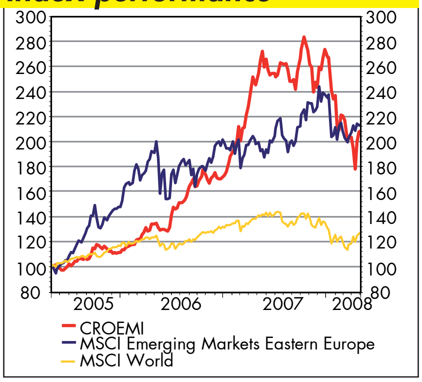
Strategy Croatia

May 2008

Index performance



Source: Thomson Financial Datastream

Recommendations (Horizon: 3 months)

Bond market

Buy

HRK
RHMF-0-172A

Eurobonds
Croatia 02/2010 4.625%
Croatia 04/2014 5%

Analysts
Raiffeisenbank Austria d.d., Zagreb

Zdeslav Santic
zdeslav.santic@rba.hr
Denis Dolinar
denis.dolinar@rba.hr
Nada Harambasic
nada.harambasicc@rba.hr

RZB, Vienna
Gunter Deuber
gunter.deuber@raiffeisenresearch.at
Aaron Alber
aaron.alber@raiffeisenresearch.at

Highlights

- The Croatian economy finished 2007 on a strong note. Although the regional economic outlook for 2008 is less favourable than in the past years due to spillovers from a weaker growth in the EU-15 as well as contagion risks from the global financial crises, we expect the Croatian economy to grow by 4.4% in 2008.

- Croatia's pronounced external imbalances (still lower than in some other SEE countries) stemming from elevated (external) private sector indebtedness and low competitiveness of the export sector should not mitigate from a short-term perspective.

- The FX rate should follow its traditional seasonal patterns, i.e. the kuna should strengthen vs. the euro when the tourism season peaks. However, such swings might be less pronounced than in the past as other factors than supply-demand dynamics resulting from the tourism season are dominating at present. From a 3-month perspective and taking current spread levels on local bonds and Croatian Eurobonds (as well as our expectations for a stronger kuna and lower benchmark yields into account) we recommend both asset classes as a buy for foreign investors.

- The Croatian equity market experienced a tremendous correction in Q1 2008 and went down by 25.3%. The global financial crisis and the liquidity shortage are curbing investors' willingness to take risk in SEE equity markets. For the Croatian equity market, which otherwise tends to develop independently of external conditions, this will translate into a higher level of dependence on international trends.

Key economic figures and forecasts

	2003	2004	2005	2006	2007	2008e	2009f
GDP (EUR bn)	26.2	28.7	31.3	34.2	37.2	41.2	44.6
GDP (% yoy)	5.3	4.3	4.3	4.8	5.6	4.4	4.7
GDP per capita (EUR)	5,909	6,459	7,043	7,712	8,470	9,339	10,136
Industrial production (% yoy)	4.1	3.7	5.1	4.5	5.6	4.4	4.3
Unemployment rate (%, avg)	19.1	18.5	18.0	17.0	14.7	13.5	12.8
PPI (avg, % yoy)	1.9	3.5	3.0	2.9	3.4	7.2	3.4
CPI (avg, % yoy)	1.8	2.1	3.3	3.2	2.9	5.8	3.6
CPI (eop, % yoy)	1.7	2.7	3.6	2.0	5.8	4.1	3.2
General budget balance (% GDP)	-6.2	-4.8	-4.1	-3.0	-2.8	-2.4	-2.0
Public debt (% GDP)	51.1	51.6	52.3	49.6	48.0	46.7	45.8
Trade balance (% GDP)	-26.6	-23.5	-24.1	-24.3	-25.5	-26.4	-25.8
Current account balance (% GDP)	-7.2	-5.1	-6.4	-7.7	-8.6	-9.2	-9.4
Official FX-reserves (EUR bn)	6.6	6.4	7.4	8.7	9.3	10.5	11.5
Foreign debt (% GDP)	75.5	79.1	81.7	85.3	89.1	90.1	89.9
HRK/USD (avg)	6.71	6.03	5.95	5.81	5.36	4.99	5.20
HRK/EUR (avg)	7.56	7.50	7.40	7.32	7.34	7.26	7.22
HRK/EUR (eop)	7.44	7.65	7.67	7.38	7.33	7.30	7.25

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Raiffeisen RESEARCH
RZB Group

Croatia
Content

The heat is on in 2008

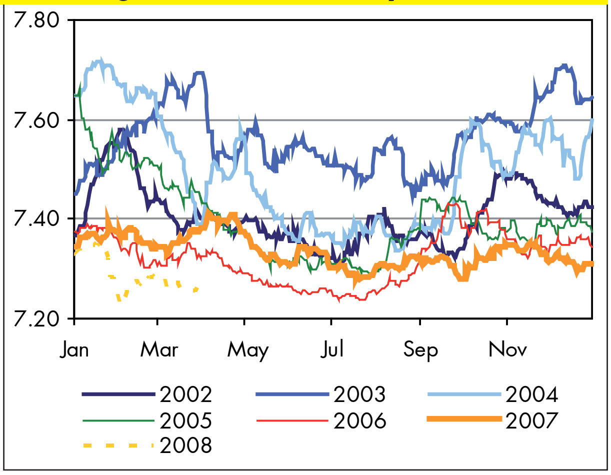
A decisive year for policy makers

The year did not start as expected, neither politically nor economically. Problems in Croatia's EU negotiations arose after it began enforcing the Protected Ecological Fishery Zone (ZERP), causing considerable diplomatic tension with Slovenia and Italy. In addition, some EU institutions pointed to the sluggish implementation of reforms. The government's decision to postpone the application of the ZERP to EU member states came as the first real test of the stability of the governing coalition, which may prove crucial when the time comes to implement less popular reforms. Following the government's decision, the European Commission announced that end of 2009 is a realistic timeframe for the completion of Croatia's EU negotiations. If Croatia intends to meet all of its obligations by that date, it will have to implement the majority of reforms and activities relating to the harmonisation with EU legislation over the course of this year.

Following last year's positive economic developments, which resulted in accelerated GDP growth, economic conditions were less favourable at the beginning of 2008. This year is expected to bring a more significant slowdown in economic activity, primarily in terms of personal consumption. Probably the biggest challenge that will be faced by economic policy makers is the elevated and still mounting inflationary pressure. Intense upward pressures on consumer prices were generated both by global developments such as the substantial increases in food and energy prices and domestic factors such as the growth in utility prices. Stronger inflationary pressures caused a tightening in monetary policy and an adjustment of fiscal policy to the new circumstances (i.e. slower real expenditure growth). All of these economic policy changes will contribute to a slowdown in GDP growth in 2008. The sizeable decline in equity markets, which caused widespread investor anxiety, also contributed to negative sentiment at the beginning of the year.

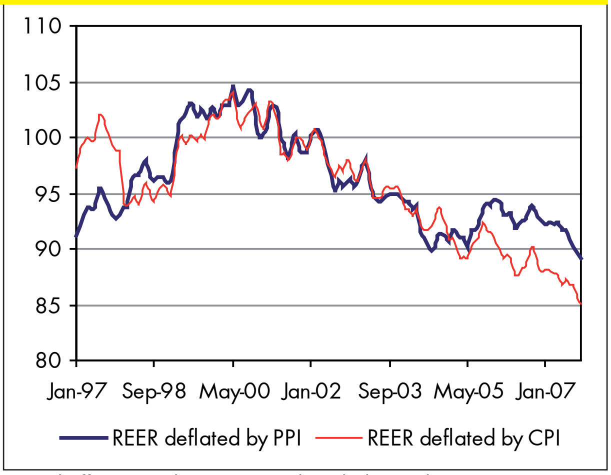
In the wake of slow growth and high inflation, the government will have to implement extensive reforms. These reforms should not only be viewed as preparation for accession to the EU, but also as the last phase of the transition to a fully functioning market economy. The final objective of these reforms is to create an environment that will enable Croatia to achieve higher growth rates on a much more sustainable basis (i.e. with less external imbalances than today).

Declining EUR/HRK volatility



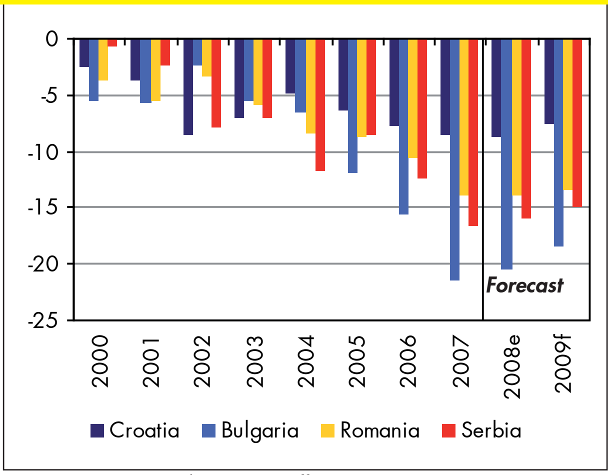
Source: Croatian National Bank, Raiffeisen RESEARCH

REER index*



* Real Effective Exchange Rate index, declining slope means appreciation; CNB midpoint exchange rate, 2001 = 100
Source: Croatian National Bank

C/A Balance SEE (% GDP)



Source: wiiw, national sources, Raiffeisen RESEARCH

Usage of EU funds
and future contribution to EU aggregates

At the beginning of this year the general public became increasingly interested in the use of the EU pre-accession funds available to Croatia. The use of these funds came under scrutiny following news of the suspension of all new contracts under the PHARE programme (whose beneficiaries are public administration bodies, public enterprises and the non-government sector). The European Commission demanded improvements in the implementation of this programme in Croatia.

In the middle of January, it was confirmed that the endorsement and approval of new projects for implementation under the PHARE programme had been temporarily suspended due to weaknesses in the decentralised implementation of managing projects financed with EU funds. This was a result of the election process, staffing difficulties, insufficient monitoring of tender documentation and difficulties in the implementation of agreed action plans at various ministries. It is worth noting that funds for the projects that are already being implemented, such as projects under PHARE 2005 or CARDS 2004, have not been suspended or lost and that the activities that have been agreed upon in regard to these projects have been carried out as planned. However, the European Commission will not sign new agreements under the PHARE 2006 (more than 20 are currently in preparation). This means that the programme will not be carried out until Croatia meets certain requirements (e.g. increase in the monitoring of implementation of projects at the government level, improvement in the fulfilment of action plans and an increase in the number of people employed by the Central Finance and Contracting Agency [CFCA]).

In order to avoid more serious consequences resulting from this "simple" suspension of further contracts the relevant bodies, primarily the CFCA (whose task is to prepare and carry out tenders and conclude support agreements, agreements on the purchasing of goods, services and works etc.), hired new employees. As a result, all of the Commission's requirements relating to the better management of pre-accession funds in Croatia have been met, which will lead to the revocation of the suspension and the verification and implementation of new agreements for projects co-funded by the EU.

If one compares the recent situation in Croatia with other countries that had the opportunity to benefit from the PHARE programme, it becomes clear that other countries had even bigger problems. For instance, the European Court of Auditors (an EU institution whose main role is to review the legality and regularity of all EU income and expenditures) published a report in June 2006 on the implementation of projects started from 2000 to 2004. It found that the completion of many projects for which funds had been allocated were postponed for periods as long as several years (e.g. in the case of Bulgaria and Romania). The European Court of Auditors did not assign all of the blame to these countries, but rather assigned some of the blame to the European Commission, which, in the opinion of the court, had overestimated the management capabilities of the Bulgarian and Romanian authorities and approved objectives and deadlines that were too ambitious. Romania was also faced with embarrassing incidents related to corruption. At the end of 2004 there was a scandal involving the minister of European integration, who was forced to step down following accusations that she had been allocating EU funds to companies owned by members of her family. Other countries also faced their share of problems: In August 2004, the EU suspended EUR 60 mn worth of funds from the PHARE programme that had been allocated to the Czech Republic. The use of the funds was approved again four months later.

Based on all this and numerous other examples, we can conclude that the situation in Croatia is not dramatic but should nevertheless be seen as a clear warning sign. Time is running out for the improvement of the quality of management for pre-accession funds and increases in staff (the deadline for contracting projects under the PHARE 2006 expires at the end of November 2008). But the most recent steps taken by authorities give reason for optimism.

If Croatia enters the EU, i.e. if the EU-27 expands to 28 member states, data on Croatia's contribution to European economic aggregates will become available. We will present a brief analysis under the assumption that Croatia will become the 28th EU member state.

Population and labour force: Assuming Croatia is included in the EU-28, its population would account for 0.89% of the EU-28's total population (4.44 million as compared to 496 million), while Croatia's territory would make up 1.25% of the entire territory of the EU-28. By comparing the labour force indicators for Croatia and the EU, it is clear that the number of employed people in Croatia (1.48 milion as of the end of 2007) would account for 0.66% of the total number of employed persons in the EU-28 (over 225.6 million). The number of unemployed people according to ILO methodology was below 200,000 at the end of 2006, which would amount to 1.05% of the total number of unemployed people in the EU-28.

Economy: If one compares the size of the Croatian economy (EUR 31.26 bn in 2005) with the latest comparable data for the EU-27 published by Eurostat (EUR 11.02 tn in 2005), Croatia's share is almost negligible. The Croatian economy would make up 0.28% of the EU-28 economy. According to the 2005 data and assuming the EU-27 economy stagnates, Croatia's GDP would have to increase some 3.5 times in order to reach a share of 1%, that is, Croatia's economy would have to become larger than the Czech economy or the combined Bulgarian and Romanian economy. The Czech Republic's GDP totalled EUR 100.3 bn in 2005, while the combined GDP for Bulgaria and Romania totalled EUR 101.4 bn compared to EUR 31.3 bn in Croatia. Considering the fact that the average rate of real economic growth was the same in the Czech Republic and Croatia (4.4%) in the period from 2000 to 2007, Croatia's economy cannot realistically be expected to come close to the size of the Czech Republic's economy. Many transition countries (such as Hungary, Slovenia, Bulgaria, Romania, etc.) also account for less than 1% of the European economy, which indicates that new EU member states located in CEE can hardly influence trends at the European level and are not expected to be ready to be unaffected by negative outside influences or to control them.

Merchandise trade: Croatia's merchandise trade would account for 0.29% of the total export of goods to non-member states based on 2007 data. Considering the fact that Croatia's export of goods to non-member states of the EU-28 totalled EUR 3.57 bn, while the import of goods from those countries totalled EUR 6.63 bn, Croatia's trade balance amounted to EUR -3.06 bn in 2007. Eurostat estimated the EU-27's trade balance with non-member states to be EUR 28.3 bn in 2007, which indicates that Croatia's contribution to this indicator would be negative. However, this piece of data on its own should not be seen as Croatia's contribution to the worsening of foreign trade for the EU-28 because the share of Croatia's economy in the EU-28 and the share of Croatia's merchandise exports in the EU-28 are well below 1%, or more accurately, below 0.3% in both cases.

Based on the strength of its economy, Croatia cannot visibly influence economic developments in the EU. Therefore, it must use and develop its comparative advantages and resources to strengthen its position and prepare its economy for joining the EU. In doing so, it should be kept in mind that, in the medium term, the dynamics of economic growth are expected to depend more and more on the success of structural reforms and the adjustment to common European market principles.

