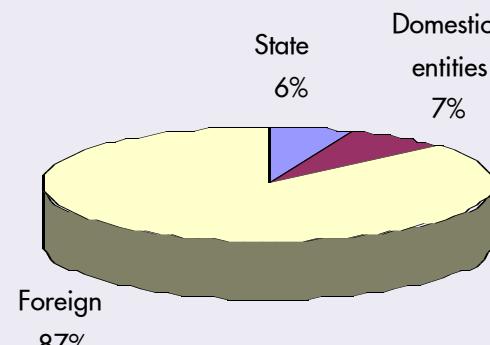
Profitability of the Croatian banking system as measured by average return on assets was 1.7% at the end of 2000. Compared to 1999, profitability of Croatian banks rose by 0.8 percentage points in 2000. Return on equity of the whole banking system was 15.65%, which is 7.66 percentage points higher than in 1999.

Assets

		<i>mn HRK</i>
2000		
1	Zagrebacka banka	32,453
2	Privredna banka Zagreb	20,574
3	Splitska banka	8,028
4	Rijecka banka	7,915
5	Raiffeisenbank Austria	5,047

Source: Reuters, RZB-Group Research

Banks' ownership - 2000



Source: CSO, RZB-Group Research

Profit Before Taxation

		<i>mn HRK</i>
2000		
1	Zagrebacka banka	978
2	Privredna banka	379
3	Rijecka banka	135
4	Raiffeisenbank Austria	111
5	Hypo Alpe-Adria-Bank	62
6	Erste & Steierm. Bank	57
7	Splitska banka	49
8	Varazdinska banka	36
9	Stedbanka	34
10	Bank Austria Creditanst.	25

Source: Croatian National Bank; Bank Bulletin; March 2001

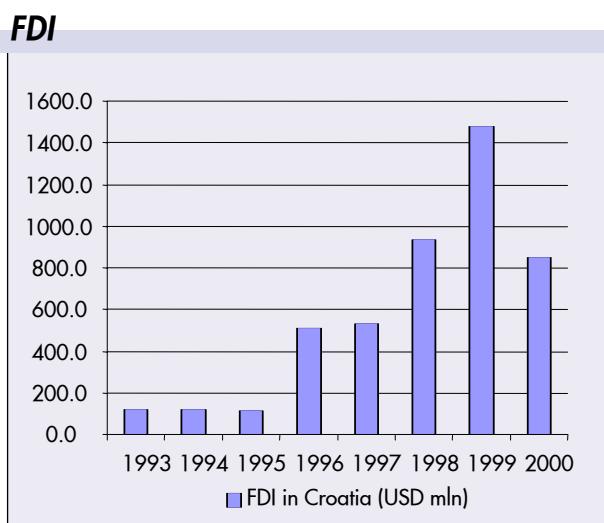
Structural progress on the privatisation front

The process of privatisation started in Croatia in 1991, and the privatisation programme aimed at privatising around 3,000 "socially-owned" enterprises. Privatisation was conducted in two phases: the first phase was implemented through the Privatisation Act of 1991, and the second through the new Privatisation Act of 1996. That is to say the IMF and the World Bank requested that two agencies appointed for privatisation merge into one. Looking at this development as a whole, privatisation processes in Croatia started relatively slowly, but accelerated after 1996, when privatisation processes were necessary for closing fiscal gaps - above all, the privatisation of profitable companies that could be sold on the international market. FDI in Croatia were mostly channelled through purchases of existing privatised companies and were to a lesser extent direct investments in

new companies. Therefore, the greatest share of privatisation processes can be deduced from the FDI position in the capital account of the balance of payments. Foreign direct investments are recorded in a wide range of sectors of the Croatian economy. The pharmaceuticals, telecommunications and financial services sectors have been most successful in attracting FDI.

In 1999 the Croatian government closed the biggest privatisation deal by selling 35% of Hrvatske Telekomunikacije (Croatian Telecom) to Deutsche Telekom. Privatisation was again strong in 2000, with three state-owned banks being sold to foreign strategic partners.

