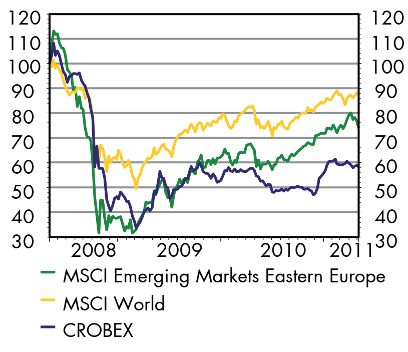
Strategy Croatia

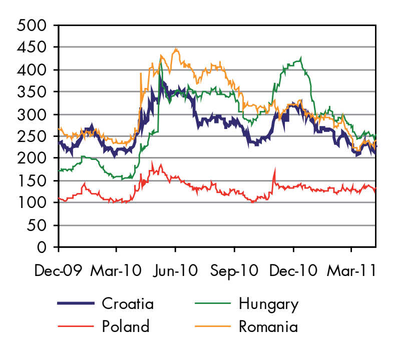
May 2011

Index performance



Source: Thomson Reuters

Eurobond spreads (bp)



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

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Highlights

- Croatia's EU accession negotiations have drawn closer to their final phase. So far, 30 chapters have been provisionally closed. If Croatia should manage to meet all the benchmarks by the end of June, the EU membership will be possible in 2013, since the ratification process takes at least a year and a half. A referendum on the EU accession is still not scheduled. The Government has decided to first focus on completing the negotiations and is planning to organize the referendum before the Parliamentary Elections in fall of 2011 or at the beginning of 2012.
- With a good tourist season, a recovery in consumer optimism and generally stronger economic activity, we expect a recovery of the Croatian economy to start in H2 2011, and the 2011 GDP growth rate should be around 1% yoy. Along with exports, we expect a positive contribution from investments. However, this will be primarily due to the base effect, since the construction sector, which accounts for some 16% of total investments (2009), is unlikely to recover this year.
- The downtrend in the EUR/HRK exchange rate is expected to continue in the coming months, supported by continued high liquidity, low interest rates but also the inflow of foreign exchange stemming from the beginning of the tourist season. Given the announced Eurobond issue in the European primary market until the end of the first half of this year, we do not consider it unlikely for market participants to position themselves before the issue.
- Trading volumes on the stock market in Zagreb also picked up tangibly in recent months, and the CROBEX10 stock index has advanced by nearly 7% since the beginning of the year. We expect to see positive development on the Croatian stock exchange for the rest of the year with price gains of around 20%.

Key economic figures and forecasts

Croatia	2006	2007	2008	2009	2010	2011e	2012f
Nominal GDP (EUR bn)	39.7	43.4	47.8	45.7	45.9	47.2	49.7
Real GDP (% yoy)	4.9	5.1	2.2	-6.0	-1.2	1.0	2.0
Industrial output (% yoy)	4.5	5.6	1.6	-9.2	-1.5	2.3	4.7
Unemployment rate (avg, %)	17.0	15.1	13.4	14.9	17.6	18.5	17.5
Average gross industrial wages (LCY, % yoy)	7.6	5.6	6.2	1.4	-0.5	1.0	1.1
Producer prices (avg, % yoy)	2.9	3.4	8.4	-0.4	4.3	5.8	3.3
Consumer prices (avg, % yoy)	3.2	2.9	6.1	2.4	1.1	3.0	3.5
Consumer prices (eop, % yoy)	2.0	5.8	2.9	1.9	1.8	3.5	2.8
General budget balance (% of GDP)	-3.0	-2.5	-1.4	-4.1	-5.3	-5.8	-5.2
Public debt (% of GDP)	35.2	32.8	29.0	35.2	41.3	44.6	47.7
Current account balance (% of GDP)	-6.9	-7.5	-9.1	-5.5	-1.4	-2.9	-3.5
Official FX reserves (EUR bn)	8.7	9.3	9.1	10.4	10.7	11.2	11.6
Gross foreign debt (% of GDP)	73.7	75.9	83.7	97.7	99.8	97.8	95.3
EUR/HRK (avg)	7.32	7.34	7.22	7.34	7.29	7.38	7.40
USD/HRK (avg)	5.83	5.35	4.91	5.26	5.49	5.20	5.78
EUR/USD (avg)	1.26	1.37	1.47	1.39	1.33	1.42	1.28

Source: Thomson Reuters, wiiw, Raiffeisen RESEARCH

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

Economy
not to awake before the summer

Economic activity failed to gain strength early this year. Industrial production has continued to fall, personal consumption is still very sluggish, exports are suffering from low competitiveness and the already weak labour market has been additionally hit by the negative cycle in the economy. In addition to all of that, Croatia has failed to move forward with any serious structural changes during the last two years of recession.
In 2011, we expect only mild GDP growth of 1.0%, borne by a good tourist season and a recovery in consumption in H2. Positive developments are visible in trade with foreign countries. Last year, the C/A deficit narrowed to only 1.4% of GDP as a result of stagnation in imports of goods, due to torpid consumption and a strong decline in investment.

According to current poll results, it seems that the ruling coalition is very far from winning the next elections, the date of which is still unknown but is likely to be in the autumn. Burdened by two long years of recession and the failure of its economic recovery programme, the HDZ, which currently holds the majority in Parliament, is suffering a huge loss of support even from its own proponents. Moreover, despite the fact that the current government, led by Jadranka Kosor, has done a lot to fight corruption, including the arrest of former prime minister Ivo Sanader, the HDZ is still perceived by the vast majority of the electorate as a party involved in the main corruption scandals. Finally, the conviction of generals Gotovina and Markac in The Hague contributed to the unpopularity of the ruling coalition, but also of the other parties. Consequently, the support for EU accession fell below 30%. Sentiment may improve slightly if Croatia manages to conclude its negotiations by the end of June, but the government needs to do a lot more if it wants the referendum on EU accession to be positive. Although the government and its policies enjoy rather weak support, the election results are hard to predict since the major opposition party, the SDP, has failed to profit significantly from the HDZ's unpopularity. Many voters are indecisive, which makes the outcome of the elections very uncertain.
However, more important than who is chosen to form the new government is the question of how the government will work to take advantage of the window of opportunity that will open in the first year of the new mandate. It will be a chance for top-to-bottom structural reforms that could reposition the domestic economy and prepare it for the new chapter in the EU.

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
Opposition parties		
Socialdemocratic Party (SDP)	Zoran Milanović	Center-left
Croatian People's Party - Liberal Democrats (HNS)	Radimir Čačić	Center
Croatian Party of Pensioners (HSU)	Silvano Hrelja	Center
Croatian Democratic Alliance of Slavonia and Baranja (HDSSB)	Vladimir Šišljagić	Right
Istrian Democratic Assembly (IDS)	Ivan Jakovčić	Center-left
Croatian Social Liberal Party (HSLS)	Darinko Kosor	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

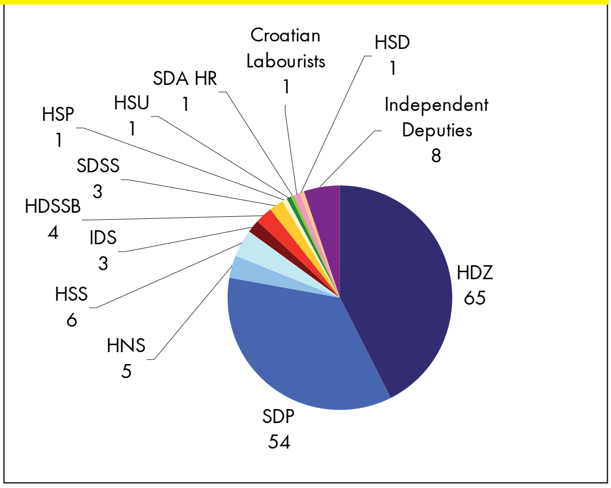
** President is elected for a term of five years, parliamentary members are elected for a four year term*
Source: Government

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

Growth in bad loans
decelerates

The ratio of banks' bad loans to total loans as a relative indicator of loan portfolio quality has risen quickly in the past two years. This is a consequence of the decrease in the collection of matured bank receivables, due to deterioration in the average creditworthiness of debtors, which is characteristic for periods of recession. The mild economic growth forecasted for 2011 will not immediately lead to a reduction in the ratio of bad loans to total loans, but it will help to slow down the rise in the indicator. A reversal of this trend and a decline in the ratio of bad loans to total loans can only be triggered by faster growth in total loans, which is not expected before 2012.

In practice, the decline in the total volume of bad loans is more often related to receivables being written off, rather than to them being collected. Therefore, in order for banks' loan portfolio to return to health it is not necessary to reduce the overall amount of bad loans, but only reduce their share in total loans. The reduction of the total amount of bad loans through collection is realised primarily via growth in demand for assets pledged as security, provided that the judiciary and the market are efficient. The difficulties in closing these two chapters of Croatia's EU accession negotiations indicate the lower-than-required level of efficiency necessary for a substantial reduction in the total amount of bad loans through enforced collection of assets provided as collateral. The second method to reduce the overall amount of bad loans is to improve the creditworthiness of debtors and reclassify loans from bad to recoverable loans. Improvement in the health of bad debtors is a characteristic of recovery following short-term economic crises. However, the structural character of Croatia's recession, as well as the slowdown in banks' enforced collection of assets provided as collateral indicate that the total amount of bad loans will stay at the level seen when exiting recession for a longer period of time.

Falling prices on financial markets hit Croatian banks as early as the beginning of 2008, before the recession affected the real sector. At that time total loans were growing, so rising difficulties in collection were not significantly reflected in an increase in the ratio of bad loans to total loans. Faster growth in bad loans was triggered by the halt in banks' lending activity in 2009, paired with accelerated growth in overdue bank receivables, connected with the sudden growth of illiquidity in the corporate sector. However, relative indicators of banks' loan portfolios point to slower change from the level of difficulties in receivables collection faced by banks at the beginning of 2009. Due to the inability to collect matured debt from companies, banks opted for restructuring repayments, assuming that loan repayment will normalise over the short term.

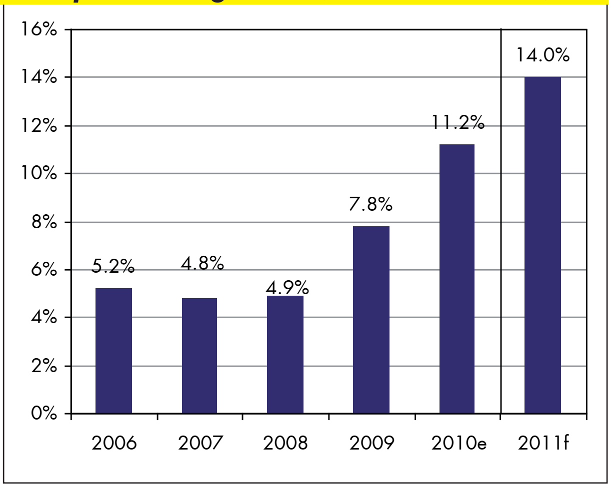
At the beginning of 2009, bank analysts were unable to precisely estimate the depth and the duration of the economic recession, corporate illiquidity and the decline in the price of real estate. Therefore, by restructuring loan repayments banks tried to postpone reclassification decisions. As a result, growth in overdue receivables and bad loans was slower than expected. Consequently, provisioning expenses at the height of the crisis were lower and banks' operating results were positive in 2009. But since recession dragged on into 2010, loans that were restructured fell due again. In 2010, analysts were able to estimate the deterioration in debtor creditworthiness and collateral more accurately, so reclassification of loans to bad loans became more common than in 2009, at the peak of the crisis. As a result, in 2010, growth in overdue receivables and bad loans accelerated. At the end of the year, the ratio of loans overdue by more than 90 days to total loans in the system rose to 13.3% (8.6% in the household segment and 18.8% in the corporate segment). This means that banks' receivables collection continued deteriorating. Reasons for this can be found in the insufficiently effective process of resolving the mounting illiquidity of the corporate sector, the reduction of employment and the strengthening of the Swiss franc, as far as the household sector is concerned.

