ICEG European Center

Quarterly

Forecast

on South-Eastern Europe

Winter

TABLE OF CONTENTS:

OVERVIEW

Slight deceleration of GDP growth in course of 2005

Economic growth

In the third quarter of 2005 the previous tendencies of the year continued. According to our expectations, the average economic growth rate of the seven Southeast European countries was 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.

In Albania, Bosnia-Herzegovina, Bulgaria and Croatia, the real GDP growth is expected to be the same or a bit higher in 2005 than in the previous year. In the rest of the countries, the pace of GDP growth is expected to decrease, mainly in case of Romania and Serbia and Montenegro.

On the one hand, the highest growth rate was achieved in Albania and Bulgaria (6%) according to our expectations. On the other hand, we expect that the GDP growth was the lowest in the Former Yugoslav Republic of Macedonia (3.5%) in 2005. In course of the year, the main engine of the growth remained the same as in the previous year: the domestic demand.

In 2006 current tendencies are expected to continue and domestic demand will remain again 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 2006 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. In case of Romania inflation rate became a one-digit figure in 2005 after many years of double-digit inflation.

On the other hand, 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 4.4% 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. Thus, 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 0.9% of GDP, which is significantly smaller than the same figure in the previous year (1.7%). Except for Albania and Croatia, general government balances are expected to be between 0% and +2.0% 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 the deficit can decrease somewhat and in the other countries the balances are expected to remain in around the same level.

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 improved only slightly, the average current account deficit reached 10.0% of GDP. Significant deterioration of CA balance was observable mainly in Bulgaria and Romania due to strong domestic demand. In case of Bulgaria, CA deficit increased from 7.5% to 14% of GDP according to our expectations. In Romania, the deficit also worsened by 1.5%-points of GDP.

On the other hand, significant improvement characterised the CA balances of the FYROM and Serbia and Montenegro. In Serbia and Montenegro, the deficit of CA balance deceased to 6.6% in 2005 from 13.4% of GDP in 2004. This good performance was mainly due to the positive impact of the improving trade balance. In case of the other countries slight improvements were observable.

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. Until 2004, there was only one country where unemployment rate was a single digit figure, which was Romania. In 2005 Bulgaria joined that “group” where unemployment rate decreased significantly in course of 2005. Our expectation is that unemployment rate was 9% at the end of 2005. It represents a 3%-points decline in unemployment rate, which is a remarkable performance. Besides Bulgaria, slight improvement was observable in Croatia and Romania related to unemployment, while the rest of the countries was not able to decrease significantly the unemployment rate in 2005.

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 2006 further decline of unemployment rate is expected in case of the EU acceding and candidate countries owing to the accelerating economic growth in the region. However, the rate of unemployment will not decrease significantly in case of the other countries.

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

SEE7 Average	2003	2004	2005*	2006*
GDP growth (%)	4.0	5.8	4.8	5.1
Inflation (%)	4.8	4.7	5.2	4.4
General Government balance/GDP (%)	-2.3	-1.4	-0.9	-1.2
Current Account/GDP (%)	-9.2	-10.0	-10.0	-9.2
Unemployment (%)	22.9	22.7	21.9	21.5

** Forecasts*

ALBANIA

Rapid growth but still one of the poorest

Economic growth

Albania's real GDP growth rate is expected to be 6% in 2005, and in case the stable economic growth can be maintained, this impressive number may be valid for the next year as well. On the other hand Albania is still one of the poorest countries in the region, with a GDP per capita only around 10% of the EU-25's average (in 2004 it was EUR 1,950).

The main engine is still the domestic demand, due to the weak foreign demand and the increasing real wages in Albania. The growth is driven by the main sectors, as services, construction, transport, agriculture and industry. Almost one forth of the total GDP comes from the agriculture sector and another forth from the increasing service sector. The share of the agriculture sector is slowly declining, due to the growing non-tradable activity. The agriculture sector is expected to grow around 4.7% and the industrial output by 4%.

Monetary conditions

The Bank of Albania's aim is to keep annual inflation in the 2-4% band. The high price of oil can endanger the inflation target, but so far, due to the exchange rate and the relatively low share of fuels in the consumer commodity basket, the impact on inflation was mild. Thus consumer prices are expected to grow by 2.2% in 2005. In the third quarter PPI has marked 2.4% annual growth.

In the first half of the year, a rapid growth of money supply could be observed, which slowed down in the third quarter. In June the annual growth rate of M3 was 18.3%, while in August is declined to 15.4%. In the same month, credit share to GDP was 11.8%, and the ratio to the broad money amounted to 18%.

Excluding the 0.25% cut of core interest rate in March, which resulted the recent 5% rate, the Bank of Albania followed neutral monetary policy. Except from some seasonal effects and fluctuations, the managed floating is successful and the Lek is relatively stable. Compared to January 2005, by the end of this year, the Lek showed appreciation against the Euro and the US dollar as well. At present 1 Euro is 122.67 Lek, while 1 US dollar is 102.13 Lek.

Fiscal developments

During the third quarter of 2005, the long post-electoral process caused a slowdown of income flows. Still, until the end of September, budget deficit and its domestic financing generally met expectations.

Despite the elections that took place in summer and the election-time promises, fiscal consolidation is on track. The improvement is assisted by the cooperation with the IMF. Budget deficit for this year is expected to be around 4.6%.

To sum up, fiscal position will continue to improvement, but due to the low level of revenue generation and collection in relation to GDP, it still remains vulnerable. Reforms in taxation and customs administration, just as essential structural reforms are needed for Albania's economic development.

Balance of payments

Until the third quarter of 2005 export increased by 14%, compared with the data from 2004 September. Import grew by 14.6% in the same period, while trade deficit increased by 14.8%. Around 70% of the trade is with EU countries, the main trade partners are Italy and Greece. In the first half of this year current deficit amounted to EUR 145 million, mainly due to the deficit in trade of goods and services, but the capital flows could cover this deficit. The balance of payments showed a positive result, EUR 11 million. During this period the capital and financial account showed a EUR 197 million surplus. Emigrants' remittances, grants, public and private debts and FDI-s embody the current inflows.

Migrants' remittances - mainly from Italy and Greece - bolster the economy and help financing the immense trade deficit. According to estimations these remittances amounted to EUR 900 million in 2004. Privatisation revenues also help financing the deficit. Regarding foreign investments, we should mention that the poor infrastructure, corruption, the problems concerning the energy situation, the lack of law enforcement discourages FDI.

Unemployment

The rate of unemployment was 14,4% last year and it is expected to remain around this level in 2005. Due to the fact that total employment is slightly increasing, the unemployment rate may decline mildly. Around 58% of the employed people work in the agriculture sector, 23% in the non-agriculture private sector and approximately 19% in the public sector. The restructuring of the economy and the privatisation process might have a negative impact on employment.

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

	2003	2004	2005*	2006*
GDP growth	5.7	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	2.9	2.2	2.8
Unemployment (%)	15.1	14.4	14.3	14.0
General government balance/GDP (%)	-4.9	-4.9	-4.6	-4.0
General government debt/GDP (%)	n. a.	55.0	54.0	53.0
Current account balance/GDP (%)	-7.1	-5.3	-5.1	-5.2
Trade balance/GDP (%)	-22.9	-20.7	-20.5	-20.0
Gross foreign debt/GDP (%)	24.3	22.0	20.5	20.0
Exchange rate (ALL/EUR)	137.5	127.6	125.5	126.0
Interest rate (end of year, %)	6.50	5.25	5.00	4.5

Source: National Bank of Albania, INSTAT

** Forecasts; 1 including grants*

BOSNIA AND HERZEGOVINA

Strict fiscal and monetary policy with external imbalances and unemployment

Economic growth

Real GDP growth was 5% last year and for 2005 an even rapider growth is expected, amounting to 5,5%. Investment activity and external activity bolsters the growth, but domestic demand remains one of the main engines. In the first eight months of this year, in the Federation of Bosnia and Herzegovina (BH) industrial output grew by almost 6%, while in the Bosnian Serb entity – Republika Srpska (RS) – this rate was over 20%. Although the country still remains one of the poorest in the region, if we take into consideration the tight fiscal and monetary policies, the growth is remarkable.

