



Quarterly Forecast on the Western Balkans and Turkey

Autumn 2007



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This report was prepared by:

Péter Bilek (editor), Tamás Borkó, Szabolcs Erdős, Pál Gáspár, Gábor Kutasi, Eszter Vadas

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Contact

ICEG European Center, 6/B Dayka Gábor Street, Budapest, H-1118 Hungary. Phone: (+36) 1 248 1160. E-mail: office@icegec.hu.

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Regional overview

Western Balkans

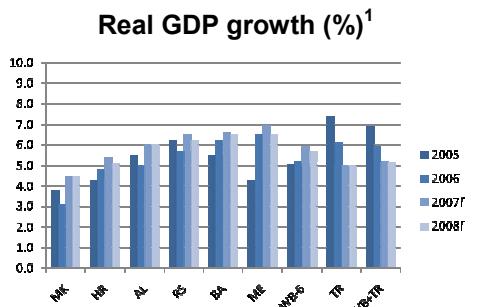
The political climate remained tense in most Western Balkan (WB) countries in the third quarter of the year as well. In the former Yugoslav Republic of Macedonia, physical fight deepened the conflict between the ethnic Albanian parties. In Serbia the Kosovo issue is still not decided and it greatly influences the country's foreign and internal affairs. In Croatia and Serbia the preparation for the upcoming elections has launched. In Albania and Bosnia and Herzegovina the parties are seeking for cooperation to progress in reforms.

Economic growth accelerated in the first two quarters of the year in most countries in the region in comparison with the previous year. Real GDP growth reached a remarkable 8% in Serbia in the second quarter which was the highest among the WB countries. In some countries, economic growth moderated slightly after the first quarter, namely GDP growth diminished from 7% to 4-5% in Croatia and the former Yugoslav Republic of Macedonia. The still rapid economic growth was supported by high private consumption and investments, which reflects that domestic demand fuels most of these economies. On the other hand, net exports had a negative contribution to GDP growth except for the former Yugoslav Republic of Macedonia. For 2007 we expect that the region's GDP growth will go up to 5.9% from last year's 5.2%. In 2008 the aforementioned trend will continue and economic growth will remain on current level.

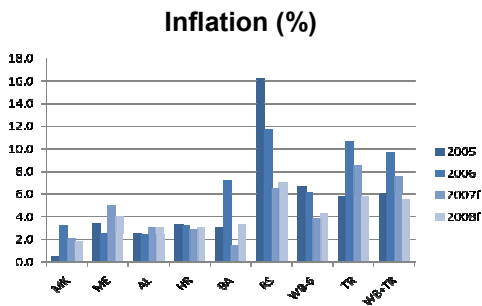
Despite of low inflation in most economies, it is worth mentioning that inflation accelerated and inflationary pressure became stronger in many countries in the region. The unfavourable weather condition increased significantly the food prices which accounts for a large part of these countries consumer basket. Beside, considerable wage increases, booming credit stocks and the increase of international oil prices also put inflationary pressure on these economies. However, inflation is expected to remain on a low level and the region's average will reach 3.8%. One can observe the highest disinflation in Serbia where inflation is expected to decline from last year's 11.7% to 6.5% in 2007.

Fiscal positions are expected to worsen slightly in 2007 compared to the previous year. In most countries public spending has been increasing due to wage increases in the public sector and growing public investments. On the other hand, revenues have increased at a lower pace which is partly due to the increasing tax competitiveness for foreign investors.

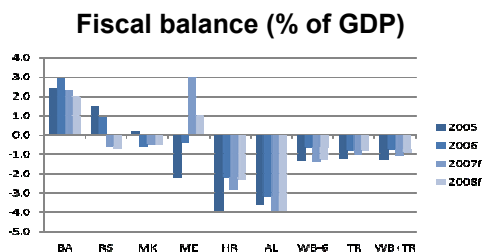
However, budget balances remain under 3% of GDP in almost all countries, only the Albanian budget deficit is expected to reach 3.9% this year. Certainly, the applied monetary policies (fixed and quasi



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



Source: national banks and statistics institutes

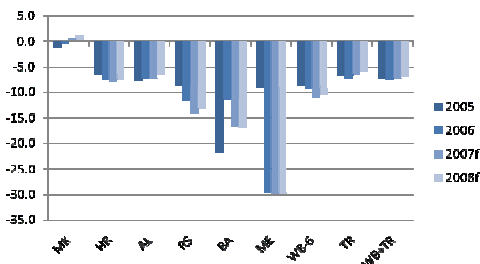


Source: national banks and statistics institutes

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

fixed exchange rate regimes in most countries) require cautious fiscal policy. In 2008 the region's average budget deficit will improve by 0.1 percentage point and go down to 1.3%.

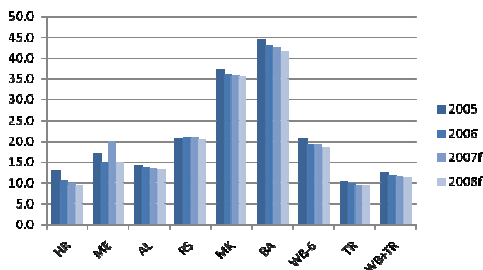
Current account balance (% of GDP)



Source: national banks and statistics institutes

External imbalance remained one of the key macroeconomic issues in the WB regions in course of the first half of this year. Current account balances worsens in all economies except for the former Yugoslav Republic of Macedonia. The deterioration of current account balances is mainly due to the growing trade deficits in the WB countries. Trade deficit is expected to exceed 20% in Albania, Bosnia-Herzegovina and Serbia. The high trade deficit is a result of high domestic demand since consumption and investment boost import, while export sector is still weak. Accordingly the region's average current account deficit will increase to almost 11% from 9.2% in 2006. In 2008 CA deficit is expected to moderate only slightly and remain above the 10% threshold. The special topic analyses the current account trends in details in the region.

Unemployment (%)



Source: national banks and statistics institutes

Unemployment remained the other weak point of the WB countries In the first half of the year. The average unemployment rate is expected to decline under 20% in this year. However, unemployment exceeds 30% in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia. Croatia has the lowest unemployment rate in the region, the only country that already went under the 10% threshold. Though, unemployment has been gradually decreasing in line with growing employment in the Western Balkan countries mainly due to the high economic growth and decreasing informal sector. For 2008 we expect that unemployment will decrease further, to 18.5% in average.

Turkey

GDP in Turkey is expected to grow fast in 2007 and 2008 though there is some moderation compared to previous years due to the sharper than expected deceleration in the growth of domestic demand driven by slowdown in the rise of private consumption. In 2008 GDP growth is to remain around 5% driven by revival of private consumption and declining contribution of net trade. The sustainability of growth is better due to sizeable productivity gains, rise in higher value added and less cycle sensitive manufacturing exports and significant increase in FDI inflows and related corporate investments.

The recent slowdown of price increases confirms that inflation target will be met thanks to prolonged monetary tightening leading to moderated domestic demand, weak labour markets reducing wage pressures and corrective measures taken by the government in the primary balance after the elections.

In 2007 the total cash deficit of the consolidated budget may increase slightly compared to 2006 and may reach 1% of the GDP. The worsening of the consolidated and primary balances is mainly due to the sharp pre-election increase in fiscal expenditures accompanied by somewhat smaller primary revenues. However the fiscal policy is under control and Turkey continues to improve its debt ratio, with public debt to GDP falling to 59% in 2007 and most likely to 55% in 2008

Albania

The Bank of Albania increased the interest rate by 25 basis points. The inflation speeded up. The trade balance keeps on worsening. The government declared his devotion to improve fiscal discipline. Parliamentary parties agreed to initiate the reform of judiciary system.

Political developments

On 17 September, President Bamir Topi urged Prime Minister Sali Berisha and the leaders of all political parties to join in a roundtable discussion about necessary reforms in the judicial system. Topi also urged lawmakers to draft reforms, as the judiciary is considered one of the most problematic institutions in Albania.

Alfred Paloka, the director of the Albanian Telegraphic Agency, nominated by the ruling Democratic Party, won special election (23 September) to fill the seat in parliament. It felt vacant after Bamir Topi became president. Only 33% of the 41,000 district voters went to the polls.

Growth

Economic growth is stable - the consensus forecast for GDP growth is 5.9% in 2007, 6.1% in 2008. – driven mainly by construction, business services and transport.

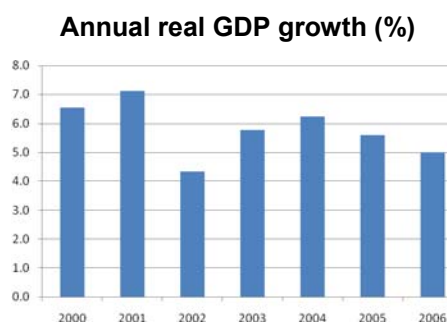
For catching-up to other Balkan economies, there is need for systematic fight against corruption and organised crime; increased efficiency and impartiality of the judiciary and public administration, particularly the customs and the tax system; and resolution of land ownership. These kind of concrete measures are expected in 2008.

Large infrastructure development particularly financed by EBRD and World Bank will start next year to improve the infrastructure related business environment, including upgrades of the road system, modernisation and expansion of seaports and regional airports.

Also, there might be progress in restructuring and privatisation of utilities to ensure reliable services, particularly in power and telecommunication sectors, and greater attention paid to environmental issues, including waste disposal and wastewater treatment as well as environmental issues related to expansion of the private sector.

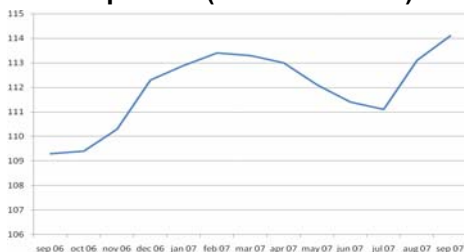
Monetary developments

The Bank of Albania's Supervisory Council decided to raise the interest rate by 0.25 percentage point to 6.00% on 9 September. According to the Bank of Albania, the data on the performance of economic indicators reveal the presence of risks that exert upward pressures on inflation rate, beyond the Bank of Albania target. The administered price rise and high international prices of raw materials are being transmitted to domestic products cost. During last two months, the developments in agricultural products' prices have reversed the downward trend that had dampened the inflationary pressures over the last two years. Also, the increasing energy costs to the economic activity is being evidenced in the overall price level



Source: INSTAT

Consumer price index, Sept 2006 – Sept 2007 (Dec 2001 = 100)



Source: INSTAT, Bank of Albania

performance.

Credit growth has supported the economic activity in the last two years. High growth of credit has boosted the aggregate demand and have permitted the transmission of higher costs to consumer price rise. The growth of the economy's demand for goods and services has been associated with current account deficit widening.

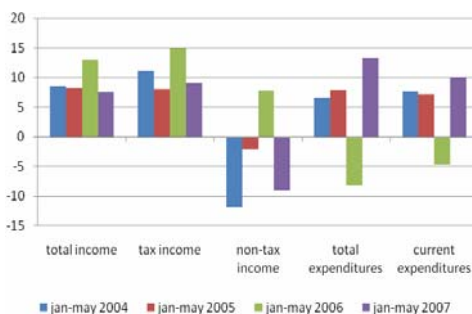
The annual rate of Consumer Price Index (CPI) in September was 4.4%. A year earlier the rate was 2.6%. The higher CPI was mainly because of significant food price increases in the second half of the year. The expected inflation for 2007 and 2008 is 3%. The fluctuation of inflation will continue as the agricultural products with seasonal effects are still very important in the Albanian consumption basket, beside, the oil prices will determine the pace of inflation through the energy dependence.

Although, the Bank of Albania increased the interest rate, the quickened pace of inflation suppose to expect altogether 0.5 percentage point increase in the next 12 months.

