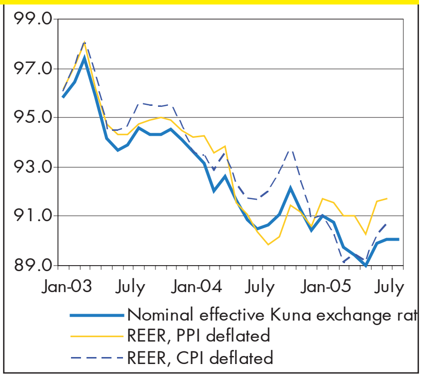
# Strategy Croatia

October 2005

## Kuna REER index*




*Source: Croatian National Bank*
*Note: REER - Real Effective Exchange Rate index; declining slope means appreciation*

### Recommendations (Horizon: 3 to 6 months)

**Bond market**

***Buy***
6.75% EUR 2011 bond
***Hold***
5.375% RHMF 2019 EUR-linked HRK bond
***Sell***
6.75% RHMF 2010 HRK bond

**Equity market**

***Buy***
Ericsson Nikola Tesla
***Hold***
Podravka

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# Highlights

■ On October 3, the EU decided to finally open accession negotiations with Croatia, after the UN prosecutor for war crimes confirmed that Croatia was cooperating fully with the International War Crimes Tribunal. The talks had originally been scheduled to commence in March, but were delayed due to lack of cooperation with the Tribunal. The start of EU accession negotiations should result in stronger commitment to the reforms that lie ahead for Croatia on the path to becoming a EU member.

■ The Government has seen strong criticism from the opposition up until this autumn, and their popularity has significantly decreased in recent months. However, situation changed substantially at the beginning of October, at least in terms of popularity. The EU's decision to open accession negotiations with Croatia brought a strong increase in support for the Government, defusing several issues which had previously caused a decline in public support. Commencement of EU membership negotiations has increased the support for the current Government, which will be needed as the Government has to tackle a number of unpopular reforms.

■ Economic data for Q1 were disappointing, but improvement was recorded in the following months. Although we expect somewhat slower growth than in 2004, due to a weak beginning to the year, economic activity should pick up in following periods resulting in higher growth in the coming years.

■ The opening of EU talks had a strong impact on domestic markets and securities. Croatian spreads tightened significantly, and prices of bonds and shares also increased strongly as stronger demand emerged. Further moves should be modest after a short period of strong growth.

## Key figures

| | 2001 | 2002 | 2003 | 2004 | 2005e | 2006f | 2007f |
|---|---|---|---|---|---|---|---|
| Nominal GDP (EUR bn) | 22.2 | 24.2 | 25.5 | 27.6 | 29.7 | 31.8 | 34.1 |
| GDP per capita, EUR | 4997 | 5451 | 5747 | 6215 | 6693 | 7156 | 7594 |
| Real GDP (% yoy) | 3.8 | 5.2 | 4.3 | 3.8 | 3.5 | 4.0 | 4.1 |
| Industrial output (% yoy) | 6.4 | 5.5 | 4.1 | 3.7 | 4.5 | 4.0 | 3.5 |
| Unemployment rate (avg, %) | 22.0 | 22.3 | 19.5 | 18.2 | 18.0 | 17.5 | 17.0 |
| Consumer prices (avg, % yoy) | 3.8 | 1.7 | 1.8 | 2.1 | 3.2 | 2.6 | 3.1 |
| Consumer prices (eop, % yoy) | 2.4 | 1.8 | 1.7 | 2.7 | 3.0 | 2.9 | 2.8 |
| Producer prices (avg, % yoy) | 3.6 | -0.4 | 1.9 | 3.5 | 2.8 | 2.9 | 3.0 |
| General budget balance (% of GDP) | -6.8 | -6.0 | -6.3 | -4.9 | -4.4 | -3.7 | -3.3 |
| Exports, EUR bn | 5.2 | 5.2 | 5.4 | 6.6 | 7.3 | 8.4 | 8.9 |
| Imports, EUR bn | 10.2 | 11.3 | 12.5 | 13.3 | 15.0 | 16.9 | 17.7 |
| Current account balance (% of GDP) | -3.7 | -8.7 | -6.9 | -4.6 | -4.5 | -4.2 | -4.3 |
| Official FX-Reserves (EUR bn) | 5.3 | 5.6 | 6.5 | 6.4 | 7.6 | 7.1 | 7.2 |
| Official FX-Reserves (% GDP) | 23.8 | 23.2 | 25.4 | 23.3 | 25.4 | 22.2 | 21.0 |
| External debt (% GDP) | 60.7 | 62.2 | 77.6 | 82.1 | 82.4 | 80.5 | 79.5 |
| HRK/EUR (avg) | 7.47 | 7.41 | 7.56 | 7.50 | 7.42 | 7.41 | 7.42 |
| HRK/USD (avg) | 8.34 | 7.83 | 6.68 | 6.03 | 5.89 | 5.79 | 5.50 |

*Source: CNB; Croatian Statistical Office; WIIW; Raiffeisen RESEARCH*

Raiffeisen RESEARCH
RZB Group

# Croatia
## Content

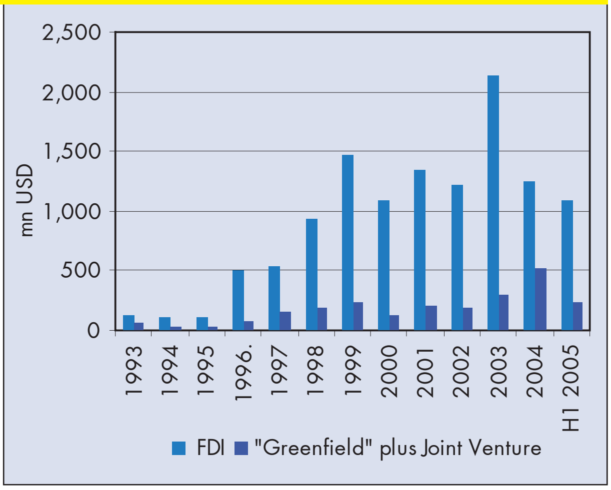
# Croatia
## EU talks should support reforms

For Croatia, the beginning of EU accession talks was clearly a milestone. The decision to open talks came amidst a tense political drama in Europe, as Austria reminded the rest of the European Union of Croatia's right to be fairly treated alongside with Turkey, whose accession Austria has challenged. Then, IWCT chief prosecutor Carla del Ponte released her second assessment, citing a good level of Croatian cooperation in finding and bringing to justice Croatia's war crime suspect general Gotovina. Thus, after a period of delay and frustration on both sides, the European Union finally opened a new chapter for Croatia. Looking ahead, we must admit that smooth EU talks are by no means a foregone conclusion, and that the EU might suspend them if the International War Crime Tribunal finds fault with Croatia's cooperation again. Therefore, the political legacy of the war years may continue to hang over the negotiation table. Notwithstanding the past difficulties, Croatia is prepared for a fast drive to wrap up its EU accession story. In particular, Croatia's officials are determined to finish the talks by 2008. Needless to say, this might be a slightly optimistic target considering the huge amount of bureaucratic work that will have to be done before accession becomes a reality. Nevertheless, fundamentally and structurally Croatia is fit to make quick progress and in some areas it might even be ahead of other two "contenders", namely Romania and Bulgaria. Economically speaking, Croatia is performing fairly well. Although Croatian growth rates "pale" compared to the Chinese miracle, they have consistently remained above 3% annually. Furthermore, the domestic economy and businesses remain strong amidst keen market competition. Croatia's business culture is an important element which it inherited from its Yugoslav years and its initial level of economic development was relatively high. Close ties to the West and a pro-European orientation have also made Croatia an attractive destination for investment. Neighbouring Austria, Italy and Slovenia allocate investment to Croatia as do Germany and other developed countries. Austria is by far Croatia's largest direct investor. Interestingly enough, the strong position of kuna national currency has not hampered economic activity, which we attribute to strong productivity gains. Strong market orientation has also made the Croatian economy fairly competitive vis-ŕ-vis other countries. Economic potential is utilised through a combination of policies favourable for domestic and foreign businesses operating in Croatia. Domestic investment is also playing a crucial role in economic development. The low level of inflation achieved in recent years brought some much-desired stability and helped to reduce the cost of money. Croatia prides itself on low inflation. The recent surge in inflation attributable to regulated tariffs and energy costs should not impact the long-term inflation trends, and the National Bank is prepared to act if inflation does become an issue. Lately, inflation has picked up from 2% to above 3% annually, but it still remains below the levels observed in some other CEE countries. Croatia's banking sector is well consolidated and foreign banks, mainly Austrian and Italian, hold a dominant share in its banking capital. To be sure, Croatia's story is not only a bed of roses. A number of problems hamper Croatia's outlook and pose a risk to its future well-being. The most visible problem is Croatia's high current account deficit and the growing stock of external indebtedness. Government finances also remain an issue and in the past the government has been unable to bring the fiscal deficit down below the thresholds pre-agreed with the IMF. Croatia's current account deficit stems from two typical problems. Imports of capital goods financed via foreign investment are pushing the current account deficit higher. While this is a typical structural economic problem found in other emerging market economies as well, the problem is aggravated by ballooning consumer imports, which adds significant pressure on the current account. The Croatian National Bank could have implemented slightly more effort to sterilize extra liquidity. Hikes on mandatory bank reserve requirements only partially neutralized the expansion of consumer lending, whereas open market operations were only introduced quite recently and have a limited effect. The interest rates tool should be used more strongly to off-set money expansion. On the other hand, consumer lending, especially in euro, leads to ballooning foreign currency liabilities. That having been said, Croatia's public debt is not high and its foreign component is pretty low by market standards. The major problem rests with the banking and private sector's external debt, which continues growing although at a slower speed now. However, the ample international currency reserves of the National Bank cover much of the external obligations and are high enough to parry a speculative attack on the kuna. Notwithstanding this, the problem of consumer credit and growing external debt must be addressed by Croatian authorities on a permanent basis.

# Greenfield investments increase

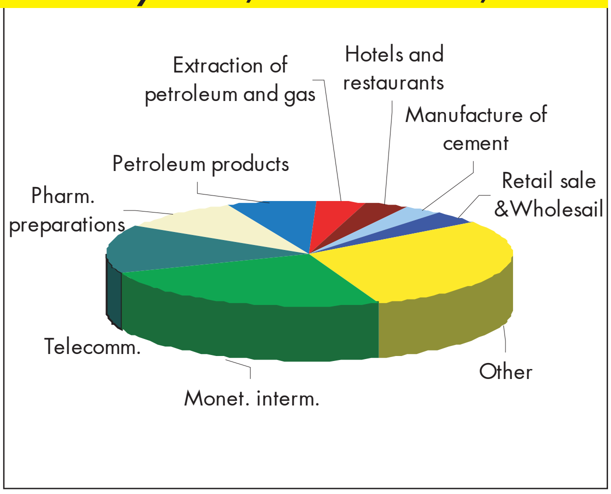
The first inflows of foreign direct investment to the transition countries began at the end of 1980s. However due to the war and the resulting insecurity, the first FDI in Croatia occurred much later. Although initial investments by non-residents in Croatia were registered in 1993, the amount remained modest. The first sizeable FDI started in 1998 with the intensification of the privatisation process. Examining the total cumulative amount of FDI from when it first started flowing until late in 2004, we see that Estonia, Hungary and the Czech Republic received the most FDI relative to the size of their markets, i.e. their population. Applying the same methodology, the level of FDI in Croatia was slightly below the average of the eight new EU Members. Among the Eastern European countries, including Romania and Bulgaria, Croatia stands out as the country with the largest relative amount of FDI. Despite this relatively high FDI level, the usual positive effects on the economy such as growth in employment, production and exports are missing, primarily due to the unfavourable investment structure. The slow restructuring of the economy and high prices of labour have resulted in a decline in Croatia's international competitiveness compared with other transition countries, which has also had an impact on the structure of FDI. Another aspect that has been lacking is a proactive policy of attracting greenfield investments, while in other transition countries potential investors were offered substantial benefits (tax and/or financial). As a result, according to the data for the period from 1993 until the first half of 2005 greenfield investment accounted for slightly less than 20% of all FDI. However, the 2004 data indicate a change in this trend with greenfield investments accounting for as much of 42% of total direct foreign investment during the year. This positive trend continued in the first half of 2005, when greenfield and joint venture investments totalled USD 240 mn. The majority of FDI so far has taken the form of 'brownfield' investments, i.e. privatisation revenues and retained profits of non-residents that have been reinvested in Croatia. In addition, the majority of brownfield investment is related to the privatisation of service providing companies oriented mostly towards the domestic market, while manufacturing has only accounted for a small share. From 1993 to the end of 2005 Q1, investment in financial intermediation accounted for close to one-fourth of total FDI. The telecommunications sector, which attracted slightly below 15% of total FDI, was the second most important sector in the structure of FDI during the period, while sale of the state-owned shares in Pliva and INA led to a substantial inflow of foreign capital to the pharmaceutical sector and the oil industry. The structure of greenfield and joint venture investments was unfavourable, however, with more than one-half of investments between 1993 and 2004 H1 concentrating on supermarket construction and the banking and insurance sectors. In the period from the first inflow of foreign capital until the end of 2005 Q1, the majority of FDI in Croatia came from Austria (28.1% of the total), Germany (14%) and the US (13.6%). As for transition countries, the lion's share of foreign capital came from Hungary and Slovenia and was invested primarily in the hotel industry and trade. The beginning of Croatia's accession negotiations with the EU is bound to have a great impact on further inflow of FDI in Croatia. The planned reforms of the judicial system and the land register as well as the removal of other barriers will further improve the investment climate. In addition, despite the long privatisation process, considerable assets remain in state ownership, meaning that the level of foreign investment will be greatly affected by the dynamics of the privatisation process. The portfolio of the Croatian Privatisation Fund includes ownership shares in 1,112 companies with a total value of over HRK 21.8 bn. The privatisation plan envisages the sale of minority shares at domestic capital markets, while companies in majority state ownership will be sold in international public tenders, finding strategic partners or establishing public private partnerships. Potential problems in the privatisation process may occur with large companies which have been accumulating losses for several years; prior to their sale they will need to go through with restructuring and debt repayment. This is particularly true of companies in traditional labour intensive sectors such as textiles, metal processing industry and shipbuilding. The sale of the 15% share in INA, the oil company, is expected at the beginning of next year according to a model which has not yet been fully defined. In accordance with EU standards on the energy markets, by the time Croatia enters the EU it will need to liberalise the distribution and transport of electricity and abolish the monopoly, which means that sizable FDI is likely in this sector as well as the privatisation of those segments of HEP, the Croatian Electricity Utility, which are connected with electricity production and trading. During the period in question it will also be necessary to liberalise transport of persons and goods, both in rail and maritime transport. The strategy for the privatisation of Jadrolinija (a liner shipping company) is underway and segments of Croatian Railways, dealing in non-core business, are also to be sold soon. After the privatisation of these public enterprises, the state shall either maintain a substantial strategic share of 25-49% or retain only the so-called "golden share" in order to be able to continue having a say in the operations of these companies and protect national interests. The land privatisation plan is regulated by the Agricultural Land Act, aiming at using natural resources in the most efficient way. The area of land under discussion is 1.1 million hectares, of which 440,000 hectares is state-owned agricultural land. Three privatisation models have been discussed: the first is a direct sale, the second is lease and the third is long-term concession. It is expected that Croatia will remain the country with the highest level of FDI in the region, especially taking into account the value of assets still in state ownership. However, a more active policy of attracting investments and the creation of a competitive incentive system are necessary to change FDI structure, i.e. raise the level of greenfield and joint venture investments in export-oriented segments of the economy. Croatia's current system of stimulating investments is largely unclear and complicated. The main reason for this is that benefits are regulated by several different acts (Investments Promotion Act, Act on the Areas of Special State Concern, Hilly and Mountainous Areas Act, etc.). Croatia also lacks incentives for retraining and additional education of workers as well as employment subsidies. Considering the much higher price of labour, primarily due to greater tax burden on and from wages, in comparison with other countries in the region Croatia can expect greenfield investments primarily in capital-intensive sectors whose products are technologically more advanced and thus create more added value. The role of regional and local governments is also extremely important for the realisation of greenfield investments, particularly in the context of establishing regional development agencies as well as business and industrial zones.

