



ICEG European Center

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# Forecast

on South-Eastern Europe

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## OVERVIEW OF THE SEE

### Accelerating economic growth in the Southeast European countries

#### Economic Growth

Regarding economic growth in the Southeast European region, we expect that in these economies the GDP growth rates will be higher in 2006 than in the last year. In most economies the economic growth rate will be higher or the last year's excellent performance will be continued. The economic growth is expected to drop back significantly only in the Former Yugoslav Republic of Macedonia.

This expectation is based on the observed tendencies of the first quarter/first half of the year and on the preliminary GDP figures of Q1 2006 in several SEE countries where it was already published. In all cases where the Q1 figure was already published (Bulgaria, Croatia and Romania) it was higher than those in the last quarters.

As it is always stated in relation to the economic growth of the Southeast European region, the main engine of the region is the domestic demand in these countries. Basically in all Southeast European countries consumption and investments fuel mostly the economy. And it is important to emphasise that the growth is not based only on the consumption but also on the investments which play an important role in the growth of the GDP in these economies (mainly in the acceding and candidate countries).

As a result of the strong domestic demand the net export contributes negatively to GDP growth in these economies via the balance of goods and services. Since the strong domestic demand boosts the import of consumer and capital goods, the trade deficit increased significantly in the last years.

According to our expectations, the highest growth will be achieved by Bosnia-Herzegovina (6.0%), Bulgaria and Romania (both 5.8%) in 2006. It is worth mentioning we expect that in all SEE countries the GDP growth will exceed (or reach) 5% except for the Former Yugoslav Republic of Macedonia, where real GDP growth rate is expected to be 3.3% in this year.

#### Monetary Conditions

Regarding consumer prices, the consumer price indices in the region will be about the same as in the last year. However, there are a few countries in the region where the inflation rate started to grow, such as in Bulgaria, Croatia and the Former Yugoslav Republic of Macedonia. The higher inflation rates in these economies are basically due to the hiking international oil prices and the adjustment of the administrative prices and increasing excises.

On the other hand, in those two economies (namely in Romania and Serbia and Montenegro) where the inflation rates were the highest in 2005, the consumer price indices decreased further in the first half of the year.

Due to inflationary pressure, in several SEE countries the central bank increased its interest rate to halt the further increase of inflation (and the rapid credit expansion as well). Thus, in many countries, such as in Bulgaria or Romania, the National Bank's base rate is significantly higher than it was at the beginning of the year.

As a result of the aforementioned process, in Romania, where the exchange rate is not fixed, as it is in several SEE countries, the Romanian currency started to appreciate significantly against the euro. This could have had a serious negative impact on the competitiveness of the Romanian export goods if this tendency had continued. However, the postponement of the final decision on the exact date of EU entry in mid-May had a negative impact on the Romanian currency and after that the Leu started to depreciate nominally against the euro. This process reflects well the complexity of the proper monetary policy and the vulnerability of these SEE economies.

#### Fiscal Developments

In 2006 the budget balances of the Southeast European countries will not change significantly in comparison with the balances of 2005. In most SEE countries the budget balance will be between -1% and 2% of GDP or these budgets will be basically in balance. Higher budget deficit will

characterise only two countries in the region, namely Albania and Croatia.

These two countries were the exceptions in last year as well. In Albania the revenue generation and collection is improving but still vulnerable, while, in Croatia the budget deficit is decreased gradually but relatively slowly. It is an interesting fact that despite the introduction of flat tax at the beginning of 2005, general government balance improved in Romania, while the corporate tax rate cut in Bulgaria (in 2005) had no significant negative impact on the balance too.

### **Balance of Payments**

The current account deficit is one of the main problems in the region. In most countries the current account balance will be deteriorating in course of the year according to our estimations. The deterioration will be the largest in Bulgaria and Romania, where C/A deficit will go up to or even exceed 10% of GDP. The significant growth of the current account deficit is mainly due to the worsening trade balances. As it was mentioned before, domestic demand boosts imports via which trade balances (and the current account balances) worsen.

It is an interesting fact that in case of the other economies the trade deficits are even higher than in case of Bulgaria or Romania, however, the large surplus of the balance of current transfers (Albania, BH, FYROM) or that of the services

balance (Croatia) is able to counterbalance a large part of the trade deficit.

On the other hand, in case of the acceding countries, the large current account deficit does not cause a huge problem because the amount of foreign direct investment inflows is also significant in these two countries. Net FDI financed and is expected to finance large part of the C/A deficit this year.

### **Labour Market Developments**

Unemployment is another key issue in the Southeast European countries; the official unemployment rate exceeds 20% on average. Until 2006, there was only one country where unemployment rate was a single digit figure: Romania. Now it seems Bulgaria joined the 'club' where unemployment rate decreased significantly in course of 2005.

Besides these countries, in 2006 slight improvement of the unemployment rates is expected in all other SEE countries except for Bosnia-Herzegovina, where the official unemployment rate exceeds 40%. The unemployment rate is higher than 20% in the Former Yugoslav Republic of Macedonia and in Serbia and Montenegro as well. On the other hand, 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.

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

<b>SEE Average</b>	<b>2003</b>	<b>2004</b>	<b>2005*</b>	<b>2006**</b>
GDP growth (%)	4.0	5.7	4.9	5.2
Inflation (%)	4.7	4.8	5.4	5.5
General government balance/GDP (%)	-2.2	-1.4	-0.7	-0.9
Current account balance/GDP (%)	-9.3	-9.9	-9.8	-10.3
Unemployment (%)	21.9	21.4	21.3	20.9

\* Preliminary data; \*\* Forecasts

## ALBANIA

### Strict monetary and fiscal policy

#### Economic Growth

The large size of the grey economy, the inadequate transportation and energy infrastructure remain major problems in Albania. Mainly due to the energy supply problems and the textile industry's difficulties, real GDP growth rate performed under expectations and finally amounted to 5.5% in 2005. Domestic demand was among the main driving forces of the economic growth, but in 2006, as a result of the expected stricter fiscal and monetary policy, the real GDP growth rate may decrease slightly. The annual growth of energy supply was 8.4% in the first two months of 2006.

According to the central bank's recently published data, sales index in the last quarter of 2005 grew by 13.5% in annual terms, and showed a change in its structure. Compared to the fourth quarter of 2004, concerning the contribution to the annual growth of economy sales, the category of "industry" and "construction" decreased significantly – in the last quarter of 2005 it was 0.36% and 1.1%, respectively, while in the same quarter of the previous year it was 2.4% and 7.9%. In the same time, the contribution of the category of "trade, hotels and restaurants" increased from 5.8% to 10.1%.

#### Monetary Conditions

The annual inflation rate reached 3.1% in May, while the average CPI growth in the first four months was 2.3%. The growth was mainly due to the growth of the foodstuff's price, which was slightly higher over expectations as a result of the supply's decrease. The inflation's other main reason was the growth of international oil prices, which may have even some second round effects. On the other hand, due to the strict monetary and fiscal policy, inflation is expected to be modest in 2006 as well, and the annual average CPI is expected to be around 2.6%.

