MEHIB HUNGARIAN EXPORT CREDIT INSURANCE
ICEG EUROPEAN CENTER

ICEG EC - MEHIB Southeast European Monitor

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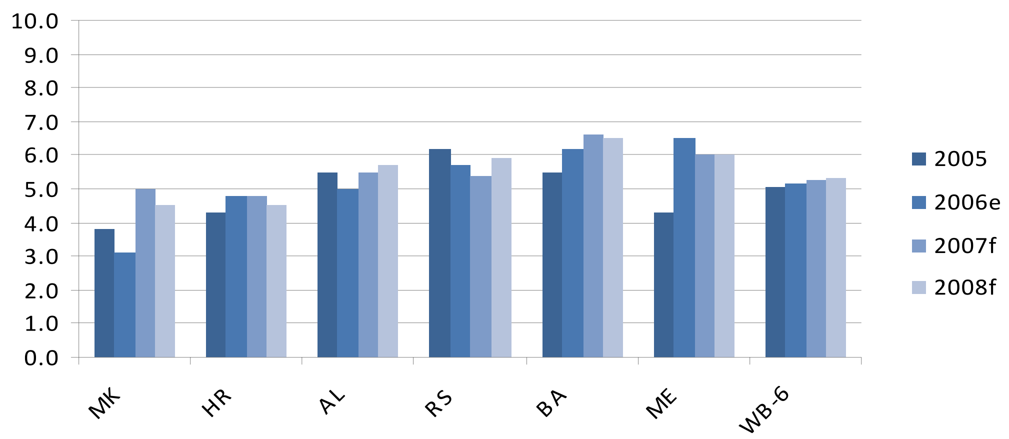
ICEG European Center's latest Quarterly Report on the Western Balkans – Second Quarter 2007

ICEG European Center published its latest quarterly forecast on the Western Balkan countries. According to the report, the political climate remained tense but improves slightly in the Western Balkan countries during the first half of 2007. In the former Yugoslav Republic, the largest ethnic Albanian party ended the boycott of the Parliament and new governments started their work in Bosnia and Herzegovina and Serbia as well. Furthermore, forthcoming election will influence the political development of Croatia. Besides, European integration progressed in candidate and potential candidate countries.

After a basically good year, economic growth accelerated further in most Western Balkan countries in this year. Real GDP growth reached 7% in Croatia, in the former Yugoslav Republic of Macedonia and in Serbia in the first quarter of 2007, while it was also significant in Montenegro (6.5%). The rapid economic growth was supported by high private consumption and investments, which reflects that domestic demand fuels most of these economies. On the other hand, net exports had a negative contribution to GDP growth except for the former Yugoslav Republic of Macedonia where trade balance improved significantly in the first few months of the year. However, export sectors' performance improved in these economies but the low level of exports compared to imports hindered its positive contribution to growth. For 2007 the Institute expects that these tendencies will continue and the regional average growth rate will exceed 5% in 2007 and 2008 as well.

Chart 1. GDP growth in Western Balkan countries, 2005-08 (%)



