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THE BRITISH EU-PRESIDENCY AND THE PROSPECT OF THE FUTURE ENLARGEMENT OF THE EU

The UK took over the Presidency from Luxembourg for the second half of 2005. The last time the UK held the Presidency was in 1998 when the negotiations on the last enlargement started. The overall role of the Presidency of the Council of the European Union is to take forward the agenda of the EU, including ensuring that negotiations from the previous Presidency are carried forward. In practical terms, the Presidency's responsibilities include organising, setting the agendas for and chairing almost all Council meetings from the Ministerial level downwards and bringing together the views of the Commission, Parliament and other Member States to reach consensus. The Presidency also represents the Council to outside bodies and negotiates with those bodies.

One of the crucial points among the tasks of the British Presidency deals with the shaping of the future role of Europe and the EU in the global political and economic competition. The EU's future prosperity depends on being able to compete in the global world. That requires strong economic performance. But it also means having strong political partnerships across the globe. During its Presidency the UK will take forward work to build up the EU's partnerships with its neighbours in the Middle East and North Africa, and in Eastern Europe, not least with those countries aspiring to EU membership.

BULGARIA, ROMANIA

The UK has always led the push for early and wide enlargement of the European Union, which culminated in the historic accession of 10 new members last May. Two more countries, Romania and Bulgaria are set to join in 2007. After having signed the accession treaty with the two countries the main tasks for the Union in 2005 and 2006 will comprise a monitoring of Bulgaria's and Romania's preparations for accession, and continuation of Bulgaria's and Romania's preparations for accession in the framework of the Europe Agreements. The monitoring intends to ensure that the *acquis* is implemented in practice and adequately enforced. The EU will support the efforts of these two countries to complete the preparation for accession and will continue to provide targeted pre-accession assistance. Compliance with the criteria for Union membership is essential.

From November 2005, the Commission will publish annual monitoring reports to ensure that both Bulgaria and Romania are meeting the commitments they made in Accession Treaty. The first such monitoring report will be prepared during the British Presidency. Any delay or problem in the preparation will be promptly reported to the Council. The Accession Treaty includes three safeguard clauses (on the economy, the internal market and judicial and home affairs) in the cases of any serious shortcomings. A specific safeguard clause will also allow the accession date to be postponed to January 2008 if there is any serious risk that one of the candidates will be unable to fulfil the conditions of accession in time.

In the last Progress Report and in several other communications, the Commission pointed out several areas in which there is an urgent need for improvement before accession. These are judicial and home affairs for both countries and competition and environment policies for Romania.

The UK has always been a strong supporter of enlargement. During its Presidency the UK will support the timely accession of Bulgaria and Romania. The UK's policy approach to enlargement is the same for every country that the criteria set out (for example at Copenhagen) have strictly to be reserved. The initial judge of those criteria is the Commission and if it gives approval the Presidency will do its best to complete the accession.

The actual political and economic situation in the EU has changed significantly. The double rejection of the Constitutional Treaty in referendums¹ and the failure to agree on the Financial perspective for the 2007-13 period in the European Council meeting in June have substantially reduced the pace of the integration process. The low economic growth rates in most of the old EU member states also do not create favourable conditions for any further enlargement. The two candidate countries' domestic political situations are also burdened by unexpected developments. Instability of the government in both countries reduces the likelihood of fulfilling the accession preconditions. Bulgaria has got a minority government after the general elections in June. Romania also faces government crisis due to the conflict between the coalition partners and has to handle, at the same time, the economic consequences of the flood which had devastating effects on a large part of the country. Under such conditions, Bulgaria and Romania, slated for membership in 2007, are likely to be delayed a year, but there is little risk that their accession will be derailed altogether.

TURKEY

In conformity with European Council conclusions, and on the basis of a report and a recommendation from the Commission, the European Council decided in December 2004 that Turkey basically fulfilled the Copenhagen political criteria and accession negotiations would be opened on 3 October 2005. The negotiation will take place in line with the terms of the conclusions of the European Council and on the basis of a general negotiating framework to be established. The EU and the UK Presidency will encourage Turkey to persist with reforms to meet all criteria and will support this through pre-accession assistance. Further work will comprise: preparations for accession in the framework of the Association Agreement and of the Customs Union with Turkey; Revision of the Accession Partnership with Turkey.