According to unofficial information, the ratio of bad loans to total loans reached 11.2% at the end of 2010, indicating that the deterioration of the loan portfolio gained speed relative to 2009. The faster growth in bad loans should have been reflected in an increase in loss provisions and consequently a reduction in bank profits in 2010, but this did not occur as coverage of bad loans with loan loss provisions fell. The reduction in coverage may be a consequence of the more restrictive lending policy, whereby banks require debtors to provide better quality of collateral and the higher quality of collateral increases the potential collection of bad loans and reduces the need for provisions. Over the last two years, banks have tightened criteria for collateral. However, the positive effect was reversed by the tendency to write down the value of assets provided as collateral due to the negative developments in the real estate market and the weaker demand for movable property such as vehicles, which are commonly used as collateral. Therefore, the sufficiency of the loan loss provisions and the amount of expressed operating profits is questionable.

The process of cleaning the loan portfolio from bad debtors will continue on long after the start of the economic recovery. Therefore, growth of the ratio of bad loans to total loans will continue even after GDP begins to expand again. In 2011, we expect bad placements to grow as a share of total placements, as a result of two processes – maturing of the loan portfolio and the falling market value of collateral. The expected mild economic recovery in 2011 is a necessary precondition for improvement in the loan portfolio, but will not be adequate to halt the growth of the relative indicator. The economic recovery will be reflected in slower growth in the ratio of bad loans to total loans as early as in 2011. As a result, loan loss provisions in the profit and loss account will be lower relative to the previous year and profits will grow. But the overall amount of bad loans, as well as their share in total loans, will continue growing until loan growth accelerates and thus reverses the maturing process of the loan portfolio. Further economic recovery in 2012 should help boost employment, but more substantial growth in total loans is unlikely. Demand for loans will only recover in the upcoming years, with the share of bad loans in total loans starting to fall from 2013.

The ratio of bad loans to total loans in Croatia and geographically nearby markets with similar ratings shows large differences between the different countries. In 2010, preliminary data pointed towards continued negative tendencies in areas with prolonged recession (Croatia, Romania, Greece) and stagnation or a sluggish economic recovery (Hungary, Bulgaria). Economic growth in these countries during the pre-recession period was founded on accelerated lending growth and the strengthening of domestic consumption. Since these economies require structural economic changes to jumpstart the recovery and not a renewed acceleration in lending growth, it is likely that the process of deteriorating loan portfolio quality will continue in the years to come. Areas where economies were quick to recover are marked by downward trends in the NPL indicator of loan portfolio quality (Turkey, Russia). Their recovery is founded on stronger exports and rising prices of exported goods and services, which spurs producer and consumer optimism and consequently demand for loans. Under these conditions, loans expand and the ratio of bad loans to total loans shrinks.

Non-performing loans (% of total loans)



Sources: CNB, IMF, Raiffeisen RESEARCH

NPL´s: Comparison with other countries*

	S&P rating	2008	2009	2010	Last available data	Real GDP growth *
Russia	BBB	3.8	9.7	9.5	Jul-10	4.0
Bulgaria	BBB	2.5	6.4	7.8	Mar-10	0.2
Croatia	**BBB-**	**4.9**	**7.8**	**9.5**	**Jun-10**	**-1.2**
Hungary	BBB-	3.0	6.7	7.8	Mar-10	1.2
Romania	BB+	6.5	15.3	17.5	Apr-10	-1.3
Greece	BB+	5.0	7.7	9.0	Mar-10	-4.0
Turkey	BB	3.8	5.6	4.9	May-10	8.0

** in 2010 (%)*
Sources: IMF, WEO 10/10, 01/11

NPL´s and provisions for NPL´s

	2007	2008	2009	2010
Outstanding credit balances (over 90 days)*	6.3%	6.8%	9.3%	13.3%
- enterprises	8.2%	9.5%	12.6%	18.8%
- households	4.8%	6.8%	6.6%	8.6%
Non-performing loans*	4.8%	4.9%	7.8%	11.2%
- enterprises	7.3%	7.5%	12.9%	18.5%
- households	3.7%	4.0%	5.8%	7.8%
Coverage of NPL´s by NPL provisions	54.4%	51.5%	42.8%	39.5%
- enterprises	45.3%	40.1%	33.2%	32.2%
- households	67.0%	67.8%	60.9%	53.9%

** % of total loans*
Source: CNB

So close
yet so far away

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

GDP 2010

Nominal, at current prices (EUR mn)	45,893
Per capita (EUR)	10,383
Real growth rate (% yoy)	-1.2

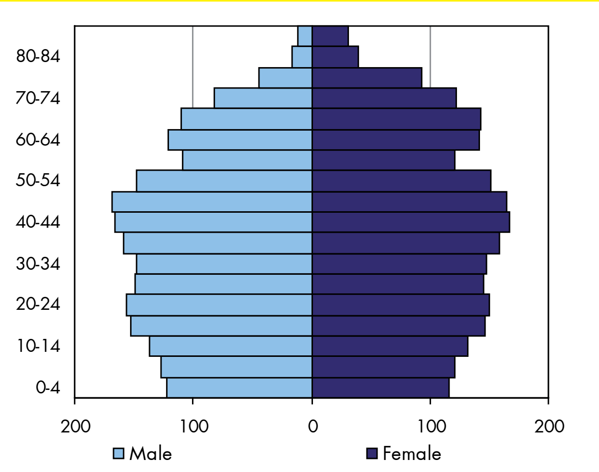
Source: CBS

Foreign currency rating

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

Source: CBS

Age distribution (2001)



Source: CBS

CROATIA and EU

Croatia's EU accession negotiations have drawn closer to their final phase. So far, 30 chapters have been provisionally closed. In addition to the chapter on competition policy, there are problems regarding Chapter 23 on Judiciary and Fundamental Rights whose conclusion requires 10 benchmarks to be met. Despite substantial progress, the latest Interim Report of the European Commission on Croatia's progress in the field of judiciary and fundamental rights stresses the need for ''tangible results regarding the judiciary and the fight against corruption and organised crime, which are essential for the credibility of the EU's enlargement process''. In addition, the report lists specific measures that need to be taken, such as reducing the backlog of cases before the courts, increasing minority employment in the public sector, following a transparent procedure for appointing judges, which should make it easier for the state authorities. The government's objective to conclude the negotiations by June seems a bit ambitious from the current perspective. However, we cannot rule out the possibility of this being achieved, provided extraordinary efforts are made by the authorities, in particular by the Ministry of Justice, the Ministry of Regional Development and the Ministry of the Interior, and provided there is strong political consensus. The will seems to be there, but the time available seems to be running out, especially considering that the European Commission lays more weight on quality and solidly meeting of the benchmarks which enable the uninterrupted and efficient functioning of the rule of law.

With the exception of Turkey, Croatian EU negotiations have been going on much longer than the negotiation of other accession countries. From 2001, when Croatia signed the SAA, until the beginning of negotiations in October 2005, four years went by, and Croatia has now been negotiating for six years. By way of comparison, the Czech Republic, Slovakia, Slovenia, Malta and Cyprus started negotiations in 2000 and completed them in 2002, while for Hungary and Poland negotiations lasted four years (1998 – 2002). It took slightly more for Romania and Bulgaria, at five years each, but still not as long as Croatia. The reason for the relatively protracted negotiation process is not only to be found in Croatia's sluggishness and political issues, but also in the caution and consequence of the European Commission in avoiding the mistakes made when Romania and Bulgaria were accepted as Members, which later proved not to be ready for the single European market.

Although we are aware of the irrationality of our optimism, we still hope that by the end of June Croatia will manage to meet all the benchmarks, not only as the accepted norm but also be able to efficiently and consequently implement the adopted standards of the acquis. In this case, Croatia's EU membership will be possible in 2013, since the ratification process takes at least a year and a half. However, we consider the functioning of the rule of law and the free market to be much more important than the actual date of accession, because as the old saying goes – if a thing is worth doing, it is worth doing well.

A referendum on the EU accession is still not scheduled. The Government has decided to first focus on completing the negotiations and is planning to organize the referendum before the Parliamentary Elections in fall of 2011 or at the beginning of 2012. On the other hand, the opposition wishes to hold the referendum after the elections.

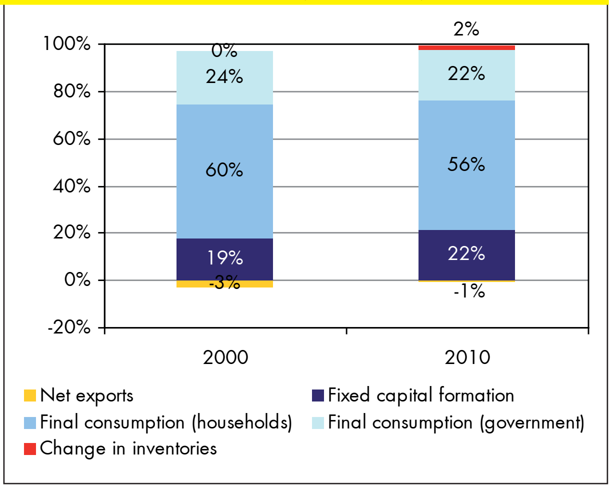
CROATIA and EMU

In a highly "euroised" economy, where 80% of total deposits are in foreign currency, the natural priority of policymakers is to enter the Eurozone as soon as possible. From the political point of view and given the population's inclination, entering the Eurozone could take place relatively quickly. Therefore, theoretically, soon after EU accession Croatia can get into ERM II and make all efforts to fulfil the Maastricht criteria.

Looking at the normative criteria, from the current perspective, the biggest challenge is the fiscal criteria, primarily public debt-to-GDP ratio, which should not exceed 60%. The current level of public debt without guarantees is at some 42% of GDP. However, the main concern is the growth dynamics, since public debt rose significantly during the last two years. According to our expectations, the public debt/GDP ratio could reach almost 59% of GDP in 2012 (note that Croatia is still not an EU Member).

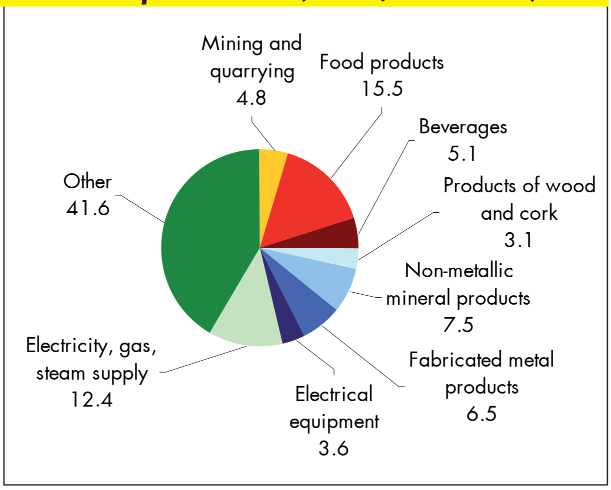
In addition, there are potential obligations in government guarantees for certain state-owned companies, which are relatively high (currently totalling HRK 43.4 bn, of which HRK 12 bn are for the shipbuilding sector). In the process of restructuring of the shipbuilding sector and other public companies, a portion of these guarantees will surely be contested, thus burdening the budget and further increasing public debt.

