ICEG European Center

Quarterly

Forecast

on South-Eastern Europe

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OVERVIEW

Positive economic outlook in 2006 mainly fuelled by domestic demand, such as consumption and investments

Economic Growth

In the first half of 2005 the average economic growth rate of the seven Southeast European countries decreased somewhat compared to the previous year. According to our expectations, the average GDP growth rate will be 4.8% in the region which is lower by 0.7%-point than that of the previous year. Though, GDP growth remains strong in this region.

The real GDP growth is expected to slow down or remain constant in Croatia, Romania and Serbia and Montenegro, while, Albania, Bosnia-Herzegovina, Bulgaria and the former Yugoslav Republic are expected to increase their economic growth pace in this year. According to our expectations, Albania and Bulgaria can reach the highest GDP growth in 2005 with 6.0%, while the performance of the former Yugoslav Republic of Macedonia is expected to be the weakest in 2005, where GDP is expected to increase by 3.5% this year.

In 2006 current tendencies are expected to continue and domestic demand will remain the main engine of these economies, namely consumption and investments. According to our expectations, the average GDP growth rate will be 5.1% in the region in the next year which represents a slight acceleration comparing to this year.

Monetary Conditions

As it was expected, inflation remained low or disinflation process continued in the first half of the year in most SEE economies. In Albania, Bosnia-Herzegovina, Croatia and the former Yugoslav Republic of Macedonia, the yearly average consumer price index is expected to be lower than 3% in this year. In Bulgaria and Romania inflation is significantly lower in this year than in the previous year. CPI increased only in Serbia where the introduction of VAT had a one-off negative impact on the development of prices. Thus, the highest CPI is observable in Serbia in this year.

In 2006, the average inflation rate of the region will be lower than this year due to the continuing disinflation process in Romania and Serbia and Montenegro. Yearly average consumer price index is expected to be 4.1% in the next year, which reflects that price stability will remain in the first group of these economies and CPI will decrease in the second group where inflation is higher.

In several countries of the region credit boom characterises the economy similarly to the NMS. Thus, national banks adopted cautious measures and cut interest rates carefully. Therefore reference rates were mainly unchanged or slightly decreased in the region, in line with the declining inflation rate.

Fiscal developments

In most SEE economies, general government balance has a surplus or only a slight deficit. The average deficit in 2005 is estimated at 1.4% of GDP which is smaller than the same figure in the previous year (1.7%). Except for Albania and Croatia, general government balances are expected to be between -1.2% and +1.0% in 2005. In Albania the revenue generation and collection is improving but still vulnerable, while in Croatia the moderate economic growth and the increasing budget expenditures have a negative impact on the annual budget. It is an interesting fact that despite the introduction of flat tax at the beginning of the year general government balance is expected to improve in Romania, while the corporate tax rate cut in Bulgaria had no significant negative impact on the balance.

In 2006 general government balances are expected to change only slightly. In Albania and Croatia and the former Yugoslav Republic of Macedonia the deficit can decrease somewhat and in the other countries the balance will worsen only slightly. However, the latter means that surplus of the budget will be lower somewhat.

On the one hand, the general government debt/GDP figures are rather low in most SEE countries. On the other hand, the relatively good general government balances and the strong economic growth support the further decline of the general government debt per GDP ratio in 2005 in these economies. The general government debt per GDP figure is expected to decrease even in Croatia where the amount of general government debt grew dynamically in last years due to the large public infrastructure projects.

Balance of Payments

External imbalance is one of the main macroeconomic problems in most Southeast European countries. In general, foreign trade balances have huge deficits in the SEE region and this factor greatly influences the development of current account balance.

In 2005 the current account balances are improving but their level are high and the average reach 9.4% of GDP. Improvement is expected in Albania, Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia as well as in Serbia and Montenegro, however, the C/A balance reaches the highest level in two of these four economies (Bosnia-Herzegovina and Serbia and Montenegro). On the other hand, the C/A balance will worsen considerably in this year in Bulgaria and Romania, by 1.5 and 1%-point respectively. This worsening is due to the increasing deficit of foreign trade balance which is a result of the strong import demand of these economies.

In 2006, the tendencies of this year will continue, namely current account balance will improve slightly in these economies, except for Bulgaria and Romania due to the import boosting effect of the strong domestic demand.

Unemployment

Unemployment is a key issue in Southeast European countries, the official unemployment rate exceeds 20% on average. The only one country where unemployment rate is a single digit figure is Romania. On the other hand, one can observe the highest unemployment rate in Bosnia-Herzegovina, in the former Yugoslav Republic of Macedonia and in Serbia and Montenegro, unemployment rates are over 30% in these economies. According to estimations, the real unemployment rate is significantly lower in these economies, it can be around 20%, however, this rate is still really high.

In 2005, slight improvement is expected in most SEE countries regarding employment and unemployment due to the strong economic growth and new investments realised by foreign investors. In 2006 the same tendency is expected owing to the accelerating economic growth in the region. However, the rate of unemployment will not decrease significantly.

Table 1. Summary indicators of the analysed 7 Southeast European countries

	2003	2004	2005*	2006*
GDP growth (%)	4.0	5.5	4.8	5.1
Inflation (%)	4.9	4.7	5.1	4.1
General government balance/GDP (%)	-2.4	-1.7	-1.4	-1.5
Current account balance/GDP (%)	-9.9	-10.0	-9.4	-9.1
Unemployment (%)	22.9	23.0	22.4	21.9

** Forecasts*

ALBANIA

Rapid growth beside structural problems

Economic Growth

Although Albania's growth is impressive, the country still remains relatively poor. Per capita GDP in 2004 was only EUR 1,950, but the real GDP growth was remarkable - the 6% rate was one of the highest in the region. The goal for 2005 is keeping stable economic growth and reaching again at least the 6% figure.

Domestic demand remains the main engine, due to the fact that foreign demand is still weak, and real wages in Albania are increasing significantly. The growth is driven by the increasing sectors of services, construction, transport, agriculture and industry. Industrial output is expected to grow in 2005 by 4%. As a result of the increasing non-tradable activity, the share of agriculture has declined to 25% of the GDP. On the other hand, this branch grew beyond expectation; by 4.4% in 2004, and for 2005 an even higher rate, 4.7% growth is expected. More detailed; agriculture sector is supposed to grow by 3.1%, agro-industry sector by 12% and fishery sector by 10%.

Monetary Conditions

The central bank's target is keeping annual inflation in the 2-4% band. In Albania the inflation is mainly determined by the agricultural production and administered price fluctuations. Annual inflation was largely influenced by the growth of administered prices in the "Rent, water, fuels and energy" group in January. On the other hand, meeting the domestic market needs from domestic agricultural supply, and lower import prices (due to favourable exchange rate developments) have influenced the decline in prices. Stability is being stimulated by prudential fiscal policy. The increasing oil prices may cause danger to the inflation target, but the appreciation of the EUR against USD can soften this effect. The annual change of the consumer price index in June was 2.9%.

Annual growth rate of money supply shows an upward trend. Annual credit balance growth was around 50%. The growth of credit to the economy compensated the low demand of government for monetary assets. The weight of Lek credit is increasing, just as the growth of credits among individuals and production sectors. Concerning the time structure, the money supply continued to orient towards longer maturity terms, thanks to the increasing confidence in the banking system and the rising attractiveness of financial instruments and services. (In 2002 the percentage of the long-term credits among the total was 16.1%, while in the first quarter of 2005 it was already 31.4%.) The central bank's aim for this year is to control the monetary supply growth at 9.8%.

Macroeconomic developments and inflation rate have supported the cut of core interest rates at the end of 2004. Due to the continuation of the weak inflationary pressures and lessening demand pressures, at the end of March, the central bank cut the core interest rate by 0.25 percentage points, leading it to the lowest historical level of 5%. As a result, in April Lek interest rates decreased in all markets, including credit market. The reduction continued even in May in the interbank market, government securities primary market and Lek deposits market.

Albania's exchange rate regime can be classified as managed floating. The Lek shows appreciation against the Euro and depreciation versus US dollar. At present 1 Euro is 121.98 Lek and 1 US dollar is 97.80 Lek. Although some seasonal effects and some fluctuations can be observed during the year, the Lek is relatively stable.

Fiscal developments

Due to fiscal consolidation, budget balance is improving. Last year the indicator was -4.9% of GDP, and for 2005 -4.7% is expected. As a result of the parliamentary elections in July, transition of power will take place, so it is still a question what will happen with the election-time promises, but most probably the cooperation with the IMF will help to keep fiscal consolidation on track.