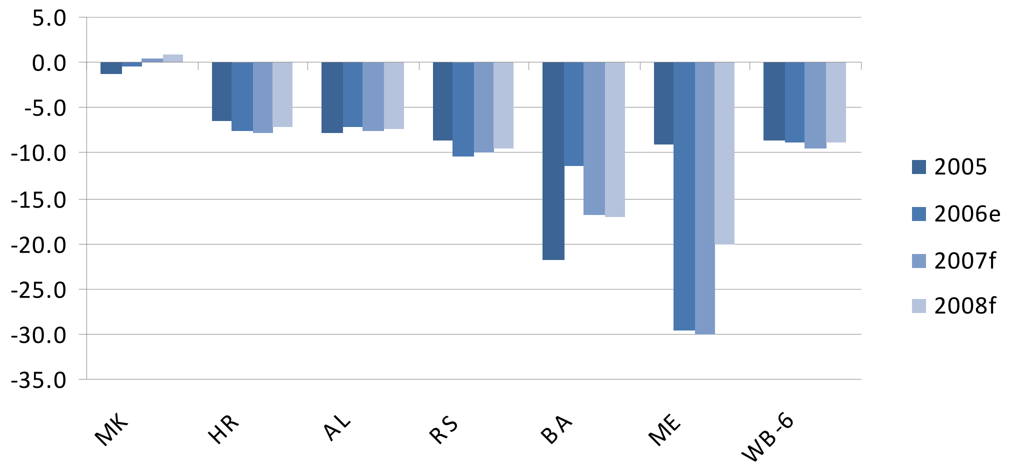
Source: ICEG EC

Regarding inflation, it will not cause problems in the region since inflation will be in the 1-3% range in five out of the six Western Balkan countries in 2007. Even the price increase of Serbia declined under 5% in that period. Inflation decreased in most countries in the region due mainly to the strong euro to which most currencies in the region are pegged, the favourable development of energy prices and due to base effects in some countries. It is also worth mentioning that credit expansion and significant wage increases characterised these economies which means that inflationary pressure may effect these economies later. In 2008 ICEG European Center expects that average inflation of the region will increase only slightly and will reach 4%.

Fiscal balances had a surplus at the end of the first half of 2007 in most countries. The improvement of the budget balance and accordingly the realisation of surplus was due on the one hand to the rapid economic growth and therefore the higher than expected tax revenues and on the other hand to the poor expenditure planning. The latter means that public spending was lower than budgeted during the first months of the year, however, budget expenditures are expected to rise in the second half and accordingly budget balances will be worsen at the end of the year compared to current situation. Besides, the fact that the applied exchange rate regime is currency board arrangement in many WB countries, it also determines a more restrictive fiscal policy for these economies. In 2007 the Institute expects that budget deficit will exceed 3% of GDP only Croatia and Albania, while regional average deficit will be 1.4%.

During the first months of 2007 current account balances continued to worsen in all WB countries except for the former Yugoslav Republic of Macedonia. In this country CA balance improved due to the significant development of export sector in the country. In all other WB countries CA balance deteriorated due to the widening trade deficits. Imports were boosted by massive domestic demand, namely private consumption and investments. Accordingly, we expect that regional average current account deficit will increase by 0.5 percentage point to 9.4% of GDP. The highest CA deficit is expected in Montenegro and Bosnia and Herzegovina. The CA balance has been deteriorated significantly in Montenegro since it was 'only' 9% of GDP in 2005. For 2008 the Institute's expectation is that that CA deficits will diminish again.

CHART 2. CURRENT ACCOUNT BALANCE IN WESTERN BALKAN COUNTRIES, 2005-08 (% OF GDP)



Source: ICEG EC

Regarding foreign direct investments, one can observe that FDI is mainly influenced by privatisation since the privatisation of a few large companies have a significant impact on the evolution of FDI in small countries such as most WB economies. In Serbia this year seems to be a peak year in that respect while 2006 was such a year in the former Yugoslav Republic of Macedonia.

Unemployment remained one of the most important macroeconomic challenges in the region. Average unemployment rate was close to 20% in 2006, and it 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.

Due to the rapid economic growth in these countries unemployment will decrease in course of 2007. Regional average unemployment is expected to decrease to under 19% this year and close to 18% in the next year.

EXPOSURE TO EXTERNAL SHOCKS OF THE WESTERN BALKAN COUNTRIES AND ITS LABOUR MARKET ASPECTS

The Western Balkan (WB) countries followed a different transition path in comparison with the Central and Eastern European (CEE) EU member states. While economic development was significantly based on dynamic growth of export sector in the CEE countries, the performance of this sector in the Western Balkan countries remained weak during the last one and a half decade. That is the reason why trade deficit reached or exceeded 20% of GDP in last year in these countries, namely in Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Serbia. These countries are relatively small economies with small domestic markets and significant trade and investment links with the EU. The most important trade partners are Austria, Germany and Italy in this region.

EXPOSURE

Regarding exchange rate regimes, fixed exchange rate arrangements were introduced in most WB countries. In Bosnia and Herzegovina currency board is established, Montenegro replaced its currency with the euro, Croatia and the former Yugoslav Republic of Macedonia applied a managed floating regime and kept a quite stable nominal exchange rate against the euro in last years. National banks in these two economies (especially in the fYR of Macedonia) prevented too excessive fluctuation of the exchange rate. Serbia has followed a managed floating regime as well, but it was much more 'flexible' and the national currency has been depreciating gradually during the last half decade. Albania introduced a free floating regime one and a half decade ago, though nominal exchange rate remained in a relatively narrow band against the euro in last years.

