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TABLE OF CONTENTS

ICEG EUROPEAN CENTER'S LATEST QUARTERLY FORECAST ON THE WESTERN BALKANS – FIRST QUARTER 2008.....	3
GDP GROWTH RATE IN BULGARIA – RETROSPECT AND PROSPECT.....	5
EU-CANDIDATE STATUS FOR SERBIA IN 2008?	8

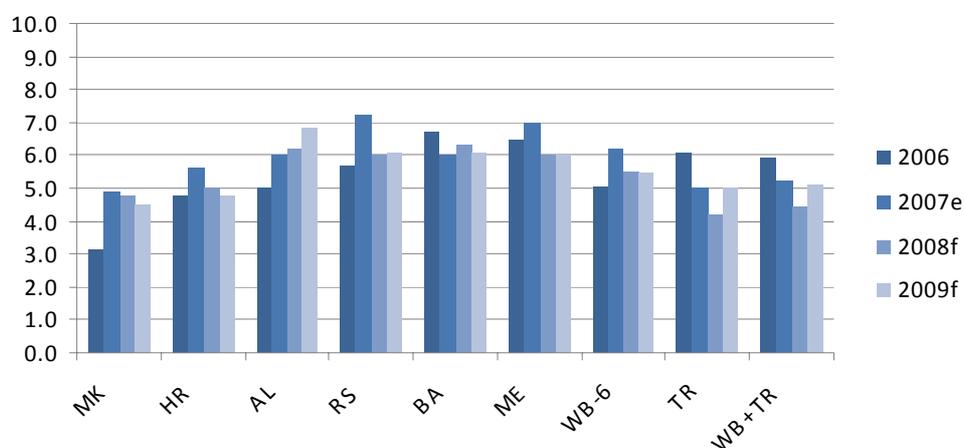
ICEG EUROPEAN CENTER'S LATEST QUARTERLY FORECAST ON THE WESTERN BALKANS – FIRST QUARTER 2008

ICEG European Center published its latest quarterly forecast on the Western Balkan countries. According to the report, political developments remained lively in course of the first few months of 2008 in the region. First of all, in mid-February Kosovo declared its independence which was considered as an illegal act by Serbia. However, many EU countries have recognised Kosovo's independence yet. Besides, Albania and Croatia were invited to join NATO at the organisation's April Summit. Due to the name dispute with Greece, the former Yugoslav Republic of Macedonia was not invited which resulted in the fall of the Macedonian government. In Croatia, a new government formulated in January with a stable majority.

Economic growth accelerated to 6.2% in 2007 from 5.1% in 2006 in the region. In 2008 and 2009 GDP growth is expected to calm down slightly and reach 5.5%. Economic growth is expected to exceed 7% in Montenegro and Serbia as well, and it exceeded 5% in almost all countries (except for the FYR of Macedonia's 4.9%).

The engines of economic growth remained the same, namely consumption and investments boosted these economies. That is not expected to change in this and next year. Wages increase gradually and foreign direct investments also increase due to improving business climate in the WB countries. Besides, credit lending is also vigorous which boosts consumption.

CHART 1. REAL GDP GROWTH IN THE WESTERN BALKANS, 2006-2009 (%)



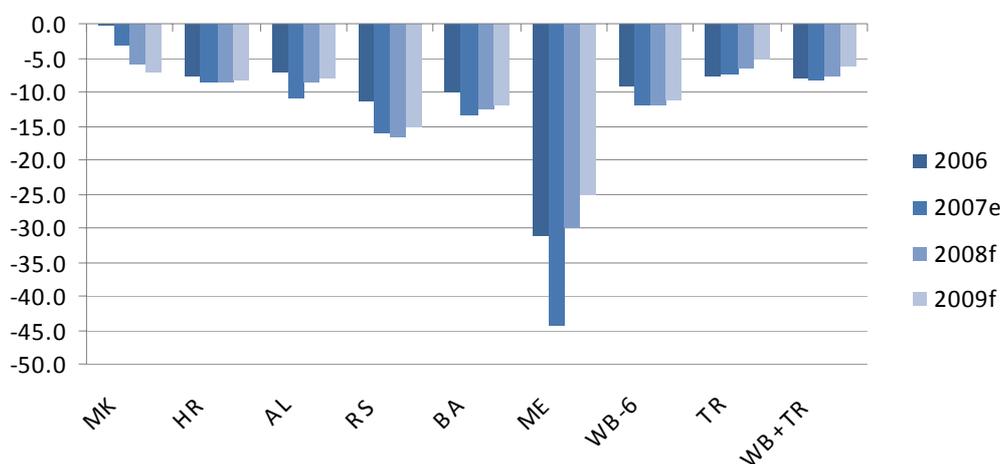
Source: ICEG European Center Quarterly Report, Q1 2008; e – estimation, f - forecast

