

The Economic Situation in South East Europe and the Role of Trade and Investment

Anthony O'Sullivan

Head of the OECD Investment Compact for SEE

CEFTA 2006 – Expanding Trade and Investment in South Eastern Europe

A Seminar for Parliamentarians from South Eastern Europe

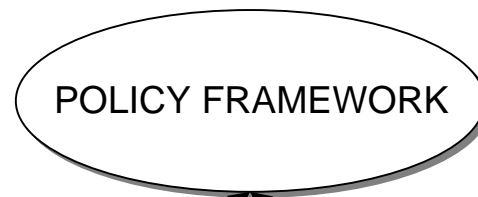
Brussels

19 April 2007

Agenda

- I. Macroeconomic and Infrastructure Environment in SEE**
- II. The Role of Trade and Investment in SEE**
- III. The Impact of FDI: Case Study of Croatia**
- IV. Regional priorities in policy reform to foster economic development in SEE**

The economic situation depends on the policy framework, the macroeconomic and infrastructure environment and investment and trade, which are all interdependent



1. Investment Policy and Promotion
2. Tax
3. Anti-corruption
4. Competition
5. Trade
6. Regulatory Reform
7. Human capital
8. SME Policy



- High GDP growth, stable inflation, improving credit ratings
- However high unemployment
- Weak energy and water infrastructure
- High cost of communication

- FDI in SEE is increasing
- But regional split is deepening
- Trade deficits are still high

Macroeconomic and infrastructure environment in SEE

The GDP growth has been strong across the SEE region and is expected to remain strong in spite of rising energy costs

Real GDP Growth Rate (%)			
Country	2004	2005*	2006**
Albania	6.7	5.5	5.0
Bosnia and Herzegovina	6.0	5.8	5.0
Bulgaria	5.7	5.5	6.0
Croatia	3.8	4.3	4.6
FYR Macedonia	4.1	4.0	4.0
Moldova	7.3	7.1	3.5
Montenegro	3.7	4.1	5.5
Romania	8.4	4.1	6.5
Serbia	9.3	6.3	6.5
SEE AVERAGE (weighted by GDP)	6.9	4.7	5.9

Source: EBRD Transition Report 2006

* Estimate

** Projection

Inflation has largely been kept under control in 2005. It is projected to have further declined in 2006 in Montenegro, Romania and Serbia, but to have significantly risen in Moldova

Consumer Price Index (%)			
Country	2004	2005*	2006**
Albania	2.9	2.3	2.3
Republika Srpska	2.2	2.7	7
Federation of BiH	-0.3	2.1	8.5
Bulgaria	6.1	5	3
Croatia	2.1	3.3	3.5
FYR Macedonia	-0.3	0.1	3.4
Moldova	12.5	12	12.8
Montenegro	2.2	2.6	3.5
Romania	11.9	9.5	6.5
Serbia	9.5	17.2	13
SEE AVERAGE (weighted by GDP)	4.7	5.2	4.4

Source: EBRD Transition Report 2006

* Estimate

** Projection

International Credit Ratings imply that the risk profile and the economic outlook of the region is improving

Available Credit Ratings in 2007			
Country	FITCH ICBA	MOODY'S	STANDARD & POORS
Albania	n/a	n/a	n/a
Bosnia and Herzegovina	n/a	B3 (Stable)	n/a
Bulgaria	BBB	Baa3 (Positive)	BBB+/Stable/A-2
Croatia	BBB-	Ba1 (Stable)	BBB+/Stable/A-2*
FYR Macedonia	BB+	n/a	BBB-/Stable/A-3
Moldova	B-	Caa2 (Stable)	n/a
Montenegro	n/a	n/a	BB/Positive/B
Romania	BBB	Baa3 (Stable)	BBB/Positive/A-3
Serbia	BB-	n/a	BB-/Positive/B

Source: Websites of FITCH ICBA, MOODY'S, STANDARD & POORS

However unemployment remains high in SEE countries, especially in Bosnia & Herzegovina, the FYRoM, Montenegro and Serbia - countries experiencing economic growth without job creation

Unemployment rate (%)		
Country	2004	2005*
Albania	14.5	14.7
Bosnia and Herzegovina	43	44.5
Bulgaria	12	10.1
Croatia	13.8	12.3
FYR Macedonia	37.2	36.5
Moldova	8	6.4
Montenegro	31.3	27.3
Romania	6.3	5.9
Serbia	31.7	31.7
SEE AVERAGE (weighted by GDP)	14.9	13.4

Source: EBRD Transition Report 2006

* Estimate

** Projection

Energy and Water infrastructure in SEE is still in bad shape, characterised by high distribution losses and high number of outages

Electricity and Water				
Country	Electricity for industrial use, EUR/kWh (incl. VAT) in 2005	Electric power transmission and distribution losses (%of output) in 2003	Electrical outages (days) in 2005	Water supply failures (days) in 2005
Albania	0.096	39.98	194.23	90.47
BiH	0.06* (summer) 0.035* (winter)	16.77	1.34	0.35
Bulgaria	0.046**	14.26	2.83	2.04
Croatia	n/a	20.17	1.03	0.04
Macedonia	0.07	n/a	1.85	0.30
Moldova	0.059***	56.61	1.51	0.96
Romania	0.0865	8.66	2.97	1.04
Serbia and Montenegro	0.035*	16.24	2.67	0.21
SEE Average	0.065	24.67	2.03 (excl. Albania)	0.705 (excl. Albania)
CEE Average	0.031 (Slovenia)	7.72	0.71	0.115

Source: World Bank World Development Indicators; WB Enterprise Surveys; Southeast Europe Investment Guide 2006; * Not clear if includes VAT; **3 tariff reading, day electricity; ***Not clear if includes VAT and industrial price;

Communication costs are still high in SEE and Internet penetration rates are relatively low. This can be attributed to a relatively weak telecommunications infrastructure and to limited competition

Telecommunications		
Country	Internet penetration rate (per 10,000 inhabitants) (%)*	Average International Phone Call (Capital to EuroZone Capital, ie Paris) (EUR/minute)**
Albania	0.8 [^]	0.54
BiH	20.1	0.13-1.10
Bulgaria	84	0.15
Croatia	78.6	0.31
Macedonia	17.4	0.25-1
Moldova	-	0.2-1.6
Romania	22	n/a
Serbia and Montenegro	26.2	0.54
Montenegro	-	0.07
SEE Average	41.38	0.47
Comparable	70.5 (Poland)	0.24 (Greece)

*Source: 2005 EBRD Transition Report (data as at 2004); **Source: 2006 Southeast Europe Investment Guide (data as at 2005); [^] Data 2003

The Interest Spreads of 2005 show that the cost of capital in SEE is still high. The average spread is 60% higher than in CEE and twice as high as in the Euro Zone

Interest Spreads in 2005			
Country	Deposit Rate	Lending Rate	Spread
Albania	5.09	13.08	7.99
BiH	3.56	9.61	6.05
Bulgaria	3.04	7.87	4.83
Croatia	1.71	11.19	9.48
Macedonia	6.60	12.17	5.57
Moldova	13.22	19.26	6.05
Romania**	6.91	12.66	5.75
Serbia*	3.48	14.60	11.12
Montenegro	n/a	n/a	n/a
SEE Average	5.24	12.55	7.10
CEE Average	4.18	7.13	4.18

Source: IMF/IFS (International Financial Statistics); National Bank of Romania; Serbia National Bank

*Excluding December 2005; **Excluding November and December 2005.

