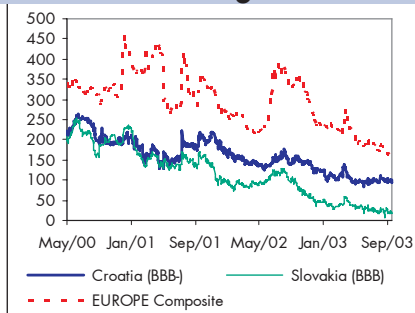


Strategy Croatia

October 2003

Croatian spread - some room for convergence? *



*(EUR EMBIG spreads bps); Source: Thomson Financial Datastream; RZB-Group Research

Recommendations (Horizon: Q4 2003 & Q1 2004)

Bond market

Sell

EUR-linked HRK bonds

Hold

Croatian sovereign eurobonds

Stock market

Hold

CROBEX

Buy

Pliva

Hold

Podravka

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Highlights

■ Croatia's parliamentary elections have been scheduled for late November 2003. Recent surveys show HDZ as the individually strongest party, which, in case it won the majority vote (around 20%-25% of seats in the parliament) would be in a position to form a new coalition government with HSL, DC and HSP, together winning a possible 15% to 20% of overall seats.

■ The overall public debt (both domestic and external) totalled 46% of the GDP in 2002. Analysis of the maturity structure of Croatia's debt clearly shows that the lion's share of its external debt is long-term as around 80% matures in over a year. So Croatia does not have a problem with the so-called hot capital, flowing quickly in and out of the country.

■ Economic growth in 2003 will exceed expectations, so we revised our forecasts from 3.5% to 4.2%. However, we expect an economic slowdown, because of the monetary tightening aimed at curbing twin deficit (balance-of-payments and budget balance), which for the third consecutive year has been at very high levels.

■ Croatia's 2003 budget is under a lot of pressure from two sides: firstly, this is an election year, which has largely determined budgetary expenditures, and secondly, there is the IMF with its clearly set targets, according to which the 2003 central government budget deficit should not exceed 4.6% of Gross Domestic Product (GDP).

Key figures

	1999	2000	2001	2002	2003e	2004f	2005f
Nominal GDP (USD bn)	19.9	18.4	19.5	22.5	28.0	31.2	34.2
Nominal GDP per capita (USD)	4,396.7	4,098.9	4,402.4	5,075.5	6,309.9	7,038.7	7,707.1
Real GDP (% yoy)	-0.4	2.9	3.8	5.2	4.2	3.0	3.5
Gross industrial production (% yoy)	-1.4	1.7	6.4	5.5	4.5	3.3	3.6
Unemployment rate (% , avg)	19.1	21.2	22.0	22.3	19.2	17.5	16.0
Consumer prices (avg, % yoy)	4.2	6.2	4.9	2.2	1.8	2.4	2.9
Consumer prices (eop, % yoy)	4.4	7.4	2.6	2.3	1.9	2.5	3.4
General budget balance (% of GDP)	-6.4	-6.9	-6.8	-6.0	-5.0	-4.5	-4.0
Exp. of goods/services/inc. (USD bn)	8.37	9.01	9.63	10.55	12.48	12.91	13.83
Imp. of goods/services/inc. (USD bn)	-10.40	-10.35	-11.74	-12.71	-14.76	-15.12	-15.39
Current account balance (USD bn)	-1.40	-0.44	-0.84	-1.59	-1.82	-1.60	-1.41
Current account balance (% of GDP)	-7.0	-2.4	-4.3	-7.0	-6.5	-5.1	-4.1
Official FX-reserves (USD bn)	3.0	3.5	4.7	5.9	6.8	6.8	6.9
Official FX-reserves (% GDP)	15.2	19.1	24.1	26.1	24.3	21.9	20.3
External debt (% GDP)	50.1	60.0	57.6	68.2	73.2	68.8	65.8
HRK/USD avg	7.11	8.28	8.34	7.83	6.71	6.35	6.16
HRK/USD eop	7.65	8.16	8.29	7.09	6.60	6.15	6.18
EUR/HRK avg	7.58	7.64	7.47	7.41	7.54	7.64	7.71
HRK/EUR eop	7.68	7.60	7.37	7.44	7.59	7.69	7.73

Source: CNB; Croatian Statistical Office; WIIW; RZB-Group Research

Croatia

Content

Content	2
Summary	3
Focus on ... External debt to remain under close watch	4
Structural Information	6
Political Situation	7
External Environment	8
Real Economy	10
Inflation & Fiscal Policy	12
Monetary Policy & Balance of Payments	13
Exchange Rate	14
Structural Issues	15
Croatian Banking Sector	15
Privatisation	16
Foreign Trade	17
Debt Market	18
Stock Market	20
Acknowledgements	23

Croatia

Summary

Politics

Croatia's parliamentary elections have been scheduled for late November, not a full four-year period after the last, held on 3 January 2000. While negotiations among HDZ, HSLs, DC and HSP on a possible pre-election coalition agreement have not been completed, the possibility of them entering one after the elections is not at all unreal. Judging by recent opinion polls, no single party would be able to gain the absolute majority in the Parliament. Recent surveys show HDZ as the individually strongest party, which, in case it won the majority vote (around 20%-25% of seats in the parliament) would be in a position to form a new coalition government with HSLs, DC and HSP, together winning a possible 15% to 20% of overall seats. Since such a centre and centre-right coalition would probably not obtain the absolute majority in the parliament, it would either have to accept additional coalition partner(s) of form a minority government.

Economy

Economic growth in 2003 will exceed expectations, so we revised our forecasts from 3.5% to 4.2%. The room for this upward revision has been created by robust results in the segments of industry, trade and gross capital formation. The third quarter GDP is expected to come in at some 4.5% due to good tourism results, which have this year registered a mild improvement of physical indicators (over-night stays and tourist arrivals) and very good financial indicators. The fourth quarter will be marked by a slightly lower GDP growth rate of around 2.5%. Further, we expect an economic slowdown, because of the monetary tightening aimed at curbing twin deficit (balance-of-payments and budget balance), which for the third consecutive year has been at very high levels. Therefore, in 2004 the already implemented monetary tightening altogether with possible additional measures directed at curbing retail credit growth, which is primarily financed by banks borrowing abroad, will slow-down GDP growth.

According to our projections next year inflation will hit again below 3%. Prices of services have continued to grow at a faster pace than before, but prices of goods increased at lower rates due to intense competition and high merchandise imports. Since prices of goods account for the largest share of the retail basket (74.51%), they will continue to dominate the movements of retail prices. Croatia's

2003 budget is under a lot of pressure from two sides: firstly, this is an election year, which has largely determined budgetary expenditures, and secondly, there is the IMF with its clearly set targets, according to which the 2003 central government budget deficit should not exceed 4.6% of Gross Domestic Product (GDP). The government generated substantial expenditures in the first half of the year by pouring funds into its road and motorway construction companies. However, based on other available data we think 2003 budget deficit will mildly exceed 5% of GDP.

Bond Market

Prices in the domestic market decreased, largely due to exchange rate movements, while movements in foreign markets, where yields have been on the rise because of favourable economic conditions (especially in the U.S.), have only had a mild influence. The kuna appreciation in July, and again at the end of August brought about a price growth, while the beginning of August witnessed a decline, stopped by the mentioned appreciation of the kuna. Nevertheless, the exchange rate movement, which influenced a price rise of domestic issues, was the factor that led to a substantial spread narrowing of domestic EUR-linked notes, vis-a-vis Croatian Eurobonds or European benchmarks. The only 'pure' Kuna bond, the 5-yr HRK issue, registered a turnover volume of over a half billion kuna. After the issue the prices went up, and yield to maturity lowered to 5.6%. However, the reduced liquidity of the domestic market and mounting pressure from increase in HRK interest rates, prompted increase of yield on this bond to the level of over 6.5%. The spread of Croatian Eurobond's longest maturities ranges between 100 and 110 basis points and is for the time being not particularly sensitive to poor external debt and balance of payments indicators.

Stock Market

At the end of August 2003 compared with 2002, market capitalization at the Zagreb Stock Exchange increased by 16.5% in domestic currency. This was a result of the new Act on Securities Market pursuant to which certain public limited companies have to be listed in the quotation of public limited companies. Pursuant to the law they were obligated to list their shares by July 25, 2003. At the end of August the market capitalisation of Zagreb Stock Exchange totalled 31,985 HRK million.

External debt to remain under close watch

Any attempt to explain the cause for Croatia's large external debt without taking into account its balance-of-payments and central government budget could simply be called superficial. When examining external debt of a country one must also take into account the movements of its balance-of-payments because the two are inseparable. The structure of Croatia's imports has changed in recent years. The share of capital goods, as a prerequisite for increase in gross capital formation, has gone up. GDP indicators show that gross capital formation, which can only be generated through imports, has increased, and financing import has in turn created external debt. The positive side to the entire process is the fact that external debt has partly been used to generate added value.

The so-called transition is a process of convergence of countries on the margins of the global market-oriented society on its very centre. This is a process during which commodity prices and other production factors (such as the price of labour) are being harmonised. In order to be able to go through transition or the process of convergence countries need large investments that greatly surpass domestic saving levels. During transition balance-of-payments current accounts go through long deficit periods, which mirrors the fact that investments exceed domestic savings.

In other words, when we accept that balance-of-payments deficit is commonplace during transition and that possibilities for stimulating growth of domestic savings are limited, short-term, we must ask, what the best way to finance this deficit, i.e. investments, would be.

There are basically only three answers to the question: firstly, by reducing residents' foreign assets, secondly, by borrowing abroad, and thirdly, through foreign investments. Unfortunately, attracting foreign investments in the form of so-called Greenfield projects has not produced desired results in Croatia, so the only solution left has been borrowing abroad.

As already mentioned, in order to make a good analysis of Croatia's external debt we must start with the analysis of its balance-of-payments current account, which has deteriorated over the last three years. There is a clear link between the steep rate of external debt growth and widening balance-of-payments deficit, which started its speedy expansion already in 2001 when it reached 4.2% of GDP. In 2002, it reached the troublesome 7.1% of GDP. Realistically speaking, a country in transition

cannot avoid having a balance-of-payments deficit. This year's figure is expected to come in at 6.5%, however, this projection is to be treated with some caution since there is still a substantial share of imports to be included into final spending results. In this context, it would be difficult to not to mention the fact that after a long time Croatia's citizens have been able to enjoy the material benefits offered by a Western economic system, and in doing so easily borrowed money from their banks at cheap (one-digit) interest rates. Financial institutions have adjusted to the situation and tried to satisfy demand, which peaked in 2002. However, this year has so far been showing first signs of reduced growth.

In addition to strong personal consumption, we should mention that the government uses both domestic as well as foreign sources of finance for covering its deficits, which again creates external debt, because neither banks nor other financial institutions have enough own funds to satisfy demand. Government's increased demand for sources of finance in domestic financial market has resulted in a textbook case of so-called "crowding out" of the private sector.

In Croatia, the share of public sector in the country's external debt is relatively good (around 41%), showing a declining trend (in July 2003 it dropped to 38%). Public sectors of countries that have gone through financial crises accounted for substantially higher shares of their external debt than it is the case in Croatia, which unlike some other countries, has passed a regulation preventing local governments from borrowing abroad as well as limited their borrowing with domestic banks.

The overall public debt (both domestic and external) totalled 46% of the GDP in 2002. Based on this indicator, Croatia is well behind countries like Hungary, Poland and Bulgaria and way behind countries that have faced financial crises - Turkey and Argentina. The 28.1% share of public sector external debt in GDP is relatively high, but if we were to exclude inherited debt regulated by Paris and London club it would drop to 20%. Nevertheless, this is still above the share of other CEE countries, but behind countries that have faced financial crises.

■ **Has Croatia's debt entered dangerous territory?**

This is the question many people have been waiting the answer to. However, giving an accurate and a simple one is not very easy, because different indicators lead to different conclusions. For instance, the share of external debt in GDP indicates that Croatia's debt has entered dangerous territory, since it has almost reached the levels Turkey saw in 2001 when it was hit by a financial crisis. On the other hand, when looking at the share of external debt in merchandise and services exports, results are much better and indicate that Croatia is still far from the territory other countries were at when hit by financial crises. Croatia's overall public debt is also at lower levels. For example, in Turkey the share of public debt in GDP prior to the crisis was 103.5%, while in Croatia this year it is below 50% of GDP, bringing us to the answer: no, Croatia's debt has not yet entered dangerous territory.

