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TABLE OF CONTENTS

<i>EBRD TRANSITION REPORT 2004</i>	
<i>– SOUTHEAST EUROPEAN COUNTRIES PERFORMED WELL IN REFORM PROGRESS</i>	<i>3</i>
<i>UNEMPLOYMENT IN BULGARIA - SOURCE OF SOCIAL TENSION OR OPPORTUNITY</i>	<i>6</i>
<i>BALANCE OF PAYMENTS IN SERBIA AND MONTENEGRO</i>	<i>8</i>
<i>PRIVATIZATION IN THE ROMANIAN ENERGY SECTOR</i>	<i>10</i>

EBRD TRANSITION REPORT 2004 – SOUTHEAST EUROPEAN COUNTRIES PERFORMED WELL IN REFORM PROGRESS

At the beginning of November 2004, the European Bank for Reconstruction and Development (EBRD) published its Transition Report. The annually issued Report deals with the development of transition countries and this year the special topic in the Report is infrastructure in these countries that contains energy, telecommunications, transport and water supply. The 27 transition countries are divided into three groups in the Report: Central Eastern Europe and the Baltic states (CEB), South-Eastern Europe (SEE) and the Commonwealth of Independent States (CIS). Certainly, within the confines of SEE Monitor we focus on the SEE countries, while the comparison of that region – mainly to the CEB – can be relevant and interesting.

The main highlights of Transition Report 2004 are the following:

- Progress in reform during 2003-2004 was most pronounced in South-Eastern Europe. Elsewhere the pace of transition was uneven. Sustained structural reforms will stimulate growth in the longer term.
- The transition countries are expected to grow by 6,1% in 2004, helped by a positive international trade environment. Rapid credit growth is boosting domestic consumption and investment.
- In the infrastructure sector, many countries have found it difficult to establish independent, accountable and credible regulatory agencies.
- Private sector participation is increasingly taking the form of concessions and management contracts rather than asset sales. Local investors are becoming more important.

Among the SEE countries, mainly the EU candidate countries' (Bulgaria, Croatia and Romania) reform progress was accelerated in 2003 and 2004. The pace of progress was more significant in these countries than in the CEB countries due to the fact that the progress of reforms slowed down after the EU accession. Despite that the business environment improved in CEB countries.

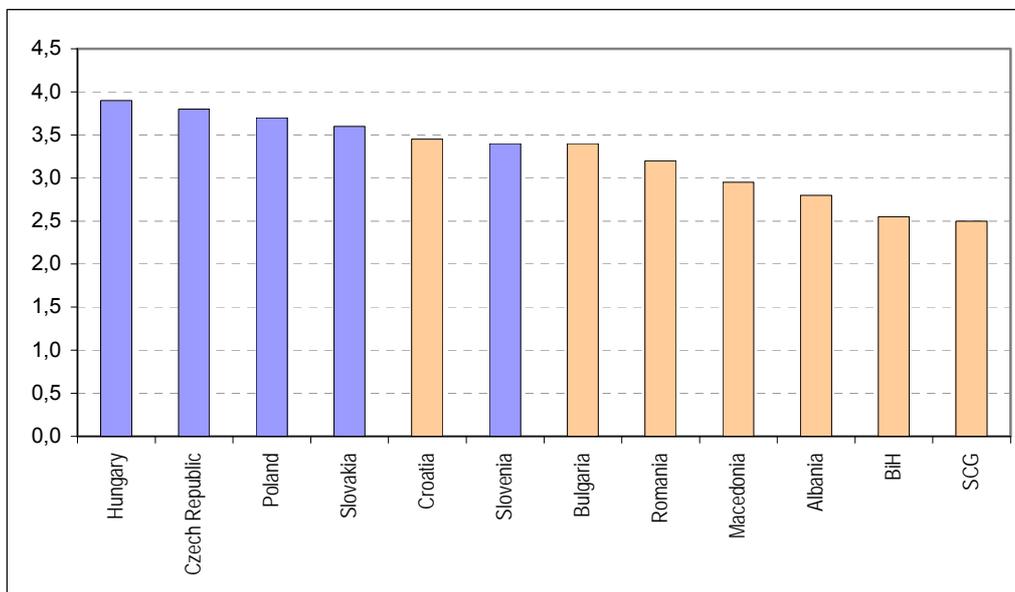
Although, the reform process was most pronounced in SEE countries during 2003-2004, the CEB countries or New Member States of the European Union are the most advanced in the implementation of reforms. According to the Report, Hungary ranks first in implementing the regulations for economic activities, tax reforms and stimulating the private initiative.

