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## ICEG EUROPEAN CENTER QUARTERLY FORECAST ON THE SOUTHEAST EUROPEAN COUNTRIES (Q3 2005) – OUTLOOK FOR 2005 AND 2006

ICEG European Center prepared its third quarter forecast on the Southeast European SEE economies. In that publication, the authors foresees that positive economic outlook will remain in 2006 which will be fuelled by domestic demand, such as consumption and investments.

In the first half of 2005 the average economic growth rate of the seven Southeast European countries decreased somewhat compared to the previous year. According to ICEG EC's expectations, the average GDP growth rate will be 4.8% in the region which is lower by 0.7%-point than that of the previous year. Though, GDP growth remains strong in this region.

The real GDP growth is expected to slow down or remain constant in Croatia, Romania and Serbia and Montenegro, while, Albania, Bosnia-Herzegovina, Bulgaria and the former Yugoslav Republic are expected to increase their economic growth pace in this year. According to the institute's expectations, Albania and Bulgaria can reach the highest GDP growth in 2005 with 6.0%, while the performance of the former Yugoslav Republic of Macedonia is expected to be the weakest in 2005, where GDP is expected to increase by 3.5% this year.

In 2006 current tendencies are expected to continue and domestic demand will remain the main engine of these economies, namely consumption and investments. According to the expectations, the average GDP growth rate will be 5.1% in the region in the next year which represents a slight acceleration comparing to this year.

**TABLE 1. SUMMARY INDICATORS OF THE ANALYSED 7 SOUTHEAST EUROPEAN COUNTRIES**

	2003	2004	2005*	2006*
GDP growth (%)	4.0	5.5	4.8	5.1
Inflation (%)	4.9	4.7	5.1	4.1
General government balance/GDP (%)	-2.4	-1.7	-1.4	-1.5
Current account balance/GDP (%)	-9.9	-10.0	-9.4	-9.1
Unemployment (%)	22.9	23.0	22.4	21.9

\* Forecasts

Inflation remained low or disinflation process continued in the first half of the year in most SEE economies. In Albania, Bosnia-Herzegovina, Croatia and the former Yugoslav Republic of Macedonia, the yearly average consumer price index is expected to be lower than 3% in this year. In Bulgaria and Romania inflation is significantly lower in this year than in the previous year. CPI increased only in Serbia where the introduction of VAT had a one-off negative impact on the development of prices. Thus, the highest CPI is observable in Serbia in this year.

In 2006, the average inflation rate of the region will be lower than this year due to the continuing disinflation process in Romania and Serbia and Montenegro. Yearly average consumer price index is expected to be 4.1% in the next year, which reflects that price stability will remain in the first group of these economies and CPI will decrease in the second group where inflation is higher.

In several countries of the region credit boom characterises the economy similarly to the NMSs. Thus, national banks adopted cautious measures and cut interest rates carefully. Thus, reference rates were mainly unchanged or slightly decreased in the region, in line with the declining inflation rate.

In most SEE economies, general government balance has a surplus or only a slight deficit. The average deficit in 2005 is estimated at 1.4% of GDP which is smaller than the same figure in the previous year (1.7%). Except for Albania and Croatia, general government balances are expected to be between -1.2% and +1.0% in 2005. In Albania the revenue generation and collection is improving but still vulnerable, while, in Croatia the moderate economic growth and the increasing budget expenditures have a negative impact on the annual budget. It is an interesting fact that despite the introduction of flat tax at the beginning of the year general government balance is expected to improve in Romania, while the corporate tax rate cut in Bulgaria had no significant negative impact on the balance.

In 2006 general government balances are expected to change only slightly. In Albania and Croatia and the former Yugoslav Republic of Macedonia the deficit can decrease somewhat and in the other countries the balance will worsen only slightly. However, the latter means that surplus of the budget will be lower somewhat.

