ICEG EC

CORVINUS
INTERNATIONAL INVESTMENT LTD.

ICEG Ec - Corvinus
SEE Monitor

No. 20.

2005.

TABLE OF CONTENTS

BUSINESS CLIMATE IN THE SOUTHEAST EUROPEAN (SEE) COUNTRIES IN COMPARISON WITH THE NEW MEMBER STATES 3

ROMANIA - DEVELOPMENT OF THE INFLATION RATE 9

TIGHTENING OF CREDIT EXPANSION IN BULGARIA 12

Business Climate in the SEE Countries in Comparison with the New Member States

Introduction

In this paper we compare briefly the business climate of the Southeast European economies by examining the key tax rates (such as the corporate tax rates and VATs) and the main indicators of the labour market in these countries. In this paper we focus on these two factors to describe the business climate.

Taxes

Regarding the tax regimes it is an interesting fact that there are nine tax regimes in seven countries. Obviously, it is understandable considering the fact that Bosnia-Herzegovina is a constitution of two entities (Republika Srpska and the Federation), while Serbia and Montenegro is the union of the two former Yugoslav republics, Serbia and Montenegro.

In the SEE region one can see that the corporate profit tax (CPT) rates are in a large range, between 10% and 30%, while the typical corporate tax rate is around 10-16%. The smallest rates (10%) are adopted in Republika Srpska and Serbia which are among the lowest not only in the region but also in Europe. On the other hand, the corporate tax rates in the other countries can also be considered as low, accordingly the business climate is relatively good in view of profit tax rates. Only Albania and the Federation part of Bosnia-Herzegovina are the exceptions in this respect.

Table 1.: Tax Rates in the SEE countries (2005)

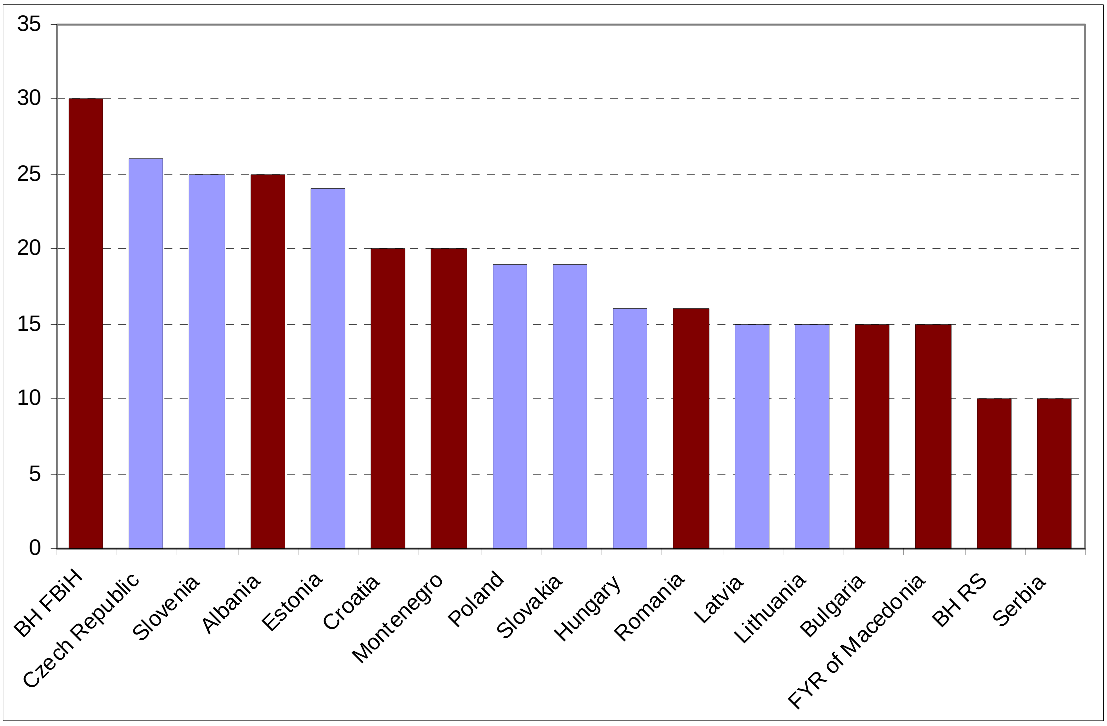
	CPT (%)	Dividends (%)	Interests (%)	VAT (st. rate, %)
Albania	25	10	10	20
Bosnia-Herzegovina				
Republika Srpska (RS)	*10*	-	-	*17*
Federation (FBiH)	*30*	-	-	*17*
Bulgaria	15	7	15	20
Croatia	20	15	15	22
FYROM	15	0	0	18
Romania	16	15	15/5	19
Serbia and Montenegro				
Serbia	*10*	*20*	*20*	*18*
Montenegro	*20*	*15*	*5*	*17*

Source: Ernst and Young

Regarding dividends and interests, in most countries these incomes are taxed and the rates are usually normal. In case of VAT, the adopted standard rates are in a small range, between 17% and 22%. It means there are no large differences among the countries from this aspect.

