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INTRA-REGIONAL TRADE IN SOUTHEAST EUROPE (SEE)

Southeast European countries performed relatively well in the last couple of years. The annual gross domestic product (GDP) growth reached 5-6% in most SEE economies despite of the weak world economic environment. However, domestic demand was the main engine of these economies and foreign demand remained moderate in this period of time. Thus, foreign trade played only a slight role in economic growth.

After transition the structure of foreign trade went through a large transformation, not only the destinations of commodities have changed but also their structure. Transition – and wars in the region - had a significant negative impact on foreign trade, thus foreign trade per GDP ratio is relatively low in these economies comparing to the New Member States. In the seven SEE countries the average value of exports and imports of goods reached "only" 66.5% of GDP in 2003. The most opened economies are Bulgaria (89.8%), Romania (72.7%) and Bosnia-Herzegovina (72.3%) with higher than 70% level.

TABLE 1.: EVOLUTION OF IMPORTS AND EXPORTS OF GOODS IN SEE ECONOMIES (2000-2003)

	Imports				Exports			
	2000	2001	2002	2003	2000	2001	2002	2003
Albania	1 174.05	1 475.94	1 589.25	1 609.48	281.38	340.28	348.57	369.28
Bosnia and Herzegovina	2 863.43	3 174.60	3 557.24	3 551.50	724.90	824.06	876.05	995.67
Bulgaria	6 890.86	8 023.18	8 282.73	9 441.45	5 155.85	5 654.69	5 956.01	6 410.46
Croatia	8 327.63	9 961.64	11 068.75	12 412.20	4 409.35	5 074.56	5 113.47	5 350.15
Macedonia, TFYR	2 257.93	1 885.02	2 093.90	1 994.23	1 067.88	992.27	788.13	849.97
Romania	14 140.38	17 373.55	18 849.59	21 313.21	11 228.88	12 719.39	14 675.27	15 506.85
Serbia and Montenegro	3 585.08	4 384.60	5 063.90	5 071.01	1 120.21	1 280.59	1 496.53	1 494.99
SEE-7	39 239.36	46 278.52	50 505.35	55 393.08	23 988.45	26 885.85	29 254.03	30 977.36