Pre-accession assistance 2007-2009*

	2007	2008	2009
Croatia	138.5	146.0	151.2
Former Yugoslav Rep. of Macedonia	58.5	70.2	81.8
Turkey	497.2	538.7	566.4
Albania	61.0	70.7	81.2
Bosnia & Herzegovina	62.1	74.8	89.1
Montenegro	31.4	32.6	33.3
Serbia	186.7	190.9	194.8
Kosovo	63.3	64.7	66.1

** EUR mn*

Source: europa.eu

Pre-accession assistance 2006 (EUR mn)

Croatia	140.0
Former Yugoslav Republic of Macedonia	43.6
Turkey	500.0
Albania	45.5
Bosnia & Herzegovina	51.0
Kosovo	59.5
Montenegro	23.0
Serbia	167.0

Source: europa.eu

Croatia and EU-27 - comparison

	Population (mn)	Area (km²)	GDP (EUR bn, 05)	Foreign trade of goods with outside EU (EUR bn, 07)	Employment (mn, 07 eop)	Rise in employment (07)	Unemployed persons (mn, 06 eop)
Croatia	4.44	56,542	31.26	3.57	1.48	54,378	0.19
EU-27 + Croatia	496.35	4,510,779	11,050.03	1,240.07	225.68	3,563,378	18.20
Share "EU-28 (%)"	0.89	1.25	0.28	0.29	0.66	1.53	1.05

Source: Eurostat, International Labour Organisation, Central Bureau of Statistics, Raiffeisen RESEARCH

Population and value creation
An overview

Major cities (population 2001)

Zagreb	779,145
Split	188,694
Rijeka	144,043
Osijek	114,616
Zadar	72,718
Sl. Brod	64,612
Karlovac	59,395
Pula	58,594
Sisak	52,236
Šibenik	51,533
Varazdin	49,075

Source: Central Bureau of Statistics

Foreign currency ratings

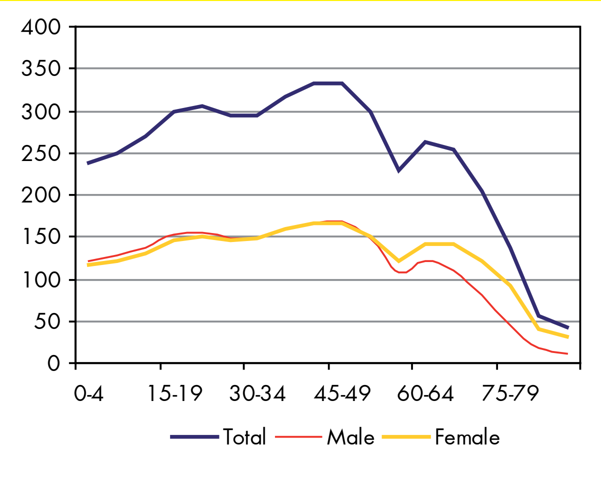
Agency	Long-term	Short-term	Outlook
S&P	BBB	A-3	stable
Moody's	Baa3	P-3	positive
Fitch IBCA	BBB-	F3	stable

GDP 2007

EUR mn (current prices)	37,506
EUR per capita	8,453
Real growth rate (% yoy)	5.6

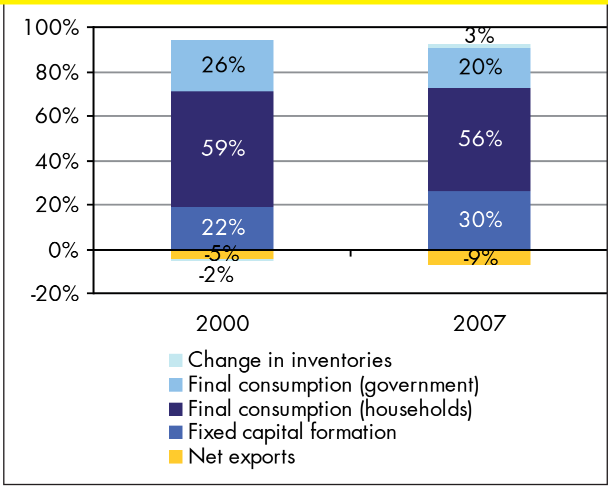
Source: Central Bureau of Statistics

Age distribution, 2001 (in 1,000)



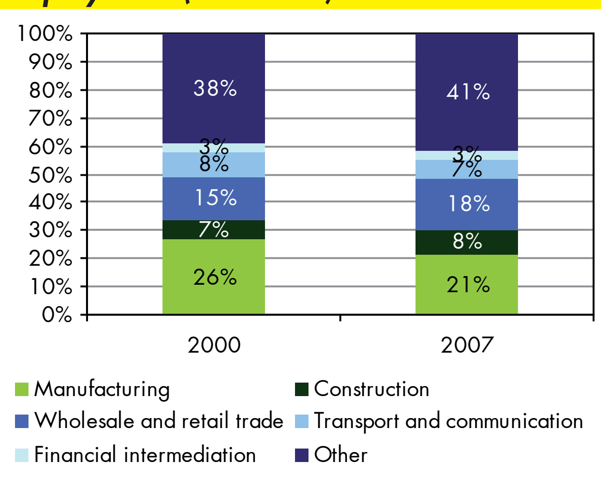
Source: Central Bureau of Statistics

GDP: demand side (% share)



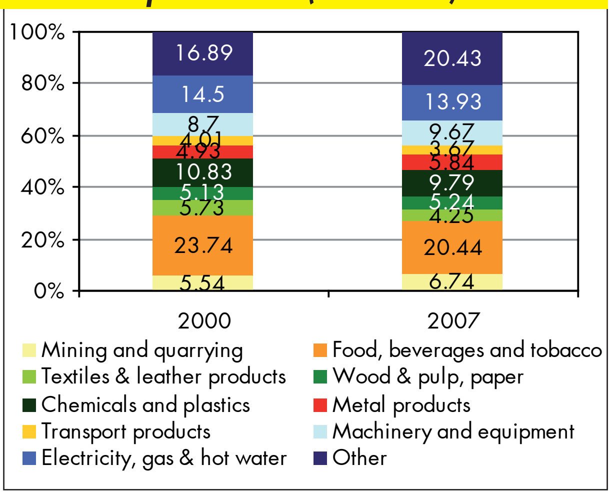
Source: Central Bureau of Statistics

Employment (% of total)



Source: Central Bureau of Statistics

Industrial production (% of total)



Source: Central Bureau of Statistics

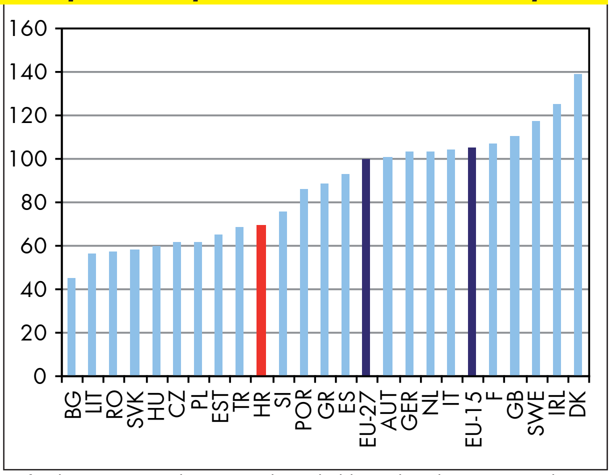
Croatia escapes
"Eastern European reform country" malady

For most of 2007, it appeared likely that Croatia would become yet another victim of the "Eastern European reform country" malady (i.e. the phenomenon that virtually all impatient democratic reform societies have voted out their governments after one legislative period) as the polls pointed at a very tight election result (between the ruling conservative HDZ and the leftist SDP parties). However, the ruling HDZ gained a modest advantage over the SDP to claim another government mandate although the HDZ had to enter into a four party coalition. Due to the leading role of the HDZ, no significant change in economic policy, relations with the EU or the stance towards foreign investors will materialise. Therefore, we expect Croatia to enter the EU until 2012 - assuming that the tensions with neighbouring countries are settled quickly and the pace of negotiations picks up this year, which is a realistic scenario.

We see willingness and vital interests on both sides - i.e. from the Croatian side and from the EU - to finish Croatia's EU integration quickly. Taking into account technical issues like elections to the European Parliament in 2009, changes in the European Commission afterwards and the required approval of Croatia's EU entry from all member states, 2008 will be a very decisive year regarding the country's ability to meet the target of an entry by 2012 (while 2011 looks to be the earliest possible entry within the period leading up to 2012). From an economic perspective focusing on real convergence (and taking into account the stage of economic development of other candidate and potential candidate countries), Croatia cannot wait for a broader enlargement round covering the Western Balkans. Moreover, we do not expect current EU member states to block the Croatian bid for purely economic reasons, as Croatia has a relatively high cost of labour and would not impose cost pressures on current EU members.

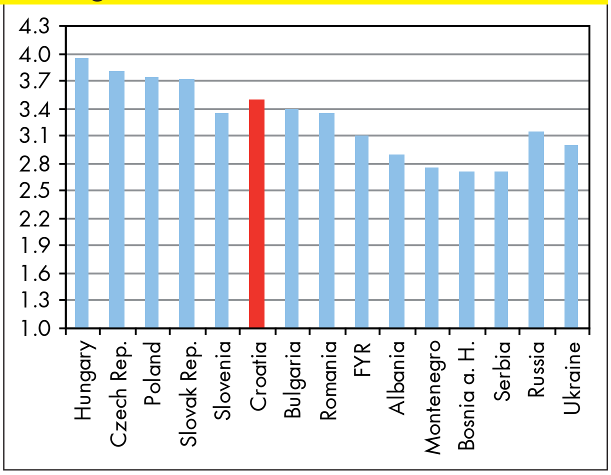
As we expect an EU entry until 2012, we expect a moderate to supportive pace of (economic) reforms in the years ahead. However, we also see some risks for a delay of Croatia's EU entry beyond 2012 (i.e. a delay to 2013 or 2014). Tensions within the Croatian government about core issues of the aquis (e.g. subsidies) that could hinder much needed reforms could be one stumbling block. Furthermore, Croatia's accession might be blocked more or less intentionally by the EU if internal tensions about institutional and financial reforms, i.e. the European institutional framework, are revived in the near future.

Comparative price levels final consumption*



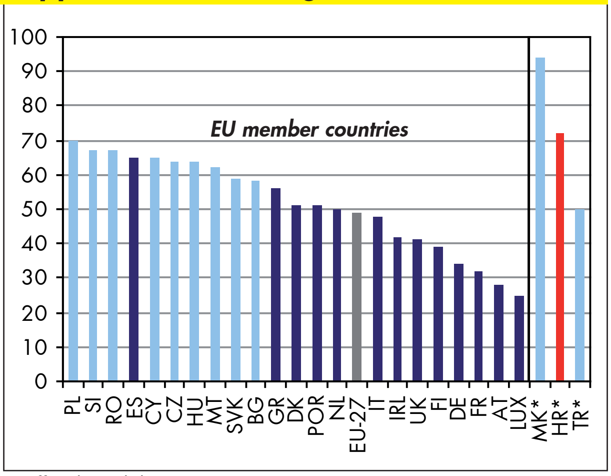
** final consumption by private households (incl. indirect taxes), data as of 2006; EU-27 = 100*
Source: Eurostat, Raiffeisen RESEARCH

Average EBRD transition score (2007)



Source: EBRD Transition Report 2007

Support further enlargement of EU



** official candidate country*
Source: Eurobarometer 67 as of November 2007

Real GDP (% yoy)

Countries	2006	2007	2008e	2009f
Poland	6.2	6.5	5.3	5.5
Hungary	3.9	1.3	2.2	2.7
Czech Rep.	6.4	6.5	4.9	5.5
Slovakia	8.5	10.4	7.5	7.0
Slovenia	5.7	6.0	5.0	5.0
CE	***6.1***	***6.0***	***4.9***	***5.2***
Croatia	4.8	5.6	4.4	4.7
Bulgaria	6.3	6.2	5.5	5.8
Romania	7.9	6.0	6.5	5.5
Serbia	5.7	7.5	6.0	6.0
Bosnia a. H.	6.2	5.5	5.8	5.5
Albania	5.0	6.0	6.0	6.5
SEE	***6.8***	***6.1***	***5.9***	***5.5***
Russia	7.4	8.1	6.5	6.0
Ukraine	7.3	7.6	5.5	5.0
Belarus	10.0	8.2	6.0	5.5
CIS	***7.5***	***8.1***	***6.4***	***5.9***
Turkey	6.9	4.4	4.2	6.0
Eurozone	***2.9***	***2.6***	***1.6***	***1.8***
USA	2.9	2.2	1.0	1.8

Source: wiiw, Raiffeisen RESEARCH

Consumer prices (avg, % yoy)

Countries	2006	2007	2008e	2009f
Poland	1.0	2.5	4.3	3.5
Hungary	3.9	8.0	5.7	4.0
Czech Rep.	2.5	2.8	6.0	2.5
Slovakia	4.5	2.8	3.8	3.0
Slovenia	2.5	3.6	4.9	3.5
CE	***2.2***	***3.5***	***4.9***	***3.3***
Croatia	3.2	2.9	5.8	3.6
Bulgaria	7.3	8.4	8.0	5.0
Romania	6.6	4.8	7.0	4.5
Serbia	12.7	6.8	8.5	6.0
Bosnia a. H.	7.4	1.5	4.2	2.7
Albania	2.5	2.9	3.4	3.0
SEE	***6.8***	***5.0***	***6.9***	***4.5***
Russia	9.8	9.1	12.5	8.9
Ukraine	9.1	12.8	24.3	12.8
Belarus	7.0	8.4	13.7	12.1
CIS	***9.6***	***9.5***	***13.7***	***9.4***
Turkey	10.0	9.3	7.8	6.2
Eurozone	***2.2***	***2.1***	***2.7***	***2.1***
USA	3.2	2.9	3.5	2.5

Source: wiiw, Raiffeisen RESEARCH

Current account balance (% of GDP)

Countries	2006	2007	2008e	2009f
Poland	-3.2	-4.0	-4.8	-5.5
Hungary	-6.5	-5.2	-5.2	-4.8
Czech Rep.	-3.1	-2.5	-3.0	-2.0
Slovakia	-7.0	-5.3	-2.7	-1.6
Slovenia	-2.8	-4.3	-2.7	-2.3
CE	***-4.0***	***-4.0***	***-4.2***	***-4.1***
Croatia	-7.7	-8.6	-9.2	-9.4
Bulgaria	-17.8	-21.5	-20.5	-18.5
Romania	-10.4	-13.9	-14.0	-13.5
Serbia	-12.5	-16.6	-16.0	-15.0
Bosnia a. H.	-8.4	-13.4	-13.2	-13.6
Albania	-7.6	-7.3	-7.4	-7.0
SEE	***-11.0***	***-14.1***	***-14.0***	***-13.4***
Russia	9.6	6.1	3.9	2.8
Ukraine	-1.5	-4.2	-6.2	-7.5
Belarus	-3.9	-6.6	-4.1	-7.2
CIS	***8.1***	***4.7***	***2.7***	***1.5***
Turkey	-6.1	-7.7	-7.4	-7.3
Eurozone	***-0.2***	***0.1***	***-0.4***	***-0.3***
USA	-6.5	-6.6	-6.0	-5.5

Source: wiiw, Raiffeisen RESEARCH

General budget balance (% of GDP)

