ICEG European Center

Quarterly Forecast on South-Eastern Europe

Spring

TABLE OF CONTENTS

OVERVIEW

Deceleration of GDP growth in 2005

Economic growth

In 2005 economic growth declined somewhat in comparison with the previous year. The average GDP growth rate of the SEE region in last year was 4.8% which is almost 1%-point lower than that of 2004. Moreover this growth pace is lower by more than 1.5%-points than the average growth of the NMS. Compared to the previous year four out of the seven SEE countries' growth decreased, namely Bulgaria, Macedonia, Romania and Serbia and Montenegro.

One can see that the most significant decline was observable in Romania where GDP growth halved from 8.3% to 4.1%. The main reason for this significant drop was the weak performance of agriculture due to the unfavourable weather conditions in the summer. Floods had the same negative impact on Bulgaria's economy through its agriculture sector in last year. However, the negative effect was lower in case of Bulgaria thus the drop-back was also smaller. In case of Serbia and Montenegro, Serbia reached a relatively good economic growth rate (6.5%), while the smaller republic of the Union performed relatively weakly, thus the performance of Serbia and Montenegro decreased in comparison with the previous year.

The most significant increase in growth was achieved by Croatia where GDP growth rate went above 4% again. In case of Croatia the main engines of the economy were investments and exports, while in case of the aforementioned countries (such as in Bulgaria and Romania) mainly domestic demand (private consumption and investments) fuelled the economy.

The highest growth (5.9%) was achieved by Albania in 2005 in the SEE region, according to our expectations, while the slowest growth was performed by the former Yugoslav Republic of Macedonia (3.5%)

For 2006 we forecast a higher economic growth in the region. According to our expectations GDP growth can reach 5.2% in average. Certainly, these expectations assume more favourable weather conditions in the summer. However, the relatively low base of agriculture sector in the given countries in last year could result in a better economic growth in this year. Besides that, domestic demand, namely private consumption and investments will remain the main engines of most of the economies.

Monetary conditions

Regarding inflation, consumer prices increased more in average in 2005 than in the previous year. Average inflation was 5.4% in last year which is 0.6% higher than that of 2004. In spite of the increase of average inflation rate, inflation is either remained low or disinflation process continued. In three countries (Albania, Bosnia-Herzegovina and the former Yugoslav Republic of Macedonia) inflation was between 0.5% and 2.5% in last year, while inflation was moderate in Bulgaria (5%) and Croatia (3.6%). In these economies inflation will remain on that level or increase slightly except for Bulgaria. In 2006 our forecast is that CPI will increase to 7.5% from 5% due to the increase of administrative prices and indirect taxes.

In Romania disinflation process continued and yearly average consumer price index went under 10% for the first time since transition. However, it is worth mentioning that the National Bank of Romania slightly missed its first ever inflation target (7.5% +/-1%-point) for December 2005, it was 8.6%. For 2006 the target of NBR is 5% with the same range but it seems hardly achievable, our expectation for 2006 annual CPI is 7.5%.

The only SEE country characterised by relatively high and growing inflation rate is Serbia and Montenegro. In Serbia and Montenegro consumer prices increased by more than 15% in 2005. There were several reasons for the increase of CPI (mainly in Serbia), such as the increase of administrative prices, a one-off rise in retail prices caused by the VAT introduction, a soar in world oil prices and heightened aggregate demand. For 2006 a significant drop is expected and CPI can go under 12% in Serbia and Montenegro.

Fiscal developments

General government balance generally improved in the SEE region. In most economies of the region, general government balance had a surplus or only a slight deficit. In Bosnia-Herzegovina, Bulgaria, the former Yugoslav Republic of Macedonia and Serbia and Montenegro budgets had a surplus (0.1%-3.2% of GDP), while budget had only a slight deficit in Romania (-0.8% of GDP).

In Albania and Croatia budget deficit reached 4-5% in last year. In Albania the revenue generation and collection is improving but still vulnerable, while, in Croatia the moderate economic growth and the increasing budget expenditures had a negative impact on the annual budget. It is an interesting fact that despite the introduction of flat tax at the beginning of 2005 general government balance improved in Romania, while the corporate tax rate cut in Bulgaria had no significant negative impact on the balance.

For 2006 we expect that the average general government balance of the SEE region will be the same as last year, it is expected to be -0.7% of GDP. Accordingly, the surplus and low deficit of budgets in the SEE region can help these countries to decrease further their general government debt/GDP ratio in 2006, too.

Balance of payments

The average current account balance per GDP figure changed only slightly. In 2005 the average current account deficit reached 9.6% of GDP while it was 9.7% in the previous year. In five out of the seven SEE countries current account balance deteriorated, namely in Albania, Bosnia-Herzegovina, Bulgaria, Croatia and Romania. The highest widening of the current account deficit was observable in Bulgaria where CA deficit increased from 5.8% to 11.8% of GDP. The deterioration also reached at least 1%-point in Bosnia-Herzegovina, Croatia and Romania. The higher CA balances were mainly due to the widening trade deficits in these countries. The strong domestic demand (consumption and/or investments) boosts import of goods which had a negative impact on current account through trade balance.

In the FYR of Macedonia and Serbia and Montenegro current account balance improved significantly. In both countries the good performance of the export sector, accordingly the improving trade balance had a positive impact on the evolution of current account balance in last year.

For 2006 current tendencies are expected to continue and average CA deficit is expected to grow to 10% of GDP. Small deterioration of CA balance is forecasted in all SEE economies except for Bosnia-Herzegovina and Serbia and Montenegro.

Labour market developments

Unemployment is a key issue in Southeast European countries; the official unemployment rate exceeds 20% on average. Until 2006, there was only one country where unemployment rate was a single digit figure: Romania. Now it seems Bulgaria joined the ‘club’ where unemployment rate decreased significantly in course of 2005. 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 25% 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. On the other hand, the unemployment rate 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	5.7	4.8	5.2
Inflation (%)	4.7	4.8	5.4	5.3
General Government balance/GDP (%)	-2.2	-1.4	-0.7	-0.7
Current Account/GDP (%)	-9.2	-9.7	-9.6	-10.0
Unemployment (%)	21.8	21.6	21.2	20.8

** Preliminary data; ** Forecasts*

ALBANIA

Slight slowdown of the rapid economic growth

Economic growth

The economy's growth continued in 2005, still Albania remains one of the poorest countries in Europe. The large grey economy, the inadequate transportation and energy infrastructure remain major problems in Albania. Approximately 22.8% of the GDP is generated by the agriculture sector, 21.5% by the industry and 55.7% by service sector. From a different approach, it is interesting that according to estimations, in 2005 14% of the country's GDP was generated by workers' remittances and it amounted to EUR 939 million.

Due to the long post-electoral situation last year and the decreased fiscal incentives, the growth of the economy slowed down in the third quarter of 2005. The inadequate electrical energy situation also had a negative impact on the economic activity. Taking all these into consideration, Bank of Albania estimated a smaller growth rate for 2005 than the 6% forecasted level. Likewise in the previous years, in 2005 as well, the economic growth was supported by the private sector's dynamism, more precisely mainly by the construction and service sectors. Concerning the main macroeconomic indicators, the impact of the external factors resulted limited and transitory. For 2006 we expect that economic growth will remain on current level.

Monetary conditions

In the second half of 2005 consumer price growth fluctuated around the lower half of the central bank's inflation target, and by the end of the year the growth rate resulted in 2.4%. High oil prices and certain energy crises were somehow balanced by monetary and fiscal policies and by the strong position of the Lek. In January 2006 annual inflation was 1.4%, and the average annual inflation rate declined to 2.2%, while in December 2005 it was 2.3%.

