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PENSION INCREASE IN ROMANIA - BACKGROUND AND POSSIBLE EFFECTS

According to the Pensions' Law which was adopted on 28th June 2007 by the Romanian Parliament old age pensions will be doubled over the next two years. The first increase became effective in September: the pension point value is hiked from RON 396.2 to RON 416 for the pensioners within the public social security system and at the same time the farmers' pensions were doubled. A 43% increase will take place in January 2008 and another 33% in 2009. The measure was criticized both on national and international level, even President Traian Basescu – who promulgated the law on 18th July – expressed his doubts. The analysts, the opposition, the IMF and the Romanian President had a common point in their opinion: all of them questioned whether sufficient budgetary sources are available for financing the application of the law.

In order to assess the possible risks of the aforementioned governmental provision it is worth looking over briefly the current Romanian pension system since the increase of the old age pensions is only a part of a series of broader reforms which have been implemented over the recent years.

Romania inherited a generous but fragmented and unsustainable pay-as-you-go (PAYGO) pension system from the socialist period. Replacement ratios were high; benefits were paid to a wide range of pensioners (e.g. survivor and disability benefits) and the regime financed non-contributory allowances as well (e.g. sick leave, maternity leave, farmers' pensions). The 1990s was characterized by ad-hoc and hesitant reforms, but as the transition advanced the overall reform became indispensable mainly because of the following two reasons:

- rapid increase in beneficiaries (as a result of population ageing¹ and generous early retirement plans)
- sharp fall in the number of contributors (as a result of an increase in unemployment² and informal employment)

The reforms have started in 2000 and an important stage is the ongoing implementation of the Ruling Program 2005-2008 which is a consistent package of legal measures concerning the social security field. The modified regime has three pillars: a public PAYGO pension system, a mandatory and a voluntary funded pension system.

The public pension system gives the right to receive a full pension when the retirement age is reached (by 2014 it will be payable to men aged 65 with 35 years of service and women aged 60 with 30 years of service) and it ensures an early retirement up to 5 years only if the full service period has been fulfilled. The amount of pension is calculated on the basis of a points system. The pension points are calculated as the ratio of the individual's monthly gross wages and other compensation to the national average monthly gross wage for that year. The employee's pension is determined by multiplying the pension points with the pension point value, which is laid down in the social security budget law every year and which was recently increased from RON 396.2 to RON 416. During the 1990s the social contribution rate had been

¹ The old-age dependency ratio was 17.6% in 1995, 19.3% in 2000, 21.1% in 2005 and it is expected to grow further to 51.1% by 2050. Source: Eurostat

² The official unemployment rate increased from 3.0% in 1991 to 9.5% in 1995, it was 10.5% in 2000 and reduced to 6.3% in 2004. Source: National Institute of Statistics, Romania

significantly increased in order to offset the negative effect of the sharp fall in the number of contributors on the state revenues³, but since 2001 the governments had been continuously decreasing it in order to make the channelling of funds possible towards the privately managed mandatory and voluntary system (the 2nd and 3rd pillar). The outsourcing is also an important element of the reform of the PAYGO system: a number of rights had been transferred to the health system (e.g. the leave and indemnity for temporary work inability).

In 2006 the public pension system had 5.808 million members out of a total 6.043 million pensioners, the difference of 0.235 million is formed of retired from the Interior Ministry, the Defence Ministry, the Romanian Intelligence Service and the Justice Ministry. Their pensions are financed by the state budget and they are based on a different pension formula. The pensions of independent farmers were first also paid directly from the state-budget but since 2006 they are included in the Social Security Budget.

In the wake of the demographic changes and economic transition the Romanian government introduced the funded pension system (it will operate from 1st January 2008) which ensures that the pensioners are to receive additional revenues. The following table contains the main characteristics of both pillars:

TABLE 1. - THE FUNDED PENSION SYSTEM IN ROMANIA

	Mandatory	Voluntary
Coverage	Obligatory under 35 years old Voluntary for the 36 – 45 age cohort	Employees and self-employed can participate (Voluntary for both groups)
Estimated number of members	2.6 million	0.3 million (during 2007)
Contributions	2008: 2% of wages 2009-2016: increase by 0.5% each year until it reaches the rate of 6% (paid by the employer)	Maximum 15% of wages (Paid by the employee and/or by the employer)
Retirement age	65 years for men, 60 years for women	60 years for both men and women ⁴
Tax treatment	Investment income is tax exempt Pension benefits are subject to ordinary tax legislation	Employee/employer contributions are tax deductible up to a ceiling of EUR 200 per year Investment income is exempted Pension benefits are subject to ordinary tax legislation

Source: International Organisation for Pension Supervisors

Although the aforementioned reform of the PAYGO system and the introduction of the funded pension system are to remedy several weak points of the former pension regime, according to the projections made by the Romanian Association of the Private Pensions Providers, the system will have a deficit of approximately 1.5% of GDP in the following years, which is still an over optimistic estimation because the expenditure figures do not contain the financing of the so-called 're-correlation' process⁵.