The exchange rate is relatively stable, subject to appreciation pressures and seasonal effect of uneven transfer of remittances peaking in summer and winter months.

Fiscal policy

Annual growth of fiscal indicators during the first 5-month period (%)



Source: Bank of Albania

In the first 5 months of 2007, the budgetary revenues increased by 7.5%. The best performance was shown in collection of VAT, PIT and tax on excises.

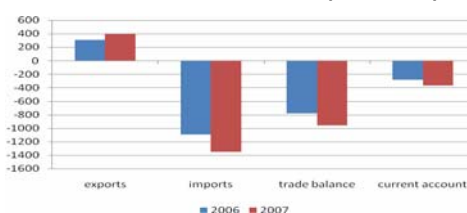
Besides, fiscal expenditures increased by 13.3%, 83% of the planned spending were already executed. The 5-month balance shows surplus, but the present run of budgetary expenditures projects a serious worsening of fiscal position and its sustainability.

On 26 September, the Socialist Movement for Integration (opposition party in the Parliament) expressed its concern about the economic situation in Albania, resulting from the government's decision to spend the expenditures, purposely without specific cost projections, and supposed that the government should take immediate action to address rising consumer prices, the electricity crisis, and hikes in oil prices.

Prime Minister Sali Berisha promised that the electricity shortage crisis (6-20 hours power cuts per day) will be resolved through a new strategy. He announced that a significant part of the 2008 budget will be earmarked to rebuild thermal power plants in Albania, aiming to guarantee power supplies in the years to come.

External balance

Trade balance and CA (ALL mn)



Source: INSTAT

External trade balance keeps on worsening. The gap between exports and imports increased in comparison to the same period of 2006. The Balance of services shows also a thin deficit (EUR 21.7 million). The repatriated income surplus and the capital transfers surplus are significant, thus they can just counterweight the enormous deficit of trade of goods and services.

Albania had shown weak performance in attracting FDI in comparison with other Balkan states, annual investment fell from USD 147 million in 2003 to only USD 36 million in 2004. However, it

staged a strong recovery in 2005, reaching USD 520 million. In 2006, FDI had rocketed to some USD 2.18 billion. Foreign investments are boosting up, and confidence in Albania as an investment destination is growing. For 2007 and 2008 similar level is expected, as in 2006, while current account will remain in deficit, about 7% of GDP, both in 2007 and 2008.

Labour market

Labour market indicators (1000 persons)

	2006Q1	2007Q1
Total labour force	1082	1080
Total employed	931	933
<i>public sector</i>	174	168
<i>private non-agri. sect.</i>	215	223
<i>private agri-sector</i>	542	542
Unemployed	152	148
Unemployment rate	14%	13.6%

Source: INSTAT, *Conjuncture*, Q1, 2007

Unemployment and employment ratios seemed to be slightly volatile but showing a mildly seasonal improvement if the first quarters of 2006 and 2007 are compared. (Unemployment rate 2006Q1 – 14%, 2007 – 13.6%) This development is explained by the increase of jobs in the manufacturing and service sector, meanwhile, the number of public employees decreased.

In the public sector, the salaries increased by 17% in the first quarter of 2007 in comparison with the same period of 2006. According to a survey of the Bank of Albania, the business sector participants expect 8.7–9.0% wage improvement for 2007.

The expected growth of nominal wages is expected to reach 9-10% in the business sector, in 2008, too. This results relative increase in real wage costs. Official unemployment remains around 15% of the labour force but underemployment is widespread.

Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
Nominal GDP (ALL mn)	837,000	896,000	979,000	1,075,000
Real GDP growth (%)	5.5	5.0	5.9	6.1
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	24.2	24.7	25.4	26.1
Exports (%)	12.0	13.0	14.0	14.0
Imports (%)	13.0	16.0	12.0	7.0
Annual average inflation (CPI, %)	2.5	2.4	3.0	3.0
Discount rate (end of period, %)	5.00	5.50	6.00	5.75
Money market rate (3-month Treasury Bill, %)	5.75	6.25	6.00	5.75
Long-term interest rate (10-year gov't bond, %)	NA	NA	-	-
Exchange rate (ALL / EUR, average)	124.2	123.1	124.0	122.5
Exchange rate (ALL / EUR, end of period)	122.6	123.8	122.5	122.0
General government balance / GDP (%)	-3.6	-3.2	-3.9	-3.9
Public debt / GDP (%)	56.7	55.7	54.5	53.7
Trade balance / GDP (goods and services, %)	-23.5	-23.4	-23.4	-22.5
Current account balance / GDP (%)	-7.7	-7.2	-7.4	-6.5
Gross foreign debt / GDP (%)	21.4	22.0	22.0	21.5
Unemployment (%)	14.2	13.8	13.5	13.1
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

Politics remain divisive, hindering structural reforms that are set as preconditions for successful negotiations with the EU on the SAA. As a result of favourable external conditions and strong domestic demand, GDP growth is expected to exceed 6% in the forthcoming years as well. Further acceleration of fiscal expenditures – including the investment activity and wage outflow – is expected in the second half of 2007. Despite affected by energy and regulatory prices, due to the base effect of the VAT introduction, inflation is expected to remain at a low level in 2007, reaching around 1.5%. Following the improvement of 2006, external imbalances are expected to significantly widen again this year. The immense unemployment rate remains a persistent problem of the economy.

Political developments

Politics in Bosnia and Herzegovina (BH) remain divisive, hindering structural reforms. The tense political climate was the main reason why the mandate of the Office of the High Representative (OHR) has been extended by an additional year. Since July 2007 a Slovak diplomat – Miroslav Lajcak – took over the post of High Representative (HR) and EU's Special Representative (EUSR). The new HR urges politicians to reach an agreement regarding key reform issues.

The police reform has been set as a key precondition by the EU for signing the Stabilisation and Association Agreement (SAA), but so far draft proposals have been rejected. There is only a small possibility of signing the SAA within this year.

Although Kosovo's final status is still uncertain, the Serb entity's (Republika Srpska – RS) independence ambition may be fuelled by a decision on independence. RS will hold presidential elections in December due to the death of Milan Jelic, but according to agreement the incumbent Bosniak and Croat vice presidents would remain in office.

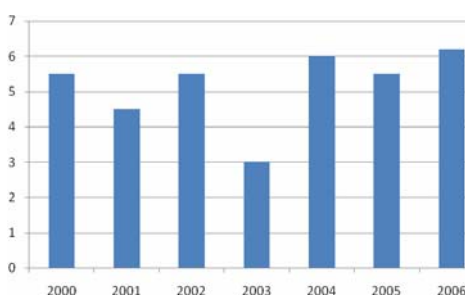
Growth

According to the central bank, the amount of GDP in 2006 was KM 19.11 billion; accordingly the GDP growth rate was 6.2%. The processing industry, wholesale and retail, real estate business increased its share of the gross value added. Favourable international developments, the significant industrial production growth, the increase of exports and inflow of investments were among the factors that fostered economic growth.

Compared to the same period in 2006, in the first half of 2007 the industrial production increased by 13% in the FBH, underpinned by the high growth of mining and processing industry. However, in the same period the industrial production increased only by 0.9% in RS, influenced by the shortfall of the electrical energy production.

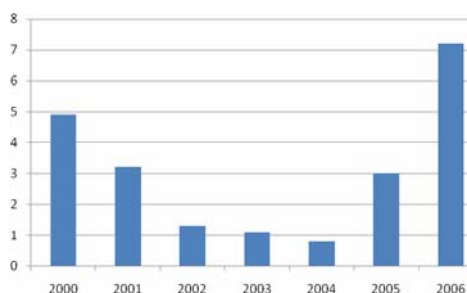
Due to the structural weaknesses, the country's economy is vulnerable to changes regarding the external conditions. Still, likewise in 2006, in 2007 as well the economic growth is expected to be underpinned e.g. by the high level of private consumption, retail sales and investment activity. In 2007 the GDP growth rate is expected to exceed 6.5% and similar high growth rates are expected for the coming year.

Real GDP growth (%)



Note: f = forecast; Source: CBBH

Consumer price index (yoy, avg, %)



Source: CBBH

Monetary developments

VAT introduction in January 2006 had a one-off effect on inflation, but from the second semester of the year CPI started to decline. Finally the annual growth of the retail price index in 2006 amounted to 7.4%. Due to the base effect of the VAT introduction, in the first half of 2007 average retail price inflation was only 1.37%. Underpinned by the currency board regime, but affected by energy and regulatory prices, inflation is expected to remain at a low level in 2007, reaching around 1.5%.

In 2006 monetary aggregate M1 increased by 23.6%, while in the first five months of 2007, M1 grew by 9.1%. By the end of 2006 total deposits of households amounted to KM 4.1 billion, which is 46.3% of total deposits. In 2006 the interest rate on long-term loans continued to decline, but the interest rate on short-term loans to households grew by 49 base points. Annual credit growth in 2006 was 23%, while a year ago this number was even higher and amounted to around 27%. According to the central bank, the total amount of credits is close to KM 8 billion, around half of this amount is owned by citizens, while the other half has been lent to entities. This means that on average every citizen has approximately KM 1 000 of debt.

By the end of August 2007 the national bank's total assets amounted to KM 6 355 million, while net foreign assets exceeded monetary liabilities by KM 334 million.

Fiscal policy

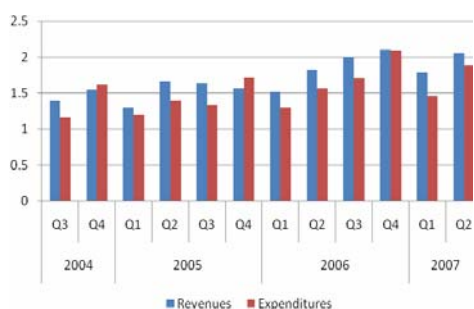
The introduction of the VAT at the beginning of 2006 resulted in higher-than-expected fiscal revenues, which supported to achieve a significant surplus despite the accelerating expenditures. As a result at the end of 2006 the budget balance per GDP was 2.9%.

In the first half of 2007 fiscal surplus was 17.6% higher than in the same period a year earlier and reached KM 492 million. So far revenues grew at a higher pace than expenditures. In the first half of 2007 total achieved revenues reached KM 3 834 million, which is 14.9% higher than in the same period a year ago. As for the current expenditures, it rose by 14.5% compared to the first half of the previous year and amounted to KM 3 342 million. The government sector's investment activity started to increase in the first half of 2007, thus net procurement increased by 7.3% compared to the same period in the previous year and reached KM 45.5 million. Likewise the state level, both entities FBH and RS reached surplus; KM 250 million and KM 140 million respectively.

Further acceleration of fiscal expenditures – including the investment activity and wage outflow – is expected in the second half of 2007, thus the surplus will probably be lower than in the previous year. The budget balance per GDP is expected to be around 2% in 2007 and this rate will probably continue to decline in the forthcoming year.

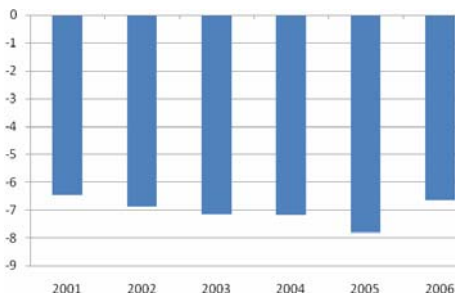
Law on government borrowing, debt and guarantees has been introduced at the state level in 2005 and in RS in March 2007. The law sets borrowing limits and serves debt management as well. A similar law for the FBH has not been approved yet.