Monetary conditions

The currency board arrangement (1 KM = 0.51129 EUR) works as an effective anchor for monetary stability in Bosnia and Herzegovina. Inflation is low – last year in the Federation consumer prices fell by 0.4%, while in RS prices grew by 2.4%. Despite the increasing oil prices, inflation will remain at a low level, thanks to the strict monetary and fiscal policy. For 2005 the consumer prices are expected to be 2,2% and the converge between the two entities will continue. The introduction of the VAT from the beginning of 2006 will have a one-off negative impact on price increases, but inflation is still expected to remain low.

Citizens' savings are growing from year to year, so as a result by the end of September this year their deposits in commercial banks were KM 3.04 billion, which is 30.2% more than a year ago. On the other hand, the savings of the citizens are still much lower than the amount of their loans. Interest rates are decreasing but still remain high.

Certain reforms were made in the banking sector – payment system reform and increase of minimum banking capital. The trend of mergers in the banking sector is still present.

Foreign reserves show continuous growth – in the first half of 2005 it increased by 136 million. By the end of September, foreign exchange assets reached KM 3.94 billion, while monetary liabilities amounted to KM 3.76 billion.

Fiscal developments

BH owns a fractured and inefficient state system with a multi-layered fiscal architecture. The strengthening of the single economic space is necessary. One step to this direction is the foundation of the state-level Indirect Tax Authority (ITA). By this institute customs administration has been unified at state-level and conditions were created for a uniform tax application. ITA has been collecting revenues since the beginning of 2005 and is now preparing for the introduction of VAT. In the first half of 2005 ITA collected 960 million KM of indirect taxes, which is 12% more in comparison to the equivalent period of 2004 before the institute started operation, and 10% above the plan of this year. ITA's scope of duties is widening. The sales tax will be replaced with a single VAT rate of 17%. Recently there are still unanswered questions concerning the distribution of the VAT incomes and financing the cantons and municipalities level. The overall success of the collection is uncertain. The components of the social programs which will aim to compensate the potential negative effects of the new tax system is still unclear.

Total fiscal surplus in the first six months of this year amounted to KM 286.6 million. Total revenues were 9.4% higher that a year ago and amounted to KM 2.917 billion, while total expenditures increased by 4.3% and were 2.559 billion. Fixed assets and non-financial assets were purchased for KM 71.3 million – 11.1% more than a year ago.

As for the entities, both the Federation and Republika Srpska recorded consolidated fiscal surplus. The government of the Federation increased surplus, but off-budget funds recorded deficit – except the Unemployment Insurance Fund. In Republika Srpska only the Health Protection Fund recorded deficit. To sum up, these numbers show responsible fiscal policy in all levels, but on the other hand, public expenditure still remains high, mainly due to the excessive and inefficient bureaucracy in the four levels of the administration.

Balance of payments

Foreign trade deficit is still enormous and remains the biggest macroeconomic problem beside the level of unemployment. This external imbalance can mean danger to BH's long term self-sustainability. Current account deficit was KM 1.327 billion in the first half of the year, which means that there was no real improvement compared to the first six months of 2004. Though the value of exports in KM in the second quarter was the largest ever recorded in one quarter, the main cause of the high current account deficit was the negative balance of goods exchange (KM 3.37 billion). In the first seven month of 2005 trade deficit amounted to KM 4.1 billion. The introduction of the VAT may result a one-off surge in imports in the last quarter of 2005. Due to the growing sector of tourism, the inflow of construction works and communication services, the account of services improved. Current transfers include a significant amount of remittances from abroad. Total new debt – including commercial banks – in the first half of the year amounted to KM 319 million.

Foreign direct investment (FDI) in the first six months was KM 256 million, which is 26% lower compared to the same period of 2004. More than half (53%) of the FDI was concentrated to the bank sector, while 41% went to the production sector. The largest investor is Austria (KM 117 million), the second is Slovenia (KM 34 million) followed by Germany (KM 19 million). Privatisation is continuing in the metal industry, wood industry, automotive components industry and in the power and gas supply. Solving the case of Energopetrol is still ahead.

It is worth mentioning that loans are expected from EBRD - EUR 70 million for railroads. A stand-by agreement (approximately EUR 50 million) with IMF is also in sight.

Unemployment

Unemployment data are still unreliable. According to the official data, unemployment is the highest in the region – it exceeds 40%. Due to the huge size of the grey economy, real unemployment is around 20%. The privatisation process may have negative impact on the employment.

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

	2003	2004	2005*	2006*
GDP growth	3.5	5.1	5.5	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, %)	0.1	0.2	1.9	2.5
Unemployment (%)	42.0	42.5	42.0	42.5
General government balance[1] (%)	0.4	-0.1	0.1	0.2
General government debt/GDP (%)	34.0	32.8	32.5	32.7
Current account balance/GDP[1] (%)	-24.5	-23.3	-24.5	-22.0
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

High current account deficit with improving employment figures

Economic growth

In the third quarter of the year, the Gross Domestic Product (GDP) growth decreased compared to the previous two quarters of the year. While GDP growth reached 6.4% in the second quarter, it declined to 4.6% in the third quarter. On the production side, all sectors' performance decreased, the gross value added of industry and services sectors grew by 6.5% and 4.8% respectively compared to the same period of the previous year, while the gross value added of agriculture decreased by 6.6% in the third quarter. This latter process was the result of the unfavourable weather conditions in the summer. Certainly, the declining production of the agriculture sector had a significant negative impact on the overall GDP growth. In fact the bad performance of the agriculture sector worsened the GDP growth figure by almost 1%-point. Hypothetically, if the agriculture sector reached a relatively slow growth rate (+2%), the GDP growth would have been around 6%, according to our calculations.

On the demand side, the main engines of the economy unchanged. The growth rate of consumption increased in the third quarter and final consumption reached 9.2% growth. Consumption was mainly determined by private consumption's high growth which was 9.7% in the third quarter. Besides that, investment also had a key role in GDP growth. Gross fixed capital formation increased by 25.4% which is outstanding. Gross capital formation per GDP level reached 28.4% in that period.

On the other hand, net exports had a massive negative impact on GDP growth. As it will be examined later, the significant deterioration of the trade balance continued and even in the third quarter - when the balance of goods and services 'traditionally' had a surplus due to the revenues from tourism sector - the balance had a deficit this year.

During the first nine months of the year, the GDP growth was 5.6% which is still really high. However, we have decreased our forecast GDP growth due to the aforementioned tendencies. We estimate a 5.7% GDP growth for the total year. In 2006 GDP growth can be higher than that, thus we have not revised our expectations on that figure.

Monetary conditions

In the second half of the year Consumer Price Index started to increase gradually which was expectable regarding the fact that elections were held in June 2005 and administrative prices and indirect taxes have remained unchanged during this period. Thus, the average inflation rate of the first half remained relatively low, it reached only 4.4%.

In the second half of 2005 CPI increased significantly in comparison with the first half of the year. In August, consumer prices increased by 5.0% compared to the same month of the previous year. The inflation rate went up to 6.9% in November 2005. The higher CPI was the result of several negative factors. Firstly, the international oil price hikes had a negative impact on fuel prices. Secondly, floods in the summer influenced negatively the production of agriculture sector and thus, food prices increased significantly in this period. Thirdly, energy prices also increased significantly in the last two months. Electricity prices and natural gas prices increased by 16% and 18.11% respectively as of October, while central heating prices went up by more than 20% due to the higher natural gas prices in November 2005. Thus, the higher inflation rate is understandable. In December, the inflation rate will remain high and we expect that annual CPI will reach 5.1%. In the next year, further increase of the administrative prices and indirect taxes are expected due to the fact that the government decided to bring forward these measures to be able to adopt the single European currency at the end of the decade, as soon as possible after the accession (2009-2010). Thus, the CPI will remain at this level and the annual inflation rate is expected to reach 5.0%.

