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BULGARIA: INFLATION RATE IS THE CRITICAL ISSUE WITH REGARD TO JOINING EMU AFTER EU ACCESSION

Bulgaria is to become member of the EU in January 2007 if the full implementation of the EU *acquis communautaire* is successfully carried out. Then, Bulgaria has also to comply with the macroeconomic requirements of the Treaty of the EU. Moreover, in the case of the fulfilment of the so called Maastricht criteria will allow and oblige Bulgaria to join the EMU. The currency board system provides that Bulgaria is already a quasi participant of the EMU. Its monetary policy is basically determined by the ECB. The budget and the debt of the Bulgarian government comply with the requirements. The inflation rate seems to be the only macroeconomic element which needs substantial economic policy attention and correction measures. The implementation of these measures is important because the political aim with regard to EMU of Bulgaria is to join it as soon as possible after the EU accession. It means that 2009 might be a target date for introducing the Euro in Bulgaria.

On 25 November 2004, the Bulgarian Finance Minister and the governor of Bulgarian National Bank (BNB) signed an agreement on joint action to step up Bulgaria's accession to the EMU and to lay the way for successful introduction of the euro in 2009-2010. The agreement was also approved by the government. This agreement was the starting point on the path leading to the adoption of the euro and Bulgaria's entry into the eurozone. The agreement was a necessary step towards a higher level of political predictability that will help to attract more foreign capital and to give the international community another reason to take Bulgaria more seriously.

Economic data show that Bulgaria already complied with almost all economic criteria of joining the EMU: the requirement for a balanced national budget has been met, the gross government debt to GDP ratio has been for years below the 60% threshold. The lev-euro exchange rate had been fixed under the terms of the currency board arrangement. BNB is required to help maintain the effective currency board arrangement until the country accedes to the EU and during the period of participation in ERM2. The inflation rate of Bulgaria is the only critical issue because it is still too high compared to the reference average value calculated from the three lowest inflation rates among the EU member states.

The current situation is that the inflation rate is likely to remain above 4% in 2005 which is lower than the 5.6% in 2003. Inflation forecast is set to average 4.4 - 4.5% in 2005 and 4.5-5.0% in 2006. In a worse case the inflation rate may increase even up to 5.5% in 2006 (e.g. UniCredit's forecast). These rates are too high concerning the aim of an early joining the EMU. From this perspective in 2007, the year of Bulgaria's EU accession, the inflation in the country should not be much higher than 2%.

The 2% target is determined by the fact that some EU countries can be expected to have inflation rate close to zero in an optimistic scenario, at the time of Bulgaria's accession. According to the Maastricht criteria, an EMU candidate country should have inflation no higher than 1.5 percentage-point above the average of the three countries with the lowest inflation rates. This is why Bulgaria's inflation rates should drop to such low levels.

Bearing in mind the target date and the necessary reduction of inflation rate, the government's idea of introducing changes in the levels of some indirect taxes earlier than planned, could be of use. This plan concerns mainly excise rates that the Ministry of Finance is planning to introduce in 2006, along with the expected 2007 raise in order to reach European levels. It is

also possible that some indirect taxes should be cut when inflation rates are measured, like it was done in Greece.

Even the EU counts on the possibility that Bulgaria will find it difficult to meet its 2006 inflation target due to higher taxes. Thus, the EU also urged Bulgarian government to work harder to cut the budget deficit when it joins in 2007. The projected inflation rate of below 4% might be difficult to achieve especially in 2006 due to changes in administered prices and increases in excise tax rates.

An inflation rate of 5.0%, an economic growth of 5.5%, a tax-free minimum of 180 Leva and a three-step scale for the taxation of physical persons' incomes – these are some of the parameters of the budget for 2006 the Finance Ministry is currently considering. In 2006 there will not be a substantial surplus in the budget because the incomes from insurances and taxes will be reduced. According to previous evaluations, the lowest wage will increase to 160 Leva, retirement pension will be indexed by 6.0% as of January. A priority is the increase of maternity remunerations. Budget-subsidized salaries will have to increase twice – in April by 5.0% and up to 20.0% by next October provided there are sufficient incomes to the budget.

