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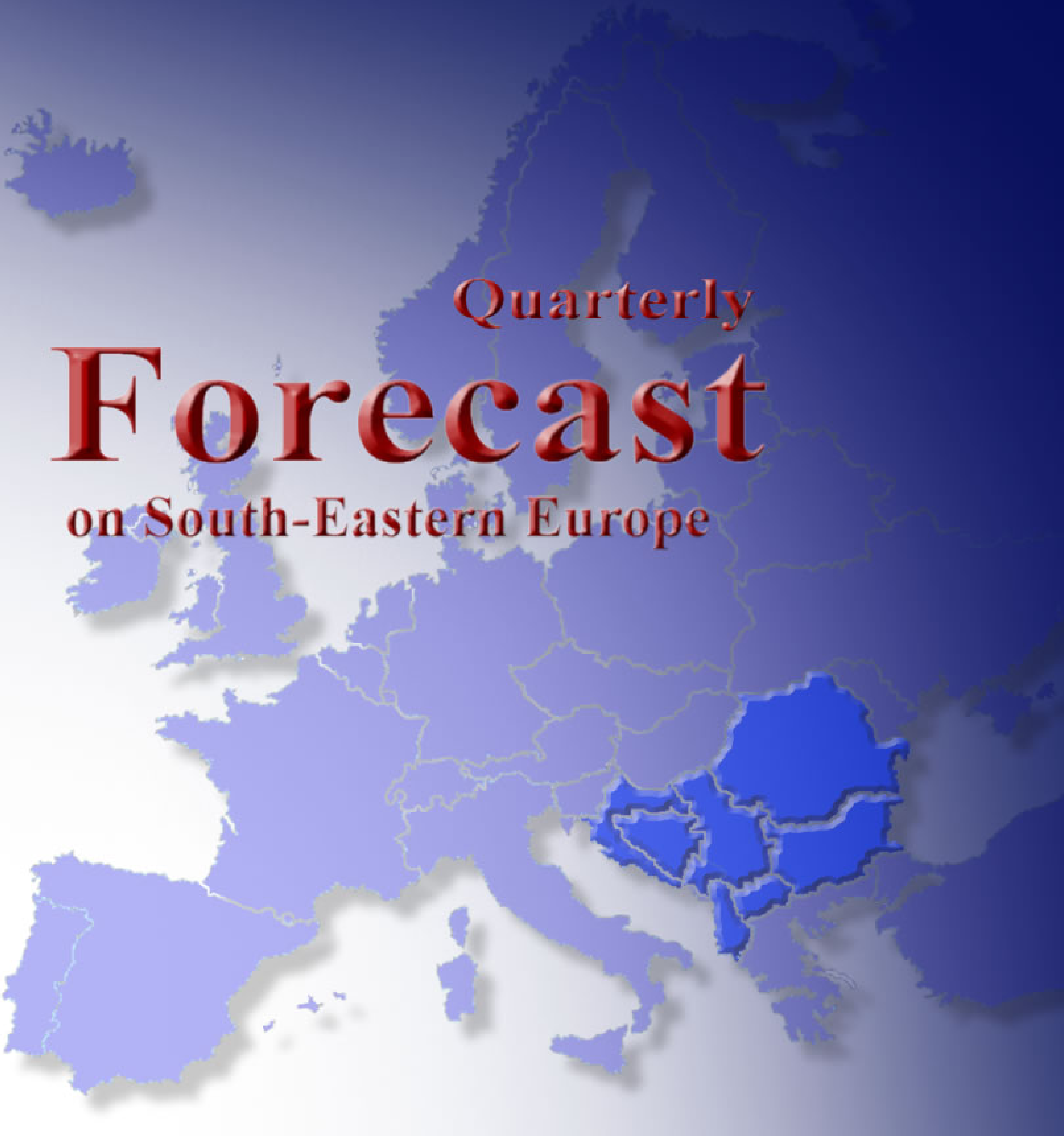

Quarterly Forecast on South-Eastern Europe

Summer

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Overview

Outstanding economic growth in the region with significant external imbalances and slowly decreasing unemployment

Economic Growth

In 2005 economic growth rate will decrease slightly in the Southeast European countries compared to the previous year. However, GDP growth remains strong in this region, the average rate of the seven SEE countries is close to 5% (it means the growth rate of Southeast European countries is almost the same as that of the New Member States). This is a 0.4% drop back compared to 2004.

The real GDP growth is expected to slow down somewhat in Bosnia-Herzegovina, Romania and Serbia and Montenegro, while, Albania and Bulgaria will be able to keep the pace of last year's economic growth. Only Croatia and the former Yugoslav Republic of Macedonia are expected to increase their GDP growth significantly in this year. According to our expectations, Albania and Bulgaria can reach the highest GDP growth in 2005, 6.0% and 5.8% respectively, while the performance of the former Yugoslav Republic is expected to be the weakest in 2005, GDP growth can be 3.5% this year. It is also an interesting fact that the standard deviation of economic growth rates decreases significantly in the region this year from 1.8% to 0.8%, which reflects convergence among GDP growth rates of this region's countries.

In 2005 domestic demand remains the main engine of economic growth in the region. While foreign demand is weak and the growth of export will decrease in 2005 compared to the previous year, the role of consumption and investments remains dominant in this year. However, the main reason for the slightly decreasing economic growth pace is right that the expansion of domestic demand slows down in several economies in the region.

Monetary Conditions

In most Southeast European countries price stability or low inflation rate characterises the economy. Among foreign factors, on the one hand, the increasing oil prices had a negative impact on inflation development, on the other hand, the appreciation of the euro against the US dollar supported decreasing inflation in 2004.

In most Southeast European countries the currencies are fixed to the euro, moreover, Montenegro adopted euro as its de-facto currency of the country. Thus, the appreciation of the euro has meant the appreciation of these currencies against the US dollar, which decreased the prices of import goods denominated in US dollar.

In 2004 the inflation rate was 4.7% on average which will increase slightly in 2005. In most SEE countries inflation remains low or disinflation process will continue except for two economies: Bulgaria and Serbia. In case of Bulgaria, the rapid economic growth has a negative impact on inflation through increasing demand, while, in Serbia the introduction of VAT - at a 18% rate - has a one-off negative impact on price increases. In the last several years Romania had the highest inflation rate in the region but in 2005 Serbia will inherit this 'title'.

In several countries of the region credit boom characterises the economy similarly to the NMSs. Thus, national banks adopted cautious measures and cut interest rates carefully. Thus, reference rates were mainly unchanged or slightly decreased in the region, in line with the declining inflation rate. Significant interest rate cut was observed only in Romania where disinflation process evolved considerably in last year. In 2005 we expect that rates will remain on the same level as last year except for Romania where significant interest rate cuts were observable in the first few months in 2005.

Fiscal Policy

General government deficit is lower in these economies on average compared to that of the New Member States. Undoubtedly, in most economies of the SEE region the applied exchange rate regimes and tight monetary policies strongly determine the fiscal policy and the evolution of budget deficit. In 2004 general government deficit reached less than 2% of GDP on average, while, this figure will change only slightly in 2005. In most SEE economies, the deficit will be lower in 2005 compared to last year, only Bulgaria and Romania will have higher general government deficit. In Bulgaria elections which will be held in June 2005 can have a negative impact on the balance, while in Romania, the introduction of flat tax regime will decrease the revenues of the Romanian government.

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

Balance of Payments

External imbalance is one of the main macroeconomic problems in most Southeast European countries. In general, foreign trade balances have huge deficits in SEE region and this factor greatly influences the development of current account balance. In 2004 the current account deficit reached 10% of GDP on average due to the aforementioned high foreign trade deficit trade (23.4% on average). However, in these economies, the roles of services balance and remittances are much higher than in the New Member States. The significant difference between the foreign trade balance/GDP and current account/GDP figures also reflects the high role of these elements. The only country in the SEE region where the structure of the current account balance is similar to that of the NMSs is Romania. In Romania's case, the foreign trade deficit was 'only' 9% of GDP while C/A deficit reached 7.5% in 2004.

