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TABLE OF CONTENTS

Bulgaria and Romania: The road to euro zone

Most countries joined the EU in 2004 planned to adopt euro as soon as possible but these schedules derailed and the adoption of the single European currency is expected to occur 7-8 years after accession in many cases. That was a good lesson to the newly acceded countries, namely to Bulgaria and Romania. Currently these two countries have two different euro adoption strategies.

Bulgaria

It seems Bulgaria plans to follow the path of the Baltic states and try to adopt euro as soon as possible after the EU accession and accordingly, Bulgaria will enter into ERM II regime this summer. According to Bulgaria's goal, the Maastricht criteria will be fulfilled till 2008-2009, thus euro can be introduced in 2010. Considering these criteria one can see that most of them are fulfilled and only inflation rate is higher than the reference.

Besides that, one can observe more similarities with Baltic states. First, Bulgaria also introduced a currency board arrangement, thus monetary policy is limited. Second, a significant credit boom was observable in Bulgaria, which was boosted by households' consumption, and in line with that real wages has also risen significantly.

Table 1. Summary table on Maastricht criteri in the selected countries

	Maastricht criteria					
		Government				
	Inflation (HICP, %)	Fiscal balance (% of GDP)	Public debt (% of GDP)	Long term interest rates (%)	ERM-II membership	
	April 2007	2006	2006	April 2007	April 2007	
Reference	**3.0**	**-3.0**	**60.0**	**6.04**	**2-year membership w/o tensions**	**-**
Bulgaria	4.4	3.3	22.8	4.22 (March)	-	3
Romania	3.8	-1.9	12.4	5.90 (Jan)	-	3
Czech Republic	2.7	-2.9	30.4	3.92	-	4
Poland	2.2	-3.9	47.8	5.28	-	3
Hungary	8.7	-9.2	66.0	6.65	-	0
Slovakia	2.0	-3.4	30.7	4.26	Since November 2005	4
Estonia	5.6	3.8	4.1	5.13 (March)	Since June 2004	4
Latvia	8.8	0.4	10.0	5.52	Since May 2005	3
Lithuania	4.9	-0.3	18.2	4.24	Since June 2004	4

Source: Eurostat, national bank, national statistics offices

The Bulgarian economy grows dynamically fuelled by investments and consumption, and attracting significant amount of FDI. In that economic and policy environment, Bulgaria should decrease its inflation rate to under 3% from last year's 7.4% to fulfil the related criterion. It is not impossible but a bit over optimistic and includes several risk factors.

Bulgarian National Bank plans to decrease inflation rate to 3.7% at the end of 2007 and under the reference value in the next year so as to be able to adopt euro in 2010. It is worth mentioning that Bulgaria's price level is the lowest in the EU. Since price level and economic development (GDP level in PPS) are in strong correlation, accordingly high economic growth results in convergence in price levels as well. Price convergence is expected to occur via inflation due to the fact that exchange rate is fixed. However, it is also true that this problem can be handled in short/medium term.

Unemployment decreased to under 10% recently and the limitation of supply of workforce is expected which could result in wage increases. Accordingly, significant increase of wages could raise inflationary pressure. Wages in Bulgaria are the lowest in the EU, even lower than those in Romania.

All these aforementioned factors mean that Bulgaria faces serious challenges to adopt euro until 2010. However, it is not an unrealisable strategy but a quite ambitious one. Thus, it could result in the delay of the introduction of euro in Bulgaria by one or two years.

Romania

Romania prepared a completely different strategy. The Romanian government and central bank plans to introduce euro in 2014 which means that Maastricht criteria will be fulfilled to 2012 when the country will enter into ERM II regime as well. Romania decided to apply a later adoption of the euro to be able to make some real convergence before the introduction of the single European currency. Certainly, it does not mean complete convergence since real figures of the country are lagging behind significantly from EU average and even from Eastern EU member states. It means only further convergence to the EU in real terms. One can consider this strategy as a better-grounded preparation for the adoption of euro based on the lessons of the Central and Eastern European countries joined the EU in 2004.