In line with global trends, food and energy prices increased significantly in the WB countries as well. Besides, the extremely warm and dry summer in 2007 had a severe negative impact (via droughts and wildfires) on the domestic food supply in most WB countries. Accordingly, inflation started to accelerate in the second half of 2007 and this trend is expected to continue in the first half of 2008 as well. As a result average inflation is expected be close to 6% in the region, while it was 2 percentage points lower in 2006. In 2009 inflation will fall back under 5% according to our expectations. Highest inflation can be measured in Serbia, 10.1% in 2007 and it is expected to decline to 8.5% in this year.

Fiscal positions improved slightly in 2007 in comparison with the previous year. Average budget balance per GDP ratio decreased to 1.4% of GDP, and several countries' budget had a surplus, such as Bosnia and Herzegovina, the fYR of Macedonia and Montenegro. Budget balances improved in line with rapid economic growth and increasing presence of foreign companies due to improving business climate. It is worth mentioning that more and more countries in the region apply low tax rates and /or flat tax regime in order to improve their business climate and enhance economic growth.

Current account deficit deteriorated in all WB countries in course of 2007. Strong domestic demand boosted imports and accordingly foreign trade balance worsened in last year. The deterioration of trade balance contributed primarily to the worsening of the current account balance. Accordingly, current account deficit of the region amounted to 12.1% of GDP. CA deficit exceeded 10% of GDP in four out of the six WB countries. In 2008 and 2009 CA balance is expected to remain on current level due to expected high domestic demand in future years. Montenegro will keep on having the highest current account deficit in next years as well.

CHART 2. CURRENT ACCOUNT BALANCE IN THE WESTERN BALKANS, 2006-2009 (%)



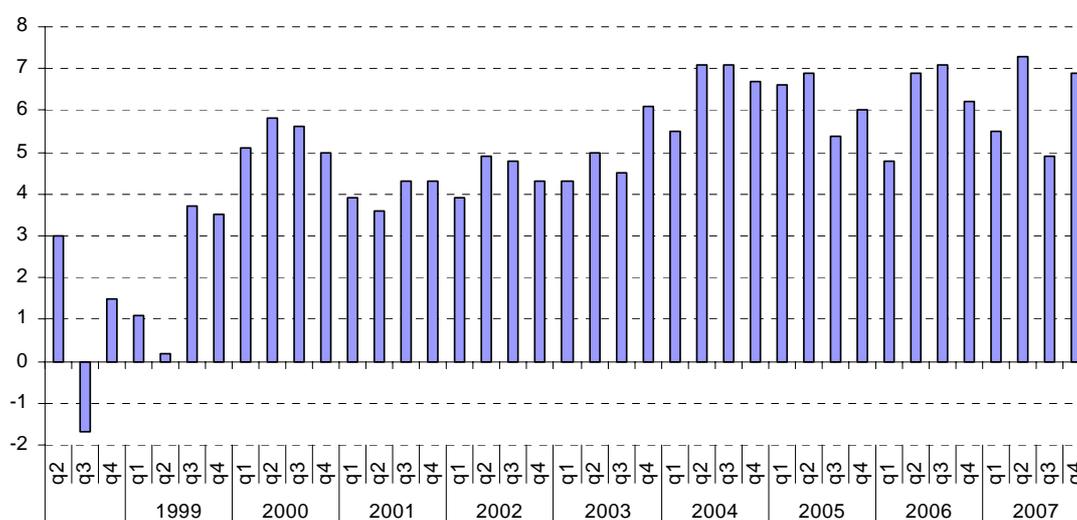
Source: ICEG European Center Quarterly Report, Q1 2008; e – estimation, f - forecast

Regarding labour markets of the region, slight but gradual improvement is observable in these economies. Unemployment rates are very in high in some cases, such as in Bosnia and Herzegovina, the fYR of Macedonia, Montenegro and Serbia, average unemployment rate decreased by 1 percentage point, to 15.6%. The decrease of the unemployment rate is due to strong economic growth and improving business climate. In the coming years, ICEG European Center expects that unemployment will decrease gradually while, in line with that employment rate will improve further. Besides, one can observe that wages increase rapidly contributing significantly to high consumption in the countries of the region.