On the one hand, the general government debt/GDP figures are rather low in most SEE countries. On the other hand, the relatively good general government balances and the strong economic growth support the further decline of the general government debt per GDP ratio in 2005 in these economies. The general government debt per GDP figure is expected to decrease even in Croatia where the amount of general government debt grew dynamically in last years due to the large public infrastructure projects.

External imbalance is one of the main macroeconomic problems in most Southeast European countries. In general, foreign trade balances have huge deficits in the SEE region and this factor greatly influences the development of current account balance.

In 2005 the current account balances are improving but their level are high and the average reach 9.4% of GDP. Improvement is expected in Albania, Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro, however, the C/A balance reaches the highest level in two of these four economies (Bosnia-Herzegovina and Serbia and Montenegro). On the other hand, the C/A balance will worsen considerably in this year in Bulgaria and Romania, by 1.5 and 1%-point respectively. This worsening is due to the increasing deficit of foreign trade balance which is a result of the strong import demand of these economies.

In 2006, the tendencies of this year will continue, namely current account balance will improve slightly in these economies, except for Bulgaria and Romania due to the import boosting effect of the strong domestic demand.

Unemployment is a key issue in Southeast European countries, the official unemployment rate exceeds 20% on average. The only one country where unemployment rate is a single digit figure is Romania. On the other hand, one can observe the highest unemployment rate in Bosnia-Herzegovina, in the former Yugoslav Republic of Macedonia and in Serbia and Montenegro, unemployment rates are over 30% in these economies. According to estimations, the real unemployment rate is significantly lower in these economies, it can be around 20%, however, this rate is still really high.

In 2005, slight improvement is expected in most SEE countries regarding employment and unemployment due to the strong economic growth and new investments realised by foreign investors. In 2006 the same tendency is expected owing to the accelerating economic growth in the region. However, the rate of unemployment will not decrease significantly.

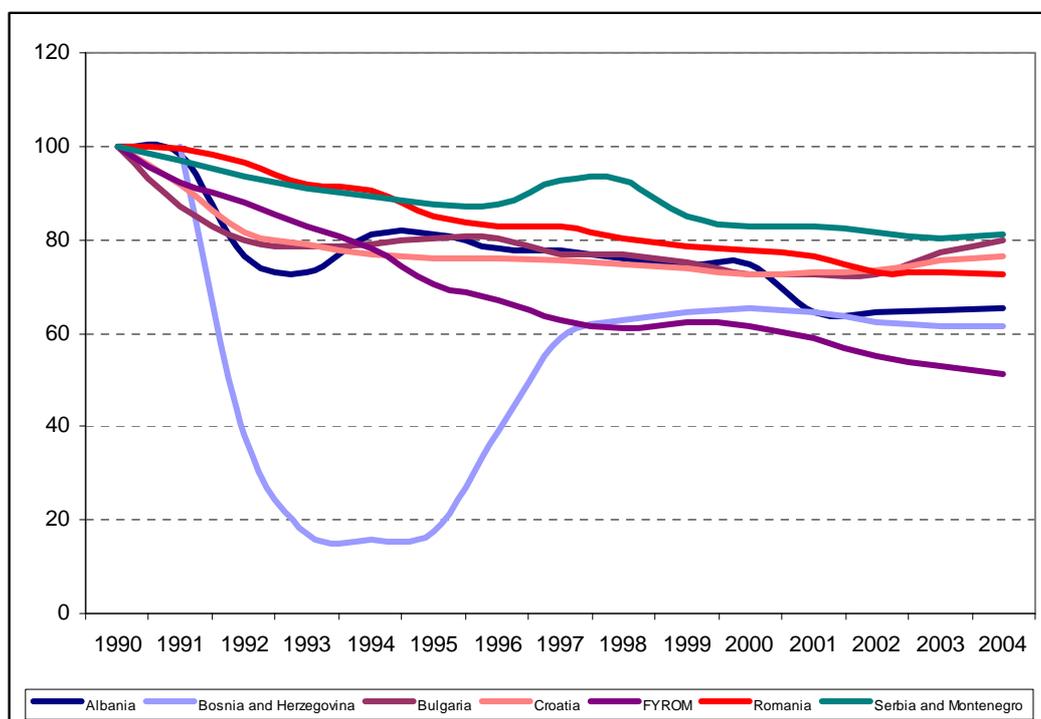
## (UN)EMPLOYMENT IN THE SOUTHEAST EUROPEAN COUNTRIES I.