Analysis of the maturity structure of Croatia's debt clearly shows that the lion's share of its external debt is long-term. Around 80% matures in over a year, so Croatia does not have a problem with the so-called hot capital, flowing quickly in and out of the country. In addition to the government, banks and companies also account for a certain share of external debt, which is in a way reassuring because in assessing Croatia's credit repayment abilities foreign creditors must have decided that it was able to service its debts. Nobody would have approved loans to companies or banks if suspecting even the slightest possibility of default. Furthermore, banks that have borrowed abroad are foreign-owned, which in itself provides certain repayment guarantees, leading us to the conclusion that it is in the interest of foreign creditors to give loans only to reliable clients.

The euro-dollar exchange rate movements have been one of the major factors influencing the overall amount of external debt and its oscillations. According to estimates, around 20% of external debt is in dollars, which means that the remaining 80% is sensitive to changes in the dollar exchange rate. Within this context, the dollar slippage against the euro accounted for 44% of the overall debt growth. The dollar's slippage at the end of the third quarter will again raise the dollar value of external debt.

FX reserves are too one of significant indicators often measured against external debt. They can be used for maintaining a country's short-term liquidity

and absorbing shocks in situations when borrowing in foreign markets is either difficult or impossible. If we measure Croatia's short-term debt as at end of May against its FX reserves it is visible that they are double the size.

In this context is of utmost importance that Croatia maintains its current investment rating (BBB-/Baa3) and a stable economy, and last but not least, cooperates with international financial institutions such as the International Monetary Fund, the World Bank and others. The country's rapprochement with the EU has been one of the most important goals Croatia accomplished, helping it bear the burden of its high external debt more easily.

External debt (%GDP)

	1999	2000	2001	2002	2003e
Argentina	51.2	51.6	52.2	132.9	110.1
Turkey	56.3	59.6	76.9	71.9	57.0
Bulgaria	81.0	85.9	77.3	70.8	65.7
Croatia	50.1	60.0	57.9	67.8	75.0
Chile	46.8	48.7	55.8	60.9	59.5
Slovakia	52.1	55.0	55.1	55.6	41.7
Hungary	60.6	65.4	63.4	52.7	45.8
Poland	42.1	42.3	39.2	44.0	47.1
Czech Rep.	41.1	41.6	38.2	38.2	34.5
Mexico	33.6	25.6	23.4	22.9	23.1

Source: RZB-Group Research

Basic information and main features

Structural information

Land Area	56.538 sq. km
Population	4,437,460 (2001)
Capital city	Zagreb
Fiscal year	Jan 1st - Dec 31st
Currency	Kuna (HRK)

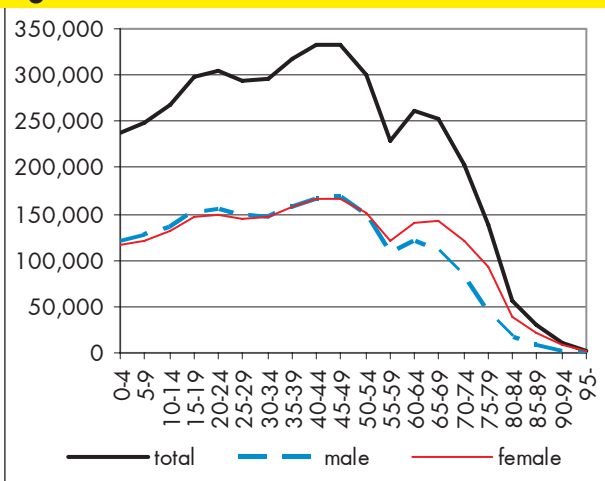
Source: Croatian National Bank, Croatian Bureau of Statistics

Foreign currency rating

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

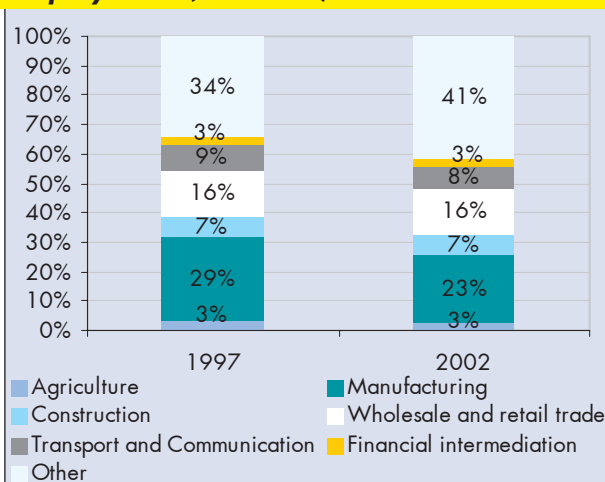
Note: On 10th Sep 2003 S&P affirmed its outlook on "stable"; on 14th January 2002 Moodys changed Croatia outlook from "negative" to "stable"; on 8th July 2003 Fitch changed outlook from "stable" to "positive"

Age distribution, 2001 census



Source: Croatian Bureau of Statistics

Employment (% of total)



Source: Croatian Bureau of Statistics

Major cities (population 2001)

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

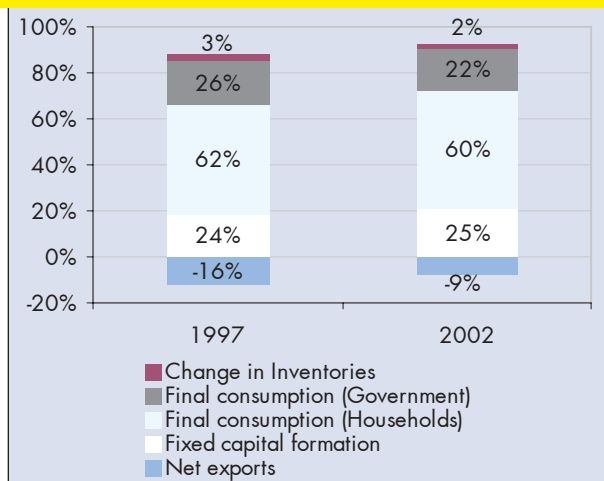
Source: Croatian Bureau of Statistics

GDP 2002

USD mil, current prices	22,558
USD, per capita	5,084
real growth rate, %	5.2

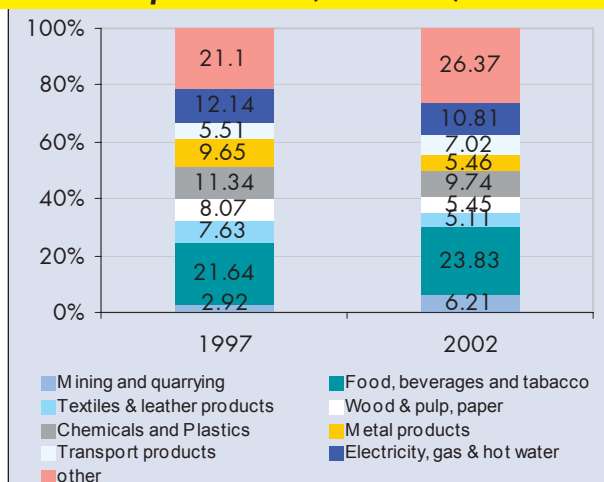
Source: Croatian Bureau of Statistics

GDP: demand side (% share)



Source: Croatian Bureau of Statistics

Industrial production (% of total)



Source: Croatian Bureau of Statistics

New elections old/new government

Croatia's parliamentary elections have been scheduled for early November, not a full four-year period after the last, held on 3 January 2003. The last four years have not been dull: from ups and downs within the governing coalition to old parties dissolving and new ones coming to the scene, mostly through old ones splitting in twos. As a result, since the last election the number of parties in the Croatian parliament (Sabor) has gone up from 12 to 17. This disintegration of several parties, especially on the right side of the political spectrum, created a need for negotiating different coalitions before the elections. While negotiations among HDZ, HSLs, DC and HSP on a possible pre-election coalition agreement have not been completed, the possibility of them entering one after the elections is not at all unreal. Only a group of small centre-right parties has managed to agree on a pre-election coalition agreement. Judging by recent opinion polls, no single party would be able to gain the absolute majority in the Parliament. Recent surveys show HDZ as the individually strongest party, which, in case it won the majority vote (around 20%-25% of seats in the parliament) would be in a position to form a new coalition government with HSLs, DC and HSP, together winning a possible 15% to 20% of overall seats. Since such a centre and centre-right coalition would probably not obtain the absolute majority in the parliament, it would either have to accept additional coalition partner(s) or form a minority government, which is less likely.

There is a greater likelihood that the next government will be formed by current, the governing, centre-left coalition members, but with a changed division of powers. The prime minister might again come from SDP's ranks. The following two government candidates and current governing coalition members HSS and HNS are expected to do much better than in the 2000 elections, while the two liberal parties in the current governing coalition, LIBRA and LS are currently thought to have an unrealistically high number of representatives (8.6%) in the parliament and are not expected to win as much this time round. The present government is expected to bear the fruits of the strong gross capital formation - particularly in the construction and road-building segments - and rapprochement to the European Union.

Upcoming elections are special in so far that the next government might be the one to lead Croatia to the very doorstep of the European union (Croatia's full membership is expected by 2008), which in itself would be enough to remain in power for another term.

Main political parties in parliament

Ruling Coalition	Party leader	Orientation
Socialdemocratic Party (SDP)	Ivica Racan	Center-left
Croatian Peasant Party (HSS)	Zlatko Tomcic	Center-left
LIBRA	Jozo Rados	Center-left
Liberal Party (LS)	Ivo Banac	Center-left
Croatian People's Party (HNS)	Vesna Pusic	Center-left
Opposition Parties		
Croatian Democratic Union (HDZ)	Ivo Sanader	Center-right
Croatian Social Liberal Party (HSLs)	Drazen Budisa	Center
Croatian Bloc (HB)	Ivic Pasalic	Center-right
Croatian Party of Rights (HSP)	Anto Djapic	Center-right
Istrian Deomocratic Party (IDS)	Ivan Jakovic	Center-left
Democratic Center (DC)	Mate Granic	Center

Source: political parties

Election schedule*

Presidential election	January 2005
Parliamentary elections	November 2003

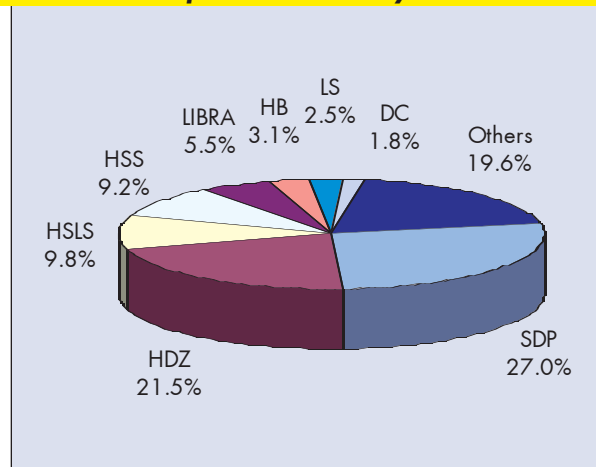
* elections for president are every 5 years, elections for parliament every 4 years

Ruling persons

Function	Name	Party Affiliation
President of the Republic	Stipe Mesic	
Prime Minister	Ivica Racan	SDP
Speaker of the Parliament	Zlatko Tomcic	HSS

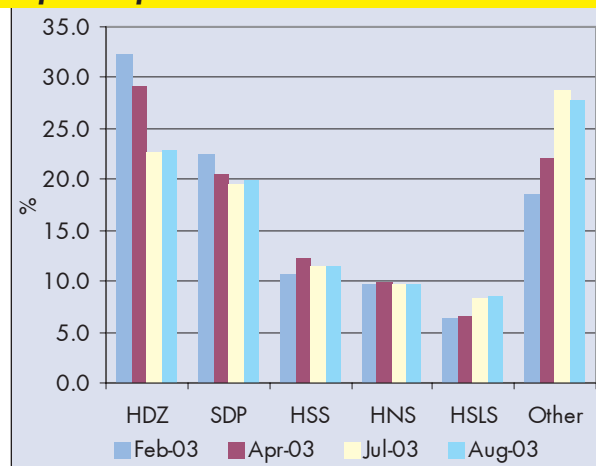
Source: the Government, the Parliament, the Office of the President

Seats in the parliament, July 2003



Source: Croatian Parliament

Opinion polls



Source: Media Metar

Economic indicators Croatia within CEE: Outlook

Real GDP (% yoy)

