



Quarterly Forecast on the Western Balkans and Turkey

Winter 2007



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Regional overview

Western Balkans

Despite political climate remained tense in most Western Balkan countries emphasis shifted towards foreign politics in almost all countries. April Summit of NATO is approaching where countries from the region can be invited to join the organisation. In line with that, name dispute between the former Yugoslav Republic and Greece continues. Montenegro signed Stabilisation and Association Agreement with the EU. And last but not least, the Kosovo issue is still not decided.

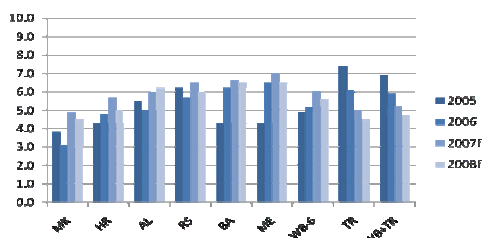
Economic growth accelerated significantly in 2007 according to our expectations. Real GDP growth reached 6.1% in average in the Western Balkan countries. It was 0.9 percentage point higher than that in 2006. Gross domestic product growth exceeded 6% in four out of the six WB countries. The still rapid 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. In 2008 slight moderation of economic growth is expected. Accordingly average economic growth will decelerate to 5.6% in the WB countries, which still can be considered as high.

In line with global trends, food and energy prices increased significantly in the WB countries as well. Besides, the extremely warm and dry summer in 2007 had a severe negative impact (via droughts and wildfires) on the domestic food supply in most WB countries. Due to the aforementioned factors inflation accelerated in most countries in the region in course of the second half of 2007. Although, annual average inflation rates remained unchanged or increased slightly compared to the previous year, the limited impact of significant energy and food price hikes was basically due to the fact that these factors contributed negatively to the evolution of inflation only in the second part of the year. However, it results that inflation is not expected to decline significantly in the first half of the year due to base effect. Accordingly, we expect that 2008 annual average inflation will reach 4.4%, slightly higher than in 2007.

Fiscal positions are estimated to have worsened 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. It is worth mentioning that more and more countries in the region apply low tax rates and /or flat tax regime in order to improve their business climate and enhance economic growth.

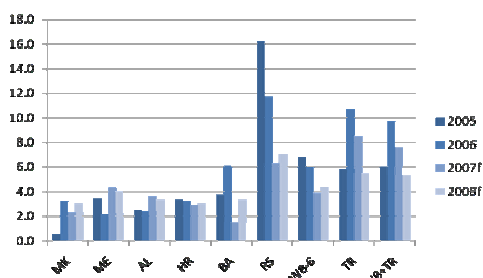
Still budget balances remained well under 3% of GDP in almost all

Real GDP growth (%)¹



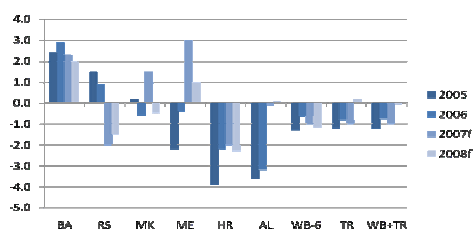
Note: e = estimation, f = forecast; Source: national banks and statistics institutes

Inflation (%)



Source: national banks and statistics institutes

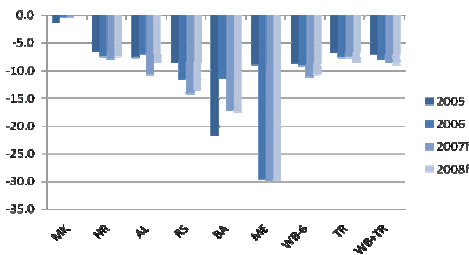
Fiscal balance (% of GDP)



Source: national banks and statistics institutes

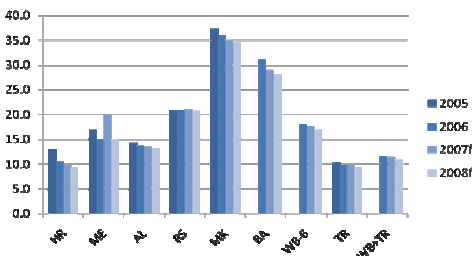
¹ Abbreviations: AL – Albania, BA – Bosnia-Herzegovina, HR – Croatia, MK – FYR of Macedonia, ME – Montenegro, RS – Serbia, WB-6 – Western Balkans (averages weighted by nominal GDP), TR – Turkey, WB+TR – Western Balkans and Turkey

Current account balance (% of GDP)



Source: national banks and statistics institutes

Unemployment (%)



Source: national banks and statistics institutes

countries, and surplus was achieved in Bosnia and Herzegovina and Montenegro. In 2008 no significant shift is expected and WB countries' budget balances remain on their 2007 level.

External imbalance remained one of the key macroeconomic issues in the WB regions in 2007 as well. Current account balance deteriorated in almost all WB countries. The average CA deficit increased to 11.3% of GDP from 9.2% in 2006. The increasing current account deficit was mainly due to the widening trade deficit in these countries. Imports were boosted by high domestic demand, namely consumption and investments. The only exception where current account deficit remained unchanged was the former Yugoslav Republic of Macedonia. In the fYROM export sector performed well in 2007 and export growth exceeded the growth pace of imports. In 2008 we expect that external imbalance remains a key issue and current account balances will improve only slightly in this year.

Unemployment remained high but has been decreasing gradually in course of 2007 in the WB countries. In average unemployment rate decreased from 17.9% in 2006 to 17.6% in last year. Decreasing unemployment was supported by dynamic economic growth and improving business climate which resulted in the decreasing role of informal sector. It is also worth mentioning that labour costs increased considerably as well, therefore consumption was boosted by growing incomes of households.

In 2008 we expect that last year's tendencies will continue and employment and unemployment figures will improve further. Accordingly, unemployment rate in average can go down to 17% in the WB region.

Turkey

GDP in Turkey decelerated in 2007 compared to the 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 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. Import growth will not be compensated by export growth as exports will be negatively affected by the stronger Turkish Lira and slowdown in the growth of Turkey's main export markets. In line with economic expansion, employment is forecast to increase by about 1.5% in the coming years. This will lead to a gradual reduction of unemployment rate from 9.8% in 2007 to 9.4% in 2008.

In the first three quarters of 2007, inflation remained within the uncertainty band set around the path consistent with the inflation target of the Central Bank. In the last quarter of the year, supply-side shocks (drought and hikes in energy prices) and the adjustments in administered prices led to stagnation in the disinflation.

In 2008 some budgetary surplus is projected as a result of gradual fiscal tightening and falling interest rates. General government debt is expected to further decline gradually, to 51% in 2008.

Albania

Energy shortage outlasts and slows the production. However, economic growth shows smooth speed-up by FDI. Inflation quickens by the world market price impacts but the central bank can control it. The increasing trade deficit creates serious risk. The sinking trend of employment seems to have broken in 2007 after more than a decade, and has got to an upward path.

Political developments

The European Commission announced that it will provide Albania roughly EUR 200 million to help the country reform its economy and judiciary sectors. The programme will be implemented through 2009. Thousands of opposition party supporters took part in a rally in downtown Tirana on 21st of December, accusing the government of being responsible for the energy crisis, water shortage, low salaries and pensions, and large-scale corruption in the country.

Albania technically proved the readiness for NATO membership in a NATO and Partnership for Peace exercise. That expresses the Albanian willingness to join the NATO. However, the Parliament surveys the position of the public prosecutor as he failed in the act against organised crime and endangered the cooperation with the EU and the NATO.

Growth

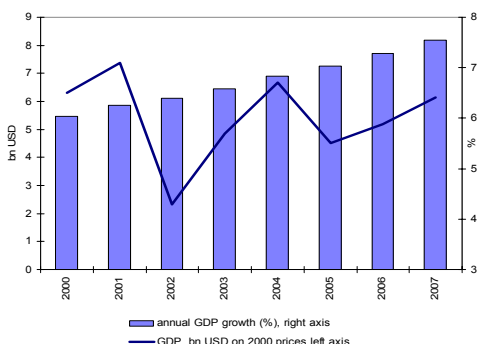
To attract foreign capital, the rate of corporate tax was halved since 1st of January 2008, from 20% to 10%, just as the current single rate of personal income tax. Only the same rate of Serbian corporate income tax can compete with so low tax burden in case of capital attraction. Besides, companies can borrow land for factory and public works and services for symbolic price, 1 Euro. Since 2008, the possibility is open to create international trade zone. However, the spread of energy shortage, the corruption and the very underdeveloped level of infrastructure keep the risk high on direct investments. The energy production kept decreased by 30%, the reserves by 25% compared to 2006 figures. So far, only the 1.8 billion barrels potential oil resources caught the attention of foreign direct investors significantly.

The ministry of economic and energy affairs contracted with the biggest Italian energy company, Enel SpA to build a coal power plant with 1300 MW capacity in Albania. The IMF considers the instable financial position of the state-owned energy monopoly (KESH) to be the root of energy shortage, and supposes privatization to stabilize the energy service.

Both the second and third quarter of the year were characterised by a dry and unfavourable weather for agricultural production, which caused the reduction of supply of agricultural products.

Economic growth has remained strong at about 6% despite the energy crisis and regional drought, but cost pressures have added to inflation and fiscal risks are on the horizon. Stronger-than-projected exports and manufacturing activity have offset the negative impact of the energy crisis and drought on growth. The growth outlook remains positive but serious world market challenges

GDP and its real growth



Source: WorldBank

will have to be treated.

Monetary developments

Bank of Albania prepares to launch the new, inflation targeting monetary regime at the beginning of 2009. The New set of rules for operational framework will be introduced in the first half of 2008 to regulate the financial market, and it aims to increase the efficiency of the inter-bank borrowing market, it targets thinking on the margin behaviour of the banks by reducing the frequency of treasury bills auctions, rearranging required reserves regulation and introducing a prime rate. The increase and consolidation of the banking activity is accompanied by a rapid growth of credit to economy. This rapid credit growth has become the challenge of the moment.

