Quarterly Forecast on the Eastern EU Member States

Autumn 2007

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Company information

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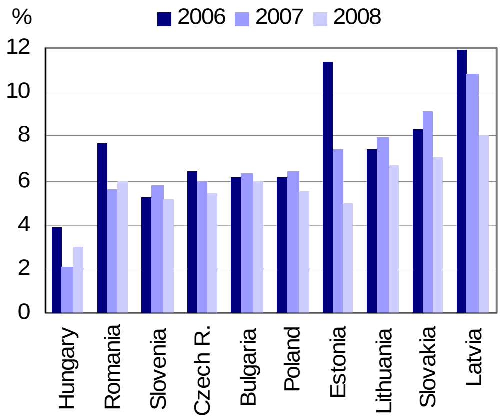
Regional overview

GDP growth in the region



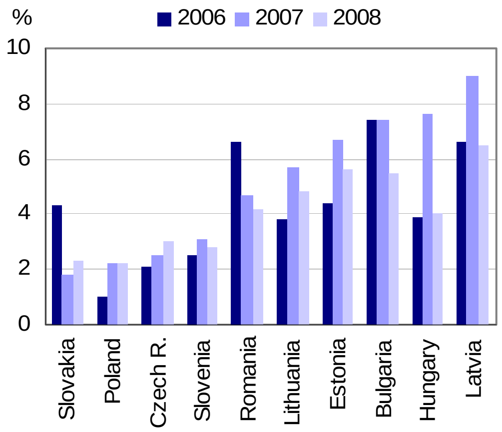
Growth

Growth remains strong in the region. The main driver is domestic demand, notably private consumption and investments. The external environment helps exports; the contribution of net exports to growth typically depends on the development of import demand. This contribution is positive in only three countries: the Czech Republic, Hungary and Slovakia.

Our outlook for 2007-08 involves a mild slowdown as external demand recedes and positive output gaps start to close in the region. The average growth rate of the ten countries will be 6.7% this year and 5.8% in 2008. The slowdown will be more pronounced in Estonia where the housing boom has passed its peak. In the case of Hungary the recovery after the fiscal adjustment will be slower than expected.

The risks to our forecast are on the downside. Financial markets have become more turbulent and the huge external imbalances of some countries will come under more scrutiny. The risk of a hard landing is still present in the Baltic states. Meanwhile, a potential slowdown of western European growth due to credit- and mortgage-market troubles could hit exports from the region. Finally, as oil prices are on the rise again, another energy price shock is on the cards.

Inflation in the region



Note: harmonised (HICP) rates

Prices and monetary conditions

Inflation is on the rise throughout the region: the average inflation rate of the region jumps from 4.3% in 2006 to 5.1% this year.[1] Food prices are rising globally due to a combination of strong demand and poor weather. Indirect tax increases and administered prices also played their part, especially in Hungary, where they accounted for a one-off surge in inflation. Positive output gaps are a more general issue; strong wage growth drives up the prices of services, especially in the Baltic states and Bulgaria.

The expected easing of domestic demand and the potential easing of food prices will help inflation decrease in most countries; average inflation in the region could recede to 4.1% next year. The main upside risk to inflation is a potential energy price shock.

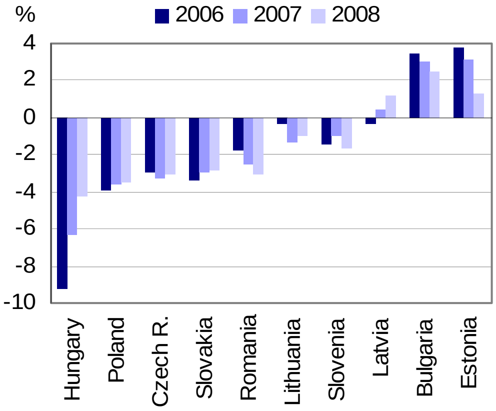
Monetary authorities respond to inflationary pressures by raising policy rates; in Hungary and Romania rate cuts may proceed slower than expected. In the Baltic countries interest spreads on euro-zone rates widened due to worries over the sustainability of their external imbalances earlier this year. Wider spreads are expected to persist in 2008 as well.

Slovakia aims to introduce the euro in 2009, but inflationary risks and a methodological revision of the budget balance may put the plan in jeopardy. For the rest of the region current inflationary trends make the fulfilment of the relevant Maastricht criterion improbable.

[1] The special topic of this report deals with inflationary developments in the region.

Fiscal policy

Budget balances in the region (% of GDP)



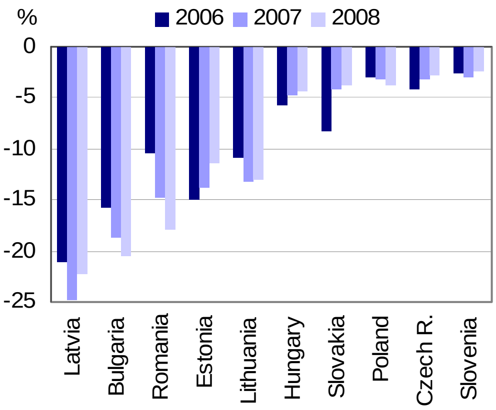
Note: according to ESA methodology

Fiscal positions remain diverse across the region. Adjustment takes place in Hungary, Latvia, the Czech Republic, Poland and Slovakia. The ambitious Hungarian stabilisation is on track but there remain question marks over the longer term.

Fiscal policy is loosening in Estonia, Lithuania, Bulgaria, Romania and Slovenia. In Estonia this may be an attempt to counterbalance the slowdown in the private sector. However, it entails risks as it could disrupt the adjustment of the economy. Loosening in Bulgaria, Romania does not threaten stability yet, but the long-term outlook is very similar to the Baltic case. Their pro-cyclical fiscal stance may contribute to overheating of the economy, mainly through catalysing wage growth. Looming elections lead to fiscal loosening in Romania and Slovenia.

External balance

Current account balances in the region (% of GDP)

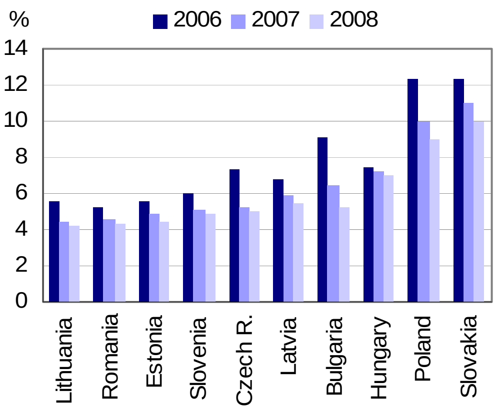


External imbalances in the region are often high and growing: the average current account deficit of the region will surpass 10% of GDP this year. The Baltic countries (led by Latvia) usually have the largest external imbalances but Bulgaria and Romania are catching up. This is due to their ongoing investment (construction) booms and buoyant private consumption. A difference is that FDI finances most of the external imbalances in the two newest EU members. Still, the sustainability of these imbalances remains a concern, particularly in Latvia. Current accounts are in better shape in Central Europe, mainly because trade deficits are smaller in these countries (the Czech Republic and Hungary run surpluses).

Current account deficits are expected to widen in Lithuania, Bulgaria and Romania. In the rest of the region slower import growth will contribute to narrowing imbalances. The main risks are related to a potential energy price shock (boosting imports) or a sharp slowdown of demand on main export markets.

Labour market

Unemployment rates in the region



Note: harmonised LFS rates

Unemployment is falling throughout the region; many countries experience historic low unemployment rates. This is thanks to domestic demand-led growth which creates a large number of jobs in labour-intensive sectors. However, large-scale emigration of (typically young) workers also contributes to falling unemployment, particularly in Poland and Romania. In the longer term this can lead to labour shortages.

A shortfall of skilled labour is already driving up wages in most countries, especially where fast economic growth speeds up job creation. Although these wage increases do not yet harm external competitiveness, they contribute both to inflation (through services prices) and to external imbalances (through private consumption).

Despite the expected slowdown in 2008 both job creation and wage growth will remain fairly strong.

Bulgaria

Economic growth accelerated thanks to soaring investments. Inflation jumped above 10% due to increasing food prices. Accordingly, the introduction of the euro is not expected before 2012. The budget reached a significant surplus while the current account balance worsened and exceeds 18% of GDP in 2007. Unemployment fell to a record low.

Political developments

The government decided to take some economic policy measures to improve the business climate and increase its popularity as well. A flat tax will be introduced for personal incomes from 2008; pensions have been and will again be increased and the social security contribution rate was cut in the autumn. These measures are partly a consequence of upcoming local elections (scheduled for 28 October). The election campaign for thousands of candidates representing 88 parties started at the end of September.

Growth

In the second quarter of 2007 economic growth accelerated to 6.6%, the fastest growth rate in the last three quarters. Accordingly, GDP growth reached 6.4% in the first half of the year, 0.4 percentage points higher than in the corresponding period of 2006.

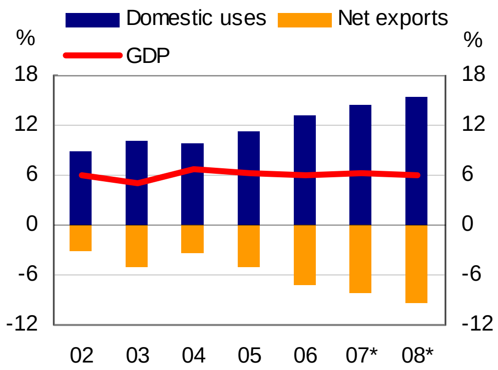
On the demand side, the structure of growth shifted slightly. Private consumption growth decelerated from 8.1% to 5.7% in the second quarter while public consumption accelerated again after a temporary fallback in the first quarter. Besides consumption, the growth rate of investments dropped as well. Gross fixed capital formation increased by 24.7%, after almost 36% in the first quarter. The fact that investments reached almost 30% of GDP during the first half of the year indicates the high role of investments in economic growth.

On the other hand, the negative contribution of net exports diminished in the second quarter since growth rate of exports accelerated (to 5.7%) while that of import decreased (to 10.7%) compared to the previous quarter.

On the production side, gross value added in agriculture diminished further in the second quarter (by 5.3%) due to severe drought in the valley of the Danube. Industry and services grew by 10.5% and 9.5% respectively. Both sectors accelerated compared to the previous quarter.

We expect that growth will slow slightly in the third quarter since the drought will have a continuing negative impact. Nevertheless, GDP growth will remain robust in 2007, reaching 6.3%. A similar growth rate is expected for 2008 as well.

Structure of growth



*Note: * forecast. Source: NSI*

Industrial production

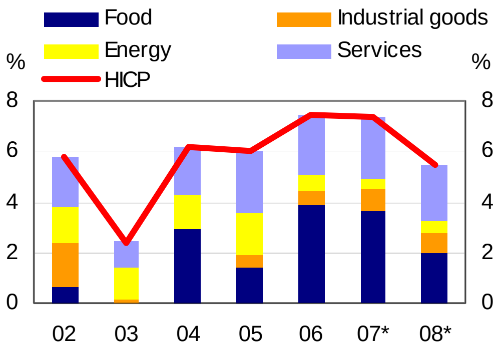
Note: annual trend growth. Source: NSI

Prices and monetary conditions

In the course of the third quarter of 2007 the inflation rate doubled. While the 12-month harmonised index of consumer prices (HICP) was slightly above 5% in June, it increased to 11% in September. In the year to September food and non-alcoholic beverages prices rose by 25.6%. This was due to rising global food prices and to the drought that shrunk food supply.

Significant wage increases in the first half of the year (reaching almost 20%) piled further inflationary pressures on the economy. Furthermore, lending to households accelerated again in recent months. In the year to August claims on households and NPISHs (Non-Profit Institutions Serving Households) increased by more than 50%. At the beginning of 2007 the 12-month growth rate was less than 30%. Accordingly, claims on households and NPISHs per GDP increased from 17.6% to 23% between January and August 2007.

Components of inflation



Source: Eurostat

Since inflation jumped significantly in the course of the year, Bulgaria's hope of joining soon the euro-zone dissolved. Entering the ERM-II regime was planned for the first half of 2007 while the introduction of the euro was targeted by the end of this decade. However, inflation is not expected to decline below the Maastricht reference level until 2010. Accordingly, the introduction of the euro can be realised only after 2012. Inflation will remain the key obstacle to the euro for Bulgaria.

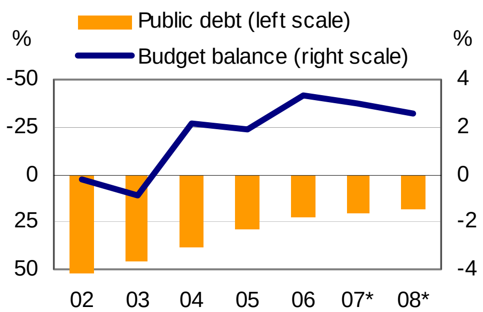
Inflation will diminish only slightly this year and the 12-month index will remain around 10% in the remaining months of 2007. Therefore we revised upwards our 2007 forecast on annual average inflation to 7.4%. Next year inflation is expected to decrease and to 5.5%.

In the second half of 2007 long-term interest rates started to pick up from 4.3% to 4.9% in line with increasing inflation and the expected delay of euro adoption. However, at the end of the third quarter long-term interest rate decreased back to 4.4-4.5%.

Fiscal policy

The budget continued to run a significant surplus: it reached 5.5% of GDP at the end of August. Budget revenues increased by 11%, while expenditures grew by a mere 6% compared to the first eight months of 2006.

Key fiscal indicators (% of GDP)



*Note: * forecast. Reverse scale on left axis.*
Source: Eurostat

This surplus is remarkable considering that Bulgaria must contribute to the EU budget and customs duties also declined to a marginal level due to EU membership. The surplus made room for pension rises and a 3 percentage point cut in social security contributions as of 1 October 2007.

In 2008 Bulgaria plans to introduce a flat tax system with the lowest rate in the world. The corporate tax rate was slashed to 10% in 2007; next year the personal income tax rate will also be reduced to 10%. The decrease of the corporate tax rate resulted in higher than expected tax revenues: corporate tax revenues increased by almost 40% during the first seven months. This signals that the tax cut contributed to the whitening of the informal and grey economy.

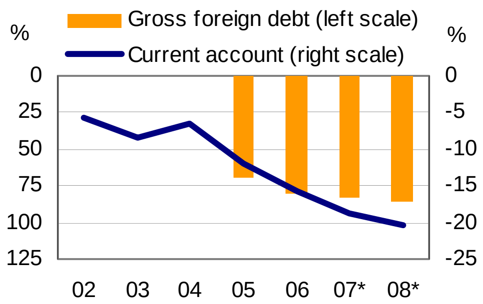
In line with the massive surplus of the budget, public debt diminished to 22% of GDP midway through 2007, although the decrease halted in the last months.

The budget surplus will reach 3.0% of GDP in 2007; the surplus will decrease somewhat in 2008 due to lower personal income tax rates and other budget amendments.

External balance

In the first eight months of 2007 the current account deficit widened further to 12% of GDP or EUR 3.2 bn. It was basically the consequence of the growing trade deficit which reached EUR 4.5 bn by August (16.7% of GDP); 39.2% more than at the same month in 2006. Import growth was boosted by still significant consumption and booming investments. Import of goods grew by 17.3%, while export increased by 8.3% in euro terms.

External balance indicators (% of GDP)



*Note: * forecast. Reverse scale on left axis.*
Source: Eurostat

Regarding other components of current account balance, services performed well thanks to tourism revenues. The services balance improved by 32.4%; its surplus reached EUR 1.1 bn. On the other hand, income balance and net current transfers worsened in comparison with the last year. In the case of the income balance, the surplus turned into deficit, while the surplus of current transfers balance was halved.

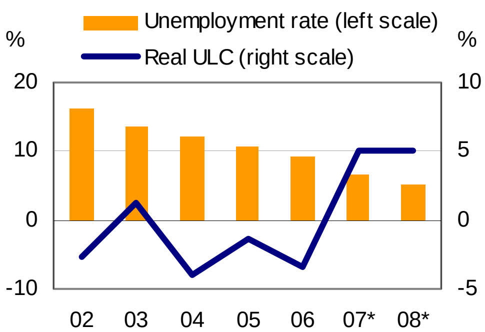
Despite the significant increase of the current account deficit, foreign direct investments were able to finance it entirely as they also increased by more than 20%. Net FDI amounted to EUR 3.3 bn in the first eight months. The 144% FDI/CA deficit ratio was even higher than last year during the same period last year.

We expect that current account deficit will reach 18.7% of GDP in 2007 due to soaring investments and private consumption. If current trends continue in 2008, the current account deficit can exceed 20%. After the delay to the euro adoption this would be another source of concern for the Bulgarian economy, especially since the risk of a current account crisis is much higher outside the euro-zone.

Labour market

In August 2007 unemployment reached a record low. The number of unemployed decreased to 259 thousand and the unemployment rate declined to 7% from 9.7% at the start of this year. This is mainly due to rapid economic development and the whitening of the informal/grey economy. However, there are still large differences in regional unemployment rates: they vary between 2% and 16%.

Labour market indicators



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

The employment rate increased in line with decreasing unemployment. In the second quarter of 2007 the employment rate reached 49%, up by almost 2 percentage points in a year.

Wages increased significantly in the first half of 2007. Monthly average gross wages rose to BGN 406 (EUR 208); their annual growth rate was 17.8% in the second quarter of 2006 after some acceleration in last months.