The growth of monetary aggregates marked a slowdown in the first quarter of 2006. The decrease of the broad money's growth rate was mainly the result of the lower level of government borrowing. Money supply increased by 10%. In the first quarter of 2006, credit grew by LEK 12 billion in Albania, thus reaching 22.3% of the M3 aggregate. Although the growth rate of credit

marked a downward trend in the period, it is still the main cause of the money supply's growth. The excess liquidity of the banking system is still present. Likewise in 2005, in this period as well the rate of credit growth to the economy showed stability, but is still the main source of the money supply's increase.

The exchange rate of the Albanian Lek is stable, 1 Euro varied around 124 and 121 Lek in the first half of this year, with a very slight appreciating pressure. Recently, in the beginning of July 2006, 1 Euro fluctuated around 123 Lek, while 1 dollar was around 96 Lek. The central bank's key interest rate has not been changed so far, so as a result it is still 5.00%.

#### Fiscal Developments

In the first five months of 2006, due to the growth of revenues and decline of fiscal deficit, budget implementation performed over expectations. By March, 106% of the planned income has been collected, while on the expenditure side, 87.6% (LEK 42.7 billion) was realised. As a result, after eight months of fiscal balance deficit, in the first quarter of this year, fiscal balance showed LEK 10.3 billion surplus, while the projected amount was LEK 1.1 billion. On the other hand, according to expectations, in the following months, budget expenditures and thus budget deficit will increase. In the draft budget 92.5% of the deficit is projected to the second half of this year, and around 4% budget balance deficit is estimated for 2006. The strict fiscal policy is partly the result of the IMF agreement.

In the first quarter of this year, compared to the same period of 2005, due to excise and tax income (mainly VAT), total income increased by 16.7%, thus marking one of the highest growth rates of the recent years. Only the income from the local government decreased. As far as expenditures are concerned, maintenance, local government and interest performed the biggest drop, by 30.7%, 18.2% and 9.0%, respectively. Personal expenditure, which represents 28.2% of total expenditures, was realised 100%. In the observed period, only expenditures of social insurance and its contributions increased. Concerning the financing structure, expenditures

covered by domestic and foreign financing, reached 75.8% and 38.7%, respectively.

### **Balance of Payments**

In January the growth rate of imports exceeded the growth rate of exports. According to the central bank's recent publication, in January 2006, compared to the same period in the previous year, exports grew by 21% and reached EUR 46 million, while imports increased by 28% and amounted to EUR 159 million, thus trade deficit grew by 31% in annual terms. The main export products in January were textiles, footwear, mineral and base metal, while mineral products, machinery and mechanical appliances, textiles, agricultural products represent the main import categories. In January as well, the main export partners of Albania were Italy (81%) and Greece (9%), while concerning imports, the geographical expansion is much wider, but still Italy (25%) and Greece (14%) are the main partners.

Trade deficit remains to be the main factor of the current account deficit, which amounted to

EUR 286.2 million in 2005. Current account deficit is mainly compensated by capital inflows. Workers' remittances continued to be the most considerable contribution to current transfers in 2005. A number of privatisation projects are expected for 2006, which might have a positive impact on the current account deficit.

### **Labour Market Developments**

Although data are not always reliable, it can be stated that mainly due to the non-agricultural sector, the unemployment rate has been slightly declining – in 2005 it was 14.3% and in this year it is expected to be around 14.0%. On the other hand, administration reform may cause a mild negative impact on employment. Most of the unemployed are above 35 years of age and their education doesn't exceed the eight-year school.



**Table 2. Major macroeconomic indicators for Albania, 2003-2006**

	2003	2004	2005*	2006**
GDP growth (%)	5.7	6.0	5.5	5.2
Private consumption (%)	n. a.	n. a.	n. a.	n. a.
Public consumption (%)	n. a.	n. a.	n. a.	n. a.
Investments (GFCF, %)	n. a.	n. a.	n. a.	n. a.
Export (%)	13.5	23.5	12.0	15.0
Import (%)	0.5	8.0	10.0	10.0
Consumer price index (average,%)	2.4	2.9	2.4	2.6
Unemployment rate (%)	15.0	14.4	14.3	14.0
General government balance/GDP (%)	-5.0	-4.9	-3.5	-4.0
General government debt/GDP (%)	40.3	55.0	55.0	53.0
Current account balance/GDP (%)	-8.0	-5.7	-7.5	-6.2
Trade balance/GDP (%)	-22.9	-20.7	-20.5	-20.0
Gross foreign debt/GDP (%)	24.3	22.0	21.4	22.0
Exchange rate (ALL/EUR)	134.3	126.3	122.5	126.0
Interest rate (end of year, %)	6.50	5.25	5.00	5.00

Source: National Bank of Albania, INSTAT

\* Preliminary data \*\* Forecasts



## BOSNIA AND HERZEGOVINA

### After VAT introduction and before elections

#### Economic Growth

Since 1998 nominal GDP has been constantly growing – it was KM 7.2 billion in 1998, while in 2005 it amounted to KM 14.7 billion. GDP per capita was KM 3 838 in 2005, while if including the non-observed economy the number is KM 5 027 in the same year. The GDP growth rate in 2005 was 5.5%, and according to expectations this number will increase this year and it may amount to 6.0%. The service sector is the most successful sector in the country and produces the largest part of the GDP, but other sectors are expected to grow as well.

We must mention that according to negotiations, CEFTA may become operative from 2007, thus replacing the bi- and multilateral agreements in the region. As a positive signal and simplification it may have positive impact on Bosnia and Herzegovina's economy in the future.

#### Monetary Conditions

There was a significant growth of retail prices in 2005, mainly due to the direct and indirect impacts of the oil price growth. In 2006, after the introduction of VAT retail prices grew by 4.3% in the first month compared to the previous month. In February retail prices slightly decreased by 0.1% compared to January. If we compare January and February to the same period of 2005, we can see that prices grew by 7.6% and 7.2%, which represent the inflation on the annual level for the corresponding month.

The annual level inflation in the two entities differed; in January 2006, compared to the same month in 2005, it increased by 6.7% in the Federation, while in Republika Srpska (RS) it grew by 9.5%. Compared to December 2005, retail prices increased by 3.9% in the Federation in January 2006, and in Republika Srpska it grew by 5.1%. Agricultural products showed the highest growth in January compared to previous year; the rate was 8.4% in the

Federation and 8.1% in RS. According to expectations after the one-off impacts of the VAT, by the end of the year the growth rate will get milder and consumer prices will amount approximately to 2.5%.