Albania handled the world market price shock better than other countries in the Western Balkan. Headline CPI inched down from a peak of 4.4% y-o-y in September to 3.5% y-o-y in November. The fastest price growth rates remained in the food and alcohol and tobacco categories, with these two groups also making the highest contributions to the headline numbers. 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.

During the third quarter of 2007, Construction Cost Index reached 126.9 (Q.IV 1999 = 100) signing an increase of 0.2% against the previous quarter. The Construction Cost Index has signed an annual rate of 2.1%. In the same period of year 2006, this change was 1.8%. The timely policy action and well-established credibility of the national bank should help bring inflation back to the target range.

In course of the third quarter of 2007 money supply grew by about 17%. Credit to business grew by over 50% in August, accounting for 16% of the GDP. Credit to households grew annually by about 70 per cent. There is structural change in credit portfolio relates to the upward trend towards longer-term lending, which consisted of 50 percent or more than total lending. The spread between interest rates of deposits and credits remains high.

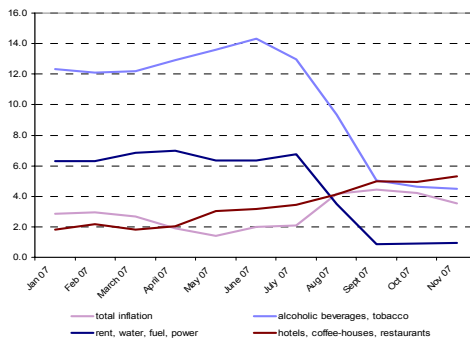
Moody's started to rate Albania and the ratings are: Ba1 for foreign-currency bonds and B1 for the government's debt obligations, B2 for foreign currency bank deposits, A3 for local currency and Baa1 for local currency bank deposits.

Fiscal policy

Progress continues in structural reforms. Steps to broaden more the tax base, together with other revenue-compensating measures, will allow the government to reduce the corporate income tax rate in a sustainable way. This and the planned improvements in the taxpayer registry and social security administration will help reduce informality and allow the economy to have benefits from the ongoing financial market development.

The Albanian budget balance is moving towards surplus. Knowing the revenue and expenditure data till November, it has a thin possibility, that even in 2007 the fiscal policy produced an insignificant surplus. In case of 2008, the expectations must take

Year-on-year inflation (%)



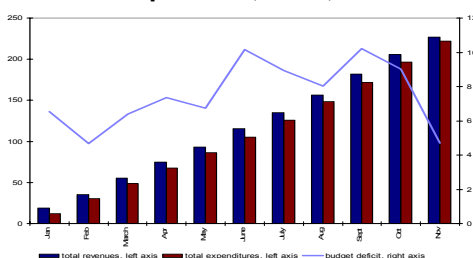
Source: INSTAT

Interest rates, January 2008

TRIBID Tirana Interbank Bid Rate	
1-month	5.20%
3-month	5.28%
6-month	5.86%
12-month	6.55%
TRIBOR Tirana Interbank Offer Rate	
1-month	7.00%
3-month	7.31%
6-month	8.01%
12-month	8.63%

Source: Bank of Albania

Fiscal position, 2007, bn ALL

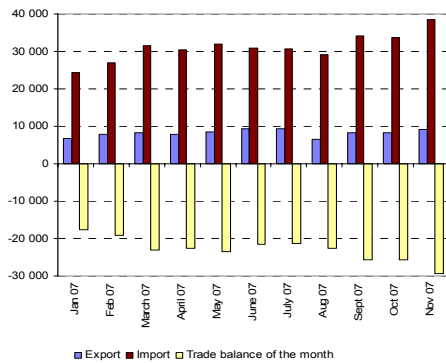


Source: Ministry of Finance

into account the tax cuts and its compensation by increasing speed of FDI inflow, thus the balance can be expected close to zero.

External balance

Monthly trade statistics (mn ALL)



Source: INSTAT

For the first nine-month period of 2007, the external sector was characterised by increasing current account and trade balance deficit, accounting for 10% and 27% of the GDP, respectively. Capital inflows have been sufficient for compensating the current deficit, enabling an overall positive balance sheet at 172.7 million EUR.

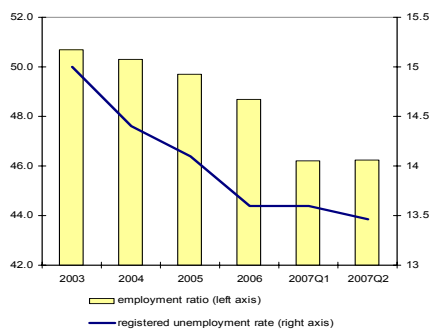
Export grew significantly by about 28% during January – August 2007. Both capital and intermediate goods imports have grown by about 30% during the first semester.

The share of EU in trade reached 60.7%. The main trade partners are still Italy and Greece. The share of Italy in export is 83.3% in import 50%, the share of Greece is 7.3% and 24.4%.

The main expectable developments in the external sector: (1) Intensive activity in the external sector, reflected in the increase of income and current expenditures. (2) Considerable growth in merchandise exports and imports. (3) Deepening of the current and trade deficit. (4) Increasing foreign capital inflows in the form of foreign direct investments. (5) Increasing financial liabilities to non-residents, created in the form of increased deposits of non-residents with the banking system. (6) Increasing foreign reserve stock of the monetary authority.

Labour market

Labour market trends (%)



Source: INSTAT, ICEG EC calculation

The level of wages is still extremely low in comparison with Central and Eastern Europe. An average white collar worker earns EUR 150 per month, a factory worker between EUR 80-120. The average pension is EUR 50. The official unemployment rate is 13.5%, but many from the population are left out from the employment statistic. That is why the employment ratio is much more informative. The first half of 2007 performed a threatening fall in the rate of employed people compared to the active population. Its trend is permanently declining from the peak of 1995 with 62,5%, in 2000 it was still 55%, but in the 2nd quarter of 2007 it was only 46.2%.

In the second quarter of 2007, the number of employed people fall to 1078.1 thousand from the 1080.4 thousand of the first quarter in 2007. Beside others, the significant cut of number of public employees with 700 persons is responsible for the decrease. However, the number of employed persons in the non-agriculture private sector is increased with 900 employees. At the end of the second quarter, the number of officially registered unemployed persons decreased from 147,708 thousand persons to 145,143 thousand, so the level of unemployment for this period achieves 13.46%.

The level of average amount of payment for family under social protection had a slight decrease compared to the first quarter from ALL 4368 to ALL 4320. The minimum wage is ALL 1400. The average monthly wage in the public sector is ALL 31850.

The inadequate level of FDI caused by the high risk on capital investments is against the improvement of living standards, even

though the fraction of the population whose real per capita monthly consumption is below Lek 4891 (in 2002 prices), fell from 25.4% in 2002 to 18.5% in 2005. This means that roughly 235,000 out of about 800,000 poor people in 2002 were lifted out of poverty. Extremely poor population, defined as those with difficulty meeting basic nutritional needs, decreased from about 5% to 3.5%.

The employment got higher in the second quarter of 2007 than it was in the first one. The sinking trend of employment level may have been broken after more than a decade.

Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
Nominal GDP (ALL mn)	837,000	896,000	983,000	1,078,000
Real GDP growth (%)	5.5	5.0	6	6.2
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	24.2	24.7	26.4	27.1
Exports (%)	12.0	13.0	27.0	17.0
Imports (%)	13.0	16.0	25.0	16.0
Annual average inflation (CPI, %)	2.5	2.4	3.6	3.3
Discount rate (end of period, %)	5.00	5.50	6.00	6.25
Money market rate (3-month Treasury Bill, %)	5.75	6.25	6.06	6.00
Long-term interest rate (10-year gov't bond, %)	NA	NA	-	-
Exchange rate (ALL / EUR, average)	124.2	123.1	123.9	122.5
Exchange rate (ALL / EUR, end of period)	122.6	123.8	121.8	122.5
General government balance / GDP (%)	-3.6	-3.2	-0.1	+0.1
Public debt / GDP (%)	56.7	55.7	54.5	53.7
Trade balance / GDP (goods and services, %)	-23.5	-23.4	-28.5	-28.5
Current account balance / GDP (%)	-7.7	-7.2	-10.8	-8.5
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

GDP growth is expected to exceed 6% in the forthcoming years. Inflation is supposed to increase over 3% in 2008. Following the improvement of 2006, external imbalances are expected to have significantly widened again in 2007.

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. However, despite the attempts of the new High Representative, police reform has still not been completed. Negotiations continue, but so far draft proposals have been rejected. Solving this issue is considered as a major precondition for signing the EU's Stabilisation and Association Agreement (SAA).

In early 2008, constitutional reform negotiations are supposed to be resumed, but taking into consideration the political climate, only limited results can be expected.

In case Kosovo unilaterally declares independence, political noise can increase in the Serbian entity of BH, Republika Srpska (RS), and independence ambitions may be fuelled.

Growth

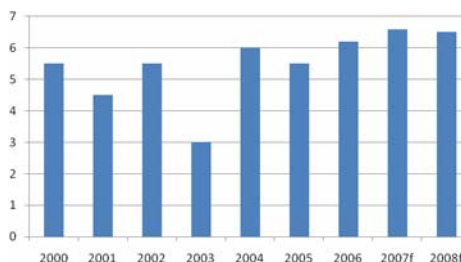
Due to the structural weaknesses, the country's economy is vulnerable to changes regarding the external conditions. Still, following the 6.2% real GDP growth of 2006, according to estimations, in 2007 the strong domestic demand and the favourable external conditions added up in a GDP growth somewhat above 6.5%. Likewise in 2006, in 2007 as well the economic growth was underpinned e.g. by the good performance of the manufacturing industry, the high level of retail sales, investment activity and private consumption. The latter was a result of the strong credit and wage growth as well. Taking into account the continuation of the above mentioned effects, in 2008 the growth is expected to amount around 6.5%.

