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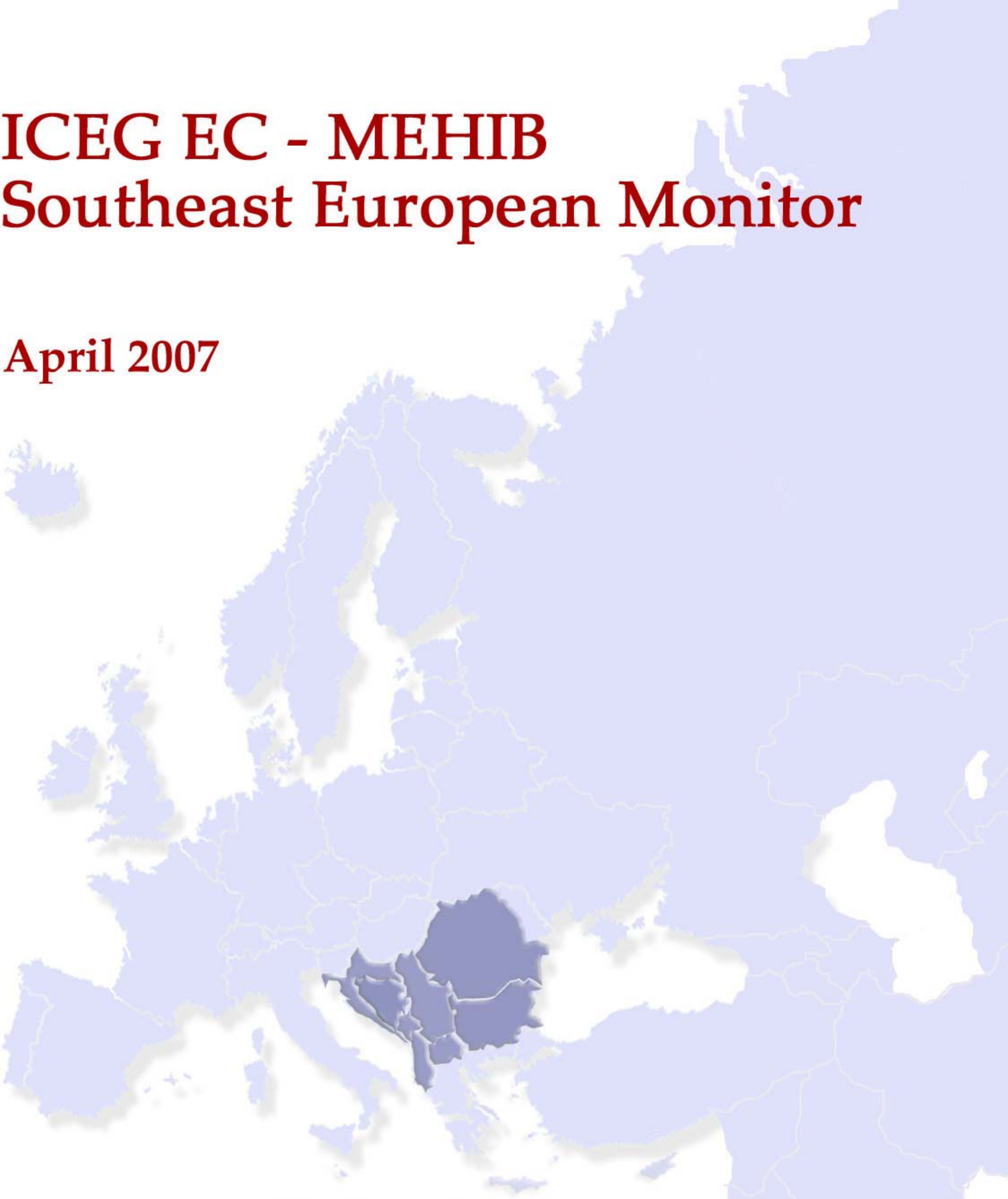

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RECORD HIGH INWARD FDI TO BULGARIA AND ROMANIA

According to the data of the National Bank of Romania and the Bulgarian National Bank, inward FDI reached record levels in both countries in 2006. Bulgaria attracted EUR 4.015 billion foreign direct investment, which was 73% higher compared to 2005 and accounted for 16.6% of GDP. Foreign direct investment to Romania increased by 75% in the same period and exceeded EUR 9 billion (9.4% of GDP), including the EUR 2.2 billion from the privatisation of the Romanian Commercial Bank (BCR).

KEY INDICATORS OF THE BULGARIAN AND ROMANIAN ECONOMY

The transition to a market economy had a similar character in both countries in the last two decades. Bulgaria experienced a decade-long delay in its transition. However, after a severe economic and financial crisis in the beginning of 1997 and the implementation of a comprehensive economic reform program including trade and price liberalization, social-sector reform and restructuring the financial, enterprise, agricultural and energy sectors directed the country to stable economic development. In five out of seven years since 2000 real GDP growth exceeded 5% accompanied by continuously decreasing unemployment, while inflation has been kept at a reasonable level.

