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Focus of this issue:

▶Fiscal developments in 2005 and after

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Content

Please note: The forecasts are shown against a grey background in the tables, and in the charts they are shown in a box.

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Commentary

EU integration: future prospects

On 16 May 2006, the EU Commission published its report on Bulgaria's and Romania's progress with reforms since the last report was released in October 2005. While the Commission confirmed that there was still considerable work to be done in certain areas (e.g. judicial system, combating corruption), with its "conditional" yes it adhered to the accession date of 2007, implicitly giving the green light for the next round of EU enlargement, which will be the sixth after 1973, 1981, 1986, 1995 and 2004.

Against a difficult backdrop characterised by issues such as the increasingly sceptical comments on enlargement, the obvious problems encountered in reaching an agreement on the financial framework for the period 2007-2013, and the unresolved issues such as the EU Constitution, institutional reform and the need to overhaul the EU's budget policies, raises the issue of future enlargement prospects. Indeed, this is an important question for Turkey and the countries in the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Serbia and Montenegro), as the long-term prospect of EU accession is probably the most important objective for the process of political, legal and economic reform that these countries are engaged in.

The EU's strategy for the Western Balkans is based on the Stabilization and Association process. Agreements within this framework (SAAs) are intended to ensure that these countries increasingly approximate to EU standards. But only two such agreements have come into force so far, namely in Croatia and FYR Macedonia. These are both countries which also enjoy a status as EU candidate countries. The EU began accession negotiations with Croatia in the autumn of 2005, possibly paving the way for the country to become a member of the EU by 2010. For FYR Macedonia, however, it looks like accession negotiations will only get underway in 2008 at the earliest, due to concerns about the country fulfilling the Copenhagen political criteria. The SAA with Albania is also practically ready for conclusion, but approximately two years will probably pass until it comes into effect due to the process of ratification by the EU Member States, a period which will be bridged by an interim agreement. Bosnia and Herzegovina and Serbia and Montenegro are only just setting out on the path to integration with the EU, with Serbia's position being hampered significantly since the suspension of the SAA negotiations, due to the lack of adequate cooperation with the international war crimes tribunal in The Hague. With its vote for independence on 21 May 2006 and dissolution of the union with Serbia, Montenegro hopes to move forward more quickly with the process of EU integration.

Even though the road leading to EU membership is long and the EU itself will have to focus more on internal issues in the coming years, the issue of enlargement will remain vitally important. The countries in the Western Balkans should not lose sight of the prospect of EU accession, in order to facilitate the process of economic and social transformation and to help prevent the emergence of radical EU-sceptical movements in the future. Hence, the objective of EU accession will function as a catalyst for reforms in the region, helping both to strengthen stability in the region and boost regional cohesion in South-Eastern Europe. The relevance of the prospect of EU accession is reflected in the similar experiences and transition successes of the new EU member states and the two accession countries.

Sándor Gardó

The Status of the European Integration Process in South-Eastern Europe

	Albania	BiH*	Bulgaria	Croatia	FYR Macedonia	Romania	SCG*
Current status	SAA negotiations finalized at the beginning of 2006	SAA negotiations opened on 25 November 2005	Accession negotiations concluded on 15 June 2004; signing of the accession treaty on 25 April 2005	Application for EU membership on 21 February 2003; SAA in force since 1 February 2005; candidate status since 18 June 2004; accession negotiations start on 3 October 2005	SAA in force since 1 April 2004; application for EU member-ship on 22 April 2004; candidate status since 17 December 2005	Accession negotiations concluded on 17 December 2004; signing of the accession treaty on 25 April 2005	SAA negotiations opened on 20 December 2005; freezing of SAA negotiations on 3 May 2006
Next steps	Signing of the SAA treaty mid-2006	Closing of negotiations and signing of the SAA treaty in 2006	Ratification process (with 17 out of 25 member states already having ratified the treaty)	Closing of the screening process and opening of the first 7 negotiation chapters in 2006	Accession negotiations expected to start in 2008	Ratification process (with 17 out of 25 member states already having ratified the treaty)	Resumption of negotiations for an SAA in 2006
Expected earliest date for EU entry	2015	2015	2007	2010	2012	2007	2015

Source: EU Commission, Bank Austria Creditanstalt Economics Department; *) BiH: Bosnia and Herzegovina; SCG: Serbia and Montenegro

Country Overview

Bulgaria
- Accession in 2007, with provisos
- Substantial current account deficit in Q1 2006

Croatia
- Strong growth, increasing imbalance

Czech Republic
- CSSD hard on the heels of ODS

Hungary
- Year off to a rousing start
- Trade deficit rose in the first quarter

Lithuania
- EU Commission does not make an exception

FYR Macedonia
- Elections on 5 July

Montenegro
- And then there were suddenly six

Poland
- Industrial production slightly weaker in April
- Export development remains impressive

Romania
- Accession in 2007, with provisos
- Inflation worries despite record-low rate in April

Serbia
- SAA negotiations suspended, government under pressure
- New measures to combat rising inflation

Slovakia
- Fairly quiet election campaign so far
- Growth trend steady in Q1 with high inflation
- Improvement in foreign trade relations in March

Slovenia
- Adoption of euro in 2007
- Strong growth in Q1, inflation meets criterion for euro adoption

Focus: Fiscal developments in 2005 and after

Bulgaria: *Achieving the budget deficit target for 2006 is difficult*

by Dimitar Mitev

Czech Republic: *Economic growth conceals structural problems in public finance*

by Pavel Sobisek

Hungary: *Stabilisation measures ahead*

by Márta Szegő

Poland: *Budget deficit on track*

by Maja Goettig

Slovenia: *Will the budget deficit rise this year?*

by Goran Šaravanja

Main Indicators

	GDP real (yoy)				*CPI (yoy)*				*Unemployment (%)*				*Current account (in % of GDP)*			
	2004	*2005*	*2006*	*2007*	*2004*	*2005*	*2006*	*2007*	*2004*	*2005*	*2006*	*2007*	*2004*	*2005*	*2006*	*2007*
Czech R.	4.7	6.0	5.4	4.5	2.8	1.9	2.7	2.8	9.8	8.9	8.5	8.3	-5.2	-2.1	-2.3	-2.5
Estonia	7.8	9.8	9.5	8.5	3.0	4.1	3.5	3.1	9.7	7.9	7.2	6.9	-12.7	-10.5	-10.0	-9.3
Hungary	4.6	4.1	4.2	3.8	6.8	3.6	2.1	2.7	6.0	7.2	7.1	6.8	-8.6	-7.3	-7.0	-6.5
Latvia	8.5	10.2	8.5	7.5	6.2	6.7	5.7	4.6	8.8	8.0	7.0	6.5	-12.9	-12.5	-12.2	-11.3
Lithuania	7.0	7.5	6.5	6.3	1.2	2.7	2.8	3.0	11.4	8.5	7.5	6.7	-7.7	-7.1	-6.8	-6.5
Poland	5.3	3.3	4.6	4.7	3.5	2.1	1.2	2.4	19.6	18.2	17.1	16.3	-4.2	-1.4	-2.0	-2.8
Slovakia	5.4	6.1	6.3	6.5	7.5	2.7	3.9	2.5	14.3	11.6	10.7	10.4	-3.5	-8.8	-6.3	-3.5
Slovenia	4.2	3.9	4.0	3.8	3.6	2.5	2.4	2.9	10.6	10.2	9.9	9.5	-2.1	-1.1	-0.5	-1.3
CEEC-8	*5.2*	*4.6*	*5.1*	*4.8*	*4.2*	*2.5*	*2.1*	*2.6*	*13.8*	*13.0*	*12.3*	*11.7*	*-5.5*	*-3.7*	*-3.7*	*-3.8*
Bulgaria	5.7	5.5	5.5	5.5	6.2	5.0	7.3	4.7	12.7	11.5	10.5	10.0	-5.8	-11.8	-12.5	-11.2
Croatia	3.8	4.3	4.4	4.2	2.1	3.3	3.2	2.9	18.2	18.0	17.8	17.5	-5.1	-6.3	-6.8	-7.0
Romania	8.4	4.1	5.6	5.5	11.9	9.0	7.5	6.2	6.8	5.8	5.7	5.5	-8.4	-8.7	-9.6	-9.3
CEEC-11	*5.5*	*4.6*	*5.1*	*4.9*	*5.0*	*3.4*	*3.0*	*3.2*	*13.2*	*12.4*	*11.7*	*11.0*	*-5.8*	*-4.6*	*-4.9*	*-5.0*

Source: National statistical offices, Bank Austria Creditanstalt Economics Department

1. Politics, public finances, structural reforms

Fresh EU transfers

The parliamentary elections in the Czech Republic (2 and 3 June), Slovakia (17 June) and Macedonia (5 July) will soon determine the political course which these countries will pursue in the next few years. At a European level, decisions have recently been taken which will have implications for the entire region. In regard to the issue of EU enlargement, the Commission further postponed the final decision on the EU accession of Bulgaria and Romania. If the two countries take timely measures to redress the deficiencies that have been identified, e.g. in the areas of public administration and the fight against corruption, they will however be welcomed into the European Union in 2007. Progress – although fairly slow – is also being made in strengthening relations within the EU. The Commission and the ECB have given Slovenia the green light for participation in the euro area as of 1 January 2007. Lithuania's application for membership of EMU at the beginning of next year was not accepted because it had narrowly failed to meet the strict inflation criteria.