Most progress was made in building market-supporting institutions: financial services continued to develop, while, bank lending to the private sector accelerated. This was complemented by improvements in regulation and further banking consolidation. Progress in infrastructure and large-scale privatisation was also significant.

In most transition countries, economic growth remained strong in 2003 and 2004. In South-Eastern European countries - mainly in Bulgaria, Croatia and Romania - the improving political stability and the outlook of EU membership underpinned the strong economic growth. The growth rate can reach 5% in these countries due to the strong domestic demand. The latter was basically fuelled by the credit boom started in these years. On the other hand, the rapidly growing stock of domestic credit helped the improvement, the deepening of financial system. One of the most significant problems of these economies is the high current account deficit due to the strongly negative balance of foreign trade. The high current account deficit in these countries is often financed by remittances and foreign aid (mainly in BiH) and not by foreign direct investments which would be more desirable according to the

mainstream economic literature. The main problem with this type of financing is that the remittances and aid are not stable financing sources, their availability is not guaranteed in the future.

CHART 1.
**TRANSITION SCORE IN SEVERAL CENTRAL EUROPEAN
 AND SOUTHEAST EUROPEAN TRANSITION COUNTRIES (2004)**



Source: EBRD Transition Report 2004

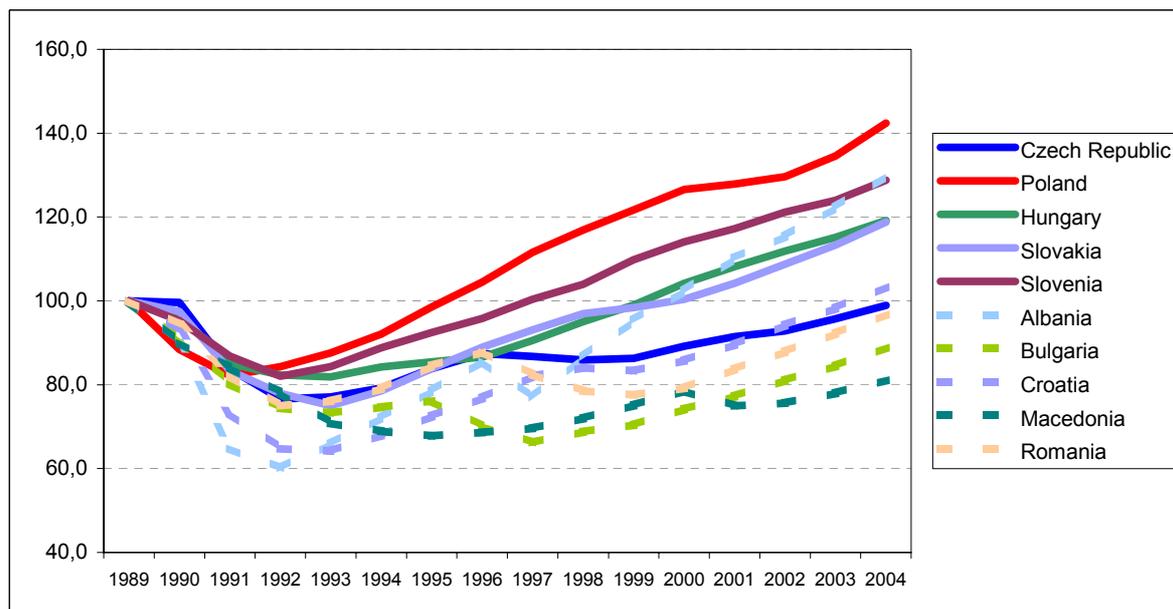
While in the more advanced CEB countries the per capita GDP in 2004 will reach about 130% of 1989 level, in average that of SEE countries still remain under the level of 1989 (approximately 90% in average). The main reason for that is the longer recession period after transition. While the most CEB economies touched the bottom mainly in the first half of the 90s, in SEE region the economies reached the nadir almost a half decade later. That is the reason why the lowest point was generally lower and the recovery started later, thus, these economies are commonly further from their 1989 level. The strong (4-5%) growth in this region started basically in this decade.