TABLE 1. KEY INDICATORS OF BULGARIA AND ROMANIA 2000-2006

	2000	2001	2002	2003	2004	2005	2006
Bulgaria							
GDP growth (%)	5.4	4.1	4.5	5.0	6.6	6.2	6.1
Inflation (%)	10.3	7.4	5.8	2.3	6.1	5.0	7.3
Budget balance (% of GDP)	-0.5	1.9	-0.6	0	1.7	3.1	3.6
Unemployment rate (%)	16.4	19.5	16.3	13.5	12.2	10.7	9.1
Romania							
GDP growth (%)	2.1	5.7	5.1	5.2	8.5	4.1	7.7
Inflation (%)	45.7	34.5	22.5	15.3	11.9	9.1	6.6
Budget balance (% of GDP)	-4.6	-3.3	-2.0	-1.5	-1.5	-1.4	-1.9
Unemployment rate (%)	7.2	6.6	8.4	7.0	8.1	7.2	7.4

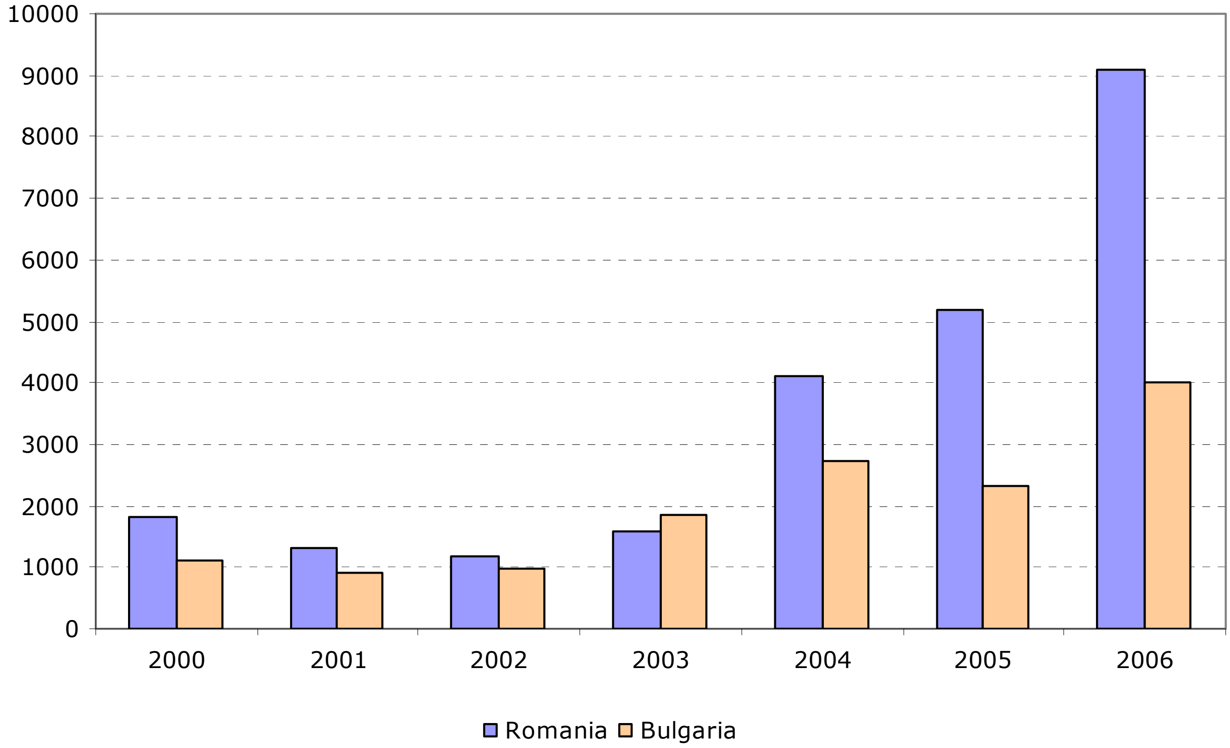
Sources: Eurostat

Similarly to Bulgaria macroeconomic imbalances remained during the 1990s in Romania. GDP started to grow slowly in 2000, thus it was still below the 1989 level in 2003. Thanks to a new economic policy including significant tax reform and privatisation the rate of real GDP growth accelerated and exceeded 5% in each year since 2001 except for 2005. In the last two years inflation dropped below 10% and a slow decrease of unemployment could be reached as well.

