

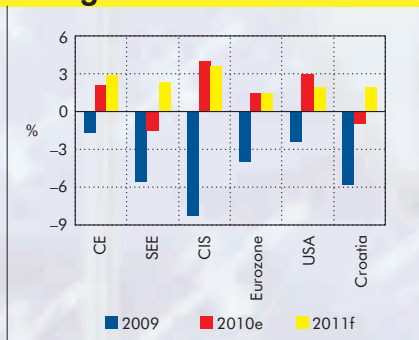
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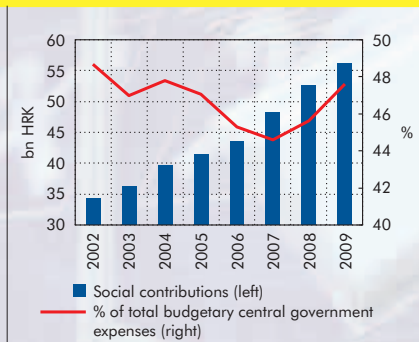
Challenges on the road to recovery

GDP growth rates



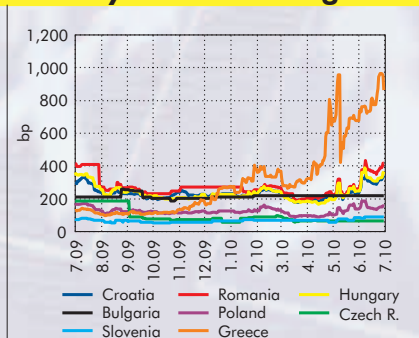
Source: Raiffeisen Research

Social contributions



Sources: MoF, Raiffeisen Research

CDS 5-year in CEE region



Source: Bloomberg

Q2 2010 was marked by positive changes which pointed towards economic stabilisation in H2 and likely growth over the next year. The start of the tourist season halted negative developments in the labour market, the opening of the last three negotiating chapters forecasted a successful closure of pre-accession negotiations with the EU and the first measures from the Economic recovery programme entered into force. Contrary to these positive impulses the dissatisfaction of those groups of society that do not envisage themselves prospering from the strengthening of market criteria in running the monetary policy is, understandably, rising. Next parliamentary elections are a year away and it will require much political skill to avoid the dissatisfaction to be expressed in undemocratic ways. Therefore, the way to a more competitive economy and economic recovery through the implementation of structural reforms, in accordance with the generally accepted standards of the EU, will not be immune to local political interests.

The first credibility test for the economic policy as regards the implementation of reforms will be in the form of the expected budget revision. Instead of adjusting public expenditures last year the Government decided to increase the tax burden. This resulted in the recession spreading throughout 2010. The upcoming budget revision should have a different approach. A stronger reduction on the expenditure side would compensate for lower revenues resulting from the introduction of lower income tax rates and thus reduce this year's deficit.

The developments in the foreign markets do not go in favour of the efforts to reduce government deficit or efforts to stabilise foreign relations. The weakening of the euro against the dollar reflected itself in the deterioration of trade conditions because Croatia is highly dependant on the import of energy, the price of which is quoted in USD. The growth of risk premiums for highly indebted European countries induced a rise in aversion towards the risk of transition markets, consequently increasing the price of financing Croatia's debt. In the circumstances of fairly high financing needs due to the refinancing of the short-term debt in the amount of 1/4 of the total foreign indebtedness, the necessity for new issues at increased risk premium is evident in the rise of financing costs, which is contrary to measures aimed at economic recovery. Therefore, the success of activities aimed at stimulating growth will depend on the reduction of government risk by undertaking a speedy budget revision and reducing counterparty credit risk by restoring order in the collection of receivables in the corporate sector.



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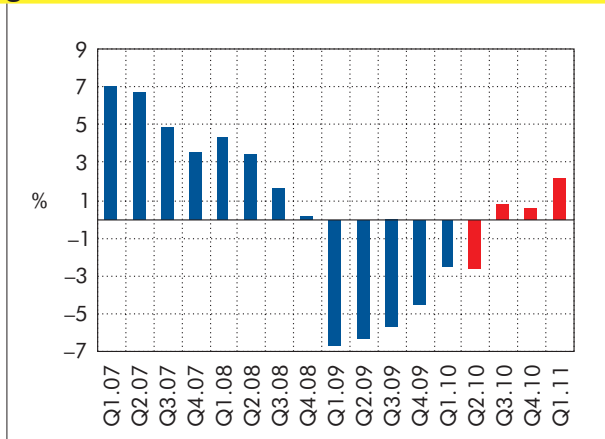
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Reforms necessary for the better future

Gross domestic product, real annual growth rates



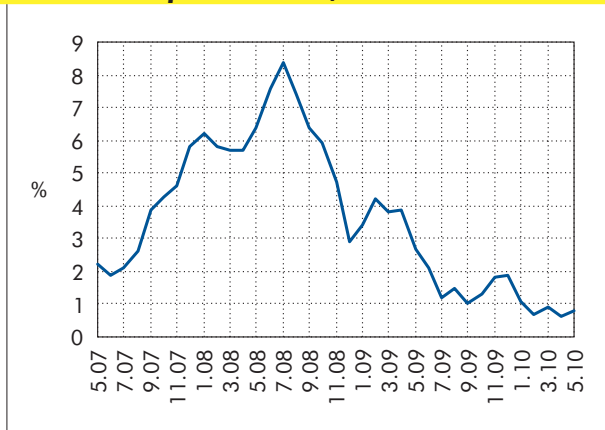
Sources: CBS, Raiffeisen Research

GDP, real annual growth rates

year	2008	2009	2010e	2011f
Croatia	2.4%	-5.8%	-1.0%	2.0%
Bulgaria	6.0%	-5.0%	-0.5%	3.0%
Slovakia	6.2%	-4.7%	2.8%	4.0%
Poland	5.0%	1.8%	3.0%	3.2%
Hungary	0.6%	-6.3%	1.0%	2.5%
Slovenia	3.5%	-7.8%	0.5%	2.0%
Czech Rep.	2.3%	-4.0%	1.0%	2.0%
Romania	7.3%	-7.1%	-3.0%	2.0%
EMU	0.5%	-4.0%	1.4%	1.5%
USA	0.4%	-2.4%	3.0%	2.0%

Sources: WIW, Raiffeisen Research, Bloomberg

Consumer price index, annual level



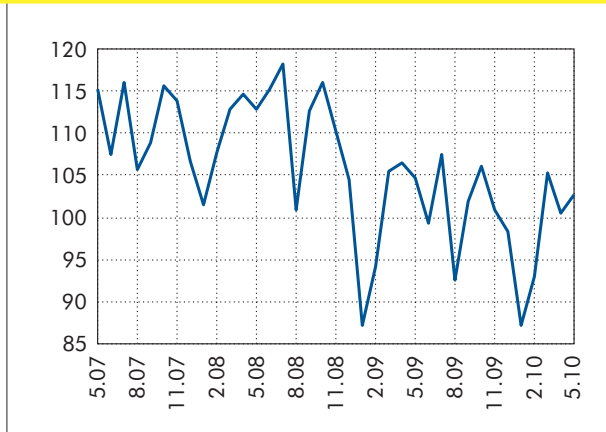
Source: CBS

A slowdown in the fall of GDP to 2.5% on annual level in Q1 is in line with our expectations. The unfavourable impact of personal consumption and investments exceeded the positive contribution of the growth of exports, which due to the recovery of foreign demand represents the only bright spot in the GDP structure. The most worrying development is the record decline in gross capital formation, especially in relation to the procurement of machinery and equipment, and construction. The growth model that we have seen thus far and that was based on consumption financed by foreign borrowing revealed all its flaws during the recession. As long as unemployment remains high and consumer optimism low, we should not expect a recovery in personal consumption. Government expenditures are under pressure by lower-than-expected revenues so cuts in government spending are almost a certainty. Raising the competitiveness of the Croatian economy and fostering a better entrepreneurial climate would bring about investments necessary to start a new production cycle. Considering that this year, despite mild positive growth rates in the second half, we will face an economic contraction, it is necessary to implement the announced reforms, which will, in the short-term, reduce economic wealth, but would provide the Croatian economy with a more favourable starting position for the future and enable it to realise stable and sustainable economic growth.

Low inflationary pressures continued through Q2 as the impact of weak domestic demand grew ever more prominent. The inflation growth was thus almost fully affected by the growth of energy prices spurred by higher crude oil prices in the world's market and the weakening of the kuna exchange rate against the US dollar. Since it is hard to expect that it will come to a more noticeable recovery in domestic demand by the end of the year, inflation will remain low, although it is likely that its rates will go up in the second half of the year due to the expected intensification of economic activity. Continued recovery on foreign markets will probably contribute to the growth in the price of oil as the key production material so some of inflationary pressures stemming from this basis will spill over to the domestic economy. In addition, there is the announced increase in the price of electricity, which will be reflected in the growth of prices of other goods. This year's average inflation rate is not expected to exceed 2%.