The Role of Trade and Investment in SEE

The Importance of Trade

- Trade is an important vehicle for generating national growth and prosperity.
 - it provides local enterprises with access to world markets and knowledge.
 - Increased trade also provides consumers with a wider choice of goods at competitive prices

- There is a positive relationship between trade and investment which also drives growth and employment. This interaction is due to three factors:
 - I. A liberal trade regime stimulates investment because it allows for specialisation and larger-scale production which matters most in small countries.
 - II. Today FDI is often motivated more by productivity enhancing opportunities than by the need to access local markets, which explains why multinationals delocalise the labour intensive part of their production chain to transition economies or developing countries. Local businesses in transition economies may benefit from this development, in that some functions of the value chain may be contracted out to domestic suppliers.
 - III. Trade can interact with FDI to increase the competitiveness of domestic enterprises exports through knowledge and technology transfer.

Trade imbalances show that SEE export competitiveness is still weak

Trade Balance (million \$)			
Country	2004	2005*	2006**
Albania	-1586	-1868	-2160
Bosnia and Herzegovina	-2832	-3123	-3107
Bulgaria	-3643	-5399	-6504
Croatia	-8350	-9296	n/a
FYR Macedonia	-1112	-1052	-1100
Moldova	-758	-1162	-1641
Montenegro	-518	-640	-645
Romania	-6611	-9873	-13125
Serbia	-6643	-5563	-6000

Source: EBRD Transition Report 2006

* Estimate

** Projection

A large majority of trade flows are still geared to the EU countries (although intra-SEE trade is rapidly increasing)

Exports to EU in 2004 as % of total	
Albania*	89.6
BiH	55
Bulgaria	58.2
Croatia	64.6
Macedonia	56.4
Moldova	30.1
Montenegro	48.4
Romania	82.6
Serbia*	54.5
SEE AVERAGE	70

Imports from EU in 2004 as % of total	
Albania*	68.7
BiH	54
Bulgaria	54.1
Croatia	69.5
Macedonia	47.2
Moldova	32.8
Montenegro	43.7
Romania	76.4
Serbia*	50.2
SEE AVERAGE	64

Source: Southeast Europe Investment Guide 2006; Acit

*Data for Albania, Serbia is from 2005

Percentage of intra SEE trade of total exports in 2004	Percentage of intra SEE trade of total imports in 2004
9.3%	5.6%

Source: IC calculation based on Stability Pact 2005, EBRD goods data.

The Importance of Foreign Direct Investment

- Direct Inflows of capital can stimulate employment and economic growth and transformation
- This can occur through transfers of technology and know-how and better access to export markets
- Industrial restructuring, including through privatisation, is stimulated when inflows of FDI accelerate
- FDI is especially important for SEE-economies – a rapid and successful transition to a market economy has usually not been possible without the knowledge and capital of foreign investors

The FDI regional split is deepening: Bulgaria, Romania, Croatia and Serbia attract an ever growing share of FDI

FDI net Inflow (mn €)				
Country	2003	2004	2005*	2006**
Albania	142	232	212	280
Bosnia and Herzegovina***	306	343	240	456
Bulgaria	1656	1944	1838	2400
Croatia	1546	610	1207	n/a
FYR Macedonia	77	109	78	240
Moldova	57	104	180	152
Montenegro	35	44	379	119
Romania	1725	4458	5270	6922
Serbia	1088	676	1185	2800
TOTAL SEE-9	6631	8520	10589	14576^
TOTAL CEC-5	5805	14883	19266	15910

Source: EBRD Transition Report 2006

* Estimate ** Projection *** Excludes capital transfers for reconstruction ^ Includes 2005 data for Croatia

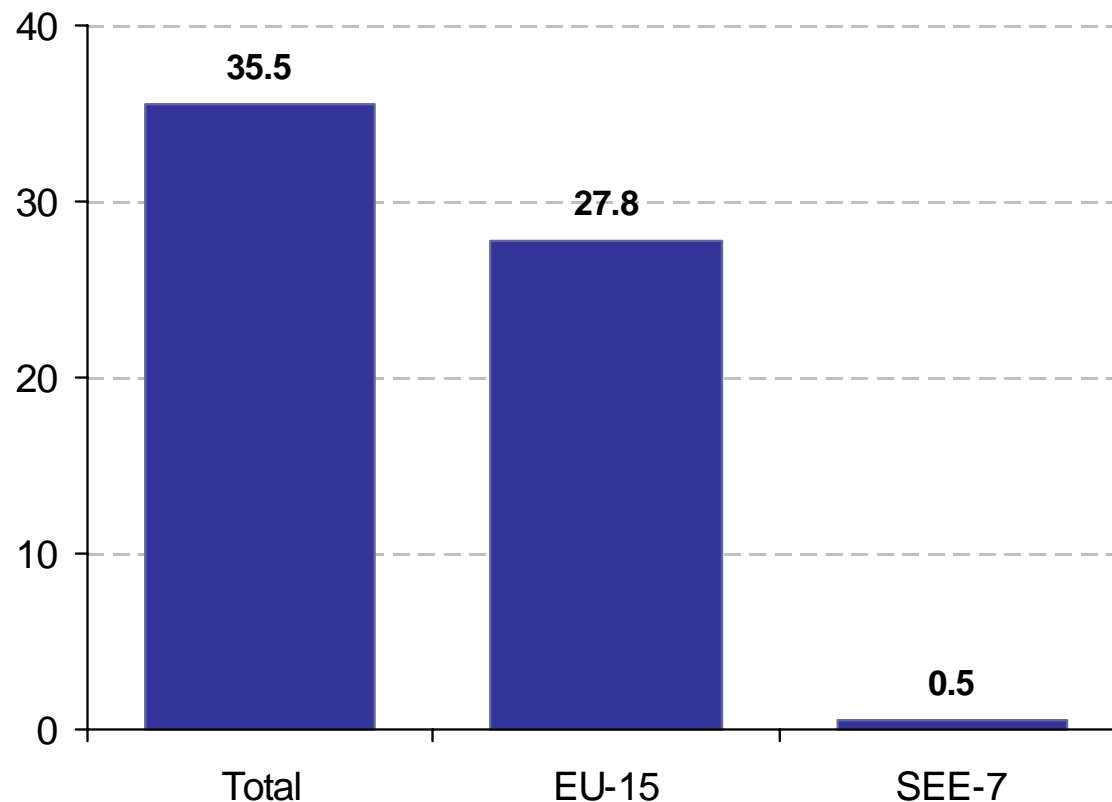
FDI inflow per capita is still more than double in CEE compared to SEE

