



ICEG EUROPEAN CENTER

Quarterly

Forecast

on Southeast Europe



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OVERVIEW

Accelerating economic growth in 2006 and positive outlook for 2007 in the SEE countries

Economic Growth

According to the statistics, economic growth accelerated in most countries in the region in the third quarter of 2006. Real GDP growth rate reached or exceeded 6% in four countries in the region, namely in Bulgaria, Montenegro, Romania and Serbia in last year, according to our estimations. In Romania the GDP increased by more than 8% during the third quarter. The annual average GDP growth rate of the region was 5.7% which was also significant.

According to our forecasts, real GDP growth rate was above 5% in almost all SEE countries, excluding Croatia and Former Yugoslav Republic of Macedonia. The poorest performance was observable in the case of the latter one in last year. Generally, economic growth accelerated in most Southeast European countries in 2006, except for Albania, the Former Yugoslav Republic of Macedonia and Serbia.

Regarding main engines behind growth, former tendencies continued in the second part of the year. The economic growth of the Southeast European region is mainly based on domestic demand, explicitly private consumption and investments. Especially in the case of the two new Southeast European Member States, gross fixed capital formation played an important role in economic growth. GFCF increased by 15-16% in the third quarter of 2006 in comparison with the same period of the previous year, which reflects well the share of investments in growth.

As a result of robust domestic demand the net export contributes negatively to GDP growth in these economies through the balance of goods and services. Since the strong domestic demand boosts the import of consumer and capital goods, the trade balance worsened in most Southeast European countries in course of 2006.

In 2007 these tendencies will continue and economic growth will remain high in most

countries, we have not changed our previous forecast on the region. We expect that average GDP growth rate of the SEE region will be 5.2%. The highest growth rate is expected to be in Romania (6.5%), while the economic growth of the Former Yugoslav Republic of Macedonia will remain the lowest (3%) in the region in 2007, according to our forecasts.

Monetary Conditions

In course of 2006 the development of inflation rate in the SEE countries was interesting. Due to strong domestic demand fuelled by real wage increases and rapid credit growth, increasing international oil prices and raise of administered prices, taxes and excises, in most countries consumer price index increased significantly in the first half of the year in comparison with the previous year. In line with that process monetary policies started to be more restrictive, mainly through the increase of base rates. The more restrictive monetary policy was observable in many countries in the region in course of 2006.

In the second part of the year inflation rates started to decrease compared to the first half of the year. The process was supported by decreasing international oil prices, favourable development of food prices in many countries and the aforementioned more restrictive monetary policy. In those countries where the exchange rate regime is not fixed or quasi-fixed, the appreciation of the currency also helped easing the inflationary pressure.

As a result Romania was able to achieve its inflation target and Serbia decreased its inflation rate under 10% again. However, excluding these two countries, consumer prices increased more in 2006 than a year before in all other countries in the region. The most significant increases were observable in Bosnia-Herzegovina (from 3.6% to 6.5%), in Bulgaria (from 5.0% to 7.3%) and in the Former Yugoslav Republic of Macedonia (from 0.5% to 3.2%). The average annual



inflation rate of the SEE region was 5.0% according to our forecast.

Though, these inflation levels are not dramatically high and due to one-off effects in many cases, inflation rates are expected to decrease in 2007 in the region. We expect that the annual average inflation rate of the region will be 4.2%.

Fiscal Developments

In SEE countries general government budgets remained in surplus or in a low deficit in 2006 as well, according to our estimations. In Bosnia-Herzegovina, Bulgaria, Montenegro and Serbia the budget is expected to have a surplus in 2006, in the Former Yugoslav Republic of Macedonia budget was in equilibrium and in the remaining countries in the region the budget deficit was under 4% of GDP according to our estimations.

The positive development of fiscal balances was supported by the higher than expected budget revenues in these countries. Mainly tax revenues became higher than those were planned by the governments. It is worth mentioning that these positive developments allow the governments to decrease tax rates, such as in Bulgaria where profit tax rate will be decreased from 15% to 10% as of the beginning of 2007. Accordingly, the Bulgarian profit tax rate is the lowest in the EU-27, together with Cyprus.

In 2007 the most significant changes are expected in the two new EU Member State, namely in Bulgaria and Romania where the expenditures of the governments are expected to increase in line with EU membership. It means that the burdens of the governments will increase due to the contribution to EU budget and co-financing EU projects. Thus, the average budget deficit is expected to increase from 0.5% to 1.1%.

Balance of Payments

In most Southeast European countries current account balance deteriorated further and that remained one of the main macroeconomic problems. The deterioration of the current account balance was basically due to the widening foreign trade deficits. Strong

domestic demand boosts import of goods which has a negative impact on trade balance. Besides that, growing international oil prices also had a negative contribution because these countries are basically oil importer economies.

Regarding the other components of current account, it is worth mentioning that these elements partially counterbalance the high deficit of trade balance, such as the services balance in Croatia or current transfers in the small Western Balkan countries.

Slight improvement is expected only in Bosnia-Herzegovina and the Former Yugoslav Republic of Macedonia in 2006 compared to 2005. In all other countries, current account balance deteriorated, mainly in the two new Southeast European EU Member States. In Bulgaria and Romania C/A deficit increased from 11.3% to 15% and from 8.8% to 10.6% of GDP, respectively.

In line with the aforementioned process foreign direct investments increased in the region. The positive development is mainly due to the improving business climate of the region, the progress in privatisation and the EU accession in case of Bulgaria and Romania. FDI was able to cover largely or completely the current account deficit in 2006 in several countries in the region. In 2007 we expect that current account will remain on the same level and average C/A deficit will reach 10.2% of GDP.



Labour Market Developments

The unemployment figures improved in all Southeast European countries in 2006 except for Serbia. The development of unemployment rate is important in these countries because unemployment is a significant problem in these economies. The official unemployment rates exceed 35% in Bosnia-Herzegovina, the Former Yugoslav Republic of Macedonia, and

higher than 20% in Montenegro and Serbia as well. Unemployment is one digit only in the two new EU Member States, in Bulgaria (8.8%) and Romania (5.3%).

In 2007, our expectation is that the decrease of unemployment rate and the increase of the number of employed persons will continue and unemployment rate of the region will decrease.

Table 1 Summary indicators of the analysed 8 Southeast European countries

	2004	2005*	2006**	2007**
GDP growth (%)	5.8	5.0	5.7	5.2
Inflation (%)	4.8	5.4	5.0	4.2
General Government balance/GDP (%)	-1.0	0.0	-0.5	-1.1
Current Account/GDP (%)	-9.0	-9.3	-10.4	-10.2
Unemployment (%)	21.7	21.7	20.9	20.2

* Preliminary data; ** Forecasts



ALBANIA

Energy system remains a hazard

Economic Growth

The Albanian economy continued its rapid increase, and according to expectations the real GDP growth may have amounted over 5% in 2006. With the help of continuous economic growth and the large amount of remittances, poverty has been reduced significantly. In the first half of 2006, industry and construction was one of the main engines of the economy, but services, transport and agriculture also performed well. For 2007 a growth rate similar to the 2006 value is expected, although certain risk factors can be noted. Structural reforms are needed in order to make growth more robust, to decrease vulnerabilities and to make weak public institutions more effective.

The infrastructure deficiencies (e.g. even in the electricity sector) still hinder the improvement of the economy. Electricity shortages occasionally have significant impact on the economy and on the growth rate of GDP. In January 2007 scarce rainfall caused severe problems for certain hydropower plants. As a result, power cuts were imposed in the country resulting in losses for companies. According to plans of the Albanian power utility KESH, the company will invest EUR 452 million to improve the energy system in 2007. New deals for energy imports have also been reached with foreign suppliers. It is yet unknown whether energy supply problems in 2007 will have any major negative impact on the GDP, as in the case of the energy crises in the last months of 2005.

Monetary Conditions

Prudent monetary policy was able to keep inflation under control in 2006 as well. The annual growth rate of the consumer price index was 2.5% by the end of the year. Among other factors, the external developments, the electricity price rise, the excess of liquidity in the banking sector, the agricultural supply affected the rate during 2006.

In October 2006, the annual growth rate of the money supply amounted to 12%. Credit growth remained rapid during 2006 and can even be considered one of the risk factors. In October the annual growth rate of credit reached 57.2% and the stock of outstanding loans amounted to 19.5% of GDP. Credit growth underpins the increase of consumption and investments. It is favourable that mainly businesses contributed to this rapid credit growth.

