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HIGH ECONOMIC GROWTH IN THE SEE REGION IN THE LAST FIVE YEARS

In the Southeast European countries, namely in Albania, Bosnia-Herzegovina, Bulgaria, Croatia, the former Yugoslav Republic of Macedonia, Romania and Serbia and Montenegro the recession period after transition lasted longer than in the Central and Eastern European countries. In case of the latter group of countries the economies touched the bottom basically in the first half of the 90s, while in case of the SEE countries the recession period was longer and in many cases the economies touched the bottom two times in the last decade (in the first half and in the second half of the '90s as well).

Unlike the Visegrad countries, during the nineties most SEE countries were not able to reach the GDP level of 1989. In 2000 the average GDP of the region reached only around 80% of the 1989 level, while in case of the Visegrad countries that level was achieved in most economies.

However, the SEE economies shifted to a dynamic economic growth path in the new millennium. The annual average GDP growth rate in the region was above 5%. Thus, in 2005 the total GDP of the region was higher by 28% in real terms in comparison with the year 2000. It resulted in that the nominal GDP of the region during that period increased from EUR 97 billion to EUR 174 billion, or by almost 80% according to our estimations.

It resulted in that the region basically reached and exceeded the 1989 level in 2005. Regarding the convergence to EU average, the period between 2000 and 2005 was also successful. Most SEE countries were able to grow faster than the EU, thus they converged to the EU. The per capita GDP of region reached 33.4% of the EU-25 (PPS) in 2005, while it was only 27.7% in 2000, which represents a 6%-points advance during that five years.

TABLE 1. ECONOMIC GROWTH IN THE SEE COUNTRIES, 1990-2005 (%)

	Annual average (%)			2000	2001	2002	2003	2004	2005*
	1990-1994	1995-1999	2000-2005						
Albania	-6.3	5.8	5.7	7.3	7.0	2.9	5.7	6.0	5.5
Bosnia-Herzegovina	n.a.	28.7	5.0	5.5	4.5	5.5	3.0	6.0	5.5
Bulgaria	-5.7	-1.2	5.0	5.4	4.1	4.9	4.5	5.7	5.5
Croatia	-7.4	4.2	4.1	2.9	4.4	5.2	4.3	3.8	4.3
FYROM	-7.2	1.7	1.8	4.5	-4.5	0.9	2.8	4.1	3.5
Romania	-4.6	-0.4	5.1	2.1	5.7	5.1	5.2	8.4	4.1
Serbia and Montenegro	n.a.	0.3	5.3	5.0	5.5	4.3	2.4	8.8	6.1

