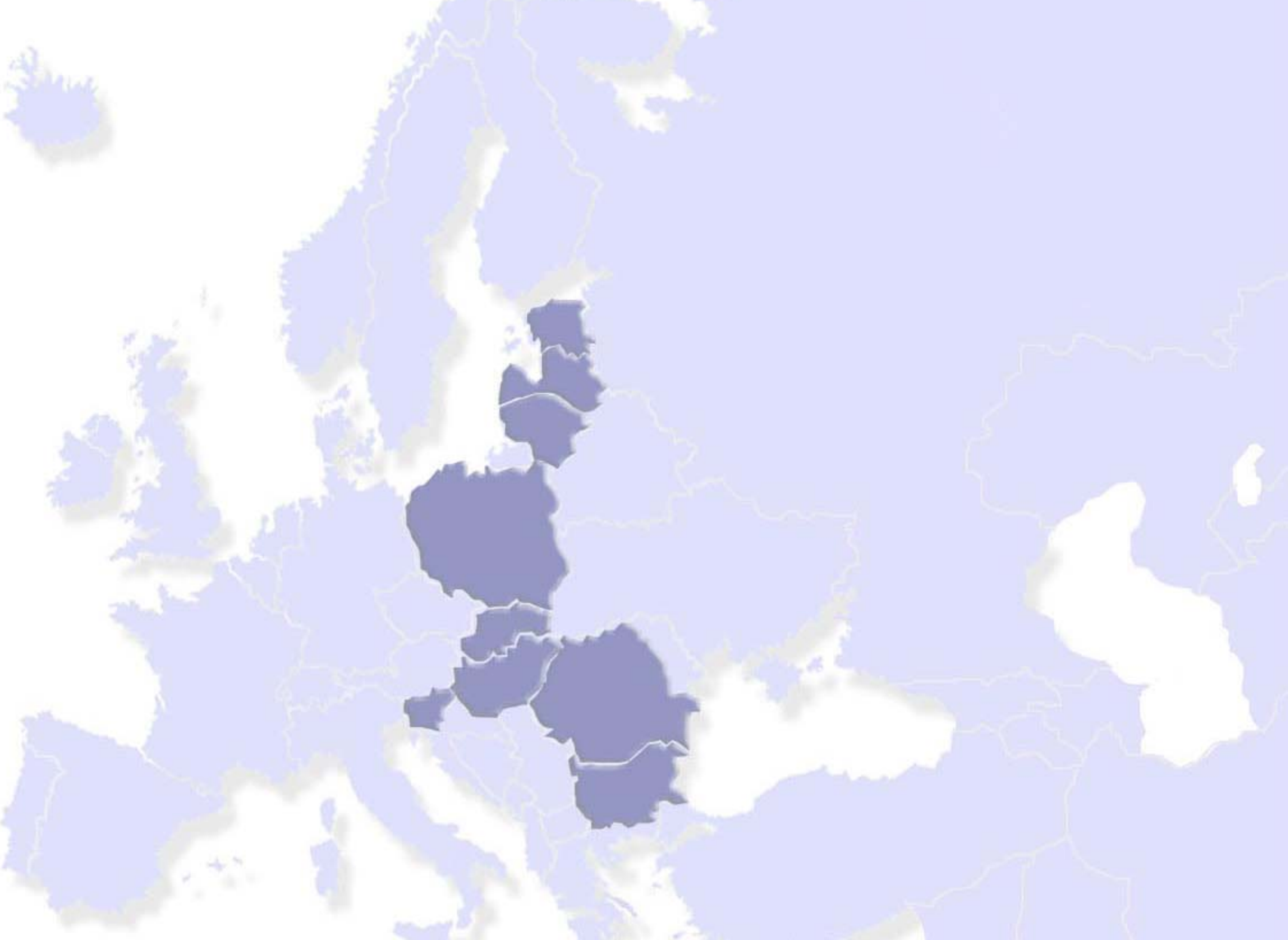
ICEG EUROPEAN CENTER

Quarterly Forecast on the Eastern EU Member States

Spring 2007



Quarterly Forecast on the Eastern EU Member States

Spring 2007

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Company information

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

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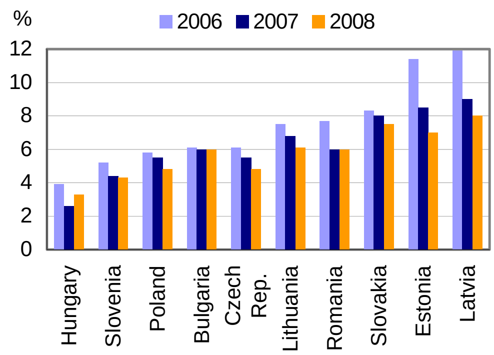
Regional overview

The European Union welcomed two new members, Bulgaria and Romania on January 1st 2007. This prompted ICEG European Center to re-design and re-label its macroeconomic forecasts. The former title of this publication, 'New Member States' has become more imprecise than before; it was meant to be temporary in any case. While our new definition of the region, 'Eastern EU Members' is far from perfect, we believe it is useful and geographically correct.

Growth

GDP growth in the region



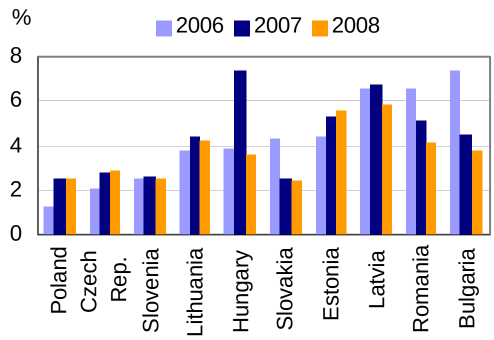
Last year brought exceptional growth throughout the region. The average growth rate of the ten countries was 7.4%. Latvia and Estonia grew fastest thanks to red-hot domestic demand. The rest of the region performed between 5-8%. Hungary is the laggard of the region as fiscal austerity measures began to take effect already in 2006 and will keep growth low in 2007-08 as well.

Strong demand in the world economy and in the European Union bolstered exports everywhere. Domestic demand is gaining momentum thanks to strong wage growth, easy credit, the inflow of EU funds and good investment opportunities.

This year is expected to bring a mild deceleration in line with a slight slowdown of the euro-area and decelerating domestic demand. Capacity constraints are also appearing in the overheated Baltic economies. Although there are signs of an orderly slowdown, a hard landing still cannot be ruled out, especially in the case of Latvia.

Monetary developments

Inflation in the region



Note: harmonised (HICP) rates

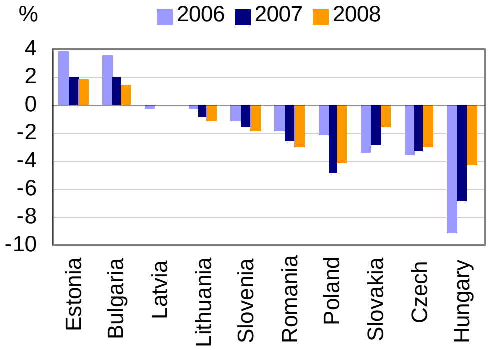
The average inflation rate of the region was 4.3% last year but individual figures varied from 1.3% in Poland to 7.4% in Bulgaria. The Czech Republic, Poland and Slovenia have achieved price stability. Bulgaria, Romania and Slovakia are on the path of disinflation. Prices are accelerating in the Baltic countries and Hungary.

Large positive output gaps, rising indirect taxes and energy prices are the key inflationary factors in the Baltics. The situation in Latvia has finally prompted the government to adopt an anti-inflationary package. In the case of Hungary fiscal stabilisation measures include tax hikes and administrative price increases, resulting in a temporary surge in inflation.

Slovenia entered the euro-area on January 1st 2007. Many others are either losing sight of the common currency (Hungary and the Baltics) due to macroeconomic imbalances or do not hurry to introduce it (Czech Republic, Romania). Of the newest two EU members, Bulgaria aims for an early euro while Romania wants to achieve more real convergence first. However, recent speculation about the sustainability of currency pegs in Estonia and Latvia should serve as a reminder that outside the euro-area these countries are exposed to the fickleness of financial markets.

Fiscal policy

Budget balances in the region (% of GDP)



Note: according to ESA methodology

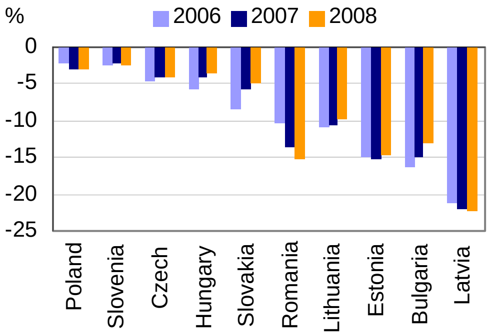
Seven out of ten countries met the 3% deficit criterion of the Stability and Growth Pact in 2006. The Czech Republic and Slovakia missed the margin by less than 0.5 percentage points while Hungary had a massive 9.2% deficit. Countries with currency boards or hard pegs (the Baltic states and Bulgaria) can rely only on fiscal prudence to keep their economies under control: Estonian and Latvian budgets 'lean against the wind' to contain rising imbalances.

EU accession will put some burden on Bulgarian and Romanian budgets. Public investments are necessary for sustainable long-term growth everywhere. Societal demand is putting the pressure on politicians who are more than happy to spend on wages and welfare. Poland may face trouble from the European Commission if its deficit increases according to our expectations.

As a result, public balances are expected to deteriorate slightly in part of the region. The average deficit will rise from 1.5% to 1.9% in 2007 before falling to 1.6% in 2008. However, macroeconomic risks and the failure to meet the 3% criterion are disciplinary forces. Hungary has an ambitious stabilisation package in place that should cut the deficit by almost 5 percentage points within two years.

External balance

Current account balances in the region (% of GDP)



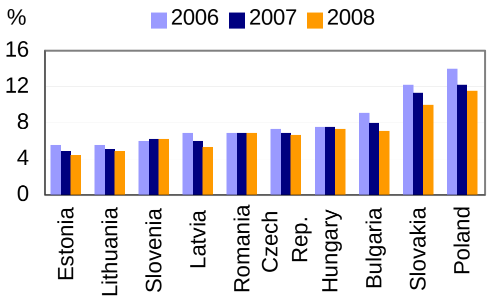
External imbalances are high and persistent in a number of countries. The regional average of current account deficits was 9.7% in 2006 and will fall by only 0.2 percentage points in 2007 and 2008. The 21.1% deficit of Latvia is dangerously high as recent turbulences prove.

Soaring domestic demand fuels imports while export performance varies. FDI inflows improve exports in Bulgaria, Poland, Romania and Slovakia but rising domestic production costs can harm competitiveness in the Baltic countries. The special topic in this publication deals with the nature and causes of external imbalances and assesses the macroeconomic risks they pose.

Foreign direct investments cover the bulk of external financing requirements in a number of countries but debt financing is dominant in the Baltics and Hungary. The associated risks are mitigated by the fact that most external borrowing takes place between foreign-owned banks and their parent companies.

Labour market

Unemployment rates in the region



Note: harmonised LFS rates

Thanks to strong economic growth, the region is characterised by job creation and falling unemployment. The average of national unemployment rates was 8.1% in 2006 and is expected to fall by 0.4 percentage points a year in 2007-08.

A number of countries face labour shortages as a consequence of large-scale migration of workers to Western Europe. This boosts labour costs even further, and may constrain growth in the longer term.

Bulgaria

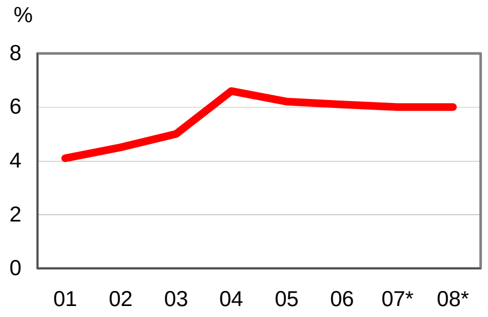
Economic growth remained above 6% for the third consecutive year. Inflation jumped in 2006 but 2007 will bring further disinflation. The government targets early euro adoption. The fiscal surplus will decrease due to EU membership, while external imbalances remain the key macroeconomic risk. Record high foreign direct investment was achieved in 2006, covering the entire current account deficit.

Political developments

Bulgaria will hold European Parliament (EP) elections on May 20th 2007. It is expected that five parties – the three coalition parties and two in opposition – will share the 18 EP seats. According to a recent poll only 36% of the electorate are planning to vote. As a form of diplomatic protest the Bulgarian nurses facing death penalty in Libya are on the list of candidates as well. It seems however that politicians show more interest in the EP elections than voters.

Growth

GDP growth



*Note: * forecast. Source: NSI*

At the beginning of April the National Statistical Institute of Bulgaria (NSI) published not only growth data for the last quarter of 2006 but also announced revised figures for previous national accounts data. Revised GDP growth rates for 2004 and 2005 are 6.6% and 6.2% respectively while the old figures were lower than 6%. On the other hand, the growth rate in the first half of 2006 was reduced to 6.0% from 6.1%. As a result we overshot slightly our forecast on GDP growth in 2006.[1]

Growth has decelerated slightly in recent months: real GDP increased by an annual 5.7% in the last quarter of 2006. The annual growth rate in 2006 reached 6.1%. It was the third consecutive year with growth over 6% according to the new statistics.

On the demand side, investments increased rapidly in 2006. Gross fixed capital formation grew by 23.8% year-on-year in the last quarter, and amounted to 31.3% of quarterly GDP. The annual growth was 17.6% while the share of investments in 2006 GDP was 26.2%. Foreign direct investment reached an extraordinary high level last year, almost 17% of GDP. Private consumption also increased significantly, by 7.1% in course of last year, while public consumption growth remained moderate at 1.7%. Net exports had a negative contribution to GDP growth due to higher growth rate of imports. They were fuelled mainly by robust investments and private consumption.

On the production side, both industry and services performed well in 2006. Gross value added in industry and services rose by 8.3% and 6.1% respectively; in agriculture it decreased by 1.9%.

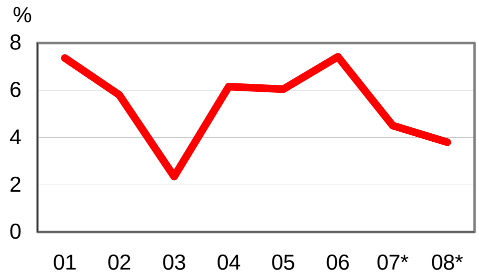
In 2007 we expect the tendencies of 2006 to continue. Private consumption and investments will remain the main engines of the economy. Our expectation is that real GDP growth will be 6% this year and that the same rate can be reached in 2008 as well. The increasing utilisation of EU funds will also contribute to growth in

1 Previous forecasts for Bulgaria were published in ICEG EC's Quarterly Forecast on Southeast Europe (continued under the title Quarterly Forecast on the Western Balkans and Turkey from Spring 2007).

coming years.

Monetary developments

Annual average HICP



*Note: * forecast. Source: NSI*

During the first two months of 2007 the disinflation that started in the second half of 2006 continued. In January the 12-month harmonised index of consumer prices rose by 6.8% but it declined to 4.6% in February, the lowest figure since March 2005. Rising food prices had a significant impact on the index. We expect future inflation to be significantly lower than in 2006. Annual average HICP will reach 4.5% in 2007 and will decline to 3.8% in 2008. Income policy is a risk to disinflation as significant wage increases are observable in Bulgaria.

The growth rate of credit to households decelerated somewhat, from 58-81% in 2003-05 to 30% last year. The fading credit boom will help future disinflation in the future by keeping domestic demand under control.

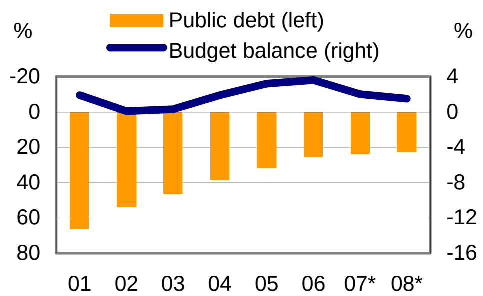
The credit rating of Bulgaria remains better than that of Romania, the other new EU member since January 2007 according to Standard & Poor's. Foreign currency sovereign credit rating has been BBB+ since the autumn of 2006.

In contrast to Romania, Bulgaria has an ambitious plan to join the euro-area. Bulgaria aims to join the ERM-II regime as soon as possible to adopt the single currency at the end of this decade. The finance ministers of EU members will decide on Bulgaria's entry into the ERM-II in April, which can result in a mid-2007 entry. This means that Bulgaria could join the euro area in the second half of 2009 or 2010.

Regarding the Maastricht criteria, the inflation rate is the only challenge to Bulgaria. Public debt was drastically reduced in the first few years of the new millennium and the budget has had a surplus for years. The Bulgarian currency is pegged to euro in a currency board arrangement. However, this regime leaves limited room for monetary policy. In our opinion, Bulgaria may not be able to meet the inflation criterion in the near future. Therefore we do not see 2009 as a certain entry date; 2010-11 is more feasible. As a result Bulgaria could spend more than the minimum of two years in the ERM-II regime, similar to the Baltic countries.

Fiscal policy

Fiscal indicators (% of GDP)



*Note: reverse scale on left axis. * forecast. Sources: Eurostat, Ministry of Finance*

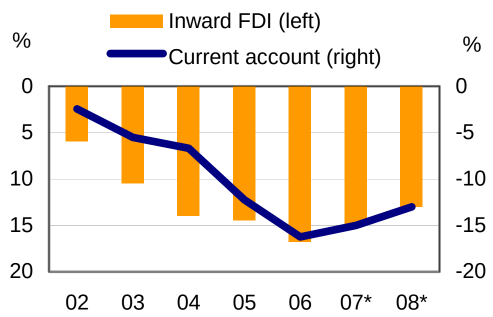
In 2006 the consolidated government balance had a massive surplus, reaching 3.6% of GDP. Revenues rose by 12.7% thanks to a 11.3% growth in collected taxes. Expenditures increased by 7.5% although salaries and wages expenditures jumped by more than 50% compared to 2005.

