

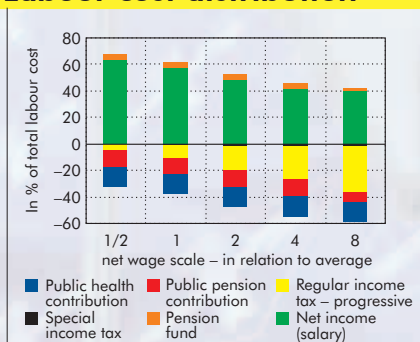
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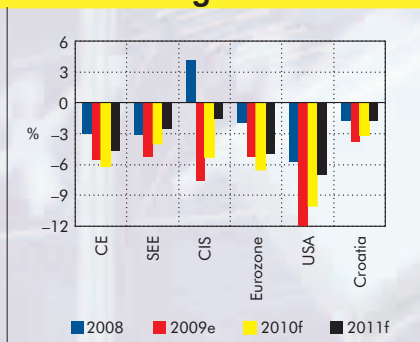
Political changes to be followed by economic changes

Labour cost distribution



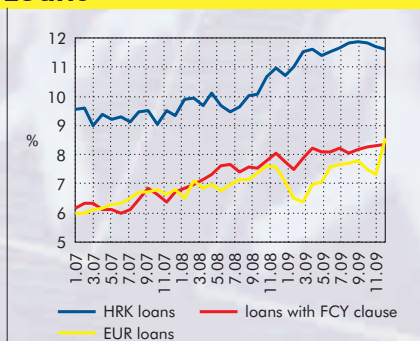
Source: Raiffeisen Research

General Budget Deficit



Source: Raiffeisen Research

Interest Rates on Banking Loans



Source: Raiffeisen Research

In Croatia the year 2010 started with the election of the new president at the regular presidential elections. The winner, Ivo Josipović, was a candidate of the largest opposition party, the SDP and an unusual candidate at the domestic political stage traditionally marked by populism-prone candidates. Now that the elections are over economic topics or rather the question of how to fight recession returned to the foreground. The 5.7% fall in economic activity in Q3 2009 warned that economic recovery will not be achieved without a more active economic policy. Therefore, the Government of the Republic of Croatia set out to halt the negative trend in domestic production and employment by adopting a series of overdue emergency measures aimed at supporting companies that offer competitive products or services and enabling better realisation and protection of employment. The Governor of the CNB announced a more active role of the monetary policy in the fight against recession, with the CNB being prepared to release additional liquidity by speeding up to process of adjusting bank reserve requirements with ECB target rates and thus help to restore corporate lending at lower capital costs. Although desirable, these measures will not suffice without a change in fiscal policy. The competitiveness of domestic companies in a relatively small and open economy like Croatia's is inevitably compared with the competitiveness of foreign companies, primarily in the region. Consequently, in comparison with companies from the broader region, Croatian companies are burdened with higher financial costs expressed through the average real interest rate on loans and relatively higher fiscal costs. The measures announced by monetary authorities and government interventions are aimed at reducing the financial costs for companies by reducing the regulatory cost (reserve requirement) and the cost of funding (increasing system liquidity) as well as through the reduction of credit risk (government guarantees). However, there is a lack of measures aimed at reducing the fiscal and quasi-fiscal burden on labour and capital, which requires painful but necessary structural reforms. Without raising labour competitiveness, the fastest way being to reduce fiscal burden on personal income, there will be no rise in employment and available income of households or recovery in consumption. In other words, in order to overcome this crisis we need a more effective and cheaper government, which is to be achieved through lower public sector expenditures and parallel reduction in tax rates and quasi-fiscal procedures and charges. Structural reforms would also result in the lowering of country risk, an extremely important category for a deeply indebted economy like ours.



**Raiffeisen
RESEARCH**

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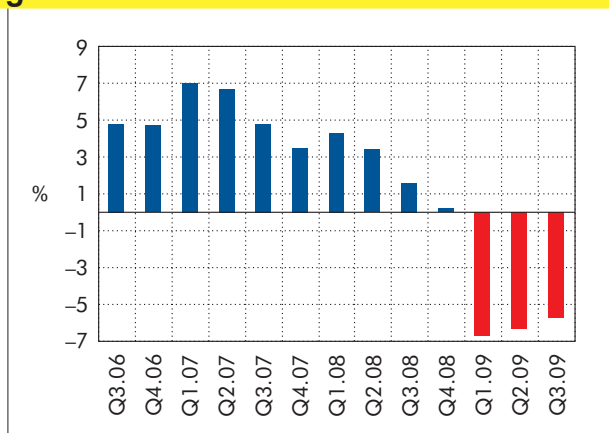
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Economic recovery in the second half of the year

Gross domestic product, real annual growth rates



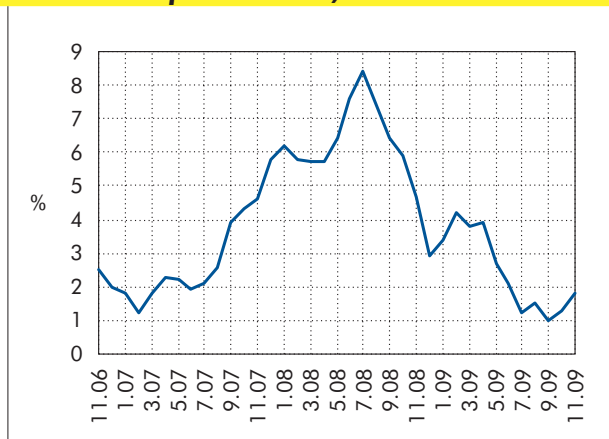
Sources: CBS, Raiffeisen Research

GDP, real annual growth rates

| year | 2007 | 2008 | 2009e | 2010f | 2011f |
|------------|-------|------|-------|-------|-------|
| Croatia | 5.5% | 2.4% | -6.0% | -0.9% | 2.6% |
| Bulgaria | 6.2% | 6.0% | -4.0% | 1.0% | 3.0% |
| Slovakia | 10.4% | 6.4% | -4.5% | 1.5% | 4.5% |
| Poland | 6.8% | 5.0% | 1.1% | 1.3% | 2.6% |
| Hungary | 1.2% | 0.6% | -6.5% | 0.0% | 2.5% |
| Slovenia | 6.8% | 3.5% | -7.0% | 0.5% | 2.5% |
| Czech Rep. | 6.1% | 2.6% | -4.0% | 0.8% | 2.5% |
| Romania | 6.2% | 7.1% | -7.5% | 1.0% | 3.5% |
| EMU | 2.7% | 0.6% | -3.8% | 1.4% | 1.5% |
| USA | 2.1% | 0.4% | -2.6% | 2.0% | 1.5% |

Sources: WIW, Raiffeisen research, Bloomberg

Consumer price index, annual level



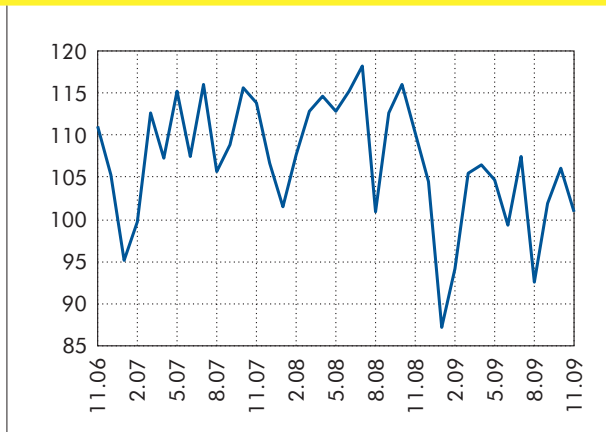
Source: CBS

The third quarter of 2009 was the third subsequent quarter of a downturn in the Croatian economy on annual level. Real GDP fall totalled 5.7%, which was a slight slowdown of its trend. In contrast to the first two quarters, in the third quarter GDP was negatively affected by the reduction in government spending (for the first time since fourth quarter 2003), while other components went down at a lower rate than in the first half of the year (partly due to the base effect). Real sector and labour market data indicated a continuation of unfavourable developments so real economic downturn for the year could reach 6%. In the first half of this year, economic activity will continue to decline with negative developments in the labour market peaking. Foreign demand, without strong changes in the domestic sector, will not suffice for industrial recovery and a start of an investment cycle. Positive influences that thus far came from the reduction in trade deficit will wear off gradually as the rates of change in imports and exports equalise and the growing prices of raw materials and energy create upward pressure on the trade deficit. According to our projections, recovery will start no sooner than at the second half of the year, taking into account a successful tourist season, repealing of the crisis tax, base effect and growing foreign demand.

After the inflation rate, measured by the consumer prices index, followed a downward trend in third quarter 2009 (predominantly due to last year's high base), inflationary pressures slightly intensified in the fourth quarter. In addition to the base effect, the largest contribution to the price growth, as expected, came from the rise in the price of energy. Due to the decline in personal consumption caused by declining available income of households, the increase in the VAT rate and introduction of additional excise duties were not transferred to the end consumer since the already curbed demand creates downward pressures on prices. The average inflation rate for 2009 is expected to be 2.4%. In the forthcoming period, we expect inflationary pressures to continue due to the increase in gas prices which will lead to the upward movements in the prices of other products, primarily the price of electricity. However, energy prices are still below real market prices so in the next two years, as part of Croatia's EU accession process, administratively set prices will have to be aligned.

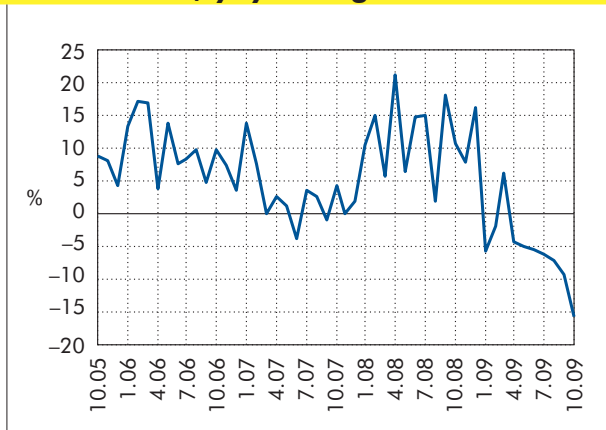
Will recession spur industry restructuring?