But it is above all the consensus on the EU financial framework for 2007-2013, recently approved by the European Parliament, which will have far-reaching implications for the countries in the region. The framework includes the funds made available to the new EU member states and Bulgaria and Romania. An amount of EUR 308 bn alone, from the structural and cohesion funds, has been earmarked for the aforementioned seven-year period for the purpose of bringing living conditions into line with general EU standards. More than one half of this amount, about EUR 180 bn, will be at the disposal of the EU countries in Central and Eastern Europe. Poland will be given almost EUR 60 bn from the structural and cohesion funds (with assistance for agricultural development, research, etc. this increases to over EUR 90 bn), making it the largest beneficiary as the EU's largest recipient of funds. In relative terms, Lithuania, which will receive more than 7% of its annual GDP, will be the largest beneficiary. On the other hand, Slovenia, the most progressive of the new EU member states, will be entitled to funds corresponding to less than 2 % of its annual GDP, which is the lowest among these countries.

Slovakia – Fairly quiet election campaign so far

The election campaign for the parliamentary elections on 17 June has so far been relatively quiet. This may partly be attributable to the results of the recent opinion polls on what Slovenians think about the reforms. The polls revealed that although about two-thirds of the population reject the reforms, more than half the population do not want to see any significant change in the reform agenda after the elections. This suggests that the reforms have led to such far-reaching structural changes that any new changes would seem to be too tedious and complicated for most of the respondents. In this context the new tone recently adopted by the Smer is understandable. The left-populist Smer (Direction - Social Democracy) is the strongest opposition party and with about 32 % voter support (April) it continues to have the best chances of winning the parliamentary elections. Smer has in the past promised to make substantial changes to reforms, such as reintroducing a progressive income tax for natural persons and the taxation of dividends, two different income tax rates, the return of the health insurance funds to public property and the conversion of the second pension pillar into a voluntary system. In the meantime, the Smer has moved away from its aggressive rhetoric against the reforms. It now just advocates, for the next legislative period, mitigating the impact of the reforms that have been implemented, especially the negative impacts on the socially vulnerable.

The speculation regarding the future coalition governments has hardly changed. The key question is still whether the Smer will succeed in finding a (reasonably reform-minded) coalition partner, and if yes, which party this will be. A possible coalition of the centre right parties, especially the Democratic and Christian Union (SDKU-DS) led by Prime Minister Dzurinda and the Christian Democrats (KDH) – both parties with about 10 % voter support - with Vladimir Meciar's L'S-HZDS (currently about 14 % voter support) is becoming more of a reality. Both parties in principle indicated that they would be willing to cooperate with the L'S-HZDS, with the proviso that Vladimir Meciar does not assume a key function.

Slovenia – Adoption of euro in 2007

The report published by the EU Commission and the ECB on 16 May gives a positive assessment of Slovenia's state of readiness for the adoption of the euro, as Slovenia has met all the criteria for participation in the euro area. This will represent the basis for the decision of the Ecofin Council (EU finance ministers) at the beginning of June, and of the EU Council (heads of state and government) at the end of June. At 1.8 % of GDP, new debt in 2005 came to less than 3 % of GDP, with 29.2 % (2005) Slovenia was well below the 60 % of GDP threshold for total public indebtedness, and long-term interest rates are currently 3.8 % (the criterion is 5.9 %). The exchange rate is also stable. The Slovenian tolar had no difficulty in complying with the maximum permitted fluctuation band of +/- 15 % against the euro parity. The criterion of a minimum two-year participation period in the ERM II exchange rate mechanism, the "waiting room for the euro area", will have been fulfilled at the end of June 2006. The biggest economic challenge on the way to adopting the euro was the fulfilment of the inflation criterion, which is currently 2.6 % - but this, too, was overcome with well-coordinated measures of the central bank and the government.

The next step for participation in the euro area will be the fixing of the official exchange rate for the adoption of the euro on 1 January 2007. This will take place in the next two to three months by way of bilateral negotiations between the ECB and Slovenia's central bank. We consider the current parity of 239.64 EUR/SIT to be an adequate rate.

Czech Republic – CSSD hard on the heels of ODS

The most recent surveys for the parliamentary elections on 2 and 3 June reveal that the lead of the Civic Democrats (ODS), the strongest opposition party, over the ruling Social Democrats (CSSD) has shrunk to a minimum. As 26.7 % of the respondents would currently vote for the ODS, and 25.2 % said they would support the Social Democrats, there are only 1.5 percentage points difference between the two parties. In April, there was still a gap of 5.5 percentage points. The CSSD has evidently benefited from the decline in the popularity of the Green Party (7.1 %), for whom electoral support had previously been soaring – by up to about 10 % – since the beginning of the year. Support for the Communists (KCSM) at around 13 %, and for the Christian Democrats (KDU-CSL), the ruling coalition partners, at some 6 %, is more or less unchanged.

In the speculation over possible coalition scenarios, the question as to whether the Green Party might participate in the next coalition government has lost some of its relevance. It is the possibility of a grand coalition between the ODS and the CSSD which has taken centre stage. It is questionable whether this option is sufficiently attractive for both partners in light of the negative experience with the "Opposition Treaty" (a treaty valid until 2002, in which the ODS guaranteed the CSSD the continued existence of its minority government for the entire legislative period). The realisation of such a coalition would presumably also call for a new leadership team for both parties. The discussions on a CSSD minority government indirectly supported by the Communists have also been additionally fuelled by further developments. After recently supporting the Social Democrats in pushing through key legislation for health care and employment, the KCSM officially announced that it would tolerate a CSSD minority cabinet. Apart from the fact that this could reduce the CSSD's chances in the elections (according to opinion polls, about one-third of those voting for the Social Democratic party are opposed to the Communists), such a government can hardly be achieved on the basis of the country's electoral system. This leaves the possibility of a coalition with the Green Party. In terms of their party programme, the Greens seem to be more liberally-oriented, closer to the ideology of the ODS. The chances for a three-party coalition with the Christian Democrats would therefore be higher than a coalition with the CSSD as senior partner. But one thing is fairly certain: an ODS-led coalition would be more reform-minded in regard to fiscal and social policy than a coalition led by the CSSD, but it would give membership of the euro area lower priority.

Lithuania – EU Commission does not make an exception

On 16 May, the EU Commission gave Lithuania's application for acceptance into the monetary union, submitted about two months earlier, a negative assessment. This was based on the strict interpretation of the inflation criterion; all other Maastricht criteria are fulfilled by Lithuania. The country's inflation, as an average for the last 12 months, amounted to 2.7 %, and thus exceeded the reference figure (the average of the three EU countries with the highest price stability plus 1.5 percentage points) by only 0.1 percentage points. Moreover, the inflation rate in Lithuania is showing a slight upward trend. The fact that the inflation rate is relatively low compared with the country's strong economic growth (GDP growth in 2005 was 7.5 %) was not taken into consideration; inflation is for example currently only 0.4 percentage points above the euro area average. Formally speaking, the decision was correct. EU Economic and Monetary Affairs Commissioner Joaquin Almunia stressed that he could not bend the rules. The decision is however not without controversy, even within the EU Commission. It is mainly argued that the stability criteria were designed for countries with a similar, high level of development, and that they are therefore generally not suitable criteria for measuring the euro-readiness of countries involved in the economic catching-up process.

Lithuania's government has in the meantime trained its sights on January 2009 as the new date for adopting the euro, since one must realistically assume that efforts to reduce inflation will take some time to feed through. We now expect that the three Baltic states will join the euro area together, but not before 2009.

Bulgaria/Romania – Accession in 2007, with provisos

As expected, the Commission, in its Monitoring Report on Bulgaria and Romania that was published on 16 May 2006, "conditionally consented" to 1 January 2007 as the accession date. The main points of criticism were also generally unchanged over the last progress report (October 2005), with the Commission calling on the countries to take further measures especially for the reform of public administration and the judiciary, for fighting corruption, and for the more efficient management of EU funds. The Commission indicates that Bulgaria has fallen behind Romania in its reform progress. In the case of Romania, the Commission's grave concerns are limited to four areas (mainly of a technical nature), while in Bulgaria there are still six areas of serious concern. These include the fight against corruption, organised crime and money laundering. The Commission will take a final decision on the accession date 2007 and the conditions of EU entry at the beginning of October. This is likely to induce the countries to step up reform efforts and to increase public acceptance of far-reaching reform measures. While the time frame for the corrective measures is compressed, the measures can be pushed through. In our opinion, it is therefore to be assumed that 1 January 2007 will remain the accession date for these two countries.

FYR Macedonia – Elections on 5 July

Opinion polls suggest that there may be a change in government after the parliamentary elections in Macedonia. Based on voter support, the Social Democrats, led by Prime Minister Vlado Buckovski, are only in second place. Nikola Gruevski, chairman of the conservative VMRO-DPMNE (Internal Macedonian Revolutionary Organisation – Democratic Party for Macedonian National Unity) thus has a good chance of becoming the new prime minister. The coalition partners could be the New Social Democratic Party headed by Tito Petkovski and the Albanian Democratic Union for Integration, which, under the leadership of Ali Ahmetis, is already a member of the ruling government coalition.

The adoption of a new Election Act at the end of March has paved the way for fair parliamentary elections, for the EU a precondition for accession negotiations. We believe that it is however very likely that before making any positive decision, the EU will wait to see whether the elections will produce a stable, reform-minded government eager to work towards an approximation of EU standards. Although Macedonia was granted candidate status in December last year, accession negotiations could be delayed until 2008.

