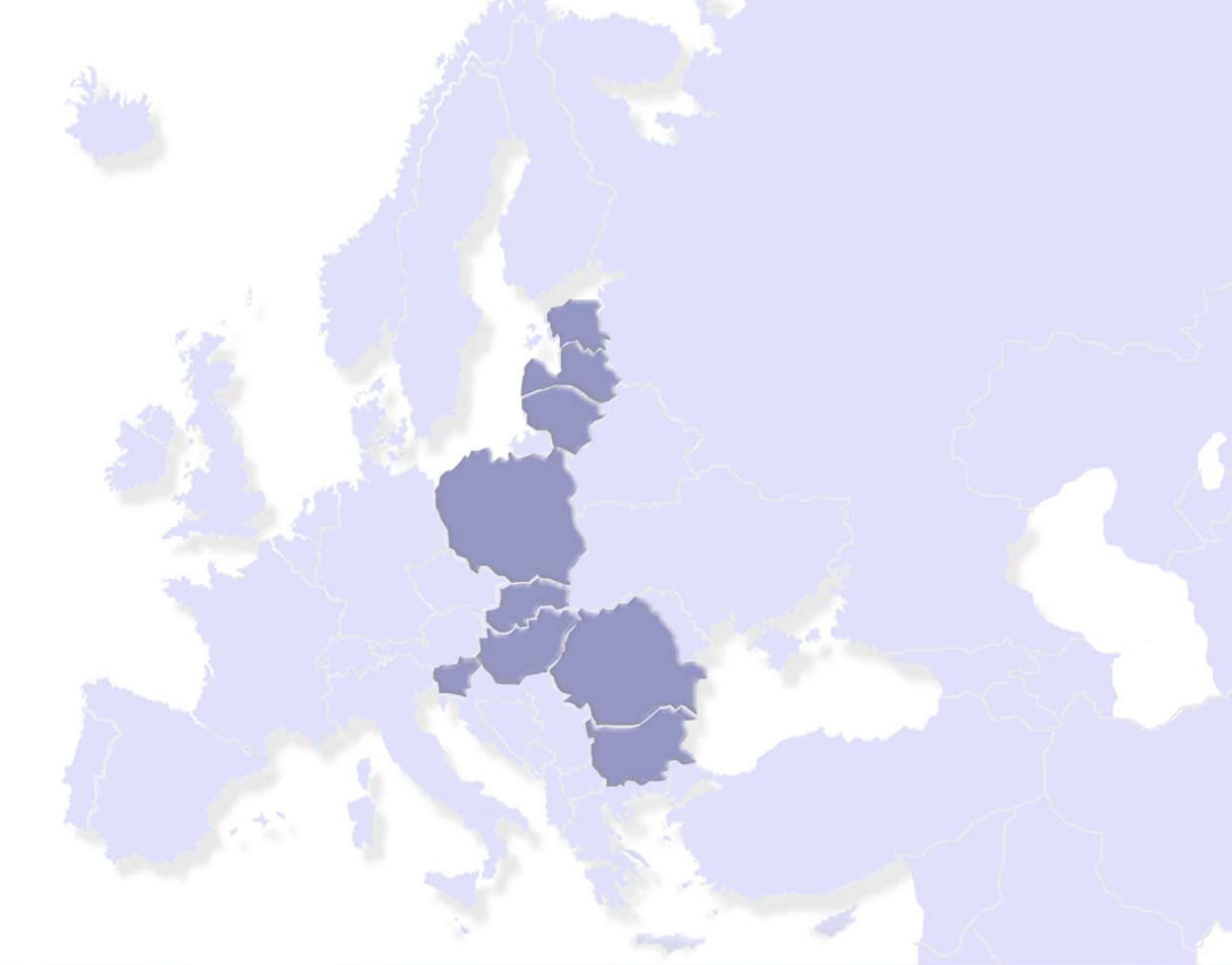
ICEG EUROPEAN CENTER

Quarterly Forecast on the Eastern EU Member States

Summer 2008



Quarterly Forecast on the Eastern EU Member States

Summer 2008

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Company information

ICEG European Center is an independent economic research institute analysing economic trends in Central and Eastern Europe. It carries out scientific research, prepares analyses and forecasts, provides policy advice and organises scientific events. It is a member of several international research networks and runs various networks under its own co-ordination. More information about ICEG European Center is available at www.icegec.org.

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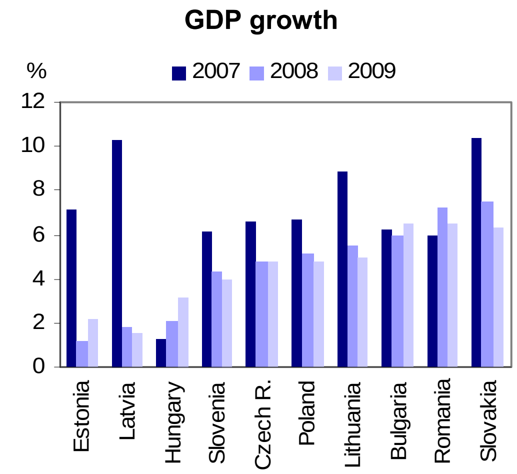
Contents

Regional overview

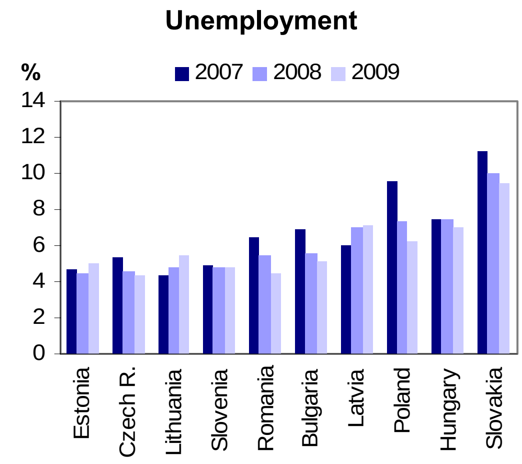


Growth

The growth outlook for the region is deteriorating. Demand for exports is weakening in western Europe, although the slowdown of the old member states has not proved as precipitous as feared so far. Domestic demand is curbed by rising inflation and stricter lending conditions. In the Baltic countries the credit-fed housing boom is over: real estate prices are falling and construction activity dwindled.

The slowdown will affect the entire region: the average growth rate of the ten countries is expected to shrink from 7% in 2007 to 4.6% this year and to 4.5% in 2009. Especially Estonia and Latvia face lean years after recent stellar performance. On the other hand, the Visegrad countries[1] are on a more balanced, broad-based growth where deceleration will be more moderate. Only Hungary will accelerate as the effect of the 2006-07 fiscal austerity package fades out. Bulgaria and Romania will be able to maintain their current growth rates. Foreign capital continues to pour into the country: these investments will eventually augment export capacities and the huge drag of net exports on growth will subside.

Risks to growth are generally on the downside. Exports will be sensitive to developments in the world economy and in western Europe, while a prolonged period of high inflation can harm private consumption.



Note: harmonised LFS rates

Labour market

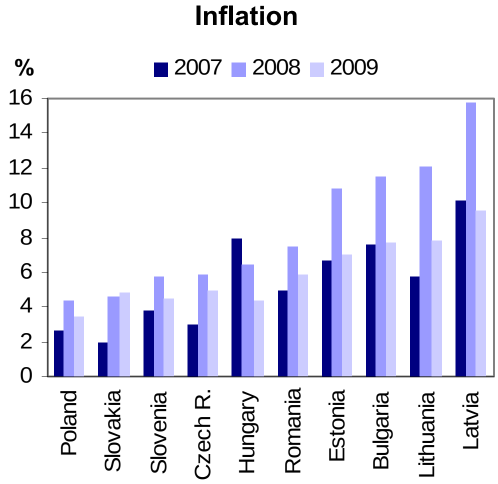
Thanks to robust growth unemployment has been falling in recent quarters, reaching record low levels in many countries. This trend is expected to continue except for the Baltics, where the sharp deceleration will lead to layoffs. Smooth labour market adjustment will be the key to the swift recovery of these economies.

However, flexibility has gained prominence everywhere as inflationary pressures start to feed into wage demands. Whether these countries can maintain their competitiveness and their strong performance in the medium term will very much depend on how they can avoid second-round inflationary effects of recent price shocks.

A positive consequence of the slowdown is that labour shortages may ease. The incentives for outward migration also diminish as the western European economic outlook deteriorates, local employment prospects improve and regional currencies gain strength (especially against the pound sterling).

[1] The Czech Republic, Hungary, Poland and Slovakia

Prices and monetary developments

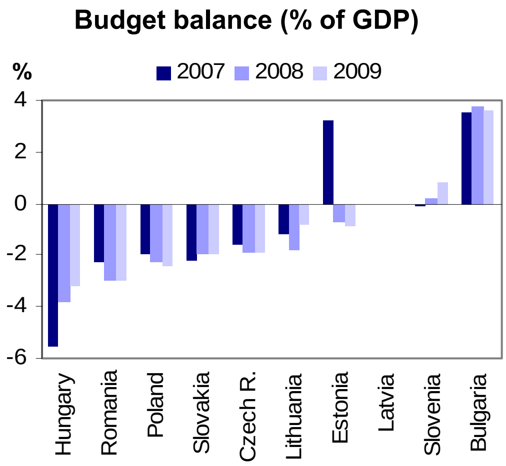


Note: harmonised (HICP) rates

Inflation is relentlessly climbing upwards on the back of global food and energy price shocks. Demand-side pressures exacerbate the situation in a number of countries, although the economic slowdown will mitigate these forces. Nevertheless, average inflation climbs from 5.4% in 2007 to 8.5% in 2008, not least due to double-digit rates in Bulgaria and the Baltic countries. If no additional external shocks materialise, average inflation can recede to 6% next year. Inflation targets are thus likely to be missed in most countries not just in 2008 but also in 2009 as well.

Monetary policy is tightening to prevent second-round effects of external price shocks. Local currencies have gained strength on the back of rate hikes and the news that Slovakia will join the euro-area in January 2009. For the rest of the region euro adoption is not on the agenda.

Fiscal policy

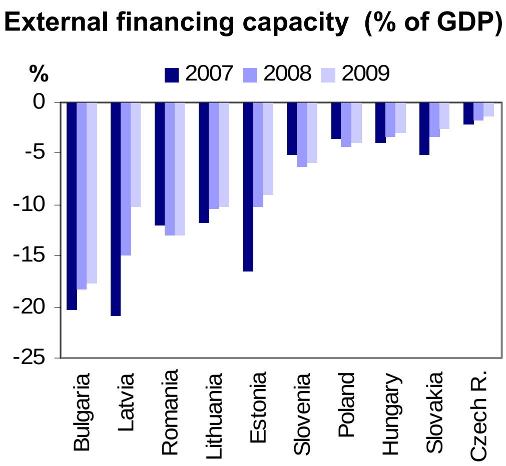


Note: according to ESA methodology

Last year was generally favourable for budget revenues and fiscal balances have improved throughout the region. This year automatic stabilisers will kick in to counter the slowdown, and fiscal balances are expected to deteriorate in five countries. Hungary is on track with its fiscal adjustment: strong revenue collection even allowed a slight reduction of the 2008 deficit target.

Tax competition continues even amid deteriorating economic conditions. Income tax rates are being cut in Bulgaria and the Baltics, while Poland aims to introduce a flat tax in the coming years. On the other hand, political commitment to reforms has all but evaporated. The Czech minority government's popularity is slipping and early elections are on the cards; the Hungarian coalition collapsed and the minority government's main goal is survival; governments keep an eye on upcoming elections in Bulgaria, Lithuania, Romania and Slovenia; while Slovakia will raise welfare spending to counter perceived inflationary effects of euro adoption.

External balance



External financing need is generally narrowing as a welcome side-effect of the slowdown. Worryingly high trade deficits in Estonia and Latvia will narrow in 2008-09 near 10% of GDP. In the case of Bulgaria and Romania the expected pick-up of exports by recent FDI projects should lead to improvements in external balances. Inflowing EU funds will be beneficial as well: surpluses on the capital account can easily reach 1% of GDP in some countries.

On the financing side, FDI inflows appear relatively unfazed by slowing economies and calamitous financial markets. Western European parents of local banks also appear to be in good health, therefore financial contagion from western Europe or within the region has not materialised. Nevertheless, such events cannot be ruled out, therefore high external financing requirements should be evaluated with caution.

Bulgaria

Economic growth remains dynamic, while inflation reached a record high level in the first months of 2008. The budget remains in the black, creating room for further tax cuts. External imbalances remain a major source of risk in 2008 as well.

Political developments

Prime Minister Sergei Stanishev survived five no-confidence votes initiated by the opposition in the first few months of 2008. The Prime Minister remained at his seat and is determined to lead his party into next year's elections. However, several ministers and deputy ministers quit the cabinet in May and June. At present GERB, a new centre-right party led by the mayor of Sofia has the biggest chance to win the 2009 parliamentary elections. It seems small parties will play a major role in forming the next government.

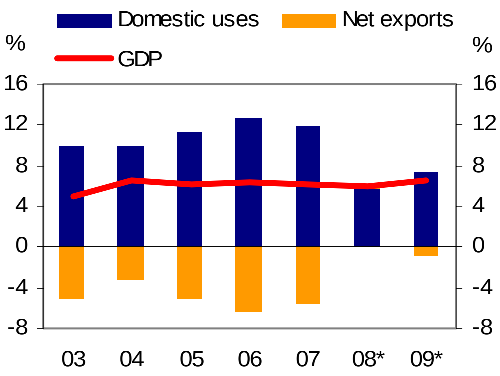
At the beginning of July President Georgi Parvanov opened a forum to discuss Bulgaria's political model and election system, including the introduction of majority representation. The forum involves the Prime Minister, the mayor of Sofia, all leaders of political parties, and several leading sociologists, political scientists and journalists. The President called for establishing clear rules for founding and registering new political parties.

Growth

Bulgaria performed excellently in the first quarter of 2008. Real GDP increased by 7% in the first three months, the third highest growth rate in the EU.

Agriculture contracted by 1.6% in the first quarter but its significant negative contribution to economic growth almost disappeared. We expect that the sector will contribute positively to growth this year due to better weather this summer than in 2007. Industry and construction decelerated slightly in the first few months of 2008. They are driven by strong domestic demand and increasing production capacities realised by foreign direct investments. Services could also enjoy vigorous consumer demand.

Structure of growth



*Note: * forecast. Source: NSI*

On the expenditure side, a favourable shift in growth factors was observable. Domestic demand lost momentum due to slowing investments (they grew 15.5% in the first quarter) and declining public consumption (-5.8%). Besides, private consumption growth remained at 5.7%, only slightly higher than 2007 average. This is still fuelled by growing wages and booming credit.

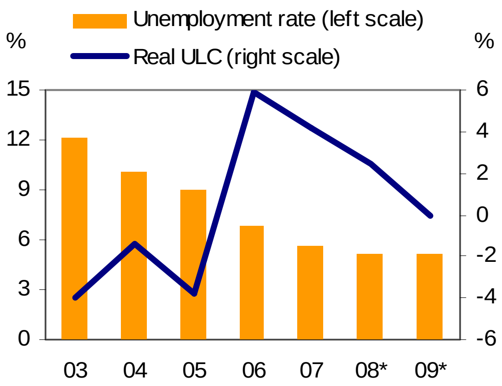
On the other hand, the growth rate of exports increased from last year's 5.2% to 9.2% in the first three months of 2008, while imports increased by 5.8%. For the second consecutive quarter net exports had a positive contribution to economic growth after ten 'negative' quarters. We expect this shift in the structure of growth to continue in 2008-09. We expect economic growth to reach 6% in 2008 6.5% in 2009. Downside risks to our forecast are present through rising energy prices, nervous international financial markets and the slowdown of the EU. On the other hand, private consumption could grow faster than expected on the back of rapid wage growth. While this can boost

GDP growth in the short term, such a development would aggravate macroeconomic imbalances and raise the risk of a sharper slowdown in the medium term.

