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TABLE OF CONTENTS

MONTENEGRO – ECONOMIC CONSEQUENCES OF SECESSION

On 21 May 2006 Montenegro organised a referendum on independence in line with the provisions of Article 60 of the Constitutional Charter of Serbia and Montenegro. According to the results published by the Republic Referendum Commission on 31 May, 86.5% of those eligible to vote took part in the referendum and 55.5% of voters supported independence. Thus the Montenegrin Parliament adopted the Declaration of Independence on 3 June (formally celebrating independence on July 12). Along with the European Union, the United States, Croatia and other countries the Government of Serbia also officially recognized Montenegro on 15 June.

BEFORE THE INDEPENDENCE

Under a 2002 agreement Serbia and Montenegro have run their own economies, currencies forming customs union and remaining part of a decentralized state. Montenegro could develop and implement its own economic strategy, run its own public administration, central bank and banking system (10 licensed banks) thus seemingly there might be little changes after gaining sovereignty. Montenegro chose the way of liberalization, privatising most major industries other than electricity and implementing a flat corporate tax rate of 9% while adopting free-market policies and EU and WTO rules of trade. However, similarly to Serbia the country faces excessive bureaucracy and corruption even if Prime Minister Milo Djukanovic has largely cleaned up economy from the smugglers' haven tolerated by the West until 2000 because it resisted Slobodan Milosevic. Montenegro managed to reach macroeconomic stability which is also reflected by the revision of outlook of Standard & Poor's on the Republic of Montenegro in December 2005 to positive from stable. The outlook change was based on the country's good progress on economic and political reforms and the strong political support for the Stabilization and Association Agreement with the EU.

TABLE 1. MAIN ECONOMIC INDICATORS 2000-2005

	2000	2001	2002	2003	2004	2005
GDP growth (%)*	3.1	-0.2	1.7	2.3	3.7	4.1
Inflation rate (%)	24.8	28	9.4	6.7	4.3	1.8
Unemployment rate (%)	32.7	31.5	30.45	25.82	22.6	18.5
Government deficit (% of GDP)*	-	-	-	-3.29	-2.18	-2.6
FDI inflow (million €)	-	-	182.9	213.62	111.08	382.8

Source: Central Bank of Montenegro, Economic Reform Agenda 2002-2007

Economy could grow at a faster pace in the last year despite the fall in industrial production by 1.9%, notably due to problems in the coal mine, the thermoelectric power plant and the steelworks. The most dynamic sectors were tourism and the financial sector. The government expects a yearly real GDP growth of 4.5% for 2006 and 2007. Inflation rate decreased significantly by 2.5 percentage points between 2004 and 2005 and the government managed to slowly decrease unemployment which remains still very high as almost fifth of the active population still does not have a job. Government deficit remained low in the last three years and there was a sharp 300% increase of inward FDI in 2005. This growth of inward FDI was thanks to the privatization of 3 major companies: Montenegrin Telekom (bought by the Hungarian Matav for EUR 147.6 millions), Podgorica aluminum plant (purchased by the Russian

Rusal for EUR 48.5 millions) and Podgoricka Bank (sold for the French Societe Generale Group for EUR 40 millions). Although the key indicators paint a positive picture of the country the share of grey economy is still 15% and there are major challenges remaining after declaring independence but also chances originating from getting rid of Serbian political burdens.

CHANCES AND CHALLANGES

There are two big advantages of independency. Firstly, Montenegrin decision makers can drop the independence issue from their agenda and can concentrate their efforts on economic growth and fiscal and microeconomic restructuring. Secondly, Montenegro can say goodbye to the stigma of Serbia's failure to capture war crime suspects which suspended EU negotiations. After gaining sovereignty Enlargement Commissioner Olli Rehn asked EU foreign ministers for a new mandate to start negotiating with Montenegro. The speed of the EU accession process will depend only on Montenegro in the future and the country could race ahead of Serbia on the road to EU integration.

Leaving behind the political tensions of war criminals and Kosovo there is a chance to improve tourism sector and attract more tourists in a peaceful, politically stable country with a spectacular coastline and beautiful mountainous areas. The government expects independence to fuel a doubling of Western tourists to 600,000 in 2006. Real estate market could also be boosted by the lost Serbian barriers of unstable political situation. Old buildings from the communist-era have been renovated and new hotels have been built. Real estate along the 290-kilometer-long coast has been bought mostly by wealthy Russians.