Underpinned by the high growth of mining and processing industry, in the first three quarters of 2007, industrial production volume grew by 11.6% in FBH (Federation of BH), compared to the same period in 2006. On the other hand, in RS industrial production stagnated with a rate of 0.1%, partly due to the shortfall of the electrical energy production.

Monetary developments

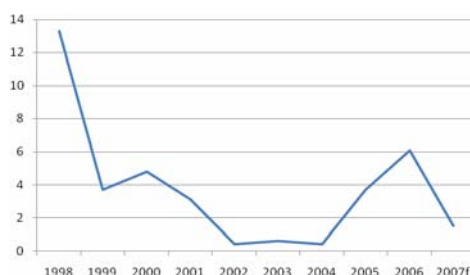
VAT introduction in January 2006 had a one-off effect on inflation and caused a huge base effect for 2007. Following the 6.1% CPI (Consumer Price Index) in 2006, the annual inflation was 1.6% in September and is estimated to have amounted to 1.5% for the total of 2007. However, taking into consideration the disappearing base effect, the high level of credit growth, the generous wage policy,

Real GDP growth (%)



Note: f = forecast; Source: CBBH

Consumer price index (yoy, avg, %)



Source: CBBH

thus the increasing public and private consumption, the planned adjustments of regulated prices, all combined with the growing energy and food prices, significant external and domestic inflationary pressure can be expected. On the other hand the currency board regime helps to underpin price stability. All in all, CPI is expected to somewhat exceed 3% in 2008.

The pace of the credit growth is demonstrated well by the figures of October, when lending to citizens increased by 30.3%, while to companies it grew by 31.5%. In September KM 1.8 billion of loans were allocated to companies and KM 921 million to households. As an attempt to mitigate the rapid credit growth, the central bank has made the decision to increase the required reserve rate from 15% to 18% from the 1st of January 2008. The interest rate policy remains unchanged, thus 1% fee is paid on the required reserves.

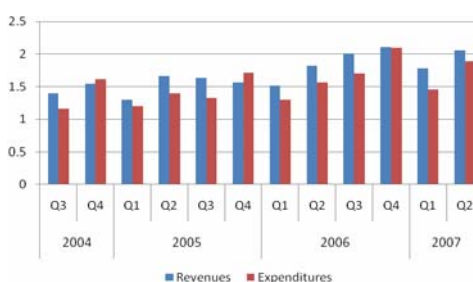
By the end of 2007, the national bank's foreign exchange reserves amounted to KM 6.69 billion, which is a growth of 22.75%, compared to the previous year.

Fiscal policy

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. During the first semester 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 – was expected for the second half of 2007, thus the surplus was probably lower than in the previous year. According to estimations, the budget balance per GDP exceeded 2% in 2007. Although the 2008 state budget law has not been approved yet, further fiscal easing is expected, thus this rate will probably continue to decline in the forthcoming year.

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



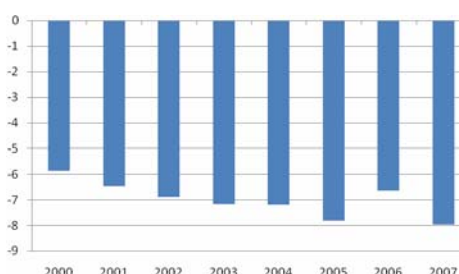
Source: CBBH

External balance

Following the external balance's improvement in 2006 - which was among many factors partly a result of the one-off effect of the VAT introduction - trade deficit and current account deficit significantly widened in 2007. However, exports increased by approximately 15%, due to favourable domestic and external developments. The export growth was mainly underpinned by the good performance of the metal and machinery sector and wood products. On the other hand, as a result of the already mentioned strong domestic demand, imports showed an even higher growth; 22% compared to 2006. As a result, in 2007 trade deficit increased by 26.5% and reached KM 7.9 billion.

In the first half of 2007, current account deficit reached KM 780 million. The large amount of trade deficit was mainly covered by current transfers that reached a balance of KM 821 million.

Trade balance of goods (KM, billion)



Source: CBBH

To sum up, in 2007 external imbalances widened, resulting in a trade deficit around 38% of GDP and current account deficit per GDP exceeding 17%. According to expectations, the mentioned trends will continue, causing further deterioration of external imbalances.

As for the FDI, following the low level of FDI inflow in 2006, in the first half of this year BH 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. 2008 can also show higher levels of FDI inflow than 2006, due to some upcoming privatisation transactions, e.g. BH's largest exporter company; Aluminij Mostar.

Labour market

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

Source: CBBH

In September 2007 the average annual nominal growth of wage was 10.1% in BH. In September 2007 the average net wage was KM 666 in FBH, KM 598 in RS and KM 688 in Brčko District. Compared to the same period in 2006, the growth rate was 9.4%, 11.1% and 1.9% respectively, which represents the trend of decreasing differences.

According to the preliminary data of the 2007 LFS (Labour Force Survey), the unemployment rate decreased slightly compared to the data of 2006; from 31.1% to 29.0%. The unemployment rate shows significant differences between the entities; 31.1% in FBH and 25.2% in RS.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (BAM mn)	16,930	19,110	20,780	22,900
Real GDP growth (%)	4.3	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
Imports (%)	13.6	4.4	25.5	20
Annual average inflation (CPI, %)	3.7	6.1	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	-38.1	-36.8
Current account balance / GDP (%)	-21.8	-11.5	-17.1	-17.5
Gross foreign debt / GDP (%)	57.9	57.0	58.5	59.6
Unemployment (%)	NA	31.1	29.0	28.0
Real ULC growth (%)	NA	NA	-	-

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

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

Croatia

The rightwing HDZ formulated the new – Ivo Sanader led - government with assertive majority. Domestic demand driven, robust economic growth despite corrective quarterly paces. Continued disinflation with breaking inflation trend at the second half of 2007. Fiscal policy proved to be relatively strict despite good times. Current account deficit is still in rise despite the favourable service balance; the external debt is distressingly high, even if its structure is improving. With remarkable structural seasonality and by steady growth of wages, labour market indicators continue to be promising.

Results of Parliamentary Elections

Parties and coalitions	% of votes	% of seats
Croatian Democratic Union (HDZ)	36.0	43.1
Social Democratic Party (SDP)	30.8	36.6
Green-Yellow coalition of 5 parties, with seats won: Croatian Peasant Party (HSS) and Croatian Social Liberal Party (HSLs)	6.4	5.2
Croatian People's Party (HNS)	6.7	4.6
Other parties and coalitions (less than 3 seats)	20.1	10.5
TOTAL	100.0	100.0

Political developments

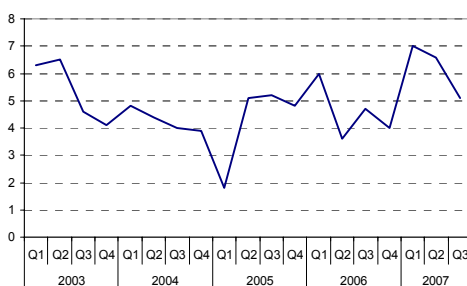
Parliamentary elections in Croatia were held on 25 November 2007. The results are in correspondence with our earlier expectations, as none of the parties could have outright majority that meant the role of small allies remains important.

The governing Croatian Democratic Union (HDZ) won the elections with 36% of votes and 43.1% of seats (66 representatives out of 153). The Social Democratic Party (SDP) collected 30.8% of votes and 36.6% of seats. The right of formulating government was given to the right wing party by the President Stjepan Mesic

On 12 January 2008, the parliament voted confidence for the new government led by the Prime Minister Ivo Sanader. The government is composed of 82 deputies of the Croatian Democratic Union (HDZ), the Croatian Peasant Party (HSS), the Croatian Social Liberal Party (HSLs) and the Independent Democratic Serb Party (SDSS). This means an assertive majority for the future.

The negotiations with EU are expected to accelerate after some reasonable slowdown because of elections. There is increasing pressure from the EU to step forward concerning fisheries, judiciary and fundamental rights.

Real GDP growth (quarterly, yoy, %)



Source: CROSTAT

Growth

By the current data there is no sign of slower real GDP growth in 2007 as compared with 2006, when Croatia grew by 4.8%. In the third quarter of 2007, in line with the weakening global business cycle and seasonal factors, the real GDP growth was 5.1%, compared to the same period of the previous year (7.0% in the first and 6.6% in the second quarter).

As in the previous periods, growth in the third quarter was mainly driven by domestic demand, particularly by private (6.2%) and public (4.4%) consumption parallel with moderation of investment activity (5.7%). The investment, measured by gross fixed capital formation seems to stabilise in this moderate pace of growth. While its structure is favourable (mainly private sector investments).

As for external activities' contribution to real growth, exports and imports increased by almost similar rates (7%). This reflects however favourable processes, as the third quarter used to be strong from the point of view of external balances. More than one third of annual exports is traditionally realised in this period, mainly due to export of services (tourism).

On the production side, in the third quarter by seasonally adjusted data of real GVA growth the main contributors were manufacturing,

wholesale and retail trade, transport and communication and financial intermediation services. Agriculture performed worse, because of moderate production.

It is worth to devote some sentences to industry and tourism sectors. Industrial performance remained robust, as the real growth of value added in the third quarter remained high relative to total. However its robust pulling role moderated.

The industrial production was by 5.9% higher in the period from January to November 2007 than the production in the same period of previous year. Manufacturing (80% of total industrial production) shows robust results with its 7.2% growth. Mining and quarrying loses momentum. The industrial production increased particularly due to above average increase of non-durable consumer goods and capital goods production.

Especially after having investigated the third quarter growth, it is inevitable to look on the tourism sector. In January-November 2007, as compared to the same period of the previous year, the tourist arrivals increased by 8%, while nights spent by 6%. Domestic and foreign arrivals increased similarly, while the share of foreign arrivals in total is dominant (reaching 84%). Foreign tourist nights increased less than domestic ones, reflecting that the average spent night increased for domestic and decreased for foreign tourists. For the same period total turnover of hotels and restaurants increased by 14%.

