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INTRODUCTION

This is the sixth issue of the "Western Balkans in Transition", which was prepared by staff within the Unit "Economic affairs of candidate countries and Western Balkans. Economic policy related to enlargement" in the European Commission's Directorate-General for Economic and Financial Affairs - Directorate for International Economic and Financial Affairs[*].

The main purpose of this publication is to give an overview of recent macroeconomic and structural developments in the countries of the Western Balkan region. The first part of the issue includes contributions on various topics that represent a common challenge for all the economies, while the second part features a country-by-country economic assessment. The structure of the horizontal part of the issue is as follows:

- a section presenting a regional overview - "Sustained growth in the Western Balkans";
- a section on "Economic Growth and Government in the Western Balkans";
- a section on "Regulatory Policies and Economic Growth in Transition Economies"; and
- a section on "Export-led growth in South-Eastern Europe?".

All four sections investigate a central theme - *economic growth in the Western Balkans, its current and potential determinants* and that is for a good reason. The progress achieved by the countries in their transition towards a market economy and the growing interconnections with the European Union driven by the long-term perspective of EU membership should result in higher productivity and living standards. The challenge of economic catching-up appears as redoubtable when looking at the fairly low level of economic prosperity in the Western Balkan economies. At the end of 2005, GDP per capita (in PPP terms) represented only about 20% of the EU-25 average in the Western Balkans (without Croatia, where the level was around 49%). In this context, the sections analyse from different perspectives the potential of the countries to expand their economic activity at high rates and on a sustainable basis.

The *introductory section* underlines the robust economic growth recently achieved in the Western Balkans, but also its uneven pattern across the region. It further evaluates the sustainability of the process in light of the macroeconomic performance and the progress attained in deepening structural reforms. The section on "*Economic Growth and Government in the Western Balkans*" dissects the various contributors to economic growth in the region. It focuses in particular on the role played by the public sector. There is a wide body of theoretical and empirical literature assessing the impact of the composition of fiscal policy on economic growth and the section looks at growth patterns in the Western Balkans from this point of view. The evaluation of the public sector performance and the levels of taxation in the economies suggest that more efficient public administrations and a rationalisation of public spending would accelerate the catching-up process in the region. Again, the continuation of structural reforms and the creation of an attractive business environment emerge as prerequisites for higher investments and stronger growth.

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[*] The previous issues of the Western Balkans in Transition are available on the Europa website at: http://europa.eu.int/comm/economy_finance/publications/externalrelations_en.htm

The third section on "*Regulatory Policies and Economic Growth in Transition Economies*" approaches the issue of growth in the region from the angle of the quantitative impact of regulatory policies by processing data from 14 central, eastern and south-eastern European transition economies. The assessment of the specific regulatory policies is based on the ratings of the 10 subcomponents of the Index of Economic Freedom which are used as exogenous variables. The data set is small and, consequently, the findings are limited. The main finding of the quantitative exercise, i.e. the negative correlation between fiscal burden and GDP growth, is in line with some of the findings regarding the negative impact of the large labour tax wedge in the Western Balkans from the previous section.

The section on "*Export-led growth in South-Eastern Europe*?" investigates the potential for an export-led growth strategy in South-Eastern Europe and the scope for further trade liberalisation and integration in this region. The good economic performance of most of the Western Balkan economies was mainly driven by private consumption and investment and only to a small extent by the contribution of net exports. The section concludes that such a growth strategy is feasible, less so within the limited size of the Western Balkan market, but more in connection with larger economies from the immediate neighbourhood, such as the EU, Romania or Turkey. Strengthening regional trade integration appears as an essential forward-looking strategy, not so much for creating an export market for local producers, but rather for developing a sufficiently large economic area that would increase the region's attractiveness for FDI.

The *country sections* give an update of the economic development and reform in the countries in the region.

The publication mainly covers Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Kosovo (SCG). Other countries, in particular Bulgaria and Romania, are partly included in the analysis for comparison and reference purposes.

The document was drafted by K. Bergkvist (Chapter VI), B. Böhm (IV, VIII), P. Grasmann (co-ordination), F. Kohlenberger (III, X), M. Macovei (II), C. Pavret de la Rochefordière (I), A. Sanchez Pareja (II and IX), M. Špolc (V, XI), U. Stamm (VII).

Corresponding editor: Peter Grasmann
European Commission,
BU-1 01/57,
B - 1049 Brussels
E-mail: peter.grasmann@ec.europa.eu

PART A

REGIONAL OVERVIEW

I. SUSTAINED GROWTH IN THE WESTERN BALKANS

- **Economic developments in the Western Balkans were overall favourable in 2005 and 2006, with a sustained average growth rate of around 5%. Inflationary tensions, which had resumed in 2005 particularly in Serbia, subsided in 2006. However, inflation remains a challenge to the monetary authorities in many of the economies. External imbalances remained significant, with an average current account deficit of some 8.5% of GDP in 2005.**

- **Fiscal consolidation was pursued further in 2005 and 2006. Average deficits in 2005 came down to 1.7% of GDP, with three countries – Serbia, Bosnia and Herzegovina, and the former Yugoslav Republic of Macedonia – posting budget surpluses. Further reducing the relative size of government in Croatia as well as in Bosnia and Herzegovina would help creating more space for private-sector-led growth.**

- **Structural reforms have progressed at an uneven pace. A large share of privatisation programmes – except in Serbia and Montenegro where the process started later – are now fairly advanced, though with important enterprises in the telecom and utilities sectors still remaining in state hands. Restructuring of energy utilities and markets has begun, boosted by the signature on 25 October 2005 of the South Eastern Europe Energy Treaty. In other areas, notably factor markets and the judiciary, progress remains uneven.**

Table 1: Western Balkans - Main economic trends

		2000	2001	2002	2003	2004	2005
Real GDP growth	*%*	4.1	4.0	4.3	3.9	5.7	4.7
Inflation (average)	*%*	n.a.	24.9	6.7	4.5	3.9	6.4
Total revenues	*% of GDP*	n.a.	40.3	41.0	42.1	42.6	41.3
Total expenditures	*% of GDP*	n.a.	45.3	45.0	45.4	45.5	43.0
General governmen balance	*% of GDP*	n.a.	-5.0	-3.9	-3.3	-2.9	-1.7
Exports	*billion EUR*	9.5	10.2	10.2	11.1	12.9	13.0
Imports	*billion EUR*	19.4	22.9	26.6	29.0	32.5	31.8
Trade balance with world	*billion EUR*	-9.8	-12.8	-16.4	-17.9	-19.6	-18.8
Trade balance with the EU	*billion EUR*	-6.9	-8.6	-10.5	-10.6	-11.7	-11.9
Current account balance	*% of GDP*	-3.9	-5.3	-9.8	-8.5	-8.8	-8.3
Foreign direct investment	*million EUR*	1,649	2,317	1,796	3,572	2,397	3,854

Source: national authorities, IMF

1. GENERAL ECONOMIC DEVELOPMENTS

Growth remained sustained in the Western Balkans in 2005 and 2006, at an average rate of around 5% of GDP. Growth dynamics were strong in Albania, Montenegro, Serbia, and Bosnia and Herzegovina with growth rates of between 5% and 7%. In Croatia and the former Yugoslav Republic of Macedonia – growth was somewhat less strong at between 4% and 4.5%. The outlier in the region remains Kosovo, with an estimated negative growth of -0.2% of GDP in 2005, followed by a 3% growth in 2006. The lower growth in Kosovo is to some extent due to the downsizing of the international community's presence which represented a significant market for local services.

The pattern of growth has been uneven. In 2005 high industrial growth was registered in some countries or areas, in particular in the former Yugoslav Republic of Macedonia and Republika Srpska (Bosnia and Herzegovina). In Serbia, growth was driven by services, while the manufacturing sector, which accounts for 75% of industrial production, recorded a decline of about 1%, reflecting the ongoing process of restructuring and adjustment in industry. Montenegro also recorded a negative industrial production trend, its GDP growth rate also being mainly driven by services (notably tourism) and the financial sector. Croatia's growth too is mainly explained by dynamic internal consumption trends and relied on services, with industrial production growing only moderately. Albania's growth was lower than in previous years owing to the effects of the energy supply crisis, which is expected to have weighed negatively – by around 0.5% of GDP – on growth, but remained strong overall, fuelled by strong internal demand.

Unemployment levels remained high throughout the region. Reported unemployment levels (at the end of 2005) varied considerably, ranging from 44% in Bosnia and Herzegovina and 36% in the former Yugoslav Republic of Macedonia to 14.2% in Albania and 17.6% in Croatia. However, it is difficult to judge to what extent official figures reflect reality, owing to the large alleged size of the informal sector. While the overall regional trend was favourable with slowly declining unemployment rates, Bosnia and Herzegovina registered an increase in reported unemployment. This appears to be due to a statistical bias, as citizens need to be officially employed or registered as unemployed in order to be eligible for social security. This appears to have boosted unemployment registration.

External imbalances of Western Balkan economies somewhat improved in 2005 with the average current account deficit down to 8.3% of GDP from 8.8% in 2004, though reflecting very dissimilar situations. The situation apparently – notwithstanding some uncertainties related to the quality of statistics – continued to deteriorate in the two economies which display the highest vulnerability to external accounts developments: Bosnia and Herzegovina and Kosovo. Bosnia and Herzegovina recorded a trade balance deficit of 48% of GDP and a current account balance of some 22% of GDP (against 21% in 2004), while Kosovo's current account deficit increased to above 15% of GDP (after grants which, although declining, remain a key source of financing). In Montenegro the current account deficit increased by more than 4 GDP percentage points to about 12% of GDP. Albania's current account situation also somewhat deteriorated, the deficit growing from 3.8% of GDP in 2004 to 6.9% of GDP on the back of a comparable widening of the trade deficit boosted by sustained growth and electricity imports at the end of the year. Croatia's current account deficit also slightly increased to 6.4% of GDP; however, it remains the country in the region with the most sustainable source of external revenue owing to sustained and increasing tourism receipts, and substantial FDI inflows to finance its current account deficit.

Table 2: Western Balkans countries - Main economic indicators

	Population *million*	Real GDP growth %		Inflation (CPI) %		General government balance (1) *% of GDP*	
	2005	2004	2005	2004	2005	2004	2005
Albania	3.1	5.9	5.5	2.9	2.4	-5.1	-3.6
Bosnia and Herzegovina	3.8	6.0	5.5	-0.2	3.3	-0.4	0.9
Montenegro	0.6	4.2	4.1	3.4	3.4	-2.6	-2.9
Serbia	8.1	9.3	6.3	10.1	16.5	0.9	1.9
Kosovo (UN 1244)	2.0	3.2	-1.0	-1.5	-1.7	-6.0	-3.1
Subtotal	***17.7***	***7.5***	***5.1***	***5.8***	***9.2***	***-1.1***	***0.2***
Croatia	4.4	3.8	4.3	2.1	3.3	-5.0	-3.9
The former Yugoslav Republic of Macedonia	2.0	4.1	3.8	-0.4	0.5	0.0	0.3
Western Balkans above	**24.2**	**5.7**	**4.7**	**3.9**	**6.4**	**-2.9**	**-1.8**
Memorandum item:							
Bulgaria	*7.8*	*5.7*	*5.5*	*6.1*	*5.0*	*1.9*	*3.1*
Romania	*21.7*	*8.4*	*4.1*	*11.9*	*9.0*	*-1.3*	*-0.4*

	GDP per capita (2) *EUR*	Trade balance (3)(4) *% of GDP*		Current account balance (5) *% of GDP*		FDI (6) *% of GDP*	
	2005	2004	2005	2004	2005	2004	2005
Albania	2,168	-21.7	-24.1	-3.8	-6.9	4.6	3.1
Bosnia and Herzegovina	1,836	-47.8	-48.1	-20.8	-21.7	7.1	5.2
Montenegro	2,649	-27.1	-30.8	-7.8	-12.2	3.3	22.8
Serbia	2,506	-22.7	-22.8	-11.7	-8.4	3.9	5.9
Kosovo (UN 1244)	1,105	-44.1	-43.3	-11.2	-15.2	0.9	2.7
Subtotal	***2,087***	***-29.3***	***-27.4***	***-12.0***	***-10.4***	***4.4***	***5.4***
Croatia	6,643	-23.7	-24.1	-5.0	-6.4	2.5	3.9
The former Yugoslav Republic of Macedonia	2,173	-21.4	-18.8	-7.9	-1.4	2.8	0.5
Western Balkans above	**3,882**	**-26.5**	**-25.6**	**-8.8**	**-8.3**	**3.5**	**4.5**
Memorandum item:							
Bulgaria	*2,504*	*-15.2*	*-20.5*	*-5.8*	*-11.8*	*11.5*	*8.7*
Romania	*2,715*	*-8.7*	*-9.8*	*-8.3*	*-8.8*	*8.4*	*6.6*

(1) including grants. (2) GDP at current prices and exchange rates. (3) incl. intra-regional trade (4) source for trade balance is IMF (5) After grants (6) Foreign direct investment inflows. *Sources* : national authorities, IMF and European Commission. Data for Kosovo are estimates, which may be subject to significant corrections. Overall, the very uneven quality of data throughout the region mandates cautious interpretations. Significant differences between the various sources and revisions of estimates are frequent.

Balance-of-payments developments in the remaining two countries, Serbia and the former Yugoslav Republic of Macedonia, have been favourable – particularly in the latter. Serbia's current account deficit narrowed to 8.4%, from around 12% in 2004, benefiting from strong exports of goods and services. The most remarkable improvement occurred in the former Yugoslav Republic of Macedonia, with the current account deficit coming down from about 8% in 2004 to 1.4% of GDP, owing to a sharp increase in exports and transfers from abroad. However, it remains to be seen whether the reported balance-of-payments data are fully reliable – there have been reported difficulties in external trade data – and whether an improvement of such magnitude can be sustainable over time.

Inflation had been declining for the previous five years throughout the region. Yet, it reaccelerated significantly in 2005 to 6.4% from 3.9% in 2004. The main reason for this

Box 1: Monetary and exchange rate regimes in the Western Balkans

The Western Balkan economies display a wide variety of exchange rate regimes and policies.

- *Bosnia and Herzegovina* introduced a currency board in 1997 in order to ensure macroeconomic stability. The local currency, the Convertible Mark (KM), was pegged to the DM and subsequently to the euro.
- *Croatia* and *the former Yugoslav Republic of Macedonia* have tightly managed floats.
- Serbia and Albania are both using managed floating arrangements, but in practice their monetary policy approaches differ quite significantly.
- The *Albanian* lek is allowed to float more freely and the central bank is pursuing a policy of informal inflation targeting.
- The monetary policy of *Serbia* placed in the past much weight on preserving external competitiveness through foreign exchange interventions and allowed in 2004 and 2005 for some nominal exchange rate depreciation. In 2006 the central bank began to withdraw from foreign exchange interventions and allowed the dinar to appreciate. It indicated to move towards inflation targeting in the future.
- *Montenegro* and *Kosovo* are special cases, as both are using the euro as sole legal tender. It is worth noting that five out of the seven economies have chosen practically fixed rate arrangements.

The beginning of the transition to a market economy and the immediate post-war period in the former Yugoslavia resulted in large macroeconomic imbalances. In order to rein in the very high inflation rates or even hyper-inflation most economies based their stabilisation programmes on the adoption of a nominal anchor in the form of -official or de facto- pegs or the introduction of the euro. Authorities aimed in this way to regain their credibility and establish a firm commitment to sound macro-economic stabilisation policies. As the majority of the economies were relatively small and open the need to contain the volatility of the exchange rates represented a crucial aspect not only for enhancing macroeconomic stability but also for eliminating uncertainties affecting trade and capital formation.

The economic stabilisation programmes were broadly successful and the official or de facto currency pegs led to a rapid disinflation process and contributed to the resumption of sound and robust growth, e.g. in Croatia where the average growth rate of CPI was reduced dramatically from over 1,500% in 1993 to around 2% in 1995, while real GDP growth rapidly resumed at almost 6%.

increase is a reversal of previous disinflation trends in Serbia, where inflation picked up from 10.1% in 2004 to 16.5% in 2005. This was due to strong domestic demand, increases in administered prices – notably energy price increases as a result of the rising cost of fuel imports – and the one-off effect of VAT introduction in January 2005.

Yet there were also inflationary tensions in a number of other countries in the region, though within more moderate limits, such as Bosnia and Herzegovina (increase by 3.5 percentage points to 3.3% in 2005, average retail price index) and Croatia (increase by 1.2 percentage point to 3.3% in 2005, average annual CPI). Price increases remained very low in the former Yugoslav Republic of Macedonia (0.5% in 2005 against -0.4% in 2004). Inflation was flat in Montenegro (3.4%). Kosovo remains a special case, with negative inflation (CPI) in 2004 and 2005, owing to weaknesses in economic activity brought about by the downsizing of the international community's presence, which had boosted prices in the early years of UNMIK's mandate. Based on first semester data, inflation is expected to increase further throughout the region in 2006, fuelled by higher energy import prices.

The monetary policy stance of the countries remained overall prudent in 2005 and 2006. In those countries pursuing dual monetary policy objectives of price and exchange rate stability the resumption of inflation is a particular challenge to the current policy stance. The region saw particularly strong growth in credit to both consumers and the private sector, albeit from rather low initial levels, which contributed to (re)monetisation. The high degree of euroisation, which affects the efficiency of transmission of interest-based instruments, limited the scope for fully-fledged independent monetary policies. The Croatian and Serbian central banks in particular had further recourse in 2005 and 2006 to non-market instruments, notably reserve requirements on local currency and euro-denominated credits, to keep credit expansion within sustainable levels. In Bosnia and Herzegovina, where under the currency board arrangement the central bank has limited room to intervene, reserve requirements were also raised in 2005.

The central bank of the former Yugoslav Republic of Macedonia continued to implement its core monetary policy based on the denar's external anchor to the euro. The tensions on the foreign exchange market that had been seen in previous years dampened in 2005 with sizeable increases in hard currency reserves, allowing for a modest decline in local interest rates. The Albanian Central Bank lowered its main intervention rate by 25 basis points to 5% in March 2005, to curtail the appreciation of the lek, though it then increased it back to 5.25% in July 2006, and further to 5.5% in December 2006, on the back of renewed inflationary tensions. In Croatia, which faces currency appreciation pressure, resuming inflationary tensions are expected to challenge the monetary authorities' current dual objectives of exchange rate and price stability. Kosovo and Montenegro's monetary authorities, which operate with the euro as legal tender, continued to use reserve requirements to curtail credit expansion. In February and April 2006 the Central Bank of Montenegro increased the deposit base on which to apply reserve requirements from 3-month to 1-year deposits.

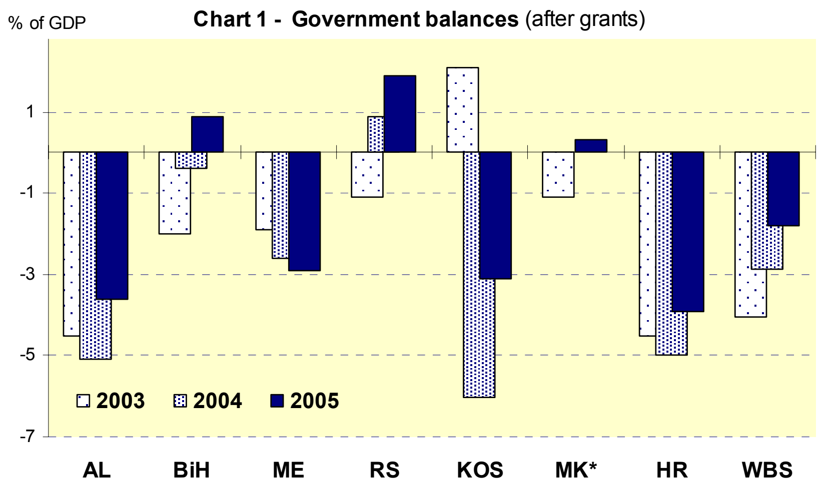
2. FISCAL DEVELOPMENTS

Further fiscal adjustment took place throughout the region in 2005, with the average general government deficit down to 1.7% from 2.9% in 2004. The positive fiscal consolidation trend was in most cases facilitated by robust economic growth. This led to budget execution outperforming initial planned levels. Further overall fiscal adjustment was achieved by sound means, mainly through reductions in expenditure (down to 43% of GDP), while revenue slightly decreased (to 41.3% of GDP). Three countries in the region – Bosnia and Herzegovina, Serbia and the former Yugoslav Republic of Macedonia – posted a fiscal surplus in 2005. The most marked improvement occurred in Serbia, where the fiscal balance improved by 1.6 GDP percentage points.

This improvement in fiscal balances throughout the region is crucial for securing overall macroeconomic stability. In these countries' heavily euroised – whether *de jure* or *de facto* – monetary situations, macroeconomic policies have lost most of their room for manoeuvre in the conduct of effective monetary policies, so that the main macroeconomic policy tool to contain internal demand, inflation and substantial external deficits is now the budget.

Despite the overall favourable trend, the fiscal situation remained heavily constrained in most countries in 2005. It is particularly fragile in ***Bosnia and Herzegovina*** where, notwithstanding a surplus of 0.9% of GDP in 2005, the size of government impedes private sector growth and may not be sustainable over the medium term in view of looming fiscal risks, notably contingent liabilities expected to materialise in the form of additional internal public debt. Without streamlining the complex fiscal governance rules and procedures, it will be difficult to achieve further progress without the anchor of an IMF programme. The relative size of government, which has been reduced by 10.7 percentage points since 2000 to 53.8% of GDP in 2006, needs to be brought down further to establish a growth-conducive environment without jeopardising the sustainability of the external accounts.

The size of government also remained very significant in ***Croatia*** (general government expenditure accounted for 50.3% of GDP in 2005), though some consolidation was achieved in 2005. The growth of current spending fell to 6.6% against 8% in 2004, supported by moderate growth in wages and social contributions. Capital spending, which had been growing rapidly in previous years – notably due to the ambitious highway programme – fell by 13.7% in 2005, adjusting towards a more sustainable level. Much remains to be done, however, since although it was reduced in 2005, the relative size of government has not materially changed over the last five years. The stock of public debt continued to rise to 45% of GDP by the end of 2005. A downsizing of the relative size of government and close-to-balance public accounts would create additional room for private-sector-led growth without further increasing external imbalances.



Source: IMF, national sources

Serbia represents an intermediate case, with general government expenditure amounting to 40% of GDP. Rapid consolidation has taken place since 2000. This process continued in 2005, with government expenditure reduced by 2 GDP percentage points and an overall budget surplus of 1.9% of GDP. However, after the IMF programme came to an end in February 2006 the temptation to adopt pro-cyclical fiscal policies on the back of high expected privatisation revenue resumed, particularly as general elections are expected before the end of the year. Plans for a EUR 1 billion (4% of GDP) investment programme have been announced. Unless implementation is phased in over several years, this could jeopardise the results attained over the previous three years to curb public expenditure and exacerbate inflationary tensions and external imbalances.

Although the relative size of government is somewhat lower, with general government expenditure amounting to some 38% of GDP, the latest developments in ***Montenegro*** have been less favourable. The deficit went up to 2.9% of GDP in 2005 from 2.6% in 2004, as foreign grants declined from 2.1% in 2004 to 0.2% of GDP in 2005, whereas transfers to the State Union budget increased from zero to 2.5% of GDP in 2005. Recorded public debt remained within sustainable levels and even decreased in 2005 to 42.7% of GDP. Montenegro further benefited in early 2006 from a 15% debt cancellation (topping up reduction of Paris Club debt granted upon successful completion of the IMF programme). Debt service however rose to 7% of GDP in 2005, more than twice the amount of the previous year. Additionally contingent liabilities, as a result of restitution proceedings, may considerably inflate public debt.

In ***Kosovo***, the deficit was curbed from 6% of GDP in 2004 to 3.1% in 2005, and the budget is expected to post a close to balance result in 2006 on the back of lower than foreseen capital expenditure. The cash deposits which financed the deficit in 2004 and 2005 are however expected to come close to exhaustion by the end of 2007, and since Kosovo cannot under the present status of the territory have access to capital markets or sovereign lending from IFIs, the bulk of deficits as of early 2008 would – subject to any changes following current status negotiations – have to be financed by grants from donors. A Letter of Intent agreed with the IMF in October 2005 limited real growth of expenditure to 0.5%. It also foresees a downsizing of the civil service, which, despite overall moderate general government expenditure (32% of GDP), is the above regional average. This would make some room for a larger share of capital expenditure financed from the budget. Another challenge ahead lies in the likely need upon status settlement to service a portion of sovereign debt currently serviced by Serbia, which would put its public finances under considerable strain, in addition to numerous other fiscal risks, notably related to the unsustainable financial situation of KEK, the energy utility, and generous provisions in favour of war veterans foreseen in legislation adopted in 2006.

The general size of government remains moderate in ***Albania***, with general government expenditure amounting to 28% of GDP (2005), and this modest level has probably contributed to the dynamic private-sector-led growth of the country over recent years. The deficit, which had increased to 5.1% of GDP in 2004, came down to 3.6% in 2005, mainly as a result of higher dynamics in revenue growth while expenditure increased only moderately. Fiscal measures to enhance revenue collection were adopted in agreement with the IMF in 2005 and seem to have already produced a positive outcome on tax performance for the first months of 2006. The gap between revenue and expenditure which stood at more than 10% of GDP in the mid-1990s has been steadily reduced over the last decade. Fiscal consolidation needs to be pursued further in view of the significant current account deficit, resuming inflationary tensions and the sizeable public debt – mostly internal and financed from local savings – which stood at 55% of GDP at end-2005.

The fiscal stance in the ***former Yugoslav Republic of Macedonia*** remained prudent in 2005. The general government balance registered a surplus of 0.3% of GDP (compared with a situation of balance in 2004), clearly outperforming the initial budget target of a 0.8% deficit. The main factors behind this favourable performance were higher-than-expected revenues together with lower-than-expected capital expenditures. The size of the public sector remains relatively low compared to other countries in the region with general government expenditure of around 36% of GDP (2005). Public debt increased to 41% of GDP by the end of 2005 upon the issue of a EUR 150 million 10-year government bond. In spring 2006, the proceeds of this bond issue were used to repay London Club debt.

3. STRUCTURAL REFORMS

Further progress has taken place in the area of ***fiscal reform***. VAT was introduced in Serbia on 1 January 2005. It was also successfully introduced in Bosnia and Herzegovina on

1 January 2006 following the establishment of a single Indirect Tax Administration. Measures to strengthen tax administration have been taken in Albania and Croatia, and the implementation of fiscal decentralisation has started in the former Yugoslav Republic of Macedonia.

A number of positive developments have taken place with measures aimed at ***facilitating market entry and exit mechanisms***. Recently approved amendments to Croatia's bankruptcy law aim to simplify and accelerate bankruptcy procedures and to enhance the transparency of the process. One-stop-shops for business registration have been established in Croatia and the former Yugoslav Republic of Macedonia. In Serbia, new bankruptcy legislation came into effect in early 2006.

Box 2: The Energy Community Treaty expected to boost structural reforms

As a result of the **Athens Process for regional energy co-operation,** the South-East European Energy Community was established on 25 October 2005 between the EU, Albania, Bulgaria, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Romania, Serbia and Montenegro, Turkey and UNMIK, representing Kosovo under UN SC Resolution 1244. Moldova is an observer.

The main objectives of the Energy Community are:

- to create a **single stable regulatory and market framework** throughout Europe,
- to enhance **security of supply,**
- to improve the **environment,**
- to develop **competition on a broader geographic scale, and**
- to exploit **economies of scale**.

Its activities include the implementation of the EU **acquis communautaire**, the creation of a single mechanism for the cross-border transmission and/or operation of energy markets and the creation of an energy market without internal frontiers.

This agreement is an important **catalyst for structural reforms** in the energy sector in each country of the region.

The Energy Community is taking measures to establish a single mechanism for the cross-border transmission and/or transportation of network energy. The creation of a single energy market is underpinned by the prohibition of customs duties and

The Energy Community extends the following parts of the EU *acquis* to SEE:

- Under the **acquis on energy** SEE countries will be obliged to unbundle the generation, transmission and distribution activities, to set up independent national energy regulators and to open access for cross-border trades in electricity and gas. The timetable envisaged for liberalisation is 1 January 2008 for all non-household customers and 1 January 2015 for other customers.
- The construction and operation of new generating plants will have to comply with the **acquis on environment** as soon as the Treaty will be effective and each contracting party shall endeavour to accede to the Kyoto Protocol and to implement the EC Directive on integrated pollution prevention and control;
- the **acquis on competition,** both on anti-trust and state aid rules.

The governance of the Energy Community involves **common institutions**: a Ministerial Council, a Permanent High-Level Group (PHLG), the Electricity Forum based in Athens and the future Gas Forum to be based in Istanbul, composed of representatives of all stakeholders, including regulators, industry representatives and consumers. An important new institution is the Regional Regulatory Board. It will advise the Ministerial Council and the PHLG on the details of statutory, technical and regulatory rules and issue recommendations on cross-border disputes involving two or more regulators. The Secretariat, based in Vienna,

quantitative restrictions on imports or exports of network energy (except on grounds of public policy or public security).	provides administrative support and reviews the proper implementation by the Parties of their obligations under the Treaty.

