ICEG EUROPEAN CENTER

Quarterly Forecast on the Western Balkans and Turkey

Summer 2008

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Company information

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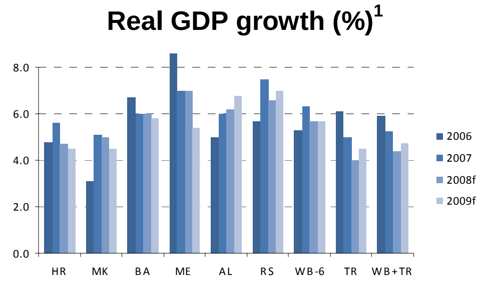
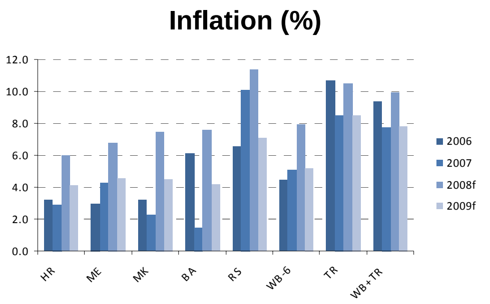


Note: e = estimation, f = forecast; Source: national banks and statistics institutes



Source: national banks and statistics institutes

Western Balkans

In the Western Balkan countries economic growth decelerates slightly, however remains strong in 2008. Average real GDP growth is expected to be 5.7% after reaching 6.3% in the last year. In most countries economic growth will exceed 5%, and highest growth is expected in Montenegro (7%).

Last years' trend continued in the first quarter in the region, the main factors of growth remained the same. In these countries domestic demand plays a key role in economic growth. Regarding domestic demand both consumption and investments fuel GDP growth. High wage increases and booming credit lending on the one hand, and improving business climate together with ongoing privatisation intentions back these two factors.

However, it seems net exports contribute more and more negatively to economic growth. While imports are boosted by high domestic demand, weaker external demand cannot counterbalance this impact. For 2008 we expect that this trend will continue and economic growth in the next year will remain at the 2008 level.

In line with global trends, food and energy prices increased significantly in the Western Balkan countries. Besides, high domestic demand also backed the acceleration of inflation.

Accordingly, inflation in all countries picked up in the second half of last year. In the first few months of 2008, inflation accelerated further and disinflation is unlikely before the second half of the year. Inflation exceeded 10% in 3 out of the 6 WB countries (the fYR of Macedonia, Montenegro and Serbia), and it reached record high value.

We expect that inflation will be higher in all WB countries than it was in the previous year. Accordingly, regional annual average inflation rate will go up from 5.1% in 2007 to 8% in 2008. Highest inflation is expected in Serbia again reaching 11.4% in this year. However, disinflation can return in 2009 in most countries, except for Albania, where some delay is expected in the impact of external price shock on Albanian inflation.

In line with increasing inflation monetary policy became stricter in the WB countries. National banks in the region increased their policy rates and/or reserve requirements. The relaxation of the monetary policy is not expected in the remaining part of 2008 in the WB countries.

Fiscal positions are expected to worsen in 2008 in almost all WB countries. Loosening fiscal policy is largely explainable by that elections were all will be held in this year. Growing wages in public sector increase public spending in these countries.

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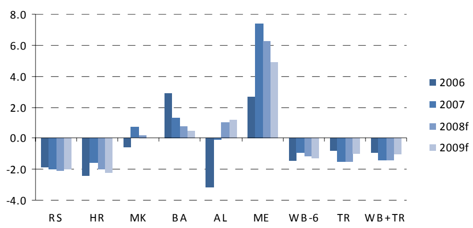
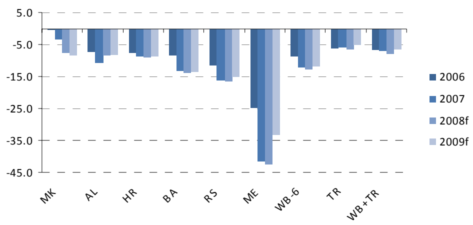
[1] Abbreviations: AL – Albania, BA – Bosnia-Herzegovina, HR – Croatia, MK – FYR of Macedonia, ME – Montenegro, RS – Serbia, WB-6 – Western Balkans (averages weighted by nominal GDP), TR – Turkey, WB+TR – Western Balkans and Turkey

Fiscal balance (% of GDP)



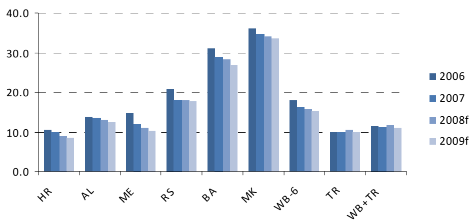
Source: national banks and statistics institutes

Current account balance (% of GDP)



Source: national banks and statistics institutes

Unemployment (%)



Source: national banks and statistics institutes

However, budget balances remain in favourable positions since many countries in the region had surplus in past years. Accordingly, average budget deficit in the region is expected to reach 1.2% of GDP which is 0.3 percentage point than in 2007. Regarding the revenue side of the budgets, higher than expected inflation and dynamic economic growth could increase tax revenues.

Public debt in these countries will mostly stagnate or slightly decrease in the WB countries in 2008. In 2009 average budget deficit in the region will remain basically on the same level as expected in this year.

High current account deficit remains one of the key macroeconomic challenges in 2008. Due to high trade deficits current account balances have a significant deficit in the WB countries. However, in many countries services balance was able to counterbalance partly the huge trade deficit.

Current account deficit will worsen in all countries but Albania and Montenegro in 2008. Average CAD is expected to reach 12.4% of GDP, and highest deficit is expected in Montenegro (30%). In 2009 only a slight shift is expected due to some improvement of export performance. However, domestic demand remains a major import boosting factor that keeps CAD high. Although, increasing foreign direct investment inflow is a favourable process in the region.

Labour market figures improved in all WB countries and this trend is expected to continue in course of 2008. Employment rates improved and unemployment decreased due to dynamic economic growth.

Despite the slowly but gradually decreasing unemployment rate, unemployment remains high in the region. Highest unemployment was registered in the former Yugoslav Republic of Macedonia, where unemployment rate exceeds 30%. Only Croatia has less than 10% unemployment rate in the region. The average level of unemployment rate is expected to decrease to 16.1%, by 0.5 percentage point lower than a year before.

It is also worth mentioning that wages increased considerably in the last months but it had no significant impact on employment and unemployment figures.

Turkey

The Turkish economy has now been growing for 24 consecutive quarters. Our growth forecast has been revised downwards to 4.0% assuming slower recovery in domestic demand and solid growth in net exports. As the economy is expected to slow down we may assume that the unemployment rate will exceed 10% in 2008 reaching 10.5% and will decline towards 10% in the next year.

Due to higher food and energy prices the central bank increased first its inflation forecasts and then its targets significantly for the next three years. Fiscal performance so far this year implies that fiscal targets are likely to be reached. This year's primary surplus target of 3.5% of GDP is equal to the realisation of the last year. One of the key problems for Turkey is the current account deficit, which reached 5.8% of GDP in 2007 and is expected to widen to 6.3% of GDP this year. Many expected a reversal in the current account balance due to the weaker national currency, but this has not occurred.

Albania

Economic growth remained strong despite electricity shortages, and GDP growth can remain at 6% level in 2008 as well. Inflation accelerated slightly but its increase was lower than in most SEE countries. Current account deficit remains a key macroeconomic challenge in this and next year as well, while unemployment decrease slightly.

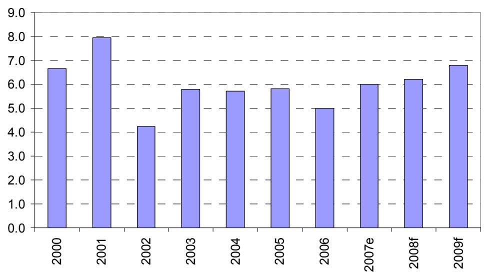
Political developments

The Prime Minister declared that the government is open for any energy supply solution, even for nuclear power plant. The foreign investors are encouraged to invest into energy sector and the government prefers the full liberalisation of in the energy sector.

In June the commissioner for human rights of the Council of Europe warned Albania to keep the human rights and offer more protection to women and children, ethnic minorities and the disabled people.

Growth

Real GDP growth



Source: INSTAT, own forecast

In April 2008 exports reached ALL 10 238 million increasing by 11.5% compared to March of 2008 and increasing 29.2% compared to April 2007.

Volume index of turnover on retail trade in the first quarter of 2008 has resulted in 160.5% of 2005 level. In year-on-year view, this is a 25.2% increase in comparison with the previous quarter volume index increased 4.6% per cent.

Imports increased by 14.5% year-on-year reaching ALL 34 892 million.

The electricity shortage remains an ongoing very serious problem that blocks the possible growth of GDP. According to INSTAT, total sources of electric power during 2007 had a considerable fall by 13.4%.

The government plans to privatise the energy distributing network, the state oil refinery and other company shares still in 2008, and moreover, it does not afraid of allow nuclear power plants to be built.

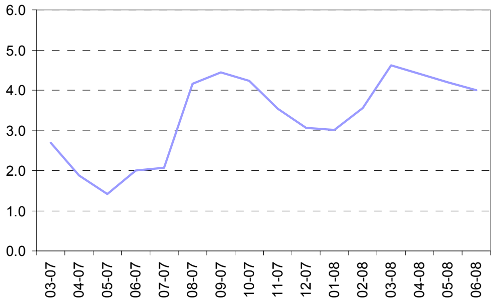
Because of low level of development the economic growth remains strong in 2008 and 2009 at about 6-7% despite the energy shortages, but cost pressures have added to inflation and fiscal risks from tax cuts are on the horizon. The growth outlook remains positive. Maybe because of the underdeveloped level of national economy, the global energy and food price shock has not affected seriously Albania, unlike her neighbours.

Monetary developments

The unfavourable up-turn of year-on-year inflation in the first quarter slowed down again. The annual HICP rate in June is 4.0%. A year earlier the rate was 2.0%.

In the second quarter, the prices typically decreased or stagnated in most of the sectors. In June price of diesel increased by 6.8% and of petrol by 4.6%.

Year-on-year change of CPI, %



Source: INSTAT

Producer price index reached 110.0% of 2005 level, signing an increase by 3.3% compared with previous quarter. Annual change of this index is 7.4 %.

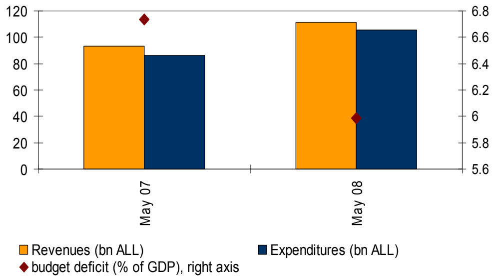
Producer price index in "Manufacturing" sector rose by 1.3 %. This sector determines 78.4% of the index. Producer price index for domestic production reached 108.2% signing an increase by 1.2% compared with previous quarter. Export index price reached 113.2% of the 2005 level.