Public finance (General government, ESA 95)

	General government budget balance (% of GDP)				*General government gross debt (% of GDP)*			
	2004	*2005*	*2006*	*2007*	*2004*	*2005*	*2006*	*2007*
Czech R.	**-2.9**	**-2.6**	**-3.5**	**-4.0**	**30.6**	**30.5**	**30.7**	**30.9**
Estonia	**1.5**	**1.6**	**1.8**	**0.0**	**5.4**	**4.8**	**4.0**	**2.9**
Hungary *)	**-6.5**	**-7.5**	**-6.9**	**-5.5**	**58.4**	**59.7**	**61.1**	**62.0**
Latvia	**-1.1**	**-1.0**	**-1.5**	**-1.3**	**14.6**	**11.9**	**11.3**	**10.9**
Lithuania	**-1.5**	**-0.5**	**-1.5**	**-1.5**	**19.5**	**18.7**	**18.3**	**17.8**
Poland *)	**-5.7**	**-4.3**	**-5.0**	**-4.9**	**45.9**	**47.9**	**52.5**	**53.7**
Slovakia *)	**-3.0**	**-3.7**	**-4.0**	**-3.5**	**41.6**	**34.5**	**36.3**	**37.7**
Slovenia	**-2.3**	**-1.8**	**-1.7**	**-1.5**	**29.8**	**29.2**	**29.6**	**29.8**
CEEC-8	***-4.5***	***-4.0***	***-4.3***	***-4.2***	***41.5***	***42.0***	***44.0***	***44.4***
Bulgaria	**1.7**	**3.2**	**3.0**	**2.0**	**40.9**	**31.9**	**26.0**	**21.8**
Croatia	**-4.9**	**-4.2**	**-4.5**	**-4.0**	**44.8**	**45.2**	**44.4**	**43.1**
Romania	**-1.2**	**-0.8**	**-1.0**	**-1.5**	**22.3**	**19.6**	**18.8**	**17.9**
CEEC-11	***-4.0***	***-3.4***	***-3.7***	***-3.6***	***39.6***	***39.1***	***40.1***	***39.8***

Source: National statistical offices, EU-Commission, Bank Austria Creditanstalt Economics Department; *) Pursuant to a Eurostat decision of 2 February 2004 and 23 September 2004, pension funds which are part of the 2nd pillar of the pension system must be classified as non-governmental as from spring 2007. As this method will be applied for assessing the state of readiness for participation in the euro area, we are already now adopting it for our country analyses. As a result, the deficits and level of indebtedness relative to our previous representations and to the official data provided by the countries themselves and by the EU will be higher.

Montenegro – And then there were suddenly six

The preliminary results of the plebiscite on the country's independence point to a slim majority in favour of secession from Serbia. With voter turnout of almost 90 %, 55.5 % of the population advocated independence. This exceeds the 55 % threshold needed to validate the result of the plebiscite, and finally seals the end of the Union of Serbia and Montenegro; the sixth successor state of the former Yugoslavia is now being created.

Politically, Montenegro's secession from Serbia will probably not pose any problems. The Serbian government had stated prior to the plebiscite that it would respect the result. Any economic-related problems are also likely to be insignificant as many areas are already autonomous (e.g. currency, central banks, customs, judiciary), although the secession process will in the next few weeks and months absorb a certain amount of administrative capacity. The Montenegrin government is hoping that independence will accelerate approximation to the EU, but this will only be the case once this process has been concluded.

Serbia – SAA negotiations suspended, government under pressure

The deadline for handing the alleged war criminal Ratko Mladic over to the UN tribunal has expired without being used after being extended by one month until the end of April. The EU has responded by suspending negotiations on a Stability and Association Agreement. Miroljub Labus, Serbia's chief negotiator, has resigned as Serbia's Deputy Prime Minister. The other ministers of the G17+ will probably remain in the government. Even if the G17+ were to leave the coalition, this would not necessarily immediately require new elections. Finance Minister Mladjan Dinkic (G17+) had planned early elections only for the autumn. According to the results of opinion polls, the elections could lead to a further strengthening of radical forces, which would not be conducive for the continuation of economic reforms. Such conditions would offer very little prospect of fruitful cooperation with the War Crimes Tribunal (extradition of Ratko Mladic or Radovan Karadzic), and Serbia's convergence with the European Union would take much longer.

Fiscal 2005 successful on the whole, but it will take more to get the CEE-3 off the Maastricht offenders list

At the end of April, Eurostat published the data on the 2005 budget deficits of the EU member states, and in early May, the EU Commission released its spring prognosis. It was interesting to note that, as a percentage of GDP, the highest deficits in the EU were recorded by Hungary (6.1 %), Portugal (6.0 %), Greece (4.5 %) and Italy (4.1 %). Three other EU Member States have a general government deficit of more than 3 % of GDP, namely the United Kingdom (3.6 %), Germany (3.3 %) and Malta (3.3 %). A budget surplus was registered in eight countries in 2005: Denmark (4.9 %), Sweden (2.9 %), Finland 2.6 %), Estonia (1.6 %), Spain (1.1 %), Ireland (1.0 %), Latvia (0.2 %) and Belgium (0.1 %).

With the exception of Hungary, the budget deficits in all of the EU CEE countries were lower than 3 % of GDP in 2005. In these calculations, the transfers to the second pillar of the pension systems are not taken into consideration, however; that will have to be reported in the budget data from 2007 on. For Hungary, this would widen the deficit by 1.4 percentage points to 7.5 % of GDP, for Poland by 1.8 percentage points to 4.3 % of GDP and for Slovakia by 0.6 percentage points to 3.5 % of GDP. Again with the exception of Hungary, budget deficits in the CEE countries tended to decline from 2004 to 2005. In Slovakia, and to a lesser degree in Estonia, the Czech Republic and Slovenia this was the result of lower spending (as a percentage of GDP). In Latvia, Lithuania and Poland, this was the result of higher revenues. The Hungarian deficit continued to rise despite higher revenues.

In 2006 and 2007, Poland, the Czech Republic and Hungary (the CEE-3) will be among the countries that have a budget deficit higher than 3 % of GDP, adjusted for economic and one-off effects (structural deficit), according to the EU Commission (see table). Countries in Southern Europe also face the prospects of having a deficit of over 3 % of GDP through to 2007, including Greece, Portugal, Italy and Malta. The forecasts are based on the plans that the governments had submitted up until preparation of the report. Poland and the Czech Republic are not planning radical cuts in spending; Hungary announced such measures following the elections, but has not yet presented any details.

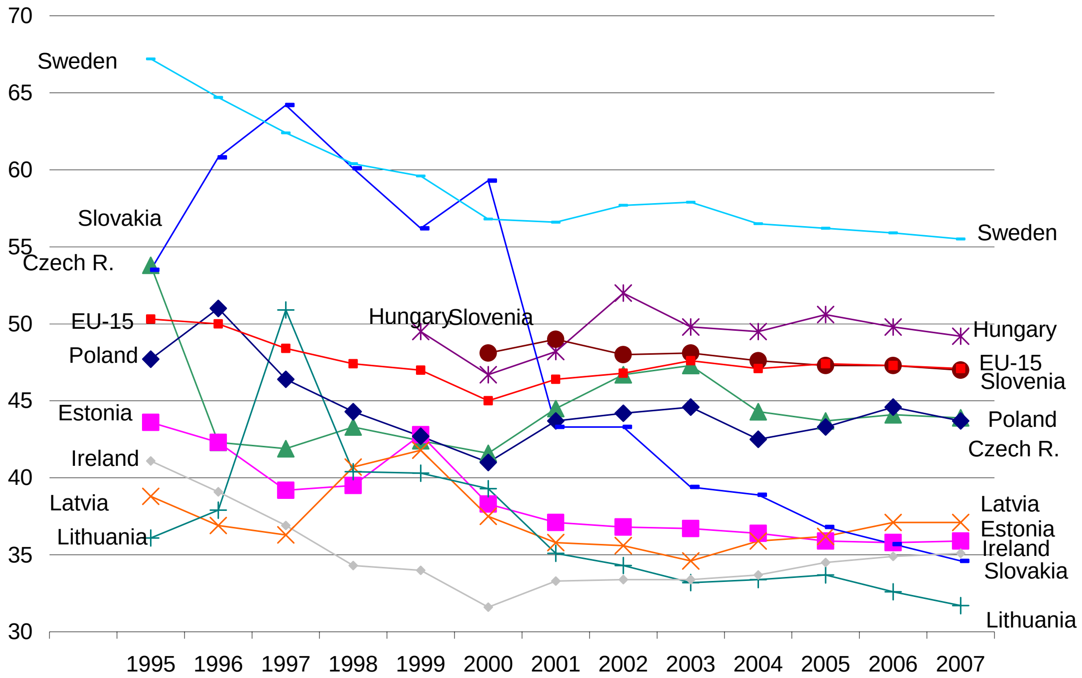
In principle, a modest budget deficit or a surplus can be achieved with a model featuring a high ratio of state spending (e.g. in Sweden, although general government spending has fallen below the level of 60 % of GDP since 1999) or with a liberal model, as found for example in Ireland or the Baltic states, which is the direction Slovakia has