As of January 1st 2007 the profit tax rate was decreased to 10%. This rate (similar to that of Cyprus) is the lowest in the EU. On the expenditure side, Bulgaria needs to start transferring its contribution to the EU budget in the value of BGN 146.5 mn during the first two months of 2007. According to plans, Bulgaria will pay a total BGN 634.4 mn into the EU budget in the course of 2007. Considering higher public spending (including co-financing to EU funds) and tax cuts, we expect that the consolidated budget surplus will decrease in 2007 and will reach 2.0% of GDP. In 2008 the surplus can decrease further to 1.5%.

Owing to favourable budget developments the year-end level of general government debt decreased to 25.3% of GDP in 2006 from 31.2% in 2005. Due to the expected budget surpluses in the next two years the debt ratio will decrease further and can reach 22.5% of GDP by the end of 2008.

External balance

External balance indicators (% of GDP)



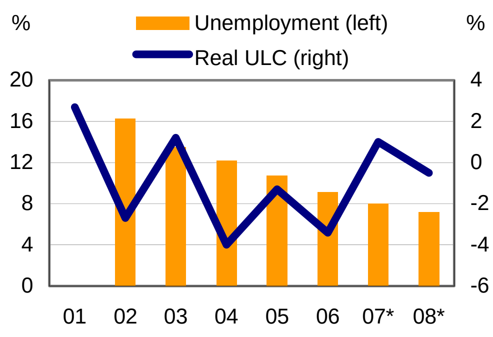
*Note: reverse scale on left axis. * forecast. Sources: BNB, Eurostat*

During the last two months of 2006 the current account deficit increased by EUR 1.3 bn, amounting to 5 percentage points of GDP. Thus, the current account deficit reached 16.3% last year. This significant growth from the 12.2% in 2005 was due to the deterioration of trade balance. Trade deficit rose to 22% of GDP owing to high domestic demand. There are two favourable trends however. First, the high growth rate of merchandise imports is the result of the high demand on investment goods from abroad and not of consumption. Second, the growth rate of exports was higher than that of imports for the first time in the last four years. Foreign investments realised in the country in the last years will improve the trade balance further. In 2007 however, the current account deficit is not expected to improve significantly yet: it will reach 15% of GDP according to our expectations. A larger improvement is expected for 2008.

Foreign direct investment inflows reached their peak in 2006 at EUR 4.1 bn or 16.8% of GDP. Net inward FDI covered the entire current account deficit in last year. Due to a declining profit tax rate, a gradually improving business climate and EU integration inward FDI will remain high in 2007 and should cover the bulk of the current account deficit. As a result the high external deficit is not a serious concern yet. The situation could change if FDI inflows decreased in the future or if private consumption ran out of control as in the Baltic countries.

Labour market

Labour market indicators



*Note: * forecast. Sources: Eurostat, NSI, WIIW*

Labour market indicators improved further in 2006. Unemployment fell below 10% while the employment rate increased by 2 percentage points to 46.7%. The number of employed persons increased by 130 thousand. Youth and long-term unemployment also declined. The only unfavourable tendency is that labour shortages start to characterise several sectors, especially in higher-skill occupations.

In 2007 and 2008 job creation will continue and labour market figures will improve due to high economic growth. The unemployment rate is expected to decline to 8.0% in 2007.

Labour costs have grown in line with productivity developments and real unit labour cost fell in recent years. Pubic sector wage increases may spill over to the private sector resulting in a minor surge in 2007.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (BGN mn)	42,797	49,091	54,600	60,800
Real GDP growth (%)	6.2	6.1	6.0	6.0
Private consumption (%)	5.5	7.1	6.5	6.5
Public consumption (%)	4.1	1.7	2.0	2.5
Investments (GFCF, %)	23.3	17.6	18.0	16.0
Exports (%)	8.5	9.0	12.0	14.0
Imports (%)	13.1	15.2	14.0	12.0
Annual average inflation (%)	6.0	7.4	4.5	3.8
Policy rate (%)	NA	NA	NA	NA
Money market rate (3-month, %)	3.62	3.69	4.00	3.70
Long-term interest rate (10-year gov't bond, %)	3.87	4.18	3.91	3.70
Exchange rate / EUR (average)	1.96	1.96	1.96	1.96
Exchange rate / EUR (end of period)	1.96	1.96	1.96	1.96
Budget balance / GDP (%)	3.2	3.6	2.0	1.5
Public debt / GDP (%)	31.9	25.3	23.5	22.5
Trade balance / GDP (goods and services, %)	-20.6	-22.0	-21.0	-19.0
Current account balance / GDP (%)	-12.2	-16.3	-15.0	-13.0
Gross foreign debt / GDP (%)	70.4	80.4	85.0	88.0
Unemployment (%)	10.7	9.1	8.0	7.2
Real ULC growth (%)	-1.3	-3.4	1.0	-0.5

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

Sources: Bulgarian National Bank, Eurostat, National Statistical Institute

Czech Republic

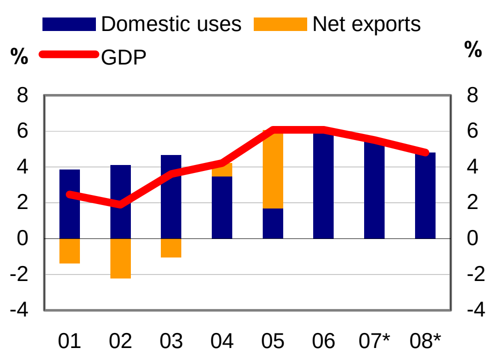
High growth rate, low inflation and decreasing unemployment are still characteristic for the Czech economy in the first quarter of 2007. The forming of the new government may lead the way out of political uncertainties and give way to the reduction of a relatively high budget deficit. In 2007 growth is likely to continue, though at a slightly lower pace than last year.

Political developments

Ending about half a year of political wrangling and uncertainties, Mirek Topolanek could finally form a government in January 2007. This was possible after winning a confidence vote in the Parliament with the help of two ’treacherous’ Socialist Party (CSSD) MPs. Three right-wing parties form the governing coalition: Mr. Topolanek’s Civic Democratic Party (ODS), the Christian Democrats and the Green Party. The new government agreed on a program with a final aim of euro adoption in 2012. This requires the fulfilment of the Maastricht criteria (first of all the deficit limit) by 2009.

Growth

Structure of growth



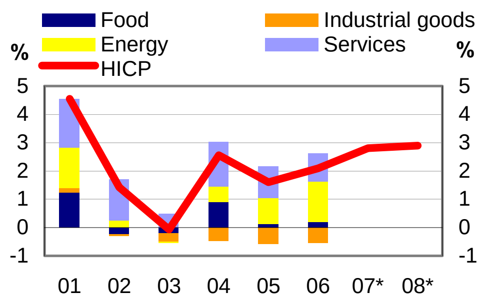
*Note: * forecast. Source: Eurostat*

The growth performance of the Czech Republic remained strong throughout 2006 resulting in 6.1% average annual growth. However, quarterly rates indicate deceleration, which is expected to continue throughout 2007, resulting in a 5.5% annual growth rate. These rates are among the leading ones in Visegrad countries though do not reach levels of the Baltic states.

Compared to 2005, when net exports were the main engine of growth, private consumption and GFCF became more important drivers in 2006. Private consumption was gaining momentum last year and at the beginning of 2007. This is indicated by the 7.7% annual growth in retail sales in January 2007 among other factors. Forecasts of high economic growth for this year are also backed by spectacular rates in the growth of industrial production (15.4% year-on-year in February), and construction (32.5%, similarly). The continued importance of domestic demand as the main engine of growth is supported on one hand by the fact that average real wages increased by 4.6% in 2006; on the other hand by the sustained rapid credit expansion of enterprises and households.

Monetary developments

Components of inflation



*Note: * forecast. Source: Eurostat*

12-month inflation (HICP) reached 2.1% in 2006, which indicates a decreasing tendency but is still higher than the euro-area average. The highest price increases were recorded for tobacco products (due to changes in excise duties) and certain services (housing, water, energy, fuel and holidays). However, the pass-through of cost shocks is far from complete as the limited impact of the deregulation of rents indicated. Industrial producer prices grew by 3.2% in February. All in all, robust domestic demand is expected to keep the rate of inflation close to 3% for 2007 as a whole.

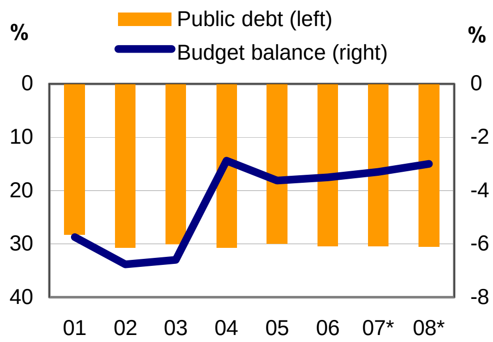
At the beginning of April the two-week repo rate of the Czech National Bank stood at 2.5%, unchanged since September 2006. This is the lowest rate in the European Union, and is lower than the

ECB rate. We do not expect significant changes in the policy rate. Therefore short- and long-term interest rates should also remain stable in 2007 at around 2.6% and 3.8% respectively (for 3-month and 10-year maturities).

Loans and credits to both enterprises and households continued to grow throughout last year, taken over in dynamics only in November by credits provided to the government sector. On a year-on-year basis, growth in households' credit rose by 29.4% in December. The same data for enterprises was 14.8%, while it amounted to 38.1% in the case of the government. The M2 monetary aggregate grew at its highest rate since 2004.

Fiscal policy

Fiscal indicators (% of GDP)



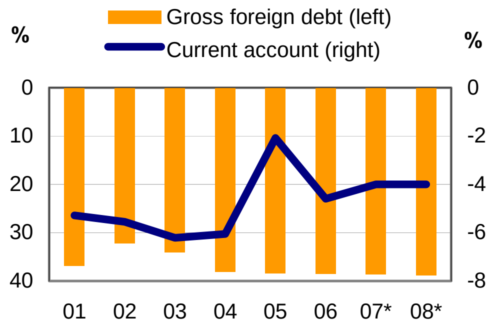
*Note: reverse scale on left axis. * forecast.*
Source: Eurostat

In 2006 increasing social spending, attributed to elections and to months of interregnum resulted in a higher-than-planned budget deficit, an estimated 3.5% of GDP according to ESA methodology. The level of government debt stood at 30.6% at the end of last year. This year, various measures are aimed at reducing the deficit below the Maastricht criterion of 3% of GDP.

The new government announced major changes to be introduced this year, conditional on parliamentary approval. According to the plans there will be a unified personal income tax rate of 15% (on cumulated gross wages). Profit tax will be gradually reduced to 19% by 2010. The lower rate of the value added tax will be increased from 5% to 9% (the higher rate will remain at 19%). A significant reduction of social expenditures (family allowance, payment on maternity leave, etc.) is planned together with a restructuring of health care expenditures. A pension reform and further privatisations are also on the list of proposed measures.

External balance

External balance indicators (% of GDP)



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

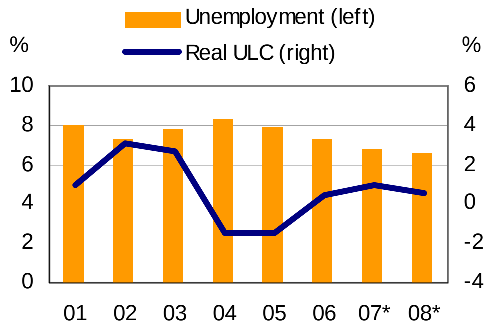
In 2006 the income balance pushed the current account in the red mainly due to dividend payments on foreign direct investments and reinvested earnings. However, both the goods and services balances showed a significant surplus. Strong net FDI inflows covered the deficit of the current account, though the inflow was only half of that of the previous year.

According to data from the first months of 2007 these trends are likely to continue. Export of goods increased by an annual 19.5% in February while imports rose by 14.5%, resulting in the highest trade surplus since 1993. Exports and imports of services also grew dynamically and resulted in a January surplus twice the size as in 2006. FDI inflows were of the same magnitude as last year, but are set to increase further because of planned privatisations. Portfolio investments however show an increasing net outflow due to increasing demand for foreign securities by domestic investors.

Labour market

The harmonised unemployment rate fell to 6.5% by the end of 2006. Registered unemployment stood at 7.2% at the same time. The participation rate reached 65.6% at the end of 2006, which is among the highest in EU-27. In 2007 similar tendencies are expected to continue. According to the latest data, registered unemployment

Labour market indicators



*Note: * forecast. Source: Eurostat*

reached 7.3% at the end of March. In 2007 unemployment could reach an average 6.8%.

The growth of average wages accelerated during 2006 both in nominal and real terms, resulting in annual increases of 6.5% and 3.9% respectively. Wages grew more rapidly in the private than in the public sector. A slight deceleration of wage growth, due to fiscal tightening, is expected this year. As wages grow slightly faster than productivity, real unit labour costs are rising marginally. For 2007 and 2008 we expect 1% and 0.5% real ULC growth respectively.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (CZK bn)	2970.3	3204.1	3461.4	3700.1
Real GDP growth (%)	6.1	6.1	5.5	4.8
Private consumption (%)	2.8	4.6	4.5	3.0
Public consumption (%)	1.0	0.3	0.3	0.2
Investments (GFCF, %)	1.3	7.3	7.0	6.8
Exports (%)	10.4	14.6	15.2	14.3
Imports (%)	4.8	14.2	15.0	14.2
Annual average inflation (%)	1.6	2.1	2.8	2.9
Policy rate (%)	2.00	2.50	2.50	2.75
Money market rate (3-month, %)	2.17	2.56	2.60	2.80
Long-term interest rate (10-year gov't bond, %)	3.61	3.68	3.80	3.90
Exchange rate / EUR (average)	29.784	28.343	28.040	27.90
Exchange rate / EUR (end of period)	29.005	27.495	28.004	27.80
Budget balance / GDP (%)	-3.6	-3.5	-3.3	-3.0
Public debt / GDP (%)	30.4	30.4	30.4	30.5
Trade balance / GDP (goods and services, %)	2.0	1.8	2.0	1.8
Current account balance / GDP (%)	-2.1	-4.6	-4.0	-4.0
Gross foreign debt / GDP (%)	38.4	38.5	38.6	38.8
Unemployment (%)	7.9	7.3	6.8	6.6
Real ULC growth (%)	-0.9	0.4e	1.0	0.5

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

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

Estonia

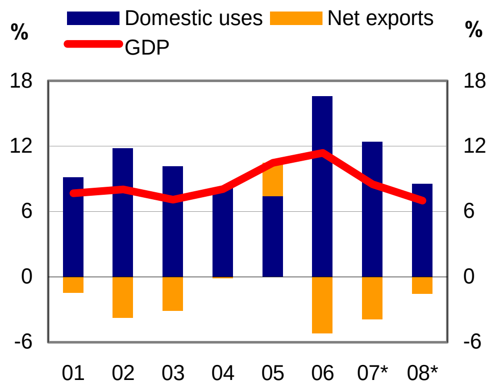
Signs are pointing to a gradual growth slowdown in 2007-2008. The current account deficit remains high, inflation is edging up and external competitiveness is on the decline. The new government seems to have settled for euro adoption no sooner than 2011 but details are yet unknown. These circumstances bring considerable risks; therefore a hard landing of the economy cannot be ruled out.

Political developments

The new government led by re-elected prime minister Andrus Ansip took office on April 4th. The coalition consists of Mr. Ansip's Reform Party (holding five line ministries), IRL (four ministries including economic affairs) and the Social Democratic Party (two ministries including finance). The coalition agreement calls euro adoption a priority. Other plans include a gradual reduction of the flat tax rate to 18% by 2011 and the boost of social benefits.

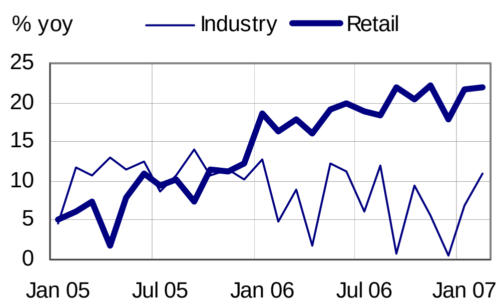
Growth

Structure of growth



*Note: * forecast. Sources: Eurostat, Statistics Estonia*

Industrial production and retail sales volume growth



Source: Statistics Estonia

GDP growth was exceptional in 2006 at 11.4%. Domestic demand was the main reason for this performance: private consumption rose by 15.7% while gross fixed capital formation increased by 19.7%. Export performance deteriorated compared to previous years, its real growth was 10%. On the other hand, imports rose by 14.7% thanks to strong demand.

Rising income levels and lending drove domestic demand last year as well. The average disposable income of households rose by 25% in 2006 while expenditures increased by 16% in value. The stock of outstanding loans grew by an annual 40.3% in February 2007; loans to non-financial enterprises and households grew by 58.3% and 60.9% respectively.

Industrial production increased by 11.1% in February. Relatively poorer performance in the second half of 2006 was explained by outlying data in the production of electric appliances by a single producer and a warm winter that set back the energy industry. Strong household demand was reflected in the 22% annual growth of retail sales in February.

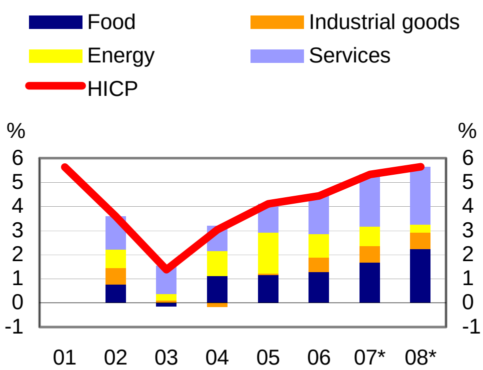
Growth is reaching its constraints in many respects. Labour markets are tight, wages and material costs are rising rapidly, reducing the competitiveness of domestic producers. Uncertainty over the indefinite postponement of euro-area entry may set back credit supply. The rising debt burden of households and the rapid rise of basic goods and services (including rents) also leave less room to increase spending despite continuing real wage growth. Rising construction costs limit investments in real estate. These developments all point to a slowdown of slowing domestic demand. Export performance is also expected to deteriorate as demand in the Nordic countries recedes slightly and competitiveness fades. However, as sub-contracting exports fall, related imports also decline, and the resulting effect on trade balance and growth is small. Declining imports for consumption and investment purposes will have a stronger impact.

