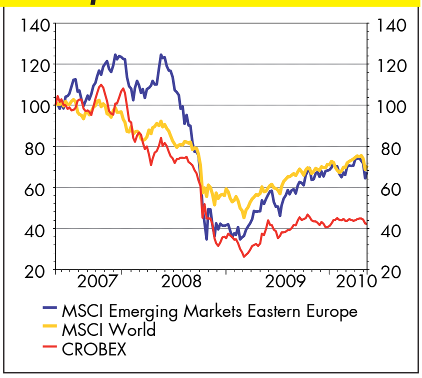
Strategy Croatia

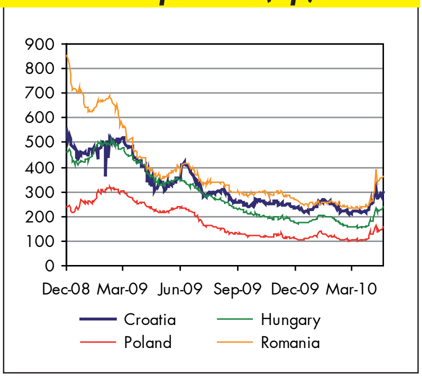
May 2010

Index performance



Source: Thomson Financial Datastream

Eurobond spreads (bp)



EUR EMBIG government spreads (bp)
Source: JP Morgan, Raiffeisen RESEARCH

Highlights

- For many years economic prosperity was financed predominantly by foreign capital, a trend interrupted by a slump in 2009. In 2010 it is more likely that the economic contraction will continue. Unfavourable trends in construction and industrial production, paired with the narrowed inflow of direct investment, will impact negatively on investments. On the other hand, GDP will be boosted by moderate growth in exports as a result of the recovery in foreign demand paired with a continued fall in imports.
- At the beginning of 2010 the Government announced and initiated programmes aimed at reviving the economy, offering direct funding participation in working capital financing, risk participation in investment financing with a partial Government guarantee, participation in venture capital funds, and finally, the restructuring of the worst companies by means of a partial debt to equity swap, which means a temporary increase in the state's equity holdings in these companies.
- The continued decrease in demand and the weak lending activity of the banking sector are likely to contribute to relatively low trade deficits, primarily as a result of the decreased imports, which will help to lower the downward pressure on the kuna. Due to the slightly increased demand for the kuna, during the summer the exchange rate is expected to float around the levels observed in the first quarter of the year. However, seasonal pressures pushing for a stronger kuna are bound to be less pronounced than over previous years.
- We are optimistic about the Croatian equity market for the year. Long-term oriented investors have the opportunity to use possible corrections triggered by the debt crisis to position themselves in a market that still remains volatile but is also very promising. In addition to domestic and international investment funds as well as local pension funds, the driving forces in this context increasingly include private investors.

Key economic figures and forecasts

	2005	2006	2007	2008	2009	2010e	2011f
Nominal GDP (EUR bn)	35.7	39.1	42.8	47.4	45.4	46.5	48.4
Real GDP (% yoy)	4.2	4.7	5.5	2.4	-5.8	-0.9	2.5
Industrial output (% yoy)	5.1	4.5	5.6	1.6	-9.2	0.6	4.2
Unemployment rate (avg, %)	18.0	17.0	15.1	13.4	14.9	17.5	16.5
Average gross industrial wages (LCY, % yoy)	5.8	7.3	6.0	8.8	1.5	0.2	2.4
Producer prices (avg, % yoy)	3.0	2.9	3.4	8.4	-0.4	3.9	3.1
Consumer prices (avg, % yoy)	3.3	3.2	2.9	6.1	2.4	3.0	3.3
Consumer prices (eop, % yoy)	3.6	2.0	5.8	2.9	1.9	3.9	3.2
General budget balance (% of GDP)	-3.5	-2.6	-2.0	-1.8	-4.3	-4.4	-3.6
Public debt (% of GDP)	45.7	43.3	41.7	42.1	50.4	50.7	50.3
Current account balance (% of GDP)	-5.5	-6.9	-7.6	-9.2	-5.2	-5.4	-4.8
Official FX reserves (EUR bn)	7.4	8.7	9.3	9.1	10.4	10.8	11.4
Gross foreign debt (% of GDP)	72.1	74.9	76.9	85.1	98.5	105.3	107.8
EUR/HRK (avg)	7.40	7.32	7.34	7.22	7.34	7.32	7.35
USD/HRK (avg)	5.97	5.81	5.35	4.91	5.27	5.67	6.13
EUR/USD (avg)	1.24	1.26	1.37	1.47	1.39	1.29	1.20

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Analysts

Raiffeisenbank Austria d.d., Zagreb

Anton Starcevic
anton.starcevic@rba.hr

Zrinka Zivkovic Matijevic
zrinka.zivkovic-matijevic@rba.hr

Ivana Juric
ivana.juric@rba.hr

Nada Harambasic
nada.harambasic@rba.hr

Ana Franin
ana.franin@rba.hr

RZB Vienna

Martin Stelzeneder, CEFA
martin.stelzeneder@raiffeisenresearch.at

Aaron Alber, CIIA
aaron.alber@raiffeisenresearch.at

Raiffeisen RESEARCH
RZB Group

Strategy Croatia
Content

Explanation:
e ... estimate
f ... forecast
p ... preliminary figures
Eurozone ... Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovenia, Spain
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)

CBRD – Croatian Bank for Reconstruction and Development
CBS – Croatian Bureau of Statistics
CDS – Credit-Default Swap
CES – Croatian Employment Service
CFSSA – Croatian Financial Services Supervisory Agency
CNB – Croatian National Bank
CODEF - Central Office for Development Strategy & Coordination of EU Funds
ECB – European Central Bank
EMU – Economic and Monetary Union
Fed – Federal Reserve System
FCY – foreign currency
IEA – International Energy Agency
IMF – International Monetary Fund
ILO – International Labour Organization
MoF – Ministry of Finance
OECD – Organization for Economic Cooperation and Development
OPEC – Organization of the Petroleum Exporting Countries
VAT – value added tax
ZSE – Zagreb Stock Exchange
WB – World Bank

Time for fiscal policy changes

After last year's GDP fall of 5.8%, negative trends in household consumption and employment continued in the first quarter of this year. Since the usual seasonal contribution of investments to the reduction in unemployment is not expected to take place given the declining demand for goods and services, the Government decided to introduce measures aimed at reviving the economy. Additionally, in April the Government announced an integral economic recovery programme split into short-term, mid-term and long-term measures. These measures call for a change in fiscal policy aimed at decreasing the government share in GDP by at least 3% up until 2020, increasing public sector efficiency and the competitiveness of the Croatian economy, reforming the legal system and attracting investment, and decreasing the unemployment rate. When selecting the most efficient measures it was able to draw upon the rich experience of European countries that implemented programmes aimed at supporting their economies during the last year.

From the Government's package of prompt measures, two CBRD auctions have already been carried out and the third is on the way, aimed at providing loans for the working capital of enterprises. Entrepreneurs and commercial banks have shown considerable interest in utilising loans at more competitive interest rates, as well as seeing the Government participate in credit risk. The implementation of the measures intended to support investments has initially fallen short of expectations. The effect of these measures and the recovery of Croatia's traditional tourist markets, paired with the growth of income from services provided to tourists, should lead to a reversal in the third quarter and consequently spur growth in domestic production.

Croatia's pending EU membership and the expected application to join the monetary union requires that the fiscal aggregates be maintained in line with the Maastricht criteria in the short term, until the expected GDP growth enables a more relaxed adjustment in the long run. As a result, fiscal policy will have to be directed at achieving an accelerated change in the structure and level of budget spending on the one side, and revenues on the other. The Government's programme contains lasting reform measures leading to politically unpopular changes in the structure of budget users and persons obliged to fund public finances. The pace of economic growth at the time of joining the European market will depend very much on the speed and success of structural changes paired with a stronger inflow of foreign capital.

Main political parties in Parliament

Ruling coalition	***Party leader***	***Orientation***
Croatian Democratic Union (HDZ)	Jadranka Kosor	Center-right
Croatian Peasant Party (HSS)	Josip Friščić	Center
Independent Democratic Serbian Party (SDSS)	Vojislav Stanimirović	Minority
Croatian Social Liberal Party (HSLS)	Darinko Kosor	Center-left
Croatian Party of Pensioners (HSU)	Silvano Hrelja	Center
Opposition Parties		
Socialdemocratic Party (SDP)	Zoran Milanović	Center-left
Croatian People's Party - Liberal Democrats (HNS)	Radimir Čačić	Center
Croatian Democratic Alliance of Slavonia and Baranja (HDSSB)	Vladimir Šišljagić	Right
Istrian Democratic Assembly (IDS)	Ivan Jakovčić	Center-left
Party of Democratic Action of Croatia (SDAH)	Šemso Tanković	Center
Croatian Party of Rights (HSP)	Danijel Srb	Right

Source: Political parties

Election schedule*

Parliamentary elections	November 2011
Presidental election	January 2015

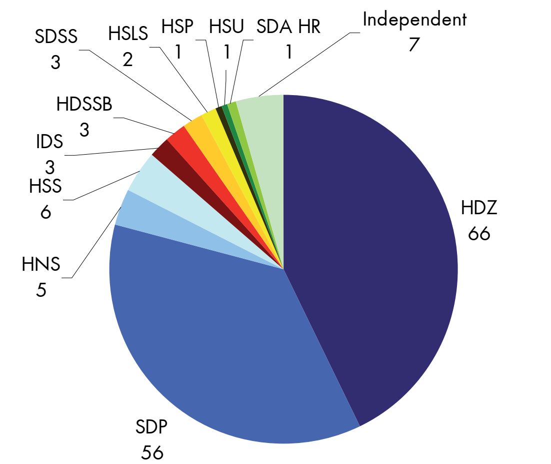
** President is elected for a term of five years, parliamentary members are elected for a four year term*
Source: Government

Ruling persons

Function	***Name***	***Party affiliation***
President of the Republic	Ivo Josipović	
Prime Minister	Jadranka Kosor	HDZ
Speaker of the Parliament	Luka Bebić	HDZ

Source: Government, Parliament, Office of the President

Seats in the Parliament



Source: Croatian Parliament

One step closer to EU

Key dates in Croatia's path towards the EU

June 2000	The Feira European Council states that all the SAP countries are "potential candidates" for EU membership.
November 2000	Zagreb Summit launches the Stabilisation and Association Process (SAP) for five countries of South Eastern Europe, including Croatia.
29 October 2001	Stabilisation and Association Agreement signed.
21 February 2003	Croatia applies for EU membership.
June 2003	Thessaloniki European Council confirms accession perspective of Western Balkans countries, including Croatia.
April 2004	European Commission issues positive opinion on Croatia's application for EU membership.
June 2004	European Council confirms Croatia as candidate country.
December 2004	European Council sets 17 March 2005 as start date for negotiations conditional upon full cooperation with the International Criminal Tribunal for the former Yugoslavia.
01 February 2005	Stabilisation and Association Agreement (SAA) enters into force.
16 March 2005	EU postpones start of accession negotiations but adopts framework for negotiations with Croatia.
26 April 2005	First meeting of Stabilisation and Association Council; meeting of extended "EU troika" on Croatia's cooperation with the ICTY.
03 October 2005	International Criminal Tribunal for the former Yugoslavia (ICTY) Chief Prosecutor assesses Croatia is now fully cooperating with ICTY. Council concludes last remaining condition for starting negotiations is met. Accession negotiations are launched the same day.
20 October 2005	"Screening" stage of accession negotiations begins.
12 June 2006	First chapter of the accession negotiations - science and research – formally opened and provisionally closed at an Accession Conference (ministerial level).
18 October 2006	Screening concluded; accession negotiations continue.
12 February 2008	The Council adopts the new Accession Partnership.
30 October 2008	7th meeting of the Accession Conference at Deputy Level sees number of negotiation chapters provisionally closed reach four. 21 chapters have been opened.
April 2010	30 chapters have been opened so far. 18 chapters are provisionally closed.

Source: European Commission

After the accession process of the domestic economy to the common European market slowed down last year due to political problems, which led to the blocking of several negotiating chapters, the first quarter of this year brought about a positive change. A more active role played by the Government in political negotiations with the EU Member States that stalled the negotiations under individual chapters resulted in them being reopened. At the end of February, seven years had passed from when Croatia submitted its official application for EU membership. With the exception of Turkey, the average duration of pre-accession negotiations is close to ten years, which illustrates the complexity of the very process of adjusting national legislation to the EU acquis communautaire.