Countries	2002	2003e	2004f	2005f
Poland	1.3	3.0	3.5	4.0
Hungary	3.3	2.8	3.0	3.5
Czech Rep.	2.0	2.3	3.1	3.8
Slovakia	4.4	4.0	4.7	4.9
Slovenia	3.0	3.0	3.5	4.0
Estonia	6.0	5.5	5.0	5.5
Latvia	6.1	5.5	6.0	6.0
Lithuania	6.7	6.1	5.0	6.0
CEEC-8	2.4	3.1	3.5	4.1
Croatia	5.2	4.2	3.0	3.5
Bulgaria	4.8	4.5	5.0	5.0
Romania	4.9	4.5	5.0	6.0
Serbia a. M.	1.3	3.0	3.5	4.0
Bosnia a. H.	3.8	3.3	5.0	5.8
SEEC-5	4.9	4.4	4.5	5.2
Russia	4.3	6.5	5.0	4.5
Turkey	7.8	6.0	4.5	5.0
EU-12	0.8	0.5	1.7	2.2
USA	2.4	2.6	3.4	2.8

Source: WIIW, IIF (Baltic states), RZB-Group Research

Consumer prices (avg, % yoy)

Countries	2002	2003e	2004f	2005f
Poland	1.9	0.8	1.5	2.3
Hungary	5.3	4.8	6.5	4.4
Czech Rep.	1.8	0.1	2.9	2.7
Slovakia	3.3	8.4	7.5	4.0
Slovenia	7.5	5.5	4.8	4.3
Estonia	3.6	2.8	2.5	2.8
Latvia	1.9	2.6	2.2	2.5
Lithuania	2.5	2.4	2.2	2.2
CEEC-8	2.9	2.2	3.2	2.9
Croatia	2.2	1.8	2.4	2.9
Bulgaria	5.8	1.5	4.0	3.0
Romania	22.5	15.0	12.5	10.5
Serbia a. M.	1.9	0.8	1.5	2.3
Bosnia a. H.	0.4	1.0	1.7	1.9
SEEC-5	13.2	8.5	7.8	6.8
Russia	15.8	13.9	12.2	11.2
Turkey	45.0	25.8	17.5	14.5
EU-12	2.1	2.0	1.8	2.0
USA	1.6	2.2	1.4	2.4

Source: WIIW, IIF (Baltic states), RZB-Group Research

Current account balance (% of GDP)

Countries	2002	2003e	2004f	2005f
Poland	-3.5	-2.5	-2.4	-3.0
Hungary	-4.0	-5.8	-5.2	-4.5
Czech Rep.	-6.5	-6.3	-8.3	-8.4
Slovakia	-8.2	-3.4	-4.6	-5.0
Slovenia	1.7	1.0	0.5	0.5
Estonia	-12.2	-8.7	-8.0	-6.8
Latvia	7.7	7.7	7.6	6.9
Lithuania	-5.5	-5.3	-5.5	-5.3
CEEC-8	-4.1	-3.5	-3.9	-4.0
Croatia	-7.0	-6.5	-5.2	-4.0
Bulgaria	-4.3	-6.0	-5.0	-4.5
Romania	-3.4	-4.0	-3.7	-3.2
Serbia a. M.	-3.5	-2.5	-2.4	-3.0
Bosnia a. H.	-19.9	-15.4	-14.1	-12.0
SEEC-5	-5.5	-5.7	-4.9	-4.1
Russia	9.5	8.1	4.6	3.3
Turkey	-0.8	-2.9	-2.4	-1.3
EU-12	0.8	0.5	0.2	0.0
USA	-4.7	-5.3	-6.0	-5.0

Source: WIIW, IIF (Baltic states), RZB-Group Research

General budget balance (% of GDP)

Countries	2002	2003e	2004f	2005f
Poland	-6.5	-6.0	-6.5	-5.5
Hungary	-9.8	-5.3	-4.5	-3.7
Czech Rep.	-3.9	-6.2	-5.5	-4.8
Slovakia	-7.2	-4.9	-3.9	-3.5
Slovenia	-3.0	-1.6	-1.8	-1.6
Estonia	1.1	1.0	0.4	0.0
Latvia	-2.7	-3.2	-2.9	-1.9
Lithuania	-1.2	-1.2	-1.5	-1.2
CEEC-8	-6.0	-5.3	-5.2	-4.4
Croatia	-6.0	-5.0	-4.5	-4.0
Bulgaria	-0.7	-0.7	-0.8	-0.7
Romania	-2.5	-2.7	-3.0	-3.0
Serbia a. M.	-6.5	-6.0	-6.5	-5.5
Bosnia a. H.	-4.3	-2.2	-2.0	-1.7
SEEC-5	-3.2	-2.9	-2.9	-2.8
Russia	1.4	1.6	0.5	0.5
Turkey	-14.0	-13.6	-12.9	-12.4
EU-12	-2.3	-3.0	-2.7	-2.2
USA	-2.2	-4.0	-5.0	-4.5

Source: WIIW, IIF (Baltic states), RZB-Group Research

Exchange rate LCY/EUR (avg)

Countries	2002	2003e	2004f	2005f
Poland	3.85	4.33	4.47	4.48
Hungary	242.9	251.8	252.9	248.7
Czech Rep.	30.8	32.1	31.7	30.1
Slovakia	42.7	41.5	40.5	39.0
Slovenia	227.0	234.0	239.0	240.0
Estonia	15.6	15.6	15.6	15.6
Latvia	0.55	0.64	0.71	0.8
Lithuania	3.59	3.45	3.45	3.5
Croatia	7.41	7.54	7.64	7.7
Bulgaria	1.96	1.96	1.96	1.96
Romania	31254	36415	41434	45351
Serbia a. M.	3.9	4.3	4.5	4.5
Bosnia a. H.	1.96	1.96	1.96	1.96
Russia	29.7	33.6	35.5	39.5
Turkey	1432343	1652548	1783316	2004133
EU-12	0.95	1.09	1.17	1.25

Source: WIIW, IIF (Baltic states), RZB-Group Research

Exchange rate LCY/USD (avg)

Countries	2002	2003e	2004f	2005f
Poland	4.08	3.97	3.82	3.58
Hungary	255.7	228.9	202.3	198.9
Czech Rep.	32.4	29.4	27.1	24.1
Slovakia	45.3	35.5	32.4	31.2
Slovenia	241.5	214.7	204.3	192.0
Estonia	16.5	14.4	13.4	12.5
Latvia	0.58	0.59	0.61	0.6
Lithuania	3.80	3.17	2.95	2.8
Croatia	7.83	6.92	6.53	6.2
Bulgaria	2.1	1.8	1.7	1.6
Romania	33055	33409	35413	36281
Serbia a. M.	4.1	4.0	3.8	3.6
Bosnia a. H.	2.1	1.8	1.7	1.6
Russia	31.4	30.9	30.4	31.6
Turkey	1514954	1499786	1496561	1603306
EU-12	1.05	0.92	0.85	0.80

Source: WIIW, IIF (Baltic states), RZB-Group Research

Economic growth and deflation

The global economic picture today is characterised by fears of deflation and sluggish economic growth worldwide. While deflation was considered something of a "Japanese phenomenon" (although not literally so) until recently, more and more market watchers are now warning of an increasing risk of deflation in the EU and the US.

These fears have been one of the major motivations for the US Fed to implement very proactive monetary easing, which brought US short-term interest rates close to historical lows. Additional remedies against deflation prescribed by the Fed and the government were fiscal loosening and a weak dollar policy. Furthermore, weaker external balances and especially a growing current account gap made it look worse for the dollar.

Similar concerns dominated Europe as well for the most part. Although deflationary pressure was not explicitly distinct, economic stagnation and growing unemployment set in, topping the agenda of European governments. However, the ECB was less quick to ease interest rates. Likewise, high rates impacted traditionally low inflation/higher cost northern members of the EU while low cost/higher inflation south felt less affected. Economic deceleration also fuelled fiscal problems in Germany and France, as both governments there could not cope with a surging social bill. As a result, they overshot the maximum public deficit ceiling established by the European growth and stability pact. Although recent data may suggest a slow turn around of economy, it might take time before the situation returns to normal.

Interestingly, CEE and SEE countries did fairly well in this difficult global environment. They were able to maintain relatively good economic growth, well above the EU average, and inflationary pressure remained for the most moderate. However, their current account deficits and fiscal imbalances in some cases remained alarmingly high. That said, the economic outlook for CEE and SEE remains rather positive, provided that EU growth accelerates adequately next year. On the monetary side, CEE and SEE will feel pressure from increasing long-term interest rates in the EU, but external financing cost will remain favourable thanks to convergence. In 2004, eight CEE countries plus Cyprus and Malta will join the EU block.

Currencies: FX per EUR

Countries		Dec. 03	Mar. 04	Sep. 04
UK	0.70 ↑	0.69 ↓	0.70 ↓	0.73
Sweden	9.19 ↑	9.00	8.80	8.80
Denmark*	7.43 ↓	7.44	7.44	7.44
Switzerland	1.56 ↓	1.54 ↓	1.52 ↓	1.52
Japan	131 ↑	125 ↓	125 ↓	131
USA	1.12 ↓	1.10 ↓	1.14 ↓	1.25
Canada	1.53 ↑	1.47 ↓	1.50 ↓	1.60

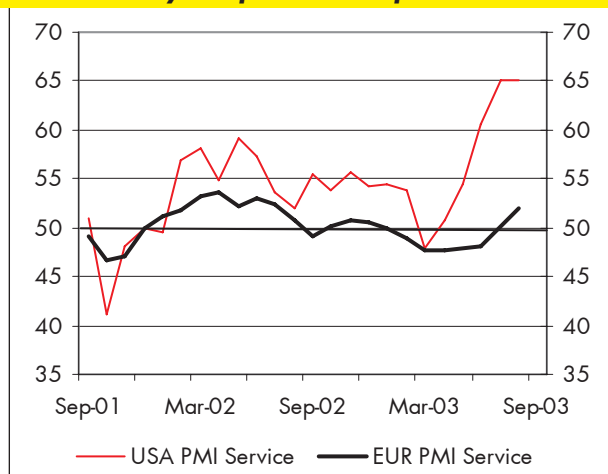
Source: Thomson Financial Datastream, Raiffeisen Research
*Consensus Forecast

Interest rates (3M)

Countries		Dec. 03	Mar. 04	Sep. 04
Euro-12	2.16 ↓	2.15 ↑	2.15	2.20
UK	3.67	3.60 ↑	3.80	3.80
Sweden	2.94 ↓	2.90 ↑	2.90	3.40
Denmark*	2.20 ↓	2.30 ↑	2.30	2.30
Switzerland	0.25	0.25	0.70	0.70
Japan	0.06 ↑	0.10	0.10	0.10
USA	1.14 ↓	1.10	1.10	1.40
Canada	2.85 ↓	2.90 ↓	3.00	3.50

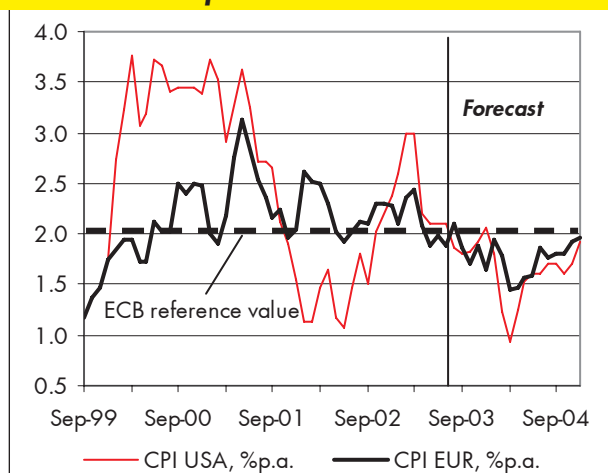
Source: Thomson Financial Datastream, Raiffeisen Research
*Consensus Forecast