Countries	2006	2007	2008e	2009f
Poland	-3.8	-2.1	-2.7	-3.5
Hungary	-9.2	-5.9	-4.0	-3.7
Czech Rep.	-2.9	-1.9	-2.0	-3.0
Slovakia	-3.7	-2.2	-3.0	-1.7
Slovenia	-1.2	-0.2	-0.5	-0.5
CE	***-4.3***	***-2.6***	***-2.7***	***-3.1***
Croatia	-3.0	-2.8	-2.4	-2.0
Bulgaria	3.6	3.7	3.0	2.0
Romania	-1.9	-2.5	-3.5	-2.5
Serbia	1.7	0.5	-0.5	-1.0
Bosnia a. H.	2.9	2.6	2.0	1.5
Albania	-4.1	-4.8	-7.5	-5.0
SEE	***-0.8***	***-1.3***	***-2.0***	***-1.6***
Russia	7.9	5.6	3.5	2.0
Ukraine	-0.7	-1.1	-2.0	-2.5
Belarus	2.2	0.3	0.1	-2.5
CIS	***6.9***	***4.8***	***2.9***	***1.4***
Turkey	-0.4	-2.3	-2.1	-1.8
Eurozone	***-1.3***	***-0.6***	***-0.9***	***-0.8***
USA	-2.6	-2.0	-3.0	-3.0

Source: wiiw, Raiffeisen RESEARCH

Exchange rate EUR/LCY (avg)

Countries	2006	2007	2008e	2009f
Poland	3.90	3.78	3.46	3.35
Hungary	264.1	251.4	257.4	257.5
Czech Rep.	28.3	27.8	26.1	25.4
Slovakia	37.2	33.8	33.0	32.5
Slovenia	239.6	239.6	239.6	239.6
Croatia	7.32	7.34	7.26	7.22
Bulgaria	1.96	1.96	1.96	1.96
Romania	3.52	3.34	3.64	3.45
Serbia	84.4	80.0	80.9	78.4
Bosnia a. H.	1.96	1.96	1.96	1.96
Albania	123.1	123.6	122.5	120.9
Russia	34.5	35.8	36.6	35.8
Ukraine	6.36	6.92	7.62	7.02
Belarus	2702	2939	3280	3289
Turkey	1.81	1.79	1.79	1.82
USA	1.26	1.37	1.52	1.43

Source: wiiw, Raiffeisen RESEARCH

Exchange rate USD/LCY (avg)

Countries	2006	2007	2008e	2009f
Poland	3.09	2.76	2.34	2.45
Hungary	209.6	183.5	170.0	181.8
Czech Rep.	22.5	20.3	17.1	17.8
Slovakia	29.5	24.7	21.7	22.7
Slovenia	190.2	174.9	157.7	167.6
Croatia	5.81	5.36	4.99	5.20
Bulgaria	1.55	1.43	1.29	1.37
Romania	2.80	2.44	2.39	2.41
Serbia	67.0	58.4	53.2	54.8
Bosnia a. H.	1.55	1.43	1.29	1.37
Albania	97.7	90.2	80.6	84.5
Russia	27.4	26.2	24.1	25.1
Ukraine	5.05	5.05	5.01	4.91
Belarus	2145	2145	2158	2300
Turkey	1.43	1.30	1.18	1.27
Eurozone	0.79	0.73	0.66	0.70

Source: Thomson Finacial Datastream, Raiffeisen RESEARCH

Raiffeisen RESEARCH
RZB Group

Dampening growth prospects

ECB rate cuts around the corner

The regional and international outlook for the Croatian economy is less favourable than in recent years, as the growth prospects for Croatia's main trade partners in the EU-27 and SEE are deteriorating. Although the Eurozone still finished 2007 on a strong note with annual GDP growth of 2.6%, we expect to see lower GDP growth rates of 1.6% and 1.8% respectively in 2008 and 2009. In 2007 economic expansion remained strong in all of the CE countries (average GDP growth of 6.0%) with the exception of Hungary. We expect this positive trend to continue in CE in 2008 and 2009, but at a slower pace (projected growth figures 4.9% and 5.2% respectively). For SEE we expect average GDP growth of around 5.9% and 5.5% in the next two years. However, there is a risk that these projections will not be met. Domestic demand, the main growth driver in all of the rapidly growing CEE countries, might slow due to the ongoing weakness of the global financial markets, limiting the level of consumption financed with credit in CEE. Moreover, Croatia and Croatian securities might suffer from an extended global risk re-pricing if it ends up being grouped together with the whole SEE region in the eyes of investors. Most of the SEE countries are suffering from considerable external imbalances (average C/A deficit in SEE is 14-16% and is only expected to marginally decrease in the coming years). However, Croatia is still one of the countries with the smallest C/A deficit (singe-digit C/A deficit of 7-9%) and the most stable foreign currency inflows due to the high level of remittances and tourism.

The major economies, i.e. the US and the Eurozone, are not likely to end up in a severe recession, although we could see renewed recession fears in the coming months. We believe that the European economy in particular will take a more severe hit than currently expected due to the considerable strength of the EUR, slowing global growth and a significant rise in financing costs. Based on weak macro data for the Eurozone, we expect bond prices to develop favourably in the months ahead, while we foresee rising yields later in the second half of 2008. The European Central Bank (ECB), which currently remains hawkish, might adopt a more dovish strategy in the second half of 2008. We expect interest rate cuts of at least 50bp in the second half of 2008 as monetary conditions in the Eurozone are still restrictive. Easing inflationary pressure in the second half of 2008 should support our outlook for European rates. By year-end Eurozone inflation should recede back down to the 2% level.

After the USD weakened dramatically against the EUR and other major currencies as a result of the economic slump in the US and the widening negative interest rate differential compared to the EUR, we expect the USD to rebound strongly as soon as the ECB sees no alternative to cutting rates later in the second half of 2008. Thus, the USD should appreciate in line with a reviving US economy in the second half of 2008 (meaning that US rate cuts will come to an end) and a decreasing interest rate differential.

International yields, 10y bonds

Countries	actual	Sep-08	Dec-08	Mar-09
Eurozone	**4.1**	**3.8**	**4.2**	**4.2**
USA	**3.9**	**3.8**	**4.2**	**4.2**
GB	4.6	4.0	4.5	4.5
Switzerland	3.1	2.9	3.2	3.2
Japan	1.7	1.4	1.8	1.9
Poland	6.0	6.1	5.9	5.9
Hungary	7.8	7.7	7.5	7.3
Czech Republic	4.8	4.2	4.3	4.3

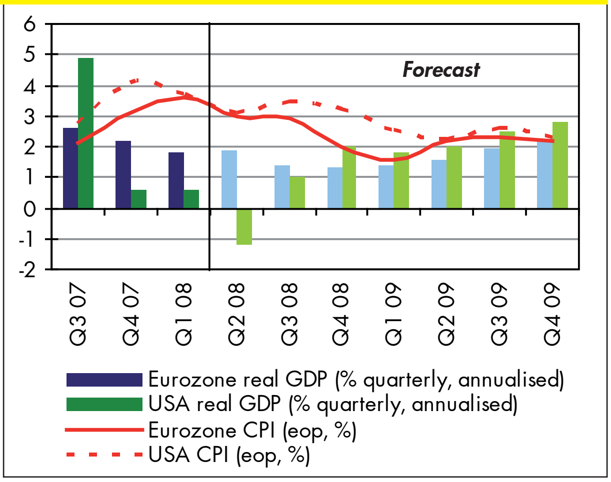
Source: Thomson Financial Datastream, Raiffeisen RESEARCH

Key interest rates

Countries	actual	Sep-08	Dec-08	Mar-09
Eurozone	**4.00**	**3.75**	**3.50**	**3.50**
USA	**2.00**	**1.75**	**1.75**	**1.75**
GB	5.00	4.25	4.00	4.00
Switzerland	2.75	2.75	2.75	2.75
Japan	0.50	0.50	0.50	0.50
Poland	5.75	6.00	6.00	6.00
Hungary	8.25	8.25	7.75	7.50
Czech Republic	3.75	3.75	3.75	3.75

Source: Thomson Financial Datastream, Raiffeisen RESEARCH

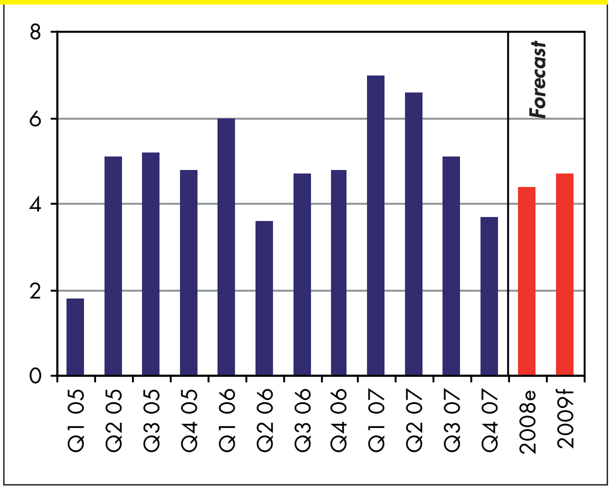
Eurozone, USA: growth and inflation



Source: Thomson Financial Datastream, Raiffeisen RESEARCH

Economic slowdown
and increasing inflationary pressure

GDP growth (% yoy)



Source: Croatian Bureau of Statistics, Raiffeisen RESEARCH

GDP growth (% yoy)

	2005	2006	2007	2008e
Croatia	4.3	4.8	5.6	4.4
Bulgaria	6.2	6.3	6.2	5.5
Slovakia	6.6	8.5	10.4	7.5
Poland	3.6	6.2	6.5	5.3
Hungary	4.2	3.9	1.3	2.2
Slovenia	4.1	5.7	6.0	5.0
Czech Rep.	6.4	6.4	6.5	4.9
Romania	4.2	7.9	6.0	6.5

Sources: wiiw, Raiffeisen RESEARCH

CPI (% yoy)

Source: Croatian Bureau of Statistics

Real GDP growth reached 5.6% in 2007 - the highest rate since 2002 - as a result of favourable economic developments especially in the first half of the year, as economic activity slowed in the second half of the year. The strongest real growth rate was achieved by gross capital formation in 2007, which was expected because 2007 was an election year and the robust growth of corporate loans continued in the first half of the year, hinting at strong investment activity. Personal and government consumption accelerated as a result of increasing real wage growth, larger transfers to households, the repayment of debt to pensioners and favourable developments on the capital market (especially the equity market).

In 2008, we expect GDP growth to decelerate to around 4.4%, primarily as a result of the usual slowdown in economic activity following elections and the slower economic growth anticipated in the EU. In addition, one could realistically expect to see smaller transfers from the budget, slower wage growth, reduced lending activity among banks and lower financial market returns, all of which will inevitably reduce personal consumption, the main component of GDP growth.

The strong inflationary pressures seen at the end of 2007 continued at the beginning of 2008, fuelling expectations that this year's growth rate for consumer prices will reach the highest level since 1998. While 2007 ended at the relatively low level of 2.9%, the average inflation rate is likely to exceed 5% this year. Such expectations are mainly based on the effects of imported inflation (i.e. growing food and energy prices). In addition, domestic factors will add to the inflationary pressure. One of the key factors is expected to be price hikes for utilities, which are still set administratively and are likely to be liberalised. However, if energy prices decline (which is a likely scenario given the slowing growth on a global scale) in the second half of 2008, inflationary pressures could ease at the end of 2008. Nevertheless, inflationary pressure could remain elevated in the medium term. The Croatian taxation system has to be adjusted to the European system, which means abandoning the concept of a zero VAT for selected products as well as increasing excise taxes, which will cause one-off price increases. In addition, some of the costs of accession affecting the corporate sector (e.g. the cost of environmental protection) might be passed to the end consumer. Strong wage growth in individual segments of the labour market as a result of labour market shortages might also add to the inflationary strain.

Positive trends
continue at the beginning of 2008

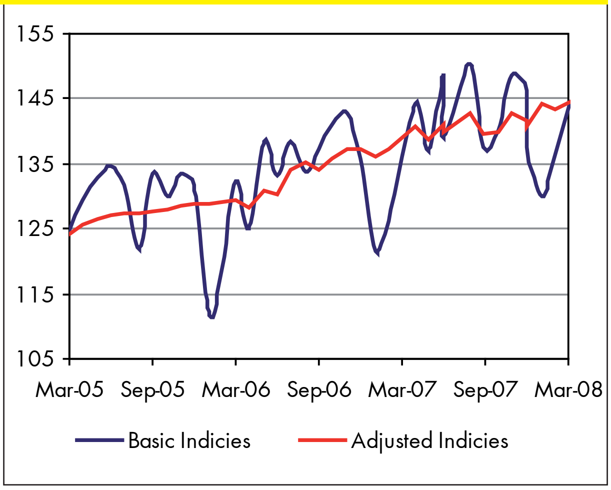
Despite the slowdown in the growth of industrial production in the second half of 2007, industrial activity still grew at the highest rate since 2001, totalling 5.6% growth for the year. The robust growth in industrial production was accompanied by growth in employment and profitability. The dynamic pace of industrial production growth continued in 2008 and manufacturing continues to be the most important segment of industry. The positive trends in the production of capital goods continued, reflecting further restructuring (i.e. increasing production of goods with higher value added), while labour productivity increased.

However, looking ahead we expect production growth to decelerate, matching the levels attained in 2006 for the entire year, partly as a result of decreasing demand for Croatian goods from its most important trading partners and partly due to the rise in inventories at the end of last year and the beginning of this year.

The average rate of registered unemployment declined to 15.1% in 2007, reflecting a long-lasting positive trend on the labour market. Last year's positive trends continued at the beginning of this year as the unemployment rate remained below 15% for the sixth month in a row. We expect unemployment to gradually decrease over the months to come, fuelled by increasing employment in the tourism and trade sector in the second and third quarter. The registered unemployment rate could be around 13.5% at the end of the year, with a further reduction of unemployment expected in 2009.

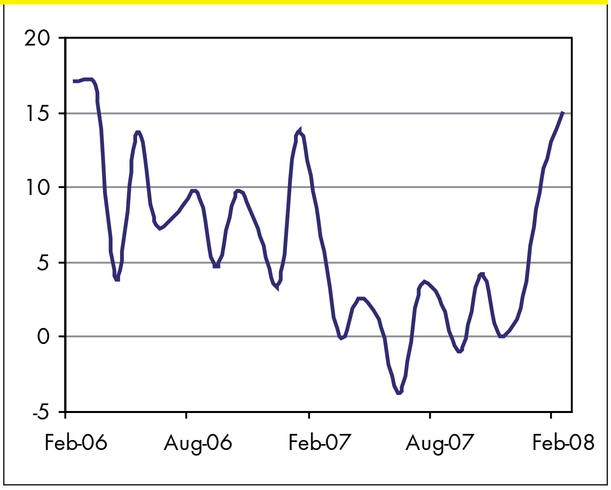
However, structural imbalances are likely to persist on the Croatian labour market, which, together with unfavourable demographic trends in the medium and long term, could weigh on potential economic growth. This is likely to be reflected in difficulties in certain segments of the labour market, primarily in the non-qualified and qualified labour segments. In addition, the potential outflow of young and educated people in the medium term when Croatia joins the European Union must be taken into account. The structural imbalances on the lower and upper ends of the Croatian labour market are also likely to limit the country's ability to substantially reduce the unemployment rate in the medium term.