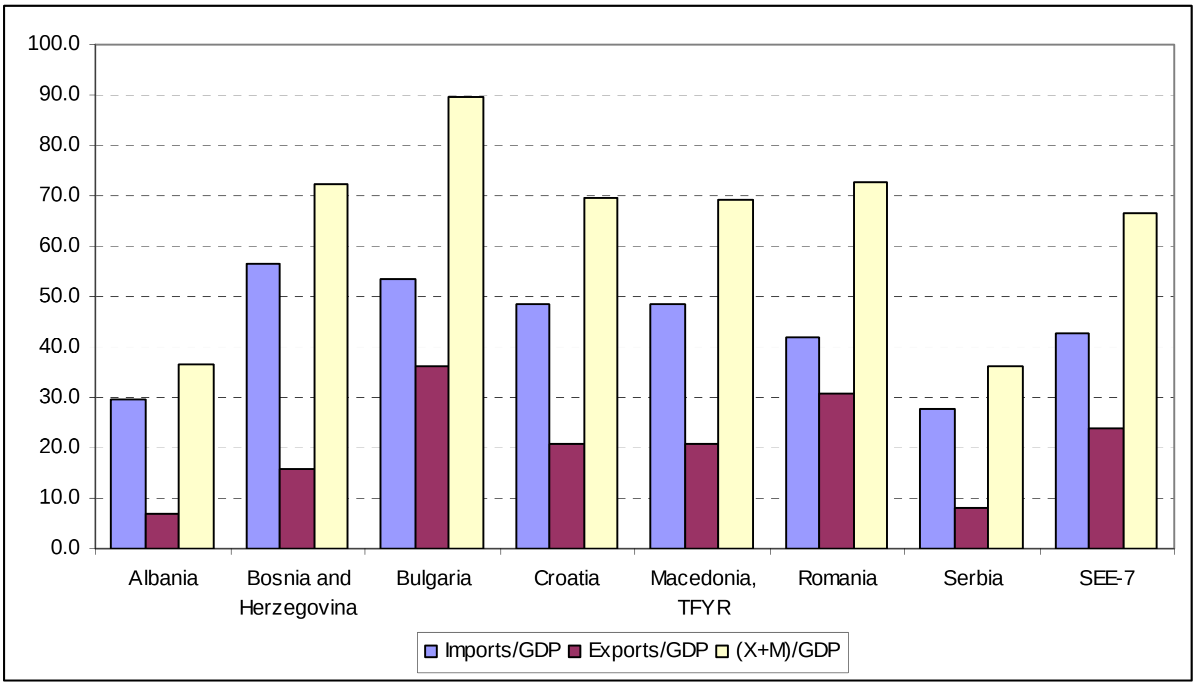
Source: UNCTAD

Generally, the smaller an economy is the more likely it is an open economy. In the SEE region it is only partly true. Romania, with its population above 20 million, is one of the most opened economies in the region, while in case of Albania or Serbia and Montenegro, where population is less than 10 million (Albania) or around 10 million (S&M), the trade/GDP figure is less than 40%. It is certainly the result of the history before and after transition in these economies. Albania was one of the most closed economies before transition, while the wars in Serbia had a severe negative impact on the economy, including export industry.

It is worthy to examine the trade structure in more detail. Regarding only the export per GDP ratio, the average figure reached 23.8% in 2003 or it means the value of imports is almost the double of the value of exports. Not surprisingly, it indicates that these countries have huge foreign trade deficits. It seems only Romania and partly Bulgaria were able to follow the economic path of the Central European transition economies where export (and foreign investments) played a significant role in economic growth and these economies became fairly opened. Trade openness figure exceeds 100% in many cases of these economies, while foreign trade balance is better than that of the SEE average. In case of Albania, Bosnia-Herzegovina, Croatia and FYR of Macedonia the trade balance deficit is between 20% and 40% of GDP.

In line with the unfavourable progress of foreign trade balance, the intra-regional trade has also narrowed in the last few years. In 2001 the intra-regional trade reached EUR 4 billion or 11.2% of total trade, it declined to approximately 7.2% (or EUR 3.1 billion) in 2003 according to our estimation. While total foreign trade increased by 18% in euro terms, intra-regional trade has shrunken by almost 25% during this two years.

CHART 1.: TRADE OPENNESS IN SEE COUNTRIES (2003)



Source: UNCTAD

The SEE region is not a free trade area, however bilateral free trade agreements ensure the liberalised trade of goods among the countries. Previously the CEFTA was established to create a free trade area in Central and Eastern Europe, which included Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia in 2003. One year later the CEFTA became a smaller club due to the 2004 EU enlargement when only Bulgaria, Croatia and Romania remained members of the CEFTA. Now the CEFTA agreement represents the trade agreement among these three SEE economies. The other bilateral relations were created basically due to the so-called Stabilisation and Association process (mainly in case of Western Balkan countries).

Trade relations among Western Balkan economies are weak considering the fact that these economies (except for Albania) formed one single country (Yugoslavia) one and a half decade ago. Certainly, the negative shock of transition and the wars which followed the transition in the 1990s made these economies find other destinations for their commodities. In fact, the reason for declining intra-regional trade was political in many cases.

Now according to a survey of Eurochambres, 51% of the companies in the SEE region responded that the importance of exports to Southeast European countries is less than 10% of turnover. Only 17% of them responded that the importance is over 50% in average (from 9% in Albania to 25% in FYR of Macedonia).