Another important difference between the two groups is the level of FDI in these economies. While in the SEE region the FDI (stock)/capita is about EUR 500 or less (with the exception of Croatia, where this figure is about EUR 1500), in the Czech Republic or Hungary the per capita FDI reach EUR 3-4000 and the respective data of Slovakia and Slovenia is approximately EUR 1500-2000. These figures reflect that the foreign investors favoured significantly the CEE region against SEE economies in the past one and a half decade. The FDI inflow started to increase rapidly only at the end of the 90s in the SEE economies and the dynamic growth of foreign investments seems to remain in 2004, too.

As it was mentioned above, the special topic of this year's Report is infrastructure. The good condition of infrastructure is essential for a stable economy, thus the reform of infrastructure plays a key role in transition. The appropriate infrastructure, on the one hand, facilitates the operation of local enterprises, on the other hand, helps the integration of the economy into the global market.

Concerning the regulation of infrastructure services, EBRD states that in the telecommunications, electricity and railways sectors, many of the advanced transition countries have succeeded in establishing independent and accountable authorities, while, other countries have struggled to put credible arrangements in place, partly due to the weak institutional environment in which regulatory reform is taking place.

CHART 2.
**ECONOMIC GROWTH IN SEVERAL CENTRAL EUROPEAN
 AND SOUTHEAST EUROPEAN TRANSITION COUNTRIES (1989=100)**



Source: IMF, national banks

According to the Report, the results from surveys of industrial consumers of infrastructure services show that the effective regulation helps to improve service deliveries. Specifically, where regulators have taken steps to encourage more commercial discipline in infrastructure services, there has been less interruption in services.

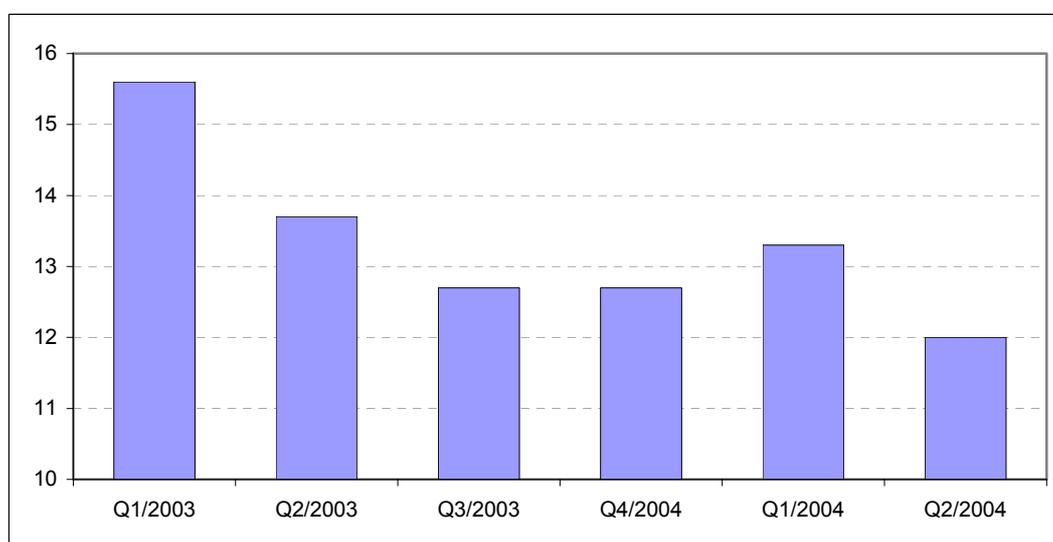
Better regulation promotes private investment and private operators have stronger incentives to raise collection rates, prevent arrears and ensure adequate revenue flows. However, the impact of private ownership on performance depends on the extent of competition.

To sum it up, the effective regulation, the competition and private sector participation (PSP) help basically to achieve a more efficient infrastructure according to the Transition Report. In the past, the telecommunication sector attracted the most private sector interest, followed by urban transport and energy sector, while it lagged behind in water supply, roads and railways infrastructure. The governments promoted the private sector participation to share risk in investments in infrastructure, to reduce the pressure on fiscal resources and to improve the performance of these utilities. According to empirical data from the transition economies, it seems that PSP helped these economies to achieve better infrastructure.