The prospect of EU membership has been one of the most significant spurs to political and economic reform in Turkey. The UK's position is that a stable and prosperous Turkey, demonstrating that Islam, democracy and respect for human rights and the rule of law are fully compatible, would have a huge impact on regional peace and stability. The launching of accession negotiations with Turkey under the UK Presidency will have a particular significance for the UK. The beginning of the negotiations will be the fulfilment of a major and long-standing goal of the UK's foreign policy. The UK will continue to lead support for EU enlargement - a process which works greatly in the UK's own interests by expanding the community of democratic and prosperous nations, opening up new opportunities for British business, and spreading reform across the whole European continent.

CROATIA

Croatia already submitted its application for EU membership in 2003. The Commission's opinion on the application was delivered in 2004 after which the European Council defined the next steps in the light of that opinion. Accession negotiations should have been opened on 17 March 2005. In March 2005, the European Council refused to start the negotiations in the scheduled time because of the objection of the International Criminal Tribunal. The UK Presidency is ready to open accession negotiations with Croatia as soon as the conditions have been met. The Council is also expected to take stock of the situation again regarding Croatia's request for accession during the UK Presidency. Until the beginning of the accession negotiations further work will comprise: a reinforced pre-accession strategy for Croatia, including the necessary financial instrument, and preparations for accession in the framework of the Stabilisation and Association Agreement with Croatia.

¹ In France and the Netherlands in June

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Already under the UK Presidency the Stabilisation and Association Council between the EU and of the former Yugoslav Republic of Macedonia held its second meeting in July 2005. The conclusion of the European Council of June 2005 were recalled which reaffirmed the commitment to full implementation of the Thessaloniki Agenda. This agenda emphasised that the future of the FYROM would be within the EU. Concerning the application of the FYROM, the main focus will be the follow up to the Commission's Opinion, expected in the second half of 2005. Under the UK Presidency, the Commission is preparing its Opinion and is having an intensive dialogue with the country's authorities for this purpose.

The list of potential and prospective EU candidates contains four countries for the time being but further applications are expected already in the near future. The internal political and economic problems of the EU will certainly further slow down the process of enlargement. The accession of Bulgaria and Romania is likely postponed by a year. Its reasons will be partly the EU's internal political and economic situation and partly those prevailing in the candidate countries. The prospective membership of Croatia and FYROM may be also delayed but then the process of their accession may take place at a relative fast pace. The UK Presidency might be decisive in this respect for all four countries' cases. For further countries with EU membership aspirations, including Turkey and Ukraine, the prospect of actual future membership is slipping away, unless the economic and political situations substantially change as well as the EU population can be persuaded that they stand to benefit from further enlargement.

CREDIT BOOM AND INCREASING EXTERNAL VULNERABILITY IN BULGARIA AND ROMANIA

In the past two-three years credit boom was observable in both the Bulgarian and the Romanian economies. This process basically contributed to the widening macroeconomic imbalances and the increasing external vulnerability. In these two economies the tightening of the fiscal policy was the response to the private sector's increasing consumption and investment. However, the result was that current account balance worsened significantly in the last years mainly because of the increasing foreign trade deficit. On the other hand, inflows of foreign direct investment were basically able to finance the high current account deficit but tight fiscal policy needs to be remained to lower external vulnerability in the future.

BACKGROUND

In both countries, credit expansion has taken place in an economy characterised by rapid GDP growth. The robust growth was due to strong domestic demand especially consumption and investment. Besides that factor, the main causes of the credit expansion were macroeconomic stabilisation, the role of foreign-owned banks, confidence after financial crisis, bank restructuring.

In the second half of the last decade both Bulgaria and Romania went through a recession period when financial sector suffered a major setback. However, the crisis accelerated the development of the financial sector and the restructuring of the economy. Reforms led to improving macroeconomic stability and rapid GDP growth at the beginning of the new millennium.

The main characteristics of credit expansion were the following: dynamism of household credit expansion was the highest; the large share of foreign currency denominated loans and the factor that maturities of loans lengthened. The following tables - including the development of basic credit indicators in Bulgaria and Romania - also reflect these processes in the past years.

