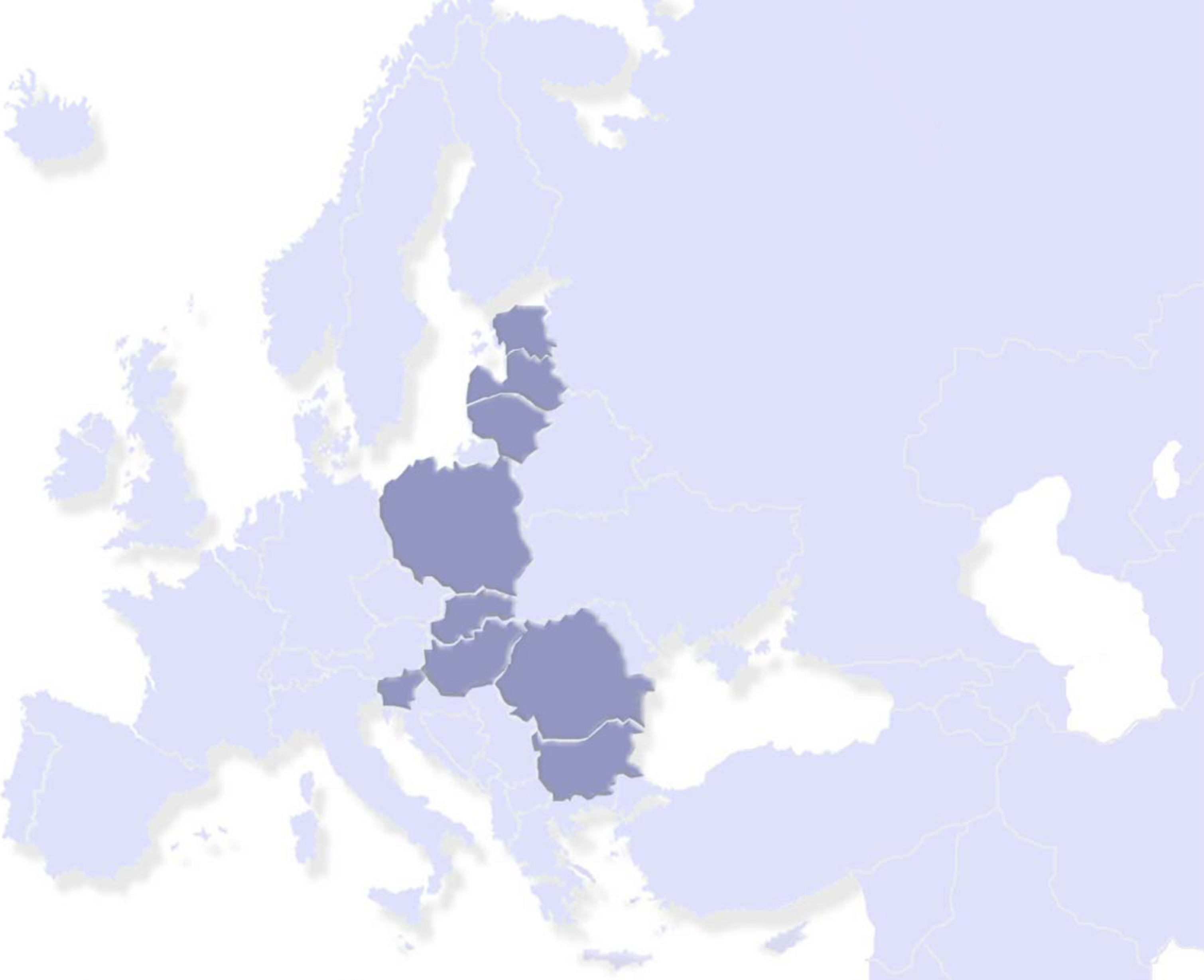
ICEG EUROPEAN CENTER

Quarterly Forecast on the Eastern EU Member States

Winter 2007



Quarterly Forecast on the Eastern EU Member States

Winter 2007

This report was prepared by:

Péter Bilek, Szabolcs Erdős, Gábor Kutasi, András Oszlay, Gábor Pellényi (editor), Magdolna Sass

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Company information

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Contact

ICEG European Center, 6/B Dayka Gábor Street, Budapest, H-1118 Hungary. Phone: (+36) 1 248 1160. Fax: (+36) 1 248 1161. E-mail: office@icegec.hu.

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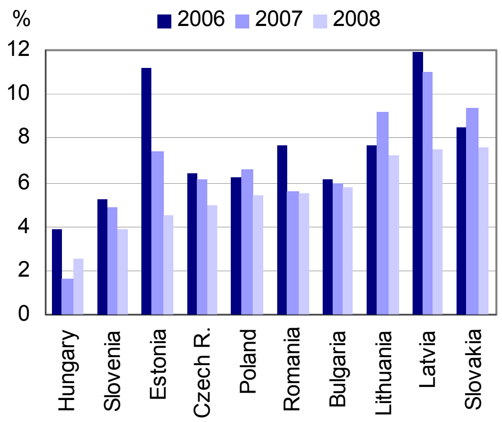
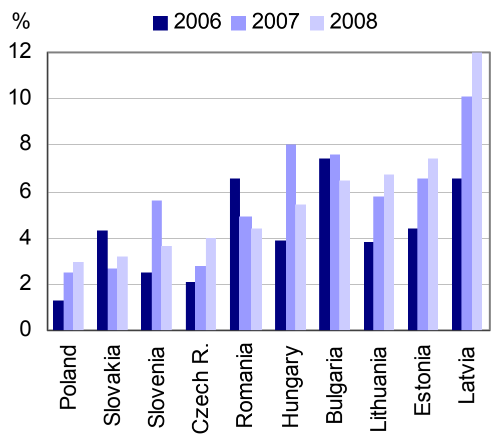


Growth

2007 brought strong economic growth for the eastern EU Member States. The average GDP growth rate of the region was an estimated 6.8%. However, signs of fatigue were emerging in a number of countries. Hungarian growth remained below the euro zone average as the fiscal austerity package set back private consumption and investments; 2008 will bring only minor improvement. A marked slowdown took place in Estonia and is about to start in Latvia and eventually in Lithuania as well. The real estate sector became saturated and investments in buildings started to shrink. Meanwhile, deteriorating growth prospects take their toll on consumer confidence and consumption and will feed into corporate investments. This deceleration is welcome since both countries grapple with rising inflation and massive external imbalances due to overheating. Bulgaria and Romania develop robustly thanks to FDI inflows and rapid credit growth; however poor harvests took their toll on agricultural output and affected GDP growth. Their vigorous growth will continue into 2008, although their macroeconomic imbalances are growing. Slovenia also had its share of extreme weather but the euro zone entry initiated a lending and investment boom that keeps growth fairly strong. The Czech Republic and Poland continue to develop healthily but the pole position in 2008 might belong to Slovakia, where huge FDI inflows boosted investments and then exports.

Inflation in the region



Note: harmonised (HICP) rates

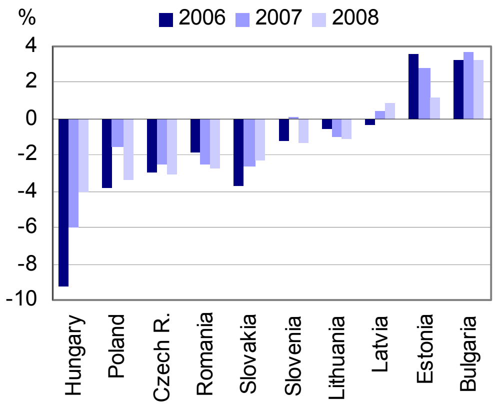
Prices and monetary conditions

It was already obvious during 2007 that inflation would rise compared to 2006. However, adverse external shocks to food and energy prices in the second half of the year accelerated price increases further and prolonged disinflation. In a number of countries 2008 will bring even higher inflation. The situation is the most worrying in Latvia, where price increases broke double digits on the back of simultaneous demand- and supply-side inflationary pressures in 2007. Expectations about pay rises are entrenched at high levels and policy tools to curb further price increases are limited; the situation is similar in Estonia and Lithuania. Inflation will fall considerably in Hungary and Slovenia in 2008: in the former the base effects of regulated price and indirect tax increases fade out; in the latter some one-off increases at the euro changeover affected 2007 developments. Slovakia is still poised to become the next euro zone member from the region, in 2009 according to government plans. For the rest of the region the euro is a distant dream. However, while the common currency would certainly cushion them from the adversities of financial markets, fiscal and structural policies must be well prepared to compensate for the loss of monetary sovereignty. Difficulties in Slovenia show that the region still has some way to go in this respect.

Fears about macroeconomic imbalances and global developments on financial markets drove up yields on the region's markets. Spreads vis-à-vis euro zone instruments were particularly high in the Baltic countries: the sustainability of currency pegs in Estonia and Latvia was scrutinised in 2007. Nevertheless, the fears of devaluation may be overblown as both countries have shallow financial markets, relative little hot capital and ample currency reserves. Currencies with flexible exchange rates continue to appreciate gradually against the euro. This driven partly by price level convergence and partly by the desire of central bankers to combat inflation.

Fiscal policy

Budget balances in the region (% of GDP)

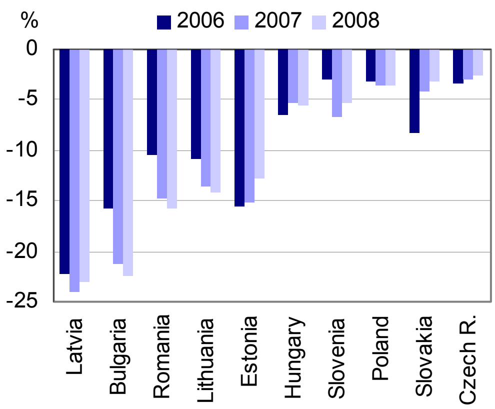


Note: according to ESA methodology

Strong economic growth and surprise inflation resulted in windfall tax revenues therefore fiscal positions in 2007 were generally better than previously expected. The ambitious Hungarian consolidation will remain on track in 2008 as well, although the structure of the adjustment is not ideal: there is too little emphasis on permanent spending cuts and structural reforms. Some countries (e.g. Bulgaria and Slovenia) are experimenting with tax cuts to attract foreign investors and promote entrepreneurship. Others (the Czech Republic, Hungary and Poland) make efforts to improve the performance and sustainability of their health care systems. Still others are busy spending extra revenues to win the favour of the electorate: fiscal policy is expansive in Romania and Estonia. The Baltic countries can easily find themselves between a rock and a hard place in 2008: with too much fiscal restriction they might push growth into greater depths; with too much expansion inflation could run out of control. In 2008 the 3% deficit criterion of the Stability and Growth Pact will be breached in Hungary and possibly in Poland. Despite methodological changes that raised the 2006 deficit of Slovakia, the country is not expected to have difficulties with the deficit criterion to euro zone entry.

External balance

Current account balances in the region (% of GDP)



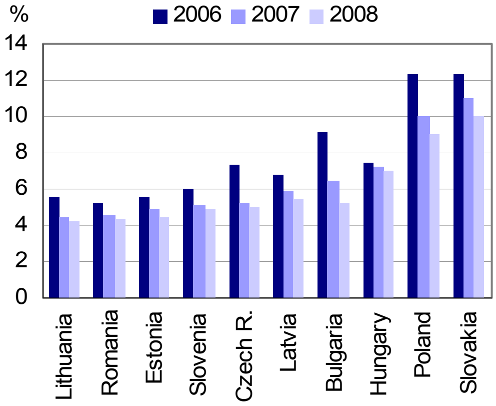
Although inflation did its best to become public enemy no. 1 in 2007, external imbalances remain the most important source of risk in most countries. While strong trade balances and limited income outflows keep current account deficits low in the Visegrad countries[1], the Baltic countries have horribly high trade deficits as their domestic demand exploded in recent years. Slovenia, normally a country with moderate current account deficits, saw its external financing requirement grow on back of the lending bonanza initiated by cheap euro funds. Following their admission to the EU, Bulgaria and Romania are undergoing similar processes as the Baltic trio therefore they should heed their example. Strict fiscal discipline is necessary to counter demand growth in the private sector and prevent overheating. An important difference between the two country groups is that FDI is pouring into Bulgaria and Romania sometimes financing the entire current account deficit, while the Baltic countries draw upon lending from the foreign parent companies of local banks to finance the domestic saving-income gap.

Labour market

Thanks to strong economic growth unemployment was retreating while activity and employment rates were rising throughout the region. Many countries now experience historic lows in their unemployment rates. However, labour shortages are emerging. Reserves of skilled

[1] The Czech Republic, Hungary, Poland and Slovakia

Unemployment rates in the region



Note: harmonised LFS rates

workers are depleting, driving up wages. Meanwhile, slow progress in education and labour market reforms stymies job creation in a number of countries. Arguably the quality of human capital will be a key determinant of medium- and long-term growth prospects in the region.[2]

Rapid economic convergence and labour market bottlenecks are the main driving forces of wage growth: most countries are gradually closing the income gap with western Europe. Public sector pay rises are sometimes reinforcing this process, which can contribute to the build-up of inflationary pressures, deteriorating cost competitiveness and widening external imbalances. Although public expectations are high, a premature convergence of wages can prove costly in the medium term.

[2] The special topic of this issue deals with the evaluation of the eastern EU Member States in the 2005-07 cycle of the Lisbon strategy of the EU; the country-specific observations and recommendations are generally focused on issues related to employment.

Bulgaria

External imbalances remained the key macroeconomic problem in 2007, but inflation also jumped above 10% again. The general government balance reached a massive surplus, while the labour market is becoming tighter. Robust growth will persist in 2008 but the imbalances warrant caution.

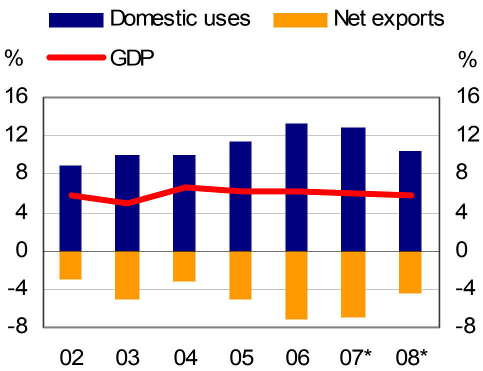
Political developments

Right-wing Citizens for the European Development of Bulgaria (GERB), a new party led by Sofia's mayor Boiko Borisov performed well in local elections. The representatives of the party gained control over the country's two largest cities, Sofia and Plovdiv. The party received more votes than the governing Socialist Party. Mr. Borisov labelled his party Bulgaria's main opposition force, even though it is not in the National Assembly. However, Mr. Borisov seeks higher position as he prepares for 2008 parliamentary elections will be held.

The turnout of the election was as low as 40%, just as in the case of previous EP elections. This indicates growing disillusionment with the style of domestic politics.

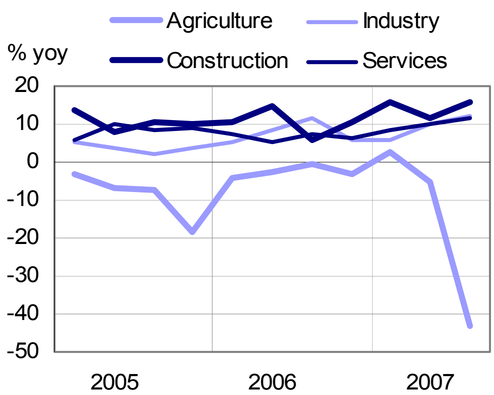
Growth

Structure of growth



*Note: * forecast. Source: NSI*

Value added growth by sector



Source: NSI

Economic growth in the third quarter of 2007 was significantly lower than in the previous two quarters: it decelerated from 6.2% and 6.6% to 4.5%. Accordingly, average economic growth in the first nine months fell below 6%.

On the production side, agriculture was the main reason for the deceleration. In the third quarter the gross value added of agriculture decreased enormously, by 43% due to severe droughts in the summer. On the other hand, other sectors performed outstandingly in the third quarter. Gross value added in industry increased by 12.8%, while services also grew by 11.1%. Industrial production growth averaged around 9% in 2007. The highest growth was achieved in the manufacture of radio, television and communication equipment (57%), manufacture of office machinery and computers (38%) and manufacture of other transport equipment (29%). This reflects the technological upgrading of the Bulgarian economy thanks to foreign direct investments.

On the demand side, the structure of growth continued to change. The annual growth rate of private consumption decelerated further to 5% in the third quarter of 2007 from 8.1% in the first quarter. Investments also decelerated, therefore gross fixed capital formation growth was 19.7% in the third quarter. The investment ratio fell to 26% from almost 30% at the beginning of the year.

A positive shift was observable in the contribution of foreign trade. The growth rate of imports was still higher than that of exports, but the gap between the two rates narrowed as exports accelerated to 6.2%, while imports slowed to below 10% in the third quarter.

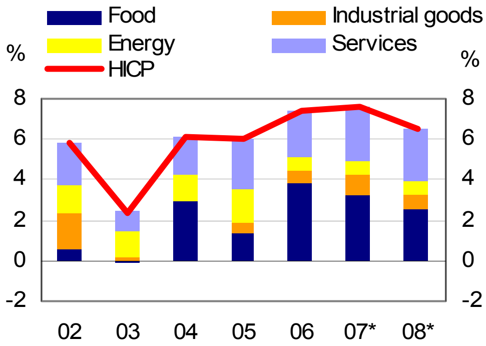
We estimate that growth could have reached 6% in 2007. In 2008 we expect current tendencies to continue; GDP growth could reach 5.8%. The role of domestic factors in economic growth will shrink slightly but remain dominant, while net exports will to have a smaller drag on economic growth.

Prices and monetary conditions

Rising food prices hit Bulgaria hard and inflation jumped to double digits. While the 12-month harmonised index of consumer prices (HICP) was 4.4% between March and May 2007, it shot up to 11.6% in December. Accordingly, annual average inflation climbed to 7.6% in 2007. December figures indicate that the prices of foods were 21.1% higher than 12 months earlier. Besides, hotel and restaurant (18%) and transport prices (14%) increased particularly fast in 2007.