UNEMPLOYMENT IN BULGARIA - SOURCE OF SOCIAL TENSION OR OPPORTUNITY

In September 2004 the Ministry of Labor and Social Policy in Bulgaria announced that one of the most serious economic problems for the country, the unemployment level, was relieved as it reached a five-year minimum of 11.74 percent (see Table below). This level is lower than the unemployment for July 2004 of the new EU members Poland (18.8 percent) and Slovakia (15.9 percent) and is close to Lithuania (11.3 percent) and Estonia (11.00 percent). This article will investigate the state and causes for the problem of unemployment in Bulgaria, the instruments for its solution, as well as the expectations for the future.

CHART 3.
UNEMPLOYMENT RATE IN BULGARIA (%)



Source: National Statistical Institute of Bulgaria

For most transition countries the time series for the unemployment level follow a particular pattern. Initially, with the process of restructuring, the typical for the communist regime zero unemployment rates increase as productivity rises, however, in the long run, increased productivity attracts new investments leading to higher employment. In this way, economies which started the structural reforms have initially incurred the price of higher unemployment, but later reached lower levels, thus forming an inverse U shaped curve.

Similarly to this tendency the process of restructuring in Bulgaria was accelerated in 1997 after a banking and currency crisis. In the process of reforms, the private share of GDP increased from 45 percent in 1996 to 75 percent in 2001. As a consequence of the restructuring in this period, unemployment rate increased from 12.5 percent in 1996 to extremely high 19.8 in 2001. Further, as in a recent paper, Valev (2004) shows the public was well aware of the causes of the problem, as even he claims the unemployed were accepting the reforms as a necessary evil. Thus there was sufficient support the reforms to take place.

However, surveys of the unemployment of Bulgaria are determining it as one of the most important economic problems for the country. In a study of the World Bank, Rutkowski (2003) establishes low employment among the young and older workers and long duration of the unemployment. Further,

there is a substantial proportion of the unemployed in the country who have decided not to look for employment actively forming a pool of 453 thousand discouraged workers outside of the labor force in the second quarter of 2004 (see Table below).

TABLE I.
LONG TERM UNEMPLOYMENT AND DISCOURAGED WORKERS IN BULGARIA

Quarter	Q1 2003	Q2 2003	Q1 2004	Q2 2004
Rate of long term unemployed	66.8	57.4	62.3	59.8
Discouraged workers	415.7	368.1	475.9	453.4

Source: National Statistical Institute of Bulgaria

Rutkowski investigates further the reasons for unemployment. Due to the restructuring the survey establishes skills mismatch. In this way unemployment is mainly structural, due to differing abilities and knowledge of the unemployed compares with the required by the employers. Another reason for the high persistent unemployment in the country is the low rate of formation and level of small and medium sized enterprises. Further the paper finds as a problem the rigidities in the labor market related with the employment and the lay off of workers, causing them to restrain from employment.

The observed recent decline in the unemployment rate may be considered as a result of the economic growth and the government programs for employment. The rate of growth of employment is consistent with the growth in the economy in Bulgaria. Thus, one of the factors contributing to the decline of the unemployment is the effect of the restructuring in the economy and the recovery.

The other factor is the government programs and EU pre-accession programs for reducing the unemployment. The efforts in this field in Bulgaria mainly concern the major problems described so far. In the end of its mandate, the current government headed by Simeon Saxe-Coburg Gotha has partial success in achieving its aims.

There is progress in the orientation of the measures from social payments to active encouragement of employment and vocational training. Such measures address the obsolete skills and abilities leading to mismatch with the demand side of the labor market. However, the declared intention of reducing the long-term unemployment to 20 percent is far from achieving (see Table 2). The other serious problem, the youth unemployment, is also addressed mainly through the pre-accession programs. Therefore, there are still substantial challenges for the next Government in the field of unemployment policy in the country.

In conclusion the high unemployment in Bulgaria may be considered as a reason for a social tension or opportunity. On the one hand, it is a serious problem for the country, especially at this high level, always a potential cause of public disagreement and an obstacle for further reforms. On the other hand, it is a source of unutilized labor resources, which can lead to economic growth with the appropriate government program. Thus it is matter of the appropriate policy for the future Bulgarian government to transform the problem into an opportunity.

BALANCE OF PAYMENTS IN SERBIA AND MONTENEGRO

The foreign trade deficit in 2004 will reach a record level, USD 6 billion, but the income of the republic from investors and donations is considerable, this will decrease the deficit of the current account to 2,5 billion dollars by the end of the year.