For 2007 we expect that unemployment will decrease further and decline under 7% by the end of the year. Since rapid economic growth and further whitening of the informal sector are expected next year as well, labour market indicators will improve in 2008 as well.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (BGN mn)	42,797	49,091	56,400	63,600
Real GDP growth (%)	6.2	6.1	6.3	6.0
Private consumption (%)	5.5	7.1	6.5	6.0
Public consumption (%)	4.1	1.7	1.0	2.5
Investments (GFCF, %)	23.3	17.6	25.0	20.0
Exports (%)	8.5	9.0	3.0	5.0
Imports (%)	13.1	15.2	11.0	13.0
Annual average inflation (%)	6.0	7.4	7.4	5.5
Policy rate (%)	NA	NA	NA	NA
Money market rate (3-month, %)	3.59	4.01	4.90	4.50
Long-term interest rate (10-year gov't bond, %)	3.39	3.82	4.70	4.30
Exchange rate / EUR (average)	1.96	1.96	1.96	1.96
Exchange rate / EUR (end of period)	1.96	1.96	1.96	1.96
Budget balance / GDP (%)	2.3	3.5	3.0	2.5
Public debt / GDP (%)	29.2	22.8	20.0	18.0
Trade balance / GDP (goods and services, %)	-16.4	-18.6	-19.9	-22.3
Current account balance / GDP (%)	-12.0	-15.8	-18.7	-20.4
Gross foreign debt / GDP (%)	69.0	80.1	83.0	86.0
Unemployment (%)	10.7	9.1	6.5	5.2
Real ULC growth (%)	-1.3	-3.4	5.0	5.0

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

Sources: Bulgarian National Bank, Eurostat, National Statistical Institute

Czech Republic

Growth is still high although signs of deceleration are present. The contribution of net exports is shrinking, while that of private consumption and investments has been growing. Inflation accelerated slightly, which induced the CNB to increase the two-week repo rate twice by 25 basis points in the third quarter. Employment grew quickly; the shortage of both unskilled and appropriately trained labour is a major problem and exercises an upward pressure on wages.

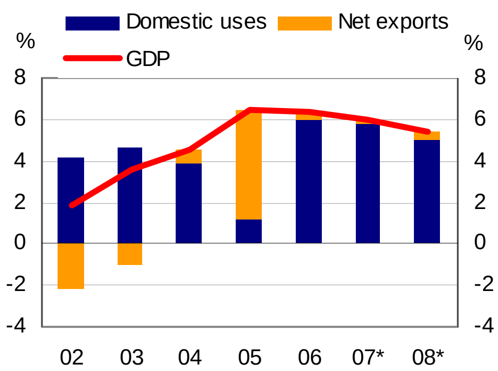
Political developments

The aim of the reform program of the government, stepping into force in 2008, is to reduce the budget deficit below the Maastricht reference level. The measures to be introduced next year form only the first stage of changes: health care reform and further changes to the tax code will follow. The aim of the latter will be to reduce the number of tax allowances and tax holidays. As the government has no parliament majority and the opposition challenged some reforms at the Constitutional Court, there is some uncertainty surrounding the ability of the government in introducing all proposed steps as scheduled.

Growth

In the second quarter of 2007 annual GDP growth decelerated to 6%, though it is still high both historically and in the region. Even 2006 data indicated the diminishing contribution of net exports and the growing role of private consumption and capital formation. These trends continue in the first half of 2007 as well. The growth of private consumption continued at a higher pace (3%). The growth rate of imports surpassed that of exports, thus the contribution of net exports continued to shrink this year, to 0.3 percentage points in the first half of 2007. It is expected to stay on that path in 2008 as well. Government consumption, after a slight positive contribution in 2006, contributed slightly negatively (by -0.3 percentage points) to GDP growth in the first half of 2007; the situation will not change in 2008.

Structure of growth



**forecast. Source: Eurostat*

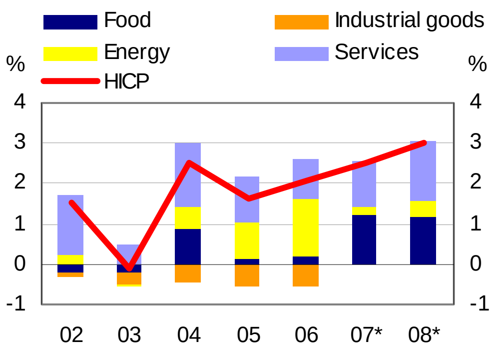
According to the Statistical Office, the build-up of inventories was broad-based; it particularly affected manufacturing, power industry and construction. On the other hand, the growth in gross fixed capital formation represents mainly investments in buildings and structures and not in equipment and machinery as previously expected. This is less favourable for maintaining a high growth rate in the longer term. The growth of household consumption expenditure, which has been accelerating up till the second half of 2007, will slow down in the near future; partly because it already grew slightly faster than disposable income and partly due to fiscal restrictions.

As far as the supply side is concerned, the most important industries contributing to GDP growth in the first half of 2007 were manufacturing (10.5% annual growth), wholesale and retail trade and repair of motor vehicles (14.2%) and real estate, renting and business activities (+11.3%).

In 2007 as a whole, a 6% GDP growth rate is forecasted. In 2008, growth will diminish to 5% as a result of the restrictive measures of the government, which are most likely to result in lower public and private consumption; and partly due to the lower contribution of net exports because of weakening external demand.

Prices and monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

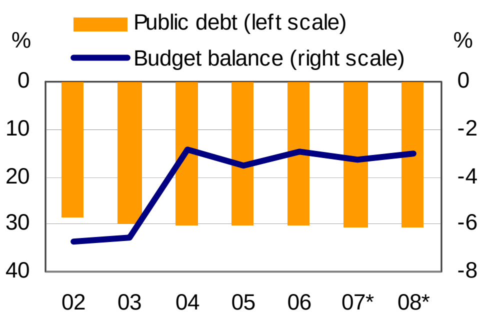
After inflation overshot Czech National Bank (CNB) forecasts in June, July and August data indicated a slight deceleration. However, on a year-on-year basis, inflation is still creeping upwards. At the end of July the central bank revised upwards its forecast for consumer price inflation to the band of 3.5-4.9% for June and December 2008. This is due to upside risks to inflation, which result from a rise in the lower VAT rate (from 5% to 9%), an increase in excise duties and changes of certain regulated prices as well as the tightness of the labour market. Until the end of August, food products (especially processed food, alcohol and tobacco) have had particularly high price increases, and the prices of certain services (e.g. package holidays and rents) also grew faster than average. Preliminary September data indicate a continuing acceleration due partly to a base effect (a substantial decrease of prices last September) and partly to changes of indirect taxes and regulated prices (especially rents).

The CNB increased the two-week repo rate from 2.75% to 3% at the end of July, and then to 3.25 % at the end of August, due mainly to higher than forecasted inflation rates. At the most recent Bank Board meeting at the end of September, the repo rate was left unchanged as downside risks to inflation (such as lower than forecasted August inflation, the strong exchange rate and interest rate developments abroad) now appear to counterbalance upside risks.

With some fluctuations, the CZK appreciated between January and September, and it is expected to continue strengthening during the coming two years as well. Short-term yields differentials compared to euro area indicators have been narrowing since April, while differences in long-term yields have become negligible.

Fiscal policy

Key fiscal indicators (% of GDP)



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

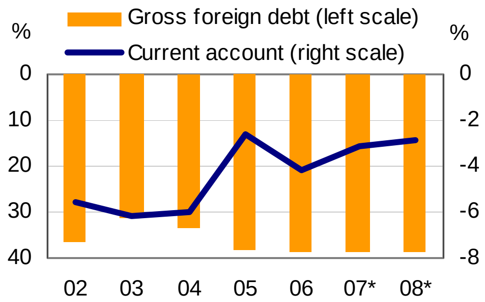
Revised budget data, compiled by the Statistical Office and based on Eurostat decisions on some methodological changes indicate more favourable developments for 2006 than previously thought. For that year, the budget deficit per GDP ratio was revised downwards to 2.69%, below the 3% Maastricht criterion.

2007 developments so far indicate a greater budget deficit compared to 2006. However, estimating its likely end-year size is hindered by the uncertainty surrounding the fiscal impact of VAT and excise duty taxes introduced during the third quarter. August data indicate a decrease in both revenues and expenditures compared to the same period of 2006. The decrease in expenditures is much smaller than that of revenues, therefore the balance deteriorated. 2008 is expected to bring better fiscal performance due to the changes in the tax system and to the reductions in social expenditures.

External balance

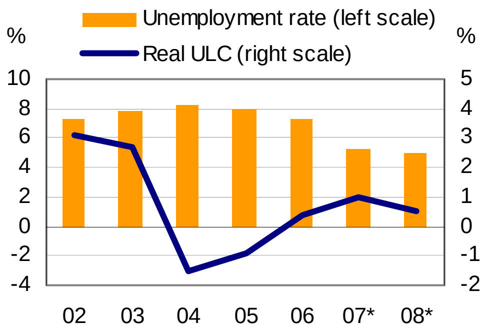
Growth of exports and imports has been slowing down during 2007. August data indicate 12.1% and 11.7% annual growth rates respectively. The trade surplus reached EUR 2 bn, almost twice doubling compared to August 2006. Similarly to previous years, growth in exports of machinery and transport equipment was the

External balance indicators (% of GDP)



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

Labour market indicators



*Note: * forecast. Source: Eurostat*

highest (12.5 % in the year to August), and the trade surplus is composed of a surplus towards the EU27 countries and a deficit in other directions.

Current account developments of 2006 continued in the first half of 2007 as well: while goods and services trade showed a surplus, the income balance pushed the current account in the red. Besides payments of dividends and reinvested earnings, increasing expenses of employing foreign workers also had a negative effect on the current account. According to CNB estimations the current account deficit will reach 3.4% of GDP in 2007.

In today's "no-privatisation" environment, the level of FDI inflows will stabilise and it will mainly take the form of reinvested earnings. The impact of capital inflows connected to EU funds has remained limited up to now, but it is also expected to increase further next year.

Labour market

Employment grew quickly in the first half of 2007 and reached its highest level since 1998. The employment rate grew to 66%.The number of unemployed decreased substantially, including a significant fall in the number of long-term unemployed. The unemployment rate stood at 5.3% midway through 2007, after dropping 1 percentage point in a year.

Labour shortages pose a more and more serious problem for the Czech economy, even though workers from abroad are imported to fill the gap between demand and supply. In 2007 similar tendencies are expected to continue, though the planned lay-offs in the public sector may result in slightly higher unemployment levels.

Wage growth is still high, 5.5 % in real terms in the first half of 2007. The rate of wage growth was the highest in trade, repair, hotel and business services. Signs of a slight deceleration due to fiscal tightening are visible, though the shortage of labour still exercises upward pressure on wages and salaries. However, real unit labour costs continued to diminish, due to strong productivity gains; similar developments are expected for the coming years.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (CZK bn)	2970.3	3204.1	3512.5	3776.2
Real GDP growth (%)	6.1	6.4	6.0	5.4
Private consumption (%)	2.8	4.4	5.1	4.5
Public consumption (%)	1.0	1.1	0.4	1.0
Investments (GFCF, %)	1.3	7.6	7.0	7.3
Exports (%)	10.4	15.9	12.1	10.2
Imports (%)	4.8	15.2	11.8	9.8
Annual average inflation (%)	1.6	2.1	2.5	3.0
Policy rate (%)	2.00	2.50	3.50	4.50
Money market rate (3-month, %)	2.17	2.56	3.45	4.55
Long-term interest rate (10-year gov't bond, %)	3.61	3.68	4.80	5.00
Exchange rate / EUR (average)	29.78	27.49	27.98	27.90
Exchange rate / EUR (end of period)	29.01	27.50	27.48	27.24
Budget balance / GDP (%)	-3.5	-2.9	-3.3	-3.0
Public debt / GDP (%)	30.2	30.2	30.6	30.9
Trade balance / GDP (goods and services, %)	2.0	1.8	2.0	1.9
Current account balance / GDP (%)	-2.6	-4.2	-3.1	-2.8
Gross foreign debt / GDP (%)	38.4	38.5	38.6	38.8
Unemployment (%)	7.9	7.3	5.2	5.0
Real ULC growth (%)	-1.5	-2.3	-1.8	-2.8

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

Sources: Eurostat, CNB (central bank), CSU (statistical office)

Estonia

The economy remains on a slowing track but inflation is creeping upwards due to rapidly rising wages and climbing food and energy prices. Some fiscal loosening is expected at the end of 2007 and in 2008. The external balance improves slightly, but heightened macroeconomic risks have built into interest rates and stock market prices.

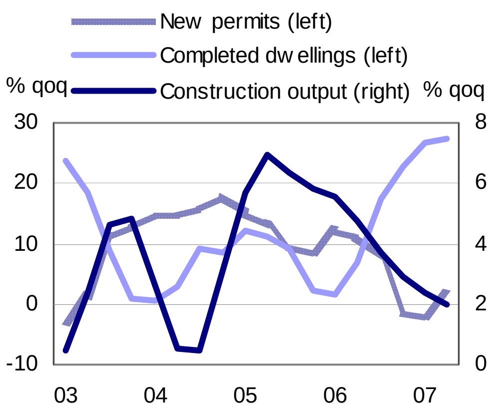
Political developments

In the internal conflict between the Estonian state and the significant ethnic Russian minority, the Estonian government initiated a school reform mandating Estonian language classes for Russian students. The President of the European Parliament Hans-Gert Pöttering declared his support to the reforms during an official visit in August by saying that the program was the key to better integration.

The Schengen accession will take place on 1 January 2008. This demands tighter and stricter external EU border control; Estonia signalled problems in controlling land borders due to the lack of border-guards. This may cause disruptions in extra-EU trade.

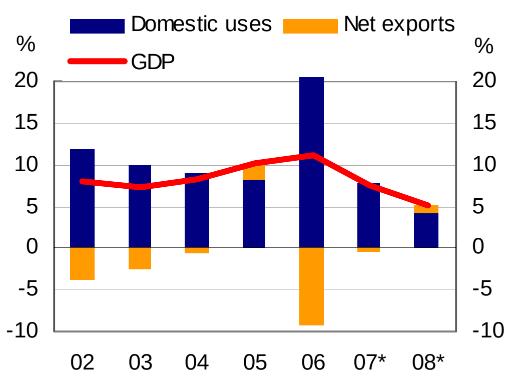
Growth

Construction output growth



Note: quarterly growth rates of trend cycles. Source: Statistics Estonia

Structure of growth



*Note: * forecast. Source: Eurostat*

The economic slowdown continued; growth was 7.4% in the first half of the year and quarterly growth rates clearly indicate a deceleration. Private consumption grew by 14.2% in the same period; it was accompanied by a slowdown of retail sales to 13% in the year to August. Public consumption increased by only 3.6% in volume (although by 20.3% in value). Both exports and imports hit a ceiling in the first half of 2007 and grew by just 3.3% and 3.5% respectively.

Annual growth rates of industrial production fell from 8-9% in the beginning of 2007 to 4% in the year to August. Within manufacturing, the downward trend continued in the manufacturing of wood and textiles. The production of chemical and plastic products also decreased in August due to summer season repair works. The production of metal products grew the fastest (20%).

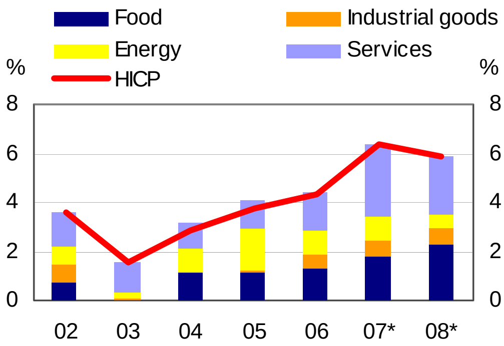
The boom of the construction sector has passed its peak; the quarterly growth trend of construction output has been falling for eight quarters. The number of new building permits dropped by an annual 16% in the second quarter; construction output rose by just 5.7%. As previously started projects are being finished, the number and of finished dwellings hit a record high; this gave a final push to gross fixed capital formation. Real estate supply now exceeds demand and prices started falling in 2007.

The halt of the construction boom, climbing energy prices, rising inflation and increasing risk premia on money markets confirm the expectations about slowing GDP growth. Business and consumer confidence indicators also point to a marked slowdown. However, improving export possibilities can partially counterbalance the deceleration of domestic demand. Decreasing import demand will contribute to closing the gap in the trade balance.

Besides a halt in capital formation, the continuing deceleration of private consumption is also expected due to slowing income growth, more stringent borrowing conditions and the wealth effects of falling real estate prices. GDP growth will reach 7.4% in 2007 and will recede to 'just' 5% in 2008.

Prices and monetary conditions

Components of inflation



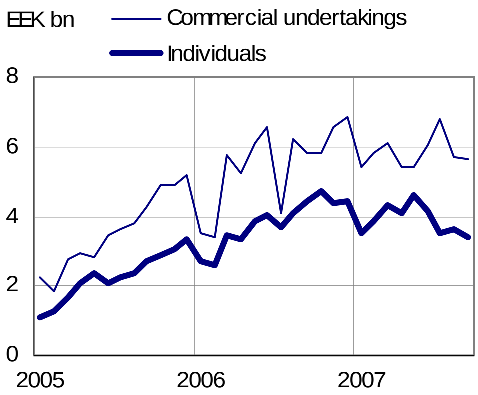
*Note: * forecast. Source: Eurostat*

During the first half-year annual consumer price growth fluctuated between 4.7% and 5.8% while the 12-month inflation climbed to 7.2% in September. The acceleration of inflation was rooted mostly in the real estate sector and in foodstuffs and motor fuel prices. The price corrections of educational and child care institutions and recreational and sports services, which occur every autumn, caused a 10% hike in prices for educational services in September.

Price increases have been driven by rapid wage growth, and several external factors including rising food and more recently, energy prices. For 2007-2008, inflationary pressures are expected to moderate slowly in the near future although Estonia's economic growth is decelerating. Excise duty increases scheduled for 2008 will also delay disinflation. Finally, the Ministry of Economy factored in a 6% rise in electricity prices for 2008, while Eesti Energia (Estonian Energy) has applied for a 23% hike. Should the larger increase materialise, inflation would jump by 0.4 percentage points in 2008.

After the 6.7% inflation rate forecasted for 2007, price increases will slow down to 5.6% in 2008. Under current circumstances meeting the monetary Maastricht criteria seems impossible till 2011, declared Fitch recently.

Loans granted during a month



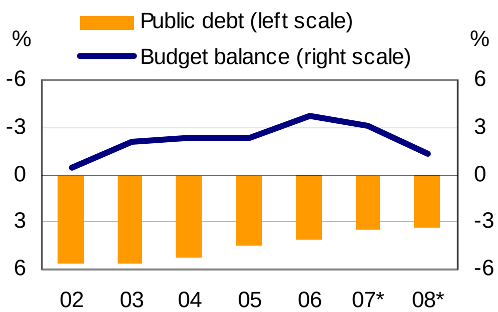
Source: Eesti Pank

The credit and leasing markets are cooling. The stock of loan and leasing portfolios of banks and their subsidiaries grew 42% in the year to June. The growth rate of new loans dropped considerably compared to last year; the main reason was decreasing demand, which was in turn conditioned by higher interest rates by the surge in real estate prices. In addition, the credit policies of banks have also become more conservative. Against the backdrop of the expected slowdown on the real estate market, balanced economic development greatly depends on banks maintaining cautious credit policies.

