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Origin and Structure of FDI Inflows into Bulgaria and Romania

The FDI inflows into Bulgaria and Romania reached record levels during 2003 and 2004. This period represents also the peak years of FDI inflows into Southeast European countries. The total inflows into the region reached almost EUR 6 bn in 2003 and about EUR 6.6 bn (estimated) in 2004, which meant 36 % and about 10 % annual increase, respectively.

These two EU acceding countries had higher growth rates, lower levels of unemployment and more stable short and medium-term prospects for growth than the rest of the region with one exception, Croatia. These trends can also explain the larger amount of inflows of foreign investments than most of the other countries in the region. Both countries could restructure their foreign debts and raise credits on private financial markets. Their improving credit ratings also benefited FDI.

Table 1.
Bulgaria: Inward FDI Stock by Economic Activities and by Investing Countries in 2003

Sectors (NACE)	2003		Investing Countries	2003	
	EUR mn	in %		EUR mn	in %
Agriculture, hunting, forestry	13,6	0,2	Greece	908,3	14,2
Fishing	0,0	0,0	Italy	672,1	10,5
Mining and quarrying	59,9	0,9	Germany	656,4	10,3
Manufacturing	1 908,7	29,9	Austria	531,2	8,3
Electric, gas, water supply	88,5	1,4	USA	463,5	7,3
Construction	158,6	2,5	Netherlands	383,2	6
Trade, repair of motor vehicles	1 136,6	17,8	Hungary	362,5	5,7
Hotels and restaurants	708,0	11,1	Cyprus	352,3	5,5
Transport, storage, communication	385,9	6,0	Belgium	326,5	5,1
Financial intermediation	1 342,9	21,0	UK	308,5	4,8
Real estate, renting	300,7	4,7	Switzerland	289,3	4,5
Public admin., soc.security, defence	n.a.	n.a.	Other	1137,6	17,8
Education	18,8	0,3			
Health and social work	0,6	0,0			
Other comm., soc. and personal service	63,5	1,0			
Other not classified activities	204,8	3,2			
Total	**6 391,1**	**100**	**Total**	**6 391,2**	**100,0**
			of which EU	**4 075,4**	**63,8**

Source: Bulgarian National Bank

Comparing the figures of FDI stocks in Bulgaria and Romania to those of other countries in the world and Central Europe in particular, the two former countries received less FDI than their size and location would suggest. The average level of FDI stocks per capita of the eight new EU member states exceeded EUR 2000 in 2003 meanwhile the same ratios of Bulgaria and Romania were only EUR 550 and EUR 465, respectively. During the last two years, it was only Bulgaria, which could achieve slightly higher levels of FDI annual inflows per capita than the eight new EU member states. It resulted in a minor reduction of the gap between the level of FDI stock per capita of Bulgaria and those of the eight new EU member states. Whereas, Romania could not attract so much foreign capital which could have reduced its relative backwardness in the position of FDI stock per capita. Thus, in the case of Romania the gap has increased further during the last two years. These relatively poor records indicate a long way ahead to catch up unless the main trends change very radically. The expected EU accession of these two countries may improve their FDI attractiveness substantially, but the difference to the other new EU member states will certainly remain for quite a long time.

It can be said that the structure of FDI by investing countries reflects the status of EU integration. Among the countries investing in the Balkans, the EU member states have increased their share over the last few years. However, there remains a striking difference between the eight new member states, the three candidate countries and the rest of the Balkans region. The shares of the former EU states were about 75 % in the new EU member states, above 60 % in the three candidate countries and about 40 % in the other countries of the Balkans.

TABLE 2.
ROMANIA: INWARD FDI STOCK BY ECONOMIC ACTIVITIES AND BY INVESTING COUNTRIES IN 2003

sectors	2003		Investing countries	2003	
	EUR mn	in %		EUR mn	in %
Agriculture	82,2	1,0	Netherlands	1473,6	17,9
Industry	4470,2	54,4	France	846,6	10,3
Construction	197,2	2,4	Germany	697,9	8,5
Retail and wholesale trade	1364,1	16,6	USA	558,3	6,8
Tourism	197,2	2,4	Italy	495,1	6
Transport	624,5	7,6	NL Antilles	474,4	5,8
Services	1281,9	15,6	Austria	471,7	5,7
			Cyprus	400,3	4,9
			Turkey	332	4
			UK	296,3	3,6
			Greece	252,2	3,1
			other	1918,9	23,4
Total	**8217,3**	**100**	**Total**	**8217,3**	**100**
			of which EU	5035,4	61,3