As the inflation risk turned back to downward, the slightly lower risk premium also got expressed in the Tirana Interbank Bid Rates (TRIBOR) and Tirana Interbank Offer Rates for any long maturity in the end of the second quarter. However, the longer term (annual) rates are higher that expresses increasing risk expectations.

The dynamic growth after getting out of electricity shortage and the postponed impact of world market prices will accelerate inflation in the Albanian economy in 2008 and 2009.

Fiscal policy

Fiscal position in 2007



Source: Ministry of Finance

According to the latest report of the Ministry of Finance, total expenditures were ALL 105,62 billion in May 2008 what is more than in the previous year, by 22.11%, but lower, than forecasted by the Financial Ministry. Current expenditures were by 13.4% higher, while capital expenditures increased by 78% in comparison with the same period of the last year. Total revenues in May were by ALL 111.6 billion or by 19.66% higher than in the corresponding period of 2007. It exceeded the ministry plans.

The average weighted yield of treasury bills is 6.28% (0.12 percentage point decrease since December) for 3-month maturity, 7.48% (0.07 percentage point increase) for 6-month maturity and 8.16% (0.1 percentage point decrease) for 12-month maturity treasury bills.

The Albanian public budget balance unexpectedly turned to negative in the last month of 2007 as a result of accelerating inflation and the necessary governmental intervention in electricity shortage.

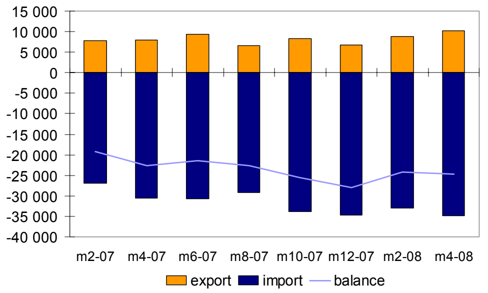
After the first 5 months of 2008, the balance was at the previous year surplus level, around 5% of the GDP. However, our balance expectations in 2008 and 2009 are much lower because of the previous year experience and the still existing energy shortage. In case of 2008, the expectations must take into account the tax cuts and its compensation by increasing pace of FDI inflow, thus the balance can be expected to be close to zero.

As the government plans to execute large volume privatisation in 2008 and 2009, it is very likely to have source for significant decrease in public debt.

External balance

Trade speeded up in the 2nd quarter of 2008, but the growth of import seems to be more dynamic, thus, trade balance is getting worse. The sharp increase of import rooted in the energy shortage that forced the national economy to double the energy import.

Monthly trade statistics (mn ALL)



Source: INSTAT

In April the trade deficit went up to ALL 24 654 million signing an increase of 2.7% compared to March 2008 and signing an increase of 9.3% in comparison with April 2007.

For the first six-month period of 2008, the external sector was characterised by current and trade deficit deepening. However, capital influx has been sufficient for compensating the current deficit, enabling an overall positive balance sheet.

The main expectable developments for 2008 and 2009 in the external sector are (1) intensive activity in the external sector, reflected in the increase of income and current expenditures; (2) considerable growth in merchandise exports and imports; (3) deepening of the current and trade deficit; (4) increasing foreign capital inflows in the form of foreign direct investments; (5) increasing financial liabilities to non-residents, created in the form of increased deposits of non-residents with the banking system; and (6) increasing foreign reserve stock of the monetary authority.

Labour market

Labour market trends (%)

Source: INSTAT, own calculation

In the fourth quarter of 2007, labour force increased by around 4 thousand active people while employment also grew by 3.25 thousand. The total growth of employment were employed in the (private) manufacturing sector. During this period, the number of employed persons in the agricultural sector and in the public sector remained the same. At the end of the third quarter, number of registered unemployed persons rose by 600.

The minimum wage remained the same (ALL 14 000). Also the base level of unemployment benefit is the same (ALL 5 240).

Until the energy shortage exists, significant increase in employment is not expectable. Although, 2008 spring and summer seems to bring favourable weather for production, so in the next quarters, agricultural employment may increase. In the previous year the government proved that Albania is not interested in the increase of minimum wage as the country can remain attractive only with very low labour cost. The average nominal wage increase will follow the productivity improvement.

Key macroeconomic indicators, 2006-2009

	2006	2007e	2008f	2009f
Nominal GDP (ALL mn)	896,000	979,000	1,040,000	1,111,000
Real GDP growth (%)	5.0	6	6.2	6.8
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	24.7	26.4	27.1	30.5
Exports (%)	13.0	25.0	17.0	15.0
Imports (%)	16.0	27.0	20.0	16.0
Annual average inflation (CPI, %)	2.4	3.1	4.3	4.5
Discount rate (end of period, %)	5.50	6.00	6.15	6.30
Money market rate (3-month Treasury Bill, %)	6.25	6.06	6.20	6.40
Long-term interest rate (10-year gov't bond, %)	NA	NA	-	-
Exchange rate (ALL / EUR, average)	123.1	123.9	122.5	123.0
Exchange rate (ALL / EUR, end of period)	123.8	121.8	123.0	123.5
General government balance / GDP (%)	-3.2	-0.1	1.0	1.2
Public debt / GDP (%)	55.7	54.5	53.7	52.4
Trade balance / GDP (goods and services, %)	-23.4	-28.6	-28.9	-27.1
Current account balance / GDP (%)	-7.2	-10.8	-8.5	-8.0
Gross foreign debt / GDP (%)	22.0	22.0	21.5	21.0
Unemployment (%)	13.8	13.5	13.0	12.3
Real ULC growth (%)	NA	NA	-	-

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

Sources: Bank of Albania, INSTAT, IMF

Bosnia and Herzegovina

BH took the first step towards EU membership by signing the SAA, which can contribute to the solid economic growth as well. CPI is increasing sharply since Q4 2007. Dynamic wage growth and accelerating fiscal expenditures fuelled the demand pressure, all adding up in the widening external imbalances. These tendencies expose the country to risk in the uncertain external economic environment, all underlining the importance of fiscal and structural reforms.

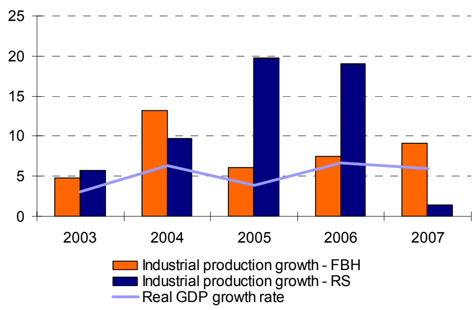
Political developments

Following years of impasse, the police reform laws have been adopted in April, which was considered as the key precondition for signing the SAA (Stabilisation and Association Agreement). As a result, finally on the 16th of June BH signed the SAA with the European Union, thus taking the first step towards EU membership. In case of the SAA wins endorsement, the parliament will set up an action plan for the implementation.

Taking into consideration the still existing deep discrepancy between the main political parties, the lack of compromise is expected in the general constitutional reform as well, but negotiations are supposed to be resumed after the local elections in October.

Growth

Real GDP and industrial production growth rate (%)



Source: CBBH

Despite certain slowdown, the 6% real GDP growth in 2007 can still be considered high and is well above the last seven year's average of 5.1%. This growth was a result of the strong domestic demand and the favourable external conditions. In 2007 as well the economic growth was underpinned by the good performance of the manufacturing industry, the high level of retail sales, investment activity and private consumption. The latter was fuelled by the households' high wage growth and large consumer credit growth, adding up with the expansive fiscal policy. The import of capital and intermediary goods increased by 30%.

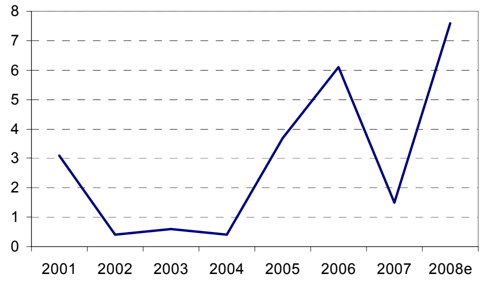
The industrial production suggests a strong growth for 2008 as well, as in the first half of the year, in the FBH (Federation of Bosnia and Herzegovina) it increased by 4.9% in real terms, compared to the same period in the previous year. Manufacturing grew by 4.7%, electricity, gas and water supply by 8.8%, while mining decreased by 0.2%. In the same period in RS (Republika Srpska) a much higher industrial production growth was recorded, namely 8.0%. However, manufacturing increased only by 1.8%, while mining and quarrying by 22.8% and electricity, gas and water supply by 21.8%.

Although the structure of BH's economy can be considered vulnerable, the already mentioned growth factors are expected to continue to support the economic growth in 2008 as well, thus reaching around 6%. The firm growth is likely to continue on mid-term as well, despite the fact that BH remains quite vulnerable to external conditions.

Monetary developments

Following the consolidation of inflation after the one-off affect of the VAT introduction, from the last quarter of the previous year inflation started to accelerate. The average CPI (Consumer Price Index) still

Consumer price index (yoy, avg, %)



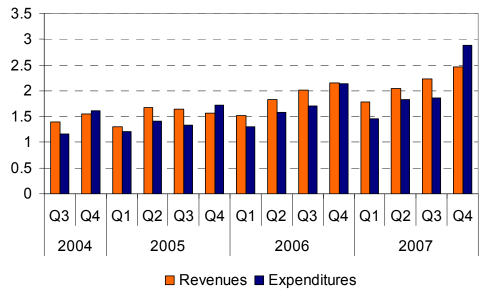
Source: CBBH

remained low with 1.5% in 2007, but in the last quarter it amounted to 4.9%. In May 2008 the inflation reached 8.2% and the average CPI of this year may be around 7.5% with an upside risk. The recent global problem of inflation gaining momentum became an issue in BH as well, causing a sharp rise of food and fuel prices. This added to the domestic inflationary pressure fuelled by the strong domestic demand.

The central bank increased its reserve requirements from 15% to 18% from the 1st of January, but credit growth is not expected to slow down significantly. In the first quarter of this year the credit growth to households was around 30%, compared to the same period a year ago. In the same period the credit to the private sector's enterprises increased slightly faster, with around 31.5%. The size of credit penetration makes the consumers more vulnerable to the recent economic environment.

Fiscal policy

Consolidated revenues and expenditures of general government (KM, billion)



Source: CBBH

Fiscal expenditures accelerated in 2007, particularly in the last quarter, when expenditures were 35% higher than in the same quarter of 2006, while this growth was only 15% for revenues. Supporting the economy, the annual growth of public investments was 53%. Generally the wage outflows, social benefits and investment activity contributed to the drop of the annual surplus, reaching BAM 278 million, which is 1.3% of the GDP. The overall public consumption increased to over 45% of the GDP.