TABLE 1. – DEVELOPMENT OF BASIC CREDIT INDICATORS IN BULGARIA (2000-2004)

	2000	2001	2002	2003	2004
Real credit growth (% , yoy, deflated by CPI)	4.5	26.3	37.2	39.5	40.4
In local currency	11.9	26.6	23.7	37.7	27.9
In foreign currency (in euro)	-6.6	25.9	61.8	42.1	57.3
Credit flows in percent of GDP	1.7	3.6	5.6	8.4	11.5
By currency: local	1.6	2.3	2.5	4.7	4.8
By currency: foreign currencies	0.2	1.2	3.2	3.7	6.7
<i>By borrower: households</i>	<i>0.4</i>	<i>1.1</i>	<i>1.4</i>	<i>3.2</i>	<i>4.9</i>
<i>By borrower: companies</i>	<i>1.4</i>	<i>2.5</i>	<i>4.3</i>	<i>5.2</i>	<i>6.6</i>
Credit stock in percent of GDP (year-end)	12.2	14.5	19.0	26.3	35.4
By currency: local	7.9	9.4	11.1	15.1	18.5
By currency: foreign currencies	4.3	5.2	8.0	11.2	16.9
<i>By borrower: households</i>	<i>2.3</i>	<i>3.1</i>	<i>4.3</i>	<i>7.2</i>	<i>11.5</i>
<i>By borrower: private companies</i>	<i>9.3</i>	<i>10.8</i>	<i>14.1</i>	<i>18.4</i>	<i>23.2</i>
<i>By borrower: state-owned enterprises</i>	<i>0.6</i>	<i>0.6</i>	<i>0.7</i>	<i>0.7</i>	<i>0.7</i>
Share of foreign currency deposits as percent of total	54	52.8	49.6	48	43.1
Share of foreign currency loans as percent of total	35.5	35.4	41.8	42.5	47.6

Source: IMF

The rapid credit expansion launched a bit later in Romania than in Bulgaria, however, the developments are the same. The level of credit (credit per GDP ratio) is still relatively low but the dynamism of credit growth is impressive (30-40% per year) in the two economies in the last 2-3 years.

Regarding the structure of credit stock in Bulgaria and Romania, the amount of household credit increased from 4.3% to 11.5% and from 1.4% to 5.1% of GDP, respectively. In line with that process, the share of foreign currency denominated loans increased especially in Bulgaria where the share was relatively low in 2001. Since then this figure jumped from 35.4% to 47.6%. In Romania the share of foreign currency loans was dominant (around 60%) at the beginning of credit boom, thus, there was no significant increase in this figure but the dominant role remained.

TABLE 2. – DEVELOPMENT OF BASIC CREDIT INDICATORS IN ROMANIA (2000-2004)

	2000	2001	2002	2003	2004
Real credit growth (% , yoy, deflated by CPI)	7.9	28.0	32.4	56.8	40.5
In local currency	-5.4	20.0	19.1	77.4	11.2
In foreign currency (in euro)	15.8	33.2	40.4	38.1	60.5
Credit flows in percent of GDP	0.6	2.9	3.3	6.2	5.6
By currency: local	0.8	1.5	1.3	3.6	1.0
By currency: foreign currencies	-0.2	1.5	2.1	2.6	4.2
<i>By borrower: households</i>	0.1	0.3	0.8	2.9	1.9
<i>By borrower: companies</i>	0.4	2.6	2.5	3.4	3.3
Credit stock in percent of GDP (year-end)	9.3	10.1	11.8	15.9	17.9
By currency: local	3.8	4.1	4.4	7.1	7.0
By currency: foreign currencies	5.5	6.1	7.4	8.8	10.9
<i>By borrower: households</i>	0.5	0.7	1.4	3.9	5.1
<i>By borrower: private companies</i>	7.5	8.0	8.9	10.5	11.5
<i>By borrower: state-owned enterprises</i>	1.4	1.4	1.5	1.5	1.3
Share of foreign currency deposits as percent of total	47.0	49.3	44.7	42.5	41.2
Share of foreign currency loans as percent of total	59.5	59.8	62.7	55.4	60.8

Source: IMF

Regarding the bank system in these two economies, the pictures are similar in these two economies. Major part of the banks is in private hand and mostly foreign ownership characterises the sector. As it was mentioned above, the parents of foreign-owned banks also contributed to the rapid credit growth seeking high yield in these economies.