TENDENCIES OF INWARD FDI

It took several years to attract a significant amount of foreign direct investment after the economic and financial crisis in Bulgaria. FDI exceeded EUR 1 billion in 2003, which meant a 100% increase compared to 2002. As economic growth continued and the business climate improved the amount of inward FDI increased and remained at a higher level until 2005. However, the break-through happened only in the year preceding EU accession of Bulgaria, resulting in a record high inward FDI of EUR 4.015 billion. 19.5% of foreign investment arrived from Austria, followed by Greece (9.7%), Germany (7.7%), Italy, (6.2%) and the Netherlands (6.1%). Almost one fifth of foreign investment project were directed to the financial sector, followed by trade and repairs and telecommunications (both having a share of 13.1%). Although construction has a share of only 3% in inward FDI, the interest in the sector is increasing, which is reflected by the 200% growth of FDI flowing to this sector.

CHART 1. INWARD FDI TO BULGARIA AND ROMANIA 2000-2006 (MILLIONS OF EUROS)



Source: central banks of Bulgaria and Romania

Despite the high potential for FDI in Romania, the level of foreign investment was lagging behind other countries of the region. Cumulative FDI between 1989 and 2002 reached only 40% of the Hungarian FDI achieved in the same period. In line with economic growth, inward FDI started to increase sharply in 2004, reaching 256% of foreign investments in 2003. Although later than expected, foreign investors reacted on the benefits offered by future EU membership of the country and increased their investments by 75% in the year before the accession. Privatisation played an important role in inward FDI in the last few years. Excluding the FDI from the privatisation of BCR, the increase of inward FDI would have reached 'only' 32.7% compared to 2005. In the last few years, Romania attracted almost half of inward FDI flowing to the region. Most investment arrived from the Netherlands, amounting to 20,8% of total FDI to Romania. Investors from three more countries, Austria, France and Germany contributed between 10% and 13% of total FDI. The sectors wholesale and services benefited the most from foreign investment, having a share of 26.9% and 23.8% respectively. Industry and retail sector attracted also a significant share in inward FDI, however having only a ten percentage point lower share compared to wholesale and services, while tourism and construction seemed to be less attractive for foreign investors by the end of 2006.

Both countries are becoming more and more attractive for foreign investors. The two economies are stable and ensure sustainable growth for the future. The business climate is developing, however both governments have to make huge efforts to fight against corruption, bribery and informal market. Low tax rates such as 16% in Romania and 15% (expected to be 12% in 2007) in Bulgaria provide also advantages in the competition for investment. Skilled labor force is available in both countries, and wages are significantly lower compared to other EU member states. Bulgaria's EUR 167 a months is far the lowest in the EU, while Romania is a bit more expensive concerning labour force, as average wages amount to EUR 275, which is 1.6 times lower than in Slovakia.

Expectations

According to the central bank of Bulgaria, FDI fell by nearly a quarter to EUR 379.8 million in the first two months of 2007 compared to the same period of the previous year. Similar trends can be observed in Romania, where foreign direct investment stood at EUR 870 million, 13% less compared to the first two months of 2006. The decrease is due to the high base of 2006, but it can be considered promising compared to the FDI level of 2005. Thus, the effects of the EU accession seem to last in the coming years as well, especially because transnational corporations delayed to take advantage of the investment opportunities in the two new member states.

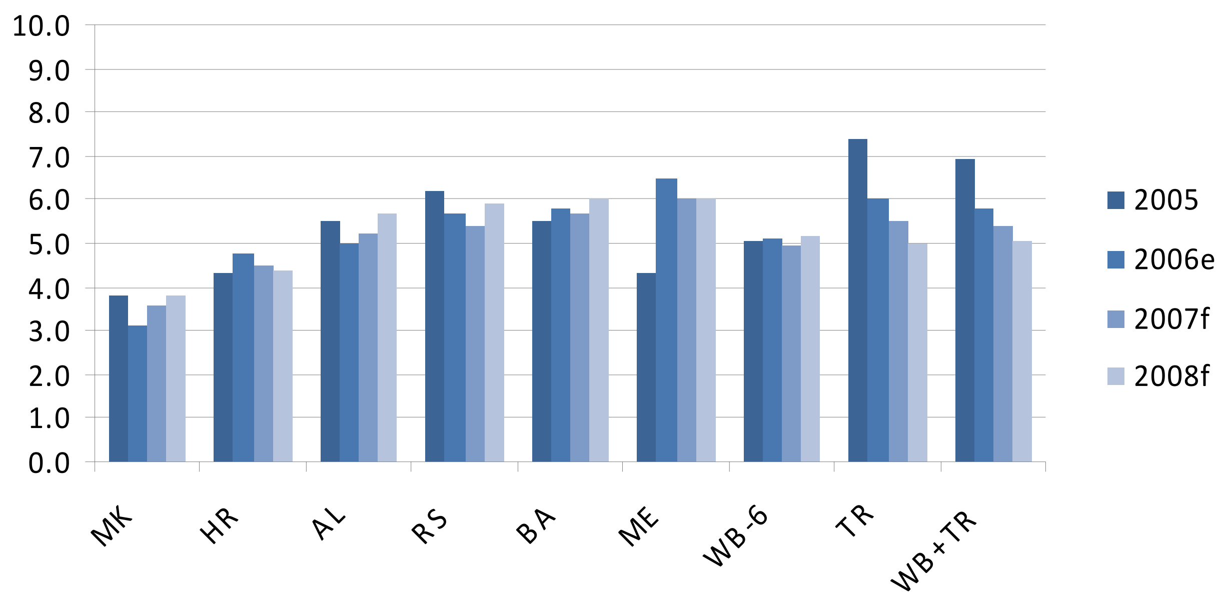
Although the business environment has been improving in Bulgaria and Romania, it is still far from being very competitive. Additionally an annual increase of 12% of labour costs can be expected after the accession. Therefore, governments should make further efforts in improving governance and administration, investing in physical infrastructure, modernizing education in order to reflect the demand side of the market and fighting corruption and the black market. The financial support offered by the EU can help both countries to improve their business climate and maintain the high level of inward FDI in the future.