We expect gradually decelerating GDP growth: 8.5% in 2007 and

7% in 2008. A hard landing scenario still cannot be ruled out however. This scenario can materialise if labour costs and domestic prices cannot be contained. As the currency peg does not allow adjustment through devaluation, real wages must fall, contracting demand and setting back growth.

Monetary developments

Components of inflation



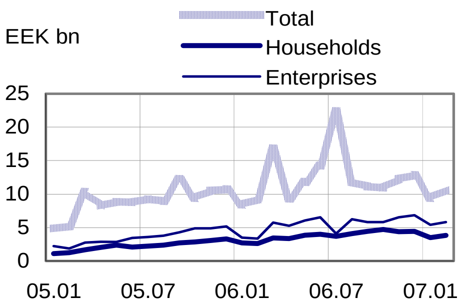
*Note: * forecast. Source: Eurostat*

Inflation reached 5.7% in March, the highest in recent years. The largest increase was experienced in housing (14.5%) as ballooning property prices translate into higher rents and regulated energy prices rise. Food and some services (health, education, restaurants and hotels) also registered higher-than-average inflation rates.

Producer prices increases are also gaining momentum. In March the 12-month increase of industrial prices climbed to 6.9% as a result of rising production costs including material prices and wages. This will eventually translate into higher consumer prices and could also undermine external competitiveness.

Tax changes and administrative price increases will add 0.96 percentage points to inflation in 2007 and almost 2 percentage points in 2008. Most notable changes include rising VAT for residential use of district heating and solid fuels in the summer of 2007, and excise tax hikes for alcohol and tobacco in 2008. The fast rise of labour-intensive services' prices will remain another key inflationary factor in 2007-08. Inflation is expected to reach an average 5.3% in 2007 and 5.6% in 2008. As the Maastricht inflation criterion cannot be fulfilled before 2009, euro adoption may take place in 2011 at earliest.

Loans granted per month



Note: enterprises excluding financial institutions.
Source: Eesti Pank

Credit growth is slowing down: after a surge of new loans mid-2006 the value of new outlays stabilised. Borrowing by households even declined slightly. By the end of February 2007 the total loan stock of banks rose by an annual 40.3%; enterprise and household loans increased by 58.3% and 60.9% respectively. In 2007-08 these growth rates are expected to subside for a number of reasons. Interest rates are on the rise (although real interest rates are still low). The average interest rate of euro-denominated loans (which constitute 75% of total loan stock) rose by 1.8 percentage points in 12 months to reach 6.93% in February 2007. Slower income growth and a higher level of indebtedness also reduce the willingness to borrow. On the supply side, foreign-owned banks may reassess the risk of their open currency positions in Estonia after the postponement of euro-area entry.[2]

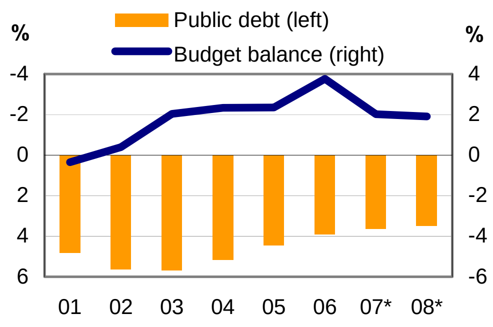
Fiscal policy

The general government finished 2006 with a sizeable surplus, 3.8% of GDP thanks to very strong economic growth. Revenues grew by 23.1% while expenditures increased by 18.3%, despite a supplementary budget allowing extra spending in November 2006.

An important change in the taxation system is the gradual reduction of the personal and corporate income tax rates from 23% in 2006 to 20% by 2009 as well as rises in tax allowances. VAT rates will rise during from 5% to 18% for some products, notably distant heating

[2] See for example: Eastern European Outlook, SEB Bank, March 2007.

Fiscal indicators (% of GDP)



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

and solid fuels sold to households as of July 2007.

The previous gradual approach to excise tax harmonisation has been scrapped. From January 2008 excise tax rates on alcohol and tobacco will rise by 10% and 15% respectively. Estonia has to raise excise tax rates the minimum level set by the EU by 2010; with the newly determined tax hikes harmonisation will take place sooner.

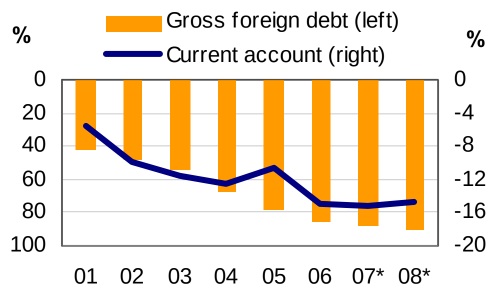
On the expenditure side, pensions and social benefits will rise; their total budgeted value is expected to increase by 17.4% in 2007 according to the latest Updated Convergence Programme of Estonia.

According to the spring forecast of the Ministry of Finance budget surpluses of 1.9% can be expected in 2007-08. We believe this is feasible given the country's record of prudent budget planning. However, Eesti Pank (the central bank) warned that a surplus in the magnitude of last year's 3.8% is necessary to counter the macroeconomic imbalances. There are also concerns that the new government might embark on a pro-cyclical expansionary course.

Public debt was 3.9% of GDP at the end of 2006. By 2008 the ratio will gradually decline to 3.5%.

External balance

External balance indicators (% of GDP)



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

The trade deficit deteriorated by four percentage points in a year to 10.3% in 2006. The services surplus could counter less of the sizeable, 16.6% merchandise trade deficit than in previous years. The value of goods and services exports rose by 18.3% while imports increased by 24.1%. The current account deficit amounted to 14.9% of GDP in 2006, the highest figure in recent years.

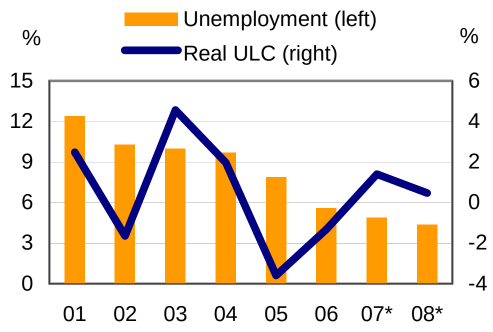
Rising labour and material costs and the increasing shortage of qualified workforce will be detrimental to competitiveness in 2007-08. Some Estonian companies are considering production relocation to Belarus and Ukraine as an answer. The resulting export slowdown will be accompanied by slower import growth. Material imports for sub-contracting exports will be affected by lower competitiveness while imports for consumption purposes will feel the domestic economic slowdown. We expect the trade balance to deteriorate slightly while the current account deficit will stabilise around 15% in 2007-08.

External financing requirement amounted to 12.4% of GDP in 2006. Net FDI inflows were a modest 2.8% due to less inward and more outward FDI than in previous years. Debt financing amounted to 12.6% mostly in the form of bank borrowing from Scandinavian parent companies. The stock of foreign reserves increased by EUR 416 mn. Gross foreign debt was 85.2% of GDP at the end of 2006, having risen 7 percentage points in a year. Similar tendencies are expected in 2007-08. Gross foreign debt will rise by 2-3 percentage points a year.

Labour market

Job creation was very strong in 2006, employment rose by 5.4% according to national accounts data and by 6.5% according to the labour force survey. The opportunity to work raised the number of actives by 3.8% as well. Unemployment fell to a historic low 5.6%.

Labour market indicators



*Note: * forecast. Source: Eurostat*

Employment growth is nearing its limits; labour shortages are already appearing. Unemployment will continue to decline to 4.9% in 2007 and to 4.4% in 2008, in effect meaning full employment.

Average gross wages rose by an annual 17,5% in the last quarter of 2006. Increases exceeded 20% in manufacturing, construction and trade reflecting increasing labour shortages. Tight labour markets have increased workers' bargaining power resulting in higher wage demands and warnings for strikes in recent months.

Productivity outpaced labour cost growth in 2006, thus real unit labour cost declined by 1.3%. In the near future the wage pressures will prove stronger than productivity gains, although both are expected to slow down. As a result, real unit labour cost will rise by 1.4% and 0.5% in 2007 and 2008 respectively.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (EEK mn)	173,062	204,600	238,600	271,900
Real GDP growth (%)	10.5	11.4	8.5	7.0
Private consumption (%)	8.2	15.7	15.0	10.0
Public consumption (%)	1.1	2.8	2.5	2.5
Investments (GFCF, %)	12.7	19.7	15.0	7.0
Exports (%)	21.5	10.0	9.0	8.0
Imports (%)	15.9	14.7	12.0	8.5
Annual average inflation (%)	4.1	4.4	5.3	5.6
Policy rate (%)	-	-	-	-
Money market rate (3-month, %)	2.59	3.75	5.00	5.00
Long-term interest rate (10-year gov't bond, %)	3.94	4.70	5.20	5.00
Exchange rate / EUR (average)	15.65	15.65	15.65	15.65
Exchange rate / EUR (end of period)	15.65	15.65	15.65	15.65
Budget balance / GDP (%)	2.3	3.8	2.0	1.9
Public debt / GDP (%)	4.4	3.9	3.6	3.5
Trade balance / GDP (goods and services, %)	-6.2	-10.3	-12.1	-12.1
Current account balance / GDP (%)	-10.5	-14.9	-15.1	-14.7
Gross foreign debt / GDP (%)	78.0	85.2	89.4	92.3
Unemployment (%)	7.9	5.6	4.9	4.4
Real ULC growth (%)	-3.6	-1.3	1.4	0.5

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

Sources: Eesti Pank, Eurostat, Statistics Estonia

Hungary

GDP growth falls to below 3% this year as the fiscal stabilisation measures start to exert their full effects on the economy. A significant rise in CPI-inflation is also mostly attributed to the fiscal package. Favourable external demand will, however, lead to further improving net exports, and the narrowing of the current account deficit will continue into 2007 and 2008 as well. Domestic demand will pick up again and the disinflation process also continues when the one-off effects of the stabilisation measures gradually die off next year.

Political developments

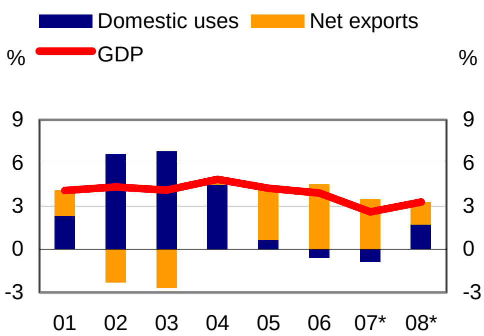
András Simor took over the helm from Zsigmond Járai at Magyar Nemzeti Bank (MNB, the central bank). He was probably the least disputed of all candidates, thus his nomination was received well by investors and markets. There were two meetings of the Monetary Council since he became governor. Despite higher than expected wage increases and soaring inflation figures the base rate has been left unchanged.

Both political parties of the governing coalition have elected new leaders. While Ferenc Gyurcsány had no real contender for the presidency of the Socialist Party, economic minister János Kóka from the Free Democrats edged out his opponent by a very narrow margin. As Messrs. Gyurcsány and Kóka are understood to have very good informal relationship, many analysts argue that the ties between the two parties will become even stronger in the future.

Fierce debates over the government's health care reforms finally led to the resignation of health minister Lajos Molnár. Neither medical chambers nor the public was in support of the most crucial measures of his reform plans. Even Socialist mayors and members of the parliament opposed a radical cut in the number of hospital departments and beds.

Growth

Structure of growth

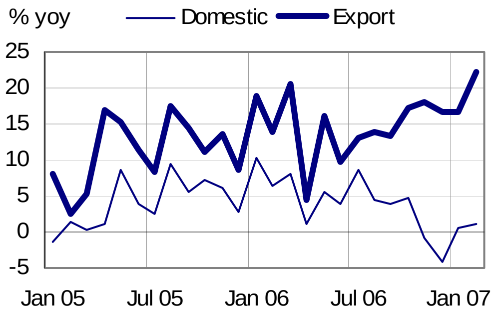


*Note: * forecast. Source: KSH (statistical office)*

The last quarter of 2006 brought apparent signs of slowdown in economic growth. Based on seasonally adjusted data private consumption stagnated in the fourth quarter, public consumption exhibited continuing sharp decline, and while gross fixed capital formation was recovering, its level was not any higher than in early 2005 due to the freefall of mid-2006. Ailing domestic demand is also reflected in the deceleration of services value added growth. On the other hand vibrant growth in Hungary's external markets gave further impetus to already strong export sales. This finally resulted in a trade surplus in 2006 for the first time since 1996 and was the main contributor to the annual average GDP growth of 3.9%.

The sharp deceleration in the components of domestic demand is mostly explained by the austerity measures introduced partly at the end of 2006 and partly at the beginning of this year. These measures are aimed at restoring the budget balance that fell deep under the 3% Maastricht limit. Rising taxes and cuts in price subsidies directly affect private consumption, but there also are elements that discourage entrepreneurial activity (e.g. stricter rules for the collection of social contributions). These measures will exert

Growth of industrial sales (volume)



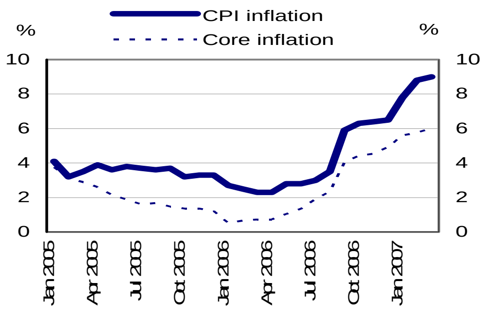
Source: KSH

their full effect in 2007, leading to continuing drop in both private and public consumption. The recovery in gross fixed capital formation will also be quite slow, since government and household investments decrease further, while (judged by the current level and trend of capacity utilisation) manufacturing investments will be far from booming. The outlook for net exports, however, remains very favourable with export growth pulled by strong external demand and import growth limited by weak domestic demand. Taken together, GDP growth in 2007 will decrease to 2.6% with domestic components contributing negatively and net export contributing positively to this rate.

As the effects of the fiscal stabilisation measures gradually fade, 2008 will see rising real earnings again after a contraction of income in 2007. Thus private consumption can embark on a slowly expanding path next year together with other components of domestic demand. External demand, however, will become less dynamic as the exceptionally high growth rates of trade partners will ease somewhat. Thus an increase in domestic demand will be accompanied by only a more moderate improvement in net trade. This will result in a 3.3% growth of real GDP in 2008.

Monetary developments

12-month inflation rates



Source: KSH (statistical office)

Annual average consumer price inflation reached 3.9% in 2006, but 12-month inflation stood at 6.5% in December. An upward pressure on consumer prices developed from last September in the wake of the fiscal stabilisation measures that affected energy and drug prices. A rise in the middle VAT rate (from 15% to 20%) also led to overall price increases. In the first months of 2007 the direct effect of further regulated price rises dominate the inflation process, though excise duties will also be raised later in two steps. In March the 12-month rate of CPI-inflation hit 9%, which is probably the peak, but figures will remain in the range of 7 to 8.5% until September. A considerable decrease will only take place at the end of 2007. We expect an annual average inflation of 7.4% this year.

Core inflation increased to a more limited extent, which gives rise to the hypothesis that economic actors will assess recent price rises as temporary. Should this be the case, it could positively affect the disinflation process from the end of this year and could lead to a well-reduced inflation rate of 3.6% in 2008.

Recent exchange rate developments

Source: MNB

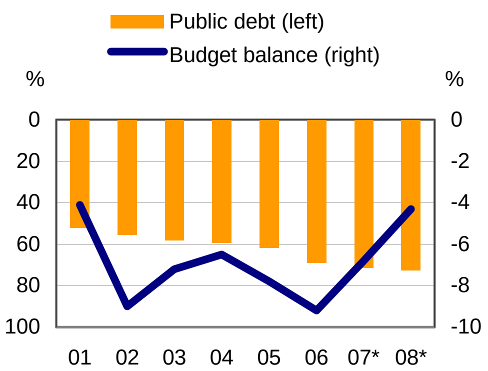
Domestic factors will not jeopardise the stability of the financial system in 2007. Besides, neither the exchange rate nor other external developments will prevent a gradual reduction of the base rate. We believe the current level of 8% to be the peak of the recent interest rate cycle. We expect the base rate to be gradually decreased to 7.25% in two or three steps by the end of 2007.

In line with faster disinflation further monetary easing is expected in 2008. It remains to be seen, however, whether wage growth in the private sector can be kept under control, as this determines the willingness of the central bank to reduce the policy rate faster or in a more conservative manner. Our guess for the end of 2008 is a base rate of 6.5%.

The appreciation of the forint at the end of 2006 is partly explained by speculation about the possible termination of the +/-15% exchange rate band of the forint. In our view, an exchange rate in the range of 250-255 would be consistent with fundamentals. On the forecast horizon we thus expect a relatively strong and stable forint vis-à-vis the euro at this level.

Fiscal policy

Fiscal indicators (% of GDP)



*Note: reverse scale on left axis. * forecast.*
Source: Ministry of Finance

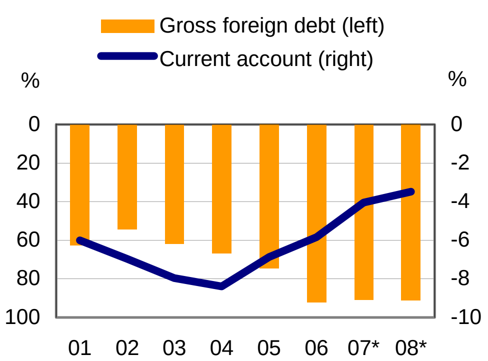
According to recent statements the budget deficit according to ESA methodology was somewhat lower in 2006 than expected, reaching ‘only’ 9.2% of GDP. This is still not the final figure for the past year, but still indicates that fiscal stabilisation measures may have materialised to some extent in 2006, mainly through improved revenue (especially tax) collection.