To contain inflationary pressure and to moderate the strong expansion in credit growth, the interest rate has been raised in July 2006 from 5.00% to 5.25% and in November by another 0.25 percentage points to 5.50%.

The Albanian lek (ALL) can be considered stable against the main currencies. During 2006 there was a mild appreciation that may continue in 2007 as well. In January 2007 the exchange rate fluctuated around 124-125 ALL/EUR.

Fiscal Developments

Due to the good performance of the budget in the first half of 2006, a supplementary budget was adopted to spend higher tax revenues and customs duties. In August 2006, budget surplus amounted to ALL 10.9 billion. Further on during the year, budget expenditures accelerated: their growth in October was 20.1% compared to the previous month, and the trend was expected to continue in the last months as well. The government planned to reach a deficit of ALL 33.8 billion by the end of 2006.

Public debt declined slightly in 2006 and is expected to decrease further in the next year. Debt management remains poor however. Local elections will be held in Albania in 2007, which may have a slight effect on fiscal policy. After severe political quarrels, the parties postponed the local elections to February 18th 2007.



Balance of Payments

The export base is still narrow in Albania, partly as a result of poor non-price competitiveness. This is a consequence of the unfavourable business environment and inadequate infrastructure. Textile and footwear, metals, minerals, agricultural products remain the main export items. During September the biggest growth was performed by the category of wooden manufacture and article of paper. Trade activity of Albania expanded during 2006. The growth rate of exports and of imports remained stable, widening the trade deficit.

Approximately 90% of exports goes to the EU; more than 70% to Italy and around 10% to Greece. More than 25% of imports are from Italy while almost 20% from Greece. In December 2006 Albania signed a bilateral free trade agreement with Turkey.

The significant trade deficit is partly financed by private remittances from abroad, which according to some estimations may reach EUR 1 billion a year. In 2006, the current account deficit widened to 8.1% of GDP. Domestic demand, fuelled by rapid credit growth is the main cause of the increasing

external deficit. In 2007 the trade balance and the current account is expected to improve slightly.

Labour Market Developments

Due to the large informal sector, particularly in agriculture and construction, it is hard to assess the exact rate of unemployment. According to official data, the unemployment rate continued to decrease marginally, and at the end of 2006 it stood at 13.8%. This downward trend is expected to continue in 2007.

In the first quarter of 2006 80% of the employed belonged to the private sector; 72% of private sector employees worked in agriculture. According to official data, in the third quarter of 2006 the number of people employed by the non-agricultural private sector increased slightly.

In the third quarter of 2006, the government increased the minimum wage by 18.6% to ALL 1400. In the same quarter, the average monthly wage of the public sector grew almost by 5% compared to the previous quarter.

Table 2 Major macroeconomic indicators for Albania, 2004-2007

	2004	2005	2006*	2007*
GDP growth	6.0	5.5	5.2	5.3
Private consumption (%)	n. a.	n. a.	n. a.	n. a.
Public consumption (%)	n. a.	n. a.	n. a.	n. a.
Investments (GFCF, %)	23.8	24.2	25.6	26.3
Export (%)	23.5	12.0	13.0	13.0
Import (%)	8.0	10.0	16.0	6.0
Consumer price index (average, %)	2.9	2.4	2.5	3.0
Unemployment rate (%)	14.4	14.2	13.8	13.5
General government balance/GDP (%)	-5.1	-3.6	-3.8	-3.9
General government debt/GDP (%)	56.5	55.3	55.2	54.6
Current account balance/GDP (%)	-5.7	-7.5	-8.1	-7.0
Trade balance/GDP (%)	-21.7	-23.5	-24.5	-23.2
Gross foreign debt/GDP (%)	22.0	21.4	22.0	22.0
Exchange rate (ALL/EUR)	126.3	122.6	123.8	122.0
Interest rate (end of year, %)	5.25	5.00	5.50	5.75

Source: National Bank of Albania, INSTAT

* Forecasts



BOSNIA AND HERZEGOVINA

New Government, same problems

Economic Growth

The winning political parties agreed on the new state government and parliamentary assembly only three months after the general elections, which took place on the 1st of October 2006. Due to the political circumstances, it is difficult to tell, what structural reforms will be done in the future and how will politics affect the economy. Moreover, the decision on the final status of Kosovo, also raises questions concerning the stability. Due to all of these facts, it is hard to estimate most of the macroeconomic figures for the future. We assume in our analysis that no major reforms will take place in the short run.

In the first nine months of 2006 industrial production increased by 6.6% in the Federation of Bosnia and Herzegovina (FBH) and by 13.5% in the other entity, Republika Srpska (RS), compared to the same period in 2005. In FBH the mining sector grew by 4.6%, the processing industry by 6.4%, while the electricity, gas and water supply by 8.3%.

Real GDP growth is expected to reach 5.7% in 2006 and in 2007 as well, but certain structural reforms may foster growth rate. In 2006 the growth was underpinned by favourable external conditions, such as increasing prices of metal. Foreign demand played an increasing role in GDP growth, but domestic demand, particularly private consumption remained the most important element of economic growth.

Monetary Conditions

The monthly retail price index grew significantly in the first quarter of 2006, it reached 4.3% in January and 1.3% in May. According to the central bank's estimation, the price increase in the first three quarters of 2006 was somewhat below 8%, while at least half of this growth was caused by the one-off effect of the VAT introduction. In the first nine months

of 2006, compared with the same period of 2005, prices increased by 7.1% in the FBH and by 9.3% in RS. As far as the cost of living is concerned in BH, in the first nine months of 2006 the index grew by 7.7%, compared to the same period a year ago. During the year, the growth of wages (see labour market developments) significantly contributed to the growth of prices. According to the estimations, inflation in 2006 reached around 6%, but will be significantly lower in the following year, supported by the favourable effects of the currency board arrangement. In order to maintain the stability of the local currency, the central bank's reserves have been further increased, thus reaching by the end of 2006 the record amount of KM 5.4 billion.

By the end of the third quarter of 2006, the annual growth of the broad money reached 24%, thus its absolute value increased by KM 1.842 million, showing the largest growth in the past four years, and amounted to KM 9 520.6 million. Both the currency in circulation and the deposits contributed to this increase. Monetary aggregate M1 annually grew by 22.9%, the growth rate of demand deposits in domestic currency amounted to 33.9%, while cash outside banks increased by 9.2%.

In the third quarter of 2006, credit activity slowed, and thus credit growth rate decreased to 23%. However, it was an unfavourable process that growth rate of credit to households has not diminished significantly, while growth rate of short-term loans to companies decreased considerably. On the other hand, deposits with commercial banks increased by 29% on an annual basis and amounted to KM 8.4 billion.

The range between the active and passive interest rates continued to narrow, mainly as a result of the growing competition among commercial banks. In September 2006, the average weighted interest rate on short-term credits to private companies decreased to 7.73%, while for citizens the rate amounted to



9.06%. This number for long-term credits increased slightly, thus for private companies it amounted to 8.12%, while for citizens it was 9.59%.

The main instrument available for monetary policy operations under the currency board regime, the rate of required reserves has been increased in the past years, partly in response to the rapid credit growth. The required reserve rate has been raised during 2004 from 5% to 10% and in 2005 to 15%.

Fiscal Developments

In 2006 fiscal expenditures most probably exceeded the planned targets for two main reasons. One is the impact of the pre-election period (including e.g. vote-winning wage rises), and the other is the fact that the higher-than-expected VAT incomes were started to be spent. In the first five months of 2006, KM 150 million more VAT has been collected than expected. So far we only know that in the second quarter of 2006 a slight consolidated fiscal surplus was recorded, and for the whole year the budget is expected to be around balance or to have a slight surplus. The higher-than-expected VAT incomes and the election environment causes spending pressure for all levels of the government, thus for 2007 a low level of fiscal deficit is expected.

The political will to adopt and to implement the National Fiscal Council law seems to be problematic. The government sector is inefficient and oversized; government expenditures are somewhat over 50% of GDP. Due to these types of problems, fiscal architecture and fiscal coordination ought to be improved, thus fiscal risks could be reduced. In case of the lack of political will, probably the IMF may help to foster the inevitable reforms.

Balance of Payments

Slight favourable changes were recorded concerning the trade deficit, due to the fact that export increased by 38%, while import grew only around 5% in 2006. On the other hand, we must emphasise that the main reason of this big discrepancy is the one-off effect of the VAT introduction, while external conditions and the successful restructuring of certain companies

(e.g. in the aluminium and steel sector) underpinned the growth of export. This positive trend may continue in 2007, while further restructuring and reforms may boost exports further on, not to mention the need of sufficient amount of private savings.

