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EXCEEDING GDP GROWTH IN THE FIRST THREE QUARTERS OF 2004

According to the estimation of INS, the Romanian National Institute of Statistics, in the Q1-Q3 period of 2004, the Romanian Gross Domestic Product (GDP) increased by 8.1% (preliminary data) compared to the same period of 2003: in the first three quarters of 2004 the GDP amounted to ROL 1,588,539 bn in current prices or approximately EUR 39,71 bn. The pace of increase is quite outstanding although the GDP followed a dynamic trend in the previous periods too: the same figures were 6.6% YY for the first semester of 2004 (ROL 907,871 bn) and 6.1% for the first quarter of 2004 (ROL 405,354 bn).

What are the factors behind this significant growth?

SUPPLY SIDE OF GDP

On the supply side the agriculture, sylviculture and pisciculture sector realized the highest pace of growth (19.7% YY), followed by the construction sector with a 10% YY increase. The significant growth of the agriculture is due to the good harvest of 2004 as well as to seasonal effects too. However, the low base in 2003 must be mentioned, when the output of the agriculture was significantly lower, due to unfavourable meteorological circumstances. The increase of construction is caused on one hand by the increase of disponable income of the population, and on the other hand by seasonal effects, as in wintertime construction activity is usually low. This process is shown in the GDP figures of 2004: the agriculture sector increased by 5.4% YY in Q1 2004 (ROL 11,692 bn), and 5.3% YY in H1 2004 (ROL 50,775 bn), while it exploded by 19.7% in Q1-Q3 2004 (ROL 184,865 bn); the construction sector grew by 7.2% YY in Q1 2004 (ROL 15,381 bn), and 8.6% YY in H1 2004 (ROL 42,723 bn), while it went up by 10.0% in Q1-Q3 2004 (ROL 79,121 bn).

TABLE 1. – STRUCTURE OF GDP – SUPPLY SIDE (Q1-Q3 2004)

Supply Side	bn ROL	m EUR	Q1-Q3/2003 = 100
Agriculture, sylviculture and pisciculture	184 865	4 622	119,7
Industry	475 548	11 889	106,2
Construction	79 121	1 978	110,0
Services	687 945	17 199	106,0
Financial intermediation services indirectly measured	-15 362	-384	104,1
Gross value added - total	***1 412 117***	***35 303***	107,9
Net taxes on product	176 422	4 411	108,9
Gross Domestic Product	***1 588 539***	***39 713***	108,1

Source: INS

The composition of the GDP reflects that services had the highest contribution to the increase of the GDP. This is in line with expectations as the services sector's share in gross value added is the highest (48.3%). The industry sector has the second largest share in gross value added, it is 33.3%, while the same figures for agriculture and construction account 13.0% and 5.4% respectively. The succession was different for the first quarter of 2004, when construction had a 4.3% share, while agriculture had 3.3% share in gross value added: it was obvious as the main activity season of agriculture is principally the middle semester of the year rather than the winter semester.

DEMAND SIDE OF GDP

On the demand side of the GDP, the private consumption was the main engine of the exceeding economic growth in the Q1-Q3 period of 2004: household consumption was higher by 9.8% compared to the same period of 2003, while government consumption increased by only 4.3% YY. This shows that in spite of the election year (elections are currently ongoing), the economic policy of the Nastase-cabinet - both the fiscal and the monetary policy – followed a general restrictive trend, and the income centralisation of the cabinet did not increase. The dynamics of household consumption started to increase at the beginning of 2003, when the overall minimum wage on the economy was significantly increased. Also the intensified credit activity of banks helped to increase the consumption of population: it is meaningful per se that since 2003 retail and mortgage credit has grown exponentially and in 2003 alone non-government credit increased by 50% in real terms. As the external demand started to decrease in 2003 and as GDP grew in the second consecutive year (2001 and 2002), thus the disponable income of the population increased too and the internal demand became the main engine of the economy.

TABLE 2. – STRUCTURE OF GDP – DEMAND SIDE (Q1 2004)

Demand Side	bn ROL	m EUR	Q1-Q3/2003 = 100
Total final consumption	**1 325 757**	**33 144**	**109,4**
Households	1 225 676	30 642	109,8
General government	100 080	2 502	104,3
Gross capital formation	**399 198**	**9 980**	**-**
Gross fixed capital formation	369 660	9 242	113,7
Net exports of goods and services	**-136 416**	**-3 410**	**-**
Export of goods and services	653 454	16 336	116,2
Import of goods and services	789 870	19 747	120,2
Gross Domestic Product	**1 588 539**	**39 713**	**108,1**