Cash flow-based figures for the central government from the first three months of 2007 also point to the role of increased revenues in the improvement of the budget balance. While there are no signs to date that expenditures began to decrease, revenues were up by 14.5% compared to the first quarter of 2006. Actual tax revenues well exceeded planned levels, probably due to a lower than expected reduction in private consumption and faster inflation. In the rest of the year we expect revenue growth to remain the main source of a narrowing budget deficit, but from the end of 2007 spending cuts will also contribute positively to the balance. Since economic growth will be somewhat higher in 2007 than originally thought, the targeted budget deficit of 6.8% can be achieved even with a minimally expected fiscal discipline. Even under these circumstances the stock of public debt will increase to 71.5% of GDP, well above the Maastricht criterion of 60%.

We have some concerns about the planned 2008 figure, though. The convergence program of the government assumes a deficit of 4.3% of GDP for next year. As our calculations suggest, this would necessitate a very considerable cut (amounting to 2.5% of GDP) on the expenditure side alone. This is only possible if planned institutional and structural reforms are undertaken with maximum determination and scrutiny. There are risks that the content and/or the extent of some measures will be relaxed. In this case the improvement in the budget deficit will be smaller, since the economy will recover only slightly in 2008, thus sources for additional fiscal revenues are limited.

External balance

External balance indicators (% of GDP)



*Note: reverse scale on left axis. * forecast.*

The last quarter of 2006 saw very favourable developments in foreign trade. It was the first time since 1995 that the balance of goods exhibited a surplus, and there were improvements in the services’ balance as well. Taken together, goods and services showed a surplus of 0.7% of GDP in 2006. The deterioration of the incomes balance continued last year with both dividend payments on foreign direct investment and interest payments on foreign debt increasing steadily. Still, the overall deficit of the current account at 5.8% of GDP was considerably lower than we expected a quarter before.

With strong external and weaker domestic demand in the background, the trade balance of goods and services can improve further this year and reach 2% of GDP. However, the risk of a significant revision of import flows is still present, as they are believed to be under-reported since Hungary’s EU entry because of

Source: MNB

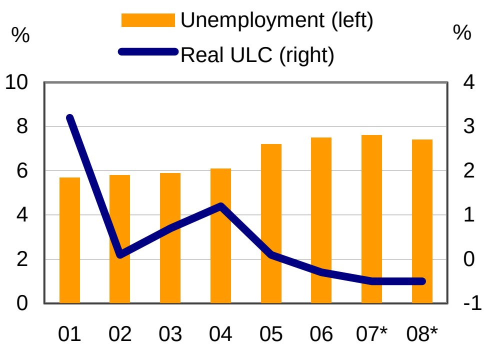
a change in the statistical reporting system. If no revision will take place, the current account will improve significantly even with a further worsening in the income balance. The final figure for the deficit could be as low as 4% of GDP this year and could contract further to 3.5% of GDP next year.

The structure of financing changed considerably in 2006 compared to 2005. Debt-generating net capital inflows remained level, but there was a net outflow in non-debt generating capital movements. This was a reflection of net FDI inflows (excluding debt-type components) falling from close to EUR 4 bn in 2005 to virtually nil in 2006. Hungarian ventures are increasingly investing abroad (OTP, the largest Hungarian commercial bank spent EUR 1.3 bn on acquisitions in Ukraine, Russia and Serbia) while some foreign investors unexpectedly withdrew from Hungary. In 2007-08 the dominance of debt-generating net capital inflows will prevail, with annual net FDI flows stabilising around only 1.5% of GDP.

Due to vanishing non-debt capital inflows the stock of gross foreign debt increased from 74.6 to 92.1% of GDP between 2005-06. This significant rise is partly attributed to the depreciation of the forint mid-2006. The foreign debt-to-GDP ratio is calculated from data in euro, and due to the depreciation nominal GDP in euro barely increased last year. The strong forint this year will have the opposite effect: despite slow real GDP growth, nominal GDP in euro will rise fast. Thus, while gross foreign debt will further increase in value, its ratio to GDP will stabilise at around 90% in 2007-08.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

The labour force survey indicated a rise in the numbers of actives and employed in February (2.7% and 2% year-on-year, respectively). At the same time, unemployment figures also rose. The unemployment rate stood at around 8% in February, 0.6 percentage point higher than a year before. Activity improved mainly due to stricter regulation on unemployment and social benefits, while job creation was weak, leading to rising unemployment.

The fiscal stabilisation measures entail a sizeable lay-off in the public sector this year. Part of this was already observed in January. In the private sector the response to weaker domestic demand takes place not through an adjustment in the number of employees, but through the less intensive use of labour. This manifests itself in lower man-hours both at the end of 2006 and at the beginning of this year. An exception is the construction sector, where a considerable drop in output is accompanied by significant reductions in the work force. Taking recent developments into account we expect an average unemployment rate of 7.6% in the course of this year. With a slowly recovering economy in 2008 job creation can pick up again, creating an opportunity for slightly decreasing unemployment. The annual average figure could be around 7.4% next year.

Whereas gross earnings in the first two months of 2007 were 6.5% higher than a year ago, due to changes in taxes and social contributions net wage growth was only 0.5%. Coupled with accelerating inflation, the real value of average (net) monthly salaries was 7.2% lower a year before. Due to within-year dynamics of both salary increases and inflation we expect that real earnings on average will only decrease by 2.8% in 2007. With inflation significantly declining in 2008, real earnings can exhibit a growth of 1.5% next year. Slowing wage dynamics coupled with productivity growth especially in the export oriented manufacturing sector mean that unit labour costs only marginally increase in both 2007 and 2008, and real ULC can even decline.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (HUF bn)	22,027	23,562	25,100	26,800
Real GDP growth (%)	4.2	3.9	2.6	3.3
Private consumption (%)	3.8	1.2	-0.5	1.5
Public consumption (%)	0.2	-5.5	-4.2	1.0
Investments (GFCF, %)	5.6	-1.8	2.1	3.2
Exports (%)	11.6	18.0	12.4	8.9
Imports (%)	6.8	12.6	9.2	7.9
Annual average inflation (%)	3.6	3.9	7.4	3.6
Policy rate (%)	6.00	8.00	7.25	6.50
Money market rate (3-month, %)	5.94	7.90	6.90	5.80
Long-term interest rate (10-year gov't bond, %)	6.97	6.71	6.30	6.00
Exchange rate / EUR (average)	248.1	264.3	251.0	252.0
Exchange rate / EUR (end of period)	252.7	252.3	252.0	252.0
Budget balance / GDP (%)	-7.8	-9.2	-6.8	-4.3
Public debt / GDP (%)	61.7	69.0	71.5	72.5
Trade balance / GDP (goods and services, %)*	-0.8	0.7	2.0	2.6
Current account balance / GDP (%)*	-6.9	-5.8	-4.0	-3.5
Gross foreign debt / GDP (%)*	74.6	92.1	90.9	91.2
Unemployment (%)	7.2	7.5	7.6	7.4
Real ULC growth (%)	0.1	-0.3	-0.5	-0.5

*Note: f = forecast. * calculated from data in euro. See methodological notes for definitions and details.*

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

Latvia

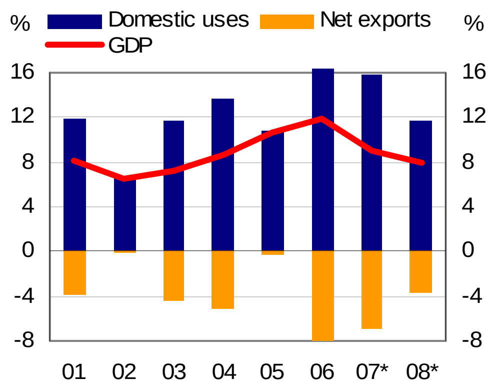
Economic policy has shifted in response to high inflation, massive external imbalances and shaky financial markets. A new anti-inflationary package is set to cool down the overheated economy. Although a hard landing is still a possibility, chances of an orderly slowdown improved. As imbalances need time to unwind, risks will remain considerable throughout 2007-2008.

Political developments

The domestic political agenda is marred by corruption scandals, controversy and feuds between the president and the government. Early March the government approved measures to contain high inflation and get the economy back to a sustainable growth path (for details see box). On March 27th Latvia and Russia signed a long-awaited border agreement in which Latvia ceded disputed territory near the town of Abrene/Pitalovo to Russia. The agreement is expected to improve Latvian-Russian relations.

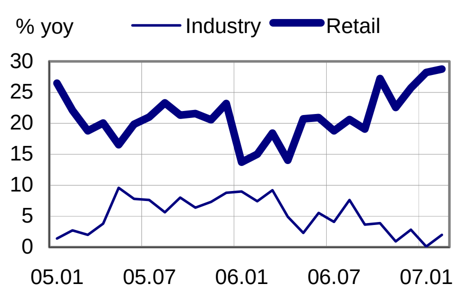
Growth

Structure of growth



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

Industrial production and retail sales volume growth



Source: Statistics Latvia

The economy continued to grow briskly in the last quarter of 2006 and the annual GDP growth rate reached 11.9%. Domestic demand was the key driver of growth: private consumption and investments rose by 19.8% and 18.3% respectively. On the other hand, the contribution of the public sector to growth remained modest although a supplementary budget increased public spending in 2006. Net exports contributed negatively to growth as in previous years. Real export growth was as low as 5.3% while strong internal demand boosted imports to 17.5%.

Domestic demand is fuelled by fast income growth and easy credit. Real wages and salaries rose by 15.6% in 2006. High inflation keeps real interest rates negative, encouraging borrowing. Loans to households rose by 75.5% while loans to non-financial enterprises increased by 52.5% between the beginning and end of 2006.

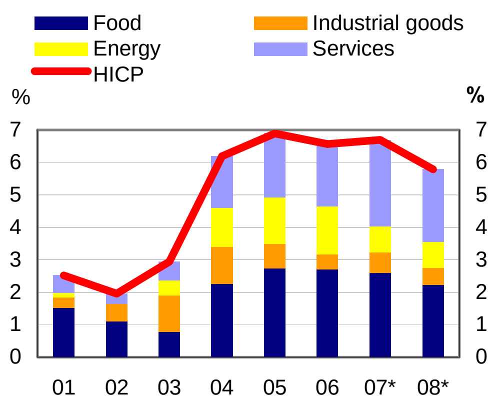
Industrial production decelerated in 2006, its volume growth declined to an annual 2% by February 2007 from a 9.2% peak in March 2006. On the other hand, spend-happy consumers kept retail sales growing: its volume grew 28.8% in February 2008 and the trend shows acceleration since early 2006. Sluggish industrial output can persist due to capacity constraints but the trend in retail sales is expected to reverse as households adjust to much lower real income growth in the coming years.

By now policymakers recognised that the economy is overheated. A hard landing resulting in a prolonged period of stagnation is a real risk. If the anti-inflationary measures of the government (see box) prove effective, a gradual slowdown is expected. Tighter credit standards should cool borrowing; new duties on real estate are meant to contain the housing boom and restrictions on public spending will slightly curb demand. In the longer term, structural reforms are meant to increase capacity and ease the tight labour market. If government measures fail to take effect, the risk of a more abrupt slowdown and a prolonged stagnation will rise.

Based on known policy measures we believe that domestic demand will decline faster than anticipated. Therefore we revise our growth forecast for 2007 from 9.5% to 9%. If the benign scenario prevails, growth will come down further in 2008 to 8%. The combination of decelerating domestic demand and slightly improving net exports will bring about this slowdown.

Monetary developments

Components of inflation



*Note: * forecast. Source: Eurostat*

Annual average inflation was 6.6% in 2006. 12-month consumer price inflation was 8.5% in March 2007 thanks to double-digit rises in the prices of food, public utilities and some services (education as well as hotels and restaurants).

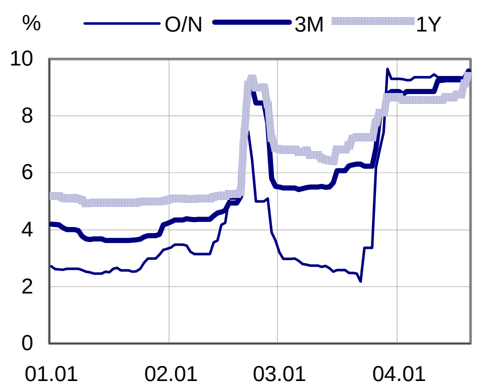
Producer prices of the industry increased by 15.8% in February reflecting rising energy and labour costs among other factors. Construction costs increased by an annual 25% in the last quarter of 2006.

Energy prices, labour costs and excise tax increases are the main supply side factors behind high inflation, while strong demand also exerts upward pressure on prices. Inflation is expected to peak in 2007 at 6.7% because the persistence of a positive output gap. Anti-inflationary measures need time to take effect; with their help inflation can decelerate to 5.8% in 2008.

Fast credit growth continued in 2006. The stock of household debt grew 75.5%, driven by long-maturity housing loans. Credit to private non-financial enterprises increased by 54.2%. New anti-inflationary measures try to contain credit growth by tightening prudential requirements (see box). Still, cut-throat competition among banks is likely to continue with the entry of major players including Danske Bank, GE Money and Societé Generale. Therefore credit growth may not slow down as much as the government would prefer.

Extraordinary current account imbalances brought doubts about the sustainability of the exchange rate in February and March. In the second half of March the lat remained stubbornly on the weak end of its +/-1% band around the central parity and Latvijas Banka (the central bank) was forced to intervene by selling EUR 332.1 mn within three weeks. Latvijas Banka also used verbal intervention to quell further speculation and lend support to the stabilisation plan of the government.

Interbank (RIGIBOR) rates in 2007



Source: Latvijas Banka

Uncertainty translated into money market volatility: the 3-month RIGIBOR climbed from 4.2% to 9.6% since the beginning of 2007. Long yields rose as well. The rate for government bonds with 10 years remaining maturity has been climbing steadily over the last 12 months up to 5.07% in February; the spread over the average euro-area yield widened from nil to one percentage point.

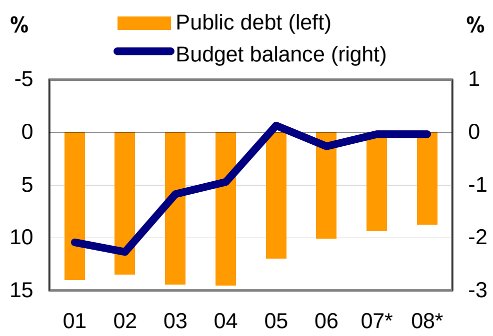
In our view devaluation of the lat is not likely. The reserves of Latvijas Banka more than cover the monetary base while shallow markets (thanks partly to low public debt) limit the amount of assets to (short-) sell. Therefore speculative attacks are difficult. The risk of a capital flight is mitigated by the fact that the largest chunk of foreign liabilities is loans from Scandinavian banks to local affiliates. Finally, new measures by the government to tackle inflation are expected to cool the economy and unwind imbalances in the medium term.

Still, recent events serve as a reminder that even the most credible exchange rate peg bears currency risk. Borrowers have taken the peg as a guarantee, which led to spontaneous euroisation: at the end of 2006 almost 75% of household and corporate loans were denominated in euros. This would make devaluation especially harmful. The only way to overcome currency risk is the timely introduction of the euro. Analysts guess that 2011-12 would be feasible entry date to the euro-area.

As a side-effect of higher risk yields are expected to remain high throughout the year. We expect further monetary tightening in 2007. Even if current turbulences subside, short- and long-term rates will hover around 6% in 2007-08.

Fiscal policy

Fiscal indicators (% of GDP)



*Note: reverse scale on left axis. * forecast.*

Source: Eurostat

The general government finished 2006 with a 0.3% deficit. Strong economic growth resulted in outstanding revenues, rising by 25.7%. A supplementary budget aimed to spend windfall receipts. The government was unable to spend earmarked investment funds but current expenditures increased. Total spending rose by 23.3%.

The Convergence Programme presented to the European Commission in January 2007 aimed to reach a balanced budget by 2010. Pension and health care reforms require increasing expenditures in the medium term. Spending on internal security and on public employees' salaries is also set to rise in 2007.

Contributions to the public pension system rise from 2% to 4% in 2007 and will increase to 9% be 2009. Other tax changes in 2007 include rises in the non-taxable minimum income and other personal income tax reliefs as well as a VAT reduction from 18% to 5% for a few goods and services, most notably residential electricity and gas supply. Excise taxes on cigarettes and oil products increase to gradually harmonise national rates with EU requirements.

The government has recently recognised that a more restrictive fiscal policy is needed to contain inflation. On March 6 the government passed a resolution on a package of anti-inflationary measures (see box). A major element is a balanced budget target already in 2007 and 2008. In our view this is achievable: built-in expenditure rises and tax changes can be offset by the rationalisation of administrative spending, and revenue collection should remain string due to still-high growth. Furthermore, plans to reduce the personal income tax rate from 25% to 15% were also shelved by the re-elected government.

Thanks to improving budget balances, public debt is expected to remain fairly stable in value and decline relative to GDP over the next years. It is expected at 9.1% in 2007 and 8.5% in 2008.

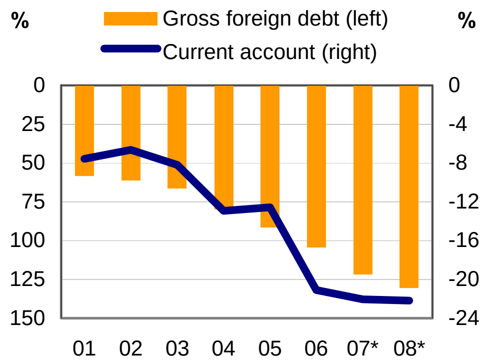
As a consequence of rising risks stemming from large external imbalances, Fitch downgraded the credit rating outlook of Latvian public debt from stable to negative on April 5, recognising government efforts nevertheless. Current foreign and local currency issuer default ratings are A- and A respectively. Moody's retained its A2 rating with positive outlook for both foreign and local currency government bonds.

