

Monthly report - Croatia

7 July 2010

Area (km ²)	56.538
Population (in mln)	4,429
GDP per capita	10.245 EUR (2009)
President	Ivo Josipović
Prime Minister	Jadranka Kosor



Croatia in the last phase of accession negotiations with the EU

Important news

Croatia has entered into the phase of accession negotiations with the EU

Croatia has entered into the last phase of accession negotiations with the European Union. At the end of June it has opened another three chapters in the fields of competitiveness, external relations and judicial system and closed two chapters in the field of public procurement and the taxation. The World Bank approved Croatia a loan in the amount of 26 million € intended for improvement of the efficiency of the judicial system. The loan is a part of accession financial aid. Croatia has so far already closed 20 out of 33 chapters. Croatia's efforts are aimed to conclude accession negotiations in the first half of the following year and become full member of the EU on 1 January 2012. Nevertheless, the Governments of some states are not keen on the entry of new countries in the time of difficult economic situation and due to concerns regarding poor democratic standards at the Balkans.

The European investment bank approved to the Croatian Bank for Reconstruction and Development (HBOR) two loans in the total value of 284 million €, of which 250 million € is intended for financing SME projects, and the remaining 34 million € for the expansion and modernisation of the chemical industry Dina Petrokemija d.d.

According to the Croatian media, Chinese investors are supposed to be interested in possible investment in transport, tourism, wood industry and water project management. The total value of the project should amount to more than 10 billion €.

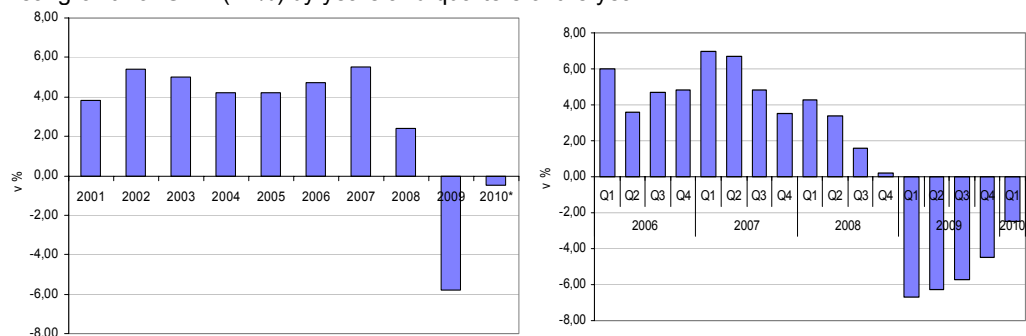
Macroeconomic indicators

Slow recovery of domestic economy; serious recovery can be expected in 2011

The negative trend of economic activity is still present. The first assessments of the Statistical Office show that in the first three months of this year economic growth has decreased by -2,5% in real terms compared to the same period last year. This is the fifth consecutive quarter to record drop in economic growth. The dynamics, however, is decreased due to the base effect from the previous year (in comparison with the first quarter of last year GDP fell by 6,7% (y/y)). The decrease has been contributed most by decrease in personal consumption. Due to the decreased consumption and negative economic trends, the country lowered its investment activities which are reflected in reduced investments in fixed capital.

According to projections of analysts, negative trend is expected to continue in the second quarter of this year as well (the expected decline in the GDP is around -2,6%), while in the second half of this year first signs of economic recovery are expected. According to the Government's projections in this year the economy is expected to reach a 0,5% growth, but according to IMF projections a zero growth. However, some significant recovery can be expected only in 2011, when according to the Economic Institute of the Republic of Croatia the economy will reach a growth of 2,2%.