ICEG European Center's latest Quarterly Forecast on the Western Balkans – First Quarter 2007

ICEG European Center published its latest quarterly forecast on the Western Balkan countries. According to the report, most Western Balkan countries (WBC) face political uncertainties or problems at the beginning of 2007. First of all, the future status of Kosovo is still not certain. In the former Yugoslav Republic of Macedonia, the largest ethnic Albanian party boycotts the Parliament. The formation of the new government in Bosnia-Herzegovina and Serbia is still not completed after the election. In Croatia, the forthcoming election may have impacts on economic development.

2006 was basically a good year for the Western Balkan countries. GDP growth averaged 5.1% in the six countries and the highest growth was achieved by Montenegro (6.5%). In the latter case foreign direct investment had a significant role in economic growth, which exhibited the progress in privatisation and improving business climate in the region. In 2007 economic growth is expected to slow only slightly, to 5% in the region. Domestic demand, namely private consumption and investments remain the main engine of the region but foreign demand is expected to play a bigger role in growth in this year. In 2008 economic growth is expected to increase in the region averaging 5.2%.

Chart 2. Real GDP growth rates (%)[1]



Note: e = estimation, f = forecast; Source: national banks and statistics institutes

In four out of the six Western Balkan economies inflation remained moderate (between 2.1% and 3.2%) in 2006. Significant acceleration of inflation was observable only in Bosnia-Herzegovina due mainly to a one-off negative effect of the introduction of VAT last year. Disinflation continued in Serbia and inflation declined under 5% at the beginning of 2007,

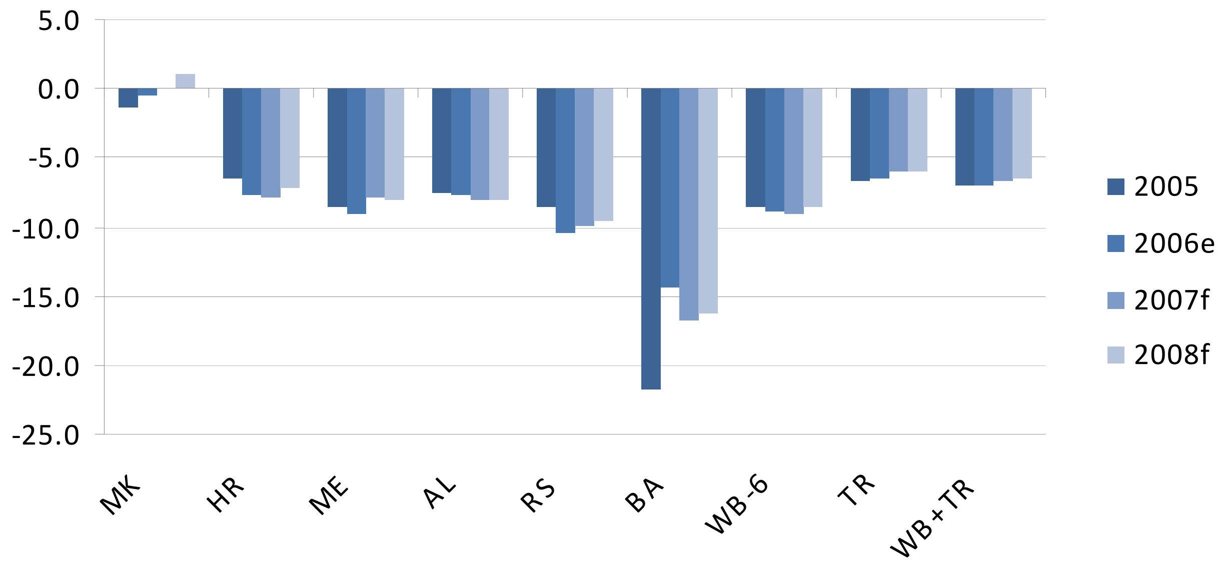
[1] Abbreviations: AL – Albania, BA – Bosnia-Herzegovina, HR – Croatia, MK – FYR of Macedonia, ME – Montenegro, RS – Serbia, WB-6 – Western Balkans (averages weighted by nominal GDP), TR – Turkey, WB+TR – Western Balkans and Turkey

accordingly all WBC will have single-digit inflation this year, averaging 4.1%. However, there are some uncertainties regarding the development of inflation. Most importantly the evolution of international oil prices may have a negative impact on prices. In 2008 our expectation is that price increases will remain on the same level as in this year.