As for 2008, the rapid growth of wages in the public sector and the FBH commitments for transfers to households are likely to contribute to further fiscal relaxation. On the other hand, in RS the government intends to freeze wages for the upcoming three years. The signing of the SAA will cause a decline of the customs revenues, but the growing amount of VAT will be able to offset this loss to a certain extent. However, these circumstances limit the room for capital expenditures. Taking all these into consideration, despite the solid GDP growth, the surplus per GDP ratio can decrease below 1%.

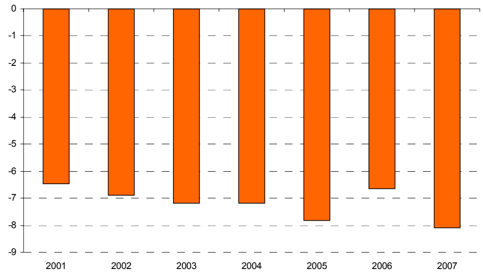
The National Fiscal Council has been established and hopefully it will start operating in order to enhance fiscal coordination. In order to improve the fiscal stability further, an agreement on a permanent formula for allocation of indirect tax revenue is recommended instead of the recent regular negotiations. The problem of the frozen foreign currency deposit bonds is still to be eventually solved.

As it is stressed even by the IMF, a tighter fiscal policy would be required to mitigate the demand pressure – thus the external imbalances and inflation – and to keep the public debt under control.

External balance

According to the Agency for Statistics of BH, in January-May the growth of imports exceeded the increase of exports; 25.4% and 16.5% respectively, compared to the same period in 2007. Thus imports amounted to BAM 6.55 billion, while exports reached BAM 2.74 billion, so the export per import ratio decreased to 41.83% from 45.0%. The largest amount of imports were recorded in the categories of machinery and electrical equipment (underpinning even investment activity), and mineral products; BAM 1 096.03 billion and BAM 1 079.84 billion, increasing with 24.4% and 43.5% respectively. As for the exports, due to the favourable external

Trade balance of goods (KM, billion)



Source: CBBH

conditions, base metals and articles of base metals, machinery and electrical equipment, and mineral products gave the largest amount of exports; BAM 776.30 million, BAM 357.44 million and BAM 294.96 million or a growth of 7.0%, 19.9% and 52.1% respectively, well representing the structural risks of BH's economy.

The private sector's continuing credit growth and the expansive fiscal policy were also underlying factors of the widening external deficit. Current account deficit reached BAM 2.74 billion or 13.2% of the GDP in 2007, and taking into consideration the trends of the first half of this year it is expected to continue to widen amounting to around 14% of the GDP.

In 2007 the gross official reserves reached the amount of 5.5 months of imports. The current account deficit was fully covered by the net FDI of BAM 2.88 billion, but 2008 suggests a drop of FDI inflow. The current global financial market disturbance adds to the external vulnerability of BH.

Labour market

LFS 2007 (BH, %)

	2006	2007
Activity rate	43,1	43,0
Employment rate	29,7	31,2
Unemployment rate	31,1	29,0

Source: CBBH

In the first quarter of 2008 net wages increased by 12.4%, compared to the same period in the previous year, thus reaching BAM 726. The largest growth was recorded in the sector of education and health and social work; 36.1% and 35.1% respectively. These numbers well demonstrate that the largest growth was recorded in the budget-financed sectors.

According to the data of the 2007 LFS (Labour Force Survey), the unemployment rate decreased slightly compared to the data of 2006; from 31.1% to 29.0%. The unemployment rate shows significant differences between the entities; 31.1% in FBH, 25.2% in RS and 40.0% in Brčko District. Although partly due to methodological reasons, but even the unreliable official unemployment data show a decreasing rate, but still reaching 39.3% in April 2008. All in all, the very high level of unemployment, coupled with the slow creation of new jobs remains one of the most severe problems in BH.

In 2007 47.6% of the employees were employed in the service sectors, 32.6% in the non-agricultural sectors and 19.8% in the agricultural sectors.

Key macroeconomic indicators, 2006-2009

	2006	2007e	2008f	2008f
Nominal GDP (BAM mn)	19,120	20,950	23,920	26,330
Real GDP growth (%)	6.7	6.0	6.0	5.8
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	NA	NA	-	-
Exports (%)	28.8	14.9	16.1	15.6
Imports (%)	1,0	18,0	22,8	19.7
Annual average inflation (CPI, %)	6.1	1.5	7.6	4.2
Policy rate (end of period, %)	-	-	-	-
Money market rate (3-month Treasury Bill, %)	NA	NA	-	-
Long-term interest rate (10-year gov't bond, %)	NA	NA	-	-
Exchange rate (BAM / EUR, average)	1.956	1.956	1.956	1.956
Exchange rate (BAM / EUR, end of period)	1.956	1.956	1.956	1.956
General government balance / GDP (%)	2.9	1.3	0.8	0.5
Public debt / GDP (%)	21.3	18.9	17.3	16.4
Trade balance / GDP (goods and services, %)	-29.7	-33.6	-35.1	-34.2
Current account balance / GDP (%)	-8.4	-13.2	-13.9	-13.5
Gross foreign debt / GDP (%)	57.0	58.4	59.6	61.1
Unemployment (%)	31.1	29.0	28.2	27.0
Real ULC growth (%)	NA	NA	-	-

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

Sources: Central Bank of BH, Agency for Statistics of BH, IMF, own calculations

Croatia

Real growth remains robust despite the inflation pressures and worsening financial market developments. Inflation is expected to peak in 2008, while the amplitude of shock is still unidentified. Fiscal policy benefited from growth and remained relatively resistant to elections. Current account deficit is increasing parallel with decreasing external debt. Labour market performance in line with still robust economic growth.

Political developments

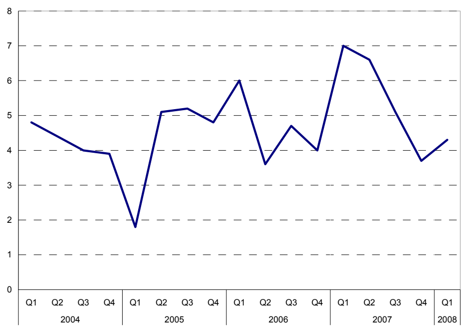
The new Croatian government is committed to achieve progress in EU negotiations, while the structure of coalition (HDZ, HSS, HSLS, SDSS) will face some obstacles, especially in agriculture, fishing, shipbuilding and steel industries.

Early April was also important for Croatia since it received an invitation to join the NATO alliance, as an EU pre-accession sign. European Commission and European Parliament members confirmed that Croatia can complete the technical elements of its EU accession process by the end of 2009 if it carries out the required reforms.

Reforms are likely to continue, however the first signs show that the government is unlikely to cut public spending, while global economic and financial market problems can bring forward the need of structural reforms.

Growth

Real GDP growth (quarterly, yoy, %)



Source: CROSTAT

Based on the quarterly estimates, the real GDP in 2007 showed an increase of 5.6%. The main contributor factor was the domestic demand.

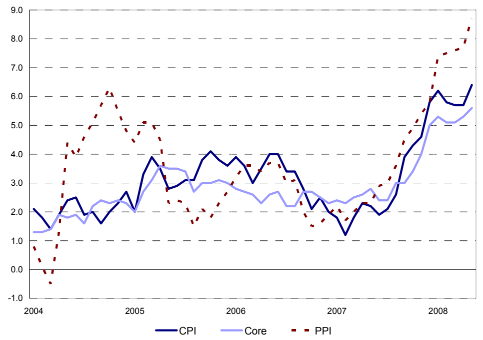
In the first quarter of 2008, real growth reached 4,3% y-o-y, despite the high base effect. Mainly the components of domestic demand, such as private consumption and government consumption lost momentum shortly after elections, while gross fixed capital formation performed relatively well, mainly because of strong construction and industrial activity. External demand continued to contribute negatively to growth, especially with surprisingly sharp slowdown in export (and particularly in merchandize export) growth and robust import growth caused partly by rising fossil fuel prices.

On the production side, gross value added growth in the first quarter of 2008 was 4.6%, driven mainly by industry (4.5%), construction (7.7%) and by transport, communication and financial intermediation services.

Cooling of credit markets due to tightening conditions will mean further weakening of domestic demand. Parallel with worsening EU growth outlook, this will mean downgraded expectations of 4.7% for 2008 and 4.5% for 2009. Much depends on the performance of agriculture and tourism.

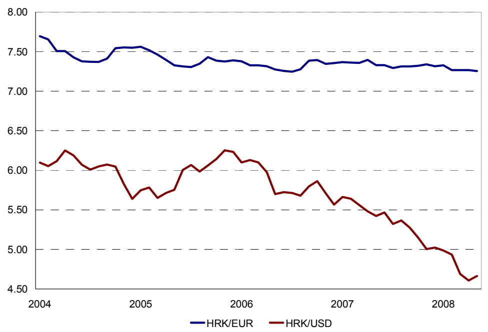
Mainly because of early Easter, tourist arrivals increased by 14.1% and tourist nights by 21.3% in the first quarter of 2008 compared to the same quarter in 2007. Weather conditions, Olympic games remain further risk for this strategic sector.

Monthly price developments (%)



Source: CNB

Monthly exchange rates



Source: CNB

Monetary developments

As in other countries of the region, the inflation proves to be the most important monetary challenge. The energy and food prices affected the Croatian inflation trends negatively.

CPI inflation in May 2008 increased by 6.4% y-o-y, pulled mainly by inflation of goods (7.1%). Core inflation (which excludes volatile components such as food and oil as well as regulated prices) rose by 5.6%. In June 2008, the CPI, as compared to June 2007, increased by 7.6% and on the annual average by 5.1%. The main drivers were foods, with annual average of 9.0% (30% share from the consumer basket).

PPI, as an early warning of CPI inflation, increased by 8.7%. This means that the peak of inflation is still not reached. In June 2008, as compared to June 2007, it increased by 9.6%. By MIG grouping, prices of energy and intermediate goods were of dominant effect, while by NKD especially manufacturing production prices proved to be rising considerably.

The inflation is expected to peak in the second half of 2008 leading to 6% this year and 4.1% in 2009. The cooling domestic demand is favourable, while demand of unions for higher wages means unfavourable pressures on price developments.

International food and oil price dynamics remain significant upside risk factors to the inflation outlook. Strengthening currency however will mean some buffering effect.

The appreciation of HRK/USD exchange rate has continued, while the HRK/EUR was kept relatively stable, with some appreciation caused by capital inflows. Our expectations on nominal exchange rates are unchanged as the relative stability against euro is of high priority, as it was expressed by the CNB governor. Against the USD further appreciation is expected that is in favour of buffering energy price related inflation pressures.