Industrial production indices (2000=100)



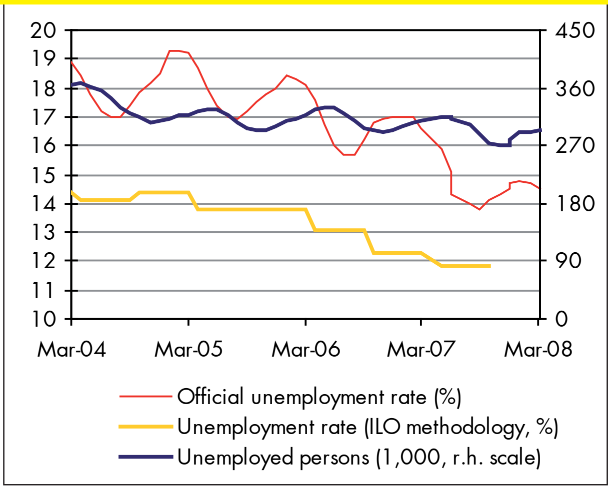
Source: Croatian Bureau of Statistics

Construction (% change yoy)



Source: Croatian Bureau of Statistics

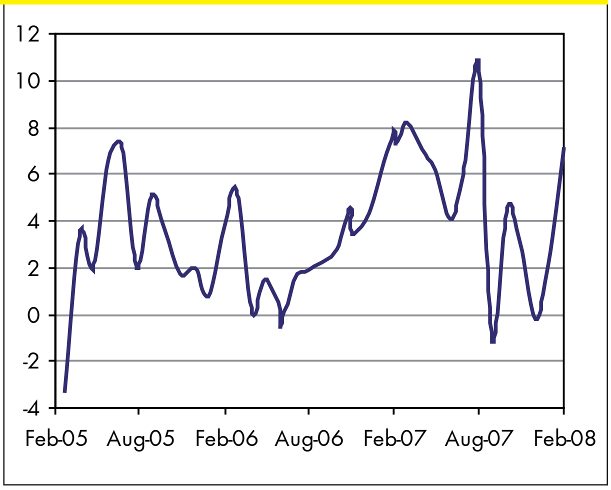
Unemployment rates, unemployed persons



Source: Croatian Bureau of Statistics

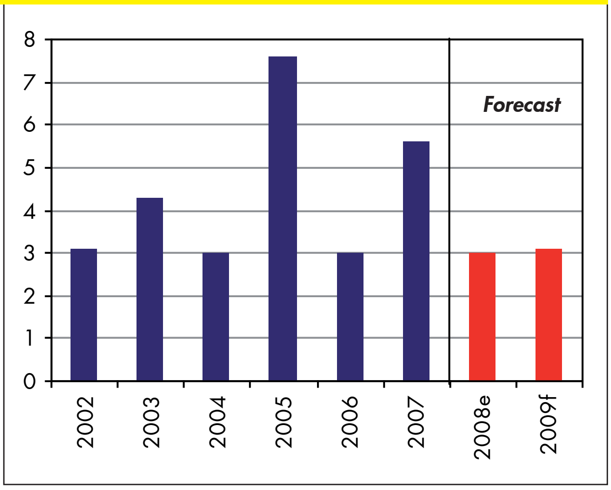
Tourist arrivals back to pre-war levels

Retail sales (% yoy)



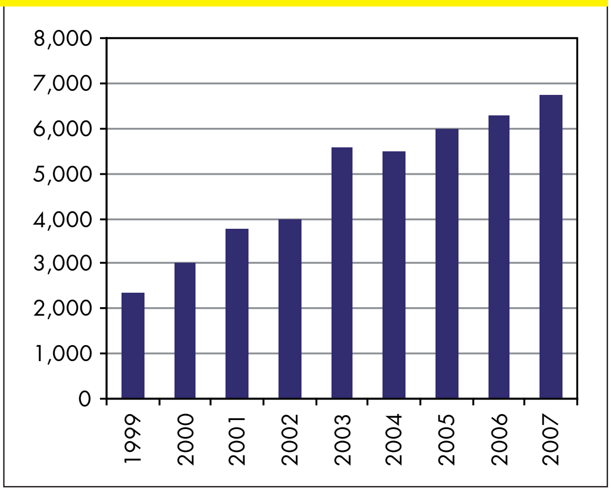
Source: Croatian Bureau of Statistics

Tourist overnight stays (% yoy)



Source: Croatian Bureau of Statistics, Raiffeisen RESEARCH

Revenues from tourism (EUR mn)



Source: Croatian Bureau of Statistics

The real growth of retail trade in 2007, which totalled 5.4%, clearly represents an acceleration of growth compared to previous years. Taking into account the substantial contribution of personal consumption to GDP, these growth dynamics clearly fuelled overall GDP growth in 2007. The robust growth of personal consumption and consequently retail trade was mainly driven by the real growth of net wages (thanks to lower inflation at the beginning of the year), larger government transfers to households in the scope of the elections, the repayment of debt to pensioners and high returns on investments on the domestic equity markets. The slowdown in the fourth quarter (resulting in a decrease in December) was partly expected based on the developments in other segments of the economy. The trend of slowing personal consumption growth is expected to continue in 2008. As a result, retail trade growth could fall to below 3%. In addition to the base effect, the slowdown is also likely to result from the accelerated growth of consumer prices (i.e. reduced individual purchasing power), since stronger inflationary pressure at the end of 2007 contributed to a real decline in wages that continued early in 2008. Another cause for the slowdown in consumption growth is likely to be the restrictive monetary policy measures, which are influencing lending policy in the banking sector.

A positive trend was visible in the tourism indicators throughout 2007, resulting in a record number of tourist arrivals and overnight stays. While the number of tourist arrivals reached pre-war levels, the number of overnight stays is still lagging behind because the overall trend in tourism (i.e. a reduction in the average number of overnight stays per arrival) is affecting Croatia as well. Revenues from tourism, which grew at an annual rate of 7.2%, reached an all-time high in nominal terms, partly due to the rise in the volume of tourism and partly due to the growth in prices for services and accommodations. These positive trends in tourism are likely to continue in 2008, but the overall number of tourists will surely not exceed 60 million (in the years before the war the overall number of overnight stays exceeded 68 million). The high degree of seasonality, the low average quality of accommodations, outdated accommodations in terms of technology, the incomplete privatisation process for hotels, the low presence of international brands and the lack of a qualified labour force continue to be the main weaknesses of this extremely important sector of the economy.

Restrictive monetary policy shows effects

As a result of the global rise in inflationary pressure, especially in emerging economies, most of the central banks in CEE have adopted more hawkish and restrictive monetary policies.

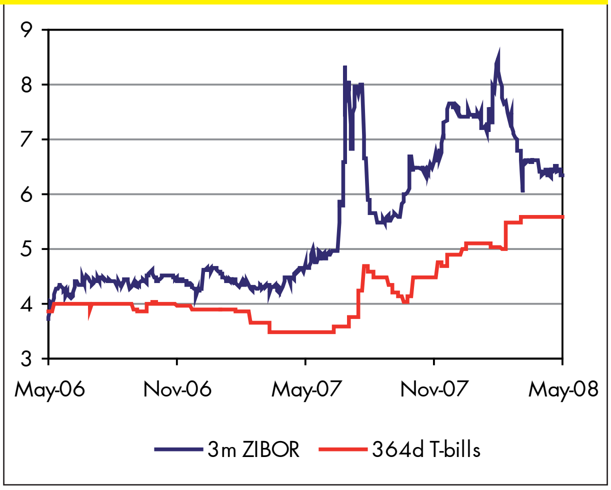
In Croatia a need arose for new measures aimed at reducing inflationary pressures in addition to the already existing measures aimed at reducing upward pressure on the current account deficit and external debt. So by decreasing its activity through open market operations (i.e. reducing the creation of additional liquidity), the Croatian National Bank (CNB) substantially affected market developments. Soon after the beginning of the year, the demand for funds increased, which consequently led to a rise in money market interest rates. At the same time, banks were again forced to satisfy their need for funds through secondary sources of financing (lombard loans). In addition, tensions on the market were intensified by the continued unbalanced distribution of funds within the financial system, which resulted in a rise of overnight deposits parallel to the lack of funds and increasing (money market) interest rates.

In the remainder of the year, we expect the restrictive monetary policy to continue to impact interest rate levels, with pressures on the market especially visible before the peak tourist season, before holidays and at the beginning of each new reserve requirement maintenance period.

Despite the visible slowdown in lending growth in the second half of 2007, lending growth still exceeded the limit (12%) introduced by the CNB in 2006, reaching 15% at the end of the year. However, due to stronger inflationary pressure, banks did not face any consequences for exceeding the growth limit. At the same time, lending to all domestic sectors decreased, with the most substantial slowdown being visible in the corporate sector. This was expected based on the alternative sources of funds available (borrowing abroad or issuing securities).

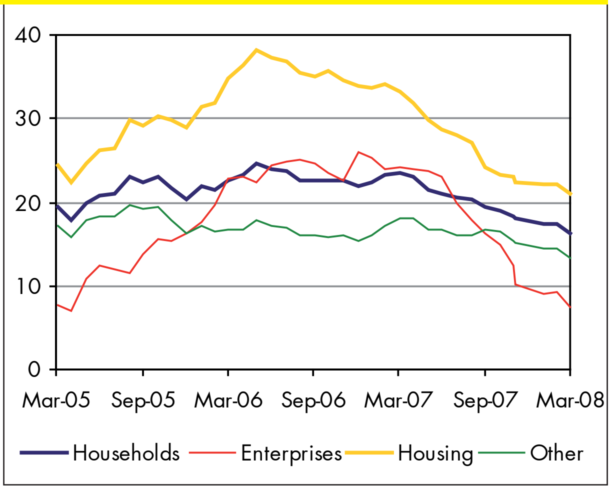
For 2008 we expect lending growth to inch towards the 12% limit. On the other hand, strong competition in the banking sector and elevated uncertainty regarding inflationary pressure could give rise to even higher lending growth.

Interest rates (%)



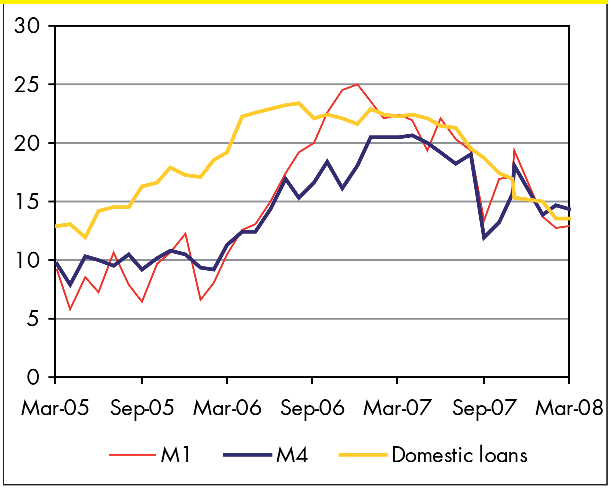
Sources: Reuters, Croatian National Bank, Ministry of Finance

Loan growth (% yoy)



Source: Croatian National Bank

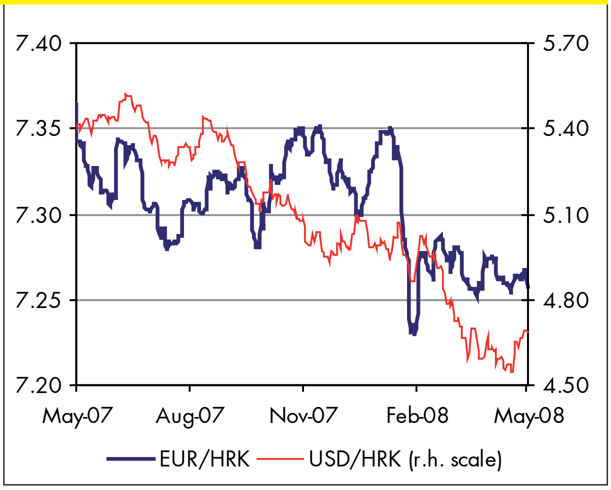
Monetary aggregates and domestic loans*



** % yoy*
Source: Croatian National Bank

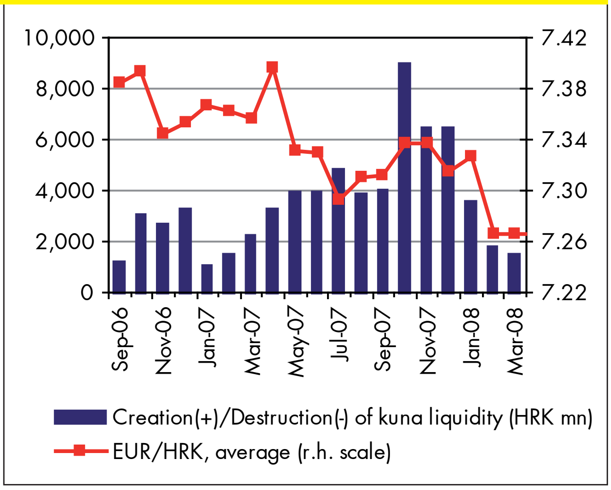
Low volatility of FX rate
likely to continue

EUR/HRK and USD/HRK



Source: Croatian National Bank

CNB operations and FX rate movements*



** effect of FX interventions and reverse repo auctions of T-bills on money supply*
Source: Croatian National Bank

Exchange rate forecast

	2008e	2009f
EUR/HRK (avg)	7.26	7.22
EUR/HRK (eop)	7.30	7.25
USD/HRK (avg)	4.99	5.20
USD/HRK (eop)	5.11	5.30

Source: Raiffeisen RESEARCH

The period of relatively stable trading levels continued in the first quarter of 2008 as did the considerable influence of liquidity in the financial system on market developments. However, the kuna appreciated more than expected based on traditional seasonal patterns on the FX market. In previous years, exchange rate movements at the beginning of the year were dominated by a strong demand for foreign currency resulting from the need to pay for a high level of imports in the last quarter of the previous year (resulting in depreciation pressures). But in the circumstances of reduced (money market) liquidity at the beginning of 2008, the most substantial influence came from the strong demand for domestic currency. Market developments were highly influenced by the CNB's announcement that it would only intervene in the market in the case of depreciation pressures on the kuna. At the same time, the CNB announced that it would not neutralise appreciation pressures on the kuna in the case of a nominal appreciation. Using these measures, the CNB aims to soften inflationary pressure from imports. An easing of the situation and the intervention of the central bank in the foreign exchange market contributed to a stabilisation of the exchange rate within a narrow band of EUR/HRK 7.26 to 7.28. A mild strengthening of the kuna before Easter confirmed that seasonal exchange rate fluctuations are still present, but at less pronounced levels due do the current global liquidity concerns.

We expect relatively stable trading levels and less seasonal volatility for the EUR/HRK exchange rate compared to previous years until the end of 2008. Within the framework of a restrictive monetary policy and less interventions from the CNB through open-market operations, the demand for kuna and money market liquidity are expected to continue having the most significant influence on the market. However, as the peak of the tourism season draws nearer we could see more intense appreciation pressure on the kuna, which could result in trading levels close to around EUR/HRK 7.20. The government's decision to return to international capital markets by issuing Eurobonds could result in some temporary appreciation pressure on the domestic currency.

In the long term, we expect appreciation pressures on the kuna to continue as a result of a larger inflow of foreign capital as well as the ongoing process of real convergence in the Croatian economy.