The composition of exports remained narrow; minerals, metals and related products gave 40% of the export, while chemicals and wood products gave approximately 20%. As far as the trade partners are concerned, the EU remained the main partner, and in the first quarter of 2006 exports to the EU increased, thus reaching almost 60% of the total exports.

Although trade deficit is partly financed by the FDI inflows and the private remittances, the current account deficit is still at an unsustainable level and it remains one of the biggest macroeconomic problems in BH. Foreign aid continues to decline. External vulnerability is affected also by the relatively high level of external debt.

FDI inflow is still relatively low in the country, partly due to the unfavourable business climate, certain political problems and the lack of structural reforms. In 2005 FDI amounted to KM 832 million, which was around 5% of GDP, while in the first half on 2006 FDI was around KM 210 million. In 2007 a higher inflow is expected, due to certain privatisation processes, e.g. in case of Energopetrol and Telekom Srpske.

Labour Market Developments

Although data still remain unreliable, the Labour Force Survey (LFS) - published in July 2006 - uses the methods and principles of the ILO, and thus gives a more credible picture of the issues concerning the labour market. According to this survey 1.5 million (56.9%) people are inactive (including children below 15 years of age and people whom didn't give a direct answer), while approximately 1.2 million (43.1%) are active. The group of labour active people consists of people whom are employed (811 thousand) and of those who are unemployed (366 thousand), resulting an employment rate of 29.7%, while the unemployment rate is 31.1%. On the other hand, according to the official data, in September 2006 the number of employed



people was 652.7 thousand, while 511.4 thousand people were unemployed. The large informal sector (its major component is supposed to be the agricultural sector) increases the unreliability of the figures. Real unemployment is probably around 25%. All in all we can conclude, that unemployment in BH is still one of the highest in the region and remains a severe problem.

In September 2006 the average net wage was KM 609 in FBH, KM 538 in RS and KM

675 in Brcko District. Compared to the same month in 2005, the average nominal wage grew significantly, but the real value increased only by 0.7% in FBH and by 5.6% in RS. As far as the educational background is concerned, according to the LFS, 25.4% of the unemployed have only primary or lower education, 70.2% finished secondary school, while 4.4% hold a university degree.

Table 3 Major macroeconomic indicators for BH, 2004-2007

	2004	2005	2006*	2007*
GDP growth	6.0	5.5	5.7	5.7
Private consumption (%)	n. a.	n. a.	n. a.	n. a.
Public consumption (%)	n. a.	n. a.	n. a.	n. a.
Investments (GFCF, %)	6.6	3.0	7.3	9.0
Export (%)	28.7	24.0	16.4	11.8
Import (%)	7.6	13.6	4.4	8.5
Retail price index (average, %)	0.7	3.6	6.5	3.2
Unemployment rate (%)	43.0	44.5	43.0	42.5
General government balance¹ (%)	-0.1	1.0	0.2	-0.8
General government debt/GDP (%)	30.0	32.0	n. a.	n. a.
Current account balance/GDP¹ (%)	-19.3	-21.3	-17.0	-17.5
Trade balance/GDP (%)	-49.5	-50.2	-43.8	-43.0
Gross foreign debt/GDP (%)	1.956	1.956	1.956	1.956
Exchange rate (BAM/EUR)	10.0	15.0	15.0	15.0
Interest rate (end of year, %)	6.0	5.5	5.7	5.7

Source: Central Bank of BH, FZS

* Forecasts; 1 including grants



BULGARIA

Positive outlook for 2007

Economic Growth

In the third quarter of 2006 the dynamic economic growth continued. Between July and September gross domestic product increased by 6.7% in comparison with the same period of the previous year. Accordingly, GDP increased by 6.3% during the first three quarters of the year.

On the expenditure side, former trends continued, namely domestic demand fuelled the Bulgarian economy. Regarding consumption, private consumption increased by 7.4% in the third quarter compared to the same quarter in 2005. Private consumption is based on wage increases and credit growth. On the other hand, public consumption remained almost unchanged (+0.7%) in that period.

Besides consumption, investments were the other element that had a significant positive contribution to GDP growth. In the third quarter of 2006 gross fixed capital formation increased by 15.9%, which was slightly lower than the first half's figure (+20.8%). Accordingly, gross fixed capital formation per GDP ratio went under 25%. It reflects that the role of investments in economic growth decreased somewhat in comparison with the first half of the year.

Net exports continued to have a negative contribution to economic growth owing to the high import demand of the economy. The growth rate of imports (+14.7%) significantly overpaced that of exports (+10.5%) during the first nine months of 2006.

On the production side, gross value added in industry reached an outstanding performance during the third quarter of the year, as it increased by 11.3%. In line with that gross value added in services increased significantly as well (+5.8%), while the performance of agriculture remained only moderate (+0.9%). Regarding the first three quarters of the year gross value added in

agriculture basically remained unchanged (-0.2%).

For 2006 we increased our forecast on GDP growth rate due to the higher than expected third quarter growth. We expect that GDP growth will reach 6.3% and will be based on domestic demand. In 2007 these trends are expected to continue and GDP growth can remain at 6.0% level.

Monetary Conditions

Inflation reached its peak in February this year when CPI was 8.8%. Since February consumer price index decreased gradually and it declined to 6.1% in November. At the beginning of the year the high inflation rate was basically due to the price increases of tobacco and alcoholic beverages. The prices of alcoholic beverages and tobacco products increased by 56% compared to December 2005 in that period. Accordingly, consumer price index increased by almost 3 percentage points as a result of price increases of alcoholic beverages and tobacco products.

In the second half of the year inflation rate started to decrease from 8.2% in June to 6.5% in December. The decrease was basically due to the evolution of food prices. The price growth of these products compared to the corresponding period of the previous year remained moderate. In December 2006 prices of food and non-alcoholic beverages were higher by 'only' 5.2% than that in December 2005. Accordingly annual average CPI was 7.3% in 2006 which was 2.3 percentage points higher than that in 2005.

In line with growing inflation at the beginning of the year, monetary policy became more restrictive in the course of 2006. Bulgarian National Bank (BNB) increased its base interest rate in almost every month in this year. In December base rate increased to 3.26%, while it was 2.05% a year ago.



Further decrease of CPI is hampered by the strong domestic demand and the impact of EU accession. For 2007 we expect that annual average consumer price index will decrease somewhat compared to 2006 and will be 6.0%.

Fiscal Developments

In the second part of the year the surplus of the consolidated budget balance increased further. At the end of November 2006 consolidated budget surplus reached BGN 2.5 billion (EUR 1.3 billion) or 5.3% of GDP. The primary balance exceeded BGN 3 billion and reached 6.6% of GDP.

The budget balance improved even compared to the previous year due to the high growth of budget revenues. Revenues increased mainly due to the significant (+12.9) rise of tax revenues, while expenditures increased by 7.5% during the first eleven months of the year.

In line with the promising development of the budget, the Bulgarian Parliament approved the reduction of the corporate profit tax rate from the current 15% to 10% as of the beginning of 2007. It means that in 2007 Bulgaria – along with Cyprus – will have the lowest corporate tax rate in the European Union.

According to our expectations, budget surplus will reach 3.3% of GDP in 2006. In 2007 surplus will decrease somewhat due to the contribution to EU budget, co-financing EU projects, tax cut and financing reforms, thus, we expect that budget surplus will reach 2.0% of GDP.

Balance of Payments

In the first ten month of the year all components of the current account balance worsened. As a result current account deficit increased by EUR 1.1 billion or by 68.8%. At the end of October current account deficit reached 11% of GDP.

The deterioration of trade balance played the major role in increasing current account deficit. During the first ten months foreign trade deficit increased to EUR 4 billion which was 17.6% higher than that in the

corresponding period of the previous year. Although, it is worth mentioning that growth rate of export overpaced that of import, the figures were 29.1% and 25.6% respectively.

The other three components of current account balance, namely services balance, income balance and current transfers have traditionally surpluses in Bulgaria but these balances deteriorated as well. In the first ten months of 2006 the surplus of the three aforementioned elements of C/A decreased by almost EUR 0.5 billion in comparison with the same period in 2005.

Foreign direct investments reached a considerable amount during the first ten months in Bulgaria. At the end of October FDI inflows reached EUR 3.2 billion or 13% of GDP. It means that FDI financed fully current account deficit in that period.