Similarly to Bulgaria the hardest goal to achieve related to Maastricht criteria is to lower inflation rate to under the reference value. In Romania disinflation has been a long process. Inflation rate exceeded 150% in 1997 and it declined under the 10% threshold only in 2005, for the first time after transition. In line with that central bank shifted to inflation targeting regime, while the national currency appreciated in real terms as well. These factors helped the National Bank of Romania to lower the inflation rate to the single digit range.

Regarding current developments, one could say that Romania did not prepare a too ambitious euro adoption plan. Now it seem that the Southeast European country could join the euro zone well before the planned date (2014). Regarding however the examples of the CEE states and their delayed accession schedules, it seems quite wise decision to set a date which is credible and not too risky.

Romanian economic growth is sound and based on private consumption and investments. High consumption growth (more than 10% annually in recent years) is fuelled by rapid increase of real wages and significant credit boom in the country. It means that significant inflationary pressure characterised the economy in the last years. In the first months of 2007 CPI declined to under 4% in Romania, however, it must be mentioned that the record low inflation was the result of the favourable progress of foods products. Besides that, strong Leu also contributed to lower inflation rate in Romania.

The National Bank of Romania targeted 4% and 3.8% end-year inflation rate for 2007 and 2008 respectively which are completely in line with the planned convergence path. However, it is also worth mentioning that interest rate policy is not always in accordance with inflation policy aims and sometimes it seems considering competitiveness aspects.

Finally, another factor must be considered related to this issue. Romania as an EU member must contribute to EU budget and co-finance EU projects, thus the burdens of the budget are expected to grow. Accordingly, fiscal deficit can be close to 3% of GDP this year. While the economy grows by 6-8% annually this factor will not cause serious problems, however the lessons of CEE member states show that these years should be used to implement reforms and to avoid the traps that some of these countries walked into.

Conclusion

The starting point of the newly acceded countries can be considered as good related to convergence criteria. At first glance it seems that euro adoption can be realised soon in both Southeast European countries. Only the reduction of inflation rate can cause problems similarly to the Baltic countries. Despite of the fact that the euro adoption strategies of these two countries are different the challenges are quite similar: price level is low, real wages increase significantly, economic growth is high fuelled by domestic demand, mainly private consumption and investments, accordingly significant inflationary pressure characterise these countries. Thus, the risk of the fast Bulgarian euro adoption is high; accordingly it can be delayed to 2011-2012.

Romania seems to have learned the lessons of the CEE countries and prepared a less ambitious schedule. Euro adoption will be realised only after some catching-up of the country. It seems that the authorities in Romania see correctly the challenges that the country faces.

Certainly, the different euro adoption strategies can be partly explained by the different exchange rate regimes as well. While the entry into ERM II regime will not affect significantly the monetary policy of Bulgaria, Romania will have to give up its autonomous monetary policy and managed floating will not be a useful tool to achieve the central banks aim. This exchange rate regime will be given up by Romanian authorities only if the period of being in ERM II regime can be decreased to the minimum (2 years).

Stagnating Unemployment Challenges Macedonia

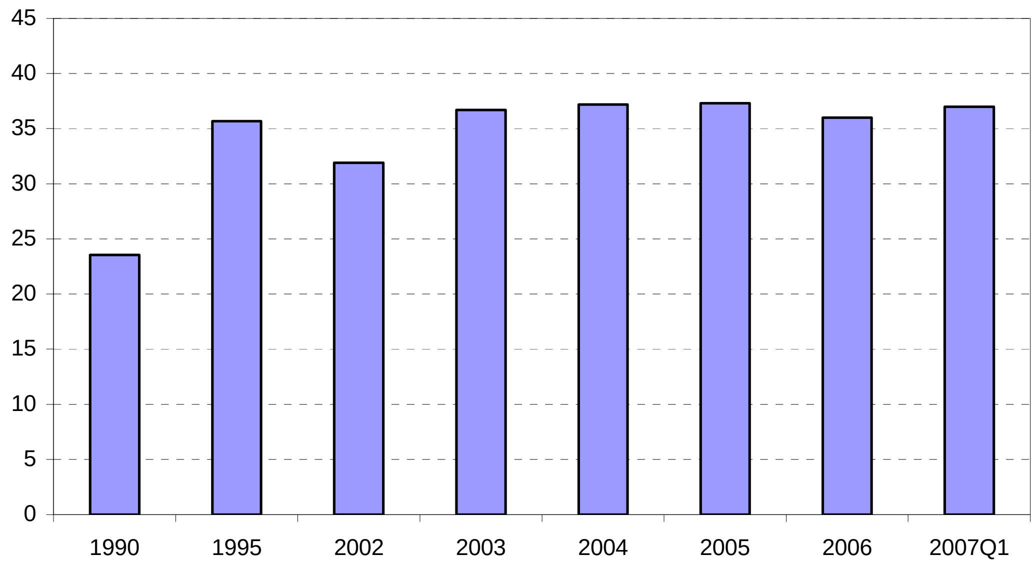
Unemployment is one of the most serious problems in the former Yugoslav Republic of Macedonia. According to the latest statistics from the State Employment Agency, unemployment is slightly rising again. There were 372 078 people without jobs in February 2007 compared to 361 335 in October previous year. The official rate of unemployment reached 37% in the second month of this year.