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



Source: CBBH

Trade balance of goods (KM, billion)



Source: CBBH

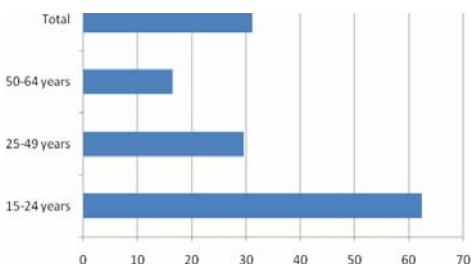
External balance

The VAT introduction, the favourable developments of the trading partners, the growth of metal prices (which can be considered as a key export product of Bosnia and Herzegovina), the development of the industry sector (including successful restructuring and privatisation of certain companies) were among the related factors that helped trade deficit to narrow significantly in 2006. Exports increased, while the level of imports retained compared to 2005. These developments contributed to the narrowing of the current account deficit as well. Moreover, the low international interest rates helped to finance the current account deficit.

As a consequence of the mentioned positive factors that still exist, exports of goods remained strong and reached 25.5% growth in the first quarter of this year. This growth was mainly underpinned by the good performance of the metal sector. On the other hand, boosted by the high domestic demand, imports of goods increased by 31% in the same period. These developments caused 37% growth of the trade deficit, compared to the first quarter of 2006, thus amounting to EUR 780 million. For 2007 the widening of external imbalances is expected, resulting in a trade deficit around 36.5% of GDP and current account deficit per GDP approximately 16.5%.

Following the low level of FDI inflow in 2006, in the first half of this year Bosnia and Herzegovina gained EUR 1.2 billion FDI, according to the Foreign Investment Agency. Half of this inflow was due to the purchase of the telecom operator, Telekom Srpske. The second half of the year is also expected to remain strong concerning FDI inflows.

Unemployment rate by age groups, 2006 (LFS, %)



Source: Agency for Statistics of BH

Labour market

Despite the impressive economic growth, the high unemployment rate in BH is persistent. The LFS (Labour Force Survey) conducted in 2007 has not been published yet, but the following are known from the data of 2006. 1.5 million (56.9%) persons are inactive (including children below 15 years of age and people who did not give a direct answer), while approximately 1.2 million (43.1%) are active. The group of active is further divided into employed (811 thousand) and unemployed (366 thousand). This results in an employment rate of 29.7%, while unemployment rate stands at 31.1%.

On the other hand, according to the official data, unemployment rate was around 43% in 2006 and is expected to decrease only slightly this year. The large informal sector (which is estimated to be between 20-40%) increases the unreliability of the figures. A realistic figure for the rate of unemployment is probably in the range of 20-30%. All in all we can conclude that unemployment in BH is still one of the highest in the region and remains a severe problem.

In June 2007 the average net wage was KM 657 in FBH, KM 584 in RS and KM 676 in Brčko District. Compared to June 2006, by the end of the second quarter of 2007 the average net wage in FBH increased by 9.7%, in RS by 11.5%, while in Brčko District it decreased by 0.1%, which represents the trend of decreasing differences.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (BAM mn)	16,990	19,100	20,780	22,900
Real GDP growth (%)	5.5	6.2	6.6	6.5
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	NA	NA	-	-
Exports (%)	24.0	28.0	23.0	20.0
Imports (%)	13.6	4.4	25.5	21.0
Annual average inflation (CPI, %)	3.0	7.2	1.5	3.3
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)	1.96	1.96	1.96	1.96
Exchange rate (BAM / EUR, end of period)	1.96	1.96	1.96	1.96
General government balance / GDP (%)	2.4	2.9	2.3	2.0
Public debt / GDP (%)	27.5	22.5	21.8	21.0
Trade balance / GDP (goods and services, %)	-44.1	-31.6	-36.6	-33.5
Current account balance / GDP (%)	-21.8	-11.5	-16.8	-17.0
Gross foreign debt / GDP (%)	57.9	57.0	58.5	59.6
Unemployment (%)	44.5	43.0	42.5	41.5
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

The finish of campaign period shows balanced competition two months before elections. Excellent growth performance seems to continue by strong domestic demand and improving export performance. Price developments are favourable, but there are some risky factors that may touch inflation processes. The first half of the year recorded above the expectations adjustment, especially led by central government position's improvement. Current account deficit is still increases. Despite the high seasonality, the data of labour market improved further.

Progress in EU-Croatia negotiations

PHASES	NO. OF CHAPTERS	
	passed through the phase	in progress in the phase
EC-Croatia Screening (1st phase), Croatia-EC Screening (2nd phase), Commission preparing the Screening Report	33	0
Council's Working Group for Enlargement discussing the Screening Report	31	2
Council deciding on Croatia's preparedness for the opening of negotiations/or opening benchmarks	30	1
Croatia fulfilling the opening benchmarks (if set)	20	10
Croatia adopting and presenting its Negotiating Position to the Presidency	18 (16)	2 (4)
Commission drawing up a Draft Common Position (DCP)	13	5 (3)
Council's Working Group for Enlargement discussing the DCP	12 (13)	0 (1)
Council adopting the EU's Common Position for the opening of negotiations	12 (13)	0
Croatia fulfilling the closing benchmarks (if set)	2	11 (10)
Provisional closing of the chapter at the Accession Conference	2	0

Note: numbers in brackets as of 26 June 2007

Source: Ministry of Foreign Affairs and European Integration (as of 26 July 2007)

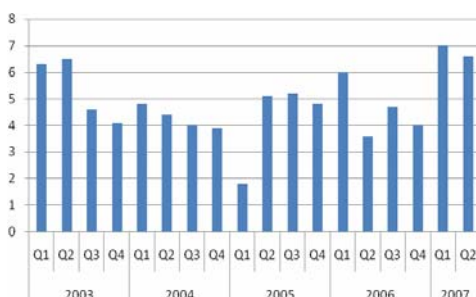
Political developments

The leading event of political life is still the parliamentary elections that will be held at the end of November this year. By the current polls it seems the Social Democratic Party (SDP) has the chance to form government. The governing Croatian Democratic Union (HDZ) lost its leading position in the last half year. However the effective outcome will depend on the results of small parties or alliances supporting either of big ones. From this point of view the forces are more balanced, as the Croatian People's Party (HNS), the more likely coalition partner of SDP is expected to show weak performance, while the right wing parties Croatian Party of Rights (HSP) and the Croatian Pensioners' Party (HSU) has chance to have balancing results. Finally the outcome will depend on the seats and strategy of the coalition of the Croatian Social Liberal Party (HSL), the Croatian Peasants' Party (HSS).

The risk of political deadlock exists in case of not viable coalition. In any other case the elections will not challenge the integration, consolidation processes.

As for now a bit effaced EU negotiations, from the situation reported in our latest prediction progress happened in the chapters: freedom of workers' movement; energy; consumer and health protection. Currently, thirteen chapters are opened, while two are provisionally closed. There is very poor progress concerning fisheries, judiciary and fundamental rights, and foreign, security and defence policy. Also further steps are needed in free movement of goods and capital, competition policy, public procurement, social policy and employment, environment.

Real GDP growth (quarterly, yoy, %)



Source: CROSTAT

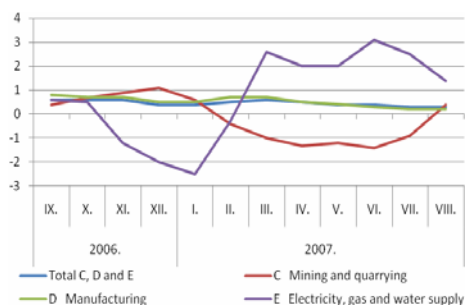
Growth

After the 4.3% growth in 2005, the real GDP in 2006 showed an increase of 4.8%, as compared to 2005, based on quarterly estimates. It seems now that the economy will outpace even these numbers.

In the second quarter of 2007, real GDP was by 6.6% higher than in the same period of 2006 (7% in the previous quarter). The Croatian growth is also pulled by the decelerating but still robust conjuncture of the EU.

The current growth is henceforward driven mainly by domestic demand, while by poorer performance of investments. In the second quarter year-on-year, household final consumption increased by 6.5%, while the governments' by 2.7%. The gross fixed capital formation increased by 5.8% that is surprising as comparing with the

Volume indices of industrial production (monthly chain indices, %)



Note: calculated on trend index basis

Source: CROSTAT

data of last years. The export and import growth show accelerated international activity, as exports of goods and services increased by 8.9% and imports by 6.4%.

Construction, wholesale and retail trade, and financial intermediation activities contributed considerably to growth of gross value added not only in the first quarter, but in the second quarter of 2007 as well. Agriculture also performed rather well despite of the not so favourable weather conditions.

Concerning industry, the gross value added of industry in the second quarter increased by 8.4%, as the industry responsible for the highest share from value added; this meant unambiguous pulling effect. The industrial production was by 7.0% higher in the period from January to August 2007 than the production in the same period last year. Manufacturing continued to perform well, as it increased by 8.8%. Mining and quarrying underperformed in comparison with its previous data (10.3%), as it increased only by 5.3%.

According to main industrial groupings (MIGs), increase of production of intermediate (7.9%) and capital goods (13.8%, especially durable ones) pulled the volume index.

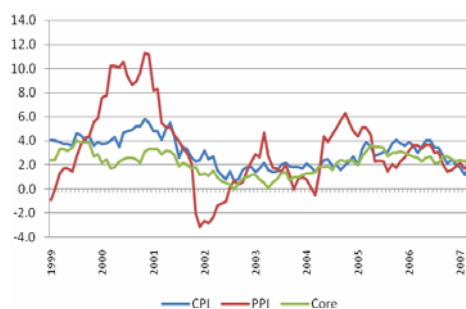
Croatia's strategic tourism sector had good opportunities determined by favourable weather conditions. In the first seven months of 2007 as compared to the same period of the previous year, the tourist arrivals increased by 8%, while nights spent went up by 7%. While the domestic arrivals and nights increased on a higher pace, the growth of foreign tourist arrivals and nights was the main contributor with its above 80% share in total. This good performance was somehow reflected in the value added growth of hotels and restaurants in the second quarter (8.4%).

While the latest trade data are favourable, because of the large gap between the exports and imports of goods, the contribution of external demand to growth expected to remain weak, or rather negative.

Growth rates of earlier estimations has to revised upward notably, as on the basis of good international environment almost all sectors performed above the expectations, especially agriculture, manufacturing and tourism. However concerns may arise because of domestic driven growth. We revised upwards our estimation to 5.4% in 2007 and 5.1% in 2008.

Monetary developments

Monthly price developments (yoy, %)



Source: CNB

The prices of Croatian economy change corresponding to price stability, even if there is risk of accelerating increase, mainly reasoned by boosted fossil fuels prices, possible after parliamentary elections electricity price hikes and damaged crops by summer heat.

By analysing the latest data on price developments, the total consumer price index (CPI) increased by 0.6% in August on July, while as compared to August 2006, that is, at the annual level, it increased by 2.6%, and on the annual average, by 2.1%.

Taking the annual average data, the main contributors were the clothing and footwear (4.7%), housing, water, electricity, gas and other fuels (3.7%). While in the month-on-month August-July data, the above then average food products were the pulling force, especially bread and cereals (4.7%) and vegetables (8.2%). But is also true for

the whole last year, measured comparing August 2007 data with the same month of the previous year.

The producer price index (PPI) increased by 0.8% in August on July, while as compared to August 2006, that is, at the annual level; they increased by 3.6%, and on the annual average, by 2.5%. The main factors behind the annual average increase were the mining and quarrying (4.3%) and electricity, water and gas supply (6.1%). By MIG, the prices of energy and intermediate goods pulled the rate.

The disinflation process continued, however internal and external factors may have upward pressure on prices. We expect a slight acceleration as compared to the current situation by the end of the year in 2007 and 2008.

Our expectations on the exchange rate developments are practically unchanged. The stability of national currency is kept.

