ICEG EUROPEAN CENTER

Quarterly Forecast on the Western Balkans and Turkey

Summer 2007

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Company information

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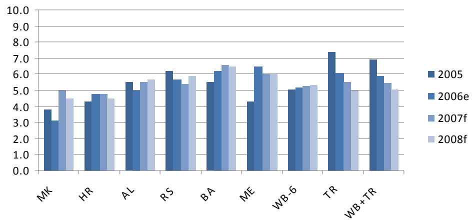
Regional overview

Western Balkans

The political climate remained tense but improves slightly in the Western Balkan countries during the first half of 2007. In the former Yugoslav Republic, the largest ethnic Albanian party ended the boycott of the Parliament and new governments started their work in Bosnia and Herzegovina and Serbia as well. Furthermore, forthcoming election will influence the political development of Croatia. Besides, European integration progressed in candidate and potential candidate countries.

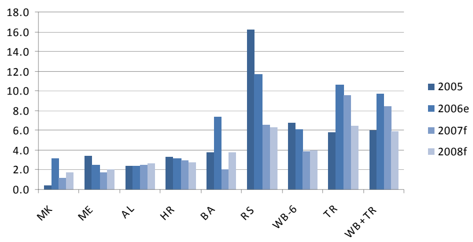
Real GDP growth (%)[1]



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

After a basically good year, economic growth accelerated further in most Western Balkan countries in this year. Real GDP growth reached 7% in Croatia, in the former Yugoslav Republic of Macedonia and in Serbia in the first quarter of 2007, while it was also significant in Montenegro (6.5%). The rapid economic growth was supported by high private consumption and investments, which reflects that domestic demand fuels most of these economies. On the other hand, net exports had a negative contribution to GDP growth except for the former Yugoslav Republic of Macedonia where trade balance improved significantly in the first few months of the year. However, export sectors' performance improved in these economies but the low level of exports compared to imports hindered its positive contribution to growth. For 2007 we expect that these tendencies will continue and the regional average growth rate will exceed 5% in 2007 and 2008 as well.

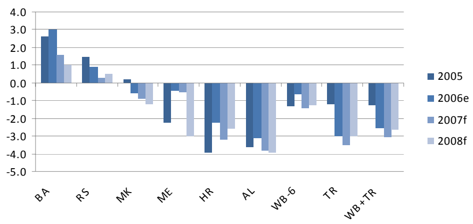
Inflation (%)



Source: national banks and statistics institutes

Regarding inflation, it will not cause problems in the region since inflation will be in the 1-3% range in five out of the six Western Balkan countries in 2007. Even the price increase of Serbia declined under 5% in that period. Inflation decreased in most countries in the region due mainly to the strong euro to which most currencies in the region are pegged, the favourable development of energy prices and due to base effects in some countries. It is also worth mentioning that credit expansion and significant wage increases characterised these economies which means that inflationary pressure may effect these economies later. In 2008 we expect that average inflation of the region will increase only slightly and will reach 4%.

Fiscal balance (% of GDP)



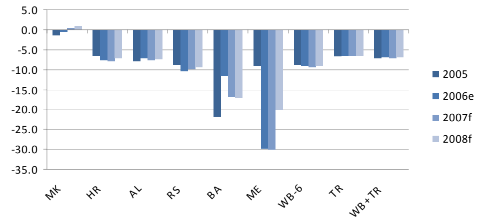
Fiscal balances had a surplus at the end of the first half of 2007 in most countries. The improvement of the budget balance and accordingly the realisation of surplus was due on the one hand to the rapid economic growth and therefore the higher than expected tax revenues and on the other hand to the poor expenditure planning. The latter means that public spending was lower than budgeted during the first months of the year, however, budget expenditures are expected to rise in the second half and accordingly budget balances will be worsen at the end of the year compared to

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

Source: national banks and statistics institutes

current situation. Besides, the fact that the applied exchange rate regime is currency board arrangement in many WB countries, it also determines a more restrictive fiscal policy for these economies. In 2007 we expect that budget deficit will exceed 3% of GDP only Croatia and Albania, while regional average deficit will be 1.4%.

Current account balance (% of GDP)

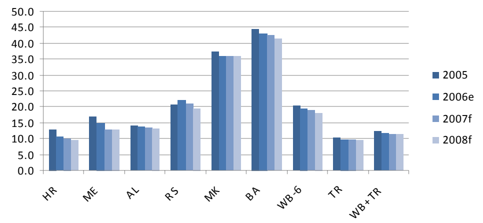


Source: national banks and statistics institutes

During the first months of 2007 current account balances continued to worsen in all WB countries except for the former Yugoslav Republic of Macedonia. In this country CA balance improved due to the significant development of export sector in the country. In all other WB countries CA balance deteriorated due to the widening trade deficits. Imports were boosted by massive domestic demand, namely private consumption and investments. Accordingly, we expect that regional average current account deficit will increase by 0.5 percentage point to 9.4% of GDP. The highest CA deficit is expected in Montenegro and Bosnia and Herzegovina. The CA balance has been deteriorated significantly in Montenegro since it was ‘only’ 9% of GDP in 2005. For 2008 we expect that CA deficits will diminish again.

Regarding foreign direct investments, one can observe that FDI is mainly influenced by privatisation since the privatisation of a few large companies have a significant impact on the evolution of FDI in small countries such as most WB economies. In Serbia this year seems to be a peak year in that respect while 2006 was such a year in the former Yugoslav Republic of Macedonia.

Unemployment (%)



Source: national banks and statistics institutes

Unemployment remained one of the most important macroeconomic challenges in the region. Average unemployment rate was close to 20% in 2006, and it exceeded 30% in Bosnia-Herzegovina and the FYR of Macedonia. Even if these are the official figures and real unemployment is expected to be lower due to significant level of informal sector, these figures are really high.

Due to the rapid economic growth in these countries unemployment will decrease in course of 2007. Regional average unemployment is expected to decrease to under 19% this year and close to 18% in the next year.

Turkey

The outlook for 2007 is good growth performance similar to the one observed in 2006. Real GDP is likely to grow somewhat below last years’ pace expanding by 5.5%, while the contribution of domestic and foreign demand is expected to shift further towards the latter one. Private and public consumption growth will moderate in 2007 while gross fixed capital formation may still rise with double digit pace. Private consumption is being driven by the increase in disposable incomes, while improving market conditions and investor sentiment as well as declining interest rates will sustain the investment rate.

In 2007 the disinflation is expected to continue with end year inflation of 7.8% and average CPI increase of 9.6%. Disinflation is driven by conservative fiscal and monetary policies, overall exchange rate developments, and the dampening effect of accumulation of inventories. The producer prices – contrary to most of 2005 and first half of 2006 – may remain below the CPI index. Turkey may expect faster disinflation in 2008 when the CPI may decline by the end of the year to 5% due to continued strict macroeconomic policies.

In the election year of 2007 public sector balances are affected by higher interest rates, higher public spending and a slowdown in privatisation receipts, which will not be balanced by the positive effect of the widening tax base and increasing efficiency of tax collection. Non-interest expenditures are seen to remain largely constant relative to GDP, while revenues may somewhat decline. The elections were to increase non-interest expenditures of the central government worsening the primary surplus and the general government deficit may increase to 3.5% of GDP.

The trend in the current account deficit is expected to improve in 2007 due to the weakening domestic demand, the robust growth in Turkey's main trading partners and the increase of receipts from tourism. However, the improvement may be weakened by the increase of oil prices and by slight expected real appreciation of the Turkish Lira, which may slow down the competitiveness gains of the producers in the tradable sector. Accordingly, we expect a current account deficit of 6.5% of the GDP.

The beneficial effects of fast GDP growth on labour market were also felt in unemployment, which declined from 10.7% in 2004 to 9.8% in 2006, the first year when it was below the threshold of 10 %. But the growth itself is unable to solve labour market problems stemming from the need to absorb Turkey's rapidly growing population as well as the effects of restructuring in the economy. In 2007 and 2008 1.3-1.4% increase in the employment rate may be expected, and unemployment will remain slightly below 10%, but will not decline considerably. In the short-term the positive effect of real GDP growth may prevail and unemployment is expected to decline in 2007 to 9.7% and to 9.6% in 2008.

Albania

Albania continues to perform strong GDP growth rate, along with low and controlled inflation. Following the first quarter's budget surplus, fiscal expenditures are expected to accelerate in the second half of the year. Political shuffle, deepening trade deficit, rapid credit growth and energy vulnerability remain among the major hazards. Concerning the official unemployment rate, the mild downward trend continues.

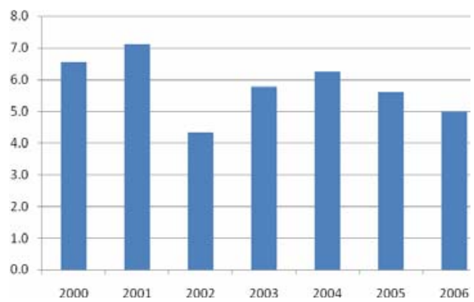
Political developments

Wrangle between the Democratic Party-led government and the oppositional Socialist Party causes tense political climate in Albania. There is a lack of consensus in the question of the presidential candidate and certain reforms, including e.g. the mandate of Attorney General, electoral changes, justice system, public administration.

The current Albanian President's - Alfred Moisiu's - term will expire on 24th July, but so far the parliamentary votes for a new president have failed. In case the further rounds will fail as well, the parliament is supposed to be disbanded and Albania would hold early elections. EU officials worn that the impasse may set back Albania's integration process.

Growth

Annual real GDP growth (%)



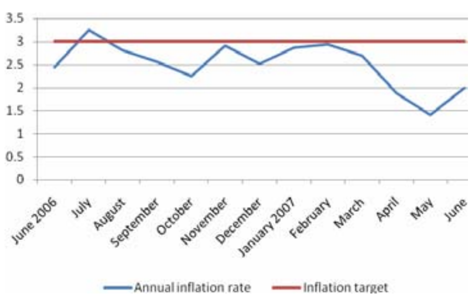
Source: INSTAT

Underpinned by the high lending pace, the growth of domestic demand is expected to remain at a high pace, providing the main driving force of the GDP growth. The construction and service sectors are the most significant segments. In 2006 the real GDP growth rate was 5%, and despite certain unfavourable factors, the real GDP growth rate is expected to reach more than 5.5% in 2007.

In the last quarter of 2006 and the first quarter of this year, the lack of domestic energy has been handled by the growth of energy import. Energy shortages eased since then. Beside the improvement of the energy system, structural reforms are needed in order to make growth more robust, to decrease vulnerabilities and to make weak public institutions more effective. This can be hindered by the recent tense political climate in the country.

Prices and monetary developments

Inflation rate and inflation target (%)



Source: INSTAT, Bank of Albania

Since January 2006, the Central Bank of Albania has an inflation objective of a point target of 3% with a tolerance zone of +/-1%. In 2006 the average annual inflation was 2.4%, while in the first half of 2007 the annual inflation rate fluctuated on average around 2.0-2.5%. Inflation is expected to remain under control for the rest of the year as well, and amount around 2.5%.

Still, it must be mentioned that certain developments cause inflation pressure. The rapid credit growth continued in the first half of 2007 as well, and is expected to amount between 20-25% of GDP by the end of the year, underpinning the increase of consumption and investment. Interest rates show the continuation of the downward trend, and the banking sector offers new lending forms. Around 75% of the credit is in foreign currency, thus limiting the efficiency of the central bank's instruments.