If we compare the corporate tax rates in the SEE region and in the eight New Member States, it is observable that the corporate profit taxes are generally lower a bit in the SEE countries than in the eight NMS. Between the 10-20% range one can find seven tax rates from the SEE region and 5 from the NMS8. Besides that, 5 out of the 8 lowest tax rates are belonging to SEE countries.

GRAPH 1.: - CORPORATE PROFIT TAX RATES IN THE SEE AND THE NMS8 COUNTRIES (2005)



Source: Ernst and Young; Blue – member of NMS8; Red – member of SEE

If we try to group the countries of the two regions, there are three different groups:

- 10-15%: Bulgaria, FYROM, Latvia, Lithuania, Republika Srpska and Serbia,
- 15-20%: *Croatia*, Hungary, *Montenegro*, Poland, Romania, Slovakia
- 20-30%: *Albania*, Czech Republic, Estonia, *Federation of BIH*, Slovenia.

It means the corporate profit tax rates are a bit lower in the SEE region than that in the eight NMS, however, the differences are not large. On the other hand, the reduction of profit taxes are planned in several NMS where CPT is relatively high (such as in the Czech Republic or Estonia).

LABOUR MARKET

Regarding the labour market, in several countries in the SEE region, high unemployment and low employment rate characterises the economy. It means that the outstanding economic growth has not generated sufficient new jobs for unemployed persons. This is one of the main differences between the two regions' (SEE and NMS) labour market developments.

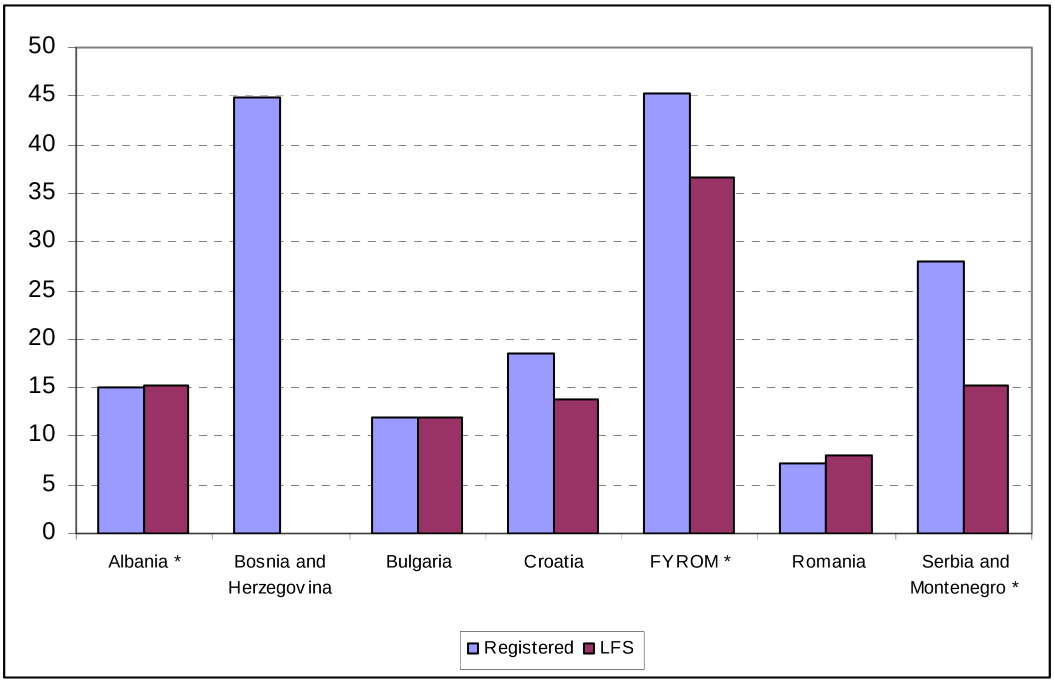
Decreasing employment rate and rising unemployment became a problem after transition. Regarding employment rate, this figure has sunk to between 60 and 80% of 1990 level, at the end of the last decade, while for example in most Central European NMS, employment never went under 80% of 1990 (Hungary is the only exception). It also means that the number of employed persons declined by 4.8 million or by 21% in the SEE region in the nineties.