As stated in the press release at the latest meeting of the Stabilisation and Association Council, negotiations with Croatia are going well and have moved closer towards their final phase. The Stabilisation and Association Council commended Croatia for efforts made during the past year and its overall progress, especially as regards fulfilling the set benchmarks. The good review by the Council was also facilitated by the establishment of the working group for the creation of the draft accession treaty with Croatia and the adoption of the financial package for the first two years of membership (under which an additional EUR 3.5 bn would be placed at Croatia's disposal). The Commissioner for Enlargement and European Neighbourhood Policy has stressed several times that the Croatian economy has made significant progress over the past few months and that there are no insurmountable problems. Croatia could join the EU without the accompanying monitoring mechanisms that were set up for Romania and Bulgaria. The European Commission sees progress in the reform of the judiciary and fighting corruption and organised crime. Currently, from 33 chapters, Croatia has opened 30, of which 18 have been temporarily closed and 3 remain to be opened (Competition policy, Judiciary and fundamental rights and Foreign, security and defence policy). An important step has been made towards opening Chapter 31 – Foreign, security and defence policy. The adoption of the arbitration agreement and its rapid ratification in the Parliament proved to be a positive political decision since Slovenia expressed its desire for the said Chapter to be opened.

After the Netherlands formally eliminated obstacles for the opening of Chapter 23 - Judiciary and fundamental rights, the Government adopted its negotiating position for the Intergovernmental Conference on the Accession of the Republic of Croatia to the European Union. This was a step forward in the formal opening of negotiations under the said Chapter. An Action Plan has been adopted for alignment with the organisation of the agricultural market in the EU, bringing Chapter 11 - Agriculture and rural development almost to a provisional close. Spain, which assumed the rotating presidency of the EU at the beginning of the year, stressed that the objective is to open the remaining chapters and close as many opened chapters as possible. By the end of June when the Spanish presidency of the EU is transferred to Belgium, it is expected that all remaining chapters will be opened and that the majority of opened chapters will be closed. This could result in the completion of pre-accession negotiations by the end of the current year, which means that negotiations have entered their final phase. However, changes and reform continue to be necessary and unavoidable throughout the convergence process. This applies in particular to the reform of public administration, the judiciary, combating corruption and organised crime, the protection of minorities, etc.

The completion of pre-accession negotiations and accession to the EU will have positive political, economic and social impacts, as was the case during previous enlargement processes and developments in the new EU Member States from the CEE. The perception of Croatia's risk will fall substantially and the cost of financing in international markets will drop too, increasing potential investor interest. Apart from certain rights, EU membership brings certain obligations not only as regards the adoption of European rules and standards, but more importantly, as regards their implementation. The necessary implementation of institutional and structural reform will help the economy spur growth and development based on the increase in competitiveness. In addition, the completion of negotiations and the accession to the EU is expected to bring a greater inflow of foreign capital (especially once the EU economy regains its strength). However, one should not harbour illusions that EU membership will bring only benefits. In the short term it will also bring costs. Nevertheless, benefits for the economy as a whole in the medium term will outweigh the drawbacks. Thus after the crisis of 2009 and 2010, the year 2011 is expected to be a year of recovery, while 2012 should be the year when Croatia joins the EU.

Chapters of the acquis communautaire

		Progress
1	Free Movement of Goods	provisionally closed
2	Freedom of Movement for Workers	provisionally closed
3	Right of Establishment and Freedom to provide Services	provisionally closed
4	Free Movement of Capital	opened
5	Public Procurement	opened
6	Company Law	provisionally closed
7	Intellectual Property Law	provisionally closed
8	Competition Policy	
9	Financial Services	provisionally closed
10	Information Society and Media	provisionally closed
11	Agriculture and Rural Development	opened
12	Food safety,Veterinary and Phytosanitary Policy	opened
13	Fisheries	opened
14	Transport Policy	opened
15	Energy	provisionally closed
16	Taxation	opened
17	Economic and Monetary Policy	provisionally closed
18	Statistics	provisionally closed
19	Social Policy and Employment	provisionally closed
20	Enterprise and Industrial Policy	provisionally closed
21	Trans-European Networks	provisionally closed
22	Regional Policy and Coordination of Structural Instruments	opened
23	Judiciary and Fundamental Rights	
24	Justice, Freedom and Security	opened
25	Science and Research	provisionally closed
26	Education and Culture	provisionally closed
27	Environment	opened
28	Consumer and Health Protection	provisionally closed
29	Customs Union	provisionally closed
30	External Relations	provisionally closed
31	Foreign, Security and Defence Policy	
32	Financial Control	opened
33	Financial and Budgetary Provisions	opened
34	Institutions	
35	Other Issues	

Source: MFAEI, Raiffeisen Consulting

IPA programme by component (EUR mn)

	2008	***2009***	***2010***	***2011***	***2012***
Assistance in transition and institution building	45.4	45.6	39.5	39.9	40.9
Cross border cooperation	14.7	15.9	16.2	16.5	16.9
Regional development	47.6	49.7	56.8	58.2	59.3
Human resources development	12.7	14.2	15.7	16.0	16.0
Rural development	25.6	25.8	26.0	26.5	27.3
Total	***146.0***	***151.2***	***154.2***	***157.1***	***160.4***

Source: CODEF

Croatia
A short overview

Structural information

Land area	56.594 square km
Population	4,437,460 (2001)
Capital city	Zagreb
Fiscal year	1 January - 31 December
Currency	Kuna (HRK)

Source: Croatian National Bank, CBS

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: CBS

Foreign currency rating

Agency	Long-term	Short-term
Standard & Poor's	BBB	A-3
Moody's	Baa3	not rated
Fitch IBCA	BBB-	F3

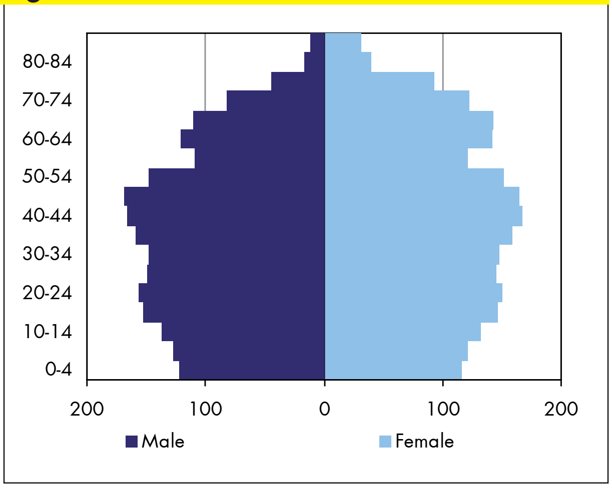
Source: CBS

GDP 2009

Nominal, at current prices (EUR mn)	45,382
Per capita (EUR)	10,299
Real growth rate (%)	-5.8

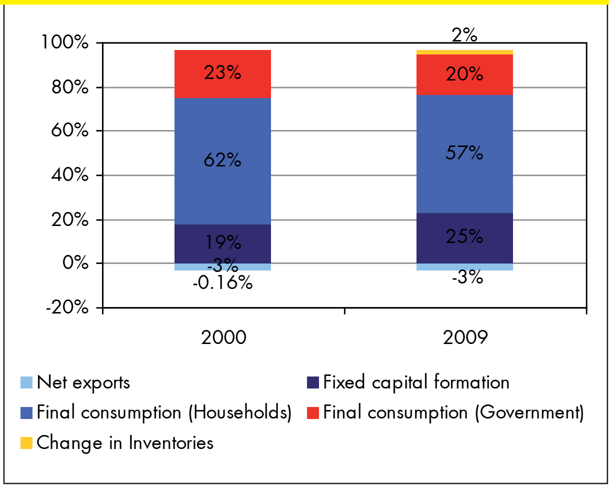
Source: CBS

Age distribution (2001)



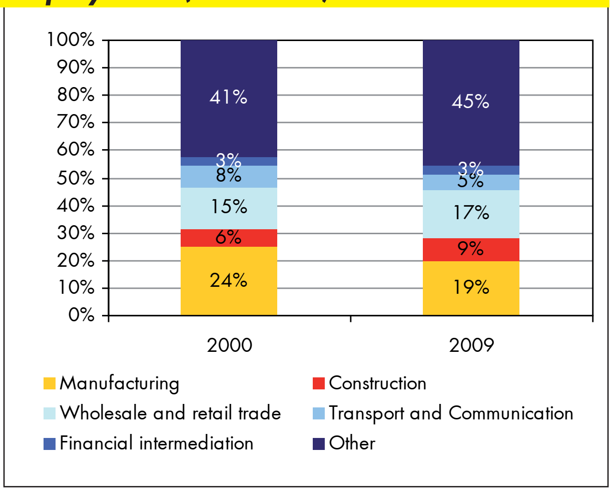
Source: CBS

Demand side of GDP (% share)



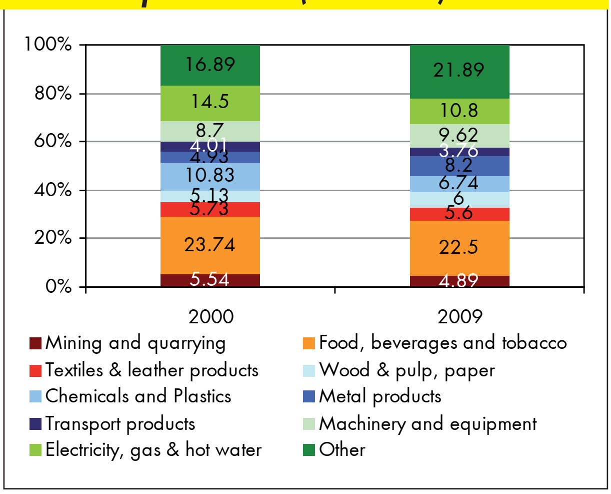
Source: CBS

Employment (% of total)



Source: CBS

Industrial production (% of total)



Source: CBS

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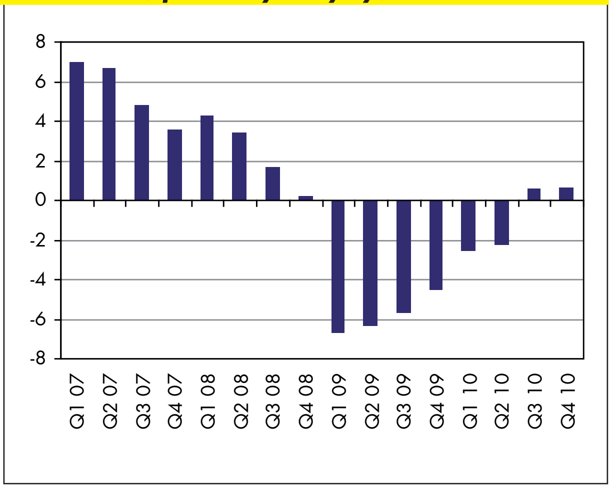
Recovery in 2010 unlikely

For many years economic prosperity was financed predominantly by foreign capital, a trend interrupted by a slump in 2009. The required reform failed to be implemented in all segments, so the slowdown in the decline in the last quarter was primarily the result of the base effect. In 2010 it is more likely that the economic contraction will continue. Led by growth in unemployment, personal consumption will continue to fall. Unfavourable trends in construction and industrial production, paired with the narrowed inflow of direct investment, will impact negatively on investments. Given the pressures regarding the decrease in government spending, we do not expect this will have a positive influence on GDP this year. On the other hand, GDP will be boosted by moderate growth in exports as a result of the recovery in foreign demand paired with a continued fall in imports. However, one big threat to this assumption stems from Croatia's heavy dependence on energy imports, so an increase in prices in this segment on foreign markets would negatively affect the domestic economy. Since the export sector is relatively poorly developed, reforms aimed at increasing the competitiveness of exports could contribute to higher and more sustainable economic growth in the long run that is less dependent on personal consumption. The first positive growth rates could be expected in the second half of the year as a result of economic policy stabilisation measures and the increase in foreign investments spurred by the optimism relating to the completion of Croatia's EU accession process.