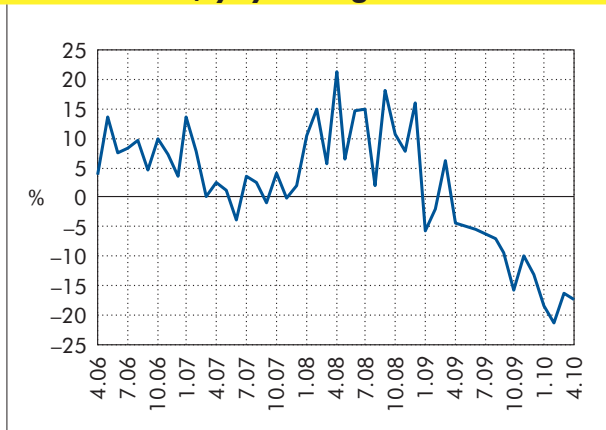
The rise of unemployment stopped temporarily

Basic indicies of industrial production, 2005 = 100



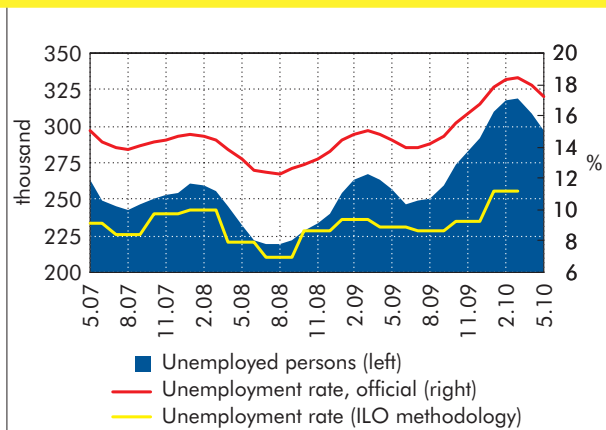
Source: CBS

Construction, yoy change



Source: CBS

Unemployed persons, unemployment rates



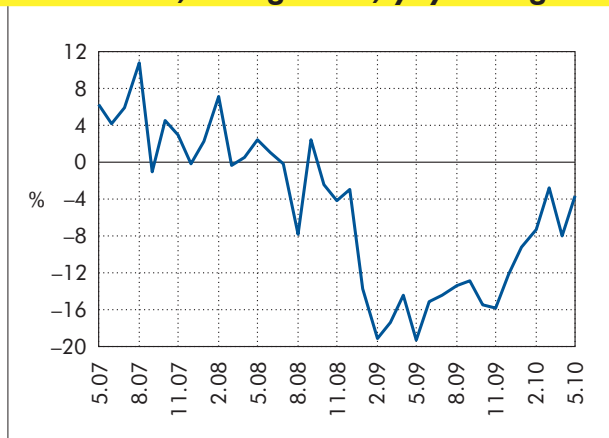
Sources: CBS, CES

All the negative developments in the industrial production structure that have been present since the 1990s came into full swing in the past year and a half. Instead of improving comparative advantages and consequently increasing production and exports competitiveness, industrial production was based on sectors with low technological intensity and lower value added. In contrast to export oriented countries like the Czech Republic or Slovakia, the recovery of foreign demand alone, without the increase in the domestic component, will not suffice to reverse the negative trend. These are the reasons why industrial production went down in Q2. During the rest of the year only small positive growth rates are probable, which will, at annual level, contribute to a mild growth rate of some 0.5%. In order to realise economic growth and development it is necessary to implement structural reforms aimed at increasing the competitiveness of the industry and its key element – labour productivity. Since the work force in the Republic of Croatia cannot compete with similar countries in terms of price, stress should be laid on investments into the human potential that can create higher value added, the education system playing the key role. After peaking in Q1 for the first time since the beginning of the recession, in Q2 unemployment went down, as expected, with the number of the unemployed decreasing below 300 000. These developments are for the most part a consequence of seasonal employment characteristic at the time before and during the peak tourist season. Therefore, it is too soon to speak of a labour market recovery. This is corroborated by the fact that unemployment has continued rising relative to the previous year. Considering the seasonal character of this rise, in autumn we expect unemployment to grow again. We do not expect a recovery before the beginning of 2011. However, a long-term improvement of conditions in the labour market will require more than merely waiting for the economy to recover. The old structural problems relating to unemployment in Croatia, reflected in the inability to adjust supply and demand in the labour market were exacerbated by cyclical problems during the recession, i.e. the decline in overall demand for goods and services which is reflected in the decline of demand for work force. And while the latter usually lasts until the economy recovers, to solve the problem of structural unemployment it is necessary to implement reforms aimed at adjusting the work force supply with the needs of the economy.



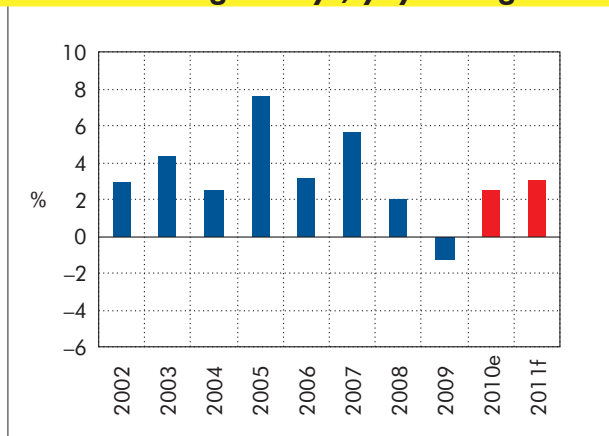
No recovery in trade, great expectations from tourism

Retail trade, real growth, yoy change



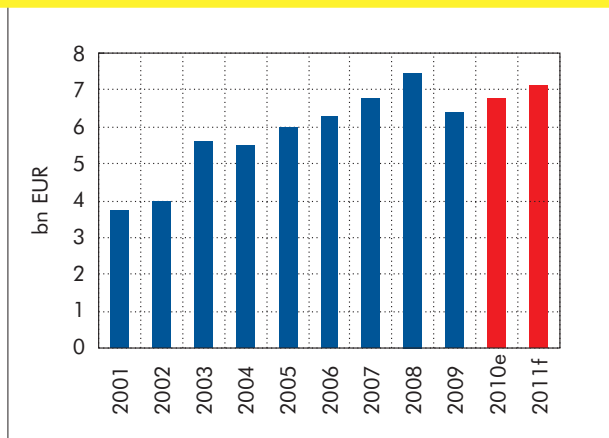
Source: CBS

Tourist overnight stays, yoy change



Source: CBS

Revenues from travel



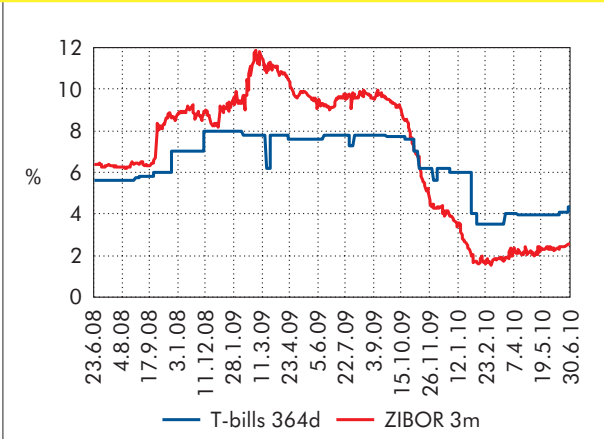
Sources: CNB, Raiffeisen Research

Slightly unexpected, the start of Q2 did not bring about a slowdown in negative trends in retail sales, which, ever since October 2008, has been seeing negative growth rates. Although the contraction in trade hit the sale of motor vehicles the hardest, excluding them from structure does not help the falling retail sales. Negative trends have been felt in the sale of foodstuffs, which is a consequence of lowered prices, by which traders adjusted to weaker demand, on one side and the optimisation between the ratio of price and quality on the other. As a result of unfavourable developments in the entire economy and especially in the labour market, consumers adjusted their habits to the insecurity as regards their future income and have postponed all of their unnecessary purchases. This is corroborated by the decline in bank consumer loans and the growth of retail savings. Mild positive shifts are to be expected in the second half of the year. The repealing of the lower rate of the special tax on salaries, pensions and other receipts could have a positive psychological impact on consumers. However, further increase in administratively set prices (especially the likely increase in the price of electricity) is bound to work in the opposite direction. A recovery in retail trade will remain impossible until there is no increase in the available income of households, which implies a recovery in the real sector and the labour market. We expect retail sale to decline by slightly less than 3% annually.

This year tourism is expected to reverse the negative trends in the domestic economy and pull the country out of recession. These expectations are based on the strong influence of tourism on other activities. With its share in GDP of some 15% to 20% and some 15% share in total employment, tourism can have a multiplicative effect on other segments of the economy. In the first five months the number of tourist arrivals slightly decreased on the year before, while the number of overnight stays went up. In the months ahead of us, the recovery that started in some foreign markets should positively affect Croatian tourism, since foreign tourists make up 90% of the total number of tourists during the peak season. Nevertheless, in view of the insecurity as regards the speed of recovery stressed by fiscal problems in the euro area, foreign tourists have adjusted their spending. This means that some of them could give up their vacations and the rest could modify their spending.