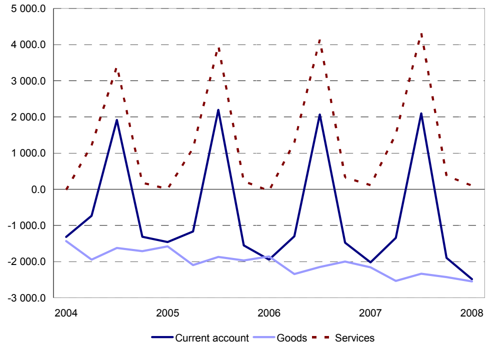
Fiscal policy

The economic cycle was in favour of fiscal processes despite the political cycle determinations (elections in November). This led to 1.6% ESA-95 general government deficit in 2007, mainly due to improved tax collection, particularly regarding profit taxes, value added taxes and excise duties. While on expenditure side social transfers, health and pension related expenditures, and compensation of employees were the leading factors.

By the passed budget for 2008, there are no plans to cut spending and proceed with fiscal consolidation. We expect general government deficit of 2% in 2008 and 2.2% in 2009, mainly based on downgraded growth expectations. Much depends also on the selling of remaining pockets of Pliva and Croatia Telecom, and on the government's policy on infrastructural investments.

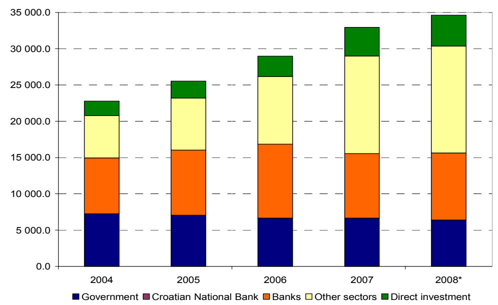
External balance

Current account deficit and its components (million EUR, quarterly)



Source: CNB

Gross external debt by sectors (million EUR)



Source: CNB

Main labour force indicators (%)

Rates	I-III 2007	IV-VI 2007	VI-IX 2007	X-XII 2007
Activity	48,2	48,7	49,5	48,9
Employment	42,8	44,2	45,4	44,2
Registered unemployment	16,9	15,1	14,1	14,7
ILO unemployment	11,2	9,1	8,4	9,7

Source: CROSTAT, Labour Force Survey

The current account deficit (CAD) widened not only in nominal but also in GDP related terms, reaching EUR 3 206 million or 8.6% of the GDP in 2007.

In the first quarter of 2008 the CAD was by 23% higher than in the same period of 2007. This increase was entirely the consequence of widening deficit in trade of goods, mainly because of oil imports.

In the first five months of 2008 as compared to the same period of 2007, export of goods increased by 6.0%, while imports by 11.8%. The coverage of imports by exports reached after first five months 43.6% that reflects widening deficit.

Exports were driven mainly by exports of capital goods, imports by energy and capital goods. By main activities, one can observe significantly increasing imports of raw materials and food products, mainly because of price hikes. Manufacturing exports growth (7.2%) was lower than imports growth (10.2%), with bias towards imports.

We expect current account deficit rising to 8.9% in 2008 and 8.6% for 2009. The trade balance of goods is expected to be lower due to adjusting domestic demand, while increasing oil and food prices, and also increasing profit repatriation will act towards widening.

The current account deficit was more than covered by FDI inflows last year, reaching EUR 3.6 billion, 9.7% of GDP. We do not expect this performance to repeat in the current year, as a large share of last year investments were the results of capital increases of foreign owned banks. The possible realisation of the sale of the remaining INA packet can attract about USD 6 billion.

External debt reaching almost 88% of GDP in 2007 is expected to fall slightly due to high nominal GDP growth and because of cooling financial markets leading to less borrowing of domestic banks abroad. The structure of gross external debt improved further, as the role of long term debt (mainly due to direct investments), and the share of other sectors' debt (enterprises, households and non banking financial institutions) increased.

Labour market

Due to economic revival in the first quarter of the year proved to be favourable for labour markets in Croatia.

Number of persons in paid employment increased by 4.4% in January-February 2008 y-o-y and reached 1 230 670 persons. The pulling sectors were construction, wholesale and retail trade, hotel and restaurants, so particularly in service sectors. Manufacturing, as the largest employer, managed to increase its employment by 2.7%.

The registered unemployment rate in May was 13.2%, as compared to 15.1% of same month of previous year. LFS data show 9.7% average unemployment in the last quarter of 2007.

Average monthly gross earnings were higher by 7.2% nominally in April 2008 year-on-year. Wage stresses between employees and employers are getting strong, unions seems to run for higher wages, threatening monetary policy by wage inflation. Labour productivity outpaces real wage growth. Much depends on government decision concerning the minimum wage level.

Due to improving construction activity, strong expectations on tourism sector, and strong labour demand in other service sectors, we forecast unemployment rate of 9% in 2008 and 8.5% in 2009.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (HRK mln)	250,590	275,078	305,000	332,000
Real GDP growth (%)	4.8	5.6	4.7	4.5
Private consumption (%)	3.5	6.2	3.8	4.1
Public consumption (%)	2.2	3.4	1.0	1.5
Investments (GFCF, %)	10.9	6.5	8.5	7.0
Exports (%)	6.9	5.7	5.5	6.8
Imports (%)	7.3	5.8	6.3	7.2
Annual average inflation (%)	3.2	2.9	6.0	4.1
Policy rate (discount rate, %)	4.50	4.50	6.50	5.50
Short terms (3-month T-bill, %)	3.00	3.60	4.00	3.20
Long-term interest rate (10-year gov't bond, %)	4.40	5.25	4.40	4.10
Exchange rate / EUR (average)	7.32	7.34	7.28	7.26
Exchange rate / EUR (end of period)	7.34	7.32	7.25	7.22
Budget balance / GDP (%)	-2.4	-1.6	-2.0	-2.2
Public debt / GDP (%)	40.8	37.7	37.3	37.1
Trade balance / GDP (goods and services, %)	-7.8	-8.3	-8.5	-8.4
Current account balance / GDP (%)	-7.7	-8.6	-8.9	-8.6
Gross foreign debt / GDP (%)	85.5	87.8	87.1	86.8
Unemployment (%), LFS	10.5	9.8	9.0	8.5
Real ULC growth (%)	-1.0	-1.1	-1.4	0.2

Note: f = forecast.

Sources: Croatian National Bank, Central Bureau of Statistics of Republic of Croatia, Eurostat, Ministry of Finance of Republic of Croatia

Former Yugoslav Republic of Macedonia

Economic growth remained relatively high while inflation accelerated further in the former Yugoslav Republic of Macedonia. Budget revenues progressed well in the first few months, accordingly budget is expected to have a surplus in this year. Labour market figures will improve gradually, however, current account will worsen in 2008 and 2009 as well.

Political developments

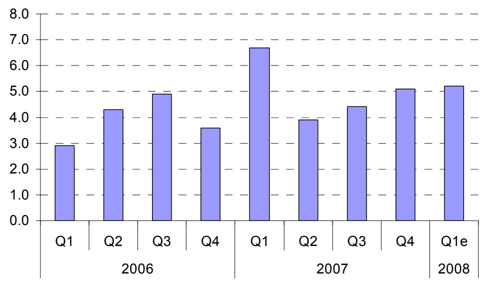
As we mentioned in our previous Forecast early parliamentary elections were held in June 2008 after NATO non-invitation. Since the country's independence that was the first early election in the fYR of Macedonia. The last elections were held in 2006.

Coalition parties ("For A Better Macedonia") have achieved stronger position since the winning coalition (led by VMRO-DPMNE) gained 63 out of the 120 seats in the parliament. Accordingly, the winning coalition now have majority. On the other hand, the opposite coalition ("SUN – Coalition For Europe"), led by SDSM won only 28 seats; that is 5 seats less than in 2006.

Unfortunately, the name dispute with Greece has not progressed in the last few months. As it is well known the fYR of Macedonia was not invited to join the North Atlantic alliance due to Greek veto.

Growth

Real GDP growth (%)



Source: SSO; Note: e - estimation

After reaching 5.1% GDP growth rate in 2007 economic growth remained relatively high in the first quarter of 2008. In that quarter the estimated real GDP increased by 5.2%, accordingly the acceleration of growth since Q2 2007 has continued.

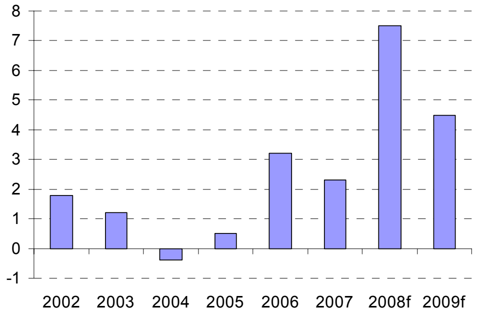
In nominal terms final consumption increased by 16.9%, while gross capital formation increased significantly (+74.5%) in the first three months. Regarding net exports, the nominal growth rate of imports (27.1%) greatly outpaced that of exports (11.7%), in line with that net exports contributed negatively to economic growth in the first quarter of 2008.

On the production side, the majority of sectors performed well. Gross value added in construction increased by 9.7%, while that in industry grew by 6.5%. Regarding industrial production, it remained vigorous in the first five months of 2008. Between January and May, industrial production was by 8.3% higher than in the same period of the corresponding period. In manufacturing, the role of higher value added divisions, such as manufacturing of machinery or equipment, or manufacturing of other transport equipments increased.

Besides, agriculture was able to grow again after last year's decline, by 4.2%. In services, wholesale and retail trade and repair reached excellent growth rate (10.2%) due to strong domestic demand.

For 2008 we expect that current trend will continue and economic growth remains higher than average growth in the last few years. This will be boosted by accelerating domestic demand. Accordingly, real GDP is expected to increase by 5% in 2008 and we maintain our previous expectation that 2009 economic growth will remain in the 4-5% range.

Annual average inflation (CPI, %)



Note: f = forecast; Source: SSO

Monetary developments

The accelerating economic growth was achieved together with growing inflation in the former Yugoslav Republic of Macedonia as well. Inflation started to pick up in the second half of 2007 in line with the global trends. In the first quarter consumer price index exceeded 10% and it remained above that threshold in the following months too. In June inflation reached 10.1% that was slightly lower than the record high level in March (10.2%).

Acceleration of the inflation rate was due to increasing food and energy prices. Prices of food and non-alcoholic beverages were by 18.7% higher in June 2008 than in last June. Accordingly, Restaurants and hotel prices also went up by 12%. On the other hand, transport related prices increased by 14.7 in the aforementioned period.