In the new decade the number of employed persons decreased further in five out of the seven SEE countries. Thus, employment rate reached a very low level in these economies. In Bosnia-Herzegovina and the former Yugoslav Republic of Macedonia, the employment rate is less than

20% which means that every fifth-sixth person has a registered job, regarding the population aged between 15 and 64. In Albania, Croatia and Serbia and Montenegro, the employment rate is not so low as in case of the earlier economies, however, it can be considered as low (between 40% and 50%). In Bulgaria and Romania, employment rate is close to the NMS, in both cases the figure slightly exceeds 60%.

Due to the low employment rate, unemployment is high in almost all SEE countries. There are three groups regarding the status of unemployment. Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro shape the first group. In these three economies official unemployment rate exceeds 25% and in the last several years the unemployment rate increased. In the second group there are Albania, Bulgaria and Croatia where unemployment is still double digit but it is less than 20%. In these economies unemployment reached its peak a few years ago and since then the figure is improving gradually. Romania forms the third "group" where unemployment is not a significant problem; the figure is less than 10%.

GRAPH 2.: - REGISTERED AND LFS UNEMPLOYMENT RATE IN SEE COUNTRIES, 2004 (%)

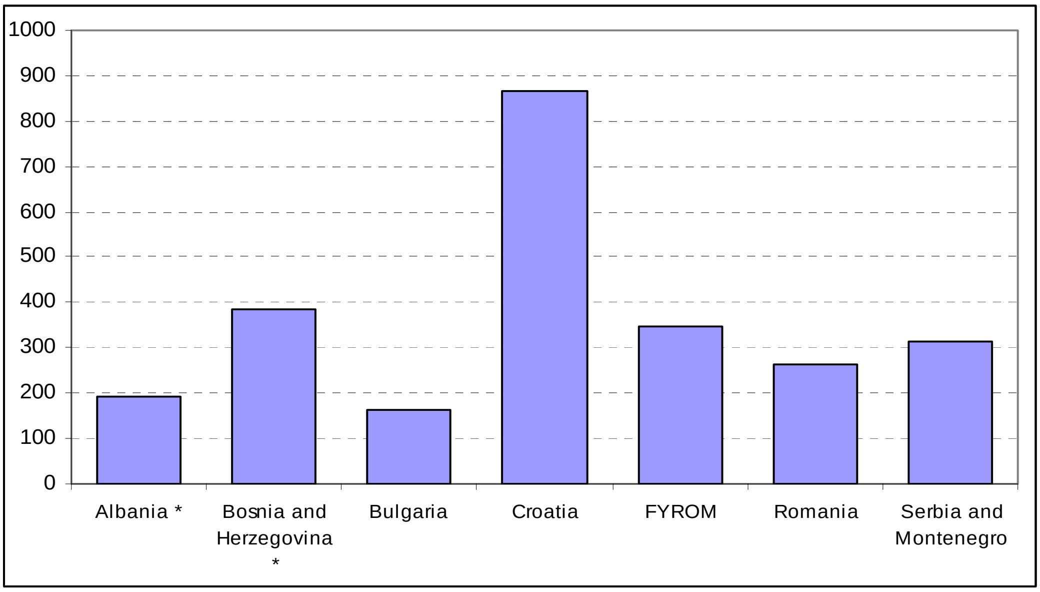


*Source: UNECE, ILO; * 2003 figures*

The aforementioned data are statistically reported figures, which reflect the registered unemployment rate. However, in some cases these data do not reflect appropriately the real situation, especially in case of the first group. The other method which is used to measure the rate of unemployment is the so-called labour force survey (LFS). Regarding the LFS unemployment figures, the unemployment rate in Serbia and Montenegro is "only" 15.2%, while that in the former Yugoslav Republic of Macedonia is 37.2%. In case of Bosnia-Herzegovina there is no LFS unemployment figure but the other two economies' example reflects that the number of registered unemployed persons is not equal to those who are really not employed anywhere. According to some estimation, the real unemployment rate is approximately the half of the registered one. Naturally, it reflects the high share of informal sector in these economies. On the other hand, the difference between registered and LFS unemployment rate is partly due to the fact that there is a large amount of persons who are registered as unemployed to benefit from social security system but they are not seeking work at all.

Regarding the average gross monthly wages in the region, there are significant differences among the countries. Wages are the highest in Croatia where wage level (EUR 870) is similar to or even higher than that of the NMS countries. Majority of the Western Balkan countries (Bosnia-Herzegovina, the former Yugoslav Republic and Serbia and Montenegro) form the second group where the average gross monthly wages are between EUR 300 and EUR 400, while Albania, Bulgaria and Romania are in the third group with less than EUR 300. Obviously, these seven countries are not exactly competitors of each other since their developments are not the same. Naturally, Croatia and Albania will not compete for the same foreign investors. However, the wage levels in Bulgaria and Romania are relatively lower than that of the second group (the three Western-Balkan countries), thus, the two EU candidates are relatively more attractive considering the wage levels and productivities.