Demand side of GDP (% share)



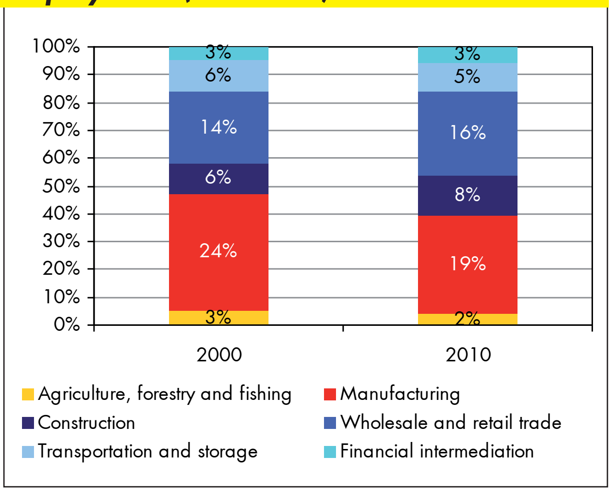
Source: CBS

Industrial production (2010, % of total)



Source: CBS

Employment (% of total)



Source: CBS

Key dates in Croatia's path towards the EU

Jun. 2000	The Feira European Council states that all the SAP countries are "potential candidates" for EU membership.
Nov. 2000	Zagreb Summit launches the Stabilisation and Association Process (SAP) for five countries of South Eastern Europe, including Croatia.
29 Oct. 2001	Stabilisation and Association Agreement signed.
21 Feb. 2003	Croatia applies for EU membership.
Jun. 2003	Thessaloniki European Council confirms accession perspective of Western Balkan countries, including Croatia.
April 2004	European Commission issues positive opinion on Croatia's application for EU membership.
Jun. 2004	European Council confirms Croatia as candidate country.
Dec. 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 Feb. 2005	Stabilisation and Association Agreement (SAA) enters into force.
16 Mar. 2005	EU postpones start of accession negotiations but adopts framework for negotiations with Croatia.
26 Apr. 2005	First meeting of Stabilisation and Association Council; meeting of extended "EU troika" on Croatia's cooperation with the ICTY.
03 Oct. 2005	International Criminal Tribunal for the former Yugoslavia (ICTY) Chief Prosecutor assesses Croatia is now fully cooperating with ICTY. Council concludes that last remaining condition for starting negotiations is met. Accession negotiations are launched the same day.
20 Oct. 2005	'Screening' stage of accession negotiations begins.
12 Jun. 2006	First chapter of the accession negotiations - science and research – formally opened and provisionally closed at an Accession Conference (ministerial level).
18 Oct. 2006	Screening concluded; accession negotiations continue.
12 Feb. 2008	The Council adopts the new Accession Partnership
30 Oct. 2008	7th meeting of the Accession Conference at Deputy Level sees number of negotiation chapters provisionally closed reach four. 21 chapters have been opened until then.
Apr. 2011	30 chapters are provisionally closed.

Source: European Commission, MFAEI, Raiffeisen RESEARCH

After 2012, under the assumption of structural changes, fiscal consolidation (i.e. cutting rights to certain interest groups as well as high state spending), much smaller state interference in the economy (through subsidies or guarantees) and higher economic growth (from 3 to 5%), the share of public debt to GDP could decline and the primary balance of central government could achieve a surplus. The above is really a great challenge for the fiscal policy over the medium to long term and it is clear that without painful, but necessary structural reforms (pension, health, social, educational system) it is unlikely to be achieved.

The FX rate (EUR/HRK) is expected to remain stable. The central bank will surely keep the managed free-float currency regime. Furthermore, the central bank has enough instruments and foreign exchange reserves to defend the stability of the exchange rate in the case of some external shocks.

As regards the inflation criteria, the average price level in Croatia is already at an exceptionally high level (at around 75%) compared with the EU average. Therefore, we do not expect significant price increases (inflationary pressures). Administratively set prices, such as prices of energy and utilities, are slowly adjusting to market criteria and the highest growth is likely to be recorded in 2012 or in 2013 (and the first year of accession if that is not 2013). In addition, we strongly believe that the central bank will remain consistent in carrying out its fundamental objectives: price and exchange rate stability.

Assuming all of the above is realised and that EU accession and the efficient implementation of necessary reforms occurs, it would be realistic to expect smooth convergence of the nominal long-term interest rate towards lower and acceptable levels.

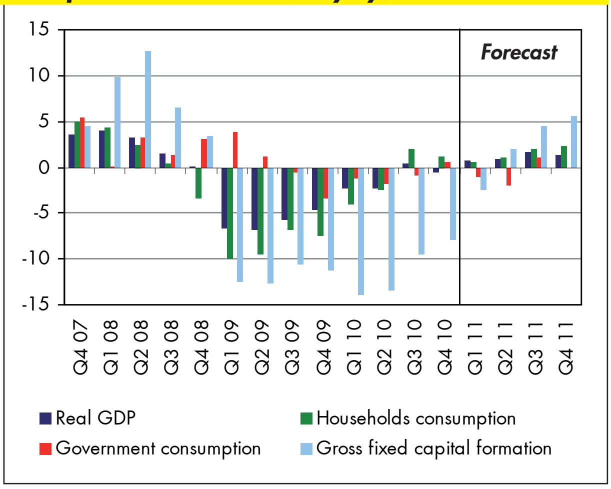
Finally, the analysis of nominal convergence shows that Croatia approaches the reference values of the EU and has achieved a high degree of macroeconomic stability. However, it lags behind the successful new EU member states in respect of trade integration and production structure, which can be regarded as important indicators of the long-term advantages of monetary integration. However, we are deeply convinced that the EU as well as the Eurozone will bring more advantages for the Croatian economy as whole then staying outside their borders.

Bottom reached?

After 2009 ended with a real GDP decline of 6%, last year saw the economy contract by 1.2%. The signs of recovery seen in Q3 2010, when GDP expanded by 0.3% yoy after seven successive quarters of decline were dispersed by the 0.6% contraction in Q4 2010. The most worrying aspects are negative trends in investments, which in 2010 were only slightly higher than in 2006. The end of the decline in retail trade in H2 2010 reflected the lower intensity of negative developments in household consumption, whose share in GDP fell from 60% before the crisis to slightly over 57%. During the last two years, the structure of GDP has undergone some changes, with the shares of household consumption and imports shrinking and the share of government spending increasing, but without any positive spillover to the economy. Exports of goods and services represent the only positive aspect. Still, exports also still have not returned to the pre-crisis levels. Judging by the real sector data collected early this year, we do not expect any growth in Q1 2011. With a good tourist season, a recovery in consumer optimism and generally stronger economic activity, we expect a recovery to start in H2 2011, and the 2011 growth rate should be around 1%. Along with exports, we expect a positive contribution from investments. However, this will be primarily due to the base effect, since the construction sector, which accounts for some 16% of total investments (2009), is unlikely to recover this year. Additional potential is to be found in the investments announced by the government. But the horizon of these projects is quite long, especially given the fact that they have only recently been announced.

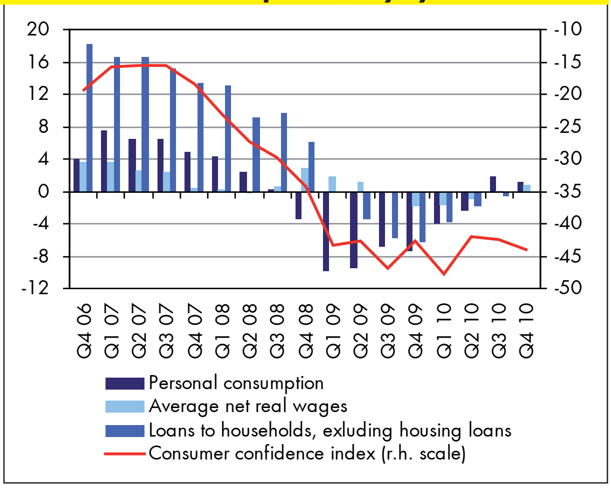
Several factors contributed to low inflation last year: subdued domestic demand and the consequent lack of spillover from higher producer prices, paired with the fact that employment went down more than GDP, thereby reducing unit labour costs. The very beginning of the year indicated that 2011 will be marked by different trends. Political turmoil in the Middle East and North Africa raised the price of oil above the expected levels. This year however, in contrast to 2010, other CPI constituents will contribute to mounting inflationary pressures: these factors primarily include food prices, which depend on the price of oil. Furthermore, we expect producers to start passing on their higher costs, which weigh heavily on their business, to final consumers at the very first sign of a recovery in personal consumption. This year, we expect the average inflation rate at 3%, representing continued moderate price growth.

Components of GDP (% yoy)



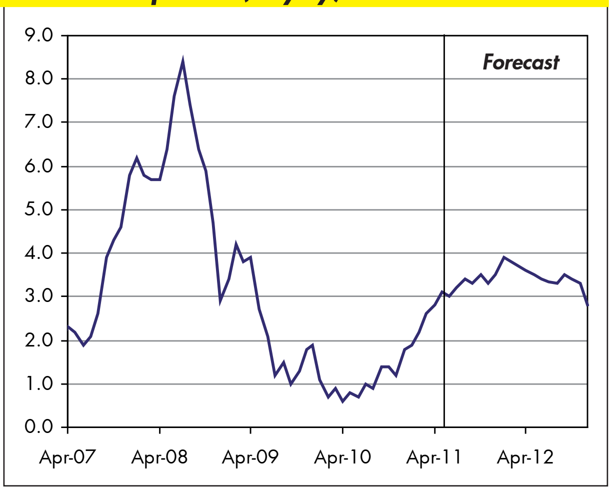
Source: CBS, Raiffeisen RESEARCH

Household consumption (% yoy)



Source: CNB, CBS, Raiffeisen RESEARCH

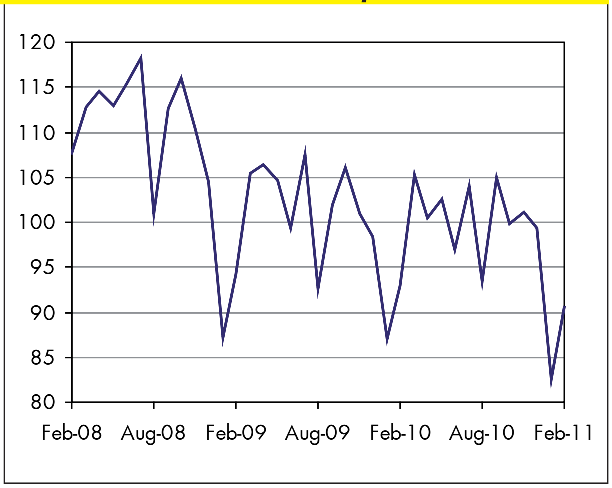
Consumer prices (% yoy)



Source: CBS

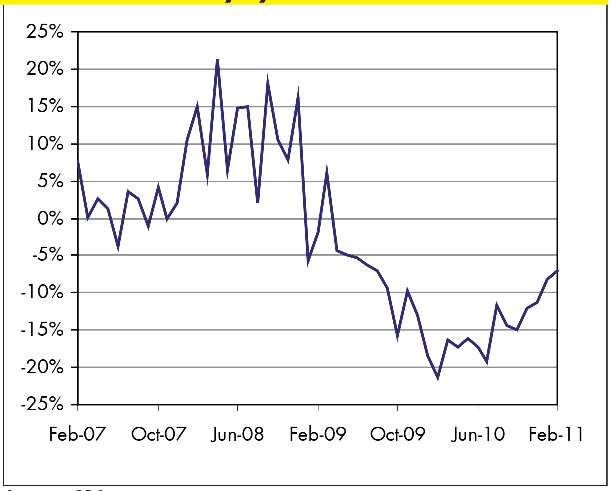
Does Croatia face a new brain drain?

