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Quarterly

# Forecast

on Southeast Europe

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## Overview

*Good performance observed in this year and this trend is expected to continue in 2007*

### *Economic growth*

Economic growth will be higher in most Southeast European countries in 2006 than it was in the previous year. Real GDP growth rate will reach or exceed 5% in all SEE countries except for the Former Yugoslav Republic of Macedonia, where a significant drop is expected in case of GDP growth rate. The highest rate is expected in Romania where economic growth returned to its former high growth pace after a moderate growth in 2005. Real GDP growth is expected to exceed 7% in the largest economy of the region.

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.

In 2007 these tendencies will continue and economic growth will remain strong, while growth rate of the region will exceed 5% again. Economic growth will decrease somewhat in only two economies of the region according to our expectation, namely in Croatia and Romania, where GDP growth rate will decrease to 4.4% and 6.2% respectively.

### *Monetary conditions*

Inflation increased in most economies in the SEE region compared to the last year,

except for Serbia and Romania. The most significant increase in inflation can be observed in Bosnia-Herzegovina and Bulgaria. In Bosnia-Herzegovina, mainly the introduction of VAT and increasing international oil prices caused the significant rise in inflation (from 2.1% to an est. 6% annual average retail price increase). In Bulgaria the price increase of tobacco and beverages at the beginning of the year had a significant negative impact on the evolution of prices. The monetary policy became more restrictive in course of the year that helped decreasing inflationary pressure from the second half of the year.

In the other economies in the region oil price hikes also had a negative effect on the evolution of prices due to the fact that these economies are basically in high need of oil import. Romania is the only country in the region which can produce relatively significant amount of oil. Thus, inflation increased in Albania, in Croatia and in the Former Yugoslav Republic of Macedonia as well. As a result, monetary policy became more restrictive not only in Bulgaria but also in Albania and Romania too.

On the other hand, in those two economies (namely in Romania and Serbia) where the inflation rates were the highest in 2005, the consumer price indices decreased further in course of 2006. Inflation remains the highest in the region in Serbia and it is not expected that consumer price index will decline back to under 10%.

In 2007 average annual inflation is expected to decrease in the region compared to this year. Inflation is expected to decrease in almost all countries in the region, except for Albania, where CPI is expected to increase from 2.7% to 3%. However, this rate will be one of the lowest in the region next year as well.



### ***Fiscal developments***

In the SEE region fiscal developments are generally not problematic regarding the budget balances. In several countries in the region general government balances have a surplus, such as in case of Bulgaria or Serbia, and the budget deficit is under 2% of GDP in Bosnia-Herzegovina, in the Former Yugoslav Republic of Macedonia and in Romania. It reflects well that fiscal policy is commonly cautious and constrained, mainly in comparison with some Central and Eastern European EU Member states.

Relatively high deficit can be observed in only Albania and Croatia, where budget deficit will reach 3.7-3.8% of GDP this year according to our expectations. However, the trend is encouraging in these economies – mainly in Croatia – because budget deficits reached 5% in 2003 which reflect well the efforts of the Albanian and Croatian government to decrease budget deficit.

In 2007 two countries in the region will become members of the EU which will have a negative impact on the budget of these countries. The contribution to EU budget and the co-finance of EU projects will burden the budget of these economies. Thus, the deterioration of the general government balances is expected in Bulgaria and Romania in 2007 compared to this year.

### ***Balance of payments***

External imbalances remained one of the key problems in the region. However, the development of current accounts in the region shows a mixed picture. In the candidate countries, namely in Bulgaria and Romania, one can observe that current account balances deteriorated significantly. The deterioration was mainly the result of the widening foreign trade deficit owing to high domestic demand in these countries.

In Albania and Croatia, the deterioration of foreign trade balance also had a negative

impact on the evolution of the current account balance, however, the improvement of other elements of the current account balance – current transfers in Albania, and services balance in Croatia - was able to counterbalance partly the deterioration of the current account balance in these economies.

In the other countries the evolution of the current account balance was positive, however, in Serbia and Montenegro, it was mainly the result of the improvement of the Montenegrin C/A balance. In Bosnia-Herzegovina, the C/A deficit is expected to decrease by 3% of GDP, however, it still remains the highest in the region (20%). The lowest C/A deficit will be achieved in the FYR of Macedonia (only 1% of GDP).

In 2007 current account balances are expected to improve somewhat in comparison with this year in most economies. However, in case of the two accession countries, C/A deficit will increase further (Bulgaria) or will decrease only slightly (Romania).

### ***Labour market developments***

As usual unemployment is another key macroeconomic problem in most Southeast European countries. The official unemployment rates reach or exceed 30% in Bosnia-Herzegovina, the Former Yugoslav Republic of Macedonia and Serbia. There are only two economies in the region where unemployment is a less significant problem. These are Romania (under 6%) and Bulgaria (9%) where unemployment rate decreased noticeably in the last years. Besides these two countries, unemployment rate decreased in Albania, Croatia and the Former Yugoslav Republic of Macedonia but the decline of the unemployment rate was quite slow in these economies.

In 2007, our expectation is that these trends will continue and unemployment rate will decrease gradually mainly in the acceding and candidate countries, namely in Bulgaria, Croatia and Romania.



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

	2004	2005*	2006**	2007**
<b>GDP growth (%)</b>	6.1	5.0	5.2	5.2
<b>Inflation (%)</b>	4.8	5.4	5.9	4.9
<b>General Government balance/GDP (%)</b>	-1.4	-0.6	-0.5	-0.9
<b>Current Account/GDP (%)</b>	-9.5	-9.6	-9.9	-9.6
<b>Unemployment (%)</b>	22.2	22.1	21.4	21.0

\* Preliminary data; \*\* Forecasts



## Albania

### *Weaker GDP growth and increased interest rate*

#### *Economic growth*

After the electricity crises in the last months of 2005, growth weakened in the first quarter of 2006 as well, partly due to the non-tradable sector's emerging capacity constraints and the shutdown of one of the main metallurgy plants. According to estimations, the GDP growth rate for 2006 will be more moderate than expected, but it will still amount to at least 5%, while in 2007 it can also reach 6%. One of the main challenges for Albania is keeping this growth rate sustainable in the long run.

Growth is still driven mainly by the domestic demand, which is underpinned by the rapid growth of credit to the economy. Industry (especially the processing industry), the trade sector, restaurants and hotels have benefited the most from economic growth. The construction sector remains an important factor of GDP growth, although a slowdown was recorded in the first quarter of the year. Services, construction and agriculture will remain important driving forces of growth in Albania.

Certain steps and plans have been made to encourage investments in Albania. For example the business registration time has been decreased, incentives are offered for foreigners, and according to a plan of a new program called "Albania for one euro", in return for a long-term development strategy, long-term leases will be offered in certain strategic sectors. As a positive signal it must be mentioned that on 6. September the European Parliament endorsed the Stabilisation and Association Agreement with Albania. On the other hand, one must note that the energy system, infrastructure deficiencies, corruption and the inefficient public sector can be considered major weaknesses.

#### *Monetary conditions*

In the first three quarters of 2006 the annual consumer price index fluctuated between 1.3% and 3.2%, reaching a peak in July. In the second quarter, stronger inflationary pressure was caused by a variety of factors, including rapid lending activity, the rise of excise tax, the late impact of seasonal factors, the upward trend of the import prices, the milder appreciation of the ALL against the EUR, and finally high oil prices. The appreciation of the ALL against the USD in the first quarter of 2006 mitigated the inflationary pressure of the oil price, but in the second quarter this effect was weaker. In September the annual rate of the CPI was 2.6%. In August and September the price increases of "Fuel and power" were among the fastest at 13.1% and 13.2% respectively, compared to the same period in the previous year. In September the prices of "Food and non-alcoholic beverages" decreased again after seven months, by 1.1% compared to one year before.