In spite of the fact that intra-regional trade has a small role in these companies' life, they wish to increase the role of the region in their turnover. However, the companies responded that they faced serious barriers in their intra-regional trade. Generally the most important barriers in intra-regional trade are the weak infrastructure between origin and destination and there are administrative obstacles hampering trade within SEE region. According to the aforementioned survey, the principal barriers are the time-consuming and expensive customs procedures, the bureaucratic and too complex company registration and the problem with the technical standards and certification.

In the short term future, it is expected that the share of intra-regional trade will not increase rapidly despite the creation of bilateral trade agreements and the strengthening cooperation and improving relationships among these economies. Certainly, the EU will remain the key trade partner, while, the role of the SEE region in total trade can go up in the distant future. Obviously, business climate improved significantly in these economies which attracts new foreign investors which can also improve the economic cooperation of these economies.

INFLATION IN BULGARIA IN 2005 AND 2006

Consumer price inflation (CPI) has declined steadily from its peak of more than 1000% in 1997 to 2.3 % on average in 2003. Inflation was higher again in the first half of 2004, but came down in the second half to a year-on-year rate of 4.0 % until December which resulted in an average rate of 6.2 % for year 2004.

The inflation rate during the first eight months of 2005 cumulated to 1.9 % and 4.4 % for January-August 2005 over the same period last year. The inflation rate was 0.6 % in August as compared to the previous month. A month earlier the inflation rate in July over June was only 0.1 %. As compared with the same month of 2004 the rate reached 5.0 % at the end of August.

The inflation rate increased differently in various sectors of the economy. In August over July the prices of food products went up by 0.7 %, while the prices of non-food products increased by 0.9 % and that of services rose by 0.1%. Food prices, which usually fall during the summer due to cheaper fruits and vegetables, rose by the unexpected rate of 0.7 % month-on-month in August as heavy rains and flooding damaged farm produce and killed livestock. Non-food prices rose by 0.9 % in August driven by a rise in fuel and energy prices.

Due to these unfavourable factors the end-year cumulative inflation forecast had to be raised to 4.5 %, from the previous 3.6 %, largely due to the surge in fuel prices on the international market. Unfortunately, these and other factors are going to keep inflation rates higher in the end of 2005 and early 2006.

TABLE 2.: INFLATION RATE IN 2005

	January	February	March	April	May	June	July	August
CPI (monthly growth rate) (%)	0.7	0.9	0.3	1.1	-0.5	-1.3	0.1	0.6
CPI (12 month growth rate) (%)	3.3	3.9	4.3	5.1	4.6	5.1	3.9	5.0

Source: National Statistical Institute of Bulgaria

An increase in excise duties will further increase cigarette and fuel prices in 2006 under the new Excise Duty Act approved by the parliamentary committee on budget on September 16, 2005. Petrol prices are expected to grow by an average 2.6 %.

Higher fuel prices, due to excise duties or international oil market price trends, will certainly have their impact on almost the entire scope of goods and services offered on the domestic market.

Transport costs rose 2.3 % in August after a 2.7 % increase in July, while lower spending on clothing, health and education helped keep inflation low. Expected increase in electricity and heating prices in the winter months would probably increase inflation.

Fuel prices have a partial effect on the consumer products market, a section that also comprises housing, maintenance, water and power costs. Fuel prices also affect transport costs. Transport companies have already started pressing for measures to ease the effect of pro-inflationary fuel prices. Transport companies demand compensations for losses they suffered from record high fuel prices. The same issue was raised first time in May 2005 but no measures were taken.