Although, the tendencies are basically similar in the two economies, there are some differences between Bulgaria and Romania regarding the financial sector. Firstly, the aforementioned factor that credit growth picked up later in Romania than in its southern neighbour, thus, credit per GDP ratio is significantly lower in Romania than in Bulgaria. Secondly, the monetary policy regimes are also different in the two countries. In Bulgaria there is a Currency Board Arrangement, while in Romania the regime is managed floating since last year.

It is also interesting to mention that the capital account is totally liberalised in Bulgaria, while in Romania there are still some controls which are planned to gradually removed in the near future.

HIGH ISPA SUBSIDY FOR ROMANIA

The European Union, through the ISPA program has assigned in all EUR 460 million for Romania. The bigger share of the amount will be spent for environmental investments, and towards EUR 250 million for developing road infrastructure of the country. Romania benefits of ISPA support for eight project of road infrastructure. These eight projects imply the construction of the Section Four of Bucharest-Fetesti motorway, the rehabilitation of Section Five of Bucharest-Constanta motorway, Fetesti-Cernavoda and the Sibiu detour route. The Romanian government proposes to build a sewage station in Bucharest, which town is the biggest sewage producer in the country, and the value of this project exceeds EUR 108 million. The present ISPA subsidy is enough only for the first fraction of the investment, to end the work Romania expect from the cohesive funds additional assistance.

The projects which are subsidised within the confines of the ISPA program help Romania to achieve its obligations from the sealing of the chapters in line with the fields: environmental and transport. The tasks are gigantic; to achieve the environmental instructions the country need to expenditure towards EUR 30 million by 2018, and this amount is just the two-third of the Romanian GNP in 2003.

ABOUT THE ISPA

ISPA was designed to address environmental and transport infrastructure priorities identified in the Accession Partnerships with the 10 applicant countries of Central and Eastern Europe. ISPA was established by Council Regulation No. 1267/1999 in June 1999 on the basis of a Commission proposal in Agenda 2000 to enhance economic and social cohesion in the applicant countries of Central & Eastern Europe for the period 2000-2006. The objective of the structural policy tool (ISPA) is to assist countries stand before official EU membership by the development of environmental and traffic.

In reference to the environmental investments are subsidised by ISPA projects with high demand for inputs, which achieve the regulations of the environmental directives of the European Union. These are the followings:

- Drinking water supply,
- Sewage polishing,
- Treatment of the hard and danger litters,
- Improvement of the air quantity.

On the field of transport the subsidies from ISPA went to the development of the future trans-European networks. Come by

In 2003 the 10 grantee countries received almost EUR 1.25 billion from the ISPA program to 75 new projects. The ISPA was launched in 2000 and till 2003 it has financed 324 projects in amount of more than EUR 7 billion. From these 324 projects, 212 have affected the field of environmental, 102 the transport and 10 the Extended Decentralised Implementation System (EDIS) Romania and Bulgaria come in for the ISPA till the end of 2006 with a growing financing.

THE EU ASSISTANCES TO ROMANIA

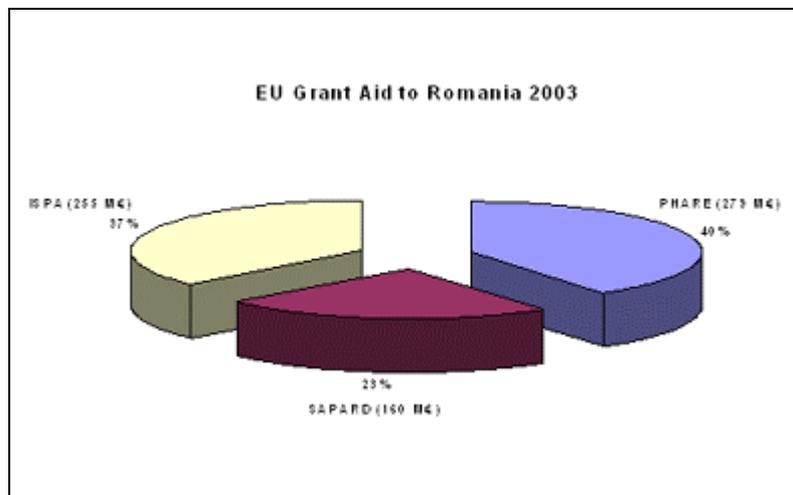
From 2000 onwards, the EU's pre-accession assistance to Romania is provided by three main instruments:

- the Phare Programme, providing funding for institution-building and investment in support of EU accession preparations;

- ISPA (the pre-accession instrument providing investments in transport and environmental infrastructure); and
- SAPARD (the financial instrument supporting agriculture and rural development).

