ICEG EUROPEAN CENTER

Quarterly Forecast on the Eastern EU Member States

Spring 2008

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Company information

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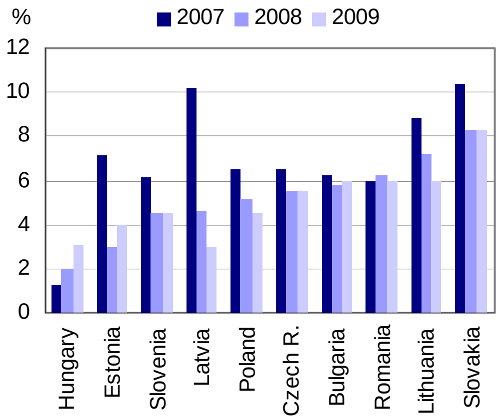
GDP growth in the region

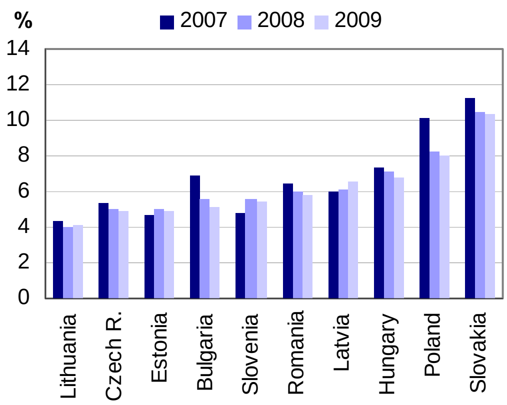


Due to unfavourable external conditions and the cooling of domestic demand, economic growth is slowing in the region. Nonetheless, the 5.2% average growth rate in 2008 is still significantly higher than in western Europe, therefore real convergence is continuing. However, two country groups show marked differences. Growth rates in central Europe are fairly robust except for Hungary, where the recovery from fiscal restrictions has proven rather slow. Net exports help Slovakia reach pole position in 2007 and they give a healthy push to growth in the Czech Republic as well. FDI-related investments are the catalysts of steady growth in Bulgaria, Poland and Romania. Capital and consumer goods imports drag down net exports in these countries, but export growth could become more vigorous in the medium term. On the other hand, the Baltic economies are slowing down after years of domestic demand-led growth. Their housing booms have passed their peak while consumer confidence is in shatters. The outlook for these countries is not rosy, although at least their macroeconomic imbalances will be more easily contained with growth rates closer to their potential.

The main risks to the region's growth stem from import demand in western Europe; the willingness of western banks to continue rapid lending in the face of financial turbulence; and domestic consumer and business confidence as inflation eats away disposable income and corporate growth opportunities become limited in a number of countries.

Labour market

Unemployment rates in the region



Note: harmonised LFS rates

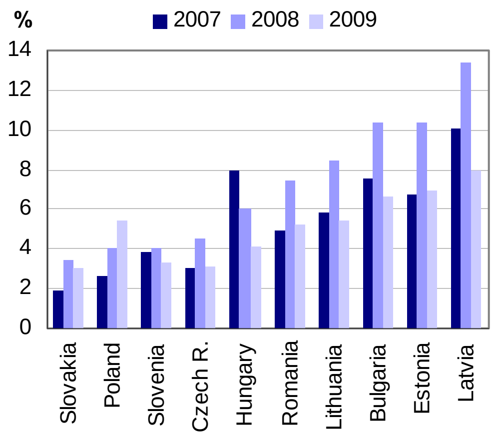
Buoyant economic growth helped job creation in 2007 and unemployment rates typically receded last year. Similar tendencies are expected to persist in 2008-09, although countries facing a slowdown (Estonia and Latvia in particular) can count on rising unemployment.

The shortage of skilled labour is a general phenomenon and is giving rise to fast wage increases in a number of countries. Labour cost growth outstrips productivity gains particularly in Bulgaria, Estonia, Latvia and Romania. This will eventually harm their cost competitiveness, although Bulgarian and Romanian wage costs are still well below the regional average. The effect of wage increases on inflation is a more immediate concern. Policymakers are usually concerned with the effect of inflation on real incomes, but neglect the reverse causation, making disinflation more difficult.

Prices and monetary developments

The spectre of inflation is haunting eastern Europe. Rising global food and energy prices are being felt everywhere while strong domestic demand and fast labour cost growth add inflationary pressures in a number of countries, including the Baltics, Bulgaria and Romania.

Inflation in the region



Note: harmonised (HICP) rates

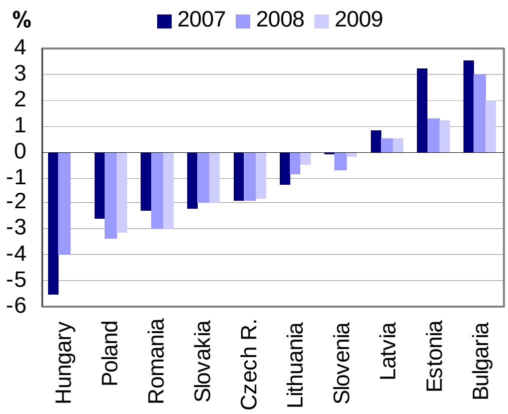
Price increases will exceed 10% in Latvia, Estonia and Bulgaria this year, although 2009 should bring disinflation if food and energy prices stabilise. Hungary is the only country with falling inflation in 2008, although this is the consequence of base effects: the 2006/7 stabilisation was accompanied by indirect tax rises and regulated price increases.

Euro adoption is becoming a reality for Slovakia: the country has fulfilled all Maastricht criteria last year and is poised to introduce the common currency in 2009. High inflation is the main obstacle for the rest of the region.

As global financial investors have become more risk averse following the U.S. subprime mortgage crisis, yields have risen in the eastern EU members, particularly where macroeconomic risks are considered severe (including Estonia, Latvia, Hungary and Romania). Given the high inflation, external imbalances (and in the case of Hungary, still high budget deficit) of some countries, their perceived risk could remain high in 2008-09 and wider spreads could persist over euro area securities.

Fiscal policy

Budget balances in the region (% of GDP)

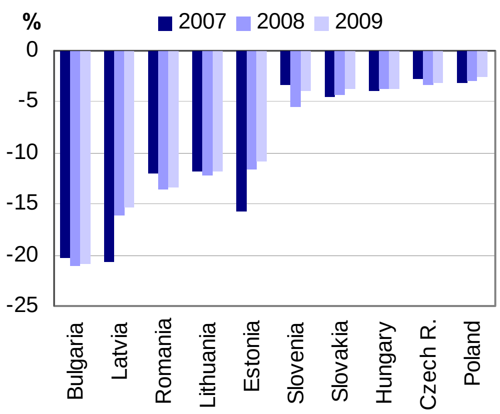


Note: according to ESA methodology

Thanks to fast economic growth and higher than expected inflation, government budgets had a good 2007 and balances have typically been better than expected. The Hungarian fiscal consolidation is still on track, although its structure and sustainability is questionable (too little emphasis on cutting expenditures). The Czech government is introducing a complex reform package to social spending and the tax code, while the new Polish government is elaborating its own plans. Bulgaria continues to slash taxes while Slovenia reduced the tax burden on labour. Tax competition thus continues, although governments will be less keen to give up revenues in the leaner years ahead. This will particularly be the case in Estonia and Latvia; in the former, a supplementary budget with expenditure cuts is already being suggested to counter the shortfall of revenues. On the other hand, upcoming elections could lead to fiscal loosening in Romania and later in Bulgaria and Slovenia.

External balance

External financing capacities in the region (% of GDP)



There are significant differences between the external financing requirements of central European countries and the Baltic states plus Bulgaria and Romania. In the former group trade balances are either positive or slightly negative; current account deficits are in a large part due to negative income balances. On the other hand, huge trade deficits are present in the second group. These deficits are related to FDI-related investments (Bulgaria, Romania) or private consumption (Baltic states). The sustainability of these deficits has come under some scrutiny in 2007. When debt-type capital inflows finance domestic consumption (as in the Baltic states and increasingly in Romania), concerns arise whether western European banks will have to cut their lending to cover losses on the U.S. subprime mortgage market and the resulting financial calamity. If that would be the case, the resulting credit crunch could bring about serious recessions. Thankfully, the sharp slowdown in the Baltic states will reduce their external financing gaps to more sustainable levels.

Bulgaria

Economic growth remained above 6% for the fourth consecutive year. The external financing requirement exceeded 20% of GDP last year and its decrease is not expected in 2008. Inflation exceeded 10% in the last quarter of 2007 and accelerated to 12% in the first months of 2008. Euro adoption now looks unlikely before 2012. The budget balance will have a significant surplus this year as well, which is necessary to contain overheating.

Political developments

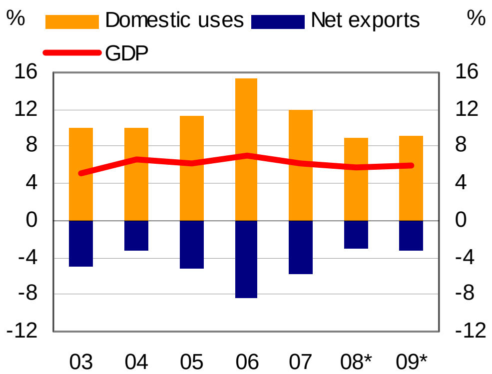
The political climate remained tense in Bulgaria in the first quarter. At the beginning of April 2008 the Bulgarian government had to face its fifth no-confidence vote. It failed thanks to overwhelming majority of the ruling coalition in the parliament. The pressure is growing on the government to fight against corruption and organised crime though, particularly after the interior minister had resigned following a corruption scandal involving top police officers and criminals. The fight against corruption and organised crime is being pushed by the EU as well.

At the beginning of April the parliamentary parties agreed on that both European Parliament and general elections will be held on 14 June 2009.

Growth

In the last quarter of 2007 economic growth accelerated to 6.9% and annual GDP growth reached 6.2%. The growth rate of the fourth quarter was the highest last year and 2007 was the fourth consecutive year with growth exceeding 6%.

Structure of growth



*Note: * forecast. Source: NSI*

On the production side, all sectors performed well in 2007 except for agriculture. Gross value added in agriculture diminished by 30% due to unfavourable weather conditions in the summer of 2007: severe droughts hit Bulgaria which contributed to the drop of agriculture production. On the other hand, gross value added in industry and construction soared last year; they increased by 13% and 17% respectively. Besides, GVA in services also increased by a solid 7.5%; thereof financial intermediation, renting and business services increased by more than 10%.

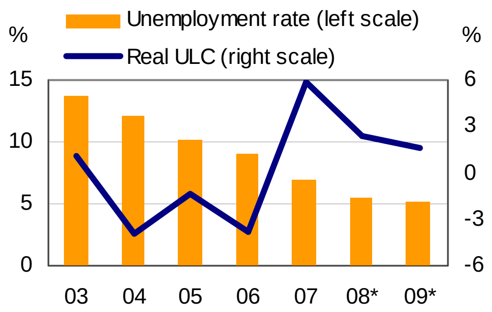
On the demand side, the tendencies of previous quarters continued and the contribution of private consumption to growth decreased further: it increased by 5.3% in the course of 2007. However, a slight acceleration of public consumption was observable in the last quarter of 2007 to an annual rate of 11.4%.

As expected, investments played a key role in economic growth last year. Gross fixed capital formation increased by 21.7% in 2007, raising the investment-to-GDP ratio from 26% in 2006 to 30%. Net exports had a significant negative contribution to economic growth. While the export of goods and services increased by only 5.2%, import grew by almost 10% on the back of strong investment (and to a lesser extent, consumption) demand. However, that growth rate of export exceeded that of imports in recent months. This can be considered the first sign of the recovery of export sector. As export-oriented foreign investment projects start operating, a lower import demand of capital goods will be coupled with faster export growth.

For 2008 we maintain our previous forecast and expect that GDP growth will remain on the same level as in 2007 (5.8%). Investments and consumption remain the key engines of the economy, while we expect the negative contribution of net exports to diminish in 2008-09.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

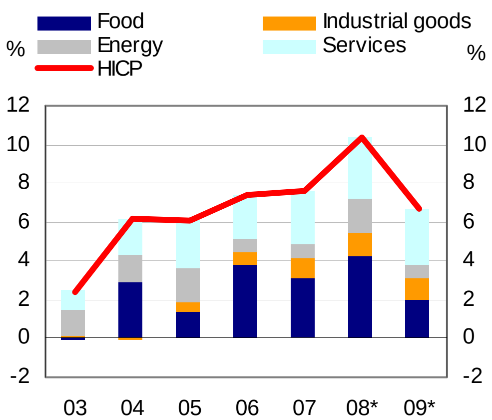
Unemployment decreased steadily and significantly in 2007. By the end of the year it fell to 6.9% from 9% a year earlier. Robust economic growth and rising employment contributed to the decrease of unemployment. The employment rate increased from 58.6% to 61.7% and the number of the unemployed decreased from 350 thousand to 240 thousand.

In line with falling unemployment the significance of labour shortages has been growing. In accordance with the tightening of the labour market wages increased considerably as well. Gross average monthly wages increased from BGN 392 in the fourth quarter of 2006 to BGN 486 (EUR 248) in the corresponding quarter of the last year.

In 2008 and 2009 we expect that the unemployment rate will decrease further to 5.6% and 5.1% respectively, due to the persistence of buoyant economic growth. However, labour shortages can become a broader problem in the economy in the medium term.

Prices and monetary developments

Components of inflation



*Note: * forecast. Source: NSI*

The rise of inflation has continued in early 2008. The 12-month harmonised index of consumer prices increased from 4.4% in March 2007 to 11.6% in December 2007, and climbed further to 12.2% by February 2008. The main factors behind the significant acceleration of price increases remained the same as in the second half of 2007. Both food and energy prices started to increase considerably in autumn 2007 and due to base effect it affects inflation figures in the first half of 2008 as well. In February food and non-alcoholic beverages prices were 21.8% higher than in the same month of 2007. Furthermore, they were 4.1% higher than that in December 2007 which reflects that the increase of food prices continued at the beginning of 2008 in Bulgaria. On the other hand, energy prices were 14.7% higher in the second month.

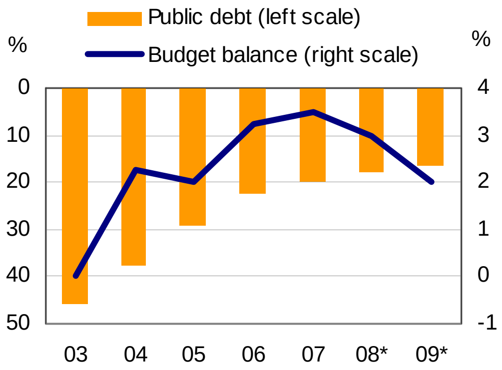
Wages increased significantly throughout the year, putting additional inflationary pressures on the economy. The nominal increase of gross average monthly wages reached 20% in 2007, compared to 7-12% in the preceding three years.

The credit boom continued in the last quarter of 2007 and in the first two months of 2008 as well. During these five months claims on households and NPISHs increased by more than 50% and claims on households relative to GDP increased from 18% in January 2007 to 24.4% in December. As these figures are still relatively low, there is still much scope for credit growth over the coming years.

ERM-II entry can become an important issue this year. At the time of EU accession Bulgaria planned to join the ERM-II regime as soon as possible, but has not done so just yet. In line with ECB's suggestion, ERM-II entry is not expected before Autumn 2008. It seems that the inflation criterion will be the hardest for euro adoption. We expect that annual average inflation will reach 10.4% in 2008 and it will decrease to 6.6% in 2009. Accordingly, euro adoption is unlikely before 2012-2013.