In the second half of the year, the government sector is expected to add to inflationary pressures slightly by accelerating the realisation of budgetary expenditures. CPI is nevertheless expected to remain around 2.7%. Generally, monetary and fiscal policy is likely to underpin a low and stable inflation rate in 2007 as well, which will amount around 3% in 2007.

It is worth mentioning that the private sector became the main consumer of the banking sector's monetary resources, as the government sector's share decreased. In the first five months of 2006, credit increased by 2.5% of the GDP, with ALL 24.5 billion. Since December 2005 annual credit growth followed a downward trend and by the end of May it amounted to 65%. According to estimations, in the first half of 2006 the outstanding credit to the economy in relation to the GDP was around 17%, while at the end of 2005 this number was around 14.6%.



In May the annual growth of M3 (broad money) was 10.5%, and M2 increased by 6.2% in annual terms. Generally it can be stated that money supply continued to be oriented towards less liquid assets and to foreign currency. In May, deposits in foreign currency represented 27.6% of M3, thus it showed 2.9% growth compared to the same month in the previous year. Bank of Albania projected 13.6% money supply growth for 2006.

As a result of the outlined monetary conditions, since April the annual inflation approached the upper range of the targeted 2-4% band. As a reaction to the increasing inflationary pressure, the Bank of Albania increased the key repurchase agreement interest rate from 5.00% to 5.25% on the 12th of July. As far as deposits are concerned, the difference between the interest rate of ALL and USD or EUR deposits narrowed. Even in the first half of the year, in the case of the USD the difference narrowed to about 1.4%, while in the case of the EUR this figure was around 2%.

In the first semester of this year, the ALL appreciated against the USD by 4.4% in annual terms, while in relation to the EUR the ALL was relatively stable and appreciated by 0.4% in the same period. In July ALL was around 121-123 EUR/ALL and 95-97 USD/ALL, while in the first days of October it fluctuated around 123 EUR/ALL or 96-98 USD/ALL.

### *Fiscal developments*

The government aims to perform a prudent fiscal policy, partly as a result of the agreement with the IMF. In the first four months of 2006 budget revenues grew by 13%, while expenditures decreased by 8% compared to the same period in the previous year, thus the budget remained in surplus. The decrease of expenditures was partly the result of investments falling below their projected level. The government successfully collected revenues especially through customs authority, where in the first quarter 30% more revenues have been collected than in the same period one year before. By July, the budget surplus amounted to ALL 9.2 billion. According to the plans set by the revised budget program, public investment will be boosted, while tax burden

for businesses will be decreased. Public debt is expected to decline further on.

According to the agreement with the IMF, revenue projections for 2007 will be based on the projected outcome of this year. Moreover, it will not include future improvements of the revenue administration and the potential privatisation incomes – all these can be included to a supplementary budget. (A few of ongoing privatisation process can be mentioned – such as the privatisation of Albtelecom – that may increase the budget's revenue even this year, while the privatisation of the electricity supply company - KESH – will probably be managed in 2007.) According to plans, in the second semester of 2007 certain tax reduction policy initiatives may take place. As far as the expenditure side is concerned, health, education and infrastructure investment will remain priority spending areas. Wage increases in the health and education sector, as well as pension increases will be in accordance with the revenue performance. These plans suggest that with the safeguard of the IMF, the fiscal policy will remain relatively strict in 2007 as well.

### *Balance of payments*

The trade deficit deepened in the first quarter of 2006 compared to the same period in the previous year, therefore the current account deficit increased. In this period, the growth rate of import exceeded the increase of export. The deficit has been partly compensated by the large inward workers' remittances, which even performed a 20% growth in the first quarter compared to the same period in 2005. According to the IMF, microeconomic surveys show that remittances are around 5-8% of the GDP, which means that the amount is significant, but probably it is substantially lower than the estimates of the official balance.

In June, the value of exported commodities increased by 2% compared to the same month in 2005, but the growth rate of imports was 18.5%. Trade deficit amounted to ALL 20 863 million, which means that the deficit increased in June by 25.5%, compared to the same period in the previous year. Current account deficit is expected to increase this year, thus it can reach



even 8% per GDP, while in 2007 it may decline again and amount around 7% per GDP.

EU countries remain the main trade partners of Albania, particularly Italy and Greece. In June 70.5% of the export went to Italy and 8.7% to Greece, while 25.6% of the import came from Italy and 14.7% from Greece. In the first quarter of 2006, Albania's most relevant export products were textiles (30%), footwear (28%) and main metals (16%), while the main import products were mineral products (16%), mechanical and electrical machinery (15%), main metals (12%) and textiles (9.2%). It is interesting to mention that Kosovo is Albania's only trade partner with which it has a positive trade balance, although its proportion is small (in the first

quarter of 2006, 1.3% of the export was oriented to Kosovo).

### **Labour market developments**

In the first quarter of 2006 the number of unemployed dropped by 4 thousand people; as a result, the unemployment rate decreased from 14.2% to 14.0%. The structure of employed did not change significantly. Certain state administration efforts have been made in order to formalise the economy and to make the registration of unemployed more accurate. The unemployment rate is expected to decline further on in 2007, and may reach 13.5%.

**Table 2. Major macroeconomic indicators for Albania, 2004-2007**

	2004	2005*	2006**	2007**
<b>GDP growth</b>	6.0	5.5	5.0	6.0
<b>Private consumption (%)</b>	n. a.	n. a.	n. a.	n. a.
<b>Public consumption (%)</b>	n. a.	n. a.	n. a.	n. a.
<b>Investments (GFCF, %)</b>	23.8	24.2	25.6	26.3
<b>Export (%)</b>	23.5	12.0	13.0	13.0
<b>Import (%)</b>	8.0	10.0	16.0	6.0
<b>Consumer price index (average, %)</b>	2.9	2.4	2.7	3.0
<b>Unemployment rate (%)</b>	14.4	14.3	14.0	13.5
<b>General government balance/GDP (%)</b>	-5.1	-3.6	-3.8	-3.9
<b>General government debt/GDP (%)</b>	56.5	55.3	55.2	54.6
<b>Current account balance/GDP (%)</b>	-5.7	-7.5	-8.0	-7.0
<b>Trade balance/GDP (%)</b>	-21.7	-23.5	-24.5	-23.2
<b>Gross foreign debt/GDP (%)</b>	22.0	21.4	22.0	22.0
<b>Exchange rate (ALL/EUR)</b>	126.3	122.5	123.0	122.0
<b>Interest rate (end of year, %)</b>	5.25	5.00	5.25	5.25

Source: National Bank of Albania, INSTAT

\* Preliminary data \*\* Forecasts



## *Bosnia and Herzegovina*

### *Questions after the elections*

#### *Economic growth*

The Statistics Agency of BH improved the methodology used for GDP calculation according to the international standards, and even recalculated the GDP for 2004. This new rate for the real GDP growth in 2004 is 6%. For 2005 this number is around 5.5%, while the grey economy has been estimated to amount around 23% of the published nominal GDP. The GDP in 2005 reached KM 15.7 billion in current prices.

In 2005, 67.9% of the total GDP was produced by the service sector, where “real estate, lease and business services” had the largest share with 12.09%, followed by “public administration and defence, mandatory social security” with 11.38%. 35.4% of the total GDP was performed by the production sector, in which the “processing industry” has had a share of 11.6% and “agriculture, hunting and forestry” has produced 10.11%. Significant growth was recorded in the industrial production, construction, trade, agriculture, transportation and financial brokerage categories. According to the Transition Report of 2005, the private sector’s share has reached 55% of the GDP, which shows that it is gradually taking over the main role in the economy.