Fiscal policy

2006 was closed with 2.2% ESA 95 general government deficit parallel with decreased general government debt. The public finance performance is promoted by nice growth performance and by relatively strict fiscal policy in good times. However the final balance will be drawn after elections.

Fiscal policy performed rather well in the first half of 2007 due to adjustment efforts, as the central government recorded a considerable surplus of 0.3% of the GDP (in GFS terms), as compared with the -0,9% deficit in the same period of the previous year. This was mainly due to increase of revenues and below the plans realising expenditures.

As for consolidated general government in the January-June period of 2007, revenues increased by 13% (86% of it realized in the central government, 10% in the local governments) mainly due to increased tax collection (especially VAT, but also in excises and social contributions). Expenditures increased in this period only by 6.7%, mainly due to moderate increase in social benefits (the biggest expenditure), while compensation of employees increased above the average. These are reflected also in the development of operating balance.

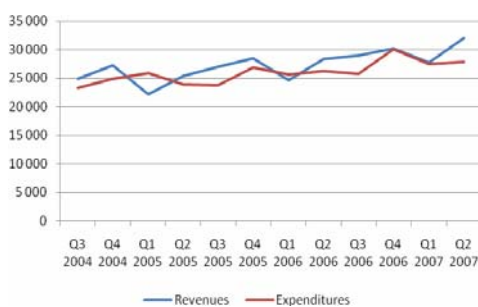
All subchapters of consolidated general government achieved a reduction of deficit, taking either extra-budgetary funds and agencies or local governments. The adjustment is going to continue mainly due to economic growth, even in the light of measures done in order to influence elections. This way, in 2007 smaller, 2.8% deficit expected and the adjustment continues only in 2008.

External balance

The special feature of Croatian economy continues to strengthening, namely the widening deficit in the trade of goods by strong service trade performance.

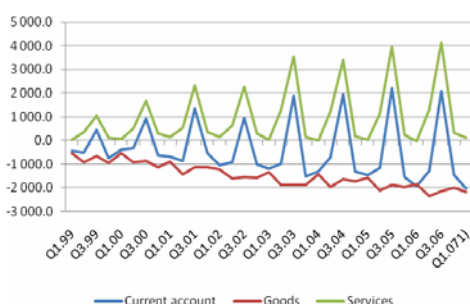
According to the most recent statistics of Central Bureau of Statistics, the import covered by export of goods reached 46.7% in the first eight months of 2007 that is a worsening as compared with 48.3% for the whole previous year.

Quarterly development of consolidated budget revenues and expenditures (HRK mn)



Source: Ministry of Finance, CROSTAT

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



Source: CNB

As the gap between exports and imports is still very high, the faster growth of exports does not mean diminishing trade deficit.

In the first eight months of 2007 as compared to the same period of 2006, exports of goods increased by 10.9%, while imports by 10.7% (manufacturing sector 13.2% and 12.6%, respectively).

Despite of the favourable data on trade of services, the trade deficit could be covered only partially by service related external activities. Thus the downward trend of current account deficit seems to be on track. Only the high real GDP growth rates can diminish its relative position.

The external debt of Croatia seems to be stabilized in a challenging level, reaching after first five months of 2007 almost 82% of our estimated nominal GDP, EUR 30 235 million at the end of May 2007. As compared to the beginning of the year, the government and domestic banks decreased their indebtedness, while other sectors increased. Based on the known data of earlier years, it is expected to increase further in the course of the current year, hitting 86% of the GDP.

Current account deficit is expected to be 8.0% in 2007 and will decrease probably only in 2008. The trade balance of goods and services will be 8.1% this year that is likely to fell to 7.3% in 2008, due to moderated domestic demand fuelled imports.

Labour market

The extreme growth performance favours the processes of labour market regarding both employment and unemployment.

By the recent labour force survey data the employment was 42.8%, while the unemployment rate 11.2% (registered unemployment 16.9%). It is in line with the usual seasonal drop.

The number of persons in paid employment increased by 1.4% in August 2007 year-on-year (and in January-August 2007 year-on-year by 1.9%) and amounted to 1 196 510. Still the construction and the wholesale and retail trade sectors are the main drivers of growth. Manufacturing rather decreased its employment.

Concerning unemployment, unemployed persons to total active population reached 13.8% in August 2007. It is fair to mention that the mainly because of seasonal effect of employment in tourism and agriculture. On year-on-year basis, however the number of unemployed decreased by 1.2%, in August.

Average monthly gross earnings increased nominally by 7.9%, in real terms by 5.7% in April year-on-year. Especially real wage dynamics are notable if comparing with previous years. This above the productivity rate wage growth influences negatively the labour force competitiveness that can have its effect on the medium run.

The economic performance and the possibly good prospects of manufacturing, construction and tourism sectors, our expectations on unemployment are revised insignificantly: 9.8% for 2007 and 9.4% for 2008.

Main labour force indicators

LFS	I-VI 2005	VII-XII 2005	I-VI 2006	VII-XII 2006	I-III 2007
Activity	49.9	49.2	48.3	49.8	48.2
Employment	43.3	43.2	42.6	44.5	42.8
Unemployment	13.1	12.3	11.8	10.5	11.2

Source: CROSTAT, Labour Force Survey

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (HRK mln)	231,349	250,590	272,000	295,000
Real GDP growth (%)	4.3	4.8	5.4	5.1
Private consumption (%)	3.4	3.5	5.5	4.5
Public consumption (%)	0.8	2.2	3.0	1.5
Investments (GFCF, %)	4.8	10.9	6.5	7.4
Exports (%)	4.6	6.9	6.2	5.6
Imports (%)	3.5	7.3	6.1	5.1
Annual average inflation (%)	3.3	3.2	2.9	3.0
Policy rate (discount rate, %)	4.50	4.50	4.50	4.50
Short terms (3-month T-bill, %)	3.70	3.00	3.05	2.90
Long-term interest rate (10-year gov't bond, %)	4.3	4.4	4.25	4.30
Exchange rate / EUR (average)	7.40	7.32	7.29	7.20
Exchange rate / EUR (end of period)	7.37	7.34	7.31	7.19
Budget balance / GDP (%)	-3.9	-2.2	-2.8	-2.3
Public debt / GDP (%)	44.2	42.1	41.5	40.0
Trade balance / GDP (goods and services, %)	-7.1	-7.8	-8.1	-7.3
Current account balance / GDP (%)	-6.5	-7.6	-8.0	-7.6
Gross foreign debt / GDP (%)	82.5	84.6	86.0	86.8
Unemployment (%)	13.0	10.5	9.8	9.4
Real ULC growth (%)	-	0.1	1.0	0.4

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

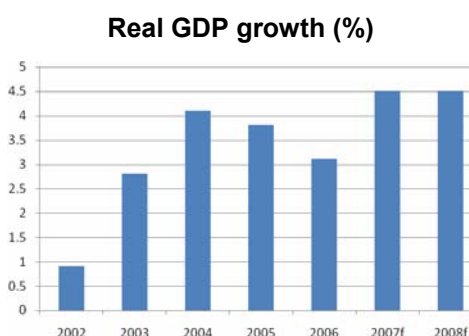
Economic growth returned to its traditional level while inflation accelerated slightly in the second half of 2007. The budget evolved favourably since tax revenues increased higher than expected despite tax rate cuts at the beginning of the year. The current account balance also improved due to lower foreign trade deficit. Unemployment remains the key macroeconomic challenge in the country.

Political developments

The political climate remained tense in the second half of the year in the Former Yugoslav Republic of Macedonia. At the end of September, Members of Parliament literally exchanged blows in course of the debate of a controversial draft bill. This fight was another outcome of the conflict between the two largest ethnic Albanian parties in the FYROM. It is well known that the largest Albanian party, the Democratic Union for Integration (DUI) boycotted the Parliament and its committees in the first few months of the year since DUI was excluded from the governing coalition.

The growing conflict between parties may have a negative impact on the international reputation of the FYROM since important evaluations of the EU and NATO are coming soon, related to the prospective joining these two organisations. Besides internal affairs, external factors can influence the accession to NATO as well. Greece expressed again its will to block Macedonia's NATO membership unless an appropriate solution to the name dispute with the FYROM is found.

Growth



Note: f = forecast; Source: SSO

In the second quarter of 2007 economic growth decelerated: it reached only 4% after a 7% increase in the first quarter. Accordingly, the Macedonian economic growth returned to its customary growth rate. However, it was the second highest growth rate in course of the last six quarters.

On the production side, agriculture sector performed modestly in the second quarter; value added in the sector increased by 1.8%. This summer was extremely dry and warm and wildfires caused severe problems in the former Yugoslav Republic of Macedonia mid-2007. As a consequence the performance of agriculture is not expected to improve in the third quarter either.

Besides agriculture, the performance of industry was also poor in the analysed period. Gross value added in mining and quarrying, manufacturing and electricity, gas and water supply diminished by 2.8%. Industrial production declined in April and May but it recovered slightly between June and August. Accordingly, industrial production increased by 2.5% in course of the first eight months. Mining and quarrying developed by 17.3% while growth in manufacturing reached 4.3%. However, electricity, gas and water supply continued to have a negative contribution to industry growth since its production decreased by 14.4%.

After last year's weak result, construction continued to increase by a moderate 4.1% in the second quarter. Among services, the highest growth was achieved by wholesale and retail trade (15.1%) and transport, storage and communication (11.9%).

On the expenditure side, net exports had a significant positive

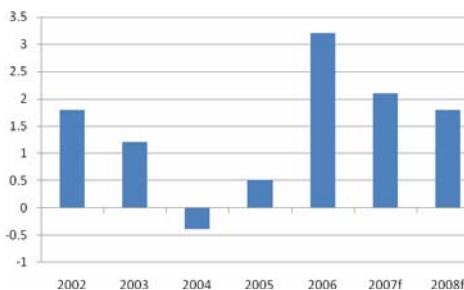
contribution to GDP growth. The growth rate of exports (34.6% nominally) greatly exceeded that of imports (9.3%). Besides positively affecting growth, the improvement of the balance of goods and services also improved the current account balance.

Regarding investments, gross fixed capital formation (in machinery and equipment) grew by 5.7% nominally in the second quarter of the year. Besides, government consumption remained basically at the same level as in the second quarter in 2006.

It seems that the first quarter's excellent growth was only a one-off phenomenon and the economy returned to a lower growth rate. This trend is expected to continue in the second half of the year as well. Accordingly, we expect that GDP growth will reach 4.5% in the former Yugoslav Republic of Macedonia in this year and in 2008 as well.

Monetary developments

Annual average inflation (CPI, %)



Note: f = forecast; Source: SSO

In the third quarter of the year inflation started to accelerate. In the year to September the consumer price index increased by 3.6%, while it remained under 1% in course of the first half of 2007. The jump of inflation was basically due to higher food and non-alcoholic beverages prices. In September food prices were 6.5% higher than that in the same month in 2006. The most significant price increases were observed in the cases of oils and fats (29.1%), vegetables (20.3%) and fruits (11.8%). Prices in hotels and restaurants also increased notably (5.5%), in line with food price developments.

Standard & Poor's confirmed its credit ratings on the former Yugoslav Republic of Macedonia at the end of May 2007. The foreign currency denominated sovereign credit rating of the country remained BB+ with stable outlook.

Since food prices increased more than expected earlier, we revised upwards our forecast on inflation. Accordingly, we expect that consumer price index will reach 2.1% in 2007 and it will only slightly decrease in 2008 (1.8%)

Fiscal policy

Development of budget revenues and expenditures 2007 (mn MKD)

	Jan-Aug 2007	Revised budget 2007	%
Revenues	77 289	114 400	67.55
Expenditures	67 409	117 896	57.18
Balance	9 870	-3 496	-

Source: Ministry of Finance

As of the beginning of 2007 the profit tax rate was reduced from 15% to 12%, while the personal income tax rate was set at 12% as well. In spite of the significant tax rate cuts the budget balance improved compared to the previous year. In the first eight months the fiscal budget had a surplus of MKD 9 870 million (EUR 161 million) which amounted to 3.1% of GDP. The improvement was basically due to higher than planned budget revenues and lower than expected expenditures. Regarding the revenue side of the budget, it is worth mentioning that profit tax revenues reached 77% of the planned amount for 2007 at the end of August.