Labour market

Unemployment decreased further in the first half of 2008, to 6.2% by May, due to dynamic economic growth and significant foreign direct investments. The number of employed increased by more than 70 thousand (by 3%) in the year to March 2008. The majority of new workplaces were created in services (mainly in trade and repair).

Labour market indicators



*Note: * forecast. Source: Eurostat*

Wages increased considerably, helped by robust productivity growth as well as tightening labour markets. Gross average monthly wages increased from BGN 400 (EUR 204) in March 2007 to BGN 500 by March 2008. Although the minimum wage was increased from BGN 180 to BGN 220 as of the beginning of 2008, trade unions demand that it be increased to BGN 400. Unions warned that strikes and protests could be expected if their demand is not satisfied by the government. Such a hike would pile even more inflationary pressures on the economy, however.

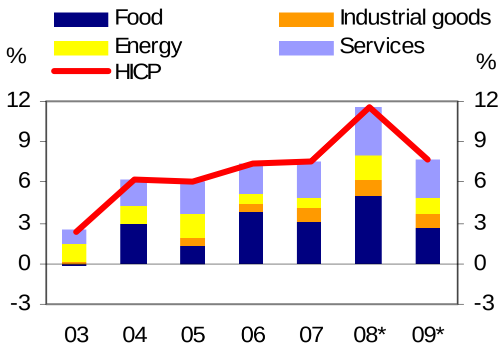
Labour productivity is expected to increase by 2% in 2008 at constant prices after growing by 3.3% last year. Since nominal wages will increase by around 20% and the number of employed is expected to grow by 4%, real unit labour cost will increase by 4.2% this year according to our estimations.

In 2008-09 unemployment will decrease further to 5.6% and 5.1% respectively due to the rapid growth rate of the economy. However, labour shortages can become a broader problem in the economy. Hence, fast wage growth is expected to continue as well.

Monetary developments

Inflation reached a record high level in the first half of 2008. The harmonised index of consumer prices has been increasing since April 2007, and it climbed to 14.7% in June 2008. Inflation has not been this high for the last ten years.

Components of inflation



*Note: * forecast. Source: NSI*

Several factors had a negative impact on inflation. Most importantly, food prices increased by a whopping 23.6% in the year to June. Global food price increases were exacerbated by last year's particularly poor harvest. Second, energy prices increased following record crude oil prices: they rose by more than 12% while transport-related costs soared by 19.1%. Third, wage increases and vigorous domestic demand contributed to rising inflation.

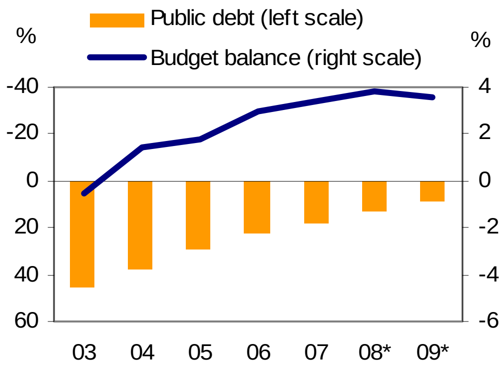
We expect annual average inflation to reach 11.5% in 2008. It will decrease only gradually over the next years since Bulgaria is growing dynamically and this implies faster price level convergence. Accordingly, inflation could decrease to 7.7% in 2009. The main upside risks to inflation are international food and energy prices and significant wage increases which boost domestic demand. Now that inflation has reached a record high, entry into ERM II is not on the agenda. Adoption of the euro is unlikely before 2013.

In line with increasing inflation interest rates picked up. Short-term yields diverged significantly from euro yields, going up from 4% in January 2007 to almost 7% by mid-2008, while short-term euro yields remained under 5%. Similar tendencies were observable with long-term yields as well.

Credit expansion remained dynamic in the first months of 2008. In the year to May 2008 claims on households and NPISHs increased by almost 50%. Accordingly, claims on households and NPISHs could exceed 25% of GDP by the end of 2008.

Fiscal policy

Key fiscal indicators (% of GDP)



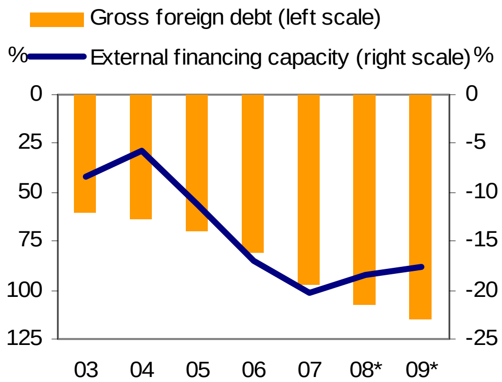
*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

Despite further tax cuts the budget balance developed favourably in the first five months: by the end of May it increased to 5.2% of GDP. Several factors helped the budget in recent months. First, higher than planned inflation was favourable for revenues. Second, robust economic growth and sound domestic demand boosted taxes even though the personal income tax rate was cut by 5 percentage points at the beginning of the year. Third, expenditures were kept in line with projected values.

We expect the budget to remain in surplus in 2008-09, reaching higher than projected values. According to our expectations, the surplus will reach 3.8% of GDP this year. Due to huge primary surpluses the public debt to GDP ratio continues to shrink.

External balance

External balance indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: BNB, Eurostat

While goods exports increased by 27.8% in the first four months of 2008, imports grew by 25.6% in euro terms. It meant that deficit of the trade balance increased by 21.6%. The services balance also worsened; deficit more than doubled to to EUR 181 mn. On the other hand both the incomes' and current transfers' balances improved.

Despite a slight deterioration in the first few months, we expect the external financing requirement to fall in the course of 2008, to 18.4% of GDP. Further significant increases are expected in goods exports due to already realised foreign investments. Second, the summer traditionally generates a significant amount of surplus in services via tourism sector. Third, fast nominal GDP growth will have a positive impact on indicators relative to GDP. In 2009 improvements could continue and the external financing need can reach 17.7% of GDP. Nevertheless, these figure are still high and warrant caution.

FDI inflows reached EUR 1.2 bn in the first four months. This is somewhat lower than in the same period of 2007 (EUR 1.4 bn), but could still finance nearly 50% of the current account deficit. After two years with over EUR 6 bn net FDI flows, we expect net inward direct investments to decline to EUR 5 bn this year.

Key macroeconomic indicators of Bulgaria, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (BGN million)	49 361	56 520	67 100	78 600
Real GDP growth (%)	6.3	6.2	6.0	6.5
Private consumption (%)	9.5	5.3	5.5	5.0
Public consumption (%)	-1.3	3.1	-5.0	1.0
Investments (GFCF, %)	14.7	21.7	16.0	15.0
Exports (%)	8.7	5.2	9.0	10.0
Imports (%)	14.0	9.9	6.0	8.0
Unemployment (%)	9.0	6.9	5.6	5.1
Real ULC growth (%)	-3.8	5.9	4.2	2.5
Annual average inflation (%)	7.4	7.6	11.5	7.7
Money market rate (3-month, %, end-year)	4.01	6.56	7.25	6.50
Long-term interest rate (10-year, %, end-year)	4.18	5.08	4.90	4.75
Exchange rate (BGN / EUR; annual average)	1.96	1.96	1.96	1.96
Exchange rate (BGN / EUR; end-year)	1.96	1.96	1.96	1.96
Budget balance / GDP (%)	3.0	3.4	3.8	3.6
Public debt / GDP (%)	22.7	18.2	13.0	9.0
Trade balance (goods and services) / GDP (%)	-18.4	-21.6	-21.4	-20.4
Current account balance / GDP (%)	-17.8	-21.5	-19.8	-18.9
External financing capacity / GDP (%)	-17.1	-20.3	-18.4	-17.7
Gross foreign debt / GDP (%)	80.7	97.3	108.0	115.0

Note: f = forecast. See methodological notes for definitions and details.

Sources: Bulgarian National Bank, National Statistical Institute, Eurostat

Czech Republic

The economy decelerates gradually, though growth is still expected to remain above 4% in 2008-09. Net exports have become the main engine of growth. The murky political outlook suggests that reforms will stall. The koruna appreciated to record heights; while this helps disinflation, exporters may yet feel its impact.

Political developments

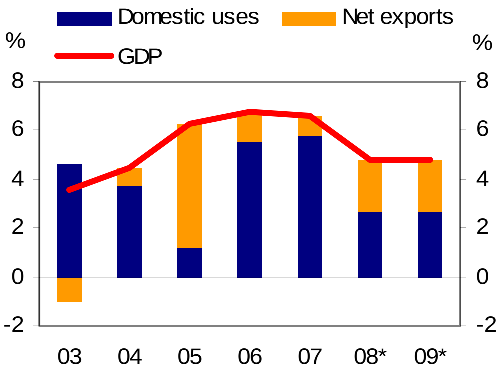
Reforms introduced in 2008 by the centre-right Topolanek government triggered indignant reactions from the trade unions, leading to strikes at the end of June. Support for further reforms evaporated even inside the governing coalition. The ensuing government crisis threatens with the break-up of the coalition and the probability of an early election has increased considerably (elections would be due in 2010).

Even if the present government remains in power, reforms can come to a halt due to their extremely low social support and to the coming local and European Parliamentary elections. The opposition Social Democrats clearly lead in the polls. They focus their campaign, with an eye on early elections, on the repeal of health care reforms and on the restoration of the previous system of social aids. Thus, with or without early elections, measures to introduce market elements into health care will most probably stay as they are or may even be repealed.

Growth

After a record high growth rate of 6.6% in 2007, signs of a slowdown have already emerged. In the first quarter of 2008 seasonally adjusted GDP growth was an annual 5.3%, after eleven consecutive quarters of growth exceeding 6%. The main reason for this deceleration is a slowdown in consumer demand, caused by rising inflation and reform measures of the government which sap consumers' spending power. Less optimistic households have increased their savings: gross domestic savings rose by over 10% year-on-year. Moreover, gross fixed capital formation decelerated somewhat. On the other hand, the contribution of net exports was higher than expected, despite the strengthening of the koruna and weaker external demand.

Structure of growth

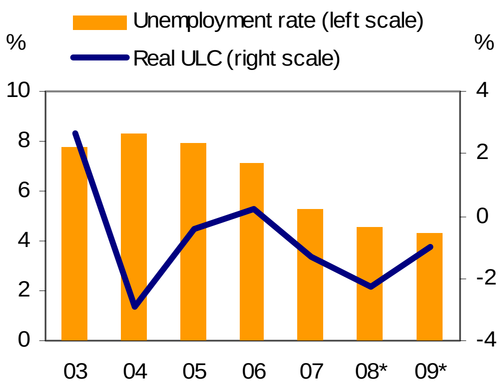


*Note: * forecast. Source: Eurostat*

These tendencies are expected to continue in 2008, resulting in a gradual slowdown of economic growth. Nevertheless, growth rates are expected to remain around 5% in both years. Sources of uncertainty surround net exports as the most important markets are expected to slow down considerably and as the strong koruna should eventually hurt some exporters.

On the production side the processing industry grew at the highest rate in the first quarter, while declines were the greatest in agriculture and construction. In 2008-09 manufacturing (partly due to the establishment of new, mainly export oriented production facilities), trade, financial intermediation and business services should remain the biggest contributors to GDP growth.

Labour market indicators



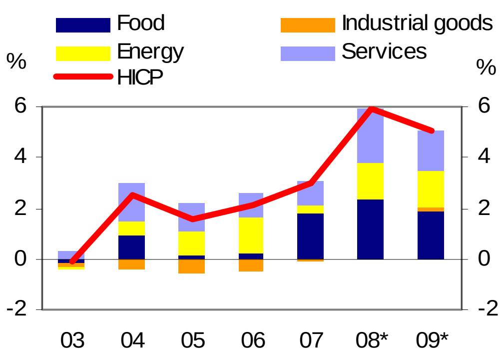
*Note: * forecast. Source: Eurostat*

Labour market

Continuing the trend of the previous years, there was a further strong increase in employment and decrease in registered unemployment in the first quarter of 2008. Employment reached a record high while unemployment a record low since 1997; the latter stood at 4.7% in the first quarter. Favourably, there was a further decline in long-term unemployment, and regional disparities in unemployment narrowed. Despite the slowdown of the economy, similar trends are expected to continue in the coming years.

Wages grew by 10.9% in the first quarter on a year-on-year basis, which is the fastest rate since the fourth quarter of 1998. However, real wages decelerated to 2.8% in the first quarter of 2008 due to rising inflation. The gap between wage growth rates in the private and public sectors is widening: they grew by 4.5% and by -3.6% respectively. The latter figure is partly responsible for the trade union activity in the first quarter of 2008. Despite rapid wage growth, robust productivity gains (especially in industry) lead to falling unit labour costs. This might partially offset the effect of the appreciation of the koruna.

Components of inflation



*Note: * forecast. Source: Eurostat*

Monetary developments

Inflation continued its upside path in the first quarter of 2008. According to the latest data, 12-month inflation reached 6.7% in June, which is well above the CNB's tolerance band around the target of 3%. One set of reasons for the increase is changes in indirect taxes and regulated prices (including health care). According to the estimation of the CNB, the first-round effects of changes to indirect taxes contributed more than two percentage points to headline inflation in June. Moreover, increases in energy and raw materials prices also fuel inflation, together with the tightness of the labour market. Annual average inflation is expected to accelerate significantly in 2008, to 5.9%. As inflationary pressures subside, inflation can gradually fall back to 5% in 2009.

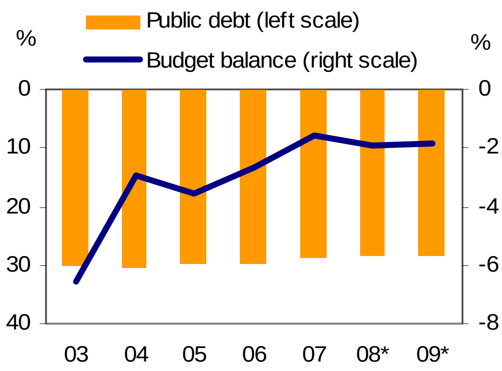
The two-week repo rate stood at 3.75 % at mid-July. Since February 2008 there were no changes to the base rate. Fast wage growth, a tightening labour market and higher than expected inflation with upside risks explain why the Monetary Council did not vote for a rate cut. In our view persistent inflationary pressures make rate cuts improbable before the third quarter of 2008. Short-term yield differentials compared to euro-area indicators have been widening since the beginning of the year, whilst differences in long-term yields have narrowed slightly.

The koruna appreciated to record heights by mid-July due to high foreign demand: it is considered one of the most secure emerging currencies. While this is favourable for inflationary developments, its impact on foreign trade is expected to manifest sooner or later.

Fiscal policy

Central budget expenditures grew by an annual 22.9% in the first quarter. The main reason for the growth in expenditures was an increase in investments into transportation infrastructure and transfers from the central to local budgets. At the same time, real wages in the public sector declined and expenditure items related to social security

Key fiscal indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat, Czech Statistical Office

and health care also fell due to recently introduced reform steps. At the same time, revenues grew by 11.6%. The deficit of the state budget reached 1.5% of nominal GDP, an increase from last year's respective period.

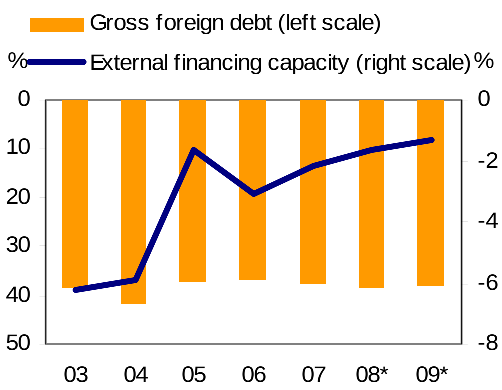
Due to the low popularity of the government, the fragility of the coalition and coming elections, some easing of fiscal policy is expected instead of expenditure-reducing reforms. The budget deficit may remain below 2% of GDP in 2008-09, but weakening economic growth may pose a risk on the revenue side. This already manifested in the first quarter through the slower growth of income and value added taxes.