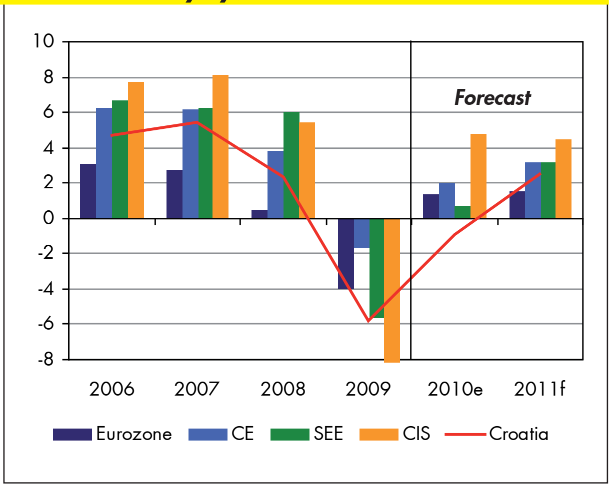
The decline in consumption in 2009 had the greatest impact on the weakening of inflationary pressures. In addition, low foreign demand reigned in inflationary pressures that are imported primarily through energy imports. Although the prices of gas went up in January, and the prices of oil products substantially increased, inflationary pressure at the beginning of the year remained weak (the average inflation rate in the first three months remained below 1%). The slowdown in inflation growth was primarily the consequence of low domestic demand, which will surely keep inflationary pressures restrained over the upcoming period. This year, the greatest upward pressure on prices will come from the possible increase in the price of oil and its spill-over into other components of the consumer price index. In addition, it is still uncertain whether electricity prices will be hiked for all consumers. As a result, compared to 2009 we expect inflationary pressures will build up in 2010, i.e. the average price of goods and services will go up by 3%.

Real GDP (quarterly, % yoy)



Source: CBS, Raiffeisen RESEARCH

Real GDP (% yoy)



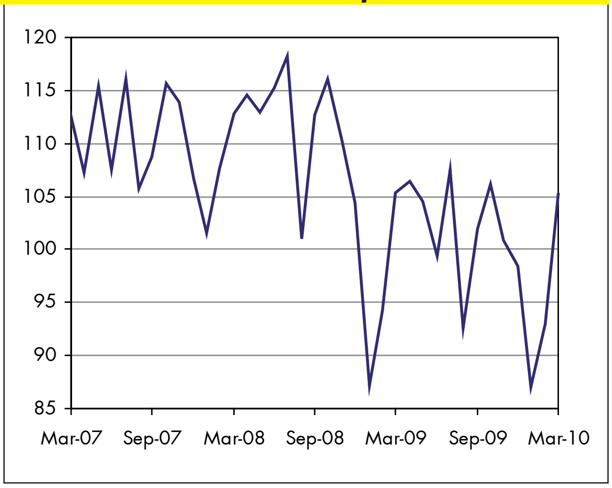
Sources: wiiw, Raiffeisen RESEARCH

Consumer prices (% yoy)

Source: CBS

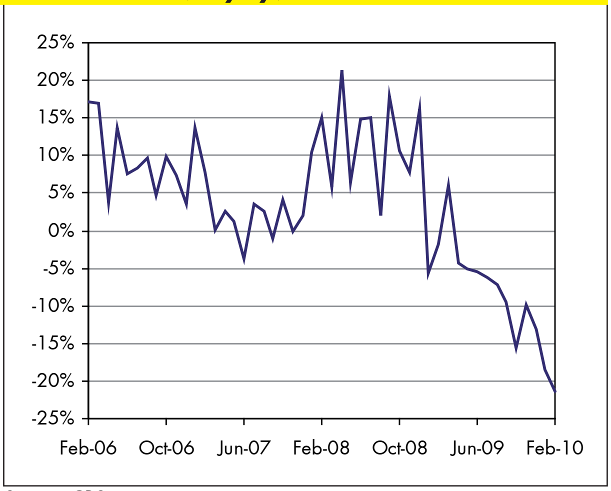
The long road
to industrial recovery

Basic indices of industrial production*



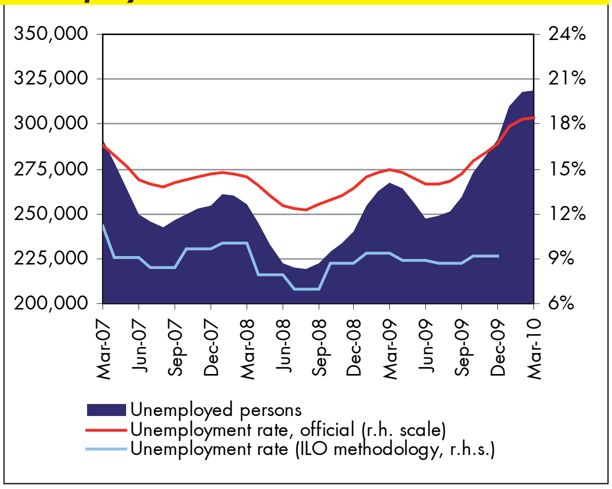
* 2005 = 100
Source: CBS

Construction (% yoy)



Source: CBS

Unemployment



Source: CBS, CES

Starting in 2010 the CBS changed its methodology of publishing the initial results of the industrial production volume index, thus adjusting the presentation and interpretation of the index in line with Eurostat standards. Accordingly, the industrial production index in the first quarter of this year went up. However, the original indices still reflect a decline in industrial production in annual terms, making it too early to draw the conclusion that industrial production has recovered. In addition, since the first quarter of last year saw relatively high annual declines, primarily due to the gas shortage, the slightly favourable movement in this year's first quarter is a consequence of the base effect. Over the coming months we expect mildly positive annual growth rates in industrial production. In the second half of the year, when domestic demand is expected to recover and the stronger influence of positive developments in foreign markets is expected to kick in, we are likely to see initial signs of a recovery in industrial production. Still, low competitiveness and the structural problems of Croatia's industrial production are two issues that demand attention. Their solution requires the implementation of difficult but necessary reforms.

As expected, negative trends in the labour market intensified at the beginning of the year. The number of those unemployed exceeded 300,000 in January, and approached 320,000 at the end of the quarter. While employers strived to cut operating costs and prevent bankruptcy in 2009 by refraining from employing new workers and by redistributing existing capacities, by the turn of the year this was no longer sufficient. As a result, the number of those out of work started to rise. The sectors that were hit the hardest were trade and construction, registering the largest number of lay-offs. The fact that the rise in unemployment is paired with a rise in the number of vacancies reflects the imbalance between supply and demand in the labour market. This is the result of inadequacies in the education system that has been failing to respond to the needs of the labour market for years. Reforms aimed at addressing this issue would surely contribute to enhancing the quality of labour force supply and the competitiveness of the Croatian economy. Since the labour market reacts to developments in the real sector with a lag of one to two quarters, this segment of the economy is unlikely to recover by the end of this year. As a result, the average unemployment rate could reach its highest level since 2005.

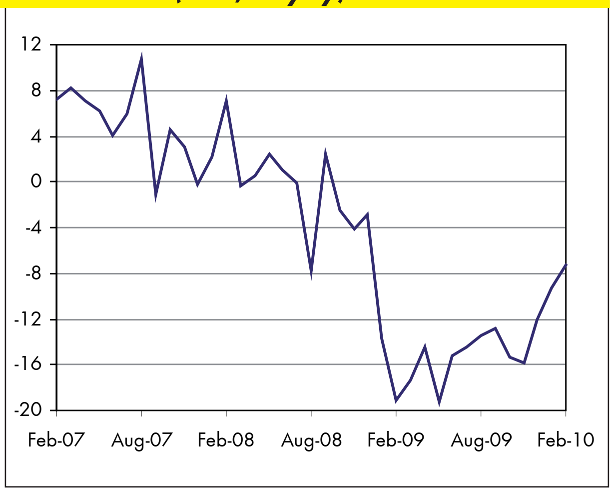
Traders hope for better days

Tourism seen as life-line

Due to the high elasticity towards recessionary developments, one of the hardest-hit sectors in 2009 was retail trade. In the first quarter of this year the adverse developments continued, but at a lower intensity thanks to the base period. The negative trends continue to be supported by negative developments in the labour market, the decline in disposable income and the high consumer pessimism. Considering that the recovery in the real sector and labour market is still not in sight, consumer pessimism, the decline in real income and rising unemployment are expected to weigh down on retail trade over the coming months. Therefore, we expect the remainder of the year to be characterised by rational spending, i.e. the postponement of durable goods purchases for "better times". The beginning of the recovery in retail trade may come in the second half of the year, assuming a good tourist season, the withdrawal of the crisis tax and more upbeat consumer sentiment. In 2010, retail trade growth is likely to be negative (some -2.8%), which will thus have a negative influence on GDP, i.e. the personal consumption component.

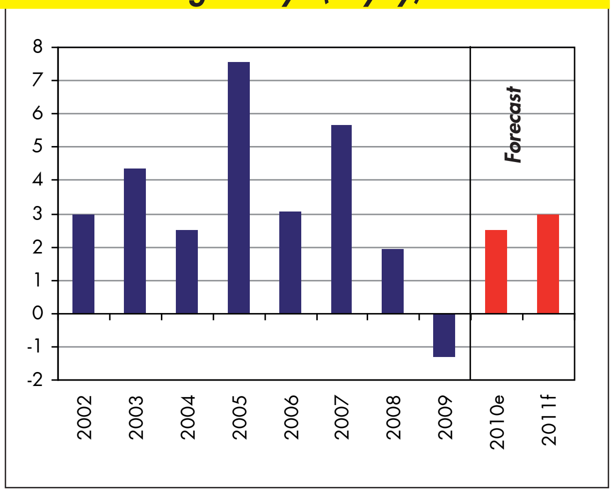
Although physical indicators in tourism (the number of tourist arrivals and overnight stays) were good in 2009, suggesting only a mild decline, revenues from tourism fell considerably (14.6% yoy). Much is expected of the upcoming tourist season, amongst other things it is hoped it will be the driving force behind the economic recovery. However, one should bear in mind that competition will be much stronger than last year. While other Mediterranean countries were relatively unprepared for the last tourist season, Croatia's comparative advantage was its geographic position and the fact that it can be reached by car, as well as the lower accommodation prices relative to the competition. However, this year the rival markets are better prepared and much more aggressive in attracting tourists. In the medium term the Croatian tourist sector needs structural changes aimed at increasing the supply of services it offers, extending the tourist season, better utilising its capacities and completing the privatisation process of the remaining state-owned tourism portfolio. In addition, in view of the competitive prices offered by destinations like Turkey and Tunisia, Croatia needs to set up a standard for the quality of its services, which would justify higher prices and increase income from tourism.

Retail trade (real, % yoy)



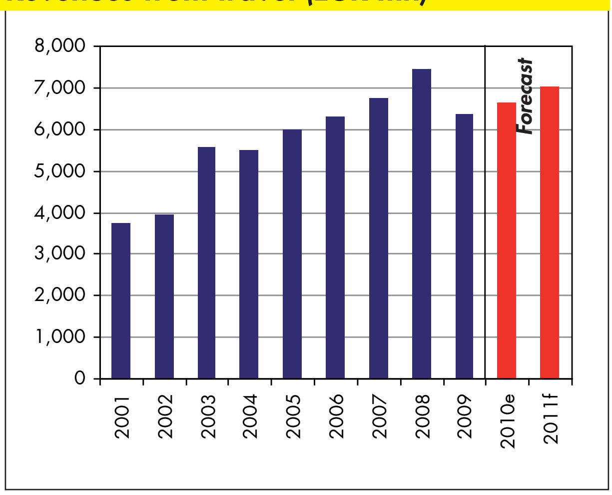
Source: CBS

Tourist overnight stays (% yoy)



Source: CBS

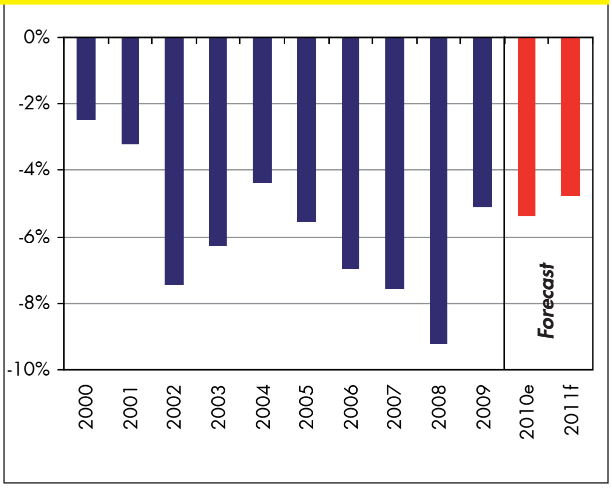
Revenues from travel (EUR mn)