Tendencies of unemployment in Macedonia

As Macedonia used to have a so-called 'self-management' system in the context of decentralized market socialism while it was part of the former Yugoslavia unemployment rate increased to a very high level compared to other socialist countries. However, until the change of regime unemployment rate remained stable. Due to transitional processes (and on the initial heavy independence on declining large-scale industry) unemployment increased rapidly at the beginning of the previous decade and reached 35.69%. Thanks to structural reforms and an increasing pace of GDP growth, unemployment rate decreased to 31.9% in 2002. However, the crisis in 2002 caused an economic throw-back, leading to record levels of unemployment in the country. Since 2003 the level of unemployment is stagnating and remained the highest in Europe.

It must be noted that reality could be a bit more encouraging because of two reasons. Firstly, the share of grey economy is significant in Macedonia. Thus many employed people go unreported by their employers in order to avoid paying high amounts of social benefits and retirement benefits to the state. Secondly unemployment data is based on the number of people registered at the employment agency. Without registering, a blue card ensuring access to the state health insurance system cannot be obtained. Thus those working in the grey economy and also farmers registered, although they had a job. According to experts' estimations real unemployment rate could be around 20% in Macedonia.

Chart 1. Unemployment rate in Macedonia (%)



Source: State Statistical Office, Republic of Macedonia

Although the whole country can be characterized by an area suffering from high unemployment, there are strong regional differences. In the Southern and Eastern regions of the country involved mostly in agriculture and tourism, the unemployment rate is significantly lower. On the contrary regions where industrial activities were concentrated before the change of regime face higher rates of unemployment. Additionally in some cities in the North-Western part of Macedonia four active people out of ten do not have a job.

There is also disparity in gender division of unemployment. The difference between male and female unemployment reached 8 percentage points favouring men ten years ago. Nowadays, this gap has been stabilised at the level of 2 percentage points, still disadvantages women. Female unemployment among gipsy and the Albanian minority is of an even greater concern, being twice or in case of the gipsy minority almost three times as high as total female unemployment.

High unemployment rate among youth aged 15-24 years is another serious problem of the Macedonian labour market. A decade ago, more than one third of unemployed belonged to this age group. The situation has improved since than, as the share of youth among unemployed decreased to 21% in 2006. Youth unemployment rate also decreased by ten percentage points to 59.8% during the last ten years. However, as 68.7% of employed are between 25 and 49 years old, younger generations will have to wait a long time to replace them. The chance of youth could be new job creation, though because of the modest level of economic development and a relatively unfavourable business environment there are very few new job opportunities. As a result Macedonia experiences the so-called 'brain drain'.

Most people are employed in agriculture and manufacturing (about 20% each sector), while the branch of wholesale and retail trade is the third having a proportion above 10%. Job creation was the highest in the latter sector, accompanied by the hotel and restaurant business. Financial intermediation, education, health and real estate services are also expanding concerning employment.

Governmental actions

The high number of unemployed people forces the Macedonian government to search for different policy responses including active and inactive labour market policy measures. Inactive policy measures mop up a significant share of the budget. A way to make unemployment benefits more efficient could be the separation of the registration for a blue card from the registration of unemployed. However, governmental means could be spent more efficiently by choosing active labour market policy measures.