It is expected that the **remaining two banks** which have been owned by the state since rehabilitation will be sold in 2001, which is very important for this year's budget to ensure funds from privatisation amounting to around USD 1 billion. Therefore, along with the two banks, privatisation will also include the **biggest insurance company** in Croatia which is still owned by the state. However, this cannot be expected to ensure sufficient income to attain the expected inflow, so that the most important privatisation will be the second round of Croatian Telecom this year. First of all, it is expected that 16% will be sold to Deutsche Telekom for approx. EUR 500 mn, which would close fiscal gaps, a part is earmarked to be sold through an IPO, and the remainder is expected to be sold to current and former employees in Croatian Telecom and war veterans. The Croatian government postponed the remaining privatisation of Croatian Telecom due to the current environment in the field of technology shares. It is expected that this situation will improve in the last quarter of this year.



Source: Ministry of Finance, RZB - Group Research

Privatisation Outlook

Year	Company	Investor
2000	Croatia Insurance	Deutsche Telekom, IPO
	Croatia Bank	
	Dubrovacka Bank	
	Croatian Telekom	
2001	INA - oil company	
	HEP - electricity company	
	Croatian Railways	

Source: RZB - Group Research

Privatisation of utilities was left for the next year and is also very important for the realisation of budget revenues. Privatisation of **utilities** will be carried out in accordance with the Privatisation Act and with specific legislation for each individual privatisation project. The method of privatisation of each utility is to be approved by Parliament following a proposal by the Ministry of the Economy. At the outset the government will retain a majority of shares but may also retain certain rights in certain utilities to ensure that the government's interests are protected. Major transactions in the utilities privatisation initiative in the near future include the national oil and gas company **INA**, and Croatian electricity utility **HEP**. These projects are planned for 2002.

Structure of Foreign Trade

Types of Goods, Regions

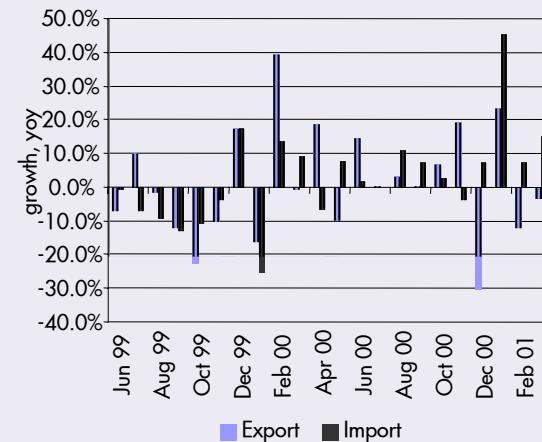
Croatia has been recording a deficit in international trade almost traditionally and mostly covers it by inflow from the service sector, primarily from tourism. The openness of the Croatian economy can best be seen in the share of total merchandise trade (exports + imports) in effective domestic demand (households + government consumption + fixed capital formation) which amounted to 64% in 2000 (in current prices). This shows that the Croatian economy is susceptible to external oscillations, but not to a dramatic extent due to poor exports, covering only 55% of imports.

Fluctuations in the developed countries of the European Union - above all in Italy, Germany and Austria, which cover 43.1% of total Croatian exports - have the strongest influence on Croatian exports. Also, two regions from the former Yugoslavia - Bosnia and Herzegovina as well as Slovenia - are important for Croatian exports and account for 22% thereof. After political stabilisation in SR Yugoslavia, Croatian exports are slowly shifting to that region as well, so that the first quarter of this year saw a 267.2% rise of exports to SR Yugoslavia, compared to the first quarter last year.

Croatia imports significant amounts of oil and oil products, medical and pharmaceutical products, machinery and transportation equipment (of which road vehicles have the largest share). Last year imports of road vehicles increased by 22.5% in comparison to the previous year. The highest export share is registered in the segment of other transportation equipment, apparel, oil and oil products, cork and wood.

