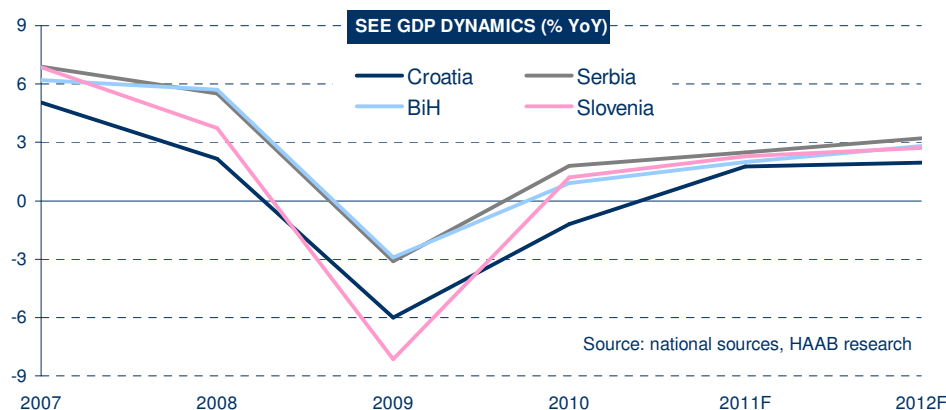


**MACROECONOMIC RESEARCH: SEE QUARTERLY**

# SEE: A MIXED BAG OF RECOVERY PATTERNS



## Slovenia: Recovery continues, fiscal austerity backloaded

- Recovery broadening continues
- Inflation modestly higher
- C/A shortfall creeping again
- Backloading fiscal consolidation?
- Attractive debt if reforms accelerate

## Croatia: Lagging recovery and fiscal uncertainties

- No swift industrial rebound
- C/A deficit nowhere close pre-crisis levels
- Is inflation returning?
- A weaker kuna backdrop
- Fiscal uncertainties abound

## Serbia: High inflation and FDI uncertainty hurt outlook

- GDP maintains a modest uptrend
- New IMF program to help rebalancing
- C/A gap to widen slightly
- Good bye inflation target for 2011!
- NBS continues to hike
- More stable dinar profile
- No serious fiscal tightening

## Bosnia and Herzegovina: Political instability impedes recovery

- Further support from exports
- Monetary condition loosened
- Inflation outlook revised higher
- The renewed C/A deficits expansion

## SEE Equities - Growth drivers still intact

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## Recovery continues, fiscal austerity backloaded

**Recovery broadening continues.** The rebound in real GDP growth in 4Q10 to 2.1% yoy mirrors the economy's acceleration to 0.6% qoq vs 0.3% in Q3 on seasonally-adjusted data. This improvement largely owes to surprisingly positive investments and consumption, while their very high import content briefly slashed otherwise hefty net exports contribution through 2010. While investment spending reflects still decent export outlook and the catching-up effects after the 2009 crisis, we also think the ongoing de-leveraging in a few problematic areas (notably construction, financial holding companies), further bankruptcies and the looming fiscal austerity pose downside risks. Admittedly, private consumption seemingly defied 7%+ unemployment, but nevertheless holding onto 4%-alike real wage growth and improved business/consumer sentiment gauges. Given that the WEU is expected to perform well in 1H11, and the order stock is also at a high level, Slovenian exports can have a good performance through 2011 as well. In essence, the EU recovery continues and matures, after the export boom, it is now clear that investment is picking up, while the third step of the recovery, namely the labour market, is increasingly showing signs of stabilisation.

Following a subdued 2010, we expect real GDP growth around 2% in 2011, still driven by exports, whereas fixed investment and private consumption begin to recover slowly after two successive years of decline. That said, while the underlying external demand remains strong, we also think the unfavourable structure of exports, which have a fairly high share of cyclically sensitive, low/medium technology goods, and past competitiveness erosion will likely result in Slovenian export underperformance in the CEE context. On a more encouraging note, most recently the increasingly positive spread between productivity and real gross wage growth of about 11pp (on 6mma average basis) shows that producers have indeed tackled difficult operating conditions. As long as fiscal tightening is back-loaded in a sense of domestic demand damage control, and weak balance sheets of state-owned banks weigh on growth prospects, we can't see any swift private demand recovery. Hence, consumption will be constrained by high unemployment, public wage restraint and uncertainty over entitlement reforms, and private capex will depend more on top-down structural reforms to restore competitiveness and banks' soundness.

**Inflation modestly higher.** CPI inflation will certainly climb through 2011, albeit the government's restraint on public wages and pensions will partly offset pressures emanating from global energy-to-food prices and a small increase in domestic demand. More worrisome, the risk premium because of the upheaval in MENA countries is unlikely to come down much, if at all, in the short term. Rising imported costs are also putting pressure on core prices, with the EC survey's 'selling price expectations' in industry as well as the manufacturing PMI's input and output price balances rising above their 2008 peaks. Another risk is that inflation may accelerate more quickly than forecast if wage growth is not restrained effectively. That said, we largely share the central bankers' concerns that inflationary pressures could additionally affect competitiveness and economic growth. Moreover, the ECB obviously wants to move pre-emptively to safe-guard mid-term price stability, while its confidence in the sustainability of the recovery has been increasing.

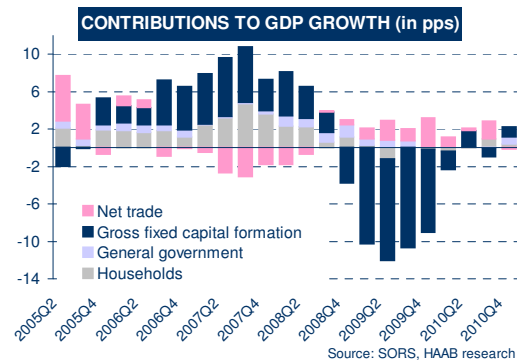
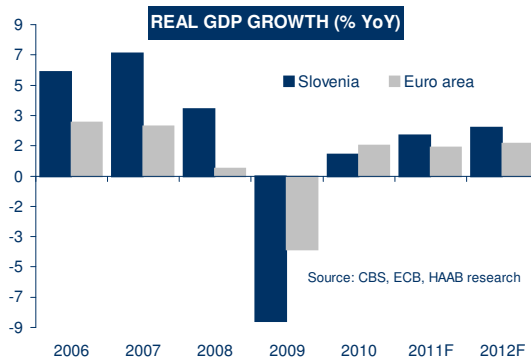
**C/A shortfall creeping again.** With above all surging commodity prices and also gradual recovery in domestic demand, we see the C/A gap widening through 2011-2012, despite decent export growth and greater absorption of EU funds. On the funding side, we think the rebound in FDI from 2010 has legs in view of the improved financial flows between affiliated firms, but also greater needs for fresh equity investment in the wake of financial restructuring of the largest holding companies and the government's non-strategic asset sales in the medium term. Meanwhile, outward FDI should also pick up as Slovenian firms resume regional expansion. At the same time, C/A financing issues thus could be less relevant for markets as the ongoing substantial (quasi)sovereign foreign debt inflows and higher intra-company lending also remain a feature of C/A trends. That we do not expect major external (re)financing problems reflects our belief that the EU's excessive deficit procedures will pave the way for a gradual healing of Slovenian public finances, fair growth prospects, and the expectation that interventionist liquidity provisions will be maintained for the time being. We do not exclude that deleveraging in some problematic sectors of the economy could potentially translate into overall corporate external borrowing being below refinancing needs, albeit this is not our baseline scenario.

**Backloading fiscal consolidation?** Having maintained expansionary fiscal policy in 2009-2010 to underpin recovery, Slovenia will begin fiscal consolidation in 2011, hence moving more slowly than envisaged in the 2013 exit plan. That said, the YE10 fiscal deficit remained high at 5.4% of GDP, courtesy of CIT/PIT underperformance and lower than envisaged EU funds absorption. The near-halving of public capex co-financed with the latter has prevented an even bigger blow to the state budget. In 2011-2012, public wage restraint and less generous indexation of social transfers will certainly help consolidation efforts, but the export nature of GDP recovery as opposed to tax-rich demand growth will see budgetary revenue performance subdued. Besides, far-reaching reforms like the pension bill, labour market flexibilization, entitlement reforms, not to mention bigger privatizations, that would bring savings over the medium to long term are likely to disappoint expectations in the run-up to 2H12 elections. Especially the national referendum rejection of pension reforms in May would shed a negative light on the capacity of the government to tackle the long-term sustainability of public finances, also triggering the need for EUR250m-alike savings already in 2011.

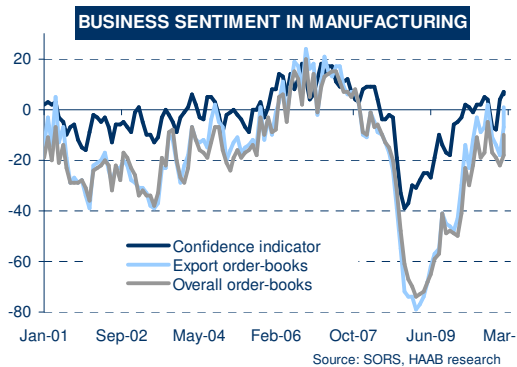
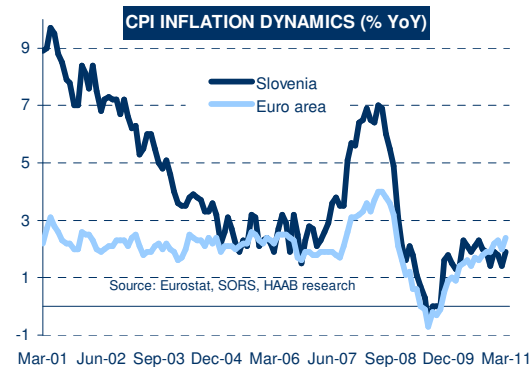
Having incorporated cautious no policy change assumption, we continue to see fiscal shortfall in excess of 4.5% of GDP through 2012 unless the cabinet can clear all the legal hurdles that stand in the way of significant reform momentum. All the above mentioned risks to overspending will come high on the agenda ahead of the 2012 elections. Therefore, since the trends in public finances must also reflect the likely slippage in meeting the official, EU enshrined 3% fiscal gap target by 2013, we expect public debt and gross public funding needs in 2012 will top 46% and 8% (of GDP), respectively, which would warrant extra spending cuts as to also offset higher interest outlays down the road. Still, the biggest issue for Slovenian finances, in our view not entirely appreciated by the markets, is that pushing back the timing of pension reforms leads to higher budget transfers to the pension funds (gradually) rising to EUR2bn p.a. by 2020. That said, Slovenia has clearly frontloaded its borrowing plans, having launched a 10Y EUR1.5bn Eurobond in January, followed by a 15Y EUR1.5bn issuance in late March, ensuring perhaps a full cover of its 2011 net borrowing needs and effectively a time-out before the markets punish Slovenian assets for the country's relatively slow reform drive.

**Attractive debt if reforms accelerate.** Despite still relatively better fiscal metrics relative to most EMU members, we think Slovenian spreads will likely exhibit some volatility in the near-term. Namely, on one hand, a comparison of Slovenian public finances to the eurozone average still shows that Slovenian public debt sub-50% of GDP has been indeed a rare exception to the general rule, while its fiscal shortfall looks much sounder than in most EMU countries. On the back of premises above, despite relatively poor liquidity of Slovenian bond issues, the ASW pickup of Slovenian issues relative to similar core equivalents (e.g. 15-40bp over Belgian curve in the 5-10Y area) is attractive in the long run, especially should structural reforms accelerate convergence to euro zone income levels. We would, however, maintain a wider spreads preference in the near term given that (i) Slovenia's referendum rejection of the pension reforms may speed up a ratings downgrade of the country with the highest credit score in Eastern Europe, and consequently (ii) EMU fiscal jitters (with e.g. Portugal entering the EFSF) are affecting Slovenia's external financing conditions. Further deterioration in banks' asset quality as well as profitability remains a non-negligible risk, particularly if it required major recapitalisation by the sovereign could also lead to negative rating action.

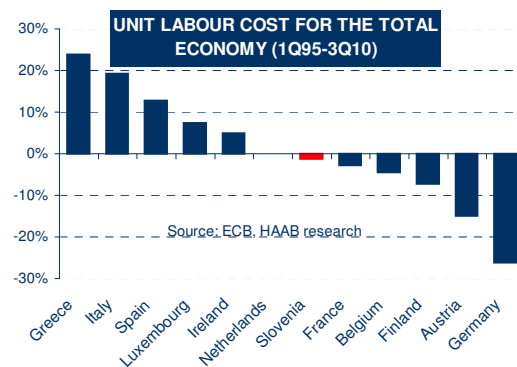
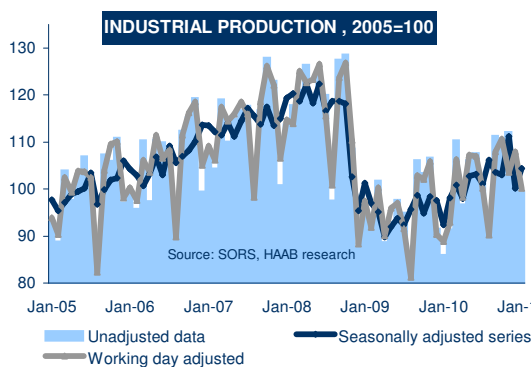
The 4Q10 GDP growth acceleration owes to surprisingly positive investments and consumption. We expect real GDP growth just above 2% in 2011, still driven by exports, whereas fixed investment and private consumption begin to recover slowly.