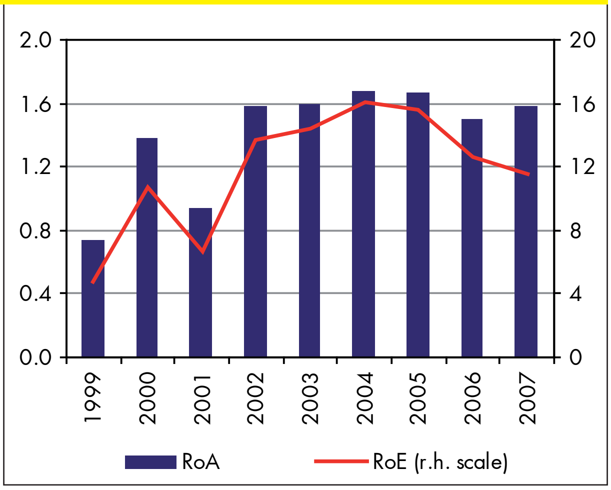
New (old) sources of financing bank lending

At the end of 2007, total banking assets stood at HRK 345 bn, while profits (before taxes) grew by 21% (HRK 5.13 bn). Only two smaller banks registered losses before taxes. Preliminary operating data indicate a decline in the profitability of the banking sector, primarily as a result of changes in the structure of banks' assets and liabilities as well as a negative contribution from interest rate trends. The developments in this business segment are strongly influenced by restrictive monetary policy measures aimed at curbing lending growth, the increases in interest rates on the international markets and the banks' preference towards more lucrative placements in the long term. The Return on Assets ratio (RoA) rebounded to 1.58% in 2007 after declining to 1.5% in 2006 as a result of the faster growth in profits than in assets seen last year (20.7% compared to 12.3%). The considerable growth of capital contributed to the deterioration of the Return on Equity ratio (RoE), which declined to the lowest level since 2002 (11.06%). In line with capital growth, capital adequacy improved at the end of the year as compared to previous years, reaching 15.4%.

In addition to significant deposit growth, the increase in capitalisation was one of the main sources of financing lending activity. After a decade of increases, foreign bank assets decreased in 2007. A series of restrictive monetary policy measures became effective in the second half of 2007. However, the volume of loans still rose at a rate of 15% for the whole year, reflecting the fact that the monetary authorities allowed banks to attain a slightly faster growth rate than the permitted 12% in light of inflationary pressure.

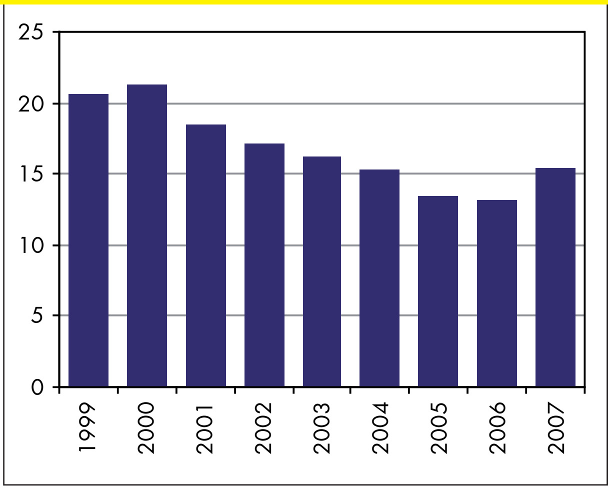
The structure of loans in 2007 was dominated by household loans with a share of 52.4% and corporate loans with a share of 40% of total loans. In terms of household loans, particularly dynamic growth was achieved by housing loans which continued to grow at rates above 20% despite a deceleration in growth. Under the circumstances of restricted lending growth, banks again turned to the household sector as corporations used alternative sources of financing and the possibility of borrowing on the international capital markets. A slowdown in bank lending, which will largely be felt by the corporate sector, will surely continue to be the main feature of the banking system in 2008. Lending activity will primarily be financed with domestic sources (deposits) and the recapitalisation of banks.

Banking sector profitability (%)



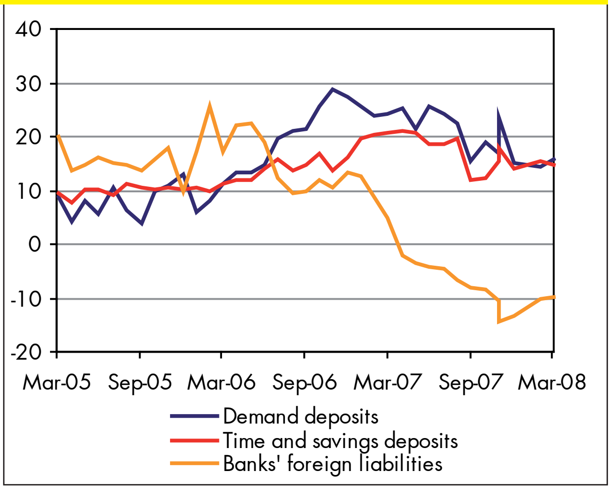
Source: Croatian National Bank

Capital adequacy ratio (%)



Source: Croatian National Bank

Foreign liabilities and deposit growth*

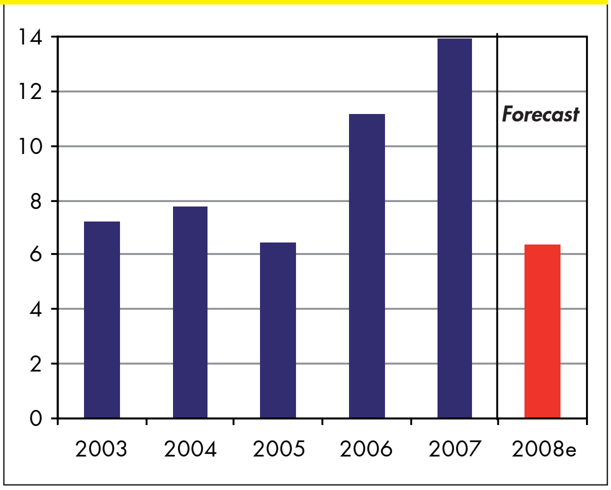


* % yoy

Source: Croatian National Bank

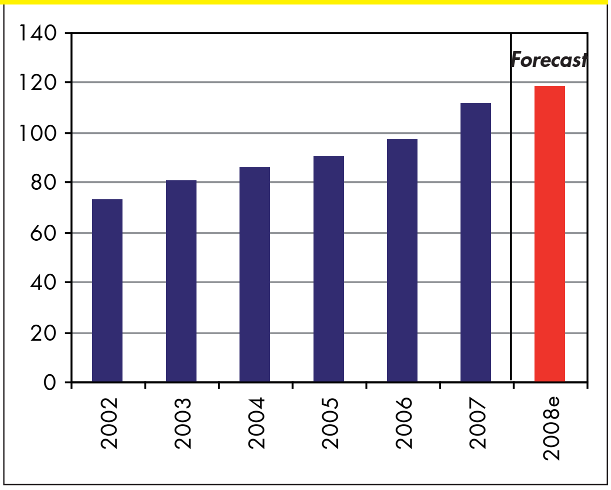
Fiscal deficit continues to narrow

Central government revenue growth*



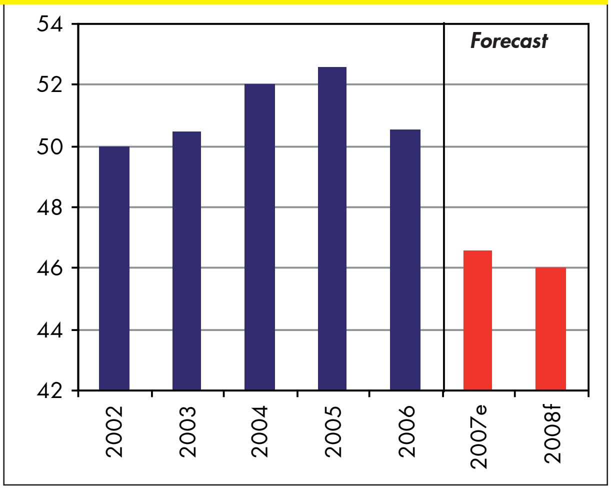
* % yoy
Source: Ministry of Finance

Central government expenditures*



* HRK bn
Source: Ministry of Finance

Public debt (% GDP, incl. guarantees)



Source: Ministry of Finance

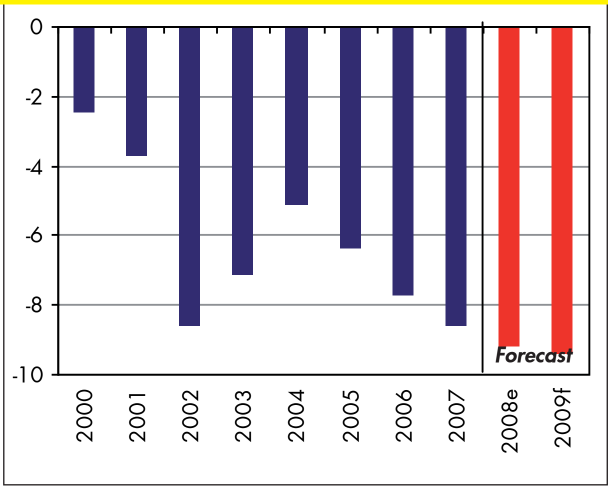
Strong economic activity and tax revenues that were higher than expected had a positive influence on the state budget figures in 2007. In the first eleven months of the year budget revenues increased by 13.4% yoy. The largest contribution once again came from profit tax as a result of last year's redistribution of budget revenues among different government levels and the good operating results achieved by domestic companies. At the same time, expenditures increased at a slower rate (+11.3%), so there was a surplus in the central government's budget. Favourable budgetary developments helped to reduce the public sector's need for additional borrowing. Therefore, public debt growth slowed further, while the share of public debt in GDP fell below 44% as a result of rapid GDP growth in nominal terms. Although the central government's debt decreased in 2007, the debt for extrabudgetary entities and government guarantees went up. The 2008 budget was adopted at the beginning of the year and stipulates increases in both revenues and expenditures. However, considering the need for fiscal policy to support the central bank's efforts to curb inflationary pressure, this year's public expenditures are expected to grow at a slower rate. According to the budget, government spending is expected to grow at a modest rate in real terms since real expenditure growth will likely come in at rates similar to this year's expected inflation rate. However, taking the anticipated decline in economic activity this year into account, plans related to revenues were set more cautiously. The relative size of the consolidated government deficit is also expected to continue to decline in 2008. Nevertheless, comprehensive structural reforms will be required in order to achieve a balanced budget in the medium term. This includes reforms to public administration, the healthcare and social welfare systems, pressing ahead with the pension reform, the restructuring and privatisation of companies under state ownership (some still heavily subsidised) and the reduction of the scope of government grants and guarantees (again mostly for unprofitable companies). Only a reduction in expenditures will give rise to the necessary cushion in order to alleviate the tax burden. Although the reforms mentioned may generate one-off costs in the budget, they are necessary for achieving long-term sustainability for the fiscal system and reducing public spending. In 2008 the external component of public sector debt and the government's share in total external debt could increase due to plans to tap international markets with a Eurobond issue.

Widening
current account deficit

The current account (C/A) deficit continued widening for the third year in a row, both in absolute terms and as a share of GDP. Despite substantial growth in tourism revenues and the increase in the surplus in the services account, the C/A deficit totalled EUR 3.2 bn in 2007 (up 19%). As a result, the ratio of the C/A deficit to GDP reached 8.6%. As usual, merchandise trade (i.e. stronger growth of expenditures over incomes in the goods account) was the main driver of the C/A deficit. Another reason for the increase in the C/A deficit was a reduction in the surplus in the income and current transfers account. The best way (i.e. non-debt-creating) to finance a C/A deficit is with foreign direct investment (FDI), the inflow of which in 2007 was sufficient to cover the C/A deficit. However, the structure of FDI remains unfavourable as the majority of investments are oriented towards brownfield investments and investments in services (especially the banking sector). In 2008, we expect a further deterioration of the C/A as a result of the growth of energy prices up to now and the weakening competitiveness of the export sector due to the real appreciation of the kuna and slower economic activity in the EU. On the other hand, our expectations of a slowdown in consumption growth could positively affect the expenditure side of goods. Thus, the pressure on the C/A deficit might be contained and the ratio C/A deficit to GDP is likely to remain in single-digit territory.

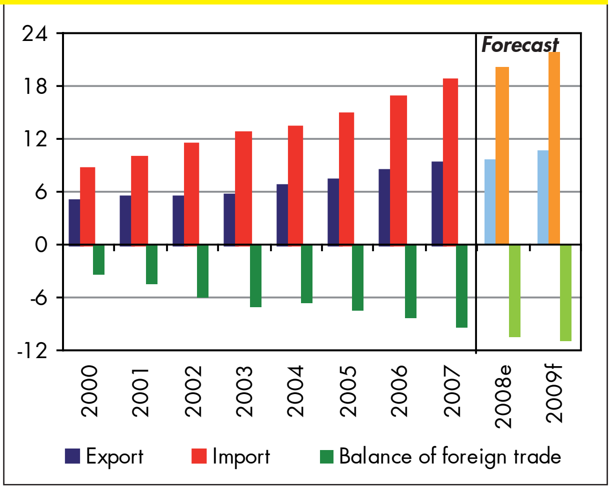
A restrictive monetary policy, aimed at curbing banking sector borrowing abroad and reducing external vulnerability, accompanied by the government being more oriented towards the domestic financial market, partly succeeded in mitigating the pressure on external debt growth. The share of banks' external debt in total external debt decreased significantly. However, this positive trend was offset by strong growth in the external debt of other sectors (primarily the corporate sector, which turned to alternative sources of financing and direct borrowing abroad in the wake of restrictive monetary policy). In light of indications that the government is planning to tap international markets for the first time in many years, it can be expected that this portion of total external debt will rise, while other sectors are likely to continue borrowing on foreign markets. Although a mild slowdown in the growth of total external debt can be expected, overall external debt could pass the level of 90% of GDP in 2008 (critical level according to IMF standards).

Current account balance (% of GDP)



Source: Croatian National Bank

Foreign trade in goods (EUR bn)



Source: Croatian Bureau of Statistics

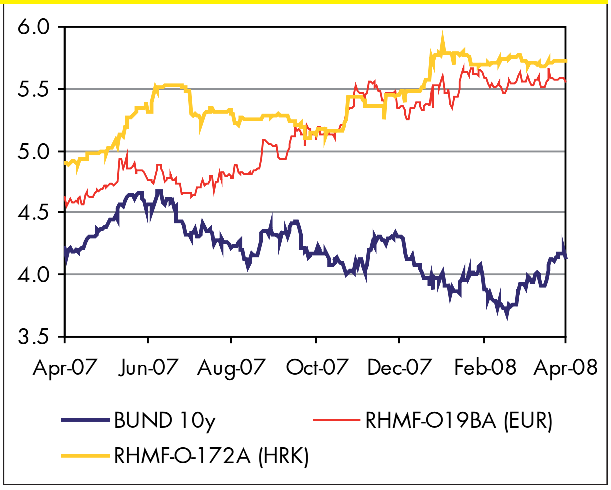
External debt, debt ratios

	External debt (EUR mn)	External debt % of GDP	External debt % of exports in goods and services	International reserves as % of external debt
Q4 04	22,781	78.3	160.0	28.2
Q1 05	23,145	79.0	161.8	28.9
Q2 05	24,262	81.2	167.5	29.1
Q3 05	24,107	78.7	160.5	29.0
Q4 05	25,541	81.7	167.2	29.1
Q1 06	26,654	82.9	168.9	30.3
Q2 06	27,716	84.5	172.1	31.5
Q3 06	27,372	81.5	165.9	29.7
Q4 06	29,274	85.5	172.2	29.8
Q1 07	29,976	85.6	174.8	31.8
Q2 07	30,818	86.1	174.4	29.8
Q3 07	30,806	84.0	170.0	28.6
Q4 07*	33,402	89.1	181.8	27.9

* year-end 2007 figures calculated according to new methodology
Source: Croatian National Bank

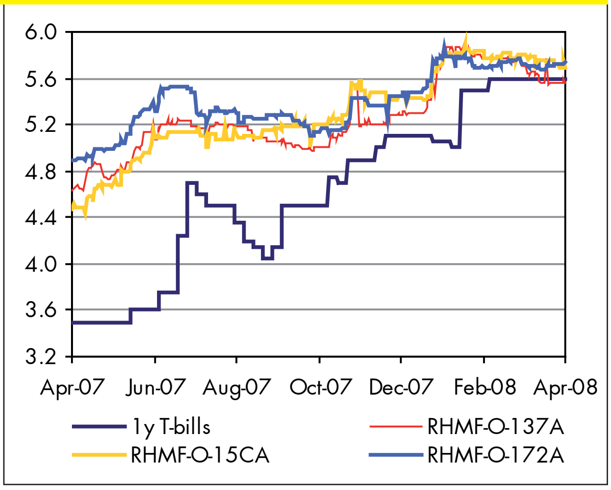
Unfavourable effects
of insufficient liquidity continue