In line with the better than expected tax revenues the government revised its budget plan for 2007 at the end of June. Accordingly, budgeted expenditures were increased to MKD 117.9 billion from MKD 112 billion.

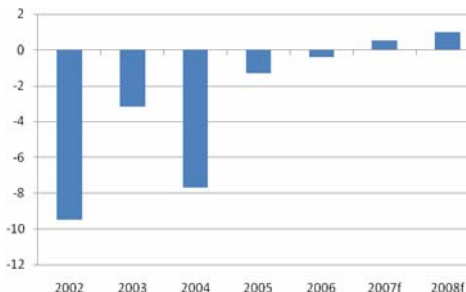
In line with the favourable development of fiscal budget public debt decreased as well. While the stock of public debt exceeded 40% at the end of the last year, it fell close to 34% in mid-2007.

The government plans that budget deficit will reach 0.7% of GDP this year. However, we expect that the deficit will be even lower due

to higher than expected revenues and poor expenditure planning. Our expectation is that budget deficit will reach 0.5% of GDP this year and it will remain on that level in the next year as well.

External balance

Current account balance (% of GDP)



Note: f = forecast; Source: SSO, NBRM

The external balance improved further this year. The current account had a surplus in course of the first seven months of 2007. At the end of July the CA surplus reached EUR 88 million or 1.7% of GDP; in the corresponding period of the previous year the current account balance had a deficit of EUR 68 million.

The significant improvement of the external balance was basically due to the decreasing deficit of foreign trade balance and higher surplus of current transfers. The aforementioned high growth of export contributed to the improvement of the trade balance, while import of goods growth remained moderate.

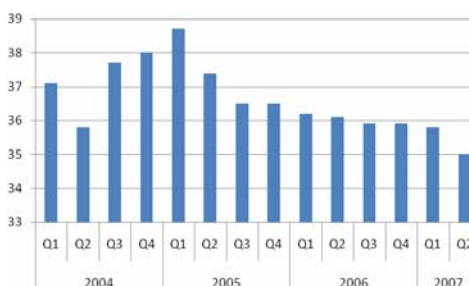
On the other hand, the incomes balance deteriorated significantly during the first seven months of 2007: it was actually in equilibrium in the corresponding period in last year, while in 2007 the deficit increased to EUR 38 million.

Foreign direct investments declined significantly compared to the previous year since 2006 was an extraordinary year regarding FDI inflows. During the first seven months of 2007 net FDI reached EUR 79 million, while it was EUR 256 million a year earlier. However, the improvement of CA balance eased the external financing need.

For 2007 we have kept our previous forecast on the current account balance. The CA surplus is expected to reach 0.5% of GDP. Besides we revised only slightly (-0.1 percentage point) our forecast on the trade balance (15.8%). In 2008 we expect the continuation of current tendencies; accordingly the current account balance will remain in surplus.

Labour market

Unemployment (%)



Source: SSO

In the first quarter of 2007 unemployment decreased only slightly compared to the previous quarter. The unemployment rate reached 35.8% in average in the first three months of the year, decreasing by only 0.1 percentage point in comparison with the same period of the previous year.. In line with that the employment rate remained at the same level, at 35.7%. However, it is worth mentioning that the number of employed persons increased by 20 thousands in comparison with the first quarter in 2006. Accordingly, the activity rate also increased by 1.3 percentage points.

In 2007 we expect labour market figures to improve slightly. Tax cuts seem to have positive impact on the labour market as well. In 2008 unemployment rate is expected to go down to 35.5%

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (MKD mn)	284,226	303,305	322,000	343,000
Real GDP growth (%)	3.8	3.1	4.5	4.5
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	NA	NA	-	-
Exports (%)	NA	NA	-	-
Imports (%)	NA	NA	-	-
Annual average inflation (CPI, %)	0.5	3.2	2.1	1.8
Discount rate (end of period, %)	6.5	6.5	6.5	6.5
Money market rate (3-month Treasury Bill, %)	NA	6.3	5.4	5.0
Long-term interest rate (10-year gov't bond, %)	NA	NA	-	-
Exchange rate (MKD / EUR, average)	61.3	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 (%)	0.2	-0.6	-0.5	-0.5
Public debt / GDP (GFS, %)	47.1	40.6	35.0	34.0
Trade balance / GDP (goods and services, %)	-19.0	-20.6	-15.8	-14.0
Current account balance / GDP (%)	-1.3	-0.4	0.5	1.0
Gross foreign debt / GDP (%)	41.5	36.9	34.0	32.0
Unemployment (%)	37.3	36.0	35.7	35.5
Real ULC growth (%)	-15.1	10.0	6.0	4.0

Note: f = forecast

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

Montenegro

The first half of 2007 in Montenegro was characterized by a record budgetary surplus and FDI inflow. On the other hand the current account deficit is on dangerous level, the industrial production declined and the inflationary expectations are growing. The Stabilisation and Association Agreement between Montenegro and the EU can accelerate the structural reforms.

Political developments

Montenegro and the European Union signed the Stabilisation and Association Agreement on October 15, a first step to EU membership. EU officials call on Montenegro to strengthen the public administration capacity and the rule of law, to step up the fight against organized crime and corruption, and establish independent judiciary. Montenegro will become the fourth Balkan country – after the former Yugoslav Republic of Macedonia, Croatia and Albania - which signs the SAA. In the period of 2007-2009, Montenegro can expect EUR 30 million assistance from the EU's new program on the Western Balkans (IPA). The Agreement will enable Montenegro an access to pre-accession funds.

Members of the Montenegrin Parliament formally proclaimed the country's second constitution on October 22. The first one was adopted in 1905 under the reign of King Nikola Petrović. The new constitution states that citizens of all nationalities living in the country have the same rights. It defines Montenegrin as the official language, but grants equal use to Serbian, Croatian, Bosnian and Albanian. According to the main opposition party (Serbian People's Party), the new constitution "left open the Serbian issue" in Montenegro.

Growth

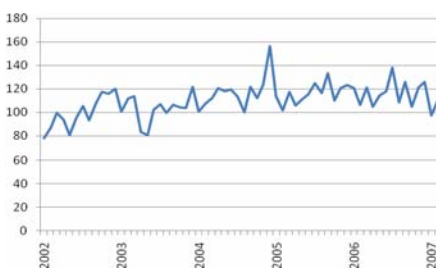
The growth rate was above expectations in the first half of the year. The real GDP grew by 6.9% in the reporting period. GDP growth is assessed to reach 7% this year. The growth rate is expected to be below 7% in 2008.

According to national accounts, the investments are the main driving forces of the Montenegrin economy. The foreign direct investments are increasing, and real estate market is expanding. Slow increase of wages are accelerated the domestic demand also.

The improving trend of industrial production has stopped in 2006 in Montenegro and the index was negative in the first eight months of this year. The production was 4,4% lower than that in the same period of the previous year. Growth was only recorded in manufacturing, while mining and quarrying sector and electricity, gas and water supply recorded falls in production. The production of electricity, gas and water supply declined by 34.2% due to problems in the operation of the thermal power plant "Pljevlja", caused by the lack of coal. The lack of resources could be explained by the unfavourable weather. Overall, the situation will improve in the following months, and industrial production could increase as the productivity of the manufacturing progresses.

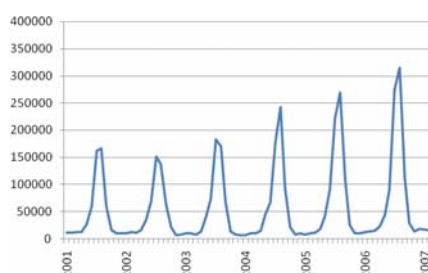
The tourism sector is the most important source of the growth in the country. The number of foreign tourist arrivals increased in the first eight months compared to the same period of the previous year,

Industrial production (2000 =100)



Source: MONSTAT

Number of tourist arrivals



Source: MONSTAT

especially from Russia, Hungary, Italy and from the USA. The most frequent visit and the number of overnight stays was in the coastal resorts. The figures clearly show that Montenegro still has a large potential in tourism. The decision makers need to develop the human and physical infrastructure to seize the opportunity.

Monetary developments

In August, the retail price index the retail prices increased by 4.5%, whereby the prices of goods increased by 5% and the prices of services increased by 2.4%. This is a significant inflationary pressure after a low, near to 2% inflation rate in the past months. The higher index could be explained by internal and external factors. The oil price increased in the world market in the past quarters, and the lack of domestic resources also pushed up the energy prices in Montenegro. Food prices and prices in fixed telephony also grew. The inflation rate (retail price index) could reach 5% in 2007. We forecast a 4% inflation rate for 2008.

The finance ministers of the EU are set to warn, Montenegro's use of the euro as its national currency is incompatible with European Union law. Montenegro adopted the single currency in January 2002. In theory, Montenegro already meets the Maastricht criteria. It has a budget surplus of 3 per cent and a public debt of 40 per cent of GDP. However, EU would not take the step of asking Montenegro to abandon the euro as a prelude to re-adopting it later.

Fiscal policy

According to the statistics of the Ministry of Finance, the primary budget recorded a high increase in revenues and a decline in expenditures in the first eight months. Budget surplus continued to increase reaching EUR 94.3 million in the first half of the year. Revenues from all kind of taxes were above the plan. The expenditures were 13% lower than it was budgeted since spending on public administration is increasing.

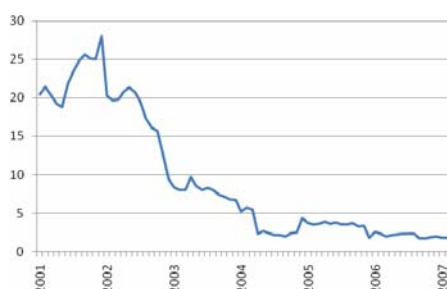
Surplus is a result of growing consumption and spending, and that money is spent on higher wages while public spending in the GDP is also growing. The surplus is expected to reach 3% of GDP in 2007. Because of slower growth rate, the surplus will decline somewhat in 2008.

External balance

Montenegro's trade deficit in the first half of the year expanded by 49% compared to the same period of previous year. While export increased only by 0.7% the import grew by 29.3% year-on-year. Italy (30.2%), Serbia (26.1%) and Hungary (15.4%) are the main export markets of Montenegro, while Serbia (26.6%), Italy (10.7%) and Germany (10.1%) are the main import partners. During the first half of 2007, the continuation of favourable developments in case of the foreign direct investments was observable. The structure of inflow has not changed. According to the National Bank of Montenegro, 56% and 34% of total FDI was related to real estate investments and banks and companies, respectively.