Budget deficits remained low or reached surplus in the WBC last year. Surplus was observed in Bosnia-Herzegovina and Serbia, while budget deficit was between 0.6% and 3.1% of GDP in the remaining four countries. In 2007 budget balances are expected to worsen on average. It is worth mentioning that Serbia still has not adopted budget in 2007. Elections will be held in Croatia; accordingly loosening fiscal policy is expected. A flat tax regime was introduced in the former Yugoslav Republic of Macedonia, and Albania also plans to reform its tax system and introduce flat tax from 2008. It means that tax competition spread over from Central and Eastern Europe to the region. WBC's governments attempt to make their business environment more attractive to increase the presence of foreign investors.

In 2006 current account deficits increased in most countries and remained high. The regional average current account deficit reached 9% of GDP, of which Bosnia-Herzegovina and Serbia had higher than 10% deficit. CA balance improved only in the former Yugoslav Republic of Macedonia where the deficit was close to zero. The evolution of CA balances is basically influenced by high foreign trade deficits. In WB countries foreign trade deficits exceeded 20% in 2006 due to high import ratios. However, the high foreign trade deficits were partly counterbalanced by services balance (tourism) and current transfers (remittances). In 2007 further deterioration of CA deficit is expected in average, the balance will improve only in the former Yugoslav Republic of Macedonia, Montenegro and Serbia.

CHART 3. CURRENT ACCOUNT BALANCES (% OF GDP)



Source: national banks and statistics institutes

Unemployment remained one of the most important macroeconomic challenges in the region. Average unemployment rate reached 20% in the region, and it even exceeded 30% in Bosnia-Herzegovina and the FYR of Macedonia. Even if these are the official figures and real unemployment is expected to be lower due to significant level of informal sector, these figures are really high. Still, unemployment decreased in 2006 and this trend is expected to continue in 2007 and 2008 as well. This process is supported by high economic growth, foreign direct investments and whitening of informal sector. Progress in privatisation may have a negative impact on unemployment, though.

THE CURRENT ECONOMIC SITUATION AND THE POSSIBLE EFFECTS OF PARLIAMENTARY ELECTIONS IN SERBIA

The Republic of Serbia held parliamentary elections in January, since after the break with Montenegro, the country adopted a new constitution in October 2006 which stipulated the dissolution of the current assembly and the need of holding elections for a new parliament. The elections had an outstanding significance as its outcome can affect the following major issues.

THE PATH OF EU-SERBIA RELATIONS

The EU suspended the negotiations on the Stabilisation and Association Agreement on 3 May 2006, due to a lack of co-operation with the International Criminal Tribunal for the former Yugoslavia (ICTY) in The Hague. The EU still awaits the delivery of alleged war criminal Ratko Mladic. However the EU announced a possible rapprochement of EU-Serbian relations, depending on the outcome of the elections. According to Enlargement Commissioner Olli Rehn the EU expects the formation of a new reform-oriented and pro-European government in Belgrade, which will make rapid progress towards the EU. Rehn also assured that in this case negotiations on the Stabilisation and Association Agreement (SAA) could be finalised soon, opening the door for EU-membership candidacy.

THE FUTURE OF KOSOVO

In order to avoid the process' influence on the result of the elections, UN special envoy Martti Ahtisaari has presented a plan for the future status of Kosovo after the elections. First he presented it to the so-called contact group (consisting of the US, the UK, Germany, France, Italy and Russia) on 26 January and then he was to produce it to the directly-involved parties in Belgrade and Pristina on 2 February 2007. The new plan envisages that Kosovo remains under the auspices of the international community and that the implementation of the settlement will be supervised by an EU and an International Civilian Representative.

The directly involved parties have different opinions on the issue: while Kosovo's Prime Minister Agim Ceku said that 'I am confident that Kosovo will be independent', the outgoing Serbian Minister of Public Administration and Local Self-Government Zoran Loncar has criticised that the plan is not the result of talks with Belgrade and he also added that Ahtisaari should have presented his plan only after the formation of the new government. The further negotiations on the future status of Kosovo will be largely determined by the standpoint of the new governing parties.

THE CURRENT ECONOMIC SITUATION AND THE CHALLENGES AHEAD

According to the European Commission's Progress Report 2006 the main outlines of Serbia's current economic situation are the follows:

- In 2005 Serbian GDP is estimated to have grown by 6.3% year-on-year driven by strong gains in trade, transportation, financial services and construction, more than offsetting a drop in agricultural output. The trend for 2006 remained strong.

