Emerging Market Spotlight: **Central Europe**

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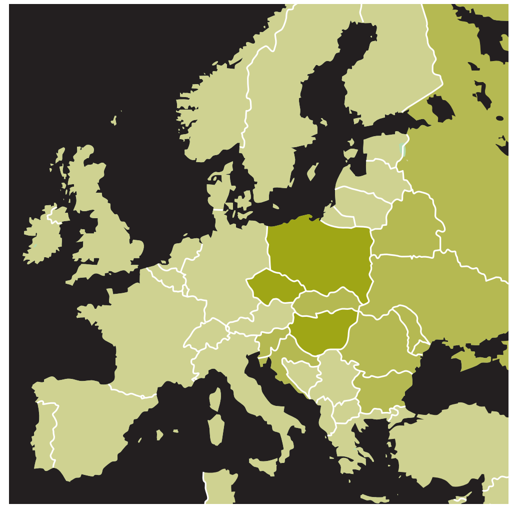
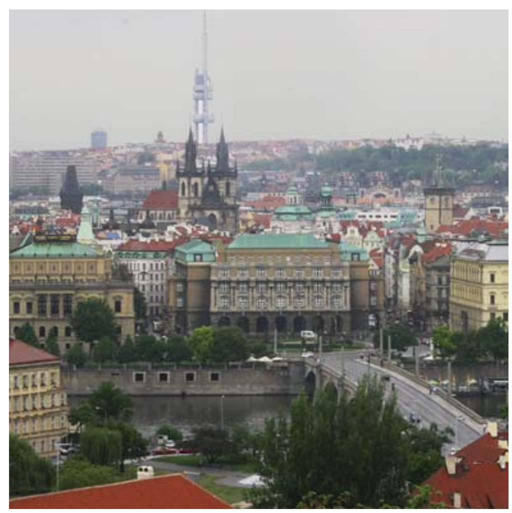


Central and Eastern Europe boast some of the most dynamic developing countries in the world today. With varying degrees of success, several countries in the region are growing faster than their Western EU counterparts, and each is struggling with, or succeeding in, making the political changes necessary to move away from their Communist legacies. We highlight the Czech Republic, Poland, and Hungary – to underscore the differences between realities of development for these recently admitted EU member states.

Aggressive privatization and an emerging service sector give the Czech Republic an early economic advantage over Poland and Hungary, which are finding it more difficult to shed their Communist legacies.

Czech Republic

The June 2006 parliamentary elections left no clear victor in the legislature. The results were split evenly between coalitions of rightist parties (Civic Democrats with the most individual party seats at 81; Christian Democrats with 13 seats; and the Green Party with six seats) and leftist parties (Social Democrats, with 74 seats; far-left Communists with 26 seats). Eight months later in January of 2007, a coalition of the Civic Democrats, the Christian Democrats, and the Green Party was confirmed. Although President Vaclav Klaus's position has little real political power, his role in naming the board members gives economic weight to his position. Since 2005, he has reappointed one governor and appointed four more liberal governors. One of the most heated international issues in which the Czech Republic will likely stand center stage is the current U.S.-Russian dispute about the U.S. installation of a radar system in Czech Republic.



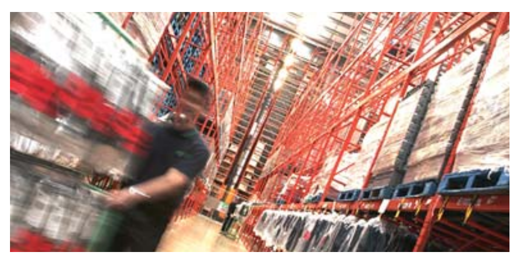
The Czech Republic's economy continues to grow, with real GDP growth of 5.8% at the end of 2006, just less than the 6.1% rate for 2005, and with expectations of slight drop during 2007. Even if the Czech Republic grows at a slightly slower pace this year, it will still be ahead of its Western European neighbors. The Czech Republic's economy is split roughly 55%:42% between services and industrial production, with agriculture making up the difference. The May 2004 entry of the Czech Republic into the EU eased the way for many Western European businesses to open their doors in the Czech Republic to take advantage of its relative low costs. This gap has been closing rapidly over the past several years.