Source: CNB, CNTB

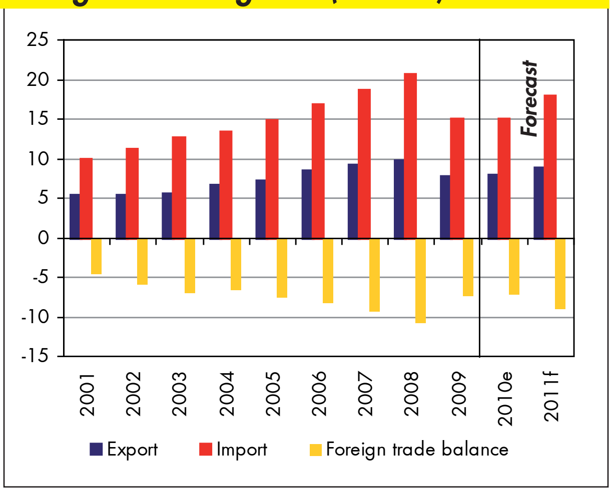
External debt
continues to grow

Current account balance (% of GDP)



Source: CNB

Foreign trade of goods (EUR bn)



Source: CNB

External debt and ratios

Quarters	External debt*	External debt as % of: GDP	Exports of goods & services	Internat. reserves**
Q4 06	29,274	74.9%	172.3%	29.8%
Q1 07	30,149	75.4%	176.1%	31.6%
Q2 07	31,058	75.9%	175.8%	29.5%
Q4 07	31,227	74.5%	172.1%	28.2%
Q4 07	32,929	76.9%	179.9%	28.3%
Q1 08	34,963	79.5%	188.2%	28.1%
Q2 08	35,403	78.3%	185.6%	28.1%
Q3 08	36,247	77.9%	182.8%	27.1%
Q4 08	40,316	85.1%	202.5%	22.6%
Q1 09	40,308	85.7%	206.4%	22.0%
Q2 09	41,823	90.0%	225.8%	21.7%
Q3 09	42,852	93.8%	255.8%	21.7%
Q4 09	44,591	98.5%	276.5%	23.3%

* EUR mn; ** % of external debt
Source: CNB

The deficit in the current account, which totalled EUR 2.4 bn, fell sharply by 46% yoy at the end of 2009. Hence the share of the current account deficit in GDP dropped to a five-year low (–5.2%) in 2009. The seemingly positive changes are solely due to cyclical movements in the economy, i.e. the strong fall in domestic consumption which reflected itself in a larger fall in goods imports than exports. On the other hand, the most important source of income, tourism, fell markedly. In the capital account, foreign direct investment, which represents the best way of financing the balance of payments deficit, declined significantly in 2009 as expected (55% yoy). The sum of EUR 1.9 bn will not be sufficient to finance the deficit so the Government will have to borrow. A larger inflow of FDI is expected when Croatia joins the EU. Since no recovery is likely in domestic demand over the months to come, we expect imports will decline; in addition to the recovery of exports, this will continue to exert a positive impact on the balance of payments. In addition, we expect tourism revenues will increase in 2010, returning to their 2007 levels.

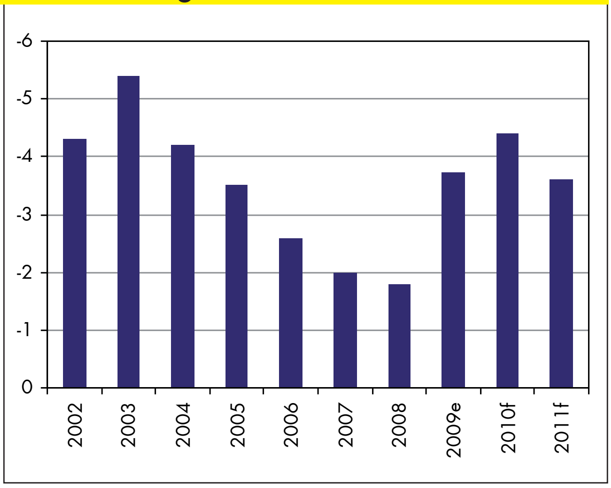
The annual growth in external debt continued in the last quarter of 2009, but at a slower pace than in the first three quarters of the year. Although, statistically speaking, all sectors but the central bank experienced a rise in debt levels in 2009, their shares in total debt are much different than in previous years. Government borrowing intensified, while the growth in the debt of banks and enterprises slowed down significantly. Considering that foreign trade narrowed substantially, even with the slowdown in external debt the share of external debt in the imports of goods and services deteriorated sharply (to 276.5% from 202.5% in 2008). The mild growth of external debt is expected to continue in the first half of 2010 given that foreign capital has become more available, and cheaper, than in previous periods, while the perception of Croatian risk has faded. The borrowing of quasi-sovereign enterprises will continue. The demand for external sources of financing is expected to be relatively subdued due to the limited operating possibilities of Croatian enterprises. Despite this, the economic contraction will increase the share of total debt in GDP, which is expected to exceed 105% in 2010.

Do we need more stable sources of income?

As expected, due the strong fall in economic activity led by the decrease in domestic demand, state budget revenue in 2009 was not only HRK 125 bn lower than expected but also fell 4.8% short of the previous year. The most generous source of budgetary revenue, the receipts from VAT and excise duties, dropped 10.3% and 7.4% respectively. Contributions, which make up over a third of the state budget and continue to be one of the heaviest burdens on the competitiveness of the economy, went down by 1.7%. In addition, negative trends in the labour market intensified in the last quarter with unfavourable developments continuing in the real sector, resulting in the decline of direct taxes (on incomes and profits). The mild growth in public spending coupled with its still unsustainable structure pushed the central government deficit over HRK 9.5 bn, a noticeable deterioration in the annual balance. Similar trends are continuing this year.

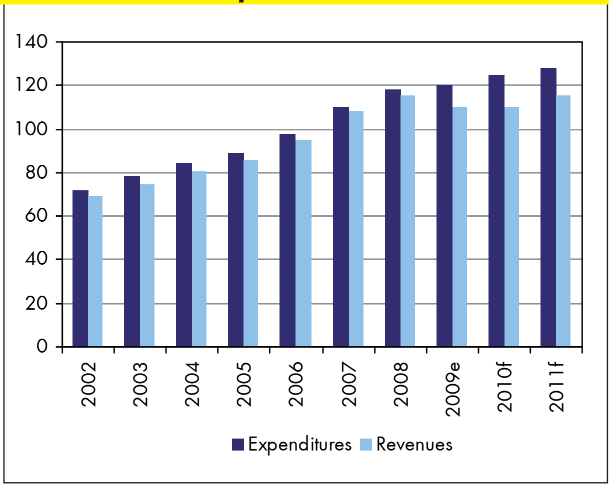
In 2010 we expect contributions will have the heaviest impact on the decline in revenue because coupled with the decline in total employment we will see a more intensive use of alternative channels of remuneration, reducing the budgetary revenue base. In addition, personal consumption will continue to be weak, implying a lower inflow of revenue from VAT and excise duties. Without the introduction of new taxes or an increase in the rates of existing taxes, and without the additional sale of state property we expect budgetary revenue will continue to decline over the coming year, but more slowly than during 2009. In addition to the necessary structural change in public spending the unsustainable nature of their financing models has become increasingly clear, since they predominantly rely on taxes which largely depend on personal consumption and the wage bill, while other bases for fiscal revenue remain underutilised. Given that the total fiscal and quasi-fiscal burden is high, there is a need to change the taxation structure without increasing the overall tax burden. The structural change in the taxation base would reduce the tax rates on income and capital invested by entrepreneurs when developing competitive products and services (reinvested gains), increasing the burden on passive capital set aside for the assets and capital engaged in speculation. Yet a reform aimed at addressing this issue cannot be carried out overnight, and certainly requires short-term spending. However, apart from resulting in more stable sources of financing it will represent the basis for sustainable economic development and higher growth rates.

General budget balance (% of GDP)



Source: MoF, Raiffeisen RESEARCH

Revenues and expenditures (HRK bn)*



** central government*
Source: MoF, Raiffeisen RESEARCH

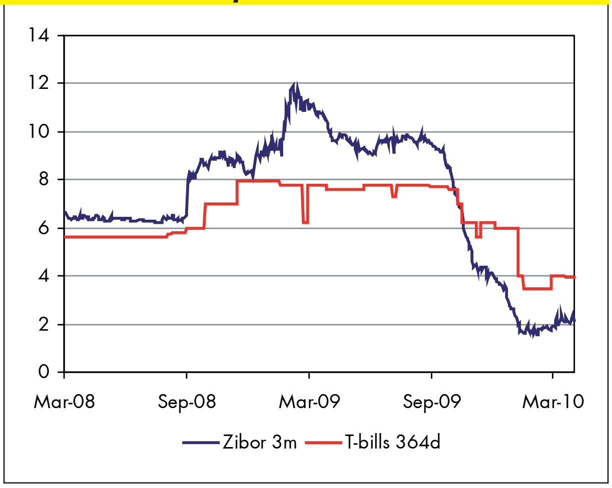
Public debt

HRK mn	General government debt	% in GDP without guarantees and CBRD	Guarantees	Total public debt*	% in GDP without guarantees and CBRD
2002	72,454	34.8	16,079	92,358	44.4
2003	81,222	35.8	15,419	101,566	44.7
2004	92,795	37.8	12,262	110,899	45.2
2005	101,185	38.3	12,455	120,780	45.7
2006	102,210	35.7	14,188	124,084	43.3
2007	104,069	33.1	17,399	131,130	41.7
2008	99,468	29.1	33,763	144,044	42.1
2009e	111,802	33.9	35,763	158,378	48.0
2010f	126,424	37.5	34,763	172,000	51.0
2011f	139,039	38.9	33,763	183,615	51.4

** including CBRD and guarantees*
Source: MoF, CBS, Raiffeisen RESEARCH

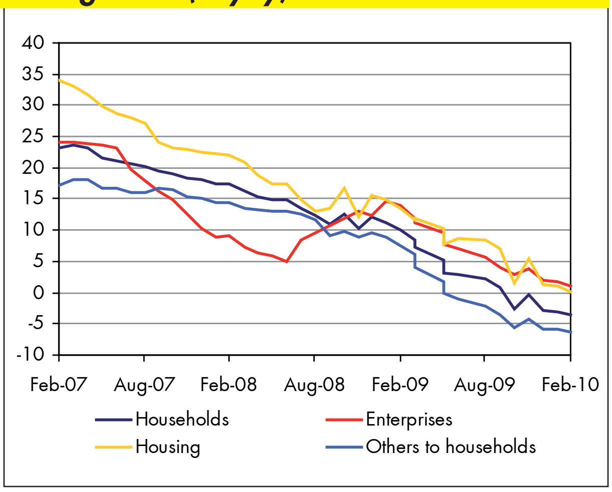
High liquidity and stable low interest rates

Interest rates (% p.a.)



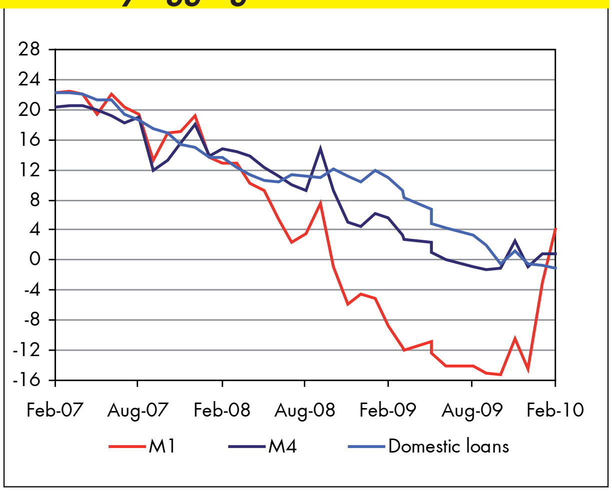
Sources: reuters.hr, CNB, MoF

Loan growth (% yoy)



Source: CNB

Monetary aggregates and domestic loans*



** % yoy*
Source: CNB

2010 has not brought any changes in the money market. The period of exceptionally high liquidity, low interest rates and modest trading volumes has continued. Under these conditions, the spilling over of kuna liquidity into the central bank's overnight deposits has become common practice, with the last repo auction being held in the middle of October 2009. Mostly loans with the shortest maturities were traded, while the usual interest rate developments before the beginning and the end of maintaining the reserve requirement failed to materialise. The central government's approach of borrowing through T-bill issues that met solid investor interest remained popular in the market, so interest rates went down despite the high government needs. The CNB did not apply any restrictive measures to reduce the downward pressure on the price of money because despite the ample money supply there were no increases in loans or inflationary pressures. Liquidity also improved as a result of the CNB decision to reduce the reserve requirement for banks from 14% to 13% in an attempt to spur economic recovery, thus releasing some HRK 2.9 bn of additional liquidity to banks. Despite the good liquidity in the money market, monetary aggregates, especially money, continued declining during the remainder of the year, reflecting unfavourable developments in the real sector. Total liquid assets have been relative stable thanks solely to the growth in foreign currency deposits (partially due to the greater conversion of kuna deposits into foreign currency deposits).