Both the internal and external state debt decreased in the first quarter of 2008. Internal debt fell as the volume of issued treasury bills remained below that of the repaid ones, which resulted in amore than 4% decrease. External state debt decreased to CZK 120 bn (around EUR 4.7 bn) following a debt repayment to the European Investment Bank.

External balance

After double-digit growth rates in the previous two years, export growth fell to single-digit territory in the first quarter of 2008. Preliminary May data indicate even lower growth rates: export stood at the May 2007 level. On the other hand, imports fell by 2%. The main reasons behind these developments are deteriorating terms of trade, weakening external demand for exports and weakening domestic demand for imports (including materials for processing and re-exporting). As in previous years, exports of machinery and transport equipment were the most dynamic and were mainly responsible for the trade surplus. The real effective exchange rate of the koruna indicates a significant decline in the price competitiveness of the Czech economy.

External balance indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat, Czech Statistical Office

In the first quarter of 2008 the surplus of the current account stood at 3% of GDP, slightly above its value in the first quarter of 2007. Trade in goods and services showed a declining surplus; the contribution of goods trade to the surplus declined while that of services doubled. As in previous years, the income balance was in the red: its deficit reached a record low in the first quarter of 2008. The balance of current transfers showed a high surplus thanks to the inflow of EU funds. Net FDI shrank as inward FDI decreased by a fifth since the first quarter of 2007 and outward FDI doubled.

The external financing capacity of the Czech economy is about to improve this year, from -2.1% of GDP in 2007 to -1.7% in 2008. This trend is expected to continue in 2009, to -1.3% of GDP. The main reasons for these changes are the improving trade balance (despite the slower growth of exports and imports) and rising transfers from the EU.

Gross foreign debt amounted to around EUR 53 bn at the end of the first quarter of 2008, a slight increase compared to the end of 2007. However, the stock of foreign debt relative to GDP will remain stable over 2008-09.

Key macroeconomic indicators of the Czech Republic, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (CZK billion)	3 215.6	3 551. 4	3 863.3	4 198.5
Real GDP growth (%)	6.8	6.6	4.8	4.8
Private consumption (%)	5.4	5.9	3.0	3.2
Public consumption (%)	-0.7	0.5	0.5	1.0
Investments (GFCF, %)	6.5	5.8	3.0	3.5
Exports (%)	15.8	14.6	12.0	11.5
Imports (%)	14.2	13.8	10.0	9.8
Unemployment (%)	7.2	5.3	4.6	4.3
Real ULC growth (%)	0.2	-1.3	-2.3	-1.0
Annual average inflation (%)	2.1	3.0	5.9	5.0
Money market rate (3-month, %, end-year)	2.56	4.05	5.00	4.75
Long-term interest rate (10-year, %, end-year)	3.77	4.68	5.10	4.90
Exchange rate (CZK / EUR; annual average)	28.34	27.77	25.56	25.56
Exchange rate (CZK / EUR; end-year)	27.49	26.63	25.56	25.56
Budget balance / GDP (%)	-2.7	-1.6	-1.9	-1.9
Public debt / GDP (%)	29.6	28.7	28.5	28.4
Trade balance (goods and services) / GDP (%)	3.2	4.7	4.3	4.2
Current account balance / GDP (%)	-3.3	-2.7	-2.3	-1.9
External financing capacity / GDP (%)	-3.1	-2.1	-1.7	-1.3
Gross foreign debt / GDP (%)	36.9	37.9	38.5	38.3

Note: f = forecast. See methodological notes for definitions and details.

Sources: Eurostat, Czech National Bank, Czech Statistical Office

Estonia

Stagflation is around the corner: the economy is on the brink of recession while external forces are stoking inflation. Labour market flexibility and disciplined income policy will be key to speedy recovery. Meanwhile, the slowdown brings a welcome improvement in the external balance.

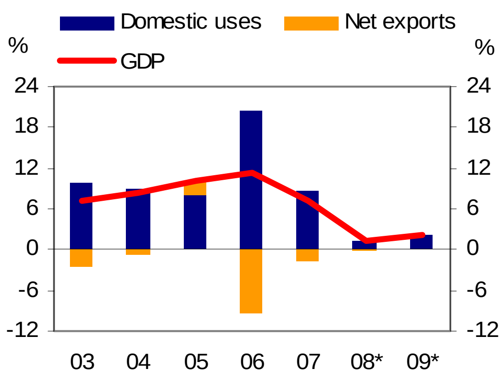
Political developments

The economic downturn brought some tensions within the government to surface. Early July, finance minister Ivari Padar suggested that further cuts to the income tax rate should be put off to improve the budget's position. Prime Minister Andrus Ansip retorted that postponing tax promises of governing parties is 'politically impossible'; the government eventually decided on continuing with planned tax cuts in 2009-10. Opposition parties criticised the decision for threatening fiscal stability and medium-term prospects while offering limited gains to taxpayers.

Growth

The economic slowdown has proved stronger than expected. GDP growth was just 0.1% in the first quarter, which amounted to a seasonally adjusted 0.5% contraction from the previous quarter. Private consumption stagnates due to slipping consumer confidence while public spending has started to shrink with the supplementary budget. Although real wages still grew by some 7% in the first quarter, new loans by households fell by an annual 23.5% in the first five months. Retail sales stagnated in the first five months of the year and residential construction orders stalled.

Structure of growth



*Note: * forecast. Source: Eurostat*

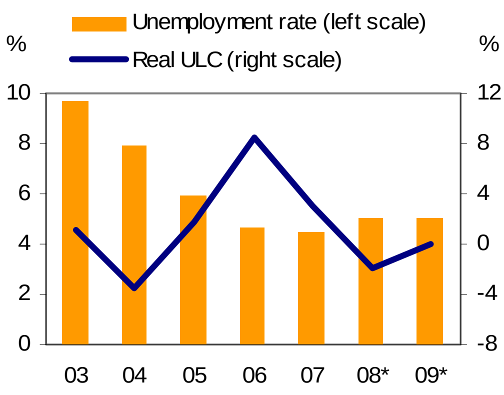
Investment growth remains in the positive territory for now, but a slowdown in construction, bleaker short-term outlook for enterprises and postponements in the use of EU Structural Funds point to a continuing slowdown. Exports and imports were shrinking by 5.4% and 3.8% respectively in the first quarter. This is due to a drop in contract manufacturing, deteriorating export opportunities and weak domestic demand, respectively.

Developments in production mirror the expenditure side: services are already contracting, construction is churning out one final surge until existing orders last, while industry appears to have adjusted to a slower growth path.

GDP growth is expected at just 1.2% in 2008 and will recover slowly, to 2.2% in 2009. Net exports will have a negligible contribution over the forecast horizon: although import growth will remain limited, a slowdown in main trade partners will keep exports at bay. Meanwhile, the role of fixed capital formation will diminish and private consumption will become the key driver. Despite the downward revision of growth forecasts, there remain downside risks. Further inflationary shocks could erode the purchasing power of households while slow wage adjustment can harm export competitiveness.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

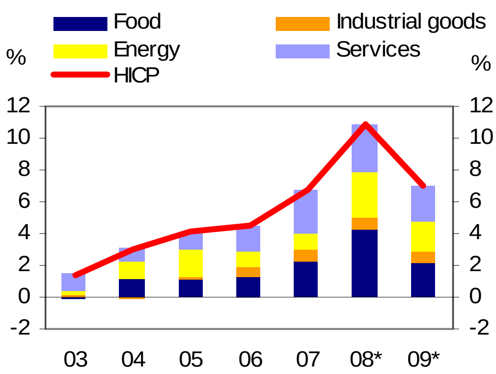
Although employment grew by an annual 2.1% in the first quarter and the unemployment dropped to 4.2%, recent labour market trends will be reversed in 2008-2009 as the economy comes to a halt. We expect the unemployment rate to climb back to at least 5% by 2009 with most layoffs coming from construction and market services.

As the profitability of enterprises drops, wage growth will continue to decelerate, although the persistence of inflationary expectations can raise wage claims and hamper adjustment. We reckon that real wage growth will be close to zero in 2008-2009. Real unit labour costs will adjust with a lag due to the inertia of labour markets: they will rise by 3.1% in 2008 and then fall by 2% next year.

The Ministry of Finance commented in May 2008 that wage adjustment proceeds slowly and acknowledges that administrative wage increases (in health care, education, etc.) played a part in sustained wage growth. Disciplined income policy in the public sector will be the key to the smooth adjustment of the labour market and the quick recovery of the economy.

Prices and monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

Renewed global price shocks resulted in persistent high inflation: 12-month HICP exceeded 11% since January 2008 on the back of food and energy price increases. Excise tax increases and rises in thermal heating prices keep inflation high in the coming months. On the other hand, industrial, construction and service prices are slowing down as domestic demand is losing steam.

Inflation is expected at 10.8% in 2008, an upward revision in our forecast due to recent external price shocks. Wages are an upside risk to our forecast: a prolonged period of high inflation may affect wage claims, fuelling a wage-price spiral. Absent additional price shocks, inflation can fall back to 7% in 2009.

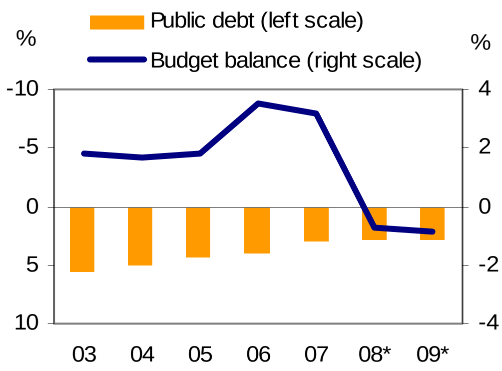
Money market rates are falling thanks to decreasing risk premia: the 3-month TALIBOR dropped from its 7.23% peak in December 2007 to 5.48% by June 2008. Although European rates have started to rise, abating inflationary pressures and an improving external balance will further improve perceptions of the Estonian economy, allowing spreads vis-à-vis European yields to fall further.

New credit outlays to households dropped by 23.5% in the first five months of 2008 as consumer confidence evaporated and private consumption came to a halt. Meanwhile, new credit to businesses fell by 3% reflecting a deteriorating short-term outlook and lower willingness to invest. The loan portfolio of banks keeps deteriorating: the share of bad loans climbed to 5.8% by May 2008 from 3.5% a year earlier. Eesti Pank (the central bank) insists that risks to the financial system are low as local banks' liquidity and capital buffers are sufficient and their Scandinavian parent banks are in healthy condition.

Fiscal policy

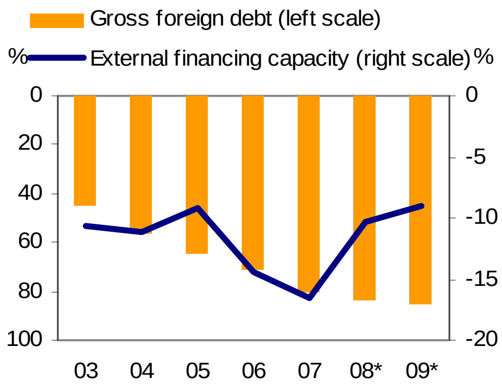
Due to the precipitous slowdown of the economy, budget revenues are arriving slower than expected: they amounted to 35.6% of the planned amount by the end of May 2008, three percentage points less

Key fiscal indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

External balance indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eesti Pank, Eurostat

than at the same time last year. Predictably, taxes on production and imports suffered the most: they fell by an annual 11% in the first quarter.

A supplementary budget was approved by the government in May to compensate for lost revenues. It trims expenditures by EEK 3.2 bn (EUR 204 mn or 1.2% of forecasted GDP), while revenues are reckoned to fall EEK 6.1 bn behind schedule. Next year's budget will see an EEK 5 bn reduction of spending from previous plans. This means that the budget is expected to end 2008 with a 0.7% deficit relative to GDP. We expect the deficit to widen slightly in 2009, to 0.9% of GDP.

Automatic stabilisers are already helping the economy to recover. Private consumption will also be aided by continuing cuts of the income tax rate (from 21% in 2008 to 20% in 2009) and rises of the threshold for exemption. However, these measures can hamper disinflation.

Despite the deteriorating budget balance government debt is set to remain fairly stable over 2008-2009.

External balance

The external balance is improving rather rapidly. In the first quarter of 2008 the trade deficit amounted to just EUR 263 mn compared to EUR 497 mn a year before. Exports of agricultural products, basic materials and machinery have grown healthily in recent months. On the other hand, processed food, wood and textile exports barely rose while oil transit and electronics contract manufacturing are being scaled back. Services exports grew thanks to transport and construction. Meanwhile, the weak economy and lower exports reduced import demand.

The inflow of EU funds contributes greatly to the narrowing of the external financing requirement through improvements on the current transfers and capital accounts. The external financing need of the economy was EUR 425 mn in the first quarter, down from EUR 800 mn in the same period last year. We expect the external financing need to fall to 10.3% of GDP in 2008 and narrow further to 9% in 2009. Though still high, these figures indicate a healthy rebalancing of the economy.

Net FDI inflows are expected at around 7% of GDP in 2008-09. Inflows of loans from the foreign parents of local banks will drop as the domestic credit boom comes to an end. Therefore gross foreign debt will stabilise at around 85% of GDP in 2008-09.

Key macroeconomic indicators of Estonia, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (EEK million)	207 061	243 252	265 100	287 200
Real GDP growth (%)	11.2	7.1	1.2	2.2
Private consumption (%)	14.9	9.0	1.0	2.5
Public consumption (%)	2.6	4.8	2.5	3.5
Investments (GFCF, %)	22.4	7.8	2.5	0.5
Exports (%)	8.3	1.5	-2.0	2.0
Imports (%)	17.1	2.8	-1.5	1.5
Unemployment (%)	5.9	4.7	4.5	5.0
Real ULC growth (%)	1.8	8.5	3.1	-2.0
Annual average inflation (%)	4.4	6.7	10.8	7.0
Money market rate (3-month, %, end-year)	3.81	7.23	5.00	4.75
Long-term interest rate (10-year, %, end-year)	5.43	6.81	6.50	5.00
Exchange rate (EEK / EUR; annual average)	15.65	15.65	15.65	15.65
Exchange rate (EEK / EUR; end-year)	15.65	15.65	15.65	15.65
Budget balance / GDP (%)	3.6	3.2	-0.7	-0.9
Public debt / GDP (%)	4.0	2.9	2.8	2.7
Trade balance (goods and services) / GDP (%)	-11.7	-11.1	-7.1	-6.5
Current account balance / GDP (%)	-16.6	-17.7	-12.1	-11.2
External financing capacity / GDP (%)	-14.4	-16.6	-10.3	-9.0
Gross foreign debt / GDP (%)	71.5	80.1	83.3	84.9

Note: f = forecast. See methodological notes for definitions and details.

Sources: Eesti Pank, Eurostat, Statistics Estonia

Hungary

Contrary to our earlier expectations the first quarter of 2008 was still characterised by relatively strong external and weak domestic demand. Overall economic activity thus remained quite suppressed. Inflation got stuck at a high level forcing monetary policy to tighten. Fiscal and external balances, however, improved considerably.

Political developments

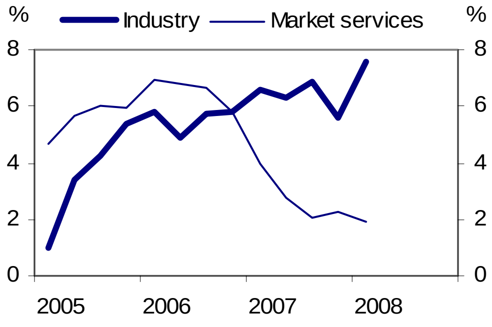
The second quarter saw further major changes in the political arena. After the break-up of the governing coalition (the junior member, SZDSZ leaving the government), Mr. Gyurcsány leads a minority government. During the break-up he was also criticised by his own party's (MSZP) members. Although rumours arose of his dismissal, no serious contender was put forward. This minority government will face its real test in autumn, because recent political developments suggest that their proposal for the 2009 budget will fail.