Wages increased significantly throughout the year, putting inflationary pressure on the economy. The nominal increase of gross average monthly wages reached 20% in the third quarter of 2007. This is a significant acceleration from the 7-12% in the preceding three years.

Components of inflation



Source: Eurostat

Credit expansion accelerated in course of 2007. Claims on households and non-profit institutions increased by more than 50% in the year to November 2007, while the growth rate was still close to 30% at the beginning of the year. Accordingly, the stock of household credit increased from 18% to 25% of GDP between January and November 2007.

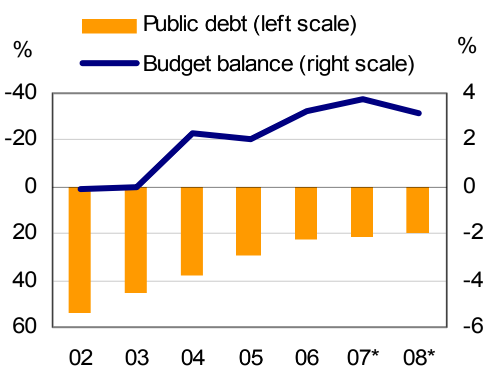
Bulgaria still plans to introduce euro in 2010-11 and preparations for ERM-II entry are ongoing. It seems that inflation will be the hardest criterion to fulfil: it is not expected to decline under the Maastricht criteria before 2010. Accordingly, the introduction of the euro may be realised only after 2012.

Inflation is expected to remain high during the first half of 2008 and it can recede in the second half due to base effects. Considering the pressures from wage increases, we expect that inflation will recede only slightly in 2008: its annual average rate will reach 6.5%.

Fiscal policy

Between January and November 2007 the general government balance had a huge surplus: BGN 4 bn or 7.1% of estimated GDP. The surplus increased gradually in the course of the year and was due to several factors: higher than planned inflation and robust economic growth and sound domestic demand boosted tax revenues even though the profit tax rate was cut by 5 percentage points at the beginning of 2007. Furthermore, expenditures remained in line with plans while revenues were under-planned.

Key fiscal indicators (% of GDP)



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

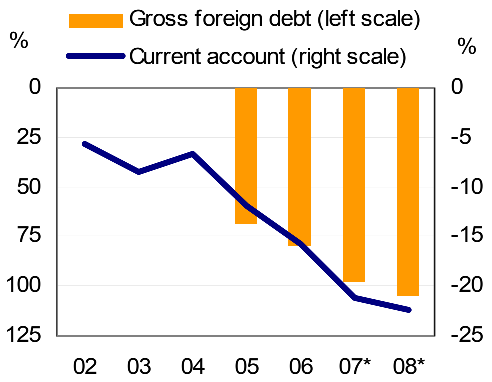
In December the surplus of the budget decreased but it remained massive. According to our estimations, the general government budget had a surplus of 3.7% in 2007.

For 2008 the government plans a 3% surplus. As it was reported in our previous forecast, one of the most important changes in 2008 is that personal income tax rate is slashed to a flat 10%, equal to profit tax rate. The government expects this measure to help reduce the grey economy just as the profit tax cut did last year. We do not expect this step to have a major overall effect on 2008 budget revenues, but it can help maintain robust economic growth. In 2008 we expect the budget to remain in surplus, close to last year's magnitude, at 3.2% of GDP.

External balance

Without doubt, external imbalances remained the main weakness of the Bulgarian economy in 2007. During the first ten months the current account deficit reached 17% of GDP (EUR 4.6 bn). The deterioration of the current account balance was basically due to the widening foreign trade deficit: Between January and October it was 21.6% of GDP. The annual growth rate of imports (18.4%) exceeded that of exports (10.5%) for this period. Compared to the three preceding years both export and import growth decelerated in 2007. Imports are definitely boosted by high domestic demand, which fuelled by foreign investments, increasing wages and credit expansion of households.

External balance indicators (% of GDP)



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

Regarding the other components of the current account, the services balance improved slightly while both the current transfers and income balances deteriorated somewhat. However, the impact of these changes was less significant than that of the trade balance.

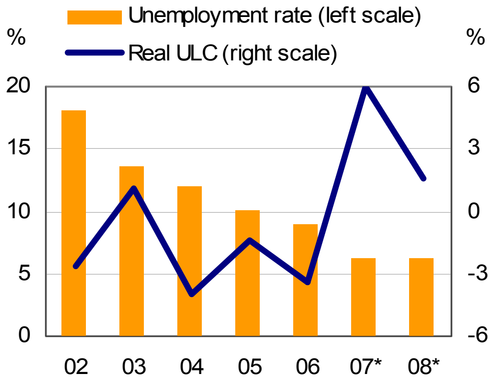
The growth of foreign direct investments was able to keep up with the current account deficit. In the first ten months of 2007 FDI financed fully the current account deficit: net inflows of direct investment reached EUR 4.7 bn (17.5% of GDP).

We reckon that the current account deficit continued to widen in the last two months of 2007, and that it reached 21.3% of GDP as the foreign trade deficit exceeded 22%. In 2008 we expect that the current account deficit will remain at last year's level. Since the adoption of the euro is still only a plan, the common currency cannot diminish the risk of a current account crisis in the near future. Prudent macroeconomic policies are therefore indispensable.

Labour market

Due to robust economic growth and the development of industry and services, the employment rate improved drastically in 2007. In the first nine months employment increased by almost 3%, while the unemployment rate fell from close to 10% in January to 6.8% in September.

Labour market indicators



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

Emerging labour shortages are beginning to cause problems. Average gross wages increased by 20% in 2007; such rapid wage growth can be explained by the limited access to skilled workers. Nevertheless, the gross average monthly wage level remains the lowest in the EU at BGN 434 (EUR 220).

In 2008 we expect that labour shortages will become more acute in many sectors since employment is expected to grow further. Accordingly, unemployment will fall while wage increases will remain dynamic. Real unit labour costs took a sharp hike in 2007 and are expected to grow further (albeit at a more moderate pace) in 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (BGN mn)	42,797	49,091	55,700	62,700
Real GDP growth (%)	6.2	6.1	6.0	5.8
Private consumption (%)	6.1	7.5	6.0	5.0
Public consumption (%)	2.6	2.3	-1.5	1.0
Investments (GFCF, %)	23.2	17.6	24.0	20.0
Exports (%)	8.6	8.9	5.0	8.0
Imports (%)	13.1	15.1	11.0	10.0
Annual average inflation (%)	6.0	7.4	7.6*	6.5
Money market rate (3-month, %)	3.59	4.01	6.50*	5.50
Long-term interest rate (10-year gov't bond, %)	3.49	4.18	4.70*	4.60
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 (%)	2.0	3.2	3.7	3.2
Public debt / GDP (%)	29.2	22.8	21.5	20.0
Trade balance / GDP (goods and services, %)	-16.4	-18.3	-22.5	-24.4
Current account balance / GDP (%)	-12.0	-15.7	-21.3	-22.5
Gross foreign debt / GDP (%)	69.0	80.1	98.0	105.0
Unemployment (%)	10.1	9.0	6.3	5.8
Real ULC growth (%)	-1.4	-3.4	6.5	1.6

*Note: f = forecast., except where marked with * . See methodological notes for definitions and details.*

Sources: Bulgarian National Bank, Eurostat, National Statistical Institute

Czech Republic

While quarterly growth rates show some deceleration, GDP growth still remained around 6%. Inflation has been on an upward track, and this trend will be reinforced by tax changes introduced in January 2008. The budget is forecasted to record a significantly better than planned deficit. The deficit of the current account continued to narrow, and there is a gradual improvement in the external financing capacity of the Czech Republic.

Political developments

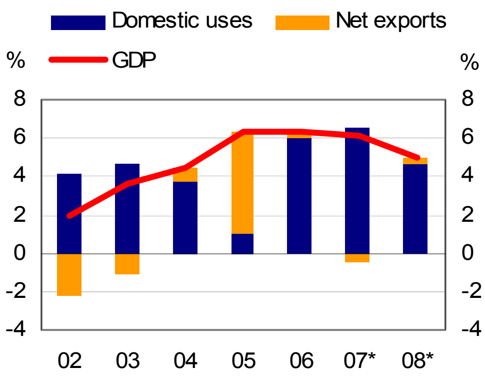
The Topolanek government introduced the first measures of its complex reform package, which affect mainly the tax system, social benefits and health care.

The government revised and rewrote the Convergence Programme inherited from the previous Paroubek cabinet. In the previous version a firm target date specified for introducing the euro (2010), but the latest version does sets no specific date. However, the finance minister maintains that the country will fulfil all the Maastricht criteria (except the ERM-II membership) next year. On the other hand, the governor of the Central Bank suggested 2019 as the date of euro introduction.

Growth

The third quarter of 2007 was the tenth quarter in a row with over 6% economic growth on a year-on-year basis. (Second quarter data were revised upwards from 6% to 6.3%.) Although there are some signs of deceleration, this is still a high rate in the region, in the EU and historically as well.

Structure of growth



**forecast. Source: Eurostat*

As far as the contribution of various growth factors is concerned, the role of private consumption and gross fixed capital formation is dominant, while the contribution of net exports is expected to turn neutral or slightly negative for 2007 as a whole. These developments are backed by the fact that the growth of private consumption accelerated further in the third quarter (5.6% annually up from 3% in the previous quarter), and this had its repercussions on net exports: due to the increase in domestic consumption the growth rate of imports exceeded that of exports. Due to the tax reform, the growth rates of private consumption and imports are expected to diminish slightly in 2008, causing a slowdown of economic growth. Government consumption is expected to contribute slightly positively for 2007 as a whole, and will turn to neutral in 2008.

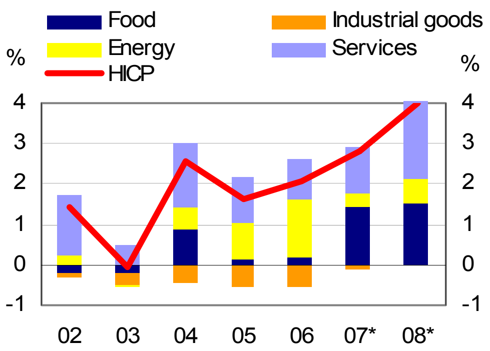
On the supply side – based on the data of the first three quarters – the most important industries contributing to GDP growth for 2007 as a whole were trade, repairs, catering, transport and financial services while the contribution of industry shrank significantly. This is another indication that private consumption is the key driver to growth.

For 2007 as a whole, a GDP growth rate of 6% has been forecasted, which is reinforced by the data of the third quarter. In 2008 a growth rate of around 5% is expected: the restrictive measures of the government are likely to result in lower public and private consumption, while the lower contribution of net exports due to weakening external demand.

Prices and monetary conditions

In November and December 2007 inflation exceeded the level forecasted by the Czech National Bank (CNB). 12-month inflation increased to 5.4% in December 2007. According to the estimation of CNB, the inflation rate of 2007 was 2.8%, higher than forecasted. One reason for the acceleration of price increases was the changes in indirect taxes (excise duties) and regulated prices. External factors also played a part (affecting food and energy prices). However, monetary policy-related ('core') inflation has also been markedly higher than the tolerance band set by the Central Bank: the tight labour market exercises upward pressures on wages.

Components of inflation



*Note: * forecast. Source: Eurostat*

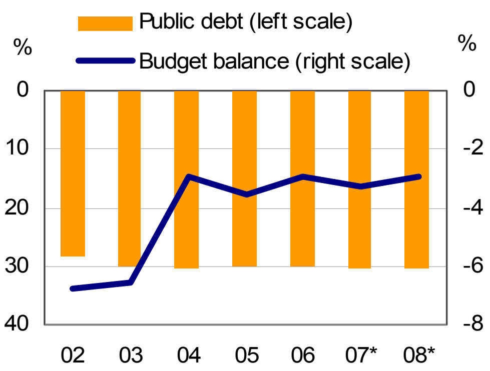
Annual inflation is expected to accelerate significantly in 2008, mainly due to a maintained increase of food prices as well as growth in services prices and tax changes. As a precursor to 2008 inflationary developments, industrial producer price inflation reached its highest level since April 2005 in October 2007.

The two-week repo rate stood at 3.25% at the end of the third quarter. Due to the higher than expected inflation rate and upside risks to expected inflation, there was another 25 basis points increase in the last quarter of 2007.

With some fluctuations, the koruna appreciated strongly in 2007: by 3.5% vis-à-vis the euro and by almost 15% against the dollar. It is expected to continue appreciating during 2008 as well. The appreciation will help to mitigate external inflationary shocks. Short-term yields differentials compared to euro-area indicators have been narrowing since April. Differences in long-term yields widened to some extent in the second half of 2007.

Fiscal policy

Key fiscal indicators (% of GDP)



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

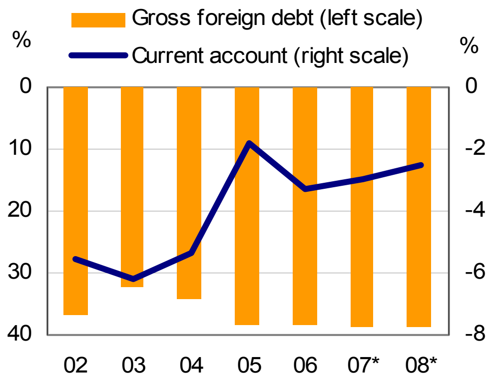
Changes in the tax system are expected to affect the fiscal balance favourably, albeit to a limited extent. The measures imply a shift from direct to indirect taxes, more limited access to social benefits and the introduction of some co-payments by patients into the health care system.

According to a speech of Finance Minister Miroslav Kalousek on 4 January, the budget deficit for 2007 was markedly lower than expected. While the Chamber of Deputies had approved a deficit of CZK 91.9 bn, the actual gap was CZK 66.4 bn, the lowest in the history of the Czech Republic. The main reason for this is the higher than forecasted growth rate of the economy, which resulted in windfall tax revenues and allowed a decrease in welfare spending. According to the finance minister the 2007 deficit was just under 2% GDP. 2008 is expected to bring a better budget performance due to the changes in the tax system and reductions in social expenditures.

External balance

The growth of exports and imports was slowing down during 2007. In the year to November they rose by 11% and 8.2% respectively. Similarly to previous years, machinery and transport equipment were the main contributors to export growth. The goods surplus is expected

External balance indicators (% of GDP)



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

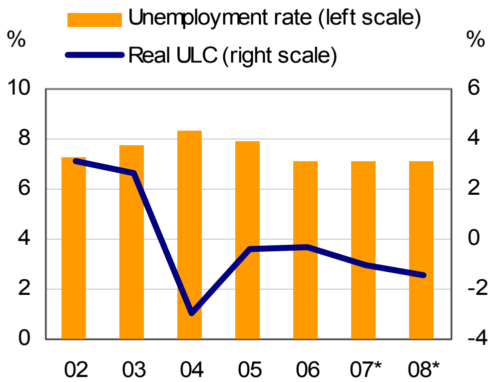
to diminish gradually during the coming years as exports will feel the slowdown of trade partners.

In the first three quarters of 2007 the balance of goods and services trade continued to show a surplus, while the income balance was negative. The increase of income balance deficit is due to various factors on the expenditure side, such as higher income from direct investments (dividends paid abroad and estimated reinvested earnings) and higher wages paid to foreigners working in the Czech Republic as well as rising interest payments on domestic bonds. Current transfers between the Czech Republic and the EU budget showed a deficit of CZK 3.8 bn. The current account deficit is expected to be lower at the end of 2007 than in 2006 and it is expected to decrease further in the coming years.

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.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

Employment continued to rise and registered unemployment kept falling in the third quarter of 2007. The employment rate reached 66.3%, almost one percentage point higher than a year ago and the highest level since 1997.

The unemployment rate (according to the ILO methodology), dropped to 5.2% in the third quarter, almost 2 percentage point lower than a year before and also a record low since 1997. Moreover, there was a significant fall in the number of long-term unemployed. The registered unemployment rate was 6.3%, 1.6 percentage points lower than a year before. There are still large (but slowly diminishing) regional variations in unemployment, which stands at 2.3% in the Prague region but at 9% in the Ústecký region.

Wage growth accelerated in the third quarter of 2007. Gross average monthly wages increased by an annual 7.6%, while real wages grew by 5.0%, supporting private consumption.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (CZK bn)	2,987.7	3,231.6	3,545.3	3,864.0
Real GDP growth (%)	6,4	6,4	6,1	5,0
Private consumption (%)	2,3	5,5	5,6	4,2
Public consumption (%)	2,2	0,0	0,6	0,3
Investments (GFCF, %)	2,3	5,5	6,0	7,0
Exports (%)	11,8	14,4	12,2	10,4
Imports (%)	5,0	13,8	12,6	10,0
Annual average inflation (%)	1.6	2.1	2.8*	4.0
Money market rate (3-month, %)	2,17	2,56	4.11*	4.10
Long-term interest rate (10-year gov't bond, %)	3,61	3,68	4,55	4,65
Exchange rate / EUR (average)	29,78	28,34	28,05*	27,94
Exchange rate / EUR (end of period)	29,00	28,72	27,94*	27,94
Budget balance / GDP (%)	-3,5	-2,9	-2,5	-3,0
Public debt / GDP (%)	30,2	30,1	30,3	30,4
Trade balance / GDP (goods and services, %)	3,0	3,0	4,7	5,0
Current account balance / GDP (%)	-1,8	-3,3	-3,0	-2,5
Gross foreign debt / GDP (%)	38.4	38.5	38.6	38.8
Unemployment (%)	8,0	7,2	7,1	7,1
Real ULC growth (%)	-0,4	-0,3	-1.0	-1.4

*Note: f = forecast except where marked with *. See methodological notes for definitions and details.*

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

Estonia

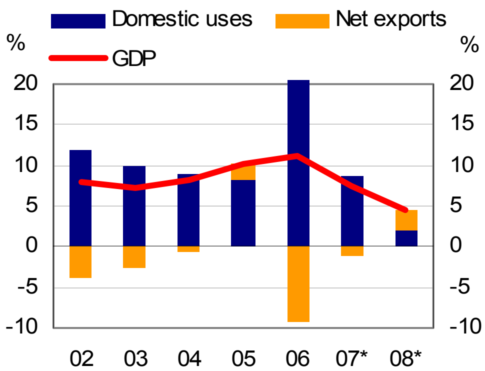
The economy is slowing down and this narrows external imbalances as well. However, macroeconomic instabilities will persist in 2008: inflation is on the rise and the anticyclical fiscal stance can make adjustment more difficult.