**Stocks of FDI and Greenfield plus Joint Venture, 1993-2005 H1**



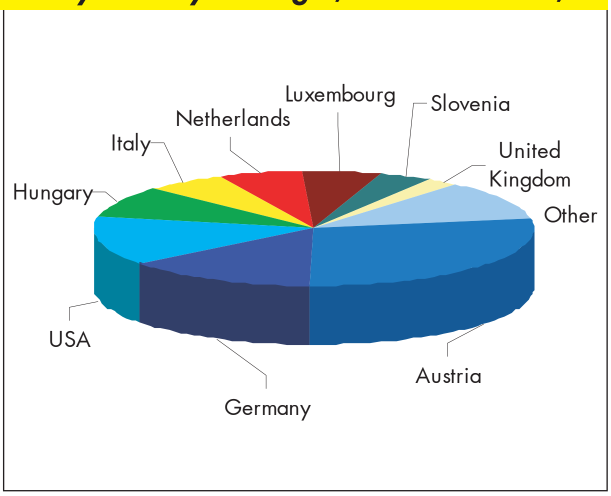

*Source: CNB*

**Foreign direct equity investments in Croatia by sector, 1993-2005 Q1, %**




*Source: CNB*

**FDI by country of origin, 1993-2005Q1, %**




**1993-2005 Q1, %*

*Source: CNB*

# Basic information
## and main features

### Structural information

| | |
|---|---|
| Land Area | 56.594 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 | A-3 |
| Moodys | Baa3 | P-3 |
| Fitch IBCA | BBB- | F3 |

*Note: On 13 August 2005, S&P changed its outlook from "positive" to "stable"; on 11 June 2003 Moodys affirmed "stable" outlook; at the beginning of July 2005 Fitch changed its "positive" outlook to "stable".*

### Major cities (population 2001)

| | |
|---|---|
| Zagreb | 779,145 |
| Split | 188,694 |
| Rijeka | 144,043 |
| Osijek | 114,616 |
| Zadar | 72,718 |
| Sl. Brod | 64,612 |
| Karlovac | 59,395 |
| Pula | 58,594 |
| Varazdin | 49,075 |
| Dubrovnik | 43,770 |

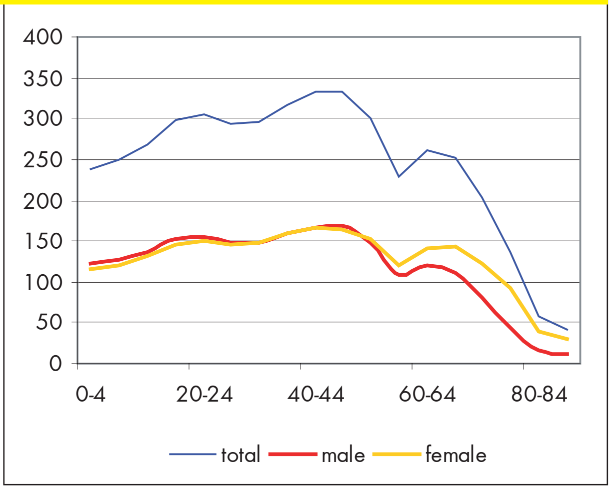
*Source: Croatian Bureau of Statistics*

### GDP 2004

| | |
|---|---|
| EUR mn, current prices | 27,629 |
| EUR, per capita | 6,202 |
| real growth rate, % | 3.8 |

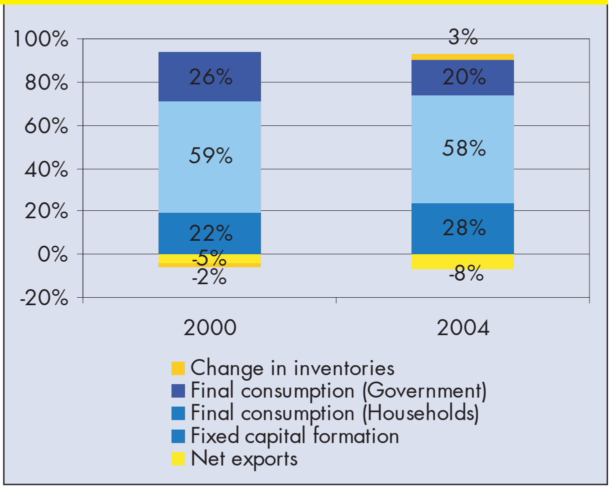
*Source: Croatian Bureau of Statistics*

### Age distribution, 2001



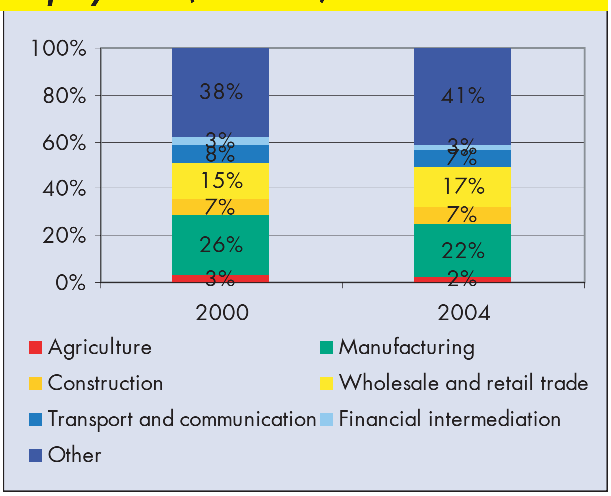

*Source: Croatian Bureau of Statistics*

### GDP: demand side (% share)



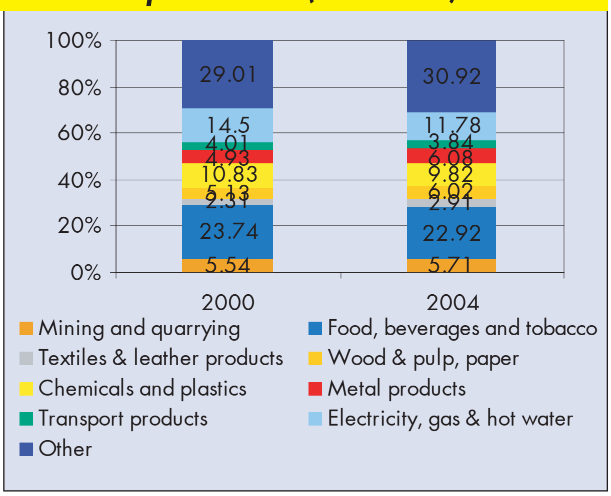

*Source: Croatian Bureau of Statistics*

### Employment (%of total)




*Source: Croatian Bureau of Statistics*

### Industrial production (% of total)




*Source: Croatian Bureau of Statistics*

# EU talks begin
## boosting support for the Government

The (HDZ-led) Government was strongly criticised by the opposition up until this autumn and their popularity decreased significantly over recent months. However, the situation changed significantly at the beginning of October, at least in respect of popularity. The EU's decision to open EU negotiations with Croatia resulted in a strong increase in support for the Government, defusing difficult issues which had previously caused a decline in public support. Polls conducted few days after this success for the Government in the international arena showed optimism among citizens and hearty support for the Government. However, analysts are still cautious regarding the recent Euphoria, considering the results of previous official polls, which showed a steady decline in support for the Government, rising popularity of the opposition parties and declining support for EU accession.

Just recently, the main opposition parties (SDP and HSP) announced that they would be putting stronger pressure on the current Government, taking them to task regarding results in economic policy and declining standard of living, as well as some issues concerning privatisation projects and fiscal policy. There have been some calls for early elections, although that seems very unlikely at the time being. The recent success in foreign affairs, which was the primary focus of the Government since their start could, at least temporary, silence such talk and give some additional time for the Government to focus more on domestic issues as a number of necessary reforms have been announced which are not popular among voters (pension reform, health sector reforms, government social contributions, wage policy in public sector, privatisation).

Official polls on EU support and climate among Croatian citizens showed a significant decline which peaked with the delay of EU talks in March and strong pressure on full cooperation with International War Crimes Tribunal. The pressure from IWCT was assessed as annoying and disturbing considering some questionable views on the Homeland War displayed in statements made by ICTW and the UN prosecutor for war crimes. However, recent developments have resulted in a strong increase in support, but we should wait few weeks for more realistic views. The start of negotiations and the issues that may arise in the course of such may result in renewed pressure on public support for EU membership and lead to a new test of strength and stability for current Government.

### Main political parties in parliment

| Ruling Coalition | Party leader | Orientation |
|---|---|---|
| Croatian Democratic Union (HDZ) | Ivo Sanader | Centre-right |
| Croatian Party of Pensioners (HSU) | Vladimir Jordan | Centre |
| Democratic Center (DC) | Vesna Skare Ozbolt | Centre |
| **Opposition Parties** | | |
| Socialdemocratic Party (SDP) | Ivica Racan | Centre-left |
| Croatian Citizens's Party (HNS) | Vesna Pusic | Centre |
| Croatian Peasant Party (HSS) | Zlatko Tomcic | Centre |
| Croatian Party of Rights (HSP) | Anto Dapic | Centre-right |
| Istrian Democratic Party (IDS) | Ivan Jakovcic | Centre-left-Reg. |

*Source: political parties*

### Election schedule*

| | |
|---|---|
| Presidental election | January 2010 |
| Parliamentary elections | November 2007 |

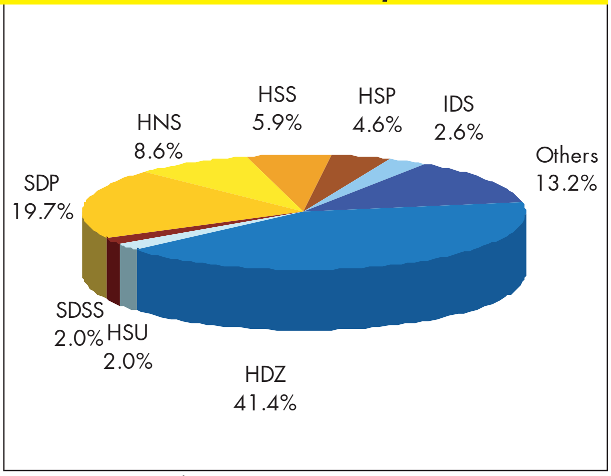
** elections for president are every 5 years, elections for parliament every 4 years*