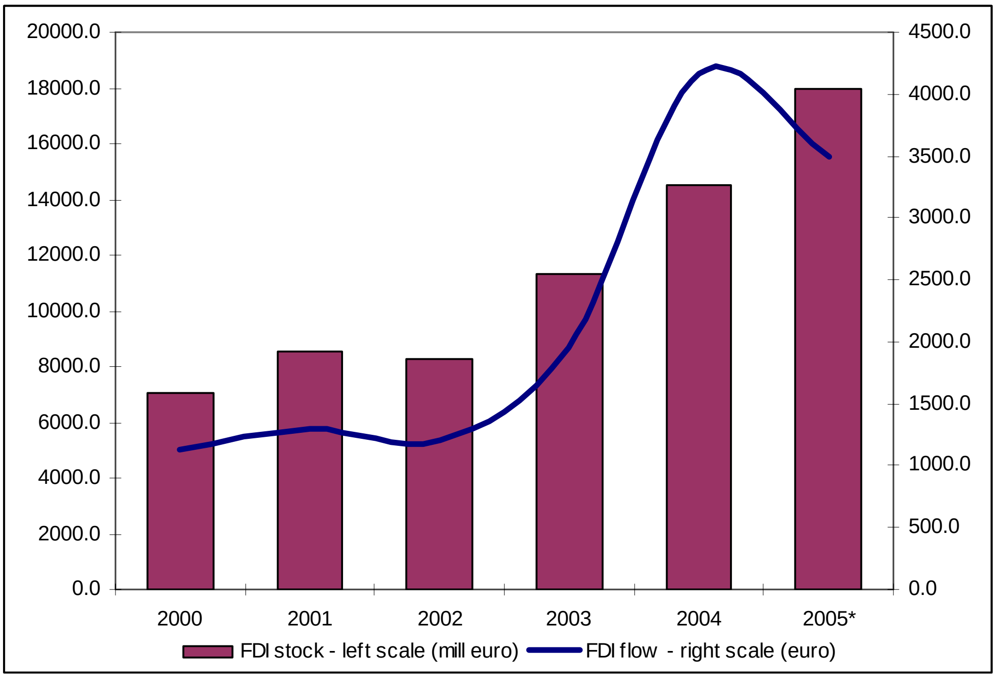
Employer organisations also called on the government to take measures and relieve the adverse effects on the still vulnerable competitiveness of Bulgarian companies. Their main argument is that the accelerated economic growth rate would be sacrificed unless the government made some moves (e.g. either a reduction of the VAT rate or an introduction of a tax relief for large electricity consumers). The government, however, does not intend to provide any compensation for expensive fuel. It refused to follow the example of some other countries which adopted such measures. The government argues that those countries were not affected by floods and disasters like Bulgaria.

As far as the next 15 months are concerned no major changes in economic policy can be expected in spite of the political uncertainties (e.g. new coalition government). A slowdown in annual real GDP growth to 5.2 – 5.5 % in 2005 (from 5.6 % in 2004), and to 4.2 – 5.0 % in 2006 are forecasted as domestic demand growth eases and export growth is constrained by weaker foreign demand. Inflation is set to average 4.4 - 4.5 % in 2005 and 4.5 - 5 % in 2006. In a worse case the inflation rate may increase even up to 5.5 % in 2006. The current-account deficit is expected to rise to 9.1 % of GDP in 2005, pushed up by high oil prices and strong domestic demand. Against this background, it is important that the government should maintain strict fiscal policy, take further steps to slow credit growth, and push ahead with structural reforms to improve the investment climate, encourage FDI inflows, and raise productivity. These economic policy steps may constrain the inflation rate.

STILL HIGH FOREIGN DIRECT INVESTMENTS INFLOW IN THE ROMANIAN ECONOMY

In the last few years, Romania became one of the most attractive economies in the SEE region. In 2004 foreign direct investments (FDI) reached EUR 4.2 billion which represents a 116% increase compared to the previous year. Last year figure was a record level which was mainly due to the privatisation of the national oil company (Petrom SA) as well as other important greenfield investments and the expansion of the already existing companies, especially in case of automotive industry and services sector. Regarding the privatisation of Petrom, that was the biggest privatisation in the SEE region in last year, its value reached almost EUR 1.5 billion and ÖMV AG was the acquiring company.

