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## SOUTH EASTERN EUROPE AFTER EU ENLARGEMENT AND BEFORE ACCESSION

ICEG European Center organized with the Hungarian Economic Association and the Confederation of Hungarian Employers and Industrialists an international conference in Budapest on 4-5 April, 2005. The purpose of the meeting was to discuss the key policy issues facing the South Eastern European countries after the recent Enlargement of the European Union and prior their future accession to the EU.

Enlargement has increasingly brought the SEE region to the center of attention for policy makers and as a process has an impact on the economic development as well as accession strategy of the SEE countries. The conference was devoted to the assessment of the likely economic consequences of recent enlargement on the SEE region, the preconditions of their EU integration, the current policy challenges and economic developments.

The conference featured presentations of several leading economists from the region, international organizations, including Lajos Bokros (Professor, CEU), Daniel Daianu (President, Romanian Economic Association), Bernard Funck (senior economist, the World Bank), Stanchev Krassen (director IME), Ben Slay (senior economist UNDP), Dubravko Mihaljek (senior economist BIS), Dragoljub Stojanov (professor, University of Sarajevo Boris Vujcic (vice president, National Bank of Croatia,) among others. The papers and presentations are available from the [www.icegec.org](http://www.icegec.org).

Due to space limits, two papers are presented in brief: Gábor Hunya's (WIIW, Vienna) view on FDI developments in the region and Dubravko Mihaljek's (BIS Geneva) contribution on the evolution of foreign currency denominated loans in South-Eastern Europe.

According to Gábor Hunya, FDI inflows have accelerated in recent years in the SEE region, driven mainly by inflows to the three major countries. Romania, Bulgaria and Croatia. His data showed that the total stock of inwards FDI in 2004 in Romania exceeded and in Croatia approached the level of FDI inward stock in Slovakia, while the Bulgarian figures were comparable to Slovenia. The remaining countries of the region proved to be less attractive recipients of FDI both in nominal and in relative terms (FDI stock as % of GDP).

There are various factors that explain the differences between FDI attraction in the three candidate countries and the remaining part of the region. One of them is related to differences in political stability as well as prospect of quick accession to the European Union. The second important difference between Romania and Bulgaria (and slighter extent Croatia) compared with the western Balkans is the difference in productivity and wage costs. The Western Balkans has become a high wage cost region, where productivity increases have not matched the pace of wage rise, making the region relatively unattractive to FDI compared to the other three countries. Among the countries Romania has especially been successful in attracting FDI reflected among others in a very fast increase in the share of foreign affiliates in employment, sales and exports of manufacturing in 2002 the last year, when reliable data were available.

Concerning the future of FDI flows the contributor thought that FDI inflows have given significant support to transformation and economic growth the region and they will continue to deliver this effect. He argued that FDI inflows are bound to intensify prior the accession in those countries which are close to complete successfully the accession related negotiations and have chances to join the EU soon. In these countries increased FDI inflows are to support the increase of their price and non price competitiveness and contribute to the export-led economic growth and catch up.

On the other hand, in order to reap these benefits both accession and other countries in the region need to take into consideration the following arguments. First, the macroeconomic effects of foreign direct investments strongly depend on the way privatization of state owned enterprises is carried out: the early lessons from the differences in the Central European countries are telling from that respect. Moreover, privatization should not be the only source of foreign direct investments as countries need to increasingly

rely on greenfield investments as well. Finally, the outcome of FDI inflows on macroeconomic performance strongly depends on the restructuring that follows privatization and foreign capital inflows and therefore policy makers need to focus sharply on the promotion of restructuring and microeconomic changes.

Second, the countries in the region should put much more emphasis on the transfer of technology and skills which have been one of the most long lasting positive effects of foreign capital inflows in countries which were net recipients of FDI. However, FDI inflows in the SEE region were not accompanied so far by measurable transfer of technology and skills and this has certainly reduced the growth enhancing effects of FDI inflows.

Third, the western Balkan countries have according to the author a special problem related to the level of their wage costs and prices. Compared to Bulgaria and Romania both the wages and prices are too high in the region and this sharply reduces their attractiveness to foreign direct investments. Their attraction is especially weak when the changes in productivity are added and productivity is viewed together with price and cost evolution. As long as either the wage gap is not diminished or the competitiveness does not accelerate, the countries will be decreasingly competitive in the attraction of FDI against other countries in the region and regions.