Basic indices of industrial production*



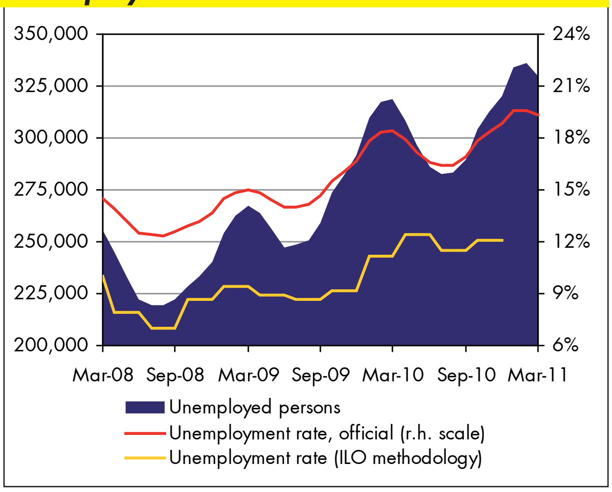
* 2005 = 100
Source: CBS

Construction (% yoy)



Source: CBS

Unemployment



Sources: CBS, CES

The relatively strong decline in industrial production, which continued in the early months of 2011, was the consequence of weak domestic demand, especially taking into account the base effect. The recovery in foreign demand has been too weak to have an influence in Croatia. However, we expect things to improve in the months ahead, especially in H2 2011, thanks to the fledgling recovery in domestic demand. In addition, industrial product inventories have continued rising, so we might see their depletion soon. Regardless of the unfavourable developments in industry, labour productivity has been on an almost uninterrupted uptrend since late 2009, due to the stronger decline in employment than production. At the same time, these trends are cyclical in nature and do not represent a shift in the structure of production and re-orientation towards sectors that can generate more added value and thus increase the competitiveness of the economy. In order to achieve sustainable growth, however, structural changes are unavoidable.

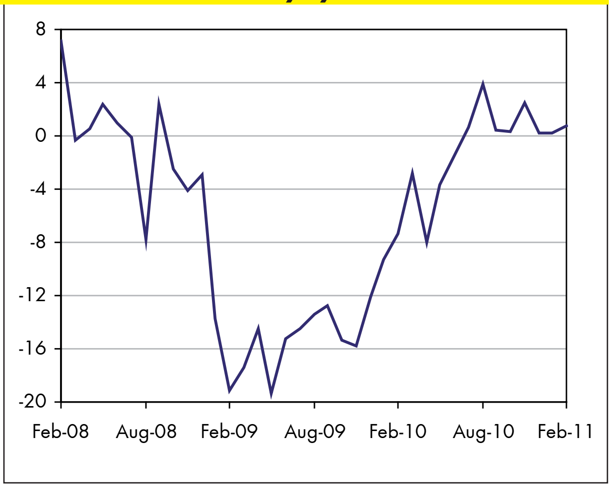
Although unemployment growth has started to taper off, we do not expect a recovery on the labour market. Annually, the number of unemployed has been rising for three years, bringing total job losses to 80,000. The companies that were able to withstand the crisis cut back their capacities to the lowest operational level and thus it has come to a slowdown in layoffs. Corporate activity has been reduced, with new projects postponed due to the persistent insecurity, thus resulting in no sustainable new hiring. In general, economic activity is too weak to generate new jobs. Consequently, there is a growing trend of unemployment among the young who have completed their education, especially higher education. Such developments (paired with long-term unemployment) are especially worrisome because they could result in a new brain drain, which an economy like Croatia's cannot afford given the already small share of highly-educated workforce. In the months ahead, seasonal employment should contribute to a decline in unemployment, with a recovery expected to start at the end of the year. However, at the annual level, unemployment will be higher than in 2010. The fact that registered and survey unemployment rate are so different indicates a sizeable grey economy. Considering that according to the 2010 plan, the Croatian Employment Service spent over HRK 1.5 bn on unemployment benefits, measures aimed at combating the grey economy have certainly become unavoidable.

Successful tourist season
may aid retail trade recovery

Considering the relatively low base, the mild retail trade growth rates early this year should not be viewed as overly favourable. The reason for this low growth, in addition to weak domestic demand, can be found in the higher crude oil prices in world markets. Automotive fuels and lubricants sales, the second most important component in the retail trade structure, strongly affected growth, with the average price of automotive fuels rising 15% yoy. Considering the negative results of retail trade in the period from 2008 to 2010, the 2.0% growth rate expected this year represents only a hint of recovery. Stronger growth rates are expected with the start of the early tourist season and during the peak season, when tourist spending will contribute to the strengthening of positive trends. On the other hand, domestic demand will remain weak due to high unemployment and the lack of consumer optimism. According to the CNB data, in the last two years the consumer confidence index reached a historical low (at around -45), reflecting the insecurity and pessimism plaguing the domestic economy.

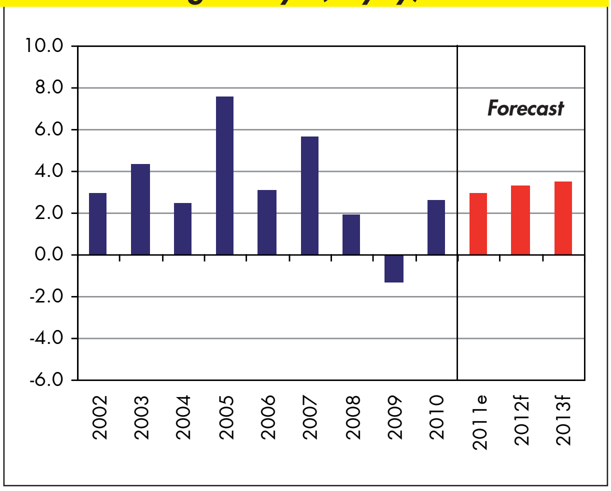
Last year's increase in tourist arrivals and overnight stays was not accompanied with growth in income from tourism. This year, in addition to growth in volume indicators we expect positive developments in that respect as well. However, while last year's political instability in Greece most likely redirected a share of tourism to Croatia, the situation in North Africa is unlikely to significantly affect Croatian tourism. Tourists might shift from Tunisia and Egypt to Turkey since domestic demand cannot respond to the requirements of tourists asking for all-inclusive service. Despite good volume indicators, the tourism sector remains below its development potential. The reasons for this should be sought in the short season, relatively high fiscal and quasi-fiscal burdens that weaken its competitiveness and low hotel sector profitability, and last but not least a lack of a long-term tourism development strategy, which due to the importance of the tourism sector for the country's economy is absolutely necessary. Future development should, among other things, include stronger orientation towards certain market segments, such as nautical tourism. Therein lies Croatia's advantages compared to Italy and France, given its more indented coastline, and compared to Greece and Turkey, given its closeness to the EU market. Since yachtsmen are better-than-average consumers, a more important share of nautical tourism should positively impact revenues.

Retail trade (real, % yoy)



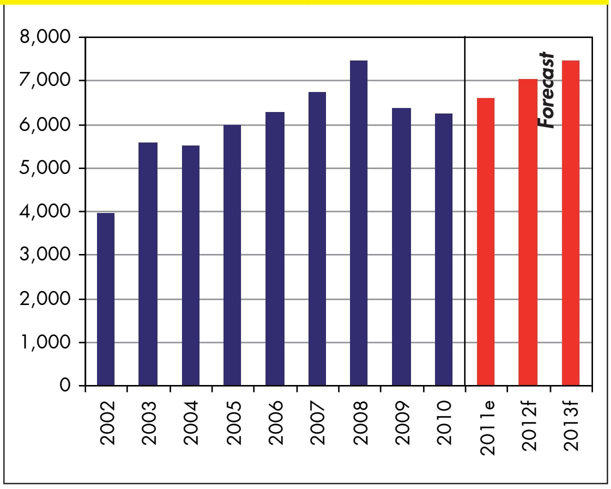
Source: CBS

Tourist overnight stays (% yoy)



Source: CBS

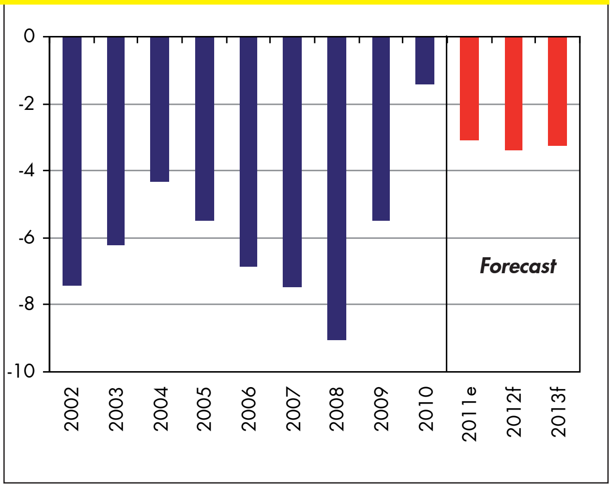
Revenues from travel (EUR mn)



Source: CNB, CNTB

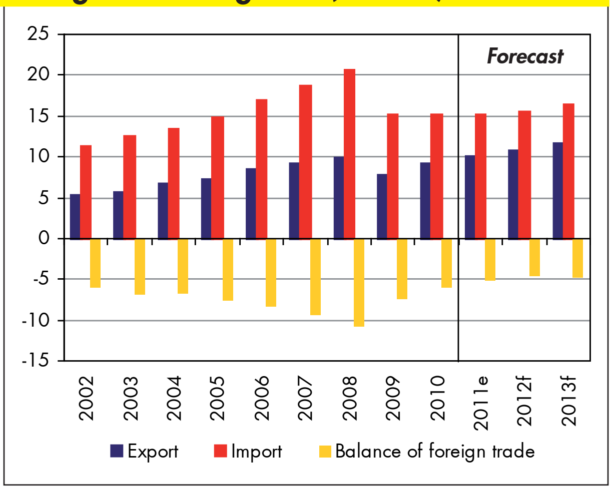
Current account
share in GDP at a historical low

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**
Q1 08	34,963	78.5%	188.2%	28.1%
Q2 08	35,403	77.5%	185.6%	28.1%
Q3 08	36,247	77.2%	182.8%	27.1%
Q4 08	39,950	83.7%	200.7%	22.8%
Q1 09	40,308	85.0%	206.4%	22.0%
Q2 09	41,823	89.2%	225.8%	21.7%
Q3 09	42,852	93.0%	255.7%	21.7%
Q4 09	44,606	97.7%	276.1%	23.3%
Q1 10	44,651	97.7%	274.3%	22.4%
Q2 10	45,067	98.6%	270.9%	22.9%
Q3 10	44,857	97.5%	263.0%	24.9%
Q4 10	45,768	99.8%	260.1%	23.3%

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

The economic recovery in the EU and weak domestic demand are the main reasons for the decline in Croatia's 2010 C/A deficit. As a result of the strong growth of goods exports and a decrease in imports, the deficit on the goods account shrank by 19%, which – paired with growth in the services account – made the largest contribution to the decline in the C/A deficit. Its share in GDP dropped to a historical low of 1.4%. Despite the series of unfavourable developments that marked the domestic economy at the beginning of 2011, the easing in this external imbalance certainly gives some grounds for optimism. However, looking at the structure of goods imports, it has not changed substantially. Exports mostly depend on exports of other transport goods, more specifically ships, which represent a fluid component determined by several orders for high-value ships, strongly affecting overall exports given their modest volume. On the imports side, the decline was impacted by the decline in demand for transport vehicles and weaker imports of machinery and equipment, as a consequence of the fall in production. In 2011, imports are likely to recover, since companies are expected to start a new production cycle, bringing about a recovery in domestic demand. Nevertheless, due to still healthy foreign demand, we expect stronger growth in exports. The most important income in the services account, i.e. from tourism, which fell short in 2010, is expected to increase this year. The C/A deficit will start widening again in the years to come. However, its share in GDP will remain significantly lower than before the crisis for some time.