Yield trends (%)



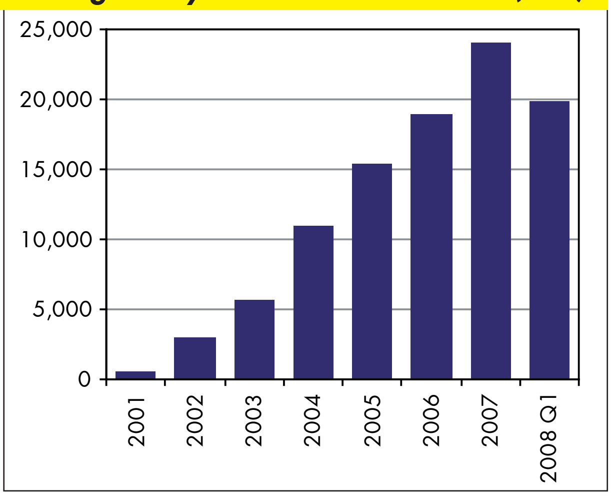
Source: Bloomberg, Reuters, Raiffeisen RESEARCH

Domestic currency yields (%)



Source: Ministry of Finance, Reuters, Raiffeisen RESEARCH

Average daily turnover local bonds (EUR)



Source: Zagreb Stock Exchange

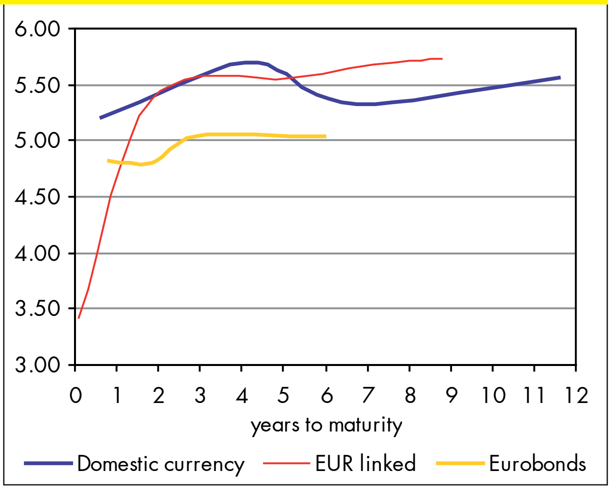
A stronger than expected global economic slowdown and more widespread problems in the global banking system has had the greatest influence on international bond markets in 2007 and 2008. Instability on the global financial markets drove investors to minimise their risk exposure by purchasing government debt issued by developed countries. While prices for US Treasuries and German Bunds went up, demand for debt from Emerging Markets - especially local currency debt - decreased substantially. These unfavourable developments also affected CEE sovereign bonds. In addition, rising yields in the CEE region (with the exception of Slovakia) were boosted by mounting inflationary pressures, which in turn led to restrictive monetary policies. However, appreciation in most of the CEE currencies allowed CEE local bonds to remain attractive in contrast to other sovereign issuers in the Emerging Market segment. In light of increased caution on the market, attention has shifted to country-specific imbalances in the CEE economies, resulting in more pronounced discrimination among issuers. At the beginning of the year, the credit outlook for the Baltic states, Romania and Bulgaria deteriorated amid increased risk related to the financing of the high C/A deficits under unfavourable global conditions. The same was true for Hungary but as a result of the slow implementation of structural reforms.

Global trends and certain domestic factors had a negative impact on the domestic Croatian bond market as well. At the beginning of the first quarter trading volumes declined well below last year's average and no new government bonds were issued. The most important market impact came from low liquidity in the banking system. The rise in money market interest rates contributed to a reduction in the activity of institutional investors on the market. In addition, the rise in yields on the domestic market was supported by the intensification of inflationary pressures. The unusual strength of the kuna against the euro also had an unfavourable influence on the development of bonds indexed to foreign currency. Trading stabilised later in the first quarter, while the impact from European bond markets became more significant.

The low likelihood that the government will receive significant privatisation revenues this year could increase government borrowing. Thus, supply in the domestic market could be higher. Moreover, restrictive monetary policy and expectations of limited liquidity in the domestic market are likely to keep money market rates at higher levels throughout most of the year, which would not be supportive for bond prices. In order to finance its needs and refinance old commitments, the government is likely to turn towards borrowing on foreign capital markets in 2008. A Eurobond issue is expected by the end of the first half of the year. Although the government's decision is understandable in view of the current market situation, as insufficient liquidity and interest rate growth make external borrowing much more attractive, it will not contribute to support the domestic market. In addition, it can be expected that the higher inflation anticipated in 2008 (5%) will negatively affect domestic bonds. The continued strength of the kuna expected in the coming months is likely to negatively influence demand for bonds indexed to foreign currency. Despite the overall unfavourable situation for domestic bonds, some new corporate bond issues (three new issues) as well as new municipal bond issues (also three new issues) were placed. As Eurobond spreads increased substantially, spreads for bonds indexed to foreign currency rose to some 150bp for some maturities. Regarding kuna bonds, it was clear that with high money market interest rates (the three-month ZIBOR was around 7.5% in the last quarter, while the interest rate on overnight deposits fluctuated between 1% and 17%) long-term yields for bonds denominated in kuna could not go down. For example, spreads went to 140bp against European reference yields. The outlook for this year will depend on the developments on the foreign markets and the domestic money market. Overcoming the loan crisis would help to reduce spreads and risk premiums (however, levels from June 2007 are hardly likely to be attained any time soon).

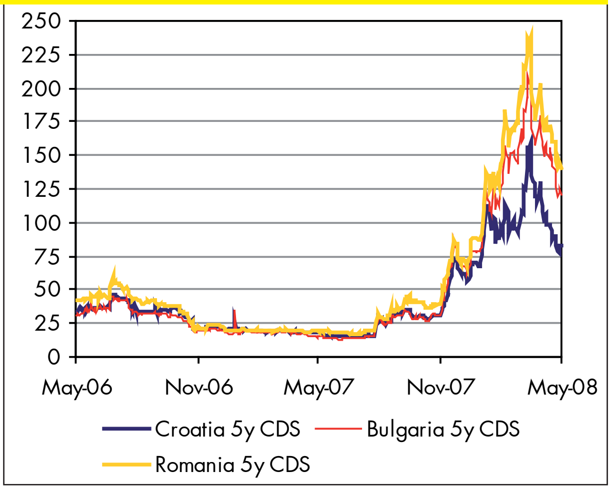
With three sovereign Eurobonds worth EUR 1.75 bn, one short-term EUR issue matures in February 2009, Croatian hard currency debt has a weight of around 5% in the EMBIG EUR index (the tenth largest index-weight out of nineteen). Year-on-year average spreads on Croatian Eurobonds widened substantially (from around 30-40bp, with all time lows at around 20bp) to some 115-120bp due to the global risk re-pricing and bearish sentiment towards Emerging Market assets. However, Croatian EUR Eurobonds still primarily developed in line with yields on Bunds. Thus, some of the spread widening was offset by plunging benchmark yields, while in year-to-date and year-on-year terms, Croatian

Yield curves of Croatian bonds (%)



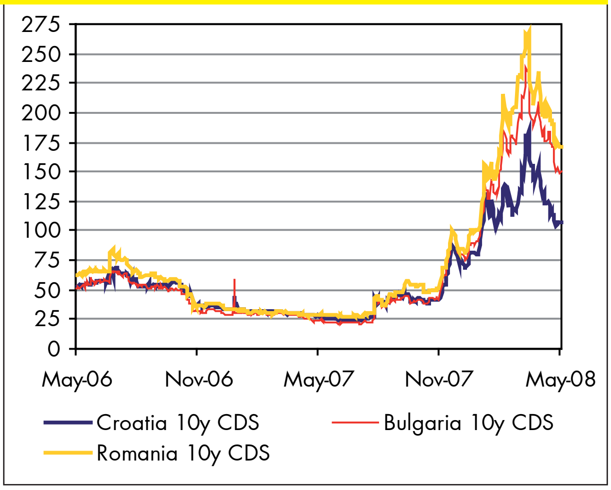
Sources: Bloomberg, Reuters, Raiffeisen RESEARCH

5y CDS premiums (bp)



Source: Thomson Financial Datastream, Raiffeisen RESEARCH

10y CDS premiums (bp)



Source: Thomson Financial Datastream, Raiffeisen RESEARCH

CEE Eurobond performance

EMBIG EUR	Return (%) mom	ytd	yoy	Current spread (bp)
Composite	**0.21**	**1.00**	**1.77**	**109**
Europe (CEE)	**-0.12**	**0.92**	**2.22**	**89**
Latin America	1.32	1.74	0.67	179
Africa	1.80	-0.87	-1.88	195
Asia	-0.22	1.28	2.93	104
Lithuania (A-)	0.12	1.59	2.61	72
Slovak Rep (A)	-0.57	1.88	2.79	36
Czech Rep (A)	-0.66	1.81	3.10	32
Poland (A-)	-0.53	0.78	1.80	64
Hungary (BBB+)	-0.11	0.32	1.67	86
Bulgaria (BBB+)	0.38	1.35	2.47	83
Croatia (BBB)	**0.38**	**1.70**	**2.97**	**97**
Romania (BBB-)	0.25	1.24	2.63	114
Turkey (BB-)	0.61	0.43	2.77	210
Ukraine (BB-)	0.64	2.14	-2.67	287

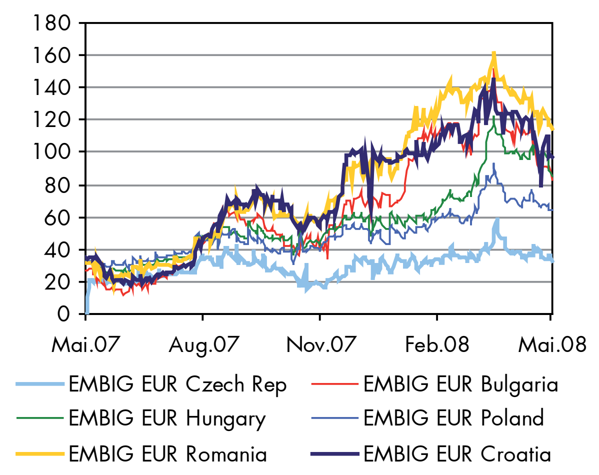
Countries sorted by S&P foreign currency rating
Source: JP Morgan, Raiffeisen RESEARCH

SEE foreign currency ratings

	S&P l-t	S&P outl.	Moody's l-t	Moody's outl.	Fitch l-t	Fitch outl.
Albania	nr	-	B1	st	nr	-
Bulgaria	BBB+	st	Baa3	pos	BBB	neg
Croatia	BBB	st	Baa3	pos	BBB-	st
Romania	BBB-	neg	Baa3	st	BBB	neg
Serbia	BB-	neg	nr	-	BB-	st
Turkey	BB-	neg	Ba3	st	BB-	st

Source: rating agencies, Raiffeisen RESEARCH

CEE Eurobond spreads (bp)



Source: JP Morgan, Raiffeisen RESEARCH

Eurobonds are still in positive return territory. Moreover, Croatian Eurobonds outperformed their SEE peers. Thus, it seems that markets are not putting Croatia in the same basket with Bulgaria and Romania, which are suffering from negative rating pressure at present. The same pattern of increasing discrimination among issuers - benefiting Croatia - has been visible in the more liquid CDS segment as well.

We expect Croatian sovereign Eurobonds to maintain their relative safe haven position, while inflation risk and volatility in local EM currencies should benefit EM foreign-currency bonds (especially euro-denominated ones). Moreover, current spread differentials on Croatian Eurobonds (in contrast to Slovak or Czech Eurobonds, which remain very tightly priced) will provide some cushion if global markets stabilise and Eurozone yields start to rise in the second half of 2008. One supportive factor for Croatian Eurobonds could be a well-received offer of a new international benchmark bond. The recent postponement of the placement clearly indicates that the Ministry of Finance is well aware of the link between primary and secondary markets under the current circumstances and is not aggressively pushing the placement.

Although, most of the significant tightening of sovereign spreads that might be expected for a transition economy with EU accession underway seems to have already taken place, Croatian Eurobonds appear fairly attractive for buy and hold investors due to their substantial current positive carry and limited downside risk. In the long run Croatian spreads should somewhat inch closer to the levels of Eurobonds issued by EU member states in CE. Some good news concerning EU accession might support Croatian Eurobonds in 2008; spreads tightened by about 10bp the week negotiations were announced in October 2005. Moreover, (international) investors might realise that Croatian external debt is the last "convergence play" that will be available in CEE for some time, resulting in additional demand.

In terms of ratings, the downside potential for Croatian Eurobonds is limited. Croatia has missed out on the long-lasting upward trend in sovereign ratings that has taken place over the last three years in CE (with the exception of Hungary) and SEE in the wake of EU euphoria. However, recent negative rating pressure on selected SEE and CE issuers indicated that this trend might be coming to an end. Thus, there is some potential for further negative rating actions due to slowing economic dynamism on the international level in the case of Croatia's peers, while we see no negative rating pressure in the case of Croatia in the next 6-9 months ahead. We expect total external debt and the C/A deficit to stabilise in 2008 and 2009 and external solvency is not a near-term threat. Moreover, Croatia's key macroeconomic figures and public finances seem to be Maastricht compatible, while the country appears to be on a fast track to EMU entry once it has joined the EU. The largely foreign-owned banking sector also mitigates risk from the run-up in private external borrowing. In addition, the high level of real convergence and a GDP per capita of around EUR 12,000 at purchasing power parity (around 50% of the EU-27 average and about 40% above the income level of Croatia's rating peers) clearly support the current foreign currency rating.

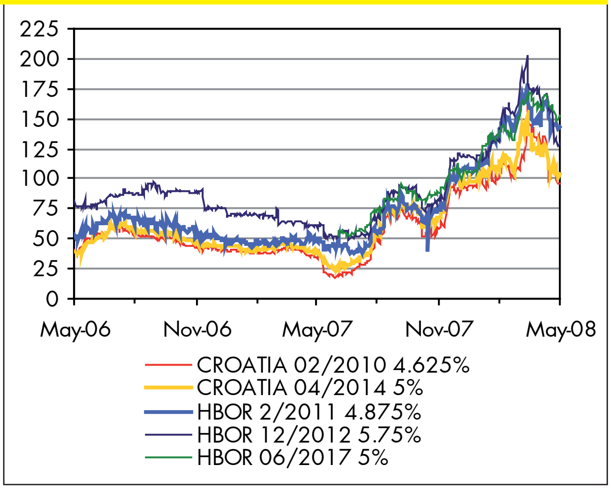
Looking at the quasi- and sub-sovereign segment, the Croatian Eurobond market offers some value as well. The international HBOR issues (Croatian Development Bank), which are explicitly guaranteed by the government and can even be found in the portfolios of conservative investors like the Norwegian sovereign wealth fund, offer some yield pick-up due to a certain liquidity premium. They are largely buy and hold bonds, while the credit risk should be the same as the sovereign risk.

