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ICEG EC Quarterly forecast on the 7 Southeast European countries – Winter 2005

ICEG European Center published its latest Quarterly Report on the seven SEE economies. In the Forecast, the authors examined the evolution of economic growth, monetary conditions, fiscal developments, balance of payments and unemployment. Regarding economic growth, in the third quarter of 2005 the previous tendencies of the year continued. According to our expectations, the average economic growth rate of the seven Southeast European countries was 4.8% in the region which is lower by 0.7%-point than that of the previous year. Though, GDP growth remains strong in this region.

In Albania, Bosnia-Herzegovina, Bulgaria and Croatia, the real GDP growth is expected to be the same or a bit higher in 2005 than in the previous year. In the rest of the countries, the pace of GDP growth is expected to decrease, mainly in case of Romania and Serbia and Montenegro.

On the one hand, the highest growth rate was achieved in Albania and Bulgaria (6%) according to our expectations. On the other hand, we expect that the GDP growth was the lowest in the Former Yugoslav Republic of Macedonia (3.5%) in 2005. In course of the year, the main engine of the growth remained the same as in the previous year: the domestic demand.

In 2006 current tendencies are expected to continue and domestic demand will remain again the main engine of these economies, namely consumption and investments. According to our expectations, the average GDP growth rate will be 5.1% in the region in 2006 which represents a slight acceleration comparing to this year.

Monetary conditions

As it was expected, inflation remained low or disinflation process continued in the first half of the year in most SEE economies. In Albania, Bosnia-Herzegovina, Croatia and the former Yugoslav Republic of Macedonia, the yearly average consumer price index is expected to be lower than 3% in this year.

In Bulgaria and Romania inflation is significantly lower in this year than in the previous year. In case of Romania inflation rate became a one-digit figure in 2005 after many years of double-digit inflation.

On the other hand, CPI increased only in Serbia where the introduction of VAT had a one-off negative impact on the development of prices. Thus, the highest CPI is observable in Serbia in this year.

In 2006, the average inflation rate of the region will be lower than this year due to the continuing disinflation process in Romania and Serbia and Montenegro. Yearly average consumer price index is expected to be 4.4% in the next year, which reflects that price stability will remain in the first group of these economies and CPI will decrease in the second group where inflation is higher.

In several countries of the region credit boom characterises the economy similarly to the NMSs. Thus, national banks adopted cautious measures and cut interest rates carefully. Thus, reference rates were mainly unchanged or slightly decreased in the region, in line with the declining inflation rate.

FISCAL DEVELOPMENTS

In most SEE economies, general government balance has a surplus or only a slight deficit. The average deficit in 2005 is estimated at 0.9% of GDP which is significantly smaller than the same figure in the previous year (1.7%). Except for Albania and Croatia, general government balances are expected to be between 0% and +2.0% in 2005. In Albania the revenue generation and collection is improving but still vulnerable, while, in Croatia the moderate economic growth and the increasing budget expenditures have a negative impact on the annual budget. It is an interesting fact that despite the introduction of flat tax at the beginning of the year general government balance is expected to improve in Romania, while the corporate tax rate cut in Bulgaria had no significant negative impact on the balance.

In 2006 general government balances are expected to change only slightly. In Albania and Croatia the deficit can decrease somewhat and in the other countries the balances are expected to remain in around the same level.

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

BALANCE OF PAYMENTS

External imbalance is one of the main macroeconomic problems in most Southeast European countries. In general, foreign trade balances have huge deficits in the SEE region and this factor greatly influences the development of current account balance.

TABLE 1. SUMMARY INDICATORS OF THE ANALYSED 7 SOUTHEAST EUROPEAN COUNTRIES

SEE7 Average	2003	2004	2005*	2006*
GDP growth (%)	4.0	5.8	4.8	5.1
Inflation (%)	4.8	4.7	5.2	4.4
General Government balance/GDP (%)	-2.3	-1.4	-0.9	-1.2
Current Account/GDP (%)	-9.2	-10.0	-9.9	-9.0
Unemployment (%)	22.9	22.7	21.9	21.5

** Forecasts*

In 2005 the current account balances improved only slightly, the average current account deficit reached 9.9% of GDP. Significant deterioration of CA balance was observable mainly in Bulgaria and Romania due to strong domestic demand. In case of Bulgaria, CA deficit increased from 7.5% to 14% of GDP according to our expectations. In Romania, the deficit also worsened by 1.5%-points of GDP.