Basic indicies of industrial production, 2005 = 100



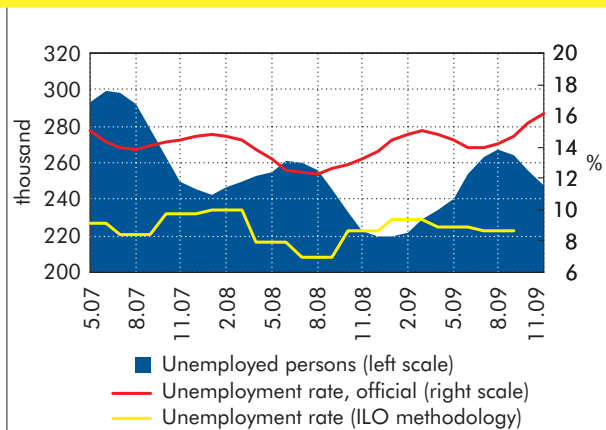
Source: CBS

Construction, yoy change



Source: CBS

Unemployed persons, unemployment rates



Sources: CBS, CES

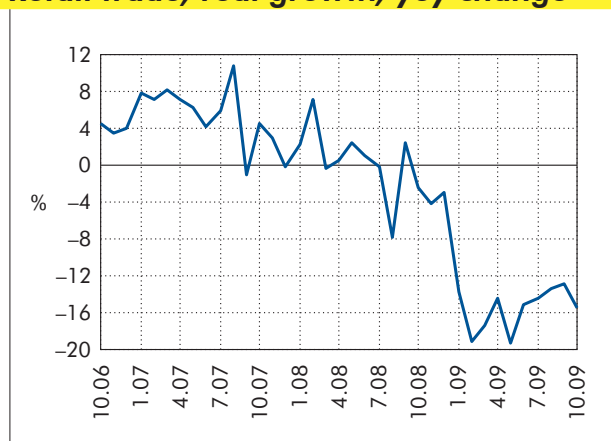
The expected favourable impact of the last year's base on industrial production fell out in the fourth quarter, with relatively high annual rate of decline continuing. In addition, the softening of the fall in industrial production was affected exclusively by the growth of energy production, which was expected in view of the start of the heating season. In the first eleven months, the industrial production volume was lower by a sizeable 9.5% relative to the same period last year. Recession showed that the problem of industrial production and its lack of competitiveness was a structural problem whose solving requires the implementation of necessary reforms. The sustainable economic growth requires dealing with structural problems of sectors with low technological intensity, like shipbuilding and textile industry, as well as promoting development in the segments that rely on new technology and knowledge with added value, i.e. promoting industries that will contribute to better productivity and higher employment. However, this requires the system of education to be adjusted to the real sector. The decline in industrial production might continue in the first two quarters of this year. Recovery is not to be expected sooner than in the second half of 2010 when positive developments in foreign markets could have a stronger influence.

The labour market is a segment of the economy which is the last to reflect recession movements. Accordingly, it will be the last to benefit from economic recovery. The number of the unemployed has been growing relatively fast over the last few months, drawing close to the number of 300 000. The strong growth in the number of the unemployed is a reflection of numerous negative economic trends. The reduction in industrial production reduced the need for workers. Manufacturing industry, trade and construction were hit the strongest so the number of layoffs in these branches of the economy are the highest. In addition, some of the companies have been trying to cut staff and redistribute their own capacities in order to reduce operating costs and avoid bankruptcy. This is confirmed by the fact that the unemployment growth is the highest in the age group of 20 to 29, i.e. among persons entering the labour market. In the forthcoming period, the unemployment growth will have negative effects on personal consumption due to decreasing available income, which will in turn further slow down the recovery of our economy, highly dependant on consumption.



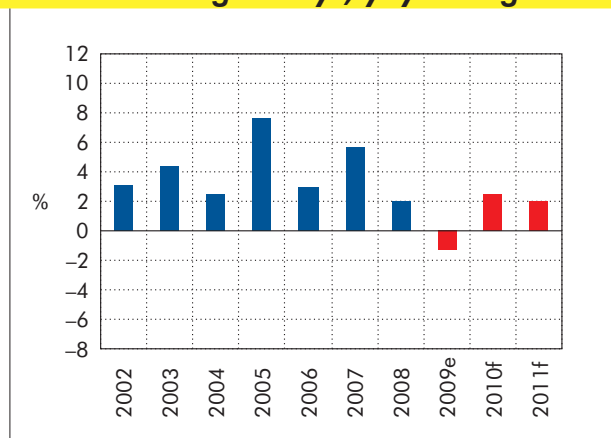
Without trade recovery, two-digit fall in tourism revenues

Retail trade, real growth, yoy change



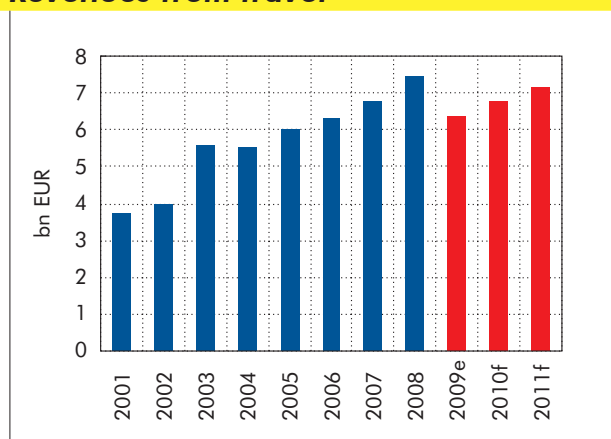
Source: CBS

Tourist overnight stays, yoy change



Source: CBS

Revenues from travel



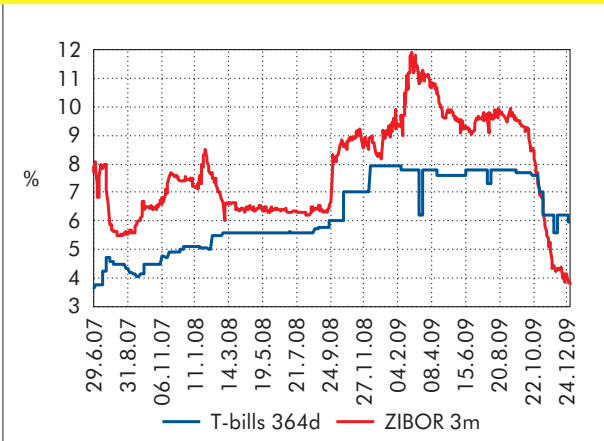
Sources: CNB, Raiffeisen research

Although the downward trend in retail trade was expected to slow down at the beginning of autumn due to the lower base, the opposite happened. Retail trade continued declining at two-digit rates. While the intensity of its fall was surprising, structurally viewed, retail trade decline was in line with expectations. The largest fall last year was registered by the sale of new and used motor vehicles, while the sale of bread and bakery goods and groceries went up. The strong fall in retail trade was primarily linked to the decrease in available income of households, which resulted from growing unemployment and increased fiscal burden on wages. The said factor will again contribute to modest retail trade results in the first half of 2010, although the rate of fall will be much lower than in 2009. Lower rates of decline will be strongly affected by the base effect since retail trade saw two-digit rates of fall throughout 2009. Since GDP is largely dependant on personal consumption, that is hit hard at times of crisis or recession, if reforms are delayed, economic recovery will take as much as retail trade recovery.

The physical indicators of the peak tourist season and in September showed that the tourist season exceeded bleak forecasts from the beginning of the year. However, the CNB's latest data show that tourism revenue fell 15.7% in the third quarter. Tourism revenue for the entire year is expected to total some EUR 6.4bn, down over one billion relative to 2008. Real sector indicators showed that tourist spending will reduce, because retail trade went down at two-digit rates even during the tourist season. In addition, the average number of tourist overnight stays per arrival went down. Furthermore, aiming at attracting guests the prices of services were cut. In the future, tourism needs to be positioned both at the level of the domestic economy and at the global level. While good results in 2009 (as far as overnight stays and arrivals are concerned) is for the major part a consequence of competitive prices and Croatia's geographic position, much more will have to be done to attract guests in 2010 because competition is bound to be more aggressive this year. This year we expect tourist overnight stays to grow by some 2.5% and revenues from tourism to go up by 6.8% on annual level.

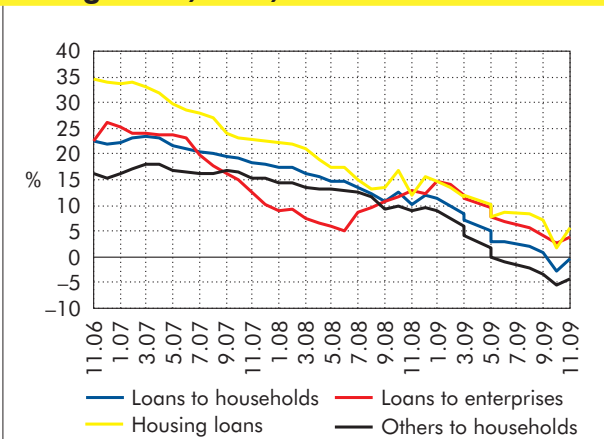
Extremely high volatility on the money market in 2009.