In the second half of the year, domestic borrowing, budget expenditures are expected to increase, underpinning the growth of domestic demand. In June 2007, the rapid money supply growth, external monetary developments, the high international raw material prices (especially concerning energy prices) affected the Supervisory Council's decision, in increasing the key interest rate by 0.25 percentage points to 5.75%.

In the second quarter of 2007 the exchange rate showed a slight appreciating trend, but was stable. In the first half of the year, the rate varied between 122-126 ALL/EUR. The rate has been affected by seasonal factors, the domestic and international market.

Fiscal policy

Fiscal expenditures and revenues per GDP (%)

	2005	2006 Plan	2007 Budget Proposal	2008 Projection
Total expenditures	27,76	29,65	30,57	30,74
Total revenues	24,40	25,56	25,80	26,76

Source: Ministry of Finance

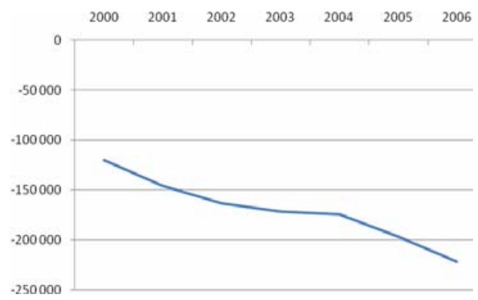
In the last quarter of 2006, public spending accelerated, but in the first two months of this year, fiscal balance resulted in a ALL 4.7 billion surplus, which may be a positive signal concerning the reduction of the interest payments on the public debt. The fiscal surplus of the first half of 2007 partly reflects the low degree of capital expenditure realisation. On the other hand, likewise in 2006, public spending will probably grow in the second half of the year, thus a higher than programmed budget deficit, amounting around the upper range of 3-4% is expected. Early elections may affect the level of public spending.

Net credit for the government is capped at 2.5 percent of GDP. Public debt is stagnating or is slightly declining, and is expected to slightly decrease further in the next year, but debt management remains poor. According to the authorities' commitment, half of the privatisation receipts will serve the decrease of the domestic debt. The Albanian telecommunication company – Albtelecom – is expected to be sold this year.

External balance

The imbalance of the external sector is caused by the deepening trade deficit. Foreign exchange continued to intensify, and in the first quarter of 2007, exports increased by 26%, while imports grew by 22%, compared to the same period a year ago. Still, due to the export's low base, it could not diminish the trade deficit. According to estimations, in the first quarter of 2007, trade deficit reached EUR 448 million, which was 21% higher than in the same period a year ago. In the first five months of 2007, the imports' coverage by exports was only around 27%.

Trade balance (ALL, mill)



Source: INSTAT

The growth of exports was a result of the favourable developments concerning Albania's main export products; namely minerals, textiles and footwear. Due to Albania's problematic energy situation, energy imports were high, beside the imports of machineries. Italy and Greece remained the main trading partners of Albania.

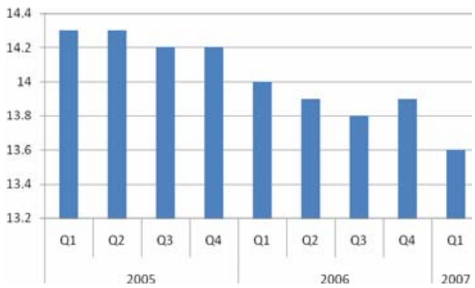
Underpinned by the expected growth of domestic demand, in 2007 the trade deficit and the current account deficit are expected to slightly widen further. Current account deficit per GDP rate is increasing year by year, and in 2007 it may exceed 7.5%. In the first quarter of 2007, the overall balance of payments reached EUR 14.5 million, and capital inflows covered 92% of the current deficit.

Remittances from abroad remain an important factor in compensating the trade deficit. In the first quarter of 2007, workers' remittances increased by 5%, compared to the same period a year ago and reached EUR 233 million. This amount financed 52% of the trade deficit of goods.

Though showing an increase of around 12%, FDI inflow remained at a low level in 2006 as well, and according to estimations it amounted to EUR 250 million. In the first quarter of 2007, FDI amounted to EUR 88 million, due to the capital inflows in the communication, processing and production industry.

Labour market

Official unemployment rate (%)



Source: INSTAT

Due to the large informal sector - particularly related to the agricultural and construction sector - it is hard to assess the exact rate of unemployment in Albania. According to the official data, the unemployment rate continued to decrease marginally, and by the end of 2006 it stood at 13.8%, while in the first quarter of 2007 it decreased to 13.6%. The data indicate that there was a slight shift from the public sector to the private non-agricultural sector. Around 70% of the unemployed are long-term unemployed. The mild downward trend concerning the unemployment rate is expected to continue in 2007.

By the end of 2006, the minimum wage was ALL 1 400, after the government increased it by 18.6% in the third quarter of 2006. In the same quarter, the average monthly wage of the public sector grew almost by 5% compared to the previous quarter.

Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
Nominal GDP (ALL mn)	837,000	896,000	979,000	1,075,000
Real GDP growth (%)	5.5	5.0	5.5	5.7
Private consumption (%)	NA	-	-	-
Public consumption (%)	NA	-	-	-
Investments (GFCF, %)	24.2	24.7	25.4	26.1
Exports (%)	12.0	13.0	14.0	14.0
Imports (%)	13.0	16.0	12.0	7.0
Annual average inflation (CPI, %)	2.4	2.4	2.5	2.7
Discount rate (end of period, %)	5.00	5.50	5.75	5.75
Money market rate (3-month Treasury Bill, %)	5.75	6.25	5.75	5.75
Long-term interest rate (10-year gov't bond, %)	NA	-	-	-
Exchange rate (ALL / EUR, average)	124.2	123.1	124.0	122.5
Exchange rate (ALL / EUR, end of period)	122.6	123.8	122.5	122.0
General government balance / GDP (%)	-3.6	-3.1	-3.8	-3.9
Public debt / GDP (%)	56.7	55.7	54.5	53.7
Trade balance / GDP (goods and services, %)	-23.5	-23.4	-23.4	-22.5
Current account balance / GDP (%)	-7.7	-7.2	-7.5	-7.3
Gross foreign debt / GDP (%)	21.4	22.0	22.0	21.5
Unemployment (%)	14.2	13.8	13.5	13.1
Real ULC growth (%)	NA	-	-	-

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

Sources: Bank of Albania, INSTAT, IMF

Bosnia and Herzegovina

Political climate remains tense, hindering structural reforms that are set as preconditions for successful negotiations with the EU on the SAA. Economic growth gained high momentum and real GDP growth rate is expected to exceed 6.5% in 2007. This year the inflation is expected to remain at a low level, reaching around 2%. Following the improvement of 2006, external imbalances are expected to significantly widen again this year. According to the official data, in 2006 fiscal surplus reached 3% of GDP, despite increasing expenditures. The immense unemployment rate remains a severe problem of the economy.

Political developments

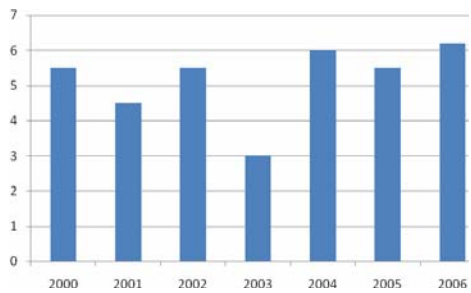
Though the government on all levels has been appointed after months of struggle, politics remain divisive, hindering structural reforms. Among many, the police reform, public broadcasting reform and full cooperation with the ICTY (International Criminal Tribunal for the former Yugoslavia) are stressed as preconditions for the successful continuation of the negotiations on the Stabilisation and Association Agreement (SAA) with the EU. Public administration reform is a precondition not only for signing the SAA, but even for the disbursement of EUR 4.5 million grants from the EC and the Dutch and Swedish governments.

The tense political climate was the main reason why the mandate of the Office of the High Representative (OHR) has been extended by an additional year. Since July 2007 a Slovak diplomat – Miroslav Lajcak – took over the post of High Representative (HR) and EU's Special Representative (EUSR).

Although Kosovo's final status is still unclear, the Serb entity's (Republika Srpska – RS) independence ambition may be fuelled by a decision on independence.

Growth

Real GDP growth (%)



Note: f = forecast; Source: CBBH

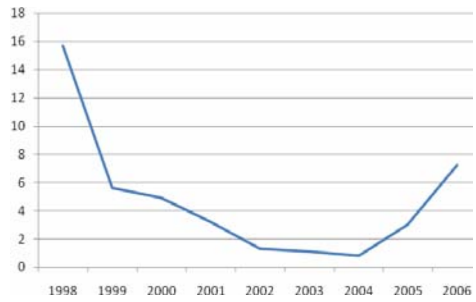
According to the central bank's estimation, the amount of GDP in 2006 was KM 17.9 billion, while including the grey economy the GDP reached KM 20.9 billion. Favourable international developments, the growth of exports and inflow of investments were among the factors that fostered economic growth. According to estimations, real GDP growth reached 6.2% in 2006. GDP growth was underpinned by significant annual industrial production growth, amounting to 7.5% in FBH (Federation of Bosnia and Herzegovina) and to 19.1% in RS.

Concerning the total gross value added in 2006, the growth trend of the shares of sectors of processing industry, wholesale and retail, real estate business continued, while the shares of agriculture, hunting and forestry, state administration, warehousing and communications represented a mild downward trend. The development of the processing industry was bolstered by new investments and the privatisation process.

In the first quarter of this year industrial output continued its rapid increase, reaching a growth rate of 10.7%, and retail sales grew by 24%. Likewise in 2006, in 2007 economic growth is expected to be underpinned e.g. by the high level of private consumption, retail sales and investment activity. Taking all these into account, in 2007 the GDP growth rate is expected to exceed 6.5%.

Prices and monetary developments

Consumer price index (yoy, avg, %)



Source: CBBH

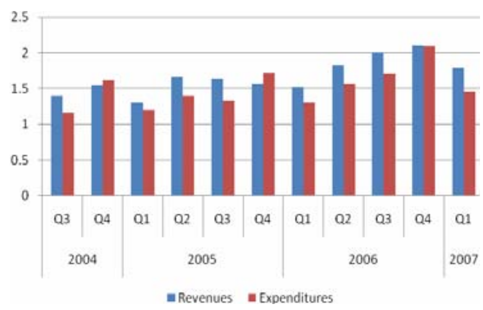
VAT introduction in January 2006 had a one-off effect on inflation, but from the second semester of the year CPI started to decline. Finally the annual growth of the retail price index in 2006 amounted to 7.4%. Due to the base effect of the VAT introduction, in the first five months of 2007 average retail price inflation was only 1.5%. Underpinned by the currency board regime, but affected by energy and regulatory prices, inflation is expected to remain at a low level in 2007, reaching around 2%.

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

The growth trend of foreign reserves continued, and in the first half of 2007 foreign reserves increased by KM 700 million, thus, by the end of the period it amounted to KM 6.04 billion, the highest level ever recorded.