Real growth of GDP (in %) by years and quarters of the year

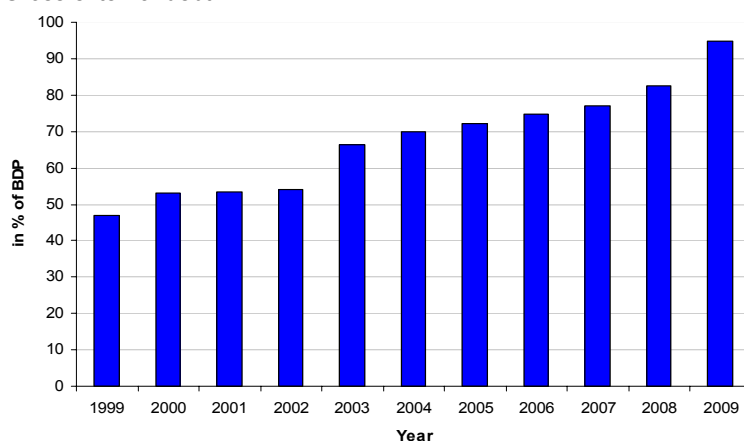


Source: Crostat

This year gross external debt could exceed the level of 100% of GDP

At the end of February, **gross external debt of the Republic of Croatia** amounted to 43,99 billion €, which was 586,1 million € less than at the end of last year. The decrease in debt is mainly the result of decrease in indebtedness of the state and of banks in the total external debt. Thus at the end of February, the share of the state in the external debt was 4,93 billion € and that of banks 10,18 billion €. The share of the state lowered to 11,2% and the share of banks to 23,1%. Decrease in the debt of the state is the result of the sale of Eurobonds, the maturity of which was in February. The loan granted by the World Bank in January functioned in the opposite direction. At the end of February, the gross external debt reached 97% of GDP. According to not very optimistic forecasts for this year regarding economic growth the share of external debt is expected to exceed the limit of 100% of GDP.

Gross external debt



Source: HNB

At the end of last year, the **total external debt** – including public debt of the state, debt of HBOR and state guarantees – amounted to 167,9 billion HRK, which was 15,9% more than at the end of 2008 so that it represented 50,4% of GDP. The most significant contribution to the growth of public debt was borrowing on the basis of bonds issued on foreign markets.

According to estimates of analysts, Croatia should need around 2 billion € for financing this year's budgetary deficit, which is expected to amount approximately 2,5% of GDP, and to pay some other outstanding liabilities in the coming months. To this purpose it should borrow on the foreign markets, but this will to a great extent depend on the situation on the capital markets.

Consumer pessimism is still present

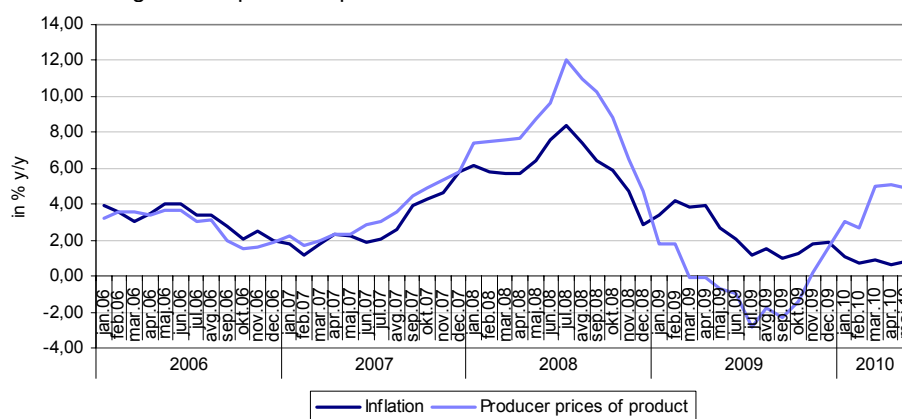
The trend of low inflation pressures continues. Due to unfavourable movements in the real sector and on the labour market as well as due to the still present consumer pessimism these inflation pressures are the result of an increase in domestic consumption. Thus the average level of consumer prices in the first five months of this year stood at 0,82%.

In March the inflation rate amounted to 0,9% (y/y), which was 0,2 percentage points more than in February. The most significant contribution to the price growth was the growth in prices of

energy, which was the result of an increase in prices of oil products and partly of unfavourable base effect. In May consumer prices rose by 0,2 pp as compared to April and amounted to 0,8% (y/y). The slight price increase was, like in the previous month, due to higher prices of energy. These among other things, had an impact on the increase in housing costs, which grew by 7,6% at the annual level, and prices of transport, which recorded a 6,0% rise. Higher increase was prevented by decrease in the prices of food and non-alcoholic beverages, which in May were reduced by 2,7% at the annual level while at the monthly level they remained almost the same. In the following months inflation pressures should remain weak mainly on account of low domestic consumption.

Since last November a **renewed growth in producer prices of products was observed again**. Thus in January, a 3,0% growth was recorded, while in March and April prices reached a growth of 5,0% and 5,1% respectively. In May, prices continued to grow fast and reached 4,9%. Considerably high growth in prices of products, which are recorded from the beginning of this year, are partly the result of lower basis in last year and partly of negative to slightly positive growth rates during the first five months of the previous year. The growth in producer prices of products was also due to the growth in oil products. Higher prices of these also brought about higher costs in companies which had an influence on the growth in prices of final products.