CHART 2.: EVOLUTION OF FDI STOCK AND FLOW IN ROMANIA (2000-2005)



*Source: UNCTAD; * forecast*

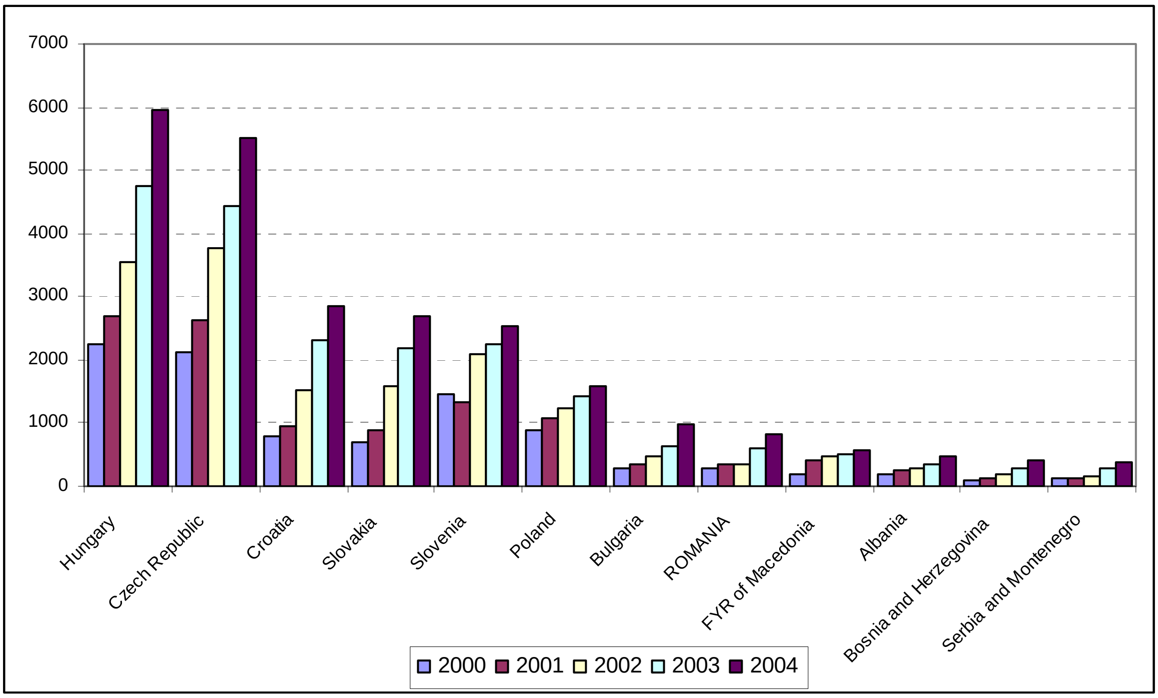
In line with the positive trend of FDI inflows, the stock of FDI increased significantly as well. At the end of 2004 the FDI stock reached EUR 14.5 billion or it increased by 28% compared to the end of the previous year. The per capita FDI (stock) also improved from EUR 518 to EUR 664 in course of 2004. However, the current foreign direct investments per capita level is still significantly lower than that of the 5 Central European NMS but it is the third highest in the SEE region after Croatia and Bulgaria.

In 2005 the favourable progress continued, foreign direct investments reached EUR 1.8 billion in the first seven months of the year. This figure is slightly better than that of the previous year (EUR 1.5 billion) which means the attractiveness of the economy remained in this year too.

Among the attractive factors it is worth mentioning that the introduction of the flat tax rate of 16% certainly had a positive impact on the business climate. Previously the rate of the corporate profit tax (CPT) was 25% which means the tax rate decreased by almost 10%-points. As a result, the Romanian CPT became one of the lowest in the region.

According to the statistics of the National Trade Register Office, the assets of the foreign-owned companies increased by 15% in course of the first eight months of the year. During that period the Top 5 largest investor countries were Austria (EUR 497.7 million), Greece (EUR 266.2 million), Italy (EUR 182.2 million), the Netherlands (EUR 152.7 million) and Germany (EUR 135.6 million). These five countries account for 78% of foreign direct investments in the first eight month of the year. Regarding the stock figures, Austria, the Netherlands, France, Germany and Italy are the largest investors in Romania.