Taking into consideration the domestic and particularly the worsening international factors our economic growth estimation for 2007 is 5.7%, while for 2008 we expect somewhat slower GDP growth, namely 5.0% in this year due to the adjustment of domestic demand factors.

Volume indices of industrial production

According to main industrial groupings	Structure (%)	Jan-Nov 2007 to Jan-Nov 2006 (%)
Intermediate goods	27.49	104.8
Energy	19.87	101.6
Capital goods	14.49	112
Durable consumer goods	2.48	116
Non-durable consumer goods	35.67	106.2
Total	100	105.9

Source: CROSTAT

Monetary developments

The global and the EU price developments changed the Croatian inflation trends as well. Fossil fuel price rise, global food price boom are the major factor have to be taken into consideration. Our earlier expectations on the risk of accelerating inflation were certified.

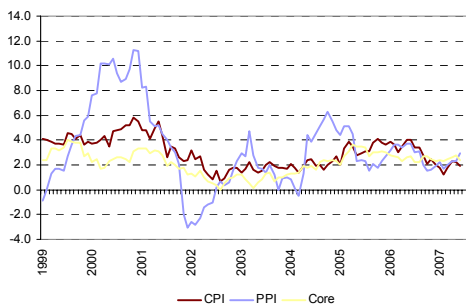
In December 2007, as compared to December 2006, that is, at the annual level, consumer price index (CPI) increased by 5.8%, and annual average inflation reached 2.9%. (CROSTAT) Even if our estimation for 2007 proved to be right, serious concerns have arisen about future developments.

Investigating the annual average inflation, the main contributors were, as mentioned before concerning international developments, food (27.7% of the basket, annual inflation 3.4%), clothing and footwear (8.45% of the basket, annual inflation 5.2%). But almost every category of goods indicated accelerating inflation, reflecting the global trends.

Producer price index (PPI) in December 2007, as compared to December 2006, increased by 5.8%, and the 2007 average was 3.4% higher than the 2006 average. This is a consequence of higher energy and intermediate goods prices. Both the manufacturing and electricity, gas and water supply prices became more expensive.

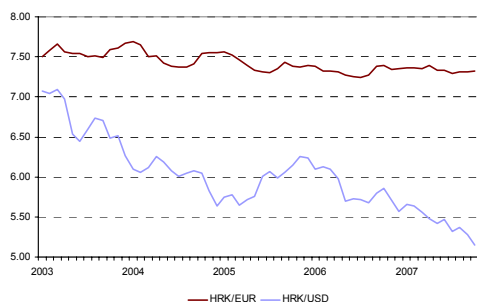
The disinflation process continued, however particularly due to external factors, the trend of inflation seems changing. This way we

Monthly price developments (%)



Source: CNB

Monthly exchange rates



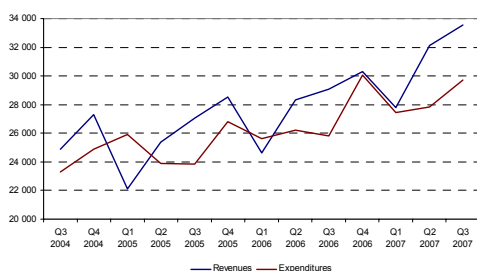
Source: CNB

modify our forecast for 2008, revising slightly upward annual average inflation to 3.2%.

Concerning exchange rate developments, 2007 shows significant appreciation of HRK/USD exchange rate, while the HRK/EUR was kept stable. The main determinant of it the continuously depreciating USD/EUR exchange rate. The CNB had to intervene several times (but fewer times as compared with previous year) in order to keep stable the national currency against the euro, last time when some appreciation pressure caused by increasing demand on domestic currency because of T-HT share purchasing.

Our expectations on nominal exchange rates are unchanged as the managed floating policy seems to be focused on stability against euro, while against the USD further appreciation is expected.

Quarterly consolidated budget revenues and expenditures (HRK mn)



Source: Ministry of Finance

Fiscal policy

High growth rate in 2007 stands for public finance processes. While final results of this year stood under the risk of parliamentary election generated irresponsible fiscal policy.

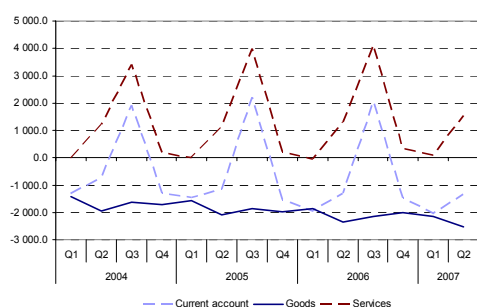
If investigating the most recent Ministry of Finance data (GFS) on consolidated general government, in the third quarter of 2007, revenues of last four months was by 11.9% higher than in the same period of 2006. Expenditures increased by 10.1%. On revenue side growth related improved tax collection (profit tax, VAT and social contributions), while on expenditure side social transfers mainly on health and pensions, and employee compensations.

The operating balance (revenues minus expenditures) relative to GDP was 1.8% in 2006, while after first three month of 2007 it was 3.1%. By our calculations – taking into consideration the usual pattern of public finances in the fourth quarters – 2007 can be closed by 2.4% operating balance.

Net lending-borrowing after first nine months reached only 0.5% of annual GDP because of very high net acquisitions of non-financial assets.

Depending on the data of last quarter in 2007 and final GDP data, the ESA-95 balance can be even better than last year. This finally can lead to decreasing general government debt.

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



Source: CNB

External balance

The main development of external economic activity in Croatia is the record-high real growth of exports of goods and services in the third quarter of the year. As it was mentioned in the growth section, this could contribute considerably to improve the trade and services balance, even if it seems unlikely that in 2007 current account and trade and services balances will be better than in 2006.

The import covered by export of goods reached 47.9% in the first eleven months of 2007 that is a worsening as compared with 48.3% for the whole previous year. In January-November 2007, as compared to the same period of 2006, exports of goods increased by 11.5%, while the imports by 10.4%. As it is natural by its share in exports, the contribution of manufacturing to increase of exports is remarkable (14.1%). The importance of exports after processing

diminished.

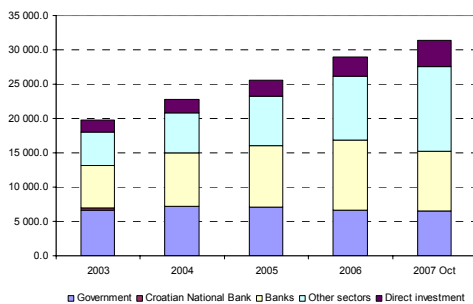
Trade of services keeps in relative equilibrium the development of current account balance. We expect that the third quarter from the point of view of final annual results is of great importance that can influence the overall performance. High GDP growth rate may improve its relative indicators as well.

The current account deficit is financed particularly by FDI, as after the first half of 2007, direct investments reached 5.8% of GDP that is 80% of FDI in 2006, mainly in connection with accelerated privatisation process.

In October, the gross external debt was EUR 31 353 million, that was at that time more than 84% of estimated nominal GDP. This happened mainly because of increase of direct investment and decrease of domestic banks and government related external debt relative to total external debt. The structure of the debt seems favourable, as considerable part of it is in long term debt and related to the private sector of enhanced external relations and increased direct investments. We still keep our forecast at 86% of GDP.

Current account deficit is still expected to be around 8.0% in 2007 and 7.6% in 2008, due to realisation of increased export potential and decreasing domestic demand on import products. The trade balance of goods and services is expected to be 8.1% this year that is likely to fell to 7.4% in 2008.

Gross external debt by sectors



Source: CNB

Labour market

Labour market processes experience gradual improvement due to favourable processes observed in the economy and some emphasised sectors.

By latest labour survey one can observe increasing activity and employment rates in the first half of 2007 if comparing with the same period in 2006. What is more important; unemployment rates - both the registered and the ILO-type ones – decreased.

The number of persons in paid employment increased by 1.8% in first eleven months of 2007 year-on-year and reached in November 1 189 085. The construction and the different service sectors are the main contributors. That is still in line with structural specialty and transitional position of the economy.

Registered unemployment rate reached in November 14.5% to total active population. As compared to the same month of 2006, this means a more than 13% drop in the number of unemployed, in terms of registered data.

On wage side, average monthly gross earnings increased nominally by 6.3% and in real terms by 3.8% in the first ten months of 2007, as compared to the same period of 2006. These processes reflect changing factor price competitiveness affecting unit labour costs, as productivity gains are growing more slowly.

The bright but moderating economic performance and the good prospects of manufacturing, construction and tourism sectors, even with increasing medium-run international challenges unemployment are continues to decrease: 9.8% for 2007 and 9.4% for 2008.

Main labour force indicators

Rates	I-VI	VII-XII	I-III	IV-VI
	2006	2006	2007	2007
Activity (%)	48.3	49.8	48.2	48.7
Employment (%)	42.6	44.5	42.8	44.2
Registered unemployment (%)	17.2	16.0	16.9	15.1
ILO unemployment (%)	11.8	10.5	11.2	9.1

Source: CROSTAT, Labour Force Survey

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (HRK mln)	231,349	250,590	273,000	296,000
Real GDP growth (%)	4.3	4.8	5.7	5.0
Private consumption (%)	3.4	3.5	6.0	4.4
Public consumption (%)	0.8	2.2	3.3	2.0
Investments (GFCF, %)	4.8	10.9	6.1	7.0
Exports (%)	4.6	6.9	6.5	5.9
Imports (%)	3.5	7.3	6.3	5.3
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	3.60	3.20
Long-term interest rate (10-year gov't bond, %)	4.3	4.4	5.25	4.30
Exchange rate / EUR (average)	7.40	7.32	7.32	7.20
Exchange rate / EUR (end of period)	7.37	7.34	7.32	7.22
Budget balance / GDP (%)	-3.9	-2.2	-2.0	-2.3
Public debt / GDP (%)	44.2	42.1	40.5	40.0
Trade balance / GDP (goods and services, %)	-7.1	-7.8	-8.1	-7.4
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	0,2

Note: f = forecast.