GDP GROWTH RATE IN BULGARIA – RETROSPECT AND PROSPECT

According to the official data published by the National Statistics Institute of Bulgaria in mid March, real GDP growth rate reached an unexpectedly high level of 6.9% in the fourth quarter of 2007. Due to the favourable Q4 growth data, the annual rate exceeds earlier forecasts as well: its value is 6.2%, while analysts' previous predictions had varied between 5.5% and 6.0%. However even the 6.2% rate is slightly lower than that of 2006, as the revised rate for that year is 6.3%. On the whole in the first year of the EU membership the economic growth remained robust, but it had not intensified.

CHART 3. REAL GDP GROWTH RATE IN BULGARIA (QUARTERLY, % CHANGE YEAR-ON-YEAR)



Source: NSI

As Chart 3. shows, the Bulgarian economy has been characterised by robust growth rates since its recovery from the crisis in 1997, as several reforms had been implemented. One of the most important measures was the introduction of the currency board arrangement, which originally aimed to decrease uncertainty concerning price dynamics; however by now several doubts have arisen whether the currency board is sustainable. The rest of the post-crisis measures were aimed at expanding economic liberty. Specifically the liberalisation process had four main elements: privatisation, elimination of several obstacles to the external and internal trade, abandonment of the protection of several industries and finally the liberalisation of the capital account. On the whole the private sector had been the main engine of economic growth throughout the last decade, while in the public sector higher efficiency is needed.

Regarding last year's quarterly GDP growth rates, it can be seen that their variation had been quite significant. As Table 1 shows, the structure of growth changed slightly on the demand side throughout last year.

TABLE 1. QUARTERLY DATA ON FINAL USE COMPONENTS OF GDP, 2007

	Volume indices (same quarter of previous year = 100, %)				Volume index (2006 = 100, %)	Share in GDP				
	Q1	Q2	Q3	Q4	2007	Q1	Q2	Q3	Q4	2007
Final consumption	106.0	105.0	104.2	104.5	104.9	92.3	84.5	77.8	88.3	85.3
individual	107.0	105.4	104.9	103.4	105.1	84.1	76.2	70.6	76.6	76.4
collective	97.3	100.7	97.5	113.3	103.4	8.2	8.3	7.2	11.7	8.9
Gross capital formation	-	-	-	-	-	36.6	35.6	34.2	40.5	36.8
Gross fixed capital formation	135.9	124.7	119.7	114.0	121.7	28.3	28.7	27.0	34.4	29.8
Trade balance	-	-	-	-	-	-28.9	-20.1	-12.0	-28.8	-22.1
Exports of goods and services	103.7	105.3	105.4	106.0	105.2	63.3	67.7	68.9	54.7	63.4
Imports of goods and services	114.7	111.1	109.3	105.7	109.9	92.2	87.8	80.9	83.5	85.5

Source: NSI

Private consumption growth decelerated significantly as it decreased from the rate of 7.0% in Q1 to 3.4% in Q4, while public consumption had been characterized by temporary fallbacks in Q1 (-2,7%) and Q3 (-2,5%) but a significant positive shift in Q4 (13,3%). The large boost in gross fixed capital formation in the beginning of the year had tamed down by Q4, however investment had been one of the main drivers of growth throughout the whole year. Regarding net exports the acceleration of export growth and the deceleration of import growth had been both positive developments, nevertheless the dependence on food imports, the high prices of grain and the high prices of oil resulted in a widening trade balance in the end of the year.

On the production side regarding the structure of growth the most significant change had been the huge decline in agricultural output: its volume decreased by 29.7% in 2007 as a result of the droughts in summer, which were later followed by heavy rainstorms. As a consequence the share of the agricultural sector in gross value added decreased from 8.5% in 2006 to 6.2% in 2007. Regarding quarterly data, as Table 2 shows, the most significant relapse occurred in Q3 2007 when the volume of gross value added in the agricultural sector decreased by 43.1% compared to the same period of the previous year. In the fourth quarter the volume of gross value added in the agricultural sector advanced only slightly.