The high level of credit growth is a characteristic of the country's economy, but it is expected to be sustainable - partly due to actions like the central bank's decision, in which it increased the required reserve rate by 5% to 15%. According to the central bank, the credit growth was 29% in 2005 compared to 2004. Banks have approximately KM 7 billion extended loans – 46% went to private companies and 48% to citizens. In 2005, compared to 2004, loans to private companies increased by 32%, while in the case of citizens it grew by 31%.

Due to the currency board arrangement the official exchange rate is stable and is EUR 1 = KM 1.95583 since 2001. In April the central bank's total assets and liabilities were KM 4 566 million. Net foreign assets exceeded its monetary liabilities by KM 178 million. The two biggest component of monetary liabilities were the currency in circulation (KM 1 902 million) and the resident banks' deposits (KM 2 155 million).

A Central Registry of Credits of Legal Entities is operational since the 13th of April. Through this registry banks are able to see the clients' debts. According to the central bank's expectations the registry will increase the safety of investments and of the entire system, moreover reliable clients may get more favourable conditions, and indirectly it may even mitigate credit expansion. According to the plans, by the end of 2006 a second stage of the registry development would be completed, thus the registry would contain data on physical persons indebted in commercial banks and their guarantors.

## Fiscal Developments

The badly needed constitution reform has been voted down so far. Elections will take place in October this year, so as a result many questions can not be answered until then. According to expectations the state-level's, the Federation's and RS's budget will show consolidated surplus in this year as well, while certain extra-budgetary funds will record deficit.

The introduction of VAT from January 2006 can be considered successful and the collections are above expectations, thus supporting public finances additionally. On the other hand some problems exist in the system. Revenues from the Indirect Taxation Administration's single account are distributed between the two entities and Brcko District according to a coefficient, which is a subject of political debates. Even further problems occur, because many tax payers fail to report the final consumption in VAT claims, on basis of which distribution coefficients can be calculated.

The new foreign debt of the government sector was KM 34 million in the first quarter of 2006, while in the same period repayment of loans' principal was KM 37 million, thus the government sector's total foreign debt decreased. According to representatives from the IMF, Bosnia and Herzegovina may start talks on a stand-by arrangement only after the elections in October. The EBRD is providing EUR 12 million loan for the realisation of the project of managing air traffic.

It can be notified as a signal of slight improvement that in May 2006 Moody's upgraded the country's key debt ratings from B3 positive outlook to B2 with stable outlook, although on the other hand this still embodies high risk.

## Balance of Payments

According to the Central Bank of Bosnia and Herzegovina, in the first quarter of 2006 current account deficit was KM 222 million, and thus it has been the lowest in the last four years. This means that the deficit was 48% lower than in the same period of the last year, and it was five times lower than in the previous quarter. Besides noting the development, we

must mention that this can partly be explained by the introduction of the VAT, which had a one-off impact on imports in the end of 2005. As far as the rest of 2006 is concerned, trade deficit is expected to worsen, but what is important that the positive trend on the export side is likely to continue.

If we take a look at the structure of the balance of payments, we can see that the exchange of goods has improved, due to the fact that its deficit was KM 1 089 billion, representing the lowest level since balance of payment statistics are being compiled, since 2001. Comparing the deficit of goods in the first quarter of 2006 to the same quarter of 2005, the deficit decreased by KM 310 million, that is by 22%. Most of the imports were related to mineral fuels and oil, followed by machinery and equipment. Import came mainly from Croatia, Germany, Serbia and Montenegro, Italy, Slovenia and Austria. In the same period the service account did not show significant change compared to the same period of the previous year, it recorded KM 187 million surplus. Looking at the composition of this surplus we can see that the incomes from construction works abroad, from tourism and from communication services were the major contributors. In the first quarter of 2006 the financial account showed low level of surplus, due to the reducing of cash and deposits, which decreased by KM 135 million in case of non-residents, while the central bank's foreign reserves increased by KM 242 million.

The trade deficit is partly compensated by transfers and remittances from abroad. FDI inflow can still be considered low, and in the first three quarter of 2005 it even decreased by 36.9% and amounted around KM 470 million. Most of the FDI went to the banking sector (50%) and production (42%). FDI inflow is strongly related to the pace and success of the privatisation process.

## Labour Market Developments

The official unemployment rate is still the highest in the region and is over 40%. Unfortunately the official data is unreliable and due to the immense grey economy, real unemployment rate is expected to be "only" around 20%. Official and real unemployment rate may increase slightly in 2006.

**Table 3. Major macroeconomic indicators for BH, 2003-2006**

	2003	2004	2005*	2006**
GDP growth	3.0	5.1	5.5	6.0
Private consumption (%)	n. a.	n. a.	n. a.	n. a.
Public consumption (%)	n. a.	n. a.	n. a.	n. a.
Investments (GFCF, %)	n. a.	n. a.	n. a.	n. a.
Export (%)	11.5	28.7	24.0	20.0
Import (%)	6.0	7.6	13.6	12.0
Retail price index (average, %)	0.1	0.2	2.1	2.5
Unemployment rate (%)	40.5	40.5	41.5	42.5
General government balance <sup>1</sup> (%)	0.4	-0.1	0.1	0.3
General government debt/GDP (%)	34.0	32.8	32.0	31.8
Current account balance/GDP <sup>1</sup> (%)	-24.5	-23.3	-24.4	-22.6
Trade balance/GDP (%)	-58.4	-53.3	-53.1	-52.0
Gross foreign debt/GDP (%)	34.0	33.0	32.0	32.0
Exchange rate (BAM/EUR)	1.956	1.956	1.956	1.956
Interest rate (end of year, %)	2.0	2.0	2.0	2.0

Source: Central Bank of BH, FZS

\* Preliminary data \*\* Forecasts; <sup>1</sup> including grants

## BULGARIA

### High economic growth with increasing external imbalances

#### Economic Growth

In the first quarter of 2006 the good performance of the Bulgarian economy continued. The gross domestic product (GDP) increased by 5.6% in real terms, which was almost the same as the growth rate in the final quarter of last year (5.5%).

On the production side, both industry and services reached high growth rate, the gross value added of the two sectors increased by 8.8% and 6.0% respectively in the first three months of 2006. On the other hand, the performance of agriculture sector was weak, gross value added of the sector decreased by 2.7%. However, the negative contribution of the agriculture sector to GDP growth was much lower than in the fourth quarter of 2005. According to our calculations, the drop of the value added in agriculture sector had only a 0.1%-point negative impact on the first quarter GDP growth.

On the expenditure side, one can observe that the last year's tendencies continued in the first quarter of the year. Namely, private consumption and investments fuelled the economy in course of that period. Private consumption growth reached 5.4%, while that of the public consumption remained basically unchanged (+0.1%). It is worth mentioning that the growth rate of private consumption decreased somewhat (2%-points) compared to the last quarter of 2005.

On the other hand, gross fixed capital formation increased by an enormous rate (21.4%) in the first three months of the year. It resulted in that gross fixed capital formation reached again also 24% of the GDP in that period. It reflects well that investments play a significant role in economic growth.