³ The social contribution rate was increased from 14% to 35% in 2001. Later it had been gradually decreased, currently the employers' contribution rate is 19.50% for the normal work conditions category, while the individual contribution rate is at 9.50%, so the total social security contribution is 29%.

⁴ Under the condition of having made contributions for a period of at least 90 months.

⁵ The pensions of those beneficiaries who had been retired before 2000 were recalculated according to the new formula and the differences were paid off.

TABLE 2. - ESTIMATED DEFICIT OF THE PENSION SYSTEM (2008-2014)*

	2008	2009	2010	2011	2012	2013	2014
Funded pillar							
Contributions (%)	2.0	2.5	3.0	3.5	4.0	5.0	5.5
Contributions as % of GDP	0.4	0.5	0.6	0.7	0.8	0.8	0.9
Capital accumulated as % of GDP	0.4	1	1.8	2.7	4.0	5.6	7.6
Number of contributors (thousands)	2 950.03	2 986.98	3 001.9	3 021.16	3 038.27	2 975.42	2 908.62
PAYGO without farmers, after reform							
Total revenue as % of GDP	4.1	4.2	4.2	4.3	4.3	4.4	4.5
Pension payments as % of GDP	3.0	2.9	3.1	3.2	3.3	3.3	3.4
Total expenditure as % of GDP	5.1	5.1	5.4	5.5	5.5	5.6	5.5
Current balance as % of GDP	-1.0	-0.9	-1.1	-1.2	-1.2	-1.2	-1.0
Total expenditure including farmers, as % of GDP	5.7	5.6	5.8	5.9	6.0	6.0	5.9
Current balance including farmers, as % of GDP	-1.5	-1.4	-1.6	-1.7	-1.6	-1.6	-1.4

Source: Romanian Association of the Private Pensions Providers, *: base year: 2003

The projection of a persistent deficit appears to be reasonable because of several factors. Firstly, an unfavourable change in the structure of stakeholders (e.g. the ratio of total beneficiaries to effective contributors is expected to increase from 78.82% in 2004 to 87.11% by 2025⁶) may be induced by the demographic challenges and by the interactions in legislation (e.g. in order to stimulate the occupation of young people the number of early retired goes up). Secondly, the collection of contributions is problematic because – although it had been gradually decreased in the past few years – the social security contribution rate is still quite high compared to other EU countries which incites employers not to register the actual number of their employees and also a large number of (especially individual) employees pays only a fraction of their actual earnings. Moreover the grey economy is quite extensive (approx. 1-2 million people⁷) where no contributions are paid. Currently the farmers also do not pay any contributions but it is likely that they will rely on the pension system later which also raises the deficit. Thirdly, the emigration of young workers (approx. 2 million people) also decreases the group of contributors and hence increases the deficit. Fourthly the implementation of the funded pension system also needs additional sources.

According to the recent decision of the government the state budget has to finance not only the aforementioned persistent deficit of the pension system, but also the doubling of pensions over the next two years. According to experts the broader economic circumstances do not underpin the soundness of this policy unambiguously. Romania has experienced an economic upswing in the last seven years with higher wages, lower unemployment, lower inflation and a widening current account deficit. Currently the economy shows the symptoms of overheating as it is characterised by a continuously widening current account deficit (assisted by the strong RON appreciation the CA deficit reached the value of 11.8% of GDP in Q1 2007, then it scored 13% in Q2 2007), an excessive domestic demand and increasing inflationary pressures (in July the inflation already achieved the NBR's inflationary target of 4%). In Q2 2007 even the real

⁶ Source: Romanian Association of the Private Pension Providers

⁷ Source: Ministry of Economy and Finance

GDP growth slowed down to an annual 5.6% as the prolonged drought damaged agricultural output and the trade deficit widened.

The budget deficit also evolves in accordance with the changing economic tendency: while it was gradually decreasing during the reform period between 2000 and 2005 and also it remained below the government's target of 2.5% in 2006 (its value was 1.68%, mainly due to the postponement of expenditures), in 2007 - after joining the EU - a relaxation of fiscal policy can be perceived. The estimated budget deficit is 3.1%⁸ for 2007 and its value may exceed the 3% of GDP Maastricht criteria even in the coming years if the current expansionary policies (the realisation of the postponed investment projects, the implementation of the 2nd pillar of the pension system and the increase of pensions) will not be changed or the revenues will not be raised (e.g. by the broadening of the tax base). The simultaneous growth of the budget deficit and the deepening of the external imbalance may raise the problem of the twin deficit.

