Strategy Croatia

October 2004

Sovereign Rating History & Outlook

Croatia Date	LCY Rating LT/ Outlook	FCY Rating LT/ Outlook
3-6m ahead	A-/Stable	BBB/Stable
June 23, 2004	BBB+/Positive	BBB-/Positive
Feb. 9, 2001	BBB+/Stable	BBB-/Stable
June 3, 1999	BBB+/Negative	BBB-/Negative
June 30, 1998	BBB+/Stable	BBB-/Stable
Jan. 17, 1997	A-/Stable	BBB-/Stable

Note: LCY - local currency; FCY - foreign currency; LT - long term; 3-6m ahead - RZB estimate
Source: Standard & Poor's Rating Services

Recommendations (Horizon: Q4 2004 & Q1 2005)

Bond market

Buy
5.5% RHMF 2014 EUR linked HRK Bond
6.75% EUR 2011 bond

Sell
6.125% RHMF 2008 HRK Bond

Stock market

Buy
Pliva

Hold
Podravka

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Highlights

- Croatia had taken a big steps towards the EU. The final result was seen on June 18, 2004 when Croatia officially became EU membership candidate. In April the European Commission had presented avis to Croatia and in June this year the European Council confirmed the status of the Republic of Croatia as a candidate country for membership and brought a decision on opening negotiations on full membership in early 2005. In October, EC published preaccession strategy for Croatia.

- After the latest parliamentary elections in November last year, HDZ have got mandate to form new government with majority of ministers from this party. Prime minister became Mr. Ivo Sanader. The Government achieved to get support on its task to lead Croatia towards EU membership which resulted in establishing Croatia as new EU candidate.

- Economic growth in first half of the year of 2004, was above expectations so we revised our expectations fom the beggining of the year. In 2004, we expect growth of 3.5% with accelerating activities in 2005. Main factors in slowing down were curbed domestic consumption and investment activities which had influence fiscal and current account deficit.

- In August, IMF approved new stand by arrangement with Croatia. The main goal of the agreed programme is the support to strengthen the fiscal consolidation and transparency, as the key economic programme of the Croatian Government, and which is directed on the stabilisation and decrease of the external debt.

Key figures

	2000	2001	2002	2003	2004e	2005f	2006f
Nominal GDP (USD bn)	19.0	19.9	22.8	28.8	33.7	37.9	41.3
Nominal GDP per capita (USD)	4289	4477	5134	6496	7638	8622	9454
Real GDP (% yoy)	2.9	3.8	5.2	4.3	3.5	4.0	4.1
Gross industrial production (% yoy)	1.7	6.4	5.5	4.1	3.6	3.8	3.5
Unemployment rate (%, avg)	21.2	23.1	21.5	19.1	18.5	18.0	17.5
Consumer prices (avg, % yoy)	6.2	4.9	1.7	1.8	2.4	2.7	2.4
Consumer prices (eop, % yoy)	7.4	2.6	1.9	1.7	3.0	2.7	2.9
General budget balance (% of GDP)	-6.3	-6.8	-5.2	-6.3	-4.5	-4.0	-3.5
Exp. of goods/services/inc. (USD bn)	9.0	9.6	10.5	14.9	16.9	18.4	19.6
Imp. of goods/services/inc. (USD bn)	10.4	11.7	12.7	17.2	19.5	21.4	22.7
Current account balance (USD bn)	-0.5	-0.8	-1.6	-2.1	-1.8	-1.8	-1.1
Current account balance (% of GDP)	-2.4	-4.2	-7.0	-7.3	-5.4	-4.7	-3.7
Official FX-reserves (USD bn)	3.5	4.7	5.9	8.2	8.2	8.4	8.7
Official FX-reserves (% GDP)	18.5	23.7	25.8	28.4	24.3	22.1	21.0
External debt (% GDP)	57.8	57.0	67.6	81.8	80.1	73.8	71.3
HRK/USD avg	8.28	8.34	7.86	6.70	6.11	6.00	5.94
HRK/USD eop	8.16	8.35	7.14	6.12	6.27	5.84	5.96
EUR/HRK avg	7.63	7.47	7.41	7.56	7.52	7.56	7.60
HRK/EUR eop	7.60	7.37	7.44	7.65	7.58	7.59	7.63

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

RZB Group

Croatia
Content

Croatia
Summary

After a decade of 'loneliness' Croatia has finally joined the ranks of EU aspirants. This year, the EU Commission recommended opening EU accession talks with Croatia. The EU decision was a major victory for Croatian politicians and a reward for economic and reform achievements attained in due course. Political hurdles related to the past war crimes seemingly lessened as Croatia demonstrated willingness to cooperate with the International Court of Justice in the Hague.

So far positive economic transformation, coupled with its geographical and cultural proximity, should make Croatia a good EU candidate. Indeed, economically speaking, Croatia appears more advanced than the other two EU contenders, Romania and Bulgaria. The pro-market orientation of Croatian politicians ensured proper development of a vast private sector in all areas of economic life, and properly aligned transformation policies helped to secure favourable economic growth in a low-inflation environment.

Presently, Croatia continues to deliver sustainable though somewhat lower growth rates, has succeeded in keeping inflation at 'bay' and remains an attractive destination for foreign direct investment. If not for the excessively slow privatisation process in certain core sectors, Croatia would indeed see much better FDI numbers.

Yet Croatian economic life is not without its problems. The most evident hurdle Croatia faces today is the twin deficit problem, as both the current account and fiscal balances show sharp deficits. The National Bank has continued to curb domestic credit expansion which is largely responsible for the increase in consumer imports, and is pursuing a slightly tighter monetary stance so as to help curtail the current account deficit. Nevertheless, such policies, while they might be the right 'medicine', may generate even more economic slowdown, prompting a more moderate growth outlook for next year.

On the other hand, the current government has been unable to cut the fiscal deficit and will most likely miss the fiscal deficit target set for this year. Fiscal loosening, in turn, reduces the efficiency of the tightening measures pursued by the National Bank. Furthermore, the domestic private sector remains overexposed to EUR loans, as evidenced by recent statistics, posing a greater potential risk for the stability of Croatia's national currency if dramatic circumstances develop.

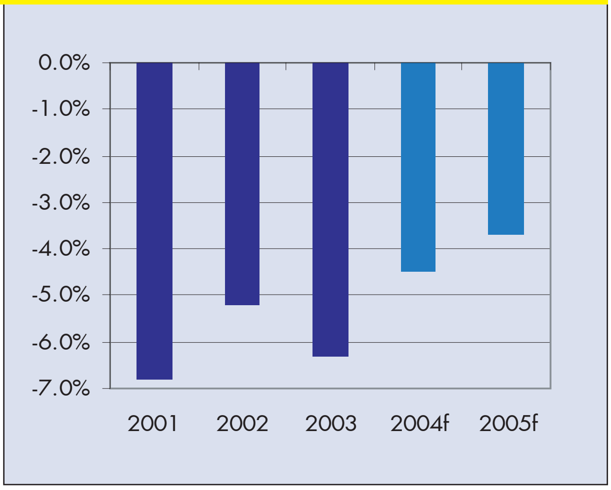
On a positive note, the central government itself runs a comparably low external debt and should not have problems with servicing, given relatively low amounts due. Another counterargument against the pessimists would be advice to take a look at Croatian international reserves, which remain in high digits and cover most of the state's external debt. Essentially, a debt sustainability problem in Croatia is not imminent and remains limited mainly to the private sector, albeit the risks there cannot be ignored. From last year the government adopted a policy aiming to curb the debt burden, but progress in this area remains rather slow, particularly because of the limited influence the government can exert on private borrowers.

When all is said and done, Croatia continues to perform well, and most of its fundamentals are in good shape. Somewhat slower but positive growth should be expected for next year. Investment flows from abroad are projected to increase in line with Croatia's progress towards joining the EU, and privatisation may intensify over the coming years. In terms of financing, Croatia remains anchored to the targets set forth by the IMF agreement, which gives Croatia access to pre-cautionary funds in case of an emergency in exchange for complying with the program targets. Such a relationship should facilitate better fiscal prudence, with the government committed to tackle fiscal imbalances, whereas the National Bank will remain firmly in charge of currency stability and inflation. Whatever it takes Croatia will remain firmly behind the reform process and steadfast in its determination to speed up EU accession. So far, tangible progress in all areas including first and foremost legislation and reform implementation should be forthcoming.

New Stand-By Arrangement

At the beginning of August the IMF executive board approved a new Stand-By Arrangement to the Republic of Croatia amounting at 97 million of SDR (Special Drawing Rights, cca USD 141.3 million) and lasting 20 months as support to economic programme. The main goal of the agreed programme is the support to strengthen the fiscal consolidation and transparency, as the key economic programme of the Croatian Government, and which is directed on the stabilisation and decrease of the external debt. These goals are evident in the budget revision and the decision to prepare the budget of the central Government for the three-year period. The Memorandum on Economic and Fiscal Policy (MEFP) lists a number of quantitative criteria for evaluating the performance of the programme execution, indicative aims and structural control points. The fiscal programme is monitored by the programme execution performance criteria, which regard budget deficit of the central Government and the CBRD (HBOR), change of balance of outstanding central Government liabilities, arranging a new unprivileged external debt of central Government and the CBRD (HBOR) and cumulative issuing of credit guarantees of the central Government. Also, deficits of chosen public companies are monitored, excluding transfers from government. Implementation of the CNB's monetary programme will be monitored by the performance criteria that regard international net reserves and net domestic assets of the CNB.
By applying the measures against external vulnerability of Croatia, attempts will be made to lessen the imbalance in the balance of payments current account and significantly lower the dependence on making external debts. Therefore, the most important short-term goal of the programme is the decrease of the central Government budget deficit from the last year's 6.3% of GDP to 4.5% in 2004 and 3.7% in 2005. This way, by slowing down of the credit growth, the real growth of GDP of 3% to 4% would be maintained, and reduce the balance of payments current account deficit at a stable rate of inflation. At the same time, a portion of the external debt in the GDP should stabilise at the level below 77% of GDP (in euro terms). Within the frame work of fiscal policy, the changes for restructuring and increasing transparency of public finance, decreasing expenditure by stopping the real growth of wages, slowing down of expenditure for road works, decrease of limitations for debts of the local Government, and control of expenditure in health care are imperative. Also, a tax reform was announced. The budget turns to domestic sources of finance.
Within the monetary policy, although of secondary importance, it is essential to hold on to the goals of slowing down of the credit expansion, keeping the exchange rate and prices stability. Also, cooperation with the Ministry of Finance was announced towards realising the prerequisites for introduction of operations into the open market as monetary policy instruments.
A part of the programme regards also structural reforms due to preparations of the economy to enter the EU. These include a number of reforms regarding public finance. The privatisation process is intended for speeding up (to privatise all companies with Government share up to 25% until the year end, and other shares until June 2005). Until the end of 2005 15% of the INA shares are to be sold and the third phase of the HT (telecom) privatisation is to come to a closure, as well as making a privatisation plan for Croatia osiguranje by the end of June 2005. The Government should withdraw from Croatia banka until the end of June 2005 and consider the options regarding HPB (postal bank).

Consolidated general government, IMF stand-by, % of GDP



Source: IMF

Croatia
A New Candidate Country

Preparations for Croatian integration into the European Union started with implementation of the Stabilisation and Association Agreement (SAA), signed in 2001. By the time the process of ratification by the old Member States was finished (on 3 September when the United Kingdom completed the ratification process), Croatia had taken major steps towards the EU. The final result was seen on 18 June 2004, when Croatia officially became a candidate for EU membership and the forerunner amongst SAP countries in terms of integration into the EU. In April, the European Commission presented avis to Croatia and in June of this year, the European Council confirmed the status of the Croatia as a candidate country for membership and resolved to open negotiations on full membership. This was a crucial step on Croatia's path towards EU, in the second wave of the EU's Eastern enlargement. The main findings of the European Commission Opinion on the application of Croatia for membership of the EU are that Croatia is a functioning democracy, with stable institutions guaranteeing the rule of law. According to the opinion, Croatia can be regarded as a functioning market economy, which should be able to cope with competitive pressure and market forces within the EU in the medium term, provided that it continues implementing its reform programme to remove remaining weaknesses. There will be need for further efforts to align legislation with the acquis communautaire and ensure the implementation and enforcement. The Commission recommended in the avis negotiations for accession to the EU to be opened with Croatia in early 2005 (most probably in March). The screening will start by the end of September 2004. The Opinion was accompanied by a draft of European Partnership for Croatia, which identified the short-term and medium-term priorities during preparation for accession. In the meantime, Croatia must prepare for the start of negotiations, including setting up negotiation structures and preparing its negotiation positions. By the end of this year, Croatia will appoint a negotiation team comprised of experts in each field. Work on the Pre-accession Economic Programme (PEP) is underway and it is scheduled to be finalised in October 2004. Croatia hopes to complete EU accession talks in 2006 and join the Union in 2007 or soon thereafter. But, in order to make membership by the "ambitious" target date of 2007 a realistic goal, negotiations will need to progress quickly. Afterwards both negotiating sides, Croatia and the 25 EU countries, will define their positions for each of the acquis communautaire chapters to be negotiated. Furthermore, on 6 October 2004, the Commission adopted a Strategy paper on progress in the enlargement process that among all other enlargement topics related to Romania, Bulgaria and Turkey, contains the pre-accession strategy for Croatia, according to which it would benefit from all three pre-accession financial instruments PHARE, ISPA and SAPARD. Taking into account the needs for preparation of Croatia's accession, the Commission recommended that EUR 105 mn (EUR 80 mn for Phare and EUR 25 mn for ISPA) be allocated to Croatia in 2005 and EUR 140 mn in 2006 (EUR 80 mn for Phare, EUR 35 mn for ISPA, and EUR 25 mn for SAPARD). Among these three old financial instruments from 2007 onwards Croatia could benefit from one new pre-accession instrument (IPA) that the Council is to create. The pre-accession strategy for Croatia also sets out the main principles on which the negotiating framework should be built. Amongst the "old" principles, the pre-accession strategy also states in written form the possibility that Commission could recommend to the Council the suspension of negotiations in the case of a serious and persistent breach of the principles of the liberty, democracy, respect for human rights and the fundamental freedoms and the rule of law on which the EU is founded.