Restructuring and privatisation have progressed. In Serbia, auctions of SMEs have been progressing swiftly. Four state-owned banks were sold in 2005 and early 2006. The process of restructuring large insolvent companies, however, has been slow. Montenegro successfully privatised three of its largest companies in the course of the year: the telecom operator, the aluminium producer KAP and Podgorikca Banka. The distribution network of the local incumbent electricity operator in the former Yugoslav Republic of Macedonia was successfully sold to a foreign investor.

Albania was less successful in 2005 as the privatisation of two main companies slated for sale in 2005 – ARMO and the Albanian telecom operator – failed. Croatia also did not advance as swiftly as foreseen with its privatisation programme. Some of its main industrial companies, in particular the still highly subsidised shipyards, remain in public hands and there has been little progress towards restructuring them. The privatisation of the first shipyard, planned for 2005, was postponed. The Privatisation Fund's attempt to sell a part of government stakes in the loss-making aluminium factory TLM also failed.

In Bosnia and Herzegovina progress has been uneven, with privatisation proceeding with renewed momentum in the Republika Srpska but slowing down in the Federation. Structural weaknesses in the governance of public enterprises – and also of a number of already privatised ones – were expected to further hinder the much-needed enterprise restructuring. In Kosovo, the privatisation of socially owned enterprises which had been re-launched in mid-2004 progressed swiftly in the course of 2005 and the first half of 2006, and 90% of the assets slated for privatisation were expected to be sold by the end of 2006. However the public electricity utility KEK is still operating with heavy losses owing to poor payment discipline on the part of its customers and has not been brought back to financial sustainability.

Further social reforms have been adopted. A reform of the Croatian health care scheme was adopted in July 2006 to address financial difficulties and stop further arrears accumulating. In the former Yugoslav Republic of Macedonia a new law on labour relations entered into force early in 2005 and second pillar pension funds have been established.

II. ECONOMIC GROWTH AND GOVERNMENT

SUMMARY

This chapter analyses the interconnection between the size and functions of government and economic growth in the Western Balkan economies. The optimal scope for government intervention in the economy is viewed differently by the various schools of economic thought. Furthermore, the available empirical literature does not provide an unambiguous view on the impact of the size of government spending on growth, despite a large number of studies claiming the existence of a negative correlation. Several studies suggest to differentiate between government consumption and redistributive spending on the one hand and government investment in infrastructure and other public goods on the other hand, in order to assess their impact on economic growth. Consequently, this chapter evaluates growth patterns, the structure of public spending, the performance and efficiency of the public sector and the levels of taxation in the Western Balkan economies. The analysis shows that economic growth is below potential in some of the economies while their public spending is relatively high. In addition, spending is concentrated in, often inefficiently managed and targeted, redistributive functions, such as social transfers and subsidies to the corporate sector and the performance of the public sector is fairly low. Further efforts towards increasing the efficiency of the public sectors and rationalising public spending would boost up the catching-up process in the Western Balkans.

1. INTRODUCTION

The current economic development of the Western Balkan economies resembles the experience of other former acceding countries, where nominal convergence or substantial progress towards nominal convergence was achieved more easily than closing the income and productivity gaps. This challenge is so much greater in the case of the Western Balkan economies, as their economic prosperity measured in terms of GDP/capita (in PPP terms) is fairly low, representing only about 20% of the EU-25 average for 2005[1]. For this reason, the current chapter deals mainly with economic growth developments and prospects for sustained real convergence in the Western Balkan economies, without questioning the importance of stabilisation policies on long-run economic growth. From the various contributors to economic growth, we chose to focus on the government's contribution to economic growth and we distinguish between:

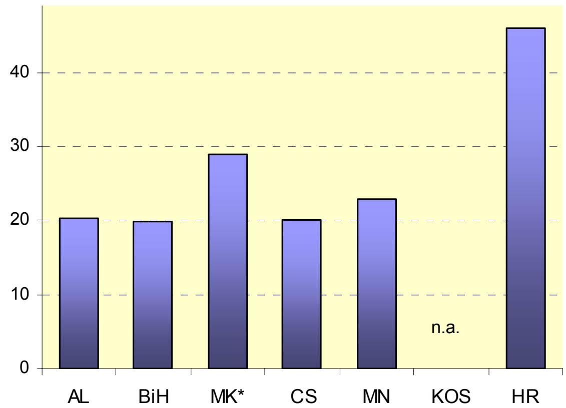
- the positive impact of making available public services and infrastructure and creating efficient institutions that foster an adequate business environment, and
- the burden represented by government with the risk of imposing too high taxes, distorting market incentives and interfering negatively in the economy by assuming roles most appropriate for the private sector.

[1] Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Kosovo (UN1244), Montenegro and Serbia are included in the analysis as the group of Western Balkan economies.

2. INTERACTION BETWEEN THE ROLE AND SIZE OF GOVERNMENT AND ECONOMIC GROWTH

Economic theory presents growth as ultimately driven by individual behaviour of households and enterprises, propensity for saving and investment, capital accumulation and technological progress. It thus assigns to public policies only an indirect, but critically important, role. While most of the economic activities take place on markets, the quality of institutional arrangements which secure property rights, provide for fair competition, enforcement of contracts and eventually stimulate economic entrepreneurship cannot be neglected. Even though challenged by some economic theories, the availability of adequate infrastructure, the provision of public goods and the settlement of the externalities issue are equally important so that the society benefits to the maximum from individual decisions.

GDP per capita (% of EU-25, in PPS)



Source: IMF *see footnote in list of abbreviations

The optimal scope for government intervention in relation to economic growth is viewed differently by various schools of economic thought, ranging from a rather limited role for the public sector in the economy, as advocated by the Austrian school of economics, to widespread intervention, justified by the need to tackle market failures and social inequity, as argued by the new welfare economics. Neo-classical economics takes an intermediate approach with regard to the functions that governments should undertake. Government intervention is justified not only to provide external and domestic security for its citizens, a fair and efficient judicial system and the enforcement of rules creating a level playing field for entrepreneurship, but also to solve the problem of externalities, ensure macroeconomic stability and promote a redistribution of incomes that corresponds to the prevalent preference of the society.

The empirical results presented in literature on the aggregate size and role of government in supporting economic growth are sometimes conflicting. A large majority of authors[2] found a negative and significant correlation between the size of government spending, or the level of taxation, and economic growth. However, other studies[3] did not find the partial correlation between the size of public sector or taxes and economic growth statistically significant. The controversial results are probably due to conceptual and qualitative problems and large informal sectors, but also to the all-inclusive nature of traditional measures of government spending. Several studies stress the importance of distinguishing between government consumption or redistribution expenditures which may be inefficiently managed or targeted or create disincentives to work and government investment in infrastructure and other public goods. They basically distinguish between two opposite

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[2] Such as Landau (1986), Kormendi and Meguire (1985), Scully (1995), Grossman (1988), Vedder and Galloway (1998), Peden and Bradley (1989), Mackness (1999), Grier and Tullock (1989), Benson and Johnson (1986), Folster and Henrekson (2001), Gwartney, Lawson and Holcombe (1998), Tanzi (2005)

[3] Among which Slemrod, Gale and Easterly (1995), Agell, Ohlsson and Thoursie (2003), Levine and Renelt (1992), Sala-i-Martin (1997) or Mendoza (1997)

impacts of government size on economic performance. The positive impact may come from public investment in infrastructure[4], general government investment[5], or spending on education[6]. Some authors find a less favourable impact on growth deriving from government consumption expenditure[7], non-productive expenditure[8], public welfare expenditure[9] and excessive burden on the private sector[10].

Both the theory and the results of empirical studies suggest that government action should not undermine but rather support the functioning of markets in order to foster sound economic growth. While adequate funding is necessary to finance core-spending activities – internal and external security, public administration, well-trained and non-corrupt civil servants and judges, basic infrastructure, health and education – poorly targeted redistributive spending may reduce growth by creating disincentives to work, save, accumulate human and physical capital or exercise entrepreneurial talent. At the same time, some authors[11] claim that countries with lower public spending-to-GDP ratios demonstrate a higher efficiency of their public administration/institutions and more growth than large public sectors which are associated with more equal income distribution and improved social cohesion. In this context this chapter attempts to assess the performance of the Western Balkan economies in terms of economic growth, size and structure of public spending, public sector performance and taxation levels.

3. ECONOMIC GROWTH AND ITS CONTRIBUTORS

Economic growth in the Western Balkan economies was fairly strong over the period 2000-2005. Real GDP grew on average by 4.4% and exceeded the more modest 2% growth performance of EU-25 countries, which shows that catching up is indeed taking place, albeit at a relatively sluggish pace given the low relative level of departure of the Western Balkan economies. Compared to the performance of other transition economies within the same time frame, such as Bulgaria (5.1%) or Romania (5.1%), this performance was not particularly strong, especially as within the group itself there are significant differences. Albania, Bosnia and Herzegovina and Serbia showed higher growth dynamics between 2000 and 2005, with annual average GDP growth of more than 5%, while the former Yugoslav Republic of Macedonia, Montenegro and Kosovo performed rather poorly with annual growth rates below 3% on average.

Although data on the expenditure side of GDP formation is not provided satisfactorily for the analysed economies, it is safe to assume that growth is driven by relatively strong investment and consumption. Investment growth is reflected by a growing investment ratio averaging 20.6% of GDP for the analysed economies in 2005. Although the ratio is slightly higher than the EU-25 average of 20.1%, it is lower than those recorded in Bulgaria (28%), Croatia (29.9%) or Romania (22.7%). In Albania (23.6%), Bosnia and Herzegovina

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4 ²Aschauer (1989), Barro (1990), Barro and Sala-i-Martin (1992), Loayza and Soto (2002)

5 ²Aschauer (1989), Easterly and Rebelo (1993), Devarajan, Swaroop and Zou (1996), Kneller, Bleaney and Gemmell (1999)

6 Evans and Karras (1994)

7 Barro (1990), Slemrod, Gale and Easterly (1995), Sala-i-Martin, Doppelhofer, and Miller (2004)

8 Kneller, Bleaney and Gemmell (1999)

9 Jones (1990)

10 Loayza and Soto (2002)

11 See also Afonso, Ebert, Schuknecht and Thone (2005)

(21.7%), the former Yugoslav Republic of Macedonia (23.4%) and Kosovo (27.1%) the investment ratios exceed the 20% level, while in Serbia and Montenegro they are around 18%. In Kosovo, the high investment ratio was boosted by investment financed directly from donor support which accounts for almost 4% of GDP. The double-digit growth rates of retail sales in Serbia and of consumer loans in Bosnia and Herzegovina (30%), Montenegro (41%) bear witness to the sustained growth in consumption that took place in the region in 2005. In the former Yugoslav Republic of Macedonia, growth of both consumption and gross fixed capital formation were moderate and economic growth was led by external demand.

The relatively low national savings ratios, net foreign direct investment (FDI) and employment levels hamper economic growth and raise concerns about the sustainability of the real convergence process. The average gross national savings ratio represented less than 11% of GDP in the Western Balkan economies in 2005 and if the substantial official transfers channelled into the region are excluded, the average savings ratio drops to around 8% of GDP. In particular, in Bosnia and Herzegovina, the national savings ratio was negative. By comparison, national savings ratios are higher in Bulgaria (16.2%), Croatia (23.8%), Romania (14.0%) or in the euro area (20.9%). Only in Albania (16.7%) and the former Yugoslav Republic of Macedonia (22%) national saving levels could be considered as supporting sustainable economic growth, while negative domestic saving ratios are recorded in Kosovo and Bosnia and Herzegovina if the foreign assistance is not taken into account. In Bosnia and Herzegovina the relatively high private savings are offset by the negative corporate savings, due to the large losses incurred by this sector. As official transfers are gradually declining – in Kosovo they declined from 40% of GDP in 2002 to less than 21% in 2005 – Bosnia and Herzegovina and Kosovo need to increase their capacity to save domestically and/or attract more foreign direct investment or foreign savings in general, in order to preserve the current investment levels.

Basic economic indicators

	Albania	Bosnia and Herze-govina	The former Yugoslav Republic of Macedonia	Serbia (SCG)	Monte-negro (SCG)	Kosovo (UN 1244)	*EU-25*
GDP growth rate (annual av. 2000-2005)	5.7	5.0	2.0	5.5	2.7	0.9	*2.0*
National savings, % of GDP (2005)	16.7	-0.9	22.0	10.3	n.a.	11.8	*20.9*
Gross domestic investment, % of GDP	23.6	21.7	23.4	18.4	n.a.	27.1	*20.1*
FDI, net, % of GDP (annual av. 2001-2004)	4.0	4.8	4.3	4.1	3.7	0.3	*n.a.*
Labour force partici-pation rate, % (2004)	58.4	43.0	55.8	68.6	64.7	55.9	*69.7*
Unemployment rate, % (2004)	14.5	48.0	37.2	32.4	22.0	42.3	*9.1*

Source: IMF

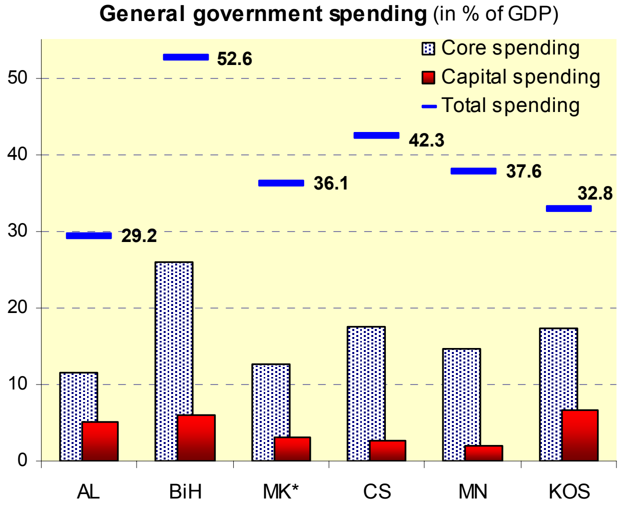
Net FDI inflows increased to an average of 4.5% of GDP in the economies in 2004, but remain lower than in Bulgaria (8.4%) or Romania (8.5%). Bosnia and Herzegovina was the most preferred destination for foreign direct investment in the region during 2001-2004, averaging almost 5% of GDP. In Albania, the former Yugoslav Republic of Macedonia, Serbia and Montenegro net FDI varies on average around the 4% level, while in Kosovo it barely grew above 1% of GDP.

The low participation on the labour market and the existence of a large informal sector prevent a better realisation of the growth potential in the region. In 2004, the participation rate of the labour force averaged 61% and it was below the level recorded in the EU-25, which is close to 70%. The labour force participation rate was comparable to the EU-25 average only in Serbia (68.7%) and Montenegro (64.7%). In contrast, it is fairly low in Bosnia and Herzegovina (43%), the former Yugoslav Republic of Macedonia (55.8%) and Kosovo (55.9%). With a participation rate higher than 58%, Albania performs slightly better, but the dynamics are quite unfavourable as the official rate of labour force participation diminished by 10 percentage points since 1999. High unemployment remains a serious deterrent to growth and economic prosperity in the economies.

The overall competitiveness of the economies is reduced by a combination of still large and not restructured state-owned enterprises and business environments that do not foster enough economic entrepreneurship. The private sector represents only around 50% of GDP in Bosnia and Herzegovina and 55% in Serbia, but is higher in Montenegro (60%) and relatively high in Albania (75%) and the former Yugoslav Republic of Macedonia (75%). These data reflect the limited progress achieved in restructuring and privatising state-owned enterprises and the large amount of resources still trapped in overstaffed and inefficient public enterprises. In the former Yugoslav Republic of Macedonia the privatisation of socially-owned companies was largely completed with the exception of the utilities sector and a pool of unviable companies that could not be sold or bounced back into state ownership after failed privatisations. In Albania, the privatisation of small- and medium-sized enterprises was completed, but unlike in the former Yugoslav Republic of Macedonia, large-scale privatisation has suffered some delays. The privatisation process is only in an intermediary stage in Serbia and in Bosnia and Herzegovina and more advanced, but still lagging behind in Montenegro and Kosovo. The weaknesses of the business environment pertain mainly to administrative barriers to market entry and exit, red-tape and corruption and inefficient enforcement of contracts and property rights due to the improper functioning of the judiciary and administration. Centralised systems of wage bargaining, strong trade unions and restrictive labour code provisions related to the dismissal of employees contribute to the inflexibility of labour markets. If the burdensome taxation of labour is added, the low participation rates and high unemployment can easily be explained.

Although all the economies in the region need to continue improving their macroeconomic stability, the attained level of macroeconomic stability is in general supportive to economic growth. Inflation remains a serious issue only in Serbia, where the CPI grew by 17.7% y-o-y in 2005. In all the other economies, the end of year inflation rate was below 4% in 2005. A significant consolidation of public finances took place throughout the region, so that general government deficits were below 3% of GDP in 2005, except for Albania and Kosovo, where the deficits stood at about 3.8% and 3.2% of GDP respectively. At the same time, the level of public indebtedness was below the 60% EC Treaty reference in all analysed economies at the end of 2005. External imbalances are high and they are a consequence of the low levels of national savings. In 2005, current account deficits as a percentage of GDP were moderate in the former Yugoslav Republic of Macedonia (1.4%), but relatively high or very high in Albania (5.5%), Montenegro (8.6%), Serbia (8.1%), Kosovo (15.3%), and Bosnia and Herzegovina (22.9%). Nonetheless a large part of these deficits were financed by non-debt creating inflows, which in combination with the relatively low levels of external indebtedness do not amplify external risks. Bosnia and Herzegovina is in a more vulnerable position due to its currency board arrangement and needs to make better use of the fiscal leverage in order to contain external imbalances.

4. SIZE AND STRUCTURE OF GOVERNMENT SPENDING



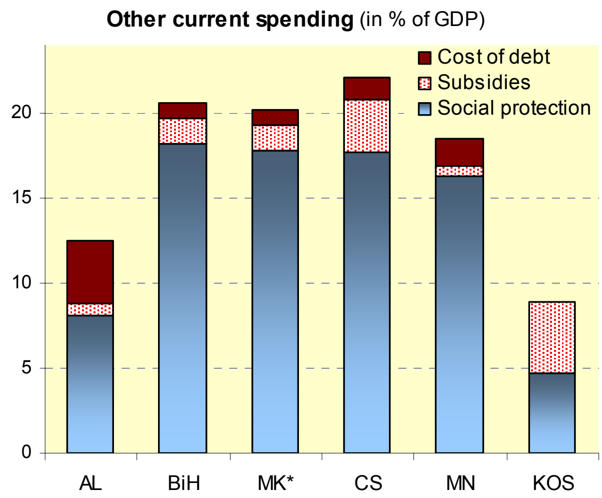
Sources: IMF, national authorities   * see footnote in list of abbreviations

Total government spending in the economies amounted on average to around 40.5% of GDP in 2004, but the range between 29.2% in Albania and 52.6% in Bosnia and Herzegovina suggests large differences across countries. The average size of government is lower than in the EU-25 (47.1%), but higher than in faster growing economies such as Bulgaria (37.5%) or Romania (31.1%), which may be in line with some of the considerations about the link between public spending and economic growth from the theoretical chapter.

Core public spending, which includes expenditures on administrative services, justice, internal and external security, basic education, health and infrastructure, was calculated as a residual after deducting from general government spending the expenditures for social transfers, subsidies to the corporate sector, cost of public debt and investment.

The average core spending was around 17.3% of GDP in the economies in 2004. This is lower than the EU-25 average of 21.5% but higher than the levels recorded in Bulgaria (15.2%) or Romania (12.4%). Although core spending in Albania is less than 12% of GDP, the quality of administrative services provided by the Albanian public sector compares relatively favourably in certain areas to the peer group that spends more, as it will be shown in the next chapter. On the other hand, Bosnia and Herzegovina spends around 26% of GDP on core public activities. This is higher than the EU-25 average, but at the same time is not reflected in a similar level of output. The different layers of government and the relatively high salaries of civil servants bring the public sector wage bill up to more than 14% of GDP. In Albania or the former Yugoslav Republic of Macedonia the wage bill represents only 6.4 and 8.5% of GDP, respectively. In addition, expenditures for defence and public order and safety are, relative to GDP, more than double the average of similar expenditures in the EU-25.

Average public capital spending was around 3.7% of GDP in the region in 2004, higher than in Romania (2.8%) or EU-25 (2.4%), but lower than in Bulgaria (3.9%) and Croatia (5.1%). Capital spending is fairly high in Albania (5%), Bosnia and Herzegovina (6%) and Kosovo (6.6%) and is a consequence of the need to upgrade the existing infrastructure and improve growth prospects. While a significant share of the capital projects in Kosovo and Bosnia and Herzegovina benefit from donor support, the high capital spending recorded in Albania is surprising in light of the lower size of total public spending.



Sources: IMF, national authorities   *: see footnote in list of abbreviations

Redistributive spending takes place both in the form of social transfers and subsidies to the corporate sector and is quite large in all analysed economies except for Albania and Kosovo. Public spending on social assistance averaged around 15.6% of GDP in the region in 2004, hence not much lower than the level recorded in the EU-25 (19.1%) and relatively higher than in Bulgaria (14.3%) or Romania (12.4%). The amount of social transfers in the vicinity of 18% of GDP recorded in Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro shows that they have largely preserved the social safety nets from the socialist times. In the case of Bosnia and Herzegovina, an important part of transfers goes to war veterans. In general, social transfers are also not efficiently targeted in these countries. The generous benefits are likely to restrain growth in the long run unless these economies succeed in reforming their social safety nets in order to reallocate resources more effectively and focus primarily on basic needs.

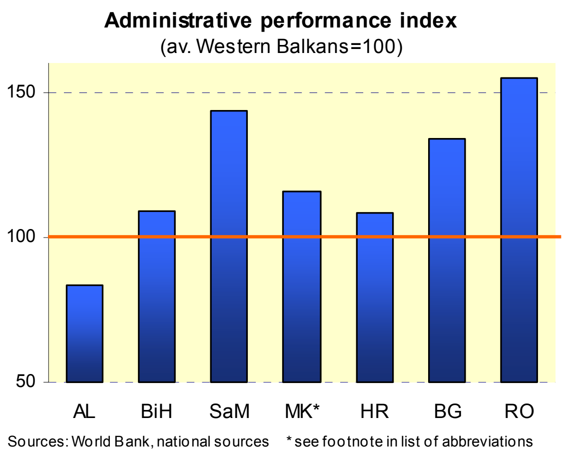
Subsidies to the corporate sector in the economies, in the vicinity of 2.3% of GDP, are comparable to the levels recorded in Bulgaria (2.2%) or Romania (2.3%), but are almost double the EU-25 average level in 2004, reflecting the need to further restructure the sector of publicly-owned enterprises. As a consequence of the lower public debt burden, the average cost of public debt represented only 1.5% of GDP in the analysed economies in 2004, which was approximately half of the EU-25 level.

5. PUBLIC SECTOR PERFORMANCE

The analysis of the public sector performance in the Western Balkans is based on the outcome of several indicators that can be grouped into four main categories: administrative, education, health and public infrastructure[12]. A competent and non-corrupt public administration combined with streamlined bureaucracy and a well-functioning judiciary represents a prerequisite for ensuring a level playing field on the market and securing property rights. We include in our assessment also indicators related to the flexibility of the labour market because it is determined to a large extent by government regulation and interaction with social partners and has a significant impact on the business environment.

Administrative performance

The amount of "red tape" in the Western Balkans is still high, especially when compared to the EU Member States. Further analysis by the World Bank on the business environment in the region shows that the number of procedures required establishing a new business is very similar amongst countries, around 12, but significant differences arise inside the group when considering costs and time. Moreover, starting a business takes from 15 days and EUR 126 in Serbia and Montenegro up to 54 days and EUR 670 in the case of Bosnia and Herzegovina. There are also significant



[12] See also Afonso, Schuknecht and Tanzi (2003)

differences when comparing the initial capital required for establishing a business. While in Serbia and Montenegro about EUR 200 are needed, in the former Yugoslav Republic of Macedonia the same procedure requires EUR 940.

As regards compliance with licensing and permit requirements for ongoing operations, the number of necessary procedures is very similar amongst countries (average of 20) and they require 212 days in Serbia and Montenegro and up to 476 days in the case of Bosnia and Herzegovina. The main handicap for some countries is the price, which can be very significant as in Bosnia and Herzegovina or Serbia and Montenegro. On the other hand, Albania or the former Yugoslav Republic of Macedonia compare favourably with other European countries such as Bulgaria.

The number of procedures for Western Balkans and European countries necessary for the registration of property is similar. In this case, the main differences arise from the number of days needed to complete the procedure, with Albania (47 days) closer to the countries of the EU, while in Bosnia and Herzegovina almost one year is needed. Also registration costs are higher in the Balkans (average of 4.6% of property value) than in Bulgaria 2.3%), or Romania (2%), but lower than in Croatia (5%).

Another important aspect for private sector development is the quality of the judiciary. In the analysed economies enforcing commercial contracts takes more procedures (34) and costs more (24.7% of debt) than in many EU countries, although the still high number of days to enforce a contract (390), is estimated to be lower than in neighbouring Croatia (415) or Bulgaria (440). The time and cost required to resolve bankruptcies is also more unfavourable in the region. Especially when the amounts recovered from insolvent firms (average 23.6%) are assessed, the analysed economies compare unfavourably with Bulgaria (33.5%) or Croatia (28.5%), but favourably with Romania (17.5%).

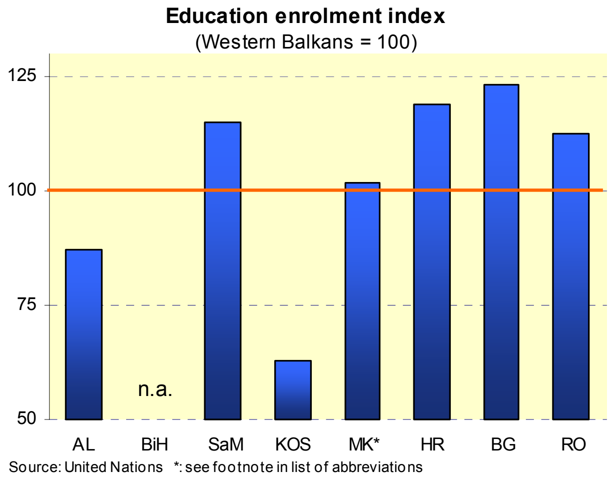
Concerning labour markets, Serbia and Montenegro show the least rigid framework and the most competitive one in costs, both for hiring (25% of salary) as for firing (21.2 weeks of wages). In general, the analysed economies present, measured by the rigidity of employment index[13], more flexibility in their labour markets (average of 43) than neighbouring Croatia (57) or Romania (59). Albania deserves a particular mention, as it has the lowest index of difficulty of firing but, on the other hand, bears the highest dismissal cost of around 64 weeks of wages.

Finally, and in a broader approach to the business environment, the corruption perception index elaborated by Transparency International[14] provides a complementary picture of the Balkans. In its 2005 report it produces a composite index drawing on 16 surveys from 10 independent institutions. The index ranges from 10 (clean) to zero (highly corrupt). The Western Balkans countries score under the 5.0 borderline reference value, which distinguishes between countries that do and do not have a serious corruption problem. The scores of the analysed economies are very close and scarcely vary between 2.9 in the case of Bosnia and Herzegovina and 2.4 for Albania. Romania, Croatia and Bulgaria also rate under the 5 points threshold (3.0, 3.4 and 4.0 points respectively).

[13] The World Bank's "rigidity of employment index" takes into account the following indicators: difficulty of hiring, of firing and the rigidity of hours measured on a scale from 0 to 100, where a higher index implies more rigidity.

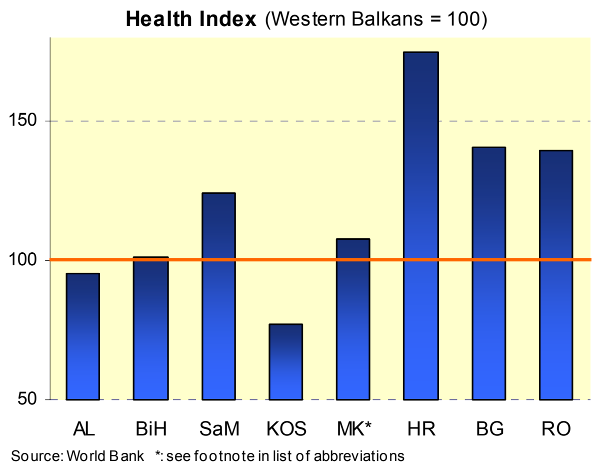
[14] "The 2005 Transparency International Corruption Perceptions Index", www.transparency.org.