During the Milosevic era most of the Montenegrin industry was destroyed by the black market. These industries were sold off cheaply to foreign investors in the last 5-10 years. The process of privatisation was very successful as 100% of telecommunication, agriculture, services, oil import and distribution and capital market is in private ownership while tourism is mostly privately owned and only one local bank remained in state ownership. Privatisation will continue this year according to governmental plans concerning a thermo power plant, Pljealjska banka, a telecommunication company, leather industry, a recreational center and a shoe factory. However, there are only few state properties to sell (the most valuable ones in the energy sector). Inward FDI in the future cannot rely on privatisation thus the business environment needs to be improved, which is characterized by a bad infrastructure and economic corruption. The latter one originates from a fine network of personal connections, interrelations and dependencies due to the cosy size of the population (620,000 people). Until market transactions are dominated by insiders, corruption and enforcement of the rules cannot be defeated. Another challenge is the extreme size of the public sector. 60% of jobs is generated by this sector which leaves rather limited room for entrepreneurship and decreases the income of the government by insufficient number of private enterprises paying taxes.

Foreign trade liberalization resulted in an average tariff of 2.5% (in Serbia the average rate of tariffs is 8.5%), but there are other barriers of import, which cause higher prices in Montenegro. Even though these barriers the country faces significant trade deficit because of the low competitiveness of the economy and the increased demand on imported products. As Montenegro is an open, non-diversified economy, the country is vulnerable to external shocks, in particular on aluminium prices and tourism inflows. In order to maintain macroeconomic stability in the long term the economy should be diversified and public administration downsized.

Expectations

The most urgent tasks are not economic issues. Montenegro needs to apply for membership in all those international organizations where Serbia and Montenegro had membership. The country became already a member of UN and applied for a membership in IMF. The process of gaining WTO membership (requiring further reforms and setting up of new institutions) needs to be continued and negotiations on the Stabilization and Association Agreement with the EU have to be resumed. What is more, Montenegro needs to reach agreement with Serbia on bilateral relations, and pending political, economic and social questions related to the dissolution of the state union. Besides these tasks the country needs to form its own army and prepare it for integration with NATO.

Concerning economy the government needs to make efforts towards diversification and decreasing unemployment (with help of the project Legalization of existing and opening of the new working places). As tourism and real estate sectors got a chance to improve governmental support is necessary in these industries. For the development of the small and middle sized enterprises and facilitating innovation, the following projects of the Economic Reform Agenda will be continued: "Enhance competitive abilities for the domestic companies", "Industrial zone Bar"; "Made in Montenegro"; " Technological park", "Incubators", and "Innovation centers". To solve the problem of trade deficit the government should try to influence economy toward export and decrease irrational import.

All in all independency could help Montenegro to restructure and boost its economy and increased the chance of becoming an EU member. However, without structural reforms, decreasing public administration, fighting corruption and developing a better business environment the country will not emerge from the family of the poor, former Yugoslavian Balkan countries.

SHADOW ECONOMY IN THE SEE COUNTRIES

Shadow economy is hard to trace as it covers all economic activities that are not registered. However, there are some estimations for the extent of this phenomenon in the SEE countries. These estimations are inevitable as they can help governments to improve economic policies in order to reduce underground economy and increase public revenues.

WHAT IS SHADOW ECONOMY?

Shadow economy consists of all commerce that is not taxed. Thus it includes not only legally prohibited activities such as drugs, prostitution or gambling in some places but also trade in legal goods and services without reporting in order to avoid paying taxes. Shadow economy appears at the labour market as well in form of not reporting employees in order to save social security contributions. One kind of categorization can be seen in Table 2.