In the current situation the increase of the pensions is a crucial question because (1) it means an additional burden of approx. EUR 2 billions (approx. 2% of GDP) for the budget, (2) it enhances the inflationary risk (especially as it is combined with wage increases in the public sector), (3) it accentuates the overheating risk and as Romania will have legislative elections in 2008 even more politically influenced decisions can be expected.

Among these circumstances the opinions are divided whether raising the pensions necessitates increasing of budgetary revenues or not. On the one hand, the government holds on to the opinion that there is no need for raising the taxes and the increase of the pensions complies with the schedule for introducing mandatory privately managed funds. According to Paul Pacuraru, Minister of Labour, the financial resources for covering the increase result from:

- economic growth (according to Varujan Vosganian, Minister of Economy and Finance, a nominal increase of GDP by 10 percent means an additional approx. EUR 1,2 billion to the state budget)
- the elimination of the contribution threshold in case of those with over five average salary in economy
- charging taxes on the incentives and bonuses paid to employees (which had not been taxed before).

On the other hand experts (e.g. Daniel Daianu, economist and former Minister of Finances or the IMF) question the feasibility of increasing the pensions among the current conditions (e.g. simultaneous implementation of the 2nd and 3rd pillar of the pension system, economic circumstances etc.). The IMF expressed its concern about the possible results of the decision (inflationary pressures, deepening of the current account deficit) and drew attention of both the consideration of budgetary limits and the conduction of a macro-economic environment analysis. According to Daniel Daianu the budgetary effects of increasing pensions will be felt in 2009 and to cover the shortfall the Romanian government may have to eliminate the flat tax, increase VAT or reduce infrastructure investments.

⁸ Source: EIU

ENERGY CRISIS IN ALBANIA

Albania's macroeconomic performance is strong, economic growth is returning to its potential level and inflation is low, however, the maintenance of these gains requires lasting solutions to the problems in the energy sector. The energy crisis that reached its peak in the summer of 2007 presents a great danger for Albania. According to the International Monetary Fund (IMF) the current crisis affects all medium-term economical indices, having adverse effects on economic growth in the future. GDP in Albania grew by 5 per cent in 2006 while this year's growth was originally projected to reach 6 per cent. Although the first two quarters seemed to match forecasts on economic growth, the drought that engulfed the Balkans this summer will lead to significant deviation in the second half of the year.

The Albanian Central Bank has expressed similar worries to the IMF, attracting attention to the effects of continued power failures on economic growth by raising the cost of production for goods and services. The energy crisis will continue to deteriorate as the Economy Minister, Genc Ruli said, preparing Albanians for a worsening power situation.

CURRENT SITUATION

The country became the victim of serious electricity shortages due to the summer drought, according to the Ministry of Economics. The heavy industry zones suffer from devastating voltage fluctuations and power outages of up to 18 hours a day. Water levels in dam lakes have dropped by 85%, forcing the government to introduce restrictions on electricity consumption by households, government institutions and factories. Even workdays have been reduced from eight to five hours in some cases as a consequence. Recently, hospitals, government institutions, water supply, bakeries and police were being given priority in power supply.

Albania is not able to sustain its needs, since the country produces 5.5m kWh of electricity daily, while an approximate 18m kWh would be necessary. The deficit is compensated only with a bit more than 6.5m kWh import daily by the public sector, which consists of KESH (Albanian Power Corporation) and TSO (Transmission System Operator). KESH holds monopoly position, - owning 99% of the electricity in the Albanian market - generating, importing and distributing electricity.

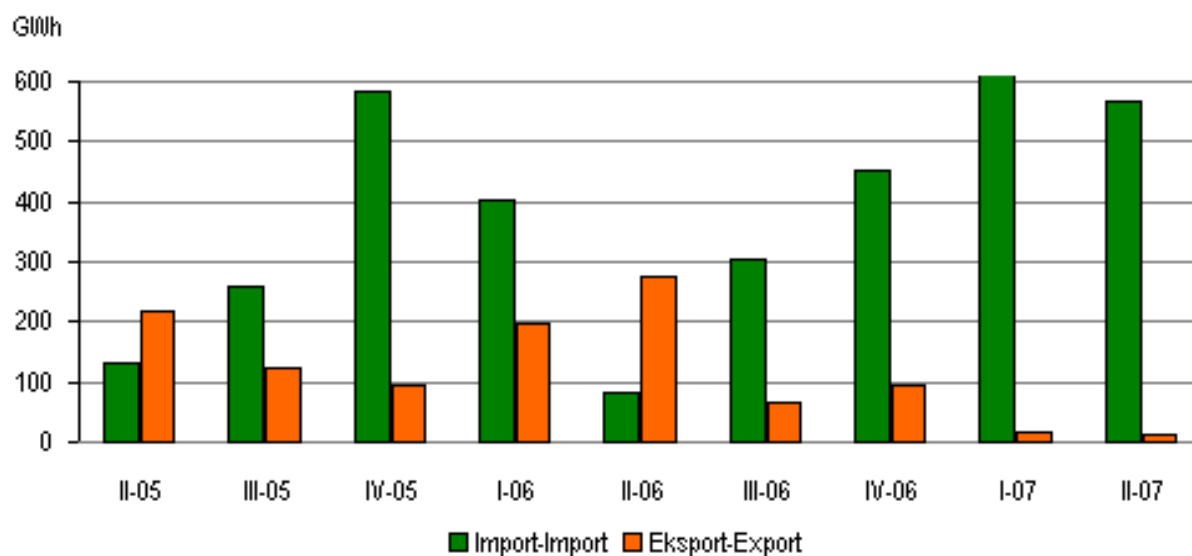
The energy crisis caused by the drought was inevitable because of the fact that the only sources of electricity in Albania - apart from some negligible foreign investments - are aging hydro-electricity plants. Albania's power generation system has not seen major investment since the early 1980s. Hydropower plants are susceptible to the weather, which means that the lack of rainfall diminishes the level of Albanian reservoirs, reducing the ability of power plants to generate electricity.