Interest rates



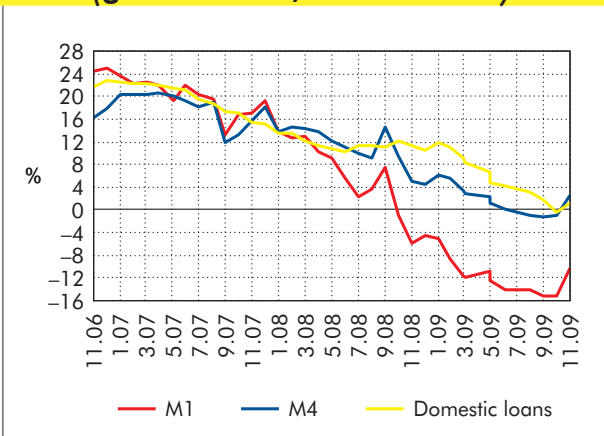
Sources: reuters.hr, CNB, MoF

Loan growth, in %, annual level



Source: CNB

Monetary aggregates and domestic loans (growth rates, annual level)



Source: CNB

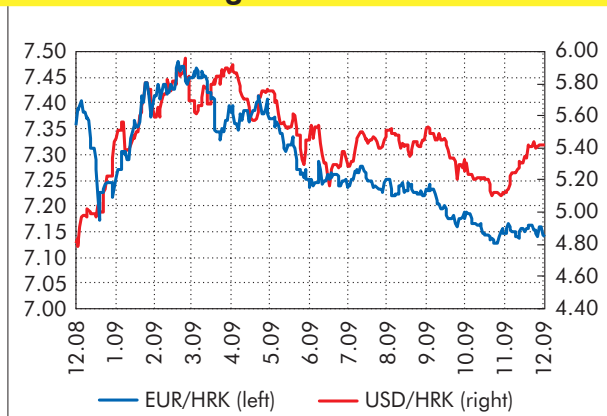
The past 2009 will be remembered in the money market by extremely high volatility, the highest and the lowest interest rates on all maturities, low liquidity in the beginning and extremely high system liquidity late in the year. Reduced kuna liquidity and a period of historically highest interest rates in the first quarter was followed by stabilisation in the second and the third quarter, and extremely high kuna liquidity in the last quarter with the lowest interest rates in the past six years. In such circumstances the central bank held its last regular reverse repo auction in the middle of October, while additional liquidity was created by foreign exchange interventions aimed at preventing the appreciation of the domestic currency against the euro. The CNB did not use restrictive measures to reduce pressure on the money price drop as despite the ample supply there were no increase in loans or inflationary pressures recorded.

The foreign exchange inflow from the government debt issued in dollars and new borrowings of public enterprises abroad provided additional support to high market liquidity until the end of the year. Despite good liquidity, monetary aggregates, especially money (M1) continued falling, thus reflecting developments in the real sector. Total liquid assets (M4) were relatively stable exclusively thanks to the growth of foreign exchange deposits. The CNB repealed bank obligation to subscribe CNB-bills if their annual loan growth exceeds 12 percent, a tool used to slow down loan growth in the previous three years. In the period ahead, the central bank will continue its policy of maintaining a stable kuna exchange rate, but with more experience from intervening in the first quarter of 2009 and stronger foreign exchange reserves. Therefore, we expect stable kuna liquidity in a period of possibly rising tensions in the foreign exchange market during the first quarter of 2010. We expect kuna liquidity to continue to be maintained at high level and interest rates to range within a band usual for the period of maintaining the reserve requirement. Nevertheless, the downward trend followed by monetary aggregates should be halted. However, considering the expectations in the real sector and the labour market we do not see a basis for a more substantial recovery, at least not in the first half of 2010. As regards deposits, we expect the period of stagnation to continue, being additionally spurred by stabilisation and a mild decrease of interest rates on deposits offered by banks.



Appreciation pressures on kuna marked the end of the 2009

Middle exchange rate of the CNB



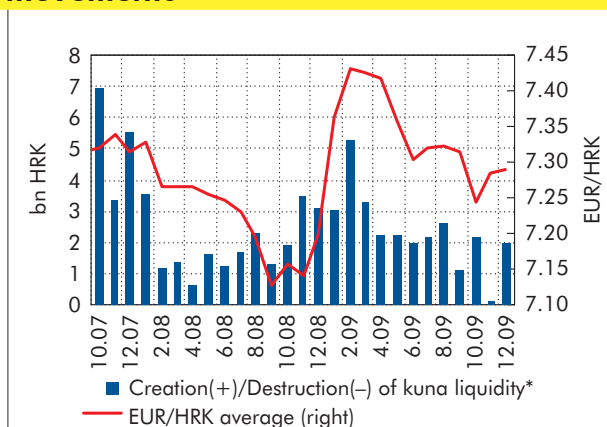
Source: CNB

Middle exchange rate of the CNB

| Currency | Middle exchange rate 31.12.2009 | Change compared to: 31.12.2008 | | |
|----------|---------------------------------|--------------------------------|------------|-------|
| | | Exch. rate | Move-ments | % |
| EUR | 7.3062 | 7.3244 | ↓ | -0.25 |
| USD | 5.0893 | 5.1555 | ↓ | -1.28 |
| CHF | 4.9094 | 4.9111 | ↓ | -0.03 |
| GBP | 8.0740 | 7.4845 | ↑ | 7.88 |

Source: CNB

CNB operations and exchange rate movements



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

Exchange rate forecast

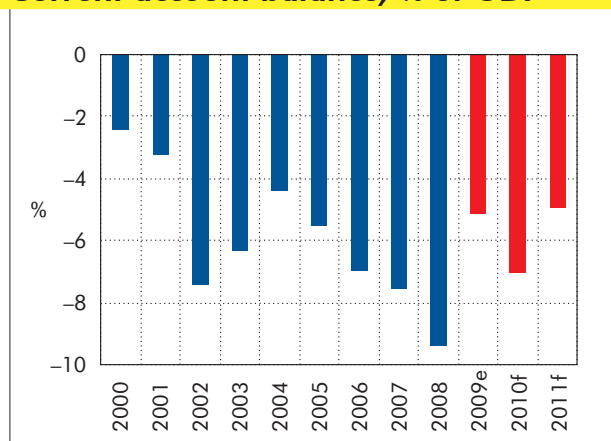
| | 2010f | 2011f |
|--------------|-------|-------|
| EUR/HRK, avg | 7.40 | 7.45 |
| EUR/HRK, eop | 7.45 | 7.50 |
| USD/HRK, avg | 5.14 | 5.32 |
| USD/HRK, eop | 5.44 | 5.36 |

The tourist season did not end with the usual EUR/HRK exchange rate growth. To the contrary, the last quarter was marked by appreciation pressures on the domestic currency. The reduced risk perception relating to developing markets slowly opened the door to foreign sources of financing in the second half of the year (although noticeably more expensive than in the pre-crisis period) so in addition to the Government's exit to foreign capital markets, foreign exchange inflow was ensured by the borrowing of public enterprises and the corporate sector. This created upward pressures on the domestic currency. Demand for foreign currency was slightly lower amid the substantially lower foreign trade and strong fall in import activities that marked 2009. In addition, the relatively strong demand for the subscription of euro T-bills contributed to the lower EUR/HRK exchange rate. Even despite high kuna liquidity, money surplus was mostly left unplaced thus not allowing the kuna to lose strength. In order to prevent excessive appreciation of the exchange rate, the central bank intervened three times in the foreign exchange market. The past year ended with the mid-point exchange rate slightly above HRK 7.30 for one euro.

A relatively large amount of foreign liabilities of both the corporate sector and the government sector is maturing in the first quarter this year, which will influence the EUR/HRK exchange rate. How the Government plans to finance the maturing Eurobonds and HRK denominated government bonds is still largely unknown. In case of exit into foreign capital markets and possible conversion of foreign exchange in the domestic market appreciation pressures will continue, although it is more likely that the conversion into the domestic currency will be carried out gradually through the central bank without a major impact on the exchange rate. On the other hand, the settling of foreign liabilities by the corporate sector, extremely high liquidity and low interest rate create the possibility of depreciation of the domestic currency. Reduced import activity will have a much lower contribution to the EUR/HRK exchange rate growth than over the previous years. In the remainder of the year the exchange rate will stabilise at some HRK 7.40 for one euro, seeing the usual seasonal movements during the summer months. Finally, it is certain that the 2010 monetary policy will remain true to its main objective of protecting the price and exchange rate stability.

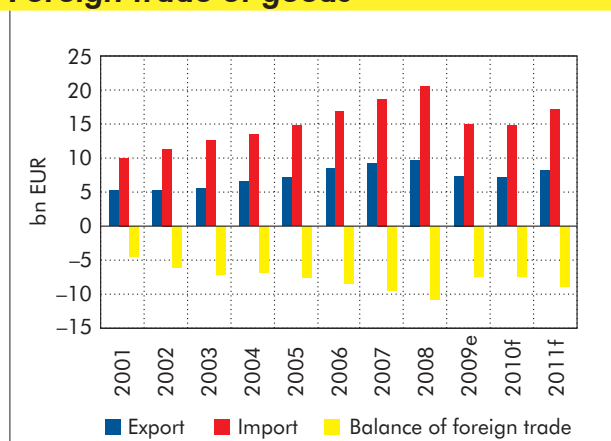
Growth of external debt towards the GDP

Current account balance, % of GDP



Sources: CNB, Raiffeisen research

Foreign trade of goods



Sources: CBS, Raiffeisen research

External debt and ratios

| Quarters | External debt (EUR mn) | External debt as % of: GDP | Exports of goods and services | International reserves (% of external debt) |
|----------|------------------------|----------------------------|-------------------------------|---|
| Q3.06 | 27,372 | 71.3% | 165.9% | 29.7% |
| Q4.06 | 29,274 | 74.9% | 172.3% | 29.8% |
| Q1.07 | 30,149 | 75.4% | 175.9% | 31.6% |
| Q2.07 | 31,058 | 75.9% | 175.9% | 29.5% |
| Q4.07 | 30,755 | 74.5% | 172.2% | 28.2% |
| Q4.07 | 33,253 | 77.6% | 181.5% | 28.0% |
| Q1.08 | 34,967 | 79.5% | 188.3% | 28.1% |
| Q2.08 | 35,409 | 78.3% | 185.5% | 28.1% |
| Q3.08 | 36,259 | 77.9% | 182.7% | 27.1% |
| Q4.08 | 39,346 | 83.0% | 197.7% | 23.2% |
| Q1.09 | 39,230 | 83.4% | 200.8% | 22.6% |
| Q2.09 | 40,806 | 87.8% | 220.9% | 22.1% |
| Q3.09 | 42,760 | 93.6% | 242.2% | 21.8% |