*Source: national statistics, own calculations; * forecasts*

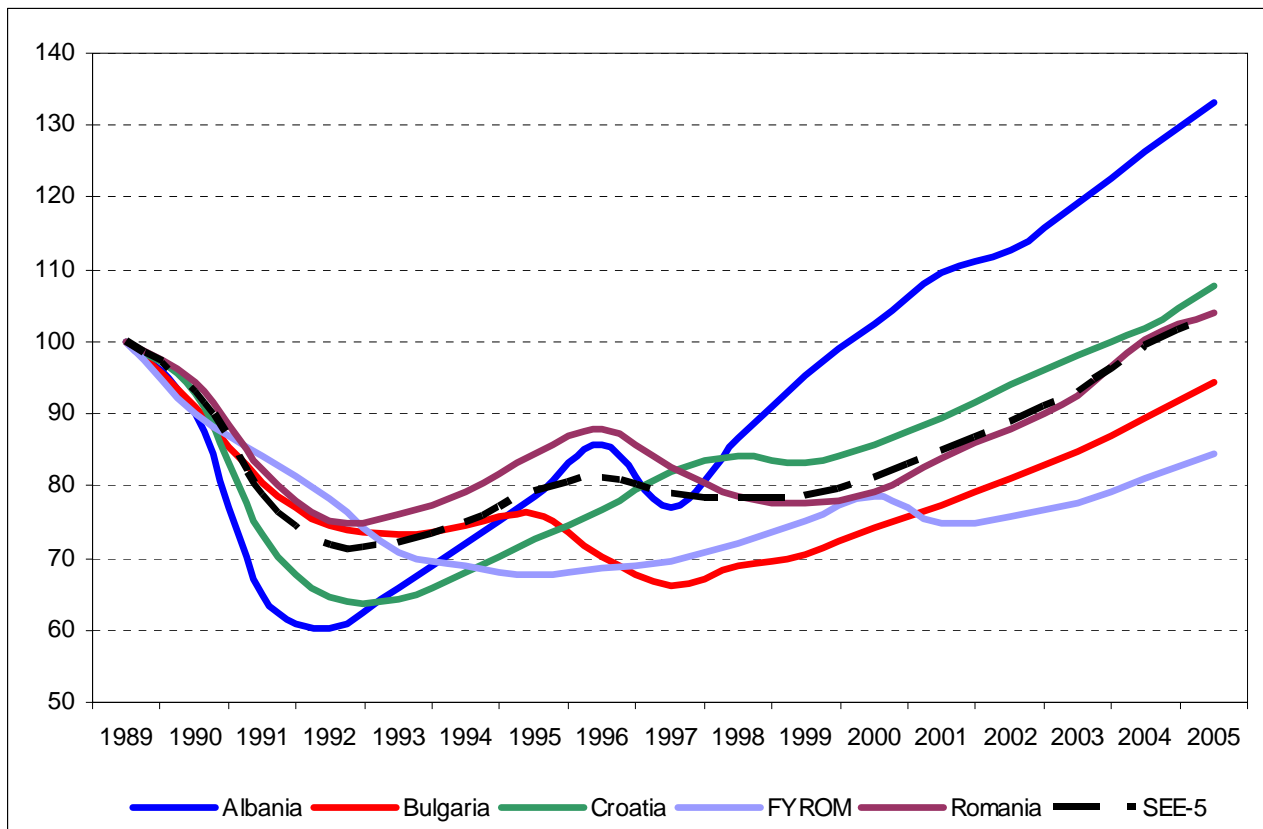
Due to the aforementioned trend the GDP/capita figure also increased significantly after 2000. In 2000 the per capita GDP was only EUR 1880 (nominal), which increased to EUR 3420 in 2005 according to our expectations. Certainly, the economies of the SEE region are not homogeneous, the above mentioned GDP/capita figure includes the figure of Albania (EUR 2150) and that of Croatia (EUR 6970) too.

Despite the dynamic economic growth of the region it is worth mentioning that the SEE countries significantly lag behind the New Member States in terms of GDP. In the so-called Visegrad countries the per capita GDP (in nominal terms) is above EUR 6000 but that relatively low figure is basically owing to the large weight of Poland which has a quite 'low' figure

compared to the other Visegrad countries, namely the Czech Republic, Hungary and Slovakia. That is why the difference between the two regions is only twofold.

The SEE countries basically have not followed the growth path of the NMS, the role of exports in economic growth was much lower in case of the Southeast European countries. The aforementioned dynamic economic growth was mainly due to the robust domestic demand. Both consumption and investments had a key role in achieving the robust GDP growth in the last years.

CHART 1. ECONOMIC GROWTH IN SOME SEE COUNTRIES, 1989-2005* (1989=100)



*Source: national statistics, own calculations; * forecasts*

One of the disadvantageous results of that type of economic growth was the widening deficit of the foreign trade balances. One can observe that foreign trade deficit reached more than 20% of GDP in several countries of the SEE region. On the other hand, the high foreign trade deficit did not result in extremely high current account deficit as in case of the Visegrad countries. There are two reasons for that. Firstly, due to the favourable geographic position in case of some SEE countries – mainly in Croatia and partly in Bulgaria – services balance has a significant role in current account balance through tourism revenues. Secondly, mainly in case of the smaller Western Balkan countries (such as Albania, Bosnia-Herzegovina and the former Yugoslav Republic of Macedonia) the current transfers play an important role in financing the huge foreign trade deficit in current account balance. The current transfers include the transfers of those employees who work abroad (mainly in Western European countries) and send money back to their family.

In the next 2-3 years the current dynamic growth of the region is expected and annual average growth of the region can exceed 5%. The main engine of the growth is expected to be the same: the domestic demand, namely consumption and investments.

ACCESSION OF BULGARIA AND ROMANIA ON 1 JANUARY 2007 – REALISTIC?

The European Commission published its second Monitoring Report on Bulgaria and Romania on 16 May 2006. As a final conclusion the Commission considered that both countries should be prepared for membership by 1 January 2007, although there are still some issues of serious concern and even more which require increased effort in the remaining seven months prior to accession.