Another leading factor that worsens current situation is the increased use of air conditioners due to record temperatures that resulted in a significant increase in energy consumption, leading to technical losses and the reduction of security of supply. Albania's high growth rate of electricity consumption averaged at 8.6% per year since 1992 to present. Unfortunately, corruption and fraud exists in the energy sector as well. A large part of the high growth has been artificially stimulated by electricity theft and non-payment of electric bills. The extraordinarily high demand and the hydroelectricity system together have precipitated a substantial supply deficit, which contributed to a social and economic crisis.

ENERGY IMPORT

The imbalance between the energy supply and demand threatens Albania's overall economic prospects and social stability, while the import of the amount of energy needed is not maintainable in the long run. Albania's capacity to import electricity is constrained by a transmission system that is in urgent need of upgrades to expand its capacity. Provisional solution could be the substitution of electricity with other alternative sources, however there has never been enough emphasis put on the introduction of such policy before. KESH has imported approximately 1.4 billion kWh of energy so far and the Government has had to subsidize imported power purchases as well, but still, according to the National Energy Strategy, Albanias's key power retailer would need some 1.1 billion Euros to ultimately put an end to power cuts.

CHART 1. – ALBANIAN ELECTRICITY BALANCE (Q2 2005 – Q2 2007, GWh)



Source: Albanian Institute of Statistics

Import of electric power increased by 197.2 percent compared with the first six months of year 2006. The imported quantity was 1 445 GWh, which is about 6m kWh daily, and composes 47.1 percent of the total quantity sources during first half year 2007⁹. Such amount cannot be imported indefinitely as import prices have recently jumped by more than 50 per cent, – well above domestic retail prices – because of the limited supplies in the Balkans.

HOW TO OVERCOME?

Since 1990, the former communist country has constantly suffered electricity problems due to poor management, outdated distribution system and lack of money because of unpaid electricity bills. The summer drought made many energy experts and former senior officials in the sector call on the government to declare a state of emergency and ask for international help.

Some projects were planned – such as the Power Sector Rehabilitation and Restructuring Project (2002) and the Power Sector Generation and Restructuring Project (2004) co-financed by the European Bank of Reconstruction and Development (EBRD) and European Investment Bank (EIB) – to have been realised this year but lack of money and foreign investment set

⁹ Albanian Institute of Statistics: <http://www.instat.gov.al/>

back development in the energy sector. In addition, power shortages cause difficulties in attracting and sustaining foreign investment in the Balkan country.

The construction of a new thermal power plant funded by the World Bank, EBRD and the EIB was expected to start in Vlora in the southern part of Albania in 2005. The plant was scheduled to be on-line this year¹⁰, however final negotiations for building the new thermal-power plant got near to conclusion only in April 2007. The building of the new system takes 18 months and the value of investments will be around USD 120 million. The new plant will have 325 MW installed capacity and is expected to decrease the sectors rainfall-dependency. Its improved transmission and the distribution facilities will eventually help relieve the energy shortages. The critical amount of imported electricity will be reduced by 30%.

Besides some existing projects, Albania will go through major changes in the near future, shifts from government to private ownerships are necessary. So far, some 40 local and foreign companies are interested in getting involved in this process. A lasting solution will be achieved by the privatisation of the distribution arm of KESH so that its financial situation could be stabilised after significant deterioration.