### Ruling persons

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

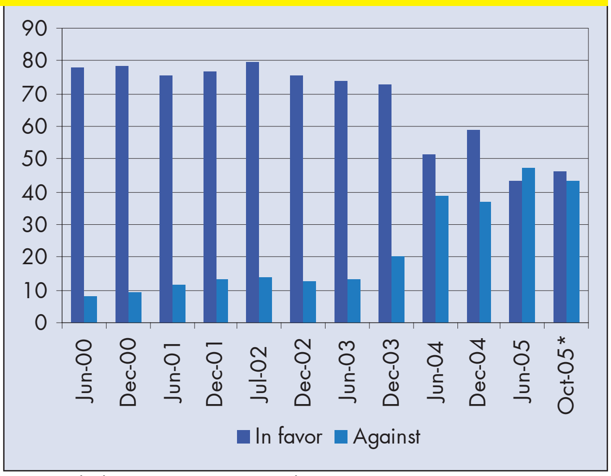
*Source: the Government, the Parliament, the Office of the President*

### Seats in the Parliament, September 2005




*Source: Croatian Parliament*

### EU support poll




**research by agency Promocija plus*

*Source : MFAEI*

# Economic indicators

## Croatia within CEE: Outlook

### Real GDP (% yoy)

| Countries | 2004 | 2005e | 2006f | 2007f |
|---|---|---|---|---|
| Poland | 5.4 | 2.8 | 4.5 | 4.5 |
| Hungary | 4.2 | 3.6 | 3.8 | 3.6 |
| Czech Rep. | 4.4 | 4.5 | 3.8 | 4.0 |
| Slovakia | 5.5 | 5.2 | 5.7 | 6.8 |
| Slovenia | 4.6 | 2.8 | 3.5 | 3.5 |
| ***CEEC-8**** | ***5.1*** | ***3.7*** | ***4.4*** | ***4.5*** |
| Croatia | 3.8 | 3.5 | 4.0 | 4.1 |
| Bulgaria | 5.6 | 5.5 | 5.5 | 5.5 |
| Romania | 8.3 | 5.5 | 5.0 | 5.0 |
| Serbia | 8.6 | 5.0 | 5.0 | 6.0 |
| Bosnia a. H. | 5.0 | 5.8 | 6.0 | 6.0 |
| Albania | 6.0 | 6.0 | 6.0 | 6.5 |
| ***SEEC-6*** | ***6.9*** | ***5.1*** | ***5.0*** | ***5.1*** |
| Russia | 7.2 | 5.5 | 5.0 | 5.0 |
| Ukraine | 12.1 | 3.5 | 5.5 | 6.5 |
| Belarus | 11.0 | 9.0 | 7.5 | 5.0 |
| Turkey | 8.9 | 5.5 | 4.5 | 6.0 |
| ***EU-12*** | ***1.8*** | ***1.3*** | ***1.5*** | ***2.0*** |
| USA | 4.2 | 3.5 | 3.2 | 2.9 |

* *including the Baltic countries*

### Consumer prices (avg, % yoy)

| Countries | 2004 | 2005e | 2006f | 2007f |
|---|---|---|---|---|
| Poland | 3.5 | 2.2 | 1.9 | 2.0 |
| Hungary | 6.7 | 3.8 | 1.8 | 2.8 |
| Czech Rep. | 2.8 | 1.9 | 2.6 | 2.7 |
| Slovakia | 7.5 | 2.8 | 3.1 | 2.0 |
| Slovenia | 3.6 | 2.5 | 2.0 | 1.8 |
| ***CEEC-8**** | ***4.2*** | ***2.5*** | ***2.2*** | ***2.3*** |
| Croatia | 2.1 | 3.2 | 2.6 | 3.1 |
| Bulgaria | 6.1 | 4.5 | 5.0 | 4.5 |
| Romania | 11.9 | 8.5 | 7.7 | 5.8 |
| Serbia | 9.9 | 16.0 | 13.0 | 12.0 |
| Bosnia a. H. | 0.4 | 0.5 | 0.6 | 0.7 |
| Albania | 2.9 | 2.5 | 3.0 | 3.0 |
| ***SEEC-6*** | ***8.2*** | ***7.3*** | ***6.5*** | ***5.5*** |
| Russia | 11.0 | 12.7 | 9.7 | 8.9 |
| Ukraine | 9.9 | 12.9 | 10.5 | 9.0 |
| Belarus | 18.1 | 12.0 | 8.5 | 7.5 |
| Turkey | 10.6 | 8.0 | 8.4 | 7.7 |
| ***EU-12*** | ***2.1*** | ***2.2*** | ***2.1*** | ***1.9*** |
| USA | 2.7 | 3.3 | 2.5 | 2.5 |

* *including the Baltic countries*

### Current account balance (% of GDP)

| Countries | 2004 | 2005e | 2006f | 2007f |
|---|---|---|---|---|
| Poland | -4.3 | -0.6 | -1.3 | -1.5 |
| Hungary | -8.8 | -7.9 | -7.4 | -6.7 |
| Czech Rep. | -5.2 | -3.1 | -2.8 | -2.7 |
| Slovakia | -3.5 | -4.1 | -3.5 | 0.1 |
| Slovenia | -0.7 | -0.7 | -0.9 | -0.8 |
| ***CEEC-8**** | ***-5.4*** | ***-3.3*** | ***-3.3*** | ***-3.0*** |
| Croatia | -4.6 | -4.5 | -4.2 | -4.3 |
| Bulgaria | -7.4 | -9.0 | -8.0 | -7.0 |
| Romania | -7.5 | -8.7 | -9.1 | -9.5 |
| Serbia | -13.1 | -13.7 | -15.0 | -14.5 |
| Bosnia a. H. | -23.3 | -23.1 | -21.0 | -18.0 |
| Albania | -4.4 | -5.0 | -4.0 | -3.5 |
| ***SEEC-6*** | ***-8.2*** | ***-9.0*** | ***-9.0*** | ***-8.9*** |
| Russia | 10.3 | 13.1 | 6.3 | 2.6 |
| Ukraine | 10.5 | 4.0 | 6.0 | 6.0 |
| Belarus | -4.4 | -2.2 | -1.9 | -0.3 |
| Turkey | -5.1 | -6.0 | -4.9 | -4.4 |
| ***EU-12*** | ***0.6*** | ***0.3*** | ***0.3*** | ***0.1*** |
| USA | -5.7 | -6.4 | -6.2 | -5.8 |

* *including the Baltic countries*

### General budget balance (% of GDP)

| Countries | 2004 | 2005e | 2006f | 2007f |
|---|---|---|---|---|
| Poland | -4.7 | -4.5 | -4.0 | -3.5 |
| Hungary | -5.4 | -6.1 | -6.5 | -5.9 |
| Czech Rep. | -3.0 | -3.8 | -3.4 | -3.0 |
| Slovakia | -3.3 | -4.2 | -4.2 | -3.3 |
| Slovenia | -1.9 | -2.3 | -1.7 | -1.8 |
| ***CEEC-8**** | ***-4.0*** | ***-4.3*** | ***-4.0*** | ***-3.6*** |
| Croatia | -4.9 | -4.4 | -3.7 | -3.3 |
| Bulgaria | 1.7 | 1.0 | 0.0 | -0.9 |
| Romania | -1.1 | -1.0 | -0.5 | -2.5 |
| Serbia | -2.5 | -2.0 | -2.5 | -2.5 |
| Bosnia a. H. | -1.1 | -0.5 | -0.5 | -0.6 |
| Albania | -4.6 | -5.0 | -4.5 | -4.0 |
| ***SEEC-6*** | ***-1.8*** | ***-1.6*** | ***-1.4*** | ***-2.4*** |
| Russia | 4.4 | 7.0 | 4.0 | 2.0 |
| Ukraine | -0.2 | -3.2 | -3.0 | -2.5 |
| Belarus | 0.1 | -0.7 | -1.0 | -1.0 |
| Turkey | -5.3 | -5.0 | -4.0 | -3.5 |
| ***EU-12*** | ***-2.7*** | ***-2.9*** | ***-2.8*** | ***-2.7*** |
| USA | -4.3 | -3.8 | -3.7 | -3.6 |

* *including the Baltic countries*

### Exchange rate LCY/EUR (avg)

| Countries | 2004 | 2005e | 2006f | 2007f |
|---|---|---|---|---|
| Poland | 4.53 | 4.04 | 3.78 | 3.73 |
| Hungary | 251.7 | 247.6 | 252.5 | 249.5 |
| Czech Rep. | 31.9 | 29.9 | 29.0 | 28.3 |
| Slovakia | 40.1 | 38.3 | 37.2 | 36.2 |
| Slovenia | 239.0 | 239.5 | 239.5 | 239.5 |
| Croatia | 7.50 | 7.42 | 7.41 | 7.42 |
| Bulgaria | 1.96 | 1.96 | 1.96 | 1.96 |
| Romania | 4.05 | 3.58 | 3.45 | 3.40 |
| Serbia | 72.6 | 82.9 | 88.4 | 93.5 |
| Bosnia a. H. | 1.96 | 1.96 | 1.96 | 1.96 |
| Albania | 127.6 | 124.1 | 123.5 | 124.0 |
| Russia | 35.8 | 35.5 | 35.6 | 36.1 |
| Ukraine | 6.6 | 6.2 | 6.0 | 5.9 |
| Belarus | 2686 | 2728 | 2803 | 2997 |
| Turkey | 1.77 | 1.68 | 1.70 | 1.88 |
| EU-12 | 1.24 | 1.26 | 1.28 | 1.35 |

* *including the Baltic countries*

### Exchange rate LCY/USD (avg)

| Countries | 2004 | 2005e | 2006f | 2007f |
|---|---|---|---|---|
| Poland | 3.64 | 3.28 | 2.96 | 2.73 |
| Hungary | 202.4 | 198.1 | 197.3 | 184.8 |
| Czech Rep. | 25.7 | 23.7 | 22.7 | 21.0 |
| Slovakia | 32.3 | 30.4 | 29.1 | 26.8 |
| Slovenia | 192.2 | 190.1 | 187.1 | 176.1 |
| Croatia | 6.03 | 5.89 | 5.79 | 5.50 |
| Bulgaria | 1.58 | 1.55 | 1.53 | 1.45 |
| Romania | 3.26 | 2.84 | 2.70 | 2.52 |
| Serbia | 58.4 | 65.8 | 69.1 | 69.2 |
| Bosnia a. H. | 1.57 | 1.55 | 1.53 | 1.45 |
| Albania | 102.6 | 98.5 | 96.5 | 91.8 |
| Russia | 28.8 | 28.2 | 27.8 | 26.7 |
| Ukraine | 5.3 | 5.0 | 4.7 | 4.4 |
| Belarus | 2160 | 2165 | 2190 | 2220 |
| Turkey | 1.43 | 1.34 | 1.33 | 1.39 |
| EU-12 | 0.81 | 0.79 | 0.78 | 0.74 |

* *including the Baltic countries*

# Growth will continue
## but a risk of slowdown remains

This year global economic growth has continued at a good pace. In the US, growth remained around 3-4% and growth also strengthened in Western Europe. Growth rates in Central and Eastern European countries remain fairly strong, with ''mature'' CEE economies projected to grow 3.7% this year. Taking into account the economies in South East Europe overall growth should even reach around 5%. Furthermore, nearly all emerging market economies have been booming this year. In South Asia, economic expansion has remained extremely robust, with China leading the region and remaining the fastest growing economy. Latin American economies also performed fairly well with the largest economies in the region posting growth rates above 3-4%. Furthermore, despite concerns about high energy prices the global growth outlook has remained rather upbeat. Many pundits expect only a moderate slowdown in the world economy, despite record-high energy prices. Importantly, there is no talk about economic recession whatsoever. Moreover, a recent IFO report on Europe's largest economy, Germany, cites encouraging evidence suggesting that Germany is coming off its sluggish economic path and will grow far stronger in future. Overall, market anticipation of the global economy is leaning towards the view that high energy prices will be unable to make a major dent in global growth, but may slow it down moderately. Another hot topic is the global currency balance and shifts in the balance of payments. In this regard, market and research opinions diverge more often. There is no doubt about the negative consequences of the high US current account and fiscal deficits for the US dollar. However, pundits are unsure about the delicate exchange rate balance which the euro might have vis-ŕ-vis the dollar. Recent euro weakening supported the view that the interest rate differential was turning in favour of the US dollar. This view is also underscored by the argument of stronger economic growth in the US. The opponents of the dollar continue to insist that huge imbalances persisting in the US cannot fade without a massive dollar decline against the euro. Particularly, they cite low domestic savings amidst record high consumer loans and high trade and fiscal deficits. So far they argue that high and increasing interest rates might not be enough to stop the dollar bleeding. As time goes by this split of opinions remains and there is no uniform view about the direction of euro/dollar "relationship". Our colleagues specialised in Western markets stick to the assumption that the dollar will repeat its slide against the euro due to the problem of imbalances. Finally, one positive observation goes forward as concerns emerging market economies. Not only the emerging economies managed to reduce their trade imbalances, many of them even managed to turn their trade and capital balances into positive territory. Some countries benefited from increased commodity and energy prices, others benefited from global outsourcing of production and inflow of capital investment. Another positive development has been that more emerging market economies have become net payers of their debts amidst declining costs of refinancing on international capital markets and improved credit strength manifested in series of rating upgrades for a number of emerging markets.