Due to the government's demand for monetary assets in the third quarter of 2005 and the unexpected cut of interest rate concerning Lek deposits, the banking sector experienced liquidity shortages during July-October 2005. Bank of Albania used monetary instruments (e.g. repo instrument) to handle the problem and by the end of the year the negative impacts were eliminated. As a result of the interventions LEK 12.4 billion was injected to the sector.

Bank of Albania regularly purchased foreign currency in the second half of 2005 and smoothed the appreciating pressure on the exchange rate. In the end of 2005 EUR 1 was equal to LEK 122.58 and in mid-April 2006 it is equal to LEK 122.67. The central bank left the key interest rate unchanged, so up till now the rate is 5%.

In 2005 a rapid money supply growth could be observed, in November the rate was estimated to be 14.3%. Lending to economy was the main factor for using the funds and monetary expansion, and the annual growth rate of credit fluctuated around 70%. In January 2006, mainly due to seasonal reasons, the growth pace of the money supply decreased, and thus the annual growth of currency outside banks was 7.6%. According to the central bank's estimation, credit in foreign currency to private sector is expected to grow by LEK 33.8 billion, while deposits in foreign currency may increase by LEK 24.6 billion is 2006.

Fiscal developments

Fiscal consolidation tendencies continued in 2005 and fiscal incomes and expenditures mainly remained within the parameters of the budget program. This can contribute to macroeconomic stability and the control of inflation. Until November in 2005, 97.8% of the planned revenues were collected, 9.3% more than in the same period of the previous year, while on the other side 93% of the expenditures were realized, which is 3.7% higher compared to the same period in 2004. In ratio to GDP, domestic budget deficit financing decreased, thus reaching its lowest level in a seven years period.

For 2006 the budget expenditures are estimated at 28.7% of the GDP, while in 2005 it amounted to 28.4%. The increase of expenditures favours the growth of capital expenditures in 5.5% of the GDP in 2006, while in the previous year this number was 5.3%. Same as in 2005, budget revenues to GDP are forecasted to be 24.6% in 2006.

Balance of payments

Due to the immense trade deficit, current account deficit continued to remain at a high level in 2005. The further growth of trade deficit can be explained by the rapid increase of import and the slowdown of the pace of export growth. Export of goods amounted to EUR 485.6 million in 2004 and was EUR 530.2 million by the end of 2005. 70% of the annual income of export of goods was represented by active manufacturing, mainly by export of textiles, footwear and base metal. On the other hand, imports amounted to EUR 1762.3 million in 2004 and in the next year this number was EUR 2006.9 million. It is worth mentioning that 24% of the import was generated by imports of machinery, equipment and vehicles. Concerning services, both income and expenditure increased – income was EUR 807.5 million in 2004 and a year later it amounted to EUR 930.4 million, while expenditures were EUR 848.0 million in 2004 and by the end of 2005 they were EUR 1097.5 million. According to estimations made by Bank of Albania in 2005, EUR 692 million of income was represented by tourism services.

Current account deficit was EUR 286.2 million in 2004 and a year later it amounted to EUR 453.7 million. Current deficit was compensated by capital inflows and resulted in a positive balance. Workers' remittances continued to be the most considerable contribution to current transfers in 2005. According to estimations, in the same year, 14% of the country's GDP was generated by these remittances and it amounted to EUR 939 million. By the end of 2005 foreign reserves amounted to EUR 1.2 billion, which is approximately equal with 4.6 months of goods and services import. Purchasing goods and services by non-residents gave 93% of current expenditures, while on the other side 43% of current income was given by current transfers, 32% by export of goods and services and 18% by income. The amount of foreign direct investment flow decreased in 2005 – in 2004 it amounted to EUR 278 million, mainly due to privatization, while in 2005 it was EUR 213 million.

Regarding January 2006, export increased by 1.5% compared to the previous month and it grew by 17.6% compared with January 2005. In the case of import, in January it decreased by 28.8% compared to December 2005, while in comparison to the same month in 2005 it increased with 24.7%. The main trade partners of the country in January 2006 remained Italy and Greece.

Labour market developments

The main structure of the labour market did not change in 2005, so as a result, the public sector still employs 19%, the private non-agricultural sector takes 23% and the private agricultural sector occupies 58% of the total labour force. Unemployment decreased slightly in 2005, thus the official rate was around 14.3%. It must be mentioned, that labour market data are not definitely reliable due to the unrecorded migration of population, the changing ratio of rural and urban population, and the existence of black labour market.

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

	2003	2004	2005*	2006*
GDP growth	5.7	5.9	5.9	5.8
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	2.4	3.0
Unemployment rate (%)	15.0	14.4	14.3	14.0
General government balance/GDP (%)	-5.0	-4.9	-4.7	-4.0
General government debt/GDP (%)	n. a.	55.0	54.0	53.0
Current account balance/GDP (%)	-7.3	-5.3	-5.5	-5.7
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	4.75

Source: National Bank of Albania, INSTAT

** Forecasts*

BOSNIA AND HERZEGOVINA

The first effects of the introduction of VAT

Economic growth

GDP growth rate was 5.5% in 2005 and for 2006 this number is expected to increase and reach 6.0%. Comparing to 2004 the industrial production growth rates increased significantly in both entities - it amounted to 6.1% in the Federation of Bosnia and Herzegovina (FBiH) and to 19.8% in Republika Srpska (RS). The growth of services sector was higher than that of the industrial production. Due to seasonal factors in the last quarter of 2005 the grow of industrial production decreased compared to the third quarter.

In FBiH the growth of mining sector was 5.1%, the growth of manufacturing was 5.5% and the electricity, gas and water supply's growth was 3.6% in December 2005 compared to December 2004. In the same period in RS the mining sector decreased by 15.1% and the electricity, gas and water supply decreased by 13.2%, but on the other hand manufacturing industry grew by 23.1%.

In FBiH high growth rates were recorded in the following branches: exploitation of metal ore 479.2%, textile production 32.5%, production of clothes 26.9%, production of cellulose, paper and paper products 27.0%, production of rubber and plastic products 23.0%, metal production 37.7% and production of electrical machinery and tools 53.2%. At the same time the production decreased in the following branches: food and beverages 13.3%, production of tobacco products 18.5%, production of coke and oil derivatives 15.4%, production of chemicals 6.0%.

In RS growth rates in the production were recorded in the following branches: production of tobacco products 94.3%, production of leather and leather products 159.7%, production of rubber and plastic products 98.4%, production of furniture and similar products 125.0%. In the same period the production decreased in the following branches: exploitation of other ores and stone 43.8%, production of coke and oil derivatives 82.3%, production of other machines and devices 33.5%.

Monetary conditions

In 2005 the growth of consumer prices was 2.1%. The introduction of VAT in the beginning of this year caused a significant growth of consumer prices in the first month. Retail prices increased by 4.3% in January 2006 compared to December 2005. In February the index decreased by 0.1% compared to the previous month. If we compare prices in January to the corresponding month of 2005 we can see a growth of 7.6%, while in February it increased by 7.2% compared to February 2005. Comparing the two entities, it can be stated that in RS retail prices grew more sharply – in January 2006 it increased by 9.5% compared to the same month in 2005, while in the Federation this index was 6.7%. In January the prices of the agricultural products showed the highest growth compared to December 2005 – 8.1% in RS and 8.4% in the Federation. It is expected that after the first impact on prices of the VAT introduction, the growth of consumer price will get milder and by the end of this year the annual growth will amount to 2.5%.