Croatia's accession to the EU was a strategic task for the previous and the present government. According to the Working Programme of the Government of the Republic of Croatia 2004-2007, integration into the EU is a top priority. The two main strategic documents regulating the Stabilization and Association Process in Croatia are the National Programme of the Republic of Croatia for Integration into the EU (NPIEU) and the Stabilisation and Association Agreement's Implementation Plan. In December 2002, Croatia launched its first National Programme for Integration into the EU, which as a crucial control mechanism of the Government's activities in the area of European integration, reflects Croatia's readiness to carry out concrete measures in order to reach its priority goals in the process of integration into the EU. As in previous years, Croatia will make the NPIEU for 2005 the framework for annual planning, which sets out short-term objectives relating to the harmonisation of national legislation with the acquis communautaire, and meeting politically-determined criteria and economic adjustments.

Basic information
and main features

Structural information

Land Area	56.594 sq. km
Population	4,442,000 (2002)
Capital city	Zagreb
Fiscal year	Jan 1st - Dec 31st
Currency	Kuna (HRK)

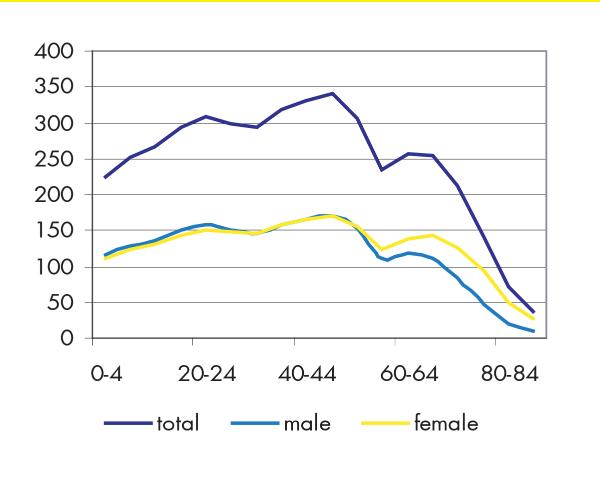
Source: Croatian National Bank, Croatian Bureau of Statistics

Foreign currency rating

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

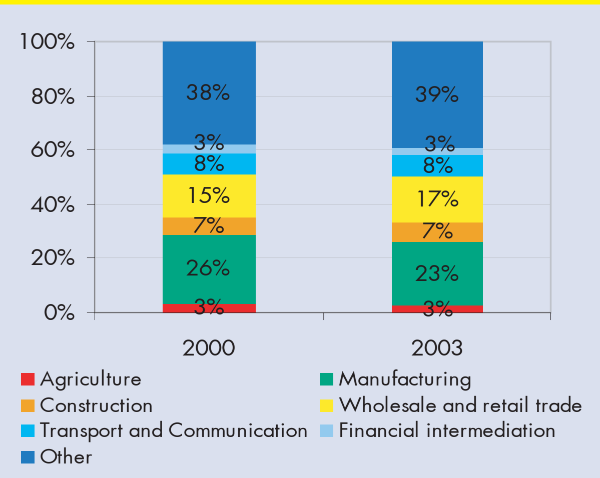
Note: On 10th Sep 2003 S&P affirmed its outlook on "stable"; on 14th January 2002 Moodys changed Croatia outlook from "negative" to "stable"; on 8th July 2003 Fitch changed outlook from "stable" to "positive"

Age distribution, 2002



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

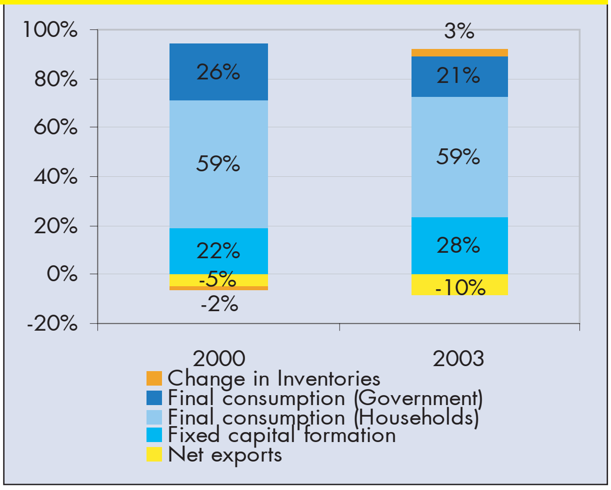
Source: Croatian Bureau of Statistics

GDP 2002

EUR mn, current prices	25,526
EUR, per capita	5,747
real growth rate, %	4.3

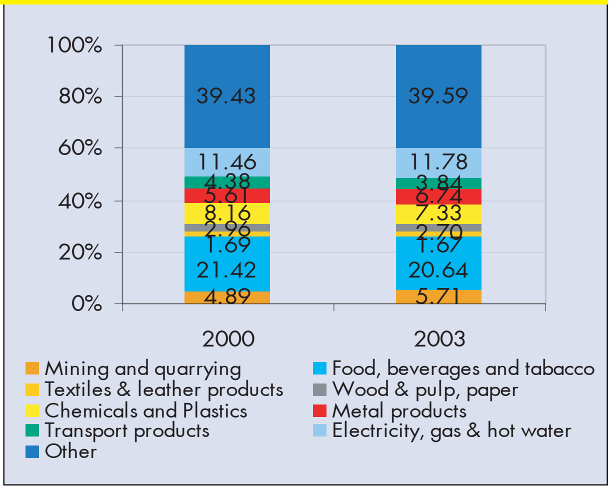
Source: Croatian Bureau of Statistics

GDP: demand side (% share)



Source: Croatian Bureau of Statistics

Industrial production (% of total)



Source: Croatian Bureau of Statistics

Heading to EU membership

Croatia's parliamentary elections were held in November 2003, not a full four-year period after the previous, held on 3 January 2000. Majority of the parliament seets (66 out 152) won largest opposition party from the last period, HDZ, centre-right party. In coallition with few smaller parties HSU (pensioner party), HSLS (liberals), DC (democratic center) and even representatives of the Serbian minority in the Parliament they have got mandate to form new government with majority of ministers from HDZ. Prime minister became Mr. Ivo Sanader. The HDZ showed determination to decouple from its past image of nationalist party and succeded to be positively accepted by the international community. Therefore, the Government achieved to get support on its task to lead Croatia towards EU membership which resulted in establishing Croatia as new EU candidate. Negotiations are expected to beginn in early 2005. New government also started to work on economic affairs getting new IMF stand by arrangement directed to fiscal consolidation and curbing external debt growth. However, actions in achieving good result in relation to EU as improving cooperation with War Crime Tribunal and some fiscal measures resulted in declining support in voting polls recently published.
Presidential elections are to be held most probably in December 2004. However, for the moment among candidates known, current president Mr. Stjepan Mesic is strong favorite. Results of some preliminary polls shows that Mr. Mesic is enjoying comfortable advantage against any candidate, even candidate from rulling party HDZ.
Croatia's entry into the EU was a strategic task for previous and for the present government. Consensus to integrate into EU exists in Croatia among all parliamentary parties. On the other hand, according to the research of the Ministry of European Integration, the public support for the accession of Croatia to the EU is on the decline. The latest research showed that most citizens (55.6%) have a generally positive opinion of the EU. But answering the question "Are you in favour of or opposed to the accession of Croatia to the EU?" the results were surprisingly worse then it was expected. 51% answered in favour and 39% were opposed while at the end of 2003 more than 72% citizens had positive opinion on Croatian accession to the EU. There are also changes in attitudes on repercussions of joining the EU. More than before, citizens are concerned about economic problems (71%) and a partial loss of national independence (68%).

Main political parties in parliment

Ruling Coalition	Party leader	Orientation
Croatian Democratic Union (HDZ)	Ivo Sanader	Center-right
Croatian Party of Pensioners (HSU)	Vladimir Jordan	Center
Democratic Center (DC)	Vesna Skare Ozbolt	Center
Opposition Parties		
Socialdemocratic Party (SDP)	Ivica Racan	Center-left
Croatian People's Party (HNS)	Vesna Pusic	Center
Croatian Peasant Party (HSS)	Zlatko Tomcic	Center
Croatian Party of Rights (HSP)	Anto Djapic	Center-right
Istrian Democratic Party (IDS)	Ivan Jakovcic	Center-left
LIBRA	Jozo Rados	Center

Source: political parties

Election schedule*

Presidental election	December 2004
Parliamentary elections	November 2007

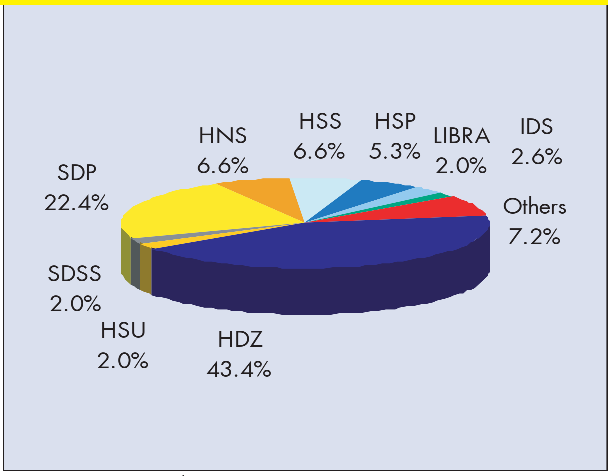
** elections for president are every 5 years, elections for parliament every 4 years*

Ruling persons

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

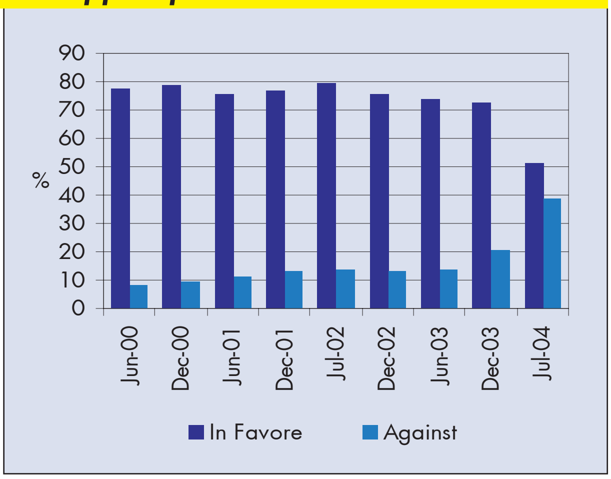
Source: the Government, the Parliament, the Office of the President

Seats in the Parliament, November 2004



Source: Croatian Parliament

EU support poll



Source : MEI

Economic indicators
Croatia within CEE: Outlook

Real GDP (% yoy)

Countries	2003	2004e	2005f	2006f
Poland	3.8	6.0	5.0	4.5
Hungary	2.9	3.8	3.8	3.9
Czech Rep.	3.1	3.5	3.6	3.8
Slovakia	4.2	5.4	4.9	5.2
Slovenia	2.3	3.0	3.5	3.5
Estonia	5.1	5.5	6.0	5.0
Latvia	7.5	7.0	6.5	6.0
Lithuania	9.0	7.5	6.0	6.0
CEEC-8	**3.7**	**5.0**	**4.5**	**4.4**
Croatia	4.3	3.5	4.0	4.1
Bulgaria	4.3	5.0	5.5	5.5
Romania	4.9	6.5	5.0	4.5
Serbia a. M.	2.0	3.5	4.5	5.0
Bosnia a. H.	3.5	5.0	5.8	6.0
SEEC-5	**4.2**	**5.1**	**4.8**	**4.7**
Russia	7.3	7.0	5.8	5.0
Turkey	5.9	7.0	5.0	6.5
EU-12	**0.5**	**1.8**	**2.2**	**1.5**
USA	3.0	4.2	3.0	2.2