FDI net Inflow per capita (€)			
Country	2003	2004	2005
Albania	51	86	67
Bosnia and Herzegovina	88	127	62
Bulgaria	237	351	231
Croatia	403	223	299
FYR Macedonia	41	62	39
Moldova	19	34	50
Montenegro	90	239	240
Romania	161	104	161
Serbia	62	81	595
SEE-9	145	208	205
CEC-5	132	299	341

Source: Vienna Institute for International Economic Studies 2006

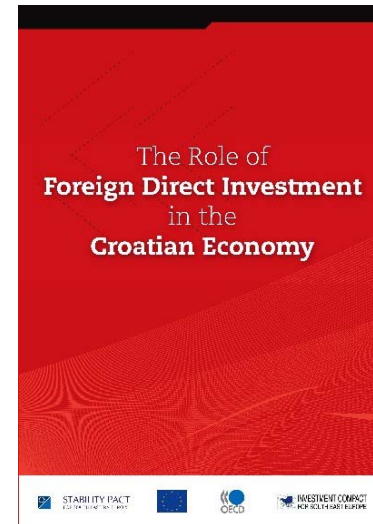
Intra-SEE FDI is extremely limited. By far the biggest bulk is invested by the EU-15 countries in the region of SEE

SEE-7: Inward FDI Stock by Home Regions (Billion Euros, 2004)



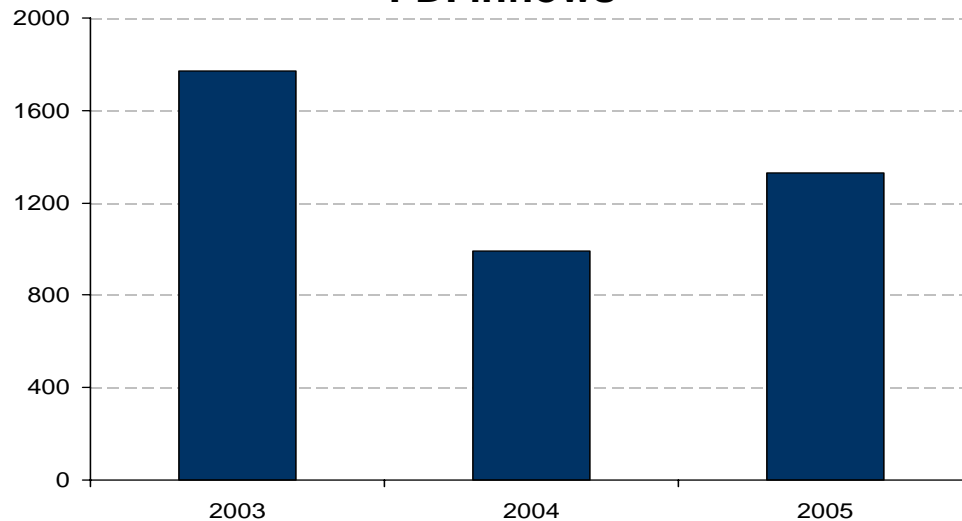
Source: WIIW 2006, SEE-7 excludes Albania and Moldova

The Impact of FDI: Case Study of Croatia

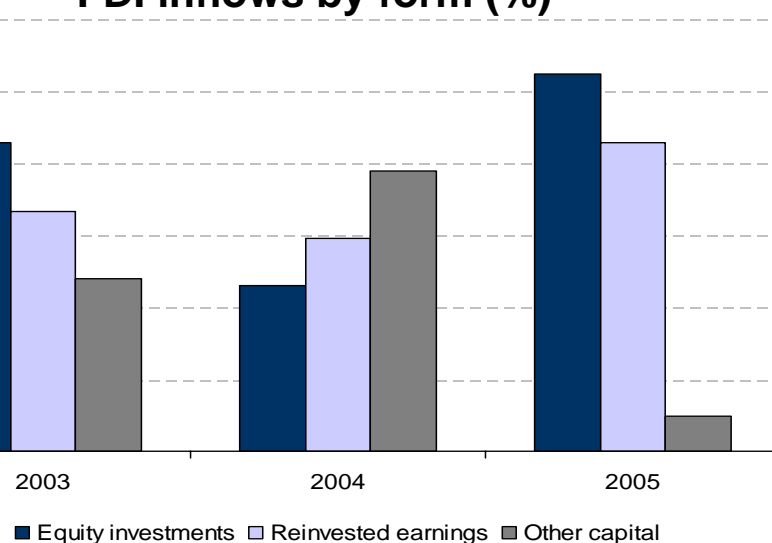


FDI in Croatia is not small and reinvested earnings are increasing

FDI inflows



FDI inflows by form (%)



- Croatia has the fifth largest FDI per capita (EUR 2756), similar to that found in Slovenia and about three times that of Romania or Bulgaria.
- Austria (banking) and Germany (trade and manufacturing) are the biggest investors in Croatia, and in 2005 these two countries together made up almost half of total FDI stock.
- Over 60% of cumulated FDI inflows between 1993 and 2004 took the form of equity investment, and reinvested earnings have been growing in the previous years.
- New investment in newly established FIEs has been growing considerably lately, which is good news as privatisation-related FDI has been decreasing.