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

Former Yugoslav Republic of Macedonia

Economic growth accelerated compared to the previous year. Inflation increased slightly due to food and energy prices. Fiscal policy was adequate and external balance improved. Unemployment decrease as well but remained high.

Political developments

The name dispute is still not resolved between Greece and the former Yugoslav Republic of Macedonia. Talks continue in the first few months of the year and the demand for an agreement is increasing since April Summit of NATO, where the FYROM can be invited to join the organisation, is approaching.

Growth

In the third quarter of 2007 economic growth remained at its 'traditional' level. After having a 4% growth in the second quarter, gross domestic product increased by 4.2% in the third quarter in real terms. Accordingly, GDP growth reached 5.1% in the first nine months.

As in most other countries in the region, agriculture performed badly in the third quarter. Gross value added in agriculture decreased by 5.1% in the former Yugoslav Republic of Macedonia. As it was mentioned in our previous forecast, last summer was extremely dry and warm, and accordingly, frequent wildfires caused severe problems in mid-2007.

Industry growth remained low but it accelerated compared to the previous quarter. Gross value added in industry increased by 1.1%. On the other hand, GVA in construction and that in services increased dynamically.

According to the monthly statistics from the fourth quarter, industrial production growth accelerated further in the last quarter. Industrial production increased by 10.5% and 5.5% in October and November, respectively.

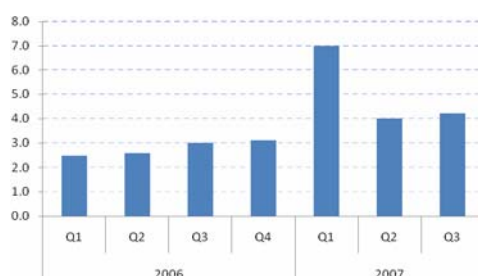
Due to improving industrial production we revise our forecast on economic growth. Accordingly, we expect that real GDP growth rate reached 4.9% in course of 2007. However, our expectation for 2008 is that economic growth will decelerate slightly and GDP will grow by 4.5% in this year.

Monetary developments

In 2007 inflation decelerated compared to the previous year. Annual average consumer price index was 2.3% in the former Yugoslav Republic of Macedonia. That was 0.2 percentage point higher than our previous forecast due to higher than expected food price and energy price increases. Besides, prices of other groups of goods and services also increased significantly in the last month of 2007.

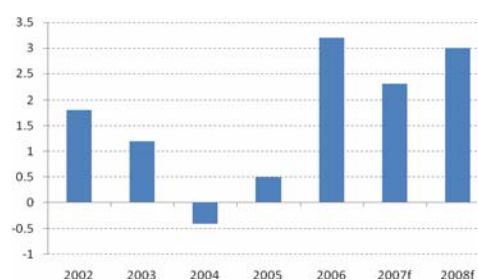
December prices of foods and non alcoholic beverages were 12.3% higher than that in December 2006, while housing, water, electricity, gas and other fuels prices increased by 5% as well. In addition in last month clothing and footwear prices jumped as well, by 3.2% compared to November. Accordingly, December/December inflation jumped to 6.1%, well above the annual average.

Real GDP growth (%)



Source: SSO

Annual average inflation (CPI, %)



Note: f = forecast; Source: SSO

Standard & Poor's credit rating on the former Yugoslav Republic of Macedonia remained the same in the second half of 2007. The foreign currency denominated sovereign credit rating of the country kept on being BB+ with stable outlook.

Due to significant increase in inflation, we expect that CPI will be higher than in last year in course of the first half. Last year's food and energy price hikes will have a negative impact on first half's inflation as well. Accordingly, we expect that 2008 inflation will be higher than that in 2007, and annual average CPI will reach 3%.

Fiscal policy

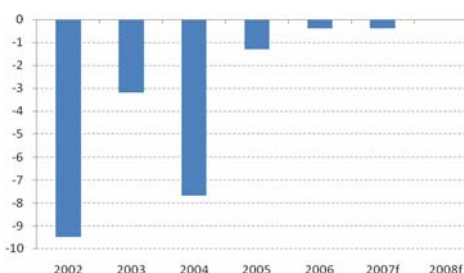
At the end of November government budget had a massive surplus. During the first eleven months budget surplus reached MKD 10.8 billion or 3.3% of GDP. The massive surplus was due to the higher than expected revenues and lower than planned expenditures. Revenues increased by 17.3%, of which taxes increased by more than 20%. Profit tax incomes increased by 25.9% despite of the fact that profit tax rate was cut from 15% to 12% at the beginning of 2007. On the other hand, 82.3% of planned (second revision of 2007 budget) expenditures was achieved until the end of November 2007.

Due to favourable development of budget balance public debt also decreased significantly in course of the year. According to our expectations, public debt per GDP ratio declined to 30% at the end of the year.

Usually, budget balance deteriorate in the last month of the year, however it is not expected that budget surplus turned into deficit. Accordingly, our forecast is that budget surplus reached 1.5% of GDP in 2007. For 2008 budget balance will be close to equilibrium again, our expectation is that budget deficit will reach 0.5% of GDP in this year.

External balance

Current account balance (% of GDP)



Note: f = forecast; Source: SSO, NBRM

External balance continued to have a surplus in the second half of the year as well. Current account surplus reached EUR 57 million or 1.1% of GDP at the end of October. Current account surplus doubled compared to the same period of the previous year.

The improvement of the current account balance was primarily due to higher current transfers which increased by EUR 80 million. Besides, services balance and incomes balance improved slightly as well.

On the other hand, foreign trade balance deteriorated somewhat, however, growth rate of export of goods was higher (28.3%) than that of import (21.6%). One of the key improvements of the Macedonian economy was that export sector performed quite well and accordingly, trade balance deteriorated only slightly and it 'helped' the improvement of current account. The key contributors to export growth were basic metals, food industry and textile industry.

Foreign direct investments decreased compared to the previous year. In the first ten month net FDI reached EUR 169 million while it was EUR 317 million in the corresponding period of previous year.

In 2007 we expect that current account balance was close to equilibrium since CA deficit reached 0.4% of GDP. We forecast that CA surplus turned into deficit in the last two months. Foreign trade

deficit remained high reaching 20.7% of GDP.

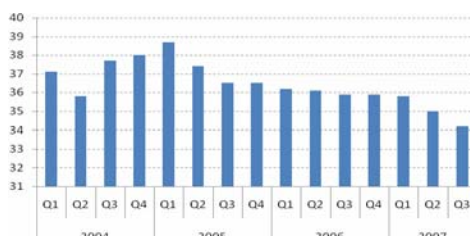
In 2008 we expect that last year's trend will continue and export sector will perform well. Accordingly, current account balance will be close to 0.

Labour market

Due to improving business climate and the decreasing role of informal economy employment rate was increasing further in the third quarter. Employment rate increased to 36.7%, while it was less than 36% in 2006. In line with that unemployment rate decreased to 34.2%.

In 2008 we expect that unemployment rate will decrease further in line with relatively stable economic growth. Accordingly, unemployment rate can decrease to 34.5% this year.

Unemployment rate (%)



Source: SSO

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (MKD mn)	284,226	303,305	325,500	346,300
Real GDP growth (%)	3.8	3.1	4.9	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	2.3	3.0
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	61.3
Exchange rate (MKD / EUR, end of period)	61.2	61.2	61.2	61.3
General government balance / GDP (%)	0.2	-0.6	1.5	-0.5
Public debt / GDP (GFS, %)	47.1	40.6	30.0	28.0
Trade balance / GDP (goods and services, %)	-19.0	-20.6	-20.7	-20.0
Current account balance / GDP (%)	-1.3	-0.4	-0.4	0.0
Gross foreign debt / GDP (%)	41.5	36.9	34.0	32.0
Unemployment (%)	37.3	36.0	35.0	34.5
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

Montenegro became one of the most politically stable countries in the region. The European Parliament ratified the Stabilisation and Association Agreement in December. That can accelerate foreign direct investments. Short-term economic prospects are highly favourable, yearly GDP growth rate is above 6%. On the other hand, current account deficit is relatively high but it is severe problem in many transition economies.

Political developments

The European Parliament on December 14th ratified Montenegro's Stabilisation and Association Agreement (SAA) with the EU and adopted a resolution after a debate on the progress and problems in the youngest European country. Stabilisation and Association process involves the following topics: drafting the SAA; development relations in the field of economy; cooperation in the field of justice; the development of political dialogue and ensure financial aid for the non-EU country. In parallel an Interim Agreement on trade and trade related issues, was signed at the same time. This will enable the trade-related provisions of the SAA to come into force on 1 January 2008.

Two main effects of the agreements can be distinguished. First, the political situation will be more stable, that can be accelerating more foreign direct investments and portfolio investments in the country. Second, according to the trade liberalisation the large external imbalance could improve in short term.

Presidential elections will be held on April 6th. These will be the first presidential elections since Montenegro became an independent state.

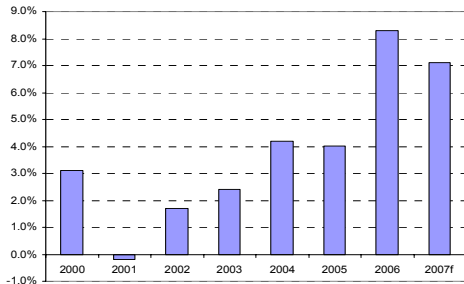
Montenegro plans to spend EUR 9.8 million to modernise the army, a government priority this year. The country is a good example of security and defence sector reforms. The government hopes NATO will invite it to start so-called Intensive Dialogue, the first step towards membership candidate status, during the Alliance summit in April.

Montenegro introduced its Economic and Fiscal Program. The EFP should be considered as a preparation for the Pre-accession Economic Programme (PEP), which has to be submitted once the status of a candidate country has been obtained. The main benefit achieved by drafting the document of the kind is to facilitate the consistent economic policy-making for the country, considering that the document is updated annually and that it justifies possible deviations from the set parameters in the previous year.