In 2005 the current account balances will improve in mainly those economies where the C/A per GDP ratio is the highest, namely in Bosnia-Herzegovina and Serbia and Montenegro. The C/A balance will worsen considerably in this year in Bulgaria and Romania by almost 1%-point. This worsening is due to the increasing deficit of foreign trade balance which is a result of the strong import demand of these economies.

Unemployment

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

In 2005, slight improvement is expected in most SEE countries regarding employment and unemployment due to the strong economic growth and new investments realised by foreign investors. However, the progress in privatisation process may have a dampening effect on the employment in these countries.

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

	2003	2004	2005*
GDP growth (%)	4.2	5.3	4.9
Inflation (%)	4.9	4.7	4.8
General Government balance/GDP (%)	-2.3	-1.9	-2.0
Current Account/GDP (%)	-9.6	-10.0	-10.0
Unemployment (%)	22.9	23.1	22.5

** Forecasts*

Albania

Robust growth remains in 2005

Economic Growth

In 2004 Albania reached robust economic growth. The Western Balkan country was able to sustain the strong growth rate, GDP rose by 6% in last year according to the expectations, which is equal to the 2003 figure. On the production side, the main engines of the economy were agriculture and construction. Agriculture sector, which accounts for approximately 25% of GDP, performed well last year due to the stable climatic conditions and good harvest. On the other hand, industrial output was moderate in 2004, however, it accelerated compared to the previous year.

In 2005 economic growth is expected to remain strong due to the fact that the performance of the agriculture sector can be strong again. Thus, Albania will be one of the economies with the highest GDP growth rate in the region this year.

Monetary Conditions

Consumer Price Index (CPI) was low in 2004, 12-month inflation reached 3%. That figure was exactly in the middle of the Bank of Albania's target range of 2% and 4%. Principally the increasing crude oil prices have the main boosting impact on the development of consumer prices. On the other hand, the appreciation of Albanian currency (Lek) has a positive impact on CPI during 2004.

Albanian Lek appreciated not only against US dollar but also against the euro. The appreciation was due to the fact that significant amount of foreign currency flowed in from tourism sector in the middle of 2004 and from Albanian workers' transfers living and working abroad.

Low-level inflation and exchange rate pressure was followed by lowered interest rates. Bank of Albania decreased its base rate to 5.25% from 6.5% in course of last year.

In the first trimester of 2005 CPI remained low, inflation reached 1.3% in April. It means Albania has price stability and Bank of Albania will manage to further keep inflation in the target range. CPI is expected to reach 2.5% in December 2005 y-o-y.

In course of 2005 further appreciation of Albanian currency is expected due to the significant foreign currency inflows from tourism sector and from Albanian workers' transfers. ALL/EUR exchange rate can decrease to approximately 120 due to the aforementioned factors. As another result, interest rate is expected to decrease too, by 50 base-points according to our expectations in course of this year.

Fiscal policy

The general government deficit remained under 5% of GDP including grants in 2004. The level of budget deficit increased, however, the figure was in line with the projections planned jointly with IMF. The achievement of planned budget deficit target also supported to reach inflation target. The temporary jump in budget deficit was due to one-off increase of non recurring expenditure, such as investment expenditures of the government. However, this one-off increase will not influence the fiscal consolidation process and budget deficit is expected to reach 4.4% including grants in 2005.

Due to the significant consolidation of the budget in Albania, which helped to decrease general government deficit to under 5% from a double-digit level, public debt level also decreased. Public debt per GDP ratio decreased to 55% in 2004 and further decrease of the indebtedness is expected in 2005 owing to the relatively low budget deficit.

Balance of payments

Probably external imbalance is the most important macroeconomic problem of the Albanian economy. High trade deficit characterises the Southeast European country and as a result of this factor current account balance is also in red.

Foreign trade deficit exceeds 20% of GDP which reflects huge imbalances in the economy. This figure is bad even if we consider that the growth of export overpaced that of the import in the last few years. The significantly lower value of export basically neutralised the positive effect of the notably higher increase pace. However, the foreign trade deficit per GDP figure is improving and it is close to 20%.

Due to the improving foreign trade balance and the significant amount of transfers from Albanian workers abroad and surplus of tourism sector, the current account deficit is significantly lower than that of foreign trade balance. C/A deficit reached 5.5% of GDP including grants in last year. Current account deficit is expected to reach 6.0% in this year so the balance will worsen a little in course of 2005.

Foreign direct investments played an insignificant role in last years in Albania, so it was not able to finance the deficit of current account balance. However, in 2005 the FDI volume is expected to increase due to the planned privatisation process, thus, FDI inflows can reach all time high in this year. According to the plans the Albanian telecom company is expected to be privatised, among other state owned companies. This would help financing the large deficit of C/A.

Unemployment

Unemployment is not such a big problem in Albania as it is in some other Western Balkan countries. Unemployment rate is still double-digit but the rate is decreasing. However, the inflows of foreign capital and the restructuring of the economy followed by privatisation process may have a negative impact on employment in course of the year. On the other hand, the unemployment rate is expected to decrease moderately in 2005.

Table 2. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004*	2005*
GDP growth (%)	6.0	6.0	6.0
Private consumption (%)	n. a.	n. a.	n. a.
Public consumption (%)	n. a.	n. a.	n. a.
Investments (GFCF, %)	n. a.	n. a.	n. a.
Export (%)	13.5	23.5	12.0
Import (%)	0.5	8.0	10.0
Consumer price index (average,%)	2.4	3.0	2.2
Consumer price index (dec/dec, %)	3.3	2.2	2.5
Unemployment ratio (%)	15.2	14.5	14.0
General government balance[1] (%)	-4.1	-4.6	-4.4
Public debt/GDP (%)	n. a.	55.0	54.0
Current account /GDP[1] (%)	-5.1	-5.5	-6.0
Trade balance /GDP (%)	-22.9	-20.7	-20.5
Gross foreign debt /GDP (%)	20.2	21.0	21.5
Exchange rate (ALL/EUR)	137.5	125.5	120
Interest rate (end of year, %)	6.50	5.25	4.75

** Forecasts; [1] including grants*

Bosnia-Herzegovina

Further acceleration in economic growth, slowly improving external balance

Economic Growth

In Bosnia-Herzegovina (BiH) economic growth accelerated in 2004 due to the improving industrial output and agricultural performance. In both entities (the Federation and Republika Srpska) industrial production increased dynamically. In the Federation part of the country mainly the processing industry, in Republika Srpska mostly the mining division were the main engines. The growth rate of the industrial production in Federation reached 14% while this figure in RS was slightly lower, 7% in 2004.

In 2005 the industrial production is expected to rise but the pace will be slower than last year. According to our expectations the industrial output growth remains a one-digit figure in both entities in this year. In line with the lower industrial production growth, GDP will increase at a slower pace this year, GDP growth is expected to be 4.8% in 2005, which is somewhat lower than the 2004 figure (5.1%).

Monetary Conditions

Retail Price Index (RPI) was stable in last years, inflation was below 1% in BiH. Price stability characterised both entities, however, while a low inflation was observed in Republika Srpska, in the Federation entity deflation is rather typical for the last years or the prices are rather decreasing than rising in general. Nevertheless, this process reflects convergence of prices and inflation rates in the two entities of the country.

Bosnia-Herzegovina chose currency board arrangement as an exchange rate regime in the last decade and this exchange rate regime helped the country to keep the inflation low.

Credit expansion characterised the economy last year too, loans to private sector continued to rise in 2005. Thus, the rate of required reserves was doubled in course of the last year in two steps, it jumped from 5% to 10%[1]. On the one hand, it increased the reserve accounts with Central Bank of Bosnia-Herzegovina, but on the other hand, this measure has not reduced significantly the growth rate of credit due to the high liquidity of commercial banks.

In 2005 inflation remains low in both entities owing to the exchange rate regime, the tight fiscal policy and the strong euro to which the currency, the Convertible Marka is pegged. In 2005 Retail Price Index is expected to be 0.6% in Bosnia-Herzegovina.

Fiscal policy

Under a currency board arrangement, fiscal policy has significant role in the development of macroeconomic tendencies. Using a CBA regime means budget should be kept in equilibrium. In last year the general government balance was almost in equilibrium, only a slight deficit was observed in BiH. As it was mentioned above tight fiscal policy characterises all levels of government in BiH.