Key anti-inflationary measures

- **Fiscal tightening:** balanced budget already in 2007-2008 and surplus in 2009-2010 to control aggregate demand. Public spending will be contained by a comprehensive review of budget base expenditures for all ministries. The real estate boom will be cooled by two new fiscal measures: a new tax will be introduced on income from the sale of real estate if held for less than three years; and land registration duties will become differentiated.
- **Prudential requirements to curb lending growth:** Banks and leasing companies must determine the purchasing power of clients and make loans available based exclusively on legal income. Financial service providers and vendors will have to require a legal income statement before transactions worth over 50 times the minimum wage. Mandatory first instalments and upper ceilings to loan-to-value ratios will be tightened. A single universal register of borrowers will be created. Accessible by all financial institutions, it will help them determine the indebtedness of clients.
- **Structural reforms:** Improving energy efficiency will reduce energy consumption; this should lower the economy's exposure to energy price shocks. The government aims to stimulate competition in retail and construction and introduce labour market reforms to increase participation and productivity. These measures will increase production capacity.

External balance

External balance indicators (% of GDP)



*Note: reverse scale on left axis. * forecast.*

Source: Eurostat

Besides high inflation, a wide current account deficit is the main symptom of overheating in Latvia. The 2006 deficit reached 21.1% of GDP exceeding the all expectations. The trade deficit of goods and services reached 21%. Exports increased by 14.5% in value while imports rose by 28.8%. Goods exports were hit by long queues on the Russian border, scandals about the quality of exported foodstuff and in all probability, loss of competitiveness due to rising production costs. Services exports were set back by declining freight from Belarus and a warm winter (meaning less railroad transport instead of shipping). On the other hand, imports of consumption goods and building materials soared.

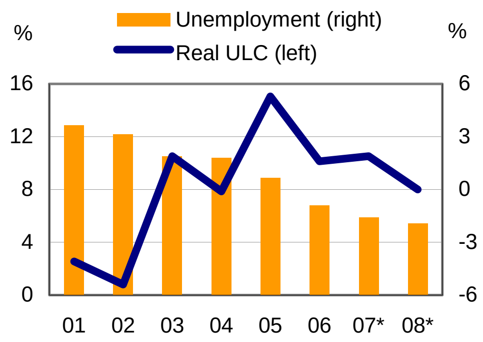
Due to the inertia of production cost increases export growth is expected to remain modest in 2007-08. On the other hand, decelerating domestic demand will slow down imports. This change in trends will not be able to reverse the deterioration of the external balance in the short term. The trade deficit will widen to 24.2% and 24.7% in 2007 and 2008 respectively. The income and transfer balance will mitigate this thanks to remittances from migrants and EU funds. The current account deficit is expected to remain around 22% in 2007-08.

Net financing requirement (the sum of the current account and capital deficits) was EUR 3.2 bn (20% of GDP) in 2006. Non-debt financing was EUR 0.9 bn; net FDI inflows accounted for almost EUR 1 bn a record high in recent years. Debt financing amounted to EUR 4.8 bn, chiefly in the form of loans by Latvian banks from their foreign parent companies. International reserves increased by EUR

1.6 bn. In the coming years debt will remain the key form of external financing. As a consequence, gross foreign debt, standing at 104.4% of GDP in 2006, may rise to 130.4% by 2008.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

Thanks to strong economic growth employment rose by 4.9% according to national accounts and by 5.3% according to the labour force survey in 2006. The number of actives rose by 2.9%, and the unemployment rate decreased to 6.8%.

Due to large-scale outward migration of workers shortages are appearing. The reduction of administrative barriers to immigration from countries outside the EU is under consideration by the government. As a result of the expected slowdown employment growth should also decelerate, but improving work opportunities and rising income levels will raise activity. In our view unemployment will decline further to 5.9% in 2007 and 5.4% in 2008.

Wage growth is strong as a result of tight labour markets, productivity gains and partly because income legalisation. Nominal labour productivity increased by 18.4% in 2006 while average labour costs per employee rose by 20.3%. As a consequence real unit labour cost rose by 1.6%. Productivity growth will slow down but all signs point to continuing wage rises. The minimum wage was increased from LVL 90 to LVL 120 from January 1, 2007; public sector salaries are set to rise further; and labour markets are becoming even tighter. Unit labour costs are expected to increase by 1.9% in 2007 and stabilise in 2008 if income growth can be reined.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (LVL mn)	9,059	11,265	13,261	15,253
Real GDP growth (%)	10.6	11.9	9.0	8.0
Private consumption (%)	11.5	19.8	14.0	10.0
Public consumption (%)	2.7	4.0	2.0	2.0
Investments (GFCF, %)	23.6	18.3	17.0	15.0
Exports (%)	20.3	5.3	6.0	7.0
Imports (%)	14.8	17.5	15.0	10.0
Annual average inflation (%)	6.9	6.6	6.7	5.8
Policy rate (%)	4.00	5.00	6.00	6.00
Money market rate (3-month, %)	3.16	4.21	6.50	6.00
Long-term interest rate (10-year gov't bond, %)	3.59	4.90	6.00	5.50
Exchange rate / EUR (average)	0.70	0.70	0.70	0.70
Exchange rate / EUR (end of period)	0.70	0.70	0.70	0.70
Budget balance / GDP (%)	0.1	-0.3	0.0	0.0
Public debt / GDP (%)	12.0	9.8	9.1	8.5
Trade balance / GDP (goods and services, %)	-15.2	-21.0	-24.2	-24.7
Current account balance / GDP (%)	-12.6	-21.1	-22.1	-22.2
Gross foreign debt / GDP (%)	91.6	104.4	121.8	130.4
Unemployment (%)	8.9	6.8	5.9	5.4
Real ULC growth (%)	5.3	1.6	1.9	0.0

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

Lithuania

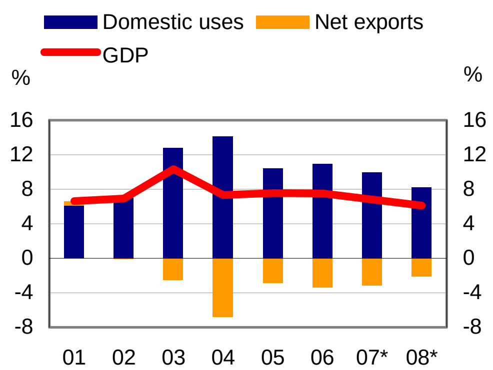
Gradually slowing economic growth and widening external imbalances characterise the Lithuanian economy in both this and the next year. While the fiscal situation is very favourable, inflationary pressures are still on the rise, emanating in a good part from the labour market. Entry into the eurozone can not be expected to take place before 2010-2011 based on current economic conditions.

Political developments

Local elections were held on February 25th. The conservative Homeland Union recorded the most votes, followed by the Social Democrats, the leading party of the ruling coalition. In Vilnius, however, former president Rolandas Paksas' party, Order and Justice came first; they also secured a nationwide third place. This came as a bit of surprise since Paksas was forced to resign from presidency in 2004 after being accused of using the security services to weaken his business rivals. The turnout on the elections was quite low (36%).

On March 27th finance minister Zigmantas Balcytis handed in his resignation to prime minister Gediminas Kirkilas. The reason behind his move was a court case involving his son. As Mr. Balcytis explained, he did not want to become a subject of speculation. His successor has not been decided to date.

Structure of growth



*Note: * forecast. Source: Eurostat*

Growth

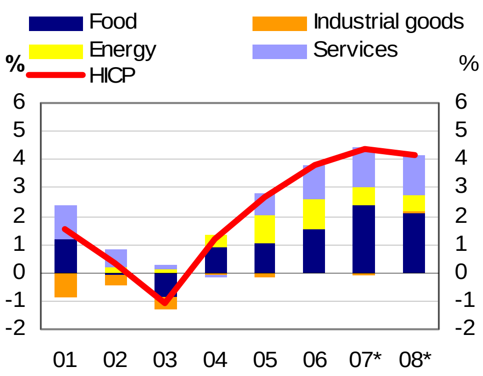
Year-on-year GDP growth in the last quarter of 2006 was 6.9%, while average annual growth reached 7.5% last year. In the third quarter some signs of deceleration were observed especially in domestic demand, but the fourth quarter brought resilient growth both in private consumption and gross fixed capital formation. This led to a more than one percentage point higher annual growth rate in both items than we projected a quarter before. Export growth, however, slowed further, possibly still reflecting the consequences of the mid-2006 accident at the country's main oil refinery, which led to a significant reduction of capacities. The trend of import growth also declined, but not as swiftly as exports, resulting in higher than expected trade deficit.

Growing incomes, continued borrowing, a rise in pensions from February, and the outlook for a further cut in the personal income tax rate will all boost private consumption in 2007, leading to a growth rate of 9%. Due to favourable financing conditions and extended availability of EU funds investments will also expand vigorously at just below 10%. Under the assumption that damaged oil-refining capacities will be restored, export will pick up this year, but due to outstanding domestic demand, import growth also remains high, pushing the trade balance deeper in negative territory. GDP growth will still be robust at 6.8%.

2008 will see continued strong economic expansion, but growth rates are expected to moderate somewhat. A possible slight deterioration in financing conditions due to fears of overheating and too high indebtedness on part of households will reduce the growth of private consumption and investments to around 7%. This will also result in slower import growth. Net trade will, however, remain a drag on overall economic performance. The growth rate of GDP could decrease to around 6% by next year.

Monetary developments

Components of inflation



*Note: * forecast. Source: Eurostat*

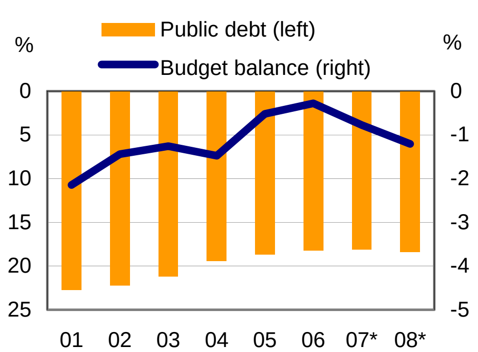
12-month consumer price inflation exhibited a 4.6% increase in March, while compared to December 2006 prices increased by 0.9%. The major sources of this rise are developments in food prices (9.1% increase year-on-year) and utility prices (10.9% year-on-year). The latter were not fully felt by households due to a warmer than usual winter, but will have a secondary effects through increasing production costs. This will keep the momentum for further price increases for a range of products and services. High wage growth will also support the acceleration of consumer price increases. We project an annual average CPI inflation of 4.4% in 2007. Considering expected developments in energy prices and wages next year, CPI inflation could decelerate only very moderately in 2008. Our forecast for annual average CPI inflation is 4.2% but there are many risks on the upside. This also means that we do not expect Lithuania to satisfy the Maastricht inflation criterion before 2010.

There is no independent central bank rate for Lithuania, as the Lietuvos Bankas (the central bank) sets its overnight repo rate equal to ECB's marginal lending facility rate. The latter was raised by 25 basis points in the middle of March. We expect a further 25 basis points rate hike in the middle of the recent year, which will be automatically followed by the Lietuvos Bankas. Differentials in short-term yields vis-a-vis euro area securities are negligible and will remain so in 2007-08 provided external imbalances prove tractable (financed in an adequate structure). Last year Standard & Poor's reaffirmed the long-term credit rating of Lithuania at grade A with stable outlook. Financial markets are sound, leaving very restricted space for speculation up to date.

Credit growth is still markedly strong: loans to households increased by almost 70% in 2006, and credit to non-financial corporations also expanded close to 50%. Heavy borrowing will be continued in 2007-08, but its pace will be somewhat slower.

Fiscal policy

Fiscal indicators (% of GDP)



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

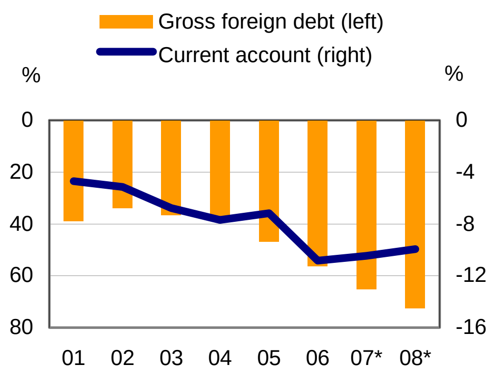
Exceptional revenues were the major reason behind the further narrowing budget deficit that was a mere 0.3% of GDP in 2006. Especially the collection of income taxes exceeded plans, but taxes on production were also beyond expectations. On the expenditure side government investments increased above average, but in essence all spending items were well controlled. Revenues from the sale of the state's stake in Mazeikiu Nafta, Lithuania's oil refinery did not directly enter the budget as it was mostly recorded in the financial accounts of the government. It could, however, boost government investments further in 2007.

Given the favourable fiscal balances, a further personal income tax cut is expected at the beginning of 2008. Should revenue collection prove as favourable in 2007 as last year, this measure could already materialise in the second half of this year. On the expenditure side we expect increased government investment on the forecast horizon and the compensation of state employees will also rise. All in all, a minor deterioration in the budget is envisaged in 2007-08. The deficit can reach 0.8% of GDP this year and 1.2% in the next year.

Public debt stood at 18.2% of GDP at the end of 2006, a further reduction from the already quite low ratio of 18.7% a year earlier. This figure masks the fact, that the stock of public debt in itself increased from LTL 13.3 billion to LTL 14.9 billion, i.e. by more than 12 percentage points and it is the growth of nominal GDP that led to this decrease. In 2007, however, nominal GDP growth will only be enough to offset further debt increases, thus the public debt ratio will be stabilized at slightly above 18%. In 2008 nominal GDP growth will be even lower and public debt could exhibit a minor rise to 18.5% of GDP.

External balance

External balance indicators (% of GDP)



*Note: reverse scale on left axis. * forecast.*

Source: Lietuvos Bankas

The current account deficit hit a record high 10.8% of GDP in 2006. In the fourth quarter weak exports and a still booming import widened the deficit on goods trade in excess of EUR 1 bn, resulting in an annual deficit of EUR 3.3 bn (almost 14% of GDP). This is partly offset by a surplus of EUR 860 mn on services. This figure, however, is not much better than it was in 2005. Significant deterioration took place in the incomes balance, as payments to both direct and portfolio investors as well as to other creditors increased considerably. The surplus on current transfers was the same as a year before.

The trade balance will deteriorate further in 2007-08. This, however, will be somewhat mitigated by a minor improvement in the terms of trade. Interest and dividend payments on the stock of foreign debt and foreign direct investment will continue rising, but their growth rate will be more moderate than in 2006. Despite these tendencies, due to high nominal GDP growth the current account deficit can narrow to 10.5% of GDP this year and slightly below 10% by 2008.

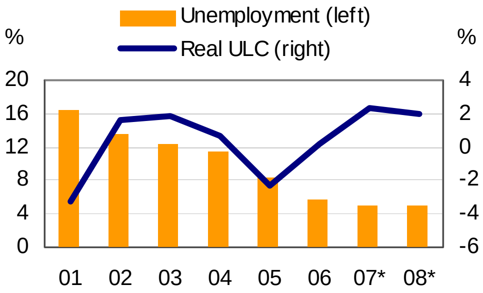
On the financing side foreign direct investment had a major role, since inflows exceeded EUR 1.4 bn (almost 6% of GDP). They were boosted by the sale of Mazeikiu Nafta to Poland's PKN Orlen in the fourth quarter of 2006. Another important source of financing was Lithuanian banks' long-term borrowing abroad, a good part of which was used to loan out to enterprises and households. The structure of the financing will not change significantly on the forecast horizon: debt-generating inflows will dominate over non-debt financing, leading to increasing foreign indebtedness.

The stock of gross foreign debt was EUR 13.4 bn at the end of 2006. This was EUR 3.7 bn higher than at the end of 2005, and amounted to 56.4% of GDP. Since revaluation and other changes do not play significant part in the evolution of the debt stock (due mainly to the peg of the lita vis-à-vis the euro), its changes will reflect the structure of financing. As mentioned above, debt-generating inflows will be more significant than non-debt creating ones, leading to markedly increasing gross foreign debt. The figure at the end of 2007 could be as high as EUR 17.4 bn (or 65.2% of GDP), and by the end of 2008 it can reach EUR 21.2 bn (or 72.5% of GDP). International reserves increased to EUR 4.4 bn by the end of 2006. They will increase only marginally in 2007-08 to EUR 4.6

and 4.7 bn respectively.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

The labour market is still very tight, which is mainly attributed to emigration. There are already more than half million Lithuanians working abroad. With the economy still expanding above its potential rate the demand for labour is high. The official unemployment figure fell to below 5% in the last quarter of 2006, and on average it was 5.6% last year. On the forecast horizon there are no major changes affecting the demand for labour, thus the end-of-year 2006 figure can stabilise for both this and the next year, resulting in an unemployment rate of around 5%.

According to preliminary data average gross monthly earnings rose by close to 18% in 2006 (year-on-year growth in the last quarter was 19.1%). Due to a cut in the personal income tax rate (from 33% to 27% mid-2006) net salaries increased even faster. Wage growth will be slow down over forecast horizon but is expected to exceed GDP growth considerably. Pay increases will be in the region of 13-15% in 2007-08. Even with high productivity growth this will lead to further significant rises in real unit labour costs in 2007-08.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (LTL mn)	71,200	81,974	92,100	101,100
Real GDP growth (%)	7.6	7.5	6.8	6.1
Private consumption (%)	9.8	13.7	9.0	7.0
Public consumption (%)	4.9	6.6	4.2	4.0
Investments (GFCF, %)	9.2	11.7	9.5	7.5
Exports (%)	14.5	13.7	8.2	7.5
Imports (%)	16.0	15.7	10.5	8.4
Annual average inflation (%)	2.7	3.8	4.4	4.2
Policy rate (%)	-	-	-	-
Money market rate (3-month, %)	2.53	3.72	4.40	4.10
Long-term interest rate (10-year gov't bond, %)	3.78	4.28	4.70	4.50
Exchange rate / EUR (average)	3.45	3.45	3.45	3.45
Exchange rate / EUR (end of period)	3.45	3.45	3.45	3.45
Budget balance / GDP (%)	-0.5	-0.3	-0.8	-1.2
Public debt / GDP (%)	18.7	18.2	18.1	18.5
Trade balance / GDP (goods and services, %)	-7.3	-10.3	-9.9	-9.2
Current account balance / GDP (%)	-7.2	-10.8	-10.5	-9.9
Gross foreign debt / GDP (%)	46.9	56.4	65.2	72.5
Unemployment (%)	8.3	5.6	5.1	5.0
Real ULC growth (%)	0.7	3.1	2.3	2.0

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

Sources: Eurostat, Lietuvos Bankas, Lietuvos Statistikos Departamentas

Poland

Foreign direct investments and domestic consumption laid the foundations of the very impressive growth rate in 2006. For 2007 we expect a bit lower GDP growth based on weaker export performance. Budget deficit could be close to the Maastricht criterion in 2007.