For 2006 we expect that current account deficit will reach 15% of GDP, while foreign trade deficit will increase to 21%. However, FDI will finance the majority of C/A deficit in this year. In 2007 we expect that export of goods will increase more than import and foreign trade balance will improve. Accordingly, current account balance will improve as well, and the deficit will decrease to 14% of GDP.



Labour Market Developments

Regarding the labour market the positive trend continued and unemployment rate declined further. In September and October unemployment decreased to 8.4% which represented 310 thousands of unemployed. Besides that, activity and employment rates also improved in the third quarter of 2006. Activity rate increased to 52.5% (+1.6 percentage points) compared to corresponding period of the previous year, while employment

rate increased to 48.1% (+1.7 percentage points) in the third quarter. The positive trend is basically due to the strong economic growth.

At the end of 2006 we expect that unemployment rate will reach 8.8% which will be almost 2 percentage points lower than that at the end of 2005. We forecast that these tendencies will continue in 2007 and unemployment rate will decrease further, while activity rate will grow as well.

Table 4 Major macroeconomic indicators for Bulgaria, 2004-2007

	2004	2005	2006*	2007*
GDP growth	5.7	5.5	6.3	6.0
Private consumption (%)	4.5	7.4	6.8	6.0
Public consumption (%)	6.0	2.2	0.8	2.0
Investments (GFCF, %)	12.0	19.0	18.0	18.0
Export (%)	13.0	7.2	10.0	12.0
Import (%)	13.0	14.6	15.0	15.0
Consumer price index (average, %)	6.2	5.0	7.3	6.0
Unemployment ratio (%)	12.2	10.7	8.8	8.2
General government balance (%)	1.7	3.2	3.3	2.0
General government debt/GDP (%)	40.7	31.9	25.0	22.0
Current account/GDP (%)	-5.8	-11.3	-15.0	-14.0
Trade balance/GDP (%)	-15.1	-20.2	-21.0	-19.0
Gross foreign debt/GDP (%)	64.2	70.5	76.0	78.0
Exchange rate (BGN/EUR)	1.96	1.96	1.96	1.96
Base rate (end of year, %)	2.7	2.1	3.3	2.8

Source: BNB, NSI; * Forecasts



CROATIA

Sustainable growth with some shift in composition

Economic Growth

The third quarter of Croatian real GDP growth resulted in a 4.7% rate in comparison with the corresponding period of 2005. This performance shows favourable developments after 6.0% real GDP growth rate of first quarter and 3.8% in the consecutive quarter of 2006. After recovered growth of 4.3% in 2005, 2006 can result in a robust pace of 4.9% at the end of the year.

Growth in the future is based primarily on strong rise in investments as gross fixed capital formation reached 9.3% in the third quarter year on year. However a slight shift happened in case of domestic and external demand. While the final private consumption accelerated to 3.9% year on year in the third quarter, increase of exports reached only 2.2% parallel with 5.5% growth of imports. Final consumption growth of government remained stable. These reflect increasing importance of domestic demand due to improving consumer and business confidence.

On the production side the most considerable development is the recovery of industrial value added (especially manufacturing and the good performance of the mining and quarrying). Wholesale and retail trade, and financial intermediation, real estate, renting and business activities were also well performers. From other point of view the capital goods and the durable consumer goods production performed well, but this is in line with the first quarter's processes.

The tourism sector, as strategic branch, responsible for almost 20% of GDP in the first six month of 2006, is performing well, naturally with strong seasonal determination. This summer has not brought extreme growth and some shift from external to domestic demand was observable in Croatian tourism data.

All in all our previous estimation of 4.9% annual growth rate in 2006 was downgraded to

4.7% because of some restructuring of the composition in economic growth, namely in the case of final private consumption and export and import of goods. Our forecast for GDP growth in 2007 is 4.4%. This prediction was kept despite of slight slowdown expectations on growth of world economy driven by the deceleration of US growth.

Monetary Conditions

Croatian monetary conditions developed in line with efforts to prove the conditions of price stability. In November 2006 as compared to December 2005, the prices of goods and services for personal consumption, measured by consumer price indices increased by 2.0%, as compared to November 2005 increased by 2.5%. Such development of CPI was reasoned by the strong annual average increase of mainly administratively determined prices of housing, water, electricity and gas (7.8%) and moderate rise of food prices (2.4%). Producer Price Index came out with an annual average 2.9%.

In 2006 no remarkable change in the exchange rate of the Kuna was expected but that of healthy appreciating trend. The HRK/EUR exchange rate closed with a 7.33 rate. The central bank commits itself to keep stable the Kuna exchange rate against the Euro, despite of the considerable pressure stemming from extra currency inflow determined by tourism sector windfalls and privatisation process (Pliva transaction). Our estimation on appreciation of Kuna for 2007 was kept.

As concerns the real effective Kuna exchange rate, price competitiveness of Croatian economy improved, as real depreciation deflated by consumer prices occurred in the first 3 quarters of 2006. Domestic consumer prices have grown at a slower pace than in its foreign counterparts.

The estimation on annual CPI growth, according to downward direction of oil prices, stable Kuna exchange rate and moderate wage



rise, needed to be revised to the level of 3.4% in 2006 and 2.8% in 2007.

Fiscal Developments

Croatian public balance continued to improve according to expectations as steps in direction of adjust its budget to EU convergence criterion is continuing parallel with favourable economic growth results.

The amount of consolidated government revenues reached the 74% of the planned for the whole year, while the expenditures reached 72%, which shows slight improvement. The revenue side is underpinned by above-the-expectations rising VAT, social security contributions and profit tax receipts, while on the expenditures side the social benefits, compensation of employees and the use of goods and services were the most important contributors. The consolidation process is based mainly on revenue growth, while the needed structural changes are slow, as concerns particularly the health care, social benefits etc.

The latest version of PEP heralds 3.0% for 2006, 2.8% for 2007. The government seems to hold on to realize this path. However the number predicted for 2007 is under the risk of election type loose fiscal policy. Due to well performing revenue side this year can finish with 3.1%. Our expectation on 2007 however is under risk factor related to election year's political cycle.

Balance of Payments

The imports/exports coverage rate slightly improved from the level of 46.9% in the first nine months of 2006 to the level of 47.2%. Both exports and imports of goods increased by 14.2% in the first eleven months of 2006 as compared to the corresponding period of previous year. Thus, the trade balance of goods has kept stable.

Regarding the developments of current account, one can observe considerable worsening as the deficit of current account more than doubled in the first three quarters of 2006 in comparison with the same period of 2005. These changes were mainly driven by considerable worsening of trade balance of

goods that was only partially offset by improvement of trade balance of services. The income and the current transfers balance also enlarged the current account balance. The worsening balance is in line with growing investments and final consumption mainly supplied through imports.

Thus, the current account deficit will be well above our previous expectations, 7.7% as compared to GDP and the trade balance on 26%. In 2007 current account deficit will reach 7.1% and foreign trade deficit is expected to be 25.0% of GDP.

Fortunately, this trend is partially compensated in the capital account, as the FDI seems to record this year due to accelerated privatization process. The FDI in Croatia in the first three quarters of 2006 reached EUR 1 754 million by balance of payments statistics of CNB, that is more than 1.5 times higher than in the corresponding period of 2005.

Labour Market Developments

Total number of persons in paid employment increased by 0.8% in the first eleven months of 2006 as compared with the same period of previous year and reached 1 130 391. However, this number is under the result of the previous months, but this is in line with fluctuations observed in and after the tourist season. Regarding the composition of this rise in employment, the main contributors were wholesale and retail trade by its 3.2%, financial intermediation 3.3% and real estate, renting and business activities 4.1%. Manufacturing and agriculture suffer from continuous decline. Thus, services sector's share in employment increased which was possibly a result of transitional process.

Unemployment rate, calculated as a ratio of unemployed persons and total active population reached 16.9% in November of 2006. According to a recent labour force survey, in the first six months of 2006, unemployment rate averaged at 11.8%, which was lower than that in the corresponding period of previous year (13.1%).

As regards wage trend, average monthly real gross earnings increased by 2.4% in the first ten months of 2006 as compared to the



same period of previous year, while net earnings increased by 1.5%.

Due to favourable FDI performance connected to privatization efforts of the

government, and better performance of economic growth, administrative unemployment expected to keep its decreasing trend further to the level of 12.2% in 2006 and to 11.8% in 2007.