Source: The National Trade Register Office

In the Balkans, where there are small and backward countries with relatively small amounts of FDI, nearby emerging market economies like the new EU member countries, Turkey and other transition countries, the USA is one of the most significant investors. In the case of Bulgaria and Romania, the USA does not have substantially larger share in the inward FDI flows than in any of the new EU member states. However, countries like Greece, Turkey and Cyprus are more important investors for these two EU candidate countries than for the new EU member states. Germany, the Netherlands, Italy and Austria are the most important investors among the former EU member states in Bulgaria and Romania. During the last few years Hungary has became an important investor in the Balkan states particularly in Romania and Bulgaria. This phenomenon resembles the late 19th century process of capital flows when besides the Austrian, German and French capital Hungarian investors also appeared in the countries of the Balkans.

In banking sector and telecom privatisation Austria, Greece and Hungary (e.g. DSK Bank in Bulgaria) were the most active. There were partial takeovers of oil companies in the region (e.g. ÖMV in Romania). Greenfield investments went into a great number of small and medium-size projects in the light industry, real estate and retail sectors both in Bulgaria and Romania. Romania was almost the only country on the Balkans which could attract more sophisticated, export-oriented machinery producers.

After the recent EU enlargement, Bulgaria and Romania became close neighbours to the EU. Their attractiveness for FDI may thus increase because the perceived geographical distance from the core of the EU has decreased. The further economic progress and the completion of implementing EU rules and regulations will certainly reduce more the investment risks in these two countries.

Croatia - Stabilisation and Association Agreement Will Come Into Force on 1 February 2005

On 21 December 2004, the European Union and Croatia signed the Enlargement Protocol of the Stabilisation and Association Agreement (SAA). This Enlargement Protocol of the SAA needed to be negotiated because of the latest enlargement round when ten - mostly Central and Eastern European - countries joined the EU. The “original” SAA was concluded well before the accession of the ten new Member States.

In line with the Enlargement Protocol, the EU and Croatia also notified each other that the ratification procedure for the SAA had been concluded, and the Stabilisation and Association Agreement with Croatia would come into force on 1 February this year. It will be another milestone of the European integration process of Croatia.

Background

The Stabilisation and Association process (SAp) was proposed by the EU in 1999 for five Western Balkan countries, including Croatia. The main purposes of the process were the promotion of - political and economic - stability and development, and the support of European integration of these countries. The promotion of establishing bilateral relations between themselves was also a key element of the SAp.

Negotiations for a Stabilisation and Association Agreement with Croatia were launched in November 2000, which lasted for less than one year. The SAA was signed on 29 October 2001. That Agreement is important because SAA is the first comprehensive agreement between the EU and Croatia.

The Stabilisation and Association Agreement with Croatia basically includes the following main areas:

- Political dialogue;
- Regional cooperation;
- Free movement of goods;
- Movement of workers, establishment, supply of services, capital;
- Approximation of laws, law enforcement and competition rules;
- Wide-ranging cooperation in all areas of Community policies, including justice and home affairs.

Regarding the basically economic focus of SEE Monitor, we emphasise here the economic aspects of the Agreement. The SAA includes that a free trade area will be created by 2007 between the Member States of the EU and Croatia. The Agreement stated that Croatian products could be exported freely to the Community, duties and restrictions were abolished from the entry into force of the SAA, except for agricultural products and some sensitive goods (like textile and steel products). On the other hand, the duties and restrictions on industrial and agricultural goods from Community imported into Croatia are also decreasing gradually. Thus, in case of the industrial products, a free trade area will be created at the beginning of 2007.