Growth

GDP growth has exceeded forecasts in the last few years in Montenegro. Short-term economic prospects of the country are highly favourable. FDI are extremely significant for the development of Montenegrin economy. High growth rate has been noted in the areas of services – tourism, trade, real estate, financial intermediation, construction industry and traffic. The price of real estates has risen, as well as increase of the real estate business scope, especially at the coastal area and in Podgorica. Net foreign

GDP growth rate (previous year=100)



Source: Monstat ; Note: f - forecast

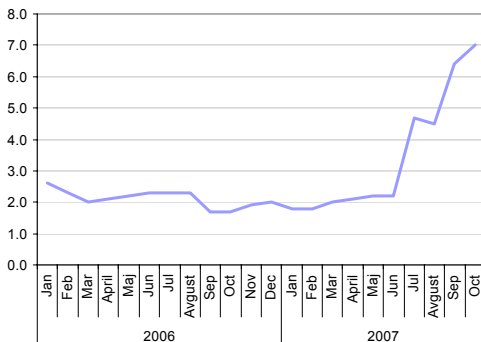
direct investments of the capital have increased. In addition, the low inflation environment also facilitated the positive performance of the economy.

Industrial production in the first 11 months of 2007 decreased by 0.7% compared to the same period in last year. Considering sectors, processing industry grew and has 9.1% share in the overall increase while 5.5% goes to ore and stone extraction. Production of electric energy, gas and water decreased 31.6%.

The economy has benefited from a reformed banking system and tax cuts. The government has set a flat corporate profit tax of 9%, and a flat personal income tax of 15% (to be lowered to 9% by 2010). This puts Montenegro at a level with top tax reformers such as the Baltics or Slovakia.

Medium-term macroeconomic and fiscal outlook seems to be favourable to sound conditions for growth according to current trends. We estimate of 7% of GDP growth for 2007, and forecast of 6.5 percent for 2008.

Retail price index (%)



Source: MONSTAT

Monetary developments

Retail prices in October increased by 0.6% compared to September. Since October 2006, growth rate of retail prices went up to 7%. Inflation measured by retail price increase in Montenegro in the first nine months of 2007 amounted to 3.5% compared to the same period last year. Such growth of retail prices could be explained with price increase of industrial and agricultural products. Industrial products in October were 0.7% higher, agricultural products were 0.1% higher, while other services remained at September level. Prices of beverages were down 0.2%. The food influenced industrial products index most, thus, it increased prices by 2.3%. Higher prices of fresh vegetables and eggs influenced growth of agricultural products index. Fruit prices were down by 1.3%. Downfall was recorded in the sectors of extracting ore and stone, electric energy, gas and water production from 1.5% to 35.9%.

In monetary area, Montenegro has stabilised low inflation rate in recent years and the monetary policy remains anti-inflationary. In 2006, inflation rate decreased to 2,2 percent, but retail prices started to increase in the second half of 2007. The year-on-year price index is expected to exceed 7% at the end of the year, accordingly we estimate a 4.3% inflation in 2007. The inflation rate could decline to 4% in 2008.

Fiscal policy

In the context of a "euroised" economy, fiscal policy is practically the only macroeconomic policy-making tool. Montenegro's fiscal policy in 2007 has not fully used its capabilities for counter-cyclic actions. The budget has strengthened in 2007, but the fiscal stabilisers have not been allowed to work fully. Strong import growth is expected to raise revenues by some 4-5% of GDP in 2007.

Strong economic performance has led to continued favourable fiscal developments. Despite the introduction of a reduced flat rate personal income tax of 15%, the growth of revenues accelerated strongly to 33.1% year-on-year. The steady growth of the economy

and robust import expansion accounted for the higher than planned VAT collection. Additionally, the revenues from corporate income tax grew well above the target, reflecting the improved performance of the real sector. By contrast, total spending grew at a slower pace (22.3% year-on-year). Spending for gross wages expanded considerably (31.5% year-on-year) though below the plan. Transfers to state funds and local self-governments also increased, but moderately. Yet, capital spending remained substantially below target (-59%).

In December 2006, Montenegro's legislative body approved a 15% flat tax rate on personal income. Effectively, the new tax code started on July 1 2007. The new tax system replaced previous progressively treated taxation of individual income with three rates: 16%, 20% and 24%. Current flat tax rate of 15% is set to reduce to 12% by 2009 and 9% by 2010.

Public balance surplus could exceed the 3% of GDP in 2007 and decrease to 1% in 2008 because of the slower GDP growth and increasing wages in public sector. Public debt is expected to decrease gradually to 33% by 2008.

External balance

According to central bank data, the current account recorded a deficit of 32.7% of projected GDP in Jan-Sept of 2007, and this is 60.9% more than in the same period of the previous year. The deficit is lower than in the previous quarter, but it can be explained by seasonality. Concerning the figures of the third quarter, the balance of goods and services improved, while the small surplus of current transfers declined. On the other hand the high current account deficit was financed by foreign investments. The sum of net foreign direct investments and other investments reached 32% of GDP in this period.

This seemingly dramatic deterioration of external balances should be seen in the context of the extraordinary inflow of FDI in recent years, on the back of further privatisations and investments in the banking sector and strong greenfield investment in tourism. Montenegro has privatised its large aluminium complex - the dominant industry - as well as most of its financial sector in recent years. The direct investment could reach EUR 600 million in 2007, and EUR 800 million in 2008.

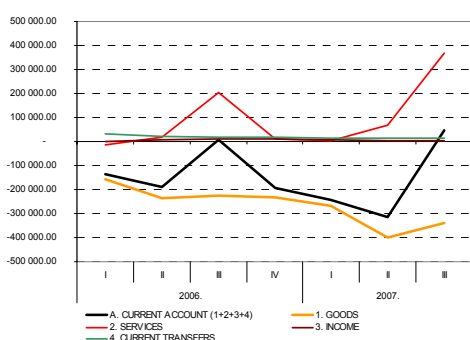
The deteriorating current account balance is mainly due to rapid import growth, which is fuelled by private consumption and investment. The import increased by more than 25% in the third quarter based on the same period of the previous year, and it seems to grow further in the future, while the export of goods will increase less rapidly.

The current account deficit could reach 30% of GDP in 2007. The imbalance of goods will determine the trend in 2008. The deficit will not decline in this year because of rapid import growth.

Labour market

The increase in total employment that was experienced in the first half of 2006 has continued in the third quarter. Employment in the third quarter has increased by 1.6% as compared to the previous

Current Account (thousand EUR)



Source: CBCG

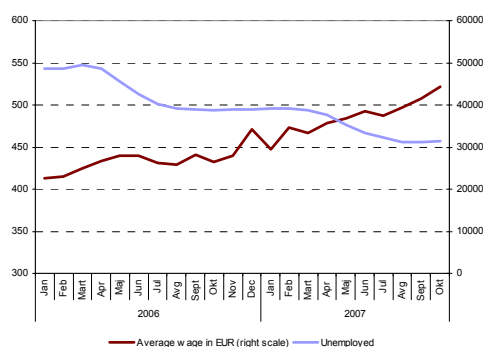
quarter, while annual growth rate of employment in the third quarter was 2.9%. The boost in employment experienced over the last year and a half is a consequence of economic recovery and reforms that made the business environment in Montenegro more stable and attractive for investments.

The number of unemployed people reduced to 31311 in October, which is its lowest number in the last fifteen years. However, the unemployment rate is still higher as compared to pre-transition periods. Despite the fact that employment is higher than in the early stage of the transition period, the unemployment rate is still higher due to a higher rate of activity among the working age population, i.e. the number of people looking for a job is higher.

Average Montenegro earnings without taxes and contributions in November increased by 3.1% to EUR 366 compared to October. In the first 11 months, it amounted to EUR 334 or 18.9% more in relation to the same period last year. The lowest average earnings without taxes and contributions in the first 10 months of 2007 were in fishery sector, EUR 141, and the highest in financial mediation amounting to EUR 759. November earnings without taxes and contributions in real terms increased by 2.1% compared to October considering that living costs in October increased by 1%.

Unemployment rate stayed relatively high in 2007, but could decrease in 2008 because of the strong economic performance in recent years.

Unemployment and wages



Source: Monstat and Employment Bureau

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	2.2	4.3	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 (%)	41.3	45.3	43.0	40.0
Trade balance / GDP (goods and services, %)	NA	NA	-2.0	-2.6
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

Despite the lack of major structural reforms, economic growth exceeded 6% in 2007. The 2007 fiscal policy was expansive, thus contributed to the deepening of the trade deficit and the inflation pressure. The internal and external inflation pressure caused sharp growth of prices by the end of 2007. Tightening monetary policy is expected in order to reach the yearly core inflation target. External imbalances widened in 2007 and only modest improvement can be expected for 2008. Wage growth was rapid in 2007, while there was no major progress concerning the high level of unemployment.

Political developments

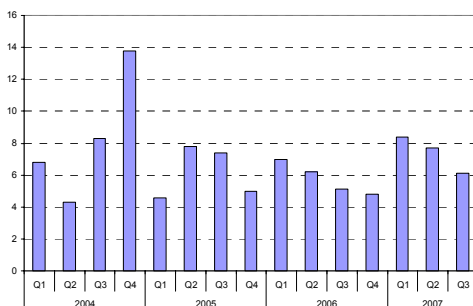
Both foreign and domestic policies are heated by the unresolved issue of Kosovo. The Serbian government adopted an action plan, which is handled top secret and is due to be implemented in case Kosovo unilaterally declares independence. Serbian officials indicate to no longer seek EU and NATO accession, provided Western countries recognise such an action. Moreover, they even suggest taking measures against any country that recognises an independent Kosovo.

Kosovo's issue is highlighted during the campaign of the forthcoming presidential and local elections that will be held in the first half of this year. So far, recent President, Boris Tadic is expected to be re-elected, but most likely there will be a tight race between Tadic and the Radical Party deputy leader, Tomislav Nikolic.

The Stabilisation and Association Agreement has been initialled in November 2007, but handing over Ratko Mladic to The Hague tribunal remains a precondition for signing and implementing the accord.