SEE EUR Eurobonds

	Spread (bp)		Return (%)	
	current	-1y	ytd	yoy
Sovereign				
BULGARIA 01/2013 7.5%	110	76	1.33	2.54
CROATIA 02/2009 6.25%	95	65	1.58	3.98
CROATIA 02/2010 4.625%	97	62	1.82	3.93
CROATIA 03/2011 6.75%	116	82	2.01	3.20
CROATIA 04/2014 5%	101	63	2.32	2.32
ROMANIA 06/2008 10.625%	41	22	1.74	4.32
ROMANIA 07/2010 5.75%	117	86	1.70	3.46
ROMANIA 05/2012 8.5%	132	99	1.14	2.16
Quasi-sovereign				
HBOR 2/2011 4.875%	142	93	1.28	3.02
HBOR 12/2012 5.75%	128	67	1.91	3.90
HBOR 07/2016 4.807%	109	50	0.78	2.04
HBOR 06/2017 5%*	150	n.a.	-0.21	n.a.

** no yoy data available as bond was issued in June 2007*
Source: Thomson Financial Datastream, Raiffeisen RESEARCH

Croatian Eurobond spreads (bp)



Source: Thomson Financial Datastream, Raiffeisen RESEARCH

Government bonds in domestic market

Bond	Currency	Volume (mn)	Maturity	Coupon (%)	Ytm (ask, %)	Spread to Bunds (bp)	Spread to EUROSWAP (bp)	Ytm (ask, %)	Ytm (ask, %)	Ytm (ask, %)
					29-Apr-08	29-Apr-08	29-Apr-08	31-Dec-07	30-Sep-07	30-Jun-07
RHMF-O-08CA	EUR*	200	12/14/2008	6.875	5.20	189	31	5.01	4.83	4.83
RHMF-O-125A	EUR*	500	5/23/2012	6.875	5.70	182	120	5.36	4.97	4.72
RHMF-O-142A	EUR*	650	2/10/2014	5.500	5.41	148	91	5.42	4.99	4.91
RHMF-O-157A	EUR*	350	7/14/2015	4.250	5.33	128	77	5.39	5.03	4.77
RHMF-O-19BA	EUR*	500	11/29/2019	5.375	5.56	116	78	5.36	5.04	4.76
RHMF-O-085A	HRK	1,000	5/28/2008	6.125	3.43	194	-	5.55	4.26	4.20
RHMF-O-103A	HRK	3,000	3/8/2010	6.750	5.37	183	-	5.03	4.39	4.30
RHMF-O-137A	HRK	4,000	7/11/2013	4.500	5.56	167	-	5.31	5.06	5.07
RHMF-O-15CA	HRK	5,500	12/15/2015	5.250	5.70	164	-	5.45	5.17	5.09
RHMF-O-172A	HRK	5,500	2/8/2017	4.750	5.73	159	-	5.48	5.28	5.31

** indexed to euro; secondary trading, interest and principal payment mid rate of CNB on trading day or maturity day*
Source: Ministry of Finance, Zagreb Stock Exchange, Reuters

Local currency debt instruments

Description	***Treasury bills***	***Treasury bonds***	***Corporate bonds***	***Municipal bonds***
Issuer	Ministry of Finance	Ministry of Finance	Big local banks, companies	Municipal governments
Currency	Croatian Kuna (HRK)	Croatian Kuna (HRK) & Euro-linked issues settled in HRK	Croatian Kuna (HRK) & Euro-linked issues settled in HRK	Croatian Kuna (HRK) & Euro-linked issues settled in HRK
Settlement currency	HRK	HRK; for Euro-linked in HRK according to CNB mid-rate for EUR/HRK	HRK; for Euro-linked in HRK according to CNB mid-rate for EUR/HRK	HRK; for Euro-linked in HRK according to CNB mid-rate for EUR/HRK
Minimum denomination	100 000	1	1	1
Tenor(s)	3-12 months	5-15 years; Euro-linked 3-15 years	3-7 years; Euro-linked 3-7 years	7-10 years
Interest rate/coupon	zero coupon (discount)	HRK 4.500% - 6.750%; Euro-linked 3.875% - 6.875%	4.125% - 9.125%; Euro-linked 4.500% - 6.500%	4.125% - 6.500%
Coupon payment dates	none	semi-annual	semi-annual; annual	semi-annual
Interest accrual basis	365 days	365 days	365 days	365 days
Day count basis	actual/365	actual/actual	actual/actual	actual/actual
Amortization schedule	bullet	bullet	bullet	bullet
Form of issue	dematerialised	dematerialised	dematerialised	dematerialised
Total outstanding at face	HRK 11.8 bn	HRK 19.6 bn and EUR 2.3 bn	HRK 5.5 bn & EUR 400 mn	HRK 127 mn and EUR 60 mn
PRIMARY MARKET				
Auction style	American style	Fixed price	Fixed price	Fixed price
Average issue size	HRK 150 - 500 mn	HRK 2-3 bn and EUR 400 mn	HRK 100 - 500 mn and EUR 20 mn	n.a.
Frequency	weekly	irregular	irregular	irregular
Participation	only domestic legal entities	via authorized government market-makers	via appointed primary placement bank	via appointed primary placement bank
Settlement	T+2	T+3	T+3	T+3
Reuters/Bloomberg screens	HR/DEBT -> <MFHT> / n.a.	n.a. / <CROATE Govt>	n.a.	n.a.
SECONDARY MARKET				
Trading floor(s)	interbank market	ZSE	ZSE	ZSE
Liquidity (average daily turnover during last 365 days)	n.a.	HRK 67.9 mn	HRK 2.2 mn	n.a.
Settlement	T+0 *; T+2	T+3	T+3	T+3
Clearing mechanism	CDA (Central Depository Agency)	CDA	CDA	CDA
Custody	CDA	CDA	CDA	CDA
Trading hours	08:30 am - 04:30 pm	10:00 am - 04:00 pm	10:00 am - 04:00 pm	10:00 am - 04:00 pm
Reuters/Bloomberg screens	<0#HRTSY=> / <CROTB Govt>	<0#HRTSY=ZA> <HR/CONT>/<CROATE Govt>	<#HRCORP=ZA> / <Issuer name or ticker Corp>	<#HRMUNI=ZA> / <Issuer name or ticker Muni>
REGULATION / TAXES				
Restrictions on foreign investment	not allowed to invest	no restrictions	no restrictions	no restrictions
Income tax (for retail)	tax exempt	tax exempt	tax exempt	tax exempt
Income (coupon) tax	tax exempt	tax exempt	tax exempt	tax exempt
Capital gains tax **	tax exempt	tax exempt	tax exempt	tax exempt

** T+0 apllies to local banks only*

*** non-residents can obtain a tax relief subject to double taxation treaty, no taxes are levied on investments into debt securities, retail and non-residents investors do not pay Croatian local taxes, however, local companies and banks pay corporate tax; non residents are subject to taxation of their country of residence/incorporation*

Sources: Ministry of Finance, Croatian National Bank, Central Depositary Agency, Raiffeisen RESEARCH

FX forwards and useful links

Description	***FX forward***	***Useful links***	
Deliverable	Yes	Raiffeisenbank Austria d.d. Zagreb	www.rba.hr
Term	up to 5 yr	Ministry of Finance	www.mfin.hr
Liquid up to	1 yr	Croatian National Bank	www.hnb.hr
Trade Size (min-max)	1-50 mio EUR	Central Depositary Agency	www.sda.hr
Day Count	Actual/360	Croatian Agency for Supervision of Financial Services	www.hanfa.hr
Settlement	longer than T+2	Zagreb Stock Exchange	www.zse.hr
		Croatian Banking Association	www.hub.hr

Sources: Ministry of Finance, Croatian National Bank, Central Depositary Agency, Raiffeisen RESEARCH

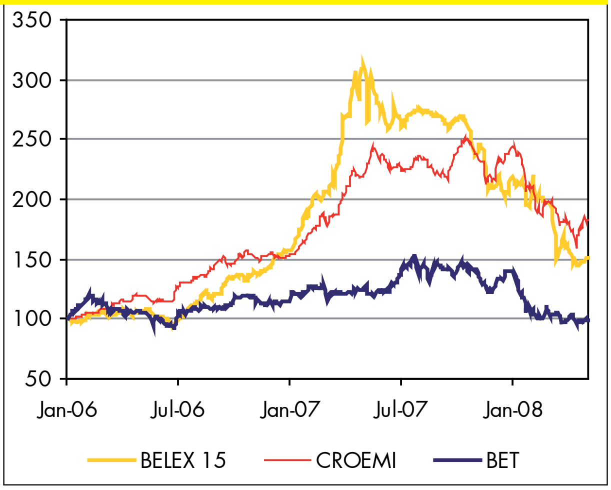
Croatian equity market
taken hostage by global sentiment

The ***global equity markets*** have been experiencing a downward trend since the second half of 2007. The ***mortgage crisis*** and the resulting liquidity shortage on the international money and capital markets continue to limit investors' willingness to accept risk. We believe that the financial crisis is yet to pass and that leading indicators in the US will not find solid ground until sometime in the summer. For the ***Croatian equity market,*** which otherwise tends to develop independently of external conditions, this will translate into a higher level of dependence on international trends despite the country's positive domestic macroeconomic conditions.

The ***Croatian stock exchange,*** which was consolidated into one location in Zagreb at the beginning of last year, is not necessarily among the largest exchanges in the CEE region, but it still delivered a dynamic performance last year. The CROEMI stock index downright skyrocketed with an increase of just under 60%. This growth was especially driven by institutional investors (domestic and foreign investment funds, local pension funds) and increased investment activity from retail investors. In the accompanying chart, one can see that the ***share of equities held by foreigners*** as measured by market capitalisation decreased significantly starting in the second half of the year. The reasons for this development primarily lie in the negative sentiment on the international markets and the continued elevated risk classification of Croatia's equity market, not least due to the higher valuation of the market compared to both international and regional equity markets. ***Pension funds,*** which were decisive in the previous outstanding performance of the CROEMI, have been avoiding the domestic equity market since the beginning of the year, currently eliminating an important supportive factor. These funds are permitted to invest up to 15% of their assets in domestic equities in addition to the 50% they are allowed to invest in government bonds. Since December of last year these funds have been allowed to invest directly in shares listed in the JDD quotation (which, with 112 stocks up to date, covers significantly more stocks than CROEMI), so it is safe to assume that certain equity investments will also take place outside of the first quotation of ZSE.

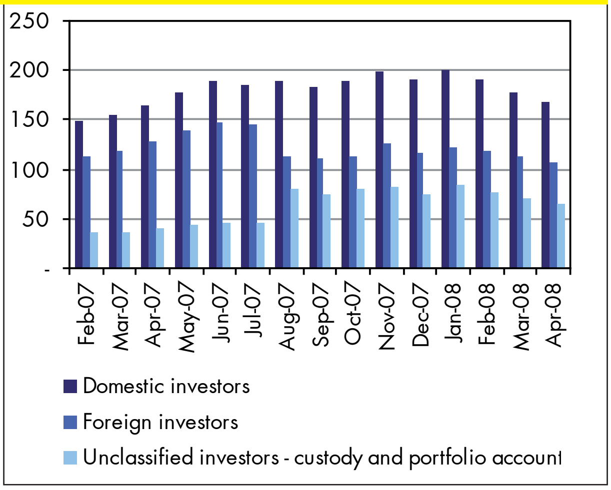
The Zagreb Stock Exchange has witnessed considerable increases in terms of ***market capitalisation*** in recent years. The IPOs staged by the state-owned oil and gas group INA and Hrvatske Telekomunikacije (HT) are two prominent examples

SEE indices



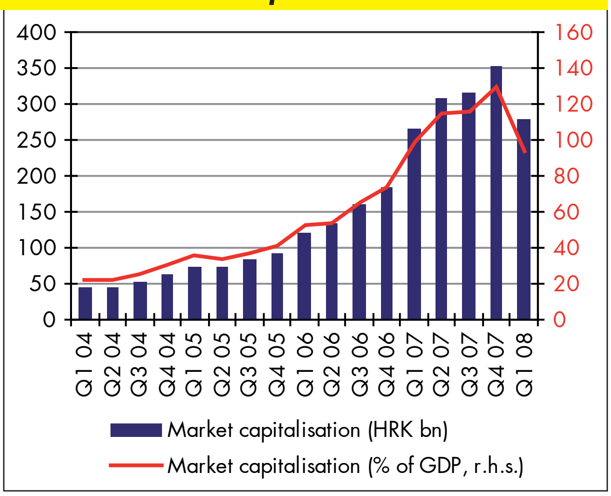
Source: Bloomberg, Raiffeisen RESEARCH

Holdings in stocks*



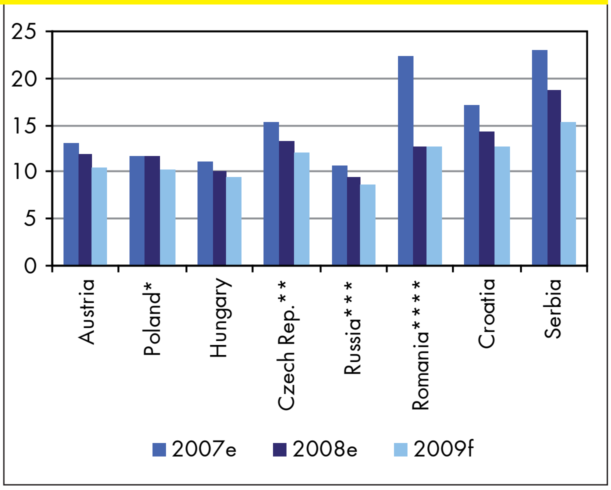
** HRK bn*
Source: CDA

Croatia: market capitalisation

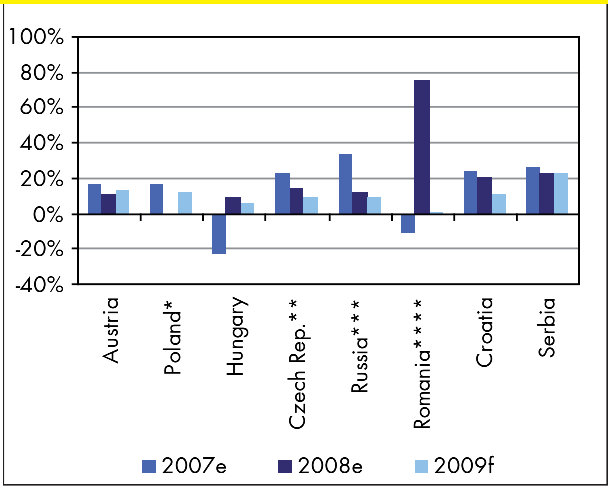


Sources: Zagreb Stock Exchange, Raiffeisen RESEARCH

P/E ratios in comparison

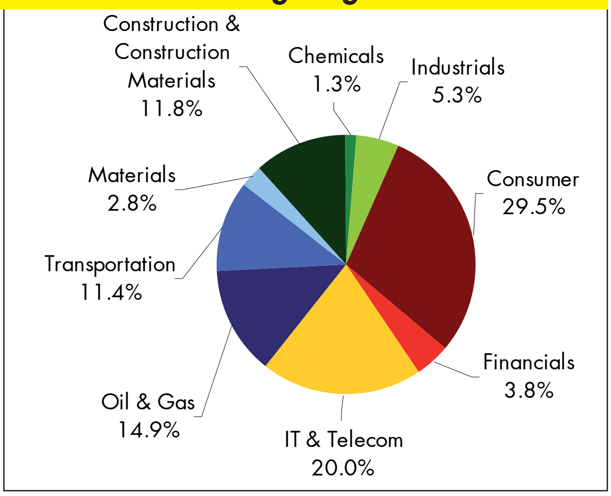


Earnings growth



** PL (WIG 20): excl. POLNORD & CEZ, ** CZ (PX): excl. Erste Bank & ECM Real Estate, *** RU (RTS): excl. Avtovaz & VTB Bank, **** RO (BET): excl. Biofarm & SSIF Broker; DY calculation based on only Petrom, BRD-Group, Turbomecanica & Transelectrica;*
Source: Thomson Financial Datastream, IBES, Raiffeisen RESEARCH

CROEMI sector weightings



Source: Reuters, Raiffeisen RESEARCH

of companies that have benefited from investors' growing interest in the Croatian equity market. Sustained growth can be expected on the capital market, not least because of the limits on lending growth (the minimum reserve requirement for deposits at banks is currently 17%), which will result in more inflows for the stock exchange.