There are several reasons why the Western Balkan countries are heavily exposed to external shocks. First, they have high trade and current account deficits and their tradable sectors are relatively underdeveloped. Exports represent a lower share in GDP than in the EU8+2, the product composition of exports is biased towards segments facing more volatile demand conditions. Moreover, these countries face serious current account imbalances, the financing of which hinges on net capital inflows. Their net financial position depends on investors' sentiment, on the changes in global risk conditions and on factors affecting the risk position of emerging economies.

Based on these features, the Western Balkan economies are exposed to exogenous real and financial shocks. Real shocks may stem from the changes in the business cycle and associated decline in demand on their major export markets, changes in the relative competitiveness of these countries and other major competitors, adverse cross exchange rate movements. These countries are also heavily exposed to changes in terms of trade, evolution of energy prices and the related effects stemming from them. Finally, the financial shocks stem from their heavy exposure to external energy imports, to changes in the risk attitude of foreign investors, especially portfolio ones.

All these point to that, Western Balkan countries are highly exposed to external shocks and sufficient flexibility of goods and factor markets is necessary to prevent worsening of international competitiveness. Due to the fact that both attraction of (foreign) investment and increase of export sector's performance are elemental interests of these countries the deterioration of competitiveness affects negatively the evolution of the economy. Accordingly, rigidities in these markets lead to slower return to the new equilibrium.

Shocks

Regarding external shocks in the Western Balkan countries, changes in commodity prices, the evolution of global (or EU) output or even aid shocks may have the most significant (external shock) impact on these economies. During transition goods and factor markets improved significantly, financial markets progressed due to privatisation and settlements of foreign banks in these countries.

Several elements determine the adjustment capacity of a national economy towards exogenous shocks. One of them is the applied exchange rate regime, whether it can serve as a cushion against exogenous shocks or they are transmitted directly to domestic real and financial variables. The more flexibility the exchange rate regime has, the bigger is the adjustment capacity of the economy to exogenous shocks: in that respect the WB countries show different patterns.

Second, the adjustment capacity is also determined by the flexibility of the factor markets, which influence the level to which the adjustment in factor prices and quantities allows the reaction towards exogenous shocks. The flexibility depends on institutional (level of regulation, freedom of flows of factors of production), structural (relative share of various sectors in output and employment), policy (tax and income policies e.g.) factors.

Third, the adjustment capacity is also determined by the extent of the reaction of traditional macroeconomic policy instruments, especially the monetary and fiscal policies. The less are these policies bound in their reaction the broader is the capacity to adjust, which depends on the level of fiscal deficit and public debt, on the level of public sector redistribution or on the strength of the monetary policy transmission channels.

Labour market aspects

Labour markets have however remained one of the key (macroeconomic) weak points of the countries in this region (together with high external imbalances). The main labour market indicators show bad picture in general in comparison with CEE countries or EU-average. Activity rates and employment are much lower in these economies while unemployment reaches extreme high level in some countries. According to the official statistics, unemployment exceeded 40% in Bosnia and Herzegovina, 35% in the fYR of Macedonia, 20% in Serbia and it was more than 10% in the rest of the countries for several years. Youth unemployment rates – similarly to other economies – are even higher in these economies.

These figures reflect well the challenges these countries face and they also show that labour market flexibility would not be sufficient in case of external shocks. This is specifically the case in those Western Balkan countries where the aforementioned pegged exchange rate regimes were introduced.

Labour market developments were basically influenced by armed conflicts in the region during the 1990s that resulted in economic recession and high unemployment. Dynamic economic growth has followed the stabilisation of the region, liberalisation and privatisation processes have gained some momentum in last years, with some delay in comparison with CEE countries. Owing to the positive processes characterising the region in last years, economic growth reached high (5-6%) rates in several countries. Employment figures however have not improved or have worsened in most WB countries except for Croatia, and one could observe economic growth without job-creation.

In fact the same process was observable in case of the CEE countries as well. In line with the positive effects of high economic growth, privatisation, restructuring and downsizing of large enterprises had negative impact on employment. Massive job destruction started when transition period began due to the non-rational nature of the former regime.

Besides high unemployment emerged, the role of the informal sector has also grown. Certainly, there are no exact calculations on the size of the informal sector in these economies, but according to some estimation, the figures are at least about 10% in the more developed countries (Croatia) and it could reach 30-40% in some other countries. In fact, informal employment 'improves' the official employment figures and it provides more income to households, but workers in informal sector are exposed to significant labour-related risks without any protection and have no employment and income security. On the other hand, it is also worth mentioning that informal employment is completely flexible.