According to the Ministry of Finance, total revenues were 93.4 billion Lek at the end of June 2005, which is by 1.7% less than the planned amount and 8.7% more than a year ago. At the same time total expenditures were 102.9 billion Lek; 2.3% below the forecast and 9.0% than the same period of last year. This means that total deficit amounted to 9.468 billion Lek at June 2005. Budget revenues in 2005 are expected to grow by 12% compared to 2004, which would result in the same relative level to GDP, with 22.5%.

The fiscal position has continued to improve but remains vulnerable given the low level of revenue generation and collection in relation to GDP. The new government should continue the reforms in taxation and customs administration, hopefully structural reforms will continue.

Balance of Payments

Though there is a further narrowing of current account deficit, large imbalances remain in the external sector. External debt was 21% of GDP in 2004. Although there are certain improvements in the trade balance, the current account deficit remains one of the major problems in Albania and the country remains dependent on external financing.

The relative stability of imports from 2004 mean a positive signal, just as the fact that exports grew at a faster pace than imports, which may represent a slight increase of the country’s competitiveness. Current account deficit is expected to decline this year, for example due to tourism and transfers.

Migrants’ remittances – mostly from Greece and Italy, giving around EUR 900 million in 2004 - bolster the economy and help to offset the towering trade deficit. Privatisation revenues also help financing the deficit. Foreign direct investment (FDI) inflow showed an impressive growth last year; net FDI inflow was EUR 157 million in 2003, while in 2004 inflow almost doubled, amounting to EUR 274 million, partly as a result of the privatisation of the Savings Bank.

Unemployment

The unemployment rate may decrease, but only at a very slow pace. The restructuring of the economy and privatisation can have a negative impact on the employment. The official unemployment rate in June 2005 was 14.3%.

Table 2. Major macroeconomic indicators for Albania, 2003-2006

	2003	2004	2005*	2006*
GDP growth	5.9	5.9	6.0	6.0
Private consumption (%)	n. a.	n. a.	n. a.	n. a.
Public consumption (%)	n. a.	n. a.	n. a.	n. a.
Investments (GFCF, %)	n. a.	n. a.	n. a.	n. a.
Export (%)	13.5	23.5	12.0	15.0
Import (%)	0.5	8.0	10.0	10.0
Consumer price index (average, %)	2.4	3.0	2.2	2.5
Unemployment (%)	15.2	14.5	14.3	14.0
General government balance/GDP (%)	-4.9	-4.9	-4.7	-4.5
General government debt/GDP (%)	n. a.	55.0	54.0	53.0
Current account balance/GDP (%)	-7.1	-5.3	-4.8	-5.0
Trade balance/GDP (%)	-22.9	-20.7	-20.5	20.0
Gross foreign debt/GDP (%)	20.2	21.0	21.5	21.0
Exchange rate (ALL/EUR)	137.5	127.6	123.5	124
Interest rate (end of year, %)	6.50	5.25	4.75	4.5

Source: National Bank of Albania, INSTAT

** Forecasts; [1] including grants*

BOSNIA AND HERZEGOVINA

Rapid economic growth with external imbalances and high unemployment

Economic Growth

GDP growth was approximately 5% in 2004, mainly due to the industry's performance. In RS (Republica Srpska - Bosnian Serb entity) industrial production increased by 9.7% last year, while in the Federation (The Federation of Bosnia and Herzegovina - FBiH) manufacturing output rose by 13.2%. Further development is expected in investment activity and external activity, and thus, GDP growth may reach 5.5% in 2005.

The outlook for economic growth is positive, but the pace of the real GDP growth is expected to slow down somewhat due to the tight fiscal and monetary policies. Although there is a certain revival of external demand, domestic demand remains the main engine.

According to the central bank's estimation, the "unregistered" economy is around 30% of the GDP. Certain reforms - like for example the introduction of a 17% VAT in January 2006 - will hopefully bring positive changes and the huge grey economy will slowly start to shrink.

Monetary Conditions

Due to the currency board system (pegged to the EUR – since 1999, 1 KM (Convertible Mark) = 0.51129 EUR) which works as an effective anchor for monetary stability, inflation was low in the country and is expected to remain at a low level. Last year in the Federation prices fell by 0.4%, while in RS consumer prices grew by 2.4%. Although oil prices are increasing, the strict monetary and fiscal policy, and the strong EUR will result in low inflation in 2005 as well. Inflation rates are expected to converge between the two entities, with 0.8% in the Federation and 2.2% in RS. Further on, the introduction of the VAT will have a one-off negative impact on price increases.

The central bank's total assets and on the other side total liabilities and capital grew by 4% in the first half of this year. The central bank's foreign reserves have recorded constant growth, and this trend was to be continued by the end of 2005. By now, the foreign reserves reached record amounting to KM 3.7 billion. In the first two quarters of 2005 net foreign assets (net foreign exchange reserves minus monetary liabilities) decreased by 3%, due to the monetary liabilities' 4.3% growth.

Although it will not have any major effect on the economy, it is worth mentioning that the Presidency of Bosnia and Herzegovina has approved the proposal of putting into circulation 5 Fening and 5 KM coins – according to the plans the coins would be released in circulation in the beginning of next year.

Fiscal developments

Including governments' budget and non-budgetary funds, the total fiscal surplus in 2004 amounted to KM 244 million at state level. The result shows responsible fiscal policy at all levels. The total achieved income grew by 5% last year, compared to 2003 (KM 5,574 billion), while the growth of the expenditure was 3% (KM 5,191 billion). Investment activities of the government decreased. In the case of both entities, consolidated fiscal surplus was recorded, and non-budgetary funds, with the exception of health insurance funds, also resulted in surplus. The public expenditure still remains high, mainly due to the excessive and inefficient bureaucracy in the four levels of the administration. Bosnia and Herzegovina owns a fractured and inefficient state system, with a multi-layered fiscal architecture.

Privatisation will continue in the metal industry, construction, retail, agriculture, manufacturing, bank sector, paper and wood industry, so further on privatisation options will be available.

There are still many questions to be answered in the issue of the introduction of VAT in 2006. It is not known yet, how it will exactly affect fiscal revenues. During the heated debates, many politicians demand social programs to compensate the potential negative effects of the new tax system.

Balance of Payments

External imbalances continue to be high in Bosnia and Herzegovina, which can mean danger to the country's long term self-sustainability, even to the currency board. In 2005 improvements are expected in the export sector as well, but there is no real probability of a radical decrease of the current account deficit. The foreign-trade deficit in the first seven months amounted to KM 3.6 billion, which is higher by 5% comparing to the last year. According to the plans VAT will be introduced next year, so as a result a one-off surge in imports is expected in the last quarter of 2005.

The reason of the current account deficit growth was the increasing deficit on goods and income, which could not be compensated by the small improvement of the balance of services and current transfers. The most important cause of the current account deficit is the large trade deficit, which cannot be financed by the current transfer either, which includes the significant amount of remittances from abroad. According to certain estimations, repatriations from people working abroad are up to KM 2 billion a year. Current account deficit is financed by the capital account and other investments.

FDI inflow in 2004 grew by 45% compared to 2003, and amounted to KM 956 million. The investments came mainly from Austria, Netherlands and Croatia. 50% of the FDI was invested into production, 25% into the banking and 9% into the non-banking financial sector. On 31st December 2004, FDI stocks were KM 3.8 billion, while portfolio and other foreign investments were KM 2.1 billion. The country still remains aid dependent, due to the fact that FDI inflow is still relatively low and external deficit is significant. There are initiatives and reforms for improving the business climate - like the Bulldozer Initiative, new laws on bankruptcy and liquidation, new laws on insurance – but an impressive boom is still to come.

According to the plans for 2005, Bosnia and Herzegovina will repay KM 232.9 million. More than 56% of this amount will go to IMF (KM 70.2 million) and IBRD (KM 60.4 million), while the rest will be paid to government and governmental organizations (KM 26 million) and private creditors (KM 14.3 million). Overall foreign dept amounted to KM 4.1 billion at the end of the observed period.

Unemployment

Beside the current account deficit, unemployment remains the other major problem of Bosnia and Herzegovina's economy. According to the official data, unemployment rate in the country is the largest in the region and exceeds 40%. Due to the huge size of the grey economy, this data should be considered with caution. The estimate of the real unemployment rate is around 20%. The progress in privatisation process may have a negative effect on the employment.