- The current account deficit diminished from 12.6% to 9.8% due to the strong growth of exports (it was up to 13.2% year-on-year) and the decrease of the imports (it was down to 6.7% year-on-year).
- The FDI inflows are continuously growing in Serbia (2005: 4.3% of GDP, first half of 2006: 5.7% of GDP), but as they are strongly related to the privatisation process - which is in early stage in Serbia – the further expansion of these inflows can be largely attributed to this reason as well.
- The unemployment rate amounted to 27% in 2005 and important regional disparities exist both in employment and unemployment, while the agriculture remains a sizeable source of employment. The large and increasing extent of informal employment induces statistical, legal and taxation problems.
- Inflation remained at double digits throughout the year and stood at 17.5% on the year-on-year basis in December 2005, due to the rising costs of fuel imports, the VAT introduction, the strong domestic demand and the widespread exchange rate indexation of the prices. In 2006 retail price inflation eased somewhat and reached 11.6% on a year-on year basis in September.
- Concerning the macroeconomic policy mix, in 2005 the fiscal consolidation continued as the personal and corporate income tax grew in real terms as well as the expenditures declined by 0.4% due to permanent cuts in subsidies and transfers. However in 2006 the fiscal policy turned expansionary mainly because in addition to the increased expenditures, the government launched a national investment plan worth about EUR 1.6 billion for 2006 and 2007. The monetary policy has been tightened to curb credit growth and to repress high inflation, for implementing the latter the National Bank of Serbia launched an inflation targeting programme in September 2006.

Although Serbia has made a significant progress since 2000 it faces several challenges nowadays:

- An overall reform agenda is needed, which addresses the roots of low investment. With capital formation rates regionally low and employment reportedly falling, much of the economic recovery since 2000 has reflected growth in total factor productivity. A reform agenda ranging from improved business and political climates to bankruptcy and privatization is indispensable.
- As the unemployment rate is high, the future restructuring may result in further layoffs and the shift of the employment structure towards private sector is mainly attributable to re-classification due to privatization rather than job-creation by private firms, Serbia’s labour institutions should be reassessed. The reforms should include the complex wage-setting mechanisms in the public sector inherited from the Yugoslav era. The review of the 2005 Labour Law would be needed from the point of view of the young people and the females as among the members of these groups the unemployment is relatively also high. Initiatives such as labour tax cuts, while helpful at the margin, cannot play a central role in improving employment performance.
- As the 2005 Banking Law strengthened banking regulation (which was needed among others because of the rapid credit growth), the key challenge now is implementation. Increased regulatory capacity is needed to monitor and manage indirect credit risk arising from foreign exchange exposures.

- A flexible exchange rate regime, managed with little or no discretionary exchange intervention, but with other policies aimed to avoid excessive volatility in the nominal exchange rate, could be the best solution for Serbia as some of its characteristics (like high euroization and high exchange rate pass-through) requires a relatively stable nominal exchange rate, while others (e.g. the strength of capital inflows and the risk of reversal) demand flexibility.
- The inflation targeting programme which was launched in September 2006 faces difficulties because of the uncertainties, which are posed for example by the structural shocks which influence core inflation through the exchange rate. The experiences of other emerging market countries – which adopted inflation targeting in the face of similar uncertainties –about the determinants of inflation could be very useful.
- Approximation to the EU and the WTO accession will require further reforms (including privatisation of large public enterprises) and changes in the foreign trade regime (adjustment of import rules, including technical standards, quality and sanitary control of goods entering the territory of Serbia).

Consequently the aforementioned three major issues – the continuation of negotiations on the SAA with the EU, the future of Kosovo and the economic reforms – were the main stake of the elections. Concerning the technical details of the elections, the voters chose members of the country's unicameral legislature, the 250-seat National Assembly and the seats were distributed among lists that received at least five percent of the vote. This requirement was waived in the case of ethnic minorities, their lists needed to poll just 0.4% of the votes in order to secure parliamentary representation. The turnout was 60.56% and the election had the following results:

TABLE 2. SUMMARY OF THE 21 JANUARY 2007 NATIONAL ASSEMBLY OF THE REPUBLIC OF SERBIA ELECTION RESULTS

Parties	Votes	%	Seats
Serbian Radical Party (SRS) – Dr Vojislav Šešelj	1 152 105	28.59	81
Democratic Party (DS) – Boris Tadić	915 014	22.71	64
Democratic Party of Serbia–New Serbia (DSS - NS) - - Dr Vojislav Koštunica	666 889	16.55	47
G17 Plus — Mlađan Dinkić	274 874	6.82	19
Socialist Party of Serbia (SPS)	227 304	5.64	16
Liberal Democratic Party–Civic Alliance of Serbia–Social Democratic Union–League of Social Democrats of Vojvodina - - Čedomir Jovanović	214 028	5.31	15
Parties of ethnic minorities (above the 0,4% natural threshold)			
Alliance of Vojvodina Hungarians — József Kasza	52 458	1.3	3
Coalition List for Sandžak - Dr Sulejman Ugljanin	33 819	0.84	2
Roma Union of Serbia — Dr Rajko Đurić	16 995	0.42	1
Albanian Coalition from Preševo Valley	16 972	0.42	1
Roma Party — Šajn Srđan	14 568	0.36	1