Source: CNB

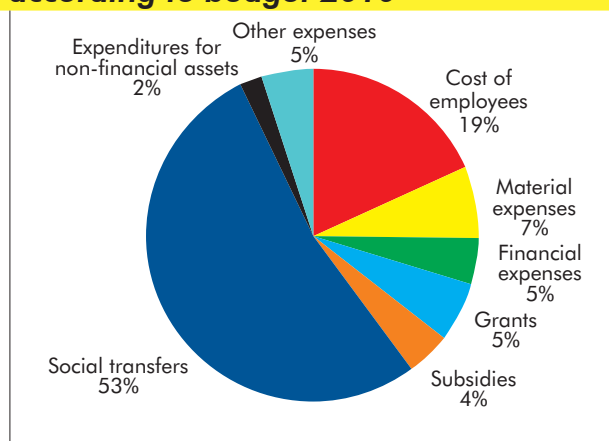
The balance of payments current account surplus that is usual in the third quarter of the year went down by 7.5% in 2009 relative to the same period in 2008. Since GDP fall slowed down slightly during the same period, the share of the balance of payments current account deficit in GDP went up to 6.2%. The main reason for the decline in surplus lies in the expected two-digit decline in revenues from the tourist season relative to the previous year. The negative contribution from the goods account to the balance of payments current account in the period under view was much milder than in the previous year since the import of goods declined much faster than the export of goods. We expect the balance of payments deficit for 2009 to amount to 5.2% considering the economic contraction of 6%. Since the last year's two government exits to the foreign capital market indicated solid interest for government bonds, deficit financing should not pose a major problem amid reduced foreign direct investments. In 2010, foreign trade in goods should start recovering. However, since we expect negative changes in foreign trade due to the expected growth of the average price of energy and raw materials in 2010, it will come to the widening of the balance of payments current account deficit.

In the last year's third quarter, the total external debt continued growing, reaching EUR 42.8bn or 93.6% of GDP, according to the latest CNB data. While in July it reduced mildly, partially thanks to the repayment of the 2004 bond, in August and September the upward trend intensified as reflected by the monthly growth of more than one billion euros. The largest contribution to the growth of foreign liabilities came from the growth of foreign direct investments and greater activity of enterprises in foreign markets. The bank and government sector continued reducing their shares in total external debt, which in September totalled 23.9% and 9.6% respectively. We expect that foreign borrowing continued growing at a moderate rate in the last quarter of the past year. By debt structure, the government share is expected to have increased due to its exit to the international capital market. In addition, at the beginning of this year the government will have to refinance its existing liabilities, most likely in the foreign market. Despite the slowdown in the growth of external debt relative to previous years, due to the economic contraction the share of debt in GDP will rise.



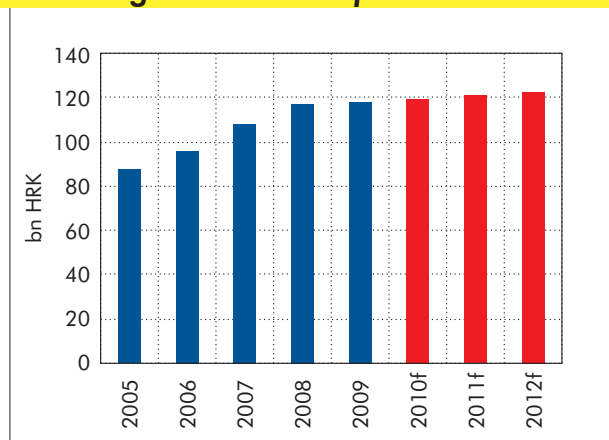
The 2010 budget – unchanged!

General government expenses according to budget 2010



Sources: MoF, Raiffeisen Research

Central government expenditures*



* MoF estimates

Sources: MoF, Raiffeisen Research

Public debt

| Year | General government debt (mn HRK) | % in GDP without guarantees and CBRD | Guarantees | Total public debt* | % in GDP without guarantees and CBRD |
|-------|----------------------------------|--------------------------------------|------------|--------------------|--------------------------------------|
| 2002 | 71,140 | 34.2 | 15,579 | 90,535 | 43.5 |
| 2003 | 79,846 | 35.2 | 15,327 | 100,126 | 44.1 |
| 2004 | 92,671 | 37.7 | 12,275 | 110,722 | 45.1 |
| 2005 | 101,061 | 38.2 | 12,223 | 120,419 | 45.6 |
| 2006 | 102,210 | 35.7 | 14,188 | 124,084 | 43.3 |
| 2007 | 104,069 | 33.1 | 17,399 | 131,131 | 41.7 |
| 2008 | 99,468 | 29.1 | 33,763 | 144,044 | 42.1 |
| 2009e | 112,946 | 34.3 | 35,763 | 159,522 | 48.4 |
| 2010f | 125,309 | 37.2 | 34,763 | 170,885 | 50.7 |

* including CBRD and guarantees

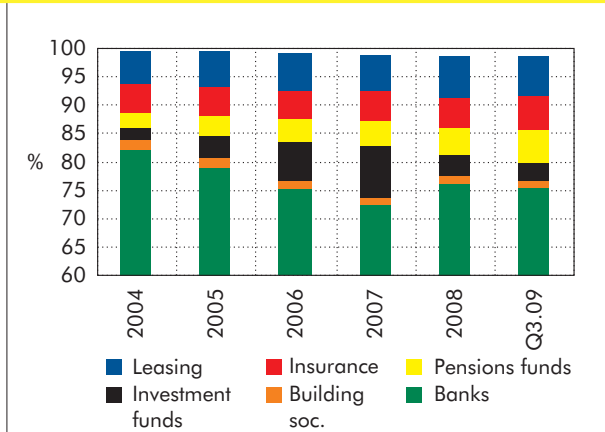
Sources: MoF, CBS, Raiffeisen Research

Considering the expectations in the real sector and the labour market it is highly likely that the revenue side of the planned 2010 budget will not be realised, so the Government might revise the budget already in the first half of the year. As a result of planned expenditures, lower revenues and still present risk of the government's guarantees being activated, the 2010 budget deficit might reach 3.7% of GDP. However, the very size of the budget deficit is not an issue, especially because we do not expect problems with its refinancing. The problem lies in the structure and the amount of expenditures. In particular, the new budget again missed the chance for important structural changes of public finances that have once again been organised in a way which does not reflect a declining tendency in expenditures or the implementation of the necessary structural changes. In the medium term, fiscal policy thus represents a growing burden for sustainable growth and development. Recession developments confirmed this view since in the circumstances of a declining economy expansive fiscal policy and its anti-cyclical influence was hindered by burdens from the past, i.e. delayed implementation of reform. Active fiscal policy is that much more important if one takes into account that automatic stabilisers of fiscal policy in Croatia are quite weak. Fiscal policy should take up a pro-active role in the reduction of overall public spending and the improvement of its efficiency. The room for this is to be found in public administration, health care and pension systems, the system of state subsidies and public procurement. The only thing that remains is hope that fiscal and economic policy-makers will disregard the fact that we are approaching an election period and press ahead with painful but necessary reform of the public sector and, together with monetary policy, play an active role in finding a solution that will start recovery and lay down new foundations for economic growth.

The widening budget deficit and maturing liabilities will lead to the growing financing needs and a rise of public debt. Although we are still far from the Maastricht criteria, in a small and open economy, at the development stage that Croatia is at, one should ask whether such a growth dynamics is sustainable. In addition, the expansion of state guarantees and inadequate structure of state subsidies reflects all the problems faced by the public sector.