Fiscal developments

In the third quarter of 2005 consolidated budget surplus increased further and reached EUR 785 million at the end of September. This amount of surplus is equal to the 3.7% of the estimated GDP. The growth rates of the budget revenues and expenditures were almost the same, 13.9% and 13.4% respectively. In 2005 general government balance will have a surplus again which can be around 2% of GDP.

For 2006 the government planned that the budget will be in equilibrium. We expect that this target is realisable, even a bit too pessimistic, thus we forecast that the general government balance will have a surplus in the next year too. The surplus is expected to reach 0.5% of GDP.

The massive amount of the budget surplus and the rapid economic GDP growth supported the further decline of the general government debt. At the end of October the public debt reached EUR 6.9 billion or 32.7% of GDP, thus we maintain our forecast on debt per GDP ratio, it is expected to be 33% of GDP at the end of the year. In next year, the same tendencies will continue, accordingly the public debt s expected to decrease further, our expectation is 30% of GDP.

Balance of payments

In the third quarter of the year the deterioration of the current account balance continued. In the first ten months of 2005 the current account deficit reached EUR 2.2 billion. It means the CA deficit increased by EUR 1.3 billion or 142.3% compared to the same period of the previous year. This massive worsening of the CA deficit is basically due to the deterioration of trade balance.

Trade deficit grew by EUR 1.2 billion or close to 60% between January and October this year. While the growth of imports rose by 27.6% that of the exports increased by 18%. It reflects the negative impact of the strong domestic demand on the trade balance. On the other hand, the international oil price hikes also had a negative effect on the value of imports.

Regarding the other components of the CA balance, the surplus of services balance decreased, while the same tendency was observable in case of the current transfers balance. Only the balance of incomes improved slightly, however the progress of these elements played a much less important role in the development of the current account balance.

FDI inflows increased slightly in the first ten months of the year and reached EUR 1.4 billion. It is almost the same amount as it was in the same period of 2004. However, the net FDI is able to finance a much less percent of the CA deficit than last year.

For 2005 we have revised our forecast on the CA balance per GDP figure considering the aforementioned negative processes. Now we expect that the current account deficit will reach 14% of GDP this year. In 2006 the current account deficit is expected to remain high but decrease somewhat.

Unemployment

In the third quarter of 2005, the positive tendencies continued regarding the labour market. Employment rate increased by 1.1%-point which means that 73 500 more jobs were registered in the economy in comparison with the same period of the previous year.

It also means that unemployment declined, the rate of unemployment reached 9.2% in that period which is almost 2%-points lower than that in the third quarter of 2004. This rate is the lowest in the last ten years.

Youth unemployment rate also declined (from 24.9% to 20.5%), while long-term unemployment grew to 61.7%. The positive tendencies are the result of the good economic performance, however, the activity rate is still quite low.

Table 4. - major macroeconomic indicators for Bulgaria 2003-2006

	2003	2004	2005*	2006*
GDP (%)	4.3	5.7	6.0	6.0
Private consumption (%)	6.4	4.5	8.0	7.0
Public consumption (%)	7.3	6.0	6.5	6.0
Investments (%)	14.0	12.0	17.0	15.0
Export (%)	8.0	13.0	7.0	8.0
Import (%)	15.0	13.0	17.0	12.0
Consumer price index (average, %)	2.3	6.2	5.1	5.0
Unemployment ratio (%)	13.5	12.0	9.0	8.0
General government balance (%)	0.5	1.5	2.0	0.5
General government debt/GDP (%)	46.0	38.0	33.0	30.0
Current account/GDP (%)	-9.5	-7.5	-14.0	-12.0
Trade balance/GDP (%)	-12.5	-14.0	-18.6	-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	2.2

*Source: BNB, NSI; * Forecasts*

CROATIA

Domestic demand driven growth amidst unchanged macroeconomic performance

Economic growth

The quarterly evolution of GDP in Croatia was quite hectic in 2005, as the 1.9% decline in the first quarter was followed by surge of output (5.1% increase) in the second one. Altogether the Croatian economy was expected to grow by 3.7% in 2005 in line with the output growth of 2004. However, there have been several changes in the composition of growth. First, the contribution of gross fixed capital formation declined considerably mainly due to worsening confidence and expectations of the private sector. Second, the growth of private consumption also decelerated, partly in relation to slowdown of nominal wage increases and some deceleration of private sector credit growth. At the same time the contribution of net exports to GDP worsened slightly, due both to the faster rise of imports and slowdown in export growth. One factor contributing to the acceleration of import demand was the increase of public consumption, which partly substituted for the decline of private consumption.

As described in the previous report the increase in manufacturing and construction production was slower than expected, while at the same time retail sales expanded fast compared to 2004.

In 2006 growth is forecasted to accelerate to 3.9 %, based mainly on stronger private investment due to the privatisation and enterprise restructuring, slightly improving business sector expectations, generally strong export performance. At the same time based on tight monetary and associated incomes policy similar to 2005 growth of private consumption (3.5%) is expected which together may accelerate the contribution of domestic demand to output growth. Public sector consumption will increase in line with its growth of 0.5% in 2005. Concerning the contribution of net exports, one may not expect significant changes in 2006 compared to 2005 as both exports and imports will pick up slightly compared to the previous year. The growth of exports is driven mainly by strong services exports, while at the same time the rising stock of FDI and the acceleration of gross fixed capital formation improve the prospects for merchandise exports. Real imports are expected to expand more slowly than exports, but they will accelerate in line with growing GDP mainly due to the high import demand of private investments and consumption.

Monetary conditions

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 was observed as both factors added to inflation above initial expectations. The average price increase in 2005 was around 3% also associated with faster rise in oil and food prices. At the same time the adjustment of administrative prices continued, which added an additional momentum to price increases.

As also noted in earlier report the stability of the exchange rate, and the moderate rise in nominal wages kept the inflationary consequences of oil and food price as well as administrative price increases moderate, reducing the second round effect of these inflationary factors.

In 2006 some acceleration of inflation is expected as the adjustment of administrative prices continues, some faster increase of nominal wages is expected and domestic demand is foreseen to rise faster than in 2005.

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, moreover it depreciated until October, which was followed by continuous appreciation till the end of the year. In 2006 no change in the exchange rate of the Kuna is expected and the Euro will fluctuate around 7.4-7.5 Kuna.

Fiscal developments

The general government deficit is expected to be reduced from 5.0% of GDP in 2004 to 4.3% in 2005. 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%." There was a need for a supplementary budget, which 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 had uncertainties, but the forecasted deficit of 4,3% of GDP could be met.

The fiscal developments were partly influenced by the long lasting effects of the initial revenue reducing measures (among others the increase of the tax-free threshold for personal income or abolishing taxation of distributed profits) while at the same time the expenditure side of the budget was determined by the costs of structural reforms. But the fast rise in GDP and the supplementary budget proved to be sufficient in keeping the deficit within the mentioned level.

The forecast for 2006 assumes a further reduction of the deficit to 3.8% in 2006. The decline of fiscal deficit will be linked to the reduction of current spending in GDP, which will partly be stimulated by policy measures already taken in 2005 (change in pension indexation among others). At the same time it is likely that the pace of the rise of public investments associated with the ambitious highway construction will moderate and return to a more sustainable level. While expenditures are expected to decline sizeably, revenues as a share of GDP, in particular indirect taxes will only slightly decline allowing the mentioned decline in deficit.

Fast GDP growth accompanied with smaller deficit in 2006 will mean a further decline in public debt, which may reach 53.0% of GDP.