Heightened macroeconomic risks and uncertainties are reflected in interest rates as well. The 3-month TALIBOR rate rose up to 5.21% till the end of September from 4.74% in June. The spread over the 3-month EURIBOR rate widened to 418 basis points, 7 times higher than it was in June.

Fiscal policy

Key fiscal indicators (% of GDP)



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

Fiscal policy still plays a key role in supporting the smooth adjustment of the economy. Although, government expenditure increased rapidly (by 16.1% in the first half of 2007) the budget maintained a considerable surplus, amounting to EEK 3.1 bn or 3.5% of GDP over the same period.

Revenue collection remained strong but the expansion of quarterly expenditures hints at the willingness of the government to counterbalance the economic slowdown. This implies a long-term fiscal loosening which will not help to stabilise prices. The budget is expected to finish 2007 with a 3.1% surplus, while both the tax burden and the public spending in GDP-ratio will increase by 0.7%.

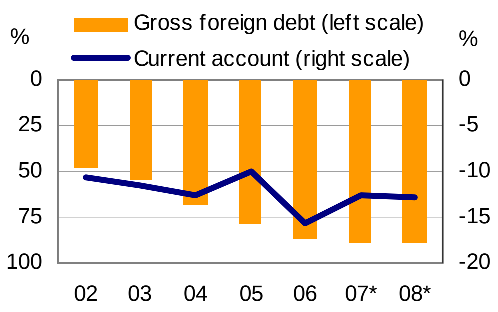
In 2008, taking into consideration various risks and the rather optimistic forecast of the Ministry of Finance, the 2008 surplus could be approximately 1.7-2%, depending on the development of expenditures in the second half of the year. The government plans a 1.3% surplus for 2008.

At the end of July the stock of central government debt was EEK 0.8 bn. This was EEK 1.7 bn less than a year ago, since euro bonds were repurchased in June. As a result, general government debt continues to decrease as well.

The government released plans for an Ecological Tax Reform on the recommendation of the European Environment Agency. The key principle of the reform is a partial re-orientation of taxes from income to the use of natural resources and pollution. This way, the government plans to substitute the shortfall of personal income taxes. Since 2004 the income tax rate has been decreasing by a percentage point every year with the ultimate goal of 18% by 2011. The excise duty on petrol and gas, oil, coal, kerosene, heating fuels, electricity will increase as of 1 of January 2008.

External balance

External balance indicators (% of GDP)



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

In the first half of 2007, the trade balance has improved thanks to the slowdown in domestic demand. In the second quarter of 2007 the trade deficit grew by an annual 14.1%. Among product groups, the biggest deficit was on vehicles, which accounted for 40.2% of the goods' deficit. The growth of exports accelerated to 10.2% in the year to May, thanks to the rise of mineral fuels exports. Imports of goods accelerated to 11.2% in May due to smaller decline in mineral fuels and faster growth of vehicles.

The exporting sector has been enjoying rather favourable external demand during the past couple of years and economic expansion has been faster than forecasted. Estonian export growth has remained rather dynamic, being slightly stronger in the second quarter of 2007 compared to the first quarter.

The current account deficit amounted to EUR 1.3 bn in the first half of the year, up 56% since the same period of 2006. The deterioration of the trade balance accounted for 53% of the increase; the rest was due to a growing deficit on the income balance.

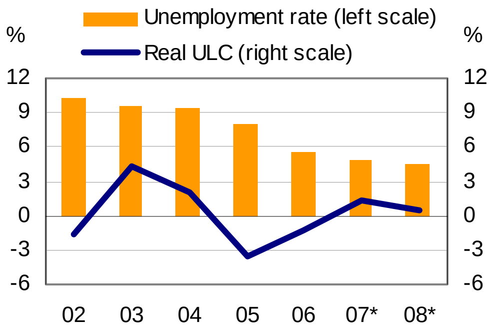
The growth of export sales is expected to accelerate slightly while the import demand will slow down as the economy decelerates. Thus, the enormous trade deficit will decrease and the current account balance will improve as well. We expect the current account deficit for 2007 to reach 13.7%, already lower than last year. The improvement will continue in 2008, to 11.4%.

Net FDI inflows amounted to EUR 394 mn in the first half of 2007, up by 20% since last year even though outward FDI activity increased. Inward FDI rose by 47% to EUR 1 bn in the first six months.

Labour market

Unemployment fell to a record low level of 5% in the second quarter while the number of employed persons grew by an annual 1.3% up to 658 thousand. The average gross salary was EEK 11 549 (EUR 738) in the second quarter, growing by an annual 21.1%. As the growth of salaries exceeds the growth of labour productivity, export performance (and growth) may suffer and inflationary pressures may increase. There are not many direct signs indicating that wage growth has

Labour market indicators



*Note: * forecast. Source: Eurostat*

started to decelerate.

In 2007 and 2008 the number of employed people will increase despite the economic slowdown. Export-oriented manufacturing FDI inflows doubled in the first half of 2007 compared to the same period of last year, while labour-intensive sectors (e.g. trade, business services) continue to attract FDI. This will also help keep up job creation. Since labour costs are rapidly rising in the other Baltic economies as well, the competitiveness and attractiveness of Estonia may not be dented.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (EEK mn)	173,062	204,600	219,740	235,122
Real GDP growth (%)	10.5	11.4	7.4	5.0
Private consumption (%)	8.2	15.7	10.8	6.4
Public consumption (%)	1.1	2.8	2.2	2.5
Investments (GFCF, %)	12.7	19.7	15.0	7.0
Exports (%)	21.5	10.0	5.3	5.5
Imports (%)	15.9	14.7	5.0	4.0
Annual average inflation (%)	4.1	4.4	6.7	5.6
Policy rate (%)	-	-	-	-
Money market rate (3-month, %)	2.59	3.75	5.25	5.50
Long-term interest rate (10-year gov't bond, %)	3.94	4.70	5.20	5.50
Exchange rate / EUR (average)	15.65	15.65	15.65	15.65
Exchange rate / EUR (end of period)	15.65	15.65	15.65	15.65
Budget balance / GDP (%)	2.3	3.8	3.1	1.3
Public debt / GDP (%)	4.4	3.9	3.5	3.3
Trade balance / GDP (goods and services, %)	-6.2	-10.3	-9,0	-8.0
Current account balance / GDP (%)	-10.5	-14.9	-13.7	-11.4
Gross foreign debt / GDP (%)	78.0	85.2	87.7	90.1
Unemployment (%)	7.9	5.6	4.9	4.4
Real ULC growth (%)	-3.6	-1.3	1.4	0.5

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

Sources: Eesti Pank, Eurostat, Statistics Estonia

Hungary

Economic growth is at its lowest rate in more than ten years and the outlook is far from bright. A recovery in currently ailing domestic demand seems slower than expected, while the peaking of the external business cycle reduces the potential for further gains from net trade. Disinflation was also dealt a blow by rapidly increasing food prices, and following some major changes the labour market is rather flat again. At least fiscal and external balances are improving; some concerns, however, also surround these areas.

Political developments

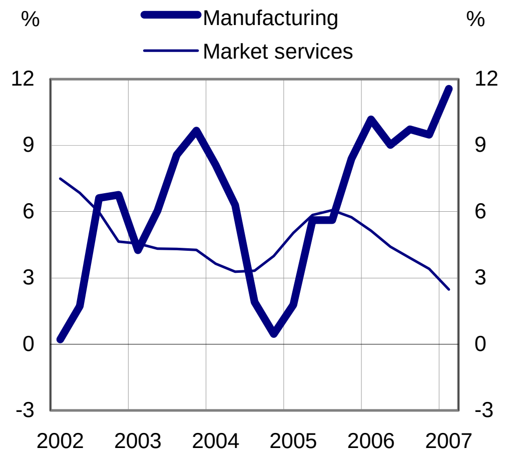
There are re-emerging rumours about the removal of increasingly unpopular Prime Minister, Ferenc Gyurcsany, but lacking a real alternative, the ruling Socialist Party will hardly risk any potentially hazardous step. Anyway, recent polls indicate the biggest difference since last elections between Fidesz, the main opposition party and the Socialists in the favour of the former.

The strong political dividedness of the population manifested itself in diverse reactions to the establishment of a controversial civil group, the Hungarian Guard. While this group defines its mission as “nursing national traditions and defending the citizens”, its paramilitary character and their symbolic have unpleasing connotations indeed. With the exception of Fidesz, all parties in the Parliament were quick to distance themselves from the Guard.

Scandals over the allocation of EU and other state funds in the 2004-06 period extended to parliamentary politicians. Janos Zuschlag, a former Socialist member of the parliament became the most prominent subject of investigations into these matters. The Prime Minister and other high-profile Socialist politicians were heard as witnesses during his prosecution.

Growth

Value added in the tradables sector



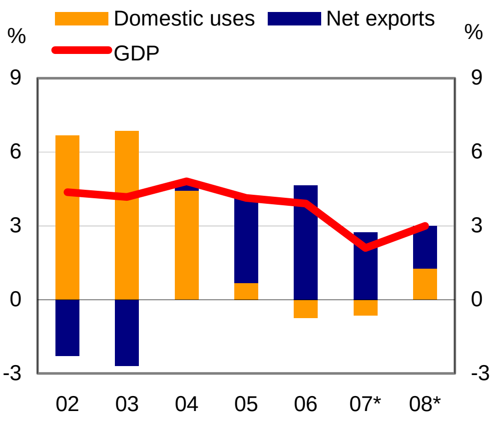
Note: 12-month growth of seasonally adjusted series.
Source: KSH

Year-on-year increase of GDP was just 1.2% in the second quarter of 2007, which is the lowest growth rate in more than ten years. The deceleration of economic growth already began early 2006 and it became more pronounced following the introduction of fiscal austerity measures in the middle of last year. Yet, as the latest data indicate, the slowdown might be deeper and more lasting than originally expected.

On the production side, sectors that are mostly exposed to developments in domestic demand all performed rather poorly. Agriculture and construction output fell considerably and there was also a drop in public services related to administrative functions, education and health. Meanwhile the value added of market services effectively stagnated in the first half of 2007. It was only the most export-oriented manufacturing branches that expanded at a relatively high rate, but this was due to exceptionally favourable foreign demand conditions. With the external business cycle slowly peaking out, the dynamics of manufacturing output growth also decreased somewhat recently.

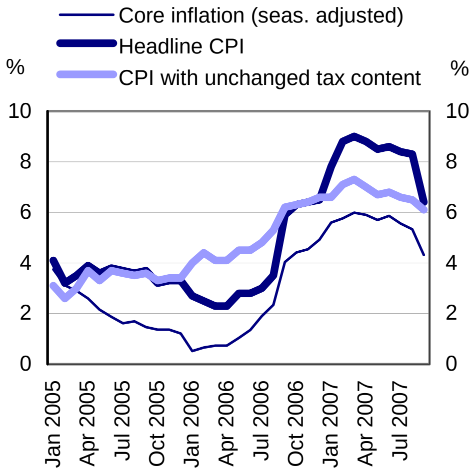
Social transfers in kind were close to 14% lower in the second quarter

Structure of growth



*Note: * forecast. Source: KSH*

Evolution of 12-month inflation



Source: KSH

of 2007 than in the same period last year. It was the major cause of the marked fall (3.4% compared to the second quarter of 2006) in households' final consumption. Another reason might be weaker consumption smoothing, since hopes of a rapid return to the previous income growth path are probably diminished in the light of the latest developments of wages and inflation. Gross fixed capital formation was characterised by contracting public investments and real estate developments. Apart from the completion of some larger projects, investment activity is also dismal in the corporate sector. A slight deceleration of exports in the second quarter was probably temporary, based on foreign trade data available for July and August. Import growth was minimal, probably reflecting a correction after the unexpectedly high increase in the first quarter that was not consistent with slowing domestic demand.

The rest of 2007 will see hardly any improvement the components of domestic demand. As the recent slump seems to be persistent, corporate investments will not recover, while public investments and the construction of residential dwellings will decline further. Gross fixed capital formation will thus increase by a mere 1% this year. Private consumption will not decrease further in the second half of 2007, but even this will result in a 1.1% drop compared to 2006. As the effects of fiscal correction fade out in 2008, some recovery will take place albeit at a rather slow pace.

Net exports will remain the engine of growth even in 2008, but the gap between export and import growth will become closer as external demand loses momentum. Taken together, average annual GDP growth can be as low as 2.1% this year; for 2008 we expect an increase of 3%.

Prices and monetary conditions

12-month CPI-inflation was 6.4% in September, an almost 2 percentage point drop from its August value. This is entirely a consequence of base effects: in the wake of the announcement of fiscal austerity measures in August 2006, the first sharp price rises already took place last September. As a result, there was a marked decrease in the growth rate of energy prices, some services prices and regulated prices in September 2007.

Nevertheless, recent economic circumstances are not favourable for rapid disinflation. Producer prices in agriculture exhibit a strong upward trend mostly due to bad weather conditions in the summer, but growing world market prices for crops also had an effect. In August, agricultural producer prices were 18% higher than a year earlier (growth was 32% for crops). This will lead to increased food prices in the rest of the year even if sharp competition between the biggest supermarket chains dampens the extent of price rises.

There are two more product segments where price developments can impede fast disinflation. The prices of (mostly imported) durable goods broadly follow external price developments corrected for exchange rate changes. As HICP-inflation is also on the rise in the euro-zone and there is very narrow room for further forint appreciation in the near future, prices of durables are set to rise in the coming months whereas they were decreasing throughout the past years. There is also a risk of higher energy prices, not just because of soaring oil and gas world market prices but also as a consequence of cuts in gas price subsidies for households. The planned liberalisation of the electricity market can also have price-increasing effects on the short run.

Thus, disinflation both in the rest of 2007 and in 2008 will be slower than we expected earlier. Accordingly, average annual CPI-inflation can be 7.6% this year, while in 2008 consumer prices will increase by 4%.

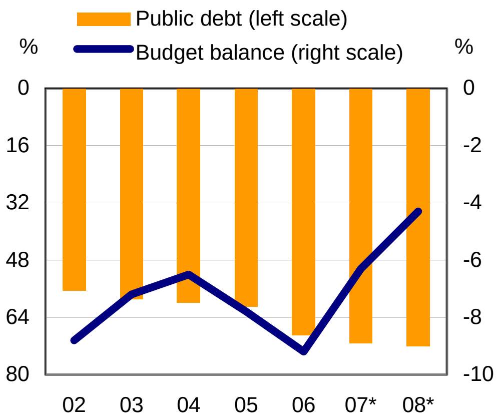
It remains to be seen whether food and energy price rises generate second-round effects; but as it seems that wage developments will not jeopardise the 2008 inflation target, and there is no deterioration perceived in investor sentiment, cautious monetary easing can continue. The Monetary Council also has to take into account the possibility of a fall in global liquidity, should the credit crisis emanating from American secondary mortgage markets spill over to other markets. Considering these developments we expect a base rate of 7.25% by the end of this year and 6.50% by the end of 2008.

The current HUF/EUR exchange rate of around 250 seems to be consistent with economic fundamentals, but very disciplined monetary and fiscal policy is a must to keep the exchange rate at this level.

Fiscal policy

In the first nine months of the year cash-based budget figures indicated a deficit of 4.5% of GDP, or 75% of the amount planned for the whole year. This signals a considerable improvement compared to the same period in 2006. The biggest improvement (almost HUF 300 bn or EUR 1.2 bn) took place in the social security funds. However, the central government balance has hardly changed, at least in nominal terms.

Key fiscal indicators (% of GDP)



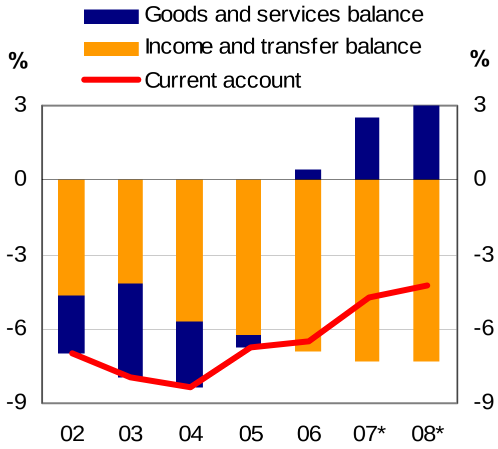
*Note: * forecast, reverse scale on left axis.*
Source: PM (ministry of finance)

While the improvement in the overall fiscal balance was even better than anticipated, some aspects of the improvement are causes for concern. First, better balances are almost solely the consequence of revenue growth. Expenditures were not reduced but even rose further in nominal terms. Second, the primary deficit improved to a lesser extent than planned, and a more favourable outcome for the overall balance is due to significantly lower interest payments on public debt. Third, there are already intentions to spend some of the extra (above planned) fiscal savings which puts into question the determination of the government to irreversibly cut expenditures which would be especially crucial to meet the fiscal target for 2008.

Despite these caveats the 6.3% budget deficit (relative to GDP) for 2007 is not in danger, and we also see higher probability to achieve a 4.3% deficit next year than we did a quarter before. Nevertheless, some risks remain. External financing conditions will certainly not improve: at best they will not deteriorate in 2008. Plans for increasing fiscal revenues further might prove too optimistic because there are no guarantees that the tax base can still be widened even with stricter revenue collection. Finally, there is also a danger on part of local governments. They may not be able to perform all their old and new tasks with reduced budgets or they could become highly indebted.

Despite improving budget figures the level of public debt will increase further to around 71% of GDP by the end of this year and to 72% by the end of 2008.

Current account developments (% of GDP)



*Note: * forecast. Source: MNB*

External balance

Supported by continuously strong external demand, the goods and services balance recorded a surplus of EUR 600 mn in the second quarter of 2007. Based on seasonally adjusted time series there was no further improvement in the trade balance which probably reflected somewhat less dynamic export growth; this halt will probably prove temporary, however. On the other hand the deficit of the income balance widened to EUR 2.3 bn with both profits of foreign direct investors and net interest payments towards foreign borrowers increasing steadily. There was thus a deficit of EUR 1.7 bn on the current account in the second quarter, which, together with a slight surplus in the capital balance resulted in a EUR 1.67 billion external financing requirement.