Education



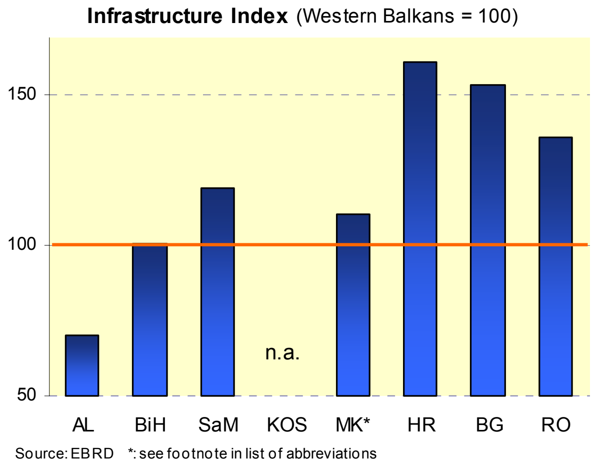
The education sector across the region seems to confirm the handicap for small economies in achieving economies of scale, as they try to provide similar levels of service to their citizens as bigger countries do. For instance, the smallest economies in the region, like Kosovo, show the highest levels of expenditure in education (5.7% of GDP). By contrast, other Balkan economies dedicate some 3% of their GDP. However, this trend is reversed when considering the results attained by their respective systems. Because of data availability constraints we are primarily looking at enrolment ratios, even though there are other aspects regarding the quality of the education systems that would provide a more complete picture. While all countries in the region present similar levels in primary and secondary education enrolment, the largest economies show the highest levels in tertiary education. In this sense, the case of Serbia and Montenegro is illustrative; each republic displays very different enrolment figures in tertiary education (59% in Serbia and 13.6% in Montenegro), while they invest in education 3.3 and 5% of their GDP respectively (for reference, the EU-25 expenditure on education was 5.2% of GDP in 2002). However, in certain cases, enrolment in tertiary education is substantially lower than in Bulgaria or Croatia (39%).

Health



As a paradox, Bosnia and Herzegovina is of the countries with the highest public spending on health (7% of GDP) and at the same time the one which shows the least favourable ratios in number of physicians and hospital beds per inhabitants (1.3 and 3.2 per 1,000 inhabitants respectively). The large spending is also not reflected in an improvement of the life expectancy of its citizens, which remains the same as in its neighbouring countries (73 years). On the other hand, Albania with the lowest ratio of health spending (3.4% of its GDP) displays very similar figures (1.4 physicians and 3.3 hospital beds per 1,000 inhabitants, life expectancy at birth of 74 years and infant mortality rate of 18 per 1,000 live births) with its peer group. Moreover, Kosovo, which also ranks on the high side of the expenditure scale with 8.1% of GDP, shows very poor results - 1 physician and 2.2 hospital beds per 1,000 inhabitants, life expectancy of 69 years and infant mortality rate of 2.7%. For comparison purposes, Croatia spends about 7.3% of its GDP on health, but the results are clearly better (2.4 physicians and 6 hospital beds per 1,000 inhabitants, 74 years life expectancy and 0.8% infant mortality rate).

Public infrastructure

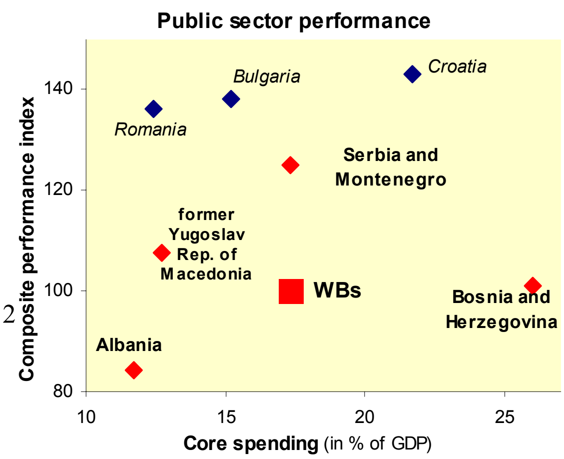


The quality of public infrastructure in the analysed economies, especially in transport infrastructure, is significantly lower than in Member States or faster growing economies and impacts negatively on the development of the economic activity. The limitations to road infrastructure reflect not only current levels of public capital spending, but are also a legacy of the past, when some countries needed to repair their networks following war damages. Keeping in mind this caveat, the average number of kilometres of paved roads per square kilometre in the region, is significantly lower in the region than in Bulgaria, Croatia or Romania in 2003. Regarding communications infrastructure, the gap is smaller, but still important. In 2003, the average number of both fixed and mobile lines in the analysed economies was about half than, for instance, in Bulgaria or Croatia. In terms of used resources, Serbia and Montenegro dedicated only 2.7% of GDP for public investment in 2004, while Bosnia and Herzegovina and Albania spent 6.4% and 5% of GDP, respectively for the same year. However, Albania is the country of the region with the highest density of roads, but only 39% of them are paved. With the lowest expenditure, Serbia and Montenegro count, with 59% of paved road, for a network three times longer than the Albanian one (although 10% less dense taking into account the country surface).

The telecommunications sector, a traditional indicator of infrastructure development, has in recent years suffered dramatic changes with the arrival of mobile phones that are to a large extent developed by private operators. In order to reflect this evolution, only data on fixed line networks is used to construct the performance indicator at the end of the chapter. Nevertheless, it is still interesting to observe the evolution and differences within this sector in the Western Balkans. Thus, in Albania in 1999 there were 3.7 fixed lines per 100 inhabitants and practically no mobiles. By 2004 fixed line subscriber numbers increased slightly to 7.6 but there were already 45 mobile phone subscribers per 100 inhabitants. One of the main reasons why mobile phone penetration is so much greater in some countries than in others is government policy. Those who have liberalized their telecoms markets, issuing mobile phone licenses to private operators, including international companies, and have ended state telecoms monopolies, like Montenegro, have seen relatively rapid mobile phone penetration (87% in 2005). Those that did not fully liberalise have seen relatively low penetration like the former Yugoslav Republic of Macedonia (54% in 2005) or Bosnia and Herzegovina (27.4% in 2004).

Public sector performance

Finally, in order to get a rough picture of the public sector efficiency in the analysed economies, a comparison is made between a composite index of public sector performance and the resources used for this purpose, i.e. core public spending as a percentage of GDP. The composite index



is constructed by aggregating the above-mentioned performance indicators for public administration, education, health and infrastructure, using the Western Balkan's aggregate performance as benchmark. Core public spending includes expenditures for administration, justice, internal and external security, basic education, health and infrastructure and was calculated as a residual after deducting from general government spending the items on social transfers, subsidies, cost of public debt and capital. The results point to large differences between the economies. Public sectors in Croatia, Bulgaria and Romania showed the best results, outweighing the Western Balkan's average by about 40%. However, in terms of used resources Romania spent only around 12.4% of GDP to obtain broadly similar results as Bulgaria and Croatia that spent 15.2 and 21.7% of GDP, respectively, pointing to potential efficiency reserves in the latter two countries. Serbia and Montenegro exceeded the benchmark performance by almost 25% and used almost the same amount of core spending as the Western Balkan's average. Public sector results in the former Yugoslav Republic of Macedonia and Bosnia and Herzegovina are only marginally better than the average. For this purpose, the former Yugoslav Republic of Macedonia spent 12.7% of GDP while Bosnia and Herzegovina allocated around 26% of GDP, probably being the worst performer in terms of public sector efficiency. In Albania, the index of public sector performance came out only slightly above 84% of the Western Balkan average, but this is largely explained by the reduced amount of core public spending – 11.7% of GDP.

6. TAXATION LEVELS

This section aims at providing a broad picture of the fiscal pressure in the analysed economies by looking at four main categories of taxes – income tax, corporate tax, value added tax (VAT) and social contributions of the labour force – both in terms of rates and revenues collected to the budget.

Judging from statutory rates, taxation of incomes appears to be lighter than in certain RAMS or EU-15 when we take into consideration the level of the top-bracket rates. The average top-bracket rate is around 25% in the analysed economies, thus much lower than in Croatia (45%), Slovenia (50%) or Hungary (40%), but higher than in Bulgaria (24%), Slovakia (19%) or Romania (16%). As the top brackets start at monthly incomes lower than EUR 500 in most analysed economies and the social contributions that are paid on salaries are on average higher than 40%, the total fiscal pressure on the labour is fairly burdensome. In combination with labour market rigidities this results in high levels of informal employment. For example, in Albania the top-bracket rate of 30% led to revenue collections of less than 1% of GDP in 2004, while in the Czech Republic around 9% of GDP was collected in revenues on the back of a 32% top marginal tax. Slovakia collected around 5.8% of GDP in revenues from the flat 19% income tax in 2004, while Bosnia and Herzegovina and Kosovo collected about half of this amount with a slightly higher tax arrangement. A similar situation occurs in the case of revenues collected from social contributions. While social contributions rates are only marginally higher in Croatia than in Serbia, the amounts collected to the budget are, in terms of percentage of GDP, by almost 3 percentage points higher. Again Albania stands out by collecting only 4.3% of GDP in revenues with a social contributions rate of almost 42%, which is about three times less effective than in the case of Slovenia.

The top marginal corporate profit tax averages around 16% in the economies and is in line with the rates applied in Bulgaria (15%), Hungary (16%), Romania (16%), Poland (19%) or Slovakia (19%). In Serbia (10%) and Montenegro (9%) the corporate tax rates are significantly lower than in Albania (20%) and the Federation of Bosnia and Herzegovina (30%). At the same time revenues collection from corporate profit tax represented only 0.6% of GDP in the Federation of Bosnia and Herzegovina, which is about half of the amount collected in Montenegro and one quarter of collections in Bulgaria.

Tax and social security rates (in %) and revenues (in % of GDP)

		Personal income tax	**Corporate income tax**	**Value Added Tax**	**Social contributions** employee	employer
Albania	Rates	5-30	20.0	20.0	11.2	30.7
	Revenues	0.9	2.1	8.1	4.3	
Bosnia and Herzegovina						
Federation BiH	Rates	10-25	30.0	17.0	32.0	11.5
	Revenues	1.8	0.6	11.1	16.0	
Rep. Srpska	Rates	22.0	10.0	17.0	40.0	12.0
	Revenues	3.4	0.5	13.2	13.8	
The former Yug. Rep. of Macedonia	Rates	15-24	15.0	18.0	0.0	32.0
	Revenues	3.9	n.a.	10.0	10.9	
Serbia	Rates	14-30	10.0	18.0	17.9	17.9
	Revenues	5.5	0.5	11.4	11.0	
Montenegro	Rates	15-23	9.0	17.0	18.0	20-42
	Revenues	4.2	1.1	10.3	11.2	
Kosovo (UN1244)	Rates	0-20	20.0	15.0	n.a.	
	Revenues	3.7	n.a.	11.0	n.a.	

The standard VAT rates vary from 15% in Kosovo to 20% in Albania. Reduced rates for certain items were used in several cases, such as Serbia and Montenegro or Bosnia and Herzegovina. As for many Member States, VAT collection represents the most important item on the revenue side of the state budgets, but again high rates are not always a guarantee for large collections. In 2004 Albania collected revenues of around 8% of GDP with a 20% VAT rate, while the former Yugoslav Republic of Macedonia collected more than 13% of GDP in budget revenues with a 17% VAT rate. Since 1 January 2006, Bosnia and Herzegovina have harmonised the VAT rate to 17% for all goods and services and over all its territory and centralised VAT collection.

7. CONCLUSIONS

A significant difference between the analysed economies in the Western Balkans and Bulgaria or Romania consists in the much lower investment ratios recorded in the former, as a result of more pronounced weaknesses in business environments, low levels of domestic savings and poor public sector performance. The meagre participation rates to the labour force and the existence of very high informal and formal unemployment rates also restrain growth. Governments in the economies can better contribute to the acceleration of economic growth by developing business environments fostering investment and entrepreneurship in order to become more attractive destinations for foreign direct investment that triggers productivity increases.

In countries like Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia or Serbia and Montenegro, the private sector's contribution to output is relatively limited, the sector of inefficient state-owned enterprises is still large, the share of unproductive public spending relative to GDP is important, and taxation levels are significant. Public sector spending is concentrated on redistributive functions -social transfers and subsidies to the corporate sector –which are significantly higher in GDP percentage terms than in the faster growing economies, whereas the performance of the public sector in terms of providing adequate administrative, education, health and infrastructure services in the economies fares much worse than in the EU-25 or in Bulgaria, Romania or Croatia. It follows that the real challenge for the Western Balkans is to increase the efficiency of their public sectors with existing resources or to reallocate resources towards core activities and capital formation. They should also reduce the tax burden and try to broaden the tax base in the sectors where it results in a large share of informal activities and tax avoidance.

The best economic performer over the period 2000-2005 was Albania. This appears to be the result of accelerating the implementation of structural reforms and limiting the amount of inefficient resource allocation in the public sector. The relatively moderate public spending-to-GDP results mainly from restrained redistributive spending in the form of social transfers and corporate subsidies. Core public spending is on the low side, but the public sector performance is inadequate, Albania ranking the lowest in the group. By increasing the efficiency of the public sector and the allocation of resources to core public spending, Albania could create a business environment more conducive to growth. Improved economic performance and more effectively targeted public spending should allow Albania gradually strengthen its social safety net.

III. REGULATORY POLICIES AND ECONOMIC GROWTH IN TRANSITION ECONOMIES

SUMMARY

This chapter evaluates the quantitative impact of regulatory policy on the growth rate of GDP per capita in purchasing power terms of 14 central, eastern and south-eastern European transition economies, all of which were faced with the task of setting regulatory policies in such a way as to facilitate a speedy transition from socialism to market capitalism and eventual EU accession. The study is based on the 10 subcategories of the Index of Economic Freedom which is published annually by the *Heritage Foundation* and the *Wall Street Journal* since 1995. The regression results indicate that i) only two of the 10 policy variables are statistically significant in explaining growth of GDP per capita, and ii) that fiscal burden of government correlates negatively with income growth, while the degree of inflation over the past ten years correlates positively with it, albeit at a lower statistical significance level and without suggesting a causal relationship. Also gross fixed capital formation is found to play a significant role on explaining growth.

1. INTRODUCTION

Endogenous growth theory argues that policy measures can have an impact on the long-run growth rate of an economy, even if they do not change the aggregate savings rate. In addition, findings of the new empirical growth literature suggest that economic development is to a large extent determined by a country's regulatory policies in the economic sphere[15]. This is in support of the an economic view, which emphasises the role of secure property rights, enforcement of contracts, the operation of the court system to resolve disputes, but also the absence of excessive government intervention, access to stable money, freedom to trade internationally, sensible business regulation as well as a sound financial system and absence of corruption as the foundations for the smooth and efficient operation of a market economy[16]. Other economic schools[17] emphasis in addition to those factors just mentioned e strong anti-trust and competition legislation, a high degree of market transparency and minimal hurdles for market entry and exit. These priorities are also reflected in pro-market policy advice by Washington-based institutions and form the core of what became known as the *Washington consensus*[18].

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[15] For a survey of the new empirical growth literature see Dulauf, S. and D. Quah: *The new Empirics of Economic Growth*, in *Handbook of Macroeconomics*, edited by J. Taylor and M. Woodford, Amsterdam, 1999.

[16] Chapter 2 of this document gives an overview on some key elements of government action to economic growth in the region.

[17] In particular ordoliberalism, which is also known as German neoliberalism in Anglo-Saxon countries, emphasises the role of *Ordnungspolitik* as the foundation for the functioning of a market economy. According to Ordoliberalism, the state must create a proper legal environment for the economy and maintain a healthy level of competition through measures that adhere to market principles.

[18] The term *Washington Consensus* refers to policy recommendations which were seen in the 1990s as consensus among the US Congress and Administration on one side and the IMF, Wold Bank and Washington-based think tanks on the other side. They include fiscal discipline, redirecting public expenditure, tax reform, financial liberalisation, a single competitive exchange rate, trade liberalisation, elimination of barriers to FDI, privatising state-owned enterprises, deregulating market

This chapter tries to evaluate the impact of specific regulatory policy areas on the growth rate of GDP per capita in purchasing power terms, following the approach of cross-country empirical growth research[19]. The focus will be on 14 central, eastern and south-eastern European transition economies[20]. All of these were faced with the similar task of setting regulatory policies in a way to facilitate a speedy transition from socialism to market capitalism and eventual EU accession. With the focus on a group of countries that have been faced with a similar challenge, we aim to reduce the problem of country heterogeneity, which has tended to plague large multi-country growth regressions[21].

To reduce the risk of spurious regression results we embed our analysis in a simple neoclassical growth framework, with fixed capital formation and population growth as structural exogenous variables. In addition, we evaluate the robustness of the regression results to variations in the set of exogenous variables, since fragile results have been identified as a main short coming of cross-country growth regressions[22].

2. THE DATA

This study is based on the Index of Economic Freedom which is published annually since 1995 by the *Heritage Foundation* and the *Wall Street Journal*[23]. It currently covers 161 countries in 10 subcomponents of regulatory policy, each variable score ranging from 1 for the least regulated economy to 5 for the most densely regulated environment. The available data cover the period from 1994 to 2005. This data set was used as it provides for the most comprehensive coverage of European transition economies, both in terms of number of countries and length of time series[24].

The 10 subcomponents of the index can be interpreted as proxies for specific regulatory policy areas and will be used in this study as exogenous variables. They include measures for trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investments, banking and finance, wages and prices, property rights, regulation, and informal market activity. In addition to these variables, variables for fixed capital formation and population growth are included as elements of a neoclassical growth framework and a dummy variable is added to control for EU-candidacy status.

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entry and competition and ensuring secure property rights. For an overview see Williamson, John, *What should the World Bank think about the Washington Consensus?* The World Bank Research Observer, vol. 15, no. 2 (August 2000), pp. 251–64

19 For an overview of empirical growth research see IMF, *World Economic Outlook 2003,* chapter 3.

20 The chapter includes the EU Member States Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, the acceding countries Bulgaria and Romania, the candidate countries Croatia and the former Yugoslav Republic of Macedonia, and the potential candidate countries Albania and Bosnia and Herzegovina. Serbia and Montenegro could not be included due to lack of data.

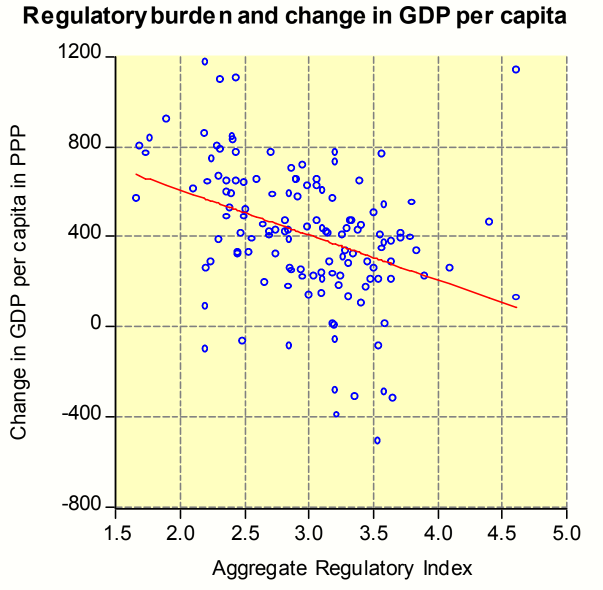
21 For a further discussion of country heterogeneity see Durlauf, Steven N., *Policy Evaluation and Empirical Growth Research*, in: *Economic Growth: Sources, Trends, and Cycles*, edited by Norman Loayza and Raimundo Soto, Santiago de Chile, 2002.

22 See Levine, Ross and David Renelt, Cross-Country Studies of Growth and Policy: Methodological, Conceptual, and Statistical Problems, World Bank Working Paper, March 1991 (1991).

23 Miles, Marc A. et al: *2006 Index of Economic Freedom*, Washington DC, 2006

24 There exist other indicators, including those of the EBRD, which cover a similar range of issues.

To allow for a large as possible number of observations we have opted for a cross-section time-series regression, under which the time series of a country's variables are pooled with cross-section equivalents of other countries. This approach raises the number of data points to a maximum of 168 (12 observations for 14 countries). However, the effective number is slightly smaller due to some missing data points.



The chart to the right shows a negative relation between a country's aggregated regulatory index score and its change in GDP-per capita in purchasing power parity terms, lending support to the hypothesis that the degree of regulation matters for changes in income.[25] Although one could argue that endogeneity may play a role here in the sense that higher rates of income growth may cause an improvement in the regulatory environment and not vice-versa. A causality test would provide some indication in this respect, but due to the rather short time series such a test does not yield meaningful results. A discussion of the risk of multicollinearity between exogenous variables follows in section 5.

Endogenous variable

For the purpose of this study we define economic development as the first difference of logs of GDP per capita in purchasing-power terms in US dollar.

Structural exogenous variables

In the spirit of a neoclassical growth framework we add gross fixed capital formation as a percentage of GDP and annual population growth to the set of exogenous variables.

Regulatory exogenous variables

As discussed above, this study uses the score of ten subcomponents of the *Index of Economic Freedom* as proxies for regulatory policies[26].

- *Trade policy*: The trade policy score is based on a country's trade-weighted average tariff rate. A country with a weighted average tariff rate of below 2.5% receives a score of 1, the best available. In contrast, a country with a weighted average tariff rate of above 20% receives the worst score of 5.

[25] Keep in mind that a low index score corresponds to less regulatory burden and vice versa, resulting in a negative slop of the regression equation.

[26] For additional methodological information see Miles, 2006

- *Fiscal burden of government*: The score for the fiscal burden of government has three components: the top marginal income tax rate, the top marginal corporate tax rate and the year-to-year change in government expenditures as a share of GDP.

- *Government intervention*: Government intervention is measured by three variables: government consumption in percent of GDP, government ownership of businesses and industries, share of government revenues from state-owned enterprises and government ownership of property, and economic output produced by the government.

- *Monetary policy*: This factor's score is based on a country's weighted average of annual inflation from 1995 to 2004, with declining weights for observations further in the past.

- *Capital flows and foreign investment*: The score of this factor is based on the assessment of each country's policies towards foreign investment. Questions examined include whether there is a foreign investment code that defines the country's investment laws and procedure; whether the government encourages foreign investment through fair and equal treatments of investors; whether there are restrictions on access for foreign exchange; whether foreign firms are treated the same as domestic firms under the law; whether the government imposes restrictions on payments, transfers and capital account transactions; and whether specific industries are closed to foreign investment.

- *Banking and finance*: This factor measures the relative openness of a country's banking and financial system. It is scored by determining whether foreign banks and financial services firms are able to operate freely, and the degrees of difficulty to open banks and other financial services firms, of regulation of the financial system, of the presence of state-owned banks, of the government influence in the allocation of credit, and whether banks are free to provide customers with insurance and invest in securities.

- *Wages and prices*: The score for this factor is based on the extent to which a government allows the market to set wages and prices. Specifically, it looks at the degree of prices administration and whether the government has a minimum wage policy or otherwise influences wages. The factor's scale measures the relative degree of government control over wages and prices. A score of 1 represents wages and prices that are set almost completely by the market, whereas a score of 5 means that wages and prices are set almost complexly by the government.

- *Property rights*: This factor scores the degree to which a country's laws protect private property rights and the degree to which its government enforces these laws. It also assesses the likelihood that private property will be expropriated and analyzes the independence of the judiciary, the existence of corruption within the judiciary and the ability of individuals and businesses to enforce contracts.

- *Regulation*: This factor measures the relative easiness of opening and operating a business. It also examines the degree of corruption of government and whether regulations are applied uniformly to all businesses. Another consideration is whether the country has a planning agency that set production limits and quotas. A score of 1 indicates that corruption is virtually nonexistent and regulations are minimal and applied uniformly, whereas a score of 5 indicates that corruption is widespread, regulation are applied randomly and the general level of regulation is very high.

- *Informal economy*: This factor relies on Transparency International's Corruption Perceptions Index, which measures the level of corruption in 146 countries, to determine the informal market scores of countries that are also listed in the Index of Economic Freedom.

Dummy variable for EU candidacy status

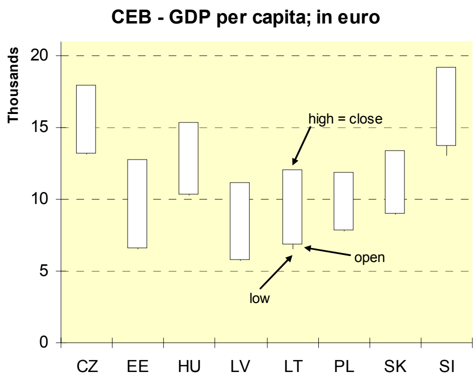
The process of EU-rapprochement typically comprises several steps. At the beginning stands the recognition as a potential EU candidate country for some undetermined future date. This is normally followed by the negotiation of a Europe Agreement or Stabilisation and Association Agreement, which already attempt some alignment of the country to EU standards. As a country progresses sufficiently towards meeting the Copenhagen criteria[27] it is eventually granted EU candidacy status. At that point a country has reached a critical mass in EU approximation. To capture any effect related to this, we include a dummy variable for EU candidacy status.

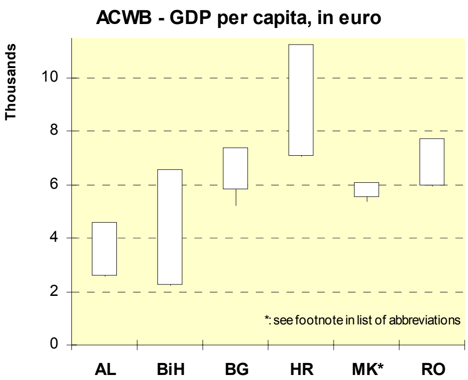
3. HISTORICAL TRENDS OF MODEL VARIABLES

Before formally specifying and estimating the econometric relationship between economic developments and regulatory policy we report in the following section a few stylised observations of the model variables historical pattern, using what is known as Japanese candle sticks or open-high-low-close charts[28]. A comparison between EU Member States of Central and Eastern Europe and the Baltic countries (CEB) on one side and acceding and other Western Balkan countries (ACWB) on the other side, helps to identify and benchmark developments in different policy areas.

Economic development

In raising GDP per capita, the Baltic countries performed strongest among the CEB. While starting from a relatively low level, GDP per capita nearly doubled in Estonia, Latvia and Lithuania between 1994 and 2004. However in 2004, Slovenia, the Czech Republic and Hungary rank highest.





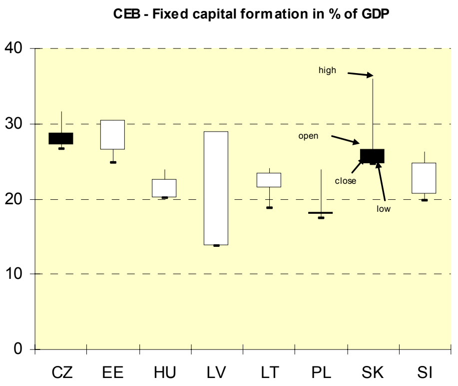
[27] The European Council of June 1993 concluded that "*Membership requires that the candidate country has achieved ... the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union*".

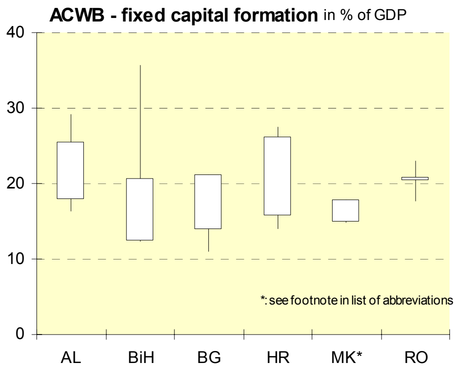
[28] An open-high-low-close chart helps visualising the development of a variable over time. The top and bottom of the thin vertical line, drawn through the black or white bar, indicate the highest and lowest value of a variable within a time period under consideration, respectively. The colour of a bar reveals information on whether the value of a variable has been increasing or decreasing during the time period. A white bar indicates an increase in the value of a variable, as the closing value of the variable is greater than its opening value. A black bar shows a decline of a variable, as its closing value is lower than its opening value.

Among the ACWB, GDP per capita grew most strongly in Bosnia and Herzegovina (by 195%), Albania (79%) and Croatia (59%). Bulgaria and Romania gained both about 30%, while income in the former Yugoslav Republic of Macedonia grew by a mere 10% between 1994 and 2004.

Fixed capital formation

Fixed capital formation has been increasing in most CEB countries. In Slovakia, investments as a percentage of GDP have been rising from 26.5% in 1994 to 36% in 1998 but declined to 25% in 2004. A similar pattern, of an initial increase followed by a decline, can be observed for Poland and the Czech Republic. In Latvia, fixed capital formation almost doubled during the time period under consideration, albeit from a relatively low level of only 15% of GDP in 1994. In 2004, Latvia had the second highest investment-to-GDP ratio among the CEB countries, only second to Estonia.

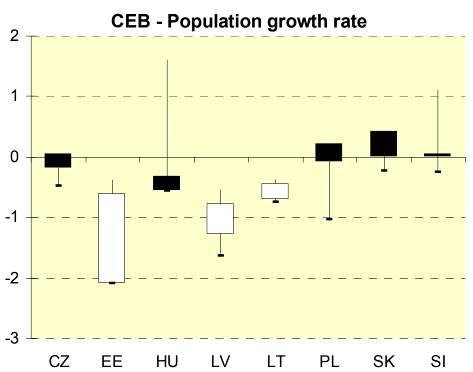


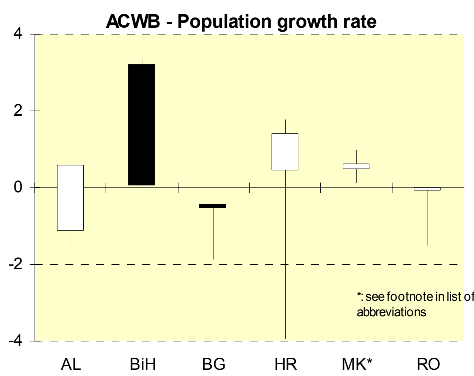


In 2004, Croatia's and Albania's fixed capital formation stood at 26% and 25% of GDP, respectively, putting them in the lead among the ACWB countries and even higher than the laggards of the CEB. Over time, countries of this group have raised their investment ratios substantially, with the exception of Romania.