Bosnia and Herzegovina operates with currency board arrangement, the exchange rate is the following: EUR 1 = KM 1.95583. At the end of February 2006 the central bank's total assets and liabilities amounted to KM 4,401,226,292. Net foreign assets exceeded its monetary liabilities by KM 193,907,947, foreign currency reserves continued the growing trend.

In the fourth quarter of 2005 monetary aggregate M1 increased by 5.8%. Certain structural changes can be observed here, due to the fact that non-cash transactions are replacing traditional cash payments. Due to the strong increase of the monetary base M2 grew as well, in the fourth quarter by 5.2% and specifically in December the highest growth of the year could be observed, 3.3%.

One important characteristic of the country's economy is the high level of the credit growth and in 2005 this rate increased by 29%. Total debt of citizens at commercial banks amounted to KM 3.45 billion, household use the loans mainly to finance their spending, while importers to pay for the growing imports. All this may be partly explained by the introduction of the VAT and thus the increased consumption in 2005. The structure of the loans was the following: citizens 48%, private companies 46%, public enterprises 3%, others 3%. Short-term loans increased by 12% and thus, amounted to KM 1.7 billion by the end of 2005, while long-term loans grew by 23% and amounted to KM 4.8 billion. In September of 2005 citizens' savings increased by 22% compared to the end of 2004 and amounted to KM 2.9 billion.

Interest rates continued to decrease, so as a result by the end of 2005, interest rate on short-term loans for enterprises fell by 89 bp compared to the previous year, while in the case of long term loans this number was 53 bp. Moreover, as a result of the increased inflation rate, the real interest rate was even lower.

According to the decision of the central bank, in December 2005 the required reserve rate increased by 5% to 15%. The aim was to slow the growth of the banks' lending. Timely all banks met the new requirement and there was no disturbance in the sector. On the amount of the required reserves rate of remuneration is 1%.

Fiscal developments

The adoption of the budget for 2006 was transferred to the first quarter of 2006 in both entities, so as a result financing from the budget in the beginning of this year is carried out on the basis of temporary decisions. Although official data is not published yet, it is likely that VAT collection is successful and is over expectations.

In the first nine months of 2005 the state-level, FBiH and RS budget showed consolidated surplus, while some extra-budgetary funds recorded deficit. On the state-level, current revenues amounted to KM 4496.8 million, which is 11.0% higher compared to the same period in 2004. Current expenditures were KM 3861.1% in the first nine months of 2005 and were 7.2% higher than in 2004. Non-financial transactions were mostly related to net funding of fixed assets purchase (83.6%) and amounted to KM 111.9 million.

In FBH in the first nine months of 2005 revenues were KM 2955.2 million, which are 8.5% higher compared to the same period in the previous year. Expenditures amounted to KM 2537.7 million, 2.9% higher than in January-September 2004. In the other entity, RS, in the first nine months of 2005 revenues amounted to KM 1158.5 million, which was 5.5% higher compared to the same period of the previous year. In RS the performed expenditures were KM 1027.7 million in the first three quarters of 2005, which was 2.1% more than in January-September 2004.

Balance of payments

In the last two months of 2005 imports were record-high, while exports as well continued the growing trend. In the fourth quarter of 2005 imports grew by 16.1%, while exports by 7.7% compared to the third quarter of 2005. If we compare this period to the forth quarter of 2004, we can see exports increased by 20.2% and imports by 23.9%. Imports coverage by exports was 31.1% in the last quarter of 2005, which was the worst compared to the other quarters of the year. In the fourth quarter foreign trade deficit amounted to KM 2.5 billion and thus was higher by 25.6% compared to the fourth quarter of 2004. Mainly the following reasons caused the growth of trade deficit: the announcement of the introduction of the VAT from 2006, seasonal influences and the prices of the imported energy. It is expected that in the first quarter imports will decrease.

In the third quarter of 2005, current account deficit grew by 1.2% compared to the same period of 2004, while compared to the previous quarter of 2005 the deficit slightly decreased and mounted to KM 868 million. The large trade deficit is the main reason for current account deficit. Current transfers including private remittances from abroad are important debiting items in the current account. The balance of capital account amounted to KM

187 million, the financial account to KM 210 million and other investments to KM 451 million in the third quarter of 2005. Although with a weaker intensity, but foreign direct investment (FDI) inflow continued in 2005, mainly due to the inflow for the banking sector. In the third quarter FDI inflow was around KM 109 million. The total balance of foreign debt for the county’s government sector amounted to KM 56 million by the end of 2005, 6.3% higher compared to 2004 (contracted but non-disbursed funds – KM 847.7 million - and the optional debt to the London Club – KM 436 million - are not included). The total of 230.5 million for servicing foreign debt was paid by the end of 2005.

Labour market developments

According to the unreliable official data unemployment rate is over 40%, which is the highest in the region. In 2005 it was around 41.5% and for this year 42.5% is expected. Due to the immense size of the grey economy the real unemployment rate is estimated to be around 20%. The tendency of the decreasing number of unemployed changed in 2004, when the unemployment rate grew by 0.9% and amounted to 21.5%. The privatization process may have negative impact on employment.

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

	2003	2004	2005*	2006*
GDP growth	3.0	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	24.0	20.0
Import (%)	6.0	7.6	13.6	12.0
Retail price index (average, %)	0.1	0.2	2.1	2.5
Unemployment rate (%)	40.5	40.5	41.5	42.5
General government balance[1] (%)	0.4	-0.1	0.1	0.3
General government debt/GDP (%)	34.0	32.8	32.0	31.8
Current account balance/GDP[1] (%)	-24.5	-23.3	-24.4	-22.6
Trade balance/GDP (%)	-58.4	-53.3	-53.1	n.a.
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

Sound economic growth with increasing inflation

Economic growth

In the final quarter of the previous year, Gross Domestic Product (GDP) increased by 5.5% which was significantly higher than that of the previous quarter (4.6%). It resulted in a 5.5% annual increase of GDP in 2005, which is slightly lower than our previous expectations (5.7%).

On the production side, both industry and services sectors reached high growth pace, gross value added of the two sectors increased by 7.3% and 6.6% respectively in course of 2005. On the other hand, the performance of agriculture sector was weak, gross value added of the sector decreased by 8.6%. The drop of the gross value added of agriculture sector decreased the GDP growth by 0.8%-point according to our calculations, which means that even if the sector had reached a slight growth, GDP growth rate would have been around 6.5% in last year.

On the demand side, private consumption and investments fuelled the economy in the last year too. Private consumption growth reached 7.4% in course of the year, while that of the public consumption remained moderate (2.2%). Gross fixed capital formation also increased by 19%. In 2005 gross fixed capital formation reached 23.7% of GDP which is 3%-points higher than that of the previous year. It reflects well the significant role of investments in the economic growth. On the other hand, net exports had a massive negative impact on GDP growth in 2005 due to the significant deterioration of the trade balance.

In 2006 the sound growth of the Bulgarian economy is expected to continue and GDP growth rate can reach 6.0% if weather conditions will be favourable, while private consumption and investments are expected to remain the main engines of growth.

Monetary conditions

In December 2005 CPI decreased slightly compared to the previous month, consumer price index was 6.5%. Accordingly, annual average CPI reached 5.0% in last year due to the lower average of the first half of the year.

In the first quarter of 2006 inflation went up and reached 8.7-8.8% in February and March. The main reason for the significant growth of consumer price index is the further increase of administrative prices and indirect taxes. In February the prices of alcoholic beverages and tobacco increased by 46.6% in comparison with the previous month. This increase had a significant negative impact on CPI in February, it increased monthly CPI by 2.3%-point, while total monthly CPI was 3.0%. It reflects well that even if this consumer group has relatively small weight (4.9%) in consumer basket this measure had a significant negative effect on consumer prices.