czech republic

The first quarter 2007 unemployment rate of 6.8% remains lower than most European countries, and has been declining steadily over the past several years. The inflation rate dropped in the fourth quarter of 2006, to an annual rate of 1.6%. Short and long-term interest rates remain low, but have edged up from 2.1% and 3.6% at the end of 2005, to 2.6% and approximately 4%, respectively, at the end of 2006.

A large part of the economic progress in the Czech Republic is attributable to aggressive privatization, with the state's nearly complete control of assets in 1989 falling to just slightly more than 10% by 2005. The influence of the opening of markets can be seen in formerly state-run assets, including a Polish stake in Unipetrol, Spanish control of Cesky Telecom, Russian LNM Group's ownership of Vitkovice steelworks, German RWE Gas's stake in Transgas, Slovak-Czech private ownership of Aero (maker of sub-sonic jets), and Japanese and European stakes in the banking sector.

Foreign direct investment (FDI) has been strong, albeit with some inconsistency over the past several years. In 2006, South Korea's Hyundai announced plans for an auto factory in Ostrava, on the eastern side of the country, which is estimated to produce 300,000 cars and 600,000 transmissions by 2010. This comes several years after Toyota and Peugeot made the decision to jointly invest in a €1.5 billion facility in Kolin. The automotive sector generally has been a strong source of FDI. Japanese manufacturing firms have also taken advantage of the lower cost labor pool in the country with several investments over the past few years, making two announcements in 2005 alone. Daikin announced plans to build air-conditioning compressors in Brno, and Kyocera opened a plant in North Bohemia. And Muramoto joined the already present electronic manufacturers Panasonic and Mitsubishi to manufacture plasma screens. More than 35 other Japanese firms have made investments in the country over the past five years.



The government's focus on attracting foreign investment came initially by way of selling off state assets and attempting to attract manufacturing investment. However, because of the country's relatively low cost base, there is an agenda to also attract the service sector activity. This is being done through tax incentives which aim to replicate the success in bringing manufacturing facilities to the country. Additionally, overall corporate tax rates have been reduced, from 35% in 1999, to 24% in 2006 (with promises from the President to cut as low as 18% once a Parliament was approved). New developments such as DHL's planned information technology center highlight the success of aggressive FDI campaigns. In addition to DHL, in late 2005 toymaker Lego announced it would replace the activities of five of its European warehouses with operations based near Prague, operated by DHL's logistics division.

As part of the ascension into the European Union, Czech Republic's labor laws have been made more like those found in "old Europe," with the unfortunate effect of extending vacation times, limiting work weeks and overtime, and other labor regulations. Generally speaking, labor laws are becoming more pro-worker and pro-union. However, there is no sign that the Czech Republic will succumb to the standards of its EU neighbors.

Building regulations remain strict, with basic building permits requiring a complex web of health, ventilation, utilities and other standards. Many of these rules are inconsistent across regions of the country and are dated. Clear titles remain an issue. Zoning amendments have been put onto the books to control expansion in an attempt to maintain a balance between environmental and commercial interests. This is intended to reverse the trend of many years of disregard for environmental issues under Communist rule. Issues have arisen, however, and the process for development needs refinement.

Foreign private persons are still prohibited from directly owning real estate, but by using shell companies, foreigners have taken advantage of an amendment that allows ownership of non-wooded or farmland properties by branches of foreign entities.

Poland

Twin brothers Lech and Jaroslaw Kaczynski continue to "lead" the Polish government as President and Prime Minister. While stories of childhood identity manipulation are troubling enough, the appointment by the President of close ally Slawomir Skrzypek to the key post of central bank governor is far more troubling. The challenge Poland faces is that there is neither consensus among various parties to form a legitimate set of coalition partners to the Law and Justice party, nor is there consensus amongst the opposition to pose a challenge to the current party. As such, the current regime appears capable of surviving.