On the other hand, significant improvement characterised the CA balances of the FYROM and Serbia and Montenegro. In Serbia and Montenegro, the deficit of CA balance deceased to 6.6% in 2005 from 13.4% of GDP in 2004. This good performance was mainly due to the positive impact of the improving trade balance. In case of the other countries slight improvements were observable.

In 2006 the tendencies of this year will continue, namely current account balance will improve slightly in these economies, except for Bulgaria and Romania due to the import boosting effect of the strong domestic demand.

Unemployment

Unemployment is a key issue in Southeast European countries, the official unemployment rate exceeds 20% on average. Until 2004, there was only one country where unemployment rate was a single digit figure, which was Romania. In 2005 Bulgaria joined that "group" where unemployment rate decreased significantly in course of 2005. Our expectation is that unemployment rate was 9% at the end of 2005. It represents a 3%-points decline in unemployment rate which is a remarkable performance. Besides Bulgaria, slight improvement was observable in Croatia and Romania related to unemployment, while the rest of the countries were not able to decrease significantly the unemployment rate in 2005.

On the other hand, one can observe the highest unemployment rate in Bosnia-Herzegovina, in the former Yugoslav Republic of Macedonia and in Serbia and Montenegro, unemployment rates are over 30% in these economies. According to estimations, the real unemployment rate is significantly lower in these economies, it can be around 20%, however, this rate is still really high.

In 2006 further decline of unemployment rate is expected in case of the EU acceding and candidate countries owing to the accelerating economic growth in the region. However, the rate of unemployment will not decrease significantly in case of the other countries.

BALANCED BUDGET 2006 IS PLANNED IN BULGARIA

On 20 December, the bill of the Budget 2006 was approved by the Parliament. The debate on the bill included fierce criticism and supporting arguments. The main argument against the bill focused on the claim that it lacked reform proposals of the public sector and clear priorities. The supporting arguments claimed that in spite of its weak points the approved budget was the only possible option.

The assumptions of the budget includes that the inflation rate will decrease from 5.8 % to 4.9 % by end-2006, the GDP will grow by 5.5 % (BGN 45 615.4 million) at a crude oil price of USD 61.4 per barrel in 2006 and the exchange rate will be 1.61 BGN/USD.

The main declared goals set in the Budget 2006 are to maintain macroeconomic stability, to continue the policy of stable economic growth, to prepare the country for membership of the European Union and to stimulate social responsibility. The budget 2006 is to meet public expectations for accelerated progress in the process of socio-economic cohesion and integration of the economy in the common European market.

Budget 2006 is to be balanced (no surplus or no deficit). It is the first budget since the beginning of the transition period with a projected balanced fiscal position. The expected revenues amount to BGN 18 258.0 million, which corresponds to 40 % of the GDP. The planned expenditure is of the same size.

One of the key discussed issues was just the feasibility of achieving a balanced budget. The government aimed at providing at least the same or even higher surplus as during 2005. At the same time, the government presented a consolidated budget for 2006, which was balanced. Some analysts, however, predicted a hidden budget surplus varying between BGN 0.7 and 1.5 billion.

The government projected its revenue of BGN 18,258 million, of which 82% will come from taxes. The consolidated revenues will increase by 12,4 % compared to the projected sum of the budget 2005. The expected rise in tax revenues is about 14 %.

The major parameters in taxation are channelled into the reduction of social insurance and tax burden, the development and harmonization of legislation in line with EU directives and the simplification of administrative procedures.

The social insurance burden decreases by 6 % - from 29 % to 23 %. The income will rise by 6 % from 1 July. The average wage in the budget sphere will become BGN 459.9. The minimum wage will rise to BGN 160 on 1 January. Old-age pensions will rise by 5 % from 1 January, 2006. The maximum amount of a pension will be BGN 455.