Population growth

Population developments have been volatile in most countries of the region during 1994 and 2004 and broad trends area difficult to identify. Military conflict and political and economic uncertainty have often played a role in determine migration trends. All countries of the CEB were faced with shrinking or at best unchanged populations in 2004.

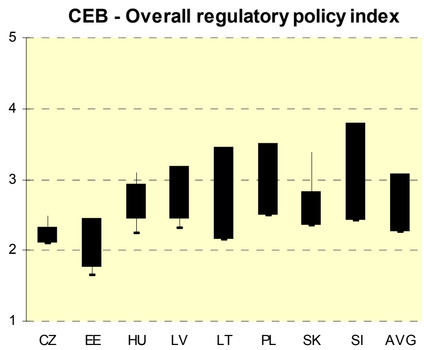


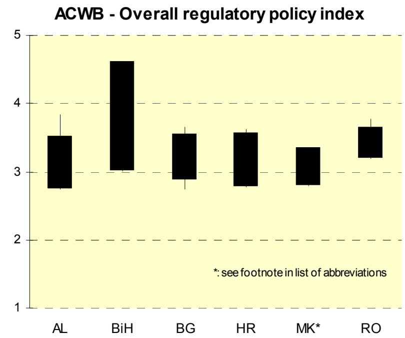


Among all European transition economies only Croatia, the former Yugoslav Republic of Macedonia and Albania had positive population growth rates in 2004. However, most countries managed to turn around any negative trends of the 1990s. For those countries which had experienced strong population growth at that time, like Bosnia and Herzegovina, Slovenia and Hungary, developments have normalised by 2004.

Overall regulatory policy index

Between 1994 and 2005, the overall regulatory score has improved for all countries. While the ACWB started at a higher regulatory burden than the CEB the average degree of improvement between 1994 and 2005 was about the same for both groups.[29]



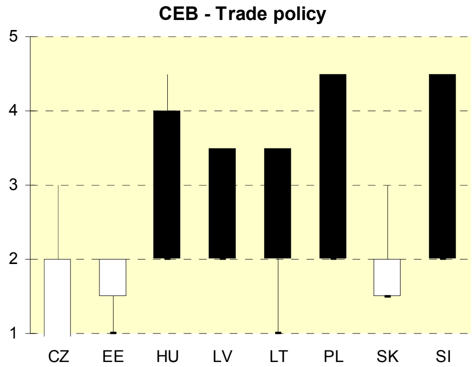


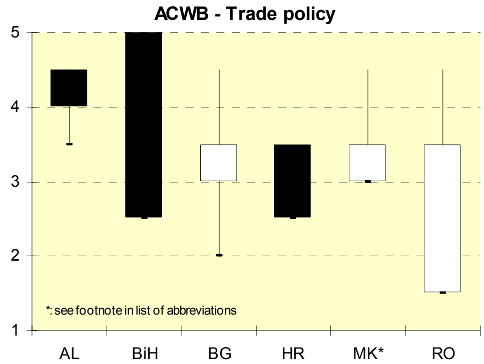
For the CEB, improvements were boldest between 1998 and 2000, around the time when they were granted EU-candidacy status. Since 2001, improvements in the average index score for this group of countries continued, but at a lower pace. This pattern of an improved reform effort around the date of receiving EU-candidacy status is not observed for Bulgaria and Romania, which both became candidate countries in 2000. In fact, in the case of Romanian, reform progress, in terms of the index level, stalled or backtracked between 2000 and 2001, but resumed more vigorously in 2004 and 2005. Of all ACWB countries, Bosnia and Herzegovina improved most, albeit from an extremely poor, post-conflict related, index score.

Trade policy

Related to EU accession, the trade policy scores for the CEB have converged at a score 2.

[29] Between 1994 and 2005, the score for both the ACWB and CEB declined by 0.8, to 2.3 and 2.9, respectively.



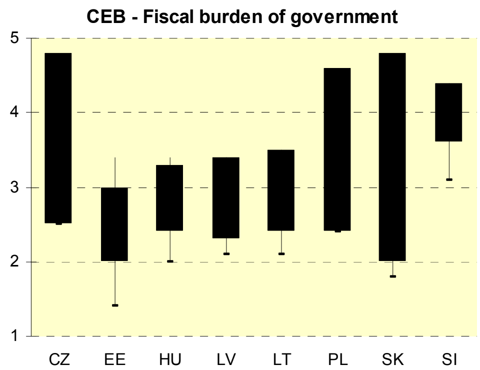


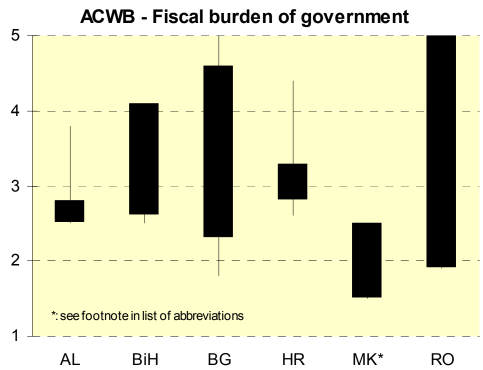
While this was a substantial improvement for those countries, which had average tariffs above the common EU level, it has also led to an increase in average tariffs for those countries, which had a more liberal trade regime prior to EU accession.

The trade scores for the ACW countries remained less favourable compared to the CEB. While Bosnia and Herzegovina improved substantially in this area, for the above mentioned reason, the average score in 2005 for this group of countries was 3.25, substantially worst than for the CEB. It is worth noting that a number of ACWB countries had more liberal trade regimes in 1994 than most CEBs.

Fiscal burden of government

The index score in this area, which is a reflection of a country's degree of taxation, has improved substantially for most CEB countries and reached a more uniform level across all countries. While Estonia and Slovakia perform best in this category, partly due to their low effective tax rates, Slovenia lags in this category.

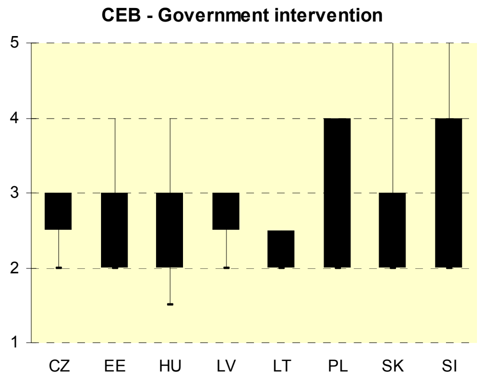


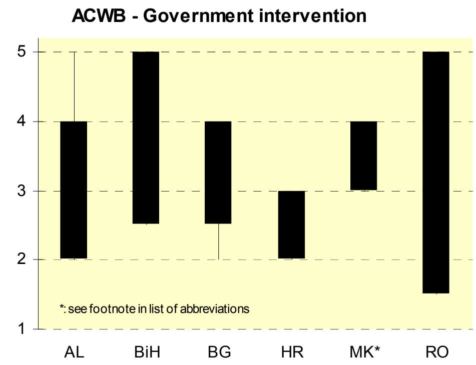


The picture is less homogenous for the ACWB countries, among which Romania has improved most, largely due to the bold tax reform of 2005. Progress in Albania has been comparatively low. However since it started from a relatively low level of taxation, the scope for a further improvement was limited. Within the ACWB countries, the former Yugoslav Republic of Macedonia scored best, in contrast to Croatia, which had the highest level of taxation.

Government intervention

Most countries of the CEB have improved their score for government intervention and reached a score of 2 in 2005, while only the Czech Republic and Latvia had a slightly less favourable score of 2.5.



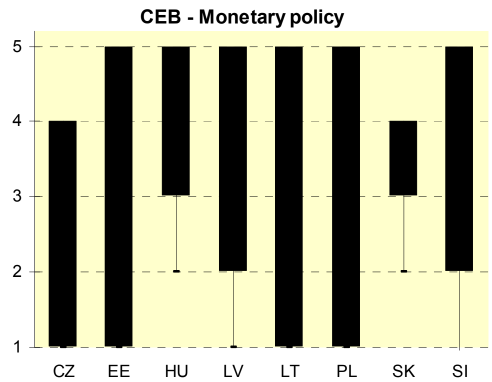


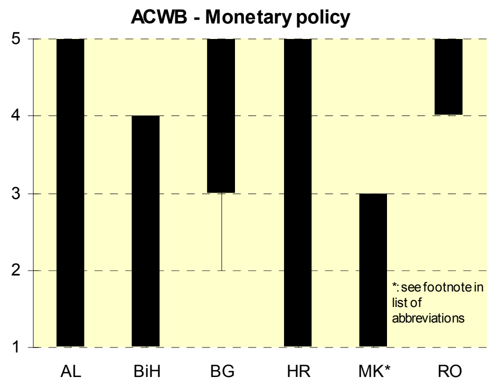
Slovenia and Slovakia, both of which had scored poorly during the late 1990s, have strongly reduced government intervention in the economy by 2005.

Among the ACWB countries, Albania, Bosnia and Herzegovina and Romania stand out as having substantially reduced government intervention between 1994 and 2005. Among all European transition economies Romania performed best, having a score of 5 in 1994, reflecting a very high level of government intervention, and reaching the lowest score of all countries under consideration in 2005.

Monetary policy

All countries have made substantial progress in achieving price stability. Among the CEB, Hungary and Slovakia are the laggards, followed by Latvia and Slovenia.





Among the ACWB, progress has also been remarkable, while Bulgaria and in particular Romanian are still critically away from a low inflation environment.

4. The Econometric Model

Data issues

Data are available for a period of 1994 and 2005 allowing for 12 data points for each country. This is clearly not sufficient to allow for a country-by-country time-series analysis with 13 exogenous variables. We therefore use pooled time-series, cross-sectional which raises the number of available data points to 131. To estimate the regression coefficients we use pooled least square methods and allow for seemingly unrelated standard errors and covariance between cross-sections to account for possible heteroskedasticity.

Model specification

The general regression model is

$$Y_{it} = \alpha + X_{it}'\beta_{it} + \delta_i + \varepsilon_{it}$$

where Y_{it} is the endogenous variable, X_{it} is the k-vector of regressors and ε_{it} are the error terms for $i = 1, 2, \ldots, M$ cross-sectional units observed for dated period $t = 1, 2, \ldots, T$.

The α-parameter represents the overall constant in the model, while the δ_i represents cross-section specific effects.

5. Regression Results

Two of the ten exogenous policy variables (for fiscal burden of government and capital flows and foreign investment) are significant at the 5% level and their coefficients have the expected minus sign (see table below).

One variable (monetary policy) is significant at the 10% level, however the sign of the coefficient is positive. Fixed capital formation and population growth are significant at the 1% and 5% level, respectively. The coefficient for population growth features a negative sign, which could be explained by the fact that the endogenous variable is expressed in per-capita terms.

Table 1: Results first round

Exogenous variable	Coefficient estimate	t-statistic	Level of signifi-cance [30]
Trade policy	0.008	1.314	-
Fiscal burden	-0.017	-2.445	**
Government intervention	0.008	1.229	-
Monetary policy	0.008	1.686	*
Capital flows/ foreign investment	-0.018	-2.214	**
Banking and finance	0.002	0.239	-
Wages and prices	-0.000	-0.025	-
Property rights	0.014	1.123	-
Regulation	-0.003	-0.271	-
Informal economy	-0.045	-1.092	-
Fixed capital formation	0.006	3.013	***
Population growth	-0.009	-2.108	**
EU candidacy status	0.015	1.444	-

R^2: 0.432 F-stat.: 3.052 Schwarz criterion: -3.124

[30] *, ** and *** indicate significance levels of 10%, 5% and 1%, respectively.

In a second round, we eliminated the insignificant variables and re-estimated the regression equation. While the significance of the variables for fiscal burden and monetary policy has thereby improved, the variable for capital flows and foreign investment has become insignificant.

Table 2: Results second round

Exogenous variable	Coefficient estimate	t-statistic	Level of signi-ficance
Fiscal burden	-0.02	-3.378	***
Monetary policy	0.009	2.646	**
Capital flows/ foreign investment	-0.007	-1.063	-
Fixed capital formation	0.006	3.393	***
Population growth	-0.008	-1.828	*
R^2: 0.386	F-stat.: 3.052	Schwarz criterion: -3.343	

In a third round, we again eliminated the insignificant variables of the second round and re-estimated the regression coefficients. The final results show 1% significance for the exogenous policy variable of fiscal burden of government and fixed capital formation. The monetary policy variable, albeit with a, counterintuitive, positive coefficient sign, and population growth are significant at the 10% level.

Table 3: Results third round

Exogenous variable	Coefficient estimate	t-statistic	Level of signi-ficance
Fiscal burden	-0.02	-3.20	***
Monetary policy	0.008	2.619	**
Fixed capital formation	0.006	3.36	***
Population growth	-0.008	-1.839	*
R^2: 0.382	F-stat.: 4.116	Schwarz criterion: -3.374	

These results are striking in a number of ways: only two of the ten policy variables are statistically significant in explaining growth of GDP per capita. However, the results indicate that the variable measuring the fiscal burden relates negatively to income growth and, albeit at lower empirical strength, that inflation correlates positively with it.

One might, however, keep in mind when interpreting the results, the exact definition of these variables. In particular "fiscal burden", as laid out above, is the result of the top marginal income and corporate tax rates and the year-to-year change in government expenditures relative to GDP. Hence this variable is a combination of level factors (the tax rates) and changes. Furthermore, the correlation might not necessarily signal causality. It could also simply be a result of the automatic stabilisers, which lead, under higher growth to a slowdown of public expenditures relative to GDP and vice versa. Fixed capital formation strengthens income per capita while population growth does not. The result on the positive impact of investment on growth is intuitive and compatible with most findings on economic growth. The absence of a positive impact of population growth is more difficult to motivate. The rather counterintuitive sign of the coefficient estimate for the monetary policy variable might be partly explained by the specification of the variable, a moving average of inflation over previous years, together with the specifics of the sample, in which some countries in early transition exhibited high inflation followed by, sometimes, after a stabilisation crisis, an acceleration of growth. None of the other regulatory policy variables as well as EU candidacy status seem to be relevant in explaining developments of GDP per capita.

Assessing collinearity

In other empirical cross-country studies, it has often been the case that variables measuring market-friendly institutions tend to be strongly collinear.[31] In our analysis, coefficient estimates have remained robust as variables have been sequentially eliminated from the regression specification. In addition, significance levels of coefficients, at least for those which have survived earlier elimination rounds, and R^2 levels have remained stable in all three regressions. In addition, joint significance, as measured by R^2, was not extremely high.

We can not fully exclude that some degree of collinearity between endogenous variables might have caused the elimination of variables which otherwise would have shown higher significance. However, we are for the above-mentioned reasons somewhat reassured that the final specification of the third regression round has in fact produced robust results.

6. CONCLUSIONS

Following the approach of empirical growth research, we analysed the impact of ten regulatory policy variables, as approximated by subcomponents of the Index of Economic Freedom, on income for 14 European transition economies between 1994 and 2005. Given the small sample size and the many structural breaks these countries encountered in their transition, significant results are limited, and these should be interpreted with some caution. Nevertheless, the cross-country growth regression found that the composite variable capturing the fiscal burden of government, as defined in this approach, correlates negatively to income growth. Also, the volume of gross fixed capital formation shows in this setting a significantly positive influence on growth, while the degree of inflation over the past ten years correlates positively to it, albeit at a lower statistical significance level and without suggesting a causal relationship. All other regulatory policy variables were insignificant in explaining growth of GDP per capita.

[31] Endogenous variables are considered collinear when their measured values are too highly inter-correlated to allow for precise analysis of their individual effect on the exogenous variable. When regressors are highly correlated, small changes in the data often result in wide swings in parameter estimates. In addition, coefficients may have very high standard errors and low significance levels in spite of the fact that they are jointly highly significant and the R2 in the regression is quite high.

IV. EXPORT-LED GROWTH IN SOUTH-EASTERN EUROPE?

SUMMARY

The chapter looks at the potential for an export-led growth strategy in South-Eastern Europe. In economic terms, the region is relatively small, especially once the two largest economies of this area, Bulgaria and Romania, will have joined the EU. Economic integration in South-Eastern Europe still follows largely historic patterns, with relatively low integration between the 3 sub-regions of the area: (1) Albania, (2) former Yugoslavia and (3) the former CMEA countries Bulgaria and Romania. However, the conclusion of bilateral free trade agreements, which entered into force by 2000, seems to have promoted intra-regional trade.

Due to the limited size of the Western Balkan, the biggest potential for export-led growth probably lies in the populated catching-up economies in the immediate neighbourhood, such as Romania or Turkey, or in the deep markets of the European Union. However, the experience of the recently acceded Member States points to the importance of locking the export-driven value added into the region, for example by trying to maximise the integration of local or regional producers into the production chain. In this context, the creation of a regional free trade zone (CEFTA 2006) is an important element for maximising the regional benefit of the increasing integration of this region into the global economy.

1. INTRODUCTION

After the fall of the iron curtain, the perspective of EU accession proved to be an effective tool for fostering a peaceful transformation and for accelerating structural reforms in the so-called "transition economies", enabling those countries to enter a catching-up process towards “European” income levels.

In the Western Balkan the starting point for such an EU oriented stabilisation process is more complex, as the dissolution of the main economic and political entity in the region, the former Socialist Republic of Yugoslavia (SFRY) was accompanied by ethnic violence and bloodshed. As a result, economic integration in the region of South-East Europe has been strongly distorted by institutional and historic factors. Economic integration could prove to be an important tool towards political and economic stabilisation.

So far, the economic catching-up process was relatively slow in most countries of South-Eastern Europe. Especially in the Western Balkan area, which is still further away from EU membership, economic growth seems to be less dynamic than in comparable countries. In this context, the following chapter tries to look at the role of trade in the region's catching-up process. First, some key characteristics of trade in this region are described; second, the chapter tries to draw lessons from the experience of the New Member States, especially with respect to the role of trade for the convergence process of the 8 transition economies among the new Member States; and third, it attempts to provide some quantitative background for the question, whether better economic integration of South-Eastern Europe could foster export-driven economic growth in the region.

By their very nature, trade issues have to be regarded in a regionally broader context. Thus, this chapter looks at the whole region of South-Eastern Europe. However, the main focus of this chapter will be the "Western Balkans" (or SEE-5) only, including nearly all successor states of the former SFRY[32] and Albania. Besides the "Western Balkans", the region of South-Eastern Europe encompasses the "Eastern Balkans" (Bulgaria and Romania) and Moldova[33]. For the sake of simplicity, those countries will also be called SEE-8 countries.

2. MAIN FEATURES OF THE ECONOMIES IN SOUTH-EASTERN EUROPE

Historic background

The economic and political history of the region of the South-Eastern Europe (SEE-8) is a very complex one. From the end of the 17th century to the end of the 19th century, the region was split between two political and economic gravity zones, with the northern section of this region[34] being part the Habsburg empire, while the southern part[35] was integrated into the Ottoman empire. This bi-polar orientation changed only in the late 19th and early 20th century, with the establishment of multi-ethnic "national states". After the second World War the division of the region became even more pronounced, with the creation of the 3 different groupings: (1) the "Socialist Federal Republic of Yugoslavia" (SFRY), (2) Albania, and (3) Bulgaria and Romania, 2 officially independent countries but in practise strongly oriented towards the Soviet Union. Economic integration between these 3 economic entities has been relatively low, with Romania[36] and especially Bulgaria strongly oriented towards the CMEA trading block and Albania being the most closed economy in Europe. Former Yugoslavia appears to have been the only economic entity with a relatively high degree of openness for international trade. At the same time, intra-SFRY trade played an important role until the dissolution of the SFRY, with intra-republican trade accounting for nearly the same amount as exports abroad[37]. However, with an intra-trade share of about 50% to total trade, the degree of economic integration within former Yugoslavia appears to have been lower than in the European Union, where intra-trade accounts for more than 60% of total trade (Kaminski, 2003: p 25, European Commision, 2006, pp 51).

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[32] Slovenia as EU member state is not taken into account in this grouping, despite still significant trade links of this country with the region.

[33] In the context of the Stability Pact, the concept of SEE-8 usually refers to all signatory states of the "Memorandum of Understanding on Trade Facilitation and Liberalisation", which means including Moldova and excluding Slovenia.

[34] Slovenia, Croatia, Romania

[35] Bosnia and Herzegovina, Serbia and Montenegro, Albania, Bulgaria

[36] In 1989, Romania exported only 3.2% of its exports to the SEE region (Albania, Bulgaria and the SFRY). Imports from this region accounted for only 4.4% of its total imports. In the case of the SFRY Romania, export and import shares to and from the SEE region were 2.1% and 2.2% only. Bulgarian exported 13.4% of its commodities to the SEE region, while importing only 6.5% (Uvalic, 2005, p.4).

[37] For example, in 1987, the last year for which intra-Yugoslavian trade data exist, exports between the various republics of the SFRY ranged between 13-29% of the Gross Material Product (GMP), while exports abroad ranged between 11-22% of GMP. Thus, within the SFRY, the "home market" appears to have played an important role, although sometimes as a second-best alternative, for commodities which could not be exported abroad (Uvalic, 2005).

With the breakdown of the Soviet Union in 1991 and the disintegration of Yugoslavia during the first half of the 1990s, traditional trade and production links were interrupted and new possibilities of economic integration started to emerge. The decade of the 1990s was dominated by the increasing orientation of some countries of the SEE-8 region towards the EU on the one hand, and a sharp economic disintegration of former Yugoslavia on the other hand. During the first half of the 1990s, Albania, Bulgaria and Romania managed to benefit from trade facilitation measures and technical and financial assistance offered by the G24 group in general and the EU in particular. Albania signed a Trade and Economic Cooperation Agreement with the EU in 1992, while Bulgaria and Romania signed an Association Agreement with the EU in 1993 and applied for membership in 1995. In the case of the former SFRY, the violent disintegration led to a breakdown of economic links between the federal republics and to international trade sanctions from abroad. Slovenia and Croatia were the first countries to leave the SFRY and to apply for EU membership. However, despite the severe disruptions and distortions of trade during the 1990s, a number of studies[38] point to a certain degree of economic integration that has survived.

Attempts to revive economic integration of this region only gained momentum after the end of the Kosovo war with the creation of the Stability Pact for South-Eastern Europe in 1999. In parallel with the Stability Pact, a Stabilisation and Association Process (Sap) was initiated, in which Stabilisation and Association Agreements (SAA) are a key element. Those agreements contain a substantial trade liberalisation component and became the core instrument to integrate the countries of the region with the EU. Those SAAs go markedly beyond free trade issues, as they also contain important areas of acquis alignment, such as introducing common standards in the area of public procurement, competition, etc. So far, the former Yugoslav Republic of Macedonia, Croatia and Albania have signed those agreements, which contain explicit provisions for future EU membership. The remaining countries of the region (Serbia, Montenegro and Bosnia-Herzegovina) have started to negotiate those agreements.

Another important development in the context of regional integration has been the accession of the countries of South-Eastern Europe to a regional free trade agreement, the CEFTA 2006. This free trade agreement is expected to start operating in January 2007 and could significantly strengthen the region's economic dynamics and attractiveness for foreign investors.

Economic characteristics of the economies in this region

The region of South-Eastern Europe (SEE-8) consists of a population of 55 million and accounts for an aggregate GDP of about € 190 bn (see table 1). This compares roughly with the population of Italy and the GDP of Portugal, at current prices. Most countries of the region are relatively small. Within the Western Balkan (SEE-5) country group, nearly half of the output is generated in Croatia (some € 30 bn in 2004, compared to some € 18 bn in Serbia and Montenegro and some € 4-6 bn in each of the remaining economies). In terms of population, Serbia is clearly the biggest country in this group, with a population of around 7.5 million. The remaining countries are relatively small, with a population size ranging between 0.6 to 4 million.

[38] Uvalic (2005), De Sousa and Lamotte (2005), Lamotte (2005), Damijan et al (2006)

Per-capita income and trade volume

The region is characterised by significant per-capita income differentials. Slovenia and Croatia have the highest per-capita incomes in the region (80% and 47% of EU-25 in PPP), while in Bosnia-Herzegovina (BiH) and Serbia per-capita incomes account for around 30% of the EU-25 average (in PPS). In the former Yugoslav Republic of Macedonia, estimates are at around about 25% of the EU-25 average in PPS, while in Albania income levels are estimated to be at around 20% of the EU-25 average.

Table 1: Key economic and trade data

	Population	**GDP**				**Trade**		
	mio. Persons	total EUR billion	per capita 1000 EUR	per capita EU-25 = 100 nom.	PPS	Exports EUR billion	Imports	Trade ratio[1]
Albania	3.2	5.4	1.7	7.2	20.0	0.6	2.3	31.9
Bosnia and Herzegovina	4.0	6.0	1.5	6.4	30.0	1.6	1.9	85.0
Croatia	4.4	29.7	6.8	28.9	46.6	8.0	16.6	51.6
The former Yugoslav Republic of Macedonia	2.0	4.3	2.2	9.2	25.0	1.7	2.9	47.5
Serbia	9.5	17.3	1.8	7.8	30.0	3.8	11.1	34.0
Montenegro	0.7	1.7	2.4	10.4		0.5	0.9	82.4
Total SEE-5	**23.1**	**62.7**	**2.7**	**11.6**	**36.7**	**15.7**	**34.8**	**80.6**
Bulgaria	7.8	21.3	2.7	11.7	31.8	9.9	14.5	63.6
Romania	21.6	78.1	3.6	15.5	32.5	23.5	32.7	41.8
Slovenia	2.0	27.8	13.9	59.5	81.1	15.9	17.6	60.8
Total SEE-3	**31.4**	**127.2**	**4.1**	**17.3**	**43.0**	**49.3**	**64.8**	**49.6**
SEE-7	52.5	162.1	3.1	13.2	34.2	49.1	82.0	
SEE	54.5	189.9	3.5	14.9	35.9	65.0	99.6	

1: Commodity Exports and Imports % of GDP; Source: AMECO, Worldbank

The data on trade volumes reveals a similar picture. In absolute terms, Romania's commodity exports and imports account for about half of the trade flows in South-Eastern Europe. Within the narrower SEE-5 country group, Croatia accounts for about half of the regions' exports and imports, while Serbia and Montenegro plays an important part with respect to imports only.

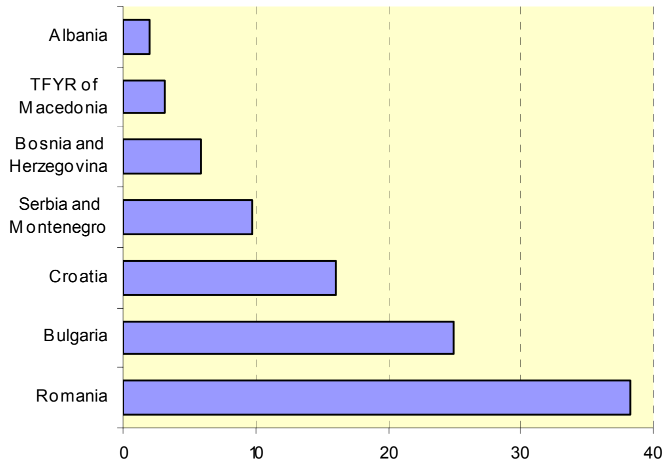
Openness to trade and EU integration

With respect to openness to trade[39] and EU orientation of trade, the SEE is again characterised by a significant diversity. In order to take into account the size effect, which results in relative high trade shares for small countries and low trade shares for larger ones, Table 2 ranks the SEE countries according to their GDP and compares the share of trade with EU countries of similar size. Overall, the degree of trade openness appears to be largely in line with the distribution among EU Member States. However, Albania and Serbia and Montenegro were clear outliers, with a relatively low degree of trade openness. In the case of Albania is to a large extent a legacy of its history of having been a relatively

[39] "Openness of trade" is defined as the average of export and import of goods and services in % of GDP.

closed economy. In the case of Serbia and Montenegro the low degree of trade integration is more surprising, given the high export orientation during the times of former Yugoslavia. Possible explanations are the effect of trade sanctions during most of the 1990s, but also a high degree of unreported trade. The trade openness of the former Yugoslav Republic of Macedonia also appears to be relatively low, when compared with a similar sized economy, for instance Bosnia and Herzegovina. The degree of trade integration with EU-25 is to a lesser extent influenced by the size of the country. Important factors for explaining this feature are the proximity to EU markets, the commodity composition of trade, trade agreements and of course also historic links. In the case of most countries of South-Eastern Europe, the EU-25 is the most important trading partner, to an extent which is very similar to many of the new Member States. Major exceptions in this respect are Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Bulgaria. Especially in the case of Albania, the high trade share with the EU is striking, when taking into account the relatively low degree of the economy's integration with the global economy[40].

Trade flows (exports + imports, 2005, % of regional total)



Source: Comtrade

Development of trade flows

Any quantitative analysis on trade in South-Eastern Europe is impeded by a relatively low reliability of available trade data. (For more details see box B.1) Especially with respect to the successor states of the SFRY the decade of military conflict was accompanied by a decline in registered trade and a significant increase of smuggling and triangular trade in order to circumvent trade sanctions. To a certain degree, the reporting of trade flows, especially with respect to regional trade is still limited. Thus, actual trade probably is underreported.