The institutional setup of the government also changed. The Ministry of Economy and Transport were split into three parts: development policy issues are concentrated at the Ministry for National Development and Economy led by Mr. Gordon Bajnai; infrastructural issues will be dealt with by the Ministry of Transport, Telecommunication and Energy led by Mr. Pál Szabó, and there will be an independent office for R&D issues led by a minister without portfolio. The more pronounced treatment of R&D issues is also supported by the fact that the European Commission selected Budapest to host the headquarters of the European Institute of Innovation and Technology. This can finally steer Hungary (and the EU) towards a more technology-driven growth path.

Growth

Developments in the real economy developments went against our expectations in the first quarter of 2008. Supported by favourable external demand the most export-oriented industrial branches exhibited solid performance, whilst the growth of market services was disappointing. Behind this lies the fact that the anticipated pick-up in domestic demand has not yet materialised. Year-on-year GDP growth reached 1.7% though, but adjusting for calendar effects this figure would be a mere 0.9%, hardly an improvement compared to the previous quarter.

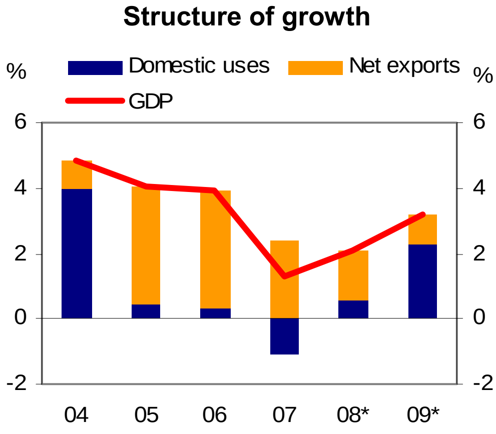
Value added in the tradables sector



Note: year-on-year growth rates, seasonally adjusted.
Source: KSH (statistical office)

Agriculture finally showed signs of recovery following a continuous fall in the past three years. It would be too early, however, to project exceptionally high agricultural growth based on first quarter data, especially as a humid summer points to rather unexceptional crop yields. Construction output fell further and was 20% lower than a year ago. Based on monthly data, however, the first months of the second quarter can eventually prove to be a turning point.

On the expenditure side there were little changes in private consumption: in-kind transfers from the government still contributed negatively to its growth, while consumption expenditures themselves were at best stagnating. Retail sales were still ailing in the first months of the second quarter. Gross fixed capital formation was dealt another

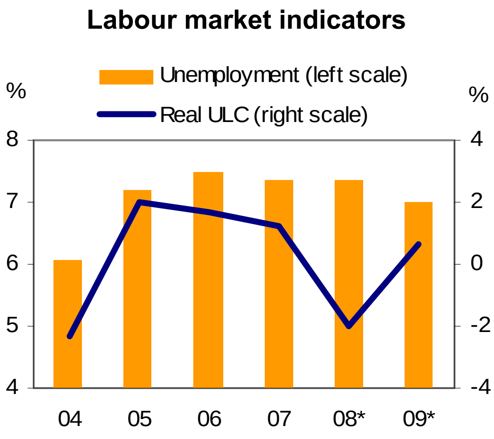


*Note: * forecast. Source: KSH (statistical office)*

blow by particularly weak state investments in the first quarter. Rising capacity utilisation, however, points to possible improvements in corporate investment. Exports and imports both increased at double-digit rates, and the trade surplus widened further.

There are already signs that external demand will drop sizably from the second quarter, reducing the possibility of further gains from net export. The components of domestic demand, however, will gradually recover as the effects of fiscal austerity measures slowly fade out. Yet, net export will remain the main contributor to 2008 GDP growth, which will remain subdued at 2.1%. The structure of growth will be more balanced in 2009: domestic demand will gain strength as both corporate and state investments will be on the rise, and a more favourable income outlook is expected to boost private consumption. This will result in a GDP growth of 3.2% next year, still slightly below potential.

Labour market

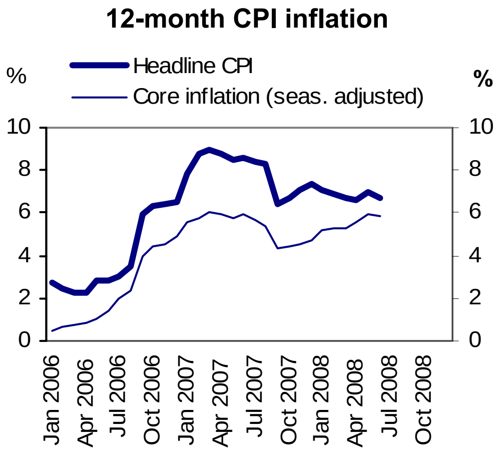


*Note: * forecast; real ULC based on gross wage growth. Source: KSH (statistical office)*

There are reasons to believe that the labour market finally arrived at a turning point in the first quarter of 2008. Based on seasonally adjusted figures the steady decrease in the number of the active and the employed seems to be over. Unemployment stabilised according to the Labour Force Survey, although registered unemployment is still on the rise: the creation of new jobs in industry and some market services are still offset by job losses in construction and public services. Real wages have also stabilised as bonus payments in the corporate sector were recovering from the very low levels of 2007.

The pick-up of domestic demand and incentives to return to the labour market will lead to a slight increase in employment in the rest of the year, but the rate of unemployment will not decrease significantly before 2009. It could still be 7.4% on average this year, before going down to 7% next year. A moderate increase in real wages is expected in 2009, but only for private sector employees. Yet, accounting for lower productivity growth in 2009, this will be enough to turn real ULC-growth positive by next year.

Prices, monetary conditions



Source: KSH (statistical office)

The gradual disinflation was broken in May due to soaring food and energy prices. In June, however, the rise of seasonal food prices was more moderate and the continued slowdown in services prices growth also helped headline CPI to fall somewhat. The 12-month rate of change was 6.7% in June, while in the first half of 2008 cumulated CPI inflation was 6.8%. In addition to external price shocks, developments in core inflation remain a source of concern. The 12-month indices of this indicator are stuck at around 6% pointing to the possibility of strong inflationary inertia through higher expectations.

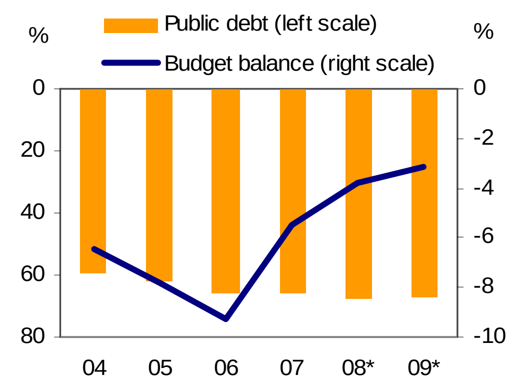
The domestic currency significantly appreciated vis-a-vis the euro: at the end of June it broke the former flotation band's strong edge (at 240 HUF/EUR), and by the middle of July it further appreciated to below 230 HUF/EUR. Should this exchange rate prevail, it could exert a beneficial effect on inflation from the second part of 2008. It should be noted, however, that a significant part of this appreciation is due to regional effects. Still, improving trade and fiscal balances also contributed, and monetary policy has also gained credibility recently.

The central bank raised its policy rate two times in the second quarter from 8% at the end of March to 8.5% by the end of May. The reasoning behind the rate hikes was a bad outlook concerning the realisation of the 2009 inflation target. In June, however, the central bank kept the policy rate unchanged contrary to expectations arguing that no further worsening in the inflation outlook is foreseen. While this claim itself can be challenged, the appreciation of the forint and moderating wage rises possibly also played a role in the decision.

The 2009 inflation target is still in danger, though, thus no monetary easing is expected. Inflation will be decelerating in the second half of 2008, but will possibly be as high as 6.4% on average. Slow disinflation will continue throughout 2009, but this will not be rapid enough to meet the inflation target: at the end next year the 12-month rate of change could still be 3.7% (0.2% above the upper edge of the target band), while average annual inflation will be around 4.4%.

Fiscal policy

Key fiscal indicators (% of GDP)



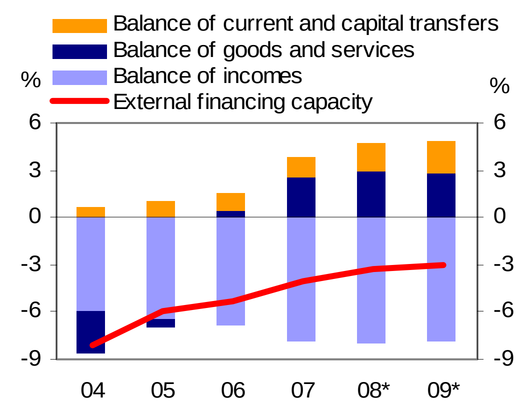
*Note: * forecast, reverse scale on left axis.*
Source: PM (ministry of finance)

There were encouraging fiscal developments in the first quarter of 2008. The deficit was a mere 2.6% of GDP, reflecting a slow increase in incomes but a more pronounced decline in expenditures. Of the former the continued improvement in both direct and indirect taxes should be mentioned, while the latter was mainly caused by lower compensation for public employees and a very low level of state investments that were last seen five years ago. However, while rising revenues from production taxes significantly contributed to the improvement of the budget balance, they were also a drag on the growth of the real economy. Despite the improvements in the budget and the appreciating domestic currency, the stock of public debt increased from 65.9% to 67.1% of GDP by the end of the first quarter as the stock of government bonds held by residents and non-residents both increased, and a syndicated loan amounting to CHF 350 mn was also extended to the state budget.

The outlook for this year is bright, however: the budget deficit will be even lower (at 3.8% of GDP) than the previously anticipated 4%. The next year (being the year before parliamentary elections) will be characterised by upside risks, but a very disciplined fiscal policy can result in a 3.2% deficit, consistent with the goals set out in the Convergence Programme.

External balance

External financing capacity (% of GDP)



*Note: * forecast. Source: MNB (central bank)*

A massive surplus in the capital account (attributed to inflows from EU funds) helped reduce the external financing need to a mere EUR 367 mn (or 1.4% of GDP) in the first quarter. Unexpectedly strong external demand kept the trade balance improving: even with the anticipated deterioration of net income payments, the external balance seems to be moving in the right direction. The financing structure has also improved: it was more balanced between debt and non-debt net capital inflows. While FDI flows did not rise significantly, net portfolio equity inflows exhibited positive balances again. Stocks of FDI and foreign debt were modified by some methodological changes and are thus not directly comparable to earlier figures. Gross foreign debt at the end of the first quarter stood at EUR 101.4 bn (99.2% of GDP).

Due to the moderation in external demand, further improvements in the trade balance will be contained. Yet, increasing surpluses in EU-related transactions will lead to a significant reduction in the external financing need: it could be as low as 3.3% of GDP in 2008 and could fall further to 3% of GDP in 2009. Meanwhile, a more balanced structure of financing will result in a slower build-up of debt stock. Given that the forint has significantly appreciated against the euro, nominal GDP expressed in euros will rise quite sharply in 2008-09. This eventually leads to a marked improvement in the foreign indebtedness indicators: the stock of gross foreign debt will decrease to 95.5% of GP by the end of this year and will be further reduced to 92.2% of GDP by the end of next year.

Key macroeconomic indicators of Hungary, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (HUF billion)	23 795	25 406	27 400	29 400
Real GDP growth (%)	3.9	1.3	2.1	3.2
Private consumption (%)	1.9	-1.9	0.2	1.8
Public consumption (%)	5.8	-3.1	-1.0	1.7
Investments (GFCF, %)	-2.5	0.1	3.0	4.9
Exports (%)	19.0	14.2	11.7	9.6
Imports (%)	14.7	12.0	10.8	9.3
Unemployment (%)	7.5	7.4	7.4	7.0
Real ULC growth (%)	1.7	1.2	-2.0	0.6
Annual average inflation (%)	3.9	8.0	6.4	4.4
Money market rate (3-month, %)	7.93	7.45	8.10	7.00
Long-term yields (10-year gov't bond, %)	6.71	7.08	7.50	6.40
Exchange rate / EUR (average)	264.14	251.31	244.77	238.00
Exchange rate / EUR (end of period)	252.30	253.35	236.00	240.00
Budget balance / GDP (%)	-9.2	-5.5	-3.8	-3.2
Public debt / GDP (%)	65.5	65.9	67.5	67.0
Trade balance / GDP (goods and services, %)	0.4	2.5	2.9	2.8
External financing capacity / GDP (%)	-5.3	-4.0	-3.3	-3.0
Gross foreign debt / GDP (%)	90.5	96.9	95.5	92.6

Note: f = forecast. See methodological notes for definitions and details.

Sources: Eurostat, KSH (statistical office), MNB (central bank), PM (ministry of finance)

Latvia

A massive slowdown is on the cards: the credit-fed construction boom is over, inflation is eating away incomes and consumer confidence is slipping. External imbalances will heal themselves thanks to lower import demand, but persistently high inflation is a risk to adjustment.

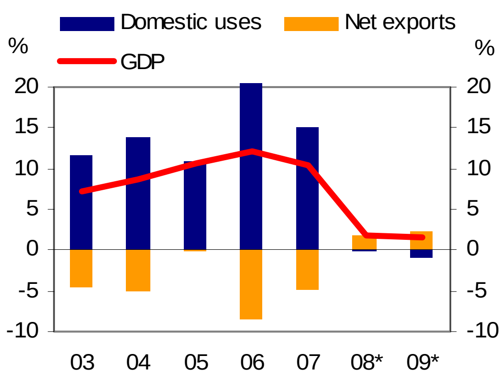
Political developments

Tensions with Russia and corruption scandals continued in recent months. Russian extremists harassed the Latvian ambassador in Moscow on 25 June. A few weeks later a report from Latvia's Security Council labelled Russia one of the major threats to the country's national security. Meanwhile, opposition forces in the Riga city council launched a petition to oust the major based on allegations of corruption and negligence.

Growth

The economy is gradually losing steam. Seasonally adjusted GDP growth rates are shrinking and the economy expanded by just an annual 3.3% in the first quarter. Private consumption remains weak as high inflation and a bleak outlook hurt consumer confidence; fiscal tightening sets back public consumption as well. Retail sales fell by an annual 1.1% in the first five months of 2008 compared.

Structure of growth



*Note: * forecast. Source: Eurostat*

Investments maintained a 5.1% growth in the first quarter, but a depressed housing market and deteriorating investment prospects are expected to hurt fixed capital formation in the second half of the year. The price of a standard apartment in Riga fell by over 20% in the year to July. Until prices stabilise, recovery of housing investments is not expected. Public investments are also axed. Exports put in a decent performance, while slowing domestic demand is already affecting imports; therefore the large drag of net exports on growth is disappearing.

Construction is expected to slow as new orders dry up while domestic services will feel the pinch in consumer spending. Industrial production continues to shrink: it fell by an average 2.5% over January-May. Demand for building materials is falling, wood, furniture and textile exports are suffering and the food industry also experiences falling production volumes.

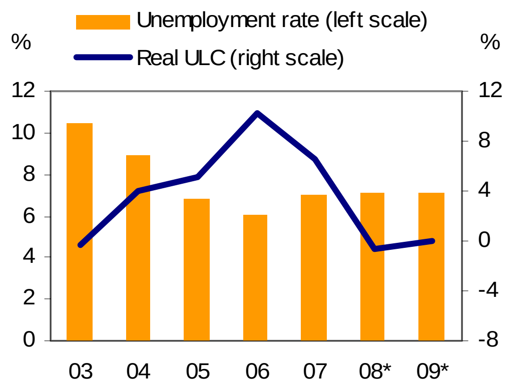
Our forecasts are strongly revised downwards. GDP growth could be a meagre 1.8% in 2008 and just 1.5% in 2009. The contribution of domestic demand could be close to zero in both years; therefore net exports will become the driver of the economy in the short term. Therein lie the main uncertainties to our forecast. If wages spiral out of control or external demand for Latvian products dwindles, foreign trade may not be able to keep the economy afloat.