US recovery outpaces europe



Source: Thomson Financial Datastream, Raiffeisen Research

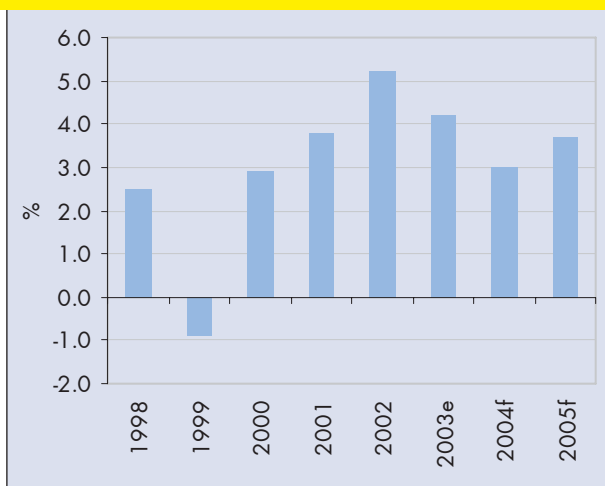
Low inflation pressure



Source: Thomson Financial Datastream, Raiffeisen Research

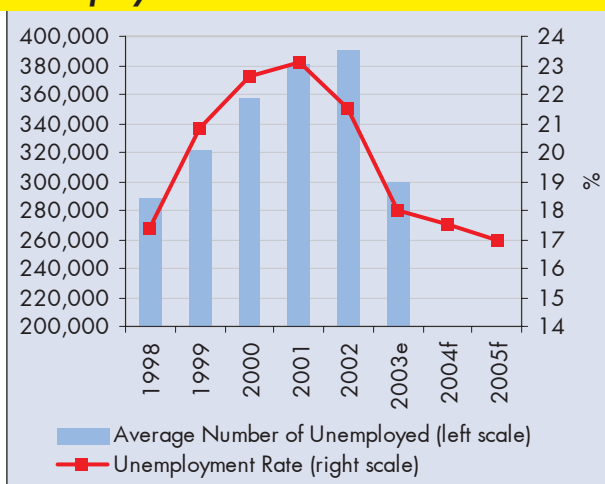
Croatia's pre-election economic upturn

Growth outlook



Source: Croatian Bureau of Statistics, RZB-Group Research

Unemployment



Source: Croatian Bureau of Statistics, RZB-Group Research

External debt and ratios

Quarters	External Debt (USD mn)	External Debt as % of:		
		GDP	Exports of Goods and Services	International Reserves (% of External Debt)
III. 00	10,182	54.0%	117.5%	33.2%
IV. 00	11,055	60.0%	127.6%	31.9%
I. 01	11,329	61.2%	129.6%	31.0%
II. 01	11,370	60.6%	129.0%	33.4%
III.01	11,875	62.1%	126.3%	37.2%
IV.01	11,317	57.9%	117.5%	41.6%
I.02	11,628	58.8%	121.0%	42.0%
II.02	13,401	65.9%	134.8%	41.8%
III.02	13,655	63.4%	132.2%	41.8%
IV.02	15,284	67.8%	144.9%	38.5%
I.03	16,996	70.9%	151.9%	36.5%
II.03	18,560	72.4%	152.2%	36.5%

Source: CNB

Economic growth in 2003 will exceed expectations, so we raise our forecasts from 3.5% to 4.2%. The room for this upward revision has been created by robust results in the segments of industry, trade and gross capital formation. We expect this year's second and third quarter to register high growth rates due to healthy growth in personal consumption and gross capital formation. The third quarter GDP is expected to come in at some 4.5% due to good tourism results, which have this year registered a mild improvement of physical indicators (over-night stays and tourist arrivals) and very good financial indicators (West European tourists with better purchasing power). The fourth quarter will be marked by the parliamentary elections, so in that context we expect it to see a slightly lower GDP growth rate of around 2.5%. After the election we expect an economic slowdown, because of the monetary tightening aimed at curbing so-called twin deficit (balance-of-payments and budget deficit), which for the third consecutive year has been at very high levels. Therefore, in 2004 the already implemented monetary tightening altogether with possible additional measures directed at curbing retail credit growth, which is primarily financed by borrowing abroad will slow down GDP growth. Since economic growth is largely based on aggregate consumption, so any limitations to these growth drivers could quickly, probably some time next year, even bring Croatia's economy into recession.

The decline in the number of registered unemployed persons, started in April 2002, continued this year. Administrative measures by government authorities, which created additional pressure on reducing the number of the unemployed, are expected to bear results also over the next period. However, the announced job cuts in the public sector, if carried out, could push the jobless figures in the opposite direction. In July, the statistical unemployment rate again went down (to 18.5%), but more as a result of the reduction in the number of registered unemployed persons than a rise in the number of employed persons. If this trend continues, the statistical unemployment rate would be pushed further down. According to the ILO methodology Croatia's unemployment rate at the end of 2002 totalled 14.5%, which is still very high if compared with the 11.6% in the pre-recession 1998.

Industry

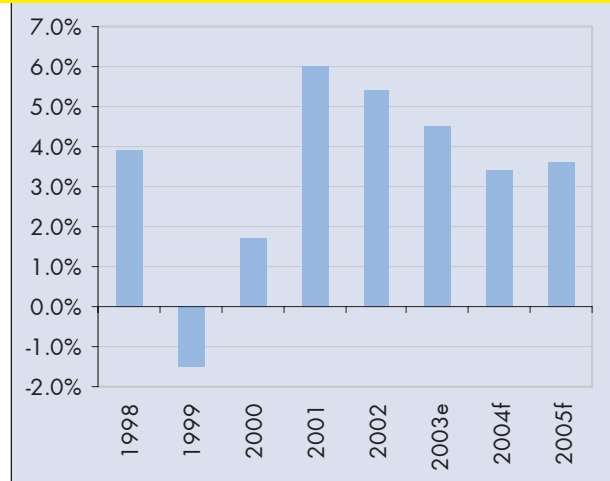
shows first signs of economic slowdown

Robust industrial production growth registered over the first half of this year started slowing down, which is in line with our expectation. However, summer months usually show reducing growth rates, so in order to be able to give an accurate estimate we should wait for the September results to come in. In evaluating the latest industrial production results one should bear in mind the effects of the upcoming elections and the base index, which will probably bring about a reduction in its growth rate. Production of durable goods showed a substantial reduction which could continue over the next period, while energy production is expected to provide impetus to production growth, if the weather permits it. We therefore expect 2003 industrial production to go up by 4.5%, and slow down to a growth rate of 3.4% in 2004.

Trade as a very important segment of Croatia's economy achieved good results again this year. In the first seven months this year it went up by 5.5%, in real terms, which is a decrease from 13% a year ago, resulting from the monetary restrictions aimed at curbing credit growth and merchandise trade deficit. This reduction is most prominent in the segment of car sale, maintenance and repairs, which on annual level in July saw a drop of 15.7%. Our expectations for 2004 trade growth are some 2.1%, in real terms.

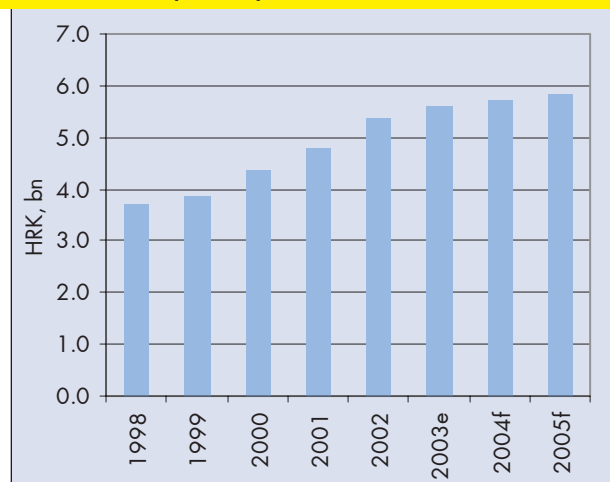
The overall number of tourist over-night stays in the first seven months of this year went up 2%, with over-night stays of foreign tourist going up 2% and over-night stays of domestic tourists going up 7% on a year ago. The over-night stays of foreign tourist in the first seven months of the year would probably had reached an even higher figure had it not been for a 7% decline in the over-night stays of German tourists (traditionally the most numerous). This is thought to be a consequence of the recession the German economy went through in the first half of the year. The times in which Croatia registered high growth rates of tourist over-night stays are over, but there is still room for gradual improvement of tourism related services as well as increase in capacity. Here, a big contribution should come from privatisations of hotels still largely owned by the state. After last year's growth of overall tourist over-night stays of 3.1%, this year's results might even surpass this level. Slightly lower results in the first quarter, resulting from global insecurity related to the war in Iraq, should not have a major influence on overall 2003 results.

Industrial production outlook



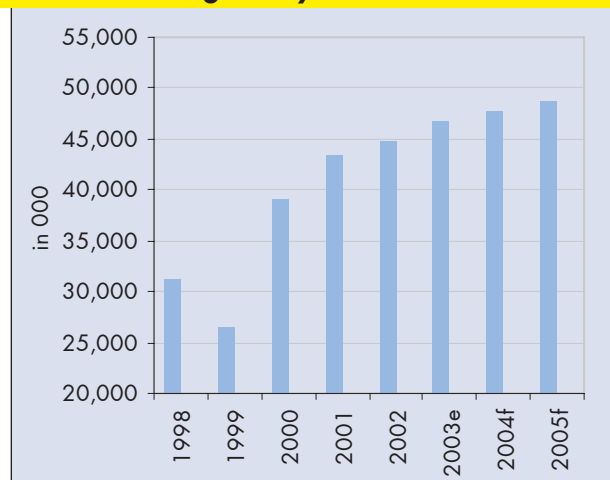
Source: Croatian Bureau of Statistics, RZB-Group Research

Retail trade, total, real



Source: Croatian Bureau of Statistics, RZB-Group Research

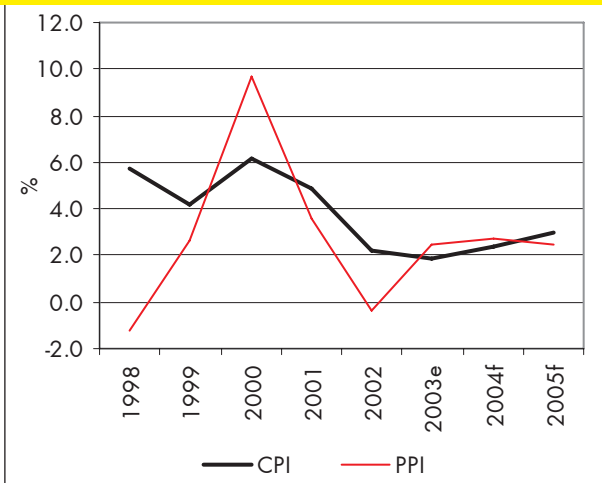
Tourist overnight stays



Source: Croatian Bureau of Statistics, RZB-Group Research

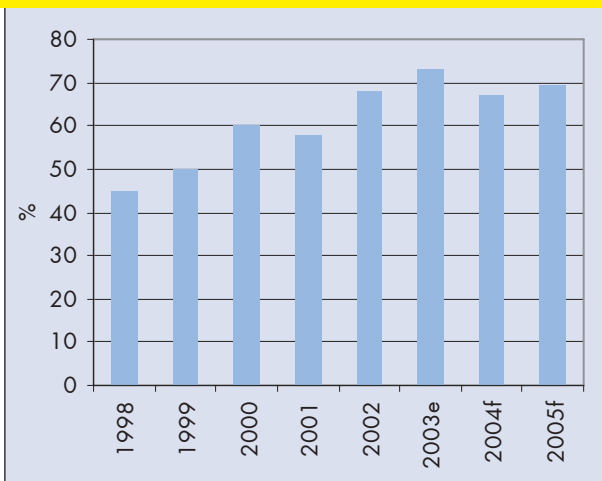
Ten years of low inflation

Inflation outlook



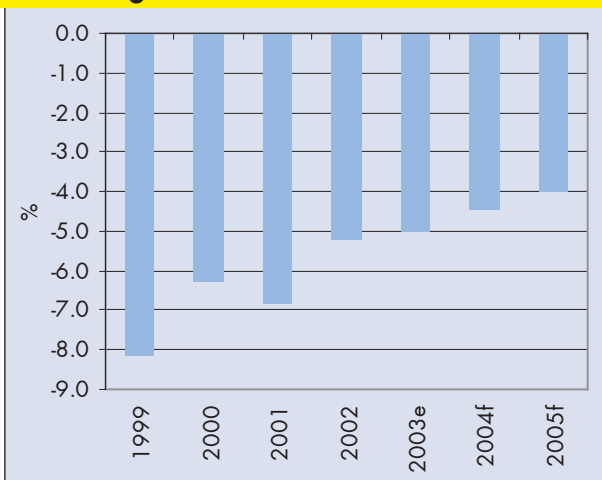
Source: Croatian Bureau of Statistics, RZB-Group Research

External debt, % of GDP



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

General government balance, % of GDP



Source: MoF, RZB-Group Research

Inflation in Croatia has been at very low levels as well as inflation rates in the rest of Europe. In the eight months of 2003 it went up only 1.4% yoy and by the end of the year it is expected to reach the level of 1.9%. Croatia has been seeing low inflation for 10 years, since the implementation of the stabilisation programme in 1993, with this year's low price growth again testifying to the success of the program. According to our projections, next year will also see a below 3% growth rate. Prices of services have continued to grow at a faster pace than before, while commodity prices increased at lower rates due to intense competition and high merchandise imports. Since prices of goods account for the largest share of the retail basket (74.51%), they will continue to dominate the movements of retail prices.