EU RELATIONSHIPS WITH BULGARIA AND ROMANIA

Bulgaria and Romania established diplomatic relations with the EU in the end of the 80s. Their first two major steps towards accession were signing the Europe Agreement in 1993 entering into force on 1 February 1995 and the application of Romania for EU membership in June 1995 followed by the application of Bulgaria six months later. However, negotiations were started only four years later, in February 2000 after the recommendation of the European Council and the Commission in December 1999. On 15 June 2004 the EU set a new "safeguard clause" and six months later the parties concerned closed negotiations on 17 December 2004. The process was crowned by signing the Accession Treaty on 25 April 2005 which was ratified by Bulgaria and Romania later in that year. Since then the Commission has been monitoring the progress towards balanced economic development and reaching a high degree of alignment with the 'acquis'. The first Monitoring Report was published in October 2005 followed by the latest on 16 May 2006. As there were still areas raising serious concerns a third report will be published just before the accession in October 2006. This last report will decide whether the accession will be postponed by one year or Bulgaria and Romania will become members of the EU on 1 January 2007.

ISSUES TO WORK ON

According to the report both countries have reached a considerable degree of alignment with the 'acquis' and fulfill the political criteria for EU membership. Bulgaria and Romania have a functioning market economy while maintaining macroeconomic stability and advanced structural reforms. Economic growth was above 4% in the last two years in both countries. However, trends are different. The real GDP growth rate of Bulgaria increased by 0.6 percentage points from 2002 to 2005 and the inflation rate was kept around 5%. On the contrary Romania faced a decreasing real GDP growth rate of 1 percentage point in this period reaching a peak in 2004 (8.4%). The inflation rate is much higher compared to Bulgaria but decreased by 13.4 percentage points from 2002 to 2005. General government debt was decreased in both countries by 15.2 percentage points (to 38.8% of GDP in 2004) in Bulgaria and by 4.8 percentage points (to 18.5% of GDP in 2004) in Romania. Despite the progress made in the last years Bulgaria and Romania have still several areas to work on.

Both countries are considered to be ready for accession if current pace of progress is maintained in the areas of public procurement, regional policy legislation, visa policy and customs preparations. There are some additional areas in this category for each country (see Table 1.). These issues will not prevent the accession of these countries.

The second group of areas which need further progress are issues that need increased efforts. Bulgaria and Romania have to adapt to the VAT and direct taxation rules of the EU. Furthermore labor law, social dialogue and inclusion, public health and the structure of

receiving money from the European Social Fund need to be improved. Environmental questions such as horizontal environmental legislation, water quality and waste management are also lagging behind. In addition, judicial cooperation, fight against drugs and legislation to fight money laundering need more efforts in both candidate countries. Last but not least the translation of the 'acquis' into Bulgarian and Romanian has to be done before the accession. Other issues requiring increased efforts concerning either Bulgaria or Romania are included in Table 1.

There are two areas raising serious concerns in both countries:

- setting up a proper integrated administration and control system (IACS) in agriculture
- building- up of rendering collection and treatment facilities in line with the acquis on TSE and animal by-products.

Besides these two areas Bulgaria needs to take urgent steps in the following issues:

- Clearer evidence of results in investigating and prosecuting organized crime networks,
- More effective and efficient implementation of laws for the fight against fraud and corruption,
- Intensified enforcement of anti-money laundering provisions,
- Strengthened financial control for the future use of structural and cohesion funds.

Additionally, Romania still needs to accredit fully operational paying agencies for handling direct payments to farmers and operators under the CAP. Some progress has already been made in this area which can be built on in the coming months. In order to enable a correct collection of VAT throughout the EU internal market, tax administration IT systems have to be ready for inter-operability with those of the rest of the EU.

Comparing the monitoring reports of October 2005 and May 2006 the number of areas requiring increased efforts decreased by 2 (to 32) in Bulgaria but increased by 21 (to 44) in Romania while the number of issues raising serious concerns decreased by 10 in both countries, to 6 in Bulgaria and 4 in Romania. The decreasing number of serious issues does not ease the workload of general governments and public administrations of the candidates as there are numerous questions needing increased efforts.

EXPECTATIONS

The two most important issues – which cannot be solved in a couple of months – influencing the success of Bulgaria and Romania are fighting corruption and preparing the administration for receiving money from structural and cohesion funds. The latter will help increase competitiveness of these countries in the EU and accelerate structural reforms and regional development. Currently the competitiveness of the two countries is lagging behind as Bulgaria is ranked at 58th position and Romania is at 67th place, while Poland having the worst position among EU members is at 51st place according to the Growth Competitiveness Index (GCI - composed of the technology index, the public institutions index and the macroeconomic environment index) of the World Economic Forum in 2005.