Fiscal policy

Key fiscal indicators (% of GDP)



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

The budget had a huge surplus in 2007: it reached BGN 2 bn or 3.5% of GDP (only 0.2% lower than expected in our previous report). In line with the high surplus, public debt decreased to under 20% of GDP by the end of 2007. The higher than planned surplus was due to several factors. First, rising inflation was favourable for revenue collection. Second, robust economic growth and sound domestic demand boosted taxes even as the profit tax rate was cut by 5 percentage points at the beginning of the year. Third, expenditures were kept in line with plans while revenues were under-planned.

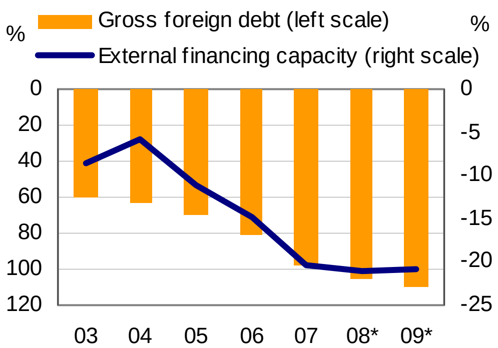
For 2008 the government plans 3% budget surplus. The most important change in 2008 is that personal income tax rate was cut to 10%, the same level as for profit tax. The government expects to 'whiten' the economy with this step, just as the corporate profit tax cut did last year. During the first two months of 2008 the consolidated budget surplus reached BGN 575 mn, 0.9% of projected GDP.

We expect that the 2008 budget balance remains positive, reaching the government's plan of 3%. In 2009 we forecast that the surplus of the budget may decrease since general and EP elections will be held and a slight easing of current restrictive fiscal policy may take place.

External balance

The external financing requirement reached a record high level in 2007: it amounted to 20.3% of GDP or (EUR 5.9 bn) while the current account deficit was even higher, 21.5% of GDP. The latter was just higher than our previous forecast and almost 6 percentage points higher than in 2006.

External balance indicators (% of GDP)



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

The deterioration of the current account balance was the result of developments on the trade balance. While goods exports increased by 12.2% in 2007, the growth rate of import reached 18.5%. Accordingly, the trade deficit increased from EUR 4.6 bn in 2006 to EUR 6.2 bn last year. Imports are boosted by high domestic demand, which is in turn fuelled by foreign investments and increasing wages and credit expansion of households. On the other hand, the services and incomes balances improved slightly in 2007. The balance of current transfers deteriorated due to contribution to EU budget as of the beginning of 2007.

Foreign direct investment remained significant in 2007 as well, reaching EUR 6.1 bn or 21.1% of GDP. This is one of the highest ratios among eastern EU member states. Thus FDI inflows were able to finance almost 100% of the current account deficit last year.

For 2008 we expect the external financing requirement to rise further (to 21%) due to the deterioration of the trade balance. Since investment will remain the main engines of growth in 2008 it will continue to boost imports. Accordingly, the external financing requirement is expected to rise to 21% in 2008 and it may decrease only slightly in 2009. Since the adoption of the euro (which provides protection against a currency crisis) is unlikely before 2012, Bulgaria needs to focus on the sustainability of its external imbalance over the coming years.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (BGN million)	49,361	56,520	65,200	73,900
Real GDP growth (%)	7.1	6.2	5.8	6.0
Private consumption (%)	8.0	5.3	4.0	5.0
Public consumption (%)	2.4	3.1	5.0	4.0
Investments (GFCF, %)	23.9	21.7	22.0	20.0
Exports (%)	8.7	5.2	10.0	10.0
Imports (%)	16.2	9.9	10.0	10.0
Unemployment (%)	9.0	6.9	5.6	5.1
Real ULC growth (%)	-3.8	5.9	2.4	1.6
Annual average inflation (%)	7.4	7.6	10.4	6.6
Money market rate (3-month, %, end-year)	4.01	6.56	6.50	6.00
Long-term yields (10-year, %, end-year)	4.18	5.08	5.00	4.00
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	3.5	3.0	2.0
Public debt / GDP (%)	22.7	19.8	18.0	16.5
Trade balance (goods and services) / GDP (%)	-18.2	-21.6	-23.4	-23.0
Current account balance / GDP (%)	-15.6	-21.5	-22.1	-21.8
External financing capacity / GDP (%)	-14.9	-20.3	-21.0	-20.9
Gross foreign debt / GDP (%)	80.7	97.3	105.0	110.0

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

Sources: Bulgarian National Bank, National Statistical Institute, Eurostat

Czech Republic

Record high growth in 2007 is expected to diminish somewhat in the following two years, but should remain above 5%. Inflation increased considerably in 2008 partly due to one-off tax and regulated price changes. However, annual inflation is still expected to be much higher this year.

Political developments

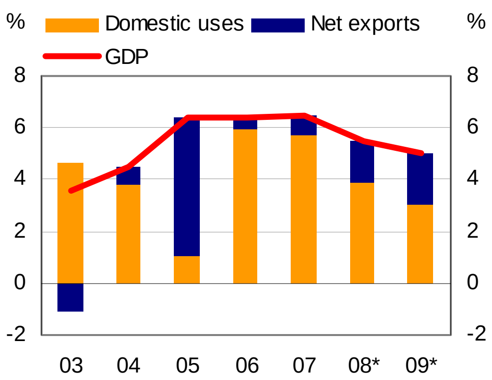
The presidential election was the most important political event in 2008 so far. For the coming five years, Mr. Vaclav Klaus will remain President of the Czech Republic.

The Topolanek government introduced the first measures of its planned complex reform package, including tax changes and co-payment in the health care system. Partly due to these changes, the government's popularity diminished. If elections had been held in March, the opposition Social Democrats would have won by a 7 percentage point margin over the governing Civic Democratic Party, according to March survey data.

Growth

2007 witnessed a record high growth rate of 6.5%. In the fourth quarter, a slight acceleration was recorded, to 6.6% on a year-on-year basis. This marked the eleventh successive quarter with growth above 6%. In the last quarter of 2007, increased health care expenditures, motorway and road repair and construction gave an extra impetus to growth. Both items resulted in a higher than expected government consumption. On the other hand, private consumption grew slower than in the previous quarters partly due to the measures introduced by the government, and partly due to lower growth in real income because of higher inflation. Nevertheless, it remained the most important contributor to GDP growth, followed by GFCF. Both exports and imports slowed, which resulted in a lower contribution of net exports to growth than expected earlier. Weakening foreign demand will continue to shape net exports over the following years.

Structure of growth

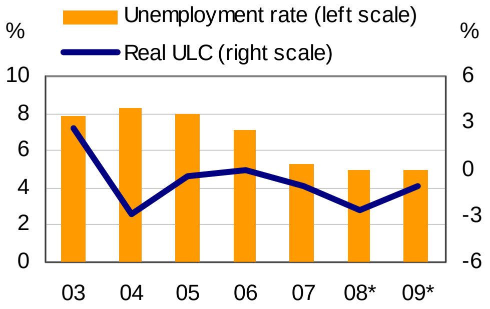


*Note: * forecast. Source: Eurostat*

Slower growth of private consumption and net exports will affect economic performance in 2008-09. However, growth is expected to remain above 5% for both years. The main (downside) risk concerns the development of foreign demand, which will determine the evolution of net exports.

As far as the supply side is concerned, manufacturing, wholesale and retail trade and financial intermediation and business services contributed the most to GDP growth for 2007. New, mainly export-oriented manufacturing facilities have been established with FDI financing, which is an encouraging signal for the future. These same sectors are expected to remain the most important engines of GDP growth on the supply side in 2008-09 as well.

Labour market indicators



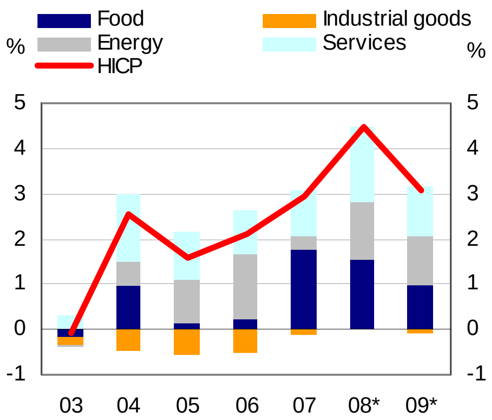
*Note: * forecast. Source: Eurostat*

Labour market

Strong increases in employment continued and registered unemployment fell in 2007 as a whole. Employment reached its highest level and unemployment its lowest since 1997. The employment rate stood at 66.5% at the end of 2007, almost one percentage point higher than a year ago. The average number of unemployed (ILO methodology) decreased by 86.5 thousand in 2007. The unemployment rate has dropped to a ten-year minimum of 4.9%, 1.7 percentage point lower than at the end of 2006. Similar tendencies are expected to continue in 2008-09, although job creation will slow down somewhat.

The tightness of the labour market resulted in wage growth and more imported labour from neighbouring countries. Wage growth slowed at the end of 2007 and accelerated again in the first months of 2008. It is not clear yet whether this latter is a compensation for lower growth at the end of last year, or a permanent trend. Productivity continues to grow briskly, and real unit labour costs are slowly falling (by 1.1% in 2007).

Components of inflation



*Note: * forecast. Source: Eurostat*

Prices and monetary developments

Inflation is on an upward path in the Czech Republic. Annual inflation was 7.5% in February, the same as in January. Changes in indirect taxes and regulated prices (some public services, including health care) have a significant one-off contribution to price increases. However, core inflation has also been markedly higher than the tolerance band set by the Central Bank in the last months of 2007 and in the first months of 2008. The tightness of the labour market and marked increases in food and energy prices continue to exercise upward pressure on wages.

Due to these factors annual inflation is expected to accelerate significantly in 2008. However, the impact of tax and regulated price increases will diminish during the rest of the year. Preliminary March inflation data already indicate a decrease in the price level compared to February. In 2009 inflation could fall to 3% absent major global inflationary shocks.

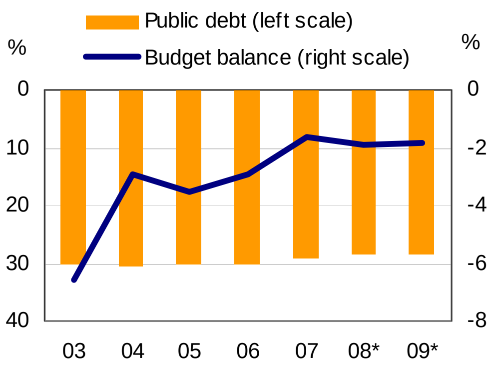
Due to higher than expected inflation and its upside risks, the last quarter of 2007 witnessed another increase in the two-week repo rate (to 3.5%), and in February 2008 there was another 25 basis points rise. Because of weakening external demand, the deceleration in private consumption and upside risks of inflation, it is unlikely that the Central Bank will decrease the repo rate before the third quarter of 2008.

With some fluctuations, the koruna appreciated strongly in 2007 and in early 2008 as well, helping anti-inflationary efforts. Short-term yield differentials compared to euro area indicators have been narrowing, while differences in long-term yields widened to some extent.

Fiscal policy

The budget deficit for 2007 was markedly lower than expected. Revenues grew faster than expected thanks to faster then projected growth, while welfare spending could be cut thanks to rising employment. According to the latest data, the budget deficit fell to 1.9% of GDP (ESA95 methodology). The 2008 state budget is approved with a slightly higher deficit-to-GDP ratio. This may materialise because of changes in the tax system and reductions in social and health expenditures. However, there is a risk of the government shying away from further changes due to its lower popularity. In 2009, further improvements are expected; the Prime Minister recently hinted at a level of around 1.7% of GDP.

Key fiscal indicators (% of GDP)



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

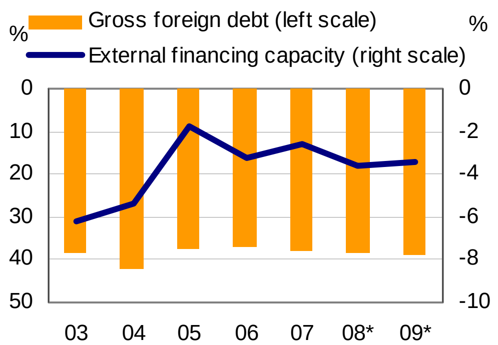
So far, the planned improvement of 2008 budgetary performance is not supported by data. March figures of the Ministry of Finance indicate a deficit while in the corresponding period of 2007 the budget showed a surplus. Higher revenues from consumer tax and value added tax were not able to compensate for higher spending on social benefits and capital formation.

Central government debt increased from CZK 802 bn to CZK 892 bn (EUR 33.5 bn) during last year. Domestic borrowing through treasury bonds accounted for the bulk of the increase according to data of the Finance Ministry. General government debt relative to GDP stood at 28.7% at the end of 2007, down from 29.4% in 2006.

External balance

After a slight deceleration at the end of last year, February 2008 data indicate a double-digit growth in both exports and imports, while the trade surplus grew slightly compared to the same period of last year. Machinery and transport equipment sectors played a key role in improving export performance. However, there is a strong downside risk due to the weakening foreign demand. Thus, for 2008 and 2009, lower growth rates of both exports and imports are envisaged, while the trade surplus is expected to maintain its current level.

External balance indicators (% of GDP)



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

Both the goods and services trades showed rising surpluses in 2007, while the income balance was more in a red than in 2006. This resulted in a negative current account balance, as in previous years. The current account deficit surpassed EUR 1 bn in 2007 (3% of GDP). According to the National Bank, the rise in the deficit of the income balance is due to various factors, including higher reinvested earnings and wages paid to foreigners working in the Czech Republic, as well as interest payments on domestic bonds. However, there was also an increase in the income from foreign assets of commercial banks and from the Czech National Bank's international reserves. The current account deficit may decrease further in the coming years if exports can weather the slowdown of external demand.

On the financial account the inflow of foreign direct investments still surpassed the outflow, and this was only partly counterbalanced by a net outflow of portfolio investments. Foreign direct investment increasingly takes the form of other capital (loans) and reinvested earnings, while the share of new investments (equity) is decreasing. Foreign debt amounted to EUR 50.6 bn in 2007, which represents 37.9% of GDP.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (CZK billion)	3231.6	3557.7	3933.5	4254.1
Real GDP growth (%)	6.4	6.5	5.5	5.5
Private consumption (%)	5.5	5.6	4.0	4.0
Public consumption (%)	0.0	0.9	1.0	0.8
Investments (GFCF, %)	5.5	6.1	6.0	5.0
Exports (%)	14.4	14.5	12.0	11.5
Imports (%)	13.8	13.7	10.4	9.8
Unemployment (%)	7.2	5.3	5.0	4.9
Real ULC growth (%)	0.0	-1.1	-2.7	-1.0
Annual average inflation (%)	2.1	3.0	4.5	3.1
Money market rate (3-month, %, end-year)	2.56	4.05	4.85	4.65
Long-term yields (10-year, %, end-year)	3.68	4.65	4.80	4.60
Exchange rate / EUR (average)	28.34	27.77	26.83	26.83
Exchange rate / EUR (end of period)	27.49	26.63	26.83	26.83
Budget balance / GDP (%)	-2.9	-1.9	-1.9	-1.8
Public debt / GDP (%)	30.1	28.7	28.5	28.4
Trade balance (goods and services) / GDP (%)	3.0	4.7	3.0	2.8
Current account balance / GDP (%)	-3.3	-3.0	-3.6	-3.5
External financing capacity / GDP (%)	-3.0	-2.8	-3.3	-3.2
Gross foreign debt / GDP (%)	36.9	37.9	38.5	38.8

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

Sources: Eurostat, Czech National Bank, Czech Statistical Office

Estonia

Growth slows sharply while inflation peaks in 2008. The government is making contingency plans to maintain a tight fiscal stance. A positive side-effect of the slowdown is that external imbalances are narrowing. However, uncertainties regarding economic developments in 2008-09 remain significant.