The concern over the budget and inflation rate was repeated in the statement released after the EU finance ministers' meeting on 12 July 2005. The EU warned the country against planning a wider budget deficit and higher government spending in 2007. The government is targeting a deficit of 1.3% of GDP and expenditure of 41.3 % of GDP for 2007, saying that defence, education and healthcare are its spending priorities for 2005-2007. Higher excise duties are estimated to contribute 1.1%.points to annual inflation in 2006 and 0.24%-point in 2007, according the government's EU entry program. The program forecasts consumer price inflation at 3.9% in 2006 and 4.0% in 2007.

Bulgaria is counting on EU entry in 2007 to boost living standards and attract more foreign investment. Progress toward EU entry last year brought in a record investment inflow of EUR 2.5 billion. Bulgaria has been raising excise taxes on alcoholic beverages, tobacco, fuel and gasoline toward EU levels since 2003 in a series of steps to cushion the possible shock of a one-off increase.

TABLE 1.: EVOLUTION OF GENERAL GOVERNMENT DEFICIT, DEBT AND INFLATON

	2002	2003	2004	June 2005	July 2005	2005	2006	2007
General government deficit								
(in million BGN)	-209.5	0.9	659.2	1 127.3	1 133.3	-	-	-
(as % of GDP)	-0.6%	0.0%	1.7%	6.1%		1.0%	0.0%	-1.3%
General government debt								
internal (mn BGN)	2 111.7	2 241.2	2 679.5	2 772.2	2 847.1	-	-	-
external (mn BGN)	15 947.3	14 268.6	12 876.6	11 919.0	10 908.1	-	-	-
(as % of GDP)	55.8%	47.8%	40.9%	39.9%	-	41.0%	42.0%	43.0%
Inflation (%)	3.8%	5.6%	4.0%	5.1%	3.9%	4.5%	5.0%	3.0-5.0 %

Source: National Statistical Institute of Bulgaria; Bulgarian National Bank, own calculations

Regarding the main macroeconomic fundamentals and their tendencies the inflation rate seems to be the only critical element. It cannot be brought down easily below the level which is determined by the Maastricht criteria. A relatively high inflation rate may be expected to prevail for several years because the currency board system lacks the effective monetary policy instrument which can bring down high inflation rate. A protracting relative high inflation rate may bring about substantial inflation differential in regard with the eurozone countries.

This situation may cause an increasing real appreciation of the Bulgarian Lev. As the aim of the agreement of the National Bank and the government is to maintain the present currency board system and conversion rate until joining EMU it might happen that the Lev becomes substantially overvalued which may hinder the competitiveness of the Bulgarian economy. Productivity growth can play an important role to mitigate this adverse effect.

STRONG SECTOR WITH STRONG PERFORMANCE: TOURISM IN CROATIA

IMPORTANCE

The tourism sector bears crucial role in Croatian economy. Not only because of the sector's contribution to value added, but also because of its share in employment and spill over effects on other branches of economy like on the construction.¹ Last but not least, the tourism sector contributes considerably to development of current account, capital account and movements in exchange rates through foreign exchange inflows.

Through investigation of growth indices of value added performed by hotels and restaurants can be stated, that the dynamic of this sector slowed down in the year of 2004. Last year, the contribution of hotels and restaurants to total value added formation was 0.1 percentage points that is the smallest contribution since 2001. The main reason behind is the weak overall economic performance. However, the receipts on tourism in 2004 exceeded by 7% the receipts of the previous year and reached the amount of 7 billion EUR. The services account of the balance of payments is considerably influenced by the net income caused by the tourism sector that covered almost 3/4 of the deficit observable in the trade balance in 2003 and 2004. The hotel, motel and restaurants sector that is tightly attached to tourism attracted 5% of total FDI flowing into Croatia.