FIEs perform generally better than domestic companies on key indicators

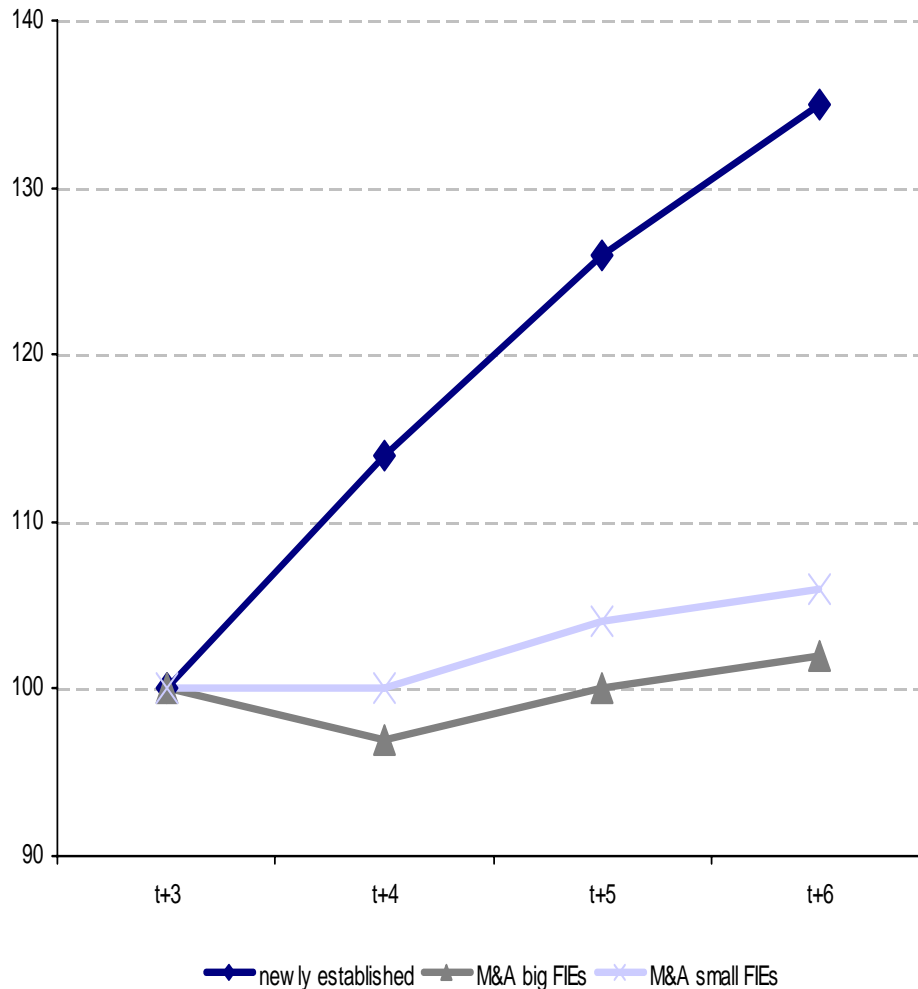
Shares of FIEs in the Croatian Economy

	2000	2002	2004
Number of firms	1	1.3	2.4
Total assets	10.1	12.7	18
Employment	6	8.6	11.2
Wages	9.4	12.1	14.9
Total sales	11.7	16.1	21.4
Export sales	15	24.4	36.5
Profits after tax	86	32	30
Wages/employee	157	141	133
Sales/employee	195	187	192
Sales/assets	116	127	119
Exports/sales	128	152	171
Profits/sales	735	198	140

- FIEs are significantly larger in terms of employment and sales than domestic companies.
- Profits are generally higher in FIEs, and profits/sales in 2004 were 40% above the average for companies as a whole.
- Labour and capital productivity were also higher than in companies as a whole, remaining relatively constant as domestically owned companies had still not caught up with FIEs.
- FIEs are much more export-oriented than Croatian companies as a whole, and their share of exports/sales has been increasing.
- Although the labour productivity of FIEs remained relatively constant between 2000 and 2004, their wage premium (wages/employee) fell – wages in companies as a whole are catching up with those of FIEs.

FDI in Croatia resulted in a net employment gain for both M&A and greenfield related FDI

Employment change in greenfield and M&A foreign enterprises (%)



- **Initial negative effects on employment in M&A-related FDI**

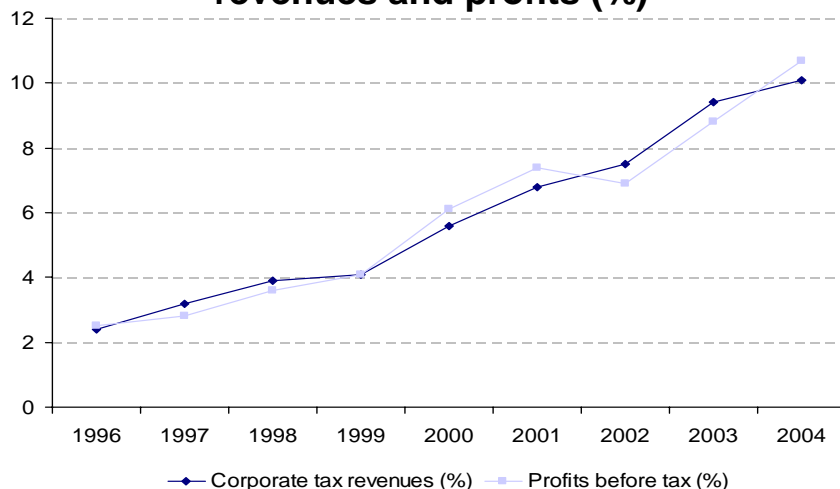
- After foreign take-over, firms generally shed labour, however employment tends to increase beyond the original level around year four largely due to completed restructuring resulting in improved productivity.
- Employment tends to increase more significantly in smaller companies.

- **Almost by definition greenfield FDI creates new jobs**

- Newly established FIEs created a total of 36,302 new jobs between 1996 and 2004, mostly in the services sector (26,550).

Croatia has paid little in investment subsidies and has lost less in tax revenues

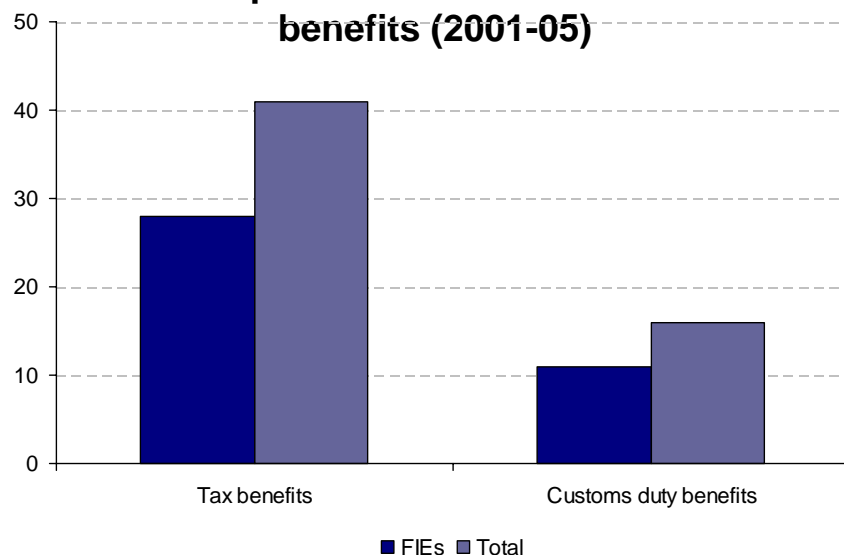
Greenfield FIEs' share of total corporate tax revenues and profits (%)



- Incentives given to greenfield FIEs have not resulted in tax revenue losses

- Greenfield FIEs' share of total profits before tax only differs slightly to their share of total corporate tax revenues, pointing to modest usage of investment incentives in Croatia.