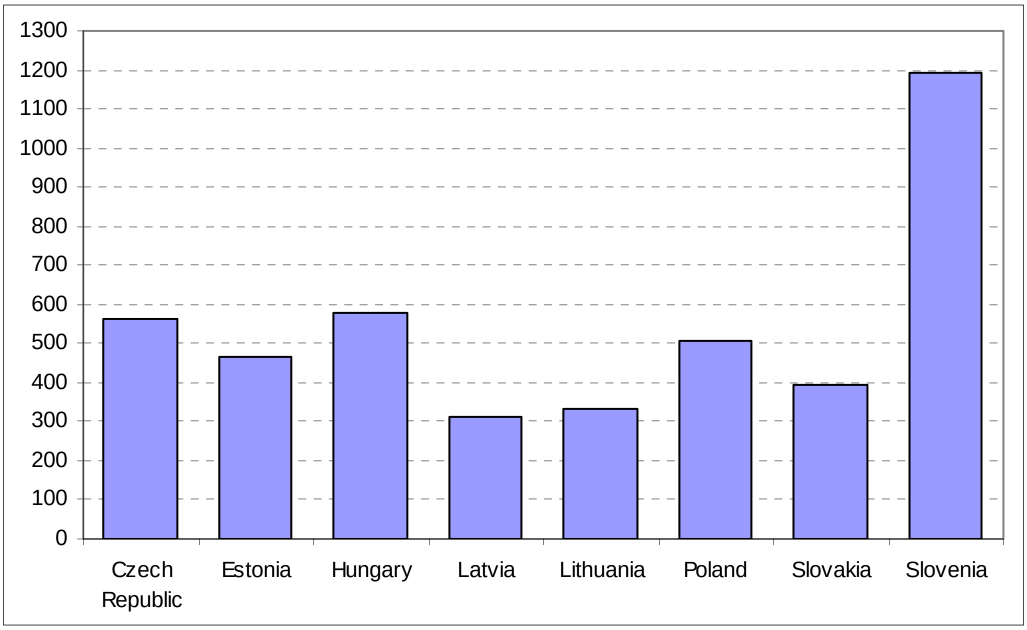
GRAPH 3.: - AVERAGE GROSS MONTHLY WAGES IN SEE COUNTRIES (2005 JUNE/JULY)



*Source: national statistics institutes; * 2004 figures*

In terms of average gross monthly wages the NMS-8 countries are far less attractive than the SEE states (not counting Croatia). Here we can also make three groups. The first one contains only one country, Slovenia, with a wage level of almost EUR 1200. The second group of NMS-8 countries consists of Hungary, the Czech Republic, Poland and Estonia, with average gross monthly wages falling in the EUR 400-600 range. The third group (consisting of Latvia, Lithuania and Slovakia), with average gross wages between EUR 300-400 per month, can only compete in this respect with the Western Balkan countries, but not with the low wage level EU candidates, Bulgaria and Romania.

GRAPH 4.: - AVERAGE GROSS MONTHLY WAGES IN NMS-8 (2004)



Source: WIIW

Minimum wages in the SEE countries (excluding Croatia) are significantly lower then in the NMS8. The minimum wage in Latvia, the country with the lowest minimum wage in the latter group is almost 25% higher than in Romania, where the minimum wage is around the average of the SEE states. Average minimum wages of SEE countries (not counting Croatia) match the minimum wages experienced seven years earlier in Hungary.

TABLE 2.: - MINIMUM WAGES (IN EUROS)

Minimum wages	
Southeast European Countries	
Albania	86
Bulgaria	77
Croatia	285
Romania	91
Serbia	73
New Member States	
Czech Republic	238
Estonia	172
Hungary	232
Latvia	121
Lithuania	159
Poland	208
Slovakia	163
Slovenia	514

Source: Federation of European Employers

"SYNTHETIC INDICES"

The World Bank's Doing Business and the World Economic Forum (WEF) Growth Competitiveness Index (GCI) are synthetic indices. The Doing Business index indicates the quality of the business environment of a country, while the GCI contains information about competitiveness. With the exception of Bulgaria, all the SEE countries rank behind the worst ranking NMS-8 country (Slovenia) with respect to the Doing Business index. However, in the GCI ranks all SEE countries are behind the NMS-8. Among SEE countries Bulgaria occupies the most favourable place in case of both indices.