TABLE 2. VOLUME INDICES OF GROSS VALUE ADDED (SAME QUARTER OF THE PREVIOUS YEAR = 100, %)

	Q1	Q2	Q3	Q4	2007
Agriculture, hunting and forestry, fishing	100.26	93.06	55.89	63.60	70.25
Industry including energy	109.18	113.02	114.04	115.97	113.15
Construction	114.23	111.71	115.11	125.98	116.93
Trade, hotels, transport, communications	102.05	108.49	103.92	108.49	105.98
Financial, real-estate, renting and business activities	105.60	111.05	115.91	111.82	111.25
Other service activities	102.68	102.31	107.38	105.04	104.49

Source: NSI

However on the production side the construction sector and the industry had shown favourable growth tendencies. The former can be considered as a top performer, especially in the fourth quarter, when the volume index of GVA in this sector increased by 25.98%, outpacing the other sectors by 10 percentage points. The positive developments in the construction sector are due to the opening of the Bulgarian construction market and the accession to the EU,

which are both attracting foreign enterprises to the sector. In the industrial sector the solid growth last year was driven by a 15% increase of gross value added in manufacturing, a 15.4% rise of gross value added in the processing industry and a 17.2% enhancement of gross value added in the heating, electricity and energy sector. The only decliner in terms of GVA contribution was the mining industry. As a result of the predominantly positive developments, the share of industry in the total gross value added increased from 30.9 in 2006 to 32.3% in 2007. Compared to the construction and the industry sectors, services had raised slower, their contribution to the GVA increased by an overall rate of 7.5% in 2007. As a consequence the share of services in the GVA rose only slightly, the ratio increased from 60.6% in 2006 to 61.5% in 2007.

The projections for GDP growth in 2008 are varying by the forecasting entity, but generally analysts expect the rate to descend well below 6% (between 5.5% - 5.8%), while the government's medium-term fiscal framework contains a 6% GDP growth rate for 2008.

The drivers of this year's growth may be the continued growth of the industrial and the services sectors. In the case of the construction sector the growth will continue, but at a slower pace: in 2007 investors have tried to exploit the benefits of the euphoria after the EU accession, in the coming years the market will enter a more balanced phase. Last year retail properties had been the most in demand, but the industrial sector is expected to draw alongside and as the economy grows demand for residential properties will rise as well. The recovery of the agriculture and the return on the already invested EU structural funds along with the drawing of further EU financial resources may also have positive effect on growth. The export growth is expected to accelerate slightly, however the EU subsidies will further boost imports and the strength of the Euro will make imports more expensive thus the trade gap is unlikely to shrink considerably.

On the whole a slowdown is presumptive as the result of external and internal factors. Such external circumstances as the slower growth in EU countries and in particular in the Euro zone along with the continuing problems on global capital markets will negatively affect the Bulgarian economy through trade and financial channels. Regarding internal factors one major problem is that wage growth is not in balance with productivity growth. The wages in the public sector have been raised by 10% in 2007, which may generate higher wage demands in the private sector as well. Overall increase of wages poses risk for inflation and external competitiveness. Another problematic issue is whether the slower growth of domestic demand will be sustained, as it would be important from the point of view of the improvement of the external balance and the amelioration of the composition of growth.

EU-CANDIDATE STATUS FOR SERBIA IN 2008?

After the collapse of Milosevic regime in the end of 2000, Serbia achieved great progress on the way to the European Union. Many reforms have been implemented so far with the assistance of European Commission (EC). The signs of change and development are definitely visible for anyone, but there are serious problems, which can be managed by cooperation and political willingness. However, the actual events endanger potential benefits, so the next few months are crucial in the medium-term future of relations between EU and Serbia. Both the EU and Serbia have to ensure keeping up the dialogue and dealing the EU integration separately from the case of Kosovo.

RESULTS AND CHALLENGES

Since the Thessaloniki Summit in June 2003, Serbia is a potential candidate for the EU accession. As a potential candidate country, Serbia has not only rights and opportunities but obligations too. The Stabilisation and Association Process (SAP) is the official EU policy for Western Balkan countries, in which the EU offers institutional framework programmes, like Community Assistance for Reconstruction, Development and Stabilisation Programme (CARDS) and trade preferences, like Autonomous Trade Measures (ATMs). Due to the developing relations Serbia produced remarkable development both in politics and economy.¹

As a transitional country, Serbia had to make efforts to transform the old and anachronistic institutions; reduce high level of corruption and increase transparency and competitiveness.

TABLE 3. COMPETITIVENESS AND CORRUPTION INDEX OF SERBIA

	2003	2004	2005	2006	2007
Growth Competitiveness Index ratings	79	89	80	87	91
Corruption Perceptions Index ratings	106	97	97	90	n. a.

Source: World Economic Forum; Transparency International

The reports of the two international organizations above, demonstrate well the two-faced character of Serbia. It is undoubted, that there is a permanent improvement in the fight against corruption, thanks to the government's endeavour. However, attracting foreign investors is much more complicated and the EU assistance is indispensable. This duality is very typical of every sector in Serbia; including promising sections and structural problems.