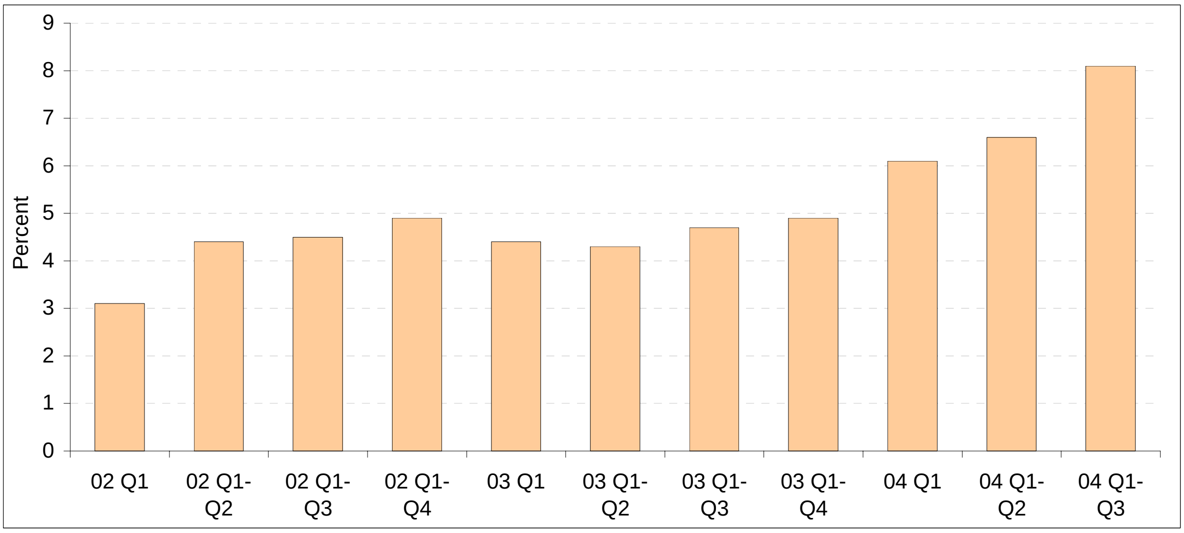
Source: INS

Gross fixed capital formation also followed an increasing trend in 2004: in the first quarter of 2004 it grew by 7.3% YY, in the first semester it continued to increase by 10.4% YY, while in the first three quarters of this year it registered a significant growth of 13.7% compared to the same period of the previous year. The investment rate calculated as the ratio of gross fixed capital formation and the gross value added was 28.3% in Q1-Q3 of 2004, while it was 24.7% for the same period of the previous year. The same figures for Q1 and H1 2004 were 18.9% and 23.7%.

In the first nine months of this year the increase of imports continued to overwhelm that of exports. In this period exports grew by 16.2% YY, while imports went up by 20.2% YY. The same figures were 17.1% YY and respectively 19.1% YY for H1 2004, and 10.2% YY and respectively 12.4% YY for Q1 2004. This significant difference between the pace of increase of exports and imports – especially for the summer period, resulted a foreign trade deficit of EUR 3,410 mn for Q1-Q3 2004. In spite of this, the external equilibrium of the economy is in better shape, since net current transfers counterbalance the worsening balance of foreign trade (i.e. the Romanian guest workers in Western Europe and Israel transfer a lot of hard currency back home to support their families): in Q1-Q3 2004 net current transfers were EUR 1647 mn, while for the same period of 2003, this value was EUR 1205 mn.

The structure of exports and imports by goods shows that the Romanian economy still has to develop: the increase in the macroeconomic income (this is the base of the growth of household consumption) is partly a result of the lohn-system manufacturing. In the lohn-system, foreign investors manufacture labour intensive products using cheap labour force: due to this, the share of clothing, textiles and footwear is 29.3% in total exports and 13% in total imports.

CHART 1. – GDP GROWTH (COMPARED TO PREVIOUS PERIOD, %)



FUTURE PROSPECTS

Should the boom return in the European Union, the role of private consumption in the increase of GDP is expected to diminish, and exports are expected to be the driving engine of economy. However, in the next few months, this is a rather improbable scenario for Romania's main trading partners like Germany and Italy, and therefore the private consumption is expected to play a major role. In spite of this, the internal equilibrium of the economy is in good shape as the consolidated budget deficit and GDP ratio is around 2%, respectively the inflation is following a decreasing trend.

In longer term, GDP is expected to grow in a higher pace compared to the European Union, as risks associated to Romania will decrease before the EU accession and as the technological transfer through green-field investments will increase due to the cheap labour force. Also the fact that some industries are not yet restructured will have a positive effect on the dynamics of GDP. This trend is reflected by the fact that the Romanian GDP/capita calculated on PPP bases was 25% of the European Union average in 2000, while the same figure went up to 30% in 2003.

What are the factors behind this significant growth?

FINAL CONSUMPATION OF POPULATION: INCREASING HOUSEHOLD CREDIT

The main factors behind this outstaning increase is the final consumption of population: in the first quarter of 2004 it grew by 8.4% YY, while in the first semester of 2004 it increased by 9.0% YY. The same figures for total final consumption were 8.1% YY and 8.8% YY. The consumption of population was impulsed by the increase of discreationary income of population: the minimum salary of the economy was increased and bonuses at companies for 2003 and for Eastern 2004 were paid in January and May. Due to the income outflow, productivity decreased, however this does not have a negative effect on the global macroeconomic equilibrium.

The growth was significantly driven by higher activity volumes and, consequently, by higher gross value added in industry (+5.9%), construction (+8.6%) and services (+6.5%), whose contribution to the Gross Domestic Product was 83.9%.

PRIVATIZATION IN THE BULGARIAN ELECTRICITY SECTOR

The National Assembly adopted the Energy Strategy of Bulgaria in 2002, paving the way for the start of the privatization process in the Bulgarian energy sector. The regulatory authority of the sector is the State Commission on Energy Regulation (SCER), which has been responsible for setting electricity tariffs since January 2002. The power market is expected to be rapidly liberalized, as full liberalization must be achieved by Bulgaria's planned EU accession date, 2007.

The privatization process of the Bulgarian energy sector started in 2003, with the privatization of the energy distribution companies. Three sale packages were constructed of the seven electricity distribution companies (the eighth one, Zlatni piasazi was already in private hands). The Western Bulgaria package consisted of EDC Stolichno, EDC Sofia Oblast, and EDC Pleven. The Southeastern Bulgaria package consisted of EDC Plovdiv, and EDC Stara Zagora, and the Northeastern Bulgaria package consisted of EDC Gorna Oriyahovitza, and EDV Varna. All in all, in the electricity sector 17 companies were going to be privatized in 2004. Apart from the companies dealing with distribution, also generation, repair, transport, maintenance and coalmining companies were planned to be privatized in 2004. The main aim of the privatization of companies in the electricity sector (besides gaining revenues) is to improve customer service through commercialization of all aspects of the electricity business. The privatization of the seven state owned regional electricity distribution companies was the first stage in the energy sector privatization strategy of the Bulgarian government. The second stage will be the privatization of three power generation companies. At the same time the privatization of district heating companies will begin.