Table 3. Major macroeconomic indicators for BH, 2003-2006

	2003	2004	2005*	2006*
GDP growth	3.0	5.1	5.4	6.0
Private consumption (%)	n. a.	n. a.	n. a.	n. a.
Public consumption (%)	n. a.	n. a.	n. a.	n. a.
Investments (GFCF, %)	n. a.	n. a.	n. a.	n. a.
Export (%)	11.5	28.7	12.0	15.0
Import (%)	6.0	7.6	7.0	5.0
Retail price index (average, %)	0.6	0.4	0.6	1.5
Unemployment (%)	42.0	44.6	44.5	43.0
General government balance[1] (%)	0.4	-0.1	0.1	0.0
General government debt/GDP (%)	34.0	32.8	32.0	32.0
Current account balance/GDP[1] (%)	-24.5	-23.3	-22.5	-21.0
Trade balance/GDP (%)	-58.4	-55.4	-54.8	-52.0
Gross foreign debt/GDP (%)	34.0	33.0	32.0	32.0
Exchange rate (BAM/EUR)	1.956	1.956	1.956	1.956
Interest rate (end of year, %)	2.0	2.0	2.0	2.0

Source: Central Bank of BH, FZS

** Forecasts; [1] including grants*

BULGARIA

Strong growth with improving employment and worsening trade balance

Economic growth

In the second quarter of the year, the economic growth remained strong and accelerated further in Bulgaria. In the second three months of 2005, GDP growth reached 6.4% compared to the same period of 2004, thus, gross domestic product was up by 6.2% in the first half. On the demand side, domestic demand remained the main engine of the economy. Both private and public consumption increased significantly, by 6.5% and 7.4% respectively, in the first half of 2005. The high growth rate of public consumption is mainly due to the fact that parliamentary elections were held in the first half, while private consumption was fuelled by real wage increases and significant credit boom. On the other hand, the growth rate of investments accelerated and gross fixed capital formation reached an outstanding increase, 13.4% in the first half. In the meantime, net exports had a dampening effect on GDP mainly due to the massive worsening of the trade balance.

On the production side, the gross value added from industry increased by 8.8% while that of the services sector reached 6.9%. Both sectors performed well in the first half of the year. The good performance of the two sectors helped improving the employment rate and decreased the unemployment. On the other hand, agriculture sector declined compared to the same period of the previous year mainly due to the unfavourable weather conditions.

Our forecast for 2005 is that economic growth will be 6.0% due to the strong domestic demand, namely consumption and investments will boost the economy in course of the year. In 2006, the current tendencies are expected to continue and GDP growth is expected to be close to 6.0% again.

Monetary conditions

Consumer Price Index reached 5% in July 2005 year-on-year, and the average of the first seven months was slightly above 4%. It means inflation was lower in the first part of the year than that was in the same period of the previous year. However, the good performance is partly due to the fact that administrative prices and indirect taxes have remained unchanged before the parliamentary elections held in June 2005.

In the rest of the year, further disinflation is not expected due to the high oil prices and some of the controlled prices will increase in the second part of the year. Thus, annual average inflation is expected to be 4.1% in 2005 and a slight improvement is forecasted for the next year.

Fiscal developments

In the first seven months of 2005 consolidated budget had a surplus of EUR 580 million mainly due to the higher than planned revenues such as from profit taxes and customs duties which were the results of rapid economic growth and increasing imports. Thus, it seems the government's plan to reach surplus of 1.0% of GDP is realisable in 2005. In 2006 a slight deterioration of the balance is expected due to the increasing expenditures.

Owing to the aforementioned factor (surplus of budget), a further decline is likely in 2005 regarding public debt. Debt does not seem to be a serious constraint for policy makers in Bulgaria.

Balance of payments

In the first seven months of 2005 the current account deficit reached record value in Bulgaria. Between January and July current account deficit rose to EUR 1.5 billion. In the previous year C/A deficit remained under EUR 1 billion (EUR 748 million) so the balance worsened by almost 100% during that period of the year.

The worsening of the current account balance is mainly due to the rising deficit in foreign trade. In the first seven months trade deficit reached EUR 2.0 billion compared to EUR 1.4 billion in the same period of the previous year which is a 40% increase in nominal terms. In fact, the worsening foreign trade balance also characterised last year when trade deficit per GDP ratio jumped from 12.5% (2003) to 14% in 2004. Actually, the growth rate of exports and imports were close to each other in the first half of the year. Export of goods increased by 19.0% in the first seven months, while the same figure of import reached 24.2% in the same period.

There are two major factors responsible for the worsening tendency of the trade balance. Firstly, due to the fact that Bulgaria is a significant energy importer, oil price hikes had a major impact on energy import value. Net balance worsened by 37.7% in case of SITC 3 category (mineral fuels, lubricants and related products) and as a result, balance worsened by approximately EUR 456 million, mainly because of the rising oil prices. Secondly, import demand was boosted rather by investment than consumption. Import of capital goods increased more significantly than consumer goods due to the robust growth of investments. On the other hand, consumption growth also gained momentum and had a negative impact on the evolution of trade balance. In the second half of the year, these factors are expected to continue, thus, the deficit is expected to increase to 16.5% of GDP or EUR 3.5 billion in current year.

Regarding the balance of services, the tendency is similar to that of the last year in the first half of 2005. The balance was in deficit in the first five months and after that the balance turned to a surplus due to seasonal factors. From June to September, the balance of services is usually improving due to the massive amount of revenues from tourism sector. Accordingly, that sector has a major role in financing a significant part of the deficit cumulated in case of other components of the current account (such as foreign trade). The other two main components played less important role in the evolution of current account.

Considering the aforementioned factors and processes, current account deficit can reach EUR 1.9 billion which represents an approximately 30% increase of the deficit in nominal terms in 2005. It also means that the C/A deficit per GDP figure is expected to climb from 7.4% to 9%. In the next year, the C/A deficit is expected to worsen slightly and can reach 9.5% of GDP.

At first glance it seems a serious problem of the Bulgarian economy; however, it is also worthy to regard the financing side of the account. In last year when C/A deficit reached EUR 1.4 billion the value of net foreign direct investment was more than EUR 1.6 billion which was able to easily finance the massive deficit of the current account. In this year, net FDI is expected to reach or even exceed the 2004 level, thus, the C/A deficit will be financed again mainly by FDI in 2005.

Unemployment

In the second quarter of 2005, the positive tendencies continued regarding the labour market. Employment rate increased by 0.6%-point which means that 39 000 more jobs were created in the economy compared to the same period of the previous year. It also means that unemployment declined, the rate of unemployment reached 10% in that period which is 2%-points lower than that in the second quarter of 2004. Youth unemployment rate also declined (from 24.5% to 22.6%), while long-term unemployment grew to 60%. The positive tendencies are the result of the good economic performance, as a matter of fact, Bulgaria is one of the scarce SEE countries which was able to increase the employment in line with the rapid GDP growth.

Table 4. Major macroeconomic indicators for Bulgaria, 2003-2006

	2003	2004	2005*	2006*
GDP growth (%)	4.3	5.7	6.0	6.0
Private consumption (%)	6.4	4.5	6.5	7.0
Public consumption (%)	7.3	6.0	7.0	6.0
Investments (%)	14.0	12.0	15.0	15.0
Export (%)	8.0	13.0	9.0	8.0
Import (%)	15.0	13.0	13.0	12.0
Consumer price index (average, %)	2.3	6.2	4.1	3.7
Unemployment (%)	13.5	12.0	9.0	8.0
General government balance/GDP (%)	0.5	1.5	1.0	0.5
General government debt/GDP (%)	46.0	38.0	33.0	30.0
Current account balance/GDP (%)	-9.5	-7.5	-9.0	-9.5
Trade balance/GDP (%)	-12.5	-14.0	-16.5	-17.5
Gross foreign debt/GDP (%)	60.7	63.8	60.0	58
Exchange rate (BGN/EUR)	1.96	1.96	1.96	1.96
Base rate (%)	2.6	2.7	2.0	2.0

Source: Bulgarian National Bank, NSI

* Forecasts

CROATIA

Slower growth with worsening macroeconomic performance

Economic growth

The growth of economic activity in the first quarter of this year slowed down considerably compared with the last quarter of 2004 driven simultaneous by the observed weakening of both domestic and foreign demand. As a result of this weakening real GDP rose by only 1.8% in the first quarter, which is a significant slowdown compared with the previous year and represents according to CNB „….the largest slowdown in real terms in total economic activity from end-2000."