Balance of payments

The trade balance will show again a deficit around 24% of GDP which shows an unchanged position compared to previous years. There is a huge deficit in merchandise balance, which was strongly affected in 2005 by the rise of oil prices and oil imports. At the same time exports accelerated slightly in 2005 compared to the previous year, but the terms of trade losses wiped out the gains from the real rise in exports.

The current account worsened slightly in 2005 as the service surplus moderated and became less than in the previous year. The current account deficit of 6.2% of GDP is however sustainable and can be financed mainly with the inflow of non-debt creating foreign investments.

In 2006 we expect a small improvement in the current account mainly due to the higher tourism surplus, while the trade balance will remain unchanged compared to 2005.

Unemployment

The officially registered unemployment rate in the last quarter of the year (around 17.8%) was lower than a year ago (18.1%), suggesting a gradual improvement of the domestic labour market situation. This is confirmed by the evolution of both unemployment and the employment rate: according to recent labour force survey data, the unemployment rate declined to 13% by the end of the year as compared to 13.8% a year earlier.

Two factors seem to stand behind the improvement of the labour market conditions. First, the recent years of accelerating growth were accompanied by growing labour demand: in line with fast GDP growth employment rose on average by around 1.5% in the last three years. On the other hand labour market reforms brought more flexibility to the system, reducing the number of total and long-term unemployed.

Average gross wages grew in the third quarter by 4.1%, as compared to 4.5% during the first half of the year. This translates into a real wage increase of 0.6% year on year, which is small compared to the evolution of productivity. This suggests that wage competitiveness of Croatian forms could have improved thanks partly to the tight incomes policy.

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	3.5	3.5
Public consumption (%)	-0.3	-0.3	0.5	0.5
Investments (%)	16.5	5.5	3.5	4.5
Export (%)	10.0	6.5	6.0	6.5
Import (%)	11.0	4.0	4.5	5.0
Consumer price index (average, %)	1.4	2.1	3.0	3.2
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	-6.0	-5.5
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*

FORMER YUGOSLAV REPUBLIC of Macedonia

Improving external balance and employment figures

Economic growth

In the first ten months of the year the industrial sector performed relatively well. During that period industrial production increased by 7.6% 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. Comparing to the 2003 level, industrial production grew by 2.2% between January and October this year, which represents 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 8.2% in comparison with the average production in 2003. On the other hand, production of mining and quarrying rose by almost 78% compared to 2003 average.

The Statistical Office of the Republic of Macedonia published its final data on GDP in 2004. According to these new statistics, the GDP growth reached 4.1% in the last year, mainly consumption and investments were the main engines of the economy. Private consumption increased by 5.8% in 2004 while the increase of gross fixed capital formation reached 9.3%. On the other hand, net exports had a massive negative impact on GDP growth, the deterioration of the balance of goods and services worsened the GDP growth rate by 3.3%-points. In conclusion, the GDP growth in 2004 was moderate mainly fuelled by domestic demand.

According to the Ministry of Finances, the GDP growth in the second quarter of the year may have reached 4.5-5.0%. In fact, the real figure is still not published but we expect that this expectation is a bit too optimistic.

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 maintain our expectation that 2005 figure will reach 3.5% and this pace will remain in 2006 too.

Monetary conditions

As it is usual, Consumer Price Index (CPI) remained close to zero in the first eleven months of the year. In November CPI was only 0.2% compared to July 2004. Considering the entire eleven-month-long period consumer prices increased by only 0.4% in comparison with the same period of the previous year.

The highest price increase was observable in case of liquid fuels (+29.9%), while the largest deflation was noticeable in case of audiovisual, photographic and information processing equipment. Price changes of most products and services reached less than 2%. It is also important factor that prices of goods increased by 0.2% during the first eleven months, while that of services increased by 1.4%).

In 2005 price stability keeps on characterising the former Yugoslav Republic of Macedonia, CPI is expected to be only 0.4% in this year. The strong position of the euro against US dollar also supports 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 seven months of the year, the general government budget had a significant surplus, it reached EUR 57 million or 1.3% of the estimated GDP. The good budget balance is mainly due to the high increase of budget revenues (+8.8%) and the relatively moderately (+2.6%) growing expenditures during that period.

Despite the surplus of the budget, general government debt increased by almost EUR 30 million during the second quarter of 2005. At the end of June 2005 public debt reached EUR 1969.5 million or 44.1% of GDP. This is a slight increase in comparison with the same figure at the end of 2004.

In course of 2005 general government balance is expected to worsen only slightly, thus budget will not have surplus but expected to be in equilibrium at the end of the year. On the other hand, the tight fiscal policy remains in line with the agreement with IMF. On the other hand, the low deficit can support the decline of the public debt level, too. In 2006, the process will continue and budget deficit is expected be in equilibrium again.

Balance of payments

In the first nine months of the year, the current account balance improved significantly. The CA deficit shrunk from EUR 229.3 million (Jan-Sept 2004) to EUR 45.4 million or by 80.2%. The improvement of the CA balance is basically due to the positive development of almost all components of the current account balance. Trade balance improved by EUR 20.6 million in the first nine months in comparison with the same period of the previous year. Trade balance improvement is mainly due to the fact that the growth of exports overpaced that of the imports. The growth rates were 25.6% and 14.1% respectively, in euro terms.

Besides trade balance, the balances of services and current transfers also improved, the deficit of the former decreased by EUR 30.3 million, while the surplus of the latter balance increased by almost EUR 150 million. That also means the current transfers play an important role in counterbalancing the trade deficit in the current account balance (the amount of net current transfers in the first nine months reached 14% of the estimated GDP in 2005).

Net foreign direct investment reached EUR 69.2 million in the first nine months of 2005 which is lower than that of the the previous year. The Russian Federation was the largest investor during that period with its EUR 12.1 million investment into the Macedonian economy. That means the attractiveness of the economy has not improved.

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 third quarter of 2005 the number of employed persons increased close to 890 thousands which reflects slight positive tendencies in the Macedonian labour market. In the same period of 2004 this figure was only almost 855 thousands, namely the number of workers rose by 35 000 persons. In line with that the activity rate of the economy increased from 53.6% to 55.3%, which is a positive progress considering the fact that the high unemployment rate and low activity rate are among the main problems in the Republic of Macedonia. In the third quarter the unemployment rate also decreased to 36.5%, while the figure was 37.2% in 2004.

As we always state this is the official unemployment rate and it 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 the second half of 2005, it seems positive progress started considering the labour market. The number of unemployed persons decreased while the number of employment increased. Thus, we expect that the unemployment rate will decrease to 36% at the end of the year, while further decrease is expected in the next year.

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

	2003	2004	2005*	2006*
GDP growth (%)	2.8	4.1	3.5	3.5
Private consumption (%)	1.8	5.8	n. a.	n. a.
Public consumption (%)	-4.3	4.6	n. a.	n. a.
Investments (GFCF, %)	3.7	9.3	n. a.	n. a.
Export (%)	2.4	9.1	18.0	15.0
Import (%)	-2.5	12.4	12.0	10.0
Consumer price index (average,%)	1.2	-0.4	0.4	0.6
Unemployment (%)	36.7	37.2	37.0	36.0
General government balance (%)	-1.0	0.0	0.0	0.0
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	61.2	61.3
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, own calculations

** Forecasts*

ROMANIA

Significant drop in GDP growth in the third quarter of the year

Economic Growth

The Gross Domestic Product (GDP) increased by 3.6% in the first three quarters of the year in real terms. This pace is much lower than the last published GDP figure was. In the first semester of 2005, economic growth was higher, GDP increased by 4.9% in real terms compared to the same period of 2004.

The weak performance of the agriculture sector was the most important factor that resulted in the significant decrease of the GDP growth. In the first nine months of 2005 the production of the agriculture sector decreased by 12.6% which was the result of the unfavourable weather conditions in the summer. As we have mentioned in our previous Quarterly Report, July flood had a negative impact on the production of sector and also on GDP growth. However, the volume of the negative impact was bigger than we have expected earlier. On the other hand, the increase of the value added of services and construction sectors were strong – 7.9% and 7.1% respectively – but the overall GDP growth remained moderate due to the aforementioned factor.