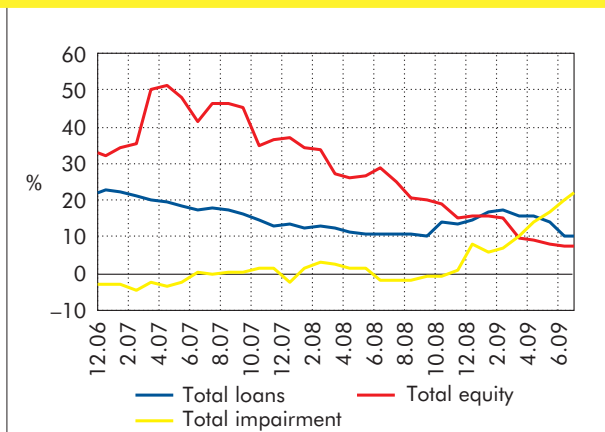
Demand simplification

Croatian Financial Sector, structure



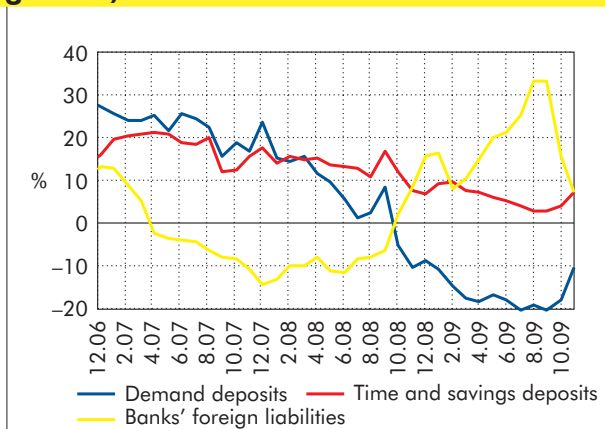
Sources: CNB, CFSSA

Loans, Equity and Imparments growth, annual level



Source: CNB

Foreign Liabilities and Deposits growth, annual level



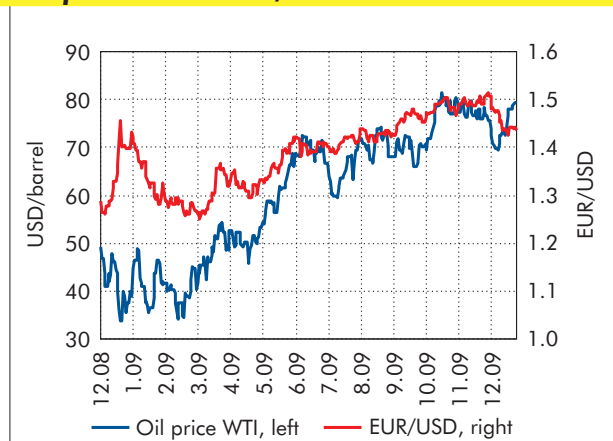
Source: CNB

In the Q4 2009, liquidity of the Croatian financial system finally reached a high level. Tensions relating to the beginning of the monthly period of allocating the reserve requirement disappeared and excess of supply in the foreign exchange market maintained continued appreciation pressure on the kuna, enabling monetary authorities to maintain the exchange rate stability as one of the key anchors of financial stability. Following the shocks that the financial industry was exposed in the first half of the year, stable operating conditions and high competitiveness of financial institutions remained an ideal framework for the development of financial services supply. Nevertheless, recession forced the finance industry to face a new challenge – a reduction in demand for financial services. The process of demand simplification is at hand, as part of which clients avoid using complicated financial products, which include more complex financial services, thus narrowing the revenues of the financial industry. As a result, competition among financial institutions is being transferred from the revenue side to expenditures side. The predominant struggle within the financial services sector is going on in the segment of reducing operating costs and achieving lower price per transaction. Recession also faced the financial industry with losses in portfolio values. While losses on equity portfolios were primarily incurred in 2008, losses from debt securities were seen in the H1 2009 due to the growth of government risk and in the second half of the year due to the growth of corporate risk. They led to the reduction in the share of investment funds in the financial market and strengthening of bank market shares despite the slowdown in the growth of loan portfolios. However, the crisis is reflected in the growth of losses in the loan portfolio with a time lag. Thus, in the first three quarters of 2009, bank losses arising from loan value adjustments were twice higher than in the whole of 2008 with a rising trend continuing into 2010. With the reduction in loan demand by households it is expected that loan supply to corporates will continue. The continued growth in the non-performing loans will have the greatest impact on bank operations in 2010. Due to the need to finance government spending interest rates on domestic deposits and loans received several growth impulses over the past year. It has been announced that in 2010 monetary policy and a package of measures for state incentives to economy will have a more important role. Under these conditions, we may expect interest rates to go down.



Recovery of economic demand brings rise of oil prices

Oil price and EUR/USD rate



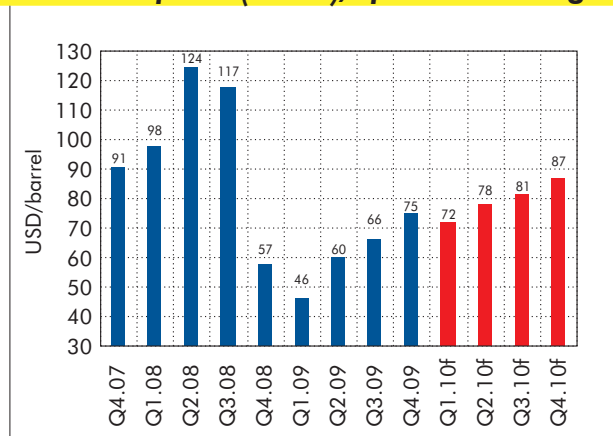
Sources: Bloomberg, CNB

World oil demand and supply, mnb/d

| | 2006 | 2007 | 2008 | 2009e | 2010f |
|-----------------|------|------|------|-------|-------|
| OECD | 49.6 | 49.2 | 47.6 | 45.5 | 45.5 |
| - OECD Europe | 15.7 | 15.3 | 15.3 | 14.6 | 15.4 |
| - North America | 20.7 | 20.7 | 19.4 | 19.0 | 19.2 |
| China | 7.2 | 7.5 | 7.9 | 8.4 | 8.7 |
| Total demand | 85.1 | 86.0 | 86.2 | 84.9 | 86.3 |
| OECD | 20.0 | 19.8 | 19.3 | 19.0 | 19.0 |
| - OECD Europe | 5.2 | 5.0 | 4.7 | 4.2 | - |
| - North America | 8.3 | 8.5 | 8.5 | 8.9 | 9.1 |
| TOTAL Non-OPEC | 51.2 | 50.1 | 49.8 | 50.8 | 51.2 |
| OPEC | 35.8 | 35.4 | 35.7 | 28.7 | 35.4 |
| Total supply | 87.0 | 85.5 | 84.9 | 86.1 | 87.3 |

Source: IEA

Crude oil price (Brent), quarter average



Sources: Bloomberg, Raiffeisen Research

After the turn of the year 2008 to 2009 was marked by relatively low prices of oil, they started rising towards the end of 2009. In the period from October to December the price of WTI crude oil, which is to be delivered the following month, on the New York Mercantile Exchange ranged between USD 69 and USD 81 per barrel. At the beginning of December the International Energy Organisation (IEA) once again made an upward correction of the world's expected demand for oil in 2009 and 2010. According to their forecasts crude oil demand in 2009 was expected to reach 84.9 mb/d and 86.3 mb/d in 2010. The reasons for this should be sought primarily in the positive movements of economic indicators which point to a recovery of the US and Chinese economies, the world's two largest crude oil consumers. The overall oil supply in November went up to 85.8 mb/d (from 84.9mb/d in September) and was generated primarily by the increase in supply from non-OPEC members, while supply by OPEC members has been growing at low rates since the beginning of 2009. The latest forecasts showed that the last quarter of 2009 could see an annual growth in the global crude oil demand for the first time in the last six quarters (since the second quarter of 2008). Until a few months ago it was not quite clear whether the growth in the price of oil was a consequence of the growth in crude oil demand or market speculations since the dollar lost a lot of its value against the euro in the last quarter of the past year. The strengthening of the dollar paired with the growth in the price of oil at the end of the year showed that positive developments in the price of oil do indicate a recovery of the global economy. According to the IEA's latest medium-term forecasts for the period from 2008 to 2014 Nigeria and Iraq, both OPEC members, have the greatest growth potential in the production of oil. The forecasted production growth in Nigeria is based on large quantities of unused natural wealth and creation of positive business conditions in this country over the past few months when the Government succeeded in signing a ceasefire with rebels and implementing a series of measures aimed at attracting foreign investors. The expected growth of production in Iraq has to do with US investments and interest in this extremely wealthy area. Nevertheless, it is noteworthy that all production growth estimates relating to these two countries should take into account political and security risks which render all estimates less reliable.

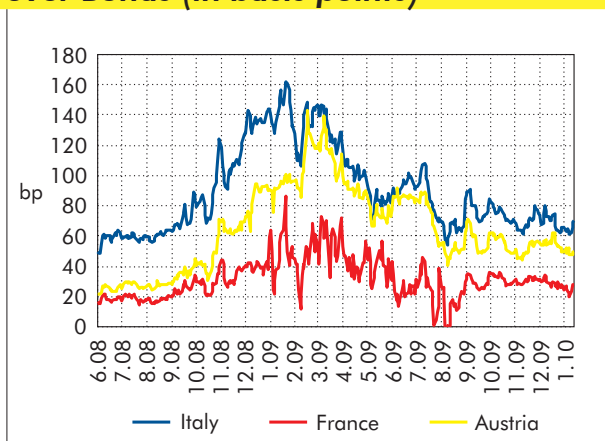


Foreign capital: never more expensive, scarcer but more needed

The collapse of one of the world's five largest investment banks, Lehman Brothers, on 15 September 2008 pushed up risk perception to extreme heights, causing an exacerbation of the global financial crisis. The increase in the risk perception paralysed the interbank lending market and consequently bank lending to other clients. Distrust in the interbank market destroyed the possibility of maturity transformation so banks shortened the maturities of new loans. Government consumption went up to compensate for private consumption and budget deficits of developed countries grew, which finally resulted in the backward movement of capital in the global market. At the same time, for-

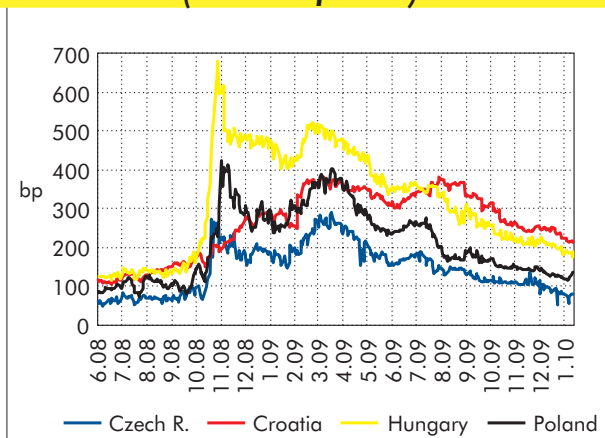
eign capital inflow to higher risk markets (developing markets) was halted. Those were markets that up to the onset of the crises financed their growth primarily through foreign borrowing. Therefore, the problem of refinancing debts that were due in 2009 came to the foreground. International trade balance narrowed, personal consumption, production, investment and employment declined and the world went into recession. From that point onward the crisis has been felt ever more strongly in CE and SEE countries and spilled over to equity and bond markets, foreign exchange and currency markets, leading to substantial strengthening of borrowing conditions and a halt in foreign borrowing. Central banks of developed countries reacted with extremely expansive monetary policies, releasing liquidity to the system, with such monetary policy being accompanied by expansive fiscal policy. Economic policy measures in developed markets that were directed at reviving the financial markets, increasing liquidity and solvency of financial institutions slowly started seeing results in the second quarter of 2009. Benchmark interest rates on interbank money markets were in decline but it came to the increase in risk premiums which raised the price of borrowing for riskier borrowers. The growth of the risk premium charged for investments in CE and SEE countries outstripped the decline in interest rates in the market, which substantially increased financing costs in the world's financial markets. Equally important as the price of borrowing until the middle of 2009 was the scarcity of foreign capital assets. While risk premiums for CE countries at the onset of the crisis in 2007 grew gradually from 35–40 basis points to 50–100 basis points, and that of SEE countries to 100–150 basis points, fast spillover of the crises starting from the third quarter 2008 resulted in an extremely strong risk premium growth. The additional growth in risk perception (especially prominent in countries with greater external imbalance) was spurred by problems in the Hungarian foreign exchange market and by the strong depreciation of the Hungarian currency. The majority of countries faced liquidity shortages, high interest rates and depreciations of their currencies against the euro. Last but not least, risk premium was also under strong influence of speculations on high exposure individual euro area banks to SEE countries. The eurobond market reacted with the strong widening of spreads on government bonds relative to benchmark German bonds, i.e. with the strong growth of risk premiums. All this contributed