OHRID SUMMIT

The first highest-level summit ever in the region, held in Ohrid on 20 April 2007 was dedicated to energy issues. Macedonian President Branko Crvenkovski hosted the summit entitled "Long-Term Energy Stability". Leaders from the seven Southeast European countries (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro and Serbia) drafted a plan aimed at stabilising the energy situation and ending frequent power shortages. The plan estimated an amount of around EUR 30 billion needed to be put into effect. The necessity of a common strategy on long-term energy stability is a main precondition for economic development, growth and environment protection. Energy security and energy investments are the keys for economic growth and cooperation between the countries in Southeast Europe. Members also discussed how to adjust the regional policy on alternative, renewable energy sources to the EU policy. The participants of the Ohrid summit concluded that creating a functional and transparent energy market in the region is an important step forward European integration.

EXPECTATIONS

With the assistance of the International Monetary Fund and the World Bank, improvement in efficiency, reduction of energy theft and rise of collection rates will be expected with the help of better financial management and technical improvements. As a result of the support of the international institutes, Albania will have the ability to overcome the ongoing crisis, and with the improvement of the performance in the energy sector, growth and economic stability will be conserved as well.

Sali Berisha, the Prime Minister even told the Financial Times: "We expect to be exporting electricity again within four years. We believe these hydro projects will be built on time because there is increasing demand in Europe for electricity produced from renewable sources."¹¹

¹⁰ The Start of the Improvement in the Albanian Energy Sector (2005): ICEG European Center – SEE Monitor, No. 13-14., page 11.

¹¹ Kerin Hope (Aug. 2007): Power Cuts Plunge Albania into Gloom – www.msnbc.msn.com

CROATIAN PARLIAMENTARY ELECTIONS WILL BE HELD IN NOVEMBER 2007

The next parliamentary elections in Croatia will likely be held on 25 November 2007. The date has been approved by the government and by parliament. After having amended constitution in 2000 and 2001 the Republic of Croatia now has a parliamentary system with a unicameral parliament called *Hrvatski Sabor*. There are 14 MPs chosen from party lists in each of the 10 constituencies. There is also a special constituency to represent minorities and another for non-residential citizens. At present there are 152 seats in Sabor with 8 minority and 4 non-residential seats but this number can vary according to the number of diaspora votes.

After the ten years of *Tudman* era, SDP (Social Democratic Party) won the elections in 2000. Four years later in November 2003 HDZ (Croatian Democratic Union) led by *Sanader* returned to power. *Sanader's* HDZ was a right centre party which popularity has decreased with years. According to polls of early September this year, the most popular party is SDP with 29.2 percent followed closely by HDZ with 25.6 percent. Four other blocks have around 6-8 percentage support just beyond the 5 percent threshold. In the following we take a look at the country's economic performance and the process of EU and NATO accession. Then we investigate the possible changes in Croatian economic and foreign policy on account of the possible results of the forthcoming elections.

CROATIAN ECONOMY

Overall, Croatia has a stable economy with relatively high growth rates and low inflation rates. As we can see in the table below, from 2001 on the growth rate of GDP has not dropped below 4 percent, while the inflation rate has moved around 3 percent. Since 2000 the unemployment rate has gradually decreased from 16.1 to 11.2 percent, however, according to the Progress Report 2006 of the EU Commission the still relatively high unemployment rate and limited job creation remain one of the most challenging economic problems of Croatia. Owing to fiscal consolidation government deficit has dropped to 3 percent by 2006 while public debt has remained under 50 percent of GDP. The financial intermediation has expanded rapidly in the past few years. The key player in the financial sector remained the largely privately owned banking sector while capital markets continued to play a minor role in financing the economy.

TABLE 3. - MAIN ECONOMIC INDICATORS IN CROATIA, 2000-2006

	2000	2001	2002	2003	2004	2005	2006
GDP per capita (in EUR)	4 560	4 997	5 507	5 905	6 461	7 038	7 706
GDP - year-on-year rate of growth (in %, constant prices)	2.9	4.4	5.6	5.3	4.3	4.3	4.8
Average year-on-year inflation rate	4.6	3.8	1.7	1.8	2.1	3.3	3.2
Consolidated general government balance (as % of GDP)	-7.5	-6.8	-4.9	-6.2	-4.8	-4.0	-3.0
Public debt (as % of GDP)	48.7	49.8	48.8	48.6	48.9	49.2	46.6
Unemployment rate (ILO, persons above 15 years of age)	16.1	15.8	14.8	14.3	13.8	12.7	11.2

Source: Croatian National Bank

In spite of the stable macroeconomic and financial situation in Croatia there are some fields in which the country lags behind some Central and Eastern European democracies. State intervention remained to be high in the productive sector - state aid accounts for over 2 percent of GDP, a great amount of which is spent to subsidise non-viable, loss-making

companies. There is a wide public condemnation of privatisation and a number of structural reforms need to be started or accelerated. Besides, corruption has remained to be a serious problem in Croatia.