A possible explanation for the otherwise foreseeable success of the Radicals was the attraction of their usual nationalist supporters as well as large numbers of the former middle classes, whose status and jobs have been destroyed over the past 17 years by war and sanctions, and now by the strains of economic transition. As economically the SRS focuses on the fight against corruption and organised crime, it would concentrate mainly on these issues also in its government programme. Although the Serbian Radical Party won the highest amount of the votes, it cannot form alone the future government (which had not been a presumptive scenario even before the elections) and it is unlikely to form a coalition with any of its rivals. Due to their similar standpoint on the issue of Kosovo an SRS – SPS – DSS or a DSS – SRS coalition cannot be utterly rejected, but the chance for the evolvement of such a situation is very low. The outgoing prime minister, Vojislav Kostunica can be the key figure of the negotiations on the formation of the future government, as he had not rejected unambiguously the possibility of a coalition with the radicals, while he asserted the prospect of the cooperation with the democratic parties.

In the current situation a democratic bloc is likely to rule. This includes the party of Vojislav Kostunica and that of Boris Tadic, Serbia’s president. Kostunica’s DSS-NS is a centre-right coalition advocating co-operation with the international community, but "not at any cost" (for example they insist on the preservation of Kosovo), while Tadic’s DS advocates a liberal economy, political pragmatism, co-operation with the international community, fast integration of Serbia to the EU and the need for regional co-operation. Thus, although their economic principles and their attitude towards the international community differ at some points, the result may yet force both to cooperate. The G17 Plus and the Liberal – Democratic Coalition are also possible members of a future governing coalition and both of them are committed to strengthen the framework of market economy. The G17 Plus – led by Mladan Dinkic former Finance Minister – based its programme on economic issues, such as stable currency, lower interest rates and ambitious plans for investing in the country's infrastructure. It also takes a clear pro-European position. The Liberal – Democratic Coalition is wooing young, urban voters, pledges to fight for the rights of all minorities and it asks for a confrontation with the past, which will make it possible for the country to go forward. They plead for liberal values, modern economy and good relationship with neighbour countries. They would accept the independence of Kosovo.

So ever the exact composition of a democratic governing coalition would evolve, they have to answer the above-mentioned economic challenges and for accomplishing this aim a useful device could be the lessening of the government’s role in the economy.

MONTENEGRO AND THE STABILISATION AND ASSOCIATION AGREEMENT

The referendum on independence held on May 21, 2006 was supported by all political forces in the Montenegrin Parliament. After the successful result, the EU Council decided to develop further their relations with the new independent states, and the Montenegrin Parliament adopted the integration into the EU as a new strategic plan. Furthermore they determined to fulfil the conditions of the Copenhagen criteria and the Stabilisation and Process. On 15 March 2007, the Stabilisation and Association Agreement was initialled by Prime Minister Sturanovic and EU Commissioner Olli Rehn.

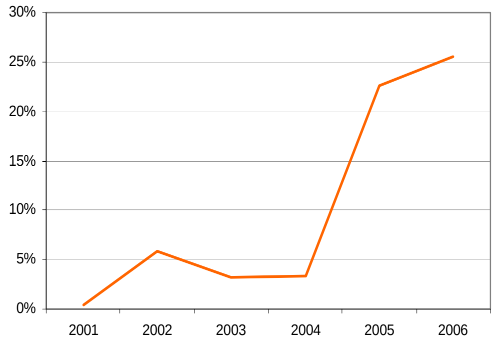
Stabilisation and Association process involves the following topics: drafting the Stabilisation and Association Agreement (SAA); development relations in the field of economy; cooperation in the field of justice; the development of political dialogue and ensure financial aid for the non-EU country. The need for regional co-operation is stressed particularly strong. So the SAA is a framework for cooperation and a comprehensive agreement between the non-EU country and the EU official. It aims at the creation of a free trade zone between the state and the EU and provides for extensive liberalisation in a number of economic fields. It also implies that Montenegro undertakes to adopt Community legislation in areas such as customs and trade, competition, public procurement, electronic communications, protection of intellectual property rights and other fields. A number of provisions will provide for advanced cooperation in the area of Justice, Freedom and Security. Similar to the "Europe Agreements" with countries of Central and Eastern Europe in early 90's, the SAA will provide a legal framework for the relations between the EU and Montenegro for the entire period prior to the possible future accession.

The Agreement will bring concrete benefits to the citizens and the enterprises in Montenegro and prepare the country's integration into the EU. It foresees the establishment of a free trade area between the country and the EU by the end of a 5-year period as well as enhanced cooperation in the economic field; this means more trading opportunities, creating jobs and economic development. The agreement also foresees enhanced cooperation in the field of environmental protection and in the area of justice and security.