As a result of the increasing consumer price index, the National Bank of Bulgaria increased its base interest rate. At the end of the last year base rate was 2.05% while it increased to 2.48% in April 2006 in line with the rising inflationary pressure.

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

Fiscal developments

In 2005 the surplus of the consolidated budget was higher than we expected in our previous Quarterly Forecast. Consolidated budget surplus reached 3.2% of GDP due to the large surplus of primary balance. The surplus of primary balance reached EUR 1 billion or 4.8% of GDP. The good result was mainly due to the higher than planned VAT revenues.

In the first two months of the year consolidated budget remained in green, the surplus was EUR 75 million or about 2.0% of estimated GDP of this period. For 2006 we expect that general government balance will have a surplus due to the robust growth of the economy and the tight fiscal policy. For the whole year we forecast a surplus of 1.5% of GDP.

The massive amount of the budget surplus and the rapid economic growth supported the further decline of the general government debt. At the end of 2005 the public debt decreased to 31.9% of GDP. In 2006, the same tendencies will continue, accordingly the public debt is expected to decrease further, and it can go below 30% at the end of the year.

Balance of payments

In the fourth quarter of 2005 the deterioration of the current account balance continued. In course of the year the current account deficit reached EUR 2.5 billion. It means the CA deficit increased by EUR 1.4 billion or 123.7% compared to 2004.This massive worsening of the CA deficit is basically due to the deterioration of trade balance. Trade deficit increased to EUR 4.4 billion or 20.4% of GDP which reflects well the negative impact of the strong domestic demand.

Regarding the other components of the CA balance, the surplus of services balance decreased while, the balances of current transfers and incomes improved slightly However, the progress of these elements played a less important role in the development of the current account balance.

In line with the increasing CA deficit FDI inflows decreased to EUR 1.8 billion in 2005. In 2004 net FDI inflows reached EUR 2.7 billion which was able to finance the current account deficit easily. In 2005 net FDI reached 'only' 70.7% of current account deficit.

In the first two months of the year the deterioration of current account balance continued and CA deficit reached EUR 661 million. In the same period of 2005 the CA deficit was 'only' EUR 370 million. For the entire year we expect that these tendencies will continue and current account deficit can reach 15% of GDP due to the worsening trade balance.

Labour market developments

Regarding the labour market the positive trend continued in the last quarter of 2005. As a result, employment rate increased to 44.7% from 43.7%. the number of employed people increased by almost 58 000 and the total number reached almost 3 million.

In line with the aforementioned process unemployment rate decreased significantly. The unemployment rate declined by almost 2%-points in comparison with the previous year. This rate is the lowest in the last ten years. Youth unemployment rate also decreased significantly, from 25.8% to 21.6%, while long-term unemployment went up by 0.4%-point to 59.7%.

For 2006 the decline of unemployment rate and the increase of the number of employed persons are expected due to the strong economic growth. We forecast that unemployment rate will decrease to 8.5% in 2006.

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

	2003	2004	2005	2006*
GDP (%)	4.3	5.7	5.5	6.0
Private consumption (%)	6.4	4.5	7.4	7.0
Public consumption (%)	7.3	6.0	2.2	6.0
Investments (GFCF, %)	14.0	12.0	19.0	15.0
Exports (%)	8.0	13.0	7.2	8.0
Imports (%)	15.0	13.0	14.6	12.0
Consumer price index (average, %)	2.3	6.2	5.0	7.5
Unemployment rate (%)	13.5	12.0	10.1	8.5
General government balance (%)	0.0	1.7	3.2	1.5
General government debt/GDP (%)	48.2	40.7	31.9	27.0
Current account/GDP (%)	-9.2	-5.8	-11.8	-15.0
Trade balance/GDP (%)	-12.5	-15.1	-20.4	-22.5
Gross foreign debt/GDP (%)	60.7	64.2	67.7	70.0
Exchange rate (BGN/EUR)	1.96	1.96	1.96	1.96
Base rate (%)	2.6	2.7	2.0	2.4

*Source: BNB, NSI; * Forecasts*

CROATIA

Better than expected growth with contradictory sub-market performances

Economic growth

Economic growth of Croatia shows high volatility as after 4.7% average growth rate of the period 2001-2003 and after 3.8% real GDP growth of 2004, 2005 brought a quite remarkable performance despite of slight start in the beginning of the year. This means by quarterly division 1.8%, 5.1% and 5.2% respectively in the first three quarters of 2005. The fourth quarter's real GDP growth of 4.8% developed the annual real GDP performance based on the quarterly estimates to 4.3%, that is far over expectations.

The industrial growth contributed considerably to the annual growth in 2005 by its 5.1% accelerated pace. This industrial performance was underpinned by 4th quarter 6.2% growth. The periods accelerated industrial growth was driven mainly by manufacturing industry (food and beverages 6.9%; publishing, printing 15.8%; chemicals and chemical products -1.9%) with a 6.5% seasonally adjusted annual rate, while mining and quarrying and electricity-gas supply performed negative development, 3.0% and 1.1% decline respectively. By other grouping the main pulling factors were capital goods, intermediate goods and non-durable goods with above average rates.

The annual growth rate of retail trade slowed down from 6.0% in the second quarter to 2.7% in the third and 2.1% in the fourth quarter. In real terms the annual growth of retail trade turnover reached 2.8%. The tourism sector outperformed higher cumulative growth rates in 2005 as compared with 2004. The cumulative growth rate of tourist overnight was 2.5% in 2004, while in 2005 this index reached 7.6%. In 2005, by 6.2% more tourist arrivals were registered.

Having a look on composition of real GDP growth development on expenditure side, the main pulling contributors in the last quarter of 2005 were the 9.9% rise in gross fixed capital formation and the 4.9% increase in export activity parallel with less adjusting government consumption 1.4%, showing the favourable growth composition of Croatian economy.

In line with wage developments of first months of 2006, a stronger contribution of final consumption is expected in current year boosting domestic demand. The external demand is expected to improve, as the EU and especially Germany, France and Italy is forecasted to grow more rapidly, thus the exports contribution will back stronger growth performance that will be moderated by consumption driven import rise. 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.

In 2006 growth is forecasted to accelerate to 4.6%, based mainly on stronger investment dynamics, on further privatisation and enterprise restructuring, generally strong export performance and rising private consumption.

Monetary conditions

In line with our previous estimation on CPI growth, the year-on-year rate of change reached 3.6% that is 0.6 percentage points higher as compared with our estimation but reflects as well acceleration trend driven mainly by continuous adjustment of administrative prices (annual core inflation for the same period reached 3%) and the oil price increase. The stable exchange rate and the tight income policy through wages managed to keep the inflation rate relatively moderate. Nonetheless, as it is inevitable to adjust real wage growth to the productivity growth and the administrative prices adjustment is to continue, further acceleration in inflation is expected to the annual level of around 4.5% in 2006, not mentioning the world wide increasing inflation pressures effecting imported inflation.

Related to managed floating exchange rate developments, CNB managed to keep stable the Kuna against the Euro during 2005, despite of several need for intervention on forex market against the appreciation pressure. In 2006 no remarkable change in the exchange rate of the Kuna is expected and the Euro will fluctuate around 7.3-7.4 Kuna. However, slow appreciation has to be realized that can resulted in the end of the year in a 7.30 HRK/EUR exchange rate.

Fiscal developments

As can be seen in the fourth quarter growth composition, the final consumption of government is on an accelerating pace with its 1.4% quarterly and 0.8% annual rise as compared to 2004

Nevertheless the general government deficit has been managed to reduce from 5.0% of GDP in 2004 to estimated 4.2% in 2005 that data is in line with our previous expectations.