The successful consolidation of the general government budget in last years contributed to the decrease of public debt of the country. The public debt per GDP ratio declined to less than 33% in last year and the further improvement of the indebtedness figure is expected in 2005 in line with the sustained restrictive fiscal policy.

Balance of payments

Current account deficit is one of the most important macroeconomic problems of Bosnia-Herzegovina. High C/A deficit is mainly the result of the enormous foreign trade deficit accumulated by the economy in every year. The value of import of goods greatly exceeds that of the export, thus foreign trade deficit exceeds 50% of GDP. It reflects the high import demand of the economy and the under-

[1] From 1 September the reserve requirement was increased to 7,5% and from 1 December 2004 it was increased to 10%.

development of the domestic industry sector. The huge difference between the values of export and import fades the fact that growth rate of export greatly overpaced that of the import. However, the decreasing foreign trade deficit per GDP ratio is a positive sign for the economy and the continuation of this trend is expected in this year too.

Current account deficit is also huge even if including grants. C/A deficit reached 23.3% in 2004 which is slightly lower than the 2003 figure. The current account deficit is significantly lower than that of foreign trade due to the large amount of current transfers. Net amount of current transfers reached 22% of GDP which was able to cover partly the deficit of foreign trade balance. In other words, current transfers from abroad finance a significant part of enormous import.

Foreign direct investment inflows increased in 2004 by almost 20% and reached EUR 400 million. The significant increase was the result of the improving business climate and the finalisation of some privatisation deals.

In 2005 the foreign trade balance will improve slightly due to the facts that credit expansion boost further the import demand of the country and the introduction of 17% VAT at the beginning of 2006 may have a negative impact on foreign trade balance in last month of 2005. On the other hand, export of goods is expected to grow dynamically and this can support the decrease of foreign trade deficit.

Due to the decreasing foreign trade deficit current account balance is expected to improve slightly and can reach 22.5% of GDP. In line with that tendency, the amount of FDI inflows will be around the same level than last year according to our expectations.

Unemployment

High unemployment is the other main problem of the economy. According to the official figures, unemployment rate exceeds 40%. The level of unemployment is almost the same in Republika Srpska and the Federation.

However, the official statistics do not reflect well the situation of unemployment in the country. According to estimations, the real unemployment rate is around 20% in Bosnia-Herzegovina and it is improving. It means a significant part of unemployment people works in the grey economy which also shows the large size of grey economy. According to the estimation of Central Bank, the size of grey economy is around 40% of official GDP figure.

In 2005 the official rate of unemployment is expected to remain around 44.5. The evolution of privatisation process may have a negative impact on employment rate in course of the year.

Table 3. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004*	2005*
GDP growth (%)	3.0	5.1	4.8
Private consumption (%)	n. a.	n. a.	n. a.
Public consumption (%)	n. a.	n. a.	n. a.
Investments (GFCF, %)	n. a.	n. a.	n. a.
Export (%)	11.5	28.7	12.0
Import (%)	6.0	7.6	7.0
Retail price index (average,%)	0.6	0.4	0.6
Retail price index (dec/dec, %)	0.6	0.5	0.5
Unemployment ratio (%)	42.0	44.6	44.5
General government balance[1] (%)	0.4	-0.1	0.1
Public debt/GDP (%)	34.0	32.8	32.0
Current account /GDP[1] (%)	-24.5	-23.3	-22.5
Trade balance /GDP (%)	-58.4	-55.4	-54.8
Gross foreign debt /GDP (%)	34.0	33.0	32.0
Exchange rate (BAM/EUR)	1.956	1.956	1.956
Interest rate on RR (end of year, %)	2.0	2.0	2.0

** Forecasts; [1] including grants*

Bulgaria

Accelerating growth with widening imbalances

Economic growth

Bulgaria has experienced in recent years a gradual but continuous acceleration of its GDP growth from 4.1% in 2001 to 5.7% in 2004. The growth in last year was mainly driven by three major factors. One was the fast expansion of exports thanks to the improving competitiveness of Bulgarian tradable sector (reflecting partly the results of the ongoing restructuring, higher FDI inflows in recent years) and favorable terms of trade developments. The second driving factor was the increase of private sector gross capital formation, which was closely linked to the increase of exports and reflected growing foreign direct investments and improving market expectations of the corporate sector. Finally, the expansion of private consumption was also brisk due to the increases in both net wages and employment and a fast rise in bank credit to the household sector. Similarly to other New Member States and some South-Eastern European countries, Bulgaria has been experiencing a fast increase in foreign currency denominated loans by the household and enterprise sectors.

In 2005 slight acceleration in GDP growth and its changing composition are expected. The main change will come from the election driven stimulus provided by the government, reflected in the fast rise of private and government consumption. Private sector consumption is expected to accelerate, thanks to further rise in wages (partly linked to the increase in minimal wages at the beginning of 2005), some changes in tax system and uninterrupted rise in private sector borrowing. Public consumption is driven by the election stimulus, which leads to a sizeable expansion of government outlays. This changes slightly the composition of domestic demand and net exports in favour of the former, as import demand is likely to increase leading to higher deficit in the contribution of net exports to GDP.

Monetary conditions

Last year saw a significant reversal in the continuous disinflation observed since 2000 in Bulgaria as consumer prices increased by 4.5% after being virtually unchanged in 2003. The faster rise in consumer prices was linked to the described acceleration of GDP growth as demand pressures were translated to price increases. The acceleration of inflation was also linked to the increases in administrative prices and rise in import prices due to the changing in oil prices and worsening terms of trade. Finally, monetary conditions in 2004 were relatively easy reflected fast rise in money supply and domestic credit. In 2005 a slight moderation of consumer price increase is expected, mainly because administrative prices and indirect taxes will remain unchanged as a reflection of upcoming elections. On the other hand the acceleration of wage increases far exceeding the expected rise in productivity, and the changes in import prices will add to inflation which thus will moderate only very gradually.

Fiscal Policy

Bulgaria has achieved in recent years general government surpluses, thanks to the adherence to the currency board arrangement. The fiscal surplus was due to conservative fiscal policies, adjustment in expenditures and favorable structural changes (decline in unemployment) reducing fiscal outlays. Last year the surplus of the general government increased further and reached 1.5% of GDP. Besides the usual factors the fast increase on GDP and higher inflation broadened the tax base and led to significant rise in revenues. The positive cyclical effects were also accompanied by the favourable outcome of structural reforms (mainly reduction of unemployment).

In 2005 the fiscal balance is expected to deteriorate notwithstanding the fast rise in GDP. The major reason behind that is the change in the stance of fiscal policy towards a more expansive one, determined by the elections. Fiscal expenditures are expected to rise (one off measures, and wages in the public sector), while revenues may stabilize as tax cuts partly compensate for the rise in tax base due to GDP growth. The position of the general government is likely to deteriorate by around 2 percentage points of GDP leading to a deficit of 0.7% of GDP.

General government gross debt has seen a continuous decline thanks to the primary surplus and fast increase of real GDP. Between 2001 and 2004 general government debt declined from 66% to 38% of GDP and further decline is likely in 2005 due to the favourable growth performance. Debt does not seem to be a serious constraint for policy makers in Bulgaria.

Balance of Payments

After increasing substantially in 2003 current account deficit shrunk in 2004, while at the same time trade deficit kept on rising further. The worsening of the trade deficit was driven by the fast rise in imports, which were not compensated by the increase of exports growing above 10%. While trade deficit widened, the current account returned to a more solid deficit after rising fast in 2003. The improvements in the current account were due to the increase in service revenues, fast rise in tourism incomes and smaller debt service expenditures.

In 2005 both the current account and the trade balance are expected to worsen mainly because of the projected fast rise in import demand. Trade deficit will again exceed 15% of GDP as the fast expansion of imports is accompanied by slowdown of exports due to worsening external demand and growing competitiveness pressures on Bulgarian exporters. Imports will rise however very fast driven by the expansion of domestic demand as both consumption and private sector gross capital formation are likely to grow. The increase in trade deficit will only be partly compensated by the rise in tourism revenues, which will bring the current account deficit from last years' 7.5% again close to 9% of GDP.