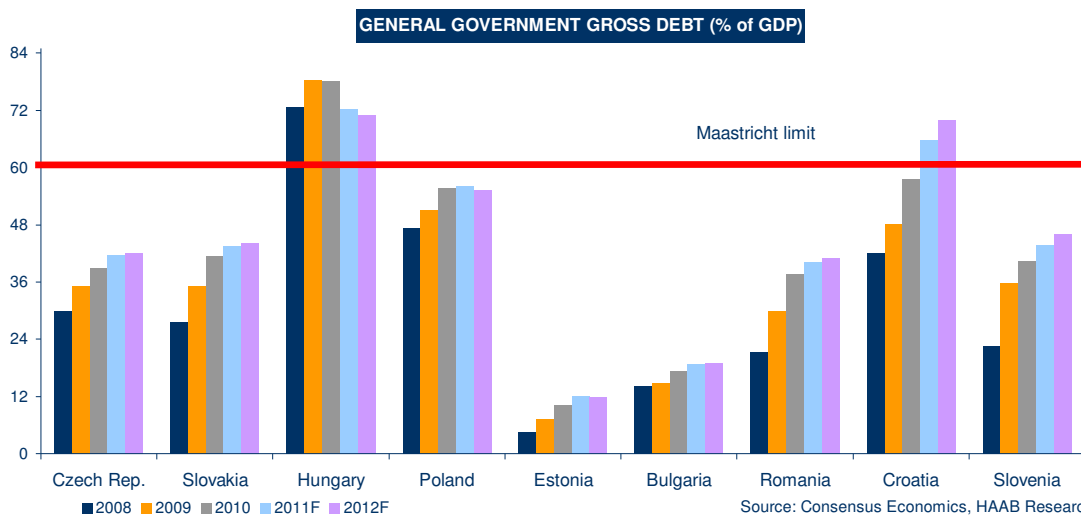
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## SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011F	2012F
<b>Activity</b>						
Nominal GDP (EURbn, current prices)	34,6	37,3	35,4	36,1	37,7	39,9
Nominal GDP (USDbn)	47,3	54,6	49,2	47,8	52,6	57,0
GDP per capita (EUR)	17.123	18.450	17.331	17.582	18.400	19.464
GDP per capita (USD)	23.467	27.136	24.174	23.291	25.643	27.773
Real GDP (constant prices YoY, %)	6,9	3,7	-8,1	1,2	2,3	2,7
Private consumption (YoY, %)	6,7	3,6	-1,6	0,5	1,1	2,4
Fixed investment (YoY, %)	12,8	8,5	-21,6	-6,7	3,4	5,3
Industrial production (YoY, %)	7,5	1,6	-17,1	6,7	5,0	5,5
Unemployment rate end-year (ILO, %)	4,9	4,4	5,9	7,3	7,2	6,9
<b>Prices</b>						
CPI inflation (average % YoY)	3,6	5,7	0,9	1,8	2,3	3,0
CPI inflation (end-year % YoY)	5,6	2,1	1,8	1,9	3,0	2,8
PPI inflation (average % YoY)	4,2	3,9	-1,3	2,1	3,4	2,8
PPI inflation (end-year % YoY)	3,4	2,2	-1,2	4,2	3,3	2,7
Net wage rates (% YoY, nominal)	5,9	7,9	3,5	3,9	2,5	3,2
<b>Fiscal balance (% of GDP)</b>						
State budget balance (ESA-95)	0,0	-1,7	-5,5	-5,4	-5,0	-4,6
Public debt	23,4	22,6	35,9	40,3	44,0	46,3
<b>External balance</b>						
Export of goods and services (EURbn)	23,944	25,091	20,468	22,713	24,212	25,599
Import of goods and services (EURbn)	-24,562	-26,248	-20,053	-22,621	-24,236	-25,521
Merchandise trade balance (EURbn)	-1,666	-2,650	-0,699	-0,962	-1,094	-1,394
Merchandise trade balance (% of GDP)	-4,8	-7,1	-2,0	-2,7	-2,9	-3,5
Tourism receipts (EURbn)	1,666	1,918	1,800	1,743	1,816	1,888
Current account balance (EURbn)	-1,646	-2,489	-0,526	-0,417	-0,740	-1,089
Current account balance (% of GDP)	-4,8	-6,7	-1,5	-1,2	-2,0	-2,7
Net FDI (EURbn)	-0,2	0,4	-0,5	0,5	0,8	1,3
FDI (% of GDP)	-0,6	1,0	-1,5	1,4	2,1	3,3
FDI cover (%)	-12,8	15,3	-102,5	125,2	108,1	121,2
Gross international reserves (EURbn)	0,724	0,703	n/a	n/a	n/a	n/a
Import cover (months of imports)	0,4	0,3	n/a	n/a	n/a	n/a
<b>Debt indicators</b>						
Gross external debt (EURbn)	34,783	39,234	40,276	40,851	43,518	46,850
Government (EURbn)	3,036	3,736	6,570	8,167	9,687	11,577
Private (EURbn)	28,159	31,866	30,110	30,309	30,831	32,273
Gross external debt (% of GDP)	100,6	105,2	113,8	113,3	115,3	117,4
Gross external debt (% of exports)	145,3	156,4	196,8	179,9	179,7	183,0
<b>Exchange rates and money growth</b>						
EUR/USD (end-year)	1,47	1,42	1,43	1,31	1,36	1,39
EUR/USD (average)	1,37	1,46	1,39	1,32	1,39	1,43
Money supply M1 (% YoY)*	-6,6	-3,7	7,7	13,5	5,4	5,8
Broad money M3 (% YoY)*	5,0	8,9	0,6	4,5	4,2	6,6
Domestic credit (% YoY)	32,3	18,1	2,8	3,3	5,7	6,5
ECB reference rate (end-year %)	4,00	2,50	1,00	1,00	1,75	2,75
EURIBOR 3M interest rate (end-year %)	4,68	2,89	0,70	1,01	2,00	2,95
SLO 2016 government bond yield (end-year %)	4,5	4,2	3,7	3,6	4,0	4,2

\* Since 2007 ECB data

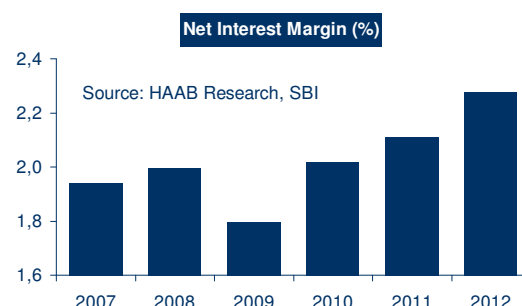
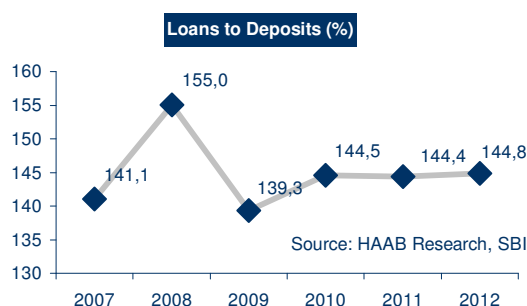
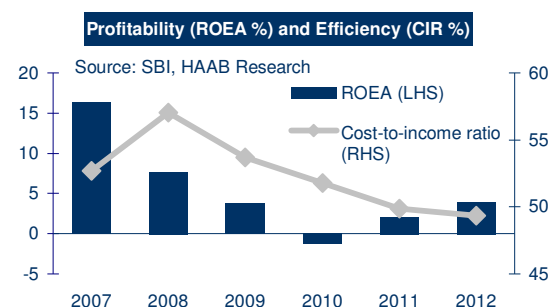
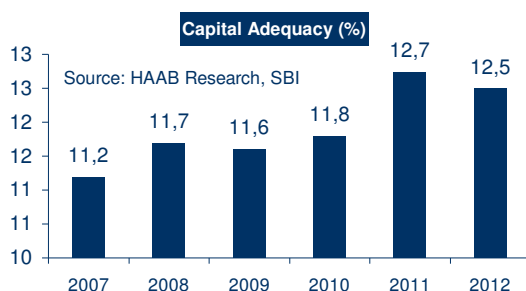
Source: Slovenian National Bank, Statistical office of the Republic of Slovenia, Ministry of Finance, IMF, HAAB research

## SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011F	2012F
<b>Balance sheet figures and ratios</b>						
Assets (EURm)	42.095	47.369	51.923	51.307	53.257	55.355
Loans (EURm)	26.715	31.549	32.443	33.515	35.425	37.732
Loans (% YoY)	32,3	18,1	2,8	3,3	5,7	6,5
Loans (% of GDP)	77,3	84,6	91,7	92,9	93,9	94,5
Deposits (EURm)	18.937	20.349	23.289	23.186	24.531	26.052
Deposits (% YoY)	8,4	7,5	14,4	-0,4	5,8	6,2
Deposits (% of GDP)	54,8	54,5	65,8	64,3	65,0	65,3
Loans-to-deposit ratio (%)	141,1	155,0	139,3	144,5	144,4	144,8
Capital adequacy ratio (%)	11,2	11,7	11,6	11,8	12,7	12,5
<b>P&amp;L figures and ratios</b>						
Net interest income (EURm)	816	945	932	1.036	1.124	1.259
Total operating income (EURm)	1.433	1.360	1.425	1.471	1.574	1.700
Net reservations & adjustments (EURm)	163	278	500	757	742	668
Pre-tax profit (EBT, EURm)	514	306	161	-48	93	178
Net interest margin (%)	1,9	2,0	1,8	2,0	2,1	2,3
Cost-to-income ratio (%)	52,7	57,1	53,7	51,8	49,9	49,4
ROEA (Pre-tax income/equity, %)	16,3	7,7	3,7	-1,2	2,1	4,0
ROAA (pretax, %)	1,2	0,6	0,3	-0,1	0,2	0,3
Non-performing loans (%)	2,5	2,9	3,7	6,8	11,0	9,6
Cost of risk (% of outstanding bank loans)	0,6	0,9	1,5	2,3	2,1	1,8

Source: Slovenian National Bank, HAAB research

**Highlights:** In 2010, Slovenian banking system posted pre-tax loss of EUR48m vs profit of EUR161m a year earlier mostly on deteriorated asset quality, hence hefty provisioning in 4Q10 (up 44% yoy). Although corporate lending fell by 2.6% yoy, Slovenian banks' loans structure still depicts high corporate loan concentration (50% of the total) at end-2010. The decrease in deposits of the non-banking sector in 2010 courtesy of a significant decline in government deposits saw the loan-to-deposit ratio surge by 520bp yoy. Further deleveraging in real sector as well as faster rising households' saving ratio will allow better deposit collection in 2011, hence bring about stabilization in the loan-to-deposit gauge. Meanwhile, ongoing weakness of Slovenian corporate sector (construction and highly indebted holding companies, in particular) could result in further deterioration in assets quality and induce recognition of bad debt. Thus, we expect NPL to top 11% in 2011 on intensified troubles with SMEs heavily interconnected business-wise with debt-burden blue-chips.



## Lagging recovery and fiscal uncertainties

The CBS revised up 4Q10 GDP (-0.6% yoy) by one tenth for a 0.2pp lower FY10 GDP fall (-1.2%) than initially reported. Downward revisions of 2009 data, especially on net exports, are also behind better FY10 outcome. The key culprits behind Q4 decline include inventory drawdown and ongoing albeit slowing investment slump in light of working capital-restrained corporate reality and chronic absence of FDI. These were partly offset by strong net exports contribution mostly due to hefty shipbuilding and commodity exports. Private spending slowdown relative to Q3 owed to job-shedding, uncertainties over entitlement reforms, onerous households' debt-servicing costs and consumer pessimism. Croatia will remain one of the slowest recovering economies in CEE in 2011 for several reasons. For starters, despite low base effects and electioneering in 2011 (e.g. road-building plans doubled!), we think contours of post-election austerity, overdue restructuring and unemployment will check domestic demand. With the real wage deflation, citizens' de-leveraging and food inflation only aggravating consumer fundamentals, the best we see is a capex reversal from 2H11 on better sentiment ahead of the EU entry and stronger large corporate credit (+12% as seen by TOP6 banks). Moreover, even if EMU fiscal woes and commodity shocks do not derail external demand, we expect even a gradual improvement in import-intensive local demand and weaker export momentum to bring about 3.5pp lower net trade contribution. The ECB tightening and risk aversion in response to growing fiscal risks may also hurt the outlook.