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.

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

Balance of payments

The current account deficit of Croatia has widened sharply in 2005 as compared to 2004 because of widening deficit of trade balance that was only partially offset by well performing services balance backed by strong tourism sector season realized in third quarter of 2005.

The trade balance will keep its high level as compared to GDP despite of above import growth accelerating exports, but it will decrease slightly. As regarding to total current account balance, it depends on performance of service and mainly on tourism sector performance. Taking into consideration the favourable growth expectations the current account balance will be on around 6.5% as compared to GDP and the trade balance on 23%.

Labour market developments

Though, the unemployment rate on downturn trend since the end of 2001, in January 2006 the registered unemployment rate reached 18.4%, and 18.3% in February, after a slight decline in the fourth quarter of 2005 to 18%. Developments of first two months of 2006 are in line with cyclical reasons. As regarding employment the total employment stagnated by the weak 0.2% growth during the 2005 year. According to recent labour force survey data, the unemployment rate declined to 13% by the end of the year as compared to 13.8% in the end of 2004.

As of wage developments, the average real gross wages in the 4th quarter of 2005 grew by 0.9% and by 1.2% as for the average for 2005 as a whole. This is a 3 percentage point slower growth as compared with 2004. The beginning of the year 2006 started with remarkable real wage increase as the annual growth rate of real wages was 2.2% in the end of January 2006 mainly due to some correction of wages to productivity growth paces after tight income policy of previous times.

The improvement of labour market conditions is continuing, that is in line with growing labour demand originated from increasing foreign capital attraction, capacity building in industry and tourism sectors, the acceleration of real GDP growth rates and the results of reforms aimed on more flexible system.

Taking into consideration favourable trends in the labour market, by our estimation the employment will increase in a moderate pace, while unemployment will follow a more spectacular declining performance by 0.5 percentage points, reaching 17.5% as for registered rate and 12.5% as for ILO surveyed data. However the pressure from the employee side to adjust wages to far faster productivity growth can influence this expectation negatively.

Table 5. Major macroeconomic indicators for Croatia 2003-2006

	2003	2004	2005	2006*
GDP growth (%)	4,3	3.8	4.3	4.6
Private consumption (%)	4.1	3.9	3.4	4.3
Public consumption (%)	-0.3	-0.3	0.8	0.4
Investments (%)	16.8	4.4	4.8	6.0
Export (%)	10.1	5.4	4.6	6.5
Import (%)	10.9	3.5	3.5	6.0
Consumer price index (average, %)	1.8	2.1	3.6	4.5
Unemployment (%)	14.3	13.8	13.0	12.5
General government balance (%)	-6.3	-5.0	-4.2	-3.8
General government debt/GDP (%)	51.5	54.0	53.5	53.0
Current account balance/GDP (%)	-6,9	-5.2	-6.3	-6.5
Trade balance/GDP (%)	-27.5	-25.5	-25.0	-23.0
Gross foreign debt/GDP (%)	77.6	82.5	82.5	80.0
Exchange rate on December 31 (HRK/EUR)	7.64	7.67	7.37	7.30

*Source: Croatian National Bank, DZS; * Forecasts*

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Improving external balance and employment figures

Economic growth

In the third quarter of 2005 gross domestic product increased by 3.9% compared to the same period of previous year. The highest growths of value added were registered in case of industry sector (+5.9%), wholesale and retail trade (+8.6%), hotels and restaurants (+7.0%) and transport and communications (+8.0%) sub-divisions of services in the third quarter of last year.

In the third quarter of 2005 industrial production increased by 6% which also reflects the relatively good performance of the sector. In course of the year the growth of industrial production was even higher, it reached 7.0%. Among industrial sub-sectors manufacturing had a major role in the good performance. In 2005, production of manufacturing increased by 7.3% in comparison with 2004. On the other hand, production of mining and quarrying rose by 40% compared to the previous year. In January 2006 industrial production growth decreased significantly to 1.8%.

Due to the fact that GDP growth in the third quarter was slightly higher than we expected and the good performance of industry continued in the fourth quarter, we increased our forecast for GDP from 3.5% to 3.8%. For 2006 we expect that GDP growth will decrease slightly in comparison with 2005 figure, it can reach 3.5%.

Monetary conditions

Not surprisingly, Consumer Price Index (CPI) remained close to zero in last year. In 2005 annual average CPI was only 0.5%. In course of the year the highest increase was observable in case of tobacco (+10.9%), liquid fuel (+21.5%), fuels and lubricants for personal transport equipment (+14%), while the price of audiovisual, photographic and information processing equipments decreased mostly, by almost 9%. In conclusion price stability characterised the economy of the former Yugoslav Republic of Macedonia in 2005.

In January 2006 tobacco prices increased by 36.9 thus CPI rose by 1.7% compared to the previous month. On annual basis (jan/jan) the growth reached 2.8% that is significantly higher rate than the average of the previous period. It also means that CPI is expected to be higher in 2006 than it was in last year. According to our expectations consumer price index can reach 1.2% in 2006, which can be still considered as low.

Fiscal developments

In last year general government budget had a slight surplus. General government surplus reached EUR 9.4 million or 0.2% of estimated GDP. The better than expected balance is due to the higher-than-expected tax revenues (mainly in case of profit tax and VAT), and due to the lower-than-planned expenditures. In the first version of the budget government planned that general government deficit would reach EUR 55 million that was revised and decreased to EUR 23 million. Finally general budget had a surplus due to the aforementioned factors.

It is worth mentioning that general government budget had a surplus of EUR 42 million which means that expenditures increased significantly in the last month of the year and exceeded revenues by EUR 33 million.

Despite the surplus of the budget, general government debt has not decreased in 2005. At the end of the year it reached EUR 1950 million or 44% of GDP according to our expectations.

In 2006 the process will continue and general government deficit is expected be in equilibrium, while general government debt can be decreased by 1%-point to around 43% at the end of the year.

Balance of payments

In 2005 the current account deficit was EUR 65.45 million or 1.5% of GDP. This ratio is much lower than that of the previous year when current account deficit reached almost 8% of GDP. The improvement of the CA balance is basically owing to the rapid growth of export and the significant increase of current transfers.

Regarding the trade balance the growth rate of export overpaced that of import. While the growth of export of goods reached 21.9% that of import was ‘only’ 11.1%. Thus, the decrease of the trade deficit had a significant positive impact on the positive evolution of the current account. Besides trade balance, the balance of services also improved slightly (by 37.8% or EUR 16.5 million), while income balance worsened somewhat.

As it was mentioned the balance of current transfers also improved a lot in 2005. Its growth rate reached 34.5% or EUR 219.5 million. It is worth mentioning that net current transfers were reached almost 20% of GDP in last year, which reflects well the importance of current transfers in Macedonian economy.

Despite the fact that the amount of foreign direct investment inflow decreased significantly in 2005, FDI was able finance the deficit of current account balance. In last year FDI was EUR 78 million which is significantly lower than last year’s data (EUR 125 million).

In 2006 further improvement is expected regarding balance of payments. We expect that the growth of export will overpace that of the import again while current transfers will also play an important role in the development of current account. We expect that current account deficit will reach 3% of GDP while trade deficit can decline to 18%.

Labour market developments

In the fourth quarter of 2005 positive trend continued on the Macedonian labour market. In the last quarter the activity rate increased to 54.6%, which is 4.3%-points higher than that of the last quarter of 2004. In line with that employment rate also increased from 31.25 to 34.6% which means that the number of employed workers increased by more than 57 000 workers.