Despite slowing foreign demand, sustained high growth of exports is expected in the rest of the year, while the balance of income and transfers will slip further into negative territory. As the magnitude of the latter will be smaller, the current account deficit will decrease to 4.8% of GDP from last year's 6.5%.[2] In 2008 net exports will improve further, albeit at a slower pace due to decelerating external demand. This improvement will still be enough to further reduce the current account deficit to 4.3% of GDP.

The nearly EUR 2 bn sale of Budapest Airport (by Ferrovial to Hochtief) appears as a disinvestment in the financial account of the balance of payments. Coupled with seasonally high profit repatriation and continuing net equity purchases within portfolio investments, this resulted in an exceptionally high (EUR 4.2 bn) net outflow of non-debt capital. This will hardly be offset in the rest of the year, thus the financing structure in 2007 will look somewhat unusual, with no non-debt financing at all. Debt-type instruments will dominate the financing of the current account deficit in 2008 as well, but the structure of financing will be less extreme.

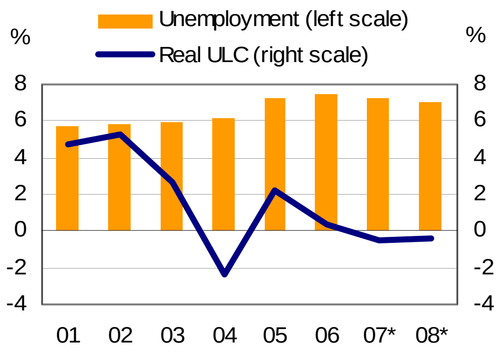
Reflecting the reliance on debt-generating capital inflows, the stock of gross foreign debt increased to EUR 96.2 bn by the end of June from its level of EUR 84.7 bn at the and of 2006. We expect that the stock of gross foreign debt will approximate EUR 100 bn (97.4% of GDP) by the end of December, and increase to EUR 107.8 bn (98.7%) by end-2008. The fast increase of gross foreign debt is not necessarily a cause of concern, though. Net foreign debt will remain well under 50% of GDP on the forecast horizon, and the stock of international reserves is stable at around EUR 17-18 bn, giving sufficient flexibility for the MNB (the cantral bank) to manage its operations in the interbank market.

Labour market

The labour force survey of KSH (the statistical office) indicated a slight increase in the rate of employment in the second quarter; on the other hand, payroll lists exhibited a decrease of 0.7% in the number of employed. This figure is the result of a 4.6% drop in public sector employment, partly offset by a 0.7% increase in the private sector. Weak economic activity also manifested itself in a decreasing amount of hours worked, and in almost entirely disappearing overtime. Despite these processes, the rate of unemployment is somewhat lower than

[2] The current account of 2006 was revised from 5.8% to 6.5%.

Labour market indicators



*Note: * forecast; real ULC based on gross wage growth. Source: KSH*

we expected earlier and can be as low as 7.2% by the end of the year, before decreasing further to 7% in 2008. This, however, merely reflects that labour supply will also be shrinking: in effect the labour market is characterised by slack.

Gross wages rose 10% in the year to July, but most of this is increase is attributed to bonus payments in the public sector. Non-regular payments in the private sector increased to a much lower extent (and might have even decreased if we also account for the effects of whitening of the grey economy), as the corporate sector tries to offset deteriorating profit outlooks. In the average of the first seven months, gross wages increased by 8.1%, but net wage growth was only 1.8%. The gap between gross and net wage growth will close in the remaining months of the year, because the effects of increases in the rate and the minimum base of social contributions last September will die out from wage time series. Still, even with decelerating inflation, real wages will decline by approximately 4.5% in 2007. Higher wage growth in 2008 and lower inflation will result in real wages increasing by around 0.5% next year. Following years of consecutive increases, unit labour costs will marginally decline in both 2007 and 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (HUF bn)	22,055	23,753	25,700	27,300
Real GDP growth (%)	4.1	3.9	2.1	3.0
Private consumption (%)	3.9	1.9	-1.1	0.5
Public consumption (%)	-0.1	0.2	-3.9	0.2
Investments (GFCF, %)	5.3	-2.1	1.0	3.2
Exports (%)	11.7	17.9	14.5	10.6
Imports (%)	6.9	12.4	12.1	9.5
Annual average inflation (%)	3.6	3.9	7.6	4.0
Policy rate (%)	6.00	8.00	7.25	6.50
Money market rate (3-month, %)	5.94	7.90	7.20	6.40
Long-term interest rate (10-year gov't bond, %)	6.97	6.71	6.50	5.90
Exchange rate / EUR (average)	248.05	264.27	250.61	250.00
Exchange rate / EUR (end of period)	252.73	252.30	250.00	250.00
Budget balance / GDP (%)	-7.8	-9.2	-6.3	-4.3
Public debt / GDP (%)	61.0	69.0	71.3	72.0
Trade balance / GDP (goods and services, %)*	-0.5	0.4	2.5	3.0
Current account balance / GDP (%)*	-6.8	-6.5	-4.8	-4.3
Gross foreign debt / GDP (%)*	74.6	92.1	90.9	91.2
Unemployment (%)	7.2	7.5	7.2	7.0
Real ULC growth (%)	2.3	0.5	-0.6	-0.5

*Note: f = forecast. * calculated from data in euro. See methodological notes for definitions and details.*
Sources: Eurostat, KSH (statistical office), MNB (central bank), PM (ministry of finance)

Latvia

Growth continues at a breakneck pace although some early signs of a deceleration are visible. External imbalances are massive but do not appear unsustainable. On the other hand, inflation is spiralling upwards. The government's newly-found fiscal tightness may not suffice to control price increases.

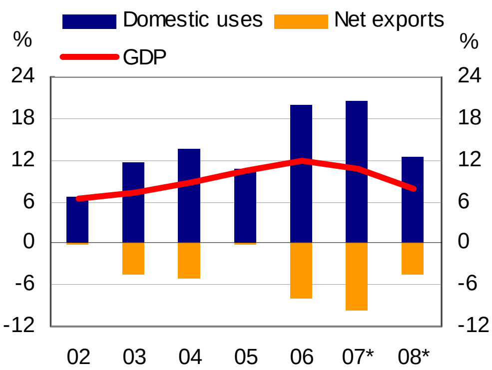
Political developments

The government appears to admit the seriousness of inflationary developments and tightened fiscal policy by proposing modest surpluses for 2007-10. This has drawn criticism from unions and even within the governing coalition. However, even the newest plans may not suffice to rein in the overheating economy.

Prime Minister Aigars Kalvitis survived a no-confidence vote on 23 October after a failed government attempt to remove the head of the anti-corruption institution earlier this month. Vote on the controversial budget plans is scheduled for 24 October.

Growth

Structure of growth



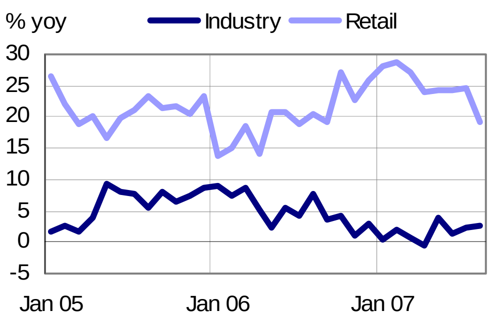
*Note: * forecast. Source: Eurostat, Statistics Latvia*

Economic growth was 11.1% in the first half of 2007; there were still no definite signs of deceleration in quarterly growth figures. However, some elements of GDP show some deceleration.

Private consumption growth came down to 18.3% in the second quarter although it still grew at 19.3% in the first six months. Retail sales also signal a slowdown: they rose by only 19% in the year to August. Rising income levels and easy bank lending continue to support consumption. While credit growth is slowing, real wages rose by a whopping 24% in the first half of 2007.

Investment growth was 25.9% in the first half, quarterly figures indicate some deceleration. The value of capital goods' imports grew by 29% in the first half of the year, signalling the continuing appetite for investments in machinery. The volume of construction output rose by 16% in the second quarter, but seasonally adjusted quarterly growth rates suggest some deceleration. Apartment prices around Riga started to decline in the first half of 2007 although they still rose by 20% in the year to August, according to Latio, a real estate agency.

Industrial production and retail sales



Source: Statistics Latvia

Exports continue to perform well; their volume rose by 8.6% in the first half. Import volume increased by 26.1%, although national accounts show a dip in the second half. Seasonally adjusted trade statistics also indicate a halt in the value of imports, especially of consumption goods. This could be another sign of easing private consumption.

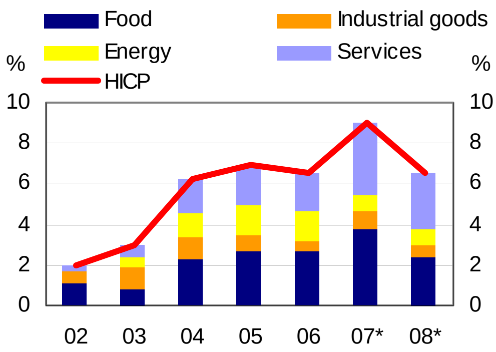
Industrial output grew by just 1.6% in the first eight months but after a weak start to 2007 it is on the way to recovery; in the year to August its growth was 2.6%. Besides declining industries (leather, wood), the machinery industry took a slump. On the other hand, the value of machinery and transport equipment exports rose by 50% in the first half of 2007, accounting for one-third of the export growth in the period.

GDP growth revised upwards to 10.8% because private consumption is taking more time than expected to decelerate while investments and exports grow faster than anticipated. Our expectation for 2008 stays at

8%, assuming a scenario of benign gradual deceleration. However, the risk of a sudden halt of GDP growth is still present.

Prices and monetary conditions

Components of inflation



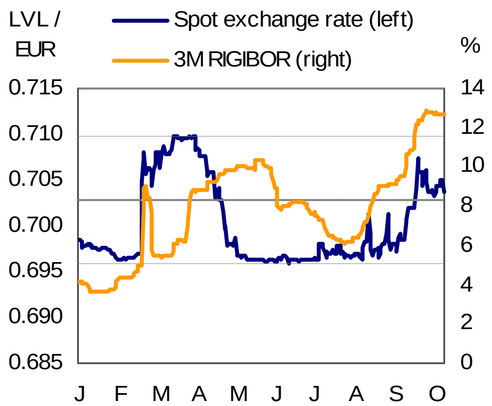
*Note: * forecast. Source: Eurostat*

The 12-month index of consumer prices reached 11.4% in September while the average inflation rate of the first eight months climbed to 8.8%. International food price increases are felt locally as well (up 11.2% in the first eight months). On the other hand, Industrial goods prices are rising moderately (3.2%) and thanks to moderating oil prices in the first half of the year, the inflation of energy was only 7.1%. However, services prices are exploding since the beginning of 2007 (11.6% in the same period). The Balassa-Samuelson effect is visibly at work here as labour-intensive services must increase their prices to keep up with economy-wide growth of labour costs.

The 12-month producer price index peaked in May at almost 20%; by August it came down to 17%. Construction cost growth is also past its peak but is still very high at an annual 29.1% in the second quarter.

Many uncertainties surround the effectiveness of the government's anti-inflationary programme as well as future external inflationary shocks. Price increases are now built into expectations and push wage demands upwards. In light of recent developments and expected external shocks to food and energy prices, we revise our 2007 inflation forecast upwards to 9%. If the anti-inflationary measures of the government prove effective, consumer price inflation can recede to 6.5% in 2008.

Exchange rate and interest rate developments in 2007



Note: horizontal lines indicate the central LVL/EUR parity (0.7028) and the ±1% fluctuation bands. Source: Bank of Latvia, Eurostat

In August the average interest rate of outstanding loans in LVL was 16.6% for long-term loans and 11.1% for short-term loans; 5.8 and 3.3 percentage points higher than a year before. Higher interest rates as well as tighter regulations on lending and deteriorating consumer confidence slow credit growth, although the stock of total credit to residents rose by 56.2% in the year to June.

The LVL/EUR exchange rate returned to the strong end of the ±1% fluctuation band in the summer, but the LVL weakened again in September. This is likely due to renewed concerns over the health of the economy and the downgrading of Latvia's credit rating by Fitch on 17 August. The foreign currency issuer default rating (IDR) was changed from A- to BBB+ on while the local currency IDR was also downgraded fro A to A-.

Money markets have been reacting to macroeconomic turbulences; the 3-month RIGIBOR interbank rate peaked at 12.84% in late September. It has not reached such heights since 1998; the RIGIBOR-EURIBOR spread widened to over 600 basis points in September. Long-term yields follow suit: the Maastricht reference rate (for bonds with 10 years remaining maturity) came back from its 6.03% peak in July to 5.32% in August, but is on the rise again.

There is no firm target for euro adoption; the unofficial date is sometime 'after 2011'.

Fiscal policy

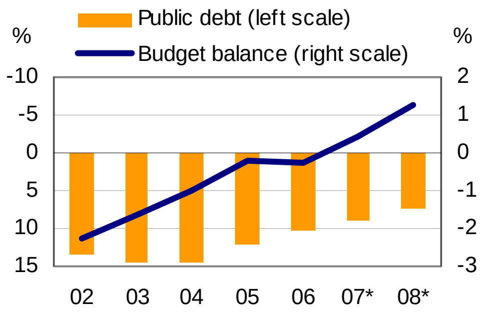
Fiscal policy is tightening slightly. On 20 September the Saeima (the parliament) approved amendments to the 2007 budget which improve the planned budget balance by LVL 232.3 mn to a surplus of LVL 54.5 mn. This is thanks to windfall tax revenues that resulted from under-

Headline figures of the 2008-10 draft budget (LVL mn)

	2007*	2008	2009	2010
Revenues	4,520	5,498	5,983	6,613
Expenditures	4,465	5,335	5,769	6,309
Balance	55	163	213	304

*Note: * according to amendments approved on 20 September 2007. Source: Ministry of Finance*

Key fiscal indicators (% of GDP)



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

estimated economic growth and inflation: in the first seven months tax revenues rose by 36.7% compared with the same period of 2006.

The draft of the 2008 budget was accepted by the cabinet on 8 October. The budget plans a surplus of LVL 163 mn (1% of GDP) for 2008. It has been declared as an 'austerity budget': public sector employment and wage growth (catalysts of economy-wide labour market pressures) will be strictly controlled. The budget drew criticism both from within the government coalition and from union leaders. It is worth recalling that in its September economic comment the Bank of Latvia recommended a 2% surplus for 2008 to stabilise the economy while EU commissioner Joaquín Almunia suggested 3-4% during his July visit to Latvia.

A medium-term budgeting framework was used for the first time in the preparation of next year's budget. It sets 3-year expenditure target ceilings for ministries and other institutions; it provides more reserves and allows more flexibility in reallocating resources. The proposed budget surpluses for 2009 and 2010 amount to 1.2% and 1.5% of GDP according to Ministry of Finance Estimations.

A long-term stabilisation reserve is also proposed in the draft budget on the recommendation of Finance Minister Oskars Spurdzins. The fund would be filled with central budget revenues exceeding the budgeted value; privatisation revenues would also flow into the fund. The Cabinet of Ministers would decide upon the fund's spending on the recommendation of the Minister of Finance. The fund would help to control public spending, and could be used as an anti-cyclical fiscal instrument.

In our view the targeted surplus will be easily attained in 2007 and its value relative to GDP will reach 0.4%. In 2008 revenues could once again grow faster than the Ministry of Finance anticipates while built-in constraints will limit spending growth. Therefore we expect the 2008 surplus to slightly exceed the budgeted value and to reach 1.2% of GDP. Public debt relative to GDP will fall further, below 10% in 2007-08.

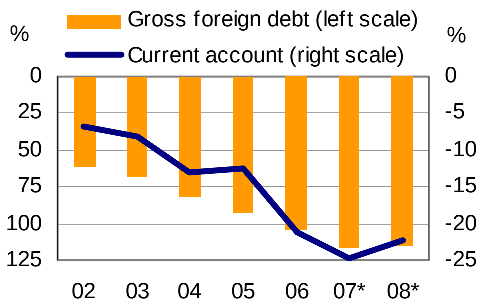
External balance

The value of goods exports rose by an annual 21.7% in the first eight months of 2007. Strong demand and rising global commodity prices helped growth rates above 25% for food and foodstuffs, wood, pulp and paper as well as base metals – products that account for over half of Latvian exports. Machinery, electrical equipment and vehicles exports also performed well, their combined growth rate was 34.8%. Services exports grew by an annual 20.8% in January-August 2007. Sea transport performed poorly (only 4.8% growth in the first half of the year), not the least because the weak USD eroded revenues in EUR (and LVL) terms. The value of imported goods increased by an annual 28.8% in January-August. Services imports rose by 296% during the same period; personal travel, construction and financial services were the key drivers.

The appreciation of the consumer and producer price-based real exchange rates signals deteriorating price competitiveness while sharply rising domestic wages hurt cost competitiveness. Exports could withstand these pressures so far but a shift to exports with higher added value content is still necessary.

The deficit on goods and services trade amounted to EUR 2.9 bn

External balance indicators (% of GDP)



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

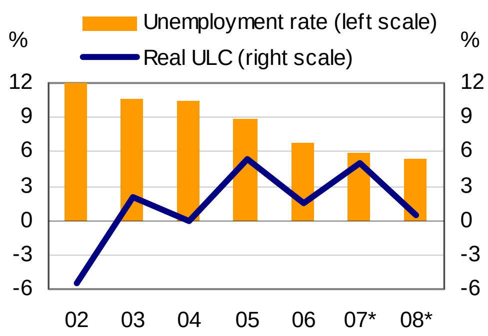
between January and August, 6% more than in the same period last year. The current account deficit rose by 10% to EUR 3.2 bn.

The net inflow of EU funds (on the current transfer and capital accounts) amounted to EUR 160 mn in the first half of 2007, 5% more than a year before. The external financing requirement (the sum of the current and capital accounts) was just below EUR 3 bn by the end of August. Net FDI inflows totalled EUR 880 mn in the first half of the year, covering 42% of the external financing requirement of the same period.