Regarding flexibility of the labour markets, one could observe that self-employment became popular after transition began but its role started to decrease as economic growth accelerated in the Western Balkan countries. In other words workers preferred dependent jobs against self-employment. It is also worth mentioning that the rate of fixed-term contracts increased mainly through new contracts; that reached the highest role in the former Yugoslav Republic of Macedonia (almost 20%), higher than EU-average. On the other hand, part-time jobs are preferred in the WB countries neither from the workers' side due to high living costs and expensive childcare facilities versus the availability of long maternity and parental benefits; nor from the employers' side owing to the fact that part-time jobs are not profitable.

Transition had a serious impact on the regulation of labour markets as well. New acts enabled enterprises to terminate employment for economic reasons and in return of that regulations ensured compensation and helped to find a new workplace in case of the termination of a job. Regarding labour market challenges mentioned above, over-restrictive employee protection can cause high unemployment and low participation rates in these economies as well.

Examining the World Bank's *Doing Business* indicators and primarily the 'Rigidity of Employment' Index in these countries one can see that the rigidity is higher than OECD average or than the index of most CEE countries which underpins the former statement. Regarding indicators in *OECD Employment Outlook*, the same observation can be done, namely labour market regulation is more rigid on average in the WB countries than in EU-15 or NMS-8, however the differences are small. The difference is mainly due to the more rigid legislation of temporary contracts basically in comparison with the NMS-8 countries. This could lead us to the conclusion that there is a trade-off between 'liberal' legislation with higher employment and more restrictive regulation with massive evasion from formal labour market. However, this view is only one possible explanation of high unemployment in the region. Besides that, EU integration process will enforce the harmonisation of legislations to *acquis communautaire.*

Due too high unemployment in the region, the role of active labour market policies is quite low in these countries and accordingly unemployment benefits are important instruments in labour policy. On the other hand, tax burden on labour is generally lower than in CEE countries but higher than the average of OECD low income countries. The problem is that high tax burden can result in depressed labour demand and lower new-job creation, and consequently it means that the level and duration of unemployment will increase.

It is also worth mentioning that the mechanism of changing strictness of legislation could result in different outcomes. In case of OECD countries, stricter legislation could cause higher unemployment, while in case of WB countries, the same shift could decrease unemployment. This difference is mainly due to the size of informal sector; stricter legislation could enforce the decrease of informal employment.

Returning to adjustment capacity to shocks with the focus on labour market, adjustment mechanism could basically progress through three ways according to the literature: labour mobility, flexibility of wages and prices, budgetary transfers. It must be mentioned that adjustment to external shocks is easier through the exchange rate than via wages and prices. This is mainly due to the stickiness of nominal wages (and prices) in the short-term.

Regarding the two well-known examples of the US and the EU, in the US labour mobility is the adjustment channel in case of labour market shocks, which means empirical evidences underpin the theory in case of the US. On the other hand, labour force participation plays a much higher role in adjustment in case of the European Union, which means workers rather leave labour market than migrate to another region/country. Certainly, the EU case is basically different. On the one hand, regulation does not allow completely free migration of labour, it is only allowed with limitations in some cases (such as temporary limitation in case of workers from the NMS). On the other hand, cultural, language and other differences also contribute to low mobility of European workers.

Since the Western Balkan countries introduced mostly pegged exchange rate regimes, adjustment capacity of labour market has a particular role in case of external shocks. Flexible exchange rate regimes seem better to offset external shocks according to empirical results. However, the link between external shocks and unemployment is uncertain.

Labour markets of the Western Balkan countries can accommodate shocks via two main channels (as it is true in case of all countries). These are either quantities or prices or the combination of these two channels. The first one results in less worker (or working time) while the second means lower wages in case of a negative shock. In the latter case not nominal but real wage flexibility that matters in adjustment to shocks. Due to the fact that inflation is low in most WB countries (owing to fixed exchange rate regimes) real wage flexibility is close to nominal wage flexibility which is disadvantageous in adjustments (stickiness of prices). It means adjustment to external shocks is expected to be slow and costly in these countries. On the other hand, employment and unemployment rates were affected significantly in case of external shocks instead of wages. However, the exact impact of shocks on labour market is not exactly known in the Western Balkan countries.

HUNGARIAN CAPITAL EXPORT TO THE SEE COUNTRIES

Since the second half of the 1990s the Hungarian companies have appeared as capital exporters in the surrounding countries, which is mainly the result of the strengthening of the privately owned enterprises and it is also a consequence of the saturation of the domestic market. Both the volume of the total capital export and the share of the SEE countries within the total amount have been dynamically grown in the past years.