**No swift industrial rebound.** Industrial output has yet to bottom out as stronger orders work their way through. Poor local demand (notably for capex) and competitiveness erosion result in much shallower performance in CEE/SEE comparison. Indeed, it is disappointing that Croatia has been the worst performer in its flagship intermediates despite actually most pronounced German demand within exactly semi-finished goods segments. That the forward-looking PMIs from the main EU trading partners stay above their long-run averages is not decisive for Croatian industry in the near term as the goods export sector is simply too small to offset headwinds from local demand and the long overdue and EU-required corporate restructuring. Given still positive external influences, manufacturers' productivity outpacing the real gross wage growth by 6-7pp alongside rising REER, and stocks replenishment after almost two-year long steep decline, we see industrial output growth closer to a 2.5% new normal in 2011. It is 'only' that we do not see material product/market mix nor technology changes that would ensure sustainable industrial recovery and thus faster convergence.

**C/A deficit nowhere close pre-crisis levels.** The Q4 C/A deficit sank 31% yoy to EUR1,055m on ~20% lower merchandise trade gap thanks to hefty shipbuilding exports, stronger/pricier commodity exports, but also stagnating imports courtesy of poor domestic demand. In relation to GDP, the C/A gap narrowed on a 4-quarter trailing basis to a record low 1.4% from 2.5% at end-3Q10. Tourism receipts were 4% yoy lower for a 2% FY10 decline (to EUR6.2bn) as the combination of package discounts across Mediterranean and tight household budgets offset supportive factors from the Greek crisis. Moderating foreign demand and weaker/not any more subsidized shipbuilding orders suggest the slowdown in Croatian exports to 5%-alike pace is underway. With also a genuine commodity shock, gradual import-intensive recovery in domestic demand, stronger credit activity and higher dividend outflows, we see the 2011 C/A gap near 3.5% of GDP, but nowhere close to pre-crisis levels. While irregular dividends and debt costs pose upside risks to the C/A deficit, we think these are also partly offset by constructive tourism outlook given resilient consumer confidence on the key source markets (Germany!) and rising hotel occupancy as well.

Despite a near FDI drought plus sharp non-resident withdrawals of retained profits (largely financials) in Q4, the four-quarter net FDI cover remains above 90%, albeit only due to greater than expected C/A gap shrinkage. Despite some upside in M&A activity, FDI outlook is weak, given the sluggish mid-term economic perspective, no big state asset sales this side of elections and Croatian firms' seeking M&A deals abroad (e.g. ATGR's acquisition of Kolinska). Given also no economic reasoning for external bank sources of finance in liquidity abundant banking system, we think 2011's funding options largely rest on a smart balance between (quasi)sovereign debt and portfolio inflows. Indeed, having just sold a 10Y USD1.5bn bond, Croatia is already eyeing another EUR1-1.5bn issuance this spring, leading to a record reliance on portfolio flows in C/A funding (around 5% of GDP). Even without a major FDI rebound, we anticipate a closure of the basic balance (C/A+FDI) gap, which is certainly kuna supportive as long as 32%/GDP-alike external short-term debt is comfortably refinanced.

**Is inflation returning?** EM-driven commodity-price rally and MENA turmoil raise concerns about a repeat of the 2008 CPI inflation spike, with world agricultural and metal prices indeed back at contemporary highs. In the case of food, Croatia's dominant net importer status and a high share (23%) of processed food CPI only enhance the external pass-through impact. Still, we see inflation as moderate given poor consumer demand and stable kuna taming the price growth. Rising unemployment, real disposable income deflation, negative feedback loop from commodities and subdued retail lending all hit purchasing power. There are upside risks to our inflation projections from administered price hikes (~25% of CPI basket), but we don't get too excited about that in the election year. While we see some slowdown in inflation in spring as commodity pressures ease, with some gradual upward normalization in domestic inflation underway, we see average CPI at 2.5% or slightly higher this year. The biggest risk to medium term inflation emanates from the long overdue market-oriented energy price adjustments.

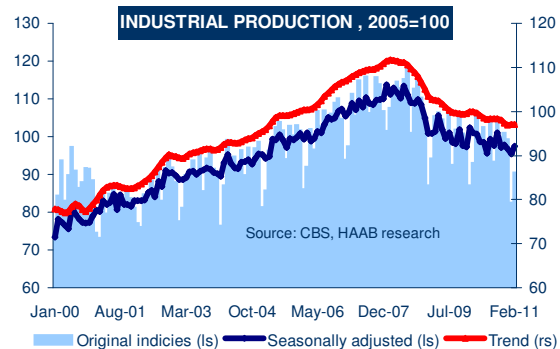
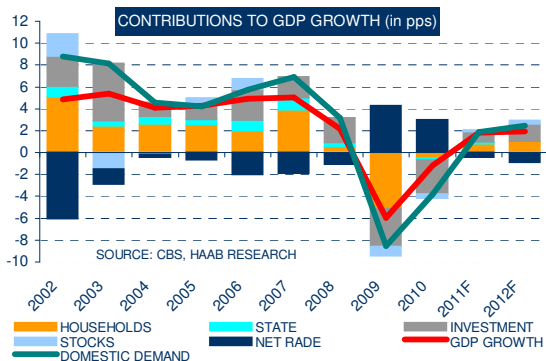
**A weaker kuna backdrop.** Corporate external de-leveraging, bank profit repatriation and bank provisioning after-effects largely explain somewhat weaker kuna profile since last winter. Thankfully, further sovereign ability to (re)finance abroad, still 300bp+ higher goods import cover and the CNB's FA/FL ratio 3pp cut to 17% that brings EUR850m in new FC liquidity have all discouraged speculative longs. The FX stability and thus CNB-supported excess HRK5bn+ inter-bank liquidity - against muted credit activity have seen short-end rates not far off their record lows (within 0.5-3%), with the market participants also fully aware of the CNB's easing bias in the medium term. Hence, T-bill yields have just followed suit, as investors, given ample liquidity and little alternative investment options, remained insensitive to poor fiscal discipline. Also, tolerable FX risks going forth and substantially reduced supply have seen kuna bond spreads tighten by up to 140bp (on 5Y+ maturities) in about five months.

While the basic C/A balance, slightly lower debt service and (quasi)sovereign borrowing are kuna supportive, we keep slightly bearish outlook for 2011 on negative net trade contribution, income-to-capital outflows, further bank provisioning and fiscal jitters. The increasing reliance on portfolio flows is slightly worrying too should this issue gain more attention in the market. The CNB's recent FC liquidity relaxation on top of enhanced CBRD credit schemes is certainly credit activity supportive, especially when considering the ongoing state crowding out private credit. However, we do not exclude the CNB's liquidity withdrawals on any signs that the monetary easing adds to external imbalances and fuels FX volatility. The sovereign's failure to borrow from abroad is the key upside risk factor for short-end kuna rates in an abundant liquidity environment. Still dovish CNB against fiscal risks, thus relatively stronger pressure at the long-end, forebode steeper yield curve. Momentarily reduced supply of Eurobonds replaced by new benchmark USD bonds and non-market funding, allowing some spread compression on the former, suggests renewed upward pressure on yields, when Croatia aims to boost euro issuance. Neither the EU accession story nor improved risk appetite for EM assets of late are panacea per se.

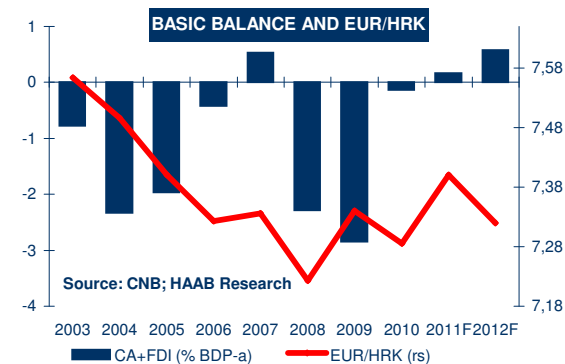
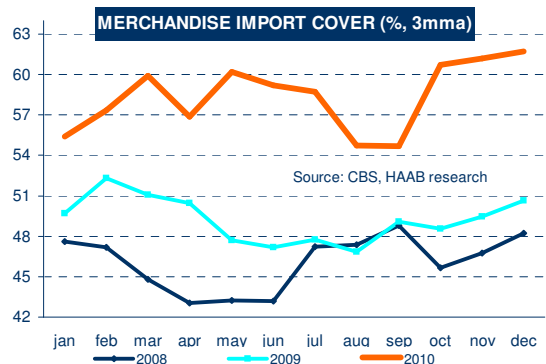
**Fiscal uncertainties abound.** The electoral 2011 general budget is largely a carryover from 2010, with upwardly revised official fiscal deficit target of 5.1% of GDP (prev. 4.3%). Even if the budget benefits from the full-year effect of abolished PIT relief and ongoing freeze of public sector wages and pensions, there is still need for ex ante 1-2pp discretionary fiscal cuts given that HRK1.5bn higher interest costs, higher pension bill and the EU-related outlays will raise total spending anyway. The grim reality is that mandatory spending nears 90% share of total spending and the pension deficit exceeds 5% of GDP unless excessive entitlement spending cuts are on the table. Further risks are related to shipyards' restructuring cost, likelihood of costly populist moves ahead of elections and rising public payment arrears.

All in, our consolidated general deficit forecast for 2011 (inc. quasi-fiscal stuff) nears 7.5% of GDP, which leaves the public debt on an unsustainable path. Namely, with the structural budget deficit stuck in the 4% area, usual no policy change assumption and up to 2pp higher funding costs than the underlying GDP growth, we can see the public debt/GDP ratio spiralling upwards by 5pp+ p.a. towards 75% of GDP by 2013 from 2010's 58%. Hence, Croatia's status of a regional fiscal laggard in a spread widening environment, weak external funding flexibility and structural impediments to growth have raised the risk of a sub-investment grade rating. While details on austerity moves past the electoral 2011 are light other than headline deficit projections of 3.4% and 2.1% for 2012 and 2013 (respectively), Croatia has little choice but to push sizeable discretionary tightening in the medium term. Namely, Croatia has a host of far-reaching measures to deal with - from public sector efficiency/downsizing, revision of social transfers - that must be taken to target healthier fiscal position plus the growth model.

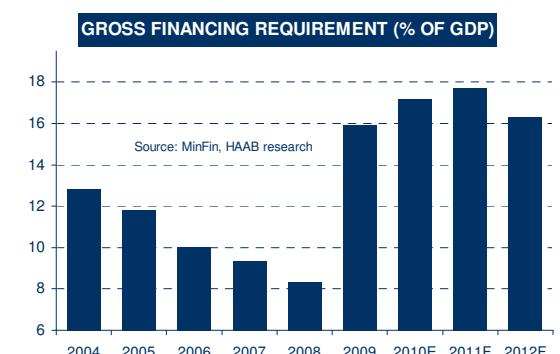
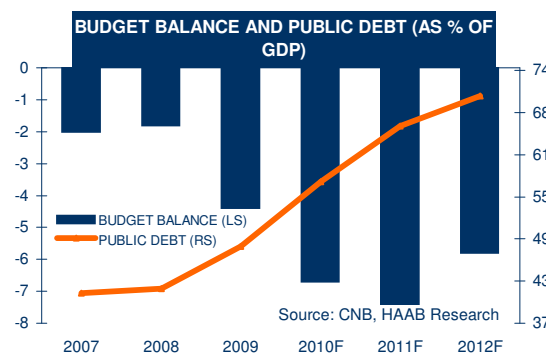
Despite low base effects and electioneering in 2011 (e.g. road-building plans doubled!), we think contours of post-election austerity, overdue restructuring and unemployment will check local demand going ahead.



With a genuine commodity shock, gradual import-intensive recovery in domestic demand, stronger credit activity and higher dividend outflows, we see the 2011 C/A gap near 3.5% of GDP, but nowhere close to pre-crisis levels.



Our consolidated general deficit forecast for 2011 (inc. quasi-fiscal stuff) nears 7.5% of GDP, which leaves the public debt on an unsustainable path.



With the structural budget deficit stuck in the 4% area, usual no policy change assumption and up to 2pp higher funding costs than the underlying GDP growth, we can see the public debt/GDP ratio spiralling upwards by 5pp+ p.a. towards 75% of GDP by 2013 from 2010's 58%.