Yields on 10-year Government Bonds over Bunds (in basis points)



Sources: Bloomberg, Raiffeisen Research

Yields on 10-year Government Bonds over Bunds (in basis points)



Sources: Bloomberg, Raiffeisen Research



to the rise in the cost of borrowing. In addition, as a result of high financing needs at time of crisis paired with reduced liquidity and capital outflow to safe havens capital became scarce. In the circumstances of increased risk, spreads in the yield curve of government bonds of EU 15 countries also went up substantially, while investors redirected their assets to relatively safer financial instruments, seeking a safe haven in US and German government bonds. Prior to the crisis, the differences in yields on government bonds compared with reference bonds (like German or US government bonds) were not great. Spreads of 100 basis points (bp) were more of an exception. However, since the onset of the crisis spreads of 100bp are no longer an exception, because spreads have been rising to up to as much as 300bp. Strong growth of financing costs generated concerns that market risk of individual countries is not correctly assessed. Assuming that market mechanisms are functioning the question arises to what extent the widening of the spreads may be explained by higher budget deficit and higher public debt, and to what extent it is a consequence of the growth of risk aversion in general. Empirical data showed that interest rate spreads positively correlate with the growth of budget deficit and public debt since the said indicators indicate a fiscal laxity and a probability of (partial) default. Further, the mentioned spreads increased together with the increase in global risk aversion so assets are redirected into high quality and safe financial instruments, such as the highest rated bonds. After Lehman collapsing, the influence of deficit and public debt on yield spreads went up. According to

some estimates, the growth of budget deficit relative to GDP of a country by one percentage point (relative to German or US ratio) now raises the price of borrowing (interest rate) by some 12 basis points. Prior to the onset of the crisis and under the same conditions the cost of borrowing would go up by 3.5 basis points. At the same time, the growth of public debt in GDP of a country by one percentage point (relatively to the German or US ratio) raises the price of foreign borrowing through government bond issues by 1.2 basis points relative to 0.2 basis points prior to the crisis. The reduction in the availability of foreign capital relative to the pre-crisis period and the increase in sensitivity of the risk premium to changes in the creditworthiness of the borrower will have a lasting impact on the global financial market. Although market liquidity is currently very high, insecurity and risk are still present. Therefore, when deciding on venturing to foreign markets countries should bear in mind that this year is expected to see record government bond issues. The Hungarian government announced bond issues worth EUR 1.5bn in the first half of the year, to be used for refinancing its due liabilities. Poland, which raised euros, yens, Swiss francs and dollars in the foreign capital market in 2009 announced two new issues, one in dollars and one in euros. One should not forget Romania, which postponed its exit to the foreign capital markets to 2010 due to the political situation and high costs of borrowing. Not to mention Russia, Bulgaria and a number of less developed countries.

Finally, it should be noted that the growth in risk premiums, i.e. in financing costs and the scarcity of capital once again pointed to external imbalance and the dangers inherent an economic policy that relies on consumption mainly financed through the foreign borrowing. At the same time, this stresses the need for structural changes in the growth model of transitional countries and presents all the participants with the challenge of adjustment to the new growth model that should be based on domestic, and not external, saving sources.

Sources:
 Mihaljek, D., 2009. "The financial turmoil in central and eastern Europe and fiscal policy in Croatia" [online]. Newsletter, No. 40.
 Schuknecht, Ludger, Jürgen von Hagen and Guido Wolswijk (2009), "European government bond spreads in the current crisis", VoxEU.org, 21 December.

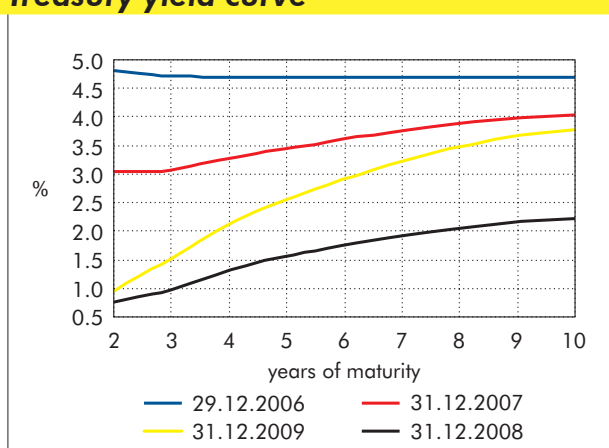
Budget balance (% of GDP)

| | 2008. | 2009. | 2010.f | 2011.f |
|-------------|-------|-------|--------|--------|
| Austria | -0.4 | -4.3 | -5.5 | -5.3 |
| Germany | 0.0 | -3.4 | -5.0 | -4.6 |
| France | -3.4 | -8.3 | -8.2 | -7.7 |
| Netherlands | 0.7 | -4.7 | -6.1 | -5.6 |
| Italy | -2.7 | -5.3 | -5.3 | -5.1 |
| Spain | -4.1 | -11.2 | -10.1 | -9.3 |
| Eurozone | -2.0 | -6.4 | -6.9 | -6.5 |
| UK | -5.9 | -12.6 | -12.0 | -9.0 |
| Poland | -3.6 | -6.3 | -6.9 | -4.6 |
| Hungary | -3.7 | -4.0 | -6.5 | -4.7 |
| CzechRep. | -2.1 | -5.7 | -5.2 | -4.6 |
| Slovakia | -2.3 | -6.4 | -5.5 | -4.0 |
| EU-27 | -2.6 | -7.2 | -7.5 | -6.8 |
| USA | -5.7 | -12.0 | -10.0 | -7.0 |

Sources: Thomson Reuters, EU-Commission, Raiffeisen Research

A year abundant in new issues

Treasury yield curve



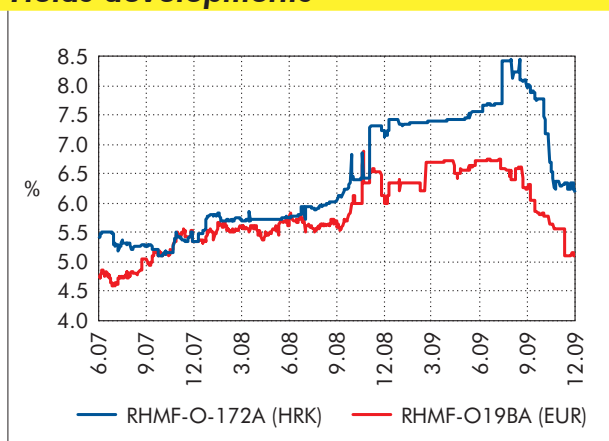
Sources: reuters.hr, Raiffeisen Research

Forecasts

| | Q1.2010 | Q2.2010 | Q3.2010 |
|-----------------|---------|---------|---------|
| USA | | | |
| Key rate | 0.1 | 0.1 | 0.1 |
| 3M LIBOR | 0.3 | 0.3 | 0.4 |
| 5Y | 2.2 | 2.2 | 2.6 |
| 10Y | 3.5 | 3.5 | 3.8 |
| Eurozone | | | |
| Key rate | 1 | 1 | 1 |
| 3M LIBOR | 0.8 | 1.2 | 1.4 |
| 5Y | 2.4 | 2.5 | 3.1 |
| 10Y | 3.3 | 3.3 | 3.7 |
| Spread | 20 | 20 | 10 |

Source: Raiffeisen Research

Yields developments



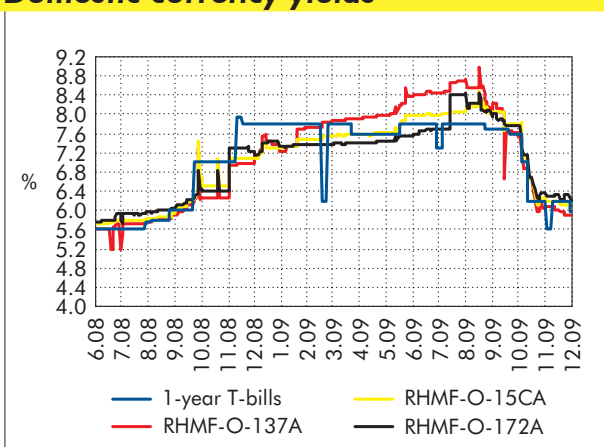
Sources: reuters.hr, Raiffeisen Research

Real sector data that indicate the recovery of the Eurozone in Q3 2009 has continued throughout the year, showing that slow and gradual but still positive trends could continue in the Q1 2010. However, money supply and credit activity directed at the private sector (enterprises in particular) continued on the downward path, reflecting the still-present insecurity and risk. This segment is not expected to stabilise and then recover until the middle of the year. However, despite high system liquidity, money is mostly directed at relatively safe financial instruments, government and corporate bonds, and since this situation could last for months prior EURIBOR forecasts were corrected downwards. The movements of German government bonds are therefore expected to grow only slightly, with spreads on the yield curve of government bonds of euro area countries narrowing. Relatively high volatility of yields on US government bonds that has been going on since May 2009 will continue in the first half of 2010. If it comes to clearer announcements from the labour market of a recovery in this segment of the economy, paired with more prominent inflationary pressures in the first quarter, we expect that the market will start speculating on the increase in interest rates already in the second quarter. Consequently, yields on 10-year US government bonds could easily reach (or even exceed) 3.70%. However, as soon as worse economic indicators come in, doubts will arise as regards the sustainability of an economic recovery and expectations of increased interest rates will fade or be delayed to the end of the year, in line with our expectations. Consequently, yield levels could (at least temporarily) decrease to some 3.2%. One of the key influences on developments in the government debt markets will be ample supply of new government issues not only by developed economies but also by the so-called peripheral European markets and CEE countries. This year's announced new issues in the European market will exceed EUR 900bn. Investor focus on the eurobond market of CEE countries in the last quarters of 2009 turned out as relatively good investments. Although at a slower pace, risk premiums continued declining and a similar trend can be expected in the first quarter of this year. While the forecast for the entire 2010 is relatively optimistic, expecting spreads to narrow towards their pre-crisis levels, the first quarter could see increased risk aversion, under the influence of a possible correction in the developed equity markets amid speculations on the