In the first quarter the growth of private consumption slowed down considerably, and this was accompanied by steady level of gross fixed capital formation and stagnating government consumption. Besides the slowdown on private consumption the slower GDP growth was attributable to worsening contribution of net exports, which made a negative contribution to real GDP growth. While the trends in external demand weakened slightly in the second quarter, the rise in oil prices and the slower growth in the major export markets of Croatia make the contribution of net foreign exports to growth more negative in 2005 than expected.

On the production side the increase in manufacturing and construction production in the first half of the year was slower than expected, while at the same time retail sales expanded fast compared to 2004. Altogether monthly indicators show that some acceleration in economic activity and recovery in the dynamics of economy activity may occur in the second quarter.

Altogether the slower increase in GDP in the first quarter and the worse exogenous conditions will result in slower than expected growth of GDP. The revision of GDP growth means that we expect its expansion to remain at the level of 2004 (3.7%) and foresee no significant acceleration of output growth for 2006 as well.

Monetary conditions

The combination of fixed exchange rate and monetary restraint resulted in 2004 in altogether quite low CPI increase of 2.1%. Our previous report noted that in 2005 consumer price increases are expected to accelerate since with unchanged monetary framework fiscal adjustment is accompanied by further adjustment of administrative prices and the high oil prices increase imported inflation as well. This process could already be observed as both factors added to inflation above initial expectations. The monthly price increase in the second quarter were above or around 3% and therefore we expect inflation to be higher than in 2004 and a CPI index of 3% as compared with the previous forecast of 2,6%. On the other hand as noted earlier the stability of the exchange rate, the restraint of unemployment on wage growth keeps the second round effect of these inflationary pressures moderate.

There was an almost continuous appreciation pressure on the domestic currency in the first quarter of the year, which abated in June and most of July as the nominal Kuna/euro exchange rate stood at HRK/EUR 7.31 at end-June, remaining at its end-May level. The recent exchange rate developments differed markedly from previous years as the summer tourist season did not bring an appreciation of the Kuna, it remained basically unchanged till the end of August. Since then however there is a market depreciation of the currency, which brought its level from 7.31 HRK to 7.45 HRK against the Euro. Some further weakening in the remaining months of the year is expected bringing the euro exchange rate of Kuna above 7.5.

Fiscal developments

The budget for 2005 set a target for the general government deficit of 3.7 percent of GDP. The ambitious plan was based on several revenue reducing measures (including among others the increase of the tax-free threshold for personal income or abolishing taxation of distributed profits) while on the expenditure side the budget was strongly determined by the significant structural reform costs, mainly related to the priorities for harmonization with the *acquis communautaire.*

Our previous forecast noted that " …the deficit plans for 2005 are too optimistic, partly based on higher than likely growth scenario and tax collection efforts…..and thus the deficit… may be 4.3% instead of 3.7%." The lower-than-expected tax revenue collection in 2004, the slower output growth this year, the delay in the change of the base for indexation of pensions from wages to a price-wage composite and more generally a faster than planned increase of expenditures forced the government to revise its budget. Without additional measures the deficit would have reached 5% of GDP and thus a supplementary budget was approved in mid July with a deficit target of 4,2%.

The supplementary budget included an updated and improved revenue projection reducing the level of expected revenues as well as number of expenditure reducing measures. While the new budget plan still has its uncertainties (among others the questionable effect of higher oil prices on the Croatian growth and inflation), but we maintain the original forecast of 4,3% of GDP for the fiscal deficit. On the other hand slower GDP growth accompanied with unchanged deficit forecast for 2005 will mean a further rise in public debt, which may reach 54,5% of GDP.

In 2006 the Government will have to take additional measures to reduce the deficit and bring it closer in line with the 2005 planned figures. At the same time the macroeconomic performance of the economy may be more favourable, the effects of revenue increasing and tax evasion reducing measures may materialize and therefore we expect a fiscal deficit of around 4% of GDP.

Balance of payments

In January-May, total goods exports were USD 3.5bn, up 11.6% year-on-year, while imports reached USD 7.4bn, up 14.6% year-on-year, leading to foreign trade deficit of USD 3.9bn, which was an increase of USD 0.6bn or 17.4% compared with the same period in 2004. The worsening is due to the rise in import values of oil, steel and iron which was the outcome of the increase in their prices on commodity exchanges. The increase in imports of oil and refined petroleum products, iron and steel accounted for more than one third of the absolute annual increase of total imports. At the same time export growth slowed down due to the weakening external demand for Croatian exports. While these trends will weaken in the second half of the year, a worse trade balance is expected for 2005

It is still questionable whether the service balance and the tourism revenues may counterbalance the worsening of the trade balance allowing the achievement of current account deficit equal to 4.5% of GDP. The assumption is that the deficit will be higher but it can mainly be financed with net FDI inflows.

We expect a better trade and current account balance for 2006 as both the increase of exports will be faster due to higher growth in the major export markets and import demand may rise only modestly due to the envisaged fiscal adjustment.

Unemployment

In Croatia the acceleration of growth in 2002-2003 was accompanied by growing labour demand, while labour market reforms brought more flexibility to the system and as a result, the unemployment rate declined below 14% in 2004. While GDP growth is weaker than expected in 2005 further decline in unemployment is likely as seen from the developments in the second quarter. The rise in real wages has been moderate and therefore wage pressures do not pose a serious problem for expansion of employment. It is likely that the original assumption in the previous report concerning the further decline of unemployment rate to 13% of the labour force.

Table 5. Major macroeconomic indicators for Croatia 2003-2006

	2003	2004	2005*	2006*
GDP growth (%)	4,3	3,7	3,7	3.9
Private consumption (%)	4.1	4.0	2.6	2.8
Public consumption (%)	-0.3	-0.3	-0.5	-0.5
Investments (%)	16.5	5.5	5.0	6.0
Export (%)	10.0	6.5	6.5	8.0
Import (%)	11.0	5.0	6.5	7.0
Consumer price index (average, %)	1.4	2.1	3.0	2.8
Unemployment (%)	14.5	14	13.0	12.5
General government balance (%)	-6.3	-5.0	-4.3	-3.8
General government debt/GDP (%)	51.5	54.0	53.5	53.0
Current account balance/GDP (%)	-7.0	-5.0	-5.0	-4.5
Trade balance/GDP (%)	-27.5	-25.5	-25.0	-23.0
Gross foreign debt/GDP (%)	77.5	82.0	82.0	80.0
Exchange rate (HRK/EUR)	7.64	7.67	7.55	7.45

Source: Croatian National Bank, DZS

* Forecasts

FYR OF MACEDONIA

Improving external balance in the first half of 2005

Economic growth

In the first seven months of the year the industrial sector performed relatively well. During that period industrial production increased by 8.6% compared to the same period of the previous year. However, this remarkable figure is mainly due to the low basis of last year when industrial production dropped back by more than 2%. Comparing to the 2003 level, industrial production grew by 3.2% between January and July this year, which reflects well the bad performance of the previous year.

Among industrial sub-sectors manufacturing had a major role in the good performance. In July 2005, production of manufacturing increased by 7.5% in comparison with the average production in 2003. On the other hand, production of mining and quarrying rose by almost 60% compared to 2003 average.

In the first quarter GDP growth rate was 2.7%. Regarding the production side, industry had a major role to achieve this performance. Gross value added of industry reached 4.7% in the first three months, while that of agriculture and construction reached 2.5% and -9.6% respectively.

Due to the relatively good performance of industrial sector – which is mainly due to the low 2004 basis - GDP growth is also expected to be above 2004 level, accordingly we expect that 2005 figure will reach 3.5% and this pace will remain in 2006 too.

Monetary conditions

Consumer Price Index (CPI) remained close to zero in the first seven months of the year. In July CPI reached 0.7% compared to July 2004. Considering the entire seven-month-long period consumer prices increased by only 0.3% in comparison with the same period of the previous year.

The highest price increase was observable in case of tobacco and beverages (+5.1%), while the largest deflation was noticeable in case of hygiene and health products and services. Price changes of most products and services reached less than 2%. It is also an important factor that prices of goods increased by 0.9%, while, that of services declined slightly (by 0.1%).

In 2005 price stability keeps on characterising the former Yugoslav Republic of Macedonia, CPI is expected to be 1.0% in this year. The strong position of the euro against US dollar also support this process while central bank is expected to cut interest rates carefully. In 2006 inflation will be increase slightly but price stability will characterise the economy.

Fiscal developments

In the first trimester, budget deficit increased compared to the same period of the previous year. Between January and April general government deficit increased to EUR 10.2 million mainly due to the lower than planned non-tax revenues.