Although the budget allocated the highest amount to social programs and the matters of employment - over BGN 6 billion - it is the first time, that the national budget envisions a decrease in social security. About 13.5% of the GDP will be allocated for social insurance, assistance and social care. Under the social program item of the budget, family allowances for each firstborn will be BGN 18, and this amount will be increased by BGN 2 for every following child.

An additional BGN 2.3 billion is to be given for defence, security and internal order. They represent about 5.1% of the GDP. The education and health sectors will receive approximately BGN 2 billion each. It will mean that about 4.2% of the GDP will be channelled in education and about 4.4% of the GDP will be allotted for health.

The expenditure of the Budget 2006 amounts to BGN 18 258 million. The main items are the following:

TABLE 2. THE MAIN BUDGET ITEMS IN BULGARIA

Main Budget Items	Amount (bn BGN)	In % of GDP
1 social programs, matters of employment	6.1	13.5
2 defence, security and internal order	2.3	5.1
3 education	2	4.2
4 health	2.1	4.4
5 flood damage and protection	0.5	1.1
6 public works and environmental protection	1	2.2
7 capital expenditure (investments)	2.2	5
8 municipal capital expenditure	0.3	0.7
9 other	1.7	3.3
Total	**18.258**	**40**

Source: Ministry of Finance

Nearly BGN 60 million from the income predicted for budget 2006 was redistributed to provide additional funds for various sectors. In this way the cabinet will be able to relocate money for the higher wages promised to teachers. The lawmakers approved the negotiated two-step increase of salaries of Bulgarian teachers - by 4 % as of January 1 and by additional 6 % as of July 1, 2006. For the budget item of public works and environmental protection about 2.2% of the GDP will be allocated.

A 10% cut has been planned in the administration and will probably be executed in April. Meanwhile, budget-funded organisations will receive salaries increased by 6 % as of July 2006 and pensions will grow by 5 % as of the beginning of 2006.

To cover the severe damages caused by the summer floods in 2005, the budget plans to allocate about BGN 500 million, including BGN 110 million to be doled out for preventive measures against another disaster of such scale.

A considerable rise in capital expenditure is planned, with a view to encouraging economic growth. Capital expenditure amounts to BGN 2 226.9 million, which is includes an increase of 32.7 % compared to 2005. The implementation of some projects will continue in 2006 as well, including the second bridge over the Danube at Vidin-Calafat, the extension of Sofia airport, the construction of regional waste depots and waste water purification stations.

For municipal capital expenditure BGN 325.3 million will be allocated. The total amount is increased by BGN 73.6 million compared to the consolidated budget 2005.

Besides a zero budget deficit the budget 2006 envisages and a 12 % current account deficit per GDP, compared to the forecasted 13.5 % level in 2005. The January-September 2005 current account deficit reached at 1.837 billion euro, or 8.7 % of GDP, against a deficit of 696.6 million euro (3.6 % of GDP) for the same period in 2004. In September 2005 alone, the current account deficit amounted to 227.1 million euro, compared to a positive balance amounting to 23.8 million euro for the same month in 2004. The current account deficit at the end of October was 2.4 times higher compared to the figures for the same period in 2004. This size of the deficit was much higher than it had been expected by the IMF. It totalled BGN 2.2 B, or 10.5 % of GDP. The IMF revised its prognosis. Its new prediction for the deficit in 2005 was increased to 13.8-14 % of GDP by the end-2005. The FDI inflow was expected to at least partially offset the negative effect of the rapidly increasing current account deficit.

In October, 2005, the IMF mission failed to negotiate with the Bulgarian government some of the key economic parameters of the agreement. Then the IMF concluding report read that Bulgaria had lagged behind in meeting deadlines to implement structure reforms.

The IMF had evaluated the budget 2006 again before it was submitted to be approved by Parliament. The mission did not have good news because the IMF continued to demand that national expenditure should not exceed 40 % of the GDP. In addition, the recommendations of the IMF demanded that all surplus income should be saved. IMF experts predicted that then the budget surplus in 2006 could reach at least BGN 1 billion. IMF representatives were expected to discuss the budget surplus once again with Bulgarian economists, but a final decision would not be taken during the next IMF mission in January.