In the meantime, net exports had a massive negative impact on GDP growth in the first quarter of 2006. Export of goods and services increased by 12.9%, while the import of goods and services grew by 20%. It means that the

balance of trade and services deteriorated further significantly.

In 2006 the sound growth of the Bulgarian economy is expected and GDP growth rate can reach 5.8% if weather conditions will be favourable. On the other hand, private consumption and investments are expected to remain the main engines of growth.

#### Monetary Conditions

During the second quarter of the year consumer price index increased somewhat compared to the first quarter of 2006. The average consumer price index was 8.3% between April and June 2006. The highest CPI was observed in May when the index reached 8.5%, while in June consumer price index decreased slightly to 8.0%.

The higher inflation rate is basically due to the price increases of tobacco and alcoholic beverages in the first three months of the year. The prices of alcoholic beverages and tobacco products increased by 56% compared to December 2005. In the next three months, monthly consumer price indices remained low, however, the price increases in the first quarter had a negative impact on the y-o-y indices.

As a result of the increasing inflation (and strong private consumption) the Bulgarian National Bank increased its base rate in almost every month of 2006 (May was the exception). As of the beginning of July 2006, base rate was increased to 2.69%, while it was 2.05% at the end of last year.

In course of the year the tendency of June is expected to continue, namely inflation rate will decrease slowly. On the other hand, further increase of the administrative prices and indirect taxes are expected due to the fact that the government decided to bring forward these measures to be able to adopt the single European currency at the end of the decade, as soon as possible after the accession (2009-

2010). Thus, annual average consumer price index can reach 7.9% in 2006, according to our expectations.

### **Fiscal Developments**

In the first three months of the year the budget balance had a surplus in Bulgaria. The surplus of the budget reached EUR 219 million in the first quarter. The surplus of the primary balance was even higher; it was EUR 391 million. The good balance was achieved by the significant increase of the tax revenues in this period, while the expenditures increased only moderately.

In April these tendencies continued and the primary balance had a surplus of EUR 680 million. For 2006 we expect that general government balance will have a surplus due to the robust growth of the economy and the tight fiscal policy. For the whole year we forecast a surplus of 1.0% of GDP.

The massive amount of the budget surplus and the rapid economic growth supported the further decline of the general government debt during the first quarter of the year. At the end of March 2006 the public debt decreased to 27% of GDP. In course of 2006, the same tendencies will continue, accordingly the public debt is expected to decrease further, and it can go down to 25% at the end of the year.

### **Balance of Payments**

In the first five months of the year the negative trend continued and current account deficit increased significantly. Between January and May C/A deficit reached EUR 1 745 million, which was higher by 73% than the deficit in the first five months of 2005. Basically, all components of the current account deteriorated during this period compared to the same period of the previous year.

Regarding the foreign trade balance, both export of goods and import of goods increased by 29-30% in euro terms. As the value of import was significantly higher than that of the export, the almost same growth pace resulted in a 28% increase of the trade deficit. The import is mainly boosted by high domestic demand

(consumption and investments), while the export sector's good performance was the result of the growing presence of foreign companies and the Bulgarian economy's rising competitiveness.

The other major factor that worsened the current account balance was the deterioration of services balance compared to the last year. In the first five months the services balance had a deficit of EUR 258 million, while it was only EUR 46 million a year before. Beside the balance of goods and services, the balances of incomes and current transfers also worsened, however, in these cases not the deficit grew but the surplus decreased. However, the role of the deterioration of these two balances played much less role than the aforementioned two balances.

In line with the worsening C/A balance, the amount of foreign direct investments improved. Between January and May 2006 net FDI amounted to EUR 1 164 million which was able to finance 66.7% of the current account deficit.

For the entire year we expect that these tendencies will continue and current account deficit can reach 15% of GDP mainly due to the worsening trade and services balance.

### **Labour Market Developments**

In the labour market the positive trends continued and the unemployment rate declined further. In the first quarter of 2006 unemployment rate decreased to 9.7%, which was lower by 1.6%-point than that of the unemployment rate in the first half of 2005. It also means that the number of unemployed persons were lower by 47 thousands.

On the other hand, employment rate also improved and it increased from 42.5% to 44.2%. The positive trend is basically due to the strong economic growth.

For 2006 the further decline of unemployment rate and the gradual increase of the number of employed persons are expected. We forecast that unemployment rate will decrease to 9.0% in 2006 considering the strong economic growth.

**Table 4. Major macroeconomic indicators for Bulgaria 2003-2006**

	2003	2004	2005	2006*
GDP (%)	4.3	5.7	5.5	5.8
Private consumption (%)	6.4	4.5	7.4	6.0
Public consumption (%)	7.3	6.0	2.2	3.0
Investments (GFCF, %)	14.0	12.0	19.0	18.0
Exports (%)	8.0	13.0	7.2	10.0
Imports (%)	15.0	13.0	14.6	14.0
Consumer price index (annual average, %)	2.3	6.2	5.0	7.9
Unemployment ratio (%)	13.5	12.2	10.7	9.0
General government balance (%)	0.0	1.7	3.2	1.0
General government debt/GDP (%)	48.2	40.7	31.9	25.0
Current account/GDP (%)	-9.2	-5.8	-11.8	-15.0
Trade balance/GDP (%)	-12.5	-15.1	-20.4	-22.5
Gross foreign debt/GDP (%)	60.2	64.2	67.7	65.0
Exchange rate (BGN/EUR)	1.96	1.96	1.96	1.96
Base rate (%)	2.6	2.7	2.0	2.5

Source: BNB, NSI; \* Forecasts



## CROATIA

Continous considerable growth performance with strengthening sub-market performances

### Economic Growth

Croatian real economy performance continued to come out with regionally remarkable indices of growth. After 5.1%, 5.2% and 4.8% quarterly real GDP growth rates of last three quarters in 2005, the first quarter of 2006 outperformed its earlier indices of ten quarters and resulted in 6.0% real GDP growth related to the same period of 2005. That is a record as concerned the latest two and a half years. After last year 4.3% yearly performance, that is an index far over expectations our prediction on the current 2006 year seems to be underpinned by first period data.

As concerned the composition of GDP growth measured by expenditure method, the growth can be evaluated as healthy. The first quarter rise of gross fixed capital formation by 18.1% performed far above the average index of real GDP growth. As a matter of fact the private consumption contributed also considerably as it was 4% in first quarter, while the public consumption remained moderate, it grew by 1%. Thus domestic demand is the main growth factor. Investments and consumption was mainly fuelled in the first quarter of 2006 by the extremely high 16.1% import rise that was partially offset by the 14% rise of exports that changed the trend of previous periods of decreasing deficit of net exports.

As of supply side of growth performance, every branches of economy managed to overcome its previous quarter value added growth index that compares the current quarter with the same quarter of the corresponding period. The industrial growth accelerated to 6.4% in the first quarter year on year, after a 5.1% annual data of 2005. The growth was driven mainly by the largest contributor manufacturing 6.4% (especially food and beverages 5.2%, metal, non-metallic and machinery production and publishing and printing), mining and quarrying 7.4%. By MIG grouping the production of intermediate and

capital goods were above the average growth rate.

