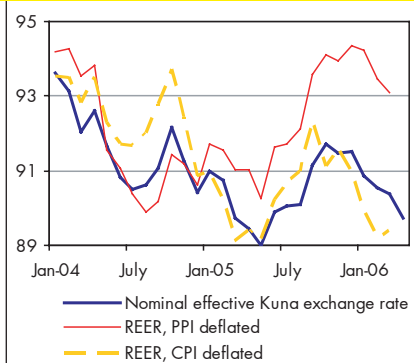


Strategy Croatia

June 2006

Kuna REER index*



Note: REER - Real Effective Exchange Rate index;
declining slope means appreciation
Source: Croatian National Bank

Recommendations (Horizon: 3 to 6 months)

Bond market

Neutral

5.375% RHMF 2019 EUR-linked
HRK bond

Neutral

5.25% RHMF 2015 HRK bond

Underweight

6.75% EUR 2011 bond

Equity market

Buy

Adris

Buy

Dom Holding

Analysts

RBA, Croatia

Hrvoje Dolenec

+385 1 6174 320

Zdeslav Santic

+385 1 6174 337

Ivana Blaskovic

+385 1 6174 335

Lidija Brkanic

+385 1 6174 336

RZB, Vienna

Gintaras Shlizhyus

+43 1 71707 1343

Highlights

■ Croatia moved strongly into the negotiations process, setting itself an ambitious target of completing the accession negotiations quickly. However, actual progress has been a bit more modest. Croatia opened the screening of 20 chapters and received confirmation for opening talks on one chapter by the end of June. One planned screening for an important chapter 'Judiciary and fundamental rights' was postponed to the autumn, giving an opportunity for Croatia to improve even more in this field, due to the sensitivity of this area for negotiations.

■ Despite some changes in the ministerial team, the Government has remained stable and should stay in control until the next regular parliamentary elections in late 2007. However, some domestic issues have become more important and are challenging for the Government as the opposition brings pressure to bear on topics with greater social resonance.

■ Economic activity has picked up recently, with accelerating GDP growth and improvements in fiscal policy. Positive developments in investments and employment have also improved the overall picture. Maintaining momentum in investment activity should continue to be one of the main challenges in economic policy. However, important issues remain in the field of external imbalances, as external debt continues to rise and the current account deficit grows. Monetary policy is focusing on these developments.

■ Foreign developments have had strong impact on the domestic markets as prices in bonds market decline, interest rates rise and the equity market has performed strongly. Nonetheless, LCY bonds may find some support in following months from demand, while on the equity side corrections can not be ruled out.

Key figures

	2001	2002	2003	2004	2005	2006e	2007f
Nominal GDP (EUR bn)	22.2	24.5	26.2	28.4	31.0	33.8	36.2
Real GDP (% yoy)	3.8	5.6	5.3	3.8	4.3	4.5	4.0
Industrial output (% yoy)	6.4	5.5	4.1	3.7	5.1	5.0	4.0
Unemployment rate (avg, %)	22.0	22.3	19.5	18.2	18.0	17.5	17.0
Nominal industrial wages (% yoy)	5.2	7.4	5.2	4.9	5.4	4.9	4.7
Producer prices (avg, % yoy)	3.6	-0.4	1.9	3.5	3.0	3.3	2.5
Consumer prices (avg, % yoy)	3.8	1.7	1.8	2.1	3.3	3.4	2.8
Consumer prices (eop, % yoy)	2.4	1.8	1.7	2.7	3.6	2.9	3.0
General budget balance (% of GDP)	-6.8	-6.0	-6.2	-4.8	-4.1	-3.7	-3.3
Current account balance (% of GDP)	-3.7	-8.6	-7.1	-5.1	-6.3	-5.7	-4.8
Official FX-Reserves (EUR bn)	5.3	5.7	6.6	6.4	7.4	7.8	8.3
EUR/HRK (avg)	7.47	7.41	7.56	7.50	7.40	7.32	7.31
USD/HRK (avg)	8.34	7.83	6.68	6.03	5.95	5.81	5.41

Source: Croatian Bureau of Statistics, Croatian National Bank, Ministry of Finance



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Croatia **Content**

Content	2
Summary	3
Focus on ... Croatia & the EU From Screening to Accession Negotiations	4
Structural information	6
Political situation	7
External environment	8
GDP & inflation	10
Industrial production & employment	11
Inflation & fiscal policy	12
Monetary policy & Interest rates	13
Exchange rate	14
Financial sector	15
Fiscal policy	16
Balance of payments, foreign trade, external debt	17
Debt market	18
Stock market	20
Acknowledgements	23

EU accession goes well but current account is a problem

Croatia's EU accession talks got a boost from the capture and extradition of fugitive general Gotovina to the international war-crime tribunal in the Hague. However, the EU's proposal to postpone further enlargement until the present EU members can come to an agreement on the EU charter can delay expected membership for Croatia. Furthermore, the opinion polls in the "old" European countries show increasing scepticism about the enlargement and dwindling popular support for the process. At the same time, the idea of "restricted" or "incomplete" membership initially suggested for Turkey is gaining popularity among EU politicians, which means that such membership may be offered to other countries. Although Croatia most likely will not be offered to accept "reduced" EU membership instead of "full" membership we believe the existence of such a talk might unnerve some Croatian politicians. In the end, the enlargement idea might come to be at serious risk if the EU would insist on "reduced" status for all newcomers. Speaking of economic integration, we believe that Croatia is doing very well with two strategic European partners, Italy and Austria, beefing up their investment and reciprocal economic ties. So Croatia is taking full advantage of co-operation with these countries. In this light we must say that EU accession will be an important but not critical factor for Croatia's future and ties to the West. We feel that Croatia's level of economic and infrastructure development compares rather well to other CEE countries, and it is in any case the highest among all EU aspirants in Southeast Europe.

Croatian economy remains in relatively healthy shape. Notwithstanding some concerns Croatian growth rates have consistently remained above 3-4% annually. Last year the growth topped the market expectations at 4.3%, and we project that this will come in at around 4.5% for 2006 as a whole. Furthermore, domestic economic and businesses activity remains strong underpinned by strong investment and consumption. Close ties to the West and a pro-European orientation have made Croatia an attractive destination for foreign investment. Interestingly enough, the strong position of the kuna has not hampered economic activity, a fact that we attribute to the strong productivity gains achieved in due course.

The low level of inflation achieved in recent years brought some much-desired stability and helped to reduce the cost of money. Still, the recent surge in inflation that can be attributed to regulated tariffs and energy costs poses a modest risk to long-term

inflation trends. However we expect the National Bank to act if inflation does become an issue. We expect inflation to decelerate from 3.6% annually to just below 3% this year. Yet, inflation in Croatia remains well below the levels observed in other SEE countries and some CEE countries.

Notwithstanding this a number of problems are casting a shadow on Croatia's prospects and pose a risk to the country's economic well-being. The most visible problem is Croatia's high current account deficit, which climbed slightly above 6% of GDP in 2005, and Croatia's growing external debt (presently over 80% of GDP). Regrettably, we can expect only small improvements in these areas in 2006. Croatia is apparently unwilling to put the brakes on the economic growth, in spite of the fact that this would help bring down the current account deficit, while foreign debt will remain high due to aggressive lending by foreign banks and the rapid growth of consumer borrowing.

Having said that we feel that Croatia's current account deficit stems from two major problems. The first problem is growing imports of capital goods financed via foreign investment, which is pushing the current account deficit higher. While this is a typical structural problem in other emerging markets as well, this situation is being exacerbated by ballooning consumer imports, which add to the current account deficit. Therefore we believe the National Bank would have done well to put more effort into sterilizing extra kuna liquidity. Hikes in the mandatory reserve requirements for the banks can only partially neutralized booming consumer lending, whereas open market operations were introduced only recently and until now have shown limited success. Given the already high level of mandatory reserve we suggest that interest rate tools be used more aggressively to offset credit growth in future. The growing current account deficit also puts pressure on external debt, as the country needs to finance growing external gap. Therefore external liabilities continue to grow, particularly in the domestic private sector. Nevertheless, Croatia's public debt (only government level) is not yet high by conventional standards, and the foreign component of this debt is rather moderate. The major problem still rests with domestic banking and consumer borrowers, whose foreign currency liabilities have grown rapidly if at a slower pace as of late. Therefore the problems of excessive consumer borrowing and growing external indebtedness should be addressed more vigorously and immediately.



Croatia & the EU

from screening to accession negotiations

Although the process of Croatia's rapprochement has been growing more and more intense, even just a few years ago Croatia's current status seemed like the distant future. Croatia's relations with the EU were not institutionalized until late in 2001, when on 29 October the Stabilization and Association Agreement (SAA) was signed, creating the legal basis and framework for Croatia's relations with the EU. After that, it took less than four years for accession negotiations to be officially opened, aiming at Croatia becoming a full-fledged EU member. In February 2003, Croatia submitted its application for membership of the EU. In April 2004, the European Commission issued a positive opinion (avis) on the Croatian application for EU membership and proposed that Croatia be given candidate status. In mid-2004, the European Council awarded Croatia candidate status for EU membership. On 4 October, the Council of Ministers decided that accession negotiations with Croatia could be opened, announcing the start of the screening process (an in-depth analysis of harmonization of the legislation of the candidate country with European legislation) for 20 October 2005. This opened a new chapter in Croatia's relations with the EU.

With the opening of the screening process, Croatia entered the most challenging phase on the road to full membership. Although real negotiations are still ahead, completing the screening process is the necessary prerequisite. The main objective of the screening process is to determine the differences under each chapter of negotiations (in Croatia's case there are 35 chapters) between the legislation of the candidate country and the EU's *acquis communautaire*. The screening process for the 35 chapters of *acquis* will be followed by negotiations which will focus on the conditions under which the candidate country is to adopt, implement and carry out the *acquis*.

In contrast to negotiations, the duration of the screening process can be assessed more easily. The screening of several chapters of the *acquis* started in 2005, aiming at parallel opening of several easier chapters (Science and research, Education, Statistics...) and more difficult chapters (Agriculture, the Judiciary and Internal Affairs). The overall screening of Croatia's legislation could last until the autumn of this year. It is noteworthy that the Commission will start issuing regular annual reports on Croatia's progress as of this autumn. After completion of the screening process, a decision is taken on opening negotiations on an individual chapter,

i.e. the phase of negotiations on the conditions under which a country is to adopt and implement *acquis communautaire* within a certain chapter is entered. Croatia has finished roughly one-half of the screening process. The explanatory phase of the screening process has been completed in a majority of chapters (in this phase the representatives of the European Commission make Croatian representatives acquainted with the *acquis communautaire* relating to a certain area), while as regards the majority of them the bilateral screening phase has also been completed (when Croatian representatives present to the European Commission the legislation pertaining to the particular chapter).

The screening process has not been without difficulties. At the beginning of March, the European Commission recommended that beginning of the screening process in the area of the judiciary and human rights be postponed until autumn in order for reports on the situation in Croatia to be better. The proposal was motivated by the assessment that at that particular moment the report would be negative and Croatia would be faced with the same situation as Bulgaria and Romania which met with the possibility of their membership being postponed due to problems in the judiciary and the need to press ahead with reforms. However, the fact that the screening process of one of the most demanding chapters was postponed should be viewed in a positive context, as it means that Croatia has the opportunity to make progress in this area until autumn. In this case, the annual report by the European Commission (the so-called Progress report) issued in the autumn, which contains all the screening reports, may record certain progress in the area, making the annual report more favourable.

In June, it is expected that Croatia will begin negotiations on the chapter "Science and research", with the possibility that negotiations on the chapter "Education and culture" might also start.

The further process of Croatia's approximation to EU will not depend solely on the speed of the screening process, the establishment of negotiation positions, the transitional periods granted for individual chapters and finally the implementation of the *acquis*, but also on the ability of the Croatian economy to carry out structural reform necessary for efficient entry into the common market. As a result, Croatia must not only concentrate on successfully completing the negotiation process, but also on successful utilization of the EU's pre-accession funds.

In parallel with the screening process, Croatia continues with other activities which make it part of the process of integration. 2006 is the final year during which Croatia may request funds from the pre-accession programmes PHARE, ISPA and SAPARD. From 2007, assistance will be provided through a united pre-accession assistance programme - IPA (the Instrument for Pre-Accession), which will unite the fields covered by the aforementioned three programmes. IPA should thus contain the following components: transition assistance and institution building, regional and cross-border and transnational co-operation, human resources and rural development. The financial aspect is still unknown, but it is expected that funds awarded to Croatia on an annual basis within the framework of the IPA programme will at least equal this year's funds (EUR 140 mn are envisaged under PHARE, ISPA and SAPARD).

Accordingly, the management of PHARE, CARDS and ISPA programmes was transferred to Croatian bodies in the middle of February, while the decision relating to the SAPARD programme is expected later on. However, while the assets from the ISPA fund (dealing with environmental and transport infrastructure priorities) have already been contracted, the process of preparation of the utilization of the SAPARD fund, which is behind plan, is now being completed. Its main objective is to provide assistance in the implementation of *acquis communautaire* in the field of the common agricultural policy and other necessary interventions and measures aimed at development of rural areas.

The utilization of SAPARD funds in other countries was not at an enviable level, which must be clear to Croatia as well. Delays in the creation of administrative procedures in Croatia and the establishment of the overall system, delays in the preparation of instructions for users, and end-users being unprepared for the stringent demands that are placed on them as well as possible lack of quality projects may negatively affect utilization of the available funds.

