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ICEG EC QUARTERLY FORECAST ON SOUTHEAST EUROPE – THIRD QUARTER IN 2006

ICEG European Center published its latest Quarterly Forecast on the Southeast European countries. Regarding economic growth, it will be higher in most Southeast European countries in 2006 than it was in the previous year. Real GDP growth rate will reach or exceed 5% in all SEE countries except for the Former Yugoslav Republic of Macedonia, where a significant drop is expected in case of GDP growth rate. The highest rate is expected in Romania where economic growth returned to its former high growth pace after a moderate growth in 2005. Real GDP growth is expected to exceed 7% in the largest economy of the region.

As it is always stated in relation to the economic growth of the Southeast European region, the main engine of the region is domestic demand in these countries. Basically in all Southeast European countries consumption and investments fuel mostly the economy. And it is important to emphasise that growth is not based only on the consumption but also on the investments which play an important role in growth of the GDP in these economies (mainly in the acceding and candidate countries).

As a result of strong domestic demand the net export contributes negatively to GDP growth in these economies via balance of goods and services. Since strong domestic demand boosts the import of consumer and capital goods, trade deficit increased significantly in the last years.

In 2007 these tendencies will continue and economic growth will remain strong, while growth rate of the region will exceed 5% again. Economic growth will decrease somewhat in only two economies of the region according to our expectation, namely in Croatia and Romania, where GDP growth rate will decrease to 4.4% and 6.2% respectively.

TABLE 1. SUMMARY INDICATORS OF THE ANALYSED 7 SOUTHEAST EUROPEAN COUNTRIES

	2004	2005*	2006**	2007**
GDP growth (%)	6.1	5.0	5.2	5.2
Inflation (%)	4.8	5.4	5.9	4.9
General Government balance/GDP (%)	-1.4	-0.6	-0.5	-0.9
Current Account/GDP (%)	-9.5	-9.6	-9.9	-9.6
Unemployment (%)	22.2	22.1	21.4	21.0

** Preliminary data; ** Forecasts*

Regarding consumer prices, inflation increased in most economies in the SEE region compared to the last year, except for Serbia and Romania. The most significant increase in inflation can be observed in Bosnia-Herzegovina and Bulgaria. In Bosnia-Herzegovina, mainly the introduction of VAT and increasing international oil prices caused the significant rise in inflation (from 2.1% to an est. 6% annual average retail price increase). In Bulgaria the price increase of tobacco and beverages at the beginning of the year had a significant negative impact on the evolution of prices. The monetary policy became more restrictive in course of the year that helped decreasing inflationary pressure from the second half of the year.

In the other economies in the region oil price hikes also had a negative effect on the evolution of prices due to the fact that these economies are basically in high need of oil import. Romania is the only country in the region which can produce relatively significant amount of oil. Thus, inflation increased in Albania, in Croatia and in the Former Yugoslav Republic of Macedonia as well. As a result, monetary policy became more restrictive not only in Bulgaria but also in Albania and Romania too.

On the other hand, in those two economies (namely in Romania and Serbia) where the inflation rates were the highest in 2005, the consumer price indices decreased further in course of 2006. Inflation remains the highest in the region in Serbia and it is not expected that consumer price index will decline back to under 10%.

In 2007 average annual inflation is expected to decrease in the region compared to this year. Inflation is expected to decrease in almost all countries in the region, except for Albania, where CPI is expected to increase from 2.7% to 3%. However, this rate will be one of the lowest in the region next year as well.

In the SEE region fiscal developments are generally not problematic regarding the budget balances. In several countries in the region general government balances have a surplus, such as in case of Bulgaria or Serbia, and the budget deficit is under 2% of GDP in Bosnia-Herzegovina, in the Former Yugoslav Republic of Macedonia and in Romania. It reflects well that fiscal policy is commonly cautious and constrained, mainly in comparison with some Central and Eastern European EU Member states.

Relatively high deficit can be observed in only Albania and Croatia, where budget deficit will reach 3.7-3.8% of GDP this year according to our expectations. However, the trend is encouraging in these economies – mainly in Croatia – because budget deficits reached 5% in 2003 which reflect well the efforts of the Albanian and Croatian government to decrease budget deficit.

In 2007 two countries in the region will become members of the EU which will have a negative impact on the budget of these countries. The contribution to EU budget and the co-finance of EU projects will burden the budget of these economies. Thus, the deterioration of the general government balances is expected in Bulgaria and Romania in 2007 compared to this year.

External imbalances remained one of the key problems in the region. However, the development of current accounts in the region shows a mixed picture. In the candidate countries, namely in Bulgaria and Romania, one can observe that current account balances deteriorated significantly. The deterioration was mainly the result of the widening foreign trade deficit owing to high domestic demand in these countries.

In Albania and Croatia, the deterioration of foreign trade balance also had a negative impact on the evolution of the current account balance, however, the improvement of other elements of the current account balance – current transfers in Albania, and services balance in Croatia - was able to counterbalance partly the deterioration of the current account balance in these economies.

In the other countries the evolution of the current account balance was positive, however, in Serbia and Montenegro, it was mainly the result of the improvement of the Montenegrin C/A balance. In Bosnia-Herzegovina, the C/A deficit is expected to decrease by 3% of GDP, however, it still remains the highest in the region (20%). The lowest C/A deficit will be achieved in the FYR of Macedonia (only 1% of GDP).

In 2007 current account balances are expected to improve somewhat in comparison with this year in most economies. However, in case of the two accession countries, C/A deficit will increase further (Bulgaria) or will decrease only slightly (Romania).