Other most important pulling contributors in the first quarter were construction with its real value added growth rate of 11.5% (Construction works in the 1st quarter increased by 15.9% a compared to the same period of 2005), transport, storage and communication 9.9%, financial intermediation 8.9%. The retail trade turnover in real terms was 2.7% that is 0.6 percentage points higher than in the previous quarter.

The tourist sector rather stagnated in first quarter by its 1% rise in arrivals and 3% drop in nights backed by strong growth experienced in domestic tourist turnover (14% measured by nights) and decrease by foreign tourists (-19% in spent nights).

According to favourable international growth prospects and auspicious structure of growth driven mainly by strong capacity building defined by high investment activities this year can develop into remarkable 5% GDP growth and next year in 4.5% growth following the international slowdown. The main risk of these estimations lies in the tourism sector performance. The strong credit growth and the unbroken consumer confidence will strengthen the domestic demand contribution to its growth prospect, especially in 2007 when parliamentary elections will be held.

The biggest near-term risk lies in the fuel, oil prices. The oil price assumption of the forecast (USD 68.9 per barrel on average for 2006 and USD 71 per barrel for 2007) is subject to a considerable risk, both on the upside and downside.

### Monetary Conditions

In May 2006, the prices of goods and services for personal consumption, measured by consumer price indices increased by 4% at the annual level as compared to the same month of previous year and by 3.5% at the



annual twelve month average, reflecting the accelerating inflation in line with our previous estimations. The core inflation however declined as the peace of adjustment of administrative prices slowed down.

Investigating the composition of CPI, reviewed by main groups of products annual average growth, the highest increase was shown in prices of: food 3.9% (especially meat, fruits); housing, water, electricity gas and fuels 5.8%; medical services. Thus the services and the food, beverages and tobacco increased above the average peace by 4% and 3.8% respectively.

The estimation of 4.6% annual average CPI growth is kept further, reflecting acceleration trend driven mainly by continuous, but slower adjustment of administrative prices and strong oil price increase, however kept by Kuna appreciation against the main foreign currencies. The strong domestic demand also causes upward pressure on inflation rate. The main pushing up factor is the growing wages that pulls consumer prices from demand side. Also the inflation pressure coming from outside the country affects through imported inflation underpinned by strong import dynamics the domestic CPI index.

The Kuna is kept stable as its exchange rate against the Euro experiencing a slow natural appreciation with from time to time intervention of CNB on forex market in the exchange rate system of managed float. Henceforward, in 2006 no remarkable change in the exchange rate of the Kuna is expected and the Euro will fluctuate around 7.25-7.3 Kuna. However, slow appreciation has to be realized that can result in the end of the year in a 7.25 HRK/EUR exchange rate.

### **Fiscal Developments**

The general government deficit has been managed to reduce from 5.0% of GDP in 2004 to estimated 4.2% in 2005 that data is in line with our previous expectations.

The forecast for 2006 assumes a further reduction of the deficit to 3.8% in 2006. This reduction peace is viable due to accelerated GDP growth and higher tax receipts via its relative position. But the growing wages, repayment of pensioner's debt and the stronger public consumption, especially in 2007

election year can have negative effect on adjustment in case of economic slowdown. As of government debt, only slow reduction, rather stagnation is possible.

In case of fiscal developments, the remarkable GDP growth is the main determination factor, thus the main risk.

### **Balance of Payments**

The current account of Croatia has widened sharply in 2005 to 6.3% as compared to 2004 5.2%, because of widening deficit of trade balance up by 0.4 percentage points from 23.7% in 2004, that was only partially offset by well performing service balance (surplus up by 0.7 percentage points to 17.1% in 2005) backed by strong tourism sector season realized in third quarter of 2005. Additionally the income deficit rose and the transfer surplus narrowed. The current account deficit was covered in a 60% in 2005 by FDI.

Somehow we have to redefine our estimation on the external balance represented by trade and current account balances. The trade balance will keep its high level, but it is to increase due to boosted investment and consumption demand on imported goods. Despite of the strong double digit export performance, the net exports rose. As regarding to total current account balance, it depends on performance of service and mainly on tourism sector performance. Taking into consideration the favourable growth expectations the current account balance will be on around 6.5% as compared to GDP and the trade balance on 23%.

As of FDI in capital account, due to continuing and accelerating privatization processes the current account balance will be financed on the level experienced in previous years (50-60% of the CA deficit).

The external demand is expected to improve in the current year, as the EU is forecasted to grow more rapidly, thus the exports growth (with high import content) will be moderated by consumption and investment driven import rise. Growth of exports is driven mainly by strong services exports, while at the same time the rising stock of FDI and the acceleration of gross fixed capital formation improve the prospects for merchandise exports.

Real imports are expected to expand more slowly than exports, but they will accelerate in line with growing GDP mainly due to the high import demand of private investments and consumption.

### **Labour Market Developments**

The number of persons in paid employment rose by 0.8% (women 1.2%) in the first five months of 2006 as compared with the same period of previous year and reached 1 120 897 persons. Branches of economy that managed to growth employment were: construction (2.9%), wholesale and retail trade (4.1%), financial intermediation (3.6%), education (2.6%). Agriculture and the main employer manufacturing decreased employment by 4.3% and 2.8% respectively.

The total registered unemployment rate in May 2006 was 16,7% that is 1.7 percentage point lower than in the beginning of the year, continuing its downward trend-line backed mainly with strong real sector developments. According to recent labour force survey data, the unemployment rate is on 13% by the end of the year 2005 as compared to 13.8% in the end of 2004.

In comparison with January-April 2005, the average monthly paid off net earning for the same period of 2006 was nominally by 5% and really by 1.4% higher. The most considerable increase were observable in agriculture (6.5% in real terms, change index of average monthly paid off net earnings according to payoffs for month), mining and quarrying (5.1%).

The good trend in labour market seems to be continued as the main influencing factors, like accelerating real GDP growth, boosted tourism in the current year and the earlier started labour market reforms will affect positively the unemployment decrease to a 12.5% in 2006, and the moderate employment rise.