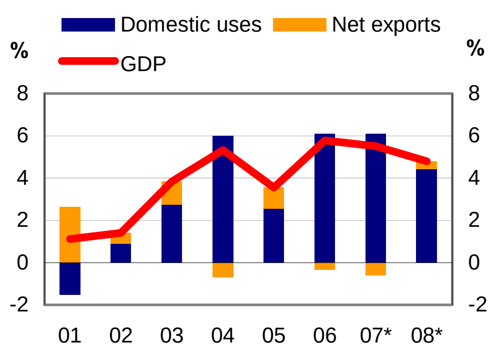
Political developments

The ruling Law and Justice (PiS) party suffered defeats in many towns in the local elections in November 2006. The main opposition force, centre-right Civic Platform (PO) won the largest proportion of provincial assembly seats. Overall, however, the elections failed to bring a seismic political shift that could have unseated the current government.

Right-wing PiS continues to head an unstable coalition with the populist Self-Defence and the Catholic-nationalist League of Polish Families (LPR). Tensions between coalition parties are rising again, with Self-Defence demanding further tax incentives for its agricultural constituency. Some political analysts believe the coalition will collapse before the next elections. However no political party is sure about winning an early election. The opposition PO would be the main winner of any early election, but would still find it difficult to form a government.

Growth

Structure of growth



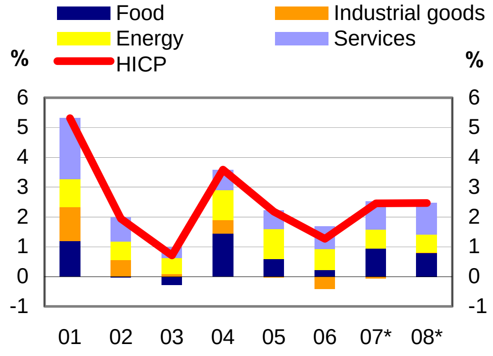
*Note: * forecast. Source: Eurostat*

Economic activity continued to be strong at the end of 2006. GDP growth is estimated to have surged to 6.4% year-on-year in the last quarter of 2006. Very strong growth in the fourth quarter contributed to an annual growth rate of 5.8% higher than our previous forecast. Impressive growth was due to continued strong investments activity and dynamic growth of household consumption. Investments jumped by 16.7% in the last quarter.

Value added growth was mainly driven by output in market services and, to a smaller degree, in industry and construction. Business climate is good for market services, particularly for real estate activities and services connected with business activity as well as for financial intermediation. Favourable developments in production have continued in industries with a high share of export sales. Strong growth persists in rubber and chemical industries, the manufacture of metal products, machinery and equipment and also in the automotive and electronic equipment industries. Business climate surveys point to a continuation of favourable tendencies in industry.

Growth is likely to ease somewhat in 2007. As we calculate a historically high growth rate in the first quarter of 2007, GDP is expected to grow by 5.5% this year. Consumption and investments remain the main drivers of growth. Investments accelerated thanks mainly to high FDI inflows; this tendency is expected to continue next year. Lower external demand due to a slower EU GDP growth rate will affect Polish growth in the second half of the year. We expect GDP to rise by less than 5% in 2008.

Components of inflation



*Note: * forecast. Source: Eurostat*

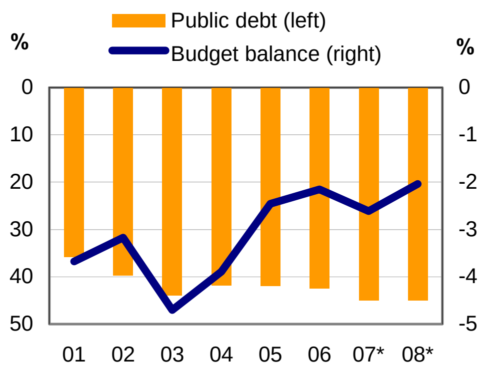
Monetary developments

The harmonised index of consumer prices averaged 1.3% in 2006. There was hardly any change in price growth rates during the first two months this year, but consumer prices jumped in March close to the inflation target of the Narodowy Bank Polski (NBP, the central bank). Planned excise duty hikes and higher wage demands will raise the price index in 2007. A stronger zloty may counteract the higher pressure on inflation. According to the latest information we forecast 2.5% inflation for 2007. The main upside risk is the potential inflationary pressure of strong domestic demand.

However, with inflation currently around 1.6% the central bank has little incentive to tighten monetary policy, and we expect that it will leave its base rate at the current level of 4% throughout 2007. Interest rates are only supposed to hike if unit labour cost shoots up and inflation is expected to overshoot the upper band of its 2.5+/-1% target range.

Standard & Poor's upgraded Poland's long-term foreign currency credit rating to 'A-' from 'BBB+' and its long- and short-term local currency ratings to 'A/A-1' from 'A-/A-2'. At the same time, the 'A-2' foreign currency short-term rating was affirmed. In its comment to the upgrade, S&P said that the revision reflects Poland's good growth prospects, which have remained independent of political developments. S&P also noted that the political situation would be the key to further rating changes.

Fiscal indicators (% of GDP)



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

Fiscal policy

The EU executive recommended Poland to take action and cut the deficit which is due to exceed the Maastricht criterion in 2007. The deficit is expected to hit 4.8% in 2007. This figure was revised upward as contributions to private pension funds cannot be counted as budget revenues from January 2007. The deficit rose in 2007 despite strong growth, because the government has not made any substantial efforts to reform spending.

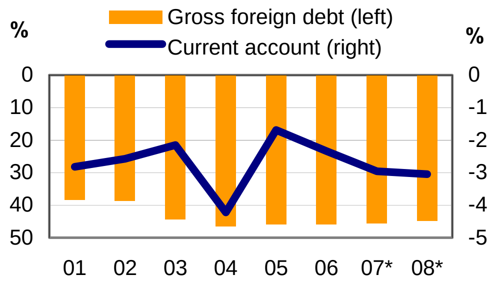
The government has presented a tax reforms package to be introduced in 2007. The Ministry of Finance has already announced a draft for a bill containing amendments to laws affecting all major taxes including the corporate income tax, personal income tax, VAT, tax on inheritance and donations and social security contributions.

Despite the government promise in the Convergence Program to the annual budget deficit to PLN 30 bn in 2007-2009, public spending is set to rise sharply early 2007. However, there is a stricter fiscal rule for debt detailed in the Constitution; this should to set a limit on debt accumulation. Thus the debt-to-GDP ratio is expected to remain under 60% in medium term.

External balance

Current account deficit exceeded 2% of GDP in 2006 according to NBP. In comparison with the corresponding year, current account deficit deepened by EUR 2.1 bn. This was a result of a significant increase in merchandise imports, accelerated by strong domestic demand. On the other hand, the income account deficit was lower than a year earlier. Simultaneously, there were higher surpluses on

External balance indicators (% of GDP)



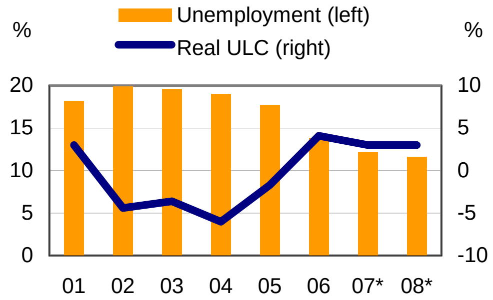
*Note: reverse scale on left axis. * forecast.*
Sources: Eurostat, NBP, WIIW

both the current transfers and services accounts. Meanwhile, the current transfers account and the services account both recorded higher surpluses than a year earlier. We expect a slight increase in the current account deficit in 2007, although it should remain moderate: it could reach 3% of GDP in the next years.

In 2006 FDI inflows continued to exceed the current account deficit. The inflow of FDI is accompanied by the inflow of new technologies and new practices of management, which supports the rise in labour productivity. I0n the coming years this FDI inflow will still be acting towards increasing potential output.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

Consumption is supported by a labour market recovery. In 2006 the employment rate increased by 1.8 percentage points, while unemployment fell by 3 percentage points as 550 thousand new jobs were created in 2006. Improvements are expected to continue, albeit at a slower pace due to emerging skill mismatches. Poland may face labour shortage as workers go west. According to employers the construction industry is currently short at least 150 thousand workers.

2006 brought accelerating income growth. Wages excluding bonus payments rose by an annual 6.4% in February 2007. The government has already promised more wage increases as the pressure is on in the public sector, especially in health care. Wages are expected to grow faster than productivity in 2007-08.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (PLN bn)	980.7	1050.9	1122.0	1190.0
Real GDP growth (%)	3.5	5.8	5.5	4.8
Private consumption (%)	1.9	5.1	3.9	3.8
Public consumption (%)	5.3	2.4	3.3	3.0
Investments (GFCF, %)	6.5	16.7	10.5	9.0
Exports (%)	8.0	15.1	11.0	12.5
Imports (%)	4.7	15.4	12.0	11.0
Annual average inflation (%)	2.2	1.3	2.5	2.5
Policy rate (%)	4.50	4.00	4.00	4.00
Money market rate (3-month, %)	4.62	4.20	4.10	4.00
Long-term interest rate (10-year gov't bond, %)	5.34	5.14	5.00	4.80
Exchange rate / EUR (average)	4.02	3.89	3.85	3.85
Exchange rate / EUR (end of period)	3.86	3.90	3.85	3.85
Budget balance / GDP (%)	-2.5	-2.2	-4.8	-4.1
Public debt / GDP (%)	42.0	42.5	45.0	45.0
Trade balance / GDP (goods and services, %)	-0.3	-1.3	-2.0	-2.6
Current account balance / GDP (%)	-1.7	-2.3	-3.0	-3.0
Gross foreign debt / GDP (%)	45.9	46.0	45.7	44.8
Unemployment (%)	17.7	13.8	12.2	11.6
Real ULC growth (%)	-1.7	4.1e	3.0	3.0

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

Romania

Economic growth accelerated and disinflation continued in last year. The current account deficit increased significantly due to a widening trade deficit. In 2007 these tendencies will continue, but growth and the pace of disinflation will slow. The current account deficit remains one of the key macroeconomic challenges in the future.

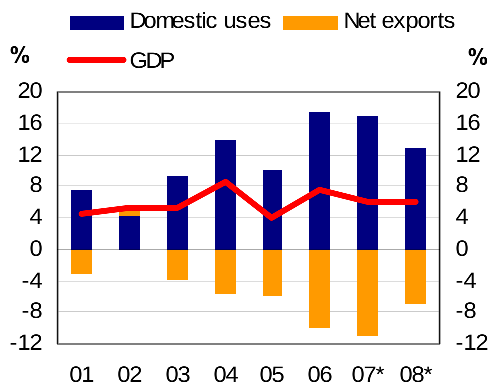
Political developments

The political climate deteriorated shortly after EU accession. It seems the right-wing coalition was held together only by the joint aim of acceding to the European Union. At the beginning of April 2007 a new government was formed and the Democratic Party was ousted from it, while the Social Democrats support the minority cabinet from opposition. With that step the Prime Minister not only changed the structure of his government but also isolated the President whose influence was diminished by the change.

The consequence was that the Parliament voted for the President's impeachment and the Senators and Deputies decided to suspend President Basescu. He has to resign on April 23rd and a new presidential election has to be held if the Constitutional Court validates the suspension.

Growth

Structure of growth



*Note: * forecast. Source: Eurostat*

In the final quarter of 2006 economic growth remained high and real GDP increased by 7.7% compared to the same quarter of previous year. Owing to the high quarterly growth rates last year, real gross domestic product increased by 7.7% in 2006. This was a significant acceleration since 2005, when GDP increased by only 4.1% mainly due to mid-year floods.

On the production side, construction grew dynamically due to post-flood reconstruction activities. The value added in construction increased by 19.4% in the fourth quarter of 2006. Industry and services also performed well, growth rates of value added in these sectors reached 6.6% and 6.5% respectively. Agricultural production rose again in 2006 after a setback the year before.

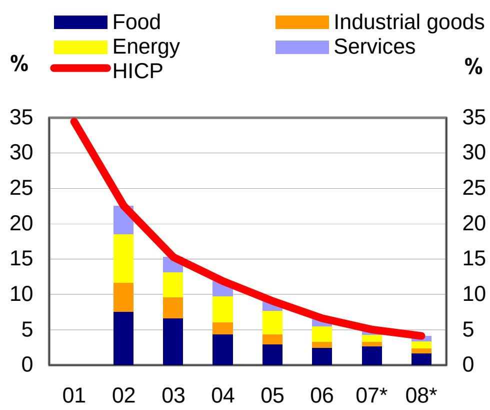
On the demand side, private consumption and to some extent investments were the main engines of the economy in 2006. Private consumption continued to grow at a very fast rate (13.8%) in the last quarter due to credit growth and wage increases. Gross fixed capital formation also performed well (18% growth) thanks to significant foreign direct investment inflows and post-flood reconstruction. On the other hand, net exports had a negative contribution to GDP growth and in the fourth quarter of 2006 the growth rate of imports greatly outpaced exports (25.3% and 8.6% respectively) as high domestic demand boosted imports considerably.

Domestic demand will fuel the economy in 2007 as well. Private consumption and investments are expected to increase at around the same pace as last year due to gradually increasing wages, credit to households, and thanks to foreign direct investments. According to our forecast economic growth will slow down slightly to 6.0% owing to slower growth of consumption and investments. In

2008 this picture is not expected to change significantly. However, utilisation of EU funds will grow, thus the positive impact of EU accession on growth will increase somewhat.

Monetary developments

Components of inflation



*Note: * forecast. Source: Eurostat*

The inflation rate was kept within the target range (5% +/-1 percentage point) in 2006, and the consumer price index remained low in the first few months of 2007 as well. In January and February 2007 12-month inflation reached 4.0% and 3.8% respectively. During this period there were no significant increases in administered prices and the exchange rate of the leu remained strong against the euro, between 3.35 and 3.41 in the first two months of the year. It started to strengthen gradually from the end of January 2007 to 3.3548 at the end of the first quarter.

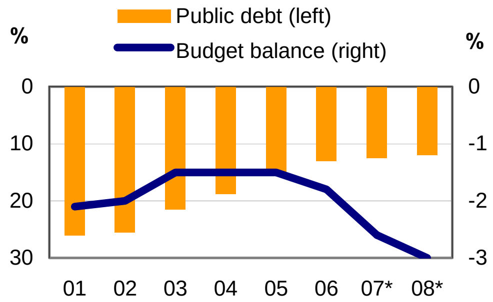
In line with disinflation the board of the National Bank of Romania (BNR) decreased the policy rate from 8.75% to 7.5% in two steps (on February 9th and March 26th). However, the cut of the policy rate was a response to the strengthening currency rather than to decreasing inflation. Still, the policy rate cut had a marginal impact on exchange rate developments to time. At the beginning of April the leu appreciated to under 3.34 against the euro. There is no room for further decreases in the policy rate in the second quarter of the year because of inflationary pressures due to dynamic real wage increases, high household credit growth and rising public spending. We anticipate that disinflation will halt and the CPI will start to increase in the middle of the year. We expect that annual average inflation in 2007 will reach 5.1%. However, the year-end target (4% +/-1 percentage point) is still achievable. The policy rate is expected to decrease to 7.0% by the end of 2007. In 2008 disinflation will continue and annual average inflation will fall to an estimated 4.1%.

Standard & Poor's downgraded its outlook from positive to neutral due to the aforementioned political crisis while affirming Romania's BBB- foreign currency sovereign credit rating. The cut occurred before the suspension of the President; further downgrades are possible because of the uncertainties related to early election.

Now that Romania became an EU member a key policy question is when the country will join the euro area. The central bank, in accordance with the government, plans to join ERM-II regime in 2012. Accordingly, Romania could adopt euro in 2014.

Regarding Maastricht criteria Romania now fulfils three out of five. Public debt is way under 60% of GDP, fiscal deficit is also lower than 3% of GDP and exchange rate developments remained within the limits during the last two years. Only inflation (6.6% in 2006) and long-term interest rates (7.5% in 2006) exceed the Maastricht criteria. Based on recent inflationary developments and targets, Romania is expected to fulfil these conditions earlier than 2012 (around 2010). However, the country will focus not only on fulfilling the nominal criteria but also on the development in real convergence and reforms that certainly need time. Our opinion is that the planned target date is realistic but authorities need to be cautious that the prolonged period should be used for reform measures.

Fiscal indicators (% of GDP)



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

Fiscal policy

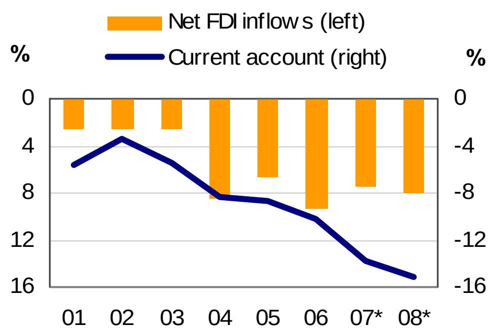
Consolidated government budget deficit reached 1.8% of GDP in 2006 according to ESA methodology. This was more favourable than the planned figure (2.5%), and also lower than our previous expectation (2.0%).[3] The budget was in surplus during the first eleven months and it turned to deficit only in December 2006 when the budget balance deteriorated by RON 9.8 bn or 2.9% of GDP. Despite the fact that the planned budget was revised several times and expenditures were increased in these cases, the deficit remained relatively low and can be considered as a favourable outcome. In line with the low budget deficit the stock of public debt also decreased and remained under 20% of GDP.