In the first half of this year, industrial production performed 20% of the GDP, while its growth rate was 6.8% in FBH (the Federation of Bosnia and Herzegovina) and 10.8% in RS (the Serb entity, Republika Srpska), compared to the same period in 2005. For 2006 the real GDP growth rate is expected to amount again around 6%, so as a result it can be stated that the growth of BH’s economy is continuing to be impressive.

Elections took place on the 1st of October, and according to the results, the so called radical politicians won. Many questions can not be answered yet: how will the confronting parties be able to cooperate; will further steps

be taken to create a single economic space and state structure or a certain turning back will take place; how will RS react on the future status of Kosovo, etc.? Moreover, the Office of the High Representative will be closed in June 2007, and will be replaced by a lower-key EU mission – this means that the country’s politicians will take full responsibility further on. All these mean a potential threat for the necessary reforms that are also needed e.g. for the EU accession process and even for creating a better business environment.

#### *Monetary conditions*

Inflation started increasing in the second quarter of 2006, and in June with 8.8% it reached the highest level recorded in the last 7 years. This inflationary pressure was caused among many factors by the VAT introduction from the beginning of the year and the high oil prices. The inflation rate shows difference between the two entities; in the first semester of 2006 it was 6.9% in FBH and 9.2% in RS.

According to the central bank, money supply increased in the second quarter of this year, mainly due to the growth of the KM deposits and cash out of banks, while the monetary base reached KM 937.1 million. In the same quarter the M2 (broad money) monetary aggregate increased by KM 489 million or 5.9%, while in the first quarter of the year it grew by 2.9%. Credit growth fell below 25%, which represents certain slowdown. At the end of the second semester total deposits at commercial banks amounted to KM 7.68 billion, and showed higher growth rate than the loans. In the second quarter the average weighted interest rates on short- and long-term credits for private companies fluctuated slightly and were around the same level like in the previous quarter. In case of these short-term credits the average weighted interest rate was 8.20% in June, while on long-term credits it was 7.84%.

By September 2006, the foreign reserves of the central bank reached the highest level (KM



5 billion) since the bank's establishment, which means that this level of reserves provides the coverage of 4.8 months of the average import.

### ***Fiscal developments***

In the first half of the year fiscal consolidation continued, and the consolidated balance of the governments' budget showed surplus in both entities and on the state level as well. On the other hand, the pre-election period weakened the discipline, and even for the future the budget plans are uncertain. According to the IMF's preliminary estimations, if the current policies continue, general government surplus will decrease and may result in a 0,25% deficit by the end of this year, while in 2007 the deficit may amount to 1%.

As far as the VAT introduction is concerned, definite conclusions still can not be drawn, but it is certain that it has already made progress in reducing the grey economy. According to official registrations, 16-17 thousand of VAT subjects were expected, but finally until the VAT introduction 34 thousand subjects registered, which can be partly considered as a certain proof of the decline of the grey economy. Moreover the VAT introduction is an important step in the direction of creating a single economic space.

### ***Balance of payments***

In the period of January-August 2006, the foreign trade gap decreased by 13.5% year-on-year, amounting to EUR 1.9 billion. In the same period, export growth continued to be high and was 38.7%, compared to a year ago and reached EUR 1.6 billion. The increase of imports was 5.1% year-on-year, thus imports amounted to EUR 3.5 billion. Trade deficit was around EUR 255-300 million in every month between May and August. The reason of this favourable tendency is that exports grew significantly in the beginning of this year, and meanwhile imports in the second quarter were lower than in the same quarter a year ago. Probably the introduction of the VAT had positive effect on the improvement of the trade balance. In the second quarter most of the exports were to Croatia (18.8%), Italy (14.4%),

Germany and Slovenia (12.8% of the total), while import arrived mainly from Croatia (16.6%), Germany (12.7%), Serbia and Montenegro (9.7%).

The current account deficit was KM 221.5 million in the first quarter of 2006, which is lower by 48% compared to the same quarter a year ago, showing improvement in the countries external position, but still, current account deficit remains one of the most severe problems of BH's economy. It amounted to KM 221.5 million, which was the lowest recorded deficit since 19 quarters. The main source of the current account deficit is the trade deficit. Current transfers decreased slightly compared to the first quarter of the year, the category of services improved, the balance of revenues decreased, while current transfers – including remittances from abroad - remained important sources of the funding.

FDI can still be considered low in BH – in 2005 it amounted to KM 823 million, which is over 5% of the GDP, but lower than in 2004. According to plans, major investments will take place in the energy sector, and the privatisation of certain telecom companies are also expected (e.g. the tender for the privatisation of 65% of the telecom operator in RS - Telekom Srpske - has been launched in August). In 2005, the largest amount of FDI arrived from Austria (KM 427 million), the second largest investor was Slovenia (KM 144), while the third was Croatia (KM 81 million). 50% of the FDI went to the banking sector, followed by companies in the production sector (26%) and the non-banking financial sector (17%). By the end of December 2005, FDI stock reached KM 4.4 billion, while including portfolio and other foreign investments as well, it amounted to KM 7.3 billion.

### ***Labour market developments***

A Labour Force Survey was published in July this year, and most probably holds much more reliable data than the official publications. According to this survey, approximately 2.7 million people are in their working age, but 56.9% of them are recorded as inactive. The employment rate is 29.7%, while the unemployment rate is 31.1%. 70.2%



of the unemployed are with secondary education, 25.4% with primary or lower

education and 4.4% has university or doctoral degree.

**Table 3. Major macroeconomic indicators for BH, 2004-2007**

	2004	2005*	2006**	2007**
<b>GDP growth</b>	6.0	5.5	6.0	6.0
<b>Private consumption (%)</b>	n. a.	n. a.	n. a.	n. a.
<b>Public consumption (%)</b>	n. a.	n. a.	n. a.	n. a.
<b>Investments (GFCF, %)</b>	n. a.	n. a.	n. a.	n. a.
<b>Export (%)</b>	28.7	24.0	18.0	16.0
<b>Import (%)</b>	7.6	13.6	8.0	7.0
<b>Retail price index (average, %)</b>	0.2	2.1	6.0	4.0
<b>Unemployment rate (%)</b>	40.5	41.5	42.5	42.5
<b>General government balance<sup>1</sup> (%)</b>	-0.1	1.0	-0.2	-1.0
<b>General government debt/GDP (%)</b>	32.8	32.0	n.a.	n. a.
<b>Current account balance/GDP<sup>1</sup> (%)</b>	-21.0	-23.0	-20.0	-18.0
<b>Trade balance/GDP (%)</b>	-53.3	-53.1	-52.0	-51.0
<b>Gross foreign debt/GDP (%)</b>	33.0	32.0	n.a.	n. a.
<b>Exchange rate (BAM/EUR)</b>	1.956	1.956	1.956	1.956
<b>Interest rate (end of year, %)</b>	2.0	2.0	2.0	2.0

Source: Central Bank of BH, FZS

\* Preliminary data \*\* Forecasts; 1 including grants



## Bulgaria

### *Increasing economic growth with high current account deficit*

#### *Economic growth*

In the second quarter of 2006 GDP growth rate remained considerably high, gross domestic product increased by 6.6% in real terms. Due to the strong performance in the first quarter as well, GDP growth reached 6.1% during the first half of the year.