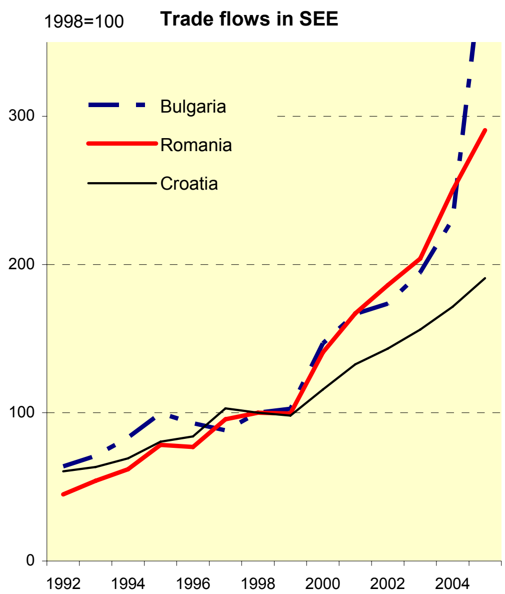
40 In 2004, about 90% of Albania's exports were directed towards the EU (mainly Italy and Greece), while about 75% of imports came from the EU.

Available time series on total trade of the SEE countries indicate that in terms of trade volume, Romania, Bulgaria and Croatia are those countries with the highest involvement in trade. For example, in 2005, Romanian exports and imports accounted for nearly 40% of total trade of the SEE-8 country group. Bulgaria's share in total trade of this region was about 25%. Among the successor states of Former Yugoslavia, Croatia and Serbia and Montenegro accounted for 15% and 10% of the region's total trade. The trade of Bosnia and Herzegovina and of the former Yugoslav Republic of Macedonia represented together another 10% of total trade, while the share of Albania was below 5% of total trade only.

However, in interesting recent development has been the sharp acceleration of total trade, which gained momentum after the opening of EU markets and the conclusion of the bilateral free trade agreements among the countries in the region. Again, in the case of the two acceding countries Romania and Bulgaria, the acceleration of trade was much more pronounced than in the case of the Western Balkan countries. Only in the case of Albania, growth accelerated at a similar rate, although from a significantly lower level compared to the two acceding countries.

Regional trade pattern

Concerning the regional distribution of trade of the countries of South-Eastern Europe, one already mentioned key feature is the high EU orientation. As can be seen in Table 3, the EU is by far the most important trading partner, with shares in total commodity exports ranging between 53% (Serbia and Montenegro) and 91% (Albania). Interestingly enough, Italy seems to be the most important EU export destination for nearly all countries of South-Eastern Europe, followed by Germany, Greece, Austria, Slovenia and Hungary.



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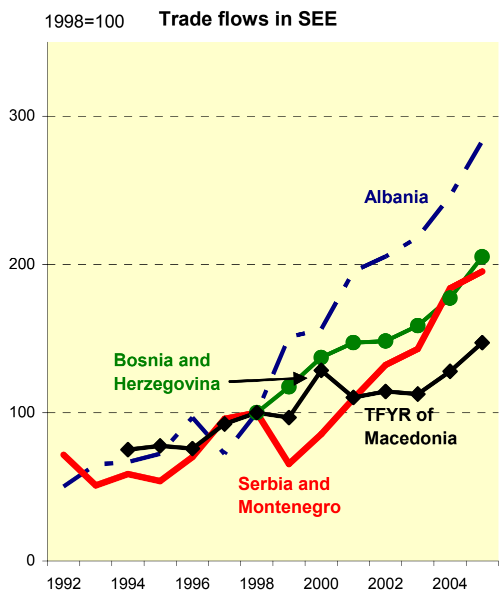


Source: Comtrade

Table 3: Regional export structure, 2004

	Albania	Bosnia and Herzegovina	Croatia	TFYR of Macedonia	Serbia and Montenegro	Bulgaria	Romania	Turkey
EU-25	90.6	54.0	64.6	57.0	53.4	58.3	73.1	55.3
thereof								
Germany	3.1	11.3	11.2	18.9	9.3	10.2	15.0	13.9
Italy	73.1	15.8	22.9	8.0	15.2	13.1	21.4	7.4
Greece	12.0	0.5	0.2	13.7	4.3	9.9	2.7	1.9
Austria	0.3	4.6	9.4	0.5	2.5	2.2	3.1	0.9
Slovenia	0.1	8.4	7.5	1.6	4.2	0.3	0.5	0.3
Hungary	0.0	3.7	1.3	0.1	3.4	0.9	3.8	0.6
SEE-5	1.7	37.6	19.3	28.9	28.5	5.7	2.5	1.2
Albania		0.2	0.3	1.4	0.6	0.4	0.1	0.3
Bosnia and Herzegovina	0.1		14.4	2.0	17.0	0.1	0.2	0.2
Croatia	0.1	20.4		4.8	4.1	0.4	0.8	0.2
TFYR of Macedonia	1.2	0.8	0.9		6.8	2.1	0.5	0.2
Serbia	0.4	16.2	3.7	20.8		2.7	1.0	0.3
AC	**0.3**	**0.2**	**1.2**	**3.2**	**4.9**	**4.0**	**1.9**	**3.4**
Bulgaria	0.3	0.1	0.4	3.1	1.6		1.9	1.4
Romania	0.0	0.1	0.9	0.1	3.3	4.0		2.0
Turkey	1.9	1.0	0.9	3.2	1.7	10.0	7.0	

Source: Comtrade

With respect to trade within the South-Eastern Europe, the historic pattern of three different areas of economic integration appears to prevail. The successor states of the SFRY still appear to export a significant share of their trade within the territory of former Yugoslavia (e.g. between about 19% of total exports in the case of Croatia and 38% in the case of Bosnia and Herzegovina), while trade with the Eastern Balkan or Albania is very low.

However, a closer looks reveals a high bilateral trade concentration. For example, in 2004, about 70% of Croatia's exports towards the SEE-5 were absorbed by Bosnia and Herzegovina, while the share of exports to Serbia and Montenegro was 20% only. A similar pattern, to a lesser extent, can be observed with all successor states of SFRY.

Another striking feature of regional trade in South-Eastern Europe is the low degree of regional integration of Albania, with exports to the Western Balkan amounting to 1.7% of total exports only. According to available data, the only significant regional export flows of Albania are directed towards the former Yugoslav Republic of Macedonia.

From an economic point of view, this highly fragmented trade pattern is surprising. In the absence of major differences in resource endowment or natural hindrances to trade, economic theory would predict a more evenly distributed regional trade pattern. However, in view of South-Eastern Europe's history, the current regional trade pattern between the 3 economic areas (Albania, former Yugoslavia and Eastern Balkan) is less surprising. However, current trade flows within former Yugoslavia appear to have changed significantly when compared to the pre-war structure. This is largely as a result of the military conflicts and the international sanctions in the wake of the disintegration of former Yugoslavia. A later part of this chapter will try to provide some estimates on the trade potential of this region in case of an assumed "normalisation" of trade flows and volumes, reflecting to a larger extent economic factors shaping trade flows, such as market size, proximity, resource endowments, and other factors such as a common border or a common language.

Commodity composition and concentration

The commodity composition of total exports of South-Eastern Europe is characterised by a relatively high share on intra-industry trade, i.e., trade of the SITC groups 6-8. This similarity in the overall pattern of trade specialisation of the SEE countries is not surprising, given the relative similarity of South-Eastern Europe with respect to the resource endowments (natural resources, capital stock, and human capital).

The main outliers of this overall pattern are: (1) Albania, with a relatively high concentration of exports of manufactured commodities (SITC group 8), which among others contain clothing, (2) Bosnia and Herzegovina with a relatively high share of the resource intensive trade categories (crude materials and fuels)[41] and (3) Serbia and Montenegro with a relatively high share of foodstuff in its export structure.

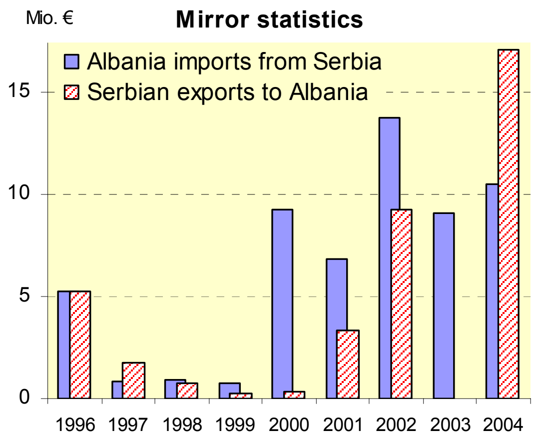
This pattern changes drastically, when analysing the trade composition of regional trade. In contrast to the overall pattern, trade between the countries of South-Eastern Europe appears to be dominated by inter-industry trade, e.g. exports of agricultural goods and importing manufactured goods.

[41] SITC 2 and SITC 3

Box 1: Data reliability

In principle, trade data is collected by two sources, the exporting and the importing country. In theory, the reported values of both sides should be roughly the same. However, in practise important differences exist, resulting from differences in the way of recording the value of the imports of costs, insurance and freight, but also from registering trade flows at different points in time. Thus, reporting differences of up to 10-15% of the registered values are quite common in trade statistics. (Kaminski and de la Rocha, 2003, p.16).

In the case of South-Eastern Europe, the differences in reported trade are far beyond this margin. One rather striking example for this quite common feature in the region are the differences in the reported trade flows between Albania and Serbia and Montenegro. As can be seen in the graph, in most years, the differences were quite significant and well beyond the usual 10-15% range. For example, for 2000, Albania reported imports from Serbia amounting to EUR 9.3 million, while Serbia-Montenegro recorded exports to Albania amounting to EUR 0.3 million, only.



Source: Comtrade

The absence of any export data of Serbia in 2003 and the high discrepancy in 2004 could be interpreted as a serious underreporting or absence of any reporting in 2003, which might have been compensated by over reporting in 2004.

In view of the existence of import tariffs, importing countries usually have a higher incentive to record incoming trade flows more accurately than outgoing ones. Thus, import data tends to be more reliable. However, important factors for the strong deviations in registered trade flows are:

1. *Systematic underreporting in order to avoid tariffs*: Another issue is the tradition of "unrecorded trading" (smuggling) in this region, driven by trade embargoes during the 1990s but also high differences in tax rates and tariffs, which existed between the 3 trading blocks or were imposed after the disintegration of former Yugoslavia. As a result, the degree of unrecorded trade appears to have been significant during the last 15 years.
2. *Institutional weaknesses* add to these reporting divergences. For example, Bosnia and Herzegovina tended to collect trade data not for the country as whole, but separately for the two entities, the Bosnian Federation and the Republika Srpska, while for the Brcko corridor no data were collected at all (Uvalic, 2005, p. 18).

The divergence in trade data not only occurs in the case of trade within the region, but also as regards their trade with other countries. For example, there are also significant differences between the values reported by the countries in the region and the data reported in the trade data base of Eurostat, which is based on the reporting of EU Member States.

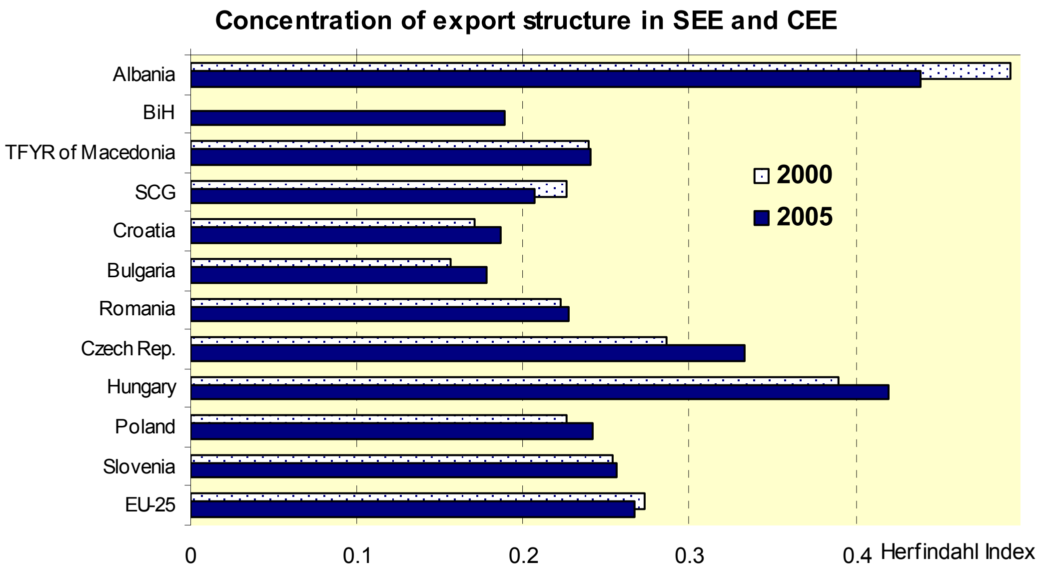
Concerning the specialisation of South-Eastern European countries on a certain group of commodities, economic theory such as the Heckscher-Ohlin approach, would suggest a specialisation of an economy towards commodities which reflect the country' relative abundance of a certain set of production factors (i.e., capital, labour, natural resources).

Table 4: SITC export composition, SEE-5, 2004; **% of total exports**

	Animals, food, beverages *SITC 0+1*	Raw materials *SITC 2-4*	Chemical goods *SITC 5*	Manu-factured goods *SITC 6*	Machinery, transport equipment *SITC 7*	Misc. manu-factured goods *SITC 8*
Albania	5.7	12.2	0.4	14.2	3.9	63.7
Bosnia and Herzegovina	4.8	32.4	2.4	26.0	17.1	17.0
The former Yugoslav Rep. of Macedonia	15.1	7.6	4.8	32.4	5.9	34.0
Serbia and Montenegro	18.8	9.6	10.3	36.4	11.1	13.5
Croatia	8.7	17.1	9.4	14.8	32.3	17.8
Bulgaria	9.1	14.2	6.6	27.4	12.4	25.6
Romania	2.3	13.1	5.5	21.2	23.7	33.8
EU-25	5.1	5.3	15.8	14.3	45.2	11.9

Source: Comtrade

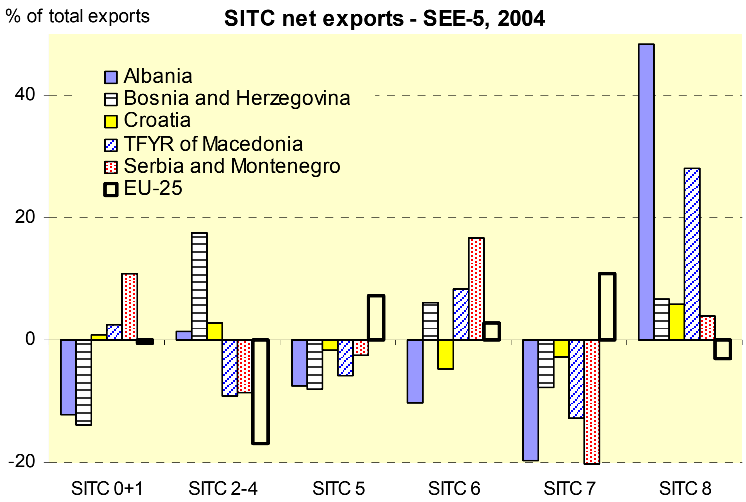
In practise, those clear specialisation patterns, which are mainly driven by the resource endowment, can hardly be observed, as a number of additional factors (economies of scale, historic patterns, etc.) also play an important role. However, one could expect that smaller economies tend to have a higher degree of specialisation, reflecting their more limited endowment base and thus the higher need to trade.



Available data points to an overall degree of trade specialisation in South-Eastern Europe, which seems to be rather similar to the degree of trade specialisation observed in other countries, such as the New Member States (see the following graph which presents Herfindahl-Hirschman[42] concentration ratios for the SEE countries and some of the new Member States).

[42] The Herfindahl-Hirschman Index is a simple, but frequently used, indicator for the degree of concentration. It is calculated as the sum of the squares of the shares of a certain variable. A HHI

Again, Albania stands out as a special case with a high and over time decreasing export specialisation. On the other hand, the larger economies of the region, such as Romania, Bulgaria or Croatia tend to have levels of specialisation comparable with some of the New Member States. Interestingly, most countries, with the exception of Albania and Serbia, register an increase in trade specialisation, which is in line with the expectations and the fact of increasing trade integration. For characteristing trade flows of an economy, it is not only interesting to look at a country's concentration on exports of a certain group of commodities, but also at trade surpluses or deficits for the different commodity groups. These "imbalances" could be seen as an indication of a countries' "revealed comparative advantage"[43].



For the Western Balkan countries, the overall pattern of specialisation points to a significant specialisation in the export of miscellaneous manufactured commodities (SITC-8), while the region registered a marked trade deficit in the category machinery and transport equipment (SITC-7). This pattern reflects the specialisation of many economies in the region in the processing of textiles, clothings and shoes, while they are clear net importers of investment equipment. Interestingly, Serbia and Montenegro is net exporter of foodstuff (SITC 0+1), while Bosnia is a net exporter of raw materials (SITC 2-4).

value of 0 indicates the absence of concentration, while a value of 1 indicates total concentration.

HHI= $\frac{\sum_{i=1}^{N} a_i^2}{\left(\sum_{i=1}^{N} a_i\right)^2}$, where i denotes the item (i.e., commodity group) and a the share of item i in total.

[43] For more details on this concept see: Balassa, (1965)

Box 2: Foreign trade of Montenegro

In this chapter, data on trade still reflect those of the former state union of Serbia and Montenegro. On 3 June 2006 the Montenegrin Parliament declared the Republic's independence, after a referendum on 21 May on the dissolution of the union with Serbia. This box intends to provide a glimpse on the trade activities of Montenegro.

Given the small size of the economy, imports of goods amount to a relatively high 57.3% of GDP and exports of goods to 26.5%, translating in a trade deficit of 30.8% of GDP. Exports exhibit a fairly high product concentration. SITC category 6 (Manufactured goods) accounts for 56% of exports, mostly unalloyed aluminium. Other main export goods are food, beverages and tobacco, machinery (mostly rolling element bearings), wood and timber.

Foreign trade: product structure (2005)

SITC Category	Exports EUR mill	Exports % of total	Imports EUR mill	Imports % of total
0 Food, live animals	36.2	8.3	147.2	15.6
1 Beverages, tobacco	31.1	7.1	33.8	3.6
2 Crude materials, except fuels	34.5	7.9	18.6	2.0
3 Mineral fuels	9.3	2.1	146.3	15.6
4 Animal/vegetable oils, fats, waxes	0.3	0.1	9.8	1.0
5 Chemical products	11.9	2.7	81.7	8.7
6 Basic manu-factured goods	243.4	56.0	132.9	14.1
7 Machinery, transport equipment	50.6	11.7	209.7	22.3
8 Misc. manufactured articles	17.2	4.0	160.4	17.1
Total	**434.5**	**100**	**940.3**	**100**

Source: Central Bank of Montenegro

Montenegro is a relatively large exporter of services, primarily as a growing tourist destination. In 2005, total foreign tourism revenues amounted to EUR 215 million, or 12.9% of GDP. These revenues are rising rather fast; in 2005 they were by more than 25% higher than in 2004.

Serbia is the most important market for Montenegro (36.8% of total exports, mostly metal products, food, beverages and tobacco, and 34.8% of imports, mainly agricultural and chemical products, and machinery). The EU accounts for 45% of total exports, of which Italy alone 27.3%, followed by Greece (mostly aluminium in both cases). The third important export market is the Western Balkans, with an increasing share pointing to the return of Montenegro to the markets in the region, partly thanks to the free trade agreements. Regarding imports, after Serbia, the main partners are the EU countries (40.3% share in 2005), of which the single biggest partner is Italy. Imports are concentrated on energy, automobile and electronic industry.

Foreign trade: partner countries (2005)

Exports	EUR mill	% of total	Imports	EUR mill	% of total
Serbia[1]	160.0	36.8	Serbia[1]	327.5	34.8
Italy	118.6	27.3	Italy	86.9	9.2
Greece	39.7	9.1	Slovenia	66.8	7.1
Slovenia	29.6	6.8	Croatia	66.1	7.0
Bosnia and Herzegovina	22.8	5.3	Greece	53.0	5.6
Hungary	9.5	2.2	Germany	46.4	4.9
Egypt	7.6	1.7	Austria	41.9	4.5
United	7.0	1.6	Switzerland	41.7	4.4
Others	39.7	9.1	Others	210.0	22.3
Total	**434.5**	**100**	**Total**	**940.3**	**100**

1: incl. Kosovo (UN1244) Source: Central Bank of Montenegro

After independence, the institutional set-up of trade is not expected to change in the short term. Under the previous framework of the state union, Montenegro was already responsible for its own economic and trade policy. Montenegro will need to establish those trade-related institutions which were under the responsibility of the state union (i.e. centres for metrology, standardisation and intellectual property). The government has set up a platform to reach an agreement with Serbia on the free flow of persons, goods, services and capital. In a broader regional context, Montenegro actively participates in the technical negotiations on free trade in South Eastern Europe. This new agreement should replace by end-2006 the existing ones between the countries of the region. Finally, Montenegro's application for WTO membership is currently dealt with by the responsible WTO bodies.

3. Trade agreements and their importance for economic integration

In view of the limited size of most of the SEE countries, trade integration is a crucial instrument for promoting growth and development. Local companies need access to sufficiently large markets. Openness to trade allows the import of new technologies and know-how, consumers benefit from the larger variety of available goods at lower prices, reflecting competition from abroad.

As described above, the situation with respect to economic integration is quite diverse in South-Eastern Europe. Historically established economic links within former Yugoslavia fell apart during the years of warfare, while economic links with Albania and the 2 former CMEA countries Bulgaria and Romania were not very developed. International trade sanctions and triangular trade in order to circumvent international sanctions and unilaterally declared trade embargos led to substantial distortions in trade flows. Trade policy thus became an important instrument in the post-conflict situation not only to foster economic development, but also to help to stabilise this region in political terms.

Institutional framework

In an attempt to promote the economic and political stabilisation of the region, the European Union initiated the creation of a "Stability Pact for South-Eastern Europe" in 1999, which was joined by several other nations, such as the USA, and key international institutions[44]. The Stability Pact also contains a significant trade component, which is covered by the so called Working Table II. This Working Table set up a Working Group on Trade Liberalisation and Facilitation, with the objective of reducing impediments to trade within the region of its signatory countries (Western Balkan, Eastern Balkan and Moldova). In this context the European governments initiated in 2001 a "Memorandum of Understanding on Trade Facilitation and Liberalisation", which was signed by all countries of the region, including Bulgaria, Romania and Moldova. In this memorandum, the countries of the region agreed to establish a network of bilateral free trade agreements among themselves by 2002. Furthermore, the importance of membership to the WTO[45] is stressed.

In parallel, the EU offered to the Western Balkan countries to negotiate and sign Stabilisation and Association Agreements (SAA) with the perspective of EU membership. These agreements also include the obligation to conclude free trade agreements with all other countries which have signed SAAs with the EU. In June 2003, the EU European Council adopted the "Thessaloniki Agenda", which among others called for deeper trade relations, including closer regional trade integration as step towards membership to the EU.

Overall, there are thus 3 different processes, taking place at the same time and shaping the trade policy of this region:

1. *multilateral*: on a global level, WTO obligations are increasingly relevant for the region, as most countries are already member, and the remaining ones are in the process of joining;

[44] Overall, some 40 countries and major international institutions, such as the World Bank, IMF, WTO, EIB, EBRD, etc.), joined this framework for stabilising the region (Wijkman, 2003).

[45] The SFRY had been member to the WTO. However, after the dissolution of the SFRY in 1991, the successor states had to reapply for membership.

2. *bilateral with the EU*: in the form of autonomous trade measures (ATMs) and the Stabilisation and Association Agreements (SAA), which contain a substantial trade element with asymmetric trade liberalisations; and

3. *regional*: bilateral free trade agreements (FTAs) between the countries of this region. In April 2006, the governments of the Stability Pact countries agreed to start negotiating the creation of regional free trade area, which should be concluded by the end of 2006. In practice, the countries of the region intend to join the already existing Central European Free Trade Area and to modify this existing framework into a new set-up, the so-called CEFTA 2006. This framework will result in a significant simplification of the current network of bilateral free trade agreements and should help to promote regional trade. It also should increase the region's attractiveness for foreign investors.

Membership to the World Trade Organisation (WTO)

Most countries of South-Eastern Europe[46] have become members to the WTO, which usually resulted in a significant reduction in trade barriers. Important exceptions in this respect are Bosnia and Herzegovina[47] and Serbia and Montenegro[48], which currently have observer status and have started the application procedure. After an initially joint application, Serbia and Montenegro decided to file separate application procedures for each of the two republics. As a result of WTO membership, the overall level of tariff protection has declined markedly in those countries, leading to lower prices for consumers, but also lower incomes from tariffs for the governments.

Trade relations with the European Union

With respect to trade with the European Union, the trade regime is characterised by two different frameworks: Autonomous trade measures and trade agreements in the framework of the Stabilisation and Association Agreements. Together with financial and technical assistance, those elements form the Stabilisation and Association Process (SAP).

- Autonomous trade measures (ATMs)

After the end of the Kosovo war in 1999, the European Union offered to the countries of South-Eastern Europe **autonomous trade measures** (ATMs), which allow 95% of their

[46] Romania was the first country of the region to join the WTO, by 1 January 1995. Slovenia followed on 30 July 1995, Bulgaria on 1 December 1996, Albania on 8 September 2000, Croatia on 30 November 2000 and the former Yugoslav Republic of Macedonia on 4 April 2003.

[47] Bosnia and Herzegovina's Working Party was established on 15 July 1999. Bosnia and Herzegovina submitted a Memorandum on the Foreign Trade Regime in October 2002. Following the submission of initial offers on goods and services in October 2004, bilateral market access negotiations have started. The second meeting of the Working Party took place in December 2004.

[48] The Federal Republic of Yugoslavia submitted a request for accession in January 2001. In 2004, the Republic of Serbia and the Republic of Montenegro decided to apply individually for accession, as two separate customs territories. Two Working Parties were established on 15 February 2005 to examine the applications from Serbia and Montenegro, respectively. Both Working Parties held their first meetings in October 2005 and completed a first reading of the respective foreign trade regime.

exports to the EU to enter the Union free of duties and any quantitative limits[49]. In 2005, the ATMs were extended until the year 2010.

As can be seen in the Table 5, those autonomous trade measures probably contributed to a strong increase of the region's commodity exports to the EU. Since the entering into force of the ATMs in 2001, SEE-8 exports to the EU increased by 45%, reaching a volume of about € 29 billion, compared to some € 20 billion in 2001. As a result, the share of EU imports from the SEE-8 region in total imports rose from 2% to about 2.6%. However, a large part of the EU trade with the SEE-8 region is actually trade with the two acceding countries, Bulgaria and Romania, which account for about for some 50% and 20% the region's imports respectively. The exports of the Western Balkan countries to the EU rose by roughly 40% during this period and reached a level of some € 8.5 billion. This accounts for about 0.8% of total EU imports. Half of the Western Balkans' exports to the EU come from Croatia, which rose by 27% during 2000 and 2005.

Table 5: Trade of SEE-8 with EU-25, 2001-2005

	Imports from EU			**Exports to EU**			**Total trade with EU**			**Trade balance with EU**	
	EUR billion		growth	EUR billion		growth	EUR billion		growth	EUR billion	
	2001	2005	%	2001	2005	%	2001	2005	%	2001	2005
SEE-5											
Albania	1.11	1.32	18.5	0.34	0.46	36.6	1.45	1.78	22.7	-0.78	-0.86
Bosnia and Herzegovina	2.05	2.70	32.0	0.70	1.32	90.2	2.74	4.03	46.8	-1.35	-1.38
Croatia	7.04	10.37	47.3	3.13	3.97	26.9	10.17	14.34	41.0	-3.91	-6.40
Serbia and Montenegro	3.18	4.95	55.6	1.27	1.74	37.8	4.45	6.69	50.5	-1.91	-3.20
The former Yugoslav Republic of Macedonia	1.41	1.34	-4.9	0.69	0.95	37.7	2.10	2.29	9.1	-0.72	-0.39
Total	*14.79*	*20.68*	*39.8*	*6.12*	*8.45*	*38.1*	*20.91*	*29.13*	*39.3*	*-8.67*	*-12.23*
Acceding Countries											
Bulgaria	4.44	7.13	60.8	3.74	5.28	41.2	8.18	12.42	51.8	-0.70	-1.85
Romania	12.10	21.79	80.0	10.14	15.28	50.7	22.24	37.07	66.7	-1.97	-6.51
Total	*16.54*	*28.92*	*74.9*	*13.88*	*20.56*	*48.2*	*30.42*	*49.48*	*62.7*	*-2.66*	*-8.36*
Moldova	0.51	0.80	56.9	0.26	0.36	40.7	0.77	1.16	51.4	-0.25	-0.43
Total	31.84	50.40	58.3	20.25	29.37	45.0	52.09	79.77	53.1	-11.59	-21.03

Source: Comtrade, DG Trade; Serbia and Montenegro: 2004 data

Imports of the SEE-8 region from the EU rose by nearly 60% since 2001, reaching a value of € 50 billion. Again, Bulgaria and Romania are important destinations for EU exports. Croatia, accounts for nearly 20% of the South-Eastern Europe's imports.

