



# Quarterly Forecast on the Western Balkans and Turkey

Spring 2007



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**The dataset of this report was closed on 19 April 2007.**

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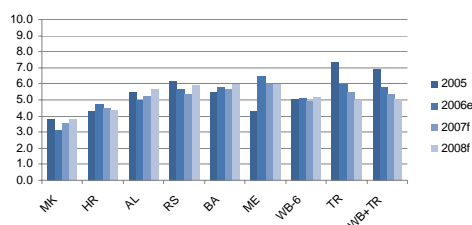
# Regional overview

## Western Balkans

Most Western Balkan countries (WBC) face political uncertainties or problems at the beginning of 2007. First of all, the future status of Kosovo is still not certain (see *Special topic*). In the former Yugoslav Republic of Macedonia, the largest ethnic Albanian party boycotts the Parliament. The formation of the new government in Bosnia-Herzegovina and Serbia is still not completed after the election. In Croatia, the forthcoming election may have impacts on economic development.

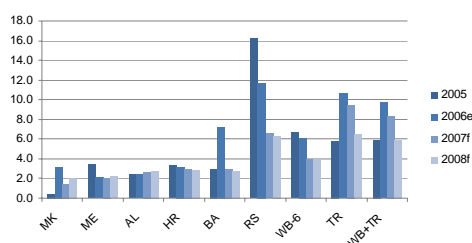
2006 was basically a good year for the Western Balkan countries. GDP growth averaged 5.1% in the six countries and the highest growth was achieved by Montenegro (6.5%). In the latter case foreign direct investment had a significant role in economic growth, which exhibited the progress in privatisation and improving business climate in the region. In 2007 economic growth is expected to slow only slightly, to 5% in the region. Domestic demand, namely private consumption and investments remain the main engine of the region but foreign demand is expected to play a bigger role in growth in this year. In 2008 economic growth is expected to increase in the region averaging 5.2%.

### Real GDP growth (%)<sup>1</sup>



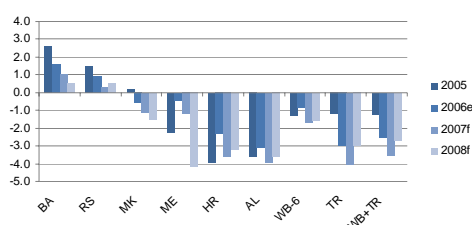
Note: e = estimation, f = forecast; Source: national banks and statistics institutes

### Inflation (%)



Source: national banks and statistics institutes

### Fiscal balance (% of GDP)

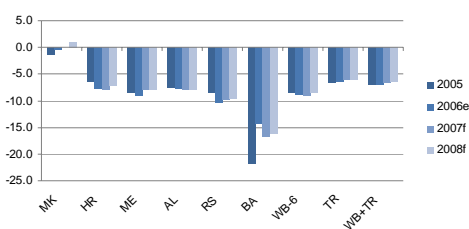


Source: national banks and statistics institutes

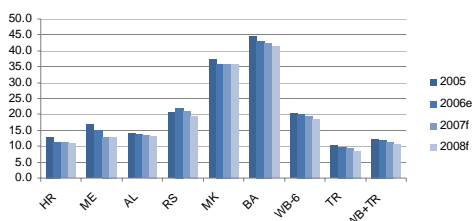
In four out of the six Western Balkan economies inflation remained moderate (between 2.1% and 3.2%) in 2006. Significant acceleration of inflation was observable only in Bosnia-Herzegovina due mainly to a one-off negative effect of the introduction of VAT last year. Disinflation continued in Serbia and inflation declined under 5% at the beginning of 2007, accordingly all WBC will have one-digit inflation this year, averaging 4.1%. However, there are some uncertainties regarding the development of inflation. Most importantly the evolution of international oil prices may have a negative impact on prices. In 2008 our expectation is that price increases will remain on the same level as in this year.

Budget deficits remained low or reached surplus in the WBC last year. Surplus was observed in Bosnia-Herzegovina and Serbia, while budget deficit was between 0.6% and 3.1% of GDP in the remaining four countries. In 2007 budget balances are expected to worsen on average. It is worth mentioning that Serbia still has not adopted budget in 2007. Elections will be held in Croatia; accordingly loosening fiscal policy is expected. A flat tax regime was introduced in the former Yugoslav Republic of Macedonia, and Albania also plans to reform its tax system and introduce flat tax from 2008. It means that tax competition spread over from Central and Eastern Europe to the region. WBC's governments attempt to make their business environment more attractive to increase the presence of foreign investors.

<sup>1</sup> Abbreviations: AL – Albania, BA – Bosnia-Herzegovina, HR – Croatia, MK – FYR of Macedonia, ME – Montenegro, RS – Serbia, WB-6 – Western Balkans (averages weighted by nominal GDP), TR – Turkey, WB+TR – Western Balkans and Turkey

**Current account balance (% of GDP)**

Source: national banks and statistics institutes

**Unemployment (%)**

Source: national banks and statistics institutes

In 2006 current account deficits increased in most countries and remained high. The regional average current account deficit reached 9% of GDP, of which Bosnia-Herzegovina and Serbia had higher than 10% deficit. CA balance improved only in the former Yugoslav Republic of Macedonia where the deficit was close to zero. The evolution of CA balances is basically influenced by high foreign trade deficits. In WB countries foreign trade deficits exceeded 20% in 2006 due to high import ratios. However, the high foreign trade deficits were partly counterbalanced by services balance (tourism) and current transfers (remittances). In 2007 further deterioration of CA deficit is expected in average, the balance will improve only in the former Yugoslav Republic of Macedonia, Montenegro and Serbia.

Unemployment remained one of the most important macroeconomic challenges in the region. Average unemployment rate reached 20% in the region, and it even exceeded 30% in Bosnia-Herzegovina and the FYR of Macedonia. Even if these are the official figures and real unemployment is expected to be lower due to significant level of informal sector, these figures are really high. Still, unemployment decreased in 2006 and this trend is expected to continue in 2007 and 2008 as well. This process is supported by high economic growth, foreign direct investments and whitening of informal sector. Progress in privatisation may have a negative impact on unemployment, though.

**Turkey**

After financial market turbulences in 2006, annual economic growth has been decelerating slightly with its growing reliance on net foreign demand. GDP growth decreased from 7.4% in 2005 to 6% last year due to weakening domestic demand. Inflation jumped to above 10% in 2006 as a result of the significant depreciation of the Turkish lira in the first half of the year. Accordingly, monetary policy tightened and in spite of the limited effect of tightening to domestic demand, CPI started to decrease in the second half. Current account deficit reached almost 7% of GDP in 2006 mainly due to significant domestic demand, namely private consumption and investment. Unemployment fell under the threshold of 10% in 2006.

Macroeconomic developments in 2007 are influenced by the political cycle due to the elections. General government deficit is expected to rise and inflation to remain close to last year's figure. Economic growth is expected to grow slightly below last year's pace and remain above 5%. It is also worth mentioning that current account balance will improve this year which will be supported by weakening domestic demand, the robust growth in Turkey's main trading partners and the increase of receipts from tourism. In 2008 faster disinflation and further fiscal adjustment is foreseen.

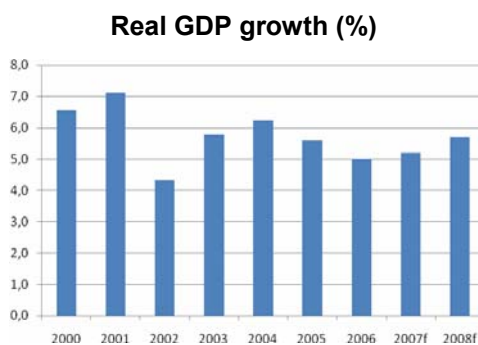
# Albania

**GDP growth remains between 5-6% beside tense political climate. Rapid credit growth continues while inflation is still under control. Budget expenditures accelerated, and current account deficit continues to increase. The official unemployment rate is still slightly improving.**

## Political developments

Local elections held in February 2007, represented voters' discontentment concerning the ruling coalition and caused a reshuffle of the government. Presidential election is scheduled for June this year. Wrangle between the Democratic Party-led government and the oppositional Socialist Party causes tense political climate in Albania. There is a lack of consensus in the question of the presidential candidate and certain reforms (including electoral changes, justice system, public administration, etc.). Without compromise there is a possibility of early elections.

## Growth



Note: f = forecast; Source: INSTAT

Albania's real GDP growth rate continues to be in the range of 5-6%, and according to the central bank, in 2006 the growth rate was 5.0%. The largest growth was recorded in the sector of industry (11.0%), while growth in the construction sector was 10.3%, transport 7.0%, agriculture 3.0% and services 2.1%. The share of GDP by sectors was the following: services 43.1%, agriculture 21.5%, construction 17.3%, industry 10.1% and transport 8.0%.

Structural reforms are needed in order to make growth more robust, to decrease vulnerabilities and to make weak public institutions more effective. This can be hindered by the recent tense political climate of the country, and the pre-election period.

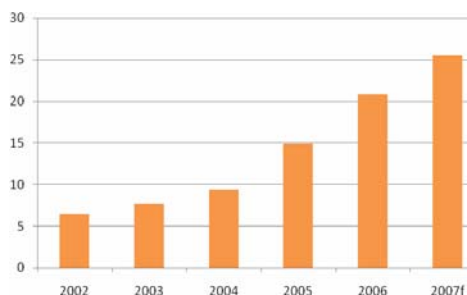
The infrastructure deficiencies (e.g. even in the electricity sector) still hinder the improvement of the economy. Electricity shortages occasionally have significant impact on the economy and on the growth rate of GDP. In January 2007 scarce rainfall caused severe problems for certain hydropower plants. 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 improvement 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 developments

Inflation remained low in 2006 and in the first quarter of 2007 as well. Average annual inflation was 2.4% in 2006, while for 2007 the national bank's annual inflation rate target is  $3\pm 1\%$ . Among other factors, certain external developments, the electricity price rise, the excess of liquidity in the banking sector, the agricultural supply affected the rate during 2006. The national bank aims M3 monetary supply growth to be 11.9% in 2007.

Credit growth remained rapid during 2006 and can even be

**Credit to private sector per GDP (%)**



Note: f = forecast; Source: Bank of Albania

considered one of the risk factors. According to the central bank, credit to the private sector per GDP rate was 20.8% in 2006 and is expected to be around 25.5% in 2007. Credit growth underpins the increase of consumption and investments. Interest rates were historically low, and the banking sector offers new lending forms like consumer credit and real estate loan.

Due to potential risk concerning the long-term inflation and in order 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 lek's exchange rate against the euro remains continually stable.

**Fiscal expenditures and revenues per GDP (%)**

	2005	2006 Plan	2007 Budget Proposal	2008 Projection
Total expenditures	27,76	29,65	30,57	30,74
Total revenues	24,40	25,56	25,80	26,76

Source: Ministry of Finance

**Fiscal policy**

In the first semester of 2006, fiscal balance remained at the programmed levels, but from October the acceleration of budget expenditures has started. This growth of expenditures may continue in 2007 in connection with elections, resulting a higher than programmed budget deficit, amounting around the upper range of 3-4%. Public debt is stagnating or is slightly declining, and is expected to decrease further in the next year, but debt management remains poor.

In order to improve business climate, the prime minister plans to introduce a 10% flat tax system from 2008, but no further information is known yet on this issue.

**External balance**

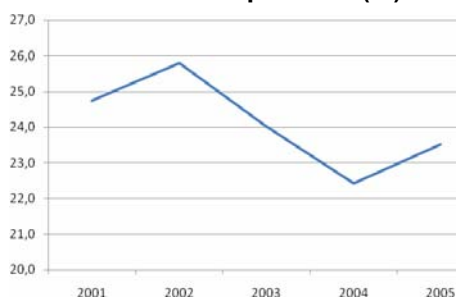
The export base is still narrow in Albania, partly as a result of poor non-price competitiveness. This is a consequence of the unfavourable business environment and inadequate infrastructure. Textile and footwear, metals, minerals, agricultural products, leather, etc. remain the main export items. Trade activity of Albania expanded significantly 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.

In 2006, the current account deficit continued widening. Domestic demand, fuelled by rapid credit growth is the main cause of the increasing external deficit. In 2007 the trade deficit and the current account deficit is expected to widen further on slightly. Current account deficit per GDP rate is increasing year by year, and in 2007 it may exceed even 8%.

Remittances from abroad remain an important factor for compensating the trade deficit. In the first three quarters of 2006, workers' remittances increased by 17% and amounted to EUR 683 million. Though showing an increase of around 12%, FDI inflow remained at a low level in 2006 as well, and according to estimations it amounted to EUR 250 million.