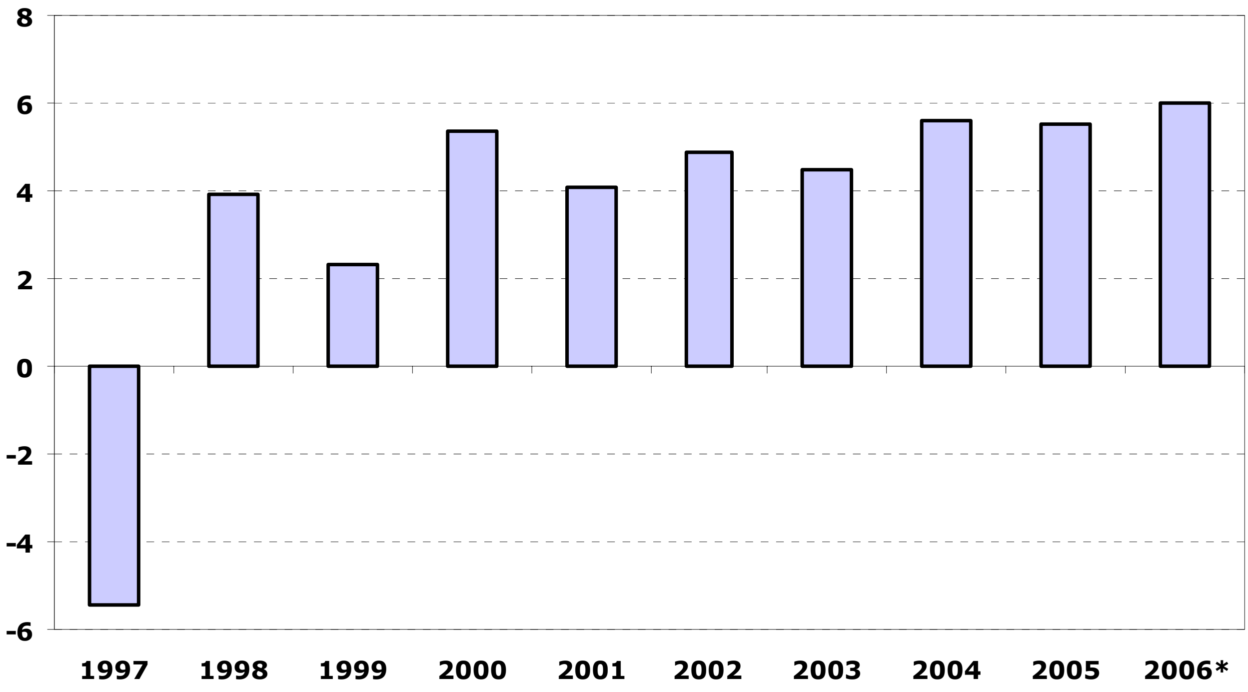
As usual unemployment is another key macroeconomic problem in most Southeast European countries. The official unemployment rates reach or exceed 30% in Bosnia-Herzegovina, the Former Yugoslav Republic of Macedonia and Serbia. There are only two economies in the region where unemployment is a less significant problem. These are Romania (under 6%) and Bulgaria (9%) where unemployment rate decreased noticeably in the last years. Besides these two countries, unemployment rate decreased in Albania, Croatia and the Former Yugoslav Republic of Macedonia but the decline of the unemployment rate was quite slow in these economies.

In 2007, our expectation is that these trends will continue and unemployment rate will decrease gradually mainly in the acceding and candidate countries, namely in Bulgaria, Croatia and Romania.

Growth rate of the GDP in the first semester of 2006 in Bulgaria

According to the report of the National Statistical Institute (NSI) in the second quarter of 2006 Bulgaria had reached the highest real GDP growth (6.6%) since 1998 when the country had recovered from an economic crisis. The real growth rates continued to be above 5% since 2004 and have even accelerated, this tendency is clearly shown also by the data of the second quarter of 2006: it implies a 1%-point increase compared to the first quarter of 2006 when the growth rate of the GDP was 5.6%.

Chart 1. Evolution of gross domestic product in Bulgaria, 1997-2006 (%)



*Source: Eurostat, *forecast*

After the economic crisis in 1997 some pro-market reforms were undertaken and also during the past years several economic policies have been implemented which promoted the current favourable results. One of the most important measures was the introduction of the currency-board arrangement, which relieved the inflation expectations and provided stability to the Bulgarian lev. Thus the uncertainty concerning the price dynamics decreased which considerably cut the expenditures of citizens and companies to hedge from the influence of inflation. The rest of the main measures were aimed at expanding economic liberty. Specifically the liberalisation process had four main elements which had positive effects on the country’s economy:

- The privatisation, which is still incomplete, contributed to the rise of efficiency in the economy as the privatized companies were rationalized. After the unproductive jobs had been cut, released human and physical capitals were directed to more profitable activities.
- The elimination of several obstacles to the internal and external trade (e.g. the reduction of excise duties) enabled the Bulgarian consumers to choose among a greater range of different goods and services.