On the demand side, consumption remained strong but the pace decreased somewhat, below 10%. In the first nine months of 2005, final consumption increased by 9.3%, of which private consumption increased by 9.7% during that period. It means consumption is still high and that factor is one of the main engines of the economy. The high consumption figure is understandable regarding the introduction of the new tax system (flat tax), which resulted in higher real wages and disposable income.

On the other hand, gross fixed capital formation (GFCF) remained the other main factor that fuelled the economy in the first three quarters of the year. During that period, GFCF increased by 9.4% that is almost 2%-points higher than that was in the first semester. It means investments increased massively in the third quarter and resulted in that the investment rate per gross valued added figure jumped to 27.3%.

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 in the third quarter of 2005, besides the fact the trade balance also worsened significantly.

In the last quarter, we expect that consumption and investments remain the main engines of the economy, while net exports will have a negative impact on GDP growth. On the other hand, we have revised our forecast on GDP growth due to the larger than expected negative impact of the agriculture sector. Thus, in course of the year we expect that GDP growth will reach 4.6%. In 2006, the economic growth is expected to be stronger than this year and it can reach 5.5%, we have not revised this figure.

Monetary conditions

The decrease of inflation rate continued in the last 3-4 months and it diminished to 8.1% in October 2005. In November, consumer prices increased by 8.7% again which reflects a slight increase basically due to the 20% increase of thermal energy prices in that month.

Considering the tendency of disinflation process, the realisation of the inflation target is hardly achievable. The dec/dec target inflation of the National Bank of Romania is 7.5% with a +/-1%-point range. It means the CPI could not be higher than 8.5% in December 2005, while it was 8.7% in November. We expect that CPI will be 8.6% in the last month of 2005 which means the inflation target will be surpassed slightly. It also means that our earlier expectation on yearly average CPI is tenable, it is expected to be 9.0% in this year. In 2006, NBR's target is 5% with the same range. We expect that the yearly average inflation will be 7.0%, while dec/dec CPI is expected to be

6.0%. The rapider disinflation is not expected due to the strong domestic demand.

As we have forecasted in our previous Quarterly Report, the NBR cut the reference rate slightly to 7.5%. Further cuts are not expected in the remaining days due to the aforementioned factors. In the next year the reference rate is expected to be cut further, it is expected to decrease to 6.0% at the end of 2006.

Fiscal developments

According to the preliminary statistics of the Ministry of Public Finance, in the first 11 months general budget had a significant surplus, it reached approximately 1.0% of the estimated GDP. The 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). It means the revenues are above the most optimistic expectations despite the lower tax rates.

Accordingly, we have raised our expectations and we forecast that the budget is expected to have a 0.6% surplus in 2006, while the deficit in the next year can reach 1.0% of GDP in 2006.

Balance of payments

In the third quarter of 2005, the trade balance worsened further and the trade deficit increased to EUR 5 billion in September. This deficit is EUR 1.7 billion or 51.6% higher than that of the previous year.

In the first nine months imports of goods rose by 23.7%, while the increase of exports reached 'only' 17.6% in euro terms. Mainly consumption and investments boosted imports, while the strong Leu had a negative impact on the exports of goods.

On the other hand, the balance of incomes and current transfers improved somewhat during that period. The deficit of incomes balance decreased by EUR 371 million and the surplus of current transfers balance increased by EUR 471 million compared to the same period of the previous year.

As a result of the worsening trade balance, the current account balance also worsened. The current account deficit reached EUR 3987 million which is 28.2% or EUR 878 million higher than that in the same period of the last year. As it was mentioned, the significant deterioration of the current account is owing to the worsening trade balance. In 2005 we forecast that current account deficit can reach 9.0% of GDP, while trade deficit per GDP ratio is expected to be 12%. We have raised our forecasts due to the weaker than expected GDP figure in the third quarter.

In the last few months, nominal appreciation of the Leu has been stopped. In the second part of September and in November the national currency depreciated to almost 3.7 from 3.5 against the euro and the RON/EUR exchange rate remained between the 3.6-3.7 range in the last two months. This small (4-5%) depreciation may have had a slight positive impact on the export sector. At the end of the year, we expect that RON/EUR exchange will appreciate slightly, close to 3.6.

Unemployment

The number of registered unemployment was almost half a million in October 2005, which means the number of registered unemployed persons decreased by 51 000 during the last 12 months. Regarding the unemployment rate it decreased from 6.1% to 5.7% in this period. In course of the year we expect that unemployment rate will be 5.8% and that will decrease slightly in the next year.

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

	2003	2004	2005*	2006*
GDP growth (%)	5.2	8.3	4.6	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	9.0	8.0
Export (%)	11.4	14.1	7.5	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	5.8	5.6
General government balance (%)	-2.0	-1.4	0.6	-1.0
General government debt/GDP (%)	21.3	18.5	19.0	19.0
Current account balance /GDP (%)	-6.0	-7.5	-9.0	-9.0
Trade balance /GDP (%)	-7.8	-9.0	-12.0	-11.0
Gross foreign debt /GDP (%)	31.1	30.7	32.0	33.0
Exchange rate (RON/EUR) **	37.6	40.5	36.0	35.0
Reference rate (end of year, %)	21.25	17.96	7.5	6.0

Sources: EC, NBR, own calculations

** Projections, expectations; ** As of 1st of July 2005, RON is the new currency.*

SERBIA AND MONTENEGRO

Weak industrial production but improving current account balance

Economic growth

In 2005 a fall in industrial production was experienced in both Serbia and Montenegro. In the first eight months of the year industrial output declined in Serbia by 0.7%, while Montenegro was characterized by stagnation in the same time period. The fall in industrial production in Serbia effected manufacturing the most significantly in Q1, while production in mining and quarrying experienced the largest fall in February and June, and electricity, gas and water supply in May and June. Difficulties were also experienced in agriculture and construction in Serbia, while the services sector recorded a rise in the real volume of sales.

Despite the respective fall and stagnation of industrial production in Serbia and Montenegro the growth rate of GDP in the union is still expected to reach 4.5% in 2005. It is expected to remain at 4.5% in the following year as well.

Monetary conditions

Annual inflation in Serbia, measured by the retail price index reached 18% in October. Monthly inflation growth has also been strong in October, reaching 2%, while in August retail prices remained stable compared to the previous month. Cost of living in October increased in by 2.3%, mostly caused by the increase of goods prices. In Montenegro the month on month increases in both consumer and producer prices were quite low during the first ten months of the year. In July a decrease occurred in the retail price index and the CPI, while producer prices decreased in March and August.

Inflation, as measured by the yearly average growth of retail prices is expected to reach 15% in 2005 in the union as a whole, which is a downward change compared to our last forecast. We maintain our view that the yearly average growth of retail prices in 2006 will decrease to 10% in S&M.

The value of the dinar vis a vis the euro has undergone a gradual depreciation during the first ten months of the year. The depreciation vis a vis the USD was slightly more pronounced. In October the average CSD/EUR exchange rate was 85.5, while the average CSD/USD exchange rate was 70.4. The yearly average dinar exchange rates in 2005 against the euro and the dollar are expected to be 83 CSD/EUR and 66 CSD/USD.

Fiscal developments

A budget revision took place in July in Serbia, which is expected to result in CSD 32.2 billion fiscal surplus at the end of the year. The surplus will be used for public debt repayment and housing construction, as well as other internal needs. A fiscal surplus was also recorded in Montenegro in H1 2005, which amounted to EUR 115.7 million. It was primarily the result of revenues from privatisations that occurred in March, revenues from taxes and fall in expenditures. Since VAT was introduced in April 2003 budget revenues have been continually increasing in Montenegro. The reduction of the corporate income tax and personal income tax also contributed to the increasing trend of budget revenues.