Political developments

Relations with Russia remained frosty: Estonia recently prohibited Russian-German gas pipeline venture from conducting geological surveys. This manifested in repeated cyber attacks against Estonian websites and declining inflow of tourists from Russia among others. In response to last April's riots, the Interior Ministry proposed a set of amendments to expand police powers.

Growth

Structure of growth

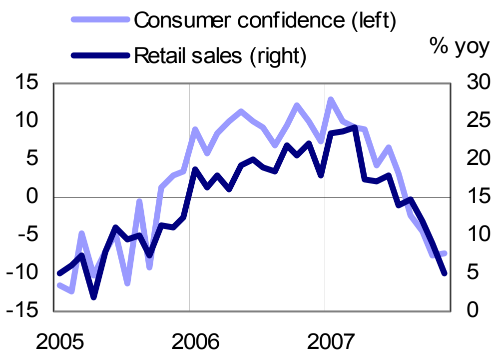


Note: * forecast. Source: Eurostat

The economy continued to slow in the second half of 2007. Private consumption decelerated markedly: although the third quarter still saw an annual growth of 5.2%, the seasonally adjusted quarterly figure was already shrinking then. This is also visible in retail sales, which kept losing momentum and grew by only 5% in value in the year to November. The slowdown of private consumption can be attributed to higher precautionary saving since personal income continued to grow robustly: real wages rose at an estimated 14% in the second quarter. However, rising public sector wages and pensions can lend momentum to private consumption in 20008 as well.

The supplementary budget meant accelerating public spending in the second half of 2007 although its effect on growth remains modest. A slight fiscal expansion in 2008 will partially offset the lower contribution of the private sector to growth. Gross fixed capital formation continued to fall in real terms: it shrank by an annual 5.7% in the third quarter of 2007 due to falling construction activity. Investment in equipment and machinery still look healthy although industrial confidence indicators are falling; this could depress investments at least in the early months of 2008.

Consumer confidence and retail sales



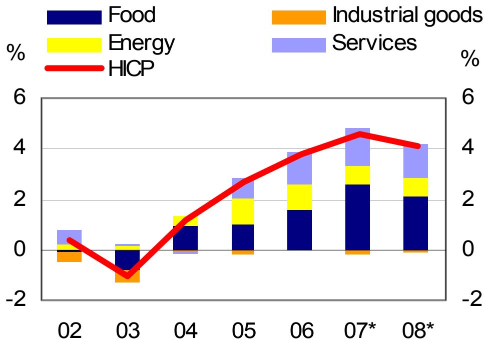
Source: Eesti Konjunktuuriinstituut, Statistics Estonia

The volume of exports barely rose in the first three quarters but slowing domestic demand set back import growth. Therefore the contribution of net exports to GDP growth will be negligible in 2007 after a massive drag in 2006. In 2008 this contribution will turn positive and net exports can account for half of GDP growth. Overall, the economy is expected to grow by around 7.4% in 2007 and will slow down to 4.5% in 2008.

Industrial production slowed down in the second half of the year but is expected to recover in 2008. After a final burst in 2007, construction will come to a halt in 2008; services (especially trade and transport) will also feel the domestic slowdown.

Prices and monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

Inflation climbed to 6.6% in 2007. A wide range of factors contributed to accelerating consumer prices. Strong domestic demand and labour cost increases led to rapidly rising services prices; excise tax increases affected energy costs while global developments pushed up food and energy prices. Meanwhile, industrial producer prices climbed by 8.4% in the year to November while construction costs rise by an annual 11.1% until September 2007.

Both industry and consumer surveys suggest that inflationary expectations are entrenched. Public sector wage increases will also add to inflationary pressures in 2008 while external developments (energy and food prices) also bear risks. Therefore inflation is set to rise further to 7.4% in 2008.

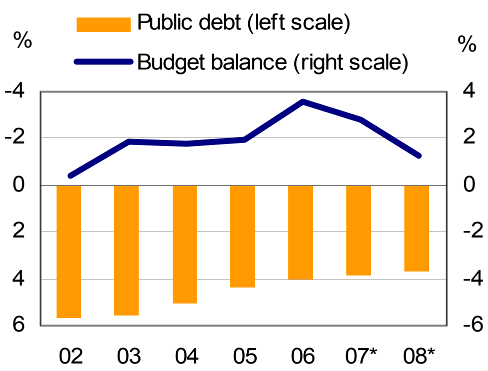
Financial markets were affected by heightened macroeconomic uncertainties, including fears of devaluation. The spread between the three-month TALIBOR and EURIBOR interbank rates rose to almost 240 basis points in December 2007 from around 10 basis points at the beginning of the year. Given Estonia's currency board arrangement (with its ample currency reserves), devaluation of the kroon is not likely. Still, persistent inflation, external imbalances and more wary global financial markets will keep risk premia high in 2008.

The Tallinn Stock Exchange index lost 13.3% of its value in the course of 2007, although trading volumes increased massively.

Lending to households is slowing due to the saturation of housing markets, the bleak outlook of would-be borrowers and rising domestic interest rates. The amount of new credit to individuals was shrinking in the second half of the year although the stock of outstanding loans still grew by 37% in the year to November 2007. The monthly amount of new credit to companies is stable; the stock of corporate loans increased by an annual 33% in November. The quality of banks' loan portfolios is slightly deteriorating; the amount of loans past due kept rising throughout 2007 and amounted to 4.2% of the total loan stock in November.

Fiscal policy

Key fiscal indicators (% of GDP)



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

Despite the slowdown of the economy, revenues continued to pour in. The favourable mid-year budgetary position permitted a supplementary budget (passed on 5 December). This raised budgeted revenues by EEK 6.2 bn and expenditures by EEK 2.7 bn. The additional spending includes investments originally planned for 2008. We expect the general government surplus to reach 2.8% of GDP in 2007.

The 2008 budget plans a surplus of EEK 3.6 bn. According to our forecast this amounts to 1.2% of GDP. The tax code will change according to long-term plans: the flat tax rate will decrease by a percentage point while various excise duties will increase in 2008. On the expenditure side, welfare spending and public sector wages will grow strongly. The pay rise will amount to 20% for civil servants and more for security services. The indexation of pensions will change and the base amount of pension will increase in 2008, leading to a 22% average pension rise in April. Various other social benefits (including parental benefits and benefits for the disabled) will also increase.

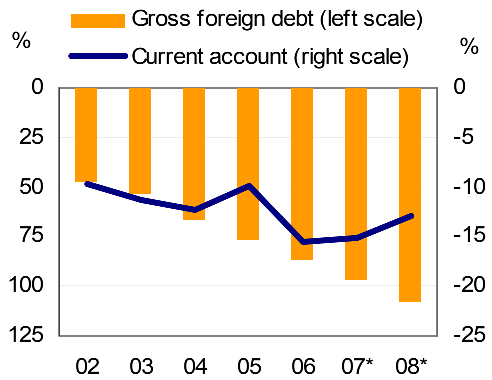
Fiscal policy is thus anticyclical, but hefty pay rises in the public sector will make it more difficult to reduce inflation. If rapid wage growth persists, external competitiveness could deteriorate and exports could suffer. This could set back economic growth even further and could aggravate external imbalances even further.

Public sector debt continues to shrink slightly, to below 4% in 2007.

External balance

Goods exports barely increased, they rose by just 4.1% in the first ten months of 2007. This was due to a large fall in the export of electrical equipment (a decline in contract manufacturing) and oil products (lower transhipment because of tensions with Russia). On the other hand, food exports rose by 31%: Estonia could increase its market share thanks to poor harvest in major exporting countries. Manufacturing exports grew at a decent rate; the top performers among major commodity groups were pulp and paper (40.6% growth in the first ten months) and vehicles.

External balance indicators (% of GDP)



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

The growth of domestic labour costs was offset by rising commodity prices and strong external demand in 2007. However, as the European economy slows down and local production costs increase, export growth could still suffer in 2008.

Goods imports were similarly affected by the fall of contract manufacturing and transit, but slower domestic demand plays an equally important role. The value of imports increased by 4.6% in the first ten months of 2007.

Rising freight costs and relations with Russia affected trade in transport services (the former positively, the latter negatively). Travel services declined while the exports and imports of financial and business services both grew dynamically.

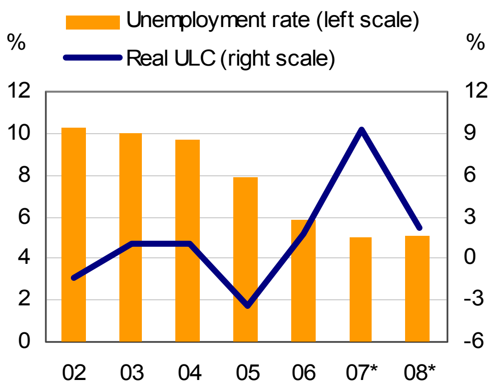
In all, the trade balance is expected to improve gradually. On the other hand, massive outflows are registered on the income account thanks to the profitability of foreign-owned enterprises in Estonia. Therefore the current account deficit may have declined only narrowly to 15.2% of GDP in 2007, and will reach 12.8% in 2008.

Net FDI inflows amounted to EUR 380 mn in the first three quarters, financing 21% of the current account deficit; the surplus of the capital account covered another 5%. The bulk of the external financing gap is still covered by the lending of Scandinavian parent banks to their local affiliates. This trend is likely to continue; therefore the stock of gross foreign debt is projected to rise in 2007-08 and is likely to exceed 100% of GDP in 2008.

Labour market

Employment and activity continued to grow in 2007 before the economy started to decelerate. The number of employed rose by 1.7% in the first three quarters according to Labour Force Survey data. This was driven by construction; job creation was more sluggish in services and the number of the employed decreased in agriculture, industry and community services. Unemployment may have hit its lowest level; we estimate the 2007 rate at 5%. The slowdown of the economy will not necessarily raise unemployment but it will certainly halt the creation of new jobs.

Labour market indicators



*Note: * forecast. Source: Eurostat*

Wage growth was exceptionally fast: wages and salaries per employee increased by 27.5% in the first three quarters of 2007. This boosts real unit labour costs which may have grown by as much as 9.2% in 2007. Public sector pay rises in 2008 could raise private sector wages as well; on the other hand, premium payments are expected to dwindle as firms' profits shrink. Therefore aggregate wage growth will be more moderate in 2008. However, labour productivity will also grow slower as the economy brakes, therefore real unit labour costs are expected to keep on growing, by close to 2% in 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (EEK mn)	175,392	207,061	242,600	273,100
Real GDP growth (%)	10.2	11.2	7.4	4.5
Private consumption (%)	10.7	14.9	9.3	4.0
Public consumption (%)	1.6	2.6	4.4	2.2
Investments (GFCF, %)	9.9	22.4	6.5	1.0
Exports (%)	20.5	8.3	2.0	4.8
Imports (%)	16.3	17.1	2.9	1.5
Annual average inflation (%)	4.1	4.4	6.6*	7.4
Money market rate (3-month, %)	2.59	3.81	7.23*	6.50
Long-term interest rate (10-year gov't bond, %)	3.94	4.70	5.50	5.50
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 (%)	1.9	3.6	2.8	1.2
Public debt / GDP (%)	4.4	4.0	3.9	3.7
Trade balance / GDP (goods and services, %)	-6.3	-11.6	-9.0	-7.4
Current account balance / GDP (%)	-10.0	-15.5	-15.2	-12.8
Gross foreign debt / GDP (%)	76.9	86.2	96.6	107.7
Unemployment (%)	7.9	5.9	5.0	5.1
Real ULC growth (%)	-3.5	1.8	9.2	2.2

*Note: f = forecast except where marked with *. See methodological notes for definitions and details.*
Sources: Eesti Pank, Eurostat, Statistics Estonia

Hungary

While the performance of the real economy was still a concern in the third quarter of 2007, improvements in the fiscal and external balances continued. Some signs of recovery in domestic demand are already present, but this will partly be offset by less favourable outlook for further net export gains. Following a mere 1.6% GDP-growth in 2007, the economy can expand at a rate of 2.5% in 2008. It now seems however that the external balance will not improve further in 2008, and without deeper structural reforms the fiscal outlook will also deteriorate after 2008.

Political developments

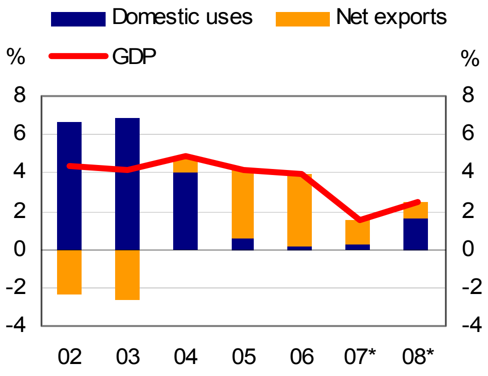
The most recent issue that creates enough opportunity for politicians to keep their supporters alarmed is the planned introduction of a new funding scheme in the healthcare system that will be based on competition between various health insurance companies. While there is dividedness concerning this plan even among coalition MPs, opposition MPs unequivocally refuse it.

New economic minister, Csaba Kakosy replaces Janos Koka, who will concentrate on rebuilding the smaller coalition party, the Free Democrats. The new minister was given a tough test in the first days in his office, when a badly prepared and executed action resulted in confusion in train traffic on the first working day in 2008. The state railway company is supervised by the Ministry of Economy, and some politicians from the main opposition party Fidesz were calling for the resignation of Kakosy following the scandal.

Growth

Whereas based on short-based indicators economic growth slightly increased in the third quarter (0.3% compared to the previous quarter according to seasonally adjusted data) this was not enough to keep the year-on-year growth rate from falling further to a mere 0.9%. This was clearly below expectations.

Structure of growth



*Note: * forecast. Source: KSH*

On the production side, weak domestic demand continued to be a drag on the output of market services and construction. Public and community services were also below their last year's level due to the effects of the fiscal austerity measures, while agriculture was hit badly by exceptionally unfavourable weather conditions. Export-oriented manufacturing branches still performed strongly, but as the external business cycle slowly peaks out (despite a better than expected outturn in the third quarter), some deceleration is also envisaged for this sector.

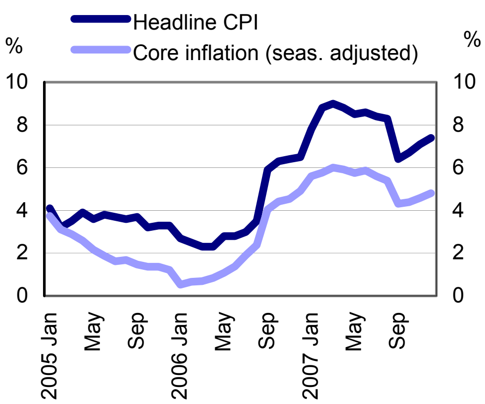
The marked fall in households' final consumption began to moderate somewhat in the third quarter, but retail sales figures for the fourth quarter are not really encouraging. Gross fixed capital formation were further characterised by contracting public investments and real estate developments, and investment activity in the corporate sector expands at a very modest rate. While export growth was sufficiently dynamic, the growth rate of imports began to approximate that of exports, reducing the gap between the two. While this does not threaten a further improvement in net trade, the extent of the improvement will be somewhat below expectations formed earlier.

Even considering a stabilisation or slight pick up in domestic demand components in the fourth quarter, we significantly revise our previous forecast for 2007 GDP growth down to 1.6%. While this figure seems to be rather low in itself, it could be even worse without assuming a relatively high accumulation of inventories, since private consumption will exhibit a decrease of 2.2% in 2007 while gross fixed capital formation is virtually flat compared to 2006.

In 2008 the tendency of very slowly unfolding pick-up in domestic demand and a gradually decreasing growth dynamics in net exports combined will lead to somewhat higher GDP growth. With private consumption growing again – albeit at a mere 0.5% rate – and gross fixed capital formation expanding at above 3%, even a less marked improvement in net exports could result in a 2.5% GDP growth. While there are some upward risks as well (e.g. agricultural output can easily be higher than our rather conservative estimate), in the light of potential downside risks (the assumption of further increasing inventory accumulation still cannot be dropped) a growth forecast above this rate does not seem to be justified.

Prices and monetary conditions

Evolution of 12-month inflation



Source: KSH

In the fourth quarter of 2007 consumer prices continued to follow an upward trend. Energy prices were driven by global oil price hikes, while food prices were both affected by increasing world demand and the bad performance of the domestic agricultural sector, mostly due exceptionally bad weather conditions. The year-on-year change in the headline CPI reached 7.4% in December leading to an average annual inflation of 8%, far in excess of analysts' expectations at the beginning of 2007.

It was not solely exogenous factors, however, that kept hindered disinflation. Core inflation also seems to get stuck in the range of 4.5 to 5%, with even durable goods prices exhibiting an upward tendency. This, of course, has a negative bearing on inflation expectations. In addition a further significant rise in energy prices for households in the first months of 2008 will also contribute to the 12-month rate of inflation remaining above 7% in at least the first quarter of 2008. Food prices will only gradually decrease; even assuming a much better agricultural output and a concomitant deceleration in the price rises of unprocessed foods, the aggregate food component can still exhibit an 8-10% increase in the whole year. In the second part of 2008 disinflation may finally get on track, eventually leading to a year-on-year growth of close to 4% in December. Average annual inflation can still at best be 5.4% with the risks predominantly located on the upward side.

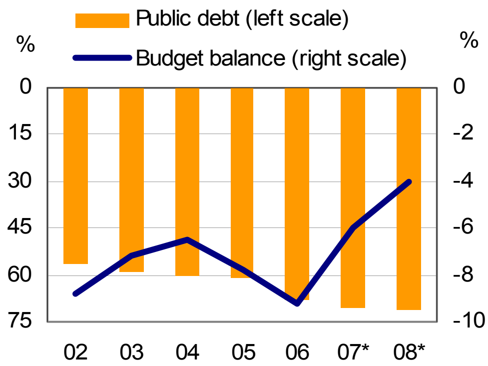
These recent price developments eventually cancelled a generally expected base rate cut by the Monetary Council of the central bank in the fourth quarter of the year, thus it remained at 7.5%. Given the inflationary environment, no rate cut is expected in the first quarter of 2008, since the Monetary Council also has to take into account the volatility in global liquidity, resulting from the credit crisis emanating from the American secondary mortgage markets. There will be, however, some room for monetary easing in the second part of 2008, and by the end of the year a base rate of 6.50% would not be inconsistent with the expected fundamentals.