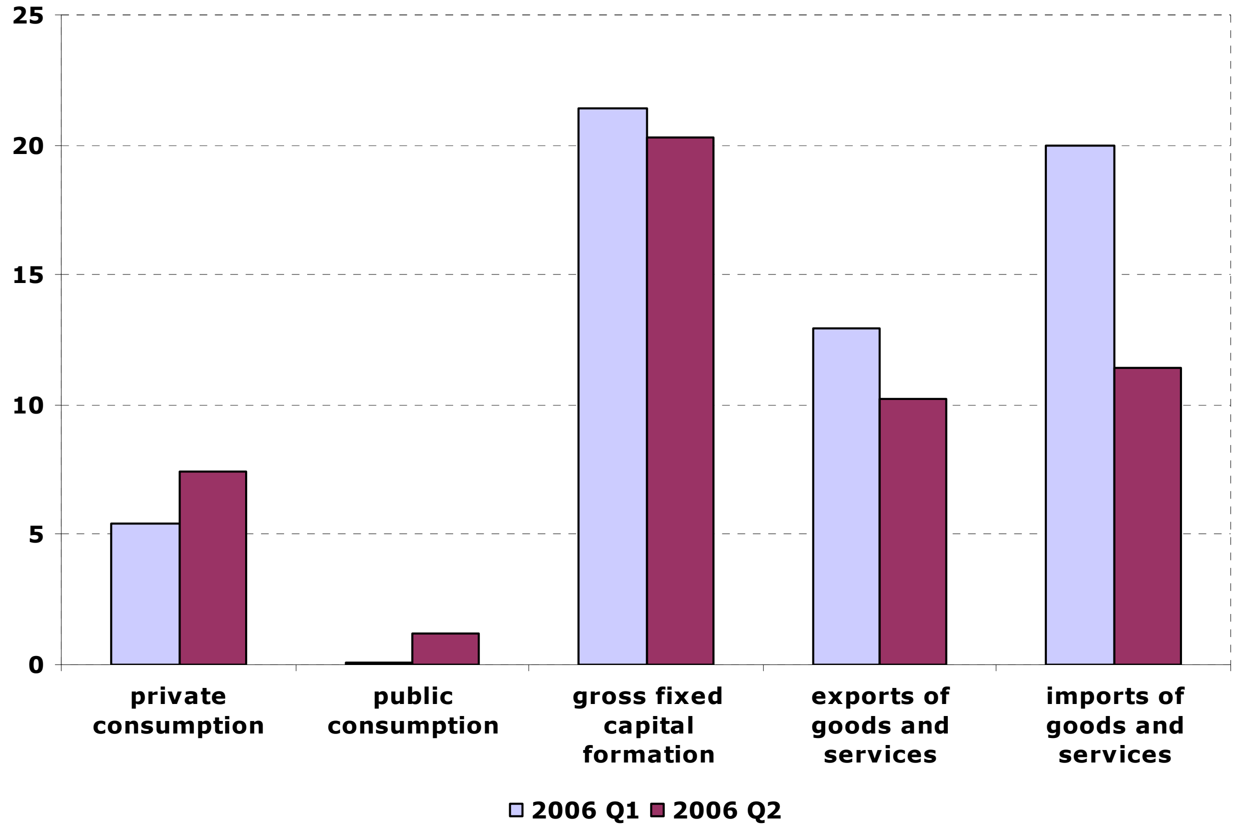
- The abandonment of the protection of several industries induced stronger competition, thus the companies were forced to produce at lower costs or more qualitative products, while the less effective ones were compelled to drop out from the market.
- The liberalisation of capital account had promoted the free movement of capital, which is a crucial factor in the forming and attracting of capital.

Beside the areas which have been developed by the above-mentioned measures, there are several fields of the Bulgarian economy where stagnation or even deterioration could have been observed during the last years. Among others one important deficiency is that the slowness of the process of debt collection contributed to the higher risk of investments which are for this reason also more expensive than the average for the European countries. Another area which should have been developed in the future is the education. At present the system is inadequate, the supplied skills and abilities by persons do not suit the actual demand by companies. Moreover currently in the case of several industries the lack of specialists is an obstacle for their faster development.

Generally, activities dominated by the government were featured by low efficiency and slower development. The private sector was the generator of economic growth. The data of the second quarter of 2006 also support this fact as the gross value added increased by 7.3% in the private sector, while in the public sector this indicator had decreased by 0.9%-point compared to the same period of the previous year.

Real GDP growth remained robust into the first quarter of 2006, following 5.5% growth in both the fourth quarter of 2005 and the full year 2005 real GDP growth accelerated slightly to 5.6% in the first quarter. Compared to this in the second quarter the indicator had grown in a more dynamic way: it had reached 6.6%.

CHART 2. GROWTH INDICES OF GDP BY CATEGORIES OF USES, 2006 Q1-Q2 (%)

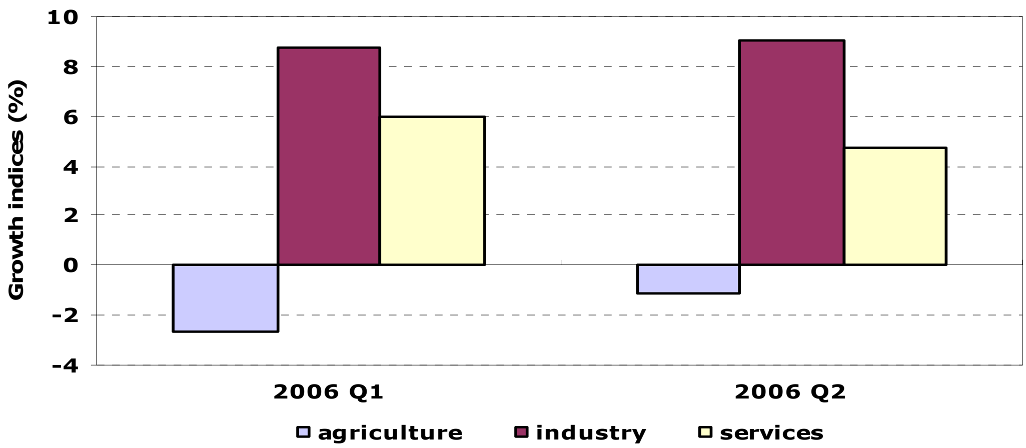


Source: NSI

In the first quarter of 2006 on the expenditures side gross fixed capital formation reached the highest growth rate (21.4%) and it has been above 20% for the third consecutive quarter which reflects both the efforts to upgrade the capital stock in view of accession-related requirements and also an expansion of capacity. Consumption contributed to the growth to the largest extent, its share in the GDP was 94.3% and it had grown by 4.8% in the first quarter compared with the same period of the previous year. Within this indicator the private consumption growth decelerated noticeably from the value of 7.1% in the fourth quarter of 2005 to 5.6 in the first quarter of 2006. This decrease is mainly due to the higher inflation and hence lower real disposable income as well as the measures of the central bank aimed at reducing household credit growth. The public consumption remained almost unchanged (it grew by 0.1% in the first quarter of 2006) which indicates the efforts to achieve a higher general government surplus in 2006 than in 2005. Net exports continued to contribute negatively to real GDP growth as the growth rate of the imports (20%) outpaced the same rate of the exports (12.9%) during the first quarter of 2006.