Growth

Quarterly real GDP growth rate (%)



Source: National Bank of Serbia

Following the rapid growth of the first quarter of 2007, economic growth slowed down in the following two quarters (7.7% and 6.1% respectively). This deceleration was partly the result of the slower growth pace of industrial production, milder increase of the construction industry, the contraction of the agriculture sector and as a regulatory factor; the national bank's restrictive credit policy. Still, the real GDP growth is estimated to have reached around 6.5% in 2007.

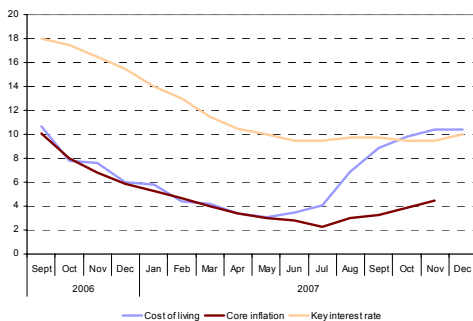
Industrial production increased by 4.6%, while in this group manufacturing grew by 5.4%. The largest growth was recorded in the sectors of retail trade (22.8%), construction (19.1%), financial intermediation (approximately 20%) and telecommunication (39.7%). Due to the drought, the agriculture sector dropped by 8.1%, thus contributing to the deceleration.

In 2008 as well, the real GDP growth rate is expected to reach around 6%, based on credit and real wage growth, booming retail sales and favourable foreign demand. On the other hand, 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.

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 2007 price rises remained moderate, due to the appreciation of the dinar, underpinned by capital inflows as well. However, despite the strengthening dinar, from May inflation started to increase due to several factors. Underpinned by expansive fiscal policy, strong credit and wage growth, domestic demand continued to increase. Oil prices and regulated prices also caused/cause inflationary pressure. Due to bad weather conditions, the price of agricultural products and industrial foodstuff increased dynamically from August.

Cost of living, core inflation (annual rate, %) and key interest rate (%)



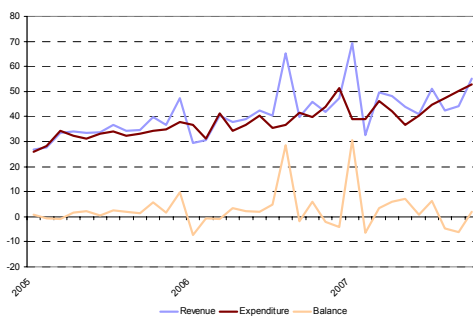
Source: National Bank of Serbia

As a result of the above mentioned factors, by the end of 2007, retail price growth reached around 10%, while the core inflation remained in the target band with 5.4%. In 2008, the internal and external inflation pressure will remain present, thus a tightening monetary policy is expected in order to reach the inflation target. Already in December the key interest rate has been raised by 0.5 percentage point to 10%. Moreover, partly to mitigate the booming credit growth, the national bank introduces administrative measures. All in all, the central bank expects the core inflation to grow until the middle of the year, but believes to reach the already mentioned yearly target. Most probably the core inflation rate will settle at the upper range of the target band by the end of 2008.

As a favourable trend, in 2007 household's savings deposits showed a record growth and more than doubled, reaching around RSD 420 billion by the end of the year. Another positive characteristic was the lengthening of the deposits' maturity.

Fiscal policy

Public finance (RSD, billion, eop)



Source: National Bank of Serbia

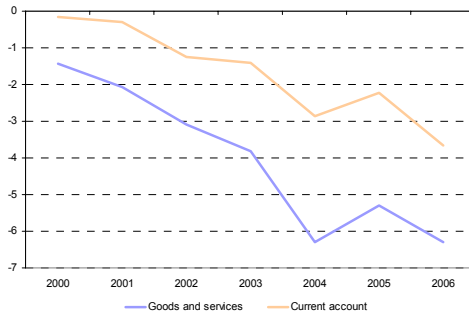
Following the interim financing for the January-June 2007 by a decree, the Law on the 2007 budget was adopted in June and came into force on 1st July. Following the interim period, in the third quarter of 2007 the share of revenue in GDP decreased, while on the expenditure side it increased. In the same quarter, total consolidated revenues (excluding grants) reached RSD 240.5 billion, showing a growth of 8% in real terms, compared to the same quarter in 2006. On the other hand, expenditures reached RSD 254.0 billion, presenting a 14.1% growth in real terms compared to the third quarter a year earlier. As a result, budget deficit amounted to RSD 13.5 billion. Thus as it was expected, fiscal policy was significantly expansive from the second half of the year and spending remained predominantly social-oriented. According to expectations, public spending continued to accelerate by the end of the year. As a result, budget deficit reached around 2% of the projected GDP.

In 2008, fiscal policy is expected to be mildly expansive. Despite the government decision to freeze wages at the November 2007 level, wage-related budget spending will have the largest share. Capital investment is expected to contribute to further spending. The approved 2008 budget is 9.9% higher, compared to the previous year and calculates with a deficit of EUR 185 million. The Memorandum on Medium-Term Fiscal Policy envisages returning to a budget surplus in 2009, parallel with the gradual reduction of

public expenditures' share of GDP.

External balance

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



Source: National Bank of Serbia

As a result of credit growth and accelerating fiscal expenditures, domestic demand fuelled the increase of imports, but generally did not cause a slowdown of export growth. In the period of January-November 2007, export of goods and services reached EUR 5.85 billion, increasing by 26.9% compared to the same period a year earlier, while imports amounted to EUR 12.05 billion, growing by 27.8%. This indicated a trade deficit of EUR 6.19 billion, representing an increase of 28.6%.

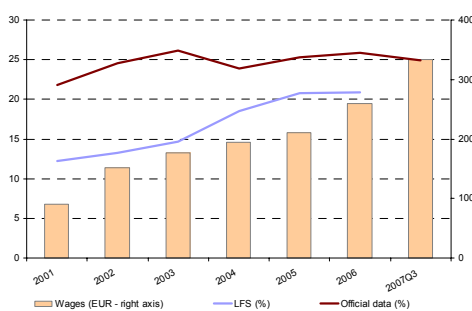
Due to the deepening trade deficit and the significantly lower level of current transfers, current account deficit in January-October 2007 widened, reaching USD 5.22 billion, which means it almost doubled compared to the same period of 2006. According to estimations, in 2007 the current account deficit per GDP ratio somewhat exceeded 14%. As for 2008, the same factors are likely to affect the current account balance, thus, no major improvements are expected.

During the first three quarters of 2007, net FDI inflows to Serbia remained at a moderate level of USD 1.2 billion, while in the same period of the previous year this figure was USD 2.7 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.

In the third quarter of 2007, the central bank's foreign exchange reserves reached USD 13.47 billion, increasing by 9.1%, compared to the previous quarter and reaching a comfortable import cover of 8 months.

Labour market

Unemployment rate and wages



Source: National Bank of Serbia

In the third quarter of 2007, both employment and unemployment continued its downward trend. In September total employment decreased by 3.4% year-on-year, while registered unemployment declined by 11.6% in the same period. Unfortunately this drop of registered unemployment was mainly due to certain data transfer. As a negative characteristic, almost half of the unemployed are first-time job seekers. The official unemployment rate in September decreased to 24.9%, while in the end of 2006 the ratio was 25.9%. The Labour Force Survey supposes a lower unemployment rate; 20.9% for 2006, while data for 2007 are not available yet. No significant change is expected concerning the high level of unemployment in 2008.

Although the wage growth mitigated in the second half of the year, the annual growth remained rapid for 2007, particularly in the public sector. According to the statistical bureau, in the period of January-November 2007, net real salaries grew by 21.39% or by 28.55% in nominal terms, compared to the same period a year earlier.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
GDP nominal (RSD bn)	1,750	2,050	2,330	2,610
Real GDP growth (%)	6.2	5.7	6.5	6.0
Private consumption (%)	NA	5.4	9.5	4.9
Public consumption (%)	NA	8.3	16.1	5.7
Investments (GFCF, %)	NA	15.2	28.6	20.2
Exports (%)	NA	28.2	32.6	25.8
Imports (%)	NA	22.2	36.5	20.5
Inflation (Retail price index, %)	16.2	11.7	6.3	7.0
Policy rate (%)	19.8	14.0	10.0	10.0
Short-term interest rate (3-month T-bill, %)	17.5	13.5	6.6	6.0
Long-term interest rate (182 day T-bills, %)	NA	NA	-	-
Exchange rate (RSD/EUR, average)	83.2	84.4	80.3	78.3
Exchange rate (RSD/EUR, end of period)	85.5	79.0	79.0	77.0
Budget balance / GDP (%)	1.5	0.9	-2.0	-1.5
Public debt / GDP (%)	46.2	38.8	35.3	27.5
Trade balance / GDP (goods and services, %)	-23.4	-22.1	-24.2	-22.4
Current account balance / GDP (%)	-8.6	-11.6	-14.2	-13.6
Gross foreign debt / GDP (%)	58.7	61.7	60.2	59.5
Unemployment (%)	20.8	20.9	21.1	20.8
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 Turkish economy has gradually been becoming exposed to external pressures reflected in slower than expected economic growth, higher than planned inflation and uncertainties regarding the current account developments.

Political developments

The victory of the ruling AKP at the July 22 general elections and the nomination of Abdullah Gul to the post of Turkey's president provided the background for calm political developments.

There were only two offsetting developments: the 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 the conflict with Kurdish rebels in northern Iraq.

But even this latest development was unable to raise doubts over the optimism that the government would be able to manage the economy well and keep the momentum of growth remaining strong for almost 23 consecutive quarters.

Growth

The growth rate, which was 6.8% in the first quarter of 2007, declined to 1.7% in the third quarter, the slowest pace since the 2001 recession. The growth rate in the first nine months stood at 4.0% and average for the 2007 is expected to be 5%.