PUBLIC DEBT SUSTAINABILITY - BASELINE SCENARIO					
Time	Debt/GDP	Structural Balance	Real Interest Rate on Debt	Real GDP Growth	Change in Debt/GDP
2010	57,8%	-4,0%	5,0%	-1,4%	7,8%
2011	65,6%	-4,0%	4,0%	1,8%	5,4%
2012	69,9%	-4,0%	4,0%	2,0%	5,4%
2013	75,2%	-4,0%	3,8%	2,5%	5,0%
2014	80,2%	-4,0%	3,5%	2,5%	4,8%
2015	85,0%	-4,0%	3,4%	2,5%	4,7%

## SELECTED ECONOMIC FORECASTS

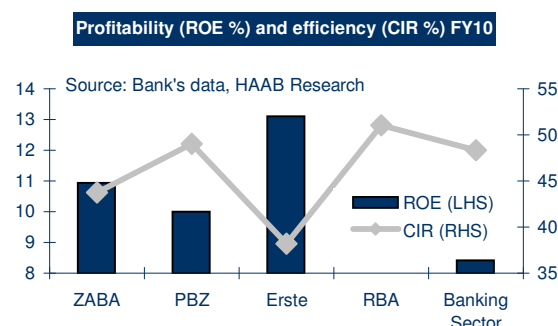
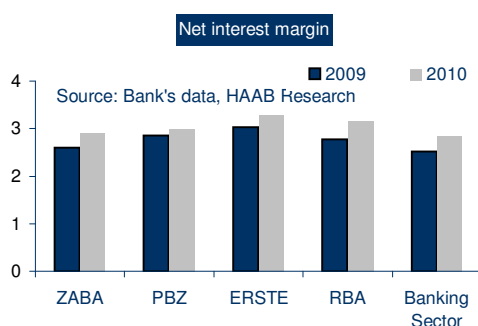
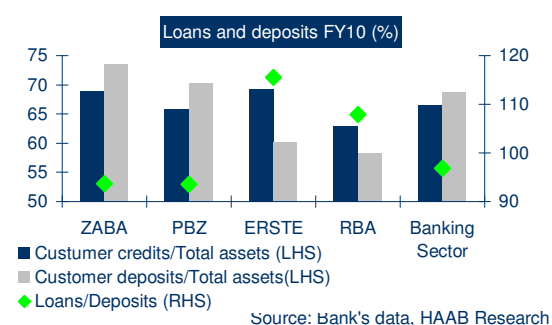
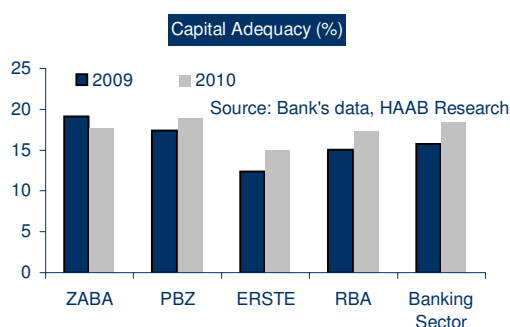
	2007	2008	2009	2010	2011F	2012F
<b>Activity</b>						
Nominal GDP (HRKbn, current prices)	318,3	345,0	335,2	334,6	349,8	368,8
Nominal GDP (EURbn)	43,4	47,8	45,7	45,9	47,3	50,4
Nominal GDP (USDbn)	59,3	69,9	63,5	60,8	65,9	71,9
GDP per capita (EUR)	9.656	10.772	10.311	10.368	10.671	11.375
GDP per capita (USD)	13.372	15.769	14.333	13.735	14.872	16.231
Real GDP (constant prices YoY, %)	5,1	2,2	-6,0	-1,2	1,8	2,0
Private consumption (YoY, %)	6,3	0,8	-8,5	-0,9	1,3	1,7
Fixed investment (YoY, %)	7,1	8,2	-11,8	-11,3	3,7	6,4
Industrial production (YoY, %)	5,7	1,8	-9,2	-1,5	2,5	3,0
Unemployment rate end-year (ILO, %)	9,6	8,4	9,2	12,0	12,5	11,8
<b>Prices</b>						
CPI inflation (average % YoY)	2,9	6,1	2,4	1,0	2,6	3,4
CPI inflation (end-year % YoY)	5,8	2,9	1,9	1,8	3,5	2,9
PPI inflation (average % YoY)	3,4	9,7	-0,4	4,3	3,2	2,9
PPI inflation (end-year % YoY)	5,8	9,6	1,6	5,7	3,3	3,0
Net wage rates (% YoY, nominal)	5,2	7,0	2,6	0,5	1,0	1,8
<b>Fiscal balance (% of GDP)</b>						
State budget balance (ESA-95)	-2,0	-1,8	-4,4	-6,7	-7,4	-5,8
Public debt	41,3	42,0	48,2	57,8	65,6	69,9
<b>External balance</b>						
Export of goods and services (EURbn)	18,307	19,905	16,157	17,596	18,276	19,157
Import of goods and services (EURbn)	-21,474	-23,741	-17,868	-17,739	-18,911	-20,354
Merchandise trade balance (EURbn)	-9,829	-11,232	-7,691	-6,225	-6,767	-7,734
Merchandise trade balance (% of GDP)	-22,7	-23,5	-16,8	-13,6	-14,3	-15,4
Tourism receipts (EURbn)	6,753	7,459	6,380	6,237	6,449	6,707
Current account balance (EURbn)	-3,236	-4,336	-2,506	-0,654	-1,362	-1,912
Current account balance (% of GDP)	-7,5	-9,1	-5,5	-1,4	-2,9	-3,8
Net FDI (EURbn)	3,5	3,2	1,2	0,6	1,4	2,2
FDI (% of GDP)	8,0	6,8	2,6	1,3	3,0	4,4
FDI cover (%)	107,2	74,9	48,2	90,7	105,7	115,1
Gross international reserves (EURbn)	9,307	9,121	10,376	10,736	11,466	12,296
Import cover (months of imports)	5,2	4,6	7,0	7,3	7,3	7,2
<b>Debt indicators</b>						
Gross external debt (EURbn)	32,929	39,950	44,606	45,768	47,842	50,602
Government (EURbn)	5,372	4,197	5,165	5,935	7,035	8,285
Private (EURbn)	27,557	35,753	39,441	39,834	40,808	42,318
Gross external debt (% of GDP)	75,9	83,6	97,7	99,7	101,2	100,4
Gross external debt (% of exports)	179,9	200,7	276,1	260,1	261,8	264,2
<b>Exchange rates and money growth</b>						
USD/HRK (end-year)	4,99	5,16	5,09	5,63	5,41	5,24
USD/HRK (average)	5,37	4,93	5,28	5,50	5,31	5,13
EUR/HRK (end-year)	7,33	7,32	7,30	7,38	7,36	7,3
EUR/HRK (average)	7,34	7,22	7,34	7,29	7,40	7,32
Money supply M1 (% YoY)	19,3	-4,6	-14,6	4,2	5,5	6,0
Broad money M4 (% YoY)	18,3	4,3	-0,9	4,4	4,7	5,1
Domestic credit (% YoY)	15,0	10,5	-0,6	6,8	5,6	7,1
ZIBOR 3M interest rate (end-year %)	7,4	8,2	3,5	2,7	3,2	4,4
RHMF 2017 kuna bond yield (end-year %)	5,3	6,2	6,3	6,3	6,9	6,0
Croatia 2015 eurobond yield (end-year %)	-	-	5,2	5,0	5,8	5,2

## SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011F	2012F
<b>Balance sheet figures and ratios</b>						
Assets (EURm)	47.109	50.529	51.864	52.137	53.180	55.546
Loans (EURm)	29.418	33.800	34.169	36.947	39.422	42.182
Loans (% YoY)	13,7	14,9	1,1	8,1	6,7	7,0
Loans (% of GDP)	67,8	70,8	74,8	80,5	82,5	82,7
Deposits (EURm)	27.113	28.048	28.298	29.288	30.824	32.612
Deposits (% YoY)	19,2	3,4	0,9	3,5	5,2	5,8
Deposits (% of GDP)	62,5	58,7	62,0	63,8	65,9	65,1
Loans-to-deposit ratio (%)	108,5	120,5	120,7	126,2	127,9	129,3
Capital adequacy ratio (%)	16,4	15,2	16,4	18,5	18,9	18,0
<b>P&amp;L figures and ratios</b>						
Net interest income (EURm)	1.167,8	1.359,6	1.293,0	1.484,6	1.551,4	1.625,8
Total operating income (EURm)	1.731,4	1.961,9	2.093,7	2.208,1	2.345,0	2.427,0
Net reservations & adjustments (EURm)	128,1	149,9	473,0	491,8	473,1	450,0
Pre-tax profit (EBT, EURm)	701,4	783,1	586,4	612,4	661,4	742,8
Net interest margin (%)	2,5	2,7	2,5	2,8	2,9	2,9
Cost-to-income ratio (%)	52,1	52,4	49,4	50,3	49,3	50,9
ROEA (Pre-tax income/equity, %)	11,9	11,5	8,1	8,3	8,4	8,7
ROAA (pretax, %)	1,5	1,5	1,1	1,2	1,2	1,3
Non-performing loans (%)	4,8	4,9	7,8	11,2	14,2	13,3
Cost of risk (% of outstanding bank loans)	0,4	0,4	1,4	1,3	1,2	1,1

Source: Croatian National Bank, HAAB research

**Highlights:** The FY10 pre tax-profit rose 5.6% yoy to HRK4.5bn on (i) 14.8% higher net interest income (NII), (ii) 7.6% higher net fees and commissions (NFC) and thanks to (iii) flat opex. Moreover, higher NII came exclusively on lower interest cost (-23%) as interest income also fell 7.1%. Contemporaneously, banks' aggregate operating income barely rose by 2.6% yoy as higher NII and NFC are offset by plummeting net trading income (-45%) courtesy of poor 1H10 showing, when e.g. ZABA lost HRK311m on FX swaps. Much lower interest costs simply reflect the lack of bank competition for deposits amidst practically non-existent lending activity. The asset quality has improved slightly in 2010 as reservations increased just 2%, suggesting low-teens peak NPL prospects perhaps in 2H11. We still think a quick normalization of reservations is unlikely in 2011 given rising unemployment and overdue restructuring in a few over-leveraged sectors, e.g. construction and real estate. That said, provisioning will stay elevated through 2011, allowing for only a slight decrease in cost of risk.



## High inflation and FDI uncertainty hurt outlook

**GDP maintains a modest uptrend.** The 4Q10 GDP (+1.7% yoy) shaped a higher-than-expected FY10 average 1.8% GDP growth, but nonetheless marked a slowdown from 2Q-3Q10's 2.5% pace largely due to lower industrial output exacerbated by unfavourable base effects. According to high-frequency data (industry, foreign trade) the slowdown was likely temporary, as external demand, manufacturing, FDI/public capex, enhanced subsidised credit schemes and perhaps some electioneering will all feature in accelerating growth going forth. We have nevertheless slightly lowered our 2011 GDP forecast to 2.5% as consumer demand remains unstable amid high unemployment, weaker real incomes and early election calls, and delayed sale of the incumbent Telekom Srbije may prolong vast public investments partly 'hedged' by privatisation income. Besides the ECB tightening will translate into predominant flexible interest rate loans, potentially also making some investment projects less attractive.

**New IMF program to help rebalancing.** The key policy relevant issue with a heavy impact on medium term outlook is a possible credibility-boosting pre-cautionary deal with the IMF (and conditions attached to it) post April-2011's expiry of EUR2.9bn stand-by, albeit Serbia may be reluctant to accelerate the associated major entitlement reforms in the run-up to mid-2012 elections. That said, our real concern is that relatively toothless structural reforms tempo, hence sub-potential 3%-alike GDP expansion going forth, results in weak hiring prospects and over-reliance of productivity gains on micro-level internal adjustment. On a more positive note, we still see the cabinet's strong focus on FDI attraction, cheap skilled labour, low taxes, strong trading links to CIS plus potential USD800m in financial investment support from Russia make a conducive environment for investments as the key precondition if you build decent export capacity. As such, the Serbian economy is rebalancing faster than its SEE peers - toward becoming less-dependent on domestic demand.

The beginning year's strong industrial output data reflect hefty production within sectors more open to foreign trade and closely linked to the global investment cycle, namely automotive, chemicals, machinery and equipment. Besides, there are increasing signs that FDI incentives alongside past REER underperformance in the EE-FX context is helping few export industries. We expect further manufacturing strength in 2011 as forward-looking EU/CEE PMIs remain at their historical highs and capex rebound will lead the domestic demand recovery. More so, the cumulative subsidized credit schemes ensure enough working capital and prevent that liquidity-stricken businesses excessively weigh on the recovery prospects. We expect strong manufacturing dynamics to sustain through 2012 and beyond thanks to notable FDI-fuelled capacity expansions notably in automotive (FIAT effect) and metals industries (US Steel).