Dubravko Mihaljek analyzed in his presentation the reasons and consequences of fast credit expansion in the SEE region as well as in Central European economies. According to his figures the Cumulative expansion of bank credit to the private sector over 2002-04 exceeded in nominal terms 200% in Bulgaria, Romania, Serbia and Montenegro, varied between 90 and 170% in Albania (and also in Hungary the Baltic states) and showed a still impressive growth of 40-75% in Bosnia and Herzegovina, Croatia, Macedonia and Slovenia.

According to the author there are two views on the credit expansion: a benign view and another one which sees these developments with more concern and caution. According to the benign view the recent expansion of foreign currency denominated loans is not a source of concern as the recent growth mostly reflects low base and low levels of financial, where it is natural to observe fast increases.

Moreover, the recent reforms in the financial sector has resulted in an unexpected improvement of banking sector indicators compared to earlier years: banking sectors in most of the countries have been able to lower the share of non-performing loans, could keep their capital adequacy ratios high and sometimes even rising and have overall increased the profitability of their operations. As a result, the recent rise of foreign currency denominated lending should not be a source of extreme concern as the banking sectors are amidst deep structural changes and forward looking reforms (including but not limiting to the privatizations in Albania and Serbia and Montenegro, consolidation in Bosnia and Herzegovina, improving banking sector supervision in Macedonia) and the performance of the banking sector has improved considerably. According to other opinions while the performance of the banking sector has been improving and the initial figures were low indeed, there are still reasons for concern.

One of them is related to the extent of credit expansion: in Bulgaria, Croatia credit has expanded by 5% of GDP or more annually for the last five years and in the last two years credit growth has exceeded this benchmark also in Bosnia and Herzegovina and Romania.

Second, there is an emerging asymmetry in the balance sheet of the banking sector as recent trends reveal that lending has been expanding faster than deposits as banks borrow from their foreign headquarters. As a result so that one could see a fast rise in the foreign liabilities of the banking system and increase of the external indebtedness of the banking sector and the economies themselves. These increases have prompted some of the central banks in the regions (notably in Bulgaria, Croatia and Romania) to make some precautionary measures against the speed of this increase.

Third, the major reason of concern is that while loans have increased fast there is still some time till they can mature and one has to consider that some of them will become nonperforming and as a result the quality of banking sectors' assets may significantly worsen in the future, posing additional risk for the banking sectors.

Finally, analysts and central banks also warned that the increase of FX lending may create increasing exchange rate tensions and pressures and as a result the economies may be increasingly exposed to unexpected and undesired exchange rate risks. This may be a serious source of concern especially in those countries which have more flexible exchange rate regime and the market players have so far not been able to hedge themselves appropriately against the rise in FX risk.

Altogether, the rapid rise of foreign currency lending has its bright and dark sides: it may accelerate financial deepening and lending to the private sector but it creates additional risks for the banks the banking sector and the recipient economies as well.

## BULGARIA: FIXED EXCHANGE RATE OF CURRENCY BOARD AND THE COMPETITIVENESS

During the 1990s Bulgaria suffered at least three financial crises. The most critical period was in 1996 when the strong depreciation of the Leva led to price explosion, which was followed by mass bank runs. The economy experienced a serious downturn. The economic policy failed to restore confidence. The consequence of this failure was the collapse of exchange rate and the outbreak of a hyperinflation in 1997. The large depreciation of the Leva led to an irreversible process of currency substitution. The parallel currency system further limited the ability of the central bank to control inflation. Under such macroeconomic conditions the economic policy chose the hard peg for the Leva and moved from a free float or managed float system to a currency board arrangement, which was first linked to the DM and then to the Euro. This policy move could restore the confidence very fast. Inflation rate quickly fell. It reached single-digit levels already by mid-1997. In spite of several adverse external shocks (Russian crisis, global financial crisis, etc.) the economy could quickly stabilise and experienced increasing GDP growth rate.