The volume of the total capital export increased at a great pace especially after 2002: within three years it had reached a more than threefold level as it had grown from EUR 1908.1 million to EUR 6589.2 million in 2005. There was an even more sudden bound in the share of the SEE countries as it increased from 6.6% in 2000 to 26.3% in 2001 and this development proved to be lasting as this proportion has been still above 25% in the past few years. Considering the volume of capital export to the different countries of the SEE region, it can be observed that Croatia received the highest amount (EUR 22.4 million in 2005) and it was followed by Macedonia, Romania and Bulgaria. In Serbia and Montenegro the presence of the Hungarian investors significantly strengthened in 2005, which was mainly due to the large scale investments of OTP Bank and MOL (Hungarian Oil and Gas Company) in the country.

TABLE 1. DISTRIBUTION OF CAPITAL EXPORT AMONG SEE COUNTRIES, 1998-2005 (MILL EUR)

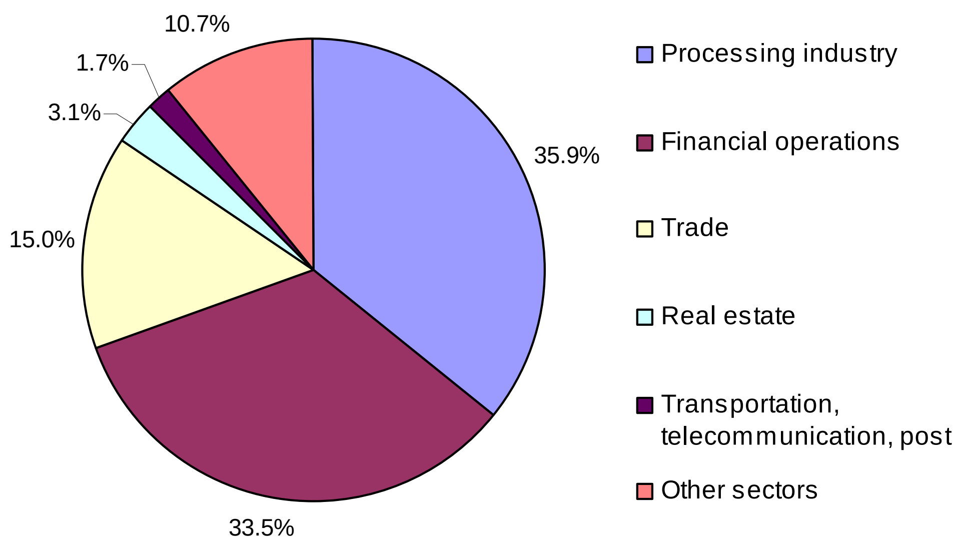
Recipient country	1998	1999	2000	2001	2002	2003	2004	2005
Albania	-	-	0.1	0.1	-	0.1	-	-
Bulgaria	-	1.5	4.1	0.8	11.4	136.4	218.2	306.6
Croatia	7.7	12.2	17.6	23.5	51.7	323.4	359.9	522.4
Macedonia	-	-	-	319.9	281.2	255.6	355.4	397.5
Romania	61.2	64.6	65.7	95.4	151.6	165.9	202.5	313.4
Serbia and Montenegro*	-	-	-	0.4	0.3	5.0	14.9	146.6
SEE-6	68.9	78.3	87.5	440.1	496.2	886.3	1150.9	1686.5
Total	582.4	810.1	1326.4	1675.4	1908.1	2541.0	4107.8	6589.2
Proportion of SEE-6 within total amount of outward FDI (%)	11.8	9.7	6.6	26.3	26.0	34.9	28.0	25.6

*Source: Hungarian National Bank (MNB), own calculations; *The state union disintegrated in 2006.*

Beside their strengthening and the saturation of the domestic market, the Hungarian enterprises have several additional reasons for investing in the Southeast European countries. Firstly, the SEE region has become more stable economically and politically since 2000. Secondly, these countries are still in the state of transition, which involves that the privatisation is still in progress and numerous attractive state-owned companies have been sold while in the case of several others this process is expected in the immediate future. The privatisation is an efficient measure of the stimulation of foreign investment in these countries. Thirdly, the GDP growth rates are high in the region – especially in relation with the Western European growth rates – which among others results in a dynamic expansion of the market. Due to this tendency the rate of return is higher, which creates the opportunity for the foreign investors to gain higher profits. As the cost of labour is lower than the Hungarian level and the taxes are favourable for the foreign investors, these conditions make the region to be an attractive target of investment for the Hungarian enterprises. The geographical proximity enhances this attractiveness as well as the EU’s increasing presence in the region.