On the expenditure side, the main tendencies remained unchanged. Compared to the same semester of the previous year, the GDP growth rate in the first half of 2006 was basically identical, and its structure changed only slightly. The most important change was the decreasing role of collective consumption and the growing importance of investments.

In the first half of 2006, the main engines of economic growth were gross fixed capital formation (+20.8%) and private consumption (+6.4%), while the growth rate of public consumption was only 0.7%. Owing to the massive increase of investments, gross fixed capital formation per GDP increased further and exceeded 25% in the first half of the year.

Net exports continued to have a negative contribution to economic growth owing to the high import demand of the economy. The growth rate of the imports (+15.3%) significantly outpaced that of the exports (+11.4%) during the first six months of 2006.

On the production side, gross value added in industry and services sectors reached high growth in course of the first half of the year, 8.9% and 5.3% respectively. The performance of the agriculture sector remained basically unchanged compared to the same period of the previous year. It is also worth mentioning that the share of industry increased by 2%-points in GDP due to its strong growth.

Last year the unfavourable weather conditions resulted in a significant decline of the agriculture output in Bulgaria. This year similar decline is not likely thus agriculture

sector will not have such a negative contribution to economic growth than in last year. For 2006 we still expect that GDP growth will reach 5.8%, and the economy will be further fuelled by domestic demand. For 2007 this trend is not expected to change significantly and our expectation for economic growth is 6.0%.

#### *Monetary conditions*

During the third quarter of the year the consumer price index decreased significantly compared to the first and second quarter of the year. While average consumer price index was more than 8.0% in the first and second quarter of 2006, it declined to 6.7% between July and September. Thus a significant decline was observable in the second part of the year since CPI decreased from 8.8% in February to 5.6% in September. After June, the consumer price index started to decline by 0.5-1%-point in each month which was the result of the more restrictive monetary policy.

The high inflation rate was 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 that period.

As mentioned, monetary policy became more restrictive during the third quarter of 2006. Bulgarian National Bank (BNB) increased its base interest rate in every month in this period and as of 1st October 2006 base rate was increased to 2.98%. This rate was 2.56% in June 2006 and 2.05% in December 2005. It reflects well that BNB tries to control inflationary pressure on the economy by operating a more restrictive monetary policy.

As a result, CPI is expected to decrease to 5.5% in December 2006 and the annual average inflation will be 7.0% according to our expectations. The further significant decrease of CPI is hampered by the strong domestic



demand and the impact of EU accession at the end of the year. For 2007 we expect that annual average consumer price index will decrease somewhat compared to this year and will be 5.2%.

### ***Fiscal developments***

In the first half of the year consolidated budget balance reached a considerable amount of surplus. Between January and June the budget surplus reached EUR 719.4 million or 2.9% of estimated GDP in 2006. In July and August, the surplus increased further and reached EUR 1018 million or 4.1% of GDP.

The budget balance improved even compared to the previous year due to the high growth of budget revenues. Revenues increased mainly due to the significant (+12.1%) rise in tax revenues, while expenditures increased by only 5.2% during the first eight months of the year.

In line with the promising development of the budget, the Bulgarian parliament approved the reduction of the corporate profit tax rate from the current 15% to 10% as of the beginning of 2007 in October. It means that from 2007 Bulgaria – along with Cyprus – will have the lowest corporate tax rate in the European Union.

According to our expectations, the budget surplus will reach 3.5% of GDP in 2006, while the surplus will decrease somewhat in next year due to the contribution to EU budget, co-financing EU projects, tax cut and financing reforms, thus, we expect that budget surplus will reach 2.0% of GDP in 2007.

### ***Balance of payments***

In Bulgaria the high and increasing current account deficit is still the main macroeconomic challenge. In the first eight months of the year current account deficit reached EUR 1.9 billion or 7.7% of GDP. The C/A deficit in the first two trimesters of 2006 was 75.6% higher than that of the same period in the previous year, when the deficit was EUR 1.1 billion.

During that period, basically all components of the current account deteriorated compared to the same period of the previous year. Regarding foreign trade balance, the deficit increased by 20.1% and reached EUR 3.1 billion, although the nominal growth rate of export of goods (+30.0%) was slightly higher than that of import (+27.1%).

On the other hand, the other main components of C/A balance – namely balance on income, balance on services, and current transfers balance – had a surplus. However, these surpluses decreased compared to the same period of the previous year. The largest decrease was observable in case of the balance on income, the surplus of the balance decreased by EUR 143 million compared to last year.

In line with the worsening C/A balance, the amount of foreign direct investments improved. Between January and August 2006 net FDI amounted to EUR 1755 million which was able to finance 92.2% or the majority of the current account deficit. For the entire year we expect that these tendencies will continue and maintain our previous forecast on current account deficit that can reach 15% of GDP mainly due to the worsening trade balance.

### ***Labour market developments***

In the labour market the positive trends continued and the unemployment rate declined further. In the second quarter of 2006 unemployment rate decreased to 9.0%, which was lower by 1.0%-point than that of the unemployment rate in the second half of 2005. It also means that the number of unemployed persons were lower by 24 thousands. On the other hand, employment rate also improved and it increased from 45.1% to 47.1%. 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% at the end of 2006 and these tendencies will continue in 2007 as well.



**Table 4. - Major macroeconomic indicators for Bulgaria 2004-2007**

	2004	2005	2006*	2007*
<b>GDP (%)</b>	5.7	5.5	5.8	6.0
<b>Private consumption (%)</b>	4.5	7.4	6.5	6.0
<b>Public consumption (%)</b>	6.0	2.2	1.0	2.0
<b>Investments (GFCF, %)</b>	12.0	19.0	21.0	20.0
<b>Exports (%)</b>	13.0	7.2	11.0	12.0
<b>Imports (%)</b>	13.0	14.6	15.0	15.0
<b>Consumer price index (annual average, %)</b>	6.2	5.0	7.1	5.2
<b>Unemployment ratio (end of year, %)</b>	12.2	10.7	9.0	8.0
<b>General government balance (%)</b>	1.7	3.2	3.5	2.0
<b>General government debt/GDP (%)</b>	40.7	31.9	26.0	24.0
<b>Current account/GDP (%)</b>	-5.8	-11.3	-15.0	-17.0
<b>Trade balance/GDP (%)</b>	-15.1	-20.2	-21.0	-22.0
<b>Gross foreign debt/GDP (%)</b>	64.2	67.7	68.0	69.5
<b>Exchange rate (BGN/EUR)</b>	1.96	1.96	1.96	1.96
<b>Base rate (end of year, %)</b>	2.7	2.0	3.0	2.8

Source: BNB, NSI; \* Forecasts



## Croatia

### *Still promising overall outlook despite of temporary lurch*

#### **Economic growth**

Croatia experienced slight moderation in its economic growth performance in the second quarter of 2006. The 6.0% real GDP growth rate of first quarter (attributed partly to the base effect) was followed by 3.8% in the consecutive quarter of the current year that data can give rationale for downgrading our expectations on the yearly rates of 2006 and 2007, however in the light of the possible data on two remaining periods it is likely for Croatia to come out with a data closed to previously signed prediction on 2006.

Croatian growth continued to be in favourable composition of influencing factors, as more than 2 percentage points of real GDP growth rate came from 8.4% real growth of gross fixed capital formation in the second quarter. While final consumption expenditure of households remained on the moderate 2.1%, especially in comparison with the previous four quarters above 3% growth rates. Parallel, the final public consumption expenditure quarterly growth is a three years old record, as in the second quarter compared to the same quarter of previous year it rose by 1.7%, thus contributing to real GDP growth rate by around 0.35 percentage points, that is double of previous quarters' contribution. As of external demand, the country's export rise exceeded the import rise – 5.2% and 4.2% in the second quarter. One can evaluate this data, as considerable slowdown in view of previous quarter, but this is in line with average performance. Croatian economy's growth continues to be in so called favourable structure with short exception note on public consumption acceleration. The growth is dominated by domestic demand.