TABLE 3.
MAIN MILESTONES IN THE RELATIONS BETWEEN THE EU AND CROATIA

1997	The Council of Ministers establishes political and economic conditionality for the development of bilateral relations with Croatia
1999	The EU proposes a new Stabilisation and Association Process (SAP) for the five countries of south-eastern Europe, including Croatia.
2000	Adoption by the Commission of a positive feasibility report on the opening of negotiations for a Stabilisation and Association Agreement (24 May)
2000	Feira European Council states that all the SAP countries are "potential candidates" for EU membership (June)
2000	Opening of negotiations for an SAA in the margins of the Zagreb Summit (20 November)
2001	Signing of the SAA (29 October)
2002	An Interim Agreement enters into force (1 March)
2003	Croatia submits an application for EU membership (21 February)
2004	Opinion on the application of Croatia for membership of the European Union (20 April)
2004	Croatia becomes an official candidate country (18 June)
2004	EC's recommendation: negotiations will launch on 17 March 2005 (16 December)
2005	SAA enters into Force (1 February)
2005	Accession negotiations will launch (17 March)
2007 - 2008 *	Conclusion of negotiation process
2007 - 2009 *	Ratification process
2008 - 2010 *	Croatia can be a member of the EU

*Source: European Commission, own expectations; * Expectations*

The SA Agreement with Croatia is basically similar to the Europe Agreements which were signed between the EU and CEE countries in the early '90s. The establishment of political dialogue and cooperation, the harmonisation of law to EU standards, the issue of four freedoms and the creation of a free trade area were all important elements of the Europe Agreements. However, in case of SAA, the economic and political stability gained greater role, as its name reflects too.

As it happened in case of Europe Agreements, an Interim Agreement entered into force on 1 March 2002 with Croatia, which covered the trade and trade-related measures. It supports the trade liberalisation between the Member States of EU and Croatia.

The fact that SAA will enter into force on 1 February 2005 reflects that Croatia has arrived to another milestone in the relations between European Union and Croatia. It means that all the "remaining" parts of the Agreement will come into force following the trade and trade-related issues. The entry into force of the Agreement is a significant step in the process of European integration, it can be the base of the accession negotiations which will also launch soon.

Croatia applied for EU membership on 21 February 2003. The European Commission published its opinion on the application of Croatia one year later. In this Opinion, the EC recommended that the Council should grant Croatia the candidate country status. In the middle of the year, Croatia became officially an EU candidate, while at the end of the year the roadmap of Croatia's European integration became more detailed.

The accession negotiations will launch on 17 March 2005. According to our expectations, the negotiation process can be concluded between early 2007 and 2008. Due to the fact that the ratification process after the conclusion of the negotiation needs at least 1-1.5 year, it seems that Croatia can be a member of the EU in 2008 at the soonest, assuming a smooth negotiation process at a quick pace.

Bank Privatisation in Serbia

Jubanka will be the first Serbian bank which will be privatised after the beginning of restructuring of the banking sector from 2001. Jubanka is 88% state-owned bank, the 7th largest bank in Serbia and the 3rd largest bank among the state-owned banks in 2004.

The Greek Alpha Bank made the best offer with EUR 152 million. The Serbian government has estimated the value of the bank around EUR 115 million before invitation for tender.

From 11 potential inquirers, 7 banks and one unit trust suited the requirements to buy the documentation, which served as the basis for investors to make their bid. The invitation for tenders was on 28 May 2004, the potential investor had to make its offer by 30 August 2004.

From all interested banks-Alpha Bank (Greece), Bank Austria (Austria), Erste Bank (Austria), OTP Bank (Hungary), Societe Generale(France), Unicredito (Italy), Nova Ljubljanska Bank. (Slovenia) and General Electric Europe Capital-, the Greek bank won the tender. If the Alpha Bank withdraws from the purchase, the Hungarian OTP Bank as the second best tenderer – who dynamically expands in the region - will have the right for purchase.

Background

Jubanka was founded in 1991, and since then the bank has been profitable and had continuing liquidity. Jubanka has 88 branches in the territory of Serbia, 1300 employees, 230 000 individuals and 30 000 corporate clients. Jubanka's share was 6,6% from total turnover of payment (financial turnover) in Serbia and 9,6% from all transfers in 2003. The equity capital and reserves were 10.6 billion dinars (EUR 136 million) during the first 3 quarters in 2004.

Agency for Deposit Insurance, Rehabilitation, Bankruptcy and Liquidation is responsible for arrangement of privatization. The participants in Serbian bank privatisation have to satisfy the following conditions: they need to have qualified experience in retail banking, need to be present in minimum one European country beside the headquarter country and the bank needs to have more then EUR 5 billion total balance sheet (this amount depends on the bank which will be privatized)

Table 4.
Top ten banks in Serbia (in thousand dinar)