ACCESSION TO NATO AND EU

The Balkan war of 1991-1995 marked not only the socio-economic but also the foreign policy developments in Croatia. The country has missed the recent enlargement waves of EU and NATO and the two organizations enjoy very low public support. According to the latest polls 53.5 percent of Croatian citizens are in favour of EU accession and only 48.6 are in support of joining NATO. At the political level, however, there is a consensus on whether Croatia should join EU and NATO as soon as possible. All parliamentary parties agree on this completely. There is only a disagreement about whether there should be a referendum or not. The Croatian constitution envisages a referendum only for EU accession. Many, however, would like to see a referendum on NATO accession, too.

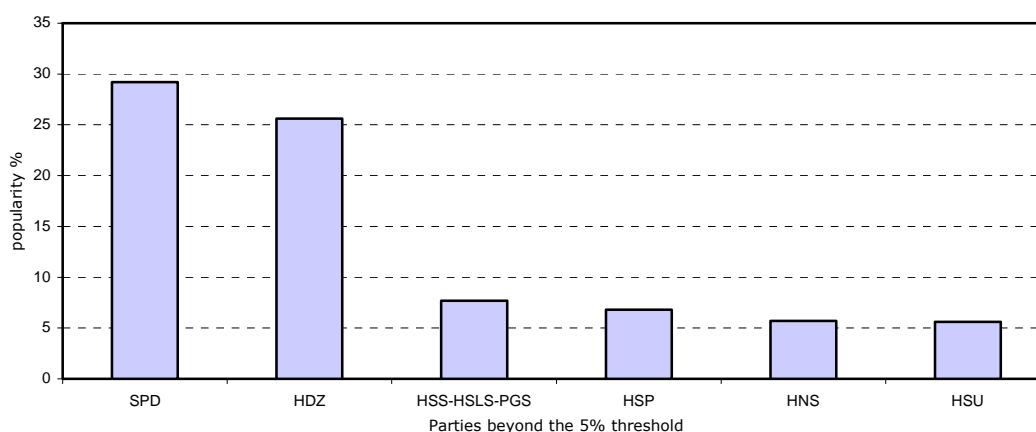
NATO is interested in accepting Croatia for geo-strategic and security reasons as well. Croatia will probably be admitted together with Albania and Macedonia with whom it will constitute a so called security triangle for maintaining stability in the still insecure region of Southeast Europe. It can be expected that in the next NATO Summit in Bucharest in 2008 Croatia will receive an invitation for full membership, on the condition that prior to that it solves the problem of the still insufficient support of its own citizens for that process.

The accession to the European community, however, will not likely to happen before 2009. After the arrest of *Gotovina* in December 2005 entry negotiations have begun anew but the rejection of EU constitution made any future accession more difficult. Croatia is the next on the list but it must make further efforts in areas such as cooperation with ICTY (International Criminal Tribunal for the former Yugoslavia), judiciary reform and transition to a market economy.

POSSIBLE OUTCOMES OF NOVEMBER ELECTIONS

The election campaigns started at the beginning of September. According to an opinion poll from early September the future government will likely to be lead by the current Prime Minister *Ivo Sanader* (HDZ) or SPD's candidate *Ljubo Jurcic*.

CHART 2. – SUPPORT OF CROATIAN PARTIES AT THE BEGINNING OS SEPTEMBER 2007



Source: *Promocija Plus*

However, the difference between the two major forces seems to be too tight to make forecasts. The performance of the smaller parties and their willingness to form coalitions will surely be decisive. HDZ's possible partner could be its present partner Croatian Party of Pensioners (HSU) or the block of HSS-HSL-S-PGS. The Croatian Party of Right (HSP) is an extreme right party that is not likely to take part in any coalitions, while the Croatian Peoples Party (HNS) is rather a possible ally for SDP.

SUMMARY

It seems to make not a big difference whether HDZ or SDP gains the victory in the end. In the most essential questions agree the two major parties – Croatia will be heading towards the EU and NATO, and the tasks are given on this way. There might be a greater risk of joining the NATO in case SPD triumphs while unlike HDZ the social-liberal party stands for a referendum on which there is a possibility of rejection.