Regarding to supply side of growth, the industrial production experienced weak quarter. The total industrial production was by 1.1% lower in the last month of the second

quarter in 2006 than in the corresponding month of 2005 and, in the period from January to June 2006, it was only by 2.9% higher than the production in the same period last year. The main pulling back branch was the manufacturing, while mining and quarrying performed above the average. From other point of view the capital goods and the durable consumer goods production performed well, but this is in line with the first quarter's processes. All of these industries' value added growth was 1.1%.

By real growth rates of value added in the second quarter, the most important pulling effects came from construction (8.3%), transport, storage and communication (8.5%), and financial intermediation (8.1%).

It is inevitable to have a look on tourism sector, as it proved to be of strategic importance for the country. This summer did not bring extreme growth and this moderate performance was backed by domestic demand. The reason of it was the so called world cup effect that kept far significant external demand from Croatian tourism capacities. The sector's strategy to have a shift to the domestic consumers was valid.

Despite of second quarter performance, the remaining quarters' growth seems to be recovered. The monthly industrial production in the Republic of Croatia in August 2006, as compared to August 2005, increased by 5.2% reflecting recovery of industrial indicators especially from July, mainly due to regeneration of manufacturing (81% of total industrial output) and to mining and quarrying performance rates.

In consequence of moderate growth observed in the second quarter our GDP growth rate estimation is slightly downgraded to 4.9% in 2006 and 4.4% in 2007. However our outlook is positive as it is expects further investment and export driven growth, parallel with strengthening domestic demand



originated from parliamentary elections in 2007. 2007 reflects the slight slowdown of growth in world economy and especially in the EU.

### **Monetary conditions**

Consumer price index (CPI) rose by 3.4% in August 2006 as compared to the same month of previous year. CPI was mainly pulled by increase of prices of housing, water, electricity and gas – 8.9%. CPI calculated on goods increased by 2.5%, while services' CPI by 5.9%. Producer price index (PPI) performed 3.1%. The core inflation increased by 2.2% y-o-y, in August 2006.

Croatian National Bank (CNB) is strictly committed to maintaining the nominal stability of the Kuna against the euro, which has helped to counteract upward pressure on inflation stemming from high oil prices. The Kuna is kept relatively stable against the Euro (HRK/EUR period average in August 7.28) with some seasonal appreciation in summer and with a serious pharmaceutical industry foreign capital inflow generated demand for Kuna. Parallel, some appreciation was observable in relation of US dollar (HRK/USD period average in August 5.68). CNB intervenes time to time on forex market in the exchange rate system of managed float, usually by purchasing foreign currency to counteract upward pressure on Kuna mainly related to investment and tourism originated foreign currency inflow.

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 depreciation has to be realized till the end of the year that can result in the end in a 7.30 HRK/EUR exchange rate. However its long term appreciation trend have to be realized in such emerging country, thus in 2007 7.15 HRK/EUR is expected at the end of the year.

Regarding our estimation on annual CPI growth, according to downward direction of oil prices, stable Kuna exchange rate and moderate wage increases, it has to be revised to the level of 4.0% in 2006 and 3.2% in 2007.

### **Fiscal developments**

Croatian public balance continued to improve steadily due to persistent efforts on fiscal adjustment and to supporting economic growth. It is worth to mention that parallel with these adjustment measures to consolidate government finances and to cut deficit, the government consumption expanded and became a considerable contributor of economic growth.

The processes of fiscal developments thus suit the general government deficit results of previous years: 5.0% in 2004 and 4.2% in 2005.

According to GFS data from Ministry of Finance, consolidated central government deficit decreased notably by almost 46% in the first half of 2006 as compared to the same period of 2005. This was mostly a result of considerable rise in revenue side of the central budget driven mainly by largest collection of VAT, social contributions, profit tax and excise revenues, while expenditures rose by 3.5% that is well behind of 11.2% rise in revenues. The obvious upturn of economic activity seems to be the main determination factor of budgetary processes.

Croatia is a highly centralized country in comparison with other Central-European states, it is even true if taking into account initiative and concrete measures to decentralize public functions and resources. Thus central government issues bear crucial importance in general government balance.

Concerning of public finances reforms, after changes in the pensions' indexation, introduction of administrative fees in medical service providing, changes in state aid system, rethinking the role and future of state owned companies, Croatia is committed to continue its efforts to shift its subsystems into more sustainable feature, especially in restructuring and rationalizing of public spending on health care.

The forecast presumes a further gradual decline in public deficit that matches our prediction on growth, but includes our estimation on adjustment and public finance rationalization effects as well. This means 3.7% for the current year and 3.2% deficit in



2007. Our expectation on 2007 however is under risk factor related to election year's political cycle.

### ***Balance of payments***

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 that was only partially offset by well performing service balance.

The imports/exports coverage rate improved to the level of 46.2% in the first eight months of 2006. In the period from January to August in 2006 total exports increased by 16.1% y-o-y, with main contribution of exports on transport and equipment, oil and refined products. As of import rise of 15.2%, the main contributors were oil and refined petroleum products, road vehicles, basic metals. So the trade deficit widened.

In line with strong investment and consumption demand on imported goods our trade balance estimation is kept further, despite of the export performance. Taking into consideration the favourable growth expectations the current account deficit will be around 6.7% as compared to GDP and the trade balance on 23%. In 2007 6.3% deficit as of current account and 24.0% trade balance.

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 net direct investments reached the 1100 million Euro in the first half of 2006.

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. However export growth capacities expected to improve as the capital goods imports are considerable.

### ***Labour market developments***

By latest data on employment statistics Croatia managed to continue its march to increase employment and to reduce unemployment. Rising FDI and improved productivity of SME ensured good environment for improvement.

The number of persons in paid employment rose by 0.8% (women 1.2%) in the first eight months of 2006 as compared with the same period of previous year and reached 1 138 175 persons. Main branches of contribution were: construction (2.7%), wholesale and retail trade (4.0%), financial intermediation (3.3%) and education (2.5%). Manufacturing achieved further decrease of employment by 2.6%, like agriculture as well with its 5.7% fall.

Total registered unemployment rate in August was a decade record of 15.7% that is almost 3 percentage points lower than at the beginning of the year, mainly due to favourable real sector performance.

Wages continued to grow. Average monthly real gross earnings increased by 2.2% in the first seven months of 2006 as compared to the corresponding period of 2005, while net earnings measured with the same methodology by 1.2% as of result of rising tax payments.

The good trend in labour market with its closing scissor defined by rising employment and declining unemployment is to keep further. Accelerating real GDP growth and started labour market reforms are affecting positively these processes. Administrative unemployment expected to decrease further to the level of 12.3% in 2006 and to 11.8% in 2007.