The exchange rate of the forint seems to be well-grounded at its current rate of around 255 vis-à-vis the euro, and in the presence of improving fiscal and not significantly deteriorating external balances this can remain stable in 2008.

Fiscal policy

Mainly attributed to revenue increases, the accrual-based central budget deficit could be as low as 5.8% of GDP in 2007. Even together with the balance of local governments (which will become known only later) the consolidated budget deficit will not exceed 6% of GDP. The main are of revenue increases were a broadening tax base, the 'whitening' in some sectors of the economy, and higher than expected inflation, that boosted revenues especially through excise taxes and consumption taxes. On the other hand, there were mixed successes in reducing expenditures. While the decrease in health related spending can indeed have lasting effects, in some other elements cuts are at best temporary. There were also expenditure headings, where no reduction has taken place at all. This is partly because the much needed structural reforms are still not on their way except perhaps the healthcare system.

Key fiscal indicators (% of GDP)



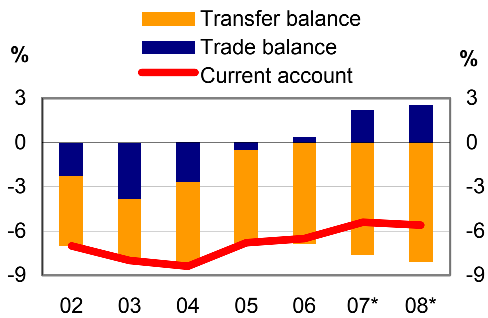
*Note: * forecast, reverse scale on left axis.*
Source: PM (ministry of finance)

Thus, while developments in the revenue side can be a guarantee for meeting the 2008 target for the budget deficit (indeed, our calculations now suggest, that this figure could be as low as 4% of GDP), it is doubtful, that further improvements could be achieved without deeper reforms at the expenditure side. What's even more worrying is that without these reforms economic growth could remain depressed even after the shocks created by the fiscal austerity measures introduced in 2006 and 2007 will finally die out.

External balance

In the third quarter of 2007 there was an EUR 1.39 bn deficit in the current account, yet, the external financing need was only EUR 0.79 bn as an outstanding EUR 600 mn net capital inflow was recorded in the capital account. This latter reflects increasing use of EU funds.

Current account developments (% of GDP)



*Note: * forecast. Transfer balance = incomes + current transfers. Source: MNB*

The basic tendencies remained unchanged, thus the balance on goods was again positive, and the same holds for services. The deteriorating income balance was also in line with the latest developments, as both profits on direct investment and interest payments on foreign debt continued increasing. However, import growth seems to be stronger than we anticipated a quarter before, and the gap between export and import growth is closing faster despite still weak domestic demand. And while the inflow of EU funds was outstanding in the capital account, they were sharply reduced among current transfers, which resulted in an unusually large negative balance.

This leads us to revise our earlier forecast for the balance of the current account downwards: in 2007 the deficit could reach 5.4% of GDP. Considering that the improvement of the trade balance will be smaller in 2008 and the steady deterioration of the income balance will also continue, we no longer expect that the current account will improve further in 2008. What's more, we expect a slight increase in the current account deficit, as the improvement of the trade balance will not be enough to offset the worsening of income transfers. Thus we estimate a current account deficit amounting to 5.6% of GDP in 2008. Since net inflows in the capital account will be approximately 1% of GDP in both years, the external financing need will be lower by this amount.

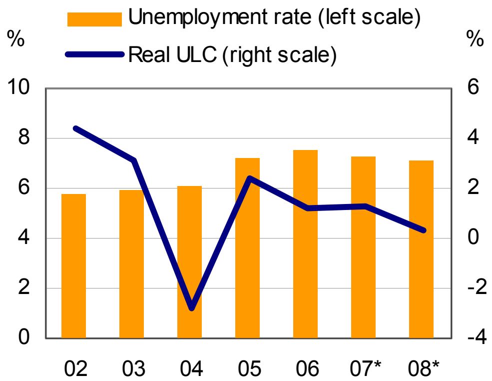
Despite relatively high foreign direct investment (especially reinvested earnings) in the third quarter, non-debt financing was still negative, as Hungarian investors' purchases of foreign equities were also high, and the own equity purchases of MOL (the Hungarian oil company) from foreign investors in fact embodied capital outflows. This means that the main source of financing remains debt-type capital inflows, which, however, also contribute to the accumulation of foreign debt stock.

The financing structure will probably be less asymmetric in 2008 and non-debt net capital inflows will be positive again, but the dominance of debt-generating financing will be maintained. This is reflected in the fact that gross foreign debt increased to EUR 96.7 bn by the end of September, and could further rise to EUR 99 bn (or 98.4% of GDP) by the end of December. By the end of 2008 gross foreign debt can even break above 100% of GDP. This is not a cause for concern, though, as the level of international reserves will remain quite stable, and the stock of net foreign debt will not deteriorate to such an extent thanks to the increase of foreign assets.

Labour market

There was some difference between data from the labour force survey conducted by the KSH (statistical office) and payroll lists. While the former indicated slightly increasing employment in the first three quarters of 2007, the latter indicated a decline: stable employment in the private sector was accompanied by a 4.9% decrease in the public sector. As expected, besides job losses in the public sector it was construction, where employment has significantly decreased (though one has to take a deeper look into developments, as LFS data and payroll data again point into different directions). Despite plummeting domestic demand employment in the market services sector has continued to rise. Due to changes in the regulation of retirement, the activity rate has somewhat declined and will possibly be declining. This results in an unemployment rate of 7.3% on average in 2007 while a small decline to 7.1% is expected in 2008.

Labour market indicators



*Note: * forecast; real ULC based on gross wage growth. Source: KSH*

Gross wages were 8.3% higher in the first eleven months of 2007 than a year before. The increase amounted to 9.7% for the same period in the private sector but to only 6.3% in the public sector. This difference could have been even larger, since regular payments hardly increased in the public sector at all, while the private sector accommodated to shrinking profits by decreasing non-regular payments. As the effects of the increase of the minimum base for social security contributions and the increase of the rate of the contribution itself in September last year died out at the end of 2007, the gap between gross and net wages virtually closed, leading to a net wage growth of 3.4%. With inflation strengthening in the second part of the year real wages might have declined by approximately 4.3%. Due to inflation getting stuck at above 5% in 2008, we expect no increase in real wages. Unit labour costs probably marginally increased in 2007 due to higher wage growth and weaker GDP growth, but they can stabilise in 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (HUF bn)	22,055	23,757	25,300	26,800
Real GDP growth (%)	4.1	3.9	1.6	2.5
Private consumption (%)	3.6	2.1	-2.2	0.5
Public consumption (%)	-0.1	6.6	-6.2	-2.1
Investments (GFCF, %)	5.3	-2.8	0.1	3.3
Exports (%)	11.5	18.9	14.7	10.3
Imports (%)	6.8	14.5	13.7	9.8
Annual average inflation (%)	3.6	3.9	8.0*	5.4
Money market rate (3-month, %)	5.94	7.90	7.63*	6.50
Long-term interest rate (10-year gov't bond, %)	6.97	6.71	6.93*	6.10
Exchange rate / EUR (average)	248.05	264.27	251.12*	254.79
Exchange rate / EUR (end of period)	252.73	252.30	253.35*	255.00
Budget balance / GDP (%)	-7.8	-9.2	-6.0	-4.0
Public debt / GDP (%)	61.0	68.0	70.7	71.3
Trade balance / GDP (goods and services, %)+	-0.5	0.4	2.2	2.5
Current account balance / GDP (%)+	-6.8	-6.5	-5.4	-5.6
Gross foreign debt / GDP (%)+	76.5	94.2	98.4	100.5
Unemployment (%)	7.2	7.5	7.3	7.1
Real ULC growth (%)	2.5	1.2	1.3	0.3

*Note: f = forecast except where marked with *. + calculated from data in euro. See methodological notes for definitions and details.*

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

Latvia

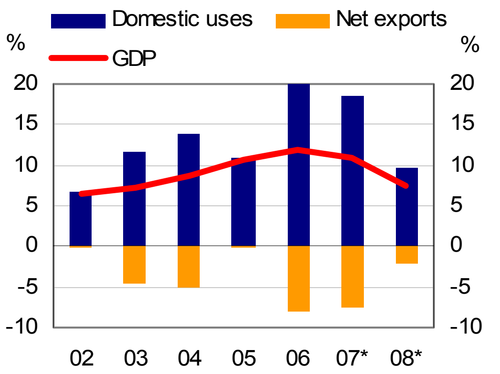
Testing times are ahead: the economy is about to decelerate markedly, inflation is spiralling upwards and the current account deficit is extremely high. Policy tools are limited: abandoning the currency peg is not an option, further fiscal tightening might squeeze growth excessively while a loosening would stoke inflation.

Political developments

Unpopular Prime Minister Aigars Kalvitis resigned on 5 December 2007. His successor is former Interior Minister Ivars Godmanis, who was charged by President Valdis Zatlers to 'restore trust' in the government. Mr. Godmanis had already served as prime minister between 1990 and 1993; on his watch Latvia underwent transition from planned to market economy, although the severe economic crisis during the process raises some dark memories among citizens. Nevertheless, as 16 of the 19 ministers had been members of the previous government, a break with past policies is unlikely. This will not appease dissatisfied voters, many of whom would prefer early elections.

Growth

Structure of growth



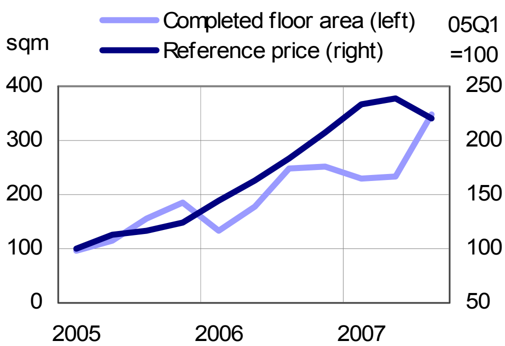
*Note: * forecast. Source: Eurostat, Statistics Latvia*

The economy is gradually running out of steam. It still grew at an annual 10.9% growth in the third quarter of 2007, but a number of indicators already point to a deceleration.

Private consumption, the greatest single contributor to growth, rose by 17.5% in the first three quarters of 2007. However, retail sales growth dipped to 12.3% in November from well above 20% in the first half of 2007. Bank lending to households, a major catalyst of private spending, is slowing, although the annual growth rate of households' loan stock was still 44% in November 2007. In a benign scenario private consumption decelerates gradually in 2008, but it will remain the key contributor to growth.

Public sector spending gained momentum. The price index of public consumption rose by an exceptional 27.5% in the first three quarters; nevertheless, real public consumption managed a 17.5% increase. Gross fixed capital formation continues its steady growth (14.6% in the first nine months). Real estate accounted for 74% of non-financial investments, half of which was attributed to the public sector. However, the tide is already turning: house prices fell continuously in the second half of the year and transaction volumes are dropping. We expect housing investments to dwindle in 2008, dragging down investments.

Residential real estate developments



Note: reference price = average price of standard apartment in Riga. Source: Latio, Statistics Latvia

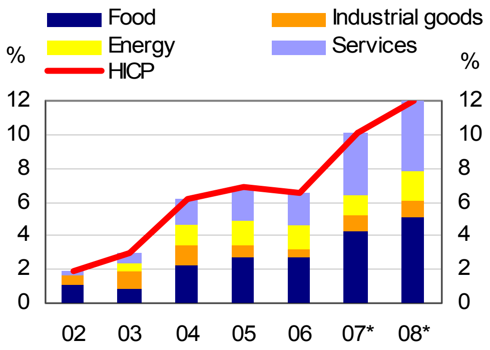
Exports recovered after a slip-up in 2006: they rose by 9.4% in the first nine months. On the other hand, excessive domestic demand fuelled the 22.2% import growth at the same time. Therefore net exports will remain a massive drag on growth in 2007. This will change in 2008, mostly because import demand is slowing down.

On the supply side 2007 was a good year for agriculture. Industrial production stagnated for most of the year, while construction had its peak in 2007. 2008 is expected to bring a slow recovery for industry and a marked slowdown for construction. Likewise, market services performed well in 2007, only to follow private consumption downwards in 2008.

Our growth forecast is edged up a bit to 11% in 2007, but revised downwards to 7.5% in 2008. However, macroeconomic risks have not decreased in recent months and fiscal policy is piling pressure on the economy. Therefore the probability of a growth collapse is still considerable if inflation and external imbalances get out of control.

Prices and monetary conditions

Components of inflation

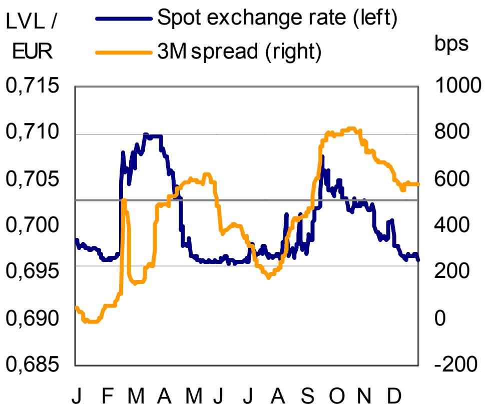


*Note: * forecast. Source: Eurostat*

Inflation spiralled upwards in 2007 and reached 10.1% on average, greatly exceeding our previous expectations. External and domestic factors both contributed to high inflation. Global food and energy prices soared in the second half of 2007 while strong domestic demand and rising labour costs sent services prices skyrocketing. Rising excise taxes and administered price increases also played an important role. According to the 2007-2010 Convergence Programme, the latter added 2.3 percentage points to 2007 inflation and will contribute 3.1 percentage points in 2008 as well due to sharply rising electricity prices.

In light of developments in 2007 we revise our expectations for 2008 as well. Factors causing high inflation currently will persist in the near future, while the government's anti-inflationary measures have proven feeble so far. As a result, inflation will accelerate even further in 2008 and could reach 12%.

Exchange rate and interest rate developments in 2007



Note: horizontal lines indicate the central LVL/EUR parity (0.7028) and the ±1% fluctuation bands. 3M spread of RIGIBOR over EURIBOR. Source: Bank of Latvia, Eurostat

Rising labour costs are also reflected in producer prices. Industrial prices rose by 16.7% on average in the first ten months of 2007 while construction costs increased by 27.6% in the first three quarters.

As inflation rose and external imbalances widened, the sustainability of the currency peg came under scrutiny in 2007. The lat approached the weak end of its fluctuation band in March and then in September. Risk premia have risen and the spread of the 3-month RIGIBOR interbank rate over EURIBOR exceeded even 800 basis points before coming back to around 600 by the end of 2007. With persistent and serious macroeconomic imbalances yields will remain high in 2008 as well.

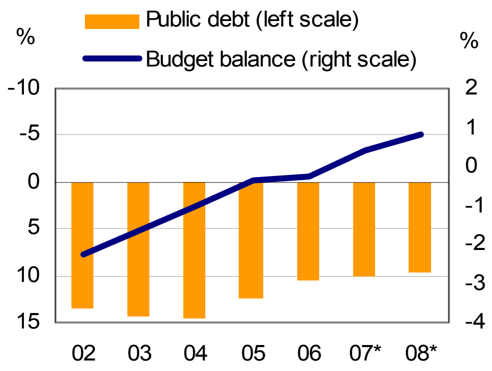
The saturation of the real estate market reduces credit demand although inflation keeps real interest rates low. The stock of outstanding loans to companies grew by 39.5% in the year to October 2007 while loans to households increased by over 50%. Nevertheless monthly growth rates point to a slowdown in lending, which is likely to continue in 2008 as well.

Fiscal policy

Government revenues grew buoyantly in 2007: by November over 90% of budgeted taxes had been collected. Central government and social security spending remained under control but the expenditures of local governments rose by almost 45% in the first eleven months of 2007. Still, the targeted consolidated surplus of LVL 55 mn could have been achieved easily; this amounted to 0.4% of estimated GDP.

The 2008 budget calls for more disciplined spending; public sector employment and pay rises will be strictly controlled. Consolidated

Key fiscal indicators (% of GDP)



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

revenues of the general government will rise by 22.5% while expenditures will increase by 20.3%. The updated Convergence Programme for 2007-2010 plans a surplus of LVL 110 mn in 2008. This target may even be slightly exceeded and the surplus could reach 0.8% of GDP.

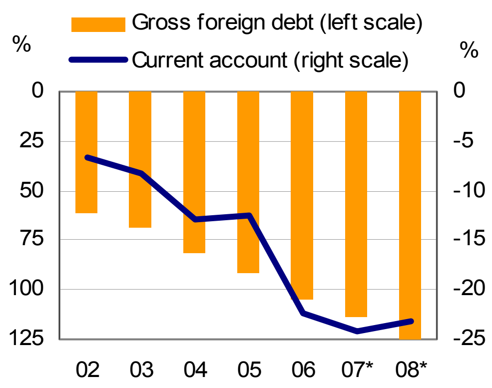
This fiscal tightening means that the cyclically adjusted budget balance turned positive in 2007 and the adjusted surplus will rise in 2008. Since macroeconomic imbalances are severe, fiscal policy cannot become expansionary to counterweight the economic slowdown. The new, medium-term budgeting framework and the stabilisation reserve will help fiscal policy become a more effective tool of macroeconomic stabilisation tool in the long term. However, the excessively loose fiscal stance in plentiful years will make it harder to weather the leaner years immediately ahead.

General government debt is gradually decreasing, to below 10% of GDP in 2007-08.