Fiscal policy

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



Source: CBBH

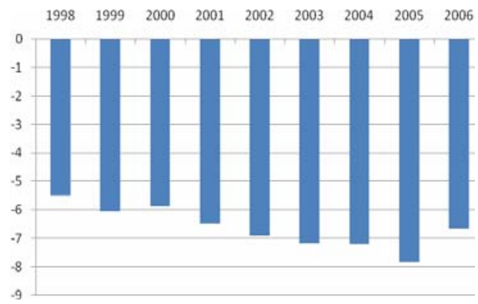
The introduction of the VAT at the beginning of 2006 resulted in higher-than-expected fiscal revenues, which supported to achieve certain surplus despite the accelerating expenditures. In 2007 the growth of expenditures may lead the budget close to balance. Solving the case of internal debt can cause further burden for the fiscal sector.

In 2006 total fiscal surplus at state level reached KM 557 million, or 3% of GDP. Current expenditures were around KM 7.45 billion, which was 19% higher that a year earlier. The highest growth of expenditures (76%) was performed by the state institutions, due to certain shift of authority from the entity level. In 2006 consolidated expenditures grew by 15% in FBH and by 21% in RS. In the same period consolidated income on state level was KM 8.43 billion or 21% higher than in last year. The budgets of FBH, RS and consolidated cantons reached significant surplus. The consolidated balance of municipalities in FBH reached surplus as well, while in RS the municipalities recorded certain deficit.

External balance

The VAT introduction, the favourable developments of the trading partners, the growth of metal prices (which can be considered as a key export product of Bosnia and Herzegovina), the development of the industry sector (including successful restructuring and privatisation of certain companies) were among the related factors that helped trade deficit to narrow significantly in 2006. Exports

Trade balance of goods (KM, billion)



Source: CBBH

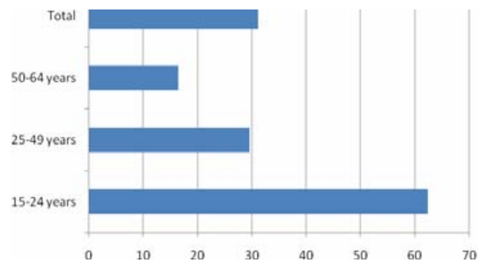
increased, while the level of imports retained compared to 2005. These developments contributed to the narrowing of the current account deficit as well. Moreover, the low international interest rates helped to finance the current account deficit.

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

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

Labour market

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



Source: Agency for Statistics of BH

Although data still remain unreliable, the Labour Force Survey (LFS) – first published in July 2006 – uses the methods and principles of the ILO, and therefore, gives a more credible picture on the issues concerning the labour market. According to the survey 1.5 million (56.9%) persons are inactive (including children below 15 years of age and people who did not give a direct answer), while approximately 1.2 million (43.1%) are active. The group of active is further divided into employed (811 thousand) and unemployed (366 thousand). This results in an employment rate of 29.7%, while unemployment rate stands at 31.1%.

On the other hand, according to the official data, unemployment rate was around 43% in 2006 and is expected to decrease only slightly this year. The large informal sector (its major component is supposed to be the agricultural sector) increases the unreliability of the figures. A realistic figure for the rate of unemployment is probably around 25%. All in all we can conclude that unemployment in BH is still one of the highest in the region and remains a severe problem.

Average net wage was KM 586 in 2006, representing 8.9% nominal or 1.4% real growth compared to 2005. As far as the entities are concerned, the real average net wage growth was 1.2% in FBH and 3.4% in RS, which shows a trend of decreasing differences.

Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
Nominal GDP (BAM mn)	15,800	17,900	19,600	21,600
Real GDP growth (%)	5.5	6.2	6.6	6.5
Private consumption (%)	NA	-	-	-
Public consumption (%)	NA	-	-	-
Investments (GFCF, %)	NA	-	-	-
Exports (%)	24.0	28.0	23.0	20.0
Imports (%)	13.6	4.4	25.5	21.0
Annual average inflation (CPI, %)	3.8	7.4	2.0	3.8
Policy rate (end of period, %)	-	-	-	-
Money market rate (3-month Treasury Bill, %)	NA	-	-	-
Long-term interest rate (10-year gov't bond, %)	NA	-	-	-
Exchange rate (BAM / EUR, average)	1.96	1.96	1.96	1.96
Exchange rate (BAM / EUR, end of period)	1.96	1.96	1.96	1.96
General government balance / GDP (%)	2.6	3.0	1.6	1.0
Public debt / GDP (%)	27.5	22.5	21.8	21.0
Trade balance / GDP (goods and services, %)	-44.1	-31.6	-36.6	-33.5
Current account balance / GDP (%)	-21.8	-11.5	-16.8	-17.0
Gross foreign debt / GDP (%)	57.9	57.0	58.5	59.6
Unemployment (%)	44.5	43.0	42.5	41.5
Real ULC growth (%)	NA	-	-	-

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

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

Croatia

The political stability stays under the pressure of parliamentary elections. However, it seems to have no effect on main direction of the EU integration process. The growth prospects are good; the contribution of private consumption is strong, while that of exports is poor. Main monetary processes are under control, however some reverse in price developments evolved. The fiscal adjustment is likely to be reversed temporarily.

Political developments

Presumably, the parliamentary elections in November could be the main determining factor of political process in the following months. It bears the risk of changing rhetoric causing race of promises that used to affect the sustainability of growth mainly through worsening budgetary positions. Accordingly, the EU Council emphasised the importance of a stronger fiscal consolidation, assessing the latest Croatian Pre-Accession Economic Programme.

The elections may threaten the already achieved results of integration process towards the European Union that strongly influenced the record of reforms, the privatisation process. The left-wing Social Democrats (SDP) without their deceased former leader, Ivica Racan and with the new president, Zoran Milanovic, and the right-wing Croatian Democratic Union (HDZ) with Ivo Sanader competing for the second term. The trophy is the right to lead the country and to determine final path into the EU. In addition, the risk of political deadlock exists, in the meaning of appearance of unstable and weak coalition.

With opening of six additional chapters and with progress in solving institutional crisis of the EU the accession negotiations will accelerate. Currently, twelve chapters are opened, while two are provisionally closed.

There is very poor progress concerning chapters of fisheries, judiciary and fundamental rights, and foreign, security and defence policy. Also further steps are needed in free movement of goods and capital, competition policy, public procurement, social policy and employment, environment. According to political analysts, the country is expected to join the EU in 2010.

Progress in EU-Croatia negotiations

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

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

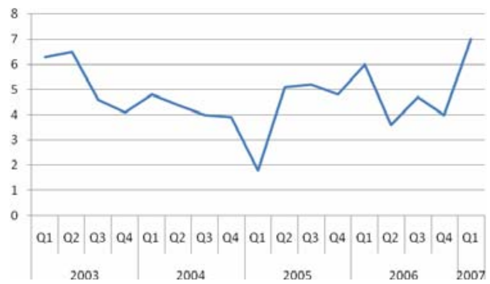
Growth

Based on the quarterly estimates, the real GDP in 2006 showed an increase of 4.8%, as compared to 2005. The Croatian growth performance of the first quarter in 2007 corresponds to general favourable conjuncture of EU, as it reached 7% year-on-year record high real GDP growth as compared to 6% of the same quarter in 2006.

This pace was achieved in the first quarter mainly through stronger domestic demand, especially driven by household consumption (7.1%) and gross fixed capital formation (11.2%). The contribution of foreign trade weakened, as exports of goods and services increased by 3.0% in line with 3.7% of imports. The government consumption increased by 2.8%.

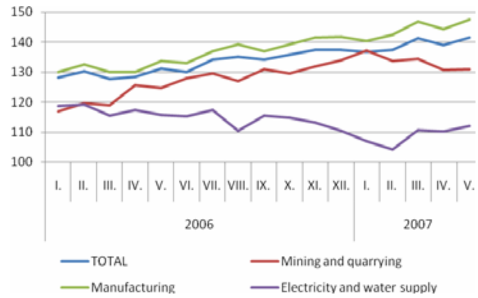
Thus, the domestic consumption has unambiguously stepped

Real GDP growth (quarterly, yoy, %)



Source: CROSTAT

Volume indices of industrial production (seasonally adjusted, monthly, 2000=100)



Source: CROSTAT

forward in line with our expectations on main factors of growth in 2007 and 2008 of our previous forecast.

As for industrial performance, the total industrial production was by 8.1% higher in the period from January to May 2007 than the production in the same period last year. Manufacturing performed well by 10.6%, similarly to mining and quarrying (10.3%). According to main industrial groupings (MIGs), production of intermediate and capital goods pulled the volume index.

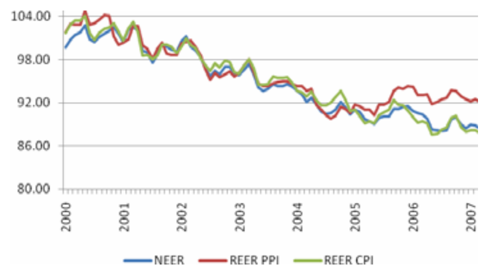
Construction, wholesale and retail trade, and financial intermediation activities contributed considerably to growth of gross value added in the first quarter of 2007.

Much depends on the tourist sector this year after relatively weak year in 2006. It is a question whether by success of internal tourism could be complemented by increasing external demand. Considerable improvement of foreign trade contribution is not expected until 2008.

Taking into consideration the expected developments of political processes and international favourable environment, we slightly upgraded our estimation to 4.8% in 2007 and 4.5% in 2008.

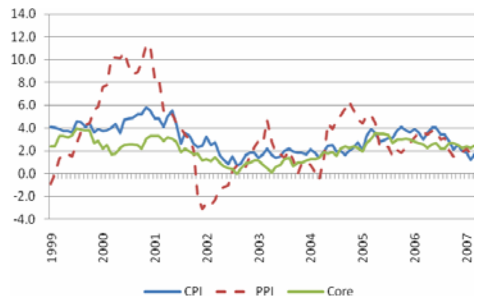
Prices and monetary developments

Monthly nominal effective and real effective exchange rates (2001=100)



Source: CNB

Monthly price developments (yoy, %)



Source: CNB

The Croatian national currency is stable despite of the slight volatility on money markets. It keeps its exchange rate against the EUR 7.30-7.40. Nevertheless in case of HRK/USD parity, there is a slight but steady appreciation have taken place during the recent periods. Accordingly, our forecast on continuously stable HRK/EUR and slightly appreciating HRK/USD ratio remained unchanged.

Croatia is operating under the conditions of price stability, as already in 2006, its annual average inflation was closed to 3% and it seems it is stabilised nearby. Having a look on the monthly year-on-year inflation statistics, some reverse in trends occurred, mainly under the pressure of higher GDP growth, driven by internal demand (private consumption). In May 2007, consumer price index (CPI) of goods and services for personal consumption increased by 2.2%, as compared to May 2006, driven mainly by services' prices. Monthly year-on-year CPI of food prices almost stagnated by 1.1% increase. On annual average CPI increased by 2.5% in May, thus the fact that in the second quarter prices were significantly higher than in the first one, was not able to hook the inflation's downward trend.