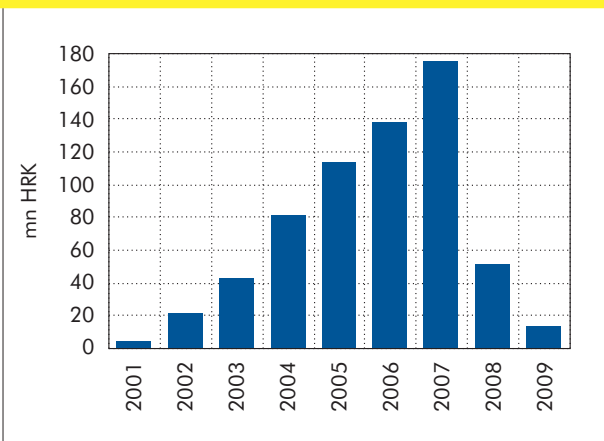
Strong (re)financing needs

Domestic currency yields



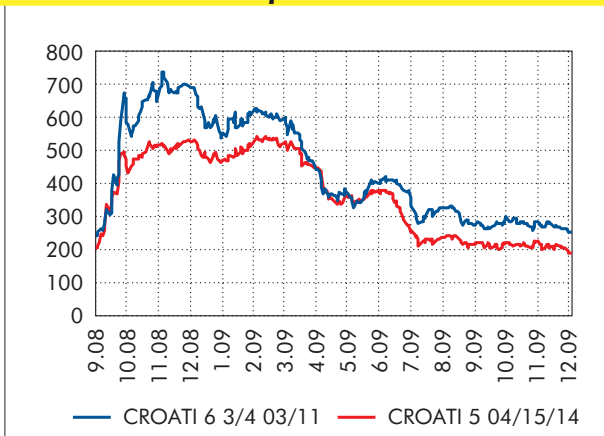
Sources: MoF, Reuters.hr, Raiffeisen Research

Average daily turnover of domestic bonds



Source: ZSE

Croatian bonds' spread



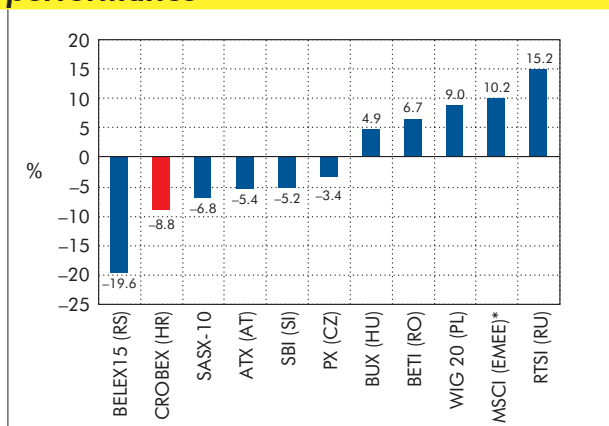
Sources: Bloomberg, MoF, Raiffeisen Research

rise of benchmark interest rates and still-prominent insecurity as regards economic recovery. Fiscal policy will remain in the investor focus throughout 2010. Apart from Croatia, the Czech Republic, Poland and Lithuania came out with new issues in the last quarter of 2009, and some countries already announce new eurobond issues in 2010 (Hungary, Poland, Romania, Russia, Bulgaria and several others less developed countries.)

Croatia once again ventured to the foreign capital market in November, issuing a new government bond worth USD 1.5bn. Investor interest was relatively high but borrowing conditions deteriorated in line with the current situation in the global market, thus reflecting increased risk perception of foreign investors. The reported trading volume in the domestic bond market remained modest in the last quarter. High system liquidity in the last quarter was one of the main generators of activity in the domestic bond market, increasing the attractiveness of HRK denominated government bonds and creating pressure on yields. Relative to benchmark German bonds spreads of euro denominated government bond issues and eurobonds, as well as CDSs continued reducing. The Government's (re) financing needs will remain strong in the upcoming period, even more so because two bonds, a HRK denominated bond and a eurobond, are due in the first quarter of the year, worth almost one billion euros. Further, recession movements will lead to deterioration in the inflow to the state budget and all reviewed factors corroborate expectations of new government borrowing through new bond issuance. Despite high system liquidity, it is more likely that the Government will once again venture to the foreign market. State short-term debt that totalled some HRK 20bn at the end of 2009 will continue growing. Nevertheless, ample demand for T-bills paired with reduced supply could lead to a spillover of a share of assets to the bond market so, with moderate demand for bonds, yields could continue ranging around current, relatively low, levels.

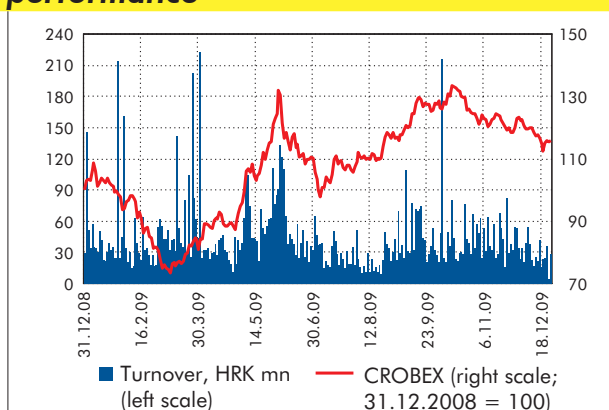
Russian index topped the region

Regional indices – Q4 2009 performance



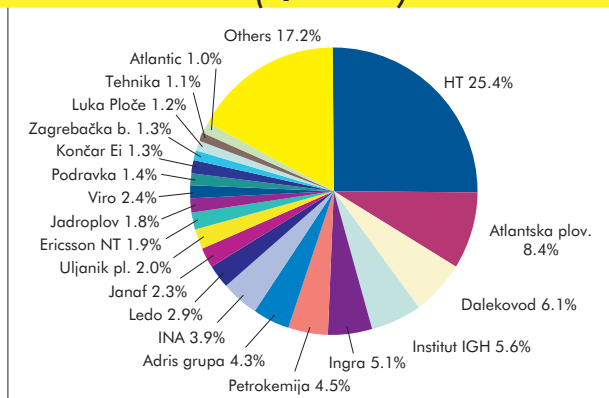
* MSCI Emerging Market Eastern Europe
 Note: In local currency, value on December 31, 2009
 Sources: Bloomberg, Raiffeisen Research

Market turnover and yield – 1y performance



Note: Daily values for period from December 31, 2008 to December 31, 2009
 Sources: ZSE, Raiffeisen Research

Shares turnover (Q4 2009)



Sources: ZSE, Raiffeisen Research

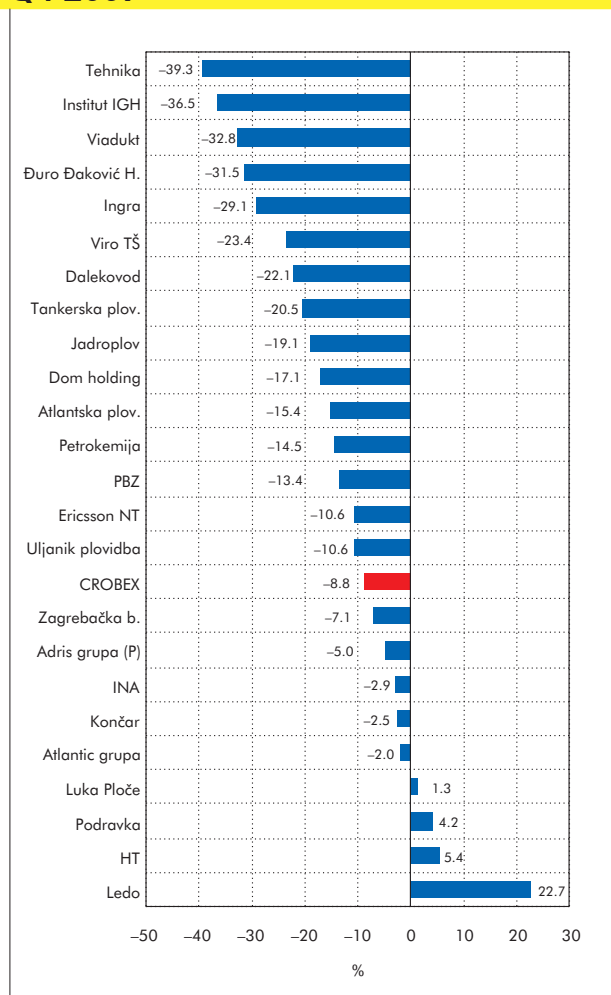
Regional returns. The majority of regional equity markets saw negative returns in the last quarter of 2009. On the other hand, favourable macroeconomic situation in Poland, recovery in oil prices and optimistic outlook for the Russian market contributed to the positive sign of the MSCI EMEE index. The Romanian BETI continued rising in the last quarter of the year, growing by as much as 62% in 2009. The two-digit decline of CEE equity indices was registered on stock exchanges in Belgrade and Sofia. The Serbian BELEX15 lost 14% during the last year due to the withdrawal of foreign investors from the market, who accounted for more than a half of the turnover in the last quarter.