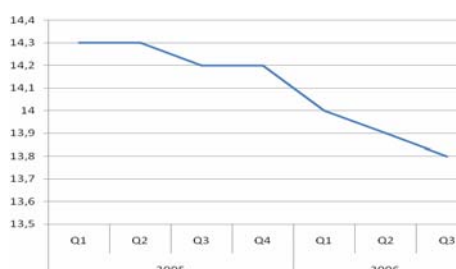
**Trade deficit per GDP (%)**



Source: INSTAT

## Labour market

### Official unemployment rate (%)



Source: INSTAT

Due to the large informal sector - particularly related to the agricultural and construction sector - it is hard to assess the exact rate of unemployment in Albania. According to the official data, the unemployment rate continued to decrease marginally, and by the end of 2006 it stood around 13.8%. The data indicate that there was a slight shift from the public sector to the private non-agricultural sector. Around 70% of the unemployed are so called long-term unemployed. The mild downward trend concerning the unemployment rate is expected to continue in 2007.

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. In 2007 the elections may further affect the growth of wages.

### Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
Nominal GDP (ALL mn)	837,000	896,000	979,000	1,075,000
Real GDP growth (%)	5.5	5.0	5.2	5.7
Private consumption (%)	NA	-	-	-
Public consumption (%)	NA	-	-	-
Investments (GFCF, %)	24.2	24.7	25.4	26.1
Exports (%)	12.0	13.0	14.0	14.0
Imports (%)	13.0	16.0	12.0	7.0
Annual average inflation (CPI, %)	2.4	2.4	2.7	2.8
Discount rate (end of period, %)	5.00	5.50	5.75	5.75
Money market rate (3-month Treasury Bill, %)	5.75	6.25	-	-
Long-term interest rate (10-year gov't bond, %)	NA	-	-	-
Exchange rate (ALL / EUR, average)	124.2	123.1	124.5	122.5
Exchange rate (ALL / EUR, end of period)	122.6	123.8	124.0	122.0
General government balance / GDP (%)	-3.6	-3.1	-3.9	-3.6
Public debt / GDP (%)	54.9	55.0	54.5	53.6
Trade balance / GDP (goods and services, %)	-23.5	-24.5	-23.2	-22.5
Current account balance / GDP (%)	-7.5	-7.7	-8.0	-8.0
Gross foreign debt / GDP (%)	21.4	22.0	22.0	21.5
Unemployment (%)	14.2	13.8	13.5	13.1
Real ULC growth (%)	NA	-	-	-

Note: e = estimation, f = forecast. See methodological notes for definitions and details.

Sources: Bank of Albania, INSTAT, IMF



# Bosnia and Herzegovina

GDP growth remained dynamic, but even the economy is hampered by the lack of political consensus. Following the one-off negative effect of VAT introduction on inflation in 2006, price stability continues. Due to the pre-election period and the higher-than-expected VAT incomes, fiscal expenditure accelerated. The high level of trade deficit and unemployment remains severe problem of the economy.

## Political developments

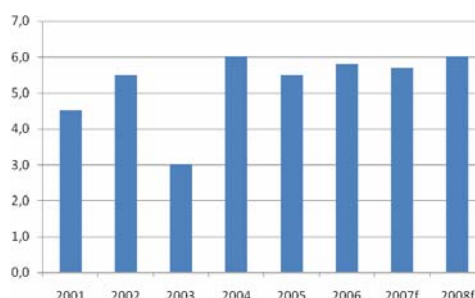
After the elections in October 2006, the formation of the new government is still not completed on all levels - namely in the Federation of BH (FBiH). Institutional, structural and legislative reforms are needed but the lack of political consensus often blocks the process, accordingly hindering further economic growth and events like the signing of the EU's Stability and Association Agreement. Though the Office of the High Representative (HR) is due to close this summer, the HR questioned the country's political and institutional maturity, thus it is still uncertain when the office will actually close. The Serb entity's (Republika Srpska – RS) independence ambition may be fuelled by the potential independence of Kosovo. BH became a member of NATO's Partnership for Peace Programme in December 2006 and joined CEFTA from 2007.

## Growth

GDP growth in 2006 exceeded that of 2005, and for 2007 the growth rate is expected to be around 5.7%. It is a good sign that growth in 2006 has been underpinned by a significant industrial output growth – in 2006 annual industrial production growth reached 7.5% in the Federation of BH (FBiH) and 19.1% in the Serb entity Republika Srpska (RS).

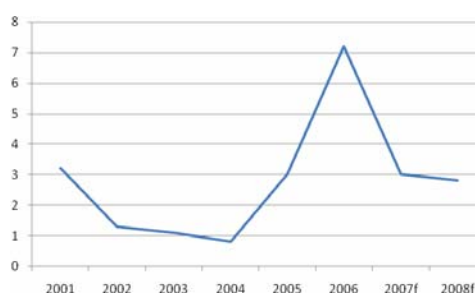
The high level of growth has been supported by favourable external conditions, like growing foreign demand and increasing prices of metals. Although foreign demand played an increasing role in GDP growth, domestic demand and particularly private consumption remained an important element of economic growth. This was underpinned by the growth of wages related to the pre-election period, and the continuing credit boom, further supported by remittances from abroad.

Real GDP growth (%)



Note: f = forecast; Source: CBBH

Annual average inflation (CPI, %)



Source: CBBH

## Monetary developments

VAT introduction in January 2006 had a one-off effect on inflation, but from the second semester of the year CPI started to decline. Finally the annual growth of the retail price index in 2006 amounted to 7.4%. Annual inflation in January 2007 was 1.2% compared to the same month in 2006, while a year ago it was around 6-8%, well demonstrating the effect of the VAT introduction. This year price stability is supposed to return, thus the retail price index is expected to be around 3%.

In 2006 money supply increased by 24.8%. By the end of 2006 total deposits of households amounted to KM 4.1 billion, which is 46.3% of total deposits. In 2006 the interest rate on long-term loans continued to decline, but the interest rate on short-term loans to

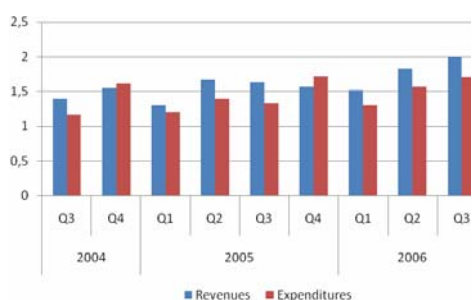
households grew by 49 base points. Annual credit growth in 2006 was 23%, while a year ago this number was even higher and amounted to around 27%. According to the central bank, the total amount of credits is close to KM 8 billion, around half of this amount is owned by citizens, while the other half has been lent to entities. This means that on average every citizen has approximately KM 1 000 of debt. In January a further step has been achieved to the realisation of the Central Registry of Credits.

The central bank's foreign exchange reserves continued to grow and amounted to KM 5.4 billion (or 5.4 months of imports) by the end of 2006, while a year earlier it was KM 4.2 billion (or 4.2 months of imports). Total assets amounted to KM 5.48 billion by the end of January 2007. Since 2000, BH's total foreign debt fluctuates around KM 4.03 billion and KM 4.42 billion.

In February 2007 the Eurosystem Needs Assessment Program has been signed, which is due to identify areas in which the central bank ought to achieve progress and adjust its standards with the European system.

### Fiscal policy

**Consolidated revenues and expenditures of general government (KM, billion)**



Source: CBBH

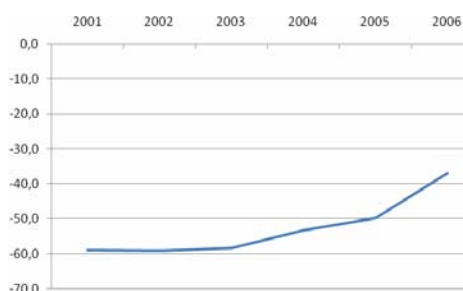
In 2006 fiscal expenditures most probably exceeded the planned targets for two main reasons. One is the impact of the pre-election period (including e.g. vote-winning wage rises), and the other is the fact that higher-than-expected VAT revenues have begun to be spent. It is expected that this tendency will continue, resulting in lower budget surplus. The budget for 2007 in FBiH has not been adopted yet, while for BH and RS a slight surplus is expected.

In the first five months of 2006, KM 150 million more VAT was collected than expected. In the first three quarters of 2006, the income of BH budget based on tax increased by 24.9%, compared to the same period in 2005. This growth was based on tax revenues, moreover it is supposed that due to the introduction of VAT, fiscal discipline improved. Thanks to these, although government consumption increased significantly, higher public revenues resulted in surplus. During the first three quarter of 2006, BH's consolidated budget surplus amounted to KM 661.74 million, FBiH's to KM 437.79 million, while RS's to KM 131.51 million.

The political will to adopt and to implement a strong National Fiscal Council law seems to be problematic. The government sector is inefficient and oversized; government expenditures are approximately around 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 the absence of strong political determination it is the IMF, that may probably help to foster the inevitable reforms.

### External balance

In 2006 the value of imported goods was KM 11.1 billion, representing almost stagnating growth. The low growth rate of import was partly due to the one-off import boom by the end of 2005, generated by the introduction of VAT. On the other hand, annual average export growth rate was 28% in 2006, and export amounted to KM 5.2 billion. This high export growth was underpinned by better external conditions, the successful

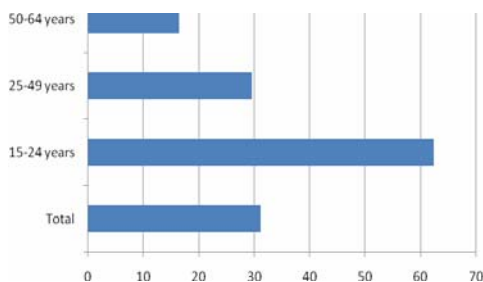
**Trade balance per GDP (%)**

Source: CBBH

restructuring of certain companies (e.g. in the aluminum and steel sector), and also the improved recording of exports as an effect of the VAT.

Due to moderate import growth and booming export, the deficit on the trade of goods decreased from EUR 4 billion to EUR 3.4 billion, but it can still be considered very high. According to the central bank, this deficit is partly financed by current transfers (44%, workers remittances 31%), services (14%) and income (11%). As a result of the changes in trade flows, the current account deficit decreased from EUR 1.72 billion to EUR 1.05 billion in 2006. This deficit is financed by capital transfers to the public sector (21%), FDI (27%) and other investments (51%). Due to the fact that by 2007 the VAT will not have major effect on the trade balance, and provided that no extensive restructuring will take place in the private sector, significant improvements in the external balance can not be expected.

FDI inflow remained low in 2006 as well; according to estimations it amounted to EUR 338.77 million, while in 2005 it was EUR 420.87 million. In 2007 higher inflow is expected, due to certain privatisation processes, e.g. in the case of Energopetrol and Telekom Srpske.

**Labour market****Unemployment rate by age groups, 2006 (LFS, %)**

Source: Agency for Statistics of BH

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 on the issues concerning the labour market. Final data will be published only later in 2007, but the following are known from the data published in July 2006. According to the survey 1.5 million (56.9%) people are inactive (including children below 15 years of age and people who did not give a direct answer), while approximately 1.2 million (43.1%) are active. The group of active is further divided into employed (811 thousand) and unemployed (366 thousand). This results in an employment rate of 29.7%, while unemployment rate stands at 31.1%.

On the other hand, according to the official data, unemployment rate was around 43% in 2006 and is expected to decrease only slightly this year. The large informal sector (its major component is supposed to be the agricultural sector) increases the unreliability of the figures. A realistic figure for the rate of 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.

Average net wage was KM 613 in December 2006, representing 9.7% growth compared to the same period in 2005. The real value of wage growth was 3.5% in the same period; 1.9% in the FBiH and 7.2% in RS.

**Key macroeconomic indicators, 2005-2008**

	2005	2006e	2007f	2008f
Nominal GDP (BAM mn)	15,750	18,000	19,700	21,400
Real GDP growth (%)	5.5	5.8	5.7	6.0
Private consumption (%)	NA	-	-	-
Public consumption (%)	NA	-	-	-
Investments (GFCF, %)	NA	-	-	-
Exports (%)	NA	-	-	-
Imports (%)	NA	-	-	-
Annual average inflation (CPI, %)	3.0	7.2	3.0	2.8
Discount rate (end of period, %)	NA	-	-	-
Money market rate (3-month Treasury Bill, %)	NA	-	-	-
Long-term interest rate (10-year gov't bond, %)	NA	-	-	-
Exchange rate (BAM / EUR, average)	1.96	1.96	1.96	1.96
Exchange rate (BAM / EUR, end of period)	1.96	1.96	1.96	1.96
General government balance / GDP (%)	2.6	1.6	1.0	0.5
Public debt / GDP (%)	27.5	30.8	32.0	33.7
Trade balance / GDP (goods and services, %)	-44.1	-31.6	-36.6	-33.5
Current account balance / GDP (%)	-21.8	-14.4	-16.8	-16.3
Gross foreign debt / GDP (%)	57.9	54.7	54.5	54.5
Unemployment (%)	44.5	43.0	42.5	41.5
Real ULC growth (%)	NA	-	-	-

Note: e = estimation, f = forecast. See methodological notes for definitions and details.