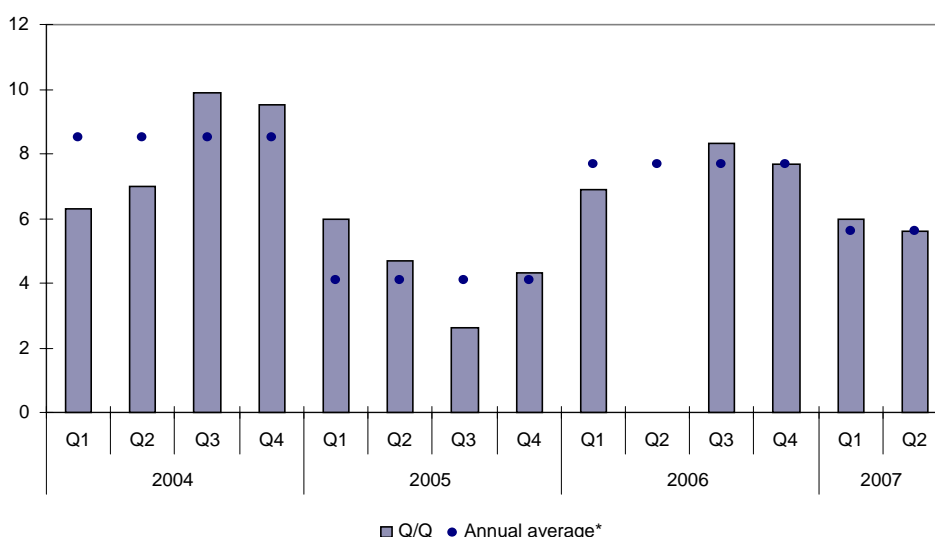
The elections in 2007 are not nearly as significant as that of 2000 when Croatia decided to step off the way of radical nationalism. Now a centre right and a centre left party contend to reach the citizens. After the elections Croatia is likely to follow the example of Romania and Bulgaria in their pre-accession period – the common goals to access the EU and NATO made a somewhat stronger unity in domestic affairs. Politically stable years are to be expected, where the most important question besides EU and NATO accession will be whether the victorious party has courage and determination to go ahead with the necessary structural reforms.

ECONOMY SEEMS COOLING DOWN SLIGHTLY IN ROMANIA

In the second quarter of 2007 GDP growth in Romania decreased to 5.6%. This figure was the lowest in the last six quarters and accordingly, economic growth is expected to decrease in 2007 in comparison with the last year. Accordingly, GDP growth reached 5.8% in the first half which was significantly lower than that in the first half of 2006, when economic growth reached 7.4%.

On the demand side, consumption and investments remained the main engines of growth. However, a slight but gradual shift is observable in the composition of growth. While the growth rate of private consumption decreased to 11.5% (lowest in the last six quarters), gross fixed capital formation increased by almost 20%, and growth of public consumption accelerated as well in the second quarter. On the other hand, the negative contribution of net exports to GDP growth increased since imports grew dynamically (20.8%) while exports remained basically unchanged (2.4%).

CHART 3. – EVOLUTION OF QUARTERLY AND ANNUAL GDP GROWTH, Q1 2004 - Q2 2007 (%)



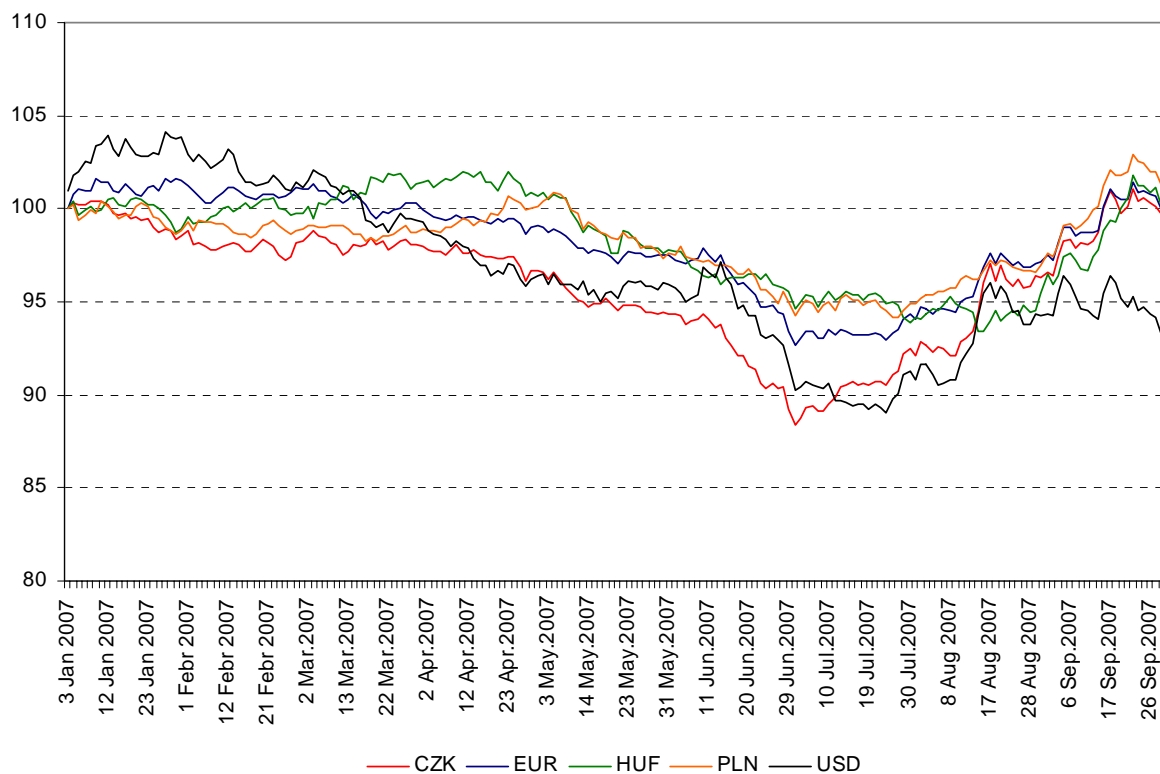
Source: INNSE; *2007 is forecasted by ICEG EC