- Trade policy in the framework of the SAAs

In addition to the autonomous trade measures, **Stabilisation and Association Agreements (SAA)** are crucial instruments for trade liberalisation between the EU and the countries of

[49] So far, the EU import regime contains preferential tariff quotas on imports of wine, baby beef and certain fishery products. Furthermore, there are quotas on the import of textiles from Montenegro and Kosovo.

the region. The SAAs are comparable to the Europe Agreements, which the EU concluded and implemented with the 8 transition economies of Central and Eastern Europe during the second half of the 1990s. Like those Europe agreements, which prepared the way for EU membership, the SAAs cover not only trade liberalisation, but also other areas, such as legal approximation and issues of industrial policy, environment, energy etc.

With regard to trade in goods, the aim of these agreements is to progressively establish a free-trade area (FTA) between the EU and the countries of the region, on the basis of reciprocity but in an asymmetric manner. The SAAs thus goes beyond the scope of the autonomous trade concessions granted in 2000, by taking over the concessions, but also requiring a gradual opening of the local markets for EU products.

Currently, two SAAs are in force: with the former Yugoslav Republic of Macedonia (since 1 May 2004) and with Croatia (since 1 February 2005). Albania and the EU signed an SAA in June 2006, which currently is in the process of ratification. Negotiations with Serbia, Montenegro and Bosnia and Herzegovina were launched in 2005[50]. These agreements also require the conclusion of bilateral free trade agreements with countries with which the EU has signed SAAs.

In order to qualify for free access to the EU market, exporters have to comply with a set of rules-of-origin, which have the purpose to prevent third country exports to enter the EU market as transit trade through those countries with free trade agreements. For the exporters, this system of the rules-of-origin can lead to a series of constraints and bureaucratic requirements. Enterprises have to establish a system of reporting and documentation, which can impede market access for smaller enterprises. Furthermore, those restrictions can also prevent local producers to take advantage of cheaper third country inputs as with the use of those inputs the product might fail to meet the rule-of-origin requirements. As a result, the rules-of-origin could hinder intra-regional trade[51].

Regional Trade Agreements

In view of the interruption of regional (and international) trade during the dissolution of former Yugoslavia[52], the creation of numerous new borders in the region and the traditionally low trade flows between the three sub-regions of South-Eastern Europe, the Stability Pact tried from the very beginning to promote and facilitate regional trade as a tool to improve the political stability of the region. In addition, promoting regional integration was also seen as an instrument to diminish the "hub-and-spoke effect", i.e. to avoid a too strong trade orientation of the countries of the region towards a single dominant trading partner (Wijkman, 2003).

[50] Currently, the negotiations on the SAA with Serbia have been interrupted by the EU, due to insufficient cooperation of Serbia with the International Criminal Tribunal for the former Yugoslavia (ICTY).

[51] For more details, see Brenton and Manchini (2002)

[52] During 1992-1995, the United Nations imposed a trade embargo on the Federal Republic of Yugoslavia. During 1994-1995 Greece imposed a trade embargo on the former Yugoslav Republic of Macedonia in the context on the dispute on the name of the newly independent state.

Table 6: Regional free trade agreements (FTA) in place (June 2006)

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	FYR Macedonia	Romania	Serbia and Montenegro	UNMIK/ Kosovo
Albania		FTA	FTA	FTA	FTA	FTA	FTA	FTA
Bosnia and Herzegovina	FTA		FTA	FTA	FTA	FTA	FTA	FTA
Bulgaria	FTA	FTA		FTA	FTA	FTA	FTA	
Croatia	FTA	FTA	FTA		FTA	FTA	FTA	
FYR Macedonia	FTA	FTA	FTA	FTA		FTA	Rev. FTA	FTA
Romania	FTA	FTA	FTA	FTA	FTA		FTA	
Serbia and Montenegro	FTA	FTA	FTA	FTA	Rev. FTA	FTA		
Kosovo	FTA	FTA			FTA			

Source: Stability Pact for South Eastern Europe

The conclusion of an immediate Free Trade Area appeared politically not feasible. Thus the international community urged the countries of the region to conclude bilateral trade agreements as a first step towards better economic integration. By now, more than 30 bilateral trade agreements are in place (see table 6), which resulted in a substantial reduction in trade barriers, especially in the area of trade of manufactures (Messerlin P.A. and Miroudot S., 2004). The existence of this network of bilateral trade agreements does not imply the existence of free trade in the region. Each bilateral agreement has specific provisions on the scope and the timing and the speed of bilateral trade liberalisation. Overall, trade in industrial commodities in the region should be liberalised by 2008 only. Also, managing a trade regime with a considerable number of different agreements represents a significant administrative challenge.

Although it is difficult to quantify the exact impact of those bilateral regional trade agreements on the development of actual trade flows, available data point to a significant increase in regional trade since 2002, when most bilateral FTAs entered into force. According to Eurostat data, intra-SEE-8 exports rose by some 33% (to € 3.5 billion), compared to an increase of overall trade of the region by 21%. Croatia appears to be the most important exporter to the region, with an export volume of about € 1 billion, which accounts for about 27% of total regional trade. The share of Bulgaria and Romania in trade within the SEE-8 region is surprisingly low, in particular in view of its prominent role for overall trade. However, as already indicated above this rise probably reflects to a large degree a higher level of bilateral trade and not necessarily an increase of multilateral trade within the region.

Since 2005, governments of the region have started to work towards upgrading the current network of bilateral free trade agreements into a single regional free trade area. Negotiations on modifying CEFTA[53] into a framework for a Single Free Trade Area in South Eastern Europe started on 6 April 2006. Negotiations were concluded in October 2006. This should allow the new free trade area, called CEFTA 2006, to enter into force by January 2007. The free trade area will include Albania, Bosnia and Herzegovina, Croatia, Kosovo[54], Moldova, Montenegro, Serbia and the former Yugoslav Republic of Macedonia. This step will lead to a significant simplification of the existing bilateral trade agreements and could be an important step to support the creation of a "home market" for the region.

Table 7: Intra-SEE trade, 2002-2004

	Exports to SEE region			Exports total			SEE trade in % of total	
	2002 EUR million	2004 EUR million	growth (%)	2002 EUR million	2004 EUR million	growth (%)	2002	2004
SEE-5								
Albania	13	15	15.4	348	426	22.4	3.7	3.5
Bosnia and Herzegovina	164	267	62.8	874	1174	34.3	18.8	22.7
Croatia	839	1066	27.1	5111	6215	21.6	16.4	17.2
Serbia and Montenegro	60	70	16.7	1519	1673	10.1	3.9	4.2
The former Yugoslav Republic of Macedonia	421	512	21.6	1101	1196	8.6	38.2	42.8
Total	1497	1930	28.9	8953	10684	19.3	16.7	18.1
Acceding countries								
Romania	519	763	47.0	14634	17560	20.0	3.5	4.3
Bulgaria	570	727	27.5	5942	7204	21.2	9.6	10.1
Total	1089	1490	36.8	20576	24764	20.4	5.3	6.0
Others								
Moldova	65	98	50.8	680	967	42.2	9.6	10.1
Total	2651	3518	32.7	30209	36415	20.5	8.8	9.7

Source: Comtrade, DG Trade; Serbia and Montenegro: 2004 data

Overall characteristics of trade regime

Progress in trade liberalisation during the transition period has, overall, led to fairly open trade regimes in the region. As indicated above, these unilateral efforts have been reinforced, and locked into, by a set of bilateral and multilateral obligations on trade facilitation.

[53] The Central European Free Trade Agreement (CEFTA) was established in 1992 by Poland, Hungary and then Czechoslovakia. Its main intention was to facilitate and liberalise trade among its members. It was later joined by Slovenia (1996), Romania (1997), Bulgaria (1998), Croatia (2002) and the former Yugoslav Republic of Macedonia (2006). Due to their EU membership, Poland, Hungary, Czech Republic, Slovakia and Slovenia left the agreement in 2004, Bulgaria and Romania are supposed to leave on 1 January 2007.

[54] Kosovo under UN Security Council Resolution 1244

Overall customs protection, as measured in the average MFN rate for industrial products, has declined markedly. However, there are indications that with the decline in tariff protection, non-tariff barriers have increased in recent years (Damijan et al, 2006, Holzner, 2004). Also other indicators show a fairly open regime. The EBRD transition indicator for trade and foreign exchange shows that most countries in the region already fully achieved liberalisation. Only Bosnia and Herzegovina and Serbia and Montenegro still have some residual restrictions. A similar picture emerges from the joint EBRD/World Bank Business survey, as conducted the last time in 2005. When asked about customs regulations as a problem for doing business in the respective countries, overall the share of those respondent companies which consider this as an obstacle had fallen compared to the previous survey in 2002. Customs regulations are not seen as a main impediment to doing business, if compared to other regions and also if compared to other perceived problems for doing business in the region. On the other hand, in all the Western Balkan countries around 30-40% of respondents (and almost 50% in Albania) identified customs regulations as a problem for the business environment.

Table 8: Openness of trade regime[1]

Country	Indicator
Albania	4.25
Bosnia and Herzegovina	3.75
Croatia	4.25
The former Yugoslav Republic of Macedonia	4.25
Serbia and Montenegro	3.75
average SEE-5	**4.05**
Bulgaria	*4.25*
Romania	*4.25*
average RAMS-8[2]	*4.25*
average CIS	*3.27*

1: EBRD Transition indicator for trade and foreign exchange system, 2005; scale from 1 to 4.25 (least to maximum progress)

2: Czech Rep., Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia

Source: EBRD

Furthermore, according to these surveys the situation seems particularly difficult in Albania and more moderate in Serbia and Montenegro, the former Yugoslav Republic of Macedonia and Bosnia and Herzegovina. Comparably favourable seems to be the situation in the acceding and candidate countries, Bulgaria, Romania, Croatia and Turkey.

4. WHAT CAN BE LEARNED FROM THE NEW MEMBER STATES?

The countries of South-Eastern Europe are in the position of being able to learn from the experience of the Central and Eastern European countries, which recently joined the European Union and which to a certain extent faced similar challenges in restructuring their economies.

As regards trade the following stylised facts appear to be noteworthy:

- **With respect to openness to trade and EU orientation, most countries of SEE are in a similar situation as the CEE-8 countries.** Between 1993 and 2005, the EU-10 countries' share of trade with the EU-15[55] rose from 57% to 67%. This is slightly above the average of trade between the countries of the EU-15. This is not really surprising, given the relatively small size of most of the new Member States. Especially countries with a relatively low initial share of EU trade, such as Latvia or Slovakia, experienced a strong increase in their trade flows with the EU. In the case of Poland and Slovenia, intra-EU-10 trade increased from less than 5% of total trade in 1993 to some 10% in 2005. However, it remained relatively low, compared to Latvia and Lithuania, where intra-EU-10 trade rose from about 15% to above 20% of total trade. In the case of Slovakia, intra-EU-10 trade recovered from the split with Czech Republic and accounts

[55] Sum of exports to and imports from EU in percent of sum of total exports and imports of EU-10

for some 30% of this country's total trade. Not surprisingly, export growth in the EU-10 countries has been more dynamic than in the EU-15 countries. However, the structure of trade flows indicates an increasingly sophisticated integration of the New Member States into intra-industry trade, with a declining share of primary commodities and an increase in the share of more sophisticated parts and components (EU Commission, 2006).

Concerning the EU orientation of trade, the Western Balkan region reveals a similar diversity, with a low share of EU trade in the case of Bosnia and Herzegovina (42% of total trade in 2004) and a relatively high degree of EU orientation in the case of Albania, (despite the low overall openness for trade of this country). In the case of CEE-8 countries, those with the lowest EU orientation showed the fastest increase in their EU trade orientation share. Overall, the level of trade orientation of the countries of South-Eastern Europe towards the EU is not too different from the New Member States.

- **Most of the 8 transition economies (CEE-8) experienced initially a rapid reorientation of trade towards EU markets. However, later intra-CEE-8 trade started to increase.** A series of studies[56] explain this diversification as a result of the trade creating effects of the establishment of Central European Free Trade Area (CEFTA) and the Baltic Free Trade Area (BFTA).

  With respect to regional trade, the Western Balkan countries show a similar profile as many New Member States at the beginning of the accession process. In 1993, the group of the future 10 New Member States fell into different categories: (1) the Czech Republic and Slovakia as a group on its own with strong (bilateral) trade ties, leading to a share of regional trade of 25% of total trade for the Czech Republic and more than 45% for Slovakia, (2) the Baltic countries with a share of EU-10 trade between 10-15% of total trade, and (3) a group of countries with a very limited trade within the region, including Poland, Hungary and Slovenia. Cyprus and Malta were also hardly integrated into this country group. The countries of South-Eastern Europe currently show a similar diversity. A few countries have very low regional trade, such as Albania (3.5% of total exports in 2004), Serbia and Montenegro (4.2%) and Romania (4.3%), while Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia, both land-locked economies, have a relatively high share of regional trade of 22.7% and 42.8% respectively. Croatia's share of regional trade was 17.2% in 2005, which is higher than in the case of most New Member States in 1993. However, regional trade in the Western Balkan is highly concentrated, with relatively strong trade ties between specific countries and relatively little trade with other countries in the region.

- **However, with respect to the growth performance, the CEE-8 countries appear to clearly outperform most countries in South-Eastern Europe.** To some extent, the stronger growth rates in the second half of the 1990s might reflect a sharper recession immediately after the breakdown of the COMECON. Further important factors for the less dynamic development in the SEE-8 country group probably were the war in many parts of former Yugoslavia, the trade embargoes accompanying the tensions in the region and the smaller FDI inflows.

- **In the case of the EU-8 transition countries, the main source of growth was domestic demand, and not export growth** (see table 7). Despite significant increases in export orientation, the high import content of exports and also investment resulted in a rather insignificant contribution of net-exports to growth. Exports played an important role.

[56] Adam et al (2003), Kaminski and De la Rocha (2003), De Benedictis et al (2005)

However, in view of a sometimes weak economic integration of export oriented industries, the overall effect on the economy might have been less than expected.

Table 7: Growth and integration of selected new Member States, annual average 1996-2005

		CZ	EE	LV	LT	HU	PL	SI	SK
GDP growth	%	2.5	6.4	6.6	5.9	4.0	4.2	3.9	4.3
FDI inflows	% of GDP	6.7	8.0	3.6	3.4	6.2	3.4	2.0	5.4
Contributions to GDP growth (in percentage points):									
Final domestic demand		2.6	7.0	8.4	6.9	4.6	4.4	3.9	4.3
Private consumption		1.5	3.9	4.3	4.3	2.4	2.7	1.7	2.3
Public consumption		0.4	0.6	0.3	0.6	0.5	0.5	0.6	0.7
Gross fixed investment		0.7	2.5	3.8	2.0	1.7	1.2	1.6	1.3
Stocks		0.0	0.4	0.2	0.7	-0.6	0.0	0.0	0.6
Net exports		-0.1	-1.0	-2.0	-1.7	0.0	-0.2	0.0	-0.6
Exports		5.1	7.4	3.3	4.6	7.4	2.4	1.2	6.2
Imports		-6.0	-9.4	-5.3	-6.3	-8.8	-3.0	-4.0	-7.6
Openness to trade (2005)									
Openness to trade	% of GDP	71.9	82.3	51.9	55.8	67.3	38.6	60.8	78.1
Change since start of transition	pp	30.5	10.0	8.7	-0.5	37.6	15.7	-23.1	47.1

** pp: Percentage points. Source: AMECO, EcoWin*

- **FDI inflows appear to have played a much more prominent role in the CEE-8 countries, while especially in the case of SEE-5, workers remittances are a key factor in financing the trade account deficit.** By far more impressive than the trade creation and reorientation has been the high FDI inflows, which entered the CEE countries, accounting on average for some 4% of GDP annually. Overall, the foreign capital stock accumulated to roughly 40% of GDP of this country group, compared to 45% in the EU-15. More than 80% of this accumulated capital stock was absorbed by the 3 largest economies, namely Poland, Hungary and Czech Republic, which however also account for nearly 80% of the EU-10 GDP. About 77.5% of the stock of FDI in this country group came from EU-25 countries, with Germany, France, Netherlands and Austria being the most important countries of origin of those investments.

Like in the case of the CEE-8 countries, the EU is the most important trading partner of the Western Balkan countries, accounting for about 60% of total trade Furthermore, the level of EU orientation of trade appears at a similar level or even slightly higher than in the case of the transition economies at the time of the start of their accession process. This probably reflects the already high degree of trade integration with the EU even before the disintegration of former Yugoslavia. Interesting outliers in this context are: (1) Albania, with very low degree of trade openness and a particularly high share of EU orientation, and (2) Bosnia and Herzegovina with a degree of trade openness, which is largely in line with expectations, but a very low share of EU trade, amounting to some 43% of GDP only.

5. ACTUAL AND POTENTIAL TRADE - A GRAVITY PERSPECTIVE

As described above, the pattern of economic integration in South-Eastern Europe is very complex and reflects to a large extent historic developments. This feature of hysteresis in economic relations has been observed in similar situations[57] However, in view of the political changes in that region during the last 15 years, the question on the region's potential pattern of trade appears, in particular in view of the currently ongoing efforts to strengthen regional trade. One important question in this context is to which extent the current trade pattern (volumes and regional distribution) is deviating from a pattern which would have appeared without non-economic influences. In this respect, the following chapter will summarise the main findings of a number of research papers using gravity models in order to estimate the deviation from "natural" trade patterns. However, another interesting question is related to the region's potential as an export market for the other countries in the region. In this respect, a rough extrapolation of the region's potential export markets will be presented.

Actual trade pattern in the light of theoretical expectations

When trying to estimate the trade potential of a country, gravity models have been used widely in recent years. This concept applies Newton's gravity equation to trade flows, assuming that bilateral trade flows are positively influenced by the economic "weight" of the involved countries while distance has a negative impact on the size of the trade flow. There is a considerable strand of literature on the (weak) theoretical underpinning of this concept and the correct specification of this model[58]. Despite a number of methodological and theoretic caveats, this approach in general proved a useful tool in describing real world trade flows. For South-Eastern Europe a number of gravity models have been estimated in recent years, with strongly deviating results[59] depending on the model specification and the used data.

However, a main common feature of most estimates appears to be[60]:

(1) a confirmation of a significant degree of "under-trading" between the 3 subregions (Albania, former Yugoslavia, and Bulgaria and Romania)

(2) a significant degree of "under-trading" between Croatia and Serbia, the two countries with the biggest economic "weight" in the Western Balkan,

(3) a significant degree of "over-trading" between Croatia and Bosnia and Herzegovina and between Serbia and Bosnia and Herzegovina.

On the level of the 3 sub-regions, the relatively low degree of trade integration to some extent appears to reflect the history of the region, but also the geography and the lack of infrastructure linking those regions. In order to promote trade on this level, it would be

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[57] for example in the cases of the disintegration of the Soviet Union and Czechoslovakia (Fidrmuc and Fidrmuc, 2003), the Austro-Hungarian Empire (De Menil and Maurel, 1994) and the CMEA (Maurel and Cheikbossian, 1998). A recent study by De Sousa and Lamotte (2006) includes the case of former. Yugoslavia

[58] For example see: Baldwin R. (1993), Egger (2002).

[59] For example see: Kaminski B. and De la Rocha (2003), Christie (2002), Adam et al. (2003), Damijan et al (2006), Worldbank (2005), De Sousa and Lamotte (2006), Kernohan (2006).

[60] Kaminski B. and De la Rocha (2003), Christie (2002), Damijan et al (2006).

necessary to improve transport infrastructure between those 3 regions and to foster the elimination of non-tariff trade barriers.

Within former Yugoslavia, the two relatively large economies in the region, Croatia and Serbia, trade less than one would expect taking into account their economic size. However, when considering the recent history of those 2 countries, the low degree of trade is less surprising. This pattern probably reflects to a large extent the historic experience of warfare and might be overcome with time. Yet, the overall dimension of the initial slowdown of bilateral trade is largely in line with the experience of other countries during their phase of disintegration, such as the Soviet Union or the break-up between the Czech Republic and Slovakia[61].

At the same time, trade of Croatia and Serbia with their immediate neighbours, such as Bosnia and Herzegovina, seems to be higher than their economic size would suggest. There seem to be mainly 2 possible explanations for this feature. To some extent, this data reflects "ethnic trade", which is taking place between, the Croatian community in Bosnia and Herzegovina and their Croatian counterparts in Croatia on the one hand and the Serbian community of Bosnia and Herzegovina and their Serbian counterparts in the Republic of Serbia on the other hand. However, to a certain extent, the relatively high trade flows might indicate "triangular trade" circumventing direct trading contacts between Croatia and Serbian enterprises.

Export market potential in the region and its neighbourhood

A stylised fact of international trade is that a relatively large share of trade is done with neighbouring countries and with large economies. Hence, one would thus expect Germany, Italy, Russia and Turkey to be important trading partners, when taking into account the size of the economy and its relative proximity to the region. In order to give a general idea of the potential export markets in the region itself and in its neighbourhood, table 8 gives rough estimates of the medium-term potential of the region's trading partners, using current population data and assuming all countries with a per-capita income below the EU-25 average would catch-up to this average.

[61] For example see Kaminski B. and De la Rocha, (2003), Fidrmuc and Fidrmuc (2003).

Table 8: Actual and potential market sizes

	Popul-ation	Per capita income	Actual (bn EUR)			Potential (bn EUR)			Export market increase	
	Mio.	in % of EU-	GDP	Export	Import	GDP	Export	Import	in %	in bn EUR
Albania	3.2	15.0	5.4	0.6	2.3	36.0	4.0	15.3	567	13
Bosnia and Herzegovina	4.0	30.0	6.0	1.6	1.9	20.0	5.3	6.3	233	4
Croatia	4.4	46.6	29.7	8.0	16.6	63.7	17.2	35.6	115	19
The former Yugoslav Republic of Macedonia	2.0	25.0	4.3	1.7	2.9	17.3	6.8	11.6	300	9
Serbia	10.2	30 E	18.3	3.8	11.1	61.0	12.7	37.1	233	26
Montenegro	0.7	30 E	1.7	1.0 E	1.0 E	5.7	3.3	3.3	233	2
Total SEE-5	**23.8**	**36.1**	**63.7**	**15.7**	**34.8**	**198.0**	**48.8**	**108.3**	**211**	**73**
Bulgaria	7.8	31.8	21.3	9.9	14.5	67.0	31.1	45.6	214	31
Romania	21.6	32.5	78.1	23.5	32.7	240.3	72.3	100.6	208	68
Slovenia	2.0	81.1	27.8	15.9	17.6	34.3	19.6	21.7	23	4
Turkey	72.7	29.2	289.9	63.0	97.5	992.8	215.8	333.9	242	236
Greece	11.0	83.0	167.2	15.2	52.8	201.4	18.3	63.6	20	11
Italy	58.5	104.0	1417.2	353.5	355.2	1417.2	353.5	355.2	0	0
Austria	8.2	122.7	246.5	103.7	104.5	246.5	103.7	104.5	0	0
Hungary	10.1	62.0	87.8	55.5	60.2	236.1	149.2	161.9	169	102
Moldova	4.5	20 E	2.2	1.0 E	1.0 E	11.0	5.0	5.0	400	4
Ukraine	47.4	20 E	63.0	30.0	27.0	315.0	150.0	135.0	400	108
Russia	143.0	20 E	490.0	181.6	75.5	2450.0	908.0	377.5	400	302
Total neighbours	**355.4**		**2763.8**	**803.5**	**773.7**	**5870.1**	**1706.6**	**1643.3**	**112**	**870**
Germany	80.0	108	2246	700	724	2246	700	724	0	0
France	55.0	110	1696	450	431	1696	450	431	0	0
EU-25	462.0	100	10800	1059	1173	10800	1059	1173	0	0

Source: AMECO, Worldbank, E: own estimates.

Not surprisingly, countries with a larger population register higher increases in absolute terms by per-capita incomes converging to the EU-25 average. In the SEE-5 region, Serbia's and Croatia's GDP would increase mostly in absolute terms, while in the SEE-8 Romania would register the biggest absolute increase. Yet, the trade potential within the region remains relatively small compared to the potential in the neighbourhood, of countries with large populations and relatively low per-capita incomes, such as Russia and Turkey.

6. Conclusions

The countries of South-Eastern Europe are rather small in economic terms. Thus, openness to trade is a crucial precondition for realising necessary economies of scale and sufficient access to export markets. When compared to countries of a similar size, the level of international trade is relatively low. This reflects a turbulent past, political sensitivities, insufficient infrastructure but also a similar production and trade structure.

The positive experience of the new Member States can be partly transferred to the Western Balkans. The positive growth performance of most Western Balkan countries was mainly driven by fixed investment and private consumption, while the contribution of net exports was relatively small (due to the high import content of investment and exports). Furthermore, investment concentrated in relatively big and "centrally" located economies.

Favourable conditions for investment (business environment, market size) are crucial preconditions for catching up.

Trade in South-Eastern Europe appears to be characterised by a significant degree of hysteresis in economic trade patterns: Between the 3 historic economic areas (1) Albania, (2) the successor states of former Yugoslavia, and (3) Bulgaria and Romania, trade is relatively low. Within the area of former Yugoslavia, the violent disintegration of this economic space left deep traces in terms of trade suppression and trade diversion, with relatively little trade between the 2 main economic cores of the region, Croatia and Serbia, but relatively developed trade links with other neighbouring countries of former Yugoslavia.

The market size of the Western Balkans is fairly limited. Therefore, further regional trade integration might have only a limited impact economic growth in the region. The key markets for potentially higher volumes and higher quality of exports are the more advanced markets in the region's neighbourhood, particularly the EU including the new Member States, Bulgaria and Romania, but also Turkey, Russia or Ukraine.

However, further regional trade integration is nevertheless an essential forward-looking strategy. Its importance lies not so much in creating a potential export market for local producers (home market for SMEs, …), but rather as an avenue for realising existing synergies and in order to create a sufficiently large economic area, for example for increasing the region's attractiveness for FDI. The diagonal cumulation of rules-of-origin is thus highly relevant, allowing to increase the value-added content created within the region.

PART B

COUNTRY ANALYSIS

V. ALBANIA

General macroeconomic situation

Albania's fairly stable macroeconomic environment, characterised by strong GDP growth and subdued inflation, has been maintained throughout 2005 and 2006. However, the country suffered from frequent power supply shortages at the end of 2005, mainly as a result of the strong dependence on hydro sources for generating electricity and the failure of tenders for purchasing additional electricity from abroad. The repercussions of the crisis on economic growth combined with weakening economic activity in the construction sector and deceleration in export growth are estimated at 0.5% of GDP in 2005 and 1% of GDP in 2006. The estimates of real GDP growth have thus been revised downwards to 5.5% for 2005 and to 5% for 2006 Due to sustained growth in disposable income, considerable progress continued in reducing poverty. The share of people living in poverty fell from around 25% in 2002 to around 18% in 2005.

International transactions

After a significant improvement in 2004, indicators for 2005 and 2006 show a marked deterioration of external accounts. The trade deficit increased to 24.1% of GDP in 2005, compared to 21.7% in 2004. During the first eight months of 2006, it widened further by 17% on an annual basis. The current account deficit (including official transfers) in 2005 is estimated at 6.9% of GDP, compared to 3.8% in 2004. Due to the lek appreciation and stronger competition in the textile industry, export growth has declined to 9% in 2005 from 23% in 2004. For the same period, imports grew at 15%, outpacing exports, mainly on the back of strong growth and electricity imports. Export base remained very low, narrow and undiversified, mainly due to a lack of non-price competitiveness, resulting -among others- from poor infrastructure and uninviting business environment. The financing of the trade deficit continued to depend largely on significant remittances and other current transfers, estimated at around 15% of GDP in 2005 and 2006. Foreign direct investment (FDI) is estimated at 3.1% of GDP for 2005 and 3.3% of GDP for 2006.

Gross usable reserves continued to rise throughout 2005 and 2006. This was partly due to inflows of private transfers and FDI, but also to the Bank of Albania's foreign exchange market interventions in the first half of 2005 aiming at dampening appreciation pressures on the euro-lek exchange rate. Foreign currency reserves reached EUR 1.2 billion at the end of 2005, a 17% increase compared to the end of 2004, and a cover of around 4 months of the country's imports.

The external debt situation continued to improve last year as external debt declined to 17.6% of GDP in 2005 from 18% in 2004. Total public debt declined to 55.3% of GDP in 2005 compared to 56.5% a year earlier.

Labour market

The labour market situation improved slightly throughout 2005 and 2006. The unemployment rate (based on registered data) declined marginally to 14.2% in 2005 from 14.4% at the end of 2004. Data for the first eight months of 2006 indicate a further decrease of the unemployment rate to 13.9%. In the second quarter of 2006, private sector employment accounted for more than 4/5 of all working people, out of which 71% worked in agriculture sector, which continues to have an important function as economic and social buffer, reducing poverty and unemployment.

Prices

Inflation has been on an upwards trend since July 2005, when CPI inflation reached a low of 1.8% (y-o-y). It peaked in October 2005 (3.3% y-o-y) due to persistent pressure from rising oil prices on certain domestic prices.

Inflationary pressure were however somewhat moderated by the continuing appreciation of the Albanian lek vis-à-vis the euro, apparent in particular in the first semester of 2005. Average annual inflation reached 2.4% in 2005. Thereby it remained at the lower end of the Bank of Albania's informal 2-4% annual inflation target range. After a temporary drop in the first quarter of 2006, CPI inflation rose back to 2.9% y-o-y in November 2006. Average annual inflation stood at 2.3% in November 2006.