Some of the most important economic policy measures which are proposed and urged by the IMF can have far reaching political consequences. The advice of the IMF considers two public services, namely the education and health service where deep going reforms are needed before extra budgetary public funds should be allocated for salary increases.

After 20 December, the IMF mission in Bulgaria expressed satisfaction with the budget deficit and the budget 2006, which was approved by the parliament in spite of the fact that the IMF and the Bulgarian government could not reach an agreement on the budget.

The IMF stated that its comments aimed only to focus attention on fiscal policy in the outgoing and the new budget framework of 2006. It proved to be successful from the point of view of defining priority tasks to be completed until the next mission of IMF, probably in January 2006. It is expected that then Bulgaria signs a new agreement with the IMF.

VAT INTRODUCTION IN BOSNIA AND HERZEGOVINA

A single 17% VAT rate was introduced in Bosnia and Herzegovina (BiH) on January 1st, 2006. The VAT introduction was preceded by two years of preparations, which involved tax policy and tax administration changes. A high level of controversy surrounded the recent introduction of the single-rate VAT, as it is feared to worsen the situation of the poorer part of the population. The same 17% VAT is now used in the whole of BiH, which consists of two the Entities (Federation, Republika Srpska) and Brcko District (BD).

The recently introduced single VAT rate in BiH is lower than the standard VAT rates used in the South-East-European region. It is also lower than the single rate used in Slovakia, where it amounts to 19%.

TABLE 3. VAT IN THE SOUTHEAST EUROPEAN COUNTRIES

	VAT
Croatia	22% (banks and insurance companies exempt)
Romania	standard 22%, reduced 11%
Bulgaria	20%
Albania	20%, exports 0%
Serbia & Montenegro	standard 18%, reduced 8%
FYR Macedonia	standard 18%, reduced 5%, exports exempt
BiH	17%
Slovakia	19%

Source: E&Y Worldwide Corporate Tax Guide, 2005

Before the start of the indirect tax reform in 2003, both Entities and the Brcko District had different systems of indirect taxation. Repbulika Srpska (RS) had a sales tax with a standard rate of 18% and a reduced rate of 8%. The sales tax on services also amounted to 8%. The sales tax rates in the Federation were somewhat higher, with a 20% standard and a 10% reduced rate. Sales taxes in Brcko District were similar to those in RS. Excises and customs were included in tax base in both Entities and the BD.

The revenue loss in the complicate tax system of BiH amounted to 4.1% of GDP in 2002, which was connected to sales tax, and another 4.1% of GDP connected to shortcomings in customs procedures.

The introduction of a single rate VAT was a significant step towards the simplification of the tax system in Bosnia and Herzegovina. The three separate customs administrations of the Federation, RS and BD were merged into a single unit. The sales tax was abolished and replaced by the VAT in both Entities and BD, and a single administration was established for all indirect taxation. The Indirect Tax Authority (ITA), which was established after the Indirect Tax System Law was adopted in December 2003, is now responsible for indirect tax administration, which includes customs, excises, sales tax, and VAT. Members of the ITA Board include the State and the two Entity Ministers of Finance, and nominated experts. The responsibility of the entities and Brcko District was reduced to collecting and administering direct tax revenues only.

All taxes, which the ITA is responsible for must be paid into a single account operational since January 1st, 2005. Indirect tax revenues pooled into the single account are later distributed back to the Entities and Brcko District. Besides redistribution, a share of the single account revenues goes for covering the state's administrative expenditures, and external debt service. The share of Republika Srpska and the Federation is divided between the two General Governments, the Municipalities (RS) and Cantons (Fedeartion), and the two Road Directorates of the two Entities.

Before VAT introduction there was strong controversy whether the rate should be single or multiple. Nationalist parties, the European Commission and the IMF supported the single rate, while trade unions supported the multiple rate. According to the former group the multiple rate would have been expensive and inefficient in BiH because of the high corruption level. However the trade unions are concerned about the effects of the single rate VAT system on the population living below the poverty line (about 16-18%). They also proposed the exemption of basic food. Additional social programs are to be developed to support the poorest part of the population. However it is not yet clear what the exact sources of the funds for the programs will be.