In the last four years, the Southeast European (SEE) economies performed well, the GDP growths of these countries were rapid during this period. The increase of gross domestic product was excellent in comparison with the EU and even with the five Central European new Member States (NMS), including the Czech Republic, Hungary, Poland, Slovakia and Slovenia. Between 2001 and 2004 the average annual growth rate of the seven SEE countries was higher by approximately 1%-point than that of the five NMS or reached 4.4% in average. Certainly, that figure includes the outstanding performance of Romania in 2004 (+8.3%) and the significant recession year of the former Yugoslav Republic of Macedonia in 2001 (-4.5%).

Considering the good performance of these countries, the developments in the labour markets were not so remarkable. Moreover, in several countries in the SEE region unemployment and low employment rate characterises the economy. It means that the outstanding economic growth has not generated sufficient new jobs for unemployed persons.

This is one of the main differences between the two regions' (SEE-7 and NMS-5) current economic paths. While NMS-5 economies grew by a relatively slower pace and gradual job creation characterised these economies (except for Poland), in case of SEE-7 countries, GDP growth was higher but the employment rate decreased in most cases (except for Bulgaria and Croatia) and unemployment remained a difficult issue.

**CHART 1. EMPLOYMENT IN SEE COUNTRIES (1990=100)**



Source: UNECE

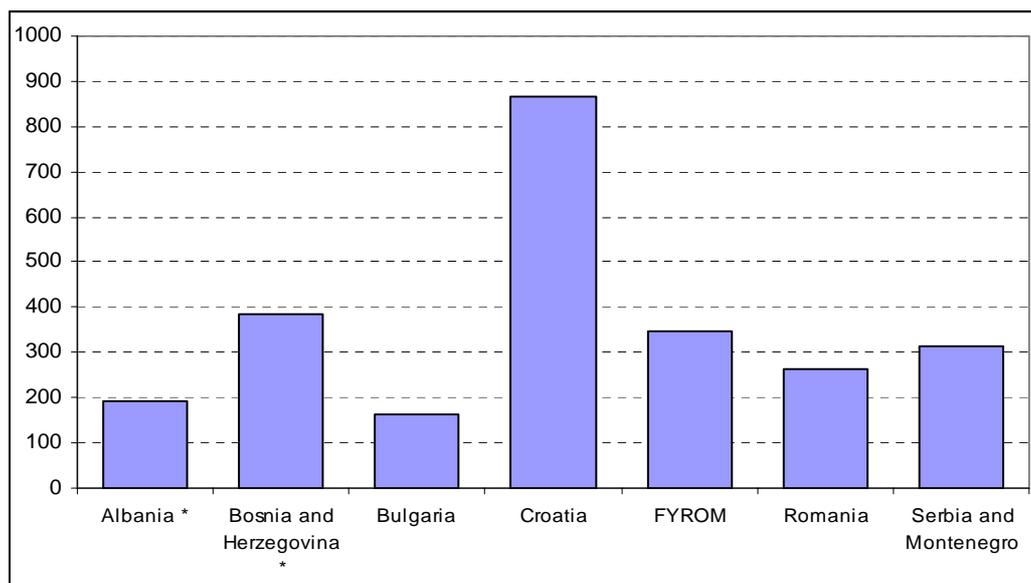
Decreasing employment rate and rising unemployment became a problem after transition and many economies in the region also suffered from wars in early '90s. In Bosnia and Herzegovina the number of employed persons decreased by 83% between 1991 and 1993 which means the employment declined from 630 000 to 107 000 in two years, mainly due to

the Bosnian Civil war (1992-1995). On the other hand, due to the wars in the region and the better performance of the Central European economies in transition process, foreign investors have not showed any serious interest in investing into these economies, while the number of jobs decreased gradually.