The minority government in Serbia did not succeed in pushing through the first reforms concerning the pension system, which would involve the introduction of a voluntary funded pillar.

The small surplus that the budget balance in S&M will show in 2005 is expected to amount to 0.2% of GDP. In 2006 the budget is expected to be in equilibrium.

Balance of payments

Higher net FDI inflows were experienced in the first three quarters of 2005 compared to the same period of the previous year in Serbia. Net FDI inflow in the first eight months of 2005 already exceeded its full year value observed in 2004. This was mainly the result of acceleration of privatisation, especially in the banking sector.

Serbia experienced a narrowing in its foreign trade deficit in the first half of 2005. The current account was also in a much better position than in H1 2004. However, in July the current account deteriorated slightly, mainly as a result of the deterioration of the level of net current transfers. In August the opposite development occurred: parallel to the significant improvement in current transfers, the current account turned positive.

Montenegro, as opposed to the other republic, was characterized by less favourable tendencies concerning the current account in H1 2005. The trade balance deteriorated in the second quarter, which was caused by the greater fall experienced in exports than in imports. Foreign direct investments in H1 2005 in Montenegro amounted to EUR 215 million. 81% of these investments took place in the services sector.

The current account deficit as a percentage of GDP is expected to reach 6.6% in S&M in 2005. This will be a significant improvement compared to the previous year, when it was more than double, amounting to 13.4% of GDP. It is expected to improve further by one percentage point in 2006, to 5.6% of GDP.

Unemployment

In the first eight months of 2005 there has been a slight gradual increase in the unemployment rate and in the number of unemployed people in Serbia. In August the official unemployment rate reached 32.8%.

Yearly average unemployment rate is expected to reach 32.5% in S&M in 2005, and only a slight decrease to 32.2% is expected in 2006. Only the speeding up of industrial restructuring and more (especially greenfield) foreign investment could contribute significantly to the reduction of the official unemployment rate.

In January 2005 the real value of average monthly earnings fell by 19.5%. A 4.7% fall was again experienced in May. In August and September real value of earnings grew by 1.8% and 1.1% respectively.

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

	2003	2004	2005*	2006*
GDP growth (%) Serbia and Montenegro	2.1	7.5	4.5	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	12
-Import (%)	5.2	20.4	4.5	8
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	15.0	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	32.5	32.2
General government balance (% of GDP)	-3.1	-0.2	0.2	0.0
General government debt/GDP (%)	76.6	n.a.	n.a.	n.a.
Current account balance/GDP (%)	-7.4	-13.4	-6.6	-5.6
Trade balance/GDP (%)	-24.1	-28	-25	-22.0
Gross foreign debt/GDP	69.9	63.3	57.6	57.6
Average exchange rate (CSD/EUR)	65.1	72.6	83	88.2
Base rate	9	8.5	8.5	9

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

** Forecasts*

FOREIGN DIRECT INVESTMENTS IN THE SOUTHEAST EUROPEAN (SEE) COUNTRIES IN COMPARISON WITH THE 8 NEW MEMBER STATES (NMS8)

Introduction

As a result of the transition process, the former Eastern bloc and Yugoslavia divided into three groups of countries. The first group is comprised of the front-runner transition countries such as the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, or eight of the ten so-called New Member States. In the second group one can find the CIS countries, which include 12 former Soviet Republics[1]. The third group constitutes the Southeast European countries, consisting of Albania, Bulgaria, Bosnia-Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia (FYROM), Romania and Serbia and Montenegro.

Certainly these groups are not homogeneous; however, the three groups are distinguishable. Each group has its own characteristic which differentiates itself from the other groups. In case of the NMS, the relatively successful restructuring and transition process, the more advanced market economy, or the EU membership, while in case of the CIS countries, the slower progress in transition, the less developed economy, or the fact that these countries have slight chance to be a member of the EU in this or next decade, are all special features which characterise the given group.

Actually, the third group is quite interesting. In this group one can find countries which are not members of the EU but there are several official acceding and candidate countries, such as Bulgaria and Romania or Croatia, while the rest of the group is potential candidate country. Regarding the performance of their transition process, these economies were not as successful as the NMS; however the dynamism of the progress advanced significantly in the last few years. Nowadays, it seems most countries in the SEE region aim to close the gap between itself and the front-runner transition countries by implementing important measures similar to those adopted in the NMS, or even more significant.

One of the most important lessons from the economic transition process of the NMS is that foreign direct investment played and important role in restructuring the former centrally planned economies into market economies, integrating the national economy into the world economy and increasing the competitiveness of the economy. Besides privatisation which was a necessary consequence of the transition, these countries aimed at becoming more and more attractive for foreign investors by improving their business climate to draw more and more foreign capital into the economy. Nowadays, privatisation process is basically over and green-field investments constitute the majority of foreign direct investment inflows.

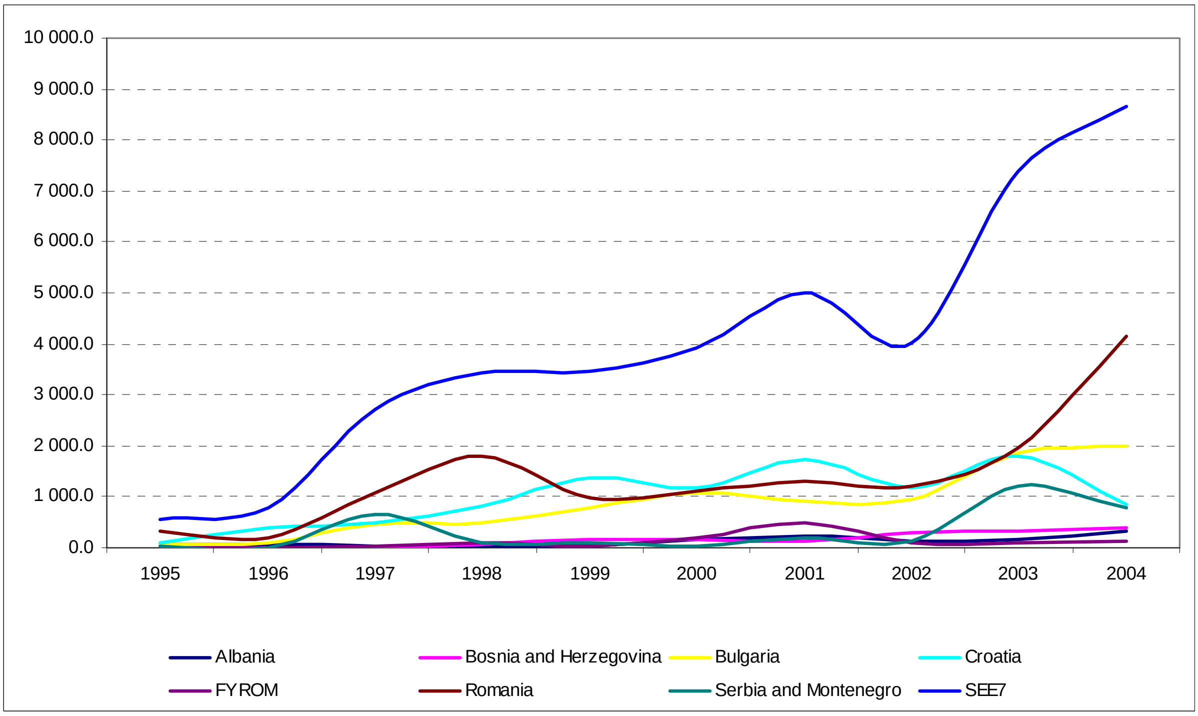
In the SEE countries this development started later, privatisation is still an ongoing process while the increasing competition for foreign direct investments is an exogenous factor to every country in the region. The main aim of this paper is to analyse the foreign direct investments inflowed into the SEE economies in comparison with the eight New Member States.