Nevertheless, the SAPARD programme should be understood not only as a source of co-financing but as a process of learning, with the end-users learning how to comply with EU directives and guidelines, which eventually leads to faster and easier adjustment to the EU market and legislation.

Chapters for screening

	Chapters of the <i>Acquis</i>	Screening started
1	Free movement of goods	✓
2	Freedom of movement for workers	
3	Right of establishment and freedom to provide services	✓
4	Free movement of capital	✓
5	Public procurement	✓
6	Company law	
7	Intellectual property law	✓
8	Competition policy	✓
9	Financial services	✓
10	Information society and media	
11	Agriculture and rural development	✓
12	Food safety, veterinary and phytosanitary policy	✓
13	Fisheries	✓
14	Transport policy	
15	Energy	✓
16	Taxation	
17	Economic and monetary policy	✓
18	Statistics	
19	Social policy and employment	✓
20	Enterprise and industrial policy	✓
21	Trans-European networks	
22	Regional policy and coordination of structural instruments	
23	Judiciary and fundamental rights	
24	Justice, freedom and security	✓
25	Science and research	✓
26	Education and culture	✓
27	Environment	✓
28	Consumer and health protection	
29	Customs union	✓
30	External relations	
31	Foreign, security and defence policy	
32	Financial control	✓
33	Financial and budgetary provisions	
34	Institutions	
35	Other issues	

Source: MVPEI, Raiffeisen RESEARCH



Basic information and main features

Structural information

Land Area	56,594 sq. km
Population	4,437,460 (2001)
Capital city	Zagreb
Fiscal year	Jan 1st - Dec 31st
Currency	Kuna (HRK)

Source: Croatian National Bank, Croatian Bureau of Statistics

Foreign currency rating

Agency	Long-term	Short-term
Standard & Poor's	BBB	A-3
Moodys	Baa3	P-3
Fitch IBCA	BBB-	F3

Note: On 13 August 2005, S&P changed its outlook from "positive" to "stable"; on 11 June 2003 Moodys affirmed "stable" outlook; at the beginning of July 2005 Fitch changed its "positive" outlook to "stable".

Major cities (population 2001)

Zagreb	779,145
Split	188,694
Rijeka	144,043
Osijek	114,616
Sl. Brod	64,612
Karlovac	59,395
Pula	58,594
Varazdin	49,075
Dubrovnik	43,770
Cakovec	30,455

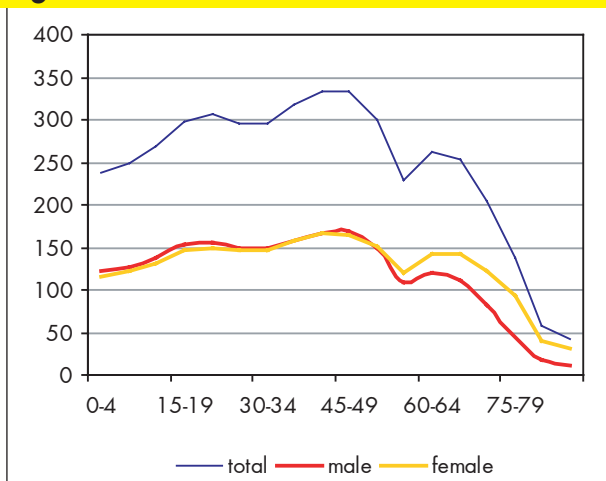
Source: Croatian Bureau of Statistics

GDP 2005

EUR mn, current prices	30,959
EUR, per capita	6,977
Real growth rate, %	4.3

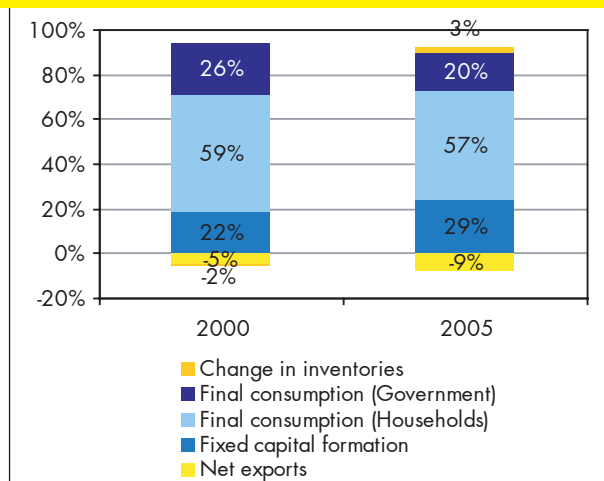
Source: Croatian Bureau of Statistics

Age distribution, 2001



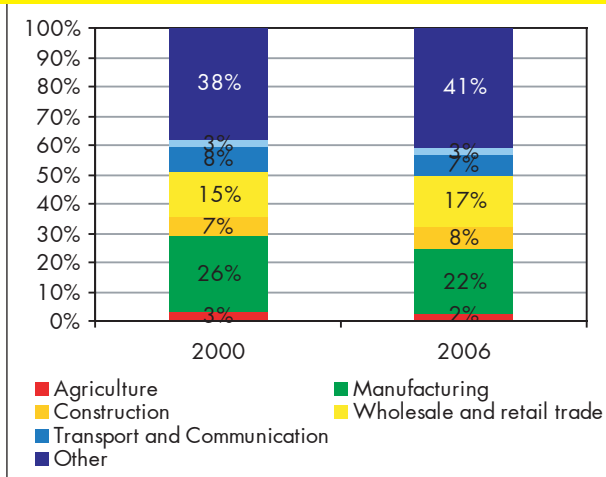
Source: Croatian Bureau of Statistics

GDP: demand side (% share)



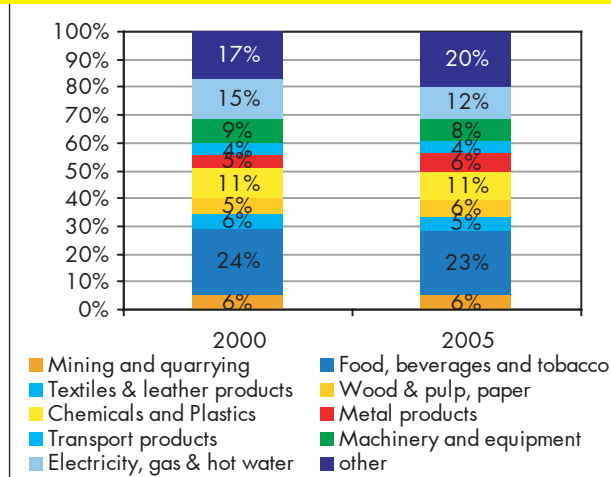
Source: Croatian Bureau of Statistics

Employment (% of total)



Source: Croatian Bureau of Statistics

Industrial production (% of total)



Source: Croatian Bureau of Statistics

Foreign affairs issues replaced by domestic issues

The current Government's success in opening EU talks is fading slightly as domestic issues have become more interesting in recent months. The Government has garnered some support from improvements in economic activity and the positive revision of the current stand-by arrangement (extended for another seven months until November). Improved economic activity has also helped support the goal of fiscal consolidation, but the Government is conducting reforms more slowly than planned, due to the high social sensitivity of such moves. Areas that should be tackled during the remaining part of its mandate include the health sector, further pension reform, restructuring of the public sector, reform of policy of subsidies, judiciary and legal reform, and privatization of remaining state-owned shares in the corporate sector. Improvement in some of the areas should come with the process of fiscal consolidation as this should have a direct impact on more efficient distribution of public expenditures. Some of these reforms have also become political issues and the subject of strong criticism by the opposition in the country.

The Government also took a few hits due to some issues involving conflict of interests for government officials, as well as due to some rather confusing public appearances by some of the members of the Government. Nevertheless, Government has remained stable despite changes in its composition, and our current view remains the same. The current Government should remain in power until the next regular elections in late 2007 despite some surprising changes in its team. The removal of the Minister of Justice coming from small coalition party created some disturbances, but support in the parliament for the current Government remained sufficient (although it shrank after this move). The popularity of the Government however declined after reaching highest level with the opening of EU talks. However, the current leading party (HDZ - Croatian Democratic Union) still remains the strongest individual party in Croatia with a narrow margin over the largest opposition party (SDP- Social Democratic Party).

Although more room was given to topic on EU talks in the previous pages, it has significant role in political picture of the country. Some delays in planned process and postponement of screening for important chapter of Judiciary and Fundamental Rights to autumn were a sign that negotiations team target of opening screening on 25 chapters and negotiations on 8 chapters by the end of June was too ambitious. Currently, start of negotiations is confirmed for only one chapter (Education).

Main political parties in parliament

Ruling Coalition	Party leader	Orientation
Croatian Democratic Union (HDZ)	Ivo Sanader	Center-right
Croatian Party of Pensioners (HSU)	Vladimir Jordan	Center
Opposition Parties		
Social Democratic Party (SDP)	Ivica Racan	Center-left
Croatian Citizens's Party (HNS)	Vesna Pusic	Center
Croatian Peasant Party (HSS)	Zlatko Tomcic	Center
Croatian Party of Rights (HSP)	Anto Dapic	Center-right
Istrian Democratic Party (IDS)	Ivan Jakovcic	Center-left-Reg.
Democratic Center (DC)	Vesna Škare Ozbolt	Center

Source: Political parties

Election schedule*

Presidential election	January 2010
Parliamentary elections	November 2007

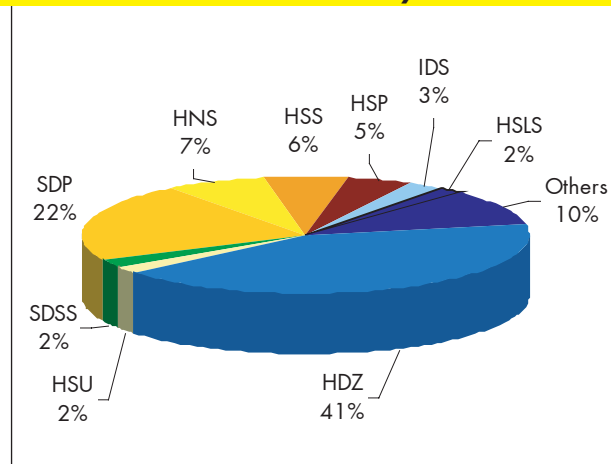
* Elections for president are every 5 years, elections for parliament every 4 years

Ruling persons

Function	Name	Party Affiliation
President of the Republic	Stjepan Mesic	
Prime Minister	Ivo Sanader	HDZ
Speaker of the Parliament	Vladimir Šeks	HDZ

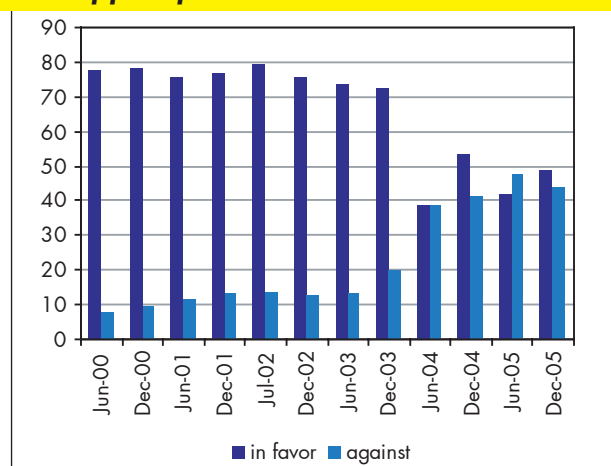
Source: The Government, the Parliament, the Office of the President

Seats in the Parliament, May 2006



Source: Croatian Parliament

EU support poll



Source: MFAEI



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Economic indicators

Croatia within CEE: Outlook

Real GDP (% yoy)

Countries	2004	2005	2006e	2007f
Poland	5.4	3.2	4.5	4.8
Hungary	4.6	4.1	4.0	3.5
Czech Rep.	4.7	6.0	4.8	4.5
Slovakia	5.4	6.1	6.0	7.1
Slovenia	4.2	3.9	4.0	3.5
CE	5.1	4.2	4.6	4.6
Croatia	3.8	4.3	4.5	4.0
Bulgaria	5.7	5.5	5.5	5.5
Romania	8.4	4.1	4.5	4.0
Serbia	9.3	6.3	5.0	6.0
Bosnia a. H.	6.0	5.5	6.0	5.5
Albania	6.7	6.0	6.0	6.5
SEE	7.1	4.7	4.8	4.6
Russia	7.2	6.4	6.3	5.7
Ukraine	12.1	2.5	0.5	3.5
Belarus	11.0	9.2	7.5	6.5
CIS	7.7	6.2	6.0	5.6
Turkey	8.9	5.8	2.5	5.0
EU-12	1.8	1.4	2.3	2.0
USA	4.2	3.5	3.4	2.6

* including the Baltic countries

Consumer prices (avg, % yoy)

Countries	2004	2005	2006e	2007f
Poland	3.5	2.1	1.1	2.8
Hungary	6.8	3.6	2.1	3.6
Czech Rep.	2.8	1.9	2.8	2.7
Slovakia	7.5	2.7	4.1	2.0
Slovenia	3.6	2.5	2.5	2.0
CE	4.3	2.4	1.9	2.8
Croatia	2.1	3.3	3.4	2.8
Bulgaria	6.1	5.0	8.5	5.0
Romania	11.9	9.0	7.7	5.8
Serbia	11.0	16.1	14.0	10.0
Bosnia a. H.	0.4	3.6	4.3	3.7
Albania	2.9	2.4	3.0	3.0
SEE	8.3	7.7	7.4	5.4
Russia	11.0	12.5	10.6	8.3
Ukraine	9.9	14.4	11.0	9.5
Belarus	18.1	10.3	8.5	9.5
CIS	11.1	12.6	10.6	8.4
Turkey	10.6	8.2	11.9	12.0
EU-12	2.1	2.2	2.1	2.1
USA	2.7	3.4	2.7	2.5