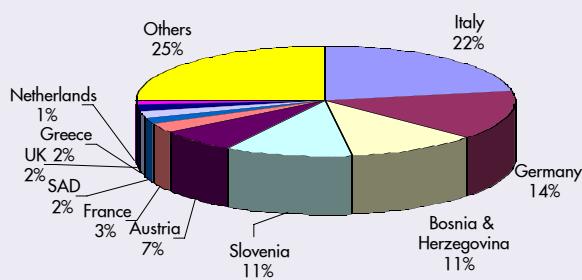
The trend of fast import growth and slow export growth has continued this year. In the first quarter, merchandise imports were around 26.7% higher than in the same period last year. Imports of road vehicles - which account for about 10% of overall imports - increased by 20.8% and reached USD 1.4 bn in the first quarter. The trade deficit for the first quarter amounted to USD 891 mn, which is 51.1% higher than in the same period last year. Imports increased much stronger than we expected, while export developed in line with our expectations with a 7.2% increase in the first quarter. The main reason for higher than expected figures on the import side is car sales which reached a record level in March. Due to the government's decision to abandon prerogatives of war veterans to import cars free of tax, customs and tariffs, we the trade deficit to remain high in the first half of 2001. This will have a negative impact on the current account of the balance of payments.

Export, Import



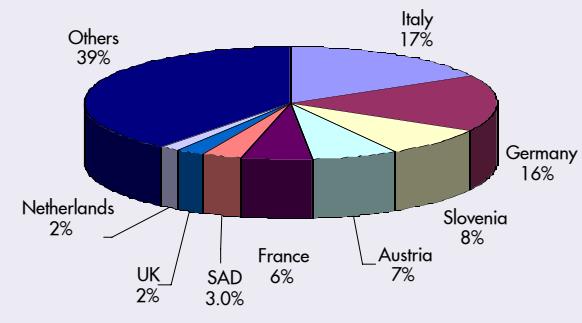
Source: Croatian Bureau of Statistics, RZB-Group Research

Structure of export by region



Source: Croatian Bureau of Statistics, RZB-Group Research

Structure of import by region



Source: Croatian Bureau of Statistics, RZB-Group Research

Short term and Euro dominates

Since their inaugural Eurobond issue in February 1997, the Croatian government has almost exclusively used international markets for medium and long-term financing, leaving the domestic bond market largely undeveloped.

Supply and Demand

Croatia's domestic debt market is dominated by government securities issued by the Ministry of Finance and by the Croatian National Bank. The main instruments are **Treasury bills** with 42, 91 and 182 days maturity and **CNB bills** with 35, 70 and 105 days maturity. The current outstanding volume of T-bills amounts to HRK 4.6 bn and HRK 2.6 bn, respectively. It is expected that the CNB will slowly decrease the issuance of its bills, leaving the MINFIN as the only issuer of short-term government securities.

Last year, two **government agencies** (the Croatian Health Fund and the Croatian Agency for Deposit Insurance and Bank Rehabilitation) issued bonds with 3, 4 and 5 years maturity and a total volume of EUR 552 mn, guaranteed by the government. The bonds which are now traded on the Zagreb Stock Exchange are **denominated in EUR**, with all **payments** however **effected in HRK** at the prevailing mid-rate of the CNB.

On the demand side, besides the banks as the main investors for government securities, increased demand from other institutional investors was observed last year. Privatisation funds, investment funds and insurance companies are increasingly investing in fixed income instruments. With the pension system

reform scheduled to start in January 2002, we expect further increase in demand for debt instruments in the second half of 2002 which should then encourage the government to **start regular domestic bond issuance**.

Instruments and primary market

T-Bills are issued by the Ministry of Finance at self-organised auctions which are open to all physical and legal persons of Croatia. The Bills are issued as registered dematerialised securities with a nominal value of HRK 100,000. The Ministry of Finance organises and conducts the auctions, keeps the register and arranges the transfer of ownership in case of secondary market transactions.