In light of the upbeat investor interest for T-bills we do not expect changes in relation to surplus liquidity by the end of the second quarter, while interest rates on the shortest maturities (mostly traded loans of up to six months) will remain at low levels. The downward trend in monetary aggregates was halted at the beginning of the year; however, we do not see any basis for a more significant recovery at the beginning of the year, though throughout 2010 we do expect to see single-digit growth rates. As regards deposits we reckon the stagnation will continue, spurred additionally by stabilisation and the mild reduction in bank interest rates on deposits. Credit activity will also narrow because of the public sector tendency to borrow abroad, which heaps additional pressure on the lower interest rates in the domestic market. Only at the end of Q3 2010 we expect demand for loans to increase and the excessive bank liquidity to fall as a result. Furthermore, this should initiate the start of growth rates on the money market.

No fear of kuna depreciating

The seasonal depreciation pressures on the domestic currency, usually at the beginning of the year due to the increased demand for foreign exchange needed to service maturing foreign liabilities, failed to materialise this year. The exchange rate remained relatively low, ranging between HRK 7.25 and 7.31 for one euro, supported by the decline in trade or rather the strong fall in goods imports paired with the inflow of foreign exchange from the borrowings of quasi-state enterprises, the continued practice of the central government to borrow based on FCY indexed T-bills and, finally, the positioning of market participants in anticipation of one bond maturing and new bonds being issued in the domestic capital market. Moreover, against the modest trading volumes the volatility of the kuna exchange rate against the euro (+/– 0.5%) in the foreign exchange market remained low, supporting our expectations that the EUR/HRK exchange rate will remain stable throughout 2010, ranging between 7.25 and 7.35 kuna per euro, fluctuating little. Given the reduced aversion towards Croatian risk we do not expect any problems with the refinancing of the country's external debt, which will alleviate the expected depreciation pressure in the second quarter. The continued decrease in demand and the weak lending activity of the banking sector are likely to contribute to relatively low trade deficits, primarily as a result of the decreased imports, which will help to lower the downward pressure on the kuna. We expect the EUR/HRK exchange rate will be exposed to mild depreciation pressures in the period up until the beginning of the tourist season. The high liquidity in the money market and the low interest rates that are expected until the second quarter will support the appreciation pressures on the domestic currency. More substantial depreciation pressures are not anticipated (at least not in the short-term) because there will be no sizeable recovery in imports given the persistently weak domestic demand, especially if pressures on the euro caused by the financial troubles in some parts of the Eurozone continue. Due to the slightly increased demand for the kuna, during the summer the exchange rate is expected to float around the levels observed in the first quarter of the year. However, seasonal pressures pushing for a stronger kuna are bound to be less pronounced than over previous years. Since the monetary policy is based on maintaining a stable exchange rate within a narrow band (managed free float), the CNB is likely to manage the exchange rate first and foremost by intervening in the foreign exchange market.

Middle exchange rate of the CNB

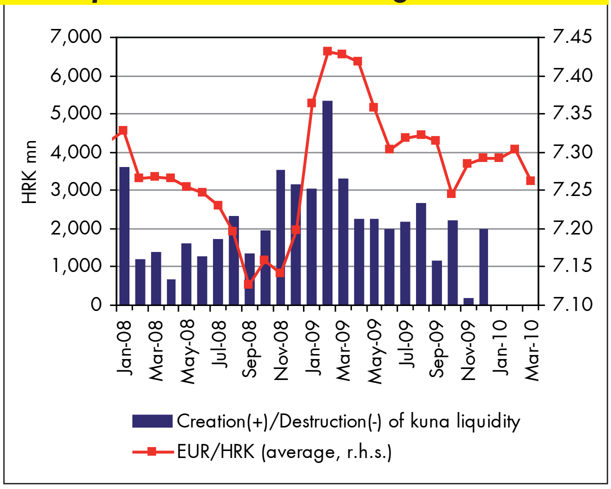
Source: CNB

Middle exchange rate of the CNB

Currency	Middle exchange rate 31 Mar-10	Change compared to: 31 Dec-09 Exch. rate	Movements	%
EUR	7.2593	7.3062	↓	-0.64
USD	5.3925	5.0893	↑	5.96
CHF	5.0718	4.9094	↑	3.31
GBP	8.1264	8.0740	↑	0.65

Source: CNB

CNB operations and exchange rate



Effect of FX interventions & reverse repo auctions of T-bills on money supply
Source: CNB

Exchange rate forecast

	2010e	2011f
EUR/HRK (avg)	7.32	7.35
EUR/HRK (eop)	7.32	7.40
USD/HRK (avg)	5.30	5.65
USD/HRK (eop)	5.42	5.69

Source: Reuters, Raiffeisen RESEARCH

Government supporting economic recovery

In the majority of European countries the first phase of the recession back at the beginning of last year was marked by state intervention measures aimed at helping domestic enterprises overcome the crisis period. The lack of similar measures in Croatia is one of the reasons why illiquidity in the corporate sector escalated, production plummeted and the domestic economy was slow in coming out of the crisis. Finally, at the beginning of 2010 the Government announced and initiated programmes aimed at reviving the economy. The first set of programmes announced in January consists of four measures aiming to increase corporate sector creditworthiness. Based on the assumption that the majority of private enterprises have worsened their debt ratios during the crisis, the conclusion is that despite the permanently high liquidity in the banking sector, banks are still not ready to increase corporate lending given the higher corporate credit risk than before the crisis. And without fresh capital, enterprises are not capable of increasing production or investing in competitive products or services. In the set of programmes the Government offers direct funding participation in working capital financing (Programme A), risk participation in investment financing with a partial Government guarantee (Programme B), participation in venture capital funds, and finally, the restructuring of the worst companies by means of a partial debt to equity swap, which means a temporary increase in the state's equity holdings in these companies (Programme C).

So far, two auctions have been held as part of the programme for lending working capital to enterprises (Programme A). With the help of this programme, enterprises have access to loans for working capital with three-year terms and fixed interest rates that are below the market rates, which encourages them to increase production and employment. The objective of Programme A is to lower the interest rate for the end user of the loan, which is achieved by state participation in the credit risk through CBRD. The CBRD participates in the overall amount of the loan to the tune of 40%, with an interest rate of 3.8%. The assets at the CBRD's disposal were raised by loans provided by commercial banks and were released by the CNB as part of the action to provide support to the economy when it lowered the bank reserve requirement from 14% to 13%. If the programme is successful, the CNB has expressed its readiness to continue the process of reducing the bank reserve requirement to 11% during the year. The remaining 60% of the loan amount from Programme A is financed by commercial banks which carry out risk assessments of individual clients, loan administration, assessments of collateral and collection procedures in accordance with the procedures agreed in advance with the CBRD. At the first two auctions where the CBRD offered quotas of HRK 200 mn, banks submitted applications that were selected according the criterion of the offered interest rate. 56% of overall bank offers were accepted, which was necessary to satisfy the bank participation of 60% in the total loans, while other offers were rejected. A total of 16 banks participated in the first auction, and as many as 10 banks were rejected because they offered uncompetitive interest rates. At the second auction, of the 16 offers received only 4 were rejected. The average interest rate for the end user achieved during the first tender was 5.05%, and during the second 4.70%. The third auction is planned at the end of April with a quota of HRK 250 mn split into two parts, with maturities of one year and three years.

In addition to loans for working capital the Government is offering Programme B, aimed at stimulating investments by covering a share of the bank credit risk. Banks bid for guarantee quotas at auctions, from which the Government issues guarantees, while the assets for financing the loans have to be provided by the banks themselves. In this process the Government will issue guarantees for loans with maturities ranging from three to five years and loans with maturities from five to ten years. The first auction under Programme B did not achieve any results like the auctions in Programme A. From the offered quota of HRK 200 mn only HRK 36.9 mn was accepted by two banks. Contrary to working capital financing where the clients' credit risk is a major obstacle for the recovery in lending, an improvement in the long-term market prospects is required for a recovery in investment financing. Partial measures are not enough to convince entrepreneurs about the sustainable recovery of the economy, hence the Government has to announce and implement an integral programme of structural reforms.

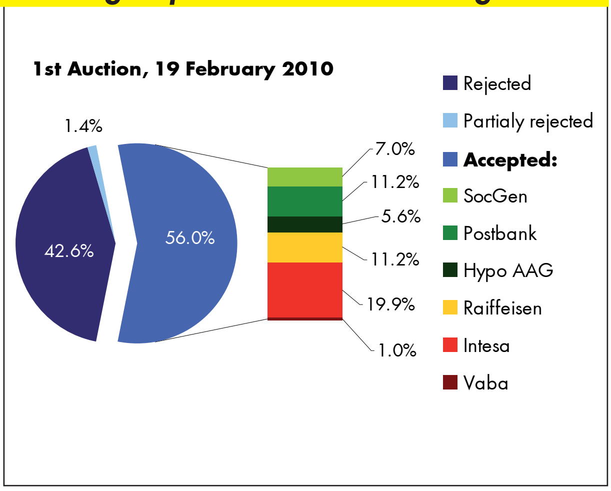
The third programme aimed at providing support to the economy is to establish venture capital funds, in which the Government is expected to have a 50% stake. This programme has not been realised yet, but the Government intends to participate in risk capital funds to the tune of HRK 1 bn over five years. In the meantime the Government has planned subsidies this year for young couples in purchasing their first properties, aimed at reviving the construction sector, which was affected most severely by the crisis at the beginning of 2010.

Another measure aimed at helping the economy has been submitted for parliamentary approval. According to the measure the Government intends to write off unpaid tax obligations for companies which realised losses before the crisis. Such long-term problematic companies include shipyards and railways for example. In compensation for writing off credits the Government will take on equity shares in the companies through recapitalisation. Due to the fact that the Government is already a major owner of the target companies and cumulated losses already exceed their nominal capital, it is obvious that the Government will not gain any benefits from the sale of future stakes equal to the written-off credits.

Finally, in the middle of April the Prime Minister announced an integral economic recovery programme. The main economic problems in that programme have correctly been identified, but the accuracy of the analysis and the economic strategy developed based on the analysis results are similar to the new programmes periodically accepted by every government during the last decade. The programme authors emphasised the fact that all measures in the programme have already been discussed in public during the crisis. But the problem is always in the political readiness to carry out unpopular measures as part of structural reforms. Every political position calculates the influence of necessary measures on the next elections and tries to avoid a decline in popularity. The case of the Hungarian government which implemented budget-saving measures during the crisis, and the election results in the first vote after the crisis, is a strong de-motivating factor for any reform. The questionable political willingness to carry out all of the measures prescribed in the programme limits a more sophisticated analysis of the Government programme. The majority of the proposed measures have to be approved by the Parliament, where the final solutions can differ significantly from the basic programme ideas. How fast this may be realised is mostly unknown, and also subject to amendments during the parliamentary approval process.

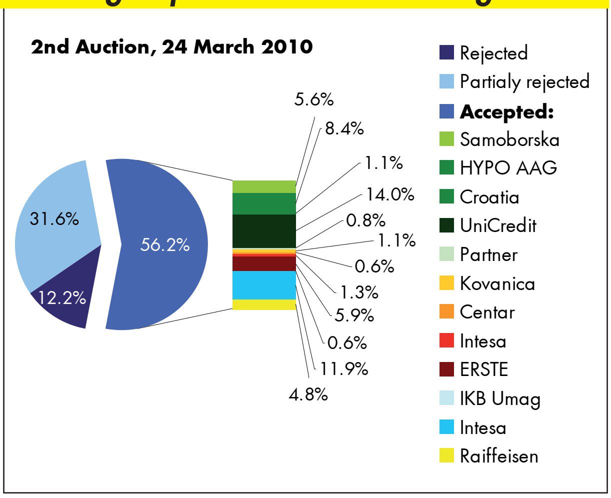
The first examination of the political readiness for the reforms is the acute illiquidity problem in the corporate sector. The one measure in the programme which has to be implemented from June at least is the one-off payment of all central and local budget obligations that are due, together with the due debts of all government-owned (controlled) companies, and keeping the maximum maturity below 60 days until the end of 2010. This shall be cut to 45 days in 2011. If the first cut in due debts is successfully achieved in the next two months we can be moderately optimistic regarding the realisation of the programme and the economic recovery in the second half of the year and onwards.