Number of companies received tax or customs duty benefits (2001-05)

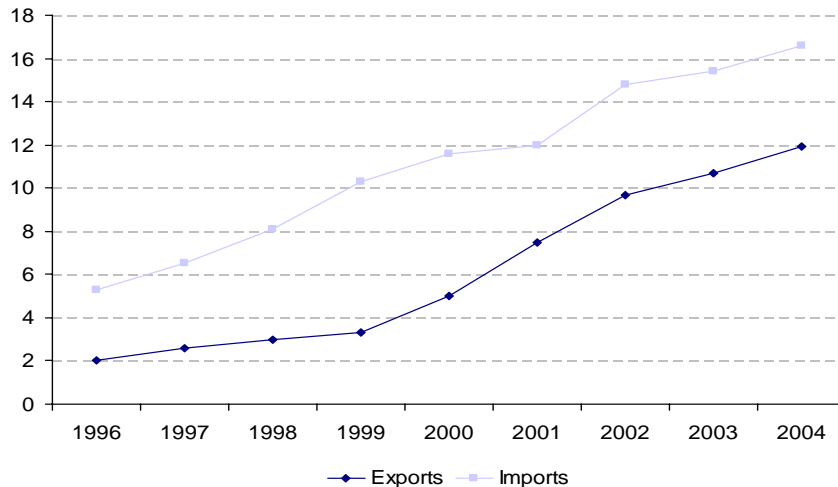


- Relatively few companies qualify for tax or customs duty incentives per year

- Croatia has not made extensive use of tax incentives, nor does it provide direct investment subsidies – approximately eight companies (six FIEs) per year qualify for tax or customs duty incentives.

In Croatia, FDI has generally not improved access to foreign markets

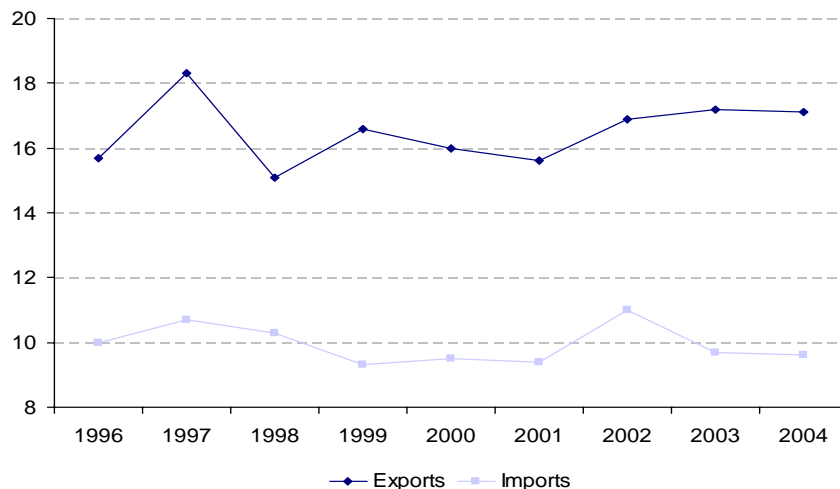
Greenfield FIEs' share in total exports and imports (%)



- **Greenfield FIEs' are more import- than export-oriented**

- Imports exceed exports resulting in a trade deficit for greenfield FIEs, high foreign investments in the services sector. Firms in retail and wholesale trade and especially attracted to Croatia's domestic consumer market.

M&A FIEs' shares of total exports and imports (%)



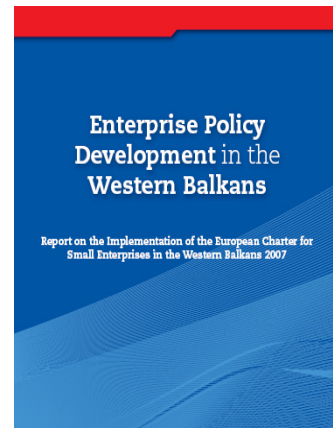
- **Following foreign takeover, M&A FIEs' do not import or export more**

- There is no obvious trend of changes in import or export propensities following foreign takeover – this leads to the conclusion that, in Croatia, FDI through privatisation has had a more limited effect on the foreign trade pattern of acquired companies than it has in other CEE economies.

Regional priorities in policy reform to foster economic development in SEE



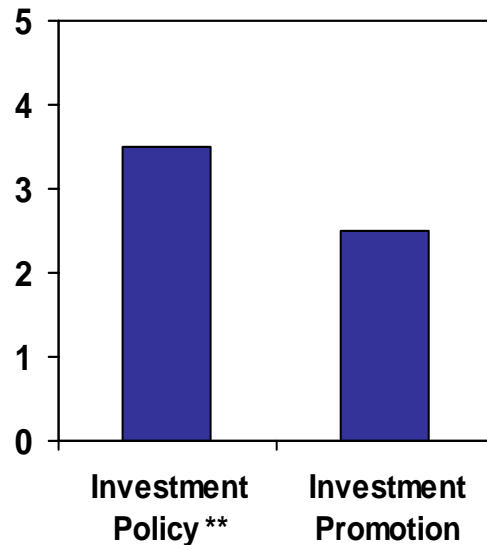
**The
Investment
Reform
Index (IRI)**



**The
SME
Policy
Index**

1. Key issue in Investment Policy and Promotion: Solid progress in investment policy but weak investment promotion

Average IRI Score for SEE *



Investment Promotion in SEE

	Comprehensive IP Strategy	Investment Promotion Agency	Coherent Incentive-based programme	SME linkages to FDI programme
Albania		✓	✓	
BiH		✓		
Bulgaria	✓ ✓	✓ ✓	✓ ✓	✓ ✓
Croatia		✓	✓	
Macedonia		✓	✓	
Moldova ***		✓		
Montenegro		✓	✓	
Romania	✓	✓	✓ ✓	✓
Serbia	✓	✓	✓	

- Lack of a proactive investment promotion approach results into a weaker image of the Region, limited contact with potential investors and limited linkages between FDI and local enterprises.
- More emphasis should be put on targeted sector specific marketing campaigns and providing on-the-ground services to potential and existing investors (e.g. assisting investors in dealing with licenses and permits for greenfield investment, supporting cluster and SME linkage development).