TABLE 3.: – RANKINGS OF THE SEE COUNTRIES AND NMS

	Doing Business	GCI
Southeast European Countries		
Albania	117	100
Bosnia-Herzegovina	87	95
Bulgaria	62	58
Croatia	118	62
FYR Macedonia	81	85
Romania	78	67
Serbia & Montenegro	92	80
New Member States		
Czech Republic	41	38
Estonia	16	20
Hungary	52	39
Latvia	26	44
Lithuania	15	43
Poland	54	51
Slovakia	37	41
Slovenia	63	32

Source: World Bank Doing Business, WEF Competitiveness Index

It is not surprising that the ranks of the SEE countries are lower than that of the New Member States, however, it is worth examining the improvement in the positions that these countries made. In the last years several SEE countries were able to improve their rank year by year. Their business climate improved significantly in the last few years and the FDI inflows also increased dynamically. In conclusion, we can state that several countries in the SEE region will become competitors of the NMS, not in short term but rather in medium or long term.

Romania - Development of the Inflation Rate

In the third quarter of 2005 the average annual inflation rate decreased one percentage-point compared to the previous quarter to 8.9%, falling back into the target band. But in November 2005 the year-on-year inflation rate went up again to 8.7% from 8.1% in September. In the last month of the year the dec/dec inflation rate is not expected to decrease into the 7.5% +/- 1pp target band of the National Bank. We expect that CPI will be 8.6% in December year-on-year.

Romania's Monetary policy

In August 2005 the National Bank of Romania has shifted to a new monetary policy regime, nowadays it is known as inflation targeting regime. In pursuance of this the primary objective of the national bank is ensuring sustainable disinflation in the medium and long run. So the national bank announces a numerical goal for the inflation rate and assumes obligation to achieve this. The functioning of the policy relies largely on anchoring inflation expectations to the inflation targeting announced former by the national bank and implicitly the good communication with the general public. The appointed objective to the annual inflation rate is 7.5% plus/minus 1 percentage point target band at December 2005, and 5% +/- 1 percentage point target band at the end of 2006. The monetary authority is particularly interested in strengthening its credibility by ensuring that the inflation target is met.

Development of the Inflation Rate

As expected the process of disinflation resumed in the third quarter 2005. The average annual inflation rate dropped one percentage point over the previous quarter to 8.9% and the annual rate was only 8.1% in October. But the decreasing trend seems to change, the year-on-year inflation rate reached 8.7% in November. The baseline scenario of the former projection shows an annual inflation rate between 8.1-8.3% at the end of 2005, but this rate is doubtful now. Considering the month-on-month terms, the prices level grown by 1.2% compared to October.

The fact that this forecast is higher than the 7.5-8% band forecasted in the Inflation Report issued in August 2005 is due to larger than expected increases in oil and food prices, as well as a higher forecasted exchange rate of the RON against the Euro for the fourth quarter of 2005. The month-on-month rise in the prices of the different sectors was the higher in the food items sector (from 0.2% in September to 1.2%) and in the service sector (from 1.2% to 2.2%). But the year-on year figures in 2005 show decreasing tendency in the prices of the food items until October 2005.

The resumption of decreasing trend in the inflation rate was buttressed chiefly by the following three facts. The first one is the change in administered prices, which fell to 12.5% from 14.3% in the second quarter 2005. The larger drop was observable in the adjustment of electricity price (from 12.5% to 9.6%) due to the lower production costs and in the prices of medicines (from 1.0% to -1.3%) and telephony (from 4.3% to -1.0%). As for the latter items, the nominal strengthening of the RON played the key role. While the prices in the transport sector rose from 21% to 25.9% in the third quarter, and the prices of the natural gas and heating among non-food items changed almost nothing. Exactly the faster nominal strengthening of the RON against the Euro had already positive effect to the inflation. Aside from the direct impact induced via cheaper import prices, this factor also spurred competition between

Romanian-made products and competitive imports. And the third fact was the declining in prices for milling and bakery products. (*Data source: National Bank of Romania and National Institute of Statistics of Romania*)

TABLE 4.: - CHANGES OF THE ADMINISTERED PRICES IN 2005 (ANNUAL PERCENTAGE CHANGE %)

	2004. III.	2004. IV.	2005. I.	2005. II.	2005. III.
INFLATION RATE	**11,9**	**10,0**	**8,8**	**9,9**	**8,9**
ADMIN. PRICES	**17,9**	**11,2**	**10,8**	**14,3**	**12,5**
1.Non-food items	**17,2**	**12,1**	**12**	**16,5**	**14,7**
electricity	30,7	17,7	12,5	12,5	9,6
heating	0,0	10,4	12	12	12
natural gas	36,1	22,2	21,6	45,2	45,3
medicines	-6,6	-6,9	1,4	1	-1,3
2.Services, of which	**18,2**	**9,8**	**8,9**	**11**	**9,1**
water, sewerage	23,2	23,4	22,4	27,8	27,4
telephony	15,4	-0,1	3,1	4,3	-1
railway transport	17,5	19,2	14,6	12	9,9
city transport	16,4	17,0	16,3	21	25,9
MARKET PRICES	**10,1**	**9,5**	**8,2**	**8,5**	**7,8**