Despite the currency board arrangement, inflation rate remained relatively high. Since 2000 the average inflation rate has been about 5 to 6 %. This rate was caused mainly by external factors such as increasing oil prices, the volatility of USD exchange rate and changes in administered prices. In general, under the conditions of fixed exchange rate inflation differential with respect to the anchor country may lead to an overvaluation of the real exchange rate and should result in an increasingly serious deterioration of international competitiveness. In the case of Bulgaria such problem has not occurred to substantial extent. The explanation of this fact lies mainly in the development of productivity and unit labour costs.

To assess the risk of overvaluation and deterioration of international competitiveness first the current account position and then the unit labour cost development have to be analysed.

**TABLE 1.**  
**MAIN MACROECONOMIC INDICATORS**  
**DETERMINING INTERNATIONAL COMPETITIVENESS OF THE BULGARIAN ECONOMY, 2000-2004**

	2000	2001	2002	2003	2004
GDP growth (%)	5,0	3,9	5,0	4,2	5,4
Inflation (% dec/dec)	11,4	4,8	3,8	5,6	4,0
Export (mill EUR)	5 253,1	5 714,2	6 062,9	6 668,2	7 993,9
Import (mill EUR)	7 084,9	8 127,8	8 411,2	9 610,5	11 617,4
Trade balance/GDP (%)	-13,4	-15,9	-14,2	-16,7	-18,7
Current account/GDP (%)	-5,6	-7,3	-5,6	-9,2	-7,4
Average monthly wages (EUR)	-	122	131	139	n/a

*Source: BNB, NSI, own calculations*

In the case of Bulgaria, the current account had deficits and they increased from 0.5 % of GDP in 1998 to 8.3 % and % in 2003 and 2004, respectively. This increasing deficit was the result of fast growth of consumer goods imports, but mainly also of the increase in imports of investment goods. By contrast, the fiscal account that is the government budget was either close to balance in the recent years or had surplus as it was in 2004. The current account deficits have been largely covered by FDI inflows. While initially the largest part of the external financing came through privatisation revenues, Bulgaria also managed to draw substantial funds from green-field investments after the privatisation process slowed down. Under such conditions, one may suppose that the possible currency overvaluation has not posed a substantial risk to the Bulgarian economy.

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The developments of unit labour costs have remained moderate since the annual rate of change was about 2.5 % between 2000 and 2002. Meanwhile the inflation has been much higher. The main reason of the lower increase in unit labour costs than the inflation rate is the rapid productivity increase. Bulgarian economy is relatively underdeveloped compared to the European average, thus there are sufficient margins for possible productivity gains. These favourable unit labour costs developments have provided the possibility to sustain the position of competitiveness in spite of the inflation differential and overvaluation of the Leva. That is, price and wage indicators do not point to a loss in competitiveness of the Bulgarian economy. This fact suggests that the real exchange rate appreciation since 1998 has to a large extent been attributable to the Balassa-Samuelson effect on the one hand and to price liberalisation on the other.