Before 2005 laws regulating the labour market were very strict, making hiring and dismissing difficult and costly. Thus companies were less likely to hire new employees, as they were not sure whether they can dismiss them in case of market changes. Thanks to the judicial reform a new balance was found between flexibility and job security, making it easier to fire employees, allowing private employment agencies to operate (but still with limitations) and removing virtually all limits on the use of temporary contracts.

Macedonian business environment should also be improved in order to attract foreign direct investment and to facilitate the creation of new small and middle sized enterprises going in hand with new job creation. Barriers of a favourable business climate are the long time needed for setting up a business (one of the highest among the 155 countries surveyed by the World Bank in 2006) and the relatively high minimal wages, making labour force more expensive compared to other transition countries. The minimum wage reached 65% of average wages in Macedonia, while it is 24% in Slovakia and 33% in Slovenia.

Other active policy instruments used by the government include job counselling and employment advice, training and retraining, counselling for start-up new businesses, incubators for new micro businesses and small entrepreneurs and planning of regional economic development.

Expectations

As the level of unemployment has been stagnating for six years already, the government should make higher efforts in the fields of active labour market policy. Macedonia spends approximately 0.05% of GDP on active labour market policy measures compared to 0.7% in OECD countries. In case the government becomes successful in facilitating new job creation by improving business climate and attracting more foreign direct investment the unemployment rate could slowly decrease. Whitening the grey economy by lower taxes and making health insurance independent from unemployment registration could have an additional, dramatic effect on the number of unemployed.

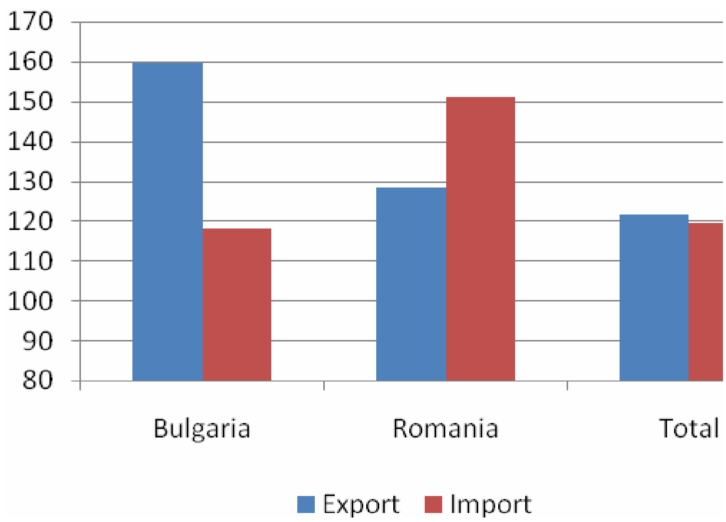
HUNGARY: STRENGTHENING ECONOMIC RELATIONS WITH THE TWO NEWLY ACCEDED COUNTRIES

The fifth enlargement round, namely the integration of the Central and Eastern European transition countries into the European Union was finished at the beginning of 2007 when Bulgaria and Romania joined the EU. Only these two countries, which started accession negotiations at the very beginning of the millennium, were excluded from the first phase of this enlargement round in 2004. Now this process concluded and the CEE group rejoined within the Union. Obviously, the framework has become different and the accession had impacts on the economies of which some are already observable even though only a few months passed since the accession of these countries.

For Hungary the EU accession of these countries resulted in a significant improvement of economic relations with Bulgaria and Romania. Certainly the geographic position is one major reason why trade relations with these two countries were already significant before accession, Romania is a neighbouring country while Bulgaria is relatively close to Hungary as well. However, the development of trade with these countries accelerated considerable after accession.

According to the latest statistics, export of goods to Bulgaria increased by 59.7% during the first two months of 2007 while import of goods increased by 18.1%. This increase of export is noteworthy for three reasons. First, Hungarian total export increased by 21.7% in this period which means that export to Bulgaria grew quite above the average in the first few months of the year. Second, the average growth pace of export to Bulgaria was between 20% and 40% in the last years. Third, analysing this issue from the other side, Bulgarian import increased by 15.9% in that period. This resulted in the growing share of Hungarian products in total import.