Source: National Bank of Romania

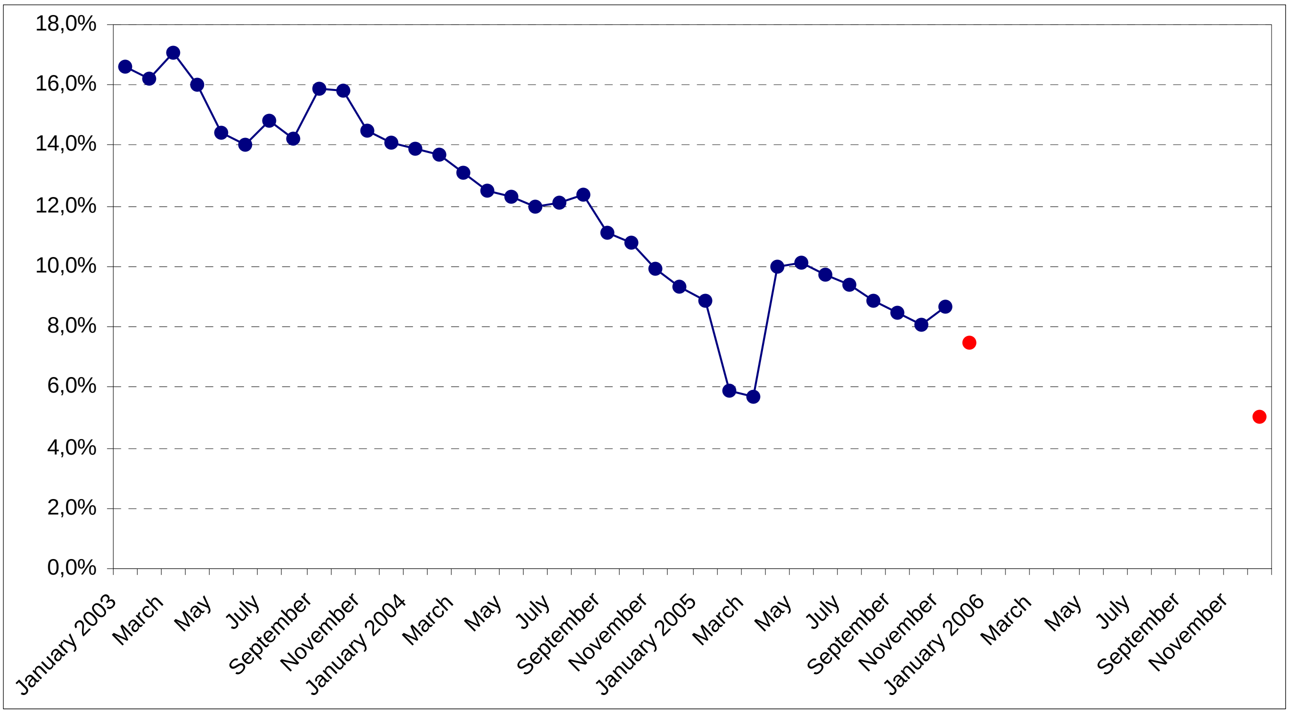
INFLATION EXPECTATIONS

Disinflation is projected to continue through 2006, supported by the gradual reduction of the excess demand — assuming increasingly austere fiscal and income policies, as well as monetary policy tightening — and by the favourable effects of developments in the exchange rate of the domestic currency on import prices. But it can happen that the substantial adjustment projected for administered prices, along with a temporary slowdown in the reduction of inflation expectation in the first part of 2006, will push the year-end inflation to the upper bound of the target band.

But there are many risks of deviations from the projected inflation path: new significant hikes in world oil and gas prices, or an increase in administered prices which may differ in terms of magnitude and timing from the forecast assumptions. It can imagine that the exchange rate dynamics as well as fiscal and wage policies will change in a different way than assumed in the baseline scenario.

The NBR Board made an in-depth assessment, and found that there is a strong threat, in the short term at least, of exacerbating demand-side inflationary pressures. Furthermore, the NBR Board decided to remain vigilant and monitor all developments that might affect the future path of disinflation, standing ready to take immediately measures.