* including the Baltic countries

Current account balance (% of GDP)

Countries	2004	2005	2006e	2007f
Poland	-4.2	-1.7	-1.9	-1.9
Hungary	-8.8	-8.1	-8.0	-7.3
Czech Rep.	-5.2	-2.1	-1.5	-1.0
Slovakia	-3.5	-6.9	-4.0	-1.4
Slovenia	-2.1	-0.9	-0.5	-0.6
CE	-5.0	-3.3	-3.0	-2.6
Croatia	-5.1	-6.3	-5.7	-4.8
Bulgaria	-8.4	-11.8	-10.0	-8.5
Romania	-8.4	-8.7	-9.3	-9.0
Serbia	-13.0	-8.7	-9.5	-9.3
Bosnia a. H.	-22.4	-22.5	-21.3	-20.8
Albania	-4.7	-5.5	-5.5	-4.8
SEE	-8.8	-9.1	-9.1	-8.6
Russia	10.1	11.3	10.1	4.3
Ukraine	10.5	2.0	-3.0	-2.2
Belarus	-4.4	2.2	1.3	-0.3
CIS	9.6	10.3	8.8	3.7
Turkey	-5.2	-6.2	-4.3	-3.9
EU-12	0.6	-0.3	0.3	0.1
USA	-5.7	-6.4	-6.6	-6.0

* including the Baltic countries

General budget balance (% of GDP)

Countries	2004	2005	2006e	2007f
Poland	-3.8	-3.6	-3.9	-3.9
Hungary	-5.4	-6.1	-7.4	-5.9
Czech Rep.	-3.0	-2.8	-3.0	-2.7
Slovakia	-3.8	-3.2	-2.9	-3.0
Slovenia	-2.3	-1.8	-1.4	-1.4
CE	-3.8	-3.8	-4.1	-3.8
Croatia	-4.8	-4.1	-3.7	-3.3
Bulgaria	1.7	2.4	3.0	1.0
Romania	-1.2	-0.8	-0.9	-2.5
Serbia	1.0	2.0	2.1	1.5
Bosnia a. H.	1.8	0.5	0.3	0.1
Albania	-4.9	-5.0	-4.5	-4.0
SEE	-1.2	-0.8	-0.7	-1.7
Russia	4.5	7.7	6.6	4.3
Ukraine	-3.2	-1.8	-4.5	-4.0
Belarus	0.1	-0.2	-1.5	-1.5
CIS	3.8	6.8	5.5	3.5
Turkey	-5.3	-2.0	-2.4	-3.0
EU-12	-2.8	-2.4	-2.5	-2.1
USA	-4.7	-3.6	-3.9	-4.0

* including the Baltic countries

Exchange rate EUR/LCY (avg)

Countries	2004	2005	2006e	2007f
Poland	4.53	4.03	3.79	3.66
Hungary	251.7	248.4	260.0	268.8
Czech Rep.	31.9	29.8	28.8	28.0
Slovakia	40.1	38.6	37.5	36.4
Slovenia	238.9	239.5	239.5	239.5
Croatia	7.50	7.40	7.32	7.31
Bulgaria	1.96	1.96	1.96	1.96
Romania	4.05	3.62	3.50	3.46
Serbia	72.6	82.9	88.3	92.0
Bosnia a. H.	1.96	1.96	1.96	1.96
Albania	127.6	124.1	123.7	124.0
Russia	35.8	35.2	34.5	35.3
Ukraine	6.6	6.3	6.6	6.9
Belarus	2687	2677	2696	3038
Turkey	1.77	1.67	1.83	2.00
EU-12	1.24	1.24	1.26	1.35

* including the Baltic countries

Exchange rate USD/LCY (avg)

Countries	2004	2005	2006e	2007f
Poland	3.64	3.25	3.03	2.71
Hungary	202.3	198.7	206.3	199.1
Czech Rep.	25.7	24.0	23.0	20.7
Slovakia	32.3	31.1	30.0	27.0
Slovenia	192.4	193.1	191.6	177.4
Croatia	6.03	5.95	5.81	5.41
Bulgaria	1.58	1.58	1.56	1.45
Romania	3.26	2.92	2.78	2.56
Serbia	58.3	66.7	70.1	68.1
Bosnia a. H.	1.57	1.57	1.55	1.45
Albania	102.6	99.9	98.2	91.8
Russia	28.8	28.3	27.4	26.2
Ukraine	5.3	5.1	5.2	5.1
Belarus	2160	2154	2157	2250
Turkey	1.43	1.35	1.45	1.47
EU-12	0.81	0.80	0.79	0.74

* including the Baltic countries

Inflation worries

harm interest rates

Intensifying worries about inflationary risk in developed markets and its impact on interest rates dashed global market positivism. A year-long euphoria about interest rates came to an abrupt end in May when financial markets suffered their worst decline in 12 months. Nearly all assets came under selling pressure resulting from changing expectations for inflation in the US and Europe, which in turn pulled down the global growth outlook and signalled the ending of the era of money for "free". Indeed, global markets had rallied in large part thanks to abundant liquidity and "cheap" cash. Not only were prices for most financial assets at historical highs until recently, markets for financial derivatives were also flourished en masse. When the situation changed abruptly, the market suddenly felt the impact of shrinking liquidity and the unwinding of leveraged trades. Core inflation is now on the rise in the US, and similar pattern can be seen in Europe. We expect US core inflation to top out at near 3% this year. However the two Central Banks might react differently to this challenge. Contrary to earlier opinions that high energy prices were having no significant impact on US consumer prices, more market pundits are now beginning to cite the impact of higher energy costs on inflation and the economy. US core inflation is expected to deteriorate further over the remainder of the year. Nevertheless, our western markets colleagues argue that the US economy is likely facing a slowdown in the coming months, which should partially offset inflation fears for the Fed. Probably, as has been the case in the past, weaker economic growth might set off alarms for the Fed and prompt a long pause, though not until after another 25bp hike at the end of June. Furthermore, if the economic slowdown in the US turns out to be more severe, the Fed might even be willing to cut rates by 25bp as early as the beginning of 2007. Meanwhile in the EU, core inflation is accelerating amidst strengthening economic growth, which should convince the ECB to hike interest rates during the summer months. Our "western" experts believe that the ECB will be hiking by a quarter percentage point in June and then in August. Moreover, the ECB is expected to continue hiking rates until the neutral level at which previous monetary easing will be completely removed. Thus we expect the euro key rate to reach 3.5% over the next 12-months. Consequently our interest rate outlook for Europe remains bearish. In global FX, market trade and capital imbalances will play a key role in determining the currency exchange balance. The US dollar is likely to fall further as a result of

growing trade imbalances and possible capital outflows. Some pundits also cite the US government favouring a weaker dollar to help reduce the growing foreign trade deficit. The interest rate differential between the US and Europe will continue shrinking, which should eat into the dollar exchange rate. We are not expecting a sustainable dollar rebound any time soon. On the contrary, we project a further drop for the US currency and have therefore revised our euro/dollar forecasts accordingly to 1.30 for September and 1.35 for December 2006.

Interest rates (3M)

Countries		Jun-06	Sep-06	Mar-07
Euro-12	2.89	3.0	3.2	3.5
UK	4.63	4.7	4.8	5.0
Poland	4.04	3.9	3.9	3.9
Hungary	5.93	6.4	6.5	7.3
Czech Rep.	2.00	2.3	2.5	2.8
Switzerland	1.37	1.5	1.8	2.3
Japan	0.26	0.1	0.2	0.7
USA	5.18	5.2	5.2	4.8

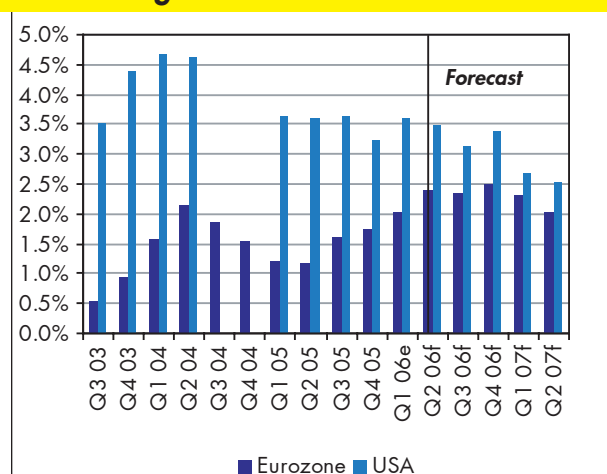
Source: Thomson Financial Datastream; Raiffeisen RESEARCH

Currencies: FX per EUR

Countries		Jun-06	Sep-06	Mar-07
UK	0.68	0.68	0.69	0.70
Poland	3.95	3.80	3.75	3.65
Hungary	262.7	260	260	275
Czech Rep.	28.2	29.2	29.0	28.3
Switzerland	1.56	1.56	1.55	1.53
Japan	144.2	141	140	135
USA	1.29	1.28	1.30	1.35

Source: Thomson Financial Datastream; Raiffeisen RESEARCH

Economic growth to slowdown in the US



Source: Thomson Financial Datastream

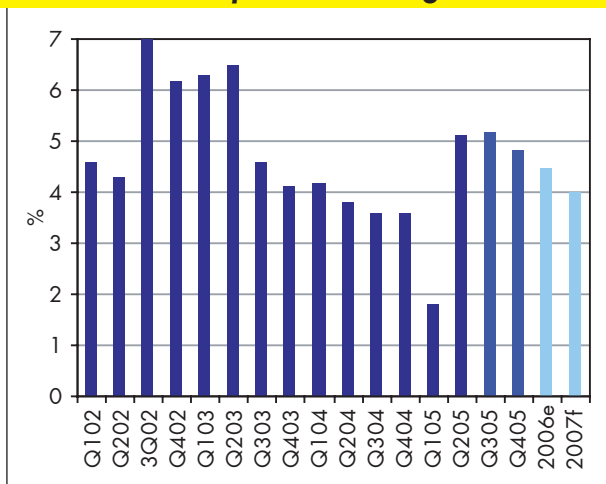


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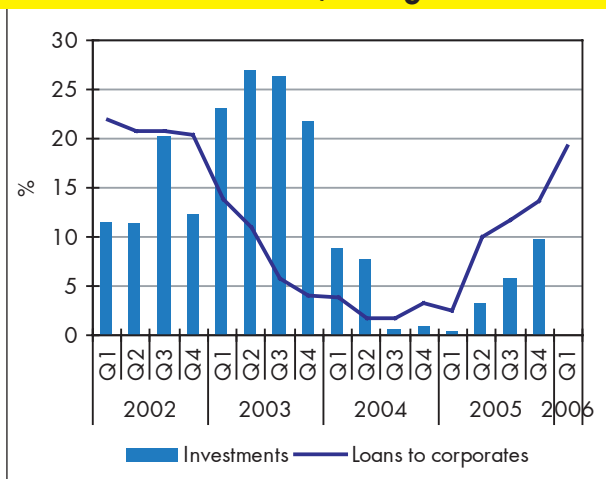
Growth momentum from 2005 sustained

Gross domestic product, real growth rates



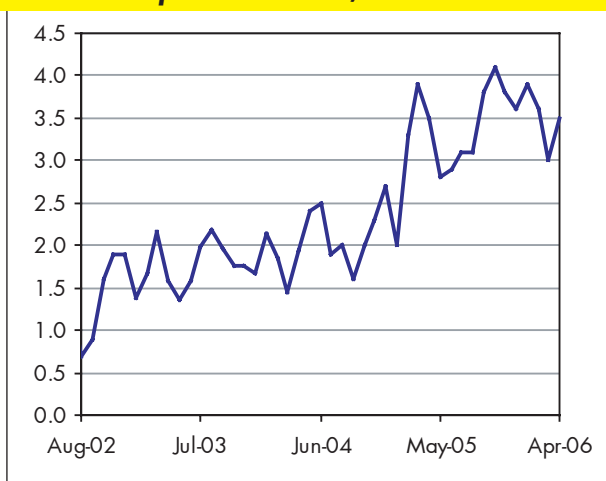
Source: CBS, Raiffeisen RESEARCH

Investments and loans, real growth rates



Sources: CBS, CNB, Raiffeisen RESEARCH

Consumer price index %, annual level



Source: CBS

The beginning of last year saw an unexpected slow-down in economic activity and the weakest growth yet in the gross domestic product (GDP). However, the remainder of the year was marked by much more positive trends in the economy, which generated higher rates of economic growth, exceeding even the most optimistic forecasts. In the last three months, the intensity of GDP growth was a positive surprise, ending 2005 at 4.3%. Apart from the fact that GDP was above expectations, it is also noteworthy that the dynamics of the economic slow-down changed. In analysing GDP growth by consumption category, it can be seen that the influence of certain categories on economic growth also changed. Personal consumption, which was the most important growth generator over the past years, in 2005 registered its weakest growth in the past six years. In 2005, the strongest influence on GDP growth came from capital formation and faster growth of exports of goods and services over imports. This year, we expect real GDP growth to remain at the level of some 4.5% (with possible impetus for stronger growth), with more rapid expansion expected to be recorded during the first quarter. The expected weaker growth of physical indicators in industry, tourism and retail trade as compared with last year could contribute to a somewhat slower pace of economic growth in 2006. GDP growth this year could be positively influenced by faster growth of exports of goods and services over imports again, while it will also be interesting to see the developments in personal consumption following the repayment of debt to pensioners and further movement of investments.