CHART 3.: PER CAPITA FDI (STOCK) IN 5 NMS AND 7 SEE COUNTRIES (END OF 2004, EURO)



Source: UNCTAD

According to the UNCTAD's World Investment Report 2005, published recently, Romania ranked 35th in 104 countries in terms of performance index for foreign direct investments. It is a significant advance considering the fact that Romania ranked 76th in 2003 and 57th in 2004 (regarding the performance of the previous year). In 2006 this good position is expected to remain or improve further in view of the positive tendencies of this year.

In the SEE region, Bulgaria and Romania were the main destinations for foreign direct investments in last year, 70% of FDI was attracted by these two economies. During that period 168 greenfield projects were attracted which is significantly more than that of the previous years in Romania (2003: 112, 2004: 116).

According to the expectations of the Romanian Agency for Foreign Investments (ARIS), the value of the foreign direct investments can go up to EUR 3.2-3.8 billion in this year. They state that the amount of the FDI is greatly depends on the level of privatisation revenues in course of the year. Our expectation for FDI inflows into the Romanian economy is EUR 3.5 billion in 2005.

Deep overview of FDI movements in Croatia

Short macroeconomic overview

Economic growth slowed down to 3.8% in real terms in 2004, from the 5.2% and 4.3% in 2002 and 2003 respectively. The reason for this weaker performance was the slowing down growth in total investments, especially due to the completion of several road construction projects and the weakening of private consumption as well. This development in factors of growth was accompanied with improving external balance. Supply side of the GDP was backed by the following developments. The industry value added in real terms went down by 0.6 percentage points to 3.9% in 2004. The same indicator in the construction branch was 5.6% in 2004, but as regarding to the contribution to total value added, it felt down to 0.4%-point in 2004 from the 1.3 percentage points of previous year. The trade value added was also smaller in 2004 (0.6 pp) than in the previous period. As the growth of tourism value added also slowed down in real terms, the contribution to total value added went down to 0.1%-point in 2004 from the 0.3%-point value of the previous two years. The contribution of transport and communication went up to 0.6%-point due to 6.9% value added growth in real terms in 2004.

The inflation indicators (CPI, PPI, Core) accelerated in 2004 mainly according to some changes in the tax burden, especially the growth of excise taxes on alcohol and tobacco products. The main anchor of the inflation processes in the country was backed by the relatively stable Kuna exchange rate moving around the 7.5 Kuna/Euro level. By the developments of the first part of the year 2005, the CPI rate accelerated mainly due to core inflation developments.

The current account deficit felt from 6.9% in 2003 to 4.6% in 2004 mainly because of the more balanced situation in foreign trade balance and a fall in net expenditures in the income account.

By the expectations of ICEG European Centre, the growth remain in the level of 3.7-3.9% in the years 2005-2006. The macroeconomic developments of Croatia are in line with weak economic performance of main partner, the EU. However, the capital attractiveness of Croatia is favourable not only in narrow regional view, but also among New Members.