Labour market

Job creation has reached its peak recently. Employment grew by an annual 4.9% in the first quarter of 2008 as labour demand in services remained strong. Meanwhile, the labour force increased by 4.6%. Unemployment (among the 15-74 years old) approached 5% at the end of 2007 but is already rising. As the economy slows and layoffs start, it is expected to climb back to around 7% in 2008-09. Since economic conditions in western Europe deteriorate, outward migration will not be able to mitigate the impact of domestic job losses.

Meanwhile, wages continue to soar; they increased by 20.8% in the first quarter. Brisk economic growth, tight labour markets and public sector pay rises were the key drivers of income growth in 2007. High inflation will be the main reason for strong nominal wage growth in 2008-09, but this will be accompanied by a much more moderate increase in real income. This year personnel costs will outpace labour productivity by over 6 percentage points, but productivity will take over in 2009.

Labour market indicators



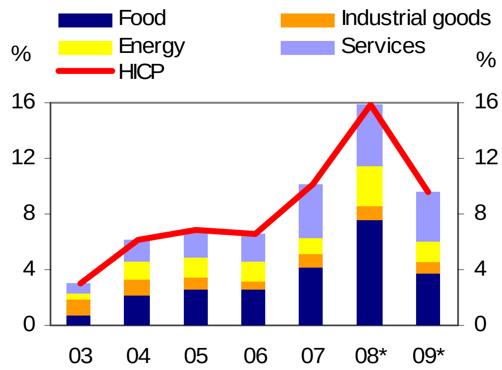
*Note: * forecast. Source: Eurostat*

Monetary developments

Due to external food and energy price shocks in recent months, inflation kept rising. Consumer prices increased by 17.7% in the year to June. As labour and energy costs keep increasing, producer prices got stuck at around 11-12% in the second quarter. It seems that supply-side pressures are taking the place of excessive demand; therefore disinflation could be a lengthy process, especially if nominal wage growth remains stuck at a high pace. Assuming no further external shocks to food and energy, inflation can subside in the second half the year and reach an average 15.8% in 2008, before receding to 9.5% in 2009.

Short-term interest rate differentials against the euro area have diminished but high inflation has raised spreads on longer maturities. Bank lending continues to slow; in the year to May the outstanding loan stock of enterprises and households grew by 25% and 21% respectively. Lower consumer and business confidence and a depressed housing market will keep credit demand weak in the following months.

Components of inflation



*Note: * forecast. Source: Eurostat*

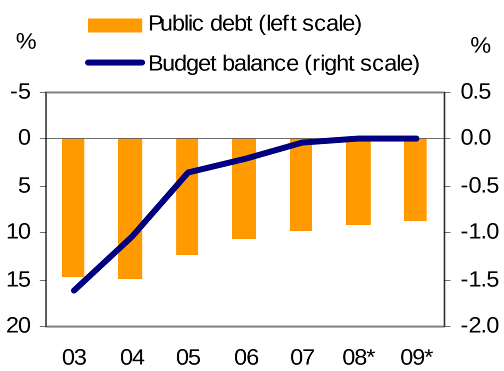
Fiscal policy

Between January and May 2008 consolidated revenues of the central government rose by an annual 21.7%, while expenditures increased by 28.6%. However, VAT revenues rose by just 5.4% as domestic consumption slumped; corporate income taxes also seem to arrive slightly behind schedule.

The Convergence Programme planned budget surpluses of 0.7% of GDP in 2008 and 1% in 2009. However, the outlook has deteriorated in recent months. On one hand, revenue collection will remain weak; on the other hand, high inflation may necessitate expenditure increases on top of existing plans (e.g. wages, social spending). Early July the finance minister noted that this year's surplus will be a meagre LVL 8 mn (0.05% of GDP) even after spending cuts worth LVL 169 mn. Our own forecast also entails balanced budget for 2008-09.

Following the EUR 400 mn debt issuance the stock of public debt rose temporarily, but given the overall budget surplus for 2008-09, it will fall below 9% of GDP.

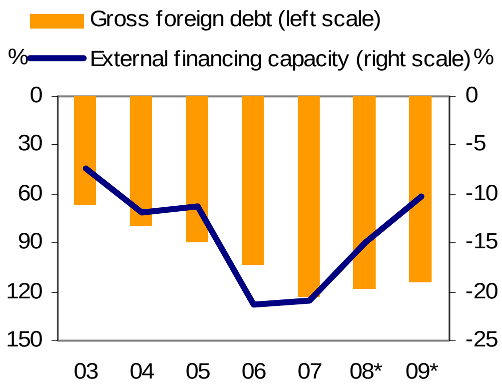
Key fiscal indicators (% of GDP)



*Note: * forecast, reverse scale on left axis*
Source: Eurostat

External balance

External balance indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

The external financing need of the economy amounted to EUR 1.3 bn between January and May 2008, EUR 0.5 bn less than in the same period last year. While goods exports rose by 14.8%, imports increased by just 2% despite a surge in energy prices; services also registered an improving balance. A fall in outward current transfers more than compensated for a slight rise in the deficit of the income balance. Inflowing EU funds boosted the surplus of the capital account to almost EUR 0.2 bn between January and May.

We expect the external financing requirement to fall sharply in the coming quarters, to 15% of GDP in 2008 and to 10.3% in 2009. Most of the improvement will come through the trade balance. Export growth will slow down: textile and wood sales abroad are already falling while mineral fuels, pharmaceuticals and furniture show signs of fatigue. However, weak import demand will compensate for this deceleration and the trade balance (of goods and services) is expected improve by 9 percentage points of GDP between 2007 and 2009.

The financing side will also reflect developments in the real economy. The deteriorating economic outlook will moderate inward FDI, while the end of the credit boom will reduce the role of other investments (mainly loans from foreign banks to domestic subsidiaries). On the other hand, the eurobond issuance of the government in February gives a temporary boost to portfolio debt financing. Nevertheless, the stock of foreign debt relative to GDP is past its peak, and could decline by a few percentage points to around 114% by the end of 2009.

Key macroeconomic indicators of Latvia, 2006-2009

	2005	2006	2007f	2008f
Nominal GDP (LVL million)	11 172	13 957	16 100	17 900
Real GDP growth (%)	12.2	10.3	1.8	1.5
Private consumption (%)	21.2	13.9	1.5	-0.5
Public consumption (%)	4.9	4.8	1.0	1.0
Investments (GFCF, %)	16.3	8.4	2.0	-1.5
Exports (%)	6.6	11.1	3.0	4.0
Imports (%)	19.3	15.0	-1.0	-1.0
Unemployment (%)	6.8	6.0	7.0	7.1
Real ULC growth (%)	5.1	10.2	6.6	-0.7
Annual average inflation (%)	6.6	10.1	15.8	9.5
Money market rate (3-month, %, end-year)	4.21	10.78	7.50	7.00
Long-term interest rate (10-year, %, end-year)	4.90	5.10	5.50	5.00
Exchange rate (LVL / EUR; annual average)	0.70	0.70	0.70	0.70
Exchange rate (LVL / EUR; end-year)	0.70	0.70	0.70	0.70
Budget balance / GDP (%)	-0.2	0.0	0.0	0.0
Public debt / GDP (%)	10.7	9.7	9.1	8.7
Trade balance (goods and services) / GDP (%)	-22.2	-20.9	-16.1	-11.7
Current account balance / GDP (%)	-22.5	-22.9	-16.3	-11.5
External financing capacity / GDP (%)	-21.3	-20.9	-15.0	-10.3
Gross foreign debt / GDP (%)	103.4	122.9	118.0	114.2

Note: f = forecast. See methodological notes for definitions and details.
Sources: Eurostat, Latvijas Banka, Statistics Latvia

Lithuania

Soft landing continues, but inflation remains on an upward path. Although external imbalances are improving, external and internal macroeconomic risks remain considerable.

Political developments

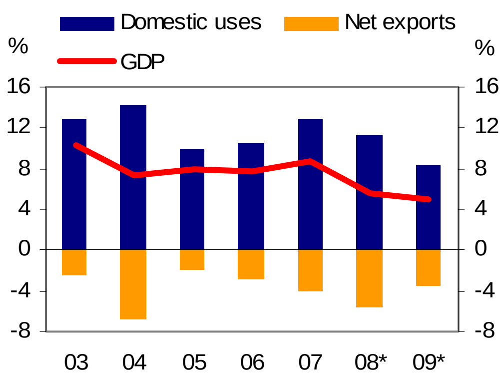
Confrontations with Russia continue; current issues include U.S. missile defence installations, compensations for damages during the soviet occupation, and the ban on the use of soviet symbols. Lithuania also vetoed EU-Russia's partnership and cooperation talks.

France expressed its wish to join the Baltic nuclear energy project. Concrete measures are still missing, because Poland aims for higher share of output, while Latvia wants an own power plant. The Ignalina nuclear plant has to be closed in 2009, meaning increasing dependence on fossil fuels, from Russia.

The country is approaching general elections in October. It now seems that the Social Democratic Party led minority coalition will scrape through without significant measures until then, although macroeconomic challenges call for action.

Growth

Structure of growth



*Note: * forecast. Source: Eurostat*

Slowdown has continued in early 2008. In the first quarter GDP growth was 7%. Growth is still driven by domestic demand, although with a changing structure. Private consumption (growing at 12.1% in the first quarter) was boosted by dynamic wage and credit growth. However, consumer confidence is slipping away and lending conditions are tightening, therefore a slowdown is on the cards. Gross fixed capital formation slowed down considerably (to 5.9%) as construction activity is cooling. The first quarter also brought improving export performance thanks to the restoration of capacities of the Mazeikiu Nafta refinery. However, the contribution of net exports to growth is still negative due to strong private consumption.

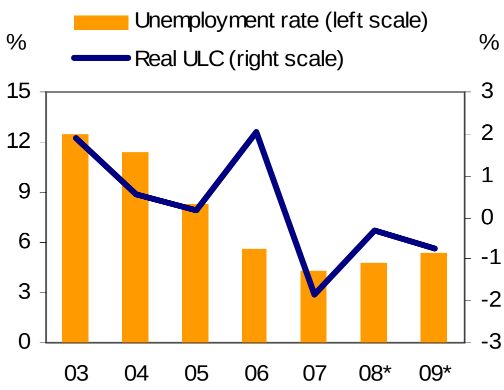
On the production side, despite the cooling housing markets, construction, and services were the main sources of value added growth. However, the slowdown of consumption and investments will affect these sectors the most.

Domestic demand is expected to remain the driving force of growth, but the negative contribution of net exports will narrow. GDP growth is expected at 5,5% in 2008 and at 5% in 2009, slightly below the potential rate. The major downside risk is the development of consumer confidence and inflation, which may negatively affect private consumption.

Labour market

Deteriorating growth performance will be followed by worsening employment data. The downturn was already apparent in the last quarter of 2007 as seasonally adjusted employment growth started to slow down. Even more apparent is the rise in seasonally adjusted unemployment data. The unemployment rate reached 4.6% in the first quarter of 2008. Agriculture, industry and construction were the main

Labour market indicators



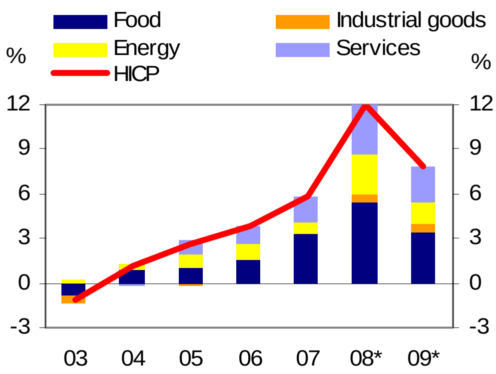
*Note: * forecast. Source: Eurostat*

sources of layoffs, while service sectors performed relatively well. We anticipate a slight fall in employment in 2008 and 2009 that will manifest in an increase of the unemployment rate to 4.8% in 2008 and 5.4% in 2009. Compared to previous years, employment prospects for migrants abroad are less favourable, therefore outward migration can decrease, leading to the easing of the labour market.

The pace of wage growth is still remarkable. Accelerating inflation and a tight labour market pose a challenge for moderating wage claims. Earlier minimum wage rises and income tax cuts boosted earnings considerably, adding to increasing inflationary pressures. Real unit labour costs will decrease only slightly in 2008-09, as productivity gains will just outpace labour cost dynamics.

Prices, monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

Inflation took off in the first five months of 2008: the HICP index increased by an average 11.3%. The drivers of this acceleration were partly driven by international food and energy price developments. However, some domestic factors also contributed, including rising excise duties, strong private consumption and wage inflation. The producer price index increased by more than 20% in the year to May, pointing to supply side pressures on prices.

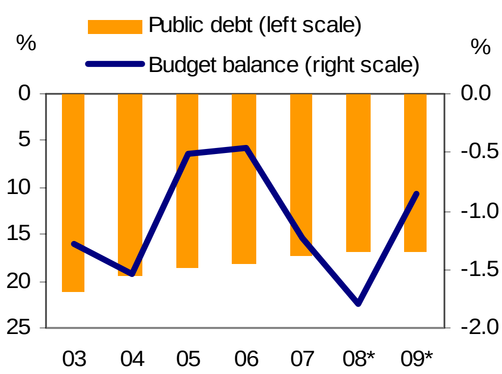
Inflation is expected to peak this year at 12.1%. Improving agricultural performance, the stabilisation of energy prices and cooling domestic demand can lead to 7.8% inflation in 2009.

Bond spreads reflect higher sensitiveness to country specific risks. Even though the gap between the euro-area and Lithuanian short-term yields narrowed in the first half of 2008, spreads can rise again as long as external imbalances and inflation cause vulnerabilities and fiscal rigour is under question.

Lending to the private sector shows signs of cooling, mainly because credit conditions are getting stricter and consumer and business confidence have deteriorated.

Fiscal policy

Key fiscal indicators (% of GDP)



*Note: * forecast, reverse scale on left axis. Source: Eurostat*

After a 1.2% deficit of general government balance in 2007, a slight increase is expected for 2008, due to the ongoing pension reform and tax reductions (personal income tax and temporary tax on corporate profits). These will set back revenues despite significantly improving tax collection. Also, we expect the increase of social transfers and a rise in public sector salaries is expected in 2008.

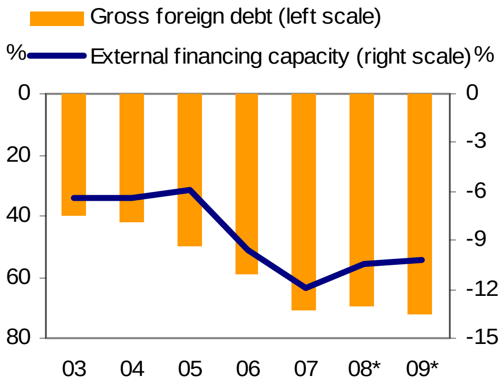
2008 will be the second consecutive year when the target set in the Convergence Programme (-0.5%) is violated, reflecting the anti-cyclical stance of fiscal policy. In an election year adjustment is unlikely; therefore we expect deficits of 1.8% in 2008 and 0.8% in 2009. In order to meet the numbers of the Stability and Convergence Programme the 2009 budget needs adjustment measures, particularly regarding accelerating public sector wages and social expenditures. These steps are also important to contain inflation and ensure the orderly deceleration of the economy.

The stock of public debt amounted to 17.3% of GDP at the end of

2007. Despite a rising deficit, it may fall slightly (to 16.9%) this year.

External balance

External balance indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Lietuvos Bankas

We expect the external financing requirement to narrow slightly, to 10.4% in 2008 and to 10.2% in 2009. This forecast is based on the improving balance of goods and services, led by restored export capacities (fuels, lubricants) of the Mazeikiu Nafta refinery. Relatively high import growth will gradually slow, as private consumption cools down. The demand for imported investment goods has already weakened. The income deficit will remain comparable to earlier years in nominal terms, while current transfers yield increasing surpluses due to inflowing EU funds.