Unemployment

Bulgaria has been able to reduce vigorously its high unemployment rate: while the number of unemployed stood at more than 19% of the labour force in 2001, it decreased to 12% in 2004. Two major factors have been responsible for the decline of unemployment. First, the fast rise of GDP, increased domestic and foreign investments created high demand for labour allowing fast rise in employment. Second, the government tackled more seriously unemployment and especially long-term unemployment with labour market policies fostering the return of unemployed to the labour markets. The growth of employment was also driven by the moderate rise of gross and net wages in 2004, which allowed a favourable development in unit labour costs.

In 2005 the picture is expected to change slightly, as gross and net wages will grow much faster than in 2004 mainly because of the rise in minimal wages and election driven stimuli provided to wage increases. This year the increase of gross wages will far outweigh the productivity gains leading thus to sizeable increase in unit labour costs. Notwithstanding these changes, employment is expected to grow much faster thanks to the employment generation by the private sector, driven by the fast rise in output. Unemployment may decline to 11% by the end of the year, which adds additional percentage point to the continuous decline observed since 2001.

Table 4. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	4.3	5.7	5.8
Private consumption (%)	6.4	4.5	7.0
Public consumption (%)	7.3	6.0	7.5
Investments (%)	14.0	12.0	15.5
Export (%)	8.0	13.0	8.0
Import (%)	15.0	13.0	12.5
Consumer price index (average, %)	2.3	6.2	4.1
Unemployment ratio (%)	13.5	12.0	11.0
General government balance (%)	0.5	1.5	-0.7
Public debt/GDP (%)	46.0	38.0	33.0
Current account/GDP (%)	-9.5	-7.5	-8.5
Trade balance/GDP (%)	-12.5	-14.0	-16.0
Gross foreign debt/GDP (%)	60.7	63.8	60.0
Exchange rate (BGN/EUR)	1.95	1.95	1.95
Base rate (%)	2.6	2.7	2.1

** Forecasts*

Croatia

Slight decline of growth accompanied by improving internal and external balances

Economic growth

Croatia recorded in 2004 a slight slowdown in the previously quite impressive growth performance. While the average growth rate in 2001-2003 was 4.7%, in last year GDP grew by 3.8%. The major factor behind the slowdown of GDP was the smaller growth of investments, mainly as a result of the completion of several infrastructure projects and smaller rise in public sector investment expenditures. While privatization and FDI related investments could boost private sector investment activity, altogether the investment growth fell sharply due to the decline of public investments. As a result of previous investments, increased inflow of foreign capital and associated privatization of former state-owned enterprises, one could observe a more dynamic increase of exports, a shift from the negative contribution of net exports to GDP towards neutral or even slightly positive one, which foreshadows the likely evolution of Croatian exports and trade balance. At the same time the central bank tried to restrict the growth of household sector borrowing by applying tight monetary conditions and raising the domestic interest rates, which gradually led to the declining growth of private consumption.

In 2005 private consumption is likely to decline somewhat: it will grow by 3.8% slightly below the last years' rate because of the full effect of central bank's tight monetary policy. High interest rates will be able to slow down the credit demand of the private sector, and this slowdown will not offset by the fast rise of private sector wages linked to the decline in unemployment and increasing demand for labour.

As most of the earlier initiated infrastructure projects are close to completion it is not likely that investment will pick up as growing private investments will be more than offset by the declining public sector gross capital formation. While there is no sizeable change in the demand composition of domestic factors, it is the increasing export supply which may help increase the rate of growth in 2005 to almost 4.3%. Export from the manufacturing sector has been soaring and this has implications both for the growth performance and current account balance of Croatia.

Monetary Conditions

The monetary conditions in Croatia are determined by the almost fixed exchange rate of the Kuna against the euro, the relatively high private sector foreign currency holdings and the significant reliance on volatile foreign capital inflows to cover the current account deficit. Last year one experienced a tighter monetary policy due to external imbalances and the need to weaken the credit growth channel. As fiscal policy was initially quite accommodative, the central bank had to take measures to stem the growth of domestic credit and demand. The combination of the fixed exchange rate and monetary restraint resulted in altogether quite low consumer price increases reaching 2.1% in 2004.

In 2005 consumer price increases are expected to accelerate somewhat, bringing the CPI to 2.7% on average. While the monetary framework remains unchanged the fiscal adjustment is accompanied by further adjustment of administrative prices and the high oil prices increase imported inflation as well. But the stability of the exchange rate, the restraint of the still high (though declining) unemployment on wage growth will keep the second round effect of these inflationary pressures moderate and will result in low inflation.

The exchange rate policy is expected to be driven by nominal strength and stability of Kuna as long as the degree of euroisation is high, the effect of exchange rate level on inflation is strong while on foreign balance weak, and the discipline effect on fiscal policy seems to have been working increasingly stronger.

Fiscal Policy

The fiscal policy in 2004 influenced by the political cycle was quite accommodative allowing and the revenue collection failed short of plans leading to a much bigger than expected deficit of the general government, reaching 5% of GDP. The elections in the mid of 2004 brought a new government which announced a fiscal adjustment package within the economic convergence programme for the period prior to the EU membership. Within this program the government took the obligation to reduce the fiscal deficit from 5% of GDP to 3% by 2007. This will require significant efforts to restructure and reduce fiscal expenditures in relation to GDP, while at the same time the government has to broaden the tax base and intensify tax collection.

The plans for the 2005 fiscal deficit seem to be at the same time too optimistic, partly based on higher than likely growth scenario and tax collection efforts. While the near completion of huge infrastructure programs reduces public spending on investments and the restructuring of public sector leads to lower employment and current expenditures, the deficit is to decline gradually and this year it may be 4.3% instead of the planned 3.7%. The deficit lower than in 2004 will also lead to the stabilisation of the public debt level, which increased from 51% in 2003 to almost 54% in 2004. In 2005 lower deficit, significant real GDP growth will stabilize and slightly reduce public debt to GDP to 53%.

Balance of Payments

Thanks to recent investments, foreign capital inflows and ongoing restructuring in the corporate sector, exports started to grow much faster than earlier, leading to a reversal in the contribution of net exports to GDP and slight decline of trade deficit. While the trade deficit is still above 25% of the GDP, current account deficit declined from 7% in 2003 to slightly above 5% in 2004 mainly due to the increased service and tourism revenues. The recent infrastructure and tourist sector investments will result in a longer-term increase in tourism revenues improving the current account balance.

This is likely to happen in 2005 as well when the trade balance is expected to improve further due simultaneously to the faster rise in exports and slowdown in import demand due to slower than earlier rates of economic growth. On the other hand service balance and the tourism revenues are expected to improve fast reducing the current account deficit to 4.5% of GDP. The deficit can mainly be covered by net FDI inflows, though it declined in 2004 compared to the previous year.

One serious weakness of the Croatian economy is the fast rise in net foreign debt, which more than doubled between 1997 and 2003 reaching 82% of the GDP. The rise was mainly covering the public sector's huge infrastructure and other investments, and reached dangerous levels both in terms of sources and costs of its financing. At the same time the stability of the exchange rate, the gradually improving macroeconomic conditions prompted Standards and Poor's to upgrade Croatia's rating for long-term foreign currency lending by one degree from BBB- to BBB at the end of the last year. Notwithstanding the changing market perception, the remaining current account deficit and volatility of FDI inflows will mean that net foreign borrowing will still play an important role in the future, making difficult for the monetary authorities the reduction of net foreign debt.

Unemployment

Croatia has been for long period one of those candidate countries, where unemployment is extremely high, driven by structural deficiencies and poor labour market policies. But the recent acceleration of economic growth in 2002-2003 was accompanied by growing labour demand (and thus increasing employment) and labour market reforms, which brought more flexibility to the system. As a result, the unemployment rate declined below 14% in 2004, which is a significant difference with rates exceeding 4-5 years ago 20% of the labour force.

In 2005 further decline in unemployment is likely as the employment in the economy expands fast. The ongoing restructuring and privatization of the Croatian firms will not have a significant impact on the labour markets, and increasing manufacturing, still sizeable construction activities and rising tourism revenues will reduce further the unemployment rat to 13% of the labour force.