Similarly to other transition countries capital export started up in the second half of the 1990s in Hungary according to the tendency that above a given level of development the unilateral capital importer position automatically alters. However, the volume of capital import still exceeds with order of magnitude the volume of capital export: in 2005 the former was EUR 46.7 billion while the latter amounted to only EUR 6559.2 million EUR. The capital export has several peculiarities. Firstly, it has a dual structure: it is determined by a few large companies, while the SMEs are represented in large number but their invested capital is not significant. Secondly, the sectoral and geographical orientation is determined by the large companies. Thirdly, the companies integrated to the world economy lately; accordingly, they are not classical multinational companies which can lead to anomalies. These characteristics can be observed also in the case of the capital export which tends toward the SEE region. It is worth examining the distribution of the total capital export among sectors in order to see that the investments of the individual companies in the SEE region have a great influence on the allocation of the total capital export.

CHART 3. DISTRIBUTION OF CAPITAL EXPORT AMONG SECTORS IN 2005 (%)



Source: Hungarian National Bank (MNB)

In 2005 the processing industry had the largest share with 35.9%, which was mainly due to the large amount of investments in the oil refining industry (the amount of capital export in the oil refining industry was EUR 1924.6 million while the total was EUR 2357.5 million). MOL (the Hungarian Oil and Gas company) is the most important actor in this sector and it has implemented large investment projects in the SEE region in the recent years. It has subsidiaries in Romania and Serbia and it also has a strategic partnership with INA in Croatia, although according to analysts the company may sell its 25% share in the INA if it can not reach a breakthrough on the market, but the transaction may be realised only after the elections.

The financial operations had the second largest share in the total volume of capital export. In this sector OTP Bank (National Savings and Commercial Bank) is the most significant actor, it has completed several successful acquisitions in the past few years also in the SEE region: it acquired DSK Bank and its subsidiaries in a privatization process in Bulgaria in 2003, then it purchased the Romanian RoBank in 2004, the Croatian Nova Banka in 2005 and recently it turned towards Serbia. OTP acquired the Serbian Niska Banka in 2005, then it purchased the Zepter Banka and the Kulska Banka in 2006 and the latest development was the merger of these three banks in May 2007.

Trade sector had the third largest share (15%) in the total capital export, while the residents' real estate purchase and the households' foreign capital investment had the fourth place in 2005 with a share of 3,1%. The latter has a much lower share in the total volume of capital export, nevertheless in the recent years a dynamic increase could be observed, its volume increased from 16,8 million EUR in 1998 to 202,8 million EUR in 2005. TriGránit Development Corporation had an important role in this increase as it has implemented several investment projects in the surrounding countries in the recent years. In the SEE region it has stake in real estates in Romania (shopping malls in Cluj Napoca, Bucharest and Constanta) and Croatia (holiday resort in Ciovo, shopping mall and a sports stadium in Zagreb).

The sector of transportation, telecommunication and post had a share of 1,7% in the total amount of capital export in 2005. In this sector Magyar Telekom (Hungarian Telecommunication Company) is the main actor and it has obtained a stake in several companies also in the SEE region recently. First it became a dominant owner of Makedonski Telekommunikacii in 2000, then in 2005 it purchased the 76,54% of Crnogorski Telekom Group's shares, which is a telecommunication company in Montenegro, thus Magyar Telekom currently it's majority owner. The company has also a stake in the Bulgarian Orbitel and the Romanian Combridge, the latter was established in 2002.

Beside the above mentioned companies a few others also play a prominent role in the investments in the SEE region and in the capital export as a whole, as 80% of the total capital export is realised by 10-15 large companies. Some of those which have stake in companies in the SEE region are Danubius Hotels (Romania), Richter Gedeon (Romania), DunaPack (Romania). There are a couple of other companies which intend to invest in the SEE region, such as Graphisoft, which has gradually closed its subsidiaries in the developed countries and now it turns to the East. In the frame of this strategy the IT company plans to acquire enterprises in Romania.