CHART 1.: THE YEAR-ON-YEAR INFLATION RATE IN ROMANIA 2003-2005 AND THE INFLATION TARGETS AT THE END OF 2005 AND 2006



Source: NBR

ABOUT THE EU-ACCESSION

On 13th April 2005 the European Parliament approved Romania's accession to the EU. But in pursuance of clause of the accession contraction, the EU can delay the date of admission of Romania in the case Romania will not fulfil the pre-engagements. Among others one of the main problems in the country is the high inflation rate. So the new government — the election was in November 2004 — must urge the process of the disinflation more intensive and hold the inflation stable and low rate.

Tightening of credit expansion in Bulgaria

The Bulgarian current account deficit has substantially increased since January of this year and one of the latest projections envisaged a deficit of about 11 % of GDP by the end of 2005. The IMF expressed its concern already several months ago regarding this unfavourable trend and urged the Bulgarian government to take adequate economic policy measures. The IMF suggested that the government budget surplus should be maintained or even increased and the credit expansion should be radically reduced. In October, the IMF mission and the Bulgarian government could not reach an agreement on this basis on the necessary economic policy steps (see previous report).

In spite of the different opinions, on 10 November, the Bulgarian National Bank (BNB) announced a new set of measures, which aims at reducing the credit expansion. The central bank is to further increase its minimum reserve requirements for those credit institutions, which boost their lending very substantially.

The new rules will be the latest ones in a series of measures adopted by the Bulgarian authorities since last July to tighten reserve requirements. The tightening happened in response to pressure from the IMF however no agreement was reached on the economic policy. The previously introduced measures aiming at limiting credit expansion apply to all banks. It brought about that banks now have to keep an 8 % minimum reserve at the BCB. Furthermore, the cash deposited in the vaults and ATM machines of the banks is no longer recognised as minimum reserves.

According to the announced new rules the BNB is to introduce a supplementary fund, which commercial banks will have to keep in addition to their minimum reserve accounts. The additional reserve obligation will be tied to the volume of loans extended and the size of the reserve obligation will be progressive. The aim is to further discourage lending.

Lending expansion fell to an average of 39 % by the end of August, from about 50 % at the end of 2004. It was the result of the series of restrictions recommended by the IMF and imposed by BNB. The BNB endeavours to further reduce the annual growth rate of bank lending to 30 % even in this year and to 20 % in 2006. Several banks have had business strategies of expanding their market shares in lending and using cheap foreign financing for it. Such lending policies of many banks brought about a significant increase in lending which substantially exceeded its planned growth rate.

The new regulations will be effective from the first quarter of 2006. Credit institutions will have to increase progressively their minimum reserves, depending on the rate of lending growth exceeding the rate set by the central bank. According to the new regulations, the progressive increase in the deposit implies that if a credit institution exceeds the quarterly lending growth limit of 5 % level set by the BNB by up to one percentage point it will have to deposit additional cash reserve, which is equal to double of the excess amount. Moreover, if a credit institution exceeds the limit by up to two percentage points, will have to deposit additional cash reserves equal to three times the excess amount. Up to 7 % above the level set by the BNB, a credit institution will have to deposit four times the excess amount.

The announced rules will represent substantial changes in regard to the current regulation. Now, the BNB's limit on credit growth is 5 % for 3 months, 12.5 % for the 6 months, 17.5 % for 9 months and 23 % for a year. Moreover, the central bank also raised the provisions for consumer and mortgage loans by between 10 and 25 percentage points. The new restrictive measures will not apply to corporate lending.

In spite of these recent steps, the IMF expects Bulgaria's current account deficit to reach the record 13.5 % of GDP at the end of 2005. It will be a substantial difference compared to an initial forecast of 7.6 % of GDP, which was envisaged in the country's agreement with the IMF. While the IMF could be satisfied by the announced new measures, which will be effective from early 2006 onwards, both Bulgarian analysts and bankers received the announcement of the new measures with pessimism immediately. These opinions are based on such expectations that the announced new set of requirements will hardly have any serious effect on the demand for credits, which was influenced by strong structural factors. Among these factors one can mention macroeconomic stability, the increase in incomes and employment and the expectation for an upward trend in the prices of real estate, as well as the fast developing construction.

The dynamics of private sector lending in the past two quarters of 2005 showed that it is highly possible that the end of the year and drop to about 30 % would delay credit expansion. Experts calculated that the rate of credit expansion reached about 37.5 % at the end of September. The main engine of credit growth was consumer credits. At the end of September, corporate credits' growth was just 25.4 % year-on-year (compared to 42 % at the same time in 2004).

The new measures, which were announced by the BNB are considered by many experts as a natural continuation of the efforts to limit credit expansion. It is expected by some of them that the new minimum-reserve limits will make it harder for banks to evade the restrictions. Other experts, however, consider that it was too early to introduce new measures before seeing the effects of the previous ones. The restrictions of July have led to some results, because BNB reports already showed that banks almost reached the 30 % credit growth rate, which was aimed by the BNB.