In 2005 the sale of three electricity generation companies is expected to bring a large amount of revenue to the Bulgarian state. The sale of TPP Bobov Dol, TPP Varna and DHC Russe are expected to be finalized in the first half of 2005. All three companies to be privatized have been incorporated as 100 percent state owned joint stock companies. They are managed by a board of directors of five members appointed by the Minister of Energy. Each company has an executive director, responsible for developing the company's strategy and policy.

DHC Russe is located in Northeast Bulgaria, on the bank of the Danube. This enables it to take advantage of Port Russe. DHC Russe includes two parts: TPP Russe East and TPP Russe West. TPP Russe East generates electricity and thermal power. TPP Russe West generates thermal power. The energy source of DHC Russe is high calorific value imported black coal, with low sulfur content. This enables the cogeneration of electricity and thermal power. Russian and other imported coal is used here. DHC Russe (like the other two power plants to be privatized) is an intermediate load power plant. TPP Russe East has been historically dispatched at 25 percent. Annual average electricity output over the period 1996-2000 was only 382 GWh, while net output was 507 GWh in 2001 and 507 GWh in 2002. Electricity output is expected to reach 1,000 GWh annually over the period 2008-2015. This will be enabled by the planned refurbishment of Unit 3 (110MW), which has been out of operation for technical reasons since 1991.

TPP Varna is located in Northeast Bulgaria, 10 kilometers west of the town of Varna. The nearby Varna Lake enables it to take advantage of Port Varna. TPP Varna has a total installed capacity of 1,260 MW. It has six 210 MW units, which were commissioned in the 60's and the 70's under Russian design and technology. Imported coal with high calorific value and low sulphur content is burned in the power plant. TPP Varna was historically dispatched at a low rate, covering the intermediate load of the domestic power system. Over the 1996-2000 period average electricity production was 1,889 GWh. In

2002 it reached 2,300 GWh. The projected demand for TPP Varna's energy output is expected to reach an annual average between 4,000 and 6,000 GWh in the next ten years.

TPP Bobov Dol is located in Southwest Bulgaria, 70 kilometers south of Sofia. The power plant was built between 1973 and 1975. It has three 210 MW units, therefore the total installed capacity reaches 630 MW, while the available capacity is 570 MW. The units were initially designed to burn indigenous brown coal with high ash content. Later the combustion units were adapted to burning blended coal. Currently the power plant is supplied by 12 mines, which are located in Southwestern- and Western-Bulgaria. These domestic coal reserves will only be sufficient to supply all three units about until 2007. At the same time the plant is located near gas pipelines, therefore in the future gas could become alternative fuel for supply. Because of the suboptimal fuel base compared to design, the availability per unit stands at 190MW, which is about 90 percent of designed capacity. Because of the expensive and inefficient production process, TPP Bobov Dol basically covers intermediate to peak loads and acts as reserve capacity for the system.

Two electricity generation companies were privatized in 2003: TPP Maritza-3 Dimitrovgrad and TPP Maritsa East 3. The former was privatized through the stock exchange. It is located in Southeast Bulgaria, and it burns domestic lignite. The latter represents the first ever private equity involvement without state guarantee in the Bulgarian power generation segment.

The Privatization Agency is also planning to sell Toplofikatsia Plovdiv EAD, Toplofikatsia Schumen EAD, Toplofikatsia Varna EAD and Toplofikatsia Pernik EAD following the implementation of investment projects. The privatization of NPP Kozloduy and TPP Maritsa East 2 is not expected in the near future.

As for the district heating companies, 2005 will also be a year of intensive privatization activity. In the case of DHC Pravetz, DHC Loznitza and DHC Razgrad immediate privatization through auction is planned. The public announced tender method will be used in the case of DHC Velko Tarnovo, DHC Lovech, DHC Babrovo, DHC Pleven, and DHC Bourgas. Privatization of DHC Plovdiv, DHC Schumen, DHC Varna and DHC Pernik will only begin after the implementation of investment projects.

The fact that Bulgaria has a significant export capacity in its energy sector increases the interest of private investors in investing in this segment. The Bulgarian energy sector had 11.9 gigawatts installed capacity in 2001. In the same year 32.5 billion kilowatt hours of electricity production was consumed at home, while 41.4 billion kilowatt hours were generated, with the rest being exported, mostly to Turkey and other surrounding countries. The Bulgarian transmission network is interconnected with Turkey, Romania, Moldova, Greece, Macedonia, and Serbia. The Kozloduy nuclear power plant supplies some of the export capacity, but two of its reactors are expected to be closed down about five years ahead of schedule, in 2006. A new nuclear power plant is planned to be built near Kozloduy, in Belene, but no timetable has been set yet.

BOSNIA AND HERZEGOVINA: SIGNIFICANT ROLE OF FOREIGN AID

In case of Bosnia and Herzegovina (BiH), the international aid had a key role in external financing, due to the fact that the foreign direct investment remained modest and the low creditworthiness restricted the access to the international financial markets in the past 10 years. After the 1992-1995 war, BiH has been supported by international institutes and donor countries to be able to rebuild the country and transform the economy to a functioning market economy.

According to a publication (*International Assistance to BiH, 1996-2002*), during the 1996-2002 period Bosnia received a significant amount of international aid, more than USD 5 billion from the international institutions and countries. The annual inflow averaged some 700-750 million US dollars in this period, which meant around 10% of GDP of Bosnia and Herzegovina. Considering the fact that the population of BiH averaged around 3,8 million, the per capita value of foreign aid reached almost USD 200.