Despite the slight deceleration of consumption, it plays major role in economic growth. Private consumption remained strong due to high wage increases and significant credit expansion. Besides, the appreciation of the Romanian currency (Leu) against the euro in course of the first half of 2007 also supported the purchase of imported products. On the other hand, the appreciation of Leu had a negative impact on export sector and consequently the economy's competitiveness worsened. Accordingly, foreign trade deficit almost doubled during the first seven months of 2007 compared to the same period of the previous year and current account deficit may reach 15% of GDP this year, which raises the issue of sustainability of the high current account deficit.

Regarding the production side, one can observe that agriculture sector's performance was weak in Q2, gross value added in agriculture decreased by 10.9%. As floods deteriorated the sector's performance two years ago, now drought caused severe problem for the agriculture

and had a negative impact on the economy. The drought were so severe as it made the National Prognosis Commission cut its 2007 estimation for GDP growth from 6.5% to 6.1%. Besides, gross value added in industry increased by only 4.4% in Q2 which was significantly the result of the appreciation of the Leu. The strong Leu influenced negatively the Romanian export sector's performance. However, the depreciation of the Leu may have a positive impact on the exporter companies in the second half of the year. In the third quarter of the year, Leu depreciated by almost 8% against the euro and other currencies in the Central European region.

CHART 4. - EVOLUTION OF EXCHANGE RATES AGAINST RON, JANUARY - SEPTEMBER 2007 (3 JANUARY 2007 = 100)



Source: national banks, own calculations

Regarding other sectors, value added in construction reached an excellent growth of 32.2% in the second quarter of 2007. The sector is boosted by infrastructure investments and demand for industrial and retail properties. Besides, value added in services increased by 6.2% due to the still robust consumption of the private sector. However, this figure was the lowest increase in the last ten quarters which indicated the gradual diminishing of consumption.

As it was mentioned above Romania had revised downwards its expectation for 2007 growth but it is already higher than market's expectation. It was set at 6.1%, however, third quarter growth is expected to be even lower than that of the second quarter owing to drought which has deteriorated further the performance of the agriculture sector. In fact GDP growth is not expected to reach 5% in the third quarter, and accordingly, annual growth rate will be 5.6% in 2007.

On the other hand, much depends on how the exchange rate will develop in the last months of the year. In case of the re-appreciation of the currency would hinder the growth of export and support further import increase. If current depreciation remains or continues, it may help

exporter companies' activity but it – together with high food prices owing to drought - will threaten the achievement of inflation target at the end of the year. And in case of the high volatility of the currency, it would worsen the business climate and increase risks. However, it is expected that RON/EUR will remain at current 3.3-3.4 level in the last three months of the year.

Comparing Romania to the EU-8 countries or the EU-27 average growth, one can observe that growth in Romania is expected to be the sixth highest in the EU after the Baltic states, Slovakia and Bulgaria. Besides, growth will be 2.9 percentage points higher than that of the EU-27. Accordingly, convergence continues in this year as well, however, its pace decreased somewhat in comparison with the previous year. This process is essential since Romania – together with Bulgaria - has the lowest per capita GDP in the EU. In 2007 per capita GDP is expected to reach EUR 9 700 on purchasing power parity, which is 39% of EU-27 average.

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Number 2007/6.

- ICEG European Center's latest Quarterly Report on the Western Balkans-Second Quarter 2007
- Exposure to external shocks of the Western Balkan countries and its labour market aspects
- Hungarian capital export to the SEE countries
- High growth rate remained in Bulgaria and Romania

Number 2007/5.

- Bulgaria and Romania: The road to euro zone
- Stagnating Unemployment Challenges Macedonia
- Hungary: Strengthening economic relations with the two newly acceded countries
- Structural and Cohesion Funds in Bulgaria and Romania

Number 2007/4.

- Record High Inward FDI to Bulgaria and Romania
- ICEG European Center' latest Quarterly Forecast on the Western Balkans – First Quarter 2007
- The current economic situation and the possible effects of parliamentary elections in Serbia
- Montenegro and the Stabilisation and Association Agreement

Number 2007/3.

- European Funds for the Bulgarian and Romanian Agriculture - What Is It Enough For?
- Kosovo - Divided and economically backward
- The Instrument for Pre-Accession Assistance (IPA)
- Stabilising Labour Market in Bulgaria