Despite the positive trend unemployment is high in the former Yugoslav Republic of Macedonia. In the last quarter of 2005 unemployment rate reached 36.5% though it decreased by 1.5%-points compared to the same period of the previous year.

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.

For 2006 we forecast that current trend will continue and activity rate and employment rate will increase gradually. As a result unemployment rate will decrease and it can go under 36% at the end of the 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	21.9	15.0
Import (%)	-2.5	12.4	11.1	10.0
Consumer price index (average,%)	1.2	-0.4	0.5	1.2
Unemployment (%)	36.7	37.2	36.5[Q4]	36.0
General government balance (%)	-1.0	0.0	0.2	0.0
General government debt/GDP (%)	45.0	44.0	44.0	43.0
Current account balance /GDP (%)	-2.9	-7.7	-1.5	-3.0
Trade balance /GDP (%)	-16.4	-20.6	-19.3	-18.0
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	61.2
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

Acceleration of GDP growth is expected in 2006

Economic Growth

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

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

It is also worth mentioning that industrial production was also weak in course of 2005, the sector registered a growth of 2.0% in comparison with 2004. In case of manufacturing production the growth rate reached 2.5%. The growth of industrial production declined significantly in the second part of the year. In the first quarter of the year industrial output reached a growth rate of 5.3% which declined to 3.0% in the first semester and to 1.5% in course of the first three quarters of the year.

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

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

As a result of strong consumption and investments imports of goods and services reached a high growth (+17.2%), while that of the exports reached 7.6% in 2005. Net exports had a negative impact on GDP growth in last year. These tendencies were in line with our previous expectations.

For 2006 we expect that the Romanian economy will gain some momentum, however the encore of the performance of 2004 is not expected in this year. We expect that GDP growth can reach 5.5%, while consumption and investments will fuel the economy on the demand side. On the supply side, we expect that the role of industrial sector will increase in this year compared to 2005, while agriculture sector can also reach a good performance considering the low basis of 2005, if the weather conditions will be favourable.

Monetary conditions

In 2005 average annual consumer price index (CPI) decreased to 9%, which was completely in line with our previous expectation. That was the first year after transition when annual average CPI declined under 10% and became a one-digit figure. However, the disinflation process slowed down somewhat, CPI reached 11.9% in the previous year or that means CPI decreased by 3%-points.

As we have predicted in our previous forecast, the central bank slightly missed its (first ever) inflation target for 2005. The NBR’s target for dec/dec inflation was 7.5% with a +/-1%-point range, while CPI was 8.6% in December 2005. For 2006 the target was set at 5%. Now, in the first quarter of the year it seems that this low target is hardly achievable. In the first two months of the year, CPI reached 8.9% and 8.5% respectively. It is not surprising that the central bank increased its reference rate from 7.50% to 8.47% at the beginning of March 2006. We expect that the target will be revised in course of the year particularly if we consider the planned increases in administrative prices.

For 2006 we forecast that annual average CPI can reach 7.5%, the NBR's current target seems to be unachievable. In course of the year further increase of reference rate can be expected if CPI will not decrease at the adequate pace.

Fiscal developments

In 2005 general government deficit reached 0.8% of the GDP according to preliminary data. It means fiscal deficit decreased by 0.3%-point of GDP compared to the previous year. The higher-than-planned indirect tax revenues and cuts in capital expenditures supported the improvement of the budget, while according to calculations the introduction of flat tax in 2005 resulted in an about 1% of GDP revenue loss through the decrease of personal income tax and corporate profit tax revenues.

It is also worth mentioning that the budget still had a significant surplus (1% of GDP) at the end of November as we wrote it in our previous forecast. It means that the surplus turned to deficit only in December that reflects that fiscal policy eased significantly in the last month.

At the beginning of 2005 taxation changed significantly, flat tax was introduced. At the beginning of January 2006 further changes were implemented in taxation such as the decrease of the social security contribution rates. These reforms improve the business climate of Romania but it has a negative impact on budget balance.

For 2006 the budgeted deficit is 0.5% of GDP. We forecast that the budget balance will remain low but the general government deficit can reach 1% of GDP in 2006.

Balance of payments

In 2005 current account balance worsened further. In last year C/A deficit increased to EUR 6891 million from EUR 5099 million in 2004. It means current account deficit went up by 35% and it reached 8.7% of GDP.

The worsening of the current account balance is mainly due to the widening of the trade deficit. The foreign trade deficit increased by 46.6% in 2005 that reflects well the significant impact of domestic demands on foreign trade. In line with that the balance of services also worsened significantly, the deficit increased from EUR 213 million to EUR 434 million. On the other hand, the other two elements of current account (incomes balance and current transfers balance) improved somewhat in course of 2005 but these two elements were able to counterbalance only partly the huge deficit of trade balance.

It is worth mentioning that the Romanian currency, the Leu appreciated significantly against the euro from the beginning of the year. During the first two months of the year Leu appreciated by more than 5% and reached its peak at 3.47 rate. In the second part of March it depreciated back to around 3.50. This significant increase has no positive impact on the export sector.

For 2006 we expect that current tendencies will continue and current account deficit can reach 9% of GDP. Trade deficit can reach 11% of GDP owing to the strong domestic demand expected in 2006.

Labour market developments

The number of registered unemployed persons increased slightly in the last quarter of 2005 but unemployment is not a problem in Romania. In December unemployment rate was 5.9% and it increased to 6.2% in January 2006. However, this figure was lower by 14 000 than that of January 2005. In 2006 the current situation is expected to remain only a slight decrease is expected in course of the year.

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

	2003	2004	2005	2006*
GDP growth (%)	5.2	8.3	4.1	5.5
Private consumption (%)	7.2	10.8	9.0	9.0
Public consumption (%)	4.6	4.6	3.0	2.0
Investments (GFCF, %)	9.1	10.1	13.0	10.0
Exports (%)	11.4	14.1	7.6	10.0
Imports (%)	16.4	17.8	17.2	15.0
Consumer price index (average,%)	15.3	11.9	9.0	7.5
Unemployment (%)	6.8	7.1	5.8	5.6
General government balance (%)	-2.3	-1.1	-0.8	-1.0
General government debt/GDP (%)	21.3	18.5	19.0	19.0
Current account balance /GDP (%)	-6.0	-7.5	-8.7	-9.0
Trade balance /GDP (%)	-7.8	-9.0	-10.4	-11.0
Gross foreign debt /GDP (%)	31.1	30.7	32.0	33.0
Exchange rate (RON/EUR) **	3.76	4.05	3.62	35.0
Reference rate (end of year, %)	21.25	17.96	7.5	8.0

Sources: EC, NBR, own calculations

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

SERBIA AND MONTENEGRO

Economic activity stronger than expected in 2005, while external imbalances and high inflation persist

Economic growth

Economic growth in Serbia in 2005 exceeded expectations, and real GDP growth rate reached 6.5% year-on-year. Economic growth is expected to remain strong in 2006 as well in the larger republic. At the same time a contraction in economic activity was experienced in Montenegro, which mainly took place in the first half year. However a recovery started in the second half year. Strong tourism activity, increases in real wages, domestic demand driven by rapid credit growth and large remittances were the driving factors behind growth in Montenegro. Overall the real GDP growth rate in the smaller republic reached 4% in 2005. It is expected to remain around 4% in 2006 as well. Real GDP growth rate for the union as a whole reached 5% in 2005.