Table 5. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	4.3	3.7	4.3
Private consumption (%)	4.1	4.0	3.8
Public consumption (%)	-0.3	-0.3	-0.5
Investments (%)	16.5	5.5	5.0
Export (%)	10.0	6.5	7.5
Import (%)	11.0	5.0	5.5
Consumer price index (average, %)	1.4	2.1	2.7
Consumer price index (dec/dec, %))	1.7	2.7	3.0
Unemployment ratio (%)	14.5	14.0	13.5
General government balance (%)	-6.3	-5.0	-4.3
Public debt/GDP (%)	51.5	54.0	53.5
Current account/GDP (%)	-7.0	-5.0	-4.5
Trade balance/GDP (%)	-27.5	-25.5	-24
Gross foreign debt/GDP (%)	77.5	82.0	82.0
Exchange rate (HRK/EUR)	7.64	7.67	7.55
Discount rate (%)	4.5	4.5	4.5

** Forecasts*

FYR of Macedonia

Slight improvement in economic performance in 2005

Economic Growth

In 2004 economic growth slowed down in the former Yugoslav Republic of Macedonia. GDP growth rate reached 2% according to estimations which is a significant decline compared to the previous year when gross domestic product increased by 3.4%.

The performance of the industrial sector was week which was one of the key factors resulted in the slowing economic growth last year. The declining industrial production was due to the restructuring process occurred in the sector. Industrial production decreased by a double digit rate, by almost 13% in last year. Mining and quarrying declined by 66% while the performance of manufacturing decreased by 11.6%. On the demand side, public consumption increased a little but the tight fiscal policy also restrained economic growth.

In 2005 the figures seem to be better, industrial production increased by 4.8% in the first three months of 2005, however it was mainly owing to the relatively low basis of the previous year. Compared to 2003, first quarter's figure is lower, thus, the pace of industrial production growth will slow in the course of the entire year, according to our expectations. Thus, GDP growth is expected to be 3.5% in 2005.

Monetary Conditions

Between 2000 and 2003 Consumer Price Index (CPI) declined from more than 10% to approximately 1% so Macedonia reached price stability in last year. In 2004 consumer prices have not increased but decreased, namely deflation characterised the Macedonian economy.

Consumer Price Index reached -0.4% which was the result of the decreasing food prices and the appreciation of the euro. Food prices account for almost 50% of the Consumer Price Index basket, while the Macedonian currency (Denar) is de-facto fixed to the single European currency and the appreciation of the euro against the US dollar supported the control of inflationary pressures.

The main objective of the central bank is to maintain price stability via pegging Macedonian Denar to the euro. In 2003, central bank loosened its monetary policy and interest rates were cut significantly. In 2004 central bank increased the interest rates due to the fact that government expenditures accelerated and low interest rates led to a pressure on foreign exchange market and foreign reserves declined.

In 2005 price stability will keep on characterising the former Yugoslav Republic of Macedonia, CPI is expected to be 1.0% in this year. The strong position of the euro against US dollar can support this process while central bank is expected to cut interest rates carefully in the future.

Fiscal Policy

After a remarkable fiscal consolidation in 2003 when budget deficit decreased to 1.0% of GDP from 5.6% of GDP in 2002, fiscal policy has not loosened significantly in last year. In 2004 budget deficit reached 1.5% of GDP due to growing government expenditures. The main factors of growing government expenditures were the implementation of the so-called Ohrid Framework Agreement and hiring more members of ethnic minorities in public administration.

Fiscal consolidation supported not only the decrease of the general government deficit but also the level of public debt. While public debt reached around 57% of GDP at the end of the last decade, in 2004, the level of the debt is expected to decrease to 45% of GDP which reflects a significant decline in public debt level. However, the appreciation of euro (and Denar) against US dollar also supported the decrease of public debt due to the fact that half of the debt is denominated in foreign currencies, such as US dollar.

In 2005 general government balance will not expected to worsen, the budget deficit can reach 1.5% of GDP. The tight fiscal policy remains in line with the agreement with IMF. Slight improvement of economic growth will also help reaching higher revenues and lower budget deficit. On the other, the low level deficit can support the further decline of the public debt level, too.

Balance of Payments

One of the most important economic problems is the external imbalances of the Macedonian economy. Trade balance deficit reached 21.2% of GDP in 2004 which was a significant increase compared to the previous year (16.4%). While in 2003 the growth rate of exports was higher than that of the imports, in last year growth rate of imports greatly overpaced that of the exports. In 2004 significant increase has taken place in imports of machinery and transport equipments, while in case of exports, mainly the performance of textile, steel, iron and oil derivatives sectors have incited the increase of exports.

Due to the large trade deficit, current account deficit reached almost 8% of GDP or it is almost tripled in last year. In spite of the fact that transfers have a significant role in financing the trade deficit, it was not increasing at such a fast pace and that resulted the significant worsening of current account balance compared to the previous year.

Foreign direct investment inflows remained moderate in 2004. It was the third year in a row when FDI inflows remained between EUR 80 and 100 million, according to the estimations. Obviously, that low level of FDI was not able to finance the current account deficit, approximately 20% was financed by foreign direct investments.

In 2005, external imbalances are not expected to improve, trade deficit can reach 22% of GDP in this year. The growth rate of export of goods is expected be lower than that of the import, thus, foreign trade balance will worsen slightly this year. Thus, the current account deficit will also worsen slightly compared to the previous year. C/A deficit is expected to be 8.2% of GDP.

Unemployment

Mainly due to the week economic performance in 2004, declining employment increased unemployment rate further in the Former Yugoslav Republic of Macedonia. On the other hand, the increasing willingness to enter into the labour market also increased the number of unemployed people.

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

According to estimations, the rate of truly unemployed people is approximately half of the official rate. To restrict the criteria for registering as unemployed, the government approved an Employment Act in June 2004.

In 2005 the better economic performance and the new Employment Act can have positive impact on the unemployment rate which is expected to decrease to 36% in this year.

Table 6. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004*	2005*
GDP growth (real, %)	3.4	2.0	3.5
Private consumption (%)	n. a.	n. a.	n. a.
Public consumption (%)	n. a.	n. a.	n. a.
Investments (GFCF, %)	n. a.	n. a.	n. a.
Export (%)	2.4	12.1	5.0
Import (%)	-3.8	19.7	8.0
Consumer price index (average,%)	1.2	-0.4	1.0
Consumer price index (dec/dec, %)	2.6	-1.9	1.0
Unemployment ratio (%)	36.7	38.0	36.0
General government balance (%)	-1.0	-1.5	-1.5
Public debt/GDP (%)	46.6	45.0	44.0
Current account /GDP (%)	-2.9	-7.9	-8.2
Trade balance /GDP (%)	-16.4	-21.2	-22.0
Gross foreign debt /GDP (%)	38.1	38.4	38.0
Exchange rate at the end of period (MKD/EUR)	61.3	61.3	61.3
Discount rate (end of year, %)	6.5	6.5	6.5

** Forecasts, preliminary data*

Romania

Outstanding economic performance continues in 2004

Economic Growth

Romania reached excellent economic growth in 2004, GDP increased by 8.3%. The robust economic growth was fuelled by mainly the agriculture sector, which grew by 22.2% compared to the previous year. The other sectors also performed well last year, construction increased by 9% and industry reached a 5.3% growth rate.

On the demand side, foreign demand remained weak, thus, domestic demands (consumption and investments) were the main engines of the economy. Private consumption increased by more than 10% in 2004. The remarkable growth rate was reached due to the high (+9.6%) increase in real wages, the significant growth of credit both in case of households (+58.3%) and also business sector (31.3%), and the decreasing unemployment rate also had a positive impact on consumption. On the other hand, elections held in Romania last year have also boosted the growth of consumption.

The other important domestic factor boosted the economy was investments which increased by 8.2% in real terms. The growth rate of gross fixed capital formation achieved 10.1%, mainly as an effect of the restructuring and privatisation of the enterprise sector. In 2004 the privatisation accelerated, especially due to the positive attitude of the government towards it – the main transactions took place in the energy sector.