On the whole the capital export to the SEE region has dynamically increased in recent years, its share within the total value increased from 11.8% in 1998 to 25.6% in 2005. This proportion is expected to be stable also in the future, but beside the investments in the region (SEE and CEE countries) in the medium term an entrance to the markets of the developed countries is also probable. Regarding the sectoral structure of the capital export, it is expected that the importance of the services will grow. The dual structure of the capital export, namely the dominance of large companies vis-à-vis the SMEs should be moderated, however the increase of the significance of SMEs within the total amount of capital export depends on the incentive policies. In the coming years the Hungarian enterprises may also take advantage of participating in such EU development projects as the IPA in order to intensify their presence in the Western Balkans, but it also depends on the incentive policy.

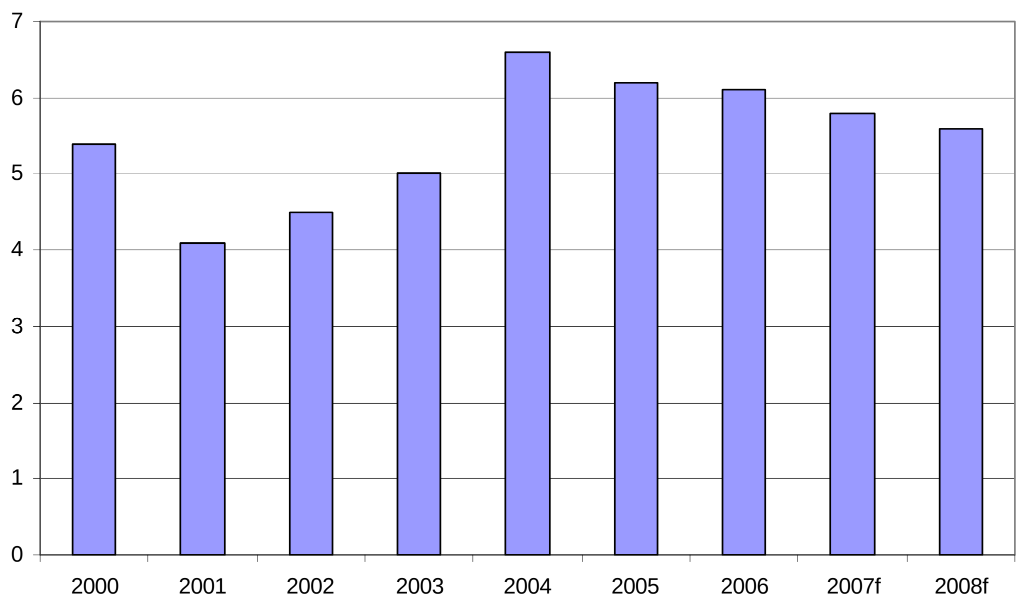
HIGH GROWTH RATE REMAINED IN BULGARIA AND ROMANIA

In 2006 both Bulgaria and Romania reached an outstanding growth rate, 6.1% and 7.7% respectively. Accordingly, the two newly acceded countries joined the EU with a rapidly growing economy. The economic growth was based on domestic demand, mainly private consumption and investments in recent years in these countries. Now it seems the good growth rate remained after the EU accession according to the first quarter GDP growth figures which were published by national statistics offices.

BULGARIA

In the first quarter of 2007 gross domestic product increased by 6.2% in Bulgaria. Accordingly, GDP growth was higher than the growth in the fourth quarter of 2006. This growth rate was higher then most analysts expected. On the demand side, private consumption and investments remained the main engines of the economy. Private consumption growth accelerated to 8.1% due to increasing loans to households and wage increases. Gross fixed capital formation grew by an enormous 35.9% in comparison with the corresponding period of the previous year, therefore investments reached 36.5% of GDP in the first quarter. On the other hand, net exports had a negative contribution to GDP growth since imports of goods and services increased by 13.2%, while exports grew by only 2.2%.

CHART 4. ECONOMIC GROWTH IN BULGARIA, 2000-2008 (%)