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

Consumer prices (avg, % yoy)

Countries	2003	2004e	2005f	2006f
Poland	0.7	3.5	3.5	3.0
Hungary	4.7	6.8	4.8	3.6
Czech Rep.	0.1	2.9	2.5	2.8
Slovakia	8.5	7.7	3.3	2.8
Slovenia	5.5	4.0	3.5	3.0
Estonia	1.3	2.8	3.1	2.9
Latvia	2.9	4.0	4.0	3.3
Lithuania	-1.2	0.2	2.0	2.0
CEEC-8	**2.1**	**4.2**	**3.5**	**3.0**
Croatia	1.8	2.4	2.7	2.4
Bulgaria	2.3	6.5	5.0	4.0
Romania	15.3	12.0	8.2	6.4
Serbia a. M.	9.4	9.0	9.0	8.0
Bosnia a. H.	0.6	0.9	1.5	1.9
SEEC-5	**8.8**	**8.1**	**6.3**	**5.2**
Russia	13.6	10.9	11.2	10.1
Turkey	25.6	14.2	14.5	13.8
EU-12	**2.1**	**2.2**	**2.1**	**1.9**
USA	2.3	2.8	2.9	2.5

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

Current account balance (% of GDP)

Countries	2003	2004e	2005f	2006f
Poland	-2.0	-1.5	-2.5	-2.5
Hungary	-8.9	-8.6	-7.6	-7.0
Czech Rep.	-6.2	-6.4	-5.7	-5.5
Slovakia	-0.9	-2.1	-2.8	-1.8
Slovenia	0.1	-0.2	-0.5	-0.5
Estonia	-12.6	-9.8	-9.2	-8.2
Latvia	-8.6	-9.0	-8.5	-8.0
Lithuania	-6.6	-6.5	-6.0	-5.5
CEEC-8	**-4.3**	**-4.1**	**-4.3**	**-4.0**
Croatia	-7.2	-5.5	-4.7	-3.7
Bulgaria	-8.5	-8.0	-8.0	-7.5
Romania	-5.8	-6.0	-5.8	-5.5
Serbia a. M.	-12.5	-10.5	-9.5	-10.0
Bosnia a. H.	-29.6	-29.0	-28.5	-27.5
SEEC-5	**-8.6**	**-7.9**	**-7.6**	**-7.2**
Russia	8.3	9.5	5.6	3.9
Turkey	-2.9	-4.2	-4.0	-3.5
EU-12	**0.5**	**0.7**	**0.3**	**0.0**
USA	-4.9	-5.3	-5.0	-4.8

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

General budget balance (% of GDP)

Countries	2003	2004e	2005f	2006f
Poland	-4.1	-6.0	-4.5	-4.0
Hungary	-5.9	-5.0	-4.4	-4.1
Czech Rep.	-5.2	-6.2	-5.2	-4.5
Slovakia	-3.5	-3.8	-3.4	-2.9
Slovenia	-1.8	-1.7	-1.5	-1.5
Estonia	2.6	0.0	0.5	0.0
Latvia	-1.8	-2.5	-2.0	-2.0
Lithuania	-1.7	-3.0	-2.5	-2.0
CEEC-8	**-4.2**	**-5.2**	**-4.1**	**-3.7**
Croatia	-6.3	-4.5	-4.0	-3.5
Bulgaria	0.0	-0.3	-0.7	-0.9
Romania	-2.3	-1.7	-1.3	-0.8
Serbia a. M.	-4.0	-3.0	-3.0	-4.0
Bosnia a. H.	0.4	0.0	0.0	-0.5
SEEC-5	**-2.9**	**-2.2**	**-2.0**	**-1.8**
Russia	1.7	1.5	1.3	0.5
Turkey	-10.2	-9.7	-8.8	-7.0
EU-12	**-2.7**	**-2.9**	**-2.5**	**-2.7**
USA	-4.8	-4.7	-4.5	-4.5

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

Exchange rate LCY/EUR (avg)

Countries	2003	2004e	2005f	2006f
Poland	4.40	4.62	4.51	4.40
Hungary	253.8	252.9	254.5	258.5
Czech Rep.	31.8	32.0	31.3	30.8
Slovakia	41.5	40.1	39.3	38.6
Slovenia	234.0	239.0	240.0	240.0
Estonia	15.6	15.6	15.6	15.6
Latvia	0.64	0.64	0.63	0.64
Lithuania	3.45	3.45	3.45	3.45
Croatia	7.56	7.52	7.56	7.60
Bulgaria	1.96	1.96	1.96	1.96
Romania	37556	41217	42312	42440
Serbia a. M.	65.3	70.0	75.0	80.0
Bosnia a. H.	1.96	1.96	1.96	1.96
Russia	34.7	35.6	37.5	40.1
Turkey	1692007	1751377	2055397	2306860
EU-12	1.13	1.23	1.26	1.28

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

Exchange rate LCY/USD (avg)

Countries	2003	2004e	2005f	2006f
Poland	3.89	3.76	3.58	3.44
Hungary	224.2	207.0	201.3	202.0
Czech Rep.	28.2	26.0	24.8	24.1
Slovakia	36.7	32.6	31.2	30.2
Slovenia	206.8	194.3	190.5	187.5
Estonia	13.8	12.7	12.4	12.2
Latvia	0.57	0.52	0.50	0.50
Lithuania	3.05	2.80	2.74	2.70
Croatia	6.69	6.11	6.00	5.94
Bulgaria	1.73	1.59	1.55	1.53
Romania	33200	33510	33581	33156
Serbia a. M.	57.4	57.0	58.5	62.5
Bosnia a. H.	1.73	1.59	1.55	1.53
Russia	30.7	29.0	29.8	31.3
Turkey	1505314	1441855	1608826	1798919
EU-12	0.88	0.81	0.79	0.78

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

Growth increases
So do interest rates?

Since last year, the world economic picture has changed for the better. The US economy is flirting with economic growth of 3-4% for the year as a whole, whereas the European economy remains weaker with prospects of 1-2% increase in due course. The emerging world economies have done far better than expected. This year, China and India should sustain high growth while Russia is joining the ranks of the world's fastest growing economies. As regards the main interest rates (USA and EU), the outlook remains bearish as the economic recovery gains steam. The US Fed finally delivered a long-awaited series of rate hikes beginning in the middle of this year. Yet after losing ground in the first half of 2004, the US Treasury (UST) market took a pause and later exhibited a bullish curve flattening. The market seemingly shrugged off upbeat growth reports, concentrating more on other factors such as jobless claims, payrolls, inflation and energy prices. Fiscal and external imbalances continue depress the US dollar outlook vs. EUR. Market pundits are becoming increasingly concerned about the sluggish jobs recovery and subdued inflation. After a brief increase in the first half of 2004, US inflation set back again, leaving some market pundits wondering about the causes. In its statement the Fed admitted that while inflation was picking up, it was not doing so at an alarming pace. The interpretation immediately went along the lines that the Fed could take a longer pause and not hike rates till the end of this year. Yet the inflation debate reveals two camps of market watchers peddling somewhat opposite views. The first camp argues that the Fed is still behind the curve and that (notwithstanding the current inflation numbers) prices will jump significantly during next year owing both to external and internal pressures. The other camp firmly believes that the inflation threat for the US economy is grossly overstated as evidenced by recent economic numbers and that the impact of global outsourcing and productivity gains on domestic prices is not properly valued. Nevertheless, both camps agree that record-high energy prices are a wild card for the global economy, and that imbalances in the US constrain the US dollar outlook. Therefore, the majority believes that interest rates will have to move higher next year, although the magnitude of monetary tightening and the UST curve shaping remain the subject of dispute. Yet, high energy and raw material prices curtail the economic growth outlook and may reduce the likelihood of aggressive monetary tightening. Many agree that the economic recovery is uneven, and a bumpy road certainly lies ahead.

Currencies: FX per EUR

Countries	current	Dec-04	forecast Mar-05	Sep-05
UK	0.70	0.69	0.70	0.72
Sweden	9.08	9.10	8.90	9.00
Denmark	7.44	7.44	7.44	7.44
Switzerland	1.54	1.51	1.51	1.53
Japan	136	136	133	134
USA	1.26	1.21	1.23	1.30
Canada	1.57	1.54	1.55	1.57

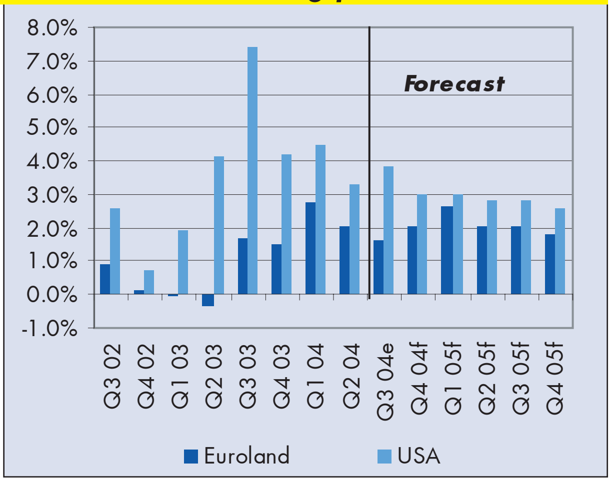
Source: Thomson Financial Datastream, RZB-Group Research

Interest rates (3M)

Countries	current	Dec-04	forecast Mar-05	Sep-05
Euro-12	**2.17**	**2.3**	**2.6**	**2.9**
UK	4.87	5.3	5.3	4.9
Sweden	2.17	2.5	3.1	3.2
Denmark	2.28	2.4	2.6	3.0
Switzerland	0.69	1.0	1.3	1.3
Japan	0.03	0.1	0.1	0.1
USA	2.11	2.3	3.0	3.5
Canada	2.62	3.0	3.3	3.6

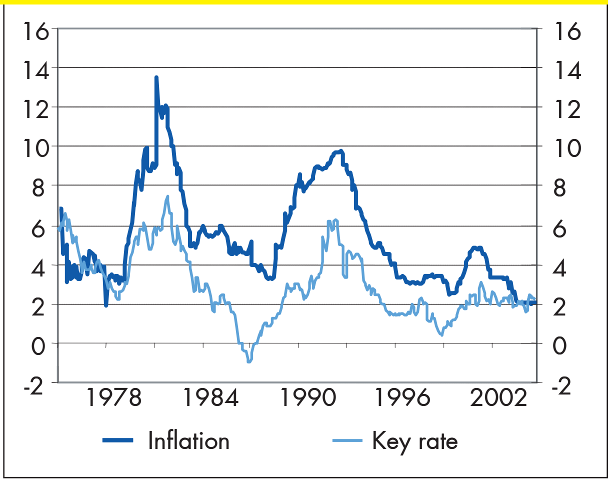
Source: Thomson Financial Datastream, RZB-Group Research

Growth rates reaching potential



Source: Thomson Financial Datastream, RZB-Group Research

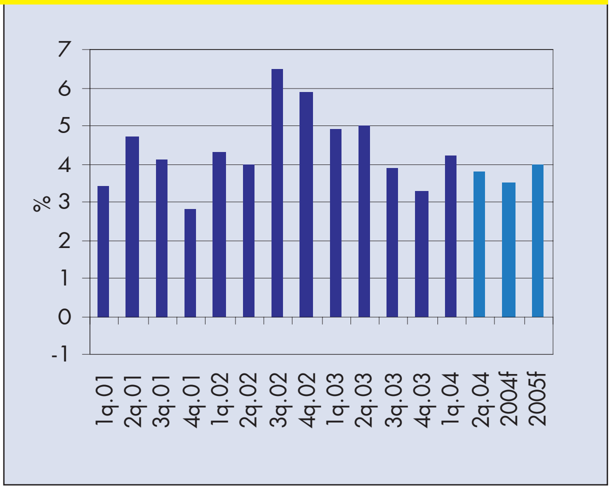
Low nominal and real interest rates



Source: Thomson Financial Datastream, RZB-Group Research

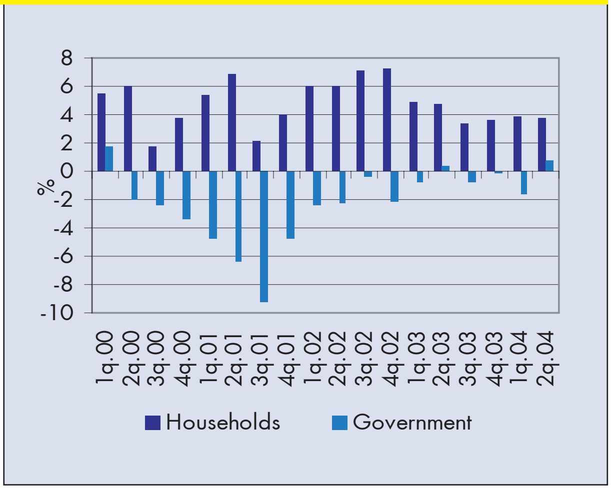
Favourable Economic Growth
Higher Inflation Rates?