The following diagram shows the constitution of them in 2003:

CHART 1. – EU GRANT AID TO ROMANIA



Source: <http://www.europa.eu.int/comm/enlargement/romania/index.htm>

As a result of the first wave of enlargement, in December 2002 the European Council decided to increase EU assistance to Romania by 20% (compared to 2003) in 2004, 30% in 2005 and 40% in 2006.

Under ISPA in all EUR 256.5 million was made for Romania in 2002. In 2003 a provisional commitment of EUR 255.1 million was made for the country.

The strategic objectives in the field of transport are intended to address serious weaknesses in the network of roads and railways and are focused on the modernisation of the trans-European corridors crossing the country. Other priorities are dealing with increased traffic levels around urban areas and developing the use of waterways.

In the environment sector, Romania faces acute problems in the field of air, water and soil pollution - all of which require large-scale investments from the public and the private sectors as well. The major environmental problem is the poor quality of the water. Another major cause of environmental damage and related health hazards is the uncontrolled disposal of (mainly urban) waste.

THE FUTURE

The accession negotiations were sealed by the Romanian government at the end of 2004, and the accession contract was signed in April 2005 in Luxembourg. The probable date to be an official Member of the European Union could be expected by Romania to 1 January, 2007. The contract contains an exceptionally strict clause, which allows the delay of the Romanian accession with one year, if the country not fulfils the requirements.

The „current” ISPA subsidy is a good kick for Romania to carry on the arrangements to get closer to achieve the requirements of the European Union and to be an official member in 2007.

A FURTHER STEP TOWARDS EUROPE – INTRODUCING VAT IN BOSNIA AND HERZEGOVINA

According to plan, the final stage of Indirect Tax reform will take place on 1st January 2006, with the introduction of the Value Added Tax system. Finally in January 2005, the BiH House of Representatives' adopted the VAT law at a single 17% rate. Introducing a viable state-level VAT system is a substantial precondition for Bosnia and Herzegovina's integration into Europe. Besides meeting the EU's requirements, further benefits are expected from the new VAT system. The increase of government revenue can be spent on developing social services, infrastructure, etc. Tax evasion will become more difficult, so corruption may be reduced and the massive grey economy² is expected to decrease. In the context of other recently-enacted laws, the business climate will develop and potential investors may think more seriously about putting money into Bosnia and Herzegovina's economy. Furthermore, these steps help to develop BiH's single economic space.

DEBATE IN POLITICS

The introduction of VAT is a perfect field for politicians to give voice to their opinion and criticism in order to increase popularity. The main question was the number and level of rates to be introduced and the necessity of social programs related to the introduction of the VAT. A number of arguments were discussed regarding validity of the VAT calculation system based on one, i.e. several tax rates. The adoption of the law was prolonged and was finally adopted with the single 17% rate only in January 2005.

It is worth mentioning that in December 2004, the state-level Law on Sales Tax and the Law on Excise Duties Tax has been adopted. As a result, same rates were introduced for taxation in the entire country. This can be considered as a major step towards the integration of internal economic space and avoiding tax evasions.

INDIRECT TAXATION AUTHORITY

No doubt that Bosnia and Herzegovina owns a fractured and inefficient state system, with a multi-layered fiscal architecture. It was time to make significant changes in the fiscal policy. In 2004 the competences for indirect taxation were transferred to a newly formed agency; the Indirect Taxation Authority (ITA). By this institute customs administration has been unified at state-level and conditions were created for a uniform tax application.