Exports achieved relatively good performance last year, however, the foreign trade balance worsened due to the fact that growth rate of imports overpaced that of exports which is an understandable process considering the high consumption growth which had significant import boosting impact on the economy.

In 2005, the pace of economic growth remains strong, tax reform initiated at the beginning of the year can have a further impetus to GDP growth. However, due to the slowly improving foreign demand and the high basis in 2004, the Romanian GDP growth is expected to be 5.6% in 2005. Domestic factors will remain the main engine of growth, such as consumption and investments.

Monetary Conditions

Except for a short period in the middle of 2004 (July-August), Consumer Price Index (CPI) was declining gradually in every month in last year compared to the same period of the previous year. Inflation went under 10% in November 2004 year-on-year, and Romania has achieved a single-digit inflation for the first time since transition. The annual average inflation rate reached 11.9% in 2004. The disinflation process was partly a result of the appreciation of national currency, the Leu. In the second half of 2004, Leu appreciated not only in real terms but also in nominal terms against the single European currency, the euro. In line with positive macroeconomic trend further appreciation of Romanian currency is expected.

In the first quarter of 2005, this tendency has continued, CPI was between 8.7% and 8.9% in the first three months of the year. The appreciation of the Leu accelerated in the first 4 months, the ROL/EUR exchange rate reached almost 36.000 while it was still around 39.000 at the beginning of the year. It means the Romanian currency appreciated against the euro by almost 10%. For 2005, annual average inflation is expected to be 8.6% while CPI can decrease to 6.7% at the end of 2005, y-o-y.

In line with declining inflation, National Bank of Romania was able to lower its reference rate. In 2004, the Central Bank cut its reference rate by 329 base points in course of last year (it was 17.96% in December 2004). In the first five months of 2005, the reference rate was decreased further significantly to 7.96% due on the one hand to the aforementioned declining inflation rate and on the other hand to the partial liberalisation of current account which allows non-residents to place Leu deposits. Understandably, Central Bank attempts to limit speculative capital inflows by gradually lowering the interest rate gap.

Fiscal Policy

General government deficit was low, it reached 1.4% of GDP in 2004. This relatively good result was achieved by the adjustment of fiscal policy in 2004 because originally the government planned a 3% deficit for the last year. Considering the fact that elections have been held at the end of the year the deficit figure reached a really good level.

In parallel with the good fiscal deficit figure, public debt per GDP ratio also improved due to the outstanding GDP growth, the mainly unchanged amount of public debt in nominal terms and the appreciation of the Leu against US dollar and euro.

At the beginning of 2005, the new government kept his promise and initiated a new tax rate system, in case of income and profit tax significant tax cut (flat tax) was introduced[2]. As a result of tax cuts, general government revenues will be lower by approximately 1.5% of GDP owing to the decreased tax rates, thus, government could choose either the budget deficit would be significantly higher than last year or adjustments could be taken. After disputes, government decided to increase the tax rate on the earnings from the capital market, estate transactions and interest for bank deposits would be taxed 10%. This rate will be further increased to 16% as of the beginning of 2006. Moreover, Ministry of Finance introduced excises on so far excises free products, too. However, this adjustment may have negative impact on disinflation; it can slow the pace of the process.

Owing to the adjustments in tax system, we expect that the general government deficit will widen slightly in 2005, this can reach 2.4% of GDP.

Balance of Payments

In 2004 current account balance worsened significantly due to the fact that the deficit of foreign trade increased remarkably. The worsening process started in 2003 continued in last year and the deficit of current account balance increased by more than EUR 1.3 billion or +43.8% in euro terms and reached EUR 4.4 billion. Compared to 2002, the increase is even larger: almost EUR 2.8 billion or +171%. Regarding the deficit per GDP ratio the figure increased to 7.5% in last year from 3.4% in 2002 and 6.0% in 2003. Trade balance worsened despite the fact that exports increased by 14.1. That was owing to the process that the pace of imports (+17.8%) overpaced that of exports. It reflects the aforementioned import boosting impact of the strong domestic demand, especially private consumption and investments.

On the other hand, a large part of the deficit of the current account was easily financed by the foreign direct investment inflows, which amounted to EUR 4.1 billion in 2004. FDI inflows doubled in last year due to privatisation and improving business climate.

In 2005 the tendencies of 2004 are expected to continue. The strong consumption and investments will boost imports and foreign trade deficit can come close to 10% of GDP. In line with the worsening trade balance current account deficit will also worsen it is expected to reach 8.5% of GDP. On the other hand, the role of foreign direct investments remains significant in financing the current account deficit in 2005.

Unemployment

Unemployment is not a problem in Romania, unemployment rate is low. At the end of 2004, the rate reached 6.2% while it was somewhat higher a year before (7.4%). In February 2005 the number of employment in economy improved to more than 4.5 million which is a 125 000 increase compared to the same month of the previous year. Tax cuts may have a further positive impact on employment rate in course of the year.

[2] *The income tax rate was reduced to a flat 16% from the rates ranging between 18% and 40%, while, the companies' profits tax was reduced from 25% to 16%.*

Table 7. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP growth (%)	5.2	8.3	5.5
Private consumption (%)	7.2	10.8	8.0
Public consumption (%)	4.6	4.6	3.0
Investments (GFCF, %)	9.1	10.1	10.5
Export (%)	11.4	14.1	13.2
Import (%)	16.4	17.8	17.5
Consumer price index (average,%)	15.3	11.9	8.8
Consumer price index (dec/dec, %)	14.1	9.3	6.7
Unemployment ratio (%)	6.8	7.1	6.8
General government balance (%)	-2.0	-1.4	-2.4
Public debt/GDP (%)	21.3	18.5	19.0
Current account /GDP (%)	-6.0	-7.5	-8.4
Trade balance /GDP (%)	-7.8	-9.0	-9.9
Gross foreign debt /GDP (%)	31.1	30.7	30.0
Exchange rate (ROL/EUR)	37 555.9	40 532.1	37 500.0
Reference rate (end of year, %)	21.25	17.96	7.5

** Forecasts*

Serbia and Montenegro

Healthier structure of growth, but remaining external imbalances

Economic Growth

The growth performance of Serbia and Montenegro was more robust in 2004 then earlier expected (with projections of a 4 to 5% growth rate), reaching 6%. The reasons behind the good growth performance were strong domestic demand, a good year in agriculture, and solid industrial activity. Domestic demand was driven by wage increases beyond productivity mainly in the socially owned enterprises, which was enabled by arrears build-up and subsidies. Wage increases also occurred in the public sector before the elections at the end of 2003, effecting domestic demand in 2004. Demand for imports increased substantially, as well.

GDP increased by almost 3% in Montenegro in 2004. Dynamic developments occurred in industrial production (with a 13.8% yearly growth rate) and tourism (with the number of overnight stays increasing by 14.7%).

Growth is projected to slow down to 4.6% in 2005 in Serbia and Montenegro. The role of investments is expected to increase as a result of the acceleration of the privatization process this year, while there will be a policy-driven slowdown in consumption because a tightening in both monetary and fiscal policy is expected. Therefore the unhealthy structure behind growth, which was mainly driven by wage increases larger then those of productivity, will be changed to a healthier driving force of investments, and eventually with the improvement of competitiveness, exports.

Monetary Conditions

Inflation has been higher in Serbia in 2004 then earlier expected. In December year on year CPI reached 13.7%. The price rise was mainly driven by the wage increases, and high oil prices. The domestic factors accounted for about two-thirds of the rise in the price level, while for the rest the commodity price increase was responsible. Financial deepening and intermediation improved, but as a negative consequence credit grew rapidly, which gave a further boost to the rise in imports. As most bank loans are denominated in or indexed to foreign currency, the banks could face serious risks in the future. At the same time the supervisory capacity of the National Bank of Serbia is still limited. The real effective exchange rate depreciated towards the end of the year. The discount rate of the National Bank of Serbia remained at 8.5% in the first quarter of 2005, at the same level where it was during 2004. The NMB tightened monetary policy in August, by raising the required reserve ratio on all Dinar and enterprise forex deposits by 3 percentage points to 21%.