Sources: Central Bank of BH, Agency for Statistics of BH, IMF, own calculations

# Croatia

EU integration process gives good stimulus for economic development. Strong growth performance is fuelled mainly by domestic demand. Export activity is in rise, but external imbalances are rising. Monetary policy's results correspond to price stability objective. The fiscal adjustment is likely to be reversed. Current account deficit is widening due to increasing trade deficit. Further decline in unemployment and rise in employment is going to realise.

## Political developments

The political situation is stable mainly due to integration process that anchors political direction. Strong record of reforms and structural convergence is continuing. Restructuring of loss-making public companies and the privatisation process are under way.

However, there are still areas waiting for measures. Having 'an open, competitive market economy' Croatia must comply with agreed targets for the sale of state-owned interests in companies and for the reduction of state subsidies to particular industries. There are also important tasks in connection with environmental legislation, acquisition of real estate by EU nationals, cooperation with International Criminal Tribunal, speeding up judicial and state administration reforms.

The most important political event of 2007 can be the parliamentary elections in November that could cause a challenge both for already realised structural changes and for composition of growth. The centre-right (HDZ) led Croatian government may face unfavourable political environment as its current position might weaken.

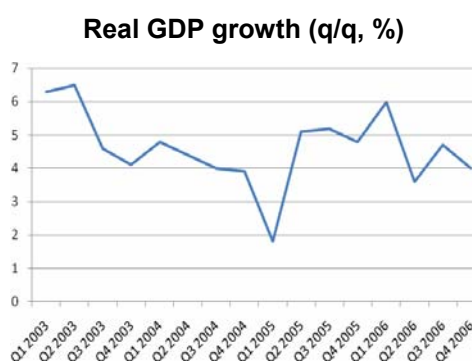
## Growth

In the last quarter of 2006 real GDP growth was 4.8% y-o-y. Based on the quarterly estimates, this result led to the same rate of 4.8% as of annual one which is fairly closed to our previous estimation (4.7%).

In the last quarter of 2006, in y-o-y terms, main contributors of growth were private consumption (4.1%) and gross fixed capital formation (9.2%) and surprisingly exports that grew by 11.2%. Contribution of government final consumption expenditures managed to be extremely high with its 4.4% in the fourth quarter in 2006.

If investigating the whole year 2006, domestic demand remained the main contributing factor, despite of unexpected contribution of net exports in the last quarter. In annual terms, private consumption grew moderately, while public consumption reached 2.2% as compared with 0.8% in 2005. The development of GFCF increased by 10.9% in 2006. Despite of quarterly development, imports grew stronger than exports leading to negative contribution from the side of net exports, showing that investments and consumption were mainly satisfied through imports.

In year 2006, industrial production increased by 4.5% that was mainly driven by production of capital goods (14.5%). Manufacturing with 82% share in total production increased by 4.5%, with main contribution of the manufacture of machinery and equipment, food



Source: CROSTAT

products and beverages. Business confidence predict strong growth and this is backed by the developments of total industrial production that was by 5.7% higher in February 2007 than in February 2006, also mainly driven by mining a quarrying and excellent manufacturing performance.

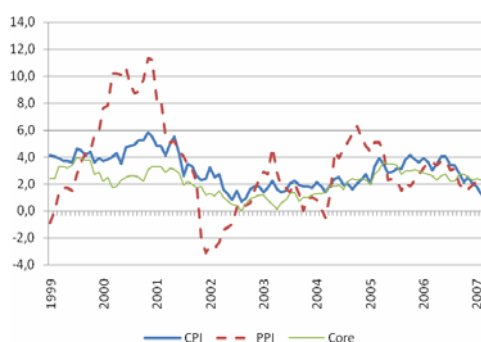
Positive trends can be observed in the development of construction and retail trade, especially as of the end of 2006. The tourism sector performed relatively weakly, as some slowdown happened in increase of tourist nights and arrivals. These developments have happened by some shift from foreign to domestic target groups.

As of future, we do not expect decrease in private consumption predicated on elections. Investments by necessity need to adjust from the high rate of 2006 not only as a result of statistical base year effect, but also as real development. We expect a slight slowdown in the growth of foreign trade but its negative contribution to growth will persist in 2007 and some shift is expected in 2008.

Taking into consideration the expected internal and international risks and the favourable developments of EU growth, we are keen on upgrading our estimation to 4.5% in 2007. Slight moderation estimated for 2008 with its 4.4% real GDP growth.

### Monetary developments

Monthly price developments (%)



Source: CROSTAT, CNB

In February 2007, consumer price index (CPI) of goods and services for personal consumption increased by 1.2%, as compared to February 2006 (on the annual average by 2.8%). This favourable improvement happened mainly due to price fall in food and non-alcoholic beverages (-1.0%). Also lower increase in transport and housing prices contributed to more moderate inflation. The core inflation in February was 2.3% y-o-y.

Producer price index (PPI) increased by 1.7% (on the annual average by 2.6%) mainly pulled by intermediate and non-durable consumer goods. Manufactured products pushed down PPI inflation.

The HRK/EUR exchange rate remained relatively stable with slight volatility during the first three month of 2007. However the HRK/USD exchange rate experienced slight weakening in the beginning of the year mainly as a consequence of appreciation of USD against EUR.

Some monetary tightening happened in January 2007 as M1 decreased by 5.27%, while in y-o-y terms increased by 23.5% that is remarkable acceleration if comparing with the previous period. The growth of M4 aggregate also slowed down in January (0.3% growth), but in y-o-y it increased by 20.4%.

The disinflation process is going to continue, however the already experienced and the expected wage developments could counteract, rather stabilising annual average inflation near 3% both for 2007 and 2008. Regarding HRK/EUR exchange rate slight appreciation is expected.

### Fiscal policy

Fiscal policy continued its efforts to adjust its public finances and its indicators. Budget deficit in GFS terms expected to reach a close to 3% data that means in ESA 95 terms even lower one.

This favourable development was mainly reached with the sharp adjustment of central government deficit. However, all segments of consolidated general government recorded a reduction of deficit, taking either extra-budgetary funds and agencies or local governments.

Consolidated general government revenues exceeded the planned revenues. This happened mainly to considerable progress towards better collection and control of government revenue and process of expense execution. On revenue side mainly direct taxes contributed significantly.

It is expected that Croatia will not be able to keep its latest commitment expressed in PEP, as the election undoubtedly means considerable risk. In 2007, 3.6% of deficit expected and the adjustment continues only in 2008. The general government debt will increase in 2007 and due to further adjustment it will decrease slightly in 2008.

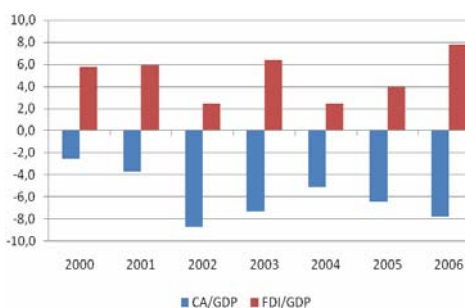
### External balance

According to available data on international accounts, the current account deficit (CAD) increased sharply to 7.7% of GDP in 2006 from 6.4% in 2005, reflecting growing external imbalances. After first three quarters of 2006 the CAD almost doubled. Despite of bright improvement of it in the last quarter, the annual result was worse as compared with 2005.

This is a result of simultaneous widening of trade balance deficit and narrowing of service balance surplus. The worsening balance is a final result of growing investments and final consumption both of private and public sector mainly supplied by imports, and by relatively weak tourism performance.

Coverage of imports by exports concerning foreign trade of goods improved, as it increased by 1 percentage point up to 48.3% during 2006. This happened due to 15.6% increase in exports and 13.3% increase in imports from 2005 to 2006. But the growth advantage of exports was not enough to offset its negative influence on trade balance.

**Current account balance and FDI per GDP (%)**



Source: CNB

The given level of CAD seems to be sustainable as the full amount of it was financed by FDI inflows, mainly based on accelerated privatisation process. The FDI of EUR 2.8 billion in 2006 is almost double of 2005.

The level and the development of external debt seems worrisome as it reached 85% of GDP and closed to EUR 29 000, but it is fair to mention that it was mainly driven by growing external borrowing of corporate sector. The government managed to reduce its external indebtedness.

Concerning balance of payment indicators worsening is expected mainly determined by domestic demand driven growth supplied with imports. Despite of the improving export activity the trade balance is expected to widen and reach 26% of GDP in 2007. As the service balance will not be able to offset its influence on CAD that will finish 2007 with a closed to 8% data. This jingles with possible economic outcomes of election year. 2008 will break this trend due to inevitable adjustment in consumption and rising exports as a realisation of accelerated investments. Thus 25.3% trade deficit and

7.2% CAD is predicted. The contribution of service balance (tourism sector) seems to be the major risk.

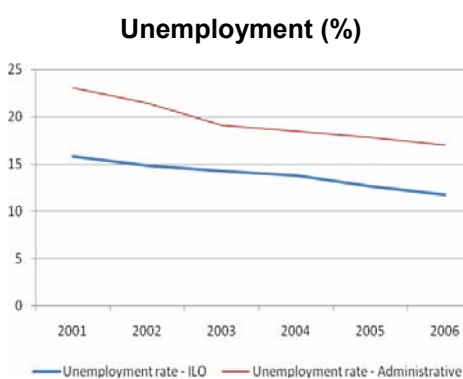
### Labour market

The total number of persons in paid employment increased by 1.6% in February 2007 y-o-y. This was mainly driven by increase of employment in construction (4.1%), wholesale and retail trade (3.5%). Manufacturing improved only with the moderate 0.5%.

Unemployment rate measured as unemployed persons to total active population reached 17.0% in February 2007 that is 1.3 percentage point lower than in the same period of previous year. By known labour force survey data for the period of first six months of 2006, unemployment rate averaged at 11.8%.

Average monthly gross earnings in January 2007 increased nominally by 7.3% while in real terms by 5.4% y-o-y. Average monthly paid off net earnings for the same period were 6.3% nominally and 4.4% really.

Taking into consideration the favourable growth prospects of the economy based on strong performance of manufacturing industry and construction, continuous improvement is expected as of decline in unemployment rate. 11.1% for 2007 and 10.8% for 2008 is estimated.



Note: end of period data; Source: CROSTAT

### Key macroeconomic indicators, 2005-2008

	2005	2006	2007f	2008f
Nominal GDP (HRK mn)	231,349	250,590	270,000	290,000
Real GDP growth (%)	4.3	4.8	4.5	4.4
Private consumption (%)	3.4	3.5	4.1	3.5
Public consumption (%)	0.8	2.2	1.8	1.2
Investments (GFCF, %)	4.8	10.9	7.5	7.4
Exports (%)	4.6	6.9	4.9	5.6
Imports (%)	3.5	7.3	5.2	5.1
Annual average inflation (%)	3.3	3.2	3.0	2.9
Policy rate (discount rate, %)	4.50	4.50	4.50	4.50
Short terms (3-month T-bill, %)	3.70	3.00	-	-
Long-term interest rate (10-year gov't bond, %)	4.3	4.4	4.7	4.5
Exchange rate / EUR (average)	7.40	7.32	7.28	7.20
Exchange rate / EUR (end of period)	7.37	7.34	7.30	7.19
Budget balance / GDP (%)	-3.9	-2.3	-3.6	-3.2
Public debt / GDP (%)	44.2	42.2	43.4	43.2
Trade balance / GDP (goods and services, %)	-24.3	-25.8	-26.0	-25.3
Current account balance / GDP (%)	-6.5	-7.6	-7.8	-7.2
Gross foreign debt / GDP (%)	82.5	84.8f	85.2	85.5
Unemployment (%)	13.0	11.6f	11.1	10.8
Real ULC growth (%)	NA	NA	-	-

Note: f = forecast.

Sources: Croatian National Bank, Central Bureau of Statistics of Republic of Croatia, Eurostat



# Former Yugoslav Republic of Macedonia

Economic growth decelerated and inflation jumped slightly, while external balance improved in 2006. From 2007 flat tax regime was introduced and we expect that economic growth will accelerate and inflation will decrease compared to the previous year. Labour market and external balance figures will improve as well.

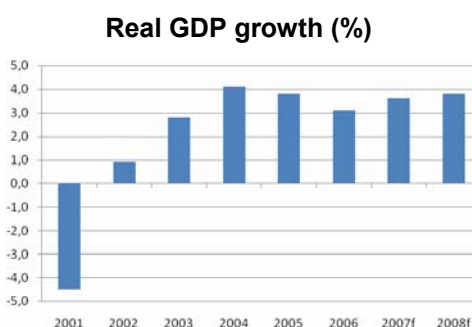
## Political developments

2007 has not started well since political crisis evolved and the largest Albanian party, the Democratic Union for Integration (DUI) and its partner, Party for Democratic Prosperity boycotted Parliament and parliamentary committees. The boycott was a protest against the ruling parties because the exclusion of DUI from the governing coalition was evaluated as a violation of the 2001 Ohrid Agreement provisions on minority representation, according to the ethnic Albanian opposition party. The wrangling resulted in the slow down of the reform process in a period of time when the country plans to join two organisations, namely the European Union and NATO.