**Table 5. Major macroeconomic indicators for Croatia 2004-2007**

	2004	2005	2006*	2007*
<b>GDP (%)</b>	3.8	4.3	4.9	4.4
<b>Private consumption (%)</b>	3.9	3.4	3.7	4.3
<b>Public consumption (%)</b>	-0.3	0.8	1.3	1.1
<b>Investments (GFCF, %)</b>	4.4	4.8	10.6	7.5
<b>Exports (%)</b>	5.4	4.6	5.3	5.1
<b>Imports (%)</b>	3.5	3.5	4.9	4.8
<b>Consumer price index (average, %)</b>	2.1	3.3	4.0	3.2
<b>Unemployment (%)</b>	13.8	13.0	12.3	11.8
<b>General government balance (%)</b>	-5.0	-4.2	-3.7	-3.2
<b>General government debt/GDP (%)</b>	54.0	53.5	53.0	52.5
<b>Current account balance/GDP (%)</b>	-5.2	-6.3	-6.7	-6.3
<b>Trade balance/GDP (%)</b>	-25.5	-25.0	-23.0	-24.0
<b>Gross foreign debt/GDP (%)</b>	82.5	82.5	80.0	81.0
<b>Exchange rate on December 31 (HRK/EUR)</b>	7.67	7.37	7.30	7.15
<b>Discount rate (%)</b>	4.50	4.50	4.50	4.50

Source: Croatian National Bank, DZS; \* Forecasts



## **Former Yugoslav Republic of Macedonia**

### ***Increasing but still low inflation***

#### ***Economic growth***

According to the estimation of the National Bank of the Republic of Macedonia, GDP increased by 2.3% in the first quarter of the year. This is a smaller increase as it was in last year and several figures back this moderate growth. In the first three months of 2006 industrial production increased by only 0.5% compared to the same period of the previous year. This picture did not change in the next half year; between January and August industrial production increased by only 2.8% in comparison with the same months of 2006.

Despite the absence of significant changes in industrial output, it is worth mentioning that its structure has modified somewhat. Owing to the fact that the production was restarted in some mining facilities of the country, the industrial production volume of mining and quarrying increased by 42.3%.

Due to the low share of the mining and quarrying in industrial production (1.8%) this sector had only a slight positive impact on the evolution of the total industrial production. The production of the other two segments of industry (manufacturing and electricity, gas and water supply) increased slightly, by 2.1% and 1.4% respectively in the first eight months of the year.

For the whole year we expect that GDP in the Former Yugoslav Republic of Macedonia will increase by a moderate 2.5%. We revised our previous forecasts (3.3%) due to the lower than expected figures for industrial production, retail trade and agriculture. In 2007 similar rate of economic growth is expected.

#### ***Monetary conditions***

During the first eight months of the year CPI increased significantly in comparison with the same period of last year. Between January and August consumer prices increased by

3.3%, while CPI remained under 1% in course of 2005.

There are three reasons why consumer prices jumped from under 1% to above 3% in 2006. First, tobacco prices increased by 36.9% in January 2006 (due to increasing excises), and this had a major role in the rise of CPI. This measure was in line with the harmonization process with the EU Directives. If the impact of the increase of tobacco prices is excluded the CPI would be close to 2%, which reflects well the contribution of tobacco price increases to consumer price index.

Second, as an external factor the gradual increase of oil prices during January-August had a negative effect on the transport prices in the Former Yugoslav Republic of Macedonia. This factor increased fuel prices and prices of road transport as well.

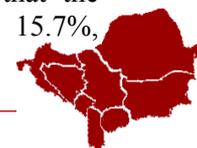
Finally, the price increases of some food products – mainly vegetables and sugar, jam, honey, chocolate and confectionery products – also fuelled inflation. The aforementioned three factors influenced basically the evolution of CPI, which would be on about the same level as in last year (0.5%) if these factors would be excluded.

For 2006 we expect that CPI will reach 3.1%, slight disinflation is expected owing to decreasing oil prices. In 2007 the consumer prices will not increase more than this year but it will not fall back to the 2005 level due to further harmonization, according to our expectations.

#### ***Fiscal developments***

In the second quarter of the year, general government balance turned from deficit to surplus. At the end of May 2006 the surplus of the budget reached EUR 26.2 million or 0.5% of the estimated GDP in 2006.

The reason for the surplus was that the growth rate of the revenues reached 15.7%,



while that of the expenditures was ‘only’ 11.5%. The good result of the revenue side of the balance was due to the high increase of profit taxes (+52.3% or +EUR 12.8 million) and pension insurance contributions (+9% or +EUR 10.7 million) in comparison with the first five months of 2005. Accordingly, as it was expected in our previous forecast, the revenues increased and the drop back in the first months was only temporary.

In course of the year we expect that the general government balance will be in equilibrium in 2006 while the balance will have a slight deficit in 2007.

### ***Balance of payments***

During the first seven months of the year current account balance improved further in the Former Yugoslav Republic of Macedonia. Current account deficit reached EUR 41.8 million or 0.9% of forecasted GDP in 2006. This figure is significantly better than that of the last year in the same period, when C/A deficit reached EUR 75.2 million. All components of the current account balance improved except for the trade balance.

The growth rate of export of goods was 9.1% in euro terms, while that of import of goods was slightly higher, 12.7%. Accordingly, foreign trade balance deteriorated by 19.9% between January and July in comparison with the same period in the previous year. It is worth mentioning that the increase of the international oil prices had a negative impact not only on the evolution of the consumer prices but also on the foreign trade balance via the import of mineral fuels, lubricants and related materials (almost 10% share in total import).

On the other hand, the other three main balances of the current account, namely services balance, income balance and current transfers improved in that period. The balance of current transfers improved by EUR 81 million owing to the significant growth of private current transfers. This shows that

private current transfers are essential to finance the deficit of the foreign trade balance.

Owing to the privatisation of ESM, the country’s energy distribution company, FDI increased to EUR 260 million which was the highest figure since the privatisation of the national telecom company (Maktel). It means the low current account deficit is easily financed by foreign direct investments this year.

For 2006 we expect that current account deficit will be lower than it was in 2005 and C/A deficit will improve to 1.0% of GDP. In 2007 the C/A is expected to rise somewhat to 2.0% of GDP.

### ***Labour market developments***

Unemployment rate decreased from 37.4% to 36.1% in the second quarter of 2006 in comparison with the same quarter of the previous year. The improvement is the result of the improving employment figure. In the second quarter the number of employed persons increased by 13.500 persons or to 566.300. 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 the former Yugoslav Republic of 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 effectively unemployed persons is approximately half of the official rate.

For 2006 we forecast that current trend will continue 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. In next year the unemployment is expected to decrease further to under 36%.



**Table 6. - Major macroeconomic indicators for FYROM, 2004-2007**

	2004	2005*	2006**	2007**
<b>GDP growth (%)</b>	4.1	4.0	2.5	2.5
<b>Private consumption (%)</b>	5.8	n. a.	n. a.	n. a.
<b>Public consumption (%)</b>	4.6	n. a.	n. a.	n. a.
<b>Investments (GFCF, %)</b>	9.3	n. a.	n. a.	n. a.
<b>Export (%)</b>	9.1	n. a.	n. a.	n. a.
<b>Import (%)</b>	12.4	n. a.	n. a.	n. a.
<b>Consumer price index (average,%)</b>	-0.4	0.5	3.1	3.0
<b>Unemployment (%)</b>	36.7	36.5	36.2	35.8
<b>General government balance (%)</b>	0.0	-0.6	0.0	-0.5
<b>General government debt/GDP (%)</b>	36.6	40.9	36.0	35.0
<b>Current account balance /GDP (%)</b>	-7.7	-1.5	-1.0	-2.0
<b>Trade balance /GDP (%)</b>	-20.6	-19.3	-19.0	-20.0
<b>Gross foreign debt /GDP (%)</b>	38.4	38.0	37.5	
<b>Exchange rate (end of per., MKD/EUR)</b>	61.3	61.2	61.2	61.2
<b>Discount rate (end of year, %)</b>	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

### *Slight shift in the production side of GDP growth*

#### **Economic Growth**

In the second quarter of 2006 economic growth increased further. During the first semester of the year GDP increased by 7.4% compared to the same period of the previous year. After last year's moderate economic growth (+4.1%), Romania found its way back to vigorous growth. At first glance, it could seem normal that the growth pace returned to its high level after 2005 when unfavourable weather conditions hindered the achievement of a higher GDP growth rate owing to the weak performance of agriculture. In 2003 and 2004 GDP growth exceeded 5% and 8% respectively, and the strong growth in the first semester of 2006 reflects that Romania will enjoy a year of rapid growth again, thus the former tendency continues after a bad year. This, however, is not exactly the case.