In light of recent economic developments we revise our forecast for the current account deficit; we expect it to peak at 24.8% of GDP in 2007 and subside to 22.3% in 2008. This massive external imbalance is clearly a risk to macroeconomic stability. However, the financing of the external deficit still appears sustainable (mostly in the form of FDI and loans from foreign banks to local affiliates); net foreign assets of the Bank of Latvia more than cover the monetary base while the Bank and policymakers are committed to the LVL/EUR peg; finally, local financial markets are shallow. Therefore the probability of devaluation (either voluntarily or forced by a speculative attack) is practically zero.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

Rapid economic growth keeps up the pace of job creation. Activity and employment continue to rise (by the annual rates of 0.8% and 2.3% respectively, in the second quarter), while the number of the unemployed keeps falling. The harmonised unemployment rate fell by 1.4 percentage points in a year to 5.8% in the second quarter of 2007.

Labour shortages persist; the rate of job vacancies was stable at 2.1% during the first half of 2007; public administration is particularly affected. In the private sector there is particular need for more qualified workers and operators.

Average gross wages increased by 33% in the first half of 2007 while real wage growth remains at 24%. Total hourly labour costs in the private sector increased by an annual 31.2% during the same period. The public sector fuelled wage growth to attract employees – however, this is expected to change with the stricter 2008 budget.

2007-08 will be characterised by a continuing fall in unemployment and fast (although subsiding) wage growth. The unemployment rate is expected at an average 5.9% in 2007 and 5.4% in 2008. Real unit labour costs can rise by as much as 5% in 2007 before coming close to a halt in 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (LVL mn)	9,059	11,265	14,104	17,365
Real GDP growth (%)	10.6	11.9	10.8	8.0
Private consumption (%)	11.5	19.8	18.0	12.0
Public consumption (%)	2.7	4.0	4.0	3.0
Investments (GFCF, %)	23.6	18.3	14.4	9.0
Exports (%)	20.3	5.3	9.5	9.0
Imports (%)	14.8	17.5	22.0	12.0
Annual average inflation (%)	6.9	6.6	9.0	6.5
Policy rate (%)	4.00	5.00	6.00	6.00
Money market rate (3-month, %)	3.16	4.21	7.50	7.00
Long-term interest rate (10-year gov't bond, %)	3.59	4.90	6.00	5.50
Exchange rate / EUR (average)	0.70	0.70	0.70	0.70
Exchange rate / EUR (end of period)	0.70	0.70	0.70	0.70
Budget balance / GDP (%)	0.1	-0.3	0.4	1.2
Public debt / GDP (%)	12.0	9.8	8.9	7.4
Trade balance / GDP (goods and services, %)	-15.2	-21.0	-23.3	-22.3
Current account balance / GDP (%)	-12.6	-21.1	-24.8	-22.3
Gross foreign debt / GDP (%)	91.6	104.4	117.0	117.0
Unemployment (%)	8.9	6.8	5.9	5.4
Real ULC growth (%)	5.3	1.6	5.0	0.5

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

Sources: Bank of Latvia, Eurostat, Statistics Latvia

Lithuania

Resurging domestic demand led to higher than expected economic growth, but also resulted in a further deterioration of the current account. Rising costs of production and (to a smaller extent) consumption demand manifested in record high HICP-inflation. With fiscal policy being expansionary, signs of overheating are still present.

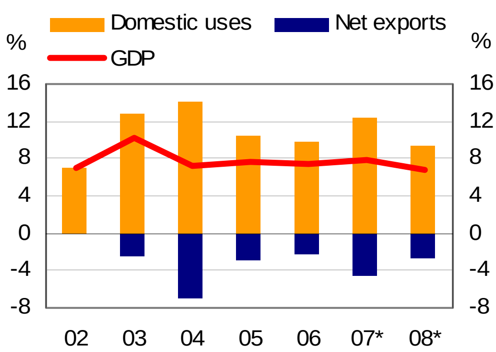
Political developments

Recent political disputes mostly involve fiscal and energy issues. An example for the former was a debate on whether pensions, withheld between 1995 and 2002, should be immediately disbursed from the budget. Opposing the plan was prime minister Gediminas Kirkilas who even threatened to resign should this legislation get through. As regards the latter, Lithuania has recently hosted a conference on energy security for Central and Eastern European countries. The outcome for Lithuania has been mixed, though: an agreement with Azerbaijan, Georgia and Ukraine on the construction of a gas pipeline avoiding Russia is regarded a success, but confrontations with Poland over capacity shares in a new nuclear power plant to be built on Lithuanian soil in the near future is certainly a blow.

Growth

In the second quarter of 2007 GDP increased an annual 8%, thus the resurgence of economic activity continued. Spurred by exceptionally high wage growth (gross monthly wages were 20.1% higher in the second quarter of 2007 than a year before) private consumption gained further momentum contrary to our expectations: it rose by 4.4% compared to the first quarter (on seasonally adjusted terms). While gross fixed capital formation decreased from the first quarter, it still exhibits an impressive 20.5% growth compared to the second quarter of 2006. Domestic demand was thus soaring, which also resulted in a heavy increase of imports. While export performance also improved (Lithuania's main oil refinery began operation again as restoration works following an incident at the end of 2006 were finally completed), this was not enough to offset growing imports. The trade deficit thus considerably widened in the second quarter of 2007.

Structure of growth



*Note: * forecast. Source: Eurostat*

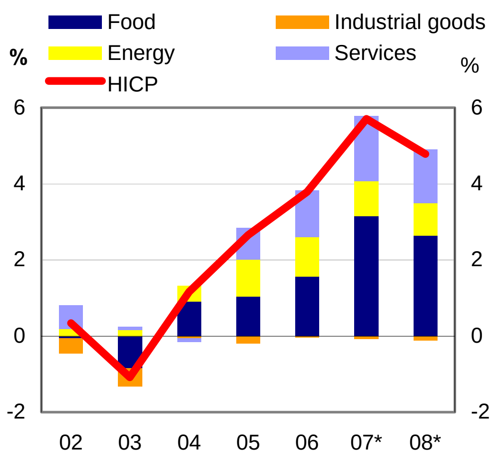
Private consumption will also remain high in the second half of the year, as income growth will be further boosted by the increase in the minimum monthly salary from LTL 600 (EUR 174) to LTL 700 (EUR 203). The recent construction boom will also keep the growth rate of investments high. In addition, foreign direct investors also increased their reinvested earnings. Net exports, on the other hand, will continue to fall sharply. Taken together, we revise our GDP projection for 2007 strongly upwards: average annual economic growth can be 7.9% this year.

However, domestic demand will lose some of its dynamism in 2008 as wages will increase at a lower pace than this year. An expected cut in the personal income tax rate will keep consumption-growth close to double digits nevertheless. Slower domestic demand will also reduce import growth while exports will revive. This will not be enough to turn the trade balance into surplus, but it can partly offset the lower growth contribution of domestic demand components. We expect a GDP growth of 6.7% in 2008.

Prices and monetary conditions

Somewhat peculiarly, the same Lithuania that was close to fulfilling all Maastricht criteria only 18 months ago, posted a 12-month CPI-inflation of 7.1% in September 2007. Apart from some services, it is still the increasing costs of production rather than consumption demand that led to this shocking figure. Food prices increased by 12.6% on the year, while energy price rises rose 9.5%. Services prices also exhibited a sharp hike in September, but even prices of industrial goods went up a bit. Reflecting these changes, some of which will also extend to 2008 (most notably that of energy price rises), our forecast for annual average CPI inflation is 5.7% this year. This means a more than 1 percentage point upward revision compared to our latest forecast. With most risks remaining on the upside, a gradual decrease might take place in 2008, so we project a 4.8% CPI inflation for next year. There seems to be no room for fast disinflation even in 2009; therefore the fulfilment of the Maastricht inflation criterion is not realistic for Lithuania before 2011.

Components of inflation



*Note: * forecast. Source: Eurostat*

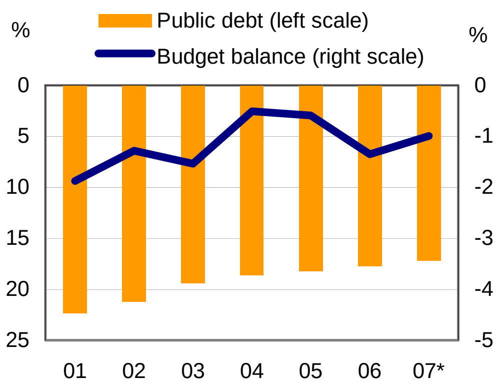
Short-term yield differentials vis-a-vis euro-zone securities widened further. While there was hardly any difference between the 3-month VILIBOR rate and the corresponding EURIBOR rate at the beginning of 2007, an increasing differential is observed since March. The spread reached 70 basis points by the end of August. This gap opened when the sustainability of Latvia's massive current account deficit was questioned. Lithuania now faces similar current account problems; thus the spread is unlikely to diminish in the near future.

Credit growth to households is still quite strong (the outstanding amount grew by 65% in the year to August). Very favourable income outlooks will keep credit growth high on the forecast horizon. However, given the current circumstances, it does not threaten to undermine financial stability.

Fiscal policy

While the revival of economic activity kept the growth of indirect tax revenues high in the first half of 2007, last year's income tax rate cuts resulted in a marginal growth in the value of direct taxes. Social contributions from employers increased as a result of legalisation of shadow-economy wages. There were much more pronounced increases in expenditures, however: significant rises in public sector wages and higher government investments both contributed to rising spending.

Key fiscal indicators (% of GDP)



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

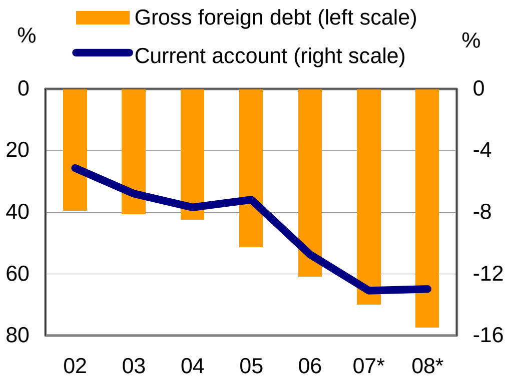
While the minimum wage rise will give a further boost to collected social contributions, revenue growth will not match the rise of expenditures. Fiscal revenues increase to 33.7% of GDP this year (a 0.4 percentage point rise compared to 2006) while expenditures will amount to 35%. This will result in a budget deficit of 1.3% in 2007, thus fiscal policy will be relatively expansionary. This deficit forecast is higher than our previous expectations.

In 2008 public investments will further increase due to the new nuclear plant project; some other expenditure items will grow slower than nominal GDP. Thus a slight improvement in the budget balance can take place in 2008, with the deficit not exceeding 1% of GDP. The stock of public debt will remain well below 20% of GDP throughout the forecast period.

External balance

An acceleration of private consumption and gross fixed capital formation in the first half of 2007 led to outstanding import growth, pushing the trade balance further into negative territory. The deficit on goods and services trade increased from EUR 953 mn in the first half of 2006 to EUR 1693 mn in the first six months of this year. Net income payments to abroad also increased, from EUR 391 mn to EUR 567 mn as a result of higher FDI and foreign debt stock. The balance of current transfers exhibited some improvement thanks to increased workers' remittances and the inflow of EU funds, but this could not prevent the current account from sliding further into deficit.

External balance indicators (% of GDP)



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

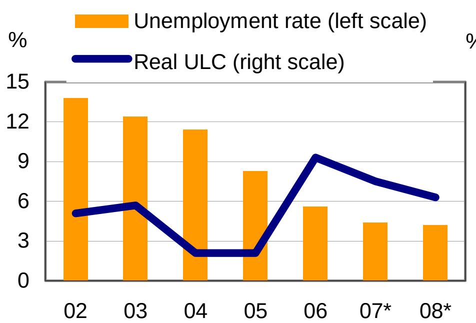
In the second half of the year exports will finally pick up following the restoration of capacities at Mazeikiu Nafta, the country's oil refinery. Even with an improvement in the terms of trade, the deficit on goods and services trade will widen further. The deterioration in the income balance will also continue, eventually leading to a current account deficit of 13.1% of GDP in the whole of 2007. Trade developments will be more favourable in 2008, but dividend and interest payments to foreign investors will also increase dynamically, reflecting recent increases in the stock of both FDI and foreign debt. Thus a current account deficit of similar magnitude (13% of GDP) is expected for 2008 as well.

Non-debt financing was virtually zero in the first half of 2007, as the FDI inflow of EUR 368 mn (almost exclusively reinvested earnings) was totally offset by close to EUR 50 mn outward FDI and net purchases of equities from foreign investors within portfolio investments amounting to EUR 300 mn. Debt-generating financing thus clearly dominates non-debt capital movements, and this phenomenon will also prevail in 2008.

The stock of gross foreign debt was EUR 16.9 bn at the end of June, roughly two-thirds of GDP. Because of the structure of current account financing, this stock will further increase to EUR 19.1 bn (69.9% of GDP) by the end of this year. Rapidly growing foreign indebtedness together with steady current account deficits warrant caution even if the service of foreign debt seems to be smooth. As the recent surge in domestic demand slowly fades out, there should be a possibility for Lithuania to partially restore its external equilibrium.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

The labour market remained demand-driven in 2007. Many new jobs have been created during the recent boom, but there is shortage of workers with special skills. Unemployment was a mere 4.1% in the second quarter of 2007; there is hardly any room for further decreases. Luring foreign workers in large numbers is not yet on the agenda due to the many bureaucratic obstacles. Furthermore, language barriers make the hiring of guest workers difficult. This means that the labour market will remain tight, with the average unemployment ratio decreasing to 4.4% this year (from 5.6% in 2006) and further to 4.2% next year.

Average gross monthly earnings rose by an annual 20.1% in the second quarter. Wage growth was higher in the private sector, but this could also be the consequence of legalisation of shadow-economy wages. It was in the middle of 2006, that a cut in the personal income tax rate (from 33% to 27%) led to a jump in net wages, but this effect will die out from the data in the second half of 2007. Wage growth will thus be somewhat moderated in the forecast horizon, but real unit labour costs – even controlling for high productivity growth – will continue to rise markedly.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (LTL mn)	71,200	81,991	94,200	105,700
Real GDP growth (%)	7.6	7.5	7.9	6.7
Private consumption (%)	9.8	13.6	12.1	9.0
Public consumption (%)	4.9	7.3	5.6	4.2
Investments (GFCF, %)	9.2	11.9	15.2	10.3
Exports (%)	14.5	15.4	8.4	11.2
Imports (%)	16.0	15.4	12.5	12.0
Annual average inflation (%)	2.7	3.8	5.7	4.8
Policy rate (%)	-	-	-	-
Money market rate (3-month, %)	2.53	3.72	5.75	5.50
Long-term interest rate (10-year gov't bond, %)	3.78	4.28	5.20	5.00
Exchange rate / EUR (average)	3.45	3.45	3.45	3.45
Exchange rate / EUR (end of period)	3.45	3.45	3.45	3.45
Budget balance / GDP (%)	-0.5	-0.6	-1.3	-1.0
Public debt / GDP (%)	18.6	18.2	17.7	17.2
Trade balance / GDP (goods and services, %)	-7.3	-10.4	-11.5	-10.9
Current account balance / GDP (%)	-7.2	-10.8	-13.1	-13.0
Gross foreign debt / GDP (%)	51.3	60.8	69.9	77.4
Unemployment (%)	8.3	5.6	4.4	4.2
Real ULC growth (%)	0.7	3.1	2.5	2.1

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

Sources: Eurostat, Lietuvos Bankas, Lietuvos Statistikos Departamentas

Poland

The early election could help to bring the political stability to Poland. The high growth rate accelerated by domestic demand helped to decrease the budget deficit, but some new uncertainties have emerged. Monetary policy needs to counter the negative effect of rising wages and risk of easing fiscal policy.

Political developments

After intensive disputes the Polish Parliament decided to dissolve on 7 September. The leading party, Law and Justice fell well short of a majority in 2005 and formed a shaky coalition with two smaller, populist parties (the right-wing League of Polish Families and Self-Defence). The coalition collapsed in August, leaving Prime Minister Jaroslaw Kaczynski with a minority government and prompting him to opt for early elections. News on corruption in ministries and on conflicts between the leader parties made the headlines in the past months.

While Mr. Kaczynski wants a clear mandate for social policies to support families who have not benefited from an economic boom and to strive against the 'corrupt post-communist elite'; the eventual winner, the centre-right Civic Platform of Donald Tusk wants to speed up reforms in Poland.

Early elections were held on 21 October with a high turnover. The Civic Platform won the elections and will be able to form a coalition with a comfortable majority. The former coalition partners of Law and Justice failed to make it into the Sejm (the lower house of the parliament).

Preliminary results for the 21 October 2007 elections

	% of votes	Seats in Sejm
Civic Platform (PO)	41.4	209
Law and Justice (PiS)	32.2	166
Left and Democrats (LiD)	13.2	53
Polish People's Party (PSL)	8.9	31
German minority (MN)	0.2	1
Total		460

Source: National Election Commission

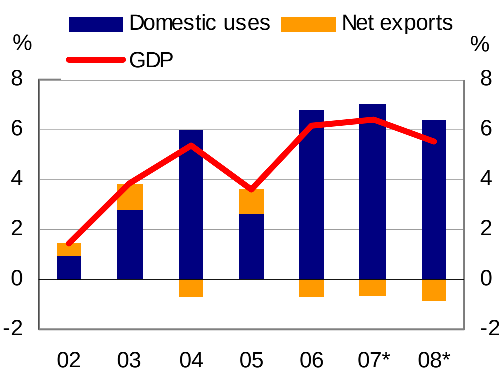
Growth

Poland's economy expanded an annual 6.7% in the second quarter. Though faster than expected, this fell short of the figure of the first quarter (7.4%). Domestic demand increased by 9.3% in the second quarter, up from 8.6% in the first quarter. The prime contributors to second quarter growth came from fixed investments and a build-up of inventories; gross capital formation boomed by 22.1%. Fixed investments seem to have replaced private consumption as the main contributor to growth. Net exports made a negative contribution to growth. While exports increased 7.8% on the year in the second quarter, imports grew 14.2%.

The services sector expanded 6% on the year but industrial output growth slowed to 6.3% in the second quarter. Industrial production expanded 9% in the year to August. Deceleration was broad-based, as all three industrial sectors (especially mining) performed worse than in the previous month.