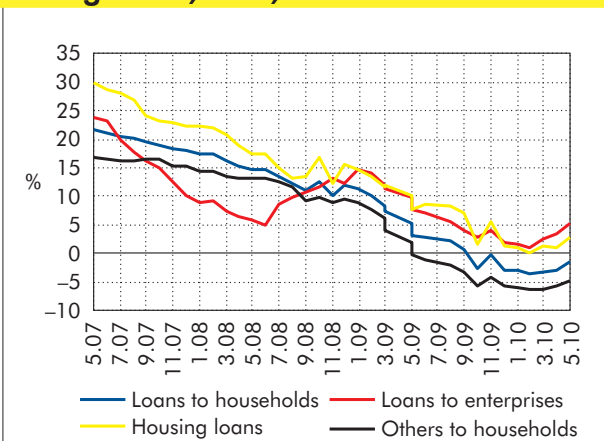
High liquidity but no placements

Interest rates



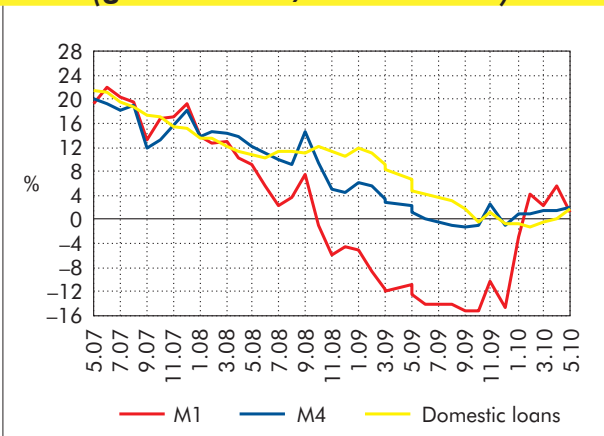
Sources: reuters.hr, CNB, MoF

Loan growth, in %, annual level



Source: CNB

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



Source: CNB

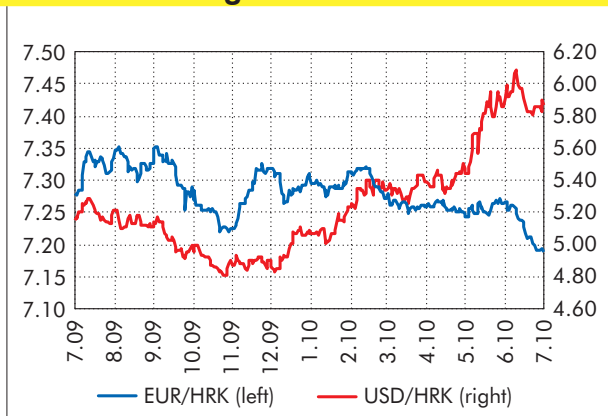
In nearly nine past months the banking system was marked by high liquidity which reduced banks' need to finance their primary liquidity in the money market. Consequently, modest trading volumes were accompanied by low interest rates, ranging around their five-year low. High liquidity also reflected itself in daily redirection of surplus money into overnight deposits with the CNB due to the lack of more attractive investments and placements. The average daily balance of overnight deposits in the first half of this year was more than HRK 4.5bn. Under these conditions the solid interest of investors for subscription of T-bills continued so despite the relatively high Government needs for refinancing the required yields on short-term government securities trended downwards. Until the end of the year we expect continued high liquidity in the money market, low trading volumes and interest rates which are expected to maintain their current low levels. The Government's high refinancing needs support our expectations of the Government continuing to borrow in the short-term market through T-bill issuance. At the longer end of the curve, despite Solid investor interest, a trend of rising yields arises, which will consequently reflect itself in the interest rates of the longest maturities.

Money (M1) slowly started recovering, primarily thanks to the growth of deposits. Broadest money (M4) was under the influence of declining savings and time deposits. Kuna deposits continued falling, while FCY deposits slowed down their growth, merely reflecting real developments in the economy. The growth in bank lending activity was mostly directed at enterprises and the government, the positive thing being that the share of lending to private enterprises is growing. However, the increase in corporate loans, that is based on the Government's measures aimed at aiding the economy (A and B model), is wearing thin. Lending to the retail sector will continue to be negatively affected by low creditworthiness, induced by continued decline in employment after the seasonal recovery and the reduction in the real available income of employed persons (high tax burden, decline in real wage, growth of administratively set prices). In view of expected developments in the real sector and the labour market we do not see a basis for more significant recovery of monetary aggregates. Thus, at the end of the year money (M1) and broadest money (M4) could only register a mild annual growth rate.



Appreciation pressures on the kuna dominate

Middle exchange rate of the CNB



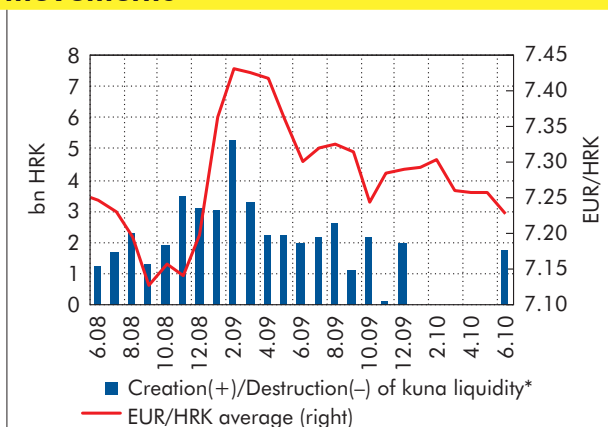
Source: CNB

Middle exchange rate of the CNB

Currency	Middle exchange rate 30.6.2010	Change compared to: 31.12.2009		
		Exch. rate	Move-ments	%
EUR	7.1935	7.3062	↓	-1.54
USD	5.8972	5.0893	↑	15.88
CHF	5.4221	4.9094	↑	10.44
GBP	8.8710	8.0740	↑	9.87

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

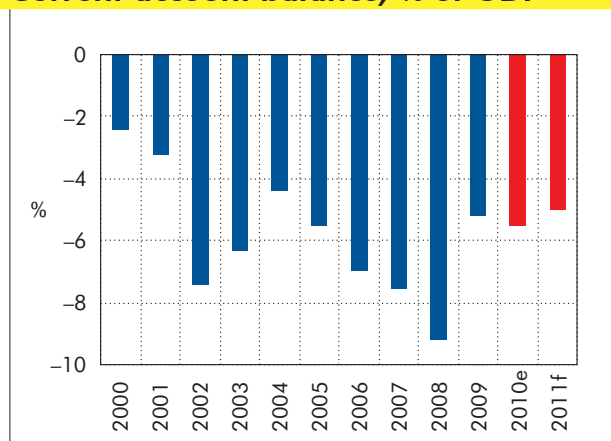
	2010e	2011f
EUR/HRK, avg	7.28	7.30
EUR/HRK, eop	7.32	7.32
USD/HRK, avg	5.83	6.24
USD/HRK, eop	6.10	6.37

High liquidity, low interest rates, much lower goods imports (and consequently lower demand for foreign currency) paired with the inflow of euros from quasi state borrowing abroad provided support to appreciation pressures on the domestic currency in H22010. Additional upward pressure on the kuna came from the expected domestic issue of the EUR denominated bond that motivated investors to prepare their positions for participation in the issue. Consequently, the EUR/HRK CNB's middle rate dropped to below 7.19, the lowest level in the past year and a half. In the first six months of this year, the kuna appreciated by slightly over 1% against the euro. Despite the appreciation pressures, the exchange rate was less volatile than over the previous years. At the end of June (for the first time in 2010) and at the beginning of July the CNB three times intervened in the FX market, aiming to halt the appreciation pressures by purchasing euros from banks (EUR 363.7m).

After the issue of the government bond, trading in the FX market should go back to above 7.20 kuna for one euro. However, a more significant EUR/HRK growth is limited by the inflow of foreign currency from tourism, continued fall in the imports of goods and reduced borrowing by the corporate sector in foreign capital markets. The conversion into the domestic currency of foreign currency stemming from the issue of the USD denominated international bond (nominal value of USD 1.25bn) will be completed slowly through the central bank without significantly affecting the FX rate. Therefore, there is no danger of depreciation pressures before autumn, while appreciation pressures that are common during the tourist season will be less prominent than over the previous years. In addition, in case of major pressures on the EUR/HRK exchange rate, the CNB will surely intervene, consistently implementing its policy of maintaining a stable exchange rate. We think that the EUR/HRK will hold within a band of 7.20 and 7.32 until the end of the year. EUR/HRK is expected to go up after the end of the tourist season. However, one is not to expect prominent depreciation movements since EUR/HRK would most probably continue to stand at levels from the first quarter of this year, trending towards the upper limit of the band. As a result, the year 2010 could be marked by high exchange rate stability with a lack of more significant seasonal oscillations and the tendency of the kuna to grow stronger against the euro.

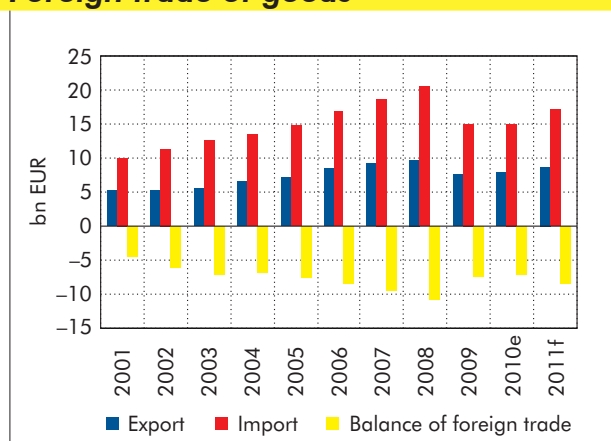
Decline in imports reduces current account deficit

Current account balance, % of GDP



Sources: CNB, Raiffeisen Research

Foreign trade of goods



Sources: CBS, Raiffeisen Research

External debt and ratios

Quarters	External debt (mn EUR)	External debt as % of:		International reserves (% of external debt)
		GDP	Exports of goods and services	
Q1.07	30,149	75.4%	176.1%	31.6%
Q2.07	31,058	75.9%	175.8%	29.5%
Q4.07	31,227	74.5%	172.1%	28.2%
Q4.07	32,929	76.9%	179.9%	28.3%
Q1.08	34,963	79.5%	188.2%	28.1%
Q2.08	35,403	78.3%	185.6%	28.1%
Q3.08	36,247	77.9%	182.8%	27.1%
Q4.08	40,316	85.1%	202.5%	22.6%
Q1.09	40,308	85.7%	206.4%	22.0%
Q2.09	41,823	89.8%	225.8%	21.7%
Q3.09	42,852	93.6%	255.7%	21.7%
Q4.09	44,583	98.2%	276.2%	23.3%
Q1.10	44,564	98.2%	274.3%	22.5%