Corruption has several negative affects on the economy such as lowering investment and retarding economic growth, loss of tax revenue, raising the level of public expenses, reducing the effectiveness of aid flows through the diversion of funds and lowering the quality of

infrastructure and public services. The high rate of corruption is not only reflected by the Growth Competitiveness Index mentioned above but also by the Business Competitiveness Index (BCI) prepared by the World Economic Forum, which takes company operations and strategy and the quality of the national business environment into account. The BCI ranking of Bulgaria was 78 while Romania reached rank 67 compared to Latvia (the worst EU member on the list) at 48th position in 2005.

TABLE 2. AREAS STILL REQUIRING PROGRESS

	Bulgaria	Romania
Ready for accession if current pace of progress is maintained	mutual recognition of industrial product specifications, freedom to provide non-financial services, most agriculture Common Market Organizations, aviation, excise duties, taxation implementing structures, postal services liberalization, chemicals and genetically modified organisms, noise legislation	protection of personal data, animal welfare, fisheries resource, fleet, control and market policies, protection of the EU's financial interests
Areas still requiring increased efforts	Mutual recognition of professional qualifications, financial services, information society services, protection of personal data, agriculture trade mechanism, the Common Market Organizations on wine and alcohol and beef meat, legislation in the veterinary and phytosanitary sector, most aspects of fisheries, sea transport, anti-discrimination policy, energy market liberalization, nuclear energy and nuclear safety (in particular the commitments to early closure and subsequent decommissioning of the reactors of the Kozloduy plant), steel industry restructuring, electronic communications, capacity of programming, monitoring and procurement for regional policy, integrated pollution prevention and control, consumer protection, asylum, protection of the EU's financial interests	Protection of intellectual property rights, veterinary border inspection posts and animal identification and registration, animal disease control measures, veterinary aspects of public health, institutional and financial management structures for regional policy, industrial pollution prevention and control, Schengen preparations and management of the future EU external borders, fight against fraud and corruption, industrial product horizontal and procedural measures, product requirements under the old approach including the production and marketing of GMOs, EU citizens' rights, freedom to provide non-financial services, capital requirements for banks and investment funds, motor insurance, State aid control and steel restructuring programs implementation, most agriculture Common Market Organizations, quality policy, agriculture trade mechanism, zootechnics, animal nutrition, trade in live animals and animal products, structural actions in fisheries, occupational health and safety, equal treatment of women and men, Community Youth program, audio-visual policy, regional policy monitoring, nature protection, police cooperation and fight against organized crime, public internal financial control, external audit and control over structural actions expenditure

Source: Monitoring report, 16 May 2006

The discussion of the monitoring report in the European Parliament was less optimistic compared to the report itself. Most of the political group speakers expressed their appreciation

of the huge development Bulgaria and Romania has achieved since the change of regime, but opinions were divided concerning the date of accession. Bigger groups shared the conclusive remarks of the monitoring report and believe that the EU will have 27 member states from 1 January 2007. However, they emphasized that further steps are needed in the highlighted issues and the candidates should be judged no more or less harshly than previous applicants. According to other political groups the main question is not the accession itself but the date of it and stressed that there are so many issues requiring increased efforts or even raising serious concerns that it is not possible to fulfill each criteria in the 7 months remaining till 1 January 2007.