Political developments

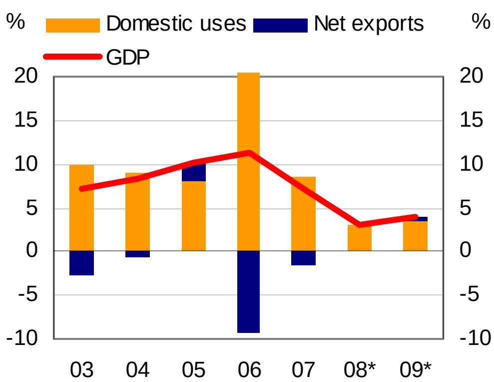
Deteriorating economic prospects affect voters' sentiment towards the government: according to a poll in March 2008 support of the governing Reform Party dropped from 45% last May to 30%.

There are risks that tensions between Estonians and ethnic Russians could rise, hurting Estonian-Russian economic relations: The first anniversary of riots following the removal of the Bronze Soldier statue in Tallinn is approaching, while the economic downturn could bring higher unemployment.

Growth

Growth forecasts for the Estonian economy have been radically reduced recently due to deteriorating domestic and external developments. Our own forecast for 2008 is revised to 3%. We expect gradual recovery in 2009 as private consumption and investments both pass their nadir; growth can reach 4% next year.

Structure of growth



*Note: * forecast. Source: Eurostat*

Private consumption is ailing although the most recent retail sales data may signal some (possibly temporary) improvement. Real wage growth is still well into double figures and a 22% average pension rise this spring is in the pipeline; on the other hand, lending to households is decelerating (new credit values fell by 27% in the year to February) and consumer confidence remains low.

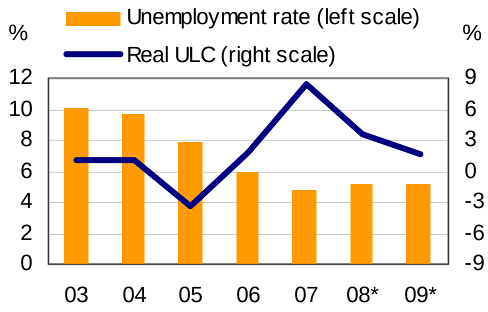
As cuts in government spending are planned for 2008, public consumption may decelerate slightly. Gross fixed capital formation is a major uncertainty. The real estate sector face a deep slump: the floor area of new building permits fell by half from the last quarter of 2006 to the same period in 2007. The bleak economic outlook will depress corporate investments as well.

Exports and imports are both stagnating, although they are strongly affected by a decline in oil transit (from Russia) and in the contract manufacturing of electrical equipment. Since major export partners are also slowing, export sales will grow modestly. However, weak domestic demand will keep imports at bay, therefore the contribution of net exports to growth will be slightly positive in 2008-09.

On the production side, the sectors most affected by the domestic downturn are construction and market services. Planned budget cuts in 2008 could further depress construction activity; the Finance Ministry has already frozen plans for new headquarters worth EEK 260 mn (EUR 16.6 mn). Industrial output growth has been slowing since early 2006 and could hit the bottom in 2008.

Labour market

Labour market indicators



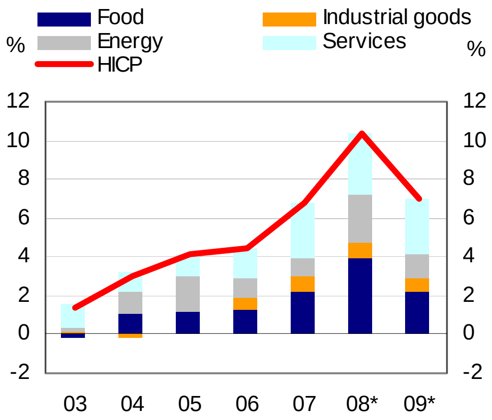
*Note: * forecast. Source: Eurostat*

As the economy slows, employment is expected to decrease in 2008 and the unemployment rate will rise from its record low 4.7% to at least 5% this year. Seasonally adjusted employment figures already indicate layoffs in construction, trade, catering and transport in the last quarter of 2007; these trends are expected to continue in 2008 before a gradual recovery can happen in 2009.

Wage growth is still exceedingly fast (24.6% annually in the last quarter of 2007) and the high inflation rate may continue to stoke wage increases in 2008. Labour cost growth clearly harms export competitiveness: since productivity growth could not keep up with wage increases, real unit labour costs grew by as much as 8.5% in 2007 and will continue to increase in 2008-09 as well, although at least in part for cyclical reasons. On the other hand, real wage growth will slow down considerably, from 12.8% in 2007 to around 2-3% in 2008-09, setting back private consumption.

Prices and monetary developments

Components of inflation



*Note: * forecast. Source: Eurostat*

Inflation keeps crawling upwards due to rising food and energy prices. The 12-month price index may have peaked at 11.5% in February 2008 and receded to 10.9% by March. Strong domestic demand and labour cost increases continue to contribute to the rapid rise of services prices. The producer price index of industry is gradually slowing down; it has risen by 8.3% in the year to February.

Our inflation forecast for 2008 was revised upwards due to marked price increases at the beginning of the year as well as persisting price pressures. We forecast HICP inflation to reach an average 9.6% this year. However, if global food or energy prices continue to rise, it could easily exceed even 10%. Price developments will be more modest in 2009 when inflation can fall back to around 7%.

Interbank market yields are still high, reflecting macroeconomic uncertainties: the spread between the three-month TALIBOR and EURIBOR interbank rates rose to almost 255 basis points in January 2007. We expect yields to remain comparatively high throughout 2008 and 2009 as well.

Credit growth is slowing down: new outlays to businesses and households fell by 12% and 27% respectively in the year to February. Low business and consumer confidence and high interest rates will discourage borrowing in the near future. The quality of banks' loan portfolio is deteriorating: the stock of bad loans relative to total outlays reached 5.3% in February, up by 1.4 percentage points since the same month of 2007.

Fiscal policy

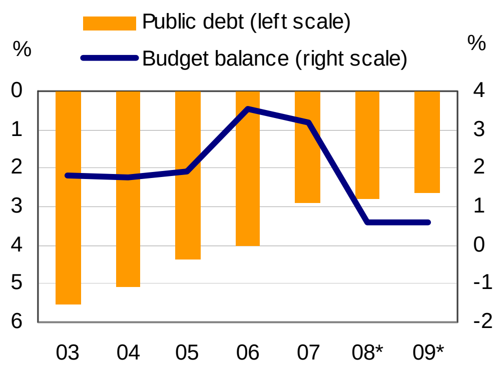
The budget ended 2007 with a sizeable, EEK 7.8 bn surplus (3.2% of GDP). However, low growth will set back revenue collection in 2008 considerably. The 2008 budget was prepared in August 2007 with a growth forecast of 7.3%. Last November real GDP growth projections were revised to 5.2% but the GDP deflator was raised so that nominal GDP growth projections remained unaffected. Meanwhile, our own forecast for nominal GDP growth in 2008 was revised from 17% to

11% since January 2008.

As late as 20 March, Prime Minister Andrus Ansip declared that there was no need to cut expenditures in the face of a slowing economy. However, by April the official stance has shifted and the Ministry of Finance is already contemplating spending cuts in a supplementary budget. According to their April forecast no changes to expenditures would run the budget into a deficit of 1.1% of GDP. Therefore the Ministry has asked ministries to voluntarily cut their spending by a total EEK 3.1 bn in 2008. As pension rises and increased spending on health care cannot be reversed, operating expenses, wages and investments are the main potential areas for retrenchment.

Given the government's growing awareness of the situation, surpluses around 0.6% of GDP may be achieved in both 2008 and 2009 if spending cuts are carried out. Maintaining a budget surplus and a more careful control of incomes is a necessary precondition for combating inflation, which is in our view the most pressing macroeconomic issue at present.

Key fiscal indicators (% of GDP)



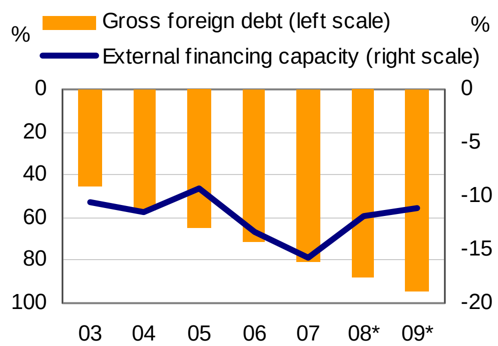
*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

External balance

The external financing requirement reached its peak in 2007 with an amount of EUR 2.4 bn (15.8% of GDP). One-off effects set back the growth rate of goods exports and imports but their rise will remain modest for fundamental reasons (the external and domestic slowdown) in 2008-09. Although high commodity prices help exporters of basic and processed materials, rising labour costs seem to have priced textile exporters (accounting for 5% of export revenues in 2007) out of the market. Other industries may follow suit if wages continue to grow unchecked. The slight improvement of the services balance could not offset the deterioration of the goods balance, therefore the overall trade deficit widened slightly in nominal terms in 2007. However, relative to GDP it narrowed (to 10.8%).

The slowdown of the Estonian economy will improve the external balance significantly, both through lower imports and through the lower outflow of capital incomes. The external financing requirement will fall by over 4 percentage points to 11.8% of GDP in 2008 and to 11.2% in 2009.

External balance indicators (% of GDP)



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

Net FDI inflows amounted to a modest 4.5% of GDP in 2007 and will not rise significantly in 2008-09 either. The dominant form of external financing remains borrowing of domestic banks abroad. As a result, gross foreign debt continues to rise. Nevertheless, less borrowing by residents will slow down the accumulation of foreign debt, which can still exceed 90% of GDP by 2009.

Although the external borrowing of foreign-owned banks has been perceived a safe form of capital inflow, this may not be taken for granted in the future. The soundness of these loans (and indeed, the sustainability of the current account deficit) will very much depend on the financial stability of Scandinavian banks, which may come under scrutiny on today's nervous financial markets.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (EEK million)	207,061	243,252	269,800	297,500
Real GDP growth (%)	11.2	7.1	3.0	4.0
Private consumption (%)	14.9	9.0	3.5	4.5
Public consumption (%)	2.6	4.8	3.5	3.0
Investments (GFCF, %)	22.4	7.8	0.5	1.5
Exports (%)	8.3	1.5	1.6	6.0
Imports (%)	17.1	2.8	1.3	4.5
Unemployment (%)	5.9	4.7	5.0	4.9
Real ULC growth (%)	1.8	8.5	2.8	6.2
Annual average inflation (%)	4.4	6.7	10.4	7.0
Money market rate (3-month, %, end-year)	3.81	7.23	6.00	5.50
Long-term yields (10-year, %, end-year)	4.70	7.56	6.00	6.00
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 (%)	3.6	3.2	1.3	1.2
Public debt / GDP (%)	4.0	2.9	2.8	2.6
Trade balance (goods and services) / GDP (%)	-11.6	-10.8	-7.8	-8.0
Current account balance / GDP (%)	-15.5	-17.3	-13.2	-12.6
External financing capacity / GDP (%)	-13.3	-15.8	-11.7	-10.9
Gross foreign debt / GDP (%)	71.2	80.1	87.1	92.6

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

Sources: Eesti Pank, Eurostat, Statistics Estonia

Hungary

Last year's GDP growth of a mere 1.3% was the lowest in more than ten years. It was also accompanied by an average annual inflation of 8%. While at least the fiscal and external balance improved significantly, the outlook is still rather bleak. A very gradual upswing in economic activity is foreseen in 2008, with growth staying at 2% and inflation remaining high at 6%. 2009 will see stronger domestic push for growth, but without deeper structural reforms growth opportunities will be limited.

Political developments

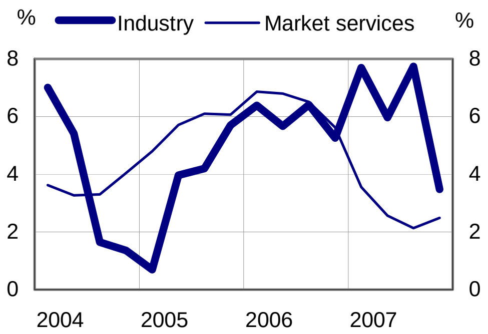
After losing the March referendum on charges for visiting the doctor and the hospital and also on tuition fees, severe conflicts between the ruling coalition parties have emerged. This finally resulted in the withdrawal of their ministers from the government by SZDSZ, the liberal party and junior member of the coalition. While MSZP (the socialist party) seems determined to continue governing even in minority, Prime Minister Gyurcsany's position has weakened severely following the coalition crisis. In this situation it is highly unlikely that the government will try to push through the most unpopular structural reforms. In the long run this will definitely have an adverse affect on Hungary's competitiveness.

Re-emerging strikes initiated by trade unions in public transport companies also contribute to tensions. Workers of BKV (the public transport provider of Budapest) went on strike when it was announced that the capacity of the company would be reduced by close to 10%. Railway workers also have wage claims that are described as irrational by MÁV Start, the company organising rail passenger traffic. Negotiations between employers and the leaders of the trade unions have proved fruitless so far.

Growth

The fourth quarter of 2007 saw a further deceleration in GDP growth in year-on-year terms. Compared to the same period of 2006 the economy only expanded at a rate of 0.8%, the lowest figure in more than ten years. This also stands for the resulting annual average GDP growth of a mere 1.3%.

Value added in the tradables sector



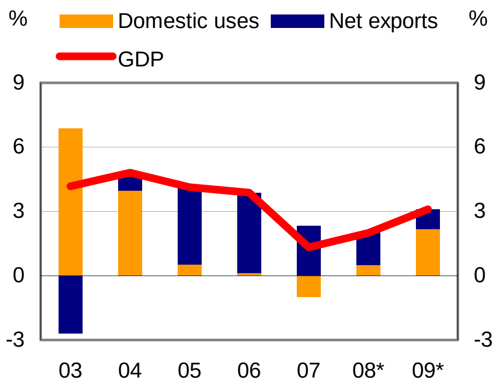
Note: seasonally adjusted year-on-year growth rates.
Source: KSH (statistical office)

From the production side a sizable drop in industrial value added growth offers some explanation, but further deterioration characterised the agriculture and construction sectors as well. On the other hand, market services seem to be gaining some strength.

Households' final consumption still reflected the effects of the fiscal austerity measures in the fourth quarter: its in-kind transfers component still exhibited a decline of over 5% year-on-year. Gross fixed capital formation, however, exhibited some sign of possible recovery, even despite further contracting public investments and real estate developments. Export growth was not particularly strong in the fourth quarter (as can be suspected from weaker industrial production figures), but import growth were even lower, thus the anticipated closing of the gap between export and import growth has not yet materialised. This leads us to think, that further gains from net trade are still possible in 2008.

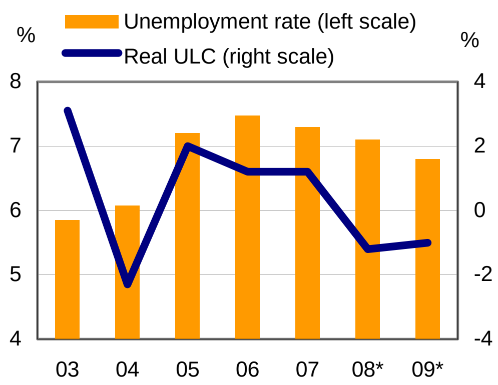
As the income outlook for this year is rather grim and consumer

Structure of growth



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

Labour market indicators



*Note: * forecast; real ULC based on gross wage growth. Source: KSH (statistical office)*

confidence is really low, household consumption will hardly increase in 2008. Gross fixed capital formation can be much stronger due to increased corporate investments, and we expect a growth rate of over 3% this year even without a turning point in public investments. The growth rate of export can again be double-digit in 2008, as foreign demand will not decelerate sharply, since Europe is much more diversified now than it was in earlier instances of global downturns. In 2008 thus it is still net exports that will be the main driver of economic growth, which, nevertheless, will not exceed 2%.