BALANCE OF PAYMENTS

	2003 jan-sept	2004 jan-sept	Index
I. Current account	-1135	-1942	171,10
Goods, net	-3236	-4964	153,40
Export	2036	2466	121,12
Import	-5272	-7430	140,93
Service, net	230	269	116,96
Export	716	1029	143,72
Import	-486	-760	156,38
Net factor import	-130	-99	76,15
Current transfer, net	1553	2517	162,07
Official grants	348	355	102,01
II. Capital account	1885	1466	77,77
Foreign direct investment	919	560	
Disbursement mid and long-term credits, net	710	681	
Short-term loans, net	-4	193	
Commercial bank, net (increase -)	-94	-44	
Other capitals inflows, net	354	78	
III. Net errors and other omissions	418	516	
IV. Overall balance (I+II+III)	1068	40	
V. Financing - Currency reserves of NBS (increase -)	-1068	-40	

Source: National Bank of Serbia

The foreign trade deficit till September this year increased by 53,4% in comparison to last year's data, which means an increase from USD 3 236 million to USD 4 964 million. Export increases by 21,1% and import by 40,9% this year.

To decrease the deficit in balance of foreign trade the government forbade the import of cars older than 3 years on 7 October 2004. By this date in 2004 the volume of car import had reached 1 billion dollars, 700 millions dollars of this was spent on second-hand cars.

The volume of foreign trade (export + import) till September 2004 compared to the same period of last year increased by 35,4%, so the openness of Serbian economy have been growing. The proportion of investment to GDP is low, however the structure of import is favorable, because the third quarter of imports goes to further consumption, and only one quarter is consumption goods.

The main export products are: steel and iron, fruit and vegetables, products from chaoutchouc etc, and the main import products are: oil and oil products, road vehicles, industrial machines etc.

TABLE 2.
MAIN TRADING PARTNERS OF SERBIA AND MONTENEGRO

	Export			Import	
	Value (mill. USD)	Share in Total (%)		Value (mill. USD)	Share in Total (%)
Bosnia-Herzegovina	452	18,3	Germany	1016	13,7
Italy	297	12,0	Russia	912	12,3
Germany	260	10,6	Italy	695	9,3
Macedonia	188	7,6	China	342	4,6
Russia	111	4,5	USA	297	4,0
Other	1158	46,9	Other	4168	56,1
TOTAL	2465	-	TOTAL	7430	-

Source: National Bank of Serbia

The current account deficit increased by 54,2%, which is relatively high, but in absolute terms is lower than the balance of foreign trade deficit, due to the amount of transfers and exchange businesses. Despite of the high deficit the liquidity of the government improved, the reserve of National Bank of Serbia was USD 40 million in September 2004.

The Serbian government wants to improve the economic situation with the increase of foreign investments. According to a statement of the Privatization Agency in the period from the transition till October 15 2004 1235 companies were privatized and 88,9 billion dinar (around 1,5 bn dollar) flowed into the Exchequer.

After the drop of processing industry by 3% in 2003 till September this year the growth of manufacturing was 6,9%. The degree of utilization in Serbian industry is still very low, especially in the processing industry, according to estimations in some sectors it is only one third of the existing capacity.

The trade volume increased by 14,8% in first nine months of 2004, behind this there is the increase in real wages and one-time effect was the introduction of the fiscal cash register in the third quarter of this year. The goal of the introduction of the cash registers is to control the turnover of trade and the money circulation and to direct the inflow of revenues into the budget instead of the area of gray economy.

The internal demand exceeded the internal production, because of that the need for import increased. (This structural problem is waiting for solutions.). The average of net wages in September 2004 was around USD 237, real wages in the third quarter of 2004 increased by 11,7 % compared to the same period last year.

The growth of this year's GDP is 7,5%. It is obvious that the increase of wages is higher than the increase of productivity, but it is promising that the growth shows a reducing tendency.

The inflation was 9,7% in the first three quarters of 2004, where increase of price of goods was 7,3 % and 2,4% that of services. Behind the higher than planned level of inflation there are is the decrease of disparity in regulated price products -especially the rise of energy prices, which increased by 14,4%- and the high oil prices.