### Interest rates (3M)

| Countries | | Dec-05 | Mar-06 | Sep-06 |
|---|---|---|---|---|
| Euro-12 | 2.2 | 2.1 | 2.2 | 2.3 |
| UK | 4.5 | 4.6 | 4.3 | 4.1 |
| Poland | 4.3 | 4.1 | 3.8 | 3.8 |
| Hungary | 6.2 | 5.3 | 4.9 | 4.8 |
| Czech Rep. | 1.9 | 1.8 | 2.0 | 2.3 |
| Switzerland | 0.8 | 0.8 | 1.0 | 1.0 |
| Japan | 0.0 | 0.1 | 0.1 | 0.1 |
| USA | 4.2 | 4.2 | 4.2 | 4.2 |

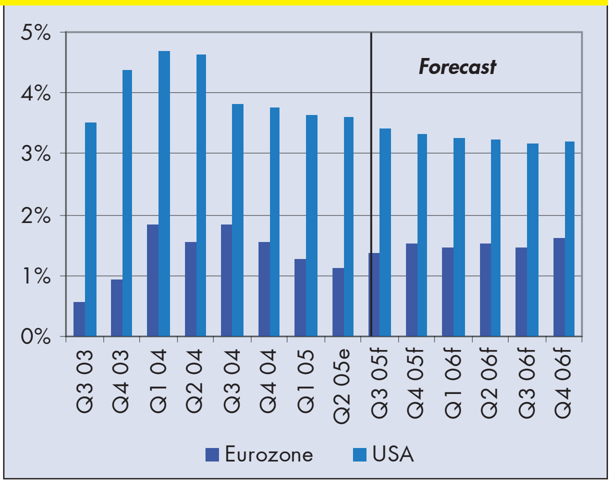
Source: Thomson Financial Datastream; Raiffeisen RESEARCH

### Currencies: FX per EUR

| Countries | | Dec-05 | Mar-06 | Sep-06 |
|---|---|---|---|---|
| UK | 0.7 | 0.7 | 0.7 | 0.7 |
| Poland | 3.9 | 3.9 | 3.8 | 3.8 |
| Hungary | 253.3 | 245.0 | 250.0 | 245.0 |
| Czech Rep. | 29.7 | 29.5 | 29.2 | 29.0 |
| Switzerland | 1.5 | 1.5 | 1.5 | 1.5 |
| Japan | 138.7 | 120.4 | 121.4 | 120.1 |
| USA | 1.2 | 1.2 | 1.2 | 1.3 |

Source: Thomson Financial Datastream; Raiffeisen RESEARCH

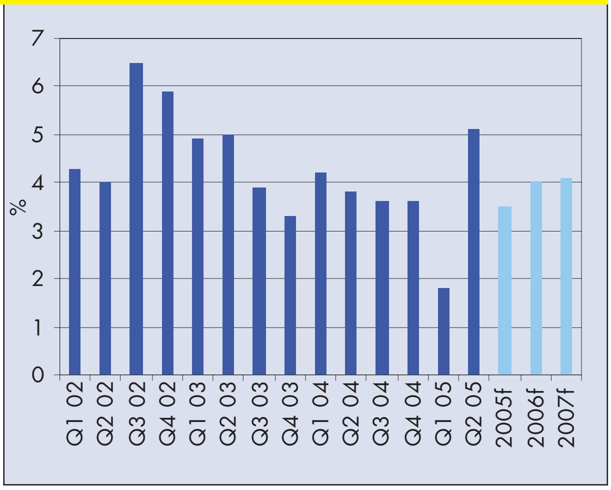
### Growth to stabilize after a brief slowdown




Source: Thomson Financial Datastream; Raiffeisen RESEARCH

# Economic activity intensifies
## inflation still around 3%

### Gross domestic product, real growth rates



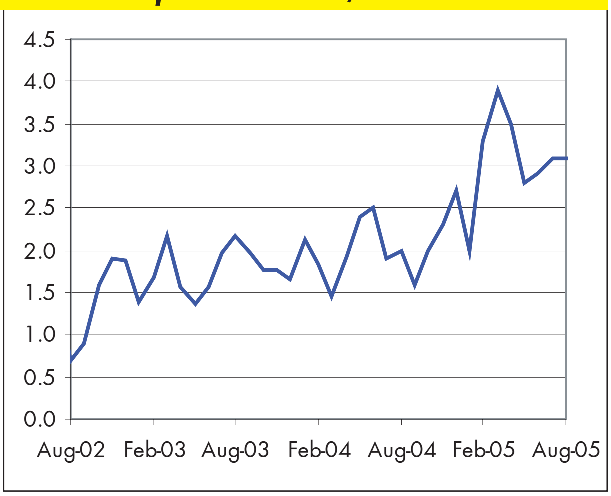

Source: CBS, Raiffeisen RESEARCH

### GDP growth rate, real

| year | 2003 | 2004 | 2005 Q1 | 2005 Q2 |
|---|---|---|---|---|
| Croatia | 4.3% | 3.8% | 1.8% | 5.1% |
| Bulgaria | 4.5% | 5.6% | 6.0% | 6.4% |
| Slovakia | 4.5% | 5.5% | 5.1% | 5.1% |
| Poland | 3.7% | 5.4% | 2.1% | 2.8% |
| Hungary | 2.9% | 4.2% | 2.9% | 4.1% |
| Slovenia | 2.5% | 4.6% | 2.6% | 5.2% |
| Czech Rep. | 3.2% | 4.4% | 4.4% | 5.1% |
| Romania | 4.9% | 8.3% | 5.9% | 4.9% |
| EU-12 | 0.4% | 1.8% | 1.3% | 1.1% |
| EU-15 | 0.8% | 2.1% | 1.4% | 1.2% |
| USA | 3.1% | 4.4% | 3.6% | 3.6% |

Sources: WIIW, RZB, central banks, Raiffeisen RESEARCH, Bloomberg

### Consumer price index %, annual level




Source: CBS

Real GDP growth in 2005 Q2 came in at 5.1%, the highest value achieved over the period in question ever since 2001. The positive results in the real sector, i.e. substantial growth in industrial production, exports of goods and retail trade turnover, all pointed to an intensification of economic activity in the second quarter of the year. These trends led to the healthiest growth in personal consumption (4.4% annualised rate) seen in the past ten quarters. The increase in foreign net consumption combined with the highest export growth (6.7%) in the past six quarters and slower import growth (5.8%) spurred GDP growth. Indicators from the summer months reflect a continuation of the upward trend in economic activity but at a less intensive pace. July and August saw slower growth in industrial production volume, and slower growth in retail trade turnover was registered in July as compared to the second quarter. A positive effect on GDP growth in the third quarter is expected from tourism, considering the strong growth of tourist nights and arrivals. In 2005 GDP growth is expected to reach 3.5%, the same level it reached in the first two quarters cumulatively. Over the mid-term, the pace and success of reforms in the labour market, restructuring of state-owned companies and fiscal consolidation will have the most significant effect on economic developments.

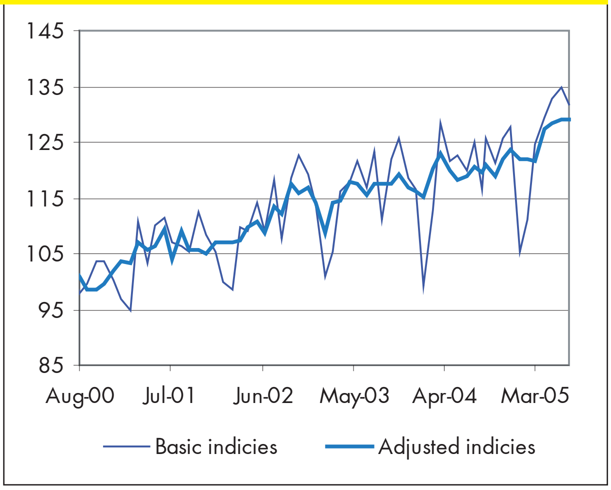
Due to the impact on prices of oil derivatives, the increase in crude oil prices on the international markets resulted in a substantial rise in producer prices in the second half of last year and the first four months of this year. With a certain amount of delay, the ensuing increase in prices of industrial products contributed to inflation growth in the beginning of the 2005. During the summer, inflation stabilised while the average annual rate of price growth was slightly over 3%. Considering the trend of slightly lower increases in producer prices that started in May and limitation of fuel price growth, we expect inflation to slow down. Our end-of-year inflation forecast is 3%, while the average price growth in 2005 is expected to be slightly higher, at around 3.2%. The review of price growth in the region shows that in the majority of cases strong growth at the beginning of the year is followed by a slowdown at mid-year, at the juncture of the second and third quarters.

# Industrial production on the rise
## as unemployment falls below 17%

After a reduction in the volume of industrial production in February and March 2005 as a result of the strong base effect from last year and fewer working days, industrial production intensified in the following months. In June, industrial production volume grew by 12.3%, the largest change since September 2002. However, this increase was not generated solely by stronger production but also by the fact that in this year June had two more working days as compared with the same month a year ago. In the summer months of July and August, industrial production grew less quickly. In the first eight months of 2005, overall industry recorded 4.8% growth in production volume compared to the same period last year. Reviewing the production trends by main industrial groupings, we see that the production of capital goods registered the strongest growth (14.7%), while intermediary goods and non-durable goods, which make up two-thirds of total industrial production, experienced growth of 6.3%. We expect that industrial production volume will continue growing at a moderate pace, resulting in the 4.5% annual growth rate for 2005. Stronger growth may be expected in October as a result of the last year's lower base as well as the fact that this year October has one more working day.

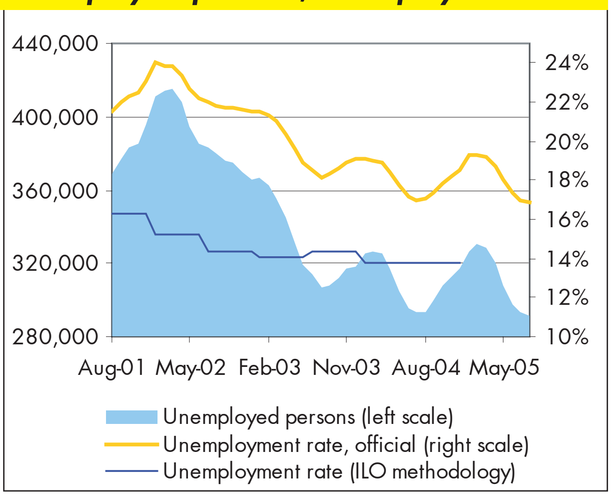
The number of the unemployed reached 330,183 in February, the highest number since May 2003, while the unemployment rate stood at 19.3%. However, due to seasonal employment and intensified economic activity, the following month saw a reduction in the number of the unemployed. In comparison with the previous year, the number of unemployed persons was higher during all months but July, when it stagnated, and August, when there were 1% less unemployed persons. As a result of these developments in the labour market, the unemployment rate declined to the lowest registered level for the first time in August, when it totalled 16.9%. Autumn is about to bring an increase in the number of the unemployed and the unemployment rate due to the end of seasonal employment. Unfavourable movements in the labour market will be underpinned by the Government repealing its active measures aimed at boosting employment. As a result, we expect the unemployment rate to rebound to 18% at the end of this year.

### Industrial production index, 2000=100



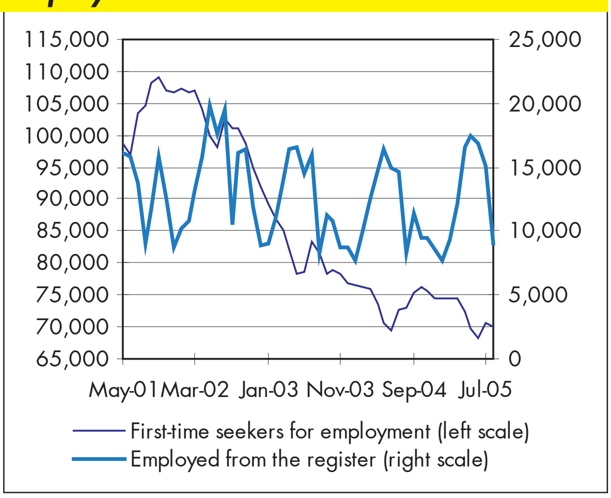

Source: CBS

### Unemployed persons, unemployment rates




Sources: CBS, CES

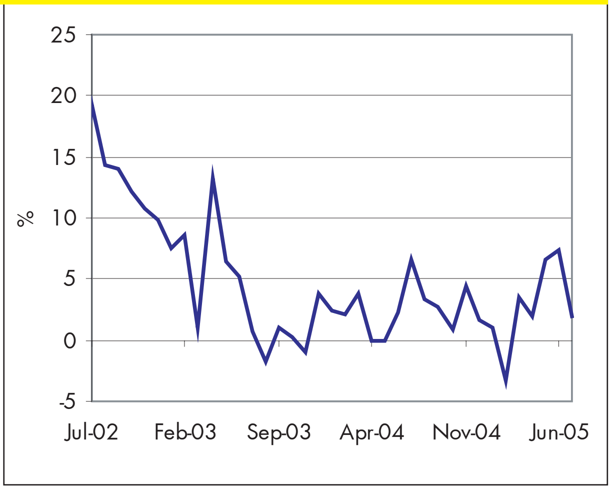
### Employment




Source: CES

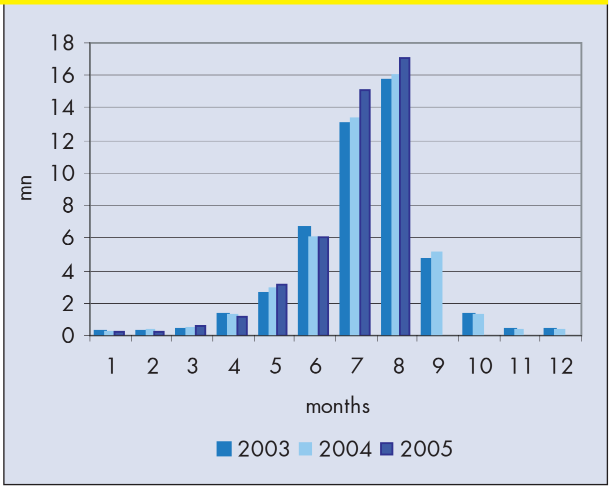
# Trade turnover growth...
## and tourism indicators at record highs