In the second quarter on the expenditures side the investment measured by the gross fixed capital formation kept rising significantly (by 20.3%) which indicates higher optimism among investors due to the forthcoming EU membership. The share of investment in GDP also kept on rising: from 23.9% in the first quarter it had grown to 26.1% in the second quarter, which is a typical tendency of fast developing economies. The other engine of the growth was consumption because of its traditionally high share in the GDP: it amounted to 86.2% of the GDP in the first quarter of 2006. The private consumption growth accelerated by 2%-points (from 5.4% in the first quarter to 7.4% in the second quarter), which evolution reflected the strong employment growth and the improved consumer confidence. In contrast public consumption again remained almost flat, it had increased very slightly from the value of 100.1% in the first quarter to 101.2% in the second quarter compared to the same period of the previous year, which clearly reflects the government's efforts to further tighten the fiscal stance this year in view of a growing external deficit. The third factor of the second quarter's strong growth performance was that the contribution of net exports to GDP growth – while still negative – has improved considerably. Although the growth rate of imports still outpaced the same rate of the exports, but in the second quarter the difference between them was very slight which meant a significant improvement (the growth rate of the imports and the exports in the first quarter were 20% and 12.9%, while in the second quarter these values were: 11.4% and 10.2%).

CHART 3. GROWTH INDICES OF GDP BY CATEGORIES OF RESOURCES, 2006 Q1-Q2 (%)



Source: NSI

In the first quarter on the production side the gross value added reached its highest growth rate in the case of the industrial production (8.8%) and the services sector (6%). However their share in GDP changed in the opposite direction: the industrial production had increased from 24.2% in the fourth quarter of 2005 to 28.9% in the first quarter of 2006 while the same data in the case of the service sector are 54.6% and 52.6% which shows a slight decrease. The agriculture have a low value of share in GDP, it was only 4.2% in the first quarter of 2006, which is naturally lower than in the fourth quarter of 2005 (it reflects the seasonal effect). Nevertheless its volume shows a significant improvement compared to the above-mentioned period, as in the last quarter of 2005 the volume of the agricultural production was 82.9% compared to the same period of the previous year, while in the first quarter of 2006 this indicator was 97.3%. This change shows that in the course of the current year the effects of the floods in 2005 will be in all probability offset.

In the second quarter on the production side the fastest growth was again realized in the industrial production (9%) which was due to the dynamic growth performance, a fairly high degree of macroeconomic stability, strong foreign capital inflows and the prospect of EU entry in 2007. The development of services was slower (it dropped from the value of 6% in the first quarter to 4.7% in the second quarter). The growth rate of the agriculture kept on rising although this time it had only slightly increased as it reached 98.9% in the second quarter of 2006. Although the negative effects of the floods in 2005 seem to be offset during 2006, the other kind of problems in agriculture had to be remedied in order to retain this favourable tendency.

Generally, data show the positive trend of the Bulgarian economy. The real growth rate is higher than in the older EU member states but Bulgaria has unfavourable results if we compare it to the fastest developing countries in the EU. During the second quarter of 2006, the real growth of GDP in Lithuania was 8.4%, in Latvia it was 11.1% and in Estonia it was 12.4%. The economic policies of these countries can serve as an example of successful reforms which lead to the faster increase of incomes. In the following years the trend is not expected to change significantly, the anticipated values of the growth rate are 6.0% and 6.2% for 2007 and 2008.

LABOUR COSTS IN THE SEE COUNTRIES

In 2005 labour productivity grew dynamically in the SEE region. The minimum productivity growth was achieved in Bulgaria, where the GDP/employee ratio increased by 7.9%. The leader among SEE countries concerning this indicator was Romania in the previous year, being 16.7% more productive compared to 2004. The growth of average gross wages did not follow the high pace of productivity improvement. Wages grew between 2% and 6% in 2005. The only exception was Serbia and Montenegro, where the growth rate of wages (24%) exceeded productivity growth (15.4%).

DEVELOPMENT OF AVERAGE MONTHLY EARNINGS

Bulgaria and Romania, the two countries becoming a member of the EU on 1 January 2007 are lagging behind the 10 new member states, concerning average monthly gross earnings. Bulgarian average monthly earnings amounted only to 24.77% of the average of the ten new member states, while Romanian monthly earnings were only slightly more than one third (34.69%) of the average of NMS-10 in 2000. Bulgaria was not able to close the gap, as average earnings reached only 27.9% of the level in the new member states in 2004, compared to a 12 percentage point change of Romanian monthly earnings between 2000 and 2004. Croatia as the candidate country being the next to join has already exceeded the average monthly earnings of the new member states (150.3%). Other SEE countries, further from EU accession are at a promising development level concerning average earnings. Average earnings in Macedonia and Bosnia and Herzegovina were close to two-thirds of the average of new member states. Albania and Serbia and Montenegro are below 50% of the NMS10 average, however, the speed of closing this gap was significant, as the average earnings compared to the NMS-10 average increased by 14%- points in Albania and 20%-points in Serbia and Montenegro.