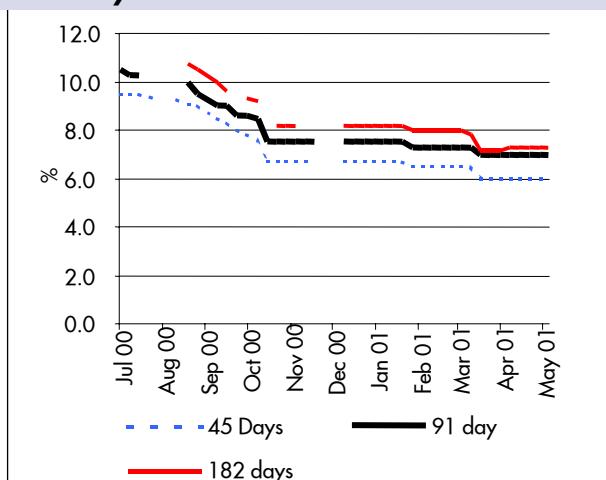
Instruments:

Discount Treasury Bills

These instruments have maturities of 42, 91 and 182 days. Auction frequency: Weekly, on each Tuesday. The issue series, maturities and the total amount to be issued is announced a few days earlier. Auction procedure: (a) On the auction day, before 11 a.m., the Ministry of Finance receives the offers (volume offered, discounted price and tenor if applicable); (b) The Ministry of Finance ranks the offers according to the price offered and determines the lowest acceptable discounted price; (c) All offers at or above this price are accepted. The accepted discount price is the price then charged to all participants. Payment: On the second working day after the auction. Issue form: Dematerialised, book entry in the Register at the Ministry of Finance.

CNB-Bills are issued by the Croatian National Bank at similar self-organised auctions which are however only open to Croatian financial institutions. The Bills are issued as registered dematerialised securities with a nominal value of HRK 100,000. The Croatian National Bank organises and conducts the auctions, keeps the register and arranges the transfer of ownership in case of secondary market transactions. Currently, there are no regular government bond issues.

Treasury Bills Rates



Source: Ministry of Finance, RZB - Group Research

Domestic Bond market

In the year 2000, three bonds were issued on the domestic market, namely by the Croatian Health Fund (HZZO) and the Croatian Agency for Deposit Insurance and Bank Rehabilitation (DAB 3 and DAB 5).

Yields on all three domestic bonds declined sharply in the first quarter of the year, in line with Croatian Eurobonds traded on the international markets. However, with a spread of 120-140 bps over Eurobonds with a similar maturity, domestic bonds **still offer very nice yield advantages**, especially for domestic investors. Foreign investors are still reluctant to take advantage of this opportunity, mainly due to the currency risk and FX costs which they face when selling or redeeming the bonds at maturity, since all payments are effected in HRK at the prevailing CNB mid-rate.

Secondary market

To buy or sell domestic bonds, investors are required to have a "securities account" with the Central Depository Agency (CDA) and a HRK account with a Croatian bank, or a custody account with a Croatian bank and have to place orders with a registered Zagreb Stock Exchange (ZSE) member. All major Croatian banks are able to quote prices on demand, however due to current ZSE regulations the transactions have to be executed on the ZSE.

Treasury Bills are traded OTC, and transfer of ownership is arranged by the Ministry of Finance on a free delivery basis. T-Bills are expected to be included into the services of the CDA by the autumn.

There are **no legal limitations on foreign investors'** purchases of bonds and T-Bills in the secondary market.

Croatian Eurobonds

In the first quarter of 2001, Croatian Eurobonds benefited from positive news regarding the stand-by arrangement with the IMF, as well as from the increasingly improving relations with the EU.