The trade balance is expected at 13.1% in 2008 and 12.8% in 2009. The export of goods and services increased by almost 9% in the first quarter of 2008 (on a year-on-year basis), while imports grew by 18.8%. The main drivers of recent export growth were refined fuels, fertilizers, food products and plastics. The outlook for exporters is not favourable, as demand of main export destinations (Baltic countries, EU) with a share of more than 50% in total exports will falter. However, this might be partially offset by robust demand of the CIS region. Deteriorating cost competitiveness and the slowing external environment pose a downside risk to our assessment of the external balance.

Debt financing is expected to lose significance as the credit boom ends, and gross foreign debt could stabilise at its current level relative to GDP, around 70%.

Key macroeconomic indicators of Lithuania, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (LTL million)	81 905	96 740	115 900	131 800
Real GDP growth (%)	7.7	8.8	5.5	5.0
Private consumption (%)	11.9	11.6	11.0	9.2
Public consumption (%)	5.5	3.8	5.0	4.2
Investments (GFCF, %)	17.4	15.8	4.8	3.2
Exports (%)	12.2	4.7	10.5	7.0
Imports (%)	13.8	9.1	15.5	9.2
Unemployment (%)	5.6	4.3	4.8	5.4
Real ULC growth (%)	2.0	-1.8	-0.3	-0.7
Annual average inflation (%)	3.8	5.8	12.1	7.8
Money market rate (3-month, %, end-year)	3.72	7.07	5.25	4.50
Long-term interest rate (10-year, %, end-year)	4.28	4.94	4.85	4.50
Exchange rate (LTL / EUR; annual average)	3.45	3.45	3.45	3.45
Exchange rate (LTL / EUR; end-year)	3.45	3.45	3.45	3.45
Budget balance / GDP (%)	-0.5	-1.2	-1.8	-0.8
Public debt / GDP (%)	18.2	17.3	16.9	16.8
Trade balance (goods and services) / GDP (%)	-10.4	-12.5	-13.1	-12.8
Current account balance / GDP (%)	-10.8	-13.7	-13.4	-13.3
External financing capacity / GDP (%)	-9.6	-11.9	-10.4	-10.2
Gross foreign debt / GDP (%)	59.2	71.1	69.8	72.0

Note: f = forecast. See methodological notes for definitions and details.
Sources: Eurostat, Lietuvos Bankas, Lietuvos Statistikos Departamentas

Poland

Strong growth is expected to continue in Poland, although strong domestic demand and weakening growth in main trading partners will lead to a widening of the current account deficit. Inflation and structural problems of the labour market could be the main obstacles to ERM-II entry.

Political developments

President Lech Kaczynski declared that he will not sign the EU's Lisbon Treaty after Irish voters rejected it in a referendum in May. It was approved in April by the Polish parliament, but needs the signature of the president to become effective. The views of the Polish president are in sharp contrast with the mainstream position of EU leaders, who said at the Brussels summit on 20 June that the ratification of the Lisbon Treaty should continue.

A new initiative by Sweden and Poland to strengthen the EU's ties with its eastern neighbours was officially presented in May. It calls for more cooperation with the Ukraine, Moldova, Georgia, Armenia and Azerbaijan and is seen as a complement to the French-driven 'Union for the Mediterranean'.

Finance Minister Jacek Rostowski was quoted as saying in June, “We want to join ERM-2 when the economy will be extremely well-prepared to join the euro.” The country now fulfils criteria on debt and the budget deficit, and it may well meet the conditions on inflation next year. On the other hand, the centre-right cabinet may postpone applying for ERM-II membership: prospective general elections in 2011 would come just as the obligatory two-year membership would end and the country would introduce the euro.

The Civic Platform (PO)-led government has revealed ambitious plans to reform Poland's social security system, to reduce the size of the public sector and to accelerate privatisation.

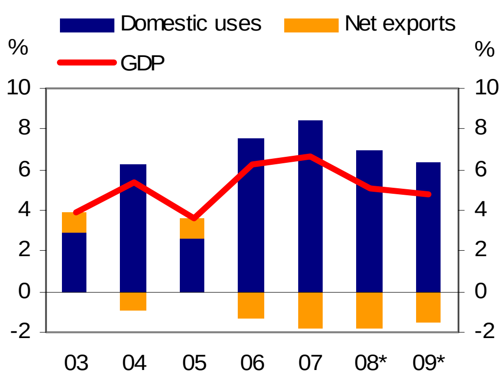
Growth

Gross domestic product grew at an annual 6.1% in the first quarter of 2008. Strong economic growth was primarily an effect of vigorous domestic demand. Consumer spending is growing strongly, although increase in industrial and retail sales growth was lower than projected in recent months. The best performing sectors include household appliances and consumer electronics, while new car sales have also rebounded after two years.

Polish exports have surged ahead, despite the fact that the zloty had appreciated by around 25% against the euro since May 2004. This suggests that manufacturers have been using the strong zloty to invest in capital goods to improve productivity. This hypothesis is supported by the fact that the main component of the import growth was capital goods. The medium-term outlook has improved thanks to an improving business climate: productivity-enhancing reforms and better regulation are expected to attract export-oriented foreign investments.

We expect favourable economic conditions to persist in 2008. Domestic demand will remain the main driving force of GDP growth,

Structure of growth

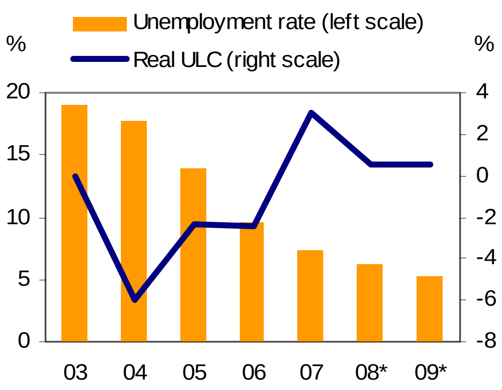


*Note: *forecast. Source: Eurostat*

but investments are likely to stay robust as well. GDP growth is expected to hit 5.1% in 2008 despite the worsening outlook of trade partners. A similar, 4.8% growth rate is projected for 2009.

Labour market

Labour market indicators



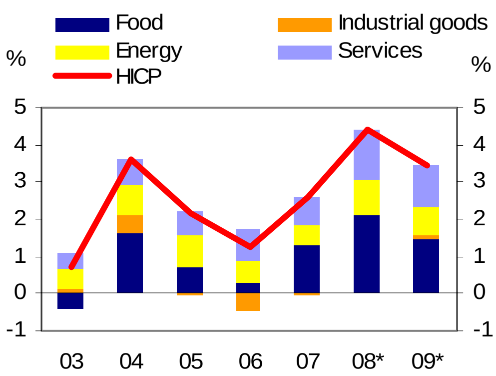
*Note: * forecast. Source: Eurostat*

Marked improvements are visible on the labour market. Wages and employment are growing fast while unemployment is decreasing. Poland's jobless rate declined to its lowest in almost a decade in recent months, and the country no longer 'boasts' the highest unemployment rate in the EU. The upcoming tax reform is expected to have beneficial effects on employment, therefore further improvements are possible. Meanwhile, labour shortages can be eased by the return of migrants from western Europe who are lured home by a deteriorating outlook in host countries, improving conditions at home and the strength of the zloty (especially against the pound sterling).

The upward trend in wages continues and fuels private consumption. Nevertheless, productivity growth is broadly in line with wage developments: real ULC will probably growth by just 0.5% in 2008 and 2009 after a strong (3%) increase in 2007.

Prices and monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

In May inflation rose to the highest since the end of 2004. Poland's inflation rate has now exceeded the central bank's target for six consecutive months, a situation which has led to seven increases in the key interest rate since April 2007. Annual inflation will probably peak this year in August at around 4.5-5%. A similar jump in prices last occurred when the country joined the European Union in 2004. Then, the prices increased because of changes in indirect tax rates (due to excise tax harmonisation). Global food and energy prices are partly responsible for the surge in inflation, but core inflation is also picking up reflecting demand-side pressures.

Consumer price inflation will crawl up from 2.6% in 2007 to 4.4% in 2008. Subsiding demand pressures and the fading out of recent external price shocks should allow inflation to drop to 3.5% in 2009.

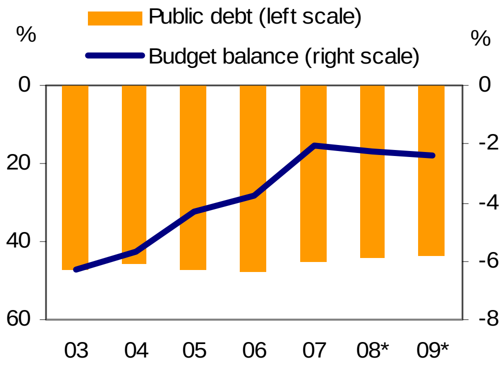
The Monetary Policy Council may avoid further rate hikes because expectations of more monetary tightening may lead to excessive appreciation of the zloty, although it will monitor second-round effects of inflation closely. The zloty should eventually face further pressures for appreciation in the pre-euro ERM-II exchange rate system, as was the case with the Slovak koruna.

Fiscal policy

In June the European Commission recommended lifting the excessive deficit procedure against Poland after the budget deficit dropped to 2% of GDP in 2007, comfortably below the 3% set in the Stability and Growth Pact. In parallel, Poland reduced its government debt to 45.2% of GDP.

In 2007 the budget deficit reached only 2% of GDP thanks to more prudent policy regarding expenditures, higher than expected economic growth resulting in windfall tax revenues, and falling unemployment, reducing social spending requirements.

Key fiscal indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

In February 2008 Prime Minister Donald Tusk revealed plans for a new flat income tax rate for individuals. The idea of flat tax rate is not new in Poland: proposals for a flat tax system were about to be unveiled early 2007. However, following the September 2005 elections, a compromise plan was cooked up by the winning Law and Justice Party and the runner-up Civic Platform.

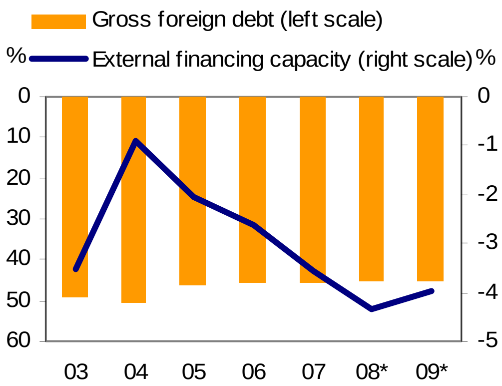
The planned flat tax rate of 17% would come into effect in 2010 and would replace three currently effective personal income tax brackets (19, 30 and 40%). As a first step, personal income tax rates will be reduced for most taxpayers in 2009 by simplifying the system to two brackets (18 and 32%).

As a result of the tax reform, the budget balance will slightly worsen in 2008-09, to 2.3% and 2,4% respectively. Cuts of labour taxes will be partially offset by increased revenues due to higher inflation, a widening of the tax base thanks to rising employment and the 'whitening' of the economy, and excise duty hikes related to EU tax harmonisation. Meanwhile, public debt will remain stable around its current level.

External balance

Both imports and exports picked up in the first quarter. Annual export growth jumped from 8.2% in the previous quarter to 13.4%, but imports accelerated slightly more, from 8.2% to 13.7%. As a result, the contribution of the external sector to overall growth decreased slightly.

External balance indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

The current account balance deteriorated by EUR 1.57 bn in the first quarter of 2008, compared to the corresponding period of 2007. The primarily reason was a sharp drop in the surplus on the current transfers account, caused by a rise in Poland's contribution to the EU budget. However, the external financing need grew to a smaller extent as capital transfers from the EU simultaneously increased. The income and trade deficits also widened markedly.

According to our forecast, the external financing requirement will grow slightly in 2008, to 4.3% of GDP, while 2009 is expected to bring an improvement to 4%.

The nature of foreign direct investment in Poland is changing: reinvested profits now comprise the largest share of FDI. However, the attractiveness of the country to new investments has also improved. In the first quarter of 2008, the Polish investment agency PAIZ signed 16 contracts worth EUR 700 mn, which is nearly 40% of the total value of 2007 investment deals.

Key macroeconomic indicators of Poland, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (PLN billion)	1 060.0	1 167.8	1 288.7	1 391.1
Real GDP growth (%)	6.2	6.7	5.1	4.8
Private consumption (%)	5.0	5.0	5.5	4.8
Public consumption (%)	6.1	5.8	0.5	1.0
Investments (GFCF, %)	14.9	17.3	13.0	12.0
Exports (%)	14.6	8.4	7.5	6.5
Imports (%)	17.4	12.2	11.0	9.0
Unemployment (%)	13.9	9.6	7.3	6.2
Real ULC growth (%)	-2.4	3.0	0.5	0.5
Annual average inflation (%)	1.3	2.6	4.4	3.5
Money market rate (3-month, %, end-year)	4.20	5.67	6.00	5.50
Long-term interest rate (10-year, %, end-year)	5.14	5.86	5.80	5.30
Exchange rate (PLN / EUR, annual average)	3.90	3.78	3.54	3.52
Exchange rate (PLN / EUR, end-year)	3.83	3.59	3.52	3.52
Budget balance / GDP (%)	-3.8	-2.0	-2.3	-2.4
Public debt / GDP (%)	47.7	45.2	44.0	43.5
Trade balance (goods and services) / GDP (%)	-1.8	-2.7	-3.7	-4.4
Current account balance / GDP (%)	-2.7	-3.7	-4.6	-5.3
External financing capacity / GDP (%)	-2.6	-3.6	-4.3	-4.0
Gross foreign debt / GDP (%)	45.9	45.8	45.4	45.1

Note: f = forecast. See methodological notes for definitions and details.

Sources: Eurostat, NBP (central bank), GUS (statistical office)

Romania

Economic growth remained the second highest in the EU in the first quarter on the back of vigorous domestic demand. Inflation increased in line with regional trends and external imbalances remain high. Unfortunately for macroeconomic risks, the budget balance is set to deteriorate this year.

Political developments

In June the two-ballot local election was held and the three big parties excelled in the election. The Social Democratic Party (PSD), the Democratic Liberal Party (PD-L) and the National Liberal Party (PN-L) won 472, 432 and 348 mayor's offices respectively. The Democratic Liberal Party lost Bucharest even though their candidate was backed by President Traian Basescu and an independent candidate, Mr Sorin Oprescu (leaving the Social Democratic Party) has just won the seat.

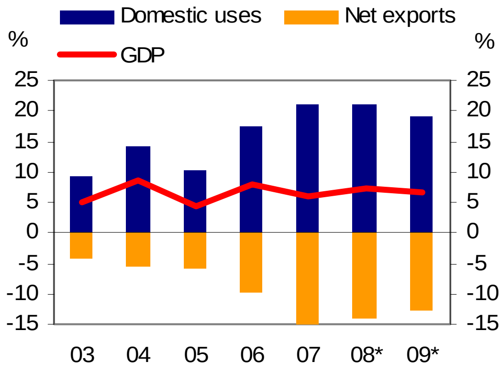
PSD winning the most mayor's offices sends a message ahead of the upcoming parliamentary elections as well. However, it is worth mentioning that most of their seats were won in rural areas. It seems that the third big actor, PN-L may have a decisive role in forming the new government after elections, which are due to be held in the autumn.

Growth

Romania maintained robust economic growth in the first quarter of 2008: real GDP increased by 8.2% in the first three months. That was the second highest growth rate among the 27 EU Member States.

On the production side, the engines remained the same as last year: construction, industry and market services. The negative contribution of agriculture gradually disappears as the effect of last year's poor harvest fades out.

Structure of growth



*Note: * forecast. Source: Eurostat, INSSE*

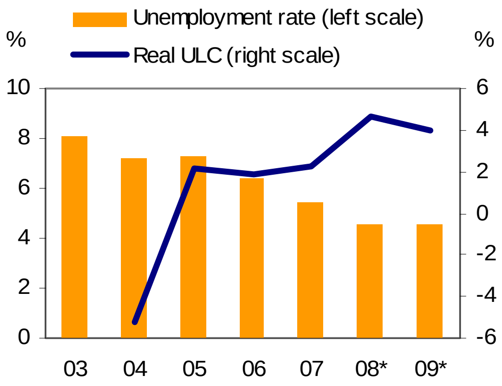
On the demand side last year's trends have changed slightly. Private consumption growth picked up significantly (it grew by an annual 15.5% in the first quarter), after a temporary deceleration last year. This high growth was backed by hefty wage increases and credit expansion. Besides consumption, investments also had a massive contribution to growth: gross fixed capital formation increased by 33.2% in the first three months.