Producers' prices went up 2.5% in the first eight months of 2003, with additional upward pressure created by the increase in prices of retail oil prices, especially in the first half of the year. This year we expect producers' prices to grow at 2.5% on average, while 2004 could see an even higher growth rate.

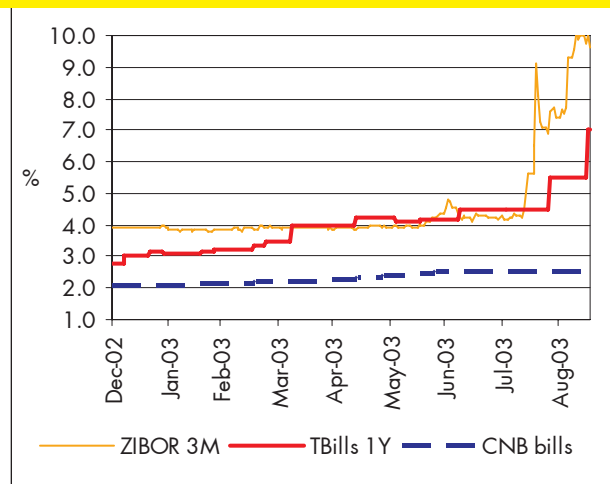
Croatia's 2003 budget is under a lot of pressure from two sides: firstly, this is an election year, which has largely determined budgetary expenditures, and secondly, there is the IMF with its clearly set targets, according to which the 2003 central government budget deficit should not exceed 4.6% of Gross Domestic Product (GDP). The government generated substantial expenditures in the first half of the year by pouring funds into its road and motorway construction companies, which will have a great influence on its rating in the upcoming election. For the time being, the available data on central government budget do not suffice to make a reliable evaluation whether or not the target set by the IMF will be met. However, based on other available data we think 2003 budget deficit will mildly exceed 5% of GDP. Although this is an election year, by entering an agreement with the IMF the government consented to reduce spending. We expect government spending to go down in 2003, in real terms, so we have based all our economic growth projections on this assumption. The 2004 budget will not be passed during this government's term in office. It will rather pass only a preliminary first quarter budget, leaving it to the new government to draw up the annual 2004 budget.

New monetary measures, against balance-of-payments deficit

Recent central bank's measures aimed at discouraging banks from borrowing abroad, thus slowing down external debt growth and reducing balance-of-payments deficit, increased activity in the HRK money market. The market was under pressure from rising demand for the kuna, spurred by the banks' preparing for the implementation of the said central bank's measure (higher percentage of FX reserve requirement is included in the Kuna reserve requirement and allocated in Kuna). Money market interest rate on occasions increased over 10%. Interest rate on 365-day T-bills rose to 7%, the highest level since they were introduced. Additional pressure on interest rates has been created by the fact that a number of treasury bills is maturing in the second half of September, substantially increasing the price of short-term government borrowing. Interest rates are expected to remain at high levels until the end of the year, due to the elections approaching. Year-on-year growth rates of monetary aggregates have been declining. This year due to the slower deposit growth new central bank's measures will also affect their movements. Credits were up 22.1% in July on a year ago, while deposits grew at a rate of 14.1%. Money supply rose 18.8% on a year earlier. The monetary measures introduced this year will reduce credit growth, so the overall growth rate for this year should total 17%, judging by the movements of growth rates so far.

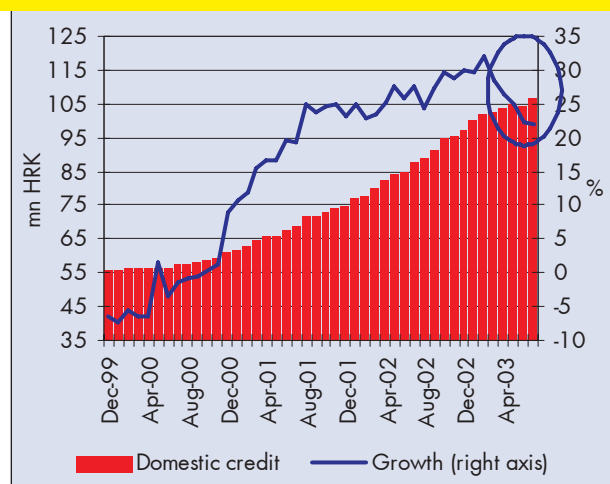
Last year ended with one of the widest balance-of-payments deficits so far, running at 7.1% of GDP, largely as a consequence of the large trade deficit. After this year's first quarter again showed a balance-of-payments deficit, the central bank's governor warned about the balance-of-payments deficit exceeding the level agreed with the IMF. Such a wide balance-of-payments deficit is partly a consequence of a significantly larger trade deficit compared with a year ago. Future balance-of-payment movements will be affected by the projected imports growth, while there are no strong signs of exports recovery in sight. The contribution of services income is usually most pronounced in the third quarter when the balance-of-payments normally registers a surplus. However, tourism, as the most important item to maintaining a stable balance-of-payments current account, this year experienced certain growth limitations. Therefore, we expect this year's balance-of-payments current account deficit at around 6.5% of GDP, which is still very high.

Interest rates



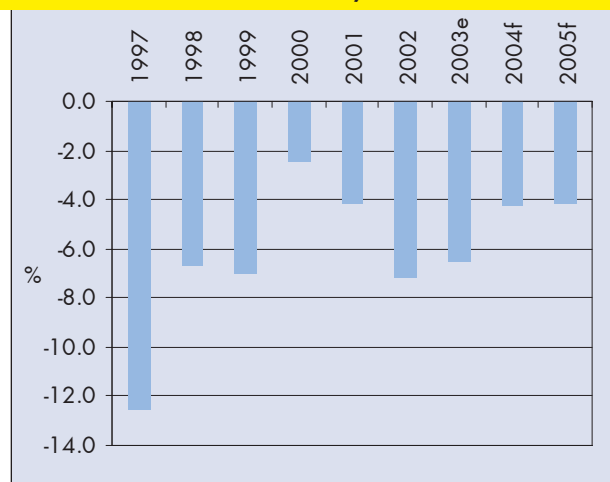
Source: biznis.infoforum.hr, CNB, MoF

Domestic credit



Source: CNB

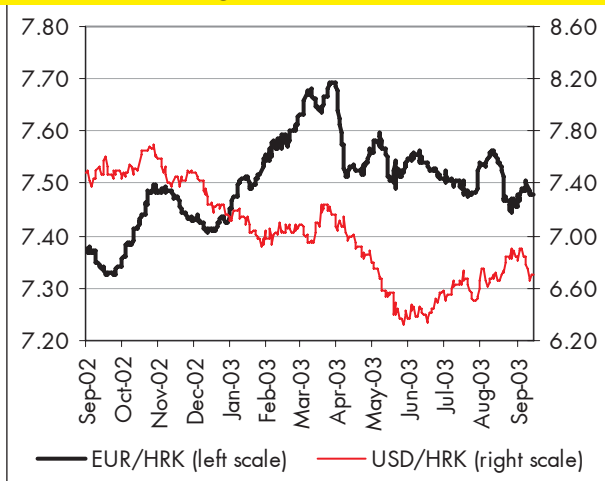
Current account balance, % of BDP



Source: CNB

Monetary measures influence exchange rate

Middle exchange rate of the CNB



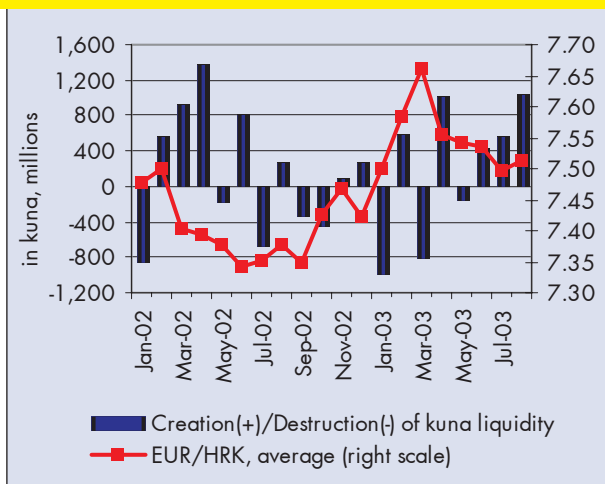
Source: CNB

Middle exchange rate of the CNB

Currency	Middle Exchange Rate	Change Compared to: 1/1/2003		
	9/15/2003	Exch. Rate	Movements	%
EUR	7.4785	7.4519	↑	0.36
USD	6.7053	7.1106	↓	-6.04
CHF	4.8133	5.1286	↓	-6.55
GBP	10.6896	11.4521	↓	-7.13

Source: CNB

CNB operations and exchange rate movements



* effect of FX interventions and auctions of CNB bills on money supply

Source: CNB

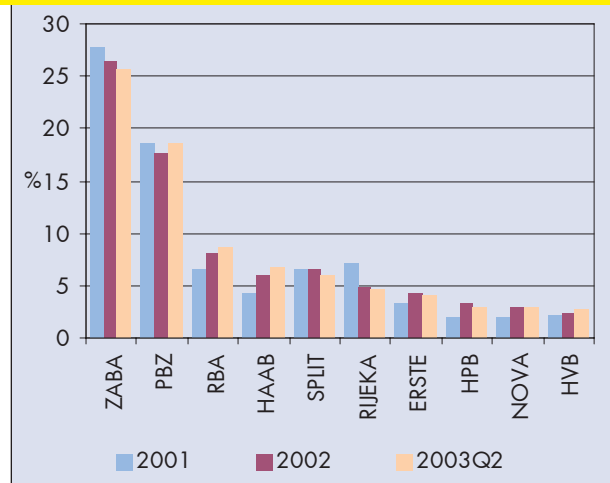
After EUR moving in a range between 7.45 and 7.70 HRK in the first five months of this year, in the following three months the range of the euro exchange rate narrowed to between 7.44 and 7.57. Uncommonly, the Kuna had been gaining strength at the end of June throughout July, to weaken at the end of July amid increased demand for foreign exchange. In the first half of August the kuna slipped because demand for foreign exchange continued to exceed supply. Then, the Croatia National Bank (CNB) announced its new monetary measures as counter to worsening external debt indicators and widening balance-of-payments current account deficit. The announced monetary measures (higher percentage of the calculated foreign exchange reserve requirement is included in the calculated Kuna reserve requirement and allocated in Kuna) increased the demand for kuna in the marketplace since banks are required to meet their shortfall. The kuna firmed to below 7.44 for the euro, despite the expected slippage at the end of August, when commonly large kuna quantities available and increased demand for foreign exchange required to pay for imports result in the kuna depreciation. Reduced demand after building up banks' kuna position put an end to its appreciation. Compared to the dollar, the kuna slipped from 6.33 to nearly 6.90 during the summer, as a consequence of the U.S unit rising to the level of 1.08 to the euro.

Last autumn the central bank reacted to the kuna slippage by holding FX auctions, but this year its new monetary measures prevented the traditional autumn decline of the Croatian unit. CNB had not stepped into the market since the first quarter when it intervened by selling euros in a bid to stop the kuna decline, due to its newly implemented measures, especially the new required A/L ratio, which contributes to a kuna slippage at the end of each quarter. During this year the influence of government transactions on the FX market reduced due to better cooperation between the central bank and the treasury in managing FX needs of the country. Influenced by the effect of central bank's measures, the kuna is not expected to weaken much until the end of this quarter. However, during this year's last quarter and much of the beginning of next year, the exchange rate will be strongly influenced by the effects of the upcoming elections and increased demand for foreign exchange required to pay for large imports.