Accordingly, political crisis characterised the first weeks and months of the year, however, party leaders met in March with the aim to resume political dialogue. It is their elemental interest to continue the co-operation because both aforementioned organisations foster that and it is a pre-condition to be a member of these organisations.

Regarding NATO accession if everything progresses well the former Yugoslav Republic of Macedonia could join the Euro-Atlantic organisation in next year, while EU accession date is still not determined and is not expected in the next 3-4 years.

## Growth



Note: f = forecast; Source: SSO

According to the State Statistical Office of the Republic of Macedonia, gross domestic product increased by 2.6% in the fourth quarter of 2006. Economic growth decelerated compared to the previous quarter, when real GDP grew by 4.0%. As a result GDP growth for the total year reached 3.1% which was close to our previous forecast (3.0%), the expected deceleration occurred in the last months of the year.

According to previous data, industry and services sector increased by 3.6% and 3.7% respectively. Regarding services, the highest growth rate was achieved by transport, storage and communication branch (7.5%) in course of 2006. On the other hand, both construction sector and agriculture performed weakly. Agriculture reached 0.6% growth in last year, construction sector declined by 0.4%.

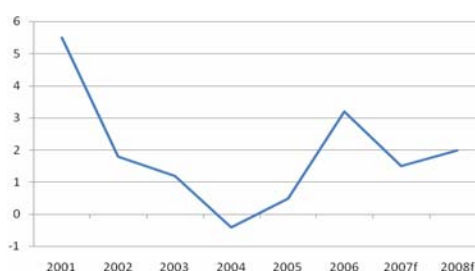
On the expenditure side, it is worth mentioning that both investments and exports had increased significantly during 2006. On the one hand, growth rate of exports was higher than that of imports for the second consecutive year, nominal growth rates were 18.1% and 17.0%. On the other hand, investment in machinery and equipment also reached considerable growth rate, it increased by 18% in course of 2006. Besides that GDP growth decelerated in 2006, the composition of economic growth improved further due to

the good performance of export of goods and services.

In 2007 we expect that further improvement of export sector will be observable and its contribution to GDP growth will increase. In line with that, economic growth will accelerate slightly compared to the previous year and it will reach 3.6%. We also expect that foreign investors' attention to the country will grow owing to lower tax rates introduced from 2007. In 2008 GDP growth can increase further and could reach 3.8%.

### Monetary developments

Annual average inflation (CPI, %)



Note: f = forecast; Source: SSO

In the first two months of 2007 inflation remained low. Consumer price index was 0.7% and 0.5% in January and February, respectively. Considering the fact that CPI was more than 3% in the last months of 2006 this low figures seem favourable. The low figures are mainly due to the fact that only heating prices were increased significantly (more than 20%) at the beginning of the year, while prices of all other goods remained unchanged or increased modestly since December 2006.

The decrease of CPI figures was not surprising because at the beginning of last year a significant growth of excise duties – tobacco prices were increased by almost 37% - had a negative impact on the development of inflation. As this impact phased out in the beginning of this year CPI declined under 1.0% again.

In 2007 we expect that price stability will characterise the Republic of Macedonia and CPI will reach 1.5% this year. However, there are some risks, namely the development of international oil prices and the evolution of food prices that may have a negative impact on consumer price index this year.

### Fiscal policy

In 2006 general government deficit remained relatively low, reaching 0.6% of GDP. However, the budget balance deteriorated compared to 2005, mainly due to higher expenditures of the new government in the second half of the year. Budget revenues increased by 12.1% in course of 2006, while, expenditures grew by 14.7%. On the revenues side, it is worth mentioning that profit tax revenues increased significantly in 2006, it grew by 66%. On the expenditure side, it was observable that the new government kept its promises and realized some measures increasing budget expenditures. Only other transfers burdened the budget by MKD 2334 million or 0.8% of GDP in December 2006 which resulted in that this element of expenditures side increased by 90.1% during 2006.

In line with the favourable development of budget balance in 2006, public debt also decreased significantly. At the end of last year public debt decreased to 41% of GDP and it will decline under 40% in the next two years according to our forecast.

From the beginning of 2007, flat tax regime was introduced in the Republic of Macedonia, accordingly another country in the region decided to use that simple and competitive form of taxing. As of 1<sup>st</sup> January 2007 profit tax was reduced from 15% to 12%, while personal income tax rate was set at 12% as well and consequently the former 15%, 18% and 24% rates were eliminated. Furthermore, the flat tax rate will be reduced further from 2008, down to 10%. The

Budget 2005-2006 (mn MKD)

	2005	2006	2006/2005 (%)
Revenues	92 805	104 078	12.1
Expenditures	92 228	105 782	14.7
Balance	577	-1 704	-

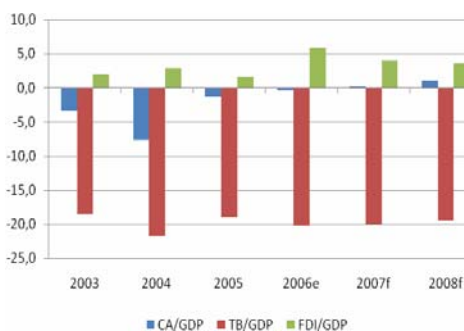
Source: Ministry of Finance

main aim of the reduction of tax rate is to make the business climate of the Republic of Macedonia even more attractive for foreign investors. To achieve that government also decided to make reinvested profit taxed by zero rate. In our opinion, the introduction of flat tax regime in the Republic of Macedonia means that tax competition irrevocably started among the Western Balkan countries too, which eagerly try to attract more and more foreign investors in their countries.

For 2007 our expectation is that the budget balance will deteriorate slightly compared to 2006, mainly due to the changes in tax system and higher planned budget spending. We expect that general government deficit will reach 1.1% of GDP, while public debt will decrease further in 2007 as well.

### External balance

**Current account, trade balance and FDI (% of GDP)**



Note: e = estimation, f = forecast; Source: SSO, NBRM

In 2006 current account balance improved in comparison with 2005. Current account deficit diminished to EUR 18.9 million or 0.4% of GDP from 1.3% in the previous year. The improvement of C/A balance was due to the improvement of services, income and current transfers balance, and the good performance of export sector as well.

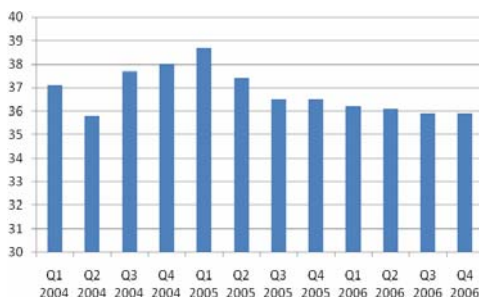
Both export and import of goods rose considerably, by 15.8% and 17.1% respectively. In spite of the good performance of export sector, trade balance deteriorated in last year and reached 20.2% of GDP. On the other hand, all other components of C/A balance improved, especially (private) current transfers counterbalanced the deficit of foreign trade balance. Net current transfers reached 19.9% of GDP.

Regarding foreign direct investment, 2006 was a good year from this aspect as well. Due to privatisation of ESM, the Macedonian energy distribution company at the beginning of the year, net FDI reached EUR 285.9 million. That amount of FDI was the highest since 2001 when national telecom company was privatised.

In 2007 we expect that current account balance will improve further and it will be close to equilibrium this year. Improvement is expected in the cases of services income and current transfers balances and export sector is also expected to perform well in 2007 too.

### Labour market

**Unemployment (%)**



Source: SSO

In the last quarter of 2006 unemployment rate decreased to 35.9%, while the number of employed persons increased by 4.1%. It means that employment increased by almost 23 thousand workers in the fourth quarter of 2006 in comparison with the corresponding period of the previous year. Owing to the positive development employment rate increased to 35.7%. Not only employment rate improved but also wages increased significantly in 2006. During last year nominal wages increased by 8.0%, while wages increased by 2.7% in the previous year.

For 2007 we expect that labour market figures will remain basically unchanged or improve slightly, namely unemployment rate will stagnate, while employment will increase somewhat. Tax cuts may have a whitening effect on labour market as well and inflowing foreign investments may also have a positive impact on

employment. In 2008 unemployment rate will fall under 36.0% according to our forecast.

### Key macroeconomic indicators, 2005-2008

	2005	2006e	2007f	2008f
Nominal GDP (MKD mn)	284,226	303,000	322,000	342,000
Real GDP growth (%)	3.8	3.1	3.6	3.8
Private consumption (%)	NA	-	-	-
Public consumption (%)	NA	-	-	-
Investments (GFCF, %)	NA	-	-	-
Exports (%)	NA	-	-	-
Imports (%)	NA	-	-	-
Annual average inflation (CPI, %)	0.5	3.2	1.5	2.0
Discount rate (end of period, %)	6.5	6.5	6.5	6.5
Money market rate (3-month Treasury Bill, %)	NA	6.3	6.4	6.1
Long-term interest rate (10-year gov't bond, %)	NA	-	-	-
Exchange rate (MKD / EUR, average)	61.3	61.2	61.1	61.0
Exchange rate (MKD / EUR, end of period)	61.2	61.2	60.9	61.0
General government balance / GDP (%)	0.2	-0.6	-1.1	-1.5
Public debt / GDP (%)	48.6	41.0	39.5	38.0
Trade balance / GDP (goods and services, %)	-19.0	-20.2	-20.0	-19.5
Current account balance / GDP (%)	-1.3	-0.4	0.1	1.0
Gross foreign debt / GDP (%)	41.5	37.0	35.2	35.0
Unemployment (%)	37.3	36.0	36.0	35.8
Real ULC growth (%)	-15.1	10.0	6.0	4.0

Note: e = estimation, f = forecast. See methodological notes for definitions and details.

Sources: National Bank of the Republic of Macedonia, State Statistical Office of the Republic of Macedonia

# Montenegro

The Stabilisation and Association Agreement between Montenegro and the EU was initialled on March. Backing the agreement more reforms is expected in medium term. Although GDP growth rate was relatively high in 2006, output downtrends are recorded in industrial production in January-February. Retail price index remains low. Thanks to the lower political risk, improving public finances and fruitful FDI activity S&P raised Montenegro's long-term ratings on March.

## Political developments

On 21 May 2006 Montenegro organised a referendum on independence. According to the results, voters supported independence. Thus the Montenegrin Parliament adopted the Declaration of Independence on 3 June. After the declaration Montenegro started to build its own international relations. The first elections took place on September 10, 2006, with Prime Minister Milo Djukanovic claiming absolute victory for his centre left.

Improving international relations can be noticed in the first quarter of 2007. On January 18 Republic of Montenegro joined the IMF becoming the institution's 185<sup>th</sup> member. On March the Stabilisation and Association Agreement between the EU and Montenegro was initialled. The completion of the agreement talks (Montenegro began discussions on a Stabilisation and Association Agreement with the EU in October 2005) is accelerating further economic and political reforms in medium term. The agreement will bring concrete benefits to the economy and society. It foresees the establishment of a free trade area between the country and the EU by the end of a 5-year period as well as enhanced cooperation in the economic field. Three main benefits can be distinguished: economic development through fruitful cooperation, political stability through deeper integration into the EU and improvement of the quality of life through the reforms.

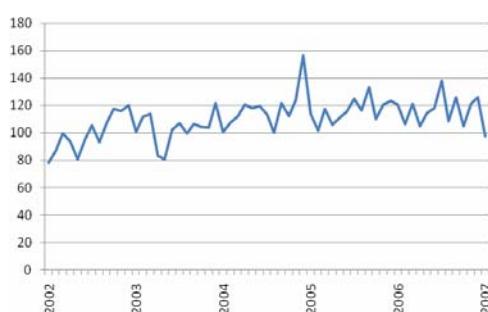
The stable outlook on Montenegro reflects the expectation that economic reform, fiscal consolidation, and strong investment will continue, and the prospect of EU integration will remain a driver for further reforms and ongoing political stabilisation. On the other hand the final status of Kosovo may moderately affect Montenegro's political and economic environment.

## Growth

Montenegro's GDP expanded by approximately 6.5% year-on-year in 2006. The strong growth rate was mainly driven by strong domestic demand, and growth in construction, banking and tourism sectors. The tourism industry experienced significant gains last year. Further reforms (social security, privatisation, infrastructure investment) are expected to sustain annual GDP growth at an average of 6% in the medium term.