Inflation and growth of producer prices



Source: Crostat

In the first two months of this year for the first time after 2008, **growth in industrial production was observed**. The most significant contribution to the growth was that of durable and non-durable consumer goods. On average the former increased by 28,5% and the latter only by 8,3%. On the other hand the highest drop was observed in production of intermediate goods, which on average fell by -7,5%. Weak growth in January and February was mainly the result of the base effect and only to a lesser degree of the improved foreign demand and smaller volume of inventories of goods in the last months.

In March slight drop in industrial production (-0,6%) was observed again, which further increased in April (-6,6%) and May (-3,4%). The decrease in the volume of industrial production was mostly contributed to by the fall in the growth of intermediate products (-12,2% in April and -5,4% in May) and the fall in the growth of non-durable consumer products (-3,4% and -5,0%).

Further decrease in the volume of industrial production is the result of low domestic demand and negative economic trends, while foreign demand is too weak to reverse the trend of domestic industry. The actual improvement may only be expected by the end of this year or when the international environment will strengthen so much that it will have positive influence on the domestic demand as well and thus turn the trend of domestic industrial production upwards.

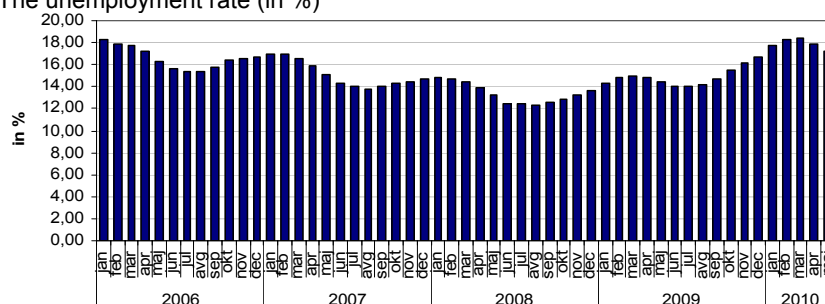
Growth in industrial production was observed in first two months of the year

The average unemployment rate is still relatively high

In spite of rising unemployment at the beginning of this year, in April and May slight improvement was observed in the labour market, as the rate of unemployment dropped from the previous 18,4% to 17,9% (308.675 unemployed persons) in April and to 17,2% (296.348 unemployed persons) in May. Smaller number of the unemployed and the increased employment in the last two months are the result of seasonal works, mainly in tourist sector. Thus in May in this segment there were 6.588 newly employed persons, which was 35,6% more than in the previous month or 18,0% more than in May last year. Total employment increased most in the segment of overnight stays (26,8%), trade (15,9%) and manufacturing (13,0%).

When can we expect improvement in the labour market? When the real sector recovers. In view of the fact that the effects of economic recovery in the labour market are seen with a certain delay, we can expect – according to forecasts of some analysts that economy should slowly recover in the second half of this year (more serious recovery is forecast for 2011) – that the situation on the labour market should start improving in the second half of 2011.

The unemployment rate (in %)



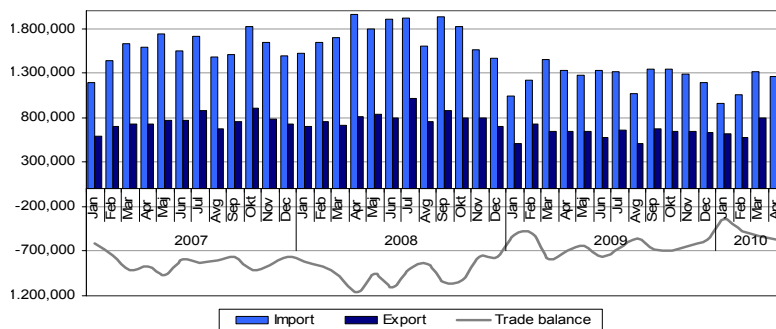
Source: Crostat

After a minor fall in exports in February over January, in March this greatly increased and reached the value of 799 million €, the highest one since 2008. This was mainly the result of the increased ship export in this month. On the other hand the imports amounted to 1.319 million €, which was the highest value after the last October.

The cumulative data for the first four months of this year show that **exports in comparison to the same period last year increased** by 122 million € or 4,8% and so amounted to 2.659 million €, while **imports in the same period decreased** by 453 million € or -8,9% and so amounted to 4.590 million €. Alongside with further decrease of imports, a foreign trade deficit also decreased and in the observed period amounted to 1.931 million €, which represented a 22,9% decrease in comparison to the same period last year. In the first four months the export-to-import ratio improved in comparison to the same period last year (50,6%) and amounted to 58,0%.