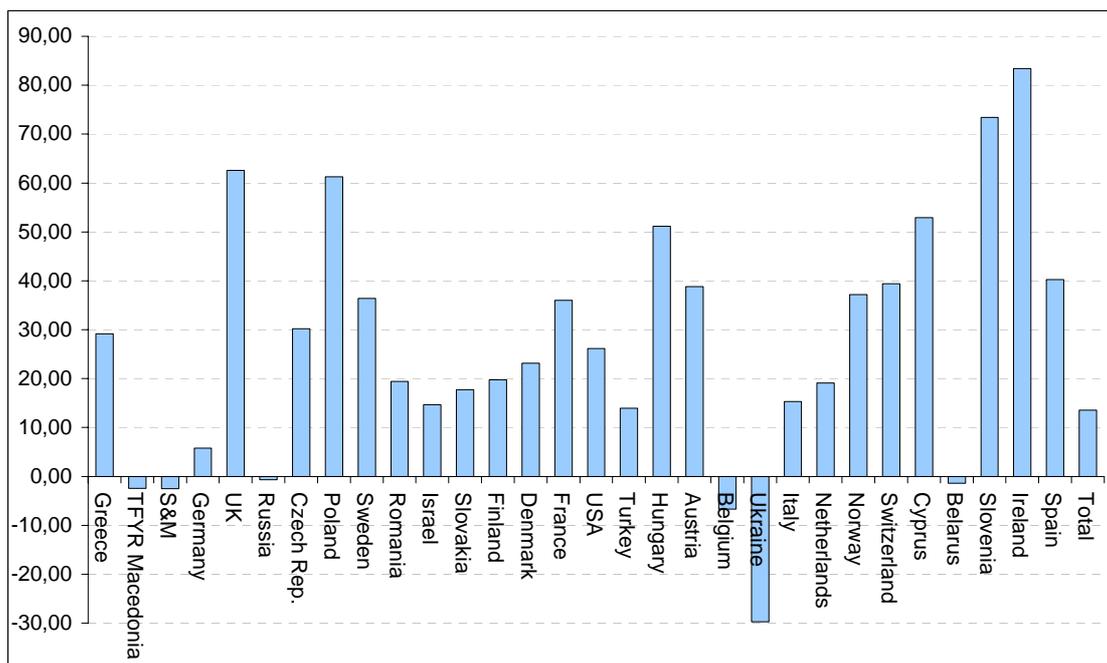
So long the increase in productivity exceeds the rate of real appreciation of the Leva the present currency board system will not cause adverse effects to the international competitiveness of the Bulgarian economy. The fast productivity increase will be maintained by the FDI-led relatively rapid modernisation and structural changes of the economy.

## BULGARIAN TOURISM INDUSTRY

The tourist industry has been expanding rapidly in Bulgaria in recent years, with a 10-15 percent annual growth rate. 13 % of the country's GDP comes from tourism, and the sector employs 15 % of the Bulgarian workforce. Bulgaria is an attractive location for foreign investors, because of its political stability, low costs, and strong economic growth. The tourism industry is an especially preferable sector for foreign investment. In the summer of 2004 the tourist season was extremely strong. 4.01 million tourists visited Bulgaria last year, which represents a 13.6 % increase compared to the previous year. Young Bulgarians also travel more across the country than they previously did.

Bulgaria as a holiday location was the most popular among tourists from Greece (707,453), the FYR Macedonia, and Serbia and Montenegro. German tourists also represented a large group, with 565,337 tourists entering Bulgaria in 2004 for the purpose of leisure and recreation, followed by the United Kingdom with 259,092 visitors. The largest increase of foreign tourists between 2003 and 2004 was from Ireland (83.39%) and Slovenia (73.4%), both countries representing a small portion of the total tourist number arriving in Bulgaria. Among the countries with a larger number of tourists arriving in Bulgaria, a 62.6% increase was observed in the case of the United Kingdom, and a 61.25 % increase in the case of Poland.

**CHART 1.**  
**2004/2003 % CHANGE**



Source: Ministry of Economy of the Republic of Bulgaria

\*The countries are in a decreasing order according to the total number of tourists arriving in Bulgaria for leisure and recreation, with Greece being the first one, with the largest number of Greek tourists in Bulgaria.

The lack of qualified staff proves to be a serious problem for the rapidly expanding Bulgarian tourist industry. There were 3,000 vacancies last year in the tourism sector. In 2005, before the start of the summer season, the most serious problem is the lack of highly qualified staff in the high-end hotel industry. At the same time the five-star bed capacity will increase by 1,200, and 130 new tourist facilities will open.

In Bulgaria tourism is concentrated in the Northern Black Sea region in the summer and in the mountains in the winter. There are various plans for the diversification of the Bulgarian tourism sector, in order to raise the number of visitors, to distribute the tourists wider across the country and across the seasons. A broader tourist industry could be developed based on the country's culture and natural beauty. For the development of ecological and other sustainable types of tourism, the Bulgarian Association for Rural and Environmental Tourism (BARET) has been established. The association has already started constructing eco-paths. Currently there are seven such paths available, in picturesque territories in mountainous and semi-mountainous regions. More bridges, rails, and staircases are being built. Rural tourism is also on the rise, with possibilities for participating in Bulgarian country life, wine tasting, and visiting ethnographic complexes. Cultural tourism is gaining ground as well, since Bulgaria has a 1,000 year old history, and as a result there are numerous cultural monuments in the country, which are also included in the UNESCO list. There are also rich possibilities in this South-Eastern European country for balneology tourism. Bulgaria has more than 550 spots of 1,600 mineral water springs of great diversity.