As of January 2007 Romania has to contribute to EU budget. Expenditures of the state thus increased: it was observable in the first few months' budget figures in 2007. The Ministry of Public Finance in Romania paid RON 992 mn to EU in the first two months and the will pay an additional RON 9 bn in the course of the year.

In 2007 we expect that budget deficit will increase compared to 2006 and will reach 2.6% of GDP due to increasing public spending, EU contribution, and co-financing activity. In 2008 the budget deficit will just remain under the Maastricht criterion.

External balance

External balance indicators (% of GDP)



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

In 2006 current account deficit per GDP deteriorated significantly despite the robust growth. Last year the current account deficit reached 10.3% of GDP or almost EUR 10 bn. In euro terms the current account deficit increased by 44.7%. The deterioration was mainly due to the widening trade deficit of the economy. The deficit of goods and services balance increased by 44.1% or EUR 3.6 bn in 2006 compared to the previous year. This took place due to significant domestic demand, mainly private consumption and investments.

Regarding the other two components of current account balance, the incomes balance also worsened while the surplus of current transfers increased from EUR 3.6 bn to EUR 4.8 bn in 2006.

In the first two months of 2007 the current account deficit widened significantly mainly due to the further deterioration of the trade balance. In line with the elimination of customs duties and the adoption of the common commercial policy the export of goods increased by 10.2% while the growth rate of import exceeded 27% in euro terms. The transfer of the contribution to EU budget also burdened the current account balance during the January-February.

In line with the worsening current account balance, foreign direct investments poured in the country last year. Net FDI inflows reached EUR 9.1 bn or 9.3% of GDP, which represented a 74.2% growth compared to the previous year. It also means that FDI financed the majority of current account deficit last year.

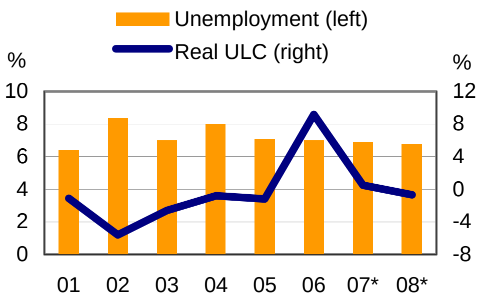
In 2007 we expect that current account balance will deteriorate slightly and its deficit will reach 10.8% of GDP. In 2008 it can reach

[3] Previous forecasts for Romania were published in ICEG EC's Quarterly Forecast on Southeast Europe (continued under the title Quarterly Forecast on the Western Balkans and Turkey from Spring 2007).

10.9% according to our estimations.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

In December 2006 the registered unemployment rate decreased to 5.2%, down 0.7 percentage points compared to end-2005. Unemployment, measured by the labour force survey, remained at around 7%. Employment improved due to the robust growth of the economy and the whitening process of informal sector.

In line with improving employment figures wages increased dynamically as well. In February 2007 gross monthly average earning amounted to RON 1264 or approximately EUR 380. In February 2006 this figure was RON 1017, or around 20% less in nominal terms. Pay rises exceeded productivity in 2006 by a wide margin, resulting in a surge of unit labour costs. In 2007-08 wage increases are expected to remain in line with productivity developments.

In 2007 we expect that unemployment figure will stay on its current low level while further whitening of the informal sector is expected. In some (mainly higher qualified) occupations companies can face labour shortages.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (RON mn)	288,048	342,418	380,000	420,000
Real GDP growth (%)	4.1	7.7	6.0	6.0
Private consumption (%)	9.7	13.9	12.0	10.0
Public consumption (%)	8.5	2.5	3.0	3.5
Investments (GFCF, %)	12.6	16.1	14.0	15.0
Exports (%)	8.1	10.6	10.0	10.0
Imports (%)	16.6	22.9	15.0	15.0
Annual average inflation (%)	9.1	6.6	5.1	4.1
Policy rate (end of period, %)	7.50	8.75	7.00	6.00
Money market rate (3-month BUBOR, %)	9.79	8.77	7.80	7.00
Long-term interest rate (10-year gov't bond, %)	-	-	-	-
Exchange rate (RON / EUR, average)	4.05	3.62	3.36	3.35
Exchange rate (RON / EUR, end of period)	3.68	3.38	3.34	3.32
Budget balance / GDP (%)	-1.5	-1.8	-2.6	-3.0
Public debt / GDP (%)	15.2	13.0e	12.5	12.0
Trade balance / GDP (goods and services, %)	-10.2	-12.0	-14.9	-15.4
Current account balance / GDP (%)	-8.6	-10.3	-13.7	-15.2
Gross foreign debt / GDP (%)	31.5	27.5	27.0	26.5
Unemployment (%)	7.1	7.0	6.9	6.8
Real ULC growth (%)	-1.2e	9.2e	0.5	-0.7

Note: f = forecast, e = estimation; See methodological notes for definitions and details.
Sources: Eurostat, National Bank of Romania, National Institute of Statistics

Slovakia

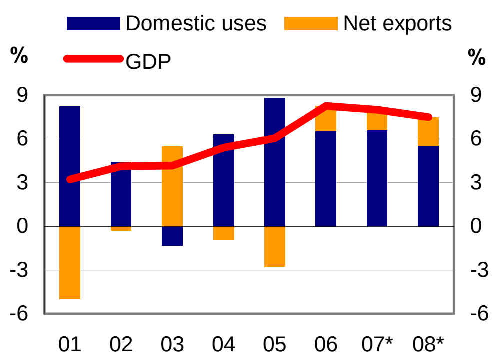
Record high economic and employment growth characterised 2006. These tendencies are expected to continue this year, though at a slightly lower rate. The long-awaited positive impact of FDI on exports in the automotive and electronics sectors started to manifest this year, changing favourably the composition of growth factors.

Political developments

The Fico government enjoys high popularity, reinforced in the local elections in December 2006 and supported by high economic growth and some popular economic policy measures with a limited impact on the budget. However, these loosening measures remained below the expectations because the government wants to stick to the introduction of the euro in 2009.

Growth

Structure of growth



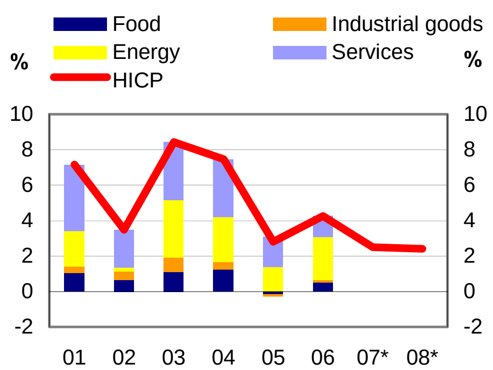
*Note: * forecast. Source: Eurostat*

A record high economic growth of 9.6% was recorded in the last quarter of 2006, resulting in a growth rate of 8.3% for the year as a whole. There is considerable change in the factors of growth compared to 2005: while the role of investments and especially private consumption is still significant, net exports became the third most important contributor to economic development. There was also a slight increase in the share of public consumption, which can be explained by the slight fiscal loosening under the Fico government. Expecting a continued increase in the growth contribution of net exports and lower share of private consumption, our GDP growth forecast for 2007 is around 8%.

Growth is fuelled mainly by the production of FDI-related car and electronics companies, namely local affiliates of Volkswagen, PSA Peugeot-Citroen and Kia as well as Sony and Samsung. However, this constitutes a considerable downside risk for economic growth: changes in demand induced by the business cycles of these industries may result in a sudden drop in the output of local affiliates and consequently in the rate of economic growth.

Monetary developments

Components of inflation



*Note: * forecast. Source: Eurostat*

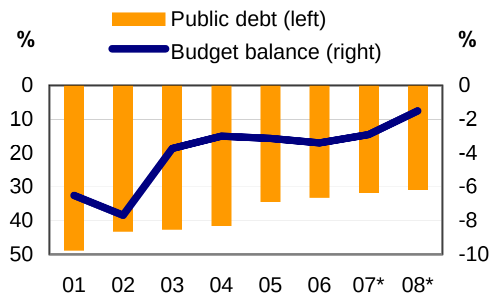
After the acceleration of 2006, the latest data indicate decelerating inflation. Average HICP inflation was 4.3% in 2006 while the 12-month February data indicated a price increase of 2%. Core inflation stood at 1.8% at the same time. The prices of food and beverages, together with various services grew faster than average. For 2007 as a whole, a weaker inflationary pressure is predicted, resulting in 2-3% inflation.

The central bank board changed the two-week repo rate from 4.75% to 4.5% with effect from March 28th taking into account decreasing inflationary pressures and the higher than predicted rate of economic growth. Other interest rates were also decreased: the overnight sterilisation rate was set at 2.5% and the overnight refinancing rate at 6%.

With effect from March 19th 2007, the Slovak koruna central rate against the euro has been revalued at SKK 35.4424 / EUR.

Fiscal policy

Fiscal indicators (% of GDP)



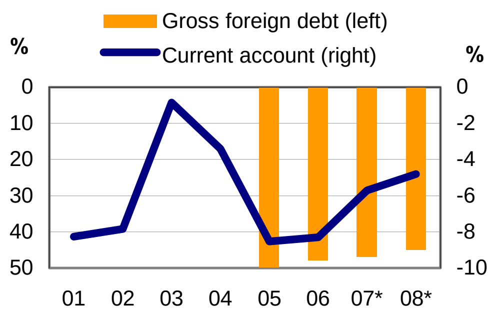
*Note: reverse scale on left axis. * forecast.*
Source: Eurostat

In spite of an expansionary fiscal stance, the budget deficit was less than envisaged in 2006, reaching an estimated 3.4% of GDP, including cost of pension reform. The main reason for this is larger than expected revenues due to robust economic growth. The central government budget deficit was SKK 8.5 bn at the end of February 2007, in contrast to a surplus of approximately similar size last year. While the government plans to meet the Maastricht criterion this year, data of the first two months and risks of higher than planned deficits at municipalities and in other parts of the budget may jeopardise this aim. On the other hand, revenues may prove under-planned due to strong growth.

While the Fico government envisaged changes in both the revenue and expenditure sides of the state budget, there were only marginal modifications in the tax system stepping into force in 2007, concerning e.g. the decrease of VAT on medicaments and medical tools. These did not affect the simplicity and efficiency of the tax system of Slovakia, nor other beneficial effects of the previous fiscal reform. According to government plans the share of government revenues and expenditures in GDP will be gradually reduced in the coming years to 34% by 2008.

External balance

External balance indicators (% of GDP)



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

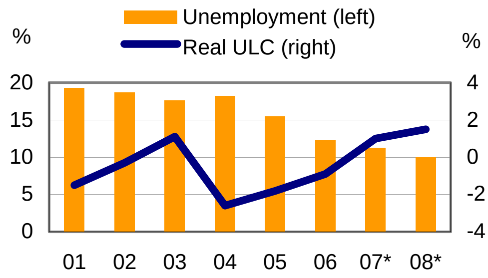
According to preliminary data the current account showed a deficit of EUR 3.8 bn (over 8% of GDP) in 2006, as high import demand of the car industry and growing domestic consumption together with deteriorating terms of trade resulted in a growing trade deficit. The capital and financial accounts for the same period ended in a surplus of EUR 900 mn: FDI partly covered the deficit of the current account.

This trend did not continue into the new year: in 2007 January the current account showed a surplus of EUR 210 mn and the trade balance was also positive, EUR 110 mn. Growing exports of cars and electronic goods, connected to the activity of FDI-related projects have gradually translated into a better foreign trade position. As a consequence, the current account deficit is expected to narrow significantly in 2007. FDI inflows continue to be strong, partly because of reinvestments of profits of affiliates, and partly because of new projects. This latter may increase the surplus of the capital and financial account.

Labour market

Unemployment continued to decrease, reaching 12.3% in the fourth quarter of 2006, the lowest level since 1998. However, this rate is still the second highest among the eastern EU members after Poland. Employment increased by 3.8% by the end of 2006 compared to 2005. Significant regional inequalities persist in unemployment. Certain regions in Central and Eastern Slovakia still face low participation rate and persistently high unemployment. The gradual integration of these regions in economic activity and continued strong growth are expected to result in further decreases

Labour market indicators



*Note: * forecast. Source: Eurostat*

in unemployment and rises in the participation rate.

In 2006, as a whole, real wages increased by 3.3%. In the fourth quarter, real wages rose by 3.9%, signalling some acceleration. Wage growth was considerably higher in the public than in the private sector. Tightening of the labour market and strong profitability bear the risk of a further, potentially excessive increase in real wages in 2007. As a consequence, the tendency of falling unit labour costs is expected to reverse in 2007-08.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (SKK bn)	1471.1	1636.3	1767.2	1899.7
Real GDP growth (%)	6.0	8.3	8.0	7.5
Private consumption (%)	7.0	6.1	5.8	5.5
Public consumption (%)	-0.6	4.1	3.5	3.0
Investments (GFCF, %)	17.5	7.3	9.2	6.5
Exports (%)	13.8	20.7	18.8	17.8
Imports (%)	16.6	17.8	16.9	15.8
Annual average inflation (%)	2.8	4.3	2.5	2.4
Policy rate (%)	3.00	4.75	4.50	4.00
Money market rate (3-month, %)	3.12	4.82	4.65	4.23
Long-term interest rate (10-year gov't bond, %)	3.62	4.15	4.03	4.02
Exchange rate / EUR (average)	38.6	37.2	36.3	36.0
Exchange rate / EUR (end of period)	37.9	34.4	33.0	32.0
Budget balance / GDP (%)	-2.9	-3.4	-2.9	-1.5
Public debt / GDP (%)	34.5	33.1	31.8	31.0
Trade balance / GDP (goods and services, %)	-4.4	-4.6	-4.4	-4.3
Current account balance / GDP (%)	-8.5	-8.3	-5.7	-4.8
Gross foreign debt / GDP (%)	49.8	48.0	47.0	45.0
Unemployment (%)	15.5	12.3	11.3	10.0
Real ULC growth (%)	-1.8	-0.9	1.0	1.5

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

Sources: Eurostat, Slovak National Bank, Slovak Statistical Office

Slovenia

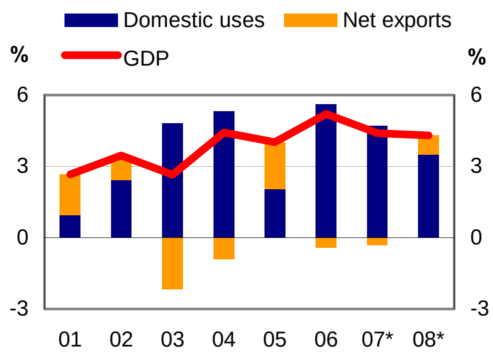
The first 'newcomer' in the euro-area will enjoy a rate of economic growth above 4% in 2007-08. No improvement is expected concerning the consolidated government balance as parliamentary elections get closer.

Political developments

The governing centre-right Slovenian Democratic Party (SDS) leads the opinion polls. Prime Minister Janez Janša is expected to remain in power until the next parliamentary elections that are scheduled for autumn 2008. The split within the main opposition party, Liberal Democracy of Slovenia (LDS) has intensified in recent months when six MPs of LDS formed a new parliamentary faction. The only major political event will be the presidential election at the end of this year. Concerning international relations the most important event will be Slovenia's EU presidency (the first new member state to hold this status) in the first half of 2008. The way the Slovenian government will manage while holding the EU presidency might influence its chances of re-election.

Growth

Structure of growth

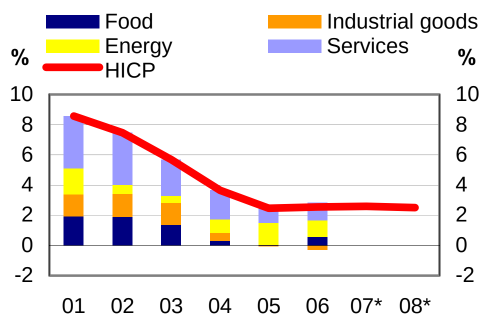


*Note: * forecast. Source: Eurostat*

Real GDP grew at an impressive 5.2% in 2006 which is the highest growth rate since 1999. Gross fixed capital formation was the main contributor to this remarkable growth figure, increasing by almost 12% in 2006. Unlike in 2005, net exports had a slight negative contribution to GDP growth while private consumption continued to contribute significantly to overall growth. The share of public consumption in GDP growth was rising but remained marginal in 2006. We expect that Slovenia's real GDP growth rate will slow to around 4.4% in 2007 and remain in the region of this figure in 2008. Although investment activity will be weaker than in 2006, investments will remain the main contributor to GDP growth in 2007. This will be mainly due to the positive effect of corporate tax reforms on business investments. We expect public consumption to gain momentum as parliamentary elections draw nearer in 2008. According to our forecast net exports will contribute positively to GDP growth in 2008 due to improved export prospects.

Monetary developments

Components of inflation

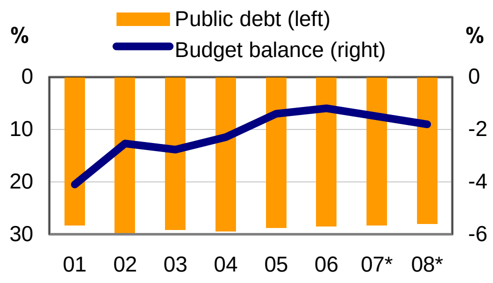


*Note: * forecast. Source: Eurostat*

After successfully joining the EMU on January 1st 2007, Slovenia became the 13th member of the euro-area. Representatives of Slovenia became members of all decision-making bodies of the European Central Bank. The irrevocable exchange rate at which Slovenia introduced the euro was set at SIT 239.64 / EUR. The very short dual (tolar-euro) circulation period ended on January 15th 2007. Since that date the common European currency is the only legal tender in Slovenia. In order to prevent price perception problems, tolar prices remain displayed until the end of June 2007. The Slovenian authorities are committed to prevent the change for euro leading to unfair price increases. The last main refinancing rate of Banka Slovenije (the central bank) was 3.75% in December 2006. As Slovenia's central bank transferred the authority for conducting monetary policy to the ECB the euro-zone's 3.5% policy rate applied for Slovenia since January 1st, which was raised by 25 basis points later in March to 3.75%. Average HICP inflation reached 2.5% in 2006. It was virtually unchanged compared to 2005. We expect average HICP inflation to reach to 2.6% in 2007 and 2.5% in 2008.