2009 will see domestic demand components gaining momentum. As real earnings will finally begin to increase, household consumption will accelerate, and with the 2010 elections approaching, public investments will also be on the rise. The increased volume of import will lead to a shrinking growth contribution from net exports. In sum, we expect GDP growth a little over 3% in next year.

Labour market

The labour market became flat at the beginning of 2008 with the employment rate plummeting to just below 50%. Such depth has not been seen since the beginning of 2003. Since the activity rate has also fallen due unfavourable outlook and the tightening of retirement rules, unemployment has only moderately increased, but it still reached 8% in February. With market services value added improving, the sector will increasingly offer new jobs, and as activity will not significantly improve, the average unemployment rate can decrease to 7.1% in 2008. A further slight decrease is foreseen for 2009.

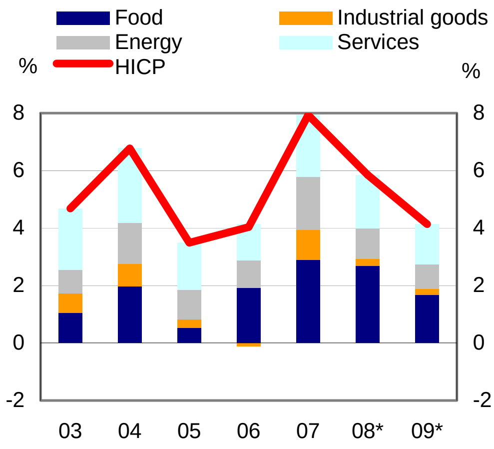
Gross wages increased by 8.1% in 2007. Behind this lies a relatively high increase (above 10%) in the regular earnings in the private sector that was partly offset by a 4.5% decline in bonus payments, due to worsening corporate profitability. In the public sector the tendencies were opposite: regular earning increased by just 2.3% while irregular payments by 16-17% (not counting the early payment of some bonuses in the second half of 2007, which are regularly disbursed in January). As the gap between gross and net earnings was wide, and inflation high, real earnings declined by about 5% last year. Gross wages are expected to increase by 6.5% in 2008, but real earnings will stagnate or even decrease again, and can only increase from 2009, when domestic demand really begins to pick up. Slow real wage growth means that unit labour costs will decrease both in 2008 and in 2009.

Prices and monetary developments

The first quarter of 2008 saw 12-month headline CPI stuck into a narrow band of around 7%, with food prices and household energy prices still increasing at a fast pace. Services price rises continued to be slowing, however changes in consumer durable goods prices seem to be heading for positive territory. Core inflation is almost unchanged in a narrow band of somewhat above 5%.

While food price rises will probably be moderated, as world market price shocks will eventually calm down, the stickiness of core inflation is a cause of concern for monetary policy. Recent analyses have confirmed that Hungarian economic actors are relatively more prone to consider temporary price shocks as lasting than economic actors in most other European countries. This keeps inflationary expectations

Components of inflation



*Note: * forecast. Source: Eurostat*

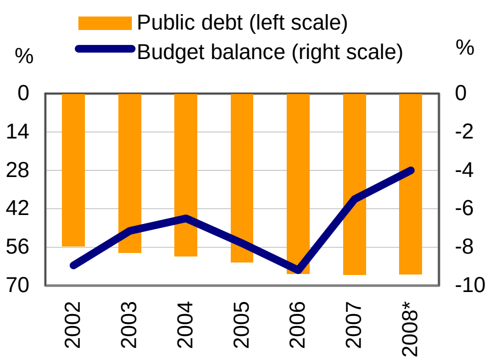
high that is highly unfavourable as it may trigger or reinforce upward wage-price spirals. Thus while the disinflation process can already be on its way, it will be a rather gradual process due to high inflation inertia. Yet, by the end of this year 12-month CPI-inflation can decrease to below 5%, and on average inflation will be reduced to 6%. Even this scenario has its upward risks, as consumer durable goods prices can also increase with much stronger dynamics than we now see. Should, however, our baseline view prevail, inflation can be brought down to 4.1% in 2009.

It is not only resilient inflation that monetary policy should closely monitor, but also the consequences of the international financial turbulences on the Hungarian capital markets. As amidst increased uncertainties investors continue their flight into more secure assets, countries with unfavourable macro indicators may suffer the lack of investor interest. In the beginning of 2008 the Hungarian money markets (and especially the government securities market) were badly hit. Buyers have disappeared and yields sharply increased. The decision of the Monetary Council to raise the policy rate by 50 basis points to 8% at the end of March probably also reflected money market developments.

Quite unexpectedly, the forint markedly appreciated vis-a-vis the euro in the first days of April, thus some analysts say, there is no need for further monetary tightening. Even if they prove to be right, easing is not expected either at least before the third quarter of 2008. Then, however, with inflation getting more under control, the central bank will have some space to cut its policy rate. We now expect 7.25% by the end of this year.

Fiscal policy

Key fiscal indicators (% of GDP)



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

According to the recently released figures by the Central Statistical Office, the accrual-based general government deficit declined in 2007 well below the expectations to 5.5% of GDP. The improvement of the balance (from 9.2% of GDP in 2006) was mainly due to the increase of revenues, while expenditures declined only in real terms. The main areas of revenue increases were a broadening tax base due to the social security payment and personal income tax measures, the higher than expected inflation, resulting in fast increase of excise taxes and consumption taxes. At the same time expenditures performed differently as a decline in some (e.g. health care spending) was offset by increase in others (operating expenditures of public institutions, increase in interest spending etc.). The debt of the general government declined to 66.1% of GDP mainly because of the high increase in nominal GDP.

In 2008 the expectation is that the planned general government deficit of 4% of GDP could be reached and a more balanced contribution from rising revenues and declining expenditures is expected. The slightly changing macroeconomic performance (slower than expected real GDP growth, higher than planned inflation) will not have a long lasting effect on the budget as they will cancel out each other, while the rise in yields and the overall higher interest rate level will add to expenditure pressures in 2009.

The expected decline of spending is partly due to the long-lasting weak performance of public investments, while public consumption is expected to decrease too due to the absence of certain expenditures that have burdened the budget in the previous years (purchase of

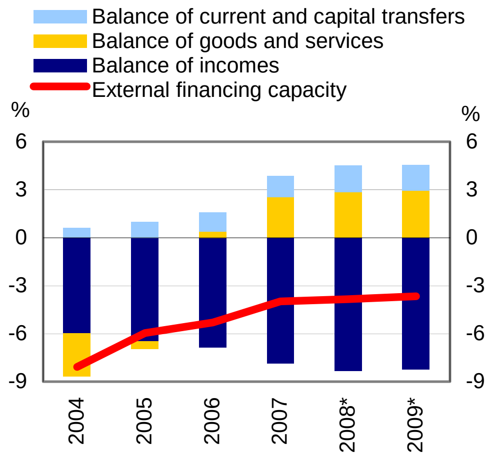
Gripen fighters, the highway construction program, etc.). At the same time revenues are expected to grow, driven by slightly expanding household consumption, still high inflation and the broadening of the tax base.

External balance

The combined current and capital account exhibited a deficit of EUR 765 mn in the last quarter of 2007 eventually leading to an external financing requirement of EUR 4 bn (or 4% of GDP) last year. It was the lowest annual deficit since 1996.

While the underlying developments remained broadly unchanged, it seems, that contrary to our earlier expectations, the gap between export growth and import growth is not closing as rapidly as third quarter data implied. This finally resulted in a somewhat higher sufficit on goods and services than we previously calculated (EUR 2555 mn, or 2.5% of GDP). At the same time, however, the income balance continued to worsen, as both interest payments and direct investors' profits were on continuous rise. Net income flows abroad almost accounted for 8% of GDP in 2007. Increasing net inflow from EU funds, however significantly improved the balance of current and capital transfers.

External balance indicators (% of GDP)



*Note: * forecast. Source: MNB (central bank)*

Since import growth will be lower than we expected a quarter before (when we projected 2.5% GDP-growth for 2008 with more rapidly recovering domestic demand), the balance of goods and services can further improve to 2.8% of GDP this year and close to 3% of GDP in 2009. Some improvement will also take place in the balance of current and capital transfers, but the income balance will get deeper into deficit. Combined, this will lead to an external financing need of below 4% of GDP both in 2008 and 2009.

While there was a clear upswing in foreign direct investment inflows in the fourth quarter of 2007, the dominance of debt-generating financing was still prevalent in the financial account of the balance of payments. The reason for this was a very pronounced net outflow in portfolio equity investments. While this item mostly exhibited net inflows in the past, 2007 was a clear exception with a close to EUR 5.4 bn net outflow, in itself reaching 5.4% of GDP. It should be noted, however, that almost half of this amount is attributable to oil giant MOL's own equity purchases from foreign investors, in an effort to avoid a buyout by Austrian OMV. This unbalanced financing structure led to a rapid accumulation of foreign debt though.

The stock of gross foreign debt increased to EUR 97.5 bn by the end of December, which is 96.5% of GDP. This means an increase by almost EUR 16 bn in a year, which is quite huge an amount, even if a good part of it is attributable to exchange rate changes (especially to the average appreciation of the HUF vis-a-vis the euro). Since the financing structure will still be dominated by debt-generating capital inflows in 2008, gross foreign debt can increase to EUR 105 bn by the end of this year and peak at 99% of GDP. The growth of the debt stock will be somewhat lower in 2009, and will fall short of nominal GDP growth, thus by the end of the next year the debt-to-GDP ratio can even decrease to around 98%.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (HUF bn)	23,757	25,374	27,200	28,900
Real GDP growth (%)	3.9	1.3	2.0	3.1
Private consumption (%)	2.1	-2.1	0.4	1.8
Public consumption (%)	6.6	-3.2	-0.2	1.5
Investments (GFCF, %)	-2.8	1.0	3.4	4.6
Exports (%)	18.9	14.2	11.4	9.5
Imports (%)	14.5	12.2	10.5	9.2
Unemployment (%)	7.5	7.3	7.1	6.8
Real ULC growth (%)	1.2	1.2	-1.2	-1.0
Annual average inflation (%)	3.9	8.0	6.0	4.1
Policy rate (%)	8.00	7.50	7.25	6.00
Money market rate (3-month, %, end-year)	7.90	7.45	7.20	6.20
Long-term yields (10-year, %, end-year)	6.71	7.08	6.90	5.80
Exchange rate / EUR (average)	264.14	251.12	256.76	255.00
Exchange rate / EUR (end of period)	252.30	253.35	255.00	255.00
Budget balance / GDP (%)	-9.2	-5.5	-4.0	-
Public debt / GDP (%)	65.6	66.0	66.5	-
Trade balance / GDP (goods and services, %)	0.4	2.5	2.8	2.9
External financing capacity / GDP (%)	-5.3	-4.0	-3.8	-3.7
Gross foreign debt / GDP (%)	90.6	96.5	99.3	98.3

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

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

Latvia

The economy is slowing while inflation is rising, although one-off factors and external developments play an important role. The government wishes to quell speculations of a hard landing, but it cannot mask the risks to the economy's path in 2008-09.

Political developments

New corruption cases have emerged in recent months, concerning city councils and the Ministry of Transport, while the Revenue Service has already uncovered three major money-laundering schemes this year.

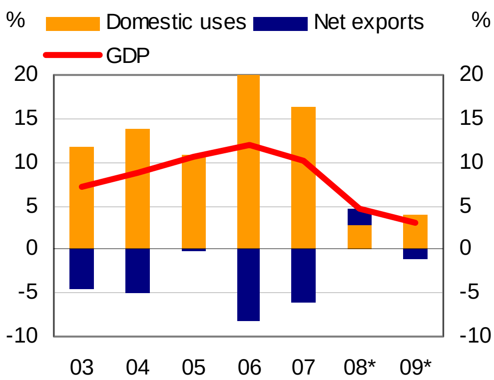
Political forces struggle for the favours of pensioners. Two former ministers registered a new political organisation to hold a referendum on pension rises. Although the government disapproves of the idea, it still promised pension increases. This could easily backfire: looser income policy could stoke inflation further while reneging on promises would lead to a loss of credibility.

Meanwhile, the government has also resorted to verbal intervention to improve economic sentiment. It successfully urged the European Commission to drop hints to a hard landing scenario from the assessment of Latvia's most recent Convergence Programme.

Growth

Growth was as high as 10.2% in 2007 but the economy began to lose momentum in the last months of the year. Private consumption grew by just an annual 4.1% in the last quarter despite strong growth of incomes and employment. Retail sales stopped growing at the end of 2007 and lending to households is slowing down. Although gross fixed capital formation grew by 10.3% in 2007, seasonally adjusted figures indicate a slight contraction in the last quarter of 2007. This could be down to two factors. The peak of real estate investments has passed while the outlook for the corporate sector is poor. Exports are still running at 13.3% year-on-year but faltering domestic demand is beginning to affect imports, therefore the negative contribution of net exports to growth is diminishing.

Structure of growth



Source: Eurostat, Statistics Latvia

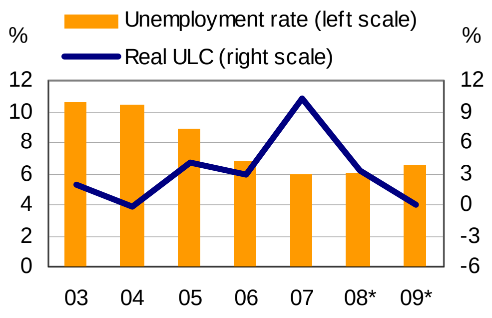
Our GDP forecast for 2008 is strongly revised downwards. We believe that the end of the housing bonanza, deteriorating export possibilities and declining consumer confidence will drag down growth considerably, which will fall well short of its potential. Even our 4.6% forecast includes downward risks, related primarily to investments, exports and the availability of credit. 2009 can bring further slowdown to the region of 3%.

On the production side, industrial output has barely grown since 2005 (its annual growth was 0.9% in 2007). Meanwhile, construction and services will be especially affected by the economic downturn.

Labour market

According to labour force survey data job creation remained strong in 2007: the number of employed grew by 2.8% and the unemployment rate fell to 6%. Employment growth remained brisk in the last quarter of 2007, but it is not expected to continue in 2008 ad 2009. Labour

Labour market indicators



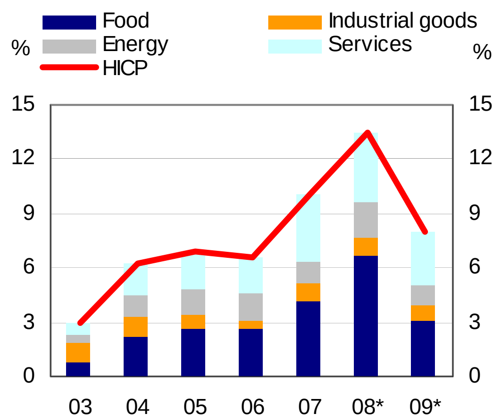
*Note: * forecast. Source: Eurostat*

markets are already tight and the slowdown of domestic demand will particularly affect labour-intensive services as well as construction. As output falls short of its potential, unemployment could rise again.

On the other hand, loosening labour markets could finally bring moderation to wage developments. Compensation per employee rose by 32.8% in 2007 and real unit labour costs jumped by 10.2%. This undermines the competitiveness of Latvian exporters and will have repercussions on GDP growth, the external balance and FDI attractiveness. Furthermore, rising inflation is expected to feed into pay rises, and double-digit wage increases could persist in 2008 and 2009. Since GDP (and productivity) growth slows down, real ULC may continue to rise in 2008.