The main driving force behind economic growth in Serbia in 2005 was the trade and services sector, while structural adjustment in the economy also made a significant contribution to growth through increasing the value added per product units. In 2005 the greatest rise in industrial production was experienced in the sector of production and distribution of electricity, gas and water (6.6%), and in extractive industry (2.1%). At the same time the production in the processing industry dropped by 0.7%. Looking at the branches of the processing industry, there was a high increase in the production of motor vehicles and trailers (20.3%), mostly sold in the domestic market. However production of office machinery and computers and the production of machines and appliances apart from electrical ones experienced a steep fall (74.4% and 39.1% respectively).

Monetary conditions

Inflation was high in Serbia in 2005. Retail prices rose by 17.7% year-on-year. The main contributing factors to the retail price rise were the increase of administrative prices (prices of electricity, public utility and other services), a one-off rise in retail prices caused by the VAT introduction, a soar in world oil prices, and heightened aggregate demand. A steep rise was also experienced in the case of agricultural products prices, as a result of bad yields in agriculture. Strong domestic demand also contributed to high inflation in 2005. The depreciation of the dinar against the euro had a strong influence on inflation as well. Core inflation was higher than in the previous year, reaching a 14.5% year-on-year rise at the end of the year (11.5% in 2004).

Inflation in Serbia is expected to decline to 11.5% by the end of 2006. The factors that could contribute to driving inflation higher than this forecast are persistently high oil prices, prevailing inflation inertia, and high money supply (M1) growth, which reached 30% in 2005. Inflation reached about 3% in Montenegro in 2005. In 2006 a slight rise is expected, to 3.6%.

Fiscal developments

In 2005 the Serbian budget closed with a surplus, which reached 1.5% of GDP. The 2006 budget also forecasts a surplus of 2% of GDP. The revenues from the newly introduced VAT were higher than projected, reaching CSD 215 billion, which represents a 61% increase compared to revenues of the turnover tax (the tax which was replaced by the new VAT). However the clearance of pension arrears in December required a reduction in the fiscal surplus target. Public debt as a percentage of GDP was reduced to 46.2% of GDP in 2005 in Serbia, from 56.6% of GDP in 2004.

In 2006 fiscal adjustment is expected to take place in Serbia. The planned CSD 10 billion surplus is to be achieved through adjustments in the Republican Budget, and the Health Insurance Fund.

In Montenegro VAT revenues exceeded forecasts in 2005. The structure of spending was shifted to infrastructure investment. At the same time overall expenditure limits were achieved. Privatisation revenues helped to lower the level of public debt.

Balance of payments

In 2005 in Serbia the current account deficit as a percentage of GDP reached 8.5%, which is an improvement compared to 2004, when it reached 12.6%. In the union as a whole the current account deficit reached 10.2% of GDP in 2005, which is also a reduction compared to its 2004 level (when it reached 14.8% of GDP). However negative net exports are still one of the most serious problems faced by the economy of Serbia and Montenegro. Unresolved structural problems in the economies of the republics are the factors that are responsible for the large trade deficit. In Serbia, in euro terms exports of goods reached the value of EUR 3,742 million, while the import of goods equalled EUR 8,221 million. This represents a 20.9% year-on-year increase of exports, while the import of goods increased by 11.1% compared to 2004. A rebound of exports is observable since mid-2004. The main driving forces behind this development were the strong dollar and the strong investment in export-oriented, privatised companies. The import of goods to the export of goods ratio was 45.5% in Serbia, higher than in the previous year, when it reached 35.9%.

In 2005 Serbia's regular servicing of interests to creditors resulted in a net outflow that was 37.5% higher than in the previous year. The deficit of the balance of goods and services, and interests payments were mostly offset by receipts from current transfers. In 2005 the mentioned deficit was offset by net inflow of funds from current transfers to a larger extent than in 2004.

In Montenegro strong revenues from tourism contributed to the reduction of the current account deficit in 2005. At the same time oil and aluminium price developments in the world market contributed to the deterioration of the trade balance. FDI continued to be strong, especially in the telecom and tourism sectors.

Labour market developments

In 2005 the unemployment rate reached 27% is Serbia, which is a rise compared to 2004, when it reached 26.1%. The number of employees reached 2.7 million in September 2005, while the number of the unemployed amounted to 1 million in the same month. However official data does not include unregistered employees. Therefore the unemployment rate could be much lower in reality. According to a survey conducted in 2004, unemployment in reality reached 18.5%.

Average annual wage growth in Serbia was 23.4% in 2005, which corresponds with the wage growth rate experienced in 2004. At the same time the growth rate of real wages slowed from 10.4% in 2004 to 6.2% in 2005. This broadly correlates with the estimated productivity growth in the economy as a whole.

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

	2003	2004	2005	2006*
GDP growth (%) Serbia & Montenegro	2.7	7.2	5,1	5.0
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 (%) Serbia	33.7	30.7	20.9	22.0
Import (%) Serbia	32.9	44.5	11.1	10.0
GDP growth (%) Serbia	2.4	9.3	6.5	6.0
GDP growth (%) Montenegro	2.3	3.1	4.0	4.0
Consumer price index (average, %)	9.7	10.9	15.2	11.5
Retail prices (% p.a.) Montenegro	7.8	3.3	3.0	3.6
Retail prices (% rel. to end of last year) Serbia	7.8	13.7	17.7	11.5
Unemployment rate (%) Serbia	26.1	26.1	27.0	26.7
General government balance (% of GDP) Serbia	-1.4	-0.1	1.5	2.4
General government debt/GDP (%) Serbia	71.6	56.6	46.2	43.2
Current account balance/GDP (%) S&M	-7.4	-13.4	-8.7	-7.6
Trade balance/GDP (%)	-24.1	-28.0	-25.0	-22.0
Gross foreign debt/GDP S&M	69.9	63.3	57.2	58.9
Average exchange rate (CSD/EUR)	65.1	72.6	83.4	88.4
Base rate	9.0	8.5	8.5	9.0

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

** Forecasts*

CEFTA – a new member from southeast Europe joined

After the candidacy of Macedonia on 23rd April 2004, the country became a member of the Central European Free Trade Agreement (CEFTA) on 27th February 2006. Macedonia is the fourth member after Bulgaria, Croatia and Romania. The document awaits ratification by the Macedonian Parliament.

CEFTA in brief

On 21st December 1992 former Czechoslovakia, Hungary and Poland (the Visegrad countries – V4) signed the Central European Free Trade Agreement in Krakow. CEFTA went into effect in March next year. The process started already in February 1991 when these countries agreed to mobilize joint efforts in order to facilitate the integration process to Western Europe, particularly to institutions, political, economic, security and legal systems. As each founder country had signed association agreements with the EU before December 1992, CEFTA functioned as a preparation for full EU membership.

The agreement aimed to introduce gradually a free trade area by its members by 1st January 2001. The main objectives set by the members were harmonizing the development of economic relations through expansion of treed, speeding up the development of the commercial activities, raising standards of living and ensuring better employment opportunities, increased productivity and financial stability. Fair trade and expansion of world trade were also important principles of the agreement. CEFTA covers industrial and agricultural products and contains general provisions concerning rules of origin, co-operation in customs matters, internal taxation, general exceptions, security exceptions, state monopolies and the rule of competition (state aid, dumping, etc.).

From the beginning duties have been eliminated on approximately 40% of industrial goods. Further liberalization followed in August and December 1995 with the signing of Additional Protocol Nr. 2. and Nr. 3. The proportion of duty free imports increased to over 50%. By January 1996 duties were abolished on 80% of industrial products and the reduction of agricultural duties had started. The Additional Protocol Nr. 5 consummated the liberalization process, duties on industrial products were completely abolished except for some “sensitive items” from January 1997.