External balance

The value of goods exports increased by 19.2% in January-November. Food exporters exploited poor harvests elsewhere while the demand for commodities (wood, chemicals, basic materials) remained strong. However, the most dynamic growth (almost 38%) was registered in machinery and electrical equipment. Goods imports growth reached 21.7% in the first eleven months of 2007 due to strong private consumption and investments. The surplus on services increased thanks to rising freight costs, but the trade deficit was still EUR 3.2 bn (or 22.5% of GDP) in the first three quarters of 2007. The current account balance also remained heavily in the red. We estimate that the current account deficit can climb to a new record high of 24.1%. As a result of the impending domestic slowdown the trade deficit will gradually narrow. Still, the current account deficit will remain horribly high in 2008 and may exceed 23% of GDP.

External balance indicators (% of GDP)



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

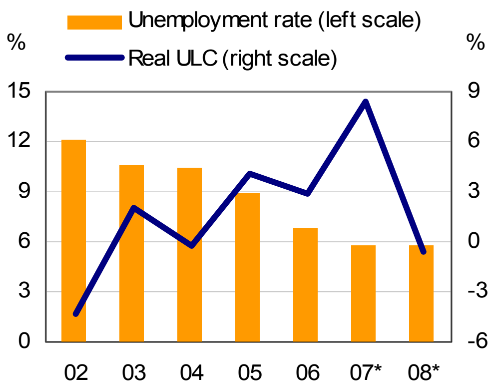
The sustainability of this massive external imbalance needs to be scrutinised carefully. Export competitiveness seems unscathed although the real exchange rate vis-à-vis major trade partners appreciated by 8.6% in the year to October 2007. However, as external demand falters, the declining cost competitiveness of Latvia may be exposed.

The key source of financing for the current account deficit is still foreign banks' lending to their local affiliates; net FDI inflows amounted to almost EUR 1.2 bn in the first three quarters. Due to the dominance of debt financing the stock of gross foreign debt continued to grow. At the end of 2007 it could have reached 114% of GDP and could climb further to over 120% in 2008.

Labour market

Job creation remained strong in the first three quarters of 2007: the number of employed grew by 3% compared to the same period of 2006. Good employment prospects boosted activity as well: the number of the labour force rose by 1.8% during the same period. Unemployment is still declining, and may have reached 5.7% in 2007 as a whole. However, as economic growth is expected to drop considerably in 2008, further reductions are unlikely.

Labour market indicators



*Note: * forecast. Source: Eurostat*

Gross wage growth was a spectacular 32.2% in the first three quarters of 2007. Net wages increased at a slightly higher pace and real wage growth was close to 22% despite rising inflation. This was a direct consequence of tight labour markets and public sector pay rises. Reducing the growth of wages will be a major challenge in 2008 as rising inflation and the memory of fast income convergence are planted into expectations of workers.

Real unit labour costs could have risen by as much as 8.5% in 2007 due to the rapid rise of wages. We expect the stabilisation of this indicator in 2008, although a more dramatic growth slowdown would keep it rising.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (LVL mn)	9,059	11,265	14,100	16,600
Real GDP growth (%)	10.6	11.9	11.0	7.5
Private consumption (%)	11.2	19.8	16.5	8.5
Public consumption (%)	2.7	4.0	5.0	4.0
Investments (GFCF, %)	23.6	18.3	13.6	9.0
Exports (%)	20.3	5.3	11.0	7.0
Imports (%)	14.8	17.5	19.5	7.5
Annual average inflation (%)	6.9	6.6	10.1*	12.0
Money market rate (3-month, %)	3.16	4.21	10.50*	8.50
Long-term interest rate (10-year gov't bond, %)	3.59	4.90	5.20*	5.50
Exchange rate / EUR (average)	0.70	0.70	0.70*	0.70
Exchange rate / EUR (end of period)	0.70	0.70	0.70*	0.70
Budget balance / GDP (%)	-0.4	-0.3	0.4	0.8
Public debt / GDP (%)	12.5	10.6	10.2	43.8
Trade balance / GDP (goods and services, %)	-15.2	-22.1	-22.1	-20.4
Current account balance / GDP (%)	-12.5	-22.3	-24.1	-23.1
Gross foreign debt / GDP (%)	91.8	104.4	114.2	124.7
Unemployment (%)	8.9	6.8	5.7	5.7
Real ULC growth (%)	4.1	2.9	8.4	-0.6

*Note: f = forecast except where marked with *. See methodological notes for definitions and details.*
Sources: Bank of Latvia, Eurostat, Statistics Latvia

Lithuania

While both the rate of GDP-growth and its composition underwent a favourable change in the third quarter of 2007, problems related to overheating and external disequilibrium are still at the forefront of investors' concern in the case of Lithuania. With inflation increasing steadily, the date of euro adoption – that seemed to be so close even one and a half years ago – seems rather distant at the moment.

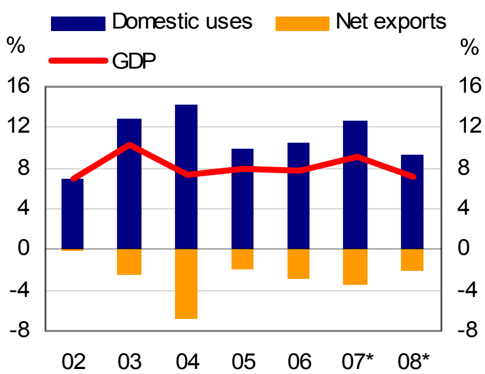
Political developments

2008 brought fierce debates in the Seimas (the Lithuanian parliament). Conservative MPs tried to pass a resolution that would oblige the government to take harder stance vis-à-vis Russia to get more compensation for the years of Soviet occupation. But Foreign Minister Petras Vaitiekunas, did not support the draft resolution, maintaining that Lithuania's exposure to Russian energy sources would make such a confrontation a risky adventure. Environment Minister Arunas Kundrotas, resigned early January after being repeatedly criticised by opposition MPs for poor his performance in office, and after only narrowly surviving a vote of confidence in December. There are ongoing talks between the ruling coalition and the Social Liberal Party to invite the latter to join the government. This would give 10 more seats for the coalition in the 141-seat Seimas. This could be a crucial decision as the ruling coalition is not in majority in the parliament without the Social Liberals.

Growth

For the third consecutive quarter Lithuanian GDP increased well above expectations. Compared to the third quarter of 2006 it expanded at a spectacular 10.8% rate helped especially by surging exports. Export growth was most marked in the case of agricultural products and chemical products. The first one is related to increased demand for agricultural products by Poland, where agriculture was badly influenced by unfavourable weather conditions. The second is mostly related to the acceleration in the output of Mazeikiu Nafta, the recently re-built petroleum refinery. From the production side, construction also contributed markedly to strong GDP-growth.

Structure of growth



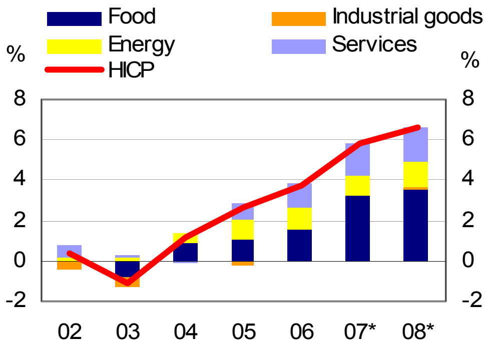
*Note: * forecast. Source: Eurostat*

Contrary to our expectations, the components of domestic demand have decelerated somewhat. Both private and public consumption exhibited sharp decreases in their year-on-year growth rates compared to the second quarter of 2007 (in fact seasonally adjusted figures even fell). Developments in private consumption are especially interesting since wage growth remained strong, and the minimum wage was raised from LTL 600 to 700. But even gross fixed capital formation increased at a lower pace than we expected by increased reinvested earnings of foreign direct investors and the booming construction activity. This deceleration was, however, more than offset by net export gains: the already mentioned outstanding export growth was accompanied by low import growth, leading to a marked improvement in the dynamics of net trade. This made us to revise upwards our earlier forecast for 2007 GDP sizeably: we now expect a 9.2% average annual GDP growth.

What's more, for 2008 the gap between the growth rate of exports and imports could narrow further, as decelerating domestic demand will require smaller import growth, while export will be supported by still strong foreign demand. It is not to say, that domestic demand will be weak, however: gross fixed capital formation will increase at double-digit rate in 2008 as well, and private consumption will probably expand at a rate of 7%. Taken together, GDP-growth can be in the region of 7.2% in 2008, which is half percentage point higher than what we envisaged a quarter ago.

Prices and monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

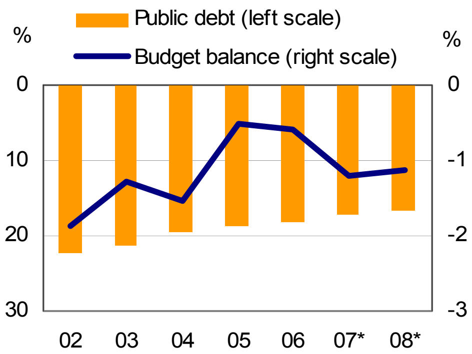
Consumer prices continued rising steadily in the fourth quarter of 2007, hitting an 8.2% year-on-year growth rate in December, and eventually leading to a 5.8% average annual growth rate for 2007. Food prices in December were 13.2% higher than a year before, even though their increase was somewhat moderated in the fourth quarter. Energy prices, however, also rised steeply in the last quarter of 2007, and were 11.3% higher than at the end of 2006. Services prices increased at exceptionally high rates, and even changes in industrial goods prices were consistently in the positive territory in the second half of 2007. Since these developments are likely to prevail in the first months of 2008, there is no room for disinflation before the second part of the year. This means that average annual inflation could increase further: we now expect 6.7% growth in consumer prices for 2008; developments in gas prices remain an upward risk.

Short-term yields skyrocketed in the fourth quarter of 2007, thus the differential vis-à-vis euro area securities widened further. Even in February there was hardly any difference between interest rates on 3-month government securities, but the gap increased to 70 basis points by the end of August, 120 basis points by the end of October and finally to 220 basis points by the end of December. Behind this lies the perception of foreign portfolio investors that the Baltic economies could face serious problems in the near future due to overheating and concomitant external balance problems.

The outstanding amount of loans to the private sector was 46% higher in November 2007 than a year before. Within this, households indebtedness increased by 60%. Increasing interest rates, however, can reduce the rate of further credit growth despite the favourable income outlook in 2008.

Fiscal policy

Key fiscal indicators (% of GDP)



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

The third quarter resulted in a marked increase in the collection of taxes on income and wealth; at the same time taxes on production and revenue from social contributions also increased at an accelerating rate. The expenditure side was more balanced: while government investments were increasing rapidly, the fall in the compensation of public employees was stronger (in seasonal terms) than usual for the third quarter. Thus the budget balance was surprisingly favourable (exhibiting LTL 570 mn surplus).

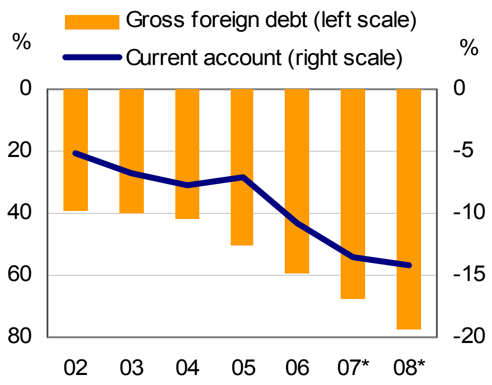
This, nevertheless, is only a temporary improvement, and just assuming average turnover in the fourth quarter of 2007, we end up with revenues increasing to 34% of GDP, but expenditures reaching 35% of GDP for 2007 as a whole. This results in a budget deficit of 1% of GDP in 2007.

Government investments will be further boosted in 2008 giving another push to expenditure growth, and payments of social benefits will also continue growing steadily. But revenue growth will almost match that of expenditures due to more intense economic activity. We thus expect only a minor deterioration in the budget, the consolidated deficit reaching 1.1% of GDP in 2008. The stock of public debt, which stood at 18.2% of GDP at the end of 2006 could have fallen to 17% by the end of 2007, and will shrink to 16.5% by the end of 2008. The improvement compared to our previous forecast is mostly due to the considerably higher level of GDP.

External balance

Due to exceptionally strong export growth and rather small import growth the sharp deterioration of the trade balance eased somewhat in the third quarter of 2007. Nevertheless, its cumulated deficit from the beginning of the year is EUR 2.4 bn, almost the same as it was in whole 2006. This was coupled by a twist in terms-of-trade developments to the detriment of Lithuania in the third quarter. Since net income transfers abroad continued rising (due to the higher stock of foreign debt accumulated in recent years), the current account deficit in the first three quarters amounted to close to EUR 2.8 bn or almost 14% of GDP.

External balance indicators (% of GDP)



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

While the outlook for exports remained bright in the fourth quarter, worsening of the terms-of-trade and the deteriorating income balance will lead to a current account deficit of 13.6% of GDP by the end of 2007. 2008 will see some more improvement in the trade balance through the closing of the gap between export and import growth, but even under these circumstances an improvement in absolute terms is unlikely. This, together with further increasing income payments to foreign investors will push the current account into a deficit of 14.1% of GDP in 2008.

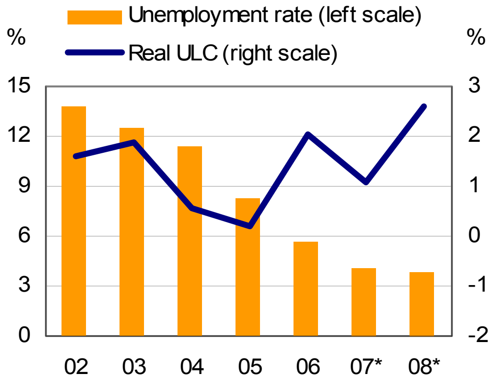
The level of non-debt financing is still very low, as new foreign direct investments were virtually zero in the first three quarters of 2007, while Lithuanian residents' purchases of foreign equities and the sale of Lithuanian equities on part of foreign investors almost offset the amount of reinvested earnings. This resulted in a rather asymmetric financing structure, with debt-generating financing amounting to more than 90% of total net capital inflows. Despite some pick-up in incoming foreign direct investment, this phenomenon will also prevail in 2008.

At the end of September the level of gross foreign debt was EUR 17.7 bn, a very considerable increase from its end-2006 value of EUR 14 bn. As the structure of financing is skewed towards debt-generating capital inflows, this stock will further increase to EUR 18.7 bn (67.8% of GDP) by the end of 2007. Since debt-generating capital inflows remain the main source of financing in 2008 as well, the stock of gross foreign debt could increase to EUR 23.8 bn (77.4% of GDP) by the end of 2008, which could not really restore foreign investors' sentiment towards the Lithuanian economy in the short run.

Labour market

Labour shortages – especially among workers with special skills – remain one of the unfavourable characteristics of the labour market. While the migration of Lithuanian workers to other EU economies (primarily the United Kingdom) has become less of a problem recently, the labour market is still demand-driven. The unemployment rate stood at a mere 3.7% (seasonally adjusted) in the third quarter of

Labour market indicators



*Note: * forecast. Source: Eurostat*

2007, since employment growth well exceeds the growth of the active population. Labour shortages are most pronounced in industry and construction (despite the fact that in the latter employment increased by 16.6% compared to the third quarter of 2006). On average, the rate of unemployment could be as low as 4.1% in 2007 and might fall below 4% in 2008.

Average gross monthly earnings rose by 19.2% year-on-year in the third quarter. Annual increases were in excess of 20% in industry and market services. Public sector wages increased more moderately, and in fact sharply decreased in the third quarter of 2007. On the forecast horizon we expect gradually decreasing wage growth despite higher than expected inflation and a further increase of minimum wages from LTL 700 to 800 in 2008. Real unit labour costs will still increase though, as labour productivity growth will be less dynamic in 2008 following a transitory upward jump.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (LTL mn)	71,380	81,905	95,400	106,300
Real GDP growth (%)	7.9	7.7	9.2	7.2
Private consumption (%)	11.9	11.9	10.7	7.0
Public consumption (%)	3.6	5.5	3.9	4.4
Investments (GFCF, %)	10.9	17.4	17.5	10.0
Exports (%)	17.7	12.2	8.6	11.4
Imports (%)	17.2	13.8	11.3	11.5
Annual average inflation (%)	2.7	3.8	5.8*	6.7
Money market rate (3-month, %)	2.53	3.72	7.07*	7.50
Long-term interest rate (10-year gov't bond, %)	3.78	4.28	4.94*	5.20
Exchange rate / EUR (average)	3.45	3.45	3.45*	3.45
Exchange rate / EUR (end of period)	3.45	3.45	3.45*	3.45
Budget balance / GDP (%)	-0.5	-0.6	-1.0	-1.1
Public debt / GDP (%)	18.6	18.2	17.0	16.5
Trade balance / GDP (goods and services, %)	-7.3	-10.4	-12.3	-12.7
Current account balance / GDP (%)	-7.2	-10.8	-13.6	-14.1
Gross foreign debt / GDP (%)	50.0	59.2	67.8	77.4
Unemployment (%)	8.3	5.6	4.1	3.9
Real ULC growth (%)	0.2	2.0	1.1	2.6

*Note: f = forecast, except where marked with *. See methodological notes for definitions and details.*
Sources: Eurostat, Lietuvos Bankas, Lietuvos Statistikos Departamentas

Poland

Although our GDP growth forecast is revised downwards, it is still expected to hit 5.4% in 2008. Domestic demand remains the main driving force. On the other hand the strong wage growth, higher energy prices and especially increasing food prices will keep inflation well above the Polish central bank's inflation target.

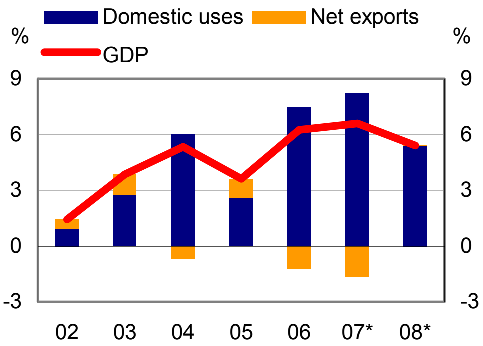
Political developments

In the October 2007 election, the liberal Civic Platform Party managed a stunning victory over President Kaczynski's conservative Law and Justice Party. Donald Tusk, the leader of pro-business Civic Platform, became Poland's new Prime Minister. The new foreign policy is likely to be the most important change; relations with Germany have already improved. The new government wants to rebuild its relationship with the EU and the Russian Federation, but it will withdraw all 900 of its troops from Iraq by the end of 2008. However, while Mr. Tusk hinted that his government might be more flexible on the question of a planned German-Russian Nordstream gas pipeline he also called for more cooperation from EU partners on energy security.