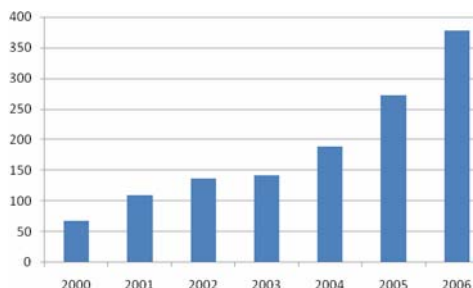
Industrial production in Montenegro decreased in the first two months. Only manufacturing had the increase of production during January and February this year, compared to the same months of the previous year (11.5%). Increase was recorded only in the manufacturing of tobacco, the manufacturing of paper, the printing in reproduction, the manufacturing of basic non-metal products and the manufacturing of furniture. On the other hand, the remaining two

Industrial production (2000 =100)



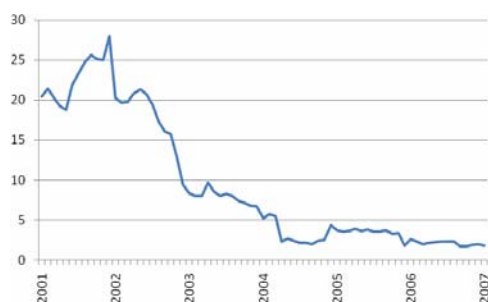
Source: MONSTAT

### Arrivals of non-residents staying in hotels and similar establishments (Thousand persons)



Source: MONSTAT

### Retail price index (%)



Source: MONSTAT

### Budget revenues and expenditures (mn EUR)

	2006	Plan for 2007
Revenues	582.3	616.9
Expenditure	579.8	616.9

Source: Ministry of Finance, Montenegro

sectors had decreased production: mining (-16.1%) and electricity, gas and water supply (-40.8%).

Tourism plays a major role in Montenegro's economy. The government marked the sector as one of the strategic industries in the country, and according to the Master Plan for tourism development, Montenegro aims to become one of the most attractive destinations on the Mediterranean. The structure of tourist visits shows a larger share of foreign tourists.

According to our evaluation the GDP growth rate will be around 6 percent in 2007 and 2008. Increasing foreign direct investment is expected in the following years.

### Monetary developments

Index of retail prices in January and February 2007, compared to the same period in the previous year, increased by 1.8%. Prices of services increased by 0.3%, while prices of goods remained the same as in the previous month. The inflation of food, clothing and households utilities was relatively high.

Standard & Poor's Ratings Services raised its long-term ratings on the Republic of Montenegro to 'BB+' from 'BB' on March 27, 2007. At the same time the 'B' short-term rating was affirmed. The outlook is stable. The upgrade is based on Montenegro's significantly improved growth prospects owing to strong investment spending and improving public finances.

Strong FDI coverage of the current balance and use of the euro provide protection from a potential exchange rate crisis in the country.

Inflation rate is expected around 2 percent in 2007. Because of growing domestic demand the rate could exceed the 2 percent in 2008.

### Fiscal policy

In January 2007, the budget of the Republic of Montenegro recorded a surplus of EUR 7.98 million. The surplus is a result of a dynamic increase in current revenues, especially revenues from tax collections and reimbursements. The increase in tax revenues was mainly due to a remarkable increase in the collection of VAT, excise duties, and tax on international trade and transactions (customs duties).

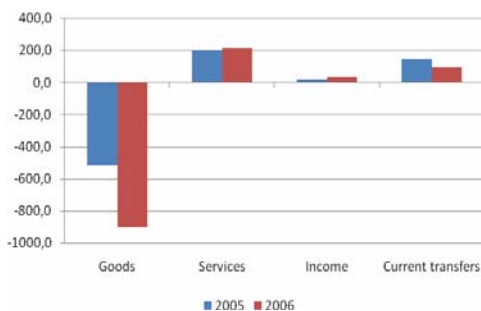
The government's fiscal strategy also supported the improvement as evidenced by the lower general government deficit of about -0.4% of GDP in 2006. In medium term this deficit is expected to increase. The general government debt in percent of GDP will rise in 2007, owing the one-off issuance of the remaining restitution bonds, which will settle all outstanding property claims from Montenegro's past.

### External balance

The external imbalance in Montenegro is historically large. The current account deficit increase in 2006 was primarily due to an increase in the foreign trade deficit. Owing to strong construction-

related imports and investment in the tourism sector, the current account deficit significantly widened, reaching an estimated 31.1% of GDP in 2006. Preliminary data on Montenegro's balance of payments show that the current account deficit in 2006 amounted to EUR 568.2 million. It is expected to decline in medium term following a slowdown in investment as well as rising tourism receipts.

**Components of Current account deficit (mn EUR)**



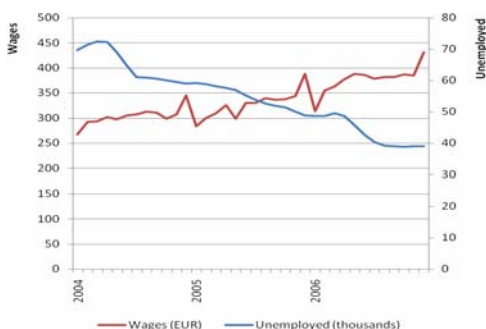
Source: Central Bank of Montenegro

The country's smooth path to independence in 2006 significantly reduced political risk, triggering high foreign direct investment inflows in real estate, tourism, and other sectors, estimated at 34% of GDP in 2006. The coverage of the foreign trade deficit with the surpluses achieved in other current account sub-balances was only 37.3%, which is 32.8 percentage points less than in 2005. The current account deficit was mainly financed by an inflow of foreign direct investments. According to preliminary data, the inflow of foreign direct investments into Montenegro in January 2007 amounted to EUR 33.5 million, which is 149.4% more than in the same month of 2006.

Thanks to the good performance in the tourism sector the current account deficit is expected to decline in medium term. According to our forecast the deficit-per-GDP ratio does not exceed the 8 percent in 2007 and 2008.

**Labour market**

**Unemployment rate (%) and monthly average gross wages (euro)**



Source: MONSTAT

The labour market of Montenegro is characterized by high unemployment rate and low level of activity. Unfortunately the picture of the Montenegrin labour market differs significantly depending on which data source is used. According to the ISSP survey the unemployment rate was 17% in 2005, while the registered unemployment rate was approximately 30%. Nevertheless the unemployment rate decreased last year without reference to the method. The remarkable increase in employment is mainly due to the good performance in the services sector. Also, major investments in the infrastructure, tourism, and banking have contributed to this increase. The tourist season was very successful and was marked by a record number of visitors. The inflow of foreign direct investments has also contributed to this employment boom. The unemployment rate could decline in medium term thanks to the growing FDI inflows.

**Key macroeconomic indicators, 2005-2008**

	2005	2006	2007f	2008f
GDP nominal (EUR mn)	1,690	1,760(e)	1,900	2,050
Real GDP growth (%)	4.3	6.5(e)	6.0	6.0
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	NA	NA	-	-
Exports (%)	NA	NA	-	-
Imports (%)	NA	NA	-	-
Inflation (Retail price index, %)	3.4	2.1	2.0	2.2
Policy rate (discount rate, %)	NA	NA	-	-
Short terms (3-month T-bill, %)	NA	NA	-	-
Long-term interest rate (182 day T-bills, %)	1.01	0.97	1.0	1.0
Exchange rate / EUR (average)	NA	NA	-	-
Exchange rate / EUR (end of period)	NA	NA	-	-
Budget balance / GDP (%)	-2.2	-0.4	-1.2	-4.2
Public debt / GDP (%)	44.5	37.2	36.8	36.2
Trade balance / GDP (goods and services, %)	NA	NA	-	-
Current account balance / GDP (%)	-8.6	-9.1	-7.9	-8.0
Gross foreign debt / GDP (%)	NA	NA	-	-
Unemployment (%)	17.0	15.0(e)	13.0	13.0
ULC (%)	NA	NA	-	-

Note: f = forecast, e=estimation; Source Statistical Office of Montenegro, ISSP, Eurostat



# Serbia

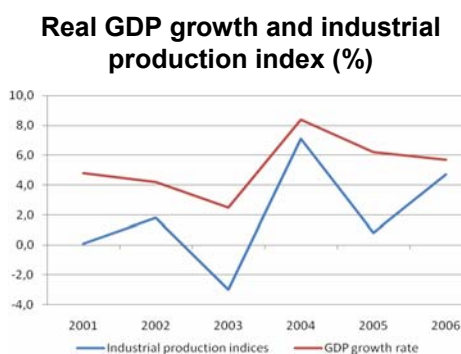
Despite tense political climate, economic growth is expected to remain strong in 2007 as well. Inflation is expected to continue to moderate, reaching single-digit rate, underpinned partly by strong and stable national currency. Due to the lack of agreement on the formation of the new government, the budget for 2007 has not been adopted yet. External imbalances and unemployment remain significant in 2007 as well, although slight improvement is expected.

## Political developments

Following the election in January 2007, in March the democratic parties still could not reach an agreement on the formation of the new Serbian government. This causes delay and uncertainties on the fiscal policy, and the reform process that is needed to support economic development. The formation of the new government and the cooperation with The Hague Tribunal are prerequisites for successful EU negotiations. Serbia became a member of NATO's Partnership for Peace Programme in December 2006 and joined CEFTA from 2007.

Having an impact on politics, the future status of Kosovo still remains uncertain. As a result of the referendum in October, the new constitution has been adopted, in which it is stated that Kosovo is indivisible part of Serbia.

## Growth



Source: Statistical Office of the Republic of Serbia

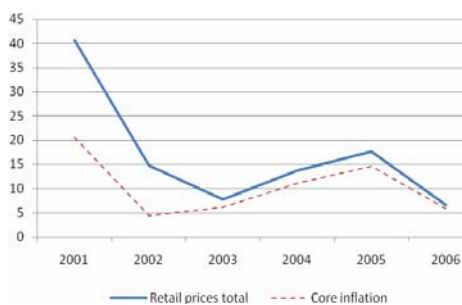
During the four quarter of 2006, real GDP growth decreased from 7.0% year-on-year in the first quarter, to 5.0% year-on-year in the fourth quarter, thus finally the annual real GDP growth amounted to 5.7%. The highest growth rates in 2006 were achieved by the sectors of transport, storage and communication (27.5%), financial intermediation (17.2%), wholesale and retail trade, certain repair (10.6%), construction (9.3%), manufacturing (5.6%), mining and quarrying (4.1%), while the biggest drop was performed by hotels and restaurants (-10.2%). GDP growth was underpinned by the favourable foreign demand combined with widening export capacities, the strong domestic demand and investments.

In January-February 2007, the growth of industrial production reached 5.8% year-on-year. Compared with the rate of 2006, for 2007 a slightly lower or stagnating GDP growth rate is expected, amounting to 5.2-6.0%. Partly as a result of the election, the average growth of real wages was high, fuelling the domestic demand. Due to this reason, in January retail sales increased by 28%. Likewise in 2006, GDP growth is expected to be underpinned by the high level of domestic demand, but this may decrease gradually. Further on, the level of investments and corporate restructuring remains uncertain due to the lack of political consensus.

## Monetary developments

In 2006 inflation slowed down, and is expected to remain moderate in 2007, although as a consequence of the spending level at the beginning of the year and the increasing prices of crude oil an upward pressure may be present. The national bank's main

**Retail prices and core inflation (%)**



Note: core = excluding administrative prices and agricultural products; Source: National Bank of Serbia

objective is to achieve and maintain price stability, and for 2007 the target core inflation rate has been set at 6±2% December-on-December. In the first quarter of 2007, inflation remained moderate, so the consumer price index amounted to 4.8% year-on-year. The moderate inflation was partly due to the strength of the dinar, also underpinned by capital inflows. Despite the risk factors, inflation in 2007 is expected to decrease to approximately 6%.

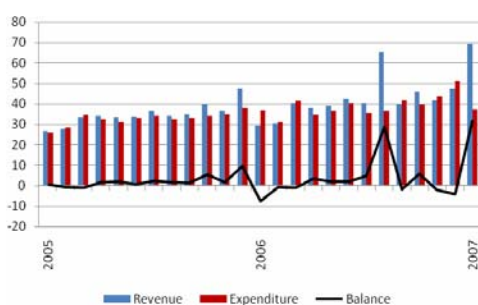
As a result of the moderate core inflation rates and the decline of inflation expectations, in the first three months of 2007, the national bank has decreased its key policy rate by 350 base points, thus at the end of the first quarter it was 10.50%. This supported the decline of the money market interest rates, while the appreciation pressure on the dinar's exchange rate mitigated. The favourable monetary developments may result in further decrease of the key policy rate, amounting to 10% by the end of 2007.