Gross domestic product, real growth rates



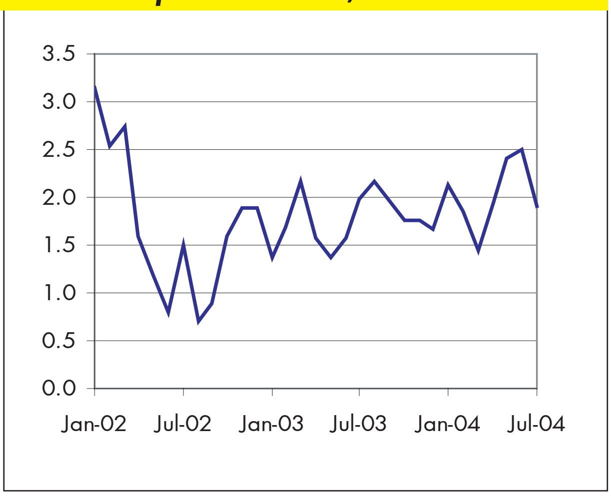
Source: CBS

Consumption, real growth rates



Source: CBS

Consumer price index %, annual level



Source: CBS

The Croatian economy grew by 3.8% yoy in the second quarter, after expanding by 4.2% in the first quarter of 2004, which was somewhat above expectations. One impetus behind GDP growth in Q1 came from personal consumption, which saw a slight recovery (after 3.6% growth in 2003 Q4, 2004 Q1 posted a 3.9% increase). In 2004 Q2, personal consumption recorded almost the same growth rate (3.8%). Investments grew briskly (8.9% and 7.7%), but still slower compared to previous periods. While government spending declined during the first three months (by 1.6% in Q1), in the second quarter of 2004 government consumption unexpectedly turned around, with a positive growth rate of 0.7% (mainly due to the state investment in transport infrastructure). In 2004 Q1, growth in exports of goods and services was higher than the growth rate for imports, but here again the situation reversed in Q2. Despite the fact that growth rate of imports slowed compared to 2003 Q2, from May to June of 2004 it was higher (5.4%) than growth in exports (3.9%). GDP trends in 2004 Q1 were also influenced by a recovery in industrial production, which saw much faster growth than expected after the slowdown at the end of 2003. Retail trading also increased in the first quarter, after an earlier slowing, and thus positively influenced the GDP trends. These positive trends weakened in second quarter, but for the following period we expect a favourable GDP growth rate, due to the better results in retail, industrial production, higher exports rate and probably the best results in tourism since the beginning of 1990s.

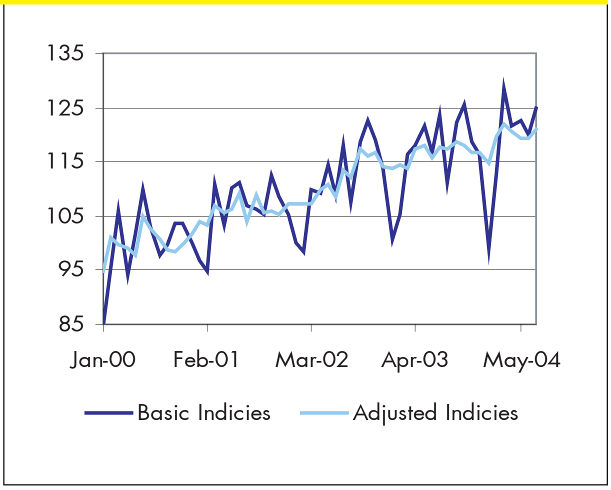
After a slight price rise in goods and services used for personal consumption in June, July and August brought another drop in annual inflation to below 2%. However, the impact of higher prices for petroleum products on the domestic market did not yet exerted its full influence on prices during the summer months. As no considerable decrease in crude oil prices is expected in the world markets, which have a direct impact on petroleum products prices on the domestic market, and thus also on the overall economy, we can expect to see higher inflation rates by year-end, also leading to a higher average inflation rate in year-on-year terms.

Slowdown in Industrial Production Growth

Industrial production growth rates in June and July confirmed our expectations of a slowdown in industrial production growth this year. Hence, after encouraging data in June when the industrial production index recorded 2.8% growth yoy, in July the rise was only 1.2%. This slower growth in July is mostly the consequence of production in the manufacturing industry that makes up more than 80% of the total industrial production structure. The manufacturing industry experienced unusually low growth of 0.5% in July, confirming that the past four month's rise was much weaker than in past years. As manufacturing industry trends are strongly influenced by the production of food and drinks, which accounts for 20%, negative growth rates in the aforementioned activity for as long as three months running have definitely contributed to such movements. But August showed surprisingly positive data for industrial production, with the strongest growth rate (4.8%) in the last five months mainly as a consequence of growth in the manufacturing industry which recovered in August (posting a growth rate of 5.7% yoy). Despite the fact that these movements may be signs of recovery, it should be noted that in August were two working days more than in the same month of 2003, thus affecting the monthly level indices by about 5%. However, as we approach the end of 2004 Q3, we expect that this year's industrial production will be somewhat weaker than in past years.

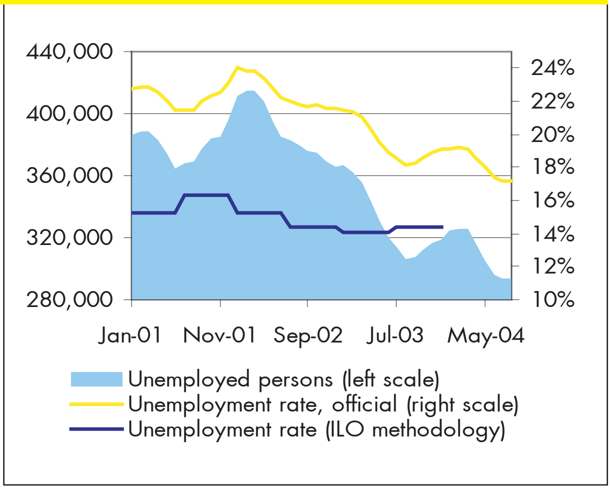
The summer of 2004 saw a continuation of positive developments on the labour market. The registered unemployment rate fell below 18%: in July, and in August it was 17.2%, which is also the lowest in the past several years. This only continued the downward trend in the unemployment rate, which has been seen for the fifth month in a row. Although the decrease in the unemployment rate can be partly attributed to seasonal factors as well, i.e. stronger demand for employees during the summer season, we expect that this year's unemployment rate will be lower than last year's and should come in at around 18.5%. For the first time in a long time, June brought the number of employed persons to over 1.4 million and such trends have been confirmed by July as well, with 1.413 million employed persons, up 0.7% on June. After the summer months there will surely be a slight fall in the number of employees, but positive market trends ought to continue until the end of the year.

Industrial production index, 2000=100



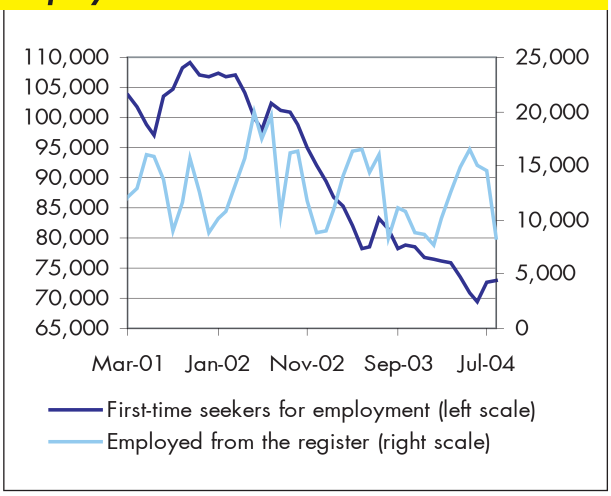
Source: CBS

Unemployed persons, unemployment rates



Sources: CBS, CES

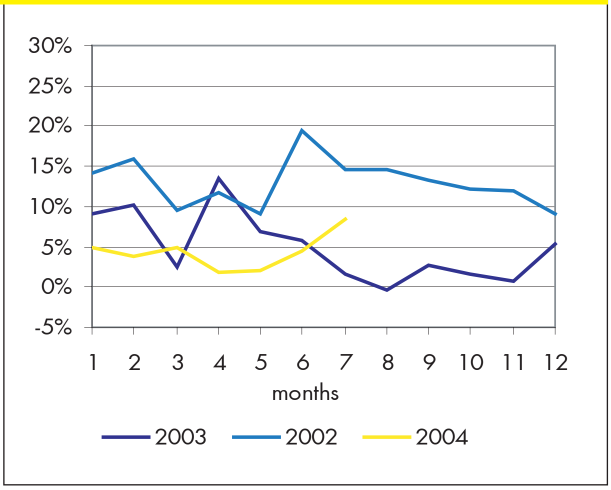
Employment



Source: CES

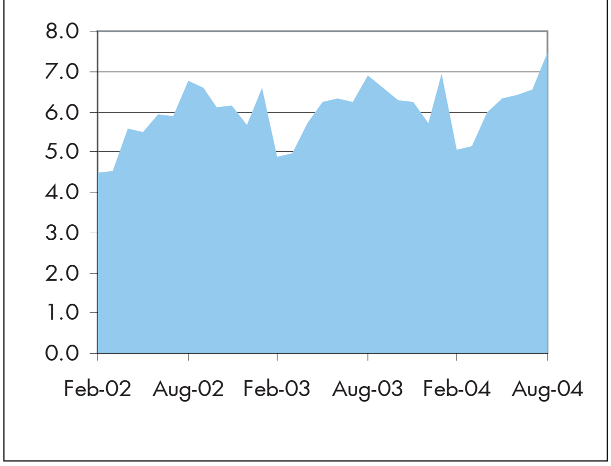
Tourist Season 2004 - Best So Far?

Retail trade, nominal growth, yearly



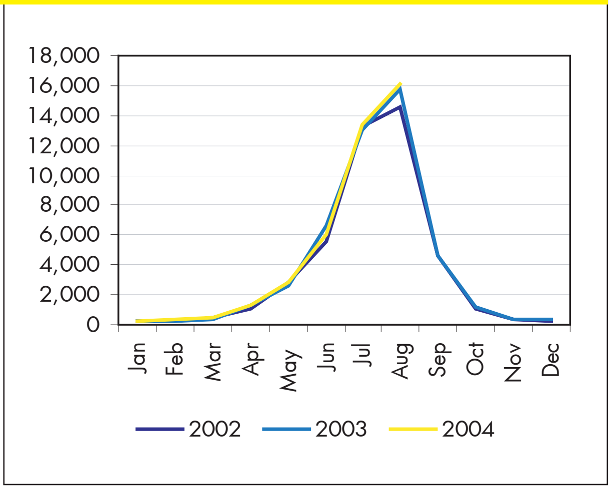
Source: CBS

Retail trade turnover,billion kuna, nominal



Source: CBS

Tourist overnight stays, thousands



Source: CBS

After the unexpectedly favourable retail trade growth in 2004 Q1, for two months in a row (April and May) retail trade turnover recorded real stagnation in annual terms. The slowdown in trade can be also partly attributed to a downturn in lending activity, lower merchandise import rates, lower sales of new vehicles, etc. June put an end to the aforementioned trend in retail trade, to which also the start of the tourist season contributed very much. Although it is common that retail trade turnover posts better results during summer months, i.e. during the tourist season, July still managed to surprise us with an unusually high annual growth rate of 6.6% in real terms (the highest in the past seventeen months). This was also partly influenced by the increased sale of new vehicles as a market reaction to the announcement of higher excise duties. Until year-end the trends should include a further slowdown in new approved retail loans as well as lower merchandise import rates, and finally retail trade turnover should be lower after the summer months.