Growth

The recent years have been successful for the Polish economy. Real GDP growth expected at 6.6% in 2007, while is forecasted to be 5.7% in 2008, despite the deteriorating outlook for the global economy. Since the Polish economy is not as open as many of its neighbours, it may be less affected by external developments.

Structure of growth



*Note: * forecast. Source: Eurostat*

Domestic demand remained the main leading force of growth in 2007. Both private consumption and investments rose healthily. Private consumption was rising on the back of high employment growth, robust real wage rises and the high growth of credit to households. Robust credit growth, high FDI inflows and a further increase in the absorption of structural funds accelerated fixed capital formation further. The drag of net exports on growth increased due to strong domestic demand.

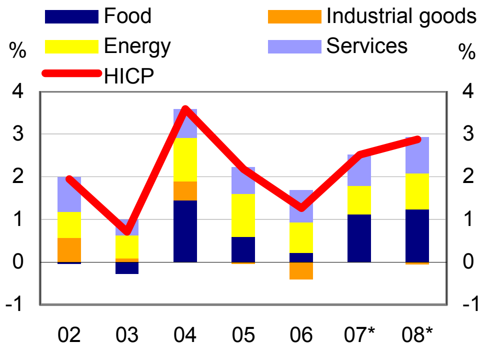
In the coming quarters, the country's fast GDP growth is expected to continue, driven by a rapid increase in GFCF and personal consumption; investment will continue to grow above 10%. We forecast 5.4% GDP growth for 2008. Import growth of the main trading partners and oil price developments are the main sources of downside risk to growth.

Prices and monetary conditions

12-month inflation jumped to 3.6% in November 2007, and is and expected to have reached 4% in December. The rise in inflation is largely explained by higher food prices, but it is also obvious that demand-side pressures remain and wage growth is outpacing productivity growth.

While we expect growth to ease somewhat in 2008, the lagged impact from strong wage growth and especially higher energy prices will keep inflation well above the Polish central bank's inflation target of 2.5%

Components of inflation



*Note: * forecast. Source: Eurostat*

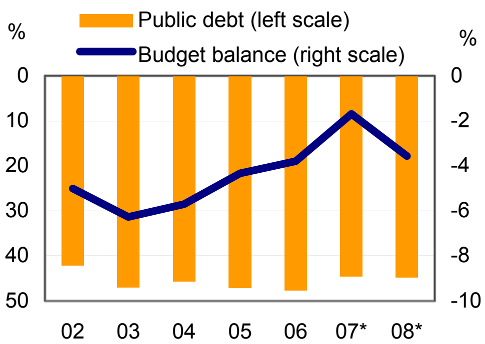
during all of 2008: it might reach as much as 2.9% on average in 2008.

Rising inflation could force the Polish central bank (NBP) to tighten monetary conditions further; therefore we anticipate another 25 basis points rate hike in the first quarter of 2008. Interest-rate hikes are good news for the zloty. The Polish currency is likely to keep strengthening in 2008, although to a smaller extent than in 2007.

Fiscal policy

As of April 2008 payments of individuals to private pension funds cannot be classified as government revenues according to the ESA methodology. Excluding these revenues will add about 1.9 percentage points to the budget deficit according to government calculations.

Key fiscal indicators (% of GDP)



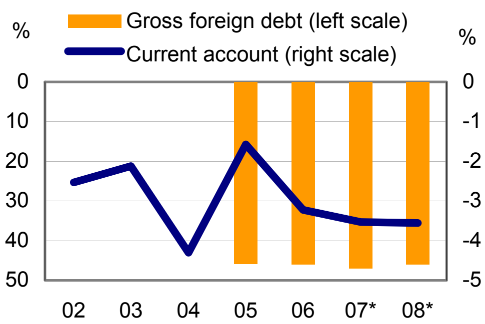
*Note: * forecast, reverse scale on left axis. Source: Eurostat*

Stronger than expected economic growth will help the state budget deficit to end 2007 far below the PLN 30 bn deficit target, although some spending scheduled for 2008 is being brought forward to 2007 in order to reduce pressure on the 2008 budget. The government approved a 2008 draft budget cutting the central budget deficit to PLN 28.16 bn, or about 2.4% of GDP, from an earlier plan of PLN 30 bn.

The new liberal government wants to transform state-owned hospitals into commercial operations which would be wholly or majority-owned by local authorities. In addition, the reform package foresees the introduction of additional voluntary payments to supplement the current system of compulsory health-care contributions. The sector has also been hit by mass departures of personnel, many of whom have left the country for better-paid jobs in Western Europe. The national medical association says around 6% of the country's 100,000 doctors have left the country since Poland joined the EU in 2004.

External balance

External balance indicators (% of GDP)



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

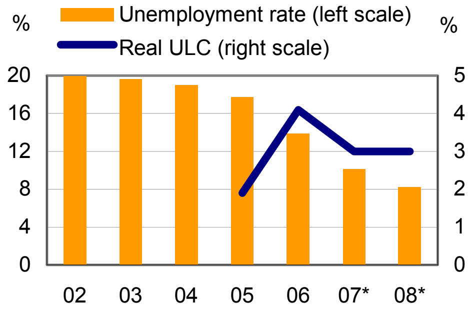
Poland's current account deficit fell to EUR 351 mn in November 2007, well down from EUR 1.29 bn in October. The stronger zloty will decrease exports and increase imports in the short term, which in turn will increase the current account deficit.

We estimate that Poland's current account deficit stayed around 3.5% of gross domestic product in 2007, due to growing imports on the back of the booming economy. We project the current account deficit as a percentage of GDP to remain relatively stable in 2008: it will reach 3.5% of GDP in 2008.

Poland attracted 31 new FDI projects in the first half of 2007, primarily in the electronics sector, according to the Polish Information and Foreign Investment Agency.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

The continuing revival on the labour market and the decrease in social insurance and tax burden will translate into a fast increase in household incomes. Additionally, some uncertainty remains about the bottlenecks on the labour market, which could lead to the acceleration of real wages, higher inflation and, finally, to tighter than expected monetary policy.

Employers will have problems recruiting new workers and will have to deal with a further increase in wages, something that has already undermined their competitiveness. Real wages are expected to grow by more than 10% in the first half of 2008, a rate that will subsequently slow down in the latter part of the year. Household growth will be boosted by changes in obligatory social security contributions: those made by employees fell by 2 percentage points as of January 2008, in addition to a previous decrease of 3 percentage points (from 6.5% to 3.5%) in July 2007. Consequently, employees will now be paying only 1.5% of their gross wages as a social insurance contribution.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (PLN bn)	983.3	1060.2	1167.5	1273.6
Real GDP growth (%)	3.6	6.2	6.6	5.4
Private consumption (%)	2.0	4.8	6.0	3.9
Public consumption (%)	5.2	5.8	0.5	2.5
Investments (GFCF, %)	6.5	15.6	23.0	13.5
Exports (%)	8.0	14.6	8.5	10.0
Imports (%)	4.7	17.4	12.0	9.0
Annual average inflation (%)	2.2	1.3	2.5	2.9
Money market rate (3-month, %)	4.62	4.20	5.40	5.40
Long-term interest rate (10-year gov't bond, %)	5.16	5.14	5.70	5.70
Exchange rate / EUR (average)	4.02	3.90	3.82	3.79
Exchange rate / EUR (end of period)	3.86	3.77	3.79	3.79
Budget balance / GDP (%)	-4.3	-3.8	-1.5	-3.4
Public debt / GDP (%)	47.1	47.6	44.5	44.8
Trade balance / GDP (goods and services, %)	-0.3	-1.4	-1.3	-1.5
Current account balance / GDP (%)	-1.6	-3.2	-3.5	-3.5
Gross foreign debt / GDP (%)	45.9	46.0	47.0	46.0
Unemployment (%)	17.8	13.9	10.1	8.2
Real ULC growth (%)	1.9	4.1	3.0	3.0

*Note: f = forecast except where marked with *. See methodological notes for definitions and details.*
Sources: Eurostat, Central Statistical Office of Poland, Narodowy Bank Polski, OECD

Romania

Due to growing inflation the national bank missed its 2007 inflation target. Accordingly, the national bank increased its policy rate in two steps. External imbalances were worsening in 2007 and this trend is expected to continue in 2008 as well. Fiscal policy is forecasted to loosen due to upcoming elections.

Political developments

At the end of November 2007 European Parliament elections were held in Romania. The biggest winner was the Democratic Party, which won 13 seats, eight more than before the vote. The Social Democratic Party lost two seats (10), the National Liberty Party gained six seats again, the Liberal Democratic Party won three seats for the first time, while Democratic Union of Hungarians in Romania and László Tőkés, an independent candidate won two and one seats respectively. Finally, the Greater Romania Party and the Conservative Party lost all their seats on the elections (five and two respectively).

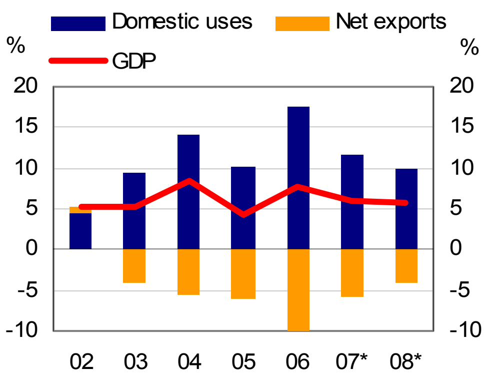
In the last months of 2007 the tension between the President and the government remained. Romania has an interim Justice Minister since the President is unwilling to accept the candidate of the Prime Minister. The most recent move of President is the authorisation of criminal investigations against eight former and current ministers. The political climate is thus tense and its improvement is not expected in the short run.

In 2008 local and parliamentary elections will be held in Romania, and preparations are already under way. The governing party appears to use pension and minimum wage increases to gain the sympathy of the voters.

Growth

In the third quarter of 2007 economic growth remained at almost the same level as in the previous quarter: it reached 5.7% in comparison with the corresponding period of the previous year. Now it obvious that economic growth in Romania was lower in 2007 than a year earlier.

Structure of growth



*Note: * forecast. Source: Eurostat*

Agriculture was one of the main reasons for the deceleration of economic growth. In the third quarter, gross value added in agriculture decreased by 23.8%. As expected in our earlier forecasts, severe droughts had a significant negative impact on the performance of the sector. The decline was even higher than that in the second quarter, when the contraction reached 10% on a year-on-year basis. On the other hand, construction boomed in 2007; this trend was reflected in the third quarter figures as well. In that period value added in construction jumped by 37.4%, the highest growth rate in recent years. Both residential and non-residential construction increased rapidly (by more than 30%) in the first ten months of the year. Gross value added in industry increased by a mere 5.6% during the first nine months, just below real GDP growth. Manufacturing production growth was slightly higher (6.8%) than industry average (5.8%) and the most vigorous sub-sectors were tobacco production (27%), manufacture of wood and wood products (20%) and manufacture of transport equipment (17%). Gross value added in services increased by 8%: higher sales of food and beverages fuelled retail trade, while motor vehicle sales and the activities of hotels and restaurants also contributed considerably to the growth of market services.

On the demand side, the main engines of the Romanian economy have not changed in the third quarter; however, a slight shift was observable (as already indicated in our previous forecast). Private consumption growth fell below 10% for the first time in the last one-and-half years. The deceleration of consumption growth had started in the third quarter of 2006: since then its growth rate decreased gradually from 15.5% to 8.7%. Still, rapidly growing wages and credit expansion will keep supporting private consumption. Public consumption growth also decelerated slightly: its growth rate was 4.3% in the third quarter.

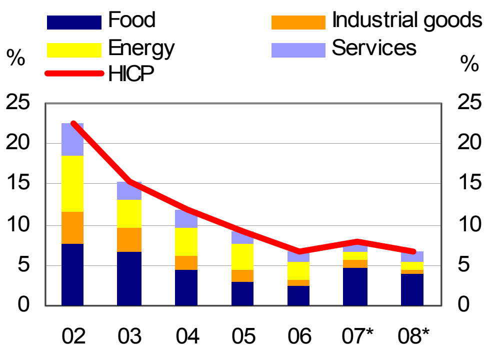
The other engine of the economy, investments strengthened. Gross fixed capital formation increased by a robust 32.2% in the third quarter of 2007. Investment in construction increased by almost 40%, but investment in equipment also rose by a sound 27%.

The significant negative contribution of net exports to GDP growth remained in the third quarter. While the export of goods and services increased by less than 2% in real terms, imports increased by 22.4% in the third quarter. In those months the depreciation of the leu had just started, so it may have had no significant impact on foreign trade. the positive impact of the depreciation on the export sector could materialise in the last quarter of 2007 and in early 2008.

In 2007 GDP growth could have reached 5.7%, 2 percentage points lower than in 2006. In line with our previous forecast third quarter growth was lower than the previous one and now we expect that fourth quarter growth remained at that level. In 2008 there are many risks and uncertainties surrounding our growth forecast. The main factors determining growth in 2008 are the impact of significant external imbalances on the currency, parliamentary elections in the second part of the year, the revival of agricultural output and external factors including oil and food prices. Taking all these uncertainties into account we expect that economic growth will remain fairly stable and should reach 5.5% in 2008.

Prices and monetary conditions

Components of inflation



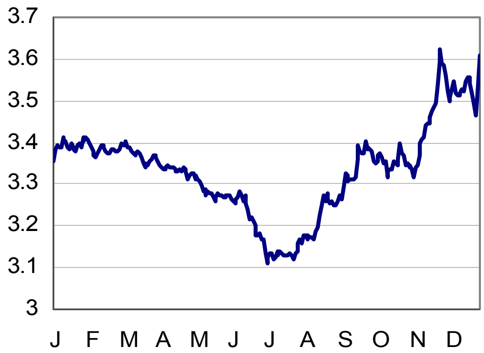
*Note: * forecast. Source: Eurostat*

During the last quarter of 2007 inflation remained relatively high. In the last three months the 12-month consumer price index exceeded 6% compared with less than 4% on average in the first half of 2007. Food price hikes brought about the jump of inflation. The increase of tobacco, fuel and transport prices also contributed negatively to the evolution of consumer prices. Accordingly, the harmonised index of consumer prices reached 4.9% in 2007, while the consumer price index was 4.8%.

Due to the significant worsening of external balance and partly due to the deterioration of investment sentiment, the leu depreciated significantly in the second half of 2007. While the RON/EUR exchange rate reached its nadir mid-2007 (at 3.11) it fell back to above 3.6 at the end of the year. In 2007 as a whole, the leu depreciated against the single European currency, although it was appreciating in the first half of the year.

The inflation target for December 2007 was missed. By October it became become obvious that the targeted inflation (4%±1 percentage point) was not achievable and the national bank (NBR) duly

Exchange rate fluctuations in 2007

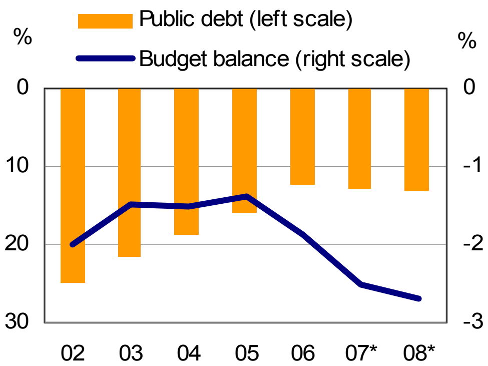


Source: National Bank of Romania

announced this. They then set expected inflation at 5.7% but this expectation also proved too optimistic. At the end of October 2007 the Board of the NBR increased its policy rate from 7% to 7.5%; at the beginning of January 2008, another 50 basis points rise followed. However, the inflation target for December 2008 (3.8%±1 percentage point) remained unchanged. Fast wage increase, rapid credit expansion and the upcoming elections are all potential inflationary factors. Besides, inflation is not expected to fall below 6% during the first half of 2008 due to base effects. The only opportunity of the NBR is to keep interest rates high to decrease demand side pressure on the economy. For 2008 we expect that annual average inflation will be 4.4%, only slightly lower than in 2007.

Fiscal policy

Key fiscal indicators (% of GDP)



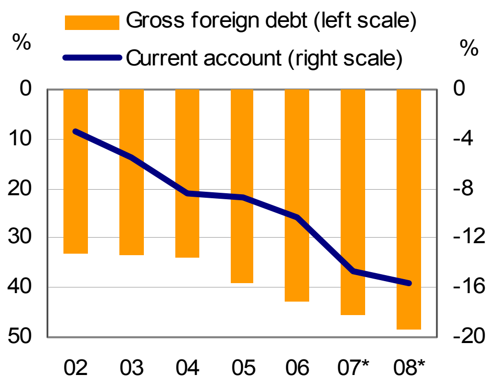
*Note: * forecast, reverse scale on left axis.*
Source: Eurostat

In the eleventh month of 2007 the consolidated government budget balance turned from surplus into deficit (from RON +450 mn to RON -4.4 bn). This deficit amounted to 1.1% of GDP; it could have increased further in December (as happened in 2006). Thus, the consolidated government deficit is expected to reach 2.4% of GDP in 2007 as a whole. This is slightly lower than the latest plan of the government (2.8%) and under the 3% threshold of the EU. The VAT contribution to the EU budget increased the burden of the budget but it has not caused serious problems; however, the deficit was noticeably higher than in 2006 (1.9%).

The government plans that the budget deficit will reach 2.7% of GDP in 2008; revenues and expenditures will grow by more than 20%. Pensions and health insurance expenditures are planned to increase by almost 12%. In our view the pension rise was the first step to loosen fiscal policy since legislative elections will be held in 2008 (the minimum wage was also increased). Social expenditures are expected to increase significantly this year in comparison with the previous one. Accordingly our forecast is that consolidated government deficit will go up to 2.8% of GDP in 2008.