The accelerated economic growth, the record inflow of FDI and the high level of investment activity have influenced the increase of

Retail price index (%)



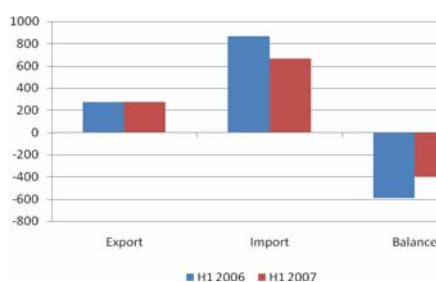
Source: MONSTAT

Budget revenues and expenditures (mn EUR)

	Jan – Aug 2007	Plan for 2007
Revenues	510.1	616.8
Expenditure	393.8	579.8

Source: Ministry of Finance, Montenegro

Trade balance (mn EUR)

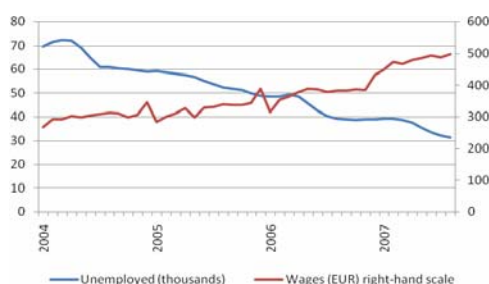


Source: Central Bank of Montenegro

imported goods. The investment activity is expected to grow, but the competitiveness of the domestic economy is likely to develop in short term, so the current account deficit is increasing in this year. The deficit will be approximately 30% of GDP in 2007 and in 2008.

Labour market

Number of unemployed persons and monthly average gross wages



Source: MONSTAT

The number of registered unemployed persons in August amounted to 31.271, 21 percent less than in the same period of the previous year. The unemployment rate by regions is the highest in the north and above the average, while it is the lowest in the south. State administration recorded the highest growth in employment and the number of employees declined in all other sectors – but it is explained by methodology changes introduced by Monstat. The method of calculating average salaries has also changed. These factors make it difficult to analyse the labour statistics in this period.

In conclusion, thanks to the relatively high growth rate, the continuing foreign direct investments and high level of investment activity the rate of employment is expected to grow. On the other hand, it is important to emphasize, that the employed people in Montenegro is high. According to the official estimations approximately 30% of employed persons are seasonal workers in summer. We forecast a gradually decreasing unemployment rate in the future reaching 15% in 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
GDP nominal (EUR mn)	1,690	1,760	2,100	2,250
Real GDP growth (%)	4.3	6.5	7.0	6.5
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	NA	NA	-	-
Exports (%)	NA	NA	-	-
Imports (%)	NA	NA	-	-
Inflation (Retail price index, %)	3.4	2.5	5.0	4.0
Policy rate (discount rate, %)	NA	NA	-	-
Short terms (3-month T-bill, %)	NA	NA	-	-
Long-term interest rate (182 day T-bills, %)	1.01	0.97	1.00	1.00
Exchange rate / EUR (average)	NA	NA	-	-
Exchange rate / EUR (end of period)	NA	NA	-	-
Budget balance / GDP (%)	-2.2	-0.4	3.0	1.0
Public debt / GDP (%)	44.5	37.2	40.0	40.0
Trade balance / GDP (goods and services, %)	NA	NA	-	-
Current account balance / GDP (%)	-9.0	-29.7	-30.0	-30.0
Gross foreign debt / GDP (%)	30.3	27.6	28.0	30.0
Unemployment (%)	17.0	15.0	20.0	15.0
ULC (%)	NA	NA	-	-

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

Serbia

The issue of Kosovo causes continuous tense political debate in Serbia distracting the attention from problems regarding the reform process. Still, Serbia's GDP increased by a remarkable 8.0% in the first half of the year. The 2007 budget envisages expanded expenditures, thus can contribute to the deepening of the trade deficit and the inflation pressure. External imbalances are expected to further widen. Inflation started to accelerate due to several factors from May, thus the central bank raised its key policy rate. Regarding the labour market, wage growth was rapid, while there is no progress concerning the high level of unemployment.

Political developments

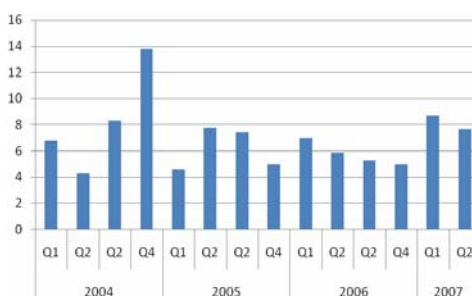
The issue of Kosovo causes continuous tense political debate in Serbia distracting the attention from questions regarding reforms and economic problems. Still no breakthrough has been achieved concerning the final status of the province. There is a chance that by the end of December - following the new negotiations - Kosovo Albanians will unilaterally declare independence. Leading Serbian politicians occasionally suggest no longer seeking EU and NATO accession, provided Western countries recognise such an action. Moreover, they even suggest taking measures against any country that recognises an independent Kosovo. Meanwhile Pristina initiated talks with the WTO on possible membership.

Most likely Kosovo's issue will be highlighted during the campaign of the forthcoming presidential and local elections that will probably be held by the end of this year or in the first half of next year. No major political changes are expected and most likely President Boris Tadic will be re-elected.

EU officials are assessing Serbia's progress regarding the cooperation with the ICTY (International Criminal Tribunal for the former Yugoslavia), which is a precondition for signing the SAA (Stabilisation and Association Agreement). In June the arrest of war crime suspects Zdravko Tolimir and Vlastimir Dordevic signalled a closer cooperation with the ICTY, and following this event, the EU resumed the negotiations with Serbia on the SAA. As a precondition for completing and signing the SAA, full cooperation with the ICTY is required, but the delivery of Mladic and Karadzic has failed so far.

Growth

Real GDP growth rate (% , quarterly)



Source: National Bank of Serbia

Following the 5.7% real GDP growth rate of 2006, in the first half of this year Serbia's GDP increased by a remarkable 8.0%, compared to the same period in the previous year. In the second quarter of 2007 the real GDP growth was 7.7% with the following sectors showing the highest increase; transport (21.4%), financial intermediation (20.0%), trade (19.3%), hotels and restaurants (12.2%), construction (9.6%), electricity, gas and water (7.5%), manufacturing (4.4%). On the other hand it is worth mentioning that due to the drought in summer, the agriculture sector has suffered severe losses in the third quarter.

Rapid credit and real wage growth, booming retail sales and favourable foreign demand all support an impressive GDP growth, while the slow pace of structural reforms, the moderate growth of the industrial sector (which is still particularly based on the raw material-based products), together with tightening monetary policy is

a drag on growth. Still, annual GDP growth is expected to exceed 6% in 2007 and a somewhat lower but still strong growth is foreseen for 2008.

Monetary developments

For 2007 the national bank's core inflation target has been set at $6 \pm 2\%$ December-on-December and for 2008 the core inflation objective is set as a band with a 3% lower and 6% upper edge. As a continuation of the inflation slowdown of 2006, in the first half of this year price rises remained moderate, due to the appreciation of the dinar, underpinned by capital inflows as well. In this period, the average core inflation amounted to 4%, reaching a historically low level.

However, from May inflation started to increase due to several factors. Domestic demand increased, underpinned by strong credit and wage growth and expansive fiscal policy. Oil prices and regulated prices also caused/cause inflationary pressure. During the first three quarters of the year the contribution of regulated prices amounted to 4.9% within a total 6.8% price growth, but this effect is expected to decline in the fourth quarter of this year. Due to bad weather conditions, the price of agricultural products and industrial foodstuff increased dynamically from August. By the end of 2007 the annual average cost of living growth rate is expected to be around 6.5%. It can be assumed that the inflationary pressure of the mentioned factors will be present in 2008 as well.

Due to favourable inflation developments in the first half of the year the central bank cut the key policy rate (two-week repo rate) from 14.00% to 9.50% in five steps. However, as a reaction to the accelerating inflation from May, the national bank increased its key rate by 25 base points to 9.75% in August and further monetary tightening can take place in the fourth quarter of the year. Furthermore, to curtail credit growth in the retail segment, the central bank introduces administrative measures.

In September the dinar's official exchange rate against the euro varied in the range of 78.19-79.96, and the appreciation may continue in the fourth quarter, especially in case of further interest rate rises.

During the third quarter of 2007 the national bank's foreign exchange reserves increased by 3.6% and amounted to EUR 9.51 billion, while the ratio over the M1 monetary aggregate decreased slightly and reached 344%.

Fiscal policy

The decree for interim financing for the January-June 2007 period was based on the budget law for 2006, appropriating RSD 260.6 billion for revenues and RSD 239.7 billion for expenditures. RSD 18.8 billion of the surplus was envisaged for public debt repayment. The surplus in the first half of the year reached RSD 41.5 billion.

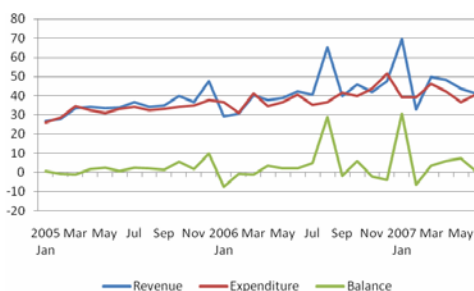
The Law on the 2007 budget was adopted in June and came into force on 1st July. The Law lays out RSD 581.8 billion revenues and RSD 595.5 billion expenditures, thus generating RSD 13.7 billion budgetary deficit. RSD 58.6 billion is earmarked for the repayment of public debt. The 2007 budget envisages expanded expenditures (21% higher, compared to the previous year), thus can contribute to the deepening of the trade deficit and the inflation pressure. Public

Cost of living and core inflation (% annual)



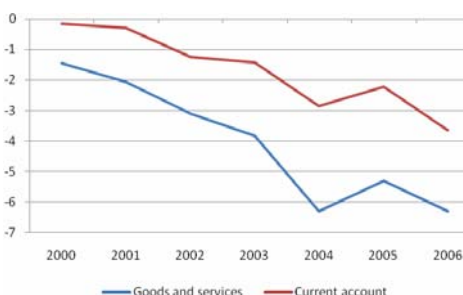
Source: National Bank of Serbia

Public finance (bn RSD, eop)



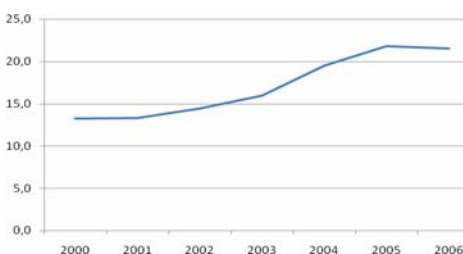
Source: National Bank of Serbia

Goods and services balance and current account (bn USD)



Source: National Bank of Serbia

Unemployment rate (LFS, %)



Source: Statistical Office of the Republic of Serbia

sector salaries grew at a very rapid pace, endangering fiscal stability; in the last 12 months wages increased by almost 30%. For 2007, RSD 144.6 billion is earmarked for public sector salaries, but this fund is planned to be frozen at the November 2007 level for the next year. It is worth mentioning that the funds for the National Investment Plan are four times higher compared to 2006, but the key point will be the efficiency of the distribution.

Despite the large surplus recorded in the first half of the 2007, due to the expected expansive fiscal policy in the second half of the year, the government calculates with deficit of 0.6% per GDP. The national bank - partly due to methodological differences - expects the deficit to reach 2% of GDP.

Public expenditure is expected to decrease from 41.4% of GDP in 2007 to 39.7% in 2008. Expenditures for public investments are planned to be reduced by 20%, for goods and services by 10%, while for subsidies by 5%.

External balance

As a result of credit growth and accelerating fiscal expenditures, domestic demand fuelled the increase of imports, but did not cause a slowdown of export growth. In the period of January-August 2007, export of goods and services reached USD 7.4 billion, increasing by 41% compared to the same period a year earlier, while imports amounted to USD 12.6 billion, growing by 38%. This indicated a trade deficit of USD 5.2 billion, representing an increase of 34%.

Due to the deepening trade deficit and the lower level of current transfers, current account deficit in January-August 2007 widened, reaching USD 3.8 billion, which is 83% higher than in the same period of 2006. In 2007 no major improvements are expected in these trends, thus external imbalances will widen, and the current account deficit may exceed even 14% of GDP.