Consolidation in the banking sector

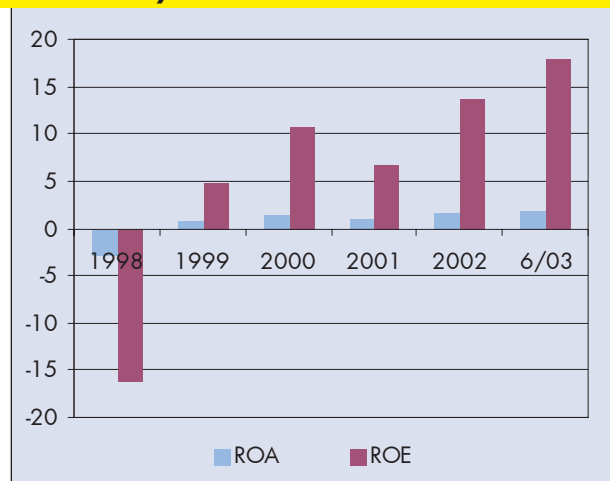
The Croatian banking sector has experienced significant structural changes over recent years. Despite the reduction in the number of banks, resulting from the consolidation in the banking sector (receiverships, mergers and acquisitions), the sector has ceased to be as concentrated. In the middle of 2003, the number of banks went down to 46 and continued reducing on account of new mergers and acquisitions. The two largest banks hold 44% of the market by their share in total banking sector assets, while the four largest together hold 59% of the market. Competition for the third place in the banking market got especially fierce. Still, one of the main characteristics of Croatia's banking sector has been the high share of foreign-owned banks. The majority ownership of 22 banks, holding more than 90% of total banking sector assets, is in foreign hands. Foreign owners have brought the know-how and intensified competition in the domestic market, which resulted in development of new products and services, reduced interests and provided easier access to foreign sources of financing, helping the banking sector stabilise completely from the banking crises of the past. The size of the banking sector in 2002 reached the level of Croatia's nominal GDP, continuing its growth in 2003. In the middle of the year it totalled HRK 182.9 billion (EUR 24.4 billion). Its profitability has also been improved. The return on average assets in 2002 reached 1.6%, while the return on average equity totalled 13.7%. Preliminary data for the first half of 2003 show an improvement to 1.7% and 17.9%, respectively. Asset quality has improved over the past years (less non-performing loans, lower bad debt provisioning and increased capital adequacy ratio). The latest trends reflect a growing share of retail loans in banks' loan portfolios. Total retail loans this year outpaced corporate loans. However, after several years of accelerating loan growth, the central bank has introduced measures aimed at curbing credit growth, which reduced its growth rates. By influencing banks' HRK liquidity, central bank has also counteracted declining interest rates. Nevertheless, Croatia's banking sector has continued growing, still dominating the financial sector, in face of rising competition from other financial institutions such as building societies, pension and investment funds, and insurance companies. At the end of 2002 banks accounted for near 89% of the financial sector.

Assets share



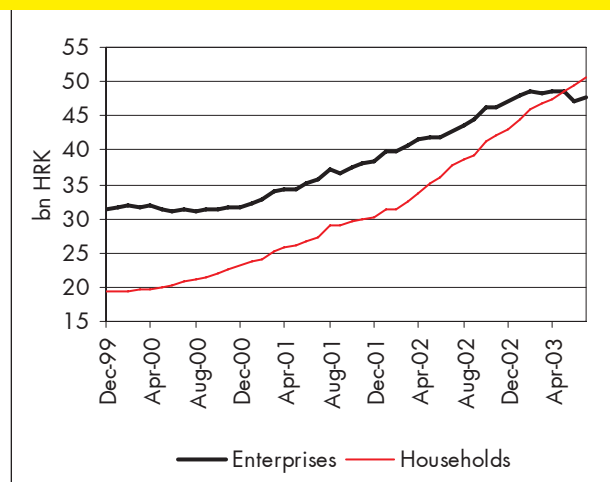
Source: CNB

Profitability



Source: CNB

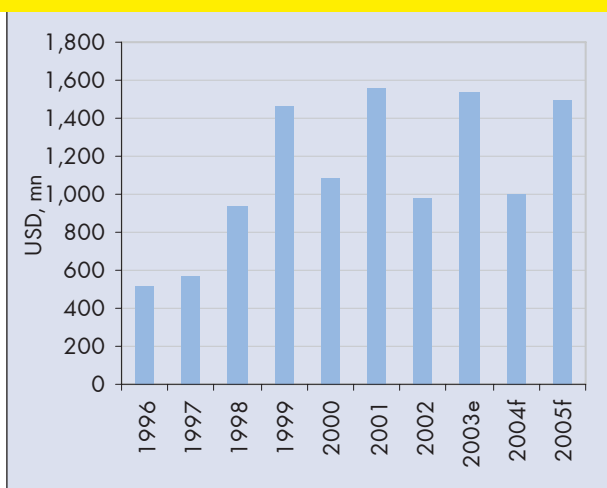
Loans



Source: CNB

Great privatisation potential of Croatia's tourist sector

FDI



Source: CNB, RZB-Group Research

FDI in Croatia, in %

Activity	1993 - 2003 Q1
Telecommunications	26.10
Other monetary intermediation	20.91
Manufacture of pharmaceutical preparations	13.62
Manufacture of cement	4.44
Hotels and motels, with restaurant	3.26
Extraction of crude petroleum and natural gas	2.98
Other wholesale	1.66
Manufacture of beer	1.33
Manufacture of bricks and construction prod.	1.21
Manufacture of television and radio transmitters	1.07
Other	23.40
TOTAL	100.00

Source: CNB

Privatisation outlook

Year	Company	Industry
2003	INA - oil company (sold)	Oil
2004	various hotels	Tourism
	Croatia Bank	Banking
	Poštanska Bank	Banking
	Croatia Osiguranje	Insurer
no date	HEP	Electricity
	HT	Telecommunications
	Janaf	Pipeline System

Source: RZB-Group Research

Up to the first quarter 2003 the lion's share of foreign direct investment went into telecommunication, financial intermediation and pharma sectors. The probably largest privatisation to date was carried out in 1999 when a 35% stake of Hrvatske Telekomunikacije (Croatian telecommunications) was sold to Deutsche Telecom for US\$ 850 million. Under the Memorandum of Economic and Financial Policies, which the Croatian government submitted to the IMF in June this year, there have been some changes in its privatisation policy, which, among other things, are related to the privatisation of Croatia Osiguranje (Croatia's biggest insurer) holding roughly a half of the country's insurance market. The government backed away from the planned merger of two of its banks (HPB and Croatia bank) and announced a takeover of a 19% stake in HPB by ICF, while the plan for privatisation of Croatia bank is to be drawn up by the end of the year. The largest privatisation project of the year 2003 has been the sale of the 25% stake plus one share in the state oil and gas concern INA to a Hungarian oil company MOL in July. The government sold the stake for unexpectedly high US\$ 505 million, which is very important for maintaining budgetary stability.

In the coming period tourist sector will show the greatest privatisation potential. Although, several tenders for purchase of hotel and leisure complexes were cancelled in 2003, it is to be expected that the privatisation process in the tourist sector will gain momentum, especially due to the fact that the majority of Croatia's hotels are still state owned and the government cannot provide the funds necessary for either improving the quality of service or accommodation. As a result, the Croatian Privatisation Fund announced the privatisation of several hotels. Among interested foreign investors there are many who already own hotels at the Adriatic coast. Although, the Law on privatisation of Croatian electrical utility (HEP) was passed already in 2002, the privatisation of the company has not been started yet. Pursuant to the law the government plans on retaining the majority stake (51%) until Croatia becomes a full member of the EU. Some of HEP's units have not been included in privatisation plans, such as the transfer and distribution unit. Since HEP's privatisation is yet to be started, and JANAF's (Adriatic pipeline) privatisation, although planned, is nowhere in sight, it is possible that Croatia's 2004 FDI be lower than in 2003. However, things are expected to improve in 2005.

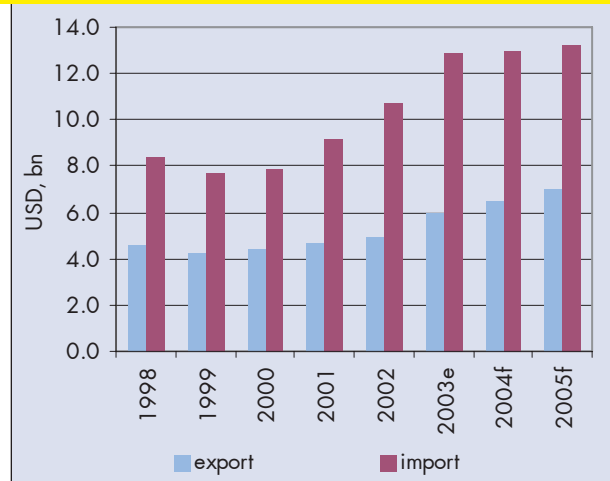
Change in imports structure Important for future production

It has become traditional for Croatia's trade to accumulate deficit, since a surplus has not been seen once in over nine years. In 2002, the overall trade deficit reached an all-time high of US\$ 5.18 billion. However, since in the first seven months of this year trade deficit level already reached US\$ 4.47 billion, we expect this year's cumulative results to even surpass those from a year ago. Merchandise imports have been growing throughout this year, with July recording the highest ever imports level of US\$ 1.4 billion and the widest ever trade deficit totalling US\$ 831.4 million.

Croatia's trade needs a change in structure much more than it needs to reduce the actual rate of its imports growth. For instance, imports of capital goods, which in the seven months of the year rose 20% on the year earlier, have recorded the overall highest growth rates (excluding the effect of the dollar recovery). However, a large share of it has been used for carrying out different infrastructure projects, with their positive effects on production and services exports (tourism & transport) yet to be felt. The euro-dollar exchange rate and the currency structure of Croatia's trade have the determining effect on its movements. Over 57% of Croatia's foreign trade is conducted with the countries of the European Union, so every time the euro firms against the dollar, the dollar value of Croatia's trade goes up (in the first seven months of 2003, the euro strengthened by nearly 10% against the dollar). Countries of the European Union have traditionally been Croatia's most important trading partners, especially Germany and Italy, accounting for around 40% of its merchandise exports. Expected gradual recovery of the European economy until the end of this year and continued positive growth rates over the next, should have positive, although not far-reaching, effects on Croatia's merchandise trade.

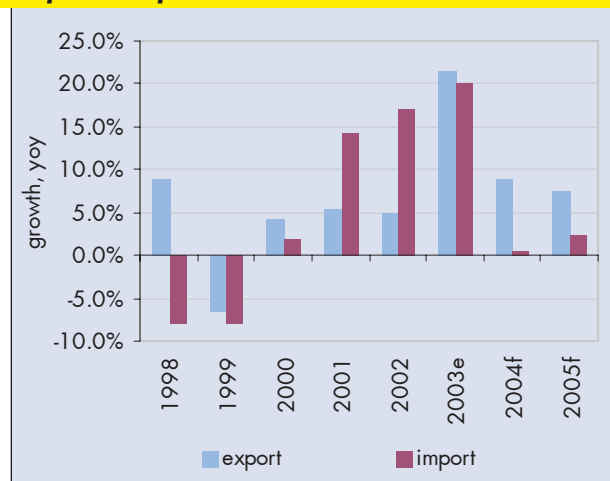
Central bank's new monetary measures could affect a reduction in credit activity of banks and slow down domestic demand, restraining imports growth over the coming period. This year's merchandise imports might surpass US\$ 12.8 billion, making it a 20.1% rise compared with 2002, while in 2004 and 2005 it might record only low growth. Exports growth over next years will probably not reach a two-digit rate, however, this just might be enough to top the rate of imports growth. The coverage of imports by exports fell at the middle of the year to very low 39%, but the anticipated faster growth of exports over imports will gradually bring the coverage of imports by exports to an average 46.2% in 2004 and 50.1% in 2005.