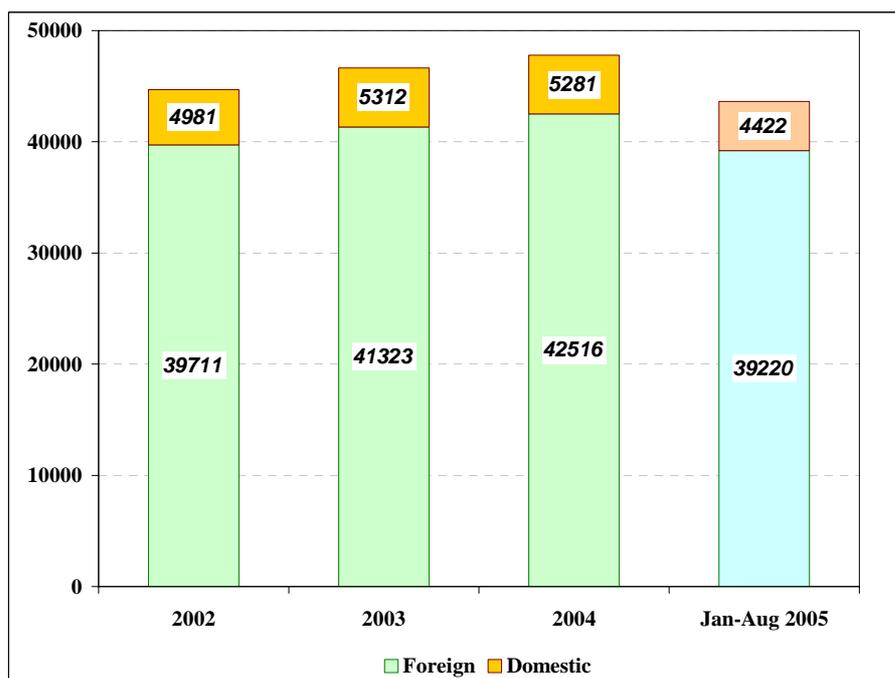
PERFORMANCE

As regarding to the quantitative performance of the tourism sector (see chart), an unbroken improvement can be observed in the development of tourist nights spent in Croatia in the period of 2002-2004. In 2004 people from abroad and inside the country spent in Croatia 47 797 nights (9 412 thousand arrivals), that is more by 3105 nights than in 2002. During two years it increased by almost 7%.

Nevertheless, the contribution and the growth trends of domestic and foreign citizens are different. Croatian people spent by 6.6% more nights inside their country in 2003 than in the previous year, but after this extremely high rate, in 2004 it decreased by almost 1%. It is even more interesting, if we are looking on the data of arrivals: the number of persons increased to 1.5 million in 2004 or by 31 000. It means that the average number of nights per arrival of domestic people went down, but this decreasing trend is true in total as well. From the other side, the foreign visitors are responsible for the overall growth of spent nights.

The volume indices did show improvement in annual growth of tourism, while the financial numbers are reflecting slight decrease in growth performance. The reasons behind this issue are in connection with structural changes related to chosen type of accommodation by tourists and to number of spent nights by different countries.

¹ Croatia improved remarkably the infrastructure mainly because of the tourism sector.

CHART 1.: THE NUMBER OF SPENT TOURIST NIGHTS, 2001 – 2005 (THOUSAND NIGHTS)

Source: Republic of Croatia, Central Bureau of Statistics

The table below shows data on the volume changes by type of accommodation horizontally in 2003-2004. As it can be seen in the table, the importance of paid accommodations diminished, especially in the group of tourist and apartment resorts mainly because of lower attractiveness or smaller average spent night index. Nevertheless, the nights spent in camping sites grew considerably because of the structural composition change in the age and purchasing power of visitors. The most remarkable development can be observed in the number of spent nights in nautical ports that shows 13% increase during one year.

TABLE 2.: THE NUMBER OF SPENT TOURIST NIGHTS BY TYPE OF ACCOMODATION AND BY ORIGIN IN 2003 AND 2004

	Total		Domestic		Foreign	
	2003	2004	2003	2004	2003	2004
Hotels and all-suite hotels	13 275	13 745	2 003	2 014	11 272	11 731
Tourist and apartment resorts	4 835	4 687	485	557	4 350	4 130
Camping sites	12 675	13 288	435	402	12 240	12 886
Households	11 188	11 579	1 037	1 026	10 151	10 553
Nautical ports	1 000	1 129	36	49	964	1 080
Other	3 662	3 369	1 316	1 233	2 346	2 136
TOTAL	46 635	47 797	5 312	5 281	41 323	42 516

Source: Republic of Croatia, Central Bureau of Statistics

Concerning the distribution of foreign tourists by country of origin, the most important sender states are: Germany (25.6%), Italy (12.5%), Slovenia (11.8%), Czech Republic (9.8%), Austria (8.6%) and Hungary (4,9%). This six country, mainly from the neighbourhood, give 70% of all visitors and a bit more than 97% of all tourists originated from European country. There are remarkable reserves of potential tourists outside Europe.