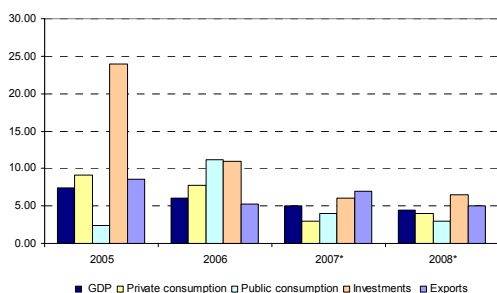
Looking at the growth rate from the supply side substantial slowdown was experienced in the agricultural sector as a result of the severe and long drought. At the same time moderate growth in the industrial sector continued and there was a fair growth in the construction sector as well.

Analysing the growth from the demand side private consumption expenditures slowed down in the first half of 2007 due to monetary tightening and showed recovery in the third quarter. Private investment expenditures continued to increase. The contribution of fiscal policy was different in the two half years as the upward trend in public expenditures in the first half of 2007 lost pace in the second half. Altogether the contribution of the private sector to growth was higher than that of the public sector.

According to the Central Bank the private sector has been the engine of growth since 2001. Between 2001 and the third quarter of 2007, investment and consumption expenditures of the private sector increased by 149.3% and 38.9%, respectively, in real terms. Productivity gains have underpinned economic growth as from 2001 onwards, the cumulative increase in productivity reached 43.4%.

We slightly lowered our forecast for 2008 from 5% to 4.5% reflecting the weaker economic performance of the last quarter and the effects of global economic slowdown. In 2008 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. Import growth will not be compensated by export growth as exports will be negatively affected

GDP growth and its composition (%)



Note: * = forecast; Eurostat, CBTR

by the stronger Turkish Lira and slowdown in the growth of Turkey's main export markets.

Both private and public investments are expected to grow faster, partly driven by the 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 remains supportive for economic growth.

Monetary developments

In the first three quarters of 2007, inflation remained within the uncertainty band set around the path consistent with the inflation target of the Central Bank. In the last quarter of the year, supply-side shocks (drought and hikes in energy prices) and the adjustments in administered prices led to stagnation in the disinflation. In November 2007, consumer price increase was 8.4% and also 8.4% in December, unchanged from the previous month and more than double a year-end target of 4% backed by the IMF.

As a result the central bank has again missed its inflation target and in 2007 actual inflation turned out to be much higher than targeted similar to 2005 and 2006. The Central Bank blamed higher oil prices and drought for the gap and said that the planned adjustments in electricity, natural gas and food prices continue to pose further risks to disinflation.

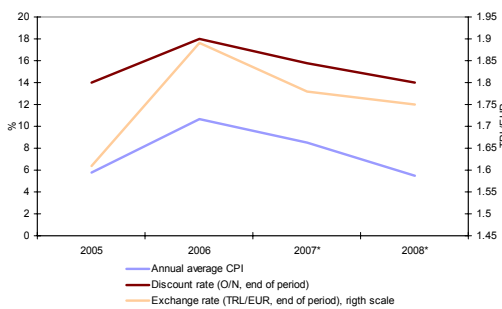
Determining the main contributors to inflation food prices contributed the most in 2007 as non-food inflation showed deceleration compared to 2006. The year-on-year goods inflation, which started to decelerate in April 2007, declined to 5.7% in July, but rebounded to 8.3% in November due to increased food and energy prices along with adjustments to administered prices. At the same time the slowdown in services inflation has become significant in recent months a good news for the Central Bank.

In the Inflation Report of October 26, 2007, under the assumption that policy rate cuts continue until first quarter of 2008 and then remain unchanged for a while inflation was predicted to be between 2.5% and 5.7% (mid-point 4.1%) at the end of 2008; and between 1.7% and 5.5% in the third quarter of 2009 (midpoint 3.6%).

The Turkish lira showed its biggest annual gain against the US dollar in 2007. While the lira has gained almost 7% against the dollar since the bank began cutting rates in September, it rose altogether 21% versus the U.S. dollar in 2007, more than any emerging-market currency. Gains for the lira help curb inflation by lowering the cost of imported raw materials and consumer goods.

The central bank kept its benchmark interest rate at 17.5% until September, before cutting it in each of the past four months by a combined 2.00 percentage points to 15.5% by January 2008. The interest rate cuts were motivated by similar moves worldwide and the slowdown of economic activity and inflation expectations. The Fed's key rate was 4.25% making the lira attractive for carry trade and contributing to the mentioned appreciation of the Turkish currency.

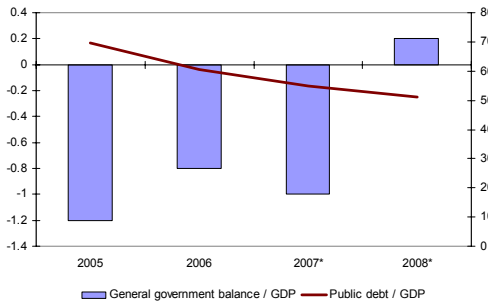
Evolution of monetary indicators



Source: CBTR, ECB

Fiscal policy

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



Note: * = forecast; Source: Eurostat

In the first half of the election year 2007, fiscal policy was loosened followed by corrective measures. As a result a primary surplus of 5% of GDP maybe within reach in 2007 with slight 1% overall deficit.

The substantial primary surplus and strong GDP growth led to a reduction in the debt ratio, from 60,5% of GDP at the end of 2006 to 55% at the end of 2007.

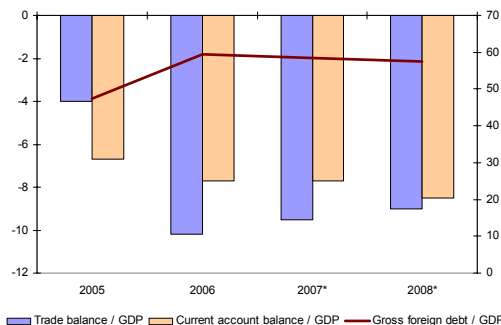
Public sector balances are affected by higher interest rates, higher public spending and a slowdown in privatisation, while revenue based reforms are expected to widen the tax base and increase the efficiency of tax collection.

In 2008 some budgetary surplus is projected as a result of gradual fiscal tightening and falling interest rates. General government debt is expected to further decline gradually, to 51% 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. In the third quarter of 2007 the average maturity of the domestic debt stock was 35 months up from 27 months in 2005, while average maturity of domestic borrowing increased in the same time period from 20 to 27 months.

External balance

Current account deficit, trade deficit and gross foreign debt



Note: * = forecast; Source: Eurostat, ECB

Despite a slowdown in machinery-equipment production, imports of machinery-equipment gained speed in 2007. In addition, both production and imports in the electrical machinery industry increased significantly on a year-on-year and per quarter basis. Imports of capital goods grew sharply on year-on-year basis and seasonally adjusted figures point to a continued acceleration.

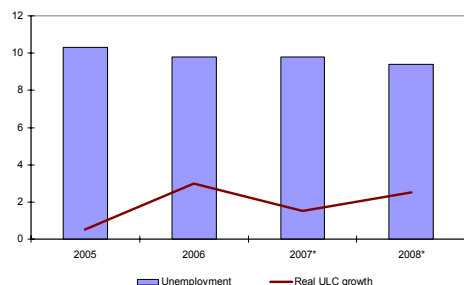
Exports continued to expand owing to productivity gains and on the back of strong external demand. While exports recorded a high growth rate in dollar terms, real exports grew at a lower pace than real imports in the second half of the year. The strengthening demand for imported goods, particularly automobiles and commercial vehicles and other capital goods, signal that the contribution of net foreign demand to growth will continue to be negative in the last quarter.

In 2008 the growth of imports will remain strong, partially reflecting a rather high import content of exports. In 2008-2009 exports will feel the negative effects of stronger currency and slowdown in the main export markets. The current account deficit is therefore projected to grow moderately, from 7.7% of GDP in 2007 to 8,5% of GDP in 2008. A higher surplus of the services balance should contribute to maintain positive medium-term prospects in the external sector.

As of October 2007, net cumulative inflows for the last 12-month period reached USD 17.8 billion. Foreign direct investment was one of the items with the biggest share in the financing of the current account deficit in 2007. According to 2006 figures, Turkey ranks 5th among developing countries in foreign direct investment.

Labour market

Unemployment and real ULC growth (%)



Note: * = forecast; Source: Eurostat

As of October 2007 unemployment increased by 0.2 percentage point to 9.3% compared to the same period last year. Non-agricultural unemployment remained unchanged at 12% compared to the same period last year. In some segments of the labour market there are deeper problems as for example youth, urban and female unemployment was 19%, 11,8% and 10,7% respectively and the participation rate was 48%

There has been a rapid shift from the agricultural sector to non-agricultural sectors since 2002. In the last four years, the cumulative decline in agricultural employment reached 24.3%. Employment in industrial sector rose by 12.5%. Services sector has the largest share in total employment.

In line with economic expansion, employment is forecast to increase by about 1.5% in the coming years. This will lead to a gradual reduction of unemployment rate from 9.8% in 2007 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	4.5
Private consumption (%)	9.1	7.8	3.0	4.0
Public consumption (%)	2.4	11.2	4.0	3.0
Investments (GFCF, %)	24.1	11.3	6.0	6.5
Exports (%)	8.5	5.2	7.0	5.0
Imports (%)	11.5	6.4	6.0	5.5
Annual average inflation (%)	5.8	10.7	8.5	5.5
Discount rate (O/N borrowing rate, end of period, %)	14.0	18.0	15.75	14.0
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	1.78	1.75
Exchange rate (TRL / EUR, end of period)	1.61	1.89	1.71	1.8
General government balance / GDP (%)	-1.2	-0.8	-1.0	0.2
Public debt / GDP (%)	69.5	60.5	55.0	51.0
Trade balance / GDP (goods and services, %)	-4.0	-10.2	-9.7	-9.0
Current account balance / GDP (%)	-6.7	-7.7	-7.7	-8.5
Gross foreign debt / GDP (%)	47.5	59.5	58.5	57.5
Unemployment (%)	10.3	9.8	9.8	9.4
Real ULC growth (%)	0.5	3.0	1.5	2.0

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

Sources: IMF, Eurostat, CBTR