Most international aid was approved in the Federation (FBiH), the Bosniak-Croat entity. It reached 4.1 billion dollars between 1996 and 2002. Republica Srpska (Bosnian Serb entity) approved around 16.5% of total international aid, while, the same figure of District of Brcko is around 1.6%. The largest donors were the European Union, the USA, the World Bank, the IMF and Japan.

The structure of the inflows reflects that the main share of the international aid supported the development of infrastructure and the reconstruction. Around 54% of the foreign aid was approved to this purpose. After the 1992-1995 war, the GDP of Bosnia reached only 20% of pre-war level, thus, it was obvious that the foreign donors granted their financial support to rebuild the country, mainly the infrastructure. Due to the large amount of aid (and low base of GDP level), the economic output grew drastically, the growth pace averaged around 30% from 1996 to 1999. It was the reconstruction-driven recovery period of the state. However, from 2000 the GDP growth rate decreased significantly to 4-5% owing to the political obstruction in Bosnia and Herzegovina. From 2000 onwards, the main focuses of international assistance have also changed, the support of institutional reforms has gained larger share in international aid.

For the 2004-2007 period, the government accepted a medium-term development strategy, called Poverty Reduction Strategy Programme (PRSP). The main goals of PRSP are (1) creating conditions for sustained and balanced economic development, and restoring partial creditworthiness on international financial markets, (2) reducing poverty by one-fifth, and (3) accelerating the EU accession process. These objectives assume the following preconditions: 5-5,5% GDP growth; low inflation; decreasing current account deficit (to 11% of GDP); high export growth (15-22% annually); total amount of FDI will be 2 billion dollars in this period; seven-fold increase in domestic savings; and the reduction of public debt (to 49% of GDP). These assumptions are quite ambitious, while, the objectives of the PRSP are expecting the further decrease of international aid. Thus, the increase of creditworthiness is a key point of the medium-term development plan.

TABLE 3. – TOTAL ALLOCATION OF EXTERNAL ASSISTANCE BY SECTOR TO BIH, 1996-2002

SECTOR	Amount Approved (USD equivalent), 1996-2002				Total (USD equivalent)
	State (BiH)	FBiH	RS	District of Brcko	
Energy and Mining		663 707 004	91 687 053	7 527 932	762 921 989
Social Sector	594 310	632 469 575	93 117 601	43 240	726 224 726
Industry		636 600 279	74 574 447		711 174 726
Transport and Communications		439 399 724	107 983 103		547 382 827
Finance, Banking & Budgetary Support		376 254 533	169 419 660	445 642	546 119 835
Environment/Urban Planning/Housing/Local Administration	1 581 500	366 722 342	104 122 914	1 670 484	474 097 240
Health & Social Protection		183 931 274	56 622 333	1 659 499	242 213 106
Agriculture, Forestry, Veterinary & Water Management		156 941 188	70 546 278	6 180 983	233 668 449
Education	275 422	187 801 251	36 224 327	2 895 736	227 196 736
Water Supply		196 055 174		6 801 779	202 856 953
Institutional Development/Technical Assistance	15 541 331	154 776 909	6 474 881	8 300 081	185 093 202
De-Mining	3 000 000	58 574 940	14 577 478	838 921	76 991 339
Labour, Employment, Veterans		20 970 484	14 523 601		35 494 085
Reconstruction				24 851 208	24 851 208
Infrastructure				17 114 380	17 114 380
Democracy		16 755 189			16 755 189
Culture & Science		12 835 648	31 488		12 867 136
Entrepreneurship		7 727 941			7 727 941
Economic Development	133 900			3 334 216	3 468 116
Physical Culture, Sport & Youth		2 657 987	501 459	91 483	3 250 929
Public Buildings		2 450 000		147 936	2 597 936
Statistics	1 830 000		753 400		2 583 400
Justice			2 422 214		2 422 214
Civil Aviation	1 000 000				1 000 000
Media			804 502		804 502
Internal Affairs			470 216		470 216
Trade and Tourism			244 821		244 821
Information Technology	100 000			85 406	185 406
Other					33 183 826
TOTAL					**5 100 962 433**
		Of which:			
Infrastructure and reconstruction	*1 581 500*	*2 302 484 523*	*378 367 517*	*57 965 783*	*2 740 399 323*
Social services	*869 732*	*1 004 202 100*	*185 964 261*	*4 598 475*	*1 195 634 568*
Finance, Banking & Budgetary Support	*0*	*376 254 533*	*169 419 660*	*445 642*	*546 119 835*
Agriculture, Forestry, Veterinary & Water Management	*0*	*156 941 188*	*70 546 278*	*6 180 983*	*233 668 449*

Source: UNDP

By 2004, the GDP recovered to about 60% of pre-war GDP level. One of the most significant macroeconomic problems of the economy is the high current account deficit. In the last four years, the foreign trade deficit reached 55-60% of GDP which had significant impact on current account balance. Thus, the latter was between 20 and 30% of GDP in the 2000-2003 period. Although the balance of foreign trade improved in this period, the current account balance worsened by almost 10%-points.

The main reasons for the worsening current account balance are the gradually decreasing amount of current transfers and the falling sufficit of income balance. Mainly the sharp decrease in current transfers caused the worsening current account balance. While in 1999 the net current transfers reached 33.5% of GDP, the same figure in 2003 was less than 20%. It reflects the tendency that the role of foreign transfers (including international aid) has diminished in the last years. Accordingly, the improving trade balance had no positive impact on the current account balance.

On the other hand, it is a positive process that the amount of foreign direct investment increased dynamically in the last three years. In 2001, the net FDI inflow was USD 260 million, the same figure in 2003 was USD 660 million or 5.4% of GDP.