TABLE 2. AVERAGE MONTHLY GROSS EARNINGS 2000-2005 IN THE SEE COUNTRIES AND NMS10

	2000	2001	2002	2003	2004	2005
Albania	112.5	149.1	145.2	164.8	201.4	n. a.
Bosnia and Herzegovina	276.6	305.8	337.5	366.6	382.5	408
Bulgaria	116.4	124.4	133.6	141.6	151.6	n. a.
Croatia	n. a.	n. a.	744	761.9	812.6	849.7
Macedonia	n. a.	n. a.	n. a.	327	340.4	352.2
Romania	163	196.1	191.3	201	252.5	303.5
Serbia and Montenegro	n. a.	149.3	212.2	229.7	259.2	297.7
NMS-10	469.7	538.9	557.1	527.3	540.8	n. a.

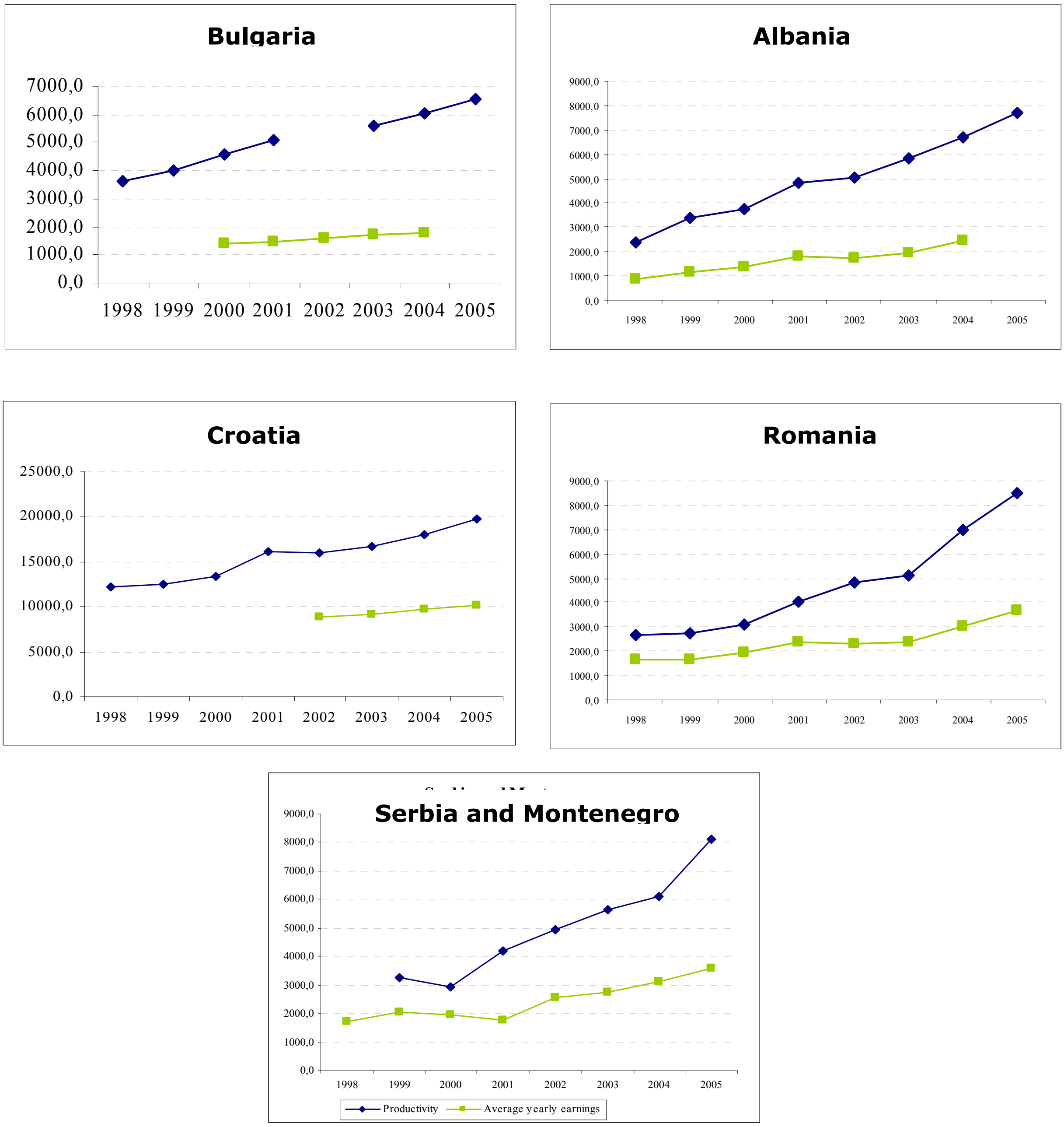
Source: Eurostat and the National Statistical Offices of the SEE countries

According to Eurostat, wages had a share of 74% in total labour costs in Bulgaria and Romania. Thus low wages in the region mean lower labour costs compared to the new member states of the EU. This can be one of the main competitive advantages of the region. The indicator of Unit Labour Cost (labour cost per unit of output) also indicates a competitive advantage, as ULC reached 46% of the level in the ten new member states in Bulgaria and 85% in Romania in 2005. Compared to one of the old member states the difference is even bigger. Bulgarian ULC amounted to 20% and Romanian ULC to 35% of the Austrian level.

LABOUR PRODUCTIVITY

Labour productivity, expressed as GDP/employee, compared to the EU-25 average showed a similar trend to average monthly earnings in case of Bulgaria and Romania. Both countries started at around 29% of the EU-25-level in 1999. However, according to half year data, Romania reached 40.7% of EU-25 average productivity compared to the Bulgarian 33.8%. Croatia is also in case of productivity ahead of the two 2007 accession countries. In 1999 Croatian economy reached half of the EU-25 productivity, and grew by 10 percentage points until 2006, to 61.3%. Albania and Serbia and Montenegro overtake Bulgaria (EUR 6541), as the GDP/employee reached EUR 7702 and EUR 8098 respectively in 2005, but remained below the Romanian level (EUR 8500).