PROSPECTS

Through having a look on the already existing data on first eight month of 2005, the sector already performed 91% of the previous year measured in spent nights, despite of weak domestic and foreign demand and unfavourable weather conditions in the beginning of the year. In August 2005 the number of domestic tourist nights remained on the same level, and the number of foreign tourist nights increased by 7% as compared to August 2004.

In August 2005 the number of tourist arrivals in the Republic of Croatia increased by 2% and the number of tourist nights by 7% comparing to August 2004. Tourists realized 17.1 million tourist nights: 7.9% by domestic tourists and 92.1% by foreign tourists. In August 2005 the number of domestic tourist nights remained on the same level, and the number of foreign tourist nights increased by 7% in comparison with August 2004.

Concerning the distribution of foreign tourists by country of origin the following countries were the most important: Germany (23.6%), Italy (21.1%), Slovenia (10.9%), the Czech Republic (7.8%), Austria (6.4%), Hungary (5.7%), Netherlands (4.3%) and France (3.5%).

It predicts a successful year in tourism for Croatia, as the earlier efforts on improvement of infrastructure (investments in roads, highways, in accommodation capacities) and additional services seem to succeed. A further important factor of the strong performance is the strategic targeting on the sector backed by legislation and government. The Croatian Bank for Reconstruction and Development (CBRD) created a credit facility on favourable interest rates (2-4%) for entrepreneurs favouring foreign guests and having dominantly domestic shareholders, owners.

Interesting additional information is that the Croatian National Bank used to appreciate the Kuna before the start of the tourist season increasing this way the foreign exchange receipts. The other practical solution is the usage of seasonal fees on motorways. These two measures also increase the indirect incomes of the country on tourism.

INFLATION IN SERBIA AND MONTENEGRO IN 2005-2006

Inflation in Serbia and Montenegro in recent years was mainly due to price rises in the former republic. As the table shows, average CPI in Serbia and Montenegro was 9.8% in 2004, and it is expected to reach 15.5% in 2005. This is mainly due to price rises in Serbia, with expected CPI being significantly higher this year than in the previous year (11.4% in 2004, and 15% expected in 2005). As for Montenegro, retail prices grew by 3.3% in 2004, and the price rise is expected to be lower in 2005, reaching 3%.

TABLE 3.: EVOLUTION OF PRICES IN SERBIA AND MONTENEGRO

	2004	2005*	2006*
Consumer price index (average, %)	9.8	15.5	10.0
Retail prices (% p.a.) Montenegro	3.3	3.0	3.0
Consumer prices (% p.a.) Serbia	11.4	15.0	10.0

*Source: Bank Austria Creditanstalt, WiiW; * Forecasts*

SERBIA

In the first quarter of 2005, year on year CPI has doubled compared to the first quarter of the previous year in Serbia. In March year on year CPI reached 17.4%, while in the same month in the previous year it was only 7.9%. Even within the quarter a slight increase in the CPI was observable (with a January CPI level of 14.4%). This was mainly due to the introduction of an 18% rate VAT in January. The effects of this change will likely settle towards the end of the year. The expected reduction of the budget deficit will also have a positive impact on inflation. However the single digit inflation rate hoped by the government will not be achievable in 2005.

During the months of the second quarter of 2005 year on year inflation remained at about the same level as experienced in the first months of the year. A slight reduction was experienced in June, when consumer prices rose by 16.8% compared to the same period in the previous year. In May the year on year price rise was higher, reaching 17.5%. The month on month price rise also decreased between May and June from 1.1 to 0.8%. The earlier projected 13% year on year CPI will be overrun by the end of the year in Serbia, as a result of the increase of world oil prices, and the leap in the prices of utilities and public services. As mentioned earlier, CPI is expected to reach 15% by the end of the year.

Numerous steps should be taken to help halt inflation in Serbia, such as the reduction of public spending and imports, and stepping on the road of structural reform. Some improvements already started in the first quarter, as there was a reduction in the value of imports. The financially unsustainable pension system, in which the evasion from contributions is widespread, should be reformed. The status of the state and socially owned enterprises, which play an important role in the Serbian economy, needs to be solved as well, as their deficits have likely contributed to the macroeconomic imbalances of the country.

The discount rate of the National Bank of Serbia remained unchanged so far in 2005, at 8.5%, the same level where it stood during 2004.