Two main effects of the agreement can be distinguished. First, the political situation will be more stable, that can be accelerating more foreign direct investments and portfolio investments in the country. Second, according to the trade liberalisation the large external imbalance could improve in short term.

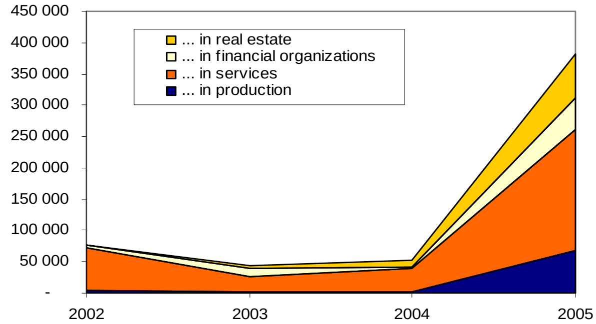
The country's smooth path to independence in 2006 significantly reduced political risk, triggering high foreign direct investment inflows in real estate, tourism, and other sectors, estimated at 34% of GDP in 2006. The coverage of the foreign trade deficit with the surpluses achieved in other current account sub-balances was only 37.3. The current account deficit was mainly financed by an inflow of foreign direct investments. According to preliminary data, the inflow of foreign direct investments into Montenegro in January 2007 amounted to EUR 33.5 million, which is 149.4% more than in the same month of 2006.

CHART 4. FDI INFLOWS (% OF GDP)



Source: Central Bank of Montenegro

CHART 5. INVESTMENTS (THOUSANDS OF EUROS)

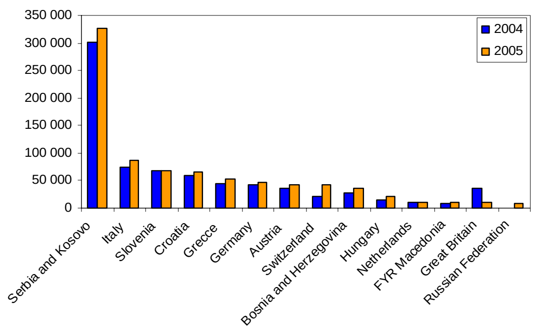


Source: Central Bank of Montenegro

Presumably the FDI inflows increase in the Stabilisation and Association process. Many companies from the member states (especially from France) have already heralded their intent in investments. The main target will be the tourism (parallel to the real estate investments) and the industries based on cheap manpower. The FDI inflows in the percentage of GDP could reach the 30 percent in the following years. There is only one risk. If political conflicts would appear about the status of Kosovo, the risk could increase in the region, including Montenegro.

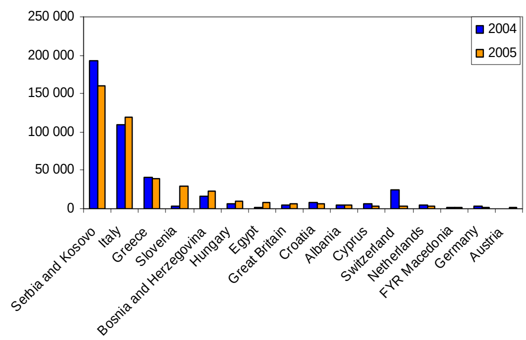
On the other hand, the main benefit of the Agreement could be result in the improvement of external balance. The imbalance in Montenegro is historically large. The current account deficit increase in 2006 was primarily due to an increase in the foreign trade deficit. The deficit of trade balance was EUR 906 million in 2006, after 513 million euro in 2005. Owing to strong construction-related imports and investment in the tourism sector, the current account deficit significantly widened. Preliminary data on Montenegro's balance of payments show that the current account deficit in 2006 amounted to EUR 568.2 million. It is expected to decline in medium term following a slowdown in investment as well as rising tourism receipts.

CHART 6. IMPORTS (THOUSANDS OF EUROS)



Source: Central Bank of Montenegro, Bulletin

CHART 7. EXPORTS (THOUSANDS OF EUROS)



Source: Central Bank of Montenegro, Bulletin

The main trade partners of Montenegro are Serbia and Kosovo, but the weight of Italy is also growing. According to the latest data the Montenegrin exports to the EU represents a share of 0.016% of the EU's total imports. In the same period, EU exports to Montenegro represent a 0.04% share of the total EU exports. It is expected that countries from the European Union build their economic connection with Montenegro in the future. The trade deficit probably decline after 2007, when the investments are working and the export of industrial product to the EU increase.

Overall, the Montenegrin economy is a target of the foreign direct investments and portfolio investments nowadays. In short time – according to the large import connecting investments – the trade deficit and current account deficit increase, but largely covered by FDI. In medium term the foreign companies are expected to accelerate the growth rate, and export. Main risks probably come from the structural problems of labour market with the relatively high unemployment rate, and from the political instability of the neighbouring Kosovo.

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