Monetary policy

After the Bank of Albania (BoA) had cut its main policy rate by 25 basis points in March 2005, it followed a neutral course of monetary policy. In July 2005, the BoA changed the direction of its operational instruments by starting to perform reverse repurchase agreements, injecting additional liquidity into the banking system. This has helped to stabilise temporarily volatile money market interest rates and Treasury bill yields. The key interest rate remained unchanged until July 2006, when the BoA raised it back to 5.25% and further to 5.5% in December 2006, on the back of renewed inflationary pressures. The BoA currently examines prerequisites for a gradual change in its monetary policy strategy towards a formal inflation targeting regime with the aim of enhancing transparency and credibility of its monetary policies.

Annual growth of the monetary aggregate M3 dropped from previously higher levels (19% in mid-2005) to 14% in the last quarter 2005 and further down to 10% in August 2006. The narrowing interest rate spread between the euro and the lek together with growth in private transfers from abroad resulted in a massive increase in the growth rates of foreign currency deposits of 31% in 2005, a record high for the last three years. In August 2006, they however decreased to 18%. Also credit to the private sector recorded a significant expansion, growing by 74% during 2005, twice as fast as in 2004. Appreciation pressures of the Albanian lek against the euro eased towards the end of 2005. The lek appreciated against the euro by approximately 3% in nominal terms during 2005, while remained relatively stable vis-à-vis the euro during the first eleven months of 2006.

Fiscal developments

The 2005 budget execution was better than planned. At end of 2005, the general deficit reached 3.6% of GDP (against 5.1% in 2004), mainly due to the better performance of revenues and only moderate increases in expenditures. In October 2005, the IMF reached an agreement with the authorities on the remainder of 2005 budget and key parameters of the 2006 budget, envisaging a set of reform measures for the tax administration and public finance management. These measures aimed at improving fiscal discipline, tax administration efficiency, tax collection as well as public expenditure and debt management. Given a favourable performance of the budget in the first half of 2006, a supplementary budget was adopted in July 2006 for the second half of the year in the amount of 2.2% of GDP, mainly for infrastructure development. Over the first ten months of 2006, the budget registered a surplus of 0.6% of GDP. Nevertheless, for the whole year a budget deficit of 3.8% of GDP is expected. Very limited progress was achieved in strengthening public debt management. Albania still lacks a comprehensive debt management strategy and an adequate risk management capacity, which would enable to lengthen the maturity of the domestic debt and introduce new debt instruments.

In November 2006, the Assembly voted the 2007 budget. It foresees a deficit of 4.7% of GDP. Priority sectors for government expenditure will remain infrastructure, health care and education.

Structural reforms

Progress in public administration reform has continued, the administrative capacity of the tax administration has further improved and several crucial reforms have been put in place throughout 2005 and 2006. Whereas privatisation of small- and medium-sized enterprises has been completed, large-scale privatisation has suffered delays. The ratification of the sale agreement that would complete the privatisation of Albtelecom was rejected by the Albanian parliament in October 2005, which led to a review of the sale contract and the tender procedure. The attempt to sell a majority stake in ARMO to a strategic investor in May 2005 failed due to the lack of market interest.

Certain progress has been achieved in improving the business environment, mainly in terms of reducing certain administrative barriers to market entry. Nevertheless, the remaining shortcomings such as legal uncertainty and weakness in law implementation, poor infrastructure (in particular unreliable power supply) and fraudulent practices impede economic activity and investment. Financial sector reform progressed by preparing the ground for the establishment of a new Financial Supervision Authority, which is envisaged to be in charge of the supervision of the insurance, pension sectors and securities. Regarding statistics, a first set of national account estimates has been prepared for the previous years up to 2004.

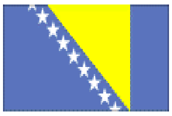
The energy sector remains one of the major risk factors for the economy. Measures enhancing electricity supply over the medium- and long term, improving the financial performance of KESH, the state power utility, as well the transmission network capacity and securing alternative energy sources to hydropower are key to mitigate further negative impacts of major sector inefficiencies on economic development.

Albania - Main economic trends

		2001	2002	2003	2004	2005	2006	
Gross domestic product	Ann. % ch	7.0	2.9	5.7	5.9	5.5	5.0	IMF proj
Private consumption	Ann. % ch	-0.6	13.6	8.1	N.A.	N.A.	:	
Gross fixed capital formation	Ann. % ch	24.6	4.7	15.7	N.A.	N.A.	:	
Unemployment	%	15.2	16.0	15.2	14.4	14.2	:	
Employment	Ann. % ch	0.4	-14.1	0.9	-0.8	1.3	:	
Wages	Ann. % ch	15.9	22.7	8.5	16.5	7.9	:	
Current account balance, including official transfers	% of GDP	-2.8	-7.2	-5.5	-3.8	-6.9	-6.6	IMF proj
Direct investment (FDI, net)	% of GDP	5.0	3.0	3.2	4.6	3.1	3.3	IMF proj
CPI	Ann. % ch	3.1	5.2	2.3	2.9	2.4	2.3	Nov
Interest rate (3 months)	% p.a.	7.7	9.6	8.7	6.8	5.5	6.0	Sep
Bond yield	% p.a.	10.5	11.7	10.7	8.9	7.5	7.1	Sep
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	:	
Exchange rate LEK/EUR	Value	127.7	131.7	136.8	127.2	123.7	123.8	Nov
Change real eff. exchange rate	% eop	9.8	-10.9	1.2	5.1	1.5	:	
General government balance	% of GDP	-7.9	-6.6	-4.5	-5.1	-3.6	-3.8	IMF proj
General government debt	% of GDP	67.6	65.0	61.8	56.5	55.3	55.2	IMF proj

Sources: Reuters/Ecowin, national sources, IMF

VI. BOSNIA AND HERZEGOVINA



General macroeconomic situation

The economy experienced relatively strong growth of around 5.5% in 2005 and is expected continue to grow at a similar pace in 2006. Any analysis of economic developments is however impeded by poor quality and availability of statistics. The base for economic growth continued to be narrow, with a strong emphasis on raw materials and related manufacturing in the economy. However, in the Republika Srpska (RS), previous privatisations helped supporting increased manufacturing also in some other sectors.

In the RS, industrial production grew rapidly and had in October 2006 expanded by 43.7% year-on-year, compared to a 20% increase in 2005. The Federation on the other hand experienced a more moderate growth rate in industrial production of 7.9% in October year-on-year, a slight acceleration compared to the growth rate of 6% registered for 2005.

International transactions

The current account deficit widened from 20.8% of GDP in 2004 to 22.5% of GDP 2005, but the upward trend was reversed in 2006. A large part of the widening in 2005 was driven by increased imports in the fourth quarter in the run-up to VAT introduction. It was matched by a sizeable reduction of the current account deficit in 2006. During the first six months, exports increased by 30% while imports decreased by 1% compared to the same period the year before. Export growth was supported by improved reporting, as incentives to report exports increased after VAT introduction and by stronger performance and favourable price developments in some sectors. Import figures in 2006 were favourably affected by the forward shift of imports to end-2005. Partly due to temporary factors, the current account deficit therefore decreased significantly in the first half of 2006, to around 15% of GDP.

FDI inflows in 2004 had been strong at 7% of GDP on the back of a few large privatisation transactions. Inflows weakened in 2005 to 5.2% of GDP and the downward trend continued in 2006 as inflows dropped by 8% in the first half of the year compared to the same period in 2005. However, the agreement reached in December 2006 to sell Telekom Srpske will have a large positive impact on total inflows for 2006.

Other types of investment inflows grew strongly in 2005 and covered over half of the current account deficit. They were partly a result of transfers from foreign parent companies to banks. Such mainly banking-related investment inflows decreased somewhat in 2006. However, their role in financing the current account deficit remained strong. Errors and omissions in the balance of payments statistics remained large at 20% of the current account deficit.

The downward trend of public external debt continued. The debt stock amounted to 27.2% of GDP at end 2005 and it decreased by 4% in Euro terms during the first six months of 2006. Private external debt on the other hand rose in 2005 and is estimated to have been around 30%, but with limited data on developments available.

Large domestic debt claims related to the war and pre-war period remain outstanding. An initial deal to restructure the debt to a net present value of 10% of GDP was rejected by the courts and future arrangements are bound to be more costly. Legal frameworks to set out terms and conditions for repayments of different types of claims are under preparation or have been adopted. The final outcome of the debt restructuring is not yet clear, but the settlements are likely to have significant fiscal impact over the coming years.

Labour market

Official unemployment rose from 43% in 2004 to 44.6% in December 2005 and thereafter declined to 44.3% in March 2006. The decline in 2006 was mostly due to a revision of registration methods in the RS and does not necessarily reflect an increased number of jobs. Data showed a reduction in jobs in the manufacturing sector by 8% in March 2006 compared to a year earlier, a result of recent privatisations and ongoing restructuring in certain sectors.

However, official statistics do not correctly reflect unemployment levels, since data includes people employed in the informal sector who register as unemployed to get access to social insurance. A Labour Force Survey conducted in April 2006 estimated unemployment to be around 30% of the labour force, while labour force participation was estimated to be only 43%.

Real wage growth in 2005 was higher in the RS compared to the Federation, likely a reflection of comparatively higher productivity gains, contributing to reducing the existing gap in wage levels between the entities. Average net real wages increased by 2.9% in December 2005 compared to a year before. Real wage growth slowed down in the first quarter of 2006 and amounted to 0.9% compared to the same period the year before.

Prices

The introduction of VAT in January 2006 impacted inflation developments, in particular in December 2005 and the beginning of 2006. Inflation (retail price index) jumped from 4.3% in December 2005 to 7.6% in January 2006. Upward inflationary pressures have thereafter largely subsided. In October, inflation reached 7,3% in the Federation and 7.0% in the RS on an annual basis.

Monetary policy

The monetary framework is the currency board and the Convertible Mark remained pegged to the euro at a fixed rate. The main policy tool was the level of reserve requirements for commercial banks, which was raised from 10% to 15% at end 2005 mainly with the aim to curb the high growth in banking sector credit. The measure seemed to have some effect and total yearly credit growth slowed down from 27.3% in December 2005 to 22.8% in October 2006. The slowdown was partly driven by slower growth in loans to private enterprises which reached 24% in October on a yearly basis. Credit to households grew by 28.7% in October on an annual basis, compared with 31% in December 2005.

Net foreign reserves increased by 20% in Euro terms during 2005 and covered around 4 months of imports. In the first 7 months of 2006 reserves rose by another 17%. The real effective exchange rate (REER) of the KM has remained fairly stable. Fluctuations in REER are mainly driven by exchange rate movements vis-à-vis non-EU neighbouring countries.

Fiscal developments

The consolidated budget balance turned from a deficit in 2004 to a surplus of 0.9% in 2005. This change stemmed mainly from stronger sales and excise tax revenues. The state and entity budgets for 2006 were expansionary and most of the increases in spending were of a permanent nature. Several decisions were also taken in the run-up to the October parliamentary elections which will have negative fiscal implications, mostly as of January 2007. In addition, proposed amendments to the state-level law on Frozen Foreign Currency Deposits will, if adopted, have a serious negative fiscal impact. Government expenditure is therefore set to increase from an already high level of around 50% of GDP.

However, revenue collection was strong in 2006, in particular resulting from higher than expected VAT revenues. Total indirect tax collection increased by around 30% in the first nine months compared to the same period in 2005 which was largely due to temporary factors. The extra revenues are likely to fully cover the increasing expenditures in 2006, but fiscal risks will increase thereafter.

The mechanism for how to divide the collected indirect tax revenues between different levels of government continued to be a contested issue. Funds in the single account were blocked several times during 2006 due to lack of agreement and only temporary solutions were found to unfreeze the funds.

Structural reforms

Progress in structural reforms continued to be overall slow and the political will in many cases weak. A major achievement was the successful implementation of a single VAT rate across the country as of 1 January 2006. This was an important reform supporting the creation of a single economic space and the reduction of the grey economy. Fiscal coordination was also intensified with the creation of the National Fiscal Council (NFC), but continued to have serious flaws. The NFC has been functioning without a clearly defined legislative basis, lacking deadlock-breaking and enforcement mechanisms and with a limited role in the budgeting process.

The privatisation process continued in the RS, with a number of large companies sold during 2005. In December 2006 it was agreed to sell a 65% stake in Telekom Srpske to the Serbian company Telekom Srbije, for 646 million Euros. In the Federation the privatisation process stalled, largely due to lack of political will and an inadequate legal framework. Some improvements in the legal framework were however adopted in 2006.

Problems in the corporate sector however go beyond the companies to be privatised. Bankruptcy procedures, in particularly in the Federation, do not function well and corporate governance practices are often weak. Restructuring of network industries is in its initial phase and their ownership remains public. The financial sector is the area where foreign ownership is the most present and reforms over recent years have been substantial. However, banking supervision remained conducted by two separate entity banking agencies, and was coordinated by the Central Bank. The approach is showing clear limitations in the increasingly integrated banking sector. Supervision for other parts of the financial system remains limited and fragmented.

Bosnia and Herzegovina - Main economic trends

		2001	2002	2003	2004	2005	2006	
Gross domestic product	Ann. % ch	4.5	5.5	3.0	6.0	5.5	:	
Private consumption	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Unemployment	%	40.3	40.9	42.0	43.1	44.6	:	
Employment	Ann. % ch	-2.3	1.9	-0.6	0.8	0.8	:	
Wages	Ann. % ch	20.5	1.4	8.4	4.3	6.1	9.6	Q3
Current account balance	% of GDP	-16.6	-21.7	-22.6	-20.8	-21.7	-14.5	Q2
Direct investment (FDI, net)	% of GDP	2.6	4.1	5.3	7.1	5.2	3.9	Q2
RPI	Ann. % ch	-1.6	-2.6	0.2	-0.2	3.3	8.8	Jun
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Bond yield	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Exchange rate BAM/EUR	Value	1.95	1.95	1.95	1.94	1.95	1.94	Nov
Nominal eff. exchange rate	Index	N.A.	100.0	97.4	96.3	95.0	94.4	Q1
General government balance	% of GDP	-3.3	-4.1	-2.0	-0.4	0.9	0.7	IMF est.
General government debt	% of GDP	40.3	36.8	32.6	29.9	31.0	:	

Sources: Reuters/Ecowin, IMF, national sources.

VII. CROATIA

General macroeconomic situation

Real GDP growth accelerated to 4.3% in 2005, up from 3.8% in 2004. In the first half of 2006, GDP grew by 4.8%, up from 3.5% in the same period a year ago. Economic output remained largely driven by domestic demand. In particular, investment spending increased strongly by 12.6%, strongly supported by private sector initiative. Private consumption expanded by 3%, somewhat less than during the same period a year ago. Real growth of imports of goods and services was slightly stronger (9.5%) than exports, and net exports posted a negative contribution to growth (2.2 percentage points). Industrial production grew by 5.1% in 2005 and by around 4.5% on average in the twelve months to October 2006.

International transactions

According to data published by the Croatian National Bank, the current account deficit widened further. In the twelve months to end-June, it increased sharply to 7.7% of GDP as compared to 6.4% of GDP in 2005. In the same time, the trade deficit rose to 24.8% of GDP (up from 24.3% in 2005) and the surplus in services slightly declined to 16.8% (from 17.1%). Moreover, a higher income balance deficit of 3.4% (3.1% in 2005) and a lower surplus in transfers of 3.7% (against 4.0% in 2005) added to the increase of the current account deficit. FDI flows have continued to finance a considerable share of the current account deficit. Net FDI inflows increased from 2.5% of GDP in 2004 to 3.9% in 2005 and further to 4.6% in the twelve month to June 2006.

External gross debt continued to grow in 2005, although at a slower pace compared to previous years. External debt amounted to 82.6% of GDP by end-2005, compared to 80.2% a year before. The further increase in external debt was particularly driven by strong commercial bank borrowing abroad which accelerated towards the end of 2005 and in early 2006. At the same time, the government's outstanding external debt declined, due to a shift of government borrowing from external to domestic markets. In the period to August 2006, external debt continued to grow to 86.7% of 2005 GDP.

Labour market

The officially registered unemployment rate continued to decline to 15.7% in July compared to 16.9% in the same months a year ago, but accelerated to 16.8% in October due to the usual seasonal factors. According to official data from the Employment office, employment increased by a mild 0.6 year-on-year in October, but data of the Pension Insurance Fund suggest stronger employment growth of above 3% on average in 2006. Most recent labour force survey data suggest a decline in the unemployment rate to 11.8% in the first half of 2006, down from 13.1% in the first half of 2005.

Prices

Average annual consumer price inflation increased significantly from to 2.1% in 2004 to 3.3% in 2005, resulting from higher prices for energy (oil), transport and food. On a twelve-month moving average, inflation further increased to 3.4% in October 2006, also fuelled by adjustments of administrative prices. Average producer price inflation stood at 2.9% in November 2006, slightly lower than a year before.

Monetary policy

Monetary policy continued to be geared at maintaining price stability through a tightly managed float. Under the conditions of a highly euroised financial system, exchange rate stabilisation remained an important objective of monetary policy. Open market operations were introduced in April 2005 with a view to fine-tuning liquidity and smoothing short-term interest rate fluctuations. In order to constrain the accelerating growth of commercial banks foreign borrowing, the Central Bank increased marginal reserve requirements in February and May 2005 and again in January 2006 to 55%. Moreover, a special reserve requirement on banks' securities was introduced as banks had started to re-finance their operation through issuing securities abroad instead of taking loans from their parent banks. However, despite these measures the growth of credit and money aggregates accelerated again since mid-2005. Year-on-year growth of M4 picked up from 8.2% in 2004 to 9.6% in 2005, and stood at 19.1% in October 2006. Annual domestic credit growth accelerated from 14% in 2004 to 17.2% in 2005 and further to 22% in October 2006. In 2005, commercial bank lending to households has been growing stronger (20.3%) than lending to enterprises (14.3%), but the growth of lending to both sectors accelerated to around 22.5% year-on-year in October 2006.

During 2005 and 2006, the exchange rate of the Kuna vis-à-vis the Euro remained generally under appreciation pressures due to strong demand resulting from government bond issues, continued capital inflows as well as appreciation expectations generated by the EU accession process. The central bank has intervened nine times in 2005 and twelve times from January to November 2006, in all but one case buying foreign exchange to contain appreciation pressures. The exchange rate of the Kuna vis-à-vis the Euro appreciated by 1.4% in 2005 and by a further 0.9% in the twelve months to November 2006. At end-2005, official reserve assets of the Croatian National Bank stood at a comfortable level of EUR 7.4 billion, reflecting a nominal increase of around 16% as compared to end-2004, and equivalent to around 5.1 months of 2005 imports of goods and services. In 2006, official reserves further increased to around € 8.5 billion at end-October or by 20% year on year.

Fiscal developments

Fiscal consolidation continued through 2005 and 2006. According to the Spring 2006 fiscal notification submitted by Croatia, the general government deficit declined from 5% in 2004 to 3.9% in 2005. According to officially released budget data based on GFS, which has been used for programme purposed, the general government deficit shrank from 4.9% to 4.2% of GDP (GFS), which was in line with the adopted budget framework and with the policy targets set under the Pre-Accession Economic Programme and the precautionary IMF stand-by programme which expired in November 2006.

The revised budget framework for 2006 foresees a further reduction of the general government deficit to 3% of GDP (GFS). Fiscal trends in the first nine months have been relatively favourable as growth was higher than expected. Revenue growth accelerated to 10% and current spending grew by a moderate 5.4%. However, further fiscal consolidation is warranted against the background of a high and still increasing external debt. Its implementation will require an acceleration of structural reforms, in particular in the area of health care, social welfare spending and state aid to enterprises.

Fiscal consolidation over the last two years led to a stabilisation of the general government debt ratio at around 44% (ESA 95) at end-2005. However, if issued guarantees as well as the outstanding debt of the state development bank HBOR is included, total public debt amounted to around 53% of GDP.

Structural reforms

Structural reform progress has been uneven. Some important measures were taken in mid-2005 aimed to support fiscal consolidation, such as the introduction of an administrative fee for health services, a change in pension indexation, a reduction in housing subsidies and a tightening of employment subsidies.

A health care reform was adopted in July 2006, although its scope was less ambitious than initially discussed. Moreover, the government has agreed on a subsidy reduction plan and a new state aid law was adopted in November 2006 with the intention of bringing legislation in line with EU requirements.

Generally slower progress has been made in the area of enterprise restructuring and privatisation. In February 2006, the Privatisation Fund issued a tender for an advisor to establish a comprehensive restructuring and privatisation plan for this sector. With some delays, the authorities have proceeded with the next rounds of the privatisation of the oil company INA in late 2006.Little progress has been achieved with respect to the restructuring of the shipbuilding and steel industry and the privatisation of the first shipyard, planned already for 2005, has been postponed.

Croatia - Main economic trends

		2001	2002	2003	2004	2005	2006	
Gross domestic product	Ann. % ch	4.4	5.6	5.3	3.8	4.3	4.8	H1
Private consumption	Ann. % ch	4.5	7.7	4.6	3.9	3.4	3.0	H1
Gross fixed capital formation	Ann. % ch	7.1	13.9	24.7	4.4	4.8	12.6	H1
Unemployment (ILO)	%	15.8	14.8	14.3	13.8	12.7	11.8	H1
Employment	Ann. % ch	-5.4	4.4	0.1	1.6	0.4	0.6	Oct
Wages	Ann. % ch	3.9	6.0	4.8	6.4	4.4	5.3	Sep
Current account balance	% of GDP	-3.7	-8.6	-7.2	-5.0	-6.4	-7.7	Q2*
Direct investment (FDI, net)	% of GDP	5.9	2.5	6.4	2.5	3.9	4.6	Q2*
CPI	Ann. % ch	3.7	1.7	1.8	2.1	3.3	3.4	Oct
Interest rate (3 months)	% p.a.	N.A.	4.63	5.42	7.31	6.21	4.35	Nov
Bond yield	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Stock markets	Index	971	1,167	1,129	1,284	1,920	3,256	Nov
Exchange rate HRK/EUR	Value	7.48	7.42	7.58	7.50	7.40	7.35	Nov
Nominal eff. exchange rate	Index	100.0	97.80	94.94	91.66	90.49	89.66	Sep
General government balance	% of GDP	-6.5	-4.1	-4.5	-5.0	-3.9	-3.6	2006**
General government debt	% of GDP	40.1	40.0	40.9	43.7	44.2	44.5	2006**

*Sources: Eurostat, Reuters/Ecowin, national sources, *four quarter moving average, **EC Autumn 2006 forecast*

VIII. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

General macroeconomic situation

In 2005, real GDP growth was 4.0%, similar to the increase by 4.1% in 2004. Exports appear to have been the most dynamic element of the economy, increasing by 7.4%. Final consumption and investment remained subdued with an increase of 0.8% and 1.5%, respectively. In 2006 and 2007, economic growth could further accelerate towards 4½%, based on improvements in the investment environment and strengthened consumer confidence.

Industrial production, which accounts for some 20% of total value added, rose by 7.2% in 2005, after a decline by 2.2% the year before. This strong fluctuation reflects the temporary closure of a few, significant production sites due to changes in ownership in 2004 and the reopening of production in those plants in mid-2005. In the first ten months of 2006, industrial production rose by 2.8% only.

International transactions

The external balance registered a significant improvement during 2005, with a decline in the current account deficit to 1.4% in 2005 from nearly 8% of GDP in 2004. About half of the improvement was due to higher exports, whose share increased to 36% of GDP in 2005 from 31% of GDP in 2004. Net private transfers increased to 17.6% from 13.3% of GDP in 2004, adding another 4¼ percentage points to the improvement in the current account. Foreign direct investment declined slightly, to 1.7% in 2005 from 2.8% of GDP in 2004. Balance-of-payments data for the first half of 2006 indicate a rather stable trend, with an annualised current account deficit of about 1.3% of GDP, while FDI inflows accounted for about 5% of the estimated 2006 GDP The trade deficit stood at roughly 19.6% of GDP in mid-2006, compared to a deficit of 17.4% of GDP the year before.

Total trade increased by 13% (in USD terms) during the first eight months of 2006. Nominal exports increased by some 12%, while nominal imports rose during this period by 14%. The most important export products were iron, textiles and tobacco. On the import side, oil products, motor vehicles and electricity were the most important items.

At the end of October 2006, official reserve assets of the National Bank stood at a level of EUR 1.2 billion, equivalent to 4.8 months of estimated 2006 imports of goods and services.

Long and medium-term external debt-to-GDP increased from € 1.7 billion (35% of GDP) at the end of 2004 to € 1.83 billion (41% of GDP) at the end of 2005. By October 2006, the external debt level had again declined to 35% of GDP. The main factor behind this increase was the issue of a € 150 million government bond. The rating of the Eurobond issue was BB/positive by Fitch and BB+ by S&P. The proceeds of this Eurobond issue were used to finance the buyout of London Club debt (€ 184 million) in early 2006. Short-term external debt consists mainly of trade credits and amounts to about 8-10% of GDP. External debt service increased to 15% of exports of goods and services.

Labour market

Unemployment is declining, but is still on a high level. According to labour force survey data, unemployment has declined to 36.1% in the second quarter of 2006, which is 1.3 percentage points lower than a year before. The number of employed rose by 2.4% year-on-year, while the labour force rose by 0.2%.

Nominal wage growth appears to accelerate. After strong rises of nominal gross wages in the post-crisis period 2002-2004, wage growth moderated to 2.7% in 2005. However, towards the end of the year, nominal wages started to increase again, reaching a 3.8% growth in the fourth quarter of 2005. In the first nine months of 2006, wages rose by 8.3%.

Prices

Consumer prices increased by 3.2% during the first eleven months of 2006, compared to 0.4% during the same period a year ago. One of the main reasons for the low inflation in the past years had been declining food prices as a result of import liberalisation due to the countries accession to WTO. However, during 2006, higher energy prices and increases in excise taxes led to an acceleration of consumer price rises. For the whole year of 2006, an increase of consumer prices by 3 ¼ % is expected.

Monetary policy

Monetary conditions eased markedly during 2006, reflecting improved confidence in the stability of the exchange rate regime. Average weighted lending rates declined from 12.1% at the end of 2005 to about 10.9% in October2006, while interest rates on deposits came down from 5.6% in December 2005 to 4.6% in October 2006. Credit growth in the private sector continued to be high, at some 23% during the first three quarters of 2006. Growth of M4 was 18% during the first nine months of 2006.

The exchange rate of the denar has remained largely unchanged against the euro on a level of 61.3 MKD/EUR. The National Bank intends to maintain its current peg vis-à-vis the euro.

Foreign exchange reserves amounted to EUR 1.4 billion by end-August, which corresponds to more than 4 months of imports. Important reasons for the rapid increase in reserves were the inflow from the proceeds pf the privatisation of ESM, the energy distribution network (about 5% of GDP) and other foreign exchange inflows through cash exchange offices.

Fiscal developments

Central government revenues increased by about 8% in 2005, and its expenditures rose by 6%. As a result, the general government balance registered a surplus of about 0.3% of GDP in 2005, compared to a balanced general government budget in 2004. The original fiscal target has envisaged a deficit of some 0.4% of GDP. The main reason for the improved performance is better than expected revenue while planned public investment remained below expectations.

As a result of the sale of the EUR 150 million Eurobond, the general government debt ratio increased to 41% of GDP at the end of 2005. However, after the buyback of London Club debt at the beginning of 2006, the ratio has come back to some 37% of the projected full-year GDP.

Structural reforms

During 2005 and the first three quarters of 2006 a number of important structural reforms were adopted and implemented. In early 2005, a pension reform took place, establishing second Pillar Pension Funds.

The new law on labour relations entered into force in early 2005. The main objective of this new law was to improve the flexibility of the labour market.

In mid-2005, the implementation of fiscal decentralisation increased the financial and administrative independence of the local communities.

In early 2006, a one-stop shop system for enterprise registration has been opened, leading to a marked simplification and acceleration of the registration procedures. As a result, the number of new business registrations has increased significantly.

The privatisation of the electricity sector has been prepared by splitting the sector into energy production and distribution. So far, the distribution network has been sold to a foreign investor.

The functioning of the real estate cadastre has been improved, by allowing outsourcing to private geodetic companies. As a result, the duration of real estate registration has decreased considerably.

The former Yugoslav Republic of Macedonia - Main economic trends

		2001	2002	2003	2004	2005	2006	
Gross domestic product	Ann. % ch	-4.5	0.9	2.8	4.1	3.8	2.6	Jan.-June
Private consumption	Ann. % ch	-11.6	12.5	-1.5	6.2	:	:	
Gross fixed capital formation	Ann. % ch	-8.6	17.6	1.1	10.9	:	:	
Unemployment	%	30.1	31.9	36.7	37.2	37.3	36.1	Q2
Employment	Ann. % ch	9.0	-6.3	-2.9	-4.1	4.4	2.4	Q2
Wages	Ann. % ch	3.5	6.9	4.8	4.0	2.7	8.3	Jan.-Sep.
Current account balance	% of GDP	-6.5	-9.5	-3.5	-7.9	-1.4	-1.3	Jan.-June
Direct investment (FDI, net)	% of GDP	11.8	2.1	2.0	2.8	0.5	5.0	Jan.-June
CPI	Ann. % ch	5.5	1.8	1.2	-0.4	0.5	3.2	Jan.-Nov.
Interest rate (3 months)	% p.a.	10.0	9.2	6.7	6.5	5.7	4.6	Oct.
Bond yield	% p.a.	:	:	:	8.5	10.0	6.1	Nov.
Stock markets	Index	1 000	1 095	1 179	1 352	1 941	4 020	Nov.
Exchange rate MKD/EUR	Value	60.9	61.0	61.3	61.3	61.3	61.3	Nov.
Nominal eff. exchange rate	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
General government balance	% of GDP	-6.3	-5.6	-1.1	0.0	0.3	-0.6	2006**
General government debt	% of GDP	48.8	42.9	39.0	36.6	40.9	35.6	2006**

*Sources: Reuters/Ecowin, national sources, ** EC Autumn forecast*

IX. MONTENEGRO

General macroeconomic situation

In 2005, real GDP rose by 4.1%, reflecting a strong performance in services. In particular, the tourism sector expanded strongly (16.6% rise in the number of arrivals). Also the expansion of the financial sector contributed to growth (assets of commercial banks increased by 56.6%), and construction, which rose by 40%. Growth seems to have been more vigorous in 2006: in the second quarter, GDP grew by 6.5% year-on-year. Industrial output declined by 1.9% year-on-year in 2005, driven by a contraction of 13.4% year-on-year in the utilities sector, which accounts for 23% of total industrial production. In contrast, output in the manufacturing industry rose by 2.5% year-on-year, aided by 10.6% growth in the food sector and 194.9% increase in the chemical industry. Mining and quarrying (6% of total industry) inched up by 0.2% year-on-year. In the first half of 2006, industrial production rose by 2.9% year-on-year.