	Name	Balance sheet total
1	Raiffeisenbank Jugoslavija a.d. Beograd	60,120,117
2	Delta banka a.d. Beograd	50,719,883
3	Komercijalna banka a.d. Beograd	45,159,261
4	Vojvođanska banka a.d. Novi Sad	37,197,561
5	Societe Generale Yugoslav Bank a.d. Beograd	21,501,963
6	Hypo Alpe-Adria-Bank a.d. Beograd	19,867,092
7	Jubanka a.d. Beograd	17,103,657
8	AIK banka a.d. Niš	13,699,927
9	HVB banka Jugoslavija a.d. Beograd	13,396,032
10	ProCredit banka a.d. Beograd	11,400,071

Source: National Bank of Serbia, September 2004

The reconstruction of the bank sector started in 2001. According to the law on regulation and settlements of relation of legal entities (corporation) and banks with the London and Paris Club, the Serbian government took over these obligations of the banks (debts). The consequence of this act is that property of these banks became the Serbian Republic's own poperty. After the debt-equity swap, the income of privatization will be used to repayments of debts to Paris and London Clubs, and it will not flow into budgetary incomes.

Before the reconstruction, the banking sector was characterised by low level of reserves for potential losses, insolvency of the biggest banks, liquidity problems etc. After bankruptcies and mergers, the number of banks reduced from 86 to 46 in the Q3 in 2004, and by the end of the year, it reduced to 43.

TABLE 5.
TOP TEN BANKS OWNED BY REPUBLIC OF SERBIA (IN THOUSAND DINARS)

	Name	Balance sheet total
1	Komercijalna banka a.d. Beograd	45,159,261
2	Vojvođanska banka a.d. Novi Sad	37,197,561
3	Jubanka a.d. Beograd	17,103,657
4	Poštanska štedionica a.d. Beograd	10,845,350
5	Panonska banka a.d. Novi Sad	10,362,685
6	Novosadska banka a.d. Novi Sad	10,360,596
7	PB Agrobanka a.d. Beograd	9,189,844
8	Continental banka a.d. Novi Sad	8,057,208
9	Srpska banka a.d. Beograd	7,707,376
10	Jugobanka Jugbanka a.d. Kosovska Mitrovica	7,013,654

Source: National Bank of Serbia, September 2004

Five foreign banks - Microfinance Bank AD Belgrade, Raiffeisen Bank Yugoslavia AD Belgrade, Alpha Bank AE (Belgrade subsidiary), HVB Bank Yugoslavia AD Belgrade and National Bank of Greece (branch in Belgrade) - had permission in 2001 and other 9 foreign banks have opened bank offices on the territory of Serbia.

Serbian bank regulation is mainly similar to Basel directives. Banks are required to have their financial part of share capital to be over EUR 10 million, the capital adequacy index is need to be over 8%, the sum of largest credits should not be over 400% of the equity capital etc. Banks have obligation to insure each individual deposit to 5000 dinars (EUR 64) – which is very low comparing to the EU - with the Agency for Deposit Insurance, Rehabilitation, Bankruptcy and Liquidation or with another insurance organization.

The National Bank of Serbia has suspended the license of green-field investments in banking sector with the aim that the takeovers of state-owned banks would be the only way of penetration of foreign banks in Serbia.

The real reconstruction of banking sector is started now with the sales of state-owned banks. These banks together have a tradition in corporate and retail banking, have many branches all over the territory of Serbia, and they are on the way to follow the needs of market economy and providing adequate banking services. The confidence in banks which was decreased in the past 10 years - especially considering residents - started to build up again. In 2003, the payment turnover got back to banks from the Offices of NBS, it was a positive step towards developing the financial sector.

Bank privatisation is continuing, the deadline for tender of Novosadska Bank (Bank of Novi Sad) and Continatal Bank was 22 October 2004 and the result is expected to be announced in February 2005.

Five foreign banks were interested in Novosadska Bank: Erste Bank (Austria) , Banca Intesa and Unicredito (Italy), EFG Eurobank and Piraeus Bank (Greece).

Novosadska Bank is the 6th largest state-owned bank (82,79%) and 14th considering the total balance sheet; it has an old tradition in retail banking. Every fifth citizen of Vojvodina has an account in this bank. It has 72 branches, 247000 individual and 18000 corporate clients, and it has 20356 depositors with active accounts. Equity capital and reserve were approximately 4 billion dinars (EUR 52 million) in Q3 2004.The total payment turnover was around EUR 2.77 billion and the international turnover of payment was USD 912.7 million in the first 3 quarters of 2004. Currently Novosadska Bank has 879 employees. In case of Novosadska Bank the potential buyer's total balance sheet needs to be over EUR 3 billion.