In 2004 the goal of monetary policy is to decrease inflation further. First projection was 7 %, later the prediction changed to 8,5%, but now is clear that we should expect double -digit inflation, it will be around 11% . Besides low inflation, other intentions are the stability of financial system and increasing the reserves of NBS. The base rate in 2004 is 8,5%.

PRIVATIZATION IN THE ROMANIAN ENERGY SECTOR

During the years 2003 and 2004 a speed-up in the privatization process of the Romanian energy sector could be observed. This development resulted on the one hand from the need of improving energy efficiency, and also from the pressure of the coming EU accession. By 2007, the planned year of accession, the Romanian energy market will have to be 100 percent liberalized. The privatization of the energy sector is vital for the completion of the restructuring of the Romanian economy, as the amount of subsidies, losses and bad debts in this sector reached 1 billion USD as of 2002.

According to the Office of State Ownership and Privatization in Industry, operating as a part of the Ministry of Economy and Commerce, the objectives of the privatization process are the modernization of management, technology and infrastructure, as well as increasing security during exploitation, providing new jobs, ensuring competitiveness, consumer protection and improving the quality of service. Ensuring the transparency of the privatization process is also a priority.

A long-term strategy paper called 'Energy Road Map for Romania' has been created by the government, which covers the period until 2015. In the Road Map it is pointed out that the privatization in the electricity and gas distribution, as well as on the electricity generation side should be accelerated. The legal and regulatory framework of the energy market should be improved and market mechanisms should be harmonized with the EU Directives. Before privatization, restructuring programs should be implemented at the companies to be sold. Equal treatment should be ensured between buyers. In the energy sector about 10,485 million USD investment is needed in the medium term, while in the natural gas sector 4,498 million USD is needed until 2010.

POWER SECTOR

In the beginning of the 90s the only actor in the Romanian power sector was the 100 percent state owned RENEL. In mid 1998 RENEL was reorganized into several specialized entities. The Nuclear Power Company remained 100 percent state owned, while all the other activities were gathered into CONEL. In July 2000 CONEL was further restructured into four specialized companies. Transelectrica is responsible for power transmission and it is the market operator, Termoelectrica is the thermal power and heat generator, Hidroelectrica is the hydropower generator, and Electrica is the power distributor. An independent regulatory body, the National Electricity and Heat Regulatory (ANRE) was also established. A legal and institutional framework evolved, that made it possible to gradually continue the liberalization process in the energy market.

Transelectrica is a 100 percent state owned company, and will not be privatized because of strategic reasons. The company is responsible for the safe and efficient functioning of the power system and the wholesale energy market and for the connections to the electricity networks in neighboring countries. The aim of Transelectrica is to become a major exporter to these neighboring countries, as well as to the Eastern Mediterranean region.

Termoelectrica is the company responsible for running the thermal power plants of Romania. In addition to producing electricity, it also produces thermal power, it is responsible for district heating and providing the related supply fuel. Since March 2003 Termoelectrica has been divided into four regional units. Three of these are production subsidiaries (Turceni, Rovinari and Bucharest), and one of them is a services and maintenance unit. Termoelectrica is a 100 percent shareholder in all four companies. The asset base of the company is obsolete, with over 82 percent of the generating capacities being older than 20 years, and 34 percent being older than 30 years. This leads to the inefficient performance of the company and its subsidiaries, which is characterized by high generation

costs, high emission levels that fail to meet the EU environmental standards, and also poor financial performance. Therefore Termoelectrica is in the need of investment. It is looking for financing for projects totaling 1.7 billion dollars, 600 million of which is needed only for environmental investment.

The primary energy resources burnt by Termoelectrica each year are 23.1 million tons of lignite, 3.5 million tons of pit coal, 1.7 million tons of fuel oil, and 3 billion cubic meters of natural gas. Some 55 percent of the installed capacity uses coal, and the rest (45 percent) of the installed capacity uses hydro carbonates. Around one third of the primary energy resources burnt are imported. This is a source of problems, as Termoelectrica often lacks the hard currency funds to pay for these resources.

In 2004 three energy complexes have been set up: in Rovinari, in Turceni and in Craiova. At these complexes the mining sites have been integrated into the complexes as cost centers of the power plants. This way it will be possible to enhance profitability of both the coal mining and the power-generating sector. For S.C. Complexul Energetic Rovinari S.A. there have been 9 Letters of Intent submitted, for S.C. Complexul Energetic Turceni S.A. 10 companies expressed their interest, and for S.C. Complexul Energetic Craiova S.A., 5 companies. Besides these, also the EBRD and IFC have also showed intentions in investing in these complexes.