FORMER ISSUE'S TABLE OF CONTENTS:

Number 2005/19.

- Foreign Direct Investments in the Southeast European (SEE) Countries in comparison with the 8 New Member States (NMS8)
- Croatia - on the way on accession
- The role of World Bank credits in the Fyr of Macedonia

Number 2005/18.

- Bulgaria: Inflation rate is the critical issue with regard to joining EMU after EU accession
- Strong sector with strong performance: Tourism in Croatia
- Inflation in Serbia and Montenegro in 2005-2006
- The EU-Albania relations - The present engagement of the SAA

Number 2005/17.

- Intra-regional Trade in Southeast Europe
- Inflation in Bulgaria in 2005 and 2006
- Still High Foreign Direct Investments Inflow in the Romanian Economy
- Deep Overview of FDI Movements in Croatia

Number 2005/16.

- ICEG EUROPEAN CENTER Quarterly Forecast on the Southeast European Countries (Q3 2005) - Outlook for 2005 and 2006
- (Un)employment in the Southeast European Countries I. & II.
- GDP Growth Rate of Bulgaria in the first half of 2005

Number 2005/15.

- Bulgaria and Romania en route to the European Union
- Agricultural Sector in South Eastern European Countries II.
- Romania: Slower Economic Growth in the first half of 2005

Number 2005/13-14.

- The Powerful Nature - The Romanian Floods
- Current Account Development in Bulgaria: Big Problem at First Glance
- VAT Increase in Romania- A Makeshift
- The Start of the Improvement in the Albanian Electricity Sector

Number 2005/12.

- The British EU-Presidency and the Prospect of the Future Enlargement of the EU
- Credit Boom and Increasing External Vulnerability in Bulgaria and Romania
- High ISPA Subsidy for Romania
- A Further Step Towards Europe - Introducing VAT In Bosnia and Herzegovina

Number 2005/11.

- Agricultural Sector in South Eastern European Countries I. - Albania, Bulgaria and Romania
- Balance of Payments in Bosnia and Herzegovina
- New Leu and the Future in Romania
- Croatia's Accession Negotiation with EU - Developments in European Integration

Number 2005/10.

- Tax Regimes in Bulgaria, Croatia and Romania
- The Impacts of General Election on the Economic Policy of Bulgaria
- Worsening Current Account Balance in Romania
- The Attractive Bulgaria - Prominent FDI Inflow in 2004

Number 2005/9.

- EU Begin Talks with Serbia and Montenegro
- Tax Regimes in the FYR of Macedonia and Serbia and Montenegro
- Tax Regimes in Albania and Bosnia-Herzegovina
- Interest Rate Policy in Romania: 10 Percent Off in 5 Months

Number 2005/8.

- More EU Assistance for the Western Balkans
- One Step Closer to EU Membership
- Bulgaria Reached Record GDP Growth in 2004
- The Development of Public and External Debt in Croatia

Number 2005/7.

- South Eastern Europe after EU Enlargement and before Accession
- Bulgaria: Fixed Exchange Rate of Currency Board and the Competitiveness
- Bulgarian Tourism Industry
- Plans on the Albanian Privatisation Process

Number 2005/6.

- Development of Inflation in Southeast European Countries
- IMF versus the Romanian Government
- 8.3% GDP Growth in 2004 in Romania – Positive Signals for Investors
- Higher Inflation and Trade Deficit in Serbia

Number 2005/5.

- Tax Reduction Suggested in Bulgaria
- Croatia: Delays in Starting Accession Negotiations?
- Tourism in Croatia
- Montenegro Wants to Lead its Fortune under its own Hand

Number 2005/4.

- Bulgaria: Record Foreign Trade Deficit in 2004
- Macroeconomic Targets in Romania for 2005
- Montenegro: Budget in 2005
- Albania – EU Accession in 2014?

Number 2005/3.

- World Bank Strategy for 2005-2008 – Assistance for Croatia
- Record Budget Revenues in Bulgaria in 2004 – An Estimated Surplus of the Budget Again
- Montenegro: Economic Policy Focuses on Privatisation
- Macedonia – Status of European Integration One Year after Application

Number 2005/2.

- Origin and Structure of FDI Inflows into Bulgaria and Romania
- Croatia: Stabilisation and Association Agreement will Come into Force on 1 February 2005
- Bank Privatisation in Serbia
- Growing External Imbalances in Romania

Number 2005/1.

- Hungarian Foreign Direct Investment Outflows to the Southeast European Countries
- Western Balkan Countries: Outlook for 2005
- Candidate Countries Performed Well Last Year – Outlook for 2005
- Radical Tax Reform in Romania: 16% Flat Tax Rate from 2005