This change indicates that foreign demand is slowly experiencing an upward trend, while domestic demand is still in a crunch. The question what will the foreign trade be like for the rest of the year depends mainly on the speed of recovery of international environment, which will have impact also on the speed of recovery of domestic economy.

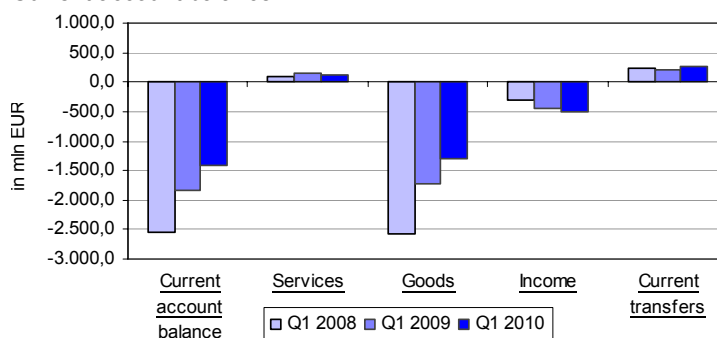
Trade balance (in mio €)



Source: Crostat

In the first quarter of this year, the **deficit in the current account of the balance of payments** was 1,4 billion €. The income balance and the goods balance recorded a deficit in the amount of € -492,6 million and -1.288,6 million € respectively, while the service balance and the balance of current transfers recorded a surplus in the amount of 123,8 million € and 252,7 million € respectively.

Current account balance



Source: HNB

Banking sector and central bank regulations

HNB, which decreased the level of mandatory reserve from 14,0% to 13,0% in February, gave notice that this year it does not intend to further decrease the level of mandatory reserve, because the scope of liquidity should suffice to meet the needs for loans.

The state borrowed from domestic banks 500 million € of syndicated loan to repay previous borrowing. The loan has a variable interest rate of 6-month EURIBOR + 4,25%.

Unfavourable trends in the real sector were reflected also in trends of monetary aggregates. Thus in March, for the first time in four months, a **decrease in monetary aggregate M1 is recorded again**. At the end of March, this amounted to 47,7 billion HRK, which represented a 2% decrease at a monthly level. The most significant contribution to total decrease was that of deposits (-2,8%). At the annual level, the monetary aggregate M1 recorded a growth of 2,3% or 1,1 billion HRK. Growth resulted from lower basis in the last year and relatively high growth rate of deposits. At the end of March, deposits amounted to 32,9 billion HRK, which was 6,9% more than in the respective last year's period, and the amount of cash in circulation amounted to 14,8 billion HRK, which was 6,6% less than in the same period last year.

An increase of M1 monetary aggregate on yearly basis

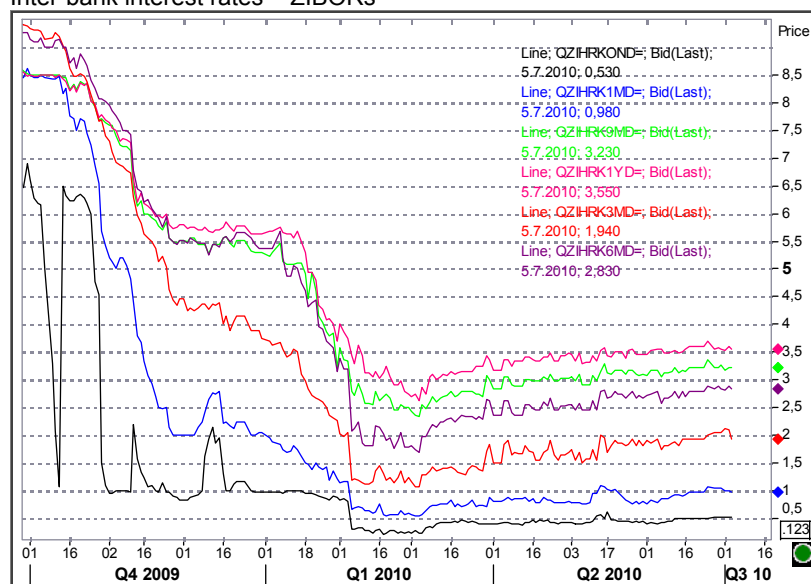
At the end of March, the **monetary aggregate M4** amounted slightly more than 222 billion HRK, which was 0,6% less than the month before. Thus, it increased by 1,6% or 3,4 billion HRK at the annual level. Although there is a growth at the annual level, stagnation is observed. High rate of unemployment and decreased spending of population have negative impact on trends of deposits and thereby on monetary aggregate. Simultaneously with recovery of economy, more considerable growth in monetary aggregates can be expected.