Mainly due to the aforementioned factors the economic recession period was longer in case of the SEE countries, thus, the bottom was also lower. Regarding employment, this figure has sunk to between 60 and 80% of 1990 level, at the end of the last decade, while in most NMS, employment never went under 80% of 1990 (Hungary is the only exception). It also means that the number of employed persons declined by 4.8 million or by 21% in the SEE region in the nineties.

In the new decade the number of employed persons decreased further in five out of the seven SEE countries. Thus, employment rate reached a very low level in these economies. In Bosnia-Herzegovina and the former Yugoslav Republic of Macedonia, the employment rate is less than 20% which means that every fifth-sixth person has a registered job, regarding the population aged between 15 and 64. In Albania, Croatia and Serbia and Montenegro, the employment rate is not so low as in case of the earlier economies, however, it can be considered as low (between 40% and 50%). In Bulgaria and Romania, employment rate is close to the NMS, in both cases the figure slightly exceeds 60%.

**CHART 2. AVERAGE GROSS MONTHLY WAGES IN SEE COUNTRIES (2005 JUNE/JULY)**



Source: national statistics institutes; \* 2004 figures

Regarding the average gross monthly wages in the region, there are significant differences among the countries. Wages are the highest in Croatia where wage level (EUR 870) is similar to that of the NMS countries. Majority of the Western Balkan countries (Bosnia-Herzegovina, the former Yugoslav Republic and Serbia and Montenegro) form the second group where the average gross monthly wages are between EUR 300 and EUR 400, while Albania, Bulgaria and Romania are in the third group with less than EUR 300. Obviously, these seven countries are not exactly competitors of each others since their developments are not the same. Naturally, Croatia and Albania will not compete for the same foreign investors. However, the wage levels in Bulgaria and Romania are relatively lower than that of the second group (the three Western-Balkan countries), thus, the two EU candidates are relatively more attractive considering the wage levels and productivities.

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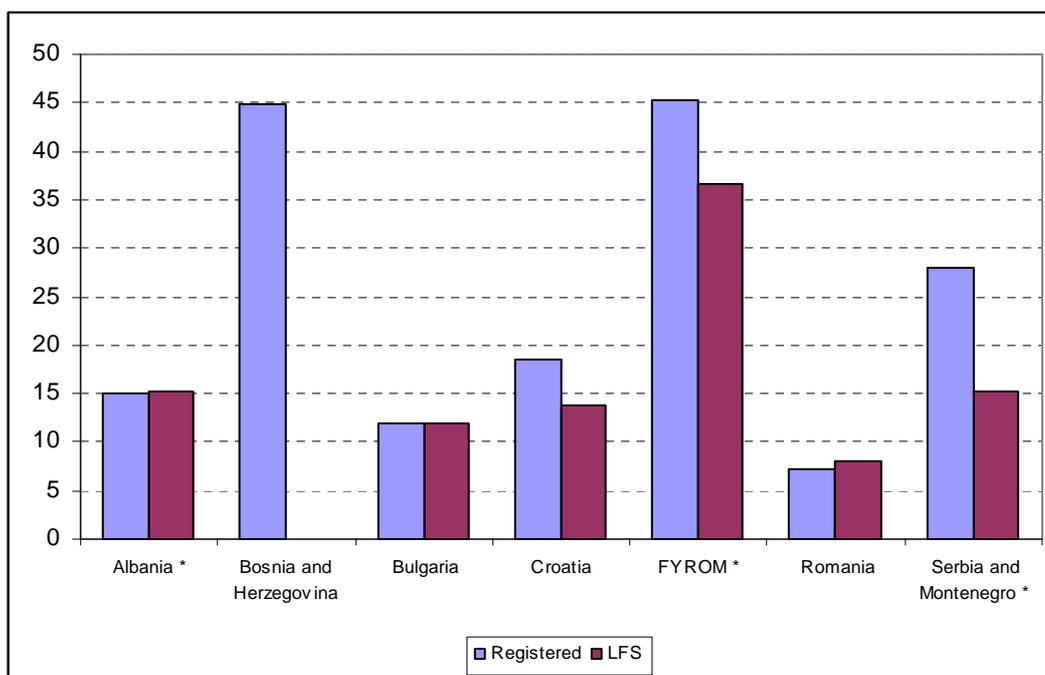
In conclusion, it is clear that employment in the SEE region is problematic in most countries. The main problem is the low employment and the high unemployment rate despite the rapid economic growth. Unfortunately, the robust GDP growth was not followed by sufficient job creation in the last years.