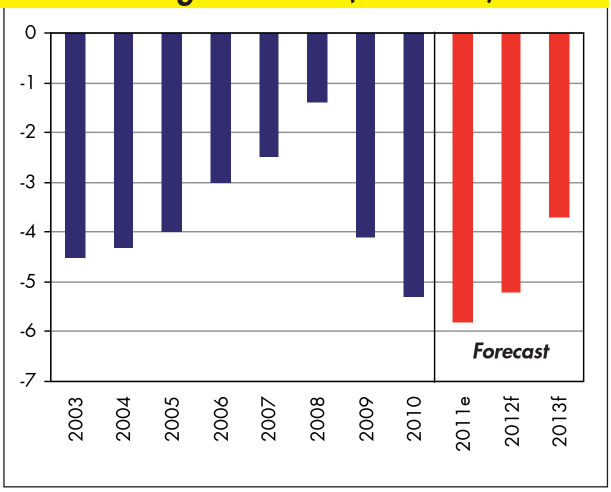
The mild growth in gross external debt in 2010 reflects the weak overall economic activity. Only 2.5% yoy is a consequence of inclusion of circular investments in the statistics of direct investments, foreign exchange movements and public sector debt growth. The public sector is burdened by the need to finance its maturing debt. On the other side, slack domestic demand and relative unfavourable business conditions resulted in much weaker growth in corporate debt. Despite the weak growth, the volume of gross external debt came close to GDP. This year, external debt growth is expected to accelerate in line with the economic recovery. However, its pace will largely depend on the government's need to refinance its debt. In March, the government issued a USD bond, worth 1.5 bn, announcing another issue in EUR in H1. The risk of stronger growth will also be present if credit activity intensifies, resulting in stronger bank borrowings.

Fiscal consolidation, a priority

The recession years 2009 and 2010 were marked by strong deficit growth, rising public debt and insufficient structural changes. Unfortunately, these trends from the previous two years will surely continue in 2011. Despite freezing expenditures at the nominal level from 2010, it is likely that budget revenues will fall short and a large share of government guarantees will fall due (especially in shipbuilding, where according to MoF data the overall amount of government guarantees has climbed to some HRK 12 bn), finally resulting in the widening of the deficit and higher public debt. Nominally speaking, the current debt level is a relatively smaller problem than the public debt growth dynamics and the utilisation of the funds. If consolidation (which is not likely before 2012) occurs within two to three years, public debt could cross the threshold of 60%, which would result in significant negative consequences apart from the failed entry into EMU. The rising deficit, i.e. the increase in public debt directed exclusively or predominantly towards demand, burdens future generations, reduces the potential economic growth rate, spurs an increase in risk premiums, which raises the price of borrowing, restricts economic policy makers in implementing the adequate economic policy and, last but not least, leads to inefficient resource allocation.

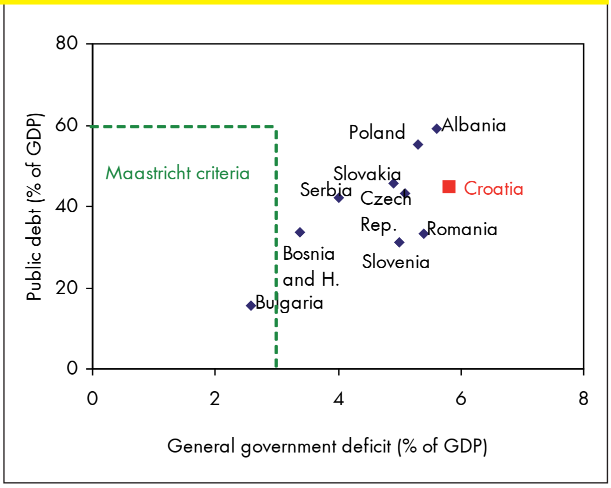
There is no quick fix to reduce public debt. However, in order to halt its growth and then decrease public debt is necessary to achieve primary surpluses in the budget. The alternative is to increase revenues or reduce expenditures. Given the relatively high tax burden, an increase would only further discourage economic activity and recovery. Consequently, on the revenue side we are left only with an improvement in the efficiency of the tax administration and a reduction in the grey economy without imposing additional taxes. The key lies in the expenditure side of the budget, which presupposes reforms, including the rationalisation and change in the structure of public spending through a reduction in the public sector wage bill and corporate subsidies and rationalisation of expenditures for public health and pensions, as well as better distribution of expenditures for social benefits. In order to improve competitiveness, it is necessary to carry out reforms aimed at solving labour market inefficiencies, that is to introduce higher flexibility in employment policies and social benefits to remove negative incentives for the work force. Although some of the measures require initial reform costs, over the medium to long term they will lead to more balanced public finances, which are a precondition for sustainable growth and development.

General budget balance (% of GDP)*



* ESA 95
Source: MoF, Raiffeisen RESEARCH

Public finances (2011 estimates)



Sources: Raiffeisen RESEARCH

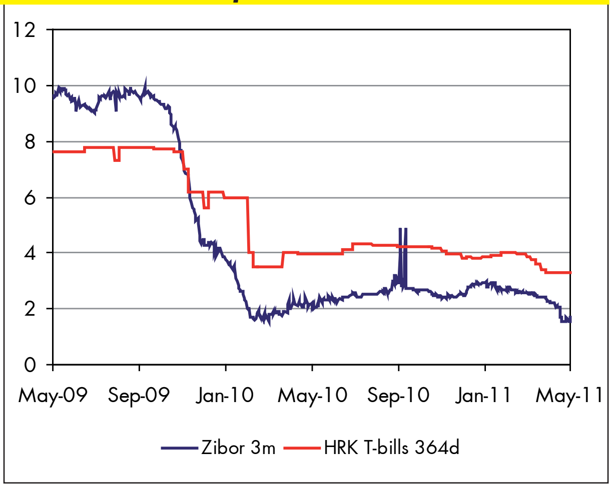
Public debt

HRK mn	General government debt	% in GDP without guarantees and CBRD	Guarantees	Total public debt*	% in GDP with guarantees and CBRD
2004	92,955	37.6	12,262	111,059	44.9
2005	101,485	38.1	12,455	121,079	45.4
2006	102,513	35.2	14,188	124,388	42.7
2007	104,471	32.8	17,399	131,532	41.3
2008	100,146	29.0	33,836	144,795	42.0
2009	117,934	35.2	38,209	168,467	50.3
2010	138,019	41.3	44,000	196,019	58.6
2011e	155,227	44.6	43,000	215,727	62.0
2012f	175,400	47.7	35,000	231,400	63.0
2013f	185,827	47.7	30,000	240,327	61.7

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

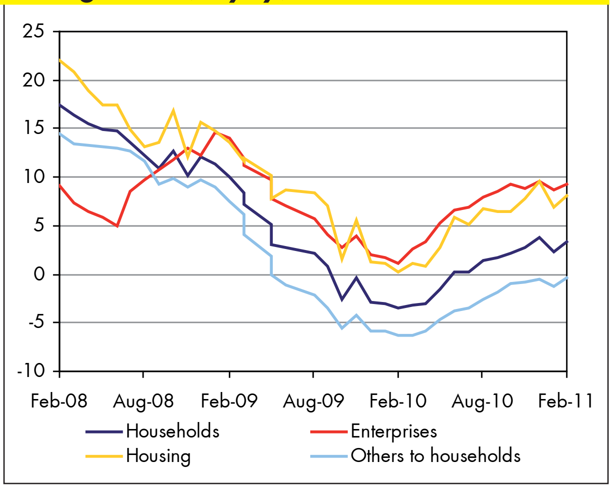
Interest rates
at minimum levels

Interest rates (% p.a.)



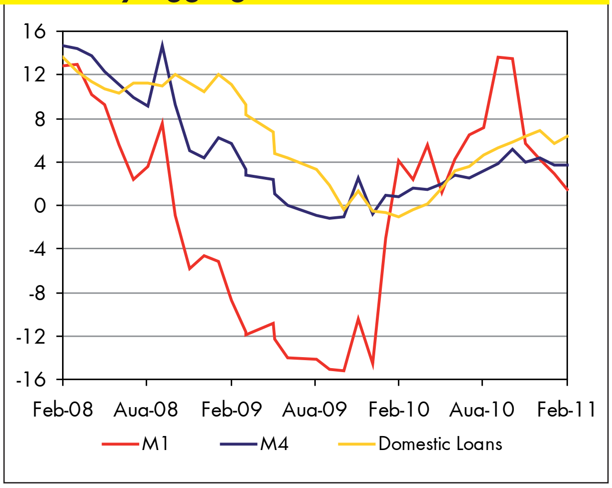
Sources: reuters.hr, CNB, MoF

Loan growth (% yoy)



Source: CNB

Monetary aggregates and domestic loans*



** % yoy*
Source: CNB

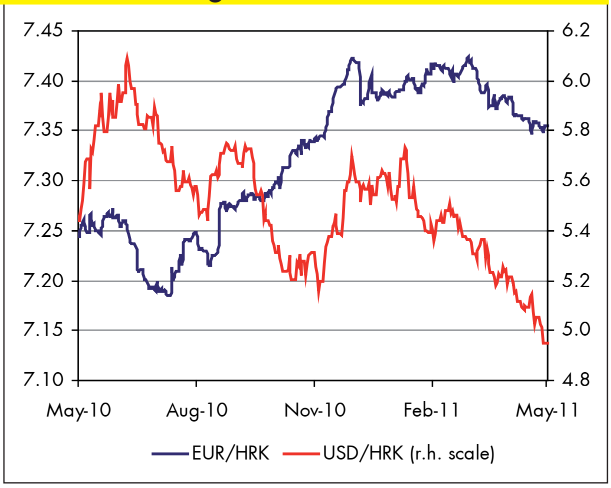
The period of high liquidity, low interest rates and reliance of market participants in the money market on MoF T-bills, where the demand continues to surpass the planned issue amounts, continued. Despite the relatively high financing needs of the central government, the required yields on issued T-bills during Q1 showed a downward trend. There is lively interest in one-year HRK T-bills, because with the stable exchange rate conditions they provide more attractive returns relative to EUR-linked T-bills of the same maturity. Therefore, despite stronger inflationary expectations and possible negative real returns, the yield on one-year HRK T-bills fell to its lowest level since 2002. Furthermore, the spread between the one-year EUR-linked T-bill and the 12-month Euribor dropped to below 100bp. The usual depositing of surplus kuna liquidity into overnight deposits with the CNB has continued and was not deterred by the central bank's decision to reduce interest rates on deposits with the CNB (to 0.25%). Consequently, interest rates in the money market continued declining, with ZIBOR quotations reaching new historic lows. The period of high liquidity is sure to continue throughout Q2, with the usual outflow during the tourist season unlikely to more seriously jeopardise kuna liquidity. The downward tendency in interest rates can be halted only by an increase in loan demand. However, we do not expect a more substantial recovery in bank lending in 2011, especially not to households and SMEs. Despite reduced, but still present downward tendency in both loan and deposit rates, a more substantial recovery in lending is limited by weaknesses in the real sector and unfavourable trends in the labour market. Therefore, we expect the money market to keep its interest rates low, place its kuna liquidity in overnight deposits and be concentrated on T-bill auctions. Due to the lack of more attractive investments we expect demand to be solid, leading to falling yields in Q2 2011. In Q2 alone, the government is faced with HRK 13 bn of T-bills maturity, which are more than likely to be covered by new issues. The fledgling recovery in monetary indicators will continue this year, but only at moderate single-digit growth rates, supported by the expected mild growth in the kuna exchange rate against the euro.