**Table 5. Major macroeconomic indicators 2003-2006**

	2003	2004	2005	2006*
GDP (%)	4.3	3.8	4.3	5.0
Private consumption (%)	4.1	3.9	3.4	4.1
Public consumption (%)	-0.3	-0.3	0.8	1.1
Investments (GFCF, %)	16.8	4.4	4.8	12.0
Exports (%)	10.1	5.4	4.6	10.0
Imports (%)	10.9	3.5	3.5	11.0
Consumer price index (average, %)	1.8	2.1	3.3	4.5
Unemployment (%)	14.3	13.8	13.0	12.5
General government balance (%)	-6.3	-5.0	-4.2	-3.8
General government debt/GDP (%)	51.5	54.0	53.5	53.0
Current account balance/GDP (%)	-6.9	-5.2	-6.3	-6.5
Trade balance/GDP (%)	-27.5	-25.5	-25.0	-23.0
Gross foreign debt/GDP (%)	77.6	82.5	82.5	80.0
Exchange rate on December 31 HRK/EUR)	7.64	7.67	7.37	7.25

Source: Croatian National Bank, DZS; \* Forecasts

## FORMER YUGOSLAV REPUBLIC OF MACEDONIA

### Improving external balance and employment figures

#### Economic Growth

According to the preliminary figures the gross domestic product increased by 4.0% in course of 2005. In the last quarter of the year the GDP increased by 3.8% compared to the same quarter of the previous year. That was the second lowest figure out of the four quarters of 2005. Therefore, the declining growth of GDP reflects well that the growth rate in 2006 will not exceed significantly the figure of 2005. In line with the dropping GDP growth rate, industrial production also achieved a slowing performance in course of the last year. While the growth rate of industrial production reached 13% in Q2 it declined to only 4.1% in the last quarter.

On the production side, industry and some sub-divisions of services were the main engines of the economic growth in 2005. The gross value added of the industry sector increased by 6.8% in course of 2005, while that of the wholesale and retail trade (+7.9%), hotels and restaurants (+6.6%) and transport and communications (+6.1%) also achieved significant growth. On the other hand, the agriculture sector's performance was only moderate (+3.1%) and construction contributed negatively to GDP growth (-5.0%).

In the first quarter of the year, the industrial production increased by only 0.5% and that trend changed only slightly in the next two months. Between January and May 2006 the industrial production was basically on the same level as it was in the same period of 2005. Although these figures measure the volume index of industrial production, we expect that the growth rate of the gross value added in industry is likely to be lower compared to the same period of the previous year.

Considering the aforementioned trend we expect that real GDP growth in the Former Yugoslav Republic of Macedonia can reach 3.3%, which will represent a slight drop in the economic growth in 2006.

#### Monetary Conditions

The consumer price index (CPI) increased somewhat in comparison with the average inflation rate of the last few years. In the first half

of the year consumer price index reached 3.1%. Even if the CPI increased significantly in the first half of the year the level of the inflation can be still considered as low.

As it was mentioned in our previous Quarterly Forecast, the tobacco prices increased by 36.9% in January 2006 (due to increasing excises), and CPI rose by 1.7% compared to the previous month. In May 2006 the prices of vegetables (+9.8%), fuels (+6.1%) and road transport of passengers (6.4%) increased significantly and accordingly consumer prices increased by 1.2% compared to the previous month. The former (vegetables prices) was due to seasonal effect and prices declined in June, while the increasing prices of fuels and transport were the result of the hiking international oil prices. In the other four months of the first half of 2006, consumer prices remained basically unchanged.

Due to the exogenous factors such as the increasing oil prices that had negative impact on the consumer price index, we increased our forecast on the annual average CPI. We expect that CPI can reach 2.5% in Macedonia in course of the year.

#### Fiscal Developments

During the first two months of 2006 general government deficit reached EUR 23.7 million. It is significantly higher than the deficit at the end of February 2005. The higher deficit this year is basically due to the decrease of tax revenues. As of the beginning of 2006, the delayed payment of VAT for goods for inward processing was introduced according to a new law, which resulted in the lower VAT revenues. On the other hand, the expenditures of the budget increased by 4%, therefore, the overall budget deficit became higher in relation to the same period of the previous year.

In course of the year we expect that the deficit of the general government balance will increase slightly in comparison with 2005. The revenue will go up in the later months and the drop back of the revenues will be only temporary. Accordingly, our forecast is that the budget deficit can reach 1% of the GDP.

## Balance of Payments

Between January and March 2006, current account balance had a slight deficit in the Former Yugoslav Republic of Macedonia. In the first three months the current account deficit reached EUR 15.4 million which was almost equal to the deficit of the first quarter of 2005 (EUR 16 million). However, the balances of the components of the current account were not the same.

On the one hand, the balance of goods deteriorated by EUR 53.5 million or by 36.8% in euro terms compared to the same period of the previous year. On the other hand, the balance of current transfers improved by almost the same amount (EUR 53.1 million), which meant that the improvement of the balance of current transfers counterbalanced the deterioration of the trade balance. The balance of current transfers improved via the private transfers. The balances of the other two components of the current account remained basically unchanged.

During the first three months the amount of foreign direct investments increased to EUR 214 million which was able to finance the small current account deficit.

In 2006 we expect that the export sector will improve its performance and the growth rate of export will increase later in this year. This can have a positive impact on the foreign trade balance and current account. Besides that, current transfers will also play an important role in the development of current account. We expect that current account deficit will reach 3% of GDP while trade deficit can decline to 19%.

## Labour Market Developments

In the first quarter of the year the activity rate improved further and it increased to 54.3%. This

figure was 2.7%-points lower in the same period of the previous year. The activity rate of the economy increased not by the growth of unemployed persons but via the increase of the employed persons. Namely, not the inactive persons started to seek jobs.

Accordingly, the unemployment rate decreased to 36.2% while it was 38.7% in the first quarter of 2005. In line with that progress, the employment rate rose from 31.6% to 34.6%. It means that the number of employed persons increased by more than 50.000 while the number of unemployed persons decreased by 2.000. Regarding the high rate of informal economy in the country the aforementioned trend reflects the whitening of the grey economy.

However, the size of the informal economy is still high and we always state that this is the official unemployment rate and it should be evaluated carefully in Macedonia. It is usual that people register as unemployed to access health insurance or social assistance while working at the grey sector at the same time. According to estimations, the rate of the really unemployed persons is approximately half of the official rate.

For 2006 we forecast that current trend will continue and the activity rate and the employment rate will increase gradually. As a result the unemployment rate will decrease and it can decline close to 36% at the end of the year.

**Table 6. Major macroeconomic indicators for the FYROM, 2003-2006**

	2003	2004	2005*	2006**
GDP growth (%)	2.8	4.1	4.0	3.3
Private consumption (%)	1.8	5.8	n. a.	n. a.
Public consumption (%)	-4.3	4.6	n. a.	n. a.
Investments (GFCF, %)	3.7	9.3	n. a.	n. a.
Export (%)	2.4	9.1	n. a.	n. a.
Import (%)	-2.5	12.4	n. a.	n. a.
Consumer price index (average,%)	1.2	-0.4	0.5	2.5
Unemployment (%)	36.7	36.7	36.5	36.2
General government balance (%)	-1.0	0.0	-0.6	-1.0
General government debt/GDP (%)	39.0	37.6	41.0	39.0
Current account balance /GDP (%)	-2.9	-7.7	-1.5	-3.0
Trade balance /GDP (%)	-16.4	-20.6	-19.3	-19.0
Gross foreign debt /GDP (%)	38.1	38.4	38.0	37.5
Exchange rate (end of per., MKD/EUR)	61.3	61.3	61.2	61.2
Discount rate (end of year, %)	6.5	6.5	6.5	6.5

Sources: NB of the Rep. of Macedonia, State statistical office of the Rep. of Macedonia, own calculations

\* Preliminary and estimated data \*\* Forecasts



## ROMANIA

### Acceleration of GDP growth is expected in 2006

#### Economic Growth

In the first quarter of the year the gross domestic product (GDP) increased by 6.9% compared to the same quarter of the previous year. As we expected in our previous Quarterly Forecast, the economic growth gained some momentum after the relatively moderate performance of 2005 when GDP growth reached 'only' 4.1% in real terms.