ITA has been collecting revenues since the beginning of 2005 and is now preparing for the introduction of VAT. In the first half of 2005 ITA collected 960 million KM³ of indirect taxes, which is 12% more in comparison to the equivalent period of 2004 before the institute started operation, and 10% above the plan of this year.

ITA's scope of duties is widening. Some other tasks as well will be delegated from the entities to ITA; for example issuing tax stamps that appear on tobacco and alcohol products. Of course the institute's main duty is introducing VAT. A single state level account has been activated and all indirect tax legislation is at the state level. When the institute will assume full responsibility for administration of all indirect taxes, the Entity Tax Administrations and the Brcko District Tax Administration will continue to cooperate by transferring or

² According to estimations, the size of grey economy is around 40% of GDP figure.

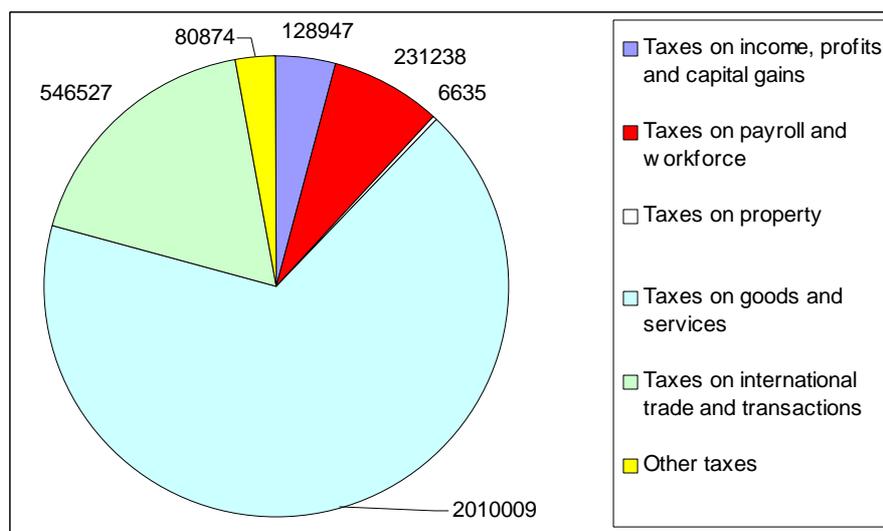
³ 1 KM = 0,51129 EUR

making available all taxpayer databases, records and other relevant intelligence and information. To ensure stability of revenue flows, the transition of responsibility must happen as soon as possible.

BRIEFLY ABOUT SOME SIDE EFFECTS

In general the country's macroeconomy is considered to be stable due to the responsible fiscal policy together with stable monetary policy. In 2004 total fiscal surplus amounted to 1.9% of estimated GDP. In Bosnia and Herzegovina the total tax revenues amounted in KM 3 billion (its structure can be seen on the diagram). It is still a question how will the new taxation system affect the fiscal revenues. In case of other macroeconomic indicators, it is expected that introducing VAT will cause a one-off surge in imports in the last quarter of 2005, which will worsen the current account deficit.

CHART 2. – TAX REVENUES IN BiH IN 2004 (IN THOUSANDS OF KM)



Source: Central Bank of Bosnia and Herzegovina

The 17% VAT rate is one of the lowest in the region, and most probably won't have a crucial impact on the rise of prices, considering that other factors will have a much greater effect on this aspect. Traders could take this opportunity and increase the prices for the purpose of realizing extra-profits. "We are prepared together with the Entity governments to define the measures of social protection for the most endangered population, which would come into force simultaneously with the introduction of VAT, and we are particularly prepared to monitor the rise of prices in order to prevent eventual abuses", said Chairman of the BiH Council of Ministers Adnan Terzic. This statement shows that further questions must be answered by politicians.

CONCLUSIONS

It seems that there is willingness in the country to press ahead with difficult reforms, and as a result more and more fields are delegated to state level. For example it is a positive sign that the once rival Bosnjak-Croat and Serb armies and intelligence agencies have unified the command by now. Introducing VAT will be another example to show Europe the capability to achieve reforms. The trend of unification is obvious.

The expectations concerning VAT are high, but development can be achieved only by wide reform programs. The state has to be cheaper in order to be able to reduce taxes. Laws have to be harmonised with international principles, and not least these laws must be respected and financial discipline has to be increased.