TABLE 2. A TAXONOMY OF SHADOW ECONOMIC ACTIVITIES

	Monetary transactions	Non-monetary transactions
Illegal activities	Trade in stolen goods; drugs dealing and manufacturing; prostitution; gambling; smuggling and fraud	Barter: drugs, stolen goods, smuggling, etc. Produce or growing drugs for own use. Theft for own use.
Legal activities		
Tax evasion	Unreported income from self-employment; Wages, salaries and assets from unreported work related to legal services and goods.	Barter of legal services and goods
Tax avoidance	Employee discounts, fringe benefits	All do-it-yourself work and neighbour help

Source: Schneider – Enste: Shadow Economies

CAUSES AND CONSEQUENCES

There are several factors influencing the extent of shadow economy. Firstly, high intensity of legal and administrative regulations, such as business registration, license, and permit requirements, can increase the intention of flight into the shadow economy. High overall tax and social security burden motivates employers and employees to move to the black labour market. The lack of trust in official institutions and the presence of administrative corruption (court system, unclear legislation and bureaucracy) are also barriers of "white economy". In case property rights are not clear companies cannot access official financial institutions such as credits, insurance, etc. which undermine formal economy. Interestingly the reduction of weekly working time, part time work and the early retirement enable people to search for additional income in the shadow economy. The extent of shadow economy is not only influenced by administrative rules and financial legislation. The morale of people is also an important issue. A long-term decline in civic virtue and loyalty towards public institutions can lead to the increase of underground economy. Broad acceptance of illicit work also strengthens shadow economy.

In the region of the SEE countries some of the above mentioned factors have stronger effect and because of their special history (young, former communist states, some of them gaining independency after a war period) there are some additional factors influencing shadow economy. Because of the young age of these countries the trust in official institutions is extremely low, as the administration is often incompetent, inefficient and corrupt. Property rights are not always guaranteed and the enforcement of laws and regulations is inadequate. Because of the underdeveloped economic and democratic institutions, informal and unofficial institutions appear (including the mafia as well), some of them having negative effects on society, but others creating social structures which can support the weak official structures. High taxes are bigger motivation in the SEE countries to act in the shadow economy as there is no adequate supply of public goods and infrastructure in return. The decision on the flight to the shadow economy is a cost-benefit-calculation where illicit work and tax evasion are more attractive because of the low probability of being caught.

Increasing proportion of shadow economy leads to decreased public revenues. Thus the governments will not be able to improve administration, public goods and infrastructure. The quality and quantity of publicly provided goods and services will decrease, while the government tries to avoid it by increasing tax rates. Increased burdens accompanied by worse public services and infrastructure motivate more actors of the official economy to relocate its activities into the shadow economy. A vicious circle arises which can be hardly defeated.

Size of the shadow economy in the SEE countries

The exact size of shadow economy as percentage of GDP is not possible to calculate. As the example of *Albania* shows, depending on the method used for estimating the extent of shadow economy very different results will emerge. In 2002 INSTAT estimated informal economy at 25% of GDP while Schneider got 33% as a result. Latest estimates (2004) are between 30% and 60%. *Bosnia and Herzegovina* is in a quite similar situation. In 2001 shadow economy was estimated at 21% of GDP while 3 years later it was 58%. *Macedonia* and *Montenegro* belong also to those SEE countries that have very high shadow economies. In Macedonia the estimations are quite exact, as shadow economy was 39% of GDP in 2001 and 40.8% in 2003. In Montenegro estimations set shadow economy at 27% in 2001 but at 60% in 2004. In these countries reality could be in this interval.

The other group of SEE countries also faces the problem of shadow economy, but it is not as extended as in the previous group. In *Bulgaria* estimations were between 16% (in 2000) and 34% (in 2001). However, the Bulgarian government stated that shadow economy has recently dropped to 25%. The shadow economy of *Croatia* is similar, as estimates are between 23.5% (average of the years 1990-1993) and 32.4% in 2001. The government is very optimistic concerning defeating underground economy and intends to decrease it to 15% of GDP by the time of its EU accession. In case of *Serbia* according to the only available estimation shadow economy was 195 of GDP in 2001. Last but not least *Romania* is catching up to these countries as shadow economy decreased from 46% in 2001 to 25% in 2005. As a comparison informal economy was 18% of GDP in the Czech Republic, 21% in Hungary and 31% in Poland in 2001.