## (UN)EMPLOYMENT IN THE SOUTHEAST EUROPEAN COUNTRIES II.

Due to the low employment rate, unemployment is high in almost all SEE countries. There are three groups regarding the status of unemployment. Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro shape the first group. In these three economies official unemployment rate exceeds 25% and in the last several years the unemployment rate increased. In the second group there are Albania, Bulgaria and Croatia where unemployment is still double digit but it is less than 20%. In these economies unemployment reached its peak a few years ago and since then the figure is improving gradually. Romania forms the third “group” where unemployment is not a significant problem; the figure is less than 10%.

The aforementioned data are statistically reported figures which reflect the registered unemployment rate. However, in some cases these data do not reflect appropriately the real situation, especially in case of the first group. The other method which is used to measure the rate of unemployment is the so-called labour force survey (LFS). Regarding the LFS unemployment figures, the unemployment rate in Serbia and Montenegro is “only” 15.2%, while that in the former Yugoslav Republic of Macedonia is 37.2%. In case of Bosnia-Herzegovina there is no LFS unemployment figure but the other two economies’ example reflects that the number of registered unemployed persons is not equal to those who are really not employed anywhere. According to some estimation, the real unemployment rate is approximately the half of the registered one. Naturally, it reflects the high share of informal sector in these economies. On the other hand, the difference between registered and LFS unemployment rate is partly due to the fact that there is a large amount of persons who are registered as unemployed to benefit from social security system but they are not seeking work at all.

**CHART 3. REGISTERED AND LFS UNEMPLOYMENT RATE IN SEE COUNTRIES, 2004 (%)**



Source: UNECE, ILO; \* 2003 figures

Not only the high rate of unemployment is a significant problem in these economies but also its long duration. According to the statistics, the share of long-term unemployment in total exceeds 50% in most SEE countries (in Albania, the share exceeds 90%), which results that these unemployed persons have minimal chance to get a job in formal sector. These persons being long-term unemployed are usually low skilled, higher aged, territorial immobile, having health problems or belonging to some ethnic minorities.

With the exception of Romania, the SEE economies face high rates of youth unemployment. Youth unemployment rates reach 30-40% in the region, accordingly that age group (15-24) is largely hit by unemployment which is a quite large social and economic challenge for these economies. The large youth unemployment is partly understandable considering the fact that the enrolment in tertiary education is lower in several countries in the region than that of the CEE average, especially in case of Albania, Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia, Romania and Serbia and Montenegro. Therefore, young persons become job-seekers and step into the labour market earlier.

Regarding the gender composition of unemployment, in some cases, the rate of female unemployment is higher than that of the male, such as in Albania, Croatia, Serbia and Montenegro and partly in the former Yugoslav Republic of Macedonia. In the rest of the seven SEE countries, the unemployment rates are almost the same in the two gender groups, or the rate of female unemployment is a bit lower. Certainly, the unemployment rates of genders largely depend on the structure of employment and the orientation of the economy. If for example the light industry (textiles, leathers, shoes, and so on) plays an important role in the economy than the rate of female employment is obviously higher (Romania is a good example).