Working Capital Finance Loan Programme



Source: CBRD, Raiffeisen RESEARCH

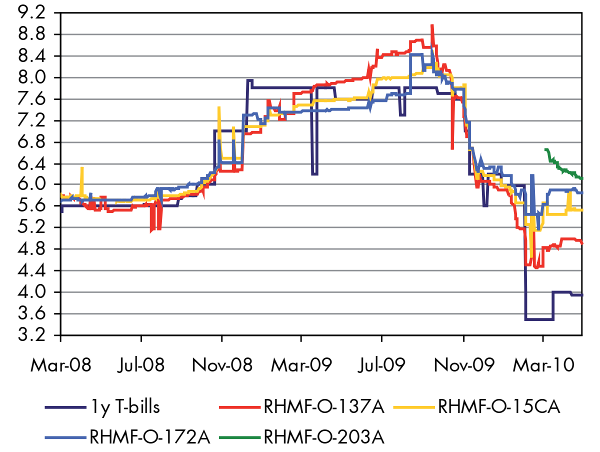
Working Capital Finance Loan Programme



Source: CBRD, Raiffeisen RESEARCH

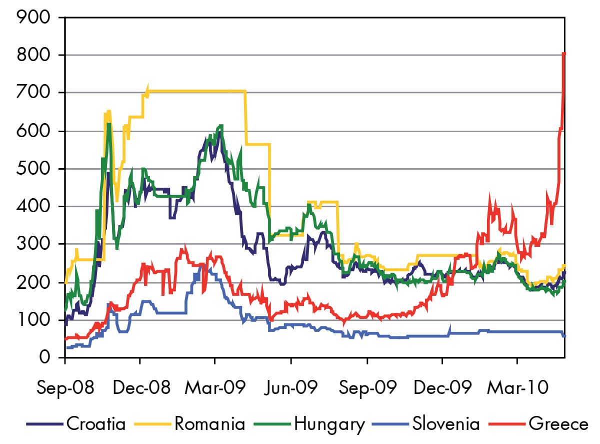
New issues
in the domestic market

Domestic currency yields (% p.a.)



Source: MoF, Thomson Reuters, Raiffeisen RESEARCH

CDS 5y spreads (bp)



Source: Bloomberg

Government bonds in domestic market

Bond	Currency	Maturity	Coupon (%)	YtM* (ask, %)	Spread to Bund*
RHMF-O-125A	EUR**	23 May-12	6.875	4.74	372
RHMF-O-142A	EUR**	10 Feb-14	5.500	5.28	364
RHMF-O-157A	EUR**	14 Jul-15	4.250	5.58	325
RHMF-O-19BA	EUR**	29 Nov-19	5.375	5.83	283
RHMF-O-203E	EUR**	05 Mar-20	6.500	5.86	280
RHMF-O-137A	HRK	11 Jul-13	4.500	5.15	-
RHMF-O-15CA	HRK	15 Dec-15	5.250	5.56	-
RHMF-O-172A	HRK	08 Feb-17	4.750	5.99	-
RHMF-O-203A	HRK	05 Mar-20	6.750	6.34	-

* 31 March 2010
** indexed to euro; secondary trading, interest and principal payment mid-rate of CNB on trading day or maturity day
Sources: MoF, ZSE, CDA, Thomson Reuters

The refinancing needs of the state have remained high over the past four months. Two bonds matured, one HRK bond and one Eurobond, totalling EUR 1 mn. To service its long and short-term liabilities that are falling due the Government once more decided to issue bonds in the domestic market. A kuna government bond, worth HRK 3.5 bn, was issued at 6.75% with a ten-year maturity, as well as a euro-indexed bond worth EUR 350 mn with a 6.5% coupon. High investor interest was seen in the primary market, and the listing on the ZSE intensified the government bond turnover, especially relating to new issues, where prices increased and the slope of the yield curve decreased. Positive market sentiment and reduced risk aversion towards CEE was reflected in the narrowing of the spreads relative to benchmark German bonds, the decline in yields and the appreciation of national currencies against the euro. CDSs followed the same pattern, getting close to their levels from the autumn of 2008. These developments triggered a decline in the yields on Croatian Eurobonds with a narrowing of spreads relative to German benchmark securities. However, the Greek troubles and insecurity regarding the spill-over of the crisis into other EU Member States increased risk perception, halting the trend of narrowing yield spreads relative to German bonds, whose yields usually increase strongly under such conditions due to their safe haven status.

The Government is not expected to press for a new issue in the first half of the year since the lion's share of the budgetary deficit has already been covered by the latest issues, while due liabilities related to borrowings from domestic banks, worth EUR 500 mn, have been reprogrammed for a period of three and four years with a variable interest rate, equalling the six-month EURIBOR plus 4.25%. However, given that the government announced in the economic recovery program that by June it would solve the problem of illiquidity caused by public sector payment arrears, we do not rule out the possibility of re-borrowing through the new loans or the issuance of new bonds. We expect the Government will cover the remaining short-term debt that is falling due by issuing new T-bills, whose yields are attractive to investors thanks both to the current and the expected high liquidity. Paired with the modest turnover in the domestic bond market, the slow downward trend in yields will continue as regards both the kuna issues and the foreign currency-indexed issues. Croatian bonds will be influenced by the core market, i.e. they will mimic the developments in the Eurozone.

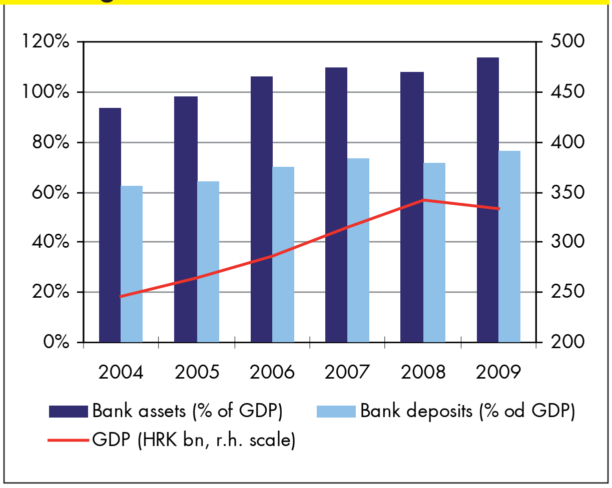
Local currency debt instruments

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) and Euro-linked issues settled in HRK	Croatian Kuna (HRK) and Euro-linked issues settled in HRK	Croatian Kuna (HRK) and Euro-linked issues settled in HRK	Croatian Kuna (HRK) and Euro-linked issues settled in HRK
Settlement currency	HRK; for Euro-linked in HRK according to CNB mid-rate for EUR/HRK valid on 2 days before maturity	HRK; for Euro-linked in HRK according to CNB mid-rate for EUR/HRK valid on maturity day	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	1,000,000 HRK (HRK issues) 1,000 EUR (Euro-linked issues)	1	1	1
Tenor(s)	3-12 months	3-10 years; Euro-linked 3-10 years. Eurobonds 2-5years	1-7 years; Euro-linked 3-7 years	5-7 years
Interest rate/coupon	zero coupon (discount)	HRK 4.500% - 6.750%; Euro-linked 4.25% - 6.875%,Euro-bonds 4.625%-6.75%	4.125% - 9.150%; Euro-linked 4.500% - 9.000%	4.125% - 6.500%
Coupon payment dates	none	semi-annual; 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 and amortising	bullet
Form of issue	dematerialised	dematerialised	dematerialised	dematerialised
Total outstanding at face	HRK 13.9 bn EUR 1.35 mn	HRK 18.5 bn and EUR 2.35 bn (domestic) EUR 2 bn USD 2.357 (Eurobonds)	HRK 4.35 bn and EUR 45 mn	HRK 70 mn and EUR 30
PRIMARY MARKET				
Auction style	American style	Fixed price	Fixed price	Fixed price
Agent	Ministry of Finance	Domestic banks market-making govi debt	Domestic banks	Domestic banks
Average issue size	HRK 200 - 400 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	via domestic banks	via Govi market-makers	via appointed primary placement bank	via appointed primary placement bank
Settlement	T+2	T+3	T+3	T+3
Reuters/Bloomberg screens	MINFIN / HRTS_HLSL	n.a. / <CROATE Govt>	n.a.	n.a.
SECONDARY MARKET				
Trading floor(s)	money market (TNZ)	ZSE	ZSE	ZSE
Liquidity	HRK 5 mn	HRK 30 mn and EUR 10 mn	HRK 5 mn and EUR 0.5 mn	n.a.
Settlement	T+0 *; T+2	T+3	T+3	T+3
Average trade size	1-2 mn	HRK 4 mn and EUR 1 mn	HRK 1 mn and EUR 0.1 mn	n.a.
Clearing mechanism	CDCC (Central Depository&Clearing Company)	CDCC	CDCC	CDCC
Custody	CDCC	CDCC	CDCC	CDCC
Trading hours	08:30 am - 04:30 pm	08:30 am - 04:30 pm	08:30 am - 04:30 pm	08:30 am - 04:30 pm
Reuters/Bloomberg screens	MINFIN / HRTS_HLSL	<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	no restrictions	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

ZSE - Zagreb Stock Exchange
** T+0 applies 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.*
Source: Ministry of Finance, Croatian National Bank, Central Depositary Agency, Raiffeisen RESEARCH

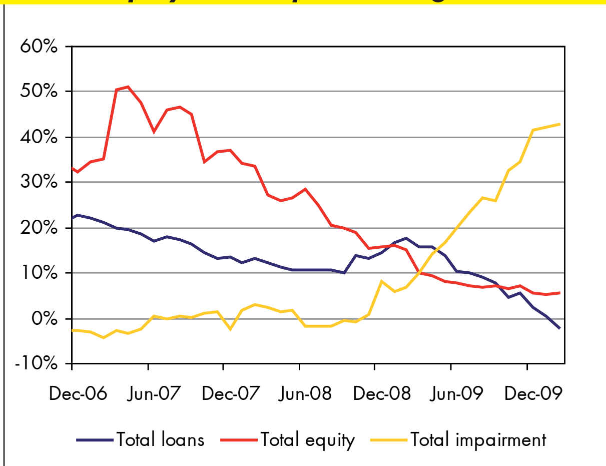
How to spur growth in demand for loans?

Banking indicators



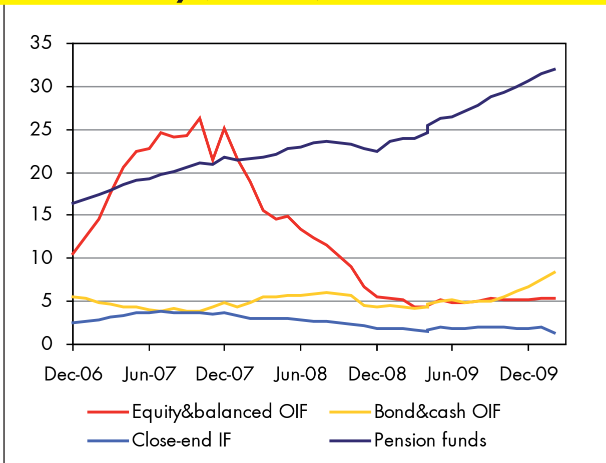
Source: CNB, CFSSA

Loans, equity and imparments growth*



* in % yoy
Source: CNB

Fund industry (HRK bn)



OIF ... open-end investment fund; IF ... investment fund
Source: CFSSA

High bank liquidity characterised the beginning of 2010. The surplus liquidity was the consequence of a prolonged decline in demand for loans coupled with a stronger inflow of capital from abroad on the supply side. The Government used the positive change in the sentiment of foreign investors towards the risk of European transition countries to make an attempt to finance the current budget deficit and public sector investment activity outside the domestic financial system. Household demand for loans is lower than the monthly level of loan repayments, which frees up a share of bank placements. Corporate demand for loans has been hit by the consequences of the last year's recession and illiquidity within the sector on the assessment of corporate creditworthiness. The value of collateral that borrowers can offer banks has also fallen, due both to past declines and further expected falls in the price of real estate, investment goods and inventories. As a result, banks and other credit institutions are faced with the problem of placing surplus liquidity under conditions of growing credit risk.