CHART 4. LABOUR PRODUCTIVITY AND AVERAGE YEARLY EARNINGS IN THE SEE REGION 1998-2005



Source: Eurostat, National Statistical Offices, ILO and own calculations

The gap between average yearly earnings and labour productivity started to grow fast after a relatively stable period between 2001 and 2002. As productivity growth accelerated in the last year, the gap is going to be wider in the coming years. Thus employees of the SEE countries will only partly benefit from productivity growth.

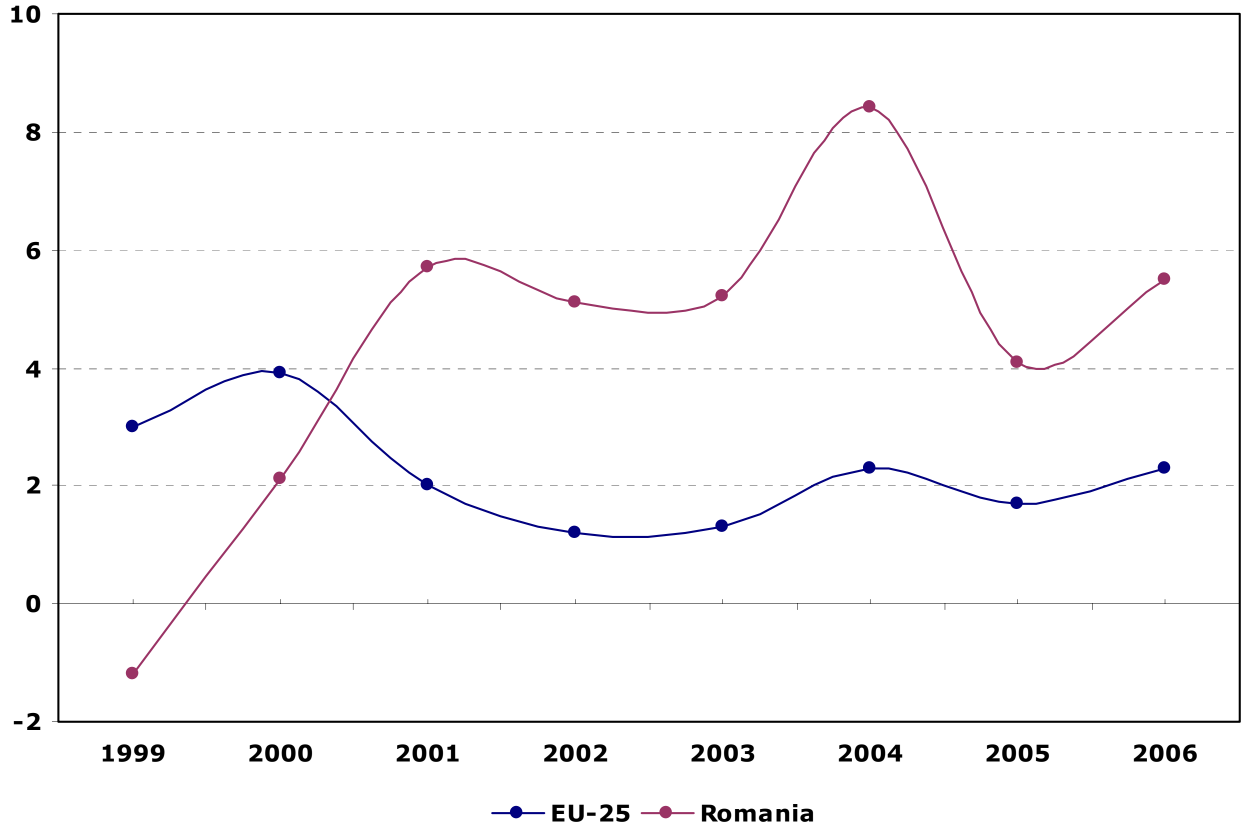
Expectations

As unit labour cost and average monthly earnings are below the EU25 and NMS10 average, the SEE region has a competitive advantage, which will result in the relocation of production lines. As these countries are only slowly pulling up with the EU, the advantage will exist in the coming period as well. Parallely to these processes, labour productivity will grow at a higher pace and will reach the European level faster. The target countries of the relocation of production lines will primarily be Bulgaria and Romania, as these two countries will joint the EU in the beginning of 2007. However, the process of relocation will be gradual, as the Bulgarian and Romanian (and also SEE) conditions for entrepreneurial activity are still not satisfactory.

Growth rate of the GDP in the first semester of 2006 in Romania

According to the report of the Romanian National Institute of Statistics (INSSE) on the first six months of 2006, the Romanian economic growth accelerated. The growth rate of the GDP was 7.8% in the second quarter, which means a 0.9%-point increase compared to the first quarter, when the growth rate was 6.9%. Up to the present the performance of the Romanian economy is above the expectations as the predicted growth rate of the GDP for 2006 is 5.5%.

Chart 5. Growth in the EU and in Romania, 1999-2006 (%)