Money and capital market

From the beginning of March and up till the beginning of April, the value of interbank interest rates – Zibor of all maturities slightly increased. So the values as at 1 April moved between 0,40% for the shortest O/N maturity and 3,17% for longer maturities (1Y). Since the end of April and to the beginning of July, slight increase in interest rates of longer maturities (3M, 6M,...) is observed. As at 6 July they ranged between 1,94% and 3,55%, while Zibor for the shortest maturity remained at relatively constant level since the beginning of June and as at 6 July amounted to 0,53%. Liquidity of the banking system still remained at a high level, which is reflected mainly in interest rate movements and in placement of surplus funds over night with HNB.

A slight increase of inter-bank interest rates

Inter-bank interest rates – ZIBORs



Source: Thomson Reuters

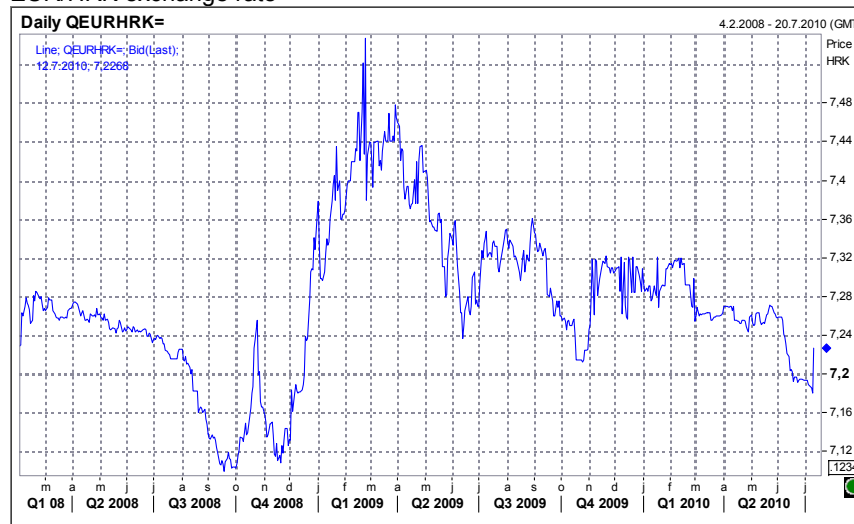
Appreciation pressures on the domestic currency continue. Thus in the second half of June the exchange rate dropped below 7,20 and remained at this low level even in early July. As a result, the mean exchange rate EUR/HRK decreased to the lowest level in comparison to December 2008. The increase in the value of domestic currency is influenced by lower demand for foreign exchange due to a decreased foreign trade, position of investors before subscription of treasury bills with a currency clause and due to speculations on the market regarding release of bonds in the domestic market. Due to the beginning of tourist season and thereby larger inflow of foreign exchange in the country, further appreciation pressures on the domestic currency are expected.

Increasing the value of the domestic currency continues

In this year there were three interventions of HNB in the foreign exchange market, namely on 24 June, 29 June and 9 July, purchasing 363,7 million € from banks. By means of the purchase of euro's HNB wanted to protect the exchange rate against further appreciation.

By buying back euros HNB protects the exchange rate

EUR/HRK exchange rate



Source: Thomson Reuters

From March and until the beginning of July 13 auctions were carried out in total value of 507,6 mio €.

In March, the Republic of Croatia carried out five auctions of treasury bills with standard maturity (3M, 6M and 1Y), the total value of which was 3,4 billion HRK. In April, two auctions of treasury bills with standard maturity in the total value of 728 million HRK were carried out, while in May only one auction in the value of 514 million HRK took place. In June,

developments on the capital market were more dynamic again, as there were four auctions of treasury bills with standard maturity and with the total value of 1,74 billion HRK. In early July, up till now only one auction in the value of 323 million HRK was carried out. In the last six months yields ranged between 2,00% and 2,50% for 91-day treasury bills, between 3,00% and 3,50% for 182-day treasury bills, and between 3,50% and 4,10% for 364-day treasury bills.