External balance

External balance indicators (% of GDP)



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

The current account balance deteriorated further in the second half of the year. During the first ten months it reached EUR 13.3 bn; it nearly doubled in comparison with the same period of the previous year (EUR 7.8 bn).

The deterioration of the CA balance is basically due to the increasing foreign trade deficit, which grew by 62% or EUR 5.4 bn. While the growth rate of export of goods reached 13.2% in the first ten months, that of import was significantly higher, reaching 27.2% in euro terms. The latter was boosted by private consumption and investment growth as well as the appreciation of the currency.

Regarding the other components of the current account, the income balance deteriorated further (by 31.3%) while net transfers improved somewhat (by 17.3%) during the first ten months of 2007. The services balance remained basically unchanged.

Compared to 2006 foreign direct investment inflows diminished considerably. While in the first ten months of 2006 net FDI reached EUR 7.8 bn, it remained just under EUR 6 bn in the corresponding period of 2007.

In 2007 current account the deficit could have reached 14.7% of GDP, more than 4 percentage points higher than a year earlier. In 2008 we expect the continuation of current trends, although the pace of deterioration can slow down slightly: our expectation is that CA deficit will reach 15.7% of GDP in 2008.

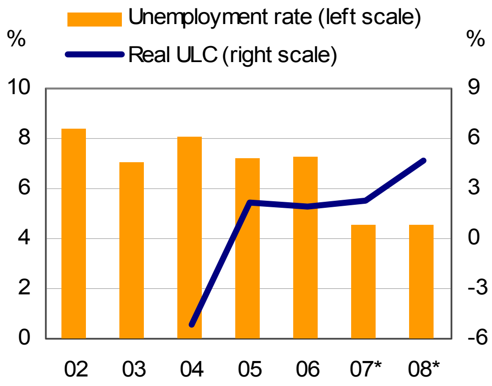
Labour market

The unemployment rate remained under 7% according to Labour Force Survey statistics in the third quarter of 2007, while the registered unemployment rate fell to 4.1%. However, the employment rate is still low (51%) in comparison with other EU member states.

Wages increased significantly in 2007: in the year to November 2007 gross average monthly earnings grew by 25% to RON 1522. At 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 by mid-2008.

In 2008 we expect that the strong growth of wages will continue due to the loosening fiscal and income policies in the run-up to the elections. The unemployment rate will remain at its current, relatively low level.

Labour market indicators



*Note: * forecast. Source: INSSE*

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (RON mn)	288,048	342,418	397,800	449,000
Real GDP growth (%)	4.2	7.7	5.6	5.5
Private consumption (%)	9.8	13.9	11.0	10.0
Public consumption (%)	8.5	2.5	6.0	7.0
Investments (GFCF, %)	12.5	16.1	25.0	22.0
Exports (%)	8.1	10.6	6.0	12.0
Imports (%)	16.6	22.8	22.5	20.0
Annual average inflation (%)	9.1	6.6	4.9	4.4
Money market rate (3-month BUBOR, %)	6.36	8.19	7.80*	7.00
Long-term interest rate (10-year gov't bond, %)	7.15	7.42	6.90	6.50
Exchange rate (RON / EUR, average)	3.62	3.53	3.34*	3.63
Exchange rate (RON / EUR, end of period)	3.68	3.13	3.61*	3.60
Budget balance / GDP (%)	-1.4	-1.9	-2.5	-2.7
Public debt / GDP (%)	15.8	12.4	12.7	13.0
Trade balance / GDP (goods and services, %)	-10.2	-12.1	-15.6	-16.9
Current account balance / GDP (%)	-8.6	-10.4	-14.7	-15.7
Gross foreign debt / GDP (%)	39.1	42.6	45.4	48.5
Unemployment (%)	7.2	7.3	6.9	6.5
Real ULC growth (%)	2.2	1.9	2.3	4.7

*Note: f = forecast except where marked with *. See methodological notes for definitions and details.*

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

Slovakia

GDP growth remained robust in the third quarter of 2007. Inflation is higher than previously expected by the national bank, mainly due to a higher than forecasted growth in food and energy prices. The budget deficit is expected to stay below the Maastricht criterion of 3% in 2007. Slovakia is still on track to be able to introduce the euro in 2009.

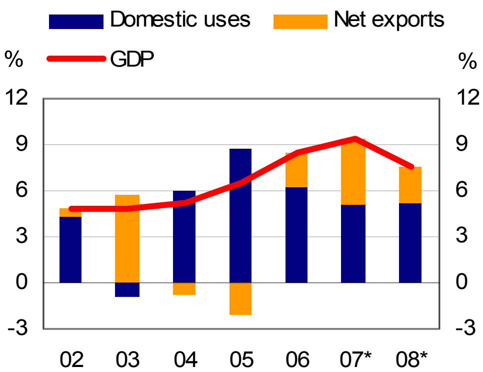
Political developments

Together with the parliamentary vote for the 2008 budget in December 2007, Prime Minister Robert Fico asked for a vote of confidence because of bitter debates among coalition partners. The government passed the vote of confidence, which strengthened Mr. Fico's position. The government is still committed to the 2009 euro adoption, although recently the opposition came up with a more cautious approach towards the euro zone entry.

Growth

After the high growth rates attained in the first half of 2007, robust GDP growth characterised the third quarter as well: a year-on-year rate of 9.4% indicates a renewed momentum. This rate is again the highest among the Central European countries and is on par with the rates recorded by the Baltic states. Changes in the composition of growth continued with net exports being the most significant contributing factor. The contribution of private consumption and gross fixed capital formation also remained substantial, which is mainly a result of the production of FDI-related (automotive and electronic) companies. These trends could have continued until the end of 2007, resulting in an estimated 9.4% GDP growth rate for the year as a whole. In 2008 similar developments are expected, with a shrinking contribution of net exports, and persistently strong private consumption and investments resulting in an above 7% growth rate.

Structure of growth



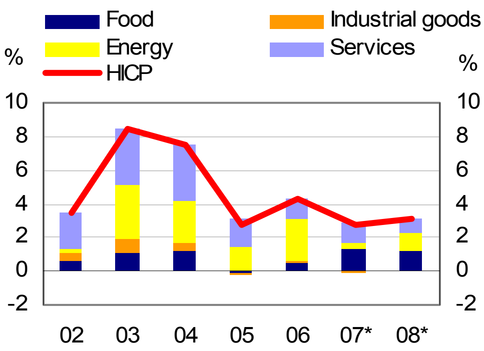
*Note: * forecast. Source: Eurostat*

As far as the value added of various sectors is concerned, industry, financial intermediation and real estates and public services recorded a double-digit growth rate in the third quarter of 2007. On the other hand, a significant decrease was observable in the added value of agriculture and construction. These developments are expected to continue this in 2008, although industry is expected to slow somewhat while agriculture and especially construction should recover.

Prices and monetary conditions

In the year to December 2007 the harmonised index of consumer prices increased by 2.5% according to the National Bank. Core inflation was even higher (2.8%), exceeding the expectations of the National Bank. These developments were mainly due to higher than forecasted increases in food, industrial and energy prices. On the other hand the inflation of services prices remained below the expected level. In January 2008 there was an increase of regulated prices for a wide range of utilities (electricity, gas, heating, public transport, waste collection). This, together with an increase in certain excise taxes (e.g. tobacco) can result in a higher inflation in 2008 than in 2007.

Components of inflation



*Note: * forecast. Source: Eurostat*

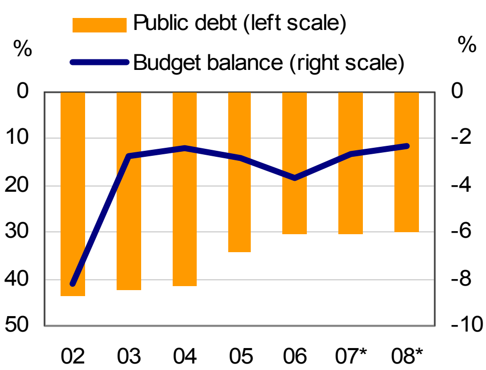
The central bank board decided not to change the two-week repo rate after April 2007, despite higher than expected inflation. The rationale behind the decision was the cost-push character of inflation, caused mainly by higher prices of (imported) food, dynamic GDP growth as well as the observed deceleration of wage growth which eases inflationary pressures. At present the rate stands at 4.25%. There has been some widening in the spread of Slovak bonds vis-á-vis the euro benchmark for long-term yields.

In the fourth quarter of 2007 the exchange rate remained relatively stable. As last year's base effect (summer depreciation) fades, the trend of year-on-year appreciation weakens in 2008.

Fiscal policy

The 2006 deficit target had to be modified upwards because of the accrual-based recording of taxes and social contributions and certain other changes in methodology (e.g. exclusion of concessions for Slovak Television and Slovak Radio from revenues). This resulted in a 3.7% budget deficit, 0.7 percentage points higher than originally announced for 2006. According to the new methodology, 2007 preliminary data indicate a 2.7% deficit, which is still in line with the Maastricht criterion.

Key fiscal indicators (% of GDP)



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

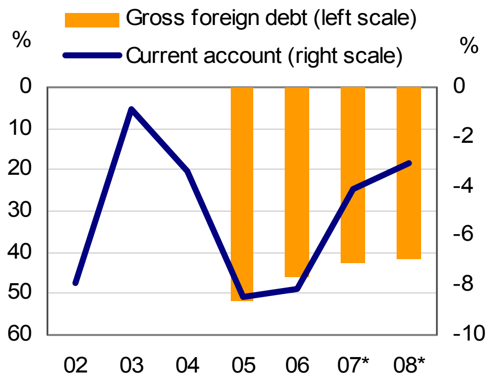
The 2007 budget seems to have reached a lower than planned deficit, due to strong economic growth which resulted in higher than planned tax revenues. Revenues were almost 4% higher than expected. On the other hand, EU transfers could not reach than planned amount; they were more than 10% less than originally expected. On the expenditure side, almost 1% was saved compared to the original plans in current expenditures. However, part of the savings was spent on capital expenditures, which surpassed the originally set limits by almost one third.

According to plans, the 2008 budget deficit would be 2.3% of GDP. Additional sums will be allocated to education, health care, R&D and agriculture. No significant tax changes are considered; the only item to change is VAT on books and medicaments (to be reduced from 19% to 10%). Slovakia has a formally set date, 2009 for the entry into the euro area. Last year's budget performance, with a deficit lower than the Maastricht criterion of 3%, is a step into that direction. However, due to methodological problems concerning the 2006 deficit, the ECB will monitor closely the fulfilment of this criterion in 2008.

External balance

In the year to November 2007, the export of goods rose by 9.9%, while imports increased by 8.3%. This lowered the trade deficit compared to the January-November period of 2006. The deceleration in the growth of both exports and imports during the course of last year is likely to continue into 2008. This also indicates that after the start of production and exporting of major FDI projects in the automotive sector (and to a smaller extent in the electronics sector), new, similarly large capacities have not been established in the Slovak Republic. This is also backed by the fact that in the first three quarters of 2007 there was a substantial (around 50%) decrease in FDI compared to the same period of 2006. FDI now mainly takes the form

External balance indicators (% of GDP)



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

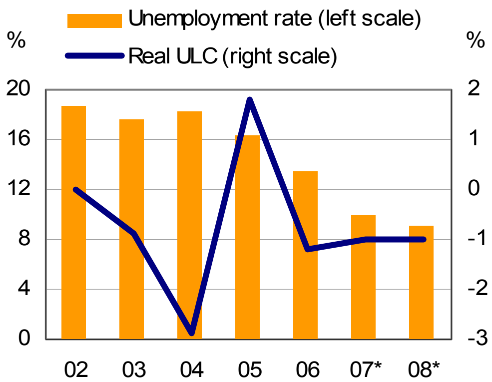
of reinvested earnings (around half of inward FDI during January-September 2007): there are less new (greenfield) investments and the emphasis shifts to capacity extensions.

Still, with a lower growth of imports compared to exports and with an increasing surplus on services trade, we expect an improving current account balance in the coming years: its deficit may narrow to around 3% of GDP.

The continued inflow of short-term investments consists mainly of deposits by non-residents on the accounts of Slovak banks, probably with the aim of speculation. This item compensated for the lower FDI and portfolio investments compared to the 2006.

Labour market

Labour market indicators



*Note: * forecast. Source: Eurostat*

Employment increased significantly during 2007, according to November data. The increase in the number of workers exceeded 10% in the sale and maintenance of motor vehicles, while there was also a significant rise in construction and a wide range of market services. Industrial employment also increased by 3%.

The registered unemployment rate continued to fall, to 7.8% at the end of November, while unemployment according to the Labour Force Survey stood at 11.2% at the end of the third quarter.

Real wages growth was around 8 % in the third quarter of 2007. Services sectors recorded the fastest rates, above 10 % on a year-on-year basis.

Unit labour costs are expected to continue to fall slightly in real terms, as strong productivity growth will continue to exceed increases in labour costs.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (SKK bn)	1,485.3	1,659.6	1,855.5	2,032.5
Real GDP growth (%)	6.6	8.5	9.4	7.6
Private consumption (%)	6.5	5.6	7.3	6.3
Public consumption (%)	3.5	10.1	0.8	2.2
Investments (GFCF, %)	17.6	8.4	6.8	7.0
Exports (%)	13.9	21.0	12.5	12.0
Imports (%)	16.1	17.7	8.0	10.0
Annual average inflation (%)	2.8	4.3	2.7*	3.2
Money market rate (3-month, %)	3.12	4.82	4.12*	3.80
Long-term interest rate (10-year gov't bond, %)	3.62	4.15	4.50	3.90
Exchange rate / EUR (average)	38.59	37.23	33.81*	33.58
Exchange rate / EUR (end of period)	37.88	33.64	33.58*	33.58
Budget balance / GDP (%)	-2.8	-3.7	-2.6	-2.3
Public debt / GDP (%)	34.2	30.4	30.2	29.8
Trade balance / GDP (goods and services, %)	-4.3	-4.3	-0.9	1.0
Current account balance / GDP (%)	-8.4	-8.2	-4.1	-3.1
Gross foreign debt / GDP (%)	51.7	46.2	42.8	41.5
Unemployment (%)	16.3	13.4	10.0	9.2
Real ULC growth (%)	-1.0	-2.0	-1.0	-1.0

*Note: f = forecast except where marked with *. See methodological notes for definitions and details.*

Sources: Eurostat, Slovak National Bank, Slovak Statistical Office

Slovenia

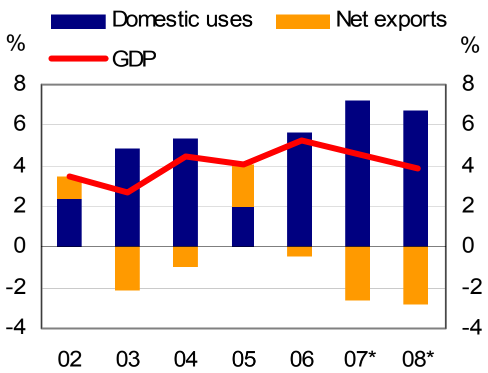
Slovenia holds the EU presidency in the first half of 2008. Economic slow-down continues, while inflation is on the rise and the trade balance started to worsen. Workers protested for higher real wage increase and the period of moderate income growth may hove come to an end.

Political developments

In November 2007, Danilo Türk, the candidate of the governing Social Democrats was elected President with 68% of the votes. Slovenia holds the rotating EU presidency in the first semester of 2008, which can be a good opportunity to draw more attention on the country.

Growth

Structure of growth



*Note: * forecast. Source: Eurostat*

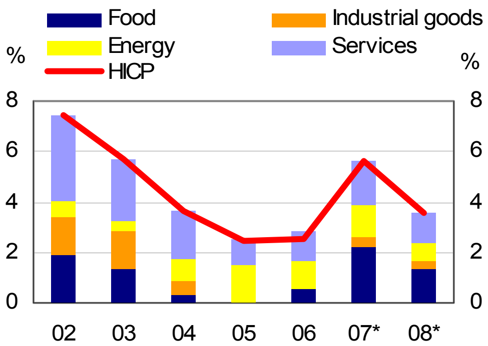
The economic slowdown continued in the fourth quarter of 2007 because of the global slowdown and the relatively strong euro. Cost competitiveness is waning as the relative wage is on the rise in comparison to Central and Eastern European trade partners. This is due to the appreciation of the single currency and the significant real wage growth.

In the third quarter of 2007 GDP increased by an annual 6.3%. But the impending slowdown implies that 2007 GDP could come down to 4.6%. Final consumption increased by 2.5% in the third quarter of 2007. The main driver of growth was gross fixed capital formation, which increased by 17.7%. Investment in buildings grew particularly fast, by 22.5%; on the other hand, investment in machinery and equipment rose by 10%. The estimated cost of floods and storms in2007 is estimated at EUR 200 mn, which shaves 0.3 percentage points off GDP growth, although approximately EUR 50 mn will be compensated from EU aid.

Our expectation for 2008 is a slowdown of growth. Public and private consumption will keep growing at a moderate pace while the gross fixed capital formation will slow down to around 12%. The contribution of net exports to growth will deteriorate.

Prices and monetary conditions

Components of inflation



*Note: * forecast. Source: Eurostat*

12-month inflation rose sharply in the fourth quarter of 2007. From the 3.5% of September it jumped to 5.2% in October. The peak was in November with 5.8%, while annual average inflation for 2007 is 5.6% (the euro zone average was 2.6%). The hike was caused by world market price shocks in the energy, oil and food sector. The impact of euro introduction on inflation is estimated at +0.3 percentage points.

To help curb inflation, the government adopted a plan of to moderate administered price increases in 2008 and 2009 at its last 2007 session. Structural problems in fiscal policy and the labour market made it difficult to counter external shocks in the absence of independent monetary policy, which signals that Slovenia was not completely ready for the single currency from a structural point of view.