Public debt also increased mildly in the first quarter of 2005 in nominal terms. At the end of March 2005 public debt reached EUR 1 940 million or 43.1% of estimated GDP for 2005 which represent a slight decrease in public debt per GDP ratio.

In 2005 general government balance is not expected to worsen significantly, however, the budget deficit can reach 1.2% of GDP. The tight fiscal policy remains in line with the agreement with IMF. On the other hand, the low deficit can support the further decline of the public debt level, too. In 2006, the process will continue and budget deficit is expected to reach 1.0%.

Balance of payments

In the first half of the year, trade deficit shrunk significantly mainly due to the remarkable improvement of export sector. During the first six months the value of export of goods increased to EUR 776.8 million from EUR

600.6 million which means a 29.3% increase in euro terms. In the meantime, import grew from EUR 1 085.1 million to EUR 1 228.4 million which represents a significantly lower growth rate (+13.2% in euro terms). Thus, foreign trade deficit reached EUR 451.6 million in the first half of 2005.

Partly due to the improvement of the foreign trade balance, current account deficit decreased significantly between January and May. CA deficit reached EUR 83.6 million compared to EUR 172.4 million in the first five months of 2004. Besides foreign trade, the balances of services, incomes and current transfers also improved extensively which supported the decrease of CA deficit.

Foreign direct investment reached EUR 44.7 million in the first five months of 2005. The Russian Federation was the largest investor during that period with its EUR 12 million investment into the Macedonian economy. This amount of FDI is really small regarding the massive current account deficit.

In 2005, external imbalances expected to improve further, trade deficit can decrease to 20% of GDP in this year. The growth rate of export of goods is expected to overpace that of the imports; consequently foreign trade balance will improve this year. In the meantime, the current account deficit will also decrease notably compared to the previous year. C/A deficit is expected to reach 5.0% of GDP. In the next year current processes are expected to continue thus current account deficit can decrease slightly to 4.8% of GDP.

Unemployment

In the first quarter of the year unemployment rate increased to 38.6% while the figure was 37.2% in 2004. The number of unemployed persons increased by almost 5% compared to the same period of 2004. That process is partly due to the increasing number of active population and partly due to the decrease in the number of employed persons in comparison with the mentioned period.

On the other hand, the official unemployment rate should be evaluated carefully because the size of grey economy is considerably large in Macedonia. It is usual that people register as unemployed to access health insurance or social assistance while working at the grey sector at the same time. According to estimations, the rate of truly unemployed people is approximately half of the official rate.

In 2005, in spite of the better economic performance and the new Employment Act, unemployment rate remains basically unchanged or increase somewhat. According to our forecast, unemployment rate can reach 38% in course of the year and it is not expected to improve in the next year.

Table 6. major macroeconomic indicators for FYROM, 2003-2006

	2003	2004	2005*	2006*
GDP growth (%)	3.4	2.0	3.5	4.0
Private consumption (nominal, %)	1.3	n. a.	n. a.	n. a.
Public consumption (nominal, %)	-4.8	n. a.	n. a.	n. a.
Investments (GFCF, %)	n. a.	n. a.	n. a.	n. a.
Export (%)	2.4	12.1	18.0	15.0
Import (%)	-3.8	19.7	12.0	10.0
Consumer price index (average,%)	1.2	-0.4	1.0	1.5
Unemployment (%)	36.7	37.2	38.0	38.0
General government balance (%)	-1.0	0.0	-1.2	-1.0
General government debt/GDP (%)	45.0	44.0	43.5	43.0
Current account balance /GDP (%)	-2.9	-7.9	-5.0	-4.8
Trade balance /GDP (%)	-16.4	-21.2	-20.0	-18.5
Gross foreign debt /GDP (%)	38.1	38.4	38.0	37.5
Exchange rate (end of per., MKD/EUR)	61.3	61.3	61.5	61.7
Discount rate (end of year, %)	6.5	6.5	6.5	6.5

Sources: NB of the Rep. of Macedonia, State statistical office of the Rep. of Macedonia

** Forecasts*

ROMANIA

Strong growth remained in the first half of 2005

Economic growth

In the first semester of 2005, economic growth remained strong and domestic demands contributed mainly to this good economic performance. In the first six months gross domestic product (GDP) increased by 4.9% in real terms compared to the same period of 2004.

On the demand side, it is observable that consumption is still quite strong, in the first half of the year, final consumption increased by 11.2% which is stronger than the average of the last year (+10.3%). It means consumption accelerated mainly due to the introduction of the new tax system (flat tax), which resulted in higher real wages and disposable income. On the other hand, the other main engine of the economy, the gross fixed capital formation (GFCF) increased moderately in this period, by 7.6%. It means consumption became more of a determining factor in the Romanian economy, while the role of GFCF in economic growth decreased somewhat in the first part of the year.

Owing to the strong consumption and the appreciation of the Romanian currency (Leu), the growth rate of imports overpaced that of the exports. Thus, net exports had a negative impact on the economic growth, besides the fact that the trade balance also worsened significantly.

On the supply side, the gross value added from services and industry were significant, growths of these sectors reached 6.9% and 3.6% respectively. Good performance of services sector is in connection with the strong consumption, explicitly the latter factor had a positive impact on retail sales. In case of industry, the modernisation of the sector lost some of its momentum because industrial production increased more than gross value added of the sector (4.0% against 3.6%). Construction increased below GDP (+3.9%) mainly due to seasonality.

In course of the year, the mentioned processes are expected to continue, namely mainly consumption and partly GFCF will play major role in economic growth. The introduction of flat tax resulted in higher disposable income which boosts consumption. July flood may have a slight negative effect on this year's GDP but this effect is expected to be limited. Considering these factors, we expect that GDP growth can reach 5.2% which is somewhat (-0.3%-point) lower than our last expectation and it is still one of the highest in the region. In 2006, the economic growth is expected to remain strong and can reach 5.5%.

Monetary conditions

At the beginning of July 2005, redenomination of the Romanian currency has taken place when four zeros were cut from the end of the old currency. The new code of the Romanian currency is RON (1 RON = 10 000 ROL). The redenomination had no impact on the inflation; it was simply a practical modification.

During the first 7 months, Consumer Price Index (CPI) followed an interesting path. Between January and March, the disinflation process continued and CPI reached 8.7% in March 2005. In April, the inflation accelerated again mainly due to the rising energy prices and tax increases. In April and May, CPI reached 10% and disinflation continued only in June when inflation became single-digit again (9.7%). In July, consumer prices increased by 9.3%.

Regarding foreign factors, the – nominal - appreciation of Leu had a positive effect on the evolution of CPI, while the increasing oil prices had a negative impact. Regarding domestic factors, strong demand (mainly consumption) puts inflationary pressure on the economy which reduces the pace of disinflation process. For 2005, we modified our previous expectations and forecasts, consequently annual average inflation will be 9.0% while CPI can decrease to 7.8% in the last month of 2005, y-o-y. In 2006 disinflation process will continue and yearly average inflation is expected to go down to 7%.

Due to the above-mentioned factors (high consumption, inflationary pressure), National Bank of Romania has not cut its reference rate which remained at 8.0% in course of the Summer. Further cuts are expected in the second half of the year when inflation is expected to decrease further. At the end of the year, reference rate is expected to decrease to 7.5%.

Fiscal developments

In the first 7 months general budget had a considerable surplus, it reached approximately 0.5% of the estimated GDP. The strong economic growth supported the growth of the revenues, while, it seems the modification of the tax system had no significant negative impact on the budget balance (on the revenues side), however, some tax adjustments occurred in course of the year, as it was listed in our previous quarterly report.

The positive development of the budget incited the government to revise its deficit target which was decreased from 1.5% to 0.75% of GDP. Regarding the positive processes of the first half of the year, the revision is reasonable, however, the achievement of the new target is greatly depends on the fact how the July food will influence government spending in course of the year. Accordingly, we expect that general government deficit will reach 1.0% of GDP in this year and the same deficit is expected in 2006 too.

Balance of payments

In 2005 the worsening tendencies of current account balance continued. Mainly consumption and partly investments boost imports, thus, foreign trade deficit increased significantly in the first half of the year.

In the first half of 2005 imports increased by 22.9% compared to the same period of the previous year, while during that period, exports rose by 16.6%. The trade deficit reached EUR 4.2 billion in the first six months, which represents an almost 42% nominal increase.