In the future, the decrease of international aid is expected, thus further reduction of foreign trade deficit (through dynamic export increase) and further improvement of business climate are needed. In the first half of 2004, the figures show that the growth of export overpaced that of import, which is – certainly – a necessary condition of improving trade balance. In this period, the net FDI inflow reached almost USD 400 million which is 21.7% higher than in the same period of the previous year. It reflects that in Bosnia and Herzegovina – in line with the decreasing amount of international aid – the role of foreign direct investments increased in the last years due to the speed up of privatisation process.

MAIN MACROECONOMIC INDICATORS AND SITUATION OF BULGARIA IN 2004

In the course of 2004, the Bulgarian economy went through some important changes. Some of them have improved the current economic situation meanwhile others include open or potential risks. The recent macroeconomic data reveal acceleration of economic activity underpinned by private sector growth, a substantial increase in imports and exports, a growing investment, an improving and favourable budgetary position as well as a further growing domestic demand supported by salary increases and credit expansion.

Following a 4.9 % GDP growth in 2002, the economic growth rate of Bulgaria decreased to 4.3 % in 2003. The declining trends of quarterly GDP growth rate changed in the second quarter of 2003 and began to increase again. This growth has remained vigorous for the whole period since then. During the second quarter of 2004, the GDP growth rate (on year/year basis) reached 6 %. (Table 1)

In the course of 2003, both domestic consumption, which increased by 6.6 % and investment, which surged by 13.8 % continued to drive expansion. This situation partly changed in the first two quarters of 2004. The growth rate of domestic consumption continuously decreased during both quarters meanwhile the investment boomed (by 21.4 %) in the first quarter but dropped substantially (to 6.3 %) during the next three month. The fluctuations of consumption and investment were partly offset by the continuous increase of exports. It meant that the export increase contributed to the GDP growth rate more than the increase of final consumption. The growth rate of export has been, however, uneven and minor to the growth rate of import since 2003. From the beginning of 2004, the economic growth has been based on the increase of investment and export but it generated further import needs.

Following the economic collapse between 1989 and 1997, which resulted in an about 30 % fall of real GDP, the economic recovery has brought about a significant degree of catching up with the pre-crisis level. In 2003, the real GDP per capita reached again the level of 1989, meanwhile the total real GDP reached about 90 % only of the pre-crisis level. This difference between the two indicators was basically caused by the decrease in the number of total population.

The sectoral breakdown of GDP growth rate reveals some important characteristics of changes in the macroeconomic situation of Bulgaria. In 2003, the production of agriculture and forestry decreased by 1.3 %. This trend was reversed during the first two quarters of 2004 but the growth rate of the production was rather modest. Meanwhile, the production of the industry has increased continuously by approximately 7 % for the last one and half years. The development of the service sector gained momentum again. Its annual growth rate declined in 2003 compared to 2002 but it increased again during the two first quarters of 2004 to the level where it was one and a half years earlier.

The consumer price index has had variable trends for the last two and half years. Meanwhile the inflation index measured at the end of each year increased from 3.8 % in 2002 to 5.6 % in 2003, the average annual inflation rate declined from 5.8 % to 2.3 %, respectively. This volatility of inflation trends has also continued in 2004. (Table 2) The annual inflation rate of 2004 is expected to be around 7 %. It is a favourable fact that Bulgaria has pursued responsible fiscal policy for years. The fiscal deficits were around or less than 1 % of the GDP between 1999 and 2002. In 2003, the budget was closed with a slight surplus. This fact has to be evaluated cautiously because the improvement in the budget could be resulted in by such temporary items as higher revenues from VAT, excise and customs duties due to the recent pick up in imports. The consequence of this budgetary policy is that government's internal debt has slightly increased but its external debt could be reduced more significantly.

The economic policy aims at increasing incomes through providing a stable and predictable economic environment, lowering corporate profit tax for business in regions with high unemployment and restricting the grey economy. Official wages paid through labour contract have been growing, reflecting wage increases granted by the government policy. Average wages in public sector exceed wages in private sector. (Table 3) In certain sectors of the economy, the wages increased faster than the labour productivity, which deteriorated their competitiveness and may cause problems in the future. Meanwhile the unemployment rate declined from 12.7 % in 2003 to 12.0 % at the end of the 2nd quarter of 2004.

Due to the faster increasing import demand than the export growth the current account deficit has widened for the last two years. (Table 4) With the deteriorating trade balance and current account deficit, the economy remains vulnerable to an increase in domestic demand, which will increase imports and thereby adversely affect the current account. Furthermore, the current account could be put under more pressure by the worsening income component of the current account, which is expected to reach a deficit of 7 % of GDP as a result of the growing private debt, foreign debt restructuring and the transfers of dividends and profits. The current account deficit has been fully or almost fully covered by the FDI capital inflows. Services and current transfers substantially improved the current account position.

Critical issues of the outlook for the Bulgarian economy are the strong domestic demand and slow economic recovery of her main trading partners. These two factors have resulted in the deteriorating balance of trade. This situation was eased by the expansion of FDI. Their further effects are the positive impacts on restructuring of the Bulgarian economy and the improvement in competitiveness of the Bulgarian firms. These factors can substantially improve the economic growth outlook of Bulgaria.