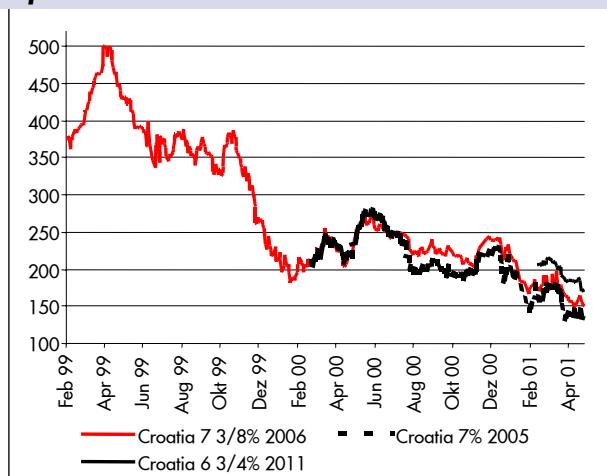
Spreads on all Croatian benchmark Eurobonds declined by approx. 60-70 bps. Moreover, the first 10-year benchmark issued by the Republic at Bonds + 215 bps was very well received by the market, and the spread has since tightened to 171 bps.

Domestic Currency Bonds

	HZZO	DAB 3	DAB 5
Volume	Eur 222 mln	Eur 105 mln	Eur 225 mln
Maturity	7/17/04	12/19/03	12/19/05
Coupon	8.500%	8.000%	8.375%
Coupon frequency	semi-annually		
Accrual method	actual/actual		
Form	registered, dematerialized		
Trading	Zagreb Stock Exchange		
Clearing + Settlement	Central Depository Agency		
Settlement	T + 4 working days		
Settlement Currency	secondary trading: HRK		
Exchange rate for settlement	Payment of Interest and Principal: HRK		
Last price	Secondary trading: Mid rate of CNB on trading date		
Yield to maturity	Payment of Interest and Principal: Mid rate of CNB on payment date		
Average daily volume	104%	103%	104%

Source: RZB - Group Research

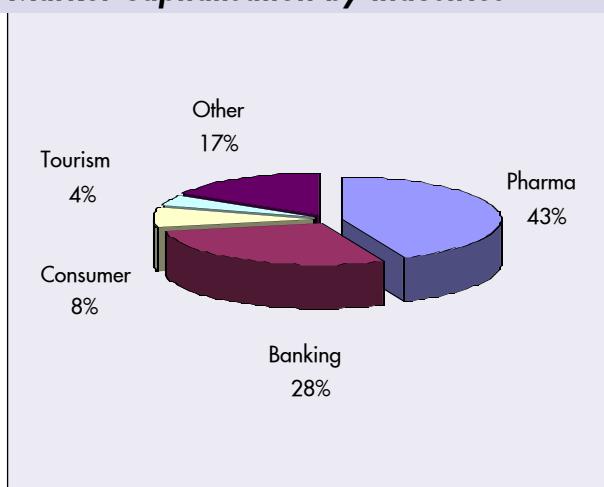
Spread on Croatian Eurobonds



Source: RZB-Group Research

Valuations are reasonable

Market Capitalisation by Industries



Source: RZB-Group Research

Capitalisation and PER

Market capitalisation at the ZSE increased by 15% in domestic currency and 8% in USD terms in the year 2000. The Crobex achieved an increase by 24.4% yoy, which made it one of the most successful indices in 2000. At the end of April 2001, market capitalisation increased by 13% in domestic currency and 10% in USD. The main reason for the increase in the year 2000 was political change at the beginning of the year, because the Croatian market was trading at a major discount compared to other CEE markets in the year 1999. The main reason for the increase in market capitalisation was the performance of Zagrebacka Banka in the first four months of 2001, when takeover speculations boosted the share price by 28%.

The most important sectors in terms of market capitalisation are pharmaceuticals, banking, consumer goods and tourism. The pharmaceuticals and banking sectors represented 71.4% of the entire market capitalisation at the end of the year 2000. We expect that the listing of the Croatian Telekom will dramatically increase the capitalisation of the ZSE.