By using the interbank trade reports, the daily official exchange rate is being determined by market forces, and the national bank confirmed that in the future it intends to use less direct intervention to influence the exchange rate. In the first quarter the central bank occasionally kept the exchange rate around 79-81 RSD/EUR, while in 2007 the average exchange rate is expected to be around 79 RSD/EUR.

Following the robust growth of 2006, by the end of the first quarter of 2007, foreign exchange reserves of the national bank amounted to EUR 8,787.6 billion (376.4% of M1 money supply cover ratio and around 9 months of import cover). Early repayment towards the World Bank has been completed in December 2006. In addition, due to early repayment in March towards the IMF, the national bank was able to pay back its debt for the organisation, thus improving its debt position. Negotiations will take place in April on further financial support from the World Bank and the IMF.

**Fiscal policy**

**Public finance (bn RSD)**



Source: National Bank of Serbia

By the end of the first quarter the political parties still could not reach an agreement on the formation of the new Serbian government, thus the fiscal policy is uncertain since no budget for 2007 has been adopted yet. According to a decree on interim financing for the period of January-June 2007, a surplus of RSD 20.9 million is planned, which would be used mainly for repayment of public debt. Foreign debt per GDP continues decreasing, but foreign debt servicing remains a significant burden, and even new loans are expected.

Due to the election, the wage growth in the public sector also increased the government expenditure, affecting expenditures even in 2007. As a result of the fiscal expansion, it is expected that the first quarter of 2007 ended around balance, and until the temporary financing continues, the same will apply for the forthcoming period.

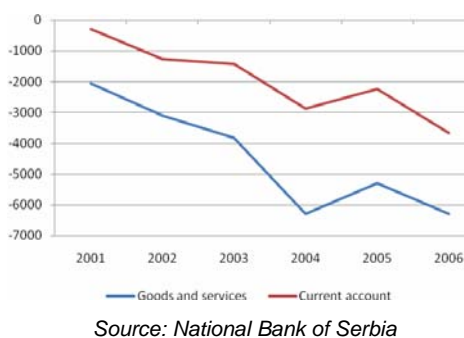
During 2006 budget revenues increased by 19.3%, while expenditures grew by 19.7%. By the end of 2006, budget surplus amounted to RSD 30.3 billion, thus according to estimations the budget balance per GDP ratio decreased compared to 2005 and reached 0.9%. This ratio is expected to decline further in 2007, reaching around 0.0-0.5%.

In 2006, EUR 1.8 billion has been collected from privatisation. This

amount was mainly the result of the successful deal concerning Mobi 63 - a mobile phone operator – selling it for the price of EUR 1.51 billion. Privatisation of certain Serbian companies may improve the revenue side in 2007 as well, but the formation of the new government is inevitable for this.

### External balance

**Goods and services balance and current account (bn USD)**



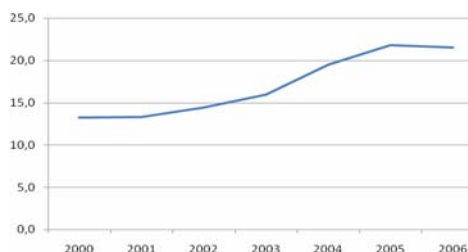
In 2006 - showing a robust growth during the year - exports increased by 29.4%, while imports grew by 22.2% compared to the previous year, while the coverage of imports by exports amounted to 48.8% and trade deficit reached EUR 5.36 billion. The increase of imports has been generated by the excessive growth of spending, higher investment demand and potentially the appreciation of the dinar. The increase of exports has been the result of growing export capacities (partly as a result of restructuring certain state-owned enterprises), favourable world market developments (e.g. growth of base metal prices). During 2007 the trade deficit is expected to decrease slightly – reaching around 20% compared to the GDP - but this depends on factors like the level of corporate restructuring and foreign demand.

Although trade deficit is compensated partly by investments, remittances, etc., as a result of the high trade deficit, current account (CA) deficit increased significantly in 2006. In January 2007 the CA deficit amounted to EUR 300 million, which is around twice as big as a year earlier. In 2007 the annual CA deficit per GDP rate is expected to decrease compared to 2006, and reach around 10%.

In 2006 foreign direct investment (FDI) inflow performed a remarkable growth and amounted to EUR 3.2 billion, partly as a result of the successful privatisation deal of the telecom operator Mobi 63 for EUR 1.5 billion. As far as 2007 is concerned, the privatisation of the RTB mining complex in Bor has been successful, thus from March the Romanian company Cuprom has become the new owner, for the price of EUR 303 million, plus the Romanian company is supposed to invest an additional EUR 137 million. This deal was completed because arrangements started before the election, but further deals for 2007 are still questionable, because the privatisation process has been stopped, and can be restarted only after the new government is set up. Still, due to the RTB privatisation, it is certain that concerning FDI, Serbia can expect a strong year in 2007 as well.

### Labour market

**Unemployment rate (LFS, %)**



Unemployment in Serbia is considered to be high, and the official unemployment rate continued rising in 2006 as well, reaching 22.2%. During 2006 the number of employees decreased by 1.3%. The tendency of growing unemployment rate may change from this year.

In 2006 average net wages increased by 24.1% or in real terms by 11.2% (just to compare, in 2005 the real growth was 6.4%). Partly as a result of the election, the average growth of net wages remained high in the first two months of 2007, amounting to 24.85% year-on-year.

**Key macroeconomic indicators, 2005-2008**

	2005	2006e	2007f	2008f
GDP nominal (RSD bn)	1,750	2,050	2,325	2,600
Real GDP growth (%)	6.2	5.7	5.4	5.9
Private consumption (%)	NA	NA	-	-
Public consumption (%)	NA	NA	-	-
Investments (GFCF, %)	NA	NA	-	-
Exports (%)	NA	NA	-	-
Imports (%)	NA	NA	-	-
Inflation (Retail price index, %)	16.2	11.7	6.6	6.3
Policy rate (%)	19.8	14.0	10.0	8.50
Short-term interest rate (3-month T-bill, %)	17.5	13.5	-	-
Long-term interest rate (182 day T-bills, %)	16.3	15.8	-	-
Exchange rate (RSD/EUR, average)	83.2	84.4	79.0	77.5
Exchange rate (RSD/EUR, end of period)	85.5	79.0	78.0	76.5
Budget balance / GDP (%)	1.5	0.9	0.3	0.5
Public debt / GDP (%)	61.2	51.0	39.9	36
Trade balance / GDP (goods and services, %)	-23.4	-22.1	-20.7	-19.5
Current account balance / GDP (%)	-8.6	-10.4	-9.9	-9.5
Gross foreign debt / GDP (%)	64.4	64.0	59.4	58.0
Unemployment (%)	20.8	22.2	21.0	19.5
Real ULC (%)	NA	NA	-	-

Note: e = estimation, f = forecast. See methodological notes for definitions and details.

Sources: National Bank of Serbia, Statistical Office of the RS, IMF, own calculations

# Turkey

After 2006 Spring turbulence on the financial market, annual economic growth has been slightly decelerating with its growing reliance on net foreign demand. Macroeconomic developments in 2007 are influenced by the political cycle due to the elections: general government deficit is expected to rise and inflation to remain close to last year's one. In 2008 faster disinflation and further fiscal adjustment is foreseen.

## Political developments

In recent years Turkey enjoyed the benefits of political stability created by the AKP government. There have been three important political aspects creating the background for economic policy. First has been the effect of the EU anchor and the beginning of the EU negotiations accompanied by reform measures.

This was combined with the IMF anchor reflected in the adherence to the IMF stabilisation program. The country has an IMF Stand-by Agreement covering 2005-2007 under which the sixth review has been completed successfully recently, which allows the country to draw on funds, which actually it does not need.

The third pillar has been the adherence of the AKP government to market stability and prudence, which has been tested by market turbulence, among others in 2006.

Against this positive background there has recently been a rising concern over the elections as both parliamentary and presidential elections are due in 2007.

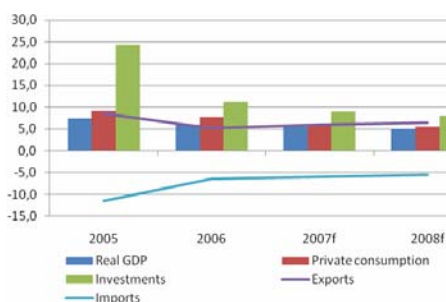
## Growth

Turkey has reached impressive growth in recent years: after growing on average by 3.1% between 1992 and 2002, real GDP increased by 7.4% between 2003 and 2005. The main demand side driver of growth has been domestic demand with gross fixed capital formation expanding above 10% and private consumption growing steadily. Declining inflation (54.4% average CPI in 2001 and 8.2% in 2005) and interest rates (28.6% real domestic interest rates in 2001 and 7.4% in 2005) boosted private investments, while restored confidence in macroeconomic policies and rising real wages private consumption.

Last year Turkey experienced slight slowdown in real GDP growth, coupled with its changing composition. The slowdown of GDP growth to 6.1% was driven by weakening domestic demand and expanding net exports. In 2006 both private consumption and gross fixed capital formation grew slower than in the preceding years. The turbulence on the financial markets in 2006 and the widening current account deficit contributed to this slowdown by weakening public confidence and raising risk premia. Moreover, higher interest rates in response to the acceleration of price increase in 2006 reduced credit growth and dampened domestic demand.

On the other hand expanding world trade, fast increase in export markets, real exchange rate depreciation following the market turbulences, and the impact of recent years' investment rise on export capacities improved the competitiveness of Turkish exports,

**GDP growth and its composition (%)**



Note: f = forecast; Eurostat, CBTR

reducing the negative contribution of net foreign demand to growth compared with previous years.

The outlook for 2007 is the continuation of growth performance observed in 2006. Real GDP is likely to grow somewhat below last years pace expanding by 5.5%, while the contribution of domestic and foreign demand is expected to shift further towards the latter one. Private and public consumption growth will moderate in 2007 while gross fixed capital formation may still rise with double digit pace.

The slowdown of domestic demand is reflected in import growth as well: while in 2004 the growth of imports in GDP outpaced more than two times exports (24% compared to 12%), in 2007 and most likely in 2008 the gap will be closed and they will rise at similar rates.

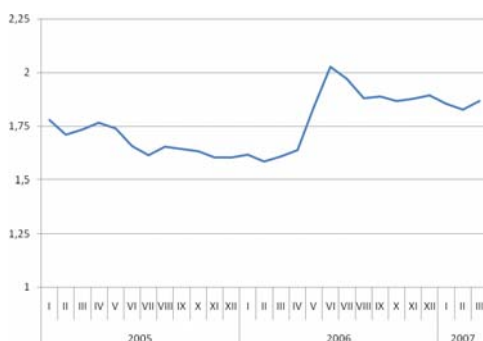
As a result net foreign demand may contribute slightly more positively to GDP growth. Moreover, the rise in exports as well as the growth of the economy seem to be more sustainable now than in the past as they are both driven by the private sector, productivity rise, and by higher value added sector like vehicles and consumer durables

### Monetary developments

In recent years Turkey reached significant progress with disinflation after experiencing serious crisis and price explosion in 2001. Disinflation was driven by the mix of conservative fiscal and monetary policies. The strong and persistent fiscal adjustment leading to significant primary surpluses, decline of public debt was the decisive element of disinflation, coupled with restrictive monetary policy.

The disinflation was supported by trend appreciation of the Turkish Lira from 2002 driven by the reverse currency substitution, increasing policy credibility and high real returns that increased the attractiveness of Turkish investments for both domestic and foreign investors. The positive effect of credible macroeconomic policies on inflation was weakened by the rigidities in service prices (due to the low level of competition in the service sector) and by the high level of exchange rate pass-through.

**Evolution of TRL/EUR exchange rate**



Source: CBTR

In 2006 Turkey experienced again a rising inflation, driven mainly by the price developments of the first half year. The main driving factor of accelerating price increases was the depreciation of the Turkish Lira (almost 25% between March 2006 and June 2006) and its pass-through impact and by the increase of certain administrative prices.

As a response to price developments the central bank tightened monetary policy in May and June 2006, the effect of which was moderate: while there was a slowdown in M2 growth, the decline of domestic demand was small due to underdeveloped domestic loan market. However inflation developments reversed in the second half of the year and the end year CPI came down below the psychological threshold of 10% thanks to fiscal prudence, the significant nominal appreciation of the Turkish Lira reflecting the renewed investor exposure to the emerging markets in the second half of 2006.