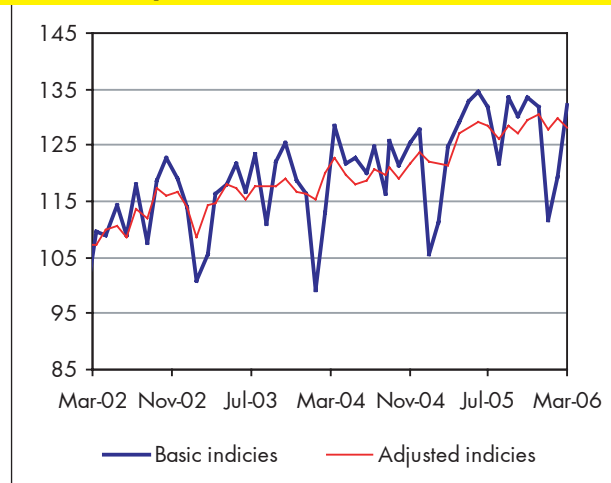
The end of 2005 saw the highest inflation rate (3.6%) in the past few years, and the pressure prices continued this year. At the very beginning of the year an increase in the prices of utility services at the local level first led to an increase in producer prices and then significantly impacted the growth rate of producer prices. This year, we expect the average growth in the prices of goods and services used for personal consumption to total some 3.4%, i.e. slightly more than in 2005. Slightly stronger growth in prices should be observed in the first half of the year, while the remaining part of the year will see weaker inflationary pressures. As a result, consumer prices growth at the end of 2006 could decline below 3% (if another rise in energy prices does not occur).

Signs of favourable trends in the labour market

After unfavourable movements in industry were registered in the first quarter of last year, the remainder of 2005 saw a rise in production, with total industrial production in 2005 increasing by 5.1% compared with 2004. Positive trends in industry continued early in 2006, with February being the eleventh month in a row of rising industrial production volume. This year, we expect the positive trends to continue, however, the pace of growth will likely be lower than in 2005. Despite strong growth in January and February, also as a result of the last year's base, we expect growth of industrial production volume in 2006 to amount to roughly 5% year-on-year. Apart from the dynamics of industrial production growth it is also important to underline that trends in the first three months of this year point towards a restructuring in the industrial sector. Capital-intensive sectors, such as the production of machinery, apparatus and communication equipment, continue to boast above-average growth. At the same time, traditional branches of industry, such as shipbuilding and the textile industry register below-average growth or even a decline in production.

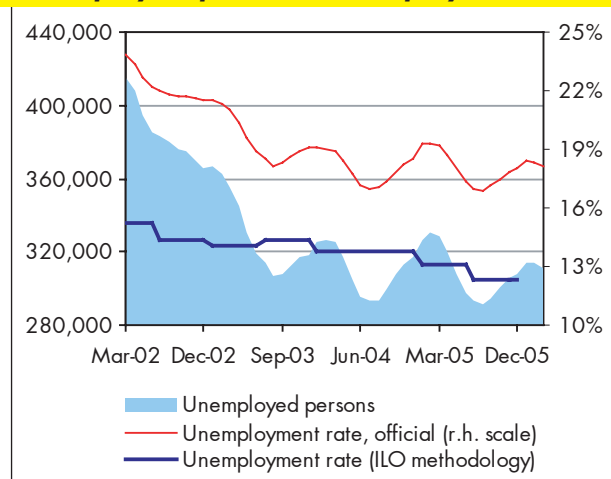
Despite the fact that Croatia continues to have one of the highest official unemployment rates among the new EU members and EU candidate countries, more optimistic trends can be seen in the domestic labour market. Since August of last year there has been a downward trend in the number of unemployed at an annual level, and thus the official unemployment rate totalled 18% at the end of 2005, which is the lowest level since the end of 1998. In addition to the reduction in the number of unemployed persons at the annual level, the first four months of 2006 saw positive trends also at the monthly level, pointing to the start of favourable seasonal developments on the labour market. As a result of greater work intensity in tourism and construction, we expect a possible further decline in the unemployment rate in the second and third quarter of this year. An important influence on the monitoring of unemployment will also come from greater stress being laid on following survey unemployment, which reflects much lower unemployment levels (roughly 13% in 2005), thus indicating the influence of the grey economy on Croatia's overall economy.

Industrial production index, 2000=100



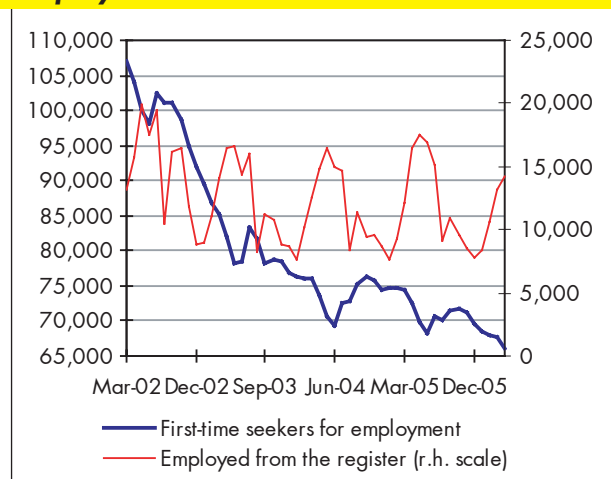
Source: CBS

Unemployed persons, unemployment rates



Sources: CBS, CES

Employment



Source: CES

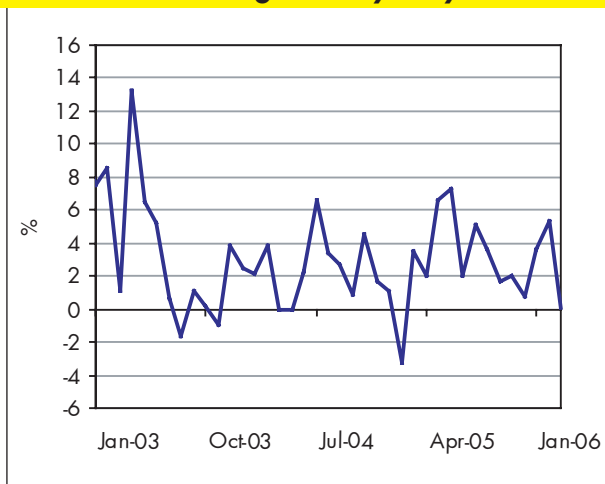


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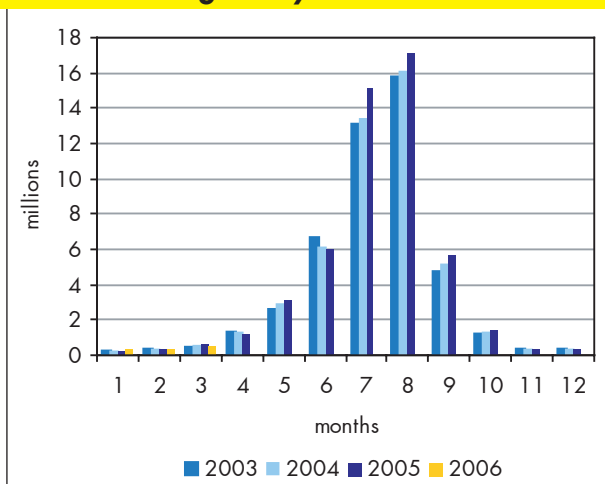
Positive developments in trade and tourism continue

Retail trade, real growth, yearly



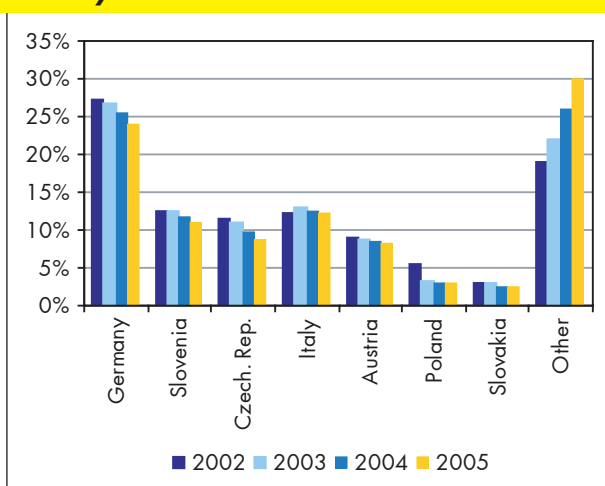
Source: CBS

Tourist overnight stays



Source: CBS

Foreign tourist overnight structure by country of residence



Source: CBS

Last year, retail trade turnover grew by 2.8% in real terms compared with 2004. Following weak growth in the last quarter of 2005, the beginning of 2006 saw stronger retail trade growth, partly due also to the lower last year's base. However, we expect positive trends in retail trade to continue throughout 2006 with turnover growth being slightly stronger than last year, totalling some 3% in real terms. According to the available data for 2006, car sales continue to have a positive influence on movements in retail trade, as they are rising at above-average rates. In addition, judging by motor vehicle imports in Q1 2006, we expect this positive influence to continue in the following months. The expected stronger growth in net wages than registered in 2005 should also make a positive contribution to retail trade growth. A possible negative effect on this year's movements in retail trade should come from a slowdown in lending activity by commercial banks (not seen so far in 2006). In addition, higher-than-expected rises in consumer prices could negatively affect the growth of households' purchasing power and thus retail trade.

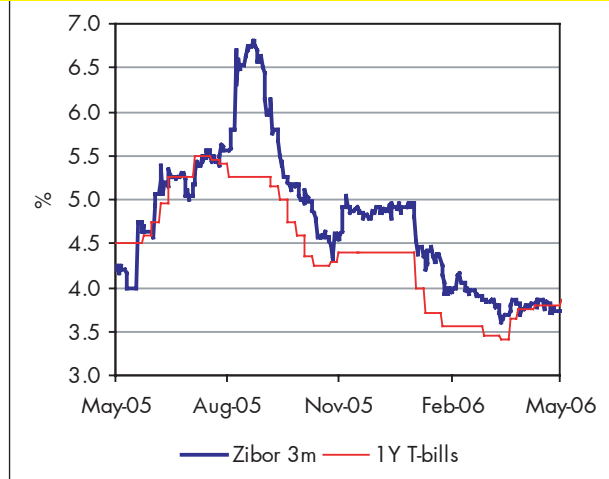
In 2005, the number of tourist arrivals and overnight stays rose by 6% and by 8%, respectively, compared with the previous year. Last year, developments in tourism were affected most significantly by arrivals of foreign tourists during the peak of the tourist season. In addition to the growth of physical indicators in 2005, income generated from arrivals of foreign tourists grew by 7% year-on-year, which had an important influence on movements in the current account on the balance of payments. In 2006, we expect physical indicators in tourism to grow at a slower pace, with the growth of total tourist nights amounting to some 3%. The slightly weaker intensity of growth in tourism could be affected by limited accommodation capacities and the World Cup in Germany, which may result in a weaker number of tourists primarily in June. On the other hand, the extension of the tourist season beyond the summer months paired with the improvement in services offered to tourists may have a positive contribution to the rise in income from tourism.

Interest Rate fluctuations narrowed

Although the year started in a more relaxed tone, the first quarter did not pass without new restrictive monetary policy measures. The central bank decided to gradually influence movements of monetary aggregates by reducing the reserve requirement and at the same time reduce the effects of other sources of banks' expansion such borrowing abroad and bond issuance. As a result, a new measure limiting bank borrowing from bond issuance was implemented in February, through the introduction of the so-called special reserve requirement, the allocation of 55% of the interest-free requirement to the account of the central bank for each new bank borrowing on the basis of bond issuance. Banks continued borrowing abroad in the beginning of this year, regardless of high costs of such borrowing, spurring strong issuing growth, which accelerated in the second half of last year. Annual growth rates reached above 20% (the level from 2003). The main characteristics are a significant acceleration of the growth of corporate loans paired with still high rates of growth in lending to households. On the other hand, there is a noticeable increase in banks' foreign liabilities and a decline in foreign assets which is substituted by much slower growth of deposits in the system (at growth rates of some 9%). Considering how restrictive the new measures are, it is expected that the growth of monetary aggregates will slow down this year (primarily the growth of loans).

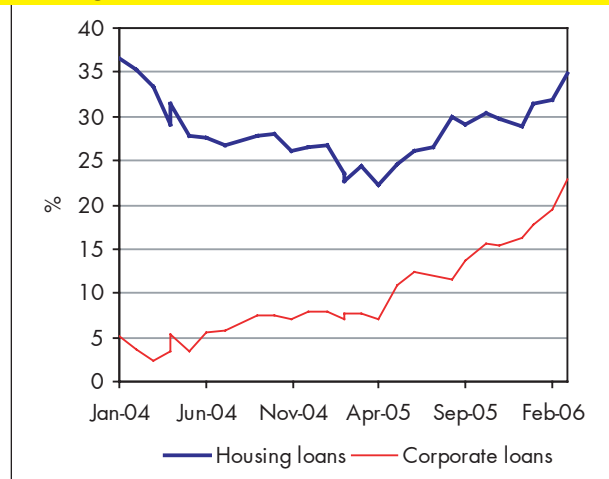
The improvement in kuna liquidity and gradual rise in the confidence regarding open market operations contributed to greater stability of money market interest rates and a reduction in interest rates, i.e. convergence to the central bank's reversed repo rate. The existence of surplus kuna liquidity enabled short-term interest rates to fall below this rate and therefore during this period when there was no great demand for kuna, regarding the shortest maturities, in the money market interest rate enable cheaper financing of short-term banks' needs in the interbank market. However, both recently and in the period to come seasonal influences of liquidity movements on interest rates may still be expected and thus also higher interest rates over the summer months or at the end of the year when kuna demand usually grows. One should also not to forget impact of interest rate hikes by ECB. However, central bank operations should result in much milder fluctuations than in the past with better adjustment to the movements of the reversed repo rate. The movements of T-bill yields are also expected to adjust to this.