Table 5 Major macroeconomic indicators for Croatia, 2004-2007

	2004	2005	2006*	2007*
GDP growth	3.8	4.3	4.7	4.4
Private consumption (%)	3.9	3.4	4.3	3.9
Public consumption (%)	-0.3	0.8	1.9	1.3
Investments (GFCF, %)	4.4	4.8	10.2	7.5
Exports (%)	5.4	4.6	3.1	4.5
Imports (%)	3.5	3.5	5.2	4.2
Consumer price index (average, %)	2.1	3.3	3.4	2.8
Unemployment (%)	13.8	13.0	12.2	11.8
General government balance (%)	-4.9	-4.1	-3.1	-3.3
General government debt/GDP (%)	54.0	53.5	53.0	52.5
Current account balance/GDP (%)	-5.2	-6.3	-7.7	-7.1
Trade balance/GDP (%)	-25.5	-25.0	-26.0	-25.0
Gross foreign debt/GDP (%)	82.5	82.5	84.0	84.4
Exchange rate on December 31(HRK/EUR)	7.67	7.37	7.33	7.15
Discount rate (%)	4.50	4.50	4.50	4.50

Source: Croatian National Bank, DZS; * Forecasts



FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Slow economic growth and improving external balances

Economic Growth

In the first quarter of 2006 gross domestic product increased by 2.6% in real terms. This growth rate was the lowest since the fourth quarter of 2003 when GDP increased by only 1.2% year-on-year. In 2004 and 2005 GDP growth rate reached 4.1% and 4.0% respectively and the relatively low figure in the first quarter reflects a decelerating trend in the Former Yugoslav Republic of Macedonia.

As it was expected based on low figures of industry production output in the first part of 2006, gross value added in industry sector increased only slightly in the first quarter of the year (0.5%). Construction sector also had a negative contribution to GDP growth, it decreased by 2.4% between January and March in comparison with the corresponding period of the 2005.

Gross value added in agriculture increased slightly above the average, it increased by 3.0%, while in case of services gross value added in transport and telecommunication (8.3%) and that in wholesale and retail trade (6.2%) increased mostly.

After the first quarter of the year, industrial output increased somewhat. During the first eleven months of 2006 industrial production increased by 3.0% in comparison with the same period of the previous year. Accordingly, in the third quarter of the year, industrial production growth accelerated.

During that period basically mining and quarrying increased significantly (32.5%), while the output of manufacturing only by 3.2%. The highest increases in manufacturing were observable in case of manufacture of other non-metallic mineral products (15.3%) and manufacture of basic metals (10.7%) in line with the good performance of mining and quarrying sector.

In 2006 we expect that GDP growth rate will be lower than in 2005 due to weak performance of industry sector mainly driven

by moderate contribution of manufacturing. According to our expectations GDP growth rate will be 3.0%. For 2007 we expect 3.0% as well.

Monetary Conditions

Regarding inflation, trend of the year continued in the last months of 2006. The annual average CPI increased significantly in comparison with the previous year, as consumer prices grew by 3.2% y-o-y. Consumer price index was 0.5% in 2005 in the Former Yugoslav Republic of Macedonia. Despite the considerable increase, CPI remained relatively low.

The significant increase of consumer prices was basically owing to three factors. First, tobacco prices increased by 36.9% at the beginning of 2006 (due to increasing excises), and this had a major role in the rise of CPI. This measure was in line with the harmonization process with the EU Directives. Excluding the effect of increasing tobacco prices, CPI would be more than 1 percentage point lower, close to 2%.

Second, as an external factor, the gradual increase of the international oil prices in the middle of the year had a negative effect on the transport prices in the Former Yugoslav Republic of Macedonia. This factor increased the fuel prices and the prices of road transport as well.

And third, the price increases of some food products – mainly vegetables and sugar, jam, honey, chocolate and confectionery products – also fuelled inflation in 2006. The above mentioned three factors influenced basically the evolution of CPI, which would be on the same level as in 2005, if these factors were excluded.

For 2007 we expect that CPI will not fall back to the 2005 level, and inflation rate will remain at this low inflation level instead of price stability that characterised the economy in the last four years before 2006. In 2007



consumer price index will reach 3.0% according to our forecast.

Fiscal Developments

In the first half of the year consolidated budget surplus increased to MKD 373 million or EUR 6 million (approximately 0.1% of GDP), while central budget surplus was MKD 346 million at the end of June 2006.

Budget revenues increased significantly (7.6%) during the first six months of the year due to increasing tax revenues. Basically, the increase of profit taxes was remarkable that grew by 57.1%, while other tax revenues – including VAT, personal income tax, excises - increased as well.

Central budget expenditures increased by ‘only’ 3.9% in the first six month of the year. Regarding the public spending, expenditures for salaries and allowances increased by 2.2%, while that for goods and services grew by 2.8%. In case of transfers the increase reached 7.4%.

For 2006 we expect that the consolidated budget was in equilibrium due to the positive development of central budget revenues in the first half of the year. In 2007 the consolidated government balance will have a slight deficit according to our expectations.

Balance of Payments

During the first three quarters of 2006 current account (C/A) balance turned into a surplus of EUR 75.7 million or 1.5% of expected GDP. In 2005 current account had a deficit of EUR 38 million during the corresponding period, consequently the improvement of current account balance continued in the third quarter of 2006 as well.

Among the main components of current account balance only the trade balance worsened in comparison with the previous year. In the first nine months the deficit of trade balance increased by EUR 234 million. On the other hand, significant increase of private current transfers (EUR 267 million) in the same period counterbalanced the deterioration of trade balance. Besides current transfers, the balances of services and income

improved as well, by EUR 25 million and EUR 40 million, respectively.

Regarding foreign direct investments, due to the privatisation of ESM, the country’s energy distribution company, FDI increased to EUR 324 million during the first nine months of 2006. FDI achieved the highest level since the privatisation of the national telecom company (Maktel).

For 2006 we expect that current account will have a surplus of 1.0% of GDP. In 2007 the C/A balance is expected to worsen somewhat and it will have a deficit of 1.0% of GDP due to further deterioration of trade balance.



Labour Market Developments

Unemployment rate decreased from 36.5% to 35.9% in the third quarter of 2006 in comparison with the same quarter of the previous year. In line with that tendency employment rate increased from 35.1% to 35.6%. It meant that the number of employed persons increased by approximately 12 000 thousand workers and reached 576 800.

Regarding the high rate of informal economy in the country the aforementioned trend reflects the whitening of the grey economy.

For 2006 we forecast that current trend will continue and the employment rate will increase gradually. As a result the unemployment rate will decrease and it can decline under 37% in annual average. In 2007 unemployment is expected to decrease further to 36.5%.

Table 6 Major macroeconomic indicators for FYROM, 2004-2007

	2004	2005*	2006**	2007**
GDP growth	4.1	4.0	3.0	3.0
Private consumption (%)	5.8	n. a.	n. a.	n. a.
Public consumption (%)	4.6	n. a.	n. a.	n. a.
Investments (GFCF, %)	9.3	n. a.	n. a.	n. a.
Export (%)	9.1	n. a.	n. a.	n. a.
Import (%)	12.4	n. a.	n. a.	n. a.
Consumer price index (average, %)	-0.4	0.5	3.2	3.0
Unemployment (%)	37.2	37.3	36.8	36.5
General government balance (%)	0.0	-0.6	0.0	-0.5
General government debt/GDP (%)	36.6	40.9	36.5	35.0
Current account balance/GDP (%)	-7.7	-1.5	1.0	-1.0
Trade balance/GDP (%)	-20.6	-19.3	-22.0	-23.0
Gross foreign debt/GDP (%)	38.7	39.5	40.0	41.0
Exchange rate (end of per., MKD/EUR)	61.3	61.2	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

* Preliminary and estimated data ** Forecasts



ROMANIA

Record low inflation in Romania

Economic Growth

In course of the third quarter of 2006 economic growth accelerated further in Romania. Between July and August gross domestic product increased by 8.3% in real terms in comparison with the same period of the previous year. This rate was the highest in 2006, as it grew from 6.9% and 7.8% in first and second quarter respectively, and significantly higher than that of the third quarter in 2005 (2.4%). Though, that low growth rate in 2005 was greatly influenced by weak performance of agriculture sector owing to unfavourable weather conditions in 2005. Regarding the first three quarters of 2006, GDP growth reached 7.8% compared to the same period of the previous year.

On production side, contribution of main sectors to GDP growth was mixed. The performance of agriculture sector remained moderate and despite of the fact that its production dropped back significantly (by 14.7%) in 2005, gross value added in agriculture increased by 5.2% in the third quarter and by only 3.5% in course of the first three quarters of 2006.