Prices and monetary developments

Components of inflation



*Note: * forecast. Source: Eurostat*

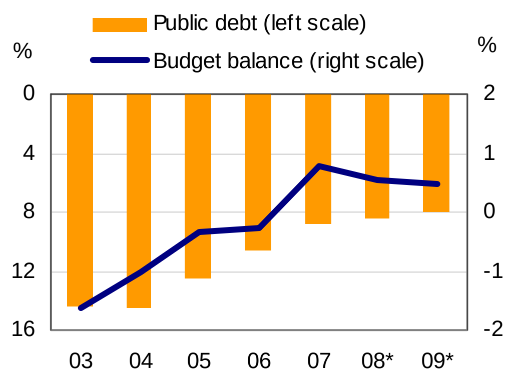
Inflation remains on the rise: after averaging 10.1% in 2007, the consumer price index rose by 16.8% in the year to March 2008. Wage pressures are an important factor behind the 11.4% annual rise of industrial prices in February, although producer prices have been decelerating for months. Global food and energy prices could continue to increase as well; therefore inflation may reach 13.4% in 2008 as a whole. Second-round effects of inflation will affect 2009 as well, when the average inflation rate can still reach 8%. Excise tax increases (tobacco and fuel) and administered prices contribute 3.1 and 1.1 percentage points to inflation in 2008 and 2009 respectively.

Since their peak in October 2007, money market interest rates have been falling and the spread between the 3-month RIGIBOR and EURIBOR rates narrowed from 800 basis points to around 300 by February. However, macroeconomic uncertainties and high inflation will keep spreads high in 2008-09.

Credit growth continues to slow: the loan stock of enterprises and households increased by 33.3% and 35.6% respectively, in the year to January 2008. Deteriorating economic prospects and high interest rates deter borrowers. On the other hand, there is a risk that foreign parents of local banks may curb lending in Latvia either if they have to cover losses related to the U.S. subprime mortgage crisis or if the quality of local loans deteriorates significantly.

Fiscal policy

Key fiscal indicators (% of GDP)



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

The Ministry of Finance reported that the budget ended 2007 with a surplus, amounting to 0.8% of GDP. This was achieved thanks to very strong revenue growth (due to high GDP growth and rising inflation) and fiscal discipline in the central government and social security.

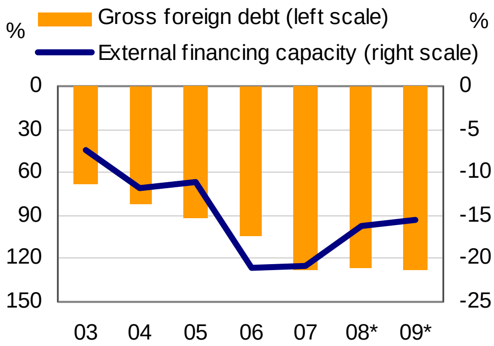
The 2007-2010 Convergence Programme targets surpluses of 0.7% and 1% in 2008 and 2009 respectively. Fiscal policy is indeed becoming more disciplined and public sector pay rises will be strictly controlled. However, some increases of social spending (parent benefit) are in the pipeline; others may be prompted by higher than expected inflation. On the revenue side, slow economic growth will set back tax collection. Therefore actual surpluses are expected to fall short of plans and may amount to 0.5% of GDP in 2008-09.

The stock of public debt continues to shrink relative to GDP; it could fall to 8% by the end of 2009 although its value will rise by close to 20% over two years.

External balance

As the economy began to slow at the end of 2007, external imbalances started to narrow. The external financing requirement and the trade deficit both amounted to 20.7% in 2007. We expect both to improve by at least four percentage points this year as slower domestic consumption growth curbs imports; some further improvement will take place in 2009.

External balance indicators (% of GDP)



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

Source: Eurostat

Goods exports rose by 21% (in euro terms) in 2007. Food and basic materials could benefit from rising prices but machinery exports grew the fastest, by over 36%. However, the slower growth of export markets can expose the rising cost of Latvian products and foreign sales could suffer in 2008-09. This constitutes a downside risk to our forecast. On the other hand, a faster than expected consumption and investment slowdown could bring about a faster improvement of external balance indicators.

Net FDI inflows amounted to 7.2% of GDP in 2007, leaving the bulk of financing to debt-generating capital flows, mostly in the form of foreign loans of domestic banks. As a result, gross foreign debt is still rising and it reached 127% of GDP by the end of last year. Scandinavian parent banks of local outfits appear untainted by U.S. (and global) credit market troubles. If the situation changes and these banks must withdraw capital from Latvia, the current structure of external financing may become unsustainable and the resulting credit crunch may have grave consequences.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (LVL million)	11,265	14,048	16,600	18,800
Real GDP growth (%)	11.9	10.2	4.6	3.0
Private consumption (%)	19.8	13.7	2.0	2.5
Public consumption (%)	4.0	5.6	6.0	3.5
Investments (GFCF, %)	18.3	10.3	2.0	4.0
Exports (%)	5.3	10.3	2.5	2.0
Imports (%)	17.5	16.6	-1.0	3.0
Unemployment (%)	6.8	6.0	6.1	6.6
Real ULC growth (%)	2.9	10.2	3.8	-1.4
Annual average inflation (%)	6.6	10.1	13.4	8.0
Money market rate (3-month, %, end-year)	4.21	10.78	7.50	7.00
Long-term yields (10-year, %, end-year)	4.90	5.10	5.00	5.00
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 (%)	-0.3	0.8	0.5	0.5
Public debt / GDP (%)	10.6	8.9	8.2	7.8
Trade balance (goods and services) / GDP (%)	-22.1	-20.7	-16.4	-15.4
Current account balance / GDP (%)	-22.3	-22.8	-18.1	-17.1
External financing capacity / GDP (%)	-21.1	-20.7	-16.2	-15.4
Gross foreign debt / GDP (%)	104.4	127.1	126.5	127.8

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

Sources: Eurostat, Latvijas Banka, Statistics Latvia

Lithuania

Growth is gradually slowing but inflation is spiralling upwards due to rising fuel and energy prices and labour costs. Loose income policy could pose problems if high wage growth translates into further price increases and deteriorating export competitiveness.

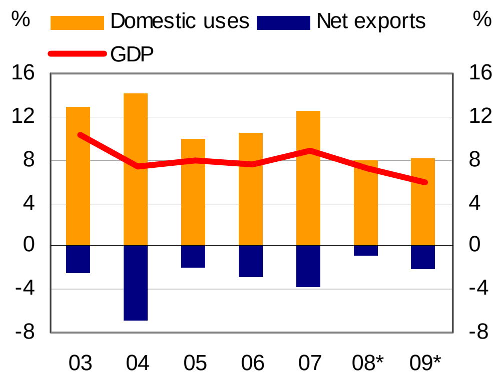
Political developments

Energy security has been an important issue in recent months. The Ignalina nuclear power plant is scheduled to be decommissioned in December 2009 at the demand of the European Union, but several politicians and a civil action group plan to hold a referendum on the extension of the reactor's lifetime. Meanwhile, the Law on Nuclear Power Plant was amended to allow private investors into the establishment of a new nuclear plant to replace Ignalina. Poland is also interested in the project. The Presidents of Lithuania and Poland also agreed to connect the electricity grids of the two countries. However, the two neighbours at are at odds over the sharing of the planned reactor's capacity.

Growth

Growth was faster than expected for most of 2007. However, seasonally adjusted growth figures suggest that the economy entered recession in the last quarter. Main expenditure items show a mixed picture. Private consumption lost momentum in the second half of 2007 but recent retail sales figures indicate a rebound. This is supported by strong real wage increases (17.7% in 2007), rising employment and credit growth. Public consumption also rose markedly in the last quarter. Although we foresee slowing consumption growth, it will remain the key contributor to growth in 2008 and 2009 as well.

Structure of growth



*Note: * forecast. Source: Eurostat*

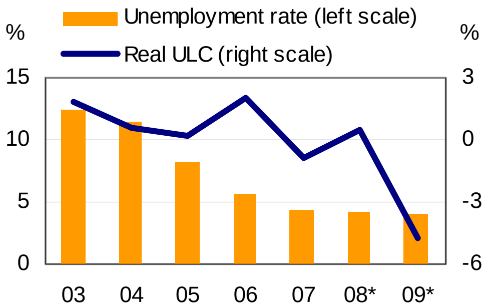
Investments took a dive in the last quarter of 2007; seasonally adjusted GFCF fell by a quarterly 4.4%. Business statistics indicate that construction (which accounts for 60% of corporate and public investments) decelerated markedly in the fourth quarter. On the production side, construction activity also stalled at the end of 2007, while housing prices peaked according to InReal, a real estate agency. There are two positive developments, though. Investments into equipment and machinery continued to grow at around 20% annually, and new building permits keep rising (when measured by the floor area of issued permits). In sum, gross fixed capital formation will slow down in 2008-09 but it will still contribute to economic growth.

Exports and imports also shrank at the end of 2007, falling by a quarterly 7.1% and 6.2% respectively in the last three months as production in the Mazeikiu Nafta refinery declined. As the plant's output recovers, the negative contribution of net exports to growth will decrease markedly.

In sum, domestic demand will cool gradually but will remain the key contributor to economic growth in 2008 and 2009. We expect GDP growth to reach 7.2% this year and 6% in 2008. Risks are on the downside: exports to neighbouring Baltic countries could falter, labour cost increases may harm competitiveness and the construction activity could still decelerate.

Labour market

Labour market indicators



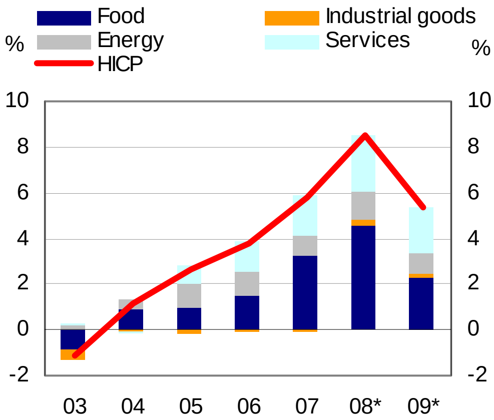
*Note: * forecast. Source: Eurostat.*

The poor economic performance of the last quarter in 2007 brought job cuts as well. Seasonally adjusted employment figures dropped by a quarterly 3.7% due to layoffs in services. The unemployment rate reached an average 4.3% in 2007, slightly exceeding our expectations. Given the slowdown of the economy we anticipate a slight increase in employment in 2008 and 2009. Unemployment will remain stable just above 4%.

Tight labour markets and rising inflationary expectations sent wages spiralling upwards. The 16.7% minimum wage rise last year boosted salaries, especially in the service sectors; gross average earnings in the entire economy rose by 21.2% in 2007. Labour costs will continue to grow briskly for three reasons. In January 2008 the minimum wage rose again, from LTL 700 to LTL 800 (EUR 232); shortages of skilled labour are still apparent; and rising inflation feeds into higher wage demands. Thanks to productivity gains real unit labour costs still managed to fall slightly last year. 2008 will bring a slight reversal, but productivity will again outpace labour costs in 2009.

Prices and monetary developments

Components of inflation



*Note: * forecast. Source: Eurostat*

Inflation rose sharply at the beginning of 2008: the harmonised (HICP) index increased by 11.1% in the year to March. The double-digit rise of food prices follows global trends and also includes the effect of rising excise duties on alcohol. Solid and liquid fuel prices follow world market developments while the price of gas jumped by 26% from December 2007 to January 2008. Electricity prices remained unchanged but these could also rise in the future. There is also uncertainty whether heating services' providers will be allowed to raise prices more than once a year.

Services prices rose by 11.8% in the year to March, reflecting higher labour costs. As strong wage growth persists supply-side inflationary pressures are mounting. Industrial prices have risen by 22.3% in the year to February. Although the current surge will gradually subside, inflation will remain on an upward track in 2008 and could reach 8.5% on average. As global food and energy prices stabilise and wage growth eases, inflation could recede to 5.4% in 2009. If these favourable developments fail to materialise, inflation could remain well over 7% in 2009 as well.

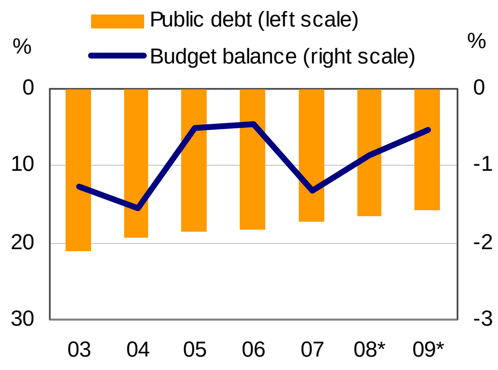
Wobbly financial markets sent short-term yields skyrocketing in the fourth quarter of 2007 but spreads vis-à-vis euro area securities have since narrowed. The 3-month VILIBOR-EURIBOR spread in particular fell from 220 basis points last December to 50 basis points by February 2008. We expect a similar gap to persist in 2008 and 2009 as the concerns over the Baltic economies have grown recently.

The stock of bank loans to residents rose by 41% in the year to February 2008; the stock of household debt went up by 53% while that of non-financial corporations increased by 35% during the same period. Although these growth rates are still high, they are declining gradually. Rising interest rates and the economic slowdown will cool lending further in 2008 and 2009.

Fiscal policy

The general government budget ended 2007 with a LVL 1270 mn deficit, which amounted to 1.3% of GDP. This was higher than our expectations and 0.4 percentage points above the target set out in the Stability and Convergence Programme submitted to the EU in 2007. Social benefits and government investments both rose markedly while public sector salaries had to keep pace with strong aggregate wage growth. On the revenue side, improving tax collection and the buoyant economy led to a 21% rise in collected revenues.

Key fiscal indicators (% of GDP)



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

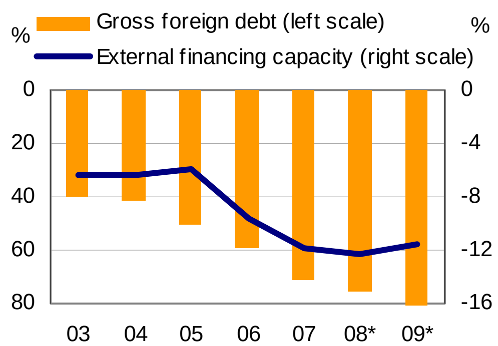
We do not expect a significant tightening of fiscal policy in 2008-09. Although growth will slow down, higher inflation and rising incomes will still boost revenues. On the other hand, the wage bill and investment costs are set to rise significantly and higher inflation can induce a faster than planned increase in social expenditures. A higher than expected slowdown can also induce an anti-cyclical fiscal expansion. Our baseline scenario involves a 0.9% deficit for 2008 and 0.5% for 2009; a less favourable scenario would involve slightly higher deficit levels.

The stock of public debt amounted to 17.3% of GDP at the end of 2007 and is expected to fall somewhat in 2008-09. Rising interest rates raised the cost of debt servicing; the Maastricht criterion rate (of government debt with 10 years remaining maturity) stood at 4.51% in February, 51 basis points above the average for the euro area. A similar spread is expected to remain in 2008 and 2009 as well.

External balance

Goods exports slipped at the end of last year but this was entirely due to falling sales of fuels and lubricants from the Mazeikiu Nafta refinery. Non-energy exports continued to grow at a healthy pace, registering a 21% year-on-year growth in the last three months of 2007. Exporters could benefit from strong growth in export markets and rising commodity prices. On the other hand, service exports rose by just 2.7% in 2007; transport and related services suffered from the weakness of the U.S. dollar and tourism revenues also stagnated. The total value of goods and services exports grew by less than 10% in 2007.