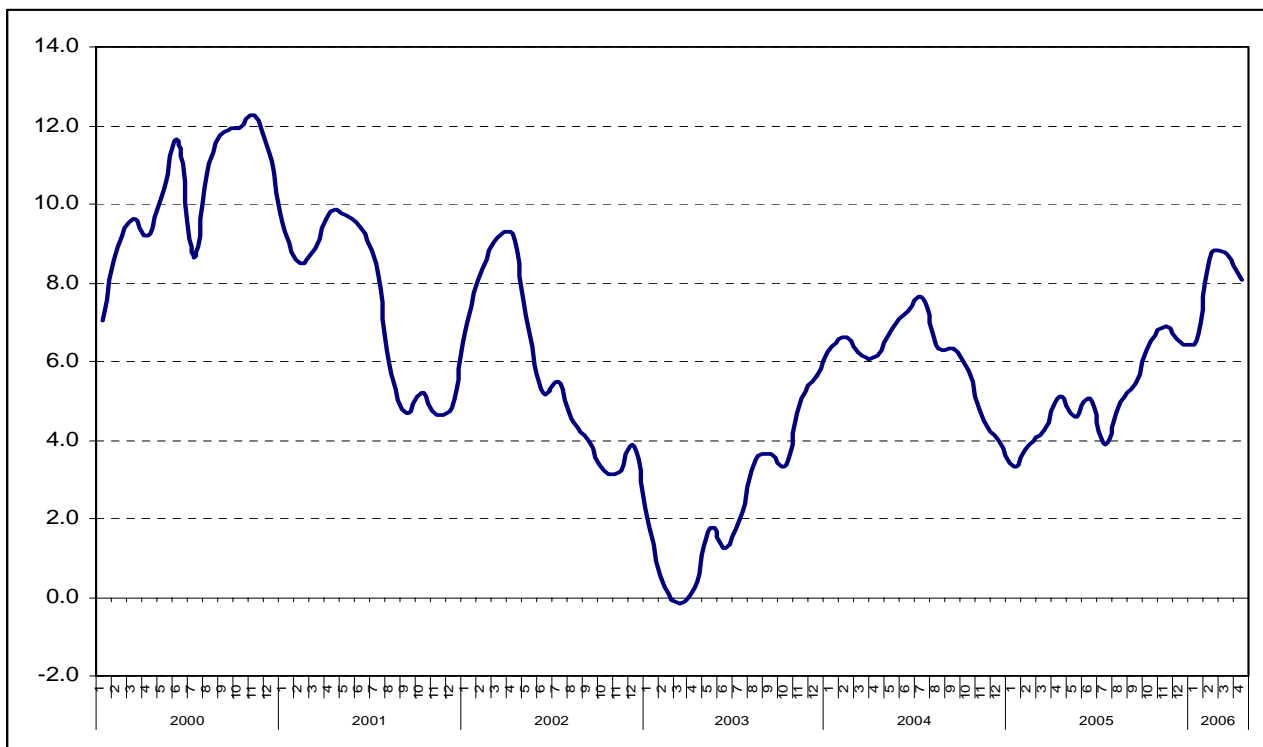
The monitoring report of May 2006 did not decide the date of accession but postponed it to October 2006 and left some time for the applicants to achieve improvements in the remaining shortfalls. The possibly new date of accession would be 1 January 2008 thus postponing accession should be taken into consideration. In the additional year Bulgaria and Romania could be more prepared, more competitive thus could benefit more from their accession, but also the EU needs this time for finishing its constitution.

INCREASING INFLATION IN BULGARIA

In the second half of 2005 consumer price index (CPI) started to increase in Bulgaria. While in the first half of the year CPI was only 4.4%, it increased to 5.7% in the second half, thus the annual average inflation rate reached 5%. Consumer price index started to increase gradually which was expected regarding the fact that elections were held in June 2005 and administrative prices and indirect taxes remained unchanged during this period. Thus, the average inflation rate of the first half remained relatively low.

In the second part of the year, inflation rate went up to 6.9% (in November 2005). The higher CPI was the result of several negative factors. Firstly, the international oil price hikes had a negative impact on fuel prices. Secondly, floods in the summer influenced negatively the production of agriculture sector and thus, food prices increased significantly in this period. Thirdly, energy prices also increased significantly. Electricity prices and natural gas prices increased by 16% and 18.11% respectively as of October, while central heating prices went up by more than 20% due to the higher natural gas prices in November 2005.

CHART 2. DEVELOPMENT OF CONSUMER PRICE INDEX IN BULGARIA, JANUARY 2000 – APRIL 2006
(%, COMPARED TO THE SAME MONTH OF PREVIOUS YEAR)