The key priorities for Serbia according to the European Partnership² are the follows:

- Ensure full cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY).
- Ensure full compliance with the future obligations under the Stabilisation and Association Agreement (SAA) and the Interim Agreement (IA).

¹ Since the extension of ATMs (2001), Serbian exports to the European Union have grown by about 70%. Today more than 80% of all goods from Western Balkans region enter Europe with no customs restrictions. (European Commission)

² European Partnership is the most important element of the SAP; identify priorities and obligations to be fulfilled.

- Ensure that the constitution and constitutional law are implemented in line with European standards.
- Engage constructively in the further negotiations to find a sustainable solution on the status of Kosovo together with the provisional institutions for self-government in Pristina.
- Improve the functioning of the judiciary, guarantee its independence, professionalism and efficiency and ensure that the career development and recruitment of judges and prosecutors are based on technical and professional criteria and free from political influence.
- Step up the fight against corruption at all levels and develop a comprehensive public system of financial control to increase transparency and accountability in use of public finances.
- Finalise the process of privatisation or, when appropriate, liquidation of social-owned and state-owned enterprises.
- Continue efforts to implement the reform of the public administration, to ensure transparent recruitment, strengthen the European integration structures, improve coordination throughout the public administration and parliament and pay particular attention to policy coordination.

WHAT DOES EU OFFER?

The EU is extremely interested in reconciliation the region of Western Balkan, because the Union is a very weak actor in international politics. Offering the possibility of accession for Serbia, can bring peace and prosperity into this region and increase the power of EU in foreign policy.

TABLE 4. IPA MULTI-ANNUAL INDICATIVE FINANCIAL FRAMEWORK FOR SERBIA (EUR, 2007-2011)

	2007	2008	2009	2010	2011
Transition Assistance and Institution Building	181 496 352	179 441 314	182 551 643	186 206 679	189 956 810
Cross-border Cooperation	8 203 648	11 458 686	12 248 357	12 493 321	12 743 190
Total	189 700 000	190 900 000	194 800 000	198 700 000	202 700 000

Source: European Commission

In order to realize the stabilisation, the EU provides specific targeted financial aid for candidate and potential candidate countries, so as to support their efforts to enhance political, economic and institutional reforms. The new Instrument for Pre-accession Assistance (IPA) came into force on 1 January 2007, bringing all pre-accession support³ into one single, focussed instrument. The financial assistance of EU (Table 2.) grants the opportunity for Serbia to continue the reconstruction and development. If Serbia reaches the official candidate status, further resources will be available for rural, regional and human resources development.

EU INTEGRATION WITHOUT KOSOVO

On 18 September 2007 were signed the Visa Facilitation and Readmission Agreements following long period of negotiation. Two months later, on 7 November, the Stabilisation and

³ CARDS; ISPA; SAPARD; PHARE

Association Agreement (SAA) was initialled between the EU and Serbia with the expectation of signing in 2008. With these agreements Serbia looked to get closer to the EU. Nevertheless, the status of Kosovo was a constant threat in the integration process. In December 2007 the parliament of Serbia passed a resolution underlining their opposition to Kosovo's independence and warning of repercussions for European integration. The EU wanted to accelerate the integration by signing the SAA in January 2008 between two rounds of Serbian presidential election. However Netherlands and Belgium rejected to sign, because Serbia did not cooperate fully with the ICTY. Instead of SAA the EU offered to sign an interim political pact⁴, in order to influence Serbian's runoff election. The pro-EU president, Boris Tadic retained his position, but the government decided to postpone the signing. The aim of government is to link the solution of the Kosovo problem with Serbia's EU integration process. These steps serve only political interests because over 70% of the Serbian people support the European integration. According to Olli Rehn, the EU Commissioner for Enlargement, now Serbia has to show its commitment to the European Union.

⁴The agreement would provide a framework for progress on political dialogue, free trade, visa liberalization and educational cooperation.

FORMER ISSUE'S TABLE OF CONTENTS:**Number 2008/01.**

- ICEG European Center's Latest Quarterly Forecast on the Western Balkans – fourth quarter 2007
- eGovernment in Romania and Bulgaria
- Export-Driven Economic Growth in the Former Yugoslav Republic of Macedonia
- Southeast Europe: Competitors in the EU'S Neighbourhood

Number 2008/02.

- Flat Tax in Bulgaria – Reason and Expectations
- Some Highlights of Recent eGovernment Developments in the Western Balkans
- The Energy Profile of Southeast Europe
- Croatian GDP Growth Prospects in 2008