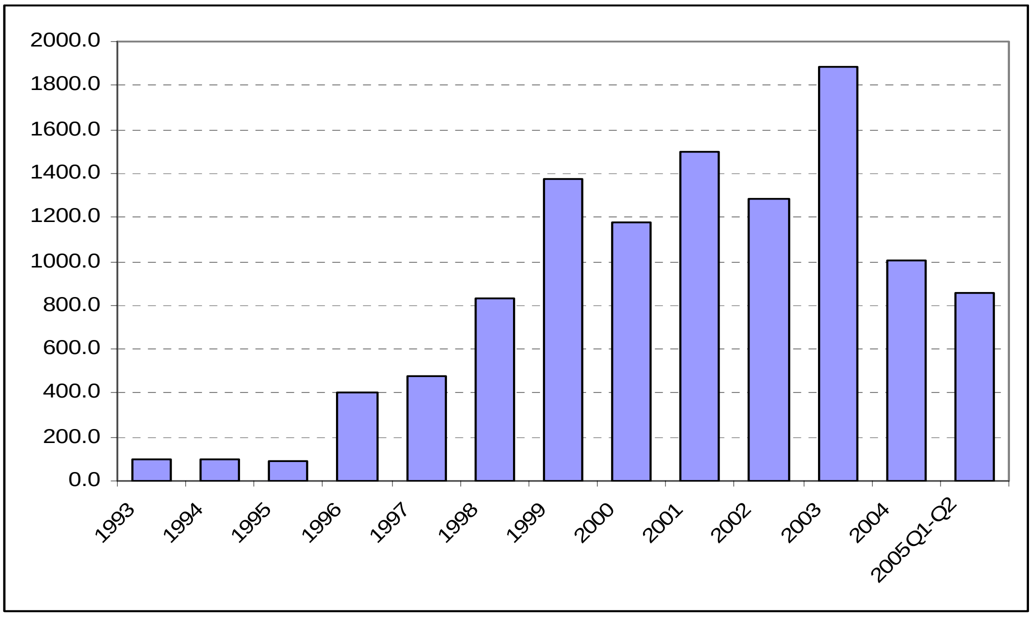
FDI volume and quality

In the last few years the region of Southeast European economies became very attractive for different types of capital, especially for direct investments.

From one side this process can be observed in all Southeast European countries, but from other side reflects the special economic structure and position of Croatia in the region. Total inflows into the region have reached around EUR 6.5 billion in 2003 and 2004. This expansion in FDI inflow reflects the permanently growing importance of the region in the sight of investors.

Croatia is one of the most dynamic countries in the region, the years of 1995-1996 brought a recovery in view of capital, as the war finished. With launching the privatisation process Croatia managed to have around EUR 1-1,5 billion year by year in the period of 1999-2004 with exception of extremely high data of the year 2003, when MOL, the Hungarian Oil Company bought the 25% plus one of INA shares for USD 500 million and brewery shares was also sold.

CHART 4.: THE FOREIGN DIRECT INVESTMENT IN CROATIA (1993 - 2005Q1-Q2, MILL. ECU/EURO)



Source: National Bank of Croatia

In 2003 among transition economies only Hungary, the Czech Republic and Poland had higher FDI inflow. The year 2004 is a sharp fall in FDI in comparison with the previous year, as it went down by almost 50% and reached EUR 1 billion. The existing data on the year 2005 shows that in the first half of the year the amount of direct capital inflow reached almost the whole amount of the previous year. This can be the reflection of the continuous interest according to the EU accession within foreseen future.

By investigation the structural composition of FDI we can observe the following trends. The equity investments were recorded in the year 1999 and remained the most important contributor of FDI until 2004. The share of reinvested earning has permanently grown from the year 1999 and reached extremely high share in 2003. This was according to natural development of earlier equity investments regarding to needed expansion of production or technological changes.

The biggest investor in Croatia is Austria by 25% of all FDI, followed by Germany and USA with the share of 17.7% and 12.3% respectively. The position of Hungary is also remarkable due to geographical situation and to tight economic relations. The share of EU as a whole is more than 80%. The main aimed branches for equity investments were monetary intermediation (25%), telecommunication (15%), pharmaceutical industry (9%), oil and gas industry (4%, mainly due to Hungarian MOL investment in INA). In the first half of 2005 the monetary intermediation, the financial sector was the leading magnet with 62% share of all FDI.

Finally it can be stated that Croatia is situated among most attractive countries in the broad region. By the attracted FDI per capita only the Czech Republic, Hungary and Estonia are coming before Croatia.

According to expectations and the experiences of countries of Central and Eastern Europe, the process of accession of Croatia will accelerate the growth rate of capital inflow not only in direct investments but also in portfolio and other capitals.