CHART 2. GROWTH RATES OF HUNGARIAN EXPORT AND IMPORT TO BULGARIA AND ROMANIA, JANUARY-FEBRUARY 2007 (CORRESPONDING PERIOD OF PREVIOUS YEAR = 100)



Source: KSH

It is also worth mentioning two other factors in connection with the aforementioned process. First, mainly the export of machinery and transport equipment increased (doubled) during the analysed period. And second, the dynamic growth of export to Bulgaria started in course of

2006 when growth of export was close to 40%, in fact the growth pace doubled in comparison with 2005. Certainly, the approaching accession date of the country induced the dynamic increase of trade between the two countries.

Naturally, the fact that Bulgaria and Romania became members of the single European market supported the strengthening of economic relations with these two economies. Consequently, intra-EU export is expected to grow to 78-79% (+4-5%-points), while that of import could grow to 69-70% (+1.5-2.5%-points) in 2007 due to the accession of these countries. It means that a larger part of export goods will not leave the territory of the Community and will be bought in the single European market.

Besides Bulgaria, trade with Romania also progressed in the last few months; however, there were differences in comparison with the Bulgarian case. First, the growth rate of import of goods exceeded that of export. While import grew by 51.2% export increased by 'only' 28.6% in the first two months of the year. On the other hand, both rates were well above the average growth rates which means that share of Romania in foreign trade increased further.

Second, the evolution of trade between the two countries remained constantly dynamic and both export and import growth rates were above the total growth rate in last years. Hungary plays a significant role in Romanian external trade since Hungary is among the Top10 trading partners, and the most significant among the New Member States.

Third, progress of trade was based on more groups of products. Regarding imports, all main commodity groups increased more than 30% and the highest increase was reached by fuels and electric energy which increased by more than 80%. On the other hand, the increase of export was fuelled by growth of foods, beverages and tobacco, and machinery and transport equipment.

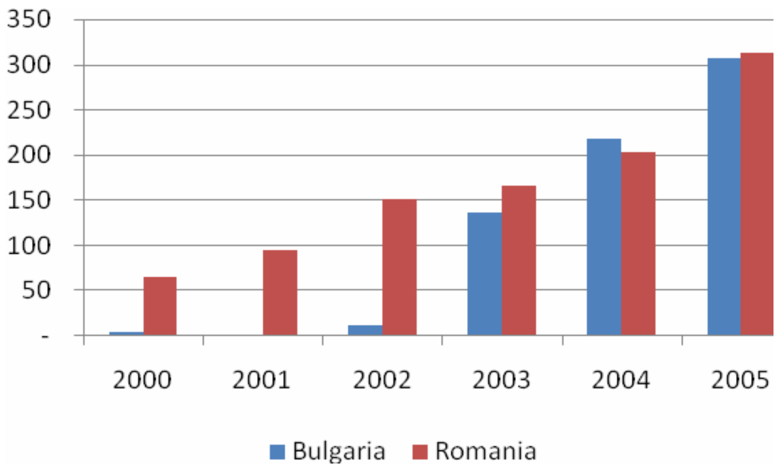
It is worth mentioning that both the Bulgarian and Romanian economies grew by 5-7% in real terms in the last few years and economic growth was fuelled by domestic demand. The latter fact boosted markedly the import of goods and services. Besides that wages started to increase as well in line with robust economic growth. In case of Romania the population exceeds 20 million which means that Romania is the second largest country in the CEE region after Poland. This factor is important in medium or long term because in line with the increasing wages and incomes the attractiveness of the Romanian 'domestic' market will appreciate further.

Besides foreign trade, it is also necessary to mention that Hungarian investments in these countries increased significantly as well. Although, there are no recent statistics on outward FDI by countries as in case of foreign trade, it is a well-known process that Hungarian firms and banks started to invest abroad, mainly in countries in the region.

The share of Bulgaria and Romania was almost 10% in all outward FDI stock at the end of 2005. The largest Hungarian actors were OTP and MOL in these two countries from Hungary accordingly the largest part of the investments were invested in banking sector and oil industry, however smaller firms also settled in these countries, but especially in Romania. The majority of former Hungarian investments in these countries occurred via privatisation in line with progress in privatisation process in Bulgaria and Romania.

In line with the accession, the improving business climate and the rapid economic growth the attractiveness of these economies improves continuously and accordingly Hungarian investors can find good opportunities to produce goods or provide services with profit. Besides the aforementioned factors, Romania is a neighbouring country and there is a language advantage at the border region, thus Hungarian investors could be in advantage compared to other investors providing other conditions are similar.