Interest rates



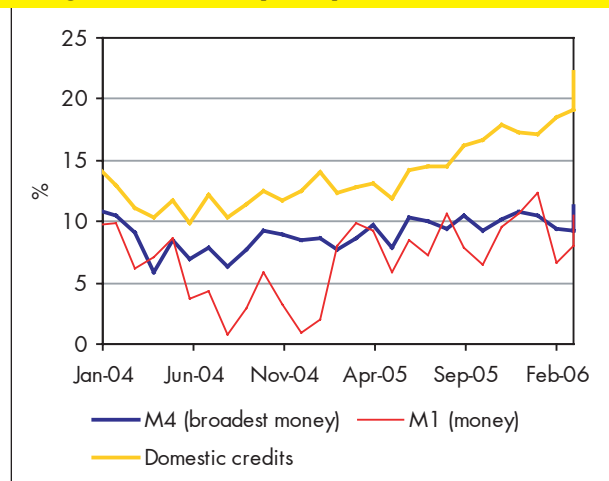
Sources: *biznis.infoforum.hr*, CNB, Ministry of Finance

Loan growth, in %, annual level



Source: CNB

Monetary aggregates and domestic credits (growth rates, yearly basis)



Source: CNB



Summer Strengthening of appreciation factors

Middle exchange rate of the CNB



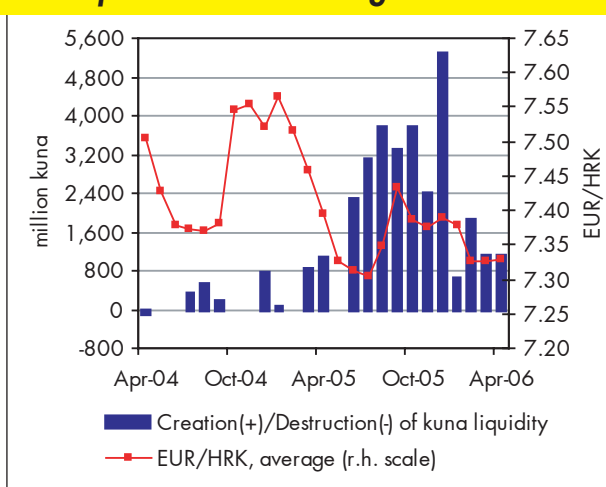
Source: CNB

Middle exchange rate of the CNB

Currency	Middle exchange rate 3/31/06	Change compared to:		
		3/31/05 Exch. rate	Movements	%
EUR	7.3236	7.4418	↓	-1.61
USD	6.0651	5.7443	↑	5.29
CHF	4.6487	4.7940	↓	-3.13
GBP	10.5481	10.8087	↓	-2.47

Source: CNB

CNB operations & exchange rate movements



* Effect of FX interventions and reverse repo auctions of CNB bills on money supply
Source: CNB

In the first quarter of 2006, the exchange rate continued fluctuating within a historically very narrow band of EUR/HRK 7.30 to 7.40, with occasional pressure to the lower edge of the band until the implementation of the new monetary policy measures, which resulted in interest rates on foreign currency deposits in the interbank market going up. This picked up the exchange rate from the lowest levels and created a counterweight for the previous appreciation pressures. The exchange rate stabilised in March, but appreciation pressures continued in the following quarter. The first three months were dominated by banks' foreign borrowing and intensive lending activity, which due to the compliance with limitations regarding the open foreign exchange position caused strong foreign currency supply by banks and created downward pressure on the exchange rate to levels of EUR/HRK 7.30. Additional pressure from the new CNB measures led to a rise in the cost of banks' foreign borrowing, against strong kuna liquidity arising from open market operations and, primarily, lower kuna interest rates. This temporarily resulted in softening of appreciation pressures and allowed demand for foreign currency to raise the exchange rate. Inflows of foreign capital however led to renewed pressures which brought exchange rate to levels of EUR/HRK 7.26 - 7.27. Appreciation pressures prompted the central bank to intervene a few times so far to prevent excessive strengthening of the domestic currency, stabilising the exchange rate at such levels recently.

The approaching of summer and the tourist season should bring about renewed appreciation pressures, although this year we may expect weaker effects in July when World Cup in Germany is set to begin, and soften foreign currency inflows from tourism. Other summer months should bring about strong pressure on kuna strengthening as well as lowering of the kuna exchange rate to levels of close to EUR/HRK 7.20. The effects of the government's delayed privatization projects should also not be neglected, which could by attracting investors bring certain foreign currency inflows. Depending on these influences, the realization of which is still uncertain, in autumn the exchange rate should rise to levels much higher than over the summer with developments similar to those during last year. At the very end of the year, demand for the kuna could strengthen and the exchange rate could end the year at levels similar to those attained at the end of last year.

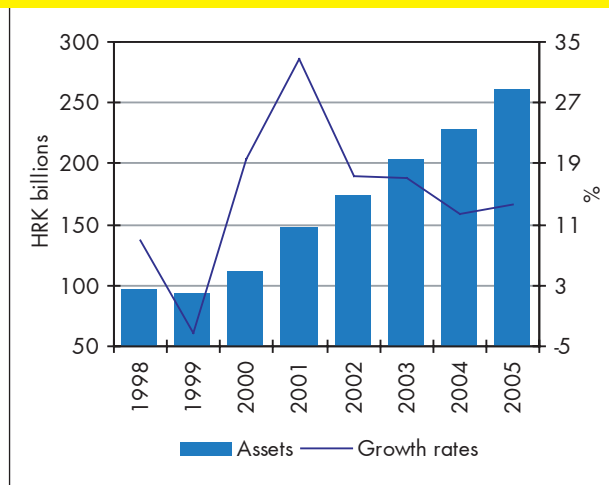
Growth of Bank loans accelerates

Data obtained from monetary statistics and banks' balance sheets reflect that banks' placements and loans accelerated their rate of growth compared with last year. This year saw the highest growth rates since 2003. Placements to household continue to grow at high rates, with housing loans, which again rose at levels exceeding 30% year-on-year, leading the way. It is noteworthy that housing loans make up one-third of all retail loans. Their rise is greatly affected by growing prices of residential housing in Croatia. However, the main characteristic is stronger growth in corporate lending, whose annual growth rate was above 16%, according to the latest available data. Faster growth in corporate loans points to a stronger corporate investment cycle which is reflected in last year's increasing investment growth rate. Strong growth in government borrowing during last year was replaced this year by a decline in the growth rate, due to a smaller central government deficit in the beginning of this year and reduced needs for finance. In view of the modest growth in sources of finance, the rise in banking system assets (13.5%) did not follow the rise in placements. As a result, there was a rearrangement of assets in banks' balance sheets with banks' foreign assets being substantially reduced as the source of financing the growth of placements.

On the liabilities side, in the sources of finance a major contribution to the growth of system assets came from increased foreign borrowing by banks (some 10% in 2005, that is, higher rates at the beginning of this year) considering that the rise in deposits was not sufficient to support such placements growth (annual growth rates of some 10%). At the beginning of this year, placements grew faster than total deposits in the system.

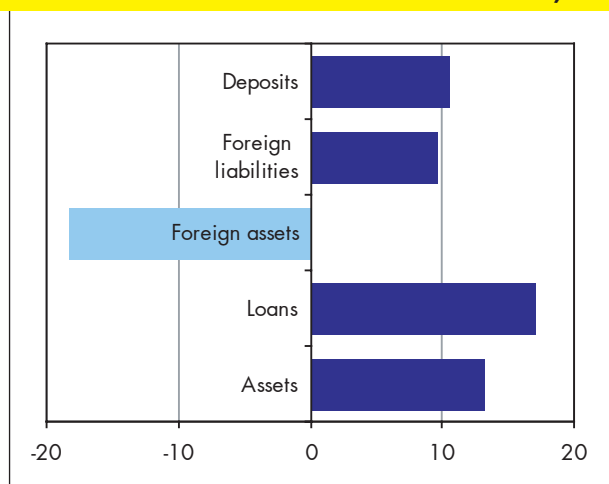
In contrast to the banking system, other segments of the financial market grew more strongly. Open-ended investment funds doubled their assets last year, surpassing the level of HRK 10 bn early this year. Currently they are banks largest competitors in attracting savings, due to the yields they provide in the capital market. Building societies and insurance companies also saw greater asset growth rates than the banking system, as well as the second-largest segment of this market, the leasing companies. Mandatory pension funds exceeded the level of HRK 12 bn and have long been an important player in the domestic money market, foreign exchange market and capital market.

Bank assets



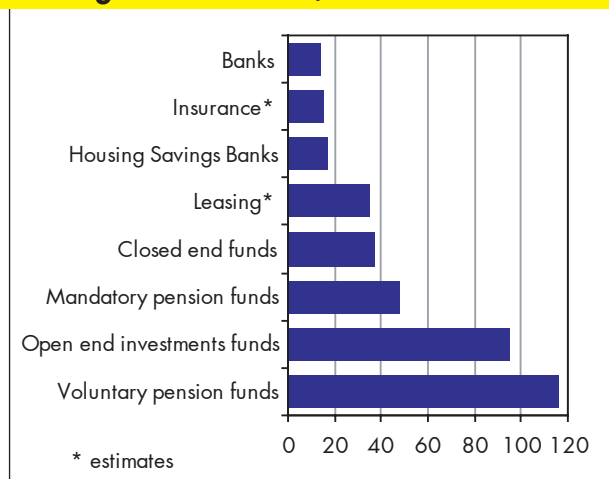
Source: HNB

Growth rates of banks' balance sheets, %



Source: HNB

Asset growth in 2005, in %



Sources: CNB, HANFA, Raiffeisen RESEARCH

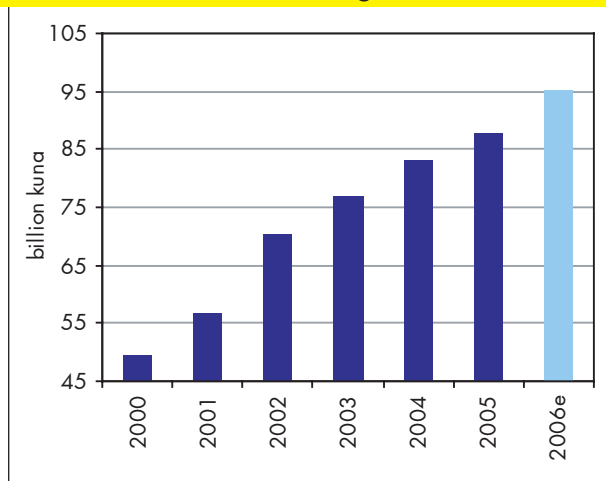


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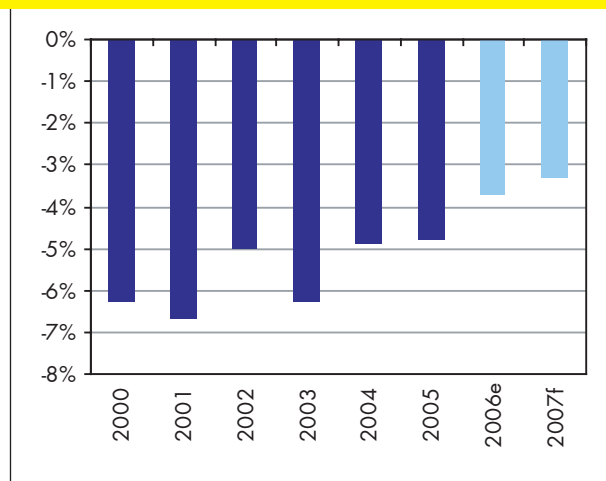
Meeting the 2005 revised target

Central Government Budget



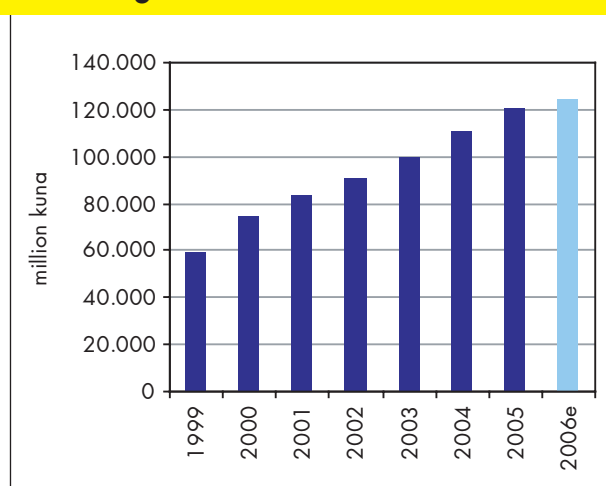
Source: Ministry of Finance

Consolidated general government, % of GDP



Source: Ministry of Finance

General government debt stock



Sources: Ministry of Finance, CNB

Preliminary data on movements in public finances indicate that the deficit target of the general government for 2005 was met. The budget revision of July 2005 introduced a target of 4.2% of GDP. The deficit realized (according to the modified accrual basis) in 2005 totalled HRK 9.3 bn, or 4.1% of GDP. Income and expenditures were realized according to the revised budget plan. VAT revenues, as the main component of budget revenues, exceeded expectations (1.2%) by rising 8% compared with the previous year. Excise duties came in slightly below expectations as well as social contributions. Expenditures were in line with the plan. As the greatest savings in realizing the target deficit were made in connection with the movements of non-financial assets which were at the level of 91.5% of the budget revision (that is 0.3% of GDP below expectations that is the planned amount). By controlling these costs (the largest items are accounted for by extra-budgetary users, primarily Croatian Motorways and Croatian Roads) targets set within the scope of fiscal adjustment were met. Even stronger adjustment paired with monitored expenses is planned for 2006. The stress will be on reform (the new Act on Government Subsidies entered into force; more detailed control is expected in health care paired with revenues from administrative fees) and privatisation of state shares.