External balance indicators (% of GDP)



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

The outlook for exporters is deteriorating. Demand slows in neighbouring Baltic countries and western Europe which purchase 19% and 31% respectively of Lithuanian goods exports. Rising labour costs may hurt competitiveness in agriculture and low-tech industries which still account for a large share of exports. On the positive side, commodity prices remain high, but this will not offset faltering external demand and cost pressures.

The value of imports rose by 14% in 2007 on the back of strong consumption and investment demand. In 2008-09 import growth will remain moderate due to the economic slowdown. The trade deficit, which reached EUR 3.5 bn (12.5% of GDP) in 2007, is expected to stabilise relative to GDP.

The income balance deteriorated by EUR 0.5 bn in 2007, chiefly because the dividends and reinvested earnings of foreign-owned enterprises rose by 45%. On the other hand, inflowing EU funds and remittances of Lithuanians working abroad improved the combined balance of current transfers and the capital account by EUR 0.5 bn.

As a result, although the current account deficit reached 13.7% of GDP, the external financing requirement remained just below 12%. Given the deterioration of the trade balance, the latter will exceed 12% in 2008 before improving slightly in 2009.

Non-debt financing remained weak throughout 2007; net FDI inflows remained below EUR 1 bn (3.5% of GDP). Purchases of Lithuanian and foreign debt securities both declined, but on balance a slight net inflow of portfolio investment in debt (EUR 0.2 bn) could be registered. Foreign loans of domestic banks remained the dominant source of financing, therefore gross foreign debt continued to rise: it increased by 12 percentage points to 71% of GDP in 2007. These tendencies will not change in 2008 and 2009 although the build-up of external debt will slow down as the economy decelerates. The stock of gross foreign debt is expected to exceed 80% of GDP by the end of 2009.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (LTL million)	81,905	96,773	114,100	129,400
Real GDP growth (%)	7.7	8.8	7.2	6.0
Private consumption (%)	11.9	11.2	7.5	7.0
Public consumption (%)	5.5	4.3	8.0	2.5
Investments (GFCF, %)	17.4	15.3	5.0	9.5
Exports (%)	12.2	5.2	9.0	12.0
Imports (%)	13.8	9.1	8.0	12.0
Unemployment (%)	5.6	4.3	4.0	4.1
Real ULC growth (%)	2.0	-0.9	0.9	-3.4
Annual average inflation (%)	3.8	5.8	8.5	5.4
Money market rate (3-month, %, end-year)	3.72	7.07	5.00	4.50
Long-term yields (10-year, %, end-year)	4.28	4.94	4.50	4.00
Exchange rate / EUR (average)	3.45	3.45	3.45	3.45
Exchange rate / EUR (end of period)	3.45	3.45	3.45	3.45
Budget balance / GDP (%)	-0.5	-1.3	-0.9	-0.5
Public debt / GDP (%)	18.2	17.3	16.6	15.8
Trade balance (goods and services) / GDP (%)	-10.4	-12.5	-12.8	-12.7
Current account balance / GDP (%)	-10.8	-13.7	-14.0	-13.5
External financing capacity / GDP (%)	-9.6	-11.9	-12.3	-11.8
Gross foreign debt / GDP (%)	59.2	71.1	75.5	80.4

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

Sources: Eurostat, Lietuvos Bankas, Lietuvos Statistikos Departamentas

Poland

The new government seems more liberal in its economic policy, but radical changes are unlikely. The Polish economy will likely expand faster than other countries of the region over the coming two years, in part thanks to rapid inflows of foreign direct investments. On the other hand, significant inflationary pressures are apparent. Increasing consumer prices and the nominal appreciation of zloty in the short term could delay the date of euro entry.

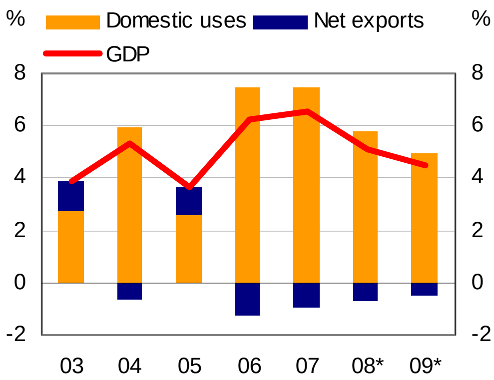
Political developments

The new government (in office since early elections in October 2007) of the liberal-conservative Civic Platform (PO) and the agrarian Polish Peasants Party (PSL) offers good prospects for political stability. The government likely will adopt a liberal approach to economic policy, but radical changes are unlikely.

After a long debate, both Houses of the Polish Parliament have approved the Lisbon Treaty with an opt-out from the European Union Charter of Fundamental Rights. The approval of the Treaty required support from the right-wing and earlier governing Law and Justice opposition party as needed a two-thirds majority vote.

Growth

Structure of growth



*Note: * forecast. Source: Eurostat*

The last quarters of 2007 marked a high growth in gross fixed capital formation. Fast investment growth combined with a surge in private consumption brought about a considerable increase in domestic demand. As a result, imports rose faster than exports and net exports continued to contribute negatively to GDP growth. Strong growth is expected to continue: the economy will likely expand by 5.1% in 2008 and by 4.5% in 2009.

The continuation of the high growth of private consumption resulted from the steadily improving economic situation of households, in particular the considerable growth of household disposable income. Private consumption should remain one of the key factors driving GDP growth in the quarters to come, despite signs (for example in retail sales figures) that it may increase somewhat slower than previously expected.

The coming quarters are expected to bring sustained strong investment activity in the corporate sector. The results of the National Bank of Poland (NBP) Economic Climate Surveys point to high and persistently growing rate of production capacity utilisation in enterprises. Further growth in investments will also be supported by the inflow of foreign funds, both in the form of structural funds (the allocation of EU funds granted to Poland for 2007-2013 is expected to start soon) and foreign direct investment.

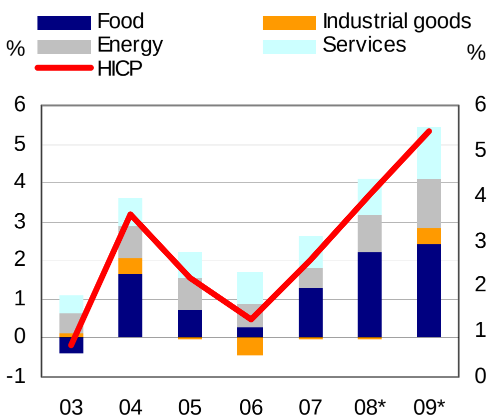
Labour market

Economic growth helped bring the unemployment rate down to 10.1% in 2007, and 2008 is likely to see the figure drop below the 10% mark. However, this figure is still high in regional comparison, while the employment rate remains very low. According to international organisations boosting the labour force holds the key to long-term growth prospects. Measures are needed to raise Poland's exceptionally low level of labour participation. Restrictions on early retirement and further rationalising of disability payments should be the key elements of the desired reforms.

Since Poland joined the EU, labour costs have been growing slower than in neighbouring countries. Until last year, the labour costs were increasing even slower than in the European Union. The situation has changed in 2007 when wages started catching up very fast thanks to robust economic growth. In the last quarter of 2007 nominal wages in the economy showed a continued rapid growth, albeit slower than in the preceding quarter. Expected wage growth in 2008 and 2009 may also be driven by escalating wage demands in the public sector. This process will eventually affect cost competitiveness and FDI attractiveness.

Prices and monetary developments

Components of inflation



Source: Eurostat

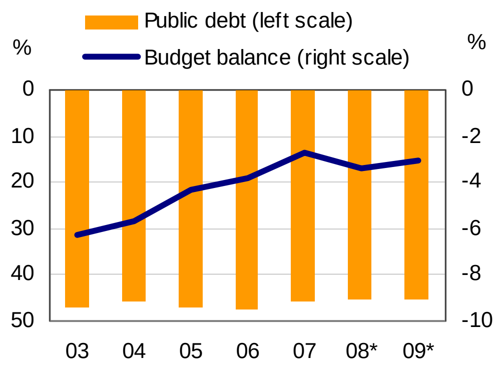
Consumer prices rose to 4.2% in February as food prices continued to grow strongly. Inflation will remain well above the 2.5% target this year: according to our prognosis rapid wage growth and higher food prices will push up consumer price inflation from 2.5% in 2007 to 4.0% in 2008. Lowering inflation is a key macroeconomic challenge in 2008. Doing so would not only prevent second-round effects stemming from higher inflationary expectations, but it would also help avoid the risks related to speculative capital inflows which are based on expectations of a prolonged monetary tightening. Such capital inflows have been experienced in the last years and have put upward pressure on the zloty.

Standard & Poor's improved Poland's long term foreign-currency credit rating from BBB+ to A- with a stable outlook. S&P noted that the political situation will be the key to further rating changes. The improved rating is an acknowledgment of the economy's fundamental strength, and especially the trend of the strengthening Polish zloty.

Polish financial markets have remained largely unaffected by global market turbulences, even though the volume of foreign borrowing is increasingly significant. A possible slowdown of the European and global economy will not carry the same consequences for Poland as for other countries in the region since the Polish economy is less open and its growth is more reliant on domestic demand.

Recent data, including industrial output, retail sales and wages, raise concerns that inflation may well accelerate further. The current policy tightening cycle began in February 2007. Since then rates have been raised seven times; the last time in March 2008 when the key market intervention rate reached 5.75%. Most analysts expect the monetary tightening cycle to continue with at least one more rise this year. Changes in the policy could take place at the end of the year, and we expect the interest rate to gradually decline in 2009.

Key fiscal indicators (% of GDP)



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

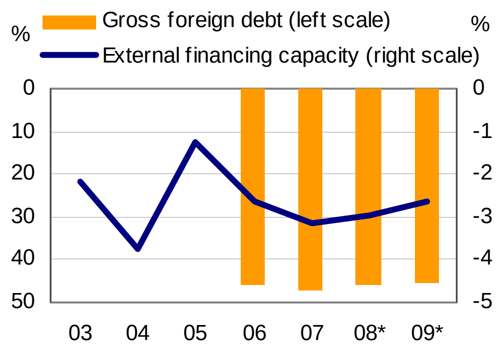
Fiscal policy

The new government is currently formulating more detailed plans to achieve its fiscal objectives. The main goal is reducing the tax burden in the medium term. A necessary precondition is the reduction of the budget deficit. This implies expenditure cuts, especially in social benefits. These unpopular moves will be an important challenge for the new government.

According to the Polish Convergence Programme the structural deficit will decrease to 1% of GDP by 2011. The Minister of Finance highlighted six pillars of fiscal policy for the coming years: reducing public debt, upholding previous decisions to cut payroll taxes, rising development expenditure, accelerating privatisation, economic liberalisation and preparing the Polish economy for euro adoption.

Poland's 2008 budget, prepared by the previous conservative government, anticipated privatisation income of PLN 2.3 bn (EUR 0.6 bn), but officials said that revenues could even surpass PLN 5-5.5 bn. Nonetheless, a privatisation revenue target of PLN 5 bn will be difficult to be met in 2008 because of weaker market conditions. Overall, the budget deficit this year might reach PLN 22 bn, almost 20% below the planned level, mainly due to higher than expected revenues. However, measures on the expenditure side are needed for significant deficit cut in 2009.

External balance indicators (% of GDP)



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

External balance

The increase in net exports contribution to GDP growth was accompanied by rising trade activity with the euro area. A slight acceleration of exports was driven by high demand in the euro area and in particular in the new EU members. The continued appreciation of the euro was an important factor behind the acceleration of consumer goods imports at the end of 2007.

In the end of 2007 a rising income deficit and the narrowing of the positive balance of transfers accompanied the growing negative balance on the trade of goods relative to 2006. As a result, the external financing requirement rose by a half percentage point, to 3.1% of GDP. Poland's trade deficit is not likely to deteriorate significantly in the coming quarters. The external financing requirement will remain stable in 2008 before declining slightly in 2009.

Strong FDI inflows and a further increase in the absorption of structural funds are expected to continue in 2008-09.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (PLN billion)	1,060.2	1,162.9	1,258.9	1,355.0
Real GDP growth (%)	6.2	6.5	5.1	4.5
Private consumption (%)	4.8	5.2	4.8	3.5
Public consumption (%)	5.8	0.7	1.2	1.0
Investments (GFCF, %)	15.6	20.4	15.0	10.0
Exports (%)	14.6	9.1	7.5	6.5
Imports (%)	17.4	10.8	8.5	7.0
Unemployment (%)	13.9	10.1	8.2	8.0
Real ULC growth (%)	4.1	3.0	3.5	3.5
Annual average inflation (%)	1.3	2.6	4.0	5.4
Money market rate (3-month, %, end-year)	4.20	5.67	6.40	5.75
Long-term yields (10-year, %, end-year)	5.14	5.86	6.00	5.90
Exchange rate / EUR (average)	3.90	3.78	3.60	3.60
Exchange rate / EUR (end of period)	3.83	3.59	3.60	3.60
Budget balance / GDP (%)	-3.8	-2.6	-3.4	-3.1
Public debt / GDP (%)	47.6	45.2	45.5	45.5
Trade balance (goods and services) / GDP (%)	-1.4	-1.6	-1.9	-1.7
Current account balance / GDP (%)	-3.2	-3.6	-3.5	-3.1
External financing capacity / GDP (%)	-2.6	-3.1	-3.0	-2.6
Gross foreign debt / GDP (%)	46.0	47.0	46.0	45.5

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

Sources: Central Statistical Office of Poland, Eurostat, Narodowy Bank Polski, OECD

Romania

Economic growth remained fast despite the weak performance of agriculture. Inflation accelerated further at the beginning of 2008 due to a combination of supply and demand shocks. Budget balance is expected to worsen this year since elections will be held in the second half of the year. Rising external imbalances are increasingly a source of risk.

Political developments

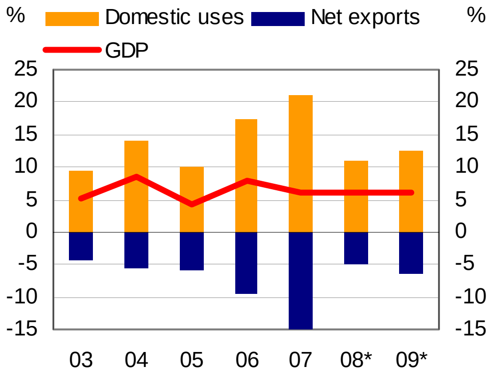
Slightly more than four years after Romania joined NATO, the 20th NATO Summit was organised in Bucharest in April 2008, where Croatia and Albania were invited to the organisation, while the invitation of the Former Yugoslav Republic of Macedonia was postponed due to the name dispute with Greece. This event was a perfect opportunity to improve Romania's external relations, especially with Russia.

Regarding domestic politics, local and general elections will be held in 2008 which determine the political situation. The date of local elections has already been set: the two ballots will be held on 1 June and 15 June. General elections will be held later this year, most likely in November or December.

Growth

Economic growth accelerated in the last quarter of 2007. GDP growth reached 6.6% in the last three months and the quarterly growth rate for that period was the highest in 2007. Annual GDP growth was higher than expected at 6%.

Structure of growth



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

On the production side, the picture remained the same as in the previous quarters of the year. Agriculture contributed negatively to economic growth since gross value added in agriculture decreased by 16.5% in the fourth quarter. The poor performance of the agriculture sector was the result of the unfavourable summer weather conditions in Romania. Construction continued to roam in the last quarter: gross value added in the sector grew by 33.6% in 2007 as a whole. Both residential and non-residential constructions increased rapidly. Services also performed well; their growth rate accelerated to 12.2%. However, the performance of industry was moderate in the last three months: the sector's gross value added growth rate dropped to 3.5% in the last quarter of 2007, while industrial output growth decreased to 2.6% in last December. However, it is the consequence of a decline in traditional manufacturing branches (textiles, leather, etc.). On the other hand, more sophisticated sectors (e.g. manufacture of machinery or transport equipment) grew considerably faster. Therefore the industrial structure of Romania has continued to shift in 2007 as well.