During January-August 2007, net FDI inflows to Serbia remained at a moderate level of USD 1 billion, while in the same period of the previous year this figure was USD 3 billion. The main reason of this drop was the high amount of FDI outflow in June, related to the acquisition of one of Bosnia and Herzegovina's telecom operators, Telekom Srpska.

Labour market

In 2006 - according to the Labour Force Survey - unemployment rate was 20.9% and the number of employees decreased by 1.3%. In the period of January-July 2007 both the number of employed and unemployed persons continued to decline slightly. No significant change is expected concerning the high level of unemployment in the following months.

Just as in the fourth quarter of 2006, rapid wage growth continued in the first months of this year, particularly in the public sector. According to the statistical bureau, in the period of January-August 2007, net wages grew by 23.6% or by 29.1% in nominal terms, compared to the same period a year earlier. The accelerated increase resulted in a loss of competitiveness and a structural mismatch between the demand and supply side of the labour market.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
GDP nominal (RSD bn)	1,750	2,050	2,300	2,650
Real GDP growth (%)	6.2	5.7	6.5	6.2
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	17.1	19.5	19.5	20.8
Exports (%)	18.9	19.5	26.4	20.0
Imports (%)	-5.3	19.9	23.5	22.0
Inflation (Retail price index, %)	16.2	11.7	6.5	7.0
Policy rate (%)	19.8	14.0	10.0	9.5
Short-term interest rate (3-month T-bill, %)	17.5	13.5	6.8	7.0
Long-term interest rate (182 day T-bills, %)	18.4	14.6	7.2	7.0
Exchange rate (RSD/EUR, average)	83.2	84.4	79.8	78.5
Exchange rate (RSD/EUR, end of period)	85.5	79.0	79.0	78.0
Budget balance / GDP (%)	1.5	0.9	-0.6	-0.7
Public debt / GDP (%)	49.0	35.3	30.5	25.5
Trade balance / GDP (goods and services, %)	-23.4	-22.1	-24.2	-22.4
Current account balance / GDP (%)	-8.6	-11.6	-14.2	-13.2
Gross foreign debt / GDP (%)	64.4	64.0	64.4	65.0
Unemployment (%)	20.8	20.9	21.1	20.5
Real ULC (%)	NA	NA	-	-

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 recent victory of the AKP in the general elections may give new boost for the vital structural reforms and may accelerate further fiscal consolidation and disinflation.

Political developments

The ruling AKP secured a decisive victory in the July 22 general elections, receiving 46.7% of the votes and gaining 340 of the 550 seats, which led to absolute majority in the Parliament. As expected before the elections the popular support for AKP remained very strong in recent years, reflected among others in the fact that the percentage of voters voting for the party turned out to be higher than the 34.4% support in the 2002 election. As a result of the elections, AKP has been able to receive majority in two consecutive elections, which is almost without precedent in Turkey.

Following the victory at the general elections, former Foreign Minister Abdullah Gul became Turkey's president in presidential elections. This has closed down a long period of political tensions, though the army and the secular forces remain still doubtful about the real intentions and policy steps of the AKP.

While the end of elections led to calming down of political climate, there has been a recent increase in the tensions between the USA and Turkey due to the US Congress bill on the Armenian genocide and the rise in PKK terrorism and misunderstanding between the USA and Turkey about the ways of its management.

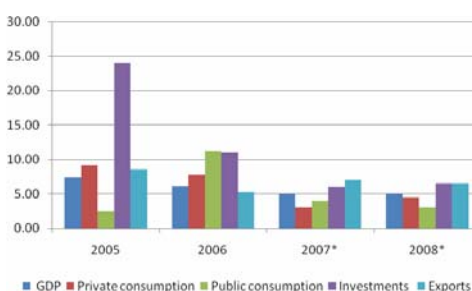
Growth

Following robust growth in last years (the Turkish economy has been growing for more than 20 consecutive quarters) GDP is expected to grow fast in 2007 and 2008 though there is some moderation compared to the average growth of 2004-2006. In 2007 the growth is likely to moderate to 5% and in 2008 similar GDP expansion is forecasted with some notable changes in its demand side composition.

In 2007 there was a sharper than expected deceleration in the growth of domestic demand driven by slowdown in the rise of private consumption. This has been driven mainly by the aftermath of the last years Lira depreciation and rise in interest rate levels, which reduced household sector consumption. At the same time fiscal policy was in 2007 more expansive due to the effect of the elections and this has partly been reflected in the expansion of public consumption. At the same time investments are expected to grow slower in 2007 compared to 2006, while the contribution of net trade is on rise caused by improving competitiveness of exports, inflow of FDI.

In 2008 we expect GDP growth to remain around 5% driven by basically unchanged composition of demand factors. There may be some revival of private consumption due to lower inflation, rise in real incomes and the gradual decline of interest rate levels. At the same time the contribution of net exports to growth will be smaller due to the expected rise in import demand. Both private and public investments are expected to grow faster, partly driven by the

GDP growth and its composition (%)



Note: f = forecast; Source: eurostat, CBTR

significant inflow of foreign direct investments and partly by local capital accumulation. As the central bank is expected to reduce its interest rate in the following period, and no abrupt changes in fiscal policy are likely, the fiscal-monetary policy stance is also supportive for economic growth.

Economic growth has been supported by the positive spill over effect of structural reforms, which sharply improved the country's macroeconomic fundamentals, continued fiscal and monetary discipline, which increased the credibility of policy makers and sustainability of policies, and the decline of political uncertainties and turmoil caused by the re-election of the market-friendly government.

The sustainability of this growth is also better than earlier as it is driven by the continuous and already sizeable productivity gains, shift in the composition of output to higher value added sectors, rise in higher value added and less demand dependent manufacturing exports and export/GDP ratio and very significant increase in FDI inflows and related corporate investments.

Monetary developments

The recent monthly increase of prices around 1% is likely to support the disinflation process and the meeting of the inflation target. The inflation target of the Central Bank is 4% by the end of 2008, and the Central Bank expects inflation to be between 5.1% and 6.9% by the end of 2007 and 1.5% and 4.9% by the end of 2008. The average consumer price inflation in 2007 will be 8.5%, which is by more than 1 percentage point lower than in 2006. There are several factors that contribute to disinflation in Turkey.

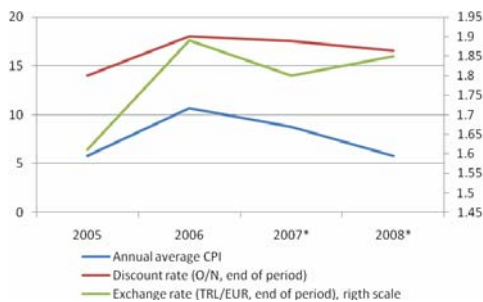
First, due to the prolonged monetary tightening, domestic demand has moderated, reflected mainly in the slowdown of household consumption, while the expected slowdown in global economic growth has been reducing external demand.

Second, despite solid economic growth in recent years, the Turkish labour market remains weak with labour participation rate remaining around 50%. This significantly reduces wage pressures coming from employees and keeps the rise of real wages in line with productivity gains. Third, while there was some changes in fiscal policy stance towards more expansive one during the pre-election period, but the corrective measures taken after the elections by the government are likely to help the disinflation process.

The meeting of inflation target and the visible decline of inflation allowed the central bank to start the process of cautious interest rate cuts. On September 13, a 25 basis point cut in the interest rate occurred due to favourable inflation developments, modest recovery of domestic demand and downsizing risk in international capital markets. Further cautious interest rate cuts are expected this year following the reduction of inflation and policy risks.

Following the relative calm in domestic politics and the improvement in global investor appetite, the lira started gaining strength. At the exchange rate level of TRL/USD of 1.20 with the expectation of further currency appreciation, the policy dilemma occurred whether the central bank is going to tolerate further appreciation or will intervene with buying the dollar. The appreciation could be certainly helpful for disinflation and further interest rate cuts, but the

Evolution of monetary indicators



Note: left-hand scale - %; right-hand scale TRL/EUR

Source: CBTR, ECB

competitiveness of tradable goods and the rise in exports reduces the scope of the likely appreciation. So far the CBRT has increased the amount of daily dollar purchasing auctions but no significant substitution occurred and more time is needed to observe the real outcome of the policy actions.

Fiscal policy

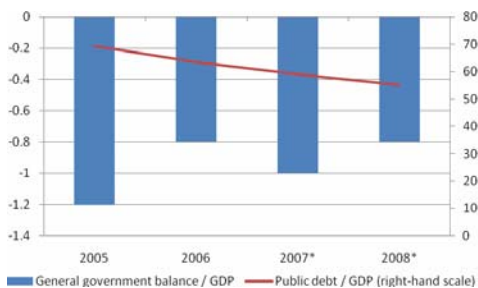
In 2007 the total cash deficit of the consolidated budget may increase slightly compared to 2006 and may reach 1% of the GDP. This is mainly caused by the declining surplus in the primary balance, which more than offsets the decline in interest expenditures caused simultaneously by declining interest rates and debt level.

The worsening of the primary balance is mainly due to the sharp increase in fiscal expenditures accompanied by somewhat smaller primary revenues than in 2006. The rise in expenditures reflects pre-election spending and the impact of ongoing structural difficulties (like social security deficits and problems in central government administration). The shortfall of primary revenues is partly linked to the weaknesses of tax collection, which was especially visible in case of VAT and also the special consumption tax

Turkey's debt ratios have improved markedly, with the public debt to GDP ratio falling from 106.1% in 2001 to 63.1% in 2006. Due to the fast rise in nominal GDP, decline of interest rate level and associated interest rate expenditures, the ratio of public debt to GDP may decline to 59% in 2007. General government debt is expected to further decline gradually reaching at the end 55% of GDP in 2008.

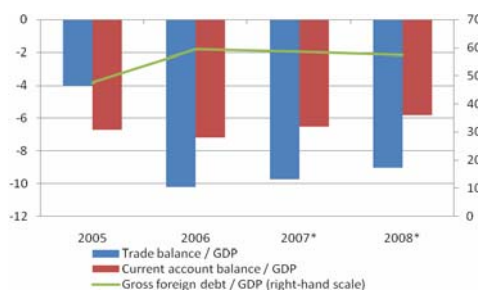
The government has been making progress in lengthening the average maturity and swapping foreign denominated into lira denominated debt, which is expected to reduce its vulnerability to interest and exchange rate volatility. Enhanced exchange rate stability and declining interest rates may decrease interest expenditures on public debt.

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



Note: f = forecast; Source: Eurostat, CBTR

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



Note: f = forecast; Source: Eurostat, ECB

External balance

After remaining around USD 1-2 billion for years, FDI inflows accelerated sharply in the last years. Inward FDI amounted to USD 9.8 billion in 2005 and USD 20.2 billion in 2006. Although big individual privatisation deals contributed to the acceleration of inflows, the private sector deals were the main driving force behind these inflows. The sharp rise in FDI inflows confidence of foreign investors in the country's long-term competitiveness and growth prospects, the improvement of the business environment in Turkey and the benefits of the EU accession process.

FDI inflows have accelerated in the beginning of this year and while somewhat slowed down in relation to the uncertainties caused by the election, they are expected to reach USD 23 billion over the whole year, the best result in several years. The significant inflow of FDI has boosted private sector investments, increased the competitiveness of exports and has contributed to the growth of exports. As a result of these inflows, FDI will be overall able to cover around 8% of the current account deficit both in 2007 and in 2008.

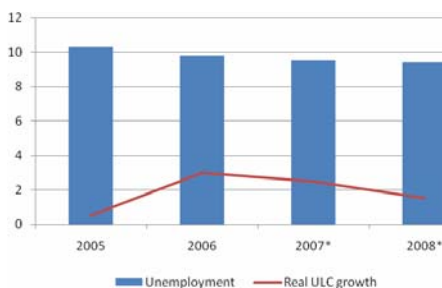
The current account deficit has been growing in recent years,

notwithstanding the mentioned growth and structural changes of exports. While the rise of exports in recent years has been very strong, import demand increased faster than export supply, leading to worsening of trade and current account deficit.