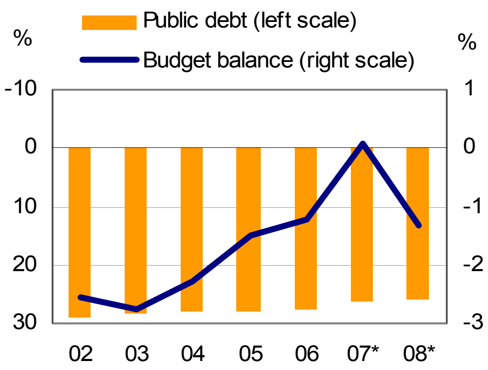
Our expectation for 2008 on inflation is that it can remain about 2 percentage points higher than the euro zone average, at around 3.6%.

Energy, food and services will contribute the most to inflation.

Rising domestic inflation turned real interest rates negative, encouraging borrowing in the private sector. Household savings decreased considerably in 2007 while around EUR 85 mn new loans were issued to households every month in 2007, half of which was spent on housing. Similarly, credit to enterprises grew very rapidly.

Fiscal policy

Key fiscal indicators (% of GDP)



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

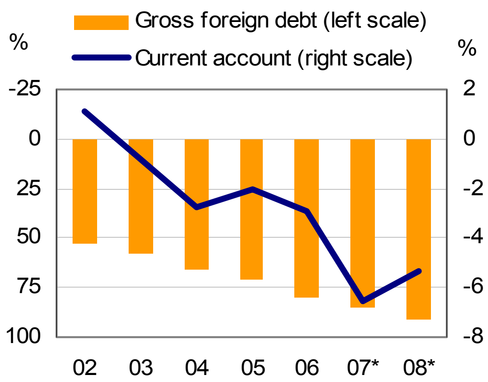
Source: Eurostat

The budget realised a thin, EUR 30 mn surplus in 2007. The tax reform is continued in 2008: since 1 January 2008 there are three personal income tax rates instead of five, and the corporate tax rate was slashed from 25% to 23%. Payroll taxes were reduced as well. Finally a number of tax exemptions were abolished. These decisions may encourage direct investment inflows and boost employment. However, the tax reform does not reduce significantly the tax burden, it only restructures revenues. Nevertheless, the 2008 budget calculated with a slight decrease in the size of the budget relative to GDP. Deviating from the national Stability Program on euro zone participation, the deficit target for 2008 was raised from 1% to 1.3%. This follows the prevailing political business cycle: there will be general elections in autumn 2008.

Slovenia will take on EUR 1.57 bn new debt for budget funding in 2008, but most of it, EUR 1.44 bn will be spent on the repayment of old liabilities. The government takes advantage of falling yields: in 2007 EUR 1 bn debt was replaced with more favourable financing. The debt to GDP ratio is decreasing gradually.

External balance

External balance indicators (% of GDP)



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

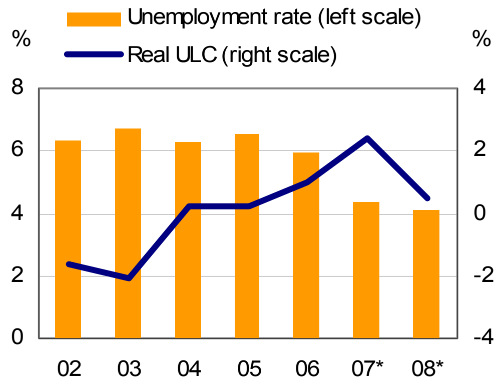
Source: Eurostat

The trade deficit increased in the fourth quarter of 2007, and this tendency will prevail in 2008. According to provisional data for the first eleven months of 2007, Slovenia's exports amounted to EUR 17.97 bn (a 16.5% increase compared to the same period of 2006), while imports amounted to EUR 19.69 bn (a 18% rise). The current account also deteriorated because of the rising trade deficit, as it could not be counterbalanced with the combined surplus on services trade, incomes and current transfers.

Net FDI inflows grew: outward FDI decelerated while inflows doubled in 2007 compared to 2006. In 2007 the estimated growth of gross external debt is 30%. Around one third of the EUR 3.5 bn increase took the shape of intercompany lending. This is related to the euro zone accession and is the source of the ongoing lending boom. Long-term debt (which constitutes 60% of total external debt) increased by 12% while short-term debt grew 23%. Long-term public debt increased by 40% as the government can increasingly turn to foreign sources of financing.

In 2008, we expect the current account deficit to narrow to 5.3%. Slovenian export positions will worsen towards the 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. Tax reforms may attract more FDI to the country but the build-up of foreign debt will continue.

Labour market indicators



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

Labour market

In the fourth quarter of 2007 the number of actives and employed increased slightly, while the unemployment rate decreased from 5.8% to 4.4%.

According to provisional data, labour costs per hour worked grew by an annual 5.0% in the third quarter of 2007. The pace of real wage growth is quickening (to 4.8%)and the trade unions are threatening with general strikes to achieve more pay rises. The more than a decade old social and political consensus that real wage increase should always remain below the real GDP growth, begins to break up. This can have consequences for relative wage competitiveness: we expect real unit labour costs to rise by over 2% in 2007 while a slight increase is anticipated for 2008 as well.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (EUR mn)	27 625	29 736	32 800	35 400
Real GDP growth (%)	4.0	5.2	4.6	3.9
Private consumption (%)	3.4	3.3	3.0	3.0
Public consumption (%)	2.2	3.8	2.9	3.2
Investments (GFCF, %)	1.5	11,9	16,5	12,2
Exports (%)	10,5	10,0	15,1	13,0
Imports (%)	7,0	10,4	18,3	15,7
Annual average inflation (%)	2,5	2,5	5,6	3,6
Money market rate (3-month, %)	4,00	3,67	4,67	4,50
Long-term interest rate (10-year gov't bond, %)	3,69	3,90	4.80	4.80
Exchange rate / EUR (average)+	239.60	239.60	NA	NA
Exchange rate / EUR (end of period)+	239.60	239.60	NA	NA
Budget balance / GDP (%)	-1,5	-1,2	0,1	-1,3
Public debt / GDP (%)	28,0	27,7	26,2	26,0
Trade balance / GDP (goods and services, %)	-0,6	-1,0	-3,6	0,0
Current account balance / GDP (%)	-2,0	-2,9	-6,6	-5,3
Gross foreign debt / GDP (%)	71,4	80.0	85,0	91,0
Unemployment (%)	6,5	6,0	4,4	4,1
Real ULC growth (%)	0.2	1.0	2.4	0.5

*Note: f = forecast except where marked with *. + SIT / EUR before January 2007. See methodological notes for definitions and details.*
Sources: Banka Slovenije, Eurostat, WIIW

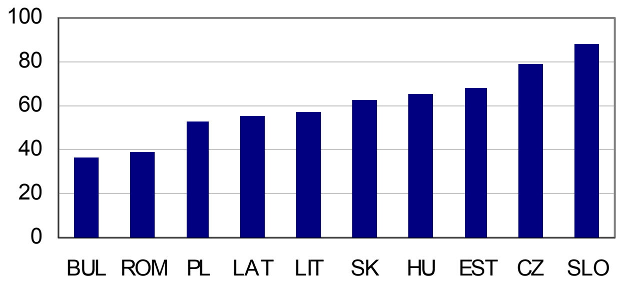
Special topic

Performance of the central and eastern European Member States in the 2005-07 cycle of the Lisbon strategy

The European Union has launched the Lisbon strategy in 2000 to boost its economy through improving competitiveness. The main experience of the first period (2000-2005) was the lack of effective coordination that can bring in line the efforts made on Member States level and on the Community level. On the basis of these experiences a new method of coordination was introduced in 2005. A cycle lasts three years: at the beginning of it all Member States and the Community prepare a reform programme, and at the end of each year implementation reports must be submitted. The Commission evaluates Member States' reform programmes and implementation reports. These then form the basis for recommendations for the countries for the following period. Fourteen selected structural indicators measure the performance of Member States. This kind of 'soft' policy coordination can promote the exploitation of opportunities offered by the huge European economy.

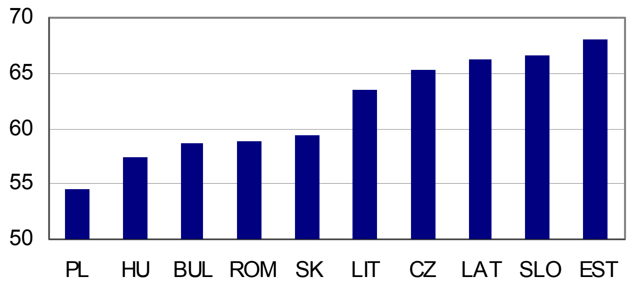
This essay carries out the comparative analysis of the evaluations of the ten new Member States in central and eastern Europe (CEE). We expect to draw conclusions on medium-term growth prospects that depend on the answers given to the challenges identified in the Commission evaluation report. The central message of the evaluation is the Commission's proposal for key areas where Member States need the most urgent actions. We first analyse the present state of the CEE Member States, then we deal with the country-specific recommendations, which highlight the main difficulties of the different countries. This overview is expected to describe a 'development map' of the region for the forthcoming years.

Chart 1 – GDP per capita in PPS (EU27 = 100)



Source: European Commission

Chart 2 – Employment rate (%)



Source: European Commission

The Lisbon strategy focuses on four priority areas since 2006: R&D, business environment, energy policy and employment. The balance and sustainability of macroeconomic processes are considered the most important pre-conditions of competitiveness. This pre-condition and the above-mentioned priorities are reflected in the recommendations as well. The country specific recommendations for CEEs can be divided in three groups:

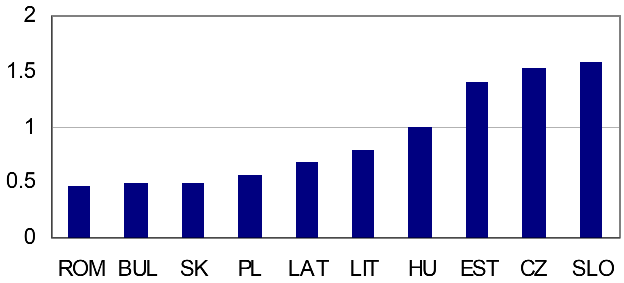
- Macro conditions (Restrictive fiscal policy, Sustainability)
- Priority areas related recommendations (R&D, Business environment, Network industries, Flexicurity)
- Administrative capacities.

Recommendations by areas of intervention

Estonia is the only CEE Member State without country-specific recommendations, and is thus the leader CEE economy in the pursuit of the Lisbon goals. Only the latest new members (Romania, Bulgaria) have received recommendations concerning administrative capacities. Fiscal policies require a more restrictive approach even on the short term in the case of Poland, Hungary, Latvia, Romania and Bulgaria. The sustainability of public finances is crucial for Hungary, Czech Republic and Slovenia (the pension system for all of them, health care for Hungary and Czech Republic, and public administration and education for Hungary). There are no macroeconomic recommendations for Slovakia, Estonia and Lithuania.

Three different microeconomic recommendations were addressed to the CEE Member States: in the area of R&D, better regulation and network industries. According to the Commission urgent action regarding R&D is necessary in Poland, Czech Republic, Slovakia, Latvia and Lithuania. It is instructive to confront these recommendations to the relevant structural indicator of individual countries.

Chart 3 – Gross domestic expenditure on R&D (% of GDP)



Source: European Commission.

Better regulation is a crucial area for Slovakia, Romania and Bulgaria. Besides the two new members, Slovakia is the only country with this kind of recommendation. The Commission calls for a comprehensive better regulation strategy and the simplification of the existing legislation in Slovakia. Regarding network industries only Poland has received a country-specific recommendation, the improvement of the competition framework, a review of the role of regulators and the vigorous continuation of the liberalisation of energy markets. In the field of employment all CEE Member States except Estonia received country-specific recommendations to further improve flexibility and security (flexicurity) in the labour market.

The recommendations do not contain all necessary steps; they focus on the most urgent ones. Through their examination different phases of development can be distinguished among the analysed countries. Bulgaria and Romania face different problems than the others, and in the next period they are expected to face the same challenges like those the others are confronting. In the macro area Hungary has the most serious problems: besides the urgent need of continuing restrictive fiscal policies, the sustainability of public finances in several sectors should be improved, too.

Recommendations by Member States

The next part analyses in details the performance of the CEE Member States. Table 1 measures the performance of every country as measured by its own National reform programme as well as by the four priority areas of the Commission.

Table 1. Progress of the CEE Member States in the Lisbon strategy

4 priority areas	Limited	Some	Good	Significant	Very good
Very good					
Significant					
Good					EST
Some		CZ, LAT	SLO, LIT		
Limited	PL, HU	SK			

National reform programme

Source: own chart using the evaluations of the European Commission.

Country Specific Recommendations (CSRs) for Poland:

1. Restrictive fiscal policy. 2. R&D. 3. Flexicurity. 4. Network industries.

The Commission evaluated Poland's progress as limited in implementing its National Reform Program as well as in the four priority areas. Poland has received country-specific recommendations in almost all areas that can be problematic in its own phase of development. The strenghts of Poland's progress are observable in the labour market, developing entrepreneurship and in the strong correlation of the reform program with EU funding. Besides the main areas collected in the country-specific recommendations, reforms are also needed in upgrading transport infrastructure, the speeding-up the business registration process, implementation of e-government programmes, improving the transposition of internal market legislation and increasing the provision of child care facilities.

CSRs for Hungary:

1. Restrictive fiscal policy. 2. Sustainability of public finances (Pensions, Healthcare, Public Administration (PA), Education). 3. Flexicurity.

Hungary's progress was evaluated as limited regarding both the National Reform Programme and the four priority areas. In all macroeconomic issues Hungary received recommendations, both for a restrictive fiscal policy and for the improvement of public finances in several sectors. Network industries are not mentioned as problematic areas; in the case of R&D progress is acknowledged although further steps are needed. Among the strengths of Hungary's progress are steps of fiscal consolidation, the adoption of structural reform steps (macroeconomic area), positive developments in the business environment and on the labour market (introduction of incentives to work, transformation of undeclared work into formal employment).

CSRs for the Czech Republic:

1. Sustainability of public finances (Pensions, Healthcare). 2. R&D. 3. Flexicurity.

The Czech Republic has shown some progress both in the case of the National Reform Program and in the four priority areas. Fiscal policies and network industries do not belong to the problematic areas. The main strengths are in business environment, in educational reforms and in steps to make work pay. There is a need for further improving business environment (e.g. intellectual property rights) and the labour market (e.g. disadvantaged groups, regional disparities).

CSRs for Slovakia:

1. R&D. 2. Flexicurity. 3. Better regulation.

Slovakia has shown some progress concerning the National Reform Programme, but the progress was only limited in the four priority areas. This reflects that Slovakia is changing to a new phase of development: after developing the primary conditions, it can concentrate on the main European priorities in the next period. Restrictive fiscal policy is underlined among the strenghts, important initial steps were also done in the structural policy. Slovakia has implemented also some crucial reforms in employment policy (e.g. revision of employment legislation). Beside microeconomic and labour policy reforms, competition in power supply is also mentioned among the proposed directions of further reform steps.

CSRs for Slovenia:
1. Sustainability of public finances (Pensions). 2. Flexicurity.

Slovenia received a 'good' evaluation for its National Reform Program, and some progress was identified in the four priority areas. The country develops on a good path, but several further steps are needed to answer challenges that are crucial for most European economies. Beside the 'usual' flexicurity recommendation only the sustainability of pensions is underlined. As a main strength the adoption of the euro is mentioned, but significant reforms in the micro area and in the labour market are also admitted, underlining the involvement of social partners in drafting all major reforms of the labour market. Areas where further reforms are needed include energy efficiency and environmental sustainability, demonstrating that Slovenia enters a new phase of development and can give the highest priority on the typical problems of the most developed economies.

CSRs for Estonia:
None

Estonia has shown the best performance among the analysed countries with very good progress in its National Reform Programme and good progress in the four priority areas. The Commission praised the R&D policy of Estonia, and the strong increase in the employment rate was also highlighted. The most important challenge for the country is the modernisation of its labour law.

CSRs for Latvia:
1. Restrictive fiscal policy. 2. R&D. 3. Flexicurity.

Some progress was identified in both the National Reform Programme and the four priority areas. Macroeconomic recommendations underline the need for restrictive fiscal policy, but problems with the sustainability of public finances do not emerge. Further improvements are need in R&D and flexicurity, but network industries are not mentioned among the crucial areas. The strengths include the increased role of the Competition Authority in market surveillance.

CSRs for Lithuania:
1. R&D. 2. Flexicurity.

Lithuania has not received recommendations in the macro field. Adoption of the Vocational Training Law is mentioned as a major achievement. The general evaluation of structural and employment policies is very similar to the Latvian case.

CSRs for Romania:
1. Restrictive fiscal policy. 2. Flexicurity. 3. Administrative capacities. 4. Better regulation.

CSRs for Bulgaria:

1. Restrictive fiscal policy. 2. Flexicurity. 3. Administrative capacities. 4. Better regulation.

In the newest Member States the evaluation refers only to the programme because this was their first year in the Lisbon strategy. Development of administrative capacities is mentioned among the recommendations only for them, underlining their special features in the CEE area. Other country-specific recommendations are also similar for these two Member States. The Romanian programme focuses on the right challenges according to the Commission. In Bulgaria the Commission praises the coordination and monitoring methods of the National Reform Programme.

Conclusions

The evaluations draw up a map of competitiveness of the eastern part of the European Union. Estonia shows the best performance, but its two Baltic neighbours also perform well. Latvia and Lithuania are invited to accelerate reforms in the area of R&D and flexicurity, while Latvia need to apply a more restrictive fiscal policy as well. Slovenia can be included in this leading group as well. In its case the sustainability of the pension system is identified as main challenge. All four economies in the leading group are small; the bigger countries need to implement further reforms to improve their competitiveness. They can be divided in two further groups: the Visegrad countries and the newest members. Among the Visegrad countries, the network industries are underlined for Poland, while macroeconomic conditions need to be improved in Poland, Czech Republic and Hungary. This latest problem is the gravest in Hungary. Slovakia has some problems that are typical in the case of the newest members (better regulation); following fast development the reforms should be extended to all areas of the economy. The Czech Republic is the best performer of this group. Romania and Bulgaria are in an earlier phase of development: they have to pay particular attention to the strengthening of the administrative capacities and the improvement of regulations.

- Márk Bató -

Methodological notes

Definitions of variables

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