HRK
unlikely to weaken

The relatively quiet first quarter in the foreign exchange market and the slow drift in the exchange rate towards the expected level of EUR/HRK 7.40 was interrupted by the central bank's decision to cut the minimum required bank foreign currency reserves from 20% to 17%. This decision increased foreign exchange liquidity by additional EUR 850 mn, neutralising potential depreciation pressures on the domestic currency arising from the seasonal outflow of foreign exchange and the lower inflow of foreign exchange usual for the first half of the year. The move resulted in an increased supply of foreign exchange, consequently lowering the mid-point exchange rate to its lowest level since the beginning of the year (EUR/HRK 7.37).

The downtrend in the EUR/HRK exchange rate is expected to continue during summer, supported by continued high liquidity, low interest rates but also the inflow of foreign exchange stemming from the beginning of the tourist season and later the peak season. Bank lending remains relatively modest, with weak domestic demand making it unlikely that lending will recover or that liquidity will decline on this basis in the coming one or two quarters. This is confirmed with data and expectations on goods imports and this more substantial demand from this aspect will not materialise. Nevertheless, the trend of domestic companies repaying their debts abroad continues, that is, their and the government's increased reliance on domestic financial intermediaries when covering their foreign debt. Given the announced Eurobond issue in the European primary market until the end the first half of this year, we do not consider it unlikely for market participants to position themselves before the issue. On the other hand, demand for foreign exchange from institutional investors is also expected as a result of the purchase of the new bond. Nevertheless, we think that the possible conversions from the said issue could largely be made with the central bank gradually over a certain period, without them having a more substantial influence on the exchange rate. The summer and the peak tourist season will bring about the usual appreciation pressures on the domestic currency against the euro, with it ranging in the expected range of EUR/HRK 7.25 to 7.38, followed by a depreciation towards the levels attained late in Q1. We expect 2011 to be marked by relatively high kuna exchange rate stability against the euro, but at fundamentally justified higher levels.

Middle exchange rate of the CNB



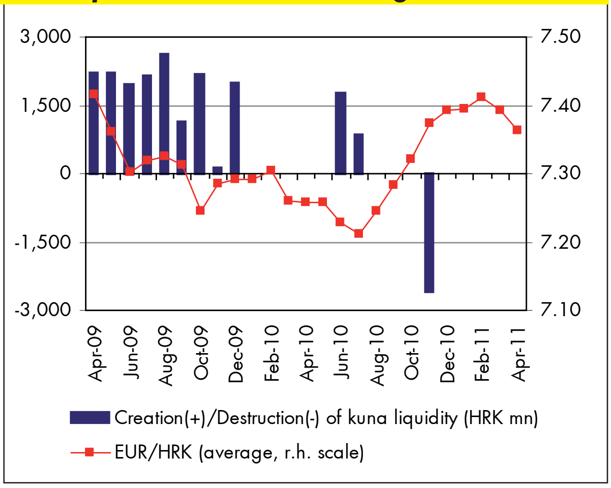
Source: CNB

Middle exchange rate of the CNB

Currency	Middle exchange rate 30 Apr 2011	Change compared to: 31 Dec-10 Exch. rate	Movements	%
EUR	7.3543	7.3852	↓	-0.03
USD	4.9474	5.5683	↓	-5.82
CHF	5.7064	5.9300	↓	-4.07
GBP	8.2457	8.6084	↓	-2.14

Source: CNB

CNB operations and exchange rate



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

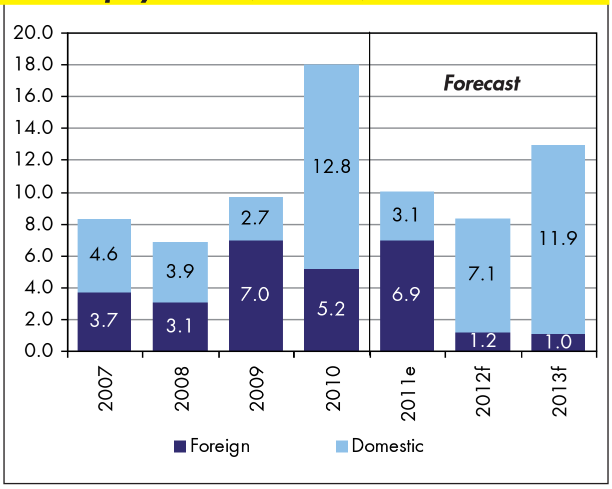
Exchange rate forecast

	Sep-11	Dec-11	Mar-12	Jun-12
EUR/LCY (eop)	7.38	7.42	7.42	7.38
USD/LCY (eop)	5.09	5.50	5.71	5.68
EUR/USD (eop)	1.45	1.35	1.30	1.30

eop - end of period
Source: Thomson Reuters, Raiffeisen RESEARCH

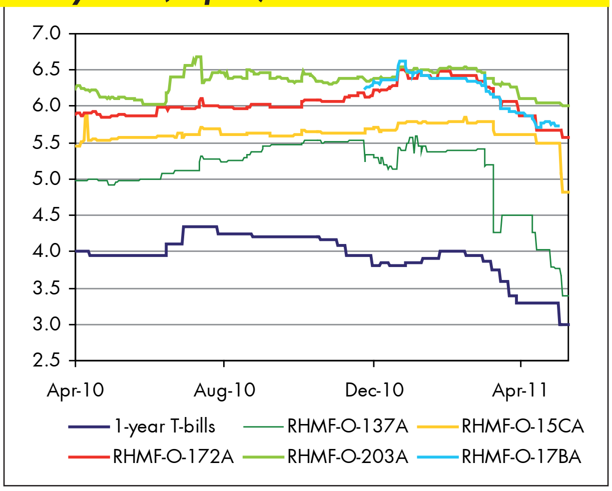
Narrowing of the spreads
in waiting for new issues

Debt repayments (HRK bn)



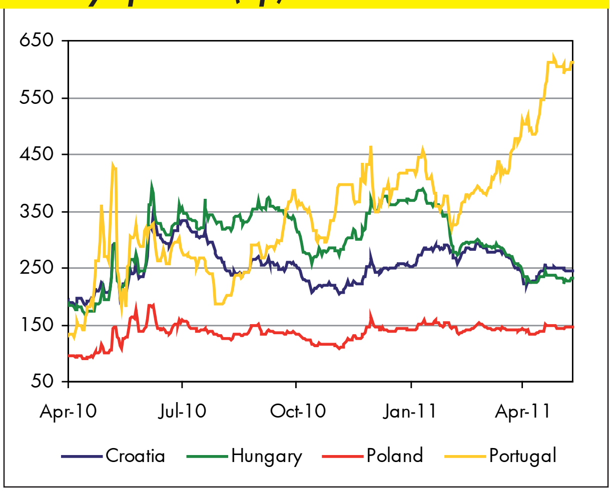
Central government: bonds and loans
Source: MoF

HRK yields (% p.a.)



Source: MoF, reuters.hr, Raiffeisen RESEARCH

CDS 5y spreads (bp)



Source: Bloomberg

At the beginning of the year, Croatian bonds also came under pressure from the negative impact of the latest cut in the credit rating by S&P. Additional insecurity came from this year's high government refinancing needs, totalling HRK 28 bn, along with insecurity as regards the repayment of the Eurobond and accrued interest in mid-March. The bond was repaid with short-term bank loans (totalling EUR 825 mn) and was accompanied by a foreign issue, in the US market, worth USD 1.5 bn with a ten-year maturity and a coupon of 6.375% (yield at issue 6.617%). Still, good market liquidity supported high demand for both kuna and currency-indexed issues. Yields saw a more substantial decline, while spreads narrowed substantially in comparison to benchmark securities. Especially attractive were yields above 6%, paired with demand for the currency-indexed RHMF 12 due to the difference between the required yield compared with the yield on the one-year T-bill indexed to foreign currency. Despite weak fundamentals and insufficient fiscal consolidation, the highly liquid domestic and external markets saw investment in Croatian government bonds as relatively attractive. The decline in yields, the narrowing of spreads and the CDS continued early in Q2, and such developments, although weaker in intensity, expected to continue throughout the end of the quarter if the mood on Emerging Markets remains favourable in the foreign markets. The narrowing of the spreads will be supported by the expected growth in US and German yields, partly due to the continued recovery of these economies and partly due to the expected rise in benchmark interest rates. Therefore, despite the unsolved fiscal crisis in Europe, the turmoil in North Africa and the tragic events in Japan, assets could be redirected to more-risky debt securities. Croatian bonds would certainly get a boost from the completion of EU membership negotiations, because fiscal consolidation and reforms are not to be expected during an election year. Amidst the ample liquidity but a shallow market, despite the decline in yields, demand in the domestic market will be strong until the government comes out with a domestic issue announced for the second half of the year. The Ministry of Finance announced a Eurobond issue by the end of June, which will most likely have a maturity of 5 or 7 years, given that none of the foreign issues matures in 2016 or 2018.

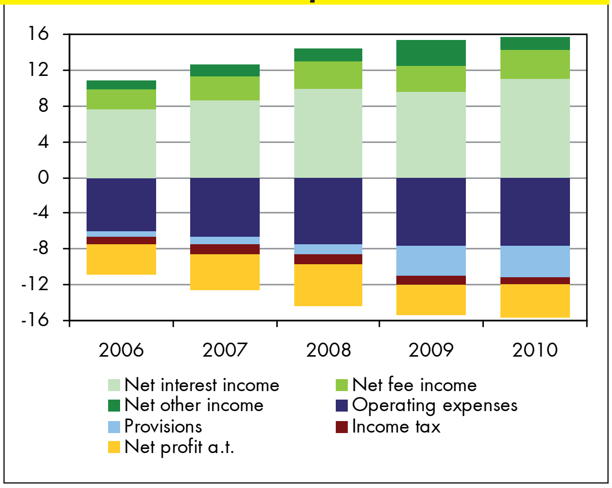
Local currency debt instruments

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	1	1	1
Tenor(s)	3-12 months	3-10 years; Euro-linked 3-10 years. Eurobonds 3-10 years	1-7 years; Euro-linked 3-7 years	2-7 years
Interest rate/coupon	zero coupon (discount)	HRK 4.500% - 6.750%; Euro-linked 4.25% - 6.875%,Eurobonds 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 bn	HRK 24 bn and EUR 3 bn (domestic) EUR 1.25 bn USD 4.25 bn (Eurobonds)	HRK 3.2 bn and EUR 34.1 mn	HRK 150 mn and EUR 42.8 mn
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 2-4 bn and EUR 400-600 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	min. T+0; usual T+2	T+3	T+3	T+3
Average trade size	HRK 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 CET	08:30 am - 04:30 pm CET	08:30 am - 04:30 pm CET	08:30 am - 04:30 pm CET
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