*Source: Eurostat, *:forecast*

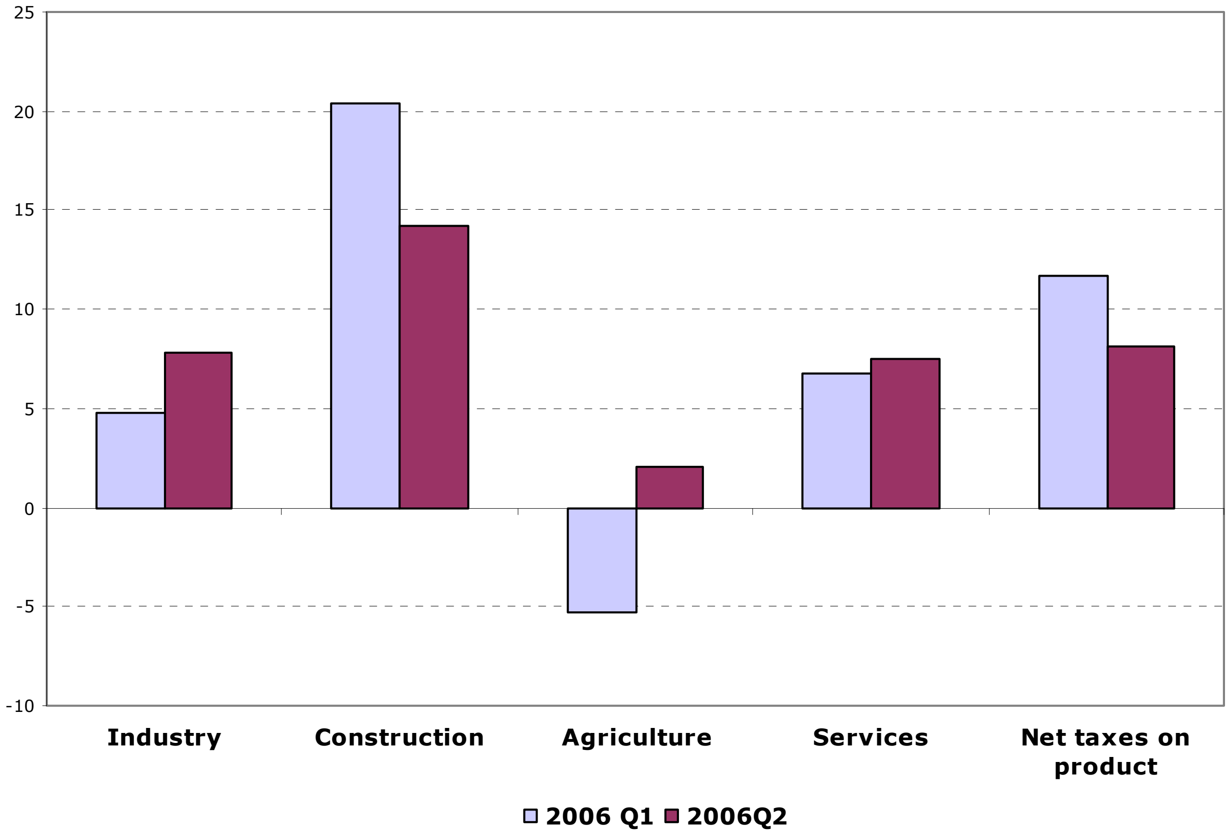
Though in the past few years the level of the growth rate in Romania have exceeded the EU-25 average, still it fits well into the growth tendency of the EU member countries. This year both the EU's and Romania's growth rate are predicted to go beyond their values of 2001 after their significant decrease in 2005.

Romania emerged in 2000 from a three-year recession due to mainly the strong demand in EU export markets. In the next three years despite the global slowdown in 2001-02 (which recession is clearly observable in the case of the EU-25 average), strong domestic activity in construction, agriculture, and consumption have kept growth around 5%. In 2004 Romania reached a robust growth rate of 8.4% but it was considered as driven mainly by domestic demand as the consumption increased by 10.4% and the fixed investments by 10.1%. This phenomenon, coupled with the government's fiscal reforms involved the risk of growing macroeconomic imbalances. In 2005 the growth rate significantly dropped, it fell to the value of 4.1%, which was mainly due to the direct and indirect consequences of the repeated floods during the summer of 2005. In the first nine months of 2005 the production of the agricultural sector decreased by 12.6%, which had a great effect on the growth rate of the GDP as the proportion of the agricultural production in the gross domestic product fell from 12.8% in 2004 to 8.9% in 2005.

In comparison with the growth rates of the EU members in the first and especially in the second quarter of 2006, Romania has reached favourable results. In the above-mentioned periods the EU-25 average were 2.4% and 2.9% and Romania's growth rate of 6.9% and 7.8% have been exceeded only by three member countries: Estonia (Q1: 11.6%; Q2: 11.8%), Latvia (Q1: 13.1%; Q2: 11.1%) and Lithuania (Q1: 8.5%; Q2: 9.2%)[1]. As Romania will join the EU in the beginning of the next year, among others it is an important element that the momentum of its economic growth contributes to the general acceleration of the average growth rate of the EU.

It is also important to examine which factors caused this dynamic growth of Romania's economy in the first and the second quarter of 2006. Both rates were determined by the actual conditions of the demand and the supply side.

CHART 6. GROWTH INDICES OF GDP BY CATEGORIES OF RESOURCES, 2006 Q1-Q2 (%)



Source: INSSE

In the first quarter on the supply side value added in industry increased by an unexpected 4.8% against the more modest increase of 2.5% in 2005, despite the continuous shrinkage of output in traditional sectors (e.g. textiles, clothing, leather, coal mining). The decrease of the traditional sectors' production is due to the restructuring of industrial activity, which is based on redirecting the output towards higher value added sectors (e.g. automotive, furniture, oil processing or electric equipment industries). This process seems to be on a sustainable trend