Structural budget surplus, % of GDP*

	2004	2005	2006	2007		2004	2005	2006	2007
Denmark	3.6	5.2	3.6	3.7	***EU-25***	***-2.9***	***-2.1***	***-2.1***	***-1.9***
Finland	2.5	3.2	2.8	2.7	Slovakia	-2.3	-1.6	-2.4	-2.2
Sweden	1.4	2.6	2.1	2.1	**Germany**	**-3.5**	**-3.1**	-3.0	-2.3
Spain	-0.7	1.3	1.3	1.0	Cyprus	**-4.7**	-2.9	-2.2	-2.3
Ireland	0.7	1.9	1.0	0.8	**France**	**-3.7**	**-3.1**	-2.7	-2.5
Estonia	1.8	1.5	1.1	0.5	**United Kingdom**	**-3.5**	**-3.3**	-2.7	-2.5
Netherlands	-1.1	1.0	-0.3	-0.2	**Malta**	**-4.6**	**-3.1**	**-3.2**	**-3.3**
Belgium	-0.8	0.1	-0.5	-0.3	**Poland**	**-4.2**	**-2.6**	**-3.3**	**-3.5**
Latvia	-0.8	-0.1	-1.2	-0.8	**Italy**	**-4.6**	**-3.9**	**-3.8**	**-3.8**
Luxembourg	-0.5	-1.3	-1.3	-1.0	**Portugal**	**-4.8**	**-5.2**	**-4.1**	**-3.9**
Lithuania	-2.0	-1.1	-1.0	-1.0	**Czech Republic**	**-1.3**	**-1.4**	**-3.4**	**-4.0**
Austria	-0.8	-1.0	-1.7	-1.2	**Greece**	**-7.7**	**-5.3**	**-4.4**	**-4.4**
Slovenia	-1.8	-1.5	-1.7	-1.7	**Hungary**	**-5.2**	**-6.3**	**-7.6**	**-8.5**

* In descending order according to the magnitude of the surplus; deficits of more than 3% of GDP highlighted
Source: EU Commission, Economic forecasts, spring 2006, Bank Austria Creditanstalt Economics Department

General government expenditure, in % of GDP



Source: EU Commission, Economic forecasts, spring 2006, Bank Austria Creditanstalt Economics Department

taken in a radical change (cf. chart). Which model can be used depends, however, in part on GDP per capita. While Slovenia's ratio of public spending is around the average of the "old" EU (and the country is doing fine with this), Hungary's ratio is considerably higher and this is obviously a bit too much. The ratio of state spending by Poland and the Czech Republic is in mid-range. After reaching high levels in 2003, the ratio in the Czech Republic has declined again, but forecasts predict another rise in 2006. The ratio in Poland has changed little since 2001, despite various programmes and promises. If Poland and the Czech Republic wish to avoid structural deficits of over 3 % of GDP, they will have to move forward with further fiscal reforms.

Hans Holzhacker

Czech Republic – Economic growth conceals structural problems in public finance

The public sector deficit narrowed to 2.6 % of GDP in 2005, staying below the 3 % limit for the second consecutive year. As in 2004, the reasons for the deficit turning out lower than planned were discerned on both the side of revenues and the side of expenditures. In regard to the former, an upturn in GDP growth generated CZK 18 billion in extra revenue. As regards the latter, the state authorities were unable to spend all funds allocated in the budget, transferring almost CZK 50 billion to reserve funds at the end of 2005.

For 2006, the Finance Ministry predicts the public-sector deficit to widen to 3.6 % of GDP, which would still meet the 3.8 % target set in the EU convergence programme. The latest forecast of the central bank is however more optimistic, at 2.4 %. The arguments for the CNB's optimism include again the likely overshooting of the projected GDP growth and the envisaged delay in some public tenders.

Looking just at head line figures, it would be tempting to draw the conclusion that fiscal consolidation has been successfully achieved. Actually, the sound economic situation is temporarily hiding long-term structural problems in public finance, however. The share of mandatory expenditures remains high and social transfers have lately been growing at double-digit rates. The pension reform has not started yet. The seemingly stable fiscal situation on the eve of the new election term increases the risk of neglecting the requirement for fiscal prudence.

Pavel Sobisek
Chief economist, HVB Czech Republic

Hungary – Stabilisation measures ahead

Hungary's general government budget experienced a period of indulgence in the first months of 2006 as no radical restrictive measures could be expected from any government in office during general election time. With the parliamentary elections now over, a wide range of stabilisation measures - including short-term restrictive measures and longer term reforms - were scheduled to be announced by the end of May or mid-June by the newly-formed socialist-liberal coalition government.

Hungary's general government budget has run record deficits since 2002 and was not able to cope even with the budgeted figures. In the first four months of this year, pro-rata figures were more or less on target and stood at HUF 904.2 bn by the end of April 2006, corresponding to 60.8 % of the overall targeted annual deficit. The Q1 deficit exceeded the target figure by HUF 100 bn, a development which the Finance Ministry claimed was due to prepayments of EU aid to resident entrepreneurs, while in April the same item of the central government lagged behind the budgeted figure by HUF 50 bn. The chronic above-target level of the social security fund deficit was more moderate during the period. Nevertheless, the market expects a stabilisation package of some HUF 300-500 bn for the year in order to prevent the deficit to more than 6.7-7.0 % of GDP. The off-budget financing of extensive highway construction can also help to fulfil this target (seemingly). The new government has to submit an amended Convergence Programme to the EU Commission by early September 2006, and the Commission's response regarding the feasibility of reducing the Hungarian general government deficit to the -3 % limit by 2008-2009 will be decisive for putting the HUF on the path for EMU entry in the early part of the next decade. The financial markets see the HUF on this waiting list and the position taken by Brussels will also be crucial for the fate of the HUF exchange rate.

Márta Szegő
Chief economist, HVB Hungary

Poland – Budget deficit on track

The budget deficit as of the end of April amounted to 32.8 % of the annual target. The 4-month budget revenue reached 32.5 % of the target figure, and expenditure 32.5 %. For comparison purposes: in the past year the deficit as of the end of April was 39.6 % of the annual target figure. In general, the revenue side of the 2006 budget seems to have been overestimated, but economic growth higher-than-expected at the time when the budget was prepared, and especially higher private consumption, will boost tax revenues this year, which reduces the risk associated with optimistically assumed revenues. Currently the Finance Ministry forecasts annual GDP growth at 4.6 %, compared with the 4.3 % growth rate assumed by the draft budget for this year. Overall, we do not expect Poland's fiscal situation to worsen this year, but a real challenge will be the budget for the year 2007, to be prepared by the new government coalition.

For the financing of the budget deficit, it is of some concern that privatisation proceeds in January-April amounted to only 5.8 % of the target figure, based on gross privatisation proceeds of 5.5 billion zlotys as called for in the state budget. Recently, though, the Treasury Ministry stated that the projected proceeds would not be realised and proceeds from privatisation will amount to only 3.1 billion zlotys in 2006 – in our opinion still an excessively high figure. The shortfall will probably be made up by higher government debt issues later this year. According to the Treasury Ministry, though, the shortfall will be covered by higher dividends from state-controlled companies in the amount of 3.0-3.2 billion zlotys vs. 2.4 billion zlotys assumed in the budget.

Maja Goettig
Economist, Bank BPH

Slovenia – Will the budget deficit rise this year?

Since 2002, Slovenia's budget deficit has contracted from 2.7 % of GDP to 1.8 % in 2005. In 2005 the budget benefited from better-than-expected revenue inflows as well as from the continuation of tight wages and employment policies in the public sector. Data for only the first two months of 2006 for the central budget was available at the time of writing, limiting the informative value of overall budgetary trends this year.

Nonetheless, last year's decision to index pension growth to wages rather than to a combination of inflation and wages does present an upside risk to the deficit. So does the decision to phase out payroll tax over a period of several years, even though it is expected to be compensated by an increase in VAT tax at some point.

On the whole, the macroeconomic policy pursued in Slovenia remains prudent, as evidenced by the positive Convergence Report from the European Commission and European Central Bank which paves the way for the country to adopt the euro on 1 January 2007. Policy-makers are discussing the need to increase the efficiency and flexibility of the economy, which will become a key determinant of competitiveness within the euro zone. Reforms with this goal in mind would also suggest the maintenance of low budget deficits in Slovenia in the medium-term.

Goran Šaravanja
Analyst, CA-IB Zagreb

Bulgaria – Achieving the budget deficit target for 2006 is difficult

Bulgaria is continuing to maintain a significant fiscal surplus. In 2005 the surplus of the consolidated budget amounted to BGN 986 mn, or 2.3 % of GDP. Under the national methodology, which does not consider investments in public projects as costs, the surplus was even 3.2 % of GDP. At 12.6 %, revenues of the state budget were above target, while expenses were in line with the budgeted figure. Both of the two governments that ruled the country in 2005 were in a position to limit extra spending despite parliamentary elections and numerous requests for additional public funding on account of the fiscal surplus.

In the first quarter of 2006 the consolidated surplus according to the national methodology amounted to BGN 429 mn (Q1'05 – BGN 479.3 mn), achieved as a result of lower expenditures (20.2 % of the figure budgeted for 2006). On the revenue side, the performance is almost on track with the budget (24.8 % of the 2006 budget figure). Revenues from indirect taxes did not quite manage to meet predictions, especially in the area of excise duties (Q1 - 18.8 % of the 2006 budget figure). Income from VAT, the main source of revenues, also fell short of the projected level (22.2 % of the 2006 budget figure). Lower revenues from indirect taxes seem to be temporary (a result of stockbuilding in 2005 before the introduction of higher excise duties in 2006), and in any case are not of a dimension that could jeopardise the budget. However, it seems that in 2006 the government will not enjoy the ample excess revenues, which in previous years provided the basis for both a surplus and additional budget spending on selected items in the second half of the year. This will make it more difficult to achieve the targeted surplus of 3 % of GDP (as announced after meetings with representatives of the IMF), with some MPs within the ruling coalition parties (notably BSP) pressing for an increase in social spending in line with pre-election commitments.