Source: CNB

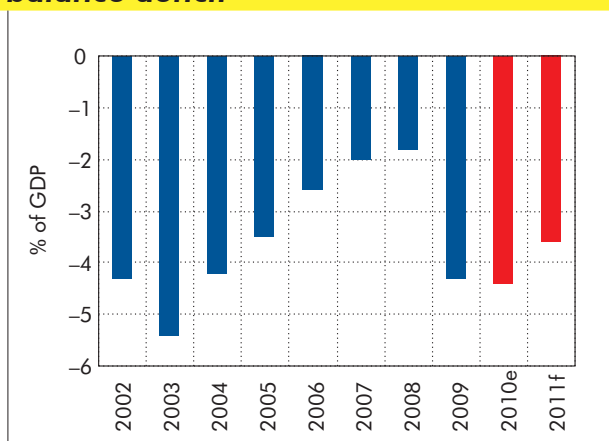
In accordance with the continued decline of economic activity at the beginning of this year, the C/A deficit decreased, both in its absolute and relative amount. In Q1 it stood at EUR 1.4bn, 23.9% down on the same period the year before. Consequently, with the continued decline in GDP, the share of C/A deficit in GDP went down to 4.4%. Considering that the goods account represents the most important item in the current transactions account, relatively strong fall in the deficit on this account contributed the most the overall deficit reduction. Smaller goods deficit is a consequence of the growth in exports and the parallel decline in imports. Considering that data on merchandise trade for April and May indicate more intensive exports of goods, influenced by the recovery in foreign demand, while domestic demand is still too weak to spur imports, in Q2 we are to expect a relatively low deficit. In the period until the end of the year, positive developments in trade could subside due to the expected mild recovery of domestic demand and especially in view of the rising tendency in the price of energy. Although we expect that FDI will increase only slightly compared to 2009, amid significantly lower C/A deficit its amount will largely be financed by FDI, which represent the most desirable way of financing the C/A deficit.

As expected, low domestic demand, financed by borrowing abroad for many years, and limited business opportunities for domestic enterprises contributed to lower demand for foreign financing. Moreover, at the end of Q1 gross external debt slightly reduced relative to the end of 2009, primarily under the influence of the reduction in central government debt. This was a result of the repayment of the Eurobond worth EUR 500m in February. Until June, external debt is expected to grow at a slower pace, with the borrowing of quasi-state enterprises being the only to account for a more sizeable contribution to this growth. Due to high needs of the government to refinance old and finance new obligations, we expect stronger borrowing towards the end of the year. This is corroborated by the Government's exit to the foreign capital market at the beginning of July, which increased the debt under the already issued US bond by additional USD 1.25bn. Since we expect GDP fall this year, external debt growth, although milder than over the previous years, will result in the growth of the share of debt in GDP to over 102%.



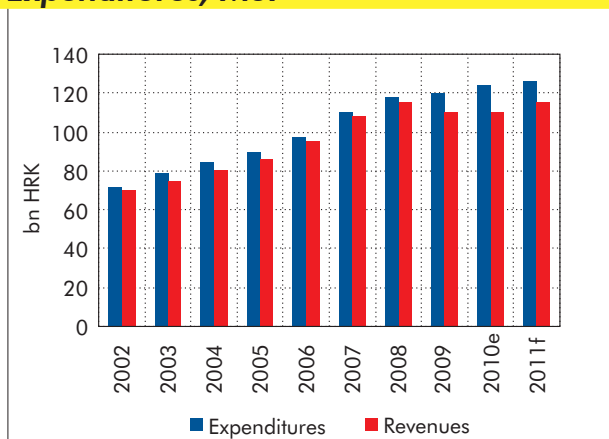
Awaiting a budget revision

Consolidated general government balance deficit



Sources: MoF, Raiffeisen Research

Central Government Revenues and Expenditures, MoF



Sources: MoF, Raiffeisen Research

Public debt

mn HRK	General government debt	% in GDP without guarantees and CBRD	Guarantees	Total public debt*	% in GDP without guarantees and CBRD
2002	72,632	34.9	16,079	92,536	44.4
2003	81,373	35.8	15,419	101,718	44.8
2004	92,955	37.9	12,262	111,059	45.2
2005	101,485	38.4	12,455	121,079	45.8
2006	102,513	35.8	14,188	124,388	43.4
2007	104,471	33.2	17,399	131,532	41.9
2008	100,146	29.3	33,836	144,795	42.3
2009	117,934	35.4	37,480	167,856	50.4
2010e	131,164	39.0	36,480	180,086	53.6
2011f	141,685	40.1	35,480	189,607	53.7

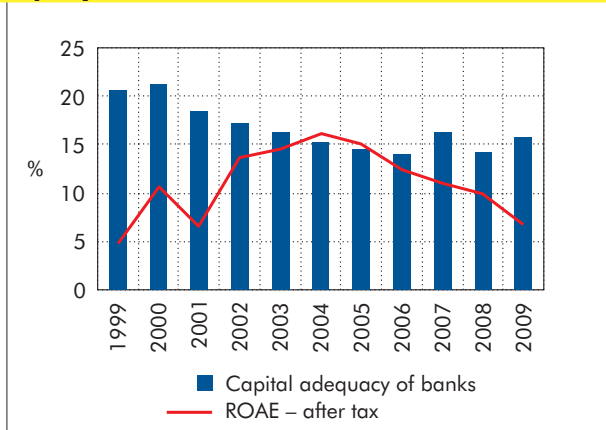
* including CBRD and guarantees

Sources: MoF, CBS, Raiffeisen Research

Continued budget revision, rising unemployment and a decline in nominal wages, as expected, contributed to a reduction in budget revenues in the first half of the year. As expected, the greatest drop was registered by revenues CIT and PIT, but also from income and contributions, while VAT revenues registered slight rise, exclusively thanks to the increase in its rate. The decline in income revenue was softened by special tax on salaries and other receipts and increased inflow from excise duties. In the same period, budget expenditures continued growing without substantial changes to their structure and funds being predominantly directed towards social transfers and unemployment benefits. State investment activity was interrupted and the signs of much needed reform have not been seen. Due to a lack of political consensus and pressures by different interest groups it is unlikely that the budget structure will see major changes this year. The state treasury deficit in the first half of 2010 was much larger than planned. Of the planned HRK 8.6bn deficit for the entire year, HRK 7.7bn or 90% was generated already in the first six months. Since its needs remain high, already a week later the Government announced that it would go out to the domestic market as well. A budget revision is under preparation, as expected in view of the implementation of some of the measures from the Government's economic recovery programme (such as changes to the income tax) and larger-than-planned deficit. In the second half of the year we expect stronger inflow to the state budget, partly due to the tourist season and partly due to the start in the recovery of domestic demand. Nevertheless, with the expected decline in gross domestic product the tax basis will go down, as well as non-tax income, which paired with the possibility of government guarantees, being activated could lead to the budget deficit even exceeding our expectations. In addition, the speed and structure of public debt growth and government guarantees is worrying. Although still below the Maastricht criterion of 60% of GDP, with the current state of economic development and borrowing dynamics and without the real intention of reducing government expenditures, the sustainability of Croatia's public debt remains questionable. It is evident that the current tax burden of both, real sector and employees does not leave much room for manoeuvres. This should finally trigger significant reforms and the budget expenditure cuts relocated to the current consumption.

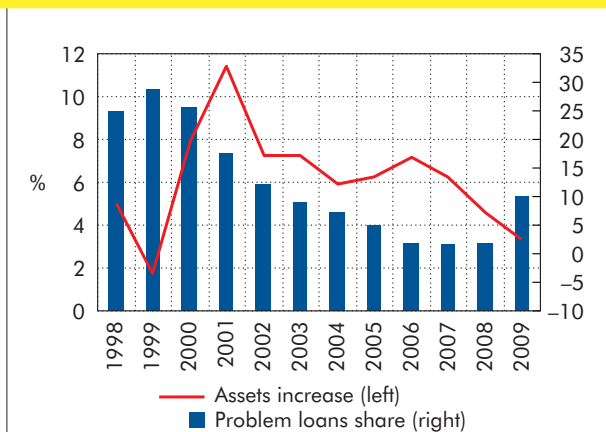
Lower return on bank equity

Capital adequacy ratio and Return on equity



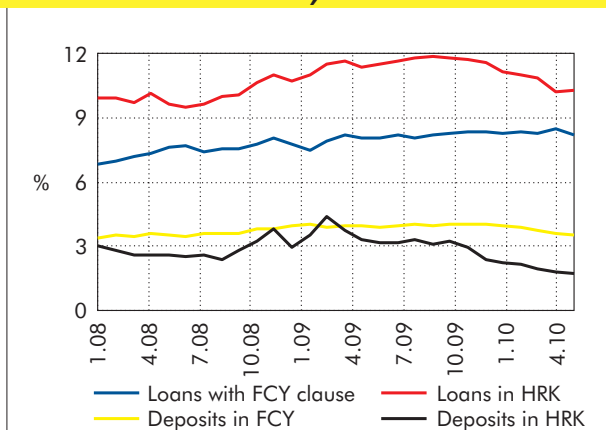
Source: CNB

Problem loans share and Banks' assets increase



Source: CNB

Banks' interest rates, annual



Source: CNB

The developments in the banking system over the past year were marked by the curbed growth of the credit portfolio and total assets of banks, by the increase in the share of NPLs in overall bank placements and by the reduction of the return on equity. In 2009, the loan portfolio went up by only 2.3% and this was only due to the increase in placements to the Government, which financed its widening deficit in H1 2009 by relying on bank lending potential. In H2 2009, the government debt to banks stagnated, as well as the amount of the total bank loan portfolio. In 2010, the lack of depreciation pressures enabled continued high bank liquidity, increasing the pressure to lower interest rates, firstly in the interbank market and secondly towards banks' clients. This spurred demand for corporate loans, with the Government taking over some of the client risk and thus reducing credit risk.