Due to higher than expected impact of international food and energy price hikes, we have increased significantly our previous inflation forecast for 2008. We expect that annual average inflation will increase to 7.5% since gradual deceleration of consumer price index is expected in the second half of the year. The government and the national bank needs to be cautious of the high inflation because that seems to be the main macroeconomic challenge in 2008. In 2009 further moderation of inflation is expected and annual average CPI can decrease to 4.5%.

In line with accelerating inflation, the interest rate on Central Bank bills reached its highest level in the last 24 months, reaching 7.0% in June 2008. However, it seems commercial banks do not follow central bank's interest rate increase. Commercial banks' average interest rate on lending has decreased slightly in the last 12 months from 10% (in May 2007) to 9.2% (in May 2008). Accordingly, credit lending to private sector increased by 44% in April 2008 compared to the same month of 2007. It means credit lending accelerated in the first months of the year. Accordingly, further increase of the interest rate on CB bills is expected in the near future.

Fiscal policy

In the first few months of 2008 budget balance had a surplus in the former Yugoslav Republic of Macedonia. At the end of May 2008 the surplus reached MD 4.5 billion (EUR 73.6 million). The high surplus was a result of higher than planned tax revenues in course of the first five months of 2008. It is worth mentioning that profit tax revenues reached more than 80% of the planned value at the end of May. Besides, other tax revenues developed well too.

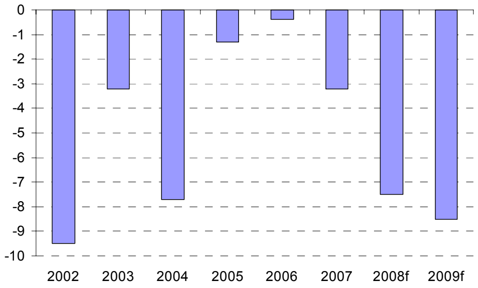
The aforementioned revenue increase occurred despite the fact that as of January 2008 the government lowered the already low tax rate on corporate and personal income from 12% to 10%. This step was in line with the plan to make the Macedonian economy more competitive and attractive for foreign investors.

On the other hand, expenditure side of the budget reached lower percent of the budgeted amount (less than 40%) in that period. Mainly capital expenditure reached quit low percentage of total budgeted value (20%).

The planned budget deficit of the government is MKD 5.5 billion or 1.6% of GDP. We maintain our previous forecast that the balance will be better due to higher inflation, poor planning and execution of public spending and increasing tax revenues. Accordingly, we expect that budget will be close to the balance in 2008.

External balance

Current account balance (% of GDP)



Note: f = forecast; Source: SSO, NBRM

In the first quarter of 2008 current account balance deteriorated in the former Yugoslav Republic of Macedonia. Current account deficit increased to EUR 188 million. In the first three months of 2007 CA balance had a surplus. In fact that was the highest first quarter deficit in the last 5 years.

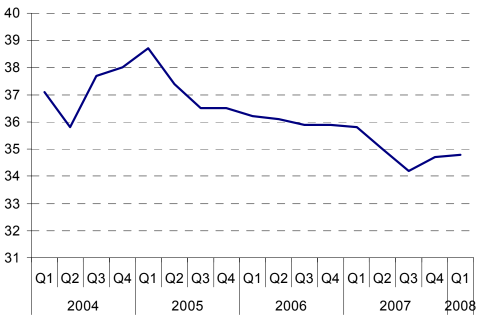
Almost every element of the current account balance worsened in the first months of this year. However, trade balance had the biggest negative impact on the CA balance. Foreign trade deficit increased by 76% in the first quarter. The growth rate of import (28%) greatly outpaced that of export (9%). The largest part of import growth is explainable by growing mineral fuels, equipment, vehicles and electric machines imports.

On the other hand, the surplus of incomes and current transfers also decreased by 75% and 21% respectively, while services balance basically stagnated in comparison with the same period of the previous year. We expect significant deterioration of current account balance in 2008 due to worsening trade balance. Accordingly, CA deficit can reach 7.5% of GDP in this year and its increase is expected in 2009.

Regarding foreign direct investment, 2008 can be a good year since net FDI in the first quarter reached 50% of the total 2007 level, namely EUR 128 million. The fYR of Macedonia is becoming a more and more attractive target of foreign investor in line with improving business climate (low tax rates, relatively cheap labour force, European integration process).

Labour market

Unemployment rate (%)



Source: SSO

Labour market figures have been slowly improving in the former Yugoslav Republic of Macedonia. In the first quarter employment rate went up from 35.7% to 36.7%. In line with that unemployment rate also decreased by 1 percentage point, to 34.8%. The positive trend was basically backed by improving business climate and relatively high economic growth in the former Yugoslav Republic of Macedonia. It is worth mentioning that activity rate also increased by 0.7 percentage point in comparison with the same quarter of 2007, and reached 56.3%.

In the first quarter nominal (annual) change of gross average monthly wage reached 8.7% which means that real wages decreased by 0.8% due to high inflation in the economy.

In 2008 we expect that labour market figures will improve slowly but gradually. Accordingly, we expect that unemployment rate could decrease to 34% at the end of the year, in line with improving employment and activity figures.

Key macroeconomic indicators, 2006-2009

	2006	2007e	2008f	2009
Nominal GDP (MKD mn)	303,305	325,500	367,000	400,000
Real GDP growth (%)	3.1	5.1	5.0	4.5
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	NA	NA	-	-
Exports (%)	NA	NA	-	-
Imports (%)	NA	NA	-	-
Annual average inflation (CPI, %)	3.2	2.3	7.5	4.5
Central bank bill (end of period, %)	5.7	4.8	6.5	5.0
Money market rate (3-month Treasury Bill, %)	6.3	5.4	7.0	6.5
Long-term interest rate (10-year gov't bond, %)	NA	NA	-	-
Exchange rate (MKD / EUR, average)	61.2	61.2	61.2	61.2
Exchange rate (MKD / EUR, end of period)	61.2	61.2	61.2	61.2
General government balance / GDP (%)	-0.6	0.7	0.2	0.0
Public debt / GDP (GFS, %)	40.6	30.0	28.0	28.0
Trade balance / GDP (goods and services, %)	-20.6	-21.6	-25.0	-26.0
Current account balance / GDP (%)	-0.4	-3.2	-7.5	-8.5
Gross foreign debt / GDP (%)	38.1	37.0	37.5	38.0
Unemployment (%)	36.0	34.7	34.0	33.5
Real ULC growth (%)	10.0	6.0	4.0	4.0

Note: e – estimations, f = forecast. See methodological notes for definitions and details.

Sources: National Bank of the Republic of Macedonia, State Statistical Office of the Republic of Macedonia

Montenegro

Economic growth remained robust in Montenegro and it continued to be fuelled mainly by services on the production side and by private consumption on the demand side. Inflation continues to accelerate primarily as a result of external shocks, although wage increases also have a considerable inflationary pressure. The large current account deficit is still the most important risk in medium term regarding macroeconomic stability.

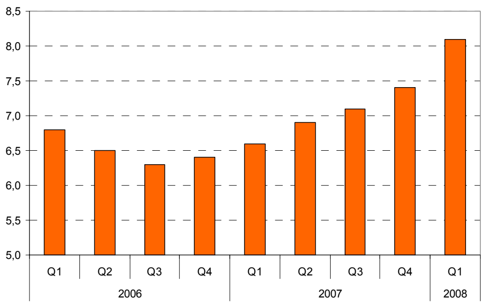
Political developments

On 21 May Filip Vujanovic began to serve his second presidential term after he won the elections in April as a nominee of the ruling Democratic Party of Socialists (DPS). The re-election of Vujanovic reaffirmed the dominance of DPS on the country's political scene, especially in the light of the fact that the leader of the party, Milo Dukanovic, returned to politics and began his fourth term as a prime minister in February. According to analysts weak institutions and endemic corruption can be partly blamed on the almost two decade presence of the party's representatives in ruling positions, thus recent developments may delay the necessary reforms.

On 5 June the government adopted the National Program for Integration of Montenegro into the EU (2008-2012). The NPI is a strategic framework for overall democratic and economic reforms in the country, thus it will serve not only as the basis for the development of annual agendas or as an instrument for the monitoring of Stabilisation and Association Agreement (SAA) implementation, but also as a transparent presentation of planned reforms.

Growth

GDP growth rate, % (year-on-year)



Source: IMF ; Note: f - forecast

According to estimations real GDP growth amounted to 7% in 2007 and this trend persisted during the first half of 2008 as well (GDP expanded by 8.1% in real terms in Q1 2008).

On the production side the robust GDP growth is continued to be fuelled mainly by services and notably tourism, financial intermediation and real estate remained the main drivers of growth. The dynamic expansion of the tourism sector has to be highlighted as in the first five months of the current year some 1.776 thousand tourists visited Montenegro which is an increase of 16.7% compared to the same period of the previous year. Industrial output expanded by 3.8% in the first five months of the year due to output growth in the mining and quarrying sector (17.2%) and in production of the utility industries (electricity, gas and water supply) (14.7%).

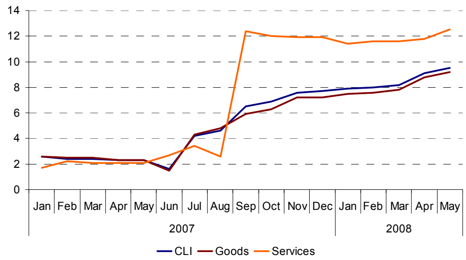
On the demand side private consumption is continuously expanding as it is fuelled by increasing salaries and relatively high credit growth. Adversely, public consumption has a slight downward trend as restrictive fiscal policy was maintained in the first half of this year as well.

Regarding external demand, the year-on-year indices for the first four months of 2008 is 66% in the case of exports and 111.7% in the case of imports. The high growth of import is mainly due to the large import of supplies and equipment intended for capital investments. However increasing consumption also fuels import growth, the share of consumption goods in total import of goods has significantly increased throughout last year.

For 2008 we raise the value of our previous forecast and we expect that GDP growth will remain at the same level as in 2007 (7.0%). Continuity of strong FDI inflows and the further expansion of the tourism sector will remain the main engines of the economy, while we expect that the negative contribution of imports could diminish this year, partly as a result of further implementation of adequate restrictive measures of monetary policy commenced in Q4 2007 that are related to credit expansion.

Monetary developments

12-month inflation (Cost of living)



Source: MONSTAT

In June 2008 year-on-year cost of living index (CLI) reached 11.4% and average inflation was 8.8% in the first half of 2008. Inflation continued to accelerate as a result of external shocks (e.g. increasing world market commodity prices) rather than strong demand pressures. Thus further rises in food prices (an average of 9.7% for the first six months of 2008), as well as in transport and communication (an average of 16.7% for the first half of 2008) negatively affect the inflation rate.