Bond issuance and taking out of new loans in the domestic market dominated in the financing of the deficit since domestic liabilities increased and foreign liabilities of the general government budget reduced. Privatisation delays thus resulted in some HRK 4 bn more borrowing than planned, because revenues from the sale of large state shares through large privatization projects were planned somewhere along these lines. More substantial privatization revenues did not come for two years in a row thus contributing to a rise in general government debt, which totalled HRK 120.4 bn at end-2005 (inclusive of CBRD debt and issued guarantees) or some 52.5% of GDP. It is expected that in 2006 the lion's share of the planned deficit of some HRK 8 bn will be financed through privatization projects (primarily of large state shares in INA and HT) worth over HRK 4 bn.

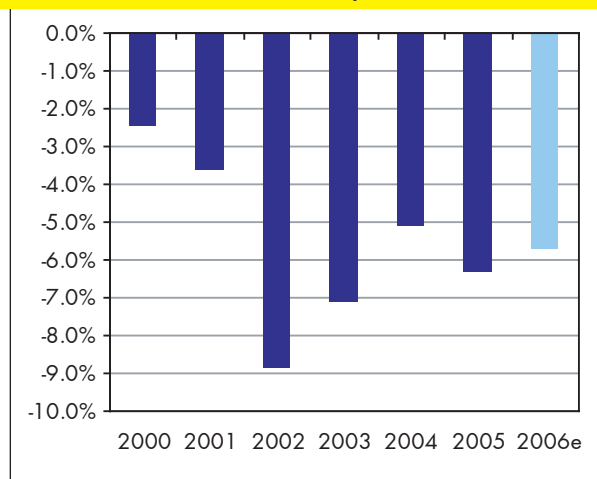
The risk for attaining the deficit target and general government debt in 2005 lies in the repayment of the debt to pensioners, estimated at some HRK 2.4 bn or roughly 1% of GDP. Hence, our caution as regards projections whether this year's targets will be met.

External imbalance still significant

Even the higher surplus on the current account in the third quarter of 2005, resulting from the strong growth of income from tourism, could not significantly reduce the deficit at the end of the year. In 2005, the current account deficit grew to EUR 1.96 bn. The ratio of deficit to GDP also grew to a high 6.3%. Faster growth in goods imports over exports and unfavourable developments in the income account were the greatest deficit generators. In 2006, we expect faster growth of goods exports over imports and a slightly reduced net outflow of income, which should significantly contribute to the reduction of the external imbalance. In addition, we expect the growth of tourism receipts should once again generate higher income from services exports. As a result, the current account deficit in 2006 is expected to fall below 6% of GDP. It will be possible to cover a substantial part of last year's deficit by foreign direct investments, which grew strongly last year, reaching the level of EUR 1.33 bn. However, the structure of foreign direct investment continues to be unfavourable, with a substantial part of the aforementioned amount relating to retained profits and the share of greenfield investments being very low. This year, we expect foreign direct investment to grow and its structure to become more favourable, although still mainly stimulated by privatizations deals.

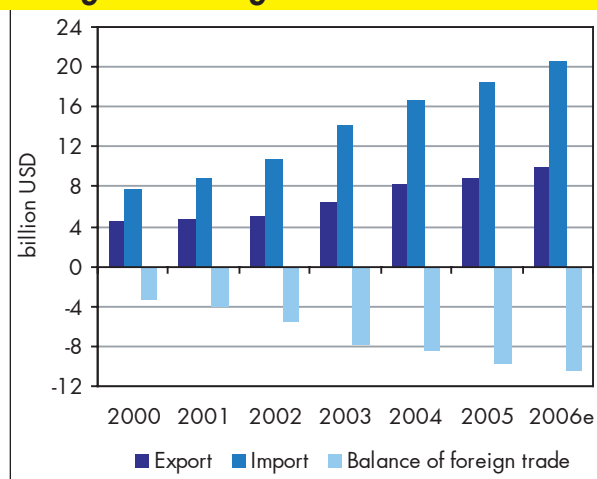
At the end of last year, Croatia's external debt totalled EUR 25.5 bn, reaching 82.4% of GDP. Last year, external debt growth followed a downward trend, with relative growth being half as strong compared with 2004. However, the last quarter of 2005 again saw a double-digit external debt growth in year-on-year terms, which led to implementation of new measures by the central bank aimed at curbing foreign borrowing by commercial banks. The measures should contribute to weaker growth of external debt and stabilisation of the ratio of external debt to GDP in 2006, despite stronger growth so far in 2006. As a result, we expect this year's external debt as a percentage of GDP to be slightly higher than in 2005, depending also on GDP growth. At the same time, the commitment of the central government to finance its needs and refinance its foreign liabilities in the domestic capital market should make a positive contribution to the slowdown in external debt growth but also to the reduction in the government's share in the structure of total external debt.

Current account balance, % of GDP



Source: CNB

Foreign trade of goods



Source: CBS

External debt and ratios

Quarters	External debt (EUR mn)	External debt as % of: GDP	Exports of goods and services	reserves (% of external debt)
Q103	16,264	65.3%	145.9%	35.6%
Q203	17,144	67.6%	145.6%	34.6%
Q303	18,244	70.6%	139.4%	33.9%
Q403	19,811	75.6%	150.8%	33.1%
Q104	20,618	77.5%	154.9%	30.0%
Q204	21,928	80.6%	162.1%	29.1%
Q304	21,963	78.8%	157.8%	29.4%
Q404	22,781	80.2%	160.0%	28.2%
Q105	23,143	80.2%	161.7%	29.0%
Q205	24,260	82.2%	167.4%	29.1%
Q305	24,080	79.7%	160.3%	29.1%
Q405	25,508	82.4%	167.2%	29.2%

Source: CNB

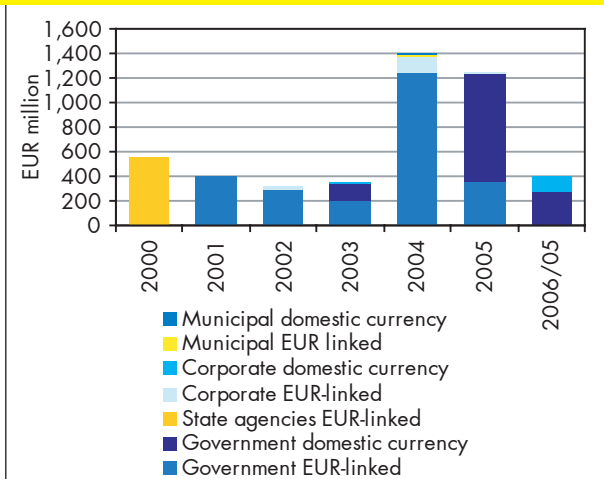


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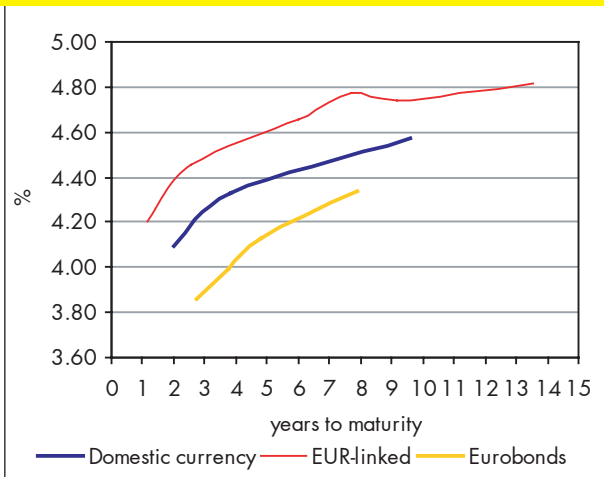
Strong influence of developments abroad

New bond issues in domestic market



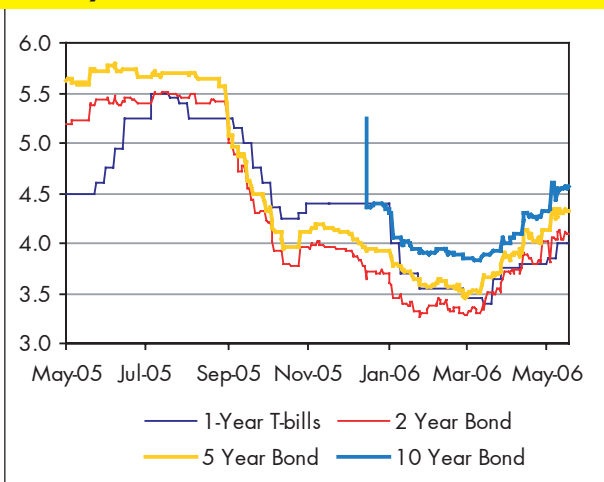
Sources: Ministry of Finance, Raiffeisen RESEARCH

Yield curves of Croatian bonds



Sources: Bloomberg, biznis.infoforum.hr, Raiffeisen RESEARCH

Kuna yields



Sources: Ministry of Finance, Raiffeisen RESEARCH

Issuers were not particularly active at the very beginning of 2006, but the market moved later. Only two new bonds were issued in the market during Q1, the second tranche of a ten-year kuna bond (worth HRK 2 bn), and the largest corporate bond issue so far, issued exclusively in the domestic market, the HRK 600 mn five-year bond of Raiffeisenbank Croatia. Since at the same time, the central bank introduced new measures, aimed at discouraging new banks' bond issues, the market went quiet after that. However, at the beginning of the second quarter we saw announcements of new corporate bond issues in the domestic market and according to the adopted 2006 budget we are going to see new government bond issues aimed at financing the deficit and refinancing maturing liabilities. In May, HRK 375 bn worth issue of Podravka, a food and beverage company, followed. The postponement of large privatization projects to the second half of the year will probably lay greater stress on new issues in the second and third quarter. Greater aptitude of corporate subjects towards financing through capital markets should result in an increasing share of corporate issues in the structure of new bond issues. Q4 2005 was marked by a reduction in spreads of domestic bond markets, while in Q1 2006 the spread widened after having hit historical lows. The reason for this can primarily be found in the influence of foreign markets. The negative influence of expected interest rate growth in Europe, combined with prolonged growth cycle in the USA, boosted yields higher (European yields grew by some 70bp by May), and are expected to go even higher by the end of the year. As a result, prices of bonds indexed to foreign currency declined greatly. Since Croatia's market is still substantially influenced by large turnovers in the domestic market, the effect of strong sales activity was more prominent over a short period, being especially prominent in relation to short-term bond issues. As a mild consolidation in European bonds is expected by the summer, counting on wider spreads than at the beginning of the year, following the last yield increase influenced by the significant exchange rate movements, bonds indexed to foreign currency could see some favourable impacts already in mid-summer, but the latter part of the year could be marked by negative effects of external developments.

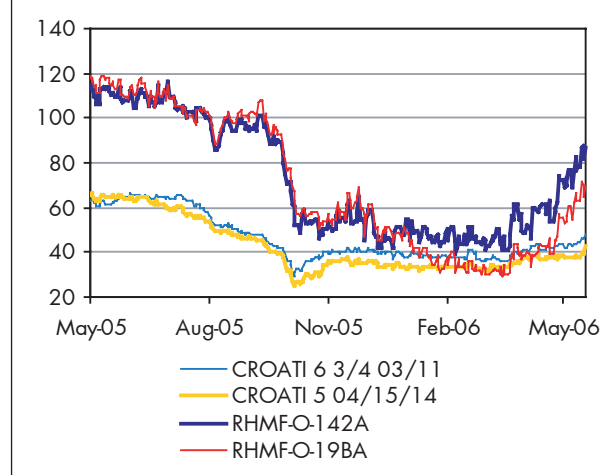
The effect of bonds weakening in the world market (that is domestic bonds indexed to foreign currency) was partly transferred to kuna bonds, although strong demand for these bonds (due the fact that

Adjustment of Kuna yields

this issue was still smaller than the interest of investors) resulted in historically low levels of kuna yields before yields began rising again. The growth of T-bill yields started at the end of the first quarter due to expected greater needs for finance through CNB's reversed repo auctions. The approaching of the summer period will bring about greater pressures on kuna liquidity. As a result, T-bills yields can grow to levels and hold above the reversed repo rate (3.5%). For domestic investors, primarily those with dominant kuna liabilities, the movement of real kuna yields is also important. The inflation rate at the beginning of this year was still at levels close to the highs of several years which at one point led to actually negative yields in certain segments of the yield curve. Considering that we can expect greater pressures in the money market combined with maintained high inflation levels as the summer approaches, we expect an additional negative influence on kuna bonds through to summer, but of course this is neutralized or overwhelmed by the existing demand for such bonds.