Besides strong consumption and investments, and as a result, high import demand, the appreciation of the currency dampened exports growth rate too. Between January and July the appreciation was significant against the euro, average monthly exchange rate (ROL/EUR) strengthened from 38 178.38 to 35 655.25 or by 6.7%. Considering the gap between CPI of the two economic areas (Romania, euro-zone), real appreciation reached even higher growth rate during that period.

In line with the worsening trade balance current account deficit also worsens. It is expected to reach 8.5% of GDP in 2005 and 9.0% in the next year. On the other hand, the role of foreign direct investments remains significant in financing the current account deficit in 2005.

Unemployment

Unemployment rate is decreasing in Romania. During the first five months, unemployment rate decreased from 6.3% to 5.5%. It means the number of officially unemployed persons diminished by almost 67 000 persons or by 11.8%. The good tendency is largely due to the robust economic growth, modification of the tax system and seasonality. In course of the year we expect that unemployment rate will be 6.0% and that will remain in the next year.

Table 7. Major macroeconomic indicators for Romania, 2003-2006

	2003	2004	2005*	2006*
GDP growth (%)	5.2	8.3	5.2	5.5
Private consumption (%)	7.2	10.8	9.5	9.0
Public consumption (%)	4.6	4.6	3.0	2.0
Investments (GFCF, %)	9.1	10.1	7.0	8.0
Export (%)	11.4	14.1	10.0	11.0
Import (%)	16.4	17.8	17.5	15.0
Consumer price index (average,%)	15.3	11.9	9.0	7.0
Unemployment (%)	6.8	7.1	6.0	6.0
General government balance (%)	-2.0	-1.4	-1.0	-1.0
General government debt/GDP (%)	21.3	18.5	19.0	19.0
Current account balance /GDP (%)	-6.0	-7.5	-8.5	-9.0
Trade balance /GDP (%)	-7.8	-9.0	-10.0	-11.0
Gross foreign debt /GDP (%)	31.1	30.7	32.0	33.0
Exchange rate (ROL/EUR)	37 555.9	40 532.1	3.65[1]	3.4[1]
Reference rate (end of year, %)	21.25	17.96	8.0	7.0

Sources: NBR, INSSE

** Forecasts; [1] RON*

SERBIA AND MONTENEGRO

Successful VAT introduction but decelerating economic activity in Serbia

Economic growth

In the first three months of 2005 the economic performance in Serbia was weaker than in the previous quarter. In Q4 2004 the growth rate of real GDP reached 13.2%, while in Q1 2005 it only amounted to 5.2%. Industrial production dropped by 3.4% compared to the same period of the previous year. As for the performance of industrial sectors, a 3.2% drop was observed in the extractive industry sector, a 6.2% drop was observed in processing industry, and the gas, electricity and water generation and supply sector registered a 5.4% rise in the first quarter. The drop in industrial production was even more pronounced compared to Q4 2004, reaching 6.3% (seasonally adjusted). The introduction of the VAT in January 2005 had a significant effect on the comparative industrial performance of the first quarter, as prior to the VAT introduction (at the end of 2004) a one-off, short term rise was experienced in the production of stocks.

In the beginning of 2005 difficulties were experienced during the preparations for agricultural production, due to extremely adverse weather conditions. Therefore it is expected that agricultural production this year will not reach the level of 2004. Construction activity was also influenced negatively by adverse weather conditions in the first quarter. Furthermore the difficulties in obtaining licences also contributed to the fact that both the value of construction work done, and the number of apartments completed was lower than in the same period of the previous year. In the first half of 2005 retail trade turnover and services were following an upward trend. At the same time there was a reduction in the proportion of imported goods in retail trade. The 30.3% year on year real rise in retail trade in Q1 2005 was strongly influenced by the introduction of VAT in January 2005, as it helped the turnover of goods to return to legal channels.

The expected GDP growth rate of Serbia and Montenegro in 2005 has been revised from 4.6% to 4%. Growth is expected to be stronger in Montenegro this year, than in Serbia. In 2006 GDP growth is expected to accelerate in Serbia and Montenegro, to 4.5%.

Monetary conditions

During the months of the second quarter of 2005 year on year inflation remained at about the same level as experienced in the first months of the year. A slight reduction was experienced in June, when consumer prices rose by 16.8% compared to the same period in the previous year. In May the year on year price rise was higher, reaching 17.5%. The month on month price rise also decreased between May and June from 1.1 to 0.8%. However it is likely that the earlier projected 13% year on year CPI will be overrun by the end of the year in Serbia, as a result of the increase of world oil prices, and the leap in the prices of utilities and public services.

Numerous steps should be taken to help halt inflation in Serbia, such as the reduction of public spending and imports, and stepping on the road of structural reform. Some improvements already started in the first quarter, as there was a reduction in the value of imports. The financially unsustainable pension system, in which the evasion from contributions is widespread, should be reformed. The status of the state and socially owned enterprises, which play an important role in the Serbian economy, needs to be solved as well, as their deficits have likely contributed to the macroeconomic imbalances of the country.

The discount rate of the National Bank of Serbia remained unchanged, at 8.5%, the same level where it stood during 2004. Yearly average CPI is expected to reach 15.5% in 2005, and decrease to 10% by 2006 in Serbia and Montenegro.

Fiscal developments

In Q1 2005 public consumption was increasing in Serbia, but at the same time fiscal deficit was significantly lower than in the same period of the previous year. In the first quarter fiscal deficit reached 2.4 billion dinars, which represents 11.7% of the planned budget deficit for 2005.

After two years of preparations, the VAT was introduced in Serbia in January 2005. The turnover tax, which had a general rate of 20%, was abolished. The new VAT has a standard rate (18%) and a reduced rate (8%). There are plans to extend the list of goods and services falling under the reduced rate.

Revenues arising from VAT and the lagging turnover tax amounted to 46.6 billion dinars, which was a 41.5% rise compared to the revenues of the same period of the previous year. A large proportion of this rise resulted from the introduction of the VAT, as it helped to "whiten" part of the grey economy. Therefore the revenues of the Serbian government were higher in Q1 2005 than earlier planned, and the changes made in the tax system contributed to the reduction of the budget deficit. Based on the performance of the first quarter, it is expected that the fiscal deficit will be reduced by the end of the year to the projected level of 20.5 billion dinars. In the first six months of 2005 a fiscal surplus of CSD 3.77 billion was observed in Serbia. This development occurred despite the fact that public demand was on the rise.

The budget balance as a percentage of GDP is expected to be positive, reaching 0.2% in 2005 in Serbia and Montenegro, while in 2006 it is expected to turn negative again, reaching –0.5% of GDP.

Balance of payments

In the first quarter of 2005 a significant improvement was observable in the Serbian trade in goods balance. The value of exports rose, and the value of imports decreased. Therefore the foreign trade deficit was significantly (40.4%) lower than in the same period of the previous year. The ratio of export to import rose from 32.3% to 54.7%. At the same time trade in services registered a deficit and there was a reduction in the surplus of current transfers and in the volume of public grants. Therefore the improvements in trade in goods could only play a reduced positive effect on the overall balance of payments. In the first six months of 2005 the foreign trade deficit declined by 27.3% in USD terms.

The positive development of trade in goods was the result of a number of factors. Import growth was reduced, because of weakened domestic economic activity, and the effects of the VAT introduction, as the new tax discouraged the invoicing of higher import values than the actual value with the aim of illegal export of capital. At the same time export growth was enhanced by the difficult conditions in the domestic market that caused the lowering of domestic aggregate demand, strengthening of the privatisation process and the restructuring of enterprises, and a higher supply of capital as a result of higher foreign direct investment inflows. At the same time the VAT introduction benefited export performance as well, because it eliminated the interest in invoicing smaller than actual value of exports.

The current account deficit is expected to reach 11.1% of GDP in 2005 in Serbia and Montenegro, which is an improvement compared to 2004. The improvement is expected to continue in 2006, when the current account deficit is expected to reach 9.8% of GDP.

Unemployment

According to the new Labour Force Survey made by the Statistical Office of the Republic of Serbia, unemployment is not as high as it was assumed. Earlier surveys based on monthly research showed an unemployment rate over 30%. However the new survey was based on a larger number of households, and it was more successful in reviewing the unregistered employees. Therefore, according to the new survey, the unemployment rate in Serbia in 2004 reached about 18.5%. However according to the previous way of calculations the unemployment rate in Serbia and Montenegro is expected to reach 32% in 2005, and by 2006 it is not expected to lower significantly (reaching 31.8%).