TABLE 4 – MONTHLY INFLATION RATE (CPI) OF BULGARIA IN 2004

	Jan.	Feb.	March	April	May	June	July	Aug.
CPI (monthly growth rate)	1.4	0.3	-0.1	0.3	0.0	-1.8	1.2	-0.4
CPI (12 month growth rate)	6.4	6.6	6.2	6.1	6.8	7.3	7.6	6.3

Source: NSI, MF, BNB

TABLE 5 – AVERAGE MONTHLY WAGES IN BULGARIA (IN BGN)

	2002	2003	2Q.2004
average monthly wage	257.6	284.0	291.4
in public sector	322.6	342.5	346.4
in private sector	217.8	247.8	260.0

Source: NSI, MF, BNB

TABLE 6 - EXTERNAL BALANCES OF BULGARIA (IN MN EUR)

	Current account	Export	Import	Capital account	FDI	Overall balance
2002	-925.5	6062.9	7754.7	1842.9	980.0	717.1
2003	-1505.2	6668.2	8867.8	1776.5	1253.9	630.3
2004 1Q	-492.0	1718.0	2227.0	764.4	366.1	-24.4
2Q	-467.1	1895.1	2688.6	1049.1	647.6	773.4

Source: NSI, MF, BNB

TABLE 7 – MAIN ECONOMIC INDICATORS OF BULGARIA (GROWTH RATES IN %)

	Annual rate	I quarter	II quarter	III quarter	IV quarter
GDP growth (y/y)					
2002	4.9	3.5	6.3	6.2	3.5
2003	4.3	3.5	4.2	4.4	4.9
2004	-	5.3	6.0	-	-
Final consumption					
2002	3.6	3.6	1.9	1.4	7.3
2003	6.6	5.8	8.0	5.4	7.0
2004	-	5.2	4.2	-	-
Gross fixed capital formation					
2002	8.5	6.7	8.3	6.1	11.5
2003	13.8	11.6	21.2	13.3	10.0
2004	-	21.4	6.3	-	-
Exports					
2002	7.0	-3.3	5.5	13.4	10.4
2003	8.0	13.2	11.7	4.0	5.3
2004	-	8.0	10.9	-	-
Imports					
2002	4.9	0.9	5.7	1.9	10.6
2003	14.8	13.8	18.3	13.3	14.0
2004	-	17.7	11.3	-	-
Agriculture and forestry					
2002	5.5	2.9	8.6	6.3	3.0
2003	-1.3	-0.3	-0.3	-1.5	-2.2
2004	-	1.2	0.9	-	-
Industry					
2002	4.6	0.7	6.6	7.2	3.6
2003	7.1	5.7	5.9	6.6	10.1
2004	-	6.4	7.5	-	-
Services					
2002	5.1	5.1	5.8	6.2	3.5
2003	3.5	2.6	3.8	4.6	3.0
2004	-	6.2	5.4	-	-

Source: NSI, MF, BNB

Romanian Disinflation Continues

The Country is Expected to Introduce the Inflation Targeting System by July Next Year.

Romania has achieved significant results with its disinflation process in the past few years. Inflation dropped to 10.8% in October compared to the 15.8% of the same period last year. Even though the National Bank of Romania (NBR) will certainly not meet its 9% end-year target, the inflation will not exceed 10% in 2004. NBR forecasts a 7% CPI for the next year. The disinflation process should be supported by the more flexible exchange rate policy that has been recently adopted by the NBR. However, this kind of monetary policy could have severe down points regarding the current account developments. Romania is planning to introduce a formal inflation targeting policy by June/July next year. The actual target for 2005 is unclear yet, the NBR says it will target 7% for end-2005, but the IMF has not agreed on it yet, and there is still a 6% inflation goal in the IMF program.

Year on year consumer price index dropped to 10.8% in October compared to the 11.1% in the previous month, and the 12.4% in August.

Table 8 – Inflation in 2003 and 2004

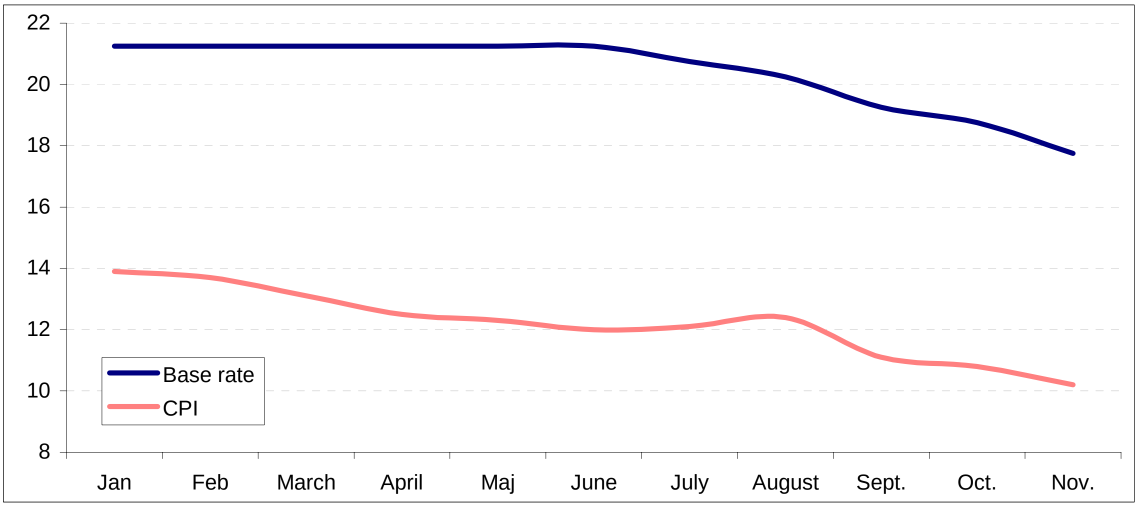
	October 2004 as against:			Monthly average rate during 1 January - 31 October	
	Sept. 2004.	**Dec. 2003.**	**Oct. 2003.**	**2004**	**2003**
Total:	**101,2**	**107,9**	**110,8**	**0,8**	**1,1**
Food goods	100,9	105,2	109,4	0,5	0,9
Non-food goods	101,5	109,9	111,2	0,9	1,2
Services	101,4	109,9	112,9	0,9	1,1

Source: NBR

According to the NBR an accelerated reduction of the CPI is envisaged for November and December. Despite the favorable decline of the price level growth, NBR will certainly miss its 9% end-year CPI target, but inflation is expected to be far below 10%, rather closer to the official target. To validate the disinflation process NBR board decided to cut the base rate by 50 basis points to 17.75% on November 21.