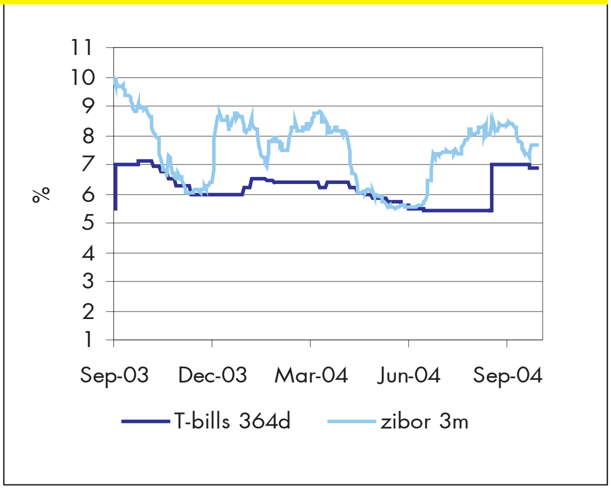
Initial results of the tourist season indicate that this could be one of the best (if not the best) year as regards realised turnover. The total number of tourist nights reached 40.1 million by the end of August. The structure of foreign tourists in the Croatian market is slowly changing, i.e. Croatia is becoming an interesting tourist destination for the tourists from countries which have not participated strongly in the tourism market so far. That is, with a slight increase of the number of total tourist nights in the first eight months, the traditional guests participating in the structure of tourist night with ca. 50% (the Germans, Slovenes and Czechs) recorded a fall in nights yoy. At the same time, the number of nights by tourists from other developed countries, such as France and Great Britain, increased at considerable inter-yearly growth rates (71% and 41%). As the tourist season results were good, and the prices of goods and services rose slightly, and as nautical tourism increased and the share of tourists from developed countries was higher, we expect that income from tourism will be higher than in 2003. Still, it is necessary that the overall tourism offerings be increased for the purpose of further development and to position Croatia as attractively as possible in the global tourism market.

Slower Growth
of Monetary Aggregates

The average annual growth rate of bank placements fell to 11.2% in the year 2004 after introduction of the CNB's strict measures against credit growth in 2003, which was an attempt at influencing the slowing down of external debt and current account deficit growth. Except the new measures at the beginning of 2004, the summer introduced another new monetary policy measure due to the continued increase of the external debt, the marginal reserve requirement, by which 24% of assets in FX are allocated to the account held with the CNB, without remuneration, for increase of liabilities towards non-residents. Also deposit growth with banks slowed down. This year's total deposits increased around 8.0% on the average, and the Kuna savings and time-fixed deposits still realise much higher growth rates than the foreign currency ones (in August 22.0% vs. 6.2%). Base money increased at a much slower pace this year than last, although a stronger growth was announced (8 to 9%). Because of such trends as regards asset sources, placement growth will slow down.

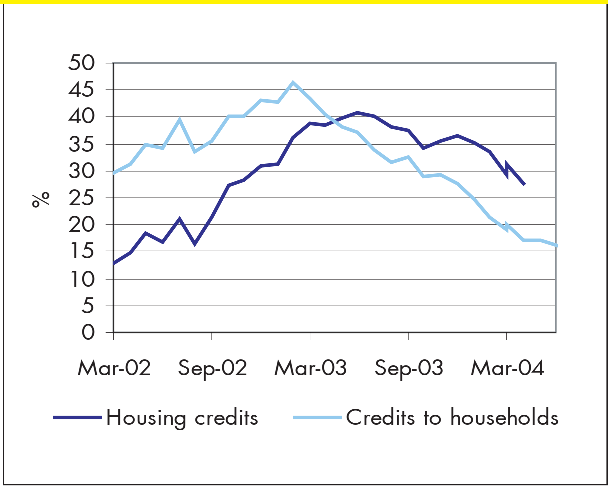
After the second quarter was characterised by good liquidity and lower interest rates in the money market, that is, by decrease of interest rates of the Ministry of Finance treasury bills, the summer months recorded a high level of interest rates. Liquidity started falling towards the end of June, followed by a new issue of Government bonds in July and a high growth of Kuna demand due to strengthened tourist season. Especially strong was the rise of cash in circulation that increased by HRK 880 million kuna in July in relation to the end of June. At the same time some of the Kuna were drawn through the issuing of the new Government bond, to settle the Government foreign liabilities. The CNB tried to supplement liquidity by FX interventions in July and August, but the pressure of demand for Kuna remained strong. Interest rates in the money market again reached the levels above 10%. Demand strongly exceeded supply. The 3M interest rate went up to the level above 8% and rested there for a longer period. The interest rate on treasury notes significantly increased at the end of summer, and interest rates may be only slightly lower until the year-end due to the high amount of treasury bills maturing in the following period and Government orientation to finance debts in the domestic market which pressures will be partly offseted by lowering reserve requirement rate (from 19% to 18%).

Interest rates



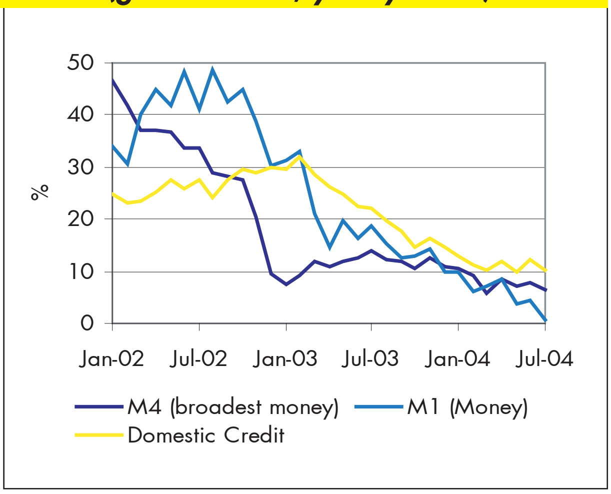
Sources: biznis.infoforum.hr, CNB, MoF

Credit growth, in %, annual level



Source: CNB

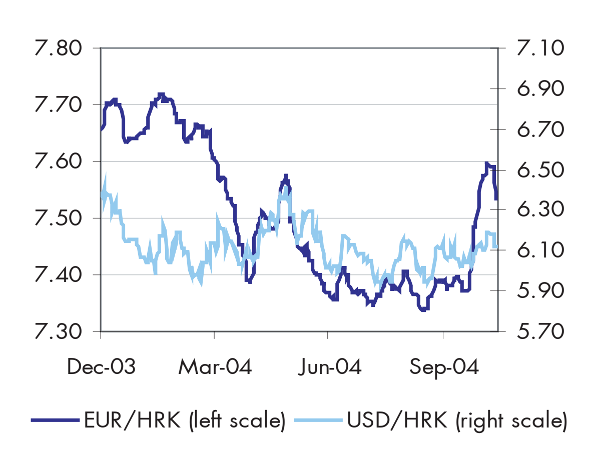
Monetary aggregates and domestic credits (growth rates, yearly basis)



Source: CNB

Strengthening of Depreciation Factors

Middle exchange rate of the CNB



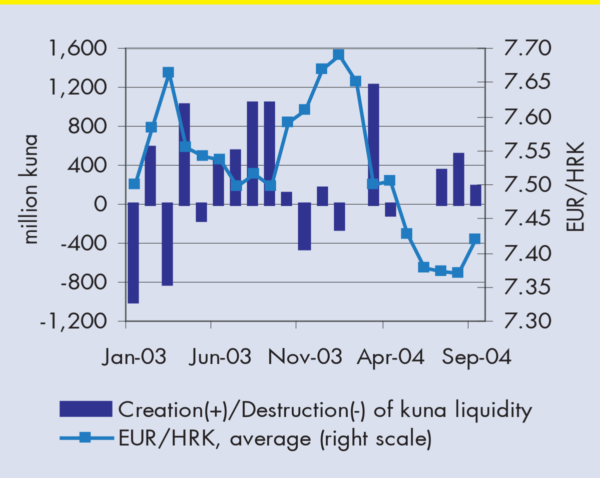
Source: CNB

Middle exchange rate of the CNB

Currency	Middle Exchange Rate 1/10/2004	Change Compared to: 3/1/2003 Exch. Rate	Movements	%
EUR	7.5631	7.5597	↑	0.04
USD	6.1354	6.4762	↓	-5.56
CHF	4.8719	4.9153	↓	-0.89
GBP	11.0329	10.8290	↑	1.85

Source: CNB

CNB operations and exchange rate movements



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

The exchange rate was highly volatile in the first few months of 2004, but after the May low levels of 7.40 kuna for the 1 euro, it moved in a much narrower field. Until the middle of May the exchange rate moved in the range between 7.39 to 7.72 kuna for the euro, and afterwards from 7.33 to 7.40 kuna for the euro. The pressure of high demand for the kuna brought about strong appreciation trends, especially in July and August when the tourist season got stronger, the inflow of foreign currency increased, and at the same time the banking system liquidity was disturbed by a high amount of cash in circulation. In such conditions not even the high corporate demand for foreign currencies did not succeed in weakening the kuna in the FX market. By four foreign exchange interventions in summer the CNB responded to high kuna demand, the banking system liquidity decrease, and strong appreciation pressure. The interventions ensued upon exchange rate falling below 7.35 kuna for the euro, which implicitly denoted this as the bottom level of the acceptable exchange rate range. The above limit was determined by interventions in the FX market at exchange rate levels of 7.70 kuna for the euro. That is the cca 5% range in which the Kuna exchange rate moves. The highest kuna appreciation was recorded in the periods just before issuing of the new Government bonds indexed to f/c.

The last quarter is expected to see kuna depreciating against the euro (imports and debt repayments). There were movements in that direction at the end of September with regard to improved banking system liquidity upon the decrease of the cash in circulation and the high FX demand. A stronger effect has been seen after the issuing of a new tranche of the ten-year bond in the domestic market. Although the beginning of the year expected slight exchange rate depreciation in relation to 2003, high FX inflow and the rising export of goods and services caused stronger appreciation pressures. Therefore, this year is expected to see a lower average kuna for euro exchange rate. The influence is the greater on the trends of the kuna for dollar exchange rate with regard to this year's weakening of the dollar towards the euro. At the end of this year we can expect exchange rate level around 7.58 kuna for euro, although there is a risk of achieving level of 7.65 if the 7.60 level would be broken. If this would happen, we can even expect some CNB actions to curb stronger depreciation.

Reducing Bank Domination

The Croatian financial system continued to grow in this year also, still, with some softening of the bank domination that was present in the past years. At the end of 2003 assets of the financial system reached the volume nearing EUR 33 billion that is, cca 125% of the value of realised GDP. Along with the strong rise in pension and investment funds, the influence of leasing companies has grown significantly in 2003, whereas the second place as regards assets is still held by insurance companies. At the end of 2003, the share of the banking system fell slightly below 85%. The biggest leap took the leasing companies growing under the influence of the CNB's monetary measures against curbing the placements with banks. Although some of the limitations were abolished during this year, leasing companies continue to grow with regard to the slow growth of the banking system placements. Continuously rising is, also, the share of pension and investment funds.

In June the Croatian banking system reached the level of EUR 29 billion. The market is dominated by six banking groups that cover 84.4% of the market when looking at their respective assets volumes. The growth of the banking system is realised by decreasing the number of banks due to the processes of merging and acquisitions, and there are new upcoming activities which will further decrease the number of banks. Currently there are 39 banks operating in Croatia with the tendency of further decrease. The biggest part of the banking system is owned by foreigners, which is evident in the high share of assets (close to 92%).

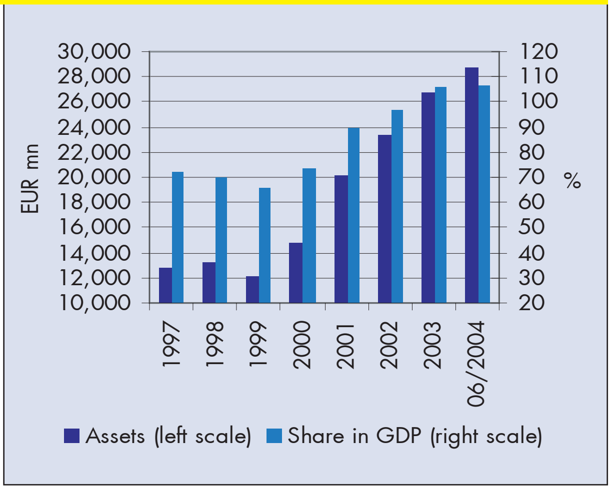
The characteristics of the Croatian banking system is a large portion of retail loans in the loan portfolio (48% of total loans), and the total retail loans have reached the HRK 58.8 billion level or cca 29% of GDP. According to the latest indicators, this is the highest share among the CEE countries, although still much below the levels in Eurozone. Total loans have reached the level of nearly 58% of GDP, which is also above the CEE countries' average, but considerably below the 110% level in the Eurozone. On the other hand, retail deposits reached the level of cca 40% of GDP, which is much above the average of the new EU members (cca 28%), whereas in the Eurozone, the level is around 55% of GDP.