According to the comparison of tax burden in the SEE countries those with relatively low burdens face lower shadow economy (Bulgaria, Croatia, Serbia) and higher tax burden means more extended shadow economy (Albania, Bosnia and Herzegovina). Macedonia is an exception as the tax burden is low, but informal economy is widespread. Comparing tax burdens with EU member states there are countries with higher or equal tax rates but lower shadow economy. Thus it can be concluded that the young, unstable economies of the SEE countries do not have enough and efficient public services, administration and infrastructure, and the moral after the war period and the change of regime is also unsatisfactory.

TABLE 3. TAX BURDEN IN 2006

	VAT	Corporate tax	Social security contribution	
			Employer	Employee
Albania	20	20	30.7	11.2
Bosnia and Herzegovina	17	30	28	10
Bulgaria	20	15	23.975 – 24.675	12.425
Croatia	22	20	17.2	-
Macedonia	18	15	11.3	-
Romania	19	16	19.75 – 29.75	17
Serbia	18	10	17.9	17.9
Montenegro	17	9	16.1	20

Source: PriceWaterhouseCoopers

The governments of the region do not need to concentrate only on reducing tax rates. It is also an important step, as it will increase public revenues and the infrastructure, administration and public goods and services can be improved which can increase trust in the official institutions. Besides tax policy, legislations need to be simplified in order to make business life easier. Besides incentive measures the governments should strengthen control bodies, and aggravate punitive sanctions against participants of the shadow economy. This way the cost-benefit analysis could result in a decision for "white economy". With the improvement of economic and social institutions and consequent penalties the moral of these young, vulnerable societies could also increase. This process takes long time and huge efforts, but as part of the preparation for EU membership it could be financially subsidised by the EU as well. At last, the vicious circle of shadow economy could be broken.

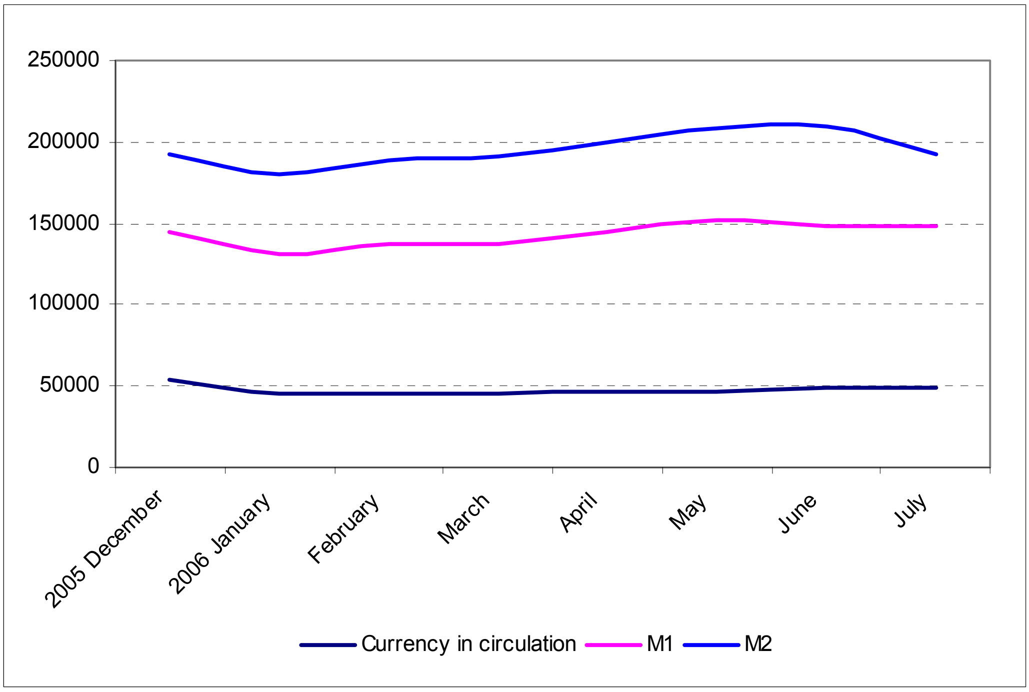
FIGHTING INFLATION IN SERBIA

It has been many times stated that in Southeast Europe the two biggest macroeconomic problems are the high level of trade deficit and unemployment, but on the other hand the region performs a remarkable economic growth rate. All these stand for Serbia as well, but in addition it has a further problematic factor that needs to be combated, namely the inflation. Despite the strict fiscal policy and monetary policy attempts, the rate is still double-digit and it is expected to remain so in 2006 and 2007 as well, thus fighting inflation remains an important issue in the economic policy of Serbia.