CHART 3. OUTWARD FDI (STOCK) FROM HUNGARY TO BULGARIA AND ROMANIA, 2000-2005 (MILLIONS OF EUROS)



Source: MNB

In conclusion it is clear that the accession boosted Hungary's economic relations with Bulgaria and Romania, according to the latest trade statistics. The fact that the two newly acceded countries has become the part of the single European market had a significant positive impact on the bilateral trade and accordingly, Hungary's intra-EU trade increased as well. In the future this trend is expected to continue. It is worth mention again that Romania with its more than 20 million citizens is a large potential market for Hungarian goods and one can observe significant development of economy, and accordingly the income of the population is increasing as well. Besides foreign trade, improving business climate and progress in privatisation made these economies attractive for investors, including Hungarian firm and banks. Due to the aforementioned factors, the attractiveness is expected to remain. Finally, euro adoption can be the next step which could strengthen further the economic relations since the adoption of the single European currency will improve foreign trade among these countries via eliminating exchange rate risks and transaction costs. Certainly, it is assumed that all three countries will adopt the euro.

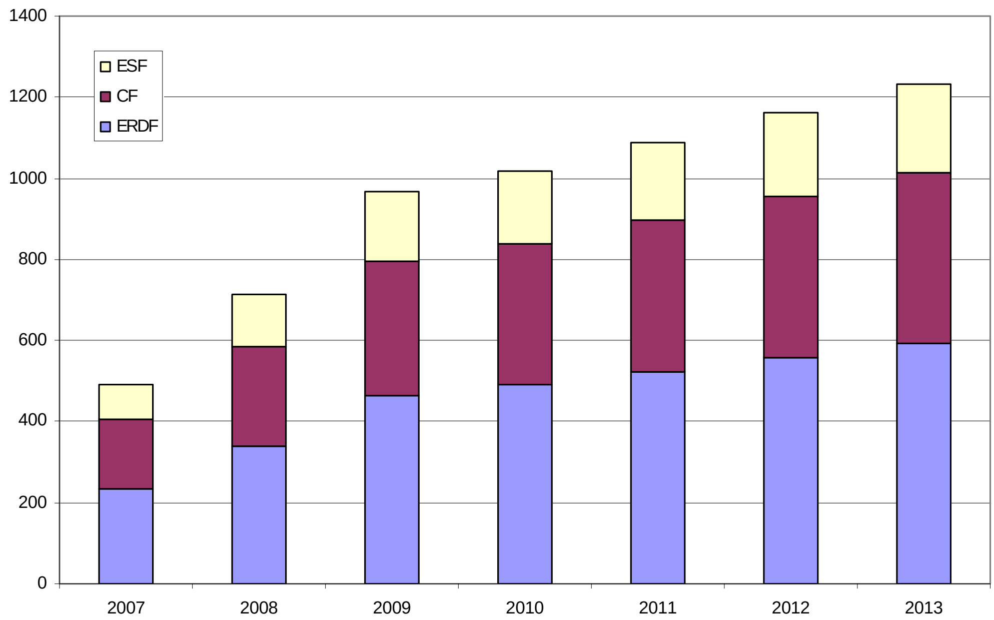
Structural and Cohesion Funds in Bulgaria and Romania

Structural Funds are the EU's main instruments for the implementation of its regional policy. The main goal of this policy is the achievement of greater economic and social cohesion within the European Union. According to the strategy of the Structural Funds resources are transferred from the most prosperous regions to less developed regions of the Union. The main objectives for the 2007-2013 period are "Convergence", "Regional Competitiveness and Employment" and "European Territorial Cooperation". As Romania and Bulgaria joined the European Union in 2007, they are also eligible to use the sources form the Structural Funds.

Bulgaria

Bulgaria expects to receive EUR 6.8 billion from the Structural and Cohesion Funds in the next programming period. The strategic document laying out the principles for the utilisation of the Structural Funds in Bulgaria is the National Strategic Reference Framework. Besides, there is a National Plan for development of agricultural and rural areas and a National Plan for development of fisheries. The documents define the Operational Programs, which will make the funds accessible to Bulgaria. Including the Technical Assistance, there are seven OP's for regional development, for competitiveness, for human resources, for transport, for environment, for administrative capacity and for the technical assistant.