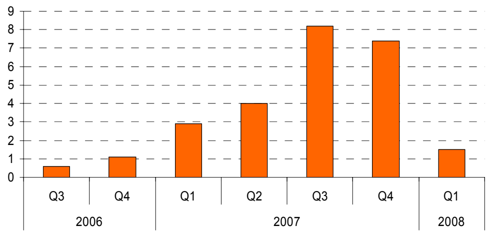
Beside the increasing world-market commodity prices, the continuation of the harmonisation process of energy and telecommunication prices are likely to negatively affect the CLI mainly throughout the current year, thus we expect that the value of the index will increase to 6.8% in 2008. As these effects may ease by next year and also the planned improvement of the competitiveness of fiscal system as well as the implementation of the Law on Competition Protection may have positive impact on the trend of the prices, we expect that the CLI will decrease to 4.6% in 2009.

Wages increased significantly in the first half of the year impinging inflationary pressure on the economy. Nominal increase of gross average monthly wages reached 24.2% in the first half of 2008, mainly due to pay rises in the public sector. Thus, in the first half of 2008 average monthly wages rose by 40.7% in the education sector, 35.7% in the health and social work sector, 34.3% in the public administration and social insurance sector and 23.9% in other community, social and personal service sector. In the private sector the average wage increase exceeded 20% only in the agricultural and the construction sector (29% and 25.8% respectively).

A series of restrictive measures were introduced by the Central Bank and entering into force in 2008 (e.g. credit growth ceilings, increased minimum solvency coefficients), thus the elevated credit activity eased. In the first five months of the current year banking loans recorded a growth of 18.2% compared with 64% a year earlier. Nevertheless deposits continued to grow slower than credits the six consecutive months, thus loans/deposits ratio amounted to 1.19 at end-May while it was much favourable in May 2007 (0.93). The loans/deposits ratio deteriorated in the case of both the household sector (it amounted to 0.89 at end-May 2008 while it was 0.69 at end-May 2007) and the corporate sector (2.29 and 1.91 respectively). Credit to corporations represented 61% of total extended loans at end-May, clearly favouring investments over consumption.

Fiscal policy

General government balance (% of GDP)



Source: Ministry of Finance

While the general government surplus stood at 7.4% of GDP in 2007, the fiscal performance continued more moderately in Q1 2008 recording a surplus of 1.5% of GDP.

Regarding the structure of revenues, tax revenues recorded the highest share (63.1%) and grew by 50.3% y-o-y as a result of rising VAT collection and increasing gains from personal income tax. In addition, revenues from excises and customs duties augmented as a result of robust import growth. In June 2008 the government amended the corporate tax law, reducing from 15% to 9% the tax rate on dividends and profit shares. The personal income tax is planned to be decreased to the same level by 2010.

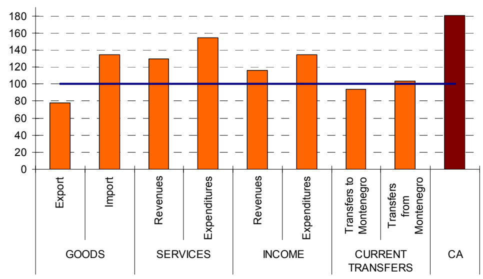
Expenditures have grown in the first five months of 2008 mainly due to the 24% increase in the average monthly gross wages and the expansion of transfers to public institutions. In contrast with previous years, the capital expenditures in 2008 are being implemented not below the target, but in line with the budgeted levels (it amounted to 3% of total expenditures in Q1 2008).

Taken into consideration the budgeted increase of public expenditures (plus EUR 33 million compared to 2007) and the mid-term prospect of slight deceleration in economic growth we expect that the government surplus will shrink to 6.3% in 2008 and decline to a balanced budget throughout the following years.

The general government debt reached 29% of GDP at the end of March 2008 as it had increased by almost 7% y-o-y in nominal terms. The share of internal debt in total debt increased from 37.3% last year to 41% in the first quarter and it shall continue growing in the following period due to restitution, obligations regarding unpaid retirements and takeover of companies' obligations. Taken into consideration the persisting budget surplus and the robust growth rate we expect that the general government debt decrease slightly to 29.1% in 2008, however the increase in internal debt has to be curbed in order to keep the general government debt under 30% on mid-term as well. On the whole Montenegro's government debt burden is still about average compared to the new EU members.

External balance

Current account balance and its components (y-o-y index, Q1 2008)



Source: Central Bank of Montenegro

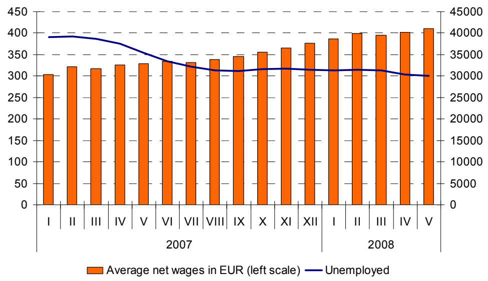
The current account deficit increased to 41.6% of GDP in 2007 and it continued widening to 45.9% during Q1 2008, which has several components. The further decline of exports – which is mainly the result of the low competitiveness of local producers - and the high expansion of imports - which was fuelled by booming domestic demand - resulted in further deterioration of the trade balance. The unfavourable world-market prices of agricultural and energy products as well as large FDI inflows also affect negatively the current account balance. It is important to note, that among the euroisation conditions the current account deficit entails less risk than in countries having their own currency but it also narrows the options of its elimination in the absence of an exchange rate policy.

During Q1 2008 FDI reached the level of EUR 464.75 million and grew by 6.8% y-o-y, but while it had covered 90% of the current account deficit in 2006, now this proportion decreased to 33%. Portfolio investments resulted in outflows of EUR 7.7 mn. Thus on the whole the country is increasingly leans on foreign debt financing to cover the growing external imbalances.

As the government already took measures to restrain credit growth, the FDI inflows decreased slightly (net FDI inflows amounted to EUR 3 million less in Q1 2008 than in the same period last year) and the revenues in tourism may increase further, we expect that the current account deficit will increase slightly in 2008 to 42.5% of GDP but it will have a moderate downward trend afterwards.

Labour market

Unemployment and wages



Source: Monstat and Employment Bureau

Unemployment rate in Montenegro has fallen to 11.8% in March from 14.8% in the same period of the previous year and it further decreased to 11.4% end-May according to the Employment Agency of Montenegro, while Monstat (the country's statistical office) reports 18% as the value of the unemployment rate in its quarterly Labour Force Survey which was published in June for the first time. According to data of the Monstat, the participation rate still stands at a modest rate (59.7%). We expect that unemployment rate will continue to decrease - although in a slower pace – due to the persistent robust growth rates.

The net average wage expanded by 24.8% y-o-y during the first half of 2008, reaching EUR 403. Education, health and state administration employees witnessed the highest increase in their net salaries (between 30% and 40%), while the highest wages remained those in financial intermediation (EUR 895 in June 2008).

Key macroeconomic indicators, 2006-2009

	2006	2007e	2008f	2009f
Nominal GDP (EUR mn)	2,149	2,423	2,696	2,850
Real GDP growth (%)	8.6	7.0	7.0	5.4
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	NA	NA	-	-
Exports (%)	NA	NA	-	-
Imports (%)	NA	NA	-	-
Annual average inflation (CLI, %)	3.0	4.3	6.8	4.6
Policy rate (%)	NA	NA	-	-
Money market rate (3-month, %)	NA	NA	-	-
Long-term interest rate (10-year gov't bond, %)	NA	NA	-	-
Exchange rate / EUR (average)	1	1	1	1
Exchange rate / EUR (end of period)	1	1	1	1
General government balance (% of GDP)	2.7	7.4	6.3	4.9
General government debt / GDP (%)	32.6	30.4	29.1	28.0
Trade balance (% of GDP)	-39.5	-62.9	-64.5	-58.3
Current account balance / GDP (%)	-24.7	-41.6	-42.5	-33.2
Gross foreign debt / GDP (%)	26.1	32.4	32.9	31.8
Registered unemployment rate (%)	14.7	11.9	11.0	10.4
Real ULC growth (%)	NA	NA	-	-

Note: f = forecast, e=estimation; Source Statistical Office of Montenegro, ISSP, Eurostat

Serbia

Led by the Democratic Party and the Socialists, the new government was formed and intends to focus on the European integration, which is good news for the markets. The GDP growth in the first quarter was rapid, while external imbalances and vulnerabilities continued to increase. Due to the very sharp growth of the inflation, the central bank increased its key interest rate to 15.75%.

Political developments

The first five parties/coalitions of the elections on the 11 May 2008

Party/coalition	Leader	Number of gained mandates
For a European Serbia coalition	Boris Tadic	102
Serbian Radical Party	Vojislav Seselj	78
Democratic Party of Serbia - New Serbia	Vojislav Kostunica	30
Socialist Party of Serbia - Party of United Pensioners of Serbia - United Serbia coalition	Ivica Dacic	20
Liberal Democratic Party	Cedomir Jovanovic	13

Source: Statistical Office of the RS

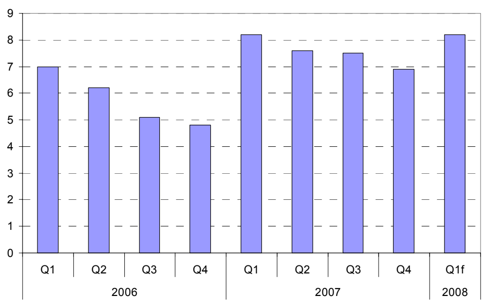
Following the uncertain political situation after the elections on the 11th May, the pro-European Democratic Party (DS) – led by President Boris Tadic – reached a coalition agreement with the coalition led by the Socialist Party of Serbia (SPS) by the beginning of July. After years of animosity between DS and SPS – which was led by Slobodan Milosevic until his death – will soon sign an agreement on political reconciliation. According to the recent statements, the new government intends to focus on Serbia's EU accession process, rejection of Kosovo's independence, economic development, social justice and fight against crime and corruption.

The new government is formed by seven parties and consists of 27 members, including 24 ministries. Members even from DS oppose the cooperation with the SPS, as they see this helps to clear the Socialists' past record. Although the capability of forming a new government is promising, it is clear that the new cabinet contains different parties, thus regarding the political and economic questions; it will be difficult to reach compromises.

The EU and Serbia signed the Stabilisation and Association Agreement before the elections in April, but its implementation will require the ratification of the parliament and the full cooperation with the ICTY – the Hague Tribunal. Thus the arrest of one of the most significant war crimes indictee, Radovan Karadzic is also considered as a step on the path of EU accession. Although this process is expected to remain long and bumpy, the recent developments indicated positive signs.