Treasury bills issued in HRK

Date of auction	91 day			182 day			364 day		
	Issue size (in 000 HRK)	Weighted average price	Weighted average yield	Issue size (in 000 HRK)	Weighted average price	Weighted average yield	Issue size (in 000 HRK)	Weighted average price	Weighted average yield
2.3.2010	100.000	99,442	2,25%	125.000	98,381	3,30%	240.000	96,627	3,50%
9.3.2010	157.000	99,504	2,00%	125.000	98,526	3,00%	397.000	96,627	3,50%
16.3.2010	70.000	99,505	2,00%	150.000	98,526	3,00%	601.000	96,627	3,50%
23.3.2010	104.000	99,505	2,00%	276.000	98,526	3,00%	340.000	96,164	4,00%
30.3.2010	202.000	99,381	2,50%	160.000	98,526	3,00%	368.000	96,164	4,00%
6.4.2010	172.000	99,381	2,50%	176.000	98,429	3,20%	129.000	96,164	4,00%
13.4.2010	53.000	99,442	2,25%	32.000	98,429	3,20%	166.000	96,210	3,95%
4.5.2010	70.000	99,381	2,50%	82.000	98,405	3,25%	362.000	96,210	3,95%
1.6.2010	143.000	99,405	2,40%	85.000	98,454	3,15%	390.000	96,210	3,95%
8.6.2010	49.000	99,430	2,30%	100.000	98,454	3,15%	235.000	96,210	3,95%
15.6.2010	135.000	99,442	2,25%	43.000	98,454	3,15%	335.000	96,072	4,10%
29.6.2010	28.000	99,442	2,25%	33.000	98,405	3,25%	166.000	95,842	4,35%
6.7.2010	2.000	99,504	2,00%	42.000	98,381	3,30%	279.000	95,843	4,35%

Source: MFRH

At the same time Ministry of Finance also issued treasury bills denominated in euro's for maturity of one year. Since March and up to June 13 auctions were carried out in the total value of € 507,6 million. The return on equity ranged between 3,34% and 3,80%.

Treasury bills denominated in €

Date of auction	364-day			
	Issue size (in €)	Total bids received (in €)	Wighted average price	Weighted average yield
2.3.2010	20.000.000	30.800.000	96,767	3,35%
9.3.2010	20.000.000	5.000.000	96,777	3,34%
16.3.2010	20.000.000	14.300.000	96,778	3,34%
23.3.2010	25.000.000	21.150.000	96,350	3,80%
30.3.2010	20.000.000	9.050.000	96,349	3,80%
6.4.2010	20.000.000	20.220.000	96,395	3,75%
13.4.2010	15.000.000	13.000.000	96,441	3,70%
4.5.2010	25.000.000	100.400.000	96,488	3,65%
1.6.2010	50.000.000	102.781.000	96,534	3,60%
8.6.2010	50.000.000	83.080.000	96,581	3,55%
15.6.2010	70.000.000	58.400.000	96,534	3,60%
29.6.2010	30.000.000	36.800.000	96,534	3,60%
6.7.2010	20.000.000	12.650.000	96,534	3,60%

Source: MFRH

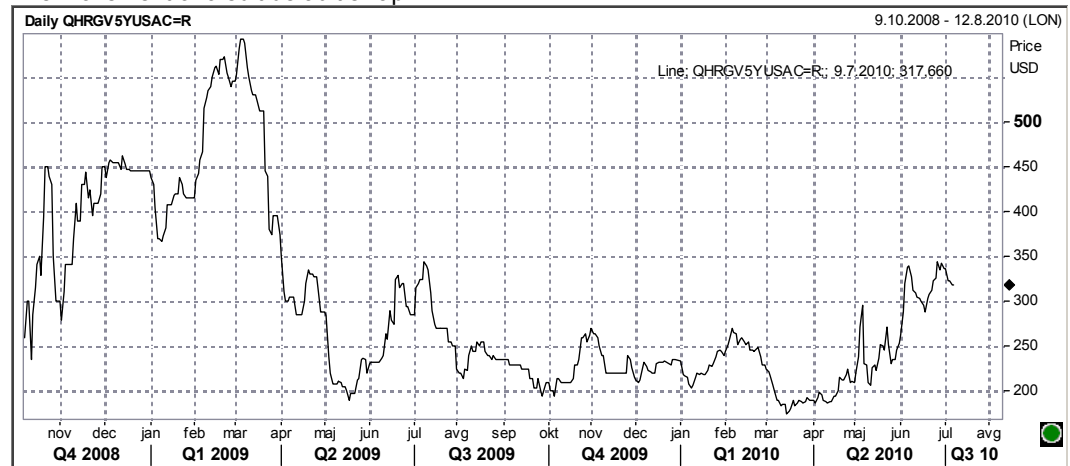
First issue of 10-year bond denominated in USD after last October

On 6 July Croatia **issued** on the international market a **10-year bond denominated in dollars** in the amount of 1,25 billion USD with a 6,75% yield at the price of 99,102. The bonds fall due on 14 July 2020. By this issue it intends to cover this year's budget deficit, which should due to lower income than initially planned, amount to around -8,6 billion HRK (1,59 billion USD). This is the second issue of bonds denominated in dollars, while with the first one in October last year it collected 1,5 billion USD.