The central bank has already slashed the key rate by 350 basis points since June this year due to the ongoing appreciation pressure and the continuing disinflation. The 50 bp rate cut was anticipated by the market, and the traders expect at least one more reduction of the key rate by the end of 2004. The NBR referred to the improved credit rating (investment grade) by the Fitch rating agency, and said that the move would certainly boost the FDI and portfolio inflows, supporting the Leu, and offset the rate reduction. „This will mean a continued tightening of the monetary policy, which will help the disinflation process". The NBR said. (*The exchange rate regime had been shifted to a more flexible float this month. The move was regarded as a milestone towards the EU accession. Foreigners will be allowed to have Leu deposits from early next year, and this will likely lead to a faster real appreciation of the Romanian currency.)* International credit rating agency Fitch IBCA upgraded Romania's long term foreign currency and local currency sovereign ratings to BBB- and BBB respectively, from BB and BB+, and also set outlooks as stable. The main reasons of the decision were the progress towards the EU membership and the sound macroeconomic performance under the IMF program. Romania was also awarded a functioning market economy status by the EU following the energy sector reforms and the privatization. Moody's and S&P, which rate Romania one notch below investment grade, are expected to follow Fitch.

CHART 2 – INFLATION AND BASE RATE IN ROMANIA



Nov CPI is just a forecast

The only weak point of the current economic developments is the widening current account gap. While the nominal appreciation of the Leu is definitely supportive for the disinflation, the stronger currency will increase the pressure on the external balance. Especially the textile industry, which accounts for 25% of the export and has proved to be one of the more dynamic area of the export will be endangered. The current account deficit of the first nine months of the year has amounted to 2.3 bln. Euros, putting the 12-month rolling basis at 6.5% of the GDP, more than one percentage point higher than it was foreseen by the stand-by agreement with the IMF. According to the BNR the expansion of the current account gap was due to the wider trade balance of 3.2 bln. Euros, versus the 2.39 bln. in the same period last year. It can almost be taken for granted that the current account deficit goal agreed under the IMF program will be overshot this year, and the 2005 goal of 5% is even more unlikely to be met, due to the expected real appreciation of the Leu. (Nevertheless 70% of the current account deficit in both years is expected to be covered by FDI inflows.) The IMF has warned that the nominal appreciation would be insufficient to achieve the inflation goals due to the fast energy price adjustments, public sector wage hikes and the lower interest rates in 2005. Since the reduction of the key rate will be inevitable to cap real appreciation and reduce the carry, fiscal policy will need to be tighter to support the disinflation and contain the current account gap.

In the statement released after the last rate cut NBR underlined to maintain its prudent monetary policy, because an uptrend of the aggregated demand is expected. Central Bank Governor Mr. Isarescu said a couple of weeks ago that private consumption was set to increase due to the growing lending and wages, while higher budget revenues would lead to the increase of the public consumption. „All horses are set to start running and we have to hold tight on the reins." NBR officials have urged the next government to conduct a tight wage and a prudent fiscal policy to support the bank's efforts to cut inflation and to prevent overstimulating growth. (*In the meantime final results of the November 28 parliamentary elections were announced, with the ruling PSD-PUR alliance winning 36.6% of the votes followed closely by the opposition PNL-PD alliance with 31.1%*) Prime Minister Adrian Nastase said that the GDP was expected to grow by 8.1% this year, after the 4.9% in 2003. According to officials Romania needs faster than 5-6% annual growth to catch up with the EU. The latest January-September growth figures confirmed Nastase's view, because the data showed a 8.1% rise compared to the same period last year. Household consumption and investment grew by 9.8%

and 26.2% respectively, which might point to some inflation pressure in the economy. The real convergence and the disinflation process will surely have some conflicts in the future.

Concerning the near future the latest inflation report of the NBR said that there would be a temporary pause of the disinflation process early next year due to the rise of the energy prices. Central Bank Governor Mr. Isarescu said earlier that the bank would like to push the CPI to 4% in 2006, and to 3% in 2007. NBR is expected to introduce an inflation targeting regime by July next year, so the targets will definitely be revealed by then. Concerning the disinflation Mr. Isarescu referred to the Polish model earlier, however that kind of method might be a bit too enforced, accompanied with significant damages to the real economy.

SERBIA IS INTRODUCING VALUE ADDED TAX

One of the conditions for Serbia to join to the EU is the tax reform, the introduction of VAT. Serbia was one of the two European countries which did not use to have VAT in their tax system. The law on VAT was accepted on 23 July 2004 and it comes into effect on 1st January 2005. The law generally follows the EU principles. The past 5 months have been the period for registration, informing ratepayers and preparing the employers of the tax authority .

From January 2005 the tax rate for sales goods and services will be 18%, and a special reduced tax rate will be 8%.

The tax base has been defined as the sales of goods and services, and import. Beside compensations for goods and services, tax base includes excise, duties, other public revenues, excluding VAT, and other cost which the taxable invoice to the recipient of goods and services

Products with 8% tax rate are mostly the products which were tax-free, like bread, milk, cooking oil, sugar, fruit and vegetables, eggs, fish, some medicaments, medical aids, daily newspapers, public services, textbooks, hotel services.

The group of tax free goods and services is precisely determined by the law, for example goods supplying diplomacy needs, cultural services, education, student accommodation etc.

Some financial transactions and circulation of capital are also tax free, for example taking over liabilities, guarantee, credit businesses…etc., but these activities are not entitled to reclaim VAT.