MONTENEGRO

In Montenegro the official means of payment is the euro. Inflation has been on a downward trend for three years in the republic. In 2004 the retail price index amounted to 4.3% (which was lower than the projected 4.5%), while the cost of living index reached only 1.5%. The long-term goal of the Central Bank of Montenegro is to reach the EMU inflation rate. The main driving force behind the rise of consumer prices in 2004 was the price rise of services (explaining 80% of the price rise). The month on month rise in CPI was 0.1-0.2% in each month of the first quarter of 2005, just like in the first quarter of the previous year.

The growth of prices was stable in the first quarter, but starting in March a comparably sharper increase has been experienced. In April the increase reached 0.4%, compared to 0.1% in the first months of the year. After the peak in April, the growth rate of prices stabilised at 0.2% (until June).

In the first half year the prices of goods grew at a higher rate than the prices of services, compared to the previous year. Prices of goods contributed to total inflation by 83.76%, while the contribution of services was 16.57%. The prices of beverages (6.4% price rise) had an unusually large contribution to inflation, reaching almost 28%. The prices of liquid fuels reached 10.3%, meaning a 12% contribution to inflation. Due to bad weather conditions in the first quarter, the prices of agricultural products were 7.5% higher, contributing by almost 32% to total inflation. Although the prices of industrial products grew by only 0.8%, due to being a high weighting factor their contribution to total inflation reached 52%.

As the Electrical Power Industry of Montenegro (EPCG) announced that it will leave electricity prices unchanged until the end of the year, it can be assumed that the planned year end inflation (3%) will materialize.

TABLE 4.: WEIGHT AND CONTRIBUTION OF THE COMPONENTS

	Weight	Contribution
	(10 000)	(100%)
GOODS	8 108	83.76%
Agricultural products	514	31.73%
Industrial products	7 594	52.09%
Industrial food products	3 246	8.85%
Beverages	526	27.78%
Tobacco	514	0%
Industrial non-food products	3 308	15.04%
Liquid fuel and lubricants	141	12.03%
SERVICES	1 892	16.57%
Professional	131	7.55%
Public utility	248	0.06%
Financial and other services	316	9.61%
Educational	114	0.73%
Public protection services	65	0%
Transportation and PTT services	1 018	-0.08%

Source: Central Bank of Montenegro

FORECASTS

Yearly average CPI is expected to reach 15.5% in 2005, and decrease to 10% by 2006 in Serbia and Montenegro. Yearly inflation rate is expected to lower to 10% in Serbia, and remain 3% in Montenegro in 2006

THE EU-ALBANIA RELATIONS – THE PRESENT ENGAGEMENT OF THE SAA

The tenth round of Stabilisation and Association Agreement (SAA) negotiations between Albania and the European Union was completed in Tirana in 30 September 2005. EC Director for Western Balkans, Reinhard Priebe announced after the two-day talks that a decision on sealing the SAA could come after 9 November when the EC's next progress report on Albania is due to be released.

The EU outlined it was confident of signing an accord soon on closer ties with Albania after the newly installed Democratic Party government repeated its resolution to step up reforms. "The new government has clearly said that signing the Stabilisation and Association Agreement is its main priority", European Integration Minister, Arenca Trashani said. The key of their talks concentrated on what concrete steps the Albanian Prime Minister's government plans to take about fighting organized crime and corruption as well as solving property issues and improving the work of the customs administration.

EU-ALBANIA RELATIONS: THE MAIN STEPS TOWARDS THE EU

Albania's diplomatic relations with the European Union has been established in 1991. The most important event in this relation was the signing of the Trade and Cooperation Agreement, including the joint declaration on Political Dialogue, which entered into force in December 1992. This agreement was the first one, which linked Albania finally to the EU. The next essential step was the Trade and Cooperation Agreement of May 11, 1992, allowed Albania to benefit from PHARE program funds, which constitutes an important step towards restructuring EU assistance to Albania in a number of areas that corresponded to the reforms in which the country was involved.

From the beginning of the official relationship between Albania and the European Union (1992) to 2004 the following key events should be mentioned:

1992: Trade and Co-operation Agreement between the EU and Albania. Albania becomes eligible for funding under the EU Phare programme.

1997: Regional Approach. The EU Council of Ministers establishes political and economic conditionality for the development of bilateral relations.