Although GDP growth this year is expected to be robust and will be close to the high growth rate of the 2003-2004 period, the structure of GDP growth is different. While in the 2003-2004 period, agriculture had a significant contribution to GDP growth – gross value added in agriculture, forestry and fish breeding increased by more than 20% in 2004 –, in the first six months of 2006 the primary sector had a negative contribution to GDP growth. In the first semester the gross value added in agriculture, forestry and fish breeding declined by 0.4%, while gross value added in industry, construction and services increased by 6.5%, 16.5% and 7.2% respectively.

The performance of the construction sector was impressive mainly due to increasing income and credit growth as well as to insufficient supply of houses. Besides construction, one can observe that the growth rates of industry and services were also significant. It resulted in a structure of economic growth that is close to more developed countries where services and

industry (and construction) are the main contributors to economic growth.

On the expenditure side, however, the picture has not changed significantly. The role of domestic demand is still decisive in economic growth. In the first half of the year, basically private consumption and investments fuelled the economy. Private consumption and gross fixed capital formation increased by 11.8% and 11.9% respectively in that period in real terms. On the other hand, net exports continued to have a negative contribution to GDP growth mainly due to the strong consumption growth which boosted imports. Growth rate of imports (18%) considerably overpaced that of exports (11.7%) in the first semester of 2006.

During that year we expect that economic growth will reach 7.0%, thus the strong performance of the Romanian economy is expected to continue in the second half of the year. Domestic demand is expected to remain the main engine of the economy while net exports will have a negative contribution to GDP growth due to imports boosted by private consumption. In 2007, these tendencies will continue and GDP growth can reach 6.2% supported by strong domestic demand.

#### **Monetary conditions**

At the end of June the Board of the National Bank of Romania (NBR) raised its policy rate from 8.5% to 8.75%. That was the second increase this year after the raising of the policy rate from 7.5% to 8.5% in February 2006. The aim of this measure was to make monetary conditions more restrictive. More restrictive monetary policy was an answer to high inflationary pressures fuelled by rapid non-governmental credit growth.

Owing to stricter monetary policy, the consumer price index started to decrease further and reached 6.0% in August. The disinflation process was supported by slower increase of administered prices. It resulted in



inflation decreasing from 8.9% (January 2006) to 6.0% (August 2006).

Following the increase of the policy rate at the end of June, not only inflationary pressures eased but the Romanian Leu also appreciated against the euro. While at the end of June the RON/EUR exchange rate was close to 3.6 it declined to the 3.50-3.55 range. The stronger Leu also supported the disinflation process in the last months, however, the NBR needs to be cautious to maintain the price (and cost) competitiveness of the Romanian export sector.

For 2006 the inflation target was set at 5% with a +/-1%-point range. Due to the disinflation process observed in the last few months the inflation target is more realistic than it was in the first or second quarter of the year. According to our expectations, CPI will be close to the upper limit of the target band and will reach 6.2%. Thus, we revised our previous forecast on the annual average inflation rate from 7.2% to 7.0%.

For 2007 the inflation target of the NBR is 4% with a +/-1%-point target band. This target seems too ambitious regarding the factors that CPI at year-end will be around the upper limit, domestic demand is expected to be high next year as well and the NBR has to be cautious with implementing too strict monetary measures which would hinder the competitiveness of the Romanian firms and the economic growth. We expect that annual average CPI will reach 6.0% in 2007.

### ***Fiscal developments***

In August 2006 the government announced an increase in the planned budget deficit again, which was the third occasion this year. Firstly, the budget deficit was increased from 0.45% of GDP to 0.9% in April, which was followed by an increase from 0.9% to 2.5% in June. In August, the budget deficit was increased from 2.5% of GDP to 2.7%. The time that elapsed between the two latest revisions of the target was quite short and thus these measures were surprising. Thus, several actors feel that the government will not be able to spend so much money considering the fact that the general consolidated budget had a surplus in the first eight months (1.6% of GDP or EUR 1.5 billion).

Despite the fact that the targeted budget deficit will not surely be achieved, it is certain that the higher budget deficit will have a boosting impact on domestic demand and a worsening effect on the current account balance – mainly through the trade balance. According to the statements of the Ministry of Finance the revisions will mainly increase the expenditures on investments.

For this year we expect that the general consolidated budget deficit will not reach the target level, however, we raised significantly our previous forecast. We expect that the deficit will reach 2.0% of GDP this year. For 2007 the budget deficit is expected to increase further mainly due to EU accession. The accession will have a negative impact on general government budget owing to the contribution to EU budget and the co-financing EU projects. For 2007 we expect that the budget deficit will reach 2.8% of GDP.

### ***Balance of payments***

The most severe macroeconomic problem is still the high current account deficit. Between January and July the current account deficit reached EUR 4.9 billion which was higher by EUR 1.5 billion (or by 43%) than the same figure last year.

The high current account deficit is mainly the result of the significant increase in the foreign trade deficit. Trade deficit reached EUR 5.1 billion during the first seven months of 2006. This is due to the strong domestic demand in the economy. If these tendencies will continue the current account deficit will exceed 10% of GDP at the end of the year. And, as it was mentioned, in line with strong private consumption and investments, the government intends to increase significantly the expenditure side of the budget which will have an additional negative impact on the current account balance. On the other hand, it is likely that import will jump before EU accession at the end of the year, as it was observed in the case of the other New Member States before accession date.

Thus, we expect that the current account deficit will reach 10.6% this year which will be an almost 2%-points increase compared to the same figure in 2005. In 2007 the current



account deficit will reach basically the same level as this year according to our estimations.

### **Labour market developments**

The number of registered unemployed persons decreased further in the last months. In July 2006 the number of registered unemployed persons was lower by almost

42.500 than in July 2005. Accordingly, in July, unemployment rate dropped to 5.1%, which was the lowest figure in this decade. In line with decreasing unemployment, employment figures also improved. For 2006 and 2007 we expect that the current trend will continue due to robust economic growth, and a further decline of the unemployment is expected.