Financial institutions' assets

31.12.2003, EUR millions	amount	%
Banks	**26,743.3**	**84.7%**
Non-banks financial institutions	**4,817.2**	**15.3%**
Insurance	1,659.3	5.3%
Leasing	1,418.2	4.5%
Loans&savings institutions	156.9	0.5%
Building societies	453.6	1.4%
Open-end investment funds	385.9	1.2%
Closed-end investment funds	127.8	0.4%
Obligatory pension funds	611.7	1.9%
Voluntary pension funds	3.9	0.0%
Total	**31,560.6**	**100%**

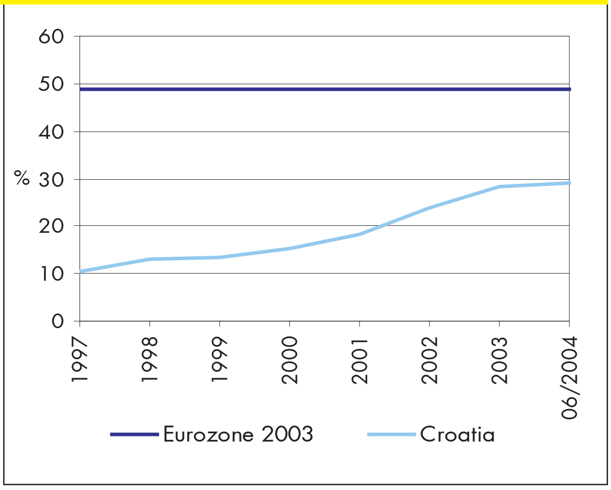
Sources: CNB, Hagena, MoF

Banks' assets



Sources: CNB, CROSTAT, RZB-Group Research

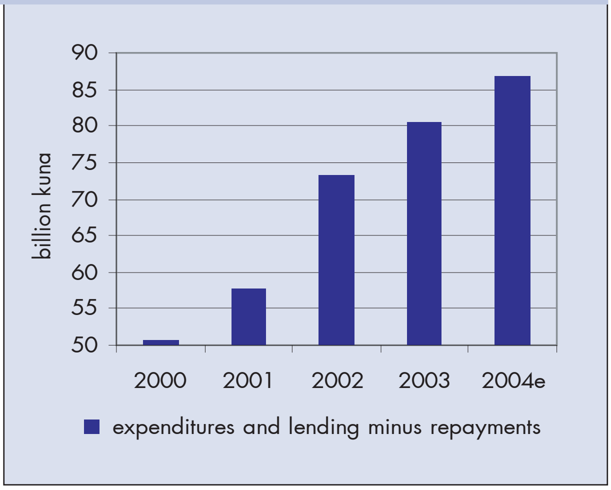
Share of credits to households in GDP



Sources: CNB, CROSTAT, RZB-Group Research

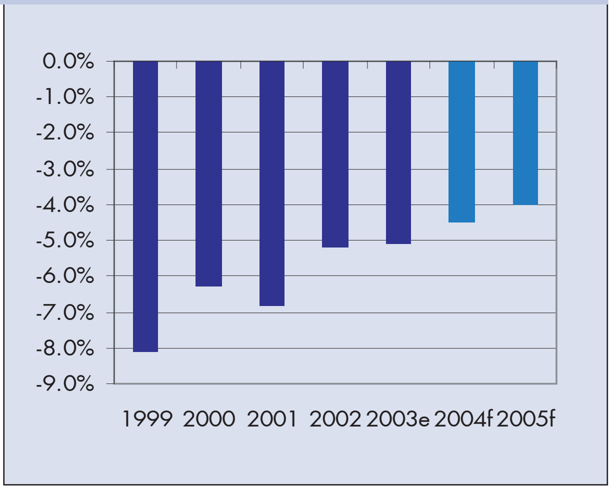
Budget Revision
with Fiscal Consolidation

Central Government Budget



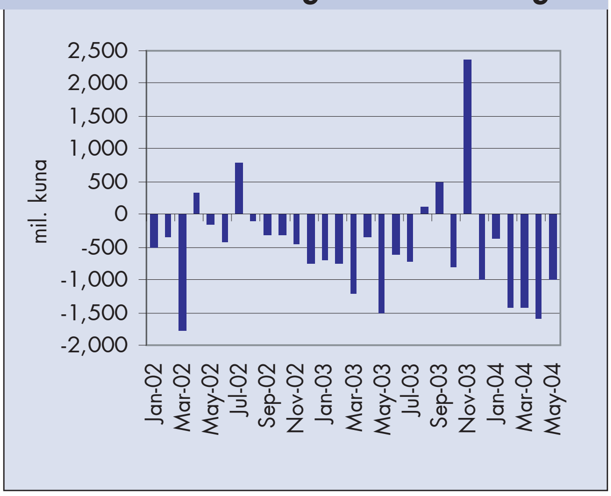
Source: CNB, RZB-Group Research

Consolidated general government, % of GDP



Source: CNB, RZB-Group Research

Consolidated central government budget



Sources: MoF, CNB

After the IMF talks regarding the new Stand-By Arrangement have come to an end, the Government made budget revision in keeping with increased expenditure and fiscal policy targets for this year. The last-year's defined deficit of 6.3% is planned to go down to 4.5% in this and to 3.7% in the year 2004. According to the Principles of Fiscal Policy for the period from 2005 to 2007, the planned deficit of the consolidated Government would have to reach the levels below 3% by 2007, and in the process public debt should remain in keeping with the Maastricht criteria below the 60% of GDP level. The fiscal policy plan is to lower the share of expenditure of the consolidated Government in the GDP to the level below 50% of GDP until 2007. This will, therefore, require substantial consolidation of expenditures. It will, also, require gradual lowering of the intensive Government investments, decreasing the dependency of certain companies on the Government budget, lowering subsidies, reform of Government administration, decrease of the total amount for salaries, cutting down some of the social transfers, activating of the Treasury and other measures which may influence the expenditures. This should open some space for lowering the fiscal burden and the increase of the economy competitiveness.

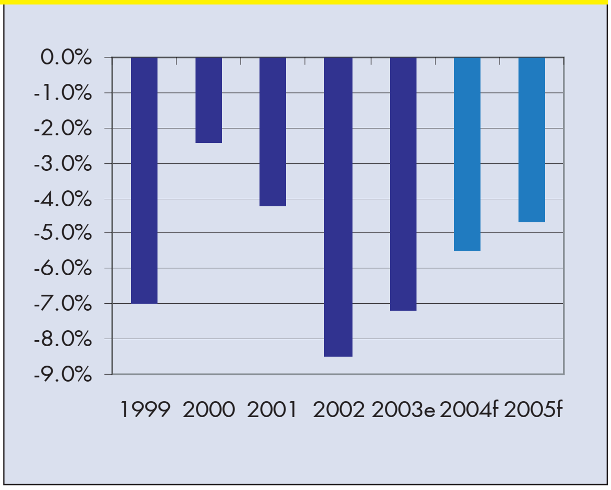
The 2004 budget revision increased both income and expenditure of the Government budget. Income rise which ensued from HT dividend withdrawal, increased excises (vehicles, tobacco) and the concession for the third GSM operator. In this way Government budget income increased by HRK 2.8 billion, whereas expenditure increased by HRK 2.2 billion. During the first five months total budget income went up 6.3% yoy, whereas total expenditure and borrowings jumped 7.1%. In the first half-year around 45% of planned income of the central Government for 2004 was realised, whereas in the same period cca 48% of all expenditures was realised. Thus, most of this-year's planned deficit of HRK 9.3 billion was realised in the first part of the year. The second part of the year should bring, along with increased tax income (tourism, stronger retail trade), income from dividends and concessions and increased excises revenues, a stronger growth of income to achieve the planned deficit of 4.5% of GDP. Putting in the perspective the Government's resolve to adjust expenditure to the target deficit level (IMF), we believe this deficit level can be realised.

Slowdown in Import Growth
and Increasing External Debt

Payments on the current account recorded a deficit of USD 1.27 bn in Q2 (representing a 13% yoy decline). In the second quarter, the positive impact came from the income account and from an increase in revenues from transportation (a surplus of USD 9.8 mn). The worse results in tourism in June had an effect on the services account, and accordingly the surplus on the services account fell to USD 980 mn in 2004 Q2 from USD 1.1 bn registered for the same period last year. Traditionally, the shortfall in the current account has been the result of external commodity exchange, that is, much higher imports than exports (but also a significant depreciation of the USD against EUR in Q1). However, during the first eight months there were some positive indications of commodity exchange which should continue until year-end. Export growth rates were higher on average than import growth rates, confirming our expectation that this year's export growth will exceed import growth, with improved coverage of imports by exports. However, the external trade deficit continued to deepen and at the end of August it amounted to close to the USD 5.6 bn (up 10.2% yoy). Continuing its restrictive monetary policy, a decrease of personal consumption, higher export growth rates and a strong increase in tourism revenues, Croatia should see a decrease in the current account deficit as a percentage of GDP.

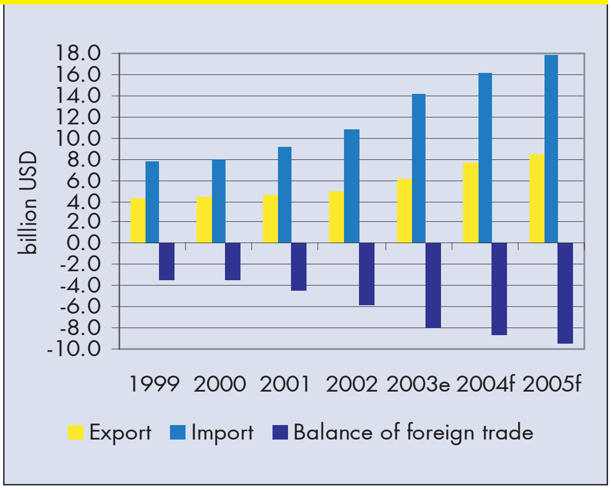
External debt continued on an upward trend, but moved more slowly. Nevertheless, at the end of July, it increased to a record high of USD 25.7 bn (up 31% yoy). Keeping in mind the intention of the government to lower dependence on external debts, i.e. that the budget be financed more through domestic sources, and the central bank's restrictive measures directed to the banking sector, we expect a slowdown in external debt growth. Additionally, in the negotiations with the IMF, the government has undertaken an obligation to control public enterprises and monitor their indebtedness in particular. Although at the end of July the biggest portion of the external debt structure lies with the state (35.5%), we expect this will decrease further whereas over time the share of other sectors in total external debt will surely increase. In the second half of this year, around USD 2.15 bn of external debt will mature (including interest).

Current account balance, % of GDP



Source: CNB

Foreign trade of goods



Source: CBS

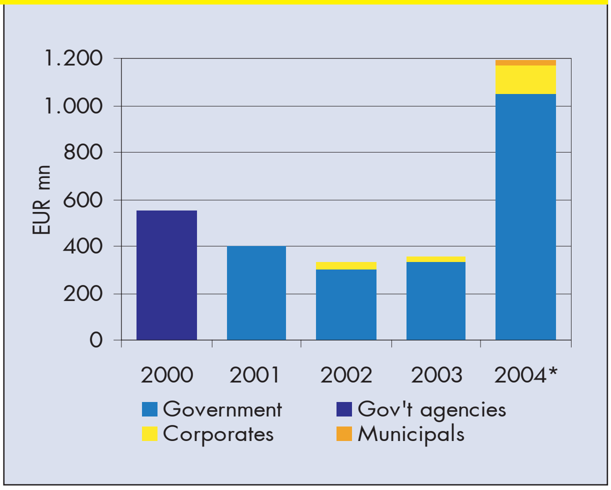
External debt and ratios

Quarters	External debt (USD mn)	External debt as % of: GDP	External debt as % of: Exports of goods and services	International reserves (% of external debt)
3q.01	11,875	61.5%	126.2%	37.2%
4q.01	11,317	57.0%	117.5%	41.6%
1q.02	11,628	57.8%	121.0%	42.0%
2q.02	13,401	64.8%	134.8%	41.8%
3q.02	13,655	62.4%	132.0%	41.8%
4q.02	15,426	67.2%	145.9%	38.2%
1q.03	17,121	70.3%	152.4%	36.3%
2q.03	19,149	73.5%	157.3%	35.4%
3q.03	20,111	73.4%	142.2%	35.1%
4q.03	23,470	81.3%	157.4%	34.9%
1q.04	23,994	78.9%	155.6%	31.4%
2q.04	25,360	80.6%	161.0%	30.6%