On the production side, the excellent economic growth was due to the outstanding performance of the construction sector (+20.4%) and the significant growth of the gross value added in services (+6.8%). In case of services, retail trade increased significantly which had a considerable positive impact on the performance of services in that period. On the other hand, the growth rates of the gross value added of industry and agriculture were lower. The growth rate of the former sector reached 4.8% while that of the agriculture was -5.3, which represents a slight decline compared to the same period of the previous year.

On the demand side, private consumption and investments remained the main engines of the economy as it was expected. Private consumption increased by 10.9% in the first quarter of 2006, which was higher than that in 2005 and it can be considered as high. Besides consumption, gross fixed capital formation also registered a high growth rate (+11.4%) in the first quarter of 2006, which was, on the other hand, a slight decrease compared to the previous year.

In line with the robust domestic demand, net exports had a negative contribution to GDP growth. In the first quarter of the year, the import of goods and services increased by 18.7%, while that of export reached 13%. Accordingly, the balance of goods and services deteriorated further which had a negative impact on the current account balance as well.

These processes reflect that the last year's trend continued as it was expected. The first quarter's GDP figure was excellent, thus we raised our forecast for 2006 GDP to 5.8% from

5.5%. In course of the year, we expect that private consumption and investments will fuel the economy on the demand side. On the supply side, we expect that agriculture sector can also catch up, and can reach a good performance, especially if one considers the low basis of 2005, and assumes that the weather conditions will be favourable.

#### Monetary Conditions

In the second quarter of the year, consumer price index started to decrease slightly. While, in the first three months of 2006 the average CPI was over 8%, it declined somewhat and dropped close to 7% in the second three months of the year.

During the first one and a half month of the second quarter, the appreciation of the Leu and the tightened monetary policy had a positive impact on the evolution of the consumer price index. However, in mid-May, the appreciation of the RON halted and in the next 1.5-2 months the RON depreciated by more than 3% against the euro. One of the main reasons for the depreciation of the Romanian currency was the increasing doubt about the exact date of EU accession. Namely, the European Commission prolonged the declaration of the final date of Romania's EU entry in May, which had a negative impact on the exchange rate of the Romanian currency.

Thus, even regarding the fact that the monetary policy was stricter (compared to the beginning of the year) and the Board of the National Bank of Romania (NBR) maintained the monetary policy rate at 8.5%, the deflation process stopped again and the consumer price index has not changed significantly between April (6.9%) and June (7.1%).

For 2006 the inflation target was set at 5% with a +/-1%-point range. In June it seems that the inflation target is more realistic than it was in March and that is mainly owing to the significantly tighter monetary policy. However, the inflation target is still hardly achievable and we expect that CPI will exceed the target in December if current trends continue. For the



whole year we expect that the annual average CPI will be 7.2%.

### **Fiscal Development**

In the first five months of 2006 central government balance had a slight surplus (EUR 170 million), which was 36% less than it was in the same period of the previous year. As it was mentioned in our previous Quarterly Forecast, further changes were implemented in taxation such as the decrease of the social security contribution rates, at the beginning of January 2006. These reforms improve the business climate of Romania but it had a negative impact on budget balance. Compared to January-May 2005, this year the growth of expenditures significantly overpaced that of the revenues.

For 2006 the budgeted deficit is 0.5% of GDP. We forecast that the budget balance will remain low but the general government deficit can reach 1% of GDP in 2006.

### **Balance of Payments**

In the first four months of 2006 the current account balance continued to deteriorate further. At the end of April the deficit of the current account balance reached EUR 2 486 billion, which was higher by close to EUR 1 billion or 57.2% compared to the first four months of 2005. The massive deterioration of the current account balance was basically the result of the increasing deficit of the trade balance.

Foreign trade balance deteriorated by EUR 900 million compared to same period of the previous year. The import of goods increased by almost 25%, while, the growth rate of export of goods was ‘only’ 17.2% in that period. It resulted in the massive deterioration of the foreign trade balance and therefore the deficit of the current account balance also increased

significantly. The high growth of import is basically owing to the robust domestic demand. Both private consumption and investments fuel the import of consumer and capital goods.

Besides foreign trade balance, the balances of incomes and current transfers also deteriorated slightly but these two components of the current account had no significant negative impact on the C/A balance. In contrast, only the balance of services improved somewhat (+EUR 195 million) compared to the same four months of the previous year.

Meanwhile, the inflow of foreign direct investments also increased noticeably and reached EUR 2.3 billion between January and April 2006. It means FDI was able to finance the major part of the C/A deficit.

For 2006 we expect that current tendencies will continue and current account deficit can reach 10% of GDP. The trade deficit can go up to 11% of GDP basically due to the strong domestic demand in 2006.

### **Labour Market Developments**

The number of registered unemployed persons decreases further in the second quarter of the year. In May 2006 the number of registered unemployed persons was lower by almost 15.000 than in May 2005. Accordingly, in May, unemployment rate dropped to 5.5%, which was the lowest figure in this decade. In line with the decreasing unemployment, employment figures also improved.

For 2006 we expect that current trend will continue due to the robust economic growth, and further decline of the unemployment is expected.

**Table 7. Major macroeconomic indicators for Romania 2003-2006**

	2003	2004	2005*	2006**
GDP growth (%)	5.2	8.3	4.1	5.8
Private consumption (%)	7.2	10.8	9.0	10.0
Public consumption (%)	4.6	4.6	3.0	3.0
Investments (GFCF, %)	9.1	10.1	13.0	11.0
Exports (%)	11.4	14.1	7.6	12.0
Imports (%)	16.4	17.8	17.2	17.0
Consumer price index (average, %)	15.3	11.9	9.0	7.2
Unemployment (end of period, %)	7.4	6.3	5.9	5.6
General government balance (%)	-2.3	-1.1	-0.8	-1.0
General government debt/GDP (%)	21.3	18.5	19.0	19.0
Current account balance /GDP (%)	-6.0	-8.4	-8.7	-10.0
Trade balance /GDP (%)	-7.8	-9.0	-10.4	-11.0
Gross foreign debt /GDP (%)	31.1	31.1	31.0	31.5
Exchange rate (RON/EUR) ***	3.76	4.05	3.62	35.5
Reference rate (end of year, %)	21.25	17.96	7.5	8.5

Sources: EC, NBR, own calculations

\* Preliminary data \*\* Forecasts; \*\*\* As of 1st of July 2005, RON is the new currency.