In 2005 GDP growth rate was 6.3%, mainly due to the service, trade and transport sector. In the first quarter of 2006 the growth remained high and was still bolstered mainly by the domestic demand, which was supported by the increased lending activity by banks. In the first six months of 2006, the growth of imports (23.6%) was higher than the increase of exports (18.9%). Public debt decreased recently and the budget turned to surplus. The restrictive fiscal policy allows only mild growth of wages and pension, which may help to mitigate the domestic demand and inflation. According to the Budget Act for 2006, budget surplus should amount to CSD 39.5 billion, but on the other hand, we must note that an election year is coming up, which may include certain risks. All these may be partly compensated by the ongoing privatisation process and the increasing FDI (recently Mobi 63 has been sold to Telenor for a record amount of EUR 1.5 billion). All these mentioned factors have an impact on the rate of inflation.

The effectiveness of the central bank's monetary policy measures is limited, due to the widespread euroisation in the banking sector. The phenomenon is the same like in the EU countries, so likewise in the case of the latter, the Serbian National Bank warned individuals about the potential dangers of foreign currency borrowing. Here we can mention the case of the exchange rate regime, where the central bank declared it "cannot and will not go against market forces", thus it does not consider the exchange rate as "an instrument for increasing exports, nor is it a nominal anchor for inflation". (Of course the bank does intervene occasionally – e.g. in August it bought USD 103 million to prevent the excessive strengthening of the dinar.) In general it can be stated that the revaluation of the dinar will not have significant effect on the inflation. As an other instrument against inflation, in August the central bank launched a third issue of savings bills, in the total nominal value of CSD 1 billion, subject to per annum interest rate of 19%, in order to stimulate household savings in dinar. The discount rate of the national bank remained unchanged at 8.5%. The currency in circulation decreased by 8.1% in July 2006, compared to December 2005, while in the same period, money supply M1 increased by 2.0% and M2 declined by 0.2%. Next chart shows how these three factors fluctuated during the recent months.

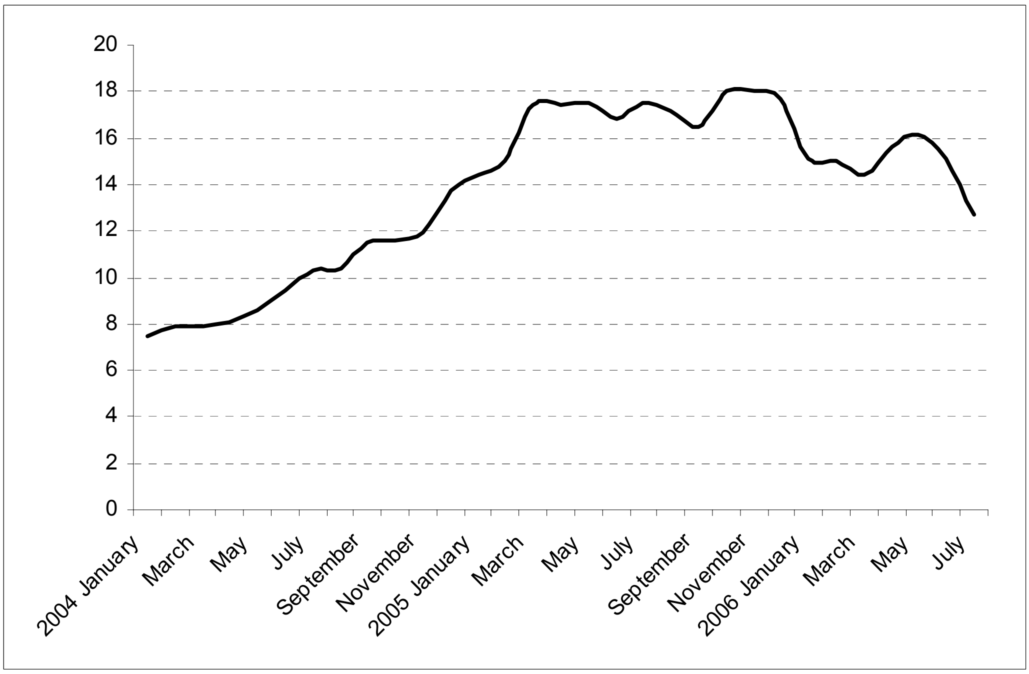
CHART 1. CURRENCY IN CIRCULATION, M1 AND M2 (IN MILLION DINARS, END OF PERIOD)*



*Source: National Bank of Serbia; * M1 and M2 - including local government deposits;*