For the rest of 2007, the Polish economy is expected to maintain its fast growing track. Consumer spending will grow steadily and investments are projected to see a double-digit growth in the coming quarters. Imports will continue to expand thanks to buoyant domestic demand. GDP will grow by 6.4% in 2007 and by 5.5% in 2008.

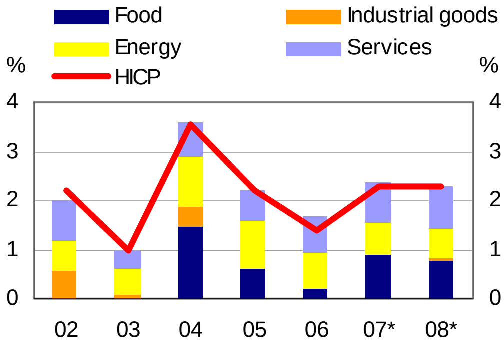
Structure of growth



*Note: * forecast. Source: Eurostat*

Prices and monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

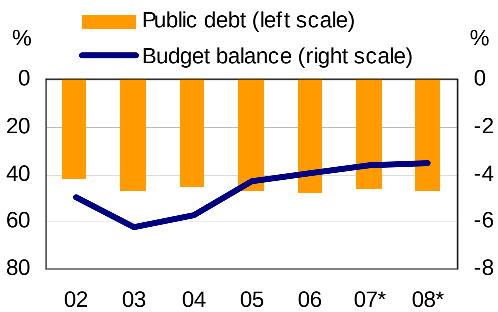
The consumer price index rose just 1.5% in the year to August, well below expectations. Headline inflation, as measured by 12-month growth of the consumer price index, climbed to a two-year high of 2.6% in June, but then fell back in July and August. Monthly net inflation, the main measure of core inflation used by the central bank, indicated a fall of 0.3%. However, unfavourable weather in summer will lead to a poor harvest, putting an upward pressure on food prices in the near future.

Poland avoided major inflationary pressures despite rising domestic consumption. The strong currency, moderate import prices and healthy productivity growth have all helped keep down inflation so far.

The Monetary Council raised the benchmark interest rate for a third time this year in August. The decision was explained by wage growth and household spending which contain inflationary pressures. More interest rate hikes are possible in the next months. The policy rate is expected to peak at 5.25% in short term.

Fiscal policy

Key fiscal indicators (% of GDP)



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

Although the budget plan for 2007 seemed over-optimistic at the beginning of the year, collected revenues have increased by 24% over the first seven months. This was faster than planned, thanks to fast economic growth. At the same time spending has been restrained, growing by 4.5%. The GFS deficit of the central budget was just PLN 8 bn (EUR 2 bn) over the first seven months.

Such good figures may encourage the government to loosen fiscal policy. There are plans to increase the minimal wages, ease the tax burden for families and raise social expenditures in 2008. The health reform and structural changes in public administration promised by the government two years ago are not among short-term plans. On the other hand, opposition parties have suggested an even larger increase in tax allowances for families than the government proposal.

Thus, the deficit is well below the national fiscal target (PLN 30 bn) and is expected to develop favourably in the short term. However, guarantees for good fiscal performance the longer term are lacking because of delayed reforms and plans for extra spending. The budget deficit will be 3.6% of GDP in 2007 and could reach 3.5% in 2008.

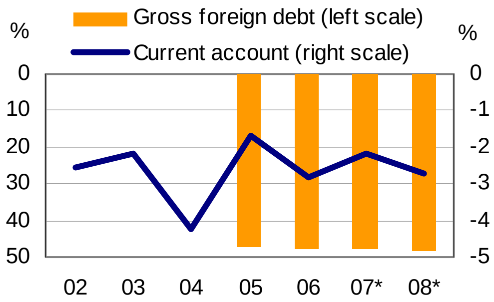
The sharp improvement in the state budget has finally been reflected in a slower growth of public debt. State Treasury debt rose from 47.1% of GDP at the end of 2005 to 47.8% of GDP at the end of 2006. The debt-to-GDP ratio will continue to rise in 2007 and 2008, although it will remain well below the Maastricht threshold of 60 percent.

External balance

Strong growth in the EU helped Polish exports; on the other hand, import is increasing thanks to the strong domestic demand. These tendencies indicate that the growth rate of exports and imports in 2007 will be higher than last year.

The current account deficit amounted to EUR 3.6 bn in the first half compared to EUR 2 bn a year ago; relative to GDP it amounted to 4.9%. The larger deficit was a result of a sharp rise in the trade deficit

External balance indicators (% of GDP)



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

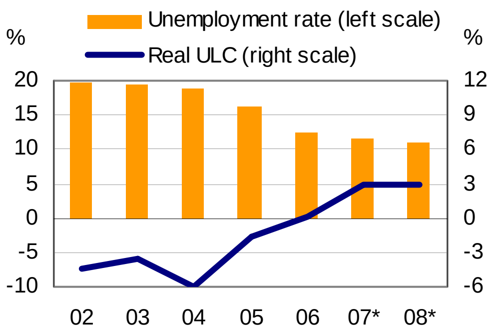
as well as an increase in the deficit on the income account. We forecast a gradual increase in the current account deficit over the next few years; to 3.2% in the whole of 2007 and 3.8% in 2008.

The country attracted 31 new foreign direct investment projects in the first half of 2007, primarily in the electronics sector according to the statistics of the Polish Information and Foreign Investment Agency. FDI inflows grew by an annual 27% to EUR 6.2 bn in the first half of 2007.

Labour market

As the economy continues to grow rapidly, the labour market situation has improved further. Since 2003 a steady growth in demand for labour is observable. The largest contribution to the rise in employment is still made by services. Unemployment continued to decline, below 10% in June, and to 9.1% in August 2007. We expect unemployment to continue its fall, reaching 10% on average this year and 9.3% in 2008.

Labour market indicators



*Note: * forecast. Source: Eurostat*

Buoyant economic growth and productivity gains have encouraged companies to raise wages: gross average wages in the private sector rose 9.5% in the year to September. Simultaneously, the Ministry of Labour and Social Policy drafted a new directive that will raise Poland's minimum gross wage by 20% from 2008. We expect the increasing trend of wages to continue in the coming quarters.

However, rising labour demand has not led to an increase in labour market participation rates. The activity rate of the population aged 15 or over was just 53.5% in the second quarter, lower than in 2000. This is related to another important structural problem: the missing of young labour force. Approximately 1.2 million young people moved to western European countries after Poland joined the EU (more than half of them to the UK). According to surveys, the average age of these migrants is below 25 years. The government has introduced a new program to keep the young workforce at home, but local experts doubt whether this will prove effective.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (PLN bn)	980.7	1057.8	1141.3	1218.5
Real GDP growth (%)	3.5	6.1	6.4	5.5
Private consumption (%)	1.9	5.1	4.8	3.9
Public consumption (%)	5.3	3.9	2.0	3.0
Investments (GFCF, %)	6.5	16.5	12.5	9.0
Exports (%)	8.0	14.8	11.0	10.0
Imports (%)	4.7	16.0	12.0	11.5
Annual average inflation (%)	2.2	1.0	2.2	2.2
Policy rate (%)	4.50	4.00	5.25	5.00
Money market rate (3-month, %)	4.62	4.20	4.90	4.50
Long-term interest rate (10-year gov't bond, %)	5.34	5.14	5.60	5.00
Exchange rate / EUR (average)	4.02	3.89	3.70	3.70
Exchange rate / EUR (end of period)	3.86	3.90	3.70	3.70
Budget balance / GDP (%)	-4.3	-3.9	-3.6	-3.5
Public debt / GDP (%)	47.1	47.8	46.0	47.0
Trade balance / GDP (goods and services, %)	-0.3	-1.3	-1.8	-2.1
Current account balance / GDP (%)	-1.7	-2.9	-3.2	-3.8
Gross foreign debt / GDP (%)	47.1	47.8	47.9	48.4
Unemployment (%)	16.1	12.3	10.0	9.0
Real ULC growth (%)	-1.7	0.1	3.0	3.0

Note: f = forecast, e = estimation. See methodological notes for definitions and details.
Sources: Eurostat, Central Statistical Office of Poland, Narodowy Bank Polski, OECD

Romania

Economic growth rate declined due to the adverse effects of summer droughts. Food prices increased as well which alone raised the inflation rate by two percentage points. The fiscal balance is expected to deteriorate due to upcoming legislative elections. The current account deficit continued to increase due to high imports growth fuelled by domestic demand. Unemployment decreased to record low.

Political developments

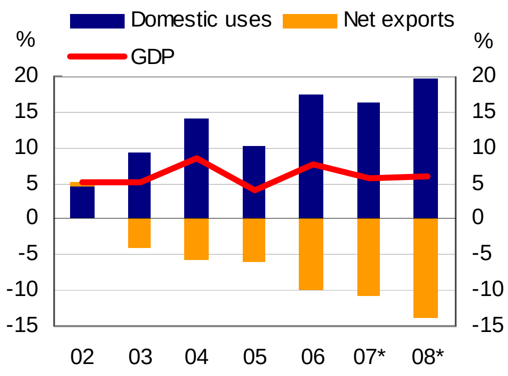
After the unsuccessful motion to remove the President in the spring, the political climate remained tense. The minority government narrowly survived a no-confidence vote filed by the main opposition Social Democratic Party: 220 members of the parliament voted against the government, while 232 votes were needed for its removal. The political climate is not expected to improve over the next months, especially as European Parliament elections (and later on legislative elections) are approaching. EP elections will be held at the end of November 2007.

In 2008 local and parliamentary elections will be held in Romania; parties are getting prepared to the new contests next year. The governing party seems to use pension increases to rally the support of approximately 5 million pensioners.

Growth

In the second quarter of 2007 GDP growth decelerated further to 5.6%. This figure was the lowest in the last six quarters and accordingly, economic growth is expected to fall in 2007 compared to 2006. The growth rate for the first half reached 5.8%, down by 1.6 percentage points since the same period of last year.

Structure of growth



*Note: * forecast. Source: Eurostat*

On the demand side, consumption and investments remained the main engines of growth. However, a slight but gradual shift is observable in the composition of growth. While the annual rise in private consumption fell to 11.5% in the second quarter (the lowest in the last six quarters), gross fixed capital formation increased by almost 20%, and growth of public consumption accelerated as well. On the other hand, the negative contribution of net exports to GDP growth increased since imports grew dynamically (20.8%) while exports remained basically unchanged (2.4%).

Despite the slight deceleration of consumption, it plays major role in economic growth. Private consumption remained strong due to high wage increases and significant credit expansion. Besides, the appreciation of the RON (leu) against the euro in the first half of 2007 supported the purchase of imported products. On the other hand, the appreciation had a negative impact on export growth and eroded price competitiveness.

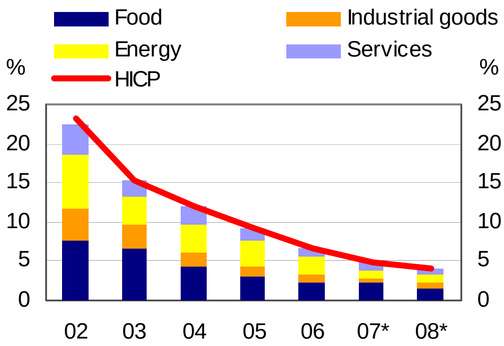
Regarding the production side, agriculture's performance was weak in the second quarter: its gross value added fell by 10.9%. Two years ago floods set back agricultural production; this time summer droughts caused severe problems. As a consequence of poor agricultural yields the National Prognosis Commission cut its 2007 growth estimation from 6.5% to 5.9% in recent months.

Gross value added in industry increased by only 4.4% in the second quarter which was significantly influenced by the appreciation of the RON. Value added in construction grew by an excellent 32.2% in the second quarter of 2007. The sector is boosted by infrastructure investments and demand for industrial and retail properties. Services grew by 6.2% due to robust consumption of the private sector. However, this figure was the lowest increase in the last ten quarters, indicating the gradual slowdown of consumption.

Even revised Romanian growth forecasts are higher than our expectations. Economic growth in the third quarter should fall further owing to the drought; it is not expected to reach even 5% in the third quarter. Accordingly, we expect the annual growth rate at 5.6% in 2007; this means a downward revision of our forecast by 0.5 percentage point. For 2008 we maintain our previous forecast (6%). Since legislative elections will be held next year, the contribution of public consumption to growth will increase.

Prices and monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

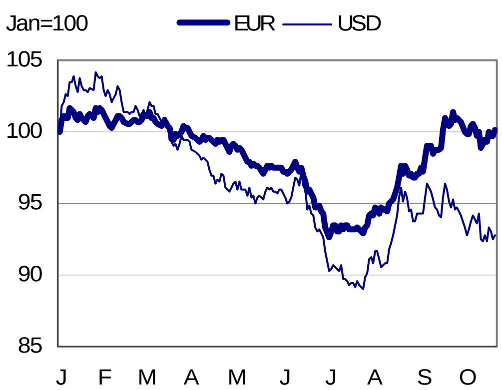
In the second half of 2007 inflation started to rise again. The acceleration of price increases was mainly due to the drought and rising global food prices which influenced negatively the prices of agriculture products. The weight of food goods in the HICP consumption basket is almost 40% in Romania; therefore food price increases have considerable effect on inflation.

In August vegetables prices increased by 3.8% compared to July 2007, while bread prices also went up by 3.6%. As a result, 12-month inflation in August was 1 percentage point higher than in July (4.96% versus 3.99%). In September the 12-month index increased by another percentage point to 6.03%.

Besides drought, the 7% depreciation of the RON in the third quarter also contributed negatively to the evolution of the consumer price index. Now the exchange rate is in a similar region (3.35-3.40) as at the beginning of 2007. This depreciation was anticipated due to the rising current account deficit and the shortfall of speculative capital inflows.

The National Bank of Romania (NBR) abstained from further interest rate cuts the third quarter. The 7% rate is not expected to change until the end of 2007. Further cuts are not expected as inflation jumped close to the upper limit of the inflation target (4% ±1 percentage point) in recent months.

Exchange rate fluctuations in 2007



Source: National Bank of Romania

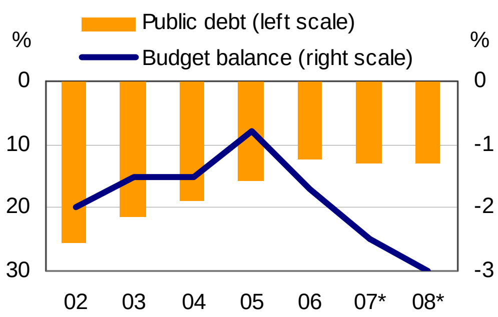
In 2007 annual average inflation is expected at 4.7%; we increased our previous forecast by 0.3 percentage point due to the adverse effects of drought. For 2008 the NBR's inflation target is 3.8%±1 percentage point; we expect that inflation will decrease only slightly, to 4.2%. There are several risks and challenges which can pile inflationary pressures on the economy. First, wages increased by 20% during the first half of the year. Second, the significant current account deficit puts pressure on the exchange rate and therefore on inflation as well. Third, elections will be held in 2008 and a loosening of fiscal policy is expected. An early warning sign is the planned pension rise (pensions will be doubled until 2009).

The National Bank of Romania maintains its plan to join the ERM-II regime in 2012, which could mean entering the euro-zone in 2014. The reduction of inflation will prove the most difficult of the Maastricht criteria.

Fiscal policy

During the first eight months of 2007 the consolidated government budget surplus reached RON 1.2 bn or 0.32% of estimated GDP. The surplus was considerably lower than in August 2006 when it reached RON 5.3 bn. The government maintained its plan that budget deficit will reach 2.8% of GDP in this year.

Key fiscal indicators (% of GDP)



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

As of January 2008 the government plans to increase pensions significantly (by 43%) which will be almost doubled until 2009 (from RON 396 to RON 747). It seems that financing of pensions increase will not cause problems in the short term because the dynamic increase of wages creates additional social security revenues. However, the financing of pensions increase is not obvious in the longer term.

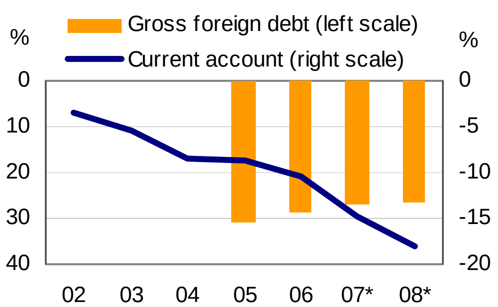
We expect that budget deficit will reach 2.5% of GDP in 2007. Our forecast is lower than the government's plan since it is not sure that all planned spending will be realised, just as in 2006.

For 2008 the government plans that budget deficit will reach 2.7% of GDP; revenues and expenditures will grow by 21% and 20% respectively. Pensions and health insurance expenditures are planned to increase by almost 12%. We expect that the pension increase is the first step to a looser fiscal policy in the run-up to 2008 elections: the consolidated government deficit may end up at 3% of GDP next year.

External balance

The deterioration of the current account balance continued in the second quarter of 2007 as well. Between January and July the current account deficit doubled in comparison with the same period of the previous year and reached EUR 7.8 bn.

External balance indicators (% of GDP)



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

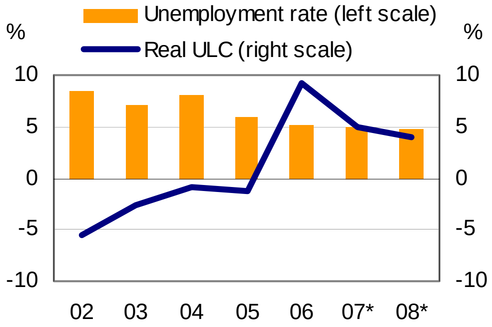
The widening current account deficit is driven by the 77% (EUR 3.4 bn) rise in the trade deficit; it accounted for 84% of the deterioration in the current account balance. The growth rate of imports significantly exceeded that of exports. While the import of goods and services grew by 29.1%, exports increased by 'only' 14.6% in EUR terms. The incomes balance deteriorated further (54.6%) while net transfers improved slightly (10.9%) in the first seven months of the year.