Growth

Quarterly real GDP growth rate (%)



Source: National Bank of Serbia

Following the dropping GDP growth rate from quarter to quarter in 2007 (the revised numbers are 8.2%, 7.6%, 7.5% and 6.9% respectively) the growth in the first quarter of this year also showed a very strong start with real GDP growth over expectations, reaching 8.2% according to the Statistical Office of RS. The background of the GDP shows double digit growth of the telecommunication and transport (20.9%), financial intermediation (18.3%), wholesale and retail trade (11.8%), electricity, gas and water (10.9%) sectors. After the 2007's drop back, the sector of mining and quarrying also performed remarkably with 9.5% growth.

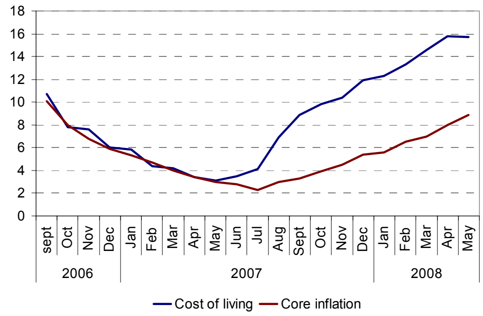
On the other hand, following the previous two years' very strong start in the first quarter, construction and manufacturing was disappointing with 4.3% and 3.9% respectively. The former is partly caused by the delayed investment projects during the election period. The structure of the GDP shows the vulnerability of Serbia's economy.

All in all, despite the tighter monetary policy the rapid growth of the first quarter remained underpinned by the strong domestic demand

– fuelled by significant wage and credit growth – and the favourable export performance. These trends are likely to continue in the upcoming quarters, adding to this other factors like favourable weather conditions and political developments, all resulting in a strong growth in 2008 as well, reaching around 7%.

Monetary developments

Cost of living, core inflation (annual rate, %)



Source: National Bank of Serbia

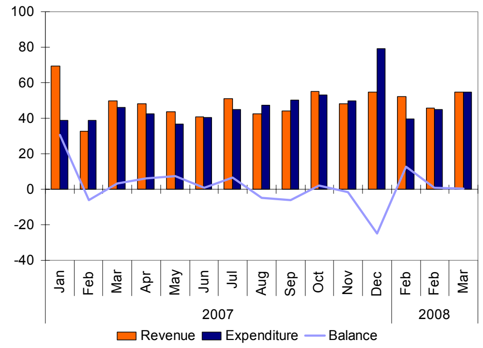
For 2008 the core inflation objective is set as a band with a 3% lower and 6% upper edge. However, the global problem of increasing inflation hit Serbia severely. Following the first half of 2007 inflation started to accelerate. In July 2007 the core inflation amounted to 2.3% and the cost of living index was 4.1%, but a year later in June 2008 the core inflation reached 10.0% year-on-year while the consumer price index edged up to 14.9%. Since the beginning of this year, the central bank increased its key interest rate from 10.0% to 15.75% in five steps, but in the second half of the year even further interest rate rise is expected. Serbia already has one of the highest interest rates in the region. The central bank is in a difficult situation, because due to the economy's very high level of euroisation, curbing inflation is not efficient via the interest rate, but rather through the exchange rate. Probably the dinar can appreciate slightly due to the high level of interest rate and the improving political situation.

In 2008, the internal and external inflation pressure will remain present. Inflation expectations, strong domestic demand, high oil and agricultural prices, the expected fiscal loosening all added up to a high inflation level. The central bank introduced administrative measures to mitigate the rapid credit growth, but bigger slowdown will not take place. To sum up, by the end of 2008, the core inflation is expected to settle at the upper range of the target band.

In May the foreign currency reserves amounted to EUR 9.95 billion, 8.62% of this amount was deposited with commercial banks.

Fiscal policy

Public finance (RSD, billion)



Source: National Bank of Serbia

Total consolidated revenues – excluding grants – rose by 7.1% in real terms in the first quarter of 2008, compared to the same period in the previous year, and amounted to RSD 262.6 billion. As for the expenditures, in real terms it increased by 6.9% and reached RSD 259.4 billion, thus resulting in a surplus of RSD 3.2 billion, which is 0.5% of the GDP. The amount of revenues is 43.5% of the GDP, while for expenditures this rate is 43.0%.

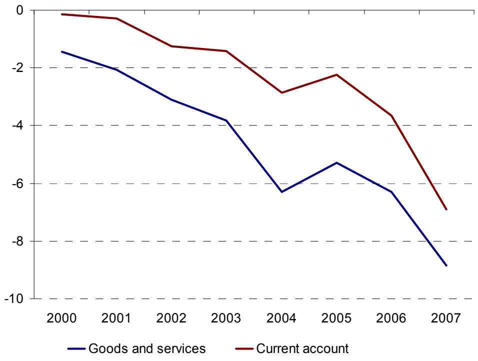
On the revenue side, customs (10.4% in real terms) and tax on profit (10.5% in real terms) increased over the growth of GDP and inflation, due to the growth of exports and profitability. On the other hand, expenditures on wages increased by 8.1%, on subsidies by 26.1% and on social benefit payments by 9.8%, all in real terms.

New wage increases have been approved in the public sector and subsidies show a growing trend, thus in the upcoming quarters the rise of transfers to households is expected to accelerate. Capital expenditures are also expected to increase. Generally we can state that fiscal relaxation will take place in the second half of the year, causing a deficit around 2% of the GDP by the end of 2008, although a tighter fiscal policy would serve the mitigation of inflation and could support economic growth.

Debt repayment means a growing burden for Serbia, but the debt per GDP rate is constantly declining. The debt repayment per GDP reached 9.8% in 2007.

External balance

Balance of goods and services and current account (USD, bn)



Source: National Bank of Serbia

The export growth remained favourable in the first half of the year, thus underpinning the economic growth. In the period of January-May external trade increased by 24.2% in terms of EUR and reached EUR 9.37 billion, compared to the same period in 2007. The growth of imports (24.7%) exceeded the increase of exports (23.1%), indicating the growth of trade deficit by 26.2%, amounting to EUR 3.42. The export per import ratio continued to decrease and reached only 46.6%.

One of the main factors of the import growth was the rapid increase of energy commodities, which gave 20.3% of the total imports. The export performance was partly the result of the privatisation process and the modernisation of certain major companies. The largest part of the export was given by various metals, steel and metal products. Trade with CEFTA countries resulted with a positive balance of USD 720 million, and the main export products were agricultural products.

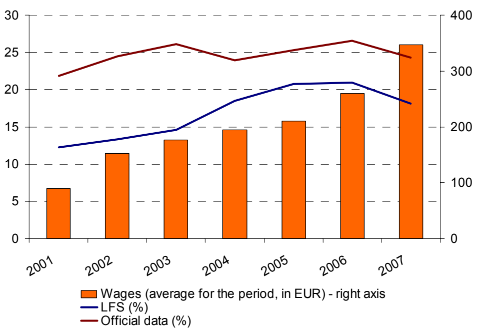
Due to the increasing trade deficit and repayments of foreign debt, the external imbalances continued to widen. Only 39.1% of the trade deficit was covered by the surplus of current transfers as remittances tend to drop. No major improvement is expected in the upcoming three quarters of 2008.

In 2007 FDI inflow remained moderate, thus the net FDI reached only USD 2.2 billion. As for 2008, a few bigger privatisation deals can bring somewhat higher FDI inflow compared to the previous year, but the amount is expected to remain moderate. The sales of 51% of the oil and gas company NIS or the privatisation of the mining complex RTB Bor can be named as examples for prominent deals.

By the end of 2007's first quarter, the central bank's foreign exchange reserves reached USD 15.08 billion, increasing by 6.1%, compared to the previous quarter and reaching a comfortable import cover of 8 months.

Labour market

Unemployment rate and wages



Source: National Bank of Serbia

In the first quarter of this year labour market showed negative trends. Total employment (2.5 million persons) continued to decrease, particularly in the sectors of tradable goods. Despite the processing industry's growth, it performed the sharpest drop of employment, while construction and transport dropped in line with their output. The number of unemployed persons increased to 759 thousand, which is 1.2% higher than in the previous quarter. New employment also slowed, parallel with the growth of vacancies, which represents the structural mismatches of the Serbian labour market. According to the Labour Force Survey (LFS), unemployment dropped to 18.1% in 2007. As for this year, a further mild improvement can be expected.

It can also be stated that productivity improved, mainly in the sector of the already mentioned tradable goods, and the increase of vacancies was milder than the economic growth. As the rise of productivity exceeded the growth of real gross wages, unit labour costs somewhat decreased in the industrial sector.

In the first two quarters of 2007 the average net real wages increased by almost 25% year-on-year, but following this sharp rise the wage growth started to mitigate. In the first quarter of this year the growth continued to loose momentum, thus average net nominal wages increased by 19.5%, while in real terms by 5.2%. The new government may somewhat increase wages in the public sector, but peaks as in 2007 are not expected and the slowdown of the growth may continue.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
GDP nominal (RSD bn)	2,042	2,450	2,910	3,265
Real GDP growth (%)	5.7	7.5	6.6	7.0
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	NA	NA	-	-
Exports (%)	32.7	34.6	34.3	34.7
Imports (%)	26.8	36.9	37.2	35.6
Inflation (Retail price index, %)	6.6	10.1	11.4	7.1
Policy rate (%)	14.0	10.0	17.0	13.0
Short-term interest rate (3-month T-bill, %)	13.48	6.44	-	-
Long-term interest rate (RS bonds, %)	5.44	5.53	-	-
Exchange rate (RSD/EUR, average)	84.4	80.3	81.2	81.5
Exchange rate (RSD/EUR, end of period)	79.0	79.2	80.1	82.0
Budget balance / GDP (%)	-1.9	-2.0	-2.1	-2.0
Public debt / GDP (%)	38.8	30.5	27.5	25.6
Trade balance / GDP (goods and services, %)	-19.9	-20.6	-21.1	-20.2
Current account balance / GDP (%)	-11.5	-16.1	-16.5	-15.1
Gross foreign debt / GDP (%)	61.7	61.1	60.8	60.6
Unemployment (%)	20.9	18.1	18.0	17.7
Real ULC (%)	0.1	2.0	-	-

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

Sources: National Bank of Serbia, Statistical Office of the RS, IMF, own calculations

Turkey

The Turkish economy has been slightly affected by domestic political and external economic shocks in 2008, which will have an impact on growth and inflation. But the previous structural reforms, commitment to fiscal prudence, end of political turmoil will maintain the fast growth of the economy.