After mentioning some of the factors that influence the inflation in Serbia, let us see how the rate fluctuated since 2004. The following chart shows that the highest rates were measured in the last quarter of 2005. Since then the inflation has been rather declining – the per annum rate was 16.1% in May, 15.1% in June and 12.7% in July. One main cause of this decline is the fact, that the introduction of VAT has no more inflation boosting effects.

CHART 2. INFLATION RATE IN SERBIA (%)*



*Source: National Bank of Serbia ; *Annual rates, the current month against the same month of the previous year.*

On the other hand, Serbia also faces the impacts of the increasing oil and basic metal prices. If we compare the first seven months of 2006 with the same period a year ago, we can see, that the largest increase can be observed in the category of "fuel and light" (17.7%), according the Statistical Office of the Republic. The category of "food" grew by 13.5%, "services" by 13.8%, while the overall category of "goods" increased by 14.0%.

In order to increase the Serbian economy's stability and viability, the reduction of inflation is a key issue among others. Although, certain attempts have been made by the national bank and the fiscal authority as well, the central bank's target for 2006 to reduce inflation to the projected range from 9% to 10%, most probably will not be achieved. One of the main reasons for this is the structural problems of the Serbian economy, which includes among many the lack of competition in many fields (other reasons were mentioned in the former paragraphs). Structural imbalances ought to be treated parallel, nevertheless in order to ease the costs of the inflation reduction process.

ROMANIA 'NEEDS' HIGHER BUDGET DEFICIT

The Romanian government has approved the planned budget on 28 June 2006, and due to this step the 0.9% budget deficit planned for this year will go up to 2.5%. The decision does not affect the macro factors, and the analysts do not wait for the significant increasing of the inflation as well.

The completion comes from taxes and dues, and will be extended chiefly on infrastructural investments. Romania, as a European country needs to be integrated into the trans-European infrastructure network, which means that Romania has to make up its leeway on the fields of road-network, education and medical-system. In the future the project will be financed by European sources further. The exact separation of the budget-completion is the following:

The subsidized field	The amount in million RON
Transport portfolio responsible for the road works	1705
Ministry of Education	1300
Medical portfolio	200
Ministry of Agriculture	476
Ministry of Labour	398,5
Ministry of Home Affairs	514

The Ministry of Education will provide the expansion of educational institutes and will discharge the payment defaults, and the Ministry of Home Affairs should set up an official army for Romania.

The Romanian budget deficit has declined in the last 4 years to a record low of 0.8% of GDP in the last year, and has remained under the 3% threshold (appointed in Maastricht) since the year of 2002. These values clearly show that Romania has postponed the infrastructural investments for long years. The further clear evidence of the retention of the Romanian infrastructural investments financed by public funds that the introduction of the 16% tax system in the last year has no significant effect on the budget balance.

Romania has achieved a substantial performance since 2000. The main driving force of the economic improvement was the fiscal adjustment, the enhanced financial performance of state-owned enterprises, and the process of privatisation. The performance of the National Bank of Romania (NBR) is also remarkable, it has achieved substantial disinflation while slowing the rate of depreciation of the exchange rate.

TABLE 4. SELECTED ECONOMIC INDICATORS OF ROMANIA

	2002	2003	2004	2005	2006*
Real GDP growth (%)	5.1	5.2	8.4	4.1	6.5
GDP/capita (EUR, nominal)	2 224	2420	2805	3665	-
Consumer prices, %	22.5	15.3	11.9	9.0	7.2
General government balance (% of GDP)	-2.6	-2.2	-1.2	-0.8	-1.0

*Source: ICEG EC, WIIW; * Forecasts*

The Romanian economy is flourishing; it started its 6th year of consecutive economic growth with an impressive 6.9% yoy for the first quarter of 2006, almost 2%-points above the market expectations. The domestic demand is really strong, and according to the expectancies it will remain strong as the government will be forced to increase expenditure, especially on infrastructure.