There are two kinds of tax exemption, one which qualifies for tax refund and the other one when the ratepayer has no right for tax refund. Practically those are products with 0% tax rate, for example the export belongs to this group.

Taxpayers whose turnover in past 12 months was bigger than 2 000 000 dinars (EUR 26 500) or who expect more than 2 000 000 dinars turnover next year are all subject to VAT. Those entrepreneurs whose turnover is over 1 000 000 dinars (EUR 13 000), but under 2 000 000 dinars can choose to become VATable, but then they will have to pay according to this system for two years. Those taxpayers whose turnover is over 20 000 000 dinars (EUR 260000) have duty of monthly tax report and paying VAT, while entrepreneurs with lower turnover has this obligation every three months.

The law on VAT has special suggestions related to some ratepayers to ease their taxation. The “small taxables” are those entrepreneurs whose one-year turnover is less than 2 000 000 dinars (EUR 26000). They do not have the right to show VAT on their invoices, and cannot reclaim it, they have a presumptive tax. Those agriculturists who decided to register as subjects to VAT taxation have a 5% tax rate. The tax base in the case of second-hand goods and antiquities is the price difference.

Comparing with the currently used sales tax VAT has a lot of advantages. It is more extensive, till now the sales tax have been paid by the retailer, in the last link before final sales to the end users. With VAT the tax can be accounted in each phase of productions. VAT is more effective in reducing gray economy. In some estimation the gray economy in Serbia is around 35-40% of the GDP, and by introducing VAT it is expected to reduce by 5-10% of the GDP. Other advantages are that the import will be tax free, deductions of expenses could be possible for entrepreneurs in case of some equipment, and it is one of preconditions of the EU membership.

At the beginning of the adaptation of the new turnover tax, a problem of imbalance can be expected on the side of the budget. That can be a reason of the fact that in a one-month period, the settlements (calculating) of taxes will not present revenues.

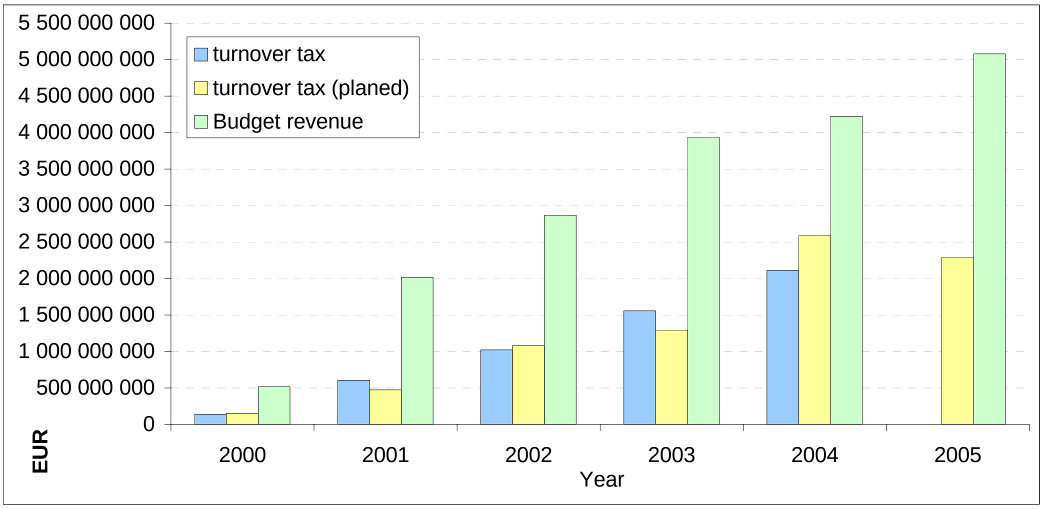
On the other hand the ratepayer will be forced to sustain the tax burden of inputs during the VAT refunding period, it can even cause liquidity problems, which are not surprising as it characterizes the whole economy. The solution to ease this problem is for example abolishing the tax of payroll fund.

One of the consequences of the application of VAT is the increasing administration costs and the increase of inflation in the first quarter of the year, but the government does not expect a considerable increase in prises due to the new tax. The question involving the principles of VAT will be timely when Montenegro and Serbia become a single market, because it is not desirable to collect VAT on more than one republic level. Montenegro introduced VAT in 2003 and the tax-rate is 17%.

Further tax reform is being planned, which would promote economic development and raise employment. For example in the new law on contribution employers would be exempt from paying taxes and social contributions after the employee aged over 50. From 1 January 2005, the new employees (entrants) will be free of paying the 14 % personal income tax for one year. Other goal of the tax reform is to help the development of the capital market and reduce interest rates, so banks will be exempt from financial transactions, services and turnover rates. Currently the corporation tax is 10%, it was reduced from 14% to attract foreign investors.

The government of Serbia will publish a monthly bulletin of public finance starting this year. This bulletin will present the balance of public revenue and expenditure. According to this bulletin, the budget deficit in the first 10 months this year was 21 billion dinars (EUR 27 million), which is less than 10 billion dinars (EUR 1,2 million) year-on-year. The budget revenue was 20% higher than last year in the same period, 22,3% rise in turnover tax revenue was a result of the introduction of fiscal cash registers.

CHART 3 – BUDGET REVENUE AND REVENUE FROM TURNOVER TAX



Source: The Governemt of Serbia, law on budget (2004 data represents the period January-October)

The government of Serbia have been making several attempts at a tax reform. The tax system did not meet the requirements of a market economy between 1994 and 2001, the tax rates were 20, 9, and 3 percent, but practically taxpayers were paying taxes with rates of 31,18 and 12 percent.. In the new law on sales tax in March 2001 the tax rate became the same,17 % for sales of goods and services, and the 3% federal tax rate was kept. In tax reform in 2001 introduced the tax number and made those products the tax rate of which is now 8% tax free.