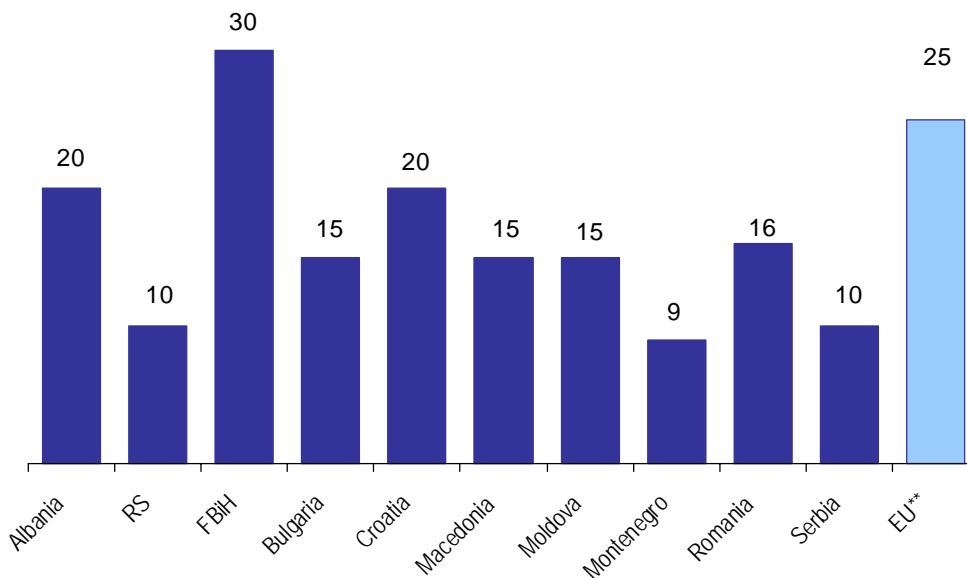
*1= no law or institution in place; 3 = solid law or institution in place; 5= solid law or institution and significant evidence of implementation according to good practice

** Investment policy includes national treatment principles, bilateral investment treaties and protection of property (IP and land)

*** Moldova is currently drafting the investment promotion strategy in co-operation with the OECD Investment Compact

2. Key issue in Tax Policy: Very low corporate tax rates but weak tax administration capacity

Corporate Tax Rates (% 2006)



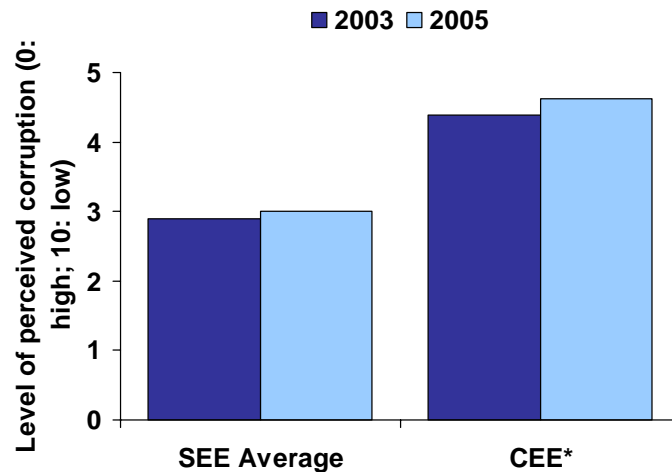
Weak Tax Administration

- **VAT reimbursements** – often takes more than 90 days, is rarely monitored and sometimes never even happens, even though the average legal reimbursement time in SEE is 40 days.
 - ▶ Companies are unable to access capital from VAT refunds.
- **Tax inspections** – the average firm in SEE incurs 21 days of tax inspections per year*, and the implementation of objective criteria and risk based audit systems is sporadic at best.
 - ▶ Onsite inspections cause firms to lose working days.
- **Unfair tax collection** – the largest taxpayers are hit the hardest by discretionary tax audits and fines from officials trying to meet revenue targets.
 - ▶ Firms are required to pay “unofficial” payments to tax administration officials and they suffer more often from intrusive inspections.
- **Appeals procedures** – in most countries, appeals procedures are very lengthy and burdensome, and they have high costs of entry, e.g. having to pay 100% of the tax before the appeal is rendered.
 - ▶ Lengthy and expensive delays prevent firms from accessing legal recourse to injustices related to the tax system.

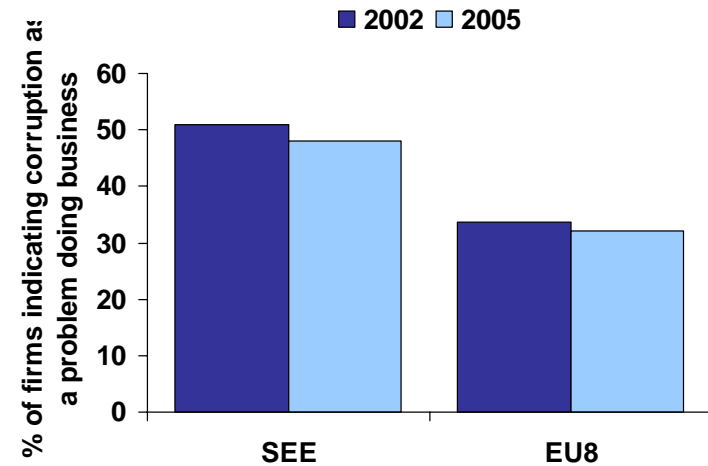
Sources: *FIAS (Foreign Investment Advisory Service) (2003), Macedonia: Administrative Procedures for doing Business in Macedonia, International Finance Corporation and The World Bank. KPMG's Corporate Tax Rate Survey 2006.

3. Key issue in Anti-Corruption Policy: The legislative framework and strategies are in place, but perceptions of corruption still high

Transparency International Corruption Perceptions Index Scores 2003, 2005



EBRD-World Bank BEEPS Corruption as a Problem Doing Business (%)



- The persistence of high levels of corruption discourages investment, competition as well as economic and social development in SEE.
- More effort needs to be put into enforcing laws and implementing and monitoring strategies and action plans. Sensitive areas such as customs and public procurement should receive particular attention.

4. Key issue in Competition Policy: Weak enforcement record and limited sanctioning power for non-EU accession countries

Average SEE Case Record*

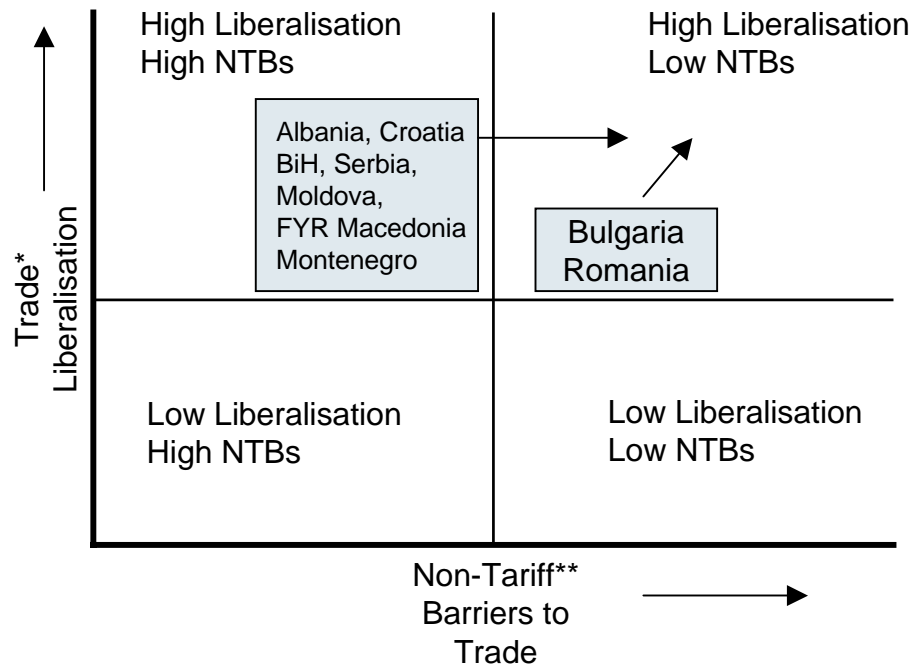
Case Record in 2005

Average SEE Case Record*		Case Record in 2005				
	Enforcement Record SEE**	Enforcement Record Czech Republic***		Abuse of Dominance	Cartels	Merger Control
Abuse of Dominance	12 cases	12 cases	Albania	3	-	2
Cartels	5 cases	17 cases	BiH	-	-	2
Merger Control	20 cases	134 cases	Bulgaria	35	20	34
			Croatia	2	3	18
			Macedonia	23 (2001-2005)	4 (2001-2005)	8 (2001-2005)
			Moldova	n.a.	n.a.	n.a.
			Montenegro	-	-	2
			Romania	42	14	115
			Serbia	3	1	3

- Outside of Bulgaria and Romania, competition agencies lack effective investigative techniques, have limited sanctioning powers, independence in decision-making, and inadequate staffing and budget resources.
- The weakness in competition institutional and legal framework translates into to higher market concentration and barriers to market entry and establishment of new companies (e.g. network industries – gas, electricity, telecommunications) as well as higher prices for consumers in some sectors.

5. Key issue in Trade Policy: Trade Liberalisation hampered by slow progress on remaining non tariff barriers to trade

Trade Liberalisation vs. NTBs



*Trade Liberalisation includes in the IRI measurement Quantitative Restrictions, Customs Duty on Capital Goods, Average Duty applied for Agricultural and Industrial Products.

**NTBs include in the IRI measurement Technical Standards, Sanitary and Phytosanitary Standards, Certification, Customs Administration.

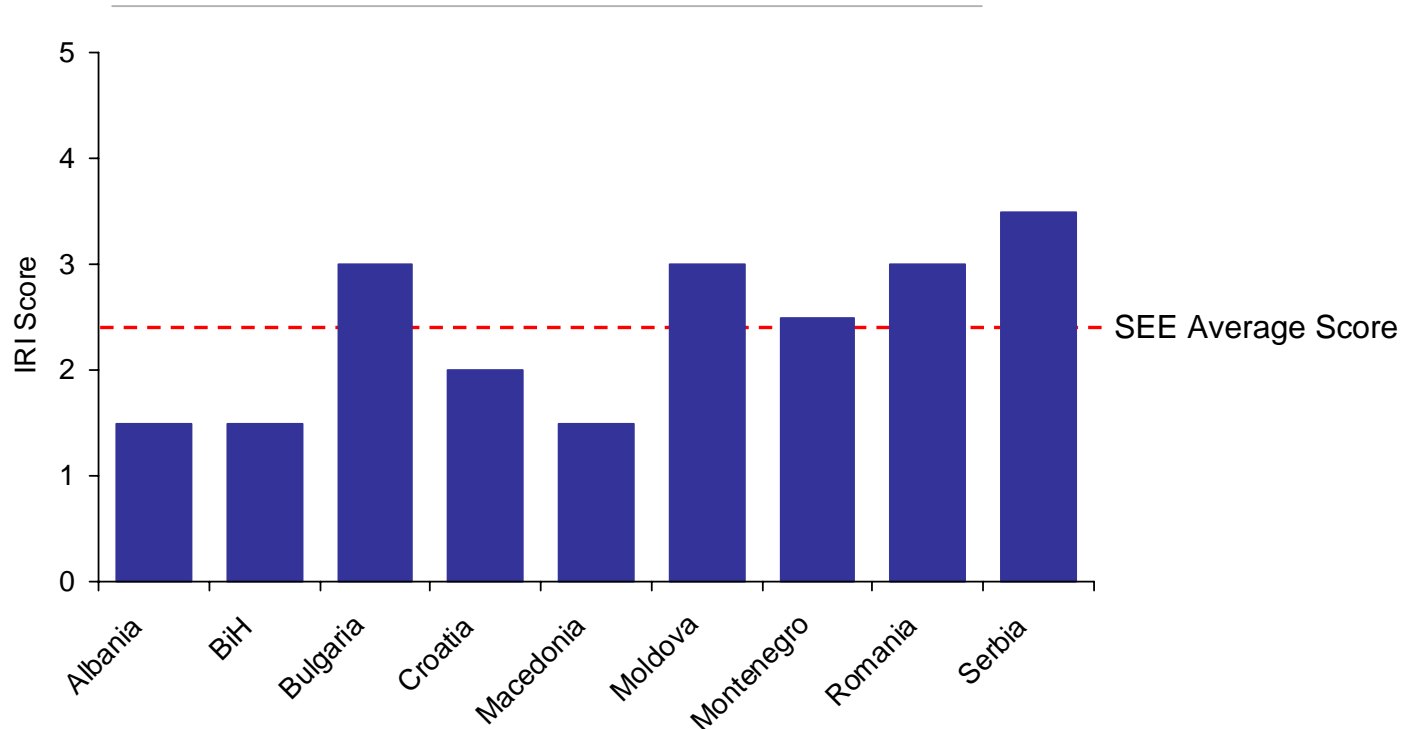
Main Issues on NTBs

- **Technical Standards** pose an obstacle to export growth – the Region is in the process of adopting standards, but they are moving at different speeds.
- SEE countries have been slower to adopt **sanitary and phytosanitary standards**, although progress is highly differentiated.
- **Weak certification system** with financially limited laboratories and limited human resources.
- Most SEE **accreditation bodies** are not yet full members of international accreditation organisations
- **Customs administration** is still very burdensome with numerous documents and licenses required to pass the borders.