### Retail trade, real growth, annual



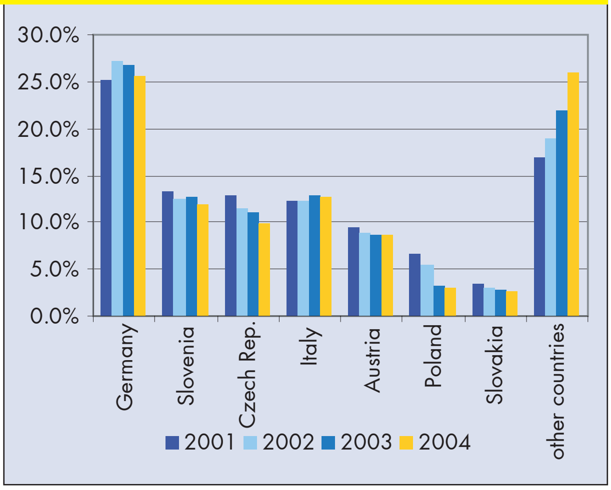

Source: CBS

### Tourist overnight stays




Source: CBS

### Foreign tourist overnight structure by country of residence




Source: CBS

Developments in retail trade have an important effect on economic activity as personal consumption accounts for 60% of GDP. A downward trend in retail trade turnover growth started in the second half of 2003 and continued through most of 2004, due to restricted growth in bank lending and falling demand. The unfavourable trends continued in 2005 Q1, contributing to weak GDP growth over the period in question. However, May and June saw higher growth rates, with the strongest retail trade turnover growth since April 2003. As a result, retail trade turnover grew by 5.3% in annualised terms in the second quarter. These positive trends are primarily a result of the upturn in domestic demand and roughly 20% growth in retail loans. Unexpectedly, despite good tourism indicators, July again saw modest retail trade turnover growth of only 2%. In the first seven months of this year, nominal growth in sales of motor fuels and sales of motor vehicles were once again above average. We expect 2005 to be marked by slightly higher retail trade turnover than the previous year, due to a good tourist season, strong growth in retail trade and nominal growth in net wages. A negative contribution to trade could come from slightly higher inflation than in the previous year, which apart from the increase in prices leads to a decrease in the purchasing power of the population in real terms.

The number of tourist arrivals and tourist nights grew by 7% and 8%, respectively, in the first half of 2005 compared with the same period last year. Positive trends continued at the peak of the season, with July boasting as much as 11% more tourist arrivals and 13% more tourist nights, thus avoiding last year's gap in the utilisation of accommodation capacity. Relative growth in August was slightly milder, primarily due to last year's strong base, and thus tourist arrivals were up 2.5% and night stays up 6.5%. However, in absolute terms, August 2005 saw the largest number of tourist arrivals (2.6 mn) and tourist nights (17.1 mn) since Croatia gained its independence. We expect the number of tourist nights to grow until the end of the year but at slightly lower rates, while in the years to come growth in tourism revenues is expected to outstrip real growth indicators due to further development of the tourism and services.

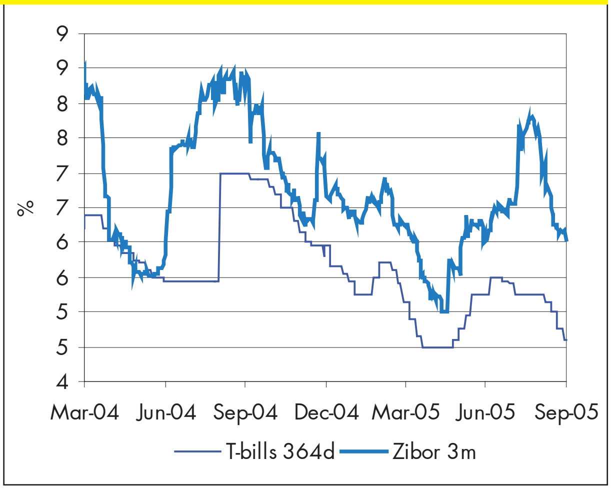


Raiffeisen RESEARCH
RZB Group

# Improved liquidity
## lower interest rates

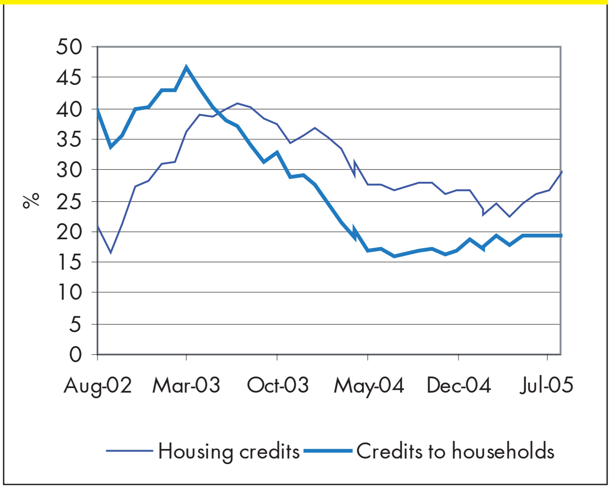
Kuna demand pressure on the money market eased during September, contributing to an improvement in financial system liquidity and lower interest rates on the money market. Interest rates on overnight loans declined to below 4%, with the three-month ZIBOR moving towards 6%. The pressure on liquidity during the summer was reflected in strong placements at the central bank's reverse repo auctions, however, demand eased at the onset of autumn. At the same time, the excess liquidity of banks flowed into T-bills of the Ministry of Finance, which despite the long maturities have not experienced refinancing difficulties, thus enabling T-bill yields to decline to their spring levels. The decline in kuna interest rates resulted in yields on kuna government bonds declining to record lows. We can expect stronger pressure on interest rates through until the end of the year only if privatisation revenues do not come in as planned, thus increasing the government's presence in the money market. An increasing interest rate is normal at the end of the year when demand for kuna rises hand in hand with the increase in personal consumption. Despite expectations to the contrary, in the first half of the year banks maintained their strong lending expansion which was financed by a reduction in foreign assets and an increase in foreign liabilities since deposit aggregates grew at a much slower rate. Retail loans grew at rates of approximately 20% and continued to dominate the structure, followed by increased lending to the government which turned to the domestic market to finance its needs. Lending to corporates also increased in the last few months, but the share of corporate loans in total bank lending is declining. Considering the slow growth of sources of finance, lending is expected to slow down by the end of the year. Money supply growth was stronger this year compared with last year, thanks to the growth of cash in circulation and deposit money whose growth is also expected to slow down until the end of the year. Total bank deposits grew at maximum rates of some 10% a year, which reflects the fact that the growth of domestic sources of finance is lagging behind bank lending. As a result, bank borrowing abroad is rising quickly. Due to weaker growth in domestic sources of funds and increasingly expensive foreign borrowing, we expect the growth in the majority of monetary aggregates to slacken in the coming period.

### Interest rates



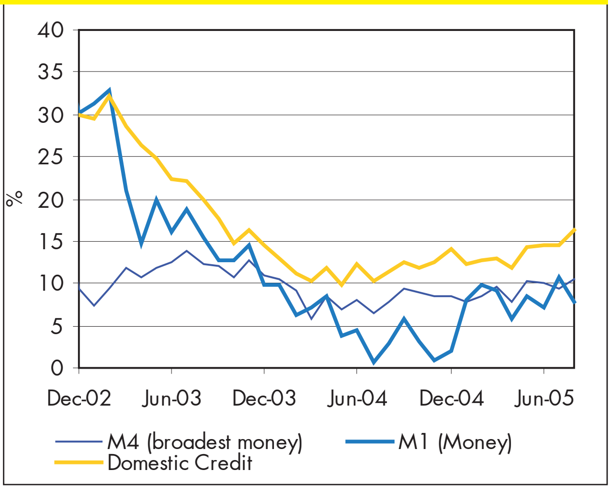

Sources: biznis.infoforum.hr, CNB, MoF

### Credit growth, in %, annual level




Source: CNB

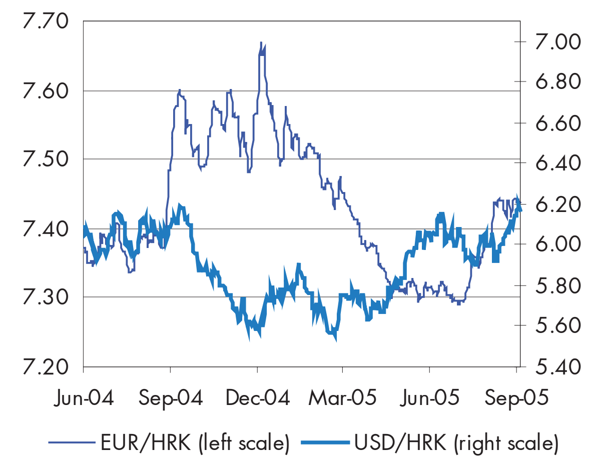
### Monetary aggregates and domestic credits (growth rates, yearly basis)




Source: CNB

# Declining probability
## of stronger kuna weakening

### Middle exchange rate of the CNB



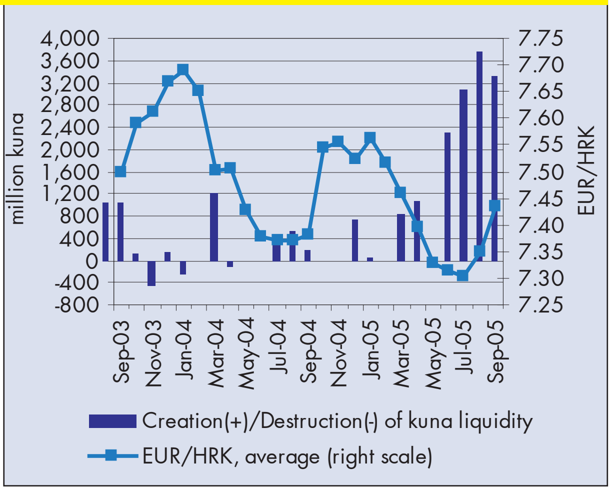

*Source: CNB*

### Middle exchange rate of the CNB

| Currency | Middle exchange rate 9/30/2005 | Change compared to: 12/31/2004 Exch. rate | Movements | % |
|---|---|---|---|---|
| EUR | 7.4387 | 7.6712 | ↓ | -3.13 |
| USD | 6.1706 | 5.6369 | ↑ | 8.65 |
| CHF | 4.7733 | 4.9713 | ↓ | -4.15 |
| GBP | 10.8976 | 10.8244 | ↑ | 0.67 |

*Source: CNB*

### CNB operations & exchange rate movements




** Effect of FX interventions and reverse repo auctions of CNB bills on money supply.*
*Source: CNB*

### Exchange rate forecast

| | 2005 | 2006 |
|---|---|---|
| EUR/HRK, avg. | 7.44 | 7.42 |
| EUR/HRK, eop. | 7.55 | 7.54 |
| USD/HRK, avg. | 5.96 | 5.73 |
| USD/HRK, eop. | 6.18 | 5.54 |

*avg. - average; eop. - end of period*

The high levels that the kuna maintained from April until August will result in the average annual kuna exchange rate being much lower than over the past two years. The exchange rate has been maintained within the ±4% boundary for the past seven years. The implicitly set exchange rate ceiling of HRK 7.30 per euro, which the CNB underlined in all its statements, was broken only a few times, with such attempts being soon thwarted by strong demand for foreign currency. As a result, over the summer the exchange rate held steady at these levels. The kuna weakened in August when the presence of institutional investors on the market grew stronger. However, for it to climb to the level of HRK 7.40 per euro one had to wait until September. Strong demand for the kuna at the beginning of summer, also spurred by the CNB's measures, continued due to the robust demand in the tourist areas of the country. The disappearance of these influences combined with strong kuna placements at CNB's reversed repo auctions, aimed at supporting the financial system liquidity contributed to a weakening of the kuna at the onset of autumn. However, depreciation pressures are not so strong this year since there is a sufficient supply of foreign currency to the financial system to offset stronger demand by the corporate sector.

Depreciation pressures on the kuna usually grow stronger in the last quarter of the year. However, this year they are expected to be less prominent. The fiscal deficit will require considerable financing, which is expected to be met by large privatisation revenues. Regardless of the way this deficit is financed, we expect that strong demand for the domestic currency will result in a lower kuna exchange rate to the euro than has been seen over the past two years. The kuna is expected to grow stronger again in the beginning of 2006 until and then on towards the summer. This should be due to increased inflows of foreign currency in the coming year and the usual seasonal strengthening of the kuna. It should not be forgotten that next year the lion's share of the deficit is planned to be financed by borrowing in the domestic market, which is a very important factor for kuna growth in the first half of the year. Croatia's accession negotiations with the EU and the increased interest of foreign investors may also create the initial pressure on the domestic currency.