In order for bank credit activity to increase, client demand for loans must rise coupled with a simultaneous lowering of bank risk assessment criteria in relation to new placements. The risk exposure of the existing credit portfolio does not advocate a lowering of the credit risk criteria. The year-on-year growth levels of the value adjustments of bank placements have exceeded 40% ever since December last year, and while the lowering of interest rates leads us to expect an increase in demand for loans on the local market, it is likely that there will be a change in bank risk assessment criteria under the conditions of the ongoing recession.

In terms of investment funds, investors are still showing a stronger interest in lower risk assets with a lower expected return. This has induced growth in the assets of money and bond funds, while the assets of equity funds have stagnated. The asset structure of pension funds also reflects a similar attitude to risk. Maintaining the investment portfolio in liquid funds indicates that the pressure to lower interest rates in the domestic money market is likely to continue, which will gradually lead to a decline in interest rates on bank loans. The pressure to lower loan rates makes the measures targeting an end to the recession and the revival of economic growth more likely to succeed.

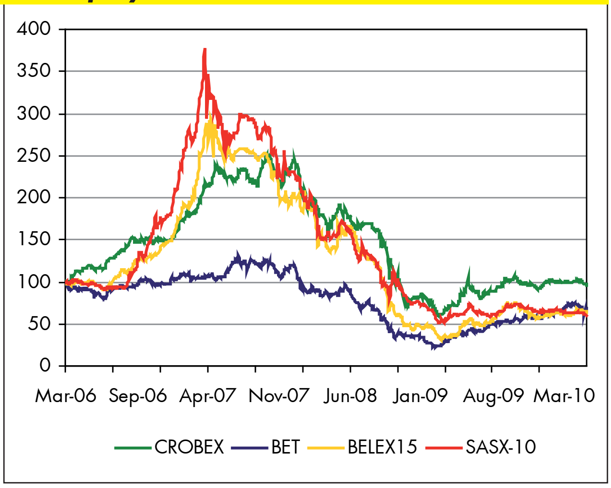
Croatian equity market
hostage to global sentiment

The bourses of Eastern and South Eastern Europe have put in massive performances in recent quarters. The brighter sentiment around the world in the wake of the global economic recovery played an instrumental role here, and this was accompanied by falling risk aversion in favour of equities. The prospect of interest rates remaining low in the economies of the established financial markets has only bolstered this trend, not to mention the very encouraging corporate results posted on the whole in recent quarters, which have stoked the optimism on the stock exchanges.

However, this satisfying development is being disturbed by some countries in Southern Europe, especially Greece, where the failure in recent decades to create a sustainable and forward-facing budget policy is now hitting back with a vengeance. The waning confidence in the stability of the Eurozone has manifested itself in a general sale of equities before the European Union announced the EUR 750 bn bailout. Depending on political developments at European level and the further decisions made by the ECB, we are inclined to overweight equities. This is because economic developments remain positive and from a monetary policy perspective there is nothing on the horizon suggesting liquidity will be siphoned off the market in 2010.

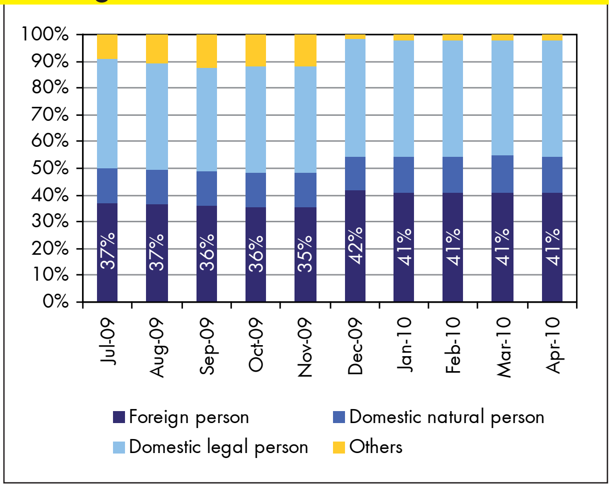
The Zagreb stock exchange was unable to escape the recent global turmoil and recently recorded some sharp falls as well. Nonetheless, there have been and continue to be some encouraging signals which suggest that once the markets calm down, the leading index, the CROBEX10, will find its way back onto its growth trajectories of old, marked by disproportionately high price gains. Such signals include the share of equities held by foreign investors, which has risen over the last months from 35% to 41%. This can be attributed first and foremost to the resumption of accession negotiations with the European Union. We expect Croatia will join in 2012 and view the opportunities derived from the convergence process as favourable for the Zagreb stock exchange. The completion of pre-accession negotiations and entry into the EU will have positive political, economic and social impacts, as was the case during previous enlargement rounds and developments in the new EU Member States from CEE. The livelier trading activity is also reflected in the higher sales figures, which experienced tangible growth in April. Even though this still falls way short of the old highs, we should add that the rather small and narrow financial markets of South Eastern Europe are not the primary target of

SEE equity market indices



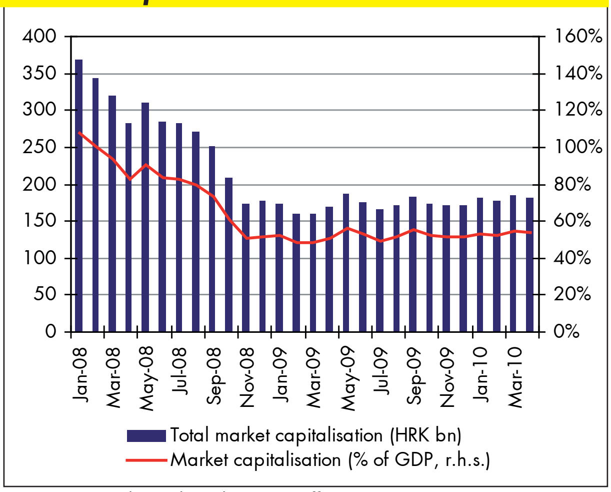
Source: Bloomberg, Raiffeisen RESEARCH

Holdings in stocks



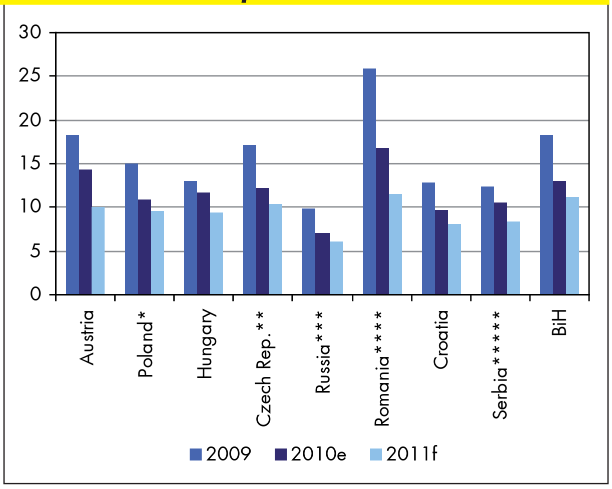
Source: CDCC (www.skdd.hr), Raiffeisen RESEARCH

Market capitalisation ZSE

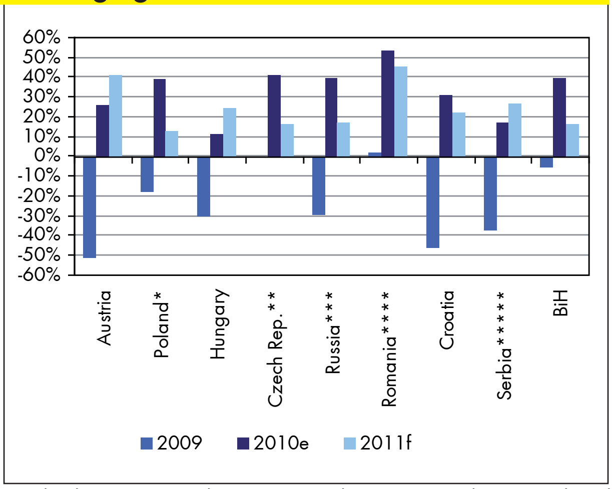


Sources: Zagreb Stock Exchange, Raiffeisen RESEARCH

P/E ratios in comparison



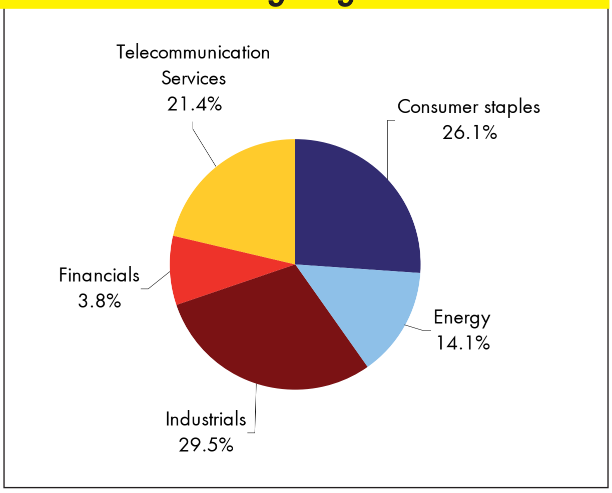
Earnings growth



** Poland (WIG 20): excl. CEZ; ** Czech Rep. (PX): excl. Erste Bank and Vienna Insurance Group; *** Russia (MICEX): excl. Fed Grid, Sberbank Pref., Surgutneftegaz Pref. and VTB Bank; **** Romania (BET): excl. SSIF Broker; ***** Serbia (BELEX15): excl. Alfa Plam, Metals Banka and Veterinarski*

Source: Thomson Datastream, IBES, Raiffeisen RESEARCH

CROBEX sector weightings



Source: Bloomberg, Raiffeisen RESEARCH

large international investors after the end of a downturn; it will take some time experiencing the globally driven upswing before investors rediscover the full potential of these markets. Croatia continues to benefit from its still moderate valuation, which implies a significant discount in comparison to many of its Eastern European counterparts. On the strength of a P/E ratio of 9.8 calculated based on estimated corporate earnings for 2010 (aggregated on an index basis) stocks in the CROBEX10 still appear attractive. Next year we expect a powerful increase in earnings too (+22.4%), which suggests a P/E ratio for 2011 of 8.0. The economic stimulus programme of the government, which comprises extensive infrastructure investments, will also exert a favourable impact on the micro-economy of the country. Moreover, the four-percent crisis tax on higher incomes will be abolished again from 1 November. Additionally, shares of state-run companies are to be brought into the Croatian Privatisation Fund with a view to selling them at a later date. Taking a look at future developments and based on the factors outlined above we are optimistic about the Croatian equity market for the year. Investors in for the long haul have the opportunity to use possible corrections triggered by the debt crisis to position themselves in a market that still remains volatile but is also very promising. In addition to domestic and international investment funds as well as local pension funds, the driving forces in this context increasingly include private investors.

IPOs

In the wake of an improvement in the capital market, some companies should venture on to the stock exchange from next year too, thus creating additional investment opportunities. Apart from the ongoing privatisation of six shipyards (Uljanik, 3. maj, Brodotrogir, Brodogradilište Kraljevica, Brodosplit i Brodosplit – Brodogradilišta), the government is expected to draw up a privatisation plan whereby one company could even be privatised through an IPO in H2 2010, according to government advisers. It is not yet decided which company that might be, but media speculations suggest it could be Hrvatske Autoceste or Hrvatska Poštanska Banka. On the other hand, one very probable scenario for this year is that the state will sell minority holdings and stakes in 441 companies as the privatisation fund is now authorised to manage the portfolio and speed up the sale process. This could elevate trading volumes and increase activity on the market since a number of the companies included are listed on the Zagreb Stock Exchange.

Croatian equities
a brief overview

Viro

Viro is the leading sugar producer in Croatia holding a share of 66% in the domestic market, and is one of the major Croatian exporters. The product portfolio includes white sugar, molasses, pasteurised liquid sugar and dry briquette sugar beet pulp. The Q1 2010 top line benefited from the higher prices yoy realised on the domestic market, whereas profitability went up on the back of the postponement of the cane sugar campaign to Q2 2010. Recently, the company acquired a 59.06% stake in Sladorana, the second-largest Croatian sugar producer, which should enhance the company's efficiency and profitability and ensure a better position vis-à-vis foreign competitors.