Source: Eurostat, ICEG EC; f - forecast

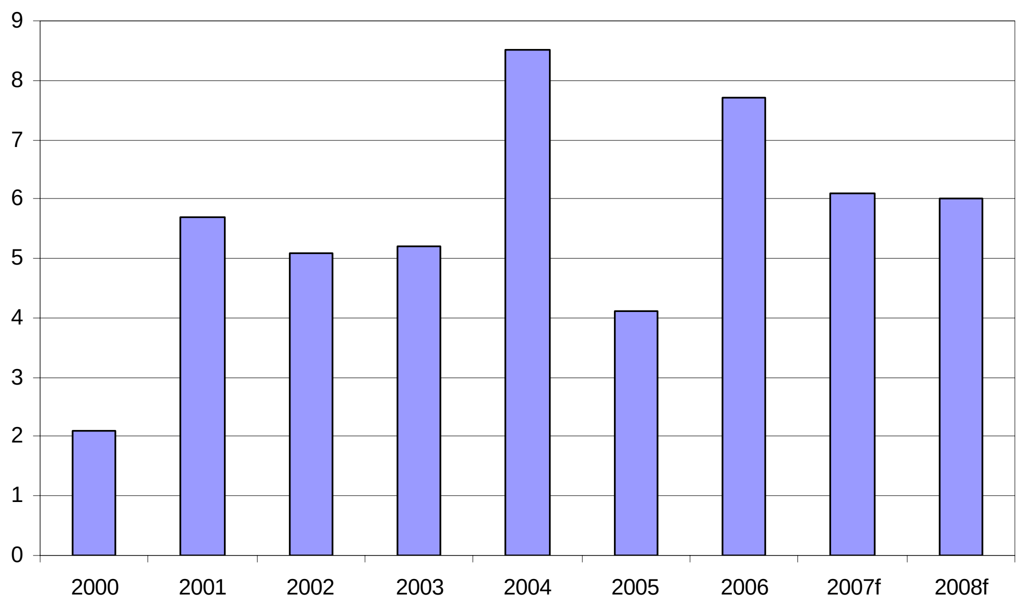
On the production side, industry and services sector performed well in the first quarter. Gross value added in industry increased by 7.6%, while that in services sector grew by 8.1%. Only GVA in agriculture was moderately lower than the average, it reached a 2.5% growth during the first three months of the year.

In 2007 GDP is expected to remain on the current level and can reach 5.8% fuelled by domestic demand, namely private consumption and investments. EU accession has given an impetus to both consumption (imports) and investments (business climate) accordingly current tendencies are expected to continue in the rest of the year. For 2008 these tendencies will continue and domestic demand remains the main engine of growth, however GDP growth will decelerate slightly.

Romania

In the first quarter of 2007 economic growth remained high but decelerated to 6.0%. That growth rate was the slowest out of the last five quarters. It means that the economy has been approaching to its long-term potential economic growth. On the demand side, private consumption and investments were the main engines of the economy. The growth of private consumption remained above 10% (12.1%), while gross fixed capital formation also increased by an enormous 17.2% in the first quarter in comparison with the corresponding period of last year. The growth of gross fixed capital formation was mainly boosted by construction investments. On the other hand, net exports continued to have a negative contribution to GDP growth due to the significant increase of the trade deficit in Romania.

Chart 5. Economic growth in Romania, 2000-2008 (%)



Source: Eurostat, ICEG EC; f - forecast

On the production side, the value added of construction reached an outstanding growth (30.7%) during the first quarter of the year, which reflects the significant role of the construction sector in the dynamic growth of the country. Besides construction, gross value added of agriculture, industry and services also reached high growth, 9.2%, 7.8% and 6.4% respectively.

In 2007 GDP growth is expected to be close to 6% which will be slightly lower than that in 2006. The slower – but still high – economic growth will be the result of the lower growth of private consumption and the dynamically growing imports that will have some negative impact on GDP growth. Economic growth will be fuelled by mainly consumption and investments, accordingly domestic demand remains the main engine of growth. For 2008 economic growth is expected to remain at the 6% level, however some shifts are expected. In 2008 legislative elections will be held in Romania, thus we expect that public spending will increase and its contribution to growth will increase as well. Besides that, it is also expected that the utilisation of EU funds will grow, thus, the positive impact of EU accession on growth will increase somewhat.

CONCLUSION

Regarding economic growth, the first year as an EU member started well in both Bulgaria and Romania. Economic growth remained close to 6% which can be considered as high, especially in comparison with the EU 27 average. Since GDP level of these two economies are the lowest in the EU catching up can be realised only if economic growth remains constantly higher than that of the EU average. GDP per capita on purchasing power parity was less than 40% of the EU average in 2006 in both countries.

The only question is whether this growth path based on domestic demand can be sustainable in the future. In both countries foreign trade and current account balances hit record high level deficit due to the import boosting impact of strong private consumption and investments. Certainly, some shifts to an economic growth based more on foreign demand would be a positive process, which could be realised when the great amount of investments will start boosting the export of goods of these countries as well.

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