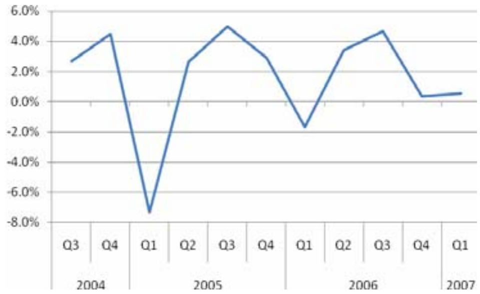
As for producer price index (PPI) increased by 2.3% (on the annual average by 2.1%) mainly pulled by intermediate goods and non-energy products. Manufactured products became relatively cheaper within the PPI basket with its 1.3% price increase.

The disinflation process is expected to continue, however, the already experienced and further expected wage developments could counteract, thus, annual average inflation may be close to 3% for both 2007 and 2008.

Fiscal policy

Fiscal policy reached progress in adjusting its public finances. 2006 was closed with 2.2% ESA 95 budget deficit parallel with decreased general government debt. The public finance performance was

Quarterly development of operating balance (% of GDP)



Source: Ministry of Finance, CROSTAT

promoted by the significant economic growth that can keep criteria below the Maastricht requirements. It is an important factor, even if Croatia is currently not an EU member.

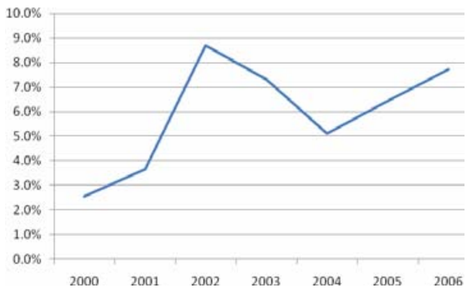
This favourable development was particularly reached by sharp adjustment in central government deficit. However, all segments of consolidated general government recorded a reduction of deficit, taking either extra-budgetary funds and agencies or local governments.

Significant progress occurred towards better collection of taxes (VAT and excise duties), control of government spending (in terms of below the revenue growth spending growth) and process of expense execution. This led to the improvement of operating balance.

It is expected that (mainly as the result of elections) Croatia will not be able to continue its adjustment efforts, despite of the favourable growth performance and the pressure of the EU calling for further efforts based on the evaluation of Pre-Accession Economic Programme. Accordingly, a 3.2% of deficit expected in 2007 and the adjustment will continue only in 2008. The performance of general government debt will depend particularly on developments of the budget deficit.

External balance

Current account deficit (% of GDP)



Source: CNB

After the sharp increase of current account deficit in 2006 to 7.7% of GDP, according to the recent estimates on this indicator, the gap widened to 8% of GDP in March 2007. This was particularly due to further increase of trade deficit that was only partially offset by growing surplus of services and decreasing deficit of income balance. Parallel net FDI exceeded 9%, reflecting sustainable financing. FDI was mainly realised through privatization process, but reinvested earnings are getting more important.

In case of balance indicators, further worsening is expected mainly determined by private consumption driven growth supplied with imports. As the service balance will improve and be able to moderate the effect of merchandise trade deficit on current account.

The level of external debt remains the main challenging factor of Croatian economy. It reached EUR 29 600 million at the end of first quarter in 2007. It is expected to grow further, however in a more moderate pace.

Regarding our expectations, current account deficit will be 7.8% in 2007 and will decrease only in 2008. The trade balance of goods and services will be 8.0% this year. Due to decreasing domestic demand and stronger merchandise export and tourism sector performance, it will fell to 7.3% in 2008. The CEFTA membership seems to be favourable development in case of international transactions.

Labour market

The number of employed persons increased by 1.4% in May 2007 as compared with the same period of the previous year and amounted to 1 178 679. Still the construction and the wholesale and retail trade are the main drivers of growth, while employment in manufacturing remained unchanged. Nevertheless, activity and employment rates are still low bearing significant potential for further improvement.

Main labour force indicators

LFS	I–VI 2005	VII–XII 2005	I–VI 2006	VII–XII 2006
Activity	49,9	49,2	48,3	49,8
Employment	43,3	43,2	42,6	44,5
Unemployment	13,1	12,3	11,8	10,5

Source: CROSTAT, Labour Force Survey

Note: end of period data; Source: CROSTAT

Concerning unemployment, unemployed persons to total active population reached 15.1% in May 2007 that is remarkable improvement from the 16.7% of May 2006. According to the latest labour force surveys, in the second half of 2006 unemployment slipped to 10.5% as compared to 12.7% for the same period of 2005.

Wages continued to grow over the productivity rates leading to increasing unit labour costs. Average monthly gross earnings increased nominally by 6.8%, in real terms by 4.4% in April year-on-year. Especially real wage dynamics are notable if comparing with previous years.

The economic performance and the possible good prospects of manufacturing, construction and tourism sectors, the current trend of increasing employment and decreasing unemployment is kept, however in a more moderate pace resulting rates 10% for 2007 and 9.6% for 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (HRK mn)	231,349	250,590	271,000	289,000
Real GDP growth (%)	4.3	4.8	4.8	4.5
Private consumption (%)	3.4	3.5	5.1	3,5
Public consumption (%)	0.8	2.2	3.0	1,2
Investments (GFCF, %)	4.8	10.9	7.1	7,4
Exports (%)	4.6	6.9	5.2	5,6
Imports (%)	3.5	7.3	6.1	5,1
Annual average inflation (%)	3.3	3.2	3.0	2.8
Policy rate (discount rate, %)	4.50	4.50	4.50	4.50
Short terms (3-month T-bill, %)	3.70	3.00	3,10	2,80
Long-term interest rate (10-year gov't bond, %)	4.3	4.4	4.25	4.35
Exchange rate / EUR (average)	7.40	7.32	7.28	7.20
Exchange rate / EUR (end of period)	7.37	7.34	7.30	7.19
Budget balance / GDP (%)	-3.9	-2.2	-3.2	-2.6
Public debt / GDP (%)	44.2	42.1	41.8	41.2
Trade balance / GDP (goods and services, %)	-7.1	-7.8	-8.0	-7.3
Current account balance / GDP (%)	-6.5	-7.6	-7.8	-7.2
Gross foreign debt / GDP (%)	82.5	84.6	85.2	85.5
Unemployment (%)	13.0	10.5	10.0	9.6
Real ULC growth (%)	NA	0.1	1	0.4

Note: f = forecast.

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

Former Yugoslav Republic of Macedonia

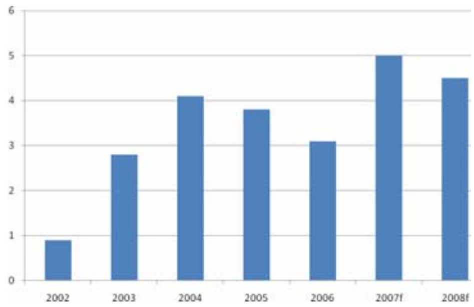
Economic growth in the first quarter reached record level, while external balance improved further. Price stability remains and fiscal balance reached a significant surplus during the first half of the year. Only labour market figures show bad picture but the overall macroeconomic situation of the former Yugoslav Republic of Macedonia is improving in this year.

Political developments

At the end of May the largest ethnic Albanian party, the Democratic Union for Integration (DUI) returned to the Parliament after a five-month boycott. The deal between DUI and the prime minister includes dialogue to reach consensus in such important topics as Euro-Atlantic integration. Accordingly, political climate improved slightly but the agreement seems weak.

Growth

Real GDP growth (%)



Note: f = forecast; Source: SSO

According to the State Statistical Office of the Republic of Macedonia, the estimated increase of gross domestic product in the first quarter of 2007 reached 7%. That GDP growth was the highest in the last 17 years.

On the production side, the highest growth was observable in case of industry, the value added in industry increased by 11.6%. The growth rate was remarkable in services sector (6%) and construction (5.8%) as well, while gross value added in agriculture increased by only 3.5% in the first quarter in comparison with the corresponding period of the previous year. Within services sector, the highest growth was achieved by imputed banking sector (12.5%) and transport, storage and communication (11.1%).

Regarding industrial production, both mining and quarrying and manufacturing performed well during the first five months. Industrial production of these two sub-sectors increased by 15.1% and 9.0% respectively. The overall increase of industrial production reached 6.3% in that period.

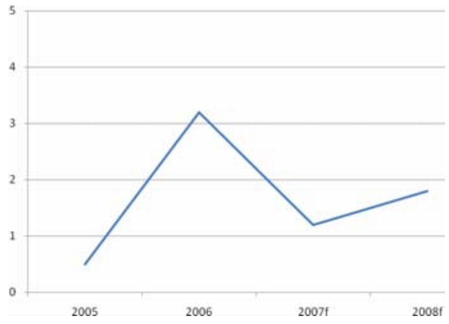
Regarding the expenditure side, SSO published only nominal growth rates for the first quarter of 2007. According to these preliminary data, government consumption and investment in machinery and equipments increased by 6.7% and 10.1% respectively and nominally. Besides that, as we expected it in our previous report, net exports had a positive contribution to GDP growth since the growth rate of exports reached 37.7% while that of imports was ‘only’ 21.2%.

Due to the higher than expect GDP estimation that SSO published recently we increased our forecast on GDP growth in 2007. We expect that gross domestic product growth will accelerate to 5.0% in this year, and we also revised our previous forecast on the next year as well.

Prices and monetary developments

In the first half of 2007 average inflation remained under 1% in the former Yugoslav Republic of Macedonia. Although inflation was not high in last year (3.2%), it declined to an even lower level in course of this year. Notable price increases were observable only in cases

Annual average inflation (CPI, %)



Note: f = forecast; Source: SSO

of services for dwellings (such as sewage collection) and energy prices (electricity, gas, heating). Besides, it is also worth mentioning that excise duties increased significantly in last year which resulted in a high base for 2007 inflation.

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

In 2007 inflation is expected to remain at the current low level, accordingly price stability will characterise the country in this year. The annual average inflation is expected to be 1.2% and it will remain on that level in 2008 as well.

Fiscal policy

Development of budget revenues and expenditures 2007 (mn MKD)

	Jan-May 2007	Budget 2007	%
Revenues	45 053	108 635	41.74
Expenditures	40 787	122 028	36.41
Balance	4 266	-3 393	-

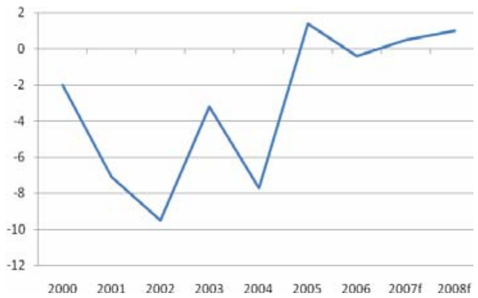
Source: Ministry of Finance

As it was mentioned in our previous report, from the beginning of 2007 profit tax rate was reduced from 15% to 12%, while personal income tax rate was set at 12% as well, consequently the former 15%, 18% and 24% rates were eliminated. Despite of the tax rate cuts tax revenues developed well during the first five months of the year. While personal income tax revenues decreased by only 4.2% in that period, profit tax revenues increased by 24.9%. Besides, VAT revenues, which accounted for 28.3% of budget revenues, increased by 20.2%. The development of tax revenues was supported by the high growth the country reached in the first quarter of the year. Accordingly, total budget revenues increased by 9.7% during the first five months of 2007. On the other hand, the budget expenditures increased by only 2.3% and several headings even decreased such as wages and allowances, expenditure on gods and services or capital expenditures. Therefore, budget had a surplus of MKD 4.3 billion or 1.3% of GDP. The planned deficit for 2007 is MKD 3.4 billion or 1.1% of GDP, however we expect that budget deficit could reach lower per GDP ratio due to higher than planned revenues.