The Government of the Republic of Serbia has set up a loan program for the unemployed who want to start their own business. The loans will range from 5 to 20 thousand euros, with a grace period of one year, a repayment period of 3 to 5 years, and an interest rate of 1% per year. The amount of the loan given will depend on the planned number of employees in the newly established enterprises. The EUR 7.5 million fund will be sufficient to finance no more than 1,500 credits. The number of created work places will not exceed 4,000, which is only 0.5% of the total number of unemployed.

Table 8. Major macroeconomic indicators for SM, 2003-2006

	2003	2004	2005*	2006*
GDP growth (%) Serbia and Montenegro	2.1	7.5	4.0	4.5
-Private consumption (%)	n. a.	n. a.	n. a.	n. a.
-Public consumption (%)	n. a.	n. a.	n. a.	n. a.
-Investments (%)	n. a.	15.5	17.0	n. a.
-Export (%)	4.4	21.7	20.0	12.0
-Import (%)	5.2	20.4	4.5	8.0
GDP growth (%) Serbia	2.4	8.6	4.0	5.0
GDP growth (%) Montenegro	2.3	3.7	5.0	5.0
Consumer price index (average, %)	11.2	9.8	15.5	10.0
Retail prices (% p.a.) Montenegro	7.8	3.3	3.0	3.0
Consumer prices (% p.a.) Serbia	9.9	11.4	15.0	10.0
Unemployment (%)	31.7	31.7	32.0	31.8
General government balance (% of GDP)	-3.4	-1.7	0.2	-0.5
General government debt/GDP (%)	76.6	n. a.	n. a.	n. a.
Current account balance/GDP (%)	-12.0	-13.2	-11.1	-9.8
Trade balance/GDP (%)	-24.1	-28.0	-25	-22.0
Gross foreign debt/GDP	69.7	60.2	57.7	58.5
Average exchange rate (CSD/EUR)	65.3	72.8	82.2	88.2
Base rate	9.0	8.5	8.5	9.0

Sources: IMF, National Bank of Serbia, Central Bank of Montenegro, BA-CA

** Forecasts*

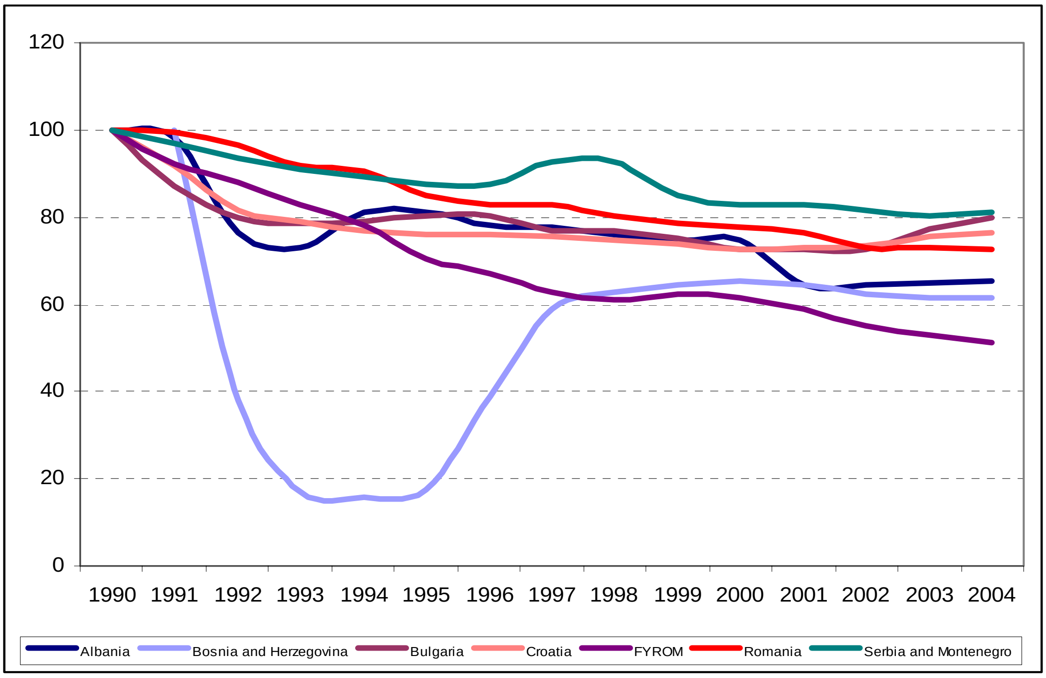
STATUS OF (UN)EMPLOYMENT IN THE SOUTHEAST EUROPEAN COUNTRIES

In the last four years, the Southeast European (SEE) economies performed well, the GDP growths of these countries were rapid during this period. The increase of gross domestic product was excellent in comparison with the EU and even with the five Central European New Member States (NMS), including the Czech Republic, Hungary, Poland, Slovakia and Slovenia. Between 2001 and 2004 the average annual growth rate of the seven SEE countries was higher by approximately 1%-point than that of the five NMS or reached 4.4% in average. Certainly, that figure includes the outstanding performance of Romania in 2004 (+8.3%) and the significant recession year of the former Yugoslav Republic of Macedonia in 2001 (-4.5%).

Considering the good performance of these countries, the developments in the labour markets were not so remarkable. Moreover, in several countries in the SEE region unemployment and low employment rate characterises the economy. It means that the outstanding economic growth has not generated sufficient new jobs for unemployed persons.

This is one of the main differences between the two regions' (SEE-7 and NMS-5) current economic paths. While NMS-5 economies grew by a relatively slower pace and gradual job creation characterised these economies (except for Poland), in case of SEE-7 countries, GDP growth was higher but the employment rate decreased in most cases (except for Bulgaria and Croatia) and unemployment remained a difficult issue.

Graph 1. Employment in SEE countries (1990=100)



Source: UNECE

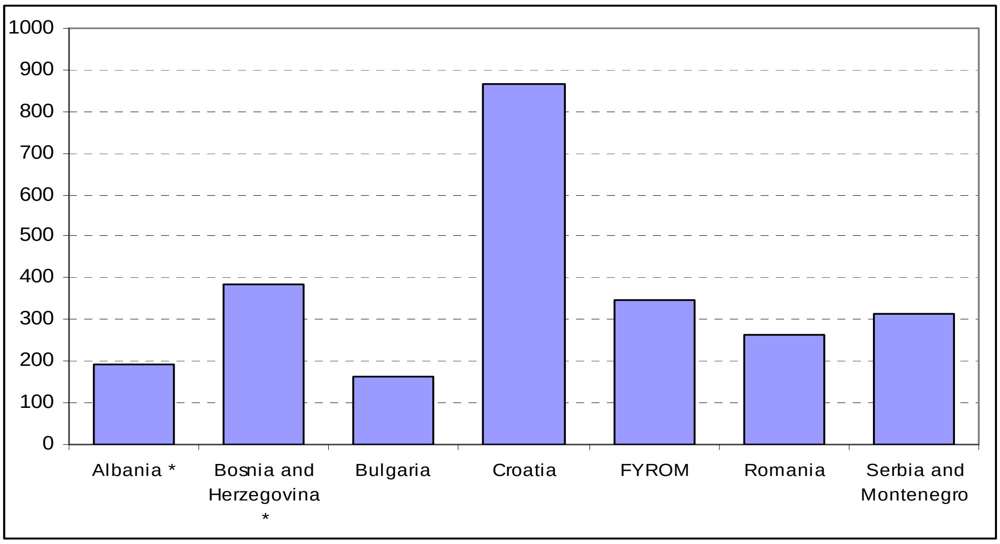
Decreasing employment rate and rising unemployment became a problem after transition and many economies in the region also suffered from wars in early '90s. In Bosnia and Herzegovina the number of employed persons decreased by 83% between 1991 and 1993 which means the employment declined from 630 000 to 107 000 in two years, mainly due to the Bosnian Civil war (1992-1995). On the other hand, due to the wars in the region and the better performance of the Central European economies in transition process, foreign investors have not showed any serious interest in investing into these economies, while the number of jobs decreased gradually.

Mainly due to the aforementioned factors the economic recession period was longer in case of the SEE countries, thus, the bottom was also lower. Regarding employment, this figure has sunk to between 60 and 80% of 1990 level, at the end of the last decade, while in most NMS employment never went under 80% of 1990 (Hungary is the only exception). It also means that the number of employed persons declined by 4.8 million or by 21% in the SEE region in the nineties.