From the perspective of the derivative CSD their value increased in comparison to the March. As at 8 July Croatian **CDS** is around 317 **basis points**. The higher value of derivatives reflects worse situation on the capital market.

0#HRBMK= HR - BENCHMARK											
Name	Coupon	Mat.Dat	Curr	Bid	Ask	Net.Chng	Bond Type	B Yld	A Yld	Yld Net.Ch	Bmk Spread
3M DEPOSIT				B1.940	A2.440	0	FIX	1.940	2.440		
6M DEPOSIT				B2.830	A3.330	0	FIX	2.830	3.330		
9M DEPOSIT				B3.230	A3.730	0	FIX	3.230	3.730		
1Y DEPOSIT				B3.550	A4.050	0	FIX	3.550	4.050		
3Y T-BOND	4.5	11JUL13	HRK	B↑98.220	A98.720	0	STR	5.149	4.965	+0.001	
5Y T-BOND	5.25	15DEC15	HRK	B↑98.220	A98.720	0	STR	5.635	5.525		
7Y T-BOND	4.75	08FEB17	HRK	B↑93.220	A93.720	0	STR	6.014	5.917	+0.001	
10Y T-BOND	6.75	05MAR20	HRK	B↑103.020	A103.520	0	STR	6.325	6.257	0	

The movement of credit default swap

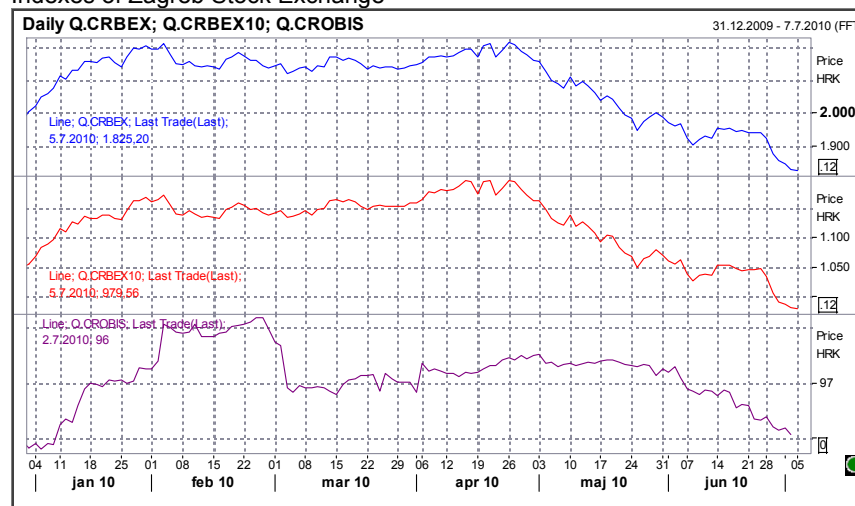


Source: Thomson Reuters

Trading at the Zagreb Stock Exchange in the first half of this year was half less active in comparison with the second half of last year, because the turnover in shares decreased by 19,5%. In the first six months the largest turnover was generated in the shares of HT, followed by Zagrebačka pivovara d.d., Atlantska plovidba d.d. etc. The total value of turnover in the first half amounted to 2,7 billion HRK, and market capitalisation of shares was 125.028,2 million HRK.

At the end of June **CROBEX index** amounted to 1.855,19 points, which was 6,6% less than in May. **Index CROBEX10** fell somewhat more and decreased by 7,4% with regard to the previous month and thus settled at around 991,37 points. The value of **index CROBIS** dropped by 1,1% and amounted to 96,15 points at the end of June. In early July the value of CROBEX index dropped to 1.829 points and the value of CROBEX10 index to 981 points. Both indices thus reached the lowest levels since the end of last year's July. In comparison to the beginning of this year CROBEX index lost 8,76% of its value and CROBEX10 index 6,93 of its value.