**C/A gap to widen slightly.** Despite a 1pp lower goods trade deficit at 16% of GDP largely reflecting hefty base metals/steel/chemicals exports, the FY10 C/A gap was almost flat at EUR2.1bn (7% of GDP) given lower remittances, intensified non-resident profit repatriation, higher interest cost and structural fund flows. Still, of most interest to us are 25%-alike yoy (6mma) higher underlying ex-metals ex-food exports thanks to successful FDI participation in the robust world trade growth, and partly competitiveness gains from 18% REER slide from 3Q08 until YE10. On financing, weaker FDI inflow for almost 25pp lower net FDI cover (41%) and substantial corporate external debt roll-overs on the domestic market induced the NBS to run down about EUR1.4bn of FC reserves in 2010, and also saw Serbia more reliant on IFI funding and carry-trade-driven portfolio flows (EUR315m in 2M11 according to the NBS).

Since the build-up of decent tradable sectors first requires higher capital goods imports, we see higher C/A gap near 8% of GDP in 2011 before settling lower in 2012 on higher car exports. Our view comprises a near halving of goods exports dynamics to a 10%-alike average pace, while higher commodity prices and stabilizing households demand will push imports. Remittances will be driven by the EU recovery and higher labour mobility within EU on visa-free travel. If TS sale receipts are received only in 2012, we expect the basic balance gap to stay near 2010's 4% of GDP level, despite stronger FDI on the back of FIAT's EUR500m investment, Delta retailer take-over and energy capex. With the (quasi)sovereign's strong ability to access funding (e.g. EIB's EUR575m loans, WB's EUR325m bond, smaller IFI lines, EUR500m Eurobond or TS-receipts-backed bridge loan), rising foreign banks' exposure and stronger portfolio inflows, we do not see major problems in covering this year's gross external financing needs of EUR8.2bn (24% of GDP). On the back of our back of the envelope calculations, Serbia does not need IMF funding this year, but the new precautionary agreement will be necessary as to attract other inflows.

**Good bye inflation target for 2011!** The surge in CPI inflation above 15% in April (~8pp above the NBS target band) owed to: i) lagged pass-through from the past dinar depreciation, ii) global food price shock aggravated by oligopolistic agricultural output structures and high share of food prices, iii) stronger-than-planned administrative price hikes and v) rising inflation expectations. Price pressures would be even stronger had the government not opted for less energetic public wage and pension hikes. Even if strong base effects suggest slowing inflation in 2H11, we continue to expect the YE11's CPI inflation about 3pp above the upper end of the NBS 4.5±1.5% CPI target amid rising global commodity prices, pre-election fiscal expansion and narrowing output gap. Also adding to upside inflation risks are persistent concerns on further dinar volatility as well as this year's harvest amid already tight agriculture supplies.

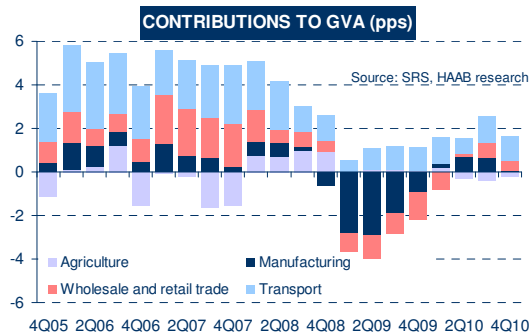
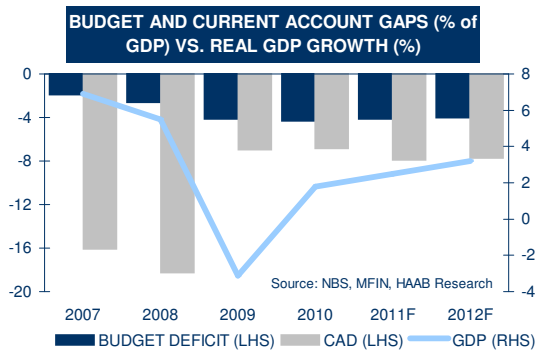
**NBS continues to hike.** The RSD rebound owes to: i) carry trade-fuelled hot money inflows, ii) improved goods trade trends and iii) cross-border debt re-booked locally (removing firms' FC demand). In its fight with above-target inflation, the NBS hiked the 2W REPO rate by 450bp to 12.50% in seven months, and also largely reversed the planned March RSD MRR cuts by a net EUR268m reduction in FX required reserves to smooth FX volatility. Still, anchoring inflation into a single-digit zone by YE11 will, in our view, require 50-75bp rate hikes in 2Q11 followed by rate cuts to 11% by YE11 as inflation gradually falls. The key risks are political opposition to monetary tightening ahead of 2012 elections and the NBS' perceived higher external imbalances in case of over-tightening and excessive RSD gains through carry trades geared into the NBS' 2W REPO and T-bills. After a good compression on non-resident appetite for one of the highest real yield in Europe, RSD yields are now in reverse mode on negative FDI newsflow as if delayed TS sale induces the budget funding mix uncertainty.

**More stable dinar profile.** Greater carry attractiveness on higher real T-bill yields in 2H11, improved credit ratings, NBS' tolerance of a 1.5% REER appreciation and ongoing corporate FC debt rollovers locally all induce us to lower our 2011 EUR/RSD forecast from 110.5 to 104.0. With the NBS still sensitive to RSD strength vis-à-vis competitiveness of exports (still the key driver of GDP growth), we think the tolerance for RSD spot appreciation will wane in 2H11 as inflation falls and rate hikes also stop. The end-2011 RSD downside towards 107 could then also reflect deteriorated quality of C/A financing at times when CAD stays relatively wide, and reduced non-resident portfolio inflow in such broader context. Given still stronger-than-expected RSD, lower inflation in 2H11 and greater public financing flexibility (see down), there is scope for RSD yields compression post 2W REPO peaks; however pre-election spending hikes and volatile non-resident risk appetite may yet exert upward pressure. The accelerated net increase of largely short-term debt in 1Q11 (total EUR880m) should be also taken with a pinch of salt as it currently brings up T-bill maturities for 2012 to ca. EUR870m.

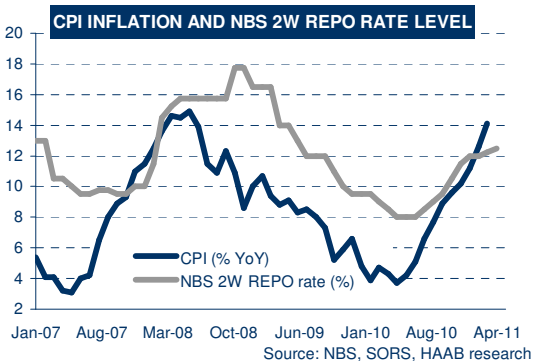
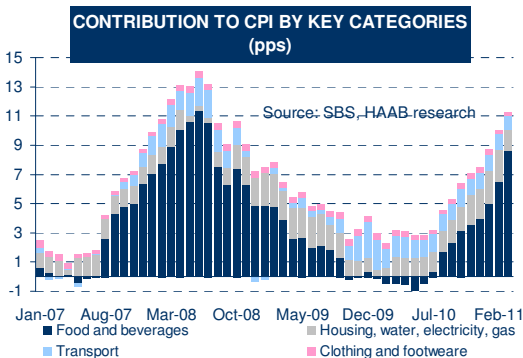
**No serious fiscal tightening.** With solid tax intake on soaring inflation and activity-supportive subsidised lending, the consolidated state budget seems well on track to meet this year's 4% fiscal deficit target. Still, we do not exclude that growing temptations to boost public spending and further adjourn painful structural (pension/health/social transfer) reforms this side of elections eventually lead to fiscal target breach. Namely, there is a danger that the cabinet accelerates the pace of public wage and pension hikes, which would then lead to recurring spending overshoot, rather than following the IMF's advice to pay RSD10bn one-off. Needless to say, such moves effectively endanger fiscal rules to reduce public spending on wages and pensions to 8% and 10% (of GDP, respectively) in the medium term, from the current 10% and 13% respectively. We also remind our readers that hitherto fiscal adjustments were done largely through wage/pension freeze and excise tax hikes, hence without much adjustment.

While Serbia's public sector debt around 40% of GDP is modest relative to peers, we think the financing part and debt dynamics deserve more attention. Namely, the postponement of TS sale is worth taking seriously as the alternative debt financing would threaten the 45% of GDP public debt ceiling. The front-loading of some T-bill issuance in 1Q11 alongside solid largely FC liquidity with the NBS has nonetheless provided a great deal of flexibility in the event of delayed TS sale and/or a 7Y EUR500m Eurobond issue, pending of course what the MinFin comes up with pre-election quarters' borrowing plans. Moreover, the cabinet has also arranged the WB-backed EUR325m loan as well as some EUR600m in combined commercial banks and insurers credit facility and T-bonds. In all, the MinFin has importantly already ensured more than a half of 2011's gross (re)financing needs, taking some pressure away from short-term borrowing at least during 2Q11. On debt dynamics, our model reveals that under the assumed structural deficit of 3-3.5% of GDP and 1-1.5pp higher funding costs than the underlying 3%-alike growth, the public debt will pierce the 45% public debt cap in 2012.

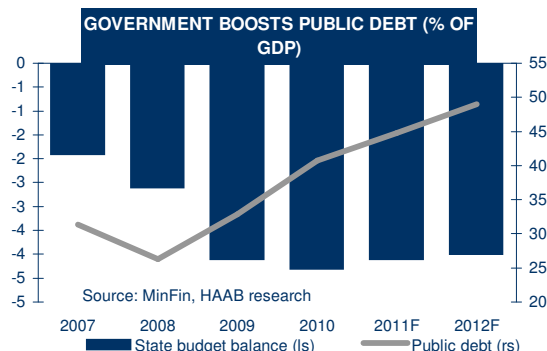
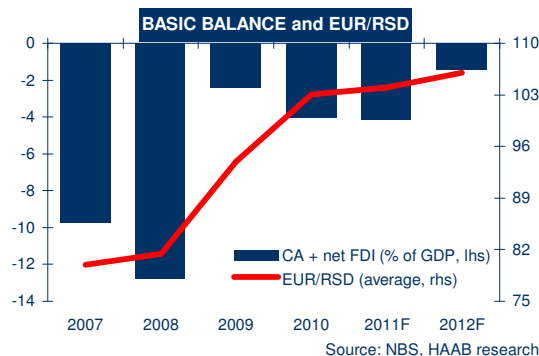
We have slightly lowered our 2011 GDP forecast to 2.5% as consumer demand remains unstable amid high unemployment, weaker real incomes and early election calls, and delayed sale of the incumbent Telekom Srbije may prolong vast public investments partly 'hedged' by privatisation income.



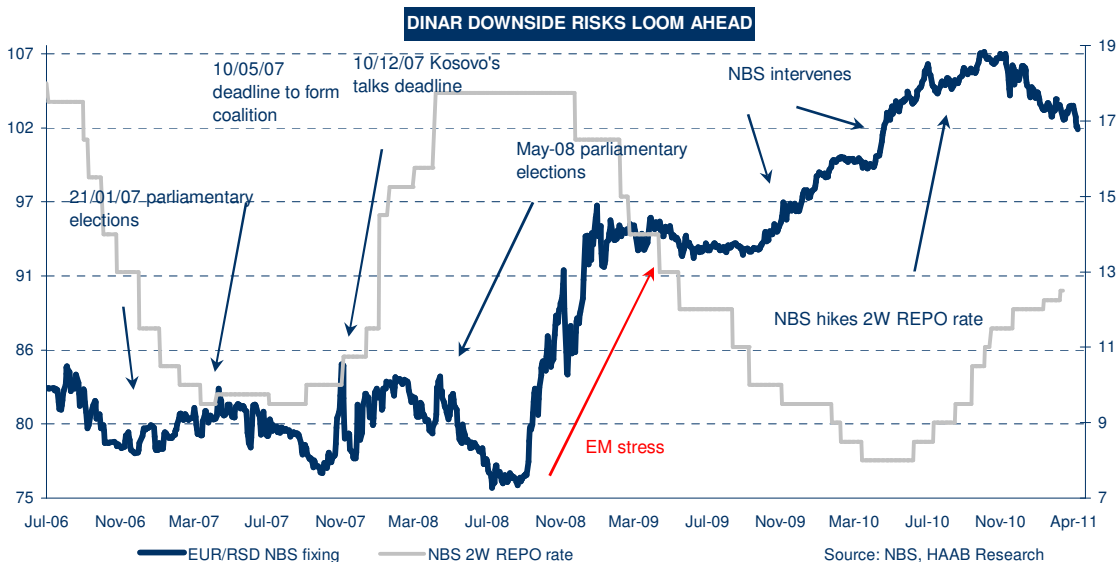
Anchoring inflation into a single-digit zone by YE11 will, in our view, require 50-75bp rate hikes in 2Q11 followed by rate cuts to 11% by YE11 as inflation gradually falls.



With solid tax intake on soaring inflation and activity-supportive subsidised lending, the consolidated state budget seems well on track to meet this year's 4% fiscal deficit target.



With the NBS still sensitive to RSD strength vis-à-vis competitiveness of exports (still the key driver of GDP growth), we think the tolerance for RSD spot appreciation will wane in 2H11 as inflation falls and rate hikes also stop.



## SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011F	2012F
<b>Activity</b>						
Nominal GDP (RSDbn, current prices)	2.302	2.722	2.815	3.043	3.414	3.756
Nominal GDP (EURbn)	28,8	33,4	30,0	30,5	35,3	38,5
Nominal GDP (USDbn)	39,4	48,9	41,7	40,4	49,3	54,9
GDP per capita (EUR)	3.900	4.547	4.093	4.148	4.809	5.235
GDP per capita (USD)	5.336	6.647	5.691	5.495	6.702	7.469
Real GDP (constant prices YoY, %)	6,9	5,5	-3,1	1,8	2,5	3,2
Private consumption (YoY, %)	4,0	7,6	-3,0	-2,4	1,2	2,6
Fixed investment (YoY, %)	25,6	1,9	1,3	2,7	7,0	5,5
Industrial production (YoY, %)	3,3	1,4	-12,3	2,5	5,1	6,2
Unemployment rate end-year (ILO, %)	18,1	13,6	17,0	20,0	19,2	18,4
<b>Prices</b>						
CPI inflation (average % YoY)	6,5	7,6	7,1	7,3	11,9	6,1
CPI inflation (end-year % YoY)	11,0	8,6	6,6	10,2	9,0	5,9
PPI inflation (average % YoY)	5,9	12,4	5,6	12,7	13,0	10,0
PPI inflation (end-year % YoY)	9,8	9,0	7,4	16,2	11,0	10,0
Net wage rates (% YoY, nominal)	46,7	23,5	-19,9	-29,5	6,5	9,0
<b>Fiscal balance (% of GDP)</b>						
State budget balance	-1,9	-2,6	-4,1	-4,3	-4,1	-4,0
Public debt	31,4	26,3	32,9	40,7	44,8	49,0
<b>External balance</b>						
Export of goods and services (EURbn)	8,686	10,157	8,478	10,070	11,222	12,432
Import of goods and services (EURbn)	-15,578	-17,878	-13,578	-14,838	-16,619	-18,114
Merchandise trade balance (EURbn)	-6,638	-7,549	-5,118	-4,773	-5,435	-5,680
Merchandise trade balance (% of GDP)	-23,1	-22,6	-17,1	-15,7	-15,4	-14,8
Remittances, net (EURbn)	2.134	1.770	2.668	2.422	2.596	2.664
Current account balance (EURbn)	-4,615	-6,089	-2,084	-2,082	-2,789	-2,962
Current account balance (% of GDP)	-16,0	-18,2	-7,0	-6,8	-7,9	-7,7
Net FDI (EURbn)	1,8	1,8	1,4	0,9	1,3	2,4
FDI (% of GDP)	6,3	5,5	4,6	2,8	3,8	6,3
FDI cover (%)	39,5	30,0	65,8	41,3	48,0	81,7
Gross international reserves (EURbn)	9,660	8,190	10,602	10,002	10,093	11,881
Import cover (months of imports)	7,4	5,5	9,4	8,1	7,3	7,9
<b>Debt indicators</b>						
Gross external debt (EURbn)	17,139	21,088	22,487	23,786	25,326	27,656
Government (EURbn)	6,285	6,521	7,764	9,076	10,026	11,226
Private (EURbn)	10,854	14,568	14,724	14,710	15,300	16,430
Gross external debt (% of GDP)	59,5	63,1	75,0	78,0	71,6	71,9
Gross external debt (% of exports)	197,3	207,6	265,3	236,2	225,7	222,5
<b>Exchange rates and money growth</b>						
USD/RSD (end-year)	53,73	62,90	66,73	80,48	78,65	78,96
USD/RSD (average)	58,39	55,76	67,47	77,76	74,63	74,29
EUR/RSD (end-year)	79,24	88,60	95,89	105,50	107,00	110,00
EUR/RSD (average)	79,96	81,44	93,95	103,01	104,00	106,00
Money supply M1 (% YoY)	24,0	-13,5	-0,8	-10,9	1,6	5,2
Broad money M3 (% YoY)	42,0	-1,8	12,3	2,6	8,0	10,0
Domestic credit (% YoY)	38,7	21,4	7,2	15,4	13,0	15,0
NBS 2W REPO (average %)	10,4	14,7	12,5	9,2	12,7	9,0
NBS 2W REPO (end-year %)	10,0	17,8	9,5	11,5	10,5	8,3
6M BELIBOR interest rate (average %)	11,3	15,7	14,5	11,0	14,7	10,7

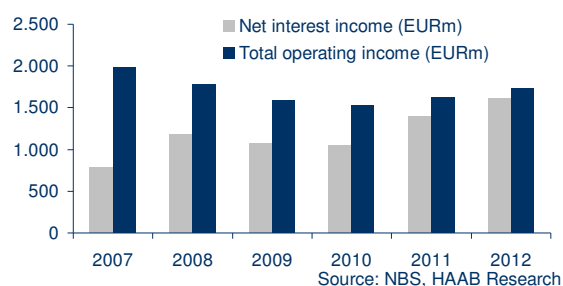
## SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011F	2012F
<b>Balance sheet figures and ratios</b>						
Assets (EURm)	21.218	21.632	22.530	24.015	25.000	26.000
Loans (EURm)	10.354	12.496	13.422	15.454	17.463	20.082
Loans (% YoY)	38,8	20,7	7,4	15,1	13,0	15,0
Loans (% of GDP)	35,0	36,5	36,7	42,7	49,1	56,5
Deposits (EURm)	10.160	9.869	11.257	11.805	12.808	14.089
Deposits (% YoY)	47,1	-2,9	14,1	4,9	8,5	10,0
Deposits (% of GDP)	35,0	36,5	36,7	32,6	35,9	39,4
Loans-to-deposit ratio (%)	101,9	126,6	119,2	130,9	136,3	142,5
Capital adequacy ratio (%)	27,9	21,9	21,4	20,0	18,0	17,0
<b>P&amp;L figures and ratios</b>						
Net interest income (EURm)	793	1.178	1.070	1.052	1.397	1.607
Total operating income (EURm)	1.986	1.786	1.594	1.533	1.625	1.737
Net reservations & adjustments (EURm)	n.a.	320,3	384,4	316,3	296,9	287,2
Pre-tax profit (EBT, EURm)	294	429	213	246	280	300
Net interest margin (%)	6,5	5,9	5,2	4,6	4,9	5,2
Cost-to-income ratio (%)	n.a.	59,2	62,6	63,5	59,0	58,0
ROEA (Pre-tax income/equity, %)	8,5	9,1	4,6	5,3	6,0	6,0
ROAA (pretax, %)	1,7	2,1	1,0	1,1	1,1	1,2
Non-performing loans (%)	5,1	11,3	15,7	19,0	20,0	18,0
Cost of risk (% of outstanding bank loans)	n.a.	2,6	2,9	2,0	1,7	1,4

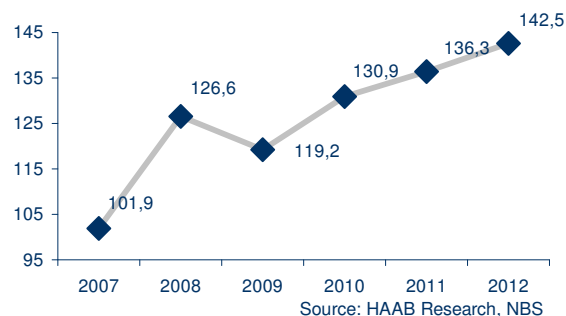
Source: National Bank of Serbia, HAAB research

**Highlights:** Serbian bank's FY10 pre tax-profit rose 15.6% yoy largely given 17.7% lower provisioning. Nevertheless, weaknesses are seen across-the-board amid (i) 1.7% yoy lower NII, (ii) 4.8% drop in NFC and (iii) and 1.9x higher net trading loss. Meanwhile, interest income was down by 3% yoy, whereby slide in interest expense also outpaced the interest income drop by 193bp. In 2011, banking sector lending activity will speed-up, with subsidized loans as the main driver of new lending. Hence, we expect credit growth to reach about 13% yoy. On the asset quality side, we expect peaking NPL prospects around 20% only in 2H11 given poor corporate liquidity, subdued local demand and low economic activity. Nonetheless, the recent government-recommended initiative for providing a framework for massive loan reprogramming by banks will probably result in further deceleration of provisioning in 2011.

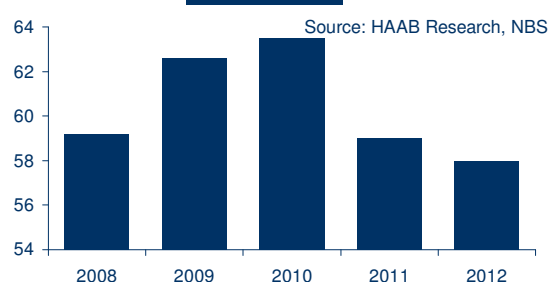
Income by segments (EURm)



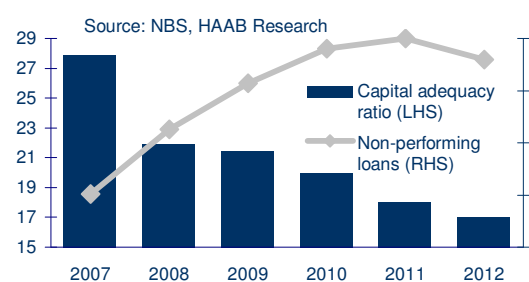
Loans to Deposits (%)



Cost to income (%)



Capital adequacy and NPL formation (%)



## Political instability impedes recovery

**Further support from exports.** With the FY10 GDP growth at 0.9%, slightly higher than we expected, we nevertheless lower our forecasts for 2011-2012 by 0.5pp on average due to the failure to form governments five months after October-2010 polls. Political stalemate will slow business-friendly reforms and delay FDI and infrastructure investment despite better access to credit. Also the *internal devaluation* in the economy running the currency board is far from over, especially as large fiscal adjustments must be achieved under lower GDP growth rates than in pre-crisis boom years. Tensions will be fuelled by the IMF-required cuts in public wage bill to war veteran benefits, while rising unemployment, real wage deflation and muted retail credit continue to affect consumption. Elevated cost of risk and balances cleansing also pose downside risks to private capex. All above said the recovery is still export-driven, with goods export growth in decent low-teens (after 28% yoy in 2010) on strong demand from developed markets, next to higher workers' remittances (14% of GDP, roughly double the SEE average) currently the key driver of consumption. Even with 2012e's GDP growth accelerating to 2.8%, the short term performance clearly remains below 4.7% growth potential, which largely rests on labour participation gains as well as technological progress. Besides, the new increasingly locally-funded bank credit normal suggests that, unless private and public savings are rebuilt significantly and/or structural reforms make fiscal room for public capex, the pace of capital accumulation and its contribution to real GDP growth will be lower in the post-crisis period.

**Monetary condition loosened.** Having lowered the mandatory reserve requirement on  $\leq 1Y$  deposit maturities by 4pp to 10%, the CBBH released an extra BAM300m in liquidity, effective from 1 February, 2011. Still, bank deposit with the central bank are maintained well in excess of minimum reserve requirements that can be explained two-fold: (i) by still rigid prudential-style liquidity tools, and (ii) generally poor corporate credit demand, partly as a result of political uncertainty. As soon as the latter is resolved and bigger investment projects are finally unfrozen, we think the latest CBBH relaxation will indeed help to stimulate lending growth, with positive consequences for corporate liquidity as well. The importance of the CBBH easing with regards commercial bank interest rate-setting also gains importance ahead of the expected interest rate hikes in the euro area, but it really boils down to bank- and client-specific issues. On balance, ample inter-bank liquidity and competition for the new quality business would forebode lower interest rates, but the ECB tightening and still elevated cost of risk will feed through largely floating interest rates.

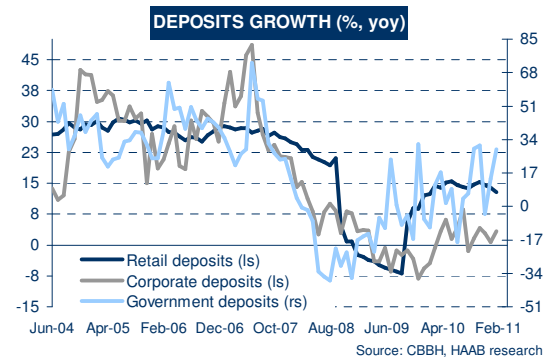
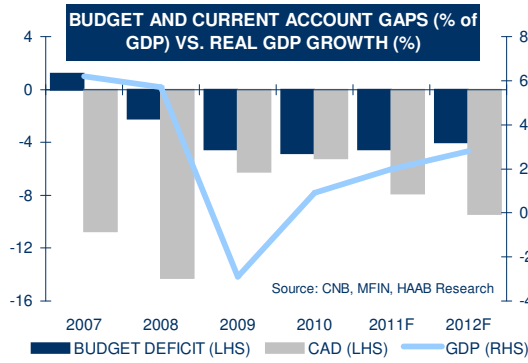
**Inflation outlook revised higher.** Muted inflation over the past year (just above 2.5% over the past six months on average) following deflation in 2009 has been another reflection of domestic demand weakness. Having marked up our 2011 CPI inflation forecast to 3.2% on heavily imported foodstuffs prices and also stronger commodity pressures, inflationary pressures will be nevertheless in check by weak purchasing power, courtesy of high unemployment, prolonged households' de-leveraging and the looming austerity measures. Conversely, a slowdown in global growth leading to a drop in global commodity prices would support the low-inflation environment. With the economy growing below its potential growth rate, the medium-term outlook is for relatively contained sub-3% inflation, but administrative price hikes continue to pose upside risks to inflation (as soon as the 2011 budgets can be finalized) as part of the general alignment with the EU-required excise tax levels.