Several factors support import growth. Wages increased by more than 20% in the first half of the year, boosting consumption. The appreciation of the Romanian currency lowered the prices of import goods. Finally, investments continued to grow buoyantly.

In 2007 the current account deficit is expected to reach 14.8% of GDP; further deterioration of the current account is expected in 2008. Undoubtedly, external imbalances can be one of the biggest macroeconomic challenges for Romania in next years.

In comparison with last year foreign direct investments decreased. Between January and July 2007 net FDI inflows reached EUR 3 bn compared with EUR 3.3 bn in the same period of 2006. We expect that FDI will not be able to finance the entire current account deficit this year: net FDI inflows can reach EUR 7 bn in 2007 while external financing requirement deficit has already exceeded EUR 7.8 bn.

Labour market indicators



*Note: * forecast. Source: INSSE*

Labour market

In August 2007 the number of unemployed dropped to 350 thousand and the unemployment rate fell to 3.9% from 5% in the same month of the previous year. Employment and unemployment rates improved due to the high growth rate of the economy. In 2007 we expect that unemployment figure will remain under 5% and it could decrease further in the next year as well.

In line with improving employment figures, wages rose dynamically as well. In the year to August gross monthly average wages increased by 24.3%, to RON 1395 (EUR 423).

According to estimations 2 million Romanians work abroad. This is a key factor behind the low unemployment rate. However, it also causes labour shortages which can threaten medium-term growth prospects.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (RON mn)	288,048	342,418	386,200	429,500
Real GDP growth (%)	4.2	7.7	5.6	6.0
Private consumption (%)	9.8	13.9	11.2	10.0
Public consumption (%)	8.5	2.5	7.0	7.0
Investments (GFCF, %)	12.5	16.1	18.5	15.0
Exports (%)	8.1	10.6	8.5	15.0
Imports (%)	16.6	22.8	20.0	25.0
Annual average inflation (%)	9.1	6.6	4.7	4.2
Policy rate (end of period, %)	7.50	8.75	7.00	6.50
Money market rate (3-month BUBOR, %)	6.36	8.19	6.65	5.80
Long-term interest rate (10-year gov't bond, %)	7.15	7.42	7.00	6.50
Exchange rate (RON / EUR, average)	4.05	3.62	3.34	3.31
Exchange rate (RON / EUR, end of period)	3.68	3.38	3.34	3.29
Budget balance / GDP (%)	-0.8	-1.7	-2.5	-3.0
Public debt / GDP (%)	15.8	12.4	12.8	13.0
Trade balance / GDP (goods and services, %)	-10.2	-12.1	-15.0	-19.6
Current account balance / GDP (%)	-8.6	-10.4	-14.8	-18.0
Gross foreign debt / GDP (%)	31.0	28.0	30.5	31.5
Unemployment (%)	5.9	5.2	4.6	4.3
Real ULC growth (%)	-1.2e	9.2e	5.0	4.0

Note: f = forecast, e = estimation; See methodological notes for definitions and details.

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

Slovakia

Besides domestic consumption and investments, net exports have contributed to high GDP growth in Slovakia. Inflation reached a record low in August, although some upwards risks are still present. Eurostat revision of the budget methodology raised the deficit to GDP ratio; this may hinder euro-zone accession. Foreign trade has been developing favourably with high growth of exports thanks to major automobile and electronics FDI projects.

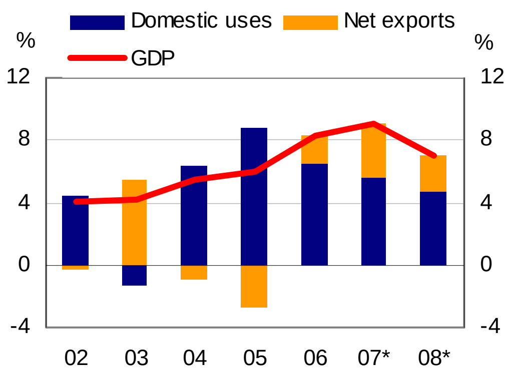
Political developments

The government is committed to the 2009 euro adoption, though the revision of budget methodology by Eurostat may jeopardise the fulfilment of the relevant Maastricht criterion. There are signs that the government wants to reverse the health care reform introduced by the Dzurinda government.

Growth

After a slight deceleration in the first quarter of 2007, second quarter data indicate renewed momentum with a 9.2% growth rate. This rate is again the highest in Central Europe and is on par with the rates recorded by the Baltic states. The favourable changes in the structure of growth which characterised last year persist. While the role of investments and especially private consumption is still significant, net exports' relatively high contribution continued. This latter is fuelled by the growing production of FDI-related car and electronic companies. Though the growth rate of final household consumption increased in the second quarter, a parallel decrease in unit labour costs and increases in net exports and in savings indicate that the economy is on a relatively sound growth path.

Structure of growth



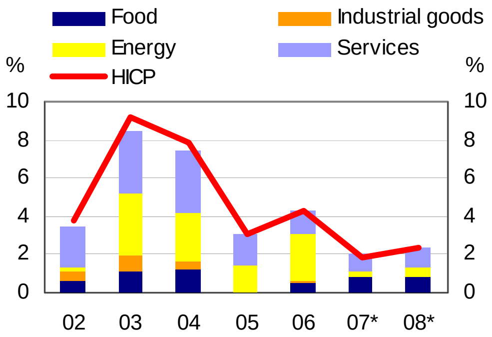
*Note: * forecast. Source: Eurostat*

According to our forecast, a similarly high contribution of exports will persist throughout 2007, and will continue into 2008 as well, resulting in a high GDP growth of around 8% in 2007 and 7% in 2008, if foreign demand remains strong. Though growing at a lower pace than GDP, private consumption will remain the contributor to GDP growth. Rapid credit growth will continue to support consumer spending over the coming years. Investments are expected to remain strong, though it might decelerate after planned foreign investment projects are be realised. Import growth will be affected by the slowdown of domestic demand; therefore net exports will continue to contribute positively to growth.

Prices and monetary conditions

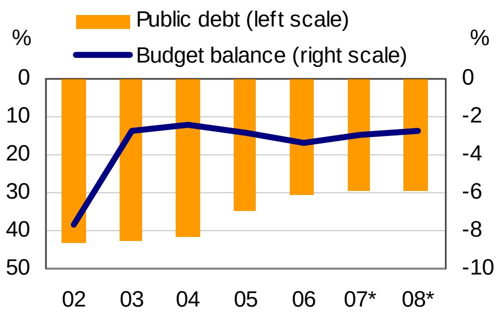
The harmonized index of consumer prices decreased by 0.1% between July and August; annual inflation was 1.2% in August, the lowest level in the history of Slovakia after 1993. However, as far as the main products groups are concerned, there is acceleration in the price increases of foodstuffs, while the prices of industrial goods, energy and services grew more moderately. If food prices continue to grow in the remaining months of the year – which cannot be ruled out given the increasing worldwide demand facing a relatively limited supply –, then inflation may be slightly higher than forecasted at the end of 2007. Preliminary September inflation data indicate that the

Components of inflation



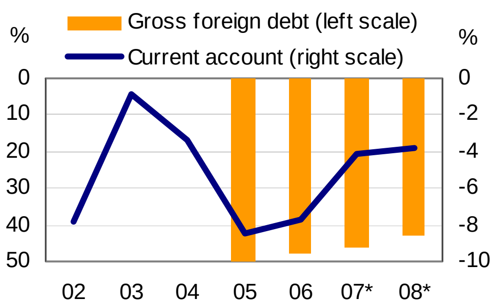
*Note: * forecast. Source: Eurostat*

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: Eurostat*

increase in food prices still persists.

Given the limited upward risk to inflation and economic developments being roughly in line with central bank forecasts, the central bank board has not changed the two-week repo rate since April from 4.25%. There has been some widening in the spread of Slovak bonds vis-á-vis the euro benchmark yield curve.

In the second quarter the exchange rate remained relatively stable. As last year's base effect (a depreciation in the summer) fades out, the trend of annual appreciation weakens. In 2008, only small changes are expected both in regulated prices and in the exchange rate, which is expected to keep the inflation rate around 2%.

Fiscal policy

It was bad news for euro adoption that Eurostat modified 2006 budget deficit figures by applying a revised methodology. The revision adds 0.7 percentage points to last year's public sector deficit, which thus reached 3.39% of GDP; the stock of public debt also increased by around EUR 140 mn. Revisions may affect the budget figures of 2007 as well. Slovakia expects a public deficit of 2.94% this year.

This year's budget, however, is not in a bad shape: at the end of August, it showed a surplus thanks to strong economic growth and the orderly implementation of expenditure plans. By August 66.5% of total revenues planned for 2007 have already been collected, while actual expenditures reached only 59% of the budgeted value. According to plans, next year's budget deficit will be 2.34% of GDP. Additional sums will be allocated to education, health care, R&D and agriculture. No significant tax changes are considered; the only proposal is a cut of VAT on books from 19% to 10%.

Slovakia has formally set 2009 for euro-zone entry. In order to stick to the original schedule, this year's deficit must be below 3% of GDP. The president of the ECB president noted that the bank will monitor closely the fulfilment of this criterion.

External balance

The growth rate of goods export value came down to 12.3% in the year to July while imports increased by 13.2%; preliminary data for August indicate further slowdown. This resulted in a sharp drop of the significantly lower trade deficit which reached just EUR 0.5 bn in the first eight months. The narrowing trade deficit contributed to the substantial decrease in the current account deficit in the first half of the year: it amounted to just EUR 1.2 bn compared with over EUR 1.6 bn over the same period of 2006. The decrease of the trade deficit seems to have halted, though in 2007 as a whole it will still contribute to a substantial narrowing in the current account deficit.

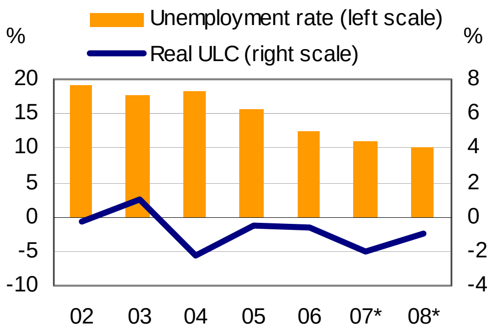
The improvement of the trade balance is mainly due to the start of production and exporting of major FDI projects in the automotive sector (and to a smaller extent in the electronics sector).However, this trend may come to a halt in the future, because there was a substantial drop in FDI inflows compared to the first half of last year: they were only one-third of the value registered in the first half of 2006. Another significant change in the balance of payments is the increase in other, especially short-term investments, which resulted in a surplus in the financial account of a size of more than EUR 3 bn. These short-term investments are deposits of non-residents on Slovak bank accounts, probably with the aim of speculation in the run-up to euro accession. This item compensated for the lower FDI and portfolio investments compared to the previous year.

We expect the current account balance to gradually improve; by our estimations it can reach 4.2% of GDP in 2007 and 3.8% in 2008. Although the growth of exports will slow down as new FDI projects drain up, slowing domestic demand will cut import growth, helping both the trade and current account balances improve.

Labour market

The registered unemployment rate continued to fall, from 9.5% at the beginning of the year to 8.3% at the end of July. The harmonised unemployment rate stood at 11.2% at the end of the second quarter, also falling substantially since the beginning of the year (12.1%). Encouragingly, the number of long-term unemployed started to decrease. However, its rate of decrease is lower than that of total unemployment, so the share of long-term unemployed rose and still exceeds 50%.

Labour market indicators



*Note: * forecast. Source: Eurostat*

Total employment grew further, by 1.8% after seasonal adjustments in the second quarter. Its slowing growth rate may reflect the deceleration in the growth of investments (including FDI).

Real wages increased by an annual 4.1% in the second quarter. They increased the fastest in some services sectors, especially in real estate, renting, and business activities and in transport – by more than 8% on a year-on-year basis. These developments are in line with our previous forecast, according to which the tightening of the labour market and strong profitability bear the risk of a further, potentially excessive increase in real wages in 2007. Still, unit labour costs will continue to fall slightly in real terms thanks to quicker productivity growth.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (SKK bn)	1471.1	1636.3	1844.1	2018.5
Real GDP growth (%)	6.0	8.3	9.1	7.0
Private consumption (%)	7.0	6.1	6.8	5.5
Public consumption (%)	-0.6	4.1	3.0	2.9
Investments (GFCF, %)	17.5	7.3	8.0	6.1
Exports (%)	13.8	20.7	18.9	13.0
Imports (%)	16.6	17.8	15.0	10.9
Annual average inflation (%)	2.8	4.3	1.8	2.3
Policy rate (%)	3.00	4.75	4.25	4.00
Money market rate (3-month, %)	3.12	4.82	4.12	3.80
Long-term interest rate (10-year gov't bond, %)	3.62	4.15	4.45	3.90
Exchange rate / EUR (average)	38.60	37.23	33.90	33.75
Exchange rate / EUR (end of period)	37.88	34.44	33.69	33.56
Budget balance / GDP (%)	-2.9	-3.4	-2.9	-2.8
Public debt / GDP (%)	34.5	33.1	29.7	29.4
Trade balance / GDP (goods and services, %)	-4.4	-4.4	-1.7	-0.1
Current account balance / GDP (%)	-8.5	-7.8	-4.2	-3.8
Gross foreign debt / GDP (%)	49.8	48.0	46.2	42.8
Unemployment (%)	15.5	12.3	11.0	10.0
Real ULC growth (%)	-0.5	-0.6	-2.0	-1.0

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

Sources: Eurostat, Slovak National Bank, Slovak Statistical Office

Slovenia

Although some deceleration takes place, a high growth rate will persist in the last quarters of 2007. Inflationary pressures arise, fuelled by the strong domestic demand. The budget government deficit will deteriorate in the forthcoming election year.

Political developments

After years of deadlock, an agreement was reached with Croatia on the border dispute concerning the Bay of Piran in August. The parties agreed to accept the arbitration of the International Court of Justice. However the border issue is still far from being solved and remains a sensitive political issue as general elections draw near in Croatia in November 2007.

Three ministers resigned at the end of the summer after their performance had been strongly criticised by the media and the opposition. Despite the cabinet reshuffle the position of the ruling coalition seems stable.

The former prime minister and main candidate of the governing parties, Mr. Alojz Peterle has good chance of winning the presidential election on 21 October 2007. Since the opposition parties do not have a joint candidate, neither Mr. Danilo Tuerk nor Mr. Mitja Gaspari is expected to win. The opposition Social Democrat's former main candidate decided to step back in the summer.

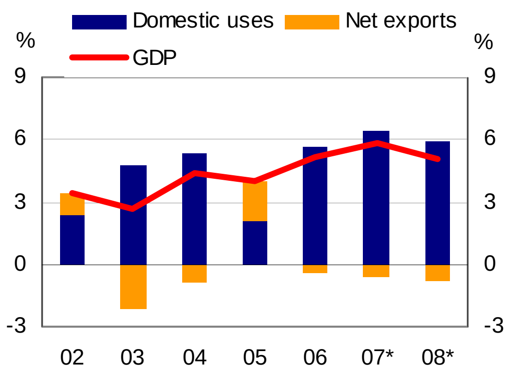
The upcoming EU presidency and the parliamentary elections will dominate the political agenda next year. Slovenia will try to focus on energy security and the starting of accession negotiations with Macedonia during its half-year EU presidency. If the excellent performance of the economy and macroeconomic stability persist, 2008 elections will be the current coalition's to lose.

Growth

Economic growth slowed down slightly in the second quarter of 2007: real GDP grew at an annual rate of 5.9%. This marks a moderation of 1.3 percentage point compared to the first quarter. Gross fixed capital formation (GFCF) is still the main engine of growth: it kept increasing by almost 22% in the second quarter, fuelled by booming construction activity and a good performance of manufacturing. Private consumption rose by 3.4 % and public consumption decreased by 0.7 % in the second quarter of 2007. Foreign trade's contribution to GDP growth turned negative.

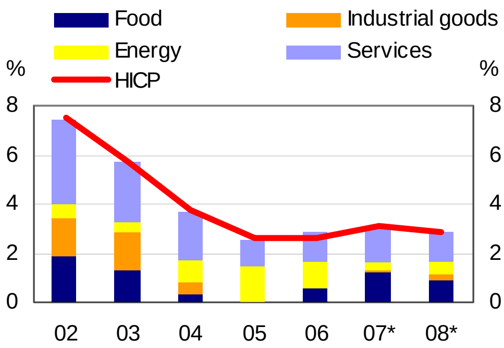
We have not modified our growth forecast for the years 2007 and 2008: growth is expected to reach 5.8% in 2007 and slow down to 5.1% in 2008. Investment activity will remain the main contributor to GDP growth in 2008. The boom in residential construction will moderate towards the end of the forecasting period, but infrastructural investments (notably the extension of the motorway network and the improvement of the railway network) will keep GFCF growth high. The growth of private consumption will moderate while public consumption might gain momentum in the run-up to 2008 elections.

Structure of growth



*Note: * forecast. Source: Eurostat*

Components of inflation



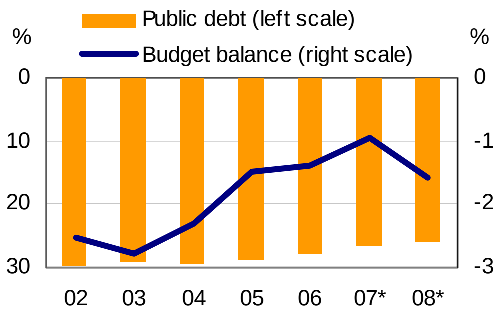
*Note: * forecast. Source: Eurostat*

Prices and monetary conditions

The 12-month harmonised index of consumer prices rose to 3.4% in August while average annual inflation stood at 3.1 % in the same month. The main reason for the acceleration was higher inflation in alcohol and tobacco (8.1% on a year-on-year basis), food and non-alcoholic beverages (6.2%) and services (5.3%). Although external factors (higher global energy and food prices, the harmonisation of excise duties on tobacco in line with EU regulations) play an important role in inflationary developments, strong domestic demand due to vigorous economic growth was also playing a role.

A slight risk of economic overheating exists but inflation will not exceed the rate implied by the convergence to average EU income and price levels. The Slovenian government will keep administered prices as low as possible and the tightness of ECB's current stance will prevent Slovenia's economy from overheating: the main refinancing rate is at 4% and may even increase to 4.25 % in 2008. We expect that average annual HICP inflation will be around 3% in 2007, and ease slightly in 2008.