In line with the positive development of fiscal balance, the evolution of the public debt was also favourable. The country has cleared fully the debt owed to the IMF recently and made an early repayment of 21% of World Bank credit in June 2007 as well. At the end of this year we expect that public debt will decrease to 37.5% of GDP.

External balance

Evolution of current account balance (% of GDP)



Note: f = forecast; Source: SSO, NBRM

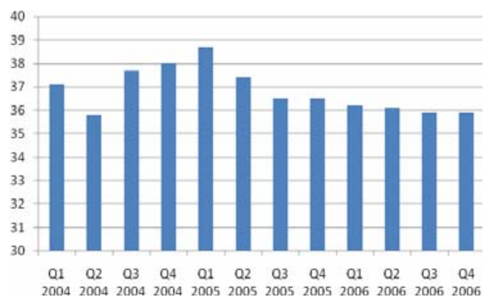
During the first four months of 2007 current account balance continued to improve. At the end of April CA had a surplus of EUR 41.3 million, while it had a deficit of EUR 68.4 million at the same time in the previous year. The realised surplus of the CA balance was basically due to the significant improvement of trade balance and current transfers. Regarding trade balance, the export of goods increased by 41.7% in euro terms, while that of import increased by 'only' 19%. Accordingly, the trade deficit diminished from EUR 327.6 million to EUR 272.5 million. This improvement of export reflects that the export-oriented production played a significant role in the high growth of industry mentioned above. Besides, the surplus of current transfers also increased by 19.7%, while services and income balances remained basically unchanged. Therefore, the surplus of the current account reached 0.8% of GDP.

Regarding foreign direct investments, after a peak in last year the amount of foreign direct investments dropped back to its average in the first few months of 2007. Between January and April 2007 net FDI reached EUR 47.8 million, while it was EUR 284.1 million in the same period of the corresponding year. However, the latter figure included the privatisation revenue of ESM, the Macedonian energy distribution company.

For 2007 we expect that the improvement of the current account balance will continue due mainly to the narrowing trade deficit, while foreign direct investments will be lower than that in the last year. Accordingly, current account balance will reach a surplus of 0.5% of GDP according to our forecast. In 2008 these tendencies are expected to continue.

Labour market

Unemployment (%)



Source: SSO

In the last quarter of 2006 unemployment rate decreased to 35.9%, while the number of employed persons increased by 4.1%. It means that employment increased by almost 23 thousand workers in the fourth quarter of 2006 in comparison with the corresponding period of the previous year. Owing to the positive development employment rate increased to 35.7%. Not only employment rate improved but also wages increased significantly in 2006. During last year nominal wages increased by 8.0%, while wages increased by 2.7% in the previous year.

For 2007 we expect that labour market figures will improve slightly. Tax cuts may have a whitening effect on labour market as well and inflowing foreign investments may also have a positive impact on employment. In 2008 unemployment rate will fall under 36.0% according to our forecast.

Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
Nominal GDP (MKD mn)	284,226	303,000	322,000	342,000
Real GDP growth (%)	3.8	3.1	5.0	4.5
Private consumption (%)	NA	-	-	-
Public consumption (%)	NA	-	-	-
Investments (GFCF, %)	NA	-	-	-
Exports (%)	NA	-	-	-
Imports (%)	NA	-	-	-
Annual average inflation (CPI, %)	0.5	3.2	1.2	1.8
Discount rate (end of period, %)	6.5	6.5	6.5	6.5
Money market rate (3-month Treasury Bill, %)	NA	6.3	6.4	6.1
Long-term interest rate (10-year gov't bond, %)	NA	-	-	-
Exchange rate (MKD / EUR, average)	61.3	61.2	61.1	61.0
Exchange rate (MKD / EUR, end of period)	61.2	61.2	60.9	61.0
General government balance / GDP (%)	0.2	-0.6	-0.9	-1.2
Public debt / GDP (%)	44.2	39.0	37.5	36.0
Trade balance / GDP (goods and services, %)	-19.0	-20.6	-15.9	-14.5
Current account balance / GDP (%)	-1.3	-0.4	0.5	1.0
Gross foreign debt / GDP (%)	39.5	39.2	38.5	38.5
Unemployment (%)	37.3	36.0	36.0	35.8
Real ULC growth (%)	-15.1	10.0	6.0	4.0

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

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

Montenegro

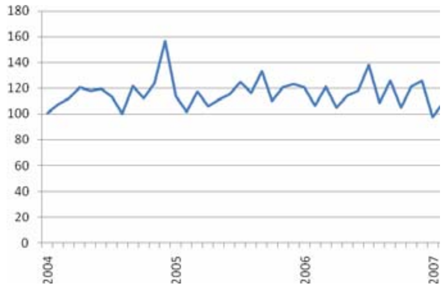
Montenegro was successful in political and economic development after one year independence. Strong growth performance, good outlook in investments especially in tourism. On the other hand the current account deficit is very high. Special focus need to be placed on fight against corruption, organized crime and illegal trade.

Political developments

The independent Montenegro celebrated its first birthday in June and the young state seems to be successful in political and economic development, especially in the field of foreign relations. Montenegro has joined the United Nations, the World Bank and the IMF, and initialled an agreement with the European Union. It has taken the first steps towards joining NATO. According to political analysts a year following restoration of its independence, Montenegro could set the example to the region. Public discussion on a new constitution has just concluded. Since either a two-thirds majority in parliament or a referendum is needed to replace the present constitution, more horse-trading is in prospect in the future.

Growth

Industrial production (2000 =100)



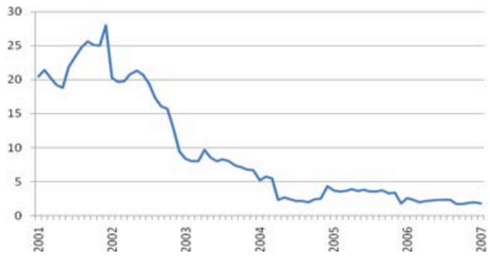
Source: MONSTAT

Real GDP growth reached 6.5% in 2006, much of it driven by tourism, construction and services. Infrastructure is cracking at the seams, but roads are being resurfaced. (National accounts for the first quarter of 2007 are not available yet.) According to preliminary data, the volume of industrial production recorded an annual growth of 1.6% in May. Industrial production in the first quarter of 2007 recorded a decrease of 5.3% in comparison with the same period of the previous year. Only manufacturing industry recorded an output increase of 8%, whereas the mining and quarrying and the production of electricity declined by 10.4% and 28.8% respectively. Construction continued to reach record high growth rate. The construction volume in the first quarter shows a 31.6% increase year-on-year.

Tourism plays a major role in the economy of Montenegro. Close to 30 thousand foreign tourists visited Montenegro in April, which was more than twice of the number of arrivals in the same month in 2006. In the structure of tourists, foreign tourists accounted for the main share, more than 70%t of all visitors arrived from abroad.

Prices and monetary developments

Retail price index (%)



Source: MONSTAT

The annual growth of retail prices amounted to 2% in May. Because of the declining trend of the retail prices, we revised our inflation prognosis and decreased to 1.8% for 2007 and 2% for 2008.

Total turnover on the Montenegrin stock exchanges (Nex Montenegro Stock Exchange, Montenegroberza Stock Exchange), and the exchange indices recorded significant increase. The value of the MSE index, MOSTE, on which are traded MSE 35 most liquid companies is 4 times higher than in the corresponding period of the previous year. The dynamic expansion of the capital market may be unsustainable in the rest of the year.

Fiscal policy

Budget revenues and expenditures (mn EUR)

	Jan – May 2007	Plan for 2007
Revenues	269.9	616.9
Expenditure	198.7	616.9

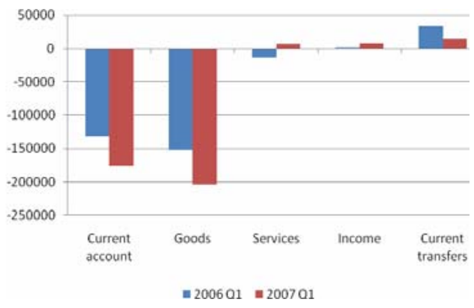
Source: Ministry of Finance, Montenegro

The first months of 2007 elapsed with total fulfilment of the goals of the fiscal policy. Due to the development of revenues significant surplus has been realised. Realisation of receipts of the Budget of Montenegro for the first five months of 2007 was by 30% higher than that of the same period of last year. The highest growth in tax revenues was realised by property and corporate tax. According to the latest figures we revised our prognosis and we expect the deficit will be 0.5% of GDP by the end of the year, and 3% in 2008.

Public debt of the Republic of Montenegro without public enterprises amounted to 795,5 million euro in the first quarter of 2007. Foreign debt reached 64% of total public debt, which reached 47.6% of GDP. It was significantly larger than that at the end of the last year (38,3%). Regarding foreign debt in the previous quarter main changes refer to new withdrawal form arrangement with Poland and Hungary within a project for regional water supply. Public debt is expected to reach 40% of GDP in 2007, and we do not expect that the debt will decline in 2008.

External balance

Components of current account balance (mn EUR)



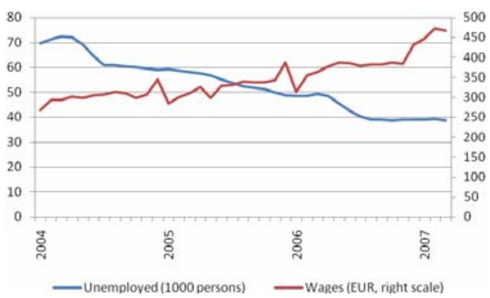
Source: Central Bank of Montenegro

According to the balance of payments statistics for the first quarter of 2007, current account deficit reached EUR 175,8 million. Regarding as a percentage of GDP, the current account deficit climbed to a record high level (40.5% of GDP). This bad figure shows the (external) vulnerability of the Montenegrin economy.

The deteriorating current account balance is mainly due to surging import growth, rising by 31.2% year-on-year in the first quarter of 2007, which was fuelled by soaring private consumption and investment. According to the latest figures, we forecast that the deficit will increase till the end of the year. We believe that this level of deficit is unsustainable in the long-term, even though ongoing strong FDI inflows are likely to continue financing the gap in the rest of 2007. The current account deficit could reach 30% of GDP in 2007 and the deficit is expected to decline in 2008 due to less negative impact of imports.

Labour market

Number of unemployed persons and monthly average gross wages



Source: MONSTAT

Official unemployment rate was 14.6%, although the figure is unreliable. Every year thousands of Bosnians, Serbs, Kosovars and Albanians pour in to work in construction, the tourist industry or agriculture. According to our forecast, the unemployment rate could decline to 13 percent in 2007.

Average monthly gross wage in May was EUR 484, while net wage was EUR 329. Having in mind the fact that living costs in May this year increased by 0.2 percent, we come to the conclusion that real salary without taxes and contributions reduced in the observed period.

Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
GDP nominal (EUR mn)	1,690	1,760	1,900	2,050
Real GDP growth (%)	4.3	6.5	6.0	6.0
Private consumption (%)	N/A	-	-	-
Public consumption (%)	N/A	-	-	-
Investments (GFCF, %)	N/A	-	-	-
Exports (%)	N/A	-	-	-
Imports (%)	N/A	-	-	-
Inflation (Retail price index, %)	3.4	2.5	1.8	2.0
Policy rate (discount rate, %)	N/A	-	-	-
Short terms (3-month T-bill, %)	N/A	-	-	-
Long-term interest rate (182 day T-bills, %)	1.01	0.97	1.00	1.00
Exchange rate / EUR (average)	N/A	-	-	-
Exchange rate / EUR (end of period)	N/A	-	-	-
Budget balance / GDP (%)	-2.2	-0.4	-0.5	-3.0
Public debt / GDP (%)	44.5	37.2	40.0	40.0
Trade balance / GDP (goods and services, %)	N/A	-	-	-
Current account balance / GDP (%)	-9.0	-29.7	-30.0	-20.0
Gross foreign debt / GDP (%)	30.3	27.6	28.0	30.0
Unemployment (%)	17.0	15.0	13.0	13.0
ULC (%)	N/A	-	-	-

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

Serbia

The Parliament appointed the new government in mid-May. As a result of the closer cooperation with the ICTY, the EU resumed the SAA negotiations with Serbia. Robust wage growth fuelled domestic demand, thus economic growth reached approximately 7% in the first quarter. Wage growth affected imports as well, leading to the deepening of the trade deficit. Still, inflation reached a historically low level, thus the central bank was able to cut the key policy rate to 9.50%. Following a reasonable surplus in the fist half of the year, fiscal expansion is expected for the second half of 2007, with a target deficit of 0.6%.

Political developments

Following the impasse after the election in January 2007, the parties were able to reach an agreement and the Parliament appointed the new government just before the deadline of 15th May. The new government is formed by President Boris Tadic's Democratic Party, Prime Minister Vojislav Kostunica's Democratic Party of Serbia and G17+. The new government structure became a bit bloated with 25 members, 5 new positions.

Although, there are major differences between the ruling parties on certain issues, according to the Prime Minister, there is a consensus that Kosovo is indivisible part of Serbia, while the importance of the European integration process, the cooperation with the UN war crimes tribunal, the improvement of the social and economic situation, the fight against corruption and organised crime are emphasised. It is still uncertain when the UN Security Council will vote on the proposed resolution for Kosovo. Russia rejected also the latest draft concerning the final status. The issue causes tense political debate that may escalate after a decision, affecting politics even in other countries of the region.

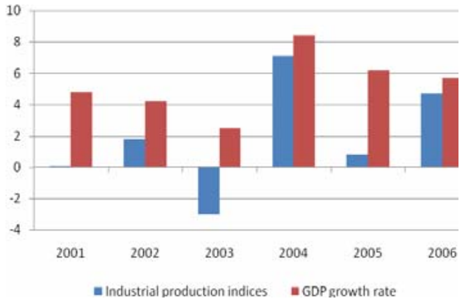
Relation with the EU still holds problematic issues, namely Mladic and Karadzic have still not been found and delivered to the ICTY (International Criminal Tribunal for the former Yugoslavia). Furthermore, a nationalist has been elected for a short period as Parliament speaker causing further temporary tension. On the other hand, in June the arrest of war crime suspects Zdravko Tolimir and Vlastimir Dordevic signalled a closer cooperation with the ICTY, and following this event, the EU resumed the negotiations with Serbia on the Stabilisation and Association Agreement (SAA). As a precondition for completing and signing the SAA, full cooperation with the ICTY is required, practically meaning the delivery of Mladic and Karadzic.

According to a draft law, property restitution would take place, thus fulfilling a requirement for EU integration. The draft earmarks EUR 4 billion for this purpose, but funding would be raised through 20-year bonds. According to plans, presidential and local elections will take place by the end of this year, or in the first quarter of 2008.

Growth

Following a 5.7% real GDP growth rate of 2006, in the first quarter of this year GDP increased approximately by 7%, compared to the same period in 2006. This strong growth was indicated mainly by the sector of trade, transport, financial intermediation and manufacturing. In the first four months of 2007 retail trade increased

Real GDP growth and industrial production index (yoy, %)



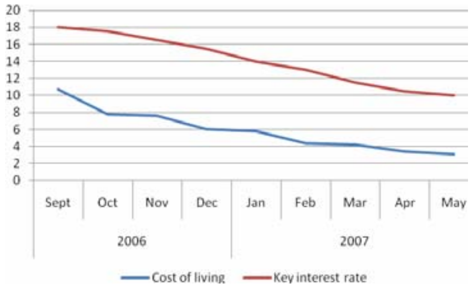
Source: Statistical Office of the Republic of Serbia

by 36.5% in nominal terms compared to the same period of the previous year. The robust growth of retail sales demonstrates the effect of the strong growth of wages and retail lending. In the first quarter the industrial sector performed a milder growth of 4.8%, which was achieved mainly by the processing industry's growth of 8.5%, based particularly on the raw material-based sectors. It is favourable that certain shift has be detected from personal to investment consumption.

The strong domestic demand, the development of foreign demand, the pace of structural reforms and investments will be among the most important factors that determine the economic growth of the following quarters. Annual GDP growth rate is expected to exceed 5% in 2007.

Prices and monetary developments

Cost of living and key interest rate (%)



Source: National Bank of Serbia

In 2006 inflation slowed down, and in the first half of the year, it remained moderate, thanks to the appreciation of the dinar, underpinned by capital inflows as well. In this period, the average inflation amounted to 4%, reaching a historically low level.

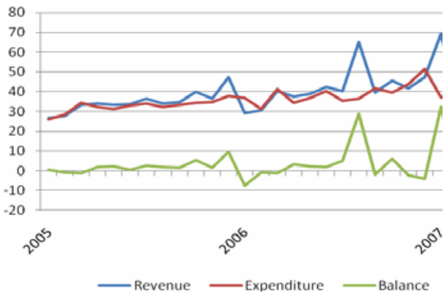
In the second half of the year, inflationary pressures will probably increase, due to the fact that domestic demand is expected to increase, underpinned by wage growth and expansive fiscal policy. Oil prices and regulated prices can also be considered as potential factors of inflationary pressures. For 2007 the national bank's target core inflation rate has been set at 6±2% December-on-December. Annual inflation in 2007 is expected to amount at the lower range of the target band. Due to the favourable results on inflation, in the first half of the year the central bank cut the key policy rate (two-week repo rate) from 14.00% to 9.50% in five steps. For 2008 the national bank is expected to set the core inflation objective as a 3-6% band.

In June, the national bank's foreign exchange reserves increased by EUR 75.2 million to EUR 9.177 billion, thus the ratio over M1 money supply increased to 353%.

Following the nominal appreciation of the dinar against the euro by 3.8% in the last quarter of 2006, the dinar depreciated by 3.2% against the euro in the first quarter of this year. In the first half of the year, the dinar fluctuated in the range of 79-82 against the euro.

Fiscal policy

Public finance (bn RSD, eop)



Source: National Bank of Serbia

The decree for interim financing for January-June 2007 was based on the budget law for 2006, and appointed RSD 260.6 billion revenues and RSD 239.7 billion expenditures. RSD 18.8 billion of the surplus was envisaged for public debt repayment. Finally, the surplus in the first half of the year reached around RSD 45 billion.

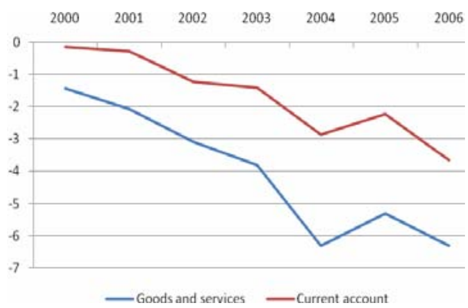
The Law on budget for 2007 has been adopted in June and came into force on 1st July. The Law lays out RSD 581.8 billion revenues and RSD 595.5 billion expenditures, thus generating RSD 13.7 billion budgetary deficit. RSD 58.6 billion is earmarked for the repayment of public debt. The 2007 budget envisages expanded expenditures (21% higher, compared to the previous year), thus can contribute to the deepening of the trade deficit and the inflation pressure. Public sector salaries grew at a very rapid pace, endangering fiscal stability; in the last 12 months wages increased by almost 30%. For 2007, RSD 144.6 billion is earmarked for salaries for budgetary users, but this fund is planned to be frozen at the November 2007 level for the next year. It is worth mentioning that the funds for the National Investment Plan are four times higher compared to 2006, but the key point will be the efficiency of the distribution.

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

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

External balance

Goods and services balance and current account (bn USD)



Source: National Bank of Serbia

The accelerating domestic demand fuelled the increase of imports, but did not cause a slowdown of export growth. In the first five months of 2007, exports reached EUR 2.4 billion, increasing by 33.4% compared to the same period a year earlier, while imports amounted to EUR 5.0 billion, growing by 28.5%. This indicated a trade deficit of EUR 2.6 billion, representing an increase of 24.7%, while the export-import rate was 48.3% in this period.

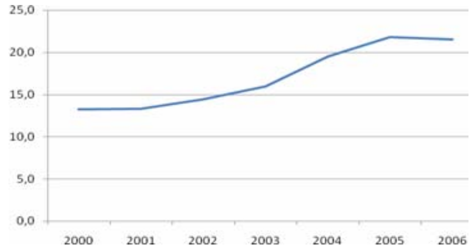
Due to the deepening trade deficit and the lower level of current transfers, current account deficit in the first quarter of 2007 widened, by reaching EUR 1.2 billion, which is a 70% growth compared to the same period in 2006. In 2007 no major improvements are expected in these trends, thus external imbalances will widen, and current account deficit per GDP may exceed even 14%.

Due to the early repayment for the IMF in March, by the end of April external debt increased only slightly and amounted to EUR 15 billion. Further financial support is expected from both the IMF and the World Bank.

In the first four months of 2007, FDI inflows to Serbia were almost five times higher than in the same period of the previous year. By the end of this period, FDI inflows amounted approximately to EUR 825 million, thus covering half of the current account deficit. As a result of successful privatisation deals, it is certain that concerning FDI inflow Serbia can expect a strong year in 2007 as well.

Labour market

Unemployment rate (LFS, %)



Source: Statistical Office of the Republic of Serbia

In 2006 the official unemployment rate was 20.9% and the number of employees decreased by 1.3%. According to the official data, in the first four months of 2007 both the number of employed and unemployed persons continued to decline slightly. No significant change is expected concerning the high level of unemployment in the second half of the year.

Likewise in the fourth quarter of 2006, in the first months of this year rapid wage growth continued, particularly in the public sector. According to the statistical bureau, in the first half of 2007, net real wages grew by 24.41%, compared to the same period a year earlier. The accelerated increase causes loss of competitiveness and structural mismatch between the demand and supply side of the labour market.

Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
GDP nominal (RSD bn)	1,750	2,050	2,325	2,600
Real GDP growth (%)	6.2	5.7	5.4	5.9
Private consumption (%)	NA	-	-	-
Public consumption (%)	NA	-	-	-
Investments (GFCF, %)	NA	-	-	-
Exports (%)	NA	-	-	-
Imports (%)	NA	-	-	-
Inflation (Retail price index, %)	16.2	11.7	6.6	6.3
Policy rate (%)	19.8	14.0	10.0	8.50
Short-term interest rate (3-month T-bill, %)	17.5	13.5	-	-
Long-term interest rate (182 day T-bills, %)	16.3	15.8	-	-
Exchange rate (RSD/EUR, average)	83.2	84.4	79.0	77.5
Exchange rate (RSD/EUR, end of period)	85.5	79.0	78.0	76.5
Budget balance / GDP (%)	1.5	0.9	0.3	0.5
Public debt / GDP (%)	61.2	51.0	39.9	36
Trade balance / GDP (goods and services, %)	-23.4	-22.1	-20.7	-19.5
Current account balance / GDP (%)	-8.6	-10.4	-9.9	-9.5
Gross foreign debt / GDP (%)	64.4	64.0	59.4	58.0
Unemployment (%)	20.8	22.2	21.0	19.5
Real ULC (%)	NA	-	-	-

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

Sources: National Bank of Serbia, Statistical Office of the RS, IMF, own calculations

Turkey

The recent victory of the AKP in the general elections may give new boost for the vital structural reforms and may reduce the macroeconomic uncertainties the country has been recently facing. In 2008 faster disinflation and further fiscal adjustment is foreseen.

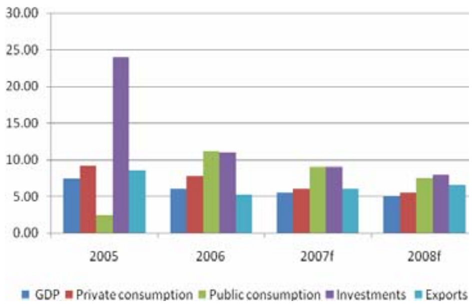
Political developments

The recent parliamentary elections strengthened the political power of the ruling AKP party, when it won by higher than expected majority the general elections. The election outcome will give the AKP new room for vital reforms and policy decisions in the area of economic stabilisation and liberalisation, European integration and political reforms. The significant majority in the Parliament may increase the chances of accelerated reforms in the country, may reduce the uncertainty surrounding economic policies and political developments in 2007.

In recent years Turkey enjoyed the benefits of political stability created by the AKP government with three pillars creating the background of economic policy. First has been the EU anchor and the launch of EU negotiations accompanied by reform measures, the second one the IMF anchor reflected in the adherence to the IMF stabilisation program, the final one the adherence to market stability and prudence tested by market turbulence, among others in 2006.

Growth

GDP growth and its composition (%)



Note: f = forecast; Source: eurostat, CBTR

Turkey has reached impressive growth in recent years as real GDP increased by 7.4% between 2003 and 2005. The main demand side driver of growth has been domestic demand with gross fixed capital formation expanding above 10% and private consumption growing steadily. Declining inflation and interest rates boosted private investments, while restored confidence in macroeconomic policies and rising real wages private consumption.

Last year's slowdown of GDP growth was driven by weakening domestic demand and expanding net exports. In 2006 both private consumption and gross fixed capital formation grew slower than in the preceding years. On the other hand expanding world trade, fast increase in export markets, real exchange rate depreciation following the market turbulences, and the impact of recent years' investment rise on export capacities improved the competitiveness of Turkish exports, reducing the negative contribution of net foreign demand to growth compared with previous years.

The outlook for 2007 is good growth performance similar to the one observed in 2006. Real GDP is likely to grow somewhat below last years' pace expanding by 5.5%, while the contribution of domestic and foreign demand is expected to shift further towards the latter one. Private and public consumption growth will moderate in 2007 while gross fixed capital formation may still rise with double digit pace. Private consumption is being driven by the increase in disposable incomes, while improving market conditions and investor sentiment as well as declining interest rates will sustain the investment rate.

The slowdown of domestic demand and the reduction in the accumulated stocks due to the high rise in investments is reflected in import growth: while in 2004 the growth of imports in GDP outpaced more than two times exports (24% compared to 12%), in 2007 and most likely in 2008 the gap will be closed and both are expected to increase at similar rates.

As a result net foreign demand may contribute slightly more positively to GDP growth, export growth is more sustainable than in the past as they are both driven by the private sector, productivity rise, and by higher value added sector like vehicles and consumer durables

Prices and monetary developments

Evolution of TRL/EUR exchange rate

Source: CBTR

After the crisis and price explosion of 2001 Turkey reached significant progress with disinflation driven by conservative fiscal and monetary policies. The strong and persistent fiscal adjustment leading to significant primary surpluses, decline of public debt was the decisive element of disinflation, coupled with restrictive monetary policy and supported by trend appreciation of the Turkish Lira from 2002.In 2006 Turkey experienced again a rising inflation, driven mainly the depreciation of the Turkish Lira and its pass-through impact and by the increase of certain administrative prices. The central bank tightened monetary policy and inflation decelerated in the second thanks to fiscal prudence, the significant nominal appreciation of the Turkish Lira reflecting the renewed investor exposure to the emerging markets in the second half of 2006.

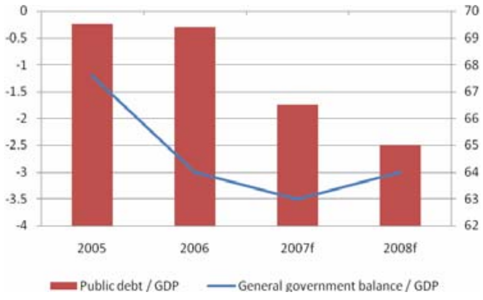
In 2007 the disinflation is expected to continue with end year inflation of 7.8% and average CPI increase of 9.6%. Disinflation is driven by conservative fiscal and monetary policies, overall exchange rate developments, and the dampening effect of accumulation of inventories. The producer prices – contrary to most of 2005 and first half of 2006 – may remain below the CPI index. Turkey may expect faster disinflation in 2008 when the CPI may decline by the end of the year to 5% due to continued strict macroeconomic policies.

A key factor of both inflationary and fiscal developments is the evolution of the exchange rate. The country experienced a significant market pressure last Spring, but the depreciation was followed by equally fast rebound of the currency with the end of year exchange rate becoming 5-6% higher than in December 2005. The previous expectation for 2007 was that in the first half of the year there would be relative stability of the exchange rate vis-à-vis the major currencies followed by more volatility in the second half of the year, due to elections. As a result we expected that the year end exchange rate will increase somewhat to 1.50 against the US dollar and 1.95 against the Euro.

However, markets proved to be more stable and the exchange rate against the Euro appreciated from 1.83 in early April till 1.75 in mid July. The election outcome and the clear majority of the AKP government may stabilise further the exchange rate, which may remain below 1.85 by the end of the year.

Fiscal policy

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



Note: f = forecast; Source: Eurostat, CBTR

The current economic policy program in Turkey relies on three pillars. One is fiscal austerity targeting 6.5 percent surplus for the public sector to GDP, the second is the contractionary monetary policy, while the last one is structural reforms consisting of privatisation, large scale layoffs in public enterprises and abolition of subsidies. The central element of the Turkish stabilisation policy has been the fiscal adjustment which resulted in the decline of the general government deficit from 11% in 2003 to 1.2% in 2005.

The fiscal adjustment was carried out through three major channels. First, the stabilisation package resulted in significant primary surplus, second privatisation revenues added to the improvements, and disinflation and the decline of nominal and real interest rates almost halved between 2002 and 2006 the interest expenditures of the central government.

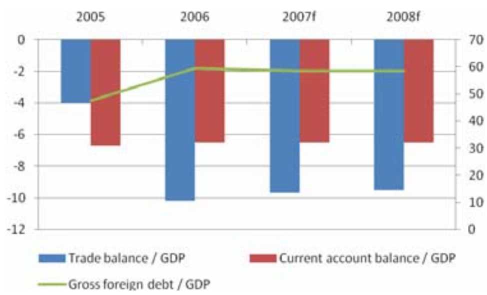
In the election year of 2007 public sector balances are affected by higher interest rates, higher public spending and a slowdown in privatisation receipts, which will not be balanced by the positive effect of the widening tax base and increasing efficiency of tax collection. Non-interest expenditures are seen to remain largely constant relative to GDP, while revenues may somewhat decline.

The elections were to increase non-interest expenditures of the central government worsening the primary surplus and the general government deficit may increase to 3.5% of GDP. There are two major tasks that the government has to accomplish after the elections. The government needs to achieve declining general government deficit in order to maintain the reduction of public debt and its credibility and it has to increase the role of expenditure reduction in the current adjustment process.

General government debt is expected to further decline gradually reaching at 65% of GDP in 2008. The government has been making progress in lengthening the average maturity and swapping foreign denominated into lira denominated debt, which is expected to reduce its vulnerability to interest and exchange rate volatility. Enhanced exchange rate stability and declining interest rates may decrease interest expenditures on public debt.

External balance

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



Note: f = forecast; Source: Eurostat, ECB

One of the critical aspects of the Turkish macroeconomic performance has been the evolution of current account balance. As since the 2001 crisis the current account has been steadily worsening from 1% deficit in 2002 to almost 7% in 2006. This has occurred notwithstanding the mentioned fast increase of exports and gains in the competitiveness of the tradable sector.

At the same time there has been a significant increase in import demand as well driven by rising private consumption and investments. The current account is highly vulnerable to exogenous shocks, especially the changes in oil prices. The trend in the current account deficit is expected to reverse in 2007 due to the weakening domestic demand, the robust growth in Turkey's main trading partners and the increase of receipts from tourism.

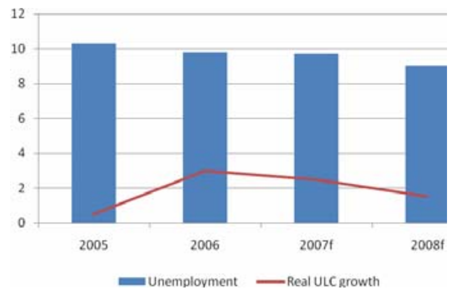
The reversal may be weakened by the increase of oil prices and by slight expected real appreciation of the Turkish Lira, which may slow down the competitiveness gains of the producers in the tradable sector. Altogether the forecast for the current account deficit is somewhat higher than in the Spring forecast as we expect a deficit of 6.5% of the GDP. Even with the declining current account deficit, the external financing needs of Turkey remain large, leaving the economy susceptible to financial market turmoil, and further reduction of current account deficit may be needed in the coming years.

Turkey has been increasingly attracting foreign direct investments: net FDI inflows have reached by the end of 2006 USD 18.5 billion after averaging USD 2 billion between 2001 and 2004. Privatisation, increased macroeconomic and political stability, rise in competitiveness of tradable and domestic demand have been behind this increase. Besides FDI, net foreign borrowing by the private sector increased too, mainly driven by the rise of foreign borrowing by domestic banks.

As a result net medium and long-term capital inflows (which were negative in 2001 and almost zero in 2002-2003) reached USD 30 billion in 2006, adding to the gross international reserves of the Central Bank of Turkey.

Labour market

Unemployment and real ULC growth (%)



Note: f = forecast; Source: Eurostat

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

Overall, in 2007 and 2008 1.3-1.4% increase in the employment rate may be expected, and unemployment will remain slightly below 10%, but will not decline considerably. In the short-term the positive effect of real GDP growth may prevail and unemployment is expected to decline in 2007 to 9.7% and to 9.6% in 2008.

Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
Nominal GDP (TRL bn)	486.4	559.5	643.5	705.5
Real GDP growth (%)	7.4	6.1	5.5	5.0
Private consumption (%)	9.1	7.8	6.0	5.5
Public consumption (%)	2.4	11.2	9.0	7.5
Investments (GFCF, %)	24.1	11.3	9.0	8.0
Exports (%)	8.5	5.2	6.0	6.5
Imports (%)	11.5	6.4	6.0	5.5
Annual average inflation (%)	5.8	10.7	9.6	6.5
Policy rate (end of period, %)	28.0	27.0	25.0	22.0
Money market rate (3-month Treasury Bill, %)	NA	-	-	-
Long-term interest rate (10-year gov't bond, %)	NA	-	-	-
Exchange rate (TRL / EUR, average)	1.67	1.80	1.82	1.85
Exchange rate (TRL / EUR, end of period)	1.61	1.89	1.85	1.85
General government balance / GDP (%)	-1.2	-3.0	-3.5	-3.0
Public debt / GDP (%)	69.5	69.4	66.5	65.0
Trade balance / GDP (goods and services, %)	-4.0	-10.2	-9.7	-9.5
Current account balance / GDP (%)	-6.7	-6.5	-6.5	-6.5
Gross foreign debt / GDP (%)	47.5	59.5	58.5	58.5
Unemployment (%)	10.3	9.8	9.7	9.6
Real ULC growth (%)	0.5	3.0	2.5	1.5

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

Sources: IMF, Eurostat, CBTR

Special topic – Exposure to external shocks of the Western Balkan countries and its labour market aspects

The Western Balkan (WB) countries followed another transition path in comparison with the Central and Eastern European (CEE) EU member states. While economic development was significantly based on dynamic growth of export sector in the CEE countries, the performance of this sector in the Western Balkan countries remained weak during the last one and a half decade. That is the reason why trade deficit reached or exceeded 20% of GDP in last year in these countries, namely in Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Serbia. These countries are relatively small economies with small domestic markets and significant trade and investment links with the EU. The most important trade partners are Austria, Germany and Italy in this region.

Exposure

Regarding exchange rate regimes, fixed exchange rate arrangements were introduced in most WB countries. In Bosnia and Herzegovina currency board is established, Montenegro replaced its currency with the euro, Croatia and the former Yugoslav Republic of Macedonia applied a managed floating regime and kept a quite stable nominal exchange rate against the euro in last years. National banks in these two economies (especially in the fYR of Macedonia) prevented too excessive fluctuation of the exchange rate. Serbia has followed a managed floating regime as well, but it was much more ‘flexible’ and the national currency has been depreciating gradually during the last half decade. Albania introduced a free floating regime one and a half decade ago, though nominal exchange rate remained in a relatively narrow band against the euro in last years.

There are several reasons why the Western Balkan countries are heavily exposed to external shocks. First, they have high trade and current account deficits and their tradable sectors are relatively underdeveloped. Exports represent a lower share in GDP than in the EU8+2, the product composition of exports is biased towards segments facing more volatile demand conditions. Moreover, these countries face serious current account imbalances, the financing of which hinges on net capital inflows. Their net financial position depends on investors sentiment, on the changes in global risk conditions and on factors affecting the risk position of emerging economies.

Based on these features, the Western Balkan economies are exposed to exogenous real and financial shocks. Real shocks may stem from the changes in the business cycle and associated decline in demand on their major export markets, changes in the relative competitiveness of these countries and other major competitors, adverse cross exchange rate movements. These countries are also heavily exposed to changes in terms of trade, evolution of energy prices and the related effects stemming from them. Finally, the financial shocks stem from their heavy exposure to external energy imports, to changes in the risk attitude of foreign investors, especially portfolio ones.

All these point to that, Western Balkan countries are highly exposed to external shocks and sufficient flexibility of goods and factor markets is necessary to prevent worsening of international competitiveness. Due to the fact that both attraction of (foreign) investment and increase of export sector’s performance are elemental interests of these countries the deterioration of competitiveness affects negatively the evolution of the economy. Accordingly, rigidities in these markets lead to slower return to the new equilibrium.

Shocks

Regarding external shocks in the Western Balkan countries, changes in commodity prices, the evolution of global (or EU) output or even aid shocks may have the most significant (external shock) impact on these economies. During transition goods and factor markets improved significantly, financial markets progressed due to privatisation and settlements of foreign banks in these countries.

Several elements determine the adjustment capacity of a national economy towards exogenous shocks. One of them is the applied exchange rate regime, whether it can serve as a cushion against exogenous shocks or they are transmitted directly to domestic real and financial variables. The more flexibility the exchange rate regime has, the bigger is the adjustment capacity of the economy to exogenous shocks: in that respect the WB countries show different patterns.

Second, the adjustment capacity is also determined by the flexibility of the factor markets, which influence the level to which the adjustment in factor prices and quantities allows the reaction towards exogenous shocks. The flexibility depends on institutional (level of regulation, freedom of flows of factors of production), structural (relative share of various sectors in output and employment), policy (tax and income policies e.g.) factors.

Third, the adjustment capacity is also determined by the extent of the reaction of traditional macroeconomic policy instruments, especially the monetary and fiscal policies. The less are these policies bound in their reaction the broader is the capacity to adjust, which depends on the level of fiscal deficit and public debt, on the level of public sector redistribution or on the strength of the monetary policy transmission channels.

Labour market aspects

Labour markets have however remained one of the key (macroeconomic) weak points of the countries in this region (together with high external imbalances). The main labour market indicators show bad picture in general in comparison with CEE countries or EU-average. Activity rates and employment are much lower in these economies while unemployment reaches extreme high level in some countries. According to the official statistics, unemployment exceeded 40% in Bosnia and Herzegovina, 35% in the fYR of Macedonia, 20% in Serbia and it was more than 10% in the rest of the countries for several years. Youth unemployment rates – similarly to other economies – are even higher in these economies.

These figures reflect well the challenges these countries face and they also show that labour market flexibility would not be sufficient in case of external shocks. This is specifically the case in those Westeran Balkan countries where the aforementioned pegged exchange rate regimes were introduced.

Labour market developments were basically influenced by armed conflicts in the region during the 1990s that resulted in economic recession and high unemployment. Dynamic economic growth has followed the stabilisation of the region, liberalisation and privatisation processes have gained some momentum in last years, with some delay in comparison with CEE countries. Owing to the positive processes characterising the region in last years, economic growth reached high (5-6%) rates in several countries. Employment figures however have not improved or have worsened in most WB countries except for Croatia, and one could observe economic growth without job-creation.

In fact the same process was observable in case of the CEE countries as well. In line with the positive effects of high economic growth, privatisation, restructuring and downsizing of large enterprises had negative impact on employment. Massive job destruction started when transition period began due to the non-rational nature of the former regime.

Besides high unemployment emerged, the role of the informal sector has also grown. Certainly, there are no exact calculations on the size of the informal sector in these economies, but according to some estimation, the figures are at least about 10% in the more developed countries (Croatia) and it could reach 30-40% in some other countries. In fact, informal employment 'improves' the official employment figures and it provides more income to households, but workers in informal sector are exposed to significant labour-related risks without any protection and have no employment and income security. On the other hand, it is also worth mentioning that informal employment is completely flexible.

Regarding flexibility of the labour markets, one could observe that self-employment became popular after transition began but its role started to decrease as economic growth accelerated in the Western Balkan countries. In other words workers preferred dependent jobs against self-employment. It is also worth mentioning that the rate of fixed-term contracts increased mainly through new contracts; that reached the highest role in the former Yugoslav Republic of Macedonia (almost 20%), higher than EU-average. On the other hand, part-time jobs are preferred in the WB countries neither from the workers' side due to high living costs and expensive childcare facilities versus the availability of long maternity and parental benefits; nor from the employers' side owing to the fact that part-time jobs are not profitable.

Transition had a serious impact on the regulation of labour markets as well. New acts enabled enterprises to terminate employment for economic reasons and in return of that regulations ensured compensation and helped to find a new workplace in case of the termination of a job. Regarding labour market challenges mentioned above, over-restrictive employee protection can cause high unemployment and low participation rates in these economies as well.

Examining the World Bank's *Doing Business* indicators and primarily the 'Rigidity of Employment' Index in these countries one can see that the rigidity is higher than OECD average or than the index of most CEE countries which underpins the former statement. Regarding indicators in *OECD Employment Outlook*, the same observation can be done, namely labour market regulation is more rigid on average in the WB countries than in EU-15 or NMS-8, however the differences are small. The difference is mainly due to the more rigid legislation of temporary contracts basically in comparison with the NMS-8 countries. This could lead us to the conclusion that there is a trade-off between 'liberal' legislation with higher employment and more restrictive regulation with massive evasion from formal labour market. However, this view is only one possible explanation of high unemployment in the region. Besides that, EU integration process will enforce the harmonisation of legislations to *acquis communautaire.*

Due too high unemployment in the region, the role of active labour market policies is quite low in these countries and accordingly unemployment benefits are important instruments in labour policy. On the other hand, tax burden on labour is generally lower than in CEE countries but higher than the average of OECD low income countries. The problem is that high tax burden can result in depressed labour demand and lower new-job creation, and consequently it means that the level and duration of unemployment will increase.

It is also worth mentioning that the mechanism of changing strictness of legislation could result in different outcomes. In case of OECD countries, stricter legislation could cause higher unemployment, while in case of WB countries, the same shift could decrease unemployment. This difference is mainly due to the size of informal sector; stricter legislation could enforce the decrease of informal employment.

Returning to adjustment capacity to shocks with the focus on labour market, adjustment mechanism could basically progress through three ways according to the literature: labour mobility, flexibility of wages and prices, budgetary transfers. It must be mentioned that adjustment to external shocks is easier through the exchange rate than via wages and prices. This is mainly due to the stickiness of nominal wages (and prices) in the short-term.

Regarding the two well-known examples of the US and the EU, in the US labour mobility is the adjustment channel in case of labour market shocks, which means empirical evidences underpin the theory in case of the US. On the other hand, labour force participation plays a much higher role in adjustment in case of the European Union, which means workers rather leave labour market than migrate to another region/country. Certainly, the EU case is basically different. On the one hand, regulation does not allow completely free migration of labour, it is only allowed with limitations in some cases (such as temporary limitation in case of workers from the NMS). On the other hand, cultural, language and other differences also contribute to low mobility of European workers.

Since the Western Balkan countries introduced mostly pegged exchange rate regimes, adjustment capacity of labour market has a particular role in case of external shocks. Flexible exchange rate regimes seem better to offset external shocks according to empirical results. However, the link between external shocks and unemployment is uncertain.

Labour markets of the Western Balkan countries can accommodate shocks via two main channels (as it is true in case of all countries). These are either quantities or prices or the combination of these two channels. The first one results in less worker (or working time) while the second means lower wages in case of a negative shock. In the latter case not nominal but real wage flexibility that matters in adjustment to shocks. Due to the fact that inflation is low in most WB countries (owing to fixed exchange rate regimes) real wage flexibility is close to nominal wage flexibility which is disadvantageous in adjustments (stickiness of prices). It means adjustment to external shocks is expected to be slow and costly in these countries. On the other hand, employment and unemployment rates were affected significantly in case of external shocks instead of wages. However, the exact impact of shocks on labour market is not exactly known in the Western Balkan countries.

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