International transactions

The current account deficit in 2005 widened to 12.2% of GDP or EUR 141 million, mainly due to an increase in the trade deficit, which rose by 34.2%, compared to a year earlier. This deterioration was driven by robust domestic demand, against a still limited export capacity. By contrast, the balances of services, income and transfers were all in surplus and reached a combined net surplus of 22.1% of GDP, due to growing tourism activity and workers remittances. In 2006, the current account deficit further deteriorated. It registered in the second quarter an annualised deficit, amounting to 17.7% of GDP, induced by investment-related increases in imports of services. The privatisation of Telekom Montenegro, Podgorica Aluminium Plant and Podgorica Banka in 2005 contributed to a record FDI inflows of EUR 375 million (or 22.8% of GDP), more than offsetting the current account deficit. FDI amounted to EUR 317 million in the third quarter of 2006. It came mostly from additional investments following privatisation operations, as well as from greenfield projects.

Montenegro's foreign debt accounted for 30.9% of GDP in 2005, down from 31.8% in 2004. It further decreased in early 2006 linked to a 15% additional write-off by the Paris Club following the successful completion by the former State Union of the 3-year agreement with the IMF. Public debt is now clearly defined following the agreement with Serbia on the allocation of financial assets and liabilities of the Former State Union of Serbia and Montenegro.

Labour market

Unemployment reached 30.3% in autumn 2005 (LFS data), as compared to 27.7% in the same period of 2004. In the same period, employment fell by 4.5%. Unemployment remains highly structural, as there is a substantial mismatch between employers' needs and workers skills.

Prices

In 2005, average inflation remained flat at 3.4% year-on-year, with a deceleration towards the end of the year. Prices of services rose by 12.6% in 2005, while prices of goods went up by 1.3%. Recent data indicate a slight annualised inflation of 1.7% in the period from January to October 2006. Industrial products' prices inched down to 1.2% year-on-year, while prices of agricultural products accelerated again to 8% year-on-year. In addition, a reduced VAT rate (7%) was introduced in 2006 for some products previously exempted from taxation, as well as for some other items such as tourism services, which were previously taxed at 17% rate.

Monetary and financial indicators

Montenegro introduced the euro as legal tender in January 2002, replacing the D-Mark, which had been introduced as the only legal tender in late-2000. The switch from the Yugoslav dinar (same currency as used in Serbia) to the D-Mark, de-linked Montenegro's monetary and economic policies from Serbia. The only monetary policy instruments are reserve requirements, and the issuing of treasury bills as an indirect possibility to influence interest rates.

The Central Bank lowered on 1 February 2006 reserve requirements for sight deposits and term deposits with less than 90 days maturity from 23% to 19%. At the same time, it introduced a 5% compulsory reserve for term deposits with maturity of more than 90 days, but less than one year.

Money supply (broad money) growth accelerated to 61.2% year-on-year in September 2006. This increase and the low impact reflect the ongoing remonetisation process in the country.

Fiscal developments

The general government deficit slightly widened in 2005 to 2.9% of GDP compared to 2.6% in 2004. Fiscal reforms, including the adoption of a centralised Treasury and a new tax system, have been accelerated. The share of VAT in total tax revenues remains substantial at 31.3%. In the first nine months of 2006, revenues exceeded expenditures by EUR 11.1 million (some 0.6% of the forecasted GDP).

General government debt further decreased in 2005 to 42.6% of GDP, while debt service rose to 6.4% of GDP, twice the amount of the previous year. Government debt is composed of 27% of domestic and 73% of foreign liabilities, the latter mainly towards the World Bank Group. Total public debt was 36.7% of GDP at the end of September 2006. However, contingent liabilities, as a result of internal restitution proceedings, may considerably inflate it.

Structural reforms

Progress in structural reforms continued in 2005. The government launched an ambitious project for the restructuring of 97 companies to be either privatised or liquidated, and their assets sold. The sales of Telekom Montenegro, of the aluminium producer KAP and of Podogoricka Banka marked key privatisation deals in 2005.

The privatisation of the banking sector has been completed in November 2006. Currently, some 80% of capital of the sector is foreign-owned. However the right of establishment of foreign banks' subsidiaries is not fully granted yet. A new banking law (under preparation) is expected to correct this situation. Bank supervision complies broadly with international standards, and risk control is largely in compliance with the basic Basel principles.

Montenegro - Main economic trends

		2001	2002	2003	2004	2005	2006	
Gross domestic product	Ann. % ch	-0.2	1.7	2.4	4.2	4.1	6.3	Q3
Private consumption	Ann. % ch	4.7	6.4	:	:	:	:	
Gross fixed capital formation	Ann. % ch	16.7	-16.1	:	:	:	:	
Unemployment	%	N.A.	N.A.	N.A.	27.7	30.3	:	
Employment	Ann. % ch	N.A.	N.A.	N.A.	N.A.	-4.5	:	
Wages	Ann. % ch	N.A.	N.A.	N.A.	N.A.	7.8	14.9	Oct
Current account balance	% of GDP	-15.7	-12.6	-7.3	-7.8	-12.2	-17.7	Q2
Direct investment (FDI, net)	% of GDP	0.9	6.9	2.8	3.3	22.8	18.9	Q2
CPI	Ann. % ch	22.8	17.8	7.9	3.4	3.4	1.7	Oct
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	10.72	1.20	0.92	Sep
Bond yield	% p.a.	N.A.	N.A.	N.A.	8.29	3.09	0.49	Nov
Stock markets	Index	N.A.	N.A.	1,000	1,758	5,670	18,021	Nov
Exchange rate EUR/EUR	Value	1.0	1.0	1.0	1.0	1.0	1.0	Nov
Nominal eff. exchange rate	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
General government balance	% of GDP	N.A.	N.A.	-1.9	-2.6	-2.9	0.6	Sep
General government debt	% of GDP	N.A.	88.3	51.1	48.3	42.6	36.7	Jun

Sources: Reuters/Ecowin, national sources.

X. SERBIA

General macroeconomic situation

In 2005, GDP has grown by 6.3% year-on-year compared to 9.3% in 2004 driven by strong gains in commerce, transportation and financial services, more than offsetting the drop in agriculture, construction and industry. Growth remained resilient during the first half of 2006. First and second quarter GDP grew by 6.7% and 6.6% year-on-year, respectively, resulting in a first half GDP increase of 6.7% compared to the same period a year earlier.

Industrial production declined sharply in the first half of 2005 but recovered somewhat in the second half, yielding a modest 0.6% annual growth rate for the whole year compared to 7.2% in 2004. Growth of industrial production in 2005 was based on the good performance of the electric power, gas and water sector (up 6.9%) which accounts for about 20% of industrial production. On the other hand, the manufacturing sector, which accounts for about 75% of total industrial production, recorded a decline of 0.8%. The highest growth rates were achieved in those sectors which had undergone substantial privatisation or restructuring in recent years, such as food and beverages, tobacco, chemicals and chemical products, rubber and plastic products, base metals, as well as motor vehicles and trailers. In 2006 industrial production strengthened and recorded an average growth rate of 5.7% year-on-year during the first half of 2006. Annual industrial output accelerated further in the summer months and reached 7.9% in July.

International transactions

In 2005, the current account deficit of Serbia has narrowed to 9.8% from 12.6% in 2004, on strong growth of exports (up 13.2% year-on-year to 25% of GDP) and declining imports (down 6.7% year-on-year to 49% of GDP), which was partially the result of the introduction of the VAT in January 2005 and the related acceleration of imports in December 2004. As a result, the trade deficit fell to EUR 4.9 billion or 23.1% of GDP for 2005 compared to EUR 5.8 billion or 29.8% of GDP a year earlier. However, imports still accounted for about 2½ times the level of exports. During the first seven months of 2006, imports resumed to expand at 26.4% year-on-year while export growth remained robust at about 26.2% year-on-year. Consequently, the trade balance has widened by about 26.6% compared to a year earlier. In the same period the current account widened by 53% year-on-year to about € 1.3 billion.

On the financing side, capital inflows increased in 2005 and reached EUR 3.6 billion compared to EUR 2.4 billion in 2004. Foreign direct investment (FDI) rose to EUR 1.2 billion or about 6.1% of GDP in 2005 from 4.3% of GDP in 2004, predominantly related to privatisation. Greenfield investment remained small. FDI covered about 60% of the seventh-month current account deficit, compared to 76% on 2005. However, this is expected to improve substantially once the proceeds from the sale of mobile operator Mobi 63 to Norwegian Telenor is reflected in the balance-of-payments data. In addition, medium- and long-term borrowing increased to EUR 1.5 billion in 2005 from EUR 1.2 billion in 2004, with the largest increase in borrowing by the private sector. This trend continued in 2006 as medium-, and long term borrowing more than doubled to about € 2.4 billion during the first seven months.

The improved trade balance and strong capital inflows contributed to a record foreign currency reserves accumulation of the National Bank of Serbia (NBS), which rose by EUR 1.6 billion to EUR 4.9 billion in 2005. During the first seven months of 2006, foreign currency reserves increased further and reached EUR 6.7 billion.

Following several years of decline, external debt of the Serbian economy has risen again.

Strong inflows of debt creating financing of the current account in the order of about 7.5% of GDP in 2005, mostly to the private sector, have put upward pressures on the level of foreign indebtedness of Serbia. At end-July 2006, total foreign debt stood at about EUR 14.6 billion or 66% of GDP. The private sector debt stock stood at about 34% of GDP and exceeded for the first time the official sector debt stock which stood at 32% of GDP. Debt service has increased to 5% of GDP and is projected to rise further in coming years.

Labour market

Amid an environment of continued enterprise restructuring and related staff reductions, employment declined by 197.000 to 2.7 million in 2005 according to the 2005 labour force survey. The number of unemployed rose by 54.000 to 720.000 and the unemployment rate rose to 20.8%. However, and partly due to sizeable informal employment, the official unemployment rate is reported at 27%.

Net average earnings grew by 23.6% and 6.4% year-on-year in 2005 in nominal and real terms, respectively. Wage growth accelerated during the first five months of 2006 and net average earnings recorded an increase of 25.4% and 9.5% year-on-year in nominal and real terms, respectively. In summary, wage growth remained strong, but broadly in line with productivity gains.

Prices

Inflation has remained at double digits throughout 2005 and stood at 17.7% year-on-year in December, mainly driven by strong domestic demand, increases in administered prices as a result of rising cost of fuel imports and the one-off effect of VAT introduction in January 2005. In addition, inflation developments were negatively affected by strong domestic demand against the backdrop of a relatively unresponsive supply side, lack of competition in domestic markets and widespread exchange rate indexation of prices amid the existing crawling band exchange rate regime with gradual nominal depreciation.

Core inflation, which excludes agricultural products, energy and services with administrative price controls, stood at 13.5% year-on-year in December 2005. In 2006, retail price inflation, without the effect of the VAT introduction and supported by the recent appreciation of the dinar, eased substantially and reached 9.3% year-on-year in October.

Monetary policy

Monetary policy has been challenged by strong capital inflows, robust credit growth and rising inflation. In response to strong capital inflows into the Serbia economy, mostly in the form of FDI and foreign borrowing, the NBS has substantially intervened in the foreign exchange market in an attempt to prevent a real appreciation of the dinar exchange rate, but also to further boost foreign exchange reverses, which have reached a comfortable level of about 6 months of imports mid-2006. Linked to the foreign exchange interventions, domestic money market liquidity has been boosted (dinar reserve money and M3 grew by 22% and 42% year-on-year, respectively), which in turned fuelled strong credit growth (credit to the private sector expanded by 57% year-on-year in) and added to domestic demand. To counterbalance the liquidity effect, the NBS attempted to absorb liquidity by selling government and NBS bills and raising reserve requirements several times during 2005 and early 2006.

In addition, against the backdrop of an acceleration of inflation during 2005, the NBS allowed for a slower nominal depreciation of the dinar (8.7% year-on-year compared to 15.4% in 2004 vis-à-vis the euro), resulting in a moderate real appreciation (3.1% year-on-year). In early 2006, the NBS began to reduce foreign exchange interventions and allowed for greater market flexibility. As a result, the dinar has appreciated vis-à-vis the euro by about 7.9% between May and September 2006. In September 2006, the NBS has adopted a monetary policy framework of inflation targeting.

Fiscal developments

The consolidated general government budget has reached a surplus of 1.9% of GDP, in 2005 compared to a surplus of 0.9% of GDP a year earlier. The revenue performance has been improving throughout the year, helped by the introduction of VAT in January 2005. Apart from VAT, personal and corporate income tax grew in real terms (4.6% and 27.1%, respectively) as well as non-tax and capital revenue (9.7% and 11.2%, respectively). For the same period, expenditures declined by 0.4%, due to permanent cuts of subsidies and transfers. It is worth noting that the 2005 reform of the pension system will result in additional permanent savings in coming years.

For the first quarter of 2006, public revenues grew by 4.4% year-on-year in real terms, driven by strong gains in personal and corporate income tax (15.5% and 75.2%, respectively), more than offsetting the decline in VAT revenues (by 14.8%). Expenditures grew at 4.7% during the same period, as wages and salaries, purchases of good and services, but also capital expenditures grew stronger. In 2006, the government has launched a national investment plan worth about EUR 1.6 billion for 2006 and, mainly, 2007, to be largely financed by privatisation proceeds received in 2006. This could contribute to an aggravation of macroeconomic imbalances, in particular inflation and the current account deficit and risks jeopardizing macroeconomic progress to date.

In September 2006, the Serbian Parliament approved the revised 2006 budget, reducing the projected surplus to 0.8% of GDP from an initially 2.1%, to allow for the implementation of the National Investment Plan, which foresees additional expenditures in the amount of about € 400 million in the remainder of 2006.

The general government debt of Serbia has declined by 7 percentage points of GDP to 61% of GDP in 2005. Of which, 54% was denominated in foreign currency, exposing Serbia to considerable foreign exchange risk. In 2006 and as a result of recent budget surpluses, early debt repayment and write-offs, Serbian public debt continued to decline to a moderate level of below 40% of GDP, of which 34% of GDP remain denominated in foreign currency.

Structural reforms

Privatisation of socially-owned companies advanced, helped by amendments to several key laws in 2005 (laws on privatisation, share fund and financial markets). However, the process of restructuring those large insolvent companies, which were selected by the Government of Serbia for restructuring through the Privatisation Agency, progressed slowly.

Preparations for restructuring and privatisation of several large state-owned companies have intensified as far as spin-off of non-core activities and assets as well as the reduction in overstaffing is concerned, while in some cases privatisation strategies are under preparation.

Overall, despite substantial progress in privatisation in recent years a competitive and dynamic private sector has not yet been fully established. The share of the private sector in Serbian GDP remains at a relatively low 55%, whereas state and social ownership still governs a large part of Serbia’s output. The absence of a larger share of private sector activity is a substantial obstacle for the provision of a dynamic supply of competitive domestic products and services, and adversely affects inflation and external accounts.

Serbia - Main economic trends

		2001	2002	2003	2004	2005	2006	
Gross domestic product	Ann. % ch	5.1	4.5	2.4	9.3	6.3	6.6	Q2
Private consumption	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Unemployment	%	12.2	13.3	14.6	18.5	20.8	21.8	Sep
Employment	Ann. % ch	0.4	-3.4	-2.7	0.4	-6.7	-3.7	Sep
Wages	Ann. % ch	18.4	30.9	14.0	11.1	6.8	9.6	Sep
Current account balance	% of GDP	-2.7	-7.9	-7.2	-11.7	-8.4	-6.9	Q1-Q3
Direct investment (FDI, net)	% of GDP	1.6	3.0	6.7	3.9	5.9	8.2	Q1-Q3
CPI	Ann. % ch	91.8	19.5	11.7	10.1	16.5	7.6	Nov
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	21.2	14.6	12.6	Sep
Bond yield	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Stock markets	Index	N.A.	N.A.	N.A.	1136.0	1,595	1,790	Sep
Exchange rate CSD/EUR	Value	59.8	60.7	65.0	72.6	82.9	78.5	Nov
Nominal eff. exchange rate	Index	81.3	99.8	98.2	92.4	87.6	102.9	Sep
General government balance	% of GDP	0.0	-3.1	-1.1	0.9	1.9	1.9	Q2
General government debt	% of GDP	104.3	80.6	70.9	56.7	52.9	38.0	Q2

Sources: Reuters/Ecowin, national sources.

XI. KOSOVO (UNSCR 1244)

General macroeconomic situation

The decline in donor's support and the downsizing of the international community's presence continue to have negative effect on economic development in Kosovo. According to IMF estimates[62], GDP is estimated to have declined by 1% in 2005. There are nevertheless some signs of increasing dynamics and resilience of private sector activity in 2006, partially compensating the continuous rapid decline in foreign assistance.

The overall economic situation in Kosovo remains bleak: Kosovo has a per-capita GDP of around EUR 1,100, the lowest in the region. According to World Bank estimates, around 37% of the population lives in poverty, with around 15% living in extreme poverty. Growth has been weak over the recent years (it was negative in 2002, 2003 and 2005) and insufficient in view of the territory's considerable development needs.

International transactions

The external situation of Kosovo remains also precarious. Owing to a considerable trade deficit of around 47% of GDP in 2005, the current account deficit, after foreign assistance, remained close to 18% of GDP. The coverage ratio of regular imports by exports was at an extremely low level of 9% in 2005, mainly due to lacking export capacity and competitiveness. Given the absence of sizeable foreign direct investment inflows, the financing of the current account deficit continued to rely on foreign assistance in the form of project support (steadily decreasing from 24.5% of GDP in 2004 to 20.8% of GDP in 2005 and estimated 16.8% of GDP in 2006) and, to a lesser extent, on private capital transfers (estimated at around 15% of GDP in 2006). Nevertheless, a modest gradual increase in foreign direct investment inflows has been recorded recently, in the wake of acceleration of the privatisation process. The IMF estimates FDI, including privatisation proceeds, at around 10% in 2006.

Kosovo has no access to external borrowing, given the UN's reluctance to enter into debt arrangements possibly resulting in UN liabilities. Kosovo in particular does not have access either to IMF and World Bank lending, as it is not a member of these institutions.

Kosovo currently does not assume any sovereign debt servicing obligations. This situation may however change if -following status negotiations under the auspices of UN special envoy Mr Ahtisaari and subject to their outcome- the servicing of a notional share of sovereign loans attributable to Kosovo which are currently being serviced by Serbia is transferred to Kosovo.

This may result in external debt becoming a major issue for the sustainability of the budget and external accounts, with the servicing of approximately USD 1 billion of debts (i.e. around one third of GDP) mainly to the World Bank, Paris Club and London Club creditors being transferred to Kosovo.

Labour market

The level of registered unemployment remains high, official statistics point to an unemployment rate between 42-44%, even though the real unemployment rate is most probably lower due to a sizeable informal economy. Labour costs in Kosovo remained in regional terms excessively high, dampening private sector development and export competitiveness.

[62] Macroeconomic data in this note are based on the IMF staff estimates, except otherwise indicated.

Prices

Inflation has been very moderate, to some extent owing to the weakness in economic activity and adjustment downwards in the context of downsizing of the international community's presence which had boosted prices in the early years of UNMIK's mandate. After two years of deflation (annual CPI inflation is estimated negative at -1.5% in 2004 and -1.7% in 2005), for 2006 the IMF estimates CPI inflation at 0.9%.

Monetary policy

The monetary framework in Kosovo is anchored on the use of the euro as sole legal tender. Given the absence of autonomous monetary policy, the budget is the core policy tool for macroeconomic adjustment. The Central Banking and Payments Authority of Kosovo (CBAK)[63] is in charge of regulating foreign exchange operations, providing payments services and supervising banks and other financial institutions. The CBAK closely monitors liquidity in the banking sector and credit expansion, with liquidity ratios and reserve requirements respectively as main tools of intervention.

Notwithstanding the conservative lending policies and prudential requirements, the annual credit growth has been substantial (38% y/y in 2005 and 30% y/y as of September 2006), in particular as regards loans with maturity over 1 year, reaching an annual growth of around 50%.

The banking sector in Kosovo appeared to be sound, profitable and well capitalised. Still, the available financial indicators should be interpreted with caution. The capital adequacy ratio of commercial banks in Kosovo was equal to 14.7% at the end of 2005. Local banks remain very liquid, with the loan-to-deposit ratio of around 61% at the end of 2005 and 68% in September 2006, partly as a result of high prudential requirements set by the BPK.

The competition in the banking sector remained limited. In March 2006, the BPK revoked a license and ordered a closure of Credit Bank of Pristina, with little detrimental impact on credibility and liquidity of the overall financial sector. Since then, there have been only six commercial banks operating in Kosovo. As a result, the degree of concentration of the three largest banks further increased in terms of assets by 6%, reaching 80% of total banking sector deposits. Around 55% of total bank's equity was owned by foreign capital at the end of 2005.

Fiscal developments

After an expansionary fiscal stance in 2004 with a budget deficit of 6% of GDP, the budget deficit was curbed down to 3.1% of GDP in 2005. The foreseeable exhaustion of accumulated cash deposits, the only source of financing the budget deficit, and the impossibility for the PISG under the current UN mandate to have recourse to public borrowing resulted into a particularly tensed fiscal situation. Therefore, vigorous fiscal adjustment has become a high priority. In October 2005, with the support of the IMF, a medium-term economic policy framework was defined by a Letter of Intent and Memorandum on Economic and Financial Policies, signed by UNMIK and PISG in November 2005, which aims at ensuring a sustainable fiscal path. According to that, the budget deficit would fluctuate depending on the cyclical position of the economy and the level of inflation. Real expenditure growth would be kept below 0.5% and the number of government employees reduced, allowing for a redeployment of public expenditure towards capital outlays. As of December 2006, discussions on a new revised Letter of Intent were ongoing between the IMF and the authorities of Kosovo.

[63] In August 2006, the Banking and Payment Authority of Kosovo has been transformed into the CBAK.

The fiscal development over the first three quarters of 2006 was on aggregate much more favourable than budgeted. Over this period, revenue collection exceeded the budget target, while only 74% of the expenditure was realized (mainly because of lack of institutional capacity for procurement). Capital investment registered the highest under-spending, at only 45% of programmed levels. Against this development, the budget for the full year is expected to post close to balance results. The budget for 2007 enacted on 28 December 2006 foresees a deficit of EUR 35 million in 2007 (1.6% of GDP). Considerable fiscal risks remain, mainly related to the vulnerability of the energy sector, additional fiscal costs arising from the upcoming status settlement -notably debt servicing- and other possible contingent liabilities (currently not reflected in the proposed budget). The authorities finalised the first Medium-Term Expenditure Framework (MTEF) in March 2006 on the basis of which a donor meeting took place in early April 2006. In line with the request of international community, the MTEF consolidated all budget and off-budget expenditure and resources and covered both recurrent and investment expenditures, including public investment projects. As of December 2006, the authorities started working on a revised framework also factoring in the post status financing needs.

Structural reforms

Privatisation of the socially-owned enterprises progressed markedly in 2005 and continued rapidly in 2006: the 21st wave was launched in December 2006. The Kosovo Trust Agency aims at privatising 90% of total assets and 50% of total number of socially-owned enterprises by the end of 2006. Good progress was also achieved in incorporation of publicly-owned enterprises. The Kosovo Post and Telecommunications utility (PTK) and Pristina Airport were incorporated in June 2005, while the incorporation of KEK, the loss-making electricity utility, Kosovo Railways and two District Heating Companies were completed at the end of 2005.

A new regulatory environment has been established in the area of energy, with the setting up of a regulatory authority and the signature of the Energy Community Treaty in October 2005, establishing a Regional Energy Market in South East Europe. In July 2005, the Ministry of Energy and Mining completed its Energy Strategy of Kosovo for 2005-2015. The process of trade liberalisation with neighbouring countries continued: as of December 2006, four free trade agreements with Albania, the former Yugoslav Republic of Macedonia, Bosnia and Herzegovina and Croatia were already in force.

However, infrastructure remained insufficient and often of poor quality. In particular, the situation in the energy sector is critical - the power supply infrastructure remained unreliable, with frequent power cuts, affecting private sector productivity and hindering economic development and investment.

Kosovo - Main economic trends

		2001	2002	2003	2004	2005	2006	
Gross domestic product	Ann. % ch	N.A.	-2.4	-0.1	3.2	-1.0	3.0	IMF proj.
Private consumption	Ann. % ch	N.A.	2.0	1.9	3.3	5.5	3.4	IMF proj.
Investment	% of GDP	29.8	26.6	24.8	25.1	25.8	28.7	IMF proj.
Unemployment	%	N.A.	47.0	49.7	39.7	42.2	:	
Employment	Ann. % ch	17.4	9.7	-24.8	4.7	-17.1	:	
Wages	Ann. % ch	N.A.	N.A.	2.0	9.3	5.6	:	
Current account balance, after foreign assistance	% of GDP	-3.0	-8.0	-9.6	-11.2	-15.2	-17.8	IMF proj.
Direct investment (FDI, net)	% of GDP	1.4	0.4	0.9	0.9	2.7	10.3	IMF proj.
CPI	Ann. % ch	11.7	3.6	1.2	-1.5	-1.7	0.9	IMF proj.
Interest rate (nonfinance corp. loans 3 - 12 months)	% p.a.	:	15.6	14.6	15.7	15.6	14.7	Sep
Bond yield	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
Exchange rate EUR/EUR	Value	1	1	1	1	1	1	
Real eff. exchange rate (CPI annual average chg)	Index	8.6	-1.5	0.5	-3.1	-4.9	:	
General government balance	% of GDP	3.7	4.4	2.1	-6.0	-3.1	0.8	IMF proj.
General government debt	% of GDP	0.0	0.0	0.0	0.0	0.0	0.0	

Sources: Reuters/Ecowin, national sources, IMF

ABBREVIATIONS

AC	Acceding Countries
ALL	Albanian Lek
ATMs	Autonomous trade measures
BiH	Bosnia and Herzegovina
CARDS	Community Assistance for Reconstruction, Development and Stabilisation
CAS	Country Assistance Strategy
CC-3	Bulgaria, Croatia, Romania
CEEC	Central and Eastern European Countries
CEFTA	Central European Free Trade Agreement
CEM	Country Economic Memorandum
CPI	Consumer Price Index
DIN	Serbian Dinar
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECHO	European Community Humanitarian Office
EIB	European Investment Bank
EU	European Union
EUR	Euro
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FIPA	Foreign Investment Promotion Agency
FTA	Free Trade Agreement
fYRoM	The former Yugoslav Republic of Macedonia
GDP	Gross domestic product
GNP	Gross national product
HRK	Croatian Kuna
IDA	International Development Association
IFC	International Finance Corporation
IFIs	International Financial Institutions
ILO	International Labour Organization
IMF	International Monetary Fund
ISG	Infrastructure Steering Group
KFOR	Kosovo Peacekeeping Force
KM	Convertible Mark
MFA	Macro-financial assistance
MFN	Most-favoured nation
MKD	Macedonian Denar
MoU	Memorandum of Understanding
MTEF	Medium-Term Expenditure Framework
NATO	North Atlantic Treaty Organization
NIS	Newly Independent States
NMS-8	New Member States from Central and Eastern Europe
OECD	Organisation for Economic Co-operation and Development
OHR	Office of the High Representative (BiH)
OJ	Official Journal of the European Union
OSCE	Organization for Security and Co-operation in Europe
PIP	Public Investment Program
PPP	Purchasing power parity
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
RS	Republika Srpska
SAA	Stabilisation and Association Agreement
SAp	Stabilisation and Association Process
SBA	Stand-by Arrangement
SCG	Serbia and Montenegro (Srbija I Crna Gora)
SDR	Special Drawing Right
SEE	South-East Europe
SMEs	Small and Medium sized Enterprises
SMP	Staff Monitored Programme
SOEs	Socially owned enterprises
STM	SAp Tracking Mechanism
T-bill	Treasury bill
TSA	Treasury Single Account
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNMIK	UN Interim Administration Mission in Kosovo
UNSCR	United Nations Security Council Resolution
USD	United States Dollar
VAT	Value Added Tax
WB	World Bank
WTO	World Trade Organization
Yoy/y-o-y	year on year

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