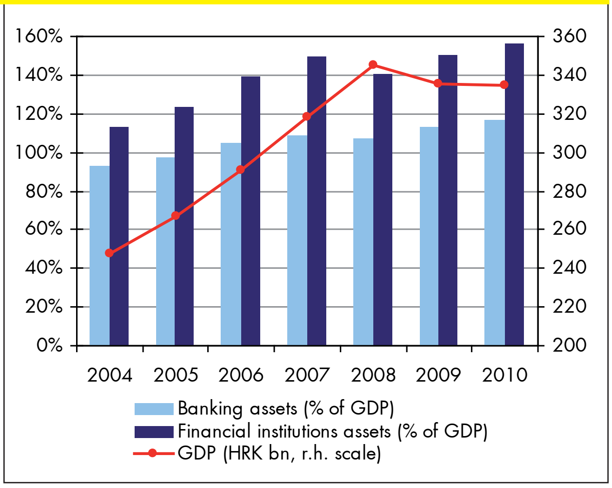
Corporate lending
recovers

Banks' income and expense structure*



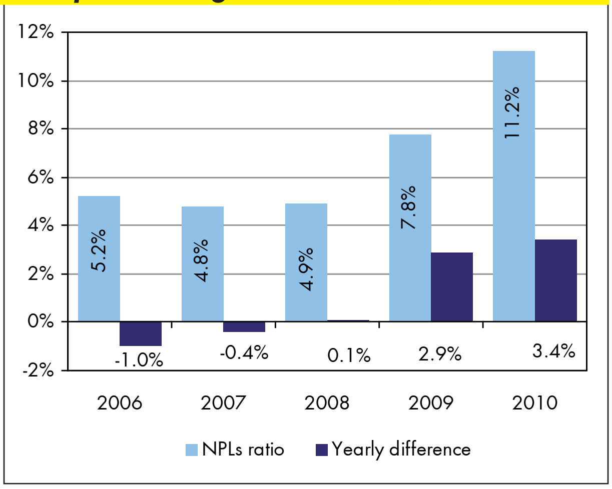
* HRK bn
Source: CNB

Financial assets



Source: CNB, CFSSA

Non-performing loans ratio (%)



Source: CNB

Although the financial sector had surplus liquidity on its hands last year, in the real sector the amount of due but unpaid receivables increased. As a result, by adopting measures aimed at assuming some of the credit risk, the government attempted to spur corporate lending and thus increase liquidity in the real sector. Following the 1% reduction in the reserve requirement, additional bank liquidity was completely directed at strengthening corporate working capital through the CBRD. However, the increase in corporate lending was not immediately reflected in their illiquidity. The amount of short-term unpaid receivables started decreasing as late as at the beginning of this year, while long-term receivables continue rising. In the following period, illiquid companies were broken down into solvent and insolvent. Solvent companies have been gradually recovering from the consequences of the two-year recession, while the business of insolvent companies is tainted by growing long-term debts and inability to access additional sources of finance. Insolvent companies quickly exit the market, while the related bank receivables are transferred to bad loans. At the end of 2010, the ratio of bad loans to total loans in the corporate segment totalled 18%, while the ratio of bad loans to total loans in all segments reached 11.2%.

By contrast, when it comes to creditworthy companies, increased lending was reflected in the shortening of repayment horizons. Thus, the positive impact of the aforementioned measures has spread among the solvent portion of the corporate sector, with companies trying to balance demand in the market, restructure obligations and renew their business. This year, the reduction in the utilisation of loans from the CBRD that became visible in the second half of last year, has been countered by relaxing the utilisation conditions. At the same time, by decreasing the minimum required coverage of foreign currency claims by short-term foreign currency claims from 20% to 17%, the CNB increased the liquidity of the financial sector. This monetary easing measure increased banks' lending potential by EUR 850 mn. In contrast to last year, no conditions have been imposed on the use of these assets. However, it is supposed that due to the slack household demand for loans, the lion's share of additional liquidity will be used to increase lending to corporates. In addition, it is expected that the supply of loans with longer repayment periods and lower capital price will increase, which should revive corporate investments in long-term operating assets.

Croatian equity market
still on track for recovery

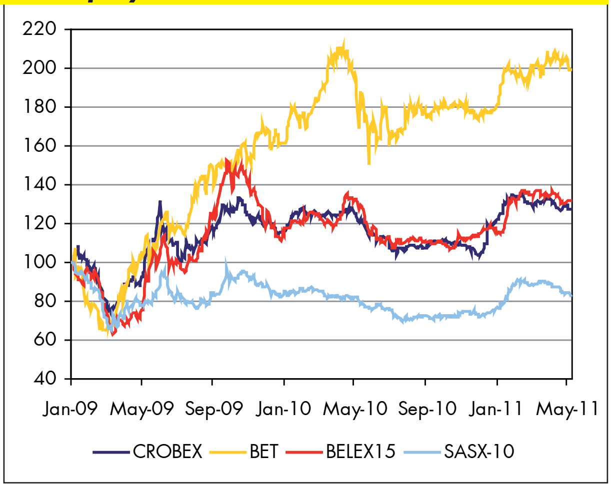
In international terms, Q1 2011 was marked by the unbelievable catastrophes in Japan and the spread of unrest in the Arab world. It was quite interesting to see that the SEE region remained almost totally unaffected by these events and has even been able to post impressive price performance since the beginning of the year. It appears that the European sovereign debt crisis is playing a subordinated role and the steady improvement in the global economy should also help to foster good overall conditions for more handsome performance on the stock markets. In global terms, the sales and earnings performance of listed companies continues to look very robust. In terms of monetary policy it does not appear as if worries about interest rates will arise. The US central bank is obviously not considering following the path of the ECB and hike its interest rates in the months to come. Furthermore, the Fed intends to scale back its quantitative easing measures (QE2) very cautiously. Along with falling risk aversion on the SEE region, this should also help pave the way for more price gains.

Although the SEE financial markets were underperformers last year, positive developments have been seen again since the turn of 2010-2011 and strong gains have been posted since then. Following a period marked by more sustained positive sentiment at the global level in the previous quarters, many investors are once again recognising the full potential of the SEE region, which should lead to catching up by the SEE stock markets, which traditionally tend to lag behind developments in the established financial markets.

Trading volumes on the stock market in Zagreb also picked up tangibly in recent months, and the CROBEX10 stock index has advanced by 6.8% since the beginning of the year, thanks first and foremost to the index heavyweight and potential takeover target INA, which has seen prices for its stock rise by 31% in the same period. Domestic institutional investors, which own roughly one-half of the domestic stocks, stepped up their purchases of Croatian names. Due to stronger buying by these investors, the share of securities held by non-resident investors dropped from 41% in May 2010 to the current level of 37%.

One particularly positive factor for the investment climate is the outlook for Croatia to join the EU in the near future. Accession negotiations are entering the final stretch and by mid-2011 the last outstanding negotiations should be completed. The completion of

SEE equity market indices



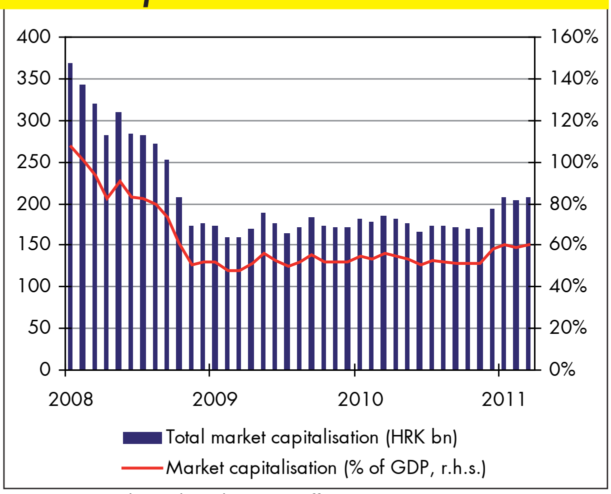
Source: Bloomberg, Raiffeisen RESEARCH

Index estimates

	actual	Sep-11	Dec-11	Mar-12
BET	5,782	6,600	7,100	7,000
CROBEX10	1,232	1,430	1,500	1,450
BELEX15	739	870	920	900
SASX-10	1,028	1,250	1,350	1,300

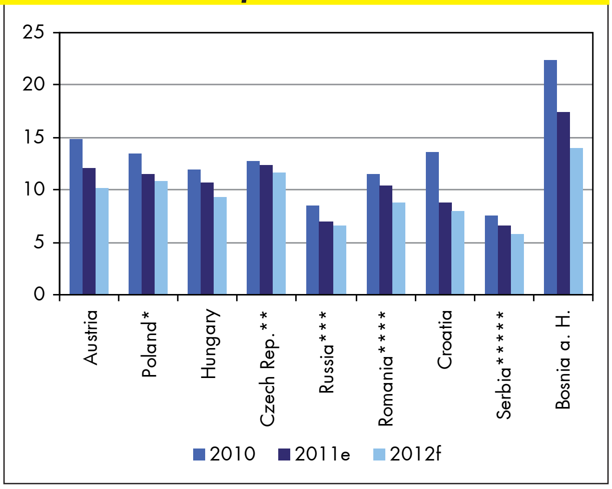
Source: Raiffeisen RESEARCH

Market capitalisation ZSE

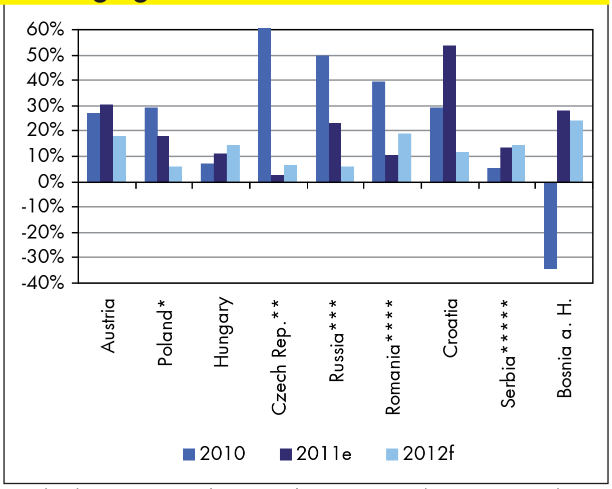


Sources: Zagreb Stock Exchange, Raiffeisen RESEARCH

P/E ratios in comparison

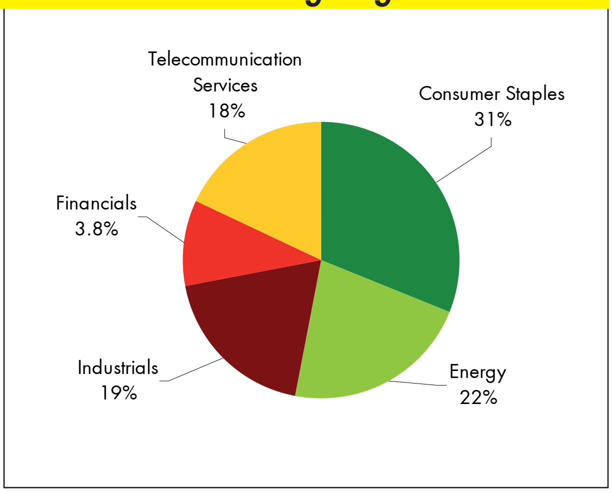


Earnings growth



** Poland (WIG 20): excl. CEZ and PZU; ** Czech Rep. (PX): excl. Erste Group, Vienna Insurance Group and ECM Real Estate; *** Russia (MICEX): excl. Inter RAO, Sberbank Pref., Surgutneftegaz Pref.; **** Romania (BET): excl. BVB, Fondul Proprietatea and SSIF Broker; ***** Serbia (BELEX15): excl. Alfa Plam, Messer, Imlek, Tigar and Veterinarski*
Source: Thomson Reuters, IBES, Raiffeisen RESEARCH

CROBEX10 sector weightings



Source: Bloomberg, Raiffeisen RESEARCH

pre-accession negotiations and accession of 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 European Parliament could then vote in favour of membership in the autumn. We see accession in 2013 as a realistic objective for Croatia and thus believe that the long-term growth outlook for the Zagreb exchange has a good foundation.