Dimitar Mitev
Chief economist, HVB Bank Biochim

2. Output, demand, inflation

Growth of industry peaks

The upswing in industrial activity that started around the middle of last year has increasingly gained momentum in the first months of 2006. In Q1, industrial production in the three EU candidate countries increased by an average 5.4 % in yoy terms. In the eight new EU Member States, industrial output jumped significantly, rising more than 12 %. The top performance in this realm was put in by the Czech Republic, thanks to robust demand for products made by the automotive industry, but Poland and Hungary also saw above-average growth in industrial output. Against the backdrop of these very favourable developments, the strong GDP data for the first quarter come as little surprise. The official initial estimates for Hungary are that GDP increased by 4.5 % in yoy terms. In Slovakia, economic growth in Q1 2006 was likely to have been over 6 % and over 8 % in Lithuania. On the whole, we expect that GDP in the region rose by 5.3 % on average.

Nevertheless, we also believe that industrial output has now peaked out. Still, thanks to robust foreign demand, industrial production should remain at high levels and continue to be a major factor behind strong economic growth as the year progresses. For 2006 as a whole, the regional average for GDP growth should be around 5 %, and thus just slightly weaker than in the first quarter.

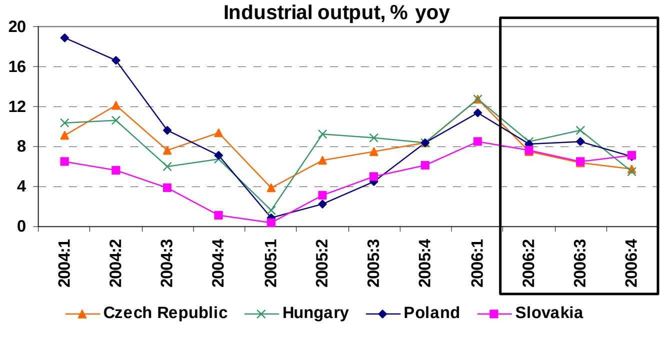
Poland – Industrial production slightly weaker in April

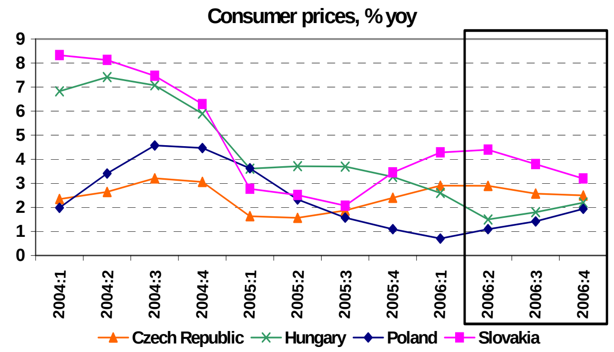
The month of April saw industrial production in Poland slip from the impressive year-on-year rate of 16.4 % in March to 5.8 %. In seasonally adjusted terms, production was down 0.6 % on the previous month, according to our calculations. While industrial production in the second quarter will probably be marginally lower than it was during the buying boom in Q4 2005 and the first quarter of this year, there is not likely to be a sharp decline. Among other things, the sectoral composition of growth points in an opposite direction. The pace of expansion in the export industries continues to be very robust. Production of radio, TV and telecommunications equipment, for example, was up 58 % on the previous year, in metals, wood products and automobiles 10-11 % increases were registered. Coal mining and cellulose and paper production dropped. Thanks to continued strong global growth resulting in high international demand for Polish products and thanks to further increases in employment and real wages in Poland, seasonally adjusted industrial output growth will probably only taper off minimally in the coming months. In year-on-year terms, however, the rates will decline as the base effect from the weak performance registered in Q1 2005 wears off. Nonetheless, annual average growth in industrial production should still reach almost 9 % for 2006.

Slovakia – Growth trend steady in Q1 with high inflation

Economic growth in Slovakia continued to be strong in the first quarter of 2006, at 6.3 % yoy. Although no detailed data are so far available on the individual demand components, we presume that the main drivers of economic growth were private consumption (due to the very robust development of retail sales) and investments. On the other hand, net exports probably made a negative contribution to growth as the development of foreign trade in Q1 was not so favourable due to the investment-driven import boom for new auto manufacturing plants.

Industrial output data for March improved sharply (February: +4.7 %; March: +15.3 %), especially in the automotive industry





(February: -16.9 %; March: +17.2 %). Employment has also benefited from this development, with an almost 2.5 % increase in the number of employed persons in Q1 2006.

On the whole, based on the results for the first quarter we confirm our forecast of 6.3 % economic growth in 2006. We expect to see private consumption remain quite robust. The investment cycle will taper off slightly when the auto manufacturing plants are completed, but this should be accompanied by a trend towards stronger performance in exports.

In April, annual inflation remained steady at 4.5 %, the same as in March. Core inflation (excluding energy and food prices) also remained unchanged at 2.4 %, indicating strong upward pressure on prices generated by demand. Our forecast is that inflation will remain at over 4 % over the coming months, due to higher fuel prices (in addition to the broader risks entailed by higher oil prices), increases in taxes on cigarettes and higher prices for medication. Inflation will then begin to lose momentum in the final quarter of 2006, when the base effects of price increases from the previous year (natural gas prices) disappears from the time series.

Slovenia – Strong growth in Q1, inflation meets criterion for adoption of euro

Over the first quarter of 2006, the signs of robust growth in the Slovenian economy grew even stronger. Industrial production jumped by 8 % in real terms from January to March, driven by brisk foreign demand. Accordingly, we believe that GDP in Slovenia probably expanded faster than 4 % in the first quarter.

Current sentiment indicators also point to vigorous growth in industrial production in the coming months, in part due to full order books. Over the rest of the year, however, it can be expected that export demand may falter a bit, despite the favourable international conditions, as it is not likely that the good performance seen in the auto industry will be repeated to the same degree, due in part to changing models. Nevertheless, investment should hold up quite well, facilitated by low interest rates, new public infrastructure development programmes, and private consumption supported by strong demand for credit, which is benefiting from the low level of interest rates as well as the improvements on the labour market. Accordingly, investment should be a factor supporting economic activity, and hence we anticipate GDP growth to reach about 4 % in 2006 as a whole.

Inflation averaged 2.3 % in the first four months of the year. Although inflation picked up slightly in the last two months due to knock-on effects of the increases in energy prices last year and the recent sharp rise in oil prices, Slovenia was still able to fulfil the Maastricht criterion on price stability and now stands ready to adopt the euro.

Hungary – Year off to a rousing start

As would be assumed after the very strong early indicators, the average rise of roughly 6 % in retail turnover in the first three months of this year and the quite robust industrial production data (Q1: +13.1 % yoy), economic growth was very brisk in Q1 2006, at 4.5 %. Although no detailed data are available yet, we presume that economic growth was probably supported in equal measure by domestic demand, fuelled by strong private consumption in the run-up to the general elections and robust foreign demand thanks to the pick-up in the European economic cycle. The bright outlook for economic activity in the key EU markets suggests that the dynamic trend in exports will also continue. Although investment activity will likely be less robust than in the previous year due to the higher real interest rates, private consumption should make a stronger contribution, as changes in the tax system should prompt higher domestic demand (e.g. VAT reduction). Accordingly, for 2006 we expect economic growth to be somewhat stronger than in 2005.

	Industrial production real (yoy)				*Retail sales real (yoy)*				*Wages in industry real (yoy)*				*Consumer prices (yoy)*			
	03/06	*04/06*	*05/06*	*06/06*	*03/06*	*04/06*	*05/06*	*06/06*	*03/06*	*04/06*	*05/06*	*06/06*	*03/06*	*04/06*	*05/06*	*06/06*
Czech R.	17.9	12.2	10.9	10.9	6.8	5.3	6.9	7.1	3.2	2.6	3.4	3.4	2.8	2.3	2.5	2.5
Estonia	9.3	9.8	9.4	8.5	18.0	12.9	13.0	11.3	9.9	4.9	6.5	7.5	4.0	4.3	4.1	3.5
Hungary	14.0	12.9	12.7	9.9	6.5	6.9	5.2	4.7	4.2	3.6	0.8	2.6	2.3	2.3	1.9	1.8
Latvia	9.9	8.7	5.6	7.0	18.5	14.0	19.9	18.1	5.4	7.2	6.8	6.9	6.5	6.1	6.3	6.0
Lithuania	12.8	10.7	7.4	12.7	15.9	10.4	10.3	8.5	9.4	8.4	8.1	9.1	3.1	3.5	3.4	3.2
Poland	16.4	5.8	13.9	7.4	10.4	12.5	10.1	6.2	5.1	4.6	4.8	4.0	0.4	0.7	0.9	1.2
Slovakia	15.3	4.7	9.4	10.5	10.0	8.6	7.8	7.3	4.0	7.5	6.8	6.6	4.5	4.5	4.4	3.9
Slovenia	9.9	5.6	7.0	6.8	-0.2	4.2	4.4	3.3	3.2	1.8	2.8	2.5	1.8	2.7	2.5	2.6
CEEC-8	*15.5*	*8.3*	*11.9*	*8.9*	*9.2*	*9.6*	*8.6*	*6.6*	*4.7*	*4.4*	*4.2*	*4.2*	*1.8*	*1.9*	*2.0*	*2.0*
Bulgaria	4.7	3.7	5.2	5.5	10.2	8.4	9.9	9.5	0.9	1.5	1.5	1.8	8.7	8.1	8.1	7.9
Croatia	6.0	-3.2	-0.1	2.0	0.1	1.7	2.0	2.3	1.4	1.8	0.6	1.2	3.0	3.5	3.6	3.6
Romania	4.3	3.5	7.8	5.7	20.2	18.4	23.9	22.8	10.7	10.1	9.8	9.5	8.4	6.9	7.3	7.2
CEEC-11	*13.2*	*7.0*	*10.6*	*8.0*	*10.2*	*10.3*	*10.3*	*8.6*	*5.2*	*4.9*	*4.7*	*4.6*	*3.0*	*2.9*	*2.9*	*3.0*

Source: National statistical offices, central banks, finance ministries, BA-CA Economics Department highlighted...forecast

Romania – Inflation worries despite record-low rate in April

In April consumer price inflation in Romania dropped to 0.4 % mom, or 6.9 % yoy, the lowest rate registered since Romania embarked on its reform path. Due to price adjustments in water supply, sewerage and sanitation, the main contributor to higher inflation was the services sector (+8.6 %). Despite a 3.5 % rise in gas prices, non-food prices rose at a rate of 6.9 %, in line with the overall pace of inflation. Food prices rose even more slowly, at +6.2 %.