# Strengthening of other financial institutions

The share of the banking sector in the financial system as a whole continued to decline modestly, i.e. other financial institutions continued their growth. The share of the banking system slipped to 80% of the financial system as a whole, which reached 140% of GDP. On the other hand, the shares of leasing companies, compulsory pension funds and open-end investment funds has also seen strong growth. Croatia's financial system reflects the importance of the banking system in the economy (exceeding a level of 110%), which puts considerable constraints on further growth in the banking system. Although it is still below the EU average, Croatia has the highest share of banking system assets amongst all of the countries in the region, including the new EU members. Croatia is also ahead of these countries in terms of the ratio of total loans to GDP, the ratio of total retail loans to GDP and the ratio of deposits to GDP. The fact that in the middle of the year banking system grew at an annualised rate of only "11.1%" reflects a slowdown in this segment of the financial system. Accordingly, there is still room for stronger growth in the segment of other financial institutions. Investment funds, primarily open-end investment funds, registered strong growth in assets under management, although such assets equalled only some 4% of GDP at the end of this year, which is significantly below the level of assets under management managed by eurozone investment funds (46.3% of GDP in 2004). Investment fund assets increase by 64% in the first half of 2005 thanks to the increase in investors' interest and the realised high yields.

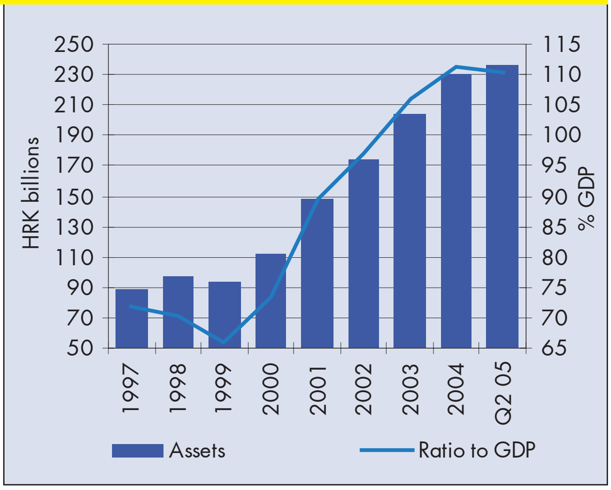
Assets under the management of the compulsory pension funds reached the level of above HRK 10 bn this year and are nearing a ratio of 5% of GDP. Leasing companies also saw strong growth over the past two years. At first this was spurred by CNB's measures aimed at limiting bank lending (car purchase loans), but later these companies became oriented more towards other forms of movable and immovable property. The assets of leasing companies put this sector in the second place in terms of their share in the financial system. They surpassed insurance companies, which also registered great growth potential considering the small share of life insurance in total household investments. Building societies stagnated this year, amongst other things due to the decision of the Ministry of Finance to reduce incentives for housing savings as part of the fiscal consolidation process.

### Financial institutions' assets

| *as of 30.06.2005 in EUR millions* | *amount* | *%* |
|---|---|---|
| **Banks** | **30,731.4** | **80.4%** |
| **Non-banks** | **7,489.2** | **19.6%** |
| Insurance | 2,048.2 | 5.4% |
| Leasing* | 2,216.1 | 5.8% |
| Loans&savings institutions* | 202.1 | 0.5% |
| Housing savings banks | 647.9 | 1.7% |
| Open-end investment funds | 968.4 | 2.5% |
| Closed-end investment funds* | 156.4 | 0.4% |
| Mandatory pension funds | 1,233.7 | 1.9% |
| Voluntary pension funds | 16.5 | 0.0% |
| **TOTAL** | **38,220.7** | 100% |

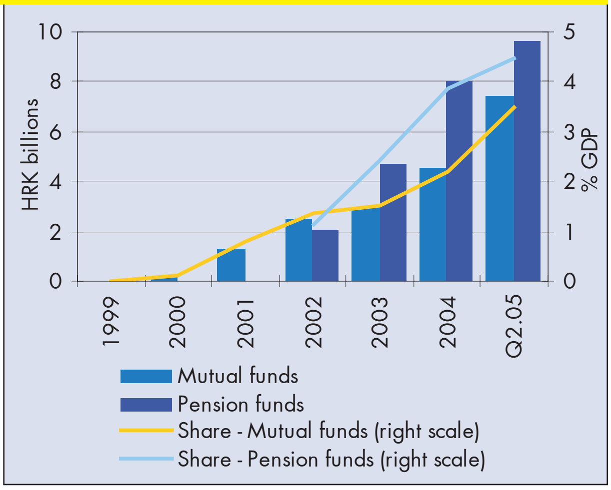
*Sources: HNB, Hagena, CROSEC, MoF, Privredni vjesnik, Raiffeisen istrazivanja*

### Banking assets




*Source: CNB*

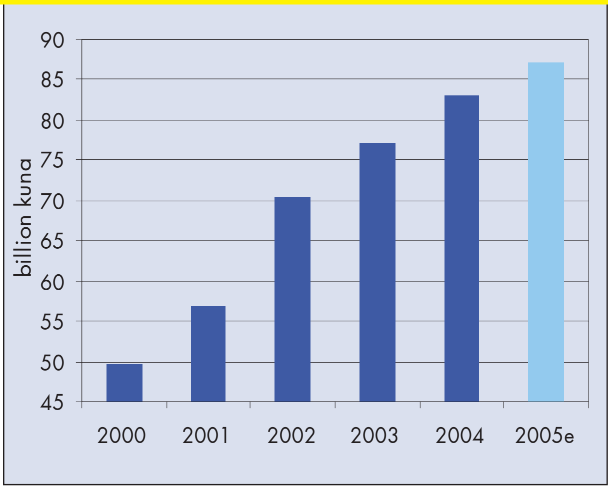
### Net asset value




*Sources: HAGENA, CROSEC*

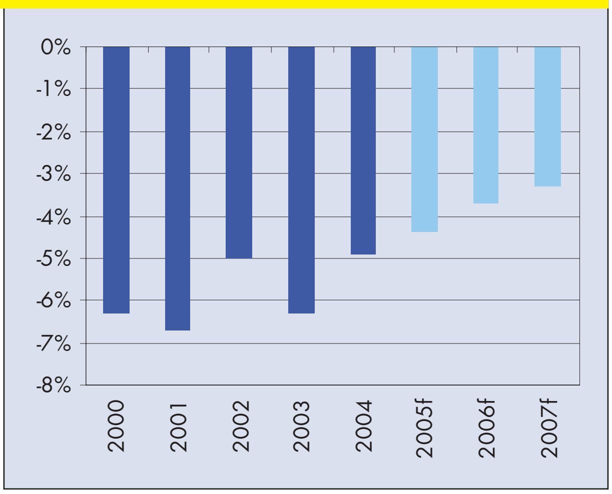
# Slower adjustment, slower consolidation

### Central Government Budget



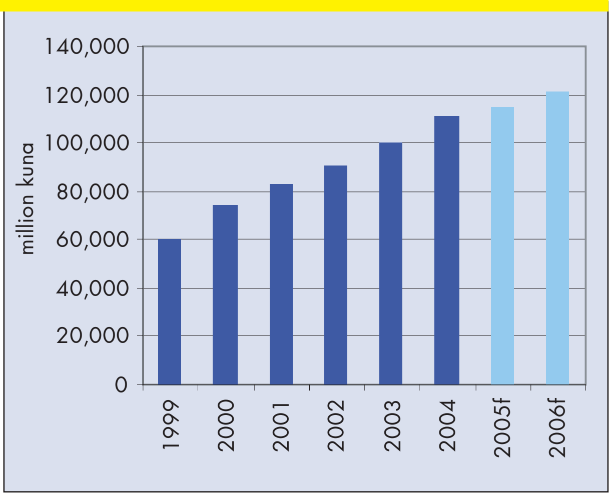

Source: MoF

### Consolidated general government, % of GDP




Source: MoF

### General government debt stock




Sources: MoF, CNB

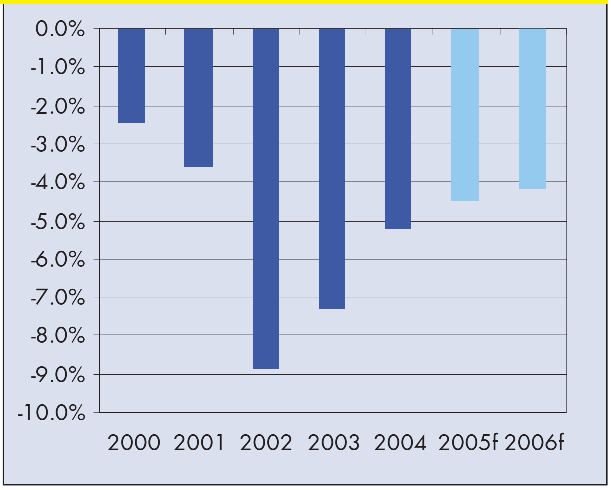
The new general government consolidated deficit of 4.2%, which has been approved by the IMF, is a consequence of adjustment to slower-than-planned revenue growth in the first quarter of this year. The situation improved slightly during the second quarter, but the gap between revenues and expenditures required an adjustment of the planned budget. The slowdown in economic activity left a mark on revenues, which stood at 45.9% of the plan in the first half of the year, while expenditures reached 50.4% of the plan. The greatest shortfall was observed in the segment of excise revenues which went up only 2.6% in annualised terms (with the weakest results achieved by excises on oil derivatives), compared with the total revenues growth of 7.2%. The healthiest contribution came from VAT revenues, which went up 4.8%, meaning that revenue growth was generated by the rise in other revenues. The planned fiscal consolidation will include substantial corrections on the expenditures side. However, the pension system reforms (adjustment of pension growth to a new formula) and health care reform (introduction of administrative fees for health care services) will be not be launched in autumn. At the same time, subsidies for companies went up by 17% in annualised terms. The risk of expenditures exceeding the plan and revenues coming in below the plan until the end of the year, increases the possibility that the deficit exceeding the target set by the Ministry of Finance. A greater share of revenues is usually generated in the second half of the year, with VAT revenues being particularly strong (due to the favourable effect of the tourist season). However, fiscal consolidation should be achieved by stronger control of expenditures which account for over 50% of GDP. Delay in implementing the necessary reforms makes this difficult. In the following two years, the budget may come under additional pressure due to repayment of the debt to pensioners (possibly accounting for 3% of the GDP over the next two years), which will put the planned deficit target and our forecasts under considerable strain.

As a result of the gap between revenues and expenditures, there is upward pressure on public debt which reached levels of above 50% of GDP. In the middle of the year debt went up to some 55% of GDP (inclusive of CBRD debt and government guarantees). By the end of the year, privatisation revenues are expected to help put the brakes on borrowing, reducing public debt to last year's level of 53.5%. However, privatisation revenues are only expected at the end of the year and their absence could result in even stronger public debt growth.

# Widening of the current account deficit

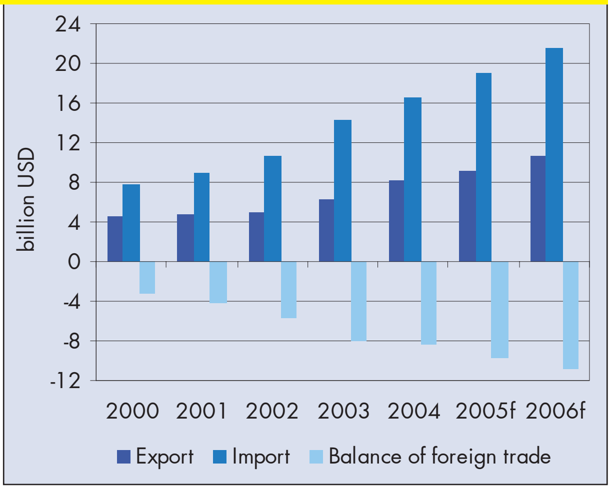
The current account deficit reached EUR 2.7 bn or 7% of GDP in the first half of the year. The 27% yoy growth in the deficit primarily results from the increase in expenditures on the income account, a larger foreign trade imbalance and the stagnation of net revenues from services rendered in tourism. The negative income account balance of EUR 814 mn is a consequence of increased expenditures. Nevertheless, over one-half of these expenditures (HRK 501 mn) was accounted for by retained profits, which are normally reinvested, thus positively affecting developments in the capital account. It is encouraging that foreign direct investment reached EUR 1.1 bn during the period in question, with the rise in the share of greenfield investments reflecting a positive trend. Recovery of exports in the months to come, paired with restrained imports, increase in revenues from tourism and other services should all positively affect the balance of payments, thus reducing the deficit on the current account. The observed trends may continue in the beginning of 2006, with higher coverage coming from the capital account due to the expected large inflow of FDI and realisation of the delayed privatisation of the state portfolio. The slowdown in the growth of Croatia's external debt continued over the summer months. After almost three years its annualised growth rates fell to below 10%, thus reflecting the government policy of attempting to redirect budget deficit financing to domestic financial markets. Croatia's external debt totalled EUR 24.1 bn at the end of July (up 9.6% yoy). In the external debt structure, the government's share declined to below 29% for the first time at the end of June, while this was also the only sector which reduced its foreign liabilities over a one-year period. Banks accounted for the highest growth (21%) as well as the largest share of external debt. Other sectors (primarily the corporate sector) started accounting for an ever more substantial share in external debt of 27%, which will undoubtedly grow further. The ratio of external debt to GDP thus continued growing, reaching the level of 84.3%. The slowdown in debt growth is expected to continue until the end of the year, with ratio of external debt to GDP dropping to 82.4%. However, there is still the risk that further borrowing of banks and other sectors might negatively affect or offset the positive effects of the reduced government borrowing at foreign markets.