Chart 4. National Strategic Reference Framework Financial Table for Bulgaria (million Euro)



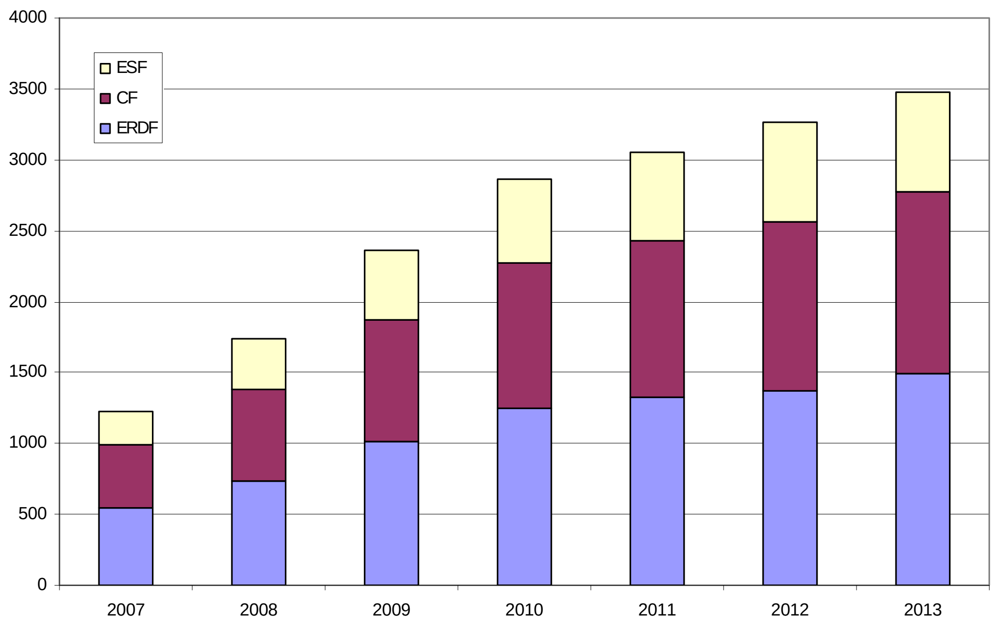
Source: DG Regio

The strategic documents provide strong support for the Lisbon agenda, with more than 60 percent of the funds in the Convergence Objective having been allocated to corresponding activities. For example the Bulgarian governments intended to increase the GDP per capita to 50 percent of the EU average, increase the employment rate to 64 percent compared to 56 percent in 2006, and rise the GERD (Government Expenditure on R&D) from 0.4 percent to 1.15 percent in 2013.

ROMANIA

Following accession in 2007, Romania is eligible for near EUR 20 billion from the EU's Structural and Cohesion Funds in the 2007-2013 period. According to the Romanian strategic documents the sources will be used for develop basic infrastructure, increase the long term competitiveness, development and more efficient use of Romania's human capital and building effective administrative capacity. The priorities of the National Strategic Reference Framework will be implemented through seven Operational Programs.

CHART 5. NATIONAL STRATEGIC REFERENCE FRAMEWORK FINANCIAL TABLE FOR ROMANIA (MILLION EURO)



Source: DG Regio

Numbers of key indicators and targets have been identified in the National Strategic Reference Framework to measure the impact of the cohesion policy. The most important goals are to increase the GDP by 15-20 percent, to increase the gross capital formation by 28 percent in the programming period, to increase the GDP per employee ratio by 5,5 percentage points yearly, and finally to increase the employment in the tradable sector by 23 percent between 2007 and 2013.

CONCLUSION

One of the crucial questions for the new member states will be the increase of their capacity to absorb the Structural Funds and to what extent it will be reflected by the improvement of regional disparities. Open question remains about the Bulgarian and Romanian administration's capacity to exploit this huge amount of money. In accordance with the Commission's opinion the two new member states has to improve their inter-institutional co-ordination, to create institutional structures necessary to increase the administrative capacity in Structural funds implementation and management. In the pre-accession period the institutional framework for regional policy suffered numerous transformations that resulted instability.

FORMER ISSUE'S TABLE OF CONTENTS: