CHAPTER 4

SOUTH-EAST EUROPE

4.1 The policy agenda

With the entry of 10 new members of the EU in 2004, the agenda for the next round of enlargement focuses on candidates from south-east Europe. In 2004, Bulgaria and Romania closed all the negotiation chapters and are scheduled to join the EU in 2007. The start of accession negotiations with Croatia and Turkey is expected to give a strong impetus to their ongoing economic reforms. The emergence of a new, regional group of potential EU members will undoubtedly have a wide-ranging and positive economic impact on the whole south-east European region.

The experience of the east European economies that have just joined the EU provides strong evidence that the realistic prospect of EU membership has been the single most important stimulus to the economic transformation of these countries. The preparation for accession to the EU defines a broad reform agenda with clearly specified goals and the means to achieve them, and establishes strong and clear incentives for policy makers. Moreover, the institutionalization of the policy commitments within a tight schedule of accession negotiations helps both to accelerate and provide direction to the reform process.

The recent experience of the south-east European EU candidate countries supports the view that a virtuous cycle of strong growth and accelerating reforms can emerge during the final years of preparation for EU membership. A similar process was also observed in the central European and Baltic countries prior to their accession to the EU. This experience indicates that, through its powerful effect on expectations, the realistic prospect of EU accession (especially when accompanied by a clear timetable for membership) can act as a major, albeit indirect, stimulus to economic growth. In particular, the recent increase of FDI in Bulgaria, Romania and, to a lesser extent, Croatia, largely reflects the change in investors’ expectations with regard to the prospect of these economies becoming part of the EU in the not too distant future. In turn, the large flows of inward FDI have undoubtedly contributed to the restructuring of these economies, giving a boost to economic activity.

The current economic revival in Turkey has a somewhat different character in that it is largely associated with a successful stabilization programme and a faster pace of reform; but, at the same time, it also bears some resemblance to what has been happening in other parts of south-east Europe (box 4.1.1). It can be expected that the eventual start of accession negotiations with the EU will also provide strong support to the economic and legislative reforms being pursued in this country.

The policy process and agenda in the other parts of south-east Europe, however, lack the clear direction that can be seen in the EU candidate countries. In Serbia and Montenegro, the largest of these economies, the reform effort has lost some momentum and focus; largely because of a difficult political situation (involving four rounds of election in 12 months). Very high and persistent levels of unemployment in most of these countries remain an acute problem that policy makers in the region have yet to solve.

In recent years, all the south-east European economies have made considerable progress in macroeconomic and financial stabilization, and 2004 has generally been no exception in this respect: Turkey and Romania, with the highest inflation rates in the region, are also the countries that have made the most progress in reducing them. The emergence of a more stable and predictable macroeconomic environment has undoubtedly contributed to the strengthening of economic activity in south-east Europe. In turn, this has had a beneficial effect on domestic financial markets where both nominal and real interest rates have generally been falling in recent years (table 4.1.1).

The economic outlook of south-east Europe as a whole depends on several key policy-related issues and factors. The first is whether individual countries will be successful in their attempts at integration with the EU. As mentioned already, unambiguous progress in this process can trigger a virtuous cycle of strong economic growth and focused market reforms. However, in order to get to this point, clear, long-term policy goals need to be established as national priorities and accepted as such by a significant majority of their populations. The absence of such a consensus about the general direction of reform in some of these countries is one of the major stumbling blocks to their economic transformation.
There has been remarkable progress in fiscal consolidation since 2001. The primary surplus of the consolidated public sector increased by more than 10 percentage points, from 5 per cent in 2001 to 15 per cent in 2004. Business confidence increased significantly, contributing to a strong rebound in productivity. The sharp fall in the rate of inflation has allowed the monetary authorities to lower interest rates significantly which, in turn, have stimulated investment in the private sector. The net inflow of portfolio capital reached some $36 billion in September 2004, up from $17 billion at the end of 2002, and well above the amount envisaged in the stabilization programme.

The major challenge for the government is to sustain the pace of reform in the face of mounting political and social pressures. In the past, policy reversals have resulted in major economic setbacks on several occasions. Sustaining the hard-won macroeconomic stability and keeping the economy on a high growth track thus requires a lasting and dedicated policy effort. Despite its reduction, the ratio of total public debt to GDP still remains high, implying net interest payments above 10 per cent of GDP in 2004. The large and rising current account deficit (around 5 per cent of GDP in 2004) remains a concern for policy makers as it is largely financed by volatile short-term capital. Inward FDI is relatively low despite a recent upturn.

Further progress in reducing inflation is needed (to low single-digit rates) if interest rates are to continue to fall. This would not only lower domestic debt service payments but would also stimulate further productive investment and help to sustain a high rate of economic growth. Indeed, a shift to a higher trend rate of growth will be needed in order to reduce the unemployment rate which has reached 13 per cent in urban areas. In view of the rapid growth of population and very low participation rates this will remain a major policy concern in the medium and long term. Growing unemployment has been accompanied by a rise in poverty and the expansion of informal economic activities.

Box 4.1.1
Economic turnaround in Turkey: can the momentum be sustained?

In early 2001, the Turkish economy was on the brink of financial default. A long period of political instability, persistently double-digit rates of inflation, growing public sector debt and deteriorating bank portfolios triggered a massive loss of investor confidence. The crisis led to a full-blown run on the banking system (forcing a massive government bailout of failing banks) and the collapse of the crawling peg exchange rate regime.1

The policy response to the 2000-2001 crisis

In spring 2001, the government launched a series of policy reforms (based on the national programme for convergence with the EU’s acquis communautaire) supported by a standby agreement with the IMF. Further measures (the so called Urgent Action Plan) were adopted in 2002. This ambitious programme envisaged wide-ranging structural reforms targeting macroeconomic stabilization and a higher trend rate of growth. It also included important changes in macroeconomic policy such as a considerable tightening of fiscal policy, the introduction of a floating exchange rate regime and the granting of operational independence to the central bank.

In the following three years the main macroeconomic targets of the programme were exceeded by a significant margin. Year-on-year consumer price inflation fell from more than 70 per cent at the end of 2001 to single digits in May 2004, the lowest rate in more than 30 years (chart 4.1.1). In November 2004, the 11-month cumulative rate of inflation was 8.8 per cent compared with the central bank’s year-end target of 12 per cent. Rising confidence in the central bank’s commitment to pursue and maintain price stability is reflected in the fact that the gap between consensus inflation forecasts and the official inflation target (a proxy for the credibility of the central bank) turned negative for the first time. Further evidence of rising investor confidence is provided by the spreads on Turkey’s eurobonds, which fell by 290 basis points, and by the equity market index (ISE-100), which rose by nearly 25 per cent in dollar terms between mid-May and end-September 2004.

After a sharp recession in 2001, the economy recovered rapidly: the cumulative real GDP growth in 2002 and 2003 was more than 14 per cent, and the current forecast is for a rise of some 9 per cent in 2004 (well above the initial forecast of 5 per cent). A strong rebound in productivity was the key factor behind this remarkable, non-inflationary rate of growth. It may also be surmised that there has been an increase in potential output growth since 2001, at least in part because of the favourable effects of successful stabilization policies on business investment and productivity. The sharp fall in the rate of inflation has allowed the monetary authorities to lower interest rates significantly which, in turn, have stimulated investment in the private sector.

There has been remarkable progress in fiscal consolidation since 2001. The primary surplus of the consolidated public sector reached 15 per cent of GDP in 2004, up from 3 per cent in 2000, and is forecast to reach 6.5 per cent in 2004, in line with the government’s programme. The ratio of total public net debt to GDP is forecast to fall to about 70 per cent at the end of 2004, down from more than 90 per cent in 2001. As part of the debt is held in foreign currency, the appreciation of the lira also contributed to the reduction in the debt to GDP ratio. Productivity driven falls in unit labour costs have prevented losses in cost competitiveness despite the appreciating lira and these have helped to strengthen merchandise exports.2 Foreign reserves reached some $36 billion in September 2004, up from $17 billion at the end of 2002, and well above the amount envisaged in the stabilization programme.

In December 2004, the European Council acknowledged that Turkey had met the Copenhagen political criteria for EU membership with a view to opening accession negotiations on 3 October 2005. This positive outcome should provide Turkey with an important external anchor for domestic policy, contributing to a further strengthening of investor confidence and a general improvement in expectations.

The challenges ahead

The major challenge for the government is to sustain the pace of reform in the face of mounting political and social pressures. In the past, policy reversals have resulted in major economic setbacks on several occasions. Sustaining the hard-won macroeconomic stability and keeping the economy on a high growth track thus requires a lasting and dedicated policy effort. Furthermore, the large public debt (which has reached 13 per cent in urban areas) will remain a major policy concern in the medium and long term. Growing unemployment has been accompanied by a rise in poverty and the expansion of informal economic activities.
Further structural reforms are needed to sustain the fiscal consolidation. The efficiency of public spending needs to be improved, together with further reforms of the system of taxation. At present, three quarters of total budgetary expenditures are non-discretionary, which reduces the room for manoeuvre in public spending. In order to enable more spending on public investment and a more effective social safety net, the pension and health-care systems will have to be reformed (some preliminary work is already underway). The current system of taxation, heavily dependent on excise duties, also calls for major changes. Tax reforms will need to be mainly focused on broadening the tax base which, if successful, should boost public revenue.

Efforts also need to be made to reduce the exposure of the economy to volatile short-term capital flows, and to attract more FDI. This, in turn, will require further improvements in the business environment, and the continuation of structural reforms. Privatization needs to be given high priority in order to strengthen the basis of the market economy.

The consolidation of macroeconomic gains also requires microeconomic adjustments. The present stabilization programme has so far been based on sound macroeconomic policies and structural reforms mainly in the public sector. The next round of reforms should focus on labour markets, competition policy and corporate governance in order to make both the product and labour markets more efficient and to lay the basis for further gains in productivity and competitiveness which should stimulate employment growth in the longer term.

Thus, sustaining the current momentum requires consistent implementation of the new policy framework and a deepening of the reform effort. So far the indications are that the government is committed to these goals, as evidenced in the announced new three-year standby agreement with the IMF (due to start in February 2005 when the present one expires). The government has also pledged to maintain its fiscal consolidation effort: according to the budget proposal for 2005 the primary fiscal surplus should remain at 6.5 per cent of GDP in spite of the projected slowdown in GDP growth. However, it is still too early to judge whether or not the recent economic recovery and the associated policies have paved the way to a new era for the Turkish economy.

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1. As a result public net debt rose from less than 60 per cent of GDP in 2000 to more than 90 per cent in 2001. The ex-post cost of cleaning up the banking system is estimated at around $50 billion, corresponding to some 30 per cent of GDP in 2002 and more than half of total banking assets at the end of that year.

2. Merchandise exports increased by nearly one third, year-on-year, in the first three quarters of 2004.

3. In January-September 2004, net FDI inflows reached $1.6 billion (or some $23 per capita), significantly below the levels recorded in other ECE emerging market economies.

4. According to the household labour force survey, the labour force participation rate was 49.2 per cent (44.1 per cent in urban areas) in the second quarter of 2004, down from 57 per cent in 1990. The employment rate for the whole economy fell to 44.6 per cent (38.4 per cent in urban areas).

5. Even though food poverty is negligible in Turkey, 27 per cent of the population was living below the food and non-food poverty line in 2002. According to official estimates, informal activities accounted for more than 50 per cent of total employment in 2004.

Structural and institutional reforms remain an important challenge for the whole south-east European region. The reforms of health care and pension systems are either at an early stage or have not yet started at all. Public institutions for a market economy in most of these countries are still underdeveloped and this has a negative effect on the business environment: the protection of property rights, including law and contract enforcement, is generally weak; the public administration is widely perceived as inefficient and lacking in transparency; and corruption is still widespread. Significant reform in these areas is a fundamental requirement for successful economic integration with the EU.

All the south-east European economies still have per capita incomes, which are much lower than those in the more developed market economies. A key prerequisite for closing the gap, namely sustaining relatively high rates of economic growth for a sufficiently long period of time, is the development of human capital. This is an important determinant of national competitiveness and a key factor of their long-term growth. Hence human capital development should be among the principal priorities of public policy in the countries of south-east Europe.

It also needs to be borne in mind that social cohesion is a crucial dimension of human capital development. The lingering social tensions amid widespread poverty in some of the south-east European countries will require a leading role for public policy if they are to be eliminated or defused. In this regard, an integrated set of structural reforms focused on increasing employment (employment rates being excessively low at present) is one of the areas where success could bring wide-ranging benefits. Policies aimed at reducing inequality – without diluting incentives to work – can also have a positive effect on future growth prospects. In
The real lending rates are the nominal rates discounted by the average rate of increase in the CPI for the corresponding period. The real deposit rates are the nominal rates discounted by the average rate of increase in the PPI for the corresponding period.

4.2 Recent macroeconomic developments

**Turkey’s economy is booming**

Aggregate GDP growth in south-east Europe generally strengthened in 2004, thanks to a robust performance in most of the EU candidate countries. During the first half of 2004, Turkey, the largest economy in the region, was expanding at double-digit rates (table 4.2.1). The upturn was broadly based but industry (mining, manufacturing and utilities) contributed most of the increase. In the third quarter, the pace of industrial output slowed down somewhat (chart 4.2.1) but industrial capacity utilization continued to rise and in September it stood at 84.8 per cent, the highest rate in the last seven years. Domestic demand (both private consumption and, especially, fixed investment) was unusually buoyant, reflecting the positive shift in expectations. With domestic demand outpacing GDP growth, net exports contributed negatively to GDP growth, despite a continued robust increase in the exports of goods and services (table 4.2.2 and chart 4.2.2). However, the rapid import growth contributed to a further widening of the already large current account deficit, which remains a major policy concern. As discussed in more detail in box 4.1.1, the current boom reflects the positive outcomes (including macroeconomic stabilization) of the reform programme initiated in 2001.

**Economic activity also strengthened in other south-east European countries...**

A broad-based economic recovery in Bulgaria and Romania gained further ground in 2004, underpinned by several factors. On the supply side, there was a notable acceleration in the pace of economic restructuring and modernization of these economies, largely driven by the recent surge in inward FDI. The upgrading and expansion

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TABLE 4.1.1

<table>
<thead>
<tr>
<th></th>
<th>Interest rates on short-term credits (per cent)</th>
<th>Interest rates on short-term deposits (per cent)</th>
<th>Total credit (per cent of GDP)</th>
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<td>Nominal Real Nominal Real Nominal Real</td>
<td>Nominal Real Nominal Real Nominal Real</td>
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<tr>
<td>Albania</td>
<td>15.3 14.3 12.1 21.5 14.3 10.0 8.5 8.4 6.9 3.1 5.7 3.6 6.3 6.6 7.8</td>
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<tr>
<td>Bosnia and Herzegovina</td>
<td>12.7 10.9 10.4 12.0 11.0 8.1 4.5 4.0 3.6 3.5 3.4 3.2 32.7 39.2 43.0</td>
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<tr>
<td>Bulgaria</td>
<td>9.8 9.2 9.1 8.5 4.0 3.9 3.0 3.1 3.2 -2.6 0.8 -2.6 16.5 22.8 28.6</td>
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<tr>
<td>Croatia</td>
<td>13.0 11.6 11.8 13.4 9.5 9.3 1.9 1.5 1.8 0.0 -0.6 -0.6 47.1 54.6 56.1</td>
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<tr>
<td>Romania</td>
<td>35.4 25.7 26.3 8.6 3.9 5.6 19.1 11.0 11.9 -2.8 -3.8 -1.5 10.7 12.5 13.8</td>
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<tr>
<td>Serbia and Montenegro</td>
<td>24.3 16.5 15.9 14.3 11.4 8.5 21.2 14.3 14.3 4.0 4.5 5.0 12.0 15.9 14.8</td>
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<tr>
<td>The former Yugoslav Republic of Macedonia</td>
<td>18.3 16.0 12.6 19.4 16.3 13.1 9.6 8.0 6.6 7.6 6.7 5.4 16.2 16.4 17.9</td>
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<td>Turkey</td>
<td>.. .. .. 12.3 16.0 12.6 19.4 16.3 13.1 9.6 8.0 6.6 7.6 6.7 5.4 16.2 16.4 17.9</td>
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</tbody>
</table>


Note: Definition of interest rates:

Credits – Bulgaria: average rate on short-term credits; Croatia: weighted average rate on new credits to enterprises and households only; Romania: average short-term lending rate; The former Yugoslav Republic of Macedonia: median rates for short-term loans to all sectors. The real lending rates are the nominal rates discounted by the average rate of increase in the PPI for the corresponding period.

Deposits – Bulgaria: average rates on one-month time deposits; Croatia: weighted average rate on new deposits; Romania: average short-term deposit rate; The former Yugoslav Republic of Macedonia: lowest reported interest rate on household deposits with maturities of three to six months. The real deposit rates are the nominal rates discounted by the average rate of increase in the CPI for the corresponding period.

a Total outstanding claims of commercial banks on the non-government sector. GDP data for 2004 are preliminary estimates.

b January-September.
of their manufacturing production capacities and the accompanying productivity gains set the stage for a large rise in merchandise exports in 2004 despite the general sluggishness of their main market, western Europe. Output in the relatively large agricultural sectors of the two countries was boosted by good harvests, especially in Romania. In Bulgaria, industrial output surged in 2004 (chart 4.2.1) while the rapidly expanding tourism industry registered record revenues for a third consecutive year. Other business services also contributed to the strong growth of aggregate output in both Bulgaria and Romania.

On the demand side, the strengthening of investor and consumer confidence has translated into a sustained upturn in their final domestic demand which, in both countries, continued to support domestic activity levels in 2004. Since 2001, the pattern of final demand contributions to GDP growth in the two countries has been broadly similar (chart 4.2.2). A relatively new phenomenon, which became even more visible in 2004, has been the surge in demand for consumer durables. This is similar to that observed in central Europe several years ago. Investment demand remained strong in both Bulgaria and Romania, with gross fixed capital formation growing at double-digit rates in the first half of the year (table 4.2.2). During the same period their domestic absorption continued to grow faster than GDP, resulting in negative contributions of net exports to GDP growth.

### TABLE 4.2.1

Changes in real GDP in south-east Europe, 2003-2004QIII
(Percentage change over the same period of the preceding year)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
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<th>2004</th>
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<td></td>
<td>QI</td>
<td>QII</td>
<td>QIII</td>
<td>QIV</td>
</tr>
<tr>
<td>South-east Europe</td>
<td>5.1</td>
<td>7.9</td>
<td>6.3</td>
<td>4.0</td>
</tr>
<tr>
<td>Albania</td>
<td>6.0</td>
<td>6.0</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>3.2</td>
<td>4.0</td>
<td>..</td>
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</tr>
<tr>
<td>Bulgaria</td>
<td>4.3</td>
<td>5.5</td>
<td>3.5</td>
<td>4.2</td>
</tr>
<tr>
<td>Croatia</td>
<td>4.3</td>
<td>4.0</td>
<td>4.9</td>
<td>5.0</td>
</tr>
<tr>
<td>Romania</td>
<td>4.9</td>
<td>7.5</td>
<td>4.4</td>
<td>4.3</td>
</tr>
<tr>
<td>Serbia and Montenegro</td>
<td>1.5</td>
<td>7.0</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Republic of Macedonia</td>
<td>3.4</td>
<td>2.5</td>
<td>2.4</td>
<td>3.6</td>
</tr>
<tr>
<td>Turkey</td>
<td>5.8</td>
<td>9.0</td>
<td>8.1</td>
<td>3.9</td>
</tr>
<tr>
<td>South-east Europe excluding Turkey</td>
<td>4.2</td>
<td>6.4</td>
<td>3.9</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Source: National statistical offices.

Note: The aggregates are computed by the UNECE secretariat using weights based on purchasing power parities. In the cases when countries do not report quarterly national accounts data, their annual GDP growth rates were used to compute the quarterly regional aggregates.

a Preliminary estimate.

### CHART 4.2.1

Real industrial output in selected south-east European economies, 2001-2004QIII
(Indices of 12-month output, corresponding period of the preceding year=100)
In 2004, a marked recovery was also underway in Serbia and Montenegro, after a rather sluggish performance in 2003. The turnaround was underpinned by an upturn in industry, after two years of a difficult adjustment of local firms to the comprehensive market reforms initiated in 2001 (chart 4.2.1), and a large increase in agricultural output due to a good harvest. The authorities in Serbia and Montenegro negotiated a major restructuring of the country’s foreign debt in 2004, including the write-off of a significant part of it.\textsuperscript{124} The debt relief is expected to have a positive effect on future economic performance.

Despite their common national border, the economies of the two entities comprising the federal state are almost entirely separated. They use different currencies (and, accordingly, adhere to different monetary policy regimes), their systems of public finance (and therefore, their fiscal policies) are entirely disconnected, and the two entities do not even maintain a customs union.\textsuperscript{125} Given the absence of strong economic links, the two parts of the federal state may display quite divergent patterns of economic performance. In fact, the upturn in 2004 is almost entirely due to the strengthening of output growth in Serbia.

Albania’s economy maintained a relatively fast pace in 2004, thanks to the large agricultural sector which also contributed to an upturn in the food processing industry.

\textsuperscript{124} As a result of three consecutive deals with Russia, the London Club and the Paris Club of creditors, a total of $2.5 billion of foreign debt (or some 17.5 per cent of the debt prior to the restructuring) was written off in 2004.

\textsuperscript{125} The absence of a common system of tariffs is one of the important stumbling blocks to progress in trade negotiations with the EU.

\textsuperscript{126} At a Consultative Group meeting held in Sarajevo on 22-23 September, donors pledged a total of $1.2 billion of financial aid to Bosnia and Herzegovina over the period 2004-2007, especially for support of the country’s poverty reduction programme. “Bosnia-
Federation of Bosnia and Herzegovina and Republika Srpska) still remain to a large extent economically segregated.

**Improving financial intermediation**

The progress of financial reforms in some south-east European countries (in particular, Bulgaria and Croatia and, to a lesser extent, Romania) has given an additional boost to economic activity. A great number of commercial banks in these countries have already been privatized, in many cases to strategic foreign investors. The ensuing overhaul of the banking sector together with the strengthening of financial regulation and supervision have greatly improved financial intermediation in these economies. Thanks to the government’s restructuring effort and the lowering of inflation – which resulted in a sharp reduction of interest rates – banking and credit activity in Turkey has been recovering rapidly, especially during 2004. The rapid expansion of credit in recent years, particularly in Bulgaria, Croatia and Turkey (table 4.1.1), has boosted both business activity and investment, and final consumer demand.

Several more specific developments also merit attention in this regard. The ongoing restructuring of the banking sector in some of the more economically advanced countries of the region has been accompanied by growing competition among the banks. One result has been the appearance of an increasing variety of new financial products on the domestic markets. Moreover, the banks have been increasingly turning their attention to the retail market, a development that not only benefits households and small businesses but also supports economic performance in general. Thus the proliferation of credit cards is not only a convenience for the customers but is having an overall positive effect on consumer demand. Furthermore, the surge in the demand for consumer durables (including automobiles) is to a large extent related to the availability of, and easy access to, various credit facilities. Similarly, the rapid growth of

Source: National statistics.

Note: The contributions shown for 2004 refer to the first half of the year and are calculated over the same period of 2003.
In the first nine months of 2004, year-on-year rates of consumer price inflation accelerated only in Bulgaria and Serbia and Montenegro, largely because of increases in administered energy prices and excise duties. However, core inflation in Bulgaria remained low, and despite the effect of these one-off increases, the cumulative rise in the 10 months to October remained just 2 per cent.

…but producer prices were under rising cost pressures

In 2004, industrial producer price inflation accelerated in most south-east European countries (Turkey being the exception) and the increases were generally larger than those in the consumer prices (chart 4.2.3). This development was largely due to higher energy prices.

Wage inflation (as measured by the change in the average gross wage in industry) varied in the first half of 2004. According to the available data, wage growth continued to moderate in Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and in Turkey, while in Croatia the rate was more or less unchanged.\footnote{Data for Albania and Serbia and Montenegro were not available.} In contrast, industrial wages in Bulgaria and Romania rose faster than during the same period of 2003.

The dynamics of industrial unit labour costs in the four EU candidate countries have been rather varied in recent years. Between the end of 2001 and mid-2004 they declined by nearly 20 per cent in Bulgaria while increasing by almost two thirds in Romania. In Turkey, in spite of a relatively favourable performance since mid-2003, unit labour costs in mid-2004 were nearly one fifth above their level at the end of 2001. In Croatia, wage growth has followed the slow increase in labour productivity and so unit labour costs have remained more or less stable.

The factors behind these changes highlight the related policy challenges. While labour productivity in both Bulgaria and Turkey has increased by some 30 per cent over the last two and a half years, wages in Turkey...
grew nearly five times faster than in Bulgaria (chart 4.2.4). Wage inflation was even more rapid in Romania while its productivity growth was much weaker. Increases in labour costs which are not matched by rising productivity lead to losses in competitiveness and, if unchecked, may weaken the growth potential of these economies and undermine their catch-up prospects. While wages in the catching-up economies are likely to continue to grow rapidly, an excessive rate of growth will involve an obvious trade-off, as income gains in the short run may come at the expense of long-term income. Maintaining an appropriate balance between the growth rates of wages and labour productivity should thus be given high priority in the policy agenda of catching-up economies.

**Labour market performance remained uneven across the EU candidate countries…**

Of the four EU candidate countries, Bulgaria continues to be the one with the most rapid growth of employment (table 4.2.4). This reflects a number of
underlying factors, including strong economic growth, robust inflows of FDI and a cautious incomes policy, which has moderated wage growth in the public sector and in state-owned enterprises. To some extent, the reported increases in both the labour force survey (LFS) and in the payroll employment data reflect the temporary measures launched in 2003. Total employment rates have continued to increase from comparatively low levels for all age groups, including older workers (55-64 years of age). Employment growth in industry has slowed down while remaining positive. Both registered and LFS-based unemployment rates continued to decline in 2004 (table 4.2.5).

It is uncertain whether the strong employment growth in Bulgaria will continue, given the ongoing privatization and restructuring of state-owned enterprises and a recent amendment to the labour code that introduces a number of obligations on employers that could have a dampening effect on job creation in the private business sector. The very low employment rates of ethnic minorities are unlikely to be improved through market forces alone and need to be addressed by specific programmes, as elsewhere in south-east Europe.

Unemployment declined in Croatia in the first half of 2004, continuing a downward trend that started in 2001. Total employment, however, stopped growing in the second quarter while industrial employment was falling from the beginning of the year. The disappointing rate of job creation may be partly due to an employment protection system that favours “insiders” (current job holders). Public sector employment in Croatia accounts for one quarter of total employment. This comparatively low activity and employment rates of ethnic minorities show up in poverty statistics. In 2003, the poverty rate of ethnic Bulgarians was 9.4 per cent. Poverty rates of the Turkish and Roma minorities were considerably higher, at 23.5 per cent and 64.3 per cent, respectively. (The poverty line was set at 60 per cent of median total expenditure per capita.)“Bulgaria: survey finds one in seven people below poverty line”, European Industrial Relations Observatory On-Line, 25 August 2004 [www.eiro.eurofound.eu.int].

128 These include a public works programme for long-term unemployed as well as wage subsidies to encourage firms to hire unemployed persons.

129 For more details see “Bulgaria: labour code amended”, European Industrial Relations Observatory On-Line, 11 August 2004 [www.eiro.eurofound.eu.int].

130 The comparatively low activity and employment rates of ethnic minorities show up in poverty statistics. In 2003, the poverty rate of ethnic Bulgarians was 9.4 per cent. Poverty rates of the Turkish and Roma minorities were considerably higher, at 23.5 per cent and 64.3 per cent, respectively. (The poverty line was set at 60 per cent of median total expenditure per capita.) “Bulgaria: survey finds one in seven people below poverty line”, European Industrial Relations Observatory On-Line, 25 August 2004 [www.eiro.eurofound.eu.int].
large share and the fiscal consolidation programme of the government imply that the public sector cannot be expected to act as the employer of last resort and that jobs will have to be created in the private sector. Despite the recent amendments to the labour code that weaken somewhat the stringent employment protection rules, much remains to be done to encourage job creation.\textsuperscript{131}

High payroll taxes may be partly responsible for a large share of informal jobs in total employment.\textsuperscript{131}

Total employment in Romania declined in the first half of 2004 while payroll employment in industry increased. According to LFS, the unemployment rate increased over the same period of 2003 as a result of layoffs in state-owned mines and other redundancies related to restructuring.\textsuperscript{132} The overall employment rate

\textsuperscript{131} High payroll taxes may be partly responsible for a large share of informal jobs in total employment.

\textsuperscript{132} It should be noted that different indicators give conflicting views of changes in unemployment in Romania. Thus, according to registration data, the rate of unemployment in the first half of 2004 was down from the same period of 2003. However, the LFS data are generally considered to present a more accurate picture of the underlying trend.

### TABLE 4.2.4

<table>
<thead>
<tr>
<th></th>
<th>Total employment $^a$</th>
<th>Employment in industry $^a$</th>
</tr>
</thead>
<tbody>
<tr>
<td>South-east Europe</td>
<td>0.3</td>
<td>1.0</td>
</tr>
<tr>
<td>Albania</td>
<td>0.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>-4.2</td>
<td>-0.8</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>2.0</td>
<td>2.7</td>
</tr>
<tr>
<td>Croatia</td>
<td>1.7</td>
<td>2.7</td>
</tr>
<tr>
<td>Romania</td>
<td>-0.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Serbia and Montenegro</td>
<td>-5.0</td>
<td>-4.5</td>
</tr>
<tr>
<td>The former Yugoslav</td>
<td>-5.0</td>
<td>-4.5</td>
</tr>
<tr>
<td>Republic of Macedonia</td>
<td>-5.0</td>
<td>-2.1</td>
</tr>
<tr>
<td>Turkey</td>
<td>..</td>
<td>..</td>
</tr>
</tbody>
</table>

\textbf{Source:} National statistics and direct communications from national statistical offices to UNECE secretariat.

\textsuperscript{a} Regional quarterly aggregates of total employment exclude Turkey, and Serbia and Montenegro; those of industrial employment also exclude Albania.

\textsuperscript{b} Figures cover only the Bosnian-Croat Federation.

\textsuperscript{c} Data relate to Serbia only.

\textsuperscript{d} Annual average.

### TABLE 4.2.5

<table>
<thead>
<tr>
<th></th>
<th>Registered unemployment $^a$</th>
<th>Labour force survey unemployment</th>
</tr>
</thead>
<tbody>
<tr>
<td>South-east Europe</td>
<td>16.1</td>
<td>15.5</td>
</tr>
<tr>
<td>Albania</td>
<td>15.2</td>
<td>15.0</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>43.1</td>
<td>43.8</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>13.7</td>
<td>12.8</td>
</tr>
<tr>
<td>Croatia</td>
<td>18.9</td>
<td>18.3</td>
</tr>
<tr>
<td>Romania</td>
<td>7.3</td>
<td>6.7</td>
</tr>
<tr>
<td>Serbia and Montenegro</td>
<td>28</td>
<td>28</td>
</tr>
<tr>
<td>The former Yugoslav</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Republic of Macedonia</td>
<td>44.4</td>
<td>44.6</td>
</tr>
<tr>
<td>Turkey</td>
<td>..</td>
<td>..</td>
</tr>
</tbody>
</table>

\textbf{Source:} National statistics and direct communications from national statistical offices to UNECE secretariat; for Bosnia and Herzegovina: The Economist Intelligence Unit (these figures cover only the Bosnian-Croat Federation; data for Republika Srpska are not available).

\textsuperscript{a} Registered unemployment rates in Serbia and Montenegro and The former Yugoslav Republic of Macedonia are UNECE secretariat estimates. Both national statistical offices report only the number of registered unemployed. The rates have been calculated as a percentage of the registered unemployed in the labour force as reported in the labour force surveys.

\textsuperscript{b} Average for the first and the second half of the year.

\textsuperscript{c} Data exclude Kosovo and Metohia. Since 2004, data relate to Serbia only.

\textsuperscript{d} October.

\textsuperscript{e} April.
declined further, while the employment rate of older workers was the lowest of all the EU candidate countries. Given the continuing restructuring of state-controlled enterprises, employment rates for all age groups may decline further over the next couple of years. The authorities have introduced a number of tax changes that seek to stimulate job creation and to enhance work incentives.

The strong growth of output in Turkey in recent years did not result in net job creation until the second quarter of 2004. The employment rate continued to fall from an already low level in 1999 until the first half of 2004, and the decline in the unemployment rate largely reflects a falling participation rate.\(^{133}\) Given the rapid growth of the working-age population, a reversal of this unsustainable trend is of key importance if Turkey is to move towards EU membership. In addition to the ongoing structural reforms in the product and financial markets, policies that address the very low degree of utilization of the available labour reserves are of the utmost importance for sustaining the successes of the macroeconomic stabilization and reform effort (box 4.1.1).\(^{134}\)

On the whole, employment rates in the EU candidate countries are still comparatively low and fall far short of the Lisbon target of 70 per cent (chart 3.2.1). The employment rate of older workers remains very low in all four countries and this may have serious long-term fiscal implications. A possible policy response is to realign incentives away from early retirement. Labour market policies that strike a proper balance between flexibility and security are also required for low-skilled workers in order to reduce the high levels of structural unemployment prevailing in the candidate countries.

\(...\text{while high unemployment persisted in western Balkans}\)

Among the remaining four south-east European economies, the employment gains of 2003 were reversed in Albania where total employment declined in the first half of 2004. Both total and industrial employment continued to fall in The former Yugoslav Republic of Macedonia. Total employment stagnated in the Federation of Bosnia and Herzegovina, while in Serbia payroll employment declined in the first eight months of 2004, stabilizing at a relatively low level in the summer.\(^{135}\) Registered unemployment fell somewhat in Albania in the first half of 2004, but remained close to 15 per cent. It stabilized at 45 per cent in Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia, and at 32 per cent in Serbia. The few available labour force surveys for the four countries indicate that involuntary unemployment tends to be significantly lower than the measure based on registration due to the large numbers employed in the informal economy.

**Macroeconomic policy: coping with fiscal and current account deficits**

The excessive macroeconomic disequilibria that featured prominently throughout the south-east European region only several years ago, now seem to be in the past. Nevertheless, several economies still face important macroeconomic policy challenges such as large fiscal and current account deficits. Although such deficits do not appear to pose immediate threats to macroeconomic stability, the inherent risks associated with them – as plainly revealed by the financial crisis in Turkey in 2001 – remain a source of concern for policy makers.

In Romania, the main policy focus in recent years has been the chronically high inflation rate, a result of the combination of a relatively loose fiscal policy and delayed structural reforms. As noted above, there was notable progress in lowering inflation in 2004, largely a positive outcome of the policy reforms. A key factor has been the successful, albeit gradual, fiscal consolidation in recent years, involving a major reform of tax administration (which has raised the efficiency of tax collection), a restructuring of expenditures as well as the reduction of various forms of implicit subsidies (mostly in the form of budgetary arrears by state-owned firms).\(^{136}\) The strong economic upturn has also helped to reduce the general government deficit in 2004.\(^{137}\) The fiscal consolidation and disinflation efforts in Romania have been underpinned by a relatively tight monetary policy.\(^{138}\)

In Serbia and Montenegro, the general government fiscal deficit widened considerably in 2002 and 2003 (reaching more than 4 per cent of GDP in both years), a

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133 Had the participation rate remained constant over the last five years, the unemployment rate in the second quarter of 2004 would have been 15.4 per cent rather than 9.3 per cent. If account is taken of discouraged workers, the rate rises to 19.5 per cent. S. Çevik, “Turkey: affluent future of a jobless society”, Morgan Stanley Global Economic Forum, 28 October 2004 [www.morganstanley.com].

134 According to OECD assessments, the problems to be addressed include heavy taxation of formal employment, excessive protection of regular workers against dismissal (the strictest among the OECD countries), low educational attainment coexisting with rapid urbanization and gender discrimination, political instability and large regional disparities with respect to the business environment. Despite the heavy taxes on labour, government revenues from this source are limited due to the extent of informal employment that accounts for one half of total employment. In turn, the very low participation and employment rates of women are partly explained by ongoing urbanization. Women from the families migrating from the countryside to large cities are often unable to find gainful employment. OECD, Economic Surveys: Turkey (Paris), 2004.

135 No recent information about Montenegro and Republika Srpska was available at the time of writing this Survey.

136 The monetization of the large quasi-fiscal deficit associated with such subsidies was an important source of the high rate of inflation in Romania.

137 The cash deficit is expected to shrink to around 1.5 per cent of GDP in 2004, down from 2.3 per cent in 2003. On a cash basis, Romania’s fiscal deficit has been falling since 2000.

138 In recent years the Romanian monetary authorities have been using the exchange rate as the main nominal anchor, in combination with relatively high central bank interest rates and capital controls on short-term capital flows. In the second quarter of 2005, the central bank intends to switch to inflation targeting.
result of the costs of the market reforms initiated by the government. The cash deficit in 2004 is expected to be halved; as in Romania, this reflects the combined result of tighter policies and a strong economic recovery.

Several south-east European economies have chronically large current account deficits (table 6.1.2). In most cases these cannot be regarded as excessive as they are a consequence of their rapid economic growth, which has been accompanied by an expansion of their export-oriented production capacity; moreover, these deficits have been largely financed by inflows of FDI. However, in Croatia the macroeconomic risks are compounded by the “twin deficit” problem. The conventional policy approach of dealing with a current account deficit that is regarded as excessive is by (fiscal or monetary) policy tightening focused on various components of domestic demand. In the case of a twin deficit, fiscal tightening is generally considered to be the more efficient policy and this was the option chosen by the Croatian government in 2004.

Although the current account deficit of Turkey is not excessively high in relative terms, it is considered to be a source of macroeconomic vulnerability as it is mostly financed by short-term capital. Reducing the current account deficit thus remains a priority for Turkey’s macroeconomic policy: both fiscal and monetary policy are set to remain relatively tight in the short run, in an attempt to curb domestic demand for imports. In Bulgaria, the sharp widening of the current account deficit in 2003 and the first half of 2004 was partly driven by the credit boom in this period. However, under the currency board arrangement the authorities have no instruments to directly control the money supply. At the same time, with public finances in surplus, a further fiscal tightening did not appear to be an efficient policy option. The Bulgarian authorities have therefore attempted to check the current account deficit in 2004 by resorting to various non-conventional policy measures to curtail the pace of credit expansion. So far, these appear to have been successful as the current account deficit has stopped growing.

4.3 The short-term outlook

Despite some deceleration, economic growth is likely to remain strong...

Most south-east European economies are set to preserve strong rates of growth in 2005. Supply-side restructuring and the associated productivity gains are likely to continue to drive economic growth particularly in the EU candidate countries. If market reforms remain on course, the inflow of FDI – which is an important component of this process – should continue and even intensify. The expected further shift towards a more restrictive macroeconomic policy stance in some economies is likely to have only a marginal effect on their domestic demand. At the aggregate level, this negative impact may be partly offset by the positive effects of improved financial intermediation (in particular, easier access to a growing number of financial products and services). Overall, domestic demand in south-east Europe as a whole should remain buoyant and provide a solid support to economic activity. In contrast, with growth in western Europe possibly losing some momentum in 2005, the demand for south-east European exports is likely to weaken to some extent.

Compared with 2004, the average rate of economic growth in south-east Europe is likely to slow down in 2005. Given the expected changes in the domestic and international environment, it is unlikely that the exceptionally high rates of GDP growth in some of them in 2004, especially Turkey but also Romania, can be sustained in 2005. As these are the two largest economies in south-east Europe, this will result in a somewhat slower rate of GDP growth in the region as a whole. Nevertheless, the rate of GDP growth in Turkey and Romania, as well as in Bulgaria, is still expected to be above 5 per cent in 2005. In the other south-east European economies, GDP growth should be more moderate, in a range of between 3.5 per cent and 4.5 per cent.

…but important risks still remain

The main risks to the outlook for south-east Europe are possible negative external shocks. Thus a more pronounced and protracted sluggishness of western European import demand would have a perceptible negative impact on exports from the region, despite the expected improvements in their competitiveness. In addition, if the recent surge in world energy prices were to translate into a lasting upward shift (and even more so if they continue to rise), the rise in import prices could threaten to check or reverse the process of disinflation in the region. In turn, this could prompt an even more restrictive policy stance, which would intensify the dampening effect on economic activity. Finally, the large current account deficits in some of the south-east European economies carry certain macroeconomic risks that should not be neglected by policy makers. In any case, the underlying determinants of the deficits should be subject to careful and continuous monitoring. If a deficit reflects the expansion of productive investment in export-oriented industries, then it can be regarded as a normal feature of a healthy-growing emerging market economy; however, the risks are significantly larger if the deficit is caused by an unsustainable growth in consumer spending – in this case, a timely policy response is appropriate.

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139 As a share of GDP Turkey’s current account deficit is much below the levels prevailing in other south-east European countries; however, in most of these economies a much larger share of the deficit is financed with FDI than is the case in Turkey (table 6.1.2).

140 In particular, the government withdrew most of its funds held in commercial banks and redeposited them with the central bank. Another set of measures undertaken by the central bank effectively increased the mandatory reserves of the commercial banks. In addition, the provisioning requirements on various types of credit were tightened. All these measures have a negative effect on the money supply and hence on credit.