### Current account balance, % of GDP




*Source: CNB*

### Foreign trade of goods




*Source: CBS*

### External debt and ratios

| Quarters | External debt (EUR mn) | External debt as % of: GDP | Exports of goods and services | International reserves (% of external debt) |
|---|---|---|---|---|
| Q1 03 | 16,264 | 66.3% | 145.9% | 35.6% |
| Q2 03 | 17,144 | 68.9% | 145.6% | 34.6% |
| Q3 03 | 18,244 | 72.2% | 139.4% | 33.9% |
| Q4 03 | 19,811 | 77.6% | 150.8% | 33.1% |
| Q1 04 | 20,604 | 79.5% | 154.8% | 30.0% |
| Q2 04 | 21,889 | 82.6% | 161.8% | 29.2% |
| Q3 04 | 21,903 | 80.7% | 157.3% | 29.5% |
| Q4 04 | 22,675 | 82.0% | 159.2% | 28.4% |
| Q1 05 | 23,102 | 82.3% | 161.4% | 29.0% |
| Q2 05 | 24,207 | 84.3% | 167.0% | 29.2% |

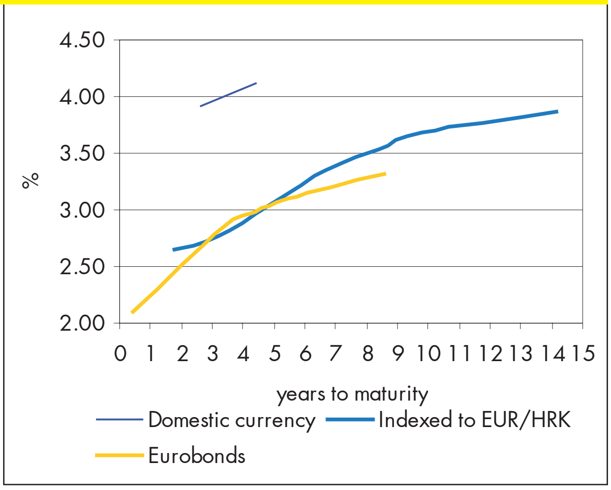
*Source: CNB*

# Greater turnover, yield reduction

### Issuance activity in domestic market

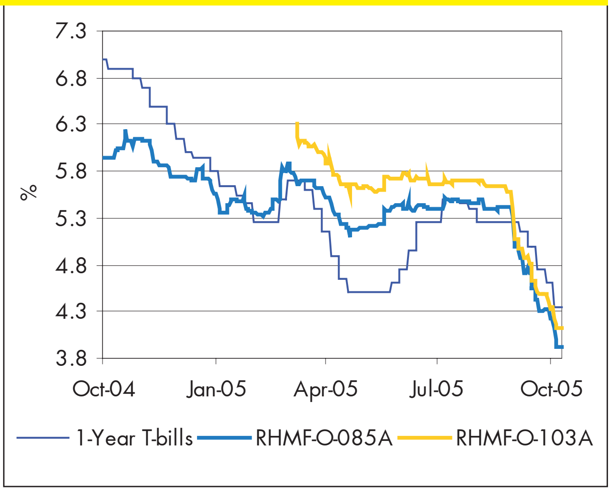

* untill September 30th, 2005
Sources: MoF, ZSE, Raiffeisen RESEARCH

### Yield curves of Croatian bonds




Sources: Bloomberg, biznis.infoforum.hr, Raiffeisen RESEARCH

### Domestic currency yields




Sources: MoF, Raiffeisen RESEARCH

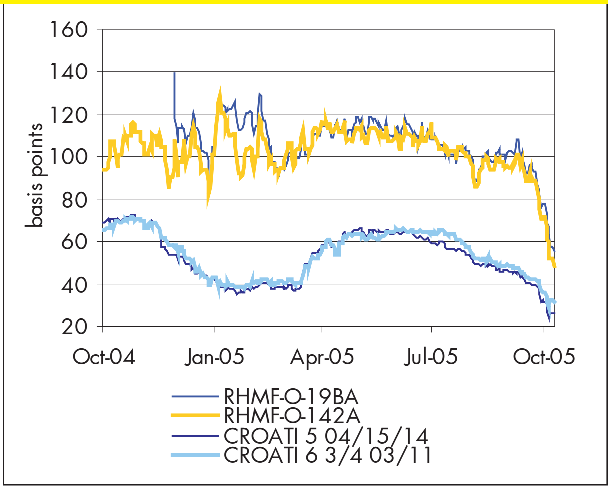
The domestic bond market saw substantial growth in turnover this year as institutional investors on the domestic market increased in numbers and the presence of foreign investors (attractive pure kuna issues) also boosted trade. Total turnover reached HRK 20 bn in the first nine months of this year (up more than 41% on the same period a year ago), growing at a healthy pace and reaching a substantial ratio to GDP (some 13.5%). However, indexation to the exchange rate remains a peculiarity of Croatian bond issues. This year, the government issued only two bonds, one kuna and one indexed to the exchange rate (in the total amount of some HRK 5.6 bn). There is a possibility of one more issue in the autumn since a domestic bond (DAB 2005) is falling due and privatisation revenues may fall short of plans, which would generate additional need for financing. As for other issuers, companies and the local government, there was no significant news. This year did not come even close to the amount of last year's new issues (EUR 117 mn in corporate bonds and EUR 26.5 mn in municipal bonds). There were no municipal bond issues and only two corporate issues in the total amount of EUR 24.5 mn. Several new issues were announced, however, the last year's activity level will surely not be reached. The price of bonds indexed to a foreign currency saw short-term stagnation and decline during the summer due to the exchange rate level. However, the weakening of the kuna in August combined with the decline in yields on European bonds towards record lows provided a strong positive influence. Yields on bonds indexed to a foreign currency declined strongly, maintaining their spreads to European bonds at the level of some 100 basis points. Prices continued growing through September and October, thanks to the influence of the exchange rate and the EU talks decision, thus significantly reducing the spread. Weakening of the kuna until the end of the year combined with favourable effects of Croatia's EU accession negotiations may result in additional price strengthening/yield reduction unless European bonds register a strong decline. With the coming of the new year, the influences of a stronger kuna may become more prominent and negatively affect these bonds. Unfavourable influences are expected from foreign markets. The prices of kuna bonds went up over the summer, especially at the turn of the month from August to September. Strong demand from institutional investors, also spurred by the wide spread kuna yields compared to bonds indexed to foreign currency and European bonds,

# EU negotiations trim risk premia

combined with expectations that this year's kuna decline will not be as pronounced contributed to the decline in kuna yields. Of course, the improved liquidity of Croatia's financial system after the peak of the tourist season also played a significant role, enabling a decline in money market interest rates, i.e. a reduction in yields on T-bills issued by the Ministry of Finance. Yields sank to their lowest level, thus making it impossible to expect a further decline considering that at the end of the year money market interest rates usually go up and the domestic currency weakens. The strengthening of the kuna next year may be a favourable factor for kuna bonds, unless money market interest rates fail to go up considerably. The advantage of kuna bonds currently lies in the small amount of the issue as against the increasing needs of institutional investors, i.e. the potential interest of foreign investors.

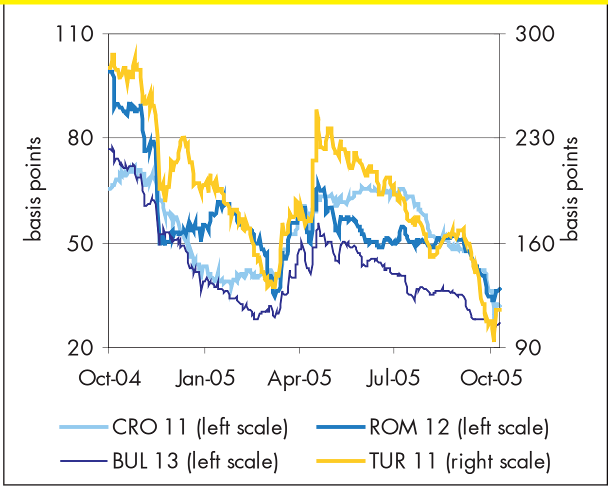
Spreads on Croatian Eurobonds fluctuated significantly during 2005. The postponement of EU negotiations, which coincided with the decline in the price of emerging market assets led to a widening in the spreads. With favourable developments for such assets and favourable news for Bulgaria and Romania (improvement of their credit rating, EU rapprochement) spreads narrowed again to the level of some 40 basis points, while the price of Croatian Eurobonds experienced strong growth due to the decline in European yields. The start of Croatia's EU accession negotiations provides additional impetus for interest in Croatian Eurobonds so spreads should move towards levels currently held by Bulgarian spreads (30 basis points).

### Croatian bonds' spread




*Source: Bloomberg, MoF, Raiffeisen RESEARCH*

### Spread comparison




*Source: Bloomberg*

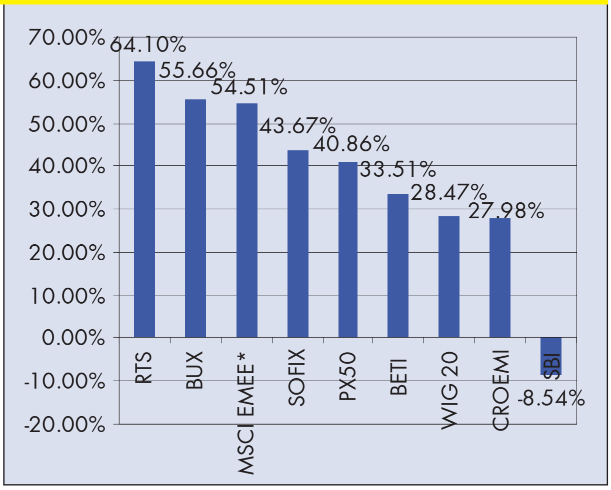
### Government and government guaranteed bonds in domestic market

| Bond | Currency | Volume (mn) | Maturity (%) | Coupon | YtM (ask, %) 10/10/2005 | Spread to Bund 10/10/2005 | Spread to EUROSWAP 10/10/2005 | YtM (ask, %) 6/30/2005 | YtM (ask, %) 12/31/2004 | YtM (ask, %) 9/30/2004 |
|---|---|---|---|---|---|---|---|---|---|---|
| DAB-O-05CA | EUR* | 225 | 12/19/2005 | 8.375 | 1.33 | -63 | | 2.11 | 3.06 | 2.40 |
| RHMF-O-077A | EUR* | 400 | 7/7/2007 | 3.875 | 2.66 | 26 | 11 | 2.84 | 3.66 | 3.38 |
| RHMF-O-08CA | EUR* | 200 | 12/14/2008 | 6.875 | 2.76 | 19 | 4 | 3.04 | 3.73 | 3.70 |
| RHMF-O-125A | EUR* | 500 | 5/23/2012 | 6.875 | 3.34 | 47 | 32 | 3.23 | 4.40 | 4.50 |
| RHMF-O-142A | EUR* | 650 | 2/10/2014 | 5.500 | 3.54 | 49 | 37 | 3.58 | 4.59 | 4.89 |
| RHMF-O-157A | EUR* | 350 | 7/14/2015 | 4.250 | 3.69 | 53 | 43 | | | |
| RHMF-O-19BA | EUR* | 200 | 11/29/2019 | 5.375 | 3.87 | 56 | 39 | 3.30 | 4.93 | |
| RHMF-O-085A | HRK | 1,000 | 5/28/2008 | 6.125 | 3.92 | 140 | 126 | 5.40 | 5.56 | 6.06 |
| RHMF-O-103A | HRK | 3,000 | 3/8/2010 | 6.750 | 4.12 | 138 | 127 | 5.66 | | |

** 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*

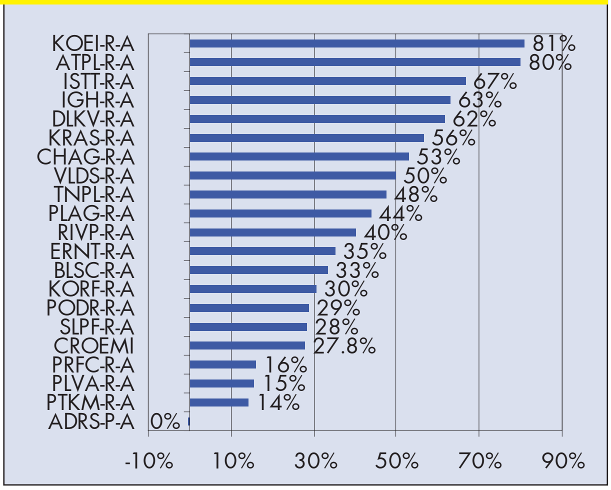
# Annual turnover
## growth 120%

### Region's core indices - YTD performance



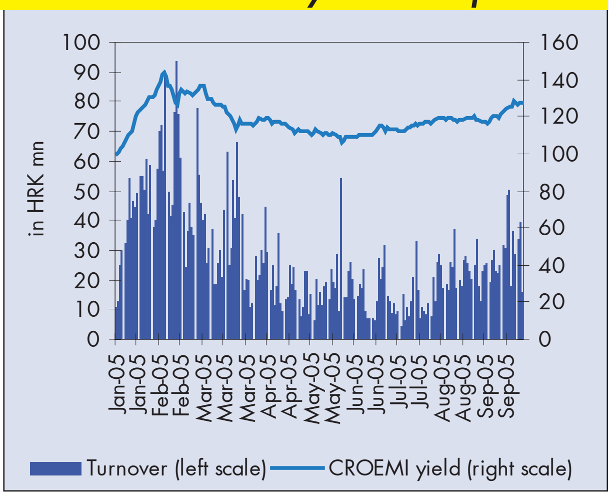

*In local currency, value on Sep 30, 2005. *MSCI Emerging Market Eastern Europe*
*Sources: Bloomberg, Raiffeisen RESEARCH*

### Performance YTD of CROEMI members




*Note: Values on Sep 30, 2005.*
*Sources: ZSE, VSE, Raiffeisen RESEARCH*

### Market turnover and yield - YTD performance




*Sources: ZSE, VSE, Raiffeisen RESEARCH*

***Regional returns.*** Over the first nine months of this year, the domestic equity market achieved a return of 28%. Although this is a strong figure, the return on the Croatian market was still nevertheless one of the lowest in the region. The highest return was recorded on the Russian market (64%), which was spurred by rampant growth at oil companies, while the lowest return, and also the only negative return, was realised by the Slovenian market (-8.5%). After the FED raised its base interest rate at the end of September, the European and the Japanese markets gained in attractiveness, especially European emerging markets. This placed the region around Croatia at the centre of investor interest. In addition to positive external circumstances, the Croatian market had one more advantage - the start of EU accession negotiations. The expected entry of INA, the oil company, in the market is also expected to arouse the interest of all those who like investing in this sector. All of these reasons point to a continuation of the positive trends, both in the form of a rise in the value of assets and an increase in equity turnover.