**Table 7. - Major macroeconomic indicators for Romania, 2004-2007**

	2004	2005	2006*	2007*
<b>GDP growth (%)</b>	8.4	4.1	7.2	6.2
<b>Private consumption (%)</b>	10.8	9.0	11.5	9.0
<b>Public consumption (%)</b>	4.6	3.0	3.0	3.5
<b>Investments (GFCF, %)</b>	10.1	13.0	11.5	12.0
<b>Exports (%)</b>	14.1	7.6	12.0	10.0
<b>Imports (%)</b>	17.8	17.2	18.0	15.0
<b>Consumer price index (average, %)</b>	11.9	9.0	7.0	6.0
<b>Unemployment (end of period, %)</b>	6.3	5.9	5.6	5.5
<b>General government balance (%)</b>	-1.1	-0.8	-2.0	-2.8
<b>General government debt/GDP (%)</b>	18.5	19.0	19.5	20.0
<b>Current account balance /GDP (%)</b>	-8.4	-8.7	-10.6	-10.0
<b>Trade balance /GDP (%)</b>	-9.0	-10.4	-11.6	-11.0
<b>Gross foreign debt /GDP (%)</b>	31.1	31.0	31.5	32.0
<b>Exchange rate (RON/EUR) **</b>	4.05	3.62	3.54	3.52
<b>Reference rate (end of year, %)</b>	17.00	7.50	9.00	8.5

Sources: EC, NBR, own calculations

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



## **Serbia and Montenegro**

### **Improving economic conditions in Montenegro, slowly decreasing inflation in Serbia**

*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. The two economies will be analysed separately from the first quarter in 2007.*

#### **Economic growth**

In Serbia, in Q1 2006 real GDP growth reached 6.3 per cent compared to the same period in the previous year. The growth in industrial production was higher in Q2 than in Q1. In June the growth rate of industrial production reached 4.7 per cent. In July and August industrial production indicated only modest performance, mainly due to the unfavourable performance of the electricity, gas and water supply sector. At the same time the manufacturing and mining and quarrying sectors performed well.

Real GDP growth is expected to reach 5 per cent in 2006 and 6 per cent in 2007 in Serbia.

In Montenegro real GDP growth reached 6.8 per cent in Q1 2006. In Q2 2006 GDP growth was slightly lower, but still strong, reaching 6.5 per cent year-on-year. In July 2006 the annual growth rate of industrial output reached 10.4 per cent. At the same time a slight (0.2 per cent) month-on-month fall was recorded in industrial production in July, due to lower production of electricity, gas and water supply. In the first seven months of 2006 the number of tourists was 17.7 per cent higher than in the same period in the previous year. The increase in the number of foreign tourist overnight stays amounted to 48.8 per cent.

Due to the favourable growth performance in the first two quarters, real GDP growth rate is expected to reach 6 per cent in 2006 in Montenegro. Tourism industry will remain a main driving force behind growth in 2007. The construction sector will have to follow the demands of the expanding tourism industry.

#### **Monetary conditions**

The year on year growth rate of retail prices stayed above 15 per cent in Serbia in Q2 2006. In Q3 retail prices grew at a slightly slower rate, with the highest rate experienced in August, reaching 13.1 per cent year-on-year (0.7 per cent month-on-month).

Inflation in Montenegro in June 2006 was 0.2 per cent (month-on-month). Year-on-year inflation in the same month reached 2.3 per cent. The rise of the retail prices of goods was higher than those of services (2.6 per cent and 0.8 per cent year-on-year, respectively, in June 2006).

In Serbia, year-on-year inflation in December is expected to reach 9.3 per cent, while yearly average inflation is predicted to reach 13.5 per cent in 2006. In 2007 a further reduction is to occur, with the former inflation measure reaching 8 per cent, and the latter reaching 8.2 per cent. Inflation will stay low in Montenegro in 2006, with an expected 2.3 per cent year-on-year inflation in December. Retail price rise is expected to stay below 3 per cent in 2007 as well.

#### **Fiscal developments**

The Serbian state budget showed a strong positive balance in August 2006. This positive budget balance was three times higher than in the same month of the previous year. The government has committed itself to a 3.6 per cent of GDP budget surplus target for 2005 and 2006. The ambitious target was not achieved in 2005. With the favourable fiscal performance experienced so far in 2006, especially in August, the general government fiscal balance as a percentage of GDP is expected to reach a



2.6 per cent surplus. The tight fiscal stance is expected to be maintained in 2007 as well, however with a slightly less ambitious target (3 per cent of GDP). External debt as a percentage of GDP (according to IMF definition) is expected to reach 63.5 per cent of GDP in 2006 and 61.3 per cent of GDP in 2007 in Serbia.

External debt in Montenegro reached 27.1 per cent of GDP in Q1 2006, which is a reduction compared to the end of 2005 (when external debt reached 31.3 per cent of GDP). Fiscal deficit in Montenegro reached 1.4 per cent of GDP in Q1 2006. A tight fiscal stance is also expected to be maintained in Montenegro in 2007.

### ***Balance of payments***

The current account deficit of Serbia is expected to reach 10.8 per cent as a proportion of GDP in 2006. In 2007 only a slight improvement is likely, to a deficit of 10.4 per cent of GDP.

The current account in Montenegro has been improving since Q4 2005, but in Q1 2006 it was still showing a large deficit, mainly due to the unfavourable position of the trade in goods. The trade deficit amounted to 38.7 per cent of GDP in Q1 2006, while the current account deficit reached 33.4 per cent in the same period. Therefore there is a strong need to improve the trade in goods, and the current account position of Montenegro.

In the first seven months of 2007 FDI inflow from non-residents to Montenegro amounted to EUR 191.7 million. In the same time period EUR 1.6 million of direct investments were withdrawn by Montenegro residents from foreign countries. The overall FDI inflow was in 64 per cent invested in real estate, while 34 per cent was invested in domestic companies and banks.

### ***Labour market developments***

The official rate of unemployment currently stands at 27.3 per cent in Serbia. At the same time according to the Labour Force Survey unemployment in 2005 amounted to 20.8 per cent. The latter is presumably the more realistic estimation.

The registered unemployment rate was 25.2 per cent in Montenegro in Q1 2006. From January to July of 2006 the number of unemployed decreased by 17 per cent. The number of employed increased by 4.6 per cent during the same time period. The average monthly wage also increased, and reached EUR 378.23 in July, while the average wage without taxes and contributions amounted to EUR 246.95 in the same month in Montenegro.

No significant improvement is expected in the labour markets of Serbia and Montenegro in the short term. However in the medium term favourable economic performance will translate to increase in employment.



**Table 8. - Major macroeconomic indicators for S&M, 2004-2007**

	2004	2005	2006*	2007*
<b>GDP (%) Serbia&amp;Montenegro</b>	8.8	6.1	5.0	5.5
<b>Private consumption (%)</b>	n.a.	n.a.	n.a.	n.a.
<b>Public consumption (%)</b>	n.a.	n.a.	n.a.	n.a.
<b>Investments (%)</b>	15.5	17.0	n.a.	n.a.
<b>Export (%) Serbia</b>	30.7	20.9	22.0	n.a.
<b>Import (%) Serbia</b>	44.5	11.1	10.0	n.a.
<b>GDP (%) Serbia</b>	9.3	6.5	5.0	6.0
<b>GDP (%) Montenegro</b>	3.1	4.0	6.0	5.5
<b>Consumer price index (average, %), S&amp;M</b>	10.8	15.2	11.5	9.7
<b>Retail prices (% p.a.) Montenegro</b>	3.3	2.4	2.3	2.9
<b>Retail prices (% rel. to end of last year) Serb.</b>	13.7	17.7	13.5	8.2
<b>Unemployment ratio (%) Serbia</b>	31.7	32.6	30.0	30.0
<b>Budget balance (% of GDP) Serbia</b>	-0.1	0.9	2.6	3.0
<b>Public debt/GDP (%) Serbia</b>	56.6	46.2	43.2	42.0
<b>Current account/GDP (%) S&amp;M</b>	-12.5	-8.7	-8.3	-6.8
<b>Trade balance/GDP (%)</b>	-28	-25	-22.0	-20.0
<b>Gross foreign debt/GDP S&amp;M</b>	61.1	61.6	58.8	53.8
<b>Average exchange rate (CSD/EUR)</b>	72.6	83.2	89.4	93.3
<b>Base rate (Serbia)</b>	8.5	8.5	8.5	8.5

Sources: IMF, National Bank of Serbia, Central Bank of Montenegro,

\* Forecasts