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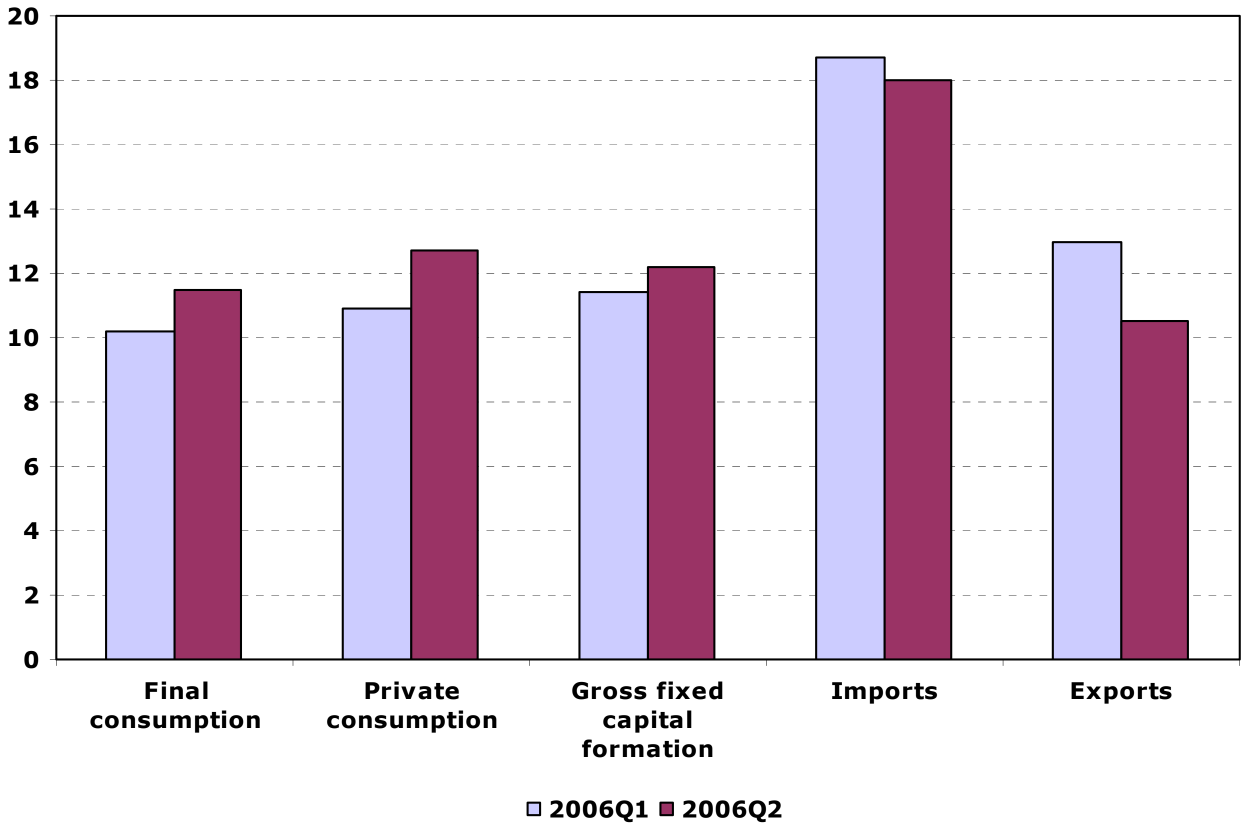
[1] Source: Eurostat Press Release 11/10/2006, Latvia's data is non-seasonally adjusted

and it was reinforced by the increasing amount of net FDI. The growth of value added in construction was exceptionally high at 20.4%, led by an increase of 29.3% in civil engineering construction related to the flood damage. The growth of the value added in the services sector was 6.8%, while the amount of net taxes on products had grown by 11.7% against the corresponding period of the previous year. The only sector where there was a decrease in this figure is the agricultural sector, in this case the value added declined by 5.3%, but its overall impact on the 2006 GDP will be observable only in the end of the year as it is mainly determined by the crop output in the last two quarters of the year.

In the second quarter of 2006 GDP grew by 7.8%, driving the average real growth rate in the first semester to 7.4% up from 4.9% in the same period of 2005. The growth of value added was the most robust in the case of the construction sector, which grew by 14.2%. Despite the continuing reallocation of output from labour-intensive sectors to technology-intensive ones, industrial production grew by 7.8% in the second quarter. The services sector's growth rate in the second quarter again indicates dynamism as it is 7.5%. The agriculture, after several periods of decreasing, recorded a modest increase of 2.1% in the second quarter, but here it also has to be noticed that its overall impact on 2006 GDP will be observable by the end of the year as it will be determined mainly by the crop output of the last two quarters.

CHART 7. GROWTH INDICES OF GDP BY CATEGORIES OF USES, 2006 Q1-Q2 (%)



Source: INSSE

Analysing the growth of GDP by the categories of uses it can be seen, that the gross fixed capital formation increased most strongly by 11.4%, outpacing final consumption, which grew by 10.2%. The growth of private consumption reached 10.9%, which phenomenon is contrary with last years process, when this rate decelerated from 12.5% in the first quarter of 2005 to 6.4% in the last quarter of 2005. The increase of the rate in the current year was fuelled by the strong growth of credit and retail sales. Imports still expanded more (by 18.7%) than exports, but the latter was more dynamic as it's increased by 13% compared with last year's average growth of 7.6%. The growth in exports was led by the automotive, oil pressing, machinery and equipment sectors.

Due to the remaining surplus in the growth of the imports compared to the exports, the trade deficit widened to around 10.6% of GDP and this effect also appeared in the current account deficit which is widened to about 9.2% of GDP in the first quarter of 2006 from 8.7% in 2005 and it was entirely covered by net FDI (this latter grew strongly by 130% in this period).

The growth in the second quarter continued to be driven by strong domestic demand. Private consumption increased by 12.7% while the growth of fixed capital formation remained equally vigorous at 12.2%. Imports expanded more than exports, while the growth of the latter slowed down to 10.5% from 13% in the first quarter of 2006. The composition of both exports and imports is improving as investments and higher value-added goods acquire a more significant weight.

Due to the again remaining surplus in the growth of the imports compared to the exports the trade deficit widened further to around 10.9% of GDP from 10.6% of GDP in the first quarter and also the current account deficit widened about 9.8% of GDP in the first half of 2006 from 8.8% in 2005, around 85% of it being covered by net FDI.

According to the forecast of the Ministry of Public Finances (MFP), Romania's economy will continue the good growth rate over the next four years, remaining for most of the macro-economic parameters to be improved or enhanced. Romania's GDP is expected to continue posting a growth rate of more than 5%, but its trend is likely to be downward. Thus, from an economic growth of 6.4% expected for next year, GDP growth rate would decrease to 5.6% in 2010.

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