In response to the good results, the Board of the NBR left the policy rate unchanged at 8.5 % at its meeting on 11 May, but announced that it planned to continue its strategy of significant sterilization of excess liquidity via open-market operations. In accordance with its quarterly report on inflation published on 16 May, the NBR also maintained its inflation target of 5 % with a fluctuation band of +/- 1 %, although the NBR did admit that there was a possibility that this target would be exceeded. Hence, further restrictive measures in the course of the year cannot be ruled out, especially as the short-term inflation outlook is less favourable. In the coming months pressure on prices is expected to mount due to upcoming increases in regulated prices and the planned increase in excise taxes on alcohol and tobacco on 1 July 2006. Consequently, we adhere to our forecast of 7.5 % average annual inflation for 2006, despite the surprisingly good result for April.

Serbia – New measures to combat rising inflation

While inflation in the first four months of this year dropped to an average rate of 14.6 %, the rate began to rise again in April due to higher prices for tobacco and electricity, despite the fact that the Serbian dinar appreciated modestly in April, which helped to cushion import prices somewhat.

Serbia's central bank has set the target of single-digit inflation by year-end and reacted to the current developments which it ascribes mainly to very high domestic demand by raising the minimum reserve requirements for foreign currency deposits from 40 % to 60 %. Moreover, the National Bank of Serbia decided that from the end of September the maximum volume of household lending may not exceed 200 % of the value of a bank's share capital. This move is intended to help keep commercial banks from borrowing abroad, as this is a key factor behind the ongoing expansion of lending to the public and corporate sectors.

In our view, the measures taken by the NBS will increase lending costs and also have the potential to limit economic growth. On the other hand, we view the positive effect on the development of inflation as rather modest. Based on the available inflation data, we have increased our forecast for annual average inflation from 12.2 % to 13 %.

Real GDP

					2003	*2004*				*2005*				*2006*	
	2004	*2005*	*2006*	*2007*	*4. Qu.*	*1.Qu.*	*2. Qu.*	*3.Qu.*	*4. Qu.*	*1.Qu.*	*2. Qu.*	*3.Qu.*	*4. Qu.*	*1.Qu.*	*2. Qu.*
Czech R.	**4.7**	**6.0**	**5.4**	**4.5**	**3.6**	**4.0**	**4.8**	**4.9**	**5.0**	**5.3**	**5.8**	**5.8**	**6.9**	**5.9**	**5.4**
Estonia	**7.8**	**9.8**	**9.5**	**8.5**	**7.7**	**9.3**	**7.3**	**8.3**	**6.6**	**7.2**	**9.9**	**10.6**	**10.5**	**10.1**	**9.6**
Hungary	**4.6**	**4.1**	**4.2**	**3.8**	**4.1**	**4.9**	**4.9**	**4.3**	**4.5**	**3.2**	**4.5**	**4.5**	**4.3**	**4.5**	**4.1**
Latvia	**8.5**	**10.2**	**8.5**	**7.5**	**7.3**	**8.7**	**7.8**	**9.1**	**8.6**	**7.3**	**11.4**	**11.4**	**10.5**	**10.0**	**8.0**
Lithuania	**7.0**	**7.5**	**6.5**	**6.3**	**11.7**	**7.4**	**7.9**	**5.6**	**7.2**	**4.4**	**8.4**	**7.9**	**8.8**	**8.1**	**6.6**
Poland	**5.3**	**3.3**	**4.6**	**4.7**	**4.7**	**6.8**	**5.9**	**4.8**	**3.9**	**2.2**	**2.8**	**3.7**	**4.2**	**4.6**	**4.5**
Slovakia	**5.4**	**6.1**	**6.3**	**6.5**	**5.3**	**5.4**	**5.5**	**5.3**	**5.8**	**5.1**	**5.1**	**6.2**	**7.6**	**6.3**	**6.7**
Slovenia	**4.2**	**3.9**	**4.0**	**3.8**	**2.8**	**3.8**	**4.3**	**4.7**	**3.8**	**2.8**	**5.4**	**3.6**	**3.7**	**4.1**	**3.4**
CEEC-8	**5.2**	**4.6**	**5.1**	**4.8**	**4.7**	**5.8**	**5.6**	**5.0**	**4.6**	**3.5**	**4.5**	**4.9**	**5.4**	**5.4**	**5.0**
Bulgaria	**5.7**	**5.5**	**5.5**	**5.5**	**5.7**	**4.6**	**5.5**	**6.2**	**6.3**	**5.9**	**6.5**	**4.6**	**5.5**	**4.9**	**5.1**
Croatia	**3.8**	**4.3**	**4.4**	**4.2**	**3.3**	**4.2**	**3.8**	**3.6**	**3.6**	**1.8**	**5.1**	**5.2**	**4.8**	**5.1**	**3.7**
Romania	**8.4**	**4.1**	**5.6**	**5.5**	**5.2**	**6.2**	**7.0**	**9.7**	**9.5**	**6.0**	**4.5**	**2.4**	**4.3**	**5.5**	**5.0**
CEEC-11	**5.5**	**4.6**	**5.1**	**4.9**	**4.7**	**5.8**	**5.7**	**5.5**	**5.2**	**3.8**	**4.6**	**4.6**	**5.2**	**5.3**	**5.0**

Source: National statistical offices, central banks, finance ministries, Bank Austria Creditanstalt Economics Department highlighted...forecast

3. External economy

High dynamism continues

In the first months of this year, the dynamic development of foreign trade in Central and Eastern Europe continued unabated. Supported by the favourable economic situation in Europe, exports of the CEEC-11 group of countries on average rose by almost 22 % year-on-year. As a result of continuously strong investment activity partly due to special factors such as the equipment of the new car manufacturing plants in Slovakia and strong private consumption, imports increased at an even higher rate in most countries. Thus, the trade balance deteriorated in the majority of the countries in the first three months of the year, which also had its impact on the current account. For 2006 as a whole, we assume that, owing to the favourable development of commodity exports, the current account balance in the region will only insignificantly exceed the level of 2005.

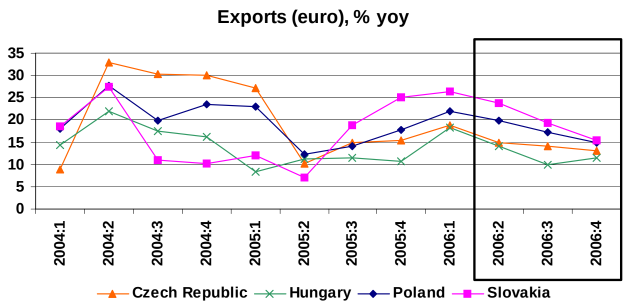
Slovakia – Improvement in foreign trade relations in March

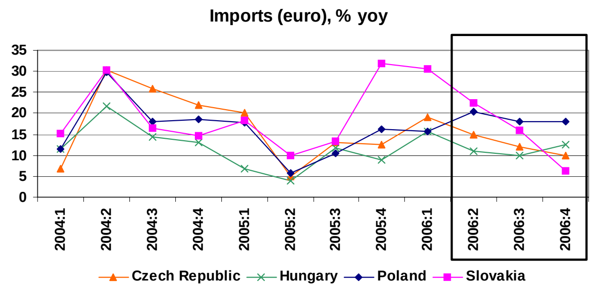
After recording large shortfalls in the winter months, the balance of trade developed much more favourably in March, showing a deficit of only 116 million euros. This is on the one hand due to a weakening of the strong increases in imports, which were caused by the higher oil price and the impetus given to imports by investments (car industry), while on the other hand exports gained momentum. Although the detailed foreign trade structure for March is not yet available, the already published figures for industrial output indicate that the export boom is probably closely connected with the car industry, which recorded an impressive increase in output of about 17.2 % in March. The other export-oriented technical manufacturing industries, such as mechanical engineering and the electrical and electronics industry, which continue to record higher than average increases in output, also contributed to export performance.

Overall, foreign trade prospects are quite favourable. Although import growth will remain strong as a result of the high oil price and investments, exports should rise at a higher rate. On the one hand, the impact of the production changeover at the VW plant is expected to taper off. On the other hand, the production at the new PSA plant, which commenced a short while ago, will gradually have an impact in the further course of the year, while the KIA plant will only have an impact on export figures at the beginning of 2007, since production is planned to commence in December 2006.