From regional aspect, unemployment is not a homogeneous problem in the different areas of the countries similarly to most Central European countries. Unemployment is higher than the national average in mostly rural areas and in those areas which were heavy industrial (mainly mining, metal, military or energy) centurms before the transition. The latter factor is the heritage of the previous (the communist) regime.

#### **BOX 1. DOING BUSINESS IN SERBIA**

The World Bank publishes its so-called "Doing business" series in every year in which the authors evaluate the business climate of more than 100 countries in the world. In 2004 Serbia and Montenegro was evaluated as the top performer in reforming and improving its business climate to spur the establishment of firms and the creation of jobs. In last year, Serbia and Montenegro improved in 8 out of the 10 areas observed by the World Bank, such as the decrease of capital requirement of starting a new business from EUR 5 000 to EUR 500, the reduction of time to start a new business from 51 days to 15 days, the introduction of a new labour law which allows the firms to offer term contracts that makes it easier to hire new workers, and so on. As a result, in 2004 the number of new registered firms increased by 42% compared to the previous year.

Although, Serbia and Montenegro was the top performer in last year, its rank is currently pretty poor, only 92. Certainly, this rank does not reflect appropriately the attractiveness of a country due to the fact that several indicators – which influence an investor's decision – are not included in the evaluation, such as the quality of infrastructure, corruption or macroeconomic environment. But the high ranking means that the given government created a regulatory environment which is favourable to the firms.

*Source: Doing Business in 2006, World Bank*

In conclusion, long-term unemployment and youth unemployment are serious concerns which represent severe social and economic challenges. On the other hand, the official and the real unemployment are not equal in all SEE countries. It means that the informal sector plays an important role in mainly the Western Balkan economies. Accordingly, it reduces not only the revenues of budget but also increases the expenditures due to the fact that the registered job-seekers benefit from social security system. Thus, unemployment is one of the most important macroeconomic issues in these economies, namely the increase of employment is essential, therefore, the governments are committed to make their economy more and more attractive for the foreign investors.

## GDP GROWTH RATE OF BULGARIA IN THE FIRST HALF OF 2005

In 2004, Bulgaria's GDP rose by 5.6 % (still a preliminary figure), to about 38 billion Leva, as it was expected. During the first quarter of 2005, the economic growth was fairly stable. On this basis even better economic performance was expected for the following second quarter due to the additional pre-election expenses which stimulated particularly the private consumption.

During the first quarter of 2005, the real value of GDP increased by 6 % as compared to the previous year. It was a record high level, which was due to the credit expansion, which resulted in increased consumption and boosted interior supply. The economic performance improved even more in the second quarter of 2005. During the second three month-period, the economy grew by 6.4 % to 9.7 billion Leva. It represented a 5.5 % growth on the year-to-year basis. Thus, during the first half of 2005, the GDP grew by 6.2 % on the year-on-year basis to more than 18.4 billion Leva. This growth rate was higher than the 5 % (still a preliminary figure) rise recorded in the same period in 2004.

The economic growth rate registered in the first half of 2005 was the highest one in the past seven years. A better economic performance was recorded after the economic crisis in 1995-1996, when the growth rate was 9.9 % in the first half of 1998. It would be impossible to reach such record figure now.

Looking at the sources of the high economic growth it can be seen that the private sector generated 77.9 % of value added in the economy, which was a 10.8 % increase compared to the first half of 2004. The remaining 22.1 % of the GDP growth was generated by the public sector, which showed a 6 % decrease compared to the same period in 2004. Foreign trade had also important role. Its increase contributed to capital investments. Foreign trade grew by 13.4 % in the first half of 2005 on the year-to-year basis and it made up 22.1 % of GDP. The trade balance continued to be negative. For the first half of 2005 imports were about 3.2 billion Leva which exceeded the value of exports.