It is clear that the Romanian economy has walked a long way in the last 10, and especially in the last 5 years. After the fluctuation of the 90s, the GDP growth was increasing from 2000 and after the 8.4% of the year 2004, in the face of the wasteful floods of the summer of 2005, it has extended by 4.1% in the last year. In 2000 the Romanian GDP/capita stood at the quarter of the European average, but for today it has increased to the tierce of the same indicator.

For the Romanian population the most representative issue is that the NBR has decreased the inflation rate to a one-digit number. (The inflation rate of Romania has galloped from the 90s, it means that for example in 1997 it stood at 155 %). The unemployment rate is also decreasing (it is around 6%), and this trend could be explained with the great number of the citizens working abroad.

The net wages increased as well. In 2005 the average monthly payment was about 215 euros, while the same value stood at 80 euros in 1995. But it is remarkable that the increase of the wages did not go hand in hand with expanding of the budget deficit, moreover, the deficit could be constrained below 1% of the GDP in the last year.

The introduction of the 16% flat tax on personal income and profits led to a loss in collections of about 1% of GDP. This loss was offset by higher-than-budgeted indirect tax collections due to strong demand for goods and services.

On the expenditure side, there were large overruns in the wage bill as a result of substantial increases in public sector wages (16-34 percent compared with the 2004 average), and significant cuts in capital expenditure. The recalculation of pensions for those retired before 2001 increased government spending as well. Finally, there was a significant slackening of the fiscal policy in 2005, as the government repaid its arrears, supported damages caused by the floods, and injected capital into Exim Bank. But two things are undoubted: the Romanian budget deficit will remain below the Maastricht criteria in the face of the increased expenditures as well and Romania urgent needs these infrastructural and other expenditures to the preparing for the EU accession at the beginning of the next year.

Romania needs substantial investments in infrastructure, in upgrading road networks. It needs to build new road networks, particularly the pan-European Corridor 4, and it needs to rehabilitate a number of secondary routes.

Next to the budget funds, the Romanian economy can finance its infrastructural investments from EU funds too in the future. According to the decision of the European Union Romania will get 18.3 billion euros from the common funds between 2010 and 2013. From 2007 to 2009 the Romanian government will come in for 10.8 billion euros.

Romania has to make up its leeway on the field of the infrastructure, and it is important in regard of the European financial supports for the future as well, because it can enjoy assistance from the cohesive funds of the European Union if it will work out programs for the infrastructure's improvement, which are realistically feasible. According to this statement 3.6 billion euros will be available to spend in Romania between 2007 and 2009 per year. The same value for the period of 2010-2013 is 4,6 billion euros. So for Romania the higher state budget deficit is a logical investment for the future.

FORMER ISSUE'S TABLE OF CONTENTS:

- Bulldozer Initiative – '50 economic reforms in 150 days'
- The Former Yugoslav Republic of Macedonia and the European Integration
- Bulgaria and Romania: One Year to Accession
- Bulgaria faces a lasting demographic crisis

Number 2006/1.

- ICEG EC Quarterly forecast on the Southeast European Countries- Winter 2005
- Balanced budget 2006 is planned in Bulgaria
- VAT introduction in Bosnia and Herzegovina
- Foreign Direct Investment in Serbia

Number 2005/20.

- Business Climate in Southeast European (SEE) countries in comparison with the New Member States
- Romania - Development of the inflation rate
- Tightening of credit expansion in Bulgaria

Number 2005/19.

- Foreign Direct Investments in the Southeast European (SEE) Countries in comparison with the 8 New Member States (NMS8)
- Croatia - on the way on accession
- The role of World Bank credits in the Fyr of Macedonia

Number 2005/18.

- Bulgaria: Inflation rate is the critical issue with regard to joining EMU after EU accession
- Strong sector with strong performance: Tourism in Croatia
- Inflation in Serbia and Montenegro in 2005-2006
- The EU-Albania relations - The present engagement of the SAA

Number 2005/17.