The two main reasons behind the fast rise in import demand have been the recovery of domestic demand after the stabilisation policy and the increase in oil prices. The net revenues from tourism served to reduce the negative effect of trade balance on the current account and contributed to small current account deficit.

Labour market

Unemployment and real ULC growth (%)



Note: f = forecast; Source: Eurostat

The participation rate in Turkey is 47%, and this has been slightly increasing as fast growth has resulted in employment creation reaching 1.5% since 2004. The beneficial effects of fast GDP growth on labour market were also felt in unemployment, which declined from 10.7% in 2004 to 9.8% in 2006, the first year when it was below the threshold of 10%. But the growth itself is unable to solve labour market problems stemming from the need to absorb Turkey's rapidly growing population as well as the effects of restructuring in the economy.

Overall, in 2007 and 2008 1.3-1.4% increase in the employment rate may be expected, and unemployment will remain slightly below 10%. In the short-term the positive effect of real GDP growth may prevail and unemployment is expected to decline in 2007 to 9.5% and to 9.4% in 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
Nominal GDP (TRL bn)	486.4	559.5	643.5	705.5
Real GDP growth (%)	7.4	6.1	5.0	5.0
Private consumption (%)	9.1	7.8	3.0	4.5
Public consumption (%)	2.4	11.2	4.0	3.0
Investments (GFCF, %)	24.1	11.3	9.0	8.0
Exports (%)	8.5	5.2	6.0	6.5
Imports (%)	11.5	6.4	6.0	5.5
Annual average inflation (%)	5.8	10.7	8.5	5.8
Discount rate (O/N borrowing rate, end of period, %)	14.0	18.0	17.5	16.5
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)	1.67	1.80	1.82	1.85
Exchange rate (TRL / EUR, end of period)	1.61	1.89	1.85	1.85
General government balance / GDP (%)	-1.2	-0.8	-1.0	-0.8
Public debt / GDP (%)	69.5	63.5	59.0	55.0
Trade balance / GDP (goods and services, %)	-4.0	-10.2	-9.7	-9.0
Current account balance / GDP (%)	-6.7	-7.2	-6.5	-5.8
Gross foreign debt / GDP (%)	47.5	59.5	58.5	57.5
Unemployment (%)	10.3	9.8	9.5	9.4
Real ULC growth (%)	0.5	3.0	2.5	1.5

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

Sources: IMF, Eurostat, CBTR

Special topic – Current account trends in the Western Balkans

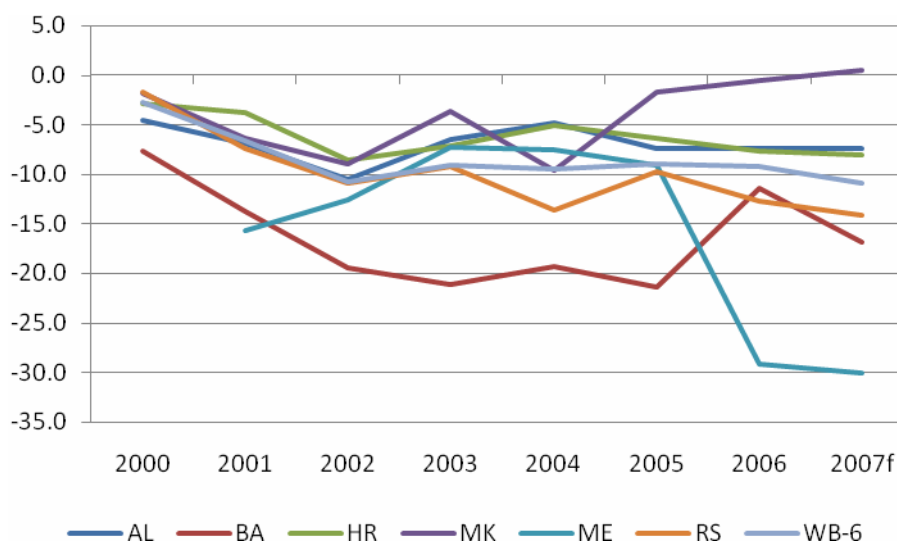
Introduction

In the Western Balkan countries macroeconomic environment improved significantly during the last years of this decade. Economic growth accelerated to 5-6% in almost all countries in the region, inflation was reduced to 2-3% in most countries and fiscal position remained at a manageable level. However, the countries in the region have to face with two significant macroeconomic challenges in recent years. One of them is the extremely high unemployment and low employment rate. The average unemployment rate is 20% in the region and it even exceeds 30% in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia as well, according to the official statistics. Besides high unemployment, current account deficit causes problems in these economies. This article tends to review and summarise the main processes related to external imbalance in the region.

External imbalances

In 2000 current account balance was in deficit in all Western Balkan countries, however, the deficit exceeded 5% of GDP only in case of Bosnia and Herzegovina. The region's average current account deficit reached only 2.8%. As economic growth returned to region in the new millennium current account balance started to deteriorate. Since domestic demand contributed significantly to the acceleration of GDP growth, it had a negative impact on the current account balance. Increasing domestic demand was the main engine of the growth of imports. On the other hand, the industry sector's restructure process and privatisation progressed slowly and these countries had to compete with more competitive economies in the neighbouring region which resulted in lower presence of foreign investors. Accordingly, the export sector in these economies remained relatively weak which could not contribute to counterbalance the import boosting impact of high domestic demand.

Evolution of Current Account deficit in the Western Balkans, 2000-2007* (% of GDP)



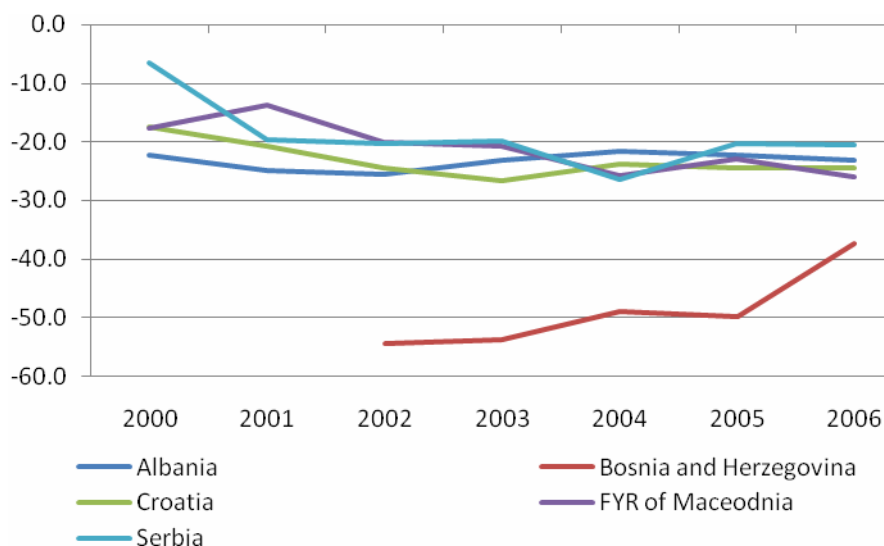
Note: * f - forecast; Source: national banks, ICEG EC

In 2006 the picture changed significantly and the average current account deficit increased to 9.2% of GDP. The largest worsening of the current account balance was observable in Serbia between 2000 and 2006. Current account deficit increased from 1.7% to 11.6% of GDP, or it increased from less than EUR 500 million to EUR 2.8 billion. However, the highest current account deficit was achieved by Montenegro, where CA deficit is close to 30% of GDP. Besides Montenegro and Serbia, the current account deficit exceeded the 10% threshold in

2006 in Bosnia and Herzegovina as well. There was only one country in the region which was able to achieve significant improvement in current account balance, namely the former Yugoslav Republic of Macedonia. While CA deficit went gradually up close to 10% of GDP in 2004, current account is expected to be in a surplus in this year. However, external imbalance is expected to increase in all the other economies in 2007.

Analysing the main components of the current account balances in the region one can easily notice that the main reason why current account balances have a huge deficit is the large deficit of trade balances. Foreign trade deficits reach 20-40% of GDP in these economies which reflect well the weak export structure of the WB countries. A few years ago trade deficit exceeded 50% of GDP, while it declined to under 40% in recent years. The lowest deficit was reached in Serbia where trade deficit slightly exceeded the 20% threshold (20.4%).

Evolution of trade balance of goods in the Western Balkans, 2000-2006 (% of GDP)



Source: national banks, ICEG EC

After transition the companies operated in these countries lost their former traditional export markets and had to face with a more competitive international environment. In line with the liberalisation process import of goods started to increase while the performance of export sector lagged behind due to slow progress in reforms and privatisation and to the not so favourable political and business climate in the region. As a result import increased gradually while export started to recover significantly later. In the new millennium export of goods increased by 10-20% annually while the growth pace of imports also reached 4-20% in these economies. That is, the growth pace was almost equal in case of export and import, however, the significant difference between the nominal value of export and import resulted into widening trade balances, except for Bosnia and Herzegovina.

Regarding the other components of the current account, it should be mentioned that services balance and current transfers also play an important role in these economies. In case of Croatia, a huge amount of money pours into the economy each year via tourism sector. Accordingly, services had a surplus of close to 17% of GDP in 2006. Services balance has a significant surplus (5% of GDP) in Bosnia and Herzegovina as well, while the role of tourism is increasing in Montenegro too.

Concerning current transfers, it is a considerable counterbalancing factor mainly in the smaller, less developed Western Balkan countries. While current transfers reach 3-10% of GDP in Croatia and Serbia, it is more significant in the other WB countries reaching 14-25% of GDP. It is noticeable that 25% of the GDP is transferred from abroad to the population and to the government. Basically, the largest part of this component is the transfers of the workers employed abroad who send back money to their families. To put it in another way, these transfers finance partly the significant import of goods of these economies.

It is also worth reviewing the evolution of foreign direct investment inflows in these economies since this element is a desirable financing method of current account deficit. During the analysed period (2000-2006) foreign direct investments reached 4-6% of GDP in average. Accordingly, FDI was able to finance only a small part of the current account deficit. The two larger countries were able to exceed 5% of GDP while the other smaller economies reached only 4-5% annually.

To compare the WB countries to Central and Eastern European countries, it is worth mentioning that in the more advanced CEE Member States export sector – and foreign direct investments - played a key role in economic growth in course of the last 15-20 years, accordingly trade balances evolved in a more favourable path. Consequently, trade balances had and has a lower CA deficit in the Visegrad countries. However, other components, such as current transfers have smaller contribution to the development of the current account balance in comparison with the WB countries.

Conclusion

The big question is if current trend is sustainable or not. As it was mentioned current account deficits exceed 7% in all countries except for the former Yugoslav Republic of Macedonia and are above the 10% threshold in Bosnia and Herzegovina, Montenegro and Serbia. One can observe that the trend is worsening; during the last six years current account deficit increased from less than 3% of GDP to almost 10% in average due to widening trade deficit. The other components of the current account were able to counterbalance only partly the huge deficit and foreign direct investments also remained moderate in this period. In the near future current trend is not expected to change. Economic growth is expected to be fuelled by consumption and investments which boost imports, while the recovery of the export sector is a slow and gradual process. On the other hand, the monetary policy has limited influence on these factors since fixed or quasi fixed exchange rate regimes were applied in most WB countries in the region. Accordingly, fiscal policies need to be extra cautious not to overheat the economy with increasing public spending which may result in further deterioration of the current account balance. It is clear that current situation is challenging and this issue remains one of the key macroeconomic problems of the region in the future years.

- Péter Bilek -