The VAT is expected to contribute to the whitening of the economy. The grey economy along with remittances from abroad gives a living to a large proportion of the population, while official economic activity is lagging. Therefore VAT introduction will effect strongly most of the population. Businesses are also concerned about slow VAT refunds. These factors along with the possibly inefficiently funded social support program for the poorest could cause further economic and social destabilization in the short term in BiH. It is yet to be seen during this and the following year if the single 17% VAT rate will bring mostly positive or negative effects in the medium term.

Foreign Direct Investment in Serbia

The Republic of Serbia has aggregated about EUR 1.5 billion of foreign direct investments in 2005, which is the highest annual volume since the country begun the transition towards a market economy. The major FDI income (EUR 680 million) was the result of the privatization of the Serbian banks. Banks' sales gave Serbia some EUR 280 million in cash last year as Serbia sold Jubanka, Novosadska, Continental and Niska Banka to foreign major bank institutions like Greece's Alpha Bank, Slovenia's NLB, Austria's Erste and Hungary's OTP Bank.

A further EUR 400 million went to the country as some private banks changed ownership, getting buyers like Italy's Intesa and Findomestic, France's Credit Agricole, and Greece's Piraeus and EFG Eurobank Ergasias.

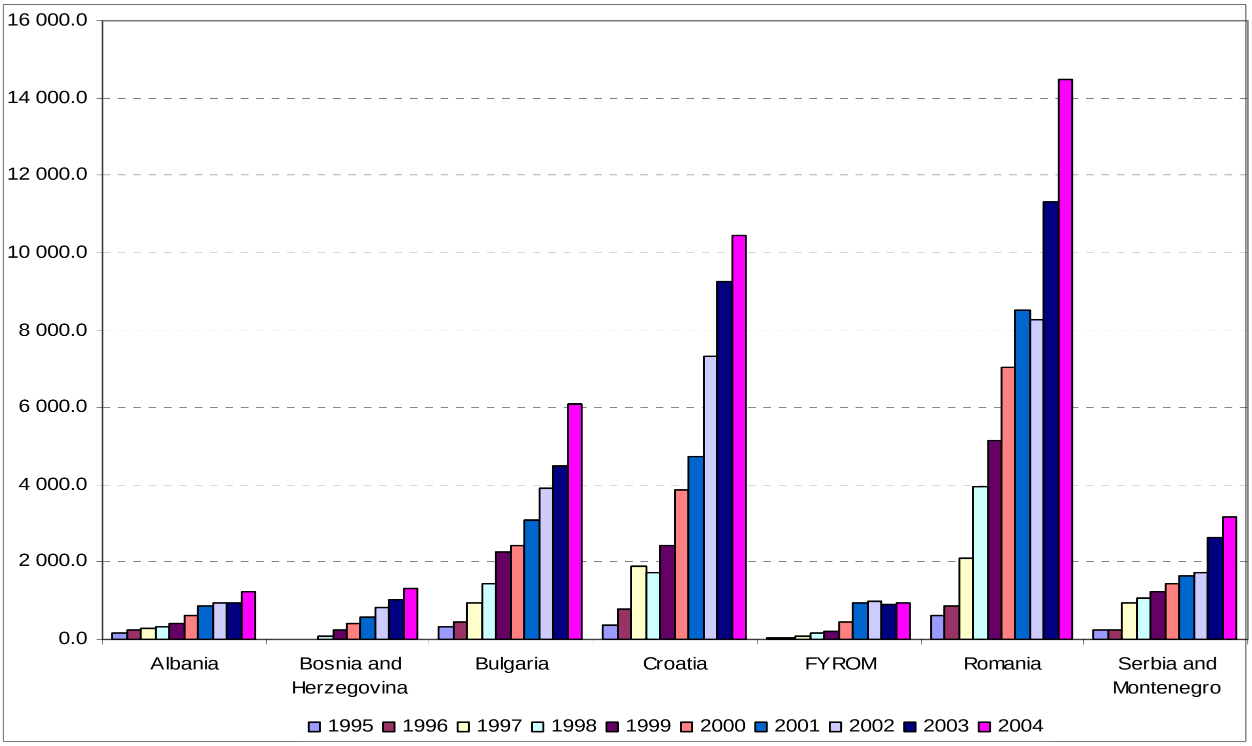
Serbia has yet to privatize some of its largest banks and the big oil and electricity monopolies as well as its flag carrier JAT Airways and the airport in Belgrade, which will probably secure high FDI inflows in the next years, too.