Key fiscal indicators (% of GDP)



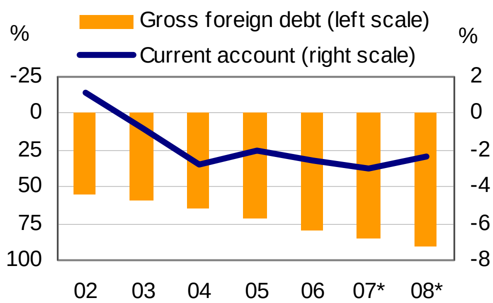
*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

Fiscal policy

Due to higher than expected inflation the Ministry of Finance promised more fiscal prudence in the second half of the year. The 2007 deficit target was revised downwards to 0.6% of GDP. We consider that this target is too optimistic and forecast a general government deficit of 1% for 2007. The continuation of the tax reform, the costs of the half-yearly EU presidency and a possible increase in social transfers in the run-up to parliamentary elections will widen the general government deficit to 1.6 % of GDP in 2008.

The stock of public debt relative to GDP continues to shrink; it will fall below 27% in 2007-08.

External balance indicators (% of GDP)



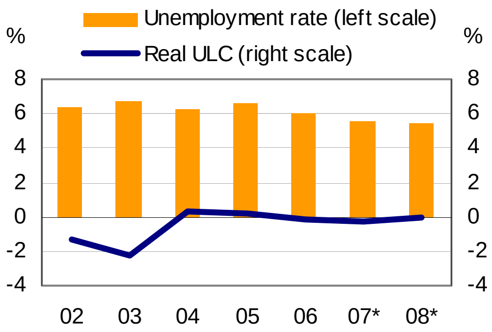
*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

External balance

The deficit of the goods balance reached 3.4% of GDP in the second quarter of 2007. The current account deficit amounted to EUR 337 mn or 2.2% of GDP in the same period. Due to strong domestic demand import increased faster than expected. However, due the rise of services exports the goods and services trade balance was positive, reaching 0.4% of GDP in the first half of 2007. The current account deficit will be around 3% of GDP in 2007 and it will shrink to around 2.5% in 2008 in line with the moderating domestic demand.

Large privatisation deals (Nova Ljubljanska Banka, Nova Kreditna Banka Maribor, Triglav insurance company), will increase substantially the inward FDI flows to Slovenia. The government will reduce its holdings to 25% plus one share in these companies, thereby retaining some control. However, these privatisations are not expected to materialise before the 2008 parliamentary elections. The only major privatisation-related transaction expected before the elections is the sale of Telekom Slovenije around the end of this year. On the other hand, outward investments to ex-Yugoslav countries continue and Slovenia will remain a net FDI exporter throughout the forecasting horizon.

Labour market indicators



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

Labour market

Robust economic growth and favourable effects of the tax reform (fewer tax brackets and lower rates) had a positive impact on the labour market. According to labour force survey data the unemployment rate was 4.6% in the second quarter of 2007. This marks a 1.1 percentage point improvement compared to the previous quarter. Labour shortages are already being felt in certain sectors: job vacancy rates are particularly high in construction, the real estate and hotel sectors.

Favourable growth prospects and the gradual phasing out of the payroll tax imply that the labour market situation will continue to improve during the forecasting horizon. We expect that the unemployment rate (ILO definition) will fall below 5% in 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (EUR mn)	27,625	29,736	31,461	33,066
Real GDP growth (%)	4.0	5.2	5.8	5.1
Private consumption (%)	3.4	3.3	3.5	3.0
Public consumption (%)	2.2	3.8	2.1	4.0
Investments (GFCF, %)	1.5	11.9	16.5	10.2
Exports (%)	10.5	10.0	14.8	11.0
Imports (%)	7.0	10.4	15.3	11.7
Annual average inflation (%)	2.5	2.5	3.1	2.8
Policy rate (%)	-	-	-	-
Money market rate (3-month, %)	4.00	3.67	4.15	4.10
Long-term interest rate (10-year gov't bond, %)	3.69	3.90	4.80	4.00
Exchange rate / EUR (average)*	239.60	239.60	-	-
Exchange rate / EUR (end of period)*	239.50	239.60	-	-
Budget balance / GDP (%)	-1.4	-1.4	-1.0	-1.6
Public debt / GDP (%)	28.8	27.8	26.6	26.0
Trade balance / GDP (goods and services, %)	-0.6	-0.8	-0.9	0.3
Current account balance / GDP (%)	-2.0	-2.5	-3.0	-2.4
Gross foreign debt / GDP (%)	71.0	80.0	85.0	91.0
Unemployment (%)	6.6	6.0	5.1	4.9
Real ULC growth (%)	0.1	-0.2	-0.3	0.0

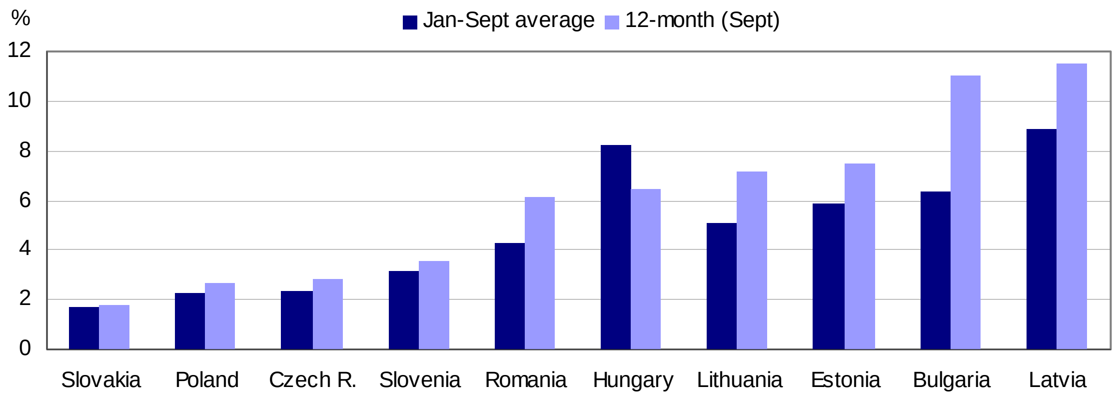
*Note: f = forecast. * SIT / EUR before January 2007. See methodological notes for definitions and details.*
Sources: Banka Slovenije, Eurostat, WIIW

Special topic

Rising inflation in the Eastern EU Member States

Inflation is on the rise in the region. Monthly inflation rates were positive for the better part of the past twelve months in every country. Annual HICP indices are also higher than a year before (except for Slovakia). The average 12-month inflation rate was 6% in September 2007 while the average index for the first three quarters was 4.8%. The leaders in terms of the 12-month index are Latvia and Bulgaria where inflation recently reached double digits (Chart 1). Average inflation in the first three quarters of 2007 was the highest in Latvia, followed closely by Hungary. The gap between 12-month and average inflation measures suggests that price increases are accelerating everywhere except for Hungary. The largest accelerations took place in Bulgaria, Latvia where 12-month inflation was 5.6 percentage points higher than a year before; the average increase in the region was around 2 percentage points. Only Slovakia managed to lower its inflation rate since September 2006, by 2.8 percentage points.

Chart 1 – HICP inflation in 2007



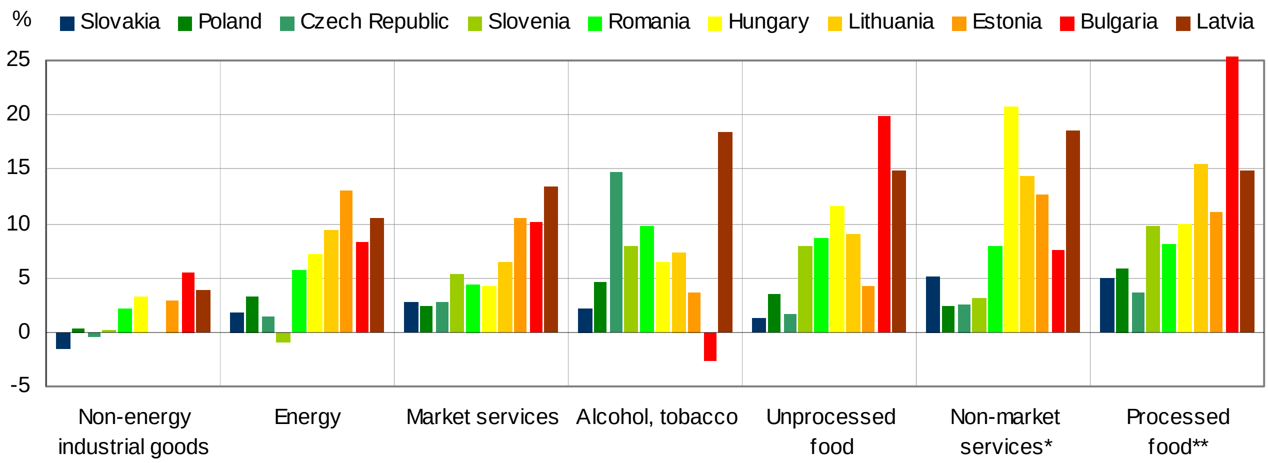
Source: Eurostat

The region has gained experience with double-digit (or sometimes even higher) inflation as recently as the 1990s. This side-effect of price liberalisation was more or less unavoidable during the transition from planned to market economy. Inflation has since been tamed with much effort. Is this achievement now threatened? What are the causes of rising inflation and what does it mean for the short- and medium-term prospects of the region?

The underlying factors

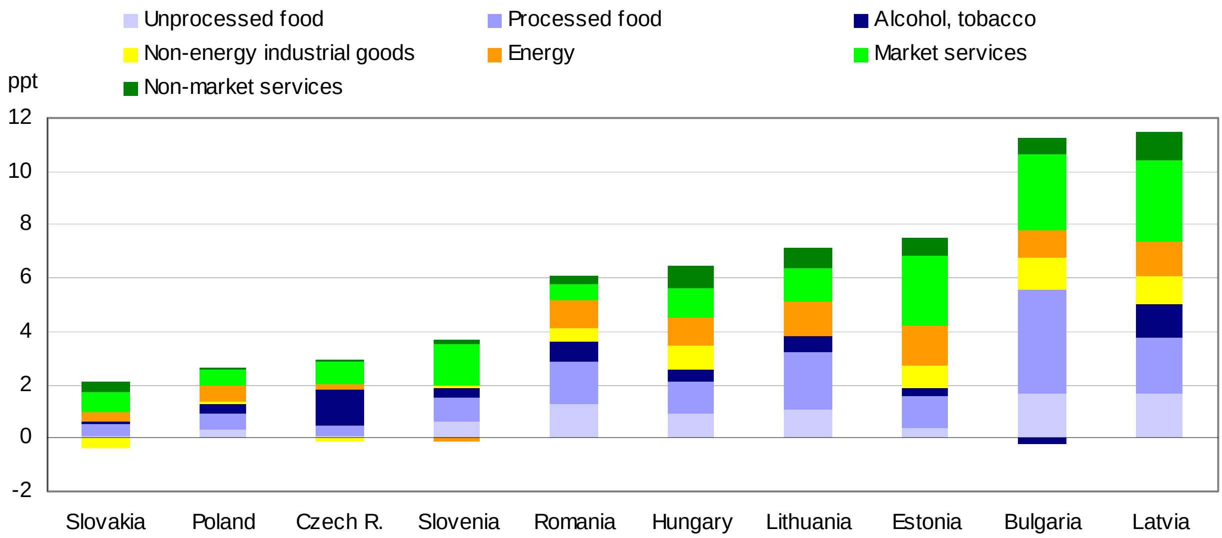
We decompose the 12-month inflation rate in September 2007 to the contributions of major product groups: processed and unprocessed food, alcohol and tobacco, non-energy industrial goods, energy, market and non-market services. The inflation rates for these product groups are compared on Chart 2, while their contributions to national inflation rates are summarised on Chart 3.

Chart 2 – 12-month price increases for major product groups in September 2007



*Note: * includes medical services, passenger transport by road and rail, postal services and education. ** excluding alcohol and tobacco. Product groups are ordered by their average inflation in the region; countries are ordered by their total HICP inflation rate in September 2007. Source: Eurostat, ICEG EC calculations*

Chart 3 – Contribution of major product groups to 12-month inflation in September 2007



Note: contributions add up to total inflation for every country. Source: Eurostat, ICEG EC calculations

Two observations readily stand out from Chart 2. There are marked differences between price developments for different product groups, but in any country of the region, the relative prices of various products are moving in a similar direction. **Industrial goods'** prices are fairly stable everywhere; their inflation rate generally remains below 2% and their contribution to total inflation is negligible. The price developments of these tradable goods are related to global developments including the 'China price', the effect of low manufacturing costs in the Far East on goods prices. **Energy** price increases have been subdued recently thanks to a moderation of global prices. However, they still managed to grow by almost 6% on average, due to administered price and tax hikes in a number of countries. Prices for **market services** typically grow faster than prices of goods, as a result of three related factors:

- Changes in factor endowments (a.k.a. the Heckscher-Ohlin effect): economic development involves capital accumulation. As labour becomes scarce relative to capital, their relative price (e.g. wages relative to returns on capital) must rise. This effect is exacerbated by shrinking population, early retirement, skill shortages and mismatches on the labour market and migration to western Europe – some of which are typical of every country in the region. Labour-intensive services are more affected by this process.

- The Baumol-Bowen (or internal Balassa-Samuelson) effect: productivity growth in the tradable sector (typically manufacturing) raises wages in this sector; however, employers in the non-tradable sector (mostly services) must also increase wages to keep attracting workers. This increases their costs more than their relatively slower productivity growth would permit; as a result, they must raise prices.[3] The effect is not always directly observable as FDI inflows into the non-tradable sector (including financial services, telecommunications, etc.) have sometimes led to faster productivity gains than in the tradable sector.
- Shifts in the structure of demand: as income levels grow, households' demand shifts in favour of services; higher demand can raise prices on its own.

Significant inflationary pressures stem from market services; although their prices grew by just 6.2%, their large share in consumer baskets resulted in a 1.5 percentage point contribution to inflation on average. It comes as no surprise that faster economic growth brings a higher inflation rate for market services their contribution was higher (over 2.8 percentage points) in fast-growing economies such as Latvia, Bulgaria and Estonia. Despite its buoyant economy Slovakia has not experienced much inflation for market services; this is most likely due to a combination of productivity gains and subdued wage growth, which is in turn reinforced by a low-inflation environment.

Food prices are escalating not just in the region, but worldwide. This is down to extreme weather and poor harvests, growing consumption in Asia, rising crop demand for biofuel production, and the lagged effect of energy price increases on production costs. Grain price developments are particularly affecting the inflation rate of processed foodstuffs. The world market price of wheat took a 67% hike in the year to September while corn rose 33%; these staple crops were key contributors behind the 24% growth of the food and beverages price index of IMF. The contribution of rising food prices to inflation exceeded 2 percentage points in eight countries and reached 5 percentage points in Bulgaria and Latvia.

Fiscal policy also plays its part in shaping inflation. The inflation rate of **non-market services** is on average 3.3 percentage points higher than that of market services. The consumption of these services is often subsidised and prices are frequently below cost recovery levels. Rising (labour) costs and/or the need for fiscal tightening force governments to raise prices of health care, education and public transport. Much of the temporary surge in Hungarian inflation can be attributed to these services: had their prices remained stable, the 12-month inflation rate would have fallen by 0.6 percentage point since last September. Similarly, tax harmonisation involves raising excise duties on alcohol and tobacco (and sometimes on energy as well); its effect is currently visible in the Czech Republic, Latvia and to a lesser extent in Estonia. Finally, the lowered VAT rate was recently increased in the Czech Republic; this affected a range of products (typically food and energy). A similar VAT rise occurred last September in Hungary; its effect on the 12-month inflation is not visible any longer.

Mixed prospects

What will the future bring? The external environment warrants caution. Rising grain prices will have second-round effects on meat and dairy prices – thus food prices may continue to climb in the near future. If extreme weather is avoided, next year could see some easing of food prices. However, a new energy price shock is already in the making. Oil prices are scaling new heights: WTI rose by over 50% in the year to mid-October to exceed USD 90 per barrel; futures contracts on NYMEX suggest that it will stay above USD 80 until next September. Gas and coal prices are likely to follow suit in the coming months. The potential impact of energy prices on 2008 inflation is considerable: liquid fuels account for 3-5% of household consumption in the region; electricity, gas and heating (all affected by oil prices) take further 6-8% shares – or even as much as 15% in Romania and Slovakia.

Fast economic growth is another factor behind runaway inflation, particularly in Latvia, Estonia (and potentially in Bulgaria and Romania as well). Even though the rising relative price of services is a natural phenomenon, fast wage increases can build into future expectations, making disinflation much harder. Wage claims seem to have accommodated high inflation in Latvia; hence the stiff resistance against a planned halt of public sector pay rises.

Fiscal policies are becoming tighter in a number of countries. The Hungarian fiscal stabilisation included many inflationary elements as it was based more on raising revenues than on cutting expenditures. Excise tax rises are in the pipeline in many countries as well. However, those most in need of a cold shower (Latvia and Estonia) are in

[3] The effect is not always directly observable as FDI inflows into the non-tradable sector (including financial services, telecommunications, etc.) have sometimes led to faster productivity gains than in the tradable sector.

a good fiscal position. The issue for them is not to collect more taxes but to abstain from spending windfall revenues (which in turn are caused partly by higher inflation).

One final consequence of rising inflation is that euro-area entry is again getting out of reach. Even Slovakia may not succeed in its aim to introduce the common currency in 2009. This is especially unfortunate for countries with serious external imbalances.

What can policymakers do? Since most of increase in inflation is attributable to external factors (food, energy prices and one-off effects of fiscal measures), the tools are generally limited. The best bet may be to carry on trimming budget expenditures, particularly public sector wages. Whether the political will is there remains to be seen.

– Gábor Pellényi –

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.
Annual average inflation	Annual average rate of HICP. Sources: Eurostat, national statistical offices.
Policy rate	Rate of the main policy instrument of the national bank, at the end of period. Not available in certain countries with currency boards. Sources: national banks.
Money market rate	3-month interbank offer rate at the end of period. Sources: 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: 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.
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.
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	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.