Hidroelectrica is the company operating the hydro power plants in the country. It is the second largest power generator (28 percent of total power consumption), and is also a power exporter. In 2003 the exports were reduced due to the severe drought. Hidroelectrica is a joint stock independent company, and is 100 percent state owned. It has 12 non-corporatized, geographical branches. Each of them operates a number of hydro power plants. There are also a number of hydro power plants, which are not completed yet. For most of them the building works had started before 1989. Hidroelectrica will complete most advanced projects under the BOT scheme, while the remaining ones (about 21 projects including 36 hydropower plants) were offered for completion to interested investors by the Ministry of Industry and Resources. Expressions of interest have been submitted by Electricite de France, Union Fenosa, ENEL, RWE, Itochu, Toshiba and Kansai (Japan), Tahal (Israel), Mecamidi (France), VA-TECH Hydro and Voith Siemens Hydro Power Generation GmbH (Austria). An initial list of 242 micro-hydropower stations have been transferred to Hidroelectrica for privatization.

Electrica is the power distributor company. In August 2001 it was reorganized into eight companies, according to the regions identified in the Government's Green Book regarding regional development. The corporatization of the eight regional distributors was finalized by mid 2002, opening the way for their privatization. Two of them, Electrica Dobrogea and Electrica Banat have already been sold to the Italian company, Enel. By the time Romania joins the EU (in 2007), all the remaining six power distributor companies will have to be privatized. In September 2004 Electrica Otenia and Electrica Moldova were already at the stage of preliminary bids.

Nuclearelectrica is the company operating the Cernavoda nuclear power plant, which consists of five CANDU units out of which only one is completed and operating. It is the third largest power producer in the country, accounting for about 10 percent of power consumption. It is also the owner of the nuclear fuel plant in Pitesti. As mentioned earlier, only Unit I is operating, while Unit II is 40 percent completed. The works have been financed by the Romanian government, manufacturer supplier credit, and a Societe Generale loan. The completion of Unit III (which is currently 16 percent finished) is expected to be financed through a PPP arrangement. Unit IV and Unit V are 5 and 4 percent completed respectively, and are not expected to be finished in the medium term.

OIL SECTOR

Romania has 955 million barrels of crude oil reserves. The reserves are located on-shore, as well as off-shore in the Black Sea. Oil production was declining until 1992, when it stabilized at about 6 million

tonnes per year. According to the Government's Strategy, a slight declining trend will continue until 2010, when production is expected to reach 5.57 million tonnes. The current crude oil production in Romania is only 25 percent of the refining capacity (ten refineries) of the country.

The sole producer of crude oil in Romania, SNP Petrom has been privatized in 2004. It owns two of the most important refineries, Petrobrazi Ploiesti and Arpechim Pitesti. In 2001 the combined capacity of these two refineries accounted for 35 percent of the sector's operating capacity, and processed 55 percent of the total crude. SNP Petrom's main competitor in the refining market is the Russian company, Lukoil. It operates the Petrotel refinery in Ploiesti. Another refinery owner is the Romanian private company, Rompetrol Group. Interagro and Omnimpex Group each own a small capacity refinery. The Romanian refining industry is overall operating under its potential. In many refineries imported crude is processed and fuel products are exported. Most of the Romanian refineries are in the need of reconstruction. The product structure also has to be improved, as the share of products with high value added is too low.

NATURAL GAS SECTOR

In 2002 in Romania the share of natural gas within the domestic primary energy resources reached 41 percent. No major discoveries of natural gas were made during the last decade.

The main actor in the exploration, production and underground storage of natural gas is SNGN Romgaz, a state owned company. In 2005 its privatization might be considered. Other actors in exploration are SNP Petrom and several other foreign companies. Transgaz, the company responsible for domestic gas transmission and international transit is 100 percent state owned. There are several natural gas distributors in Romania. Distrigaz Nord and Distrigaz Sud are state owned, while SNP Petrom, and several others (Congaz Constanta, Condmag Brasov, Vitalgaz, Gazvest Arad) are private companies. Distrigaz Nord and Distrigaz Sud are to be privatized. The privatization contract was already signed between Distrigaz Nord and EON Ruhrgas on the 21st of October 2004.