Indexes of Zagreb Stock Exchange



Source: Thomson Reuters

Croatian group
Atlantic Grupa
bought Droga
Kolinska

The Slovenian Istrabenz sold to the Croatian group Atlantic Grupa a 95% share of Droga Kolinska. The value of the purchase is 382 million €. The sale should be concluded by the end of the year, whereby the purchase amount shall be paid in cash. By means of this takeover the Group will strengthen and consolidate the existing portfolio in the region and thus become one of the major food processing companies in the South-East Europe.

International rating of credit risks

	S & P	Moody's	Fitch	Main disadvantage
Croatia	BBB	Baa3	BBB-	Extremely high external debt and growing current account deficit of the balance of payments
	Negative	Stable	Stable	

Institution		BDP - real growth (in %)	Inflation - dec/dec	Inflation - average	Current Account balance (% BDP)	Budget balance (% BDP)	Unemployment rate (registered)	Foreign debt (% BDP)
	2009	-5,8	1,9	2,4	-7,8	-2,9	16,7	95,0
The government	2010E	-0,5		2,7		-2,5		98,0
Ekonomic institute, Zagreb	2010E	-0,7		1,6	-4,6	-3,8		100,2
	2011F	2,2		3,0	-5,3			
UniCredit Bank	2010E	-1,5		1,0	-3,4	-5,9	10,0	104,1
	2011F	1,6		2,9	-3,5	-4,9	9,6	106,7
Raiffeisen Bank	2010E	-0,9	3,9	3,2	-7,0	-3,7	15,9	98,1
	2011F	2,6	3,2	3,5	-4,9	-2,8	15,2	96,0
IMF	2010E	0,2			-6,9	-3,0	9,8	
BMI	2010E	1,1					16,0	
	2011F	2,3					14,0	
	2012F	3,5					12,0	

Croatia	GDP real growth	Industrial output	Inflation (CPI)	PPI	Gross wages nominal growth	Unemployment rate	Current account	Trade balance	
12 month average index (in %, I-XII / I-XII)							S ^a in mio EUR		
2001	3,80	6,00	3,80	3,68	3,90	22,00	-820,80	-5.032,57	
2002	5,40	5,40	1,70	-0,40	6,00	22,30	-2.098,70	-5.540,21	
2003	5,00	4,10	1,80	1,93	4,80	19,10	-1.888,90	-6.373,75	
2004	4,20	3,70	2,10	3,50	6,40	18,50	-1.433,70	-6.317,30	
2005	4,20	5,10	3,30	3,04	4,40	17,80	-1.975,60	-7.880,00	
2006	4,70	4,50	3,20	2,90	6,20	16,60	-2.717,10	-8.842,80	
2007	5,50	5,60	2,90	3,40	5,20	15,10	-3.236,10	-9.825,00	
2008	2,40	1,60	6,10	8,40	7,10	13,40	-4.337,80	-11.241,80	
2009	-5,80	-9,20	2,40	-0,40		14,90	-2.447,80	-7.701,77	
Annual indeks (in %, y/y)							S ^a in mio EUR		
2009	Jan	-14,10	3,40	1,80	4,80	14,30		-523,00	
	Feb	-12,40	4,20	1,80	3,50	14,80		-496,00	
	Mar	-6,70*	-6,60	3,80	-0,10	5,60	15,00	-1.844,7*	-795,00
	Apr	-7,10	3,90	-0,10	4,10	14,80		-692,00	
	Maj	-7,30	2,70	-0,70	1,60	14,40		-639,00	
	Jun	-6,30*	-13,70	2,10	-1,00	4,40	14,00	-875,7*	-756,00
	Jul	-9,00	1,20	-2,80	1,80	14,00		-661,00	
	Avg	-8,30	1,50	-1,80	1,90	14,20		-563,00	
	Sep	-5,70*	-9,60	1,00	-2,30	0,60	14,70	1.788,4*	-680,00
	Okt	-7,10	1,30	-1,40	0,30	15,50		-692,00	
	Nov	-9,90	1,80	0,20	-0,30	16,10		-637,00	
	Dec	-4,40*	-7,20	1,90	1,60	-1,10	16,70	-1.515,8*	-567,00
2010	Jan	1,50	1,10	3,00	-1,20	17,70		-340,06	
	Feb	0,10	0,70	2,70	-1,80	18,30		-474,18	
	Mar	-2,50*	-0,60	0,90	5,00	0,20	18,40	-1.404,6*	-524,78
	Apr	-6,60	0,60	5,10	-1,20	17,90		-574,37	
	Maj	-3,40	0,80	4,90		17,20		-464,96	

*/ Q1, Q2, Q3, Q4

Source: Croatian National Bank; Crostat

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