Fiscal policy

Fiscal indicators (% of GDP)



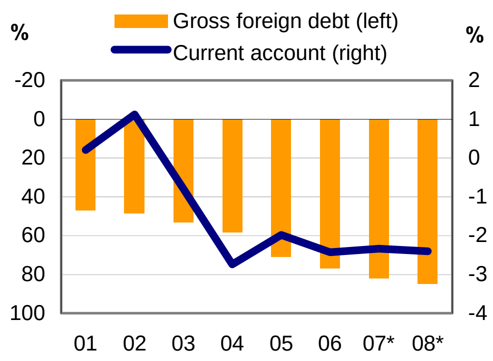
*Note: reverse scale on left axis. * forecast.*
Source: Eurostat

2006 was the fourth consecutive year when the general government deficit narrowed compared to the preceding year. General government deficit calculated on ESA basis reached 1.2 % of GDP in 2006. Although Slovenia will not breach the provisions of the Stability and Growth Pact we expect that the fiscal deficit will widen slightly in 2007-08. This will be due mainly to the shortfall in revenues caused by the tax reform and growing public expenditures in the run-up to the 2008 general elections. EU presidency-related costs will also put public finances under strain. Thus we forecast that the general government balance will increase to around 1.5% in 2007 and 1.8% in 2008.

The ratio of public debt to GDP is expected to remain stable around its end-2006 level, 28.5%.

External balance

External balance indicators (% of GDP)



*Note: reverse scale on left axis. * forecast.*
Sources: Banka Slovenije, Eurostat, WIIW

The current account deficit relative to GDP rose by 0.4 percentage points to 2.4% in 2006, compared to 2005. This was mainly due to higher than expected oil prices, and rising deficits of the income and transfer balances. As energy prices started to decrease at the end of 2006 and the euro also strengthened against the dollar we expect that the current account deficit will slightly narrow in 2007 and 2008.

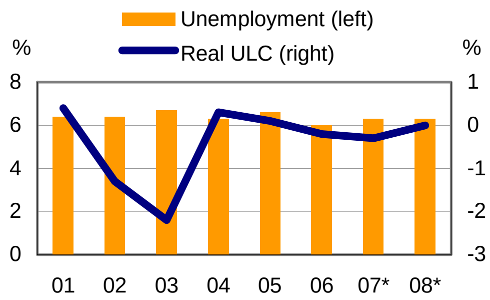
The government is planning to privatise the telecom company Telekom Slovenije and to further reduce its holdings in Nova Ljubljanska Banka, Nova Kreditna Banka Maribor (both banks) and Slovenska Industrija Jelka (a steel company). Since the Slovenian population does not really support the privatisation of Slovenian assets to foreign investors, these privatisation deals might even be put on hold or could be undertaken only after the 2008 parliamentary elections. Thus we do not expect any significant rise in inward foreign directs investment flows in 2007. Outward FDI will not be much lower than inward figures due to the continuing investment activity of Slovenian firms in the former Yugoslav republics (e.g. Nova Ljubljanska Banka signed and agreement at the beginning of 2007 to purchase more than 50% in Kasabank, the largest commercial bank in Kosovo).

Gross foreign debt is rising steadily: it stood at 77% of GDP at the end of 2006 and it will climb close to 85% by 2008. Integration into the euro-area will reduce interest rates and make foreign borrowing more available.

Labour market

The remarkable GDP growth rate had a positive effect on the labour market. According to labour force survey data the unemployment rate was 6% in 2006. The survey unemployment rate thus decreased by 0.5 percentage point compared to 2005. Favourable growth prospects and the gradual phasing out of the payroll tax

Labour market indicators



*Note: * forecast. Source: Eurostat*

imply that labour market conditions will improve in 2007 and 2008. Thus we expect that the unemployment rate will stabilize at around 6.3% while employment will continue to grow.

Labour costs rise broadly in line with productivity developments, therefore real unit labour costs are expected to remain fairly stable in 2007-08.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (EUR mn)	27,625	29,736	31,700	33,700
Real GDP growth (%)	4.0	5.2	4.4	4.3
Private consumption (%)	3.4	3.3	3.2	2.9
Public consumption (%)	2.2	3.8	2.5	3.1
Investments (GFCF, %)	1.5	11.9	8.0	4.2
Exports (%)	10.5	10.0	9.0	9.8
Imports (%)	7.0	10.4	9.2	8.5
Annual average inflation (%)	2.5	2.5	2.6	2.5
Policy rate (%)	-	-	-	-
Money market rate (3-month, %)	4.00	3.67	4.00	4.20
Long-term interest rate (10-year gov't bond, %)	3.69	3.90	4.20	4.00
Exchange rate / EUR (average)*	239.6	239.6	-	-
Exchange rate / EUR (end of period)*	239.5	239.6	-	-
Budget balance / GDP (%)	-1.4	-1.2	-1,5	-1,8
Public debt / GDP (%)	28.8	28.5	28.3	28.0
Trade balance / GDP (goods and services, %)	-0.6	-0.8	-0.7	0.3
Current account balance / GDP (%)	-2.0	-2.4	-2.3	-2.4
Gross foreign debt / GDP (%)	71.0	77.0	82.0	84.8
Unemployment (%)	6.6	6.0	6.3	6.3
Real ULC growth (%)	0.1	-0.2e	-0.3	0.0

*Note: f = forecast, e = estimation. * SIT / EUR before January 2007. See methodological notes for definitions and details.*

Sources: Banka Slovenije, Eurostat, WIIW

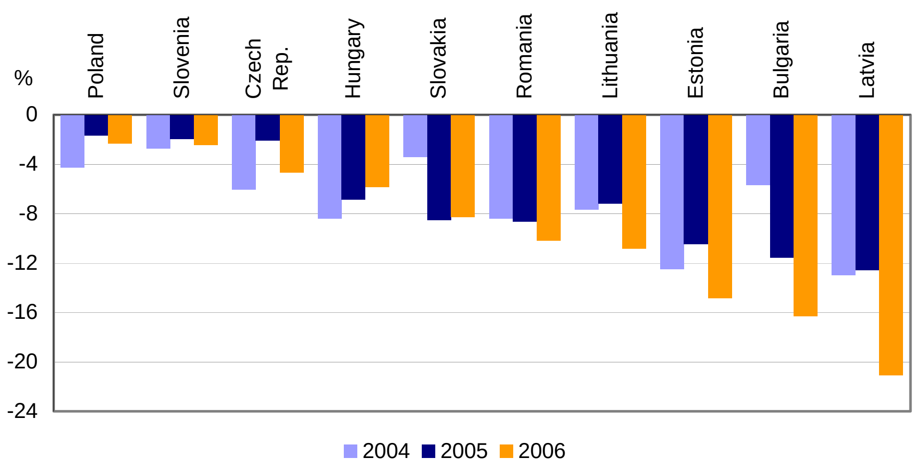
Special topic

Current account deficits – are they excessive?

In the wake of the Mexican peso crisis at the beginning of the 1990s, then later again at the time of the Thai baht crisis in the middle of the same decade, many efforts were directed at working out the concept of the sustainable current account deficit both theoretically and empirically. It was of course well known that rapidly growing low- or middle-income economies need external sources to finance the necessary investments for fast development due to an insufficient amount of domestic savings. Thus, in a period of outstandingly high economic growth current account deficits are natural phenomena for catching-up economies. However, should foreign investors at a certain point become reluctant to make funds available or even withdraw funds because of fears that borrowing economies will default on their obligations to service their foreign debt orderly and timely, a currency crisis can develop abruptly, leading to severe consequences even in the real economy.

From what we learnt from the examples of the 1990s it is obvious that the volume of the current account deficit itself is not enough to decide whether it can be maintained on a long run. Still, recent current account figures in some of the new member states of the EU again led to speculations about their sustainability. Indeed, in recent years the fastest growing economies of this country group exhibited very high and ever increasing current account deficits (see chart below), leading to a sharp rises in their foreign indebtedness. The Baltic have been the leading growth performers, but by 2006 they all exhibit double-digit current account deficits relative to GDP. New entrants Bulgaria and Romania also fall into this category. The more moderately growing Central European economies have recently enjoyed a reduction in their already lower current account deficits. An exception is Slovakia, which became more similar to the Baltic states regarding its growth and current account developments in the last two years. While for historic reasons the stock of foreign debt is less of a burden in the rapidly growing Baltic states, Bulgaria and Romania than in the Central European economies, the question still remains whether they can maintain such high current account deficits or should they make steps to reduce their external financing needs in order to avoid a possible currency crisis that would be a dent to growth.

Current account balances, 2004-2006 (% of GDP)



There are many ways to examine whether a country's current account deficits are excessive or not. In this article we restrict ourselves to qualitative assessment based on some key indicators. There are also formal methods to calculate the near exact value of the highest sustainable current account deficit for a given economy. These are based on finding the highest level of external debt that foreign investors still tolerate (i.e. they are willing to make funds available until the stock of foreign debt is below this level). Knowing this threshold one can go on calculating the amount of current account deficit that stabilises this level of foreign debt. While such formal methods do give important insights into the problem, they also have their shortcomings and are omitted here, because for some countries we were unable to estimate important parameters (e.g. the elasticity of intertemporal substitution in private consumption) due to lack of data.

For a quick qualitative assessment we take a look at some selected indicators. Observing most recent developments and data for gross foreign debt, the current account deficit and economic growth, we try to identify values in important sustainability-related variables that are not consistent with maintaining these levels of external imbalances and would thus point to the need of corrections. Since we concentrate on real economy fundamentals rather than on variables describing capital and money market expectations the usual financial vulnerability indicators (like e.g. international reserves to short-term foreign loans) are not analysed here.

Among structural indicators one of the most important is the investment to GDP ratio, since in order to generate additional income from which the increasing foreign debt is serviced, productive investments are needed. Thus, a higher investment to GDP ratio ceteris paribus makes it possible for an economy to maintain higher current account deficits. In most of the eastern EU member states this ratio is at around 25% (see the table below) which is fair enough for a current account deficit below 5% of GDP. The latter 'criterion', however, stands for only three countries, namely the Czech Republic, Poland and Slovenia. Other economies exhibit current account deficits well in excess of 5% of GDP, and from this viewpoint their investment ratios seem insufficient. This is especially true if we take into account that a good deal of investment projects is not really productive corporate investment, but rather investments into real estates that do not generate capacities for enhanced economic growth. Even in the case of Estonia and Latvia, where investment ratios are over 30% of GDP, these are not consistent with maintaining such high current account deficits even on a short run.

Selected indicators for current account sustainability

(average over 2004-06, % of GDP except where indicated otherwise)

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovakia	Slovenia
Gross foreign debt[1]	80.4	38.5	85.2	92.1	104.4	56.4	46.0	27.5	48.0	77.0
CA deficit	-11.2	-4.3	-12.6	-7.0	-15.5	-8.6	-2.8	-9.1	-6.7	-2.4
GDP growth (%)	6.3	5.4	10.0	4.3	10.4	7.5	4.9	6.8	6.6	4.5
Investment	**23.6**	25.4	**32.1**	**22.4**	**30.8**	**22.6**	18.8	**23.2**	**25.8**	24.9
Openness[2]	68.2	71.7	82.5	69.9	**53.7**	60.7	39.0	**39.0**	81.5	65.0
Trade balance[3]	**-15.6**	1.3	**-8.0**	-1.2	**-16.7**	**-8.1**	-1.0	**-10.5**	-4.1	-0.8
Budget deficit	2.7	-3.3	2.8	**-7.8**	-0.4	-0.8	-2.8	-1.6	-3.2	-1.5
Net FDI inflow[4]	9.9	5.9	8.8	3.6	**5.0**	**3.3**	3.4	7.5	3.6	0.3

Notes: [1] Stock at the end of 2006. [2] The simple arithmetic average of export and import over GDP. [3] Goods and services. [4] Including other capital (for Bulgaria, Czech Rep., Poland, Romania, Slovakia and Slovenia average over period 2004-2005). Figures in bold indicate a concern that current CA figures might already be excessive.

Openness is also an important sustainability indicator. More closed economies with a relatively small export sector may find it difficult to generate enough foreign exchange earnings to finance their debt service especially if there is a drop in investor sentiment towards those economies and external funds dry up. In this case an import compression might become necessary in order to avoid default on debt repayments and interest payments. From this viewpoint Latvia's and Romania's situation seems to be unfavourable. Their openness figure is rather low compared to the high current account deficits that they run recently. While Poland is also a more closed economy, its current account deficit is definitely far from being worrisome.

The balance on goods and services trade is also a very useful indicator. It is possible for an economy to stabilise its (net) foreign liabilities relative to GDP even by running current account deficits, but in that case the trade balance should at least partially offset the (net) payments on foreign liabilities. Thus the deficit on foreign trade has to be limited, and in most of the cases even a surplus is needed. In our sample only the Czech Republic exhibited trade surpluses on average over the course of the past three years (Hungary also produced a trade surplus in 2006, but had deficits before). Nevertheless, the other Central European economies' trade balances are also quite sound. The three Baltic states and new entrants Bulgaria and Romania, however, all have trade deficits that are very far from debt-stabilising levels even at the recent strong growth rates.

We were not able to collect reliable data on sectoral savings-investment balances for all countries, thus it is the budget balance which is supposed to reveal where the external imbalance originates from. With only Hungary, and to a much lesser degree the Czech Republic and Slovakia being the exceptions, these countries all have relatively balanced budgets. What's more, Bulgaria and Estonia even achieve sizeable budget surpluses. The problem with a high government deficit in the presence of an also high current account deficit is that in order to service its external liabilities the public sector collects resources from the private sector, thereby reducing the private sector's opportunities to create additional capacities for even stronger growth. In this respect only Hungary seems to be problematic; the Czech Republic's and Slovakia's budget deficits are well lower and can be managed more easily.

Finally, the structure of the financing of the current account deficit also has to do with sustainability. Foreign direct investment inflows represent a lasting interest in a given economy on part of foreign investors. On the one hand they are considered more stable sources of financing than do other (portfolio) flows. On the other hand they do create capacities for faster economic growth or at least to export growth. With the exception of Slovenia, where outward direct investment is more supported than the inward, all these countries record net annual FDI inflows of over 3% of GDP on average. Yet, Latvia's and Lithuania's net FDI figures (5% and 3.3% of GDP respectively) seem to be insufficient in light of their high current account deficits and can be sources of concern. At the other end of the spectre, the Czech Republic and Poland are able to attract FDI well in excess of their current account deficits, but Bulgaria and Romania also have fairly favourable financing structures.

It should be emphasised that a qualitative assessment of current account sustainability based on these indicators is far from concise. We tried to rely on variables that are more connected to economic fundamentals, but in the real world variables of political risk and market expectations are at least as important. It is nevertheless interesting to note that three countries, the Czech Republic, Poland and Slovenia are not considered problematic by any indicator. Slovakia's only concern is its relatively low investment ratio (at least compared to a current account deficit in the region of 7% of GDP) especially that it has widened recently. Bulgaria, Estonia and Hungary all have two indicators raising the issue of possibly unsustainable current account developments. There is a difference between these economies, though, since Hungary has reduced its current account deficits recently, while it is still on the rise in the other two countries. Lithuania and Romania 'fail' in three indicators and their current account deficits are also increasing. The most serious doubt for current account sustainability at the moment arises in the case of Latvia, which (with the exception of one indicator) is a possible candidate for sustainability-related problems. It is not to say, of course, that they are an immediate target of a currency speculation, especially since they run a currency board regime. But it is probably Latvia, where (in the absence of marked changes in recent trends) current account problems and the accumulation of a huge stock of foreign debt may lead later to more severe macroeconomic consequences with the largest probability.

- András Oszlay -

Methodological notes

Definitions of variables

Nominal GDP	Gross domestic product (GDP) at current market prices in national currencies. Can be transformed into EUR using average exchange rates. Sources: Eurostat, national statistical offices.
Real GDP growth	Growth rate of GDP, measured at chain-linked volumes at 2000 prices. Sources: Eurostat, national statistical offices.
Private consumption	Growth of final consumption of households and NPISH at constant prices. For further details see: Real GDP growth.
Public consumption	Growth of final consumption of general government at constant prices. For further details see: Real GDP growth.
Investments	Growth of gross fixed capital formation at constant prices. For further details see: Real GDP growth.
Exports	Growth of exports of goods and services at constant prices (national accounts data). For further details see: Real GDP growth.
Imports	Growth of imports of goods and services at constant prices (national accounts data). For further details see: Real GDP growth.
Annual average inflation	Annual average rate of HICP. Sources: Eurostat, national statistical offices.
Policy rate	Rate of the main policy instrument of the national bank, at the end of period. Not available in certain countries with currency boards. Sources: national banks.
Money market rate	3-month interbank offer rate at the end of period. Sources: national banks.
Long-term interest rate	Average interest rate of government bonds with 10 years remaining maturity (Maastricht criterion interest rate). Source: Eurostat.
Exchange rates	Period average and end-of-period exchange rates (national currency per EUR). Sources: national banks.
Budget balance / GDP	General government balance relative to nominal GDP, in national currency. Data follow the ESA95 methodology of Eurostat unless noted otherwise. Source: Eurostat, ministries of finance. WIIW
Public debt / GDP	Stock of general government debt at the end of period, relative to GDP of the respective period. Data follow the ESA95 methodology of Eurostat unless noted otherwise. Source: Eurostat, ministries of finance, WIIW.
Trade balance / GDP	Balance of goods and services. Sources: Eurostat, national banks.
Current account / GDP	Current account balance, relative to nominal GDP of the respective period. Sources: Eurostat, national banks.
Gross foreign debt / GDP	Stock of gross foreign debt at the end of period, relative to GDP of the respective period. Sources: Eurostat, national banks, WIIW.
Unemployment	Unemployment rate according to ILO definition (among the 15-74 years old), calculated from Labour Force Survey data. Some national definitions differ slightly. Sources: Eurostat, national statistical offices.
Real ULC	Real unit labour cost growth: growth of labour compensation at current prices per employee, divided by the growth of gross value added at current prices per the number of employed persons. Sources: Eurostat, national statistical offices.