Significant positive shifts have occurred in exports: their growth rate increased to 24.6% from last year's average 8.7%. The depreciation of the leu helped exporters but export capacities have also been improving thanks to incoming foreign direct investments. On the other hand, imports also grew robustly on the back of domestic demand: imports of goods and services increased by 35.2% in real terms in the first quarter.

We expect domestic demand to remain the main engine of growth in 2008, while a slight recovery of the export sector is also anticipated in the course of the year. For 2008 we expect a growth rate of 7.2%. In 2009 growth can remain as high as 6.5%. Risks are broadly balanced in the short term: on the downside, a slowing European economy can drag down exports; on the upside, rapid wage growth can boost private consumption further. However, such an overheating can result in a sharper slowdown in the medium term.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

Unemployment remained low (6.3%) in the first quarter according to the LFS statistics, while the registered unemployment rate reached 4.3% during that period. Dynamic economic growth stimulates job creation. However, the employment rate is still low and many citizens work abroad. This leads to labour shortages in some sub-sectors.

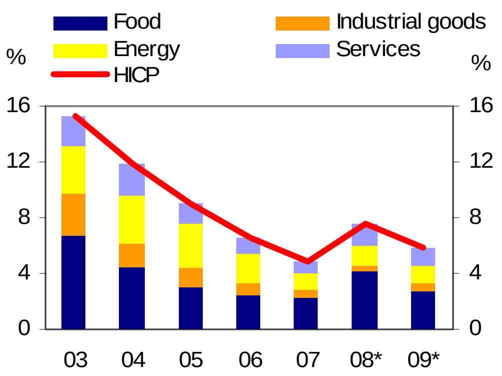
Rapid wage growth characterised the first months of 2008 as well. In May 2008 gross average monthly wages were 23% higher than in the same month of the previous year. This contributes notably to the increasing consumption of households, but also to inflationary pressures and a large external financing requirement.

Minimum wage remained at the RON 500 (approx. EUR 140) level set at the beginning of the year. When minimum wage was increased in January, the government announced that a further increase (to RON 540) could be realised effective from July. However, this increase was cancelled since the government stated that the budget cannot sustain such an increase. Accordingly, trade unions started to protest for higher salaries at the beginning of July.

In 2008 and 2009 we expect that unemployment rate will remain low, while the employment rate will improve gradually. Wages increase significantly this year due to loosened wage policy.

Monetary developments

Components of inflation



*Note: * forecast. Source: Eurostat*

Inflation remains a major macroeconomic challenge in Romania. While the harmonised index of consumer prices went down to 3-4% in the first half of 2007 it increased to 6.6% by December and exceeded 8% in February 2008. HICP reached its peak in April (8.7%) and remained at that level in May (8.6%) as well.

There are several factors behind rising inflation. First, increasing food and energy prices had a negative impact on prices in Romania as well. In May food prices were 12% higher than in the corresponding month of the previous year. Second, demand-side pressures are apparent. Third, the leu lost value as financial investors' sentiment towards Romania deteriorated. Finally, inflation expectations have started to creep upwards, feeding into wage claims.

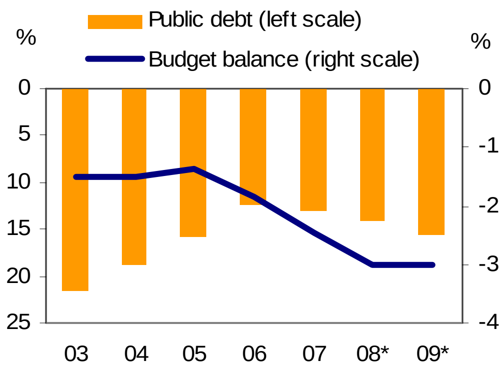
In line with the increasing inflation rate and the depreciating currency the central bank increased its policy rate six times in the last ten months. The last increase occurred at the end of June when the Monetary Board decided to raise the policy rate from 9.75% to 10%. In the next months the easing of the monetary policy is not expected. As a result, both short- and long-term yield differentials against the euro-area are (and will remain) significant.

The depreciation of the leu against the euro ended in the second quarter of 2008. In the first days of July RON/EUR decreased to 3.55, its lowest this year.

The inflation target of the central bank for December 2008 is 3.8% with a ±1 percentage point tolerance band. In its May Inflation Report the national bank admits that this target will be exceeded (just like last year). We stick to our previous forecast and expect that 2008 HICP will reach 7.5%. Inflation is not expected to come down significantly until the second half of the year. However, December inflation is expected at below 6%. In 2009 we expect lower food and energy price increases. With their help disinflation can continue and annual average inflation can decrease to 5.9%. For 2009 national bank's inflation target is 3.5% and we expect that the December inflation could be close to the upper limit of the tolerance band.

Fiscal policy

Key fiscal indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

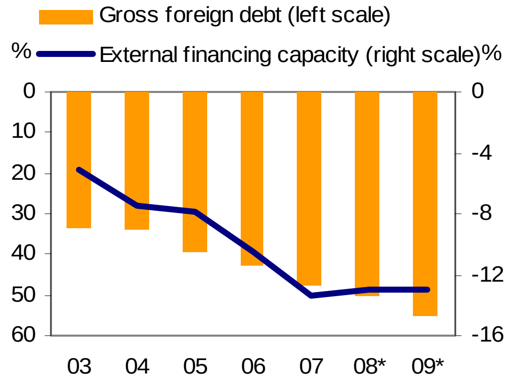
In the first five months consolidated government deficit reached RON 1.7 bn or 0.4% of the estimated GDP. In May 2007 budget still had a surplus, while this year it has already turned into deficit by the end of May.

The government revised its former 2008 deficit target from 2.7% to 2.3% of GDP in March. This deficit target remains despite the urging by the IMF to further cut the deficit target. However, as parliamentary elections loom ahead, fiscal policy is not expected to tighten this year. We expect this year's budget deficit to be higher than in 2007; it will likely exceed the planned deficit. Although the government revised downward its target, we expect that the deficit will be close to 3% of GDP.

Due to the worsening budget balance public debt will increase to 14% of GDP by the end of 2008, according to our expectations. The deficit may remain at a similar level in 2009 as well.

External balance

External balance indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

External imbalance remained worryingly high in the first few months. The current account deficit climbed to EUR 3.5 bn between January and April. The continuing deterioration of the current account balance was mainly due to the worsening trade balance.

Although the goods and services deficit increased to EUR 3.8 bn in the first four months, some positive signs are observable. The growth rate of exports has risen to 15.2% from single-digit figures last year. The current transfers also increased notably in the first four months of 2008: the net surplus was 40% higher than in the respective period of 2007. The large number of Romanian employees abroad generate significant amount of transfers into the country.

Foreign direct investments in the first four months were slightly lower than that in the same period of the previous year, reaching EUR 1.6 bn. We expect net inward FDI to reach EUR 6.5 bn in 2008.

In 2008 the external financing requirement will remain high and decrease only slightly from last year's record level, to 13% of GDP in 2008-09. The high trade deficit will be the main reason for such external imbalances. With the deceleration of Europe or the faster than expected growth of consumer spending these figures could end up even higher. As FDI will cover less than 40% of the external financing need, gross foreign debt will continue to rise and exceed 50% of GDP by the end of 2008.

Key macroeconomic indicators of Romania, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (RON million)	344 536	404 709	498 900	584 500
Real GDP growth (%)	7.9	6.0	7.2	6.5
Private consumption (%)	12.5	11.0	12.0	10.0
Public consumption (%)	-2.4	5.5	3.0	3.0
Investments (GFCF, %)	19.3	28.9	30.0	25.0
Exports (%)	10.6	8.7	20.0	15.0
Imports (%)	22.4	26.1	27.0	20.0
Unemployment (%)	7.3	6.4	5.5	4.5
Real ULC growth (%)	1.9	2.3	4.7	4.0
Annual average inflation (%)	6.6	4.9	7.5	5.9
Money market rate (3-month, %, end-year)	8.19	7.93	10.50	9.50
Long-term interest rate (10-year, %, end-year)	7.42	7.05	7.20	7.10
Exchange rate (RON / EUR; annual average)	3.53	3.34	3.66	3.55
Exchange rate (RON / EUR; end-year)	3.38	3.61	3.60	3.50
Budget balance / GDP (%)	-1.9	-2.5	-3.0	-3.0
Public debt / GDP (%)	12.4	13.0	14.0	15.5
Trade balance (goods and services) / GDP (%)	-12.1	-14.4	-14.6	-13.6
Current account balance / GDP (%)	-10.4	-14.1	-13.5	-13.6
External financing capacity / GDP (%)	-10.5	-13.4	-13.0	-13.0
Gross foreign debt / GDP (%)	42.6	47.5	52.0	55.0

Note: f = forecast. See methodological notes for definitions and details.

Sources: National Bank of Romania, National Institute of Statistics, Eurostat

Slovakia

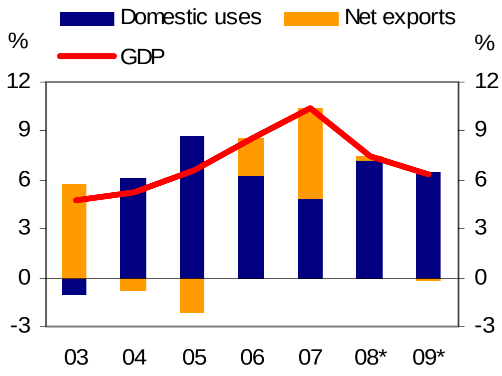
The structure of soaring GDP growth is changing: net exports are losing importance while private consumption and other domestic uses are gaining momentum. Inflation is on the rise, and entry into the euro-area in January 2009 may hamper disinflation.

Political developments

The Fico government's big achievement is entry into the euro-area in January 2009. Aware of inflationary risks of euro adoption the government campaigned fiercely for a strong parity. Even the central parity of the koruna was shifted in May and this new parity was set as the final conversion rate on 8 July. The government plans to introduce a 13th month pension and increase family allowances and pensions in 2009 to offset the potential negative impacts of euro adoption. It also tries to cajole energy companies into moderating price increases.

Growth

Structure of growth



*Note: * forecast. Source: Eurostat*

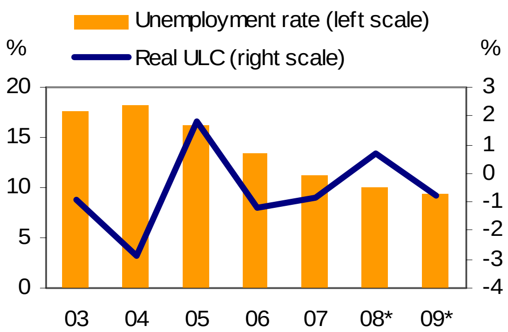
In the first quarter of 2008 GDP increased by 8.7% on an annual basis. This growth rate is higher than in the same period of 2007, but much slower than in the preceding quarter (11.5%). Still, this is the highest rate in the whole EU. Robust growth is expected to continue in 2008-09, although its pace will remain below 10%. Uncertainties to this scenario lay in foreign demand (on the downside) and in the appearance of a post-euro credit boom (on the upside).

On the expenditure side the shrinking contribution of net exports due to weakening foreign demand is compensated by growing private consumption and investments. While the contribution of public consumption is small, it is increasing compared to 2007. This is due to the planned increases in pensions and in social benefits, which are designed as a 'compensation' for the expected negative consequences of euro introduction.

The tandem of strong domestic demand and vigorous export growth results in a balanced and broad-based expansion of economic sectors. However, the export slowdown and high base values imply slower future growth rates for manufacturing branches.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

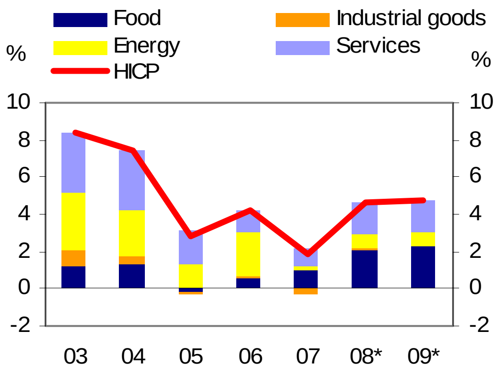
Employment continued to increase in the first five months of 2008: it rose by 2.6% in the year to May 2008. The sectoral distribution of employment growth has changed. The highest increase was recorded in construction (7.7%) and various market services; manufacturing employment grew slower while jobs were shed in energy, post and telecommunications. The number of unemployed decreased further and the unemployment rate decreased from 1 % at the end of 2007 to 10.5% by the end of the first quarter of 2008. Registered unemployment rate stood at 7.4% at the end of May, a considerable decrease from its January level of 8.1%. Job creation and declining unemployment are expected to continue in 2008-09; the unemployment rate will fall below the 10% mark.

Productivity growth is gradually slowing and the contribution of new jobs to GDP growth is rising. Strong wage increases feed private consumption but also raise unit labour costs slightly in 2008-09.

Monetary developments

Inflation is on an upside path, similarly to other countries in the region. The 12-month index of consumer prices rose by 4.6% in June. Food prices grew the most rapidly, following global trends. Certain services (e.g. health, transport) also recorded high inflation due to increasing regulated prices, while excise duties on tobacco were also raised. According to the National Bank cost-side factors dominate in inflation connected to increasing energy, food and services prices. While demand factors of inflation were basically absent in Slovakia until the end of the first quarter, they may have appeared by now as household consumption takes over net exports as the principal driver of growth. Inflation is expected to average 4.6% in 2008. If euro adoption indeed leads to one-off price increases (stemming from the rounding of prices, etc.) or the fall in interest rates and the availability of capital triggers a post-euro boom-bust cycle, inflation can rise further to 4.8% in 2009.

Components of inflation



*Note: * forecast. Source: Eurostat*

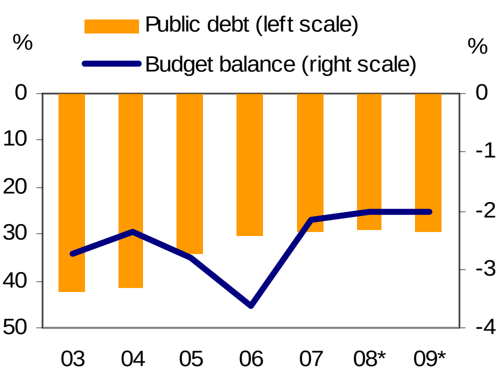
Two-week repo rate was left unchanged despite higher than expected inflation in the second quarter; at present it stands at 4.25%. Due to the 2009 entry of the country into the euro-area, no surprise rate changes are expected. On 28 May the central parity of the koruna was switched to a 15% stronger level, to 30.126. This one step resulted in a 1.4% appreciation of the exchange rate. On 8 July euro-area finance ministers took the formal decision to accept Slovakia into the euro-area and to set the final conversion rate at 30.126.

Short-term yields were influenced by developments on the foreign exchange market and by yield movements in the euro-area. The spread widened between Slovak and European benchmark yields. However, long-term spreads are narrowing in connection with the euro-area entry of Slovakia.

Fiscal policy

The central government budget deficit was SKK 4 bn (EUR 133 mn) at the end of June 2008, considerably lower than a year before. Collected revenues amounted to 44.8% of the level planned for the year as a whole, while expenditures reached just 42.2%. Taxes on incomes seem particularly under-planned: by the end of June 53.7% of planned annual revenues had already been collected. These data indicate that the government will be able to fulfil its ambitious deficit reducing plan for this year and the deficit will not exceed 2% of GDP.