On the demand side, the main engines of growth remained the same over 2007. In the last quarter private consumption increased by 10.1% compared to the same period of the previous year. Annual average growth rate of consumption amounted to 11% which shows only a slight decrease compared to 2006. The other main factor of growth remained investments. Gross fixed capital formation increased by a robust 28.9% in the course of 2007. Accordingly, the investment-to-

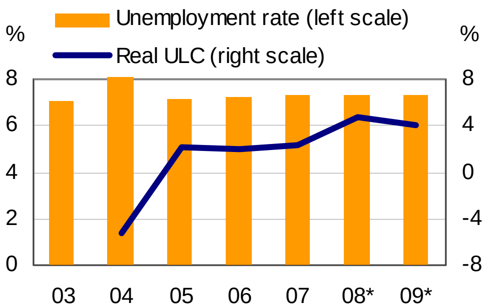
GDP ratio increased above 30% of GDP in 2007 from 23-25% in the preceding two years.

Export growth accelerated significantly in the last quarter of 2007: they grew by 14.9% year-on-year in the last three months while their annual growth rate in 2007 was 8.7%. On the other hand, imports rose by 26.1% last year due to strong domestic demand, therefore net exports continued to have a negative contribution to economic growth.

In 2008 we expect that GDP growth will not change significantly, although a small shift is expected in its composition. Private consumption will decelerate to under 10%, while net exports should play a smaller negative role in growth. We expect that GDP growth will reach 6.2% in 2008 and it will remain on the same level in 2009 as well.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

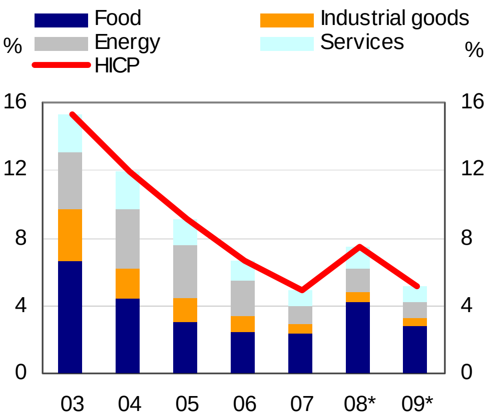
Unemployment decreased to 6.1% according to LFS statistics in the fourth quarter of 2007, while the registered unemployment rate decreased to 4.1%. However, the employment rate is still relatively low (57.8%) in comparison to old EU member states.

Wages continued to increase significantly in recent months. In January 2008 monthly gross average wages increased to RON 1637 (about EUR 453 at current exchange rates) from RON 1232 in the same month of the previous year. As of the beginning of 2008 the minimum wage was increased by 28% to RON 500. It can be increased further to RON 540 if the macroeconomic targets of the government will be achieved until mid-2008.

In 2008 we expect further growth of wages due to the loosening fiscal and income policy, influenced by upcoming elections. The unemployment rate will remain at its relatively low level in 2008 and 2009 as well.

Prices and monetary developments

Structure of inflation



*Note: * forecast. Source: Eurostat*

During the first three months of 2008 inflation continued to rise and 12-month HICP inflation reached 8% in February. Inflation has not been this high in the last 24 months. It clearly indicates that disinflation process reversed in the second half of 2007. Inflation rose from its mid-2007 low of 4% due to several factors. First, food and energy prices increased significantly in line with global trends. Second, the national currency depreciated considerably in the second half of 2007 due to the deteriorating external balance. Third, demand was higher than expected and households' incomes grew significantly, raising inflationary pressures. Fourth, inflation expectations rose as well.

In line with increasing inflation the central bank raised its policy rate vigorously. It was increased from 7.5% in December 2007 to 9.5% by March 2008 in 3 steps. The policy rate has not been this high since mid-2005.

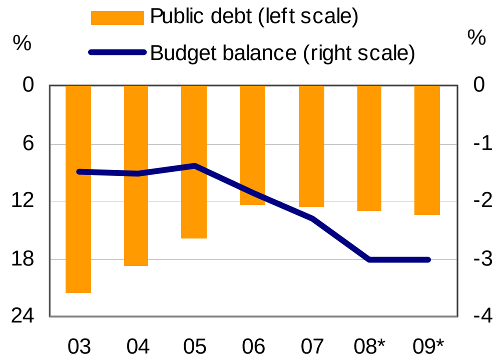
The leu depreciated significantly against the euro in recent months, from 3.35 in January 2007 to 3.7 in early 2008. The depreciation is linked to widening external imbalances of the economy. Policy rate increases have had only marginal influence on the evolution of the exchange rate.

The central bank targeted 3.8% inflation for December 2008.

However, this target will not be achieved. We expect inflation to fall to 6% by the end of this year while annual average inflation will reach 7.5%. Disinflation is expected to strengthen in the second half of the year and can continue in 2009, when price increases could reach 5.2%.

Fiscal policy

Key fiscal indicators (% of GDP)



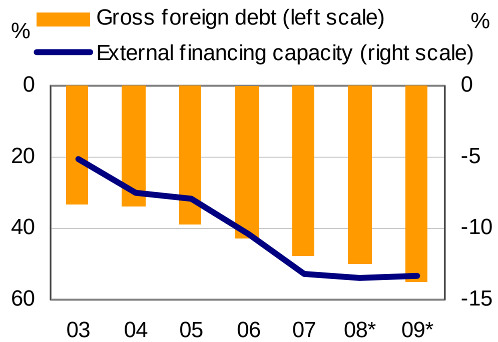
*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

In the last month of 2007 the consolidated government deficit increased further to 2.3% of GDP in accordance with our expectations. The budget deficit increased from RON 4.4 bn to RON 9.4 bn in December 2007. For 2008 the government planned a budget deficit of 2.7% of GDP. However, the forecast was revised at the beginning of March to 2.3%. Planned spending was reduced by about RON 4 bn, mostly affecting current expenditures. The fiscal tightening was necessary to lower inflationary pressures on the economy and to meet the criteria of the Stability and Growth Pact. Earlier the Commission warned Romania that the budget deficit could exceed 3% in 2008 and 2009 without cuts in public spending. Recent government measures are a clear signal to calm EU concerns and should prevent the Commission from launching an excessive deficit procedure against Romania. However, the spending cut has no significant impact on wages in public sector therefore inflationary pressures connected to labour cost developments may persist.

We expect the 2008 budget deficit to increase compared to 2007. Our forecast is that the deficit will be close to the 3% limit in 2008, despite the recent public spending cut. This year local and general elections will be held which are expected to have a negative impact on the evolution of budget balance. For 2009 we expect that the deficit will remain on this year's level.

External balance

External balance indicators (% of GDP)



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

The external financing requirement deficit reached 13.2% of GDP in 2007, 2.7 percentage points more than a year earlier. The current account deficit increased to a worrying level, which implies risks for the future. Some consequences of growing external imbalances have already occurred in the last months (depreciation of the currency).

The deterioration of current account balance was basically due to the widening trade deficit. The growth rate of import of goods greatly outpaced that of exports. While goods imports increased by 24.4%, export rose by only 13.2% in euro terms. Accordingly, the trade deficit increased by 46.7%. The robust growth of imports was fuelled by domestic demand, both by private consumption and by investments.

While the services balance improved slightly and current transfers remained basically unchanged, the incomes balance deteriorated. This was due to increasing profit payments of direct investors.

It is also worrisome that foreign direct investment inflows can finance a decreasing share of current account deficit. While net FDI inflows covered 90% of the 2006 deficit, they accounted for only 42% of the deficit last year since FDI decreased from EUR 9.1 bn in 2006 to EUR 7.1 bn in 2007.

For 2008 we expect external imbalances to widen slightly. The external financing requirement could reach 13.5% of GDP before receding slightly in 2009.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (RON million)	344,536	404,709	472,800	541,200
Real GDP growth (%)	7.9	6.0	6.2	6.0
Private consumption (%)	12.5	11.0	9.0	8.7
Public consumption (%)	-2.4	5.5	5.0	5.0
Investments (GFCF, %)	19.3	28.9	27.0	20.0
Exports (%)	10.6	8.7	17.5	15.0
Imports (%)	22.4	26.1	15.0	15.0
Unemployment (%)	7.3	6.4	6.0	5.8
Real ULC growth (%)	1.9	2.3	4.7	4.0
Annual average inflation (%)	6.6	4.9	7.5	5.2
Money market rate (3-month, %, end-year)	8.19	7.93	9.50	7.00
Long-term yields (10-year, %, end-year)	7.42	6.93	7.00	6.50
Exchange rate / EUR (average)	3.53	3.34	3.70	3.70
Exchange rate / EUR (end of period)	3.38	3.61	3.72	3.70
Budget balance / GDP (%)	-1.9	-2.3	-3.0	-3.0
Public debt / GDP (%)	12.4	12.7	13.0	13.5
Trade balance (goods and services) / GDP (%)	-12.1	-14.2	-14.6	-14.4
Current account balance / GDP (%)	-10.4	-13.8	-14.1	-13.9
External financing capacity / GDP (%)	-10.5	-13.2	-13.5	-13.3
Gross foreign debt / GDP (%)	42.6	47.5	50.0	55.0

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

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

Slovakia

Growth reached a record high in 2007. The contribution of net exports is dominating, though private consumption and investments still play an important role. Intense economic activity attracted more people on the labour market, resulting in a further fall in unemployment rate. Inflation is slightly higher than expected, mainly due to a higher than forecasted growth in food and energy prices and increases in certain regulated prices and taxes. The budget deficit is expected to fulfil the Maastricht criterion comfortably this year as well.

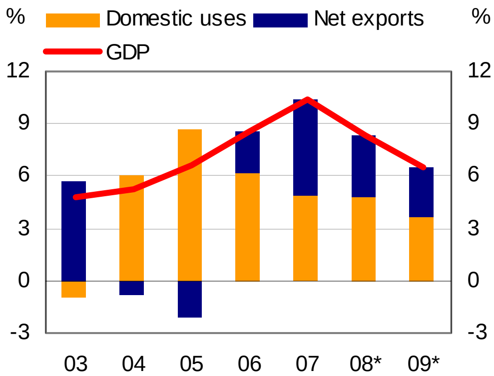
Political developments

The Fico government's popularity is boosted by favourable statistical data on growth, wages, and employment, as well as the planned euro adoption in 2009. This seems to become reality as Slovakia fulfilled all Maastricht criteria last year. Moreover, the euro area now appears to embrace the idea of further enlargement. However, opposition parties in Slovakia still advocate a more cautious approach towards euro adoption entry, considering a postponement due to related macroeconomic risks.

Growth

Slovakia can boast the highest rate of economic growth in 2007 in the EU, with 10.4%. Contrary to expectations, GDP growth accelerated even further in the fourth quarter of 2007. After the third quarter's year-on-year rate of 9.4%, the fourth quarter brought 11.5% growth. For 2008 and 2009 we expect growth to cool somewhat, although it will remain very robust at around 7% in both years.

Structure of growth



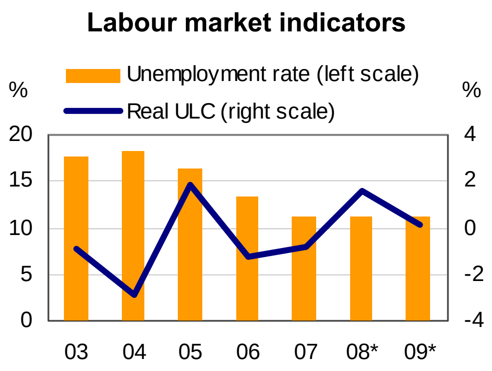
*Note: * forecast. Source: Eurostat*

The main contributing factor to GDP growth was net exports, followed by private consumption and investments. Higher than expected increases in net exports explain the record 2007 performance. In 2008 and 2009 the contribution of net exports will decrease due to weakening foreign demand. Private consumption and investments will also decelerate slightly, while public demand is expected to contribute to a very limited extent due to plans for fiscal tightening over the coming years.

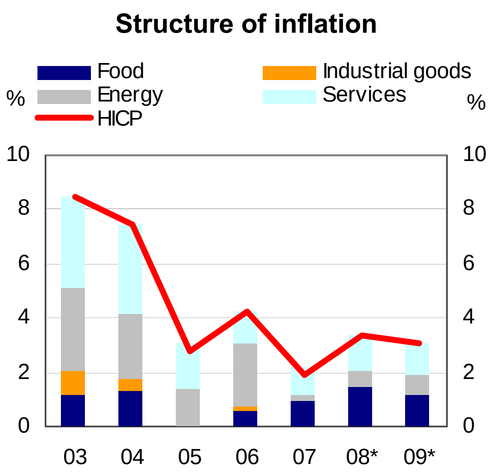
In 2007 as a whole, industry, trade, repairs, catering transport and public and community services (public administration, education and health) contributed the most to GDP growth. Value added in industry grew by almost 20% on a year-on-year basis, which can be attributed to the activities of large companies with foreign participation in the automotive and electronics sectors. These developments are expected to continue this year and in 2009, albeit at a slower pace, especially in industry, where high base values imply lower growth rates for the following years.

Labour market

Employment increased further during last year (by 2.1%). In terms of the sectoral distribution of employment, sale and maintenance of vehicles retail recorded the highest increase in 2007 (20.5%), followed by retail sale (6.8%), construction (6%) and hotels and restaurant (5.6%). They are all related to the high growth in private consumption. In manufacturing, employment increased by 3.4%. The number of



Note: * forecast. Source: Eurostat



Note: * forecast. Source: Eurostat

unemployed decreased further. According to the Labour Force Sample Survey, their number fell from 353.4 thousand at the end of 2006 to 291.9 thousand by the end of 2007. The unemployment rate stood at 10.3% at the end of the fourth quarter of 2007. Productivity grew the fastest in industry and in public and community services. A slight deceleration of productivity growth is expected for the coming years, with industry invariably taking the lead in that respect.

Real wages grew by 4.3% in 2007. The highest wage increases characterised certain services sectors. Growth in manufacturing real wages corresponded to the overall growth rate in real wages. Average monthly wage stood at SKK 20,146 (EUR 600) at the end of 2007. Unit labour costs decreased in 2007 as a whole, but they are expected to increase slightly in 2008 and 2009, due to the relatively strong growth in wages.

Prices and monetary developments

Slovakia fulfilled the Maastricht inflation criterion in 2007. Although accelerating price increases are expected in 2008 due to parallel developments in the euro area, Slovakia is expected to fulfil this criterion in 2008 as well. Data of the first two months of 2008 back this statement. 12-month HICP inflation stood at 3.4% in February, compared with the 1.9% for 2007. According to the evaluation of the Slovak National Bank, mainly cost factors were responsible for this acceleration. Demand factors were basically absent in Slovakia: there was no accelerating tendency in the growth of private consumption during 2007.

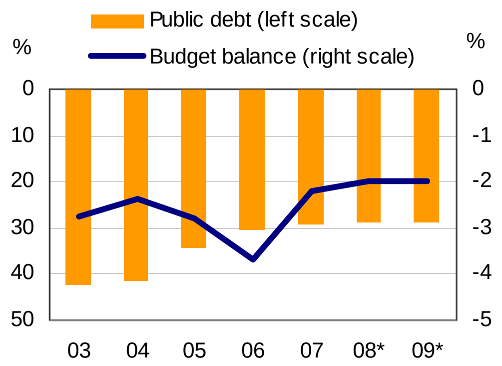
Energy and food prices are responsible for the slightly higher than forecasted price increases while the increase in the level of services prices remained below the expected pace. Moreover, increases in regulated prices (electricity, gas, heating, public transport, waste transport) and in certain taxes (e.g. tobacco) also affected price developments in the first quarter of 2008. These tendencies are expected to result in a somewhat higher inflation in 2008 (3.4%), which is expected to subside somehow in 2009.