In the first quarter of 2005, year on year CPI has doubled compared to the first quarter of the previous year. In March year on year CPI reached 17.4%, while in the same month in the previous year it was only 7.9%. Even within the quarter a slight increase in the CPI was observable (with a January CPI level of 14.4%). This was mainly due to the introduction of an 18% rate VAT in January. The effects of this change will likely settle towards the end of the year. The expected reduction of the budget deficit will also have a positive impact on inflation. However the single digit inflation rate hoped by the government will not be achievable in 2005. The inflation rate is likely to reach 13% by the end of the year.

In Montenegro the official means of payment is the euro. Inflation has been on a downward trend for three years in the republic. In 2004 the Retail Price Index amounted to 4.3% (which was lower then the projected 4.5%), while the cost of living index reached only 1.5%. The long-term goal of the Central Bank of Montenegro is to reach the EMU inflation rate. The main driving force behind the rise of consumer prices in 2004 was the price rise of services (explaining 80% of the price rise). The month on month rise of CPI was 0.1-0.2% in each month of the first quarter of 2005, just like in the first quarter of the previous year.

Fiscal Policy

Fiscal policy has been tightened beyond program targets in Serbia during 2004, in order to keep a rain on rising inflation and growing external imbalances. The revised budget reduced spending on capital and subsidies. The Serbian consolidated general budget deficit reached 1.7% in 2004, while in Montenegro the budget deficit reached 4% of GDP, in line with expectations. The budget deficit of Serbia and Montenegro together amounted to 2% of GDP.

In 2005 fiscal policy is expected to be tightened further in both republics. The deficit is planned to be lowered primarily by spending reductions. In both republics tax revenues will be reduced, as well. In Serbia tax administration reforms are expected to increase efficiency and reduce the grey economy. A Treasury reorganization plan will help improve public expenditure management. The reduction of public employment will be a part of fiscal tightening, as well. Arrears for socially-owned enterprises will be monitored closer. In Montenegro fiscal tightening will be achieved through discretionary expenditure cuts. If the policies are implemented, for Serbia and Montenegro a 0.8% budget deficit is expected for 2005. However there is substantial political risk concerning the implementation of these strict policies.

Balance of Payments

The current account deficit reached 13% of GDP in Serbia and Montenegro in 2004. This deficit level is a result of the continued significantly higher level of imports then exports, and results in increasing debt financing. The high oil prices were in large part responsible for the larger then expected deficit of the current account in 2004. The large trade deficit was partly offset by strong private remittances. The sluggish export growth is a result of the low competitiveness level of the country. Structural problems are responsible for this. Exports are among the lowest in the region, while average wages in Serbia and Montenegro are higher then in other countries in South-Eastern-Europe (excluding Croatia).

The current account deficit as a percentage of GDP is not expected to improve significantly in 2005, when it is still expected to reach 12%. This is a result of the development of the trade balance, which is not expected to improve compared to 2004, with a deficit remaining around 28% of GDP. Only improved competitiveness leading to stronger exports and the reduction of the external debt ratio will help improve the balance of payments in the medium term.

Unemployment

The unemployment rate in Serbia and Montenegro reached an estimated 31.7% in 2004. It is following a slightly rising trend, and is expected to reach 32% in 2005. The structure of unemployment is also worsening, as a large percentage of the 884,000 job seekers are young. 60% of the unemployed are high school educated, and are between the ages 30 and 40. 100,000 people have been waiting for a job over ten years. The restructuring of public companies will also contribute to the further rise of unemployment.

Table 8. Actual and forecasted major macroeconomic indicators 2003-2005

	2003	2004	2005*
GDP (%)	3	6	4.6
Private consumption (%)	n.a.	n.a.	n.a.
Public consumption (%)	n.a.	n.a..	n.a.
Investments (%)	n.a.	15.5	20
Export (%)	4.4	21.7	13
Import (%)	5.2	20.4	4.5
Consumer price index (average, %)	11.3	9.5	14
Consumer price index (dec/dec, %)) Montenegro	6.7	4.3	n.a.
Consumer price index (dec/dec, %)) Serbia	7.8	13.7	13
Unemployment ratio (%)	31.7	31.7	32
General government balance (%)	-3.4	-2	-0.8
Public debt/GDP (%)	n.a.	n.a.	n.a.
Current account/GDP (%)	-12	-13	-12
Trade balance/GDP (%)	-24.1	-28	-28.2
Gross foreign debt/GDP (%)	70	58	57
Exchange rate (DIN/EUR) Serbia	68.2	78.8	87
Base rate (%)	9	8.5	8.5

** Forecasts*

Taxation in the Southeast European Countries –

The VAT and the Corporate Income Tax

Background

Tax competition has reached not only the - Central and Eastern European - New Member States but also the countries in Southeast Europe. Tax competition means economies compete for the same tax base and each of them makes significant efforts to become more and more attractive to foreign investors. In case of Southeast European countries, foreign direct investments have great importance because FDI contributes to economic restructuring and macroeconomic development. Thus, these countries are trying to establish 'investor-friendly' business climate for foreign investors among others by cutting taxes. It is also an important note that these countries are competing not only with each other but also with the front-runner transition countries such as the NMSs. In this study we examined two types of taxes which are relevant for the corporate sector: Corporate Income Tax (CIT) and Value Added Tax (VAT) in the seven Southeast European economies.

Corporate Income Tax is a form of direct taxes concerning the income of the corporate sector. The rates applied in SEE countries are quite different. The lowest CIT rate is 10% introduced in Serbia and in one of the two entities of Bosnia and Herzegovina, in Republika Srpska. These two economies are eager for foreign investment, therefore, they were the ones who adopted the lowest CIT rates in Europe.

Table 9. Corporate Income Tax and Value Added Tax in SEE Countries 2005 (%)

		CIT	VAT
Albania		25	20
Bosnia and Herzegovina	FBiH	30	17
	RS	10	17
Bulgaria		15	20
Croatia		20	22
FYROM		15	18
Romania		16	19
Serbia and Montenegro	Serbia	10	18
	Montenegro	15/20	17

Source: Ernst & Young

The Corporate Income Tax rate can be evaluated as low in Bulgaria, in the former Yugoslav Republic of Macedonia and in Romania; the rates are 15%, 15% and 16%, respectively. These rates are more rational then those of the earlier group, while, these economies – mainly Bulgaria and Romania – are the most significant competitors of the New Member States due to their European integration in the near future, their attractive business climate and improving macroeconomic factors. In case or Romania the CIT rate was diminished from 25% to 16% at the beginning of the year, while in Bulgaria the rate was decreased to 15% from 19.5% also at the beginning of 2004. This reflects well the increasing competition in the region.

In Croatia and Montenegro[3] the Corporate Income Tax rate is 20% which can be explained by the fact that these two countries are not seeking every opportunity to draw foreign investments into the economy. In fact, the role of manufacturing and export-oriented production is notably lower in these countries then in the earlier group, while the significance of services – mainly tourism – is considerably higher.

Corporate Income Tax rates can be evaluated as high in Albania and in the Federation part

[3] *It is quite interesting that Montenegro applies progressive CIT rates. If taxable income is under EUR 100 000 then the CIT rate is 15%, while in excess of EUR 100 000 the rate is 20%.*

of Bosnia and Herzegovina, CIT rates are 25% and 30% respectively. In the future the decrease of the CIT rate is expected in these economies. They are basically under developed and the improvement of the business climate for attracting foreign investors is essential for them as well.

Value Added Tax is a form of indirect taxes and - in fact - it concerns not only to the companies but also to all economic actors in the economy. In the Southeast European region the difference among the VAT rates is not so high than in case of the CIT. The lowest rates are applied in Montenegro, where the standard VAT rate is 17%. Rates are not significantly higher in Albania (20%), Bulgaria (20%), FYR of Macedonia (18%), Romania (19%) and Serbia (18%) either. Only Croatia applies a somewhat higher standard rate (22%) but it is not significantly higher than the SEE average.

The change from sales taxes to Value Added Tax was made in most Southeast European countries, however, there is still one country in the SEE region where VAT is not yet introduced: Bosnia and Herzegovina. The introduction of Value Added Tax is expected at the beginning of January 2006 in both Entities, according to recent plans. The rate will be 17%, with no exemptions available. The VAT will replace the various sales tax systems currently used in the country.