Source: Croatian Bureau of Statistics

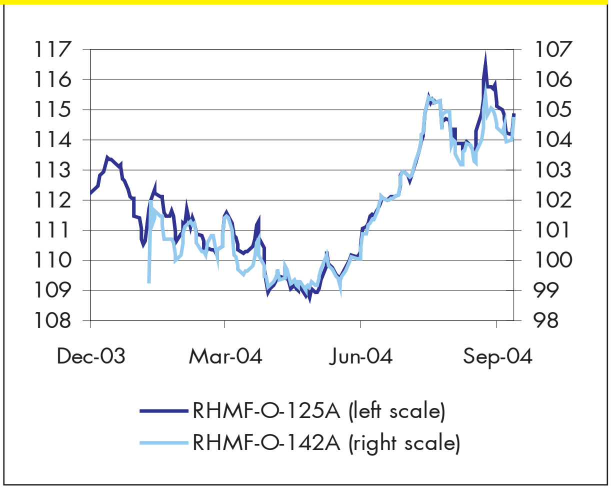
Record Amount
of New Issues

Issuance activity on domestic market



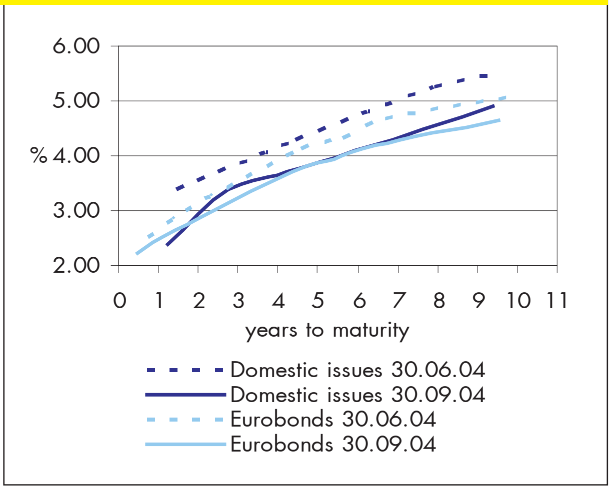
* January to September
Sources: MoF, ZSE, RZB-Group Research

Prices on domestic market



Source: biznis.infoforum.hr

Yield curve, Long-term



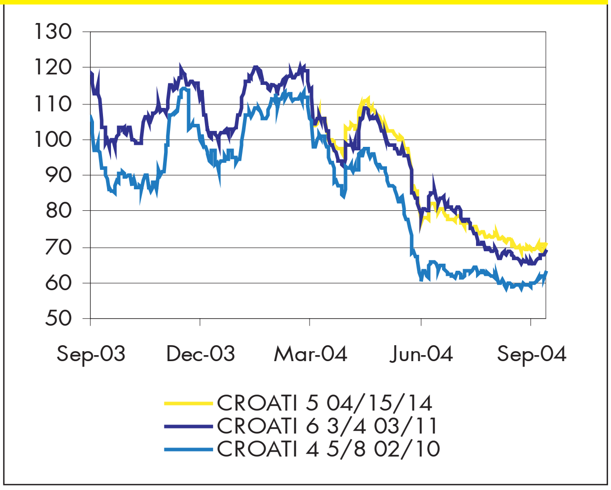
Sources: Bloomberg, biznis.infoforum.hr

This year saw the top record amount of new bond issues in the domestic market. There were issues of new Government, corporate and municipal bonds. In Q1/2004 the Ministry of Finance placed an issue of a ten-year bond indexed to FC (in two tranches and amounting at EUR 350 million). In July an issue of a three-year bond indexed to FC was placed (of EUR 400 million). According to the announcements from the Ministry of Finance, a new tranche of RHMF14 in September of EUR 300 million was issued, and some new issue could be in pipeline for the rest of the year. In July the HZZO bond issue matured in the amount of EUR 222 million and in September the RHMF04 bond of EUR 200 million. Because of financing the fiscal deficit and exchange of matured issues as well as turning to larger financing in the domestic market, the year end expects some new issues in the domestic market (along with withdrawing from issuing the new Samurai bond).
In the corporate part of the market, apart from the Podravka issues in February (EUR 27 million) and the Pliva issues in May (the biggest corporative issue exclusively in the domestic market, EUR 75 million), in May Agrokor also issued the second tranche of its Eurobond (EUR 100 million), and the bond was also listed in the Zagreb Stock Exchange. In July the Atlantic Group bond was issued of EUR 15 million with interest rate of 5.75%. In the Zagreb Stock Exchange there are currently six corporative bonds quoted (two also in foreign stock exchange markets, and the Plava laguna bond has matured) along with the kuna issue of the Hypo-Alpe-Adria-Bank bond. The town of Koprivnica issued three tranches (HRK 60 million) of their bond, and the town of Zadar a bond indexed to FC and amounting at EUR 18.5 million.
Bond price movements of domestic issues were very much influenced by exchange rate volatility in the domestic FX market. That is, kuna exchange rate oscillation towards the euro in the spreads between 7.35 to 7.70 kuna for euro at a significantly increased standard deviation, and the relationship between the market exchange rate and the middle CNB exchange rate resulted in price volatility. As domestic bonds indexed to FC are traded at the middle exchange rate as at the day of trading, the differences between the market and the middle exchange rate enable arbitrage. In the first part of the year, due to the dominant appreciation movements, a price fall trend was present in bonds indexed to FC. The increase of prices in the world markets, along with turnover growth in the domes-

tic markets and later with depreciation expectations, was reflected in the price rise of domestic issues in the summer months, which was stopped at the beginning of September by announcing new domestic bond issues and unfavourable news for the world market bonds.

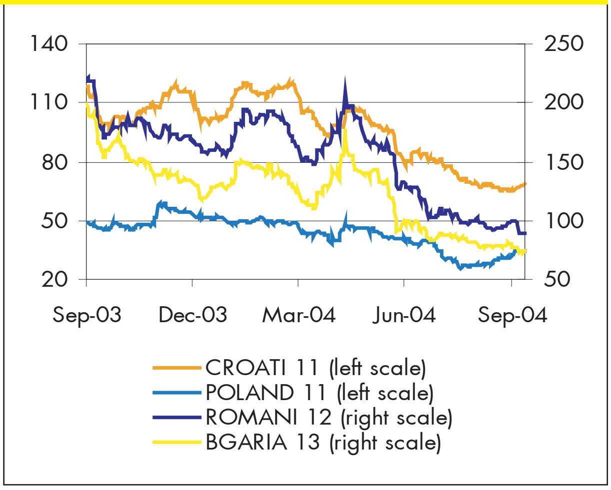
In the world markets Croatian Eurobonds were under the influences of emerging markets debt price movements and the news regarding the process of joining the EU, and regarding the Croatian credit rating. Price fall of the emerging markets debt due to expecting the increase of the American interest rates which should worsen the terms of the debt repayment caused high spread levels in Q1/2004 (110 to 120 basis points for the longest maturities). April witnessed the European Commission's positive evaluation of the Croatian application to join the EU, which resulted in spread narroeing to levels of 80 to 90 basis points. After the last news in June and with the emerging markets debt spread decrease, during the summer spreads went down to the level of 65 -70 basis points for the longest maturities (record lows). As well, spread narrowing is affected by funds transferred from funds that have invested in the countries which entered the EU this year, thus passing on to a new assets class, and the interest for Croatian Eurobonds on the basis of priority as regards credit rating in comparison to Bulgaria and Romania, and other countries that converge towards the EU. During this year Croatia has placed one Eurobond issue (maturing in 2014), whereas at the same time the 1997 bond has matured which was originally issued in German marks (EUR 153.4 million).

Eurobonds' spread



Source: Bloomberg

Spread comparison



Source: Bloomberg

Government and government guaranteed bonds on domestic market

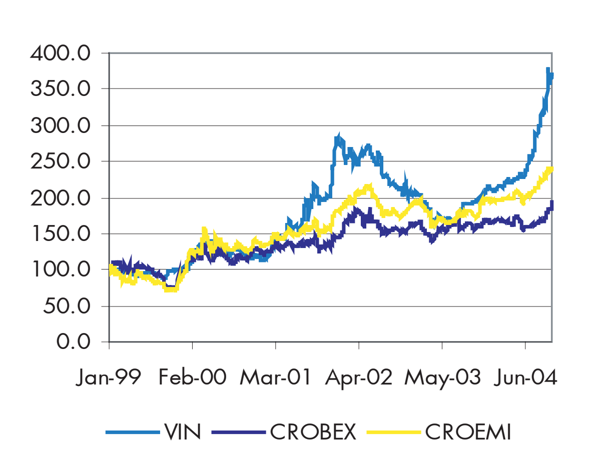
Bond	Currency	Volume (mn)	Maturity	Coupon (%)	Price (ask) 9/30/04	YtM (ask, %) 9/30/04	Spread to Bund 9/30/04	YtM (ask, %) 6/30/04	YtM (ask, %) 12/31/03	YtM (ask, %) 9/30/03
DAB-O-05CA	EUR*	225	12/19/05	8.375	107.08	2.40	4	3.40	3.52	3.11
RHMF-O-077A	EUR*	400	7/7/07	3.875	101.30	3.38	60			
RHMF-O-08CA	EUR*	200	12/14/08	6.875	112.24	3.70	54	4.29	4.42	4.34
RHMF-O-125A	EUR*	500	5/23/12	6.875	115.23	4.50	80	5.26	5.06	5.10
RHMF-O-142A	EUR*	650	2/10/14	5.500	104.51	4.89	95	5.49		
RHMF-O-085A	HRK	1,000	5/28/08	6.125	100.20	6.06	302	6.27	6.02	6.25

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

Sources: MoF, ZSE, CDA, biznis.infoforum.hr

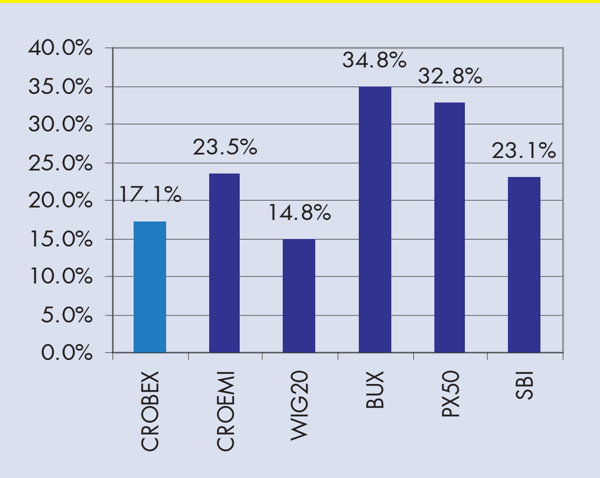
Index and Turnover Growth

Croatian indices (5 years), indexed (1999 = 100)



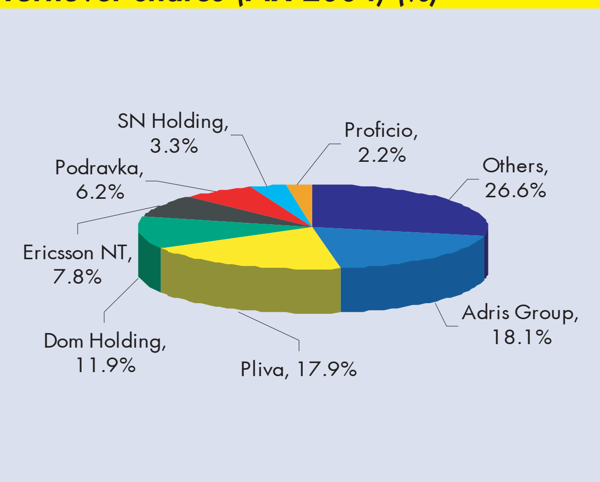
Sources: Zagreb Stock Exchange, Varazdin Stock Exchange, RZB-Group Research

Region's core indices (in local currency) - YTD Performance



Sources: Zagreb Stock Exchange, Bloomberg, RZB-Group Research

Turnover shares (I-IX 2004) (%)



Sources: Varazdin Stock Exchange, Zagreb Stock Exchange, RZB-Group Research

Trends in the Domestic Market

From the beginning of the year 2004 the CROBEX index grew by 17% and VIN index by 78%. Most of this growth was realized during the third quarter of the year. Namely, during the summer months both markets, the Zagreb and the Varazdin one, were in the positive mood. The VIN index increased by the outstanding 43% and in the same period the CROBEX went up by 21%, and both indexes reached their all-times highs. The same happened with the CROEMI index, which traces the most liquid stocks from the both Croatian stock exchanges. From the beginning of the year CROEMI grew by 24%, and during the last quarter it grew 16%. Although the growth of the Croatian market sounds remarkable, it did not beat the growth of the peer CEE markets. This growth can be compared with the growth which has happened at the beginning of the year 2000 after the Parliamentary elections which lowered the country's political risk. It only proves that the major risk on Croatian market was the political one. The growth actually started after Croatia got its positive Avis from the EU at the mid of July. The positive Avis attracted foreign investors and made Croatia an interesting market place. At the same time it "woke up" the major local players who wanted to secure their market positions and enhance them in order to make them ready and attractive in the EU market.