However, debt servicing problems in European border countries reflected themselves also in the growth of risk premiums for Croatian debt. Consequently, the price of financing went up for Croatia's banks, leading to renewed upward pressures on interest rates on loans. In addition, at the time of unfavourable conditions for government debt issues in the foreign financial markets, government demand for loans is on the rise which reduces bank surplus liquidity.

The Government's ability to contribute to the lowering of interest rates by taking over a share of credit risk will have a limited reach until order is restored in the payment of obligations among enterprises. The insecurity as regards the collection of receivables is slowing down economic recovery because it weakens the corporate motivation to assume business risk. At the same time, there are mounting problems relating to enterprises servicing their debts towards banks, which, paired with credit risk, is reflected in the increase in interest rates on loans. This means that the movement of interest rates on loans depends on government risk and the developments as regards client risk. The first factor cannot be fully controlled by economic policy, while the second one depends directly upon the success in implementing economic recovery measures in the part relating to corporate receivables collection. We expect the trend of falling interest rates to be halted by the end of the year.



Global recovery sets the pace of growth of demand for oil

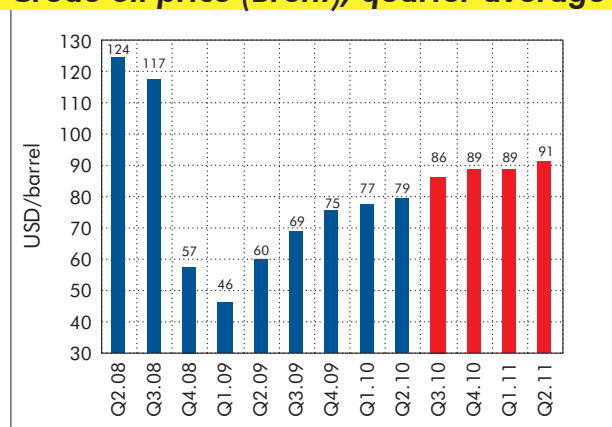
In Q2 2010 oil prices were not as much under the influence of good macroeconomic indicators in the US and the euro area, as under the oil spill in the Gulf of Mexico and the fiscal crisis in the euro area. The average crude oil price (WTI) on the New York Stock Exchange reached USD 78.1 per barrel in the period in question, while in the same quarter last year it stood at USD 59.8 per barrel. After spiking to above USD 86 per barrel early in May, in the following three weeks crude oil price declined to USD 68 per barrel, rising back again to between USD 70 and USD 80 per barrel by the end of the quarter.

According to the latest IEA report, the expectations as regards the demand for oil this year were revised upwards (by 60 kb/d), to 86.4 mb/d, as a result of the slightly higher demand in OECD mem-

ber states, especially in North America, while in Europe, which has been recovering a little slower, demand slightly reduced. Thus, after the strong fall in demand for crude oil last year, this year we are expected to see a 2% growth. According to IEA estimates, total crude oil production reduced in May by 575 kb/d to 86.3 mb/d, primarily as a result of the decline in production by non-OPEC members. The decline in the production by OPEC members was softened by the growth of production in Iraq.

The said fiscal crisis and it threatening the speed of recovery in the euro area and the global economy as well will probably represent the strongest influence on expected demand for oil in the short and the medium term. In addition, there is the issue of the sustainability of demand growth in China, which is expected to account for 40% of the total growth of demand this year, this share rising to 45% over the next five years. Due to fairly strong growth even at times of recession and the fear of its economy overheating, the Chinese central bank planned measures to slow down their economic growth. In addition, due to the market interdependence, growth slowdown in OECD countries may negatively reflect itself on China's demand for oil, for it is exceptionally export-oriented. On the supply side the strongest influence in the medium term could come from the oil spill in the Gulf of Mexico, which will probably tighten regulations relating to oil extraction not only in the US but in other countries as well. Until the end of the year we can expect further growth of demand for oil, as well as further growth of oil prices. However, under the influence of mentioned factors sizeable oscillations are possible.

Crude oil price (Brent), quarter average



Sources: Bloomberg, Raiffeisen Research

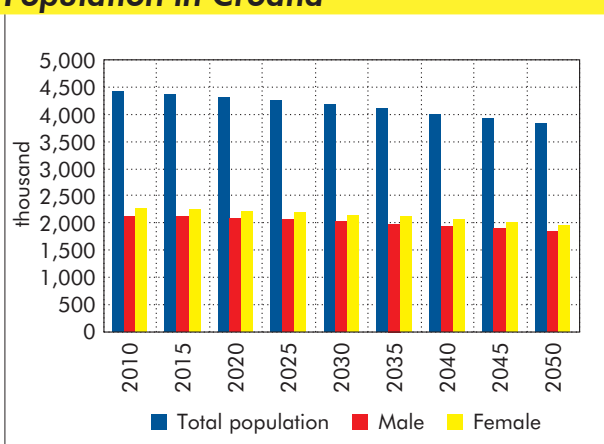
World oil demand, mb/d

	2008	2009	2010e	2011f	2012f	2013f	2014f
Optimistic scenario – higher global GDP growth							
OECD	47.6	45.5	45.5	45.4	45.2	45.0	44.8
Non-OECD	38.6	39.3	40.8	42.1	43.4	44.8	46.0
Global	86.2	84.9	86.3	87.5	88.7	89.8	90.9
Pesimistic scenario – lower global GDP growth							
OECD	47.6	45.5	45.5	45.1	44.8	44.3	43.9
Non-OECD	38.6	39.3	40.5	41.3	42.0	42.6	43.1
Global	86.2	84.9	85.9	86.4	86.8	86.9	87.0

Source: IEA

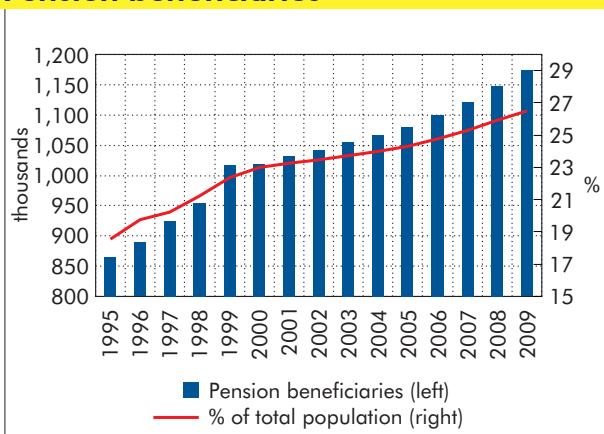
Demographic trends – a burden for future generations

Population in Croatia



Source: UN (Population Department)

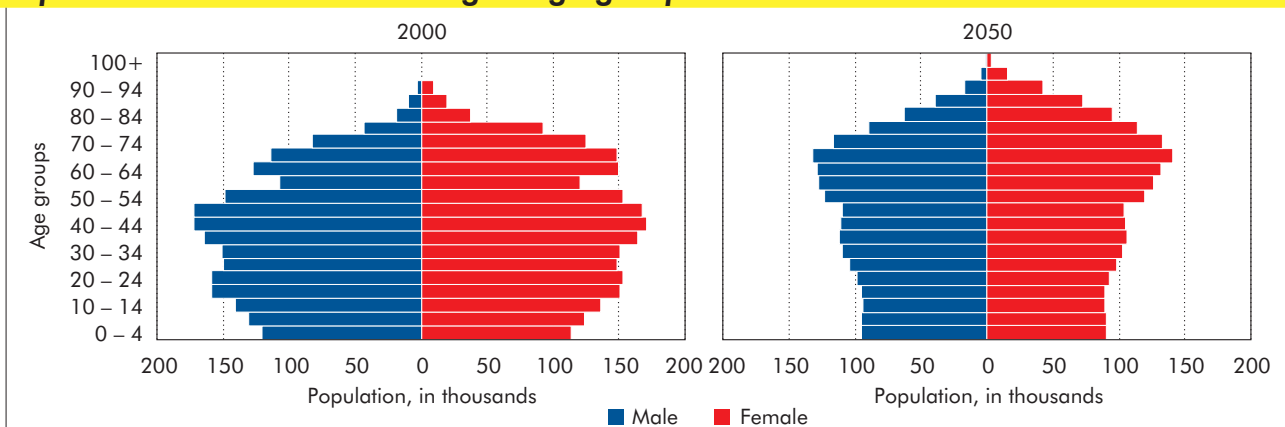
Pension beneficiaries



Sources: CPIL, Raiffeisen Research

Demographic trends that marked the second half of the twentieth century had a significant impact on the demographic structure in the first decade of the twenty-first century. From the current perspective, it will not come to visible changes for the better in either the near or the distant future. Ever since the beginning of the 1990s, Croatia's demographic picture has been marked by depopulation, which has resulted in negative Natural increase, i.e. a large number of Deaths of Live births in last ten years. This is accompanied by population aging. Although the data from the latest 2001 census are not fully comparable with current lists (considering there were certain changes in census concepts), the process of depopulation paired with the aging population was recorded also during the period between the last two censuses (1991 – 2001) and is ongoing. Partial depopulation processes started already in the late 1950s, primarily among the female population, while the process of overall (male and female) depopulation began in the second half of the 1960s. In addition to Croatia, the described processes did not avoid the developed European countries, such as Austria, Germany, Norway and Sweden. The most developed societies in Europe have up to date not managed to completely solve the problem of depopulation, the progressive slowdown of the inflow of young people into the workforce and progressive increase in the inflow of retired persons. In transition countries, which implemented stimulating population policies aimed at slowing down the decrease in the birth rate and the natural increase, the depopulation and aging process started later, in the early 1990s. Due to the lack of a similar population policy in Croatia, the

Population in Croatia according to age groups in 2000 and 2050



Source: UN (Population Department)

population that suffered in the war on one side and increased emigration on the other there were no positive impacts from the immigration wave (primarily from Bosnia and Herzegovina) so the depopulation trend started in 1990s continued.