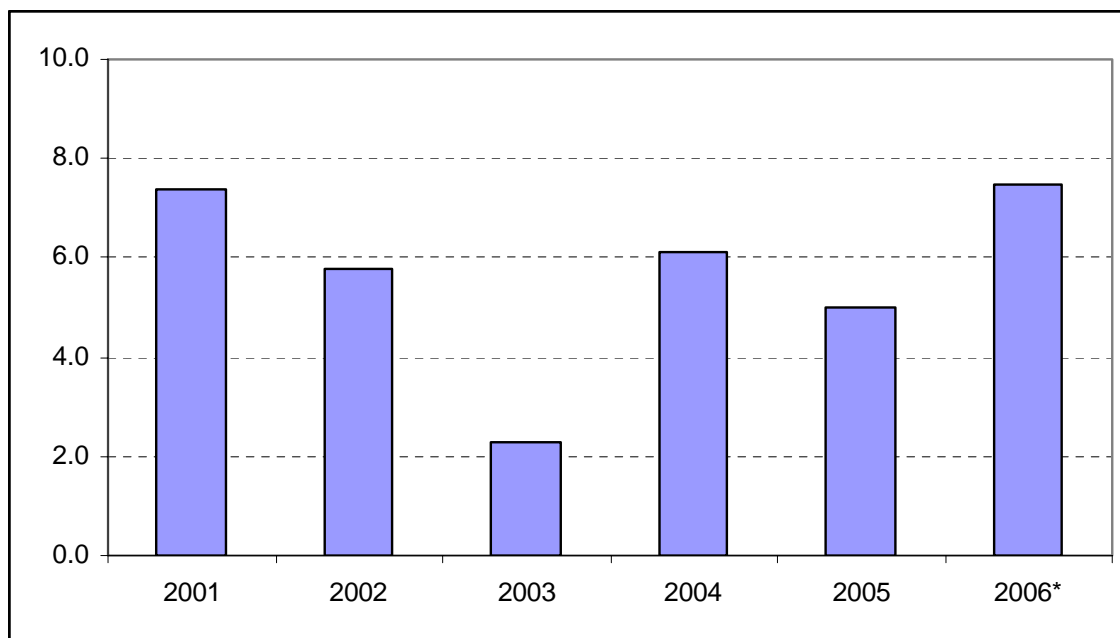


Source: NSI, own calculations

In the first quarter of 2006 inflation went up and reached 8.7-8.8% in February and March. CPI was not so high since the first quarter of 2002. The main reason for the significant growth of consumer price index was the further increase of administrative prices and indirect taxes. In February the prices of alcoholic beverages and tobacco increased by 46.6% in comparison with the previous month. This increase had a significant negative impact on CPI in February, it increased monthly CPI by 2.3%-point, while total monthly CPI was 3.0%. It reflects well that

even if this consumer group has relatively small weight (4.9%) in consumer basket this measure had a significant negative effect on consumer prices.

CHART 3. DEVELOPMENT OF ANNUAL AVERAGE CONSUMER PRICE INDEX IN BULGARIA, 2001 – 2006 (%)



*Source: BNB; *expectations*

In April consumer price index moderated to 8.1% but due to the aforementioned price hikes significant drop of inflation is not expected in this year. As a result of the increasing consumer price index, the National Bank of Bulgaria increased its base interest rate. At the end of the last year base rate was 2.05% while it increased to 2.57% in May 2006 in line with the rising inflationary pressure.