The other three sectors reached excellent growth rate in the third quarter. The highest growth rate was achieved by construction sector (19.2%). That was the fifth consecutive quarter when gross value added in construction increased by more than 10%. Services sector, which accounted for 56% in total gross value added, increased by 7.8%, while industry sector expanded by 7.1%. The good performance of industry sector is mainly determined by the evolution of manufacturing production in this period.

On expenditure side, the picture has not changed significantly: private consumption and investments remained as main engines of economy. In the third quarter of the year, consumption of households increased by 12.4% in comparison with the same period of the previous year, while public consumption

increased slightly (2.9%). Dynamic growth of private consumption was mainly fuelled by significant credit growth, increase of real wages and appreciation of national currency.

Besides consumption of households, investments had a notable contribution to GDP growth. In the first three months of 2006 gross fixed capital formation (GFCF) increased by 15.6% which resulted in the fifth consecutive quarter of double-digit growth of GFCF. In the first nine months of the year gross fixed capital formation grew by 13.7%.

Regarding net export of goods and services, it had a negative contribution to GDP growth due to the fact that imports growth rate reached 21.2% while that of exports was 11.0% in the third quarter of 2006. Imports were boosted by strong domestic demand, namely private consumption and investments.

In the last three months of 2006 current tendencies are expected to continue and GDP growth is expected to reach 7.9% in the end of the year. This forecast is 0.7 percentage point higher than our previous forecast due to the outstanding performance of the Romanian economy in the third quarter.

In 2007 GDP growth is expected to be lower slightly and reach only 6.5%. Domestic demand will remain the main engine of the economy, while external demand will continue to have a negative contribution to GDP, owing to the strong import boosting impact of expanding domestic demand.

Monetary Conditions

Monetary policy tightened significantly in course of 2006. In the first half of that year, the Board of the National Bank of Romania (NBR) increased policy rate in two steps from 7.50% to 8.75%. As a result, the tightened monetary policy helped Romania find its way back to disinflation process in the second part of the year.



In December consumer price index (CPI) decreased to 4.9%, while it was close to 9% at the beginning of the year. The average CPI fell below 6.0% in the third quarter of the year, and this trend continued in the last quarter as well. In both November and December CPI was less than 5%.

Not only had the more restrictive monetary policy a positive impact on the evolution of consumer prices but also the favourable development of volatile food prices. In December 2006 the prices of food goods (in average) were only 1.1% higher than in the same month in the previous year. Owing to the 40% share of these goods in consumer basket it had a significant positive effect on the development of CPI. Accordingly, annual average consumer price index was 6.6% in 2006.

The NBR's inflation target for December 2006 was 5% (with a +/-1 percentage point range) and due to development of food prices and relatively restrictive monetary policy this target was realized at the end of 2006. In 2005 the target was missed only slightly but in the second year of inflation targeting regime, the target was completely achieved.

NBR's December 2007 inflation target is 4%, which seems realistic, however, in the first part of the year disinflation process is expected to slow down and will continue later during the year. Therefore NBR needs to be cautious in 2007 to be able to achieve its inflation target. The annual average inflation for 2007 is expected to be 5.2%.

Fiscal Developments

During the first ten months of 2006 general consolidated budget built up a significant surplus. The surplus reached RON 6.87 billion or almost EUR 2 billion (2% of GDP). The good result was due to the remarkable increase in revenues, mainly in case of income tax and VAT.

As it was mentioned in our previous forecast, the government gradually increased the planned budget deficit from 0.45% to 2.5% of GDP. The reason for increasing the planned budget was to spend more money on investments and social welfare (education,

healthcare). However, we expect that deficit/GDP will be lower than the planned figure due to higher than planned GDP, significant surplus reached during the first ten months and the short term available to execute the lately budgeted projects. Thus, we expect that deficit will reach 2.0% of GDP in 2006.

For 2007 budget deficit is expected to increase slightly mainly due to EU accession. The accession will have a negative impact on general government budget owing to the contribution to EU budget and co-financing EU projects. For 2007 we expect that budget deficit will reach 2.5% of GDP.

Balance of Payments

In the second part of 2006 current account (C/A) balance continued to deteriorate. At the end of October 2006 C/A deficit widened to EUR 7.7 billion, which was almost 50% higher than that in October 2005. C/A deficit reached 8% of expected GDP in the first ten months of the year.

The high current account deficit is mainly due to the increasing trade deficit which reached EUR 8.4 billion in course of the first ten months of 2006. Robust private consumption and investments growth boost import of goods that worsened the trade balance significantly. In fact this trend is observable from 2003 when domestic demand became the dominant engine of the economy.

On the other hand, foreign direct investments (FDI) increased significantly in 2006. During the first ten months of the year net FDI reached EUR 7.9 billion. It was an almost 90% increase compared to the same period of the previous year. It also means that FDI financed completely the deficit of current account balance.

For 2006 we expect that current account deficit will reach 10.6% in 2006 which will be an almost 2 percentage points increase compared to the same figure in 2005. In 2007 the current account deficit will remain basically on the same level as this year according to our expectations.



Labour Market Developments

In October 2006 the number of registered unemployed persons was lower by almost 46 500 than in October 2005. Accordingly, in October unemployment rate dropped to 5.1%

from 5.7%. In line with decreasing unemployment, employment figure also improved. For 2006 and 2007 we expect that current trend will continue due to the robust economic growth, and further decline of the unemployment is expected.

Table 7 Major macroeconomic indicators for Romania, 2004-2007

	2004	2005*	2006**	2007**
GDP growth	8.4	4.1	7.9	6.5
Private consumption (%)	12.9	9.0	12.0	9.0
Public consumption (%)	4.6	4.9	3.0	3.5
Investments (GFCF, %)	10.8	13.0	13.0	12.0
Exports (%)	13.9	7.6	11.0	10.0
Imports (%)	22.1	17.2	19.0	15.0
Consumer price index (average, %)	11.9	9.0	6.6	5.2
Unemployment (end of period, %)	6.3	5.9	5.3	5.1
General consolidated budget balance (%)	-1.2	-0.8	-2.0	-2.5
General government debt/GDP (%)	18.5	19.0	19.5	20.0
Current account balance/GDP (%)	-8.4	-8.8	-10.6	-10.0
Trade balance/GDP (%)	-8.8	-9.8	-12.0	-11.5
Gross foreign debt/GDP (%)	30.1	31.0	29.5	28.0
Exchange rate (RON/EUR) ***	4.05	3.62	3.52	3.46
Policy rate (end of year, %)	17.00	7.50	8.75	8.5

Sources: INSSE, NBR, own calculations

* Provisional data, ** Expectations; *** As of 1st of July 2005, RON is the new currency.



SERBIA AND MONTENEGRO

Slowdown in the growth of corporate and household loans contribute the curbing inflation in Serbia, improvement in the tourism sector in Montenegro

The referendum held on the 21st of May in Montenegro resulted in a vote for independence. As a consequence the Union of Serbia and Montenegro (SCG) disintegrated. Therefore our economic analysis should be viewed accordingly. The two economies will be analysed separately from the first quarter in 2007.

Economic Growth

Economic activity and real GDP growth remained strong in Serbia throughout 2006. In the third quarter GDP growth rate reached 6.7%, year-on-year. This was in large part due to the favourable performance of the industrial sector. Foreign demand for Serbian products, as well as domestic demand was strong. These factors were having a positive effect on real GDP growth. At the same time in the coming year domestic demand is expected to decrease, as growing propensity to save has been observed in the household sector, and a slowdown in lending to the household and corporate sectors is already occurring.

Parliamentary elections will take place in Serbia on 21st January, 2007. The election campaigns of most political parties are centred on economic issues. However formation of the new government may prove to be a difficult process, and until the new government stands up, economic reforms cannot be started.

According to our estimates, real GDP growth rate in Serbia reached 6.6% in 2006, which is higher than our earlier forecast. Real GDP growth rate is expected to decrease in 2007, to 5.2% year-on-year.

Real GDP growth rate in the third quarter reached 6.3% year-on-year in Montenegro, which is lower than in the previous two quarters. A decrease was experienced in industrial production, which amounted to 4.8% (year-on-year) in October. Compared to the previous year the number of overnight stays increased in the third quarter. In October, compared to the same month in the previous year, an increase of 13.5% and 19.3% occurred in tourist visits and overnight stays,

respectively. This signals improvement in tourism, one of the Montenegrin economy's most important sectors. The growth rate of real GDP is expected to reach 6% in Montenegro in 2006.