In 2007 the disinflation is expected to continue with end year

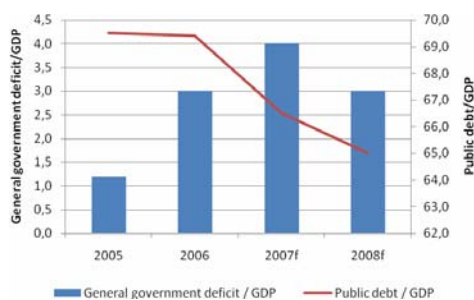
inflation coming down to 7.5% while average annual CPI increase remaining around 9.5%. Disinflation will be influenced further by conservative fiscal and monetary policies: while the general government deficit is likely to expand somewhat, the worsening is not significant and M2 growth is expected to remain moderate over the forecast period. While the Turkish Lira may weaken due to the uncertainties surrounding the elections and changes in global market sentiment, there will be a dampening effect of the accumulation of inventories due to the high output growth and unsold output. The latter is also reflected in producer prices, which – contrary to most of 2005 and first half of 2006 – have remained below the CPI index in the recent months. Turkey may expect faster disinflation in 2008 when the CPI may decline by the end of the year to 5% due to continued strict macroeconomic policies.

A key factor of both inflationary and fiscal developments is the evolution of the exchange rate. After long period of exchange rate stability, the country experienced a significant market pressure last Spring when the Turkish Lira weakened significantly against the major currencies. Besides the global factors, the rise in current account deficit, the high exposure of the Turkish Treasury to global financial market developments also contributed to the depreciation of the Lira.

The depreciation was followed by equally fast rebound of the currency, but the end of year exchange rate was by 5-6% higher than the December 2005 one. As a result of market development there was a slight real depreciation, the first after three years of appreciation. The expectation for 2007 is that in the first half of the year there will be a relative stability of the exchange rate vis-à-vis the major currencies, but this may be followed by more volatility in the second half of the year, due to elections. As a result we expect that the year end exchange rate will increase somewhat to 1.50 against the US dollar and 1.95 against the Euro.

### Fiscal policy

**Evolution of general government deficit and public debt per GDP (%)**



Note: f = forecast; Source: Eurostat

The current economic policy program in Turkey relies on three pillars. One pillar is the fiscal austerity that targets achieving a 6.5 percent surplus for the public sector as a ratio to the gross domestic product. The second pillar is the contractionary monetary policy that aims at price stability, while the last pillar is structural reforms consisting of privatisation, large scale layoffs in public enterprises and abolition of subsidies. The central element of the Turkish stabilisation policy has been the fiscal adjustment which resulted in the decline of the general government deficit from 11% in 2003 to 1.2% in 2005.

The fiscal adjustment was carried out through three major channels. First, the stabilisation package resulted in significant primary surplus which averaged 6.5% in recent years. This primary surplus produced benefits in the form of slashing public debt, lowering inflation, reducing real interest rates and the crowding out effect on private investments.

Second, while the main driving force behind this surplus has been the increase of tax revenues, the growth of privatisation revenues accompanying the sizeable inflow of foreign direct investments added to the improvement too.

Finally, the disinflation process and the decline of nominal and real interest rates almost halved between 2002 and 2006 the interest expenditures of the central government.

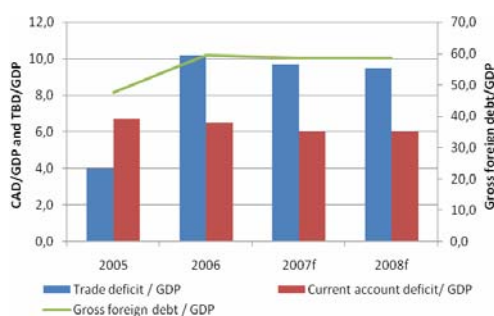
In 2007 there is an expected increase in general government deficit due to the impact of the political cycle. The incoming presidential and parliamentary elections are to increase non-interest expenditures of the central government worsening the primary surplus reached in the recent years. After last year's 3% deficit we expect the general government deficit to increase to 4% of the GDP.

There will be two major tasks that the government has to accomplish after the elections. First, the government needs to achieve declining general government deficit in order to maintain the reduction of public debt and its credibility. Second, it has to correct the weaknesses of the current adjustment as the shift in the primary balance was achieved mainly through the increase of tax revenues and indirect taxation, decline of public investments. This is not sustainable in the long run especially if growth is to be driven by the increase of international competitiveness of the Turkish economy.

### External balance

One of the critical aspects of the Turkish macroeconomic performance has been the evolution of current account balance. Since the drastic adjustment following the 2001 crisis the current account has been steadily worsening from a 1% deficit in 2002 to an almost 7% deficit in 2006. This has occurred notwithstanding the mentioned fast increase of exports and gains in the competitiveness of the tradable sector.

#### Current account deficit, trade deficit and gross foreign debt



Note: f = forecast; Source: Eurostat, ECB,

At the same time there has been a significant increase in import demand as well driven by rising private consumption and investments. The current account is highly vulnerable to exogenous shocks, especially the changes in oil prices. According to a recent estimate by JP Morgan a one dollar rise in oil prices worsens the current deficit by USD 0.4 billion which equals 0.1% of the GDP.

The trend in the current account deficit is expected to reverse in 2007 and this will lead to declining current account deficit. There are several factors supporting the reversal including the weakening domestic demand, the robust growth in Turkey's main trading partners and the increase of receipts from tourism. While in 2001-2002 the average net tourism receipts were USD 8 billion, in 2005-2006 they averaged USD 17 billion.

The reversal may be weakened by the increase of oil prices and by slight expected real appreciation of the Turkish Lira, which may slow down the competitiveness gains of the producers in the tradable sector. Altogether the forecast for the current account deficit is 6% of the GDP. Even with the declining current account deficit, the external financing needs of Turkey remain large, leaving the economy susceptible to financial market turmoil, and further reduction of current account deficit may be needed in the coming years.

While the worsening of the current account is a worrying sign for the investors and international financial markets, one has to consider that Turkey has been increasingly attracting foreign direct investments: net FDI inflows may have reached USD 18.5 billion after averaging USD 2 billion between 2001 and 2004. Privatisation,

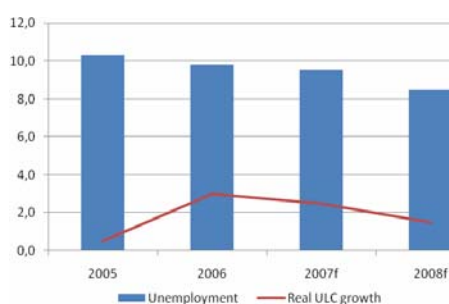


increased macroeconomic and political stability, rise in competitiveness of tradable and domestic demand have been behind this increase. Besides FDI, net foreign borrowing by the private sector increased too, mainly driven by the rise of foreign borrowing by domestic banks.

As a result net medium and long-term capital inflows (which were negative in 2001 and almost zero in 2002-2003) reached USD 30 billion in 2006, adding to the gross international reserves of the Central Bank of Turkey (CBRT), which may have increased by almost 40% in 2006. However, the current account deficit and the high level of dependence of public sector borrowing requirement on foreign financing makes the economy vulnerable of external developments and requires further adjustment to reduce current account deficit.

### Labour market

**Unemployment and real ULC growth (%)**



Note: f = forecast; Source: Eurostat

The participation rate in Turkey is 47%, and this has been slightly increasing as fast growth has resulted in employment creation reaching since 2004 1.5%. The beneficial effects of fast GDP growth on labour market were also felt in unemployment, which declined from 10.7% in 2004 to 9.8% in 2006, the first year when it was below the threshold of 10 %. But the employment situation is far from being satisfactory and growth itself is unable to solve the labour market problems of the country which stem from the need to absorb Turkey's rapidly growing population as well as workers released from the decline in agriculture.

Moreover, the fast increase in productivity and shifts in the composition of output may prevent the rise of labour intensive sectors. As a result the country needs significant reforms in the labour markets to reduce labour market rigidities and increase the flexibility of the labour force. According to the recent IMF proposal the measures may include the alleviation on requirements imposed on medium-sized and large companies, rationalisation of mandatory severance pay, more flexible terms of employment and reduction in labour taxes.

In the short-term the positive effect of real GDP growth will prevail and unemployment is expected to decline in 2007 to 9.5%.

**Key macroeconomic indicators, 2005-2008**

	2005	2006e	2007f	2008f
Nominal GDP (TRL bn)	486.4	559.5	643.5	705.5
Real GDP growth (%)	7.4	6.1	5.5	5.0
Private consumption (%)	9.1	7.8	6.0	5.5
Public consumption (%)	2.4	11.2	9.0	7.5
Investments (GFCF, %)	24.1	11.3	9.0	8.0
Exports (%)	8.5	5.2	6.0	6.5
Imports (%)	11.5	6.4	6.0	5.5
Annual average inflation (%)	5.8	10.7	9.5	6.5
Discount rate (end of period, %)	28.0	27.0	25.0	22.0
Money market rate (3-month Treasury Bill, %)	NA	-	-	-
Long-term interest rate (10-year gov't bond, %)	NA	-	-	-
Exchange rate (TRL / EUR, average)	1.67	1.80	1.92	1.91
Exchange rate (TRL / EUR, end of period)	1.61	1.89	1.95	1.90
General government balance / GDP (%)	-1.2	-3.0	-4.0	-3.0
Public debt / GDP (%)	69.5	69.4	66.5	65.0
Trade balance / GDP (goods and services, %)	-4.0	-10.2	-9.7	-9.5
Current account balance / GDP (%)	-6.7	-6.5	-6.0	-6.0
Gross foreign debt / GDP (%)	47.5	59.5	58.5	58.5
Unemployment (%)	10.3	9.8	9.5	8.5
Real ULC growth (%)	0.5	3.0	2.5	1.5

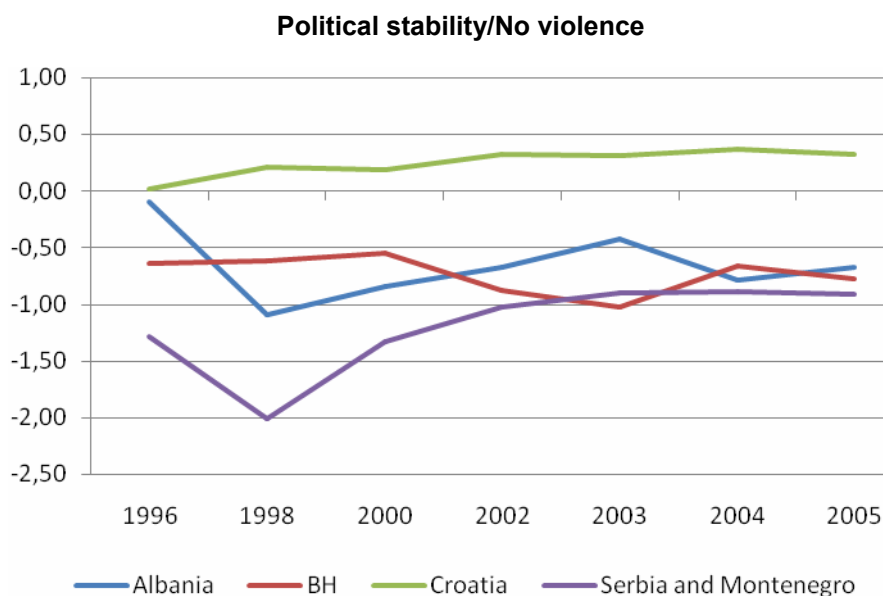
Note: e = estimation, f = forecast. See methodological notes for definitions and details.

Sources: IMF, Eurostat, CBTR

## Kosovo - Ticking bomb or the last step of consolidation

Beside the region's 'typical' economic problems – namely e.g. the external imbalances, the high rate of unemployment or the need of macro- and micro level reforms – nowadays we see a growing concern on the region's political stability and the security problems, often in the light of the final status of Kosovo. The case of Kosovo represents in a magnified form many of the typical political, economic and social problems of the region. All in all, some see (or want to see) Kosovo as a ticking bomb, endangering the fragile stability of South-Eastern Europe, while others believe that the final status of the province will bring an end to the dissolution of former Yugoslavia, eventually giving the region stability, the possibility of development and participation in the EU integration process.

When assessing a country the dimension of the governance is usually examined, which among many potential factors, encompasses the political stability. Although there are several possibilities to deal with these types of risks, companies must calculate with these factors, and no doubt that the political stability may affect the economy directly and indirectly. It is obvious that measuring these factors is problematic, but at least what we can do is to compare the related indicators or examine their change. The World Bank's governance indicators give an interesting example, by covering 213 countries and territories and measuring six dimensions of governance.<sup>2</sup> Now we take a look only at the 'political stability and absence of violence' dimension, in relation with a few countries of the region.<sup>3</sup>



Source: World Bank (<http://info.worldbank.org/governance/kkz2005/tables.asp>)

It goes without saying that these data are imperfect but they can be useful in comparing timely changes or comparing countries with each other. As we can see, except from Croatia, the countries are below the world average, with Serbia having very low scores during the Kosovo conflict. Unfortunately for Kosovo these data are not available, and scores are available only until 2005, although political hazards are still present. It can be related to this topic that the war crimes legacy and the deep ethnic divisions are present even nowadays in the region, while in certain cases causing obstacle even for development.