For Continental Bank the next potential investors are interested: the General Electric (UK), the biggest Slovenian bank Nova Ljubljanska Bank and the two Greek bank are also EFG Eurobank and Piraeus Bank. Continental Bank has 69 branches, the equity and reserves were almost 3.8 billion dinars (EUR 48.6 million) in Q3 2004, resulted that Continental Bank is the 17th largest bank in Serbia on the basis of total balance sheet.

The next invitation for tenders will occur for Vojvodjanska Bank (Bank of Vojvodina) and the Panonska Bank (Panon Bank). Vojvodjanska bank is the 4th largest bank in Serbia. It is on the first place considering dinar deposits, third place in case of foreign currency deposit, and the bank has issued the largest number of VISA cards. The bank has 203 branches, 900000 individual and 60000 corporate clients. The 74% of payment turnover is internal, which shows that the bank has a large number of clients. The bank's share in the total payment turnover in Serbia is 10%.

GROWING EXTERNAL IMBALANCES IN ROMANIA

Romania's current account deficit widened significantly over January-November 2004 compared to the same period last year. The C/A deficit in 2004 is expected to be above 6% of the GDP, exceeding the 5.3% goal, set by the IMF, Romania's main economic mentor. The deterioration is mainly due to the worsening trade gap. External imbalance is currently seen as the biggest problem for Romania. The outlook is not too bright either, since Romania is going to liberalise its capital account in April, and the inflowing capital will certainly result in the appreciation of the leu. The financing of the deficit however should not be problematic because the FDI inflows are getting stronger, and this is likely to remain so as the second wave EU entrants will become competitive investment destinations, even compared with the new EU members.

TABLE 6.
CURRENT ACCOUNT BALANCE AND ITS MAIN COMPONENTS

	Jan-Nov 04	Jan-Nov 03
C/A (mln euros)	-3272	-2489
Trade balance	-4455	-3428
Export	17376	14375
Import	21831	17803
Service balance	-138	69
Income balance	-654	-615
Current transfers balance	1975	1485

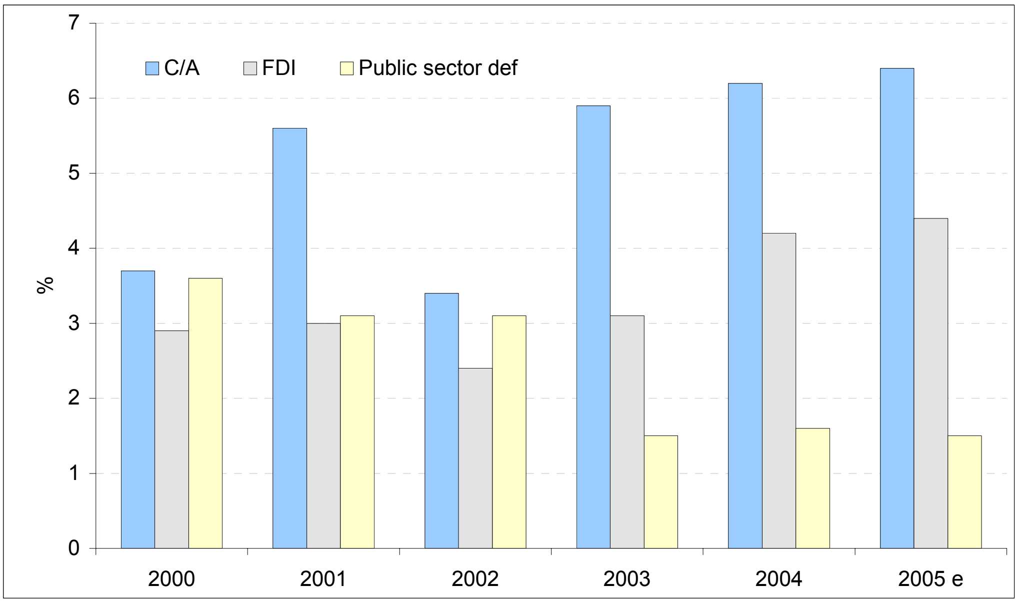
Source: National Bank of Romania

The current account deficit amounted to 3.27 billion euros over the January-November period, that meant a 31.5% rise compared to the same period last year. The trade gap, which was the main drive behind the growing imbalance jumped to 4.45 billion euros from 3.42 billion euros in 2003. The statement of the National Statistics Board (INS) said that 11-month exports went up by 20.9% to 17.4 billion euros. Metallurgical products, machines and equipment and minerals proved to be the drive of the export, they all posted higher than 22% increase and took the 40% of the total. Import has amounted to 21.8 billion euros, 22.6% rise from the same period in 2003. Transport means rose by an outstanding 80%, but minerals, metallurgical products and machinery also showed higher than 30% increases. According to the INS, the enlarged European Union remained Romania's main trading partner, taking 73.2% of exports, and supplying 65.2% of the imports.