The IMF-required austerity measures postponed in the run-up to last autumn elections should be launched as the new governments are in place, given also that the country in the opposite case won't be allowed to use outstanding stand-by tranches to shore up the budget deficit. We, however, see a more gradual fiscal deficit reduction to 4% of GDP in 2012 (a way above the IMF's 1.4% target) due to substantial GDP growth underperformance, strong opposition from interest groups to entitlement reforms, but also in the aftermath of the prolonged political stalemate, with inconclusive election results often affecting already weak institutional co-ordination between the two entities. The government's reluctance to show more fiscal teeth also comes from a simultaneous focus on other revenue generating measures such as e.g. PIT hikes, no matter how this will negatively impact on overall competitiveness, and also lead to increased tax evasion. The final but non-negligible risk to fiscal performance is still not fully appreciated shift in the growth structure away from tax-rich domestic demand towards investments and exports. The upshot is that much weaker-than-expected fiscal consolidation coupled with GDP growth underperformances will keep the debt-to-GDP ratio on an adverse trajectory.

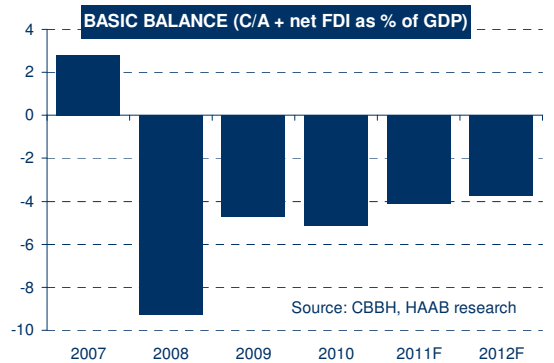
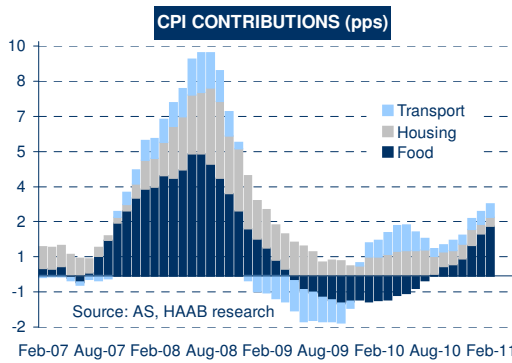
**The renewed C/A deficits expansion.** The FY10 C/A deficit fell 13% yoy to a 10-year low EUR661m (5.2% of GDP) on resurgent goods exports and recently stronger remittances, while the balances on the services and income accounts deteriorated slightly. Apart from aforementioned demand from the key trading partners, exports will additionally benefit from high international aluminium and steel prices, following a recovery in prices through 2010. That said, exports remain tilted towards raw-materials and unprocessed products that are not technology and labour-input intensive, and exporting firms are increasingly reporting skills shortages, leaving Bosnian exports dependent/vulnerable on/to fluctuations in international commodity markets. Nonetheless, the combination of more expensive importing commodities and gradually strengthening domestic demand for, hence, relatively higher merchandise imports will see the C/A deficit towards 8-9% of GDP in 2011-2012. At the same time higher migrant workers' remittances thanks to the EU wages recovery and higher labour mobility within the EU on visa-free travel barely act as an offset.

IMF funding and fresh loans as the main financing resources will help to boost FC reserves this year and next. Besides, we expect FDI to improve slightly from practically nil in 2010 as the sale of state assets resumes and infrastructure investments gradually intensify on greater private participation. Still, only profound structural reforms, political stability and competitiveness gains (e.g. via public wage cuts) - all important tasks with a stable FX policy in place - are necessary to boost investor sentiment. Meanwhile, capital transfers, especially drawdown of loans by the public sector appears to be somewhat lower mostly due to the limited implementation capacity in B-H and extended preparation processes with donors. Although the transition process to reach growth potential e.g. via stronger role of the tradable goods sectors will be a prolonged and painful affair, the commitment to maintaining the currency board arrangement and fiscal consolidation path seems intact. The CBBH reserves cover about 220% of short-term gross financing requirement and 109% of the monetary base that is sufficient to defend the CB regime and support the current single B credit rating. As always, further rating upgrades depend on progress on structural reforms and more durable political stability.

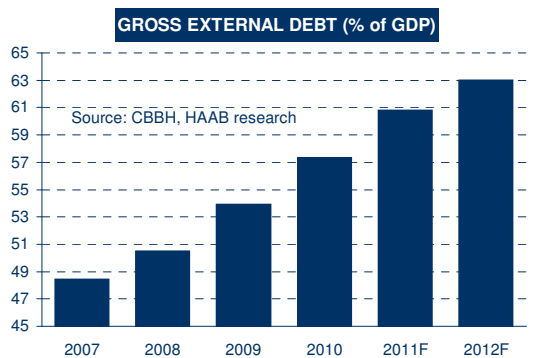
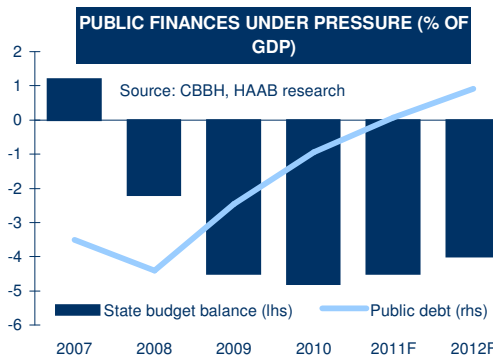
We have lowered our forecasts for 2011-2012 by 0.5pp on average due to the failure to form governments five months after October-2010 polls. Political stalemate will slow business-friendly reforms and delay FDI and infrastructure investment despite better access to credit.



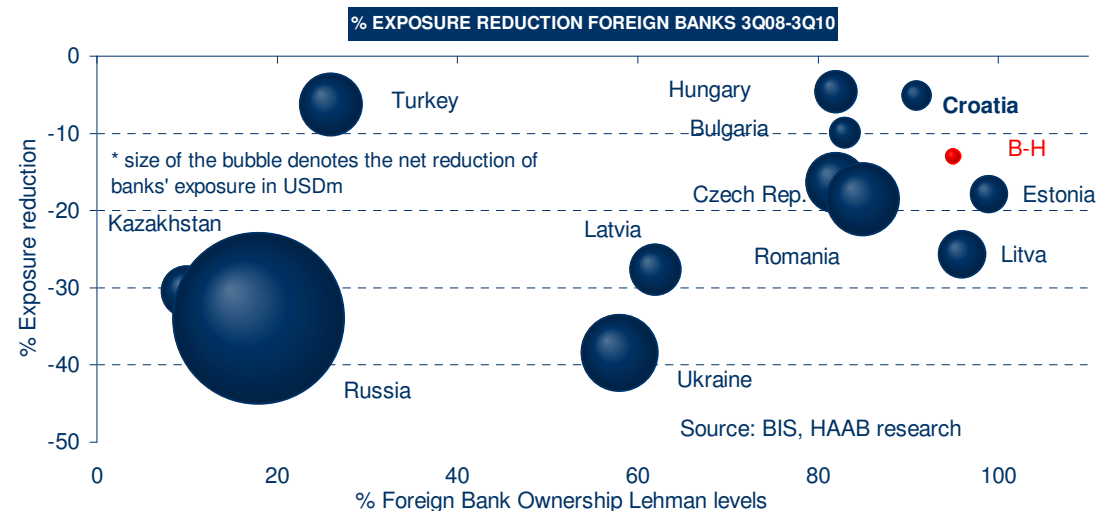
Having marked up our 2011 CPI inflation forecast to 3.2% on heavily imported foodstuffs prices and also stronger commodity pressures, inflationary pressures will be nevertheless in check.



The IMF-required austerity measures postponed in the run-up to last autumn elections should be launched as the new governments are in place, given also that the country in the opposite case won't be allowed to use outstanding stand-by tranches to shore up the budget deficit.



As soon as political uncertainty is resolved and bigger investment projects are finally unfrozen, we think the latest CBBH relaxation will indeed help to stimulate lending growth, with positive consequences for corporate liquidity as well.



## SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011F	2012F
<b>Activity</b>						
Nominal GDP (BAMbn, current prices)	21,8	24,7	24,0	24,8	26,1	27,5
Nominal GDP (EURbn)	11,1	12,6	12,3	12,7	13,3	14,1
Nominal GDP (USDbn)	15,2	18,5	17,0	16,8	18,6	20,1
GDP per capita (EUR)	2.896	3.287	3.192	3.293	3.466	3.657
GDP per capita (USD)	3.962	4.810	4.436	4.362	4.831	5.218
Real GDP (constant prices YoY, %)	6,2	5,7	-2,9	0,9	2,0	2,8
Private consumption (YoY, %)	7,7	-0,8	-2,6	0,2	1,4	3,2
Fixed investment (YoY, %)	-13,8	10,2	-22,5	-9,8	2,5	5,0
Industrial production (YoY, %)	8,6	7,9	-3,3	1,6	3,5	4,6
Unemployment rate end-year (ILO, %)	29,0	23,4	24,1	27,2	28,5	27,5
<b>Prices</b>						
CPI inflation (average % YoY)	1,5	7,4	-0,4	2,1	3,2	2,5
CPI inflation (end-year % YoY)	4,9	3,8	0,0	3,1	3,5	2,8
PPI inflation (average % YoY)	n/a	n/a	n/a	n/a	n/a	n/a
PPI inflation (end-year % YoY)	n/a	n/a	n/a	n/a	n/a	n/a
Net wage rates (% YoY, nominal)	7,5	16,6	5,1	2,3	2,2	3,0
<b>Fiscal balance (% of GDP)</b>						
State budget balance	1,2	-2,2	-4,5	-4,8	-4,5	-4,0
Public debt	32,9	30,8	35,4	39,0	41,4	43,4
<b>External balance</b>						
Export of goods and services (EURbn)	4,153	4,654	3,954	4,700	4,976	5,294
Import of goods and services (EURbn)	-7,656	-8,812	-6,792	-7,425	-7,752	-8,341
Merchandise trade balance (EURbn)	-4,142	-4,823	-3,410	-3,248	-3,432	-4,070
Merchandise trade balance (% of GDP)	-37,2	-38,2	-27,8	-25,7	-25,8	-29,0
Remittances (EURbn)	1,929	1,908	1,650	1,747	1,869	1,981
Current account balance (EURbn)	-1,191	-1,798	-0,762	-0,661	-1,048	-1,322
Current account balance (% of GDP)	-10,7	-14,2	-6,2	-5,2	-7,9	-9,4
Net FDI (EURbn)	1,5	0,6	0,2	0,0	0,5	0,8
FDI (% of GDP)	13,5	5,0	1,5	0,1	3,8	5,7
FDI cover (%)	125,9	34,9	24,1	1,9	47,7	60,5
Gross international reserves (EURbn)	3,425	3,219	3,176	3,302	3,602	3,835
Import cover (months of imports)	5,4	4,4	5,6	5,3	5,6	5,5
<b>Debt indicators</b>						
Gross external debt (EURbn)	5,385	6,378	6,613	7,251	8,099	8,854
Government (EURbn)	2,025	2,172	2,674	3,202	3,783	4,132
Private (EURbn)	3,360	4,206	3,938	4,049	4,316	4,722
Gross external debt (% of GDP)	48,4	50,5	53,9	57,3	60,8	63,0
Gross external debt (% of exports)	129,7	137,0	167,2	154,3	162,8	167,2
<b>Exchange rates and money growth</b>						
USD/BAM (end-year)	1,33	1,38	1,36	1,49	1,44	1,40
USD/BAM (average)	1,43	1,34	1,41	1,48	1,40	1,37
EUR/BAM (end-year)	1,96	1,96	1,96	1,96	1,96	1,96
EUR/BAM (average)	1,96	1,96	1,96	1,96	1,96	1,96
Money supply M1 (% YoY)	21,5	-2,7	-1,8	7,0	5,4	6,0
Broad money M2 (% YoY)	21,7	3,5	2,1	7,1	7,4	8,2
Domestic credit (% YoY)	28,4	21,8	-3,1	3,4	6,0	8,0
EURIBOR 3M interest rate (average %)	4,7	2,9	0,7	1,0	2,0	3,0