[1] In fact, the CIS is a confederation of 11 former Soviet Republics, namely Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Ukraine, and Uzbekistan. Turkmenistan is not a permanent member of the CIS since 26 August 2005 but is an associate member.

Foreign Direct Investments

As it was mentioned earlier the SEE economies were less attractive for foreign investors during the first 10 years of transition, namely in the 1990s. It was the consequence of several factors, such as the wars fought between the countries in the Western Balkans after the disintegration of Yugoslavia and the slower progress in economic and political reforms. Regarding the foreign direct investments inflows one can see that the annual average amount of FDI inflowed into the SEE region was quite low in the last decade. The total annual FDI remained under EUR 4 billion in every year in that period, which is quite low considering the population of the region (the SEE region's population is close to 55 million). The FDI inflow started to grow in the new millennium and the dynamism of this growth is significant. In the 2003-2004 period the FDI inflows reached EUR 16 billion which is remarkable.

Graph 1. - Evolution of FDI in the SEE countries, 1995-2004 (millions of euros/ECU)



Source: UNCTAD

It is observable in the graph above that the foreign investors' primary targets were Romania, Bulgaria, Croatia and Serbia and Montenegro in the last few years. These four "large" countries account for about 90% of FDI inflows in the region. Accordingly, it means the "small" countries (Albania, Bosnia-Herzegovina and the FYR of Macedonia) were not really attractive for foreign investors; their share in population reaches 18% which is significantly higher than that in FDI inflows.

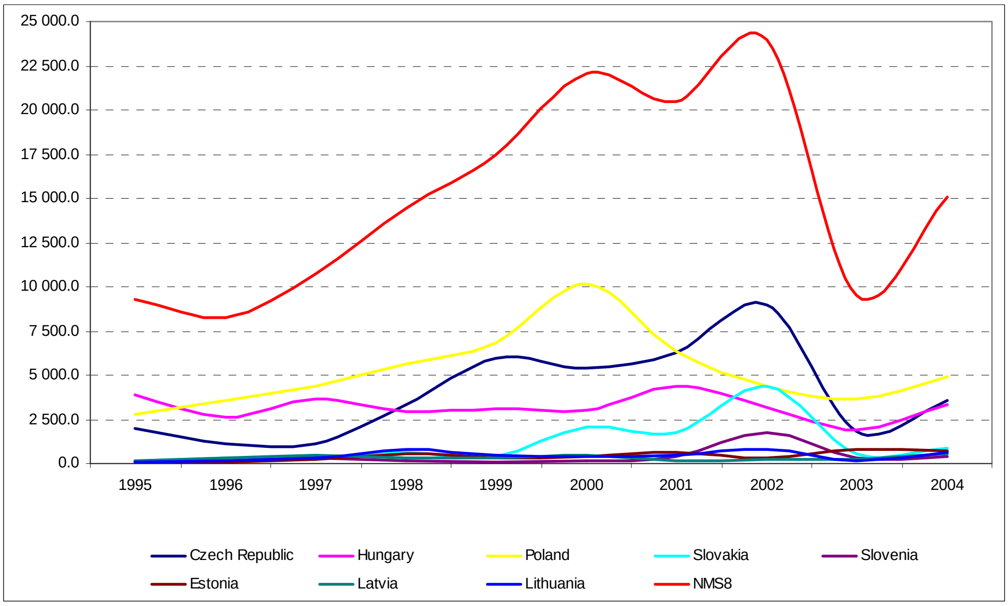
Nowadays, Romania is the most attractive target in the region. In the last two-year-long period the foreign direct investments increased by approximately EUR 6 billion or nearly 38% of the FDI inflowed into the SEE region chose Romania as the place of investment. In fact it is not a surprise that Romania accounted for the largest part of FDI in the last years considering the country's size.

On the other hand, the performances of Croatia and Bulgaria are both significant, their annual FDI inflows averaged around EUR 1-2 billion in the last years. Besides that Serbia and Montenegro is worth mentioning because its annual inflows increased to around EUR 1 billion in 2003 from almost zero. Though, it is true that this positive process is mainly due to the launch of privatisation in Serbia and Montenegro and the FDI inflows were linked to some large sales in that period.

During that period, the path of FDI inflows in the NMS was similar to a rollercoaster. In 2002 the FDI inflows into NMS-8 reached its peak

(EUR 24 billion) and it decreased sharply (to EUR 9.5 billion) in the very next year. It means that these economies were more influenced by the weakening performance of the world economy. On the other hand, the privatisation revenues also decreased due to the fact that privatisation is almost over in that region, the largest sales were concluded. Accordingly, green-field investments accounted for a significant part of the FDI inflows.

Graph 2. - Evolution of FDI in the NMS8 countries, 1995-2004 (millions of euros/ECU)



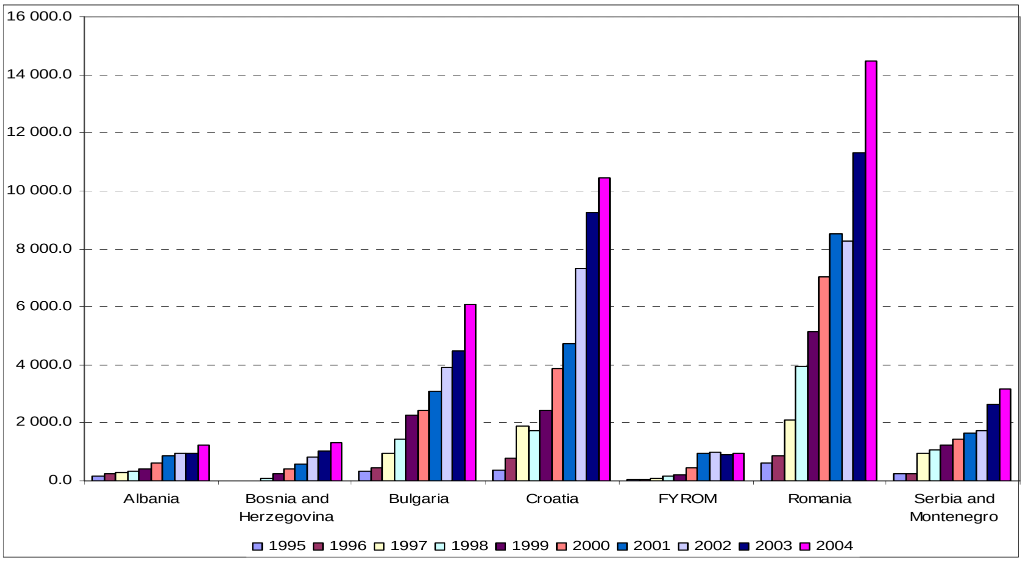
Source: UNCTAD

In case of the eight NMS, the same concentration of targets is observable as in case of the SEE countries. In the four "larger" countries, or the so-called Visegrad countries (the Czech Republic, Hungary, Poland and Slovakia) account for almost 90% of FDI inflows in the region which is mainly explainable by the size of these countries. The share of these countries in the population of the region is around 87.5%. Thus, it is a difference between the SEE countries and the NMS, namely the small countries are not under-represented in the FDI pattern.

Regarding the stock figures, the aforementioned factors are underpinned, the most important investment targets were Romania, Croatia, Bulgaria and Serbia and Montenegro between 1995 and 2004 in the SEE region. In that group the amount of FDI stock exceeded EUR 10 billion only in Romania and Croatia. In Bulgaria this figure was EUR 6 billion, while in Serbia and Montenegro it reached almost EUR 3.2 billion at the end of 2004. In these four economies the

In the other three "small" economies FDI stock was around EUR 1.0-1.3 billion in each. In case of these countries the evolution of FDI stock was mainly influenced by some larger-scale privatisation deals, the best example is the FYR of Macedonia where the privatisation of the national telecom company in 2001 resulted in a significant jump of FDI stock.