Monetary Conditions

Consumer prices rose by 8.8% year-on-year in November 2006 in Serbia. This is a decrease compared to the previous two months (11.6% and 9.3% in September and October, respectively). Producer prices rose by 12.9% year-on-year in September. Slowdown in the lending to households and the corporate sector contributed to easing inflationary pressure. The strengthening of the dinar also helped to curb inflation.

Inflation remained low in the third quarter in Montenegro, amounting to 2.3% year-on-year. In both September and October retail prices increased by 1.7% year-on-year. The annual increase in producer prices amounted to 4.1 per cent in October.

As a result of the restrictive measures of the central bank, CPI in Serbia is expected to be one-digit in 2006 and remain so in the coming year as well. In 2006 end of year inflation is expected to reach 7.1%. In 2007 a slight increase is expected, to 7.8%. In Montenegro end of year inflation is expected to amount to 2.9% in 2006. In 2007 a slight decrease is expected, to 2.2% year-on-year.

Fiscal Developments

In the first half of 2006 the budget surplus in Serbia amounted to CSD 6.9 billion. This represents 17.7% of surplus envisaged for 2006. Revenue in the first six months was a



result of robust growth of revenue from income tax, profit tax and capital gains. This was a result of positive financial position of the corporate sector, and increase in wages in both real and nominal terms. A further large inflow of non-tax revenue is expected in the second half of the year.

In October the budget surplus in Montenegro amounted to EUR 4 million. In the first ten months of 2006 the aggregate budget surplus reached EUR 28.4 million. This was the result of increased current revenues, more specifically from tax revenues and reimbursements. The tax revenues increased significantly, because of the increased inflow of VAT collection, excise duties, and tax on international trade and transactions.

Balance of Payments

Favourable trend in export growth in the first half year in Serbia was the result of demand on the world market for basic metals, and the effects of preferential treatment (introduced in 2005) on exports of clothing to the EU countries. Internal factors inducing exports included the regular VAT rebate, and privatization and restructuring of state-owned enterprises. Growth in imports was induced by more sophisticated economic activities and higher consumer and investment demand. Compared to the same period in the previous year deficit of the balance of goods in the first half year rose by 26%. FDI inflow was high in 2006 in Serbia. This was primarily due to the sale of a mobile phone operator.

Compared to the previous year a small widening of the Serbian trade deficit is expected overall for 2006. This is a result of the unfavourable trade developments in the first quarter, even though improvement started

in the second quarter. In 2006 the current account is expected to deteriorate compared to the previous year, with the deficit reaching 10.4% of GDP.

In the first half year of 2006 the trade balance and as a consequence the current account balance deteriorated significantly in Montenegro. There was a significant increase in the expenditure for foreign services, as a result of the activity of foreign construction companies. In the first half year service expenditure growing faster than service income resulted in a EUR 17.3 million reduction of the surplus compared to the same period in the previous year. The current account deficit is expected to reach 15.4% of GDP in 2006 in Montenegro. The current account deficit is only expected to improve slightly in 2007.

Labour Market Developments

In Serbia in the third quarter of 2006 nominal wages and salaries increased by 22.3%, while real wages and salaries increased by 9.8% compared to the same quarter in the previous year. In September 2006, the year-on-year increase in the number of persons seeking a job was 1.6%. Unemployment rate at the end of the year is expected to reach 22.2% in Serbia. A decreasing trend is expected to start in the following years, with the unemployment rate decreasing to 21% by the end of 2007.

Situation in the labour market is also bad in Montenegro. The official unemployment rate is expected to reach 25 per cent in 2006. Slow improvement in the Montenegrin labour market is expected to take place in following years, with the unemployment rate reaching 23% by the end of 2007.



Table 8 Major macroeconomic indicators for Croatia, 2004-2007

	2004	2005	2006*	2007*
GDP (%) Serbia	9.3	6.8	6.6	5.2
GDP (%) Montenegro	3.1	4.1	6	5.5
CPI (average, %), Serbia	11.4	16.2	11.9	8.8
CPI (average, %), Montenegro	3.3	2.4	3	2.6
CPI (dec/dec, %), Serbia	11.4	17.1	7.1	7.8
CPI (dec/dec, %), Montenegro	4.3	2.4	2.9	2.2
Unemployment rate (%), Serbia	18.5	20.8	22.2	21
Unemployment rate (%), Montenegro	n.a.	27.4	25	23
General government balance (% of GDP),	-0.3	1.9	0.8	0.3
General government balance (% of GDP),	n.a.	2.7	0.3	0
General government debt/GDP (%),	57.8	48.2	41.9	34.7
General government debt/GDP (%),	53.5	44.5	37.2	36.8
Current account/GDP (%), Serbia	-12.4	-8.6	-10.4	-9.6
Current account/GDP (%), Montenegro	-7.8	-9.4	-15.4	-15
Trade balance/GDP (%), Serbia	-30.3	-23.4	-21.6	-20.7
Total external debt/GDP (%), Serbia	66.3	66.6	60.5	55.1
Total external debt/GDP (%), Montenegro	n.a.	31.3	n.a.	n.a.
Average exchange rate (CSD/EUR)	72.6	83.2	85.4	86.1
Two week repo rate, end of period, Serbia	24.0	19.8	15.5	12

Sources: IMF, National Bank of Serbia, Central Bank of Montenegro

* Forecasts



EU ENLARGEMENT 2007 – END OF ROUND 5

On 1st January 2007 Bulgaria and Romania became Member States of the European Union. Accordingly, all Central and Eastern European (CEE) transition countries that signed European Agreement - which was a milestone in European integration -, applied for EU membership and started EU accession negotiations at the end of the millennium. In fact these transition countries were separated into two groups at the end of the last decade. The first group of candidate countries – including the Czech Republic, Estonia, Hungary, Poland and Slovenia from CEE region – was called “Luxembourg countries”, while the other group of countries, the so-called “Helsinki countries” was comprised of Bulgaria, Latvia, Lithuania, Romania and Slovakia. EU accession talks started earlier in case of the first group of countries, in 1998, while negotiations with the countries of Helsinki group launched one-and-a-half year later.

Even so, not five but eight CEE countries joined the EU on 1st May 2004, which meant that three out of five CEE countries – namely the two Baltic countries and Slovakia - from the second group were able to close the gap and made up for the lags. On the other hand, Bulgaria and Romania lagged behind in European integration process, and accordingly, these two countries were able to join the European Union more than two years later in comparison with the eight Central and Eastern European countries which became EU Member States in 2004.

The EU accession of Bulgaria and Romania delayed due to the slow pace of negotiations compared to the other CEE countries. In November 2001 or almost one year before the closure of accession talks, Hungary has already closed provisionally 21 chapters while in case of Bulgaria and Romania the number of closed chapters were 13 and 9 respectively.