The requirements of becoming a member of CEFTA were determined in the Poznan Declaration in 1997. The applicant should be a member of WTO, have an Association Agreement with the EU and have consent by all CEFTA members. Slovenia joined CEFTA in January 1996 after having bilateral free-trade agreements with all founder members. Romania became a member in 1997, Bulgaria in 1999 and Croatia in December 2002 after becoming a member of WTO on 30th November 2000. And last but not least Macedonia gained membership on 27th February 2006. Ukraine also would like to join CEFTA and Serbia and Montenegro, Bosnia and Herzegovina, Albania are also potential applicants. However CEFTA is not only growing as it lost 5 members (Czech Republic, Hungary, Poland, Slovakia, Slovenia) in 2004 due to their EU accession.

Trade in CEFTA

The agreement could not fulfil the expectations. The most important trading partner of each member state became the European Union. In the ranking of the main importer and exporter countries Germany, Austria, Italy and/or France could be found at the first three places in 1998. 6 years were not enough to remarkably improve regional trade.

Table 9. Main trading partners of CEFTA members in the first half of 1998

% of total import	1st partner	2nd partner	3th partner	4th partner	5th partner	others
Czech Republic	DE (33.7)	SK (7.4)	RU (6.0)	AT (6.0)	IT (5.2)	41.7
Hungary	DE (27.2)	AT (9.9)	IT (7.7)	RU (7.1)	FR (5.1)	43.0
Poland	DE (24.9)	IT (9.6)	FR (6.5)	RU (5.6)	GB (5.0)	48.4
Romania	IT (17.5)	DE (17.5)	RU (9.6)	FR (6.7)	HU (4.4)	44.3
Slovenia	DE (20.4)	IT (17.1)	FR (12.0)	AT (7.5)	HR (4.4)	38.6
Slovakia	DE (23.6)	CZ (18.8)	RU (11.2)	IT (6.4)	AT (4.8)	35.2
% of total export	**1st partner**	**2nd partner**	**3rd partner**	**4th partner**	**5th partner**	**others**
Czech Republic	DE (37.8)	SK (10.7)	AT (6.5)	PL (5.9)	IT (4.0)	35.1
Hungary	DE (36.5)	AT (10.4)	IT (6.1)	RU (4.3)	US (4.2)	38.5
Poland	DE (34.8)	RU (7.9)	IT (6.3)	UA (4.5)	FR (4.4)	42.1
Romania	IT (22.0)	DE (19.0)	FR (5.7)	US (4.2)	GB (3.7)	45.4
Slovenia	DE (28.8)	IT (13.1)	HR (9.3)	FR (8.1)	AT (6.8)	33.9
Slovakia	DE (27.4)	CZ (21.0)	IT (7.5)	AT (7.3)	PL (5.4)	31.4

Source: CEFTA

However, the agreement could be justified by the significant proportion of trade among CEFTA members. The share of trade with CEFTA countries was 4.5% in Poland, 5.8% in Hungary, 20.1% in the Czech Republic and 49.3% in Slovakia in 1998. It can be concluded that the strong focus on the accession to the EU hindered the exploitation of development and synergy possibilities in the framework of CEFTA (at regional level).

CEFTA and the EU

CEFTA resulted from the effort of its founders to join the EU, as a large proportion of their foreign trade was with EU member states. Thus CEFTA is adapted to EU membership hence it does not involve any institutionalization. The EU orientation could be seen in the trade structure of the CEFTA members, as the trade among them was far behind the trade with EU member states. After the EU enlargement in 2004 CEFTA seemed to lose its significance. Two of the remained three members (Romania, Bulgaria) are expected to join the EU in 2007.

The sealed fate of CEFTA turned in 2003 at the Thessaloniki summit of the EU, which ended with the statement that the Western Balkan states have a clear European perspective. The fundamental aim set for the region was to create a situation where military conflict is unthinkable and to establish peace, stability and prosperity. The framework for the EU's approach is the Stabilization and Association Process (SAP), which was designed to encourage and support domestic reform processes. In the long run SAP offers the Western Balkan countries the prospect of full integration, provided that certain political and economic conditions are met. To date only Croatia and the Former Yugoslav Republic of Macedonia have signed a Stabilization and

Association Agreement (SAA), while Albania, Serbia-Montenegro and Bosnia-Herzegovina have launched SAA talks. SAA involves the establishment of Free Trade Areas (FTA) as well.

At first the European Union planned to create a regional free trade agreement among Serbia-Montenegro, Bosnia-Herzegovina, Albania, Croatia and Macedonia, with a population of 24 million.. This agreement could replace the current web of 31 different bilateral trade agreements. However, Croatia has refused the idea since its birth, arguing that this regional agreement would mean the revival of former Yugoslavia. After several wars these countries do not trust in each other. Furthermore Croatia is far above the rest of the region from the economic point of view having a per capita GDP of USD 7000 compared to USD 2000 in Bosnia-Herzegovina, USD 2200 in Macedonia, USD 2500 in Albania and USD 2600 in Serbia-Montenegro. Croatia proposed the revival of CEFTA and finally in March 2006 EU Foreign Ministers agreed with the decision of the rest of Western Balkan countries to join CEFTA.

The new member – Macedonia

Macedonia became independent in September 1991 as the least developed Yugoslav republic, producing only 5% of the total federal output of goods and services. After Yugoslavia collapsed transfer payments of the centre ended and Macedonia could not enjoy the advantages of a de facto free trade area. Economic growth was hindered by UN sanctions on the down-sized Yugoslavia, one of the largest markets of Macedonia, by the absence of infrastructure and a Greek embargo until 1996. The improvement of main economic indicators was stopped by the ethnic Albanian insurgency in 2001. The economy shrank 4.5% because of decreased trade, intermittent border closures, increased deficit (higher spending on security needs) and investor uncertainty. Recovery started again but the country is still lagging behind the region concerning FDI (only 1.4% of the SEE inward FDI in 2004) and has an extensive grey market, estimated to be more than 20% of GDP.

After reaching political stability the economy could be boosted with help of free economic zones and free trade in the region. Free Economic Zones (FEZ) were defined in a law in 1999 and the first FEZ called Bunardzik was established, but this zone is still not active. The main trade partners of the country are the European Union (50.8%/53.1% of export and 45.3%/45.5% of import in 2002/2005), the countries of former Yugoslavia (31%/29% of export and 19.5%/11.2% of import in 2002/2005) and the Central Eastern European Countries (5.3%/6.6% of export and 19.5%/25.6% of import in 2002/2005)[1]. It means that the revival of CEFTA could help the country to increase trade with other CEFTA members but also with former Yugoslavian republics in case they become members as well. Trading with countries that are at the same development level could result in symmetric trade relationships thus trade could boost economy, increase employment and activate the free economic zones of the country.

Expectations

The birth of CEFTA was closely connected to the European Union. Similarly, the future of the agreement cannot be independent from the influence of the EU. The recent decision of reviving CEFTA means new challenges. First of all it is important to lower the requirements of membership in order to accelerate the economic development of Western Balkan. Thus the criterion of being a WTO member and having an agreement with the EU should be cancelled.

Secondly it should be decided whether CEFTA is for expanding regional trade or it is the entrance-hall of the EU. The SAP countries have had trade deficits with the EU. Because of their weak economies (lack of productive capacities, EU quality standards too high) they could not take full advantage of the asymmetric trade liberalization. Thus it seems to be a better solution to use CEFTA for expanding regional trade. The problem of similar specialization patterns of former Yugoslavian countries could be overcome by the financial support of the EU.

All in all it can be said that CEFTA could help Western Balkan countries to catch up with the

[1] State Statistical Office of the Republic of Macedonia

member states of the European Union. Free trade of the region could strengthen these countries thus the new enlargement of the EU could be easier and probably cheaper as well.