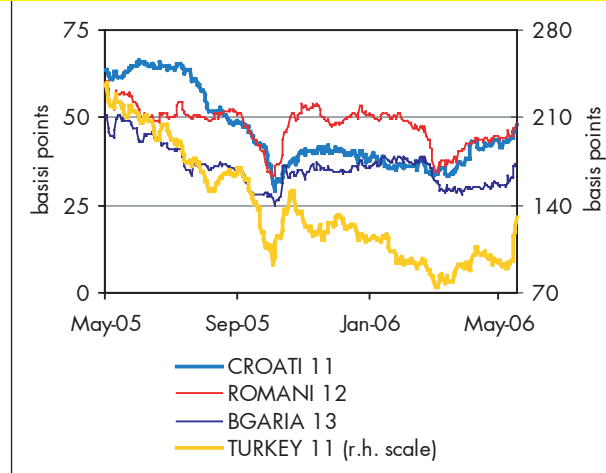
Croatian spreads in the foreign markets felt strong influences of developments in the foreign market during the first part of the year, especially in the emerging markets. News from South America on favourable economic developments and reduction of external debt again lowered spreads at one point. However, the complexity of situation in some countries and caution due to rising interest rates and yields in the world markets accompanied with unfavourable developments in the region (Hungary) resulted in the new widening of the spread to the level of some 45 basis points with only a mild reduction expected by the end of the year.

Croatian bond spreads



Source: Bloomberg, Ministry of Finance, Raiffeisen RESEARCH

Spread comparison



Source: Bloomberg

Government and government guaranteed bonds in domestic market

Bond	Currency	Volume (mn)	Maturity (%)	Coupon	YtM (ask, %) 5/18/06	Spread to Bund 5/18/06	Spread to EUROSAP 5/18/06	YtM (ask, %) 3/31/06	YtM (ask, %) 12/31/05	YtM (ask, %) 5/18/05
RHMF-O-077A	EUR*	400	7/7/07	3.875	4.20	103	82	3.89	3.38	3.12
RHMF-O-08CA	EUR*	200	12/14/08	6.875	4.45	104	82	4.07	3.48	3.37
RHMF-O-125A	EUR*	500	5/23/12	6.875	4.66	90	70	4.25	3.68	4.04
RHMF-O-142A	EUR*	650	2/10/14	5.500	4.77	87	69	4.28	3.77	4.29
RHMF-O-157A	EUR*	350	7/14/15	4.250	4.74	76	58	4.23	3.80	
RHMF-O-19BA	EUR*	200	11/29/19	5.375	4.81	70	46	4.24	3.87	4.66
RHMF-O-085A	HRK	1,000	5/28/08	6.125	4.10	75	54	3.71	3.69	5.23
RHMF-O-103A	HRK	3,000	3/8/10	6.750	4.33	71	55	3.87	3.92	5.59
RHMF-O-15CA	HRK	5,500	12/15/15	5.250	4.57	57	39	4.01	4.34	

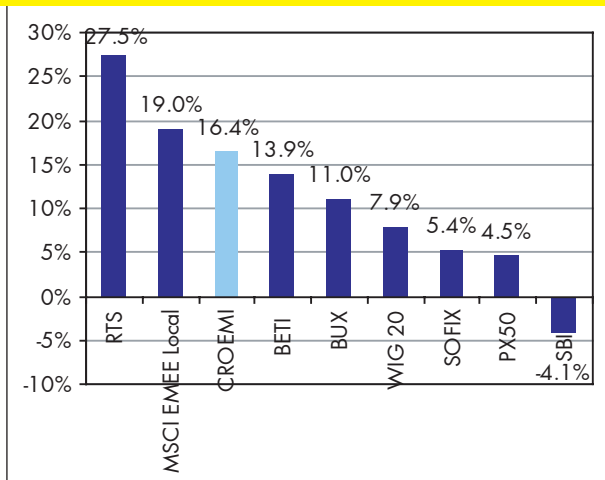
* Indexed to euro; secondary market, interest and principal payment mid rate of CNB on trading day or maturity day

Sources: Ministry of Finance, ZSE, CDA, Reuters.hr



Breaking of old records

Region's core indices - YTD performance

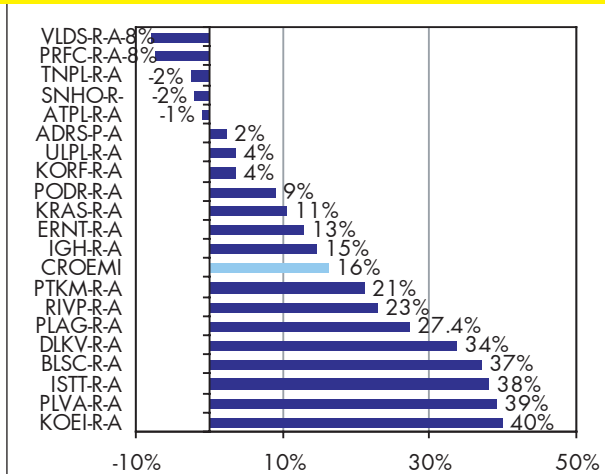


Note: In local currency, value on March 31, 2006

*MSCI Emerging Market Eastern Europe

Sources: Bloomberg, Raiffeisen RESEARCH

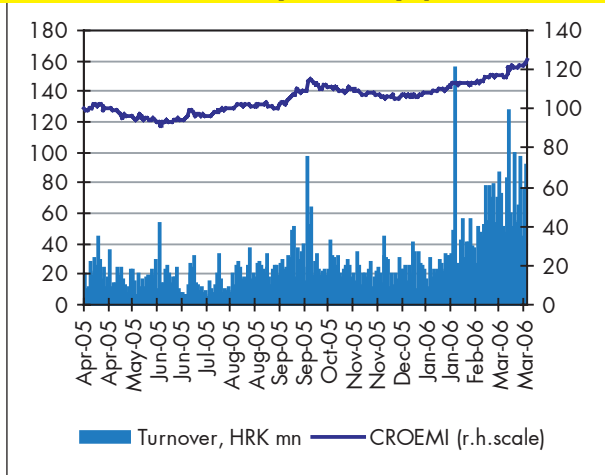
Performance YTD of CROEMI members



Note: Values on March 31, 2006

Sources: ZSE, VSE, Raiffeisen RESEARCH

Market turnover & yield - 1y performance



Sources: ZSE, VSE, Raiffeisen RESEARCH

Regional returns: The Croatian market realized a high return of 16.4% in the first quarter. Among the regional markets, the Russian market leads the way with a return of 27.5%, while the Slovenian market is at the very back with a -4.1% yield. The Russian and the Croatian market thus realized our planned returns for the entire year, which totalled 30% for the Russian and 10-15% for the Croatian market. The Central European markets of Poland, the Czech Republic and Hungary with a return median of 5.4% moved in line with our expectations (yield of 15% in 2006), i.e. belonged to the second (worst) group of regional returns. The Croatian market recorded relatively lower returns compared with the regional markets last year, but so far this year it is among the fastest growing markets in the region.

Returns in the domestic market: The more substantial return of Croatian market than initially anticipated may be due to Pliva's exceptional return. With its growth of 39% from the beginning of the year, Pliva contributed almost 50% to the rise of the overall market, measured by the CROEMI index. In the middle of March, Actavis made its non-binding offer to take over Pliva at HRK 570 per share. Pliva ended the quarter at a level slightly above the offered level (HRK 578 per share). In addition to Pliva, a significant contribution to the growth of the market was provided by the following: Ericsson Nikola Tesla with growth of 13%, Dalekovod (+33.7%), Koncar (+40%) and Podravka (+9.1%). These five issuers accounted for 77.3% of CROEMI's growth. The most substantial downward influence, with a negative return of -7.5% was realised by Proficio. CROEMI ended the first quarter at 2042.89 points, i.e. historically its highest level. Market capitalisation of all shares traded during the first quarter of 2005 totalled EUR 16.6 bn, that is, 53% of gross domestic product.

Share turnover: Apart from prices, which all broke their all-time highs, the realised turnovers also reached record levels. Total share turnover in the first quarter amounted to HRK 2.9 bn and HRK 171.5 mn of IPO turnover, making up a total of HRK 3.1 bn of share turnover (excluding auctions). As a result, turnover in the first quarter of 2006 exceeded the turnover realised at the same time a year ago by 17%, i.e. it was the highest quarterly share turnover ever recorded on Croatian exchanges. In the last 12 months share turnover reached 3.2% of the gross domestic product. The

CROEMI - Kraš and Uljanik

plovidba at 50% of free float

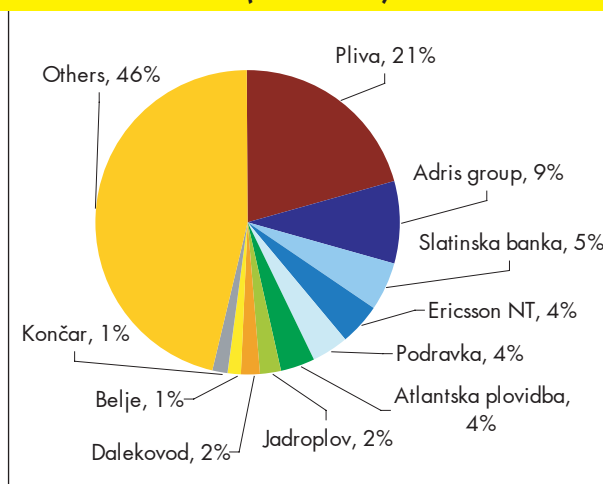
largest daily turnover, HRK 127.6 mn, was registered on 17 March 2006, primarily as a result of HRK 68 mn in trading in Pliva shares.

The most liquid share, with a 21% share in total turnover and a turnover of HRK 615.6 mn in the first quarter, was Pliva. Far behind, in second place was the share of Adris Group with HRK 250.6 mn and a mere 9% of total turnover. Slatinska banka took the third place, with turnover of HRK 152.4 mn and a share of 5% in total turnover. Among the five most liquid shares were also Ericsson Nikola Tesla and Podravka shares. The five shares with the greatest turnover accounted for 47% of total turnover, the ten most liquid for a share of 57%. In order to cover 75% of total turnover it was necessary to include turnovers of 35 shares with the largest turnover.

Regular CROEMI revision: The regular analysis of the CROEMI was carried out based on the analysis of first quarter turnovers. All liquidity and market capitalization criteria were met by a total of 51 shares. This is a record number of shares that met all the criteria, and this is a trend that has been observed for the fourth quarter in a row. All the criteria in the second quarter of 2005 were met by 24 shares, in the third quarter by 31 shares and in the last quarter of the year by 47 shares. Although CROEMI criteria were fulfilled by many shares (51), it is interesting that as much as two current index constituents did not manage to satisfy the criterion of average daily turnover. Those are Kraš and Uljanik plovidba. These two issuers recorded average daily turnovers of HRK 101 mn, while the CROEMI criterion was HRK 118.6 mn. Based on CROEMI methodology for the new composition, which entered into force on 15 April 2006, the weights of Kraš and Uljanik plovidba on the index have been reduced to 50% of their free floated shares. At the same time, shares of Plava laguna increased the factor of free shares, since they met all CROEMI criteria in the first quarter. In the new, revised CROEMI composition, the share remained, but the weights of individual shares were changed.

Movements of Sales and Net Profits: 2005 results indicate that the sale of CROEMI constituents, excluding former privatization funds, grew by 8.3%, which is some 9% more than the nominal growth of gross domestic product. In the same period, profits declined by 17%. However, if we exclude Pliva's results, profits rose by 36% and sales by 6.3%. The aggregate sales growth of

Turnover shares (Q1 2006)



Sources: ZSE, VSE, Raiffeisen RESEARCH

Net income & sales development

in HRK '000	Sales 2005	%	Net income 2005	%
ADRS-P-A	2,612,084	0%	494,939	-34.24%
ATPL-R-A	856,950	52%	432,714	295.25%
BLSC-R-A	1,093,104	8%	8,102	-43.13%
DLKV-R-A	n.a.	n.a.	n.a.	n.a.
ERNT-R-A	1,624,515	5%	235,688	8.42%
IGH-R-A	435,008	17%	38,410	98.12%
ISTT-R-A	284,350	1%	43,453	-45.82%
KOEI-R-A	1,838,097	14%	11,945	60.75%
KRAS-R-A	913,513	7%	40,866	31.93%
PLAG-R-A	326,736	3%	85,832	8.89%
PODR-R-A	3,441,378	4%	62,628	-15.39%
PTKM-R-A	1,585,416	9%	-29,481	-24.16%
RIVP-R-A	n.a.	n.a.	n.a.	n.a.
TNPL-R-A	982,935	-11%	419,097	4589.98%
ULPL-R-A	9,629	9%	29616	37.12%
Total	16,003,715	6.3%	1,873,809	36.2%
USD mn.				
PLVA-R-A	934	16%	-34	-132%

Source: CROSEC, Pliva, Raiffeisen RESEARCH

Market valuation as of March 31, 2006

	P/E 06e	P/E 07f	EPS 06e	EPS 07f
BUX	11.4	11.1	8.10%	3.00%
WIG 20	13.2	13.9	-4.70%	-5.50%
PX 50	18	15.7	20.10%	14.80%
RTSI	11.2	11.2	4.70%	0.20%
Avg wo Russia	14.20	13.6	7.8%	4.1%
Median wo Russia	13.2	13.9	8.1%	3.0%
CROEMI	14.4	n.a.	187.4%	n.a.
CROEMI discount to avg	-1%	n.a.		