As mentioned earlier, in addition to the depopulation process the Republic of Croatia is faced with the aging population. The influx of younger generations to the workforce is reducing while the outflow of older generations from the economically active population is growing. In addition, during the period of transition the unemployment problem was often solved by early retirement thus creating an increasing pressure on the pension system and the budget in the present. Today, only 55% of retired persons achieve rights on retirement pension. 23% of them is entitled to disability pension, while the remaining 22% is entitled to a survivor's pension.

As a result of the lack of reform in the area of labour market and retirement system regulation it is very hard to reach higher employment rates. The pressure on the retirement system is mounting. If we take into account the potential support ratio, i.e. the fact that one retired person is covered by a shrinking number of potential workers, the question of how long such a system can be sustained arises. Year after year, the number of retired persons will grow and the inflow of young persons into the work force will reduce. According UN estimates, the dependency rate of older population (65 years of age and up) relative to the economically active population (15 to 64 years of age) in Croatia could increase from 26% in 2010 to 49% in 2050.

The necessary reform should, *inter alia*, be directed at creating more labour market flexibility, higher workforce mobility and increase in the active participation of women in the labour market. In the years to come one should also not exclude the possibility of prolonging the required length of service, strengthen the conditions for privileged or disability pensions, as well as make attempts to, at least temporarily, reintegrate a share of younger retired persons into the work force. With all this unfavourable demographic trends can only be softened by a comprehensive policy that would span beyond the interests of a particular party and be aimed at stimulating an increase in population. What at stake here are long-term, economic interests. Experience of developed countries shows that solving

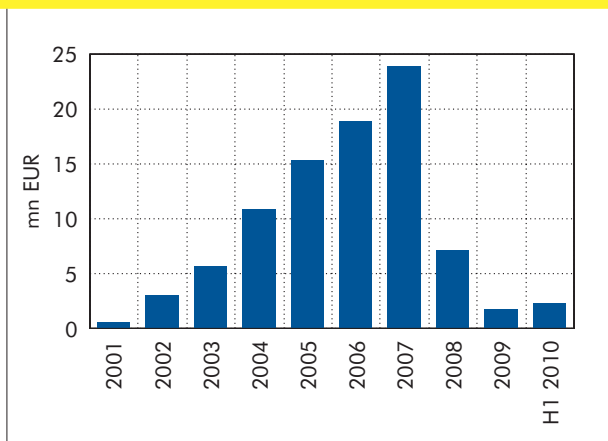
demographic problems through an immigration policy results in the increase of social expenditures when importing less educated workers, while highly educated workers demand a higher price of labour.

Further, an aging population puts the health care system under considerable strain because as the population grows older the overall costs of the health care system rise and so does the demand for hospital services and medicine consumption. The health care systems of some countries, Croatia among them, have not undergone adjustments which would make the increasing number of older population least threatening for the economy. The most important measures for the control of health care spending should build on alternative and cheaper forms of health care, which should be paired with more efficient use of preventive health care. It is evident that due to all of the above the mentioned aging of the population impacts the fiscal system, questioning the sustainability of public finances. The majority of projections involving Croatia indicate lower budget revenues from contributions to the pension system but also other social security contributions. Under the most optimistic scenario the share of contributions towards the pension system in total GDP could fall from the estimated 7.5% in 2010 to 4.1% in 2050. Since these revenues make up a fairly large share of overall budget revenues (36% in 2009), the expected decline in revenues from contributions under the influence of the aging population is a problem that should be addressed. On the other hand, if we take into account the amount of expenditures for social benefits, which make up the largest shares of total budget expenditures, with their evident growth on annual level (from 46% in 2008 to 48% in 2009), it is obvious that future expenditures will only grow higher. Another problem arose from the fact that the collected contributions for pension insurance were not sufficient to cover pension expenditures.

The described developments and assumptions based in view of the aging population (expected growth of budget expenditures and lower budget revenues) paired with the postponement or lack of structural reforms do not leave room for optimism as regards the budget deficit and public debt. Last but not least, there is the question of whether we should finally start acting responsibly towards future generations.

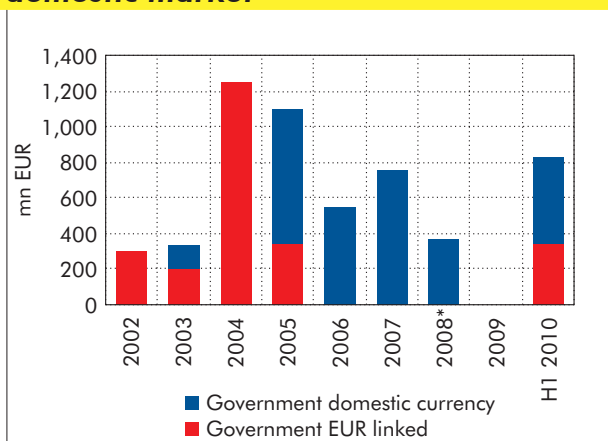
Fiscal adjustment to European reality

Average daily turnover of domestic bonds



Source: ZSE

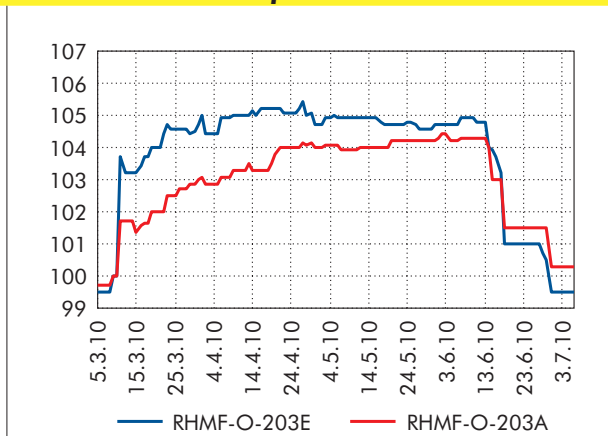
New government bond issues in domestic market



*2-year T-bills MoF

Sources: MoF, Raiffeisen Research

Croatian bonds' spread



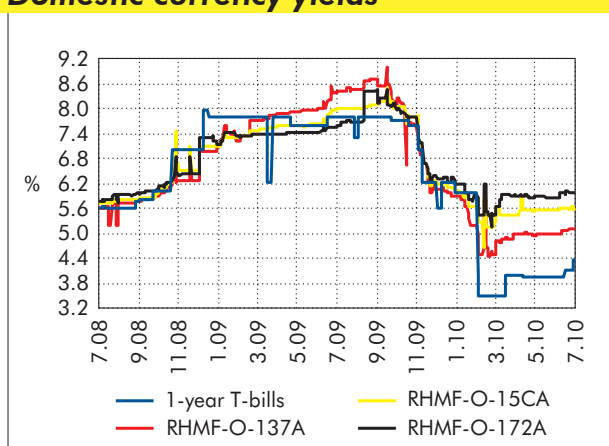
Sources: Bloomberg, MoF, Raiffeisen Research

The second quarter in the Eurobond market was very hard due to the situation in Greece and the fiscal crisis escalating in Europe. The euro area strived to address the problem by establishing an assistance fund for its Member States, worth EUR 750bn, while in order to calm the market down the ECB decided to start purchasing government bonds in the secondary market. Nevertheless risk aversion grew, and the required yields of peripheral euro area Member States widened relative to German securities, as did CDS. Debt securities of CEE countries were also not immune to described developments. Spread levels on the Eurobond market increased throughout the CEE area. On top of all this, Hungary shocked the market with some unprecedented political statements about their financial situation being comparable to that of Greece. The redirection of financial assets into safe havens, such as US and German government bonds resulted in their yields reaching historical lows. According to our expectations, most countries, Croatia included, will wait for a more favourable moment to issue new Eurobond. In view of the pessimism prevailing in the market the real question is when this moment will come. The speculations of a long and slow recovery are getting louder, with the situation being made more difficult by the necessary implementation of fiscal adjustment plans by EU Member States. Nevertheless, the majority of negative expectations have already been included in the price so we do not expect major price corrections. To the contrary, the global market sentiment in the third quarter could be marked by optimism, reducing the yields on bonds from CEE countries and narrowing the spreads relative to benchmark German bonds.

New government issues at the beginning of March and preparations for further issues during the summer months were in the focus of investor interest in the domestic bond market in the first half of the year. Market participants sold shorter maturities in order to be able to subscribe new bonds of longer maturities. As expected, insurers directed their assets into FCY indexed bonds, while pension funds opted for kuna government bonds. In addition, non-residents showed interest for domestic issues. The second quarter was marked by a sort of a lull in the market, as well as pressures on the supply side and consequently by a decline in the price of domestic government bonds, both HRK and EUR denominated. The average daily bond turnover

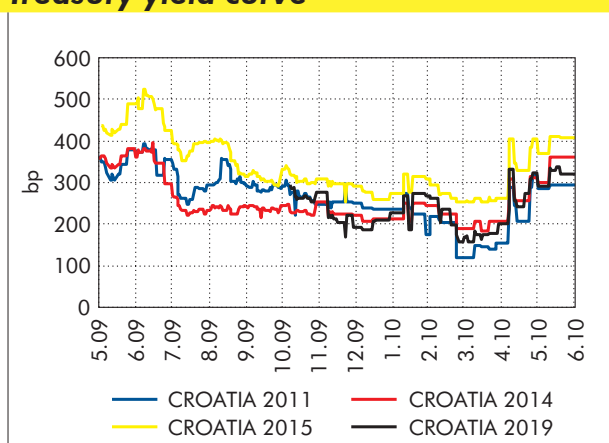
High (re)financing needs require new issues