Foreign investment is anticipated to continue, based on hopes that EU membership, relative low labor costs and residual economic growth attributable to previous foreign investment will gloss over the troubling signs in the current environment. Despite free-market reform rhetoric, actions indicate that the government is drifting away from democratic policies toward more autocratic ones. These trends can be reversed if opposition parties rally in favor of a market-based society. But given that the opposition is not so much more free-market oriented than the ruling party, a decline in market driven growth is anticipated.

The ruling brothers are neither diplomatic, nor particularly experienced in foreign policy matters. This has strained Poland's relations with some of its neighbors. The apparent reason for the cooled relations with Germany is the lack of a requested apology from the German government for a German press article that called the brothers "potatoes." Needless to say, there are deep concerns about the current political agenda.

poland

Along with Czech Republic, Poland is an international focus of the battle between the U.S. and Russia, wherein the U.S. wants to use Poland as a base for interceptor missiles. As of early June 2007, President Bush seemed amenable to Russian President Vladimir Putin's request to locate the missile base in Azerbaijan instead of the Czech Republic, eliminating Poland's role. Poland's diplomatic capabilities will be seriously tested on this issue. But the situation is a bit like taking beets and cabbage, serving them with prime Angus steak, and adding potatoes on the side as an afterthought.

Despite the country's leadership, Poland continues to do very well economically, having just enjoyed its strongest economic growth year of its recent history. Real GDP growth in 2006 ended at nearly 6%, after a 3.5% rate in 2005 (which while low in comparison to 2006, handily beat its Western European neighbors). Although predicted to drop this year, the real growth will be strong. Unemployment has come down from nearly 19% at the beginning of 2005, to 12.5% in the first quarter of 2007. Part of the problem with employing workers in Poland is that businesses are taxed heavily, a problem the government plans to fix but has yet to address.

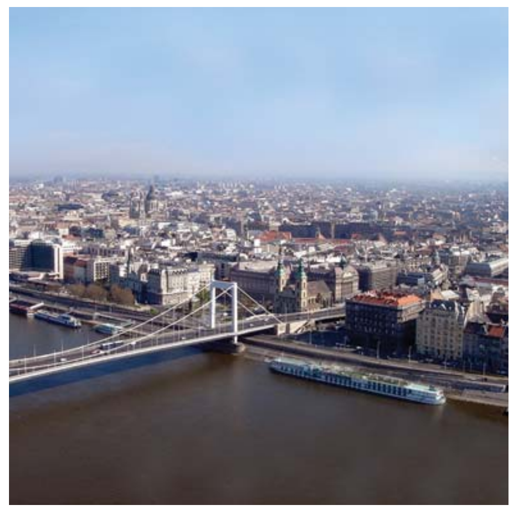
After a bumpy two years, long-term rates are roughly where they were at the start of 2005, while short-term rates have eased from 6.3% down to 4.2% over the same period. Inflation remains under control, ending 2006 at 1.4%. The government still must lower its deficit to 3% of GDP before it can enter the Eurozone. Although there is opposition, the treasury minister is an advocate of creating national conglomerates, as opposed to breaking down state assets and selling them into private hands. This is deeply troubling, undercutting many of the good things Poland has going for it in terms of location and workforce.

There are plans for three billion Zloty of asset sales in 2007, which would be a major improvement over the meager 620 million Zloty privatized in 2006. More divestitures of state assets are required for the country to achieve its potential.