Bulgaria's industry marked a boost two times bigger than the one saw back in 2004. The industrial growth excelled the services sector and the agriculture sector. In terms of production, total value added growth in the economy registered higher values compared to GDP growth. Growth in industry and services accelerated, with growth in industry outpacing growth in services, while decline in agriculture intensified. With a 52 %, the service sector accounted again for the highest share in GDP production. However, most notable in the first quarter of 2005 is industrial growth, which registered nearly twice the growth Q1 2004.

Unlike the trend observed in the previous three quarters, the accelerated total economic growth in terms of GDP consumption is now a result of the accelerated growth in final domestic consumption and of the delayed growth in investments and in the export of goods and services, and delayed growth in exports compared to imports. On the other hand, compared to the dynamics in the first quarter of last year, export of goods and services registered slight acceleration, whereas imports registered a slowdown. This trend changed in the second quarter of the year. This trend was stronger and characterised more the first half of the year.

A possible resource for accelerated total economic growth is rather the growth in quality and capital productivity than the growth in the physical volume of investments. The record-

breaking GDP growth in the first half of 2005 is accompanied by a record high share in GDP of the goods and services deficit.

An important positive economic development represents labour productivity growth, which followed last year's decline caused by the encouragement of low-productivity employment. Higher values registered after the seasonal decline in January, and the positive mid-term trend is expected to persist. Positive strides have been made in enterprise policy and the new government will have to complete them. Efforts in privatization and concessions did not yield the expected results because of the poor organization and insufficient transparency of procedures.

The financial sector had various contributions to the economic growth. A major growth factor was the spike in credit growth, with resources directed mostly to consumer consumption, which in turn promoted domestic supply. Another important development related to the banking sector's stability is the recent temporary halt of the credit expansion. During this period the stock market registered the longest downward price trends for the last three years. Fiscal policy developments remained highly condemnable for the uncontrolled spending and the swelling budget surpluses. Critical is also the situation in the health sector, where election debates failed to outline clear paths for reform.

Realistic evaluation of the current state of the Bulgarian economy expects that the 6.2 % growth figure for the first six months of 2005 could decrease by the end of the year because of the summer's floods and the rising price of fuel on the world market. The high foreign trade deficit is a risk factor for the economy. In spite of the adverse trends high annual growth rates are forecasted in construction, followed by industrial production, trade, and services.

The main GDP components – final consumption, gross fixed capital formation, export, and import also realized a real growth during the first half of 2005. However, increasing growth of final consumption causes a fall in gross savings to GDP ratio after five consecutive quarters of increase in this ratio. Savings should be the source of investments in the economy, which share in GDP is relatively constant and insufficient. This situation leads to a higher current account deficit and a financial account surplus because savings are actually imported from abroad. Growth of gross fixed capital formation has decelerated to 9.2 per cent in Q1 2005 from 22.1 per cent in Q1 2004. This can be also an indicator for slower economic growth in the last two quarters of 2005 because the trend during the last years is that lower investment growth leads to lower GDP growth. Thus, the volumes of capital formation will remain decisive factor for economic growth. In addition, it is still important how fast resources are being reallocated to more productive enterprises.

**TABLE 3. EVOLUTION OF GDP, 2004-2005**

	2004	H1 2004	Q1 2005	2Q 2005	H1 2005
Real GDP growth (%)	5.6	5.0	6.0	6.4	6.2
Nominal GDP (mn Leva)	38 000.0	16 810.0	8 681.0	9 737.0	18 428.0
Consumption (mn Leva)	33 000.0	15 138.0	8 166.0	8 718.0	16 884.0
Gross capital formation (mn Leva)	8 938.0	3 889.0	1 958.0	2 749.0	4 707.0
Trade balance (mn Leva)	-3 900.0	-2 199.0	-1 423.0	-1 722.0	-3 145.0
Exports (mn Leva)	22 209.0	9 687.0	5 115.0	6 274.0	11 389.0
Imports (mn Leva)	26 110.0	11 886.0	6 538.0	7 996.0	14 534.0

*Source: Statistical Office of Bulgaria*