Domestic currency yields



Sources: MoF, Reuters.hr, Raiffeisen Research

Treasury yield curve



Sources: Reuters.hr, Raiffeisen Research

and liquidity in the capital market in this year's first half, although better than in 2009, were still low. Early in July, after eight months Croatia again joined the world's government debt market by issuing an international bond denominated in US dollars (worth USD 1.25bn) at the price of 99.102 and average yield at 6.75% interest rate (391 bp above the comparable US securities). The maturity is in July 2020 with a coupon of 6.625%. In view of the Government's high need for refinancing, it has been announced that a new exit to the domestic capital market will also follow in July. The minimal planned value of the second tranche (10 year government bonds, HRK and EUR denominated) is HRK 5bn. Domestic bond yields should remain relatively stable until the end of the year. In case of an improvement of the global sentiment they might experience a downward pressure. It is highly likely that tax and non-tax inflows to the budget and MoF T-bill issues will not suffice to cover the budget deficit. However, it is our opinion that this year the Government will find a solution to refinance wholes in the budget, prolonging the average maturity of its obligations, but at a higher price than over the previous years. Regardless of the highly liquid market and a healthy demand risk premiums reflect high risk aversion, but also the postponement of the necessary fiscal and structural reforms. The only positive influence on the premium on Croatian debt could come from the closure of pre-accession negotiations with the European Union. This would have a more significant impact only if accompanied by sharp, deep and comprehensive reforms aimed at enabling the sustainability of public reform and economic growth and development. Otherwise, the sustainability of the economic policy will be put into question and, sooner or later, the market will punish irresponsible and irrational behaviour.

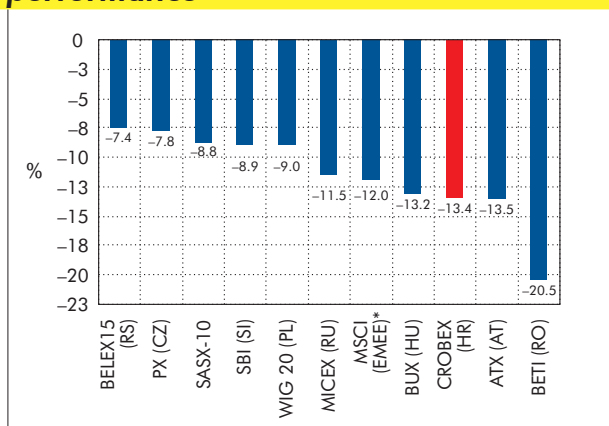
Government bonds in domestic market

Bond	Currency	Volume (mn)	Maturity	Coupon (%)	YtM (ask, %)	Spread to Bund	Spread to EUROSAP	YtM (ask, %)	YtM (ask, %)	YtM (ask, %)
					30.6.10	30.6.10	30.6.10	31.3.10	31.12.09	30.9.09
RHMF-O-125A	EUR*	500	23.5.12	6.875	4.69	460.00	377.00	4.50	4.87	6.33
RHMF-O-142A	EUR*	650	10.2.14	5.500	5.50	467.00	373.00	5.15	5.18	6.09
RHMF-O-157A	EUR*	350	14.7.15	4.250	5.52	365.00	296.00	5.46	4.88	6.12
RHMF-O-19BA	EUR*	500	29.11.19	5.375	6.15	380.00	303.00	5.76	5.11	6.25
RHMF-O-203E	EUR*	350	5.3.20	6.500	6.43	314.00	283.00	5.80	-	-
RHMF-O-137A	HRK	4,000	11.7.13	4.500	5.11	-	-	4.98	5.90	8.10
RHMF-O-15CA	HRK	5,500	15.12.15	5.250	5.62	-	-	5.46	6.00	8.01
RHMF-O-172A	HRK	5,500	8.2.17	4.750	5.98	-	-	5.90	6.18	7.96
RHMF-O-203A	HRK	3,500	5.3.20	6.750	6.56	-	-	6.27	-	-

* Indexed to euro; secondary trading, interest and principal payment mid rate of CNB on trading day or maturity day
Sources: MoF, ZSE, CDA, Reuters.hr

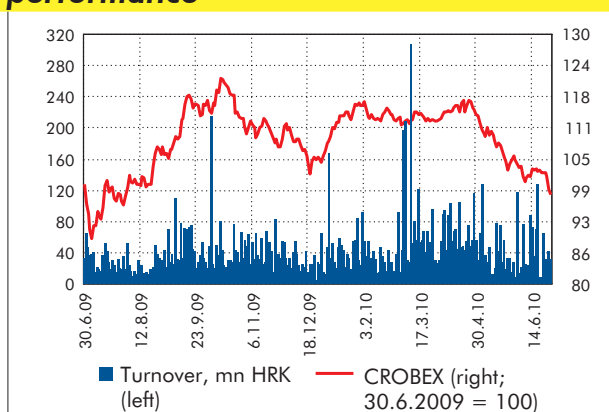
Turnovers melt down

Regional indices – Q2 2010 performance



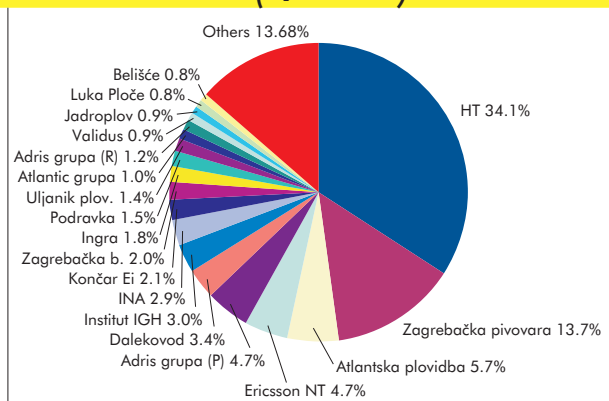
* MSCI Emerging Market Eastern Europe
Note: In local currency, value on June 30, 2010
Sources: Bloomberg, Raiffeisen Research

Market turnover and yield – 1y performance



Note: Daily values for period from June 30, 2009 to June 30, 2010
Sources: ZSE, Raiffeisen Research

Shares turnover (Q2 2010)



Sources: ZSE, Raiffeisen Research

Regional returns. Contrary to our expectations, investors' concern regarding the situation in Greece has not weakened. Instead, it spilled over to some other EU member states. The negative sentiment was accompanied with the effects of a reduction in expected growth and recovery arising from the announced austerity measures in EU countries, weaker-than-expected economic indicators in the US and the attempts of Chinese authorities to slow down their economic growth. All of this resulted in the fall of equity indices, not only in the CEE but around the world. Very low liquidity during the second quarter was the indicator of risk aversion across the region.

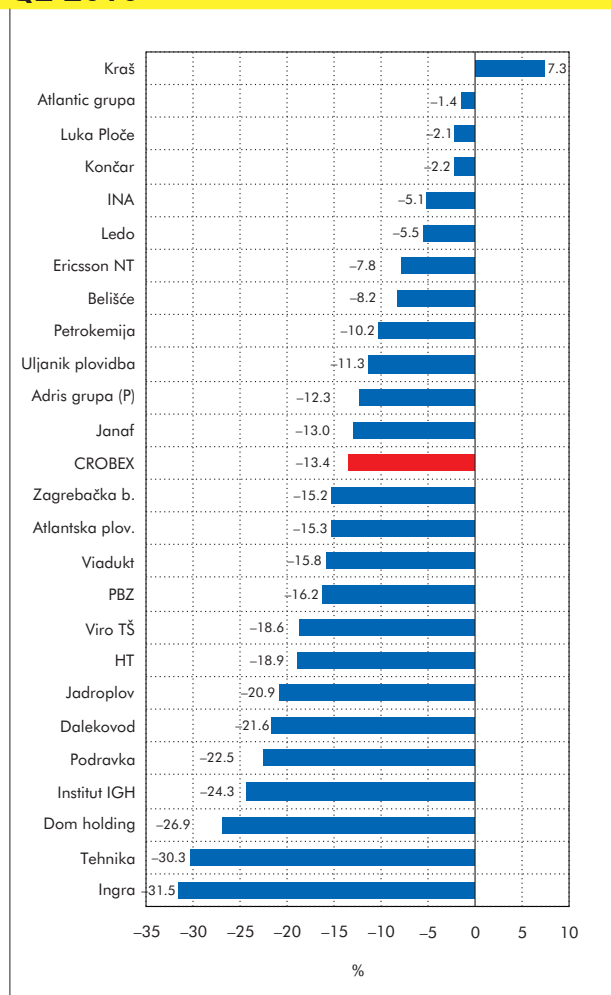
Domestic returns. In the second quarter 2010, CROBEX was moving in line with the global sentiment, ending the period at 1,855.2 points, the retreat to mid-July 2009 levels. Among CROBEX constituents, only shares of Kraš generated a positive return, while Atlantic Grupa, Luka Ploče and Končar Ei recorded a drop, but performed much better than the index. Traditionally the most volatile were shares of construction companies which realised the most negative returns for the period. A significant drop was registered in Podravka's shares, whose volatility was supported by the disagreement between the company's owners – the government and pension funds. HT's dividend of HRK 34.05 per share and Ericsson NT's dividend of HRK 120 per share as well as other dividends have not been taken into account when we calculated our returns for the second quarter, although they have played an important role in the total return for the period. Taking dividends into account, Ericsson NT with a 0.3% shares' return joined Kraš in positive performance list, while HT's negative return shrank from -18.9% to -8.3%. Broken down by sector composition of the index, F&B sector's shares went down by 8%, on average, during the second quarter, shipping shares by 16% and the shares of construction companies by 25%. At the end of the period, market capitalisation of all shares traded on the Zagreb Stock Exchange was HRK 125bn, down 7.6% relative to the end of 2009.