Foreign trade



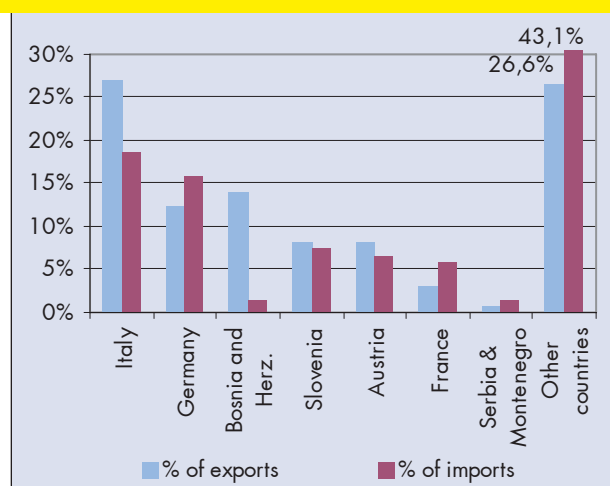
Source: Croatian Bureau of Statistics, RZB-Group Research

Export, import



Source: Croatian Bureau of Statistics, RZB-Group Research

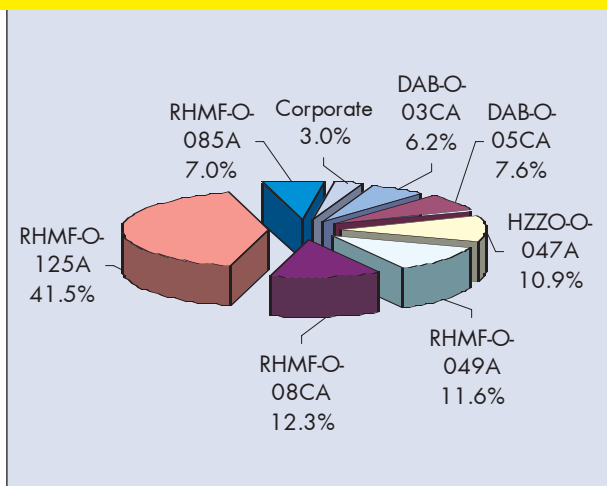
Trade of goods (I-VII.2003.), share by countries



Source: Croatian Bureau of Statistics

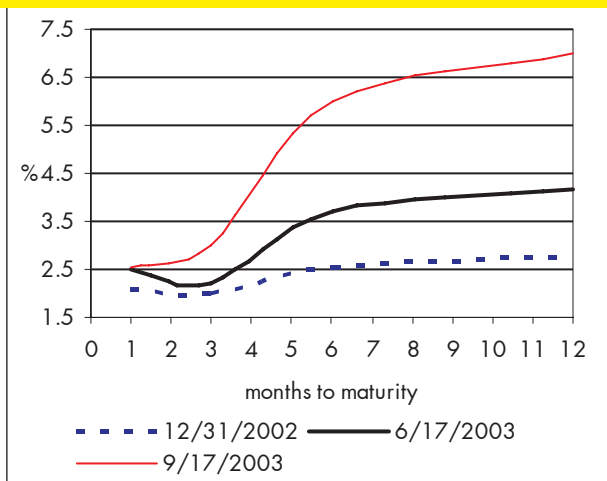
Record trade in domestic market

Turnover shares on ZSE in 2003



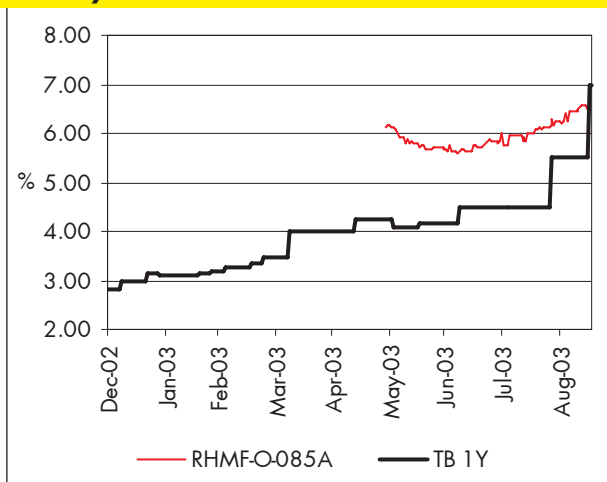
Source: ZSE

Yield curve, short-term, kuna



Source: CNB, MoF

Kuna yields



Source: ZSE, MoF

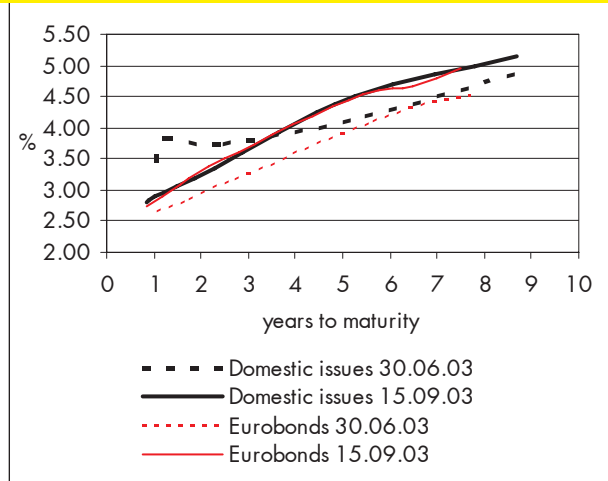
The volume of bonds traded in the first eight months of the year exceeded HRK 7 billion, out of which the last to be issued was the 5-yr bond of Hypo-Alpe-AdriaBank d.d., accounted for HRK 218 million. In July, after the first issue of kuna bonds (both government and corporate) the total turnover volume reached almost HRK 1.5 billion. The most liquid bond and still the one with the largest nominal issue has been the RHMFO 2012, accounting for 41% of the total turnover. The Finance Ministry 5-yr kuna bond also accounted for a substantial share of total turnover, nearly 12.2% of the overall turnover during the period between June to August. Turnover fell sharply at the end of August to below this year's daily average as a consequence of new central bank's measures and increased demand for the kuna. This reduced the liquidity of the market.

Prices in the domestic market decreased, largely due to exchange rate movements, while movements in foreign markets, where yields have been on the rise because of favourable economic conditions (especially in the U.S.), have only had a mild influence. The kuna appreciation in July, and again at the end of August brought about a price growth, stopped by the mentioned appreciation of the kuna. Nevertheless, the exchange rate movements, which influenced a price rise of domestic issues, were the factor that led to a substantial spread narrowing of domestic issues indexed to FX, compared with the spread of Croatian Eurobonds or European bonds. During the summer the spread of the bond with the longest maturity in the domestic market, RHMFO 2012, fell to the level of 90 basis points compared with the German bond used as benchmark. In the first half of the year the average spread was around 150 basis points. RHMFO 2008 slipped to only 60 basis points in August, while its average spread in the first half of the year totalled 130 basis points. The spread of RHMFO 2012 compared with the spread of Croatian Eurobond maturing in 2011 was neutralised at one point in August, although when it was issued the spread of RHMFO 2012 stood at 35 basis points. The average in the first half of this year was around 50 basis points. As a result, the expected exchange rate movements (slippage of the kuna) as well as increasing yields in the global market coupled with reduced spreads of domestic issues create a negative environment for domestic bonds.

Global yields growth

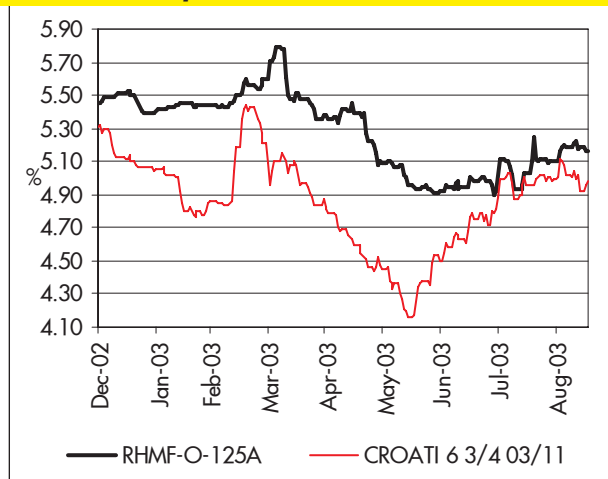
Since it was issued at the beginning of May, the 5-yr HRK bond registered a turnover volume of over a half billion kuna. After the issue the prices went up, and yield to maturity lowered to 5.6%. As a result of reduced liquidity of the domestic market and mounting pressure to increase HRK interest rates, the prices of this bond started declining. The yield, after one-year T-bills registered 5.5% and money market rates exceeded 10%, grew to the level of over 6.5%. Pressure to increase kuna interest rates arising from the central bank's new monetary measures, reduced kuna supply in the market and relatively large amounts of maturing treasury bills in autumn will pressure prices of HRK bonds into declining even further. Croatian Eurobonds closely mimic movements in world markets, so occasional spreads widening is a consequence of events in emerging market countries (mostly Latin American countries). The spread of Croatian Eurobond's longest maturities ranges between 100 and 110 basis points and is for the time being not particularly sensitive to poor external debt and balance of payments indicators. Spreads of other CEE countries belonging to the first round of EU accession candidates have had a favourable affect on the moves of Croatian Eurobonds spread, since among countries with the similar credit rating Croatia offers the best spread. Demand for emerging market debt is still high, showing that there is no risk of substantial spread widening. However, with Croatia's parliamentary elections approaching in autumn, spread could widen because elections usually make markets jittery. We could see spreads 20 to 30 basis points wider than now. Slovakia's 2002 pre-election experiences testify to the fact that spreads widen due to unpredictable election outcome. In the post-election period, its spreads again narrowed to their earlier levels, with Slovakia's potential accession to the EU playing a great role. The global bond market has registered rising yields based on the recent investor optimism, who inspired by the U.S. economic recovery started turning to more risky investments and thus reduced demand for safe government debt. It is worth noting that U.S. bonds have been seeing a much more significant yield growth, while the European bonds have been limited by the overall weak European economy. We expect continued healthy growth of U.S. yields and a mild rise in European yields compared with their current levels.

Yield curve, long-term



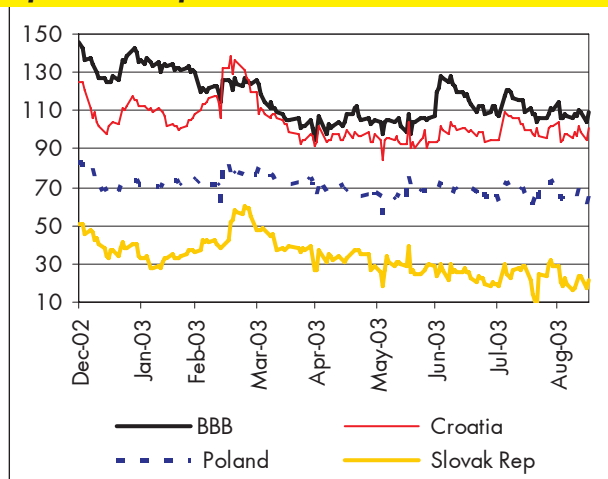
Source: Bloomberg, biznis.infoforum.hr

Yield developments



Source: Bloomberg, biznis.infoforum.hr

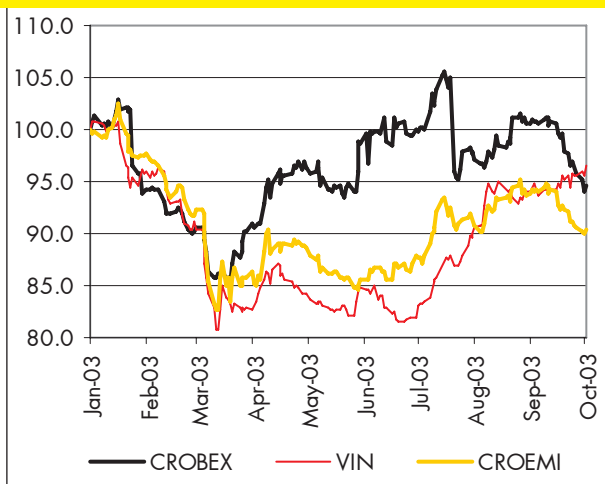
Spread comparison



Source: JPMorgan

Public joint stock companies listed on stock markets

Croatian indices



Source: ZSE, VSE, RBA Research

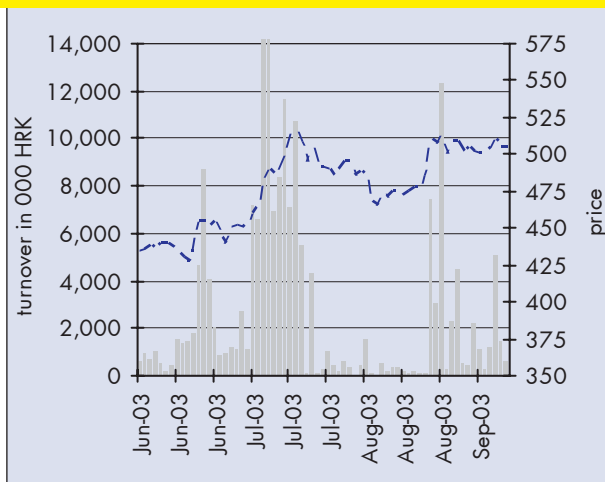
Note: Croemi traces the shares from both stock exchanges, Zagreb and Varazdin

Indicators of the Zagreb Stock Exchange

	2000	2001	2002	08/2003
No of listed securities	64	66	73	
Market cap. (HRK mio.)	22,178.6	25,815.5	28,320.4	32,985.4
Market cap. (USD mio.)	2,718.0	3,091.7	3,966.4	4,825.8
Annual turnover (HRK mio.)	1,529.2	968.5	1,171.4	
Annual turnover (USD mio.)	184.7	116.1	149.0	
CROBEX	890.0	1,034.7	1,172.6	1,169.1

Source: ZSE

Pliva



Source: The Zagreb Stock Exchange

Capitalization and JDD

At the end of August 2003 compared with 2002, market capitalization at the Zagreb Stock Exchange increased by 16.5% in domestic currency. This was a result of the new Act on Securities Market pursuant to which certain public joint stock companies (JDD) have to be listed in the quotation of public joint stock companies (JDD). Pursuant to the law they were obligated to list their shares by July 25, 2003. At the end of August the market capitalisation of Zagreb Stock Exchange totalled 31,985 HRK million.