Turnover in the Domestic Stock Market

Summer drought is a term that has not been oft mentioned during the Q3 2004, neither in the weather nor in the stock market reports. Index growth was also accompanied by increased turnover by slightly over 58.42% compared to last quarter and almost 100% growth compared with the Q3 2003. The total turnovers of the equity market during the first nine months of the 2004 amounted at HRK 2.4 billion, which is 63% more than the previous year. The depth of the market has also increased as first 5 stocks by their turnovers make up around 60% of the total turnover, which was not the case before (cca. 75%). The first five most liquid ones had not been dethroned during the Q3 2004, although their order changed. Thus, the Adris shares took the lead from Pliva primarily due to speculations regarding the "final" sale of the tobacco portion to the long-term partner, Philip Morrison. Under the influence of these speculations, the stock had again recorded an exceptionally high daily turnover (on 2 August the Adris turnover was HRK 25.5 mil whereas, without this transaction, the average daily turnover of this stock was cca HRK 2 mil). The Dom Holding stocks are on the third place and Ericsson Nikola Tesla on the fourth. The interest for the Dom Holding share followed after the public offering by SN Holding and due to the events regarding the legal dispute with the CPF (HFP).

Market capitalisation of the companies with regular turnover on the Varazdin and the Zagreb Stock Exchange totals HRK 55.563 million (Sep 30. 2004), which is 27% of the GDP projected this year. Such a high Market Capitalisation is a result of the Act on Securities Market pursuant to which certain public joint stock companies (JDD) had 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. Although the listing was obligatory, it supported the development of the equity markets.

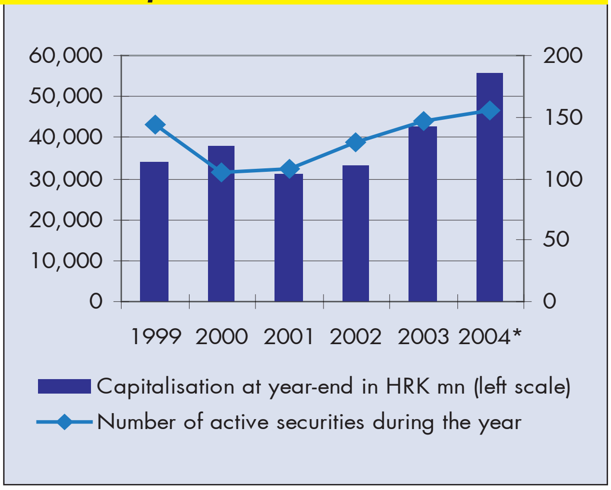
Sectors

The analysis of market capitalisation and turnover by different sectors shows the greatest differences in financial intermediation because this group includes banks, which have large market capitalisation (41% of total MCap) but a small percentage of free shares. The manufacturing industry accounts for 60% higher share in the overall turnover compared to its share in the overall market capitalisation. Real estate, renting and business activities (NACE - K) accounts for 22% of the turnover share as it contains the ex privatization funds, currently registered as holdings. There are 156 active stocks (traded during the year 2004) and 30 of them are stock in tourism (hotels and restaurants). These 19% of the total active shares make 10.5% of the total market capitalisation.

2004 half-year results of the most liquid companies show an interesting trend. The total revenues were stagnant whereas the total net income grew by 20%. This data supports our view that the organic growth of the local major players reached the top levels and that the future strategies will turn to growth through acquisitions.

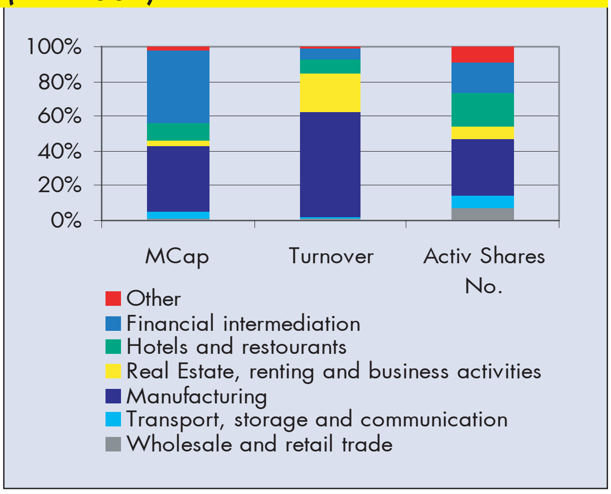
Upon sales of USD 560 mil, in September ***Pliva*** declared their solid half-year net profit of USD 90 mil. The main sales growth agent was the markets

Market capitalisation on the ZSE and VSE



*data from 30.Sep 2004; Sources: Zagreb Stock Exchange, Varazdin Stock Exchange, RZB-Group Research

Turnover, MCap Shares by Sectors (I-IX 2004)



Source: ZSE, VSE, CROSEC, RZB-Group Research

Performance of the most liquid shares

Symbol	Weight*	9/30/04	3 m chg	YTD chg
ADRS-P-A	25.00%	2,880.00	-1.2%	1.8%
BLSC-R-A	2.43%	180.00	12.4%	9.8%
ELKA-R-A	0.65%	111.00	23.3%	11.0%
ERNT-R-A	9.24%	910.00	24.7%	104.5%
ISTT-R-A	2.27%	111.00	11.0%	-7.5%
KOEI-R-A	1.53%	119.60	59.3%	68.1%
KORF-R-A	5.58%	102.00	59.4%	126.7%
KRAS-R-A	4.95%	290.06	1.8%	6.6%
PBZ-R-A	0.88%	360.00	46.9%	62.2%
PLAG-R-A	1.79%	1,700.00	21.3%	33.9%
PLVA-R-A	25.00%	464.90	4.5%	-5.1%
PODR-R-A	11.41%	212.00	17.8%	24.0%
PRFC-R-A	2.68%	61.00	37.3%	45.2%
RIVP-R-A	2.07%	220.00	46.7%	51.7%
SLPF-R-A	1.40%	39.50	27.8%	36.2%
SNHO-R-A	2.39%	127.00	101.6%	188.6%
VLDS-R-A	0.73%	42.15	40.5%	38.7%
CROEMI	100.00%	1,252.98	15.6%	23.5%

*as of 15. Jul. 2004; Source: RZB-Group Research

Selected shares liquidity

Symbol	Issuer	Sector	Avg. daily turnover Q304, HRK 000	MCap, HRK mn.	Free Float (%)
ADRS-P-A	Adris Grupa d.d.	Tobacco & Tourism	2,378	1,954	99.2
BLSC-R-A	Beliš?e d.d.	Industry/Paper	44	210	67.2
ELKA-R-A	Elka d.d.	Industry/Electr. a. optical equipm.	714	176	25.9
ERNT-R-A	Ericsson Nikola Tesla d.d.	Information Technology	910	1,212	48.7
ISTT-R-A	Istraturist d.d.	Tourism	61	519	23.3
KOEI-R-A	Kon?ar Elektroindustrija d.d.	Electrical engineering	533	301	43.7
KORF-R-A	Dom holding d.d.	Tourism & Real Estate	3,234	828	43.9
KRAS-R-A	Kraš d.d.	Food/Confectionery	242	394	75.9
PBZ-R-A	Privredna banka d.d.	Banking	108	5,998	2.7
PLAG-R-A	Plava Laguna d.d.	Tourism	123	929	11.2
PLVA-R-A	Pliva d.d.	Pharma	2,026	8,644	83.1
PODR-R-A	Podravka d.d.	Pharna & Food&Beverages	960	1,147	69.4
PRFC-R-A	Proficio d.d.	Investment fund	601	239	86.5
RIVP-R-A	Riviera Holding d.d.	Tourism	89	804	21.2
SLPF-R-A	Slavonski ZIF d.d.	Investment fund	128	132	75.2
SNHO-R-A	SN Holding d.d.	Investment fund/Tourism	724	429	56.7
VLDS-R-A	Validus d.d.	Investment fund	161	82	85.2

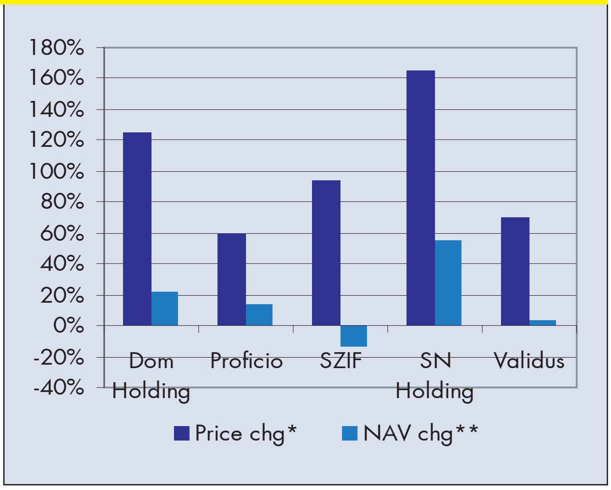
Source: ZSE, VSE, RZB-Group Research

Net income & revenue development

	Revenue		Net income	
	H1 2004	Year Chg%	H1 2004	Year Chg%
HRK 000				
ADRS-P-A	1,139,285	2.08%	284,373	8.92%
BLSC-R-A	492,528	-1.31%	2,268	-30.00%
ERNT-R-A	690,594	-10.20%	62,577	-7.17%
ISTT-R-A	91,547	7.10%	-10,488	-18.15%
KOEI-R-A	814,417	-10.67%	3,619	32.37%
KRAS-R-A	414,775	3.26%	19,957	20.70%
PBZ-R-A	999,514	3.61%	359,669	17.34%
PLAG-R-A	127,487	17.07%	-8,248	-420.71%
PODR-R-A	1,603,988	-1.44%	52,594	279.85%
RIVP-R-A	107,172	-6.70%	-20,076	-1092.88%
Total	***6,481,307***	***-1.78%***	***746245***	***20.39%***
USD mn				
PLVA-R-A	560	7.79%	90.1	8.16%

Source: ZSE, VSE, RZB-Group Research

Ex Privatisation Funds (2000-2004)



**Avarage annual return (Sep.00-Sep.04.)*
***4 years NAV chg; NAV as of Jun.00 and Jun.04*
Sources: Issuers, CROSEC, RZB-Group Research

of West Europe and the USA, whereas sale in the markets of CEE was weak. It is expected that in the second half of 2004, despite the unfavorable price movements, West Europe will remain the prime sales mover (the average price of Pliva's medicines realised a -2% decrease in Germany, -15% in Spain and a single-digit fall in Italy). Sanctura, the urological drug used in treating the overactive bladder (OAB), which Pliva activated in April, began to sell in the USA at the end of August. Pliva announced that the initial costs related to Sanctura will decrease the yearly operating profit by USD 20 mil, of which 80% will be declared in the second half-year. Pliva will not declare their expectations regarding the Sanctura sales until November, but our initial forecast is that the product will start to yield value on the level of the final result only at the beginning of the following year. We maintain the 6-12 monthly target price of USD 19.7 and the recommendation to buy.

Podravka's results of the first half-year are in keeping with the expectations for 2004, for which we expect sales of HRK 3.4 bn and net profit of HRK 115 mil. In the first half-year sales in the domestic market were stagnant whereas in the foreign markets, according to data submitted to the Commission, a 6.2% growth was recorded. Aiming at becoming the biggest food supplier in Serbia, Podravka has been actively looking for strategic partners, that is, for potential acquisitions in the Yugoslav market for some time now. Regardless of the results news, the biggest share price growth stimulator in the past period was the speculations regarding the potential buyer of the 27.94% of Government share in Podravka. According to the media, Agrokor, with the financial support of the EBRD, is still aiming at Podravka. HRK 240 is mentioned as the takeover price. Due to the current product range of Agrokor and their concentration in certain fields (primarily the bottled water), in case of this acquisition certain parts of Podravka should be ceded to other companies. As there are potential buyers to which Podravka is much more valid as a cluster of its most profitable parts (Agrokor) and those to which it is more interesting as a whole (Adris group), we believe that the potential buyer interested in the majority stock package in the name of Podravka brands and the future more operative business should offer a higher acquisition premium than around the current 15%. For the moment we shall not revise our forecasts and remain at the target price of 227 and the six-month recommendation to hold-and-accumulate.

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Abbreviations

Currencies and Countries

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

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

BUX	Budapest Stock Exchange
CECE	Central Eastern Countries Europe
CROBEX	Croatian Eastern Exchange
PX 50	Prague Stock Exchange
SAX	Slovakian Stock Exchange
RTSI	Russian Trading System Index
WIG 20	Warsaw Index General - Top 20

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

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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