Hungary – Trade deficit rose in the first quarter

In spite of a robust demand for exports, which rose by 19 % on average (in nominal terms, in euros), the trade deficit increased to almost 700 million euros (1-3/2005: EUR 513 million) in the first three months of this year, since the growth of imports in March exceeded that of exports for the first time this year. But apart from the higher oil price and the weaker forint, this is in our opinion above all attributable to non-recurrent effects, such as the delivery of the first new interceptors. We therefore continue to expect that, owing to the favourable economic situation in the major markets of Hungarian exporters, the current account deficit, which presumably still slightly exceeded the previous year's level in the first quarter, will show a slight decline as the year progresses. In 2006 as a whole, we anticipate a current account deficit of 7 % of GDP (2005: 7.3 % of GDP).





Poland – Export development remains impressive

At EUR 21.2 billion, Poland's exports according to the balance of payments statistics exceeded those recorded in the same period of last year by 21 % in the first quarter of 2006 and also continued to show a seasonally adjusted strong increase of 6.6 % compared with the previous quarter. Import growth accelerated as well, continuously rising from a seasonally adjusted 2.7 % qoq in the first quarter of 2005 to up to 6.2 % qoq in the first quarter of 2006, which also adds up to a year-on-year growth of 21 %. The trade deficit amounted to 270 million euros and almost remained unchanged compared with last year. The current account deficit showed a slight increase from 1,048 million euros last year to 1,177 million euros, which was above all due to the present lower transfers from the EU. In view of an expected continuation of strong import demand, we anticipate a slight widening of the current account deficit also for 2006 as a whole, compared to 1.4 % of GDP in 2005. The current account deficit will however probably remain below 2 % of GDP as a result of the flourishing exports.

Bulgaria – Substantial current account deficit in Q1 2006

In the first quarter of 2006 Bulgaria's current account deficit reached 1.05 bn euros or 20.7 % of GDP on a quarterly basis, a figure twice as high as the shortfall of 550 mn euros (12.3 % of GDP) in the first quarter of 2005. The widening of the current account deficit is not only attributable to the higher trade deficit but also to the more or less substantial deterioration in all other sub-accounts of the balance of payments. Due to the strong increase in services imports in the fields of transport and tourism, the deficit of the balance on services, in particular, widened, while the income balance and the balance of transfer payments showed a markedly lower surplus. However, the underlying factors responsible for the considerable trade deficit did not change much. Higher energy imports (+94.6 %) as a result of the high oil price and strong demand for imports of machinery and motor vehicles (+20.8 %) above all contributed decisively to the adverse development of the trade balance.

Although the base effect resulting from energy imports (due to the development of the oil price in 2005) is likely to subside in the second half of the year, accelerated imports of consumer and capital goods prior to EU accession will contribute to the continuation of the present strong import growth. Accordingly, the pressure on the current account is expected to persist in the further course of the year and consequently an expansion of the deficit to 12.5 % of GDP is anticipated in 2006 as a whole.

However, net FDI inflows also increased at the same pace as the current account moved into deficit. In the first quarter of 2006, net FDI inflows amounted to about 740 mn euros, up from 377 mn euros in the respective period of last year, which corresponds to about 70 % of the current account gap and thus mitigates the risks as regards financing the deficit.

Croatia – Strong growth, increasing imbalance

The considerable growth of foreign trade last year even increased in the first quarter of 2006. In the first three months, exports went up by 30 % year-on-year (in nominal terms, in euros). Strong, broad-based foreign demand comprises all sectors of the economy. Even after deducting the volatile exports of ships and oil, exports still rose by almost 17 %. At just under 27 %, overall imports grew at a somewhat lower rate than exports. Excluding imports of ships and oil, the increase in imports amounted to almost 18 %, slightly exceeding export

Foreign trade

	Exports, Euro mn				*Imports, Euro mn*				*Exports (yoy)*				*Imports (yoy)*			
	03/06	*04/06*	*05/06*	*06/06*	*03/06*	*04/06*	*05/06*	*06/06*	*03/06*	*04/06*	*05/06*	*06/06*	*03/06*	*04/06*	*05/06*	*06/06*
Czech R.	6480	6142	6262	6484	6160	6073	6046	5990	24.2	19.8	20.9	17.1	24.0	17.9	21.2	16.3
Estonia	629	579	636	650	787	772	762	779	24.8	20.8	25.6	26.5	20.9	16.4	13.8	14.1
Hungary	4981	4600	4650	5050	5247	5120	4770	5170	20.1	13.1	14.9	14.0	22.9	14.1	13.3	14.1
Latvia	394	419	408	417	664	740	685	644	12.2	13.8	12.7	21.4	25.0	37.5	28.9	22.3
Lithuania	989	940	995	1012	1353	1492	1188	1124	37.2	21.7	28.1	39.5	49.3	25.5	24.1	22.5
Poland	7225	7107	3791	7176	8396	7901	4978	7775	25.2	19.7	20.9	15.3	25.6	19.2	16.1	12.4
Slovakia	2668	2418	2610	2706	2785	2835	2771	2824	30.3	18.7	25.8	20.6	24.6	26.5	23.6	20.8
Slovenia	1478	1365	1300	1420	1605	1485	1090	1410	17.3	13.0	6.4	8.2	19.4	17.3	8.1	6.2
CEEC-8	*24844*	*23570*	*23439*	*24915*	*26996*	*26418*	*25142*	*25978*	*24.4*	*18.3*	*19.8*	*16.8*	*25.3*	*19.3*	*17.6*	*15.0*
Bulgaria	974	911	895	1027	1396	1409	1477	1472	22.9	21.9	21.4	25.2	32.0	34.2	27.8	21.3
Croatia	750	694	614	701	1493	1427	1450	1525	41.6	9.0	11.7	6.5	17.2	8.8	10.9	6.3
Romania	2332	1862	2143	2224	3030	2689	3099	3163	20.7	3.7	20.9	19.3	25.9	14.1	25.4	20.6
CEEC-11	*28901*	*27037*	*27091*	*28867*	*32914*	*31943*	*31167*	*32138*	*24.6*	*16.1*	*19.7*	*16.9*	*25.3*	*18.6*	*18.6*	*15.5*

Source: National statistical offices, central banks, finance ministries, BA-CA Economics Department highlighted...forecast growth. Strong domestic economic activity generates strong demand for consumer goods and capital goods. Consequently, the trade deficit rose to almost 2 billion euros (1-3/2005: EUR 1.6 billion) in the first three months. According to our estimate, the current account deficit thus widened to 1.85 billion euros (Q1 2005: EUR 1.6 billion) in the first quarter.

Better economic prospects in the EU will also ensure buoyant exports by Croatia in the next few months. Strong domestic demand will however continue to be reflected in a higher trade deficit and thus in an increase in the current account deficit from 6.3 % of GDP last year to 6.8 % of GDP in 2006.

Current account balance (in % of GDP)

					2003		*2004*				*2005*			*2006*	
	2004	*2005*	*2006*	*2007*	*4. Qu.*	*1.Qu.*	*2. Qu.*	*3.Qu.*	*4. Qu.*	*1.Qu.*	*2. Qu.*	*3.Qu.*	*4. Qu.*	*1.Qu.*	*2. Qu.*
Czech R.	-5.2	-2.1	-2.3	-2.5	-10.1	-2.3	-6.1	-9.5	-6.0	2.7	-3.9	-4.1	-2.8	2.4	-3.5
Estonia	-12.7	-10.5	-10.0	-9.3	-15.3	-11.1	-16.9	-5.3	-17.2	-10.8	-11.6	-7.0	-13.5	-10.6	-10.3
Hungary	-8.6	-7.3	-7.0	-6.5	-8.7	-7.3	-11.2	-8.5	-8.1	-7.3	-7.9	-7.8	-6.3	-7.4	-7.5
Latvia	-12.9	-12.5	-12.2	-11.3	-8.9	-9.4	-18.9	-13.5	-10.0	-10.9	-10.6	-12.7	-15.1	-14.1	-10.2
Lithuania	-7.7	-7.1	-6.8	-6.5	-9.7	-7.7	-10.3	-7.1	-6.0	-5.6	-7.3	-7.6	-7.5	-6.5	-8.8
Poland	-4.2	-1.4	-2.0	-2.8	-1.4	-5.0	-6.2	-4.1	-1.8	-1.8	-0.9	-1.4	-1.6	-1.9	-2.1
Slovakia	-3.5	-8.8	-6.3	-3.5	-0.9	1.3	-6.3	-5.0	-3.6	-2.1	-12.2	-4.6	-15.9	-6.0	-10.8
Slovenia	-2.1	-1.1	-0.5	-1.3	-1.1	0.6	-2.6	-1.3	-3.0	-1.9	0.6	1.1	-3.6	-2.4	-0.9
CEEC-8	-5.5	-3.7	-3.7	-3.8	-5.0	-4.5	-7.5	-6.1	-4.4	-2.4	-4.0	-3.6	-4.5	-2.9	-4.5
Bulgaria	-5.8	-11.8	-12.5	-11.2	-15.9	-10.1	-8.8	9.1	-15.1	-12.3	-11.3	-3.8	-19.9	-20.7	-11.9
Croatia	-5.1	-6.3	-6.8	-7.0	-23.8	-23.1	-9.9	25.8	-19.3	-23.4	-15.5	26.9	-20.1	-26.6	-13.9
Romania	-8.4	-8.7	-9.6	-9.3	-8.6	-4.7	-9.2	-8.4	-9.8	-7.1	-10.3	-5.7	-11.2	-9.3	-10.8
CEEC-11	-5.8	-4.6	-4.9	-5.0	-6.7	-5.6	-7.8	-4.4	-6.1	-4.3	-5.6	-2.5	-6.6	-5.5	-6.0

Source: National statistical offices, central banks, finance ministries, Bank Austria Creditanstalt Economics Department highlighted...forecast

4. Monetary Policy & FX

The Emerging European FX and interest outlook has deteriorated. Higher G3 yields coupled with a pick-up in emerging market FX volatility is eating into risk appetite, whilst accelerating growth in CEE is making the regional central bank interest rate outlook gradually more hawkish.