FDI continues to flow into the country, primarily due to the market size and low labor costs. A record $14.5 billion came in during 2006, bringing the 13-year total (since 1993) to over $100 billion. Companies from tire manufacturer Bridgestone to computer maker Dell have announced planned investments. At the same time, Poland's bureaucracy and higher labor costs relative to other former Bloc nations, as well as its underdeveloped road system are cited as reasons for losses of manufacturing. Nearby, the Czech Republic is aggressively courting international corporate funds to invest in its more pro-business foreign investment regime, and countries like Slovakia offer lower labor costs. Poland will have to do more than talk about reform to sustain its growth. The World Bank's 2006 Doing Business report ranked Poland 75th, behind Slovakia, Czech Republic, Hungary and the Baltic republics of Lithuania, Estonia and Latvia, citing that it took nearly 1,000 days and over 40 procedures to enforce a commercial contract. This red tape remains a serious challenge.

A relatively well educated population remains a notable attraction (there are more university graduates produced in Poland than in the UK). However, a brain drain has occurred since opening of EU borders. A government estimated 600,000 workers (other estimates are as high as over 2 million, in a country of 38 million) have migrated, nevermind many ending up in the UK, Ireland, and Sweden, all of which opened doors freely to newly entered EU states. Particularly problematic are the departures of medical practitioners and researchers. These are the caregivers and knowledge seekers that could, were they to have reason to stay, help the Polish people stay at the forefront of discoveries that would attract funding to the country from prestigious service industries such as healthcare, medical research and so forth. Instead, this knowledge is leaking out of the country while the government strives to retain state entities.

Hungary



The 2006 re-election of the governing alliance between the Hungarian Socialist Party and Alliance of Free Democrats was a first for Hungary since the late 1980s, when its political system transitioned to a democratic state. The victory margin over the major opposition party was wider than four years earlier. However, relations are poor between the governing coalition and the opposition. With only 55% of the parliamentary seats, these relations make it difficult for the parliament to reach the two-thirds vote necessary to modify the many outdated laws on Hungary's books.

The government's acknowledgement that the previously predicted forecast of an approximately 4.6% budget deficit for 2006 will be closer to 10% was dramatic. It delivered a wakeup call to parliament. Unfortunately, tax increases are being implemented, with reduced spending planned "in the future." The governing parties' popularity ratings have suffered, but because the blow of severe measures has been dealt early enough in the current political cycle, the negative press may be mitigated. A political will to reduce government spending remains the key.

Real GDP growth for 2006 was 3.9%, slightly down from 2005. It will fall further to about 3.5% in 2007. Private sector growth remains sound, with investment coming into the country and industrial productivity improving. Despite ranking below some of its EU new-entrant brethren, Hungary's growth is still higher than France and Germany.

Consumer prices were rising at over 2% per quarter at the end of 2006, high by EU standards. Consequently, long- and short-term rates are also higher than other members at over 8% each at year-end 2006. Additionally, plans for 2010 adoption of the Euro have been dismissed for all practical purposes. The target date now appears to be several years beyond the initial estimates.

hungary

Key areas of development include research and development, biotechnology, automotive and electronic manufacturing and corporate services. The country has attracted investments from major U.S. companies like JP Morgan and Citigroup, which are in addition to other high value-add outsourcing services based out of Hungary.

We highlight Hungary as an instance where something we've long believed to be true for the U.S. does not necessarily hold for a developing nation. In the U.S., we have long believed that gridlock, or the lack of the ability of a government to dramatically change the economic direction is a good thing. The current situation with a tense relationship between a Democratic Congress and Republican White House is a perfect example, as we believe that the predictability with which the U.S. economy can operate while knowing there will not be any major changes is great for the U.S. But this is because the general rules governing business are relatively solid and stable in the U.S. compared to other nations, and notably countries like Hungary.

Hungary inherited a Communist model, and is trying to evolve into a burgeoning economy, with attractive physical and human capital to offer businesses from the rest of the world who want to take advantage of the offer. Unfortunately, the system under which Hungarian businesses operate is not as developed as in the U.S. Therefore, where there is need for change, a gridlocked government that cannot change things is a major negative factor when considering long-term investment. The stability is there, but it is stability of a system under which it is not as easy to operate. We hope the measures being taken by the current government will move Hungary forward and give its economy the chance to develop to its full potential.

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