Pliva - buy

Pliva posted a H1 net of HRK 578.1 mn, 5% lower than expected. Total Q2 sales of HRK 1.472 bn were fully in line with our forecast for the period. The consolidation of Sidmak was clearly the top line driver. H1 Sidmak sales rose 14% yoy to USD 102.6 mn (32% of total Rx sales). But growth in CEE countries (Poland, Croatia, Russia) outperformed expectation, as did Western Europe (Spain, Italy). Sales of drugs launched in the last 5 years (excluding Sidmak drugs) rose 89% to 18.5% of Rx sales versus 12.1% in 2002.

We anticipate earnings growth to accelerate moderately in H2 and look for EPS of HRK 71.2 (USD 2.09/GDR). After the H1 we maintain our forecast for revenue growth in USD terms of around 22% (Pliva is targeting high teens) and EBIT growth of 8% (Pliva's target of low teens growth). Pliva launched new 19 molecules in Western Europe and 11 in the CEE, the majority from Pliva's own development. We can expect products launched in the H1 03 to start generating meaningful sales in by the H2 04. EPS growth this year will be flat; for 2004 we can expect 12% growth to HRK 80.0. We are maintaining our 6-12 month target price of HRK 550 (USD 16.6/GDR). At this level we would expect local sellers to enter the market. Our DCF based fair value target for Pliva is USD 18.8/GRD, or an upside of 23%. We maintain our Buy recommendation.

Podravka - neutral

In H1 of 2003 Podravka posted net loss of HRK 29.2 mn. Despite sales revenues up 24% yoy, the sales of Podravka's top brand Vegeta reduced by 22%. A decline in sales in Poland, Vegeta's main exports market accounted for the lion's share of the fall. The main reason for this reduction can be

found in the returned inventories of wholesalers accumulated over the past period, which were entered in the books as an increase in sales over the past period. Costs grew at faster pace than sales revenues. A bright spot of Podravka's semi-annual results was the pharmaceutical company Belupo, a member of Podravka Group.

Its EBIT rose from last year's HRK 33.2 million to HRK 63.7 million in H1 2003, that is grew by 91.8%. The main reason for such rapid growth was a substantial reduction in the price of raw materials for production of the two Belupo's main products, after the patent protection expired. In H2 we expect similar results, which would favourably affect the consolidated group results. At this time, Belupo is Podravka's main asset and we do not believe in the speedy sale of a 25% stake in the company, as it had been announced.

In the coming period we expect a stabilisation of Vegeta's sales in Poland, because its sales levels maintained more or less the same levels. It was unrealistic to expect sales growth. Apart from stabilisation of sales, there have been changes in the company's Management Board, expected to lead to a reduction in all possible costs. By the end of the year the number of employees is expected to reduce by 200 due to the opening of a new soup plant.

H1 sales growth was registered also in the beverages segment. Studena and Studenac were well accepted by the market, so we agree with the growth projections of 30% for the coming periods. Our DCF based Podravka value estimate is HRK 210, but the market value of Podravka's units added together does not exceed HRK 173 per share. Therefore, our recommendation is "neutral".

Kraš posted its H1 results, showing profit and revenues in line with 2003 target. Net profit totalled HRK 21 million. Our 2003 net profit forecast is HRK 45 million. Based on this and the expected EPS of HRK 35 the P/E per share is 8. We maintain our "neutral" recommendation, because we do not see room for significant growth over the coming years.

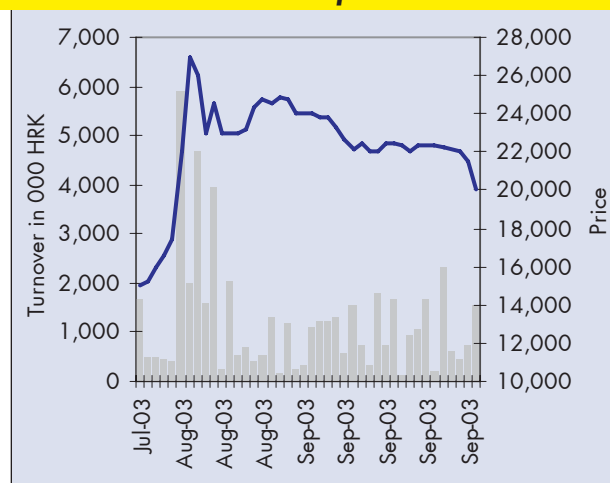
Lura was traded at HRK 360 for the first time after it had been listed in the JDD tier. The public offer was HRK 350 per share, so we can see a mild growth. EBRD and DEG are expected to join Lura's ownership structure. The absolute hit of the listing in JDD tier were the shares of the tobacco producer Tvornica duhana Rovinj. The share jumped from HRK 15,000 to an all-time high of HRK 29,000, to stabilise eventually at around HRK 21,000.

Podravka



Source: The Zagreb Stock Exchange

Tvornica duhana Rovinj



Source: ZSE

Recommendations

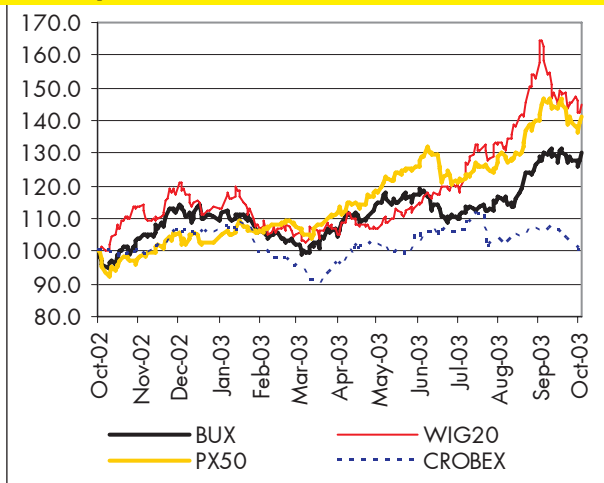
Company	Recomm.	Price			Market cap.	
		10/1/2002	10/1/2003	change	HRK mio.	P/E 2003
Pliva	buy	456.00	470.00	3.07%	8,738.5	6.5
Podravka	hold	193.11	167.49	-13.27%	878.5	7.8
Kras	hold	196.52	282.02	43.51%	382.9	7.9
Koncar	hold	80.99	72.00	-11.10%	181.2	12.0
Rivera Holding	hold	133.00	140.00	5.26%	511.5	7.4
Dom Holding	buy	42.50	44.49	4.68%	360.9	-51.45%

* discount usuall for closed-end funds, such as liquidity, transparency and market cap. discounts are not presented

Source: ZSE, VTV, RBA

CROBEX trends

Index performance



Source: Bloomberg, Zagreb Stock Exchange

Most liquid shares of the Q3 2003

Symbol	Issuer	Sector	Average daily turnover, Q3	
			2003, HRK	2003, HRK
CROS-R-A	Croatia osiguranje d.d.	Insurance	9,822,935	153,483
ERNTR-A	Ericsson Nikola Tesla d.d.	ITC	28,577,357	446,521
KOEIR-A	Končar Elektroindustrija d.d.	Electrical engineering	7,336,117	114,627
KORFR-A	Dom holding d.d.	Investment fund	22,541,246	352,207
KRAS-R-A	Kraš d.d.	Food	14,962,913	233,796
PBZR-A	Privredna banka d.d.	Banking	22,973,049	358,954
PLVA-R-A	Pliva d.d.	Pharma	156,761,217	2,449,394
PODR-R-A	Podravka d.d.	Food&Beverages	41,321,360	645,646
PRFC-R-A	Proficio d.d.	Investment fund	6,589,957	102,968
RIVP-R-A	Riviera Holding d.d.	Tourism	16,911,673	264,245
SLPF-R-A	Slavonski ZIF d.d.	Investment fund	19,452,106	303,939
SNHO-R-A	SN Holding d.d.	Investment fund	9,785,769	152,903
TDR-PA*	TDR d.d.	Tobacco	52,060,872	813,451
VART-R-1**	Varteks d.d.	Clothing/Textile	8,273,444	129,273
VLBT-R-A	Velebit ZIF d.d.	Investment fund	44,511,331	695,490

Source: ZSE, VSE, RBA reserach

Market capitalization of most liquid shares

Issuer	Issuer	Close Q3 03, HRK	P/E 2002	MCap, HRK
CROS-R-A	Croatia osiguranje d.d.	2,960	14.6	910,490,080
ERNTR-A	Ericsson Nikola Tesla d.d.	340	3.4	452,761,000
KOEIR-A	Končar Elektroindustrija d.d.	72	28.3	181,227,816
KORFR-A	Dom holding d.d.	44	-	353,742,452
KRAS-R-A	Kraš d.d.	283	8.9	384,226,270
PBZR-A	Privredna banka d.d.	210	5.5	3,498,600,000
PLVA-R-A	Pliva d.d.	468	7.1	8,701,173,338
PODR-R-A	Podravka d.d.	165	12.1	892,104,840
PRFC-R-A	Proficio d.d.	42	-	164,342,136
RIVP-R-A	Riviera Holding d.d.	139	7.9	507,838,863
SLPF-R-A	Slavonski ZIF d.d.	32	-	107,085,376
SNHO-R-A	SN Holding d.d.	38	-	126,654,038
TDR-PA	TDR d.d.	21,550	5.2	1,461,973,550
VART-R-1	Varteks d.d.	45	neg.	69,214,365
VLBT-R-A	Velebit ZIF d.d.	79	-	267,414,175

Source: ZSE, VSE, RBA reserach

Between July and September 2003 CROBEX value declined 5.8%, from 1160.00 points to 1093.20 points, peaking at 1227.20 points on 15 July. The low of the period was reached on 30 September at 1093.20 points. This decline at the end of September was caused by the mounting insecurity surrounding the upcoming elections, which increased the political risk of the country whatever their outcome.

In addition, there is the disagreement between Croatia and its neighbours over the proclamation of the protected ecological and fishing zone in the Adriatic and the long-awaited report by Carla del Ponte, (chief prosecutor of the International criminal tribunal for the former Yugoslavia), before the UN Security Council. If we add that there is the new Foreign Exchange Act, which is not to encouraging to non-residents' investments in the Croatian capital market, the reasons for this downward correction become completely clear.

We believe that by the end of the year political tensions with the neighbouring countries will subside and the elections will be over, reducing the overall risk of investment in Croatian market and thus enabling the prices and CROBEX to recover.

Market capitalisation went up 8.1% at the end of July, while at the end of September it reached HRK 35.2 million. The main reason for this growth was not the growth of market prices but a new listing in the limited public companies (JDD) tier of the Zagreb Stock Exchange. The analysis of the regular Pliva turnover showed that in July it reached HRK 105.1 million, while August and September saw a turnover of HRK 33.3 million and 18.4 million respectively. It was the same with Podravka. Turnover reduced from HRK 16 million and HRK 19 million in July and August to HRK 5.3 million in September.

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Abbreviations

Currencies and Countries

BGL	Bulgarian Lev
CHF	Swiss Franc
CZK	Czech Koruna
EKK	Estonian Kroon
GBP	Great Britain Pound
HRK	Croatian Kuna
HUF	Hungarian Forint
PLN	Polish Zloty
ROL	Romanian Lei
RUB	Russian Rouble
SIT	Slovenian Tolar
SKK	Slovak Koruna
UAH	Ukrainian Hryvnia
USD	United States Dollar

Economic abbreviations

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

Stock Exchange Indices

CROBEX	Croatian Zagreb Stock Exchange Index
VIN	Croatian Varazdin Stock Exchange Index
CROEMI	Croatian Equity Market Index
BUX	Budapest Stock Exchange
PX50	Prague Stock Exchange
WIG20	Warsaw Index

Equity related

PBV	Price Book Value Ratio
PCF	Price Cash Flow Ratio
P/E	Price Earning Ratio
P/CE	Price Cash Earning Ratio
EV/EBIT	Equity Value/Earning before Interest and Taxation
EPS	Earnings per Share
ROA	Return on Assets
ROE	Return on Equity

CEEC-4	Central and Eastern European Countries - 4 Czech Republic, Hungary, Poland, Slovakia
CEEC-8	CEEC-4 + Estonia, Latvia, Lithuania, Slovenia
SEEC-5	South Eastern European Countries - 5 Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia and Montenegro

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