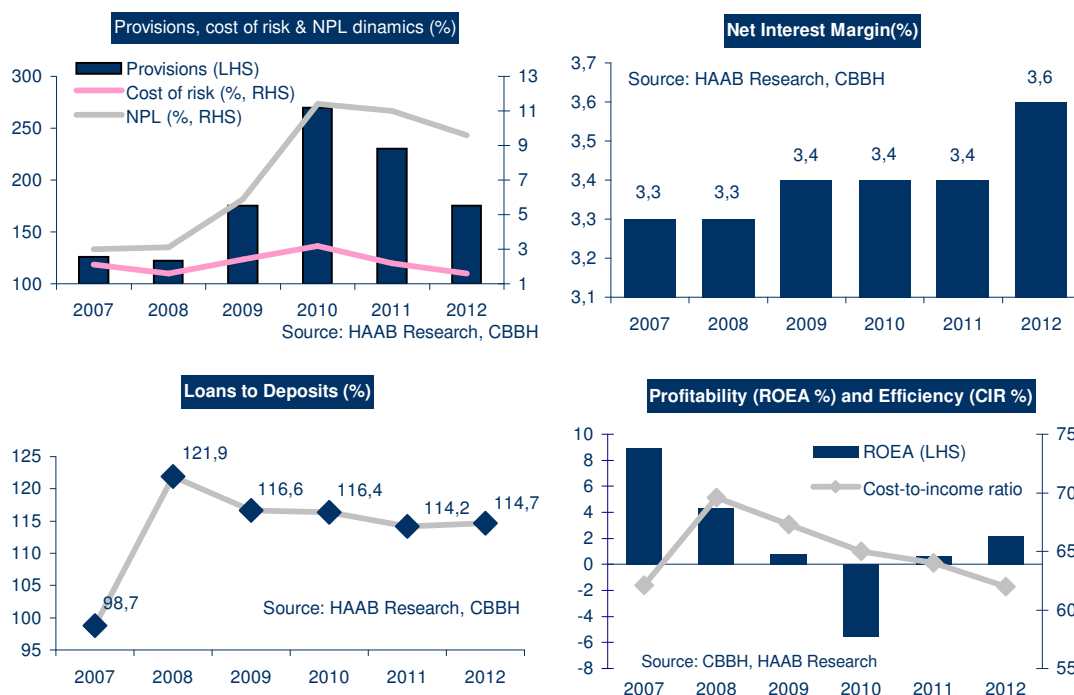
## SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011F	2012F
<b>Balance sheet figures and ratios</b>						
Assets (EURm)	9.980	10.762	10.585	10.776	11.099	11.543
Loans (EURm)	6.109	7.442	7.209	7.455	7.642	7.786
Loans (% YoY)	28,4	21,8	-3,1	3,4	6,0	8,0
Loans (% of GDP)	54,9	58,9	58,8	58,7	61,6	66,1
Deposits (EURm)	6.187	6.104	6.181	6.404	6.692	6.788
Deposits (% YoY)	37,5	-1,3	2,1	3,6	4,5	6,0
Deposits (% of GDP)	55,6	48,3	50,8	50,5	51,7	51,1
Loans-to-deposit ratio (%)	98,7	121,9	116,6	116,4	114,2	114,7
Capital adequacy ratio (%)	17,1	16,3	16,1	16,0	17,0	17,5
<b>P&amp;L figures and ratios*</b>						
Net interest income (EURm)	333,5	358,3	361,8	361,9	380,0	414,2
Total operating income (EURm)	554,9	585,0	581,0	584,1	619,2	674,9
Net reservations & adjustments (EURm)	125,7	122,0	175,2	270,0	230,0	175,0
Pre-tax profit (EBT, EURm)	84,4	56,2	14,9	-75,0	10,0	40,0
Net interest margin (%)	3,3	3,3	3,4	3,4	3,4	3,6
Cost-to-income ratio (%)	62,1	69,6	67,3	65,0	64,0	62,0
ROEA (Pre-tax income/equity, %)	8,9	4,3	0,8	-5,5	0,6	2,2
ROAA (pretax, %)	0,9	0,4	0,1	-0,4	0,1	0,3
Non-performing loans (%)	3,0	3,1	5,9	11,4	11,0	9,6
Cost of risk (% of outstanding bank loans)	2,1	1,6	2,4	3,2	2,2	1,6

\* 2010F

Source: CBBH, Banking agency RS&amp;FBiH, HAAB research

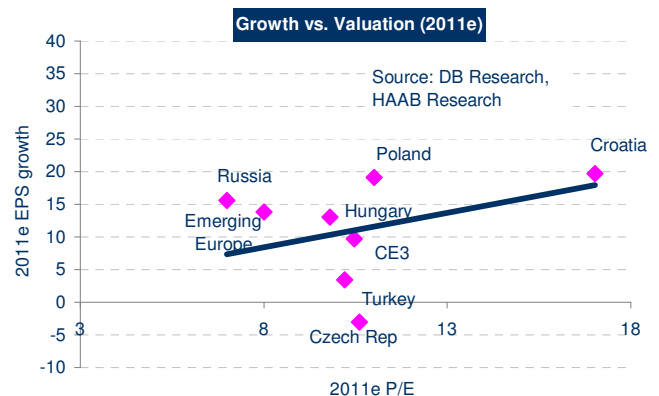
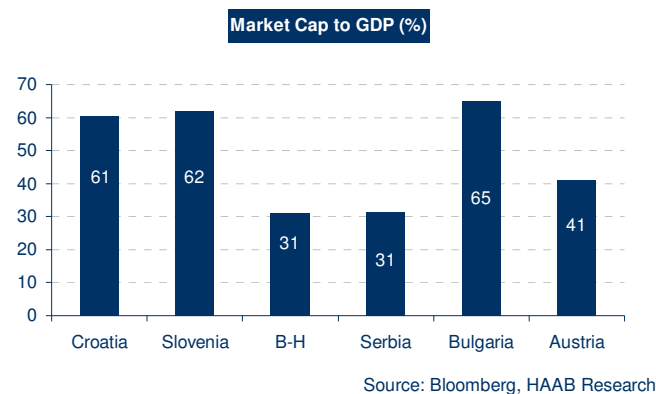
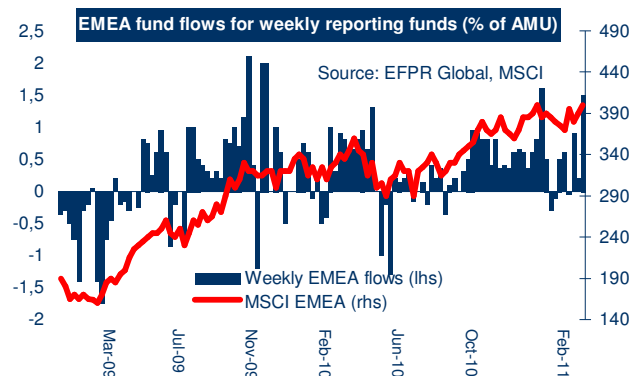
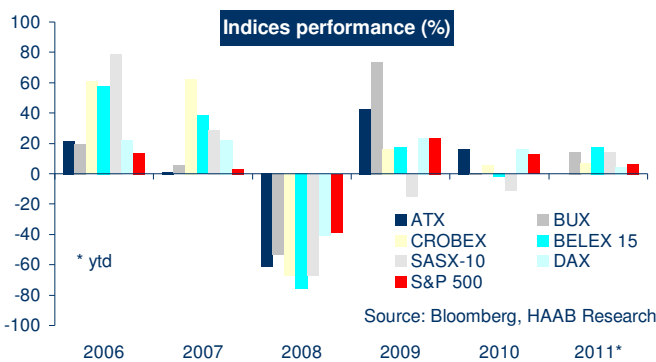
**Highlights:** Banks continued to adjust to the post-credit bubble environment, having posted a FY10 aggregate after tax loss of BAM122m (o/w BAM102.6m in Federation BH and BAM19.3m in RS), which triggered capital hikes. Unsurprisingly, credit growth moderated to just 3.4% yoy on poorer consumer demand and weak capex. Likewise, in 2011 we expect loan growth to ticks-up a meagre 3.5% yoy in sync with gradually reduced political uncertainty and the resulting capex revival. More so, we see more headroom for the banking sector's dismal efficiency having in mind sound NIM margin of 3.4% on one side and elevated CIR gauge of ~65% on the other side, hence stronger focus on the operating cost side will result in higher pre-provision profit, indeed. In all, 2011 will be another transition year with a focus on further balance sheet cleansing and corporate restructuring. However, NPL peak is perhaps behind us albeit we also do not expect sharp fall in bad loans in 2011 on still rising unemployment, hence subdued private demand.



### Growth drivers still intact

SEE-based markets unsurprisingly preformed strong in 1Q11 following a large-scale underperformance in 2010 relative to their CEE counterparts (to the tune of 15%+). Likewise, in 1Q11 the SEE equity-based growth was anchored by Serbian benchmark Belex15 as well as B-H's Sasx-10 given sound uplift of both indices by 16.1% ytd and 14.4%, respectively. Nevertheless, the Croatian equity market lagged somewhat (+4.3% ytd) as investors' milieu softened slightly after Crobex peaked in mid-February on stretched valuation prospects reflected in 2011e earnings gauge of 21x relative to EM's P/E of 11.5x. Lastly, Slovenian SBITOP preformed poorly (-3% ytd) vs its SEE counterparts, albeit mainly inline with our last bearish call on the Slovenian equity benchmark set-up in January. At that time, we pinpointed to SBITOP's overvaluation locked in 2011e P/E of 14.7x relative to Serbian 7.3x as well as Croatian 13.6x. In our view, Slovenian market still discounts grim investors' outlook on corporate earnings that are seemingly still looking for a bottom. To corroborate more, banking as well as telecommunication sector's earnings was hit hard in 2010 on higher provisioning/impairment losses and lower revenues mirroring debt-burden real sector as well as subdued local demand. Nonetheless, we believe that Slovenian equities may catch-up in 2H11 given (i) cyclical rotation gradually taking place, (ii) very probable corporate earnings trough, and (iii) high beta plays turning back into focus.

Importantly, growth drivers for SEE markets remained intact from our last call in January and have not actually changed significantly in the past months. That said, slow-but-sustainable recovery of SEE economies and M&A activity are the main catalysts for risk trades-on to stay intact. On the other hand, the main drag to SEE equities is entrenched low volumes that are still far away from the pre-crisis turnover bonanza. Nevertheless, we strongly believe that liquidity may get tailwind from frontier dedicated investors who keep pouring the money into EMEA markets. Hence, the latter reported a year-to-date inflow of USD2.9bn vs EM aggregate outflow of EUR18.4bn in the same period. Thus, it is obviously that only EMEA from the emerging market universe saw ytd inflow and thus we deem that frontier-dedicated investors have been also eying regional stocks in search for higher EM-based yield. In all, the EM-led global recovery should reverse hitherto overall emerging markets' outflow trend in months ahead and supply SEE equities with fresh liquidity. Nonetheless, risk stemming from debt-burden Europe periphery may reverse recent inflows in EMEA if debt contagion from Portugal spread over Spain and eventually hit Italy – the worst-case scenario.



## ABBREVIATIONS

AUM	Asset Under Management
BRICS	Brazil, Russia, India, China, South Africa
CAD	Current Account Deficit
CARDS	Community Assistance for Reconstruction, Development and Stabilization
CBS	Central Bureau of Statistics
CEE	Central Eastern Europe
CNB	Croatian National Bank
CPI	Consumer Price Index
EC	European Commission
ECB	European Central Bank
EE	Eastern Europe
EMU	European Monetary Union
EU	European Union
FC	Foreign Currency
FDI	Foreign Direct Investment
Fed	Federal Reserve
FX	Foreign Exchange
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
IEA	International Energy Association
IFI	International Financial Institution
IMF	International Monetary Fund
IP	Industrial Production
IPO	Initial Public Offering
ISPA	Instrument for Structural Policies for Pre-Accession
M1, M4	Monetary aggregates (the narrowest and the broadest)
M&A	Mergers and Acquisitions
MinFin	Ministry of Finance
MM	Money Market
MoM	month-on-month
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PER	Price vs. Earnings
Phare	Pologne et Hongrie - Aide á Restructuration Economique
PPI	Producer Price Index
PPP	Public-Private Partnership
REER	Real Effective Exchange Rate
S-D gap	Supply-Demand gap
SAPARD	Special Association Program for Agriculture and Rural Development
SPO	Secondary Public Offering
T-bill	Treasury bill
VAT	Value Added Tax
ZIRP	Zero Interest Rate Policy
YE	year end
yoy	year-on-year
ytd	year-to-date

## Disclosures Appendix

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