Key fiscal indicators (% of GDP)

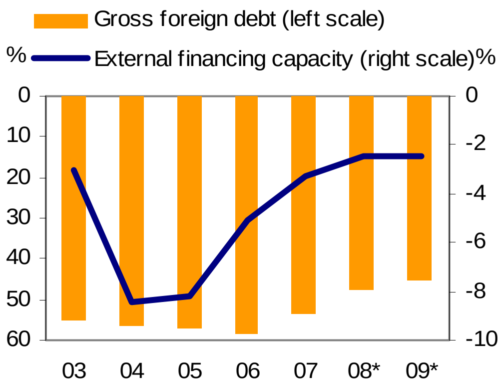


*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

However, tightening will end in 2009. The government plans to introduce a 13th month pension and aims to increase family allowances and regular pensions as a 'compensation' for possible negative impacts of euro adoption. In that respect, political considerations overwrite economic caution, because there is a danger of a boom-bust cycle after the euro-area accession. Still, due to already strong economic growth and the relatively prudent fiscal approach of the government, the room for fiscal manoeuvring appears sufficient. Due to the good budgetary performance, government debt is expected to diminish slightly in the coming years.

External balance

External balance indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat, Slovak National Bank

Balance of payments data on the first quarter of 2008 indicate an increase in current account deficit compared to the same period of the previous year. The rising goods trade surplus was unable to compensate much higher income outflows (connected to the repatriation of investment income). The services balance also turned negative, indicating a weak point of the Slovak economy: it seems that the country is less attractive for services offshoring than its neighbours and local companies buy services from abroad instead.

The capital account remains in the black thanks to inflowing EU funds. At the same time, the financial account's surplus decreased considerably, from EUR 1.5 bn in the first quarter of 2007 to EUR 0.5 bn in the first quarter of 2008. Interestingly, direct investments show a deficit of EUR 0.2 bn due to a high negative outflow in 'other' capital involving credit transactions between affiliates and their parent companies. Based on the experience of previous years, this figure is expected to turn positive later this year. However, the data also suggest that inward FDI is past its peak. Portfolio and other investments show until the end of the first quarter of 2008, but the surplus on other investments fell. Short-term investments arriving to domestic bank accounts with speculative aims seem to be leaving the country.

External financing need is set to shrink in 2008-09, driven by the continuing improvement of the goods balance. Gross foreign debt is expected to decrease below 50% of GDP in 2008; however, a post-euro credit boom could raise this figure again.

Key macroeconomic indicators of Slovakia, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (SKK billion)	1 659.6	1 851.8	2 066.3	2 266.8
Real GDP growth (%)	8.5	10.4	7.5	6.3
Private consumption (%)	5.6	7.1	8.4	8.0
Public consumption (%)	10.1	0.7	3.3	3.0
Investments (GFCF, %)	8.4	7.9	8.1	6.8
Exports (%)	21.0	16.0	11.9	7.5
Imports (%)	17.7	10.4	12.1	8.0
Unemployment (%)	13.4	11.2	10.0	9.5
Real ULC growth (%)	-1.2	-0.8	0.7	-0.8
Annual average inflation (%)	4.3	1.9	4.6	4.8
Money market rate (3-month, %, end-year)	4.82	4.31	4.35	4.20
Long-term interest rate (10-year, %, end-year)	4.15	4.61	4.50	4.40
Exchange rate (SKK / EUR; annual average)	37.23	33.78	31.00	30.13*
Exchange rate (SKK / EUR; end-year)	34.44	33.58	30.13*	30.13*
Budget balance / GDP (%)	-3.6	-2.2	-2.0	-2.0
Public debt / GDP (%)	30.4	29.4	29.2	29.4
Trade balance (goods and services) / GDP (%)	-4.3	-0.8	1.4	1.2
Current account balance / GDP (%)	-8.2	-5.7	-4.0	-3.2
External financing capacity / GDP (%)	-8.2	-5.1	-3.3	-2.5
Gross foreign debt / GDP (%)	58.5	53.4	47.9	45.3

*Note: f = forecast, * final SKK / EUR parity. See methodological notes for definitions and details.*
Sources: Eurostat, Slovak National Bank, Slovak Statistical Office

Slovenia

Economic growth is slowing while rapid wage growth threatens external competitiveness. The key challenge is to fend off inflationary pressures and contain labour costs.

Political developments

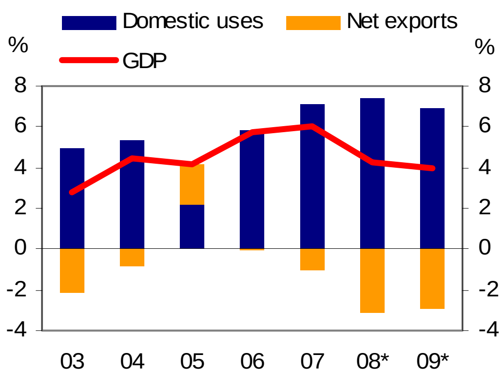
Slovenia's EU presidency ended in June. International attention turned to the country again as heads of EU member states were joined by outgoing U.S. President Bush at the closing summit.

General elections will be held on 21 September. According to recent polls the largest opposition party, the Social Democrats (led by the popular Mr. Borut Pahor) are slightly ahead the centre-right Slovenian Democratic Party (SDS) of incumbent Prime Minister Mr. Janez Jansa. The recently founded social liberal Zares, the old liberal democratic party LDS and nationalist SNS (all three currently in opposition) can also claim over 5% support. A centre-left coalition could be on the cards.

Growth

The economy grew by 5.4% in the first quarter. While this pace is higher than expected, the slowdown of exports and falling orders already signal weaker future growth. Real estate investments remained the key driver of growth in the first quarter, growing at an annual 17.1%. Tighter credit is expected to take its toll sooner or later, but infrastructure investments and construction projects already in the pipeline are expected to keep their growth rate quite high in 2008-09. Some of the slowdown in investments and exports will be offset by rising public expenditures in the run-up to the autumn elections.

Structure of growth



**forecast. Source: Eurostat*

On the production side construction is roaming at 27.4% in the first quarter, while market services are also humming along at around 5-6%. Industry is losing steam as exports decelerate.

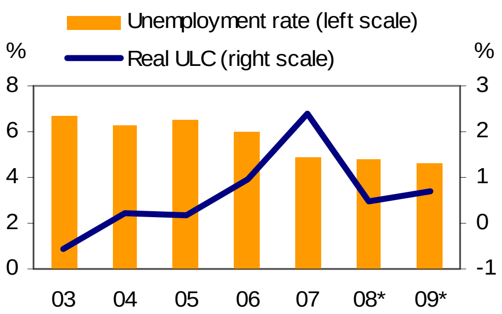
We expect GDP growth to slow to 4.3% in 2008 and further to 4% in 2009, as the drag of net exports increases. External demand and the outlook for construction are the main (downside) uncertainties to our forecast.

Labour market

Employment continues to grow while activity is fairly stable; most new jobs were created in construction and market services. The unemployment rate stood at 5.1% in the first quarter. As domestic demand remains vigorous, the unemployment rate is expected to fall further, to 4.8% in 2008-09.

Gross earnings rose by 7.6% in the year to May 2008, but inflation is eating away gains: real wages grew by less than 2%. Persistently high inflation could give rise to a wage-price spiral which could erode the competitiveness of exporters and pose significant growth challenges in the medium term.

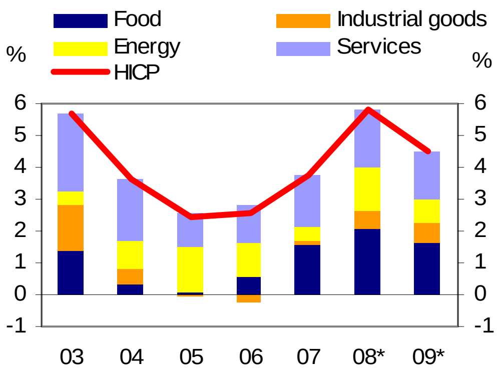
Labour market indicators



*Note: * forecast. Source: Eurostat*

Prices and monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

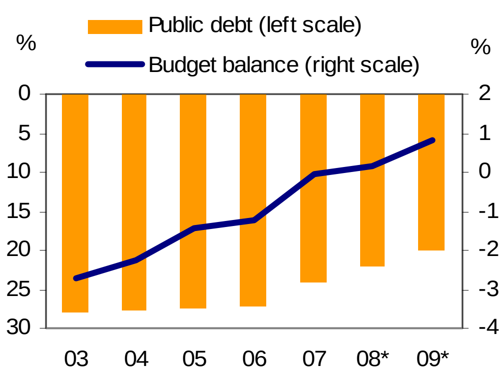
Inflation is rising since September 2007. The 12-month index of consumer prices hit 7% in June 2008. These developments are clearly driven by global food and energy prices: both categories registered double-digit inflation rates.

As commodity prices stabilise or even fall back we expect gradual disinflation. Although consumer prices will rise by an average 5.8% in 2008, they can recede to 4.5% in 2009. Although the ECB has recently raised interest rates, loosening fiscal policy does not support disinflation. Therefore upside risks to our forecast are present.

Money market rates mirrored rising inflationary expectations: 3-month rates climbed from 4.36% in January to 4.86% by the end of June. Their moderation is expected only in 2009 as the inflationary shock subsides.

Fiscal policy

Key fiscal indicators (% of GDP)



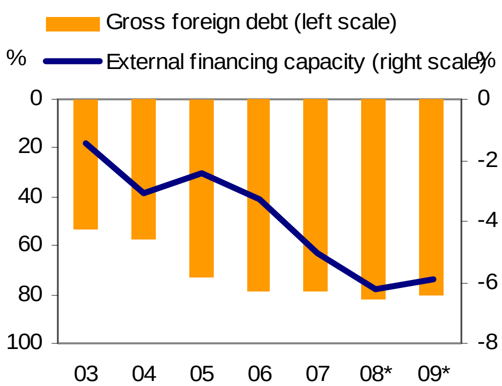
*Note: * forecast, reverse scale on left axis.*
Source: Eurostat, Statistical Office of Slovenia

Budget revenues grew by 9.6% in the first quarter while expenditures rose by just 6.4%. Employment and wage growth boosts income tax and social security revenues while spending remained disciplined by now. Although the budget balance will continue to improve, the surplus will be limited to 0.2% of GDP. Besides potentially higher spending in the second half of the year (elections are coming) automatic stabilisers will work against the budget balance as the economy cools. In 2009 gradual improvement can continue, to 0.8% of GDP.

As nominal GDP will grow at 8-9% and the budget will accumulate surpluses, the debt-to-GDP ratio will fall to 20% by the end of 2009.

External balance

External balance indicators (% of GDP)



*Note: * forecast, reverse scale on left axis.*
Source: Eurostat, Statistical Office of Slovenia

The trade balance is deteriorating: exports are slowing while imports continue to grow despite the weaker purchasing power of consumers. Strong corporate profits support investments into imported machinery and equipment: in the first quarter these grew by 8.3%. Weaker exports will be the key reason behind the widening of the external financing need of the economy: this will grow to 6.3% of GDP in 2008 before falling back to 5.9% in 2009.

FDI flows will pick up in the near future. Slovenian household appliances manufacturer Gorenje announced that the takeover ATAG, the leading kitchen technology producer in Netherlands. The EUR 130 mn acquisition is a major step for the company: by its biggest buy so far it will get access to a wide supplier network, reaching as far as Turkey and China. Regarding inward FDI, German logistics giant Deutsche Bahn would buy Luka Koper, the operator of Slovenia's only port, and Intereuropa, a logistics company that does much of its business with the port operator. The Koper port can become a major regional logistics hub, if plans for cooperation with Egypt and Brazil materialise. Egypt could give Luka Koper concession to operate a terminal in the port of Alexandria, making the firm one of the first trans-Mediterranean operators. Meanwhile, Brazil sees Slovenia as an entry point for its biofuel exports to the EU, which are set to grow briskly.

Key macroeconomic indicators of Slovenia, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (EUR million)	30 448	33 542	36 700	39 800
Real GDP growth (%)	5.7	6.1	4.3	4.0
Private consumption (%)	4.0	3.1	3.5	3.4
Public consumption (%)	4.4	1.4	3.6	2.3
Investments (GFCF, %)	8.4	17.2	16.3	14.1
Exports (%)	12.3	13.0	8.4	8.6
Imports (%)	12.2	14.1	12.1	11.5
Unemployment (%)	6.0	4.9	4.8	4.8
Real ULC growth (%)	1.0	2.4	0.5	0.7
Annual average inflation (%)	2.5	3.8	5.8	4.5
Money market rate (3-month, %, end-year)	3.67	4.85	4.95	4.75
Long-term interest rate (10-year, %, end-year)	3.90	4.55	4.65	4.50
Exchange rate (SIT / EUR; annual average)	-	-	-	-
Exchange rate (SIT / EUR; end-year)	-	-	-	-
Budget balance / GDP (%)	-1.2	-0.1	0.2	0.8
Public debt / GDP (%)	27.2	24.1	22.1	20.0
Trade balance (goods and services) / GDP (%)	-0.9	-1.9	-4.1	-4.8
Current account balance / GDP (%)	-2.8	-4.9	-6.0	-5.8
External financing capacity / GDP (%)	-3.3	-5.1	-6.3	-5.9
Gross foreign debt / GDP (%)	79.1	78.6	82.0	80.0

Note: f = forecast. See methodological notes for definitions and details.

Sources: Eurostat, IMAD

Methodological notes

Definitions of variables

Nominal GDP	Gross domestic product (GDP) at current market prices in national currencies. Can be transformed into EUR using average exchange rates. Sources: Eurostat, national statistical offices.
Real GDP growth	Growth rate of GDP, measured at chain-linked volumes at 2000 prices. Sources: Eurostat, national statistical offices.
Private consumption	Growth of final consumption of households and NPISH at constant prices. For further details see: Real GDP growth.
Public consumption	Growth of final consumption of general government at constant prices. For further details see: Real GDP growth.
Investments	Growth of gross fixed capital formation at constant prices. For further details see: Real GDP growth.
Exports	Growth of exports of goods and services at constant prices (national accounts data). For further details see: Real GDP growth.
Imports	Growth of imports of goods and services at constant prices (national accounts data). For further details see: Real GDP growth.
Unemployment	Unemployment rate according to ILO definition (among the 15-74 years old), calculated from Labour Force Survey data. Some national definitions differ slightly. Sources: Eurostat, national statistical offices.
Real ULC growth	Real unit labour cost growth: growth of labour compensation at current prices per employee, divided by the growth of gross value added at current prices per the number of employed persons. Sources: Eurostat, national statistical offices.
Annual average inflation	Annual average rate of HICP. Sources: Eurostat, national statistical offices.
Money market rate	3-month interbank offer rate at the end of period. Sources: Eurostat, national banks.
Long-term interest rate	Average interest rate of government bonds with 10 years remaining maturity (Maastricht criterion interest rate). Source: Eurostat.
Exchange rates	Period average and end-of-period exchange rates (national currency per EUR). Sources: Eurostat, national banks.
Budget balance / GDP	General government balance relative to nominal GDP, in national currency. Data follow the ESA95 methodology of Eurostat unless noted otherwise. Source: Eurostat, ministries of finance, WIIW.
Public debt / GDP	Stock of general government debt at the end of period, relative to GDP of the respective period. Data follow the ESA95 methodology of Eurostat unless noted otherwise. Source: Eurostat, ministries of finance, WIIW.
Trade balance / GDP	Balance of goods and services. Sources: Eurostat, national banks.
Current account / GDP	Current account balance, relative to nominal GDP of the respective period. Sources: Eurostat, national banks.
External financing capacity / GDP	Sum of the current and capital account balances, relative to nominal GDP of the respective period. Eastern EU Members experience significant capital transfers (EU funds) which reduce the need for external financing. Therefore it is more appropriate to examine external financing capacity when assessing the sustainability of external imbalances. Sources: Eurostat, national banks.
Gross foreign debt / GDP	Stock of gross foreign debt at the end of period, relative to GDP of the respective period. Sources: Eurostat, national banks, WIIW.