## SERBIA AND MONTENEGRO

### Favourable growth prospects in the now independent states

The referendum held on the 21st of May in Montenegro resulted in a vote for independence. As a consequence the Union of Serbia and Montenegro (SCG) disintegrated. Therefore our economic analysis should be viewed accordingly.

#### Economic Growth

Last year, and in the first quarter of 2006 growth was driven both in Serbia and Montenegro by the services sector. The trade and transport sector was the main driving force in Serbia, while in Montenegro, from the services sector tourism contributed most to economic performance.

A month-on-month decrease was experienced in industrial production in the first two months of 2006 in Montenegro, while in March a 23.3% increase occurred. Compared to the previous year industrial production grew by 3% in March in Montenegro. A similar trend was observable in Serbia, with the growth rate of industrial production turning positive (reaching 5.3%) in March, after the decrease in the first two months of the year.

Real GDP growth is expected to reach 5% year-on-year in 2006 in Serbia. The key objective of Serbian economic policy is to reach a 6.5% average year-on-year economic growth rate annually in the time period between 2007 and 2009. The main driving force behind the expected high real GDP growth rate will be the rise in investment and exports. Continuing structural reforms, as well as capital inflows from privatisation transactions will also help to achieve the high rate of economic growth. In Montenegro tourism is expected to remain the main driving force behind growth, as tourism is the most important sector, and the country is becoming more and more popular among foreign tourists.

#### Monetary Conditions

In May the average annual growth of retail prices reached 16.1% in Serbia. Month-on-month retail prices increase amounted to 1.6%. Overall retail price growth in the first four months of the year was 4.1% compared to

December 2005. The greatest contributor to the price increase was the growth in the prices of industrial non-food products, caused by the increase of the electricity price (from the 1st of April), and the increase in the price of petroleum products, driven by the rise of world oil prices.

The fight against inflation remains a top priority of Serbian economic policy. The coordination of monetary and fiscal policy, along with the implementation of structural reforms will contribute to inflation reduction efforts. In Q1 2006 interest rates of the National Bank of Serbia remained unchanged. Therefore the discount rate remained at 8.5%.

In Serbia, year-on-year inflation in December is expected to reach 9.3%, while yearly average inflation is expected to reach 13.5% in 2006. Inflation is still not a cause of problems in Montenegro. After achieving a low (2.4%) inflation rate in 2005, average inflation reached 2.9% in Q1 2006.

#### Fiscal Developments

Fiscal policy remained restrictive in Serbia in Q1 2006. In 2005 the budget surplus as a percentage of GDP was positive, reaching 0.9%, which is lower than expected. An improvement to 2.4% of GDP is expected in 2006. At the same time the fight against inflation would require an even tighter fiscal stance. The government has agreed to save all windfall revenues above the level of revenues identified in the budget for 2006. This means a willingness to make a countercyclical adjustment of fiscal policy. The government has committed itself to a 3.6% of GDP budget surplus target for 2005 and 2006. The ambitious target was not achieved in 2005, and it is not expected to be achieved in 2006 either.

As for Q1 2006, the budget showed a deficit in January, but turned into a surplus in February and March. This indicates a fiscal tightening compared to the previous year, as in all three months of Q1 2005 the Serbian budget showed a deficit.

### **Balance of Payments**

In Q1 2006 a surplus occurred in the overall balance of payments, which was higher than in the same period of the previous year (USD 531 million and USD 206 million respectively). However the current account deficit increased by USD 143 million and amounted to USD 619 million. Total trade deficit increased by 34.4% compared to the same period in the previous year. At the same time the rise of the current account deficit was offset by the rise in the balance of current transfers, which was mainly due to increased net inflows into foreign exchange accounts of non-residents, and an increased financial account balance.

Net inflows of foreign direct investment were lower by USD 128 million and amounted to USD 215 million. The process of bank privatisation resumed in Q1 2006, when the sale of Niska Banka to the Hungarian OTP was completed, at a price of EUR 14.21 million. Two other banks are planned to be sold to foreign banks in July and August.

### **Labour Market Developments**

In February 2006 unemployment rate in Serbia was 30.7%. This was a reduction

compared to the previous month, when it amounted to 32.4%. The official unemployment rate has been continuously above 32% since November 2004. In March the number of job seekers was 920,031, which was an increase by 4.1% compared to the same month in the previous year. The number of employed in Q1 2006 in Serbia was 0.8% lower than in December 2005. Therefore we can draw the conclusion that the situation in the labour market has not improved compared to the previous year and the previous quarter. Acceleration of economic growth has not yet eased the problems in the labour market. Further structural changes in the economy will contribute to increasing employment. The rise in employment will also be promoted by rising foreign investment, entrepreneurship and creation of favourable start-up conditions, and the introduction of financial incentives for raising employment.

The real growth rate of net earnings was above 10% year-on-year in the first three months of the year in Serbia. In April it amounted to 6.2% (y-o-y). This means that the year-on-year growth rate of net earnings was higher in the first four months of 2006 than in the same months of the previous year.

**Table 8. Major macroeconomic indicators for S&M, 2003-2006**

	2003	2004	2005	2006*
GDP growth (%) Serbia & Montenegro	2.7	7.2	5.1	5.0
-Private consumption (%)	n.a.	n.a.	n.a.	n.a.
-Public consumption (%)	n.a.	n.a.	n.a.	n.a.
-Investments (%)	n.a.	15.5	17.0	n.a.
-Export (%) Serbia	33.7	30.7	20.9	22.0
-Import (%) Serbia	32.9	44.5	11.1	10.0
GDP growth (%) Serbia	2.4	9.3	6.5	5.0
GDP growth (%) Montenegro	2.3	3.1	4.0	4.2
Consumer price index (average, %)	9.7	10.9	15.2	11.5
Retail prices (% p.a.) Montenegro	7.8	3.3	2.4	2.6
Retail prices (% rel. to end of last year) Serbia	7.8	13.7	17.7	15.5
Unemployment rate (%) Serbia	31.7	31.7	32.6	32.0
General government balance (% of GDP) Serbia	-1.4	-0.1	0.9	2.0
General government debt/GDP (%) Serbia	71.6	56.6	46.2	43.2
Current account balance/GDP (%) S&M	-7.4	-13.4	-8.7	-8.3
Trade balance/GDP (%)	-24.1	-28	-25	-22.0
Gross foreign debt/GDP S&M	69.9	61.1	61.6	58.8
Average exchange rate (CSD/EUR)	65.1	72.6	83.2	89.4
Base rate	9	8.5	8.5	8.5

Sources: IMF, National Bank of Serbia, Central Bank of Montenegro, BA-CA

\* Forecasts