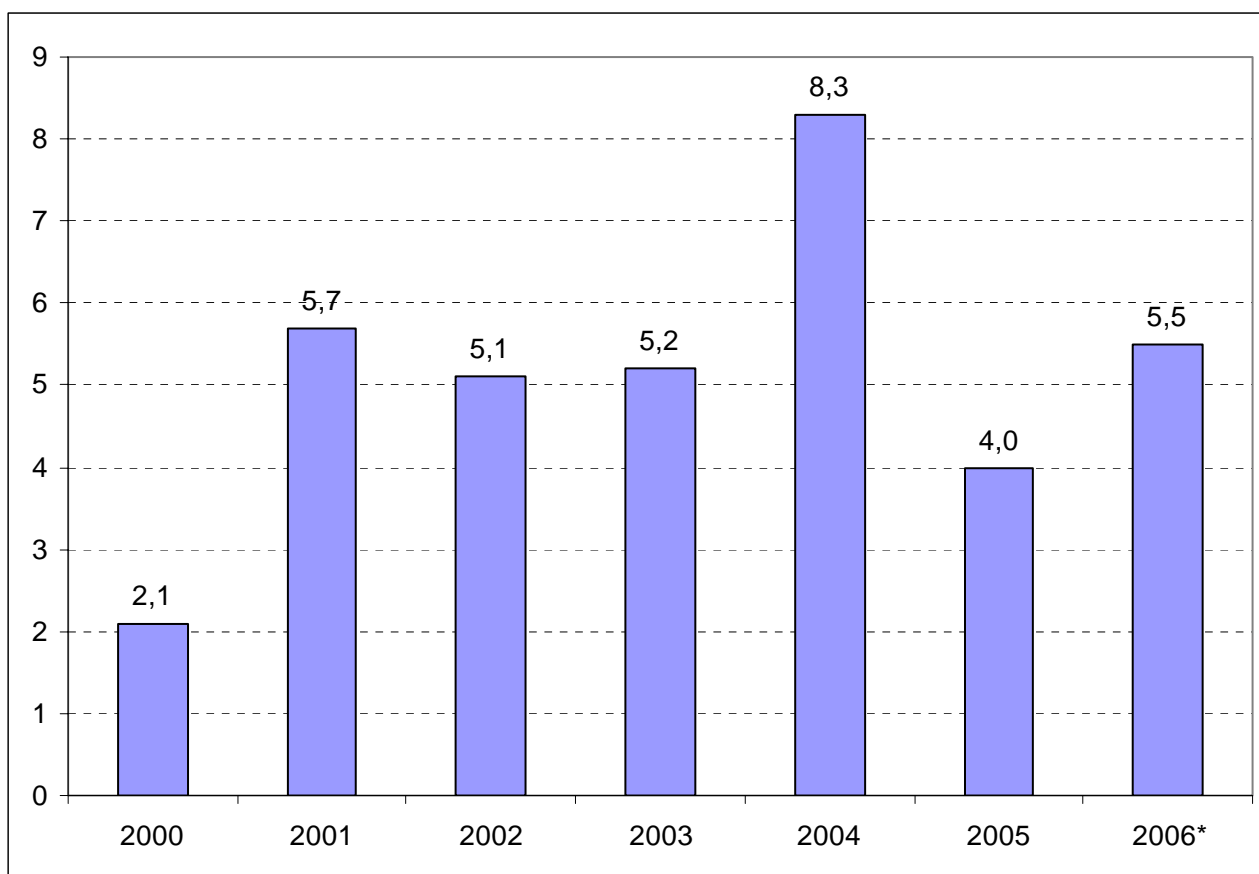
In course of the year current tendencies are expected to continue, namely inflation will be higher than it was last year. Further increase of the administrative prices and indirect taxes are expected due to the fact that the government decided to bring forward these measures to be able to adopt the single European currency at the end of the decade, as soon as possible after the accession (2009-2010). Thus, the annual average consumer price index can reach 7.5% in 2006, according to our expectations. On the other hand, CPI is expected to decrease in 2007 in comparison with 2006 even if the administrative prices and indirect taxes are expected to increase in next year too.

SIGNIFICANT DROP IN ECONOMIC GROWTH IN ROMANIA

According to preliminary statistics of the Romanian National Institute of Statistics (INSSE) GDP growth reached 4.1% in 2005 in real terms and nominal GDP reached EUR 79.3 billion. This growth is much lower than that of 2004 when gross domestic product increased by more than 8% and that is the lowest growth rate of GDP in the last five years. However, in the last quarter of the previous year some increase was observable compared to the third quarter when GDP increased by only 1.8% compared to the same period of the previous year.

The moderate performance of the Romanian economy was due to the weak performance of the agriculture sector in the mid-2005. In the first nine months of 2005 the production of the agriculture sector decreased by 12.6% which was the result of the unfavourable weather conditions in the summer. It means that July flood had a serious negative impact on the production of that sector and also on overall GDP growth.

CHART 4. EVOLUTION OF GROSS DOMESTIC PRODUCT IN ROMANIA, 2000-2006* (%)