Further support should also come from the still moderate valuations, which point to a significant discount compared to many other Eastern European counterparts. Based on estimated corporate earnings for 2011 (+54%) the price earnings ratio comes to 8.8 on an aggregate index basis, leaving the names in the CROBEX10 looking very attractive. With a dividend yields of 4.0% at the index level, Croatian names represent an interesting alternative to low-yielding sight deposits.

If global economic conditions remain positive, we also expect to see positive development on the Croatian stock exchange for the rest of the year. The growing confidence in the wake of the economic recovery is increasingly being reflected in more portfolio investment by non-resident investors, who wish to position themselves in a market with good opportunities but also higher volatility. One positive driver for the future development should be more and more investment by private investors, along with increasing involvement of non-resident investment funds and domestic pension funds.

Capital increases

In the upcoming period, the Croatian market expects two capital increases: Luka Ploče and Dalekovod. Luka Ploče is required to make significant capital investments which will increase intake capacities and management of Dalekovod will propose to the AGM two options for a capital increase: to find an international institutional investor with up to EUR 25 mn of capital contribution through the long-term Equity Credit Line for up to 25% of equity or to make a public offer on the domestic or international market and increase shareholders equity by a maximum of 50% (shareholders equity was as at 31 March 2011: HRK 229.4 mn). According to media, Podravka could tap between HRK 500 and 700 mn and Luka Ploče will attempt to raise up by HRK 132 mn.

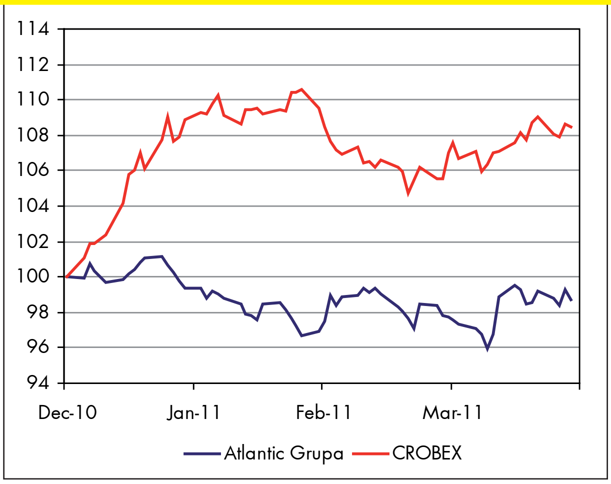
Atlantic Grupa
benefits from synergies

- **Share price (06.05.2011): HRK 747**
- **Market capitalisation: HRK 2,494 mn**

Atlantic Grupa is a Croatian multinational company, one of the largest manufacturers and the leading distributor of FMCG in the SEE region. Atlantic Grupa is the leading European producer of sports nutrition and regional leader in vitamin instant drinks and food supplements production. The company is also involved in the production of personal care products. Distribution activities cover a range of premium international consumer brands. Atlantic Grupa also operates a pharmacies chain under the brand name Farmacia. The latest acquisition was Droga Kolinska (100% stake), the largest Slovenian F&B company, which occurred in 2010. The total transaction value was EUR 382 mn, which implies an EV/EBITDA multiple of 8.6x. As the rationales for acquisition of Droga Kolinska, the management points out compatibility of markets and product assortment and enhancement of the Atlantic's presence on the Russian market. The management sees the greatest synergy potential of Droga Kolinska in the Croatian market given its current low presence there. Growth is to be achieved via a shift to Atlantic Grupa's strong distribution network, introduction of Droga Kolinska assortment to leading retail chains and the HoReCa channel.

After the Droga Kolinska acquisition, Atlantic Grupa is now a strong regional F&B manufacturer with a regional network of production facilities supported by a developed distribution network and know-how. The sales profile will be considerably changed, with decreased exposure to the Croatian market and the Serbian market becoming the second largest market. In 2011e we expect positive GDP development in all SEE markets with a mild recovery in household consumption. Some stronger sales growth rates are expected in Pharma and Sports and Functional Food Division, through consolidation of six additional pharmacies and better performance on the Spanish market due to establishment of a local company, respectively. An almost doubled share of own brands in the overall product portfolio will enhance operating profitability. Furthermore, we expect to see some synergy potential through joint distribution, logistics, supply and marketing. Although we expect some adverse impacts in the near term from rising input prices and increased currency risk related to increased exposure to depreciating RSD, we see quite some potential in the mid to long term. Hence, we see the consolidated EBITDA margin at 11.5% in 2011e, advancing to 12.5% in 2015e.

Share price and index



31 December 2010=100
Source: Bloomberg, Raiffeisen RESEARCH

Income statement and balance sheet

HRK mn	2011e	2012e	2013e	2014e
Sales	4,627.6	4,832.2	5,048.3	5,247.7
EBITDA	523.7	584.0	623.6	656.6
EBITDA margin	11.3%	12.1%	12.4%	12.5%
EBIT	345.6	408.1	448.3	481.9
Net income	75.2	136.7	174.9	215.2
Net margin	1.6%	2.8%	3.5%	4.1%
Total assets	5,322.6	5,263.2	5,296.5	5,378.9
Shareholders equity	1,445.9	1,562.6	1,705.5	1,880.6
NIBD	2,351.1	2,246.0	2,107.5	1,938.0

Source: Atlantic Grupa, Raiffeisen RESEARCH

Key ratios

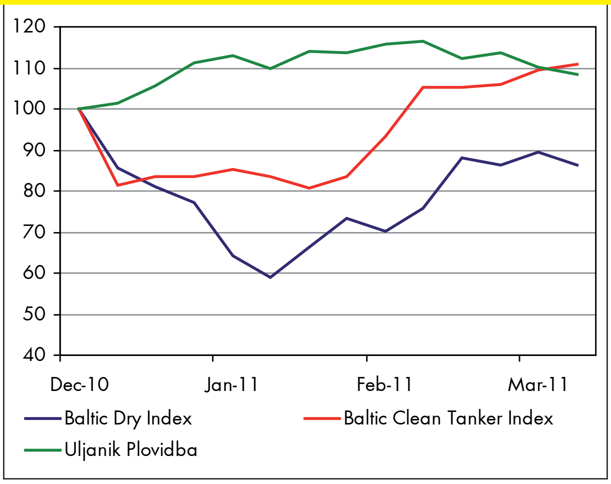
	2011e	2012e	2013e	2014e
EPS	22.6	41.1	52.5	64.6
P/E	33.8	18.6	14.6	11.8
CFPS	76.8	87.7	102.7	116.0
P/CF	9.9	8.7	7.4	6.6
BPS	434.2	469.3	512.2	564.8
P/B	1.8	1.6	1.5	1.4
Dividend yield	0.8%	1.3%	1.6%	2.1%
ROE	5.3%	9.1%	10.7%	12.0%
EV/EBITDA	9.4	8.3	7.5	6.9

Source: Atlantic Grupa, Raiffeisen RESEARCH

Uljanik Plovidba
young fleet - fresh profits

- **Share price (06.05.2011): HRK 583**
- **Market capitalisation: HRK 346 mn**

Share price and index



31 December 2010=100
Source: Bloomberg, Raiffeisen RESEARCH

Income statement and balance sheet

HRK mn	2011e	2012e	2013e	2014e
Sales	276.5	415.3	459.0	543.3
EBITDA	133.2	221.6	243.2	301.1
EBITDA margin	48.2%	53.3%	53.0%	55.4%
EBIT	27.3	104.7	114.9	183.5
Net income	51.3	116.0	121.3	189.8
Net margin	18.5%	27.9%	26.4%	34.9%
Total assets	1,901.9	2,181.3	2,289.6	2,276.7
Shareholders equity	652.4	746.6	846.2	1,014.2
NIBD	993.1	1,160.5	1,093.8	896.9

Source: Uljanik Plovidba, Raiffeisen RESEARCH

Key ratios

	2011e	2012e	2013e	2014e
EPS	94.8	214.5	224.4	351.0
P/E	6.5	2.9	2.7	1.8
CFPS	393.4	473.3	537.9	588.3
P/CF	1.6	1.3	1.1	1.0
BPS	1206.8	1381.1	1565.2	1876.0
P/B	0.5	0.4	0.4	0.3
Dividend yield	6.6%	6.6%	6.6%	6.6%
ROE	7.9%	15.5%	14.3%	18.7%
EV/EBITDA	10.0	6.7	5.9	4.1

Source: Uljanik Plovidba, Raiffeisen RESEARCH

The company owns and operates a fleet of dry bulk carriers and tanker ships. The three dry bulk ships of up to 56,000 dwt and five tankers of up to 52,600 dwt capacity each are contracted in time charter terms. The fleet is considered young, at around 4 years on average, and is therefore, together with time charter contracting, more efficient. Due to time charter and mix of dry bulkers and tankers, revenues were fairly stable through the recession. Further fleet enlargement is expected in next two years, with one tanker and four bulkers. Altogether, the fleet will number 13 ships and have a capacity of 673,000 dwt in 2013. However, the global dry bulk market is also expecting the enlargements of the capacities, especially in panamax and larger ships, but also in total supramax fleet, which could lower freight rates in this segment in next 12-18 months, despite the high demand for iron ore from the Emerging Markets and potentially higher activity triggered by Japan's higher demand for construction materials. In addition, low scrap activities make the supply even more overloaded. However, Uljanik Plovidba's tanker fleet (MR's) could be busy in transporting oil products and chemicals and the freight rates in this segment are expected to rise in next few years following the global recovery. In more detail, we expect company's contracted rates to slide from an average 22,400 USD/day in 2010 to 18,000 USD/day in 2013 in the bulker fleet, and tanker rates contracted to move from average 14,000 USD/day in 2010 to 18,000 USD/day in 2013. Therefore, the expected growth in revenues for Uljanik Plovidba is based on increasing fleet and the trade off between the two freight rates momentum. Similar to sales, operating profitability is expected to be higher but burdened by new ships arrivals, due to initial costs of equipping and higher depreciation. Since Uljanik Plovidba group is organised on a one ship-one company, consolidated results in its reports include the income from dividends received from member companies and we estimate this dividend policy to continue. The sensitivity to FX changes in USD/HRK is somewhat limited, due to natural hedge between revenues and most of the expenses as well as between market value of the fleet and majority of the debt denominated in USD.
According to Q1 2011 report, as at March 31, 2011 the fleet is reported at USD 305.5 mn in market value and net debt stood at USD 184.5 mn, including the recently acquired tanker Pomer. This makes the coverage of 1.66x. All ships are ordered from shipyards in Croatia which entitles the purchase for the state subsidy and lowers the share of debt financing. The 2010 dividend amounts to HRK 61 per share (2010: 34% payout; 2009: 39%).

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Company:	*Disclosure:*
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Agora	-
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Krka	-

Detailed disclosure and disclaimer on the aforementioned companies as well as on the "coverage universe" of Raiffeisen Centrobank pursuant to § 48 Stock Exchange Act: http://www.rcb.at.

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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