Currently tourism in Bulgaria is concentrated on budget package tours. It is necessary to introduce and expand upscale tourism in the country. For this, investment is needed to provide high quality facilities and service. However money is not the only thing that is needed. There is a strong demand for the introduction of modern marketing and managerial techniques. Bulgaria as a tourist location has to be advertised in foreign countries. The Tourism Agency at the Ministry of the Economy is responsible for the creation of the marketing strategy of Bulgaria abroad, as an all-around-the-year tourist destination.

There are numerous possibilities for investing in the Bulgarian tourist industry. Tourist infrastructure is currently strained, and it is one of the highest priorities of the government of Bulgaria to upgrade the infrastructure of the sector. However, not only tourist facilities will be receiving more investment, but the modernization of the Varna and Burgas airports, and improvements in the road and telecommunication networks are also planned.

The medium-term strategy for the development of the Bulgarian tourism sector is yet to be created, but the main ideas underlying the strategy were outlined in the discussion "Sustainable Development of Bulgarian Tourism 2005-2010". The Bulgarian government's intention is to develop the industry along the lines of public-private-partnership. The main assumptions on which the strategy should be based are the following:

- Attention should be paid not only to foreign tourists, but also to the local ones;
- To concentrate the management of the tourism industry in the hands of one body, if possible, in an independent ministry;
- Integration of tourism industry organizations;
- Tax-relieves, state incentives and special funds.

## PLANS OF THE ALBANIAN PRIVATIZATION PROCESS

Privatization, in its broadest sense, is the transfer of assets or services from the tax-supported and politicized public sector to the entrepreneurial initiative and competitive markets of the private sector. In theory, privatization helps establish a 'free market', as well as foster competition, which its supporters argue whether it will give the public better choices. Conversely, socialists view privatization negatively, arguing that entrusting private businesses with control of essential services reduces the public's control over them, and will result in unemployment and corruption.

Whereas, academic studies show that in competitive industries with well-informed consumers, privatization consistently improves efficiency. Such efficiency gains mean a one-off increase in GDP, but through improved incentives to innovate and reduce costs also tend to raise the rate of economic growth. And some SEE countries have no other choice to make up their arrears, start on the way of the development and to modernize their economic systems. Albania is a good example of this.

### PRIVATIZATION IN ALBANIA AIMS TO:

- stimulate the Albanian economy through the efficient use of natural and human resources,
- support and develop the private sector and attract strategic and financial investors,
- create the conditions for the establishment of the capital market and
- prepare and deliver fast, efficient and credible privatization process in all sectors.

Considering the fact that the GDP of 2000 has reached the 90% of the level of 1989, Albania is still one of the poorest countries in Europe. Black economy is flourishing, and by the estimates producers do not pay any taxes for the 50-70% of the retail trade. The deficit of the current balance increased to 6,8% in 2004 and likely it will stand at 7,1 % this year. Albania wants to become an official member of the European Union in 2014, and to achieve this aim it needs to stay on a growth-field and stabilize the current balance. Privatization could be a possible solution for this problem: the capital which inflows through the process, plays a big role in the equilibration of the current balance, because the ability of the countries in the region to gain the sources of the international capital market is inadequate.

However, corruption, the unreliability of the authorities and the not investment-friendly atmosphere make the inflow of the FDI harder in Albania (and everywhere in the region) in the case of the privatization and the greenfield-investments as well.

Albania can be called one of the best examples of the economic reforms. Together with the fast price-liberalization the privatization of the small enterprises passed off in 1992. The inflation rate could be reduced to one-digit for 1995, and this year was the beginning of the privatization of the medium and large corporations. The method was the so-called quasi privatization, which was based mainly on the free coupon-privatization and dragged for many years. The inflow of the FDI stood at the minimum level for many years. From the year 2000 helping foreign capital inflow, speeding up the privatization process, broadening its methods and last but not least boosting the transparency of the process are very emphatic in the economic policy objectives of the Albanian governments. The extension of the privatization to the strategic sectors (like: telecommunication, electricity supply, oil industry, water supply) and to the financial sectors was schemed. The main aim of the foreign economic strategy of the country has been the correction of the current balance position, increasing of the incomes of the export and the tourism and the attraction of the (especially Italian and German) foreign direct investment. The structural reforms ( the reforms of the tax- and custom system and the modernization of the banksector), which are related to the privatization persisted in 2000. Interest rates were reduced to the desired level, and it has given a fillip to the growing of investments.