In its end-March meeting, the Bank Board decided not to change the two-week repo rate, noting that inflation data for the first two months of 2008 were only slightly higher than expected and risks for further deviations from the bank's forecast are evaluated as minimal. At present the rate stands at 4.25%. The relative yields on Slovak bonds vis-à-vis euro area securities were influenced by developments on the foreign exchange market and by movements in yields in the euro area. Spreads widened between Slovak and European benchmark yields. The Koruna appreciated slightly vis-à-vis the euro in 2007 as a whole, and similar developments are expected for this year, although there is an overall slowdown in the pace of appreciation.

Fiscal policy

Final 2007 budget data indicate a much lower (2.2%) than planned (2.9%) deficit, and the comfortable fulfilment of the relevant Maastricht criterion, which was required for the planned 2009 entry to the euro area. The main reason behind the good budget performance was higher than expected GDP growth. Revenues were almost 4% higher than planned. On the expenditure side, almost 1% was 'saved' compared to original plans, mainly due to lower current expenditures.

Key fiscal indicators (% of GDP)



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

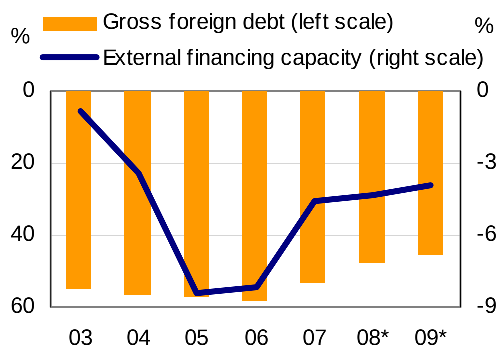
However, a part of these savings was spent on capital expenditures, which surpassed the originally set limits by almost one-third.

Data for the first two months of 2008 indicate a budget surplus. This marks a change from 2007 when February data showed a budget deficit. Though the data are very preliminary, these developments may indicate that the government will be able to fulfil its ambitious deficit reducing plan for this year, according to which the deficit must not exceed 2% of GDP. There are no significant changes or reform steps planned for 2008. As for 2009, the OECD warns that Slovak fiscal policy should continue to remain tight to counteract the danger of a boom-bust cycle after the likely euro area accession. The government is heading the right direction; it plans to slash the deficit to below 2% in 2009.

Thanks to the good budgetary performance, government debt is expected to diminish slightly in the coming years. The debt level compared to GDP stood at 29.4% at the end of last year, far below the relevant Maastricht criterion of 60%.

External balance

External balance indicators (% of GDP)



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

The current account deficit and the external financing requirement of the economy narrowed in 2007 mainly due to an improvement of the trade balance. On the other hand, the deteriorating income balance (mainly due to the repatriation of investment income) had a negative impact on the current account balance. A lower growth rate of goods exports is expected in the coming years, because since the start of operation by major FDI projects in the automotive sector (and also in the electronics sector), new, similarly large capacities have not been established. FDI inflows decreased from USD 4.2 bn in 2006 to USD 2.9 bn in 2007, and they now take overwhelmingly the form of reinvested earnings and other capital. (New) equity investments decreased considerably compared to the previous year. Nonetheless, the services trade balance is expected to increase its surplus in the coming years due to the offshoring of certain business service activities into Slovakia as well.

While portfolio investments decreased in 2007, there is a renewed inflow of other, especially short-term investments. These are deposits of non-residents on accounts of Slovak banks, probably with the aim of speculation surrounding the final conversion rate of the koruna to the euro. This item compensated for the lower FDI and portfolio investments compared to the previous year.

Key macroeconomic indicators, 2006-2009

	2006	2007f	2008f	2009f
Nominal GDP (SKK billion)	1659.6	1827.0	2021.5	2172.3
Real GDP growth (%)	8.5	10.4	8.3	8.3
Private consumption (%)	5.6	7.1	5.8	4.8
Public consumption (%)	10.1	0.7	0.4	0.2
Investments (GFCF, %)	8.4	7.6	6.2	5.0
Exports (%)	21.0	16.0	13.0	12.0
Imports (%)	17.7	10.4	10.0	10.0
Unemployment (%)	13.4	11.2	10.5	10.3
Real ULC growth (%)	-1.2	-0.8	1.6	0.1
Annual average inflation (%)	4.3	1.9	3.4	3.0
Money market rate (3-month, %, end-year)	4.82	4.31	4.12	3.80
Long-term yields (10-year, %, end-year)	4.15	4.61	4.45	3.90
Exchange rate / EUR (average)	37.23	33.78	33.42	33.42
Exchange rate / EUR (end of period)	34.44	33.58	33.42	33.42
Budget balance / GDP (%)	-3.7	-2.2	-2.0	-2.0
Public debt / GDP (%)	30.4	30.1	28.9	28.8
Trade balance (goods and services) / GDP (%)	-4.3	-0.1	0.2	0.5
Current account balance / GDP (%)	-8.2	-5.0	-4.3	-3.9
External financing capacity / GDP (%)	-8.2	-4.6	-4.3	-3.8
Gross foreign debt / GDP (%)	58.5	53.4	47.9	45.3

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

Sources: Eurostat, Slovak National Bank, Slovak Statistical Office

Slovenia

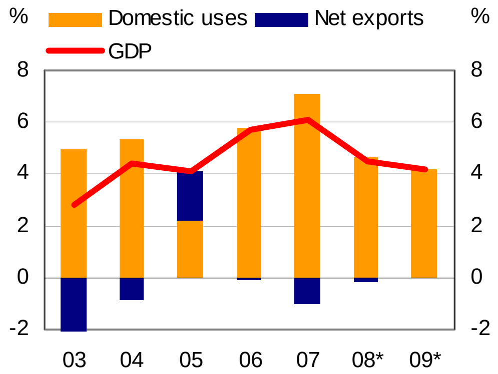
The Slovenian economy is cooling as deceleration in the EU affects the Slovenian performance, especially as the strong euro and higher domestic inflation deteriorates price competitiveness. Taxes on labour are being reduced, which is expected to boost employment and improve FDI attractiveness.

Political developments

Slovenia focuses on EU presidency in the first half of 2008. Thus, the government was responsible for creating a community opinion about the freedom of Kosovo, relations with Serbia and the promotion of the ratification of the EU reform treaty, among other issues.

Growth

Structure of growth



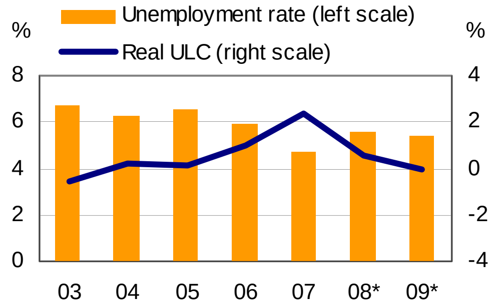
*Note: * forecast. Source: Eurostat*

The Slovenian economy is cooling. Activity in construction and manufacturing has continued to moderate gradually after peaking last year. The growth of construction eased off in last quarter of 2007. In the year as a whole, the value of construction output topped the 2006 level by 18.5% thanks to vigorous construction of infrastructure and favourable weather conditions. Manufacturing shows further moderation in all activities except the chemical industry and the manufacture of transport equipment. Data on business trends suggest further slowdown this year. In January 2008 the seasonally adjusted industrial production increased monthly 0.7% in comparison to last December. The working-day adjusted index grew by just 1.1% in the year to January 2008.

Economic growth will slow to around 4.5% in 2008 and 2009. Capital investments will remain the engine of growth, fuelled by rapid bank lending and infrastructural projects.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

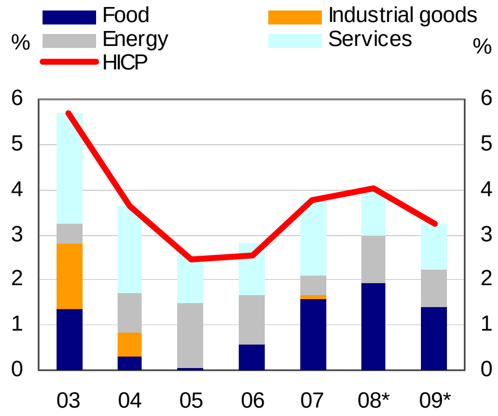
Seasonally adjusted figures indicate continuing rise of employment in January 2008. Slovenia moves well toward the Lisbon employment targets. The activity and the employment ratio continues to increase in 2008-09, although the growth rate of employment will slow down. Unemployment was as low as 4.8% in 2007. It is expected to rise slightly in 2008 but should decline again in 2009.

In 2007, labour productivity grew by 6.1%. Wages have not kept pace with inflation, slowly spreading dissatisfaction through the country. The rise of labour costs will be affected by rising wage claims (due to higher inflation), but will be counterbalanced by the elimination of payroll tax and personal income tax cuts.

Prices and monetary developments

12-month inflation continued to rise, reaching 4.7% in March 2008 (compared to 2.5% in the respective month of last year). The fastest rises were registered among food and non-alcoholic beverages (13.5%), housing, water, electricity, gas (10.4%) and restaurants and hotels (9.4%). Compared to March 2007, goods were on average 7.4% more expensive while service prices went up by 5.7%. When

Components of inflation



*Note: * forecast. Source: Eurostat*

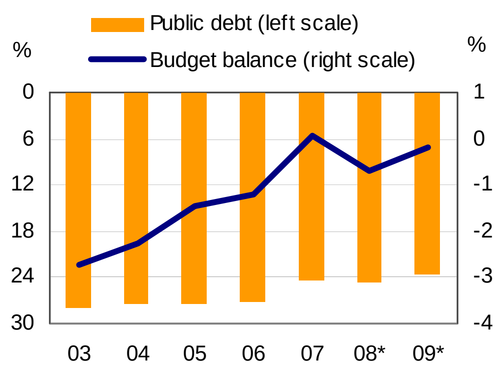
measured with the harmonised index of consumer prices, the average annual inflation rate in the EMU countries was 3.3% in February 2008; in Slovenia it stood at 6.4%. In 2008 and 2009 food and energy determine inflationary developments. Absent new shocks to these commodities' prices, disinflation is expected to below 4%. This will turn real interest rates positive again, which will curb further inflationary pressures.

The price competitiveness of the Slovenian economy as measured by consumer price-based real exchange rate declined somewhat in January. The real effective exchange rate has appreciated by 5.6% in the year to January, a record high in the past ten years.

The moderating risk of higher inflation was expressed in slight lowering of long-term interest rates. The yield on bonds with 10 years remaining maturity was 4.33% in the first quarter of 2008, down from 4.55% last December. Short-term rates also receded from their peak last December.

Fiscal policy

Key fiscal indicators (% of GDP)



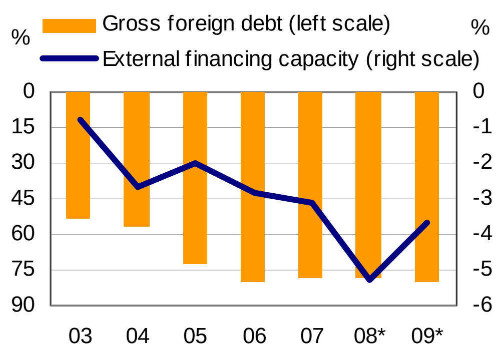
*Note: * forecast, reverse scale on left axis. Source: Eurostat, Statistical Office of Republic of Slovenia*

According to the Statistical Office, the general government deficit amounted to EUR 24 mn (0.1% of GDP) in 2007. At the local government level deficit in 2007 was negligible while the social security funds showed a surplus. The main reason for the substantial decrease of the deficit was the slower dynamics of expenditures (5.3%) in comparison with the increase of revenue (8.3%). The consolidated debt of the general government was estimated at EUR 8,071 mn or 24.1% of GDP at the end of 2007, down from EUR 8,289 million a year before.

The official forecast for 2008 amounts to a deficit of EUR 343 mn or 0.9% of GDP, while public debt will reach EUR 8,505 mn. This outcome broadly realistic since elections will be held in autumn and there is a gradual tax cut under realisation. We forecast a little bit better balance but higher debt due to uncertainties surrounding the privatisation of Telekom Slovenije. The deal seems to be postponed again. Icelandic operator Skipti and British-German consortium Bain Capital & Axos Capital & BT both offered EUR 400 per share, but the advising commission proposed to the government to reject the bids.

External balance

External balance indicators (% of GDP)



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

The current account deficit for 2007 as a whole was EUR 1,426 mn or 4.3% of GDP, significantly up from EUR 803 mn or 2.6% of GDP and a year before. The trade deficit rose by 0.7 percentage points to 1.7% of GDP, while the income and transfer balances both registered rising deficits. Only the account of capital transfers showed a surplus in 2007 thanks to the increase in capital transfers from EU institutions.

The current account deficit in this January was 35% higher than in the same month of 2007. The international financial crisis resulted in higher profit and capital repatriation as investors reallocate their portfolios away from riskier emerging markets. In 2008 we expect the current account deficit to increase to 5.3%. Slovenian trade positions will worsen towards central and eastern European partners because of the relative appreciation of the euro. Thus, the overall trade balance will show an increasing deficit in 2008 and possibly in 2009 as well. On the positive side, the decreasing cost on labour caused by tax cuts may attract more FDI to the country.

Key macroeconomic indicators, 2006-2009

	2006	2007	2008f	2009f
Nominal GDP (EUR million)	30,448	33,542	35,600	37,600
Real GDP growth (%)	5.7	6.1	4.5	4.5
Private consumption (%)	4.0	3.1	3.6	2.9
Public consumption (%)	4.4	1.4	2.5	2.0
Investments (GFCF, %)	8.4	17.2	7.9	7.4
Exports (%)	12.3	13.0	4.1	4.2
Imports (%)	12.2	14.1	4.2	4.0
Unemployment (%)	6.0	4.8	5.6	5.4
Real ULC growth (%)	1.0	2.4	0.5	0.3
Annual average inflation (%)	2.5	3.8	4.0	3.3
Money market rate (3-month, %, end-year)	3.67	4.67	4.50	4.50
Long-term yields (10-year, %, end-year)	3.90	4.55	4.30	4.00
Exchange rate / EUR (average)+	239.60	NA	NA	NA
Exchange rate / EUR (end of period)+	239.60	NA	NA	NA
Budget balance / GDP (%)	-1.2	-0.1	-0.7	-0.2
Public debt / GDP (%)	27.1	24.6	24.6	23.7
Trade balance (goods and services) / GDP (%)	-0.9	-0.2	-2.8	-1.3
Current account balance / GDP (%)	-2.8	-3.1	-5.3	-3.7
External financing capacity / GDP (%)	-3.3	-3.3	-5.6	-3.9
Gross foreign debt / GDP (%)	80.0	78.2	78.0	80.0

Note: f = forecast; + SIT/EUR before January 2007. See methodological notes for definitions and details.

Sources: Eurostat, IMAD

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.
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.
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: Eurostat, national banks.
Money market rate	3-month interbank offer rate at the end of period. Sources: Eurostat, 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: Eurostat, 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.
External financing capacity / GDP	Sum of the current and capital account balances, relative to nominal GDP of the respective period. Eastern EU Members experience significant capital transfers (EU funds) which reduce the need for external financing. Therefore it is more appropriate to examine external financing capacity when assessing the sustainability of external imbalances. 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.