***Returns in the domestic market.*** At the end of the first nine months of this year, there were no issuers that are on the CROEMI, except Adris Group, that ended the period in the red. Adris Group saw its discount being increased after the announcement that the licence agreement with Philip Morris on the production and distribution of Marlboro in the Croatian market was terminated. The strongest returns, as much as 80%, were realised by Koncar and Atlantska plovidba. Atlantska plovidba was in the centre of investor interest due to the growth in its business results that were achieved due to the rise of the price of transport fees at the end of last year. In addition, Atlantska plovidba showed that it has an active strategy of renewing its fleet and diversifying risks. An explanation for the growth of Koncar Elektroindustrija may be found primarily in the expectations of investors that this concern will be privatised and that its parts are more valuable than the whole.

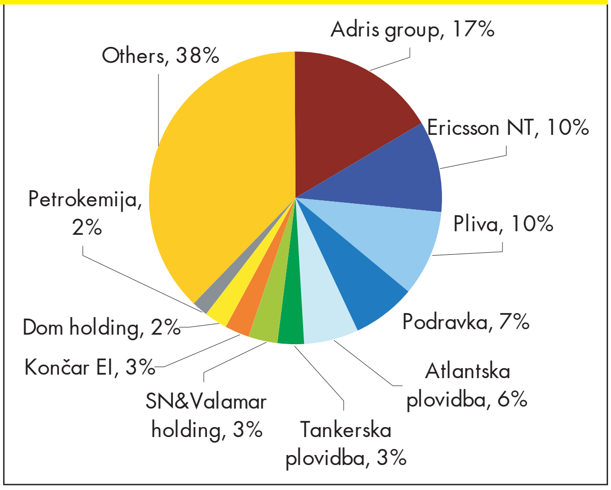
***Market valuation.*** The P/E ratio of CROEMI constituents in 2005 totals 13. This calculation does not include the former privatisation funds Dom holding, Proficio, SZIF and Validus and Koncar and Riviera holding. Koncar and Riviera holding have been excluded from the calculation due to their extremely high P/E ratio, resulting from low prof-

itability in the case of Koncar and disrupted indicators due to a large acquisition in the case of Riviera holding.
If Koncar and RIVP were included in the calculation, the P/E ratio for 2005 would amount to 14.8, which would, in our opinion, send an incorrect picture of market valuation. The current regional P/E for 2005 (Hungary, Poland and the Czech Republic) amounts to 16 (a simple average), i.e. 13 (median). This puts the current market valuation of Croatia's market at the regional level, that is, the fundamental discount of the market has declined or disappeared. Therefore, in the future investors may expect asset growth primarily through the rise of companies' fundamentals (significant sales and/or earnings growth). Since we are to see structural reforms over the next two years due to the need to adjust Croatia's economy to the European landscape, we expect that numerous companies will have to do the same in order to be efficient in the new market surroundings. It is up to investors to recognise the management and the sector that will have the know-how and the ability to achieve this.

***Equity turnover.*** The highest daily turnovers were seen in the first quarter, while the cumulative turnover in the second and third quarter was 5% below the figure realised in the first quarter. The total turnover realised since the beginning of the year amounted to HRK 5 bn, up 120% from last year. Adris Group accounted for the largest share in annual turnover with HRK 877 mn. The first five shares by turnover (Adris, Ericsson NT, Pliva, Podravka and Atlantska plovidba) accounted for 49%, the first ten shares for 62%, and the first twenty for 74% of total turnover. Third quarter turnover, totalling HRK 1.3 bn, was atypical. Apart from the order of the largest players being changed, turnover was less concentrated on individual shares. Adris again accounted for the largest share in third quarter turnover with a volume of HRK 138 mn and 10% of total turnover.

***Regular revision of the CROEMI.*** Pursuant to the data on trading in the third quarter we conducted a regular revision of the CROEMI. 31 issuers satisfied all the criteria. The number of issuers that have satisfied the liquidity criteria in the period since the beginning of 1999 until today was higher only in 2005 Q1 when it stood at 35. Since the liquidity criteria remained unchanged during the period in question (1999- present), we consider this clear evidence of the development of the Croatian equity market. The revised CROEMI will become effective

## Turnover shares (I-IX 2005)



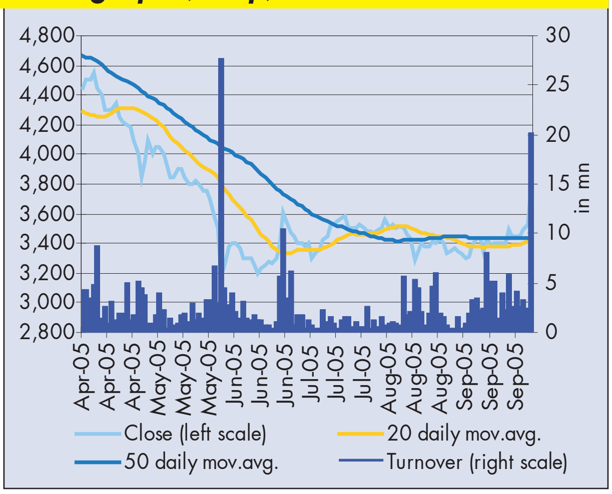

Sources: ZSE, VSE, Raiffeisen RESEARCH

## Net income & sales development

| in HRK '000 | Sales H1 2005 | % | Net income H1 2005 | % |
|---|---|---|---|---|
| ADRS-P-A | 1,148,427 | 4% | 283,996 | -0.13% |
| ATPL-R-A | 428,455 | 67% | 263,950 | 461.01% |
| BLSC-R-A | 582,603 | 22% | 4,872 | 114.81% |
| CHAG-R-A | 182,702 | -3% | 17,644 | 2.12% |
| DLKV-R-A | 614,228 | -9% | 40,328 | 14.59% |
| ERNT-R-A | 593,810 | -7% | 70,488 | 12.64% |
| IGH-R-A | 250,740 | 33% | 40,442 | -5.82% |
| ISTT-R-A | 79,027 | -11% | -17,423 | 66.12% |
| KOEI-R-A | 805,757 | 2% | 3,981 | 10.00% |
| KRAS-R-A | 436,871 | 6% | 26,342 | 31.99% |
| PLAG-R-A | 121,826 | -2% | -9,069 | 9.95% |
| PODR-R-A | 1,589,935 | 1% | 47,459 | -9.76% |
| PTKM-R-A | 766,360 | 7% | 1,354 | -95.41% |
| RIVP-R-A | 143,066 | 29% | -30,996 | 54.39% |
| TNPL-R-A | 437,966 | -19% | 244,248 | 2440.02% |
| Ukupno | 8,181,773 | 4% | 987616 | 73.82% |
| u mil. USD | | | | |
| PLVA-R-A | 526 | 12% | -83.1 | -193.06% |

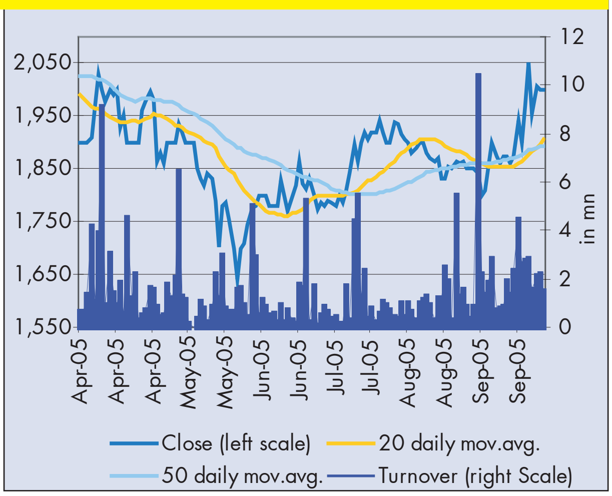
Source: CROSEC, Pilva, Raiffeisen RESEARCH

## Adris grupa (6 mj.)



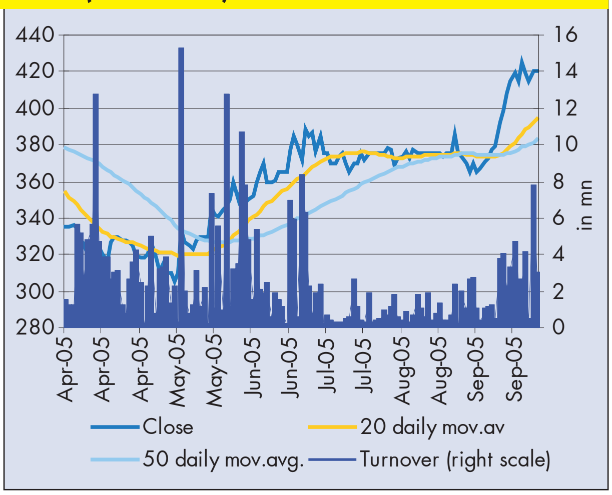

Sources: ZSE, Raiffeisen RESEARCH

### Ericsson Nikola Tesla (6 months)



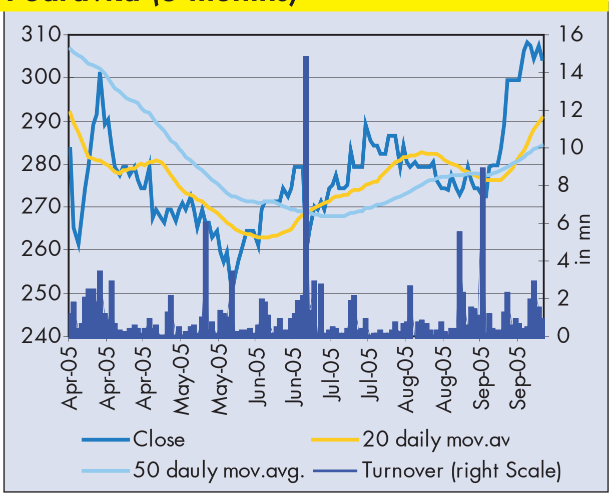

*Sources: VSE, Raiffeisen RESEARCH*

### Pliva (6 months)




*Sources: ZSE, Raiffeisen RESEARCH*

### Podravka (6 months)




*Sources: ZSE, Raiffeisen RESEARCH*

as of 15 October 2005. In comparison with the old constituents, the new CROEMI constituents will not include the shares of Chromos Agro and Slavonija fund, because they failed to meet all of the liquidity criteria for the second time in a row. SN holding and Uljanik plovidba will take their place in the index with 50% of their free-floating shares. The number of CROEMI constituents is limited to 20 shares.

***Sales and net profits growth.*** In the first half of this year, the issuers on the CROEMI index realised sales growth of 4% and net profits growth of 74%. The results of Atlantska and Tankerska plovidba conributed significantly to this result. Excluding the results of Tankerska plovidba, the profit growth rate is still a significant 33%. In the case of Tankerska plovidba, a significant influence on net results came from this year's reduced depreciation charges compared with the last year due to accelerated write-off. If we add Pliva's results to this group of issuers, the entire lot is in the red by 56% on annual level. If we exclude Pliva, whose results are exceptionally poor due to company repositioning and are not likely to be repeated in the future, the market benchmark indicates trends that we have expected - significant growth in sales profits.

***Adris Group*** has reached a decision to move its plants from Rovinj and Zagreb to Kanfanar. The plant in Kanfanar should become operational on 20 June 2006. The value of this investment is estimated at over EUR 100 mn. The new plant will have flexible capacity (over 20 million cigarettes a year). TDR, the tobacco unit of Adris Group works intensively on new products and invests in new markets in order to ensure further growth of its operations. The recommendation is still - buy.

***Ericsson Nikola Tesla*** was active in the Croatian market and the market of Bosnia and Herzegovina in the third quarter. In Croatia, it signed agreements with HT and Croatian Railways and in Bosnia and Herzegovina with BH Telecom and Eronet with a total value of over HRK 135 mn. The value of this year's agreements exceeds HRK 1 bn. Its operations are in line with our expectations so we maintain our recommendation - buy at the target price of HRK 2,444.00 per share.

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***Cut-off for data: 10th October 2005***
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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 |

# RZB Group
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