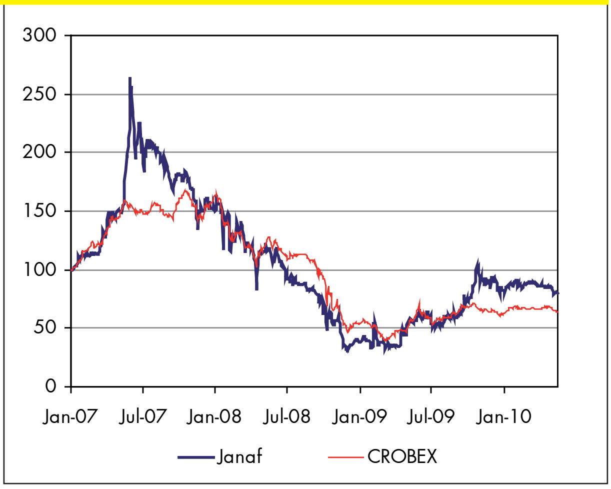
Viro

Source: Bloomberg

Janaf

Janaf manages an oil pipeline system for both local and foreign refineries. Other major activities include the reloading and storage of crude oil and oil products. In Q1 2010 Janaf's top line dropped 16.52% yoy due to the lower oil transportation volume and USD depreciation, which reduced oil transportation revenues by 34.9% yoy. On the other hand, oil storage revenues displayed an increase of 24.8% yoy following a rise in leased storage capacities. Derivatives' storage revenues went up 29.1% yoy due to the acquisition of new customers. We expect Janaf's FY 10 top line to be boosted by a stronger HRK/USD exchange rate yoy. Planned investments in FY 10 amount to almost HRK 400 mn and are to be financed solely from own funds.

Janaf

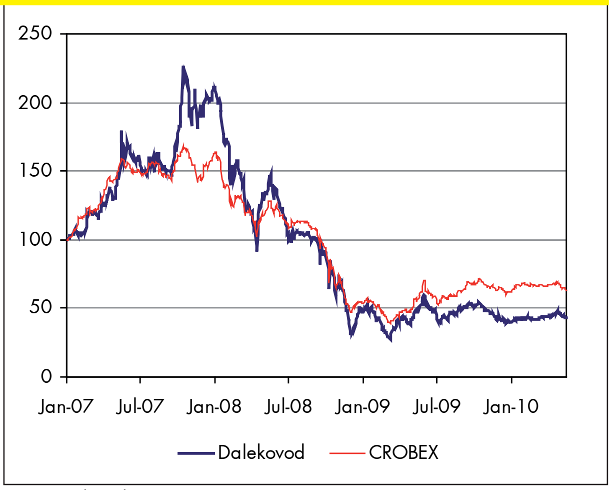


Source: Bloomberg

Dalekovod

Dalekovod provides services related to the design, manufacturing and construction of power facilities (especially transmission lines), transformer stations, networks, road and tunnel lighting, the electrification of railway lines, etc. Posted Q1 2010 figures showed a sharp drop in sales (-52% yoy), an improvement in EBIT, but a lower bottom line due to decreased financial revenues yoy. Operating profit increased thanks to the higher gross margin, the better change in inventories, as well as the savings achieved on other operating expenses. The company announced several new contracts in Western Europe worth more than EUR 100 mn in total, for delivery in 2010 and 2011. Furthermore, Dalekovod started a wind power plant construction in Croatia as both the developer and the contractor, worth EUR 16.24 mn.

Dalekovod



Source: Bloomberg

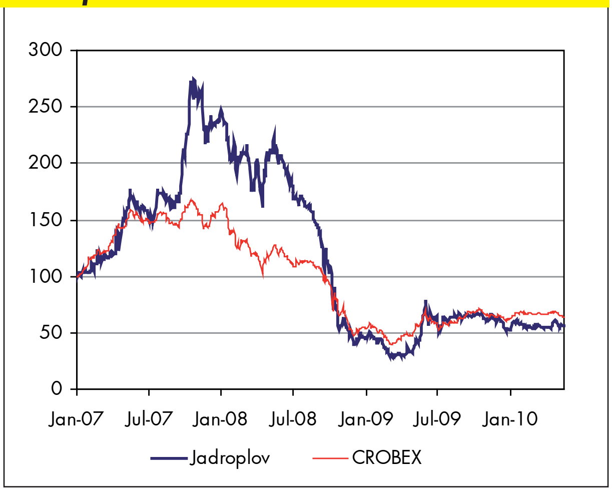
Atlantska plovidba

Source: Bloomberg

Atlantska plovidba

This company is mainly engaged in the shipping business, but also owns two hotels and an airline company with 5 jets. The shipping fleet consists of 19 ships, 7.5 years old on average, and totals 812.808 DWT. The ships mainly transport dry bulk (13 ships). One of the seven newly-ordered ships is to be delivered in 2011, followed by another six during 2012. The company reported that FY 2009 sales were down by 50% yoy and recorded a net loss of HRK -42 mn after a challenging year for the sector. However, Q1 2010 figures indicate a slight recovery and the net loss was halved to HRK -19.3 mn yoy.

Jadroplov

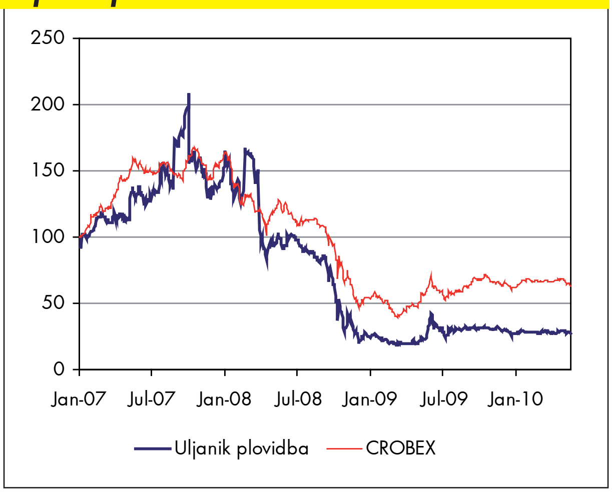


Source: Bloomberg

Jadroplov

This company operates five ships in the field of dry bulk transportation. By the year-end it is expected that the fleet could even swell to seven ships with a total tonnage of 300.000 DWT. Shares are fairly liquid but state institutions hold over 70%. The Q1 2010 figures show 31% lower sales yoy and a net loss of HRK -10 mn, supported by unfavourable USD trends. The recovery was not recorded immediately in the quarter due to time-charter contracting, however, the company has low leverage and net debt stands at HRK 25 mn.

Uljanik plovidba



Source: Bloomberg

Uljanik plovidba

The company currently owns seven ships: three involved in dry bulk and four in oil products transportation. Total carrying capacity is around 362.000 DWT and the fleet is less than four years old on average. Four new ships ordered are expected to join the fleet by 2012. The company has posted relatively stable results during the past few years as it mainly operates on a time-charter basis. However, sales in Q1 2010 were down by 7% yoy due to the weak USD, but the bottom line remains positive at HRK 6.4 mn.

RZB Group Research Team

Vienna
Peter Brezinschek (Head)
Aaron Alber
Jörg Angele
Walter Demel
Wolfgang Ernst
Christian Hinterwallner
Valentin Hofstätter
Klemens Hrovath
Ingo Jungwirth
Christoph Klaper
Marcin Kopaczynski
Lydia Kranner
Nina Kukic
Martin Kutny
Veronika Lammer
Jörn Lange
Christian Link
Hannes Loacker
Richard Malzer
Johannes Mattner
Julia Neudorfer
Christine Nowak
Doris Oswald
Helge Rechberger
Andreas Reschreiter
Leopold Salcher
Andreas Schiller
Robert Schittler
Manuel Schreiber
Andreas Schwabe
Connie Schümann
Gintaras Shlizhyus
Gleb Shpilevoy
Birgit Sigl
Alexander Sklemin
Gottfried Steindl
Martin Stelzeneder
Beatrix Thaler
Jürgen Walter
Magdalena Wasowicz
Josef Wolfesberger

Albania
Joan Canaj

Belarus
Oleg Leontev
Vasily Pirogovsky
Natalya Chernogorova

Bosnia & Herzegovina
Zeljko Pehar
Ivona Kristic
Maida Gopo

Bulgaria
Dimitar Chobanow

Croatia
Anton Starcevic
Zrinka Zivkovic Matijevic
Ivana Juric
Nada Harambasic
Ana Franin

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

Hungary
Zoltán Török
Mátyás Kovács
Ádám Keszeg
Ákos Herczenik
Levente Blahó

Poland
Jacek Wisniewski
Marta Petka-Zagajewska
Dorota Strauch
Wojciech Bogacki

Romania
Ionut Dumitru
Nicolae Covrig
Romulus Mircea
Ion Gheorghe Guta
Bogdan Campianu
Oleg Galbur
Ionut Gutis
Alexandru Combei
Iuliana Mocanu
Genghiz Curtali

Russia
Anton Pletenev
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Serbia
Aleksandra Vukosavljevic
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Slovakia
Robert Prega
Juraj Valachy
Boris Fojtik

Slovenia
Primoz Kovacic

Ukraine
Dmytro Sologub
Ludmila Zagoruyko

Company Research
Birgit Kuras (Head)

Stefan Maxian (Head Austria & CEE)
Philipp Chladek
Daniel Damaska
Natalia Frey
Bartlomiej Kubicki
Klaus Küng
Bernd Maurer
Dominik Niszcz
Klaus Ofner
Teresa Schinwald
Jovan Sikimic
Arno Supper
Iryna Trygub-Kainz

Cut-off for data: 19 May 2009
This report was completed on 20 May 2009

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

Published by: Raiffeisen RESEARCH GmbH, 1030 Vienna, Am Stadtpark 9.
Published and manufacured in Vienna
Printed by: Rabl-Druck, 3943 Schrems, Karl Müller-Straße 5

Design: Kathrin Korinek, Marion Stadler

Abbreviations

Currencies and Countries

ALL	Albanian lek
BAM	Bosnian marka
BGN	Bulgarian lev
BYR	Belarusian roubel
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
FDI	Foreign Direct Investments
FX	Foreign Exchange
GDP	Gross Domestic Product
LCY	Local Currency
mmav	month moving average
mom	month on month
pp	percentage points
PPI	Producer Price Index
qoq	quarter on quarter
T/B	Trade Balance
ULC	Unit Labour Costs
yoy	year on year

Stock Exchange Indices

BELEX15	Serbian stock index
BET	Romanian stock index
BUX	Hungarian stock index
CROBEX10	Croatian stock index
PX	Czech stock index
RTSI	Russian stock index
SASX-10	Bosnian 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
RS	Recommendation suspended
UR	Under Revision

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)

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RZB Group

Raiffeisen Zentralbank Österreich AG (RZB Austria)

Investmentbanking units

Raiffeisen Zentralbank Österreich AG, Vienna
Global Markets
Head of Sales: Stefan Weiser Tel: +43 1 71707 3974
Head of International Sales: Luca Scalzini Tel: +43 1 71707 3981
Head FI Sales (AUT/GE/LIE): Hans Rettl Tel: +43 1 71707 3300
Head of MM & FX Sales: Richard Quinn Tel: +43 1 71707 3904
Corporate Sales: Wolfgang Kalinka Tel: +43 1 71707 3959

Belgrade: Raiffeisenbank a.d. Serbia
Contact: Zoran Petrovic Tel: +381 11 2207006

Bratislava: Tatra banka, a.s.
Contact: Miloslav Paracka Tel: +421 2 5919 1386

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: Andrey Filazafovich Tel: +375 17 289 9 213

Moscow: ZAO Raiffeisenbank Austria
Contact: Sergei Monin Tel: +7 495 721 9922

Tirana: Raiffeisen Bank Sh.a.
Contact: Christian Canacaris Tel: +355 4 253 646

Prague: Raiffeisenbank a.s.
Contact: Pavel Mertlik Tel: +420 234 401 800

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

Institutional Equity Sales, 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
Financial Institutions: Axel Summer Tel: +43 1 71707 1476

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 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: Stefan Mandl Tel: +65 6305 6100

International desk

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

Belgrade: Raiffeisen banka a.d.
Contact: Sofija Davidovic Tel: +381 11 220 7807

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

Bucharest: Raiffeisen Bank S.A.
Contact: Reinhard Zeitlberger Tel: +40 21 306 1564

Budapest: Raiffeisen Bank Zrt.
Contact: Petra Reök 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: Valbona Recica Tel: +381 38 22 22 22 116

Sofia: Raiffeisenbank (Bulgaria) EAD
Contact: Karin 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: Tomasz Kwiecien Tel: +48 22 421 2375

Zagreb: Raiffeisenbank Austria d.d.
Contact: Wolfgang Wöhry Tel: +385 1 4566 462