- Intra-regional Trade in Southeast Europe
- Inflation in Bulgaria in 2005 and 2006
- Still High Foreign Direct Investments Inflow in the Romanian Economy

- Deep Overview of FDI Movements in Croatia

Number 2005/16.

- ICEG EUROPEAN CENTER Quarterly Forecast on the Southeast European Countries (Q3 2005) - Outlook for 2005 and 2006
- (Un)employment in the Southeast European Countries I. & II.
- GDP Growth Rate of Bulgaria in the first half of 2005

Number 2005/15.

- Bulgaria and Romania en route to the European Union
- Agricultural Sector in South Eastern European Countries II.
- Romania: Slower Economic Growth in the first half of 2005

Number 2005/13-14.

- The Powerful Nature - The Romanian Floods
- Current Account Development in Bulgaria: Big Problem at First Glance
- VAT Increase in Romania- A Makeshift
- The Start of the Improvement in the Albanian Electricity Sector

Number 2005/12.

- The British EU-Presidency and the Prospect of the Future Enlargement of the EU
- Credit Boom and Increasing External Vulnerability in Bulgaria and Romania
- High ISPA Subsidy for Romania
- A Further Step Towards Europe - Introducing VAT In Bosnia and Herzegovina

Number 2005/11.

- Agricultural Sector in South Eastern European Countries I. - Albania, Bulgaria and Romania
- Balance of Payments in Bosnia and Herzegovina
- New Leu and the Future in Romania
- Croatia's Accession Negotiation with EU - Developments in European Integration

Number 2005/10.

- Tax Regimes in Bulgaria, Croatia and Romania
- The Impacts of General Election on the Economic Policy of Bulgaria

- Worsening Current Account Balance in Romania
- The Attractive Bulgaria - Prominent FDI Inflow in 2004

Number 2005/9.

- EU Begin Talks with Serbia and Montenegro
- Tax Regimes in the FYR of Macedonia and Serbia and Montenegro
- Tax Regimes in Albania and Bosnia-Herzegovina
- Interest Rate Policy in Romania: 10 Percent Off in 5 Months

Number 2005/8.

- More EU Assistance for the Western Balkans
- One Step Closer to EU Membership
- Bulgaria Reached Record GDP Growth in 2004
- The Development of Public and External Debt in Croatia

Number 2005/7.

- South Eastern Europe after EU Enlargement and before Accession
- Bulgaria: Fixed Exchange Rate of Currency Board and the Competitiveness
- Bulgarian Tourism Industry
- Plans on the Albanian Privatisation Process

Number 2005/6.

- Development of Inflation in Southeast European Countries
- IMF versus the Romanian Government
- 8.3% GDP Growth in 2004 in Romania – Positive Signals for Investors
- Higher Inflation and Trade Deficit in Serbia

Number 2005/5.

- Tax Reduction Suggested in Bulgaria
- Croatia: Delays in Starting Accession Negotiations?
- Tourism in Croatia
- Montenegro Wants to Lead its Fortune under its own Hand

Number 2005/4.

- Bulgaria: Record Foreign Trade Deficit in 2004

- Macroeconomic Targets in Romania for 2005
- Montenegro: Budget in 2005
- Albania – EU Accession in 2014?

Number 2005/3.

- World Bank Strategy for 2005-2008 – Assistance for Croatia
- Record Budget Revenues in Bulgaria in 2004 – An Estimated Surplus of the Budget Again
- Montenegro: Economic Policy Focuses on Privatisation
- Macedonia – Status of European Integration One Year after Application

Number 2005/2.

- Origin and Structure of FDI Inflows into Bulgaria and Romania
- Croatia: Stabilisation and Association Agreement will Come into Force on 1 February 2005
- Bank Privatisation in Serbia
- Growing External Imbalances in Romania

Number 2005/1.

- Hungarian Foreign Direct Investment Outflows to the Southeast European Countries
- Western Balkan Countries: Outlook for 2005
- Candidate Countries Performed Well Last Year – Outlook for 2005 Radical Tax Reform in Romania: 16% Flat Tax Rate from 2005