Returns on the domestic market. Although of all indices in the CEE region daily returns of CROBEX correlated the most with the Polish WIG-20, realised returns of these two indices in the last quarter of 2009 differed substantially. Although most member shares in CROBEX saw a two-digit rate of decline, CROBEX fell only 8.8% due to positive return of HT (+5.4%) that accounts for 17.1% of the index. Shares of construction companies in the index fell by 32.0% qoq on average, while shares of shipping companies decreased by 16.4% on average. Except HT, only shares of Ledo, Podravka and Luka Ploče went up. At the end of 2009, the market capitalisation of all shares traded on the ZSE totalled HRK 135.4bn, down 4.7% yoy. The share of market capitalisation in estimated GDP reduced qoq, from 44.8% to 41.2%, and stands just below end 2008 levels when this share was 41.5%.

Turnover. Since there were no clear indicators of economic recovery, turnovers on the stock exchange were lower than in previous quarter, as expected. The total share turnover in the last quarter of 2009 was HRK 1.6bn, down 9.1% qoq and down 52.9% yoy. Average daily shares turnover was HRK 25.5m and even declining to below HRK 20m in December. As usual, the most liquid shares were HT (HRK 408.6m) and Atlantska plovodba (HRK 135.1m), followed by Dalekovod with HRK 97.7m. The ten most liquid shares participated in total turnover with 68.4%, which, compared to 71.7% in the previous quarter, indicates that investors were spreading their interest to a larger number of shares. In order to account for 75% of the total share turnover 14 shares were required, 2 more than in the third quarter 2009. A total of 176 shares were traded in the last quarter of 2009. Again the most traded sec-

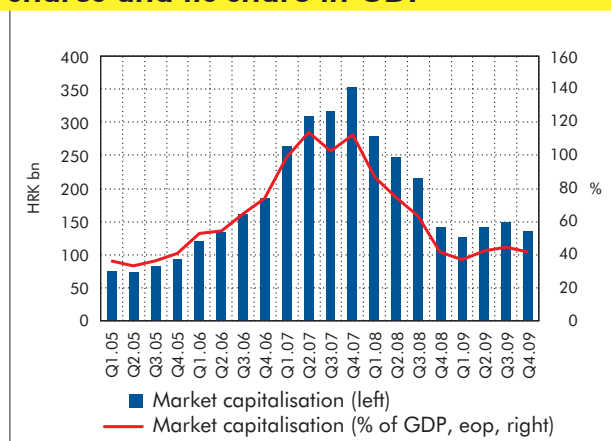
HT takes 25.4% of traded volumes

Performance of CROBEX constituents in Q4 2009



Sources: ZSE, Raiffeisen Research

Market capitalisation of actively traded shares and its share in GDP



Sources: ZSE, CBS, Raiffeisen Research

tors were shares from the transport, storage and communications sector with a total turnover of HRK 693.6m, followed by shares from the construction sector with HRK 308.7m and shares from the food and beverages sector with HRK 188.7m.

Corporate indicators. At the end of 2009, the medians of P/E and EV/EBIT ratio of CROBEX constituents totalled 9.92 and 19.22, respectively. The analysis of industry valuation multiples indicates that construction companies underperformed (P/E 4.73, EV/EBIT 18.71). These shares also lost the most value in 4Q 2009. Index valuation was supported by components from the food sector. We expect the performance of most companies to deteriorate in 2010 relative to their 2009 results. Export-oriented companies might perform better profiting from earlier recovery of western economies. On the other hand, the domestic market growth could be achieved through acquisitions and consolidation within sectors. Few companies published their expectations of 2009 results. Thus, the management board of Dalekovod expects sales revenues of HRK 2.2bn (+17.6% yoy), with a decline in operating margin from 7% to 5% and flat net margin of 4%. Končar expects net profit of HRK 142.7m (+10% yoy), while Atlantska plovidba expects its loss to decline to USD 4–6m. Atlantic group keeps earlier guidance of 7% revenue growth yoy, while operating profit is expected to stand at HRK 147m, excluding the one-off impact of HRK 7.6m realised in the first nine months of 2009.

Corporate actions. The Government and MOL signed an annex to the agreement on natural gas operations in November, stipulating the deadline for taking over the gas segment to December 1, 2010. In addition, the sale of INA's retail petrol business, Crobenz d.d. is under way. The sale of Crobenz was a condition set by the Croatian Competition Agency in the process of INA takeover. Crobenz, with its 14 petrol stations, generated income of HRK 1.2bn in 2008 (+22% yoy), while its net profit was HRK 700 thousand. Anheuser-Busch InBev sold its operations in nine CEE countries to the private equity fund CVC Capital Partners for USD 2.3bn. Hence, CVC Capital Partners became the owner of 71.92% in Zagrebačka pivovara. In December, Agrokor issued bonds worth EUR 400m. The issue was supported by guarantees from daughter companies. Two transactions were completed at the very end of the year: Konzum sold its 100% share in the



Defensive stocks in focus

Market cap. of CROBEX constituents

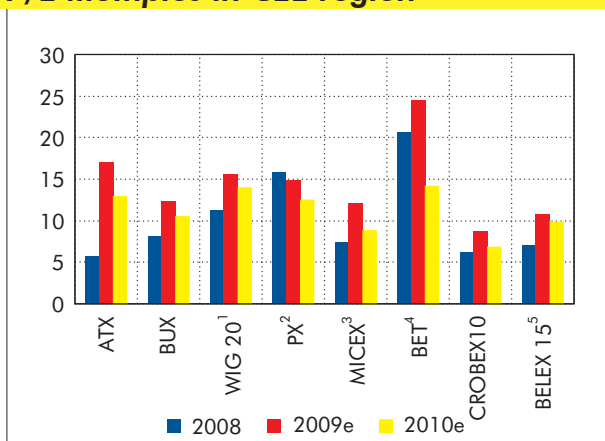
| CROBEX member issuer | MCap (in bn HRK) |
|--------------------------|------------------|
| HT | 22,478.40 |
| Zagrebačka banka | 16,640.46 |
| INA | 16,500.00 |
| PBZ | 10,778.72 |
| Ericsson NT | 1,764.37 |
| Adris grupa (P) | 1,757.08 |
| Atlantic Grupa | 1,677.22 |
| Podravka | 1,556.97 |
| Ledo | 1,475.14 |
| Atlantska plovidba | 1,199.39 |
| Končar elektroindustrija | 1,090.74 |
| Tankerska plov. | 916.92 |
| Dalekovod | 728.71 |
| Viro | 499.20 |
| Petrokemija | 454.39 |
| IGH | 407.64 |
| Luka Ploče | 339.49 |
| Uljanik plovidba | 336.52 |
| Dom holding | 292.10 |
| Ingra | 274.60 |
| Jadroplov | 261.88 |
| Tehnika | 247.35 |
| Viadukt | 125.29 |
| Đuro Đaković Holding | 115.89 |

Note: as at 31.12.2009
Sources: ZSE, Raiffeisen Research

company Kozmo d.o.o. to the private equity fund NEXUS ALPHA; while HT merged T-Mobile Croatia. Overall, the last quarter of 2009 went by without substantial M&A transactions. In 2010 we expect to witness more activity in this field, i.e. consolidation within some sectors.

Market valuation and outlook. Although the expected growth of CEE equity markets in the previous quarter did not happen, in the following quarter we still expect a negative correction. Our expectation is based on growing risk aversion amid expected rise of interest rates on global level. In addition, growth potential of US indicators is uncertain, which will negatively affect equity markets. However, fears of interest rates growth have been softened by Fed's recent decisions to keep key rate low. Nevertheless, the negative sentiment could be much milder in the Polish market due to the relatively favourable valuation of the WIG 20 index and in the Czech market since the index is mostly composed of defensive sectors' stocks with higher dividend yields relative to other indices. The CROBEX10 could also see a mild fall, predominantly due to the positive perspective of EU accession and favourable valuation based on expected earnings of its constituents in FY 2010. In contrast, a larger negative correction is expected to hit the Russian index, whose nature is more volatile, as well as the Hungarian BUX due to weaker macroeconomic fundamentals. Defensive sectors' stocks are still a better choice. The recovery that is coming after the first quarter is expected to be slow and conditioned by leading macroeconomic indicators.

P/E multiples in CEE region



¹ Poland (WIG 20): excl. CEZ; ² Czech Rep. (PX): excl. Erste Bank and Vienna Insurance Group; ³ Russia (MICEX): excl. VTB Bank and MTS; ⁴ Romania (BET): excl. SSIF Broker; ⁵ Serbia (BELEX15): excl. Alfa Plam, Bambi, Imlek and Metals Banka

Sources: Thomson Financial Datastream, IBES, Raiffeisen Research



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Abbreviations

| | | | |
|-------|--|--------|---|
| bn | – billion | GBP | – pound sterling |
| bp | – basis points | GDP | – Gross Domestic Product |
| CBRD | – Croatian Bank for Reconstruction and Development | H1, H2 | – first/second half of the year |
| CBS | – Croatian Bureau of Statistics | HRK | – Croatian kuna |
| CDS | – Credit-Default Swap | IEA | – International Energy Agency |
| CE | – Central Europe | ILO | – International Labour Organization |
| CEE | – Central and Eastern Europe | mn | – million |
| CES | – Croatian Employment Service | MoF | – Ministry of Finance |
| CFSSA | – Croatian Financial Services Supervisory Agency | OECD | – Organization for Economic Cooperation and Development |
| CHF | – Swiss franc | OPEC | – Organization of the Petroleum Exporting Countries |
| CIS | – Confederation of Independent States | Q | – quarter |
| CNB | – Croatian National Bank | SEE | – South East Europe |
| e | – estimate | USA | – United States of America |
| ECB | – European Central Bank | USD | – US dollar |
| EMU | – Economic and Monetary Union | VAT | – value added tax |
| EU | – European Union | y | – year |
| EUR | – Euro | yoy | – year on year |
| f | – forecast | ZSE | – Zagreb Stock Exchange |
| Fed | – Federal Reserve System | | |
| FCY | – foreign currency | | |

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