In the new decade the number of employed persons decreased further in five out of the seven SEE countries. Thus, employment rate reached a very low level in these economies. In Bosnia-Herzegovina and the former Yugoslav Republic of Macedonia, the employment rate is less than 20% which means that every fifth-sixth person has a registered job, regarding the population aged between 15 and 64. In Albania, Croatia and Serbia and Montenegro, the employment rate is not so low as in case of the earlier economies, however, it can be considered as low (between 40% and 50%). In Bulgaria and Romania, employment rate is close to that of the NMS, in both cases the figure slightly exceeds 60%.

Regarding the average gross monthly wages in the region, there are significant differences among the countries. Wages are the highest in Croatia where wage level (EUR 870) is similar to that of the NMS countries. Majority of the Western Balkan countries (Bosnia-Herzegovina, the former Yugoslav Republic and Serbia and Montenegro) form the second group where the average gross monthly wages are between EUR 300 and EUR 400, while Albania, Bulgaria and Romania are in the third group with less than EUR 300. Obviously, these seven countries are not exactly competitors of each others since their developments are not the same. Naturally, Croatia and Albania will not compete for the same foreign investors. However, the wage levels in Bulgaria and Romania are relatively lower than that of the second group (the three Western-Balkan countries), thus, the two EU candidates are relatively more attractive considering the wage levels and productivities.

Graph 2. Average gross monthly wages in SEE countries (2005 June/July)

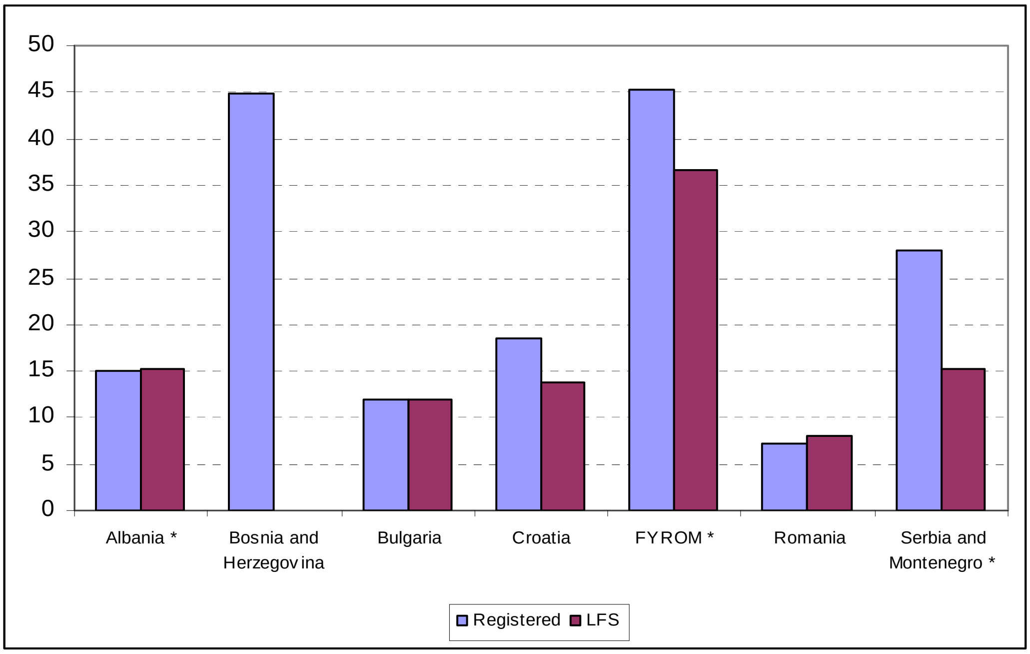


*Source: national statistics institutes; * 2004 figures*

Due to the low employment rate, unemployment is high in almost all SEE countries. There are three groups regarding the status of unemployment. Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro shape the first group. In these three economies official unemployment rate exceeds 25% and in the last several years the unemployment rate increased. In the second group there are Albania, Bulgaria and Croatia where unemployment is still double digit but it is less than 20%. In these economies unemployment reached its peak a few years ago and since then the figure is improving gradually. Romania forms the third "group" where unemployment is not a significant problem; the figure is less than 10%.

The aforementioned data are statistically reported figures which reflect the registered unemployment rate. However, in some cases these data do not reflect appropriately the real situation, especially in case of the first group. The other method which is used to measure the rate of unemployment is the so-called labour force survey (LFS). Regarding the LFS unemployment figures, the unemployment rate in Serbia and Montenegro is "only" 15.2%, while that in the former Yugoslav Republic of Macedonia is 37.2%. In case of Bosnia-Herzegovina there is no LFS unemployment figure but the other two economies' example reflects that the number of registered unemployed persons is not equal to those who are really not employed anywhere. According to some estimation, the real unemployment rate is approximately the half of the registered one. Naturally, it reflects the high share of informal sector in these economies. On the other hand, the difference between registered and LFS unemployment rate is partly due to the fact that there is a large amount of persons who are registered as unemployed to benefit from social security system but they are not seeking work at all.

Graph 3. Registered and LFS Unemployment rate in SEE Countries, 2004 (%)



*Source: UNECE, ILO; * 2003 figures*

Not only the high rate of unemployment is a significant problem in these economies but also its long duration. According to the statistics, the share of long-term unemployment in total exceeds 50% in most SEE countries (in Albania, the share exceeds 90%), which results that these unemployed persons have minimal chance to get a job in formal sector. These persons being long-term unemployed are usually low skilled, higher aged, territorial immobile, having health problems or belonging to some ethnic minorities.

With the exception of Romania, the SEE economies face high rates of youth unemployment. Youth unemployment rates reach 30-40% in the region, accordingly that age group (15-24) is largely hit by unemployment which is a quite large social and economic challenge for these economies. The large youth unemployment is partly understandable considering the fact that the enrolment in tertiary education is lower in several countries in the region than that of the CEE average, especially in case of Albania, Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia, Romania and Serbia and Montenegro. Therefore, young persons become job-seekers and step into the labour market earlier.

Regarding the gender composition of unemployment, in some cases, the rate of female unemployment is higher than that of the male, such as in Albania, Croatia, Serbia and Montenegro and partly higher in the former Yugoslav Republic of Macedonia. In the rest of the seven SEE countries, the unemployment rates are almost the same in the two gender groups, or the rate of female unemployment is a bit lower. Certainly, the unemployment rates of genders largely depend on the structure of employment and the orientation of the economy. If for example the light industry (textiles, leathers, shoes, and so on) plays an important role in the economy than the rate of female employment is obviously higher (Romania is a good example).

From regional aspect, unemployment is not a homogeneous problem in the different areas of the countries similarly to most Central European countries. Unemployment is higher than the national average in mostly rural areas and in those areas which were heavy industrial (mainly mining, metal, military or energy) centrums before the transition. The latter factor is the heritage of the previous (the communist) regime.

Box 1. – Doing business in Serbia

The World Bank publishes its so-called "Doing business" series in every year in which the authors evaluate the business climate of more than 100 countries in the world. In 2004 Serbia and Montenegro was evaluated as the top performer in reforming and improving its business climate to spur the establishment of firms and the creation of jobs. In last year, Serbia and Montenegro improved in 8 out of the 10 areas observed by the World Bank, such as the decrease of capital requirement of starting a new business from EUR 5 000 to EUR 500, the reduction of time to start a new business from 51 days to 15 days, the introduction of a new labour law which allows the firms to offer term contracts that makes it easier to hire new workers, and so on. As a result, in 2004 the number of new registered firms increased by 42% compared to the previous year.

Although, Serbia and Montenegro was the top performer in last year, its rank is currently pretty poor, only 92. Certainly, this rank does not reflect appropriately the attractiveness of a country due to the fact that several indicators – which influence an investor's decision – are not included in the evaluation, such as the quality of infrastructure, corruption or macroeconomic environment. But the high ranking means that the given government created a regulatory environment which is favourable to the firms.

Source: Doing Business in 2006, World Bank

In conclusion, it is clear that employment in the SEE region is problematic in most countries. The main problem is the low employment and the high unemployment rate despite the rapid economic growth. Unfortunately, the robust GDP growth was not followed by sufficient job creation in the last years.

Long-term unemployment and youth unemployment are serious concerns which represent severe social and economic challenges. On the other hand, the official and the real unemployment are not equal in all SEE countries. It means that the informal sector plays an important role in mainly the Western Balkan economies. Accordingly, it reduces not only the revenues of budget but also increases the expenditures due to the fact that the registered job-seekers benefit from social security system. Thus, unemployment is one of the most important macroeconomic issues in these economies, namely the increase of employment is essential, therefore, the governments are committed to make their economy more and more attractive for the foreign investors.