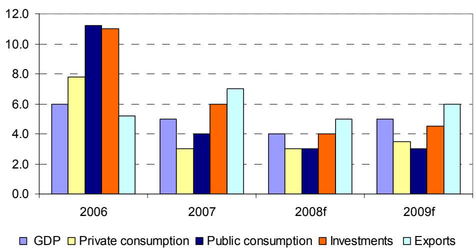
Political developments

The main recent political uncertainty has been prevented by the Constitutional Court's decision to reject demands to close down Turkey's AKP party and disallow key AKP members from being associated with a political party. At the same time the decision of penalising AKP by losing 50% of its government funding has been interpreted by political analysts and investors as a decision that may strengthen democracy in Turkey overall.

No significant political noise is expected in the coming months as Prime Minister Erdogan is likely to focus more on economic reforms and issues that have gained popularity for him and his party. The AKP is likely to perform strongly in the next municipal elections due to its high popularity, good track record in municipal elections. This likely victory may allow Mr. Erdogan to keep his fiscal policy tight as the government might not need to increase public spending to get more votes.

Growth

GDP growth and its composition (%)



Note: f = forecast; Eurostat, CBRT

While Turkey is still vulnerable to the slowdown in economic activity in the United States and the European Union, the structural reforms, the continued fiscal discipline and increase in productivity as a result of these changes have led to a significant improvement in Turkey's growth potential and actual dynamics in recent years. Not only has the country managed to sustain rapid economic growth but it also appears to be landing softly after a period of prolonged economic expansion.

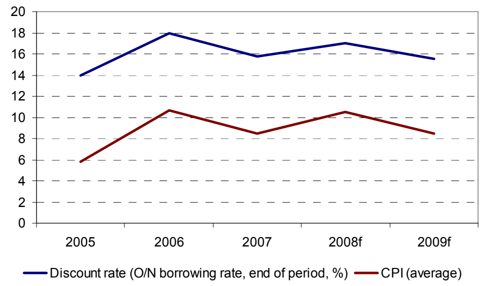
The Turkish economy has now been growing for 24 consecutive quarters and economic growth has become much more sustainable, departing from previous boom-bust cycles in three significant ways. Now growth is driven by the private sector; is supported by steady productivity gains; and overall the expansion is dominated by higher value added sectors like automotive and consumer durables rather than traditional sectors such as agriculture and textiles.

Altogether Turkey is vulnerable to slower global growth and external financial pressures. But thanks to recent structural reforms and fast economic growth the country has much stronger grounds, which will produce much smaller slowdown in export growth than in earlier downturns and will slowdown growth in an orderly way without serious disruptions.

The previous forecast of 4.2% is revised to 4.0% by assuming slower recovery in domestic demand and solid growth in net exports. In the components of domestic demand, private investments may somewhat decrease due to declining profits and uncertain market developments. At the same time the rise in private sector stock building remains below last years' figures. Notwithstanding the decline in net foreign demand exports may increase at a pace similar to the last year while the decline in import growth may somewhat be also smaller leading to somewhat higher contribution of net exports to economic growth. In the next year some acceleration towards 4.5% growth of GDP may be expected.

Monetary developments

Evolution of monetary indicators



Source: f = forecast; CBRT, ECB

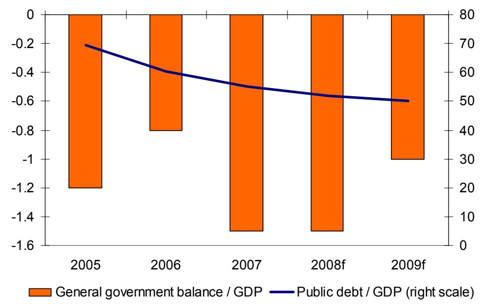
The rise in political uncertainty and supply shocks has delayed the disinflation process. Due to higher food and energy prices the central bank increased first its inflation forecasts and then its targets significantly for the next three years. The December targets for end-2009, end-2010 and end-2011 are set as 7.5%, 6.5% and 5.5% respectively. Comparing with the initial target which stood at 4.0% for the whole period, these targets are much less aggressive.

Inflation has peaked in July and is expected to start declining. As a result, inflation will start falling to 9.7% at the end of 2008. As oil prices decline we are approaching the optimistic scenario, supporting our view that the central bank will not need to hike rates anymore. The Bank is expected to start easing after the municipal elections next spring.

The Lira has remained strong as compared to what happened in previous episodes of global financial volatility. This behaviour was due to several factors. First, the high yields offered by local bonds and improved inflation dynamics attracted foreign investors to Lira positions. Second, Turkey has sharply improved her growth prospects, which makes the country an attractive destination for FDI and portfolio inflows. Finally and closely related the structural reform process which has led to a significant improvement in the country's macroeconomic fundamentals.

Fiscal policy

Evolution of general government deficit and public debt per GDP (%)



Note: f = forecast; Source: Eurostat

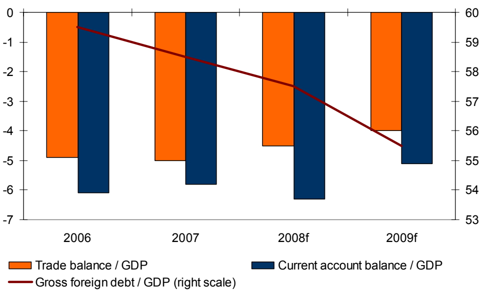
In recent years the key macroeconomic achievement has been the reduction of fiscal imbalances. The primary surplus of the consolidated budget averaged 4.7% of GDP during the last five years and the budget deficit fell sharply from 11.9% of GDP in 2001 to 1.6% of GDP in 2007.

Fiscal performance so far this year implies that fiscal targets are likely to be reached. This is expected to happen notwithstanding the fact that due mainly to an election-related jump in non-interest spending, the consolidated government sector primary surplus fell from 4.6% of GDP in 2006 to 3.5% in 2007. This year's primary surplus target of 3.5% of GDP is equal to the realisation of the last year. The fiscal performance has been much stronger than expected due to some spending discipline and to the rise in indirect tax collection. In case of the latter the biggest improvement is in the corporate tax collection which increased by 15%, showing some improvement in corporate profits and some success in fighting tax evasion.

This strong performance provides a cushion for some spending increases expected towards the end of the year related to next year's local elections and partly with some structural reforms. The total 2008 public sector deficit (per ESA standards) is expected to be less than 2% of GDP.

External balance

Current account deficit, trade deficit and gross foreign debt (%)



Note: f = forecast; Source: Eurostat, ECB

Over the last few years, the negative impact of a strong Lira has been offset by productivity gains. Turkish exports have remained strong, but because imports have outpaced them, the current account deficit has remained wide owing to recovering domestic demand and to the rise in global oil prices.

We still think that in 2008 the growth of imports will remain relatively strong reflecting the high import content of exports, the moderation of private consumption and investment growth, while exports will grow somewhat slower owing mainly to the negative real effects of external crisis.

In 2008-2009 exports will feel the negative effects of weaker external demand which may be partially offset by the weaker exchange rate and positive effect on tradables competitiveness due to low exchange rate pass-through. Altogether we expect that while the gap between the rates of growth of exports and imports will shrink, the trade balance will improve somewhat.

One of the key problems for Turkey is the current account deficit, which reached 5.8% of GDP in 2007 and is expected to widen to 6.3% of GDP this year. Many expected a reversal in the current account balance due to the weaker national currency, but this has not occurred, which is generally explained by the effect of three factors. First, the impact of high energy and other commodity prices as we wrote in the last report according to estimates a USD 1 rise in energy prices leads to a USD 450 million widening in Turkey's current account deficit. Second, notwithstanding the observed shift in the structure of exports and reduced reliance on lower value added sales, Turkish exports still are highly import dependent.

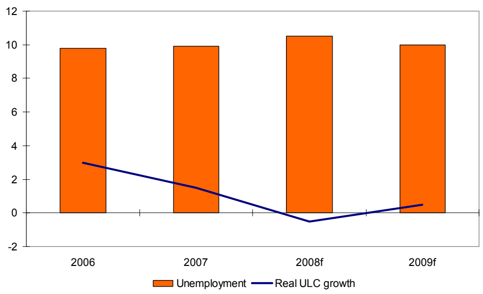
As a result export strength is accompanied by higher imports (this is reflected among others in the fact that intermediate goods imports rose by 24% in 2007, exceeding the 16% growth in consumption goods imports). Third, the net revenues from services did not increase considerably: for example tourism revenues grew much less than the number of tourist arrivals due to structural problems and intense competition.

In the financing of the current account deficit it is important that FDI inflows are expected to finance about one-third of it. The sale of state cigarette producer Tekel to BAT and the sale of the retailer Migros to the British private equity firm BC Partners and the IPO of Turk Telekom completed so far this year imply that FDI inflows remain strong. Also positive is the commitment of the government to the privatisation process with electricity distribution companies, the national lottery and the highways being the upcoming major deals. With these purchases roughly 30% of the current account deficit should be covered by FDI inflows.

As portfolio inflows are likely to remain modest due to poor global liquidity conditions, the rest of the deficit should be financed through non-bank private sector borrowing. This is achievable as the private sector has had no difficulty in borrowing from abroad, but there is concern that the situation could change if global credit conditions worsen.

Labour market

Unemployment and real ULC growth (%)



Note: f = forecast; Source: Eurostat

As the economy is expected to slow down we may assume that the unemployment rate will exceed 10% in 2008 reaching 10.5% and will decline towards 10% in the next year.

Altogether while around 350 000 new jobs were created in the non-agricultural sectors in 2007, the labour force participation rate has remained still very low at 47.8% and no shift is expected in 2008.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (TRL bn)	559.5	643.5	720.2	806.6
Real GDP growth (%)	6.1	5.0	4.0	4.5
Private consumption (%)	7.8	3.0	3.0	3.5
Public consumption (%)	11.2	4.0	3.0	3.0
Investments (GFCF, %)	11.3	6.0	4.0	4.5
Exports (%)	5.2	7.0	5.0	6.0
Imports (%)	6.4	6.0	5.5	6.0
Annual average inflation (%)	10.7	8.5	10.5	8.5
Discount rate (O/N borrowing rate, eop, %)	18.0	15.75	17.00	15.50
Money market rate (3-month Treasury Bill, %)	NA	NA	-	-
Long-term interest rate (10-year gov't bond, %)	NA	NA	-	-
Exchange rate (TRL / EUR, average)	1.80	1.78	2.00	1.80
Exchange rate (TRL / EUR, end of period)	1.89	1.74	1.90	1.75
General government balance / GDP (%)	-0.8	-1.5	-1.5	-1.0
Public debt / GDP (%)	60.5	55.0	52.0	50.0
Trade balance / GDP (goods and services, %)	-4,9	-5.0	-4.5	-4.0
Current account balance / GDP (%)	-6.1	-5.8	-6.3	-5.1
Gross foreign debt / GDP (%)	59.5	58.5	57.5	55.5
Unemployment (%)	9.8	9.9	10.5	10.0
Real ULC growth (%)	3.0	1.5	-0.5	0.5

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

Sources: IMF, Eurostat, CBRT