P/E Ratios by Companies

Company	P/E 2000	P/E 2001
Pliva	8.4	7.7
Zagrebacka Banka	4.9	9.3
Viktor Lenac	5.2	3.1
Karlovacka pivov	5.2	5.8
Podravka	14.0	6.9
Riviera Porec	31.1	10.1

Source: Reuters, RZB-Group Research

Companies

Pliva told investors in its 1Q call that full year azithromycin sales to Pfizer will fall short of the 2000 level. We were only expecting a 3.5% increase in 2001, but the shortfall will still hurt the full-year ex-royalty EBIT margin. We now expect an EBIT margin of 9.8% compared to 10.8% (it fell to 8.7% last year). Otherwise, with the exception of Polish OTC sales, results met expectations, most importantly in new products and cross-registration of drugs from the family portfolio. We lower our target price to HRK 610, but we maintain our "buy" recommendation with upward potential of still over 25%.

Indicators of Zagreb Stock Exchange

	1997	1998	1999	2000	current
No of listed securities	82	54	65	64	64
Market cap.(HRK mio)	26,760.4	18,275.8	19,225.1	22,178.6	25,024.7
Market cap.(USD mio)	2,925.3	2,513.9	2,719.6	2,993.4	
Annual turnover (HRK mio)	2,094.7	624.3	527.2	1,529.2	
Annual turnover (USD mio)	99.9	68.9	187.5		
CROBEX	1002.1	711.6	715.3	890	936.3

Source: Reuters, RZB-Group Research

Unicredito Italiano and Allianz have joined forces in a bid for the control of **Zagrebacka Banka** at a price of HRK 2,002 a share. The bid was made for the acquisition of a controlling interest of 75 percent plus one share. Unicredito will take the lead role, acquiring approximately 60 percent of the voting shares against 15 percent for Allianz. The bid will be launched this summer if the bidders get the green light from the Croatian National Bank. It will be open for three weeks, with settlement in August or September.

The stock price of **Karlovacka pivovara** has soared more than 80% since the beginning of this year. This remarkable appreciation is due to an announced dividend of HRK 100, which corresponded to a dividend yield of 30% at the time of announcement.

Podravka announced net income of HRK 80 mn for 2000, up 400% yoy. We expect sales growth of 8% in the next two years through organic growth and merger & acquisition activities or a co-operation agreement with another producer. We believe that Podravka's shares are currently fairly valued on a fundamental basis. We maintain our "speculative buy" recommendation since the company could find a strategic partner or effect a merger or acquisition to boost sales.

■ Privatisation investment funds

Voucher privatisation started in 1997 and ended with the launch of privatisation investment funds (PIFs) in the stock market in April 1999. After a maximum of five years (around April 2004) PIFs should be converted into closed-end funds. Based on the PIF Law, fund management companies are going to be rewarded for the performance during that period. Their reward is going to be about 30% of the difference between the PIF's value in the last 90 days of the 5-year (or shorter) period and the second 90 days following their creation.

The best performer among the PIFs in the year 2000 was Sredisnji nacionalni fund with a gain of 117%. We assume that all funds have upward potential in the medium term.

Dividend Yields 2000

Pliva	2.5%
Zagrebacka banka	7.9%
Rijecka banka	4.6%
Privredna banka Zagreb	10.8%
Karlovacka pivovara	36.4%
Zagrebacka pivovara	27.3%