*Source: ICEG EC; * Forecasts*

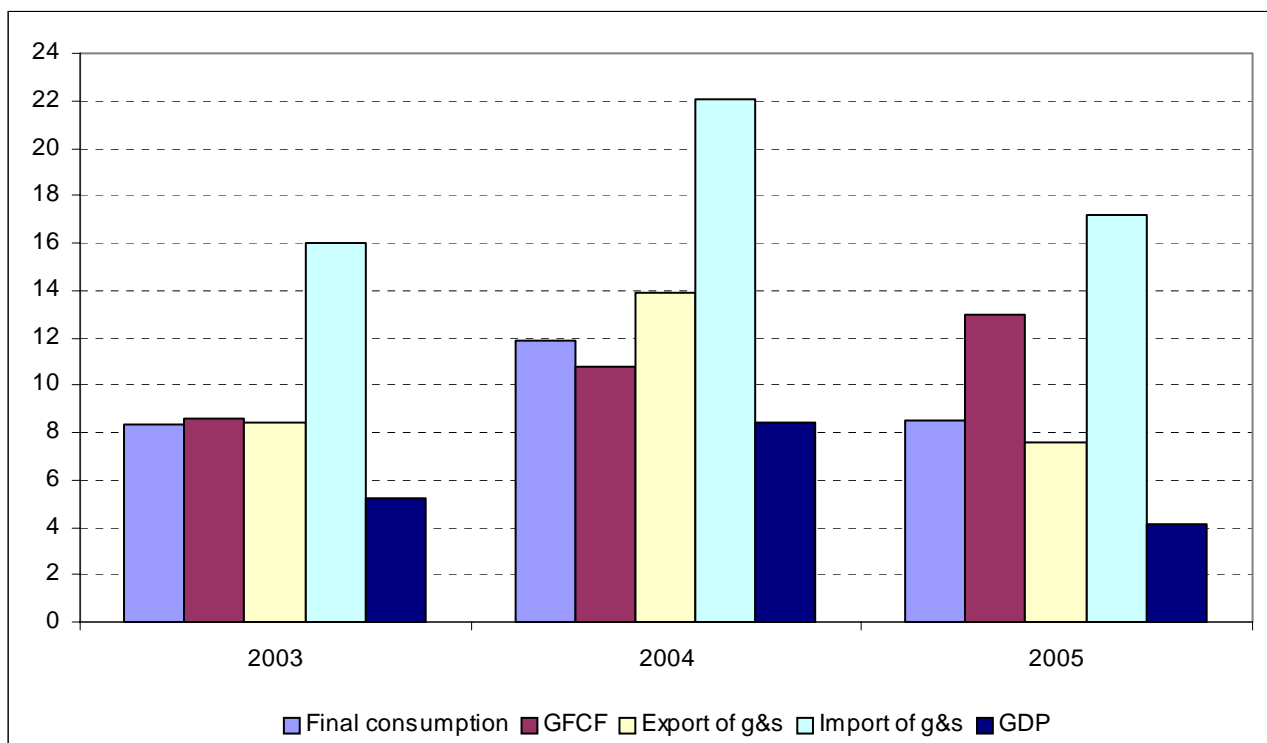
It is also worth mentioning that industrial production was also weak in course of 2005, the sector registered a growth of 2.0% in comparison with 2004. In case of manufacturing production the growth rate reached 2.5%. The growth of industrial production declined significantly in the second part of the year. In the first quarter of the year industrial output

reached a growth rate of 5.3% which declined to 3.0% in the first semester and to 1.5% in course of the first three quarters of the year.

On the other hand, the construction and services sectors reached relatively high growth in the last year. The gross value added of construction increased by 9.9% while that of the services sector reached 8.1% in 2005.

On the demand side, consumption and investments were the main engines of the economy in the last year. Private consumption increased by 9% in 2005, it reflects a slight decrease compared to 2004 but it can be still considered as high. Besides consumption, gross fixed capital formation also registered a high growth rate (+13%). Due to the outstanding performance of investments last year the investment ratio increased to 26.2% of GDP from 24.3% in 2004.

CHART 5. GROWTH INDICES OF GROSS DOMESTIC PRODUCT BY CATEGORY OF USE , 2003-2005 (%)



*Source: ICEG EC; * Forecasts*

As a result of strong consumption and investments imports of goods and services reached a high growth (+17.2%), while that of the exports reached 7.6% in 2005. Net exports had a negative impact on GDP growth in last year. Besides that, the widening of the trade deficit had a negative impact on current account balance as well. The foreign trade deficit increased by 46.6% in 2005 that reflects well the significant impact of domestic demands on foreign trade. Accordingly, current account deficit increased to EUR 6891 million in 2005 from EUR 5099 million in 2004. It means current account deficit went up by 35% and it reached 8.7% of GDP.

In 2006 analysts expect that the Romanian economy will gain some momentum, however the encore of the performance of 2004 is not expected in this year. However, the GDP growth can reach 5.5%, while consumption and investments will fuel the economy on the demand side. On the supply side, the role of industrial sector is expected to increase in this year compared to

2005, while agriculture sector can also reach a good performance considering the low basis of 2005, if the weather conditions will be favourable.

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