Sources: Raiffeisen RESEARCH

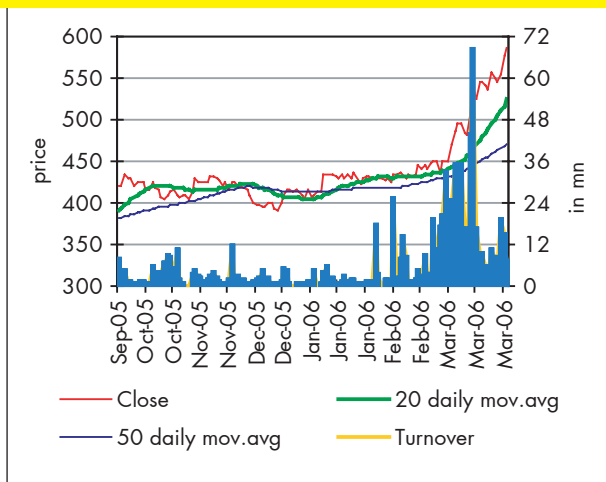


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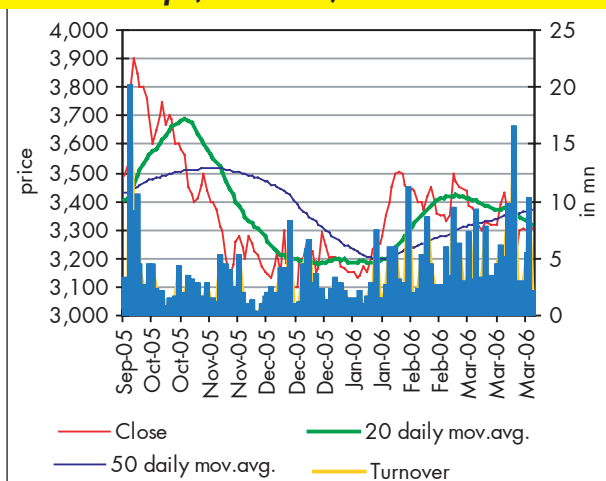
Market thinks positively

Pliva (6 months)



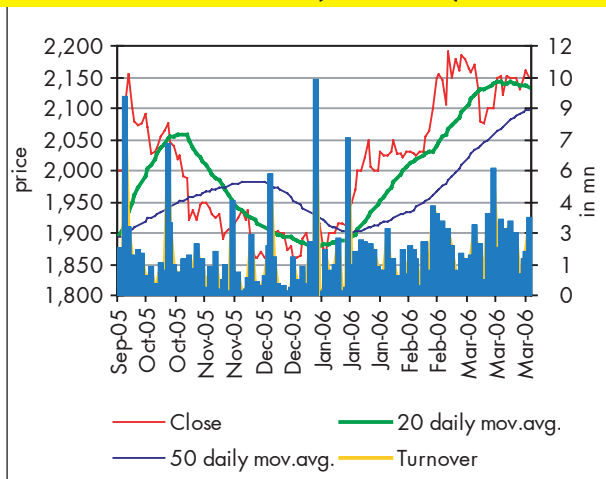
Sources: ZSE, Raiffeisen RESEARCH

Adris Group (6 months)



Sources: VSE, Raiffeisen RESEARCH

Ericsson Nikola Tesla (6 months)



Sources: ZSE, Raiffeisen RESEARCH

CROEMI constituents was influenced mostly by Pliva and Atlantska plovdba, while the aggregate growth of net profits was mostly spurred by the shares of Tankerska and Atlantska plovdba. Pliva and Adris Group made the most substantial negative contribution to aggregate fall of net profits.

Market Valuation and Expectations: Including the third quarter, the expected P/E of CROEMI constituents for 2006, exclusive of former privatisation funds, totalled 14.4 which was a premium of 1% over the same indicator for the Hungarian, Polish and the share market of the Czech Republic. We expect that in 2006 CROEMI constituents will have average profit payments of some 25%. Considering current expectations in relation to 2006 results and the percentage of profit payments, we think that the market has fundamental support at current levels. For issuers of Central European Indexes in 2007 (Raiffeisen Zentralbank and Raiffeisen Centrobank research) we expect earnings growth of 4.1%, while the expected ratio of current prices and earnings for 2007 totals 13.6. For Croatian issuers, due to substantial profit growth of Pliva, that is its return to the positive territory, we expect profit growth of 187.4% in 2006. Macroeconomic expectations of the nominal growth of gross domestic product for 2007 in the Central European countries and Croatia are more or less the same, that is, move around the level of some 7%. To support further growth of the value of the equity market, the growth of earnings of Croatian issuers should exceed 4-5% in 2007. Under this condition, our equity market would maintain the fundamental balance within the framework of comparable market valuations. Although we do not have all expectations for 2007 due to the currently very low profitability of many issuers in the index, we think there is still considerable room for growth of net profits, i.e. we think there is a good probability that the growth of net profits in 2007 will exceed 5%. Hence, further growth of the value of currently most liquid issuers, CROEMI constituents, should not provide reason for worry.

The sugar factory, Viro, and the closed-end investment fund, Breza invest, are private issuers which raised additional capital by public offering. The market expects the public offering of the 15% of INA shares and further privatization of the government's portfolio. These (new) issuers should enable further growth and development of Croatia's equity market.

RZB Group Research Team

Vienna

Peter Brezinschek
Andreas Auer
Rudolf Al-Badry
Thomas Bichler
Walter Demel
Wolfgang Ernst
Christian Hinterwallner
Thomas Hirsch
Valentin Hofstätter
Klemens Hrovath
Gerhard Lechner
Christoph Klaper
Lydia Kranner
Hannes Loacker
Herbert Matzinger
Christine Nowak
Markus Obrist
Ronald Plasser
Sebastian Pusch
Helge Rechberger
Andreas Schiller
Robert Schittler
Gintaras Shlizhyus
Wolfgang Steger
Gottfried Steindl
Martin Stelzeneder
Stephan Vrublovsky

Albania

Erma Strati
Evina Papa

Belarus

Vasily Pirogovsky
Olga Laschevskaya

Bosnia & Herzegovina

Zeljko Pehar
Amna Gabela
Davor Jukic

Bulgaria

Emilia Atanasova
Boris Penev

Croatia

Hrvoje Dolenec
Zdeslav Santic
Zrinka Zivkovic Matijevic
Ivana Blaskovic
Lidija Brkanic

Czech Republic

Pavel Mertlik
Helena Horska
Michal Brozka
Jindrich Svatek

Hungary

Zoltan Török
Akos Kuti
Bence Lanyi
Kornel Sarkadi Szabo

Poland

Jacek Wisniewski
Marcin Palenik
Marta Petka

Romania

Ionut Dumitru
Nicolae Covrig
Ion Gheorghe Guta
Bogdan Campianu
Oleg Galbur
Dorin Boboc

Russia

Madina Butaeva
Stanislav Ponomarenko
Alexander Balakhnin
Mikhail Borisov

Serbia

Aleksandra Vukosavljevic

Slovakia

Robert Prega
Elizej Macho
Branislav Baricak
Martin Jelenciac

Slovenia

Sabina Zupec-Kranjc
Darko Kovacic

Ukraine

Igor Budnyk
Yevgen Zinoviyev

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Editor: Raiffeisen Zentralbank Österreich Aktiengesellschaft

A-1030 Vienna, Am Stadtpark 9, Telephone: +43 1 717 07-0, Telefax +43 1 717 07-1715

Raiffeisen Centrobank AG

A-1015 Vienna, Tegetthoffstraße 1, Telephone: +43 1 51520-0

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Abbreviations

Currencies and Countries

BAM Bosnian Mark
BGN Bulgarian Lev
CSD Serbian Dinar
CZK Czech Koruna
EKK Estonian Kroon
HRK Croatian Kuna
HUF Hungarian Forint
LVL Latvian Lats
LTL Lithuanian Litas
PLN Polish Zloty
RON Romanian Leu
RUB Russian Rouble
SIT Slovenian Tolar
SKK Slovak Koruna
TRL Turkish Lira
UAH Ukrainian Hryvnia

CE Central European countries - Poland, Hungary, Czech Republic, Slovakia, Slovenia
SEE South East European countries - Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia
CIS European CIS (Commonwealth of Independent States) countries - Russia, Ukraine, Belarus

Economic abbreviations

avg average
yoy year on year
LCY Local Currency
GDP Gross Domestic Product
C/A Current Account
T/B Trade Balance
FDI Foreign direct investments
CPI Consumer price index
PPI Producer price index
FX Foreign Exchange
ULC Unit Labour Costs
%-chg Percentage change
(not in percentage points)

Stock Exchange Indices

BET Romanian stock index
BUX Hungarian stock index
PX 50 Czech stock index
RTSI Russian stock index
WIG 20 Polish stock index

Equity related

DY Dividend yield
EG Earnings growth
LTG Long term (earnings) growth
P/E Price earnings ratio

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**Raiffeisen
RESEARCH**

RZB Group

Investment banking units

Raiffeisen Zentralbank Österreich AG, Vienna **Global Markets**

Head: Christian Säckl Tel: +43 1 71707 3347
Financial Sales: Hans Retzl Tel: +43 1 71707 3300

Bratislava: Tatra banka, a.s.

Contact: Dusan Pivka Tel: +421 2 5919 1221

Bucharest: Raiffeisen Capital & Investment S.A.

Contact: James Stewart Tel: +40 21 302 0082

Budapest: Raiffeisen Bank Zrt.

Contact: Ferenc Szabo Tel: +36 1 484 4400

Kiev: Raiffeisenbank Ukraine

Contact: Vyacheslav Molodkin Tel: +380 44 49005 42

Maribor: Raiffeisen Krekova Banka d.d.

Contact: Gvido Jemensek Tel: +386 2 229 3111

Minsk: Priobank JSC

Contact: Vladimir Kravchenko Tel: +375 17 289 9016

Moscow: ZAO Raiffeisenbank Austria

Contact: Pavel Gourine Tel: +7 495 721 9929

Raiffeisen Centrobank AG, Vienna **Equity Capital Markets**

Head: Wilhelm Celeda Tel: +43 1 515 20 402
Sales: Manfred Schmirgl Tel: +43 1 515 20 465

Raiffeisen Investment AG, Vienna

Contact: Heinz Sernetz Tel: +43 1 710 54 00 13

Tirana: Raiffeisen Bank Sh.a.

Contact: Christian Canacaris Tel: +355 4 253 646

Prague: Raiffeisenbank a.s.

Contact: Martin Blaha Tel: +420 221 141 863

Sofia: Raiffeisenbank (Bulgaria) EAD

Contact: Evelina Miltenova Tel: +359 2 91985 451

Warsaw: Raiffeisen Bank Polska S.A.

Contact: Albert Trayner Tel: +482 2 585 2900

Zagreb: Raiffeisenbank Austria d.d.

Contact: Ivan Zizic Tel: +385 1 45 66 466

Commercial banks

Raiffeisen Zentralbank Österreich AG, Vienna

Corporates: Peter Bazil Tel: +43 1 71707 1547
Financial Institutions: Martin Czurda Tel: +43 1 71707 1120

RZB London Branch

Contact: Wladimir Ledochowski Tel: +44 20 7933 8002

Raiffeisen Malta Bank plc., Sliema

Contact: Anthony C. Schembri Tel: +356 21 320 942

RZB Finance LLC, New York

Contact: Dieter Beintrexler Tel: +1 212 845 4100

RZB Beijing Branch

Contact: Andreas Werner Tel: +86 10 653 233 88

RZB Singapore Branch

Contact: Rainer Silhavy Tel: +65 622 595 78

Central and Eastern Europe (Raiffeisen International)

Vienna: Raiffeisen International Bank-Holding AG

Contact: Peter Lennkh Tel: +43 1 71707 1709

Belgrade: Raiffeisenbank a.d.

Contact: Oliver Rögl Tel: +381 11 32021 00

Bratislava: Tatra banka, a.s.

Contact: Rainer Franz Tel: +421 2 591 912 03

Bucharest: Raiffeisen Bank S.A.

Contact: Steven van Groningen Tel: +40 21 30610 00

Budapest: Raiffeisen Bank Zrt.

Contact: Péter Felcsuti Tel: +361 484 44 40

Kiev: Raiffeisen Bank Aval

Contact: Johannes Riepl Tel: +380 44 492 06 05

Maribor: Raiffeisen Krekova Banka d.d.

Contact: Klemens Novotny Tel: +386 2 229 3100

Minsk: Priobank JSC

Contact: Alexander Klochko Tel: +375 17 289 9015

Moscow: ZAO Raiffeisenbank Austria

Contact: Johann Jonach Tel: +7 495 721 99 00-5008

Prague: Raiffeisenbank a.s.

Contact: Rudolf Rabinak Tel: +420 2 21 141 289

Pristina: Raiffeisen Bank Kosovo J.S.C.

Contact: Albert Matoshi Tel: +381 38 226 400

Sofia: Raiffeisenbank (Bulgaria) EAD

Contact: Momtchil Andreev Tel: +3592 91 985 101

Sarajevo: Raiffeisen Bank d.d. Bosna i Hercegovina

Contact: Edin Mufic Tel: +387 33 287 100

Tirana: Raiffeisen Bank Sh.a.

Contact: Steven Grunerud Tel: +355 4 274 912

Warsaw: Raiffeisen Bank Polska S.A.

Contact: Piotr Czarnecki Tel: +48 22 585 20 00

Zagreb: Raiffeisenbank Austria d.d.

Contact: Lovorka Penavice Tel: +385 1456 64 66