The rise of import came on the back of surging consumption and investment growth. The economy is estimated to grew by a robust 8.2-8.4% in 2004, and it obviously led to the widening of the current account gap. The deficit financing should not be problematic because the growing FDI, the privatisation related revenues and increased funding from the EU cover significant part of the gap. FDI alone currently finances 70% of the current account deficit, up from the 55% in 2003.

External imbalances are not likely to improve in 2005, the current account gap could remain at roughly the same level or widen further a bit. Capital account liberalisation scheduled for April this year will certainly result in the surge of portfolio capital inflows, and lead to the appreciation of the leu.

GRAPH 1.
CURRENT ACCOUNT DEFICIT, FDI AND PUBLIC SECTOR DEFICIT (2000-2005)



Source: National Bank of Romania

Government officials expect the leu to firm by 10-15% in 2005, and such a great appreciation would surely deteriorate the competitiveness of the low value added products of the export, especially in case of the textile industry. Concerning the possible sudden appreciation of tle local currency Central Bank Governor Mugur Isarescu has said recently that the greater leu flexibility was expected to discourage the hot money inflows, tempted by the high interest rate spread.

The situation of the Central Bank is quite awkward, because it should avoid the radical appreciation of the leu, but it also has to hold the base rate reasonable high to curb inflation, while the firming currency could also help the disinflation. The NBR already cut the base rate to 17% at the end of 2004, and following the better than expected 9.3% December y-o-y CPI the central bank slashed the key rate again by 50bp to 16.50% on January 16. The NBR had announced to switch to an Inflation Targeting system from the summer 2005, but has not revealed its inflation target yet. The bank has already indicated that it would target a 6-7% end-2005 CPI, while the IMF, which is going to visit Romania by the end of this month is expected to favour a target of at least 6%. Surging domestic consumption along with the high GDP growth, the tax rate cuts, the privatisation of the energy firms (with the expected price adjustments) and the redenomination of the leu (four zeros will be removed and this could result in rounding up of the prices) would all make reducing the inflation rate hard.

Because of the limited room for the monetary policy in case of the disinflation and the external imbalances, the fiscal policy will have to play a key role. Romania managed to keep the budget deficit below the IMF agreed 1.64% of the GDP in 2004. The IMF suggested that Romania should push the deficit lower this year to 1%, but prime minister Calin Tariceanu indicated that a 1-1.5% target would be more reasonable. Some additional fiscal measures will have to be introduced following the recent radical tax reform (government slashed tax rates to 16% for corporates and individuals). Although the government delayed the further cuts in social security contributions, raised dividend taxes and increased the profit tax on small enterprises to 3%, these moves are unlikely to make up the gap. IMF recommended to raise the VAT rate from the current 19%, but the prime minister rejected this option. He said that the flat tax would not seriously endanger the budget deficit because it would generate more revenues.

Capital Account liberalisation

- Current account convertibility since 1998
- Capital account liberalisation
    - started in 1999, schedule envisages, as general principle liberalising inflows before outflows; medium and long term flows before short term ones
    - schedule largely completed; only exceptions are
        - Operations in deposit accounts in ROL opened by non-residents with credit institutions in Romania
        - Operations in money market financial instruments (by moment of accession at latest)
        - Operations in current and deposit accounts opened by residents abroad with credit and other similar institutions (by the moment of accession at latest)

Source: National Bank of Romania

The overall macroeconomic outlook is positive at the moment, only the external imbalance is worrisome but the high FDI inflows provide safe financing. Foreign investors are eagerly waiting for the capital account liberalization and are ready to invest huge amounts on the Romanian markets. Fitch credit rating agency already upgraded the sovereign debt ceiling to BBB- in November 2004, and Moody’s upgrade to Ba2 is expected this year after the EU Accession Treaty is signed.