1999: The EU proposes the new Stabilisation and Association process (Sap) for five countries of South-Eastern Europe, including Albania.

1999: Albania benefits from Autonomous Trade Preferences with the EU.

2000: Extension of duty-free access to EU market for products from Albania.

2000: Feira European Council (June 2000) states that all the SAp countries are "potential candidates" for EU membership.

2000: at Zagreb Summit (November), the SAp is officially endorsed by the EU and the Western Balkan countries (including Albania).

2001: First year of the new CARDS programme specifically designed for the SAp countries

2001: The Commission recommends the undertaking of negotiations on SAA with Albania. The Göteborg European Council (June 2001) invites the Commission to present draft negotiating directives for the negotiation of a SAA.

2002: Negotiating Directives for the negotiation of a SAA with Albania are adopted in October.

2003: On 31 January, Commission President Prodi officially launches the negotiations for a SAA between the EU and Albania. These negotiations are presently ongoing.

2003: at Thessaloniki Summit (June), the SAp is confirmed as the EU policy for the Western Balkans. The EU perspective for these countries is confirmed (countries participating in the SAP are eligible for EU accession and may join the EU once they are ready).

2004 (June): Council decision on the principles of a European Partnership for Albania

Source: http://www.europa.eu.int/comm/enlargement/albania/key_events.htm

ABOUT THE STABILISATION AND ASSOCIATION AGREEMENT (SAA)

The European Union is strongly committed to the stabilisation and development of the Southeast European countries. The Union's strategy is to bring closer these countries to the European integration, to the European membership. The key element of its strategy is the Stabilisation and Association Process for five countries of the region: Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia and Serbia and Montenegro. The Stabilisation and Association Process offers stronger incentives to these five countries, but also postulates political and economic requirements as well. The need for regional co-operation is emphasised particularly strongly. In order to develop a closer relationship with the EU, these countries will have to gear their political, economic and institutional development to the values and models underpinning the European Union: democracy, respect for human rights and a market economy. The European Union supports and assists them in introducing the necessary reforms to progress in these areas.

The intensive relations between Albania and the EU in the framework of the Stabilisation and Association Process, which begun in 1999, were finalised with the official opening of the negotiations, for the Stabilisation and Association Agreement between the European Union and Albania, by the President of the European Commission Mr. Romano Prodi on January 31, 2003. The SAA aims at the economic and political stability of the candidate country. For these reasons, this agreement contains asymmetrical obligations on its behalf. The general framework of the Stabilisation and Association Agreement is based on four pillars: political dialogue and regional cooperation, trade provisions related to the progressive liberalisation of exchanges until the establishment of a free trade area between the parties, community freedoms, and finally, cooperation in priority areas, especially in the area of justice and home affairs.

Romano Prodi, President of the European Union held a speech at the official ceremony of opening talks for the SAA on 31 January 2003 at the Palace of Brigade. He said: "The Stability and Association Agreements are not general structures for dialog. They are strong bilateral agreements that establish obligations during the signing-aiming to help the preparations regarding membership.

With the signing of the SAA, the parties are engaged with number issues, such as:

- They support the sharing of some basic values and principles (democracy, human rights, functional market economy, legal state etc.)

- They gradually approach towards the EU legislation and its implementation.
- They gradually establish and Agreement of Free Market with EU and make it function.
- To develop the regional co-operation and to fight effectively the organized crime, the drugs and human trafficking and corruption as well.”

EU-Albania negotiations on the Stabilisation and Association Agreement are organized every six weeks, one political round followed by two technical rounds, a calendar which was determined at the opening of the negotiations. First political round was held on 13 February 2003 in Tirana, and the tenth on 29-30 September 2005. This latter talk concentrated on some issues, which Albania needs to do to get closer to the next step to EU membership. According to the European Union the most problematic points for the country are: the organized crime, the corruption, the property issues and the customs administration. But not only the European Union outlined in the last weeks that Albania should continue the reform process and take further measures to strengthen the rule of law. US Deputy Assistant Secretary in the Bureau of European and Eurasian Affairs Rosemary A. DiCarlo said during a visit to Tirana earlier this month.

So it is clear ahead of the whole world that the Albanian EU accession, which is planned by the country's executives for 2014 is depend on the advance of the above reforms. The new government seems to be a very good background for this

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