As a result of some successful privatization processes, the 75% of the GDP was produced by the public sector in 2001.

### SUCCESSFUL PRIVATIZATIONS

#### AMC

Albanian Mobile Communication (AMC), the only mobile operator until 2001, was launched in 1996 and privatized in 2000. The company was successfully sold to a joint-venture partnership between COSMOTE (Greece) and TELENOR (Norway). The firm has invested about USD 200 million in Albania.

#### Vodafone

In September 2000, a tender was issued for a second GSM license. In February 2001, a consortium of Vodafone (UK) and Panafon (Greece) was chosen as the winner, with an offer of USD 38.1 million.

#### Savings Bank of Albania

2003 year witnessed the successful privatization of Savings Bank of Albania by the well-known Austrian Raiffeisen Bank with an offer of USD 126 million.

#### National Commercial Bank - BKT

Another banking sector privatization milestone is the sale of the National Commercial Bank, completed in 2000. The bank was sold to a consortium of international investors that included Kentbank (Turkey), the International Finance Corporation (World Bank), and the European Bank for Reconstruction and Development (EBRD). The new shareholders injected USD 10 million in November 2000, resulting in a strong capitalization of BKT.

#### Elbasan Cement Factory and Fushe Kruje Cement Factory

In March 1997, Seament Albania acquired 70% of the Elbasan Cement Factory along with 70% of United Quarries. In November 1999, Seament Albania bought an additional 7% in Elbasan Cement Factory and in December 1999 an additional 16% in United Quarries. In July 2000, Elbasan Cement Factory won the auction for the privatization of Fushe Kruja Cement Factory, currently operating as a clinker grinding facility. Both factories are undergoing rehabilitation of existing technology and an expansion program is underway.

#### DarfoAlbania

An Italian owned company, Darfo Albania has been operating since in accordance to a 30-year concession to produce ferrochromium.

*Source: ANIH – Invest Albania*

### ABOUT THE FUTURE:

For the future privatization processes the Albanian government and the World Bank finished a plan in 2005, the so-called **Privatization Strategy Program Technical Assistance**. In the frames of this agreement act the necessity of the privatization of the following companies:

- Albanian Refining and Marketing Organization (ARMO) and Albanian Petrol Company (Albpetrol):  
During Phase 1 of the privatization process activities include the preparation of specific pricing strategies, service development, organizational evaluation, development of accounting system,

During Phase 2 activities include marketing and promotion to potential investors

During Phase 3 preparation of the tender documents and completing the sale of the company.

- Albanian Telecom Company (Albtelecom):

During the Phase 3, the activities include:

- preparation of a management contract towards completion of the sale of the company,
- update the due diligence and Information Memorandum and improvements in Albtelecom's financial and economic position as well as managerial capability.

**Nevertheless, the main privatization opportunities in Albania for the near future are:**

*In Hydrocarbons*

- The privatization of Armo s. a (in process since 2003).
- The privatization of Servcom s. a (in process since 2003).
- The privatization of the Oil Mechanic Factory s. a in Kuçove (in process since 2003 year)

*In Water Supply and Transportation*

- Mother Theresa International Airport is given in concession for a 20 years period to the Consortium "Airport Partners".
- Durres Port cereal and grain terminal concession
- Durres Port Trainferry Terminal Concession
- Water supply systems in Berat and Kuçove

*Insurance*

- INSIG – the only one state owned insurance company in the market. It operates in Albania, Kosovo and in Macedonia for the non-life insurance. 39% of shares owned by IFC and EBRD.

In the last 2-3 years Albania seemed not to be a unduly attractive blank for international investors. The participation of the foreign investors in the privatization processes in the region is rendered more difficult by the administrative barriers. To enhance its economic system and get closer to its final aim (the EU accession) Albania needs to develop a more favourable atmosphere for the privatization in the future.