The delay and slow realization of economic reforms played a significant role in

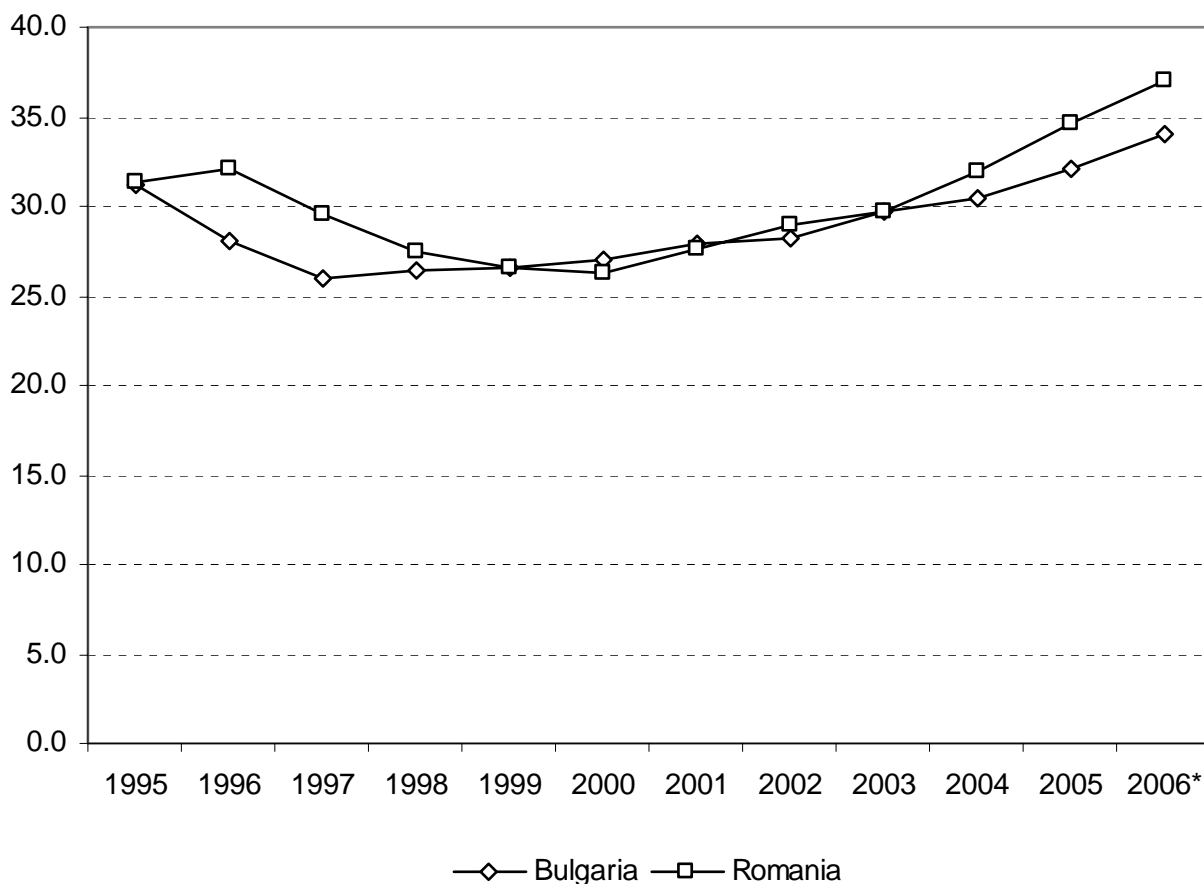
the slow progress of accession negotiation process. Economic reforms, such as stabilisation, liberalisation and privatisation, advanced slower in Bulgaria and Romania than in the front-runner CEE countries. The delay in progress is reflected well in that fact that Romania was recognized as a functioning market economy only in the 2004 Progress Report. The functioning market economy criterion is a key part of Copenhagen criteria which set the main conditions to the candidate countries to become an EU member.

Therefore, the delay of reforms resulted in the later accession to European Union. Obviously, Romania was in one of the worst situations regarding the CEE transition countries because the heritage of the previous regime was maybe the most severe in that country in the region. The welfare of the population was extremely low due to the oppressive dictatorship that lasted several decades long, and it may not have been accidental that the leader of the former regime was executed only in Romania among the CEE transition countries. Thus, one of the main aims of the leaders of the new regime was the gradual – or slow – transformation of the economy to decrease the burden of the population in course of the transition period. That is the reason why reforms progressed slowly after the transition in Romania.

Owing to the slower progress in reforms, the development of gross domestic product was also different in these countries in comparison with the front-runner CEE countries. In the second part of the previous decade Bulgaria and Romania went through another recession period while most CEE countries economic growth started to accelerate. The second decline period certainly had a negative impact on the GDP of these two countries. It resulted in that gross domestic product is approximately 20-25% lower than it would be if Bulgarian and Romanian economies had increased by the same growth rate as - for example - Hungary or Poland in the second half of 1990s.



Chart 1. Development of per capita GDP (PPS) in Bulgaria and Romania, 1995-2006 (EU-25=100)



Source: UNECE, own calculations

Eventually, Bulgaria and Romania joined the EU on 1st January 2007, and now these two countries are the poorest in the club. Per capita gross domestic product in Bulgaria and Romania reached 32.1% and 34.6% of EU-25 average respectively, on purchasing power parity in 2005. Latvia was the poorest country in that year with 47% figure which reflects well that significant difference between the countries that joined the EU in 2004 and the two new Member States. Therefore, Bulgaria and Romania hope that convergence towards EU average will be supported by EU funds within the Union.

The EU supports transition countries by financial instruments, not only the EU members but also the candidate and potential candidates in Central and Eastern European and Southeast European (SEE) regions. However, the difference between pre-accession

and post-accession funds is significant. As candidate countries, for Bulgaria and Romania the most important funds were PHARE, ISPA and SAPARD programmes. These programmes covered (1) institution-building and economic and social cohesion, (2) environment and transport infrastructure development and (3) agricultural and rural development in these countries, respectively. PHARE programme was established first (in 1989) and the two other programmes, namely ISPA and SAPARD started in 2000.

PHARE programme for Bulgaria committed a total of EUR 1.9 billion between 1992 and 2005. From ISPA and SAPARD programmes Bulgaria was allocated EUR 700 million and EUR 355 million respectively. In case of Romania these amounts were higher due to the larger size of the country. Between 1992 and 2005 total financial aid made



available from the three aforementioned programmes was EUR 6.2 billion. The annual average amount of allocation for Bulgaria and Romania was EUR 211 million and EUR 442 million since 1992. However, the financial aid from these programmes gradually increased and reached EUR 378 million and EUR 1 billion in 2005 in Bulgaria and Romania. The latter financial instruments accounted for around 1.8% and 1.3% of GDP, correspondingly.

Regarding post-accession funds one can notice easily that the volume of financial aids is significantly larger in the EU than out of it.

For the 2007-2013 period, the two new Member States will receive EUR 44.3 billion of which EUR 31.5 billion is allocated to Romania and 12.8 billion to Bulgaria. In comparison with the slightly more than EUR 8 billion the two countries received from the EU between 1992 and 2005 via PHARE, ISPA and SAPARD, it is obvious that the name of the game has changed.

For the first three years, total commitments to Bulgaria and Romania are EUR 15.4 billion. These financial aids will cover the following areas: agriculture, structural operations, internal policies and administration.

Table 9. Financial Package for Bulgaria and Romania, 2007-2009 (millions of euros)

	2007	2008	2009	Total	(% of total)
Agriculture	1141	1990	2342	5 473	35.5
Structural operations	1938	2731	3605	8 273	53.7
Internal Policies	444	434	426	1 304	8.2
Administration	96	125	125	346	2.2
Total commitment appropriations	3619	5279	6498	15 396	100.0

Source: EU Commission

Structural operations, namely Structural Funds and Cohesion Fund account for the largest share (almost 54%) in total commitments. Besides that, agricultural financial instruments (rural development, direct payments and market measures) will

have a significant share. These two sources will constitute almost 90% of total commitments between 2007 and 2009. Evidently, Romania accounts for 71% of total commitments to the two countries which is almost EUR 11 billion.

Table 10. Structure of financial aids for Bulgaria and Romania, 2007-2009 (millions of euros)

	Bulgaria	Romania
Agriculture	1 552	3921
<i>Market measures</i>	388	732
<i>Direct payments</i>	431	881
<i>Rural development</i>	733	2 308
Structural operations	2 300	5 973
Internal Policies	508	796
Administration	346	
TOTAL COMMITMENTS	4 464	10 932

Source: EU Commission



Regarding the main financial aids, agricultural financial instruments include market measures, rural development and direct payments. In case of direct payments a similar gradual phase-in of agricultural direct payments is planned as in case of the Member States joined the EU in 2004. The direct payments will start at 25% and will reach 40% in 2010; 100% will be reached in 2016.

According to the acquis structural funding cannot exceed 4% of GDP. In the case of Bulgaria and Romania there is a phase-in period and the respective caps are 2.4% in 2007, 3.2% in 2008 and 4% in 2009. It resulted in EUR 8.3 billion for structural actions between 2007 and 2009 in Bulgaria and Romania.

As it is noticeable, the revenues from the post-accession funds can be much larger than that from the pre-accession funds which also means that the development and convergence of these two countries will be supported by more financial assistance than earlier.

In line with the accession of Bulgaria and Romania, the system of pre-accession financial

assistance changed as well. As it was mentioned earlier the main pre-accession instruments were PHARE, ISPA and SAPARD programmes and CARDS in the case of Western Balkan countries. As of the beginning of 2007 a new instrument named instrument for pre-accession accession (IPA) replaced the former programmes. There were two major aims to create IPA. First, the simplification of assistance policy was needed in the EU because the former system became too complex. And second, the IPA was designed to support more effectively each beneficiaries and considering better their needs.

IPA will provide EUR 11.5 billion between 2007 and 2013 and the target countries are candidate and potential candidate countries, including Turkey. Regarding that amount of assistance and the beneficiaries and comparing it to the aforementioned commitments to the two new Member States – total commitments to Romania will be about the same amount of money for three years –, the comparison underpins the relevance of EU membership from economic aspect.