- NTB to trade limit the potential of free trade agreements => export competitiveness is reduced and access to certified suppliers is more limited

6. Key issue in Regulatory Reform: Unstable legal framework associated with weak process for review, consultation and validation of laws and regulations

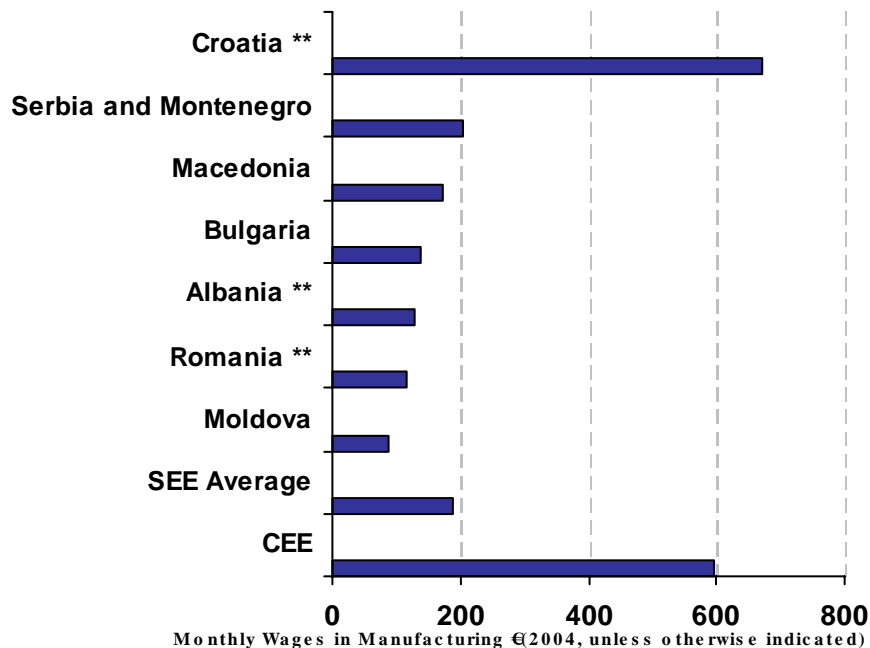
IRI Score on RIA*



- Lack of **impact evaluation** and the resulting **contradictory laws** have potentially strong negative impacts on the business sector.
- Lack of mechanism to handle an increasingly complex **regulatory pipeline for EU-accession** countries.
- Increased **instability of the legal framework** as a consequence of poor legislation, which needs to be changed or reviewed, once it has been passed.

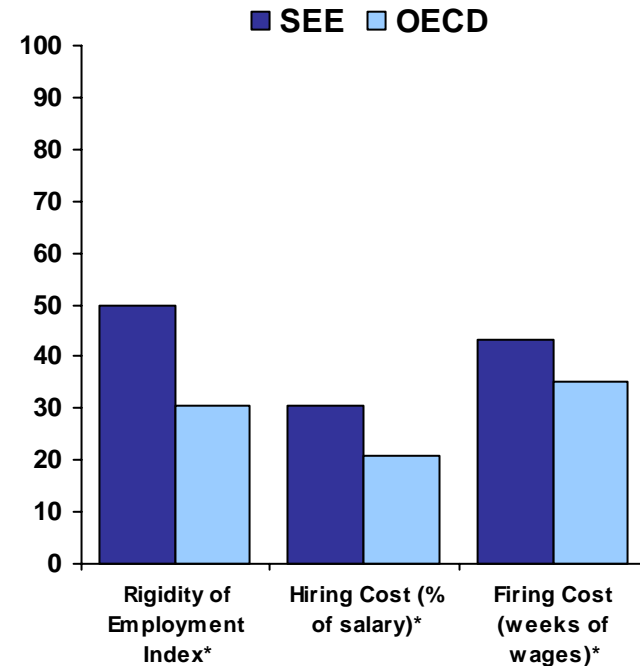
7. Key issue in Human Capital: labour costs in SEE are low, but the labour market is rigid and highly regulated

Wages in Manufacturing (€)



Source: ILO <http://laborsta.ilo.org/>

Labour Market Rigidity



Source: World Bank *Doing Business in 2006*

- Short-term competitive advantage of low labour costs is diluted by very restrictive labour laws.
- Many workers are employed informally, thus reducing tax revenue for SEE governments.
- Policies discourage firms from hiring and contribute to high unemployment and low employment levels in the region.

*The rigidity of employment index is the average of three subindices: a difficulty of hiring index, a rigidity of hours index and a difficulty of firing index. All the subindices have several components. And all take values between 0 and 100, with higher values indicating more rigid regulation. The hiring cost indicator measures all social security payments and payroll taxes associated with hiring an employee. The cost is expressed as a percent of the worker's salary. The firing cost indicator measures the cost of advance notice requirements, severance payments and penalties due when dismissing a redundant worker, expressed in weekly wages.

**2003

8. Key issue in SME Policy i)

SME Policy Index Dimensions	
1. Education and training for entrepreneurship	7. Taxation and financial matters
2. Cheaper and faster start-up	8. Strengthening the technological capacity of SMEs
3. Better legislation and regulation	9. Successful e-business models and top-class business support
4. Availability of skills	10. Developing stronger, more effective representation of small enterprises
5. Improving online access	
6. Getting more out of the single market	

➤ **Progress in developing sound SME policies has been uneven across SEE. Three groups of countries emerge, each group at a different stage of development and progress in implementing the SME Policy Index.**

Group 1: Croatia

❖ Croatia is the only country that has clearly moved from policy elaboration to the policy implementation phase

❖ Key issues:

❑ Dimension 4 Availability of skills: Croatia has a training provider community which is not sufficiently developed or aware of the market and training providers and which, in addition, is unable to respond to market requirements in terms of quality and timing.

❑ Dimension 3 Better legislation and regulation: the silence is consent principle is not yet applied to standard administrative SME procedures. This harms SMEs due to delays and uncertainty in obtaining approvals, licenses and permits.

8. Key issue in SME Policy ii)

Group 2: FYR of Macedonia, Montenegro and Serbia

❖Key issues:

These countries' legal and institutional frameworks are largely complete but work on the implementation phase has only just begun.

Notable progress has been made in establishing institutions responsible for policy elaboration and implementation – the main areas for concern are related to human capital and regulatory reform.

Group 3: Albania, Bosnia and Herzegovina and UNMIK/Kosovo

❖Key issues:

The group is made up of countries and a jurisdiction in the process of completing the legal and institutional framework underpinning SME policy development. On the scale of 1 to 5 used to evaluate stages of policy development, their typical rating is in the range of level 2.

Progress is still too dependent on donor support.

Bosnia and Herzegovina is disadvantaged by the growing disparities in approach and level of development among the two entities and the District of Brcko.

UNMIK/Kosovo's main issue remains in the incomplete institutional framework, constrained by the province's unresolved constitutional status.

Thank you for your attention.

Copies of all the reports available online: www.investmentcompact.org

For any further questions: anthony.osullivan@oecd.org