Box 1.

Hereinafter, we review the main features of the taxation regimes of each SEE economies related to Corporate Income Tax and Value Added Tax.

Albania

The tax regime in Albania is applied on both national and regional level. Taxation on the national level is far more important then on the regional level. CIT is imposed on Albanian and foreign legal entities, partnerships, or other groups of persons that conduct business in Albania, and any other person who is subject to Value Added Tax. The actual CIT rate is 25%, calculated on the basis of annual income.

The most important form of indirect taxation in Albania is the Value Added Tax (VAT). The VAT is applied on all individuals or juridical persons, who supply goods or services as a part of their activity in the Republic of Albania. Businesses are subject to this tax if their annual turnover exceeds the amount of 8 million Lek. The VAT rate is 20 percent.

Bosnia and Herzegovina

In Bosnia and Herzegovina fiscal policy, the establishment of the tax system, and passing tax legislation are conducted separately in the two Entities (Federation of Bosnia and Herzegovina and Republika Srpska). The Entity laws on sales tax are similar (both of them apply a one-phased sales tax), with some differences. At the same time there are significant differences in the personal and corporate income tax legislation.

In FBiH the corporate income tax rate is quite high, it reaches 30 percent, but there are numerous incentives available. The Corporate Income Tax law allows losses to be carried forward for a period of 5 years. Depreciation on a straight-line basis is available. A tax relief for newly founded companies amounts to 100% for the first year, 70% for the second year, and 30% for the third year of business. Full tax exemption is granted to companies with 100% foreign participation.

The corporate income tax rate in Republika Srpska amounts to 10%, with a relatively small number of tax incentives (exemptions) being granted. Unlike in FBiH, loss carry-forwards are not allowed. There are some tax-unrecognised expenditures, which increase the income/loss in the income statement (and therefore the tax basis as well).

Value added tax is expected to be introduced in both Entities of Bosnia and Herzegovina at the beginning of 2006. The rate will be 17%, with no exemptions available. The VAT will replace the various sales tax systems currently used in the country. It will be collected at a national level, and will thus move the country towards centralization.

Bulgaria

The two main categories of taxation in Bulgaria are the direct taxation of individuals and corporations, and the indirect tax forms of the Value Added Tax, and excise duties. Local taxes and charges are also present in the country.

Under the Corporate Income Tax Act (CITA) all companies and partnerships (including non-incorporated partnerships) are liable to corporate income tax. The corporate income tax rate is 15%. Bulgarian resident entities are taxed on a world-wide basis. Other entities are taxed on their Bulgarian-source income. Non-business organisations (including governmental) are taxed for their business activities. Although branches are not legal persons, branches of non-resident companies have separate balance sheet and profit ant loss accounts. They are subject to corporate income tax at the standard rate of 15%. Annual profit must be declared no later than 31 March of the year following the taxable year.

The Value Added Tax is a multi-phased, indirect tax. It is charged on the value of domestic trades in goods and services, as well as on the import of products and services. Exports are taxed at 0%. Taxable are all trades executed by a VAT-registered seller (supplier) of goods/services. The VAT rate is 20%. A taxpayer under the Law on VAT is any person exercising an independent economic activity.

Croatia

The most recent amendment to the Profit Tax Law came into force on the 1st of January 2005. Profit tax is levied on trading companies and legal persons who pursue activities for the purpose of earning a profit. It is also applied in the case of foreign-owned permanent establishments, which perform their activities in the territory of the Republic of Croatia entirely or partially. Under some conditions it is also levied on natural persons (for example if total profit exceeds HRK 400,000, or if they prefer to pay profit tax instead of income tax and they signal this to the tax authorities. The corporate income tax rate for all taxable persons is 20%. The current depreciation rates have been in effect since 30 June 2001. Only linear depreciation is allowed in Croatia. The highest rate of depreciation (25%) is provided in the case of intangible assets, and equipment and machinery.

The reformed version of the Value Added Tax Act came into force on the 1st of November 1999. Value added tax must be paid by every businessperson who delivers taxable goods or renders taxable services. The Croatian VAT system is an all-phase system with deduction of input tax. VAT is applied to supplies of goods and all services rendered domestically by a businessperson for valuable consideration; self-supplies; and imports of goods. There is a tax exemption for a wide range of goods and services, such as renting of rooms for housing purposes, health care services, basic food like bread and milk, books and scientific magazines, specific drugs, services for foreign tourists (if their stay is paid from abroad). VAT is also not levied on the export of processed goods as well as the related transport and all other shipment services, merchandise for duty-free shops, and merchandise and services rendered for consular and diplomatic posts or missions, provided this arrangement is reciprocal. The VAT rate is set at 22% in Croatia.

Former Yugoslav Republic of Macedonia

The tax regime in the FYR of Macedonia was inherited from the former Yugoslavia. Changes were later made by the Government and the Parliament of Macedonia, aiming to transform the regime in a way to make it more suitable for attracting foreign investment.

The Corporate Income Tax is a tax on profits. The computation and payment of the tax is carried out by the taxpayer, who is a legal entity or a physical person performing a registered activity – resident of the FYR of Macedonia and earning a profit from an activity in the country or abroad. The tax rate of CIT for all legal entities is 15% on taxable income, made up of 15% pure profit tax plus 1.8% contributions for health insurance for injuries during working hours. An investment relief is provided based on the amount of profit reinvested in operational fixed assets. The tax base for companies with foreign shareholders (with holdings of at least 20%) is reduced by the proportion of the foreign investment, for the first three years following that investment.

The Law on Value Added Tax came into force on the 1st of April 2000. The VAT, as a general consumer tax, is calculated and paid in all phases of production and trade, as well as in the entire branch that performs services, unless it is otherwise provided by the Law. The VAT rates are a 19% general, and a 5 percent privileged proportional tax rate on the tax base of the turnover of goods and services and import.

Romania

A major reform of the tax system of Romania took place in the beginning of 2005. Besides making tax cuts, it also involved fiscal reform, in which the emphasis was shifted from direct to indirect taxation. The tax regime was simplified.

The taxation of corporations has been changed. All legal entities doing business in Romania are liable to pay corporate income tax on their taxable profits. Earlier the standard profit tax rate was 25%, applicable to both Romanian incorporated companies and to foreign legal persons operating through a 'permanent establishment' in Romania. The corporate profit tax rate has now been reduced to a 16% flat tax (thus to the same rate as the personal income tax).

All persons who conduct a business activity (production, trade and services) independently, who are independent professionals or sell their property are required to pay value added tax. Imports are also subject to this tax. Below a minimum turnover threshold of ROL 2 billion (approximately EUR 50 000) there is no obligation to pay value added tax. The standard VAT rate is 19%, while a reduced rate of 9% is applicable to medication, hotels, books, school books, artificial limbs and orthopaedic products.

Serbia and Montenegro

The taxation system in Serbia and Montenegro is regulated at the federal level and at the republic level (Republic or Serbia and Republic of Montenegro). The federal government is responsible for specifying what types of taxes the republics can collect and under what conditions. Detailed regulations for taxation, tax collection and control are the responsibility of each republic.

In Serbia all company forms that are regulated by Company Law are subject to corporate income tax. The corporate profit tax rate is set at 10%. In Montenegro Corporate Income Tax is imposed at progressive rates. If taxable income is under EUR100 000 then the CIT rate is 15% while in excess of EUR 100 000 the rate is 20%.

A recent change in the Serbian tax regime occurred on the 1st of January 2005, when the new Value Added Tax was introduced. The introduction of the VAT was one of the prerequisites for launching the Stabilisation and Association talks with the EU. The VAT replaced the earlier 20% sales tax on goods and services, and it is applied at a general 18% rate, and at an 8% rate for basic provisions, medicines, textbooks, and newspapers. Every entity that posted over 25,000 euros in turnover in the past year, or is expected to post as much over the next 12 months, is subject to the VAT. As a result of the introduction of the VAT, tax obligations will now be charged far more quickly then before. In Montenegro VAT was introduced on 1 April 2003 at a standard rate of 17%.

Source: BA-CA, SEE Online