However, at the moment there are ***no indications that there will be any new IPOs*** in Croatia this year. This is primarily a result of negative sentiment on the equity market and the indifference being displayed by domestic retail investors. But it is very likely that there will be a few secondary public offering (SPOs), e.g. Suncani Hvar (tourism company) in June or July. There are also rumours that the market will see SPOs from HG Spot (ICT wholesaler and retailer), Ingra (construction company) and HPB (state-owned bank). Upcoming private placements include Uljanik plovidba (shipping company) and Pliva's (pharmaceutical company).

The government's plans to establish ***closed-end funds*** which could be an important event for the Croatian equity market. The plan is to transfer government shares (which are currently managed by the Croatian Privatization Fund) into newly established funds that will then be sold to private investors via IPOs. However, it is not yet clear when these plans will be realised.

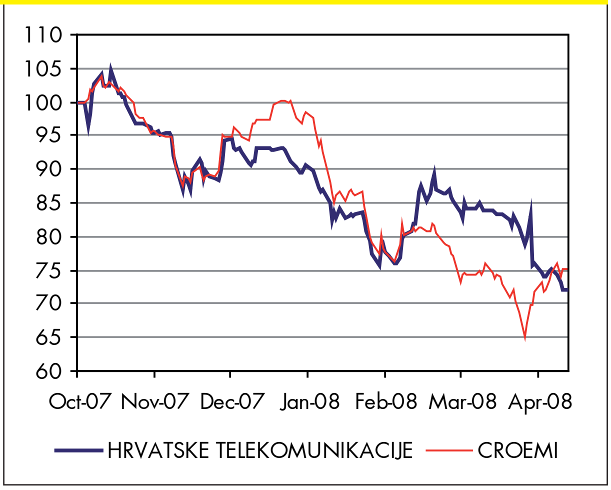
We expect to see just a moderately positive ***price performance on the Croatian equity market*** for the rest of the year. The financial crisis has not yet reached its climax and the deterioration of investor sentiment on the global markets will contribute to considerable risk aversion in the next few months - just as it has up until now - especially on the Zagreb Stock Exchange, which is overvalued to begin with. This is particularly reflected in the fact that pension funds, which are essential for the Croatian equity market, are taking an especially cautious approach in the current market environment and the fact that investment funds see themselves as being confronted with an increasing liquidity shortage as a result of the massive sell-off of shares in recent months. We believe that the investment climate will start to improve starting in the summer at the earliest after tensions have eased on the market. At that point, Croatia's positive economic conditions and the above-average earnings prospects for the companies listed in the CROEMI should once again become the focus of investors.

Croatian equities
a brief overview

Hrvatske Telekomunikacije

HT Group is a leading Croatian telecom provider offering the full spectrum of services: fixed telephony, mobile telephony, data transmission, Internet and international communications. Currently, the Group holds a 90% share of the fixed voice telephony market and a 47% market share in SIM cards. The market outlook predicts a moderate decline in the number of fixed lines including ISDN channels and growth in the areas of broadband and IPTV services due to underdeveloped markets. The Group employs some 6,700 people. Its shares have been listed on the ZSE and LSE since October 2007 when the state privatised its stake in the Group. HT's majority shareholder is still Deutsche Telekom AG (51%). Consolidated sales in 2007 were HRK 8.8 bn (+2.3% yoy) and net earnings totalled HRK 2.47 bn (+11.6% yoy).

Hrvatske Telekomunikacije

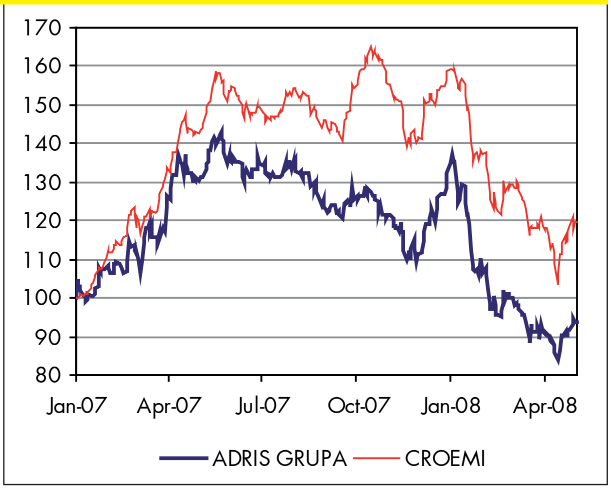


Source: Thomson Financial Datastream

Adris Grupa

The Group operates mainly in the tobacco and tourism sectors. The company's tobacco segment encompasses production of tobacco leaf, paper packages and distribution. Adris has a market share of 85% on the domestic cigarette market and high market shares in the other countries of the region. The tourism segment currently owns hotels, resorts and camps in Istria with 2.63 mn registered overnight stays and 7% sales growth. The Group invests in its lodging facilities to increase capacities and raise the ratings of the hotels in its portfolio, aiming to reach 75% of its capacity in 4- and 5-star hotels. In 2007 the Group realised revenues of HRK 3.46 bn (+16.8% yoy) and net earnings totalled HRK 670 mn (+11.3% yoy).

Adris Grupa

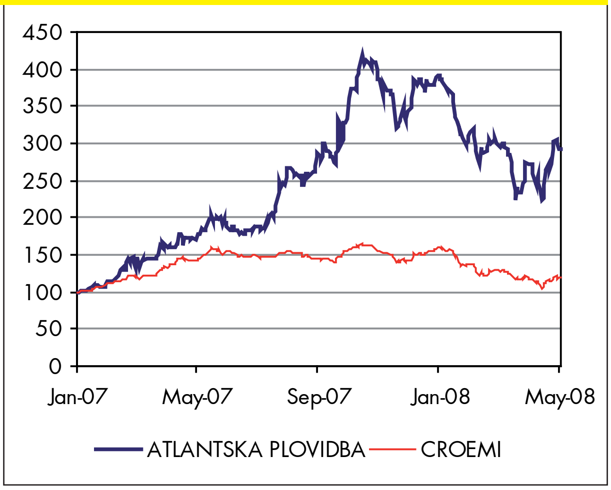


Source: Thomson Financial Datastream

Atlantska Plovidba

Atlantska Plovidba is the largest Croatian company specialising in dry bulk and heavy lift shipping. The majority of the company's revenues - more than 90% - are realised abroad, while the rest comes from domestic coastal shipping and tourism. Thanks to favourable conditions on the global maritime transportation market, Atlantska Plovidba has realised a huge increase in sales and in the market value of its fleet. The company continuously invests in the renewal and enlargement of its fleet, but also diversifies its operations towards other business activities in the airline (five planes) and tourism (three hotels) industries. In 2007 the company achieved sales of HRK 1.25 bn (+24.2% yoy) and a net profit of HRK 239.1 mn (+150.9% yoy).

Atlantska Plovidba



Source: Thomson Financial Datastream

RZB Group Research Team

Vienna
Peter Brezinschek (Head)
Aaron Alber
Andreas Auer
Walter Demel
Gunter Deuber
Wolfgang Ernst
Christian Grohotolsky
Christian Hinterwallner
Valentin Hofstätter
Klemens Hrovath
Anastassia Kastner
Christoph Klaper
Lydia Kranner
Nina Kukic
Martin Kutny
Matthias Lauermann
Hannes Loacker
Johannes Mattner
Caroline Niziolek
Christine Nowak
Ronald Plasser
Helge Rechberger
Johann Reindl
Alexander Runovich
Leopold Salcher
Andreas Schiller
Robert Schittler
Manuel Schreiber
Connie Schümann
Andreas Schwabe
Gintaras Shlizhyus
Gleb Shpilevoy
Alexander Sklemin
Gottfried Steindl
Martin Stelzeneder
Magdalena Wasowicz
Josef Wolfesberger

Albania
Helga Strazimiri
Brunilda Elezi

Belarus
Oleg Leontev
Vasily Pirogovsky
Yury Rapatsevich

Bosnia & Herzegovina
Zeljko Pehar
Sergio Ermacora
Ivona Kristic
Tarik Sirbegovic

Bulgaria
Desislava Nickolova
Hristo Durev

Croatia
Anton Starcevic
Zdeslav Santic
Zrinka Zivkovic Matijevic
Denis Dolinar
Nada Harambasic

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Pavel Mertlik
Helena Horska
Michal Brozka
Ales Michl
Jindrich Svatek
Lenka Kalivodova

Hungary
Zoltan Török
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Akos Herczenik
Levente Blaho
Norbert Harcsa

Poland
Jacek Wisniewski
Marta Petka
Marcin Grotek

Romania
Ionut Dumitru
Nicolae Covrig
Ion Gheorghe Guta
Bogdan Campianu
Oleg Galbur
Ionut Gutis
Bogdan Gogu
Alexander Combei
Iuliana Mocanu

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Mikhail Nikitin

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Ljiljana Grubic
Miodrag Sladojevic
Jovana Orlic

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Robert Prega
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Branislav Baricak
Martin Jelenciak

Slovenia
Darko Kovacic

Ukraine
Angela Prigozhina
Andrey Shklyar
Dmytro Sologub

RCB Company Research
Birgit Kuras (Head)

Stefan Maxian (Head of Austria & CEE)
Philipp Chladek
Daniel Damaska
Natalia Frey
Marta Gizejowska
Roman Herzog
Klaus Küng
Bernd Maurer
Darya Miroshnyshenko
Dominik Niszcz
Klaus Ofner
Teresa Schinwald
Jovan Sikimic
Alexander Stieger
Arno Supper
Iryna Trygub

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Acknowledgements:
Editor: Raiffeisen RESEARCH GmbH
A-1030 Vienna, Am Stadtpark 9, Telephone: +43 1 717 07-0, Telefax +43 1 717 07-1848

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Currencies and Countries

ALL	Albanian lek
BAM	Bosnian marka
BGN	Bulgarian lev
BYR	Belarusion Rubel
CNY	Chinese yuan
CZK	Czech koruna
EKK	Estonian kroon
HUF	Hungarian forint
HRK	Croatian kuna
LTL	Lithuanian litas
LVL	Latvian lats
PLN	Polish zloty
RON	Romanian leu
RSD	Serbian dinar
RUB	Russian rouble
SIT	Slovenian tolar
SKK	Slovak koruna
TRY	Turkish lira
UAH	Ukrainian hryvnia

Economic abbreviations

%-chg	Percentage change (not in percentage points)
avg	average
bp	basis points
C/A	Current Account
CPI	Consumer Price Index
EM	Emerging Markets
EU	European Union
FDI	Foreign Direct Investments
FCY	Foreign Currency
FX	Foreign Exchange
GDP	Gross Domestic Product
ILO	International Labour Organization
IMF	International Monetary Fund
NATO	North Atlantic Treaty Organization
NDF	non-deliverable forward
NBU	National Bank of Ukraine
LCY	Local Currency
mom	month on month
OTC	Over-the-counter
pp	percentage points
PPI	Producer Price Index
SME	Small and medium Enterprises
T/B	Trade Balance
ULC	Unit Labour Costs
yoy	year on year
WTO	World Trade Organization

Stock Exchange Indices

BELEX	Belgrade stock index
BET	Romanian stock index
BUX	Hungarian stock index
CROEMI	Croatian stock index
PFTS	Ukrainian stock index
PX	Czech stock index
WIG 20	Polish stock index

Equity related

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

RS	Recommendation suspended
UR	Under Revision

Abbreviations

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
CEE	Central and Eastern Europe (CE + SEE + CIS)

Investment banking units

Raiffeisen Zentralbank Österreich AG, Vienna
Global Markets
Head: Martin Czurda Tel: +43 1 71707 3347
Financial Sales: Hans Rettl Tel: +43 1 71707 3300

Belgrade: Raiffeisen banka a.d.
Contact: Zoran Petrovic Tel: +381 11 2207006

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: Raiffeisen Bank Aval
Contact: Vladimir Kravchenko Tel: +380 44 49005 42

Maribor: Raiffeisen Banka d.d.
Contact: Gvido Jemensek Tel: +386 2 229 3111

Minsk: Priorbank JSC
Contact: Yury Slepich Tel: +375 17 289 9019

Moscow: ZAO Raiffeisenbank Austria
Contact: Pavel Gourine Tel: +7 495 721 9929

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: Adam Pers Tel: +48 22 585 26 26

Zagreb: Raiffeisenbank Austria d.d.
Contact: Ivan Zizic Tel: +385 1 45 66 466

Raiffeisen CENTROBANK AG

Equity Capital Markets, Vienna
Head: Wilhelm Celeda Tel: +43 1 515 20 402
Sales: Klaus della Torre Tel: +43 1 515 20 472

Raiffeisen Investment AG, Vienna
Contact: Heinz Sernetz Tel: +43 1 710 54 00 113

Commercial banks

Raiffeisen Zentralbank Österreich AG, Vienna
Corporates: Peter Bazil Tel: +43 1 71707 1547

RZB Austria Jersey Office
Contact: Daniel Thebault Tel: +44 1534 781 000

RZB Austria 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

International Desk

Vienna: Raiffeisen International Bank-Holding AG
Contact: Rudolf Lercher Tel: +43 1 71707 3537

Belgrade: Raiffeisen banka a.d.
Contact: Christoph Pircher Tel: +381 11 220 7807

Bratislava: Tatra banka, a.s.
Contact: Oswald Brandstetter Tel: +421 2 5919 1849

Bucharest: Raiffeisen Bank S.A.
Contact: Anca Merdescu Tel: +40 21 306 1581

Budapest: Raiffeisen Bank Zrt.
Contact: Frank Daniel Tel: +36 1 484 4684

Kiev: Raiffeisen Bank Aval
Contact: Johannes Riepl Tel: +38 044 230 99 81

Maribor: Raiffeisen Banka d.d.
Contact: Thomas Schindl Tel: +386 1 475 7841

Minsk: Priorbank JSC
Contact: Julia Shigaeva Tel: +375 17 289 92 09

Moscow: ZAO Raiffeisenbank Austria
Contact: Maria Maevskaya Tel: +7 495 775 5230

Prague: Raiffeisenbank a.s.
Contact: Roman Lagler Tel: +420 221 141 728

Pristina: Raiffeisen Bank Kosovo J.S.C.
Contact: Albert Matoshi Tel: +381 38 226 400 116

Sofia: Raiffeisenbank (Bulgaria) EAD
Contact: Karin V. Nikolova Tel: +359 2 9198 5199

Sarajevo: Raiffeisen Bank d.d. Bosna i Hercegovina
Contact: Vildana Sijamhodzic Tel: +387 33 287 283

Tirana: Raiffeisen Bank Sh.a.
Contact: Adriana Jorgji Tel: +355 4 222 669 2545

Warsaw: Raiffeisen Bank Polska S.A.
Contact: Joanna Helmans Tel: +48 22 585 21 84

Zagreb: Raiffeisenbank Austria d.d.
Contact: Vesna Janjatovic Tel: +385 1 4566 426