FDI in Serbia

Serbia and Montenegro is demonstrating considerable early success in attracting foreign direct investors, little more than two years into the transition and reform process. In 2002, foreign direct investment in Serbia and Montenegro amounted to USD 475 million (according to the National Bank of Serbia).

While the major volume of foreign capital is expected to flow towards Serbia (given the relative size of its economy), Montenegro is also likely to attract more investor interest.

Graph 1. - FDI stock in the SEE countries, 1995-2004 (millions of euros/ECU)



Source: UNCTAD

Leading investor nations in Serbia and Montenegro include: Austria, France, Germany, Greece, Italy and the United States. As mentioned above, Serbia is attracting the preponderance of interest. *Foreign investor participation was started with the privatisation of Serbia's cement sector in late 2001.* Through privatisation tenders, three companies were sold to strategic partners from France, Greece and Switzerland. Since then, Serbia has successfully attracted other strategic investors: France's Michelin entered into a joint venture with a local tire producer; Germany's Henkel (detergent producer) acquired a local producer (Merima) and Heineken is purchasing Serbia's largest brewery (Apatinska). In April 2003, the Privatisation Agency issued the tenders for the privatizations of the Nis and Vranje tobacco companies. On the other hand the banking sector attracted investment from Raifeissen (Austria), HypoVereinsbank (Germany), National Bank of Greece (Greece) and Societe Generale (France). In 2003, the banking sector witnessed new market entrants: Hypo Alpa Adria (Austria), ING (Netherlands), Nova Ljubljanska (Slovenia), OTP (Hungary), Soros Fund (USA) and Volksbank (Austria).

Why is it rewarding to invest nowdays to Serbia?

Economic policies in the 90s left the country with weak economic starting conditions, and broad-based economic reform and transition started only a few years ago. Following the 2000 political changes in Serbia, the new authorities started economic reform and stabilisation. And the changes in the political systems have brought the ‘attractive outcomes’ in the economic situation of the country as well (for instance, as you can see on the diagram: before 2001 the level of the FDI in the country was equal to the zero).

But nowadays Serbia has a stable market economy with great market potential. Serbia's annual average GDP growth rate was around 5% between 2001-2004.

As a result of efforts to improve the investment and business climate in Serbia, the country became a subject to increasing inflow of FDI in 2004, and the OECD awarded for the best Greenfield investments in SEE in 2003 and 2004.

Why is the FDI important for the country long term?

The ability to attract international capital can offer large potential benefits for the developing countries. The foreign capital can be used to augment domestic savings and thus enable countries to increase the rates of capital accumulation. Consequently, this should improve longer term growth prospects and increase wealth of the population, in other words, speed the development process.

The FDI is responsible for welfare increase in the host country due to advantages related to the introduction of new technologies and innovation new managerial techniques, development of additional skills, increased capital, job creation and improvement of working conditions, and the development of industrial sector in the host country.

EU integration is one of the main political objectives of Serbia and Montenegro. In April, 2005 the EU appointed that Serbia is ready for the SAA negotiations, which was the first and crucial step on the way to the EU accession. The EU’s enlargement commissioner, Olli Rehn said that future advances in the relationship are in the hands of Serbia and Montenegro - the country’s speed of integration with Europe depends on the speed of its political, economic and judicial reforms, as well as cooperation with ICTY. So the country is before a lot of agendas.

The fact that the country get closer to the European Union can not explain in itself to intensify the FDI inflow, but it is doubtless that the high level of the foreign direct investment helps the price and non-price competitiveness, and contributes the creating of the export-controlled economic growth and the catching up. That is why Serbia has a great need for foreign direct investments in the future as well.

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