We look for Emerging European FX to record a volatile May. Countries with: (a) higher investor positioning (e.g. Poland), (b) weaker fundamentals (e.g. Hungary), are likely to see the most volatile exchange rates. The CZK looks set to outperform in May given firm fundamentals. June elections do introduce some residual political uncertainty, however, as they also do in Slovakia.

The CEE-4 central bank interest rate outlook is slightly more complicated. We look for the NBS to continue to hike rates given the firm domestic demand backdrop and associated inflation risks. In contrast, we expect Hungary and Poland to leave interest rates on hold in the near-term. The NBP looks set to watch economic dataflow carefully to determine its next move on interest rates. In Hungary, CPI and the exchange rate are keys. Scope for a medium-term deterioration on both variables suggests no room for the NBH to cut rates, whilst hikes are an outside risk.

The Czech Republic presents the most interesting interest rate outlook. Despite scope for growth to come in well above 5% again in 2006 the CNB is still broadly neutral on rates: the next move could be up or down. In short, a lot depends on where CZK heads next. An even firmer CZK would open up room for a rate cut.

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	Exchange rate, national currency per Euro						*3M interbank deposit mid rate*					
	2004	*2005*	*Current*	*3M*	*12 M*	*24M*	*2004*	*2005*	*Current*	*3M*	*12 M*	*24M*
Czech R.	**30.4**	**28.9**	**28.4**	**29.0**	**28.2**	**27.5**	**2.5**	**2.1**	**2.0**	**2.1**	**2.7**	**3.3**
Hungary	**246**	**253**	**268**	**270**	**260**	**265**	**9.3**	**6.3**	**6.0**	**6.3**	**6.0**	**5.5**
Poland	**4.06**	**3.84**	**3.94**	**3.70**	**3.95**	**4.10**	**6.5**	**4.5**	**4.0**	**3.7**	**4.1**	**4.1**
Slovakia	**38.8**	**37.8**	**37.7**	**37.5**	**36.5**	**36.0**	**3.5**	**3.0**	**3.8**	**4.1**	**4.3**	**4.3**
Slovenia	**240**	**240**	**240**	**240**	**240**	**240**	**3.8**	**3.8**	**3.4**	**3.7**	**3.1**	**2.7**
Croatia	**7.63**	**7.37**	**7.26**	**7.28**	**7.30**	**7.30**	**5.7**	**5.0**	**3.3**	**5.0**	**5.0**	**5.0**
Romania *)	**38.5**	**3.68**	**3.55**	**3.48**	**3.40**	**3.36**	**16.6**	**6.4**	**8.0**	**9.3**	**9.3**	**7.8**

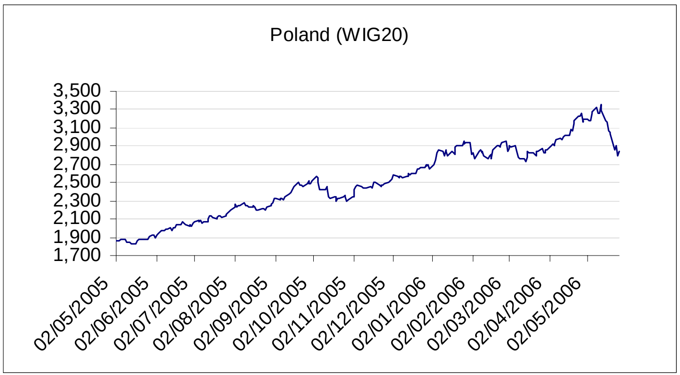
end of period

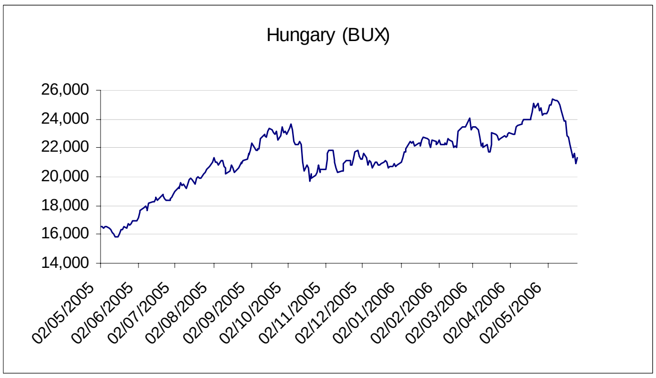
5. Stock market developments

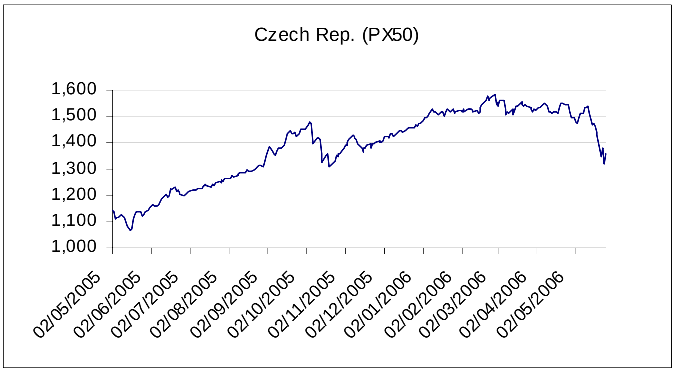
Equity markets in Emerging Europe achieved good or excellent gains during April, with the exception of Czech shares (mainly a drop for CEZ on lower forward electricity prices). Most notable was the big 15.5 % jump in Russia's RTS Index, as strong oil prices and a large pool of liquidity pushed up prices. Hungary's BUX was up 5.6 %, aided by some easing in worries over the budget deficit after the newly elected government said it would be fiscally prudent. Poland's WIG did even better, rising 9.4 % on brighter economic prospects and a good Q1 reporting season for blue-chip stocks. The progress in the markets was not especially helped by fund flows, which were only modestly positive in April – though Poland enjoyed an extra boost due to local fund inflows.

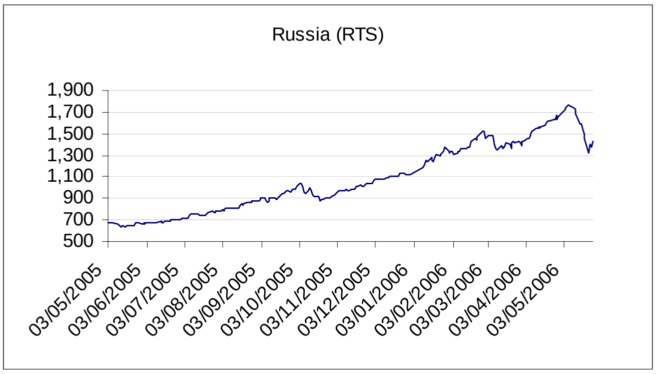
In early May a firmer tone prevailed generally, with the WIG, the BUX and the RTS touching new highs, while the PX50 regained some lost ground. The first week of May also saw a large inflow of funds (over $350m) to the region. However, in mid-May the tone changed, with investors concerned that the US Fed had left the door open to more rate increases in its comments accompanying the latest hike, to 5.00 %. This drove the US 10Y bond yield to 5.20 %, which began to pull funds out of emerging markets. Then, disappointing US inflation data added another shock to sentiment, and selling intensified. The high prices of oil and metals, as well as some soft commodities, also added to concerns over inflation. Market volatility, reflected in the VIX index, jumped, pointing to a period of greater risk aversion than in recent months, and there were some signs that fund flows to Emerging Europe had started to slip into the red.

Russia's RTS Index, after touching a record near 1,800, was knocked back to 1,300 as profits were booked, oil prices eased, and investors began to scrutinise energy-sector valuations a little more closely in a less-than-rosy political environment. But in all this, there was a hint of over-reaction, as the US inflation news was only mildly disappointing, while a better GDP outlook in Europe – with Germany leading the way in improved sentiment surveys – has combined with rising macro signals in Japan and continued strong growth in China and India, while even the US should continue to enjoy good economic growth.









Outlook: In light of the corrections just seen, and the solid GDP outlook in Emerging Europe, the next few months of the year are likely to see increased volatility but moderate gains in the CEE-3 markets of Poland (best-placed, with domestic fund flows and a dynamic recovery) Hungary and the Czech Republic, while the performance of the core Russian energy stocks will depend on the course of oil prices. So, despite the current unsettled outlook, which implies a more selective approach in the short term, a medium-term perspective still presents sufficient value for a full allocation to the region.

One additional risk factor which seems manageable so far is the weight of cash calls from IPOs. Here, it appears that the market is regulating itself: an offering of Russian meat processor Cherkizovsky struggled after it was priced too richly, and there are doubts about the size of the big Rosneft IPO due in July (or maybe Q4) due to possible legal complications; this IPO, once sized at $20bn, may in fact raise well under $10bn. On the other hand, attractively structured deals such as Seventh Continent in Russia moved easily.

Sectors: In general, we continue to favour mobile telecoms over banks (rising rate risk) and oil & gas stocks (oil prices possibly near peak), although with refining margins up, the outlook for downstream oil stocks has brightened in the past few weeks. We still see some clear upside in materials plays, despite their stunning performance in the past six months, aided by the strong trends for metal prices.

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