Source: Reuters, RZB-Group Research

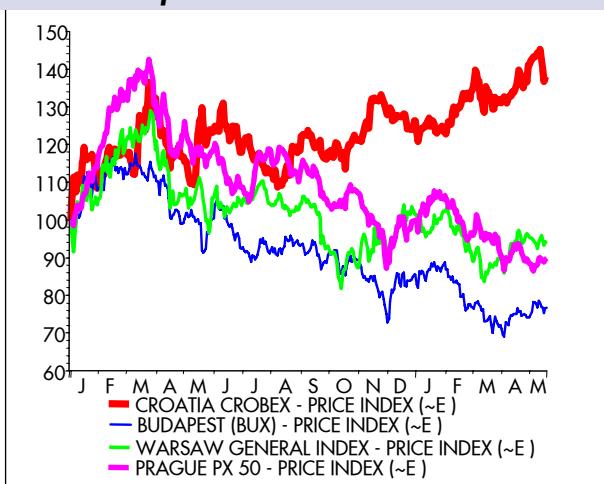
PIFs Performance in 2001

PIF	12/31/00 HRK	5/11/01 HRK	performance %
DOM	16.7	23.5	40.5%
EXPANDIA	17.8	29.9	67.8%
SNF	18.4	40.0	117.4%
VELEBIT	14.8	30.0	102.7%
PLETER	11.4	14.8	29.8%
SLAVONSKI	8.3	13.0	56.6%
SUNCE	7.7	10.7	39.9%

Source: Reuters, RZB-Group Research

Outstanding Performance How long to continue?

Index Comparison



CROBEX



CROBEX Index

Resistance2	977.00	High '01	1,000.40	TrendHigh	1,000.40
Resistance1	947.00	% f. High	-3.20	% f. THigh	-3.20
2001-05-14	968.00	% Perf.3M	3.90	% Perf.6M	5.40
Support 1	916.00	Low '01	848.30	TrendLow	431.10
Support 2	884.00	% f. Low	14.10	% f. TLow	124.50
Rating:	st=short, mt= sell 884, lt= long/spec. sell 825				

Index forecast

CROBEX	Performance	Range	current	Jun-01	Sep-01	Dec 01	Mar 02	histor. perform.
			936.3	970	950	970	1000	HOLD since 1/1/01
CROBEX			1002.1	3.6%	1.5%	3.6%	6.8%	5.2%
				910-1020	900-1000	920-1050	930-1050	
				711.6	715.3	890	936.3	

Source: Reuters, RZB-Group Research

The Crobex has been able to post an above-average performance of 8.8% since the beginning of 2001. However, the recently announced takeover bid for Zagrebacka Banka (ZABA) by the German Allianz and the Italian Unicredito has turned out to be not as positive as originally expected. As a result, takeover fantasy has disappeared from the market, and the share appears to be fairly valued on the basis of the existing data. Following the takeover of 75% plus 1 share, we forecast that ZABA will no longer be the focal point of investors' interest, and trading volume is therefore likely to dry up. We therefore do not see potential for the share that could have a similarly positive influence on the index as to date. Also, pharmaceutical group Pliva recently announced disappointing quarterly results, so that we do not expect support for a further increase of the Crobex in the short term. However, the weakness of Pliva should only persist in the short to medium term, since the company has made progress as regards cost-cutting, and we do indeed anticipate growth potential due to the drug portfolio which is currently in the pipeline. Since these two shares currently account for about 70% of the index and have already reached and temporarily even surpassed our target price, we have to revise down our rating of the Crobex to "hold". A successful privatisation of the Croatian telecom could subsequently give some fantasy again.

Technical comments

After this' index remarkable advance it finally reached 1,000 points. There it ran two tests, but did fail twice. Now, falling back into the range of its primary upward trend it looks a bit endangered: should it really drop below 884, it might test out 827 and 750 again, even a decline to 670 cannot be fully ruled out. As the technical picture of Zagrebacka Banka let us assume, HRK 1.300 will be "bullet- proof", we rate the CROBEX a speculative buy - right after the (expected) bullish reversal at 884 which should be followed by another raid against 1,000. To be more conservative: wait for the 920- line to be crossed. Else, if 884 should not proof firm - and Zagrebacka Banka to hit the floor at HRK 800 - think about the old saying: other markets, other opportunities.

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This report was completed on 25th May 2001.

Publisher: ERPEG Publikations Gesellschaft mbH
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