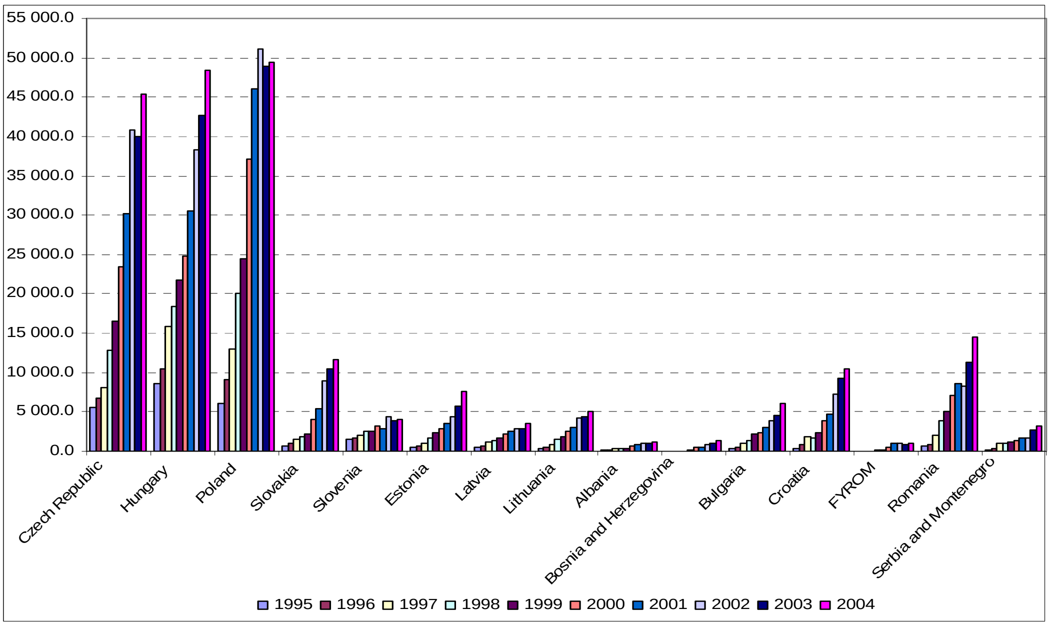
Graph 3.- FDI stock in the SEE countries, 1995-2004 (millions of euros/ECU)



Source: UNCTAD

If one compare the FDI stock figures in the SEE region and in the eight New Member States it is easily observable that even those countries which have higher FDI stock figures greatly lag behind the front-runner NMS countries, namely the Czech Republic, Hungary and Poland. In these three economies the FDI stock figure is between EUR 45 and 50 billion which is threefold-fourfold higher than that of the best performers (Romania and Croatia) in the SEE region.

Graph 4. - FDI stock in the SEE and the NMS8 countries, 1995-2004 (millions of euros/ECU)



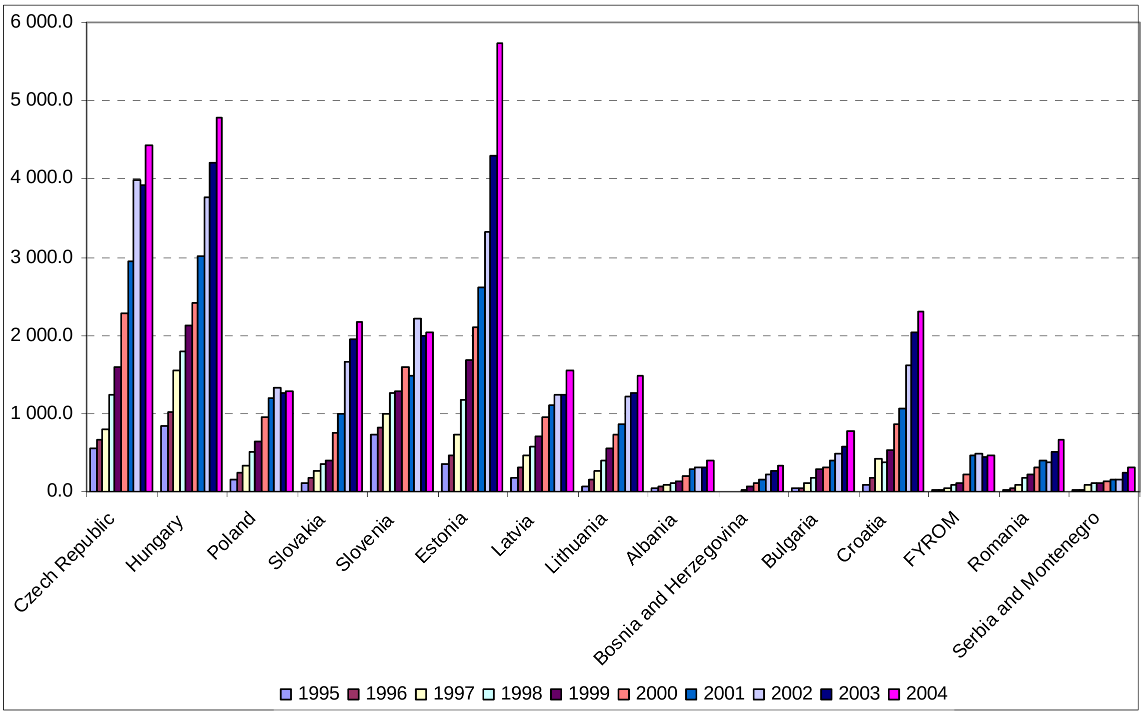
Source: UNCTAD

The figures of these best performers in the SEE region is rather comparable with that of Slovakia or Estonia from the NMS, however, the population of these countries are significantly lower than that of the aforementioned NMS countries.

Certainly, it is worth comparing the per capita stock figures which reflects a clearer picture on the FDI stocks in these countries. It was expectable that the levels of per capita FDI stocks of the Czech Republic and Hungary are significantly higher than that of Poland due to the difference in population, while Estonia has the highest per capita FDI. Generally, the per capita FDI exceeds EUR 1000 in every New Member States.

The figures of the SEE countries are really low, in most cases the per capita FDI stock level is less than EUR 1000. Romania, the best performer in total FDI is only the third in the region after Croatia and Bulgaria, in this respect. The per capita FDI is less than EUR 700. In the other four countries the figure is only between EUR 300 and 500.

Graph 5.- FDI stock/capita in the SEE and the NMS8 countries, 1995-2004 (millions of euros/ECU)



Source: UNCTAD

It seems only the figure of Croatia is comparable with that of the NMS, the per capita FDI exceeded EUR 2000 at the end of 2004. This is the same level as in Slovakia and Slovenia, while higher than that of Poland, Latvia or Lithuania.

Table 9. - Top 5 Investors in some SEE countries

	ALB		BIH		BUL		CRO		ROM	
1	2	3	2	3	2	3	2	3	2	3
1	ITA	47.9	CRO	15.5	GRE	13.3	AUT	25.7	NED	15.5
2	GRE	34.2	SLO	13.6	AUT	11.8	GER	20.7	AUT	12.2
3	MKD	2.2	AUT	13.4	NED	9.0	USA	14.7	FRA	11.1
4	USA	2.0	KUW	9.9	GER	8.7	HUN	6.0	GER	8.0
5	TUR	2.0	GER	9.2	BEL&LUX	8.4	LUX	5.9	USA	6.5

Source: Southeast Europe Investment Guide 2005; 1- Rank, 2- Investor Country, 3- Investor's share (%)

Regarding the most important investor countries in the SEE region, one can find that mainly the neighbouring developed countries are the major foreign investors in the region. The largest investors in the SEE region are

Austria, Germany, Greece, Italy and the Netherlands.

In the larger countries the shares of the largest investor country is between 13% and 26% which is not high and represents a relatively diversified investment portfolio (mainly in case of Bulgaria and Romania).

In the smaller countries the concentration of the foreign investors is higher, which is the consequence of the less investments. Thus, one can find such an “exotic” investor like Kuwait in Bosnia-Herzegovina which reflects well that the major European investor countries avoided these small countries as an investment target.