Share turnover. The 2010 spring was marked by growing risk aversion and diminishing of trading volumes. The total trading volume on the ZSE was HRK 3.1bn, of which 46% was accounted for the regular turnover. This was an increase qoq, when this share stood at 39%. Regular turnover thus went up by 9%, reaching HRK 1.4bn. However, the monthly trading



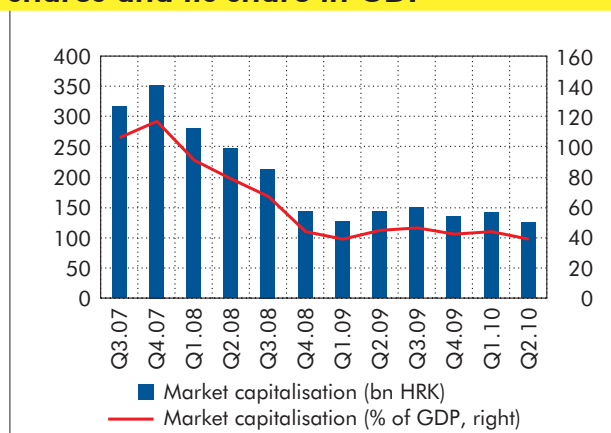
Atlantic Grupa takes over Droga Kolinska

Performance of CROBEX constituents in Q2 2010



Sources: ZSE, Raiffeisen Research

Market capitalisation of actively traded shares and its share in GDP



Sources: ZSE, Raiffeisen Research

dynamics in the second quarter indicated that trading was reducing by a half each month. The most traded share was again HT (HRK 477.5mn), followed by Zagrebačka pivovara with HRK 191.3mn and Atlantska plovidba with HRK 79.3mn turnover. The ten most liquid shares accounted for 76.1% of total volumes, which compared to 71.2% in Q1 10 indicated increasing concentration of investors' interest on a smaller number of shares in the overall trade. In Q2 10, total of 169 shares were traded on the ZSE Regulated market. As usual, the most traded were shares from the transportation, storage and communications sector; their turnover amounted to HRK 623mn, followed by shares from the food and beverages with a turnover of HRK 360mn, while the shares from the construction sector generated a turnover of HRK 132mn.

Current valuation of CROBEX constituents.

Based on end of Q2 period prices and 12M fundamentals including Q1 10, we have calculated the valuation multiples for CROBEX constituents. According to operating performance (measured by EV/EBITDA multiple) the most attractive is HT's share, followed by JANAF and Adris Group (preferred), while shares of construction companies Tehnika, Ingra and Institut IGH have the highest valuation, measured by this multiple. On the side of P/E ratio, the most attractive valuation is calculated for Dalekovod, Uljanik plovidba and Adris Group. Since EBITDA or net profit can be negative, the peer valuation cannot be applied to all shares by observing EV/EBITDA and P/E multiples. Therefore, the comparison of valuations through EV/Sales and P/BV encompasses more shares. However, these multiples could be considered as too broad. EV/Sales multiple below 1x is calculated for shares of Končar, Petrokemija, Podravka, Viadukt and Kraš, while lowest value of P/BV multiple is assigned to shares of Jadroplov, Ingra, Petrokemija and Uljanik plovidba. All in all, Adris Group (preferred) and Dalekovod shares peer valuation measured by both multiples, EV/EBITDA and P/E, seem the cheapest.

Mergers & acquisitions. In the previous quarter M&A activities were substantially higher. Undoubtedly the most interesting was the takeover of Droga Kolinska by Atlantic Grupa. The transaction was arranged at the price of EUR 382m for EV of Droga Kolinska. That is around EUR 242m for a 100% equity stake. This price assumes 1.17x (FY 2009) EV/Sales and 8.4x EV/EBITDA. The EBRD will back up

A turn for the better still expected

Peer valuation of CROBEX constituents

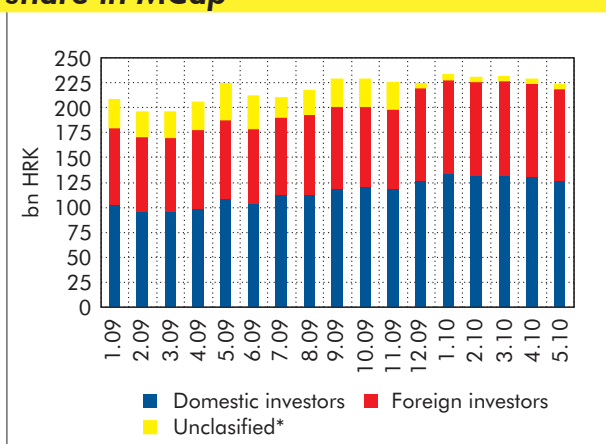
	EV/sales	EV/EBITDA	P/E	P/BV
Adris grupa	1.8	7.5	9.5	0.6
Atlantic grupa	1.2	11.1	14.4	2.1
Atlantska plov.	3.3	10.8	....	0.8
Belišće	1.4	18.1	215.8	0.9
Dalekovod	1.1	8.9	7.6	0.9
Dom Holding	1.7	11.6	....	0.1
Ericsson NT	1.1	10.4	15.1	1.5
HT	2.2	5.2	11.7	1.7
INA	1.4	16.5	343.7	1.4
Ingra	4.1	62.7	....	0.5
Institut IGH	2.5	39.0	....	0.7
Jadroplov	1.6	....	....	0.3
JANAF	4.9	7.0	15.5	0.6
Končar	0.6	13.1	10.3	0.7
Kraš	0.9	8.5	12.8	0.8
Ledo	1.9	14.2	12.5	2.0
Luka Ploče	2.4	....	53.9	2.1
PBZ*	....	....	10.3	1.0
Petrokemija	0.7	....	....	0.5
Podravka	0.8	....	....	0.8
Tehnika	1.1	383.6	....	0.6
Uljanik plovidba	5.8	11.2	7.7	0.5
Viadukt	0.7	10.8	18.2	0.8
Viro TŠ	1.6	12.2	18.9	0.9
Zagrebačka b.*	....	....	12.1	1.0

* Based on unconsolidated results

Note: Fundamentals are based on 12 months trailing data and prices as of June 30th 2010

Sources: ZSE, Raiffeisen Research

Structure of equity investors and their share in MCap



* Custody and portfolio accounts

Note: For shares that are not traded, nominal value is used

Source: CDA, Raiffeisen Research

the transaction with EUR 70mn, of which EUR 40m placed as debt and EUR 30mn as a participation in equity within the capital increase. The capital increase will be realised by issuing 864.305 new shares, and raising a total of EUR 83mn by the end of July. The Austrian Duropack acquired 62.34% of Belišće shares via a public offering (62.93% including treasury shares), 95.66% shares of Uniapapir and 67.94% shares of Bilokalnik. Acquisition of Belišće was realised at the price of HRK 500 per share, which relative to Belišće performance in 2009, implies 20x EV/EBITDA, 290xP/E and 0.62x P/S. In the upcoming period we expect more acquisitions because of the Government's renewed privatisation plans, listing 394 companies with less than 25% stake, 31 company where it has a stake between 25% and 50% and 59 companies where the state's share exceeds 50% as potential candidates for sale. The Privatisation Act stipulates that state shares below 50% have to be sold via a public auction while shares exceeding 50% can be sold via the public offering.

Market valuation and outlook. Considering that the fall in the value of shares was primarily induced by the growth of risk aversion prompted by concerns regarding the debt crisis in the EMU countries and the saving measures announced, we expect a gradual decline in risk aversion. In addition, support to equity markets could come from predominantly good economic indicators. In addition to the expected improvement in leading indicators in the second half of the year, the announced savings measures could give more positive boost to current valuations. Therefore, the developments in the CEE equity markets are expected to be positive. As for the peer valuation, CROBEX10 is expected to reach 10.4x P/E in 2010 and 8.6x in 2011. For other CEE indices, the expected P/E valuation ranges between 6.6x and 12.9x in 2010 and 5.3x and 11x for 2011. The most attractive valuation is expected for the Russian MICEX, where we expect to see 14.3% in long-term growth. We also expect a double digit long-term growth rate for Polish WIG 20, while CROBEX10 is expected to growth at 7.4% in long-term, in line with the CEE average.



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Abbreviations

...	– data not available	FX	– foreign exchange
3m	– three months	GBP	– pound sterling
avg	– period average	GDP	– Gross Domestic Product
bn	– billion	H1, H2	– first, second half of the year
bp	– basis points	HRK	– Croatian kuna
CBRD	– Croatian Bank for Reconstruction and Development	IEA	– International Energy Agency
CBS	– Croatian Bureau of Statistics	ILO	– International Labour Organization
CDA	– Central Depository Agency	MCap	– market capitalization
CDS	– Credit Default Swap	mn	– million
CE	– Central Europe	MoF	– Ministry of Finance
CEE	– Central and Eastern Europe	NPL	– nonperforming loan
CES	– Croatian Employment Service	OECD	– Organization for Economic Cooperation and Development
CHF	– Swiss franc	OPEC	– Organization of the Petroleum Exporting Countries
CIS	– Confederation of Independent States	PIT	– Personal Income Tax
CIT	– Corporate Income Tax	Q	– quarter
CNB	– Croatian National Bank	ROAE	– Return on Average Equity
CPII	– Croatian Pension Insurance Institute	SEE	– South East Europe
e	– estimate	UN	– United Nations
ECB	– European Central Bank	US	– United States
EMU	– Economic and Monetary Union	USA	– United States of America
eop	– end of period	USD	– US dollar
EU	– European Union	VAT	– value added tax
EUR	– Euro	y	– year
f	– forecast	yoy	– year on year
FCY	– foreign currency	YtM	– Yield to Maturity
FDI	– foreign direct investment	ZSE	– Zagreb Stock Exchange

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