<sup>2</sup> The six components are the following: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, control of corruption. About the 'political stability and absence of violence': 'perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including political violence and terrorism.'

<sup>3</sup> The scores may range between -2.5 and +2.5. (For more information, please visit the World Bank's homepage - <http://info.worldbank.org/governance/kkz2005/tables.asp>)

Although Kosovo's future is still uncertain, by reviewing the developments of international politics, an independent Kosovo can be expected. Moreover, in most aspects the province is already de facto independent, and the Security Council Resolution 1244 eliminated Serbian control. Albanians in the province would not accept any other solution than full independence, while leading Serb politicians think just the opposite way. The following statement can be read on Serbia's Ministry of Foreign Affairs website:

'Advocating a compromise, consensual solution to the future status of Kosovo-Metohija, the National Assembly of the Republic of Serbia emphasises that imposed independence of the province will have unforeseeable negative consequences. Such an outcome will have far-reaching consequences on the stability of the region, impede the European perspective of the entire Western Balkans and present an extremely dangerous precedent for resolving minority issues and territorial disputes throughout Europe and the world.' (Source: [http://www.mfa.gov.yu/Facts/resolution\\_kim\\_aht\\_e.html](http://www.mfa.gov.yu/Facts/resolution_kim_aht_e.html))

No doubt that there would be a potential danger as a consequence of independence, but it must be emphasised that recently 16 000 troops are deployed in the 10 849 square kilometres province, while neither leading Serbian nor other countries' politicians are threatening with the possibility of taking military actions. On the other hand, the international community, the countries of the region and even the Security Council are all politically divided in the question of Kosovo, due to the fact that most often politicians are influenced by their own minority issues, and political and economic interests.

## The divided and economically backward Kosovo

### *Basic information about the institutional system...*

Different scenarios and plans emerged since 1999, but the future status and structure of Kosovo is still uncertain. The delay of the final status of the province sets back economic development and increases the tension among the ethnic groups. Riots and protests already took place, so security remains a substantial issue and will need to be supported by international forces in the future as well.

Step by step, Kosovo is becoming a functioning state with its own central bank, ministries, local governments, etc. Institutions have been gradually built up and the power has been partly shifted to the local people, but the main power remains at the United Nations Interim Administration Mission in Kosovo (UNMIK). Kosovo is administered by the UNMIK, which is headed by the Special Representative of the Secretary-General for Kosovo. Recently four pillars guide the implementation of UNMIK's mandate:

- Pillar I: Police and Justice (led by the UN)
- Pillar II: Civil Administration (led by the UN)
- Pillar III: Democratization and Institution Building (led by the OSCE)
- Pillar IV: Reconstruction and Economic Development (led by the EU)

Even if Kosovo will gain its 'independence', it will not be sovereign in full sense since in some form the international community will support and supervise the state institutions (like in Bosnia-Herzegovina), and the number of deployed troops will be cut only gradually, depending on the state of security. According to the 'Ahtisaari plan', an EU mission would replace the UN's and it would have significant power over Kosovo's government, so the province would gain so called supervised independence. It is emphasised that the Serb minority would gain broad rights.

### *... and about the economy*

In Kosovo the typical transition and post-war symptoms are still present, with its e.g. non-restructured or closed companies, outdated technology. The province has the lowest GDP level in the region, GDP per capita is only around EUR 1 100, and although in 2004 GDP growth was recorded, the economy can be characterised by stagnation. Moreover, Kosovo shows the macroeconomic problems that can be considered typical for Southeast Europe, namely the immense trade deficit and unemployment. As a consequence of the basic problems, unemployment is pervasive. Although data are unreliable, unemployment is estimated to range between 35 and 50%, without taking into consideration the grey economy, and youth unemployment is probably even higher.

As a result of the fact that production in Kosovo is lacking, and small-scale trade and family businesses dominate (mainly in the trade sector), trade balance performs very high deficit, and e.g. in 2005 exports covered

only around 4% of the imports. Bilateral Free Trade Agreements are being negotiated by the UNMIK and a regional free trade zone is starting to develop, but until Kosovo does not produce goods for the international market, mainly this may only cause the decrease of customs revenues (the general tariff rate is recently 10%, while for exports it is 0%). Trade deficit is partly compensated by the diaspora's remittances and foreign aid. The large group of non-residents also supports the economy with their consumption, which is over EUR 100 million. On the other hand we must note that the amount of remittances, aid and the number of foreign employees has been declining, signalling further economic difficulties in the future.

Many of these facts hint that Kosovo is aid dependent. Kosovo received and receives financial support from various international institutions. Also the IMF supported the province, although special circumstances were needed, because Kosovo is not a member of the organisation, since officially it is not recognised as a country. According to the UN, the cost of reconstruction and recovery between 1999 and 2003 was approximately USD 2.34 billion, while the contribution from the international community between 1999 and 2004 reached EUR 2.76 billion. 35% of the aid was donated by the EU and 13.5% by the USA. Donor commitments for 2006 reached EUR 169 million, while in the previous year it amounted to EUR 241 million. In 2006, EBRD lent EUR 17 million and EIB provided another EUR 20 million in order to support the development of Pristina International Airport and to underpin the improvement of the financial sector.

Inflation can be considered low. As far as the monetary issues and the financial sector is concerned, after the war institutes like the IMF had to face the fact that there was a lack of financial infrastructure with no central bank or other banks. Step by step the financial sector, the regulatory and supervisory framework is being built out, and the Banking and Payments Authority of Kosovo (BPK) gradually shifted into a de facto central bank and has been transformed in September 2006 into the Central Banking Authority of Kosovo (CBAK), handling all the regular functions. CBAK regulates and supervises six banks and eight insurance companies, pension funds, micro finance institutions, etc. Kosovo uses euro as its currency. The banking sector is growing in all terms. For example the use of credit cards is increasing, but Kosovo is still quite much cash-oriented.

#### Macroeconomic indicators of Kosovo

	2002	2003	2004	2005	Q3 2006
Real GDP growth (%)	-2.9	-1.4	3.7	-0.5	NA
Inflation (%)	3.6	1.6	-1.6	1.9	NA
M2/GDP (%)	41.0	42.6	44.9	47.6	NA
Bank assets/GDP (%)	19.3	24.0	31.8	39.2	NA
Deposits of the private sector (% of GDP)	16.7	20.5	20.1	34.1	NA
Credit to private sector (% of GDP)	3.5	9.6	14.9	20.9	NA
Foreign aid inflow (millions of euros)	215.98	169.75	100.56	NA	NA
Fiscal balance (millions of euros)	106.4	62.6	-134.3	-67.8	NA
Exports (millions of euros)	27.6	35.6	56.5	48.9	69.7
Imports (millions of euros)	854.8	973.1	1 063.2	1 180	1068.8
Registered unemployment (thousands)	282	282	302	320	325

Source: BPK, IMF, World Bank, MEF, RIMS

Among the main problems that enterprises and potential investors must face is the poor infrastructure and a very problematic energy supply system. The educational system also needs to be improved, because there is lack of skilled workforce. Corruption is widespread. Unfortunately landmines are still scattered over Kosovo, including the agricultural and industrial areas. A small and relatively poor market may also be a disadvantage, even if we can speak of a so called pan-Albanian market with 6 million consumers. It is important to note that until the status of the province is uncertain, there will be lack of investments.

A key issue is the sustainability of Kosovo, which can be supported by certain opportunities. The province inherited mines and factories from ex-Yugoslavia, but in many cases these are closed or inefficient, thus large financial investments are needed to help these companies to function again. The former Socially Owned Enterprises (SOEs) have already started to be privatised by the Kosovo Trust Agency (KTA), and the first success stories appeared. These SOEs range from mining, wineries, construction companies, glass production factories, warehouses, etc. Kosovo is trying to attract investors by business friendly environment, which is incorporated by one of the lowest tax rates in the region. VAT rate is 15%, but 0% for certain agricultural goods and personal income tax rate is between 0 and 20%.

Certain opportunities ought to be named. In case the infrastructure will be further developed, the province can function as a major crossroad in the region. Kosovo has very good attributes for the agricultural sector, which gave around one third of the GDP in 1995. The province has abundance of raw materials and natural resources. For example large amount of lignite reserves that can be exploited in surface mines, but Kosovo has zinc, lead, copper, nickel as well. Electric power, mining, metallurgy, construction materials, agriculture are named as priority fields, and recently tourism is also starting to gain attention.

### **Kosovo's political effect in the region**

Apart from Albania and Kosovo, ethnic Albanians live in southern parts of Serbia, eastern parts of Montenegro and in the western parts of the FYR Macedonia. Nor in Kosovo, nor in Albania, leading politicians don't show interest in forming the so called 'Greater Albania', they rather emphasis EU integration, but in the long run the situation may change. This is a reason why even according to the 'Ahtisaari plan' Kosovo cannot unite with other countries or territories. It must be mentioned that in the FYRM the peace between the Macedonians and Albanians is fragile, and it is important to avoid separatists or extremists to gain strength and precedent from the case of Kosovo.

The Serb entity's (Republika Srpska – RS) independence ambition in Bosnia and Herzegovina has been fuelled by the independence of Montenegro and even more by the potential independence of Kosovo. Even leading politicians of the entity occasionally emphasise that if Kosovo would gain its independence their entity should have the right to decide on a referendum concerning their independence. Although the legal background is different and Ahtisaari with other diplomats emphasise that Kosovo will not function as a precedent for other territories, political noise would get higher in RS after a decision giving Kosovo independence. Although military actions are not expected – partly due to the EUFOR – the political confrontation may hinder reforms and the EU accession process in BH. The potential negative consequences can be bolstered by the fact that the Office of the High Representative (OHR) of BH, is due to close this summer, although the HR recommended that his office should continue its work, because of the political and institutional immaturity of the country.

As far as Serbia is concerned, although the Serbian Radical Party received the highest share of votes in the election in January, in general we can state that instead of 'Greater Serbia', European integration is preferred, although mentioning Kosovo as part of Serbia. As a result of the referendum in October, the new constitution has been adopted, in which it is stated that Kosovo is indivisible part of Serbia. It has been many times stated that in case Serbia will suffer the loss of Kosovo, probably a more radical political climate will rise, and the EU can be a perfect institution to compensate the country and mitigate extremism. Kosovo's independence would affect even Vojvodina, as it is expected that most of the Serbs would move there from Kosovo, changing Vojvodina's ethnic composition and potentially causing ethnic tension.

### **Other 'actors'**

Countries facing problems concerning minority issues or having territories with independence ambitions fear of Kosovo's independence, which may function in the future as a precedent. This may be one of the reasons why even the EU members can not fully agree on this question. Russia tends to support its Slav ally of the region, and Serbs believe that this will apply in the case of Kosovo as well. Russians occasionally emphasis that they might block a decision in the Security Council, that is unacceptable for both sides, and which harms Serbia's territorial integrity and sovereignty.

Organisations, donors, governments, economic relations, etc. can partly contribute to South-Eastern Europe's stability and development. One of these organisations is the NATO, because although certain topics had a negative impact on the relations, in December 2006, Serbia, Montenegro, Bosnia and Herzegovina joined NATO's Partnership for Peace Programme, following Albania (1994), FYRM (1995) and Croatia (2000).

Although the EU may have only indirect effect on the final status of Kosovo, but it will have an essential role in peacekeeping, financial support, institutional assistance – generally speaking, in stabilising the region. While considering the South-Eastern Europe's problems and stability, it is always noted that the EU perspective can bring cohesion for the society and underpin economic development.

It is often emphasised that any further delay or an unpleasant decision for Albanians would cause violence in Kosovo. The international community would be rejected, rage against the international peacekeeping force would emerge and extremism would be fuelled. According to a potential scenario, if Russia will veto the UN resolution, Kosovo politicians may declare independence (like in 1991 Croatia or Slovenia did so) and hope for recognition from other states. It is almost certain that the USA and some EU countries would support the

independence. Most probably further violence and tension would take place in Kosovo, including the danger of spill-over effects in the region.

## **Conclusions**

As for Kosovo, further institutional development is needed, although due to the activity of the international institutes, the background of a functioning state and a market economy is being laid down. At certain sectors also a broad regional integration may also underpin development. Kosovo's leading politicians have already stated that their future goal is EU integration, thus EU standards are being taken over and the province is part of the Stabilisation and Association Process (SAP). It goes without saying that the financial assistance of international donors will remain inevitable in the near future, but aid dependency ought to be altered by foreign investments. However, as noted before, many problems and hazards are present that gradually must be eliminated or handled.

To sum up, we can state that the international law does not give a definite guideline to handle the case of Kosovo, and perfect solution for its future status does not exist, because all interests can not be served. As a result of future decisions, tension among ethnic groups may get stronger. In this situation it will be primarily the international community's and the political sphere's responsibility that Kosovo will become a ticking bomb or the last step of dissolution of the former Yugoslavia.

- Eszter Vadas -